

Schroders

Global Market Perspective

Economic and Asset Allocation Views Q1 2015



Schroders

Introduction

Concerns over global growth came to the fore at the beginning of the fourth quarter with both equity markets and bond yields falling sharply. Once again central banks came to the rescue as policymakers in the US and Eurozone indicated that they were prepared to increase liquidity should activity drop away as many seemed to fear. In Asia, we saw both the Bank of Japan (BoJ) and People's Bank of China (PBoC) ease monetary policy. Equity markets and risk assets rebounded whilst bond yields came down further in response to expectations of interest rates staying low for longer.

Meanwhile, the decline in the oil price which had begun during the summer gathered momentum as Saudi Arabia refused to cut production in response to the glut in the market. No longer willing to play the swing producer, the Saudi strategy is to drive higher cost producers out of business with the focus on US shale. Markets are currently taking a pessimistic view of this development with risk assets selling off once again. Clearly, energy stocks and credits have been hit, but this needs to be balanced against the benefit consumers and many corporates receive from lower energy costs.

At this stage, markets are in a dislocation phase which occurs whenever there is a sharp fall in a price linked to incomes. This phase could well continue until oil prices stabilise. Ultimately though we see developments in the oil market as creating upside risk for the world economy in 2015 through stronger growth alongside lower inflation.

In this quarter's Perspective we take a look back at 2014 and a look forward with our themes for 2015. There are also more detailed pieces on oil prices, bond yields and long term (30 year) returns as well as a summary of our current asset allocation views.

Keith Wade, Chief Economist and Strategist, Schroders

14 January 2014

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Asset Allocation Views: Multi Asset Group

Global Overview

Economic View

Global activity undershot expectations in 2014 as the world economy struggled to shake off the malaise of the past three years. Going forward the outlook is for a modest recovery with global growth expected to be 2.8% for 2015. This is little changed from our previous forecast last quarter with downward revisions to the Eurozone and emerging markets offset by upward adjustments to the US and Japan. Upgrades in the US and Japan reflect the benefits of lower oil prices and an absence of fiscal tightening, whilst in the Eurozone and emerging economies these positives are offset by structural headwinds on growth. Against this backdrop, global inflation for 2015 has been cut to 2.9% in response to lower than expected outturns in recent months and the fall in commodity prices.

Looking ahead into 2016, our forecasts show another year of sub-par global growth at 2.8% with US activity moderating in response to higher interest rates and a stronger USD. Growth in China also eases down and when combined with the US, offsets a minor upturn in Japan and the Eurozone in response to further central bank easing and currency depreciation.

In terms of risks, three out of our seven macro scenarios are biased towards the deflationary side, such as “Eurozone Deflation” and “China Hard Landing.” The former assumes weak economic activity weighs on Eurozone prices with the region slipping into outright deflation. The latter focuses on the collapse in house prices as efforts to deliver a soft landing in China’s housing market fails. Meanwhile, we have replaced “Secular Stagnation” with a new deflationary scenario called “JPY Collapses” where investors begin to question whether the Japanese government is serious about debt reduction. We have kept a “G7 boom” scenario to highlight the risk of growth surprising on the upside globally. On the stagflationary scenarios, we have retained “Russian Rumble” and “Capacity Constraints Bite.” Finally, we have renamed the scenario “Productivity Recovers” as “Disinflationary Boom,” which represents a bounce back in productivity from current low levels and results in stronger growth and lower inflation. This would be consistent with the most recent fall in oil prices.

Central Bank Policy

In 2015, monetary policy de-synchronisation is the theme for the major developed and emerging markets. The US Federal Reserve (Fed) is expected to start increasing rates in June this year with rates rising to 1.25% by year end. The Bank of England (BoE) is also assumed to begin policy normalisation in November. By contrast, monetary conditions in the Eurozone are set to remain accommodative with the European Central Bank (ECB) providing further targeted long-term financing operations (TLTROs) along with the implementation of sovereign QE by March 2015. In Japan, the BoJ will keep the threat of further asset purchases on the table. For major emerging market central banks, interest rate hikes are expected in Brazil and Russia, but there is a likelihood of monetary easing in China and India this year.

Implications for Markets

Equities remain our preferred asset class, but we recognise that there is limited scope for a significant re-rating given the market has priced in a benign liquidity environment and valuations are generally looking less attractive. We are also cognisant that there is the risk of greater volatility driven by the normalisation of the macro environment and the impact on rate expectations. In the short-term, we are more cautious on equities given the potential disconnect between the market and economy in terms of the impact on investors’ sentiment given the sharp fall in the oil price. Over the medium-term, however, we still believe that equities remain well-supported particularly as the earnings growth comes through on the back of the global recovery.

Within equities, we still favour the US as the domestic recovery is expected to continue, helping companies to deliver further earnings growth and provide a buffer to the market’s valuation ratios. On the UK, we have remained neutral as the market has lagged global equities over the past year due to sensitivity to emerging markets and commodity prices. Hence, we believe that investors have already to a large extent discounted the disappointing news on this market.

Asset Allocation Views: Multi-Asset Group

Global Overview (continued)

Implications for Markets (continued)

Meanwhile, we have stayed neutral on European equities as the re-rating in the market has not been matched with a recovery in earnings although ECB policy remains supportive. Similarly, we are neutral on Pacific ex Japan. For Japan, we have downgraded the view to neutral as there has been a large amount of positive news discounted by the market such as the reform of Government Pension Investment Fund (GPIF) and QE expansion towards the end of 2014. On EM equities, we have retained our neutral stance despite valuations remaining attractive. Given the importance of exports for many EM economies, the earnings outlook could be constrained by the tepid recovery in export markets. Moreover, domestic growth in these economies is expected to stay sluggish. However, there remains the prospect of further policy stimulus by some authorities, which could ease the slowdown in the EM world.

We have turned neutral on global government bonds as we expect the recovery in the world economy to eventually put upward pressures on yields. Although this asset class could continue to receive support from on-going monetary easing from the ECB and BoJ. Within the universe, we are neutral on US Treasuries, UK Gilts and Japanese government bonds, but positive on German Bunds.

For emerging market debt (USD-denominated), we have kept our cautious stance as this region is still subject to negative sentiment in the near-term, particularly from Russia, which is likely to offset the carry cushion. Meanwhile, we have become negative on high yield bonds given the increase in default risk of corporates exposed to the fall in oil prices. In addition, we are still underweight on US investment grade bonds as tight spread levels have become more exposed to interest rate volatility and face pressure from greater mergers and acquisition (M&A) activity. By contrast, we have become more positive on European investment grade given the prospect that the ECB could expand the balance sheet to include the purchase of high quality corporate bonds.

On commodities, we have retained our overall neutral stance. We remain structurally bearish towards industrial metals but in the short-term, there is policy support from the Chinese authorities. On the energy complex, we have stayed neutral as further short-term price weakness is possible, but we have reached levels where over the medium term the market should find a supply/demand balance and prices should recover. For agriculture, our base case is that prices are likely to trade sideways. While the market is well-supplied and this is broadly reflected in prices, we are seeing short-covering drive prices upwards at present. On precious metals, specifically gold, we have downgraded our view to negative given the prospect of higher real rates and a stronger USD.

Table 1: Asset allocation grid – summary

Equity	+	Bonds	0			Alternatives	0	Cash	-
Region		Region		Sector		Sector			
US	+	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	+	Investment Grade Corporate	-	Industrial metals	0		
Pacific ex Japan	0	JGBs	0	High yield	- (0)	Precious metals	- (0)		
Japan	0 (+)	Emerging market debt (USD)	-			Energy	0		
Emerging Markets	0					Agriculture	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	
+	US	<p>The US continues to be one of our favoured markets as it is still a driver of global growth. Strong Q3 earnings from US companies provide fundamental support for the market's fair-to-expensive valuation ratios. Looking ahead, corporate profit margins are likely to come under pressure as wages pick-up. However, we believe that investors will continue to be attracted to the market given the superior growth opportunities in the US.</p> <p>Share repurchases are slowing, but we see greater likelihood of the strong cash flows held by companies being deployed for mergers and acquisition activity.</p>
0	UK	<p>Against a backdrop of softer global growth, the UK may underperform due to the index's sensitivity to emerging markets and commodity prices. We remain neutral on UK given that the market has underperformed global equities so far this year, suggesting that investors have already to a large extent discounted the disappointing news on the index.</p> <p>In addition, further weakness in sterling provides some relief for UK corporate earnings, as a meaningful proportion of revenues are generated overseas.</p>
0	Europe ex UK	<p>Europe continues to disappoint in terms of economic recovery and corporate earnings. Instead, European equities tend to rely on valuations and re-rating based on ECB action. However, valuations are becoming more expensive relative to history and other markets.</p> <p>Meanwhile, value in European corporates resides in the industrials, resources and energy sectors; whilst these export-oriented sectors should receive a boost from a lower euro, the weakness in the global trade-to-growth multiplier is a barrier to unlocking their value in the near term.</p>
0	Japan	<p>We have previously argued that unlike prior cycles of yen weakness, there appears to be a shift in Japanese corporate attitudes with companies not reducing overseas prices or increasing investment by the same magnitude. While capex spending has been subdued, companies have started cutting export prices. This should boost sale volumes and increase market share, but margins will face the tug of war between lower export prices and higher import prices.</p> <p>The bazooka of positive announcements on the reform of the GPIF and QE expansion towards the end of 2014 has been largely discounted. While the prospect of further policy easing remains on the table, the BoJ is unlikely to act unless growth significantly disappoints and their inflation target fails to stay on track. Meanwhile, the key support for this market over the medium-term will be evidence that Abenomics is delivering on the third arrow but we are sceptical if this will bear fruit.</p>
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	<p>Weak commodity prices and more competitive Japanese exporters could hamper the performance prospects of this region. Australia's economy remains vulnerable to a further reduction in demand for commodities and a slowdown in the property sector. Nonetheless, there are positive spill-over effects from improved sentiment towards China which is a large export trading partner for these markets.</p> <p>Valuations and momentum behind this region are also unconvincing relative to elsewhere.</p>
0	Emerging markets	<p>Valuations remain attractive particularly amongst the commodity and investment sectors, although the earnings outlook could be constrained by the tepid recovery in export growth given the importance of exports for many EM economies. The stronger USD also presents a headwind to emerging equity markets.</p> <p>Growth in these economies is expected to stay sluggish. However, there remains the prospect of further policy stimulus by some authorities, such as China, which could ease the slowdown in the EM world.</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 have turned neutral (from positive) on global government bonds as we recognise that valuations on sovereign debt are not compelling given the low levels in bond yields. At the same time, we expect the recovery in the world economy to eventually put upward pressures on yields. Although this asset class could continue to receive support from on-going monetary easing of certain central banks as the ECB and BoJ have continued to expand their balance sheets.</p> <p>Amongst the sovereign bond markets, the view on US Treasuries has stayed neutral. Whilst we believe there is dampening pressure on yields at the long end of the curve, given the lower inflation outlook, we are less constructive on the short end. The Fed is expected to raise rates later in the year in response to a tighter labour market and more robust growth.</p> <p>For UK Gilts, we have downgraded our stance to neutral following the strong rally. In comparison, our positive view on German Bunds is a reflection of playing a curve flattener led by downward pressures on yields at the long-end. In particular, the long-end could be supported as the ECB struggles to find enough eligible bonds with positive nominal yields under a potential sovereign QE programme.</p> <p>Despite the unattractive yields, we maintain our neutral position on JGBs due to the continued support provided by BoJ, especially following its recent actions to further increase monetary easing. This will keep the long-end of the curve pinned down despite a recovery in the economy.</p>
-	Investment Grade (IG) Corporate	<p>We have maintained our preference for European IG relative to the US market. US IG spreads have become more exposed to interest rate volatility and face pressure from greater M&A activity which is typically negative for IG bond holders and could increase further if rates stay low for too long.</p> <p>European credits have benefited from ECB support in response to lacklustre growth and deflationary pressures. We have become more positive on European IG given the prospect that the central bank could extend the QE programme to include the purchase of high quality corporate bonds.</p>
-	High yield (HY)	<p>US HY spreads remain vulnerable to falling oil prices and concerns over a possible increase in default risk of shale oil producers given that the energy sector has the highest weighting in the index. In addition, liquidity and greater volatility remain key risks as the Fed starts to raise rates.</p> <p>Despite monetary support from the ECB, we have turned more cautious on European HY. We believe that this sector is unlikely to benefit in the same extent as IG from fund inflows as investors are likely to be reluctant in moving their negative yielding bond holdings all the way to high yield. Furthermore, the contagion risk from the US HY market could be significant if the situation for oil companies further deteriorates.</p>
-	USD-denominated Emerging market debt (EMD)	<p>We have kept our cautious stance on emerging market USD bonds as we see a worsening inflation/growth trade-off with weakening currencies, particularly amongst many commodity producing nations. At the same time, the universe is still subject to negative sentiment in the near-term particularly from Russia.</p> <p>However, recent spread widening in EMD has made valuations more attractive relative to other fixed income assets. We also recognise that fundamentals have been improving in some emerging market countries.</p>
0	US index-linked	<p>Valuations for index-linked bonds remain uninspiring although breakeven inflation rates have fallen to a level which starts to look attractive from a risk-reward perspective. While there is evidence that wages and payrolls are rising in the US, inflationary pressures could remain subdued in the US in an environment of a stronger US dollar and deflationary pressures from the rest of the world.</p>

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

Alternatives Views

Key Points

Alternatives

- | | | |
|---|-------------------|---|
| 0 | Commodities | <p>We have maintained our overall neutral stance towards commodities. On industrial metals, continuous policy support from the Chinese authorities could provide support for domestic growth and therefore metal demand. Over the medium-term, however, this commodity segment is still held back by the structural shifts away from investment led growth in China. In addition, the large ramp up in production over the past decade has led to ample supply across most base metals, particularly copper. On balance, we therefore retained our neutral view on this sector.</p> <p>Meanwhile, our positioning in the energy segment has remained neutral. Unless we see evidence of a decline in capex from shale oil plays or a material increase in global demand, oil prices are likely to remain around or below current levels. However, we have reached levels where over the medium term the market should find a supply/demand balance and prices should recover. Overall, we are awaiting confirmation from our sentiment and capex indicators before turning more positive on the sector.</p> <p>For precious metals, specifically gold, we have downgraded our view to negative over the quarter as the key technical support level for this asset class has been breached, which could further impact sentiment. Moreover, our most likely base case is that higher real yields and a broadly stronger US dollar could weigh on the gold price.</p> <p>On agriculture, our base case is that the complex is likely to trade sideways. While the market is well-supplied and this is broadly reflected in prices, we are seeing short-covering drive prices upwards at present</p> |
| + | UK Property | <p>We expect to see another solid performance from UK commercial real estate in 2015. The latest IPF Consensus Forecast suggest offices and industrials will achieve total returns of 12% in 2015, followed by retail with total returns of around 10%. 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 is of a potential correction in the future, as interest rates start to rise. From a valuation perspective, UK real estate is still fairly priced at present, given the prospects for rental growth and the large gap of more than 3% over 10 year Gilt yields.</p> <p>The other risk to UK property is the general election in May and the uncertainty which would arise if the next government decided to hold a referendum on EU membership in 2017. That could be problematic, particularly for London, if multi-nationals started to defer their expansion plans until after the result and it might also jeopardise the city's haven status with foreign investors.</p> |
| + | European Property | <p>Over the next 12 months, we expect positive total returns on average investment grade European property to average 7 to 9% led mainly by capital values benefitting from yield compression. Further out, steady rental growth should also be a driver of returns. The main upside risk in the short-term is that the inflow of capital from Asia and the US could trigger a widespread fall in prime and secondary property yields, boosting capital values for a limited period. On the other side, the main downside risk is that the sovereign debt crisis could re-ignite, either if the next Greek government decides to re-negotiate its debt obligations, or deflation in the Eurozone becomes entrenched.</p> |
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Note: Property views based on comments from the Schroders Property Research team.

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

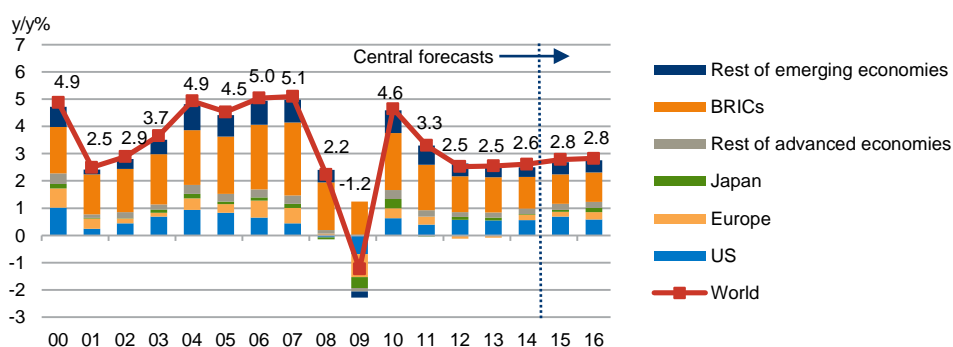
Economic View

Central View

De-synchronised recovery on track

Global recovery continues as the fall in energy prices supports consumer spending and reduces business costs, whilst the squeeze from fiscal austerity eases further. However, our global growth forecast of 2.8% for 2015 is sub-par compared to previous cycles when world activity averaged 4% per annum at this stage of the upswing (chart 1).

Chart 1: Global growth forecast for 2015 and 2016



Source: Thomson Datastream, Schroders.

In terms of our forecasts for 2015, upgrades in the US and Japan reflect the benefits of lower oil prices and less restrictive fiscal stance, whilst in the Eurozone and emerging economies these positives are offset by structural headwinds on growth. Moreover, the forecast for UK growth is unchanged as household consumption receives a boost from the fall in energy prices but this is balanced against the cooling in the housing market and the potential slowdown in investment with the general election and resumption of austerity next year.

Amongst the BRIC economies (Brazil, Russia, India and China), there have been relatively few revisions to the growth outlook for 2015 with the exception of Russia where the weaker oil price is expected to hit growth and result in a -1% contraction. In comparison, the China forecast for this year has remained unchanged at 6.8% as recent stimulus efforts have struggled to raise growth against the ongoing slowdown in the region. Meanwhile, President Dilma's victory in Brazil's election leaves us more negative about prospects there, while gradual progress by Prime Minister Modi in India has prompted hope of gradual acceleration.

In addition, our global inflation forecasts have been cut in response to the lower expected outturns in recent months and the sharp fall in commodity prices. Global inflation is expected to come in at 2.9% for 2014 with a significant reduction for the US where falling energy prices have the most impact on CPI inflation. At the same time, the inflation outlook in the emerging world is broadly lower, on the same oil effect. Although sanctions and ruble weakness in Russia is likely to keep inflation elevated next year.

On the monetary policy front, divergence remains the key theme with the Fed and BoE expected to raise rates in 2015 while the ECB and BoJ are likely to remain on an easing tack. In the US, the first rate rise is expected in June 2015 whilst the BoE starts interest rate normalisation in November. For the ECB, they will monitor the effects of recent easing measures, but sovereign QE is expected to be announced by March 2015. Moreover, the BoJ will keep the threat of further qualitative and quantitative easing (QQE) on the table, but is likely to allow the weakness in the currency to support the economy and refrain from further policy expansion.

In addition to our central view, we consider seven alternative scenarios where we aim to capture the risks to the world economy. In the next section, we discuss in more detail, the impact of the significant fall in the oil price on the world economy.

Economic View (continued)

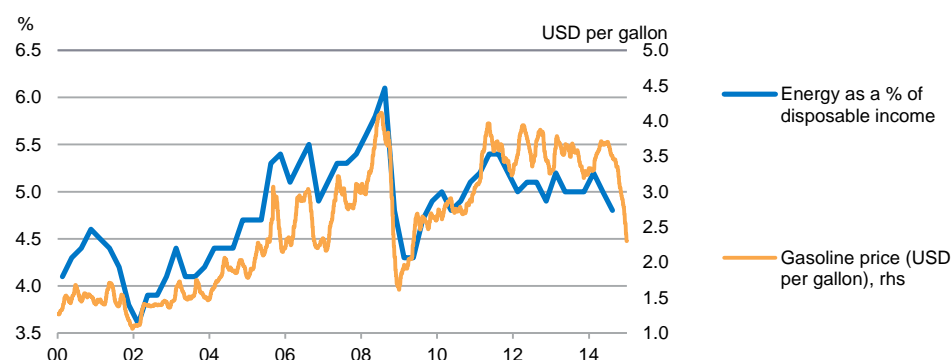
Oil price falls significantly further, boosting energy dividend to consumers and the prospects for growth

Financial markets seem more sceptical

Lower oil prices, good or bad for the world economy?

Since we put together our baseline forecast, the oil price has fallen considerably such that Brent crude is now some \$30/barrel below its original starting point in mid November. Based on our models this would imply a further boost to global growth of around 0.5% and a reduction in inflation in 2015 of about 1%.¹ Lower oil and energy costs act like a tax cut to consumers who are likely to accelerate spending (chart 2). Recent retail sales figures in the US and UK suggest that some of the energy dividend is already coming through.

Chart 2: The energy tax cut in the US



Source: Thomson Datastream, 31 December 2014

Financial market reaction, however, suggests that the outcome will not be so favourable with equity markets and bond yields both declining, a clear warning that the world is headed in a more deflationary direction. The recent rebound in equity markets tempers this somewhat, but government bond yields continue to fall.

One market concern is that lower oil prices reflect lower demand in 2015. For example, the International Energy Agency (IEA) has repeatedly downgraded global demand this year and its Oil Market Report for December² cut the outlook for 2015 global oil demand growth by 230,000 barrels per day to 0.9 million barrels per day (mb/d). This reflects lower expectations for demand from the former Soviet Union and other oil-exporting countries. Not surprisingly, the oil producers are cutting back, and whilst oil consumers will not make up this shortfall by consuming more oil (which is very price inelastic in the short run) they will increase consumption of other goods and services thus boosting overall global activity.

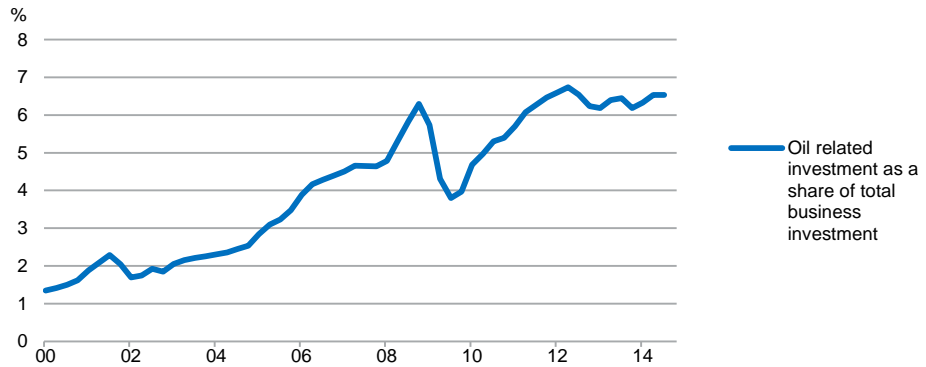
Another area of debate is whether the benefit to consumers will be outweighed as the energy industry slashes capital expenditure. There have been a number of high profile announcements from the sector, but as a share of total investment in the US for example, energy only accounts for 6.5% of total capex, around 1% of GDP (chart 3 on next page). Slower energy capex will hamper investment growth, but needs to be balanced against stronger capex in other sectors benefitting from lower energy costs and rising capacity utilisation rates.

¹ Figures are based on the fall in the oil price when the forecasts were put together in mid-November and the Brent crude December 2015 forward curve pricing as at 31 December 2014.

² The IEA [Oil Market Report](#) (OMR) for December 2014.

Economic View (continued)

Chart 3: US energy investment as % total capex



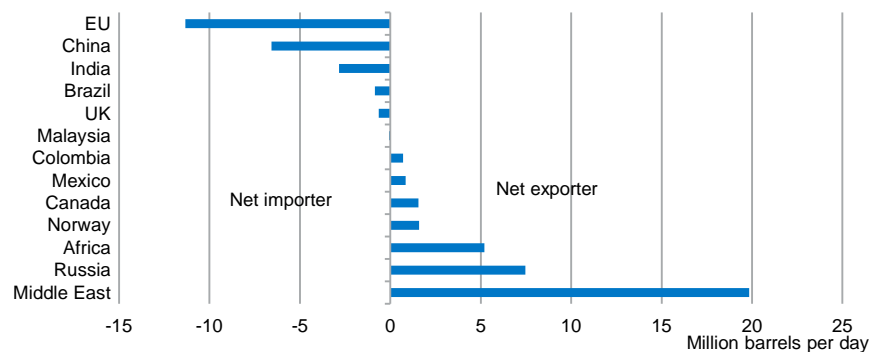
Source: Thomson Datastream, 31 December 2014

Energy though is more prominent in the US equity and credit market: the energy sector accounts for 25% of S&P 500 capex and R&D (research and development) and the impact of the lower oil price is being felt through lower earnings forecasts and an increased risk of default in credit markets. Some banks with significant energy exposures have also been affected.

Winners and losers – oil imports and exporters

Outside the US, we found that the key beneficiaries to the drop in the oil price tended to be the countries that are major oil consumers with losers being the exporters. We define importers and exporters by measuring the difference between production and consumption illustrated in chart 4. Using the Oxford Economics Forecasting model based on both Brent and WTI crude forward curve pricing,³ net oil importers such as Europe, China and India receive a growth boost of around 0.2% to 0.4% this year compared to our central base case (chart 5 on next page). Unsurprisingly, large energy producers such as Russia and Norway, where energy exports accounts for around a fifth of GDP, could see growth for 2015 reduced by 2.3% and 0.6% respectively. The stand-out from this analysis is Mexico, despite being a marginal energy exporter, the positive impact from household consumptions appears to more than compensate for the potential decline in the trade and fiscal positions.

Chart 4: Net importers and exporters of oil



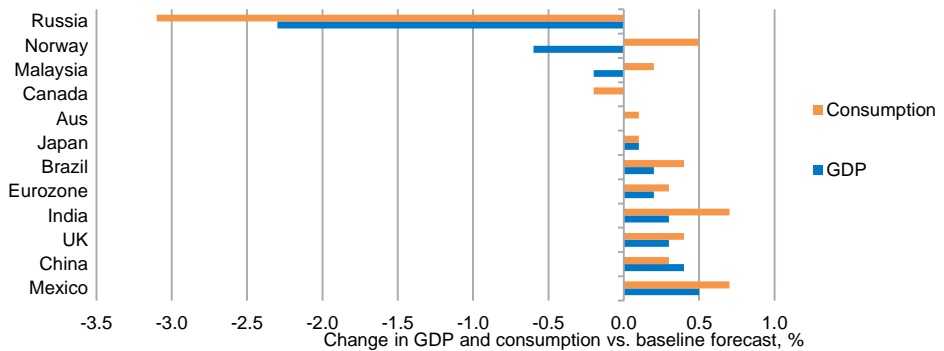
Source: BP Statistical Review of World Energy 2014

From a growth and inflation perspective, oil importers are likely to be the winners at the expense of exporters

³ Note that the Brent crude forward curve is used for our baseline forecasts.

Economic View (continued)

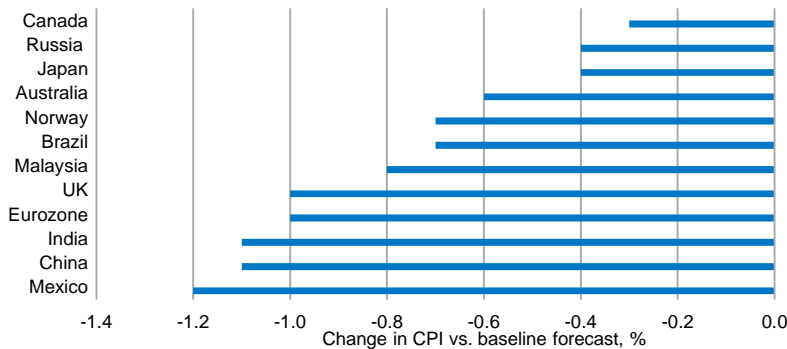
Chart 5: Oil price impact on GDP and consumption in 2015



Source: Schroders. the Oxford Economics Forecasting model, 31 December 2014

Meanwhile, the fall in the oil price has already had a deflationary impact on headline inflation rates and expectations although the magnitude of the decline is not uniform. Chart 6 shows that the potential reduction in inflation is the greater amongst the more energy intensive consuming markets compared to the oil exporters. However, the caveat is that it assumes that the currencies of these economies remain unchanged. In reality, the deflationary impact on the oil producing currencies could be less and even offset with the prospect of a weaker currency.

Chart 6: Oil price impact on inflation in 2015



Source: Schroders. the Oxford Economics Forecasting model, 31 December 2014

For the energy exporting countries, in addition to corporate concern there is increased country risk as oil states such as Russia, Nigeria and Venezuela will find they have to cut expenditure and, of course, we have seen the impact on the RUB. Default is not our central case for Russia, although the increased fragility of the oil producers will add to market volatility and they will no longer have the same level of surplus to recycle into financial markets. For example, it is estimated that at \$70/b, OPEC revenues are reduced by \$316 billion, a figure that will be reflected in lower growth in assets held in reserve and sovereign wealth funds such as US Treasuries.

Cuts in energy capex and increased volatility will offset some of the gains from lower oil prices

In conclusion, there are some offsets to the boost to growth brought by lower oil prices and these may be felt in the near term via lower capex and increased volatility in oil-related currencies and credit. Nonetheless, the benefits to consumer spending and business through lower energy costs are set to outweigh these further out with the result that global growth will be stronger and inflation lower, particularly amongst the oil importing economies.

Economic View (continued)

Macro risks: Scenario analysis

Full details of the scenarios can be found on page 14. The distribution of global risks is still skewed toward the downside for growth and inflation. Top of the list on the downside is the “**China Hard Landing**” scenario where efforts to deliver a soft landing in China’s housing market fail and house prices collapse. Household expenditure is constrained by the loss of wealth. Clearly, interest rates and monetary policy would be looser in this scenario.

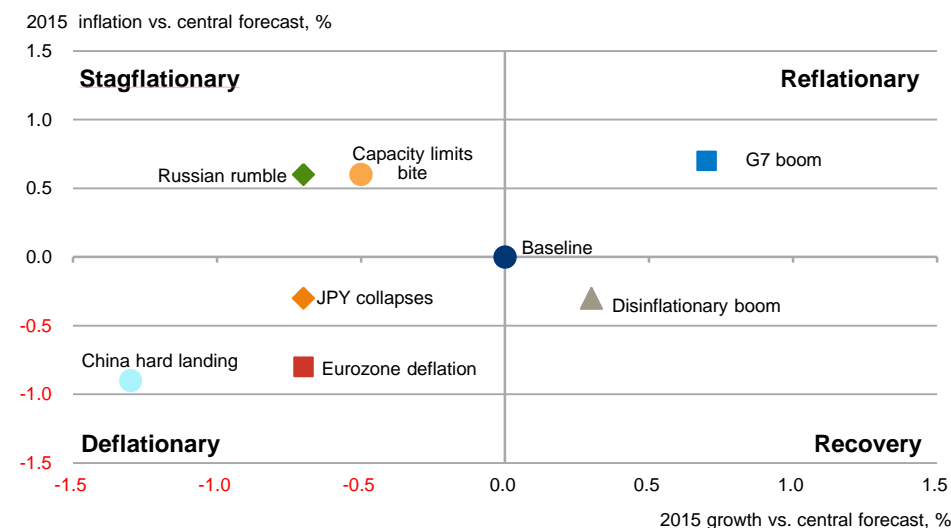
Meanwhile, we have kept the “**Eurozone Deflation**” scenario whereby the Eurozone experiences a Japan-style slump with prices falling persistently and the region experiencing debt deflation. Global monetary policy therefore would be looser than in the baseline particularly with the ECB embarking on sovereign debt QE.

This quarter, we have added a new deflationary scenario, “**JPY Collapses.**” This reflects a situation where investors begin to question whether the Japanese government is serious about debt reduction as they continue to delay tax hikes. Capital flight follows on fears of default and the BoJ is forced to raise interest rates to stem the outflow. The result is a very weak JPY and higher risk premiums in global bond markets to reflect heightened default risk, thus creating a deflationary impulse for the rest of the world.

On the stagflationary scenarios, we have retained “**Russian Rumble**” and “**Capacity Constraints Bite.**” On the “**Russian Rumble**” scenario, fighting continues in East Ukraine between government forces and rebels supported by Russian troops and the west retaliates by significantly increasing sanctions. Although the Russian economy has been worst affected, there is a risk that European confidence is hit on concerns that the situation will deteriorate further, leading to the loss of energy supplies. For “**Capacity Constraints Bite,**” the amount of spare capacity proves to be considerably less than anticipated by policymakers. Once the mistake has been realised central banks then have to tighten aggressively to bring the economy back to trend.

On the upside, we see a “**G7 boom**” which is the sole reflationary outcome whereby we see a return of animal spirits and a much stronger pick up in business spending than in the baseline. Finally, the “**Disinflationary Boom**” scenario (previously named “Productivity Recovers”) represents a bounce back in productivity from current low levels and results in stronger growth and lower inflation than in the base case. This would be consistent with the most recent fall in oil prices.

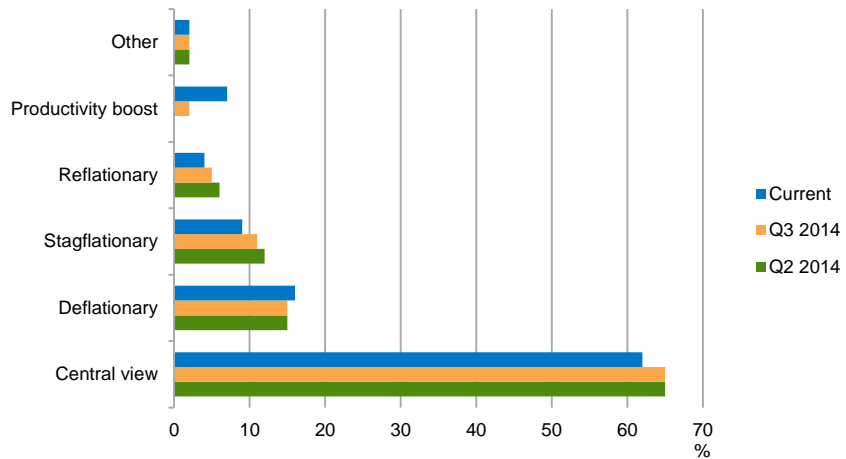
Chart 7: Scenario analysis – global growth and inflation impact



Source: Schroders.

Economic View (continued)

Chart 8: Scenario probabilities compared to previous quarters



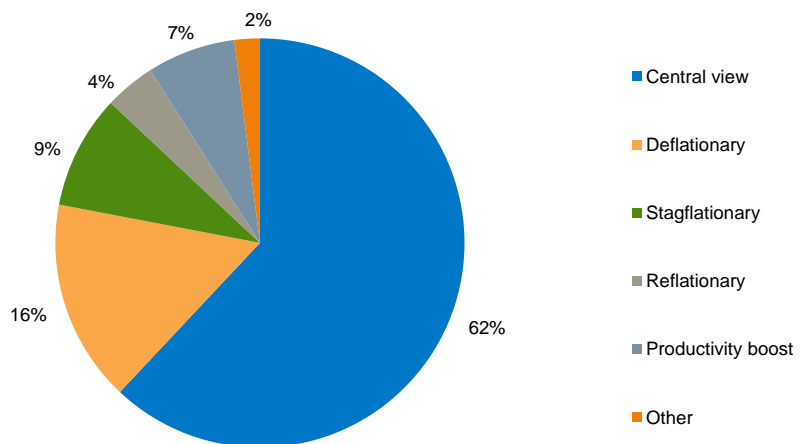
Source: Schroders.

In terms of macro impact, we have run the risk scenarios through our models and aggregated to show the impact on global growth and inflation. As can be seen in chart 7 on the previous page, three of our seven are deflationary, such that both growth and inflation are lower than in the central scenario.

In terms of probabilities, the deflation risks have risen. Although we have slightly reduced the probability attached to the Eurozone deflation scenario (as a result of the fall in the euro), we have raised the probability on China hard landing and put a slightly higher probability on the JPY collapses scenario than the one it replaced (secular stagnation, another deflationary scenario).

The probability on "G7 boom" has been slightly reduced (from 5% to 4%) to reflect the lack of traction from monetary policy to growth in the Eurozone and Japan. However, we have increased the probability on "Disinflationary Boom" from 2 to 7% to capture the risk that the fall in oil prices will lift growth by more than expected. Overall though the scenario analysis continues to suggest that the risk on interest rates is skewed to the downside with central banks likely to maintain stimulus in the face of a lower inflation outcome than in the baseline.

Chart 9: Scenario probabilities (mutually exclusive)



Source: Schroders.

Economic View (continued)

Table 2: Scenario summary

Scenario	Summary	Macro impact
1. Eurozone deflation	Weak economic activity weighs on Eurozone prices with the region slipping into deflation. Households and companies lower their inflation expectations and start to delay spending with the expectation that prices will fall further. The rise in savings rates deepens the downturn in demand and prices, thus reinforcing the fall in inflation expectations. Falling nominal GDP makes debt reduction more difficult, further depressing activity.	Deflationary: weaker growth and lower inflation persists throughout the scenario. As a significant part of the world economy (around one-fifth), Eurozone weakness drags on activity elsewhere, while the deflationary impact is also imported by trade partners through a weaker euro. ECB reacts by undertaking sovereign QE, but the policy response is too little, too late.
2. G7 boom	Developed market growth picks up more rapidly than in the base as the corporate sector increases capex and consumers spend more rapidly in response to the recovery in house prices. Banks increase lending, reducing their excess reserves and asset prices boom. The Fed begins to withdraw stimulus: Interest rates rise earlier and the Fed begins to contract its balance sheet in 2015. However, the withdrawal of stimulus is not sufficient to prevent a more rapid tightening of the labour market and a pick-up in inflation.	Reflationary: stronger growth and inflation versus the central scenario. Stronger US demand supports activity around the world. Commodity prices and US Treasury yields rise and USD strengthens as inflation picks up and Fed unwinds QE and raises rates.
3. Disinflationary boom	Weak productivity has been a feature of the recovery in the US and UK and growth has been largely driven by increasing employment. In this scenario the slowdown in productivity gradually reverses as firms deploy technology to better effect resulting in improved output/hour.	Recovery: Better growth/lower inflation. Increased productivity reduces unit wage costs thus keeping inflation in check as economic activity recovers. The Fed is still expected to tighten policy, but the lack of inflationary pressure means they can delay until later in 2015. Note that this outcome, in terms of growth and inflation, could also be created if the latest oil price is sustained.
4. Capacity limits bite	Central banks overestimate the amount of spare capacity in the economy believing there is significant slack in the labour market and a substantial output gap. However, weaker trend growth and the permanent loss of some capacity in the post financial crisis environment mean that the world economy is closer to the inflationary threshold than realised. Consequently, as demand increases, inflation starts to accelerate prompting a re-appraisal of monetary policy and higher interest rates.	Stagflationary: tighter monetary policy slows growth, but inflation continues to rise until the economy has returned to trend. Monetary policy tightens earlier in this scenario.
5. China hard landing	Efforts to deliver a soft landing in China's housing market fail and house prices collapse. Housing investment slumps and household consumption is weakened by the loss of wealth. Losses at housing developers increase non-performing loans (NPL's), resulting in a retrenchment by the banking system and a further contraction in credit and activity.	Deflationary: global growth slows as China demand weakens with commodity producers hit hardest. However, the fall in commodity prices will push down inflation to the benefit of consumers. Monetary policy is likely to ease/stay on hold while the deflationary shock works through the world economy.
6. Russian rumble	Fighting continues in East Ukraine between government forces and rebels supported by Russian troops. Putin continues to supply the rebels and the west retaliates by significantly increasing sanctions. Russia responds by cutting gas and oil supplies to Europe.	Stagflationary: Europe is hit by the disruption to energy supply resulting in a fall in output whilst alternative sources are put in place. Higher oil prices hit global inflation and the breakdown of relations between Russia and the west creates significant volatility in financial markets.
7. JPY collapses	Japanese economy fails to respond to monetary easing (QQE) and, as it becomes increasingly difficult to tighten fiscal policy, investors fear a government debt. The JPY falls sharply, inflation accelerates and bond yields rise causing the BoJ to increase interest rates to stem capital flight. Real activity is weaker in Japan despite the lower JPY as a result of higher interest rates and the squeeze on real wages from higher inflation.	Deflationary: the rest of the world has to contend with an even weaker JPY, hitting the growth and inflation outlook in Asia and in other major competitors.

Source: Schroders, November 2014.

2014 review: Geo-political risk and USD dominate

The importance of politics and policy impressed upon investors

Lessons from 2014

Having reviewed events and the performance of markets over the year, we have found a few lessons worth considering for 2015:

- **Geo-political risk is alive and well.** Not only can geo-politics act as a major downside risk to individual markets, but it can quickly spread to hurt global sentiment towards risk assets. The year also reminded us that positives from geo-political risk also exist, after the gains seen in India after the election.
- **Europe still has plenty to do.** Having started the year with lofty earnings expectations, a lack of growth and fears over deflation led to a significant underperformance of European equities. European equities still appear on the expensive side, so have markets learned their lesson?
- **The Fragile 5 are still fragile.** A lack of reforms left those reliant on overseas capital exposed in 2014. As the Fed tightens monetary policy next year, beware of this group. Once again, the majority of policymakers have shown they are not afraid to waste a good crisis. India was the exception in 2014 rather than the rule.
- **Oil prices can fall without a crisis.** Unlike 2008, the fall in oil prices has not been caused by fears of a global recession. Relatively small falls in demand and increases in supply have led to the dramatic fall in prices.
- **Gravity has caught up with China.** Investors have learnt that not only is slower growth possible in China, but the government may be powerless to do more than cushion the fall. A soft landing looks the most likely outcome.

Geo-political risk and USD dominate

At this time of year, we like to take a step back and review the performance of markets, and the lessons we can learn for the coming year. 2014 will probably be remembered for the rise in geo-political risk more than the performance of markets. Investors had ended 2013 seeing a strong rise in risk assets, and a sell-off in government bonds.

Geo-political risk returned in 2014 to impact financial markets

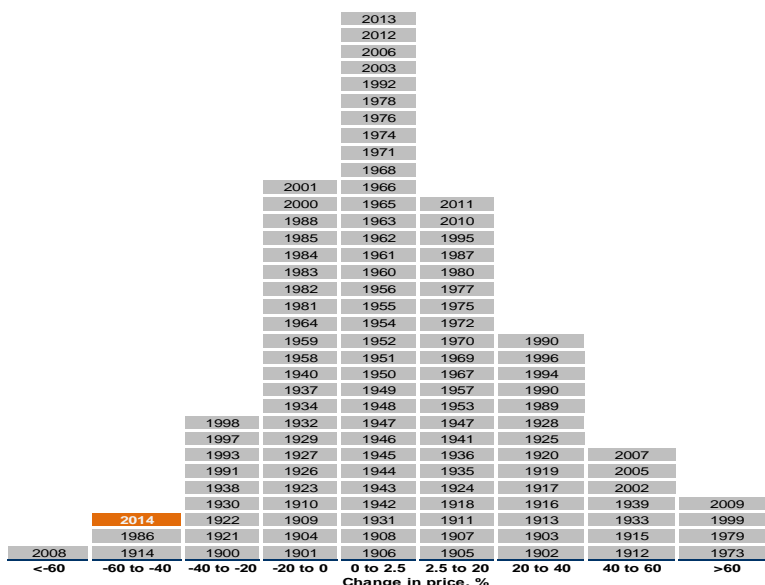
2014 started with aftershocks from the taper tantrums of 2013, as investors pared back risky positions as default risk in Argentina escalated, prompting a sharp depreciation in the peso. Meanwhile, a corruption scandal ahead of local elections in Turkey also drew the attention of investors, also leading to yet another sharp depreciation. Sharp sudden falls in emerging markets currencies were clearly going to be a theme for the year. In Ukraine, protest and unrest quickly developed into a civil-war, as President Viktor Yanukovich was ousted and forced to flee to neighbouring Russia after an arrest warrant was issued. Accusations of Russian involvement and funding of separatist rebels were escalated when Russia annexed the Crimea region in March. Russia's actions (officially denied) were quickly followed by sanctions on Russia by the US and Canada, but only joined by Europe after the tragic downing of Malaysian flight MH17 in Ukraine in July.

Another source of political risk that hit investors' confidence in the summer came in the form of ISIS in Iraq/Syria. The ease in which the group took major cities in Iraq led to concerns that future oil supplies would be at risk. Those fears were eased with the eventual international response, although the fighting continues. However, that relief and initial fall in oil prices started the downward shift, and the momentum which built throughout the year.

The fall in oil prices may go down as the single most important development of 2014. Accommodative supply faced with weaker demand pushed oil prices some 49% lower over the year – the second worst performance since 1900 (chart 10 on next page). Non-OPEC oil producers had steadily been increasing output while US shale oil (and gas) output had been building at an exponential rate. As OPEC decided not to cut output in November, the market forced prices to collapse in order to clear inventories. As discussed in the next section, the fall in oil prices acts as a tax cut to households and corporates, with the greatest benefits occurring where oil is imported. For exporters like Russia, it is a significant hit to revenues, which of course drove assets related to oil down in value.

2014 review (continued)

Chart 10: Second largest annual fall in oil prices (WTI) since 1900



Source: Global Financial Data, Thomson Reuters Datastream, 31 December 2014

Central banks were busy, but with different directions of travel

As for central banks, actions were very mixed. The Fed saw Janet Yellen take over from Ben Bernanke as the new Chair. Yellen was initially criticised over her communication, but has since found her feet and has successfully brought an end to the Fed's QE programme and changed the Fed's communication to signal monetary tightening in 2015, all without significant market volatility. Meanwhile, Mark Carney was less successful at the Bank of England having caused a false start in sterling money markets after warning of a potential rate rise by the end of 2014 (Mansion House Speech in June). He has since retreated to a more familiar dovish tone.

The ECB was probably the busiest of the central banks as Mario Draghi cut interest rates further, announced new liquidity measures targeted at boosting lending to corporates, and also unveiled private asset purchases, focusing on asset backed securities and covered bonds. European macroeconomic performance has been poor over the year, not helped by ongoing austerity, a lack of lending from banks as they faced a review of their balance sheets, and of course the impact of geo-political risk with Ukraine/Russia. Deflation concerns have not gone away either. Given the fall in oil prices, the ECB is ending the year by seriously considering whether to start buying sovereign debt in early 2015.

Finally, having sounded confident of its actions for most of the year, the BoJ surprised most economists and investors in October by increasing its target of asset purchases from 60-70 trillion yen to 80 trillion yen per year. The move came as it became obvious that Japan was heading back into recession after the government went ahead with the rise in the sales tax in Spring. The move was significant for JPY and Japanese markets.

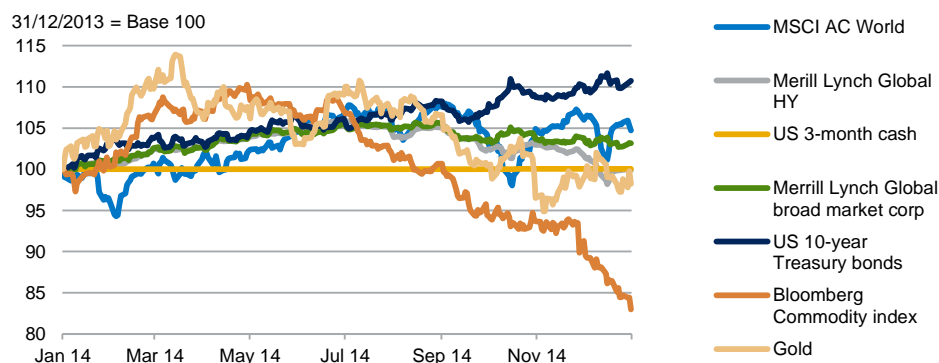
Cross-asset comparison

Looking across the major asset classes, the best performing asset class was government bonds, but was closely followed by global equities. Our proxy, US 10-year Treasury bonds, generated a total return of 10.8%, while global equities as measured by the MSCI AC World index provided a total return of 4.7% (chart 11 on next page).

2014 review (continued)

Government bonds were the best performers, but equities were close behind

Chart 11: Multi-asset performance (in USD)



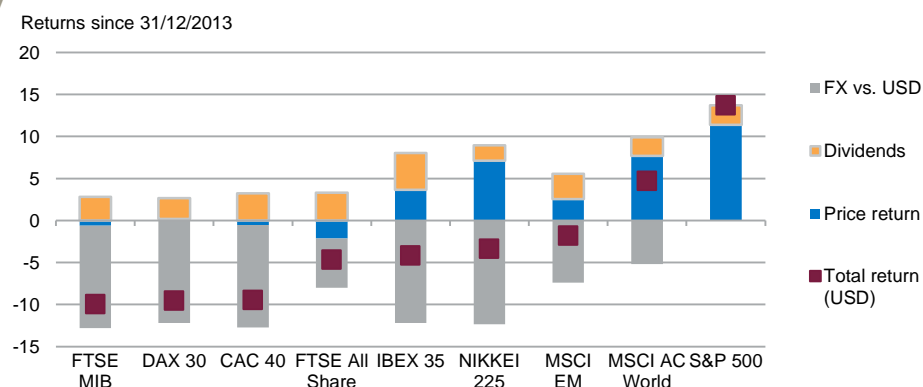
Source: Thomson Datastream, Schroders. 31 December 2014

The worst performing broad asset class was commodities. The Bloomberg commodity index returned -17%, largely driven by falls in energy prices, but in particular oil, which as measured by Brent Crude has fallen by 49% since the start of the year. This is unusual as the fall has not coincided with a global recession unlike 2008 for example. Meanwhile, gold ended the year down 1.8%, despite being up 14% by mid-March.

Thanks to the strong performance in government bond markets, global investment grade credit also had a reasonable year, generating 3.2% of returns. High yield credit bonds had performed roughly in-line with investment grade bonds for most of the year, until the sharp fall in oil prices caused investors to worry about default risk of high yield corporates in the energy sector. Global high yield returned -0.1% during the year.

US dominates equity returns as Europe struggles

Chart 12: Equity markets performance (in USD)



Source Thomson Datastream, Eurostat, Schroders. 22 December 2014.

Turning to equity markets, the UK's FTSE All Share understandably struggled with its large exposure to commodities, but the worst performers were the European bourses, as the Italian FTSE MIB (-10% in USD) led the decline. Political uncertainty during the unseating of Prime Minister Pier Luigi Bersani, was eased by his pro-reform replacement Matteo Renzi; however, Italy's dismal macroeconomic performance left investors preferring its Iberian partner. The Spanish IBEX35 enjoyed a relatively stable year, and withstood the occasional banking scare. The index was the best performer of the major four European markets, although still declined in USD terms.

2014 review (continued)

In EM equity markets, politics has been a key driver this year. For one, events in Ukraine have weighed on EM Europe more than the rest of the complex - the MSCI EM Europe index is down 29.6% (in USD), compared to a 5.3% rise in Asia and 12% fall in Latin America. Other examples can be found in countries which held elections this year, each of which prompted hopes of reforms, some of which were dashed (chart 13).

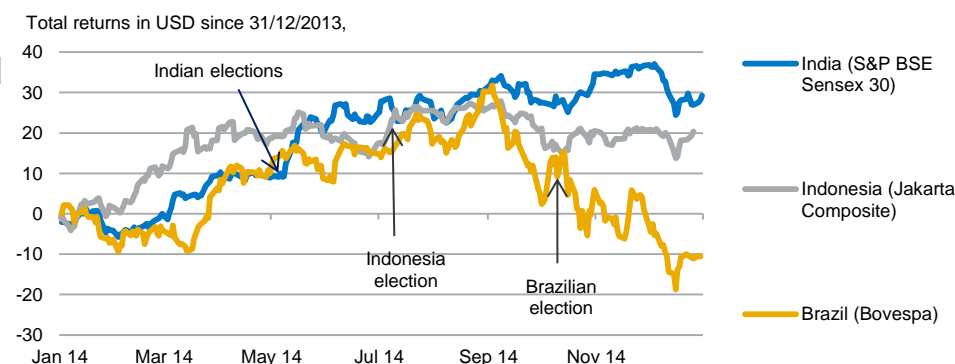
The earliest of the three was India which held its parliamentary election in April/May. Market optimism was already building months in advance of the result as anticipation grew of a win for opposition candidate Narendra Modi, widely seen as a pro-business reformer. His victory prompted further strong gains and this positive sentiment has continued almost unabated since. Helped by some progress on reform, the market is up 29.2%.

Indonesia's own election in July also promised to deliver a reformer, Joko Widodo ("Jokowi"), and the market duly swelled in anticipation. However, polls tightened going into the election and the end result was a far less convincing mandate for Jokowi than for Modi. Equities consequently have stayed flat since the election - though Jokowi's position is improving - and the market ended the year up 20.3%.

Last, and least (in equity performance, anyway) is Brazil, where October's election disappointed markets by returning incumbent populist Dilma Rousseff to power. The market had hoped, as suggested by polls, that the pro-reform candidate Aécio Neves would win, and before him the surprise candidate Marina Silva. These expectations led to a surge in equities which dissipated quickly following news of Dilma's victory. The announcement of a more market friendly cabinet since has done little to stem the equity slide; the market has gone from a high of +20% in September to -10.6% for the year.

Elections were a big factor in India, Indonesia and Brazil

Chart 13: Elections produced varying results for EM equities



Source: Bloomberg, Schroders. 31 December 2014.

Market liberalisation sparked speculation in China

One final equity market which has posted remarkable returns this year, is China's A share market. Largely closed to foreign investors, a partial liberalisation allowing investors on the Hong Kong exchange to buy shares in dual listed companies on the Shanghai A-share index (the so-called "Hong Kong - Shanghai connect") has led to large initial inflows into the Shanghai exchange and a flurry of speculative activity among domestic investors. Performance has since been propped up further by expectations of further policy easing by the central bank. We are sceptical of the sustainability of this rally, but for now the market is up over 43% since the start of the year.

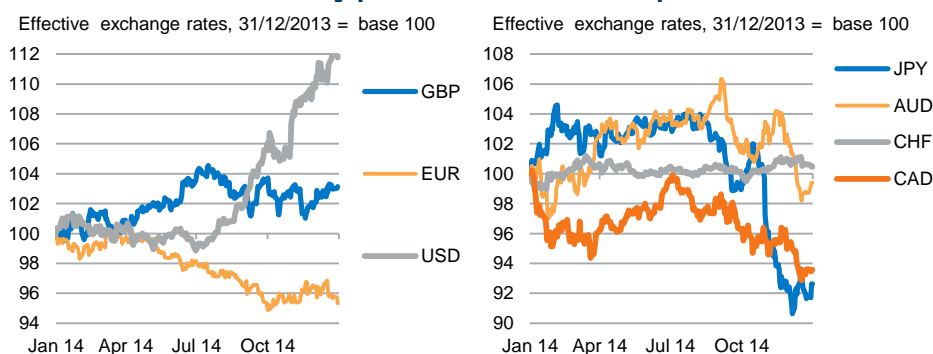
Investor expectations of policy easing reflect the stance taken by the central government and also increasingly by the PBoC of providing support to growth. Some commentators had expected another strong year for China in January, but the consensus view now is of a managed decline, or soft landing. So far the authorities have managed this reasonably well, though they have been unable to hit the 7.5% growth target - 2014 looks likely to be the first time since the Asian Financial Crisis the target will have been missed. Policymakers retain a firm grip, but they are not omnipotent - even in China.

2014 review (continued)

Comparing currency market performance

The outperformance of the US economy and end of QE helped drive the USD up against its main trading partners (+11.8%). With few economies keeping up with the US, the dollar was a favourite long for many investors against various short positions elsewhere. GBP saw a small appreciation as it too outperformed growth expectations, however, a dovish central bank, concerns over potential Scottish independence and the UK's proximity to Europe limited the gains in trade weighted GBP (+3.1%). The EUR effective exchange rate depreciated over 2014, however, more aggressive monetary stimulus in other countries meant that the depreciation was relatively small (-4.7%). One of those more aggressive countries was Japan, which saw the BoJ's increased QE programme helping trade weighted JPY fall 7.4% over the year.

Charts 14 and 15: Currency performance in developed markets



Source: Bank of England, Schroders. 31 December 2014.

Elsewhere, the CAD and AUD had mixed performances over the year, but both began to slide since the start of the third quarter as commodity prices began to tumble.

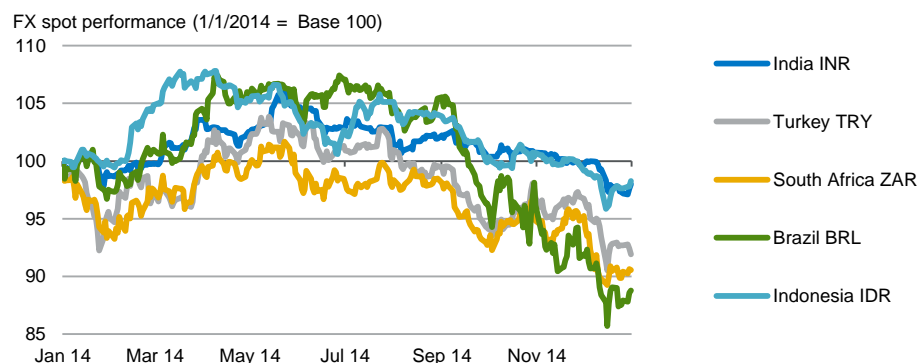
Limited reforms in EM leaves currencies exposed

In EM, after a difficult year in 2013, the "Fragile Five" currencies of India, Turkey, South Africa, Brazil and Indonesia might have been expected to recover in 2014 as their politicians moved to address the vulnerabilities exposed and attacked by the market. For the first half of the year, currency behaviour might even have indicated this was the case, with all five strengthening against the dollar for a time (chart 16 on next page). However, much of this was due to dollar weakness and a more dovish stance from the Fed (chart above), leading to improved sentiment about the broader EM complex.

Unfortunately, too few took the opportunity to address structural weaknesses and so as dollar strength has built, these gains have unwound, though more so in some economies - Brazil, Turkey, South Africa - than others. India especially has proved resilient, though even there the rupee is weaker now than at the start of the year. Still, the relative outperformance reflects the improvements India has made to its current account deficit (from 5.4% of GDP in 2013 to 1.3% this year) and the robust hawkishness of its central bank. No other EM economy has made such large improvements to its external balance sheet.

2014 review (continued)

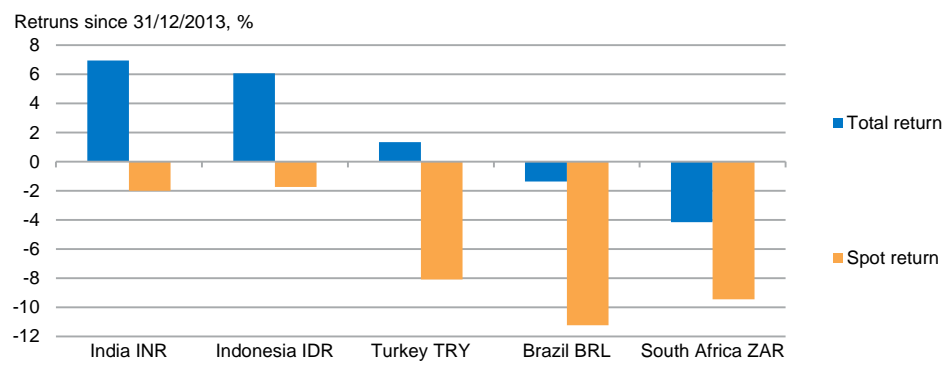
Chart 16: Dollar strength or idiosyncratic weaknesses?



Source: Bloomberg, Schroders. 31 December 2014

Of course, this is not the full story for currency returns, which also incorporate carry. The Fragile Five were forced to hike interest rates either in defence of their weakening currencies, or to combat the inflation engendered by depreciation. Brazil's policy rate today stands at 11.75%, and held the crown for highest policy rate until Russia's recent emergency hikes. Interest rates in the rest are lower, but are still relatively high compared to near-zero rates in the advanced world. Returns including carry have helped to offset some of the losses on the exchange rate, however, the BRL and ZAR still managed to generate losses (chart 17).

Chart 17: Recent weakness largely negates even high carry



Source: Bloomberg, Schroders. 31 December 2014

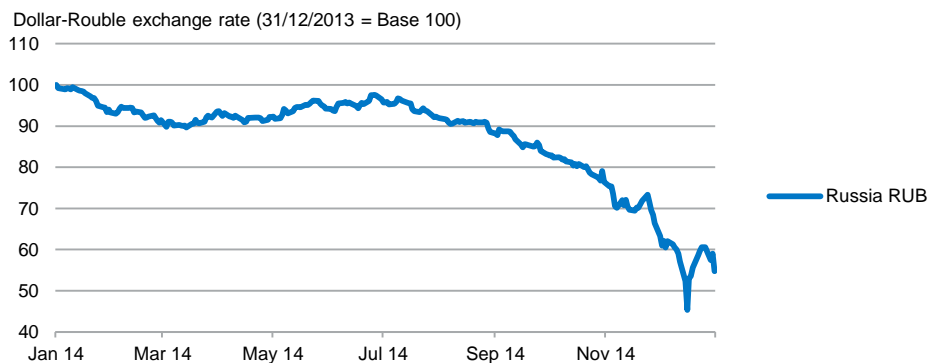
Russia's currency crisis not readily resolvable

The problems of the Fragile Five, however, pale by comparison with the recent travails of the Russian rouble (chart 18 on next page). The currency had been steadily depreciating along with other EM currencies, with additional pressure due to sanctions relating to the situation in Ukraine. The currency's crisis was really initiated following the decision by OPEC not to cut oil production. Oil prices, and the rouble, plunged. After an initial 100 basis points rate hike, and several rounds of intervention, proved ineffective, the central bank hiked rates an additional 650 basis points - only to see the currency hit new lows against the dollar.

One interpretation of the market reaction to the hike is that the central bank's defence simply is not credible – Russian corporates are already squeezed on overseas financing and now face a much higher burden at home too. Rates can not be held at this level for long without inflicting further damage on an economy already reeling from the fall in oil prices. By a similar token, spending reserves will not do much if the market is convinced resolve is weakening. Given that reserves have been used to help repay corporate borrowing in foreign currency, and that political willingness to see reserve capital disappearing into the pockets of foreigners will wane over time, many speculators are doubtless betting intervention will end before reserves are depleted completely. We may need to see further hikes coupled with capital controls to finally bring the crisis to an end, unless oil and the Ukraine situation both improve.

2014 review (continued)

Chart 18: Russia rumbled



Source: Bloomberg, Schroders. 31 December 2014

Market focus: Explaining lower US Treasury bond yields

Government bonds are not immune to the laws of demand and supply. While government bond yields often reflect general risk appetite, 2014 showed that like any other asset, when supply is restricted and demand is plentiful, the price will rise (and yields fall). Global liquidity has been an important factor, and may continue to be so next year.

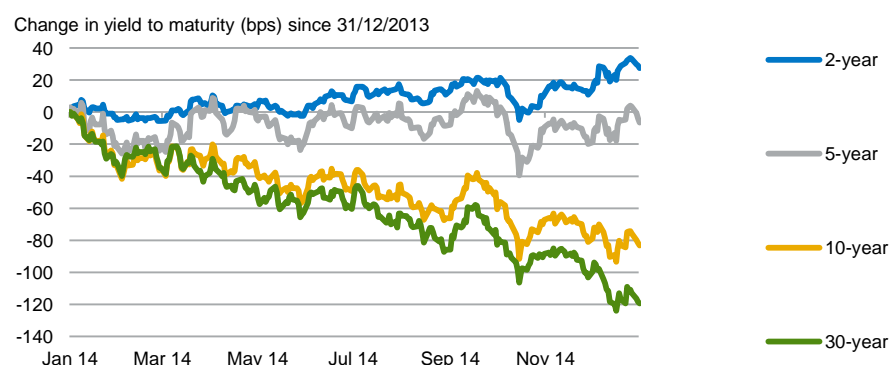
Bonds have beaten expectations of poor returns in 2014

Perhaps the title for this piece is a little ambitious, but we feel it is important to think about why government bonds have performed so well, against expectations of poor returns, especially on US Treasuries as the Fed prepares to tighten monetary policy. Indeed, some investors may have seen the outperformance of government bonds as a signal that the economy was in trouble.

In focusing on US Treasury bonds, it is interesting to note that the positive performance has not been across all maturities (chart 19). While the 30-year and 10-year bonds have seen a substantial fall in bond yields (and therefore rise in price), the 5-year bond has been largely unchanged, while the 2-year has sold off. This is important as the rise in 2-year bond yields suggests that markets did not substantially push out their expectations on the rise in the Fed funds interest rate. The fall in yields in the longer-end of the curve suggests that a contraction in the term premium has been the driver of the performance in Treasuries overall.

Chart 19: 2014 change in US Treasury yields

Lower yields are not a signal of dovish expectations for the Fed



Source: Thomson Datastream, Schroders. 31 December 2014

One factor that helps explain the lower term premium is a re-assessment of trend GDP growth estimates, and therefore a re-assessment of equilibrium interest rates. Lower productivity growth coupled with an aging population suggests potential growth in the US may be lower going forward. As a result, investors may expect the Fed to end its rate hiking cycle at a lower level than in the past. This is consistent with the rapid fall in the unemployment rate, without the boom-like growth seen in previous cyclical upswings. While this is likely to be an important factor, it is difficult to measure as regular surveys of trend growth estimates do not exist. Strangely, we would have expected this to bring down yields of the 5-year bond, but it has had little impact.

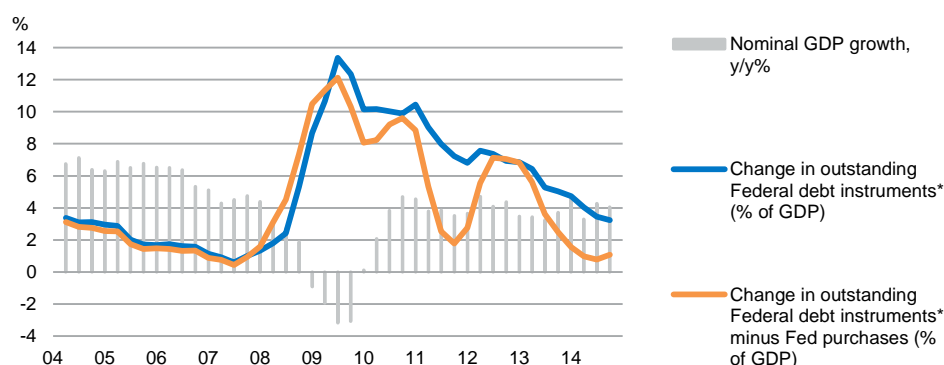
Demand and supply dynamics are a key factor...

Another factor worth considering is the change in demand and supply dynamics in the market. Starting with supply, as growth has accelerated over recent years, the US Treasury has benefited from rising tax revenues. At the same time, tight spending plans helped sharply reduce the nation's budget deficit. This has reduced the supply of new issuance to the market. Moreover, this has occurred while the Fed has continued to buy Treasuries, albeit as purchases were tapered and eventually halted. Chart 20 on next page shows the fall in the annual change in outstanding Federal debt instruments (the equivalent of new flows excluding refinancing), and the same measure minus the amount of bonds the Fed has purchased. The supply of new Federal debt instruments fell by 44% in the first three quarters of 2014 compared to the same period in 2013, however once Federal Reserve purchases are taken into account, net new supply fell by 57%.

Market focus: (continued)

...especially with supply limited by Fed purchases

Chart 20: Lower supply of Federal debt instruments



*Federal debt instruments include Treasury bills, notes, bonds and inflation-linked bonds. Source: Thomson Datastream, Schroders. 31 December 2014.

Net of Fed purchases, new issuance over the past four quarters is worth about 1.1% of nominal GDP. When compared to nominal GDP growth of 4% over the same period, it suggests that supply has been short of potential demand. Nominal GDP growth is usually used as a proxy for where long-term interest rates should be in accordance with the trend-growth argument above. However, we are looking at nominal GDP as an indicator of the growth in wealth in the economy. This is because excluding cyclical fluctuations; we would expect a certain proportion of wealth to be invested in government debt instruments, largely irrespective of their valuations. These investors will include banks, insurance companies, pension funds, and long-term investors. Therefore, if demand or an economy's wealth continues to grow faster than supply of debt instruments, it should put upward pressure on the price, and downward pressure on yields of such assets. This might help explain previous years of term premium contraction.

To test this hypothesis, we ran a simple regression using the US term premium as defined by the spread in yields between the 10-year and 2-year bonds, along with our demand/supply indicator, defined as the gap between nominal GDP growth and new debt issuance. The results are encouraging. As the gap between demand and supply widens, the term premium tends to fall. In fact, the analysis suggests that the term premium in 2014 is still higher than the equilibrium suggests - possibly due to abnormally low policy interest rates, keeping the curve steep.

A final factor worth considering is the cross-market impact from the actions of other central banks. As the ECB edges closer to sovereign QE, and as the BoJ continues with its QQE, both have successfully lowered their own sovereign bond yields, which have made US Treasuries relatively more attractive. Their actions are likely to have encouraged overseas investors to buy US Treasuries, in order to make up for the low yields available in Europe and Japan. Indeed the Fed, BoJ and PBoC have added a huge \$1.3 trillion of liquidity to the global economy so far this year through the expansion of their balance sheets. Much of that liquidity has probably found its way to the global government bond market.

Azad Zangana

Senior European Economist and Strategist, 31 December 2014

Global liquidity easing is also likely to be depressing yields

Strategy View: Themes for 2015

We outline four themes for 2015 and consider the market implications.

- **Disinflationary boom.** Oil prices have fallen faster than we/ anyone expected, skewing the outlook toward stronger growth and lower inflation. *After a period of dislocation, equities to benefit from stronger earnings. Watch for sector rotation toward consumer cyclicals.*
- **Desynchronised cycle.** The US will continue to lead the economic and monetary cycle as the Fed tightens and the ECB and BoJ keep policy loose/ ease further. *Continued USD strength, pressure on commodities and emerging markets. Flatter Treasury yield curve in the US as short end sells off while global liquidity weighs on long end.*
- **Japan: winning the currency war.** Japanese firms to use the latest move in the JPY to gain market share and boost exports. Increased pressure on rest of Asia and competitors of Japan Inc. *Nikkei outperforms, positive for Asian bonds.*
- **Back to the 1990s.** The Fed is distracted by the Russia crisis and sluggish growth in the Eurozone and China, keeps policy too loose and fuels a liquidity bubble. *Art auctions continue to set records, Nasdaq continues its ascent.*

1. Disinflationary boom

World economy likely to enjoy a combination of stronger growth and lower inflation

The first theme follows on from our comments on the effect of the lower oil price. At this stage we are not revising up our growth forecasts, but are giving a clear indication of the direction of travel: higher growth and lower inflation. Lower inflation will increase fears of deflation and such risks remain strong in the world economy, but we have resisted making deflation a theme for 2015. Instead, on the basis that oil prices stabilise, the effect on inflation will be temporary. Given the prospect of our forecasts for growth having to be revised up and inflation down in coming months, the world economy would look like it is enjoying a disinflationary boom. It is possible that global growth hits 3.3% in 2015, the best since 2011.

Markets do not seem to be priced for this level of cyclical strength which would tend to support commodity prices further out. Although low inflation might give central banks pause on policy rates, longer yields may rise, particularly if unemployment falls more rapidly as growth strengthens. Equities should benefit from stronger earnings, but look for a rotation in markets away from the bond proxy companies, who focus on pay-outs, toward cyclicals.

2. Desynchronised cycle

US leading the growth and interest rate cycle over Europe and Japan

This theme will be familiar as it has been running for much of 2014 with the US leading the global upswing and the Fed poised to be the first of the major central banks to raise interest rates. The latest FOMC meeting held on December 17th did not change this conclusion. In contrast, the ECB and BoJ are set to keep policy loose, or even looser, with the former expected to start sovereign quantitative easing in March next year.

The macro question is whether one economy can break away when the rest of the world is still treading water? At this stage the answer is still yes in our view. The US, may be one of the biggest trading nations in the world (second only to China), but the external sector is relatively small as a share of US GDP. Exports are around 13% of GDP, imports 15.5% and on our calculations net exports have been neutral for GDP growth since the start of 2012. The US recovery has been led by stronger domestic demand, particularly consumer spending.

Strategy View (continued)

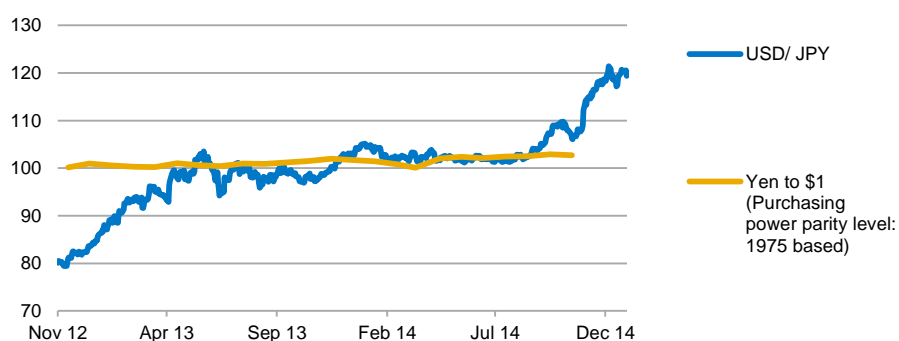
On balance we believe that domestic strength will outweigh foreign worries and keep the Fed on a tightening path. The concern however, would be that cyclical divergence pushes the USD to such a level that we see a reaction from the Fed similar to 1998. At that time fears of deflation were rife and the rise in the USD was acting to push down import prices and wider CPI inflation.

Markets have priced in a degree of synchronisation and this theme suggests a continuation of a stronger USD, weaker commodity prices and weaker emerging market equities. The implications for bonds are harder to gauge with many chastened by the experience of 2014, when Fed tapering was expected to push US Treasury yields higher. Certainly the short end of the US yield curve does not seem priced for the Fed tightening profile we expect. However, as discussed above, Treasury supply has slowed and the search for yield remains strong outside the US. Institutions in the Europe and those such as the GPIF in Japan will seek yield in international markets as they switch from Bunds and JGBs. This suggests a flatter yield curve in 2015, with yields on short dated bonds rising by more than long dated bonds.

3. Japan: winning the currency war

And the winner is...Japan! If Abenomics has achieved anything it is a weaker yen. We can think of the devaluation of the JPY in two phases. Phase one from 80 to 100 took the JPY from an overvalued position to a more neutral level and was widely seen as an appropriate adjustment by the international community, endorsed by the G7 for example. However, phase two from 100 to close to 120 may be less welcome as it takes the JPY to a more competitive level. Purchasing power parity (PPP) for the JPY is put at around 103, for example (chart 21).

Chart 21: Latest move makes JPY cheap



Source: Thomson Datastream, 31 December 2014

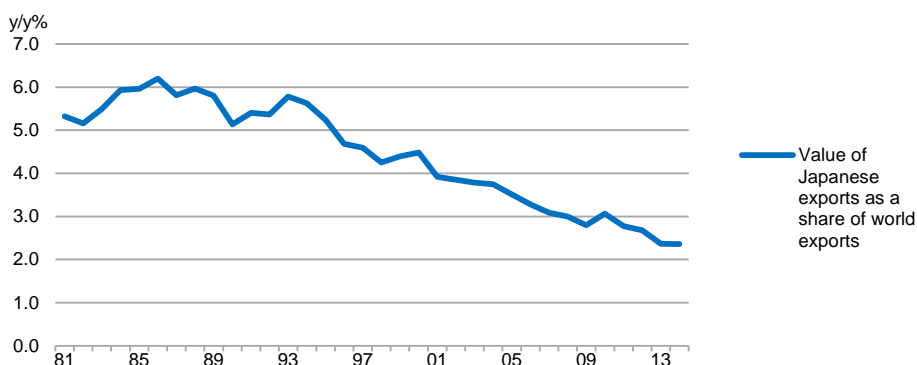
The latest fall in JPY makes Japan Inc. very competitive

Thus far, Japanese exporters have used the fall in the JPY to increase their profit margins and have kept their foreign prices stable. Margins have risen and higher profits have boosted the Japanese equity market. In turn this has helped boost consumer incomes through increased bonuses. The downside has been that export volumes have not responded and hence have not supported GDP growth.

This should now change: with the JPY at competitive levels, Japanese exporters may well decide to become more aggressive by cutting their prices to gain market share. This would help boost exports, thus reinforcing the recovery in the economy. It may be that we have to wait for new products to be introduced in different sectors before we see this effect, but it is likely to come and should see Japan reversing the long term decline in its share of global trade (chart 22 on next page).

Strategy View (continued)

Chart 22: Japan's declining share of global trade



Source: Thomson Datastream, 31 December 2014

The downside to this theme would be felt by competitors of Japanese companies who would lose market share and, given the slow growth in markets, this would probably mean seeing sales decline.

For example we would see a greater impact on Asia particularly Korea and China. However, further afield, countries like Germany which compete directly with Japan in a number of areas could also feel the squeeze from a resurgent Japan. From the perspective of these economies, Abenomics is very deflationary. We are already seeing a reaction in Asia with China and Korea easing monetary policy to head off this effect, however this could go considerably further.

Although Abenomics has been with us for a couple of years and looks like enjoying another four after the recent general election, this scenario does not seem to be fully priced in. There is still considerable scepticism about the ability of Abenomics to work on Japan. However, if the latest fall in the JPY has the effect we believe it might then it would surprise markets with stronger than expected growth. Such a move would suggest outperformance by Japanese equities particularly at the expense of the rest of manufacturing Asia and also Germany. By prompting greater monetary easing across the region it would be positive for Asian bond markets.

4. Back to the 1990's

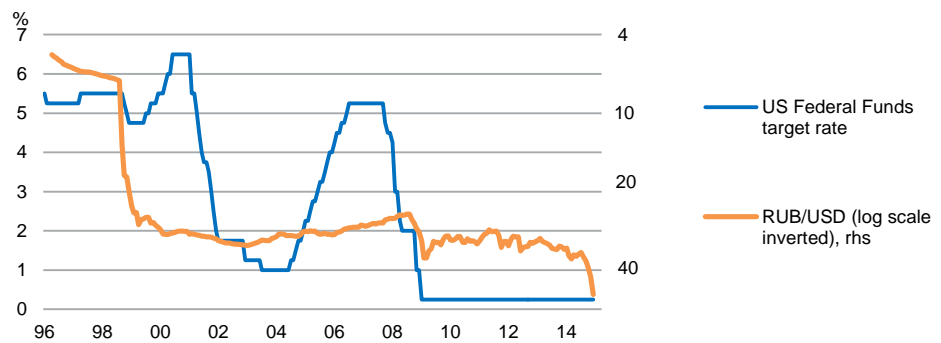
Finally, a theme which we have been discussing with clients since the summer. We have described the attraction of the USD above in our desynchronised cycle theme. An important element of this is the divergence of monetary policy. However, alongside this the US is also an attractive destination for real investment in terms of foreign direct investment (FDI) and equity portfolios. In the late 1990's we saw the USD strengthening alongside equity markets as international investors poured money into US tech stocks. The result, of course, was the tech bubble. One factor which fuelled this was the loose monetary policy of Alan Greenspan's Federal Reserve.

Back in 1998 the Fed cut rates following the Russia default (chart 23 on next page). Although the domestic economy was robust at the time the Greenspan Fed allowed itself to be distracted by external events. The same could happen again today with Russia looking increasingly precarious as oil prices weaken and capital flees the economy. We are not looking for a repeat of the Asia crisis of the late-1990s, but sluggish growth in China and the Eurozone could weigh on global inflation and Fed deliberations. Janet Yellen may see such events as reason to hold off on rate tightening, keeping rates at close to zero and helping to fuel a liquidity bubble.

Strategy View (continued)

Uncanny similarities suggest a 1990s re-run

Chart 23: Fed funds rate and the Russian rouble

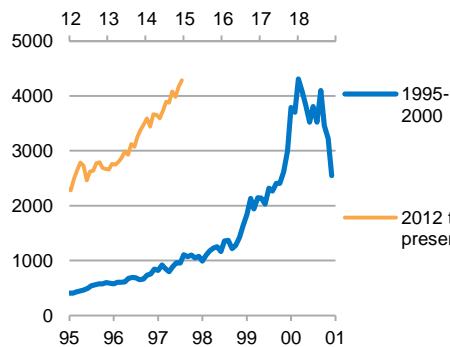


Source: Thomson Datastream, 31 December 2014

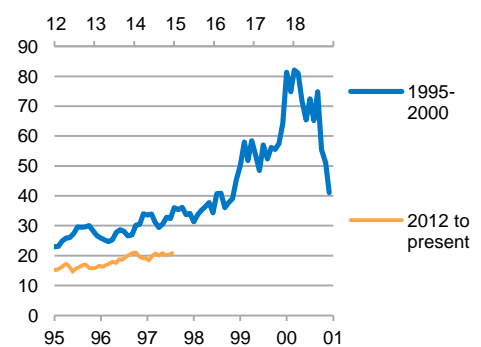
Is it in the price? Comparisons are never exact, but we have already seen evidence of excess liquidity across a range of asset classes from house prices to fine art. Recently, to continue the comparison, there has been increasing focus on the performance of the NASDAQ. Today the index is higher, but so are earnings with the result that the price-earnings ratio is still some way below the levels seen during the bubble (charts 24 and 25).

Charts 24 and 25: NASDAQ then and now

NASDAQ index



PE ratio



Source: Thomson Datastream, 31 December 2014

Keith Wade
 Chief Economist and Strategist, 31 December 2014

Long run asset class performance: 30-year return forecasts (2015–44)

Schroders Economics Group produces thirty-year return forecasts, on an annual basis, for a range of asset classes. Here we outline the methodology used, which is based on a series of building blocks and estimates of risk premia, and surmise the key conclusions from our analysis.

Cash

One of the key building blocks for our long-run forecast is our assumption regarding the returns on cash, which are almost entirely driven by movements in key policy rates (Bank of England base rate, the Federal Funds rate etc.).

The methodology we use is a multi-stage approach- in the initial stage (6-8 years depending on the region) we forecast the real return on cash to remain negative, as the de-leveraging of both private and public sector balance sheets in the developed world keeps monetary policy extremely accommodative, and negative real rates remain an attractive way of ameliorating the debt burden.

The second stage of our cash forecast is a simple normalisation in cash rates, over a five year horizon, before we reach the third and final stage, with positive real cash rates. This terminal value of real cash returns is based on an historic average, to which we make adjustments to reflect our views going forward. This year, we have made downward adjustments to the historic average for Japan, owing to poor demographics suggesting an anaemic growth outlook.

Table 3: Real cash returns assumption (% per annum)

	US	UK	Eurozone	Japan
De-leveraging phase (6–8 years)	-1.5	-2.0	-1.0	0.0
Long run (17–19 years)	1.0	1.4	0.9	-0.1
Overall (2014–43)	0.33	0.47	0.23	-0.08

Source: Schroders, January 2015

Cash return forecasts have mainly been revised downwards this year, as rates have fallen across the curve in most risk-free bond markets, with lower inflation expectations impacting rates. The only exception is Japan, in a sign that Abenomics is having some impact.

Inflation

Our preferred approach is to formulate our views on the real returns of the major asset classes and then add our inflation assumptions to give the expected nominal return. Our inflation forecasts follow a similar multi-stage approach to that used for GDP, using consensus forecasts for the initial ten years and our own forecast for the latter twenty.

Sovereign bonds

Our return assumption on sovereign debt builds on the return we have for cash, adding a maturity premium to forecast the returns to longer maturity (10-year) bonds. As with our cash methodology, we estimate the maturity premium from historical averages (in this case twenty years) and make an adjustment to reflect our own views. Using the historical average maturity is a sensible base, as there is a maximum steepness a yield curve can reach before the carry and roll becomes too attractive for investors to ignore, thus encouraging them to buy long-dated bonds and flatten the curve again. We maintain, from last year, a 40% discount to the historic steepness of the yield curve for all countries, to reflect the view that yield curves are likely to be flatter going forward than they have been since the early 1990s, as a result of loose monetary policy and a weak growth outlook.

Cash returns likely to be negative in the near term, owing to the deleveraging process

Sovereign debt should outperform cash, but returns still muted

Long run returns (continued)

For the UK and US, we also forecast the returns on inflation-linked government debt, by applying a discount to the returns on the nominal bonds. It is to be expected that inflation linked bonds offer a lower return than nominal, owing to the insurance they offer against rising prices. The reason for the greater yield discount applied to UK linkers than US TIPS is due to technical market reasons, related to the relative liquidity of the two markets⁴ and the structure of the market.

Table 4: Cash, sovereign bonds and linkers

	US	UK	Eurozone	Japan
2014–43 (% p.a.)				
3 stage model	0.3	0.5	0.2	-0.1
Cash real return	0.3	0.5	0.2	-0.1
Inflation	2.3	2.4	2.0	1.5
Nominal cash return	2.7	2.8	2.2	1.5
Bond maturity premium	1.1	0.5	0.8	0.7
Bond return	3.7	3.4	3.0	2.2
Inflation insurance premium	0.5	1.0	n/a	n/a
Inflation linked bonds	3.2	2.4	n/a	n/a

Source: Schroders, January 2015

Returns on government bonds have been revised lower almost universally, with the exception of the Eurozone. This is driven in large part by lower cash returns, though in some cases the maturity premium has also fallen. Japan is one notable example, with QE helping to push down yields at the longer end.

Credit

Credit returns are estimated as the excess over sovereigns

Our credit returns are forecast using the excess return of credit (both investment grade and high yield) over sovereign bonds for the respective market. The two key drivers of credit's excess return are the changes in spreads and the expected loss through defaults, both of which are closely linked to the economic cycle. For this reason, we combine regression analysis of spread changes and default losses with our long run US growth forecast to forecast the excess return of US high yield and investment grade credit over Treasuries. Using regression analysis again, we use the excess returns of US credit to estimate the excess returns of UK and European credit over UK Gilts and German Bunds respectively.

Table 5: Credit – Investment grade (IG) and high yield (HY)

2014–43 (% p.a.)	US IG	US HY	UK IG	Euro IG	Euro HY
Spread	1.0	5.1	0.7	0.5	5.8
Default loss	0.1	3.3	0.1	0.1	3.3
Return over 10-year govt.	0.9	1.8	0.6	0.5	2.4
10-year govt. return	3.7	3.7	3.4	3.0	3.0
Nominal return	4.7	5.5	4.0	3.5	5.4

Source: Schroders, January 2015

Credit returns have all been revised downwards, more so in the US than Europe. With our credit returns modelled using a spread versus government bonds, lower credit returns are to be expected when we are forecasting lower fixed income returns.

⁴ UK linkers make up a bigger share of the total Gilt market (roughly 20%) than TIPS do of the Treasury market (less than 10%). Thus, *relative to their main market*, TIPS are less liquid than UK linkers, and thus have a price discount (e.g. lower prices, thus higher yield and smaller differential between nominal and TIPS yield)

Long run returns (continued)

Equity return forecasts show disparity between EM and DM, particularly Japan

Equities

Our equity return assumptions use a Gordon's growth model approach, in which returns are generated through the initial dividend yield and the growth rate of dividends (via earnings growth). Thus, our equity outlook rests on our real GDP growth forecasts, from which we use the implied productivity growth— the growth in real GDP not caused by growth in the labour force— to forecast the capital growth from equities. We use productivity growth rather than GDP growth as our proxy for dividend growth, as the former translates into earnings growth better than the latter.

Our thirty-year GDP forecast is split up into the first ten years and the final twenty years. For the first ten years, we use our own economic forecasts for the first two years, and the consensus GDP forecasts from Consensus Economics for the remainder. In combination with demographics data from the US Census Bureau, we can back out the implied growth in productivity. For the latter twenty years, we make explicit productivity forecasts, using historical averages and our own outlook, and combine these with the demographic data to forecast GDP growth. We then combine the two time periods to get an overall thirty-year forecast for productivity and GDP growth.

This forecast for productivity is the basis for our capital growth assumptions, though we make adjustments for areas where earnings and trend productivity have not tended to grow in line. This is the case in the emerging markets, where productivity gains have historically not translated fully into earnings growth, hence we scale earnings growth downwards, and Europe where earnings growth has tended to exceed productivity growth (hence an upward scaling).

Table 6: Expected returns from equity markets

	US	Japan	UK	Eurozone	Pacific ex Japan	Emerging	Switzerland
2014–43 (p.a.)							
Dividend yield	2.0	1.7	3.4	2.9	3.9	3.2	2.8
Projected dividend growth	2.2	1.9	1.9	2.0	2.5	4.0	1.8
Expected real return	4.2	3.6	5.4	4.9	6.5	7.4	4.6
Inflation	2.3	1.5	2.4	2.0	2.7	3.4	1.2
Expected nominal return	6.7	5.2	7.9	7.0	9.4	11.0	5.9

Source: Schroders, January 2015

Our equity forecasts have changed only marginally, in most cases, but the changes have not been unidirectional. The largest increase in forecast equity returns was in the Pacific ex. Japan region, driven by an increase in yield and lower inflation, and the largest decrease was Singapore. The market offering the best real returns over the 30 year period remains Emerging Markets, at 7.4% per annum, followed by the UK small cap index, at 6.8%. EM returns are driven by high productivity growth, while the UK small cap index benefits from a premium relative to its large cap counterpart, which itself has a high current dividend yield. Global equities continue to offer a healthy premium over bonds and cash.

Summary

Our forecasts suggest that the long run real returns on cash will be extremely poor, and especially so in the next ten years, during which they are likely to be negative for most developed markets. Further out, for the UK, US and Europe the real return on cash should normalise and become positive, but over the entire forecast horizon cash will do little better than beat inflation.

Long run returns (continued)

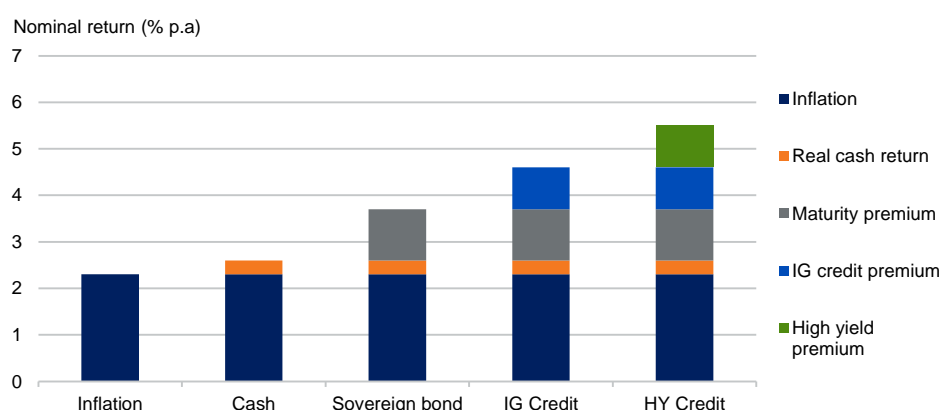
Strongest returns found in equities, particularly EM and UK small cap, while cash returns are atrocious

We would expect longer dated sovereign debt to outperform cash over thirty years, but returns in real terms are still likely to be disappointing, particularly in the near future. The current valuations of bonds considered “safe assets” are unattractive and suggest low returns.

Of the riskier assets, we expect both credit (particularly high yield) and equities to outperform sovereign bonds, though some investment grade credit offers similar returns to US sovereign debt. Equities remain the asset class offering the greatest potential for returns. On a regional basis, we believe equities will deliver an attractive return (both real and nominal) across the board, but unsurprisingly the strongest return potential is likely to come from the emerging markets.

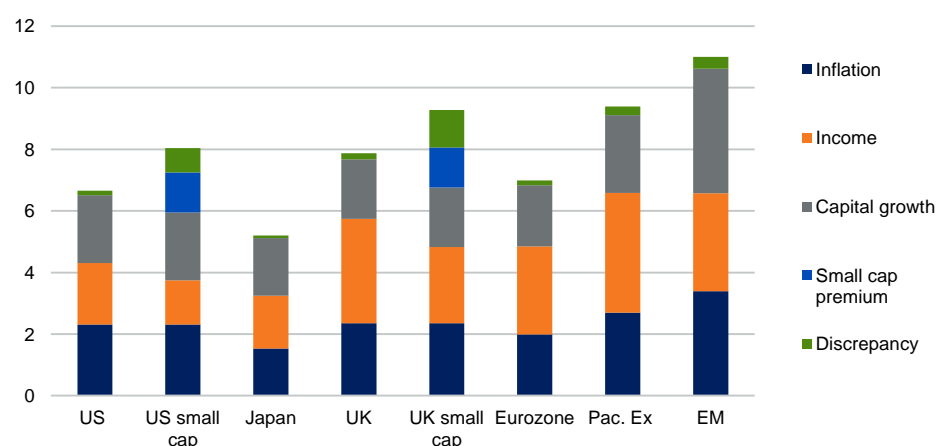
Emerging market equities, however, are more prone to periods of crisis than their developed peers, and we would expect the more generous potential return to be accompanied by greater volatility and sharper drawdowns. Elsewhere, Pac Ex., and UK small cap would appear to offer the best returns, while unfavourable demographics in Japan, with a rapidly shrinking working population, the potential growth rate of GDP and thus earnings is limited, capping the returns available to investors in Japanese equities. This effect also explains the relative underperformance of both the Japanese cash and JGB markets

Chart 26: US nominal asset returns – build up approach



Source: Schroders, January 2015

Chart 27: Nominal equity returns breakdown



Source: Schroders, January 2015

Craig Botham

Emerging Markets Economist, 9 January 2015

Long run returns (continued)

Table 7: Long-run return assumptions (2014–43)

	Currency	Yield	Capital gain	Nominal return	Inflation	Real return
Cash						
USD cash	USD	2.7	-	2.7	2.3	0.3
GBP cash	GBP	2.8	-	2.8	2.4	0.5
EUR cash	EUR	2.2	-	2.2	2.0	0.2
YEN cash	JPY	1.5	-	1.5	1.5	-0.1
Australia	AUD	2.8	-	2.8	2.5	0.3
Hong Kong	HKD	2.7	-	2.7	2.3	0.3
Singapore	SGD	1.4	-	1.4	1.3	0.1
G4 cash	<i>Local</i>	2.7	-	2.7	2.3	0.3
Government bonds (10-year)						
US Treasury bond	USD	3.7	-	3.7	2.3	1.4
UK Gilt	GBP	3.4	-	3.4	2.4	1.0
Eurozone (Germany)	EUR	3.0	-	3.0	2.0	1.0
JGB	JPY	2.2	-	2.2	1.5	0.7
Australia	AUD	3.1	-	3.1	2.5	0.6
Hong Kong	HKD	3.7	-	3.7	2.3	1.4
Singapore	SGD	2.3	-	2.3	1.3	0.9
G4 bond	<i>Local</i>	3.3	-	3.3	2.1	1.2
Inflation-linked						
Barclays 7–10 year IL Gilts	GBP	2.4	-	2.4	2.4	0.0
Barclays 7–10 year TIPS	USD	3.2	-	3.2	2.3	0.9
Credit						
US IG	USD	4.7	-	4.7	2.3	2.3
US HY	USD	5.5	-	5.5	2.3	3.1
UK IG	GBP	4.0	-	4.0	2.4	1.6
Euro IG	EUR	3.5	-	3.5	2.0	1.5
Euro HY	EUR	5.4	-	5.4	2.0	3.4
Property						
UK Commercial	GBP	5.1	0.5	5.6	2.4	3.2
EUR Commercial	EUR	5.3	0.8	6.1	2.0	4.0
Equity markets						
US	USD	2.0	4.6	6.7	2.3	4.3
US small cap	USD	1.4	6.5	8.0	2.3	5.7
Japan	JPY	1.7	3.4	5.2	1.5	3.6
UK	GBP	3.4	4.3	7.9	2.4	5.3
UK small cap	GBP	2.5	6.6	9.3	2.4	6.6
Switzerland	CHF	2.8	3.0	5.9	1.2	4.5
Europe ex.UK	EUR	2.9	3.7	6.7	1.8	4.7
Eurozone	EUR	2.9	4.0	7.0	2.0	4.9
Singapore	SGD	3.0	4.1	7.2	1.3	6.0
Pacific ex Japan	USD	3.9	5.3	9.4	2.7	6.1
Emerging markets	<i>Local</i>	3.2	7.6	11.0	3.4	7.3
Global (AC) Equity	<i>Local</i>	2.4	4.7	7.2	2.3	4.7
Global (AC) Equity Risk Premium			<i>vs. G4 bonds</i>	3.7		3.6
			<i>vs. G4 cash</i>	4.7		4.5

Note: UK Index-linked returns use RPI inflation for the nominal return. Source: Thomson Datastream, Schroders, March 2014

Market Returns

	Total returns	Currency	December	Q4	2014
Equity	US S&P 500	USD	-0.3	4.9	13.7
	UK FTSE 100	GBP	-2.3	-0.2	0.7
	EURO STOXX 50	EUR	-3.0	-2.0	4.9
	German DAX	EUR	-1.8	3.5	2.7
	Spain IBEX	EUR	-4.1	-3.7	8.6
	Italy FTSE MIB	EUR	-5.0	-8.8	3.0
	Japan TOPIX	JPY	-0.1	6.3	10.3
	Australia S&P/ ASX 200	AUD	2.1	3.1	5.6
	HK HANG SENG	HKD	-1.6	3.2	5.5
EM equity	MSCI EM	LOCAL	-2.4	0.1	5.6
	MSCI China	CNY	1.2	7.0	8.3
	MSCI Russia	RUB	-9.9	-5.9	-12.1
	MSCI India	INR	-4.3	1.5	26.4
	MSCI Brazil	BRL	-8.2	-7.5	-2.8
Governments (10-year)	US Treasuries	USD	0.4	3.6	10.7
	UK Gilts	GBP	1.6	6.5	15.6
	German Bunds	EUR	1.5	3.9	16.7
	Japan JGBs	JPY	1.2	2.2	5.4
	Australia bonds	AUD	2.8	7.6	18.4
	Canada bonds	CAD	0.6	3.6	12.2
Commodity	GSCI Commodity	USD	-13.6	-27.7	-33.1
	GSCI Precious metals	USD	0.7	-3.1	-4.1
	GSCI Industrial metals	USD	-4.4	-5.9	-7.4
	GSCI Agriculture	USD	-0.6	8.7	-10.7
	GSCI Energy	USD	-19.7	-38.9	-44.1
	Oil (Brent)	USD	-20.9	-39.9	-48.9
	Gold	USD	0.4	-2.2	-1.8
Credit	Bank of America/ Merrill Lynch US high yield master	USD	-1.4	-1.1	2.5
	Bank of America/ Merrill Lynch US corporate master	USD	-0.1	1.4	7.5
EMD	JP Morgan Global EMBI	USD	-2.9	-1.6	5.5
	JP Morgan EMBI+	USD	-2.5	-0.9	6.2
	JP Morgan ELMI+	LOCAL	0.2	0.8	3.7
Currencies	EUR/ USD		-2.9	-4.3	-12.1
	EUR/JPY		-1.9	4.7	0.3
	JPY/ USD		-1.0	-8.5	-12.3
	GBP/USD		-0.4	-3.9	-5.7
	AUD/USD		-3.7	-5.9	-6.0
	CAD/USD		-1.7	-3.4	-7.7

Source: Thomson Datastream, Bloomberg, 31 December 2014.

Note: Blue to red shading represents highest to lowest performance in each time period.



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