



Stockmarket sell-off: investing through seven lean years

In an update from the Multi-Asset Investment team, we discuss where global markets might go next and the key issues investors should consider

August 5, 2011

- The recent volatility in the markets originates from investors recognizing the deepening economic malaise associated with the (clumsy) unwinding of excessive debt in the West.
- We need to continue to monitor the cycle closely and are ready to take advantage of it in spite of our bigger picture concerns. Clearly the performance of emerging economies, and China in particular, will be critical to this call
- In our own accounts, we are unlikely to de-risk further and are looking for opportunities to pick up cheap assets

After weeks of uncertainty, markets around the world faltered this week due to an onslaught of negative news surrounding the US debt ceiling, European sovereign debt, and the sharp deterioration in global economic indicators.

Here, we discuss where global markets might go next and the key issues investors should consider from a multi-asset perspective.

The big picture

The recent volatility in the markets originates from investors recognizing the deepening economic malaise associated with the (clumsy) unwinding of excessive debt in the West.

The solution will probably lie in the following:

- an eventual realignment of exchange rates between the developed and emerging worlds,
- fiscal 'pain' as governments cut spending and raise taxes,
- a write-down of debts at some point,
- continued stress in the banking system and,
- in the short run, central banks stepping in as the guarantor of last resort – effectively printing money.

The big picture – in relation to developed markets – is therefore a negative one. Actions to date have transferred the problem from the private to the public sector, but have not addressed the fundamental issues. At the same time, the ability of the authorities to continue to 'kick the can down the road' appears to be running out with markets clearly having lost patience.

From an asset allocation perspective the situation is fraught with difficulties. As mentioned, the big picture is a negative one and we are likely to experience anemic growth in the West for several years to come.

The 'biblical overlay'

We would describe this as a "biblical overlay" (seven lean years) on the traditional cycle. The most likely outcome is a search for yield as interest rates remain ultra-low with higher quality companies and government securities the most likely beneficiaries. As a consequence, we continue to favor emerging currencies over developed currencies; emerging market debt over developed debt and corporate debt; and higher-quality, high yielding stocks.

Gold is also a useful asset as we believe that Western governments will ultimately debase their currencies.



Fight or flight?

From a shorter term perspective, we face the prospect of sovereign debt concerns evolving into systemic problems. However, short-term fluctuations in growth expectations still provide money-making opportunities. Even Japan had strong rallies during its lost decade. As a consequence, we continue to monitor the cycle closely, ready to take advantage of tactical opportunities in spite of our bigger picture concerns. Clearly the performance of emerging economies, and China in particular, will be critical to this call.

We have to, on the one hand, lengthen our time horizon so as to encompass the 'seven lean years' we are likely to experience and, on the other, shorten our time horizon, to one to three months, to capture the impact of inventory-led cyclical fluctuations and policy responses to structural concerns. The ability to consider the one- to three-month outlook within the context of a multi-year deleveraging trend will be key to successfully investing in these markets.

A silver lining?

Despite these dark clouds and recent market turmoil, not all is negative. Firstly, there is still a possibility that manufacturing data has been distorted by the disruption caused by the Japanese earthquake earlier this year. Also, corporate earnings remain robust, commodity prices – especially oil – are easing and this should be a welcome boost. Stocks, meanwhile, are trading at increasingly attractive valuations. Secondly, coordinated intervention by the US and European authorities to re-liquify the system through the purchase of bonds, for example, would provide a further boost.

How are we positioned for the next stage?

As alluded to above, we:

- believe that the relative health of corporate balance sheets is supportive of the equity risk premium;
- favor higher quality exposures within risky assets by emphasizing the US and emerging markets at the expense of Europe;
- see value in gold as a hedge on sovereign debt concerns;
- favor exposure to Asian currencies relative to developed currencies (over the medium term - where risk will be best-rewarded during these 'seven lean years');
- see value in waiting for re-entry points in corporate debt and high yield and;
- in our own accounts are unlikely to de-risk further and are looking for opportunities to pick up cheap assets.

Important Information:

The views and opinions contained herein are those of the Multi-Asset Team and do not necessarily represent Schroder Investment Management North America Inc.'s house views. These views are subject to change.

This newsletter is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument mentioned in this commentary. The material is not intended to provide, and should not be relied on for accounting, legal or tax advice, or investment recommendations. Information herein has been obtained from sources we believe to be reliable but Schroder Investment Management North America Inc. (SIMNA) does not warrant its completeness or accuracy. No responsibility can be accepted for errors of facts obtained from third parties. Reliance should not be placed on the views and information in the document when taking individual investment and / or strategic decisions.

The information and opinions contained in this document have been obtained from sources we consider to be reliable. No responsibility can be accepted for errors of fact obtained from third parties.

The opinions stated in this document include some forecasted views. We believe that we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee that any forecasts or opinions will be realized.

Further information about Schroders can be found at www.schroders.com/us.