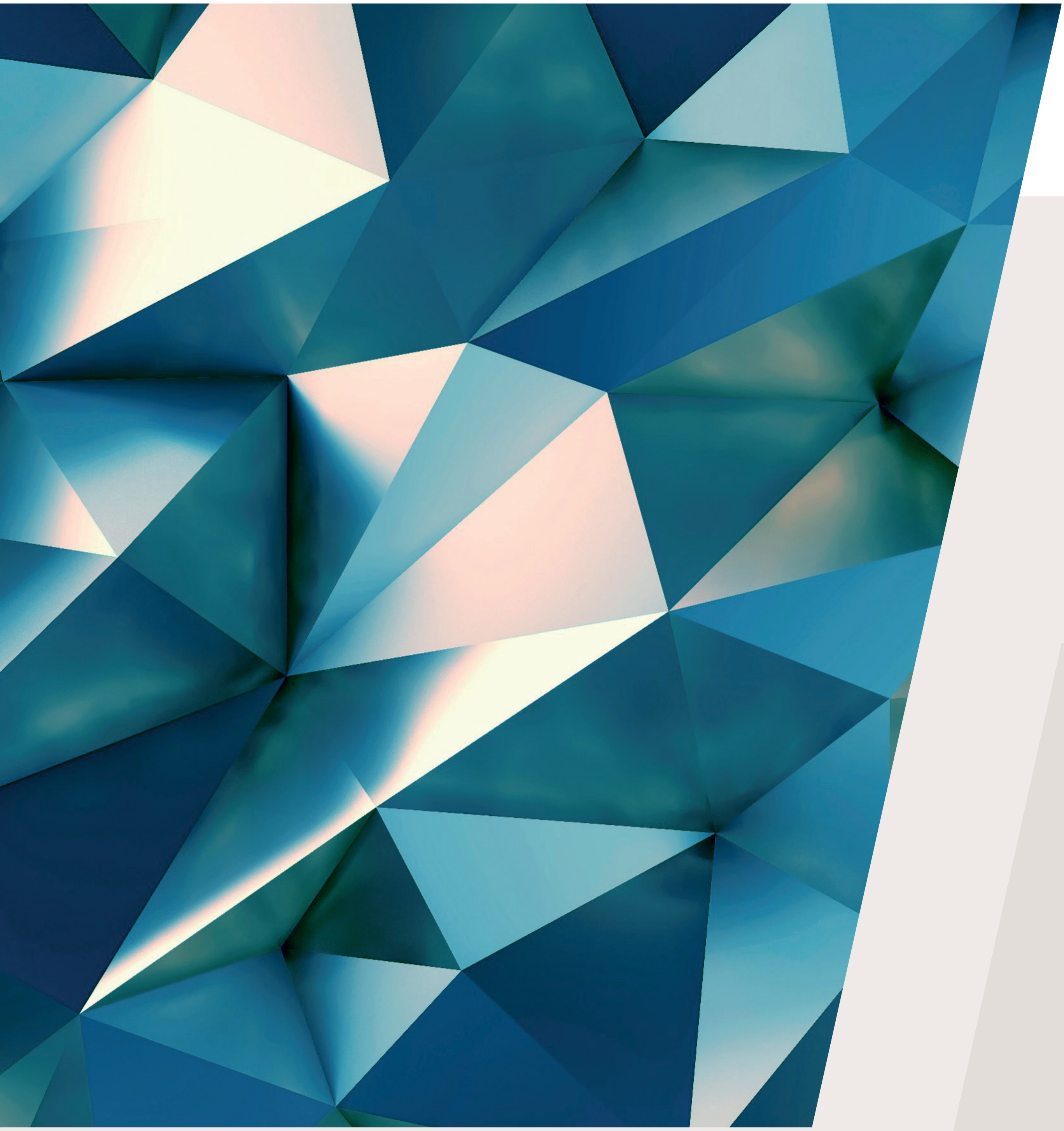

OCTOBER 2024

Mosaique Asset Allocation

Our current view

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KEY POINTS

- We should not “fight the Fed”: further cuts in US interest rates are likely soon
- Falling rates globally are coinciding with healthy corporate profitability
- We stay overweight stocks and neutral on bonds

THE MACRO PICTURE

As expected, the US Federal Reserve cut interest rates in September, but by half of one percent (50bp) rather than a quarter (25bp). As surprises go, this was not a big one: a larger move had featured in market discussion beforehand, and recent speeches from Fed officials had become less hawkish. This backdrop helped investors to see the move positively, and not as a warning of looming bad news on the economy.

The Fed’s double mandate requires it to keep inflation down and employment up. It has been delivering recently (more or less) on the inflation front, but unemployment has been drifting higher, and its rate cut is designed to help tackle that. The rise in unemployment has so far however been modest; it started from historically low levels; and it has been accompanied by spending and output data which suggest that the US economy is still growing, and perhaps at a faster pace than usual. As a result, we agree that the Fed’s move is indeed best seen as a sort of insurance policy, rather than as a response to a sudden but as yet unannounced slump in the economy. With this in mind, as long as inflation stays well-behaved, there are likely further rate cuts to come before year-end.

The Fed’s move was preceded by a widely-expected second 25bp rate cut from the European Central Bank. It has been followed this week by a package of expansionary monetary measures in China (including a small cut in one of the secondary policy rates), and as we write the Swiss National Bank seems poised to make a third 25bp rate cut.

Of the larger central banks, this will leave only the Bank of England and the Bank of Japan looking hawkish in September. In the case of the former, with a contractionary budget likely in late October, that hawkishness is likely to prove short lived. Japan’s economy, of course, has for many years followed its own highly idiosyncratic cycle, mostly of little relevance for global investors, and has if anything only just started to normalise interest rates upwards.

The European economies, and China’s, have grown disappointingly slowly of late, in contrast to the US. However, they also seem unlikely to be facing a sudden nosedive. In the investment context, then, the ongoing decline in the most important global interest rates is close to a free lunch for investors. It is delivering good news on interest rates, and as yet without any associated threat to corporate profitability.

With this market-friendly mix in mind, our asset allocation committee decided to leave its positions unaltered in September. Stocks had moved higher after August’s initial volatility, but with an unexpectedly generous Federal Reserve in play there was little appetite to reduce overall portfolio risk. We stay one notch overweight in stocks, which can benefit from both healthy profitability and falling rates, funded by an ongoing underweight position in liquidity.

We stay neutral on bonds, which benefit only from falling rates – and those gains are only reliable at the short-dated end of the market. Longer-term bond yields can actually go up if rate cuts are seen as taking a risk with inflation, and in the US they have done exactly that since the Fed's move. This has not helped our positioning within the bond market, where we have been favouring longer duration, and there was some discussion at the committee as to whether this position should be reduced. However, inflation currently seems sufficiently subdued to make a more significant rise in longer-dated yields unlikely, and on our one-year tactical time horizon we felt there was enough time (and room) for the longer-dated segment to rally.

INVESTMENT CONCLUSION

We have again left the asset allocation unchanged. Within the two big asset classes, regional, sectoral, duration and credit positions are also unaltered.

Asset allocation overview

Equities. The Fed's move is supportive for stocks, but far from a game-changer. Valuations are full, and it is hard to see the macro climate becoming much more positive than it already is. Further rate cuts are very likely on both sides of the Atlantic in what remains of 2024. The room for more cuts in 2025 is however more debatable, especially in the US if the economy were to remain resilient.

Within the equity market, we 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 by a more recent underweight in the consumer discretionary sector.

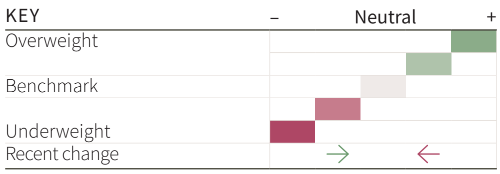
Regionally, we stay overweight the US, and since February have also favoured most of continental Europe too, at the expense of more defensive markets such as the UK and Switzerland. There is ongoing discussion of whether Europe can actually succeed in sharing market leadership with the US, but again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

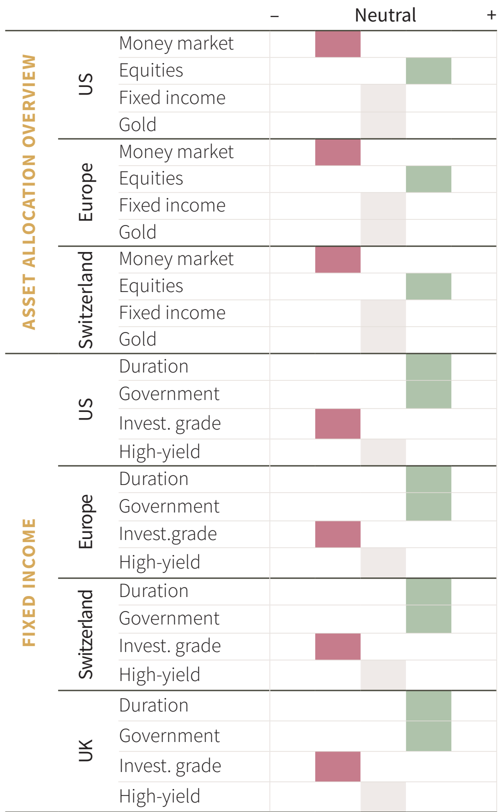
Fixed income. As noted, we continue to favour longer-duration exposure across all currency bases, despite the response of the US segment to the Fed's cut. The move may well have been unnecessary, but we doubt it will do much inflationary damage, and as short-term rates continue to trend lower there will be room for longer duration Treasuries to rally. This does not mean that we expect consumer price inflation to stick at or close to targeted rates (2%) any time soon, but we doubt the overshoot will be big enough to trouble markets on our one-year tactical view.

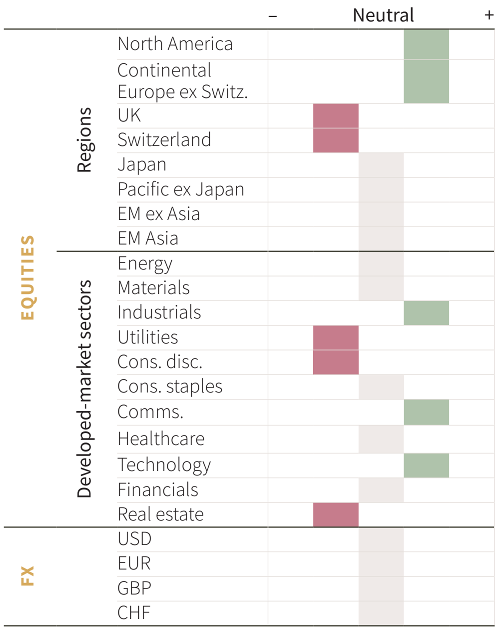
Similarly, we continue to favour government bonds over credit – not because we worry about corporate defaults, but on valuation grounds: credit spreads have rarely been significantly lower.

Currencies. The dollar has unsurprisingly softened a little further after the bigger-than-expected cut in US rates, but it remains (again) firmly inside recent trading ranges. It is still too soon to say whether this is a definitive reversal of trend, and we have no strong views about most major exchange rates currently – a view which has served us well for several years now.

Asset allocation







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