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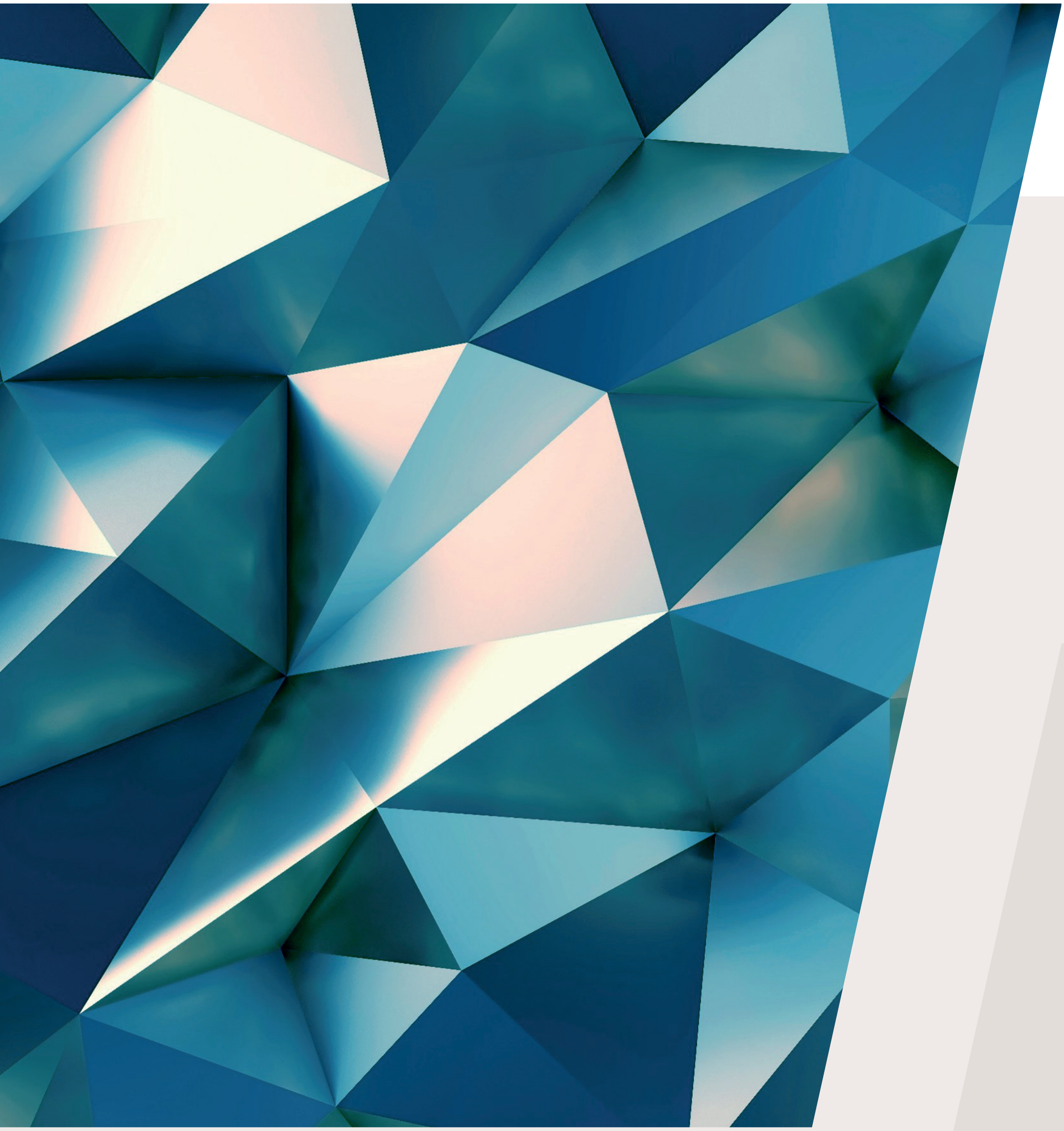

OCTOBER 2023

Mosaique Asset Allocation

Our current view

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KEY TAKEAWAYS

- The big picture has not altered significantly, softer markets notwithstanding
- Economies remain resilient, inflation is trending lower
- We stay overweight stocks, neutral on bonds and underweight cash

Bond and stock markets were weak in September, but not sufficiently to suggest that the macroeconomic outlook has changed significantly. The Mosaique Asset Allocation Committee has left its portfolio positioning unchanged for a second month.

Economic strength continues to be most visible in the US, where annualised growth in the third quarter seems to have accelerated markedly and unemployment claims remain remarkably low. Against this backdrop, and with some encouragement from the Federal Reserve, money markets have been further digesting the prospect of policy rates staying “higher for longer” – interest rates may be close to their high points, but they are unlikely to start falling soon because the US economy does not look weak enough to justify lower rates. The US Treasury note yield in September hit further new cycle highs, at levels last seen in 2007 (that is, before the Global Financial Crisis).

Growth continues to look more fragile in Europe, particularly in the eurozone, though unemployment is also historically low here too, and there remains a marked divergence between weak subjective survey data and more resilient data on output and spending. The ECB has continued to raise its policy rates, though has signalled that it is watching the softer economy closely; the Bank of England unexpectedly decided not to raise its rates, but nonetheless stated that it sees no reason for rates to fall soon. The Swiss National Bank (SNB) also decided not to raise rates further, but Swiss inflation is once again at low levels, and the SNB’s credibility has been undented throughout.

China’s economy also continues to disappoint, but it has negligible inflation, allowing its policymakers to offer support even as the Fed and ECB have been nudging interest rate expectations higher. As it is, China’s growth remains comfortably higher than in most Western economies.

Inflation generally continues to fade, but at varying speeds. The trend is best established in the US, despite its more resilient economy, whereas in Europe core inflation rates in particular have yet to peak convincingly. Slowing inflation suggests that interest rates are unlikely to rise much further, but without more convincing signs of economic weakness, this on its own does not warrant lower rates, as noted.

Overall, our view of the wider economic cycle again remains unchanged. Despite recent resilience, a technical recession is still possible in the major economies, as the full effects of monetary policy have still to make themselves felt, and it would be surprising if there were to be no further financial accidents after such a rapid tightening. However, we continue to believe that a more significant downturn is neither necessary nor likely, and note that in both the US and Europe real wages are growing again as headline inflation has subsided.

But we doubt that economic growth will be strong enough to prevent spare capacity from starting to widen again. This, together with the fading of earlier bottlenecks, and labour markets which remain remarkably well-behaved (despite cost-of-living pressures and those low unemployment rates), is likely to allow inflation to continue slowly to roll over. That said, we do not see US and European inflation rates returning sustainably to target, but see them likely sticking in the 2-4% region.

INVESTMENT CONCLUSION

Again, then, economies are soft enough to suggest that central banks have nearly finished raising interest rates, but not sufficiently weak to suggest that interest rates can soon start falling. Against this backdrop, August's "summertime blues" continued into September's stock and bond markets.

In late July we moved overweight on stocks, and despite the last two months' setback we think this remains the right stance. The risk of monetary overkill has faded, and expectations for corporate profitability are stabilising at healthy levels. Stock prices remain some way above last Autumn's lows, and are not cheap, but we think that a substantial "risk on" rally may still lie ahead (aided perhaps by a more clear-cut fading of core inflation in Europe, and by gradual improvement in US-China tensions around Taiwan). We cannot predict the timing with confidence but remain overweight in anticipation.

Bond yields even in Europe are no longer expensive, and more bonds are once again offering yields which seem likely to exceed even the above-target inflation we expect to continue. However, with the final instalments of monetary tightening still uncertain, and with resumed rate cuts only a remote prospect, we continue to think it is premature to turn more positive. In Europe, where real yields remain lower, we only returned to neutral in July.

Asset allocation overview

Equities. We restored our equity stance to overweight in late July, having cut it to neutral after Russia's invasion of Ukraine, but left our regional and sectoral preferences unchanged. We continue to favour the US and emerging Asia, China's short-term difficulties notwithstanding, and after much discussion of the prospects for the more cyclical Eurozone market, remain neutral there, and underweight in defensive Switzerland and the UK. At the sector level, portfolios are still tilted towards a mix of growth and cyclical sectors, at the expense of defensiveness. We fund this ongoing overweight in stocks from liquidity.

Fixed income. In July we also closed our long-standing underweight, in European portfolios, in bonds, as noted. That left our fixed income positioning aligned more closely with that in the US (the remaining divergence being that in European portfolios we still favour high-yield credit, whereas in US portfolios we are neutral on credit quality). As with the equity move, we funded this addition to bonds in European portfolios from liquidity.

July's changes left our overall asset allocation similarly positioned in US and European portfolios: we have a single overweight in equities, a single underweight in liquidity, and a neutral position in bonds.

Currencies. We continue to have little conviction on the major currencies – a view which continues to serve us well in an ongoing low-volatility foreign exchange climate. The dollar has received renewed support from the Fed's more hawkish forward guidance recently, but it remained expensive even beforehand, and being overweight US equities we feel we are already tilted far enough towards US exposure. Currency conviction is low at the best of times, or should be, and it is equity volatility which dominates returns from most balanced portfolios.

Asset allocation

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