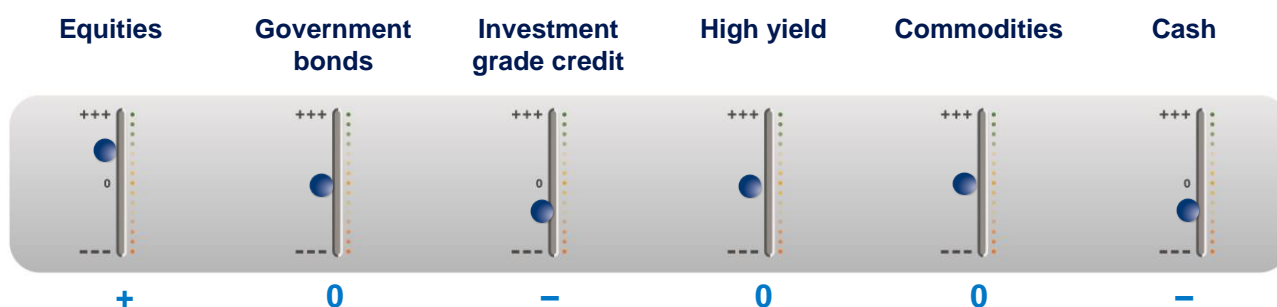


Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – August 2015

Summary



Category	View	Comments
Equities	+	We have made no changes to our views this month, as we remain constructive on equities, with a preference for developed markets where economic momentum remains firm. Our preferred markets are the US, Europe and Japan while we remain negative on emerging markets (EM).
US	+	After upgrading US equities last month, we retain our positive view this month. Relative to other developed markets, the country's strong cyclical trends should drive improvements in earnings over the medium term.
UK	0	We retain our neutral stance on UK equities this month after downgrading them from a single positive in July. While domestic sectors are seeing support from positive momentum in economic data, the FTSE 100 index has considerable exposure to commodity-related companies which we expect to continue to suffer from earnings pressure and will therefore weigh on the broader index.
Europe	+	We remain positive on European equities following the initial agreement on the latest Greek bailout deal. We believe the region's companies will be supported by three factors: the abundant liquidity provided by the European Central Bank (ECB), the weaker euro and the cyclical recovery as evidenced by leading economic indicators.
Japan	+	We upgraded Japanese equities in July and remain positive on the market in August. A return to earnings growth in the weaker Japanese yen environment has underpinned equity markets. Since inflation is still a long way below the 2% September 2016 target, we believe the door remains open for greater monetary easing later this year which should further support corporates.
Pacific ex Japan	0	We remain neutral on Pacific ex Japan equities this month. Valuations continue to become more attractive but we maintain our cautious stance due to the region's dependence on China.
Emerging Markets	-	Our decision to downgrade EM in July has so far worked in our favour as the ongoing weakness in emerging economies and collapsing commodity prices have continued to affect the region's equities. Although negative sentiment is now extreme, we believe that it is too early to position for a rebound.

Category	View	Comments
Government bonds	0	We remain neutral on government bonds, in aggregate, with momentum and the qualitative picture improving lately and value remaining neutral in most markets. This month we upgraded the US to neutral and Poland to single negative while we downgraded US inflation linked, Canadian and South African bonds.
US	0↑	We have upgraded US Treasuries this month as a result of the People's Bank of China (PBoC) devaluation of the Chinese yuan. The PBoC's surprising intervention to devalue its currency should further dampen inflation expectations, which we expect to support the long end of the yield curve when the Fed hikes. We also retain a preference for curve flatteners with the Fed slightly ahead of market expectations and the short-end of the curve already pricing in the start of the hiking cycle.
UK	+	We remain positive on the UK as gilts remain a significant beneficiary of low interest rates and QE in the eurozone. The spread over Bunds continues to look attractive, despite recent tightening, given the attractive carry and roll. We continue to prefer curve flatteners, favouring the long end of the curve, and we remain outright positive on the 10-year gilt.
Germany	+	After upgrading Germany to positive in July, we retain our view this month. We believe there is more room for the German yield curve to flatten on the expectation that the ECB will maintain, and possibly expand its QE programme. We are therefore long the 10-year Bund but we finance this from a short position in the 2-year Schatz.
Japan	0	We have maintained our neutral view on Japanese duration this month. Despite the unattractive low level of yields, we continue to maintain exposure on the belief that the Bank of Japan (BoJ) will continue to aggressively provide support, particularly following the PBoC's devaluation of the Chinese yuan.
US inflation linked	- ↓	We have downgraded US inflation linked bonds to double negative. We believe that a more hawkish Fed, stronger US dollar and weaker commodity prices will depress longer-term inflation expectations.
Emerging markets	0	We remain neutral on EM USD bonds this month as the positive carry, particularly after the recent downward moves, provides a balance against the deterioration in sentiment. We have upgraded Poland but still remain negative and have further downgraded South African local bonds given ongoing wage negotiations and a weaker currency.

Category	View	Comments
Investment grade credit	-	
US	-	We maintain our negative outlook this month as US investment grade (IG) credit remains vulnerable to volatility around the timing of the Fed's rate hike and as implied default rates remain very low on a historical basis.
Europe	0	European IG credits have generally recovered given the expected conclusion of the latest Greek crisis. Accommodative monetary policy in the eurozone is depressing yields but we note that default compensation remains low on a historical basis. We therefore remain neutral.

Category	View	Comments
High yield credit	0	
US	0	After upgrading US high yield (HY) to neutral in July, we retain our position this month. Current valuations are relatively attractive, driven by spread widening in the energy sector. We would like to see a stabilisation in energy prices and a pick-up in fund flows before becoming more positive.
Europe	0	We remain neutral on European HY. The default rate remains low at just 0.5% and is unlikely to rise meaningfully under a scenario where supportive monetary allows companies to access low-cost financing. Nevertheless, we are continuing to monitor the reduced liquidity in the asset class, which is preventing our views from becoming more positive.

Category	View	Comments
Commodities	0	Global growth has failed to accelerate in line with our expectations. We are therefore less constructive on cyclical commodity markets and hence maintain our neutral stance on broad commodities.
Energy	0	We remain neutral on energy this month. While prices have corrected since last month, the fundamental data remains mixed. Prices have returned to levels that discourage long-run investments.
Gold	–	Given that we expect stronger US data to push up real rates, we continue to hold a negative view on gold.
Industrial metals	0	After downgrading industrial metals in July, we retain our neutral stance this month. China has moved firmly into an easing cycle, bringing forward infrastructure expenditure and easing monetary policy. However, we have yet to see economic data stabilise in response to these measures.
Agriculture	0	We remain neutral on agriculture after upgrading the risk premia last month due to emerging weather risks.

Category	View	Comments
Currencies		
US dollar	0↓	We have downgraded the US dollar this month given that recent data releases in the US have failed to rebound as strongly as we had expected. At the same time, inflation indicators have begun to turn lower, which could cause the Fed to delay the first US rate hike.
British pound	0	We remain neutral on sterling. Recent comments from the Bank of England suggest a rate rise is likely in the first half of next year. However, this appears well priced by the market in the near-term.
Euro	0↑	While we expect the ECB to continue with its QE programme over the coming year, we have upgraded the euro this month to neutral due to the cyclical improvement that is underway in the eurozone and our less constructive view on the US dollar.
Japanese yen	–↑	The Japanese yen remains our least preferred currency relative to the US dollar, given weak inflation and relatively modest growth figures. It is our expectation that further accommodative monetary policy will be required over the coming year, which will weigh on the currency.
Swiss franc	0↑	Our view on the Swiss franc has been upgraded following recent weakness, principally due to our change in view on the US dollar.

Category	View	Comments
Cash	–	We continue to hold a negative view on cash in the environment of negative real rates.

Source: Schroders, August 2015. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged). The views for currencies are relative to US dollar, apart from US dollar which is relative to a trade-weighted basket.

Section 2: Multi-Asset Insights

Emerging markets' vulnerability demands focus on quality

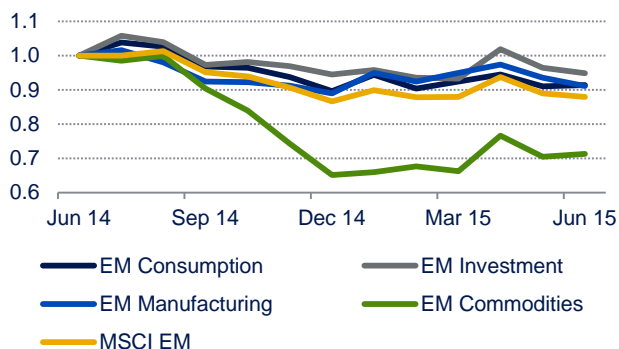
Continuing the emerging markets (EM) theme from last month, when we shared our views on how economically vulnerable EM may be in an environment of rising US interest rates, this month we provide an expanded update on our views across EM risk premia. In general, we believe that EM are in an economic malaise driven by a myriad of issues which may require a multi-year healing process.

Equities

EM equities, as measured by the MSCI Emerging Markets Index, have fallen to a four-year low since reaching a 12-month high in May. Looking beyond index performance, we find that much of the underperformance and improving valuations in EM equities can be attributed to commodity-related sectors. This suggests that assessing value in EM requires taking a view on commodity prices and the prospect of a Chinese cyclical recovery. However, our commodity risk premia group remains cautious on broad commodities and we are therefore reluctant to take a positive view on EM equities until we see value more broadly across the universe.

Figure 1 shows the relative 12-month performance (compared to the S&P 500 Index) of the EM universe by themes and highlights the severe underperformance in EM commodities sectors. Recent action by the People's Bank of China (PBOC) suggests that the risk of a serious downturn in China has increased, which is a warning sign to us that the desired China cyclical recovery may not be within reach yet. We therefore remain negative on broad EM equities.

Figure 1:
Relative (vs. S&P 500) 12 month performance of EM universe by themes



Source: Schroders, Datastream, 31 July 2015 using monthly data

Fixed Income

Both hard and local currency denominated EM bonds have struggled since April. While limited EM growth and concerns about sector flows will hinder emerging market debt (EMD) performance, we expect a relatively tame Fed hiking cycle will be partly offset by continued accommodative monetary policy in the eurozone and Japan.

EM external debt has been relatively resilient so far in 2015, supported by healthy fundamentals and stable inflows. We still prefer hard currency to local currency bonds and expect high quality assets to outperform during this period of heightened volatility. We retain a neutral view on EM hard currency spreads over US Treasuries and expect the

attractive yield to be the driver of performance going forward.

The local EM rates story is increasingly appealing but is likely to come under pressure as the Fed starts to normalise rates. However, with much cheaper currencies and high nominal yields we believe that EM local debt is much better positioned for the beginning of rate rises than prior to the 'taper tantrum' in 2013. At the time of writing, EM local currency debt trades at spreads of approximately 4.70%¹ over US Treasuries, at the higher end of its historical range. That said we remain selectively cautious on EM local bonds. For example, we are negative on Poland and South Africa due to the potential upward pressure on inflation expectations from their weaker currencies.

Currencies

Our views continue to reflect a relatively cautious stance on EM currencies versus the US dollar. As explained last month, the Fed's normalisation of interest rates is likely to be accompanied by higher volatility as investors repatriate capital from higher yielding currencies. In our view, the EM currencies most sensitive to this risk are the South African rand, Turkish lira and Brazilian real. We are particularly negative on the South African rand, which was downgraded this month to a single negative by our currency risk premia group, and is reinforced by the double negative view on South African local currency bonds taken by our duration risk premia group. We have become more positive on the Turkish lira given our belief that the negative newsflow is starting to be priced in, but we note the potential for volatility around the upcoming elections. We also remain negative on Asian currencies, such as the Singapore dollar and Korean won, due to deflationary pressures across the region.

Conclusion

Given the wide dispersion in growth and inflation dynamics across the EM universe, it is important to consider EM from both bottom-up and top-down perspectives. As the Fed begins to raise interest rates, we expect higher quality countries to outperform the broader emerging market universe, which may come under considerable stress across a number of risk premia. Our risk premia research groups remain focused on EM assets and their role in our portfolios.

¹ Source: Schroders, Bloomberg. Refers to JPM GBI EM Global Diversified Index relative to US 10 Year Treasuries

Important Information: For professional investors and advisers only. This document is not suitable for retail clients.

These are the views of the Schroders' Multi-Asset Investments team, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Schroder Investment Management Ltd (Schroders) does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Schroders has expressed its own views and opinions in this document and these may change. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. Issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA, which is authorised and regulated by the Financial Conduct Authority. For your security, communications may be taped or monitored. 941564