October 2021

Mosaique Views

Rothschild & Co
Wealth Management

Staying constructive

Growth has peaked, but may remain above trend for a while

The global economy regained pre-crisis levels of GDP faster than consensus forecasts had suggested. Growth has now peaked – the major re-openings are behind us, and covid contagion is leading to some resumed suppression measures – but may remain above trend for a while.

Vaccines are still being rolled out, adapting to a more distanced world continues, and policy remains supportive. US and European business surveys in early September point to strong growth continuing through the third quarter at least. Expectations for corporate profitability may still be too low.

US consumers' confidence has dipped, but their spending power hasn't, and the labour market is tightening. Meanwhile, with inventories low and order books high, re-stocking seems set to boost demand. Looking further ahead, President Biden's plans for extra infrastructure spending are not as expansionary as they were, but will still support medium-term demand.

More widely, despite ongoing bottlenecks, world trade has more than regained its pre-pandemic levels. China has slowed, partly because of its zero tolerance policy towards the virus, but not alarmingly, and it still has more room for added policy support than the other big economies.

This backdrop is delivering a remarkable surge in corporate profits that even now may not be fully priced into equity markets.

As economies normalise, so too eventually will policy settings. US inflation has revived, and may not be quite as "transitory" as the Fed suggests. The growing economy will eventually exert more pronounced upward pressure on real interest rates and bond yields.

At some stage, higher interest rate expectations – as opposed to the more imminent "tapering" of Fed bond purchases – may trouble stock markets too. But while stock valuations are historically on the high side, they are not prohibitively so, and remain relatively inexpensive when compared to bonds.

Within stock markets, there has been a swing back towards sectors characterized by a focus on longer-term ("structural") growth, and away from more cyclical exposure. We think this may now persist for a while, at least until higher policy rates loom closer.

Asset allocation summary

Subject to our carefully-monitored risk budgets we moved maximum overweight equities, and maximum underweight bonds, in the Spring – positions we are maintaining (as with our neutral stances on cash and gold).

– Neutral +

Equities

We felt from the onset that the lasting damage done by the shutdowns would not be as big as feared. We moved overweight equities in mid-2020 as global contagion rates slowed and the economic rebound became more visible – a stance we added to in March 2021. The second (or third) wave of contagion has had less impact than feared, vaccinations are helping and corporate profits are beating expectations. Risks increasingly focus on interest rates and valuations, not profitability.

– Neutral +

Fixed income

Safe-haven appeal was probably overpriced to begin with, and the viral crisis made it even more so. We see little chance of inflation beating returns from these levels for the asset class, and recently moved maximum underweight. We continue to prefer corporate and emerging markets ahead of core government bonds, and recently shortened the duration of our holdings.

– Neutral +

Money market

The prospect of positive returns is still remote, but cash offers a continuing opportunity to capitalise on volatility. Nominal capital values are stable, safe from the mark-to-market risk that faces expensive bonds, and low inflation (for now) helps preserve real value too. We cancelled our overweight position at mid-year as lockdowns loosened and we saw opportunities to add to risk assets.

– Neutral +

Gold

Gold has been a long-term store of value for three millennia, though its short-term volatility can be high. It has been sensitive to a rebound in interest rates and a slightly firmer dollar. But its long-term credibility does not rely on central banks, governments or an internet connection, and its low correlations with traditional investments can provide diversification.

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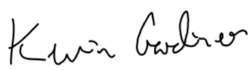

Asset allocation overview

Key	–		Neutral		+
Material overweight	●	●	●	●	◉
Benchmark weight	●	●	◉	●	●
Material underweight	◉	●	●	●	●

Fixed income

EUR					
High-grade	◉	●	●	●	●
IG low-grade	●	●	●	◉	●
High-yield	●	●	●	◉	●
Duration		◉			

USD					
High-grade	●	◉	●	●	●
IG low-grade	●	●	●	◉	●
High-yield	●	●	◉	●	●
Duration		◉			

CHF					
High-grade	◉	●	●	●	●
IG low-grade	●	●	●	◉	●
High-yield	●	●	●	◉	●
Duration		◉			

Gold

Gold	●	●	◉	●	●

Currencies

USD	●	●	◉	●	●
EUR	●	●	◉	●	●
CHF	●	●	◉	●	●
ROW	●	●	◉	●	●

Equity regions

Equity regions	–		Neutral		+
North America	●	●	●	◉	●
Developed Europe ex-UK	●	●	◉	●	●
UK	●	●	◉	●	●
Switzerland	◉	●	●	●	●
Japan	●	●	◉	●	●
Pacific ex Japan	●	●	◉	●	●
EM EMEA	●	●	◉	●	●
EM Asia	●	●	●	◉	●
EM Latin America	●	●	◉	●	●

Equity sectors

US					
Energy	●	◉	●	●	●
Materials	●	●	●	◉	●
Industrials	●	●	●	◉	●
Utilities	◉	●	●	●	●
Consumer discretionary	●	●	●	◉	●
Consumer staples	◉	●	●	●	●
Communications	●	●	◉	●	●
Healthcare	●	●	●	◉	●
Technology	●	●	●	◉	●
Financials	●	●	●	◉	●
Real estate	●	◉	●	●	●

Developed Europe ex-UK					
Energy	●	◉	●	●	●
Materials	●	●	●	●	◉
Industrials	●	●	●	◉	●
Utilities	●	◉	●	●	●
Consumer discretionary	●	●	●	◉	●
Consumer staples	◉	●	●	●	●
Communications	●	●	◉	●	●
Healthcare	●	●	◉	●	●
Technology	●	●	●	◉	●
Financials	●	●	◉	●	●
Real estate	●	◉	●	●	●

Equities: regions

Summary

The roll-out of vaccinations, together with ongoing adaptation and continuing policy support, continues to boost the prospects for the global economy and risk appetite. With China's economic recovery from the pandemic-induced disruption largely complete as well as rising virus contagion rates in APAC, we recently reduced our strong overweight in Emerging Asia, and at the same time closed off an underweight in Pacific ex Japan.

North America

Additional fiscal stimulus was recently disbursed in an already quickly-rebounding economy. GDP has effectively closed on pre-crisis levels and is likely to surge further in the months ahead. Corporate profits are rebounding strongly in 2021: expectations are still rising.

Developed Europe ex-UK

Growth is lower at the best of times, but the local setbacks seen after recent lockdowns were smaller than feared. The Eurozone can also benefit from global recovery, and the euro's credibility has been bolstered by the pandemic fund. We recently closed our underweight position.

United Kingdom

The UK market's high weightings in unpopular and ESG-challenged sectors such as oil and mining have counted against it, but a lot has been priced in and as commodity prices revive, we recently moved up to neutral.

Switzerland

Big weightings in healthcare and consumer staples give the Swiss market a defensive orientation that we feel is unlikely to appeal in a more recovery-focused climate. We recently moved maximum underweight.

EM Latin America

Governance is always an issue, and big commodity weightings and exchange rate volatility neutralise low valuations. The region lacks Asia's structural growth appeal.

Japan

Valuations have been attractive, but the trend in improving profitability had faded long before the crisis broke. Japan's market traditionally confounds most tactical calls, and its strategic shift to a more conventionally capitalist model is progressing only very slowly.

Pacific ex Japan

A strong beginning of the year for commodities continues to support the Australian economy whilst strong pandemic management in Singapore and – for now – fading political tensions in Hong Kong are also positive. We recently closed our previous underweight and moved neutral.

EM EMEA

Dominated by Russia, with its geopolitical risk, weak governance and oil-intensive economy. We prefer to stay neutral in this region.

EM Asia

On a longer-term view, emerging Asia will remain the most dynamic region of the global economy as the world's GDP and capital pivots there. In the short term, however, China's economic recovery is largely complete and geo-political tensions in the region have grown lately. Some Asian economies have seen resumed covid suppression. We recently tactically reduced our maximum overweight.

Equities: sectors

Summary

We continue to favour a mix of cyclical and structural growth, with the mix recently tilted more towards the former, as we recently cancelled a previous underweight in European financials at the expense of more defensive European healthcare. We earlier turned more positive on US industrials and US financials, which can benefit from cyclical recovery. In September we reduced our exposure to US materials whilst increasing our exposure to US healthcare.

Healthcare (US)
Healthcare (EUx)[1]

As the economic upswing matures, we think it appropriate to reduce our US cyclical exposure, meanwhile moving overweight in US healthcare.

Technology (US)
Technology (EUx)

A long duration sector, which can also perform well cyclically, and which offers some insulation from shutdowns. We recently reduced our overweight as we increasingly tilt towards sectors less affected by higher long-term interest rates.

Industrials (US)
Industrials (EUx)

We recently tilted portfolios further towards cyclical growth by adding to US industrials. Industrials are well placed to benefit when economies rebound and activity resumes.

Materials (US)
Materials (EUx)

Materials face more headwinds than most sectors from ESG considerations in the long-term. To reduce cyclical exposure, we adjusted our positions in US materials to single overweight.

Energy (US)
Energy (EUx)

Stock valuations have rebounded some way already, and we see ESG and structural challenges (such as alternative energy supplies) as too large for us to change our tactical views.

Real estate (US)
Real estate (EUx)

Despite having some cyclical content, the sector often performs as a bond proxy, and with the yield curve steepening we stay underweight. These are equites, not direct real estate.

Communications (US)
Communications (EUx)

A sector that adds social and conventional media and internet services: a beneficiary of changes to long-term working practices, but also a target for regulatory concern. We recently moved neutral in the US as we added more cyclicality.

Utilities (US)
Utilities (EUx)

A safety-first, defensive bond proxy sector. While it is not cheap, we recently reduced a material underweight in Europe as we moved underweight more volatile European real estate.

Financials (US)
Financials (EUx)

We recently moved overweight US financials which are strongly capitalised and well placed for a cyclical recovery and firmer interest rate expectations. European banks are less well capitalised, and growth is weaker, but we recently cancelled an underweight position there.

Consumer discretionary US)
Consumer discretionary (EUx)

A play on recovering growth expectations and risk appetite. Europe's consumer goods offer global exposure. US consumer cashflow pre-crisis was strong, and the housing market did not look overextended.

Consumer staples (US)
Consumer staples (EUx)

Staples might lag as confidence in the recovery grows and risk appetite revives. Its long duration characteristics are less attractive than they were, and its strong defensive qualities are distinctly unattractive currently.

[1] *EUx = Developed Europe ex-UK*

Fixed income

Summary

We think the recent flattening in yield curves is unlikely to last, and stay underweight duration. Growth may be peaking, and bottlenecks may ease for a while, but spare capacity is likely to continue to shrink and inflation may eventually be squeezed higher. Central banks are likely "behind the curve". We also continue to prefer lower quality investment grade and speculative (or "high yield") credit to core government bonds, but spreads are running out of room.

High-grade (USD)
High-grade (EUR, CHF)

Led by emergency rate cuts and the promise of open-ended QE (including corporate bonds for the first time) at the US Fed, major central banks have adopted emergency monetary policy measures to avert long-term damage being done by the economic closures. This has supported riskier bonds: reviving a liquid credit market generally has been one of their aims.

High Yield (USD)
High Yield (EUR, CHF)

High yield bond spreads initially widened substantially. In April we added to positions in European portfolios (which were less exposed than in the US to the added risks posed by the oil sector). This allowed us to capture additional yield and potentially profit from any spread tightening as the market environment improved. There is much less room for further tightening now.

IG low-grade (USD)
IG low-grade (EUR, CHF)

Substantial QE on both sides of the Atlantic has offered direct support for investment grade corporate bonds as central banks have kept liquidity flowing. We have maintained our positioning, but spreads are narrower now.

Duration

The US yield curve has recently flattened, but has not been especially steep and has plenty of room to steepen again. In Europe, steepening has barely begun. We stay underweight duration across all currencies.

Currencies

Summary

Exchange rate volatility remains low – unsurprisingly given the convergence in inflation and interest rates. A cyclical rotation away from the dollar is likely at some stage, but a renewed dollar "smile" is quite possible in the meantime if US growth continues to surprise positively. Longer-term, the dollar will likely remain the main reserve currency for the foreseeable future: the renminbi cannot challenge it until China's capital controls and structural current account surplus disappear.

US dollar

Often a safe haven at times of stress, but also a potential beneficiary of strong US-led growth. It is not especially expensive. Consensus expectations of a sustained weakening may again be premature.

CHF

The franc's safe haven appeal has faded as risk appetite has improved and the euro's credibility has been bolstered.

Euro

The French-German initiative, with mutual borrowing sharing some of the Covid recovery costs, has supported the prospects for the Union and its common currency. We cancelled a previously negative stance on the Euro in 2020.

ROW[1]

Expectations for the UK economy outside the EU are likely too low; at a more elevated level, China's growth prospects may also be under-appreciated. Neither of these are urgent calls however.

[1] GBP, YEN, Renminbi, AUD

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