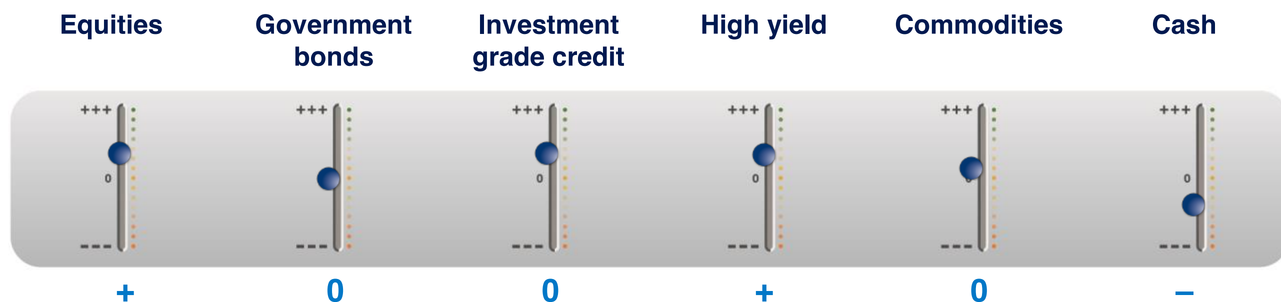
Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – October 2015

Summary

Equities	Government bonds	Investment grade credit	High yield	Commodities	Cash



+	0	0	+	0	–

Category	View	Comments
Equities	+	**We maintain a positive score on equities on the receding threat of a China-led global growth slowdown. We prefer Europe and Japan over the US whilst also maintaining our negative view on emerging markets (EM).**
US	0↓	We have downgraded our qualitative score to neutral as the strong domestic growth that led us to favour the US market is losing the battle against the strong dollar, the slowdown in the earnings cycle and rising credit spreads in our view.
UK	0	We remain neutral on UK equities as we expect profit margins to remain under pressure from higher labour costs which will hurt the domestically-focused firms. There is downside risk to the UK economy next year given the scale of fiscal tightening that is due and the uncertainty generated from the brewing “Brexit” debate.
Europe	+	We have retained our positive view on Europe as we believe that the region is in an earlier stage of the economic cycle compared to the US. Economic data on the domestic demand side is healthy and this should drive steady earnings growth for European equities.
Japan	+↑	We have upgraded our view on Japan given the ongoing earnings recovery and structural reform agenda being pushed through by the Abe government. We believe the correction in the market provides us with an attractive entry point to establish our positive stance on the market. That being said, we acknowledge that the tailwind from a weaker yen is limited without additional easing from the Bank of Japan (BoJ).
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 and lack of a medium-term growth catalyst.
Emerging Markets	–	The negative score on EM has again worked in our favour as the ongoing weakness in emerging economies and collapsing commodity prices have continued to affect the region’s equities. However, our market breadth indicators for EM are suggesting that prices may be bottoming.

Category	View	Comments
Government bonds	0	**There is no change in our views on government bonds in developed markets. We remain neutral on Duration, with positive momentum and cyclical indicators still showing worrying signs. Value remains neutral after the increase in the term premium earlier this year.**
US	0	Inflation expectations in the US have fallen further which supports our neutral view on US Treasuries. We maintain our negative view on the belly of the curve, despite the latest flattening as we believe the Fed remains keen to normalise rates.
UK	+	We remain positive on the UK as gilts remain a beneficiary of low interest rates and quantitative easing (QE) in the eurozone. In addition, both growth and inflation have recently surprised on the downside and added supports for the gilts. We continue to prefer curve flatteners, favouring the long end of the curve.
Germany	+	Potential further action by the European Central Bank (ECB) to suppress real yields, and a slightly stronger euro, should continue to support the 10-year German bund.
Japan	0	We have maintained our neutral view on Japanese duration this month. Despite the unattractively low level of yields, potential action by the BoJ is still expected to provide support.
US inflation linked	0↑	We have neutralised our negative view on US Treasury Inflation Protected Securities (TIPS) as we look to take profit on the recent underweight position. The underperformance was significant as real yields adjusted upwards over the month, driven by sharply lower inflation expectations.
Emerging markets	–	We continue to express our negative view on EM US dollar bonds with an underweight in the EM US dollar bond spread, avoiding the biggest issuers like Turkey, Russia and Brazil but have partly taken profit after the recent spread widening.

Category	View	Comments
Investment grade credit	+	
US	0	We remain neutral on US investment grade as debt affordability remains strong, but the decay in earnings momentum can rapidly change the picture.
Europe	++↑	We have upgraded our view to positive as supply activity has increased (possibly a good sign for the region), capital formation remains strong and the cycle appears in an earlier phase than in the US.

Category	View	Comments
High yield credit	+	
US	+	Bearish sentiment has further improved the risk reward profile; however, fundamentals remain mixed, with companies facing headwinds from a stronger US dollar and low growth/inflation prospects. The energy sector still poses downside risks whilst oil is volatile but spreads have moved to price this in.
Europe	0	We remain neutral on European HY. The technical picture remains weak, driven by sizeable outflows from ETFs and reduced liquidity due to higher cash levels within funds. However, fundamentals continue to show improvement with declining net leverage, EBITDA and revenue growth and a benign default outlook.

Category	View	Comments
Commodities	0	**We remain neutral on commodities as global growth has failed to accelerate.**
Energy	+↑	We have raised energy to single positive on the basis that we are finally seeing production falling both from US shale oil as well as major OPEC producers, likely putting a near-term floor on prices.
Gold	–	We remain negative on gold as we expect real rates to move higher.
Industrial metals	0	China has moved firmly into an easing cycle, bringing forward infrastructure expenditure and easing monetary policy. The hard data is yet to stabilise in response to these measures.
Agriculture	0	Wheat, corn and soybean harvests are on track for another bumper year with record or near record stocks on a global basis. El Nino continues to strengthen and we may have the third strongest event in 65 years. We are therefore on notice for potential disruptive weather in next year's harvests.

Category	View	Comments
Currencies		
US dollar	-↓	We have downgraded the US dollar over the past month following the Fed's confirmation that interest rate lift-off would be delayed and due to our expectation that US dollar-sensitive sectors of the US economy will continue to struggle.
British pound	0	We remain neutral on sterling. Comments from the Bank of England (BoE) suggest a rate rise is likely in the first half of next year. However, we believe the BoE will be influenced by weak inflation and the Fed's policy trajectory, which is being pushed out.
Euro	+	We have upgraded our euro view to positive. This reflects our expectation that the eurozone will continue to deliver the most constructive rate of change in growth out of the major economies.
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 remains at neutral with no obvious catalyst for a repricing.

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

Source: Schroders, October 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

The evolution and stage of the current credit cycle

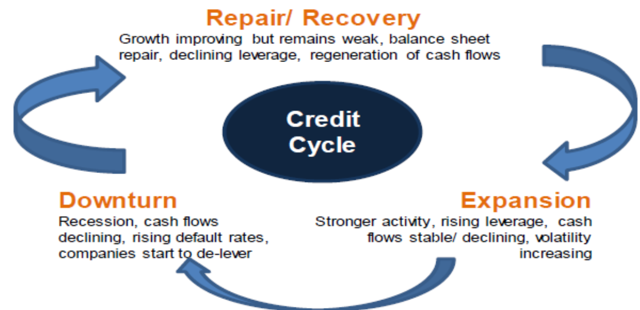
When looking at the credit cycle it is worth remembering a quote from Howard Marks: “Rule number one: Most things will prove to be cyclical. Rule number two: Some of the greatest opportunities for gain and loss come when other people forget rule number one.”[1] The pain of 2008 means very few have forgotten rule number 1, particularly given stresses in the energy sector due to commodity weakness, a series of big names coming under pressure within the US and Europe and increasing sovereign risk across the emerging markets (Russia, Brazil, China).

Credit investors globally are trying to work out if this is the beginning of the end of this cycle, or if it is a pause half way through, providing opportunity for those who can find conviction one way or another. This question is all the more complicated by the role of divergent central bank policy and an ever-evolving trading liquidity landscape, making comparisons with previous cycles all the more difficult. It really could be different this time.

Whilst there are many ways to define the credit cycle, we can say the end of the credit cycle requires at least three factors: poor fundamental credit conditions, increased risk aversion and a trigger. The trigger is always hard to predict and we are certainly in a period of increased risk aversion, reflected by recent increases in global volatility and pro-cyclical valuations. Therefore, in our analysis we attempted to review the metrics that define our understanding of poor fundamental conditions.

Our latest research showed, perhaps unsurprisingly, that the interpretation of a variety of capital market indicators could, at the moment, support rather alternative conclusions. Thisjustifies a degree of caution when trying to assess the precise stage we have reached during the current business cycle. We simply note that credit cycles remain well integrated, with global risk aversion generally leading to spread widening in all sectors during episodes of flight to quality.

With this shorter-term consideration in mind, it appears relatively clear that Europe is at an earlier phase of the credit cycle than the US and, equally, that this process is likely to continue for some time (possibly as a direct consequence of the deeper balance sheet cleansing post the regional crisis). Whilst cross-border issuance further integrates a system of market pricing between the US and Europe that is already well-integrated, those European issuers that have looser ties to overseas economies should face an extended cycle compared to their North American peers. This potentially means European issuers prove more resilient to an increase in US-driven flight to quality.



Source: Schroders

EM dollar debt credit pricing remains well-integrated with that of the US and is largely driven by global risk aversion rather than country-specific factors. Several corporate metrics still appear solid, largely owing to the quasi-sovereign nature of many issuers in those markets. However, clearly some worrisome risks of repatriation flows remain, triggered by further tightening in global monetary conditions. At this juncture, we acknowledge that some headline EM risks may be large enough to contaminate other developing markets; some examples of which are the Syrian war, the Brazilian downgrade and the renminbi devaluation. However, we remain of the opinion that the transmission mechanisms within EM are more likely to be expressed from a top-down rather than bottom up perspective, meaning that our investigation assigns a relatively low likelihood of future spillover effects emanating from the deteriorating EM corporate balance sheets.

Where does this leave us? There is growing evidence derived from fundamental metrics and fragile economic momentum that the expansionary phase of this economic cycle is approaching its terminal stage. However, excluding some energy names, corporate fundamentals still seem well within their late cycle peaks, providing the opportunity for continued expansion out beyond a 12 month horizon. As risk aversion has increased, pricing of defaults appears to have stretched beyond what is reasonable given the fundamentals we observe. With central bank action likely to remain cautious, the current picture resembles more a 2011 than 2007 scenario, i.e. more like a global growth-related risk aversion than the beginning of the end of the credit cycle.

1. Source: Marks, H. (2011*) The Most Important Thing Illuminated: Uncommom Sense for the Thoughtful Investor,* New York: Columbia University Press

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