STRATEGY UPDATE

INVESTMENT CLOCK

BULL MARKETS DON'T DIE OF OLD AGE

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ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £106.2 billion in life insurance, pensions and third party funds*.

The Global Multi Asset Portfolios (GMAPs) are available on a wide range of platforms.

*As at 30/06/2017

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UK interest rates are likely to rise a notch in November but the bond market expects base rates to average 2% or below for the next two decades. If bond markets are right, the loss of purchasing power from cash will soon outstrip the 27% drop seen over the 1970s.

With cash burning a hole in investors' pockets, it's no wonder money continues to flow into financial markets.

Stock prices have been rising for more than eight years but bull markets don't die of old age. There are few signs of the excessive growth, excessive valuation or excessive financial leverage that usually signal the approach of a bear market. The world economy is picking up but wage inflation remains muted, despite low unemployment rates. Central banks are reluctant to tighten policy in a meaningful way. With interest rates below the rate of inflation, it's not surprising that money continues to flow into markets.

Three imbalances we don't see

It has been more than eight years since the March 2009 low and yet we still see few signs of the imbalances that usually signal the end of a bull market.

1. **Growth** is not excessive – with inflation peaking, the Investment Clock is back in the equity-friendly, disinflationary Recovery phase.
2. **Valuations** are not excessive – long-term equity valuation measures are on the high side but look reasonable relative to bonds.
3. **Leverage** is not excessive – bank balance sheets have deleveraged and banks are easing, not tightening credit conditions.

Forever mid cycle

At some point a sustained rise in inflation will trigger a concerted effort by central banks to tighten monetary policy, but we're not there yet. Wage pressures remain muted and a slowdown in China is likely to keep commodity prices under control. We are overweight stocks and looking to buy dips rather than sell rallies.

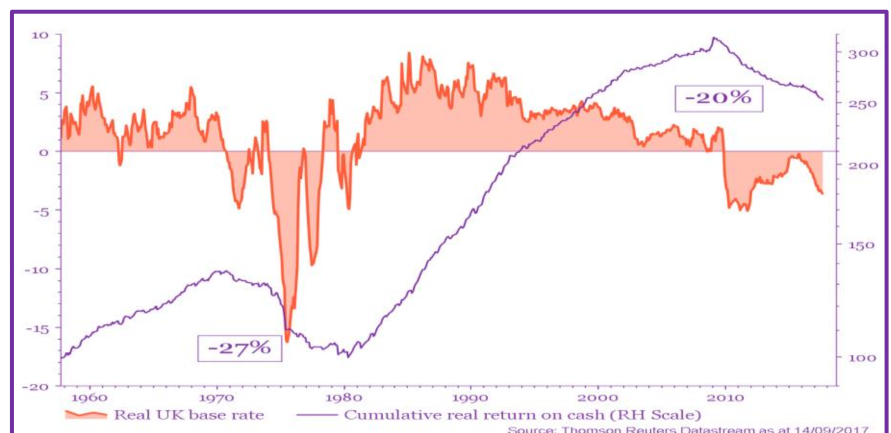
Worst drop in purchasing power of cash since the 1970s

Cash has lost 20% of its purchasing power since the financial crisis as UK rates have been held consistently below inflation (see chart). The Bank of England may reverse last summer's 0.25% rate cut, but we expect interest rates to stay negative in real terms. It's no wonder money continues to flow into financial markets.

Brexit: low risk means high sterling exposure

Brexit negotiations pose two way risks for sterling. We saw in 2016 how large an impact currency can have on multi asset returns. While a soft Brexit would be good for the economy and property markets, it could lead to poor returns from equities and overseas assets. Low risk investors should aim for high sterling exposure.

Focus chart: real interest rates and cumulative real cash returns



Source: RLAM as at 31.08.2017. Return of cash earning UK base rate versus RPI.

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

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THREE IMBALANCES WE DON'T SEE

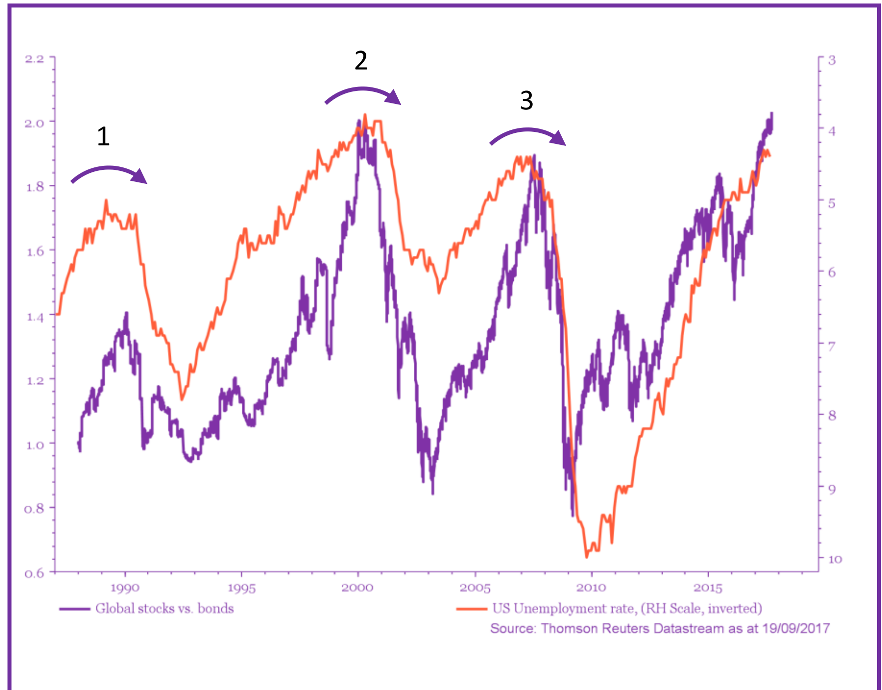
Stocks tend to beat bonds when US unemployment is dropping. There have been three big upward moves in stocks over the last three decades.

1. The 1980s bull market ended when excessive growth triggered inflation and a rate hike cycle. Today, central banks are timid.

2. The 1990s bull market ended after stock market valuations reached extreme levels in the dot com bubble. Now, valuations are on the expensive side in absolute terms but are reasonable relative to the low level of bond yields.

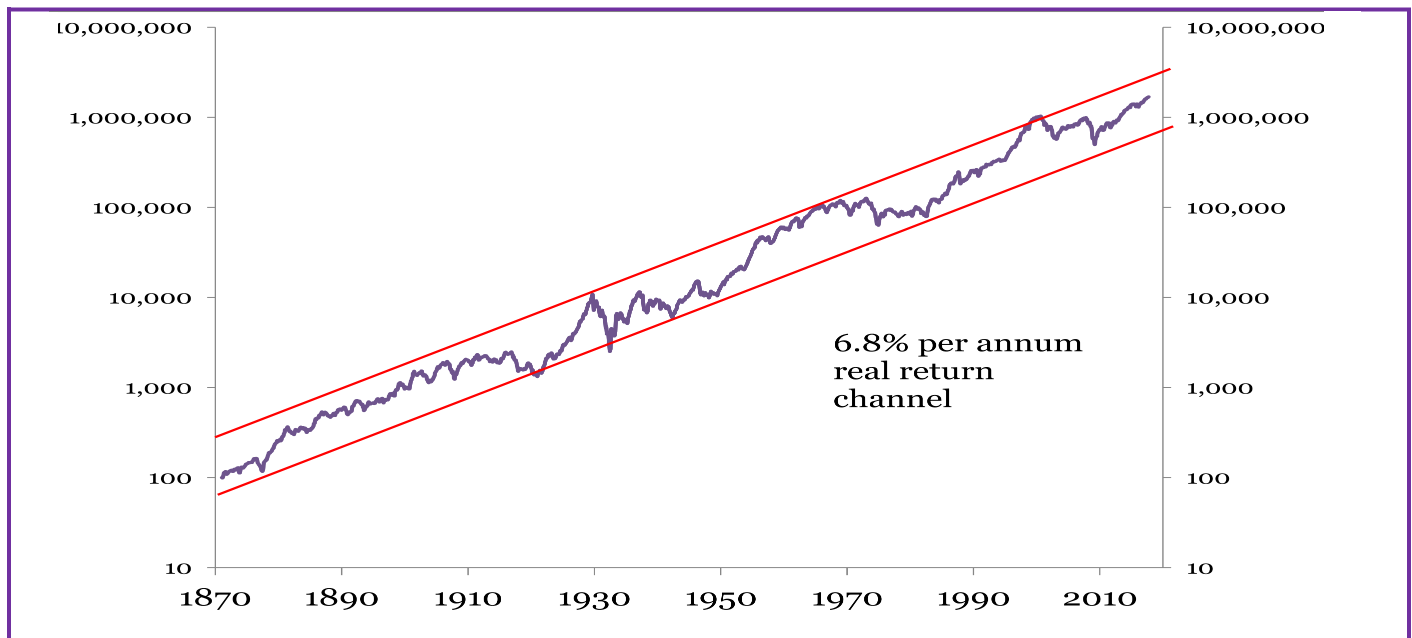
3. The mid 2000s bull market ended due to excessive leverage and a deflating US housing bubble which set off a global credit crunch. Currently, central bank balance sheets are large but their unwinding will be very gradual.

Chart 1: stocks vs bonds and unemployment (RHS, inverted)



Some market commentators are alarmed every time stocks reach new highs but this betrays a lack of historical perspective. Very long run data shows US stock returns with dividends reinvested averaging about 7% a year in real terms. Occasionally we get to the top of the return channel, as we did in the late 1960s and again in 2000, and future stock returns disappoint for a decade or so. We hit the bottom end of the channel in 2009 and have spent most of the last eight years below the previous high water mark. As things stand, we expect the current bull market to continue for at least another year or two.

Chart 2: US stock market total returns in real terms since 1870



Source: Robert Shiller, RLAM as at 31.08.2017.

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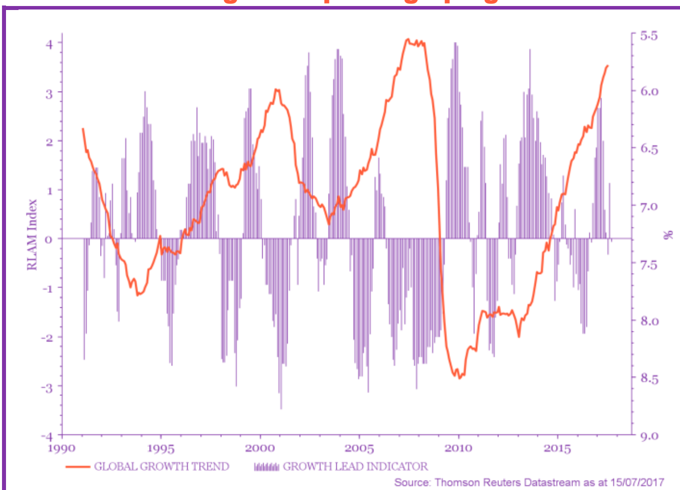
FOREVER MID CYCLE

At some point a sustained rise in inflation will trigger a concerted effort by central banks to tighten monetary policy. Rising bond yields and, ultimately, a rolling over in global growth would lead to losses in stock markets. We are very much attuned to this risk but so far, wage pressures remain surprisingly muted and a multi-year slowdown in China is likely to keep commodity prices under control.

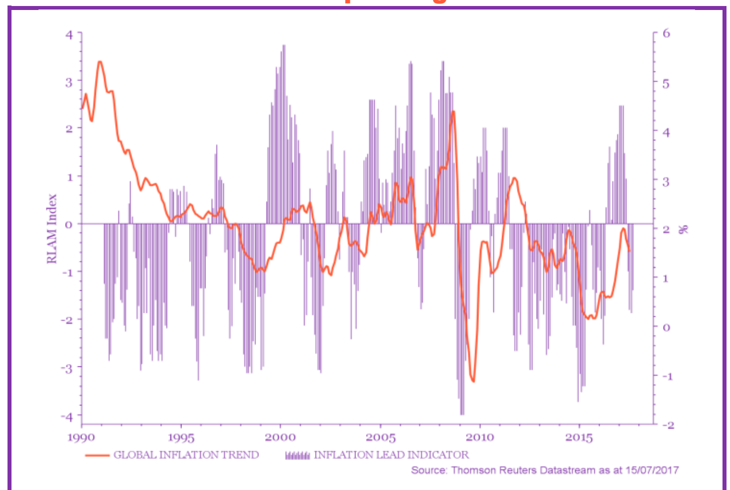
The Investment Clock model that guides our asset allocation is back in the equity-friendly Recovery phase, a mid cycle configuration with growth picking up and inflation dropping. Central banks are inching their way towards tightening in the US and UK but we don't expect a meaningful increase in interest rates against this backdrop. We are overweight stocks and looking to buy dips rather than sell rallies.

Chart 3: Global growth picking up again



Source: RLAM, DataStream.

Chart 4: Global inflation peaking

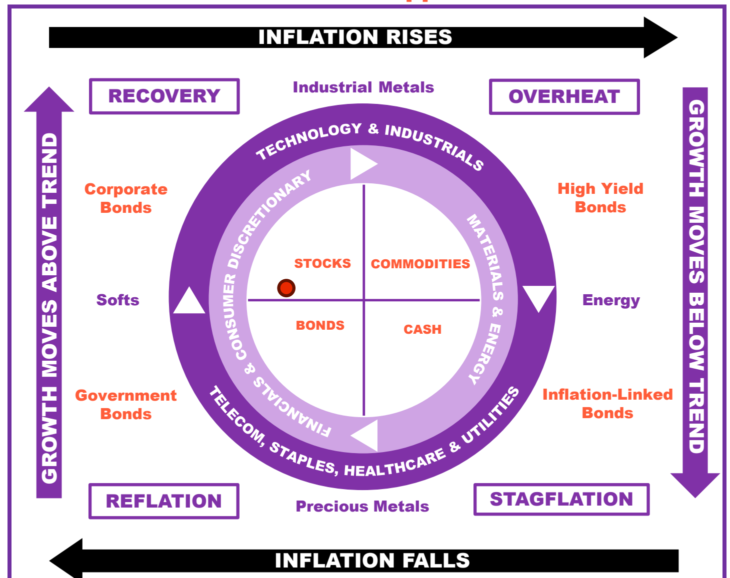


Source: RLAM, DataStream.

Chart 5: latest reading back in Recovery

Source: RLAM, for illustrative purposes only.

Chart 6: Investment Clock supportive of stocks



Source: RLAM, for illustrative purposes only.

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WORST DROP IN PURCHASING POWER SINCE 1970s

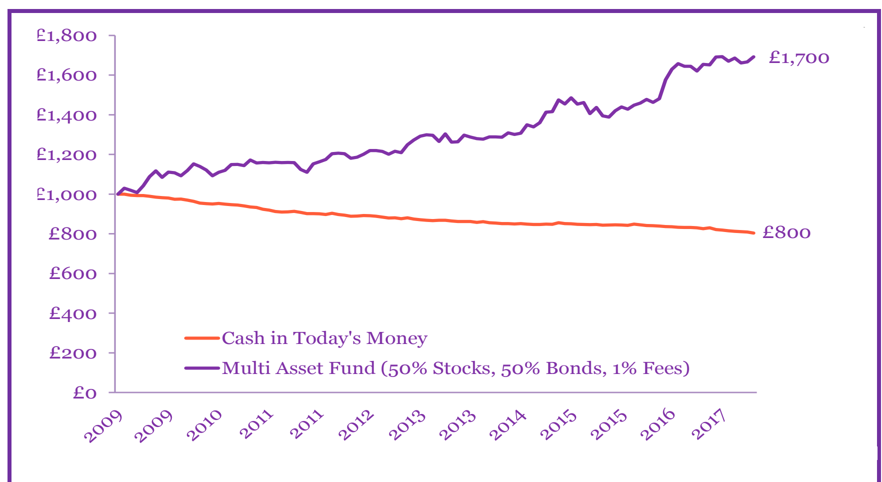
The Bank of England is likely to reverse the emergency 0.25% rate cut it made immediately after last year's EU referendum, but high levels of consumer and government debt and on-going Brexit uncertainty will keep interest rates very low. This is part of a longer-term pattern that has seen the interest on cash deposits fail to keep pace with inflation in each of the eight calendar years since the financial crisis. Cash in a bank account paying the same rate of interest as UK base rates would have lost about 20% of its purchasing power over this time (see chart).

Investors don't see this situation changing in the foreseeable future. Bond market pricing assumes base rates average 2% or below for two decades. If this is right, the loss of purchasing power from cash will soon outstrip the 27% drop over the 1970s.

To illustrate the impact of inflation, we estimate that £1,000 put into a deposit account in March 2009 would be worth about £800 in today's money. In a simple multi asset fund it would now be worth about £1,700 after fees.

With cash burning a hole in investors' pockets, it's no wonder money continues to flow into financial markets.

Chart 7: Real cash returns versus simulated multi asset returns



Source: RLAM as at 31.08.2017. Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. "Simulated returns calculated using total return data for the underlying asset classes, taking a 1% fee into account. The composite weight is made up of 50% global stocks and 50% UK government bonds

Table 1: Sterling-based returns by calendar year

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	YTD
1	EM Stocks +37.4%	Gilts +12.8%	EM Stocks +62.5%	EM Stocks +23.6%	Gilts +15.6%	EM Stocks +12.8%	Global Stocks +21.2%	Property +19.5%	Property +13.9%	EM Stocks +35.4%	EM Stocks +20.0%
2	Commodities +14.3%	Cash +5.7%	UK Stocks +30.1%	Commodities +20.5%	Property +8.1%	UK Stocks +12.3%	UK Stocks +20.8%	Gilts +13.9%	Global Stocks +4.4%	Commodities +33.3%	Global Stocks +10.8%
3	Global Stocks +11.2%	Inflation (RPI) +0.9%	Global Stocks +20.6%	Global Stocks +17.2%	Inflation (RPI) +4.8%	Global Stocks +12.1%	Property +11.0%	Global Stocks +12.2%	Multi Asset +1.8%	Global Stocks +30.3%	UK Stocks +8.2%
4	Cash +6.0%	Multi Asset -10.4%	Multi Asset +12.6%	Property +14.7%	Multi Asset +1.6%	Multi Asset +7.1%	Multi Asset +7.3%	EM Stocks +7.9%	Inflation (RPI) +1.2%	UK Stocks +16.8%	Property +6.5%
5	Multi Asset +5.5%	Commodities -10.9%	Commodities +5.9%	UK Stocks +14.5%	Cash +0.6%	Inflation (RPI) +3.1%	Inflation (RPI) +2.7%	Multi Asset +6.5%	UK Stocks +1.0%	Multi Asset +12.1%	Multi Asset +4.7%
6	UK Stocks +5.3%	Global Stocks -18.5%	Inflation (RPI) +2.4%	Multi Asset +11.7%	UK Stocks -3.5%	Gilts +2.7%	Cash +0.5%	Inflation (RPI) +1.6%	Gilts +0.6%	Gilts +10.1%	Inflation (RPI) +2.8%
7	Gilts +5.3%	Property -22.6%	Property +1.9%	Gilts +7.2%	Global Stocks -6.9%	Property +2.3%	Gilts -3.9%	UK Stocks +1.2%	Cash +0.5%	Property +2.6%	Gilts +2.5%
8	Inflation (RPI) +4.3%	UK Stocks -29.9%	Cash +1.0%	Inflation (RPI) +4.6%	Commodities -12.7%	Cash +0.6%	EM Stocks -5.3%	Cash +0.5%	EM Stocks -10.3%	Inflation (RPI) +2.5%	Cash +0.2%
9	Property -5.4%	EM Stocks -34.8%	Gilts -1.2%	Cash +0.6%	EM Stocks -18.4%	Commodities -5.4%	Commodities -11.2%	Commodities -11.8%	Commodities -20.3%	Cash +0.4%	Commodities -6.7%

Source: RLAM, DataStream as at 31.08.2017. Figures show total returns in GBP terms ranked from highest to lowest each year.

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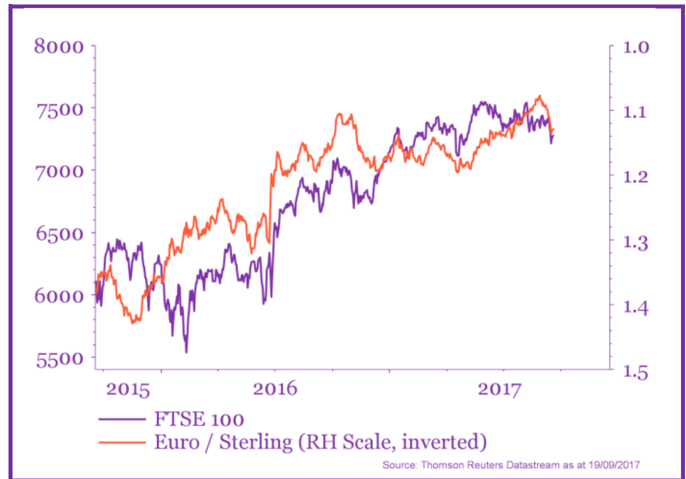
LOW RISK MEANS HIGH STERLING EXPOSURE

Brexit risks continue to point in both directions for sterling. We can imagine another 10-15% drop in the pound from current levels if the UK leaves the EU with no trade deal, a risk that we do not discount. On the other hand, a Single Market transition followed by Single Market membership could see a 10-15% rise in sterling. All of this depends on closed-door negotiations that could go either way. We saw in 2016 how large an impact swings in sterling can have on multi asset returns. The plunge in the pound boosted UK stocks, which source more than 70% of their earnings from overseas, and had a positive translation effect on overseas equities, making 2016 the best year for multi asset returns since 2009.

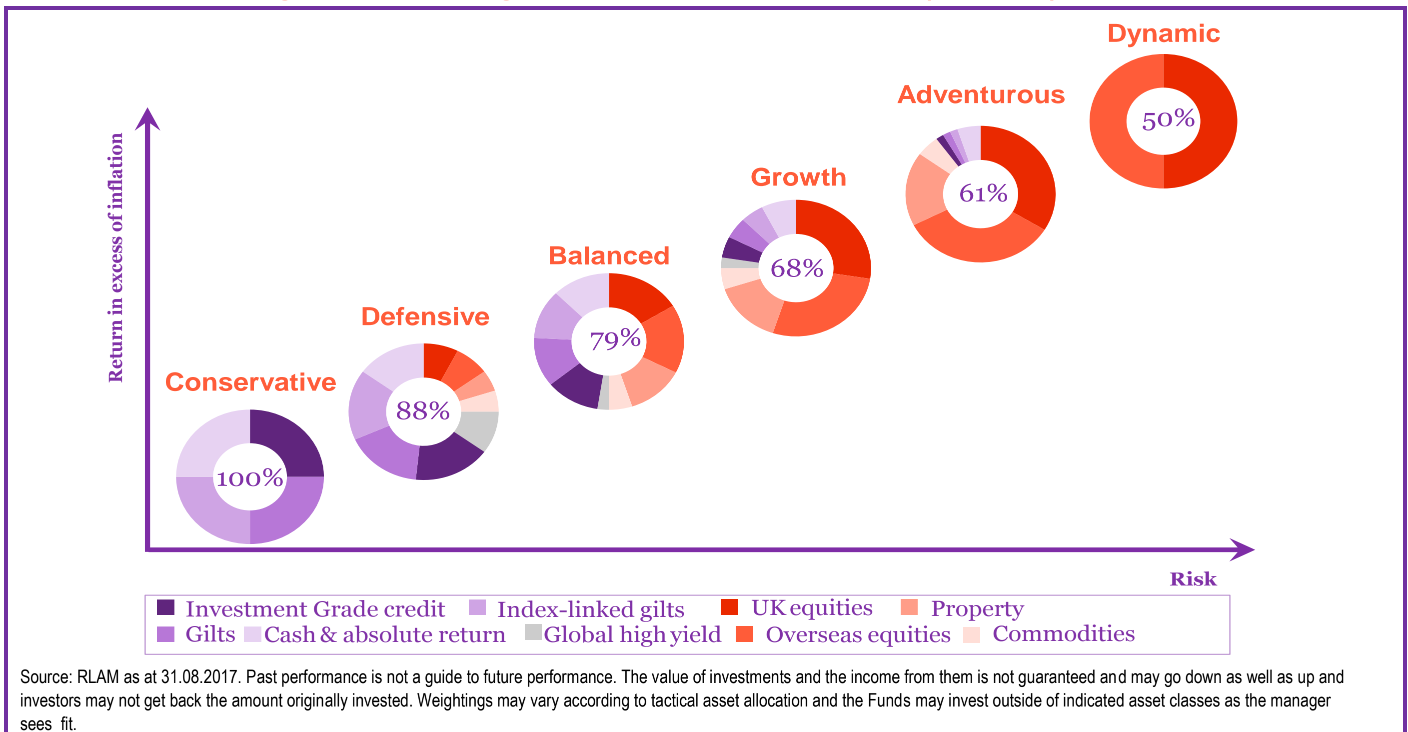
Chart 8: Sterling versus dollar and euro

Chart 9: €/£ exchange rate and FTSE100



Ironically, while a soft Brexit would be good for the economy and for property markets, it might lead to unexpectedly poor returns for UK based investors if sterling strengthens. We designed the benchmarks of our Global Multi Asset Portfolios so those with a lower long run risk target have a higher proportion of assets in sterling-denominated investments, thereby reducing exposure to currency volatility.

Chart 10: GMAP range with % sterling exposure for each benchmark (in centre)



Source: RLAM as at 31.08.2017. Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. Weightings may vary according to tactical asset allocation and the Funds may invest outside of indicated asset classes as the manager sees fit.

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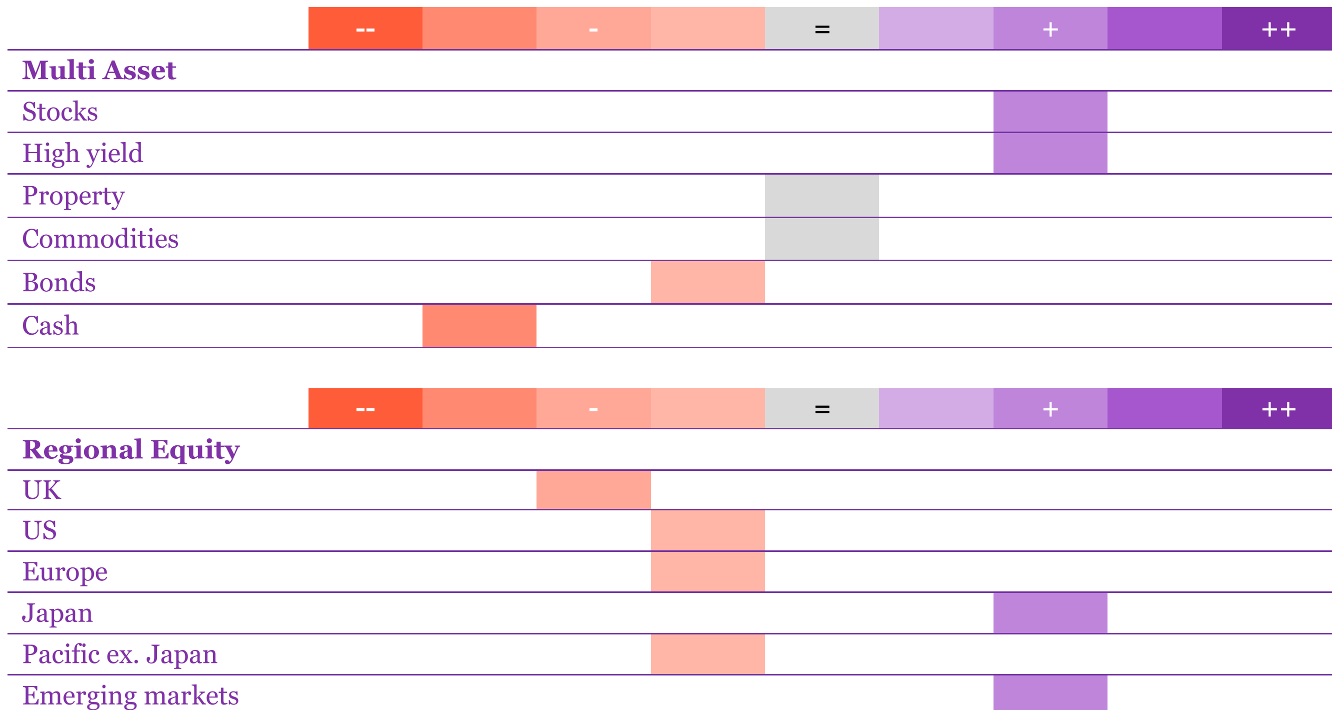
WHERE WE STAND

We are moderately overweight stocks, tilted towards emerging markets and Japan, and have an overweight position in high yield bonds. We are underweight UK stocks and underweight gilts.



Multi asset: overweight equities and high yield; underweight bonds

- We have been overweight equities since 2012 given the environment of continued global recovery and loose interest rate policy.
- We added to stocks in August during the dip caused by political tensions between the US and North Korea. Stocks have rallied since then and we've taken some profits at the margin but remain moderately overweight equities.
- We remain underweight government bonds, although less so than of late. Quantitative easing and pension fund buying have pushed yields to levels that make no sense in the long run, but inflation pressures are peaking.
- We are neutral to slightly overweight UK commercial property. A positive supply / demand backdrop and a rental yield cushion should make UK property resilient; it has proven to be so since the Brexit vote.
- We are slightly underweight commodities due to the negative roll return in those markets.

Equity Regions: overweight emerging markets and Japan; underweight UK

- Emerging Markets and Japan: we are overweight as they both benefit from continuing global growth.
- We are underweight UK equities as earnings trends are less favourable and the economy is facing the beginning of monetary tightening and Brexit uncertainty.

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