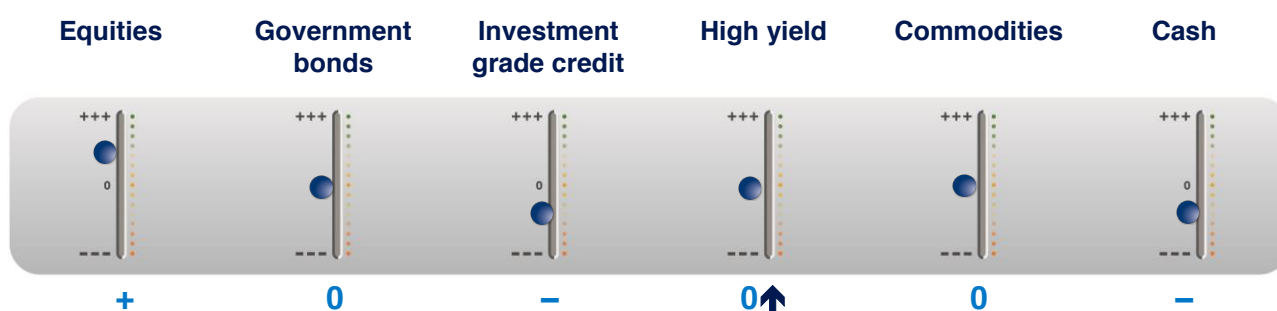


# Schroders Multi-Asset Investments

## Views and Insights

### Section 1: Monthly Views – July 2015

#### Summary



| Category         | View | Comments   |
|------------------|------|--|
| Equities         | +    | In aggregate, we believe that equities will continue to deliver positive returns but expect a high degree of rotation across regions. We maintain our positive view on equities this month but have made changes to our preferred regions. Based on the three factors we use to analyse equity markets, notably valuation, momentum and cyclical/qualitative factors, our preferred equity markets are now the US, Europe and Japan, while we have turned negative on emerging markets (EM). |
| US               | +↑   | We have upgraded our rating on US equities to positive this month. While we are cognisant of the rich valuations in the US relative to global peers, we believe this is outweighed by the country's strong cyclical trends.  |
| UK               | 0↓   | We have downgraded our view on UK equities back to neutral this month. We originally upgraded the market following the outcome of the general election, taking the view that positive momentum on the data front would lend support to domestic sectors. While domestic data has supported the market, this has not been enough to offset the weakness from the commodity sectors where earnings remain in a downward trend.   |
| Europe           | +    | Despite the ongoing uncertainty around Greece, we remain positive on European equities. This view is supported by three tailwinds: the weaker euro which will have a positive impact on corporate earnings, the cyclical recovery as seen by a pickup in leading economic indicators, and the abundant liquidity provided by the European Central Bank (ECB).  |
| Japan            | +↑   | Like the US, we have turned positive on Japan this month as the growth prospects provide a compelling case for the market on a relative basis. The rebound in earnings growth and the weakness in the Japanese yen have supported the equity markets. We believe the government's continued initiatives to provide an accommodative environment for corporates will unlock significant shareholder value.  |
| Pacific ex Japan | 0    | We remain neutral on Pacific ex Japan this month. While valuations are becoming increasingly attractive, the region's reliance on China gives us reason to maintain a cautious stance.   |
| Emerging Markets | -↓   | After turning less negative on emerging market equities in Q1, it is clear from the economic data that the situation does not give us cause to be optimistic. Despite aggressive policy easing, domestic demand is still poor, deflation remains a credible threat and financial conditions are tight. We have therefore downgraded our view to a negative rating.   |

## Schroders Multi-Asset Investments

| Category                | View | Comments   |
|-------------------------|------|--|
| <b>Government bonds</b> | 0    | We remain neutral on government bond markets overall with short positioning in US Treasury 10 year bonds while our positive outlook on European bonds is expressed via curve trades in German Bunds and UK gilts.  |
| US                      | -    | Our view on US Treasuries remains negative and we continue to prefer a butterfly (long 30 year, long 2 year and short 10 year) strategy to express our negative view with a less negative carry.   |
| UK                      | +    | We remain positive on the UK given the higher carry and lower yield volatility relative to many other developed markets. We continue to expect flows into the region from yield-starved European investors.  |
| Germany                 | +↑   | We have upgraded Germany to positive this month. We still expect curve flattening to occur but we have altered the position from a 2 year/30 year to a 2 year/10 year position. The low supply and potential further action by the ECB to suppress real yields and the euro should be supportive for the long end of the yield curve.  |
| Japan                   | 0    | We retain our neutral view on Japanese duration this month. We believe that the Bank of Japan will continue to provide accommodative conditions which, while likely increasing inflation, should also keep a cap on the long-end of the yield curve.   |
| US inflation linked     | 0    | We remain neutral on inflation in the US given the pressure exerted on the long-end of the inflation forward curve by a structurally higher US dollar.   |
| Emerging markets        | 0    | We maintain our neutral view on emerging markets this month. Carry and valuations continue to look attractive but we are concerned as to whether this will be sufficient to outweigh the potential volatility caused by the US Federal Reserve's (Fed) first rate rises. As we move closer to this event, which we expect to occur later this year, this month's Multi-Asset Views looks at the potential impact of a Fed rate rise on emerging market liquidity and funding stress. |

| Category                       | View | Comments  |
|--------------------------------|------|---|
| <b>Investment grade credit</b> | -    |   |
| US                             | -    | The US investment grade micro picture remains benign, but risk/rewards continue to look unconstructive on a medium-term horizon. Therefore, we maintain our negative outlook. |
| Europe                         | 0    | Spread valuations have marginally improved after the recent sell-off. However, the increasing supply and volatility in European rates markets supports our cautionary stance. |

| Category                 | View | Comments  |
|--------------------------|------|---|
| <b>High yield credit</b> | 0↑   |   |
| US                       | 0↑   | We have upgraded US high yield (HY) this month, based mainly on improved valuations. We have become more confident that the disruption stemming from the energy rout last year has abated to a large extent, while spreads have been resilient in the face of the latest Greek episode. |
| Europe                   | 0    | Our neutral view on European HY remains unchanged from last month. While improving growth dynamics in the region are positive for HY issuers, we remain wary of the poor liquidity in the market.   |

| Category           | View | Comments   |
|--------------------|------|--|
| <b>Commodities</b> | 0    | <b>We remain neutral on broad commodities as we are less constructive on cyclical commodity markets as global growth has failed to accelerate in line with our expectations.</b> |
| Energy             | 0    | After downgrading energy in June, we remain neutral as the price correction has not yet pushed valuations to attractive levels given the fundamental data remains mixed.         |
| Gold               | -    | We continue to hold a negative view on gold as we expect stronger US data to push up real  |

|                   |    |   |
|-------------------|----|---|
|                   |    | rates, reducing the attractiveness of real assets.  |
| Industrial metals | 0↓ | We have downgraded industrial metals this month. China's decision to bring forward infrastructure expenditure and loosening monetary policy is supportive for industrial metals. However, the data is yet to stabilise and the ongoing volatility in the Chinese stockmarket is weighing on industrial metals prices. |
| Agriculture       | 0↑ | We have upgraded agriculture back to neutral as weather risks have materialised and positioning is very negative.   |

| Category          | View | Comments  |
|-------------------|------|---|
| <b>Currencies</b> |      |   |
| US dollar         | ++   | We maintain our strongly positive view on the US dollar this month due to the expectation that US growth will reaccelerate over the coming quarters.  |
| British pound     | 0    | We remain neutral on sterling, the only G10 US dollar currency pair that we do not have a negative view on. Recent comments from the Bank of England suggest a rate rise is likely around the turn of the year, which is in stark contrast to the ECB which we expect will keep accommodative conditions for the foreseeable future.            |
| Euro              | -    | We remain negative on the euro given our expectation that accommodative monetary policy will remain until at least the start of 2017. While we expect growth in the eurozone to pick up throughout 2015, on-going concerns around Greece coupled with low real rates relative to the US and the UK should continue to put pressure on the euro. |
| Japanese yen      | --   | The Japanese yen remains our least preferred currency relative to the US dollar given weak inflation and relatively modest growth figures. It is our expectation that further accommodative monetary policy will be required which will weigh on the currency.  |
| Swiss franc       | -    | Our negative view on the Swiss franc remains unchanged this month. The stronger franc remains a headwind to the Swiss economy and we believe that it continues to be overvalued.  |

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

Source: Schroders, July 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 US dollar, apart from US dollar which is relative to a trade-weighted basket.

## Section 2: Multi-Asset Insights

### Are emerging markets prepared for the eventual US rate hike?

After nearly seven years of record low interest rates in the US, we remain of the opinion that the Federal Reserve (Fed) will raise the Federal funds rate by the end of 2015. Such action poses a significant risk to emerging markets (EM) given the reliance on US dollar funding. This month we look at the potential impact on EM liquidity as the Fed looks to normalise monetary conditions. We consider the liquidity in EM from three angles: external, domestic and, to a lesser extent, equity positioning within EM.

#### External liquidity

The rise in the issuance of local currency debt by EM countries has, in isolation, reduced reliance on external funding. EM Asia and Latin America (LatAm) gross external public debt issuance have decreased significantly in the aftermath of the Asian/EM financial crisis in the late 1990s. While the reliance of external debt has fallen, the currency breakdown of such debt has become more concentrated in the US dollar, relative to alternatives such as the yen, euro or sterling. Notably, over 70% of public external debt in LatAm and EM Asia is denominated in US dollars while EM Europe has greater external debt relative to GDP albeit with less US dollar reliance<sup>1</sup>.

Looking at the major economies within EM, Turkey and South Africa are the most vulnerable to a removal of external liquidity given their relatively low FX reserves, negative current accounts and large amounts of maturing external debt. Malaysia, Indonesia and Mexico have become more vulnerable since the “Taper Tantrum” of 2013, while Brazil and India have seen some improvement<sup>2</sup>.

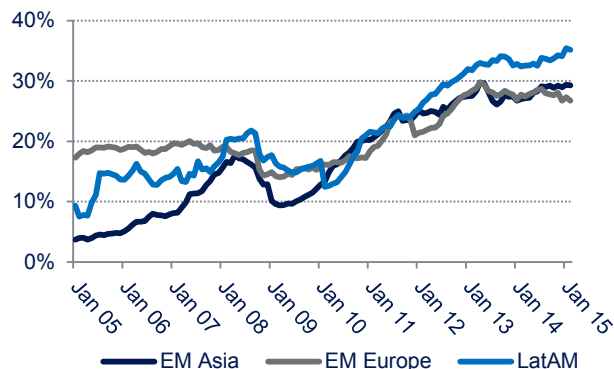
Aside from external debt, we also examined foreign ownership in local currency debt. While the rise of local currency debt is expected to reduce the vulnerability of EM countries to currency fluctuations associated with a Fed hike, the sizeable increase in foreign ownership represents significant vulnerability to external liquidity, as shown in Figure 1. In recent years, EM local currency debt markets have attracted flows as markets have opened to foreign investors. However, higher US interest rates improve the relative yield attractiveness of US government bonds and leave EM countries vulnerable to the flight of hot money from foreign investors seeking higher yields.

#### Domestic liquidity

Next, we examine the potential for EM countries to raise domestic liquidity. Most EM policy makers have the flexibility to lower interest rates with current levels above the lowest levels during past crises. Domestic and external liquidity are closely linked due to foreign investors’ positioning in the EM carry trade. Consequently, EM central banks will have to balance the need to reduce rates to provide domestic liquidity and support growth, while continuing to provide an

attractive destination for foreign investors. Brazil and Turkey have the most flexibility to cut rates given current levels of 13.75% and 10.75% respectively, while South Africa is the most constrained given that the current 5.75% rate is just 0.75% above the lowest rate over the past 15 years<sup>2</sup>.

Figure 1: Foreign ownership of local currency EM bonds



Source: Morgan Stanley. Asia includes South Korea, Indonesia, Thailand and Malaysia; CEEMEA includes Hungary, Poland, Russia, Turkey and Czech Republic; LatAm includes Brazil, Colombia, Mexico and Peru. Data as of February 2015.

While the debt dynamics of externally vulnerable economies give us cause for concern, there is scope for domestic liquidity injection via interest rate cuts albeit to a varying degree regionally. The Fed’s communication of a gradual hiking cycle is therefore essential to ensure that the more vulnerable EM economies are able to adjust monetary policies to balance growth without the risk of capital flight.

#### Equity positioning

Finally, we looked at EM equity positioning. Our analysis suggests that some of the most vulnerable countries are among the largest overweights in global EM portfolios, particularly India, Brazil, and to a lesser extent, Turkey. This could add strong negative selling to the otherwise uncertain fundamental position.

#### Portfolio positioning

As with all our research, it is important to put these conclusions into context for our portfolios. The risks to EM liquidity and growth from the Fed’s rate hikes form a part of our negative view on emerging market equities. We are neutral on EM government bonds, wary of weakness when the Fed hikes while acknowledging the attractive carry and valuations. However, performance will vary between countries as we expect heightened liquidity risk in the externally challenged economies, most notably South Africa, Turkey, Mexico, Malaysia, Indonesia, and to a lesser extent, in Brazil and India.

<sup>1</sup>World Bank, 2013, <sup>2</sup>Schroders, Bloomberg

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