It´s All About Asset Allocation

May 2023, Newsletter#83

As widely expected, the FOMC raised last week the fed funds rate by 25 bp to 5.00%-5.25%, the highest since September 17, 2007. In all, there has been **an increase of 500 bp since March 2022, making it the fastest hiking cycle ever**. But it never started out in such a deep hole either, as measured by the real fed funds rate (-5% back then). Powell did not make it official that this was the last rise but his statement was quite a declaration of intent, opening the door to a possible pause (we will see if temporary or not). He will implement a "hope and pray" policy – it hopes falling inflation and tighter credit will allow policy to be sufficiently restrictive, and prays that nothing else breaks. Nothing to do with Lagarde's press conference, where she rule out a pause as inflation to stay "too high for too long".

The market action since the autumn lows has given **plenty of ammunition for the bulls and the bears**. For the first, the six months since the market bottomed would make this an unusually long stretch within a bear market without making a new low. The widely anticipated recession – the main catalyst for the 2022 decline – has yet to manifest itself. More recently, the market took a major blow from the regional banking crisis and is still standing. For the latter, the market has not followed through as one might expect in an early bull market. The S&P 500 has been trading sideways for months. Some long-term breadth indicators have confirmed, while others have not. Meanwhile, earnings growth (although beating market expectations) looks to fall deeper into negative territory, and consensus estimates remain elevated.

Our model-based approach still leans us toward the bullish camp but not without some worries as markets remain choppy and not "in gear." Transports, in particular, have been weak. On February 2, the Dow Transports rose to its highest level since April 1, 2022. Neither the Industrials nor the Utilities confirmed the move. The Transports subsequently fell back and have been underperforming since late March. Although some investors may be tempted to ignore this relatively small sector by market capitalization, they do so at their peril. The decline in distribution activity reflects weak demand for goods. If it persists, it could lead to layoffs, which could bleed over into the services sector. **Surveys reflect investor caution, as recession worries are still present**. If future economic news turns out to be less dire than expected, it could lead to more upbeat economic expectations and motivate investors to move money off the sidelines. A reversal from extreme worry has already been indicated by our short-to intermediate-term Crowd Sentiment poll and it has also been evident during the current earnings season. With just over half of the S&P 500 reporting, 79% of companies have beaten estimates. If the result holds, it will mark the index's best quarter since Q3 2021.

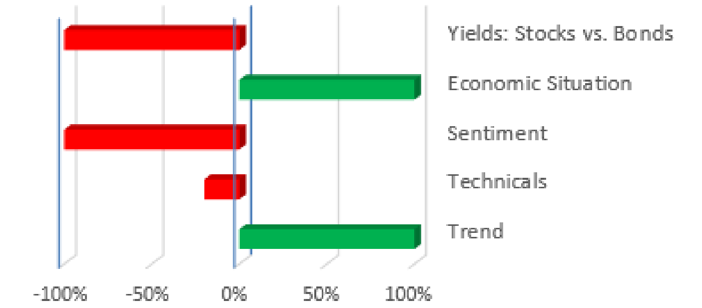
Stay tuned…

Our Global Flexible Fund, fLAB Core H-USD, has continued its good shape during April (+0.39%), posting an outstanding return of 4.89% YTD.

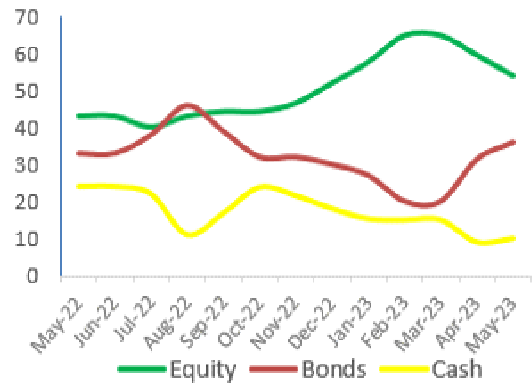
In May, our Asset Allocation model reduces stocks 5% (for the second time in a row) in favor of bonds, as yields and sentiment are less supportive for the former. We are at benchmark (55/35/10).

fLAB Core Asset Allocation Model		May-23	Benchmark
	Stocks	55%	55%
	Bonds	35%	35%
	Cash	10%	10%

Equity vs. Bonds Relative Strenght by Betalphing 5 Indicators



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



Equity Regional Allocation vs MSCI World AC			
US & Europe ex-UK	*OW*	*EmergMkts, Pacific ExJapan, UK, Canada*	*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			
Health Care & Utilities	*OW*	*Industrials*	*UW*

Government Bond Allocation vs Barclays Global Government Bond Index			
US	*OW*	*Japan*	*UW*

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

Global equities have continued to grind higher in April amid cross currents (+1.19% MSCI ACWI in local currency terms). The S&P 500 finished up 1.5% amid a backdrop of earnings season, debt ceiling negotiations, the possible conclusion of the Fed's tightening cycle, and the continued fallout from the regional bank failures. Leadership skewed defensive, with Consumer Staples, Health Care, and Utilities all outperforming during the month, and cyclical sectors of Industrials, Consumer Discretionary, Materials, and Technology finishing as the bottom performers. With the Fed apparently "on hold", whether or not the final hike is bullish or bearish for stocks has often depended on if the economy can avoid a recession. But, what we can say is that **sector leadership has tended to be more defensive around the end of the tightening cycles.** Health Care, Utilities, and Consumer Staples have had among the highest median returns six and 12 months after the final rate hike. Note that **it has taken the Fed an average of about three quarters after the last rate hike before cutting its target rate**. In response to the changing evidence and in accordance to our models, we have made the following adjustments: upgraded Health Care and Utilities to overweight and downgraded Industrials to underweight. On a regional basis, we have reduced exposure on Emerging Markets, Pacific ex Japan, U.K. and Canada, upgrading Japan to neutral.

And what could we expect for bonds? If this is the last rate hike in the tightening cycle, **then yields usually drop by the time the Fed gets around to cutting rates**. Of the ten prior cycles, yields fell in nine of them. On average, tens were down around 72 bp, fives were down around 96 bp, and threes were down about 118 bp. The only time yields rose was from 1969-70. Given that shorter-term yields fell more than longer term yields, the yield curve steepened in all ten prior cases by roughly 50 bp, on average. The Term premium behavior, instead, has been mixed. With the monthly rebalancing, we have upgraded US to overweight, thus increasing the fund duration from 2.8 to 3.10.

Our Relative Return Fund, fLAB Satellite H-USD, has been flat and is accumulating 1.26% YTD.

The compartment is invested 51% in a low risk, low duration diversified fixed income portfolio plus 21% in some uncorrelated and tactical positions, being the rest in cash. In April, the portfolio has been sideways, along with the performance of the main asset classes. Although we remain focused on the tightening of credit conditions and its impact on the economy and inflation, there are several other indicators we track that are showing a better environment for bond investors. As a result, we have increased slightly our fixed income exposure, through US Corporates 1-5Yr thus increasing the bond portfolio duration from 3.75 to 4.25. Within credit, we continue to lean with a defensive bias. If we look at spreads after the end of the tightening cycle, we would find that they have been mixed and behaved very differently in the post-Volcker era, where spreads were little changed to slightly tighter. We remain bullish on Gold (4% of the fund) while more cautious on global commodities (where we have cut half the position to 1.7%) on prospects of a global economic slowdown. We will remain flexible in terms of equity exposure (13%) and duration (2.19 for the overall fund) trying to take advantage on renewed market volatility.

fLAB Core H-USD, Jan 2023