
# A PIVOTAL OCTOBER

## Issue #14

## October 2018

ROYAL LONDON

ASSET MANAGEMENT

**Stock markets tend to post their best returns from October to April but October itself can be the most volatile month of the year. The tug of war between good news out of the US and bad news out of China could make this October no exception. However, we would see volatility as a potential buying opportunity for stocks. With fiscal policy loose in America, interest rates low elsewhere and China easing policy to offset trade war fears we expect the expansion to continue into 2019. In addition, this issue provides suggestions on how to prepare UK-based portfolios for Brexit risk.**

### October, a pivotal month

Stock markets exhibit a very high degree of seasonality. It's hard for financial markets to make headway over the summer when trading is thin and there isn't much going on in the world economy. As a result, an amazing 97% of global stock market returns since 1973 have accrued during the seven months from October to April. However, volatility also tends to reach its peak in October (see focus chart), a fact underlined by famous October crashes in 1929, 1987 and, more recently, 2008.

### The Investment Clock: In Stagflation

Cross-currents in the world economy make this October particularly pivotal. The Investment Clock that guides our asset allocation is in 'Stagflation'. Economic growth is slowing outside of the US, inflation is rising from low levels and the US Federal Reserve (Fed) is raising rates. This is usually a bad configuration for stocks but we are living in a two speed world with the emerging markets under pressure while President Trump's tax cuts and spending increases keep the US economy strong.

### Broadly neutral on equities but ready to buy dips

We bought stocks aggressively during weakness in the first quarter of 2018 and de-risked the Royal London Global Multi Asset Portfolio (GMAP) funds again heading into the early summer as markets recovered, taking emerging market equity and commodity exposure underweight. We would see October volatility as a potential buying opportunity for stocks. With fiscal policy loose in America, interest rates low elsewhere in the world and China easing policy to offset trade war fears we expect the economic expansion to continue into 2019.

### How to prepare portfolios for Brexit

Brexit is a 'known unknown' but a diverse set of outcomes is still possible, ranging from a No Deal exit to a referendum on the final deal that could see the UK remain in the EU on current terms. But how do you prepare portfolios for Brexit when you don't know what Brexit is? We outline a pragmatic approach.

**Multi asset views from RLAM**

Royal London Asset Management manages £117.1 billion in life insurance, pensions and third party funds*.

The Multi Asset team manages the Governed Range pension funds and Global Multi Asset Portfolios (GMAPs) available on a wide range of platforms.

*As at 30/06/2018

**Trevor Greetham**
Head of Multi Asset
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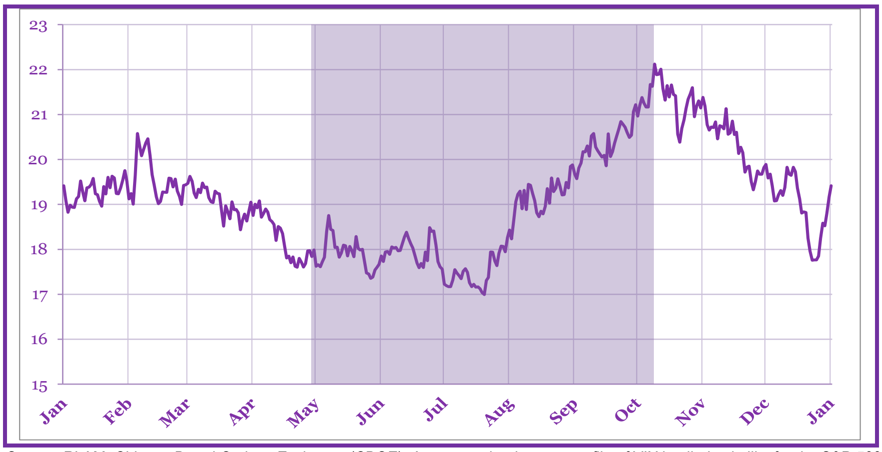
Investment Director

### Focus chart: Seasonality of stock market volatility (VIX)




Source: RLAM, Chicago Board Options Exchange (CBOE); Average calendar year profile of VIX implied volatility for the S&P 500 index from January 1990 to September 2018.

Stock market volatility tends to reach its peak in October as news starts to filter through about the strength of the world economy heading into the seasonally important fourth quarter of the year.

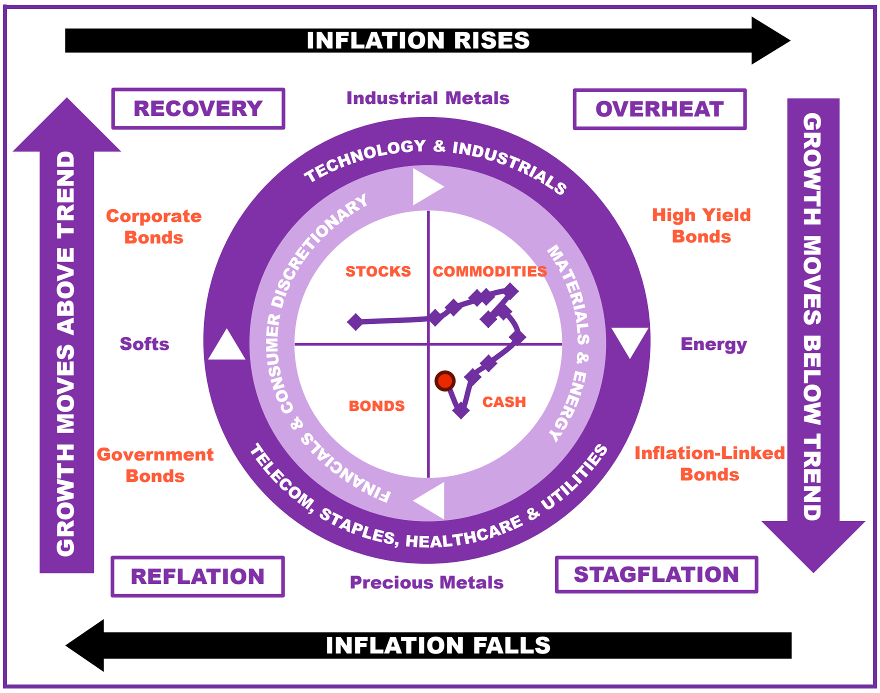
*Please visit www.investmentclock.co.uk for our blog and information about our multi asset range. For product details, contact:*
*multiassetsupport@rlam.co.uk*

# INVESTMENT CLOCK: IN STAGFLATION

Our Investment Clock model relates the performance of different investments to the prevailing economic backdrop. We 'tell the time' on the Clock by plotting growth indicators against inflation indicators in two dimensions to see which assets should be doing well at this stage of the business cycle, if history offers a reliable guide.

The Investment Clock has been in Stagflation since July, with global growth coming off the boil and inflation rising from low levels. Historically, Stagflation has not been a good stage of the cycle to own stocks.

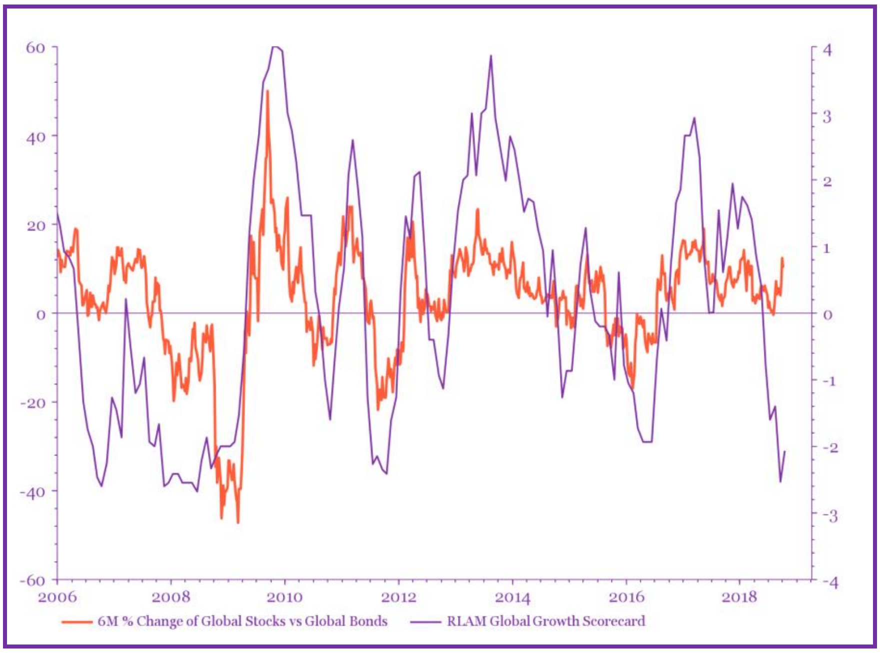
## Chart 1: Investment Clock




Source: RLAM. For illustrative purposes only. The red dot signifies this month's reading from our global growth and inflation indicators with the trail showing the evolution of readings over the previous 12 months.

Stocks usually underperform government bonds when global growth is slowing. RLAM's Global Growth Scorecard has been pointing downwards for the last six months and yet global stock prices have risen, led by the US.

## Chart 2: RLAM Global Growth Scorecard & stocks vs bonds



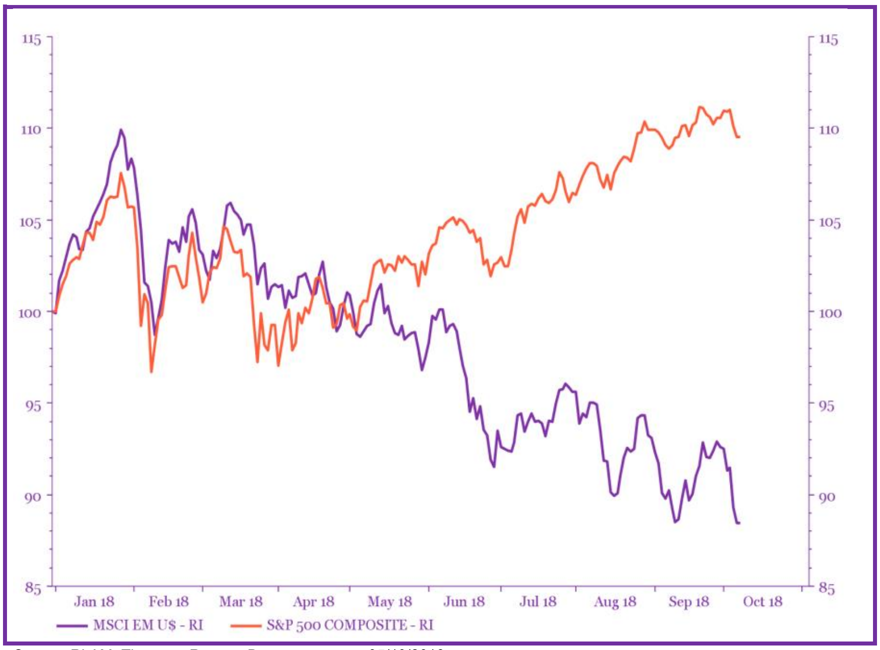

Source: RLAM, Thomson Reuters Datastream 05/10/2018; RLAM's Global Growth Scorecard factors in the monetary policy stance of the major central banks along with lead indicators and trends in business confidence surveys and consensus GDP forecasts.

# EMERGING MARKETS AND USA DIVERGE

We are living in a two speed world with China slowing while President Trump's tax cuts and spending increases keep the US economy strong. The emerging economies are caught in the crosshairs with weaker activity in China putting downward pressure on exports while US interest rate hikes increase the cost of US dollar finance.

Add in trade war concerns and geopolitical instability and you can see why the emerging markets are in bear market territory, down more than 20% since the January highs.

**Chart 3: Emerging market equities and Wall Street**

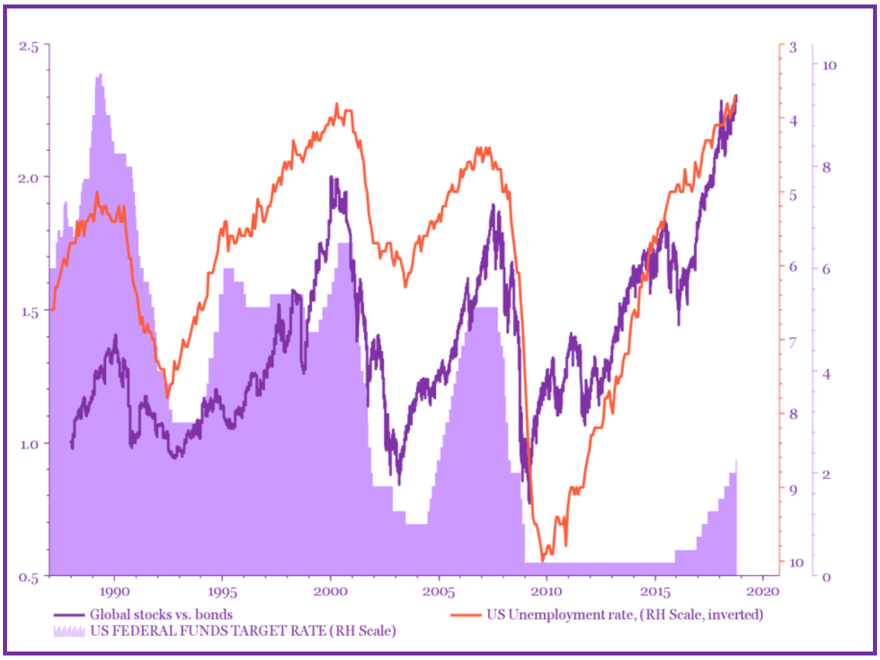



Source: RLAM, Thomson Reuters Datastream as at 05/10/2018.

Meanwhile, the bull market in US equities has continued to march to new highs, supported by the second longest economic expansion in US history.

The unemployment rate has fallen from 10.0% of the workforce in 2009 to just 3.7% today. A tighter labour market eventually stokes wage inflation but US interest rate rises have so far been modest.

**Chart 4: Stocks vs bonds with unemployment and Fed Funds**



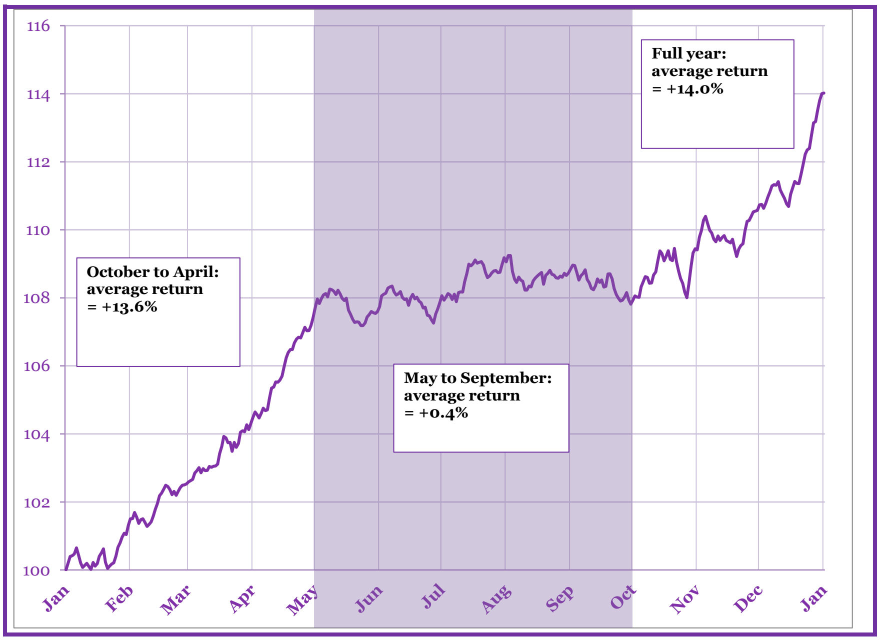

Source: RLAM, Thomson Reuters Datastream as at 05/10/2018.

# SEASONALITY IMPROVING; LOOK TO BUY DIPS

It’s hard for financial markets to make headway over the summer months when trading is thin and there isn’t much going on in the world economy.

An amazing 97% of global stock market returns since 1973 have accrued during the seven months from October to April. However, volatility also tends to reach its peak in October, a fact underlined by famous October crashes in 1929, 1987 and, more recently, 2008.

**Chart 5: Seasonality of stock market return**

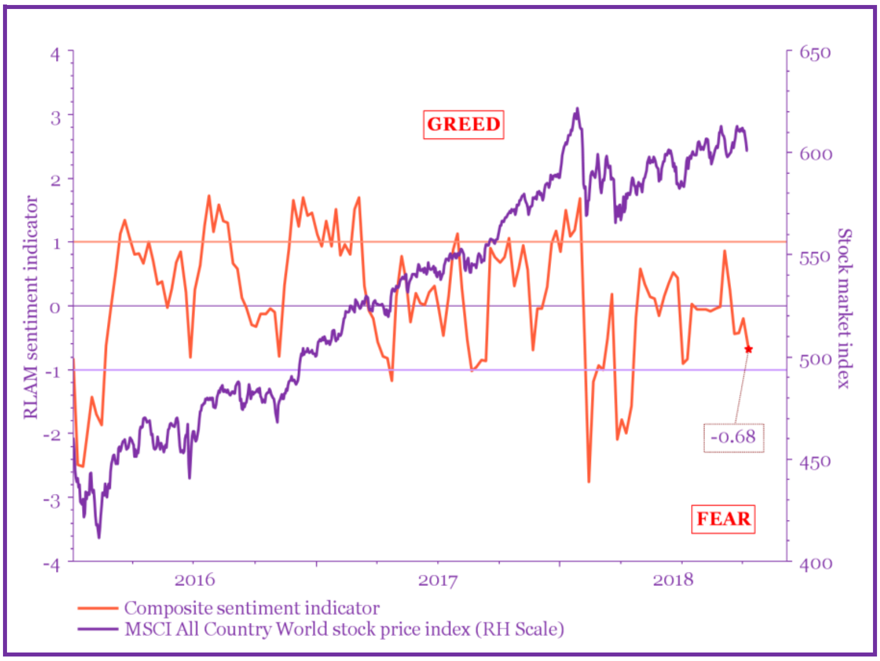



Source: RLAM. Average calendar year profile from January 1973 to September 2018 of the Datastream World USD Total Return index, rebased to 100 on 1 January.

We bought stocks aggressively during weakness in the first quarter of 2018 and de-risked the GMAP funds again heading into the early summer as markets recovered, taking emerging market equity and commodity exposure underweight.

Investor sentiment may be starting to falter once more but we would see October volatility as a potential buying opportunity for stocks. With fiscal policy loose in America, interest rates low elsewhere in the world and China easing policy to offset trade war fears we expect the economic expansion to continue into 2019.

**Chart 6: Contrarian sentiment indicator and stock prices**




Source: RLAM. Thomson Reuters Datastream as at 05/10/2018.

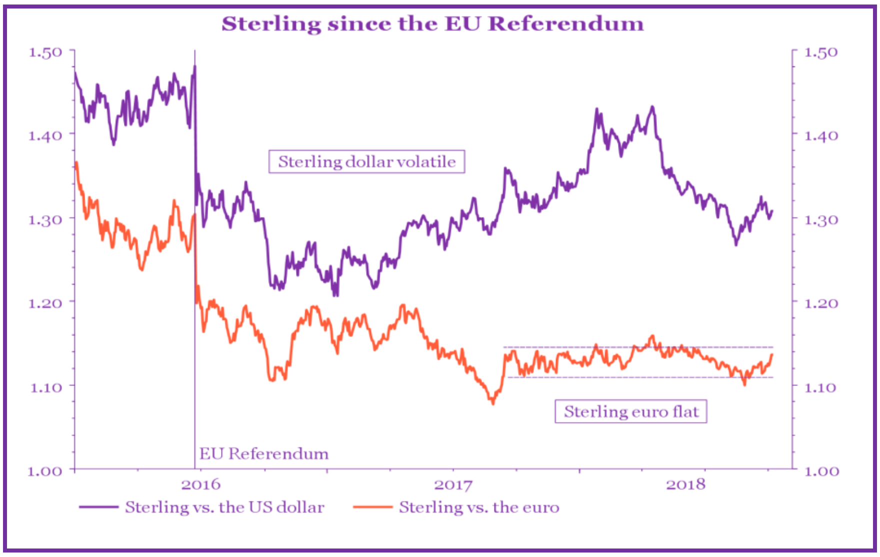
# HOW TO PREPARE PORTFOLIOS FOR BREXIT

It's hard to prepare for Brexit when you don't know what Brexit is. The UK could leave the EU with a wide range of future trading arrangements lined up. The decision will probably come late and involve last minute compromises that no one can forecast.

The impact on sterling and gilt markets will be very different in each scenario.

- The more disruptive outcomes would probably see a rally in gilts and a slide in the pound as the Bank of England kept interest rates lower for longer.
- An outcome unexpectedly close to EU membership could see gilt yields rise and the pound surge on the foreign exchanges.

**Chart 7: Sterling vs the US dollar and the euro**



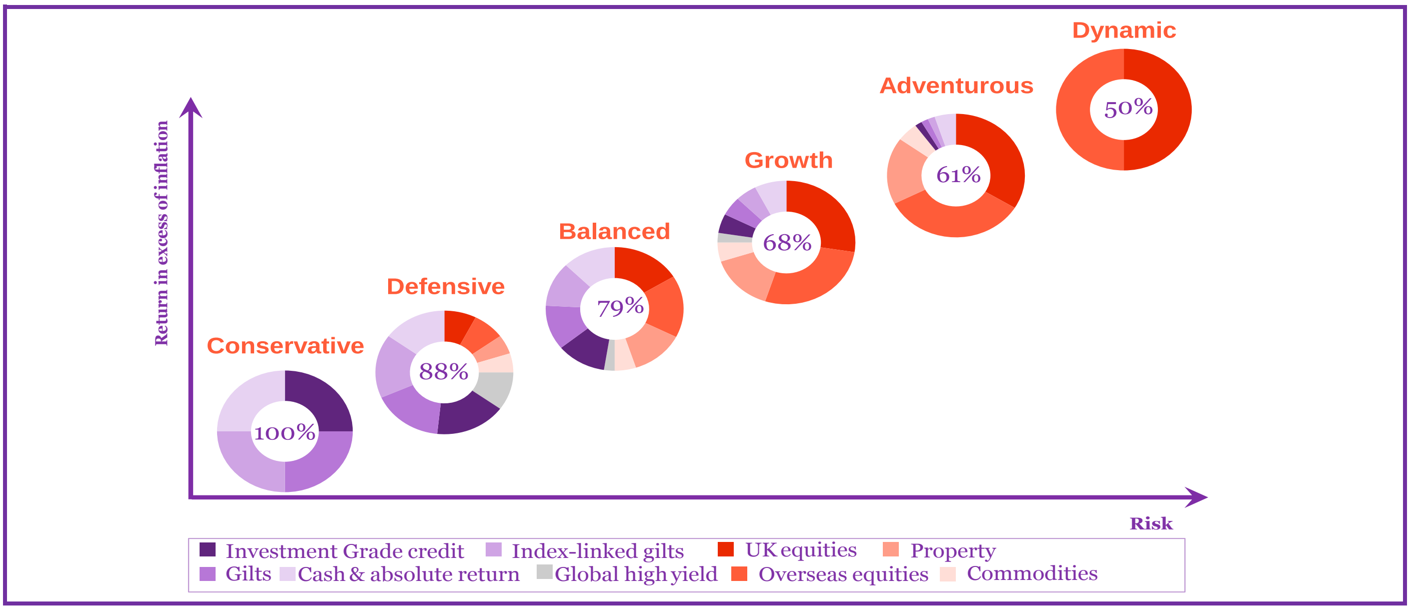

Source: RLAM, Thomson Reuters Datastream as at 05/10/2018.

We have three pragmatic suggestions when preparing portfolios for Brexit risk.

1. Given the uncertainty, we advise against structuring portfolios for a particular outcome. This is about hedging risks.
2. Investors with a lower risk appetite may wish to consider investing in lower risk portfolios with a higher proportion of their assets in sterling-denominated investments, reducing exposure to potential currency volatility. This is the approach we take with our risk-rated GMAP funds.
3. Consider investing in growth-seeking assets that would do well in different scenarios. For example, we include commercial property alongside equities. Property may do well if the UK ends up in a closer relationship with the EU. Equities may potentially do better in a more distant relationship, accompanied by a weaker pound that would inflate the value of overseas earnings.

For further details please see our blog article, How to prepare portfolios for Brexit when you don't know what Brexit is

**Chart 8: RLAM GMAP range with % sterling exposure for each benchmark (in centre)**




Source: RLAM. Text in the centre of each ring refers to the Global Multi Asset Portfolios (GMAPs). Weightings may vary according to tactical asset allocation and the fund may invest outside of indicated asset classes as the manager sees fit. Inflation as measured by the Consumer Price Index (CPI).

# WHERE WE STAND

We are broadly neutral stocks, tilting towards more defensive US equities. We have a modest overweight position in high yield bonds. We are underweight emerging market stocks and underweight commodities.

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|---|---|---|---|---|---|---|---|---|---|
| **Multi Asset** | | | | | | | | | |
| Stocks | | | | | ■ | | | | |
| High Yield | | | | | | | ■ | | |
| Property | | | | | ■ | | | | |
| Commodities | | | | ■ | | | | | |
| Bonds | | | | | ■ | | | | |
| Cash | | | | ■ | | | | | |

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

Source: RLAM. Tactical positions as of October 2018. Weightings may vary according to tactical asset allocation and the Fund may invest outside of indicated asset classes as the manager sees fit.

## Multi asset: neutral equities and overweight high yield; underweight commodities

- We cut the size of our overweight in equities at the late January highs and bought back aggressively during the February/March market panics. We took profits in the recovery and our overweight in equities is now at its lowest level since 2012. We are underweight commodities.
- With US fiscal policy loose, no central banks in a hurry to tighten policy and China easing to offset trade fears, we would probably buy stocks on weakness. We expect the business expansion to continue in 2019.
- We remain overweight short duration high yield as near-term recession risks remain very low.
- We are neutral to slightly overweight UK property. A positive supply / demand backdrop and a rental yield cushion make UK property relatively resilient, despite Brexit risks to the City of London.

## Equity Regions: overweight US; underweight emerging markets

- We remain positive on US equities and underweight the emerging markets. Trump's fiscal stimulus and tariff increases underpin this position, as does the slowdown in China.
- We remain overweight Japanese equities as a potential beneficiary of further US dollar strength.