For professional investors or advisers only

Schroders

Global Market Perspective

Economic and Asset Allocation Views Q3 2016

Schroders

Introduction

The second quarter saw a powerful rally in sovereign bond markets which took yields to new lows in many major markets. Estimates suggest that around one third of the developed government bond market is now trading on a negative yield. The bond market rally gained added impetus from the UK vote to leave the European Union on June 23rd. This event was not foreseen and investors scrambled into safe havens such as government bonds, gold and currencies like the US dollar and Japanese yen. After initially falling on the Brexit vote, global equities have subsequently rallied as investors have focussed on the increase in liquidity from central banks and the potential for fiscal stimulus in some economies.

The economic impact of Brexit will be felt most keenly by the UK and will also dampen Eurozone growth. However, the global impact is negligible as the UK only represents about 4% of world GDP and contagion effects through financial markets have been contained by the central banks. We would see the main impact from Brexit as being a warning that populist politicians should not be underestimated in the current environment where a large proportion of the population are dissatisfied with the establishment. Meanwhile, we expect the EU to pull more closely together, but there are key challenges ahead such as the need to resolve the Italian banking crisis and political risk will remain high in the run up to the US Presidential election on November 8th.

If there is a silver lining from the fall out from Brexit it may well be found in the emerging markets. Medium term prospects remain difficult as the headwinds on trade growth are likely to remain strong (see research note). However, the prospect of an easier Fed rate policy has allowed investors to refocus on fundamentals. We have yet to see the macro recovery which would accelerate emerging market growth but as inflation eases and currencies stabilise we have become more constructive on the region.

Keith Wade, Chief Economist and Strategist, Schroders

14 July 2016

Asset Allocation Views: Multi Asset Group

Global Overview

Economic View

Our global growth forecast is unchanged at 2.5% for 2016 with the principal impact of Brexit being felt in the UK where we have cut our growth forecasts in half for next year. Eurozone forecasts have also been reduced as a result of weaker demand from one of its biggest trading partners and the increase in uncertainty brought about by the referendum result. These effects will feed a broader slowdown in trade and activity in 2017, but the overall global effects are not great given the size of the UK in the world economy.

Global inflation is forecast to rise to 2.2% this year and to 2.5% in 2017. The forecast for next year is partly influenced by the forward profile of oil prices (the oil curve is higher but less steep). Additionally, we feel we will not see significant second round effects from higher inflation into wages, with the experience of recent cycles suggesting that wages have become less responsive to changes in unemployment.

In terms of risks around our baseline forecasts, the balance of probabilities remains skewed towards a weaker growth outcome although less compared to previous quarter. Meanwhile, with political risks rising, we have introduced a “Trade wars” scenario and a “Brexit shakes Europe” scenario. The former is based on the election of Donald Trump as president of the US, which brings a significant increase in tariffs on imported goods. Ultimately, this scenario is seen as stagflationary given that global trade contracts and global inflation is pushed higher. With regard to “Brexit shakes Europe”, this follows from the UK vote to exit the EU which galvanises anti-EU support across Europe and results in a number of similar referenda across the continent. Our models suggest global growth will be lower than the baseline in such a scenario, with higher inflation in Europe as the GBP and EUR depreciate significantly.

Central Bank Policy

We expect Fed Chair Janet Yellen and company to hike rates in December 2016 to 0.75%, which is followed by another two hikes to 1.25% by end-2017. Meanwhile, we expect the Bank of England (BoE) to cut interest rates in August as the economy weakens. The European Central Bank (ECB) is also assumed to reduce the deposit rate to -0.5%, where it stays through 2017. The Bank of Japan (BoJ) is no longer expected to take rates lower following the adverse reaction to their move into negative territory in January. Fiscal support and the further delay in the consumption tax relieve some of the pressure on the BoJ. However, we do expect them to start experimenting with helicopter money drops towards the end of the forecast period in 2017 in a renewed effort to stimulate growth in a moribund economy. The People’s Bank of China (PBoC) is still expected to cut interest rates and the reserve requirement ratio (RRR) over the forecast period.

Implications for Markets

Looking at our asset class views, we have maintained our neutral bias on equities. Valuations are generally looking fair relative to the risk free rate and even cheap on some absolute measures. However, our cycle and earnings measures continue to suggest a more cautious view on equities is warranted. We believe that earnings growth will be subdued this year given the sluggish global growth. Meanwhile, a driver of the deterioration of the global cycle has been a slowdown in manufacturing in areas such as the US and Japan. While the tightening in monetary policy by the Fed has been kinder to risk assets in this cycle, the liquidity backdrop remains vulnerable to higher interest rates. This suggests a more challenging landscape for earnings growth, which is critical for the equity call.

Within equities, we prefer the UK as the FTSE 100 not only benefits from high dividend yields but also a weaker currency supporting multi-nationals. Despite the high-quality and the low-beta nature of the US market, we have turned neutral. Equity valuations have become richer and have not adequately discounted the potential uncertainty from the upcoming US elections and the Fed’s continued path of policy normalisation. On Europe ex UK, we have stayed negative largely due to our belief that negative interest rates are likely to be harmful to the profitability of banks and be a headwind to the broader market. In comparison, we have downgraded Japanese

Implications for Markets (continued)

equities as we believe that consensus forecasts for earnings remain too optimistic and fail to make adequate provisions for the strength of the yen on corporate margins. We have remained neutral on Pacific ex Japan and EM equities. On the latter, we recognise that EM price-earnings multiples have adjusted a long way to reflect a subdued outlook for the global economy. Our forecasts suggest that the growth differential between the EM versus developed market is likely to increase in favour of EM, which should offer support to EM multiples and relative performance.

With regard to the duration views, we have an overall neutral bias on government bonds. Amongst the bond markets, we have retained our neutral view on US Treasuries but have turned positive on German Bunds. On UK Gilts and Japanese government bonds (JGBs), we remain neutral. We have also maintained our neutral stance on emerging market sovereign debt in USD. Instead, we prefer harvesting the carry in EMD local currency bonds given the attractive real yield.

In terms of the credit markets, we have turned neutral on both US high yield and investment grade bonds. After a period of significant spread tightening, credit is no longer as compelling from a valuation perspective. We believe the US credit sector is in the late cycle phase which means most of the returns will come from carry rather than further yield spread compression. For European credit, ultra-accommodative policy from the ECB should be positive for carry, but valuations appear to be unattractive at current levels.

We have upgraded commodities given the meaningful reduction in supply particularly in the energy market. Amongst the sectors, we believe longer-term pricing is too pessimistic on the energy sector as capital spending cuts have been dramatic and we believe that supply and demand will move into balance in the second half of the year. Meanwhile, we have maintained our neutral view on industrial metals as improvements in sentiment towards the Chinese economy are likely to support prices in the short-term. However, there remains ample supply across most base metals. For agriculture, our base case is that prices are likely to trade sideways given the tug between supply and prospects for adverse weather due to La Niña. On precious metals, specifically gold, we have retained our positive view as US real rates continue to push lower as downside risks to global growth means that the Fed is willing to tolerate higher inflation risks.

Table 1: Asset allocation grid – summary

Equity	0	Bonds	0 (+)			Alternatives	+ (0)	Cash	0(-)
Region		Region		Sector		Sector			
US	0(+)	US Treasury	0	Government	0	UK property EU property	- (0) +		
Europe ex UK	-	UK Gilts	0	Index-Linked	+(0)	Commodities	+ (0)		
UK	+(0)	Eurozone Bunds	+ (0)	Investment Grade Corporate	0 (+)	Gold	+		
Pacific ex Japan	0	Emerging market debt (USD)	0	High yield	0 (+)				
Japan	- (0)								
Emerging Markets	0								

Key: +/- market expected to outperform/underperform (maximum ++ to minimum - -) 0 indicates a neutral position. The above asset allocation is for illustrative purposes only. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions. For alternatives, due to the illiquid nature of the asset class, there will be limitations in implementing these views in client portfolios. Last quarter's GMP positioning in brackets. Source: Schroders, July 2016.

Regional Equity Views

Key Points

0	Equities	
0(+)	US	We have downgraded the US market to neutral as valuations have become richer and have not adequately discounted the potential uncertainty from the upcoming US elections and the Fed's continued path of policy normalisation. The cyclical environment also presents a more challenging earnings outlook particularly given optimistic consensus expectations for 2017. Nonetheless, the high-quality and more defensive nature of the US market makes it attractive to hold and supports a higher than average valuation compared to the rest of the world.
+ (0)	UK	The fall in investment and hiring plans as companies consider the effect of Brexit will likely lead to a slowdown in UK growth, particularly in 2017 where we have markedly downgraded growth expectations. However, more accommodative policy is assumed to soften the impact with the BoE cutting interest rates. The government is set to abandon the 2020 budget surplus rule with the likelihood of larger fiscal deficits. Meanwhile, a significantly weaker sterling should provide tailwinds for multinationals and some relief for UK corporate earnings. Hence, we have turned positive on the FTSE 100 amid the current economic uncertainty.
-	Europe ex UK	Despite the ECB's ultra-accommodative policy, which could provide some support to the economy, we have kept our underweight on European equities. We believe that negative interest rates are likely to be harmful to the profitability of banks and be a headwind to the broader market. This market is also the most exposed to the potential spread of contagion after the EU referendum result in the UK. Indeed, political risk is likely to take centre stage in the region with the Italian referendum on the constitutional reform later in the fall and general elections in the Netherlands, France and Germany next year.
- (0)	Japan	We are still concerned that consensus forecasts for Japanese earnings are too optimistic and fail to make adequate provisions for the strength of the yen on corporate margins, which could lead to the potential for earnings disappointment. While the cyclical environment warrants more stimulus measures from the authorities, the BoJ is approaching the limits of policy effectiveness. Unless we see bold moves from the BoJ or Prime Minister, Abe honour his promises on meaningful fiscal action in the autumn, we have turned negative on the market.
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	We remain neutral on Pacific ex Japan equities given uncompelling valuations and weak price momentum in Hong Kong and Singapore. Although the Australian market offers high dividends and attractive valuations. Earnings momentum also remains relatively poor compared to elsewhere, although the more dovish stance by the Fed and scope for further policy easing in China are expected to be supportive factors in the near term. Overall, we maintain our neutral score in the absence of a medium-term growth catalyst.
0	Emerging Markets	The decline in EM exports suggests that the environment for EM equities remains challenging as the region is a levered play on the global economy. However, investors' sentiment towards the market has improved due to the weakness in the USD and the recovery in commodity prices. EM price-earnings multiples have also adjusted a long way to reflect a subdued outlook for the global economy. Our forecasts suggest that the growth differential between the EM versus developed market is likely to increase in favour of EM, which should offer support to EM multiples and relative performance.

Key: +/- market expected to outperform/underperform (maximum ++ minimum - -) 0 indicates a neutral position.

Fixed Income Views

Key Points

0 (+)	Bonds	
0	Government	Amongst the bond markets, we have retained our neutral view on US given the balancing act between the continued dovish rhetoric from the Fed and a central bank compelled to eventually tighten monetary policy given the strengthening in the labour market. We expect the Fed to hike rates later in the year thus the short-end remains vulnerable to adjustments as yields have moved a long way. Although, we also recognise that the longer-end of the US curve could benefit from safe-haven flows from the increased political uncertainty over the next 12 months. After the EU referendum result, prices of UK Gilts have rallied on the back of safe haven flows and recession concerns. However, we retain a neutral view as the slowdown in the UK economy and monetary easing by the BoE are now priced in. We have turned positive on German Bunds as we prefer these bonds over US Treasuries given the former is particularly supported by ECB buying. The weaker USD is also likely to lift inflation expectations in the US while a stronger euro is likely to do the reverse. In spite of the unattractively low and negative yields, we continue to hold a neutral view on the medium to long-end of the Japanese yield curve given the aggressive support from the BoJ and low inflation expectations.
0 (+)	Investment Grade (IG) Corporate	We have downgraded US investment grade bonds to neutral over the quarter as we believe that this sector is in the late cycle phase where most of returns will come from carry rather than further yield spread compression. We see better technical support with investor inflows and higher quality issuance, though valuations are in-line with historic levels. Yield spreads have tightened considerably following the announcement of the ECB's Corporate Sector Purchase Program (CSSP), making valuations less attractive than earlier in the year. Although we believe that the CSSP effectively puts a cap on how far spreads can widen, the current elevated level of valuations means we remain neutral.
0 (+)	High yield (HY)	US high yield has benefitted from the recovery in oil prices and more dovish comments from the Fed. However, we have downgraded this credit sector as the valuation story is no longer as compelling as spreads have tightened significantly. In addition, there has been some further deterioration in corporate fundamentals with rising leverage and lower interest rate coverage. On European HY, we remain neutral. While ultra-accommodative policy from the ECB should be positive for carry, spreads remain firmly anchored around their long-term averages and valuations appear to be unattractive at current levels.
0	USD-Denominated Emerging market Debt (EMD)	We remain neutral on EMD USD bonds. Instead, we prefer harvesting the carry in EMD local currency bonds given the attractive real yield. With falling inflation expectations within some of the countries in the universe, there is scope for more policy easing or less aggressive rate hiking by central banks. Meanwhile, the recovery in commodity prices and improved sentiment towards the Chinese economy in the short-term has alleviated some of the downside risks.
+(0)	Index-linked	We have turned positive on US and UK inflation-linked bonds. Real yields continue to fall and inflation expectations could be lifted by CPI base effects and the recovery in commodity prices. In the UK, the significant weakness in the currency and easier monetary policy is expected to feed through into higher inflation.

Key: +/- market expected to outperform/underperform (maximum ++ minimum - -) 0 indicates a neutral position.

Alternatives Views

Key Points

+	Alternatives	
+ (0)	Commodities	We have upgraded commodities given the meaningful reduction in supply particularly in the energy market. We believe longer-term pricing is too pessimistic in the energy sector as capital spending cuts have been dramatic such that supply and demand will move into balance in the second half of the year. We have retained our neutral stance on industrial metals but with a downward bias. This complex is still oversupplied and should remain in surplus over the year. In particular, prices remain above the marginal cost of production given the currency depreciation in producing countries. However, prices are likely to be supported in the short term given improvements in sentiment towards the Chinese economy. Major grains in the agriculture sector are in abundant supply, but farmers are coming under increasing financial pressure from low prices, which may also impact supply. While prospects for adverse weather remain due to La Niña (periods of below-average sea surface temperatures), the outlook has not deteriorated sufficiently to support wheat and corn prices. We therefore remain neutral. We remain positive on precious metals, specifically gold. US real yields continue to push lower as downside risks to global growth means that the Fed is willing to tolerate higher inflation risks. This is supportive for gold as it reduces the opportunity cost for investors to hold this asset. At the same time, gold could be a beneficiary of safe-haven flows given the increased in political uncertainty globally.
- (0)	UK Property	In the investment market, the weakness in GBP could attract more foreign investors although their appetite is heavily influenced by prospects for the UK economy and for rents. We believe that both domestic and foreign investors will sit on their hands in the short-term such that there will be a significant drop in transactions until there is greater clarity over the political landscape. Meanwhile, office rents in central London could fall over the next 1-2 years as firms move some of their operations to the EU and attempt to sub-let the surplus space. Rental growth in other sectors could pause, as businesses put off signing leases. In addition, real estate yields could rise as investors downgrade their expectations for future rental growth and shift their attention to other countries with less political risk. Looking ahead, it is still too early at this stage to say how far capital values could fall. However, the UK and in particular, the London investment market is very transparent and prices tend to adjust and find a new equilibrium fairly quickly. The market is also better placed now to withstand a shock than in 2007, given the low level of vacancy in most office and industrial markets, the large premium in yields over 10-year Gilts and most recent purchases have been funded by equity rather than debt, so that there should be relatively few distressed sellers.
+	European Property	There are some signs that activity is moderating in the investment market as prime retail and office yields in most big cities have levelled off in the first quarter of 2016. While this could signal a negative shift in sentiment, we think it is more likely that investors are simply taking stock after a busy 2015. Despite the recent compression in yields, real estate is still priced relatively attractively, given the large yield premium over government bonds, and the prospect of steady rental growth over the next few years. Moreover, we believe investors are aware of the political risks post Brexit but are unlikely to reduce their appetite for core European property. Indeed, it could increase if some of the capital destined for the UK is now switched to the continent. We forecast that total returns on average investment grade European real estate to average 7-8% per year to the end-2020. The majority of performance will come from the income return of around 5%, but capital values should also be supported by a steady increase in rents.

Note: Property views based on comments from the Schroders Real Estate Research team.
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