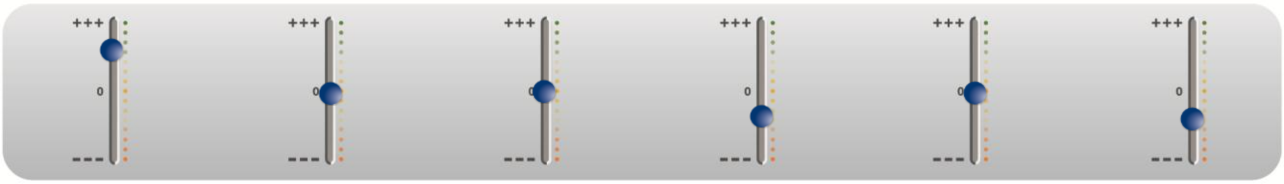
Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – September 2014

Summary

Equities	Government bonds	Investment grade credit	High yield	Commodities	Cash



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Category	View	Comments
Equities	++	**The soft patch we expected when we downgraded equities in July arrived earlier than we had anticipated. Taking advantage of the pull back in prices, we upgraded equities overall by favouring the UK, a market that has underperformed so far this year. The long-term risk environment remains supportive of corporate earnings growth. On a relative basis we favour the US, Japan and emerging markets, and are neutral on Europe/UK.**
US	+	We continue to believe that the US market offers the best potential for earnings growth, while its defensive qualities are attractive against a backdrop of weaker growth momentum and heightened geopolitical risk. We maintain our negative view on US small caps which still look expensive relative to large caps, despite the recent correction.
UK	0↑	We upgrade our view on UK equities from extreme negative to neutral. The UK market has underperformed global equities so far this year, presenting an opportunity to close out the underweight view. In addition the recent pullback in sterling provides some relief for UK corporate earnings, a meaningful proportion of which are generated overseas.
Europe	0	Although the European market has recently underperformed, we maintain our neutral positioning as the prospect of quantitative easing from the ECB remains a supportive factor for price multiples.
Japan	+	Recent economic data in Japan has been below expectations. However, we believe these effects to be temporary and remain positive on the longer term prospects for Japan given the (slowly) changing attitudes towards corporate governance and structural reforms.
Pacific ex Japan	0	We have maintained our neutral stance on the region. Australia's economy remains vulnerable to any reduction in demand for commodities or a slowdown in the property sector.
Emerging Markets	+	It appears that emerging markets are starting to benefit from the recovery in developed markets, with a broad-based improvement in export growth. This cyclical improvement could lay the foundation for a sustainable earnings-led upgrade across the region, which, given historically low valuations, makes the region attractive.

Category	View	Comments
Government bonds	**0**	**We recognise that duration is trading towards the lower end of our expected range and although we continue to expect a gradual recovery in the US, inflation and growth numbers still remain below trend. Additional liquidity provided by the European Central Bank (ECB) and Bank of Japan (BoJ) offsets marginal tightening in the US. Geopolitical risks remain high.**
US	-	We are negative on US duration as we continue to expect a gradual economic recovery in the US. We maintain our underweight position in US Treasuries on a relative basis versus Gilts and Bunds.
UK	0↓	Economic momentum has started to slow from very high levels and any negative impact from geopolitical events or sluggish European growth is likely to be positive for Gilts. Short-term, however, we have downgraded Gilts to neutral given the uncertainty around the Scottish referendum. We still hold on to a relative overweight compared to US Treasuries though.
Europe	0	We remain neutral given less attractive carry and roll characteristics compared to other developed bond markets and aggressive pricing in the front-end of the curve. However, we still strongly prefer Bunds on a relative basis to US Treasuries as we expect continued monetary divergence between the ECB and the Federal Reserve, as evidenced by the surprise ECB reduction in interest rates.
Japan	0	Despite its flat yield curve and low real yields, we maintain our neutral position on Japanese duration at the medium to long-end of the curve due to the aggressive support provided by the BoJ.
US inflation linked	+	We remain positive on US inflation-linked bonds. We expect the Federal Reserve to remain dovish for some time and potentially spark a further increase in inflation expectations. At the same time, the carry offered by the real yield curve is positive.
Emerging markets	0	We remain neutral on EM USD bonds as spreads have stabilised but remain fairly tight. In the EM local bond universe we still like the front-end of the curve in South Africa, as well as 10 year Korean bonds because of a supportive central bank and strong Asian flows.

Category	View	Comments
Investment grade credit	**0**	
US	-	While we expect the recovery in the US to be supportive of investment grade credit, the potential for renewed interest rate uncertainty could create some upward pressure on spreads. We may also see a renewed rotation out of corporate bonds into equities.
Europe	+	We continue to favour European investment grade over US investment grade. Technicals remain supportive, benefiting from demand from fixed income investors due to low government bond yields. Meanwhile the more accommodative policy from the ECB should provide further support.

Category	View	Comments
High yield credit	**-**	
US	-	High yield spreads have recovered after the mid-year widening. We believe US high yield debt still looks vulnerable, particularly as liquidity appeared to be a concern during the correction. Over the coming months we see a risk of higher volatility as the US moves closer to rate normalisation and investors rotate positioning.
Europe	0	Although fundamentals are mixed, we remain neutral overall. Europe is showing signs of weakness with poor growth and low inflation. The more accommodative monetary policy in Europe is supportive to the market relative to the US, but we expect these two markets to remain highly integrated.

Category	View	Comments
Commodities	**0**	**We remain neutral due to the risks around agriculture prices and the impact Chinese policy could have on sentiment over the short term.**
Energy	0	Prices have stabilised after their recent correction, though we will need to see a reduction in Saudi supply or better data from Europe before turning positive.
Gold	0	We maintain a neutral view as gold continues to trade in a range. We wait to see if gold breaks out of the lower end of that range and/or real rates begin to move upwards.
Industrial metals	0	We remain structurally bearish towards industrial metals given supply and demand headwinds. However, we maintain our neutral score due to the support from Chinese policymakers, who continue to ease policy. This should provide support for Chinese growth and therefore metal demand.

Agriculture	-	We remain negative on agriculture. We acknowledge after the strong correction in prices over the past month that the risk reward trade-off from our short position has deteriorated. Our base case is that prices continue to drift lower, however we are mindful that this is a consensus position and that there are large short positions in the market.

Category	View	Comments
Currencies		
US dollar	+	We expect a continuation of the recovery in the US and further tapering from the Fed. This divergence between Fed policy and other G10 central banks, which remain on hold or with a bias towards further loosening, should support the USD in the medium term.
British pound	0	We maintain a neutral position on sterling due to our belief that rate expectations are fully priced, with our view being that rate hikes are either pushed back or the economy slows as rates are increased.
Euro	-	We continue to see deflationary pressures in the eurozone and the ECB has cut interest rates further to combat deflation. We expect the euro to come under pressure in the near-term as a result.
Japanese yen	- - -	We expect that the Japanese yen will weaken in the second half of 2014 as the market begins to anticipate additional easing from the BoJ to offset the effect of the consumption tax hike. Growth friendly policy measures in China should also reduce the upward pressure that was being placed on the yen due to fears of a Chinese hard landing.
Swiss franc	- - ↓	The Swiss franc has rallied recently against the euro, leading us to downgrade it further as we anticipate a pullback. The Swiss National Bank has reaffirmed its support for the CHF/EUR floor and, with limited inflation, there is little pressure to change monetary policy.

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

Source: Schroders, September 2014. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged).

Section 2: Multi-Asset Insights

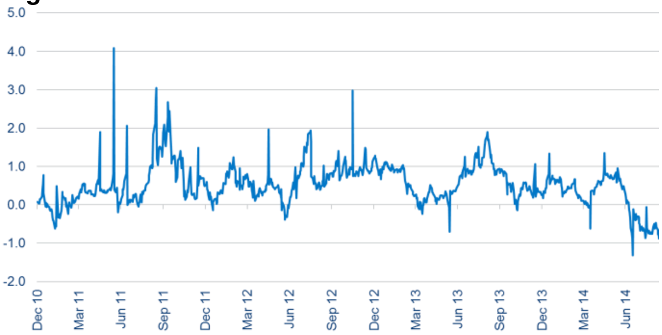
By Alastair Baker and Patrick Brenner, Multi-Asset Fund Managers

Energy – a serious bout of indigestion

Over the last few weeks there has been a large shift in the energy futures curve from backwardation (when the futures price is lower than the spot price), to contango (when the reverse is true).

The shift has been caused mainly by a steep fall in spot prices. This was last seen during the Arab spring of 2011, as shown in Figure 1 below.

Figure 1: First minus second month Brent contract



Source: Schroders, Bloomberg, August 2014

Figure 1 shows the difference between the first and second month futures contracts with near dated futures at lower levels reflecting an upward sloping curve.

Our view is that the energy markets suffered a serious bout of indigestion caused by:

1. Extended positioning earlier in 2014 – investors had built up long positions as the tensions in Ukraine and Iraq rose, and were overextended coming into Q3.

2. A jump in supply – Libya delivered additional crude to the market despite domestic instability, which coincided with the seasonal ramp-up in Saudi production.

3. A counter-seasonal softening in demand – the economic activity in Europe and China continued to soften causing weaker demand than usual over the summer months.

Interestingly, the longer end of the futures curve actually rallied following the Russian sanctions, which could constrain long term supply growth.

Our view is that prices are likely to settle at around these levels, with a recovery only likely if we see stabilisation in Europe or a reduction in Saudi supply.

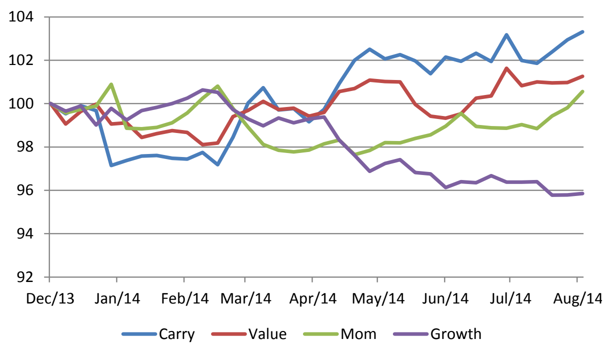
Carry on Currencies – still a good bet

We decompose currency market performance into four factors:

- **Carry**, reflecting the difference between high and low yielding currencies;
- **Value**, based on our internal value metrics;
- **Momentum**, looking at short term price moves;
- **Growth,** using a country's economic growth as a measure of currency behaviour**.**

Carry is the strongest factor so far this year, driven by the strong performance of EM currencies (except for the ruble and Chilean peso) and the weakening of low-yielding G10 currencies. The Value factor also benefitted from the recovery of EM currencies but was somewhat hampered by continuing strength in the Australian and New Zealand dollars (considered overvalued).

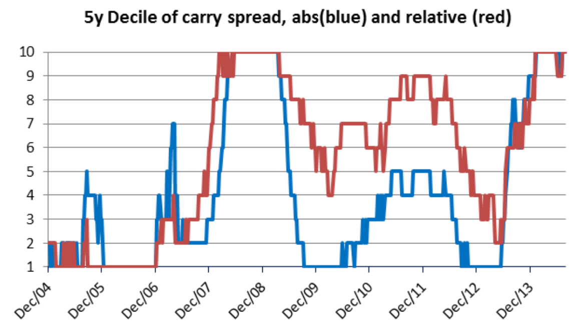
Figure 2: Currency factor performance YTD



Source: Schroders, August 2014

Despite the strong performance of Carry, we continue to find carry attractive as yield spreads remain in the upper deciles relative to history. In addition, both Europe and Japan are likely to maintain loose monetary policy, which should be supportive for carry.

Figure 3: 5 year decile of carry spread



Source: Schroders, August 2014