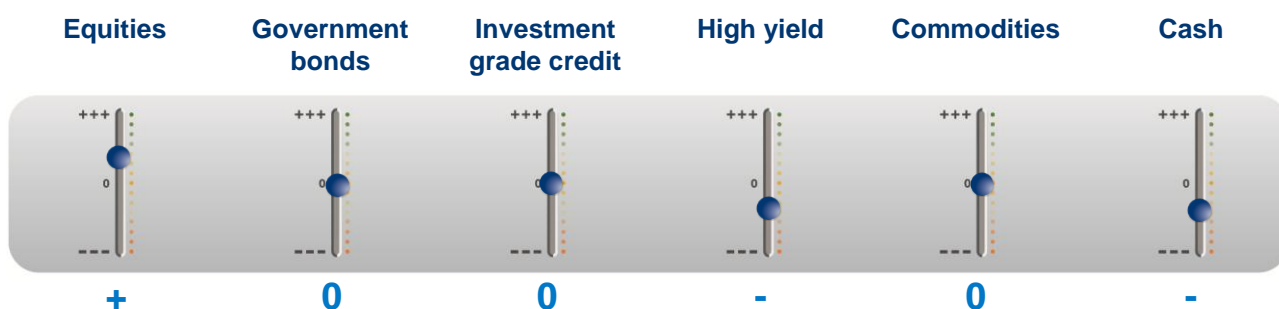


Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – July 2014

Summary



Category	View	Comments
Equities	+ ↓	We have slightly downgraded our positive view on equities, which have performed strongly year to date. As equity indices approach cyclical highs, the valuation case for the asset class is less compelling in both absolute and relative terms. The reduction is focused on Europe, which continues to benefit from lower peripheral bond yields without the hoped for earnings gains, and the UK, which continues to be impacted by the resilience of sterling.
US	+	We maintain a positive view on US equities as we believe the market still offers strong potential for earnings growth and it is encouraging to see earnings contributing more significantly to the year-to-date returns compared to 2013. Furthermore, the market's defensive qualities will be attractive should we encounter weaker global growth momentum and increased geopolitical risk.
UK	-- ↓	We are relatively less positive on the UK due to the strength of sterling and the meaningful proportion of UK corporate revenues that are generated overseas. Furthermore, Mark Carney, Governor of the Bank of England (BoE), appears to have adopted a more hawkish stance, which leads us to expect sterling strength to be sustained.
Europe	0 ↓	We have downgraded Europe to neutral even though European Central Bank (ECB) policy remains supportive. The market has performed well year-to-date and, with the predicted improvement in margins having failed to materialise, we believe it is prudent to take profits at this stage.
Japan	+ ↑	We have upgraded Japan given the recent recovery in the Japanese equity market in spite of the strong yen. This may signal that investors are starting to consider factors other than expectations of further monetary easing to support the market. Triggers for this change include the latest set of economic data that point towards an economy weathering the April tax hike better-than-expected and the well-publicised corporate tax cuts.
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	+ ↑	The recovery in developed markets finally appears to be spilling over into emerging markets, driven by higher private consumption and lower fiscal drag in the west. The cyclical improvement could lay the foundation for a sustainable earnings-led upgrade across the region, which given historically low valuations, make the region very attractive. We are therefore broadening our positive view on EM from Asia to the wider universe.
Emerging Markets Asia	0 ↓	Valuations are attractive in China but less so in Taiwan. However, in Taiwan, earnings are looking well-supported given the prospect of expanding margins this year, particularly in the technology sector. The downgrade of EM Asia reflects the more positive score for EM as a whole.

Category	View	Comments
Government bonds	0	We stay neutral on duration given ongoing monetary stimulus in most developed countries. Economic growth is moderate though there are early signs of inflation expectations rising.
US	- ↓	We downgrade US Duration to single minus because of a continued improvement in US economic data. We continue to remain underweight US Treasuries on a relative basis versus Gilts and versus Bunds.
UK	0	While recent UK data has been encouraging (and hence negative for bonds), we still expect short-term rates to rise less steeply than the market expects due to the dependence of the recovery on the UK housing market and to the high levels of household debt. Therefore, we retain our neutral outlook.
Europe	0	We remain neutral on European duration given that the ECB continues to offer liquidity to the market.
Japan	0	Japanese growth data appears to have reflected the consumption tax hike in April. While we expect that the Bank of Japan (BoJ) will maintain its quantitative easing (QE) programme, inflation has since increased, leading us to maintain a neutral view.
US inflation linked	+	Drivers of inflation are starting to increase. Wages and payrolls are rising in the US labour market, and food and rents are also trending upwards. Although a spike in inflation is not imminent, we prefer inflation-linkers to nominal bonds as the latter are underpricing inflation risk.
Emerging markets	0	We remain neutral on EM USD bonds as our positive spread outlook is offsetting our slightly negative US duration view. In terms of EM Local, we are positive on the short end of the South African bond curve and the short end of the Mexican bond curve.

Category	View	Comments
Investment grade credit	0	
US	-	Although US investment grade should be supported by the US recovery, we remain marginally negative (on a medium-term horizon). Current spreads offer little room for further tightening, while the potential for interest rate hikes could create some upward pressure on spreads. Our view should also be seen relative to the European investment grade spreads, where we continue to hold a positive rating.
Europe	+	We continue to favour European investment grade over US investment grade. Technicals remain supportive with little new issuance expected, and lukewarm growth in Europe ought to be credit-friendly. The ECB's more aggressive monetary policy should provide further support for the credit premium.

Category	View	Comments
High yield credit	-	
US	-	We maintain a negative medium-term view on US high yield. We expect more idiosyncratic risk to emerge as sector and single name fundamentals diverge. Even if the environment remains positive, we believe there could be better opportunities outside this sector.
Europe	0	Although fundamentals are mixed, we remain neutral overall. The euro area is exposed to anaemic credit growth and exceptionally low inflation. The high levels of leverage on offer seem to be moderating in 2014, while a low interest expense has kept coverage ratios well supported. The more expansionary monetary policy in Europe is supportive to the market relative to the US.

Category	View	Comments
Commodities	0	We maintain our overall neutral stance towards commodities. This partly reflects the continued uncertainty concerning both agricultural prices resulting from unpredictable weather patterns, and Chinese policy, which could lead to an improvement in sentiment.
Energy	+	Due to seasonal factors and the positive carry, we maintain our constructive view on the energy markets. We are carefully watching how the market digests the increase in Libyan supply.
Gold	0	We maintain a neutral view as gold continues to trade in a range. We will become less positive if we see gold break out of the lower end of that range and/or real rates begin to move upwards.
Industrial metals	0	We remain structurally bearish due to the unfavourable balance of supply and demand. However, the shift in Chinese policy from tightening to easing may provide support to Chinese growth and hence demand for metals.

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Agriculture	-	We remain negative on agriculture on the basis that supply appears to be ample across most commodities, particularly in soybeans. Prices are beginning to fall, reflecting this increase.
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Category	View	Comments
Currencies		
US dollar	+	We expect the US recovery to advance and for the Federal Reserve (Fed) to continue to taper QE. The divergence in Fed policy from many 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	+	The UK economy continues to make progress relative to other economies. The recovery is increasingly broadening although still dependent on the housing market.
Euro	-	We continue to see deflationary pressures in the eurozone and the ECB has further reduced rates. We expect the euro to come under pressure in the near-term as a result.
Japanese yen	- - -	We expect the yen to come under pressure in the second half of 2014 as the market begins to anticipate additional easing from the BoJ following the impact of the consumption tax hike. Growth-friendly policy measures in China should also reduce the upward pressure that was being placed on the yen by fears of a Chinese hard landing.
Swiss franc	-	The Swiss economy has strengthened over the year in line with broader eurozone improvements. The Swiss National Bank (SNB) has reaffirmed its support for the CHF/EUR floor and, with limited inflation, there is little pressure to change monetary policy. The economy remains vulnerable to a deterioration in the eurozone, which would very likely lead to a return of 'safe haven' capital and require SNB intervention.

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

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

Section 2: Multi-Asset Insights

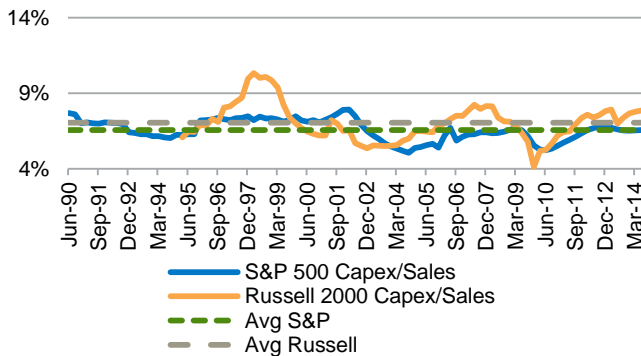
By Matthew Joyce and Ugo Montrucchio, Fund Managers, Multi-Asset

Capex – still supporting economic growth?

Much has been written of an impending pick up in capital expenditure ('capex'). With companies holding historically high levels of cash on their balance sheets, the hope is that the unusually low levels of interest rates will encourage corporates to spend more in order to generate a higher return on their investment. Indeed, the global economy would welcome the potential boost to growth from an increase in corporate spending. Likewise, firms with business lines exposed to higher corporate spending are likely to see an uplift to their revenues and earnings.

To better understand the outlook for capex in the US, we examine a number of the leading and lagging indicators. Our analysis suggests that the outlook for capex is mixed and the anticipated revival may take longer to materialise. One of the lagging indicators we look at is the capex to sales ratio. Below, we show the ratios for US large and small companies represented by the S&P 500 and Russell 2000 indices respectively. Surprisingly, for smaller caps capex is above the long-term average while for larger caps it is in line with the average. This implies that for capex to increase from here the indicators would have to increase even further from their current high levels.

Figure 1 Capex/sales ratio for the S&P 500 and Russell 2000 shows capex already at or above average levels



Source: Bloomberg

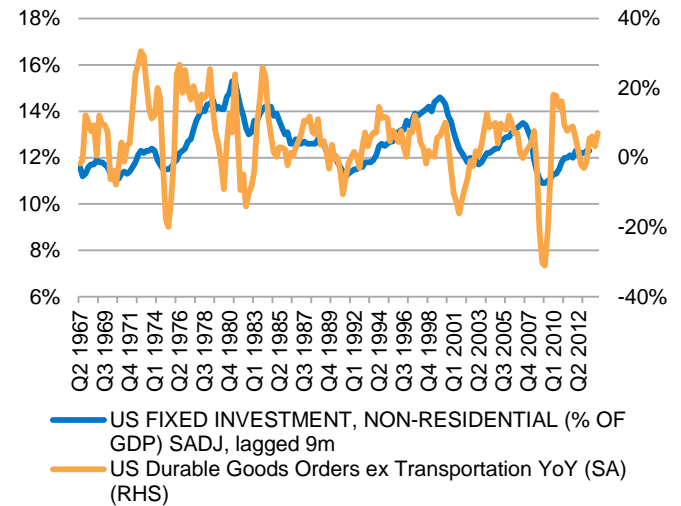
Although, this is possible if we see a large upturn in the GDP growth rate, the concern is that corporates may require more visibility of demand before increasing spending. Consequently, the prospect of higher levels of capex is closely linked with more robust economic growth. This appears to be a 'chicken and egg' situation where companies demand visibility on the economy first, and thereby, hold back GDP growth and demand.

It is also useful to analyse whether this capex spend is

concentrated among any sectors. Approximately one third¹ of all spending in the US is by energy companies. But a number of these firms have announced plans to reduce capex from current levels. We would need to see a more meaningful pick-up in investment in the other sectors to replace this.

Leading indicators, however, paint a more positive picture. Typically the ratio of US non-residential fixed investment as a percentage of GDP vs. US durable goods orders (ex transportation) is a leading indicator for capex growth with a 6 – 18 months lead (see Figure 2).

Figure 2 US non-residential fixed investment as a % of GDP vs. US durable goods orders ex transportation YoY (SA) shows some potential for capex to grow



Source: Datastream, BEA, Bloomberg, US Census Bureau

It is therefore difficult to argue conclusively that we are on the verge of a capex boom. Lagging indicators show that capex is already at average or high levels. Furthermore, we see a challenge to overall capex growth from the already high share of capital spending coming from the energy sector which may start to contract in the coming quarters/years. On the other hand, forward looking indicators do give us some cause to expect an acceleration in capex growth from here.

We shall continue to monitor the above data sets for further evidence of increasing capital spending activity, but for now we believe it probably requires a significant improvement in the GDP growth outlook for companies to increase their investment in capex above its present level.

¹ Source: Morgan Stanley Research, Thomson Reuters

European credit – still some upside?

On June 5th, the European Central Bank enacted new measures aimed at stimulating credit lending to European Small and Medium Enterprises (SMEs): The targeted longer-term refinancing operations (TLTRO). The funds will be tendered to entitled banks for a maximum of four years at a fixed cost.

This month we ran a qualitative assessment of the likely impact of the TLTRO programme. We see the new initiative as medium-term support for the region, and for European credit spreads in particular. There are a few factors that support this view:

- 1) The size of the programme has been considerably increased from the original €400 billion to a potential maximum of €1 trillion
- 2) The conditions by which the funds will be granted to demanding banks have been considerably lowered. This means that it will be easier to gain access to funds

- 3) The funds will be made available at a very competitive rate. The rate is currently +25bps but the MRO is proposing +10bps

A successful programme has the potential to unfreeze the credit market in Europe by providing a stimulus to local SMEs, while a moderately successful programme may still be positive for banks through more efficient use of their balance sheets. However, an unsuccessful programme ought to be credit neutral with no sizeable impact on the real economy, but could potentially prove challenging for banks valuations.

Overall, we think that the intervention is sizeable enough to make a medium-term impact. However, capital markets have already priced in the successful implementation of this initiative. Therefore, we remain cautious as the current pricing of default risk for financial assets is vulnerable to even marginal disappointments.

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