Schroder Multi-Asset Investments
Monthly views

April 2018

Shifting gears in a continuing volatile market

If the US economy continues to grow through the second quarter, the current expansion from trough to peak will equal and then surpass the second longest on record (106 months recorded between 1961 and 1969). Such figures naturally raise questions about the longevity of the cycle; therefore, we are closely monitoring the "vital statistics" of the US economic expansion and are on high alert for any sign of slowdown.

This is important for investors because the US equity market has been the leader in the bull market which started in 2009. At the beginning of the year we listed a number of indicators we were watching, we provide an update on each indicator below:

Our cyclical models continue to point to the "Expansion" phase of the cycle which is typically still positive for markets.

Although the US Federal Reserve (Fed) continues to raise rates, it has not surprised investor expectations. [1]

The shape of the US yield curve has been stable over the quarter and does not point to recession risk for now.

The US $ has remained weak as we predicted and this has supported global liquidity and our emerging market positions.

Trade wars or clever strategy

Talk of "trade wars" has been the main surprise of 2018. The topic has taken center stage recently with the US announcing its plans to impose tariffs of up to 25% on $60bn of Chinese exports. We see this as part of a bargaining strategy on the part of the US administration, which has been quick to grant exemptions from its earlier steel tariffs and has been wary of putting tariffs on goods which the US consumer would notice, for example iPhones. These moves suggest that trade wars are not the end game here. Instead it is likely to be a deal with China that can be held up as a victory ahead of the US mid-term elections in November.

We may be wrong of course and the recent shift in White House personnel is a cause for concern. If we see a more sustained shift towards protectionism, we would view this as a challenge for growth expectations as global trade has been the main factor driving the global expansion over the last year. We are less concerned about the inflationary consequences of protectionism as we believe that the effects would be lagged and complex. Indeed, more generally, we continue to be more worried about growth disappointing on the downside than inflation surprising on the upside.

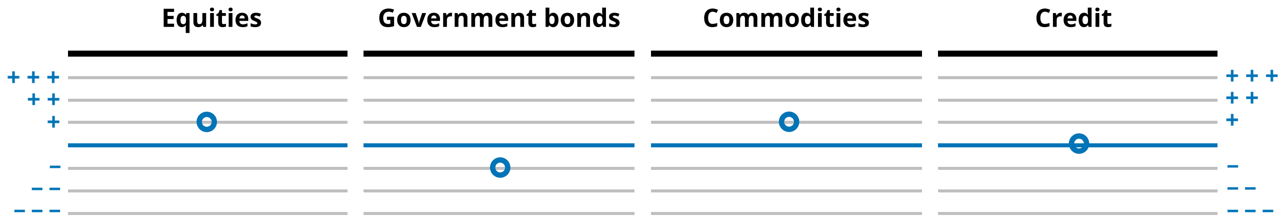
The technology sector has also come under political scrutiny of late with Facebook being in the eye of the storm. This is a not a sector we have emphasized due to concerns about lofty valuations against a backdrop of rising rates. Recent concerns about greater regulation only underpin our concern about valuation.

All in all, we are very conscious that we are in the late stages of the cycle and market prices have moved to reflect a lot of our views: US and Emerging market equities have outperformed, the dollar has weakened and the Japanese yen and emerging market currencies have strengthened.

We cannot afford to be complacent and have therefore increased diversification in our portfolios across asset classes. Based on our indicators, the traffic light is still green but expensive valuations pose a speed limit to returns and we have shifted our strategy down a gear.

[1] The US 10 year yield remains below 3% which is critical for the sustainability of US equity valuations. On top of this despite inflation measures rising more recently they remain in line with forecasts, therefore lowering the risks that the Fed is forced to accelerate their hiking cycle in the near-term. For now, the risk of tightening liquidity too quickly is not evident.

Current outlook



MAIN ASSET CLASSES

Category	View	Comments
Equities	+	We maintain our positive view as we believe support from earnings growth side will be strong enough to offset de-rating risks that are typically seen late in the cycle.
Government bonds	-	There is potential for a short-term consolidation rally but that the medium term picture remains negative given growth and inflation pressures.
Commodities	+	We remain positive given the supportive cyclical environment and on-going supply-side discipline. Short-term momentum continues to build while carry has improved.
Credit	0	Despite slightly improved valuation, weaker investor flow momentum and fundamentals offer limited support moving forward.

EQUITIES

Category	View	Comments
US	+	Valuations continue to remain elevated; but strong momentum in earnings revisions supported by strong economic growth and tax cuts support our positive score.
UK	0	We hold our view on UK equities, keeping it neutral with the continued risk of sterling appreciation and very early signs of recovery.
Europe	+	We expect European growth to remain strong but remain cautious given the strength of the euro.
Japan	++	We continue to believe in higher earnings potentials, but the timing of upward revisions to earnings forecasts may be delayed due to current headwind from the strong yen.
Pacific ex-Japan	+	While we remain positive on the region, we are now neutral on Australia due to domestic structural issues and mixed data.
Emerging markets	++	We continue to expect strong earnings growth against a favorable macro backdrop and recovery in global trade.

GOVERNMENT BONDS

US	-	The strength of US activity implies a pick up in core inflation. Forecasts imply much higher Federal and Treasury yields yet to come.
UK	0	We are skeptical that the Bank of England will be able to hike before November, with data not supportive of the May hike the market predicts.
Germany	-	Germany is our main short in the overall score, with an expectation of a more hawkish European Central Bank than the market is pricing.
Japan	0	We see some downside risks, but as the Bank of Japan's expansionary policy remains unchanged, so does our neutral view for the time being.
US inflation linked	+	No change to our view as valuations are still reasonably attractive, although we are approaching our initial target so will monitor.
Emerging markets local	+	We remain positive as there seems to be no imminent threat from inflation and EM countries still tend to be in mid, rather than late cycle.

IG CREDIT	US	-	Offers unattractive risk/rewards. We expect spreads to trade sideways to wider on renewed uncertainty, amid a new higher volatility regime.
	Europe	-	Spreads are currently supported by foreign flows and ongoing commitment to the Corporate Sector Purchase Programme, but there is limited room for error.
	Emerging markets USD	0	We keep a neutral view EM sovereign credit, and prefer EM corporate due to the higher credit quality and larger Asia tilt.
HY CREDIT	US	+	The fundamental picture remains generally stable. Demand has improved due to oil price stabilization, improvement in earnings and falling default rates.
	Europe	0	Interest coverage is back to pre-global financial crisis levels and net leverage has decreased. Valuations however are already reflective of the improved backdrop.
COMMODITIES	Energy	+	The continued OPEC production cuts should push the crude market into a small deficit this year, even accounting for the increase from shale, while carry remains positive.
	Gold	-	We remain negative on gold which is looking expensive relative to its long-term historical relationship with real rates.
	Industrial metals	+	The main drivers remain supportive: a weak dollar; current supply versus demand; and the robust Chinese manufacturing purchasing managers' index.
	Agriculture	+	Looks set to benefit from a multitude of positive factors – the weak US dollar, favourable supply/demand dynamics and declining agricultural stockpiles.
CURRENCIES	US $	-	We continue to believe that a weak or stable dollar environment will persist in the medium term as cost of liquidity keeps increasing without higher growth
	UK £	0	Brexit headwinds continue to impact the currency, although relatively cheap valuations can provide some buying opportunities
	EU €	0	We expect the pace of euro strength to moderate in the coming months.
	JPY ¥	0	Concerns regarding trade wars and strong JPY, as escalation of tensions would hurt trade-sensitive Asian FX the most.
	Swiss ₣	0	No change in view - we continue to expect little intervention by the Swiss National Bank.

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

Source: Schroders, April 2018. The views for equities, government bonds and commodities are based on return relative to cash in local currency. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged). The views for currencies are relative to US dollar, apart from US dollar which is relative to a trade-weighted basket.

Important Information