LGIM Asset Allocation Views.

For Investment Professionals only

September was a weak month for risk assets, with the downturn generally concentrated in the final days of the month. US equities suffered their worst one-day drop since the summer and posted negative performance for September, despite breaking through the headline 2000 level at one point in the month. Government bonds held up better but fixed income markets as a whole were not immune to the weakness. This was most pronounced in the high yield market, which suffered another month of poor performance and outflows.

RISKS

- Escalation in geopolitical risks
- Federal Reserve delays rate rises too long and gets behind the curve
- Market underestimating potential inflation in the global economy

OPPORTUNITIES

- Synchronised global economic growth traditionally helps risk assets
- Euro continues to weaken if European Central Bank looks more likely to move to full QE

The equity (and broader risky asset) outlook is reasonably finely balanced at the moment. We would normally see this stage in the economic cycle as fairly supportive of risk assets, and moderating price pressure suggests the current 'goldilocks' environment can persist for some time. We recently moved to a tactically neutral position on equities as the risk of a policy shift from the US Federal Reserve outweighs the boost from steady growth in dividends and earnings. We still see strong fundamental support for US-led growth offsetting the weakness in the rest of the world.

We retain our regional equity preference for Europe and Japan. In the former case, considerable weight is placed on the prospect for a global capital expenditure recovery to drive European earnings; and the importance of loosening European financial conditions. In the latter case, the reform agenda may be inching slowly along, but there is little doubt that the Bank of Japan is willing to provide further monetary stimulus if required. Indeed, Japanese equities managed to avoid the sell-off in the final week of September, to finish the month higher.

Ultimately, the key factor for markets in the near term is the eventual re-pricing of the market's outlook for rate hikes in the US and the UK. Although we remain short duration in our government bond exposure, reflecting our belief that markets are too complacent and that inflation risks are being underestimated (see the September Fundamentals – Deflation Defeated). We have reduced the scale of the position recently, given the tempering of inflation risks associated with commodity prices dropping sharply.

Overview	Views
Equities	◆
Govt. bonds	◆◆
Credit	◆
Real estate	◆
Commodities	◆

Click on each asset class for more information

Tables reflect tactical views at time of publication.
Medium-term views/biases may be different.

Legal & General
INVESTMENT MANAGEMENT

EQUITIES

After a strong second quarter, global equity markets had a volatile third quarter. The first sell-off, mid quarter, triggered by concerns about the conflict between Russia and Ukraine spiralling out of control, lasted only a short time. Losses were recovered relatively quickly as geopolitical tensions eased and US growth data continued to be strong.

At this stage, in line with our 'sell into strength' approach ahead of the first Federal Reserve rate hike, we reduced our exposure to global equities. The first rate hike has historically been associated with an almost 10% correction and this risk had become too close to ignore.

Equities	Views
US	◆◆
UK	◆
Europe	◆◆
Japan	◆
Emerging markets	◆

Our medium-term assessment that the global economy remains 'mid cycle' continues to be supportive for equities and we would expect to add again to our equity position in corrections. Our base case remains that equities grind higher roughly in line with earnings growth with the air for further re-rating becoming thinner.

Within equities, Japan was a standout performer. While Abenomics continued to be a support, the main driver during the quarter was the depreciating yen, a big boost to exporters' profits. At the other end of the performance scale were emerging markets, which gave up a large part of their Q2 outperformance as Chinese growth data softened and idiosyncratic stories in Brazil, Russia and Hong Kong hurt performance. The UK also continued to be a steady underperformer, held back by political uncertainty continuing beyond the Scottish referendum. During Q3 we continued to favour Japanese and euro zone equities over the US and UK.

FIXED INCOME

Global fixed income markets rallied during the third quarter with the European bond markets in the driving seat. Inflation expectations dropped hard in the euro zone despite the efforts of the European Central Bank (ECB) to stem the tide: negative interest rates and promises of private sector asset purchases have not been enough to counter the market's deflationary fears. The erosion of market implied inflation expectations has pushed talk of quantitative easing back onto the agenda, reinforcing the bid for fixed income assets.

Fixed Income	Views
Nominal govt. bonds	◆◆
Inflation-linked	◆
Investment grade	◆
High yield	◆
Emerging market debt	◆

The market move has seen corporate and emerging market credits underperform benchmark sovereign bonds with the underperformance most marked in the US. The excess yield investors demand to hold high yield over government bonds increased by nearly 100 basis points in the US, compared to 60 basis points in Europe. Emerging market debt in hard currency also softened somewhat with spreads returning to where they started the year, whilst debt denominated in local currency suffered from a relapse in emerging market currencies.

Looking ahead, we expect short-dated interest rates in the US and UK to start rising in 2015. Although the likely pace of that monetary tightening has moderated with the drop in commodity prices, this is still likely to put upward pressure on bond yields (and therefore downward pressure on prices) as we move closer to the 'lift off' point for policy rates. That makes us nervous about the prospects for long-dated nominal government bonds.

Within fixed income, we have a preference for inflation-linked debt. This is particularly true in the US, where the recovery appears most entrenched and the prospect of rising wage pressure is most imminent. We are positive on emerging market debt relative to corporate debt given differentials in interest rates for equivalent-rated debt. We also have a regional preference for US over European high yield bonds in light of the recent underperformance and lower default prospects in North America.

CURRENCIES

In currency markets, the US dollar was the standout performer in the third quarter. The DXY dollar index, which is a broad-based measure of the value of the US dollar relative to a basket of foreign currencies, rallied 7.78%. Many of the same factors that affected global fixed income markets drove this rally. Although many investors had expected a re-pricing of the US dollar as the end of the Federal Reserve's quantitative easing and moves towards hiking rates loomed closer, the timing and magnitude of the rally still came as a surprise.

Currencies	Views
US dollar	◆
Euro	◆
Sterling	◆
Yen	◆

The US dollar rally was not just the result of strength in the US economy, its labour market and a central bank slowly taking away monetary stimulus, it was also boosted by easing measures from other central banks. The ECB signalled that it would like to grow its balance sheet by about €1 trillion to keep deflationary fears at bay. These diverging policies have led to a rapid rise in the US dollar versus the euro. But the US dollar has not only appreciated against the euro. It has made a broad move higher against many developed and emerging market currencies, as many economies face headwinds (e.g. euro zone, Brazil, China, Russia, Japan). For commodity exporters, weakness in commodity prices compounded these moves.

Sterling was also weak against the US dollar, but strong against the euro. It was only in the weeks before the Scottish independence referendum, which saw an increasing focus on the negative repercussions of a 'yes' vote, that the pound traded weak against both the US dollar and the euro.

The Japanese yen experienced another leg of weakness as the Japanese economy tries to recover from the VAT increase earlier this year and as it becomes more unlikely that the Bank of Japan will meet its inflation target for next year.

In a historical context, the magnitude of the US dollar rally is not unprecedented and rallies have lasted for much longer in the past. Currency weakness also provides relief to battered economies via increased competitiveness and increased inflationary pressures through imported goods (the US, given its relatively closed economy, can cope with a stronger dollar). However, we expect more of a consolidation in foreign exchange markets in the coming months. The Federal Reserve may be in the process of turning more hawkish, but they will only change tone measuredly as they are willingly behind the curve in order to provide insurance against any relapse. In addition, many investors now expect a continuation in the strong US dollar environment, which pushes the hurdle higher for more appreciation.

CONTACT US

For more information, contact your usual LGIM representative or Toby Orpin on 020 3124 3275.
www.lgim.com

IMPORTANT INFORMATION