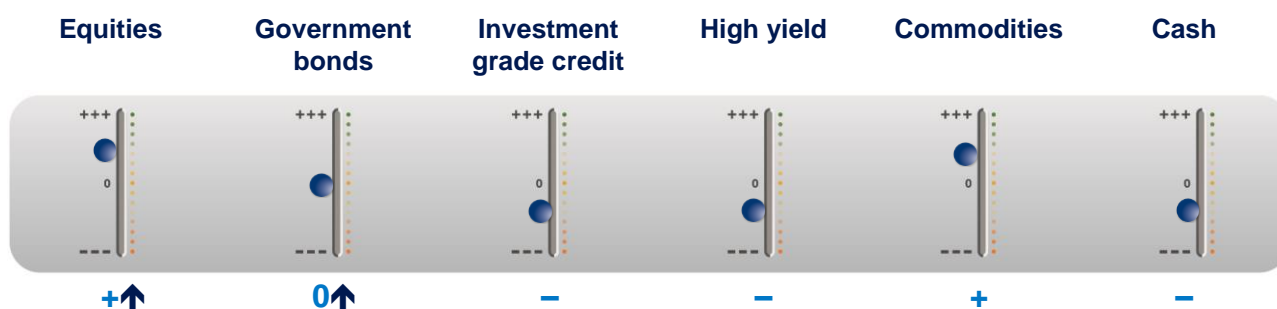


# Schroders Multi-Asset Investments

## Views and Insights

### Section 1: Monthly Views – April 2015

#### Summary



Category	View	Comments
Equities	+↑	<b>We upgrade our view on equities. The extent of central bank easing has been extraordinary and in Europe policy makers have pushed interest rates into negative territory, which should help equity valuations move higher in the short term.</b>
US	0	We remain neutral on US equities. The recent underperformance of US equities stands in direct contrast to the country's growth differential versus the world; however, they still look expensive compared to other developed market equities.
UK	0	We have not changed our view on UK equities this month. Although relative valuations have improved considerably, we prefer to err on the side of caution heading into the upcoming general election.
Europe	+	We remain positive on European equities. The weaker euro has been a key contributor to the recovery in corporate earnings. Leading indicators of economic activity are picking up, signalling the start of a healthier economic growth trend. This strengthens the case for continued outperformance of the market versus global equities.
Japan	0	Concerns over organic growth and doubts over further easing from the Bank of Japan (BoJ) hold us back from expressing a more constructive view on the market over the near term.
Pacific ex Japan	0	We remain neutral on the region. The manufacturing-based economy of Taiwan has benefited from the fall in commodity prices, giving a strong boost to its technology sector.
Emerging Markets	0↑	We upgrade our view on emerging market (EM) equities. The underperformance of EM due to concerns regarding the strength of the US dollar suggests that a lot of bad news is priced into the market. We are also seeing a narrowing of the relative earnings trend between developed and emerging makrets.

Category	View	Comments
<b>Government bonds</b>	0 ↑	<b>We upgrade our overall view on government bonds. While the prospect of US tightening later on this year is likely to increase the term risk premium, we expect the recent softness in macro data and subpar inflation expectations to keep a lid on global yields.</b>
US	- ↑	We upgrade our view. The bad weather had resulted in mixed data on the growth front. In addition, the persistent strength in the US dollar has kept inflation expectations at a low level.
UK	+ ↑↑	We expect the UK to continue to be the beneficiary of the monetary policy stimulus in Europe which forced bond investors into higher yielding government bonds with a similar credit rating.
Germany	0 ↓	We downgraded our view on Germany back to neutral as we see UK gilts benefiting more from the recent action from the European Central Bank (ECB) with a spread advantage of +1.3%. While the buying pressure from the ECB remains significant, low levels of yield and reduced liquidity make the risk reward increasingly asymmetric.
Japan	0	Despite the unattractive yields, we maintain our neutral position on Japanese duration 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.
US inflation linked	0	We remain neutral on inflation in the US as a structurally higher US dollar is putting pressure on the long-end of the inflation forward curve.
Emerging markets	-	We remain negative on EM US dollar-denominated bonds as the fundamental picture has not improved. Inflation has started to slow in the US and the Federal Reserve (Fed) is likely to be less aggressive than anticipated, a scenario which we will need to monitor closely.

Category	View	Comments
<b>Investment grade credit</b>	-	
US	-	The fundamental picture remains benign; however, risk/reward is skewed to the downside with valuations still relatively stretched. Rates-induced volatility and slowing earnings momentum may create headwinds to further spread compression. Net supply has picked up materially year to date.
Europe	+	Supply activity has been fairly subdued, but there are signs of corporates (particularly overseas issuers) tilting towards longer maturities. Carry remains well-supported amid monetary easing by the ECB, evidenced by continued strong inflows into the asset class. Compensation for incremental credit risk is low.

Category	View	Comments
<b>High yield credit</b>	-	
US	-	Technical remain supportive, with corporates continuing to take advantage of the low yield environment to issue debt and resurgent investor demand as oil prices have stabilised. However, in our view risk is not well compensated; particularly that from rate-related volatility, a strong US dollar and an uptick in defaults driven by the energy sector. Furthermore, liquidity concerns continue to weigh on the asset class.
Europe	0 ↑	A confluence of tailwinds should provide support to the asset class – amongst them the ECB stimulus package, negative sovereign yields, a weak euro, lower oil prices and an end to austerity. As investors' demand for yield intensifies, European high yield should benefit, though we are still cautious given links with the US market and broader liquidity risks.

Category	View	Comments
<b>Commodities</b>	<b>+</b>	<b>We maintain a positive view on broad commodities as we expect the depressed cyclical commodities to recover through a combination of improved demand and reduced supply.</b>
Energy	+	Global easing is likely to be supportive of demand, and there is strong evidence that capital expenditure is being cut back which should temper the current oversupply.
Gold	-	We retain a negative score as we expect stronger US data to push up real rates.
Industrial 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.
Agriculture	-↓	We have downgraded agriculture to negative as farmers are not cutting back planting intentions in response to current price levels.

Category	View	Comments
<b>Currencies</b>		
US dollar	+	The divergence in economic growth, which drove the US dollar higher, is no longer as strong. However, relative strength within the US economy remains and the Fed is moving towards a rate hike. Therefore we maintain a positive bias.
British pound	0	With the additional uncertainty of the election approaching, we continue to hold a neutral view on sterling. Political uncertainty and weak inflation are counterbalanced by a stonger economic growth profile.
Euro	-	There may be further downward pressure on the euro in the near term due to increasing divergence between ECB policy and that of other G10 central banks. In addition, the euro is likely to struggle in the face of a Fed rate hike.
Japanese yen	-	We only expect modest downward pressure on the yen in the near term and so maintain a single negative position. With inflation having been predominately driven by currency depreciation to date, we do not believe that authorities will want to see precipitous weakness in the currency.
Swiss franc	-	The Swiss economy has weakened this year following a deterioration in European growth and we expect additional weakness following the recent sharp appreciation of the currency.

Category	View	Comments
<b>Cash</b>	<b>-</b>	<b>With real rates remaining negative, we continue to hold a negative view on cash.</b>

Source: Schroders, April 2015. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged). The views for currencies are relative to USD, apart from USD which is relative to a trade-weighted basket.

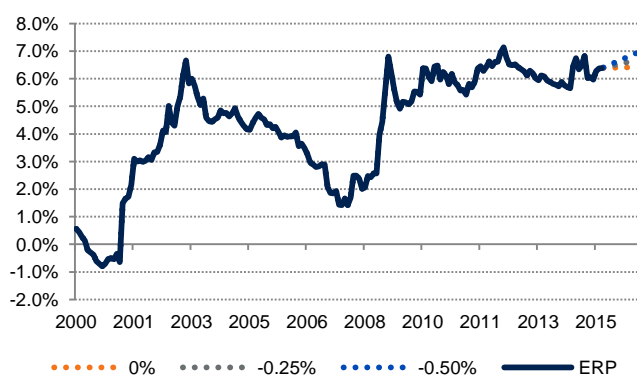
## Section 2: Multi-Asset Insights

By Remi Ajewole and Urs Duss, Multi-Asset Fund Managers

### The impact of negative interest rates on equity and credit markets

Perhaps the most direct way to examine the impact of negative rates on equities is through the discounted cashflow model (DCF). This allows us to estimate the intrinsic value of a stock by summing up the present value of all expected cashflows over the life of the security, discounted by the appropriate interest rate. Ceteris paribus, a lower risk-free rate should boost the present value of equities via a mechanical adjustment of valuations upwards. We believe that this phenomenon will be seen most clearly in Europe, where negative interest rates are creeping across sovereign bonds of all shapes and sizes in the region; the chart below illustrates the impact of negative interest rates on our measure of the equity risk premium for Europe.

**Figure 1: European equity risk premium (the required rate of return versus cash)**



In addition, the opportunity cost of holding excess cash will motivate corporations to pursue shareholder-friendly activities like buying back shares. Share buybacks are already widespread in the US and we expect this to lift off in Europe over the next few months, which at the margin is supportive for equity prices. On the other hand, negative rates unfortunately also have adverse implications; we believe they are a symptom of being in a low growth environment and future cashflows will need to be marked down accordingly. The reality is that the long-term returns for equities will be lower than we have seen historically.

Let's now examine the potential medium-term effects of the ultra-low interest rate scenario in the eurozone on three different stakeholders active in the credit markets:

#### The issuers

Barring the scenario of the credit premium itself turning negative, there are three main consequences that we can expect to affect the overall supply of credit:

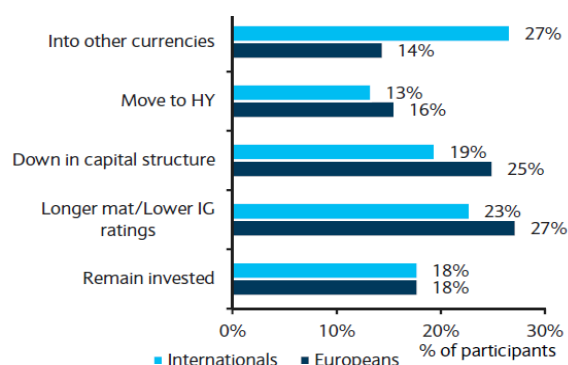
- An incentive to increase leverage either for a further deployment of today's capital or as a pre-emptive strike against less favourable future issuance.
- An incentive to restructure maturing debt towards longer maturities (leverage neutral, tenor extension).
- A cross-border incentive to issue in euro (separately hedging the currency risk) for overseas corporates.

#### The investor

The ECB's planned eurozone government bond purchases (as part of its quantitative easing – QE – programme) are much higher than the net supply coming to market. As such, it is possible to speculate that swathes of investors will be displaced.

Whilst it's hard to make explicit forecasts about the magnitude of potential flows, a recent macro survey showed that a large portion of existing owners of European investment grade credit were already considering a combination of overseas rotation and shift to lower-rated assets.

**Figure 2 Barclays GM survey: Intentions of EUR IG investors**



Note: European and Global investors were asked the same question. Source: Global Macro Survey, Barclays Research

This process could then evolve in two directions:

- The distortion of investors' natural risk habitat to become driven by loss aversion may create the premise for heightened volatility in the future.
- The creation of sizeable cross-border carry trades which by nature are destabilising for the global financial system.

#### The regulatory considerations

There are two potential implications of the recent QE policy intervention:

- A lack of available collateral (a counterparty owing collateral may have difficulties in finding credit-worthy paper to deliver) could further depress nominal bonds yields.
- Risk/pricing models of large financial organisations that are typically built on the assumption of positive interest rates may no longer be valid, and may cause mispricing of risks.

An environment of negative yields force investors to shift their asset preference, leading to a strengthening of the ongoing hunt for yield. It can sow the seeds for future instability by distorting the natural price discovery played by market participants. Portfolio rebalancing flows (euro investors moving to overseas assets in an attempt to increase their yield pick-up) and potential further increase in foreign issuance in the euro credit market would be the market dynamics that are worth monitoring.

**Important Information: For professional investors and advisers only. This document is not suitable for retail clients.**

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