fLAB

It´s All About Asset Allocation

July 2022, Newsletter#74

The first half of 2022 has been **amongst the worst starts ever, for both stocks and bonds**. The S&P 500 peaked on the first trading day of the year and has fallen as much as 23.6% (as of June 16), ending the quarter at -20.6%. Thus it's official, it has entered into bear market territory. History suggest that after declines of more than 15% in a quarter (-16.5% in Q2), unless the economy is in a deep recession, the stock market should rebound in the second half. But bear markets do not just end on their own, so we need that some macro factors to turn in their favor. **A second half recovery would require improvements from:**

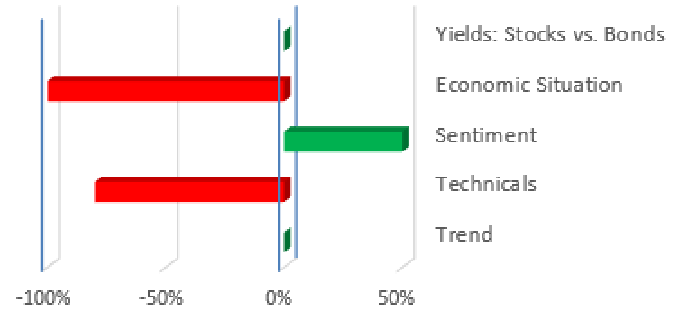
- Inflation and the Fed: a few signs of improvement on the inflation front, signaling the worst of inflation is over, could be enough to trigger a rally in stocks. The Federal Reserve is "all in" on re-establishing price stability and so does the ECB. But, there are three conditions that could alter the Fed's path before it hits its inflation target. First is the liquidity and functioning of the financial markets (which have started to deteriorate). Next are financial conditions that signal recession (credit spreads blowing out and recessionary bear markets for stocks). Credit spreads are still giving the Fed a green light, while stocks are flashing yellow. And last, is rising unemployment. Maybe the Fed can get away with running through a red light, but going through a couple of them could wind up in a crash.
- The economy: If it avoids a recession, then the current decline is approaching the average bear for both, time and price.
- Earnings: the second half estimated have barely budge so risks remain to the downside. How companies control employee costs could determine if earnings revisions in the second half are of the benign variety or a precursor to an earnings recession.
- Political risks: The war in Ukraine has already added a level of geopolitical risk in the form of higher commodity prices and negative investor sentiment. U.S. midterm elections have taken a back seat, but they could come the forefront as November approaches.As macro evidence is often only known after the rally has begun, technical and sentiment data will be key indicators to watch. Sentiment is already extremely pessimistic, positioning the market to rally in the second half. To determine if any rebounds are more than bear market rallies, we will watch for widespread breadth thrusts in order to get technical confirmation. For the time being, and until our models turned more bullish, we remain cautious.

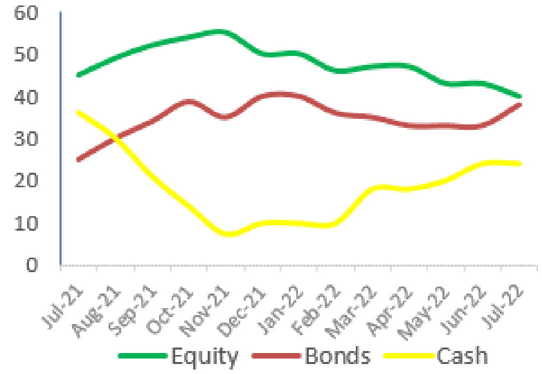
Our Global Flexible Fund, fLAB Core H-USD, has performed -10.59% in such a terrible year.

For July, our **Asset Allocation model echoes some trend deterioration of stocks against bonds**, thus turning a little bit more defensive: 40% stocks, 38% bonds and 22% in cash.

fLAB Core Asset Allocation Model		Jul-22	Benchmark
	Stocks	40%	55%
	Bonds	38%	35%
	Cash	22%	10%

Equity vs. Bonds Relative Strenght by Betalphing 5 Indicators





red (bond & cash preference) green (equity preference)

Equity Regional Allocation vs MSCI World AC

USA	*OW*	*Emerging Markets*	*UW*

Benchmark (US 57%, Eur 13.4%, Emerg Mk 12%, Jap 7.1%, UK 4.3%, Pacific 3.3%, Can 2.9%)

Equity World Sector Allocation

Energy, Utilities, Materials,	*OW*	*Cons Discretionary*	*UW*

Government Bond Allocation vs Barclays Global Government Bond Index

	OW		*UW*

Benchmark (US 48%, Europe 25%, Japan 21%, UK 6%)

All major countries and regions fell in the first half. The US was the worst region, followed by Europe ex UK. While British strength and Japan outperformance were remarkable (this one supported by the collapse in the yen). Emerging markets were weak although diverging (with some pockets of strength). The first six months of the year have favored Value over Growth sectors, but leadership has begun to transition since the June 16 S&P 500 low. If commodity prices stabilize with inflation, Growth stocks could enjoy a reprieve. Slower economic and earnings growth should favor Growth over Value as well.

Our sector model, which has favored value for most of the half, began to **shift more neutral** in May and is currently less biased towards this style. We begin the second half overweight Utilities, Energy, and Materials and underweight Consumer Discretionary. On a geographical basis, we have upgraded US to overweight, downgraded Europe ex UK and Canada to neutral and underweighted emerging markets.

In fixed income, **after having lived the most brutal first half on record**, global bond yield have started to decline since mid-June. The sharp slowdown in commodity prices and increasing fears of recession have pushed investors to buy sovereign debt at much more attractive rates than few time ago. **Have we seen the peak in 10-year treasury yields? Yes, at least for now**. We believe we have likely entered in a broad trading range, from 2.65% to 3.50%. As a result, we have neutralized our geographical bets of underweight US/ overweight Europe, and increased our total fund duration (from 2.43 to 2.94). In terms of currency, the dollar has validated once again its safe-haven status, dragging the EUR/USD to its lowest level in almost 20 years (1.0213 as I write these lines). We have a 22% real dollar exposure.

Our Relative Return Fund, fLAB Satellite H-USD, has endured quite well market volatility performing -1.86% YTD.

As we all know, **there have been few places to hide in such a hostile market**, being the US dollar Index and global commodities, the choice for most investors. However, since June 9, we have seen a commodity price decline broadened out, which if continued, would have implications on decreasing inflation expectations, economic growth and thus the broader market. A positive market response would be likely if investors would see the inflation decline as an indication that the supply disruptions had eased with demand continuing to support growth and central banks no longer hostile, the soft landing scenario in which earnings growth would hold up. A negative market response would be likely if investors would see the inflation drop more as a sign of dropping demand and a worsening recession, with negative implications for earnings growth.

The compartment enters the second half investing **50% in a low risk, low duration diversified fixed income portfolio plus 25% in some uncorrelated and tactical positions,** being the rest in cash. On the bond side, we think the worst may be behind us, with inflation fears largely priced in and possible disinflation in the coming months. Instead, in a context of global economic slowdown we will move from interest risk management to credit risk management. Our portfolio is very conservative regarding the latter but will remain flexible in terms of duration (now at 1.78 for the overall fund). In our tactical allocation, we keep 15% in equity multistrategy, 3% in global commodities, 3% in short credit (iTraxx Crossover ETF) and 3% in gold. Our overall dollar exposure is currently at 14%.

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