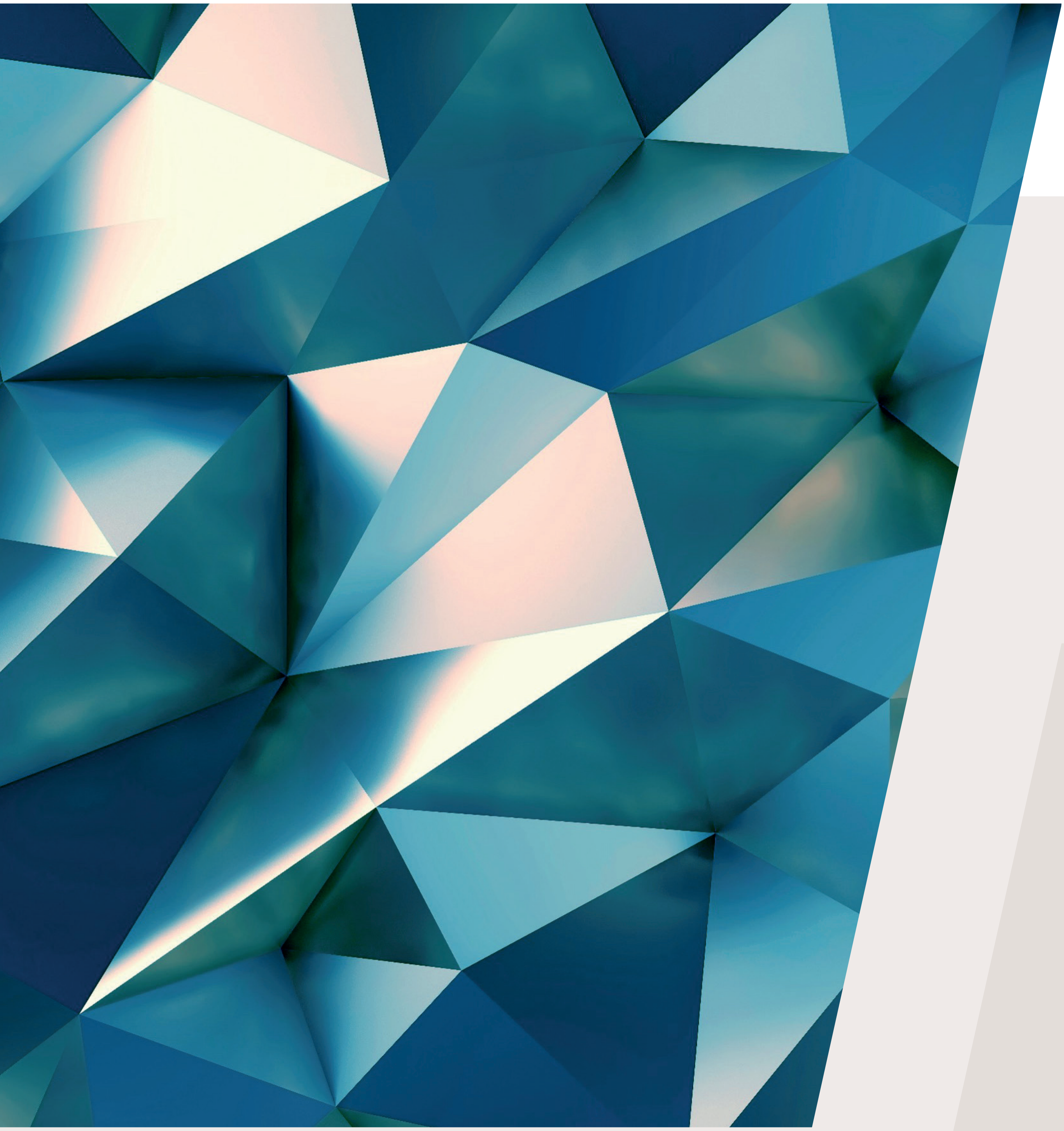


SEPTEMBER 2023

Mosaique Asset Allocation

Our current view

Dr. Carlos Mejia
Chief Investment Officer

Kevin Gardiner
Global Investment Strategist

KEY TAKEAWAYS

- Inflation risk continues to subside slowly
- Economies remain resilient
- We stay overweight stocks, neutral on bonds and underweight cash

Economic strength is most visible in the US, where annualised growth as we entered the third quarter seems to have accelerated markedly. Against this backdrop, the US Treasury note yield in August rose briefly to its highest levels since 2007. Economies look most fragile in Europe, particularly in the eurozone, though unemployment is still historically low, and there is a marked divergence between weak subjective survey data and more resilient data on output and spending. China continues to disappoint, but growth there remains comfortably higher than in most Western economies, and policymakers have a lot of room to support the economy if they wish to do so.

Inflation continues to trend lower, but at varying speeds. The trend is best established in the US, despite its more robust economy, whereas in Europe core inflation rates in particular have yet to peak convincingly. China currently faces negligible inflation, one of the reasons its authorities are able to reduce interest rates while those elsewhere are still raising them.

Overall, our view of the wider economic cycle remains unchanged. A technical recession is still possible in the major economies, as the full effects of monetary policy have still to make themselves felt, and it would be surprising if there were to be no further financial accidents after such a rapid tightening. However, we continue to believe that a more significant downturn is neither necessary nor likely. In Europe in particular the fall in energy costs is starting to support spending power in the face of those higher interest rates. But we doubt that economic growth will be strong enough to prevent spare capacity from starting to grow again. This, together with the fading of earlier bottlenecks, and labour markets which remain remarkably well-behaved (despite cost of living pressures and those low unemployment rates), is likely to allow inflation to continue slowly to roll over. That said, we do not see US and European inflation rates returning sustainably to target, but see them likely sticking in the 2-4% region.

INVESTMENT CONCLUSION

Economies are thus soft enough to suggest that central banks have nearly finished raising interest rates, but not sufficiently weak to suggest that interest rates can soon start falling again. Against this backdrop, the last month has seen both bond and stock prices fall.

In late July we moved overweight on stocks, and despite August's setback we think this remains the right stance. The risk of monetary overkill has faded, and expectations for corporate profitability are stabilising at healthy levels. Stock prices have already risen significantly from last Autumn's lows, and are not cheap, but we think that a substantial "risk on" rally may still lie ahead (aided perhaps by some further improvement in US-China tensions around Taiwan). We cannot predict the timing with confidence, but moved overweight in anticipation.

Bonds are no longer expensive, and more bonds in the US and UK are once again offering yields which seem likely to exceed even the above-target inflation we expect to continue. However, with the final instalments of monetary tightening still uncertain, and with resumed rate cuts only a remote prospect, we think it is perhaps premature to turn more positive – particularly in Europe, where real yields remain lower, and where we only returned to neutral in July.

Asset allocation overview

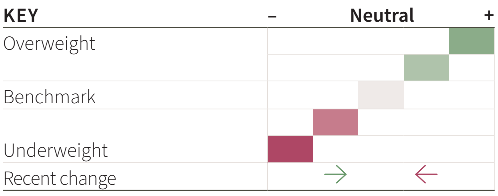
Equities. We restored our equity stance to overweight in late July, having cut it to neutral after Russia's invasion of Ukraine, but left our regional and sectoral preferences unchanged. We continue to favour the US and emerging Asia, China's short-term difficulties notwithstanding, and remain underweight in defensive Switzerland and the UK, while tilting portfolios towards a mix of growth and cyclical sectors, at the expense of defensiveness. We funded this move by reducing liquidity.

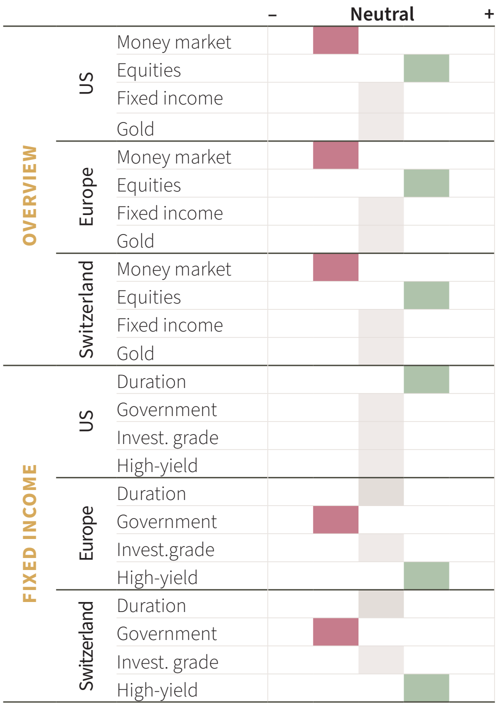
Fixed income. Last month we closed our long-standing underweight, in European portfolios, in bonds. That left our fixed income positioning aligned more closely with that in the US (the remaining divergence being that in European portfolios we still favour high-yield credit, whereas in US portfolios we are neutral on credit quality). As with the equity move, we funded this addition to bonds in European portfolios from liquidity.

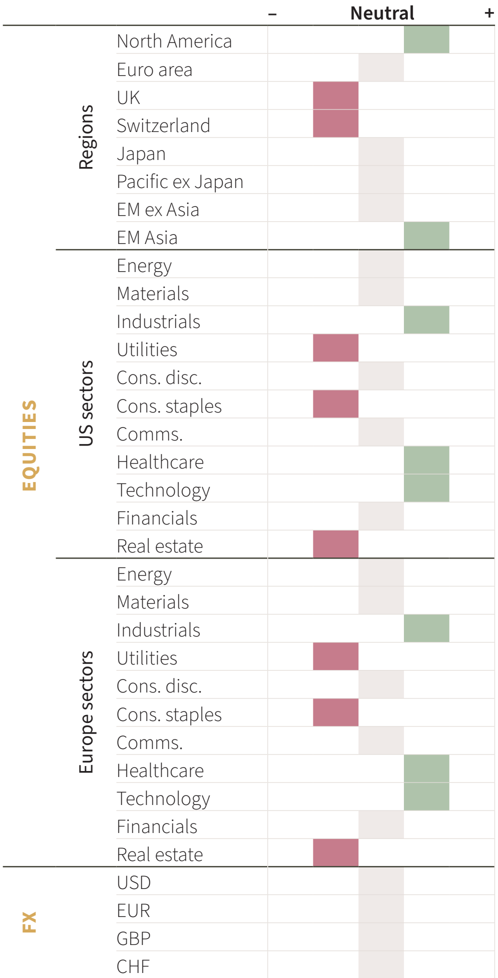
These changes left our overall asset allocation similarly positioned in US and European portfolios: we have a single overweight in equities, a single underweight in liquidity, and a neutral position in bonds. We can imagine being overweight both asset classes at some stage, but that likely requires (even)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

Currencies. We continue to have little conviction on the major currencies – a view which has actually served us well in the recent low-volatility foreign exchange climate. The dollar's underpinnings are arguably less robust than of late: the Fed looks closest to completing its monetary tightening, and a resilient global economy and improving risk appetite are arguments for dollar weakness, not strength. The US currency also looks expensive. But this is not a strongly-held view, and it has not carried 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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