

Schroders

Global Market Perspective

Economic and Asset Allocation Views Q2 2015



Schroders

Introduction

Equity and bond markets performed well during the first quarter, primarily driven by the start of Quantitative easing (QE) by the European Central Bank (ECB). Although ECB president Mario Draghi has said that monetary policy alone cannot drive the recovery, the subsequent fall in the Euro will go some way to boosting activity and alleviating fears of deflation. Meanwhile, bond yields fell to record lows across the region with the front end of the German curve dropping below zero. We believe the spillover effects to other bond markets from this will be significant.

The US Federal Reserve did not ease monetary policy, but a dovish statement pushed expectations for the first rate rise further out. Meanwhile, the quarter saw easing by other central banks with 21 authorities loosening monetary policy. Low inflation, a consequence of lower energy prices was key in allowing this move, which also pushed bond yields lower around the globe.

In terms of our own strategy we expect strong liquidity and modest improvements in growth to continue to support equities where we remain positive despite the increase in valuations. However, we have rotated away from the US toward Europe ex.UK on the back of the changes in monetary policy. We remain neutral on bonds, but have downgraded bunds and Treasuries.

In this Global Market Perspective we look at the impact of recent exchange rate moves and the latest round of the “currency wars” which have rolled around the world for the past 5 years. We also look at the way QE is affecting corporate behaviour by causing companies to favour distributions rather than other forms of expenditure such as investment. This will have important implications for the way QE affects growth in the world economy.

Keith Wade, Chief Economist and Strategist, Schroders

13 April 2015

Contents

Asset Allocation Views – Global Overview	3
Regional Equity Views – Key Points	5
Fixed Income – Key Points	6
Alternatives – Key Points	7
Economic view: Global tilt towards advanced economies	8
Strategy note: Market performance, currency wars and asset shortages	12
Market focus: Some unintended consequences of QE	16
Market returns	19
Disclaimer	Back Page

Asset Allocation Views: Multi Asset Group

Global Overview

Economic View

Despite six years of “zero rates”, global growth remains tepid. At the latest count, 21 central banks have cut policy interest rates in 2015 and long-dated yields have fallen to unprecedented levels in the Eurozone. At the time of writing the German bond yield is negative up to seven years in maturity and JP Morgan estimates that \$1.9 trillion (30%) of the euro area bond market now has a negative yield. The Eurozone has been the principal driver of the drop in G7 bond yields which in aggregate are now below G7 core inflation for the first time in 20 years.

There is a concern that the latest fall in interest rates is just another chapter in a long-running saga of declining yields and that the underlying trend is being driven by secular stagnation. This occurs when an economy suffers from a chronic deficiency of demand such that it requires lower and lower interest rates to stimulate activity. Clearly, these concerns have a significant bearing on bond markets, but are they justified?

The secular stagnation theory fits many of the facts, as global growth has been disappointingly weak despite the fall in interest rates to record lows. Six years on from the financial crisis' start, the Federal Reserve (Fed), Bank of England (BoE), European Central Bank (ECB) and Bank of Japan (BoJ) all have interest rates at – or close to – zero. If secular stagnation is the root cause, central banks may have to continue, or even restart quantitative easing. In which case; yields will trend even lower.

Our view is that the secular stagnation hypothesis is overly pessimistic. There is evidence to support it; such as a slow down in business investment in major economies such as the US, Germany and Japan. However, we see the world economy in a period of balance sheet adjustment; with countries emerging at different rates from the banking crisis. The US and UK recapitalised their banks at an early stage of the financial crisis, but the Eurozone has taken much longer. Now though we are seeing signs of a return to lending in the Eurozone following last year's Asset Quality Review and stress tests. This suggests bond yields will eventually begin to normalise somewhat. The danger in the near term is that the Eurozone upswing has come too late to prevent a slide into deflation, or that the legacy of the crisis means that banks and households have become reluctant to re-leverage.

Central Bank Policy

Following the mid-March meeting of the Federal Open Market Committee, we have pushed out our forecast for the first US rate rise until September 2015. Although the committee changed its language and opened the door to a June move, it also cut its forecasts for growth, inflation and interest rates. The main factor which has swung our view towards a later move has been the strength of the US dollar, which has exceeded even our bullish expectations. Dollar strength, which is beginning to depress core inflation through lower import prices, has effectively tightened financial conditions for the Fed. We still look for the UK to raise interest rates in November this year, but for the ECB and BoJ to continue with quantitative easing into 2016.

Implications for Markets

Although we believe the bull market in equities has taken markets to record highs and there is a risk of a setback, an environment of modest growth and ample liquidity is set to support the asset class. The biggest change to our equity positioning this quarter is our downgrading of US equities to neutral, removing the positive stance we established three years ago. At the same time we have upgraded Europe ex.UK to positive. We think the outlook for US earnings has become less attractive, not least due to the strength of the US dollar. Although we have been forecasting a stronger dollar for some time, we did not expect the scale of the move seen since the start of 2015 and see further earnings downgrades in coming months.

Asset Allocation Views: Multi-Asset Group

Global Overview (continued)

Implications for Markets (continued)

In Europe, meanwhile, we are seeing signs of stabilisation in the cyclical environment, equity valuations look relatively attractive and monetary policy will be supportive. The euro has been the main beneficiary of dollar strength as it has weakened significantly, providing a boost to corporate earnings. Germany is the biggest beneficiary of Euro weakness and we have a preference for the DAX within the region.

After Europe, Japan looks the next possible candidate for an upgrade, but for the time being we remain neutral on the country. How effective Abenomics has truly been so far remains unclear and we await clearer signs of improvement in domestic demand to appear in the data before we consider changing our stance.

We have been awaiting an opportunity to upgrade emerging market equities since 2011, and for the time being that wait will continue as the strength of the US dollar will continue to weigh on the region. There are also country specific problems such as those facing Brazil (Petrobras scandal) and Russia (Ukraine crisis, sanctions). Within emerging markets we prefer Asia which is best placed to benefit from better global growth and is likely to be more resilient to a rise in US rates.

In fixed income markets we remain neutral government bonds as we do not see an immediate inflation or growth trigger to generate enough upside yield volatility to overcome the carry. However, we have turned negative on US Treasuries and moved to neutral on Bunds. Offsetting this is a more positive view on UK gilts. Quantitative Easing by the ECB and BoJ will weigh on global yields at the long end, but the prospect of tightening in the US later this year will put upward pressure on the yield curve. In the UK, the Bank of England is likely to follow the Fed in raising interest rates and similar to the US, we continue to prefer the longer end of the curve. Otherwise, our sovereign bond position is primarily a play on global QE and a hedge against the sort of secular stagnation worries discussed above.

Within alternatives, we are neutral on commodities. Although prices are depressed, oil could remain under pressure until there is more evidence of a cut back in supply. Saudi Arabia will wish to be more confident that there has been a shift in US shale production toward more of a swing producer role. Meanwhile, there is the potential for an increase in supply from Iran following the recent agreement with western powers over its nuclear programme.

Table 1: Asset allocation grid – summary

Equity	+	Bonds	0			Alternatives	0	Cash	-
Region		Region		Sector		Sector			
US	0 (+)	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	-	Gold	-		
Pacific ex Japan	0	JGBs	0	High yield	-				
Japan	0	Emerging market debt (USD)	-						
Emerging Markets	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	
0 (+)	US	<p>Compared to last quarter, we have downgraded our positive view on US equities for the first time in three years, moving to neutral in the face of a stronger dollar and the prospect of rate rises later in the year. The dollar has surged in 2015 so far and as a result monetary conditions have tightened by more than expected, which may slow economic activity. In particular, corporate earnings are likely to come under increased pressure.</p> <p>Furthermore, valuations do not look cheap compared to other markets, although we expect flows from foreign investors to remain a supportive factor.</p>
0	UK	<p>Although the UK's growth profile remains relatively healthy compared to other European economies, we remain neutral on UK equities given their exposure to emerging markets and commodity prices.</p> <p>In addition, political uncertainty ahead of May's general election may undermine the housing-led recovery. With smaller parties set to capitalise on voters' disenchantment with the mainstream parties, political paralysis may ensue, which would likely disrupt progress on deficit reduction.</p>
+	Europe ex UK	<p>We have upgraded our view on European equities to positive. The euro has benefited from the strength of the US dollar, coming under considerable pressure over the past 12 months. This should provide a tailwind for corporate earnings. It is likely to weaken further in the face of an eventual Fed rate hike. Furthermore, our growth and inflation trackers for Europe are pointing upwards, while negative bond yields also provide support through lower financing costs for companies. Valuations in Europe look attractive compared to other developed markets and the ECB's quantitative easing (QE) programme will be supportive.</p>
0	Japan	<p>The effectiveness of the Bank of Japan's (BoJ) QE programme remains uncertain. In our view the weakness of the yen over the past year appears to have been driven more by the strength of the US dollar than by Abenomics. We expect trade to remain positive as Japanese firms gain market share in global export markets, but for a more robust recovery we need to see a continuation of the recent sign of improving domestic demand. We remain neutral on Japan for the time being, though see it as a strong contender for an upgrade in the near future as long as the data continues to get better.</p>
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	<p>We remain neutral on the region. In Australia, an exchange rate adjustment is required to boost domestic competitiveness with the economy suffering from the hangover after the mining boom. However, further Chinese stimulus could add impetus to the region with the authorities now actively seeking to support growth through looser monetary policy and targeted fiscal policy.</p>
0	Emerging Markets	<p>Emerging market equities remain a concern as the region suffers from the continued strength of the US dollar. Emerging market currencies have weakened markedly against the dollar since mid-2014, which should have provided a boost to exports. Yet this does not seem to have happened. Commodity price weakness and the generally bearish outlook for that asset class presents a bleak future for metal and oil-dependent Latin American economies, but an expected revival of Eurozone growth and continued US labour market strength should translate into gains for exporters of manufactured goods in Asia and Europe. At the moment, though, exporters under the cosh are being forced to cut prices, adding deflation to the global economy.</p>

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

Fixed Income Views

Key Points

0	Bonds	
0	Government	<p>We remain neutral on government bonds overall. Prospects of US tightening later this year is likely to increase the term risk premium, leading to rising 5-year rates and a fall in bond prices. However, with ECB QE in full flow and potential spill over effects, we see relative upside in markets such as the UK.</p> <p>Compared to last quarter, in the US we have made a downgrade to our neutral view, reflecting our concerns about the relative value of US 5-year Treasuries. We see the possibility of a front-end led curve flattening in the US, with the long end being supported by a stronger currency and the spill over effects for ECB QE.</p> <p>In the UK, we have upgraded our view on Gilts. Similar to the US, we continue to prefer the longer end of the curve. Political risk could also be a factor weighing on UK markets, although the GBP may take most of the strain from election uncertainty and potential political paralysis.</p> <p>We have downgraded our view on German Bunds to neutral, although we continue to favour them relatively over the US as concerns surrounding the recovery prospects of the Eurozone have prompted an overwhelming QE response from the ECB. Similar to the UK, we prefer the 30 year sector.</p> <p>In Japan we maintain our neutral position on Japanese duration despite the unattractive yields on offer due to the continued support provided by the BoJ. This will keep the long-end of the curve pinned down despite an expected increase in inflation.</p>
-	Investment Grade (IG) Corporate	<p>There is some argument for a spill over effect from the European bond buying programme and, due to attractive maturity profiles, debt affordability is still supportive. However, spreads do remain vulnerable to the Fed surprising the market and liquidity remains a risk factor. Hence we maintain a negative stance on the asset class overall.</p> <p>Notwithstanding increased political uncertainty following the Greek election and bailout discord, the ECB's bond buying programme should remain supportive of quality carry assets, particularly given limited supply in the sovereign and high quality credit sectors.</p>
-	High yield (HY)	<p>Energy sector dynamics continue to influence the broader US high yield index and we anticipate continued volatility here given the spring loan redetermination period. Whilst outflows have stabilised, the broader complex (i.e. excluding energy) still remains aggressively priced and exposed to global macro-economic risks or uncertainty over Fed tightening.</p> <p>In Europe, while QE and record low yields should push investors into higher yielding assets, the bulk of buying will be in higher-quality assets. Tail risks in Europe leave us cautious for now as high yield is likely to be the pressure valve, with potential spillover effects from the US high yield market.</p>
-	USD-denominated Emerging market debt (EMD)	<p>We are negative on emerging market USD bonds as we see a worsening inflation/growth trade-off with weakening currencies, particularly amongst commodity-producing nations. They are vulnerable to heightened currency volatility as a result of the likely US rate rise, but fundamentals have been improving in many emerging market countries. We prefer local market exposure (without the FX risk) over emerging market USD exposure.</p>
0	US index-linked	<p>As inflation remains low, we see the possibility of a front-end led flattening in the US. We remain neutral on US Treasury inflation protected securities (TIPS) given offsetting effects from a stronger US dollar but better wages and an improving labour market.</p>

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

Alternatives Views

Key Points

Alternatives	
0	<p>Commodities</p> <p>We are neutral on broad commodities this quarter as we wish to see more evidence that depressed prices will recover through a combination of improved demand and reduced supply.</p> <p>For example, in energy, capital expenditure is being cut back, but we await more evidence that this will temper the current oversupply.</p> <p>We remain negative on gold given our positive view on the dollar.</p> <p>We have moved to a positive stance on base metals. China has moved firmly into an easing cycle, bringing forward \$1.1 trillion of infrastructure expenditure and easing monetary policy. This, coupled with a cutback in global production, should be sufficient to stimulate a rebound in industrial metal prices. Our structural outlook remains less constructive, however.</p> <p>We maintain our neutral positioning within agriculture. While supply/ demand dynamics and the macro environment should put pressures on prices, there is currently no weather premium priced in the market, so that the margin of safety is too low to warrant a negative score.</p>
+	<p>UK Property</p> <p>The latest IPF Consensus Forecast suggests that commercial real estate will achieve total returns of 12% in 2015. Our view is that total returns in 2015 will probably be closer to 15%, although the more yields fall this year, the greater the risk there will be of a potential correction in the future.</p> <p>Potential uncertainty surrounds the UK general election, with the risk that business confidence will be shaken either by the prospect of an EU referendum, or by large increases in corporation tax and the minimum wage. The former could be problematic for London, given it is a hub for international financial and business services, whereas a jump in the minimum wage would hit care homes, hotels, leisure, pubs and retailers in particular.</p>
+	<p>European Property</p> <p>Our forecast is for total returns on average investment grade European real estate to average 7-9% per year between the end of 2014 and the end of 2018. Total returns and capital growth are likely to be front-loaded, benefiting from yield compression in 2015-2016 and rental growth from 2016 onwards. The main upside risk is that the low level of interest rates triggers an even bigger fall in yields through 2015-2016 than we have assumed in our forecasts. That would boost total returns in the short-term, but probably store up problems for the long-term, when interest rates in the Eurozone eventually rise. The main downside risk is that the sovereign debt crisis re-ignites, either because Greece leaves the euro, or because deflation in the Eurozone becomes entrenched.</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.

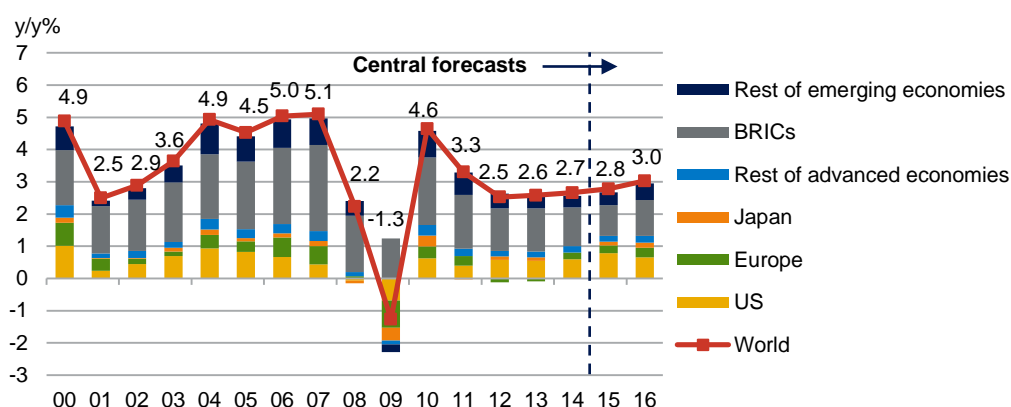
Economic View

Central View

Global tilt toward advanced economies

An increase in our growth projection for the advanced economies is offset by a cut to the emerging markets outlook to leave our global forecast at 2.8% year on year (y/y) for 2015. However, this forecast is sub-par compared to previous cycles when world activity averaged 4% per annum at this stage of the upswing (chart 1).

Chart 1: Global growth and forecast for 2015 and 2016



Source: Thomson Datastream, Schroders.

In terms of our forecasts for 2015, the decline in oil prices has favoured advanced economies over emerging ones, as the former are net oil consumers whilst the latter include a number of significant producers. Nonetheless, there are a number of economies in the emerging universe which benefit from lower oil prices e.g. many Asian countries are significant oil importers.

Currency movements have also favoured developed over emerging market competitiveness. Generally, a strong US dollar weighs on the emerging markets through commodity prices, which tend to be depressed during periods of dollar strength. We expect to see a modest further appreciation of the dollar as we forecast the US Federal Reserve to raise interest rates in September 2015 and continue tightening into 2016.

Our inflation forecasts have been cut in response to lower than expected outturns in recent months and the further fall in energy prices. Global inflation is expected to come in at 2.5% for 2015 after 2.8% in 2014. The decline would have been greater but for a pickup in emerging market inflation from 5.1% to 5.9%. We expect a significant reduction for the advanced economies to 0.5% from 1.4%. Importantly though, we expect inflation to pick up in 2016, dispelling deflation fears.

In terms of monetary policy, the Fed is still expected to look through the fall in headline inflation and focus on a stable core rate of inflation and tightening labour market so as to raise rates in September 2015. Key to this view will be further evidence of rising wage growth as signalled by the fall in unemployment. In the Eurozone, deflation concerns are expected to ease as inflation picks up in 2016 thanks to the depressing effect of lower oil prices dropping out of the index and the reflationary effect of a weaker euro. We expect the ECB to implement QE through to September 2016 and leave rates on hold, whilst for the UK, we stick with our call for the first rate hike in November 2015. In Japan, the BoJ will keep the threat of more QQE (quantitative and qualitative easing) on the table but is now likely to let the weaker Japanese yen support the economy and refrain from stepping up the asset purchase programme. China is expected to cut interest rates and the reserve requirement ratio (RRR) further and pursue other means of stimulating activity in selected sectors.

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 11. The distribution of global risks is still skewed toward the downside for growth and inflation. Top of the list on the downside is the “**China Hard Landing**” scenario where efforts to deliver a soft landing in China's housing market fail and house prices collapse. Household expenditure is constrained by the loss of wealth. Clearly, monetary policy is likely to ease under this scenario.

Meanwhile, our previous “Eurozone Deflation” scenario has become a more severe outcome: a “**Eurozone deflationary spiral**”. Here the economy falls into a major slump from which it is hard to escape, rather than just a temporary period of deflation. Inflation expectations become depressed and consumers and businesses begin delaying spending. Global monetary policy therefore would be looser than in the baseline with the ECB cutting interest rates further below zero and continuing with sovereign QE beyond September 2016.

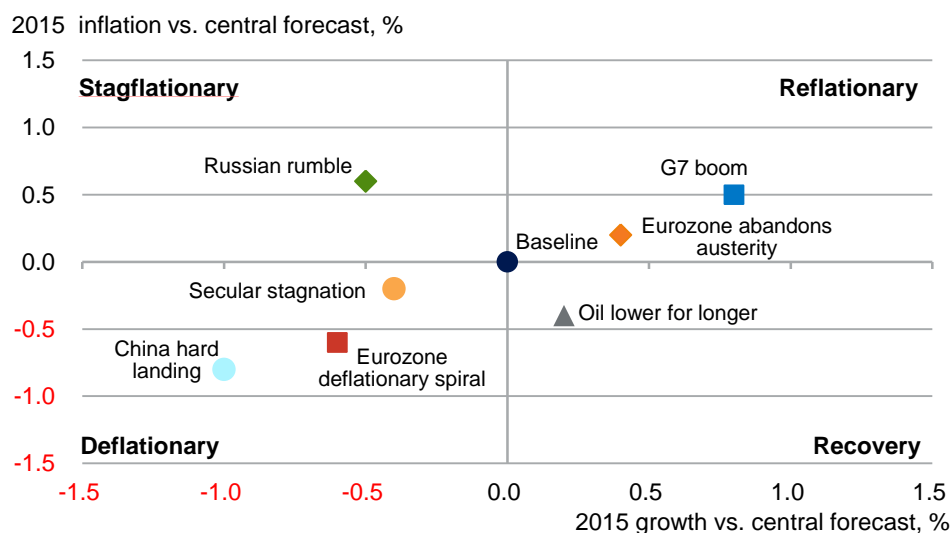
As our final downside scenario we have added “**Secular stagnation**”. Here, capital spending remains sluggish as despite interest rates being at record lows, the cost of capital remains above the expected rate of return. Household expenditure is constrained by weak real income growth, a consequence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

On the stagflationary scenarios, we have retained “**Russian Rumble**”. In this scenario, fighting continues in East Ukraine and the west retaliates by significantly increasing sanctions. Russia responds by cutting gas and oil supplies to Europe causing an energy shortage which pushes oil prices back to \$90. The disruption to European energy supplies results in a fall in output while the higher oil prices hit global inflation. Policy rates are considerably lower as central banks wish to avoid damaging confidence further.

On the upside, we have the “**G7 boom**” whereby animal spirits return causing a much stronger pick up in business spending. We have also introduced a second reflationary scenario, “**Eurozone abandons austerity**” which sees Euro governments embark on fiscal easing to head off the political backlash against austerity.

Finally, “**Oil lower for longer**” replaces “Disinflationary boom” as our recovery scenario. The oil price falls to \$30 per barrel and stays there as the Saudis turn the screw on the US shale producers. This leads to stronger growth and lower inflation, especially for oil consuming advanced economies.

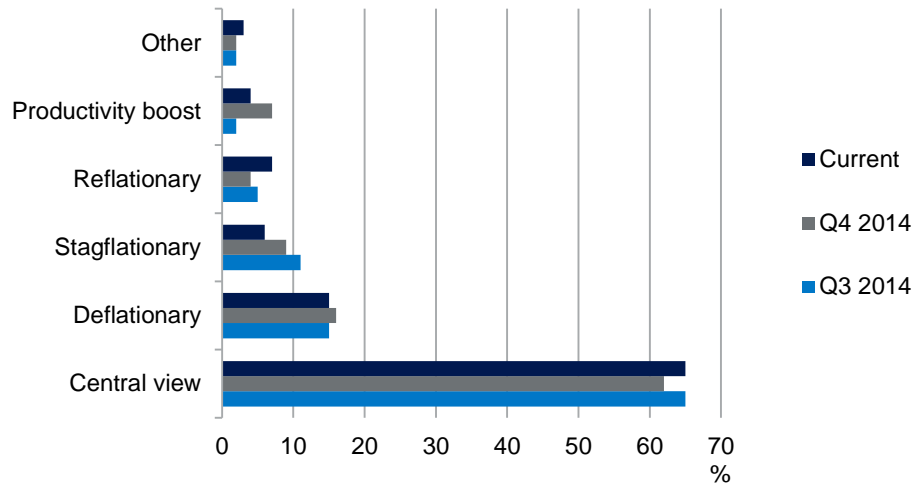
Chart 7: Scenario analysis – global growth and inflation impact



Source: Schroders.

Economic View (continued)

Chart 8: Scenario probabilities compared to previous quarters



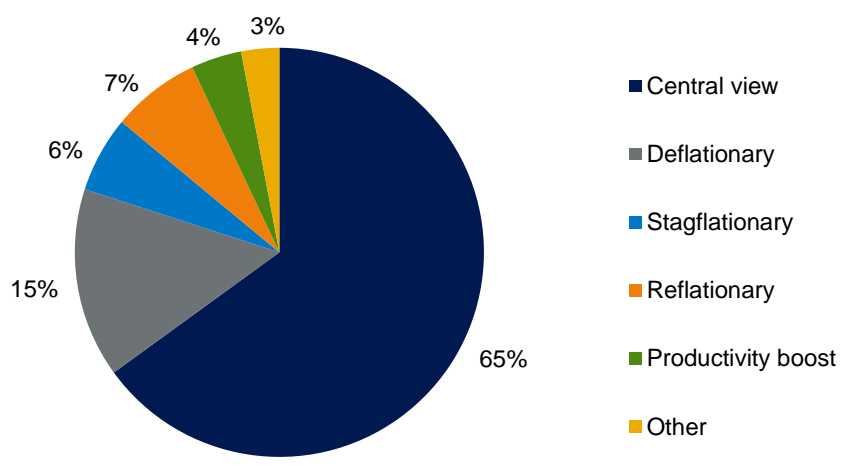
Source: Schroders.

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 7 on the previous page, three of our seven are deflationary, such that both growth and inflation are lower than in the central scenario.

With regard to probabilities, the combined chance of a deflationary outcome is now 15%, slightly lower than last quarter. This reflects the removal of the “JPY collapse” scenario and a slightly reduced probability on the more severe “Eurozone deflationary spiral” following the fall in the euro and the greater-than-expected commitment to QE by the ECB.

Meanwhile, the addition of the “Eurozone abandons austerity” scenario means the probability of refutation (stronger growth and higher inflation than baseline) has risen from 4% to 7% when combined with the “G7 boom”. There is a reduction in stagflation as a result of dropping the “Capacity limits bite” scenario. Nonetheless, despite the recent ceasefire, the “Russian rumble” remains one of the greater individual risks.

Chart 9: Scenario probabilities (mutually exclusive)



Source: Schroders.

Economic View (continued)

Table 2: Scenario summary

Scenario	Summary	Macro impact
1. Eurozone deflationary spiral	Despite the best efforts of the ECB, 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. 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. ECB cuts interest rates below zero and continues with QE, but the policy response is too little, too late. Eurozone weakness drags on activity elsewhere, while the deflationary impact is also imported by trade partners through a weaker Euro. Global growth and inflation are about 0.5% weaker this year and 1% weaker in 2016 compared to the baseline.
2. G7 boom	After a prolonged period of balance sheet repair, animal spirits return to the private sector which responds with loose monetary policy and the gains in asset prices. Advanced economy growth picks up more rapidly than in the base as the corporate sector increases capex and consumers spend more rapidly as banks increase lending. Stronger G7 demand spills over to the emerging markets taking global growth above 4% in 2016. Labour markets tighten more rapidly and commodity prices increase relative to the base resulting in a pick-up in inflation.	Reflationary: Stronger growth and inflation vs. baseline. Central banks respond to the increase in inflationary pressure with the US and UK responding faster than Eurozone. Higher wage and price inflation is welcomed in Japan as the economy approaches its 2% inflation target. This is likely to lead the BoJ to signal a tapering of QQE. Inflation concerns result in tighter monetary policy in the emerging markets with China and India raising rates in 2016. The US Fed starts to actively unwind QE by reducing its balance sheet.
3. Oil lower for longer	Saudi Arabia becomes frustrated at the slow response of US oil production and drives prices lower in a determined effort to make a permanent impact on US shale producers. Given the flexibility of the latter this means a significant period of low prices with Brent crude falling to \$30 by end 2015 and remaining there through 2016.	Recovery: Better growth/lower inflation especially for oil consuming Advanced economies. For the emerging economies, activity is only marginally better. Lower inflation allows the Fed to delay slightly, but interest rates still rise. The rate profile is also lower in China, Brazil and India, but Russia has to keep policy tighter to stabilise the currency.
4. Secular stagnation	Weak demand weighs on global growth as households and corporates are reluctant to spend. Animal spirits remain subdued and capex and innovation depressed. Households prefer to de-lever rather than borrow. Adjustment is slow with over capacity persisting around the world, particularly in China, with the result that commodity prices and inflation are also depressed.	Deflationary: Weaker growth and inflation versus baseline. Although not as deflationary as China hard landing or the Eurozone deflationary spiral the world economy experiences a slow grind lower in activity. Policy makers initially raise rates in the US although this is then reversed as the economy loses momentum. Global interest rates are lower than in the base and we would expect the ECB and BoJ to prolong their QE programmes.
5. China hard landing	Official efforts to deliver a soft landing in China's housing market fail and house prices collapse. Housing investment slumps and household consumption is weakened by the loss of wealth. Losses at housing developers increase Non-performing loans, resulting in a retrenchment by the banking system and a further contraction in credit and activity.	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	Despite the "ceasefire", fighting continues in East Ukraine between government forces and rebels supported by Russian troops. Putin continues to supply the rebels and the West retaliates by sending weapons to the Ukraine army and significantly increasing sanctions. Russia responds by cutting gas and oil supplies to Europe. The shortage of energy pushes oil prices back to \$90 per barrel in short order.	Stagflationary: Europe is hit by the disruption to energy supply resulting in a fall in output. Higher oil prices hit global inflation and the breakdown of relations between Russia and the west damages confidence and creates significant market volatility. Policy rates are considerably lower as central banks wish to avoid damaging confidence further and look through the rise in inflation.
7. Eurozone abandons austerity	Disappointment with the results of austerity and fearful of a growing political backlash the Eurozone reverses course. Governments ease fiscal policy significantly, increasing spending and cutting taxes whilst the EU fully implements the €300 billion Juncker plan of public-private infrastructure spending.	Reflationary: Stronger growth and inflation versus baseline. Eurozone growth sharply picks up, supporting growth in developed and emerging markets. UK GDP growth accelerates to over 3% whilst global growth is some 0.4% higher. Commodity prices, inflation and policy rates are marginally higher.

Strategy: market performance and currency wars

USD played key role in shaping market returns in Q1

Q1 performance review

Looking back at the performance of major asset classes in the first quarter of 2015 it has been US Treasuries which have performed the strongest by a slender margin. Following a robust start to the year, Treasury performance deteriorated in February as investors widely expected the Federal Reserve to deliver a more hawkish statement in March with regards to the first rate rise in the US. Since the subsequent FOMC meeting and Fed chair Yellen's comments, many investors have pushed back their estimates for the 'lift off' in US rates and Treasuries have since rallied, returning 2.6% over the quarter (chart 11).

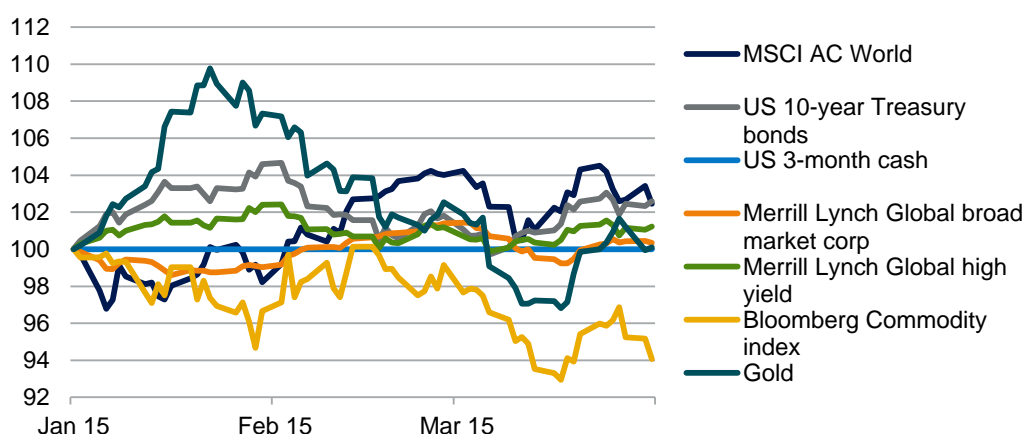
Despite a weak start to the year, global equities, as measured by the MSCI All Country World index, have also provided positive returns, finishing the quarter up 2.5% despite foreign exchange losses against the USD for many markets. In contrast commodities were the worst performing asset class, falling 5.9% against a backdrop of a strong US dollar and ongoing fears over global growth.

Gold performed well in the initial weeks of 2015, rallying just under 10% by late January as investors turned to perceived safe havens amid uncertainty. Undermined by the strengthening dollar and receding global inflationary pressures, gold has more recently sold off and lost all of its initial gains to remain largely flat for the first three months of the year.

Global high yield bonds outperformed the investment grade market, albeit marginally. High yield bonds returned just 1.2% for Q1 as investors feared a contagion effect from rising US rates, but also the underperformance of the energy sector amidst the continued weakness in oil prices. In comparison investment grade bonds struggled to remain in positive territory returning just 0.3%.

Chart 11. Q1 performance in key asset markets (USD)

Index (USD) 1 Jan = 100



Source: Thomson Datastream, Schroders, Updated 31/03/2015, Total return in USD.

Focusing on equities, the first quarter of the year has been kind to the asset class for the most part, with all but one of the major indices (the UK FTSE All share) reporting positive gains (chart 12). There is however quite a contrast amongst different geographies. Starting with the strongest performer, the Italian FTSE MIB has outperformed other major equity markets returning 12.2% in USD. Whilst Euro depreciation weighed on performance, it did not stop investors flooding into European equities.

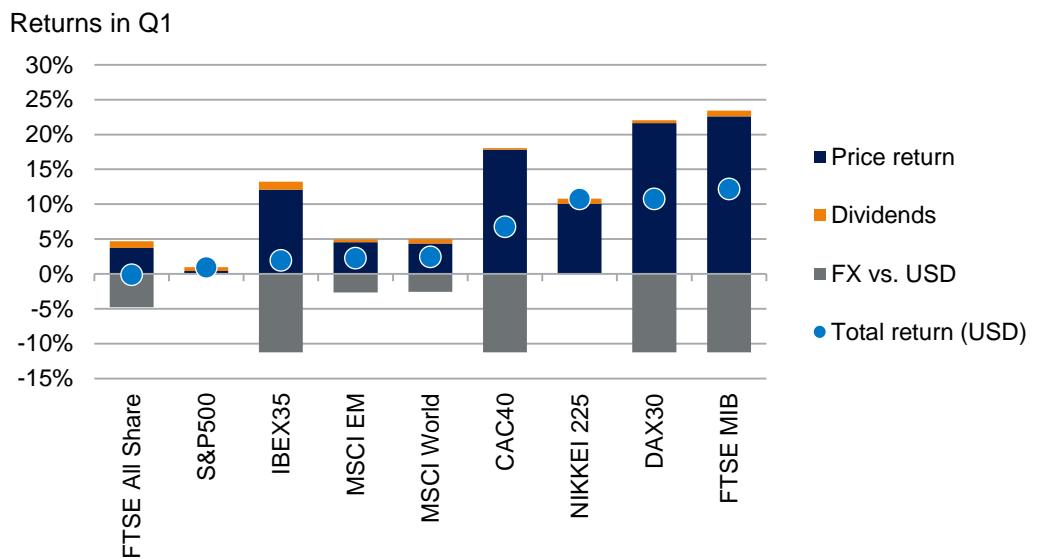
A number of factors helped the strong performance of European equities during the period. The long awaited start to Eurozone quantitative easing, the low oil price and a weak euro all contributed to increasing investor's appetite for equities in the region, despite the continued concerns over a potential 'Grexit'. Economic data had started to surprise on the upside in Europe, unsurprisingly both the German and French stock markets were amongst the stronger performing regions, returning 10.8% and 6.8% in USD respectively.

ECB easing was catalyst for Eurozone equities, with investors switching from the US

Turning to Japan, loose monetary policy was supportive for equities and signs of a gradual tightening in the labour market suggests that consumption will help drive growth in 2015. A weaker yen and a push back in the date of the second consumption tax hike until 2017 has further strengthened investors view on the economy and the Nikkei 225 returned 10.8% in USD in Q1.

Contrasting with such positive performance, the return on the S&P500 remained largely flat for the period. Having outperformed in the final quarter of 2014, US equities struggled to keep pace moving into the New Year as anticipation of the first Federal Reserve rate hike weighed on investor sentiment. Investors also expressed concerns over valuation levels compared to their Japanese and European counterparts and the effects of a strong dollar impacting corporate profitability. Finally, the UK FTSE All Share was the worst performing of these selected markets in the first quarter, largely due to the market's exposure to commodities and uncertainty surrounding the upcoming general election in May.

Chart. 12. Q1 equity market returns by region (USD)



Source: Thomson Datastream, Schroders, 31/03/2015, Total return in USD.

The ECB fights back: another round in the currency war

As can be seen from above, the past quarter has been dominated by central banks and moves in the USD. The well flagged decision by the European Central Bank to follow its counterparts in the US, Japan and UK and begin Quantitative Easing has pushed the Euro to its lowest since the financial crisis and to levels last seen in 2003 (chart 13).

Chart 13: USD vs. Euro since the financial crisis



Source: Thomson Datastream, Schroders, Updated 08/04/2015.

The move has been accompanied by a fall in Eurozone bond yields and sharp rally in European equities, which have been the best performing developed equity market in

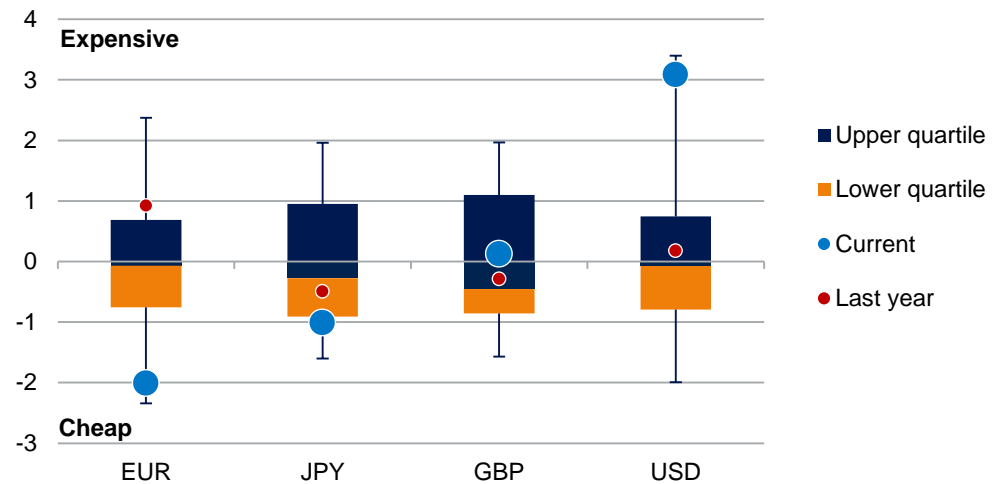
ECB QE drives Euro lower as yields turn negative in core markets

the first quarter. German bund yields are now negative out to 7 years maturity and, according to JP Morgan, some 30% of the Eurozone bond market has a negative yield.

The fall in the Euro represents the latest leg in the currency wars with the single currency region now gaining a considerable competitiveness boost. We would see this as being the main benefit of QE and can trace the pattern of earlier currency moves to first US QE and a weaker dollar, and second Abenomics and the fall in the JPY. In trade-weighted terms the USD is now trading at the top of its 10 year range whilst the Euro is close to the bottom of its range. The JPY is in its lower quartile and, as we have noted before, is very competitive at these levels (see chart 14).

Chart 14. Euro and Yen now cheap as US dollar soars

Nominal trade weighted exchange rate (10yr z-score)

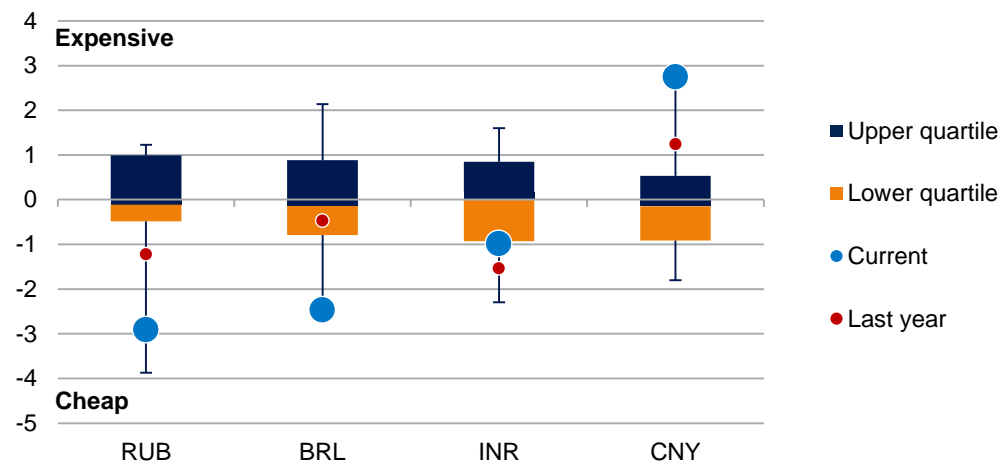


Source: Thomson Datastream, Schroders, 30/03/2015.

For the emerging markets, the currency picture is mixed. Along with the US, China is a loser in the currency war with the CNY (RMB) trading at the very top of its 10 year range by virtue of its close link to the US unit (see chart 15). This adds deflationary pressure on the external side of the Chinese picture, pushing down both growth and inflation. Pressure to devalue the RMB is likely to continue to build, although we believe it will ultimately be resisted as the authorities focus on supporting the economy through relaxing interest rates and lending criteria as well as judicious use of fiscal policy.

Chart 15. CNY tracks the US dollar higher

Nominal trade weighted exchange rate (10yr z-score)



Increasing pressure on China to devalue the RMB

Source: Thomson Datastream, Schroders, 30/03/2015.

By contrast both the Brazilian real and Russian rouble are at the lower end of their trading range, an outcome that reflects capital flight following the fall in the oil price

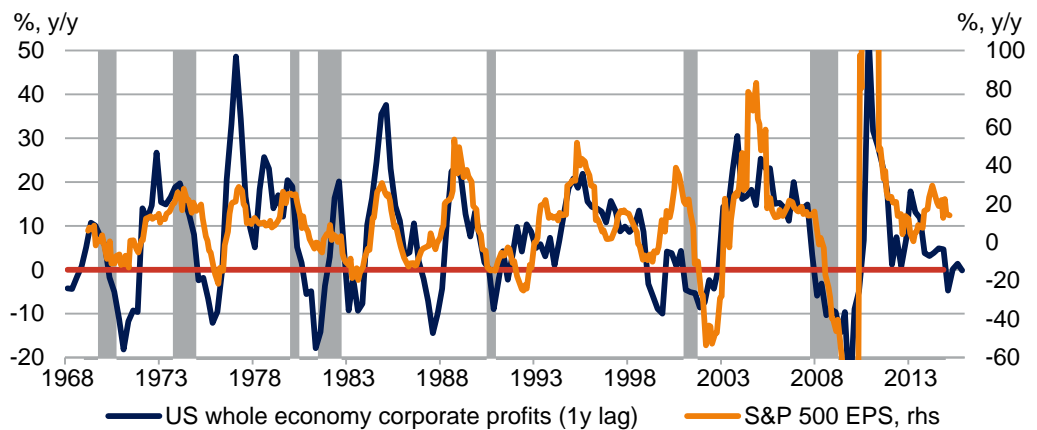
and political scandal. Russia is still at risk of facing more sanctions from the west if the ceasefire in the Ukraine breaks. Meanwhile, despite a recent rate cut by the Reserve Bank, the Indian rupee has strengthened on the back of capital inflows, much of which will have gone into the equity market. Note that on this measure, the INR is still trading below average in trade-weighted terms, suggesting it is not overvalued.

The impact of currency moves

These currency moves will be important in rebalancing growth amongst the developed markets, skewing activity away from the US where growth is on a sustainable footing, toward Japan and the Eurozone where there are persistent fears of deflation. Standard ready reckoners from the OECD macro model suggest that a 10% depreciation in the USD results in a 1% loss of GDP to the US after two years and a boost of about 0.4% to the Eurozone.

From a corporate profits perspective, 20% of earnings on the MSCI US index come from overseas a factor which will take some 2.5% off year ago earnings per share in the forthcoming Q1 reporting season. The combination of a stronger currency and increasing wage pressure means US firms will struggle to grow earnings in 2015. Such an outlook is consistent with the slowdown in the aggregate economic profits measure which tends to correlate well with and lead earnings on the S&P500 (chart 16).

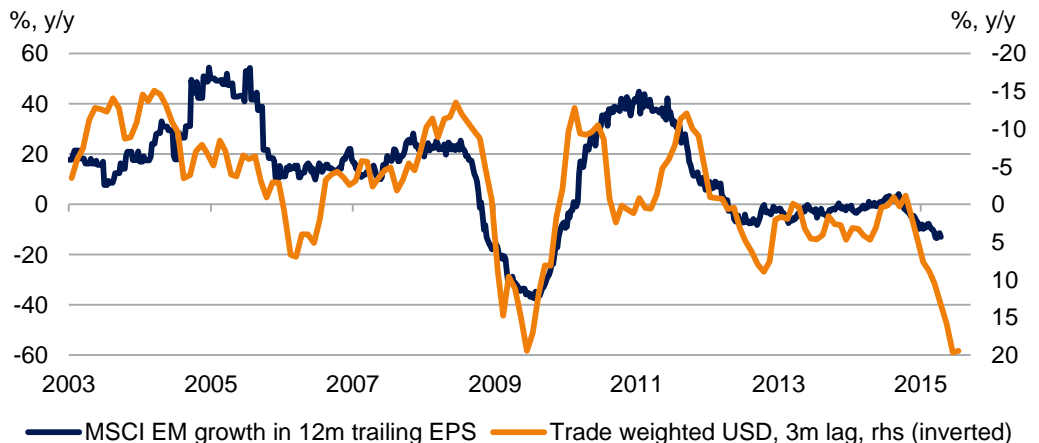
Chart 16. US corporate earnings to slow



Source: Thomson Reuters, Schroders, Updated 09/04/2015.

The flipside to this is better growth in European and Japanese earnings, but as indicated the emerging markets will struggle. The pressure from a stronger USD on emerging markets can be seen from the close relationship with corporate earnings, with the latest USD move signalling a sharp downturn in emerging EPS (chart 17).

Chart 17. USD strength to hit emerging market earnings



Source: Thomson Datastream, Schroders, Updated 08/04/2015.

Market focus: some unintended consequences of QE

Spillover effects from Eurozone bond markets will keep downward pressure on global yields

Although the well-trailed announcement by the European Central Bank (ECB) of a quantitative easing (QE) programme has been greeted with enthusiasm we would caution that investors should be careful what they wish for. Planned purchases of €60 billion per month until September next year will soon absorb the sovereign bond issuance in the Eurozone which is put at around €400 billion. From this perspective, the strength of Eurozone bond markets noted above is less of a mystery. The demand-supply balance in the Bund market will be particularly acute as Germany intends to run a budget surplus this year, making investors less willing to sell their holdings as the Bundesbank/ ECB seeks to fulfil its QE quota. Note that the ECB can also buy limited quantities of supra-national IG bonds, although this only relieves the pressure on sovereigns at the margin.

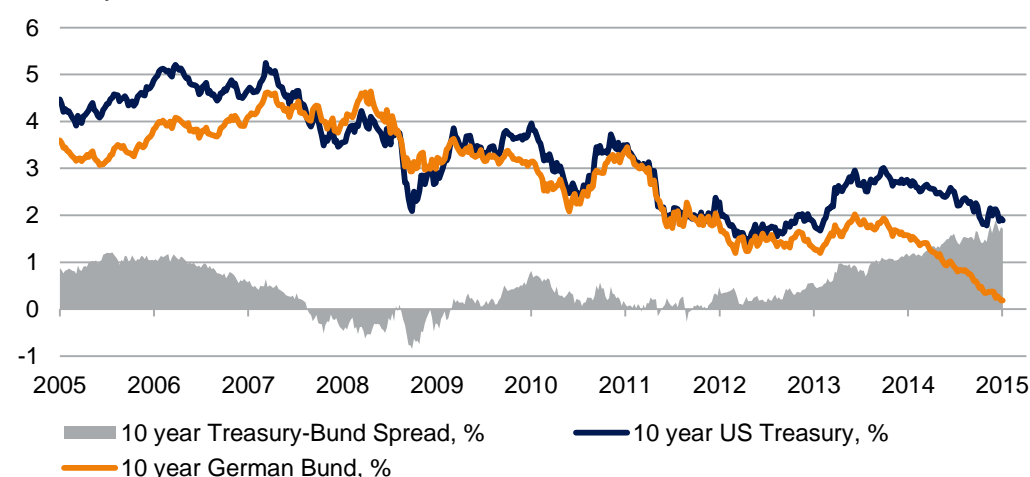
The effect of QE on growth in the Eurozone remains an open debate and we see the principal transmission mechanism to the economy as being through the exchange rate (as discussed above). If the experience of the Eurozone mirrors that of the US, UK or Japan then much of the extra liquidity being created will find its way onto bank balance sheets rather than increased lending. This in turn will boost asset prices, but unlike the US and UK, the wealth effect in the Eurozone is likely to be relatively muted given the smaller capitalisation of the equity markets.

QE also means that the supply of investible government paper will be reduced, thus creating a problem for institutions such as pension funds and insurance companies who need a steady flow of risk-free (or low risk), high quality assets to match their liabilities. Consequently, many Eurozone pension and insurance funds are looking outside the region in a search for yield. The same process is already occurring in Japan led by the Government Pension Investment Fund (GPIF).

The consequences of this are likely to be significant for global bond markets as we expect to see spill-over effects as markets outside the Eurozone experience inflows from yield seeking investors fleeing QE. The spread between US Treasuries and Bunds, for example, remains wide by historical standards, indicating the incentive to shift funds remains high (chart 18). Note that capital flows from Europe to the US to exploit the carry between bond markets have been instrumental in weakening the Euro against the US dollar.

Chart 18. Treasury-Bund spread remains wide

Treasury vs. Bunds



Source: Thomson Datastream, Schroders, Updated 08/04/2015.

Consequently, ECB QE will be widely felt and differs from QE in the US and UK where, for most of these programmes the domestic government was running a substantial budget deficit which absorbed much of the central bank's purchases. On this analysis, bond yields globally are set to stay historically low. There is likely to be some upward pressure on the US yield curve as the Fed raises interest rates, but this will be primarily felt at the shorter/ medium end of the curve. As we move further out, upward pressure on yields is likely to be tempered by yield seeking investors from overseas.

Investors are being forced even further out along the risk and liquidity curve

The spillover effects need not be confined to sovereign bond markets, as we have seen elsewhere the search for yield will take investors into credit, equity and real estate markets. At a time when the prospects for corporate earnings growth in the US are becoming restricted (see above), companies offering stable dividends will remain attractive from a yield perspective.

The incentive to buyback shares will also remain strong and we expect to see a further shrinkage of the number of outstanding shares available on the US equity market. This trend has been in place for some time and, according to independent research house Strategas, the number of publically quoted companies in the US has shrunk from 8,800 in 1997 to around 5,000 by the end of 2013. The counterpart has been significant growth in the number of private equity companies. The end result is a corporate sector which is increasingly run for cash, is more heavily funded by debt and is less dependent on equity.

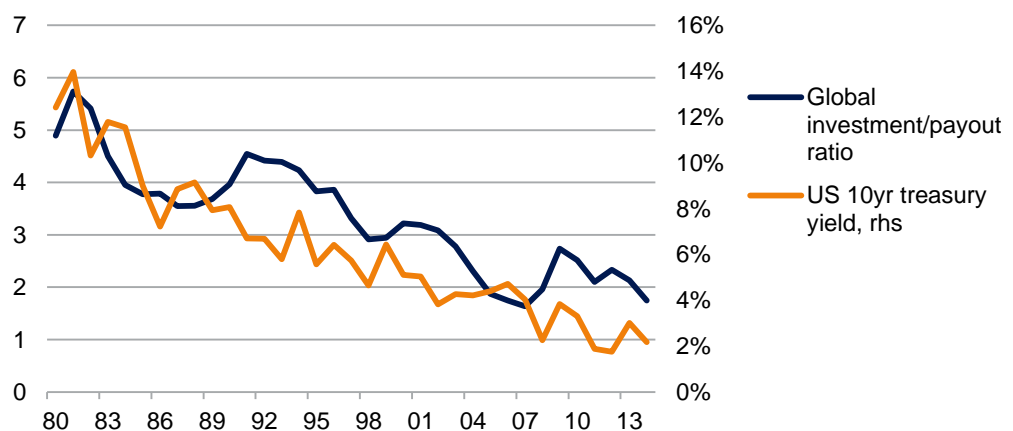
From this perspective, the latest fall in bond yields driven by the ECB QE programme, supplemented by a continuation of the Bank of Japan's buying, can be seen as another turn of the screw on financially repressed investors. Facing risk free yields of close to zero, or even negative in some cases, investors are once again being forced to accept more risk in the hunt for yield. This will also often involve sacrificing liquidity, particularly where the risk asset is credit or property.

Investor preference for "bond-like" equities will remain strong and companies will be increasingly run to return cash to investors. Company Chief Financial Officers will continue to look to replace expensive equity with cheap debt. However, whilst this reconfiguration of the financial system may meet investor needs, it may not be so good for the economy. There is a danger that in prioritising payments of dividends and interest coupons, capital expenditure will suffer.

In a recent analysis of the global equity market¹, analysts at Citigroup found that the ratio of investment (both capex and R&D) to distributions through dividends and buybacks has fallen significantly as companies have focussed on rewarding shareholders. The move was particularly marked in 2014 with global listed company investment declining 6% as much as in the financial crisis, whilst global dividends and buybacks rose by 15%.

The decline in bond yields is not the only factor driving this: CEO incentive structures are skewed in this direction and shareholders have been badly burnt during previous periods of rapid capex expansion (e.g. the tech bubble at the turn of the century and more recently the commodity boom). Nonetheless, there has been a strong correlation between the down trend in capex to distributions and bond yields (chart 19).

Chart 19. Bond yields and capex to pay-out ratio trending lower



Source: Citi research, 19 March 2015.

This creates the risk of a new low growth equilibrium where QE actually inhibits economic growth by making the corporate sector less willing to invest as low interest rates drive investor preference for bond-like companies. The resulting low level of

Needs of investors and the economy are beginning to diverge

Choice between weaker capex or lower incomes to savers

¹ See "Market wants cash cows", Citi research 19 March 2015, <https://www.citivelocity.com/t/eppublic/Af80>.

growth then reinforces low interest rates thus completing a negative loop. This rather perverse effect from QE may be one reason why investment has tended to disappoint despite the low level of interest rates created by asset purchases.

However, if it is not possible to find alternative sources of income there would have to be a cut in the pay-outs from long term savings plans. In other words, pension and insurance plans would have to cut their returns, so hitting the incomes of those in retirement. The effects would take time to come through as long term assumptions were brought down with each actuarial review. Nonetheless, the impact on consumption would be significant and would hit some of the less well off members of society. This suggests that the underlying problem is one of a lack of income growth to fund both capex and dividends. In other words we may well have to accept that we cannot have strong corporate capex in a world where companies are now playing a role as alternative income providers.

An opportunity for government involvement?

Is there any way of avoiding such a stark choice between lack of investment and growth, or depriving pensioners of income? One route which might mitigate the problem and provide a path to both better growth and more attractive risk free yields would be for government to get more involved, either directly or by priming the private sector. Whilst many will baulk at an increase in public spending there are considerable unmet needs in infrastructure and healthcare which would lend themselves to long term financing.

Given the shortage of long duration risk free assets created by QE, we would expect investors to snap up a well designed issue. The EU investment plan which intends to leverage €21 billion of public money into €315 billion of private investment will be worth watching in this respect. The plan is still small in relation to the €14 trillion EU economy but the expenditure would support growth, add to productive potential and help solve the shortage of assets.

Keith Wade

10 April 2015

Market Returns

	Total returns	Currency	March	Q1	YTD
Equity	US S&P 500	USD	-1.6	1.0	1.0
	UK FTSE 100	GBP	-2.0	4.2	4.2
	EURO STOXX 50	EUR	2.9	17.9	17.9
	German DAX	EUR	5.0	22.0	22.0
	Spain IBEX	EUR	3.3	13.0	13.0
	Italy FTSE MIB	EUR	3.7	21.8	21.8
	Japan TOPIX	JPY	2.1	10.5	10.5
	Australia S&P/ ASX 200	AUD	-0.1	10.3	10.3
	HK HANG SENG	HKD	0.8	6.0	6.0
	EM equity	MSCI EM	LOCAL	0.2	4.9
MSCI China		CNY	2.4	8.1	8.1
MSCI Russia		RUB	-7.4	15.7	15.7
MSCI India		INR	-2.9	4.5	4.5
MSCI Brazil		BRL	-0.8	2.7	2.7
Governments (10-year)	US Treasuries	USD	0.8	2.6	2.6
	UK Gilts	GBP	1.9	2.0	2.0
	German Bunds	EUR	1.4	3.8	3.8
	Japan JGBs	JPY	-0.2	-0.3	-0.3
	Australia bonds	AUD	1.5	4.8	4.8
	Canada bonds	CAD	-0.5	4.8	4.8
Commodity	GSCI Commodity	USD	-6.8	-8.2	-8.2
	GSCI Precious metals	USD	-2.2	0.4	0.4
	GSCI Industrial metals	USD	-0.1	-5.1	-5.1
	GSCI Agriculture	USD	-4.3	-9.7	-9.7
	GSCI Energy	USD	-10.0	-8.8	-8.8
	Oil (Brent)	USD	-10.6	-2.3	-2.3
	Gold	USD	-2.4	0.1	0.1
Credit	Bank of America/ Merrill Lynch US high yield master	USD	-0.5	2.5	2.5
	Bank of America/ Merrill Lynch US corporate master	USD	0.4	2.3	2.3
EMD	JP Morgan Global EMBI	USD	0.5	2.1	2.1
	JP Morgan EMBI+	USD	0.6	1.9	1.9
	JP Morgan ELMI+	LOCAL	0.5	1.3	1.3
Currencies	EUR/ USD		-4.2	-11.4	-11.4
	EUR/JPY		-3.9	-11.2	-11.2
	JPY/ USD		-0.3	-0.2	-0.2
	GBP/USD		-3.8	-4.7	-4.7
	AUD/USD		-2.3	-6.2	-6.2
	CAD/USD		-1.3	-8.3	-8.3

Source: Thomson Datastream, Bloomberg, 31 March 2015.

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



Schrodgers

For professional investors and advisors only. This document is not suitable for private customers. This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Schroder Investment Management Ltd (SIM) does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that SIM has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Schrodgers has expressed its own views and opinions in this document and these may change. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. Issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA. Registration No. 1893220 England. Authorised and regulated by the Financial Conduct Authority. For Bermuda Clients only: Schrodgers (Bermuda) Limited is an indirect wholly-owned subsidiary of Schrodgers plc and is licensed to conduct Investment Management business by the Bermuda Monetary Authority. For your security, communications may be taped or monitored. w46433