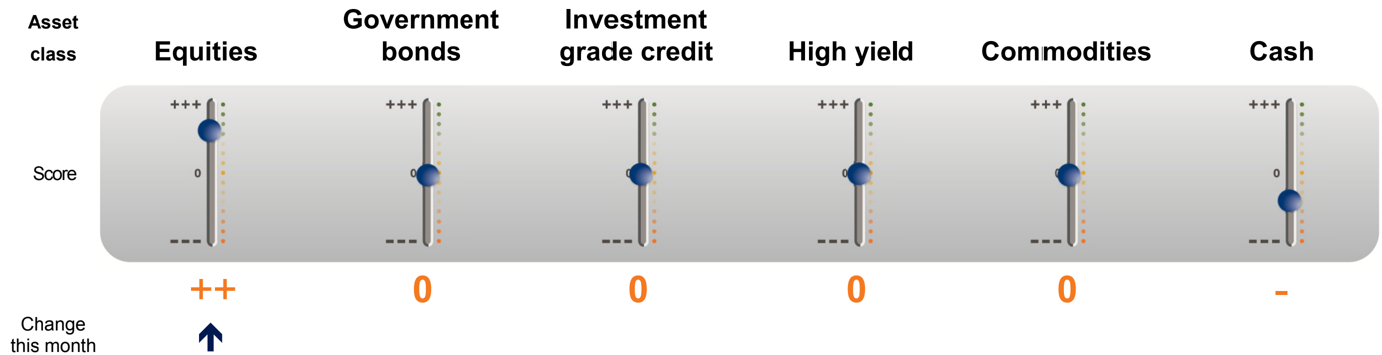
Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – April 2014

Summary



Category	View	Comments
Equities	++ ↑	**We have upgraded equities this month as a result of the valuation opportunity we see in Asian emerging markets.**
US	+	Valuations look stretched compared to other markets and are vulnerable to interest rate volatility. However, there are signs of improved profit margins. We expect there to be some top-line growth and the efforts to return cash to shareholders should be positive for investors.
UK	-	Despite a positive growth story, the UK market does not have the same potential for earnings growth as other regions. We are still negatively positioned due to the exposure to foreign earnings and the strength of sterling.
Europe	+	Europe is poised for stimulus from the ECB and together with its relative cheapness means we are positively positioned. Earnings have shown little improvement yet, but have been hampered by the strength of the euro. Growth prospects remain more positive and we expect profit margins and earnings to recover this year.
Japan	0	The strong performance of Japanese equities has been closely tied to yen depreciation. To counter the effect from raising the consumption tax there is a widespread assumption that there will be further easing from the Bank of Japan which leaves room for disappointment.
Pacific ex Japan	0	We have maintained our neutral stance on the region. Australia's economy remains vulnerable to a reduction in demand for demand for commodities and a slowdown of the property sector.
Emerging Markets	0	Valuations are at historical lows, but are concentrated in Russian energy and Chinese financials. Many EM countries remain vulnerable to capital flight and the impact of the tapering of quantitative easing by the US Federal Reserve.
Emerging Markets Asia	+	We have introduced the EM Asia category as the value within emerging markets has become more concentrated. Tactical opportunities have arisen as the People's Bank of China has softened its tightening rhetoric recently and the government introduced a mini-stimulus package, whilst Korea and Taiwan are well-positioned to benefit from the global recovery.

Category	View	Comments
Government bonds	0	**We maintain our neutral duration position given our expectation for modest growth and muted inflation. US growth momentum has slowed somewhat and geopolitical tensions in Eastern Europe have seen safe-haven markets benefit. Carry and roll remain attractive for bond holders.**
US	0	After a period of weather-induced weakness, the outlook for growth improved in March. The latest employment data has confirmed a gradual but slow recovery and thus we remain neutral on US duration since it still offers an opportunity for investors to earn carry and benefit from rolling down the curve. The slowdown in Chinese growth is likely to have a negative impact on the US trade balance, further supporting our view.

UK	0	We expect the UK economy to be positive in the long run but given the dependence of the recovery on the UK housing market and the high levels of household debt we expect short term rates to remain anchored. Therefore we hold our neutral outlook this month.
Europe	0	Bunds have benefited from the flight to quality as the Ukrainian crisis has escalated and should benefit further from the ECB's lack of aggression in terms of implementing QE (a negative impact for peripheral bonds). Slowing exports (a result of weaker Chinese demand) combined with the strengthening euro are further dampening any growth momentum whilst deflationary pressures remain.
Japan	0	Although further tapering by the US Federal Reserve is likely to be positive for JGBs, we expect the BoJ to intervene with further QE given the adverse impacts on Japanese growth of the weakness in China and weakening renminbi and therefore we maintain our neutral view. Furthermore, any weakness in US growth momentum is likely to see a strengthening in the JPY, intensifying pressure on the Japanese economy.
US inflation linked	0	Despite the tightening of the labour market in some regions and a spike in commodity prices such as agriculture this year, inflation remains muted. The economies of Japan and China are currently exporting deflation as a result of low levels of domestic inflation and weaker currencies. Lack of inflation in Europe continues to be a concern.
Emerging markets	-	A lack of inflationary signals and weaker global growth should provide support to EM bonds, however with geopolitical risks increasing in regions such as Ukraine and Venezuela we remain short on USD emerging market bonds.

Category	View	Comments
Investment grade credit		
US	-	US investment grade should stay supported by the US recovery, but after a narrowing of spreads through Q1 of this year, valuations look stretched. Solid cash buffers and recovering flows do not compensate for the risks posed by corporate activity and the vulnerability to interest rate hikes and thus we remain negative.
Europe	+	We continue to favour European investment grade over US investment grade. Corporate balance sheets are in better health with large cash buffers, whilst muted corporate activity and potential monetary stimulus from the ECB provide further support for the sector.

Category	View	Comments
High yield credit		
US	0	As valuations remain at historical peaks, the typical reward for holding high yield has eroded, with carry the only compensation. It is vulnerable to any disappointment from the US recovery and balance sheets are deteriorating but demand continues to be solid in a benign default environment.
Europe	0	Fundamentals are mixed in Europe with banks improving their balance sheets, but leverage increasing in non-financials. We remain neutral as the growth picture is unclear but demand still outstrips supply and the ECB's dovish stance is supportive.

Category	View	Comments
Commodities	**0**	We maintain our overall neutral stance towards commodities. There is uncertainty concerning the direction of agricultural prices due to unpredictable weather patterns, while Chinese policy could improve sentiment towards industrial metals in the short term.
Energy	-	Energy prices remain near the top of their range and, without significantly stronger global growth, we believe prices are more likely to drift lower than rise from current levels. Spare capacity remains well managed as Saudi Arabia continues to have control over the crude oil market so we do not anticipate a dramatic fall in prices.
Gold	0	We remain neutral on gold. The price continues to stabilise and the tension between the structural case and short-term sentiment remains. A stronger US dollar and a re-assessment of the situation in the Ukraine could weigh on the price.
Industrial metals	0 ↑	We have upgraded industrial metals to neutral as Chinese policymakers appear to be shifting from a tightening to an easing bias. This should provide support for Chinese growth and the demand for industrial metals. However, we remain structurally bearish towards industrial metals given supply and demand headwinds.
Agriculture	0	The weather is a chaotic system and inherently difficult to predict. Models indicate that an El Nino – charcacterised by a rise in temperature in the Pacific Ocean– is likely during the northern hemisphere summer in 2014. Should this happen, it is likely to affect major crops and put upward pressure on grain prices. So far this year, coffee has accounted for a significant proportion of the recent agricultural commodity index performance.

Category	View	Comments
Currencies		
US dollar	+	Although there has been some softness in economic data recently, we expect the US recovery to progress and for the Federal Reserve to continue to taper quantitative easing. The Fed's policy divergence from many of the G10 central banks, which remain on hold or with a bias towards further loosening, should support the USD in the medium term.
British pound	+	The UK economy is making good progress relative to other economies. Momentum in the housing market remains strong and the recovery is increasingly broadening. As a result we expect the BoE to sound progressively more hawkish.
Euro	-	The ECB are becoming increasingly vocal about the deflationary pressures being faced by the eurozone and the risks being posed by a strong euro. When compared to other G10 central banks, the ECB has a relatively greater inclination to loosen policy. We expect the euro to come under pressure in the near-term as a result.
Japanese yen	- - - ↓	We have downgraded the yen this month. Economic data has been softening in the run up to Japan's consumption tax hike and is likely to deteriorate further following the tax hike. Expectations of additional easing should begin to build as a result, weakening the currency. Growth friendly policy measures in China should also reduce the upward pressure that was being placed on the yen by fears of a Chinese hard landing.
Swiss franc	-	Economic growth has been steady and in line with broader eurozone improvements. The SNB has reaffirmed its support for the CHF/EUR floor and with negligible inflation there is limited pressure to alter monetary policy. The economy remains most vulnerable to a deterioration in the eurozone which would very likely lead to a resumption of "safe haven" capital and require SNB intervention.

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

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

Section 2: Multi-Asset Insights

By Johanna Kyrklund and Urs Duss, Fund Managers, Multi-Asset

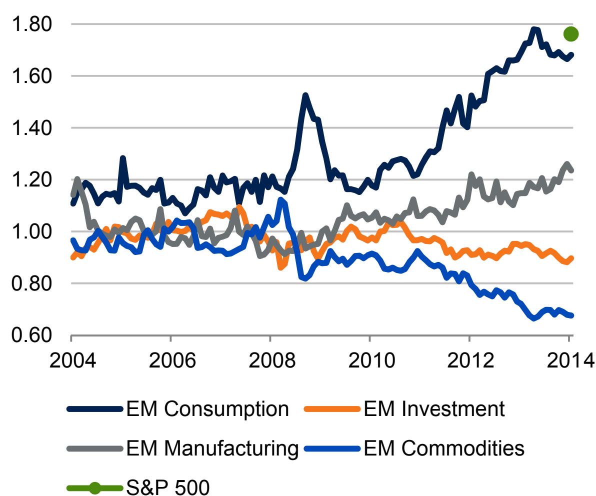
Value in emerging markets, but concentrated

Emerging market equities have had a difficult time over the last few months. In USD terms, the 12 month return to 31 March 2014 for the MSCI World index was 19.7% compared to -1.1% for the MSCI Emerging Markets index. As fund manager sentiment has turned extremely negative according to surveys such as the BAML Global Fund Manager, the question becomes whether this pessimism offers a good investment opportunity.

A cursory examination of current valuations would suggest that emerging market equities are inexpensive both relative to their own history and also US equities. Based on the historical relationship between valuation and subsequent 12 month returns, EM equities as a whole are approaching historically attractive levels and therefore could generate significant returns in 2014.

Upon closer scrutiny, however, it becomes apparent that there are particular themes that are dominating valuations. Figure 1 shows the majority of the value derives from Investment and Commodities, whilst on the other side of the spectrum, Manufacturing and Consumption are priced expensively relative to their history. Within Investment, the value really lies in Chinese financials whilst within Commodities it is found within Russian energy stocks. Consequently a position in broad emerging markets based on valuation is, to a large extent, taking a view on these particular themes.

Figure 1: EM P/B valuations relative to MSCI EM



Source: Schroders, Bloomberg, April 2014

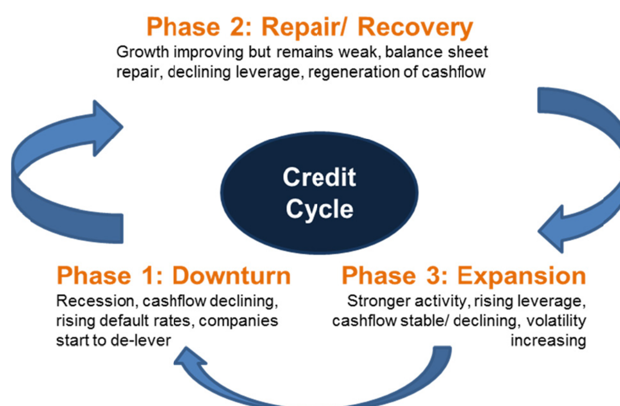
The current divergence in the fortunes of the BRIC countries highlights the need to consider emerging markets in more targeted fashion rather than as a single bloc. Russia is the most attractive based on value and fundamentals, but despite the recent sell-off remains dominated by the political risk premium. Brazil offers little reward in terms of either valuation or momentum with the continued downward earnings revisions. Elsewhere the signs are more encouraging from China and India. In the former the mini-cycles of stimulus and tightening offer tactical opportunities during the tricky road of re-balancing growth and deleveraging, whilst in the latter there is some momentum with the cheaper currency, improved current account deficit and anticipation of the election.

As a result, we consider that the current opportunity is greatest in Asian emerging markets. 30% of the MSCI EM Asia is from China, whilst another 44% consists of Taiwan and Korea; countries we favour due to their robust fundamentals and participation in global growth.

The credit cycle – entering the stability phase?

After a very strong run through 2012 and 2013, returns are likely to be restricted to the carry available (the interest earned) in 2014. Although the consensus is that valuations are now looking stretched, the more challenging question is when should we be positioned more negatively towards corporates. It can be difficult, however, to predict the direction of spreads and indeed they have long been used as effective leading indicators within economic and trading models for other markets.

Figure 2: The credit cycle



Source: Schroders, Morgan Stanley, March 2014

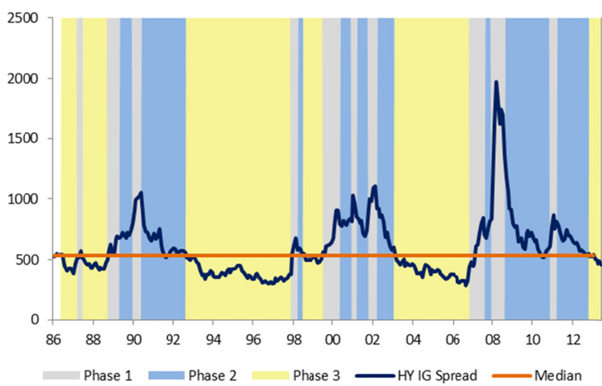
One way to approach this challenge is by analysing the credit cycle to try and establish what might trigger a correction in valuations. The credit cycle tracks the expansion and contraction of access to credit over time. Figure 2 illustrates a stylised version of the credit cycle which can be divided into three parts. The downturn is the most painful phase for corporates as the recession hits activity and defaults increase, with the recovery phase characterised by balance sheet repair. This then prepares the way for the

expansion phase of the cycle when there is increasing confidence and corporate lending resumes.

Credit spreads can help us understand where we are in the credit cycle. Phase 1 (the downturn) is when spreads are widening. To compensate, central banks cut rates as the economy is experiencing a slowdown or in recession. Phase 2 (repair/recovery) is when spreads are tightening as the economy moves out of recession and in to recovery mode. Phase 3 (expansion) is characterised by spread stability with investors benefiting from carry rather than capital appreciation.

Figure three shows a quantitative identification of these three stages for US high yield and identifies that US high yield debt is currently in phase 3 which is the expansion phase.

Figure 3: Phases of the credit cycle – US HY



Source: Thomson Datastream, Schroders, March 2014. Note: ML HY corporate spreads are comparing the corporate bond with a US treasury bond of a similar duration to proxy for OAS given data limitation (i.e. HY uses a 5-year bond). Credit cycle phases are identified quantitatively using a Markov model.

If we consider the credit cycle alongside the business cycle and the interest rate cycle, there are certain characteristics that we would normally expect to see prior to a deterioration in spreads. We would expect the business cycle to show signs of contraction and interest rates to be tightening. However, at present corporate balance sheets appear to be in good shape showing signs of recovery and interest rates have yet to rise.

Historically we have seen phase 3 of the cycle persist beyond the first rate rises and as a result we might conclude that we could expect two to three years of stable spreads. However, while this conclusion may be drawn from historical trends, there is no precedent for the current level of quantitative easing and ultra-low interest rates and as a result we remain cautiously positioned and watchful for any shift in investor sentiment triggered by a change in interest rate policy.

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