February / March 2022

Mosaique Views

Rothschild & Co
Wealth Management

Staying constructive

Covid risk has faded, and growth is intact: inflation and interest rates are the focus now

Contagion has thankfully faded now, but even when Omicron was rife, Western governments did not react by locking down economies again: for now at least, Covid-19 does not drive the investment agenda in the way it once did. Instead, with the global economy retaining some momentum into the New Year, inflation risk and the likely interest rate response is uppermost in investors' minds – as we thought it might be.

Central banks have allowed economies to "run hot", but with inflation at multi-decade highs on both sides of the Atlantic, and looking less "transitory" than it did, they seem set to act more decisively in order to avoid a more harmful overheating and retain their monetary credibility. Policy rates may rise faster and further than money markets have been pricing in – even now, after the last month's considerable adjustments, and despite the ongoing geopolitical tension around Ukraine.

With inflation so far above target, and unemployment low, there is no reason for interest rates to be at today's "emergency" settings. Many smaller central banks were already starting to normalise interest rates in 2021 – as, at year-end, was the Bank of England. Now, the Federal Reserve seems poised to act next month, and even the European Central Bank is acknowledging the probability that higher eurozone rates may be needed before year end. If it acts, the SNB will not be far behind.

There is much debate about exactly how many rate moves will be forthcoming from the Fed in particular. More important, we think, are the likely peaks for policy rates – and with money markets doubting that the Fed and ECB will push policy rates materially above inflation targets, we think the rethink on rates may not be over.

Bonds are most directly affected by inflation risk and rising rates, but stocks – the most volatile mainstream asset at the best of times – could also be vulnerable for a while. For this reason, we trimmed our equity position in January.

That said, we stay overweight. Stock valuations are on the high side, but not prohibitively so, and expectations for corporate profits continue to rise. They remain our favoured asset tactically as well as strategically and are the only one that we think can clear the higher inflation hurdle and help preserve the real value of our clients' wealth.

Asset allocation summary

We trimmed our double (maximum) overweight in equities to a single overweight in January. We are maintaining the maximum underweight bonds, and instead allocate the funds to cash, which moves up to a single overweight.

– Neutral +

Equities

We trimmed our overweight in January to reflect the possibility of resumed short-term volatility as US interest rates begin to rise. Corporate profitability seems likely to remain healthy however and we still see equities as the asset class most likely to preserve wealth in a more inflationary environment.

– Neutral +

Fixed income

We moved maximum underweight in bonds in 2021. Despite the recent sell-off, and receding negative yields, we still see little chance of inflation-beating returns. We continue to prefer corporate and emerging markets ahead of core government bonds, and despite flatter yield curves we stay underweight in duration.

– Neutral +

Money market

The prospect of positive returns is still remote but using the funds from our reduced equity position to raise cash to an overweight gives us more room to capitalise on opportunities unearthed by market volatility. Nominal capital values are stable, safe from the mark-to-market risk that faces expensive bonds, and we do not expect the overweight to last enough to incur much inflation erosion.

– Neutral +

Gold

Gold has been a long-term store of value for three millennia, though its short-term volatility can be high. It can be sensitive to a rebound in interest rates and a firmer dollar. But 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.

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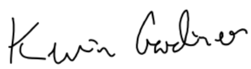

Asset allocation overview

Key	–		Neutral		+
Material overweight	·	·	·	·	◉
Benchmark weight	·	·	◉	·	·
Material underweight	◉	·	·	·	·

Fixed income

EUR					
High-grade	◉	·	·	·	·
IG low-grade	·	·	·	◉	·
High-yield	·	·	·	◉	·
Duration	·	◉	·	·	·

USD					
High-grade	·	◉	·	·	·
IG low-grade	·	·	·	◉	·
High-yield	·	·	◉	·	·
Duration	·	◉	·	·	·

CHF					
High-grade	◉	·	·	·	·
IG low-grade	·	·	·	◉	·
High-yield	·	·	·	◉	·
Duration	·	◉	·	·	·

Gold

Gold	·	·	◉	·	·

Currencies

USD	·	·	◉	·	·
EUR	·	·	◉	·	·
CHF	·	·	◉	·	·
ROW	·	·	◉	·	·

Equity regions

Equity regions	–		Neutral		+
North America	·	·	·	◉	·
Developed Europe ex-UK	·	·	◉	·	·
UK	·	·	◉	·	·
Switzerland	◉	·	·	·	·
Japan	·	·	◉	·	·
Pacific ex Japan	·	·	◉	·	·
EM ex Asia	·	·	◉	·	·
EM Asia	·	·	·	◉	·

Equity sectors

US					
Energy	·	◉	·	·	·
Materials	·	·	·	◉	·
Industrials	·	·	·	◉	·
Utilities	◉	·	·	·	·
Consumer discretionary	·	·	·	◉	·
Consumer staples	◉	·	·	·	·
Communications	·	·	◉	·	·
Healthcare	·	·	·	◉	·
Technology	·	·	·	◉	·
Financials	·	·	·	◉	·
Real estate	·	◉	·	·	·

Developed Europe ex-UK					
Energy	·	◉	·	·	·
Materials	·	·	·	·	◉
Industrials	·	·	·	◉	·
Utilities	·	◉	·	·	·
Consumer discretionary	·	·	·	◉	·
Consumer staples	◉	·	·	·	·
Communications	·	·	◉	·	·
Healthcare	·	·	◉	·	·
Technology	·	·	·	◉	·
Financials	·	·	◉	·	·
Real estate	·	◉	·	·	·

Equities: regions

Summary

The ongoing rethink about interest rates has made stocks more volatile, and as noted we have reduced our overweight. However, we have not yet changed our regional preferences. We are not convinced by the recent strength in commodity-intensive UK and emerging markets (ex Asia), but expect US leadership to resume, and emerging Asia to regain its poise. We stay underweight the Swiss market: we think it is too soon to seek the defensiveness that it offers.

North America

Ongoing restocking, together with pent-up consumer demand, seems likely to sustain solid growth even as fiscal and monetary policy becomes more restrictive. Operational leverage may continue to push expected profitability higher in 2022, even as cost pressures pick up.

Developed Europe ex-UK

Growth is lower at the best of times, but the local setbacks seen after recent lockdowns were smaller than feared. The Eurozone can also benefit from global recovery, and the euro's credibility was bolstered by the pandemic fund. We closed our underweight position some months back

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 has been priced in and as commodity prices revived in 2021, we moved up to neutral.

Switzerland

Big weightings in healthcare and consumer staples give the Swiss market a defensive orientation that we feel is unlikely to appeal at this stage of the business cycle. We moved maximum underweight in 2021.

Japan

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

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

Dominated by Russia (with its intense geopolitical risk, weak governance and oil-intensive economy) as well as Latin America (with governance issues, big commodity weightings and exchange rate volatility). We stay firmly neutral.

EM Asia

On a longer-term view, emerging Asia will remain the most dynamic region of the global economy as the world's GDP and capital pivots there. China's regulatory and real estate risk may now be priced in more fully again, and its interest rate cycle is friendlier than the West's (partly because its inflation is lower). We stay overweight.

Equities: sectors

Summary

We do not yet see a wholesale reversal of last year's market leadership, and continue to favour a mix of cyclical and structural growth, funded by underweight positions in more defensive and bond-like sectors. We also remain underweight in energy, where we think ESG concerns are prohibitive. Thus we favour US financials, industrials, and consumer discretionary sectors – but also technology.

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)

Industrials are well placed to benefit when economies rebound, with capital goods in particular capable of performing even as the recovery matures.

Materials (US)
Materials (EUx)

Materials face more headwinds than most sectors from ESG considerations in the long-term, but valuations had become compelling.

Energy (US)
Energy (EUx)

Stock valuations have rebounded a long way here, and we see ESG and structural challenges (such as alternative energy supplies) as 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, and with the yield curve steepening we stay underweight. These are equites, not direct real estate.

Communications (US)
Communications (EUx)

A sector that adds social and conventional media and internet services: a beneficiary of changes to long-term working practices, but also a target for regulatory concern and higher long-term rates.

Utilities (US)
Utilities (EUx)

Not yet sufficiently inexpensive to offset its safety-first, bond proxy characteristics.

Financials (US)
Financials (EUx)

We moved overweight US financials in 2021: they are strongly capitalised and well placed for a cyclical recovery and firmer interest rate expectations. European banks are less well capitalised, and growth is weaker.

Consumer discretionary US)
Consumer discretionary (EUx)

A play on recovering growth expectations and risk appetite. Europe's consumer goods offer global exposure. US consumer cashflow pre-crisis was strong, and the housing market did not look overextended.

Consumer staples (US)
Consumer staples (EUx)

Staples might lag as confidence in the recovery grows and risk appetite revives. Its long duration characteristics are less attractive than they were, and its strong defensive qualities are unattractive currently.

[1] *EUx = Developed Europe ex-UK*

Fixed income

Summary

Despite further increases in yields, we stay underweight duration for now. Spare capacity is likely to continue to shrink, inflation looks less transitory than it did, and central banks are 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, where spreads have widened a little.

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 recent sell-off – expensive.

High Yield (USD)
High Yield (EUR, CHF)

It feels too soon for corporate fundamentals to deteriorate, and we expect spreads to stabilise. Liquidity considerations can often catch investors unaware 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 poised to fade, but corporate cashflow and creditworthiness remain solid for the time being. We do not see recent spread widening continuing

Duration

Yield curves have been flattening as expected increases in policy rates have been priced-in, 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

Exchange rate volatility remains low – unsurprisingly given the convergence in interest rates and valuations. A cyclical rotation away from the dollar is likely at some stage, but a renewed dollar "smile" is quite possible in the meantime if US growth and interest rates surprise positively. Longer-term, the dollar will likely remain the main reserve currency for the foreseeable future: the renminbi cannot challenge it 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 strong US-led growth. It is not especially expensive. More monetary tightening is now priced in – and further surprises may be matched by those in Europe

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 has been rangebound since

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

ROW[1]

Expectations for the UK economy outside the EU are likely too low; at a more elevated level, China's growth prospects may also be under-appreciated.

[1] GBP, YEN, Renminbi, AUD

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