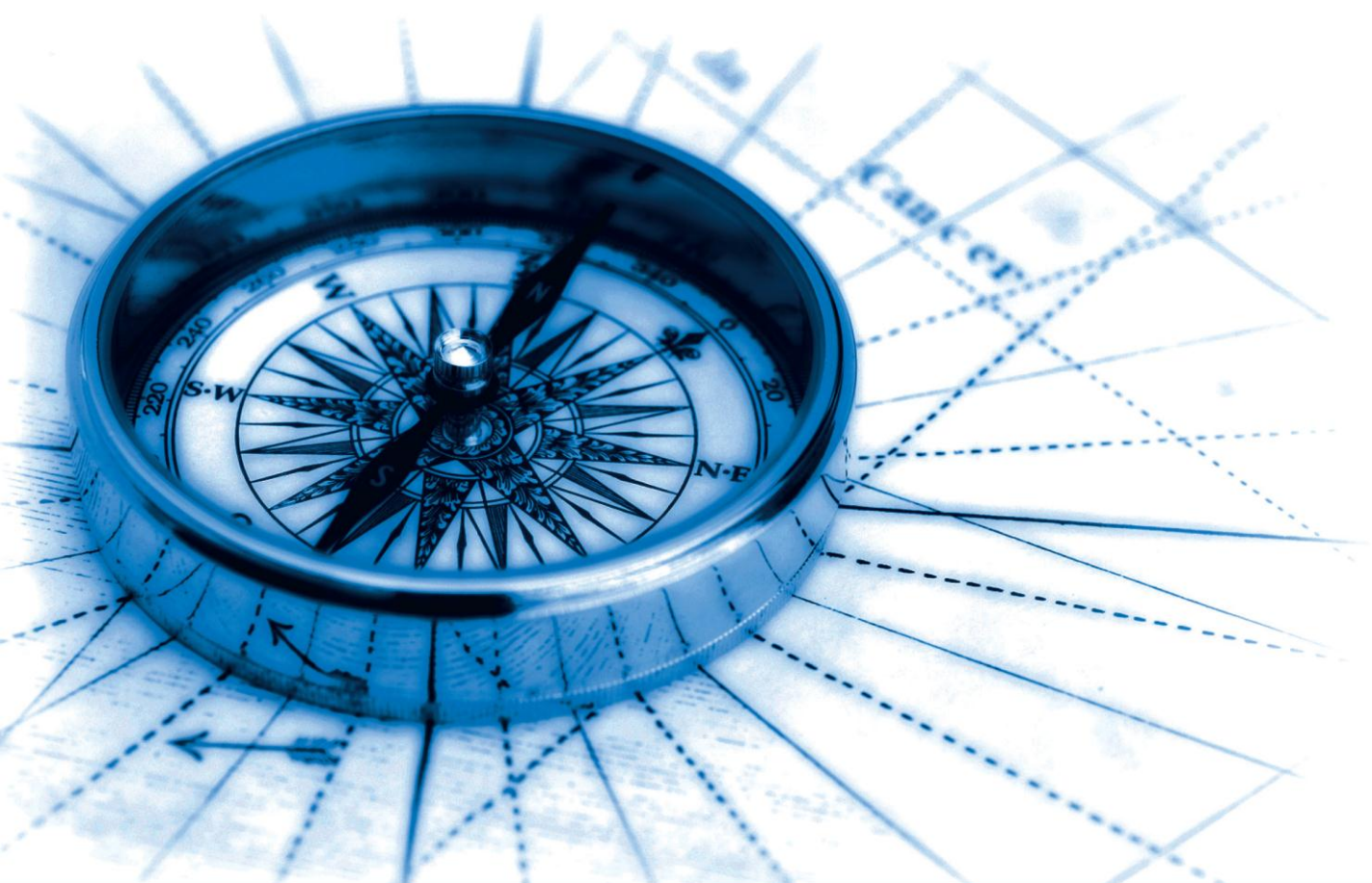


Schroders

Global Market Perspective

Economic and Asset Allocation Views Q4 2014



Schroders

Introduction

The third quarter of the year saw a surge in the US dollar and fall in commodity prices causing investors to question the sustainability of the global recovery and the rally in equity markets. There are fears that the drop in commodity prices is a harbinger of much weaker economic growth and that the move in the dollar is symptomatic of a search for safe havens. Long rates remain low and bond markets appear to offer a more pessimistic view of global growth than their equity counterparts.

The growth picture is certainly mixed: the recovery in the Eurozone and Japan has faltered, whilst activity in China remains tepid. Only the US seems to have been able to shrug off earlier weakness with a strong rebound in the second and third quarters of the year. From this perspective, the move in the US dollar is a natural consequence of divergent macro cycles, a development we would see as overdue and helpful to the world economy. In a world of sluggish growth, currency moves redistribute demand and the depreciation in the euro and Japanese yen will provide reflation to two areas fighting deflation.

The fall in commodity prices may well reflect the weakness of global demand, but supply side factors such as buoyant harvests and unexpected increases in crude oil production have also played a role. Although commodity producers will be hit by lower prices, the fall in the cost of food and energy is a benefit to the consumer, acting like a tax cut. In a world where households are unwilling to leverage, consumer spending is primarily driven by fluctuations in real income and so the move in food and energy should spur stronger spending in coming months.

Consequently, we still believe that equities offer the most attractive risk premium, nonetheless we do see reasons to cut our exposure to risk assets by trimming our overweight equity position, through a reduction in emerging markets. We discuss the factors driving the equity-bond choice and the implications of the stronger dollar below (page 12). We also look at the global cycle in asset allocation (page 29) and, taking a step back from the short run, have included our return projections for the next seven years (page 19).

Keith Wade, Chief Economist and Strategist, Schroders

15 October 2014

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Asset Allocation Views: Multi Asset Group

Global Overview

Economic View

The global economy remains on track for a modest recovery in 2014 and 2015, but we have downgraded this year's global growth from 2.8% to 2.6% to reflect some base effects from a poor first half and modest cuts to the second half in the US and Eurozone. For 2015, we believe structural headwinds will persist, not least a weaker supply side performance in the US due to adverse trends in demographics and productivity. We see past disappointments on US growth as more fundamental than just a result of unfortunate events.

For emerging markets, gradually improving demand from the US and Europe will help exports, but progress will be slower than in past cycles. Similarly, the lack of a robust upturn in Chinese demand will weigh on commodity producers such as Brazil and Russia. The latter also faces the challenge of becoming increasingly isolated from the world trading and financial system as the dispute with Ukraine continues.

Against this backdrop, global inflation for 2014 is marginally higher due to the higher consumption tax in Japan, but elsewhere we have brought our forecasts down, particularly in the UK and Eurozone. In the near term, inflation around the world should be benign given the recent falls in commodity prices. In 2015, the slight increase in global inflation is driven by the US where productivity growth is insufficient to offset higher wages such that unit wage costs accelerate. Slightly higher inflation in the emerging world also boosts the global aggregate.

In terms of risks, three out of our seven macro scenarios are biased towards the deflationary side, such as "Eurozone Deflation" and "China Hard Landing." The former assumes weak economic activity weighs on Eurozone prices with the region slipping outright into deflation. The latter focuses on the risk of a systematic implosion in the shadow financing market in China. We have kept a "G7 boom" scenario to highlight the risk of growth surprising on the upside globally. On the stagflationary scenarios, we have retained "Russian Rumble" and "Capacity Constraints Bite." However, we have swapped out the "Trade War" for a new scenario called "Productivity Recovers."

Central Bank Policy

For the rest of this year, the major developed central banks are expected to keep interest rates pinned to the floor, but policy de-synchronisation sets in motion next year. The US Federal Reserve (Fed) is expected to complete tapering of asset purchases by October this year with the first rate rise forecast in June next year. The Bank of England (BoE) is assumed to start increasing rates in February 2015. However, the Bank of Japan (BoJ) is expected to step up asset purchases later in 2014. In the Eurozone, monetary conditions are set to remain loose with the ECB providing targeted long-term financing operations (TLTROs) and undertaking asset-backed security (ABS) purchases. For emerging market central banks, particularly the BRICs (Brazil, Russia, India and China), interest rates are expected to remain unchanged in China and Brazil, but there is a likelihood of monetary easing in Russia and India in 2015.

Implications for Markets

Equities remain our preferred asset class but we have trimmed our exposure. We recognise that valuations are generally looking less compelling but we still believe that equities remain well-supported in the medium-term particularly as earnings growth comes through on the back of the global recovery. Although in the near-term, there is limited room for re-rating given the market has priced in a benign liquidity environment. Hence, we recognise that there is the risk of greater volatility driven by the normalisation of the macro environment and the impact on rate expectations.

Within equities, we still favour the US as we are confident that the domestic recovery will continue, helping companies to deliver further earnings growth and maintain profit margins. On the UK, we have upgraded our view from extreme negative to neutral as the market has lagged global equities so far this year and the recent pullback in the currency offers some relief for UK corporate earnings.

Asset Allocation Views: Multi-Asset Group

Global Overview (continued)

Implications for Markets (continued)

Meanwhile, we have stayed neutral on European equities as the strong re-rating in the market has not been matched with a recovery in earnings although ECB policy remains supportive. Similarly, we are neutral on Pacific ex Japan. For Japan, we are positive due to the earnings outlook and the prospect of greater flows towards this market triggered by the reform of the government pension investment fund (GPIF). On EM equities, we have downgraded to neutral despite valuations remaining attractive. The earnings outlook could be constrained by the tepid recovery in export growth given the importance of exports for many EM economies. Moreover, growth in these economies is expected to stay sluggish. However, there remains the prospect of further policy stimulus by some authorities, which could ease the slowdown in the EM world.

We have turned positive on global government bonds given the on-going monetary support provided by certain central banks such as the ECB and BoJ. Nonetheless, we continue to expect the gradual recovery in the world economy although growth and inflation releases have recently disappointed expectations. Within the universe, we remain neutral on US Treasuries and Japanese government bonds but positive on UK Gilts and German Bunds.

For emerging market debt (USD-denominated), we have become cautious given that the negative momentum and sentiment towards this market is likely to offset the carry cushion. Meanwhile, we have closed our negative position on high yield bonds, the latest spread widening in US high yield has made the carry marginally more attractive and reduced our preference to their European peer. In addition, we are negative on investment grade bonds as we have downgraded the European market as the expectations of further policy stimulus appear to be priced in to a large extent with scope for disappointments.

On commodities, we have retained our overall neutral stance. We remain structurally bearish towards industrial metals but in the short-term, there is policy support from the Chinese authorities. On the energy complex, we have downgraded the view to neutral as the physical market appears to have moved into surplus while demand has been subdued. For agriculture, our base case is that prices are likely to trade sideways. In particular, we expect limited downside for grains and oilseeds at these levels. On precious metals, gold should move broadly sideways with negative impacts of higher real rates and a stronger USD offset by seasonally strong demand and the re-assessment of geopolitical risks.

Table 1: Asset allocation grid – summary

Equity	+(++)	Bonds	0			Alternatives	0	Cash	-
Region		Region		Sector		Sector			
US	+	US Treasury	0 (-)	Government	+(0)	UK property EU property	+(++) +		
Europe ex UK	0	UK Gilts	+ (0)	Index-Linked	0 (+)	Commodities	0		
UK	0 (- -)	Eurozone Bunds	+ (0)	Investment Grade Corporate	- (0)	Industrial metals	0		
Pacific ex Japan	0	JGBs	0	High yield	0 (-)	Precious metals	0		
Japan	+	Emerging market debt (USD)	- (0)			Energy	0 (+)		
Emerging Markets	0(+)					Agriculture	0 (-)		

Key: +/- market expected to outperform/underperform (maximum +++ minimum ---) 0 indicates a neutral position. The above asset allocation is for illustrative purposes only. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions. For alternatives, due to the illiquid nature of the asset class, there will be limitations in implementing these views in client portfolios. Last quarter's positioning in brackets. Source: Schroders.

Regional Equity Views

Key Points

+ Equities	
+ US	<p>The US remains the favoured market but we recognise that the superior growth opportunities offered by the economy are becoming discounted in relative valuations.</p> <p>A rebound in growth should support earnings, but margins are likely to come under pressure as wages pick-up.</p> <p>Share repurchases are slowing, but we see greater likelihood of additional corporate activity as strong cash flows held by companies are deployed for mergers and acquisition activity.</p>
0 UK	<p>We have upgraded our view on UK equities from extreme negative to neutral. The UK market has underperformed global equities so far this year, presenting an opportunity to close out the underweight view. In addition the recent pullback in sterling provides some relief for UK corporate earnings, as a meaningful proportion of revenues are generated overseas.</p> <p>While market pricing for interest rates at the end of next year has fallen over recent months given dovish comments from policymakers and recent softening in macro releases, the BoE is expected to normalise monetary policy in the first quarter of 2015, which is likely to put pressure on the currency and corporate margins.</p>
0 Europe ex UK	<p>We have stayed neutral on European equities as valuations are unconvincing relative to history and the strong re-rating in the market has not been matched with a recovery in earnings.</p> <p>Meanwhile, economic activity in the Eurozone continues to be sluggish and deflationary concerns remain given the low inflation prints. Against this backdrop, the prospect of further monetary stimulus along with the already announced measures (such as targeted long-term financing operations and private QE by the ECB) remain a supportive factor for price multiples.</p>
+ Japan	<p>Our view on the market is predicated on our positive outlook on earnings. Unlike prior cycles, corporates have been able to maintain attractive margins as yen weakness has not necessarily been translated into lower overseas prices. Meanwhile, the rise in the return on equity has not matched the pace in profitability, which suggests that there is further scope to return value to shareholders via higher dividends and share buybacks.</p> <p>There is also the prospect of greater inflows towards this market triggered by the reform of the government pension investment fund (GPIF), which is expected to increase allocation to equities. In addition, there is the likelihood that the BoJ could implement further monetary stimulus if growth disappoints and their inflation target fails to stay on track, particularly ahead of the planned consumption tax rise in October next year.</p>
0 Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	<p>Weak commodity prices and more competitive Japanese exporters could hamper the performance prospects of this region. Australia's economy remains vulnerable to a further reduction in demand for commodities and a slowdown in the property sector. Nonetheless, there are positive spill-over effects from improved sentiment towards China which is a large export trading partner for these markets.</p> <p>Valuations and momentum behind this region are also unconvincing relative to elsewhere.</p>
0 Emerging markets	<p>Valuations remain attractive although the earnings outlook could be constrained by the tepid recovery in export growth given the importance of exports for many EM economies.</p> <p>Growth in these economies is expected to stay sluggish. However, there remains the prospect of further policy stimulus by some authorities, which could ease the slowdown in the EM world.</p>

Key: +/- market expected to outperform/underperform (maximum +++ minimum ---) 0 indicates a neutral position.

Fixed Income Views

Key Points

0	Bonds	
+	Government	<p>Compared to last quarter, we have turned positive on global government bonds given the on-going monetary support provided by certain central banks. The ECB and BoJ have continued to expand their balance sheets against marginal tightening in the US. However, we recognise that valuations on sovereign debt are unconvincing given the low levels in bond yields. We continue to expect the gradual recovery in the world economy but growth and inflation releases have recently disappointed expectations. In addition, geopolitical risks could trigger safe haven flows back into this asset class.</p> <p>Amongst the sovereign bond markets, we have upgraded the view on US Treasuries to neutral. Despite the prospect of policy normalisation by the Fed, the US central bank has kept their dovish language by implying rates could be maintained low for a considerable time. However, at some point, the continued tightening in the labour market will put pressure on wages and eventually inflation. In this environment, the Fed is compelled to start managing market expectations of rate rises.</p> <p>Meanwhile, we have switched to a positive position on UK Gilts and German Bunds. On the former, housing momentum in the UK has slowed and inflation pressures have been subdued. For German Bunds, our positive view is a reflection of playing a curve flattener which is mainly led by downward pressures on yields at the long-end. At the same time, aggressive pricing at the front-end of the curve could be unwound by ECB failing to meet market's expectations of more policy stimulus.</p> <p>Despite its flat yield curve and low real yields, we maintain our neutral position on JGBs at the medium to long-end of the curve. This is due to the aggressive support provided by the BoJ, as they remain the majority holder of JGBs.</p>
-	Investment Grade (IG) Corporate	<p>We continue to expect the recovery in the economy to be supportive of earnings growth but the potential for renewed interest rate uncertainty in the US could create some upward pressure on spreads. We may also see a renewed rotation out of corporate bonds into equities.</p> <p>However, our preference for European IG relative to the US market has been reduced. Despite more accommodative policy from the ECB, the expectations of further policy stimulus appear to be priced in to a large extent with scope for disappointments.</p>
0	High yield (HY)	<p>US high yield remains vulnerable particularly as liquidity appeared to be a concern during the recent correction. Looking ahead, there is the risk of higher volatility as the US edges closer to rate normalisation and investors rotate positioning. However, the latest spread widening has made the carry marginally more attractive and reduced our preference to their European peer.</p> <p>For European high yield, we remain neutral overall as fundamentals are mixed. Europe is showing signs of weakness with poor growth and low inflation. The more accommodative monetary policy in Europe is supportive to the market relative to the US, but we expect these two markets to remain highly integrated.</p>
-	USD-denominated Emerging market debt (EMD)	<p>Despite structural headwinds and low growth prospects amongst the key markets in the universe, there have been some signs of rebalancing in these economies with most countries no longer on a rate tightening cycle.</p> <p>EMD still offers attractive carry but the negative momentum and sentiment towards this market warrants a more cautious stance.</p>
0	Index-Linked	<p>Valuations for index-linked bonds remain uninspiring and the momentum behind some the drivers of inflation has ebbed. While there is evidence that wages and payrolls are rising in the US, commodity prices have continued to soften particularly against a stronger dollar environment.</p>

Key: +/- market expected to outperform/underperform (maximum +++ minimum ---) 0 indicates a neutral position.

Alternatives Views

Key Points

Alternatives		
0	Commodities	<p>We have maintained our overall neutral stance towards commodities. On industrial metals, policy easing measures in China such as the recent injection of liquidity into the banking system could provide support for domestic growth and therefore metal demand. Over the medium-term, however, this commodity segment is still held back by the structural shifts away from investment led growth in China. In addition, the large ramp up in production over the past decade has led to ample supply across most base metals, particularly copper. On balance, we therefore retained our neutral view on this sector.</p> <p>Meanwhile, our positioning in the energy segment has been downgraded from positive to neutral over the quarter. The physical market appears to have moved into surplus while demand has been subdued particularly in Europe. The return of Libya exports to the market and greater supply from Saudi Arabia has led to an unexpected rise in production. At the same time, the carry offering from investing in the energy sector has been undermined by the move into contango in the Brent market as the current oversupply has dragged down the front-end of the curve.</p> <p>For precious metals, we have kept our neutral view as gold continues to trade in a range. On balance, gold could stay flat with negative impacts of higher real rates and a stronger USD offset by seasonally strong demand and the re-assessment of geopolitical risks in the Middle East and Ukraine.</p> <p>On agriculture, we have upgraded our stance to neutral despite supply and demand headwinds. After the strong correction in prices over the recent months, the risk reward trade-off of a short position is no longer attractive. In particular, we expect limited downside for grains and oilseeds at these levels. Our base case is that the agriculture complex is likely to trade sideways.</p>
+	UK Property	<p>The momentum within the UK economy is being matched by activity and sentiment in the property market. Growing occupational demand is radiating out of the capital into the regions, alongside high levels of transactional activity. We therefore expect double-digit total returns this year. Looking further out, we have marginally trimmed our total return forecast to average 6% to 7% per annum to the end of 2018 consisting of income return of around 5% and steady rental growth of 2% to 3% per year. The big uncertainty in the short-term is investor sentiment. If the average property initial yield settles at around 5.25% in 2015 then annual total returns should be reasonably stable over the next few years. However, if investors bid down property yields aggressively by a further 0.5% in 2015, then there is a risk that increasing interest rates lead to falling capital values in 2016-2017. While the Scottish referendum is now over, the 2015 general election and the possibility of a referendum on EU membership will start to play on investors' minds.</p>
+	European Property	<p>Over the next 12 months, we expect positive total returns on average investment grade European property to average 7 to 9% led mainly by capital values benefitting from yield compression. Further out, steady rental growth should also be a driver of returns. The main upside risk in the short-term is that the inflow of capital from Asia and the US could trigger a widespread fall in prime and secondary property yields, boosting capital values for a limited period. On the other side, the main downside risk is that the sovereign debt crisis could re-ignite, if governments fail to meet targets to cut their budget deficits.</p>

Note: Property views based on comments from the Schroders Property Research team.

Key: +/- market expected to outperform/underperform (maximum +++ minimum ---) 0 indicates a neutral position.

Economic View

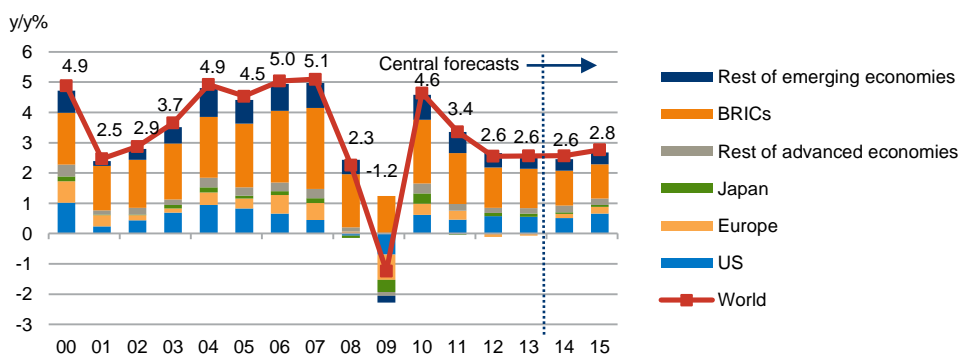
Central View

Recovery trimmed, but on track

Global recovery continues, but our growth forecasts have been trimmed with the downgrade this year largely reflecting base effects from the weak first half, although there have been minor downgrades to the second half in the US and Eurozone. Overall, the world economy remains sluggish when compared with the cycle of 2000s when global growth averaged 4% per annum at this stage of the upswing (chart 1). However, global inflation is marginally higher this year as a result of the increase in consumption tax in Japan.

For 2015, the lower growth forecast in the developed world reflects the ongoing headwind from debt deleveraging in both the consumer and public sectors and weak productivity growth on the supply side. Meanwhile, several EM economies are tackling inflation and rebalancing pressures such that growth remains sub-trend. Against this backdrop, there is a slight rise in global inflation driven by the US where we expect rent and wage costs to pick up.

Chart 1: Global growth forecast for 2014 and 2015



Source: Thomson Datastream, Schroders.

For the US, relative to consensus we are below on growth at 2% and 2.6% this year and next. We believe slower productivity growth and less favourable demographics means the sustainable path for US growth has fallen compared to the past two cycles. Credit growth is also likely to remain subdued given a reluctance to re-leverage by households and continued caution from a more heavily regulated banking sector.

Elsewhere, the UK recovery is to be sustained by housing and consumer demand, but growth is likely to moderate next year with the general election and resumption of austerity. We have lowered the forecasts for the core European economies and Italy, but have upgraded Spain given the upside risk from the implementation of the reforms over the past few years.

Amongst the BRIC economies (Brazil, Russia, India and China), our China forecast for next year has remained unchanged at 6.8% but we have revised upwards our 2014 forecast to 7.3% given the mini-stimulus package earlier in the year. For Russia, the escalation in Ukraine and resultant sanctions, have done much to diminish the growth outlook. Meanwhile, Brazilian data has been disappointing such that we have cut growth expectations for this year and next.

On the monetary policy front, divergence remains a key theme with the Fed and BoE expected to raise rates in 2015 while the ECB and BoJ are likely to remain on an easing tack. The Fed is on target to end QE by October this year, with the first rate rise forecast in June 2015. In the Eurozone, monetary conditions are set to remain loose with the ECB providing targeted long-term financing operations and undertaking asset-backed security purchases. Moreover, the BoJ is expected to step up asset purchases later in 2014 in order to reach their inflation target and cushion the impact from the consumption tax rise.

In addition to our central view, we consider seven alternative scenarios where we aim to capture the risks to the world economy.

Economic View (continued)

Macro risks: Scenario analysis

Full details of the scenarios can be found on page 10. The distribution of global risks is still skewed toward the downside for growth and inflation. Top of the list on the downside is “**Eurozone deflation**” whereby the Eurozone experiences a Japan-style slump with prices falling persistently and the region experiencing debt deflation. Global monetary policy therefore would be looser than in the baseline particularly with the ECB embarking on sovereign debt QE.

Another deflationary risk scenario is “**China hard landing**” where the financial system unravels thus resulting in a collapse in fixed investment and growth. As we have argued before this primarily impacts the emerging market economies, particularly the commodity producers. Growth in the US and Europe is also weaker, but there is some offset from the fall in oil prices and inflation.

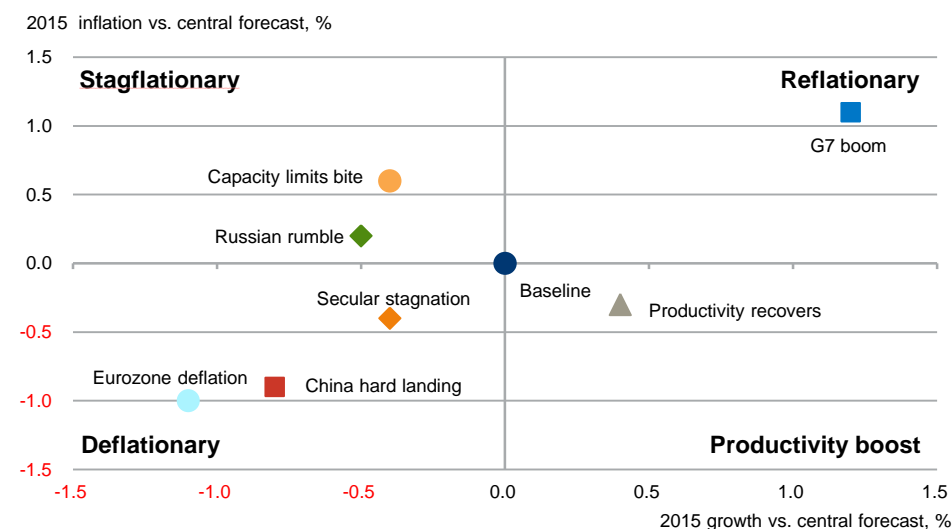
Our final downside scenario – “**Secular stagnation**” – where capital spending remains sluggish as despite interest rates being at record lows, the cost of capital remains above the expected rate of return. Household expenditure is constrained by weak real income growth, a consequence of sluggish productivity and deteriorating demographics. Clearly, interest rates and monetary policy would be looser in this scenario.

On the stagflationary scenarios, we have retained “**Russian rumble**” and “**Capacity constraints bite**,” but swapped out the “Trade war” based on an escalation of the island dispute between Japan and China with “**Productivity recovers**.” This new scenario represents a bounce back in productivity from current low levels and results in stronger growth and lower inflation than in the base case. This is not to say that the risks in East Asia have faded completely, but at present the island dispute has moved out of the spotlight.

On the “**Russian rumble**” scenario, this remains very much centre stage with sanctions from both sides being stepped up. Although the Russian economy has been worst affected, there is a risk that European confidence is hit on concerns that the situation will deteriorate further, leading to the loss of energy supplies. For “**capacity constraints bite**,” the amount of spare capacity proves to be considerably less than anticipated by policymakers. Once the mistake has been realised central banks then have to tighten aggressively to bring the economy back to trend.

On the upside, we see a **G7 boom** which is the sole reflationary outcome whereby we see a return of animal spirits and a much stronger pick up in business spending than in the baseline.

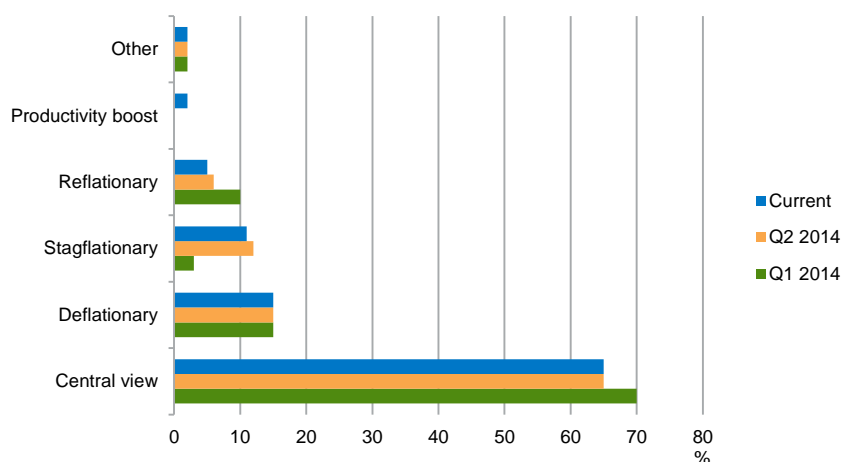
Chart 2: Scenario analysis – global growth and inflation impact



Source: Schroders.

Economic View (continued)

Chart 3: Scenario probabilities compared to previous quarters

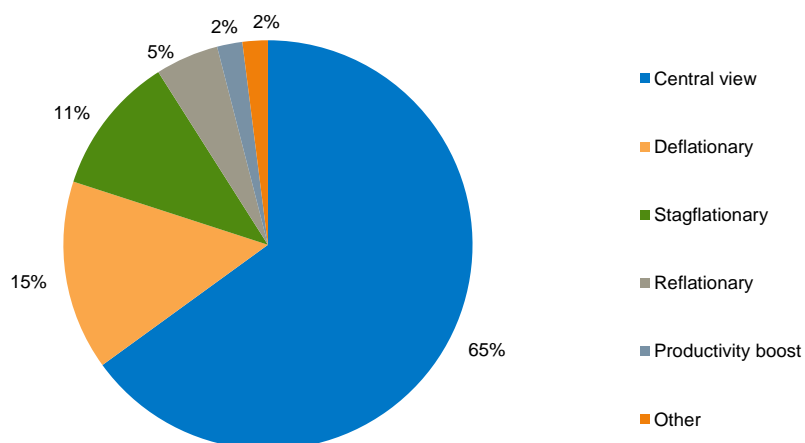


Source: Schroders.

In terms of macro impact, we have run the risk scenarios through our models and aggregated to show the impact on global growth and inflation. As can be seen in chart 2 on the previous page, three of our seven are deflationary, such that both growth and inflation are lower than in the central scenario.

Overall, there has been no change to the probability of deflation whilst there has been a slight reduction in the weight put on the stagflationary scenario, as a result of replacing the “Trade War” scenario with “Productivity Recovers”. In aggregate, the tail risks lie in a deflationary direction and in this respect the risk on interest rates is to the downside with central banks likely to maintain stimulus in the face of a deflationary outcome.

Chart 4: Scenario probabilities (mutually exclusive)



Source: Schroders.

Economic View (continued)

Table 2: Scenario summary

Scenario	Summary	Macro impact
1. Eurozone deflation	Weak economic activity weighs on Eurozone prices with the region slipping into deflation. Households and companies lower their inflation expectations and start to delay spending with the expectation that prices will fall further. The rise in savings rates deepens the downturn in demand and prices, thus reinforcing the fall in inflation expectations. Falling nominal GDP makes debt reduction more difficult, further depressing activity.	Deflationary: weaker growth and lower inflation persists throughout the scenario. As a significant part of the world economy, Eurozone weakness drags on activity elsewhere, while some of the deflationary impact is imported by trade partners. ECB reacts by undertaking QE, but the policy response is too small and too slow to avert the outcome.
2. G7 boom	Developed market growth picks up more rapidly than in the base as the corporate sector increases capex and consumers spend more rapidly in response to the recovery in house prices. Banks increase lending, reducing their excess reserves and asset prices boom. Interest rates rise and the Fed begins to contract its balance sheet in 2015. However, the withdrawal of stimulus is not sufficient to prevent a more rapid tightening of the labour market and a pick-up in inflation.	Reflationary: stronger growth and inflation versus the central scenario. Stronger US demand supports activity around the world. Commodity prices and US Treasury yields rise and USD strengthens as inflation picks up and Fed unwinds QE and raises rates.
3. Productivity recovers	Weak productivity has been a feature of the recovery in the US and UK and growth has been largely driven by increasing employment. In this scenario the slowdown in productivity gradually reverses as firms deploy technology to better effect resulting in improved output/hour.	Better growth/lower inflation. Increased productivity reduces unit wage costs thus keeping inflation in check as economic activity recovers. The Fed are still expected to tighten policy, but the lack of inflationary pressure means they can delay until later in 2015.
4. Capacity limits bite	Central banks overestimate the amount of spare capacity in the economy believing there is significant slack in the labour market and a substantial output gap. However, weaker trend growth and the permanent loss of some capacity in the post financial crisis environment mean that the world economy is closer to the inflationary threshold than realised. Consequently, as demand increases, inflation starts to accelerate prompting a re-appraisal of monetary policy and higher interest rates.	Stagflationary: tighter monetary policy slows growth, but inflation continues to rise until the economy has returned to trend. Monetary policy tightens earlier in this scenario.
5. China hard landing	An implosion in the wealth management products area results in a major cut in Total Social Financing depriving Chinese industry of funds. The resulting downturn in capex spending and the adverse impact on consumer confidence results in a sharp slowdown in Chinese growth.	Deflationary: global growth slows as China demand weakens with commodity producers hit hardest. However, the fall in commodity prices will push down inflation to the benefit of consumers. Monetary policy is likely to ease/stay on hold while the deflationary shock works through the world economy.
6. Russian rumble	Russia invades East Ukraine. The west retaliates by significantly increasing sanctions and Russia cuts gas and oil supplies to Europe.	Stagflationary: Europe is hit by the disruption to energy supply resulting in a fall in output as alternative sources are put in place. Higher oil prices hit global inflation and the breakdown of relations between Russia and the west creates significant volatility in financial markets.
7. Secular stagnation	Capital expenditure fails to revive as businesses remain cautious on the outlook believing real returns are below the cost of capital, whilst income becomes increasingly concentrated in the hands of the rich with low propensity to consume.	Deflationary: weaker growth and lower inflation as demand remains sluggish. Softer commodity prices also weigh on inflation. Fed still expected to end QE as scheduled but does not raise rates during the forecast period. The opposite of the G7 boom scenario.
8. Others		

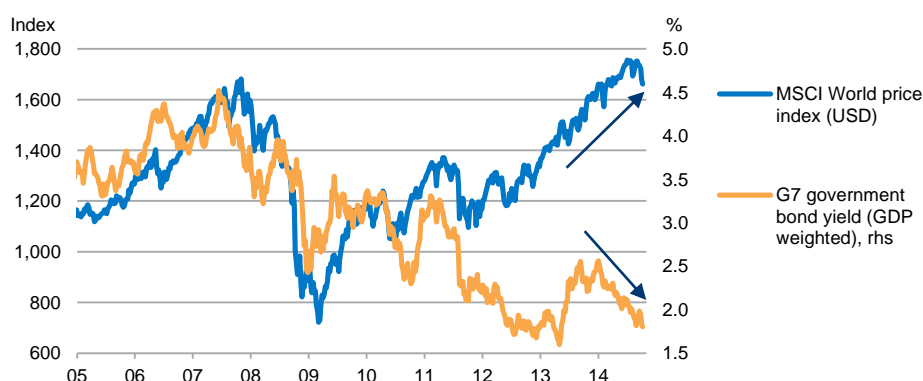
Source: Schroders, August 2014.

Strategy View: are equity and bond markets at odds?

Third quarter marked by lower commodity prices and surge in US dollar

The S&P 500 hit a new high during the quarter, but subsequently fell back as investors worried about the implications of a strong dollar and fall in commodity prices. Many strategists are questioning the bull run in equities and some see the rise in risk assets this year at odds with the message from the bond markets where yields have been in retreat. Looking at the global equity index and sovereign bond yields there has been a change in their relationship this year, from one where both moved in the same direction (i.e. lower yields/lower equities and vice versa), to one where the two have parted company (chart 5).

Chart 5: Change in correlation between equity and bond markets



Source: Thomson Datastream, Schroders, 30 September 2014.

Equity markets seem unperturbed by fall in bond yields

Some see this as setting up a battle between bond and equity markets: falling bond yields are often associated with expectations of weaker growth, a bad outcome for corporate earnings and hence equity prices. Since global growth expectations have been falling this year, the argument goes that equities will soon start to track bond yields lower, and the correlation between the two will become positive again.

Whilst it may well be that bond markets are correct about global activity we should bear in mind that equity markets also benefit from falling interest rate expectations. Equity prices reflect the discounted value of future profits and so can be boosted by a lower discount rate as bond yields decline. This suggests that the question as to who is right, equity or bond markets? It is far more nuanced than a straight call on growth. Equity investors may well judge that global growth and earnings prospects are subdued, but still see shares as attractive assets given the low discount rate, or to put it another way, the low returns offered on bonds.

This is reflected in our seven-year return forecasts for different asset classes which are based on our baseline macro views for interest rates and earnings growth (see section below). These show equities making single digit returns, but outperforming cash and bonds. On this basis, absolute returns may not be as high as in the past, but global equity markets still offer a risk premium over bonds on our projections.

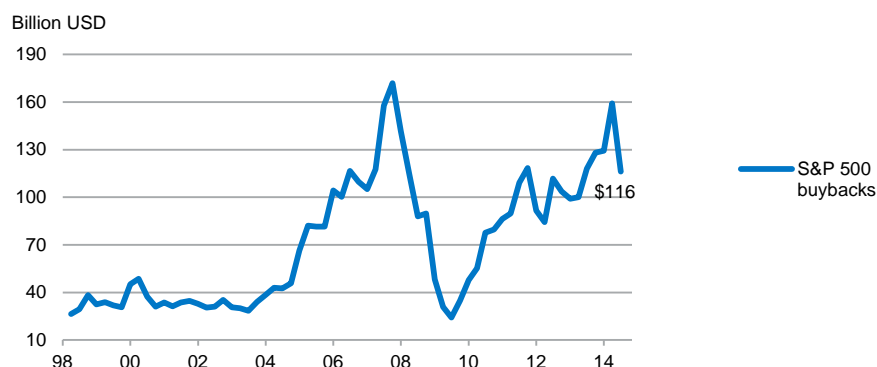
Arguably, this risk premium (which ranges from 1% to 6% depending on market) is too low to compensate for the risks associated with equities, but many investors have been reluctant to cut exposure for several reasons.

Central bank action has forced investors along the risk spectrum

One is TINA i.e. There Is No Alternative: bonds and cash simply do not deliver the returns needed to meet the objectives of savers. Investors have no option but to accept higher risk if they wish to meet their future income requirements. In some sovereign bond markets such as Germany interest rates have actually turned negative at the short end, meaning investors pay to hold the asset. Initially credit was a viable alternative and still can be in some areas. However, as spreads have narrowed, the focus has been on equities which offer a steady, albeit uncertain, dividend. In terms of the comparison with credit, the fact that companies continue to buy back their shares (chart 6), often with the proceeds of debt issuance, indicates the relative value of equity to the investor.

Strategy View (continued)

Chart 6: S&P 500 share buybacks



Source: Strategas, 30 September 2014.

Another important factor supporting equity exposure is that policy makers are committed to economic recovery. Reviving and sustaining economic growth and reducing unemployment is the priority. The low level of global inflation only reinforces this. Consequently, in the debate about sustainable growth and corporate earnings there is a sense that central banks will respond to economic weakness, just as the ECB has recently by cutting rates and announcing new measures to support bank liquidity and buy asset backed securities. The same applies in Japan where the Bank of Japan is committed to ending deflation and will step up asset purchases if necessary. Even in the US and UK, where the recovery is more established, the Fed and the Bank of England can be expected to delay tightening, or even ease should their economies falter. Both have made future tightening data dependent.

Forward guidance:
a put on equity
markets?

Such a commitment through the use of forward guidance has created a perception that central banks are underwriting equities, known in the markets as the “Draghi put”, for example. When accompanied by massive liquidity provision, the effect has been to suppress volatility creating an environment where investors are willing to accept lower returns whilst taking greater risks.

Of course, this is a dangerous process as it can and has led to the creation of bubbles in asset prices. For example, residential property prices are significantly stretched, particularly in cities such as London. Until recently, low grade credit was looking very expensive as investors drove spreads down. The appetite for bio-tech and IPO's such as Alibaba are also symptoms of excess liquidity finding its way into the financial markets rather than the real economy.

Policymakers
focussed on real
economy, not
financial markets

Higher asset prices are part of the transmission mechanism through wealth effects, boosting consumer and corporate confidence and the ability to spend. Central banks are focussed on improving the real economy, even if it means distorting markets. Fund managers who stand in the way of the central banks by betting against the Fed for example, risk becoming casualties, such as Bill Gross who departed PIMCO at the end of the third quarter after an extended spell of underperformance.

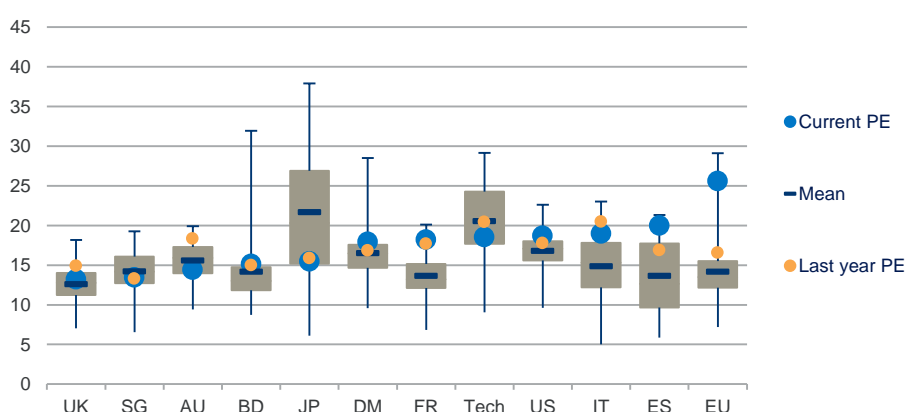
Notwithstanding the woes of high profile fund managers, the real concern is that current central bank policy will lead to a massive misallocation of capital and the same problems which led to the Global Financial Crisis. The bubble would be in a different market but may prove as damaging. However, such concerns have been downplayed by Fed chair Janet Yellen. In recent comments to Congress she indicated that she would only be worried if financial market bubbles threatened a systemic crisis and, as the banks were now better capitalised, that risk was low. Other financial institutions were not mentioned. Pension funds, insurance companies and asset managers take note!

Strategy View (continued)

Are equities expensive?

The question for multi-asset investors is whether this environment has made equities too expensive. There are certainly pockets of the market which seem frothy as mentioned above, but in aggregate we do not see significant overvaluation. For example, PE ratios have risen over the past year and are generally above average, but are not extended with most markets trading well within their historical range (see chart 7). The exception would perhaps be the European markets of Spain, Italy and France which seem to be discounting a significant recovery in earnings. Arguably the current ratings are distorted by write-offs (negative earnings), although we have trimmed some of our overweight exposure in this area. At the other end of the spectrum, Japan and the emerging markets look attractive on this metric.

Chart 7: Developed Market Trailing Price-Earnings ratio (versus 10-year history)

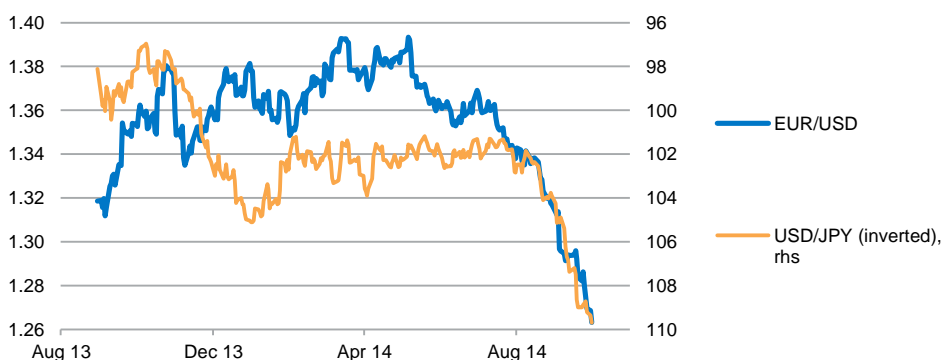


Note: SG: MSCI Singapore, UK: FTSE 100, AU: S&P/ASX 200, JP: TOPIX, DM: MSCI developed world (local currency), US: S&P 500, FR: CAC 40, BD: DAX 30, EU: Euro Stoxx 50, Tech: NASDAQ, ES: IBEX 35, IT: Italy Datastream Composite. Box and whisker plot based on 10 years of data. The vertical line shows the highest to the lowest value while the top and bottom of the rectangular box shows the lower and upper quartiles. Source: Thomson Datastream, Schroders, 30 September 2014.

Impact of a stronger US dollar

On top of these factors we have to overlay the recent moves in the currency markets which are seen by some as a sign of increased risk aversion with the US dollar counting as a safe haven for many investors. In this section we examine the macro factors driving the USD and ask what it means for the world economy. Our interpretation is more benign than most as in our view the move will help reflate the parts of the world economy which most need support. The recent rise in the dollar warrants attention from a strategy perspective given the relationship between the dollar and regional equity markets.

Chart 8: US dollar strengthens against euro and Japanese yen



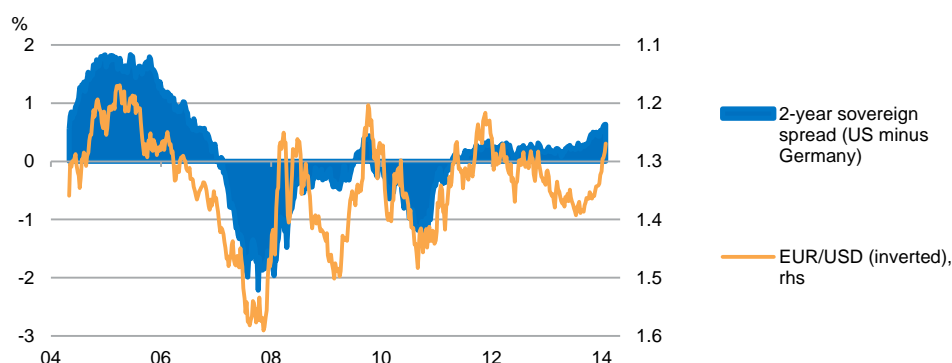
Source: Thomson Datastream, Schroders, 30 September 2014.

Strategy View (continued)

After a period of relative stability the US dollar has broken higher against the euro (EUR) and Japanese yen (JPY). The Euro is now trading at levels last seen in early 2013 while the yen is back to 2008 values (chart 8 on previous page).

In many respects the dollar rise is overdue as a divergence in monetary policy between the US and the rest of the world has been apparent for some time. Policy remains on track with the US Fed set to complete the tapering of bond purchases in October and then indicating higher rates in 2015 through its (in)famous "dot-plot". Meanwhile, the ECB has signalled that interest rates will remain low for some time to come, not least to head off the risk of deflation. These expectations are captured in the spread between two year government bonds in the US and Germany, which has increased to its highest level since 2007 (chart 9).

Chart 9: US-German spreads: yield to the dollar

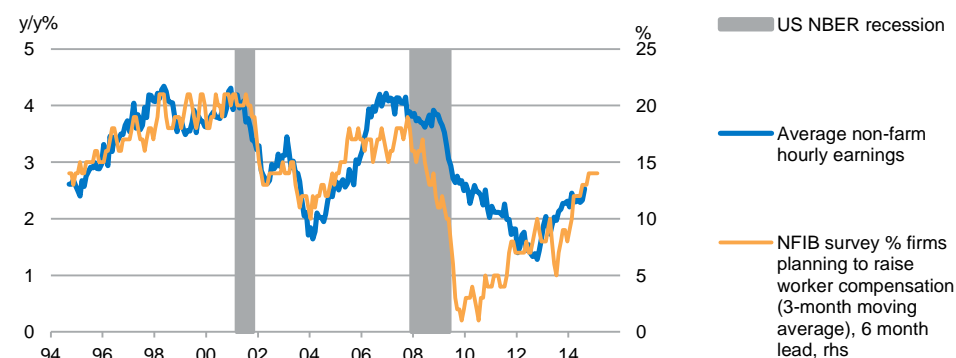


Source: Thomson Datastream, Schroders, 30 September 2014.

Against the JPY, interest rates play less of a role, but the move can be seen in the same light with the recent weakness in the Japanese economy expected to bring forward additional easing by the Bank of Japan. It is still our contention that the principal transmission mechanism for Abenomics is through the currency and we are waiting for the Bank of Japan to step up asset purchases and push the yen lower.

Clearly, higher US rates are a key driver of a stronger dollar view and are part of our baseline view. Recent indicators continue to point to a tightening of the labour market and pick up in wages. Unemployment has fallen to 5.9% and the proportion of firms planning to increase worker pay remains elevated, signalling an acceleration in wages (chart 10).

Chart 10: Survey points to stronger US wage growth



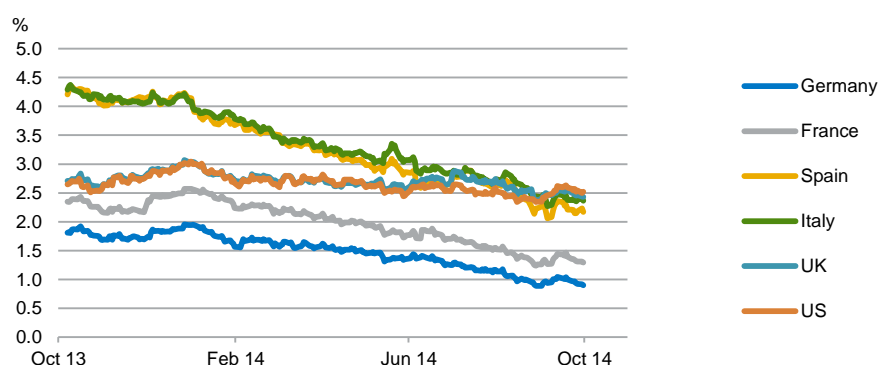
Source: Thomson Datastream, NBER (National Bureau of Economic Research), Schroders, 30 September 2014.

Strategy View (continued)

Eurozone bonds less attractive as yields fall below US and UK

One factor which has received little attention in the decline in the euro is the convergence of bond yields across the currency zone. International investors have been active participants in the convergence trade between periphery and core as the tail risk of Euro break-up has faded. Clearly this is a positive development and there may still be an opportunity in this trade, however the risk-reward has become less attractive and the two largest peripheral markets (Italy and Spain) have both traded through the UK and US (chart 11). Rather than outside investors, demand for peripheral bonds is now being driven by Eurozone banks flush with liquidity from the ECB, but facing little private sector demand for credit.

Chart 11: Peripheral yields go through Treasuries and Gilts

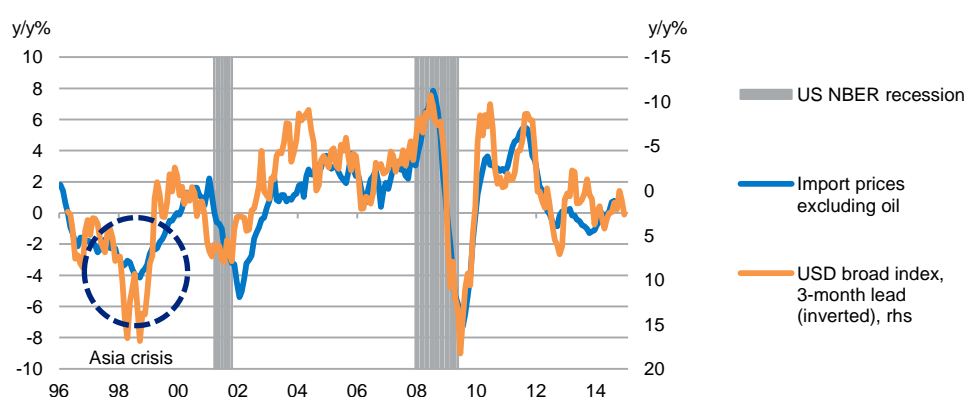


Source: Thomson Datastream, Schroders, 30 September 2014.

Move in dollar will help contain inflation, but is not as deflationary as in the past

It could be argued that by acting as a deflationary force, a stronger USD will reduce inflation and the need for tighter policy from the Fed. In this respect the rise in the dollar would become self defeating as it would reverse the forces which had driven it higher in the first place. At this stage we would discount such an effect as although the stronger currency will depress import prices, the move has not been great enough to have a significant impact on inflation. This could change should the dollar continue to rise, but at this stage deflationary pressure is far less than during the Asia crisis or the past two recessions (chart 12).

Chart 12: Trade weighted dollar and import price inflation in the US

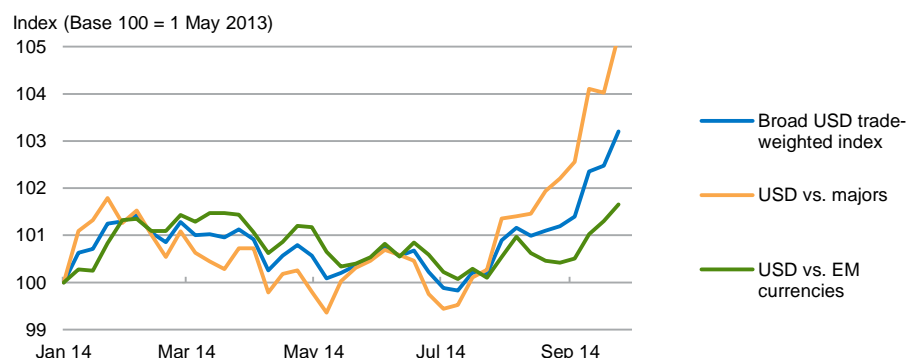


Source: Thomson Datastream, NBER (National Bureau of Economic Research), Schroders, 30 September 2014.

Chart 13 highlights an important feature of the recent move as on the broad trade weighted index (TWI): it has been less significant than versus the euro and yen. This largely reflects the effect of the emerging market currencies which comprise 56% of the TWI (China accounts for 21%) and have moved less than the majors (chart 13 on next page).

Strategy View (continued)

Chart 13: USD strength has been against the majors

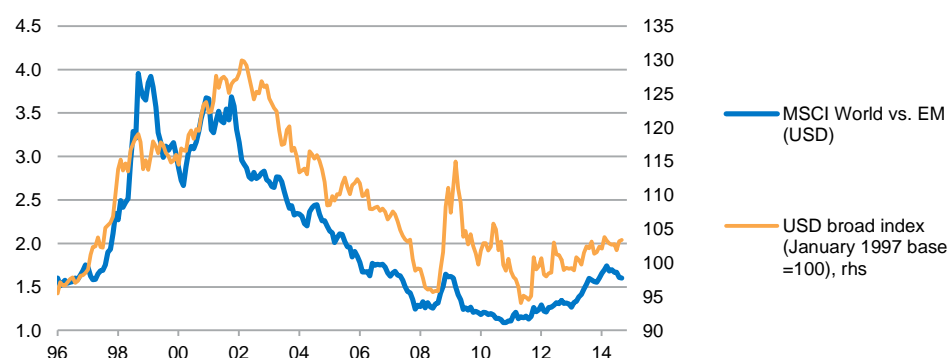


Source: Thomson Datastream, Schroders, 30 September 2014.

Pressure on EM likely

Consequently, the emerging economies will have appreciated against the majors, a factor which will weigh on their competitiveness versus the likes of Europe and Japan. Dollar strength has always been a concern to the EM countries given their links to the currency which transmits any tightening by the Fed to their economy through changes in reserves. In addition, the commodity producers are vulnerable as oil, metals and agricultural prices tend to move inversely with the dollar. These factors are reflected in the underperformance of emerging against developed equity markets during periods of USD strength (chart 14). The flipside is that Japanese and European equities benefit from a stronger dollar.

Chart 14: Stronger USD weighs on emerging vs. developed equity markets



Source: Thomson Datastream, Schroders, 30 September 2014.

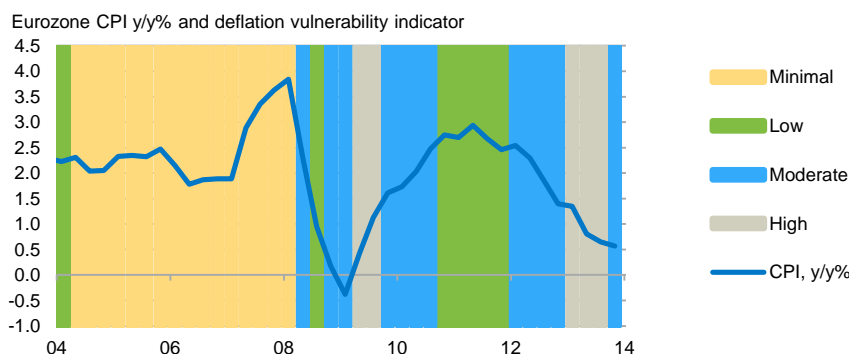
Japan and Europe benefit, through equities more than growth

It should be said that the currency benefits to European and Japanese firms primarily come through the translation effects of overseas earnings, rather than better export growth. Hence a weaker currency boosts the stock market more than the economy in the near-term as better trade performance takes time to come through. Such an outcome can be seen in Japan where the equity market has rallied on yen weakness, but net exports have been lacklustre. There is a similar pattern in the UK where the devaluation of GBP helped the FTSE but seems to have brought little benefit to trade performance. The initial effect of currency depreciation is felt through better profit margins and the benefit of a more competitive currency can take a long time to come through as firms are unwilling to adjust their production processes unless they believe the new level can be sustained.

Strategy View (continued)

Nonetheless, the reflationary effects of a weaker euro will be welcomed in a Eurozone economy where conventional monetary policy is proving ineffective. For example, our deflation vulnerability index has moved from high risk to moderate risk as a result of the EUR move (which translates into a reduction in the probability of future deflation from 25% to 14%).

Chart 15: Risk of deflation in the Eurozone reduces



Note: Vulnerability indicator as of Q2 2014. For more details on the methodology, see the May 2014 Economic and Strategy Viewpoint. Source: IMF, Thomson Datastream, Schroders, 9 September 2014.

Some conclusions

More like late 1990s than the global financial crisis

Amidst concerns about an end to the equity bull market and the seemingly conflicting behaviour of bonds we remain positive on shares. There may be an element of TINA about this but we still believe that equities can generate a premium for investors. Moreover, policymakers continue to target growth and in doing so offer support to equities.

Nonetheless, we still have to be selective, seeking those markets which offer the best in terms of the macro cycle and valuation. On this basis we continue to like the US primarily for its macro recovery, and do not believe the market has become overvalued. We also like Japan where valuations are attractive and we believe the BoJ will act. The fall in the JPY helps this case. Elsewhere the story is less clear cut. Europe will also benefit from the fall in the dollar and ECB action, but may already be pricing in a robust earnings recovery. For the emerging markets, it is the opposite: valuations are attractive but the move in the dollar may weigh on performance.

In our view, rather than risk aversion, the greater risk is that the environment could become like that in the late 1990s when the Asia crisis led to fears of deflation which caused the then Fed Chairman Alan Greenspan to delay the tightening cycle. The result was an extended period of liquidity which ultimately fuelled the bubble in technology stocks. Should further dollar strength combine with commodity weakness to keep inflation low, a dovish Yellen Fed may also delay tightening. The result could be another financial market bubble.

Keith Wade

Chief Economist and Strategist, October 2014

Medium term asset class performance: 7-year return forecasts (2014 – 2021)

Introduction

Schroders Economics Group produces seven-year return forecasts, on an annual basis, for a range of asset classes. The forecast builds on the same methodology which has been applied in previous years, as explained in the appendix to this document. As well as changes to the growth and inflation forecasts provided by the Global Economics team, these asset return forecasts reflect market conditions in July 2014. While not completely reflecting current market conditions, the difference is sufficiently small so as not to materially alter our results.

Summary

The highest returns are to be found in equities, with cash and bond returns negative in real terms

The below table summarises our asset class forecasts for the next 7 years. Note the negative real returns for cash and bonds, against some positive real equity returns. Credit and alternative investments should also provide positive returns after inflation. Emerging market equities offer the highest real returns of any asset, but it should be noted that volatility is typically higher too. A discussion of methodology can be found in the appendix.

Table 3: 7 year asset class forecasts (2014 – 2021)

		Nominal	Inflation	Real
Cash		% p.a.		
US	USD	2.2	2.6	-0.4
UK	GBP	2.3	2.5	-0.2
Euro	EUR	1.0	1.7	-0.7
Japan	JPY	0.4	1.7	-1.3
Bonds				
US	USD	2.6	2.6	-0.1
UK	GBP	2.4	2.5	-0.1
Euro	EUR	-0.5	1.7	-2.2
Equity				
US (S&P 500)	USD	3.8	2.6	1.2
UK (FT all share)	GBP	5.5	2.5	2.9
Europe ex. UK (DS)	EUR	5.7	1.7	3.9
Japan (DS)	JPY	3.4	1.7	1.7
Pacific ex. Japan (DS)	Local	12.9	3.4	9.2
Emerging Markets (DS)	Local	14.5	5.3	8.8
MSCI World	Local	4.8	2.4	2.3
Credit				
US HY	USD	3.8	2.6	1.1
US IG	USD	4.5	2.6	1.9
UK IG	GBP	4.6	2.5	2.1
EU IG	EUR	1.4	1.7	-0.3
Alternatives				
EMD\$	USD	6.0	2.6	3.3
Commodities	USD	4.3	2.6	1.6
Private Equity	GBP	9.8	2.6	7.0
Hedge Funds	USD	4.8	2.6	2.1

Source: Schroders Economics Group, July 2014. Methodology for calculation can be found in Appendix.

Medium term asset class performance (continued)

US growth
forecasts revised
down, mixed
picture on inflation

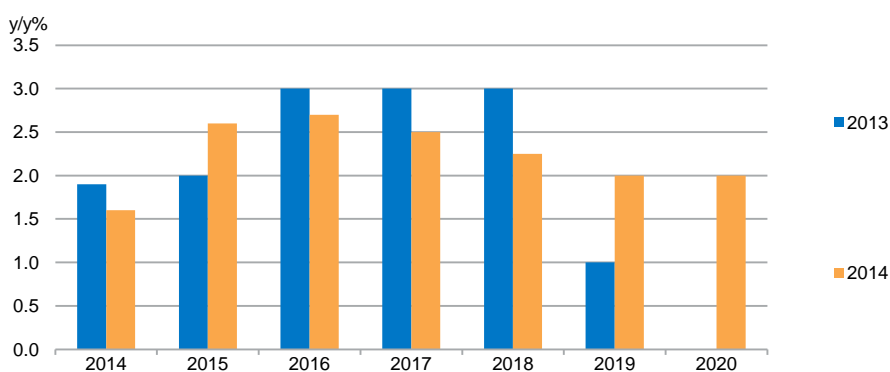
Macro Outlook

Our overall growth forecast for the next 7 years shows a recovery in the world economy, although one which is sub-par by past standards.

We have downgraded our medium term growth forecasts for the US (chart 16), to reflect a more pessimistic outlook for labour force and productivity growth. Demographics are expected to weigh on the participation rate whilst output per head gains is not expected to return to pre-crisis rates.

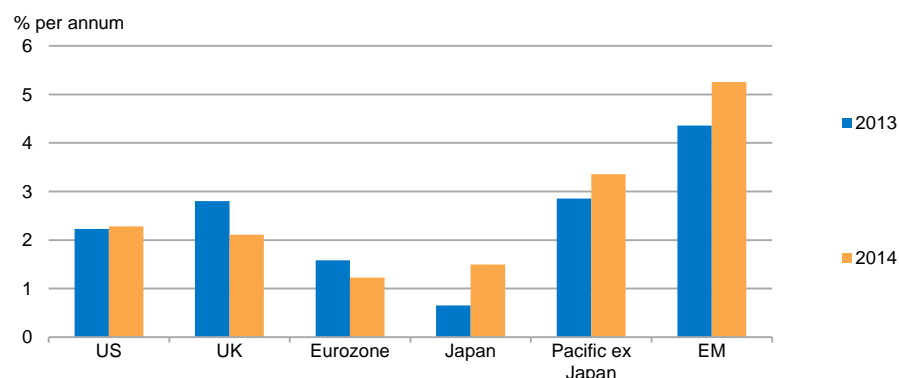
After deflationary pressure from a slowing China and softer commodity prices, a lack of reform in a number of major emerging market economies has created supply side bottlenecks and contributed to a persistence of inflation. Inflationary pressures will likely build in a global recovery and Emerging Markets (EM) economies will have to implement structural reform to tackle their inflation problem. Japanese inflation has been revised up on the impact of Abenomics, while recent developments in UK and Eurozone prices have prompted a downward revision (chart 17).

Chart 16: US growth forecast (2014 – 21 vs. 2013 – 2020)



Source: Schroders Economics Group, July 2014.

Chart 17: Inflation forecast (2014 – 21 vs. 2013 – 2020)



Source: Schroders Economics Group, July 2014.

Cash

Our forecasts for cash and bonds are based on the projected path of rates and yields over the next seven years. Returns are mixed compared to those forecasts made in 2013, with real declines in the Euro area and Japan but an upgrade to our UK outlook on a more hawkish rate outlook. Nonetheless, overall real cash returns remain negative in all four regions.

Medium term asset class performance (continued)

Table 4: Cash return forecasts

% per annum	2014 – 2021			Change from 2013		
	Nominal	Inflation	Real	Nominal	Inflation	Real
Cash						
US	2.2	2.6	-0.4	0.4	0.4	0.0
UK	2.3	2.5	-0.2	1.1	-0.3	1.3
Eurozone	1.0	1.7	-0.7	-0.3	-0.1	-0.2
Japan	0.4	1.7	-1.3	0.1	1.1	-1.1

Source: Schroders Economics Group, July 2014.

Government bonds

Cash and bond returns negative in real terms

We expect real returns on US Treasuries to rise from our previous forecast levels, partly due to the rise in yields over the last year. Lower returns are forecast for the Eurozone for the opposite reason; yields have fallen markedly since last year. The UK though sees a significant increase in real returns compared to last year's projection, partly on lower inflation but more due to a flattening of the yield curve which reduces capital losses. Overall, real returns remain negative, but only just in the US and UK. Returns are lowest by far in the Eurozone.

Table 5: Government bond forecasts

% per annum	2014 – 2021			Change from 2013		
	Nominal	Inflation	Real	Nominal	Inflation	Real
Bonds						
US	2.6	2.6	-0.1	1.1	0.4	0.6
UK	2.4	2.5	-0.1	1.8	-0.3	2.0
Eurozone	-0.5	1.7	-2.2	-1.2	-0.1	-1.0

Source: Schroders Economics Group, July 2014.

Equities

Table 6: Equity assumptions

Equity Market	Trend growth of real EPS (per annum)	PE (t)	Terminal PE
US (S&P 500)	2.0%	18.7	20.6
Japan (DS)	1.6%	14.9	19.8
Pacific ex Japan (DS)	4.3%	13.7	15.6
Emerging markets (DS)	4.0%	13.1	13.3

Note: DS is Thomson Datastream own composite. Source: Schroders Economics Group, July 2014.

We model equity returns by assuming that real earnings per share (EPS) returns to its long run trend level by the end of the seven year period, whilst the valuation metric (price/earnings) returns to a long run fair value. Three years ago, we considered the effect of a world in which growth is structurally lower, reducing the trend rate of real EPS growth by between 33% (US and Emerging Markets) and 24% (Japan and Pacific ex. Japan). We altered these assumptions (table 6) slightly last year. The main change was to reduce trend EPS growth for Emerging Markets from 6.0% to 4.0%, as China begins to transition away from its investment-led growth model, with negative implications for commodity exporters. The economy is now slowing, despite government stimulus efforts, and a return to past growth rates seems unlikely.

Note that due to a change in methodology, we cannot make a valid comparison of last year's equity returns with our current forecasts.

Medium term asset class performance (continued)

Table 7: Equity market return forecasts

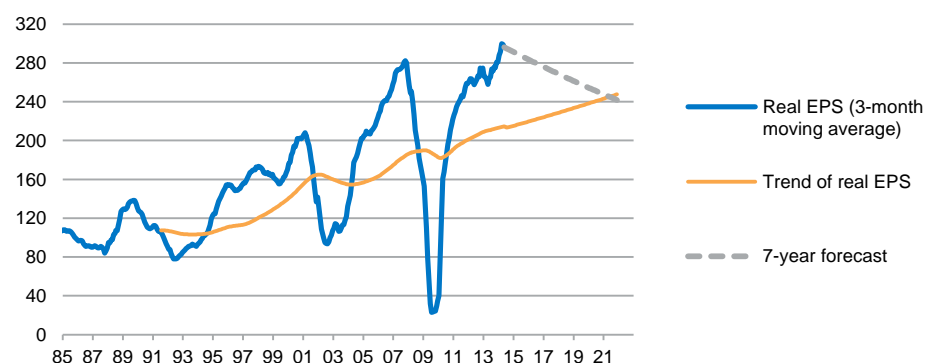
% per annum	2014 – 2021		
	Nominal	Inflation	Real
Equity			
US (S&P 500)	3.8	2.6	1.2
UK (FT all share)	5.5	2.5	2.9
Europe ex. UK (DS)	5.7	1.7	3.9
Japan (DS)	3.4	1.7	1.7
Pacific ex Japan (DS)	12.9	3.4	9.2
Emerging markets (DS)	14.5	5.3	8.8
MSCI World	4.8	2.4	2.3

Source: Schroders Economics Group, July 2014.

Pacific ex Japan has the highest projected equity returns, followed by EM

With EPS significantly above trend, we expect negative EPS growth in the US (chart 18). US valuations, measured by the Price-Earnings (PE) ratio of the market relative to its history, have become less attractive since 2013. In general, market valuations are up from this time last year, the US recovery appears to be on track, growth has picked up in the UK, policy has turned more supportive in Europe and Abenomics has spurred a rally in Japan. While a below trend PE is positive for future equity returns due to the implied re-rating, the improvement in PE ratios brings them closer to their trend levels, which is less positive for future equity returns. Nonetheless, equity returns remain significantly positive, in stark contrast to government bonds and cash.

Chart 18: US earnings relative to exponential trend

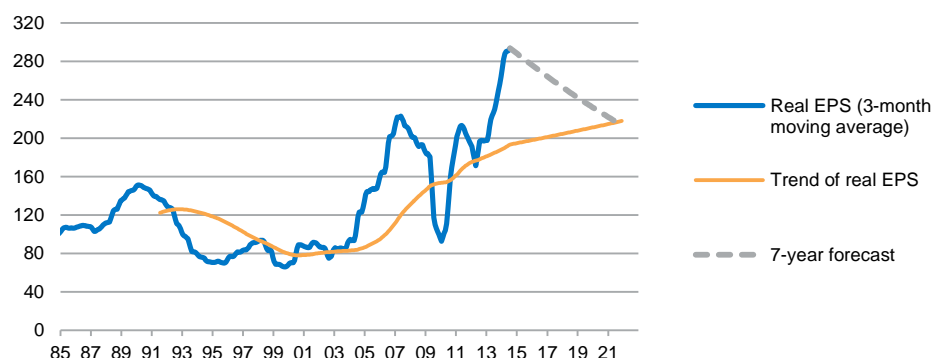


Source: Thomson Datastream, Schroders Economics Group, July 2014.

In Japan, real returns have been decreased by higher inflation. Equity valuations are much closer to trend and so have less scope for further gains. In addition, we have seen a sharp increase in real EPS (chart 19 on next page), implying a greater decline as it returns to trend. However, PE ratios have declined, providing a boost to medium term returns as they return to trend.

Medium term asset class performance (continued)

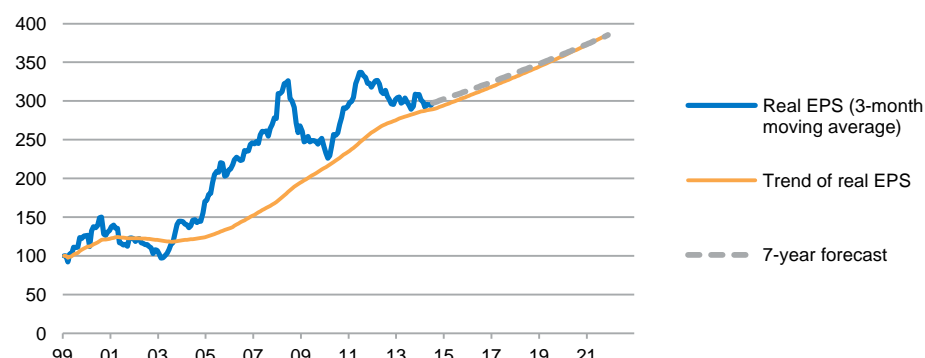
Chart 19: Japan earnings relative to exponential trend



Source: Thomson Datastream, Schroders Economics Group, July 2014.

Our downgrade of trend EPS growth for EM last year was based on the belief that the EM growth story is structurally weaker now that China's investment-led model is reaching the limits of its ability to generate growth. Demand for commodities, which had supported growth in many EM markets, will be much slower in the future. Meanwhile, EPS looks to be slightly above current trend levels, though EPS growth is expected to accelerate slightly in the medium term, so a return to trend EPS growth implies limited EPS growth over the medium term (chart 20). Valuations, based on PE, are now close to fair value.

Chart 20: Emerging Market earnings relative to exponential trend

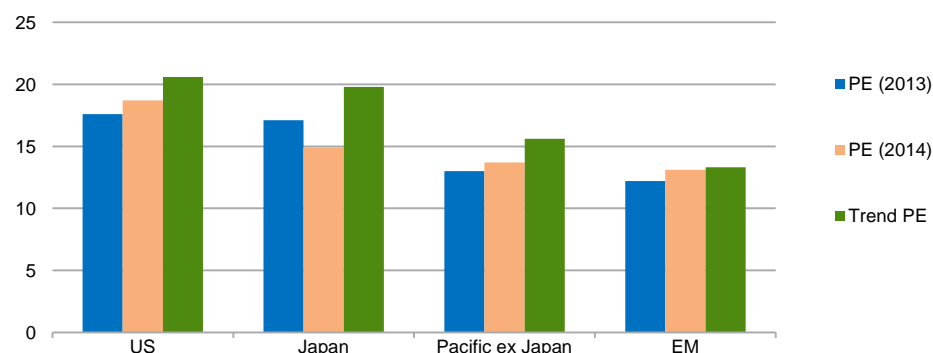


Source: Thomson Datastream, Schroders Economics Group, July 2014.

Below trend PE ratios in many markets to help drive returns

A recurring theme above was that PE ratios, in general, remain below trend, which offers one route for increased returns from equities as PE ratios return to its longer run levels in the years to come. From chart 21, below, Japan will be the largest beneficiary of rerating, while EM looks to be close to fair value. Note that with the exception of Japan, PE ratios have risen compared to last year, an important factor in reducing expected returns from equity markets.

Chart 21: Price to earnings ratios remain below trend



Source: Schroders Economics Group, July 2014.

Medium term asset class performance (continued)

Higher Treasury yields countered by tighter spreads in effect on credit

Credit

Credit return forecasts are calculated as a spread over a relevant government bond, and so our assumptions for Treasury yields have increased our credit return assumptions for US investment grade credit. Investment grade return forecast have also been raised for the UK, again because 10-year yields are expected to be higher. In high yield, however, spreads have tightened considerably this year, raising the probability of capital loss as spreads return to more normal levels. This helps explain the downgrade to projected returns in this asset class, and also means that high yield credit is expected to generate lower returns than its investment grade counterpart in the US. Though returns are lower than in equity markets, they remain positive in real terms, except in Europe where bond yield expectations have fallen.

Table 8: Credit market return forecasts

% per annum	2014 – 2021			Change from 2013		
	Nominal	Inflation	Real	Nominal	Inflation	Real
Credit						
US HY	3.8	2.6	1.1	-1.0	0.4	-1.4
US IG	4.5	2.6	1.9	1.0	0.4	0.7
UK IG	4.6	2.5	2.1	1.6	-0.3	1.9
EU IG	1.4	1.7	-0.3	-1.0	-0.1	-0.9

Source: Schroders Economics Group, July 2014.

Alternatives

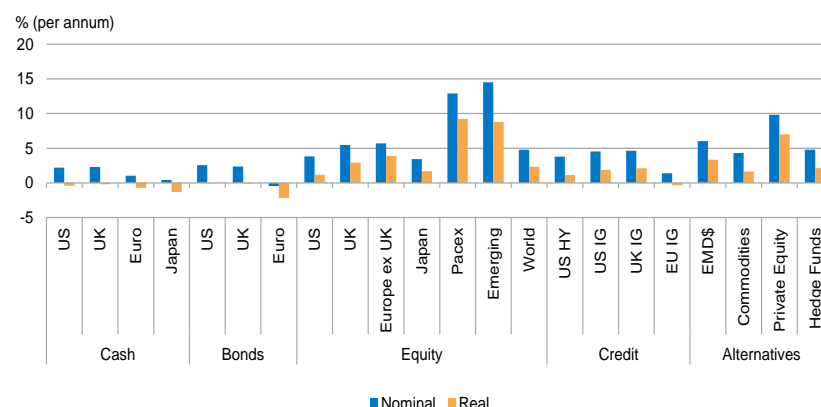
Assumed EMD\$ returns (table 9) have risen since last July, thanks to higher forecast returns on US Treasuries. The forecast return on commodities has edged higher due to higher US cash returns. Our methodology assumes that hedge funds and private equity generate equity like returns, which we proxy with the MSCI World return. So with equity returns lower, private equity and hedge fund nominal returns fall by the same amount.

Table 9: Alternative asset class return forecasts

% per annum	2014 – 2021			Change from 2013		
	Nominal	Inflation	Real	Nominal	Inflation	Real
Alternatives						
EMD\$	6.0	2.6	3.3	1.1	0.4	0.7
Commodities	4.3	2.6	1.6	0.7	0.4	0.3
Private Equity	10.5	2.6	7.7	-0.2	-0.2	0.0
Hedge Funds	5.5	2.6	2.8	-0.2	0.4	-0.6

Source: Schroders Economics Group, July 2014.

Chart 22: 7 year return forecasts (2014 – 2021)



Source: Schroders Economics Group, July 2014.

Medium term asset class performance (continued)

Conclusions

Investors looking for positive real returns should look to equity, credit and alternatives, with Pacific ex Japan, and emerging market equities promising the highest real returns (chart 22 on previous page). However, an important caveat is the higher level of volatility associated with EM equities when compared to the S&P or FTSE. As always, there is a risk-reward trade-off. Cash and government bonds would act as a hedge against equity market volatility, but are likely to deliver returns below inflation over the medium term.

Craig Botham

EM Economist, October 2014

Medium term asset class performance (continued)

Appendix 1 – Forecast methodology

Cash

Cash returns represent the annualised cash return anticipated over the next 7 years based on an explicit interest rate profile.

Government Bonds

Government bond represent the annualised return anticipated over the next 7 years based on explicit year end government bond yields.

Credit

High yield

Credit returns are based on our 7 year US growth forecast. There is a good relationship between US growth and high yield spreads. We use this relationship to forecast the evolution of spreads over 7 years. We combine this with our government bond forecasts to provide an estimate of high yield returns.

Investment grade

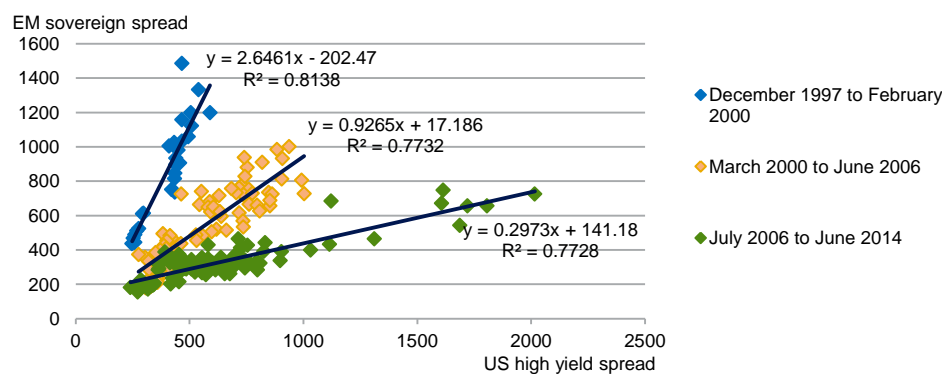
Investment grade spreads track high yield spreads closely. We use this relationship to forecast investment grade spreads. We combine this with our government bond forecasts to provide an estimate of investment grade returns.

EMD\$

Emerging market debt also has a close relationship with high yield spreads. However this relationship has gone through 3 distinct phases:

1. 1997 – 2000 where there were problems in the EMD market as several countries went through a restructure or default
2. 2000 – 2006 where both high yield and EMD markets functioned normally
3. 2006 – 2014 where high yield spreads went from being very tight to an historic wide, whereas EMD spreads remained reasonably well supported

EM sovereign spreads versus US high yield spreads



Source: Thomson Datastream, Schroders Economics Group, July 2014.

We believe that with the increasing quality of EMD debt (countries are gradually being upgrade to investment grade) we will see the relationship between EMD spreads and high yield spreads settle between phases 2 and 3 outlined above.

Medium term asset class performance (continued)

Commodities

We break our commodity forecast into 4 components.

Commodity Returns = US inflation + Index rebalancing - Roll yield + US cash.

We assume that

- In aggregate commodity prices broadly track US inflation
- That commodity price mean-revert over time, as capacity will be increased where there is a production shortage. Rebalancing the index therefore generates excess return by booking temporary price gains
- The roll yield will be negative due to synthetic storage costs
- Investors receive the return on the collateral which backs the synthetic commodity investment

Equities

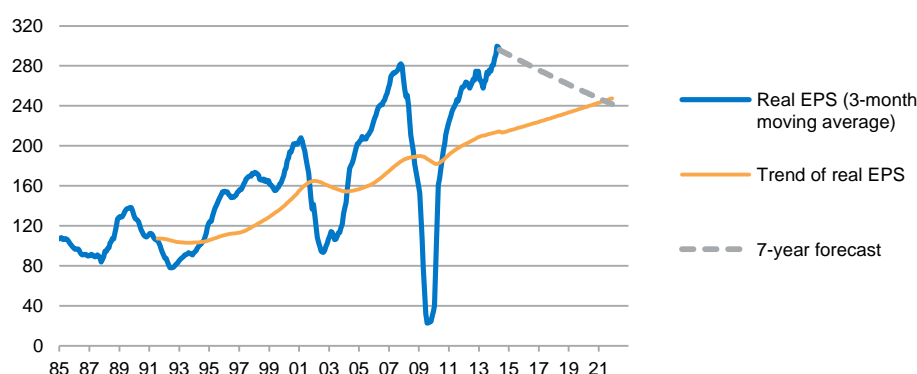
Equity returns consist of two components income and capital returns.

Income

The income component is determined by the initial dividend yield and growth in dividends. The dividend growth rate is determined by a combination of future earnings growth and the equilibrium payout ratio.

The US trend earnings growth rate is assumed equal to our forecast of US productivity growth. This is derived from our 7 year US GDP forecast and UN projected population growth. The current level of earnings is assumed to converge to the trend earnings growth rate over the next 7 years¹.

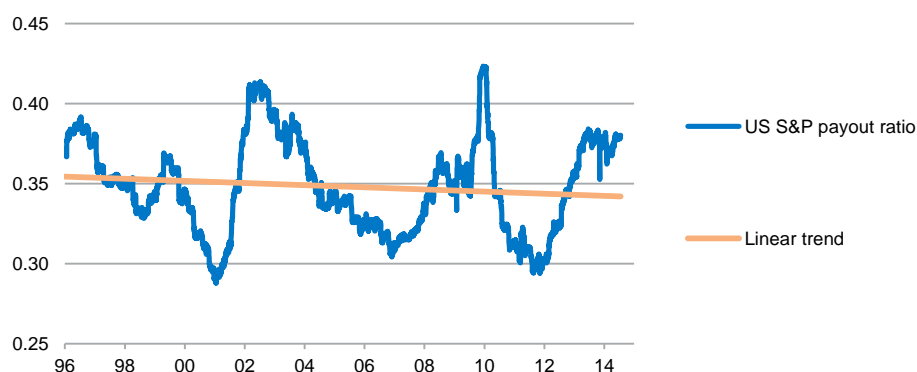
S&P 500 real earnings



Source: Thomson Datastream, Schroders Economics Group, July 2014.

The earnings growth rate is then adjusted to give the dividend growth rate. We assume that the payout ratio will revert to trend over this time period.

S&P 500 payout ratio



Source: Thomson Datastream, Schroders Economics Group, July 2014.

¹ Prior to our forecast period we plot the 30 year exponential trend earnings growth rate.

Medium term asset class performance (continued)

Capital growth

Computing capital returns require two assumptions, the rate of earnings growth and the terminal PE.

The terminal PE ratio is assumed to equal the 30 year trimmed mean. The method for calculating the earnings growth rate is described above.

Other markets

The European, UK and US market returns have historically tracked each other closely. We use this historic relationship to generate our return forecasts for Europe and UK.

For Asian and Emerging markets there is not a close relationship with US market performance. We therefore use the same method as outlined above for the US economy. We do not make explicit GDP forecasts for the Pacific ex Japan and Japanese earning trends are adjusted by the same magnitude as the US 30-year trend growth rate. For the emerging markets we make explicit GDP forecasts and gather population data as we believe using historic earnings growth trends will bias emerging market returns upwards as they are unlikely to grow at such a rapid pace in the future as their economies begin to mature.

2014 change to methodology

Previously, we had calculated trend EPS using an exponential trend fitted across the entire dataset (approx. 30 years). Increasingly, this was generating what seemed implausible results, due to structural drift. The economy is very different today to 1990, and so it seems unwise to assume that trend growth today will behave the same as then. Consequently, trend EPS is now based on a seven year moving average. In many cases, this gave us a lower trend EPS level. While terminal EPS growth rates are unchanged, they start from a lower base and this has reduced equity returns versus last year.

Market focus: Asset performance through the global cycle

Introduction

In last quarter's market focus piece, we provided an assessment of the global cycle and the level of spare capacity in the world economy. In particular, the emerging markets and developed world are out of sync with increasing slack in the former but a narrower output gap in the latter. Against this backdrop, global inflationary pressures could be well-contained and central banks have more scope to keep monetary policy accommodative.

In this instalment, we dig deeper into asset class performance in the context of the global cycle. At the same time, comparing the return profile of assets based on the US cycle with the global cycle. Looking ahead, the de-synchronisation of cycles around the world means that navigating the investment path will prove to be more challenging.

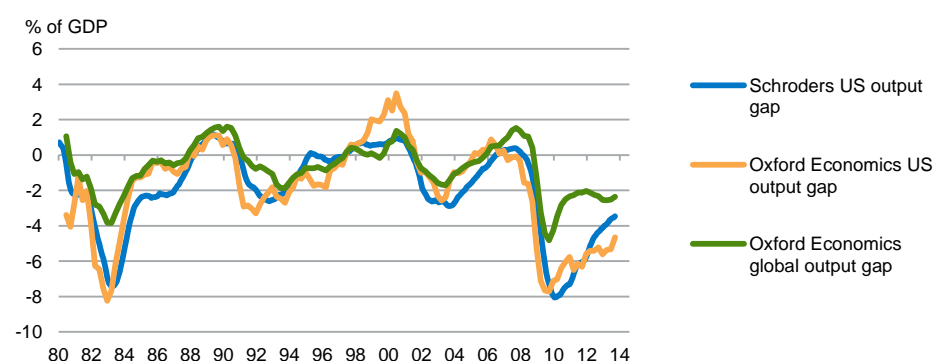
Cycles within cycles

Both the US and global cycle closely tied

Before we start delving into the investment implications of the global cycle, it will be useful to understand the contribution of the individual country/region's output gap in driving the global cycle as the importance of markets will change over time. In particular, the increasing significance of the emerging world on the global macro stage and their demand for assets such as commodities. Moreover, the co-movements of the individual cycles will have a bearing on the excess or space capacity in the global system.

As highlighted in last quarter's Global Market Perspective, the global cycle is calculated using output gap estimates from Oxford Economics including their measure of the US. Reassuringly, the profile and trajectory of the US output gap is not too dissimilar to our own measure (chart 23). Although there have been episodes of divergence during the mid-1980s and late 1990s. In both periods, according to the output gap calculated by Oxford Economics, there was much less slack in the economy than our estimates.

Chart 23: Comparing the US and global cycles



Source: Thomson Datastream, Oxford Economics, Schroders, 30 September 2014.

While the contribution of the US to the global economy has been reduced compared to 30 years ago, this market continues to be an important driver of the amount of spare capacity in the system as it accounts for a quarter of global GDP. Unsurprisingly, there has been a strong relationship between the Oxford Economics US output gap and the amount of slack in the global economy over the last 30 years. However, the troughs in the world output gap are shallower than the US and the positive gap experienced over the period of 2006 to 2008 was more prominent in the global cycle.

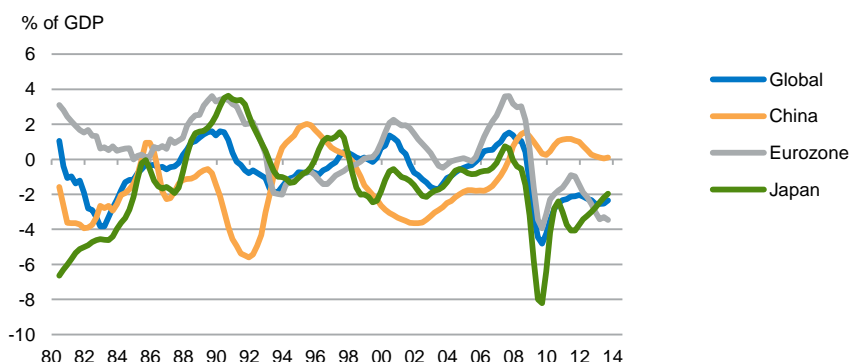
Market focus (continued)

Strong
synchronisation
between the cycles
around the world...

This was attributed to other parts of world having less spare capacity in their economies such as the Eurozone which contributes nearly a fifth of global GDP (chart 24). For most of the period, the Euro area has been relatively synchronised with the global cycle and has also tended to operate at a higher capacity level than their global counterpart. However, some of these European economies got particularly hit with austerity measures and lost of capacity post sovereign debt crisis of 2011 such that this region has been a drag on the worldwide output gap since 2012.

Not forgetting Japan, this market at one point in the 1990s accounted for almost 20% of world output but its contribution has been more than halved in recent times. Similar to the Eurozone, the Japan cycle has moved relatively closely with the global cycle. Although in the aftermath of the burst of the asset bubble in the last 1990s, Japan has been operating at a lower level of capacity compared to the rest of the world. Overall, the excess spare capacity in the developed world has been a deflationary force on the world economy and in turn key central banks have responded with ultra-loose monetary policy, which has led to a benign liquidity backdrop for risk assets.

Chart 24: China, Japan and Eurozone output gaps measures versus the world



Note: Oxford Economics global output gap calculated from the individual output gaps and aggregated using nominal GDP in USD. Source: Thomson Datastream, Oxford Economics, Schroders, 30 September 2014.

...except for EM,
particularly China

For EM, particularly China, the trajectory of the cycle has been more de-synchronised with the rest of the world particularly in the mid-1990s when China was experiencing major economic reforms and operating above capacity whilst there was significant slack in the global economy. Although at that point in time, the EM universe was unable to pick up the slack as the region only contributed a tenth of global output compared to nearly a third in present day. Instead, over the past few years, EM and China has been offsetting the large amount of space capacity in the developed world.

The lack of co-ordination between the global and China cycles is also borne out in simple correlations of China output gap series with measures elsewhere over the last 30 and 10 years (tables 10 and 11 on next page). Interestingly, the disparity between China and the US or global output gap has increased rather than narrowed over the past decade. Instead, the synchronisation amongst cycles in the developed world has tightened over the same period. Meanwhile, the relationship between China and the EM has also strengthened with EM's relationship with the global cycle staying relatively the same. In aggregate, this analysis would suggest that the developed markets remain the driving force behind the global cycle and therefore play an important part in determining asset performance over the cycle.

Market focus (continued)

Table 10: Correlations of output gaps (1980 to 2013)

	US	EU	China	Japan	EM
Global	85%	71%	-9%	60%	33%
US		47%	-15%	57%	-4%
EU			-52%	35%	14%
China				-10%	32%
Japan					-23%

Source: Schroders, Oxford Economics, September 2014.

Table 11: Correlation of output gaps (last 10 years)

	US	EU	China	Japan	EM
Global	91%	94%	-40%	90%	30%
US		79%	-73%	87%	-11%
EU			-25%	74%	36%
China				-51%	72%
Japan					15%

Source: Schroders, Oxford Economics, September 2014.

US cycle is moving into expansion whilst the global cycle is staying in recovery

Phases of the different cycles

So far we have discussed the positioning and movement of the individual economic cycles, in this section we examine where the key economic cycles are headed as we move into 2015 in order to get a fuller picture of the investment implications. In last quarter's piece, we illustrated the forecast for the global output gap based on Oxford Economists' projections of the all the markets. Here we only augment the forecast for the US by using our estimate of the US output gap which is expected to close in September next year. This is driven by our assumption that the US experiences a tighter labour market when the unemployment rate falls faster to trend levels. Consequently, the profile of the global output gap is expected to narrow and remain in the recovery phase for most of the forecast period.

In comparison, China's output gap has been in positive territory since the end of 2007 and is in the slowdown/stagflation phase according to our model of the cycle. Looking ahead, based on Oxford Economics estimates, China is expected to rotate into the expansion phase but we would estimate a less positive picture given our more sluggish growth outlook. However, the cycle in the Eurozone appears to be further behind the US and China cycles. According to our calculations, the Eurozone cycle is in the recession/disinflationary camp for now and is assumed to eventually switch into the recovery phase.

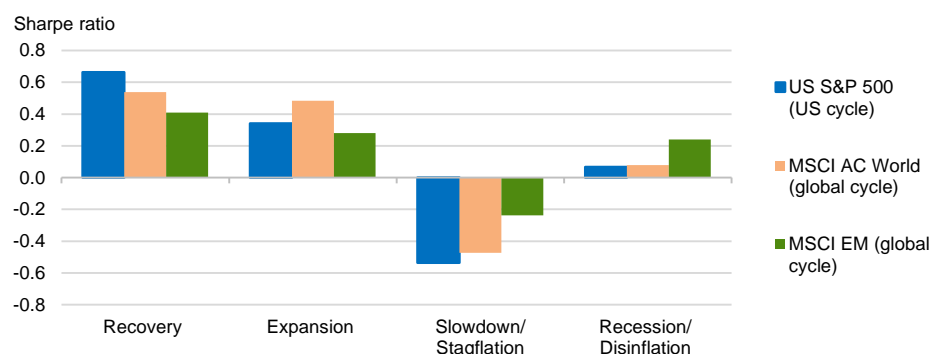
Asset performance in the different stages of the economic cycle

The typical behaviour for equities plays out during the phases of the cycle. During the recovery phase, equities tend to outperform as interest rates tend to be low and monetary policy accommodative given that inflation is muted and growth is healing. In expansion, rising interest rates and inflation pressures tempers equity returns although they remain well-supported given the strong earnings growth environment. However, as the cycle moves into the slowdown/stagflation phase, equities suffer as typically inflation and interest rates are peaking, while both economic growth and profits are faltering. Finally, in recession, equities deliver relatively flat performance which is driven by the lack of earnings growth.

From an asset allocation perspective, using the cycles based on Oxford Economic' output gap, the performance profile for US equities is not too dissimilar to the return trajectory for global and emerging equities based on the global cycle (chart 25 on next page). Overall, equities should remain well-supported with the US moving in the expansion phase and the global cycle remaining in recovery.

Market focus (continued)

Chart 25: Return of equity markets based on US, EM and global cycle



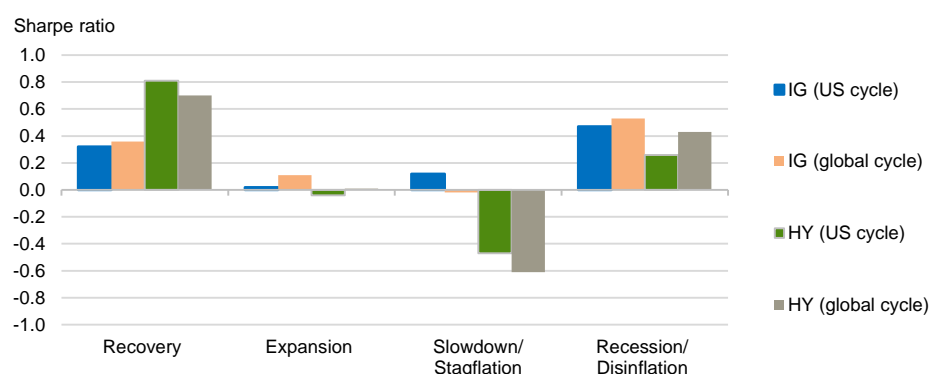
Note: Performance figures are average monthly total returns (USD) relative to US cash based on phases of the cycle derived from Oxford Economics' output gaps. Data based on completed phases of the cycle from 1987 to 2013. Source: Schroders, Thomson Datastream.

Credit and sovereign bonds are vulnerable to the US moving into expansion phase...

For credit investment grade and high yield bonds, this asset class follows a similar pattern to equities in that the slowdown/stagflation phase is the worst period particularly for high yield, which is closer to the equity-spectrum (chart 26). The key difference is that credit is an early cyclical asset in that it starts to outperform in the recession/disinflation phase as spreads generally tighten significantly as markets anticipate a rebound in the economy and corporate earnings.

Moreover, credit markets tend to experience a tougher time during the expansion phase when both inflation and interesting rates are rising. Looking ahead, the performance prospects of high yield and investment grade could be poor with the US rotating into the expansion phase. However, there could be still benefits from holding onto a credit allocation in the portfolio given that the global cycle should stay in the recovery phase with monetary policy remaining accommodative in some parts of the developed world.

Chart 26: Credit performance based on US and global cycle



Note: IG is Merrill Lynch US investment grade corporate bonds and HY is Merrill Lynch US high yield bonds for all maturities. Performance figures are average monthly total returns relative to US cash based on Oxford Economics' output gaps. Data based on completed phases of the cycle from 1987 to 2013. Source: Schroders, Thomson Datastream.

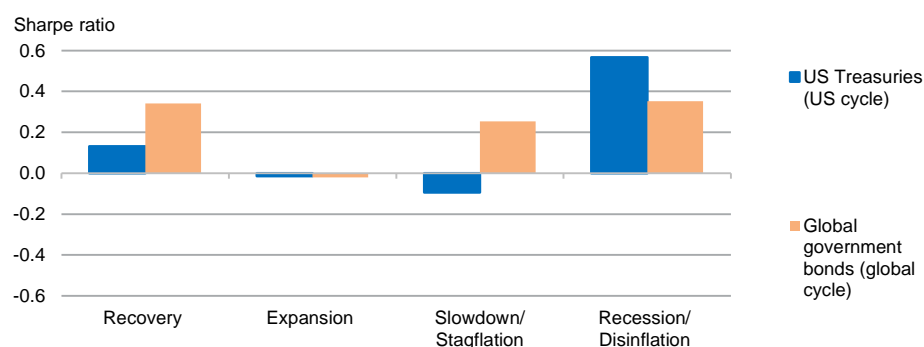
The expansion phase is also an unconvincing return period for government bonds as the strong growth and inflation environment along with tightening in policy puts upward pressure on yields (chart 27 on next page). Instead, as to be expected, the low growth and inflation landscape in the recession/disinflation phase is the best stage of the US or global cycle for sovereign debt markets. In particular, US Treasuries experienced a stronger return profile compared to their global counterpart over this phase given that the US cycle stayed longer in the recession phase in the aftermath of the last financial crisis. For the global cycle, the recession phase was over a shorter period given that the emerging world led by China was heading back into the recovery phase in 2007.

Market focus (continued)

...but global cycle still in the recovery phase and monetary policy accommodation in some parts of the world

Meanwhile, global government bonds appear to have outperformed US Treasuries during the slowdown/stagflation phase of the cycle. This has been partly driven by the global cycle lagging behind the US cycle during the last financial crisis and moving into the recession phase later. Hence, the strong rally in bonds worldwide over the period was captured in the stagflation phase for the global cycle. In terms of the implications on the allocation of government bonds, similar to the credit markets, this analysis would suggest a reduction in the holding of Treasuries when the US cycle moves into the expansion phase. Nonetheless, with the global cycle in recovery and monetary policy expected to remain loose in the Eurozone and Japan, it may warrant global investors to still retain exposure to some sovereign debt markets.

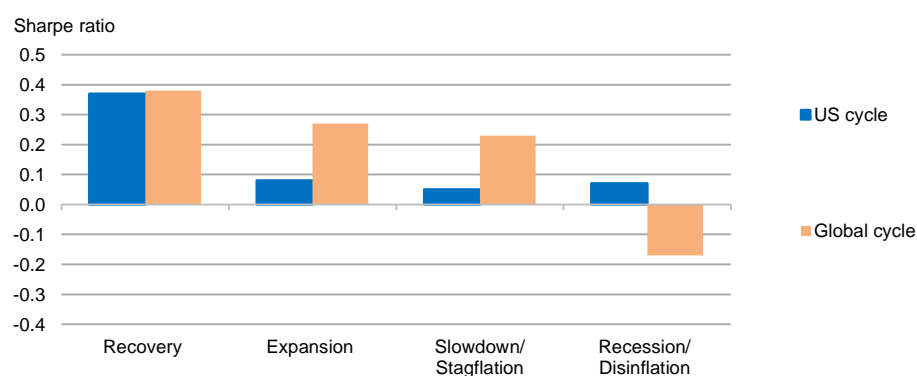
Chart 27: Performance of US and global government bonds based on US and global cycle



Note: US treasuries based on 10-year government and global government bonds is based on the Merrill Lynch global government bond index. Performance figures are average monthly total returns relative to US cash based on Oxford Economics' output gaps. Data based on completed phases of the cycle from 1987 to 2013. Source: Schroders, Thomson Datastream.

For commodities, the picture based on the US and the global cycles is more mixed (chart 28). While the best period for commodities is during recovery for both cycles, the worst is in recession for the global cycle. However, for the US cycle, there appear to be a lack of distinction amongst the other phases. Surprisingly, commodities fail to take centre stage during the expansion and stagflation phases. While on an absolute return basis, commodities delivered stronger returns in these phases, particularly during stagflation, the greater volatility experienced in both periods resulted in lower risk-adjusted returns compared to the recovery phase. Looking head, according to the global cycle, commodities appear to be well-supported although it could be against a more volatile environment for this asset class given that the US is expected to be in the expansion phase next year.

Chart 28: Performance of commodities based on different cycles



Note: Commodity performance based on GSCI commodity index. Performance figures are average monthly total returns relative to US cash based on Oxford Economics' output gaps. Data based on completed phases of the cycle from 1987 to 2013. Source: Schroders, Thomson Datastream.

Market focus (continued)

What's next?

Looking ahead, the de-synchronisation of cycles around the world means that navigating the investment path will prove to be more challenging. The US cycle based on our forecast of the US output gap is expected to close in September next year and move in to the expansion phase. This is likely to coincide with the return of the US rate tightening cycle. In this environment, equities typically outperform sovereign and corporate bonds.

In comparison, the global cycle is expected to stay in the recovery phase driven by excess spare capacity in the Eurozone and Japan. Against this backdrop, equities should remain well-supported and global investors may continue to retain a holding in credit and sovereign bonds despite the US rotating to the expansion phase. This is predicated on other parts of world keeping liquidity conditions benign with further policy accommodation from the ECB and BoJ.

Meanwhile, the outlook for commodities is less clear in that there could be stronger demand from the US but the expansion phase according to the US cycle is poor given the more volatile return profile. At the same time, the growth outlook on China remains sluggish and there is also significant slack elsewhere in the world. Consequently, there is the risk that commodities could remain subdued as we head through 2015.

Tina Fong, CFA

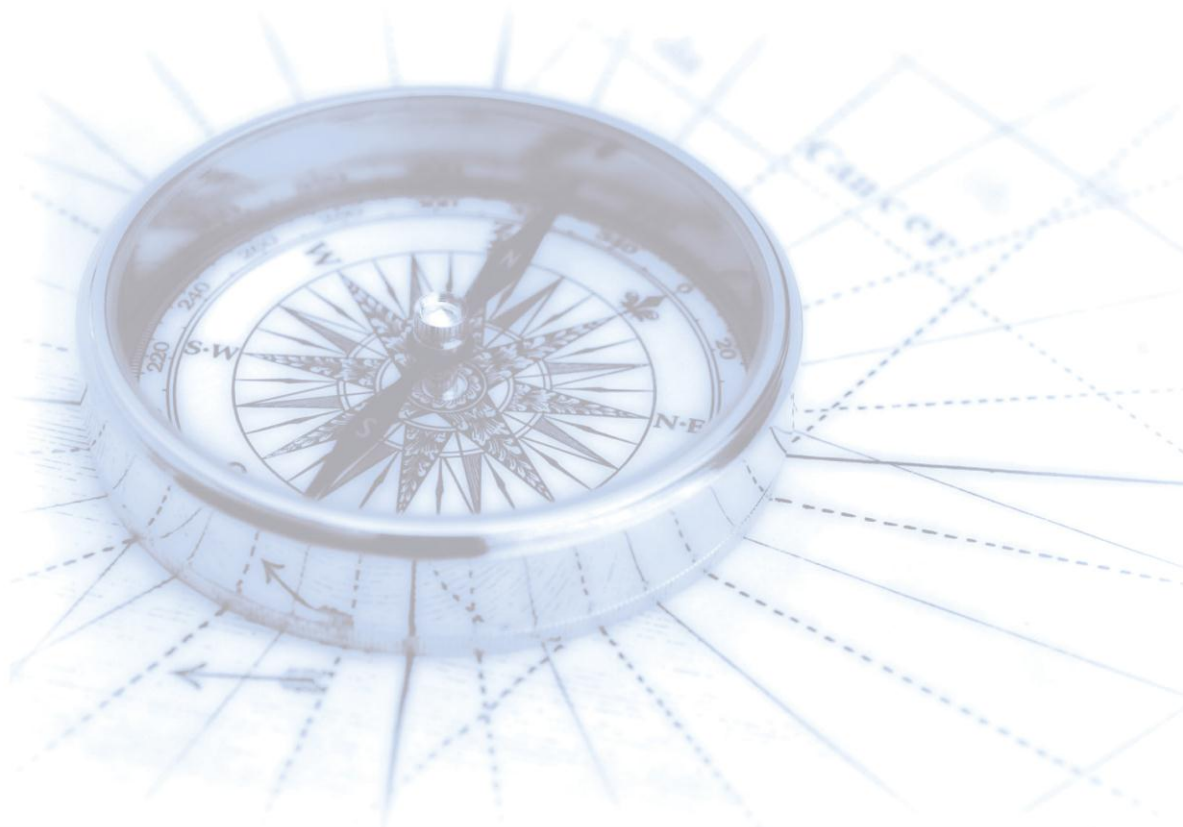
Analyst, October 2014

Market Returns

	Total returns	Currency	September	Q3	YTD
Equity	US S&P 500	USD	-1.4	1.1	8.3
	UK FTSE 100	GBP	-2.8	-0.9	1.0
	EURO STOXX 50	EUR	1.8	0.3	7.1
	German DAX	EUR	0.0	-3.6	-0.8
	Spain IBEX	EUR	1.0	0.2	12.8
	Italy FTSE MIB	EUR	2.6	-1.4	12.9
	Japan TOPIX	JPY	4.5	5.8	3.8
	Australia S&P/ASX 200	AUD	-5.4	-0.6	2.4
	HK HANG SENG	HKD	-6.9	0.2	2.2
EM equity	MSCI EM	LOCAL	-4.2	0.7	5.5
	MSCI China	CNY	-6.2	1.7	1.2
	MSCI Russia	RUB	-0.9	-4.3	-6.6
	MSCI India	INR	0.3	5.1	24.5
	MSCI Brazil	BRL	-11.6	1.6	5.1
Governments (10-year)	US Treasuries	USD	-1.2	0.7	6.9
	UK Gilts	GBP	-0.3	3.9	8.5
	German Bunds	EUR	0.0	3.5	12.3
	Japan JGBs	JPY	0.0	0.8	3.1
	Australia bonds	AUD	-1.2	1.3	10.1
	Canada bonds	CAD	-1.2	1.3	8.2
Commodity	GSCI Commodity	USD	-6.0	-12.5	-7.5
	GSCI Precious metals	USD	-6.7	-9.8	-1.1
	GSCI Industrial metals	USD	-6.1	-2.8	-1.6
	GSCI Agriculture	USD	-10.8	-19.2	-17.9
	GSCI Energy	USD	-6.3	-13.3	-8.5
	Oil (Brent)	USD	-6.7	-16.0	-15.0
	Gold	USD	-5.8	-7.9	0.4
Credit	Bank of America/Merrill Lynch US high yield master	USD	-2.1	-1.9	3.6
	Bank of America/Merrill Lynch US corporate master	USD	-1.2	0.0	6.0
EMD	JP Morgan Global EMBI	USD	-2.4	-1.6	7.3
	JP Morgan EMBI+	USD	-2.6	-2.1	7.2
	JP Morgan ELMI+	LOCAL	0.2	0.8	2.9
Currencies	EUR/USD		-3.8	-7.8	-8.1
	EUR/JPY		1.3	-0.2	-4.2
	JPY/USD		-5.1	-7.7	-4.1
	GBP/USD		-2.3	-5.2	-1.9
	AUD/USD		-6.1	-6.7	-0.1
	CAD/USD		-2.8	-4.4	-4.4

Source: Thomson Datastream, Bloomberg, 30 September 2014.

Note: Blue to red shading represents highest to lowest performance in each time period.

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