

Schroders

Multi-Asset Update & Outlook

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1. Overview

Over the last 12-18 months we have highlighted the gap between investors' perceptions of risk in asset prices and the implications of extended valuations on future returns. Consistent with this has been the link between asset prices and the aggressive reflationary monetary policies pursued by major global central banks – especially the Fed, but more recently the ECB and the BOJ. Our essential argument with respect to asset prices is that whether you look at bonds or equities, risk has been mispriced. Despite the recent declines in equities and widening in credit spreads this remains the case.

With respect to the global economic backdrop, our central thesis has been based around the idea that while the global outlook is mixed and certainly not healthy in a structural sense (given factors such as still extremely high debt levels), recession was not likely in 2015 or 2016. We expected the US to continue its recovery, core Europe to surprise modestly on the upside, Japanese growth to disappoint, Chinese growth to moderate as its economy rebalances, emerging economies to struggle as the US dollar strengthens and liquidity is withdrawn, and Australia to struggle as it fights the headwinds of a declining terms of trade. While these economic themes have more or less played out, until recently at least markets have seemed impervious. We expect these broad themes to continue.

Against this backdrop portfolio positioning has been defensive. We've preferred cash to bonds, cash to equities and foreign currency over the Australian dollar. By the end of July the cash weight in the Real Return CPI+5% strategy was nudging 40% against exposure to equities of close to 23% - in effect as defensive as we've been in the strategy since the GFC. While some clients had questioned the logic of such high cash weighting given the record low nominal cash rates prevailing, we'd argued that low but positive nominal returns were preferred to the high and rising risk of loss.

While it is fair to say that some markets had remained more resilient for longer than we would have thought (predominately those more closely aligned with QE programs), the pick-up in volatility and the pull-back in equity prices in August has validated our positioning. Cash has delivered both a positive return and a solid (relative) performer this year.

We have utilised August's volatility and added some risk back into the portfolio. Cash has been reduced by around 10%, with a 5% addition to equities (both global and domestic) and 5% to credit (both high yield and investment grade). Despite this our positioning is still broadly defensive. With a few exceptions, structural valuations remain demanding and return expectations are low as a result. From a more tactical perspective we are concerned that the Fed's dithering – having painted itself into a corner – will only add to volatility. We expect lower levels in equity markets, higher bond yields and further weakness in the Australian dollar to prevail.

2. 2015 ... The year so far

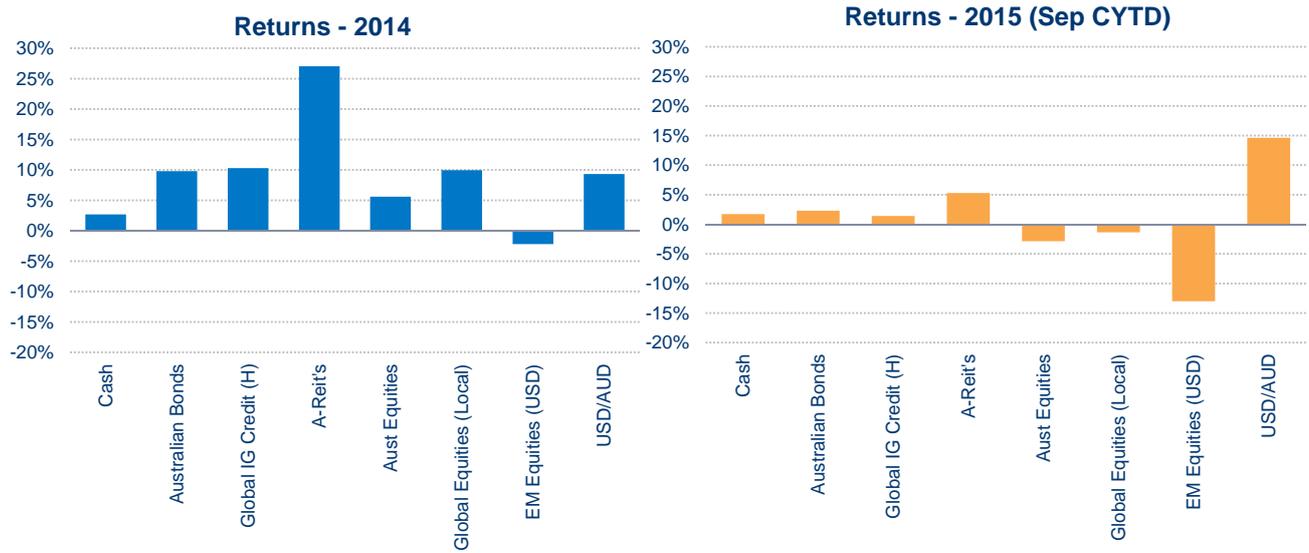
2014 was a positive year for local investors, driven mainly by gains in US and Japanese equities and declining bond yields. It was a mixed year for credit (due in part to the impact of weak oil prices on energy producers). Currency movements were significant with USD strength prevailing.

2015 has been significantly more mixed and on balance a tough year for investors. With the exception of Japan, most major equity markets have posted losses in prices terms this year¹, and even the exception, Japan, has retraced the bulk of its earlier gains. Emerging market equities have fallen sharply amid weak commodity prices, a slowing Chinese economy and a strengthening USD. Sovereign bond investors have seen volatility rise, but low headline inflation and Fed intransigence is providing little clarity. Front end yields in the US have broadly risen, but back end yields continue to range trade. Weak commodity prices have continued to place downward pressure on commodity currencies like the AUD. Credit spreads have on balance been widening leading to subdued returns from credit. A-REIT's have been amongst the best performers year to date, but most of this performance came in January and it's been downhill since (A-REIT's have fallen 10% since their early February peak). Returns for investors in offshore assets have been flattered by a 13% decline in the Australian dollar (v USD) this year.

¹ As at 23 September 2015



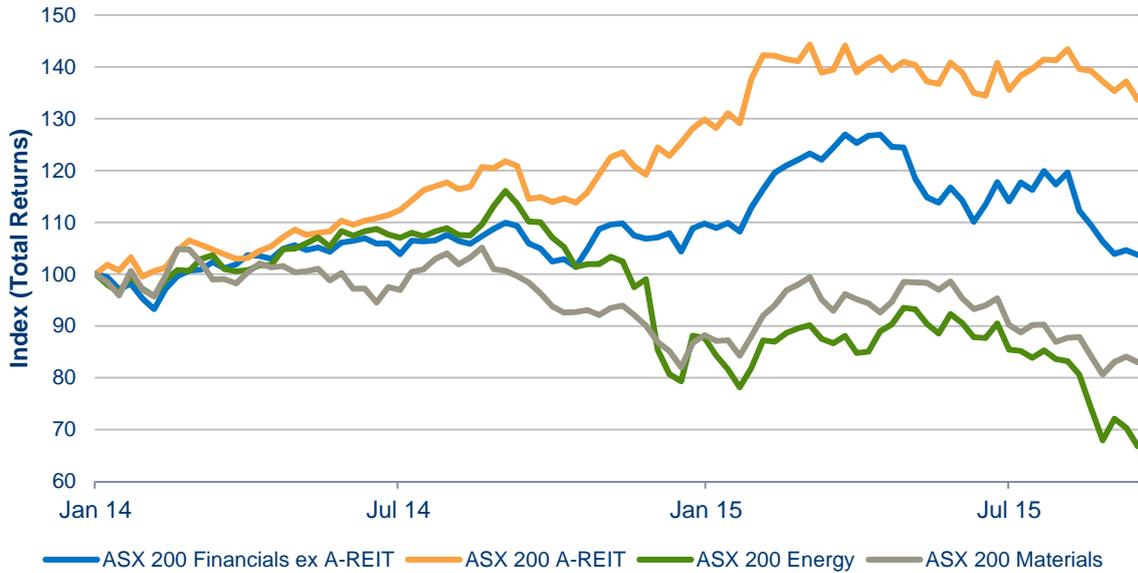
Figure 1: Asset Class Returns 2014 & 2015 YTD



Source: Schroders/Bloomberg/Datastream (to 21/9/15)

While we are not surprised that equity markets have started to unravel, we are surprised that it's taken as long as it has. Clearly central bank support has been a strong influence. This has also helped keep bond yields lower than we would expect to prevail over the medium term in more freely functioning markets. This has also played a role in supporting the markets' favourite yield proxies – A-REIT's and to a lesser extent domestic bank shares.

Figure 2: Banks & A-REIT's v Market



Source: Schroders/Datastream (to 16/9/2015)

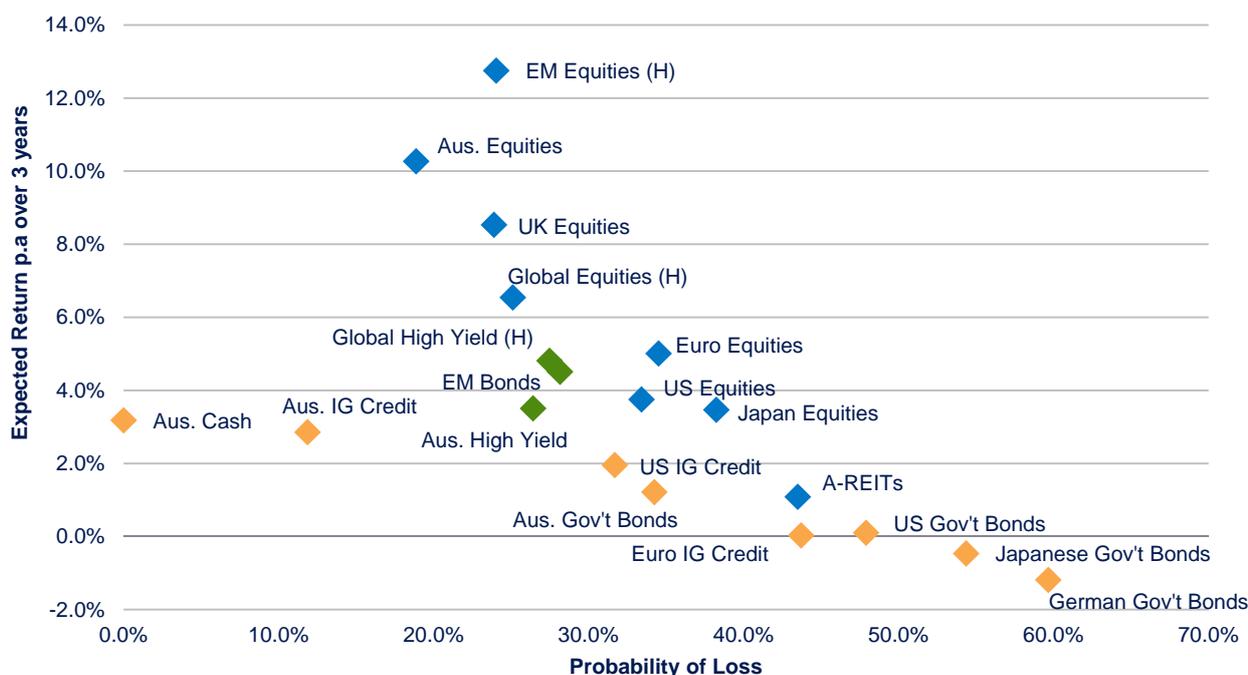
3. Outlook & Risk

3.1 Asset Class Return & Risk Forecasts

Our return forecasts continue to highlight the risks associated with relatively stretched valuations. The recent pick-up in volatility and re-pricing of equities (mainly) and credit (secondly) has done little to fundamentally change the outlook. This is largely because of the extent to which a large part of the valuation anomaly is structural and unlikely to change unless we see a material re-pricing of risk.

Figure 3 shows our return and risk forecasts based on market levels prevailing at the end of August.

Figure 3: Expected Return v Probability of Loss

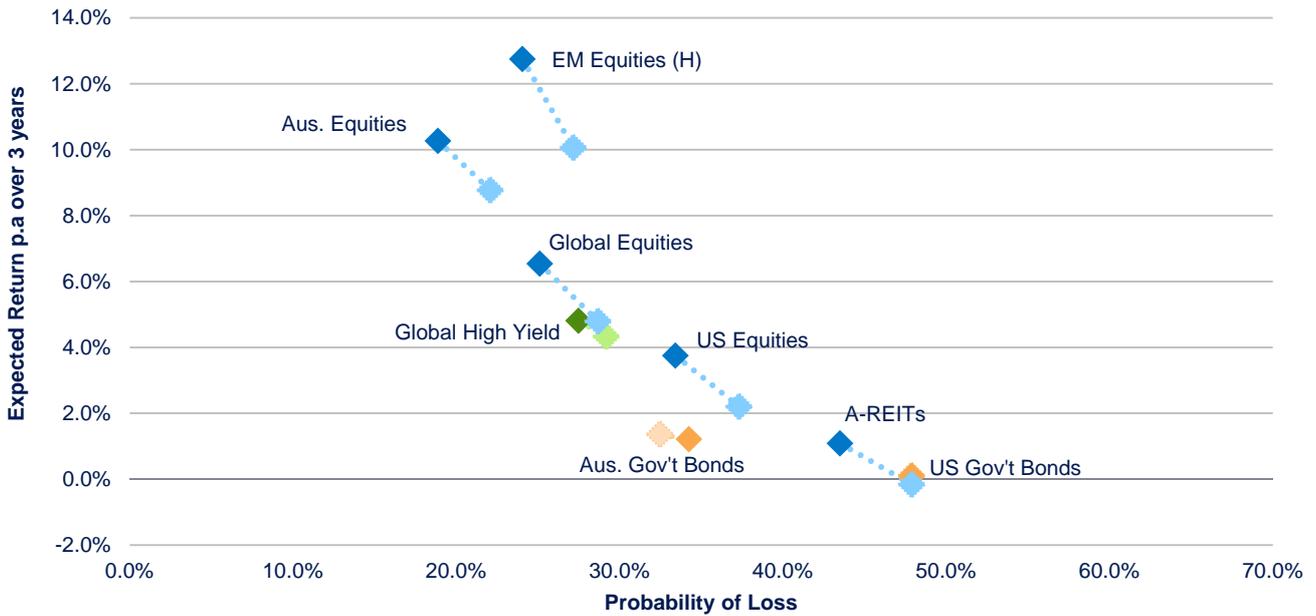


Source: Schroders as at 31 August 2015. Countries, stocks and sector weightings and returns are mentioned for illustrative purposes only and should not be viewed as a recommendation to buy/sell.

There are a few points to highlight from this chart:

- With the exception of commodity based equity markets that have suffered significantly from the sharp falls in commodity prices, return forecasts remain subdued;
- Prospective returns from those equity markets directly supported by QE in recent years are insufficient when compared to longer run required returns to compensate investors for the risk of exposure (particularly downside risk);
- Low sovereign yields imply (at best) very low bond returns and at worst, negative returns should yields revert to levels at or near structural fair value. In markets like Germany where front end nominal yields are negative, negative returns seem virtually locked in;
- Relatively narrow credit spreads coupled with low sovereign yields means subdued returns from credit (both IG and sub IG) are in prospect;
- While equities did suffer substantial falls in August, resulting in a modest improvement in return prospects, these falls did not materially change return forecasts across asset classes. Figure 4 (overleaf) shows the extent to which the moves in markets in August changed these projections.

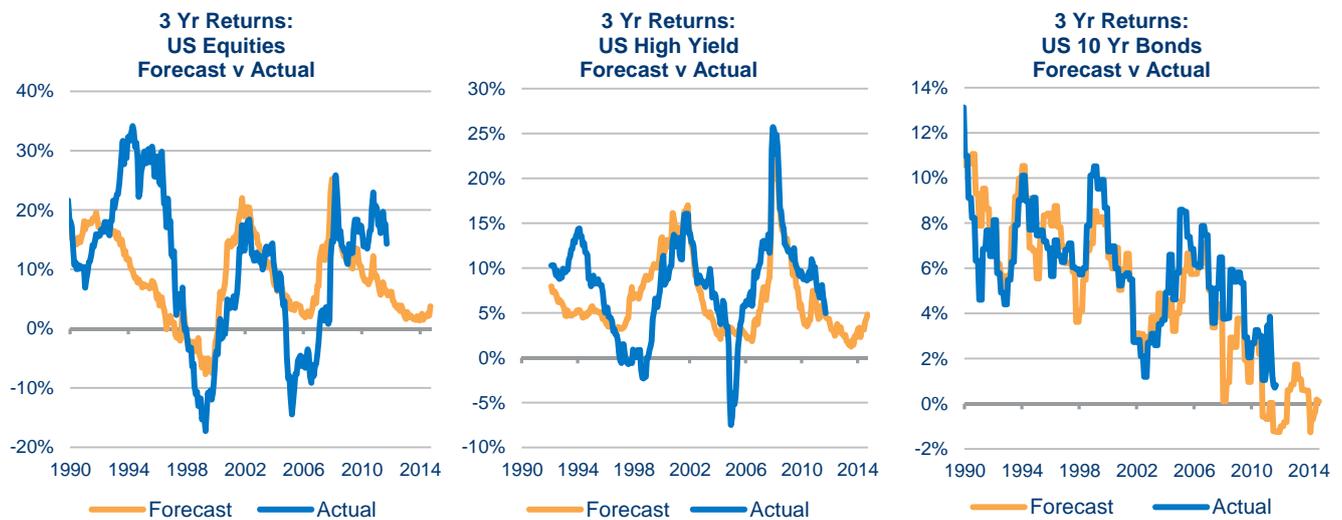
Figure 4: Changes in 3 Year Return Forecasts (July – August 2015)



Source: Schroders as at 31 August 2015. Lighter coloured diamonds indicates July data. Countries, stocks and sector weightings and returns are mentioned for illustrative purposes only and should not be viewed as a recommendation to buy/sell.

An alternate perspective is gained by viewing current prospective returns against the historical experience (both in terms of actual and expected return outcomes).

Figure 5: Schroders 3 Year Return Forecasts through time

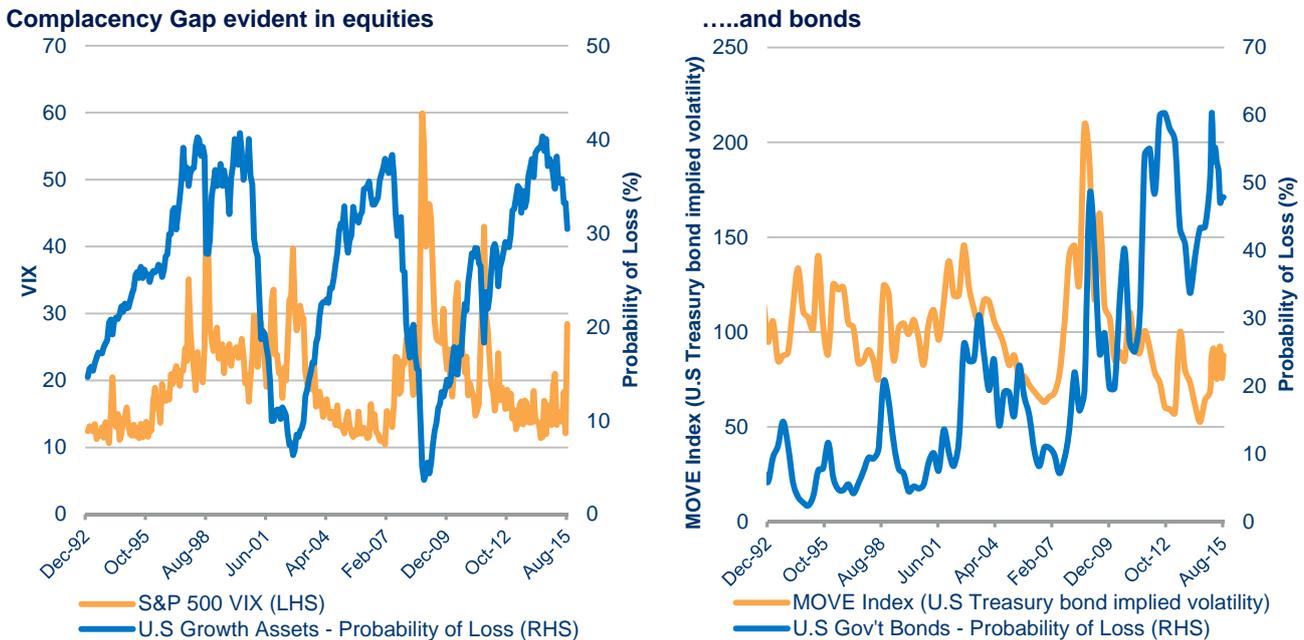


Source: Schroders

While this framework is far from perfect in capturing the precise swings in returns, it does nonetheless capture the broader trends in returns well – especially where these trends are driven by more fundamental factors – and also highlights where other factors may be distorting the behaviour of asset markets. It is interesting to note that the gap between actual and prospective returns, which had arguably been driven by QE, appears to be closing (especially for high yield and sovereign bonds).

Another point we have been emphasising has been the “complacency gap”. This is the idea that low implied market volatility (VIX) is inconsistent with the deterioration in valuations and high risk of loss. As Figure 6 shows, while recent market weakness associated with an increase in market volatility has reduced this gap, it nonetheless remains relatively wide – especially for bonds.

Figure 6: The “Complacency Gap”



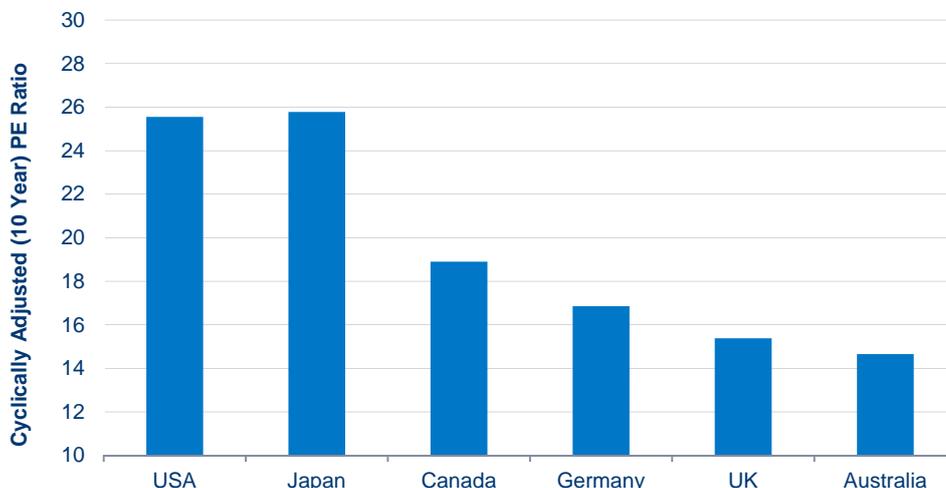
Source: Schroders, Datastream. Growth Assets is an equally weighted basket of US equities and Global High Yield bonds as at 31 August 2015

The bottom-line is that structural valuations are still problematic implying inadequate risk premium and an elevated risk of loss in most assets. Our conclusion is to remain cautious, continuing to prefer cash to equities and cash to bonds. That said, this is a broad generalisation. A number of issues impacting individual asset classes are worth drawing out.

3.2 Equities

As Figure 3 highlights, there are some significant differences between our forecasts for the various global equity markets. In broad terms those markets that have been most closely linked to falling commodity prices (Australia and the UK) now offer the most attractive returns over the medium term. This is because these markets, having already discounted significant commodity prices weakness are now starting to look cheap on a cyclical basis. When overlayed with a relatively positive structural backdrop, underpinned in Australia’s case by relatively high dividend yields (especially on an after-tax basis), and attractive longer run valuations (as reflected in Figure 7), Australia represents our preferred equity market on medium term investment horizon.

Figure 7: Cyclically Adjusted PE Ratio's



Source: Schroders, GFD

In contrast, the US and Japan represent our least preferred equity markets. This mainly reflects concerns around structural valuations and is consistent with extended structural valuation metrics such as the Cyclically Adjusted PE Ratio's. While shorter run valuation metrics are not demanding, valuations are consistent with considerable good news being embedded in the price. The common theme with these markets is that they have been clear beneficiaries of extended low rates, QE programs and "whatever it takes" central bank rhetoric. To the extent that this may be ending (at the margin anyway), investors may start to assess the risk premium that may be required to own these markets. In short, we'd rather own those markets that have discounted the "bad" news, than those that have extrapolated the "good" news.

Emerging market equities notionally offer the highest prospective returns, yet we remain cautious and have no direct exposure from an asset allocation perspective (we do have some exposure from a bottom-up perspective via the Schroder QEP Dynamic Blend Fund). There are essentially two reasons for this. The first is that while return projections have improved, they have not improved sufficiently to properly compensate for the inherent volatility and downside risk embedded in the asset class. In other words they aren't cheap enough offset this risk. The second factor is that we expect that a stronger US dollar and potential Fed tightening will continue to support a flight of capital away from the emerging market economies and continue to suppress EM equity prices. Eventually this will give us the attractive entry point we are looking for – but just not yet.

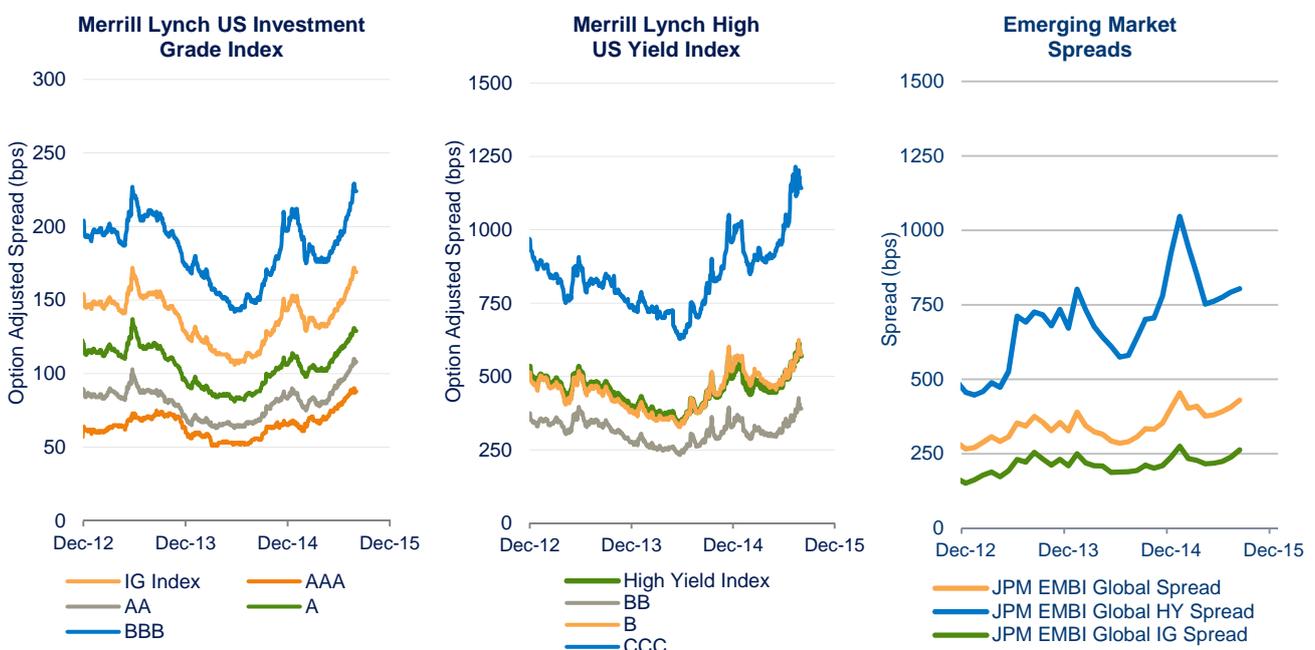
3.3 Credit

Credit has been a star performer in the post GFC environment, benefiting from the combination of low bond yields, narrowing credit spreads (amid the search for yield) and a broadly improving economic environment meaning limited defaults. Significantly cracks started to appear in credit just over a year ago when declining oil prices started to unravel the debt of US energy producers. This reflected both pressure on cash flows, concerns over refinancing as well as the overall viability of parts of the industry given their costs of production. In the context of the post-GFC experience credit spreads have broadly continued to widen and while this partly reflects an increase in corporate leverage and growing questions around credit market liquidity in the post Basel 3 environment, it also reflects the shape of the credit curve and an overall lengthening in the debt profile of corporates as they seek to lock in low rates for longer – a logical response.

From a valuation perspective we believe credit valuations have shifted from expensive to around fair value. The real risk for credit is recession as this is the environment where corporate defaults rise and spreads widen commensurately. At present we believe this is a relatively low risk.

With regards to EM debt, we have a similar view to that of equities. Spreads have widened but are not cheap enough yet to compensate for the risk of potential future capital flight.

Figure 8: US Credit and EM Spreads

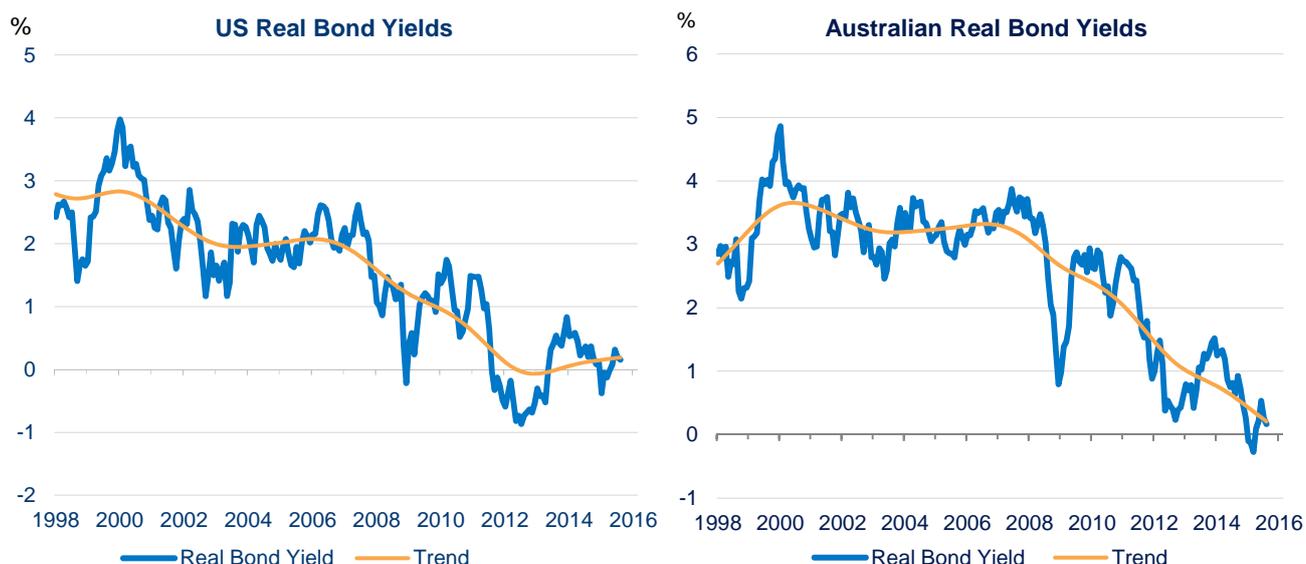


Source: Bloomberg, Datastream as at September 2015

3.4 Sovereign Bonds

From an outlook perspective the asset class that has troubled us the most has been sovereign bonds. Valuations are at the core of our approach and while we generally accept that in the short run valuations are a poor forecasting tool, they matter over the medium term. The difficulty at present is the gravitational force exerted on bond yields across the yield curve from the extreme and unorthodox central bank policies that have kept official rates at near zero and have been overlayed by subdued guidance with respect to the outlook. That said, the low levels of current yields (negative in some cases) imply a high likelihood of very low future returns from sovereign bonds. The exception to this would be an environment of broad based and protracted deflation – a scenario we do not see as likely at this point. The more likely scenario is that yields start to move higher and back toward something more sustainable in an undistorted world. As Figure 9 shows, real yields are tracking close to 0%, against a US economy growing at 2.5-3% in real terms with inflation expectations relatively stable at around 1.5-2%. In our view something (eventually) will give. We prefer cash to bonds as a result.

Figure 9: US & Australia Real Yields

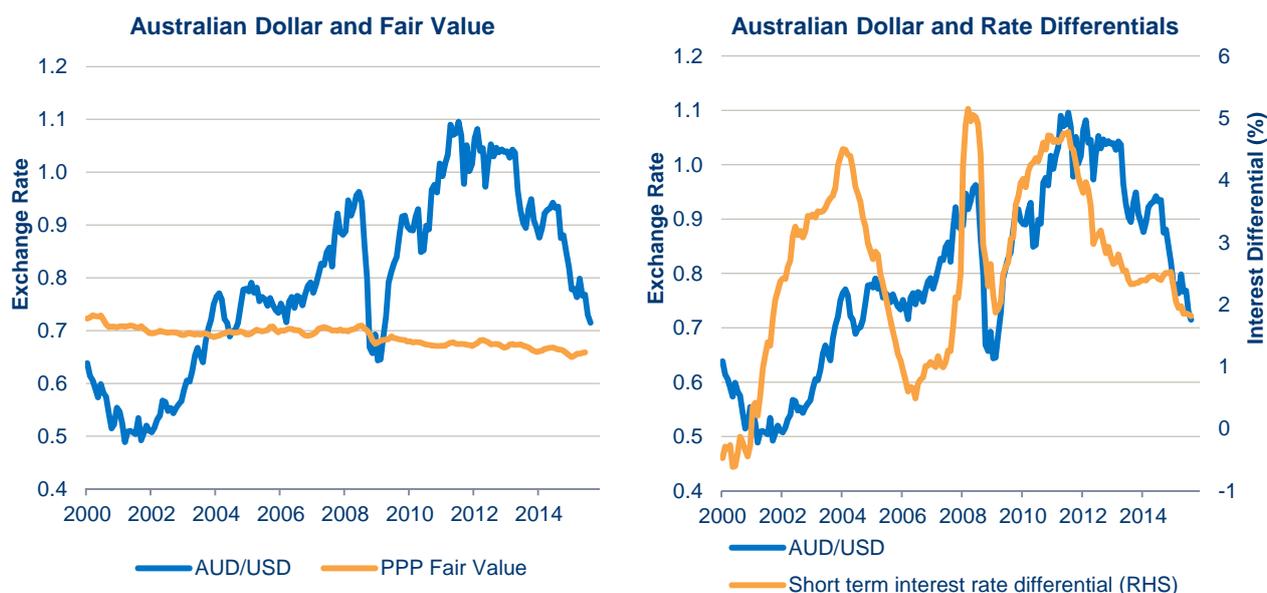


Source: Schroders, Datastream as at 31 August 2015

3.5 Currency

Unlike bonds, the Australian dollar's performance has been in line with expectations. We have for some time advocated a fall in the AUD to closer to \$US0.60 and while it still has some way to go, it recently dropped temporarily below \$0.70 and is now within a reasonable margin of error of fair value on our purchasing power parity standard. As Figure 10 (overleaf) shows, the AUD, like most currencies spends very little time at fair value and with the Australian economy still under structural downward pressure we would expect that downward pressure remains on the currency.

Figure 10: Australian Dollar



Source: Schroders, Datastream as at 31 August 2015

4. Implications for Portfolios

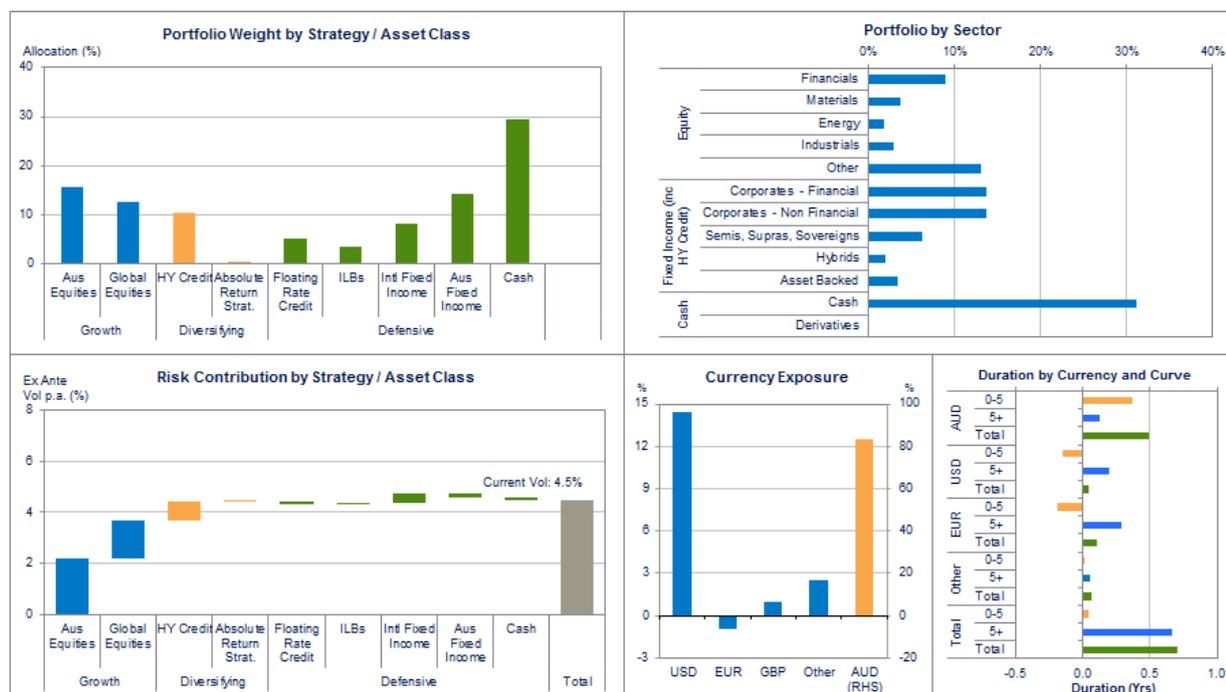
As our return projections indicate the outlook is challenging. This is in essence because current low yields and demanding structural valuations imply that returns that would normally have accrued to investors over time have already been delivered.

However, from our perspective that is the reality we need to deal with. We can't change the outlook, but can manage how we approach the challenge. To this end there are some clear implications:

- Preserving capital as markets adjust is a priority. In 2015 we progressively built our cash weight with it edging towards 40% by late July. While this did bring criticism from some quarters given cash is often seen as a “lazy” investment, our view was that better to earn a “lazy” 2% than lose money. In our view, it should be the objective that counts not the investments that we make to get there (see Figure 11). As markets corrected abruptly through August the impact on performance was muted and we chose to redeploy 10% of the cash into a mixture of credit and equities reflecting both better valuations and a reduction in risk. Importantly though we still remain defensive. Cash is still around 30% and we are unlikely to significantly reduce this exposure until we see significantly better levels in markets that effectively restore valuations (and therefore prospective returns) to more normal levels. As we were reminded in August, adjustments to market pricing can be swift, severe and come with little notice. Avoiding being caught up in them where possible is critical.
- Consistent with this we are maintaining a number of “tail-risk” mitigation strategies in the portfolio. Aside from cash we continue to hold duration (0.7 years), curve flatteners and put options against the AUD/USD and the S&P500.
- Within a challenging market environment there are opportunities. While clearly non-consensus at present, the differential performance of equity markets has opened up some clear opportunities. The relative attractiveness of Australian equities compared to many of the major developed markets is something we are looking to take advantage of – in effect we prefer to own the markets that have discounted the downside.
- The recent widening in credit spreads makes credit a more stable and attractive portfolio holding which is likely to deliver relatively stable core returns in the absence of a recession. This is clearly an exposure we will continue to actively adjust as spreads adjust and risks change.
- While often overlooked, we would also point to the potential to benefit from the changes in the level of interest rates and the shapes of yield curves as interest rates potentially start to adjust in the US. Further adjustments to currencies are also likely to provide return opportunities – we still expect further declines in the Australian dollar.
- Asset allocation also remains the most important driver over time to returns (and risk), and we expect stock selection to rebound and generate positive (perhaps even significantly positive returns) over our investment horizon. While both

active Australian equities and global equities have detracted from portfolio returns of late, we expect that this will soon reverse

Figure 11: Summary of Portfolio Positions – Schroder Real Return CPI+5% Strategy



Source: Schroders. USD Currency exposure is a weighted measure which includes pegged currencies, as well as a number of other currencies based on their performance during periods of stress.

Clearly as markets adjust, short term returns will moderate. In many ways this should be welcomed as it helps reset markets to more sustainable levels. While we acknowledge that we are in a difficult environment we see no reason why our return objectives won't be achieved. Timeframes though are important – we do expect heightened short run volatility over our stated 3 year investment horizon and pressure on shorter term returns but are confident that if we manage risk (especially downside risk appropriately) that we will achieve real 5% pa.

Important Information:

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