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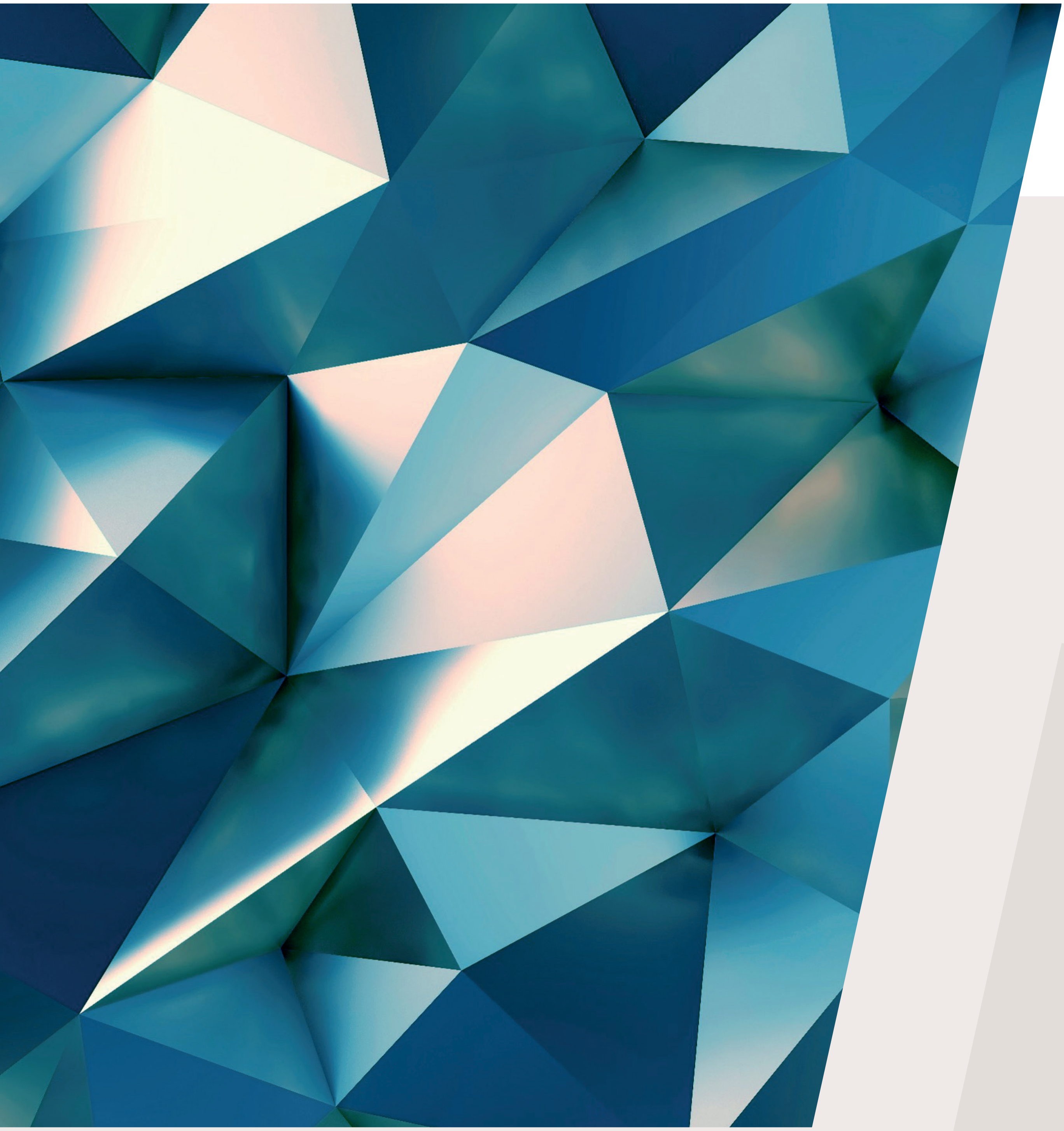

SEPTEMBER 2024

Mosaique Asset Allocation

Our current view

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KEY POINTS

- The outlook may not have changed significantly, despite stock market volatility
- Market expectations of lower US interest rates may be a little too optimistic again
- We stay overweight stocks and neutral on bonds, but trim cyclical risk

THE MACRO PICTURE

Global stock markets had a sharp but brief setback in early August, with the all-countries index on August 5th down by 8% from its mid-July peak. The US 10-year Treasury note yield fell by around 50bp over the same period. Stocks quickly rebounded – as we write they are within 1-2% of the earlier peak – but bond yields have not.

Our asset allocation committee held an ad hoc meeting to discuss the volatility. It seemed to us that two possible reasons for it were being exaggerated: the possibility of a sudden US recession, and a reversal of the so-called Japanese “carry trade”. As a result, we left our overall asset allocation intact.

That was also the conclusion at our most recent meeting, though we did decide there that some small reduction in cyclical risk was appropriate. Some moderation in growth would not be a surprise, Meanwhile, as noted, bond yields have not rebounded alongside stocks, and US interest rate expectations may be overly optimistic again.

In addition to market volatility, there has also been a lot happening in the political arena. A new UK government is settling into place; a new French government has yet to be agreed upon; and in the US, vice-president Harris is enjoying a boost in the polls as the Democrat candidate in November’s presidential campaign. We are watching closely, but as yet – as so often happens – these important political events do not yet have clear implications for financial markets.

For example, while a Democrat victory in November might seem likely to avoid increased geopolitical instability, it might also lead to higher taxes on business. Even the grim ongoing conflicts in Ukraine and the Middle East continue to have little direct impact on the global economy: disruption to oil and shipping markets remains modest in scale.

Our focus remains instead on an economic backdrop which we see as broadly constructive for portfolios. Despite the possibility of some slowing in the US economy, we still think a big downturn is neither necessary nor likely. Ongoing growth is likely to be enough to keep corporate profitability healthy, but not so much as cause a big rebound in inflation.

We do not expect inflation rates to return sustainably to targeted levels in the US or Europe just yet, but we do think that it will remain subdued enough for the European central banks to continue lowering their policy rates, and, importantly, for the Federal Reserve to start doing so soon too. The Fed’s rate cuts may not be as big as markets currently expect, as noted, but they will be enough, we think, to keep that constructive backdrop in place.

Stocks can benefit from both healthy profitability and falling rates, whereas bonds benefit only from the latter (and as noted, in the short-term may be pricing-in a little too much good news on that front). As a result, our current tactical preference remains in favour of stocks, though we have trimmed cyclical risk at the sector level, as described below. But eventually, as it becomes clear that inflation is not going to reaccelerate significantly, we can see room for further reductions in bond yields even without bigger cuts in policy rates, and we still prefer bonds to cash.

INVESTMENT CONCLUSION

We have again left asset allocation unchanged, but reduced our emphasis on short-term economic growth by making a change at the sector level.

Asset allocation overview

Equities. We do not think that August's volatility reflects a significant change in the prospects for stocks. Valuations are full, but not prohibitive. Some cooling in growth however would not come as a surprise after such a prolonged period of US consumer-led expansion, particularly if US interest rates do not fall quite as quickly as the market currently expects.

As a result, though we leave our asset allocation and regional preferences intact, we are cutting the consumer discretionary sector to underweight, and lifting consumer staples to neutral. The discretionary sector benefits from short-term or cyclical growth, while staples are a more defensive play on long-term trends in spending. Unlike some other defensive sectors, staples does not depend on significantly lower bond yields, and is relatively immune to regulatory uncertainty.

This change does not alter our stance dramatically. We still favour cyclical and secular growth sectors, with ongoing overweight positions in industrials, technology and communications. These positions are sustained by ongoing underweights in utilities (another defensive sector) and real estate (which needs bigger reductions in bond yields to perform more strongly), and now by the new consumer discretionary underweight. It does however reduce portfolio risk a little.

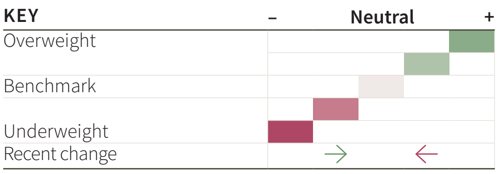
Regionally, we stay overweight the US, and since February have also favoured most of continental Europe too, at the expense of more defensive markets such as the UK and Switzerland. There has been some discussion of whether Europe can actually succeed in sharing market leadership with the US, but overall we stay patient.

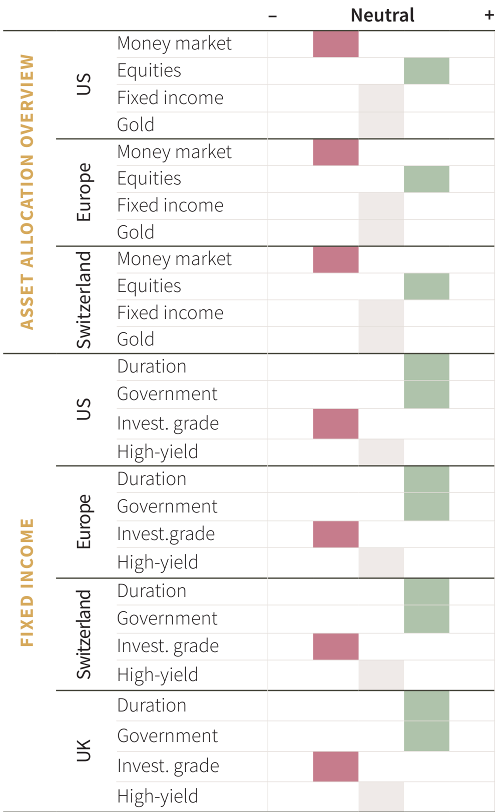
Fixed income. Within bond markets, we continue to favour longer-duration exposure across all currency bases, which has again supported performance. Recent gains, as noted, may be premature if US policy rates are not about to fall as sharply as markets expect, but we doubt whether a big or lengthy rebound in long-dated yields in particular is likely. As noted, we still doubt consumer price inflation will stick at targeted rates (2%) any time soon, but more medium term inflation risk has arguably faded as wage growth has moderated on both sides of the Atlantic.

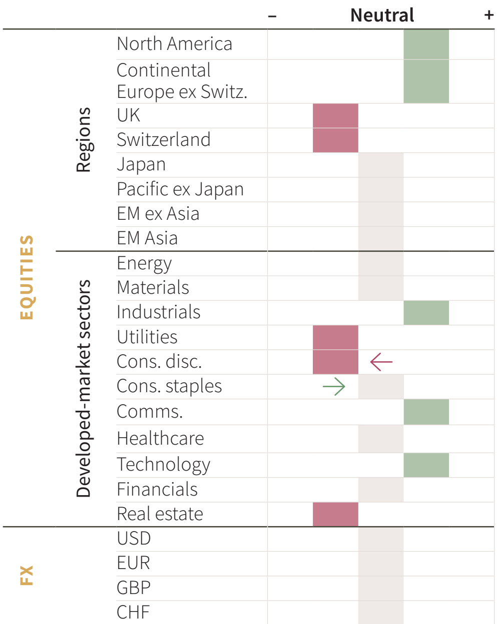
Since June we have favoured government bonds over credit. We are not especially worried about corporate default rates, but credit spreads have only widened modestly recently (largely as a result of government yields falling). Government bonds generally have longer duration and are better placed to benefit if medium term inflation risk has faded.

Currencies. The dollar has softened a little further against the euro, franc and sterling, and more materially against the yen (Japanese interest rates are still rising, and the yen had been particularly weak of late). Again, however, it is still firmly inside recent trading ranges, and it remains too soon to say whether this is a definitive reversal of trend – especially if those expected Fed rate cuts fall short of what money markets currently expect.

Asset allocation







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