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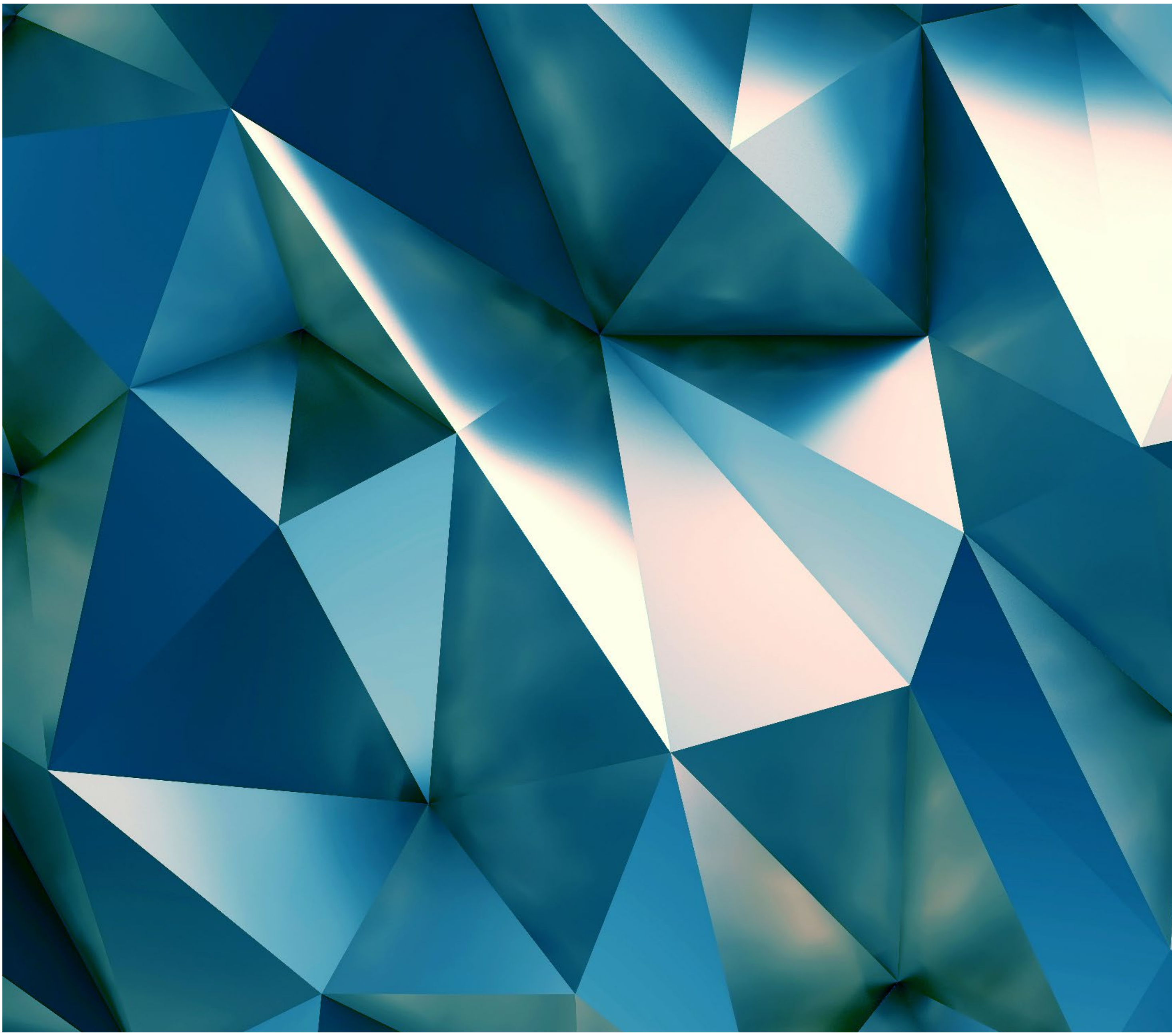

ASSET ALLOCATION | MARCH / APRIL 2022

Mosaique Views

Markets in perspective

Russia's attack on Ukraine will lower growth and boost inflation

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Our thoughts are with those hit by the dreadful conflict still raging as we write. It seems distasteful even to be talking about investment amidst such human hardship: our daily concerns are put suddenly into perspective.

Sanctions, a wider unwillingness to do business with Russia, interruptions and diversions to supply chains – particularly those relating to energy and food – will reduce global growth prospects. The disruptions will also lead to even more inflation.

As yet, we think this will slow global growth, but not arrest or reverse it. The economy had some momentum going into this geopolitical crisis – not least because of the widespread re-stocking of inventories underway as covid finally moves to the economic sidelines (developments in Shanghai permitting, of course).

Energy costs in real terms are not as elevated as they appear – real oil prices were higher in 2012 – and even a more complete shunning of Russian exports by the West might not trigger the more dramatic spikes predicted: other buyers may switch sourcing, and global supply is not completely inelastic.

So, talk of "stagflation" seems premature to us. That said, the investment climate is suddenly riskier. We hope for a peaceful settlement soon, but escalation is also possible even now: rationality may not prevail. And while the initial attack seemed to herald a reduced risk of monetary tightening, as the economic impact has appeared to be less profound than it could have been, interest rate expectations have resumed their pre-crisis upward drift.

We had already reduced our equity weightings in the New Year as it became clear that central banks were indeed planning (rather belatedly) to start normalising monetary conditions that had become needlessly lax. We reduced them further on news of the invasion.

However, our equity holdings have returned to neutral only: we still see corporate profitability staying healthy, and valuations, while stretched, are not outlandish. And the funds released are being held as liquid assets: we stay firmly underweight in fixed income.

We did not think the reduction in global risk appetite would be big enough for bonds to rally for long – and indeed, the key government bond yields on both sides of the Atlantic are at multiyear highs as we write, driven by both rising inflation expectations and real yields.

Asset allocation summary

March / April 2022

We have cut our double (maximum) overweight in equities to neutral, in two stages: first in early January, and then on February 24th. We have retained a double underweight in bonds, and have instead allocated the funds to cash, where we are now double overweight.

EQUITIES

– Neutral +

We cut our overweight firstly to reflect rising interest rate risk, and then on account of the disruption and economic slowdown associated with the conflict in Ukraine (the risk of slower growth has not resulted in a meaningful reduction in interest rate risk). Corporate profitability may not be hit hard, however, and we still see equities as the asset class most likely to preserve real wealth on a long-term view.

FIXED INCOME

– Neutral +

We moved maximum underweight in bonds in 2021. Despite the recent rise in yields, and the likely boost to safe-haven demand resulting from the Ukraine crisis, we still see little chance of inflation-beating long-term returns from the asset class. We continue to prefer corporate and emerging markets ahead of core government bonds, and despite flatter yield curves stay underweight in duration.

MONEY MARKET

– Neutral +

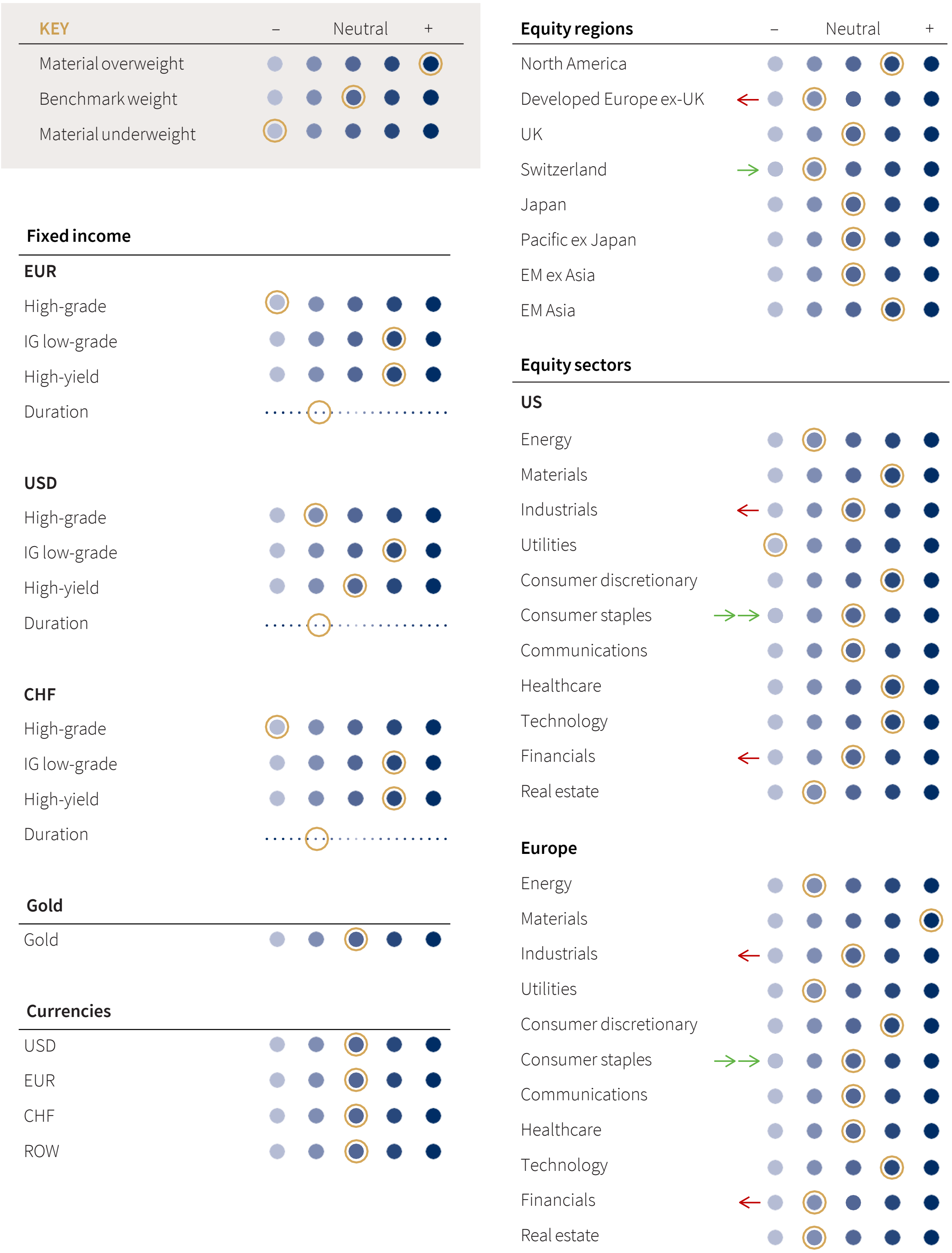
The prospect of positive real returns is still some way off, but the nominal stability of cash, and the opportunity it provides to take advantage of volatility in stocks (or, eventually, bonds), makes it attractive currently. We do not expect the overweight to last enough to incur much inflation erosion.

GOLD

– Neutral +

Gold has been a long-term store of value for three millennia, though its short-term volatility can be high. Its long-term credibility does not rely on central banks, governments or an internet connection, and its low correlations with traditional investments can provide diversification. Tactically, the boost it may receive from today's inflation is offset for us by the prospect of rising (real) interest rates.

Asset allocation overview



Equities: Regions

SUMMARY

The threat to growth from the Ukraine conflict has led us to reduce our weightings in (Continental) Europe, with the exception of Switzerland, where we have raised them on account of its defensive characteristics. We remain unconvinced by the commodity-intensive UK and emerging markets (ex Asia), but instead expect US leadership to resume, and emerging Asia to regain some poise. Russia, part of the Eastern European emerging market bloc, is now effectively uninvestable for international investors.

North America

Ukraine may have little direct effect here. Re-stocking, together with pent-up consumer demand, seems likely to sustain growth even as fiscal and monetary policy becomes more restrictive. Operational leverage may continue to push expected profitability higher in 2022, even as costs rise.

Developed Europe ex-UK

We have moved back down to underweight: Europe is most closely linked economically to Ukraine and Russia, and its stock markets can be relatively sensitive at times of global cyclical and financial stress.

United Kingdom

The UK market's high weightings in unpopular and ESG-challenged sectors such as oil and mining have counted against it, but a lot was priced in and as commodity prices revived in 2021, we moved up to neutral. We are not inclined to add further, Ukraine notwithstanding.

Switzerland

Big weightings in healthcare and consumer staples give the Swiss market a defensive orientation: in today's more nervous climate, this is no longer the deterrent that it was and we have reduced our underweight.

Japan

Valuations have been attractive, but the trend in improving profitability had faded long before the pandemic arrived. Japan's market traditionally confounds most tactical calls, and its shift to a more conventionally capitalist model is progressing glacially.

Pacific ex-Japan

Strong commodity prices offer support to the Australian economy, but rising dollar interest rates and ongoing political tensions may restrain Hong Kong. We stay neutral.

EM ex-Asia

Previously dominated by Russia (with its intense geopolitical risk, weak governance and undiversified economy) and Latin America (with governance issues, similarly big commodity weightings and exchange rate volatility). Russia has effectively been removed from the benchmark, but we do not want to chase commodity prices from here: we stay neutral.

EM Asia

China dominates this bloc, and has been badly hit by a mix of regulatory, cyclical, geopolitical and now renewed contagion concerns. It is trading at the lowest relative valuations since China joined the WTO, and in contrast to Russia remains investable (in our opinion). Longer-term, emerging Asia will remain the most dynamic region as global GDP and capital pivot there. We stay overweight.

Equities: Sectors

SUMMARY

We do not yet see a wholesale reversal of last year's market leadership, and have been favouring a mix of cyclical and structural growth, funded by underweight positions in more defensive and bond-like sectors. As a result of the attack on Ukraine, however, we have reduced some cyclical positions and become less underweight on defensives.

Healthcare (US)

Healthcare (EUx)[1]

This is the only defensive sector where we have an overweight position: US healthcare can also perform strongly as the recovery matures.

Technology (US)

Technology (EUx)

A long duration sector, but one which can also perform cyclically. We reduced our overweight last year as we tilted towards sectors less affected by higher long-term interest rates.

Industrials (US)

Industrials (EUx)

A late cycle cyclical sector that can usually withstand higher interest rates but which is vulnerable to the conflict: we have moved down to neutral.

Materials (US)

Materials (EUx)

Materials face more headwinds than most sectors from ESG considerations in the long-term, but valuations had become compelling and the conflict may favour them for a while: we stay overweight.

Energy (US)

Energy (EUx)

Valuations have rebounded further for obvious reasons, but we see ESG and structural challenges (such as alternative energy supplies) as still too large for us to change our tactical views.

Real estate (US)

Real estate (EUx)

Despite having some cyclical content, the sector often performs as a bond proxy. These are equites, not direct real estate.

Communications (US)

Communications (EUx)

A beneficiary of changes to long-term working practices, but also a target for regulatory concern and higher long-term rates. Not especially sensitive to the conflict. We stay neutral.

Utilities (US)

Utilities (EUx)

We stay underweight: it is too defensive and bond-sensitive to appeal yet.

Financials (US)

Financials (EUx)

We moved overweight US financials in 2021, but have now returned to neutral and move underweight in Europe. Financials benefit from rising interest rates, but are also highly sensitive to market nerves and growth risks.

Consumer discretionary (US)

Consumer discretionary (EUx)

We think growth will remain strong enough for this sector to stay attractive, even in Europe (where the sector's global exposure can compensate for lost business in Russia).

Consumer staples (US)

Consumer staples (EUx)

Staples' defensiveness is less of a deterrent in the current climate, and it is less likely than others to be hit by sanctions. We have closed a double underweight.

[1] EUx = Developed Europe ex-UK

Fixed income

SUMMARY

Despite further increases in yields (and hikes in US and Bank of England policy rates), we stay underweight duration for now. The conflict has not boosted safe-haven appeal as much as it might have done, and inflation and interest rate risk remains significant. Central banks remain further "behind the curve" than they planned to be. We also continue to prefer lower quality investment grade and speculative (or "high yield") credit to core government bonds: spreads have widened markedly.

High-grade (USD)

High-grade (EUR, CHF)

Ongoing inflation and interest rate risk remain headwinds for core government and high-quality corporate bond markets that are still – even after the further sell-off – expensive.

High Yield (USD)

High Yield (EUR, CHF)

Even in the light of the conflict it feels too soon for corporate fundamentals to deteriorate significantly. Liquidity considerations can be poor in this segment, but for the time being we stay constructive.

IG low-grade (USD)

IG low-grade (EUR, CHF)

Support from central bank buying is fading, but corporate cashflow and creditworthiness remain solid for the time being. We do not see recent spread widening continuing.

Duration

Yield curves have flattened further as more expected increases in policy rates have been priced-in – Ukraine crisis notwithstanding – and this process may not be over. However, there is room for yields to rise across the curve, and it may be too soon to close our underweight call on duration across the big bond markets.

Currencies

SUMMARY

The major exchange rates have remained remarkably stable in the face of the sudden rise in risk: the dollar has firmed a little on some safe-haven demand and rising interest rate expectations, but has not broken out of key trading ranges (in contrast, for example, to bond yields). We stay neutral for now. Longer- term, the dollar will likely remain the biggest reserve currency for the foreseeable future: talk of altered invoicing behaviour will not affect underlying demand and supply. The renminbi cannot challenge the dollar more fully until China's capital controls and structural current account surplus disappear.

US dollar

Often a safe-haven at times of stress, but also a potential beneficiary of a US-led monetary tightening cycle. It is not especially expensive. The Ukraine crisis tilts the odds a little further in its favour, but not decisively so yet.

CHF

The franc's safe haven appeal hasn't been so obvious in recent months, perhaps because it is closer to Ukraine than is the USD.

Euro

We closed our underweight call in 2020 when it became clear that the Franco-German borrowing initiative would support the prospects for the Union and its common currency. It may become vulnerable again on Ukraine nerves.

ROW [1]

Expectations for the UK economy outside the EU are likely too low; China's growth prospects and investment appeal may not be under-appreciated.

[1] GBP, YEN, Renminbi, AUD

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