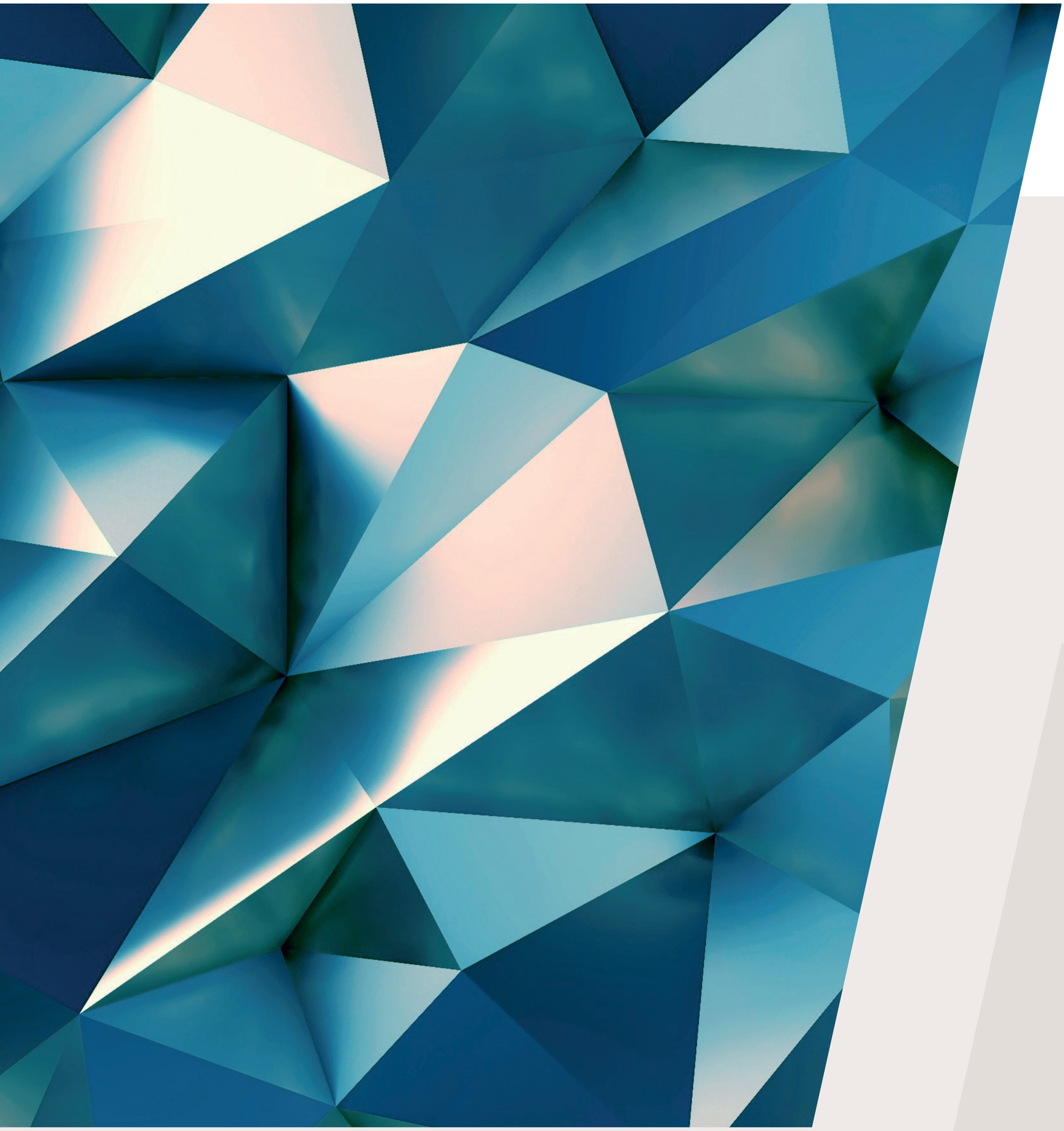
Rothschild & Co
Wealth Management



JANUARY 2024

Mosaique Asset Allocation

Our current view

Dr. Carlos Mejia
Chief Investment Officer

Kevin Gardiner
Global Investment Strategist

KEY TAKEAWAYS

- A tense year ahead geopolitically – but the business cycle may matter most to markets
- Disinflation and economic resilience can continue into 2024
- We stay overweight stocks, neutral on bonds and underweight cash

Conflict in the Middle East may be spreading to the Red Sea and Persian Gulf, but as yet the impact on the global economy seems manageable, and impersonal financial markets remain little affected. Even the geopolitically-charged US presidential election in November may have little financial impact, if history is anything to go by.

But what does seem certain to have an impact on portfolios is the continuing evolution of the biggest inflation cycle in four decades or so – and there, the news may remain constructive.

After a torrid 2022, stocks and – eventually – bonds had a solid 2023, delivering returns in excess of (falling) inflation, and in our first asset allocation meeting of 2024 we have left Mosaique portfolios positioned for more of the same. We ended 2023 favouring stocks ahead of bonds, but for the first time in many years we also prefer bonds to cash across all portfolios.

The key to market returns recently has been the combination of economic resilience with a decisive slowing in consumer prices. The resultant mix of healthy corporate profitability and disinflation has allowed central banks to pause their monetary tightening, and encouraged money markets to believe that the next moves in policy rates will be downwards, perhaps starting this spring.

The prospect of a turning point in interest rates took some time to become visible: expectations first went “higher for longer”, and if rates do now start falling from this spring they will be doing so much more slowly, and from a higher level, than the consensus thought a year ago. But as it did become clearer, it allowed bonds to stabilise and rally, while also giving further impetus to stocks, which had already been boosted by resilient corporate earnings (a big surprise to the many pundits predicting a significant economic downturn).

It is of course still too soon to take this favourable mix for granted. We doubt that the damage done by a dramatic monetary normalisation can have fully surfaced yet. But as energy costs have fallen back, especially in Europe (and despite the trauma in Ukraine and the Middle East), some relief for hard-pressed households and businesses is at hand. Real wages are growing once again on both sides of the Atlantic, and employment remains at high levels. Forward-looking business surveys continue to show little sign of an imminent slump.

And the widely-entrenched belief that a Fed tightening cycle must inevitably result in a major downturn has always been mistaken, whatever happens next. If inflation is driven not just by monetary mismanagement but also by supply constraints, it is always possible for the unlocking of those constraints to allow inflation to fall even as output continues to grow.

In this context, the most significant cyclical development in 2023 was perhaps the continuing passivity of nominal wage growth, suggesting that Western workforces have implicitly traded stable real wages for stable employment.

INVESTMENT CONCLUSION

Slowing core inflation rates in particular suggest that we are turning the interest rate corner. With bonds having sold off dramatically as “higher for longer” was priced in, there was room for them to rally in late 2023 – and they likely still have some headroom, even if (as we again suspect) policy rates don’t fall quite as fast and far as money markets are pricing in. For the first time in many years, we enter a New Year with a neutral, rather than underweight, stance in bonds in all portfolios.

In late July we moved back to overweight on stocks. We were perhaps too early, given the subsequent setback, but the market indices eventually stabilised and went on to new post-2022 highs. As noted, we are not yet out of the woods – but we do continue to think that a significant economic downturn is neither necessary nor likely.

Expectations for corporate profitability continue to stabilise at healthy levels. Valuations are not especially stretched – they weren’t even when discount rates were in the 4-5% region back in the autumn – and a further substantial “risk on” rally may still lie ahead. Stocks’ advance has been narrowly based to date, but there have been some signs of it starting to broaden.

Today’s more normal levels of bond yields may not trouble stocks’ valuation, but they do pose more direct competition (despite falling back to year end). Yields even for many eurozone bonds are offering plausibly positive returns to maturity, even if inflation does not return sustainably all the way to target. They also offer more credible diversification – and perhaps this is an area where cyclical and geopolitical risks align.

Having closed our long-standing underweight, to add further to bonds from cash now would feel a little over-confident, as it would take us close to being “fully invested“ in securities. We remain no more than neutral – though again, this is the most positive we’ve been on bonds in a decade.

Asset allocation overview

Equities. We restored our equity stance to overweight in late July, having cut it to neutral after Russia's invasion of Ukraine, but left our regional and sectoral preferences unchanged – and we are again doing so: such considerations are secondary at present.

We continue to favour the US and (less happily) emerging Asia, where China's economic growth has as yet failed to show up in corporate performance. We remain neutral on the Eurozone market, and underweight in defensive Switzerland and the UK. At the sector level, portfolios remain tilted towards a mix of growth and cyclicality, at the expense of defensiveness, and our positions in US and European portfolios are similar. We fund the ongoing overweight in stocks from liquidity.

Fixed income. In July we also closed our residual long-standing underweight in bonds (in European portfolios – we had closed it for US portfolios in late 2022). As with the equity move, we funded this addition to bonds in European portfolios from liquidity.

More recently, within fixed income, we also moved to an overweight, in European portfolios, in duration, matching an earlier move in US portfolios. This allowed us to capitalise a little on the end-year rally, which was led by longer-dated bonds.

The only divergence now between European and US portfolios is that we retain an overweight in speculative grade bonds in Europe, financed currently by an underweight in investment grade credit. Even after spreads have narrowed and yields fallen back, speculative grade bonds remain an important source of income in European portfolios, and this remains one of the better-performing segments of the entire fixed income market. The eurozone economy is the weakest of the big western economies, but even here we feel that a dramatic surge in default and loss rates may be avoided.

Currencies. As a "safe haven" currency, the US dollar could have strengthened in the face of Middle East conflict, but if anything it has softened. Generally, we continue to have little conviction on the major currencies – a view which has served us well in a low-volatility foreign exchange climate (exceptions recently perhaps being a weaker yen and stronger franc). It is equity volatility which usually dominates returns in most balanced portfolios.

Asset allocation

Wealth Insights

At the heart of Wealth Insights lies a wide set of timely and insightful publications and podcasts.

For more information please visit our page at

www.rothschildandco.com/insights

This document is produced by Rothschild & Co Bank AG, Zollikerstrasse 181, 8034 Zurich, for information and marketing purposes only. It does not constitute a personal recommendation, an advice, an offer or an invitation to buy or sell securities or any other banking or investment product. Nothing in this document constitutes legal, accounting or tax advice. Although the information and data herein are obtained from sources believed to be reliable, no representation or warranty, expressed or implied, is or will be made and save in the case of fraud, no responsibility or liability is or will be accepted by Rothschild & Co Bank AG as to or in relation to the fairness, accuracy or completeness of this document or the information forming the basis of this document or for any reliance placed on this document by any person whatsoever.

In particular, no representation or warranty is given as to the achievement or reasonableness of any future projections, targets, estimates or forecasts contained in this document. Furthermore, all opinions and data used in this document are subject to change without prior notice. Law or other regulation may restrict the distribution of this document in certain jurisdictions. Accordingly, recipients of this document should inform themselves about and observe all applicable legal and regulatory requirements. Neither this document nor any copy thereof may be sent to or taken into the United States or distributed in the United States or to a US person. Rothschild & Co Bank AG is authorised and regulated by the Swiss Financial Market Supervisory Authority FINMA.