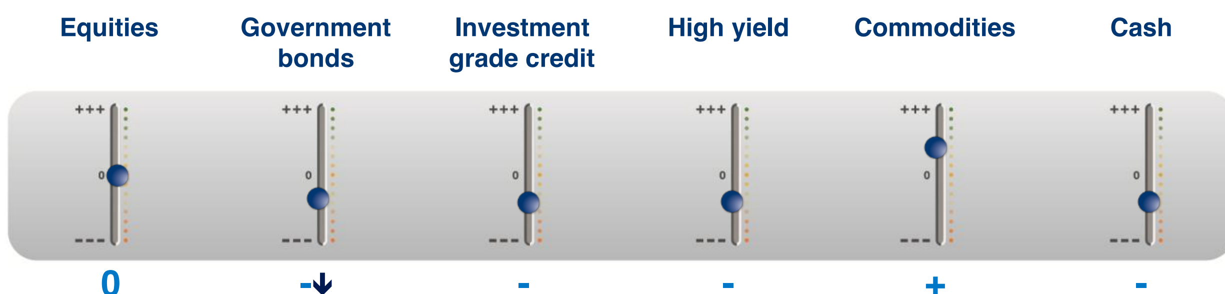
Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – March 2015

Summary

Equities	Government bonds	Investment grade credit	High yield	Commodities	Cash



Equities	Government bonds	Investment grade credit	High yield	Commodities	Cash
0	-↓	-	-	+	-

Category	View	Comments
Equities	**0**	**We remain neutral overall. Equity momentum is positive, but without valuation support equity markets are vulnerable to volatility spikes driven by investor flows and shorter-term economic cycles.**
US	0↓	We downgrade the US to neutral this month in the face of a stronger dollar and a less accommodative Federal Reserve (Fed). This may cause slower economic growth, leading to corporate earnings downgrades. Flows from foreign investors remain supportive.
UK	0	We remain neutral on UK equities given the region's exposure to emerging markets and commodity prices. In addition, political uncertainty ahead of the general election this year may undermine the housing-led recovery.
Europe	+↑	We upgrade Europe to positive. The weaker euro should provide a tailwind for corporate earnings, and our growth and inflation trackers for Europe are pointing upwards. Negative bond yields also provide support through lower financing costs.
Japan	0	The effectiveness of the Bank of Japan's (BoJ) QE programme remains uncertain. We await the results of the March labour negotiations for signs of sustained wage growth.
Pacific ex Japan	0	We remain neutral on the region. The manufacturing-based economy of Taiwan has benefited from the fall in commodity prices, giving a strong boost to its technology sector.
Emerging Markets	-	Emerging market equities remain a concern as the region suffers from the continued strength of the US dollar. The exception is Asia which benefits from the lower oil price, and renewed stimulus from the People's Bank of China (PBoc).

Category	View	Comments
Government bonds	**-↓**	**We downgrade our overall view on government bonds. Prospects of US tightening later this year is likely to increase the term risk premium, leading to steeper yield curves and a fall in bond prices.**
US	- -↓	We make a further downgrade to our negative view, reflecting our concerns about the relative value of US 5-year Treasuries. We see the possibility of a front-end led curve flattening in the US, but with the long end being supported by a stronger currency.
UK	-↓	The Bank of England is likely to follow the US Fed in raising interest rates. Similar to the US, we continue to prefer the longer end of the curve. We also foresee a stronger 2015 for the UK, despite uncertainty surrounding the general election, coupled with low inflation that has been weighing on market expectations of a hiking cycle.

Germany	+	We continue to favour Bunds as concerns surrounding the recovery prospects of the eurozone have prompted an overwhelming QE response from the ECB. Similar to the UK, we prefer the 30 year sector.
Japan	0	Despite the unattractive yields, we maintain our neutral position on Japanese duration due to the continued support provided by the BoJ. This will keep the long-end of the curve pinned down despite an expected increase in inflation.
US inflation linked	0	As inflation remains low, we see the possibility of a front-end led flattening in the US. We remain neutral on US Treasury inflation protected securities (TIPS) given offsetting effects from a stronger US dollar but better wages and an improving labour market.
Emerging markets	-	We are negative on EM USD bonds as we see a worsening inflation/growth trade-off with weakening currencies, particularly amongst commodity-producing nations. They are vulnerable to heightened currency volatility as a result of the possible US rate rise, but fundamentals have been improving in many EM countries. We prefer local market exposure (without the FX risk) over EM USD exposure.

Category	View	Comments
Investment grade credit	-	
US	-	There is some argument for a spillover effect from the European bond buying programme and, due to attractive maturity profiles, debt affordability is still supportive. However, spreads do remain vulnerable to the Fed surprising the market and liquidity remains a risk factor.
Europe	+	Notwithstanding increased political uncertainty following the Greek election and bailout discord, the ECB's bond buying programme should remain supportive of quality carry assets, particularly given limited supply in the sovereign and high quality credit sectors.

Category	View	Comments
High yield credit	-	
US	-	Energy sector dynamics continue to influence the broader US high yield index and we anticipate continued volatility here given the spring loan redetermination period. Whilst outflows have stabilised, the broader complex (i.e. ex. energy) still remains aggressively priced and exposed to global macro-economic risks or uncertainty over Fed tightening.
Europe	-	Whilst QE and record low yields should push investors into higher yielding assets, the bulk of buying will be in quality assets. Tail risks in Europe leave us cautious for now as high yield is likely to be the pressure valve, with potential spillover effects from the US High Yield market.

Category	View	Comments
Commodities	+	**We maintain a positive view on broad commodities as we expect the depressed cyclical commodities to recover through a combination of improved demand and reduced supply.**
Energy	+	Global easing is likely to be supportive of demand, and there is strong evidence that capital expenditure is being cut back which should temper the current oversupply.
Gold	-↓	We have dowgraded gold to negative. Broadly stronger economic growth is driving real bond yields higher, increasing the cost of carry on gold.
Industrial metals	++	China has moved firmly into an easing cycle, bringing forward $1.1trillion of infrastructure expenditure and easing monetary policy. This, coupled with a cutback in global production, should be sufficient to stimulate a rebound in industrial metal prices.
Agriculture	0	We maintain our neutral positioning within agriculture where we believe prices reflect the well-supplied market.

Category	View	Comments
Currencies		
US dollar	+	The divergence in economic growth, which drove the USD higher, is no longer as strong. We retain a positive view based on supportive medium term drivers such as: the housing market having troughed with US households further down the deleveraging path; and improvements in shale gas extraction being supportive for the US current account.
British pound	0	With the additional uncertainty of the election approaching, we continue to hold a neutral view on sterling. Political uncertainty and weak inflation are counterbalanced by a stonger economic growth profile.
Euro	-↓	There may be further downward pressure on the euro in the near term due to increasing divergence between ECB policy and that of other G10 central banks. In addition, the euro is likely to struggle in the face of a US Federal reserve hike.
Japanese yen	-	We only expect modest downward pressure on the yen in the near term and so maintain a single negative position. Import prices have driven inflation up but until this is reflected in wage growth, policy makers are unlikely to want significant currency depreciation.
Swiss franc	-	The Swiss economy has weakened this year following deterioration in European growth and we expect additional weakness following the recent sharp appreciation of the currency.

Category	View	Comments
Cash	-	With real rates remaining negative, we continue to hold a negative view on cash.

Source: Schroders, March 2015. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged). The views for currencies are relative to USD, apart from USD which is relative to a trade-weighted basket.

Section 2: Multi-Asset Insights

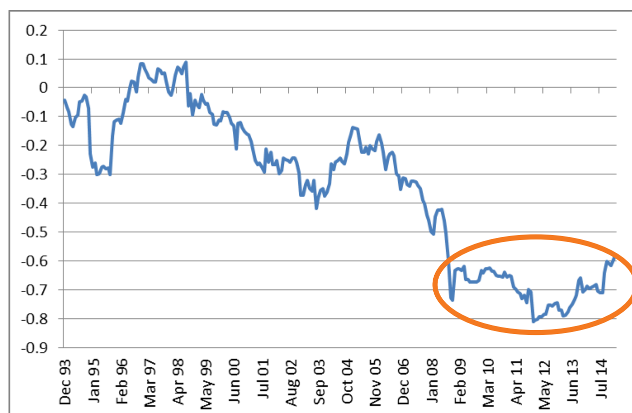
By Alastair Baker and Patrick Brenner, Multi-Asset Fund Managers

Can commodities survive a stronger USD?

Conventional wisdom is that the dollar has a strong influence on commodity prices. The explanation for this relationship is that since commodities are priced in USD, then commodity prices must move lower in USD terms when the dollar strengthens to reflect its increased purchasing power.

After the 2008 global financial crisis there has indeed been a very strong inverse relationship between commodities and the USD, as shown by the correlation chart in Figure 1 below.

Figure 1: Rolling 3 year correlation between Broad Commodity Index and USD Index monthly returns



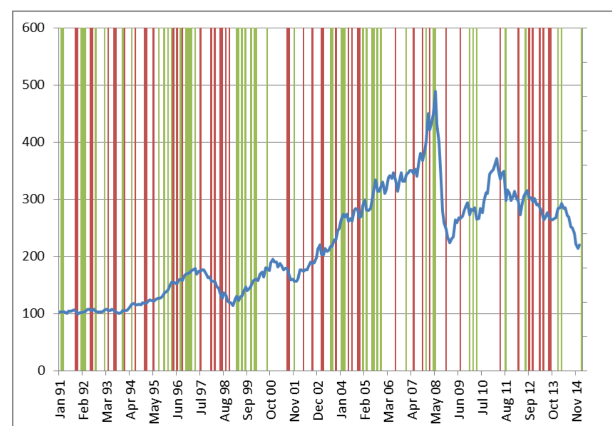
Source: Schroders, Bloomberg, 10 March 2015.

However, this has not always been the case. Prior to the financial crisis, the correlation was much less obvious. For example, during the boom years of the 1990s there was almost no relationship between the USD and commodity prices. Then, in the recovery after the dotcom bubble bursting from 2003-2006, the relationship weakened again.

We therefore reject the gross simplification that all you need to know to have a view on commodities is the direction of the USD. It does, however, help if you can identify which type of USD environment you are in.

Looking at the period from 1990 to 2015, 61% of the time we had a negative correlation between USD and commodities, and 39% a positive correlation. This 39% can be further subdivided into 23% for both commodities and USD rising, and 16% both USD and commodities falling. Figure 2 highlights in green those periods where we have both rising USD and commodities; the periods of both falling are highlighted in red.

Figure 2: Broad Commodity Index and correlation regimes



Source: Schroders, Bloomberg, 10 March 2015.

Generally speaking, during Fed rate hiking cycles we see a positive correlation regime where both USD and commodities rose together. The greatest concentration of green observations occurs in these periods: June 1996 – March 1997, March 1999 – January 2000 and June 2003 – December 2005. These were periods of both rising interest rates and stronger growth.

We are approaching a tightening cycle in the US and this is likely to result in a continued strengthening of the USD. If this is associated with continued positive economic growth then both the USD and commodities can go up. In the event that tightening is a policy mistake, or it exerts so much pressure on EM economies that we enter an EM crisis phase (slowing growth and exacerbating the demand for the USD) then commodities are likely to suffer.

Important Information: For professional investors and advisers only. This document is not suitable for retail clients.
These are the views of Alastair Baker, Patrick Brenner and the Schroders' Multi-Asset Group, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Schroder Investment Management Ltd (Schroders) does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Schroders has expressed its own views and opinions in this document and these may change. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. Issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA, which is authorised and regulated by the Financial Conduct Authority. For your security, communications may be taped or monitored. 941564