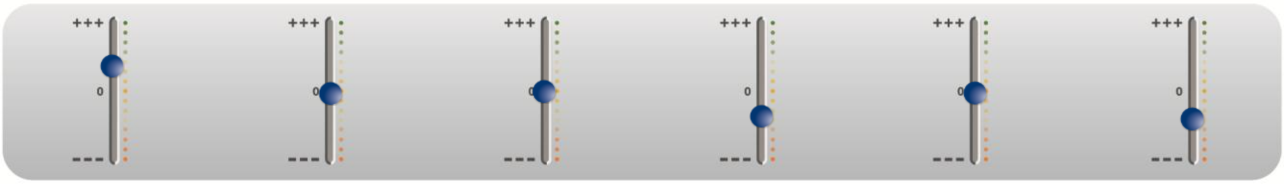
# Schroders Multi-Asset Investments

# Views and Insights

## Section 1: Monthly Views – August 2014

### Summary




| Equities | Government bonds | Investment grade credit | High yield | Commodities | Cash |
|---|---|---|---|---|---|
| + | 0 | 0 | - | 0 | - |

| Category | View | Comments |
|---|---|---|
| **Equities** | + | **Despite the recent correction, we believe the long-term risk environment remains supportive of equities. On a relative basis we favour the US, Japan and emerging markets, while we continue to see headwinds facing the UK market.** |
| US | + | We continue to believe that the US market offers the best potential for earnings growth, while its defensive qualities are attractive against a backdrop of weaker growth momentum and heightened geopolitical risk. We maintain our negative view on US small caps which still look expensive relative to large caps, despite the recent correction. |
| UK | -- | We continue to believe that the strength of sterling is likely to weigh on UK equities due to the meaningful proportion of UK corporate revenues that are generated overseas. A bounceback in economic data surprises has kept sterling momentum positive, however Governor of the Bank of England, Mark Carney's recent dovish speech has reversed the appreciation trend somewhat. |
| Europe | 0 | Geopolitical tensions and weaker growth data also served as a reminder that the region still was troubled by deep-seated structural issues. However, following their recent underperformance, European equities may be looking oversold in the short run. Consequently. we maintain our neutral positioning as the improvement in earnings which we had anticipated at the beginning of the year has failed to materialise. |
| Japan | + | Despite the stronger yen, the Japanese market has continued to recover suggesting that investors are able to look beyond this. Positive factors include the data indicating that the economy has responded to the April tax hike more favourably than expected, the (slowly) changing attitudes towards corporate governance and structural reforms and the stronger-than-expected earnings results last month. |
| Pacific ex Japan | 0 | We have maintained our neutral stance on the region. Australia's economy remains vulnerable to any reduction in demand for commodities or a slowdown in the property sector. |
| Emerging Markets | + | It appears that emerging markets are starting to benefit from the recovery in developed markets, with a rising pattern of export growth consistent across a broad range of economies. This cyclical improvement could lay the foundation for a sustainable earnings-led upgrade across the region, which given historically low valuations, makes the region attractive. We remain wary of impact to sentiment from expected changes in US monetary policy and any possible undershoot in Chinese growth data, which has surprised on the upside lately but is still affected by the slowing property sector. |

| Category | View | Comments |
|---|---|---|
| **Government bonds** | **0** | **We recognise that duration is trading towards the lower end of our expected range and although we continue to expect a gradual recovery in the US, inflation and growth numbers can still remain below trend. Additional liquidity by the European Central Bank (ECB) and Bank of Japan (BoJ) is able to offset marginal tightening in the US. Geopolitical risks remain high.** |
| US | - | We are negative on US duration as we continue to expect a gradual economic recovery in the US. We maintain our underweight position in US Treasuries on a relative basis versus Gilts and Bunds. |
| UK | + ↑ | Economic momentum has started to slow from very high levels and any negative impact from geopolitical events or sluggish European growth is likely to be positive for Gilts. We therefore recommend a slight overweight in Gilts and continue to favour a relative overweight compared to US Treasuries. |
| Europe | 0 | We remain neutral given less attractive carry and roll characteristics compared to other developed bond markets and aggressive pricing in the front-end of the curve. However, we still strongly prefer Bunds on a relative basis to US Treasuries as we expect continued monetary divergence between the ECB and the Federal Reserve (Fed). |
| Japan | 0 | Despite its flat yield curve and low real yields, we maintain our neutral position on Japanese duration at the medium to long-end of the curve due to the aggressive support provided by the BoJ. |
| US inflation linked | + | We remain positive on US inflation-linked bonds. We expect the Fed to remain dovish and therefore spark a further increase in inflation expectations. At the same time, the carry offered by the real yield curve is attractive. |
| Emerging markets | 0 | We remain neutral on EM USD bonds after the latest spread widening because of the negative carry. We do not expect a liquidity driven sell-off, while any global growth concerns should support EM bond yields. In the EM local bond universe we still like the front-end of the curve in South Africa and the long-end of the curve in Mexico. We stay neutral on Poland despite our positive European outlook because of potential credit spread volatility. |

| Category | View | Comments |
|---|---|---|
| **Investment grade credit** | **0** | |
| US | - | While we expect the recovery in the US to be supportive of investment grade credit, the potential for renewed interest rate uncertainty could create some upward pressure on spreads. Meanwhile even after the recent sell-off, valuations continue to look expensive. |
| Europe | + | We continue to favour European investment grade over US investment grade. Technicals remain supportive, benefiting from demand from fixed income investors due to low government bond yields. Meanwhile the more accommodative policy from the ECB should provide further support. |

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

| Category | View | Comments |
|---|---|---|
| **Commodities** | **0** | **We remain neutral due to the risks around agriculture prices and the impact Chinese policy could have on sentiment over the short term.** |
| Energy | 0 ↓ | We have downgraded our view from positive to neutral. The physical market looks weak and will struggle to digest any additional supply from Libya. The carry on the Brent curve has also become negative. |
| Gold | 0 | We maintain a neutral view as gold continues to trade in a range. We wait to see if gold breaks out of the lower end of that range and/or real rates begin to move upwards. |

| | | |
|---|---|---|
| Industrial metals | 0 | We remain structurally bearish towards industrial metals given supply and demand headwinds. However, we maintain our neutral score due to the support from Chinese policymakers, who continue to ease policy. This should provide support for Chinese growth and therefore metal demand. |
| Agriculture | - | We remain negative on agriculture. We acknowledge after the strong correction in prices over the past month that the risk reward trade-off from our short position has deteriorated. Our base case is that prices continue to drift lower, however we are mindful that this is a consensus position and that there are large short positions in the market. |

| Category | View | Comments |
|---|---|---|
| **Currencies** | | |
| US dollar | + | We expect a continuation of the recovery in the US and further tapering from the Fed. This divergence between Fed policy and other G10 central banks, which remain on hold or with a bias towards further loosening, should support the USD in the medium term. |
| British pound | 0 ↓ | We have downgraded sterling due to our belief that rate expectations are fully priced, with our view being that rate hikes are either pushed back or the economy slows as rates are increased. |
| Euro | - | We continue to see deflationary pressures in the eurozone and the ECB has suggested that it may introduce further monetary stimulus to combat deflation. We expect the euro to come under pressure in the near-term as a result. |
| Japanese yen | - - - | We expect that the Japanese yen will weaken in the second half of 2014 as the market begins to anticipate additional easing from the BoJ to offset the effect of the consumption tax hike. Growth friendly policy measures in China should also reduce the upward pressure that was being placed on the yen due to fears of a Chinese hard landing. |
| Swiss franc | - | he Swiss economy has strengthened over the year in line with broader eurozone improvements. The Swiss National Bank has reaffirmed its support for the CHF/EUR floor and, with limited inflation, there is little pressure to change monetary policy. The economy remains vulnerable to a deterioration in the eurozone which would very likely lead to a return of the desire for ‘safe haven' capital and require SNB intervention. |

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

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

# Section 2: Multi-Asset Insights

**By Aymeric Forest, Head of Multi-Asset Europe and Matthias Scheiber, Multi-Asset Fund Manager**

## Downside risks in Europe remain high

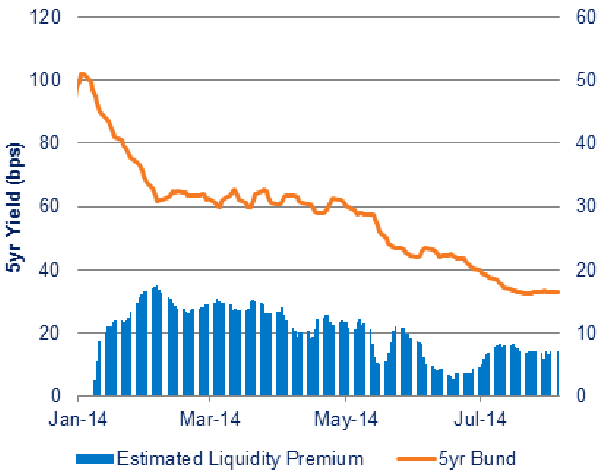
Over 2014 there has been a steady decline in the yield on German government bonds. As a result bunds have outperformed other developed markets. This outperformance could have been driven by two factors:

1. The rising liquidity premium – the premium investors are willing to pay to hold the sovereign bond (in terms of lower yields) rather than a government-guaranteed agency bond of the same maturity

2. Concerns over the European recovery and the risk of deflation

Figure 1 provides an estimate of the liquidity premium for bunds over the period. This is calculated by subtracting the yield on the bund from the agency bond. When there is demand for safe haven assets, the yield on the bund falls and the liquidity premium rises. Two such periods are highlighted in the chart, the first in February when investors became concerned about the impact of the crisis in Ukraine and the second in July when the Malaysian Airlines flight was shot down over Eastern Ukraine. However, despite these periods of heightened geopolitical tensions and risk aversion, the overall trend in 2014 has been a decline in the liquidity premium.

### Figure 1: Estimation of the liquidity premium




Source: Schroders, Bloomberg, August 2014

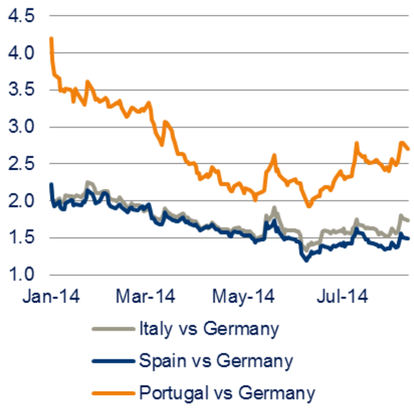
This suggests that concern over the European recovery and deflation played a more important role in the outperformance of bunds. Last week Mario Draghi, president of the European Central Bank (ECB), announced that the bank had "intensified preparatory work" on quantitative easing as a potential tool to fight deflation and the economic slowdown.

However, markets were not convinced. The 10 year German breakeven rates (the difference between the yields of nominal and inflation-linked bonds) collapsed after Draghi's speech (figure 2), while the spread between bund and periphery yields widened (figure 3).

### Figure 2: German 10 year breakeven rates


Source: Schroders, Bloomberg as at 11 August 2014

### Figure 3: 10 year peripheral spreads




Source: Schroders, Bloomberg as at 11 August 2014

Furthermore, Russian sanctions on Europe that impact growth have yet to be reflected in growth data. These are worrying signs that the ECB might still be behind the curve in terms of its policy action. We therefore remain neutral on German bund exposure even though yields are at multi- year lows.
Leading indicators, however, paint a more positive picture. Typically the ratio of US non-residential fixed investment as a percentage of GDP vs. US durable goods orders (ex transportation) is a leading indicator for capex growth with a 6 – 18 months lead (see Figure 2).

## Low volatility for now, but risks are to the upside

In the second quarter of 2014, market volatility continued to head lower helped by recovering US macroeconomic data and dovish forward guidance from the Federal Reserve (Fed) and the ECB. The implied volatility of 1 month at the money (ATM) S&P 500 options – where the strike price is equal to the current price – reached a new low, unseen since 2006 (figure 4). While we believe we are likely to remain in a low volatility regime, some short-term catalysts may move market volatility higher.

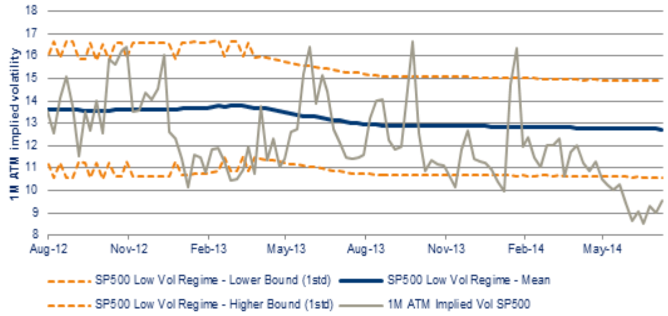
Looking at the open interest (or open commitments) of equity option contracts, market participants seem to be better prepared for a correction across global equity markets than they had been in May. Earlier in the year positioning was mainly concentrated in put options that were either at the money or where prices needed to fall by 10% to bring the option into the money. Since then there has been a shift towards further out of the money contracts. As shown in figure 5, 8% of outstanding contracts require prices to fall by 40% to be in the money, while 10% require falls of 50% or more. Therefore it appears more investors are protecting their portfolios against severe falls in prices.

Over the early summer, volatility has again flared up in reaction to a confluence of geopolitical events. Skew, which measures the premium that buyers of put options pay over buyers of call options, reached high levels in markets such as the S&P 500. A reasonable protection strategy could involve buying put spreads (buying a put option and selling a put option with a lower strike price in order to reduce the cost of protection) in expectation of a continued, but contained, market fall.

While the fundamental picture remains consistent with a low volatility environment, some catalysts could increase risk aversion such as interest rate policy changes, geopolitical events and disappointing growth data. Of these risks, the tensions over Ukraine could impact Europe, which is struggling to move into a sustainable recovery. Additional risks could emerge such as the European Asset Quality Review (AQR) of the banking sector, and the US mid-term elections in the fourth quarter.

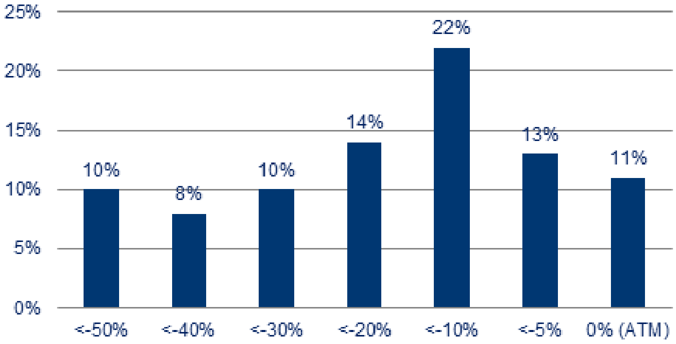
Although the stress presented by policy-related uncertainty in the US and Europe appears to be low at present, the recent flattening of the US government bond yield curve shows how sensitive economic growth and long-term inflation expectations could be to such a change of policy. The delivery of growth and the ongoing flow of liquidity from central banks remain critical for the low volatility environment to continue.

### Figure 4: Range of low volatility regime




Source: Schroders, August 2014

### Figure 5: Average of open interest December 2014 put options across equity markets




Sources: Bloomberg, Schroders. Average open interest for December 2014 put options across nine equity markets (S&P 500, NASDAQ 100, Russell 2000, Swiss Market, Eurostoxx 50, DAX, FTSE 100, Nikkei 225 and Hang Sang), as of 6 August 2014