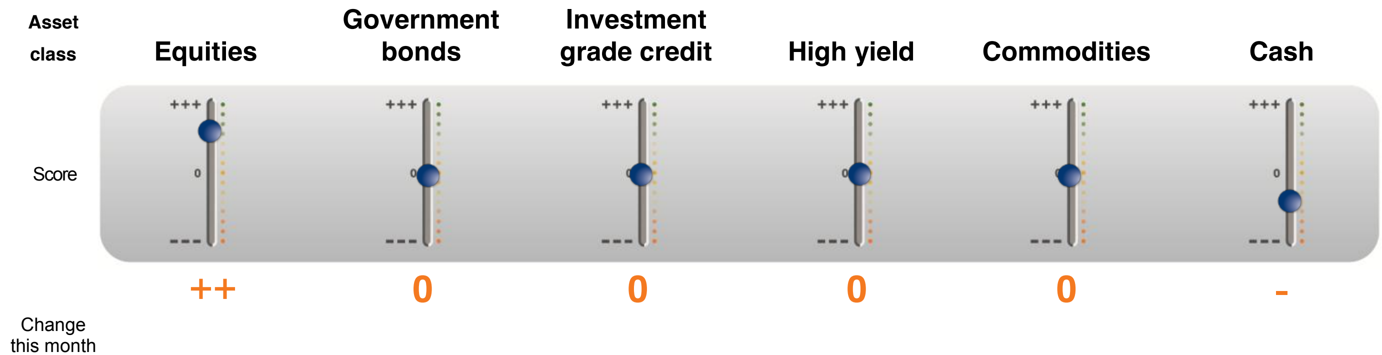
Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – May 2014

Summary



Category	View	Comments
Equities	**++**	**We maintain our positive view on equities as we believe that the gradual economic recovery will continue to drive earnings growth even though valuations are no longer looking as attractive as they were.**
US	+	Valuations look stretched compared to other equity markets and are vulnerable to interest rate volatility with margins at a historic high. However, corporate fundamentals still look solid and we are confident that the economic recovery in the US will persist.
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. There is speculation that measures will be introduced to cool rising house prices, although the market does not expect interest rates to rise in the near future.
Europe	+	The increasing probability of forthcoming stimulus from the European Central Bank (ECB) and the region's relative cheapness means we are positively positioned. Growth prospects remain positive and we expect profit margins and earnings to recover this year. The main concern on this front is that inflation continues to be weak, pointing to a lack of economic momentum.
Japan	0	The performance of Japanese equities has faltered this year in anticipation of the recent increase in the consumption tax. The widespread assumption that there will be further easing from the Bank of Japan (BoJ) is at odds with the bank's confidence in the economic recovery, potentially leaving room for further disappointment.
Pacific ex Japan	0	We have maintained our neutral stance on the region. Australia's economy remains vulnerable to a further reduction in demand for commodities and a slowdown in the property sector.
Emerging Markets	0	Although valuations are at historical lows, geopolitical tension in Ukraine remains a key concern for investors. Many emerging market (EM) countries remain vulnerable to capital flight and to the impact from the US Federal Reserve's (Fed) tapering of quantitative easing (QE).
Emerging Markets Asia	+	Tactical opportunities have arisen as the People's Bank of China recently softened its tightening rhetoric and as the government introduced a mini-stimulus package. Korea and Taiwan are well-positioned to benefit from the continuing global recovery.

Category	View	Comments
Government bonds	**0**	**We maintain our neutral duration position because reduced expectations for growth and inflation pose a high hurdle for shorting markets with positive carry. Positive carry and expectations of more monetary policy stimulus (ECB, Japan, China) are supportive for bonds.**
US	0	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 returns from carry and from rolling down the yield curve. The fall in the US 10-year Treasury yields since the start of the year was due to the previous over-reaction to the Fed's QE tapering programme and to lower inflation expectations.

UK	0	While recent UK data has been encouraging (and hence negative for bonds), we still expect short term rates to remain anchored due to the dependence of the recovery on the UK housing market and to the high levels of household debt. Therefore, we retain our neutral outlook.
Europe	0	Slowing exports (a result of weaker Chinese demand), combined with the strengthening euro, are continuing to dampen any growth momentum and so deflationary pressures persist. Meanwhile, stubbornly high real yields in periphery Europe represent a major hurdle to a recovery in economic growth.
Japan	0	Japanese economic data has recently deteriorated after the government raised the consumption tax for the first time in 17 years in April. We expect the BoJ will intervene with further QE given the adverse impact this rise will have on Japanese growth, combined with softness in China and a weaker renminbi. We, therefore, maintain our neutral view.
US inflation linked	0	Despite the tightening of the labour market in some regions and a spike in the prices of commodities such as agriculture this year, inflation remains muted.
Emerging markets	0 ↑	We upgraded our view on emerging market USD bonds to neutral because of our neutral US duration view and the positive carry. Subdued inflation and weaker global growth should provide support to EM bonds.

Category	View	Comments
Investment grade credit		
US	-	Although US investment grade should remain supported by the US recovery, we remain negative because of the possibility of interest rate hikes, a rotation into equities and policy tightening increases. Our view should also be seen relative to our view on European investment grade, where we are positive.
Europe	+	We continue to favour European investment grade over US investment grade. While technicals remain supportive, the ECB is now confronted with deflation risks. Thus we believe there is potential for further monetary stimulus, which would provide support for the sector.

Category	View	Comments
High yield credit		
US	- ↓	We have downgraded US high yield to negative. This is mainly based on valuation concerns and credit spreads having tightened substantially. US high yield currently looks expensive and even if the environment remains positive, we believe there will be better opportunities outside this sector.
Europe	0	Although fundamentals are starting to deteriorate we remain neutral. The euro area is exposed to anaemic credit growth and exceptionally low inflation. The ECB is therefore expected to ease monetary policy further and then keep it accommodative for longer.

Category	View	Comments
Commodities	**0**	We maintain our overall neutral stance towards commodities. This partly reflects the continued uncertainty concerning both agricultural prices resulting from unpredictable weather patterns, and Chinese policy, which 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 exert control over the crude oil market, meaning we do not anticipate a dramatic fall in prices.
Gold	0	We remain neutral on gold and are monitoring the price closely. The price has recently stabilised, although the tension between the structural case (demand from sovereigns) and short term sentiment (negative) continues.
Industrial metals	0	We remain neutral and have refrained from initiating a positive score on the basis that we believe the structural trend in prices is lower, given ongoing supply and demand headwinds. However, given the negative sentiment towards Chinese-related assets there is scope for a further rebound in prices.
Agriculture	0	Although we remain neutral, there is an increased amount of weather uncertainty which makes it difficult to predict future price movements. There have been some significant moves year to date, most notably in coffee prices after the drought in Brazil. We also believe soybean prices are overvalued. Agriculture prices could be peaking and so we may turn negative in the near future.

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 Fed to continue to taper QE. 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. We are not predicting a rate hike this year but expect the Bank of England to sound progressively more hawkish.
Euro	-	We continue to see deflationary pressures in the eurozone and anticipate growing expectations for additional ECB easing. When compared to other G10 central banks, the ECB remains relatively dovish. We expect the euro to come under pressure in the near-term as a result.
Japanese yen	- - - ↓	Economic data has deteriorated following Japan's consumption 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 Swiss National Bank 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 return 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, May 2014. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged).

Section 2: Multi-Asset Insights

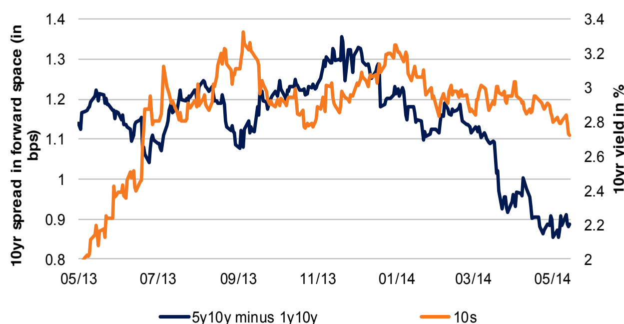
By Matthias Scheiber and Aymeric Forest, Fund Managers, Multi-Asset

What is the forward curve telling us about US Treasury yields?

US 10-year Treasury bonds have generated positive performance of +3.5% in the first four months of this year with this fall in Treasury yields taking many investors by surprise. Lower US growth in the first quarter, and lower-than-expected inflation numbers, have caused bond investors to reassess the value of long-term bonds. Most bond investors have remained underweight interest rate risk and are asking themselves how much further Treasury yields can drop from here.

The forward curve can give us some indication of future spot market moves. The UST 10-year yield in forward space (defined as the 5-year forward yield minus the 1-year forward yield in **Figure 1** below) started to price in the consequences of quantitative easing (QE) tapering only when the US Federal Reserve (Fed) took action in December last year. This resulted in a flattening of the forward curve as the Fed was perceived to be slightly ahead of the game. The UST 10-year spot yield did not react until the beginning of January to this downward pressure, as the market's optimistic growth and inflation forecasts kept short-term rates higher. This divergence between longer-term forward spreads and the UST 10-year spot rate did not last very long and yields quickly adjusted downwards. The current forward curve spread has continued to fall over the past two weeks (despite the growth rebound in the US after the harsh winter), which would suggest a lower UST 10-year yield over the coming weeks.

Figure 1: UST 10-year yield spot versus forward spread (5-year minus 1-year forward spread)



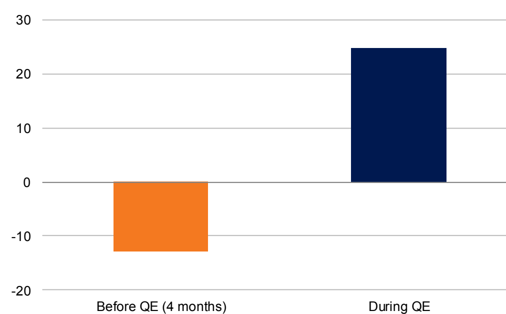
Source: Schroders, Bloomberg, May 2014

European inflation update

Despite recent signs of a modest recovery in European growth, inflation in the region continues to stay at stubbornly low levels. The last few months have seen inflation below 1% and concerns over the momentum in growth have recently sparked renewed concern over the risk of deflation faced by Europe. This low inflation was partly due to increased deflationary pressures from food and energy prices, but also lower import prices resulting from the strength of the euro. While deflation in the eurozone is not our central view, as we see economic recovery continuing, we do recognise that the risk is rising.

As a result, speculation concerning possible QE, or similar large-scale asset purchase programmes from the European Central Bank (ECB), has received a fair amount of attention lately. If the ECB decides to act, real yields in the eurozone could, all other things being equal, fall further than nominal yields as the market focuses on the ECB's ability to raise inflation expectations. Previous programmes of monetary stimulus that have been undertaken in the US and UK have highlighted that, from a timing perspective, the rise in inflation expectations has generally taken place only after the actual QE implementation (as illustrated in **Figure 2**). If history holds true, the implication of this from a portfolio management perspective would be to wait for the QE intervention to start before switching part of any nominal exposure into linkers in order to take advantage of this opportunity.

Figure 2: Change of inflation expectation (1-year ahead inflation forecast on the Philadelphia Fed Survey of Professional Forecasters)

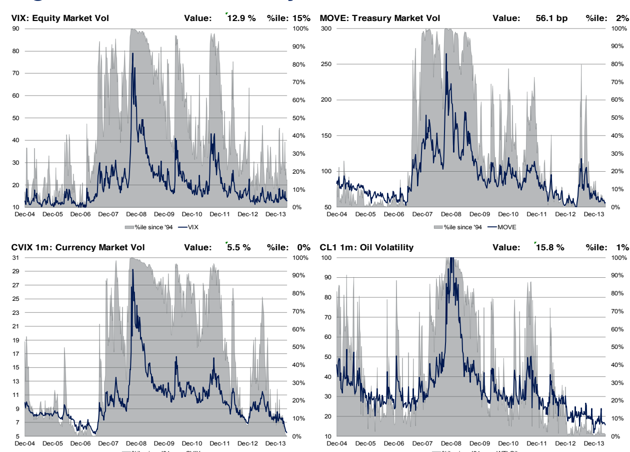


Source: Schroders, Bloomberg. November 2008 to March 2013

Why is volatility so low?

With the Fed continuing to taper QE, and with forward guidance becoming less explicit as targets are hit, it might be natural to expect to see volatility rise. However, we are currently seeing volatility decrease, not only in equities, but across asset classes with volatility hitting multi-year lows (see **Figure 3**).

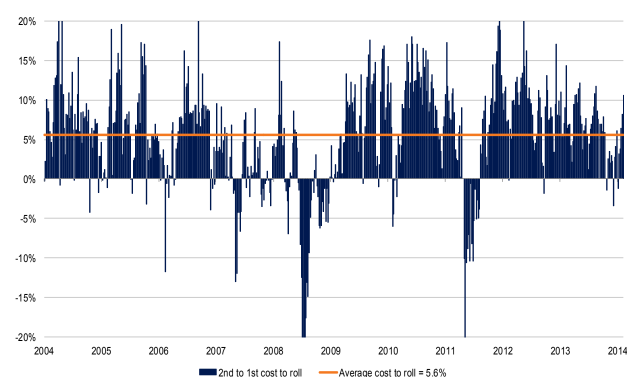
Figure 3: Market volatility



Source: Schroders, Bloomberg 9 May 2014

However, we do not believe that this current low volatility environment indicates that market participants are being complacent. For example, despite the low level of volatility, the cost of holding equity volatility[1] as protection is 10% per month, which is well above the average of approximately 5.5% (**Figure 4**).

Figure 4: Cost of holding a long position in the 2nd VIX futures contract



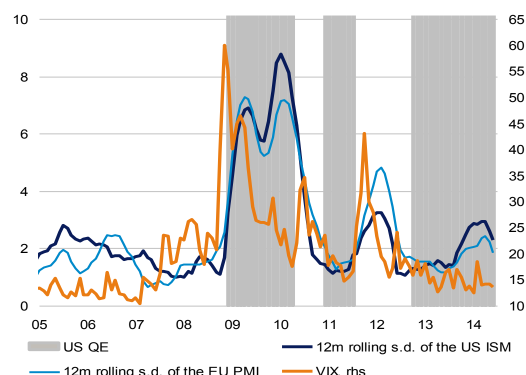
Source: Bloomberg, Schroders calculations at 19.05.14

The outstanding open interest (OI) in Dec 14 puts on the S&P 500 provides further evidence that the complacency we witnessed earlier in the year has dissipated. Puts which are 5-10% out the money (OTM) have nearly doubled as a proportion of outstanding OI at year end from 6% to around 13% at present. Further, we have seen S&P 500 3m 90-110% skew increase from very low levels to around average now, implying a greater demand for downside protection vs upside exposure than markets had been pricing earlier in the year. Finally, the volatility risk premium on the S&P 500 (1m implied at the money volatility minus 1m realised volatility) is once again positive, implying that market participants are prepared to pay more for volatility than the market is actually delivering. Taking these points together, we would argue that market participants are using the low volatility environment to add protection to their portfolios.

This phenomenon of persistently low volatility is usually explained by the Central Bank's response to the financial crisis and the 'put' option that has been in place on risky assets. This has helped to prop up global growth and markets and has, therefore, dampened volatility. Furthermore, the introduction of forward guidance has served to reduce uncertainty over the future path of interest rates, which has also served to reduce volatility. Some of the continued reduction in cross asset volatility could be in response to/anticipation of other central bank QE programs (Bank of Japan, ECB). Another source of this low volatility is that global growth is currently looking much better: the US growth picture looks healthy; the eurozone is finally out of recession (in particular the periphery is rebounding); and here at home the UK is currently the fastest growing developed market in the world. All are likely to be contributing to the low levels of volatility we are currently witnessing.

We can assess the risk environment by analysing a number of fundamental indicators[2]. These are currently showing little sign of stress across the range of indicators we monitor. The two main points of stress we do pick up from this work come from volatility in economic activity indicators (see **Figure 5**), and from the Chinese money market.

Figure 5: VIX vs. volatility of PMI data



Source: Schroders, Bloomberg.

Two potential causes of a future spike in volatility are disappointment over future growth, since expectations are already high, and the potential for stress from emerging markets/China. We had identified these in our volatility outlook paper earlier this year and we believe they remain critical to monitor.

If central bank liquidity provision and the use of forward guidance has been dampening volatility, then its withdrawal over the coming 12 months could result in an increase in volatility. Arguably the recent flattening of the yield curve is a harbinger of this. Given the gradual path of the reduction in liquidity, this process of normalisation could be extended. However, with the mean reverting nature of volatility, we believe it is currently cheap and will normalise upwards over the coming months towards its longer term average of 20. This is why we recommend adding actively managed volatility to your portfolio, which can reduce the cost of protection over time.

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[1] Represented as the cost of rolling down the VIX futures curve from the 2nd to the 1st contract

[2] See our Technical Note on volatility contagion channels

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