It´s All About Asset Allocation

January 2023, Newsletter#79

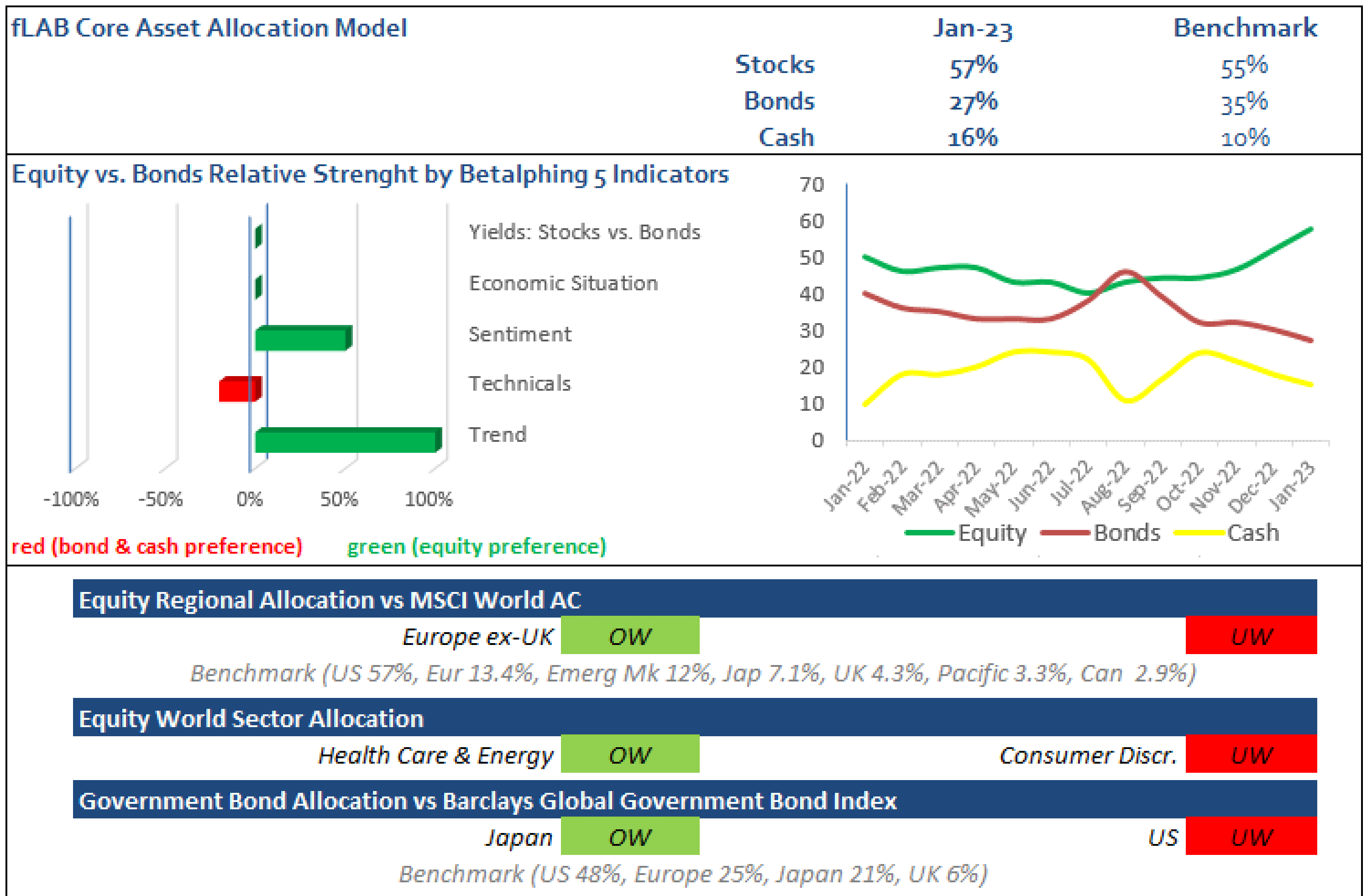
We have finally left behind a year that will become part of economic and financial markets history and, why not to say it, red accumulated returns in equities and bonds impossible to revert. The drivers are already known for all: the highest inflation and most aggressive tightening cycle in 40 years, the uneven reopening from COVID, and the Russian/Ukrainian war. From the markets' perspective, 2022 will stand out for what did not happen: unlike 1929, 1987, 2000, and 2008, **there was no stock market crash. Instead, series of double-digit selloffs were followed by failed rallies**. The S&P 500 posted its biggest decline since 2008, and the US underperformed the ACWI by the most since 2005. Stocks faced a litany of macro challenges: the economic, earnings, and Fed cycles all shifted from being accommodative to restrictive, setting the stage for the most prolonged bear market since the financial crisis.

We started 2023 with the macro headwinds still largely in place: **More Of The Same**. **The key difference is that they are further along their descents, and several could shift to being market friendly** during the year. Less clear is the path throughout the coming months. A recession could mean new lows in the S&P 500 and a steeper earnings decline. A weaker economy would allow the Fed to stop hiking as early Q1. The stock market tends to bottom before the economy, so a brief and shallow recession could allow for a cyclical bull market in the second half. If a recession is avoided, the bear market lows were likely made in the fall of 2022. Stock market gains would likely be stronger in the first half of 2023 and EPS growth could be modestly positive. Less clear would be whether a March rate hike is the end of the tightening cycle or merely a pause.

The other big risk for equities is that the **direction of earnings revisions is likely to be down**. Consensus earnings estimates appear high (especially in Q2 & Q3) if there is no recession, and fanciful if there is one. Here, the key question will be related with the magnitude. If the economy avoids a recession, revisions could be small and easier for the market to digest. But, if finally we fall into one, revisions could be the biggest since the 2020 COVID-19 shutdown. To get an idea, S&P 500 earnings decline at a 24.4% annual rate during recessions, on average. Earnings tend to lag the stock market and economy, so one cannot simply draw a straight line from the size of the earnings drop to the timing of the bear market. The S&P 500's 2022 loss (19%) amid an expected 3.6% EPS drop is a case in point of markets leading fundamentals. **Under inflation, margins matter more than sales growth** so it will be very important to watch at margin pressure since wages tend to be a lagging indicator. If overall inflation falls below unit labor cost growth (wages prove to be sticky), then margin pressures could intensify.

Our Global Flexible Fund, fLAB Core H-USD, has performed -12.2% in this "annus horribilis".

For January, our Asset Allocation model increases equity exposure (+5%) against bonds (-3%) and cash (-2%), given the following positioning: 57% equity, 27% fixed income and 16% in cash. Relative trend indicators and sentiment favor stocks over bonds.



Most countries fell sharply as the ACWI posted its worst year since 2008 (-17% in local currency). The U.S. was the worst major region at -20.8%, thus breaking a six-year stretch of outperforming the rest of the world. In contrast, the U.K. was the only major region to gain in 2022. This **divergence is explained by the different sectorial composition** of the indices as the first one is heavily weighted in growth sectors while the latter is more heavily weighted in commodity-related and defensive sectors. The biggest issue for Growth sectors was the enormous performance drag from the technology-related mega-caps. The cap-weighted FANMAG lost 37.5% for the year and has been tracking the performance after another notorious bubble peaks (since its peak on 12/27/2021). More broadly, FANMAG's downfall is part of a multi-year rotation from Growth to Value.

We started the year in the same vein, with our sector model favoring value over growth. **Equities have begun 2023 "on fire", after the failed year-end rally**, supported by better investor sentiment and the end of China's Zero- Covid policy. Technical developments are consistent with a bear market in its later stages but there is not enough evidence to declare that a bull market is underway.

Bond investors would also like to forget this past year **as fixed income had its worst year on record** (Global Treasuries USD hedged plunged 12%). The longer the duration, the worse the return. As long as central banks continue to tighten, bonds will remain under pressure. However, we believe that the bulk of the yield increase is behind us and that the yield peaks are in for the U.K. and the U.S. **We are likely to be in a trading range** at least into the first quarter (3.4%- 4.30% on the 10-yearTreasury). In Europe, we can't rule out a test or break of the highs following December's more hawkish ECB policy stance. Any legitimate breakdown or breakout should be confirmed globally. Our fixed income portfolio kicks off 2023 with a duration of 8.57 (being 2.68 for the overall fund).

Our Relative Return Fund, fLAB Satellite H-USD, has held up reasonably well with an annual return of -3.91% in this period of market turmoil.

Over the past year, we have faced a shift paradigm as we have moved from negative risk-free rate (-0,28% for the World G7 T-Bills) to an attractive 2.5%, after so many years being close to zero. This led us to **adapt our risk/return target considering our relative return policy**. The fund will aim to achieve an additional 2% above that level (from the previous 0.5%) allowing higher volatility (6% instead

of 3%), but keeping the Target Sharpe Ratio at 0.33. For this purpose, we will maintain a core, low risk low duration fixed income portfolio (47% of the fund), adding an overlay of tactical and decorrelated positions (actually at 27%). The remainder will be invested in liquidity and money market instruments. We see opportunities building in bonds and spread product but with most developed economies expected to flirt with recession, with the consequent widening of spreads, we are waiting for better opportunities and/or a pause in interest rates that will reduce volatility. So, by the time being, we stay quite conservative within fixed income with the following allocation: 29% of the fund in global corporate Investment Grade (1-5yr), 9% in Govies and other small bets such as emerging (2.8%), TIPS (2%), Covered (1.8%) or High Yield (1%).

In the most **tactical part**, we keep a 17% equity allocation, a 7% in global commodities (with gold representing 3.6 %) and the sort bet on iTraxx Crossover (3%) as a hedge against widening spreads. We will remain flexible in terms of equity exposure and duration (1,61 for the overall fund) trying to take advantage of choppy markets over the coming months.

fLAB Core-A awards, Dec 2022