BREXIT BOOST TO MULTI ASSET RETURNS

Issue #7

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ROYAL LONDON

ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £93.8 billion in life insurance, pensions and third party funds*.

In March we launched six risk-rated Global Multi Asset Portfolios (GMAPs) blending active and passive exposures with a tactical asset allocation overlay.

*As at 30/06/2016

This month's contributors

Trevor Greetham
Head of Multi Asset

Hiroki Hashimoto
Senior Quantitative Analyst

Volatility tends to increase as we head into autumn. Near-term risk factors include the US Presidential Election, the possibility of a weak patch in economic data and political tensions in Europe.

With policy loose and the world economy expanding we would look to buy dips in anticipation of stronger returns into the New Year.

Multi asset returns have been very strong since the UK referendum with stocks and bonds surging to new highs on the view that monetary policy will remain looser for longer. We expect the steady if unspectacular expansion in the world economy to continue. We are positive on stocks and would buy dips in the emerging markets where stronger activity in China is a positive and in Japan where more stimulus is on the way. We see little long-term value in gilts.

Strong sterling asset returns

The UK's vote to leave the European Union has rewarded sterling-based investors with exceptionally strong returns year to date. Bonds surged on the back of easier monetary policy expectations at home and in the US while stocks also benefitted from an increase in the value of overseas earnings in sterling terms. Domestically focused asset classes like commercial property have fared less well.

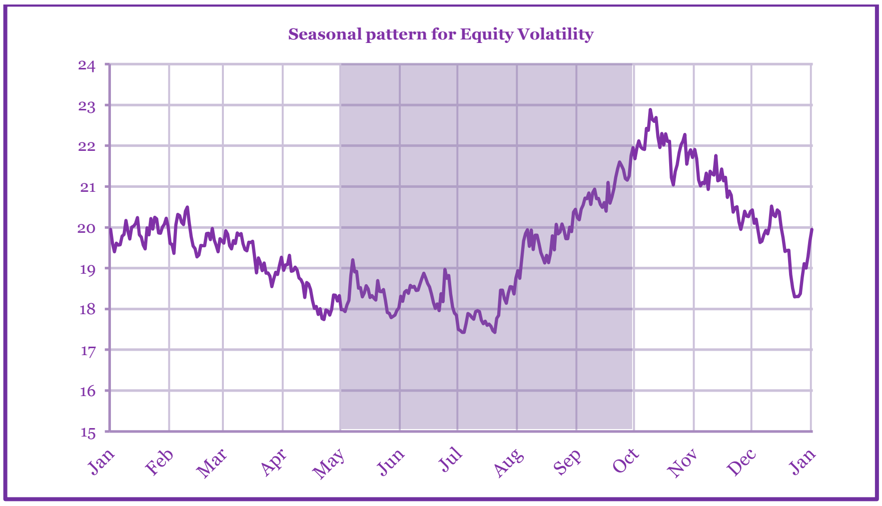
Sanguine on UK economy, negative on gilts

Brexit uncertainty will be a drag on growth over 2017. However, the prospects for increased monetary and fiscal stimulus make us sanguine about the longer-term outlook for the UK economy and we are bearish on gilts at these yields. Quantitative easing has distorted the market so much so that it is pricing in base rates of 1% or less over the next 30 years. Policy will remain loose for some time to come but to see value in gilts you need to believe the UK is heading into permanent deflation or perpetual economic contraction. We don't.

Positive on stocks globally, looking to buy dips

The Investment Clock model that guides our asset allocation is in the commodity-friendly Overheat phase characterised by above trend global growth and rising inflation. Commodities have done well, for the first year in six, helped by better data out of China. However, we don't see any major upside risk to inflation and with policy staying loose we prefer stocks, especially in the emerging markets and in Japan. We would look to buy dips if volatility picks up over the next month or so as it often does at this time of year.

Focus Chart: Volatility tends to pick up this time of year



Source: DataStream, Bloomberg, average seasonal volatility profile based on VIX data since 1990

Please visit www.investmentclock.co.uk for our blog and information about our multi asset range. For product details, contact: multiassetsupport@rlam.co.uk

MULTI ASSET RETURNS SURGE ON BREXIT VOTE

The UK's vote to leave the European Union has rewarded multi asset investors with some surprisingly strong returns year to date in sterling terms.

- Bonds surged on the back of easier monetary policy expectations with gilts posting 16% year to date and long dated index-linkers hitting 30%.
- With the pound down 10%, UK stocks benefitted from an increase in the value of overseas earnings, pushing the market up 11%. Overseas equities are up 19% and the emerging markets are up 31% in sterling terms.
- Commodities are up 17% after five years of negative returns, with stronger activity in China offsetting oversupply fears in oil.
- Domestically focused commercial property has fared less well with mark downs in capital values likely to outweigh rental income this year.

Chart 1: A very strong performance in sterling terms

Source: Thomson Reuters Datastream as at 06/09/2016

Chart 2: Annual asset class returns since 2007 and year to date

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	YTD
1	EM Stocks +37%	Gilts +13%	EM Stocks +63%	EM Stocks +24%	Gilts +16%	EM Stocks +13%	Global Stocks +21%	Property +19%	Property +14%	EM Stocks +31%
2	Commodities +14%	Cash +6%	UK Stocks +30%	Commodities +21%	Property +8%	UK Stocks +12%	UK Stocks +21%	Gilts +14%	Global Stocks +4%	Global Stocks +19%
3	Global Stocks +11%	Commodities -11%	Global Stocks +21%	Global Stocks +17%	Cash +1%	Global Stocks +12%	Property +11%	Global Stocks +12%	UK Stocks +1%	Commodities +17%
4	Cash +6%	Global Stocks -18%	Commodities +6%	Property +15%	UK Stocks -3%	Gilts +3%	Cash +0%	EM Stocks +8%	Gilts +1%	Gilts +16%
5	UK Stocks +5%	Property -23%	Property +2%	UK Stocks +15%	Global Stocks -7%	Property +2%	Gilts -4%	UK Stocks +1%	Cash +1%	UK Stocks +11%
6	Gilts +5%	UK Stocks -30%	Cash +1%	Gilts +7%	Commodities -13%	Cash +1%	EM Stocks -5%	Cash +0%	EM Stocks -10%	Cash +0%
7	Property -5%	EM Stocks -35%	Gilts -1%	Cash +1%	EM Stocks -18%	Commodities -5%	Commodities -11%	Commodities -12%	Commodities -20%	Property +0%

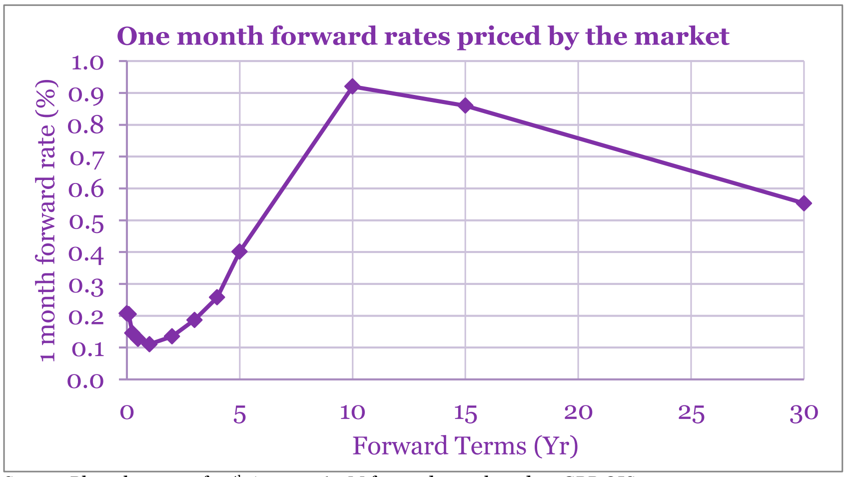
Source: Datastream; annual asset class total returns in sterling terms and year to date.

SANGUINE ON UK ECONOMY, BEARISH ON GILTS

Brexit uncertainty will be a drag on growth over 2017. However, the prospects for increased monetary and fiscal stimulus make us sanguine about the longer-term outlook for the UK economy and we are bearish on gilts at these yields.

Quantitative easing has distorted the market so much so that it is pricing in base rates of 1% or less over the next 30 years. In the long run equilibrium, base rates should be in line with nominal growth in the economy, which we estimate at just over 4%.

Chart 7: Market pricing in base rates at 1% or below forever



Source: Bloomberg, as of 24th August 16, 1M forward rates based on GBP OIS swap curve

The UK isn't Japan. The economy was expanding at a 4% nominal rate in the three years before the referendum and with additional stimulus we expect it to reach those levels again before too long.

With real yields on index-linked gilts negative, the UK government is being paid to borrow. We are hopeful that the Autumn Statement will see a significant fiscal boost that will allow domestically exposed commercial property to recover.

Chart 8: UK (3 year rolling Nominal GDP growth and base rate

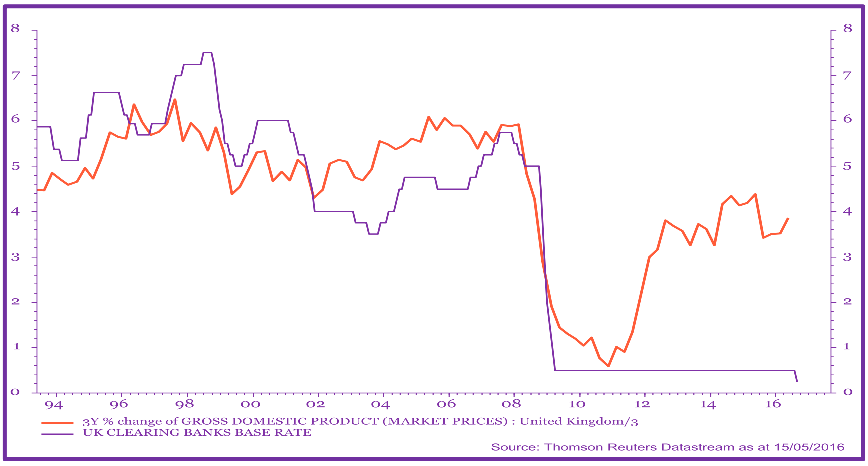
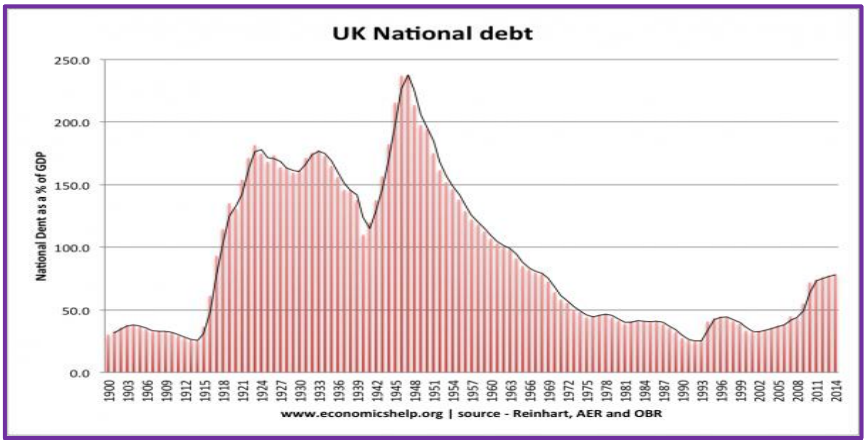


Chart 9: UK National Debt to GDP



Targeted fiscal spending can stimulate nominal growth while the Bank of England keeps interest rates close to or below the level of inflation. Such a policy of so-called "financial repression" saw debt levels drop in the decades after World War II from nearly 250% of GDP to less than 40%, transferring wealth from savers to borrowers, including the government.

Japan is something of a trail blazer when it comes to public debt today. The authorities are looking to expand fiscal and monetary policy to counter deflationary forces and keep rates low. The rest of us should watch with interest.

BACKDROP SUPPORTIVE OF GLOBAL STOCKS

We tell the time on the Investment Clock model that links asset class returns to different phases of the global business cycle by analysing trends in growth and inflation. The Clock is currently in the commodity-friendly Overheat phase, characterised by above trend global growth against a rising inflation backdrop.

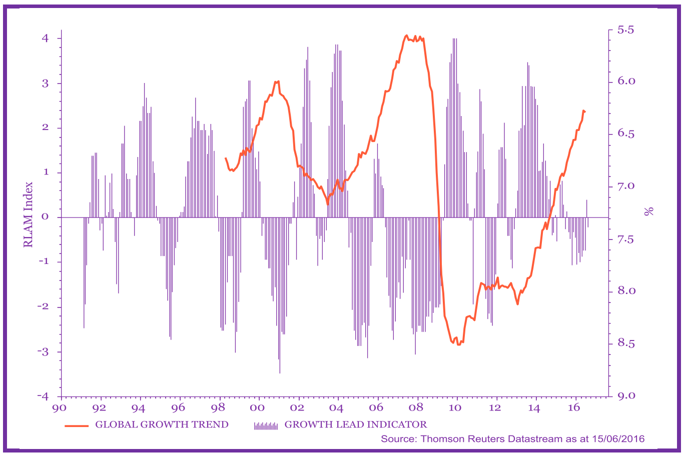
Growth trend positive, inflation low

- Global unemployment continues to fall, indicating that the period of above trend growth that began in 2009 is still in train. Lead indicators are mixed, however, and cycles are shallow and short-lived. On the inflation side, we have seen a modest rise on the back of commodity price base effects but our lead indicator isn't picking up any momentum. We expect the Clock to keep moving between Overheat and equity-friendly Recovery as inflation pressures ebb and flow.

Supportive of stocks and commodities

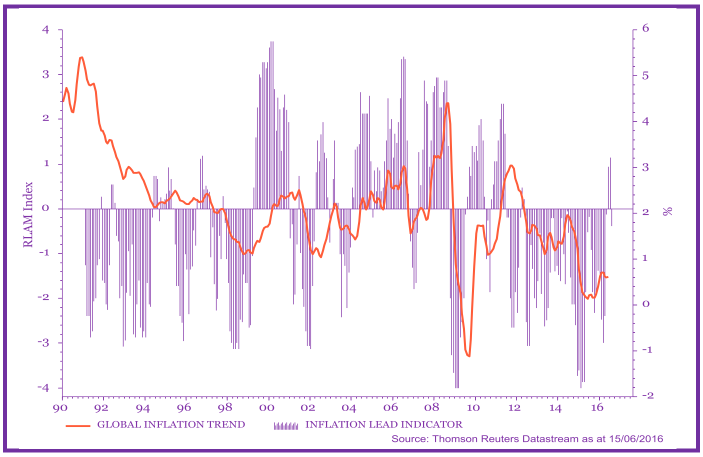
- With growth positive and policy likely to stay loose, we remain positive on stocks, especially in the emerging markets and Japan**.** We've been bearish on commodities for the last five years despite periodic forays into Overheat due to the slowdown in China, concerns over supply and US dollar strength. This year we brought them up to neutral. With the Fed unlikely to hike rates before December and Chinese activity firming, there is the potential for further gains.

Chart 3: Global growth trend positive



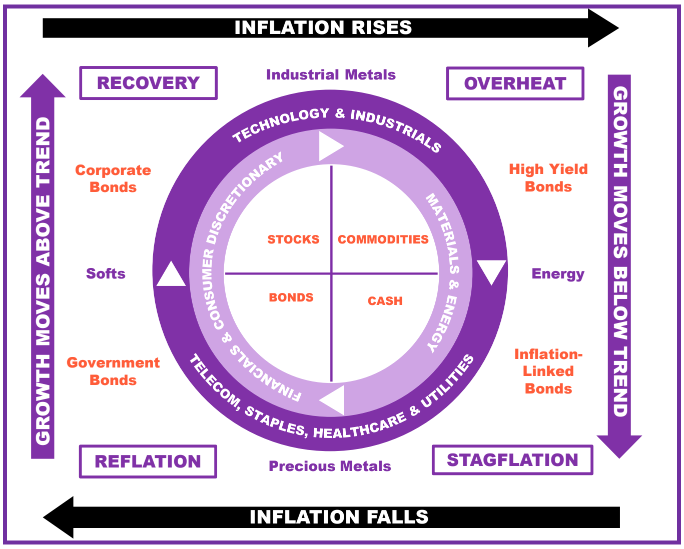
Source: Growth trend based on global unemployment rate (inverted). Lead indicator includes central bank policy, OECD lead indicators, business confidence and economist GDP forecasts.

Chart 4: Inflation scorecard directionless



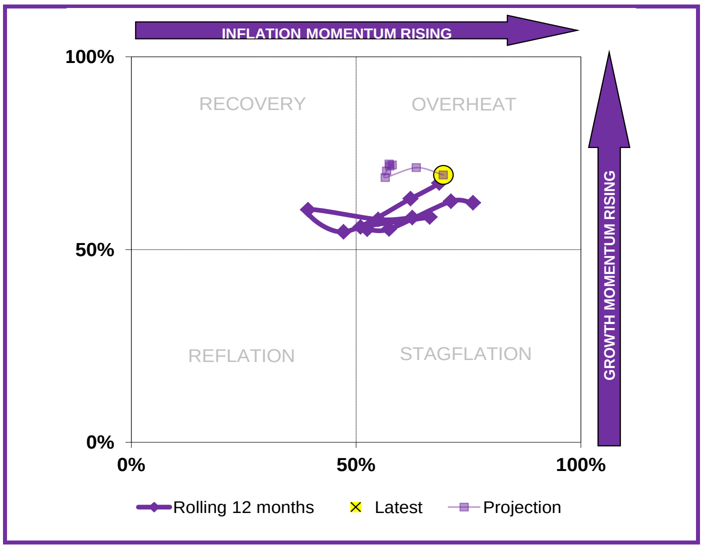
Source: Inflation trend based on global consumer price inflation. Lead indicator takes includes spare capacity, the oil price, surveys of industrial pricing power and economist CPI forecasts.

Chart 5: The Investment Clock



Source: RLAM.

Chart 6: Clock indicator in Overheat Phase



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

WHERE WE STAND

Overweight stocks, especially emerging markets and Japan; underweight bonds

	--		-		=		+		++
Multi Asset									
Stocks							■		
Property					■				
Commodities					■				
Bonds			■						
Cash					■				

	--		-		=		+		++
Regional Equity									
UK					■				
US					■				
Europe			■						
Japan						■			
Pacific ex. Japan					■				
Emerging Market						■			

Multi Asset: Overweight Equities

- We have been overweight equities since 2012 on the back of continued global recovery with loose policy and muted inflation. We have added to stocks at the margin in the last couple of months but have room to buy more during dips should the market follow the usual seasonal pattern.
- We are underweight bonds as a funding source for the equity overweight. We reduced our underweight in July, ahead of what we expected to be aggressive BoE action at the August MPC. Now yields have fallen to what we see as unsustainable levels over the long run, we are starting to sell again.
- We are neutral to slightly overweight UK commercial property. While there will be downside in the next few months created by the UK's decision to leave EU, a positive supply/demand backdrop and a large rental yield cushion should make UK property resilient as policy ease kicks in.
- We moved commodities up to neutral to take advantage of the recent supply led weakness. Commodities could benefit from loose policy and better growth in China in the near term.

Equity Regions: Overweight Japan and Emerging Markets; underweight Europe

- We are overweight emerging market equities on the basis of looser policy and positive growth trends. We are also slightly overweight Japan. Fiscal and monetary stimulus is probably on the way and it should boost the stock market and weaken the yen. We are looking to add more to Japan, should the policy makers deliver in September.
- We moved underweight European equities when they rebounded after the referendum outcome. Brexit raises political risks in Europe ahead of Italy's constitutional referendum later in the year and national elections in France and Germany in 2017 and this is likely to dampen any enthusiasm for the region.
- We are broadly neutral UK equities. While there is downside pressure on the domestic economy, loose policy and a weak pound are positive for stock prices.

MARKET RETURNS: POST BREXIT RALLY

- Stocks are up strongly on expectations of easier monetary policy, with returns particularly strong in sterling terms.
- Government bond yields fell sharply after the Brexit vote, generating double digit gilt returns.
- Commodities are up year to date but below year ago levels in dollar terms.
- UK commercial property prices are starting to see capital value mark downs.

FX	1 GBP buys	%1M (vs GBP)	%12M (vs GBP)
USD	1.33	-2.1	15.6
EUR	1.18	-0.4	16.4
CHF	1.29	-0.8	16.7
JPY	135.6	-1.5	36.0
AUD	1.73	-1.7	26.6
CAD	1.72	0.0	18.5

CB rates	Rate (%)	chg 1M (%)	chg 12M (%)
Fed	0.50	0.00	0.25
BoE	0.25	0.00	-0.25
ECB	-0.40	0.00	-0.20
BoJ	-0.05	0.00	-0.12

Bond Yield	Yield (%)	chg 1M (bps)	chg 12M (bps)
US 10 Year	1.59	0	-59
UK 10 Year	0.77	15	-107
EU 10 Year	-0.07	0	-74
JP 10 Year	-0.03	1	-39

	Local		GBP	
Multi Asset	%1M	%12M	%1M	%12M
UK Stocks	1.9	15.9	1.9	15.9
Global ex UK Stocks	1.8	11.5	0.1	30.6
Gilts	1.5	14.9	1.5	14.9
UK Cash	0.0	0.5	0.0	0.5
UK Property*	-2.3	5.5	-2.3	5.5
Commodities	0.1	-4.9	-2.1	8.0

	Local		GBP	
Equity Regions	%1M	%12M	%1M	%12M
UK	1.9	15.9	1.9	15.9
North America	0.5	15.4	-1.5	32.2
Europe ex UK	3.2	2.9	2.5	18.6
Japan	5.7	-5.3	3.7	27.1
Pacific ex Japan	2.3	16.3	1.0	42.6
Emerging Markets	3.9	18.8	1.9	39.7

Global	Local		GBP	
Equity Sectors	%1M	%12M	%1M	%12M
Consumer Discretionary	1.8	7.5	0.0	25.4
Industrials	2.7	14.5	1.1	34.2
Financials	3.9	5.4	2.3	22.7
Consumer Staples	0.9	19.2	-0.6	36.5
Utilities	-0.1	17.4	-1.7	35.0
Healthcare	-3.0	2.5	-4.6	17.8
Energy	3.5	16.2	2.0	32.2
Materials	2.5	17.8	1.2	37.8
Telecoms	-0.7	10.1	-2.3	27.6
Technology	3.0	22.2	1.0	41.9

	Local		GBP	
Bonds	%1M	%12M	%1M	%12M
Conventional Gilts	1.5	14.9	1.5	14.9
Index Linked Gilts	8.0	22.6	8.0	22.6
GBP Credit	0.9	14.6	0.9	14.6
Global High Yield	1.8	9.8	1.7	9.6

	Local		GBP	
Commodities	%1M	%12M	%1M	%12M
Energy	2.9	-26.3	0.7	-15.7
Agriculture	-0.9	5.8	-3.0	21.1
Industrial Metals	-2.4	-1.3	-4.5	12.9
Precious Metals	0.1	23.7	-2.0	41.5

Note: Standard indices sourced from DataStream and Bloomberg. (*) Property Returns as of July 2016.