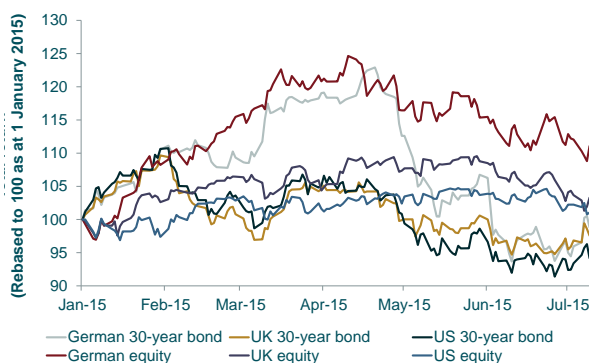


Since our last update at the beginning of the second quarter, the key development in markets has been the return of volatility. For us it is vital that, as all kinds of headlines come and go, and the market environment gets rather 'noisy' and volatile, we keep our eyes on the risks with regard to interest rates and are ever mindful of the fundamental backdrop against which we are trading.

### Volatility returns

The financial market in the second quarter of 2015 was a significantly more volatile place than the first three months of the year (see figure 1). The main issues grabbing investors' attention during the first quarter are still with us: speculation over when the US Federal Reserve (the Fed) is going to raise interest rates and concerns about growth in the euro area, in particular.

**Figure 1: Increased volatility across asset classes**



Source: Datastream, 9 July 2015.

However, during the second quarter, these themes were overlaid with heightened uncertainty over the outlook for Greece, including the return of 'Grexit' fears. Since the end of the second quarter, we have also seen dramatic declines in Chinese equity markets. The triggers for this are not particularly easy to identify since Chinese equities had previously been rallying strongly, despite evidence of a slowdown in China for some months now, and the economy has not notably accelerated recently.

Equity prices have pulled back pretty sharply from where they were in the first quarter. Bond prices have fallen significantly too and, in fact, more profoundly than equity prices. So the place to lose most money has been the bond market. That is consistent with what we have believed from a valuation perspective since the end of last year. Our portfolios have been

underweight mainstream government bonds and overweight equities for some time.

### Fundamentals still encouraging

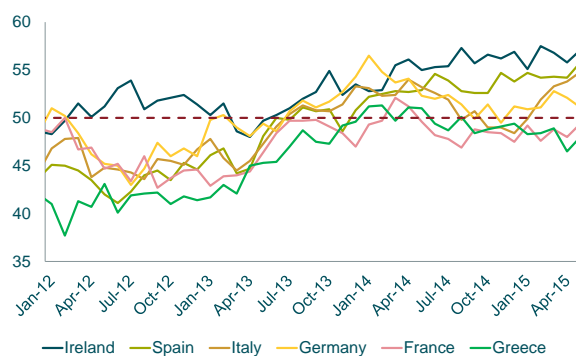
So as we start the third quarter, what do we make of this volatility? Firstly, we believe it is always very important to make the distinction between volatility and risk.

True risk is the potential for permanent capital loss, while volatility is simply the market's varying opinion about where to mark the price for different assets and is often driven by sentiment and therefore temporary. As a result, we believe it is vital that we do not overreact to short-term volatility, and instead, use it as a time to check whether our longer term fundamentals-based convictions have changed. If not, volatility may present compelling investment opportunities.

Overall, nothing has really changed in terms of the facts. European economic fundamentals, outside of Greece, are probably looking as strong as they have done for a good number of years (see figure 2 showing Purchasing Managers Indices (PMIs) in most areas indicating expansion, ie, a reading above 50).

In Germany, corporate profitability is going from strength to strength, and even in the periphery, Italian

**Figure 2: Improving European PMIs**



Source: Datastream, 1 July 2015

and Spanish macroeconomic data are improving. We are also starting to see forward earnings beginning to improve, which, if it plays out, would be a big positive for equity markets. On a cyclically adjusted basis, we believe current earnings are well below trend, so any kind of improvement could see equity markets perform very well indeed.

Meanwhile, the US and UK economies continue to make good progress. There is very little concern around inflation; at the same time, worries around deflation appear to have subsided. We are also seeing some modest wage growth. In Asia, there are ongoing worries around China, and price responses have been punchy, so this is something that we are watching closely.

The conclusion is that the global macroeconomic backdrop looks pretty benign but there has been an increase in volatility, which we view as a fertile environment for investment opportunities.

The recent move in bonds has been much more meaningful than the move in equities. Therefore, while equity market volatility may unsettle the stomach from time to time, we would see these incidences more as opportunities to acquire more at good value. Whereas on the bond side, we think there is still some distance to go before we are confident about adding to our bond exposure.

## Opportunities and challenges

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Investors today face an uncertain environment. We have just experienced an extraordinary phase in financial markets. Investors remain rattled by the shock of 2008 and this has meaningfully skewed investors' perceptions of risk. Coupled with the unprecedented intervention of central bankers in recent years – and the potentially huge disruption the

removal of this intervention could cause – this leaves asset pricing still significantly distorted.

The challenge for investors is still the attempts at interpreting what the Fed is going to do. We cannot know for sure when the Fed will raise rates, but we know that it is coming at some point in the not-too-distant future. And that will be a test for bond prices, in particular, as it pertains not just to US assets, but to global assets. As asset allocators, navigating through that will be critical. Two areas we think could offer a useful hedge against the Fed's interest rate rise are US banks and the US dollar.

In our view, many areas of mainstream government bond markets currently remain unattractive, offering extremely low levels of yield that mean previous 'safe havens' may now look rather risky. Meanwhile, despite the strong performance of equities in the past couple of years, in many areas, risk premiums are still over-compensating as investors continue to struggle to weigh evidence of slowly improving fundamentals against their recent painful experience.

All of this means we find ourselves in an environment that appears unstable, with a great deal of focus on what policymakers will do next, particularly in terms of the historically low cash rates that have affected asset prices across the global investment universe.

Therefore, investors should expect a great deal of short-term volatility, but also be prepared for the opportunities this could present. That is why genuinely and carefully diversified multi-asset funds that have the flexibility to respond to quickly changing environments could be best positioned to navigate the turbulence ahead.

**M&G**  
**July 2015**

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