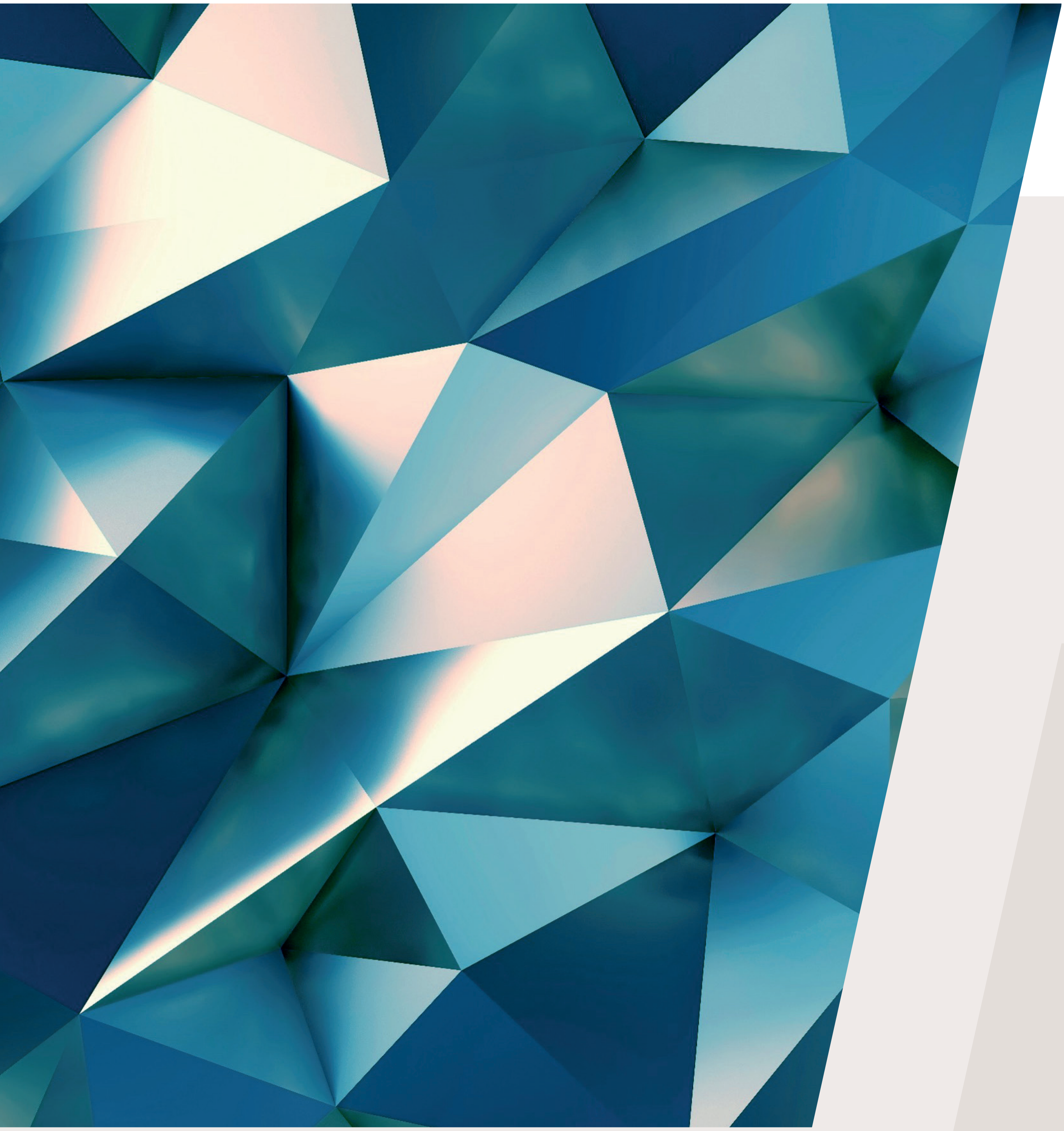
Rothschild & Co
Wealth Management



JUNE 2023

Mosaique Asset Allocation

Our current view

Dr. Carlos Mejia
Chief Investment Officer

Kevin Gardiner
Global Investment Strategist

KEY TAKEAWAYS

- Banking stress fades further, but residual interest rate risk remains
- Growth persists and core inflation is proving stubborn
- Investment view: small addition to risk appetite, Mosaique portfolios still relatively liquid.

The cyclical risks markets had to deal with in 2022 had been fading, even as geopolitical risks (Ukraine, and heightened China-US tension) remained elevated. Inflation was subsiding slowly and patchily, and economic growth was looking resilient.

However, in March the collapse of Silicon Valley Bank ("SVB") in the US, the directed takeover of Credit Suisse in Switzerland, and renewed worries about possible wider contagion, revived worries about banks. These worries faded a little in April and May but remain elevated; meanwhile, a resilient global economy and stubborn core inflation refocuses market concerns back towards interest rates.

We doubt that a full-blown banking crisis is at hand. The banks affected to date have displayed very idiosyncratic risk; banks in general look well-capitalised (certainly by comparison to 2007/8); asset quality is higher; and the authorities have shown themselves willing to act decisively and speedily.

Such a crisis would be highly deflationary, eliminating the need for higher interest rates. However, just as it has begun to look as if one will indeed be avoided, we have seen implied interest rates – and with them, bond yields – rebound, particularly in the US and UK.

Developed economies' terms of trade continue to improve as energy costs – particularly natural gas prices – continue to fall, and China's re-opening also promises support for growth. Yet, if a monetary seizure is avoided – as we think it will be – the economic prospects for the rest of the year may not have deteriorated significantly. The flip side of this of course is that core inflation will indeed remain sticky – as the monthly data are suggesting.

Valuations remain unremarkable for stocks: cyclically-adjusted PE ratios are close to trend. Bond prices, however, have been boosted by the renewed flight to safety sparked by banking nerves, and in Europe especially look a little expensive.

INVESTMENT CONCLUSION

Clearly, we are still not out of the cyclical woods. The main threat to markets this year has swung from interest rates, to earnings, and now back to interest rates again. Our equity positions remain at neutral, and our regional positions are unaltered, but as cyclical earnings risk has ebbed, we have felt able to add modestly to risk by raising industrial sectors to an overweight position and cutting consumer staples – a defensive sector – to underweight.

At the same time, the renewed sell-off in bonds has unearthed value in US longer-dated bonds, even as we see the level of short-term interest rates priced into markets being a little too low, and we are lengthening the duration of our fixed income positions in US portfolios. In European portfolios, valuations have still not reached levels at which we are happy closing our long-standing underweight positions in bonds generally, and in longer-dated bonds in particular.

We still have relatively few active positions by the standards of the last few years. But as we may still stand on the brink of a new cycle, albeit one which has been postponed by this spring's bout of bank nerves, this seems appropriate.

Asset allocation overview

In early 2022 we reduced our equity positions to neutral, in two stages, taking our liquidity holdings to overweight, and staying double underweight in bonds. Later in the year, we used some of the liquidity to reduce the bond underweight, and in US portfolios eventually closed it completely.

As interest rates approached a peak, and global business surveys seemed to be bottoming out, we stayed neutral on stocks but at end-January tilted more towards cyclical exposure, and away from defensiveness. We also further adjusted US fixed income positions to reflect what we have seen as improved relative valuations for Treasuries.

Fixed income. Before SVB's collapse, European bond yields had still not quite returned to levels that we think offer long-term inflation-beating returns, and the European Central Bank seemed furthest away from peak policy rates. Subsequent developments have not changed this judgement, and we stay underweight fixed income and duration in European portfolios, with an ongoing preference for the speculative grade (high yield) segment (heightened perceived bank risk notwithstanding).

In US portfolios, we stay neutral on the asset class and credit quality, but now move longer on duration.

Equities. At end-January we also closed a long-standing overweight on the US, and an underweight in continental Europe (ex-Switzerland). Europe is the better play on a stabilising global economy – which is still what we expect eventually to prevail – and the relative lack of "growth" stocks may not matter so much in the next cycle. Being neutral on the two big regions we think leaves us well placed to watch the evolving tussle for leadership.

We also re-established an overweight position in emerging Asia – somewhat chastened, as we had closed the position relatively recently, at lower market levels. But the facts had changed: China's cyclical outlook improved materially with the unexpected abandonment of its zero-covid stance, and has continued to do so. This judgement is not altered by the bank scare. The counterpart was a renewed underweight position in the defensive Swiss market – which has indeed subsequently underperformed, albeit not for this reason.

At the sector level, we are adding to cyclical risk by raising US and European industrials to overweight, and correspondingly cutting consumer staples to underweight.

Currencies. Despite benefitting – with bonds – from some revival in safe-haven appeal, we still think the dollar's underpinnings remain less robust than of late. The Fed still looks closer to delivering likely peak interest rates, and the global economy and risk appetite may be stabilising – arguments for dollar weakness. The US currency also looks expensive. Currency conviction should be low, but we see a stronger euro as part of the possible eventual return from that regional shift in equity holdings. That said, these considerations do not carry through to our regional equity positions.

Asset allocation

KEY	–		Neutral		+
Overweight					
Benchmark					
Underweight					
Recent change		→		←	

			–		Neutral		+
OVERVIEW	US	Money market					
		Equities					
		Fixed income					
		Gold					
	Europe	Money market					
		Equities					
		Fixed income					
		Gold					
	Switzerland	Money market					
		Equities					
		Fixed income					
		Gold					
FIXED INCOME	US	Duration			→		
		High-grade					
		IG low-grade					
		High-yield					
	Europe	Duration					
		High-grade					
		IG low-grade					
		High-yield					
	Switzerland	Duration					
		High-grade					
		IG low-grade					
		High-yield					

			–		Neutral		+
EQUITIES	Regions	North America					
		Euro area					
		UK					
		Switzerland					
		Japan					
		Pacific ex Japan					
		EM ex Asia					
		EM Asia					
	US sectors	Energy					
		Materials					
		Industrials			→		
		Utilities					
		Cons. disc.					
		Cons. staples			←		
		Comms.					
		Healthcare					
		Technology					
		Financials					
		Real estate					
	Europe sectors	Energy					
		Materials					
		Industrials			→		
		Utilities					
		Cons. disc.					
		Cons. staples			←		
		Comms.					
		Healthcare					
		Technology					
		Financials					
		Real estate					
FX		USD					
		EUR					
		GBP					
		CHF					

Wealth Insights

At the heart of Wealth Insights lies a wide set of timely and insightful publications and podcasts.

For more information please visit our page at

www.rothschildandco.com/insights