KeyValue

ASSET MANAGEMENT

MACRO RESEARCH

ASSET ALLOCATION ANALYSIS

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The Dynamics of Liquidity in European and American Financial Portfolios

In light of the recent changes in the economic landscape, the **energy crisis** and the **high inflation** have prompted many European families to **maintain liquidity in their bank accounts as a precaution**. According to S&P Global Ratings, financing conditions for European banks have tightened, affecting credit availability, as noted by the IMF. The European Central Bank has maintained a restrictive monetary policy to combat inflation, contributing to greater caution among investors.

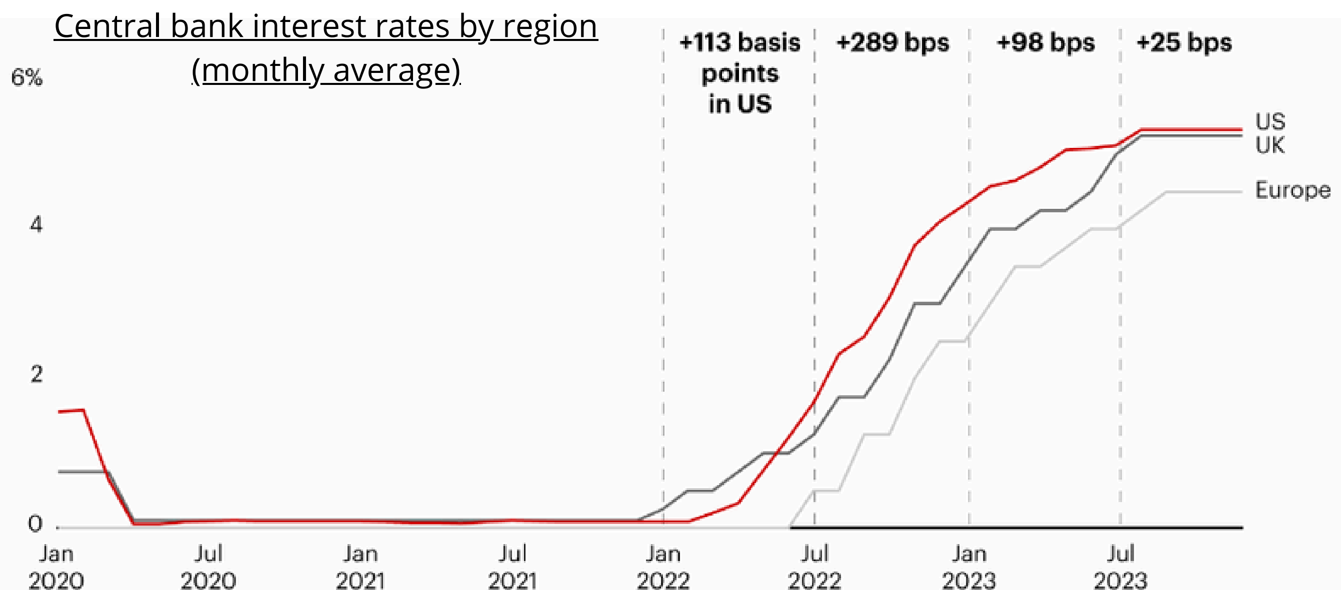
A CONSOB study found that Italian investors have reduced liquidity parked in banks, shifting towards government bonds due to rising interest rates. In 2023, bank deposits decreased by almost 50 billion euros, while investments in public bonds increased by 113.7 billion euros, now representing 4.8% of total financial assets.

In the **United States**, **high inflation led the Federal Reserve to raise interest rates**, which have surpassed 5%. This has made savings accounts and money market funds (MMFs) more attractive, with a record increase in assets transferred to MMFs.

According to Morningstar, **by the end of August 2023, investors held approximately $5.6 trillion in money market accounts**, an increase of over $1 trillion compared to the previous year. Currently, these values have remained high, reflecting a continued preference for liquidity as a form of savings during economic uncertainty.

An IMF report indicates that financial conditions in the United States have eased in recent quarters, despite the Fed's continued monetary tightening. This easing has facilitated liquidity, although investors remain concerned about inflation prospects.

One of the most discussed strategies in financial management is the balanced **60/40 portfolio rule**, which allocates 60% to stocks and 40% to bonds. This strategy has proven particularly effective in various economic contexts. Historically, a 60/40 balanced portfolio has outperformed liquidity at different starting points relative to the peak of the Fed Funds rate cycle. Investing slightly before or during the rate peak has been optimal, while investing after the peak has still yielded better returns than maintaining liquidity.



Notes: US shows federal funds rate; Europe shows euro short-term repo rate; UK shows clearing banks base rate (middle rate); basis point changes over a six-month period are displayed for the US only and calculated based on the increase in average interest rates between the end of June and December of each year
Source: LSEG

According to T. Rowe Price's analysis, a **60/40 portfolio underperformed liquidity only when invested a year before the Fed Funds rate peak**. The equity component performed relatively well during this period, but the bond component lagged due to rising interest rates. The highest outperformance occurred when investing during the peak, followed by three and six months before the peak, respectively. The outperformance was lower after the peak.

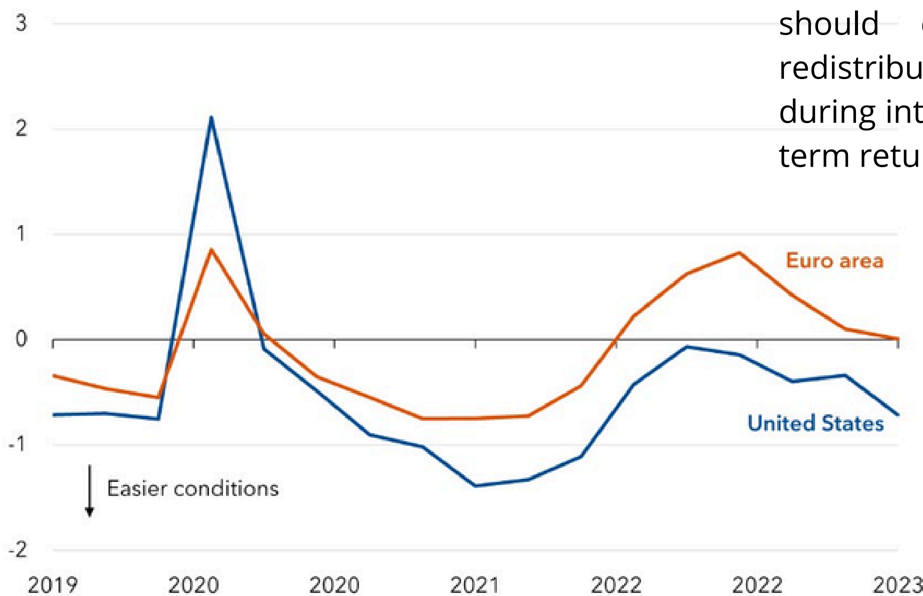
Talking about prospects and strategies, European investors face a complex landscape, with the **ECB likely to maintain a restrictive policy longer than the Fed**. The best strategy may be to balance liquidity with investments in government bonds and long-term bonds, which offer some security in a high-interest-rate environment.

An article by Bain & Company highlights how **rising interest rates have reduced dealmaking and fundraising activity** in the private equity sector, pushing investors towards more innovative liquidity solutions. However, with the possibility of rate cuts in 2024, there are positive signals for a recovery in investments.

In the USA, high interest rates have made money market accounts more attractive. However, with expectations of moderate rate cuts in 2024, it may be time to consider rebalancing towards balanced portfolios. Investing in a mix of stocks and bonds could offer better returns than maintaining too much liquidity.
An analysis by J.P. Morgan suggests that despite economic uncertainty, a balanced portfolio of stocks and bonds could offer opportunities for returns, especially if investors are willing to endure short-term volatility for long-term gains.

Historically, **reallocating liquidity towards balanced portfolios has shown superior returns**. Therefore, investors should consider the opportunity to redistribute liquidity slightly before or during interest rate peaks to optimize long-term returns.

Easing trend. Financial conditions have continued to ease in the US and euro area. Financial Conditions Indices (standard deviations):



Overview of Geopolitics, UK and China's Markets

Given the current **geopolitical climate** and the **policies of central banks**, individuals may question where they can allocate their liquidity in terms of countries and sectors. Before delving into this question, it is essential to highlight that the ongoing geopolitical tensions have the capacity to further increase the level of uncertainty around the financial markets. It is worth noting that the global economy can be influenced by geopolitical events, as highlighted by the Economic Observatory. **These events have the ability to affect the economy both directly and indirectly, through channels such as finance, trade, and commodity prices.** The current tensions have caused major disruptions in the supply chain, due to sanctions imposed by the EU and USA and attacks by Houdini on cargo ships in the Red Sea. This has led to **shortages in raw materials** such as oil and gas, which affected production worldwide; thereby increasing the level of prices and inflation. These events also exert an indirect influence on financial markets since the rise in uncertainty poses challenges in forecasting asset movements due to their heightened volatility.

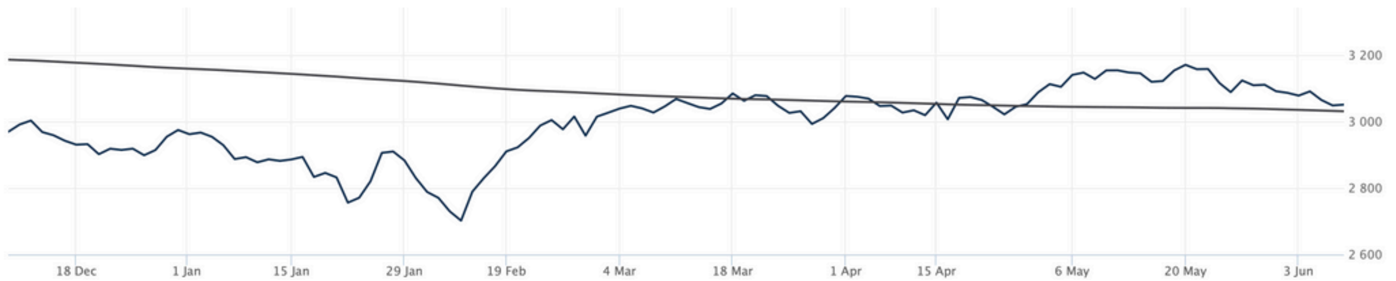
However, we might start to see the light at the end of the tunnel. Countries like Sweden and Canada and institutions like the EU are now showing **signs of economic recovery by implementing interest rate cuts**, following an extended period of keeping them at elevated levels. Furthermore, as stated by Forbes, the UK will be the next country to cut rates in June. These initiatives are set to significantly boost the attractiveness of the stock markets in these regions. As a matter of fact, after the EU interest rate cut, **European markets closed on a positive note**: CAC 40 +0.42%, FTSE MIB +0.46%, and Xetra Dax +0.41%.

On the other hand, as per Morningstar's analysis, **the bond market is expected to face repercussions from the interest rate cut.** This will lead to a decline in yields, while prices are anticipated to rise.
The countries that will benefit the most in the long run from the rate cuts are the ones with **high debt**, like Italy and Greece, and the ones with **stagnant economies**. This statement is further supported by the fact that Italy's GDP will increase by 1,0% in 2024, according to ISTAT.

As argued by Wall Street Italia, the sectors that will be experiencing the most substantial growth in the foreseeable future following the interest rate cut will be those **specializing in the distribution of non-essential "discretionary" items.** This includes luxury products, automobiles, and technology companies.

The resurgence of the European countries' economy, and soon to be followed by the USA, has not only bolstered the growth of EU member nations but has also provided assistance to countries like China. For almost a year, **China has been facing challenges with consumer prices remaining flat or dropping**, as the country's 1.4 billion consumers have predominantly opted to save rather than spend in the aftermath of the COVID-19 pandemic, as per the Financial Times. This heavily influenced the stock market, which, in January, experienced a significant decline, **hitting a four-year low** (see graph below).
Despite the challenges, the second-largest economy in the world has managed to overcome them by experiencing a significant increase in exports during the first quarter of this year. **In fact, exports have reached a remarkable 7.6% growth rate in May.** This positive development has had a direct impact on the stock market, which has seen a rise of 2.6% year-to-date.

Shangai Compostie index (WSJ)

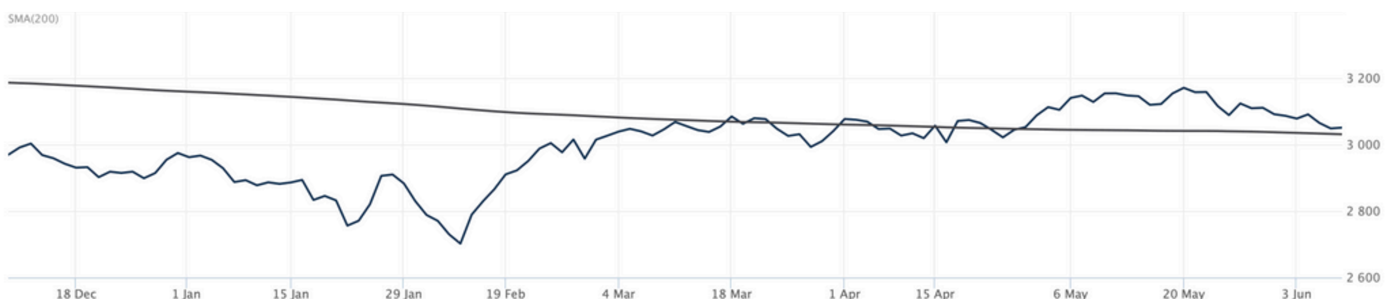


As a result, investors are feeling more optimistic about China's equity market. Morningstar reported that Société Générale's cross-asset research team stated, **"The China equity trade is back."**

Still, China's market has to recover from a **12-month loss of 5.6%**, while the EU and US stock markets reached all-time highs in the same time span.

Speaking of Europe is important to highlight the impressive run of the **FTSE 100** and **FTSE 250**, which, despite England's recession in the last two quarters of 2023, a**re up respectively 9.15% and 9.91% from January** (the FTSE 100 reached its all-time high on May 15, 2024).

FTSE 100 (WSJ):



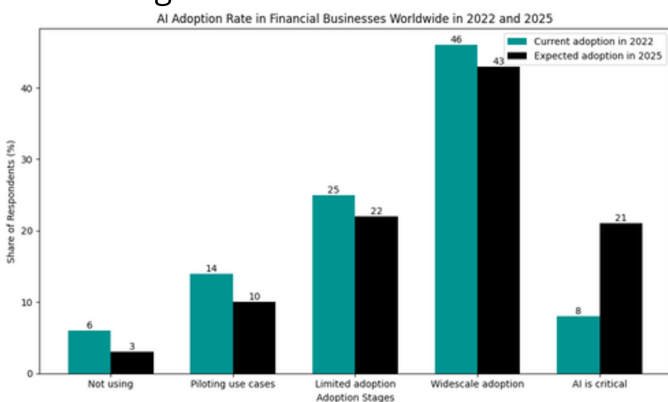
However, there are two major events occurring in the UK in the next month: **the interest rate cut and the elections.** By implementing a rate cut, there is a potential for a **greater upswing in English stocks**, as it can serve as an incentive for increased investment and consumption. This, in turn, would stimulate the GDP, **which saw a meagre growth of 0.2% in Q1 of 2024**, as reported by Yahoo Finance. Moreover, lower financing costs could prove advantageous for real estate companies and businesses with significant debt levels. On the other hand, on July 4, the e United Kingdom's citizens are called to elect their new Prime Minister. CNBC reported an analysis made by Citi which stated that the **UK stocks have been relatively flat the six months after the elections.**

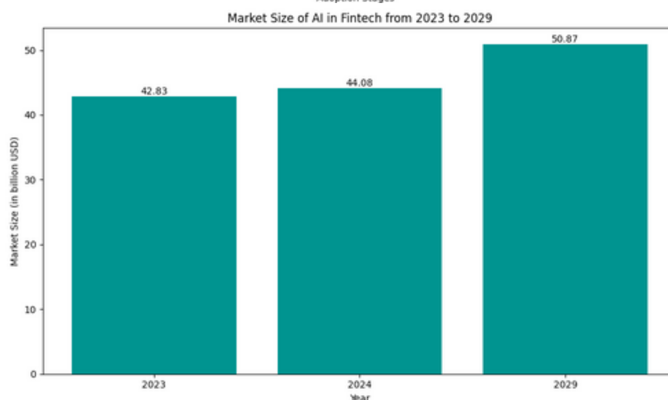
Based on Citi's analysis, the MSCI UK index for **large- to mid-cap stocks typically sees a 6% increase six months after Labour victories, but experiences a 5% decrease after Conservative wins.** Additionally, the FTSE 250 tends to outperform the FTSE 100, especially after Labour victories.

Investors should, therefore, prepare for potential market shifts influenced by these key events.

According to an Insider Intelligence survey, which involved **600 individual** respondents holding **senior technology roles**, by **2025**, the adoption rate of AI will exceed current levels, becoming an **integral and critical component of their operations**. This expectation reflects the growing confidence in AI's ability to deliver substantial benefits, including improved customer experiences, enhanced risk management, and increased operational efficiencies.

The drive towards **AI adoption** is fueled by the **competitive pressures** and the necessity to meet evolving customer demands. **Financial institutions** are increasingly recognizing the strategic importance of AI in maintaining a **competitive edge**. This recognition is leading to significant investments in AI technologies, with a focus on **applications** that can provide measurable improvements in **service delivery**, **risk assessment**, and **overall operational performance.** Moreover, the projected growth in AI adoption underscores the sector's commitment to integrate advanced technologies.





Market Size of AI in Fintech

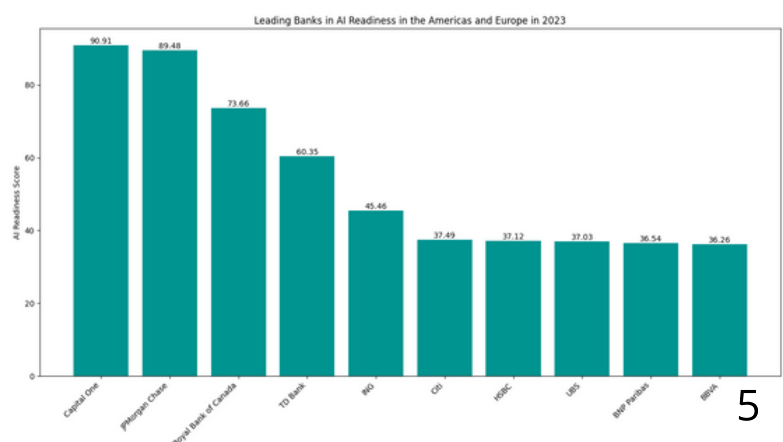
The **market size of AI in the fintech** sector was estimated at **$42.83 billion** in **2023** and is projected to grow to **$44.08 billion** in **2024**. With a compound annual growth rate **(CAGR) of 2.91%**, the market size is forecast to exceed **$50 billion by 2029.**

Generative AI Market Size in Financial Services

Generative AI in the financial services industry is **expected to grow** significantly, with a **CAGR of 28.1% from 2022 to 2032**. The market size is projected to increase from approximately $0.85 billion in 2022 to over $9.4 billion by 2032. This substantial growth underscores the increasing adoption and reliance on generative AI technologies to drive innovation and efficiency within the financial sector.

Leading Banks in AI Readiness

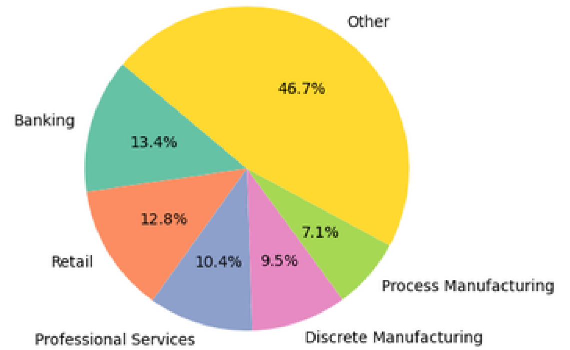
The **AI readiness index** of **leading banks** in the Americas and Europe is based on several factors, including patent applications, partnership and licensing agreements, deal-making activity, acquisitions, key personnel, product launches, and earnings transcripts. Among the largest banks, **Capital One** ranked highest with an AI readiness **score of 90.91**, followed closely by **JPMorgan Chase** with a score of **89.48**, and **Royal Bank of Canada** with **73.66.**



Global Spending on AI in 2023

In 2023, the worldwide spending on AI-centric systems was estimated at **$154 billion.** The **banking sector** emerged as the **top investor in AI**, with a total expenditure of **$20.64 billion**, followed closely by the **retail sector** with an investment of **$19.71 billion.** Other notable industries with substantial AI investments include professional services ($16.02 billion), discrete manufacturing ($14.63 billion), and process manufacturing ($10.93 billion).

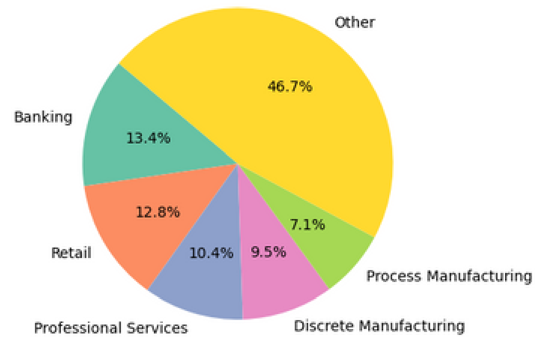
Estimated Worldwide Spending on AI-Centric Systems in 2023 (in billion USD)



Distribution of Global AI Spending by Industry

The **banking sector's spending** on AI accounted for **13.4% of the total global AI investments**, while the retail sector's share was 12.8%. Professional services contributed 10.4% to the global AI spending, followed by discrete manufacturing at 9.5% and process manufacturing at 7.1%. The remaining 46.7% of AI investments were distributed across various other industries.

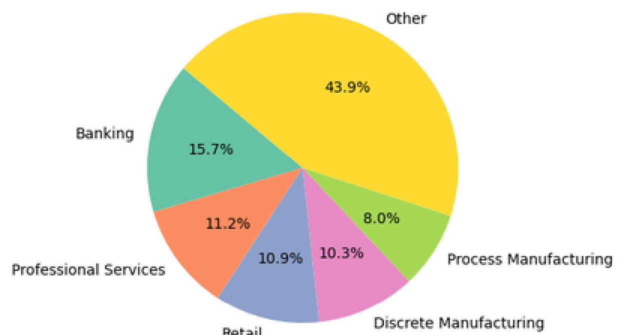
Estimated Share of Worldwide Spending on AI-Centric Systems in 2023 by Industry



AI Spending in Europe

The total AI spending in Europe was estimated at $34.2 billion in 2023. **The banking sector again** led the investments with **$5.37 billion**, followed by professional services ($3.83 billion) and retail ($3.73 billion). Other significant contributors to AI spending in Europe included discrete manufacturing ($3.52 billion) and process manufacturing ($2.74 billion).

Estimated AI Spending in Europe in 2023 (in billion USD)



Possible Portfolio Allocation: Strategy

Fund Description

The fund is structured to offer a balanced investment approach, comprising both fixed income and equities, aiming to provide investors with diversified exposure across various asset classes and regions. The fixed income component of the fund includes a selection of high-quality bond ETFs, offering exposure to government and corporate bonds across different maturities and regions. Meanwhile, the equities portion of the fund encompasses a mix of ETFs tracking major indices and individual small-cap stocks, providing access to both domestic and international equity markets.

Economic Landscape and Investment Strategy

Recent shifts in the economic landscape, including the energy crisis and high inflation, have prompted cautious behavior among investors, leading to increased liquidity holdings and a shift towards safer assets such as government bonds. The European Central Bank's restrictive monetary policy and rising interest rates have further fueled this trend, with Italian investors particularly reallocating funds towards government bonds. In the United States, high inflation and rising interest rates have made savings accounts and money market funds more attractive, although concerns about inflation persist.

Despite these challenges, a balanced portfolio strategy, such as the 60/40 rule allocating 60% to stocks and 40% to bonds, has historically proven effective in various economic contexts. While liquidity remains important, rebalancing towards balanced portfolios, particularly during interest rate peaks, could optimize long-term returns. The prospect of rate cuts in 2024 presents opportunities for recovery in investments, potentially favoring a shift towards balanced portfolios over excessive liquidity holding

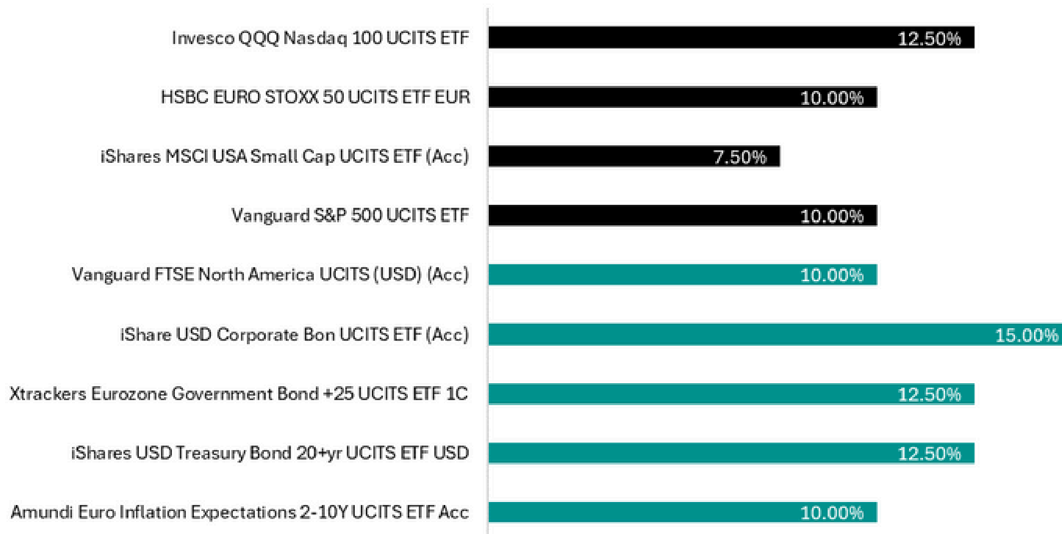
Market Analysis and Potential Opportunities

Geopolitical tensions and central bank policies continue to influence market dynamics, with ongoing uncertainties affecting financial markets worldwide. However, signs of economic recovery, including interest rate cuts in countries like Sweden, Canada, and potentially the UK, suggest potential opportunities for investors. The UK's upcoming interest rate cut and elections present both challenges and prospects, with market shifts anticipated based on election outcomes. Investors should remain vigilant and prepare for potential market shifts influenced by geopolitical events and domestic policies. Strategic asset allocation, including diversification across regions and sectors, alongside a balanced portfolio approach, can help navigate uncertain market conditions and capitalize on emerging opportunities.

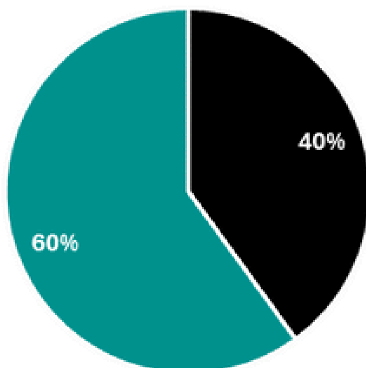
Portfolio Allocation: Outcome

■ Fixed Income ■ Equities

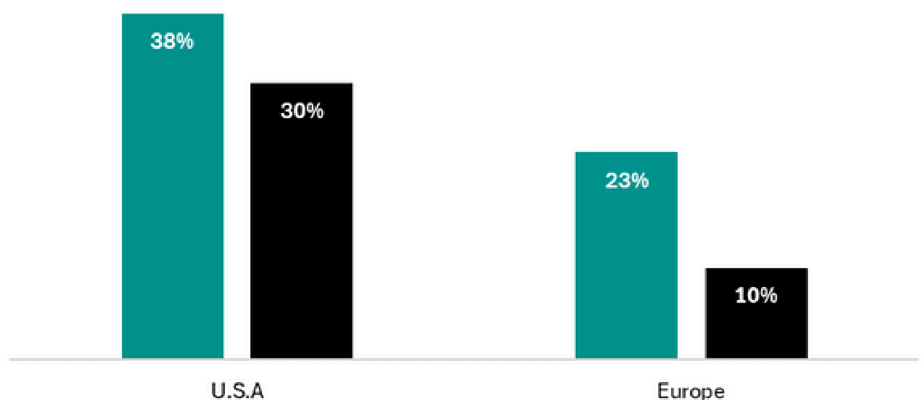
Portfolio Overview



Asset Allocation

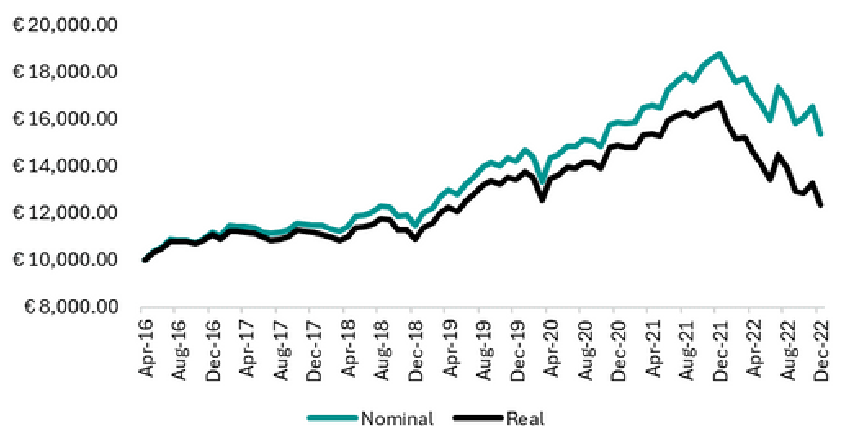


Geographical Allocation



Starting capital	10.000 €
Compound interest rate	6.66%
Compound interest rate	15.369 €
Volatility	9.95%
Sharpe Ratio	0.72

Portfolio Value



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