SELL IN MAY, MAYBE, BUT BUY THE DIPS

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Multi asset views from RLAM

Royal London Asset Management manages £86 billion in life insurance, pensions and third party funds*. We are developing new multi asset solutions for institutions and retail investors, subject to FCA approval.

*As at 31/03/2015

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Stock markets exhibit pronounced seasonal behaviour. As the focus chart shows, the world market has returned an average 10% a year since 1973. Incredibly, the return in the months of May to September has averaged close to zero.

Summer trading volumes are thin and the market is often caught in a volatile sideways trading range. This year feels no different. With depressed investor sentiment and a positive economic backdrop, we are buying the dips.

Welcome to the first edition of the Investment Clock, our regular asset allocation research report. This release coincides with the launch of a new website www.investmentclock.co.uk which includes the multi asset team's up to the minute thoughts and ideas. We hope you find it useful.

We used stress surrounding Greece's standoff with its creditors and the China stock market slide to add to equity overweights in the multi asset funds we manage. Stock markets are usually volatile in the summer but we see above trend global growth and low inflation. Policy is loose and this is the equity-friendly Recovery phase of the Investment Clock.

Introducing the Investment Clock

Over the last 20 years we have developed and refined an investment strategy that makes use of a range of intuitive tactical models to anticipate the markets and add value for our clients. The concept of an Investment Clock, linking the performance of different assets to the stage of the business cycle, is an old one. Our innovative approach uses global growth and inflation trends to tell what time it is on the Clock and to position for what is likely to come next.

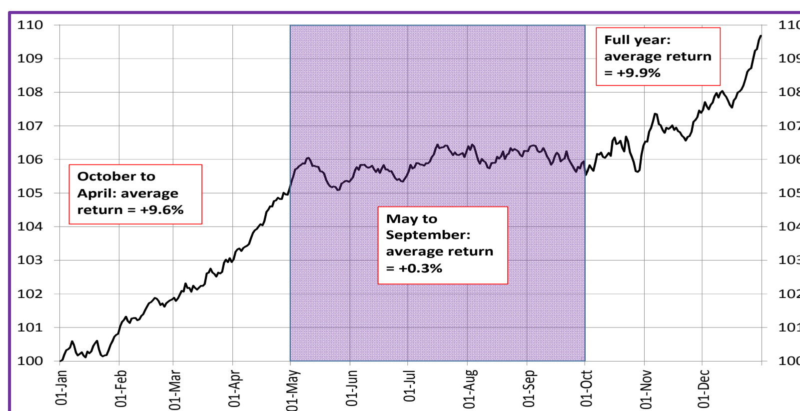
In Equity-Friendly Recovery

Global growth is above trend with unemployment rates trending lower in all of the major economies but aggressive monetary tightening is not on the cards after last year's oil price collapse caused inflation to drop. This is the equity-friendly Recovery phase of the cycle and we are overweight stocks versus bonds in the multi asset funds we manage. We favour Europe and Japan, markets with the best growth outlook and the most aggressive monetary ease.

Buying the dip on Greece, China

Thin summer markets are prone to negative shocks. Events in Greece matter greatly for the long-term viability of the euro, as we outline in a Special Report. Near term, it is hard to see problems in a country making up one percent of European Union GDP having a lasting impact on world markets. Meanwhile, weakness in China could turn out to be good news for the rest of the world if it causes a further drop in commodity prices and keeps inflation low. With sentiment depressed we have used the latest bout of uncertainty to add to equity positions.

Focus Chart: Average Global Stock Market Profile Since 1973



Source: Datastream World USD Total Return, average calendar year profile 1973 to 2014, rebased to 100 on 1 January.

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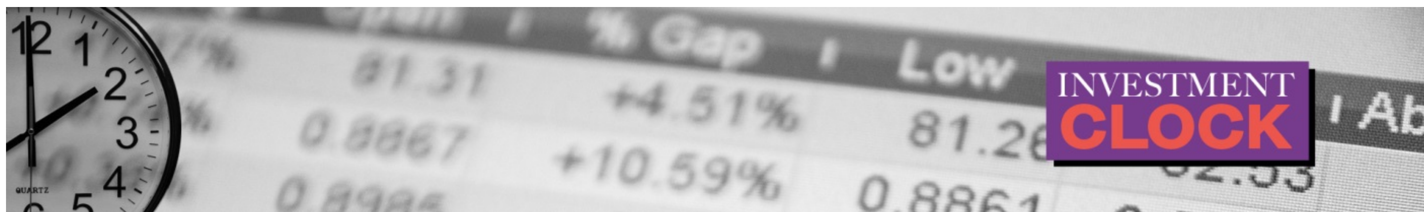


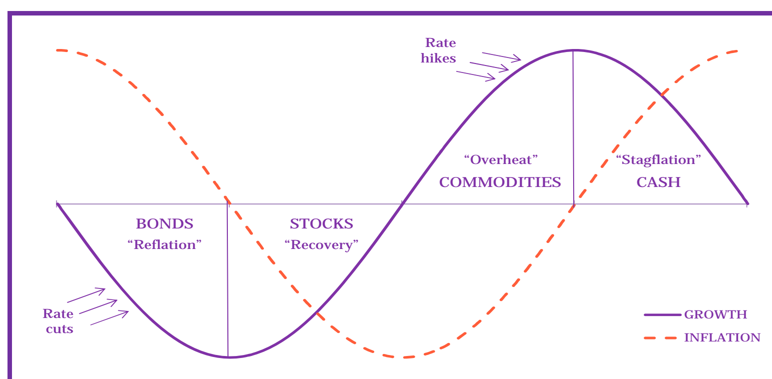
A RESEARCH-LED INVESTMENT PROCESS

RLAM's tactical asset allocation process is grounded in quantitative analysis but allows room for judgement and experience to play its part. An appreciation of history and of what drives markets helps us develop models that capture what usually works. These form the starting point of a fundamental discussion about what may be different this time and how we should position the multi asset funds we manage.

The Investment Clock is our most useful model as it can help with a wide range of decisions from high level asset allocation to equity, fixed income and commodity sector strategy.

The concept of positioning investments around a clock face representing the business cycle can trace its history back to 1937. Our insight is to understand that trends in global growth and inflation can tell you what time it is on the Clock. This allows you to analyse what does well and when, and also to develop indicators that help you to position for what comes next.

Chart 1: The Economic Cycle

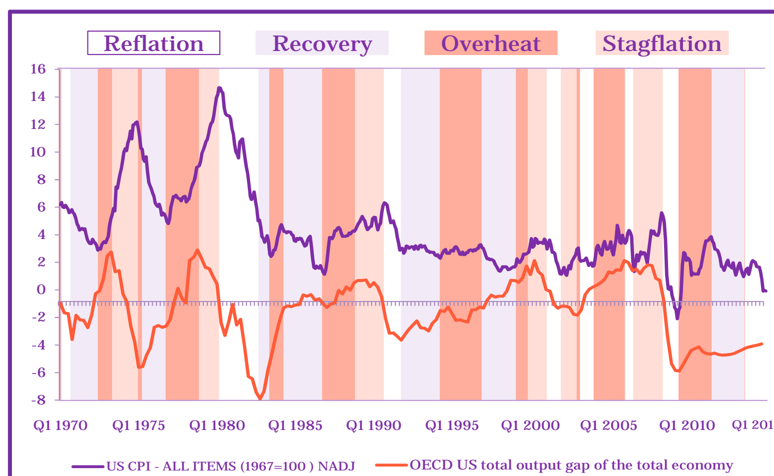


Source: RLAM

We split the cycle into four phases depending on the strength of growth and the direction of inflation and we link each with an asset class that we expect to do well at that time:

- 'Reflation' is defined by weak growth and falling inflation. Central banks cut rates and bonds should do well.
- 'Recovery' starts when monetary stimulus takes effect. Growth and profits rebound but spare capacity keeps inflation low and policy loose. Stocks should do best.
- In 'Overheat', growth and inflation are rising and central banks hike rates. Commodity prices should be strong.
- 'Stagflation' is when growth slows but inflation continues to rise, like a hang over after the party. Cash should be attractive.

Chart 2: Growth and Inflation Cycles in the US since 1973



Source: OECD detrended economic growth estimate for the US economy and headline Consumer Price Inflation.

We use the benefit of hindsight to identify the four phases of the cycle in the US economy since 1973. An analysis of returns supports the intuition with bonds doing best in Reflation, stocks in Recovery and commodities in Overheat. Cash was the best of a bad bunch of financial investments in Stagflation (though most episodes were linked to temporary oil price shocks so commodities did better).

Table 1: Real Asset Class Returns across the Cycle

	Growth	Inflation	Bonds	Stocks	Commodities	Cash
Reflation	↓	↓	9.5%	-3.3%	-27.4%	3.1%
Recovery	↑	↓	4.9%	20.9%	-10.0%	1.3%
Overheat	↑	↑	0.8%	6.8%	17.4%	0.4%
Stagflation	↓	↑	-0.7%	-13.6%	38.9%	-0.4%
	Average Return		**3.2%**	**6.4%**	**2.6%**	**1.0%**

Source: Real annualised returns for US Treasuries, S&P Composite, GSCI Commodity index and 3 month T Bills.

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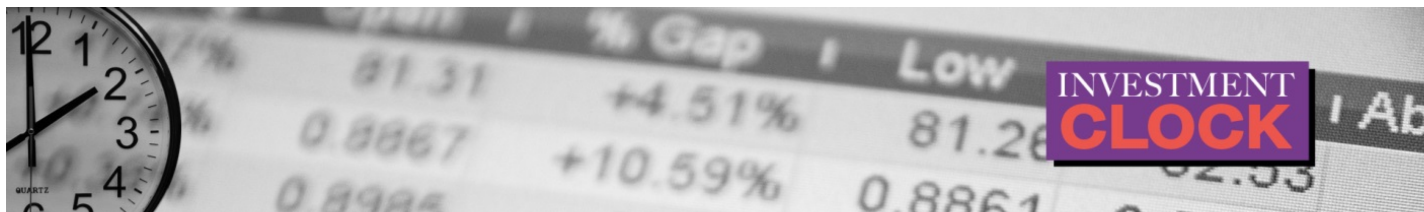

INTRODUCING THE INVESTMENT CLOCK

If we draw the economic cycle as a circle, growth and inflation become the vertical and horizontal axes. A 'normal' cycle starts at the bottom left and proceeds in a clockwise direction. We position different asset classes in the phase in which they usually outperform to create the Investment Clock.

Chart 3: The Investment Clock Diagram

INFLATION RISES

GROWTH MOVES ABOVE TREND

GROWTH MOVES BELOW TREND

RECOVERY

Industrial Metals

OVERHEAT

TECHNOLOGY & INDUSTRIALS

CONSUMER DISCRETIONARY

MATERIALS & ENERGY

Corporate Bonds

High Yield Bonds

STOCKS

COMMODITIES

Softs

Energy

BONDS

CASH

FINANCIALS & CONSUMER

Government Bonds

Inflation-Linked Bonds

TELECOM, STAPLES, HEALTHCARE & UTILITIES

REFLATION

Precious Metals

STAGFLATION

INFLATION FALLS

Source: RLAM 9 July 2015

The Investment Clock can be used to select investments when you have high conviction on the outlook for economic growth.

- If you **expect growth to be strong** you buy cyclically-sensitive assets in the top half of the diagram. That means stocks, commodities, cyclical equity sectors, corporate credit and industrial metals.
- If you are **worried about growth** you invest in 'safe haven' assets in the bottom half, such as bonds, cash, defensive equity sectors, government bonds and gold.

Equally, the Investment Clock can be used when you have a view on inflation.

- If you **expect inflation to fall** you buy stocks, financial and consumer sectors, and long duration bonds on the left hand side.
- If you **anticipate a rise in inflation** you keep your money in commodities and cash, you buy shares in resource companies and you favour inflation-linked bonds and junk bonds that will benefit as the real burden of debt is inflated away.

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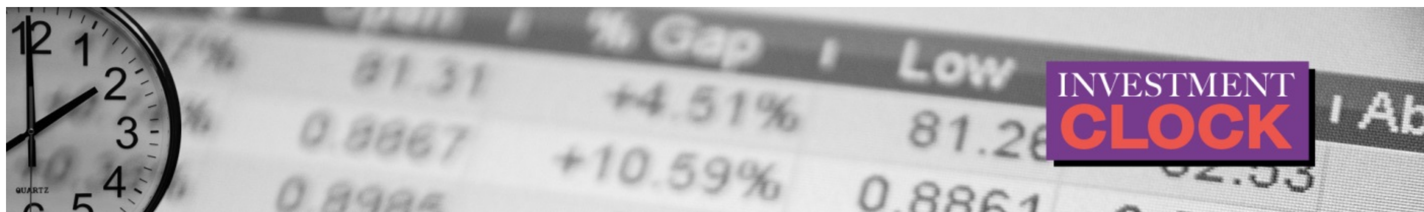


TELLING THE TIME: RECOVERY INTO OVERHEAT?

Our back-tested quantitative model uses trends and lead indicators for growth and inflation to tell where we are on the Investment Clock. Currently global growth is above trend and inflation is falling, which puts us in the equity-friendly Recovery phase of the cycle. However, inflation pressures are starting to re-emerge, which suggests a move into a mild form of Overheat in H2.

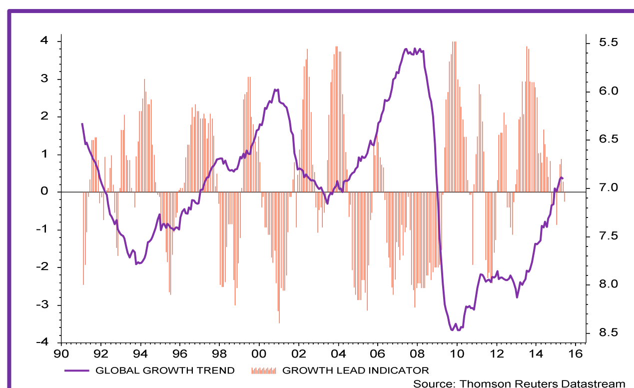
Growth is above trend

- We use the trends in unemployment rates to establish if we are in a strong or a weak world economy. A falling unemployment rate indicates above trend growth and this is what we have seen since 2009, though with a weaker 2012.
- Our global growth lead indicator has been patchy lately on the back of a surprisingly weak Q1 in the US. The US is rebounding, however, so we are constructive on growth.

Inflation is low

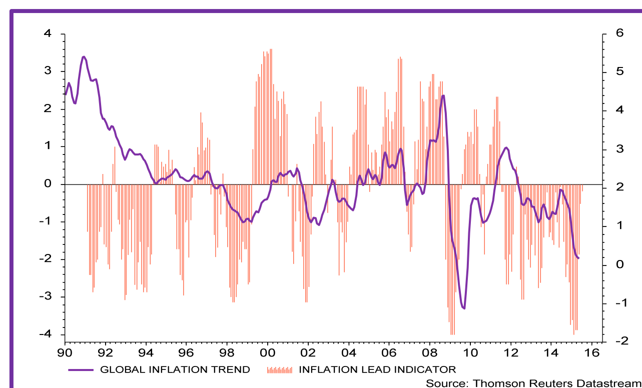
- The trend in global inflation has been downwards since China started to slow down and commodity prices peaked in 2012.
- Our global inflation lead indicator has been rising rapidly in recent months, as easier year-on-year comparisons feed through. This bears watching, though China's stock market slide may trigger further welcome falls in commodity prices.

Chart 4: Global Growth Indicators



Source: Growth trend based on global unemployment rate (inverted). Lead indicator takes into account central bank policy, OECD lead indicators, business confidence and economist GDP forecasts.

Chart 5: Global Inflation Indicators

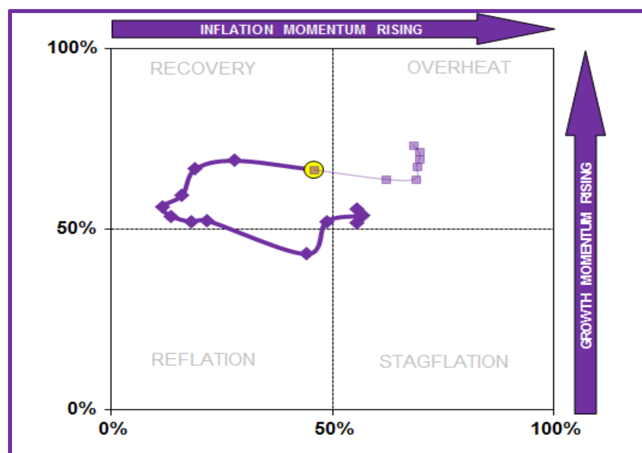


Source: Inflation trend based on global headline consumer price inflation. Lead indicator takes into account measures of spare capacity, the oil price, surveys of industrial pricing power and economist CPI forecasts.

We can use these indicators to plot a growth reading on the vertical axis versus an inflation reading on the horizontal axis to see where we are on the Clock.

As things stand we are in the equity-friendly Recovery phase of the cycle at the top left, though we are likely to move into Overheat in the next few months. This is consistent with our expectations of a rise in US interest rates later this year.

Chart 6: Where are we on the Clock?



Source: Growth and inflation in two dimensions over the last 12 months. Yellow circle is current reading. The faint trail is an RLAM projection.

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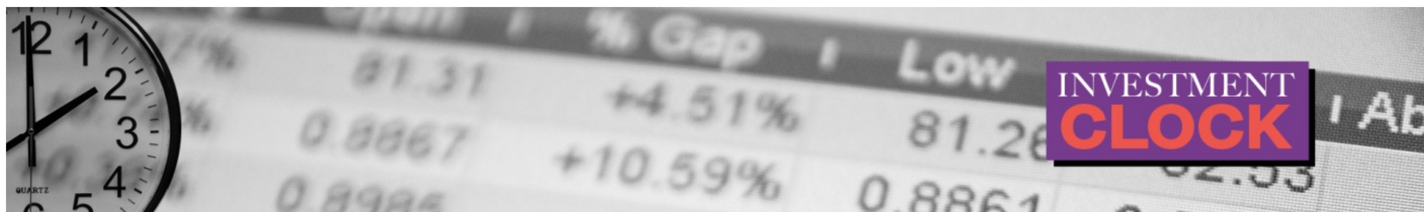
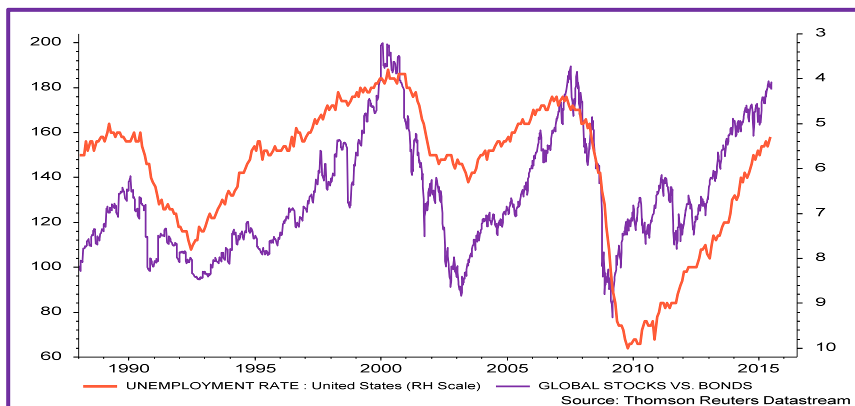


POSITIVE OUTLOOK DESPITE GREECE AND CHINA

We would remain constructive on stocks even if we move into a mild Overheat in H2 as we don't think initial tentative US rate hikes would derail global growth.

With inflation low, the Federal Reserve is nowhere near wanting unemployment to rise to put downward pressure on wages. There is a close link between falling US unemployment and stock market outperfomance as both are associated with strong global growth.

Chart 7: Global Stocks vs Bonds and US Unemployment Rate



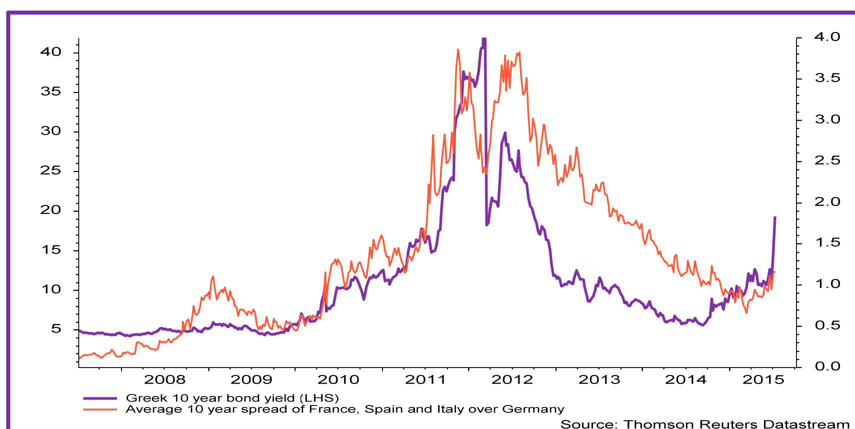
Source: MSCI AC World versus JPM Government bond index, local terms. Unemployment rate is inverted.

Meanwhile, stocks have some deflationary shocks to contend with.

Greece's standoff with its creditors has reached fever pitch but there seems to be little contagion to other peripheral bond markets. Greek 10 year yields are near 20% while the average spread of France, Spain and Italy over Germany is still only about 1.2%. Thinking globally, it is hard to see problems in a country making up one percent of European Union GDP having a lasting impact.

See our Special Report on Greece later in this publication.

Chart 8: Greek government bond yields and peripheral spreads

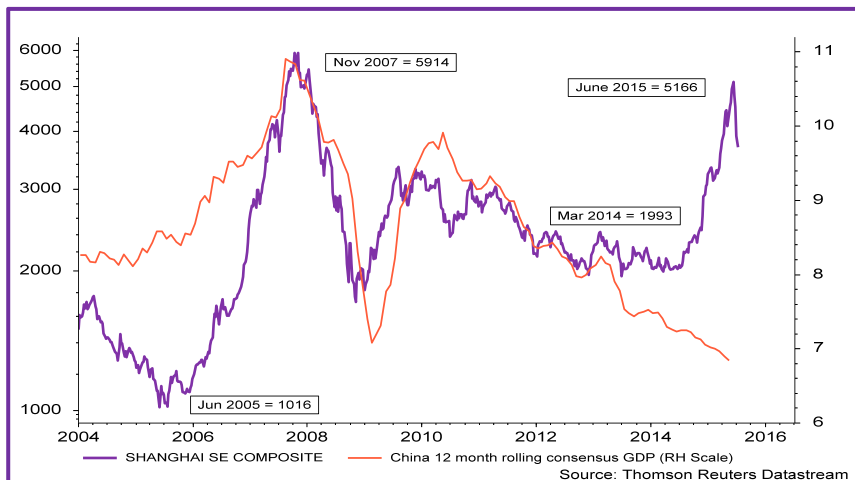


Source: Greek 10 year yield plotted against average spread of France, Spain and Italy over Germany.

China is a much larger economy and its stock market is crashing. The Shanghai Composite index is more than 35% off its June peak. The last time China saw a stock market bubble, growth expectations were rising. The recent experience was liquidity driven, coming against the backdrop of slowing growth and falling interest rates.

Animal spirits have turned but the Chinese authorities are already stepping in to limit the negative impact of stock price falls on the economy. From a global point of view, Chinese weakness isn't all bad as it means lower commodity prices and looser monetary policy.

Chart 9: China stocks and Consensus Growth Expectations



Source: China Shanghai Composite index versus 12 month rolling Consensus Economics GDP forecast (rhs).

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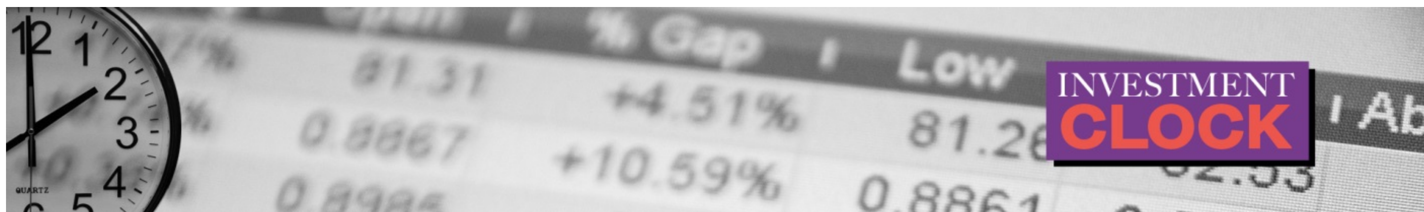


SELL IN MAY, MAYBE, BUT BUY THE DIP

Among the many rules of thumb in the investment world the one which stands up best to scrutiny is "Sell in May and go away, don't come back till St. Leger Day" (in September).

The world equity market has returned an average 10% a year since 1973. The return in the months of May to September has averaged close to zero. The same pattern is visible in the UK stock market and almost every other market you'd care to look at.

We would not mechanistically sell in May. In six summers out of ten the market goes up and there have been some spectacularly good instances, such as 2003 and 2009. We are, however, aware that thin summer markets are vulnerable to negative shocks as the sensitivity to events in Greece and China go to show.

Our composite investor sentiment indicator is registering a strong contrarian buy signal. With equity fundamentals in the major economies looking good, we are buying equities.

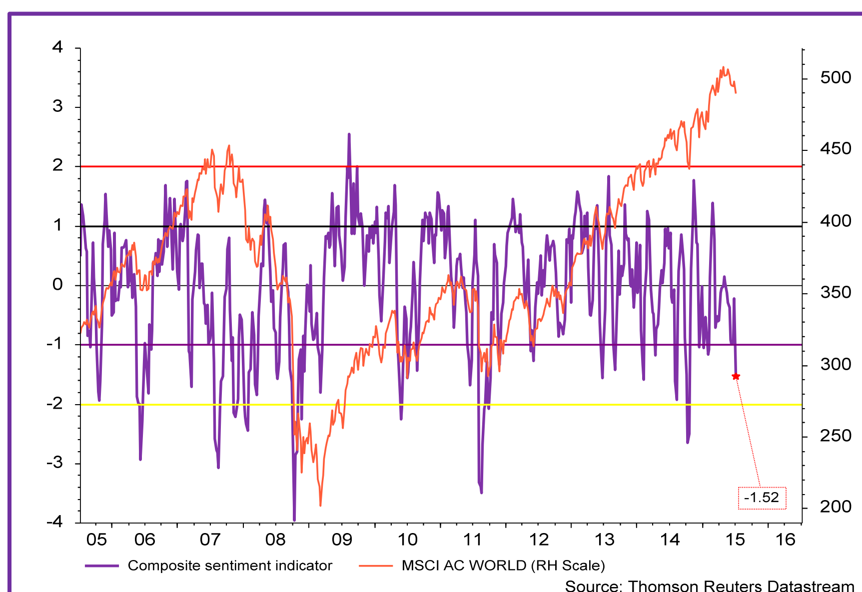
Sell in May, maybe, but buy the dips.

Table 2: Seasonality of stock returns

Seasonality	World equity market	UK equity market
No. of Years	42	45
January	1.0%	2.4%
February	0.8%	1.8%
March	1.2%	0.8%
April	2.1%	2.9%
May	0.1%	-0.1%
June	0.3%	-0.6%
July	0.7%	1.0%
August	-0.2%	1.0%
September	-0.6%	-1.0%
October	1.0%	0.6%
November	0.8%	0.6%
December	2.3%	2.5%
Total	9.9%	12.3%
Best Period	October-April	October-April
Return	9.6%	12.0%
Hit rate	74%	80%
Worst Period	May-September	May-September
Return	0.3%	0.3%
Hit rate	62%	62%

Source: Datastream total return indices, all figures annualised.
Hit rate measures the % of times the market rises over the relevant period.

Chart 10: Investor Sentiment and Global Stock Prices



Source: RLAM Composite sentiment indicator, includes retail sentiment, volatility, momentum and director dealing data.

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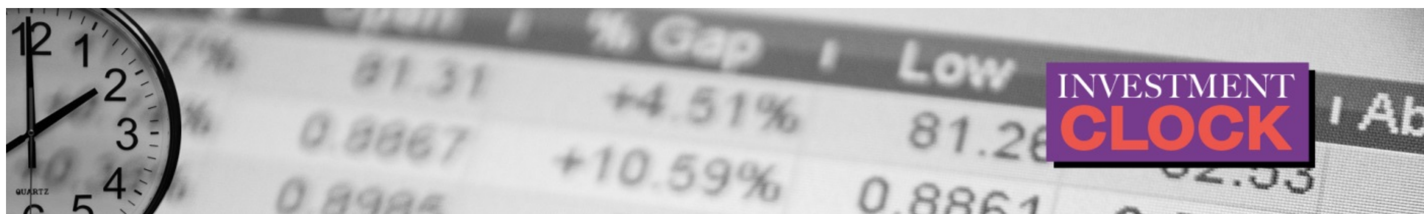


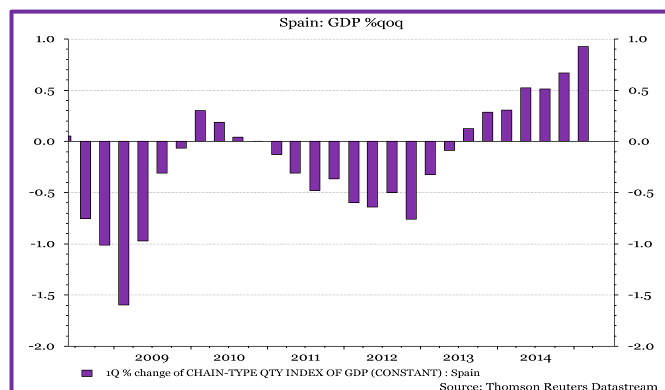
ECONOMIC OUTLOOK POSITIVE

Global growth remains on track for a solid year with activity firming in the eurozone and Japan while the recovery continues in the US and UK. Meanwhile activity in China looks to be stabilising.

Eurozone growing nicely despite Greece

Despite the standoff between Greece and its creditors, economic data from the eurozone continues to be consistent with ongoing recovery. Peripheral economies (other than Greece) have seen some of the strongest data: Spanish GDP rose by 0.9% quarter on quarter during the first quarter, while in Italy, GDP rose by 0.3%, a modest increase by most standards, but the strongest outcome since 2011, and a welcome sign of economic recovery.

Chart 1: Recovery in Spain



A notable feature of eurozone data during the month was the rise in inflation, after many months of deflation concerns. Inflation in most major economies is set to move higher in the latter part of the year, as the impact of the sharp fall in the oil price last year drops out of the annual comparison.

US bouncing back from winter weakness

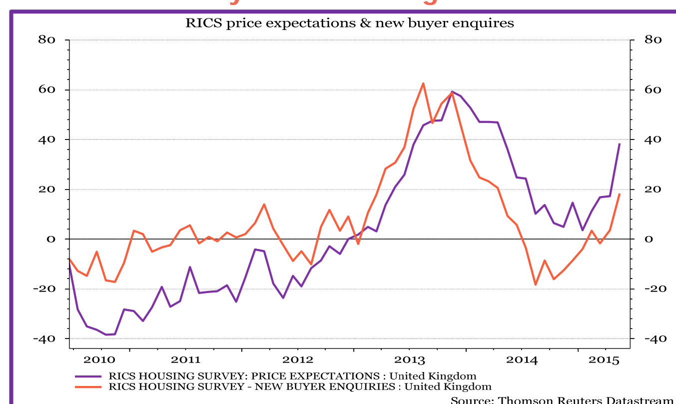
In recent weeks, economic debate in the US has been centred on two issues: was the Q1 slowdown mainly down to temporary factors such as extreme weather, and when will the Fed raise interest rates? On the first issue, the news during June tilted us towards the more optimistic interpretation of the winter slowdown, and we have seen a strong recovery in consumer and housing related data.

On the second issue, the June Federal Open Market Committee (FOMC) meeting left the door open for a rate hike later in the year, however at this stage the Fed are reluctant to be more specific in their signal. If we are right and the economic news during Q3 continues the Q2 pattern of recovery, then the Fed is likely to move in September, though tensions in Europe could stay their hand. If they do hike this would be the first tightening move since 2004.

UK election outcome a boost to housing

Although the official GDP data suggest a marked slowdown in growth at the start of the year, this is not the message from the main business surveys and indeed the Office for National Statistics (ONS) are already signalling that the GDP data are likely to be revised higher, not just for Q1 2015, but for the whole of 2014. The most notable event in recent weeks was undoubtedly the more decisive than expected General Election result, which has reduced the level of uncertainty generally and more specifically in the housing sector. This is already having an effect on the data and we have seen a bounce in housing related series, such as mortgage approvals and house prices.

Chart 2: Recovery in UK Housing



There should also be a more general boost to economic sentiment and we expect GDP growth to pick up in the second quarter.

China stabilising

Economic data from China are always difficult to read in the first quarter, since the moveable feast of the New Year holiday can distort the pattern of economic activity. More recent data from the second quarter are giving tentative signs that the authorities' attempts to balance the competing goals of structural reform with maintaining GDP growth close to 7%, are bearing fruit.

Monetary growth data and data on new loans offer some signs that previous policy easing measures are taking effect. The government has permitted local governments to refinance their debt on lower interest rates, which should ease pressure on infrastructure investment. Stock market weakness may be changing the picture, but improved housing market activity should be supportive for consumption growth, through a positive wealth effect and increased spending on housing related goods. The latest survey of property sales in the top 70 cities in China shows that house prices are back on an upward trend (see chart).

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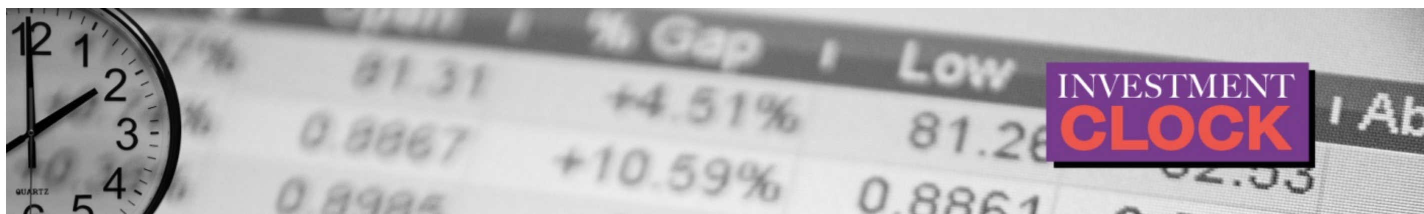
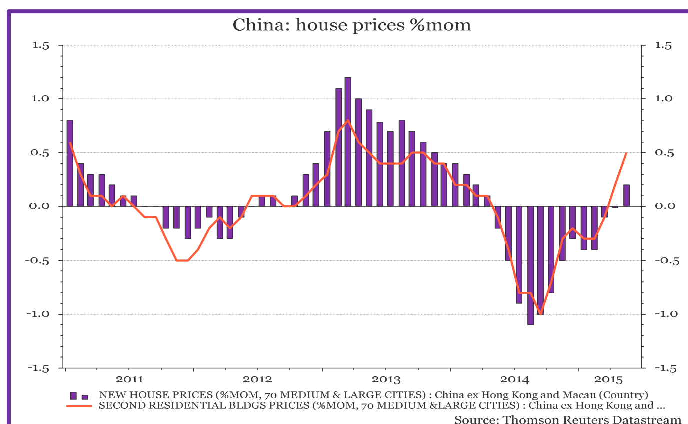


Chart 3: Some positive news in China



Source: Thomson Reuters Datastream

Stabilisation is good news. Until the recent abrupt pull back in Chinese stock prices it felt like a stronger recovery might have been on the cards. Ironically, a strong upturn in China could cause problems for the world equity and bond markets if it meant a sharp rise in commodity prices, so in this sense Chinese stock price weakness is not bad news for the rest of us.

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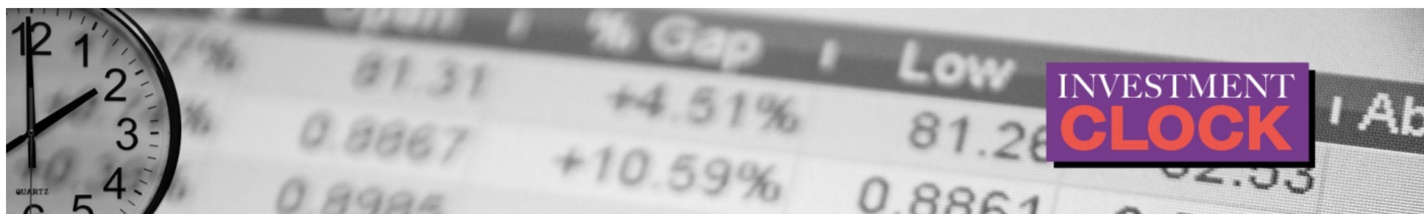

GREEK IMPACT LIMITED

Voters in Greece rejected the terms of the eurozone bailout by a 61%/39% margin in a surprise for the markets. As with the UK general election, opinion polls were finely balanced and dead wrong. There are fears that 'Grexit' will create systemic risk in markets, which in turn will have a material knock on impact on the global economy. To date, fallout appears contained but the situation is fluid as we go to press.

The politics

Greek PM Alexis Tsipras will try to use his new democratic mandate as a platform for negotiating debt reduction and less austerity. Although there have been signs of change of tone from the Eurozone in the past couple of days, and some countries (especially France) seem to be more conciliatory, there is little time to construct a new agreement, which would have to be completely re-worked anyway, since the economic situation in Greece has deteriorated very quickly.

There is very little trust in Tsipras to implement the terms of *any* agreement, even a less onerous one, so it may be the creditors try to force him out, in the hope of having a more amenable national unity government, though this is not a strategy without risk as it may fuel anti-EU sentiment more generally. The forced resignation of firebrand finance minister Yanis Varoufakis may go some way to achieving the necessary rapprochement.

The economics

Over the next few weeks it should also become clear whether contagion has taken hold in other peripheral bond markets. Until now, there has been very little contagion seen in these markets. If this situation continues, and there are good reasons to believe that the ECB would step in if it felt peripheral spreads were under too much pressure, then there should be limited economic fallout to the rest of the eurozone. Even if spreads widen a little, actual yields are now very low, which would limit the economic impact.

There have been significant changes since the last crisis, which should continue to limit contagion risk:

1. Economic growth has returned to the other peripherals (very strong growth in the case of Spain and Ireland) and these countries have ready access to bond markets
2. The eurozone banking system has little direct exposure to Greece*
3. The ECB's Quantitative Easing (QE) and Outright Monetary Transactions (OMT) arrangements were not in place during previous period of euro stress

Despite these changes however, there is still a latent fear in markets that these defences won't hold, since they have never been tested until now. Such a fear can feed on itself and eventually become self-fulfilling. It is not our base case, but there is a non-negligible risk that there will a hit to general economic confidence outside Greece. Coming at time of some uncertainty over the pace of economic recovery in the US, not to mention the perennial fears about "something bad happening in China", market chat could get quite extreme. There will be talk about a delay to Fed and Bank of England (BOE) rate hikes, which is to be expected: if the Greek situation is still 'live' by the end of the summer, the Fed will be very reluctant to hike. There will also be some more extreme talk, of a material financial shock to the global economy and a move back into recession. With central bank cupboards looking rather bare, the conclusions will become quite grim.

The markets

Markets are unruffled by the presence of an extreme left wing government in Greece, or whether its debts are paid (most people accept the debt is unpayable). The real fear is contagion and a re-run of 2010-12. While to some extent markets had begun to price in 'Grexit' risk over the past few weeks, and especially following the decision to call the referendum, in the near term, we could see a further sell off in risk assets and a rally in so-called safe havens (government bond markets).

The situation will remain unstable for next week or so, so even rallies in risk may be short-lived. The general atmosphere is bound to be skittish until things settle down. However, volatility is usually higher in thin summer trading and investor sentiment is already depressed.

Longer term, these 'panic' events often turn out to be excellent buying opportunities for equities, even if it feels very tough to do so at the time. Our asset allocation position is overweight equities and underweight bonds and, if anything, we are minded to add to equities on weakness rather than reduce positions. The acid test for us must be contagion. If we see any significant pressure on Euro peripherals, even with the ECB active in the market, then we would become more concerned.

Scenarios

1. Greece reaches an agreement with its creditors. In a sense we have been here before. Will Greece follow through with necessary reforms? How much debt forgiveness will Europe and the IMF commit to? Will the Greek economy recover sustainably or will the issue resurface further down the line?
2. Greece fails to reach agreement and events move so fast that the Greek banking system collapses, the government introduces IOUs and Greece is effectively forced out of the euro within days. The ECB would

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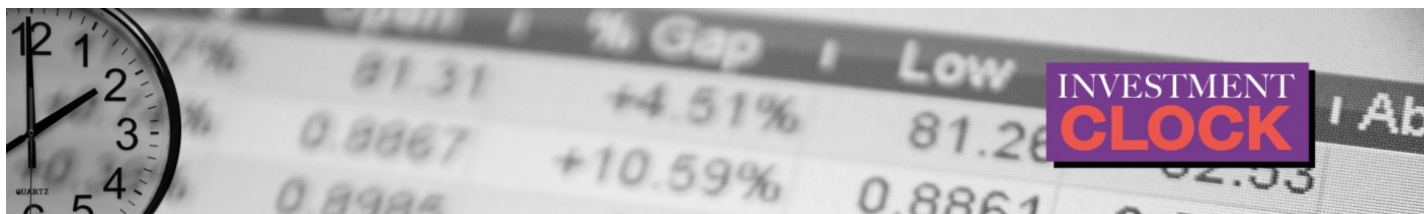

intervene to stabilise peripheral bond markets, initially verbally, but actively if needed, perhaps without reference to the capital key

3. Greece could leave the euro 'temporarily', using a parallel currency until its banking system and national finances are stabilised.

Conclusion

In the short term, the situation is probably containable, given key changes in eurozone since 2012. Whatever the outcome, the bottom line is that the euro as presently constructed, is not a fully functioning currency union. It is essentially a political construct, and this will always be its 'achilles heel', until there is a fully functioning fiscal and social union (unlikely in our view). There is no eurozone demos, which can mandate a eurozone-wide government, hence the situation where one government seeks to play its own electoral mandate off against another.

The Greek template suggests that other euro area economies suffering persistent weakness will not be able to ease monetary policy independently or devalue their currencies and fiscal transfers from other nations will not be forthcoming. The risk of populist anti-euro governments rising to power in other countries will hang over Europe, especially if Greece leaves the euro, devalues and eventually regains control of its destiny in the way Iceland has.

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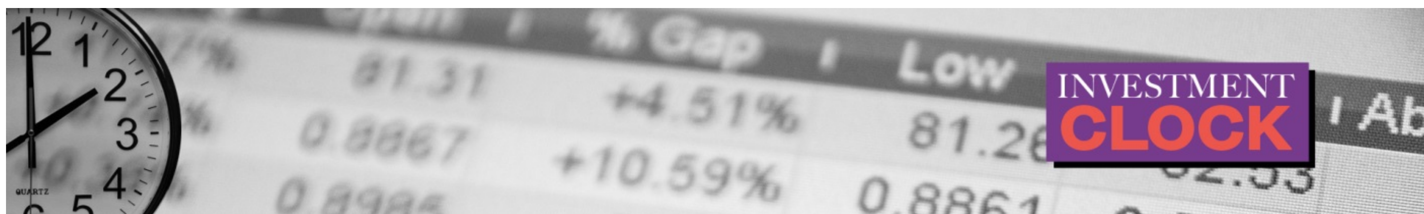

WHERE WE STAND

Overweight Japanese and eurozone stocks; underweight government bonds

Asset Allocation Strategy

- We have been overweight equities since 2012 on the back of continued global recovery with loose policy and muted inflation.

Overweight:	Neutral Zone:	Underweight:
• Equities • Japan, Europe • GBP, USD	• Corporate Bonds • USA • CAD	• Government Bonds, Cash • EM, Pacific ex Japan, UK • JPY, AUD, EUR, CHF

Multi Asset: Moderately Overweight Equities

- We have been overweight equities since 2012 on the back of continued recovery with loose policy and muted inflation. We don't expect markets to make strong progress over the summer but we would buy dips rather than sell rallies.
- We are underweight government bonds. Inflation is likely to rise as the year progresses, moving us into a mild Overheat phase. We expect Fed rates hikes to push global bond yields higher. We prefer corporate bonds to governments.
- We would be underweight commodities where the asset class is included in the mix. Excess capacity, dollar strength and slower growth in China are headwinds.

Equity Regions: Overweight Japan & Europe

- We are overweight equites in Japan and Europe, regions that capture the essence of the Recovery phase. Growth is recovering in both economies but policy is very loose with both central banks in the middle of aggressive money printing programs. Events in Greece matter greatly politically, but strong money supply suggests Europe's economies will continue to make progress in H2.
- We are neutral the US equity market, though our indicators are improving and we are likely to move overweight. We like the pro-growth policy stance but had reduced our position on the back of poor earnings revisions and better momentum elsewhere.
- We are underweight Asia Pacific ex Japan and the Emerging Markets. Emerging market growth continues to disappoint. Commodity price weakness and a return of capital to the US will weigh on these markets as the Fed beings to raise rates.
- We are also underweight the UK equity market. The housing-led recovery is best played through mid cap exposure and sterling. The overall index has a heavy weighting in resource stocks and so shares some of the negative fundamentals of the emerging markets.

Currencies: Overweight US Dollar & Pound

- We are overweight the US dollar. Sustained recovery is inconsistent with a zero Fed Funds rate. The markets will focus on the risk of rate hikes as the economy bounces back from Q1 weakness.
- We are overweight sterling on similar grounds. Strong data will drive expectations for higher interest rates.
- Our main underweight positions are in the Japanese yen and the euro. Central banks in both areas are printing money with the unstated objective of weakening their currencies.
- We are neutral the Canadian dollar but underweight the commodity-sensitive Australian dollar and underweight the Swiss franc.

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