Schroders

Schroders Multi-Asset Investments
Monthly views
January 2018

Three is the magic number

For 2018, “3” is the magic number for a reflationary environment to continue.

Growth: we expect global GDP growth to remain at roughly **3%** over the next two years. Last quarter we highlighted the potential for the US Congress to surprise on tax reform and this has proved to be the case but we would fade any fiscally-induced excitement at this point as we don’t expect US companies to fully spend the benefits of their tax cut.

US 10 year: based on our models, US equity valuations are sustainable as long as the US 10-year yield does not go above **3%.** This would require inflation to remain subdued.

Inflation: as we believe that technological disruption and aging demographics are suppressing inflation, we expect an upper limit of “**3%**” to hold and for the process of monetary normalization to be gradual. Against this backdrop, valuations become a speed limit for returns over the medium term but we think a period of lower returns is more likely than an imminent bear market.

What could upset the apple cart?

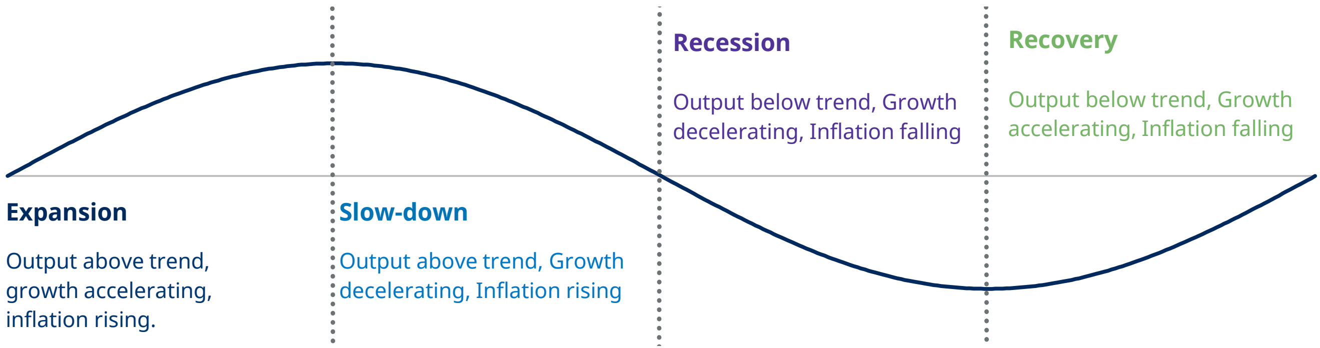
The most obvious answer is “inflation”. One indicator which suggests that growth (and therefore inflation) could surprise on the upside, is that global trade has been picking up. Another risk comes from wages; although wage growth appears to have been unresponsive to tight labor markets so far, research by the Federal Reserve suggests that the Phillips curve is non-linear and when the unemployment rate falls below a certain threshold the relationship between unemployment and inflation will re-assert itself and core inflation will begin to rise. When we model these two scenarios (“trade boom” and “inflation accelerates”) our global inflation forecast rises from 2.3% to over 3%. From an investment perspective, given market pricing, this outcome would cause volatility in the government bond markets but would also present an opportunity for more cyclically-exposed, value–driven areas of the equity markets to outperform.

A disappointment on the growth front would be more concerning for us. Developed economies are currently in the “expansion” phase, which is characterized by output above trend, growth accelerating and inflation rising. This phase of the cycle is typically benign for equities. The next phase of the cycle is the “slowdown” phase and this is the worst phase for returns.

Defining the economic cycle

Recovery in emerging markets and expansion in the developed world

Cycle characteristics



Latest cycle positioning of key markets/regions

Cycle measure	Horizon	US	Eurozone	Japan	EM	China
Growth and Inflation trackers	Short-term	Expansion	Expansion	Expansion	Recovery	Recovery
Business cycle indicators	Medium-term	Expansion	Expansion	Expansion	Recovery	Recovery
Output gaps	Long-term	Expansion	Recovery	Recovery	Recovery	Recovery
Overall		**Expansion**	**Expansion**	**Expansion**	**Recovery**	**Recovery**

Source: Schroders, 29 December 2017. Note: US output gap measure based on our own estimate of the output gap. For the Eurozone and Japan, the output gap estimate is using Oxford Economics' estimates.

The challenge is that, at first, the slowdown phase typically feels alright – output is still above trend and, although growth is decelerating, it is still positive. But by this phase equity return expectations and valuations are elevated, leaving room for disappointment and negative returns. For now the traffic light is still green but there are three trends we are watching:

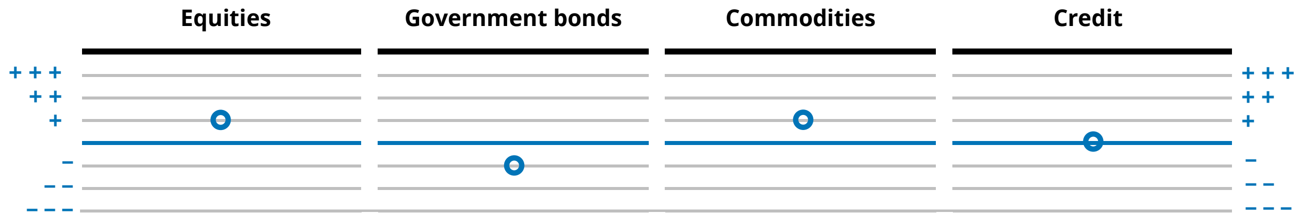
Firstly, the authorities in China and US are withdrawing liquidity. Although policy normalization is appropriate at this stage of the cycle, there is always the risk of tightening liquidity too quickly.

Secondly, yield curves are flattening, which suggests that bond markets are starting to price in slower growth. This is somewhat at odds with the optimism reflected in equity market valuations.

Thirdly, our expectation is that the US dollar is likely to remain weak as the rest of the world is catching up with US growth. If we are wrong and the US dollar strengthens, however, this would put pressure on Chinese growth and would tighten liquidity.

All in all, we continue to be positioned for a reflationary environment with an emphasis on emerging market assets which look relatively cheap. At some point in 2018 however, synchronized global recovery will morph into concerns about synchronized liquidity withdrawal. The real surprise for 2018 could be that we end the year with government bond yields lower than today.

Current outlook



MAIN ASSET CLASSES

Category	View	Comments
Equities	+	We believe equities can deliver high single digit returns in an environment of strong growth and benign inflation, driven by positive earnings growth.
Government bonds	-	We remain negative. Valuations remain expensive, central banks are (slowly) reducing policy accommodation and the cycle isn't supportive for government bonds.
Commodities	+	The cyclical environment remains supportive and with supply side discipline remaining in place the commodity markets are likely to deliver positive returns over 12 months.
Credit	0 △	We upgrade overall credit on the back of positive growth momentum and the absence of perceived catalysts for a reversal of the (currently benign) default outlook.

	Category	View		Comments
EQUITIES	US	+		Despite elevated valuations, we expect tax reform to boost earnings higher than expectations while weakness in the dollar could provide a further tailwind
	UK	-	▽	We have downgraded UK equities to neutral, expecting the market to underperform due to lackluster earnings growth amid fading uplift from sterling weakness
	Europe	+		We expect European growth to remain strong, with expanding profit margins outweighing potential euro strength
	Japan	++		The favorable global backdrop supports our bias for high beta markets like Japan, in addition to the growth-friendly 2018 tax reform plan
	Pacific ex-Japan	+		The region is attractively valued and should benefit from the ongoing improvement in global trade.
	Emerging markets	++		The market remains supported by the favorable macroeconomic backdrop and strong earnings growth.
GOVERNMENT BONDS	US	-		Valuations remain unattractive against a backdrop of low inflation expectations and unwinding of the Federal Reserve balance sheet.
	UK	0		Economic data has been mixed, while Brexit negotiations provide uncertainty.
	Germany	-		Economic data has been strong, putting pressure on the central bank to reduce policy accommodation.
	Japan	0		Remain neutral, as we still expect the Bank of Japan's expansionary monetary policy to be sustained and the long end yields to be anchored.
	US inflation linked	+		Valuations continue to look attractive and inflation should (slowly) rise, supporting our decision to remain positive.
	Emerging markets local	+		While the cyclical tailwinds are waning, we still see value in the relative steepness of the EM yield curve.
IG CREDIT	US	-		We remain negative. Rich valuations combined with an increase in leverage are a dangerous combination should inflation drift higher in 2018.
	Europe	-		No change to our view. The risk / reward profile is still unattractive as spreads remain tight.
	Emerging markets USD	0	△	We upgrade to neutral with improving fundamentals and a favourable external environment offering up a lack of visible catalysts for defaults.
HY CREDIT	US	+	△	We move to positive. While leverage remains elevated, lower defaults and earnings growth are well supported by the robust economic environment.
	Europe	0	△	Valuations have marginally improved and local economic momentum is accelerating.
COMMODITIES	Energy	+		Prices are rising as inventories continue to normalise. The largest risk being OPEC not effectively managing its exit from production cuts.
	Gold	-		We see real rates as range bound; however, gold prices and positioning look extended in our view. We have scored it negatively as we doubt gold can break higher.
	Industrial metals	0		Industrial metals had been the stand-out performer over the past 12 months. The impact of supply side reforms and robust manufacturing cycle has supported prices.
	Agriculture	0		While we see prices as depressed there is little catalyst for a recovery at present.

CURRENCIES	US $	- -	Positive drivers for the dollar appear priced in, while a continuation of the "Goldilocks" environment and structural overvaluation keep us negative on USD.
	UK £	0	We remain neutral as we believe that although fundamentals are worsening, the currency is being driven by Brexit-related news flow.
	EU €	+	We maintain our positive view as we expect further catch-up of the eurozone vs the US in terms of economic recovery and monetary policy.
	JPY ¥	0	We remain neutral on the grounds of cheap valuation and extreme short positioning combined with the beginnings of policy change from the Bank of Japan.
	Swiss ₣	0	Given continued improved cyclical picture and a reduction in European political risk we continue to expect less 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, January 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.