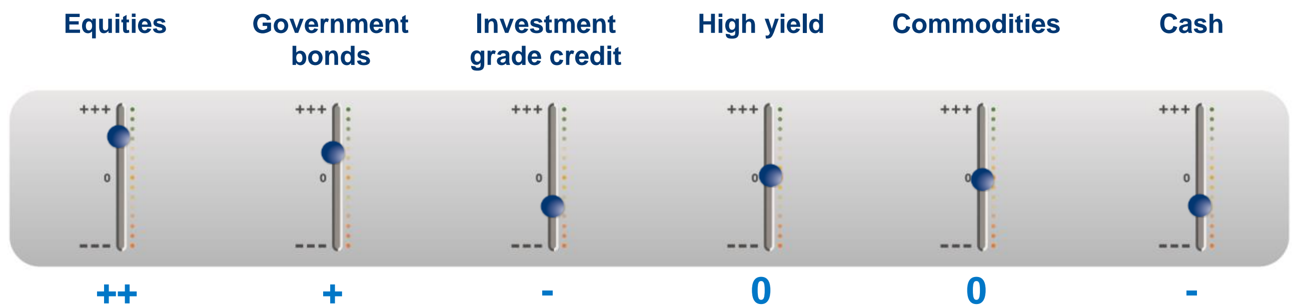
Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – October 2014

Summary

Equities	Government bonds	Investment grade credit	High yield	Commodities	Cash



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Category	View	Comments
Equities	++	**We maintain our overall positive score on equities; we recognise that valuations are not as attractive as they have been over the last couple of years but central bank liquidity and stable corporate earnings are supportive of equity returns. The main concern is that the economic recovery has, so far, been focused almost exclusively on the US. Accordingly we are focusing our positive view on the US and Japan where economic growth and corporate earnings trends are most supportive. We have downgraded emerging equities to neutral reflecting softer global growth.**
US	+	The US, which is very much leading the recovery, continues to be one of our favoured markets. Our indicators show that the trade-off between Growth and Inflation looks most attractive in the US. Rate hikes by the Fed are not expected any time soon given a lack of inflationary pressure and a somewhat stalling growth outlook for other regions such as the eurozone. Ample liquidity, along with earnings potential and growth momentum support out positive view on this market.
UK	0	While this market can perform poorly if the outlook for global growth deteriorates due to its sensitivity to emerging market and policy risk, we believe that this will coincide with a depreciation of sterling and offer some respite to the FTSE 100 index, whose consituents generate a meaningful proportion of earnings overseas. Furthermore, this market has underperformed global equities so far this year, suggesting investors have already priced much of the bad news.
Europe	0	Value in European corporates resides in the industrials, resources and energy sectors. Whilst these export-oriented sectors should receive a boost from a lower euro, the weakness in global trade multipliers is a barrier to unlocking this value in the near term. Investors remain hopeful that the ECB will come to the rescue but we believe that a material deterioration in the macroeconomic environment would be required to trigger full quantitative easing by the ECB.
Japan	+	Simially to the US, growth momentum, a liquidity cushion and attractive corporate earnings all support the case for a positive outlook on this market. Whilst the earnings recovery has been partly driven by the weaker yen, the change in corporate attitudes has also been a dominant factor. Unlike previous cycles of yen weakening, Japanese corporates have not reduced overseas prices or increased investment spending, enabling them to lock in gains and expand margins, which in turn should present opportunities for returning value to shareholders.
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	0↓	We have downgraded our score to neutral, acknowledging the deterioration in global growth prospects. Valuation opportunities are concentrated in the commodity and investment sectors, which remain most exposed to US dollar strength and economic weakness. We are more positive on the manufacturing sectors, particularly those exposed to the US recovery, but valuations are less compelling.

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Category	View	Comments
Government bonds	**+↑**	**We have upgraded our overall score for duration assets on the basis that global inflationary pressures remain very subdued and that growth momentum (with the exception of the US) is weak. Given this backdrop, we believe that Janet Yellen, chair of the Federal Reserve, is not under immediate pressure to raise rates.**
US	0	Whilst we believe that rates could fall at the long end of the yield curve, given the lower inflation outlook, we are less constructive on the short end, leaving our score at neutral overall. From a relative perspective, we continue to favour bunds and gilts over treasuries.
UK	+↑	We have upgraded to a positive score as growth momentum has slowed and gilts are benefiting from safe-haven flows as both the economic and geopolitical environment in Europe deteriorates. We favour the 10 year gilt over other parts of the curve on an outright basis and on a relative basis we prefer gilts to treasuries.
Germany	+↑	Whilst our views on the individual parts of the curve have not changed since last month and we continue to hold a 2/10 flattener position (negative outlook for the 2 year and positive outlook for the 10 year government bonds), we have upgraded our overall score. This reflects our increasingly positive outlook for the 10 year given lower inflation expectations.
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	0↓	We have closed our position, downgrading our outlook to neutral given benign inflationary pressures and a recent slowdown in growth momentum.
Emerging markets	-↓	We have downgraded our outlook for EM USD bonds as our indicators suggest that spreads will widen further. Negative momentum and sentiment are also offsetting carry. Within the local EM bond market, we have moved out of Polish 10 year government bonds after the latest rate cuts, but we still like the front-end of the curve in South Africa, as well as 10 year Korean bonds because of a supportive central bank and strong Asian flows.

Category	View	Comments
Investment grade credit	**-↓**	
US	-	We maintain our negative outlook as the uptick in M&A activity seen during the third quarter remains a dangerous headwind and US IG spreads have become more exposed to interest rate volatility. Recently IG credits have been fairly resilient to market weakness, making them relatively expensive.
Europe	0↓	European credits have benefited from ECB support which has been faced with lacklustre growth and falling inflation. Uncertainty for the region has been increasing while a lack of political will makes it more likely that the ECB will disappoint. This pushes us to downgrade Euopeam IG to neutral.

Category	View	Comments
High yield credit	**0↑**	
US	0↑	Given the sell off during September and early October, we have upgraded our view to neutral based on tactical opportunities and the fact that the relative attractiveness of European HY over US HY no longer exists. Unlike US IG credit, M&A activity should remain a supporting factor and the additional level of spread provides more of a buffer to unfavourable interest rate moves. However, at this stage we do not see valuations attractive enough to establish outright long positions.
Europe	0	From a technical perspective this market looks more attractive than its US counterpart, with fewer outflows seen in Europe compared to the US. However, underlying growth concerns and idiosyncratic events are dominating market sentiment. With support from the ECB already discounted and the growth outlook deteriorating, we no longer favour European HY over US HY.

Category	View	Comments
Commodities	**0**	**We remain neutral as prices have fallen in line with the fundamentals. For commodities to be attractive we need to see an acceleration in global growth.**

Energy	0	Prices have fallen a long way and are now trading around the marginal cost of production. Saudi Arabia appears to be tolerating prices at this level, enabling them to gain market share. We would look to upgrade our score if we saw a meaningful acceleration in global growth or greater supply discipline.
Gold	0	We maintain a neutral view as gold continues to trade in a range. ETF outflows resumed following the price drop in September and net futures positioning is at the shortest that we have seen this year. A stronger US dollar, real yields moving higher and/or if we see gold breaking out of the lower end of the range would push us to be less constructive on this market.
Industrial metals	0	Metals have suffered from a combination of US dollar strength and some renewed weakness in emerging market assets. We remain structurally bearish on this axis given supply and demand headwinds. However, we retain our neutral stance at present due to on-going support from Chinese policy makers who maintain an easing bias, which should continue to provide support for some metals.
Agriculture	0↑	We have upgraded our view from negative to neutral. After the strong correction in prices over the past month the risk-reward trade-off has deteriorated. Despite supply headwinds, we believe there is limited downside for grains and oilseeds at current price levels. We feel that the market is likely to trade sideways from here, although volatility in the soft commodities – coffee and sugar – will increasingly drive the index.

Category	View	Comments
Currencies		
US dollar	++↑	The continuation of the recovery in the US and the growing 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 maintain a neutral position on sterling due to our belief that expectations for rate rises are fully priced, while we believe that rate hikes will be pushed back on concerns at a slowdown in the economy.
Euro	0↑	We have upgraded the EUR following the recent sharp correction. Despite this, we expect it to remain under pressure relative to the US dollar due to ongoing deflationary pressures in the Eurozone and the ECB's efforts to combat them.
Japanese yen	- - -	We expect that the Japanese yen will weaken further as the market begins to anticipate additional easing from the BoJ to offset the effect of the consumption tax hike.
Swiss franc	-↑	We remain negative on the Swiss franc against the euro. The Swiss National Bank has reaffirmed its policy to prevent any CHF appreciation through the explicit CHF/EUR floor and, with limited inflation, there is little pressure to raise interest rates.

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

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

Section 2: Multi-Asset Insights

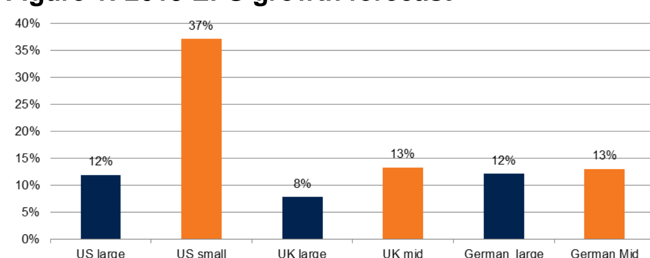
By Remi Ajewole and Urs Duss, Multi-Asset Fund Managers

US Small Caps – time to take profit?

In April we downgraded our view on US small caps to negative, based on a valuation which was extremely stretched. Since then, even though we have seen significant underperformance of this market, valuations remain stretched.

Aside from valuation, there are other factors that support our negative position. Figure 1 below shows that investors are overly optimistic with regards to US expectations of earning growth for small caps relative both to large caps and to other small cap markets.

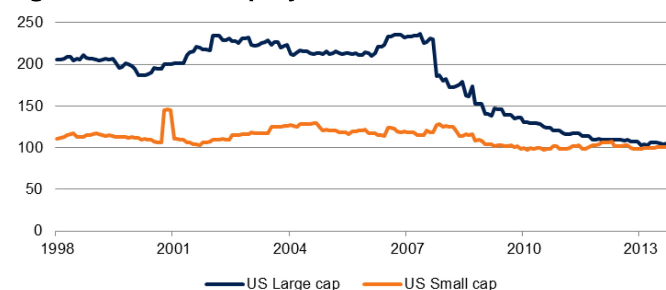
Figure 1: 2015 EPS growth forecast



Source: Datastream, as at 30 September 2014.

Furthermore, smaller companies have been the primary beneficiaries of the excess liquidity provided by central banks. While the impact of tighter credit conditions has not been consistent over history, Figure 2 highlights that, unlike their large counterparts, smaller companies have not taken advantage of the low cost of debt to de-lever their balance sheets. This suggests that small caps are more exposed to a tightening in liquidity conditions than was the case in previous cycles.

Figure 2: Debt to equity ratio



Source: Bloomberg, as at 30 September 2014.

There are, however, reasons to expect the performance of smaller caps to improve. As shown in Figure 3 a significant proportion of the overvaluation of US small caps is coming from two sectors – consumer staples and energy. The latter is dominated by the energy equipment, drilling and service sectors that have benefited from the shale gas theme. However, with the recent plummet in oil prices these stocks have already corrected significantly and we need to be aware of the potential for short-term reversal.

Figure 3: Median forward PE of small and large cap sectors

12M FWD Median P/E	Small Cap	Large Cap	Small Cap / Large Cap Rel. P/E	Average Rel. P/E	% Diff from Avg Rel. P/E
Consumer Discretionary	19.4	17.4	1.1	1.0	7%
Consumer Staples	21.0	17.6	1.2	1.0	21%
Energy	23.2	14.7	1.6	1.1	38%
Financials	15.3	15.0	1.0	1.1	-9%
Health Care	19.8	16.9	1.2	1.1	4%
Industrials	19.6	16.5	1.2	1.1	9%
IT	20.0	17.1	1.2	1.1	4%
Materials	18.9	19.0	1.0	1.0	-2%
Telecoms	N/A	16.1	N/A	N/A	N/A
Utilities	17.7	15.8	1.1	1.1	-2%

Source: BAML. Small Cap is the BAML Small Cap universe and Large Cap is S&P 500.

The strength of the US dollar could also provide relief for US small caps given their domestic orientation. For now though, the move upwards in the dollar has led to concerns over growth for more cyclically exposed smaller companies.

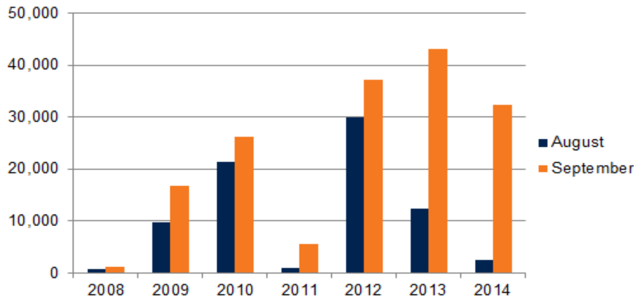
At present we do not feel it is time to upgrade our view on this market but we believe that the worst performance is behind us for this sector.

CCC issuance – risks to watch

In the credit markets, corporates returned to the market after the summer break, with a surge in issuance in September. The US high yield market saw an increase in issuance from $2.5bn in August to $32bn in September on a gross basis.

This trend of increased issuance in September has been occurring for the past few years, although as shown in Figure 4, 2013 and 2014 have seen the most notable increases. Unlike previous years however, we saw interesting supply and demand dynamics in September. Investor cash levels were at very low levels following the outflows in credit markets over the year, meaning issuance was hard to absorb without impacting the secondary market this time around.

Figure 4: US HY gross new issuance ($m)



Source: BAML as at 30 September 2014.

A key contributor to the high level of issuance over the past few years has been the attractive rate environment. For as long as Fed monetary policy remains loose, companies will take advantage of low rates either to refinance existing issues or fund corporate activity.

A consequence of this low-rate environment is that over the past couple of years we have observed a greater proportion of CCC-rated issuers accessing the high yield market and for many of these, it is their first time. This is shown in Figure 5.

Figure 5: % CCC issuers accessing primary market (12m)

Source Source: BAML as at 30 September 2014.

The current low-rate environment is conducive to this trend as investors have moved down the quality spectrum in droves to achieve the yields they require. Further, whilst ratings for first time issuers are decreasing, yields have actually decreased, with investors barely rewarded for historical levels of CCC default risk they are assuming.

Whilst there is no cause for immediate action, these indicators of aggressive issuance need to be carefully monitored as they could predict the turning of the credit cycle with a rise in defaults as financing costs rise. Whilst we upgraded our short position in US HY to neutral, we do not consider that valuations are sufficiently attractive be more positive at this stage in the cycle.

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