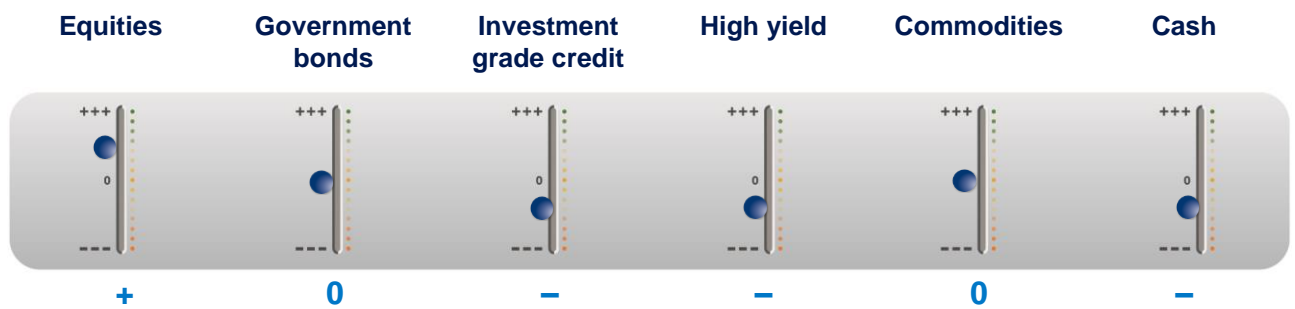


Schroders Multi-Asset Investments

Views and Insights

Section 1: Monthly Views – June 2015

Summary



Category	View	Comments
Equities	+	We retain our positive stance on equities and make no changes to our primary regional views, that is to prefer Europe and the UK in the global context. Despite entering a seasonally challenging period for equities, we expect growth to rebound in the second half of the year.
US	0	We retain our neutral rating on US equities as earnings revisions are rolling over, highlighting the challenge of potential rate hikes and strong dollar-led disappointment.
UK	+	We maintain our positive view on UK equities this month after upgrading the country in May. We prefer mid-caps, implemented through exposure to the FTSE 250 Index, as they provide a purer translation of our positive view on the UK economy following the general election. We are particularly positive on the domestic economy and the housing market which are well represented in the mid-cap index.
Europe	+	We are still positive on European equities and have noted the uptick in leading economic indicators in recent months. We remain of the opinion that the ECB's commitment to its asset-purchase programme will remain intact and continues to support the region's fundamental recovery.
Japan	0	Economic growth has been surprising to the upside recently, which has provided a boost to equity markets. The trend in corporate buybacks and improvements in corporate governance continues but we believe that recent comments from the Bank of Japan's (BoJ) governor on the yen has dampened expectations of further monetary stimulus in the short term. We still believe that the BoJ will need to loosen monetary policy eventually to support economic growth.
Pacific ex Japan	0	Our opinion on the region remains unchanged this month. The region is dominated by Australia, where we hold a negative view given the unfavourable economic situation.
Emerging Markets	0	We remain neutral on emerging market (EM) equities given the accommodative monetary policy adopted by many of Asia's central banks. However, we note the low growth, low inflation environment in many EM countries while the risk of the Federal Reserve (Fed) hiking rates too soon continues to weigh on sentiment.

Category	View	Comments
Government bonds	0	We remain neutral on duration, with a negative view on US 10 year bonds against a more positive view on European markets. We prefer markets such as Norway and UK over German Bunds because they have lower yield volatility.
US	–	We maintain our overall negative view on US bonds, continuing to prefer a butterfly approach, with positive views on 2 and 30 year bonds and a negative view on 10 year positions. Our expectation for a stronger dollar should dampen inflation expectations and therefore cap yields on the 30 year while we are positive on 2 year bonds to reduce the negative carry on the 10 year.
UK	+	Our positive view on gilts is unchanged from last month. We see continued investor flows into the country from European investors due to the higher carry, lower yield volatility and greater confidence following the election outcome.
Germany	0	We retain our neutral view on Bunds this month. We are positioned for curve flattening, with negative views on the 2 year and positive views on the 30 year with the long-end benefiting from a negative supply picture over summer. We also see this position as a tail-risk hedge in the event of a Greek default.
Japan	0	Having strengthened our view that the BoJ will have to further loosen monetary policy, we are maintaining our neutral position in Japanese duration. While this will likely increase inflation, the BoJ's action should keep a cap on the long end of the yield curve.
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	0	We remain neutral on emerging markets this month after upgrading in May. We believe that valuations are attractive and that the carry over many developed market bonds is sufficient to outweigh the potential volatility caused by the Fed's rate rises. However, we have downgraded our positive view on South Africa back to neutral given currency and inflation pressures. We have also downgraded Poland to double negative given the high sensitivity to peripheral spreads and the likelihood of further spread volatility around the Greek bail-out negotiations.

Category	View	Comments
Investment grade credit	–↓	
US	–	Despite the recent bout of weakness in government bond markets, US credit spreads have widened less than expected, thus worsening the already stretched valuations. With the addition of strong net supply, worsening issuance quality, some pressure on margins and spillover from the volatility in government interest rates, we remain negative on US investment grade (IG).
Europe	0↓	Volatility in European bond markets has risen significantly, despite the Quantitative Easing (QE) programme of the ECB. This has put pressure on spread products and shown European IG is vulnerable at current valuations despite QE support. As a result we have downgraded to neutral, considering risks are more balanced now that inflation expectations are recovering into an extended credit cycle as the shadow of Greece remains firmly in place over Europe.

Category	View	Comments
High yield credit	–	
US	–	Reducing issuance quality and strong supply into weak demand has caused high yield (HY) spreads to falter as we head into the traditionally difficult summer periods. The rebound in oil prices has caused some price recovery and additional stability for the energy sector, but is now feeding through into interest rate volatility which is unsettling to total return investors. We therefore maintain our negative stance.
Europe	0	Whilst improving growth dynamics in Europe are positive for HY issuers, we maintain our cautious stance on European HY given the high correlation with the weaker US market, potential

risks from Greece and the broader liquidity risks building in bond markets.

Category	View	Comments
Commodities	0↓	We have downgraded our view on broad commodities this month as we have become less constructive on cyclical commodities at the margin.
Energy	0↓	We have downgraded our view on energy as prices have recovered strongly and the risks to the upside and downside are now more finely balanced.
Gold	–	We maintain a negative score as we expect stronger US data to push up real rates and therefore reduce the relative attractiveness of gold.
Industrial metals	+	China has moved firmly into an easing cycle, bringing forward infrastructure expenditure and easing monetary policy. Metal prices have returned to levels seen at the beginning of the year despite an improving backdrop. We therefore maintain our positive outlook on industrial metals.
Agriculture	–	We remain negative on agriculture as farmers are not cutting back planting intentions in response to current price levels.

Category	View	Comments
Currencies		
US dollar	++↑	We have upgraded the US dollar this month due to our belief that US growth will reaccelerate in the coming quarters following the recent soft patch that has been driven by a stronger US dollar, energy capex consolidation and bad weather.
British pound	0	We remain neutral on sterling with the broad weakness across the European economy finely balanced with our expectation that the UK will maintain its relatively strong growth profile causing the BoE to raise interest rates soon after the Fed.
Euro	–	The ECB's accommodative monetary policy is scheduled to remain in place until Q4 2016 which should maintain downward pressure on the euro. Although our expectation is for growth in the eurozone to improve through the remainder of the year, we expect this to be at a slower pace than in the US and we therefore see continued pressure on the euro relative to the US dollar.
Japanese yen	—↓	We have further downgraded our view on the yen this month due to weakness in inflation and modest growth figures. We believe that further accommodative monetary policy will be required which will weigh on the currency.
Swiss franc	–	We believe that the Swiss economy is likely to experience additional weakness going forward as a result of the sharp appreciation in the franc following the national bank's abandoning of its currency peg against the euro. We believe that the franc remains overvalued.

Category	View	Comments
Cash	–	With real rates remaining negative, we continue to hold a negative view on cash.

Source: Schroders, June 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

The long-term outlook for the Japanese yen

This month we share our thoughts on a more structural view than usual: our long term outlook for the Japanese economy and the read across to the yen, as deteriorating demographics and government indebtedness continue to plague the nation.

The country's demographics are particularly concerning. The percentage of the nation's population aged over 65 is projected to rise from 25% in 2010 to 40% by 2050¹. 2014 saw a record low number of babies born and the total fertility rate (the average number of children born to a woman in her lifetime) of just 1.4 is considerably below 2.1, the generally accepted rate required to maintain a steady population in developed markets¹. These statistics point to an ageing, less economically active population which is projected to decline from the current 127 million to 105 million by 2050¹. The resulting decline in the labour force will likely weigh heavily on economic growth, while an increase in the number of those aged over 65 will add additional pressure to Japan's poor fiscal position.

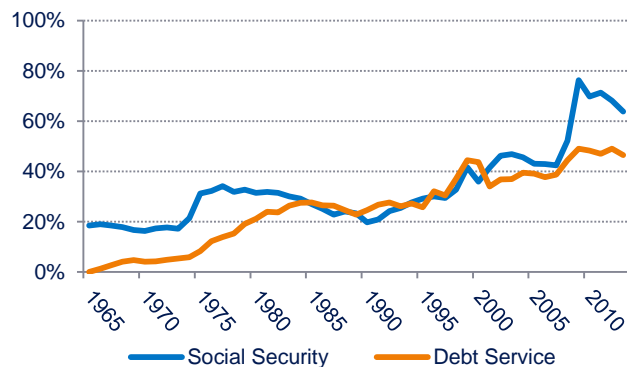
Beyond Japan's weak demographic position, the government's debt burden, at 240% of GDP, is another significant headwind. Almost 50% of the government's revenues is currently being used to cover debt service costs alone which will become a considerable problem should Japanese government bond (JGB) yields rise from their current levels.

Japan's post-war economic boom sharply turned into an asset price bubble which burst in the late 1980s. By the end of the 1980s, Tokyo commercial property prices had risen by a factor of 8 over just 20 years². Corporates had been buoyed by the rising asset prices and had increased their leverage accordingly. However, once the bubble burst, corporates sold down assets to regain balance sheet stability, pushing prices lower and a downward spiral of asset prices began. In an attempt to avoid a depression, the Japanese government began to aggressively loosen fiscal policy and raised government debt from 50% to 240% of GDP as a result. History suggests that countries with such a high debt burden would normally struggle before reaching such a level but Japan has been held stable by a rich export market leading to a current account surplus, and domestic demand for JGBs.

Given that Japan is currently using more than 100% of tax revenues (Figure 1) to pay for debt servicing and social security payments, which are both forecast to rise, the country's current fiscal path is clearly not sustainable over the long-term. Japan's internal funding source for JGB issuance also appears unsustainable given demographic trends. Replacing this domestic demand with foreign

investors may lead to higher yields and therefore higher debt service costs could cause Japan's economic path to deteriorate further.

Figure 1: Japan's Social Security and Debt Service spending as a % of Taxes and Other Revenue



Source: Thomson Datastream, Schroders. June 2015

Against the longer-term backdrop, it appears that Japan is emerging from its multi-decade balance sheet recession after a 70-90% decline in land and real estate prices. Moreover, corporates are starting to re-leverage which removes a headwind to stronger growth. The Japanese authorities have embarked on monetary easing, economic reform and fiscal consolidation in seeking to end deflation, revive the economy through boosting competitiveness and ultimately seeking to avoid looming debt troubles by boosting the denominator and shrinking the numerator of the nation's debt to GDP ratio.

We believe the end of Japan's balance sheet recession is constructive for the economy and will relieve some of the nation's deflationary pressures, while improving its growth profile. Economic reforms should also assist growth. However, we expect Japan's significant demographic headwinds and required fiscal consolidation to counter these benefits, forcing downward pressure on growth and inflation. As these positive and negatives broadly offset, we believe the Bank of Japan will be required to continue to ease policy for some time, remaining the marginal buyer of JGBs to suppress yields whilst weakening the currency to boost growth, through improved competitiveness, and to boost inflation. As a result, we expect the yen to continue to weaken against all other G10 currencies in the years to come.

¹World Bank, ²Bloomberg

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