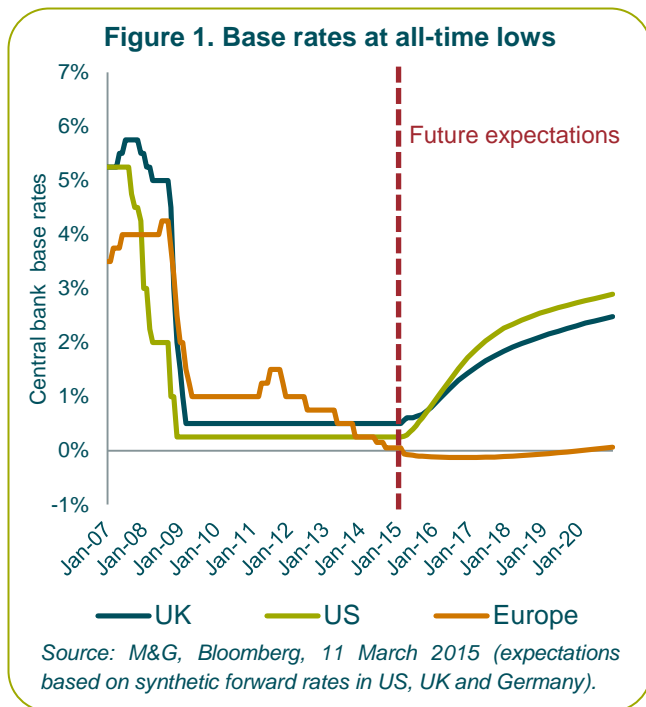


*In our updates over recent years, we have been emphasising the importance of moving money away from very low cash rates and into an array of assets, diversified across the government bond, credit and equity markets. Today, there are increasing expectations of a rate rise this year in the US and UK which could improve the returns on cash and trigger market volatility. However, it remains our view that selected equity markets are sufficiently attractive to make tolerating potential volatility worthwhile. At the same time, divergent trends in central bank policy around the world could well continue to lead to volatility in foreign exchange markets.*

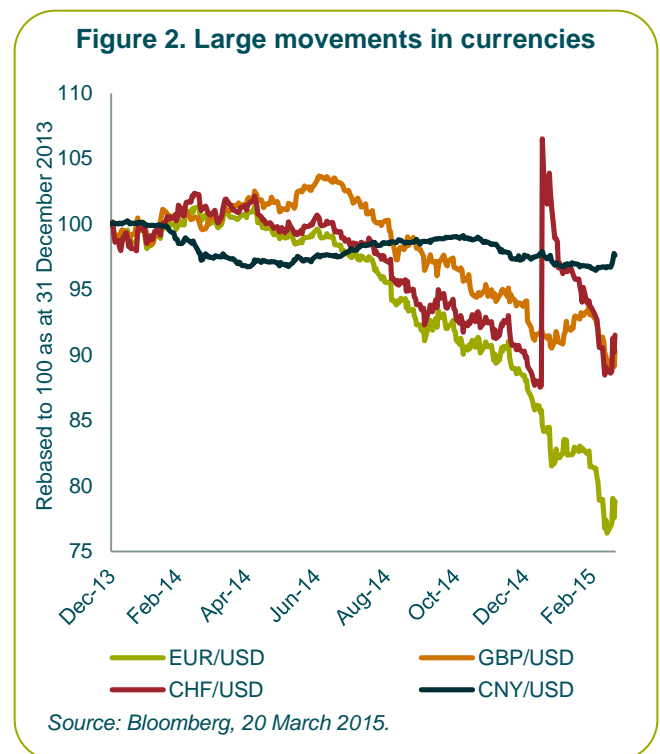
### Developments in 2015

As figure 1 would suggest, we are now reaching a time where the likely direction of cash rates is increasingly upwards rather than downwards, particularly in the US. The world's biggest economy appears to be gathering significant momentum and the Federal Reserve (Fed) is getting closer to ending its super accommodative monetary policy. Similarly, the data coming out of Europe is firming up, which means that, just as the European Central Bank (ECB) embarks on €1 trillion of quantitative easing, the underlying economy already appears to be improving.



At the beginning of the year, we anticipated that the global divergence in central bank policy and growth rates would result in some significant foreign exchange market volatility, along with subsequent implications for fixed income and stockmarkets as well. Indeed, this has played out so far.

The euro has depreciated meaningfully in the lead up to, and following, the ECB's announcement of quantitative easing. This, in turn, has been accompanied by rallying eurozone equity markets. The Swiss National Bank also removed the Swiss franc's peg to the euro, resulting in severe short-term currency volatility, as figure 2 illustrates. Meanwhile, in Asia, the People's Bank of China has started steadily easing policy alongside the Indian and South Korean central banks, which are cutting rates as well.



This means that large parts of the world are now pursuing monetary policy that is easier than it was at the start of the year. The contrasting direction of US policy therefore ought to be causing the US dollar to materially strengthen, which is already happening to some extent. Nonetheless, we would expect this to persist in the months ahead and our funds are accordingly well positioned to benefit.

## Prepared for market volatility

As figure 3 shows, selected equity markets continue to look attractive, and even after the further strong performance we have seen in a number of regions so far this year. An increasing number of fixed income valuations are, however, starting to look stretched. Selecting those pockets of value that exist or exploiting relative value opportunities is becoming increasingly important.

The impact of expectations for rising cash rates is likely to be felt in all assets. This could simply manifest itself in short-term volatility. However, for those assets that have been driven to expensive levels as a result of low cash rates, losses could well be more sustained. In our view, the best means of navigating the period ahead, as always, is to hold assets that we believe make sense in their own right over the longer term, rather than try to second-guess how markets may or may not behave in the short term.

As valuations have become less attractive across most assets over the quarter, exposure has been reduced in our multi-asset portfolios, with exposure to fixed income, in particular, being reduced in favour of cash. This is a reflection of observations on valuation, but will also enable the funds to respond quickly to any opportunities that may arise from behaviourally driven volatility.

Figure 3. Valuation signals are clear



Source: Datastream, Bloomberg, 31 March 2015. Equity proxy is MSCI World; cash proxy is EURIBOR 3 months. World Government proxy is The BofA Merrill Lynch Global Government Index. All data is inflation-adjusted.

We are maintaining an overweight exposure to equities across our funds. While we should be prepared for the short-term volatility that rising rates could deliver, we are confident that a diversified but selective positioning within the asset class is the most favourable route to attractive medium-term returns.

**M&G**  
**April 2015**

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