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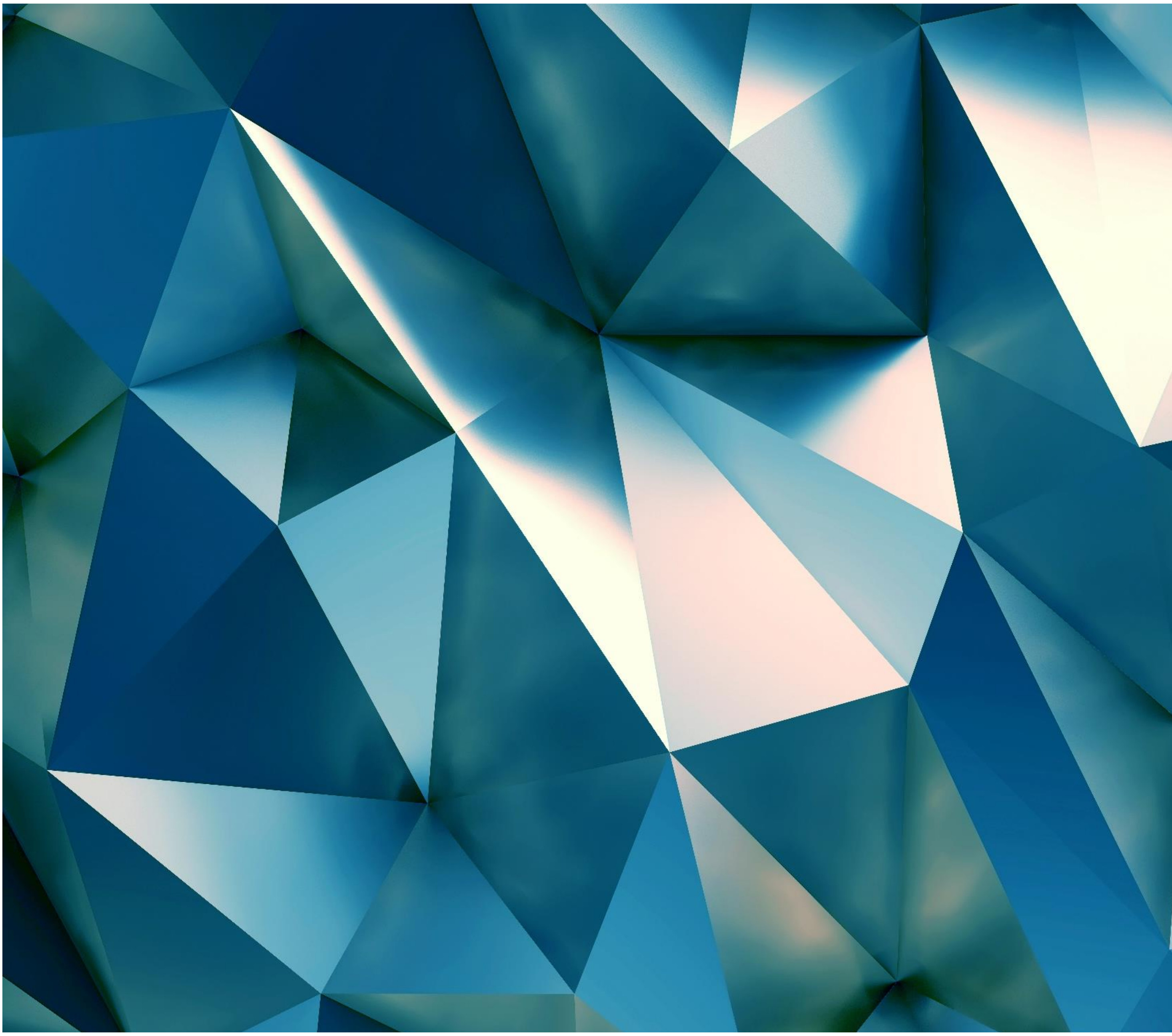

ASSET ALLOCATION | SEPTEMBER / OCTOBER 2022

Mosaique Views

Markets in perspective

Markets are still grappling with interest rate and geopolitical risk

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Our thoughts remain with those hurt by the dreadful conflict still raging, which puts our economic concerns firmly into perspective.

In the last month, those concerns have nonetheless become a little more pressing. Inflation and interest rates have yet to peak, and growth is slowing.

However, the severity of the downturn is still unclear. Europe is most at risk from higher energy costs, and in many cases from energy supply shortfalls this winter. As yet, however, despite widespread expectations of an imminent and sharp recession, forward-looking data have been slowing gradually, and governments seem likely to act further to protect poorer households from the worst of the energy squeeze.

Elsewhere, the important US economy is less exposed, and enjoys some underlying momentum (despite its poor GDP showing in the first half). China faces ongoing structural headwinds, but its immediate covid-related constraints have been eased, and it enjoys the rare luxury of a low inflation rate, allowing its authorities to follow a more lenient monetary policy.

So, talk of “stagflation” again seems premature to us. That said, the geopolitical climate remains troubling, and not just on account of the trauma in Ukraine. The West has been reminded that China’s claim on Taiwan is not negotiable (though that does not mean that it is imminently actionable either).

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 returned to neutral only: we still see corporate profitability staying healthy, and valuations, while stretched, are not outlandish. And the funds released have been held as liquid assets. Cash may not offer positive real returns, but it is more stable than securities.

We retain a long-standing underweight in bonds. With some government yields in the US now offering positive real yields to maturity, we have begun to reduce our long-standing underweight in bonds there. In Europe, however, most bonds still seem unlikely – despite recent yield increases – to deliver inflation-beating returns even on a long-term view.

Key	–	Neutral	+
Material overweight			
Benchmark weight			
Material underweight			

Asset allocation overview

We have cut our double (maximum) overweight in equities to neutral, in two stages: first in early January, and then on February 24th. In bonds, we moved maximum underweight in 2021 and instead allocated the funds to cash, where we are now double overweight. 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 in Europe, though we have now begun to reduce our underweight positions in US portfolios.

US	–	Neutral	+
Money market			
Gold			
Fixed income			
Equities			

Europe	–	Neutral	+
Money market			
Gold			
Fixed income			
Equities			

Switzerland	–	Neutral	+
Money market			
Gold			
Fixed income			
Equities			

Fixed income

Despite further increases in yields (and more committed monetary tightening by the major central banks), we stay underweight duration for now. Geopolitical stress has not boosted safe-haven appeal as much as it might have done, and inflation and interest rate risk remains significant. Despite their new-found hawkishness, central banks remain “behind the curve”. In European portfolios we have recently reduced our preference for lower quality investment grade bonds as safe haven yields have risen, but still favour speculative (or “high yield”) credit to investment grade generally. We mostly continue to prefer corporate and emerging markets ahead of core government bonds, and despite flatter yield curves stay underweight in duration.

US	–	Neutral	+
Duration			
High-grade			
IG low-grade			
High-yield			

Europe	–	Neutral	+
Duration			
High-grade →			
IG low-grade ←			
High-yield			

Switzerland	–	Neutral	+
Duration			
High-grade →			
IG low-grade ←			
High-yield			

Key	–		Neutral		+
Material overweight					■
Benchmark weight			■		
Material underweight	■				

Equities

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.

Regions: 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.

Sectors: 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. Most recently we cut materials and boosted healthcare within European stocks.

Regions	–		Neutral		+
North America				■	
Eurozone		■			
UK			■		
Switzerland		■			

Regions	–		Neutral		+
Japan			■		
Pacific ex Japan			■		
EM ex Asia			■		
EM Asia				■	

Sectors (US)	–		Neutral		+
Energy		■			
Materials				■	
Industrials			■		
Utilities	■				
Consumer discretionary				■	
Consumer staples			■		
Communications			■		
Healthcare				■	
Technology				■	
Financials			■		
Real estate		■			

Sectors (Europe)	–		Neutral		+
Energy		■			
Materials ←				■	
Industrials			■		
Utilities		■			
Consumer discretionary			■		
Consumer staples			■		
Communications			■		
Healthcare →					■
Technology				■	
Financials		■			
Real estate		■			

Key	–	Neutral	+
Material overweight			
Benchmark weight			
Material underweight			

Currencies

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.

Currency	–	Neutral	+
USD			
EUR			
GBP			
JPY			
AUD			
CNY			
CHF			

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