Schroders

For Financial Intermediary, Institutional and Consultant use only.
Not for redistribution under any circumstances.

Schroder Multi-Asset Investments
Monthly views

September 2018

Heads or tails for the US dollar?

US dollar is expensive but strength is justified…for now

Over the last three months, it has not been easy to give a strong view on the US dollar (USD). This is because while USD has become expensive according to our fair value measure, and US interest rates have slowed their rate of increase, we have struggled to see a catalyst for dollar depreciation, amid continued protectionist talk and divergence in growth between the US and the rest of the world.

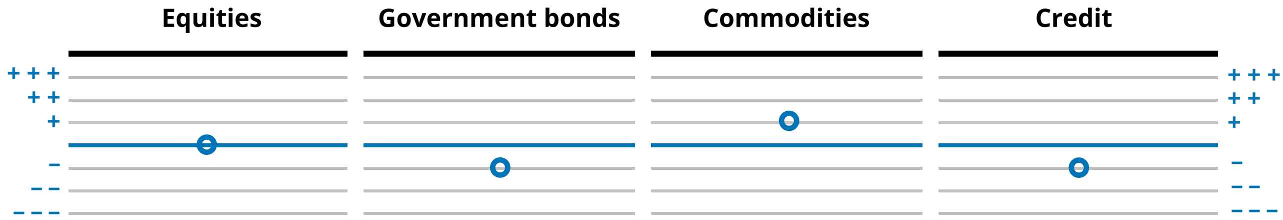
Going forward, we believe that there are three possible scenarios:

US vs. RoW Divergence continues STRONG US$	This would be a continuation of the current trend, where US assets are seen as superior to the rest of the world (RoW) for generating profits and for stronger US economic growth, while RoW continues to experience volatile conditions from higher US funding costs and more political risk (partly generated by the US).
US vs. RoW Good convergence WEAK US$	Since most major economies outside the US are in an earlier stage of the business cycle, their central banks have more policy tightening to do than the Federal Reserve (Fed). With valuations already low, higher growth and rates would provide a tailwind to many ex-US currencies.
US vs. RoW Bad convergence STRONG US$	Should US growth soften in the coming months, continued slowing of RoW growth would also be expected, resulting in continued USD strength. While confident that the Fed will keep hiking to somewhere near their neutral estimate, we question whether the European Central Bank (ECB) or Bank of Japan (BoJ) could attempt a single hike without disrupting their fragile growth recoveries.

What could change our view?

In a portfolio context, we still view the US dollar as an attractive hedge against the risk of further US monetary tightening. However, as concerns about 'trade wars' and growth divergence are increasingly reflected in market levels, we would see scope to reduce exposure.

Current outlook



	Category	View	Comments
MAIN ASSET CLASSES	**Equities**	0	Despite the expected market impact from US trade policy, we believe a future move away from politically-focused markets will create positive opportunities in equities.
	Government bonds	-	Despite cyclical headwinds, growth appears robust and we believe a further rise in yields is required to catch-up with the improved backdrop.
	Commodities	+	Top-down, the cyclical environment is positive for commodities; on a bottom up view most sectors are supported by tight supply and demand characteristics.
	Credit	-	Following a brief period of relief in July, August saw spreads resume widening although this was mitigated by government bond moves across investment grade in all regions.

	Category	View	Comments
EQUITIES	US	+	We continue to have regional preference for the US given the resilience of corporate earnings.
	UK	0	We are neutral as we believe the market is still dominated by the political noise with little sign that this can be resolved soon.
	Europe	0	Our view on eurozone equities remains unchanged, as we take into account global trade tensions and tightening financial conditions.
	Japan	0	While weakness in macroeconomic data and cyclical indicators suggest a slowdown, attractive valuations keep us neutral.
	Pacific ex-Japan	0	Momentum indicators have declined in the past couple of months but we see areas of opportunity at the regional level.
	Emerging markets	+	Despite a fall in the momentum indicator for emerging markets, especially China, we remain positive as valuations are starting to look attractive.
GOVERNMENT BONDS	US	-	Treasuries continue to look expensive. Given the Fed's tendency to telegraph rate hikes we do not see the pace of tightening as an issue.
	UK	-	Valuations remain expensive. Uncertainties around Brexit continue and further rate hikes may not materialize until a credible Brexit plan comes together.
	Germany	--	Bunds remain expensive. As the ECB steps away from quantitative easing, the market will have to focus on whether low yields are sustainable.
	Japan	0	We believe that inflation is the critical factor in whether the BoJ might consider normalization. We expect the current monetary policy stance to stay in place until inflation is close to target.
	US inflation linked	+	We remain positive on US inflation. While seasonal effects will turn negative, our latest research suggests that stagflationary fears will trump this technical factor.
	Emerging markets local	0	We remain neutral as cyclical headwinds prevent us from taking advantage of the improvement in local market valuations.

IG CREDIT	US	-		Fundamentals may be starting to weaken as shareholder friendly behavior becomes more prevalent, to the detriment of bond holders.
IG CREDIT	Europe	-		European corporates are in a stronger position, though the recent pickup in merger and acquisitions and shareholder activism is indicative of a maturing cycle in the region.
IG CREDIT	Emerging markets (EM) USD	0		We believe that the regional mix and positive earnings growth marginally favors EM corporates and sovereigns over their developed market high yield counterparts.
HY CREDIT	US	-		High yield is expensive and vulnerable to outflows, with technicals in particular unlikely to be as favourable as they were in the first half of the year.
HY CREDIT	Europe	-		Continuing political instability in the region is likely to limit spread tightening, hence we retain our negative view.
COMMODITIES	Energy	+		Global oil inventories are low; over the next six months there are risks to supplies from a number of OPEC countries that could lead to a spike in oil prices.
COMMODITIES	Gold	-	▽	Downgrade to single negative driven by our momentum signal and the increase in US 5-year real yields. Gold has not materially reacted to protectionist politics.
COMMODITIES	Industrial metals	+		Industrial metals look oversold on risks to global trade, fundamentals are supportive and China looks set to boost demand with increased infrastructure spending.
COMMODITIES	Agriculture	+		The recent sell-off has been based on concerns over trade war escalation as opposed to fundamentals; in addition, the risks relating to El Niño look to be underpriced.
CURRENCIES	US $	+	△	Despite its expensive valuation, we see room for further deterioration in growth and political sentiment against a continued backdrop of liquidity tightness.
CURRENCIES	UK £	0	△	We no longer see a strong case for excessive depreciation given that hard Brexit, having emerged as a serious possibility, now appears mostly priced in.
CURRENCIES	EU €	-	▽	EUR is downgraded on further economic slowdown and increased political tension between core and periphery.
CURRENCIES	JPY ¥	+	△	The BoJ is now seen as being forced to lift-off from its extremely dovish stance; weak external growth should also support JPY as a risk off currency.
CURRENCIES	Swiss ₣	0		Remains neutral—with its status as a safe haven currency, CHF should see relative outperformance vs. EUR.

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, September 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