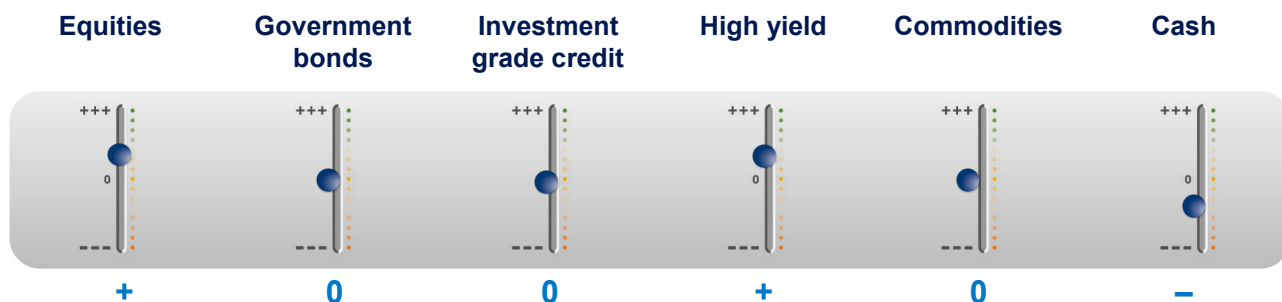


Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – September 2015

Summary



| Category | View | Comments |
|------------------|----------|--|
| Equities | + | We maintain a positive score on equities, given our view that we are in the midst of a correction in what is still a bull market. Our preferred markets are the US and Europe though we have downgraded Japan. We remain negative on emerging markets (EM). |
| US | + | We retain our positive view on US equities. Although valuations are not cheap, the country's strong cyclical trends should drive improvements in earnings over the medium term. |
| UK | 0 | UK equities are still neutral. As previously highlighted the FTSE 100 index has considerable exposure to commodity-related companies which we expect to continue to suffer from earnings pressure. This weakness is likely to offset domestic sector strength. |
| Europe | + | We remain positive on European equities as we are starting to see evidence of improving credit conditions. Leading indicators have picked up slightly and earnings momentum remains strong. |
| Japan | 0↓ | This month we have downgraded Japanese equities to neutral as the market is not immune to further weakness in the Chinese economy. Japan has a relatively high export exposure to China, and the tailwinds from the weak JPY may not be sufficient to offset the drag on demand in the near term. |
| Pacific ex Japan | 0 | We remain neutral on Pacific ex Japan equities this month. Valuations continue to become more attractive but we maintain our cautious stance due to the region's dependence on China. |
| Emerging Markets | - | The negative score on EM has again worked in our favour as the ongoing weakness in emerging economies and collapsing commodity prices have continued to affect the region's equities. Although negative sentiment is now extreme, we believe that it is still too early to position for a rebound. |

Schroders Multi-Asset Investments

| Category | View | Comments |
|-------------------------|----------|--|
| Government bonds | 0 | There is no change in our views on government bonds in developed markets. We remain neutral on duration, in aggregate, with momentum and the qualitative picture improving. Value remains neutral after the increase in the term premium earlier this year. |
| US | 0 | Inflation expectations in the US have fallen further following the devaluation of the Chinese yuan. This supports our neutral view on US Treasuries despite the broadly stronger economy. We have however adjusted our curve view, where we believe the 5 year part of the curve looks expensive while the shorter end has adjusted upward. |
| UK | + | We remain positive on the UK as gilts remain a significant beneficiary of low interest rates and quantitative easing (QE) in the eurozone. The spread over bunds continues to look attractive given the positive carry and roll. We continue to prefer curve flatteners, favouring the long end of the curve, and we remain outright positive on the 10-year gilt. |
| Germany | + | Potential further action by the European Central Bank (ECB) to suppress real yields, and a slightly stronger EUR, should continue to support the 10-year German bund. |
| Japan | 0 | We have maintained our neutral view on Japanese duration this month. Despite the unattractively low level of yields, the Bank of Japan (BOJ) is still expected to provide support. |
| US inflation linked | - - | US inflation linked bonds stay at double negative. We believe a stronger US dollar and weaker commodity prices will depress longer-term inflation expectations. |
| Emerging markets | - -↓ | We have downgraded EM USD bonds to double negative. Our momentum indicators have broken key technical levels, and the fundamental outlook continues to deteriorate. In particular we are avoiding the largest issuers such as Turkey, Russia and Brazil. |

| Category | View | Comments |
|--------------------------------|-----------|--|
| Investment grade credit | 0↑ | |
| US | 0↑ | After many months of holding a negative view, we have upgraded US investment grade (IG) credit to neutral. Spreads have moved towards the upper deciles of their long term range, and this is also likely to attract support from institutional investors. |
| Europe | 0 | European IG credits have been resilient over the summer. Accommodative monetary policy in the eurozone is depressing yields but we note that default compensation remains low on a historical basis. We therefore remain neutral. |

| Category | View | Comments |
|--------------------------|-----------|--|
| High yield credit | +↑ | |
| US | +↑ | We have also upgraded our US high yield (HY) view to positive. Credit spreads have priced in extreme risks such as a 40% cumulative default rate in the energy sector, and retail outflows appear to be tapering off. The US also looks attractive relative to EU HY. |
| Europe | 0 | We remain neutral on European HY. The default rate remains low and is unlikely to rise meaningfully under a scenario where supportive monetary policy allows companies to access low-cost financing. Nevertheless, we are continuing to monitor the reduced liquidity in the asset class, which is preventing our views from becoming more positive. |

Schroders Multi-Asset Investments

| Category | View | Comments |
|-------------------|------|--|
| Commodities | 0 | Cyclical commodities such as industrial metals and energy have been particularly hard hit by the China slowdown. However future supply is likely to shrink, leading us to maintain a neutral overall score. |
| Energy | 0 | Energy prices have reached levels where capital discipline is being forced on the oil majors. As a result prices are likely to be higher in future, but the negative carry on energy futures precludes an upgrade to positive. |
| Gold | – | Given that we expect stronger US data to push up real rates, we continue to hold a negative view on gold. |
| Industrial metals | 0 | The cost of production in base metals continues to fall, which offsets China moving into an easing cycle. |
| Agriculture | 0 | We remain neutral on agriculture, though note that predictions of the strongest El Niño on record may have a disruptive effect on markets. |

| Category | View | Comments |
|-------------------|------|---|
| Currencies | | |
| US dollar | 0 | There is no change to our neutral US dollar view. |
| British pound | 0 | We remain neutral on sterling. Comments from the Bank of England suggest a rate rise is likely in the first half of next year. However, this appears well priced by the market in the near-term. |
| Euro | + | We have upgraded our euro view to positive. This reflects our expectation that the ECB will continue with its QE programme over the coming year, the euro being cheap, and the fact that the eurozone continues to report improving growth and a current account surplus. |
| Japanese yen | – | The Japanese yen remains our least preferred currency relative to the US dollar, given weak inflation and relatively modest growth figures. It is our expectation that further accommodative monetary policy will be required over the coming year, which will weigh on the currency. |
| Swiss franc | 0 | Our view on Swiss franc remains at neutral with no obvious catalyst for a repricing. |

| Category | View | Comments |
|----------|------|--|
| Cash | – | We continue to hold a negative view on cash in the environment of negative real rates. |

Source: Schroders, September 2015. 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.

Section 2: Multi-Asset Insights

Deleveraging and the implications for the global economy and FX

In preparation for this month's Strategic Investment Group Multi-Asset meeting, we examined the reasons why the global economy is suffering from weak economic growth. In this month's Multi-Asset Insights, we explore the evidence for this and consider the implications for economic growth, monetary policy and foreign exchange (FX) markets.

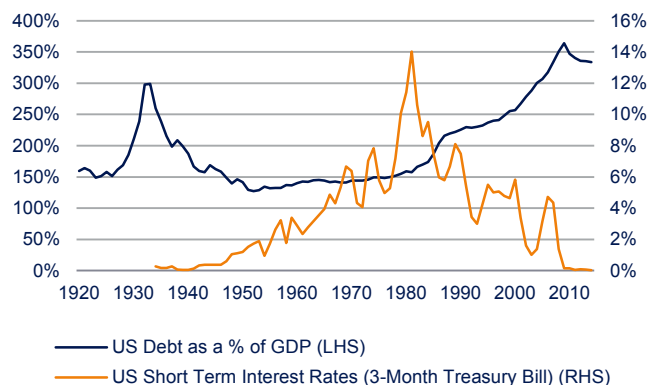
Why is global growth so weak?

Major economies around the world appear to be in a structural deleveraging cycle. We characterise this as credit growth falling short of nominal GDP growth due to shifts in demographic trends, increased financial regulation and a lack of credit multipliers.

In the 40 years prior to the global financial crisis, many developed markets became highly indebted. Using the US economy as an example, aggregate debt to GDP climbed from 150% in 1980 to 360% in 2008 (chart 1). Within this, household debt grew from 47% to 98% across the same period, financial sector debt to GDP increased from 20% to 123% and government debt grew from 43% to 70%.

The demographic trend of the outsized baby boomer populations moving through their life cycle pushed household leverage higher. Financial deregulation and innovation led to significant expansions in bank balance sheets and social welfare services brought about higher government leverage.

Chart 1: US debt to GDP and short-term interest rates



Source: Federal Reserve Bank of St Louis, as at 31 December 2014

The onset of the financial crisis coincided with baby boomers, who previously supported the expansion of household debt, moving towards retirement and deleveraging as a result. At the same time, increased

financial regulation put an end to the rapid expansion of leverage in the financial sector. However, much of the deleveraging seen in these sectors was countered by the expansion of government balance sheets with, for example, the US rising from 70% to 110% of GDP.

What are the implications for growth and how might policy makers respond?

If continued leveraging overstated growth potential in the decades before the financial crises, then a trend of deleveraging would imply that current growth potential is somewhat lower than that experienced prior to 2008. A deleveraging cycle also implies an environment characterised by deflationary pressures.

In our view, central banks will be required to maintain accommodative policy in order to support growth and allow deleveraging to occur at a modest pace. It is also likely that central banks will be required to continue to print money to counter deflationary pressures and to drive nominal growth expansion, as has been the case across many regions since 2008.

How will different economies respond?

We believe global growth is below potential due to a lack of credit multipliers during the present deleveraging phase. Central banks may seek to boost their economies to pre-crisis growth trajectories and combat deflationary pressures through QE. It is likely that this would lead to differing growth cycles. Countries where central banks engineer currency weakness will experience improved growth as their share of global growth increases, while those that have seen their currencies strengthen will experience deteriorating growth as they absorb weakness from other regions.

This has been seen recently between the eurozone and China. The collapse in EURCNY led to a meaningful pick-up in German exports while Chinese export volumes fell. The same can be seen in the US where the stronger US dollar is beginning to put downward pressure on the US trade balance and the "manufacturing renaissance", as consumers substitute domestically produced goods for their cheaper imported equivalents.

How will this affect FX?

If central banks aim to counter the pressures of deleveraging through QE, we believe this could create cycles of currency weakness followed by currency strength, with regional variations through time. Such action will have profound effects on FX pairs depending on where each central bank is in its easing cycle. However, as certain regions are in better structural shape than others, we expect these cycles to oscillate around longer term trends.

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