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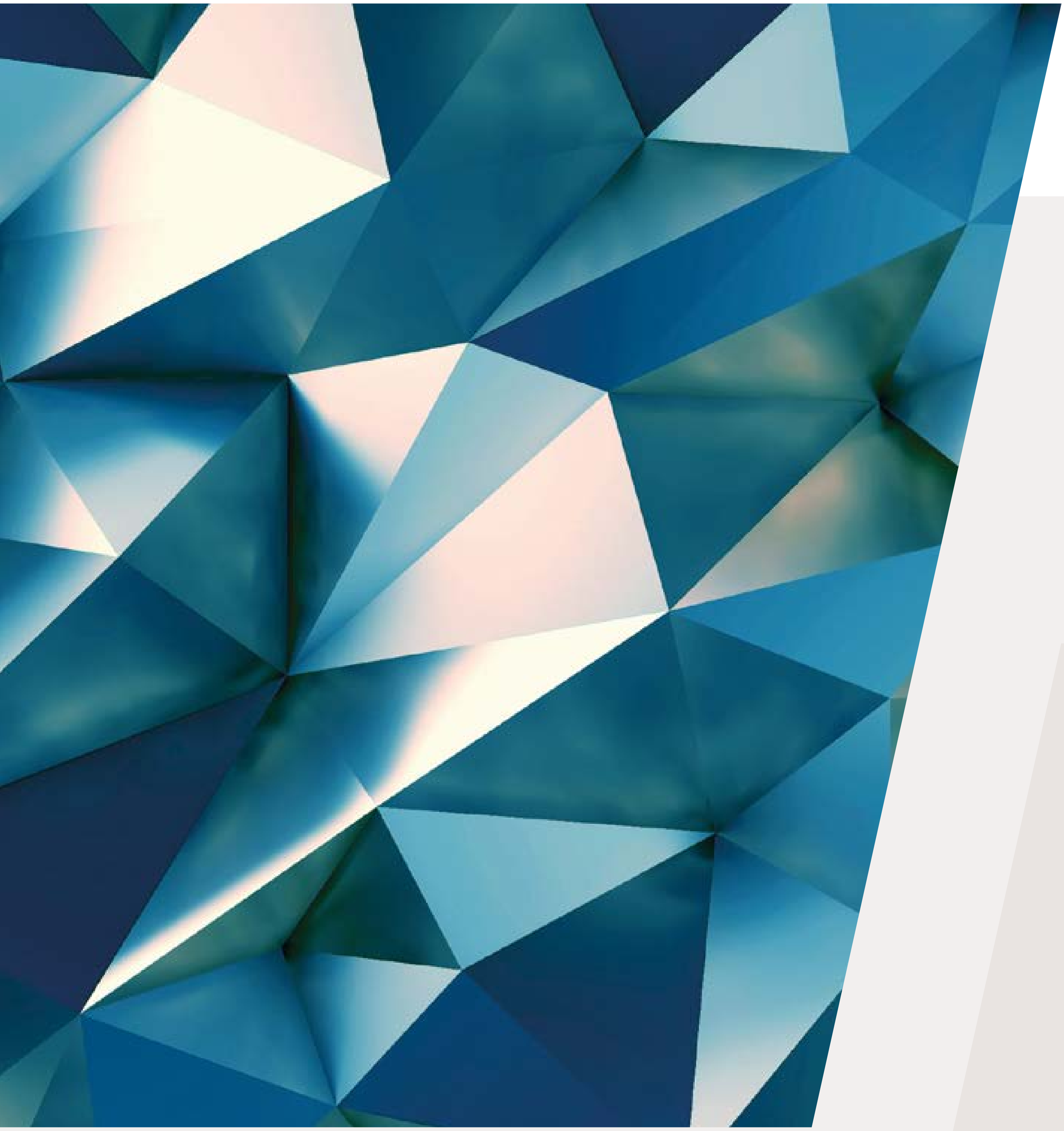

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Mosaique Asset Allocation

Our current view

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KEY TAKEAWAYS

- Geopolitical risk *may* affect portfolios – the business cycle certainly *will*
- The recent mix of resilient growth and fading inflation can continue
- We stay overweight stocks, neutral on bonds and underweight cash

Geopolitical risk has once again intensified unexpectedly. But while dreadful events can affect global investments, they may not. Markets are impersonal. The business cycle, however, certainly will, and the indications are that the latest falls in stock and bond prices reflect investors continuing to come to terms with the "higher for longer" interest rate outlook.

The Mosaique asset allocation committee knows that we cannot pretend to expert knowledge when it comes to the crisis in the Middle East. We doubt whether even those who do have such expertise can know how things will now unfold. But we are watching carefully for signs that those events are becoming a significant driver of capital markets.

So far, the movements in such potential safe havens as the gold price, flight currencies, and option prices are within the realms of routine volatility: indeed, the biggest safe haven asset, the bond market, has actually fallen in price. The oil price is the most likely transmission route through which the crisis could affect the global economy, and it has only risen a little (it was higher in September). The fall in stock prices is unremarkable, and likely reflects the interest rate theme which has been driving those bond prices down too.

Meanwhile, the business cycle continues to evolve – but again, as in the last two months, not yet sufficiently to warrant further changes to portfolios. The picture continues to be an intriguing – but not wholly unexpected – mix of economic resilience and declining inflation.

Received wisdom has seen the global economy as being on the brink of recession for perhaps eighteen months now, but in the quarter just ended, the two biggest economies – the US and China – grew at an annualised pace of around 5%, and even the weaker European economies again avoided a significant setback. Forward-looking business surveys are soft, but not dramatically so, and unemployment rates remain low.

At the same time, and notwithstanding such resilient output, the trends in developed world inflation are looking increasingly more benign. Headline rates have improved most dramatically – the eurozone's is back below 3% - but core rates are also slowly trending lower.

The main reason for thinking this can continue is that Western labour markets remain remarkably well-behaved – industrial unrest has so far been modest in historic terms. For inflation to fade further it is not necessary for economies to go into reverse, only for them to grow more slowly than their productive potential.

We are of course not out of the cyclical woods yet, even setting geopolitical risk aside. The effects of tightened monetary policy have yet to make themselves felt fully. But the recent favourable mix of resilience and disinflation can continue – and if it does, we are likely closing on peak interest rates.

However, if interest rates don't need to rise much further, with unemployment staying low and a sustained return to targeted inflation levels still yet on the horizon, they are equally unlikely to fall urgently either. And as we're seeing in markets, such an outlook was not as fully "in the price" as it might have been.

INVESTMENT CONCLUSION

So again, then, the macro picture is one in which – unless geopolitics makes itself felt more directly – economies are soft enough to suggest that central banks have nearly finished raising interest rates, but not sufficiently so to expect rates to start falling. Bonds and stocks have now been digesting this interest rate outlook since the summer. Money curves are now resembling the “plateau”-type profile that we have long had in mind.

In late July we moved overweight on stocks. Our move probably came too early – they had clearly not taken as much of that interest rate risk on board as we’d thought – but we still think this remains the right stance. We continue to think that a significant economic downturn is neither necessary nor likely.

The risk of monetary overkill has fallen as inflation has peaked, and expectations for corporate profitability continue to stabilise at healthy levels. Stock prices are not expensive – even with a risk-free rate of 4.5%, which is where we have always seen “fair value” for the US Treasury note – and a substantial “risk on” rally may still lie ahead. Possible catalysts for this might include a further fading of core inflation, and containment of that geopolitical risk. We cannot predict the timing with confidence, but we remain overweight in anticipation.

Today’s “normalised” levels of bond yields may not trouble stocks’ valuation, but they do pose more direct competition. Yields even for eurozone bonds are offering plausibly positive returns to maturity, even if inflation does settle a little above target. They also offer more credible diversification – and perhaps this is an area where cyclical and geopolitical risks align.

However, yields have not yet peaked convincingly, and resumed rate cuts as noted are only a remote prospect as of yet. Moreover, to add to bonds from cash at this juncture would feel a little over-confident, as it would take us close to being “fully invested“ in securities. For now we remain no more than neutral – though this is itself the most positive we’ve been on bonds in a decade.

Asset allocation overview

Equities. We restored our equity stance to overweight in late July, having cut it to neutral after Russia's invasion of Ukraine, but left our regional and sectoral preferences unchanged – and we are still doing so: such considerations are secondary at present.

We continue to favour the US and emerging Asia, China's short-term difficulties notwithstanding. We remain neutral on the Eurozone market, and underweight in defensive Switzerland and the UK. At the sector level, portfolios remain tilted towards a mix of growth and cyclicality, at the expense of defensiveness, and our positions in US and European portfolios are similar. We fund the ongoing overweight in stocks from liquidity.

Fixed income. In July we also closed our long-standing underweight, in European portfolios, in bonds, as noted. That left our fixed income positioning aligned more closely with that in the US. As with the equity move, we funded this addition to bonds in European portfolios from liquidity.

July's changes left our overall asset allocation similarly positioned in US and European portfolios: we have a single overweight in equities, a single underweight in liquidity, and a neutral position in bonds. However, there are two ongoing divergences: we are overweight in bond duration in US portfolios, and in European portfolios have a preference for the lowest-quality bonds at the expense of the highest.

These differences are loosely related. European government bonds even now have not quite reached what we think of as fair value (a bund yield, say, in the 3-4% range), whereas in the US the 10-year yield is if anything modestly overshooting, as noted above. Speculative grade bonds have thus been a more important source of income in European portfolios, and even after the last few weeks this is still one of the better-performing segments of the fixed income market.

Currencies. The dollar has not responded to the conflict in the Middle East in the way that it might have done (as a "safe haven" currency). Generally, we continue to have little conviction on the major currencies – a view which continues to serve us well in an ongoing low-volatility foreign exchange climate. The dollar is not cheap to begin with, and being overweight in US equities we feel we are already tilted far enough towards US exposure. It is equity volatility which usually dominates returns in most balanced portfolios.

Asset allocation

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