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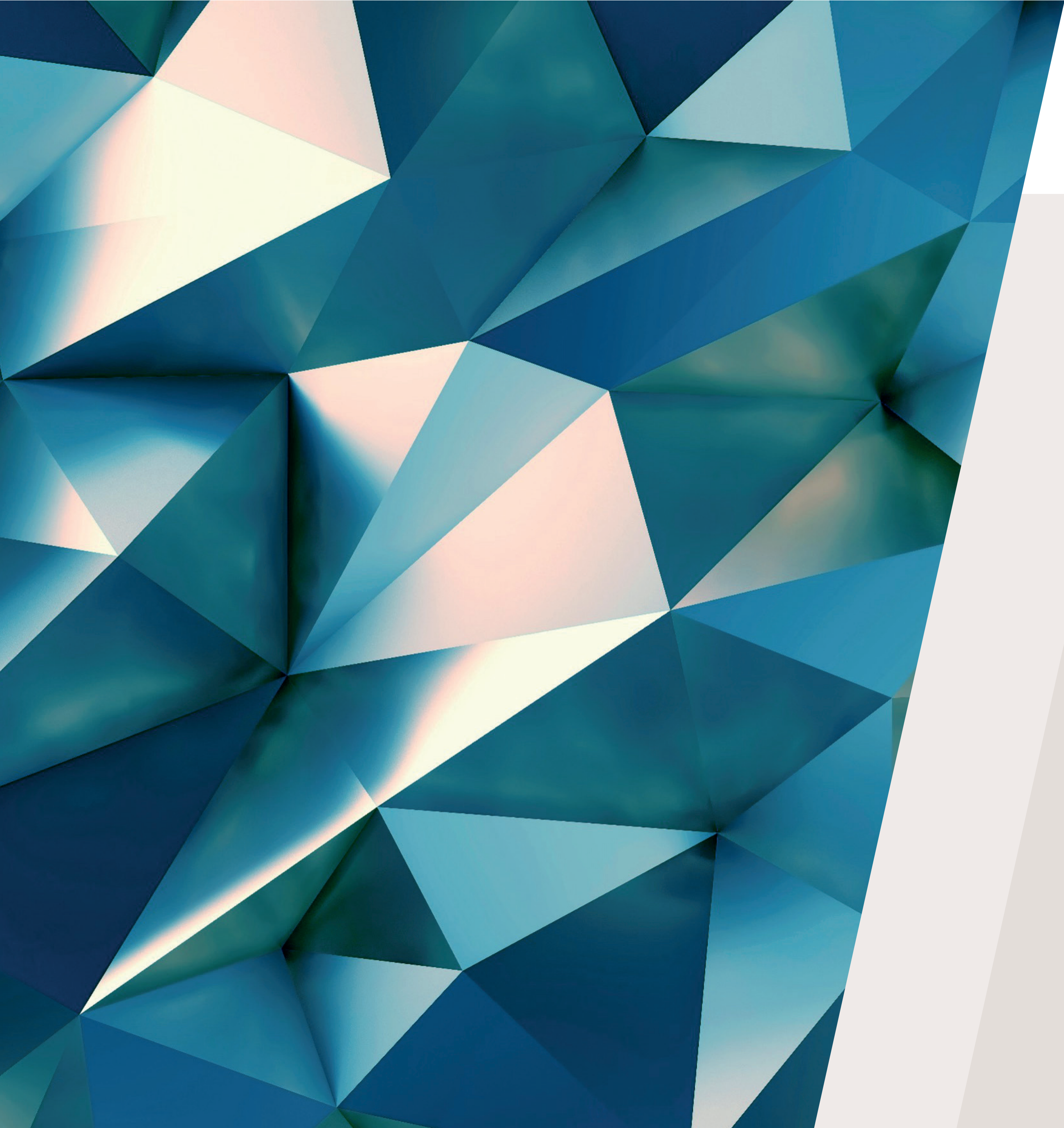

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Mosaique Asset Allocation

Our current view

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KEY TAKEAWAYS

- Inflation is rolling over, and interest rates seem close to cyclical peaks
- Growth risks may be moderating
- Tactical headwinds for portfolios are fading as a result

The cyclical risks markets had to deal with in 2022 may be fading, even as geopolitical risks (the Ukraine War and heightened China–US tensions over Taiwan) remain elevated.

Most importantly, inflation risk seems to have peaked – and with it, interest rate risk. Headline inflation has slowed on both sides of the Atlantic, and in Europe especially a four-fifths decline in the wholesale cost of natural gas suggests this trend will gather momentum during the year.

Underlying inflation rates look more stubborn, and have yet to peak definitively in Europe. However, wages – labour unrest notwithstanding – are not accelerating as they might have done, and core inflation rates too seem likely to subside gradually.

Meanwhile, the policy rates now priced into money markets later this spring are back at what we used to think of as "normal" levels (though central bank balance sheets aren't yet). Growth in aggregate demand has moderated, and supply constraints have also eased somewhat.

The slowing in growth does not yet look severe. Technical recession is still possible in 2023, but there are few signs yet of a more dramatic downturn, despite widespread predictions to the contrary. We continue to think that such a downturn is neither necessary nor likely.

The big objective threats to growth have been the worsened terms of trade for developed economies that resulted from surging commodity costs, and the impact of that belated normalisation of nominal interest rates. China's zero-covid policy has also been a significant restraint in the emerging world.

Two of these threats have faded materially. Those falling natural gas prices in Europe have cancelled and partially reversed the terms of trade hit, and China has abandoned many covid controls. Higher interest rates have yet to make themselves fully felt, but real rates are not high, and the normalisation of nominal rates may not be that potent.

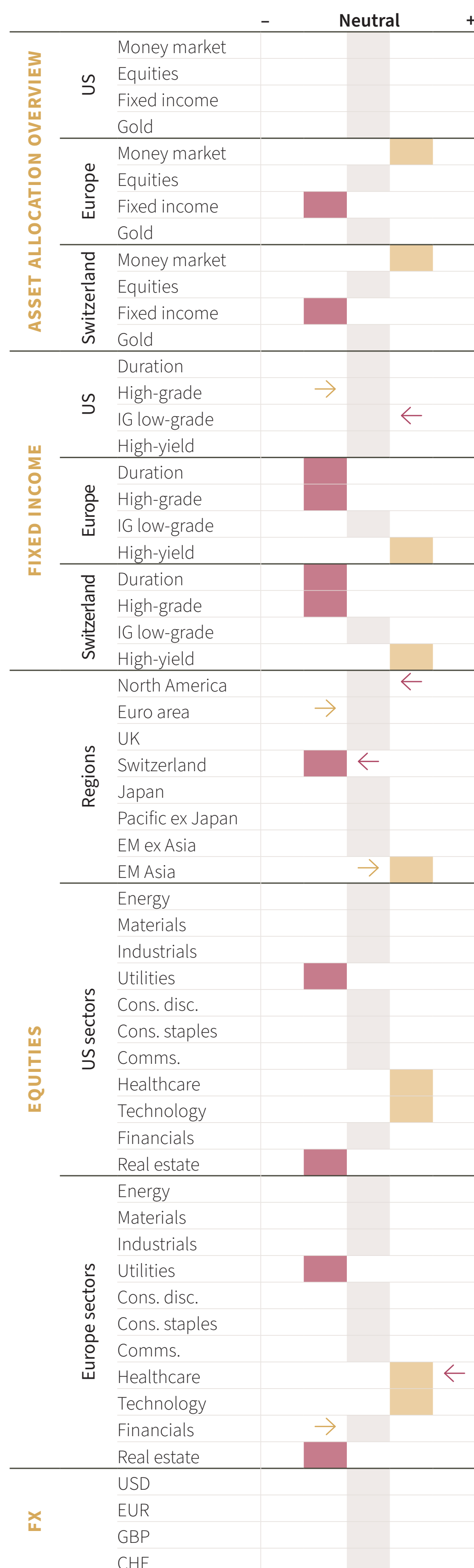
Meanwhile, market valuations have been looking reasonable. Stocks were not outlandishly expensive to begin with, and recent cyclically adjusted valuations have been in line with long-term trends. Bonds were egregiously expensive, and the big European government markets have not yet reached levels that to us look attractive (the US market looks better value). But if bonds are not yet offering textbook "risk-free returns", they at least no longer resemble "return-free risk".

INVESTMENT CONCLUSION

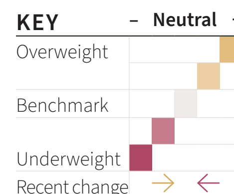
We are not out of the cyclical woods yet. Interest rates may not start to fall as quickly as the money markets believe, and expectations for corporate profits in 2023 are likely too high. We are not yet ready to add significantly to equity positions. In the fixed income portions of US portfolios, we are becoming more quality conscious, not less (as noted, government valuations there improved more than in Europe). But we are changing the disposition of our equity weightings, away from defensiveness and towards regional and sectoral cyclicality.

Net, this leaves us with fewer active positions. But as we stand on the brink of a new cycle, and the potential new leadership it could bring, this seems appropriate.

Asset allocation overview



As interest rates approach a peak, and global business surveys seem to be bottoming out, we remain neutral on stocks but are tilting towards cyclical exposure and away from defensiveness. We are further adjusting US fixed income positions to reflect what we see as improved relative valuations for Treasuries.



Fixed income. European bond yields do not seem to offer long-term inflation-beating returns, and the ECB may be furthest away from peak policy rates. We remain underweight fixed income and duration in European portfolios, with a preference for the speculative grade (high yield) segment. In US portfolios, where we are neutral on the asset class and duration, we are moving to neutral also on credit quality, closing a long-standing underweight on the highest-quality bonds.

Equities. We are closing a long-standing overweight on the US, and closing an underweight in continental Europe (ex Switzerland). Europe is the better play on a stabilising global economy, and the relative lack of "growth" stocks may not matter so much in the next cycle. Being neutral on the two big regions leaves us well placed to watch the evolving tussle for leadership.

We are re-establishing an overweight position in emerging Asia. We are somewhat chastened, as we only closed the position recently, at lower market levels. But the facts have changed – China's cyclical outlook has improved with the abandonment of its zero-covid stance, and the government is also signalling greater tolerance towards previously penalised sectors. The counterpart is a renewed underweight position in the defensive Swiss market.

In European portfolios, we have closed an underweight in financials and reduced an overweight in (defensive) healthcare. Our sector views in Europe and the US are aligned.

Currencies. The Fed is almost done, and the global economy and risk appetite may be stabilising – arguments for a softer dollar. The US currency also looks expensive. Currency conviction should be low, but we see a stronger euro as part of the possible return from that regional shift in equity holdings.

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