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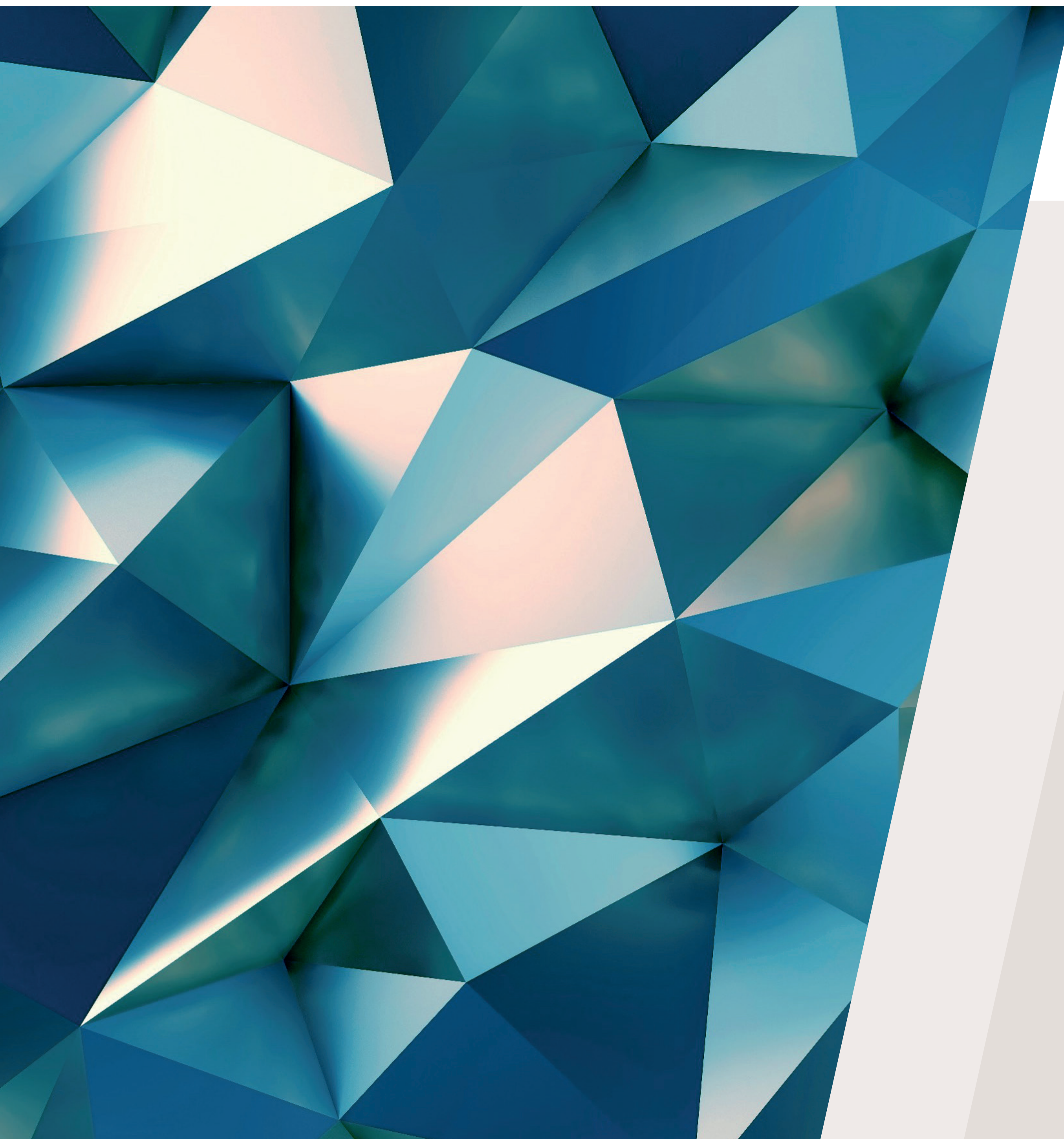

JUNE 2024

Mosaique
Asset Allocation

Our current view

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KEY POINTS

- Market expectations for interest rates may now be more realistic
- Meanwhile, the constructive macro mix of growth and disinflation continues
- We stay overweight stocks, neutral on bonds and underweight cash…
- … but make some changes to fixed income segments and equity sectors

THE MACRO PICTURE

April's re-emergence of financial volatility, which coincided with the outbreak of more direct hostilities between Iran and Israel and an ongoing re-think on the likely timing and scale of interest rate cuts, subsided in May. Stock market indices hit new highs. Bond yields remained above end-2023 levels, but short-term interest rate expectations appeared to have stabilised, suggesting that the idea of "higher for even longer" interest rates has been more fully priced in.

The business cycle is often more important for portfolios than geopolitical events, and markets' relative stability seems to have been encouraged by the continuation of the relatively favourable macro mix of ongoing disinflation with improving economic activity. Notably, for the first time in 2024, a US inflation release was in line with – rather than above – expectations, while inflation trends in Europe remained relatively benign.

Inflation generally is still looking "sticky", with a lasting return to target unlikely in our view, but not alarmingly so, given that this is likely the "last mile" of the disinflation journey. Importantly, this gradual disinflation is continuing even as business surveys stabilise, and unemployment rates remain close to historic lows. Corporate results show profitability remaining healthy, and analysts are more confident in resumed earnings growth through 2024 and into 2025.

This economic resilience has been the main reason for interest rate expectations backing up as they have done in 2024. At the start of the year, money markets were expecting around seven 25bp US rate cuts this year: in recent weeks this has fallen to just one or two. We were always in the "higher for longer" camp: we did not see expectations backing up this far, but the US economy has been even more resilient than we'd thought it might be.

Even now it would be premature to take the fabled "soft landing" for granted. After such a dramatic normalisation of policy rates, it would be remarkable for there to be no significant economic damage. That said, we still see a more severe economic downturn as neither necessary nor likely. And while the Fed seems unlikely to deliver lower rates until the autumn, a cut from the ECB is imminent (a stream of officials has offered remarkably explicit "forward guidance" to this effect). Switzerland has of course already started to reduce rates – but then it did not have much inflation to begin with.

Lower interest rates are generally positive for most assets. But stocks are able to benefit from both lower rates and economic resilience, which is why we have favoured them in our asset allocation to date. Our asset allocation remains unaltered as we now enter June: we maintain a small overweight in stocks, a corresponding underweight in liquidity, and a neutral position in bonds. We retain the room to move further underweight in cash, in favour of either stocks or bonds, depending on where the opportunity first presents itself, but still feel that this is not the right time to do so, despite the stabilisation of money market expectations. That said, we are making some small changes within our bond and stock holdings, as described below,

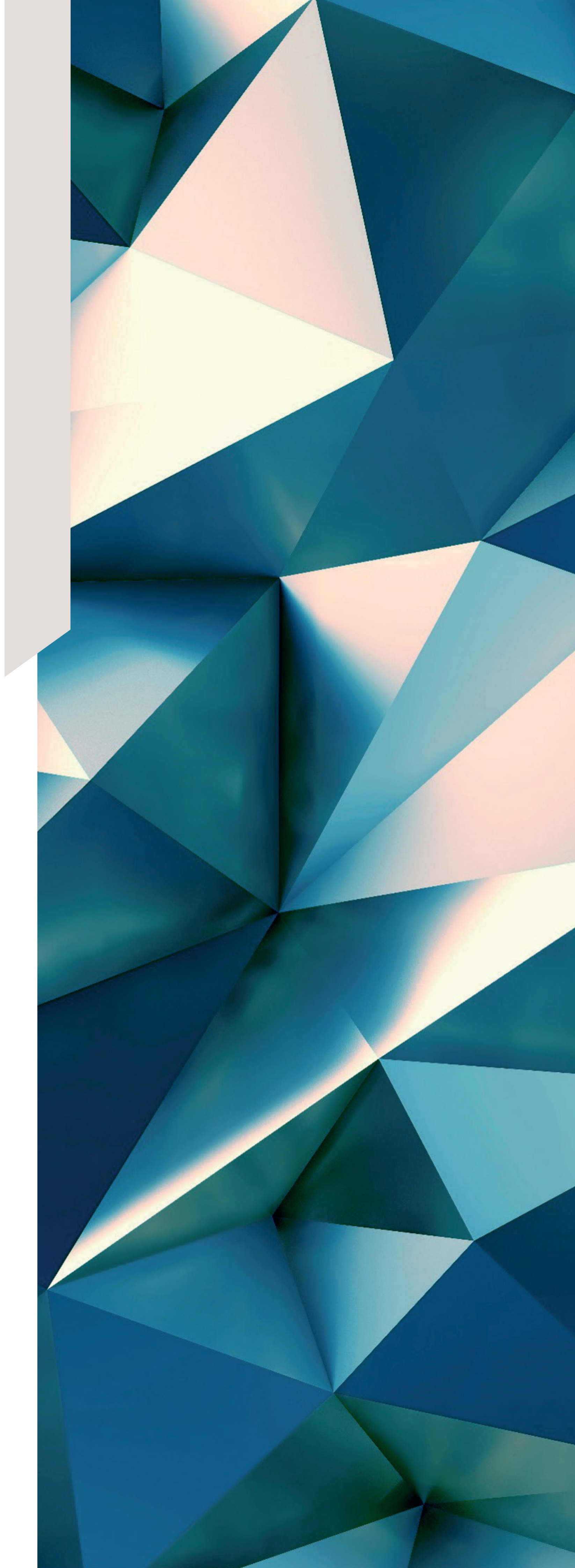
for valuation and performance (rather than macro) reasons.

The risks are not one-sided, and a significant revival in inflation, and/or evidence that higher interest rates have done more economic damage than has yet surfaced, could yet tilt our asset allocation in a more conservative direction, back towards greater liquidity.

INVESTMENT CONCLUSION

It still feels, then, too soon to be overweight bonds as an asset class, and to be fully invested in securities generally. We stay no more than neutral on bonds in all portfolios, having finally closed a residual, long-standing underweight in bonds in European portfolios in the summer, and we retain a single overweight position in stocks, financed by a correspondingly moderate underweight in liquidity.

We noted in March that some revival in short-term volatility seemed overdue. What surfaced in April was not large enough on its own to unearth significantly better tactical entry points.



Asset allocation overview

Equities. We continue to favour equities, and are encouraged by further signs that the stock market's leadership is slowly broadening, though the so-called "M7" group of US names remain in the van. Within stocks we have been favouring a mix of structural and cyclical growth sectors, and this remains the case after the sectoral changes we are now making.

We are cutting US and eurozone healthcare sectors to neutral, and lifting US communications (a growth play with some AI content) and eurozone financials (a cyclical growth and valuation play) to overweight. Healthcare has failed to perform – despite recent high-profile breakthroughs – and has behaved neither as a "growth" sector nor as a reliably defensive holding. Meanwhile, we still favour technology, but as business surveys stabilise and recession fears abate, continue to expect more conventional, cyclical growth to share more of the market leadership.

Regionally, we retain a preference for the US, where many of the more influential technology stocks are capitalised, and where developed-world economic growth tends to be more resilient. Since February we have also favoured the eurozone, which we think is able to capture the cyclical impetus from an improving global economy (perhaps more so than emerging Asia, which we cut back to neutral). Lower local interest rates would also help – but not that much, as noted.

These overweight positions have been funded by underweights in mostly defensive and interest-rate sensitive sectors, and in "low beta" markets such as the UK and Switzerland (though the latter, in particular, has been showing signs of being less rigidly defensive than usual). We continue to watch some of those sectors – especially utilities, where AI demand seems to be boosting performance recently – for signs of improving momentum as lower interest rates approach.

Fixed income. Within bond markets, we continue to favour longer-duration exposure across all currency bases, despite bonds' weakness in 2024. We still see the risk-return balance as skewed positively: with yields now back at "old normal" levels, we can see many growth bears ready to pounce on any signs of economic weakness to drive yields lower, but fewer inflation "vigilantes". If yields were to spike higher on firmer inflation data, or another rethink on longer-term policy settings, we doubt that they would stay elevated for long, and can imagine a more pronounced rally unfolding in due course as renewed recession fears took hold.

We are, however, changing our stance on credit quality incrementally. Credit spreads have fallen further and, for some indices, are close to post-GFC lows. So far this has been a "good" cycle, and defaults may be peaking – but such an outcome looks to us to have been pretty fully priced into these segments. Meanwhile, as lower interest rates approach, the attractions of straightforward rate and duration considerations is slowly increasing (though not quickly enough yet to warrant an asset class call, as noted). As a result, in European portfolios we are cutting a long-standing overweight in high yield or speculative grade bonds to go overweight government bonds, while in US portfolios we are moving overweight government bonds by cutting investment grade credit to underweight. This leaves fixed income positioning in US and European portfolios fully aligned.

Currencies. Both the Swiss franc and the yen have been lagging again – the former after reaching historic highs at year-end, the latter close to historic lows. But the dollar's recent all-round firmness did not take it outside its recent trading ranges. We will be watching closely as Fed-ECB monetary policies diverge, but currency conviction remains in short supply. Yet again, we note that the major source of portfolio volatility is usually stock prices, not exchange rates.

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				■	
		Government			→	■	
		Invest. grade		■	←		
		High-yield			■		
	Europe	Duration				■	
		Government			→	■	
		Invest.grade		■			
		High-yield			■	←	
	Switzerland	Duration				■	
		Government			→	■	
		Invest. 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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