STRATEGY UPDATE

INVESTMENT CLOCK

READY TO BUY SUMMER DIPS

Issue #10

May 2017

ROYAL LONDON

ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £104.5 billion in life insurance, pensions and third party funds*.

Global Multi Asset Portfolios (GMAPs) are available on a wide range of platforms.

*As at 31.03.2017

This month's contributors

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Stocks have rallied strongly since the two big China-devaluation shocks of summer 2015 and early 2016. Over the last year we have seen temporary but modest setbacks linked to political shocks: Brexit, Donald Trump's election and the French elections.

We could see further volatility this summer with the economic upswing starting to cool off and geopolitical risks running high. Given our positive longer-term view, we stand ready to buy dips in equity markets and have an overweight position in global high yield bonds that should pay off if we see more of a muddle through.

*Source: RLAM as at 30.04.2017 total return in GBP, bid to bid, net of fees and taxes, net income reinvested. Fund launch dates: 14.03.2017. Past performance is no guide to the future.

The upswing in global growth is coming off the boil and inflation pressures are easing. This is good for bonds but stocks may not take bad news kindly and we have taken profits. We don't think the bull market is over, however, and would buy on a dip. Eight years on from the Great Recession there is little sign of the surge in wages that marks the beginning of the end of an expansion. Policy is likely to stay loose.

Bond yields drop as growth cools and inflation pressures ease

The Investment Clock model that guides our asset allocation is in the Overheat phase of the business cycle after the strongest surge in global growth and inflation since the financial crisis. However, business survey readings are falling from recent highs and inflation looks to be peaking outside of the UK as commodity price increases will have stalled. A move away from Overheat is good for bonds and we have reduced our underweight positions. Stocks may not take negative news on kindly in the short run and we have taken some profits, reducing our overweight positions.

Beware summer shocks for equity markets

Stock markets often move sideways over the summer and volatility tends to rise. This year may prove no exception. Negative surprises could come from doubts about the ability of President Trump to implement planned stimulus measures or signs of weaker economic activity generally. The upswing in stocks started amid the China devaluation shock of early 2016 (see chart), so markets will be particularly sensitive to signs that tightening measures in China are starting to take effect.

Positive longer-term outlook hinges on wage inflation

We would buy a seasonal dip. Eight years on from the 2007/8 recession there is little sign of the surge in wage inflation that provokes central banks into removing monetary stimulus. As a result, we expect continued above trend growth in developed economies. A gradual slowdown in China into 2018 could keep inflation low and policy loose, moving the Investment Clock into equity-friendly Recovery.

Strong first year for Global Multi Asset Portfolios (GMAPs)

The six GMAP multi asset funds we launched in March 2016 delivered absolute returns ranging from around 8% to 23% in their first year*, in line with their varying risk levels with sterling weakness boosting returns on overseas assets.

Focus Chart: Investor Sentiment and Stock Prices

Source: Thomson Reuters Datastream as at 12/05/2017

Please visit www.investmentclock.co.uk for our blog and information about our multi asset range. For product details, contact: multiassetsupport@rlam.co.uk

For professional investors only, not suitable for retail investors.

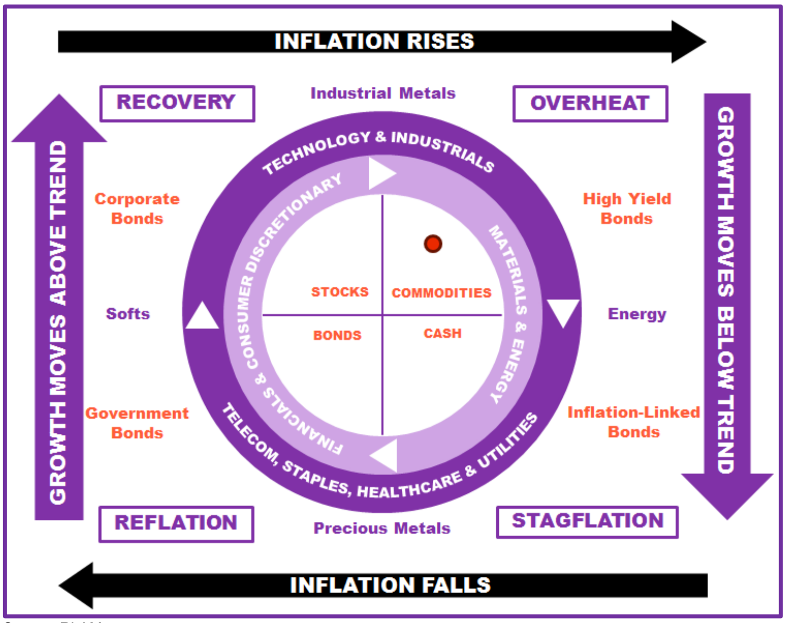
INVESTMENT CLOCK OVERHEAT FADING

The Investment Clock model that guides our asset allocation has been in the Overheat phase since July. Commodities duly outperformed bonds over 2016 after years of poor performance but the Overheat is fading.

We 'tell the time' on the Clock using scorecard indicators for global growth and inflation, both of which peaked in March. The world economy is coming off the boil if business surveys in the US and China are to be believed. Meanwhile, commodity prices are moving sideways and inflation is peaking outside of the UK (a special case due to the impact of sterling weakness since the Brexit vote).

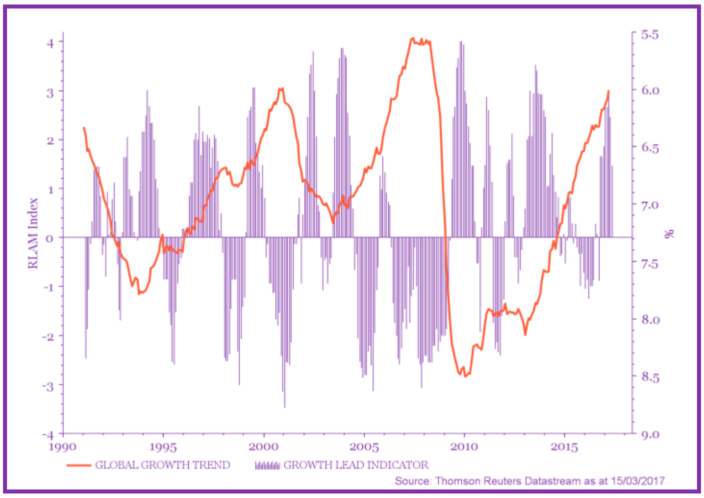
We wouldn't be surprised if the markets became concerned about slower growth in the next few months, but longer term we remain constructive. We expect growth to remain strong in developed economies. A period of renewed disinflation going into 2018 could see the Clock move back into equity-friendly Recovery.

Chart 1: The Investment Clock is in Overheat



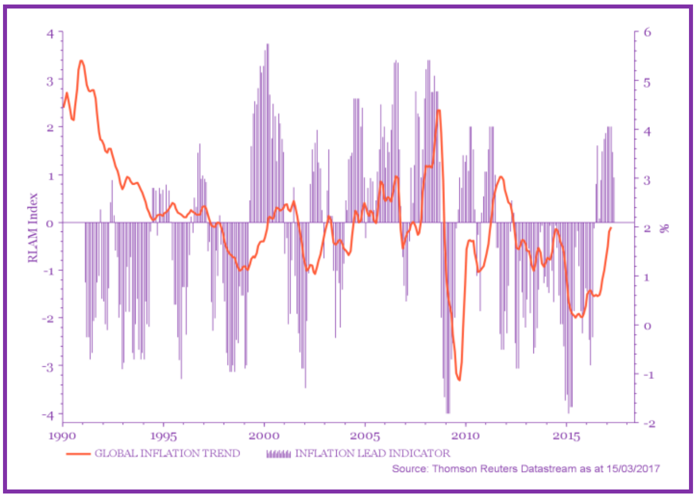
Source: RLAM.

Chart 2: Global growth coming off the boil



Source: RLAM, DataStream.

Chart 3: Global inflation peaking



Source: RLAM, DataStream.

Global Growth coming off the boil

- The global growth trend is positive with unemployment rates continuing to fall in all of the major economies.
- However, business confidence and lead indicators have started to roll over and economists have started to downgrade forecasts for US GDP growth.

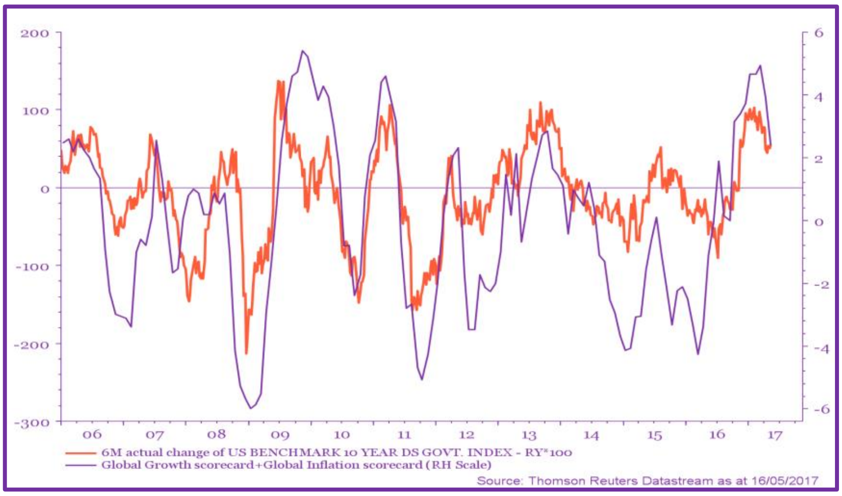
Global Inflation peaking

- Global inflation has been trending higher over the last year after a recovery in China boosted commodity prices.
- However, falls in the oil price in recent weeks suggest a peak in global inflation rates.

SUMMER VOLATILITY AHEAD?

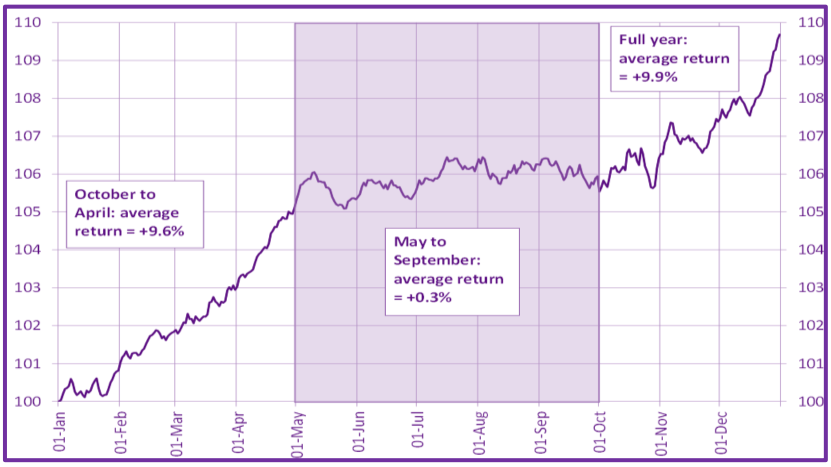
There is a close correlation between the growth and inflation indicators we use for our Investment Clock and movements in global government bond yields. The cooling off in growth and inflation could see bond yields drop further and we have reduced the underweight positions in our multi asset funds.

Chart 4: Nominal growth indicator and change in bond yields



Stock markets often move sideways over the summer and volatility tends to rise. With that in mind, we have taken some profits, moving equity weightings down towards neutral to give ourselves firepower to buy dips.

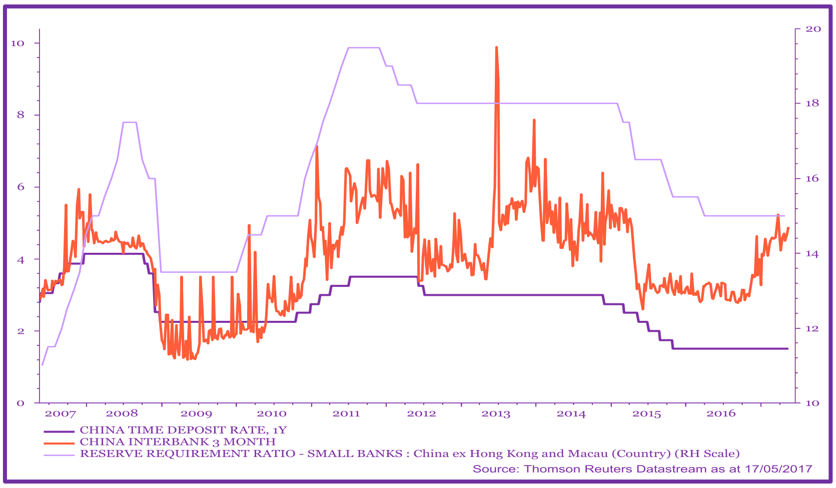
Chart 5: Stocks are prone to shocks over the summer



Negative surprises could come from doubts about the ability of President Trump to implement planned stimulus measures or signs of weaker economic activity generally.

The current upswing in global stocks started amid the China devaluation shock of early 2016, so markets will be particularly sensitive to news out of China. The rise in 3 month money rates in recent months reflects a rationing of credit which could start to cause concerns as the summer progresses.

Chart 6: China has been tightening policy



WHY WE WOULD BUY DIPS IN EQUITIES

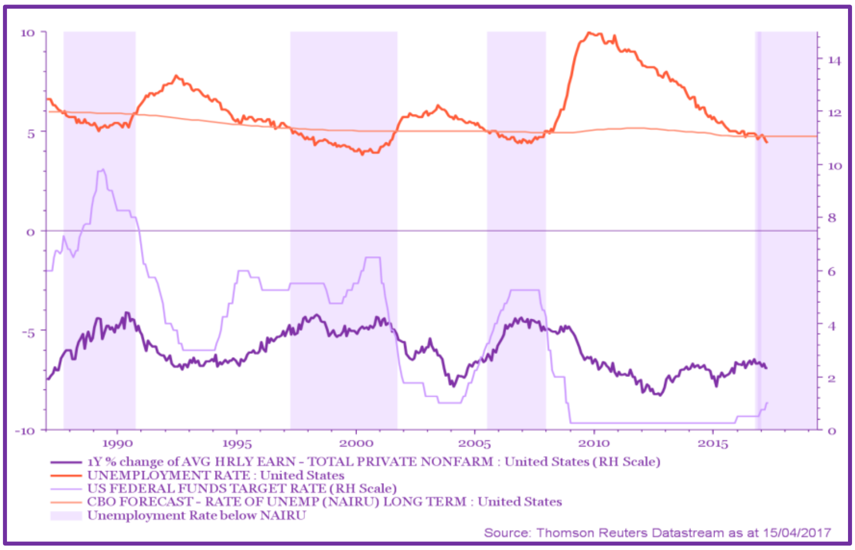
Our long-term view remains positive on equity markets. Stocks beat bonds when the global economy is seeing above trend growth and unemployment rates are falling. The US unemployment rate surged to 10% after the failure of Lehman Brothers in 2008. Since then it has more than halved and stocks have beaten bonds globally by 150%.

Chart 7: Stocks v bonds and US unemployment rate (inverted)

What is remarkable is eight years on from the Great Recession there is little sign of the surge in wages that marks the beginning of the end of an expansion. The US unemployment rate is moving below the so-called natural rate of unemployment at which we would expect to see a rapid rise in wages and yet wage growth is running around half the level of 2007.

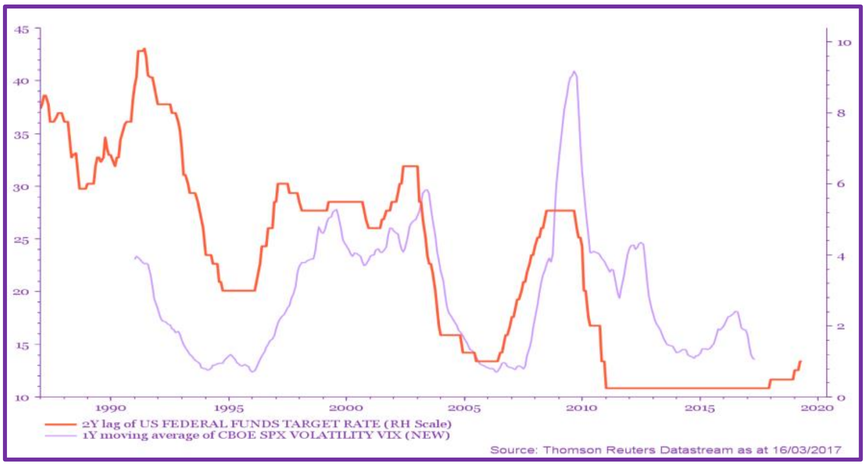
This may be due to increased job insecurity, the army of discouraged workers who have left the labour force or technological change. As long as it lasts, we are unlikely to see rapid interest rate rises and this is bullish for global equity markets.

Chart 8: US Unemployment Rate, wage inflation and the Fed



There has been much comment on the extremely low level of stock market volatility as measured by the “VIX” index. Increased summer volatility aside, we don’t expect volatility to rise meaningfully until higher US interest rates start to bite and the US economy slows. If past relationships hold good and the Fed keeps gradually raising rates this year, we could start to see signs of stress in 2018, at which point broad diversification across a wide range of asset classes will help to protect portfolios from downside shocks.

Chart 9: VIX Volatility is low but could rise in 2018



ROYAL LONDON GMAPs ONE YEAR ON

We launched the RL Global Multi Asset Portfolios (GMAPs) in March 2016, aiming to maximise long run returns over inflation for given levels of risk. The portfolios balance growth assets like stocks, property and commodities against low volatility fixed income assets and absolute return strategies.

Chart 10: The GMAP range – spanning the risk-return spectrum

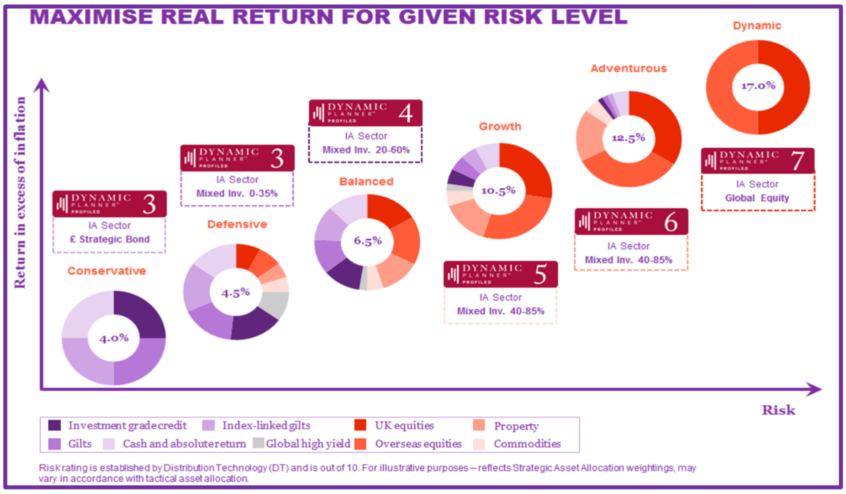
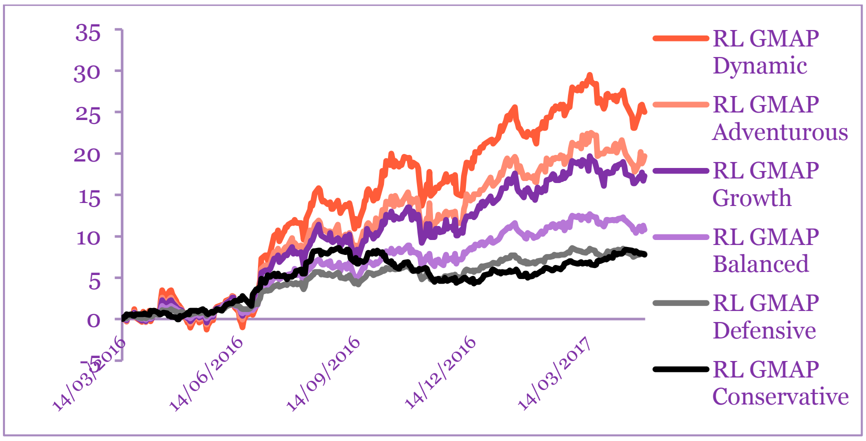


Chart 11: GMAP Performance since inception

The six funds have delivered absolute returns ranging from around 8% to 23%* over one year, with returns varying in line with the long run risk targets.

We are optimistic on returns over the next year but don't expect a repeat of 2016 which saw overseas assets and UK equities boosted by sterling weakness after the Brexit vote. Ironically, a good outcome in the EU negotiations could result in reduced sterling-based returns if the pound continues its recent recovery.



*Source: FE as at 30.04.2017. Total return in GBP, bid to bid, net of fees and taxes, net income reinvested for M Acc share classes. Past performance is no guide to the future.

Chart 12: Long-term estimates of GMAP risk and return

According to our capital market assumptions, if we are right that bond yields rise gradually over the next few years, funds with a 25% exposure to growth assets should outperform more conservative funds by quite a wide margin.

Meanwhile, taking an estimate of added value into account, funds with a 50-75% allocation to growth assets could deliver equity-like returns but at around half the level of risk.

% Growth Assets*	Expected Return (%)	Expected Risk (%)	As a % of Equity Risk
0	2.9	4.6	27%
25	5.9	4.9	29%
50	7.2	6.8	40%
75	8.6	10.7	63%
90	9.3	12.6	74%
100	9.5	17.1	100%

Source: Expected risk and return based on RLAM capital market assumptions as of March 2017. GMAP returns include an estimate of added value based on our tactical asset allocation models. Figures gross of fees. * Stocks, Property and Commodities.

WHERE WE STAND

We are slightly overweight stocks, tilted towards emerging markets and Japan, and have a small overweight in commodities. We are underweight US stocks and underweight bonds.

	--		-		=		+		++
Multi Asset									
Stocks							■		
Property					■				
Commodities						■			
Bonds			■						
Cash					■				

	--		-		=		+		++
Regional Equity									
UK					■				
US			■						
Europe					■				
Japan						■			
Pacific ex. Japan				■					
Emerging market						■			

Multi Asset: Overweight Equities and commodities; underweight bonds

- We have been overweight equities since 2012 on the back of continued recovery and loose policy. Signs of a cooling off in global growth have led us to reduced overweights ahead of the summer but we would most likely buy dips.
- We remain underweight bonds, although less so than previously. Quantitative easing and pension fund buying have pushed yields to levels that make no sense in the long run but inflation pressures are easing currently.
- We are neutral to slightly overweight UK commercial property. A positive supply/demand backdrop and a large rental yield cushion should make UK property resilient and it has proven to be so since the Brexit vote.
- We retain a moderate overweight in commodities. A tightening supply-demand balance supports higher prices but recent signs of weakness in China are a concern.

Equity Regions: Overweight Emerging Market and Japan; underweight US and neutral Europe

- Japan: Overweight on the basis of reflationary fiscal and monetary policy and a tendency to do well when the dollar is strong. We are overweight in our funds, with the yen hedged where possible.
- Emerging markets: We have been overweight emerging market equities as the global recovery is positive for these countries.
- Europe: We raised exposure to neutral after the French elections. Further outperformance is possible in the near term but we remain concerned about political risk which is likely to rise again in the next economic downturn.
- UK: We are broadly neutral on UK equities. Monetary policy will remain loose but Brexit risks will increase after the General Election as negotiations start in earnest.