

# Schroders

## Global Market Perspective

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Economic and Asset Allocation Views Q3 2015



**Schroders**

## Introduction

After a strong first quarter, equity markets took a breather in the second as the action switched to bond markets. Having fallen to almost zero, German 10 year bond yields rose sharply as evidence of better growth and an end to deflation led many to question the European Central Bank's commitment to quantitative easing. Mario Draghi has subsequently reassured investors that the programme remains in place and volatility has subsequently subsided. One factor which will keep the programme in place is the turmoil in Greece where ECB action would be critical in quelling financial market contagion across the region should Greece leave the euro ("Grexit").

Looking ahead, we see a pick-up in global activity as the US bounces back from a weak first quarter and growth in Europe and Japan resumes. An exit from the Euro by Greece, whilst clearly shocking, would put a dent in this, but would not derail the world economy in our view. At 2% of Eurozone GDP, Greece is simply not large enough as an economy whilst there are firewalls in place to prevent significant financial contagion to the rest of Europe and beyond.

The other key feature of the global picture is a lack of recovery in the emerging world with China continuing to struggle, prompting the announcement of further stimulus by the authorities. Efforts to drive up the equity market and recapitalise large parts of China's corporate sector have been unravelling as the market has slumped in recent weeks.

Our asset allocation remains positive on equities with a focus on Europe where we see better prospects for earnings growth compared to the US, which is showing signs of margin pressure as wage costs rise. After the general election the reduction in political risk should boost the UK. It is too early to go back into the emerging markets particularly with the Federal Reserve likely to tighten policy later in the year and the US dollar expected to remain firm.

**Keith Wade, Chief Economist and Strategist, Schroders**

**9 July 2015**

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# Asset Allocation Views: Multi Asset Group

## Global Overview

### Economic View

Five years on from the initial rebound in global growth witnessed in 2010 it is clear that the shape of the recovery is best described by a square-root sign. After the initial collapse and recovery, growth has flat-lined at a steady, but sub-par rate of 2.5%. Despite the benefit of lower oil prices, it also looks as though this will be the rate achieved in 2015. Our most recent forecast is that the world economy will experience a fourth consecutive year of 2.5% growth, around half the rate achieved prior to the financial crisis.

We are seeing a pick-up in activity in developed economies. In the US, retail and auto sales have strengthened after a soft first quarter and employment growth remains robust. Europe continues to expand, with little evidence that the Greek crisis has significantly damaged business or consumer confidence so far. Indeed, we do not expect a significant macroeconomic impact from a possible Grexit on the eurozone.

In the UK, the clarity delivered by the Conservative party's election victory in May will boost activity as households and businesses can take investment decisions with greater certainty over tax and regulation. Looking further out, the election results give the Conservative government the mandate to continue to implement its austerity plan, even if that plan has been eased in recent years.

Bank lending and credit growth are reviving after the contraction experienced in 2013 and 2014. Meanwhile, the latest figures show that economic performance in Japan was better than expected in the first quarter with GDP growth being revised up to a 3.9% annualised rate on the back of stronger investment. Leading indicators suggest growth remained robust in the second quarter and we are looking for Japanese consumer spending to improve as real incomes strengthen in coming months. Emerging markets remain the laggards – with China continuing to decelerate in the second quarter – and as a group they continue to lag the recovery seen in Purchasing Managers' Indices (PMIs) in the developed world.

These trends bode well for the second half of the year and into next. Our forecast assumes that global growth can pick up to 2.9% in 2016. This is based on continued recovery in Europe and Japan and steady growth in the US, which feeds through to better exports from the emerging economies. The ongoing benefits from lower energy costs, loose monetary policy and a less restrictive fiscal stance support demand in the West and underpin the forecast.

Can the acceleration in growth be sustained at this rate to take us back to something resembling a pre-crisis pace? We have our doubts. The US was the locomotive for the world economy during that earlier period as asset prices and credit growth boomed. Today, asset prices are booming again but credit growth is relatively subdued as facilities like home equity withdrawal have disappeared. This is probably for the better, but means it is harder to translate wealth gains into consumption. Meanwhile, in our view, trend growth is weaker than 10 years ago when labour market demographics were more favourable and the recovery is showing signs of strain after six years of expansion. The evidence is a tightening labour market with wages and inflationary pressures beginning to accelerate.

### Central Bank Policy

The supply side concerns mentioned above underpin our view that the Federal Reserve (Fed) will raise rates in September and into next year. Although better demand is an important part of this call, it is the supply side as seen in the fall in unemployment and slowdown in productivity which strengthens our view that the Fed will have to tighten policy. Consequently, we see the US as nearer the end of its cycle than the beginning.

## Implications for Markets

Meanwhile, in the UK the Bank of England (BoE) remains relaxed over monetary policy despite mounting evidence that labour shortages are increasingly prevalent and wage growth is accelerating. We expect the BoE to wait until February 2016 to raise rates, due largely to the lower-than-expected inflation seen in recent months which is expected to remain persistently below 1% until early 2016.

Elsewhere, we expect further policy easing from the People's Bank of China whilst the ECB and BoJ keep policy loose.

In the wake of the Greek referendum on the 5<sup>th</sup> of July, which resulted in a resounding "no" to Europe's bailout offer, financial markets are likely to remain volatile in the near term. However, as it becomes apparent that exposure to Greece is very limited and contagion from Greece is under control, European equities and peripheral bonds spreads will probably calm down. In our view, the ECB has all of the policy tools it needs to contain market contagion, and the will to use them.

Greece aside, and looking at equity markets more broadly, there has been little change to our equity views this quarter, besides an upgrade to the UK where the general election result has removed a great deal of uncertainty. In the short-term it seems clear the election result should provide businesses with a stable political and legislative background in which to invest for the future. We have a preference for mid-caps, implemented through exposure to the FTSE 250 Index, and we are particularly positive on the domestic UK economy and the housing market.

Alongside the UK, Europe is the only other region where we are positive on equities, despite the recent Greece-related volatility. Leading economic indicators continue to improve and we believe the ECB's quantitative easing programme will continue to support the region's recovery.

There is no change to our neutral stance on US equities, where the challenge of potential rate hikes and the impact of a strong dollar could hinder stockmarket progress. Indeed, we expect the US dollar to continue to strengthen as US growth is likely to reaccelerate in the coming quarters following the recent soft patch.

We also remain neutral on Japan equities, where equity markets have received a boost recently from better-than-expected growth data, but comments from Bank of Japan (BoJ) Governor Kuroda have cast doubt on the prospect of further stimulus in the short-term. Our neutral stances on Pacific ex Japan and emerging markets also remain unchanged. In the case of the latter, many emerging countries face low growth and low inflation while the prospect of a Fed rate hike also stifles sentiment.

In fixed income, we have a neutral stance towards government bonds and a negative view on investment grade credit. Specifically, on the sovereign side we are negative towards US Treasuries and in Europe we favour UK and Norway government bonds over German bunds due to their lower volatility. In corporate bonds, meanwhile, we prefer Europe, where we are neutral, to the US where we are negative.

On the commodities side, a strong recovery in the oil price has led us to downgrade to neutral our view on energy.

# Asset Allocation Views: Multi-Asset Group

## Global Overview (continued)

Implications  
for Markets  
(continued)

**Table 1: Asset allocation grid – summary**

Equity	+	Bonds	0			Alternatives	0	Cash	-
Region		Region		Sector		Sector			
US	0	US Treasury	-	Government	0	UK property	+		
						EU property	+		
Europe ex UK	+	UK Gilts	+	Index-Linked	0	Commodities	0		
UK	+ (0)	Eurozone Bunds	0	Investment Grade Corporate	-	Gold	-		
Pacific ex Japan	0	Emerging market debt (USD)	0 (-)	High yield	-				
Japan	0								
Emerging Markets	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, June 2015

# Regional Equity Views

## Key Points

+ Equities		
0	US	We retain our neutral rating on US equities. We are seeing a pick-up in activity, retail and auto sales have strengthened after a soft first quarter and employment growth remains robust. Earnings revisions are rolling over, highlighting the challenge of potential rate hikes and strong dollar-led disappointment.
+ (0)	UK	We upgrade our view on UK equities this quarter to positive. We prefer mid-caps, implemented through exposure to the FTSE 250 Index, as they provide a purer translation of our positive view on the UK economy following May's general election, when the Conservative party won a surprise majority. We are particularly positive on the domestic economy and the housing market, which are well represented in the mid-cap index. We also think the FTSE will benefit from the rotation into reflation trades, given its concentration in commodity-related sectors.
+	Europe ex UK	We are still positive on European equities and have noted the uptick in leading economic indicators in recent months. We remain of the opinion that the ECB's commitment to its asset-purchase programme will remain intact and continue to support the region's fundamental recovery, whilst quelling contagion risk from a potential Grexit.
0	Japan	Economic growth has been surprising to the upside recently, which has provided a boost to equity markets. The trend in corporate buybacks and improvements in corporate governance continues but we believe that recent comments from the BoJ's governor on the yen have dampened expectations of further monetary stimulus in the short term.
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	Our opinion on the region remains unchanged at neutral this quarter. The region is dominated by Australia, where we hold a negative view given the unfavourable economic situation. With weak capital expenditure intentions and slowing demand from China, growth is expected to remain below trend in Australia. On top of this, the economy is still suffering from an overvalued currency as it goes through structural adjustment, making exports relatively less competitive abroad.
0	Emerging Markets	We remain neutral on emerging market (EM) equities given the accommodative monetary policy adopted by many of Asia's central banks. However, we note the low growth, low inflation environment in many EM countries while the risk of the Federal Reserve (Fed) hiking rates too soon continues to weigh on sentiment.

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

# Fixed Income Views

## Key Points

0	Bonds	
0	Government	<p>We remain neutral on government bonds overall, although we maintain a negative view on US 10 year Treasuries and a more positive view on European markets, where we prefer bonds from Norway and the UK over German Bunds due to their lower yield volatility.</p> <p>Although we have a broadly negative stance on US Treasuries, particularly 10 year maturities, this is counterbalanced by a more positive view on 2 and 30 year bonds. Our expectation for a stronger dollar should dampen inflation expectations and therefore cap yields on the 30 year bond.</p> <p>Our positive view on gilts is unchanged since we upgraded it last quarter, retaining our preference towards the longer end of the yield curve. We see continued investor flows into the UK from European investors due to the higher carry, lower yield volatility and greater confidence following the outcome of the recent general election.</p> <p>We retain a neutral view on bunds and expect the yield curve to flatten. This is reflected in our negative view of 2 year bunds and positive view on 30 years, which we expect to benefit over the summer from negative supply dynamics.</p>
-	Investment Grade (IG) Corporate	<p>Despite the recent bout of weakness in government bond markets, US credit spreads have widened less than expected, thus worsening the already stretched valuations. With the addition of strong net supply, worsening issuance quality, some pressure on margins and spill-over from the volatility in government interest rates, we remain negative on US investment grade.</p> <p>We have downgraded our view on European investment grade credit compared to last quarter. Volatility in European bond markets has risen significantly, despite the Quantitative Easing (QE) programme of the ECB. This has put pressure on spread products and shown European IG is vulnerable at current valuations despite QE support. As a result we have downgraded to neutral, considering risks are more balanced now that inflation expectations are recovering into an extended credit cycle as the shadow of Greece remains firmly in place over Europe.</p>
-	High yield (HY)	<p>Lower quality of issuance and increased supply has caused high yield spreads to falter as we head into the traditionally difficult summer periods. The rebound in oil prices has caused some price recovery and additional stability for the energy sector, but interest rate volatility is unsettling to total return investors. We therefore maintain our negative stance.</p> <p>Whilst improving growth dynamics in Europe are positive for high yield issuers, we maintain our cautious stance on European HY given the high correlation with the weaker US market, potential risks from Greece and the broader liquidity risks building in bond markets.</p>
0 (-)	USD-denominated Emerging market debt (EMD)	<p>We upgraded emerging market debt over the quarter to neutral. We believe that valuations are attractive and that the carry over many developed market bonds is sufficient to outweigh the potential volatility caused by the Fed's rate rises.</p>
0	US index-linked	<p>We remain neutral on inflation in the US as a structurally higher US dollar is putting pressure on the long end of the inflation forward curve.</p>

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

# Alternatives Views

## Key Points

### Alternatives

0	Commodities	<p>We maintain our view on broad commodities at neutral, but have downgraded our view on cyclical commodities.</p> <p>Following a strong rally in energy prices, upside and downside risks are more finely balanced now, with upside returns ultimately capped by the potential for shale to return to the market.</p> <p>We maintain a negative score on gold as we expect the US recovery to continue, leading to higher real rates and therefore reduce the relative attractiveness of the precious metal.</p> <p>China has moved firmly into an easing cycle, bringing forward infrastructure expenditure and easing monetary policy. However, there is little evidence of this impacting real demand and we remain neutral until we see this changing.</p>
+	UK Property	<p>We expect UK commercial real estate to have another strong year in 2015 with capital growth close to 10% and total returns of around 15%. The main driver will be a decline in yields, although rental growth of 3% should also make a useful contribution.</p> <p>Looking ahead over the next couple of years we expect capital growth to slow significantly as the decline in yields halts and we wouldn't rule out a small fall in capital values at some point. Although in the short-term there is no correlation between property yields and long-term gilt yields, the latter are clearly an important reference point and we believe that those assets and parts of the market where there is little prospect of any income growth will be most vulnerable when bond yields rise.</p>
+	European Property	<p>We forecast that total returns on average investment grade European real estate will be 7 – 9% per year between end-2014 and end-2018. Total returns are likely to be front loaded, benefitting from yield compression in 2015 – 2016 and rental growth from 2016 onwards. The main downside risk is that a Greek exit from the euro escalates into a broader sovereign debt crisis.</p>

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.



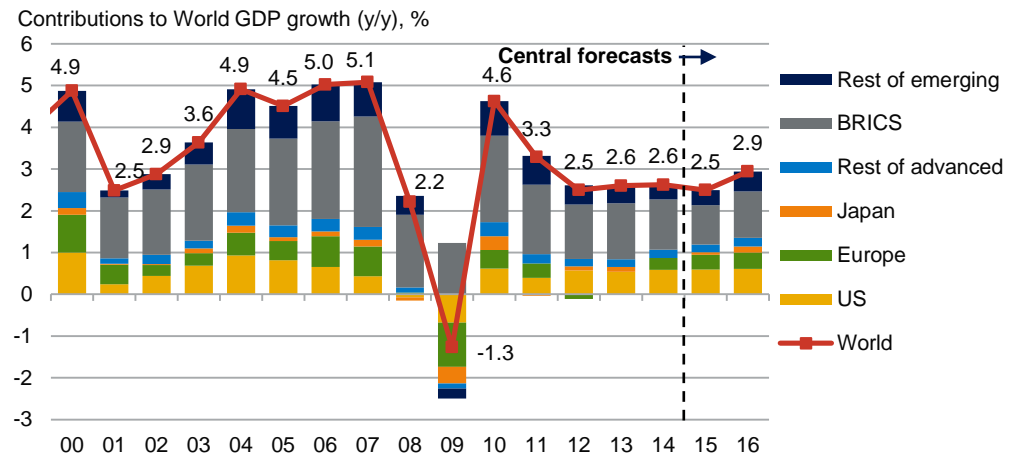
# Economic View

## Central View

### Global update: growth downgraded, but inflation pressure builds on oil and ageing US cycle

We have cut our 2015 forecast for global growth from 2.8% to 2.5%, primarily as a result of a downgrade to the US where the economy stalled in the first quarter. We have also downgraded Japan and the UK following a weaker-than-expected start to the year. US growth is anticipated to pick up going forward, but is now forecast to reach 2.4% this year (previously 3.2%), the same as in 2014. By contrast, our forecast for the Eurozone is marginally stronger at 1.4% (previously 1.3%) whilst that for the emerging markets is little changed. Both regions have performed as expected in the first quarter, with the former enjoying ongoing recovery whilst the latter have continued to struggle. For 2016, global growth is forecast to pick up slightly to 2.9% led by a better performance in the emerging markets and further recovery in the Eurozone and Japan (chart 1).

**Chart 1: Global growth and forecast for 2015 and 2016**



Source: Thomson Datastream, Schroders Economics, 27 May 2015

Inflation is expected to remain low in 2015, but we have nudged our forecast slightly higher to reflect the recovery in oil prices (both spot and forward). Global inflation is forecast to come in at 2.8% for 2015, but with a significant reduction for the advanced economies to 0.6% from 1.4% in 2014. The US Federal Reserve (Fed) is still expected to look through this and focus on a firmer core rate of inflation and tightening labour market so as to raise rates in 2015. We expect the Fed funds rate to rise to 1% by end-2015 and then peak at 2.5% in 2016.

Deflation concerns in the Eurozone are likely to ease as inflation picks up in 2016 thanks to the depressing effect of lower oil prices dropping out of the annual comparison in combination with the weaker euro. We expect the European Central Bank (ECB) to implement quantitative easing (QE) through to September 2016 and leave rates on hold, whilst for the UK, we now expect the first rate hike in February 2016. In Japan, the Bank of Japan (BoJ) will keep the threat of more QQE (quantitative and qualitative easing) on the table, but is expected to let the weaker yen support the economy and refrain from further loosening. We remain positive on the outlook given the benefits of lower energy inflation on household spending and the competitiveness of the yen. China is expected to cut interest rates and the reserve requirement ratio (RRR) further, and pursue other means of stimulating activity in selected sectors.

In addition to our central view, we consider seven alternative scenarios where we aim to capture the risks to the world economy.

## Economic View (continued)

### Macro risks: Scenario analysis

*Full details of the scenarios can be found on page 12.* 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, monetary policy is likely to ease under this scenario.

A second downside scenario is a “**Eurozone deflationary spiral**”. Here the economy falls into a major slump from which it is hard to escape. Inflation expectations become depressed and consumers and businesses begin delaying spending. Global monetary policy therefore would be looser than in the baseline with the ECB cutting interest rates further below zero and continuing with sovereign QE beyond September 2016.

We have added a “**Tightening tantrum**” scenario where bond markets sell off in response to Fed tightening. Here, tightening has a knock on effect to the rest of the world. Yields begin to rise causing capital outflows from economies with weak external accounts and negative wealth effects. Equity markets and risk assets generally weaken as the search for yield begins to reverse.

Our final downside scenario is “**Secular stagnation**”. In this scenario, capital spending remains sluggish despite low interest rates, as the cost of capital remains above the expected rate of return. Household expenditure is constrained by weak real income growth, a consequence of sluggish productivity and deteriorating demographics. Interest rates and monetary policy would be looser in this scenario.

In addition, we have added two new reflationary scenarios. “**Fed behind the curve**” is where the Fed delays raising rates until the second half of 2016. The labour market continues to tighten, with wages and inflation accelerating. US rates then have to rise more rapidly but still end 2016 at 1.5%, lower than in the baseline. Interest rates would continue to rise in 2017 as the Fed tries to control inflation.

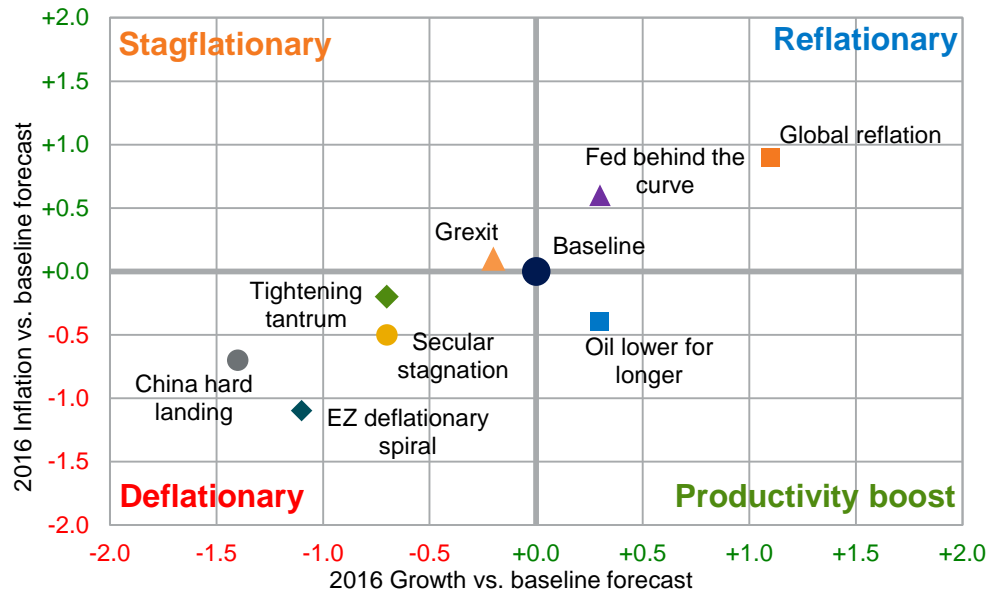
“**Global reflation**” depicts a scenario where frustration with the weakness of global activity leads policy makers to increase fiscal stimulus in the world economy. This then triggers an increase in animal spirits which further boosts demand through stronger capex. Global growth reaches 3% this year and 4% next year. However, higher commodity prices and tighter labour markets push inflation higher.

Finally, in “**Oil lower for longer**”, the oil price falls to \$30 per barrel and stays there as the Saudis turn the screw on the US shale producers. This leads to stronger growth and lower inflation, especially for oil consuming advanced economies.

**Stop press:** we have added a **Grexit** scenario to show the impact of a Greek exit from the Euro. This is negative for growth as the Greek economy collapses with a knock-on effect elsewhere. Inflation is higher as a result of a surge in prices in Greece as the new Drachma collapses. Elsewhere inflation will be lower.

## Economic View (continued)

Chart 2: Scenario analysis – global growth and inflation impact



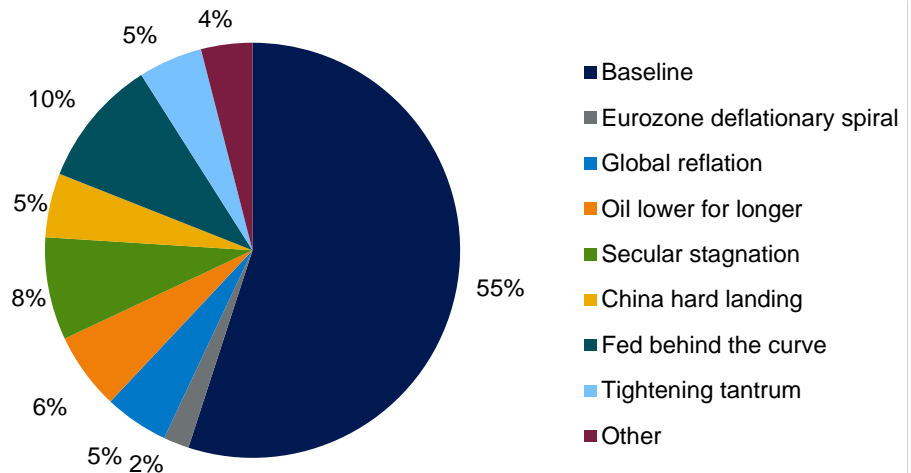
Source: Schroders Economics, 7 July 2015

In terms of macro impact, we have run the risk scenarios through our models and aggregated them to show the impact on global growth and inflation. As can be seen in chart 2, four are deflationary, with these scenarios seeing growth and inflation lower in 2016 than in the central scenario.

With regard to probabilities, the combined chance of a deflationary outcome is now 20%, slightly higher than last quarter. This reflects the introduction of “Tightening tantrum” and “Secular stagnation”, although a reduced probability has been put on “Eurozone deflationary spiral”.

Meanwhile, the addition of the “Global reflation” and “Fed behind the curve” scenarios means the probability of reflation (stronger growth and higher inflation than baseline) has risen from 7% to 15%, even with the “G7 boom” scenario taken out. There is a reduction in stagflation as a result of dropping the “Russian rumble” scenario.

Chart 3: Scenario probabilities (mutually exclusive)



Source: Schroders Economics, 27 May 2015

## Economic View (continued)

Table 2: Scenario summary

Scenario	Summary	Macro impact
<b>1. Eurozone deflationary spiral</b>	Despite the best efforts of the ECB, 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. 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.	<b>Deflationary:</b> Weaker growth and lower inflation persists throughout the scenario. ECB cuts interest rates below zero and continues with QE, but the policy response is too little, too late. Eurozone weakness drags on activity elsewhere, while the deflationary impact is also imported by trade partners through a weaker Euro. Global growth and inflation are about 0.5% weaker this year and 1% weaker in 2016 compared to the baseline.
<b>2. Global reflation</b>	Frustration with the weakness of global activity leads policy makers to increase fiscal stimulus in the world economy. This then triggers an increase in animal spirits which further boosts demand through stronger capex. Global growth reaches 3% this year and 4% next. However, higher commodity prices (oil heading toward \$90/bbl) and tighter labour markets push inflation higher by nearly 1% in 2016.	<b>Reflationary:</b> Stronger growth and higher inflation compared to the baseline. The US Fed raises rates to 4% by end-2016 and starts to actively unwind QE by reducing its balance sheet. Higher wage and price inflation is welcomed in Japan as the economy approaches its 2% inflation target, with the BoJ likely to signal a tapering of QQE. Inflation concerns result in tighter monetary policy in the emerging markets with all the BRIC economies raising rates in 2016.
<b>3. Oil lower for longer</b>	Saudi Arabia becomes frustrated at the slow response of US oil production and drives prices lower in a determined effort to make a permanent impact on US shale producers. Given the flexibility of the latter this means a significant period of low prices with Brent crude falling to \$30/bbl by end 2015 and remaining there through 2016.	<b>Recovery:</b> Better growth/lower inflation especially for oil consuming advanced economies. For the emerging economies, activity is only marginally better. Lower inflation allows the Fed to delay slightly, but interest rates still rise. The rate profile is also lower in China, Brazil and India, but Russia has to keep policy tighter to stabilise the currency.
<b>4. Secular stagnation</b>	Weak demand weighs on global growth as households and corporates are reluctant to spend. Animal spirits remain subdued and capex and innovation depressed. Households prefer to de-lever rather than borrow. Adjustment is slow with over capacity persisting around the world, particularly in China, with the result that commodity prices and inflation are also depressed.	<b>Deflationary:</b> Weaker growth and inflation versus baseline. Although not as deflationary as China hard landing or the Eurozone deflationary spiral the world economy experiences a slow grind lower in activity. Policy makers initially raise rates in the US although this is then reversed as the economy loses momentum. Global interest rates are lower than in the base and we would expect the ECB and BoJ to prolong their QE programmes.
<b>5. China hard landing</b>	Official 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, resulting in a retrenchment by the banking system and a further contraction in credit and activity.	<b>Deflationary:</b> 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.
<b>6. Fed behind the curve</b>	Concerns about the strength of the economic recovery and the impact of tighter monetary policy causes the Fed to delay raising rates until the second half of 2016. Meanwhile the labour market continues to tighten, wages accelerate and inflation increases. US rates then have to rise more rapidly but still end 2016 at 1.5%, lower than in the baseline. Interest rates would continue to rise in 2017 as the Fed battles to bring inflation under control.	<b>Reflationary in 2016:</b> Stronger growth and higher inflation compared to the baseline. Note that this scenario will turn stagflationary in 2017 as growth slows whilst inflation remains elevated. Better growth in the US provides a modest stimulus to activity elsewhere, however this is likely to be tempered by a more volatile financial environment with long yields rising as inflation expectations rise.
<b>7. Tightening tantrum</b>	Bond markets sell off in response to Fed tightening with US 10 year Treasury yields rising 200 basis points compared to the baseline. This has a knock on effect to the rest of the world as yields rise in both the developed and emerging markets. Equity markets and risk assets generally weaken as the search for yield begins to reverse causing capital outflows from economies with weak external accounts and negative wealth effects.	<b>Deflationary:</b> Weaker growth and inflation vs. baseline. Economic weakness causes the Fed to bring its tightening cycle to an early end with rates peaking at 1% and then reversing toward the end of 2016 as further stimulus is required. Emerging markets experience weaker growth, but are more resilient than in the 2013 "taper tantrum" given improvements in their external financing requirements. Global policy rates are generally lower by end-2016.

Source: Schroders Economics, 27 May 2015.

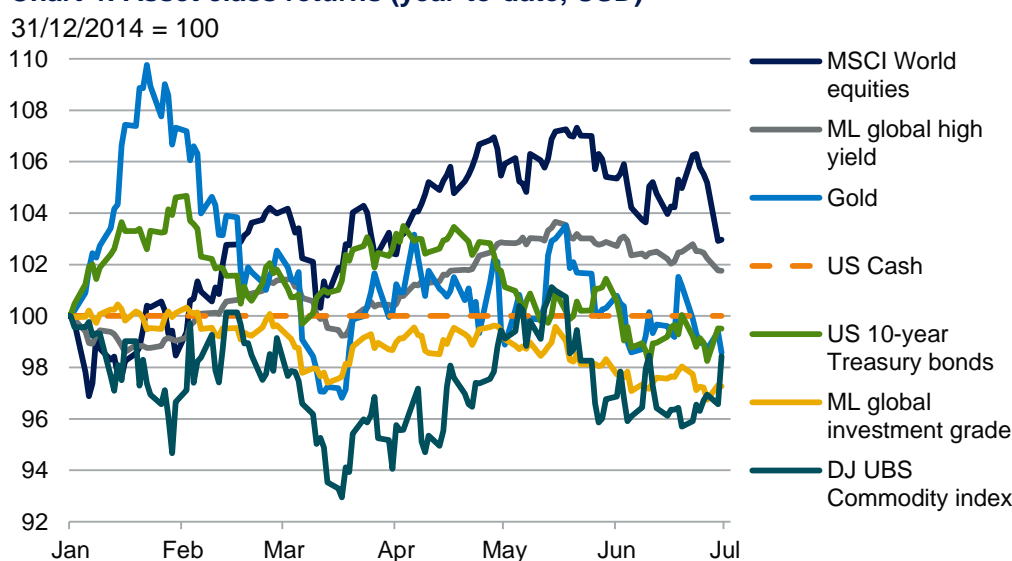
## Strategy: Mid Year Review of Market Performance

### First half 2015 performance review

Supported by continued accommodative monetary policy across many of the world's major economies, global equities outperformed returning 3.0% year to date in US dollar terms, as shown in chart 4. Aside from cash, high yield credit and global equities were the only asset classes to post positive performance over the period, despite a sell off in June hampering performance as markets digested the news that Greece officially fell into arrears with the IMF. In contrast to high yield, investment grade credit disappointed by falling 2.7% year to date as spreads refused to trend lower from already historically low levels.

**Chart 4: Asset class returns (year-to-date, USD)**

Equities continue to outperform against a backdrop of loose monetary policy



Source: Thomson Datastream, Schroders Economics. 1 July 2015.

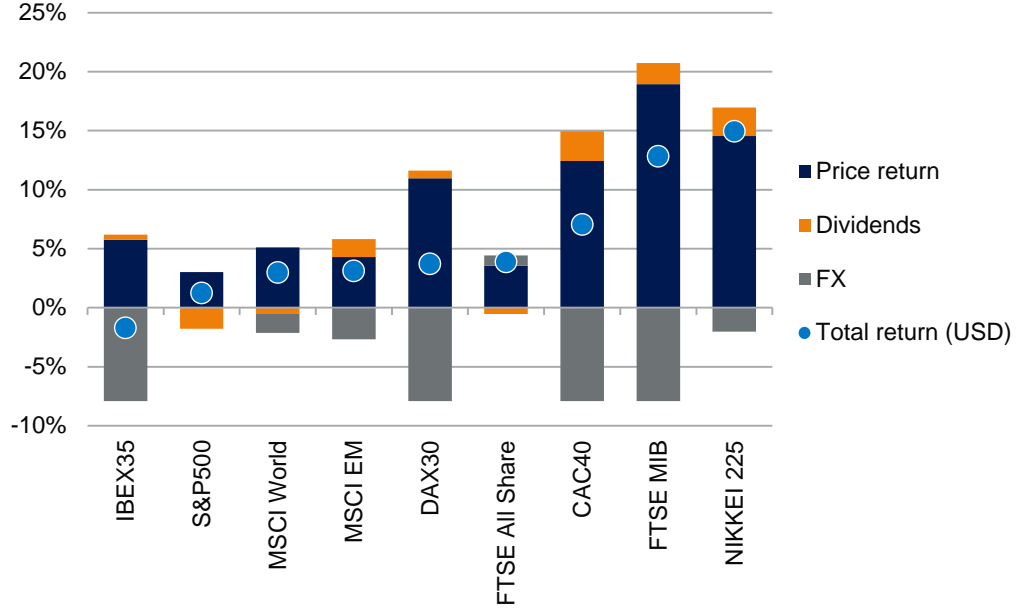
After the disappointing first quarter US GDP release, recognised by many as being transitory, economic data has gradually improved in the US. Treasury yields consequently moved higher during May and June leaving Treasury returns down 0.5% year to date. Gold had a strong start to the year, but soon pared back its initial gains having peaked in January ending the first half of the year down 1.4%. Meanwhile commodities largely underperformed throughout the first six months of the year despite a small rebound in the price of oil. A brief period of strong performance in late June helped commodities outperform investment grade credit having returned -1.6%.

Looking at equity markets over the first half of the year, a handful of European stock markets posted strong positive performance in US dollar terms in spite of the currency effect weighing on returns. Year to date, the Italian FTSE MIB returned 12.8%, with both the CAC40 and DAX30 also experiencing gains. The start of the ECB quantitative easing program in March has helped support investors' appetite for European equities with a depreciation of the euro facilitating a recovery in the region. Furthermore, relative to the US, profit margins have greater scope for expansion. Consequently, with the exception of Spain as measured by the IBEX35 index, US equities have underperformed their European counterparts given the total return of the S&P500 standing at 1.2%.

Japan's NIKKEI is the best performing major equity market year-to-date

**Chart 5: H1 equity market returns (USD)**

YTD returns to 30/6/2015



Source: Thomson Datastream, Schroders Economics. 1 July 2015.

Japanese equities ranked highest in terms of aggregate performance driven by a number of factors. A weakening yen has been supportive of corporate earnings year to date whilst Shinzo Abe's focus on reforming corporate governance has encouraged Japanese companies to pay closer attention to shareholder value as seen through elevated levels of share buybacks and an improvement on the return on equity. As for emerging markets, performance for the first half of the year falls towards the middle of the equity market spectrum having returned 3.1%. Although Chinese equities have performed noticeably well, equity markets in India and Brazil weighed on performance.

### Emerging markets review

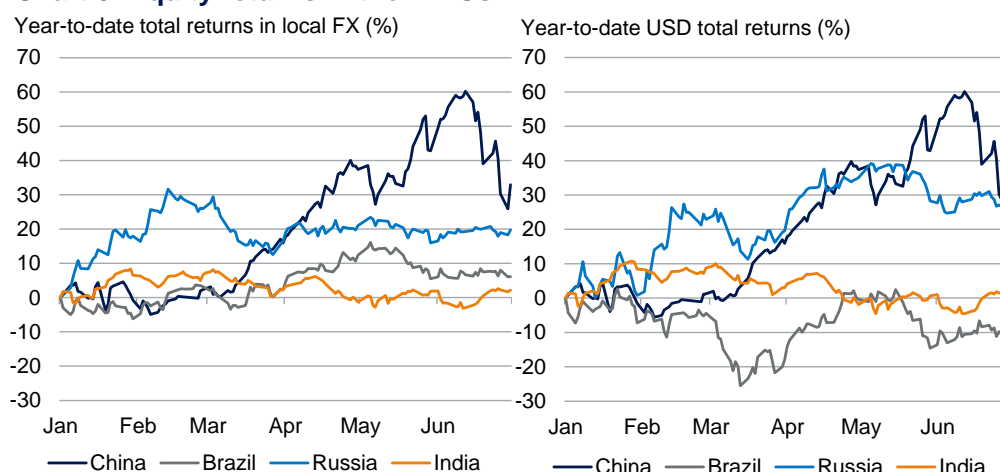
There is a clear winner amongst the BRICs for local equity market performance so far this year, though perhaps not for much longer. China's Shanghai composite index was at one point up almost 60% since the start of the year, easily outpacing the rest of EM and indeed the rest of the world, but its fortunes have since turned.

The timing of the rally – with take-off in March – suggested a disconnect from economic fundamentals. Activity data started the year poorly and then disappointed spectacularly in March; hardly the environment for earnings to perform well. But along with weak data came expectations – and promises – of policy support. Liquidity injections by the central bank in particular helped build sentiment, and a mind-set that said that every disappointing data point from now was a signal to buy more. While undoubtedly a bubble, in the sense that the elevation of PE ratios is difficult to justify in an economy suffering excess capacity and weak demand, investors were arguably not behaving entirely irrationally.

The rally had a great deal of policymaker support. The authorities are seeking to rebalance the financing mix of corporates, away from a high reliance on debt. For this to succeed, firms will need equity finance, and a buoyant stock market provides the best conditions for a series of IPOs. Banks are also looking to raise equity finance as they seek to recapitalise, which will help provide demand, in turn, for local government bonds – another aspect of the country's rebalancing. All the same, there is a strong element of sentiment to this rally, and something as simple as a change in phrasing from policymakers could prompt panic. Indeed, we have seen large one day falls in the market when the regulator has moved to reduce volatility, which points to the fragility of the bubble. Unfortunately for investors in Chinese equities, one such action by the regulator – restricting margin financing, which has set global historic records in China by reaching 3.4% of GDP – prompted an ongoing selloff. The index fell over 20% in two weeks following the clampdown, and while government efforts to forestall the collapse had some effect, it seems only to temporarily check the downward momentum.

China's stock market bubble has started to deflate

**Chart 6: Equity returns in the BRICs**



Source: Thomson Datastream, Schroders Economics. 1 July 2015.

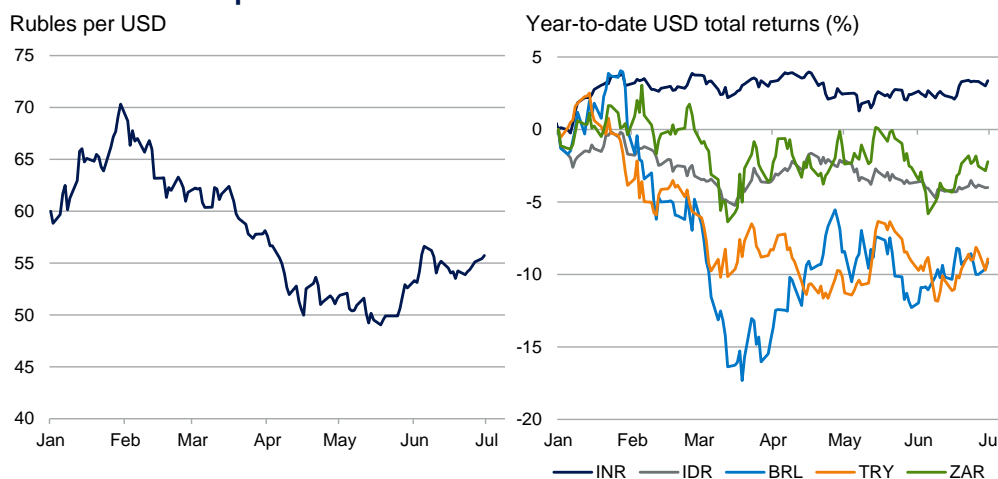
India's performance is in stark contrast to last year, when the market gained close to 30%. Essentially flat this year, it is again politics that is responsible. We find ourselves one year on from Narendra Modi's electoral victory; a stunning result which delivered a powerful mandate. However, while important steps have been taken which reduce macroeconomic vulnerabilities and improve the business environment, "big bang" reforms have been lacking. The modest pace has been largely in line with our expectations but has disappointed the more euphoric reactions to Modi's triumph. The market seems likely to tread water until fresh reform momentum builds.

While India and Brazil have so far had uninspiring years – both down, year to date, when currency moves are taken into account – Russia has enjoyed something of a resurgence as the oil price has strengthened, and as investors take advantage of cheap valuations. Oil has in fact provided two bonuses – boosting not just the earnings profile and economic outlook, but also driving a rebound in the currency. Once this is factored in, Russia’s stock market has performed as strongly as China’s for much of H1. With oil prices now stabilising, further such gains seem unlikely, but arguably this has been a more unexpected outcome than China’s policy driven rally.

Russia’s currency performance is all the more impressive when we consider the fate of other EM currencies so far this year. On a spot basis, the ruble has recovered immensely – around 20% – since its February lows against the dollar. The rest of EM, meanwhile, has suffered in a stronger dollar environment. Partly this is the inevitable result of a stronger dollar pushing down the value of other currencies, but the effects are particularly pronounced for economies with structural issues. Returning to our old friends, the Fragile Five, only the rupee has managed to deliver a positive total return (inclusive of carry) this year. Political strife and external balance sheet issues continue to take their toll on the other four, particularly Brazil and Turkey, despite carry of close to 14% in the former. The failure of this group of economies, bar India, to convincingly address their structural issues since the May 2013 taper tantrum is a great disappointment. It also, in our view, leaves them exposed to further weakness as the Fed hikes.

**Chart 7: Ruble’s performance stands out in EM FX**

The Indian Rupee is the only major EM currency to outperform the US dollar



Source: Thomson Datastream, Bloomberg, Schroders Economics. 1 July 2015.



# Strategy: Changing Correlations and End of Cycle Concerns

Bonds sell off whilst equities flatline

The past quarter has seen a significant sell off in bonds whilst equity markets have been generally flat (chart 8). Sovereign bond yields, which had been driven to extraordinary low levels in the core Eurozone markets, spiked higher on bubble concerns and evidence that deflation fears, which had motivated the ECB to start QE, might have been overdone. Meanwhile, the MSCI World equity index trod water as markets balanced a combination of soft economic news against further central bank easing. (More details of market performance during the first half of the year can be found above in the mid-year review section).

**Chart 8: Global equity and bond markets**



Source: Thomson Datastream, Schroders Economics, 1 July 2015.

The relationship between the US dollar and risk appetite has shifted

## Change in dollar correlation poses challenge to investors

One feature of market behaviour which has shifted over the past year has been the relationship between risk appetite and the US dollar. One way of viewing this is through the correlation between the S&P500 index of large cap stocks and the trade-weighted dollar (chart 9).

**Chart 9: Correlation between US equity market and the dollar turns positive**



Source: Thomson Datastream, Schroders Economics, 1 July 2015.

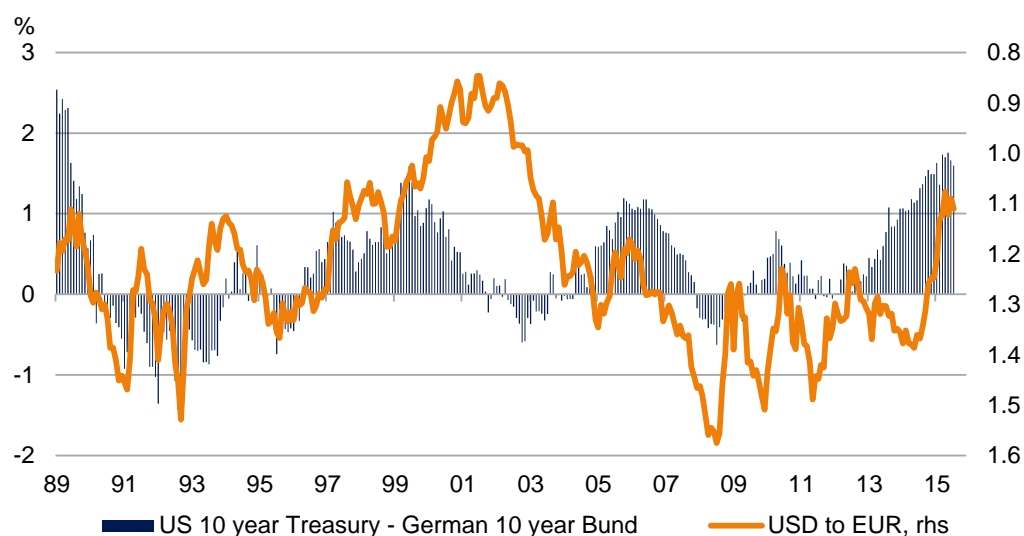
Correlation between USD and S&P500 has turned positive since the Fed ended QE

For much of the period since 2008, a weak dollar was associated with a strong equity market as investors responded to Quantitative Easing (QE) by the US Federal Reserve (Fed). Markets saw weak economic data as good news as it meant that the Fed would be providing more liquidity and effectively underwriting the recovery (a phenomena often referred to as the Bernanke “put”). As a result, risk assets rallied whilst the prospect of rates being lower for longer reduced the attractiveness of the dollar.

The correlation began to change during 2013 as it became apparent that the Fed’s QE programme was coming to an end. In the absence of QE, the main effect of weak data was to focus the market on softer corporate profits rather than extra liquidity. Consequently, a slower economy now means a reduction in risk appetite and a weaker dollar, whilst strong data works the other way by boosting US equities and the dollar together. At present the correlation is at its most positive for more than 10 years.

More recently, the start of QE by the European Central Bank (ECB) and the stepping up of asset purchases by the Bank of Japan (BoJ) has reinforced this trend: simultaneously weakening the Euro and Japanese Yen against the US Dollar, whilst boosting global liquidity and supporting risk assets. The Treasury-bund spread is a key driver of the dollar-euro rate and the current spread suggests that support for the dollar will remain firm (chart 10).

**Chart 10: Bond spread supports dollar against the Euro**



Source: Thomson Datastream, Schroders Economics, 1 July 2015

Correlation  
shift prompts  
rethink of  
hedging  
strategies

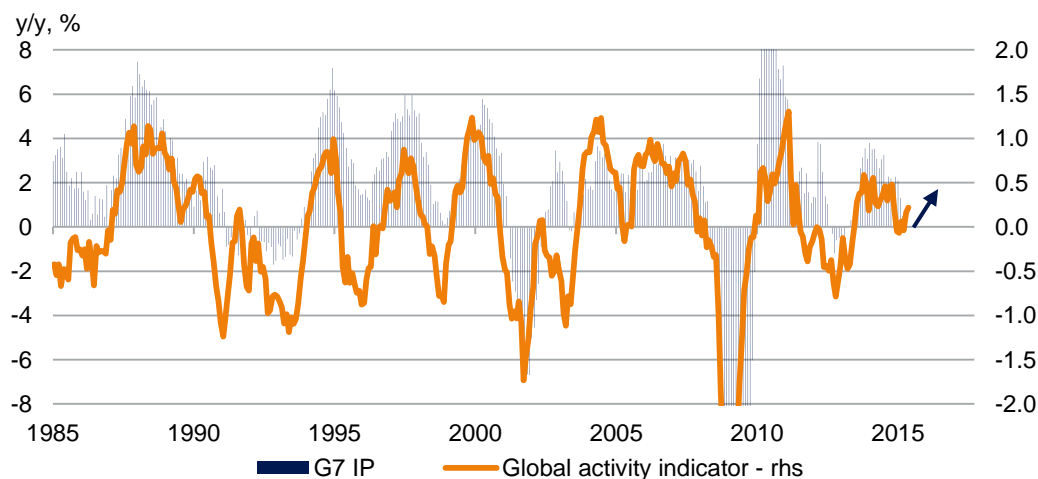
This change in correlation is affecting investors portfolios as the dollar is no longer providing a hedge against falls in risk assets. Investors had increased exposure in their portfolios as a means of reducing downside risk. Following the change in correlation the same portfolios are now more exposed to drawdowns in the event of an increase in risk aversion. This presents a challenge to investors looking to restore the risk balance. At this stage there is a reluctance to simply switch toward safe assets given the very low yields available, although the recent bond market sell off has made this less onerous.

Instead, investors are considering other currencies and, whilst the Euro may not be attractive given the current volatility around Greece, the Japanese Yen has been a proven safe haven in the past. Alternatively, investors are choosing to hedge risks directly through option strategies on their equity and credit holdings.

### End of cycle concerns: is the upswing running out of capacity

Several factors support a positive backdrop for equity markets, but we can also see signs that the cycle in the US is beginning to age, a signal that we need to be aware of potential shifts in market behaviour.

**Chart 11: Activity indicator signals upswing in industrial production**



Source: Thomson Datastream, Schroders Economics, 1 July 2015.

Growth is picking up in the developed economies

On the positive side we see growth picking up in the developed economies. For example, there has been a clear up turn in our global activity indicator which tracks the G7 industrial cycle.

Consumer demand in the US has also firmed and the latest estimates from the Atlanta Fed suggest that the US economy grew at just over 2% in the second quarter, driven by a 3% gain in consumption. Our view that the oil price would boost growth this year is now coming through more strongly in the US after earlier doubts when consumption stalled in the first quarter. We are still likely to see a drag from cuts in energy capex in the near term, but this will increasingly be outweighed by the boost to consumption as households see the fall in oil prices as a durable rather than temporary factor.

In Europe, households are already responding to the fall in energy costs and alongside easy monetary policy and a reduction in fiscal austerity, demand continues to improve. The concern here is over the situation in Greece which has taken a turn for the worse following the referendum where the Greek people backed their government in rejecting the terms offered by the EU, ECB and IMF (the “creditors”). The situation is ongoing, but we see great difficulties in achieving a deal after the loss of trust between the Greek government and the creditors with the result that the risk of a “Grexit” is now significant.

But the picture is more mixed elsewhere

In Asia and the emerging world the picture is more mixed as growth in China remains lacklustre with the economy struggling with overcapacity and the need for structural reform. This represents an ongoing drag to the commodity complex and is felt keenly in Latin America. By contrast, Japanese growth is strengthening after the self induced recession following the tax hike in 2014. Although the Bank of Japan has been under pressure for missing its 2% inflation target we expect the benefits of low inflation to combine with rising household incomes to support real consumer spending in 2015. The economy is also benefitting from the latest fall in the Japanese yen which will feed through to stronger trade performance. It is this aspect of the Japanese recovery which concerns its neighbours who see it as a beggar-thy-neighbour attempt to gain market share. Clearly this is deflationary for much of the Asian region, but the hope going forward is that stronger consumer spending in the US will support export growth.

**So with the growth reviving, why the note of caution?**

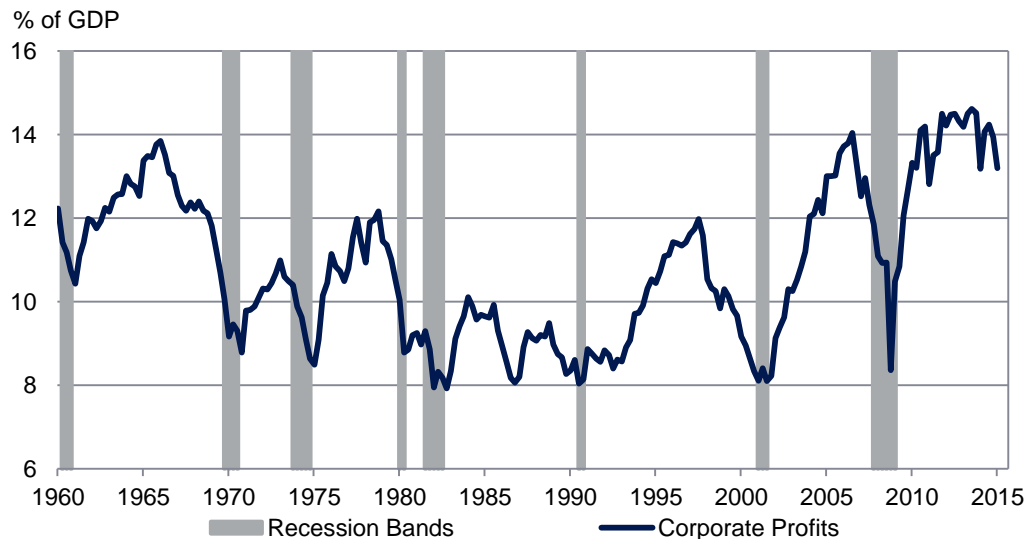
The simple answer is that growth is good for equities if it is sustainable and translates into higher corporate profits. After five years of recovery we have some doubts on whether this is achievable. For example, there are signs in the US and the UK, that wages are beginning to accelerate. Meanwhile, productivity remains weak and unit wage costs, the measure which matters most to business, have picked up sharply.

Upswing has been accompanied by stronger growth in wage costs

This will either put a squeeze on margins or lead to a pick up in inflation, depending on whether companies can succeed in passing higher costs onto their customers. Neither outcome is particularly favourable for equity markets or risk assets in general, as the first implies weaker earnings per share (EPS), and the second that interest rates need to rise faster in the future.

In the US the latest data suggest that margins took a hit with the profit share in national income falling sharply in the first quarter (chart 12). This often comes as a surprise to many as corporate profits appeared to perform well in the first quarter earnings season. Overall, corporate earnings for the S&P 500 saw 330 companies beating expectations and 112 missing.

**Chart 12: US profit share falls at start of 2015**



Putting pressure on profit margins

Source: Thomson Datastream, Schroders Economics, 3 July 2015.

However, as has become the norm, companies softened the market up with prior downgrades so as to create an easy base to beat on release day. Looking at the actual outcomes shows a clear pattern of deterioration with both operating and reported earnings falling in the first quarter on both a quarterly and annual basis. This follows a similar decline in the fourth quarter of last year.

Energy clearly played a role in this with EPS turning negative at both the operating and reported level in the sector. If we adjust for this, the picture is stronger with operating EPS up 3% year-on-year compared with a decline of 5% for the overall index. Nonetheless, this is still relatively weak and alongside energy, four other sectors experienced a fall in EPS on the quarter. Of the five that rose, only financials and healthcare looked robust.

Returning to the aggregate picture and looking ahead, we expect a modest pick-up in S&P 500 EPS as the economy recovers. However, this is tempered by continued margin pressure as wage costs rise and consequently, is not enough to prevent an overall decline for 2015 at both the operating and reported level (table 3). Note that this is not driven by any particular sector as it reflects general pressure from rising costs in the economy. Dollar strength will also weigh on EPS by depressing overseas earnings. It is possible that companies will be able to reduce write-offs and increase share buy-backs so as to boost reported EPS, but they will struggle to turn aggregate earnings positive in 2015.

**Table 3: US corporate earnings outlook**

US	2011	2012	2013	2014	2015f
<b>Economic profits</b>					
y/y%	-2.9	23.4	4.3	16.6	1.0
Non.fin. share % GDP	7.6	8.9	8.9	10.0	9.8
<b>S&amp;P 500 EPS</b>					
Operating \$	\$96	\$97	\$107	\$113	\$105
y/y%	15.1	0.4	10.8	5.3	-7.1
Reported \$	\$87	\$87	\$100	\$102	\$94
y/y%	12.4	-0.5	15.8	2.1	-8.2
S&P 500 year end level	1,258	1,426	1,848	2,104	2,104
P/E based on operating EPS	13.0	14.7	17.2	18.6	20.0
P/E based on reported EPS	14.5	16.5	18.4	20.6	22.4

Source: S&P, Schroders Economics, 27 May 2015.

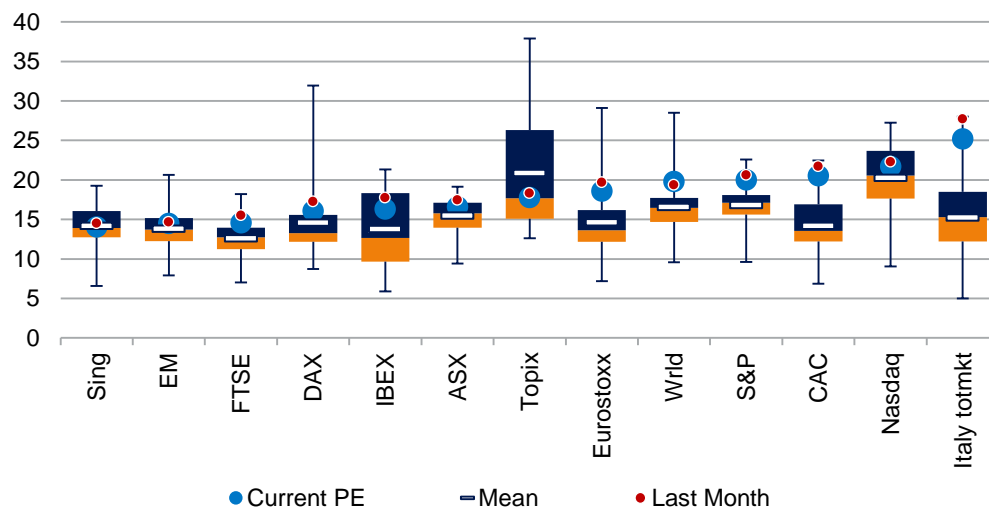
**Strategy conclusions**

Outlook for US profits may weigh on equities

Going forward US earnings are likely to struggle to make headway even as growth picks up as margins are likely to be squeezed further, a classic end of cycle outcome. It is quite possible that the market continues to be driven by share buy backs and the resurgence in M&A activity. However, given the relatively high rating on the S&P 500 (chart 13) there may be limits as to how far this can continue. We also expect the Federal Reserve to begin tightening in September, meaning that the backdrop for US equities is not encouraging.

**Chart 13: Equity valuations begin to stretch**

Developed Market PE Box and Whisker (10yr)



Source: Thomson Datastream, Schroders Economics, 29 June 2015

This could make us more cautious on equities in general given the weight of the US in global indices. However, TINA (There Is No Alternative) remains a factor given the low yields available on other assets. Risk premiums on equity markets versus bonds remain attractive.

Nonetheless, this analysis says investors should look outside the US if they wish to remain in equities. European equities are one alternative as growth is expected to continue and there is scope for margins to recover. However, valuations are relatively stretched indicating that the market is already pricing in some recovery. The Grexit risk does not help in the near term, although if it leads to a weaker Euro it will eventually boost profits. At this stage our asset allocation is tilted towards Europe within our equity portfolios.

The Japanese market looks attractive with a PE valuation close to its median and a relatively low beta vs. the US (chart 14). Meanwhile, corporate profits are improving and should receive a further lift from the latest fall in the yen, in contrast to the US where currency is working against earnings. The concern on Japan is that economic recovery may bring an end to QE and a stronger yen.

**Chart 14: Correlation between US and Japanese equity markets close to zero**



Source: Thomson Datastream, Schroders Economics, 23 June 2015.

As noted above, some of Japan's strength will be at the expense of its competitors, however to the extent that a stronger US consumer pulls in more imports there will be scope for some emerging economies to perform better. Although we remain cautious on emerging markets on concerns over the strong dollar, there will be selected opportunities as the second half of the year unfolds.

**Keith Wade**  
6 July 2015

## Market Returns

	Total returns	Currency	June	Q2	YTD
Equity	US S&P 500	USD	-1.9	0.3	1.2
	UK FTSE 100	GBP	-6.4	-2.8	1.4
	EURO STOXX 50	EUR	-3.9	-5.3	11.7
	German DAX	EUR	-4.1	-8.5	11.6
	Spain IBEX	EUR	-3.8	-5.4	6.9
	Italy FTSE MIB	EUR	-4.0	-0.9	20.8
	Japan TOPIX	JPY	-2.4	5.8	17.0
	Australia S&P/ ASX 200	AUD	-5.3	-6.5	3.1
	HK HANG SENG	HKD	-3.0	7.2	13.7
EM equity	MSCI EM	LOCAL	-2.2	0.8	5.8
	MSCI China	CNY	-5.5	6.2	14.8
	MSCI Russia	RUB	2.0	4.1	20.5
	MSCI India	INR	0.0	-1.9	2.5
	MSCI Brazil	BRL	1.0	4.0	6.8
Governments (10-year)	US Treasuries	USD	-1.9	-3.0	-0.5
	UK Gilts	GBP	-1.6	-3.6	-1.7
	German Bunds	EUR	-2.6	-5.3	-1.7
	Japan JGBs	JPY	-0.4	-0.3	-0.6
	Australia bonds	AUD	-2.0	-5.0	-0.5
	Canada bonds	CAD	-0.4	-2.4	2.3
Commodity	GSCI Commodity	USD	-0.1	8.7	-0.2
	GSCI Precious metals	USD	-2.1	-1.7	-1.2
	GSCI Industrial metals	USD	-5.0	-5.5	-10.3
	GSCI Agriculture	USD	15.5	9.6	-1.0
	GSCI Energy	USD	-2.3	13.0	3.0
	Oil (Brent)	USD	-4.8	12.2	9.6
	Gold	USD	-1.7	-1.5	-1.4
Credit	Bank of America/ Merrill Lynch US high yield master	USD	-1.5	0.0	2.5
	Bank of America/ Merrill Lynch US corporate master	USD	-1.6	-2.7	-0.5
EMD	JP Morgan Global EMBI	USD	-1.7	-0.3	1.8
	JP Morgan EMBI+	USD	-1.9	-0.9	1.0
	JP Morgan ELMI+	LOCAL	0.4	1.2	2.5
Currencies	EUR/ USD		1.5	3.9	-8.0
	EUR/JPY		-0.1	5.8	-6.1
	JPY/ USD		1.6	-1.9	-2.1
	GBP/USD		2.9	6.0	1.0
	AUD/USD		1.0	1.7	-4.6
	CAD/USD		-0.2	1.7	-6.7

Source: Thomson Datastream, Bloomberg, 30 June 2015.

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



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