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Schroders
Global Market Perspective

Economic and Asset Allocation Views Q1 2017

Schroders

Asset Allocation Views: Multi Asset Group

Global Overview

Economic View

After a series of downgrades, our forecasts for global growth have been revised up with 2016 now expected to come in at 2.6% (previously 2.3%) and at 2.8% in 2017 (previously 2.6%). For 2017, the upgrade was largely a reflection of a more optimistic view on the emerging markets (EM), the UK and the US.

Inflation is expected to pick up in 2017 to 2.4% from 2% in 2016, primarily led by oil price base effects in the advanced economies. The picture in 2018 is more mixed as price pressures continue to build in the US, but tend to moderate elsewhere.

This quarter we have made changes to our scenarios to reflect the election of US President Trump and continuing political risk in Europe. On the whole, while our baseline growth forecast has risen, scenarios are skewed even more to the downside. Specifically, the scenarios “Currency wars return”, “Secular stagnation” and “Bond yields surge” all take global growth and inflation lower over the forecast period.

Central Bank Policy

For the US, we still expect the Fed funds rate to rise to 1.25% by end 2017. Moving into 2018, the Fed is expected to tighten further as fiscal policy supports economic growth and with US inflation rising, policy rates are expected to end the year at 2.25%. The Bank of England (BoE) is expected to keep rates on hold throughout the forecast period. The European Central Bank is also assumed to keep the deposit rate at current levels with asset purchases to be maintained at 60 billion euros per month beyond the end of 2017. The Bank of Japan is expected to keep rates on hold, but maintain quantitative easing (QE) as, in a rising US rate environment, purchases will be needed to maintain the 10-year Japanese government bond (JGB) yield at zero. The People’s Bank of China (PBoC) is still expected to ease policy this year.

Implications for Markets

Looking at our asset class views, we have upgraded equities to positive. We believe that there has been a rotation towards a reflationary setting given the recovery in global growth and expectations of more fiscal expansion particularly in the US. This should provide a more supportive backdrop for earnings growth, particularly those more cyclical areas of the market. Meanwhile, global valuations are generally looking fair when we compare the equity risk premium relative to history, but we recognise that this is being supported by the low interest rate environment. Our analysis suggests that the equity risk premium can absorb moderately higher bond yields. Importantly, our positive view on equities is based on earnings growth rather than a re-rating of multiples.

Within equities, we have a preference for markets that offer access to the reflationary theme such as Japan and Europe ex UK where we have upgraded to positive over the quarter. There have been encouraging signs of improvement in the Japanese data and the weaker yen should provide a boost to corporate earnings. Importantly, analysts’ earning expectations have yet to incorporate the recent depreciation in the currency. On Europe ex UK, we have turned positive on the market as the recent outturn in the data has been on a stronger footing. Crucially, investors are likely to finally unlock the value found in European financials with a steeper yield curve.

In comparison, we have downgraded emerging market equities to neutral given headwinds from a stronger USD environment along with the prospect of more protectionist policies from the Trump administration. Nevertheless, EM equities continue to offer a valuation discount versus their developed peers. We have also upgraded EM growth expectations for this year.

Meanwhile, we have retained our neutral stance on the US, UK and Pacific ex Japan. Despite the high-quality nature of the US market, valuations have become richer. The prospect of corporate tax cuts and repatriation of overseas cash are likely to provide a substantial boost to corporate earnings. However, corporate earnings could be challenged by a stronger USD and higher interest rates along with the squeeze on profit margins from the pick up in wages. On the UK, we believe that the tailwind for revenue growth of multinationals from the weakness in the currency has faded. Nonetheless, on our measures, the UK market is one the most attractive in the

Asset Allocation Views (continued)

Implications for Markets (continued)

developed universe from an equity risk premium perspective.

With regard to the duration views, we have maintained the negative position on government bonds which remain vulnerable to shifts in interest rate expectations as central banks attempt to normalise policy with rates rises or less accommodative monetary conditions. Amongst the bond markets, we are negative on US Treasuries, UK Gilts and German Bunds, but neutral on Japanese government bonds. We have also maintained our neutral stance on emerging market sovereign debt (EMD) in USD. Instead, we prefer harvesting the carry in EMD local currency bonds given that valuations are more attractive and fundamentals continue to improve at the margin.

Turning to credit markets, we have stayed neutral on high yield and negative on investment grade (IG) bonds. While valuations for both sectors are no longer compelling, investment grade spreads are more sensitive to shifts in interest rate expectations with a lower carry cushion. For US IG credit, fundamentals are deteriorating in this sector and the elevated USD LIBOR funding costs makes returns unattractive for overseas investors after taking into account the higher hedging costs and low carry. For European credit, spreads are highly correlated with the US such that we are also negative on this segment, although to a lesser degree. This is because valuations are more attractive compared to US IG credit and there is also less rate sensitivity particularly with continued asset purchases by the ECB.

We have retained our overweight positioning on commodities as there is evidence of a meaningful supply adjustment in some of the sectors. For agriculture, we have remained positive as future supply of major grains may be impacted from low prices. For industrial metals, this sector remains oversupplied but we have started to see some rebalancing. Moreover, this segment is likely to benefit from the prospect of US infrastructure spending and Chinese stimulus. Hence, over the quarter, we have upgraded industrial metals from a negative to neutral stance. In comparison, in an environment of higher real rates and a stronger USD, we have downgraded gold to neutral. However, gold remains a hedge against the increase in political risks this year. On energy, we have retained our neutral stance despite the agreement to cut production by OPEC and non-OPEC producers. While supply-demand dynamics of the sector are more balanced, a large surplus of oil inventory still exists plus US shale production is rising again.

Table 1: Asset allocation grid – summary

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

Key: +/- market expected to outperform/underperform (maximum ++ to 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 GMP positioning in brackets. Source: Schroders, January 2017.

Regional Equity Views

Key Points

+ (0)	Equities	
0	US	We remain neutral on US equities as the high-quality nature of the market makes it attractive to hold despite higher than average valuations compared to the rest of the world. The prospect of corporate tax cuts and repatriation of overseas cash are likely to provide a substantial boost to corporate earnings. However, earnings could be challenged by a stronger USD and higher interest rates along with the squeeze on profit margins from the pick up in wages. .
0	UK	We have revised up our growth forecast for the UK this year, although a slowdown in the economy is still expected due to weaker business investment and higher inflation putting a dampener on consumer spending both consequences of Brexit. The BoE is expected to keep rates unchanged as growth has not fallen by as much as expected, while inflation is set to rise sharply. Against this backdrop, we believe that the tailwind for revenue growth of multinational corporates from the weakness in the currency has faded. Nonetheless, on our measures, the UK market is one the most attractive in the developed universe from an equity risk premium perspective.
+ (-)	Europe ex UK	Despite the tapering of QE by the ECB, monetary policy remains ultra-accommodative in the region, which should provide some support to the economy. The recent outturn in the data has also been on a stronger footing. Crucially, we expect investors to finally unlock the value found in financials with a steeper yield curve led by higher yields at the long-end of the curve. Meanwhile, political risks in the region are likely to remain a source of uncertainty given the upcoming general elections in the Netherlands, France and Germany. However, we believe that some of these concerns have been priced in by the market.
+ (0)	Japan	Over the quarter, we upgraded Japanese equities as attractive valuations were coupled with encouraging signs of improvement in the economic data. We also expect the economy to receive a lift to growth this year from additional fiscal stimulus, which should be supportive of top-line earnings growth. The BoJ is likely to offer more QE to anchor the long-end of the JGB curve towards zero. Not only would this keep monetary policy accommodative, a weaker yen should provide a boost to corporate earnings. Importantly, analysts' earnings expectations have yet to incorporate the recent depreciation in the currency.
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	We remain neutral on Pacific ex Japan equities driven by our neutral stance on Australia and Hong Kong, but are negative on Singapore. Based on our analysis, the expected equity risk premium for Australia and Hong Kong appear reasonable, but is looking low for Singapore equities when compared to other developed markets. Moreover, the Singaporean economy is highly sensitive to the prospect of higher US interest rates and a downturn in the global trade cycle.
0 (+)	Emerging Markets	Emerging equities continue to offer a valuation discount versus their developed peers. We have also upgraded EM growth expectations for this year. However, our growth indicators on the emerging markets have recently eased at the margins particularly when compared to the latest improvement in activity in the developed world. Furthermore, we recognise that emerging equities are vulnerable to a stronger USD environment along with the prospect of more protectionist policies from the Trump administration. Hence, we have downgraded EM equities to neutral.

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

Fixed Income Views

Key Points

-	**Bonds**	
-	Government	Compared to last quarter, bond valuations have improved but are still unattractive at current levels. Global growth and inflation expectations have also moved higher with the recovery in activity and commodity prices. We continue to be of the view that government bond markets remain vulnerable to shifts in interest rate expectations as central banks attempt to normalise policy with rates rises or less accommodative monetary conditions. Amongst the bond markets, we are still negative on US Treasuries as the short-end remains exposed to further yield adjustments, particularly with the Fed hiking rates this year. Moreover, the prospect of fiscal expansion feeding through at the end of this year and 2018 suggests more aggressive tightening by the Fed. Similarly, we have retained an underweight positioning in UK Gilts. The BoE is likely to remain on hold with regards to interest rates and QE given the less negative outlook on the economy. At the same time, there is the risk that longer-term inflation expectations could accelerate given the depreciation in the GBP, although the central bank is likely look through the rise in the headline rate. Meanwhile, we have downgraded German Bunds to negative given that yields at the long-end are vulnerable to less dovish rhetoric from the ECB particularly given that valuations are stretched when compared to other developed sovereign debt markets. On JGBs, we have turned neutral as the continued weakness on the currency, as a consequence of the BoJ keeping yields at the long-end well-anchored, is increasingly testing the limits of the central bank's willingness to do more QE purchases.
-	Investment Grade (IG) Corporate	We remain negative on US IG bonds given very uncompelling valuations and deteriorating fundamentals, which are at risk from greater sensitivity to higher rate expectations. In addition, given the low carry offered by US IG credit, the higher cost for currency hedges due to elevated USD LIBOR funding costs makes returns unattractive and should continue to deter foreign demand for this segment. European IG spreads are highly correlated with the US such that we are also negative on this segment, although to a lesser degree. This is because valuations are more attractive compared to US IG credit and there is also less rate sensitivity particularly with continued asset purchases by the ECB.
0	High yield (HY)	US high yield should continue to benefit from the stability in the oil price and investors search for yield. However, valuations have been eroded further as spreads have tightened significantly. Overall, we are neutral, as HY offers less rates sensitivity with a higher carry cushion. On European HY, we remain neutral. Europe is in an earlier stage of the credit cycle compared to the US, and technical factors remain broadly positive. Nonetheless, spreads remain firmly anchored around their long-term averages and valuations appear to be unattractive at current levels.
0 ++	EMD USD-denominated EMD local currency-denominated	We remain neutral on emerging market debt bonds denominated in USD as valuations have continued to turn less compelling. Instead, we prefer harvesting the carry in EMD local currency bonds given that valuations are more attractive and fundamentals continue to improve at the margin. With falling inflation expectations within some of the countries in the universe, such as Brazil and Russia, there is scope for more policy easing or less aggressive rate hiking by central banks.
0	Index-linked	We still expect inflation expectations to be lifted by base effects from the oil price along with the rise in wages and prospect of stronger growth. However, the valuation support for break-even inflation rates has moderated following a significant improvement in sentiment. At the same time, we have remained negative on the nominal bond equivalents.

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

Alternatives Views

Key Points

+	Alternatives	
+	Commodities	We have retained our overweight positioning on commodities as there is evidence of a meaningful supply adjustment in some of the sectors. There has also been a reduction in the drag on returns from the negative carry in certain commodity segments. On agriculture, consumption growth has been strong but prices continue to reflect high levels of global stocks. Instead, farmers are coming under increasing financial pressure from low prices, which may impact future supply. Overall, we maintain our positive view on the sector. In comparison, we have turned neutral on precious metals as gold is vulnerable to an environment of higher real rates and a stronger USD. However, gold remains a diversifier in the portfolio and a hedge against the increase in political risks this year, particularly in Europe. Despite the agreement to cut production by OPEC and non-OPEC producers, we have retained our neutral stance on the energy complex. While supply-demand dynamics of the sector are more balanced, a large surplus of oil inventory still exists and US shale production is rising again. There could also be a potential upset in supply from the return of production by Libya and Nigeria. Overall, we need to see evidence that the energy curve has moved into backwardation before upgrading this segment of the market. We have upgraded industrial metals to neutral given that demand is likely to benefit from the prospect of infrastructure spending under the Trump administration and Chinese stimulus to keep the economy well-supported until the 19th National Party Congress. While this sector is still oversupplied, particularly copper and aluminium, we have started to see some rebalancing with lower prices feeding into supply.
-	UK Property	In the occupier market, the outlook is mixed post Brexit where demand for offices in central London by financial services has been hit by concerns over access to the EU single market. Elsewhere, demand for retail space outside London is generally weak given the squeeze on retailers' profit margins. In contrast, there is continued demand for regional offices from professional service firms and the government's plan to consolidate the civil service outside London will provide further support. The industrial and distribution sectors also benefit from the continued growth of online retail. In the investment market, the majority of domestic and foreign institutions and REITs have remained on the sidelines, although the sharp fall in sterling has encouraged foreign private buyers back into the market. UK local authorities are also very active, using their low cost of capital to acquire properties in order to pay for local services. Overall, our base case is for the all property initial yield to rise by 0.25-0.5% in 2017, with most of the increase affecting secondary property. Yields on prime assets with secure income streams should be less affected, but yields on "bond proxy" assets such as supermarkets are likely to rise.
+	European Property	In the investment market, we believe that the era of yield compression in continental Europe is now largely over and that real estate yields will be broadly flat over the next couple of years, for two reasons. Firstly, despite the favourable outlook for rents and the large gap of 3-4% between real estate and government bond yields, we expect that the recent upturn in Eurozone bond yields will draw some capital back to these assets. Secondly, we anticipate that certain investors who entered the market in 2012-2014, such as the US opportunity funds, will now start to sell and take profits. We forecast total returns of 5-7% per annum on average for investment grade European real estate between end-2016 and end-2020, assuming the Eurozone economy continues to grow. The bedrock will be an income return of 4.5%, but capital values should also increase on the back of a steady rise in rents.

Note: Property views based on comments from the Schroders Real Estate Research team.
Key: +/- market expected to outperform/underperform (maximum ++ minimum - -) 0 indicates a neutral position.