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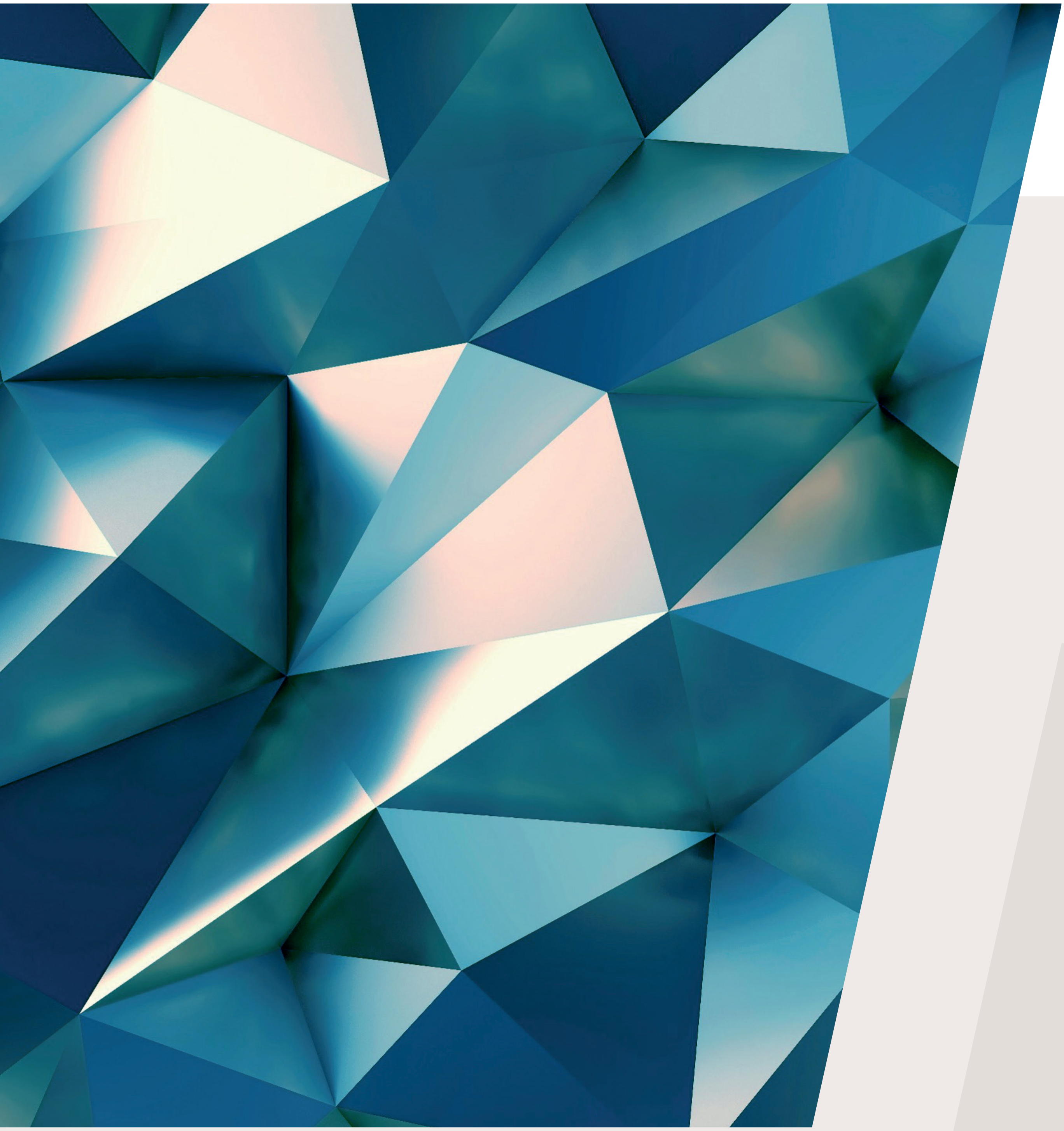

MAY 2023

Mosaique Asset Allocation

Our current view

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KEY TAKEAWAYS

- Banking stress fades, but remains the most pressing tactical headwind;
- Growth persists and disinflation mostly continues, albeit patchily;
- Investment view: overall risk appetite unaltered, Mosaique portfolios still relatively liquid .

The cyclical risks markets had to deal with in 2022 had been fading, even as geopolitical risks (Ukraine, and heightened China-US tension) remained elevated. Inflation was subsiding slowly and patchily, and economic growth was looking resilient.

However, in March the collapse of Silicon Valley Bank ("SVB") in the US, the directed takeover of Credit Suisse in Switzerland, and renewed worries about possible wider contagion, revived worries about banks. These worries faded a little in April but remain elevated. As a result, the main cyclical focus has shifted back to growth and corporate earnings, while inflation and interest rate risk has been somewhat side-lined.

We doubt that a full-blown banking crisis is at hand. The banks affected to date have displayed very idiosyncratic risk; banks in general look well-capitalised (certainly by comparison to 2007/8); asset quality is higher; and the authorities have shown themselves willing to act decisively and speedily.

Such a crisis would be highly deflationary, eliminating the need for higher interest rates: the money markets' more optimistic re-pricing makes sense. However, if one does not materialise, and systemic risks ebb once more, then we may yet see implied interest rates – and with them, bond yields – rebound, though they may not reach the levels that might have been on the cards before SVB's collapse. The mere threat of bank contagion, and the likely tightening of credit standards that will now be accelerated, helps to reduce inflation risk.

Meanwhile, developed economies' terms of trade continue to improve as energy costs – particularly natural gas prices – have fallen, and China's re-opening also promises support for growth. Yet, if a monetary seizure is avoided – as we think it will be – the economic prospects for the rest of the year may not have deteriorated significantly.

Valuations remain unremarkable for stocks: cyclically-adjusted PE ratios are close to trend. Bond prices, however, have been boosted by the renewed flight to safety sparked by banking nerves, and in Europe especially look a little expensive.

INVESTMENT CONCLUSION

Clearly, we are still not out of the cyclical woods. Until March it was interest rates holding us back from adding to stocks, but now, with perceived bank risk elevated, the cloud over corporate earnings and profitability has deepened again, after seeming to lift for a while. In these circumstances the lower interest rates currently priced into money markets offer only partial compensation. Our equity positions remain at neutral, and our regional and sectoral positions are unaltered.

Nor are we inclined to chase bond markets higher: if we are right, this latest flight to safety may not last. In European portfolios we never quite reached valuations at which we were happy closing our long-standing underweight positions in bonds, and at these higher prices we still aren't.

Once again, this leaves us with relatively few active positions by the standards of the last few years. But as we still stand on the brink of a new cycle, albeit one which may be postponed by this bout of bank nerves, this seems appropriate.

Asset allocation overview

In early 2022 we reduced our equity positions to neutral, in two stages, taking our liquidity holdings to overweight, and staying double underweight in bonds. Later in the year, we used some of the liquidity to reduce the bond underweight, and in US portfolios eventually closed it completely.

As interest rates approached a peak, and global business surveys seemed to be bottoming out, we stayed neutral on stocks but at end-January tilted more towards cyclical exposure, and away from defensiveness. We also further adjusted US fixed income positions to reflect what we have seen as improved relative valuations for Treasuries.

Fixed income. Before SVB's collapse, European bond yields had still not quite returned to levels that we think offer long-term inflation-beating returns, and the European Central Bank seemed furthest away from peak policy rates. Subsequent developments have not changed this judgement, and we stay underweight fixed income and duration in European portfolios, with an ongoing preference for the speculative grade (high yield) segment (heightened perceived bank risk notwithstanding).

In US portfolios, we stay neutral on both the asset class and duration, and most recently on credit quality too, having closed a long-standing underweight on the highest quality bonds at end-January.

Equities. At end-January we also closed a long-standing overweight on the US, and an underweight in continental Europe (ex Switzerland). Europe is the better play on a stabilising global economy – which is still what we expect eventually to prevail – and the relative lack of "growth" stocks may not matter so much in the next cycle. Being neutral on the two big regions we think leaves us well placed to watch the evolving tussle for leadership.

We also re-established an overweight position in emerging Asia – somewhat chastened, as we had closed the position relatively recently, at lower market levels. But the facts had changed: China's cyclical outlook improved materially with the unexpected abandonment of its zero-covid stance, and has continued to do so. This judgement is not altered by the bank scare. The counterpart was a renewed underweight position in the defensive Swiss market – which has indeed subsequently underperformed, albeit not for this reason.

In European portfolios, we also closed an underweight in financials in late January, and reduced an overweight in (defensive) healthcare. Our sector views in Europe and the US have since been fully aligned, and are not yet affected by bank-related fallout.

Currencies. Despite benefitting – with bonds – from some revival in safe-haven appeal, we still think the dollar's underpinnings remain less robust than of late. The Fed still looks closer to delivering likely peak interest rates, and the global economy and risk appetite may be stabilising – arguments for dollar weakness. The US currency also looks expensive. Currency conviction should be low, but we see a stronger euro as part of the possible eventual return from that regional shift in equity holdings.

Asset allocation

KEY	–		Neutral		+
Overweight					■
				■	
Benchmark			■		
		■			
Underweight	■				
Recent change		→		←	

			–		Neutral		+
OVERVIEW	US	Money market			■		
		Equities			■		
		Fixed income			■		
		Gold			■		
	Europe	Money market				■	
		Equities			■		
		Fixed income		■			
		Gold			■		
	Switzerland	Money market				■	
		Equities			■		
		Fixed income		■			
		Gold			■		
FIXED INCOME	US	Duration			■		
		High-grade			■		
		IG low-grade			■		
		High-yield			■		
	Europe	Duration		■			
		High-grade		■			
		IG low-grade			■		
		High-yield				■	
	Switzerland	Duration		■			
		High-grade		■			
		IG low-grade			■		
		High-yield				■	

			–		Neutral		+
EQUITIES	Regions	North America			■		
		Euro area			■		
		UK			■		
		Switzerland		■			
		Japan			■		
		Pacific ex Japan			■		
		EM ex Asia			■		
		EM Asia				■	
	US sectors	Energy			■		
		Materials			■		
		Industrials			■		
		Utilities		■			
		Cons. disc.			■		
		Cons. staples			■		
		Comms.			■		
		Healthcare				■	
		Technology				■	
		Financials			■		
		Real estate		■			
	Europe sectors	Energy			■		
		Materials			■		
		Industrials			■		
		Utilities		■			
		Cons. disc.			■		
		Cons. staples			■		
		Comms.			■		
		Healthcare				■	
		Technology				■	
		Financials			■		
		Real estate		■			
FX		USD			■		
		EUR			■		
		GBP			■		
		CHF			■		

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