

# Schroders

## Global Market Perspective

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Economic and Asset Allocation Views Q2 2015



**Schroders**

# Asset Allocation Views: Multi Asset Group

## Global Overview

### Economic View

Despite six years of “zero rates”, global growth remains tepid. At the latest count, 21 central banks have cut policy interest rates in 2015 and long-dated yields have fallen to unprecedented levels in the Eurozone. At the time of writing the German bond yield is negative up to seven years in maturity and JP Morgan estimates that \$1.9 trillion (30%) of the euro area bond market now has a negative yield. The Eurozone has been the principal driver of the drop in G7 bond yields which in aggregate are now below G7 core inflation for the first time in 20 years.

There is a concern that the latest fall in interest rates is just another chapter in a long-running saga of declining yields and that the underlying trend is being driven by secular stagnation. This occurs when an economy suffers from a chronic deficiency of demand such that it requires lower and lower interest rates to stimulate activity. Clearly, these concerns have a significant bearing on bond markets, but are they justified?

The secular stagnation theory fits many of the facts, as global growth has been disappointingly weak despite the fall in interest rates to record lows. Six years on from the financial crisis’ start, the Federal Reserve (Fed), Bank of England (BoE), European Central Bank (ECB) and Bank of Japan (BoJ) all have interest rates at – or close to – zero. If secular stagnation is the root cause, central banks may have to continue, or even restart quantitative easing. In which case; yields will trend even lower.

Our view is that the secular stagnation hypothesis is overly pessimistic. There is evidence to support it; such as a slow down in business investment in major economies such as the US, Germany and Japan. However, we see the world economy in a period of balance sheet adjustment; with countries emerging at different rates from the banking crisis. The US and UK recapitalised their banks at an early stage of the financial crisis, but the Eurozone has taken much longer. Now though we are seeing signs of a return to lending in the Eurozone following last year’s Asset Quality Review and stress tests. This suggests bond yields will eventually begin to normalise somewhat. The danger in the near term is that the Eurozone upswing has come too late to prevent a slide into deflation, or that the legacy of the crisis means that banks and households have become reluctant to re-leverage.

### Central Bank Policy

Following the mid-March meeting of the Federal Open Market Committee, we have pushed out our forecast for the first US rate rise until September 2015. Although the committee changed its language and opened the door to a June move, it also cut its forecasts for growth, inflation and interest rates. The main factor which has swung our view towards a later move has been the strength of the US dollar, which has exceeded even our bullish expectations. Dollar strength, which is beginning to depress core inflation through lower import prices, has effectively tightened financial conditions for the Fed. We still look for the UK to raise interest rates in November this year, but for the ECB and BoJ to continue with quantitative easing into 2016.

### Implications for Markets

Although we believe the bull market in equities has taken markets to record highs and there is a risk of a setback, an environment of modest growth and ample liquidity is set to support the asset class. The biggest change to our equity positioning this quarter is our downgrading of US equities to neutral, removing the positive stance we established three years ago. At the same time we have upgraded Europe ex.UK to positive. We think the outlook for US earnings has become less attractive, not least due to the strength of the US dollar. Although we have been forecasting a stronger dollar for some time, we did not expect the scale of the move seen since the start of 2015 and see further earnings downgrades in coming months.

# Asset Allocation Views: Multi-Asset Group

## Global Overview (continued)

### Implications for Markets (continued)

In Europe, meanwhile, we are seeing signs of stabilisation in the cyclical environment, equity valuations look relatively attractive and monetary policy will be supportive. The euro has been the main beneficiary of dollar strength as it has weakened significantly, providing a boost to corporate earnings. Germany is the biggest beneficiary of Euro weakness and we have a preference for the DAX within the region.

After Europe, Japan looks the next possible candidate for an upgrade, but for the time being we remain neutral on the country. How effective Abenomics has truly been so far remains unclear and we await clearer signs of improvement in domestic demand to appear in the data before we consider changing our stance.

We have been awaiting an opportunity to upgrade emerging market equities since 2011, and for the time being that wait will continue as the strength of the US dollar will continue to weigh on the region. There are also country specific problems such as those facing Brazil (Petrobras scandal) and Russia (Ukraine crisis, sanctions). Within emerging markets we prefer Asia which is best placed to benefit from better global growth and is likely to be more resilient to a rise in US rates.

In fixed income markets we remain neutral government bonds as we do not see an immediate inflation or growth trigger to generate enough upside yield volatility to overcome the carry. However, we have turned negative on US Treasuries and moved to neutral on Bunds. Offsetting this is a more positive view on UK gilts. Quantitative Easing by the ECB and BoJ will weigh on global yields at the long end, but the prospect of tightening in the US later this year will put upward pressure on the yield curve. In the UK, the Bank of England is likely to follow the Fed in raising interest rates and similar to the US, we continue to prefer the longer end of the curve. Otherwise, our sovereign bond position is primarily a play on global QE and a hedge against the sort of secular stagnation worries discussed above.

Within alternatives, we are neutral on commodities. Although prices are depressed, oil could remain under pressure until there is more evidence of a cut back in supply. Saudi Arabia will wish to be more confident that there has been a shift in US shale production toward more of a swing producer role. Meanwhile, there is the potential for an increase in supply from Iran following the recent agreement with western powers over its nuclear programme.

**Table 1: Asset allocation grid – summary**

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

Key: +/- market expected to outperform/underperform (maximum +++ 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 positioning in brackets. Source: Schroders.

# Regional Equity Views

## Key Points

+	Equities	
0 (+)	US	<p>Compared to last quarter, we have downgraded our positive view on US equities for the first time in three years, moving to neutral in the face of a stronger dollar and the prospect of rate rises later in the year. The dollar has surged in 2015 so far and as a result monetary conditions have tightened by more than expected, which may slow economic activity. In particular, corporate earnings are likely to come under increased pressure.</p> <p>Furthermore, valuations do not look cheap compared to other markets, although we expect flows from foreign investors to remain a supportive factor.</p>
0	UK	<p>Although the UK's growth profile remains relatively healthy compared to other European economies, we remain neutral on UK equities given their exposure to emerging markets and commodity prices.</p> <p>In addition, political uncertainty ahead of May's general election may undermine the housing-led recovery. With smaller parties set to capitalise on voters' disenchantment with the mainstream parties, political paralysis may ensue, which would likely disrupt progress on deficit reduction.</p>
+ (0)	Europe ex UK	<p>We have upgraded our view on European equities to positive. The euro has benefited from the strength of the US dollar, coming under considerable pressure over the past 12 months. This should provide a tailwind for corporate earnings. It is likely to weaken further in the face of an eventual Fed rate hike. Furthermore, our growth and inflation trackers for Europe are pointing upwards, while negative bond yields also provide support through lower financing costs for companies. Valuations in Europe look attractive compared to other developed markets and the ECB's quantitative easing (QE) programme will be supportive.</p>
0	Japan	<p>The effectiveness of the Bank of Japan's (BoJ) QE programme remains uncertain. In our view the weakness of the yen over the past year appears to have been driven more by the strength of the US dollar than by Abenomics. We expect trade to remain positive as Japanese firms gain market share in global export markets, but for a more robust recovery we need to see a continuation of the recent sign of improving domestic demand. We remain neutral on Japan for the time being, though see it as a strong contender for an upgrade in the near future as long as the data continues to get better.</p>
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	<p>We remain neutral on the region. In Australia, an exchange rate adjustment is required to boost domestic competitiveness with the economy suffering from the hangover after the mining boom. However, further Chinese stimulus could add impetus to the region with the authorities now actively seeking to support growth through looser monetary policy and targeted fiscal policy.</p>
0	Emerging Markets	<p>Emerging market equities remain a concern as the region suffers from the continued strength of the US dollar. Emerging market currencies have weakened markedly against the dollar since mid-2014, which should have provided a boost to exports. Yet this does not seem to have happened. Commodity price weakness and the generally bearish outlook for that asset class presents a bleak future for metal and oil-dependent Latin American economies, but an expected revival of Eurozone growth and continued US labour market strength should translate into gains for exporters of manufactured goods in Asia and Europe. At the moment, though, exporters under the cosh are being forced to cut prices, adding deflation to the global economy.</p>

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



# Fixed Income Views

## Key Points

0	Bonds	
0	Government	<p>We remain neutral on government bonds overall. Prospects of US tightening later this year is likely to increase the term risk premium, leading to rising 5-year rates and a fall in bond prices. However, with ECB QE in full flow and potential spill over effects, we see relative upside in markets such as the UK.</p> <p>Compared to last quarter, in the US we have made a downgrade to our neutral 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, with the long end being supported by a stronger currency and the spill over effects for ECB QE.</p> <p>In the UK, we have upgraded our view on Gilts. Similar to the US, we continue to prefer the longer end of the curve. Political risk could also be a factor weighing on UK markets, although the GBP may take most of the strain from election uncertainty and potential political paralysis.</p> <p>We have downgraded our view on German Bunds to neutral, although we continue to favour them relatively over the US 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.</p> <p>In Japan we maintain our neutral position on Japanese duration despite the unattractive yields on offer 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.</p>
-	Investment Grade (IG) Corporate	<p>There is some argument for a spill over 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. Hence we maintain a negative stance on the asset class overall.</p> <p>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.</p>
-	High yield (HY)	<p>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. excluding energy) still remains aggressively priced and exposed to global macro-economic risks or uncertainty over Fed tightening.</p> <p>In Europe, while QE and record low yields should push investors into higher yielding assets, the bulk of buying will be in higher-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.</p>
-	USD-denominated Emerging market debt (EMD)	<p>We are negative on emerging market 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 likely US rate rise, but fundamentals have been improving in many emerging market countries. We prefer local market exposure (without the FX risk) over emerging market USD exposure.</p>
0	US index-linked	<p>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.</p>

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# Alternatives Views

## Key Points

Alternatives	
0	<p><b>Commodities</b></p> <p>We are neutral on broad commodities this quarter as we wish to see more evidence that depressed prices will recover through a combination of improved demand and reduced supply.</p> <p>For example, in energy, capital expenditure is being cut back, but we await more evidence that this will temper the current oversupply.</p> <p>We remain negative on gold given our positive view on the dollar.</p> <p>We have moved to a positive stance on base metals. China has moved firmly into an easing cycle, bringing forward \$1.1 trillion 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. Our structural outlook remains less constructive, however.</p> <p>We maintain our neutral positioning within agriculture. While supply/ demand dynamics and the macro environment should put pressures on prices, there is currently no weather premium priced in the market, so that the margin of safety is too low to warrant a negative score.</p>
+	<p><b>UK Property</b></p> <p>The latest IPF Consensus Forecast suggests that commercial real estate will achieve total returns of 12% in 2015. Our view is that total returns in 2015 will probably be closer to 15%, although the more yields fall this year, the greater the risk there will be of a potential correction in the future.</p> <p>Potential uncertainty surrounds the UK general election, with the risk that business confidence will be shaken either by the prospect of an EU referendum, or by large increases in corporation tax and the minimum wage. The former could be problematic for London, given it is a hub for international financial and business services, whereas a jump in the minimum wage would hit care homes, hotels, leisure, pubs and retailers in particular.</p>
+	<p><b>European Property</b></p> <p>Our forecast is for total returns on average investment grade European real estate to average 7-9% per year between the end of 2014 and the end of 2018. Total returns and capital growth are likely to be front-loaded, benefiting from yield compression in 2015-2016 and rental growth from 2016 onwards. The main upside risk is that the low level of interest rates triggers an even bigger fall in yields through 2015-2016 than we have assumed in our forecasts. That would boost total returns in the short-term, but probably store up problems for the long-term, when interest rates in the Eurozone eventually rise. The main downside risk is that the sovereign debt crisis re-ignites, either because Greece leaves the euro, or because deflation in the Eurozone becomes entrenched.</p>

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

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