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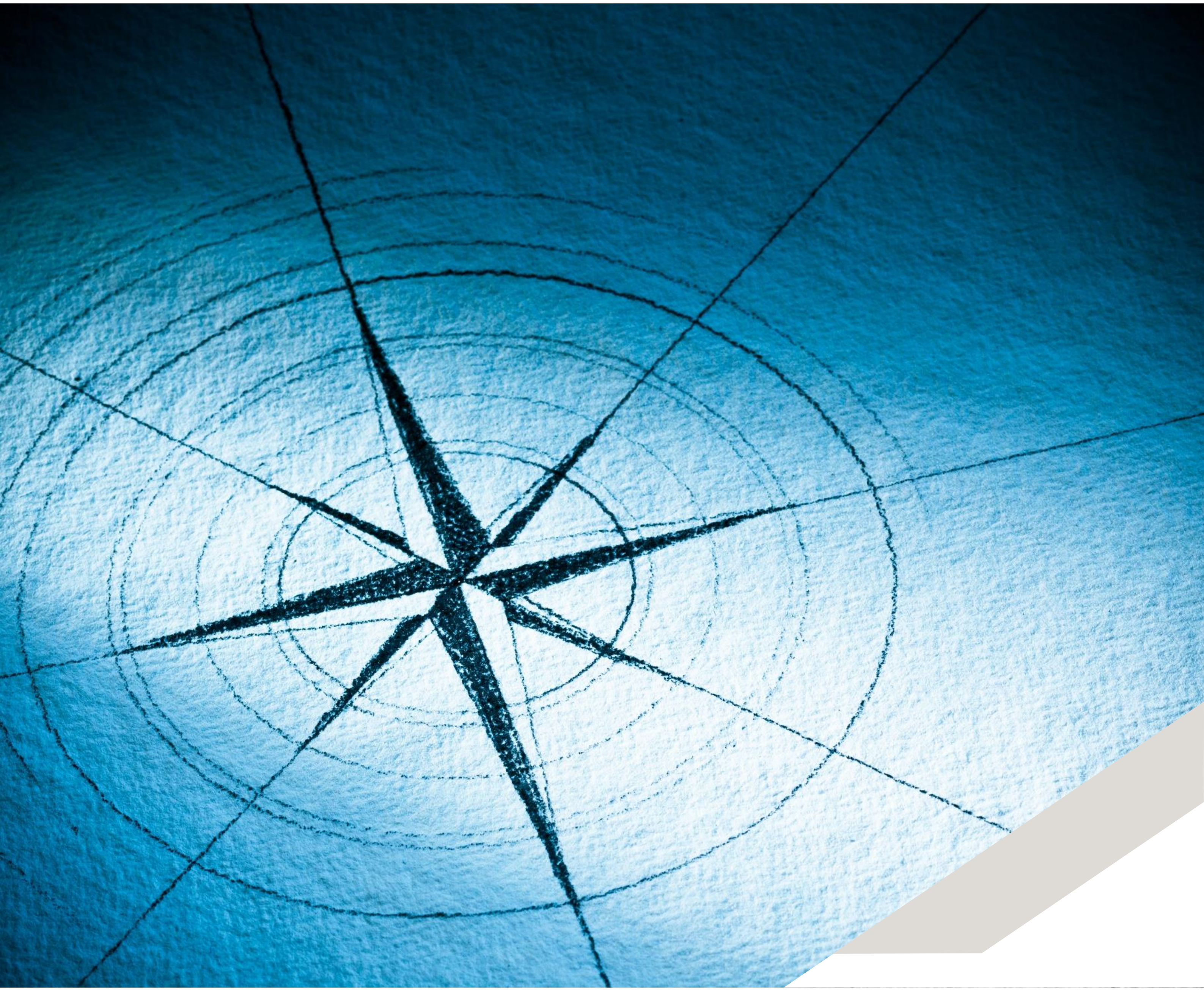

Scenario analysis

What if…?

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Foreword

The year ahead is one in which political concerns loom large. In addition to ongoing conflicts in Ukraine and the Middle East, we face a US presidential election; a European continent grappling with its own forms of populism; and a probable general election in the UK. Meanwhile, Taiwan's presidential election result will have done little to reassure China. Rarely can Switzerland's localized politics have offered such an oasis of stability.

We often note that geopolitics, unlike the business cycle, does not always have an impact on impersonal financial markets: things that matter to us as people do not always affect economies and investment portfolios. However, this scenario analysis, coming at such a politically-charged time, offers an opportunity to explore what might happen if it did.

We thus define a "worse" case here as a tense scenario in which conflict-related supply disruptions and spikes in energy costs occur alongside the growing prospect of resumed high-level trade tensions and geopolitical face-offs. Risk aversion would rise, and international investment and trade flows might falter – but if bottlenecks cause inflation to rebound for a while at least, policy rates might not fall as much as markets currently expect.

Our central scenario, as usual, is the one with which Mosaique portfolios are currently aligned, and it has not altered much since our last exercise.

In this central case, the recent mix of disinflation with economic resilience continues. Growth may remain anaemic, but a more significant economic setback will be kept at bay by the revival in real wages, and by the fading of interest rate risk as inflation continues to moderate (the result of more flexible labour markets and the partly supply-driven nature of the initial upturn).

The main change to this case is a more constructive stance on fixed income, especially longer-dated bonds, in European portfolios, where we recently closed a long-standing underweight (we had already closed a fixed income underweight, and moved longer in duration, in US portfolios).

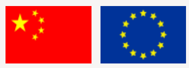
The "better" case we offer this time is also less conventionally economic in nature. In this more relaxed scenario we see energy prices not just stabilizing but falling to new lows, driven by (1) plentiful supply of carbon-based forms in a more stable world in which US shale supply is rebounding strongly, and (2) ongoing evolution in renewables technology and costs as we slowly start to leave the oil age behind.

In this better case, growth would be stronger, and more conventionally cyclical, and risk appetite higher. Yield curves, however, might be steeper, as medium-term concerns over non-energy costs resurface.

Kevin Gardiner
Global Investment Strategist

What if? - Three market scenarios

Geopolitical risk seems an obvious source for a possible “worse case” as we enter 2024, while a combination of tactical oversupply and secular transition suggest developments in energy as a source of a “better case”

Scenario	***Geopolitical tensions***	***Mosaique views R&Co central scenario***	***Energy glut and transition***
Position	Worse case	Base case	Better case
Definition	Tense geopolitics threaten trade and investment, and energy disruptions push headline inflation back up	Core inflation continues to decline, even as the major economies remain resilient	Plentiful oil and gas supplies, and innovative renewables technology, deliver a big terms of trade gain to the major economies
Macro implications			
GDP	Global GDP growth falters more visibly in 2024: US joins Germany in recession	Below-trend growth or technical recession again in 2024, but no major setback	Growth rebounds to above-trend levels in 2024 and 2025
Inflation	Headline rates rebound towards double digits, re-opening wage pressures	Falls back to 2-4% range but sticks there	Headline inflation falls firmly below target, though core inflation sticks in 2-4% range
Monetary policy	Central banks decide not to cut rates significantly as they ponder the renewed inflation threat	Central banks allow rates to start falling from the spring, though not as briskly as money markets currently expect	Interest rates fall by more than markets expect: central banks unable to resist chasing lower headline inflation – even as longer-dated inflation risks grow
Investment implications[1]			
Equities	★☆☆	★★★	★★★
Fixed income	★☆☆	★★☆	★★★
Cash	★★★	★☆☆	★☆☆
Gold	★★★	★★☆	★☆☆
Investment positioning			
			
Equity regions to favour	▪ Safe havens and defensive markets (Switzerland, US and in this context UK) may outperform ▪ Avoid Japan (energy exposure) and emerging markets (risk appetite, interest charges)	▪ Developed Market returns remain driven by sector mix: leadership varies as the cycle evolves ▪ Initial leadership favours US and growth until prospect of cyclical recovery arrives. Defensive Switzerland/energy intensive UK may underperform	▪ Continental Europe outperforms as cyclical exposure leads the way; Japan benefits from cheaper oil; Emerging Asia may return to favour as risk appetite rises
Equity sectors to favour	▪ Consumer Staples, Health Care, Utilities ▪ Energy	▪ Cyclical rotation to fluctuate with the business cycle ▪ Currently favouring: Information Technology, Health Care, Industrials	▪ Big energy users, consumer stocks may be gainers ▪ Financials benefit from steeper yield curve, fewer provisions ▪ Companies targeting Net Zero technologies to benefit
Fixed Income and Credit segments to consider	▪ Govies over Investment Grade over High Yield ▪ Yield curve flatteners	▪ High Yield over Investment Grade over Govies	▪ EM Debt ▪ Yield curve steepeners

[1] Investment implications stars are shown on a relative basis of one asset class vs the overall scenario result. The rankings for the Geopolitical Tensions and Energy glut scenarios have been supported by statistical modelling done with Bloomberg scenario analysis and may differ from reality. The rankings for the Mosaique views show our current positioning.

What if? - Three market scenarios

The regional and sectoral rankings below reflect a mix of judgement and quantitative analysis, with most weight given to the former

Equity regions	***Geopolitical tensions***	***Mosaique views R&Co central scenario***	***Energy glut and transition***
North America	★★★	★★★	★★☆
Euroland	★☆☆	★★☆	★★★
Switzerland	★★★	★☆☆	★☆☆
UK	★★★	★☆☆	★☆☆
Japan	★☆☆	★★☆	★★☆
EM Asia	★☆☆	★★★	★★★
Equity sectors			
Communications	★☆☆	★★☆	★★★
C. Discretionary	★☆☆	★★☆	★★★
C. Staples	★★★	★☆☆	★☆☆
Energy	★★★	★★☆	★☆☆
Financials	★☆☆	★★☆	★★★
Health Care	★★★	★★★	★★☆
Industrials	★☆☆	★★★	★★☆
Information Technology	★☆☆	★★★	★★★
Materials	★★☆	★★☆	★☆☆
Real Estate	★☆☆	★☆☆	★★☆
Utilities	★★★	★☆☆	★☆☆

[1] *Investment implications range from returns below inflation rates (one-star), similar to inflation rates (two-star) to above inflation rates (three-star)*

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