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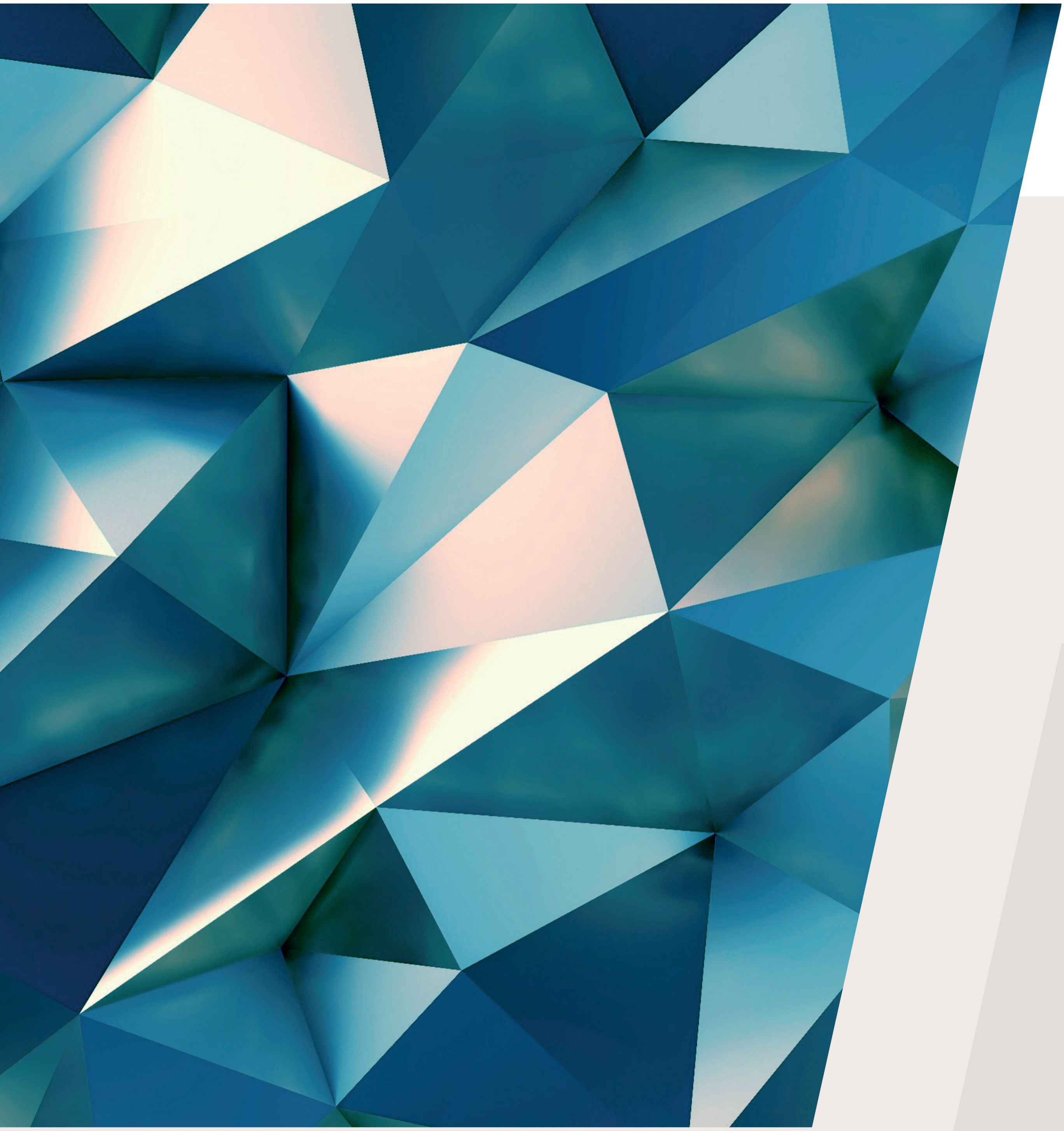

JULY 2023

Mosaique
Asset Allocation

Our current view

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KEY TAKEAWAYS

- Growth still slowing, but core inflation looks stubborn
- Central bank tightening still not quite finished
- Investment view: lengthening European duration; raising US equity weightings.

Banking worries have receded further, but there are ongoing concerns about both profitability and, especially, interest rates. Business surveys suggest that growth will slow further in the second half of 2023, while stubbornly-sticky core inflation is keeping central banks on their toes, and policy rates have yet to peak.

That said, a more dramatic economic setback still feels neither necessary nor likely. Developed economies' terms of trade have rebounded sharply as energy costs have fallen, while China's reopened economy has little inflation, and so can benefit from resumed policy stimulus should it be required. Supply-side resilience suggests that the growth in prospect need does not prevent Western inflation from eventually falling back more decisively, though a sustained return to 2% targets seems unlikely, and resumed cuts in interest rates seem a long way off. Central banks have to rebuild their monetary credibility first.

INVESTMENT CONCLUSION

Valuations remain unremarkable for stocks: cyclically-adjusted PE ratios are close to trend, the recent technology-led rally notwithstanding. Meanwhile, having long been expensive, bond prices are now offering better value, even in Europe.

However, those residual tactical concerns over interest rates and earnings suggest again that it is still too soon to return to an overweight position in stocks, and recent changes have been adding cyclicality while staying neutral on the asset class. We have seen the narrowly-led advance in stocks to date as largely a reflection of those artificial intelligence developments, not as a wider "risk on" move.

We are now making a further regional change, and turning more positive on the US equity market, where the interest rate cycle is perhaps most advanced and inflation better behaved, and correspondingly less positive on the UK.

Meanwhile, though higher interest rates have restored some value to bond markets, as noted, it has done so patchily, and in European portfolios we remain underweight, in favour of liquidity. That said, we do now see more value emerging in longer-dated bonds, and are moving up to benchmark duration in European portfolios.

We continue to have few strong convictions on currencies – something which has served us well of late. The dollar's underpinnings are now perhaps less robust than they were, as the Fed may be closer to likely peak interest rates, and the US currency also looks a little expensive. Sterling, by contrast, has looked a little cheap. But this has not stopped us moving in the other direction in our regional equity positions, as noted.

Generally, we continue to have fewer open positions than we have in most recent years, but we see this as natural as we wait to see the likely shape of the next, more disinflationary business cycle.

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.

We have since stayed neutral on stocks but have recently been adding more cyclicality at the regional and sectoral level. We have retained the underweight in European bonds, but have been adding to duration.

Fixed income. The European Central Bank may still be furthest from peak policy rates, and we stay underweight fixed income in European portfolios. However, we are now moving up to benchmark duration. In US portfolios we have been neutral on bonds, and last month moved to above-benchmark duration.

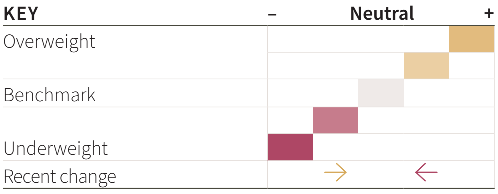
In European portfolios we retain a long-standing preference for speculative grade credit ahead of government bonds. Spreads are not especially high, however, and at some stage – as interest rates rise further – it may make sense to close or reverse this preference. By then, stocks may be a relatively more attractive source of economic exposure.

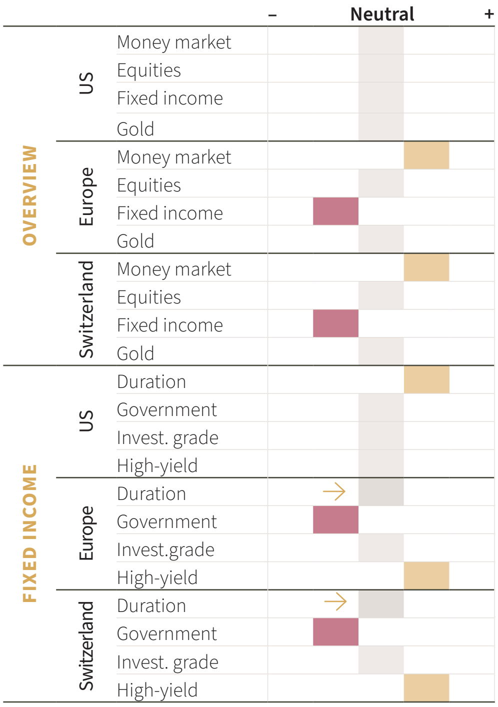
Equities. We are restoring the US to overweight (we closed the earlier position in late January), as US inflation is falling most convincingly and interest rates may be closest to their highs. A natural counterpart is to reduce the UK to underweight: it tends to be a lower-beta market, with little exposure to the "growth" segment that has been leading markets higher to date.

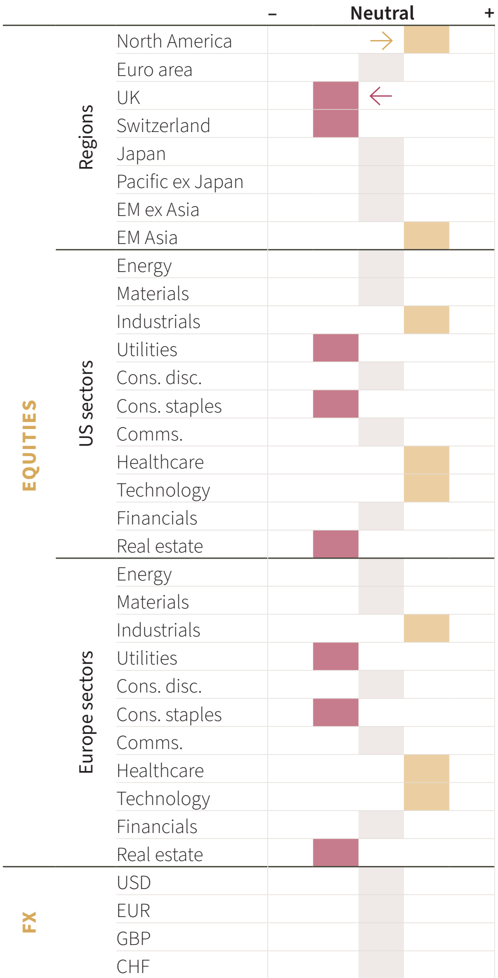
Elsewhere, we continue to favour the cyclical emerging Asia region – despite the seeming stop-start nature of China's rebound – to the more defensive Swiss market.

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. That said, these considerations do not carry through to our regional equity positions.

Asset allocation







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