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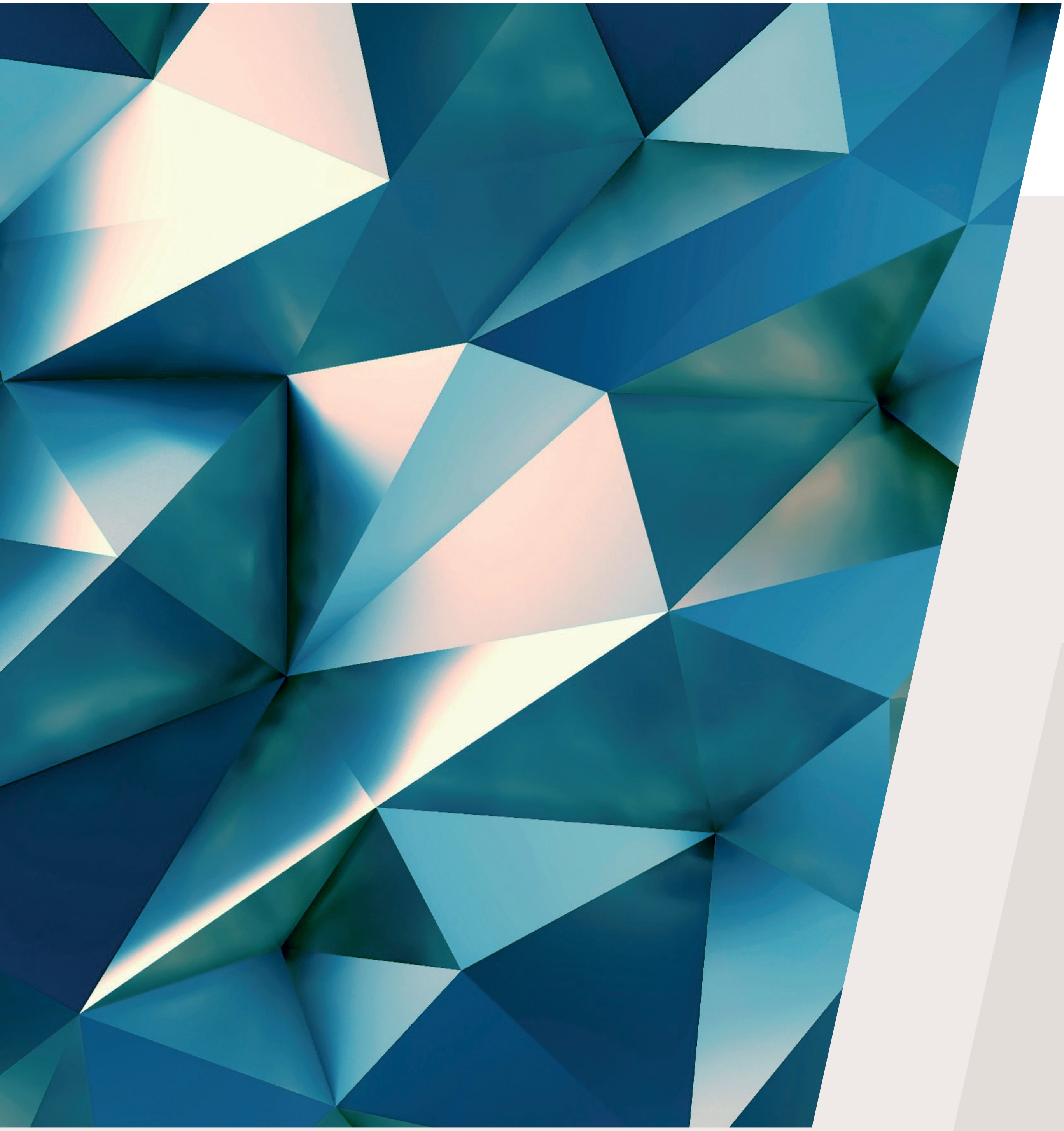

MAY 2024

Mosaique Asset Allocation

Our current view

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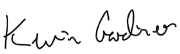

KEY POINTS

- A further rethink on US interest rates has unsettled markets…
- … but this follows a period of remarkable stability
- The wider economic climate remains benign: a mix of disinflation and growth
- We stay overweight stocks, neutral on bonds and underweight cash

THE MACRO PICTURE

The re-emergence of financial volatility in the last few weeks has coincided with the outbreak of more direct hostilities between Iran and Israel, but it is the business cycle, not those geopolitical concerns, which has been mostly responsible. Specifically, the idea that US interest rates will be staying "higher for even longer" has taken deeper root.

After a prolonged period of relative quiet across capital markets and foreign exchanges, higher volatility is neither surprising nor – yet – troubling. US inflation has been stubbornly firm, but not alarmingly so, given that we think we are likely now in the "last mile" of the disinflation journey. Meanwhile, the US economy continues to look relatively resilient, despite a softer-than-expected GDP headline in the first quarter, but not sufficiently so as to revive fears of a reversal in that disinflationary trend.

At the start of the year, money markets were expecting roughly seven 25-bp US rate cuts in 2024: as our asset allocation committee met in late April, that had fallen to barely one. After such a rethink, it would hardly be surprising if expectations of a renewed rise in interest rates were to take hold.

We have always been in the "higher for longer" camp. We did not see expectations backing up this far – but then the US economy has been even more resilient than we'd thought it might be. It would be foolish to rule out the possibility of rates having to rise further – "even higher for even longer" – but we still doubt that will happen. If it does, markets will surely be even noiser, and talk of a "soft landing" will evaporate for a while at least. But if the driver of such a move were again to be a relatively robust US economy, its lasting impact on portfolios might not be profound.

Lower interest rates are of course positive for most assets, including stocks, so their absence could hurt. But if rates stay high – or even rise further – because the US economy continues to grow steadily, stocks are capable of stabilising and benefiting from the higher profitability associated with that growth.

As yet, the changes in market prices for both stocks and bonds have not been large enough to materially alter their valuations. Stocks still look moderately expensive, and bonds are little better than fair value. As a result, our asset allocation remains unaltered: we maintain a small overweight in stocks, a corresponding underweight in liquidity, and a neutral position in bonds. We have the room to move further underweight in cash, in favour of either stocks or bonds, depending on where the opportunity first presents itself, but still feel that this is not the right time to do so.

The door is still open for European policy rate cuts in the months ahead: economies are softer, and in the eurozone – where the ECB has effectively told the markets to expect a cut in June – inflation is softer too. Switzerland of course has already cut rates. But the likely divergence in monetary policy does not yet look large enough to suggest a further rethink on regional portfolio weightings – not least because currencies may soften alongside local interest rates, restraining common-currency returns. And US interest rates of course matter most to global portfolios.

What change our overall stance, and tilt us back towards liquidity? Most obviously, perhaps, signs of an outright reversal in inflation, and/or evidence that higher interest rates have done more economic damage than has yet surfaced.

INVESTMENT CONCLUSION

Again, then, we still feel it is too soon to be overweight bonds as an asset class, and to be fully invested in securities generally. As a result, we stay no more than neutral on bonds in all portfolios, having finally closed a residual, long-standing underweight in bonds in European portfolios in the summer, and we retain a single overweight position in stocks, financed by a correspondingly moderate underweight in liquidity.

We noted last month that some revival in short-term volatility seemed overdue. As yet, it has not been large enough on its own to unearth better entry points.

Asset allocation overview

Equities. We continue to favour equities, and to look for signs that the stock market's advance is broadening. Within stocks we have been favouring a mix of structural and cyclical growth sectors: the emphasis has been mostly on the former, where we continue to favour technology, but as business surveys stabilise and recession fears abate, we expect more conventional, cyclical growth to share more of the market leadership. Further hikes in interest rates would likely postpone, but perhaps not cancel, this.

Regionally, since mid-2023 we have again had a preference for the US, where many of the more influential technology stocks are capitalised, and where developed-world economic growth tends to be more resilient. Since February we have also favoured the eurozone, which we think is able to capture the cyclical impetus from an improving global economy (perhaps more so than emerging Asia, which we cut back to neutral). Lower local interest rates would also help – but not that much, as noted.

These overweight positions have been funded by underweights in mostly defensive and interest-rate sensitive sectors, and in defensive markets such as the UK and Switzerland. Some of those sectors – namely, utilities and real estate – will need to be watched for improving momentum as lower interest rates eventually approach, but so far at least the overall mix has been a constructive one.

Fixed income. Within bond markets, we continue to favour longer-duration exposure across all currency bases, despite bonds' renewed weakness. Even as US interest rate expectations have backed up, we still see the risk-return balance as skewed positively: if US policy rates were to rise further, we doubt that long-dated yields would stay much higher for long, and indeed could imagine a more pronounced rally unfolding in due course as renewed recession fears took hold.

We have no strong preference for credit quality, favouring credit and government bonds equally. Both investment and sub-investment grade credit spreads have only been significantly lower in the 'noughties, ahead of the Global Financial Crisis, but as economies remain resilient, it is looking increasingly as if default and loss risk may be close to a peak.

There is a small divergence still in place between European and US portfolios: we retain an overweight in sub-investment grade bonds ("high yield", speculative bonds) in Europe, financed by an underweight in investment grade credit. They remain an important source of income in European portfolios, and have not yet been affected materially by the recent rebound in market noise. In US portfolios we stay completely neutral along the entire credit quality curve.

Currencies. Both the Swiss franc and the yen remain weak – the former after reaching historic highs at year-end, the latter close to historic lows. But the dollar's recent firmness has not broken out of any key trading ranges, and it is still not expensive enough for valuations in themselves to suggest an imminent reversal. We will be watching closely as Fed-ECB monetary policies start to diverge, but for now exchange rate conviction remains in short supply. Yet again, we would note that the major source of portfolio volatility is usually stock prices, not currency.

Asset allocation

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