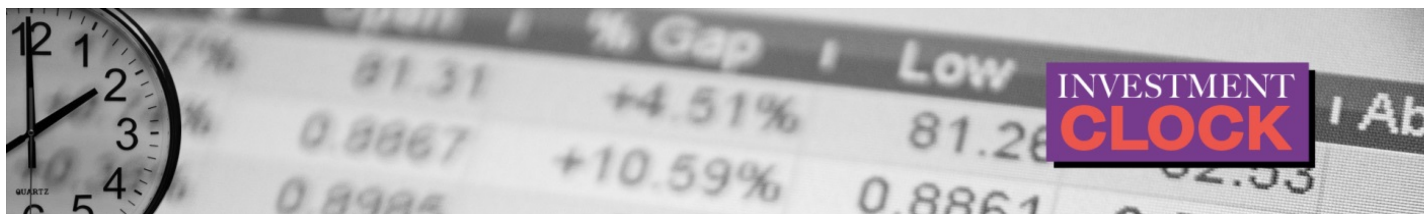

THE LONE HIKER: US RATE RISE IMPLICATIONS

Issue #3

December 2015

ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £83.1 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 30/09/2015

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Stock markets have recovered and the US Federal Reserve is set to embark on a series of interest rate rises for the first time in a decade. We review three scenarios for the post-rate hike world. Our base case is that the Fed will go it alone, with continued dollar strength benefiting developed market stocks versus commodities and the emerging markets. The most likely alternative is a synchronised pick up in global growth, hurting bond markets. European stocks look good either way.

Stocks have bounced back from their summer lows

Our investor sentiment indicator registered seven consecutive weekly buy signals for stocks this summer, putting the persistence of stress around China's surprise currency devaluation right up there with the euro crisis of 2011 (10 weeks), the Lehman failure of 2008 (10 weeks), and the inter-bank freeze up of 2007 (8 weeks). Markets rallied from their summer lows as Chinese economic data releases allayed fears of a collapse and central banks adjusted to an easier monetary policy path.

Federal Reserve impatient to get started

With US stocks back to record highs, the Fed is widely expected to start raising rates. On the face of it there isn't a lot of pressure with the global manufacturing cycle at a low ebb, commodity prices weak and inflation low. However, on traditional measures the Fed is very late to get started. The unemployment rate is already at the so-called natural rate at which economists expect wage inflation to rise (see chart). By now policy is meant to be heading into restrictive territory.

Three post-Fed scenarios for 2016

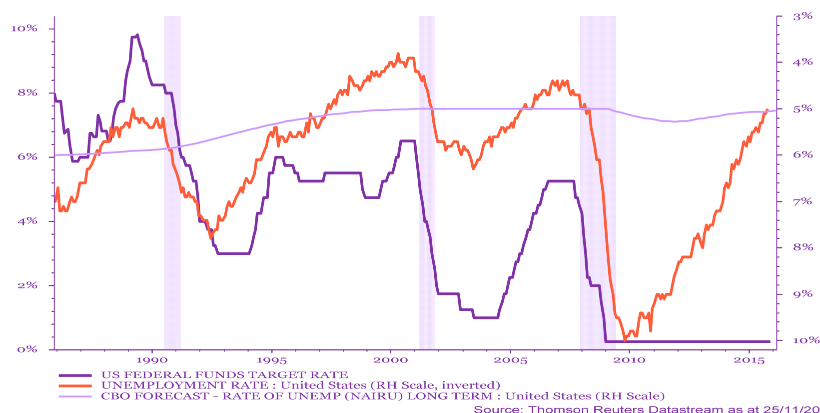
Many of today's investment bank traders were at school the last time America started to raise rates in 2004. Old hands are always nervous as the central bank usually carries on hiking until something cracks. We use our Investment Clock model to frame three scenarios. We discount an immediate relapse into recession. Our base case sees global growth pick up in 2016 led by the US with the dollar remaining strong to the benefit of developed market stocks. The most likely alternative is a more inflationary and synchronised upturn which could see a rebound in commodities and emerging markets as bond markets sell off. European equities look well placed either way.

Also in this edition, articles on the economic outlook and the prospects for manufacturing revival in 2016, along with a new page of multi asset returns. Please visit www.investmentclock.co.uk for up-to-date thoughts and ideas.

Inflation is low and manufacturing is subdued. On the face of it there isn't a lot of pressure on the US to raise rates but traditional measures suggest it is already very late to get started.

In a normal cycle, the Fed starts to raise rates as soon as growth recovers. By the time unemployment hits its so-called natural rate, as it did recently, real interest rates should be about 2% above inflation – in other words, a central bank rate of 3-4% versus the current zero. No wonder the Fed seems impatient to take the first step.

Focus Chart: Fed Funds and US Unemployment rate (inverted)



Source: Thomson Reuters Datastream as at 25/11/2015

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TELLING THE TIME: CLOCK IN THE CROSS HAIRS

Deciding what happens after the US starts to normalise interest rates is made particularly tricky right now by some confusing messages from the world economy. Our Investment Clock model linking the performance of different assets to the stage of the business cycle is caught in the cross hairs. Growth and inflation indicators are mixed and it is hard to say which stage of the cycle we are moving towards with great conviction.

The growth trend is strong but the outlook is unclear

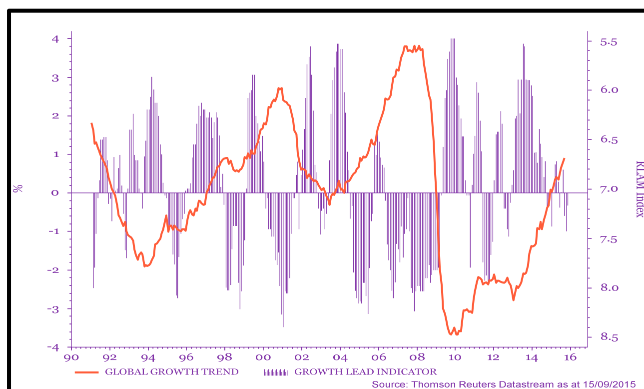
- The global unemployment rate continues to fall, indicating that the period of above trend growth that began in 2009 is still very much in train. However, our global growth scorecard continues to lack direction, registering positive readings for economic activity in Europe matched by negative readings for the US and UK.

Inflation lead indicators point downwards but base effects suggest a rise

- The trend in global inflation has been downwards since China started to slow and commodity prices peaked in 2012. Our inflation scorecard continues to point downwards but powerful base effects suggest a pickup in headline inflation .

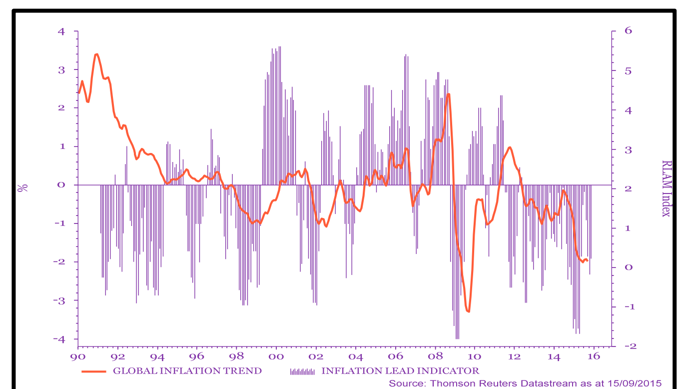
This leaves the Investment Clock trail stuck in the middle (chart 4). At these times it is difficult to say which stage of the business cycle we are moving towards and this part of our composite multi asset model would suggest tactical positions close to benchmark. On the next pages we review three scenarios for where we are heading next and the market implications of each.

Chart 1: Global growth outlook cloudy



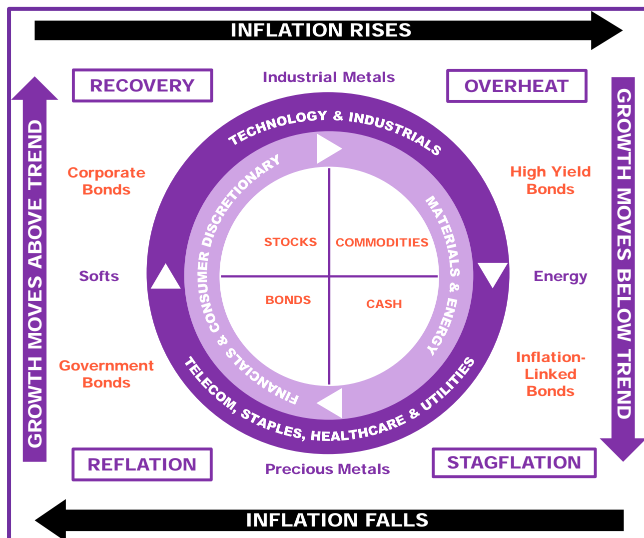
Source: Growth trend based on global unemployment rate (inverted). Lead indicator includes central bank policy, OECD lead indicators, business confidence and economist GDP forecasts.

Chart 2: Global inflation troughing on base effects



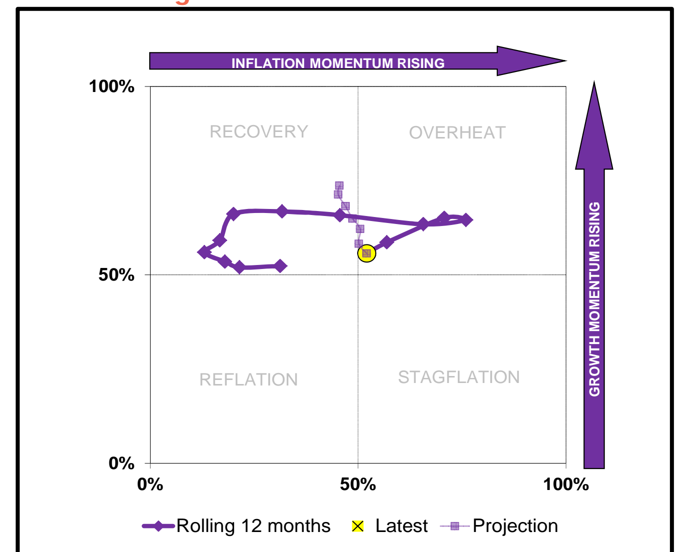
Source: Inflation trend based on global consumer price inflation. Lead indicator takes includes spare capacity, the oil price, surveys of industrial pricing power and economist CPI forecasts.

Chart 3: The Investment Clock



Source: RLAM. See "How the Investment Clock Works" later in this report for more details.

Chart 4: Caught in the cross hairs



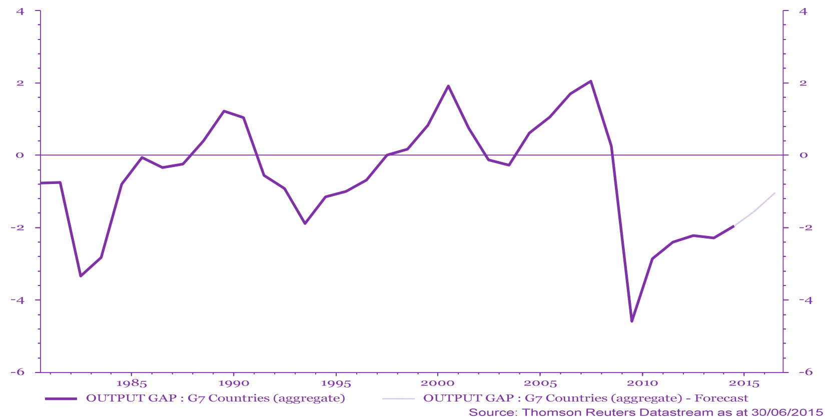
Source: Growth and inflation in two dimensions over the last 12 months. Yellow circle is current reading. The faint trail is an RLAM projection.

For professional investors only, not suitable for retail investors.

SCENARIO 1 – FED-INDUCED RELAPSE

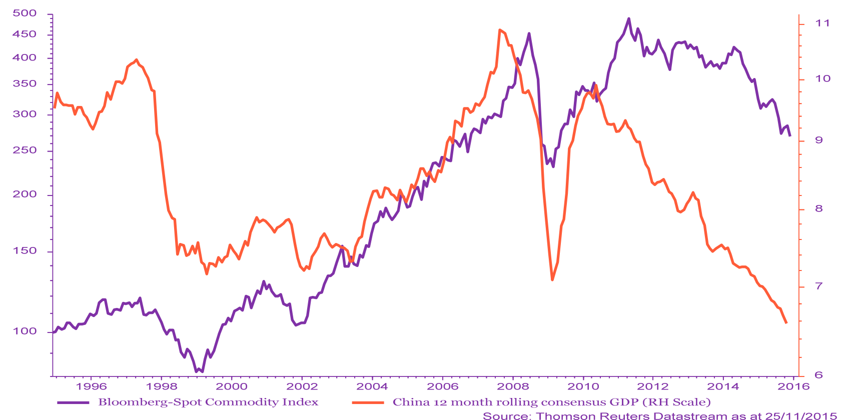
According to the International Monetary Fund (IMF) the last economic crisis created more slack in the world economy than at any time in the past thirty five years. Seven years on from the Lehman failure the world continues to operate with substantial excess capacity. Some argue that a fragile world economy might be pushed back into recession even by limited and gradual increases in US interest rates.

Chart 5: Spare capacity overhang in the world economy



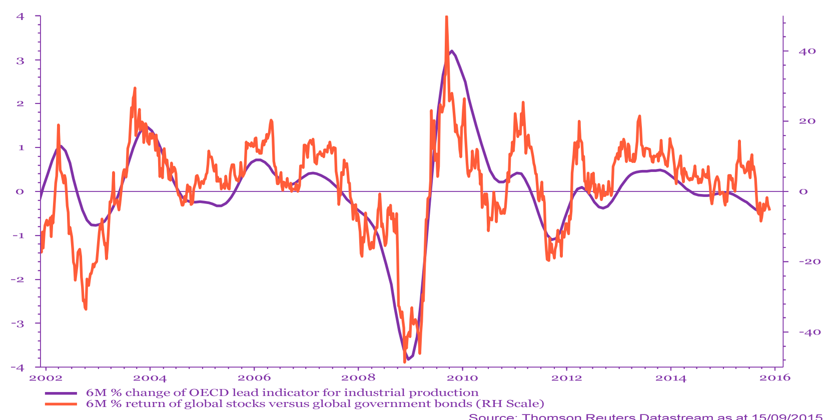
This point of view is strengthened by news out of China. The world's second largest economy is still struggling with the fallout from the excessive monetary and fiscal stimulus cocktail of late 2008. Chinese growth has been slowing for three years. Further weakness could have a destabilising effect on other emerging markets through commodity price falls and repeated devaluations in the yuan.

Chart 6: China slowdown negative for commodities



The Organisation for Economic Co-operation and Development's (OECD) lead indicator for G7 industrial production has been declining for more than two years. A further slowdown from this point would push the Investment Clock into a new Reflation phase, with equities underperforming government bonds until central banks regained control of the situation.

Chart 7: A global slowdown would be bad for stocks vs bonds



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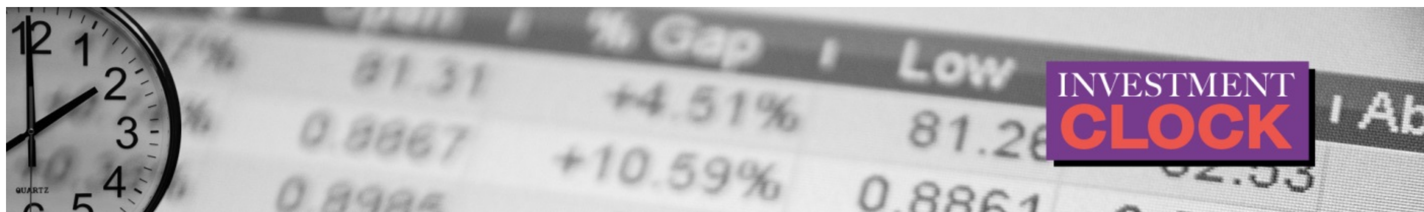
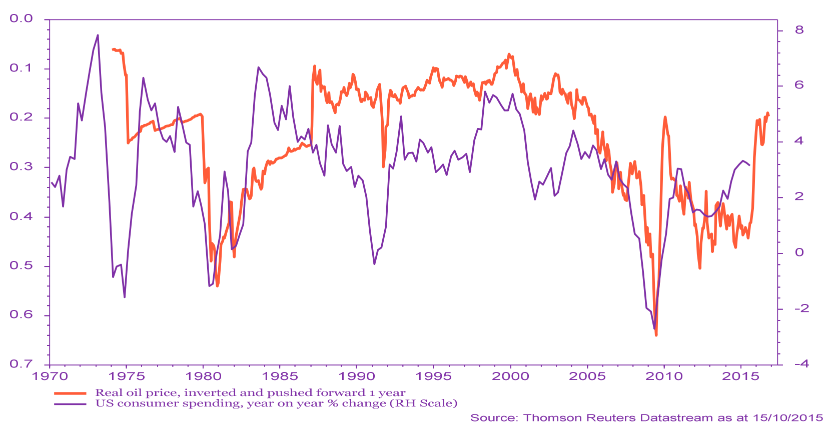


SCENARIO 2 – DISINFLATIONARY GROWTH

We are more optimistic. We think the world economy will accelerate modestly in 2016 but with inflation staying low – the equity-friendly Recovery phase of the Investment Clock.

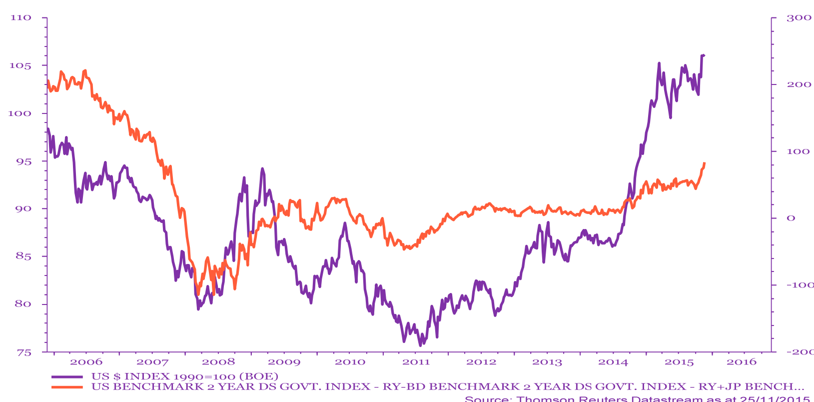
Falling commodity prices are a stimulus for the US consumer and policy remains loose in almost every economy. Manufacturing has been falling behind consumer spending globally and next year could see a catch up. The existence of spare capacity is a positive as it means inflation shouldn't rise quickly even if growth does pick up.

Chart 8: US GDP growth and the Real Oil Price



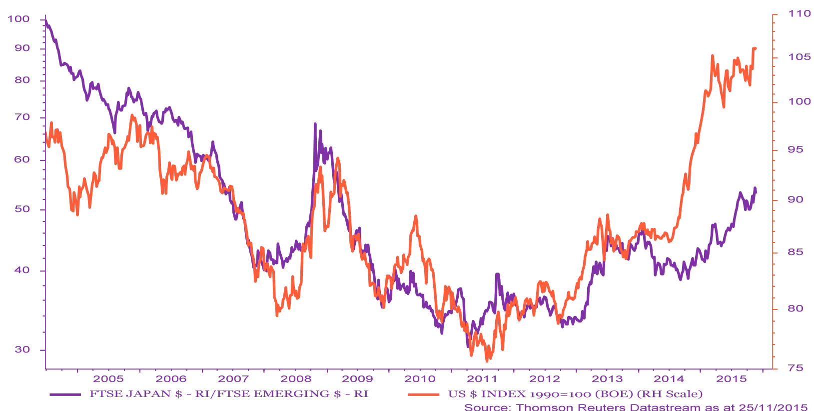
We expect policy divergence to intensify with the Fed going it alone with monetary tightening. We expect a further period of broad-based dollar strength as US interest rates rise relative to rates in the rest of the world.

Chart 9: US dollar index with interest rate differential



Historically, dollar strength has been a negative for commodities and the emerging markets. It is generally positive for Japanese and European equities, however, as the export-oriented companies that dominate stock market indices benefit from currency weakness.

Chart 10: Japan vs emerging markets with dollar index



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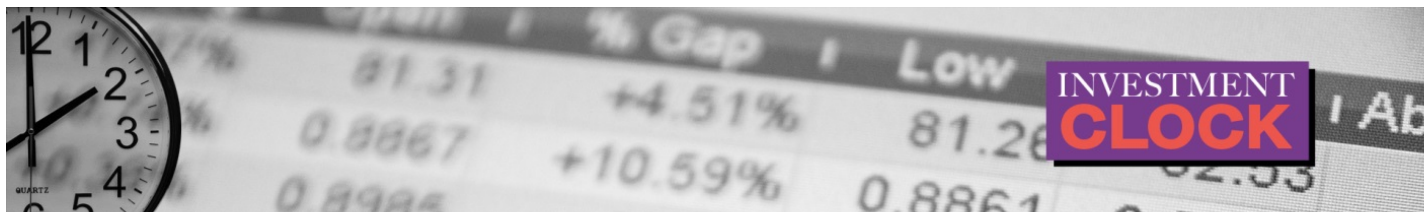
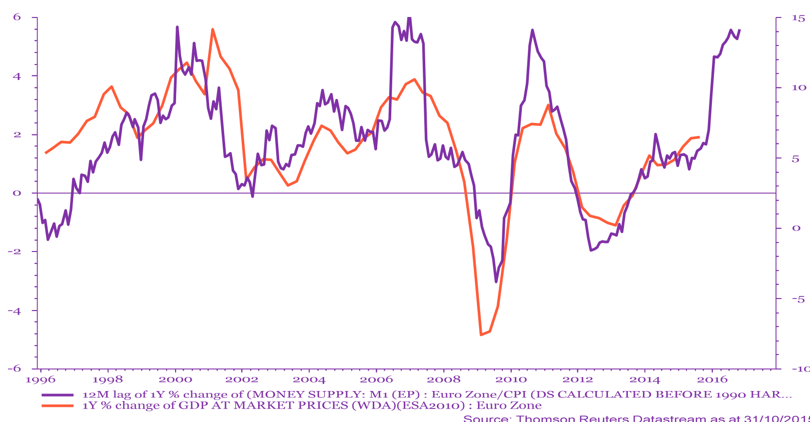


SCENARIO 3 – INFLATIONARY BOOM

The alternative scenario that we monitoring most closely is that we see a more inflationary and synchronised global upturn with all parts of the world growing more rapidly – a move into the Overheat phase of the Investment Clock cycle.

We expect US growth to remain strong. Meanwhile, Euro area growth could surprise positively with the monetary base and credit measures expanding rapidly even before the ECB increases its monetary stimulus.

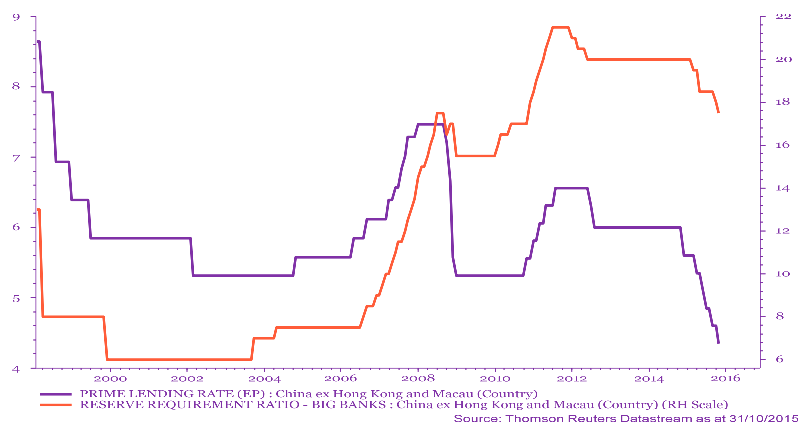
Chart 11: Euro Area real M1 growth as a lead indicator



Source: Thomson Reuters Datastream as at 31/10/2015

China's structural slowdown will be with us for years but the service sector remains relatively strong and house prices are rising. Moreover, the authorities have been increasingly uncomfortable with slower growth, cutting banking system reserve requirements and interest rates and devaluing the currency. Such temporary stimulus tends to have its effect about a year later so could take effect in 2016.

Chart 12: China is easing policy

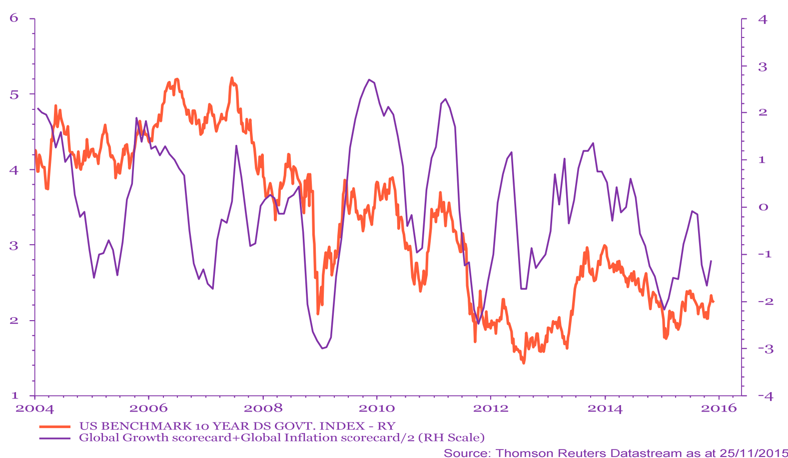


Source: Thomson Reuters Datastream as at 31/10/2015

A more inflationary upturn would show up in our global growth and inflation scorecards. In this scenario we see significant upside risk to developed economy bond yields and this could create periods of volatility in stock markets.

If evidence for this scenario starts to build and the dollar gives ground to other currencies we will have to review our negative stance on commodities and the emerging markets. Positive lead indicators and spare capacity, make European equities attractive either way.

Chart 13: US bond yields and nominal growth scorecard



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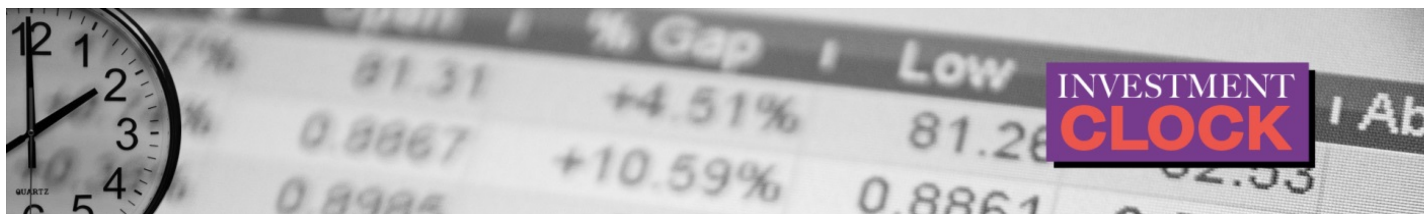

WHERE WE STAND

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 • Japanese, European equities • Dollar, Sterling	• Corporate Bonds • USA • Canadian dollar	• Government Bonds, Commodities, Cash • UK, Emerging Markets, Pacific ex Japan • Euro, Yen, Swiss, Australian dollar

Multi Asset: Moderately Overweight Equities

- We have been overweight equities since 2012 on the back of continued recovery with loose policy and muted inflation. Our base case is for equity-friendly Recovery in 2016. A more inflationary backdrop would also be positive for equities in the short to medium term but could create volatility as interest rates rise.
- We are underweight government bonds as a funding source for the equity overweight. Yields will stay low if inflation stays low but we see substantial upside risk in a more inflationary scenario. We prefer corporate bonds to governments.
- We would be underweight commodities were the asset class included in the mix. Excess capacity, dollar strength and slower growth in China are serious 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 but policy is very loose with both central banks in the middle of aggressive money printing programs. Neither economy is likely to tighten policy quickly in a more inflationary scenario.
- We are broadly neutral the US equity market. We like the pro-growth policy stance and we expect US consumer strength to dominate over industrial sector weakness. However, there is a greater risk of interest rate rises in a more inflationary scenario.
- 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 when the Fed beings to raise rates. If we see a more inflationary scenario with rising commodity prices then we would move to a more neutral stance.
- We are underweight the UK. The stock market has a heavy weighting in resource stocks and shares some of the negative fundamentals of the emerging markets.

Currencies: Overweight US Dollar & Pound

- We are overweight the US dollar. Interest rates are still likely to rise over the coming year and with no other major central bank heading in the same direction, we would expect a further round of currency strength.
- We are overweight sterling on similar grounds. Strong data and rising wage inflation will drive expectations for higher interest rates. However, the Bank of England is no hurry and a referendum on EU exit could stay their hand when it comes to rate hikes.
- Our main underweight positions are in the euro, the Swiss franc and to a lesser extent the Japanese yen. Central banks in these areas are printing money with the unstated objective of weakening their currencies and we expect this trend to continue.
- We are also underweight the commodity-sensitive Australian dollar and Canadian dollar.

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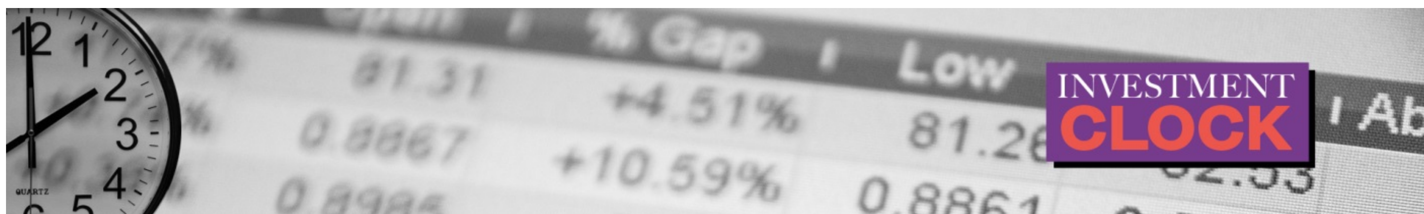


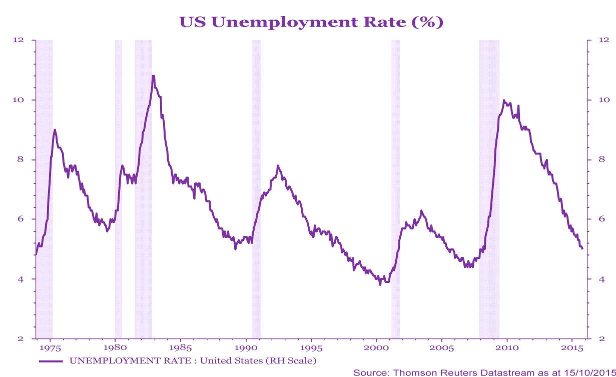
ECONOMIC OUTLOOK

The Fed look set to hike rates in December. However, we expect the pace of interest rate hikes in 2016 to be relatively modest. Meanwhile, other central banks are easing policy, with the European Central Bond (ECB) set to extend their Quantitative Easing (QE) programme. Market sentiment around China has calmed after the summer squall, with some signs of stability in economic activity. Most of the survey data in the eurozone continues to be consistent with modest GDP growth, with little sign of a major impact from emerging market weakness, or fallout from the Volkswagen diesel scandal.

US: Fed hike in December now virtually certain. Of greater importance is the pace of any rate rises

Payrolls are the great bellwether of the US economy, and for financial markets the most important data print of the month. Weaker employment growth in September and confused signals for the Federal Open Market Committee (FOMC), led markets to price out a 2015 hike in October. However, the subsequent payroll release was stronger across a number of fronts: employment rose by 270,000, the unemployment rate fell to 5%, while average hourly earnings growth rose to 2.5% year on year.

Chart 1: US unemployment rate



The Fed now look certain to hike in December, however of greater importance is the pace of any increases in interest rates during 2016. The last three Fed tightening cycles saw rates rise by 150-250bp in the first year, and 175-300bp in the first 18 months. Given that the US economy still faces some important headwinds to growth, at a time when other major central banks are actually easing policy, we expect the pace of interest rate hikes in this cycle to be much more modest: the Fed will not be seeking to raise the unemployment rate in order to contain a runway inflation problem.

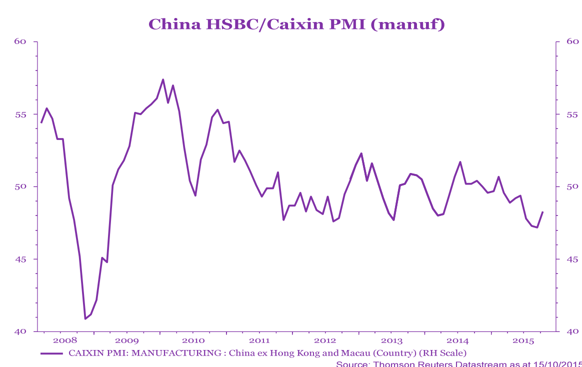
Nevertheless, a hike in the Fed Funds rate, however well telegraphed in advance, is an important turning point: the first hike in a rate cycle since 2004. Markets will need to see continued strong domestic data in the US to be comfortable that the Fed is not making a policy error.

China: the economy remains in slowdown, however there are encouraging signs of a shift in economic balance

In the last Investment Clock report, we noted that there were some signs of a pick-up in China: property sales and prices were rising, money growth had picked up and the Purchasing Managers Indices (PMIs) for the important services sector had not weakened materially. Economic growth in China had slowed, but was unlikely to have ground to a complete halt.

Even allowing for the health warnings attached to China's economic data, there is some support for our view in the latest set of data: China is slowing, not collapsing. While the industrial economy has weakened, there are now some signs of stabilisation in the PMI manufacturing surveys, while activity remains more robust in the services sector, which is taking a growing share of economic output. The 'real' GDP growth figure may still be short of the 'official' 6.9%, however there are few signs that the economy is in a severe slowdown.

Chart 2: China PMI



The services sector accounted for 51.4% of the overall economy in the first three quarters of the year, up 2.3 percentage points on 2014. China's services sector is much less import-intensive than the industrial sector, however this could benefit economies such as the UK, which have a comparative advantage in services, and a large trade surplus in this area. This gives some context to the recent visit to London by China's President Xi Jinping: the UK may be seeking to build economic ties at just the right time.

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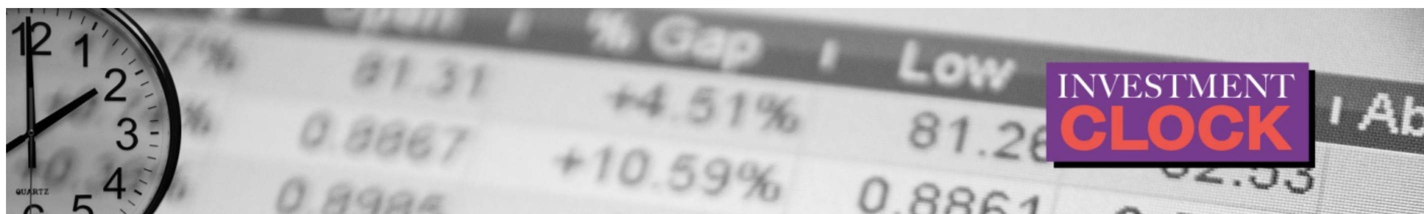
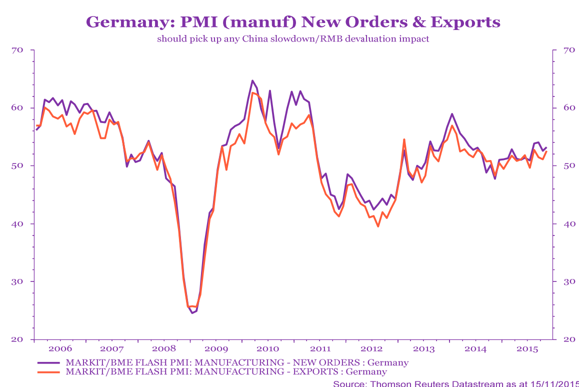


Eurozone: modest recovery continues, however low inflation expectations suggest further easing by the ECB

Since the height of the Greek debt crisis in the summer, developments in the eurozone have taken something of a backseat. Most of the main survey data continues to be consistent with modest GDP growth, with little sign of a major impact from emerging market weakness or fallout from the Volkswagen diesel scandal. Meanwhile monetary growth data points towards an even stronger upturn in 2016.

Chart 3: Germany PMI



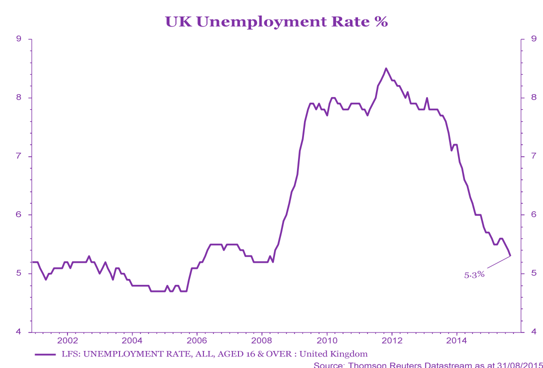
While the recent pick-up in the major business surveys looks promising, inflation remains well below target, and the ECB have given a strong signal that they will seek to ease policy further, in order to shore up medium-term inflation expectations. With the Fed moving towards tighter policy, while the ECB remains in easing mode, a weaker euro remains a key support for our overweight position in European equities.

The next few months will show if there has been any significant economic fallout in the eurozone from the terrorist attacks in Paris. Recent history suggests a limited impact from these types of events, however with France under a state of emergency, there is bound to be an impact on household sentiment.

UK: the consumer remains the mainstay of growth

With the unemployment rate falling to 5.3% and inflation at 0%, the fall in the UK's 'misery index' has driven consumer confidence to a 15 year high. Some time ago, the Bank of England's (BOE) Governor Mark Carney signalled that the Monetary Policy Committee (MPC) would not even think about raising interest rates until the unemployment rate fell below 7%. Now, markets are not expecting a rise until 2017 at the earliest.

Chart 4: UK unemployment rate



Looking ahead to 2016, the economy faces some important headwinds, in the shape of fiscal austerity and the uncertainty of the Brexit referendum. Yet with monetary policy set to stay very loose, and real household incomes growing rapidly, economic growth in the UK should remain close to trend. While headline inflation remains low, there are now signs that core inflation is rising, as non-energy goods deflation eases, while services inflation remains steady. Assuming Brexit uncertainty can be contained, with a referendum held in mid-2016, the BOE look likely to raise rates somewhat earlier than current market expectations.

Views expressed are those of RLAM Economist Ian Kernohan.

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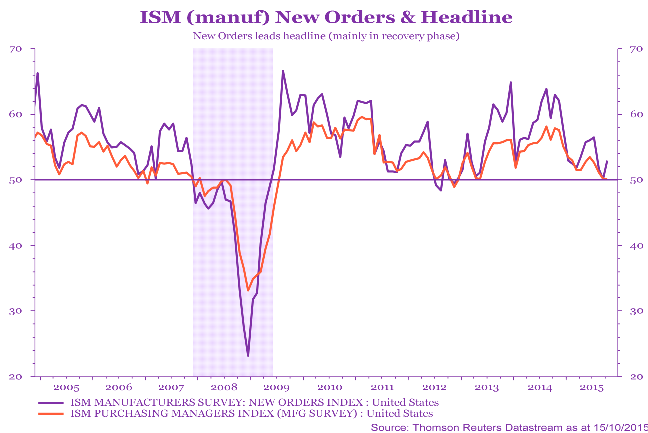
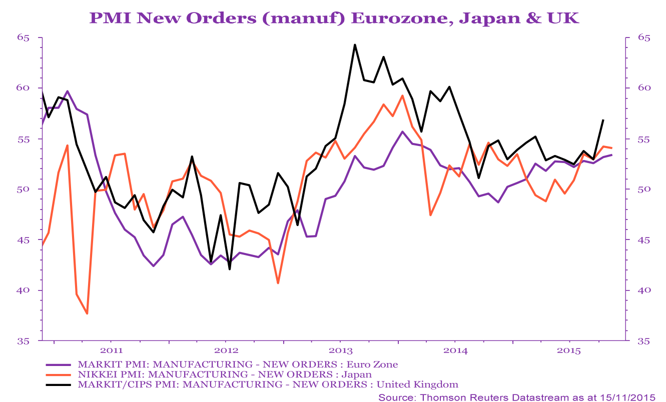
SUBDUED MANUFACTURING LOOKS SET TO BENEFIT FROM MORE ROBUST CONSUMER DEMAND

Although the manufacturing sector covers a relatively small percentage of GDP in advanced economies with an even smaller share of total employment, developments in this area remain a key issue for markets, with a considerable share of published data prints covering the sector. Manufacturing is also more exposed to the global trade cycle than the services sector and tends to be more volatile. Thus, it can provide extra information on changes in global trade patterns, and by extension, some insight into shifts in the global economy and corporate earnings.

While forward momentum in the US labour market has been deemed sufficient to warrant the first rise in Fed Funds rate in nearly a decade, strength in the country's manufacturing sector has been more conspicuous by its absence. US manufacturing activity has been curtailed by weaker demand from the shale oil sector, a strong dollar, and a slowdown in some major trading partners, particularly in emerging markets. The most recent Institute for Supply Management (ISM) manufacturing survey provides a good illustration of recent trends: the headline ISM has fallen back to 50, although the new orders balance gives some hint of improvement looking forward.



Looking outside the US, there are also some tentative signs of greater stability in global manufacturing, as evidenced by the most recent PMI new orders data across a range of developed economies.



A build-up of inventories has been another headwind for manufacturing output, with stocks a negative for US GDP growth in Q3. Since market economies are not planned, it is not unusual for supply and demand to get out of sync for short periods, leading to a build-up of inventories, followed by a drop in production until these stocks are cleared. The events of autumn 2008 still loom large in the minds of investors, when after a long period of expansion in global supply chains, there was a near total seizure in global trade and a large build-up of inventories, followed by a collapse in production. In almost every year since, there has been heightened concern about an autumnal build-up of stocks, ahead of the most important consumer spending season of the year.

Two scenarios are now possible: either robust consumer demand will help eat into this stock pile, with little or no further adjustment needed in production, or consumption weakens, forcing big cuts in production. We think the outlook for US consumption remains reasonably robust, supported by rising employment levels and real incomes. The most recent GDP estimates highlight ongoing consumer strength, although a marked pick up on the industrial side may still be some months away.

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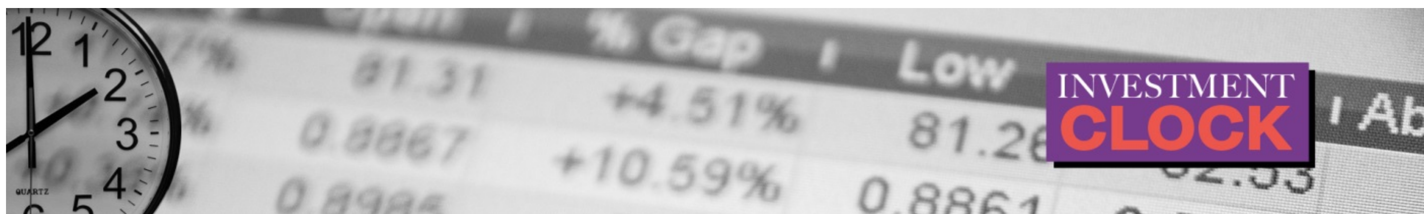
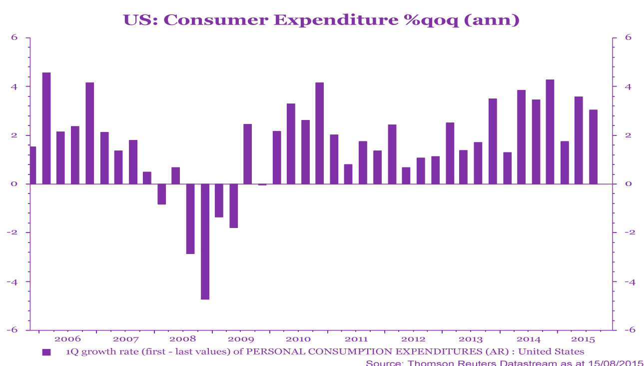
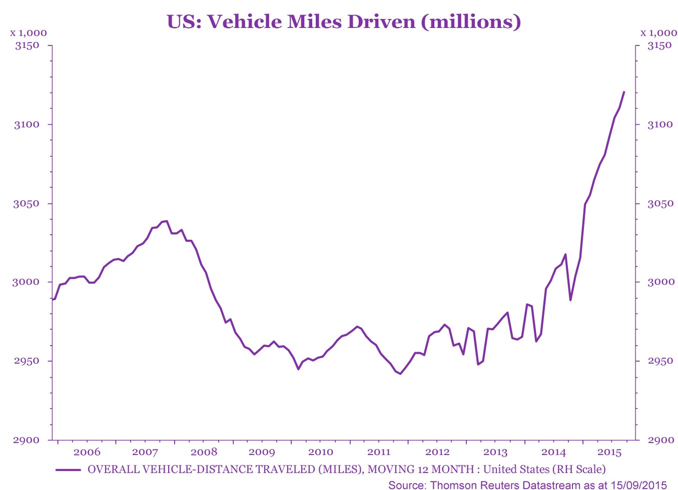




Since manufacturing output can either feed directly into immediate consumption, or as an input into another type of production, consumer spending accounts for a smaller share of industrial demand than its share of GDP. Nonetheless, it remains an important support for production. Although nominal US retail sales growth was weak in October, a broader range of consumer indicators give a more robust picture: SUV sales have recovered to pre-crisis levels, as has consumer confidence, while monthly real and nominal personal consumption growth rates have picked up strongly since Q1. Low inflation remains a positive for consumer demand and there are few signs that households have decided to save rather than spend the gain from low fuel prices.

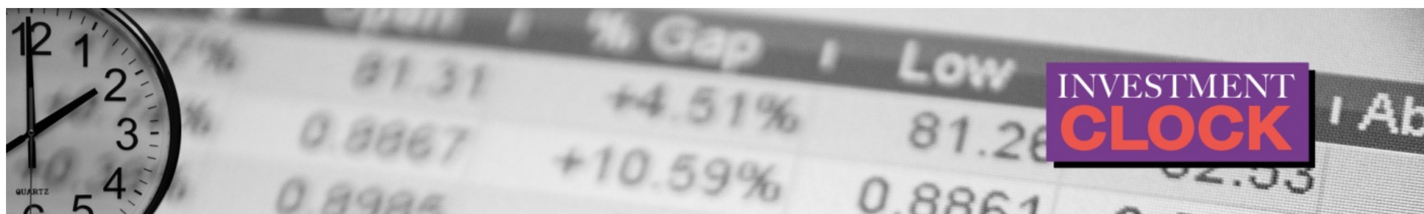


In recent weeks, some listed retailers have posted poor financial results. However, the business models of many traditional retailers are under structural pressures, and may no longer be reliable bellwethers of consumer demand.

Assuming the boost to consumer demand in US from rising employment and real income levels offsets any impact from the slowdown in emerging markets and the hit to shale, the Fed should remain on target to lift interest rates further in 2016, albeit very gradually. While this will be a hurdle for equity markets, it is the context in which any change in Fed policy takes place which is important, as well as the likely pace of any increases in the Fed Funds rate. Assuming the Fed hikes in the context of robust domestic demand indicators, this should be less of a hurdle to markets than a Fed looking to hike into tepid economic activity, simply because they feel interest rates are too low.

The US remains a broadly services based economy, and has a relatively low share of exports as a percentage of GDP. This should give some protection against the current slowdown in emerging market growth. The major risk to our view is that slower emerging market growth has a material impact on the domestic economy, via a stronger dollar and rising unemployment. This would impact consumer demand and lead to further weakness in manufacturing.

For professional investors only, not suitable for retail investors.



HOW THE INVESTMENT CLOCK WORKS

We can draw the economic cycle as a circle with growth and inflation the vertical and horizontal axes. A 'normal' cycle starts at the bottom left in Reflation and proceeds in a clockwise direction through Recovery, Overheat and Stagflation. The Investment Clock diagram shows different asset classes positioned around the clock face at the time at which they usually outperform.

The Investment Clock Diagram

INFLATION RISES

GROWTH MOVES ABOVE TREND

RECOVERY

Industrial Metals

OVERHEAT

GROWTH MOVES BELOW TREND

Corporate Bonds

TECHNOLOGY & INDUSTRIALS

High Yield Bonds

CONSUMER DISCRETIONARY

MATERIALS & ENERGY

STOCKS

COMMODITIES

Softs

Energy

BONDS

CASH

FINANCIALS & CONS

Government Bonds

TELECOM, STAPLES, HEALTHCARE & UTILITIES

Inflation-Linked Bonds

REFLATION

Precious Metals

STAGFLATION

INFLATION FALLS

Source: RLAM

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, especially the financial and consumer sectors, and long duration bonds. 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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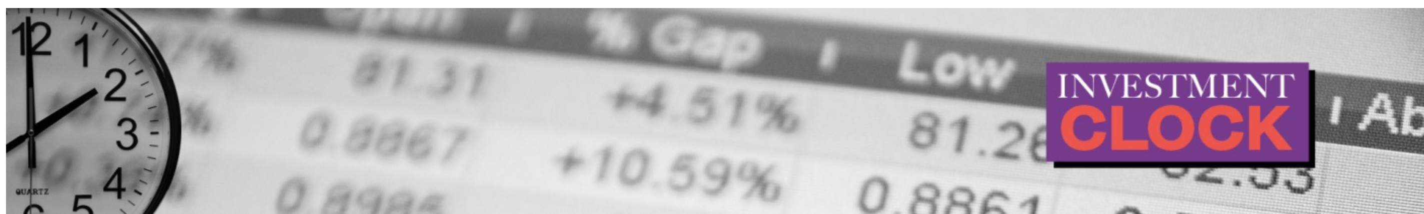

MARKETS: JAPAN AND CONSUMER STOCKS LEAD

- Stock markets have been relatively flat over the last year.
- Japanese equities and global consumer stocks have been the star performers and emerging markets and energy stocks the worst.
- European equities have performed well in local terms but have been relatively flat in sterling terms.
- UK commercial property has been the strongest asset class while commodities have fallen for a fourth consecutive year.
- The dollar has been strong. Bonds yields remain very low with central bank rates mostly at zero.

FX	1 GBP buys	%1M (vs GBP)	%12M (vs GBP)
USD	1.50	2.7	4.9
EUR	1.42	-1.5	-11.2
CHF	1.55	-1.7	-2.0
JPY	184.8	0.8	0.8
AUD	2.08	3.7	-11.3
CAD	2.01	0.6	-11.1

CB rates	Rate (%)	chg 1M (%)	chg 12M (%)
Fed	0.25	0.00	0.00
BOE	0.50	0.00	0.00
ECB	-0.20	0.00	0.00
BOJ	0.08	0.00	0.01

Bond Yield	Yield (%)	chg 1M (bps)	chg 12M (bps)
US 10 Year	2.23	9	7
UK 10 Year	1.83	-10	-10
EU 10 Year	0.47	-5	-23
JP 10 Year	0.31	0	-11

	Local		GBP	
Multi Asset	%1M	%12M	%1M	%12M
UK Stocks	0.7	0.7	0.7	0.7
World ex UK Stocks	1.1	3.6	1.8	2.9
Gilts	-0.1	3.5	-0.1	3.5
Cash	0.0	0.5	0.0	0.5
Property	1.0	14.7	1.0	14.7
Commodities	-6.4	-31.0	-4.7	-27.5

	Local		GBP	
Equity Regions	%1M	%12M	%1M	%12M
UK	0.7	0.7	0.7	0.7
North America	1.3	2.1	3.0	5.6
Europe ex UK	3.0	11.1	0.6	0.2
Japan	3.4	16.4	3.1	16.6
Pacific ex Japan	-2.6	-4.1	-1.7	-8.9
Emerging Markets	-1.6	-3.3	-0.7	-8.4

Global	Local		GBP	
Equity Sectors	%1M	%12M	%1M	%12M
Consumer Discretionary	1.4	12.6	2.0	12.5
Industrials	2.6	3.4	3.0	2.7
Financials	0.4	2.0	1.0	-0.4
Consumer Staples	0.3	9.9	0.8	8.8
Utilities	-3.0	-3.2	-2.5	-4.5
Healthcare	2.5	7.6	3.1	8.6
Energy	1.5	-15.5	2.4	-16.7
Materials	-1.2	-9.1	-1.0	-12.7
Telecoms	0.4	1.5	0.7	-1.2
Technology	1.7	6.5	3.0	9.2

	Local		GBP	
Bonds	%1M	%12M	%1M	%12M
Conventional Gilts	-0.1	3.5	-0.1	3.5
Index Linked Gilts	0.1	3.7	0.1	3.7
GBP Credit	0.6	2.8	0.6	2.8
Global High Yield	-1.1	-1.5	-1.2	-1.5

	Local		GBP	
Commodities	%1M	%12M	%1M	%12M
Energy	-6.5	-50.9	-4.9	-48.7
Agriculture	-2.2	-18.0	-0.6	-14.4
Industrial Metals	-10.0	-34.1	-8.4	-31.2
Precious Metals	-10.1	-13.3	-8.5	-9.5

Note: Standard indices sourced from DataStream and Bloomberg.

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