It´s All About Asset Allocation

April 2023, Newsletter#82

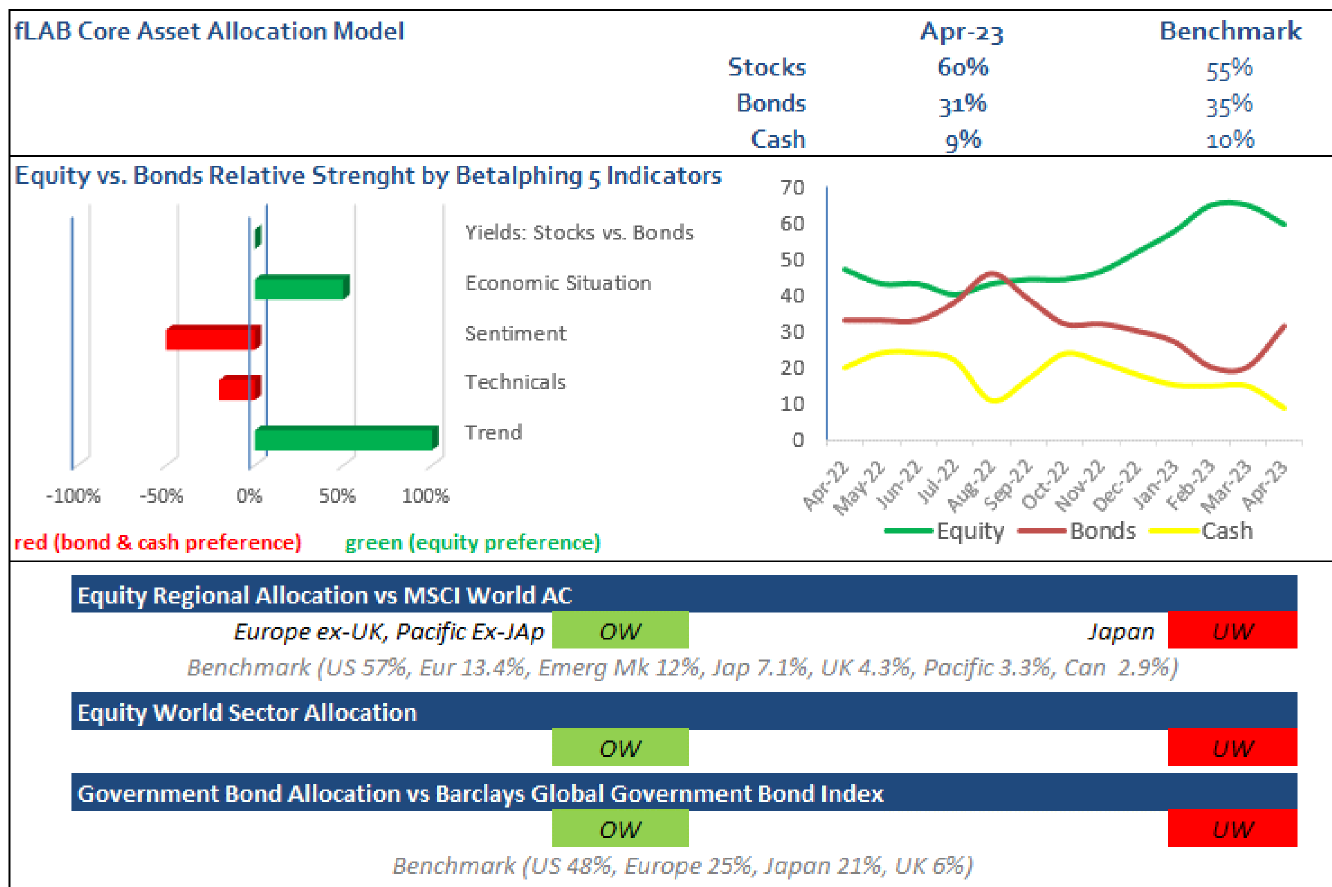
The headlines over the first three months of the year were beyond scary. They started with consensus among economists that recession was imminent. After better-than-expected economic reports, the narrative switched to higher-for-longer Fed policy. To top it off, March saw the second and third largest bank failures in U.S. history. Financial conditions have worsened across the globe since the collapse of Silicon Valley Bank. Even if an all-out bank crisis is avoided, **the end game is likely much more stringent lending standards,** which will weigh on economic growth. This increases the risk of renewed downside in the global economy late this year or early next one. **The question that arises at this point is whether the second quarter will bring relative calm rather than more big surprises. The likely answer is yes,** with volatility receding and global equities resuming the bull market uptrend that started last October. But given the current lack of indicator evidence, it would be premature to say that for sure.

The regional banking crisis sent shockwaves through the financial system, impacting Fed policy, recession risks, and bond yields. For equities, the market's initial reaction was to avoid companies that might need to tap the financial markets in the next few years. **The good news is that the crisis did not spur widespread selling of equities as an asset class**. The S&P 500 achieved to remain above its December lows and from there, bounce hard. What we have seen, is a strong rotation into companies with strong cash flow. Nowhere has it been more apparent than in the mega-cap FANMAG stocks, and nowhere is that more quantifiable than in the performance of the Nasdaq 100 Index. The NDX has risen more than 20% from its December 2022 low, meeting the traditional Wall Street definition of a bull market. A handful of stocks soared, while the rest of the market suffered. The narrative stuck, even as reality shifted. Specifically, some cited that a small number of stocks were responsible for the market's gains. The reality is that in most years, that is how it works. The largest stocks drive cap-weighted indices, and in a given year, a small number account for most of the gains. When measuring market breadth, the distinction between relative and absolute is paramount. If a handful of stocks are rallying and everything else is falling, it is a warning sign of a top. If mega-caps are leading a broad rally, it is much less of a concern. The past few weeks have been the later. **The short-term breadth improvement is a good start, but confirmation from intermediate and long-term is needed**

Another issue for this quarter will be **whether stocks and bond yields will maintain their inverse correlation**, and what are the implications. If the correlation persists, a continuing bond yield decline would most likely be accompanied by rising stock prices, with the stock and bond yield trends reflecting expectations for an economic soft landing. If bond yields would reverse course and trend higher, stocks would most likely decline, with both trends driven by rising inflation expectations. And if bond yields would drop in tandem with stocks, then a positive correlation could be expected, and the trends would reflect recession expectations. Another possibility is that the correlation would turn positive with inflation under control and real economic growth proving to be sustainable. That was the case prior to 2022, when equities and bond yields would both rise on evidence of economic growth and decline on signs of weakness.

Our Global Flexible Fund, fLAB Core H-USD, has well performed in such a volatile month (2.16%), posting an outstanding return of 4.48% YTD.

In April, our Asset Allocation model reduces stocks (-5%) and cash (-6%) in favor of government bonds. A slightly less favorable picture from technical, sentiment and economic point of view support a higher allocation into bonds.



Despite market volatility, global equities have continued to grind higher in March (+2% MSCI ACWI in local currency terms). The second quarter starts with the month that has been the ACWI's best since 1987, rising in 80% of the Aprils with a mean gain of 1.9%. As mentioned before, one of the main features over the last month has been the rotation from Value to Growth, which has been just as violent that **has sent Russell 1000 Growth/Value ratio jumping from a 38-month low to multi-year resistance**. The reason is two-fold: Financials are the biggest weight in many Value benchmarks; meanwhile, FANMAG stocks dominate the Russell 1000 Growth Index. Fortunately, our sector positioning has been quite neutral over the last two months and that's how will stay right now. Our sector model remains in a state of transition, and how the indicators break going forward will guide any future position changes. By the time being, we also keep our geographical bets.

Global yields have receded over the past month as the market expect a reversal of the tightening cycle, which **has contributed positively to our fixed income allocation through a 20% exposure and an average duration of 8.8**. Yields in the U.S. bond market are on the cusp of breaking down across most of the curve. Tens have tested our 3.35% support level on a closing basis several times and twos and fives have also been flirting with support. Bond sentiment is just starting to reverse from extreme pessimism so, there's a lot of runway for sentiment to improve before becoming a negative for bonds. The problem is that the rest of the world hasn't confirmed the potential breakdown in the U.S. So **if the data don't cooperate, yields could easily bounce off support**. A confirmed breakdown would be needed for a truly bullish view. In line with our Asset Allocation model, we have increased fixed income exposure up to 31% and also its duration, now at 9.30 (being 2.80 for the overall portfolio).

Our Relative Return Fund, fLAB Satellite H-USD, has appreciated 0.55% in this framework, accumulating 1.28% YTD.

The compartment is invested 49% in a low risk, low duration (3.75) diversified fixed income portfolio plus 24% in some uncorrelated and tactical positions, being the rest in cash. In March, **the fund has benefited from its fixed income exposure**, with global yields tending lower on hopes of a low terminal rate amid banking and growing economic concerns **and from the strong gold appreciation** (rallying above 8% and representing 4% of the fund). With the dollar and yields in retreat, gold has been resurgent. Despite a likely consolidation/correction ahead, we keep a positive view on the yellow metal due its strong momentum and its safe haven status during periods of uncertainty. Instead, global commodities (3.5% of the portfolio) have done poor, even trading below its trading range over the last months on renewed recession concerns. This month, **we haven't made remarkable changes in the fund.** We kick off the second quarter defensively positioned in terms of equity (13% exposure) and with respect to credit. Within fixed income we are positioned as follows: 28% of the fund in global corporate Investment Grade (1-5yr), 9% in Govies, 6.6% in emerging bonds and other small bets such as TIPS, Covered or High Yield. We will remain flexible in terms of equity exposure and duration (1,83 for the overall fund) trying to take advantage on renewed market volatility.

fLAB Core-A awards, Dec 2022