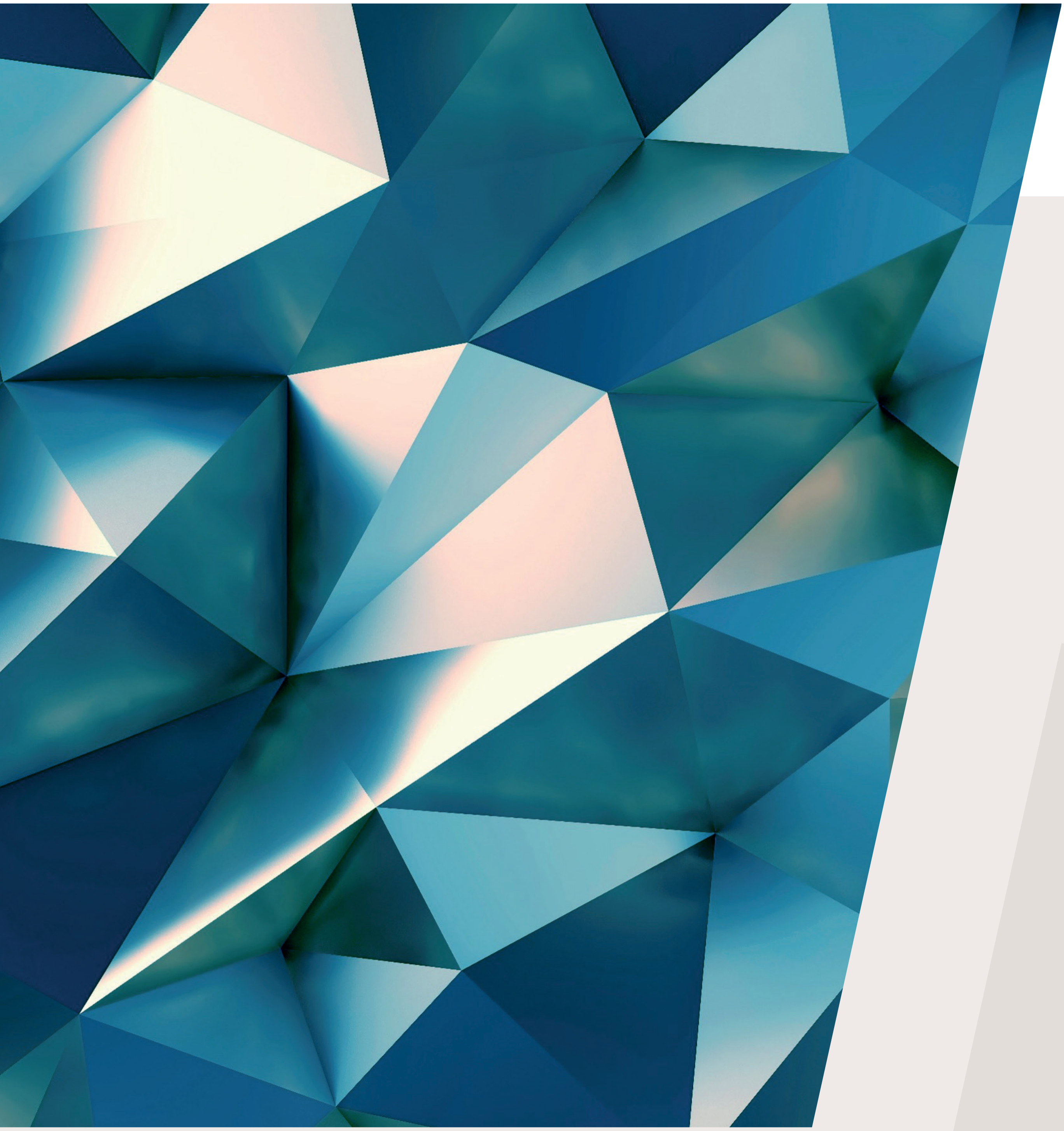

AUGUST 2023

Mosaique Asset Allocation

Our current view

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KEY TAKEAWAYS

- US headline inflation is back down to unremarkable levels
- A significant economic setback has been avoided so far
- Investment view: adding to equities and European bonds from cash

The cycle is rolling onwards. Business surveys still point to slower growth in H2, but not a collapse, and they may be bottoming out. Unemployment rates remain low. Nonetheless, the possibility of monetary overkill has faded a little as US headline inflation has fallen back to 3%, and core inflation has also cooled – evidence perhaps of supply-side resilience (the US remains by far the most important economy and capital market for global investors).

Meanwhile, developed world terms of trade have rebounded sharply as energy costs have fallen, particularly in Europe; real wages are growing again; and China's reopened economy is benefiting from resumed policy stimulus (which is possible because China's inflation recently has been negligible).

The famous "long and variable lags" which characterise the workings of US and European monetary policy mean that we are not out of the woods yet. As for the banks, it would be remarkable if there were no further financial accidents after such a rapid normalisation in rates. Nonetheless, as we see it a more dramatic economic setback remains neither necessary nor likely.

Inflation is still unlikely to return sustainably to targeted rates of 2% any time soon. Nonetheless, as long as it is headed in the right direction, and nominal wage growth has peaked, further significant increases in interest rates look unlikely. That said, resumed cuts in interest rates still seem a long way off: economies may not need them, and central banks have to rebuild their monetary credibility.

INVESTMENT CONCLUSION

Stock markets have now rallied a long way from their October 2022 lows, but the gains have been relatively narrow – concentrated in a small number of technology-influenced US stocks – and valuations remain inexpensive. Short-term setbacks and corrections are always possible, but we think a wider cyclical rebound to new highs may still lie ahead, and further declines in inflation may prove the catalyst. Some modest improvement in US-China tensions around Taiwan – even as conflict continues in Ukraine – may also add to global risk appetite.

Bonds are still not cheap, but the chances of substantial further weakness may have fallen as US inflation and interest rate expectations have moderated, heralding an approaching peak – or plateau – in European yields also.

We are making some asset allocation changes in response to this altered balance of risks. But we continue to have relatively few open positions, which we think is appropriate given that we are close to an inflection point in the cycle, and the shape of the next phase has yet to make itself clear. That applies to currencies also: conviction there should be low at the best of times, and it has been right to hold few strong opinions there of late.

Asset allocation overview

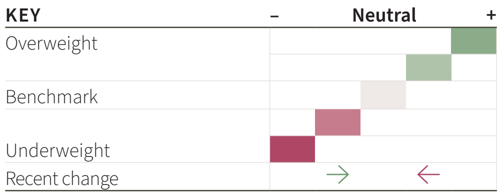
Equities. We are restoring our equity stance to overweight, having cut it to neutral after Russia's invasion of Ukraine, but leave our regional and sectoral preferences unchanged (we continue to favour the US and emerging Asia, and remain underweight in defensive Switzerland and the UK, while tilting portfolios towards a mix of growth and cyclical sectors, at the expense of defensiveness). We fund this move by reducing liquidity.

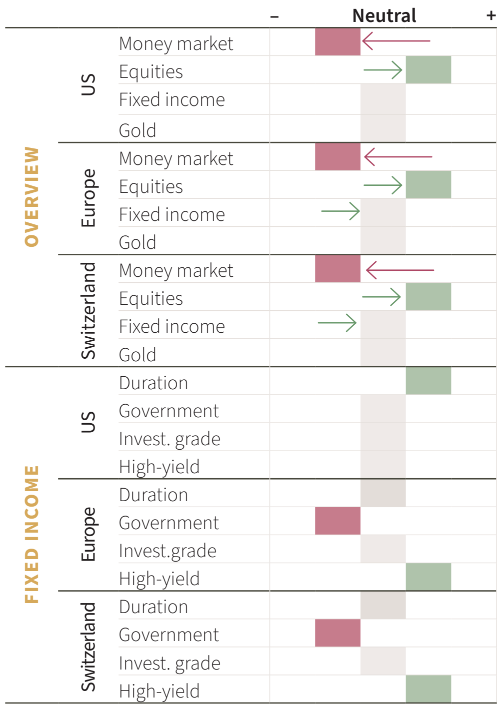
Fixed income. Last month we closed a long-standing preference in European portfolios for shorter-duration bonds, and we now close our similarly long-standing underweight in the asset class. This aligns our fixed income positioning in European portfolios more closely that in the US (the remaining divergence is that in European portfolios we favour high-yield credit, whereas in US portfolios we are neutral on credit quality). As with the equity move, we fund this addition to bonds in European portfolios from liquidity.

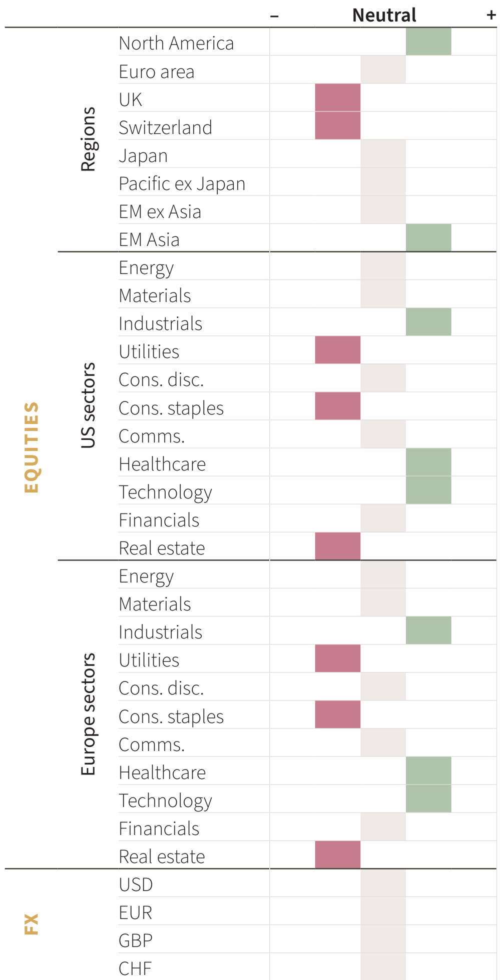
These changes leave our overall asset allocation similarly aligned in US and European portfolios: we have a single overweight in equities, a single underweight in liquidity, and a neutral position in bonds. We can imagine being overweight both asset classes at some stage, but that might perhaps require (even) greater confidence in a favourable inflation/growth mix – and the prospect of lower interest rates.

Currencies. We still think the dollar's underpinnings remain less robust than of late, but if anything it has firmed a little in recent weeks. The Fed looks closest to completing its monetary tightening, and a stabilising global economy and improving risk appetite are arguments for dollar weakness, not strength. The US currency also looks expensive. That said, these considerations do not carry through to our regional equity positions – currency conviction is low at the best of times, or should be – and it is equity volatility which dominates returns from most balanced portfolios.

Asset allocation







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