It´s All About Asset Allocation

March 2023, Newsletter#81

There is no question that the disinflation process has begun, since the US CPI inflation peaked at 9.1% last June and has come down to 6.4% in January. **What is still in doubt is the pace at which inflation will continue to moderate** and whether any progress on it will be sufficient for the Fed to loosen monetary policy. Hotter than forecast inflation in the U.S (and in the Eurozone) along with some economic data showing more resilience than expected have reset rate rise expectations and pushed off expected rate cuts into 2024. **Investors brace for a higher-for-longer scenario but, what would this mean for financial markets? Let's look back to 2006.** The Federal Reserve typically reverses course relatively quickly after the tightening cycle ends but at that time, it kept rates at a high level for over a year. Contrary to what we may think, the economy performed well (it was slowing but had not yet entered recession), yields remained range-bound, spreads stayed tight, the curve was modestly inverted and Equities (S&P 500) performed remarkably well over that period, rallying over 20%. As Mark Twain once said: ´History never repeats itself, but it does often rhyme´.

The equity rally off the autumn lows has stalled in the face of rising rates, sticky inflation, and short-term optimism. Rather than letting ourselves be carried out by fear or market "déjà vu", we are going to assess the current situation. **Our internal composites** (including price-based indicators) **for stocks on both an absolute basis and relative to bonds were not deterred by the February pullback.** From a technical point of view, there has not been a significant technical damage that should alert us. If a new downtrend was in place, we would see strong selling pressure and multiple 10:1 down days (where the total volume of stocks that decline on a day is at least 10 times the total volume of stocks that rise on the day) as it was common in the first half of 2022. None have occurred in 2023, yet the market has managed two 10:1 up days. Another positive sign is that since June 2022, fewer stocks have made new one-year lows on each decline. An expanding percentage of new lows would indicate growing selling pressure beyond a healthy consolidation, but this is not the case.
The recent correction has relieved overbought conditions and short-term optimism, sending the intermediate-term one back into the pessimism zone. The early stages of bull markets often bring reluctant bears off the sidelines. The fear of missing out (FOMO) pushes them to buy, but their confidence is shaken at the first signs of trouble. A successful consolidation period would give nervous buyers more confidence on the next rally. Last but not least, If early cycle leaders do not break down during any upcoming weakness, it would be another indication of a healthy pullback rather than a resumption of the bear market.

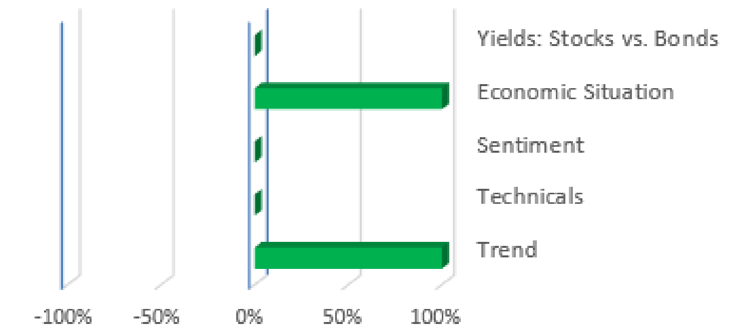
The markets will have to deal with many fronts ahead, in the likes of ´Soft landing´, ´No landing´, ´Higher For Longer´... not to mention possible hawkish messages from Fed's or ECB's officials that could derail the market at any time. Although yesterday `Bumpy´Road´ announcement, let's hope Powell doesn't back off his assertion that the disinflationary process had begun.

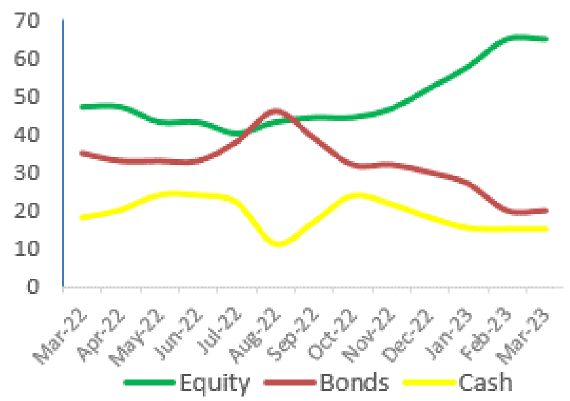
Our Global Flexible Fund, fLAB Core H-USD, has receded in a back and forth month, and is performing 2.28% YTD.

In March, our Asset Allocation model remains unchanged: 65% stocks, 20% bonds and 15% cash. The economic and relative trend indicators clearly favor stocks over bonds.

fLAB Core Asset Allocation Model	Mar-23	Benchmark
Stocks	65%	55%
Bonds	20%	35%
Cash	15%	10%

Equity vs. Bonds Relative Strenght by Betalphing 5 Indicators





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

Equity Regional Allocation vs MSCI World AC

Europe ex-UK, Pacific Ex-JAp	*OW*	*Japan*	*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

OW	*UW*

Government Bond Allocation vs Barclays Global Government Bond Index

OW	*Europe*	*UW*

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

After a stellar beginning of the year, global equities pulled back (the MSCI ACWI fell 2.04% in local currency). The S&P 500 declined 2.6%, given back roughly one-third of its gains from the October lows, the Dow Industrials was down on the year (after it fell 4,19% during the month) while the Nasdaq 100 continued to exhibit relative strength (helped by the outperformance of the FANMAG, which have surged 3.73%). Europe has been the only major region to post strong gains (+1.64% MSCI Europe) thus continuing its outperformance, in contrast with the Emerging Markets and Pacific ex Japan which have corrected the most (over 6% in dollar currency terms). **We keep our bets on a geographical basis while move closer to our benchmark in terms of sectors**. Despite the weakness, leadership trends favored cyclical sectors over defensive sectors but we prefer to stay quite neutral at this point.

Global bond yields rebounded on evidence of a stubborn inflation. **The market is pricing in a peak of nearly 5.50% on fed funds and is flirting with a peak of 4.00% for the ECB deposit rate.** Yields have made new cycle highs in Europe but are still below their September and October peaks in the U.K. and U.S. Regarding the latter, only 2 year rates have made new highs, creating an uncomfortable divergence for bond bears. As we have mentioned in previous posts, any legitimate breakout should be confirmed globally, which is still not the case. **We believe a lot of damage has already been done in the bond market** and that extreme oversold condition could lead it to an eventual rebound in the short term. But we can't rule out higher yields should data continue to surprise on the upside. In this sense, Europe is most vulnerable with inflation expectations close to making new highs and a weaker technical footing. As a result, we trim slightly our European bond exposure and back to neutral in Japan, as near-term policy risks seem limited with respect to yield curve control (YCC) normalization. We maintain an overall duration for the fund around 2 (1.93).

Our Relative Return Fund, fLAB Satellite H-USD, has not been immune to market correction but still keeps a positive return of +0.73% YTD.

The compartment is now invested 47% in a low risk, low duration (3.79) diversified fixed income portfolio plus 23% in some uncorrelated and tactical positions, being the rest in cash. We have taken advantage of **market volatility to make some adjustments in the portfolio**. On the equity side (reduced from 17% to 13%) we have decreased our exposure on low volatility stocks in favor of securities that display consistency in dividend payment. We have also rotated a small part of our most stable thematic bets (infrastructures and real estate companies) into ones with higher beta, strongly punished last year, such as Clean Energy (0.5% of the portfolio) and Digitalization (now representing 0.86%). We closed out our tactical bet on Nasdaq 100 (3.3% of the fund) after the disappointing US CPI by mid-month. In the fixed income side, we have taken 3.6% exposure to emerging sovereign debt in local currency, on prospects for a better global growth and a weak dollar over the mid-term. We will remain flexible in terms of equity exposure and duration (1.79) to benefit from a highly uncertain framework.