PREMATURE RECESSION FEARS

Issue #15

ROYAL LONDON
ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £118.9 billion in life insurance, pensions and third party funds*.

The Multi Asset team manages the Governed Range pension funds and Global Multi Asset Portfolios (GMAPs) available on a wide range of platforms.

*As at 30/09/2018

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Investor sentiment is extremely depressed with our composite indicator registering two of its most extreme negative readings ever in Q4 2018. We think markets are premature to price in a US recession and we start the year constructive on equities.

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

In our last report, "A Pivotal October", we predicted an upturn in volatility. The Investment Clock was in Stagflation and geopolitical risk was rising. We went into the initial selloff neutrally positioned in our multi asset funds and bought at the lows. We think the further leg down in December was linked to threatened year end tariff increases. Recession risks are rising but sentiment is depressed, the oil price is down and China is adding stimulus. We start 2019 constructive on stocks but expect to get more cautious as the year progresses. Brexit remains a source of great uncertainty. Here we are hedging risks rather than positioning for a specific outcome.

The Christmas Crash

We expected stock markets to weaken in October but Wall Street went on to suffer its worst December since the Great Depression. We put this down to a sudden and possibly temporary weakening in US and global growth linked to the threatened imposition of 25% tariffs on China at year end. Thin holiday markets also had to contend with erratic White House announcements and a delay in the Brexit vote.

Near-term recession risks overdone

We are late in the business cycle and volatility is likely to remain high but we think markets are premature to be pricing in a US recession. The US labour market remains strong, fiscal policy is loose and the US Federal Reserve (Fed) is close to pausing its rate hikes. Housing weakness is a concern but a sharply lower oil price should boost US consumer spending in 2019. Meanwhile China is easing policy again, in part to offset a tariff increase that has been suspended and may never come into force.

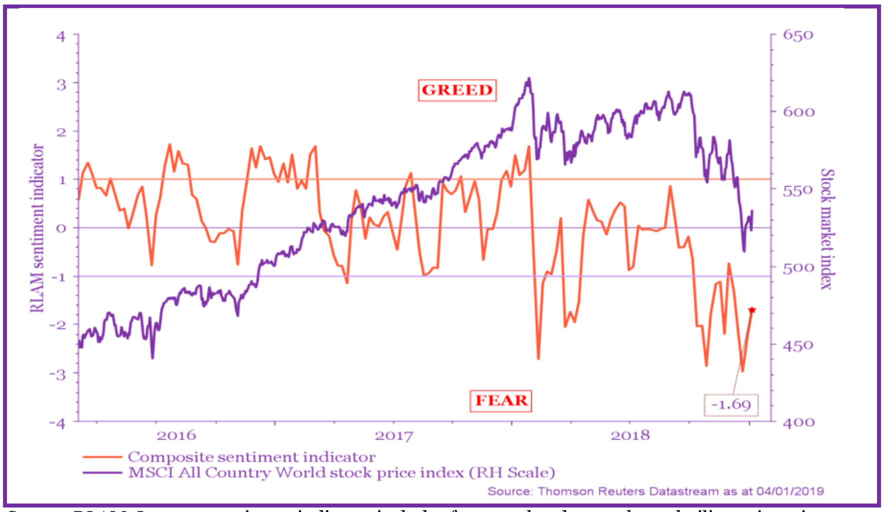
Positive on equities but expecting to get more cautious

With investor sentiment extremely depressed (see focus chart) we start the year constructive on stocks. We expect to become more cautious as the year progresses. There isn't much spare capacity in the US economy and a sharp recovery in China could lead to Fed over-tightening, raising the risk of a full blown recession in 2020.

How to prepare portfolios for Brexit

The Brexit situation remains deeply uncertain. There are many possible outcomes ranging from a No Deal exit to a referendum on the final deal that could see the UK remain in the EU on current terms. Sterling could go either way. Investors may try to hedge risks by investing across assets that will perform well in a range of different scenarios rather than positioning for any particular development.

Focus chart: Investor Sentiment and Global Stock Prices



Source: RLAM. Investor sentiment indicator includes factors related to market volatility, private investor bullishness and US director buying of shares in their own companies.

VOLATILITY IS BACK!

Volatility returned with a vengeance in 2018 after an unusually quiet 2017. Global stock markets saw some wild swings and ended the year lower in sterling terms for the first time since 2011. Our benchmark for balanced-risk multi asset funds registered its first annual decline since 2008, however, UK property was a relatively bright spot and diversification limited losses to low single digits.

Table 1: Sterling-based returns by calendar year

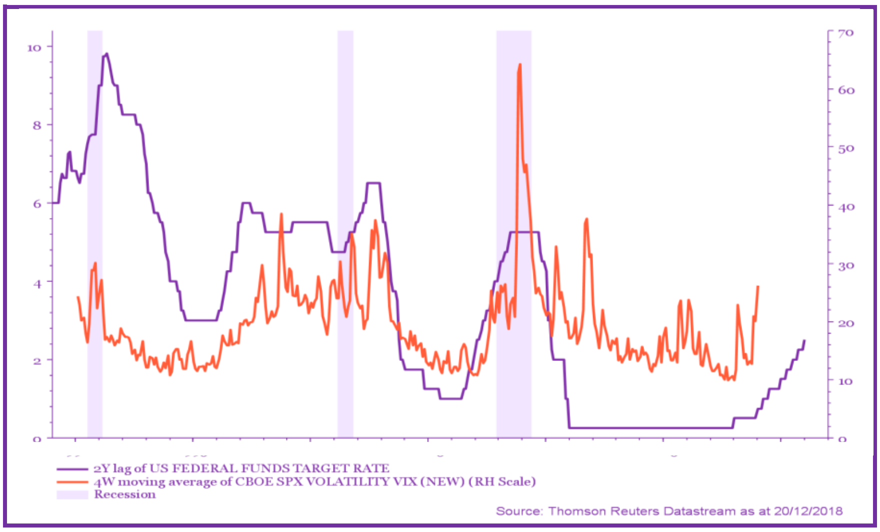
Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1	EM Stocks +37.4%	Gilts +12.8%	EM Stocks +62.5%	EM Stocks +23.6%	Gilts +15.6%	EM Stocks +12.8%	Global Stocks +21.2%	Property +19.5%	Property +13.9%	EM Stocks +35.4%	EM Stocks +21.1%	Property +7.2%
2	Commodities +14.3%	Cash +5.7%	UK Stocks +30.1%	Commodities +20.5%	Property +8.1%	UK Stocks +12.3%	UK Stocks +20.8%	Gilts +13.9%	Global Stocks +4.4%	Commodities +33.3%	Global Stocks +14.0%	Cash +0.6%
3	Global Stocks +11.2%	Multi Asset -10.4%	Global Stocks +20.6%	Global Stocks +17.2%	Multi Asset +1.6%	Global Stocks +12.1%	Property +11.0%	Global Stocks +12.2%	Multi Asset +1.8%	Global Stocks +30.3%	UK Stocks +13.1%	Gilts +0.6%
4	Cash +6.0%	Commodities -10.9%	Multi Asset +12.6%	Property +14.7%	Cash +0.6%	Multi Asset +7.1%	Multi Asset +7.3%	EM Stocks +7.9%	UK Stocks +1.0%	UK Stocks +16.8%	Property +11.2%	Multi Asset -1.2%
5	Multi Asset +5.5%	Global Stocks -18.5%	Commodities +5.9%	UK Stocks +14.5%	UK Stocks -3.5%	Gilts +2.7%	Cash +0.5%	Multi Asset +6.5%	Gilts +0.6%	Multi Asset +12.1%	Multi Asset +6.3%	Global Stocks -3.1%
6	UK Stocks +5.3%	Property -22.6%	Property +1.9%	Multi Asset +11.7%	Global Stocks -6.9%	Property +2.3%	Gilts -3.9%	UK Stocks +1.2%	Cash +0.5%	Gilts +10.1%	Gilts +1.8%	Commodities -5.7%
7	Gilts +5.3%	UK Stocks -29.9%	Cash +1.0%	Gilts +7.2%	Commodities -12.7%	Cash +0.6%	EM Stocks -5.3%	Cash +0.5%	EM Stocks -10.3%	Property +2.6%	Cash +0.3%	EM Stocks -7.6%
8	Property -5.4%	EM Stocks -34.8%	Gilts -1.2%	Cash +0.6%	EM Stocks -18.4%	Commodities -5.4%	Commodities -11.2%	Commodities -11.8%	Commodities -20.3%	Cash +0.4%	Commodities -7.1%	UK Stocks -9.5%

Past performance is not a reliable indicator of future results. Source: RLAM, DataStream as at 31 December 2018; Property Return as at November 2018. Multi Asset returns are based on the benchmark asset mix of the Royal London Global Multi Asset Portfolio (GMAP) Balanced Fund / Governed Portfolio 6 (GP6).

We are late in the business cycle and stock market volatility is likely to remain high over 2019. Volatility usually rises about two years after the US Federal Reserve starts to hike interest rates. 2018 was right on cue.

Markets tend to calm down again once interest rates have been cut and a new economic recovery is underway but that still feels a way off, so we should probably get used to wide trading ranges.

Chart 1: Fed Funds as a 2 year lead of stock market volatility

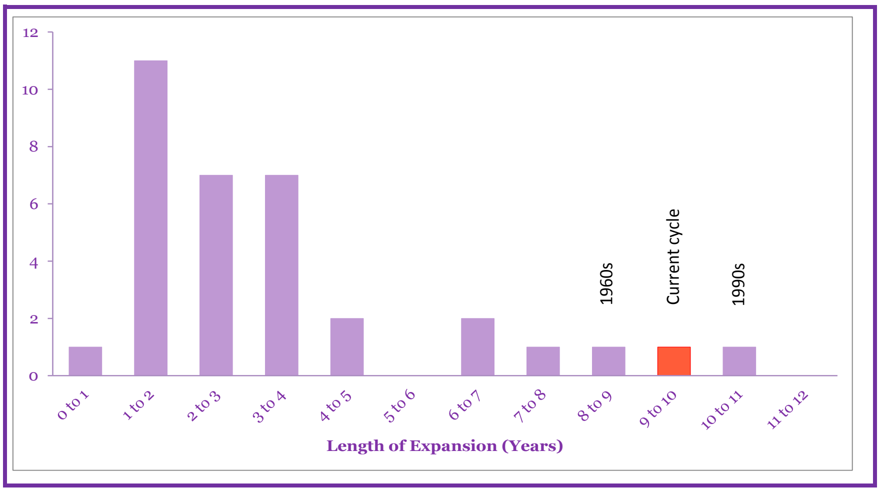


Past performance is not a reliable indicator of future results. Source: RLAM, Datastream

MARKETS PRICING IN RECESSION

Bull markets in equities are linked to expansion phases in the world economy. At nine and a half years and counting this has been the second longest US expansion on record. The economic expansion has to last another six months to equal that of the record-breaking 1990s. Market participants doubt it will make it.

Chart 2: US business cycle expansion lengths: 1857 to 2019

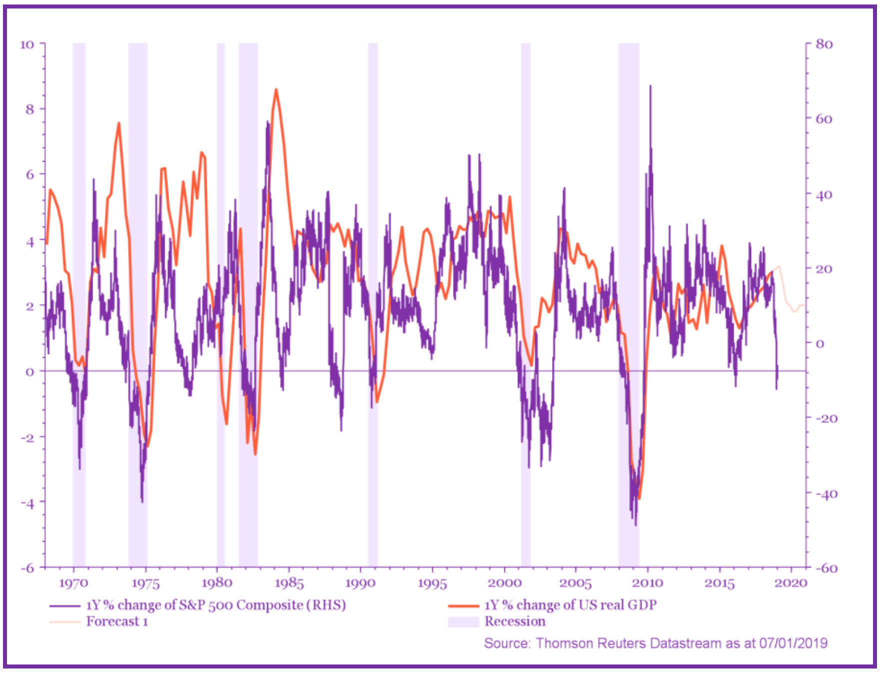


Source: RLAM, National Bureau of Economic Research.

The drop in stock prices over the last year is pricing in a recession in the US economy. Stock markets don't always get it right, though. Prices moved sideways in 2011 and dropped in 2015/16 with the economy slowing rather than stalling in both cases.

December weakness may reflect a temporary drop in activity associated with the timing of threatened tariff increases. Investors were also surprised by President Trump attacking the independent Federal Reserve, unexpectedly recalling troops from Syria and triggering a US government shutdown, not to mention the delay in the UK's Brexit vote.

Chart 3: US equity prices and GDP growth



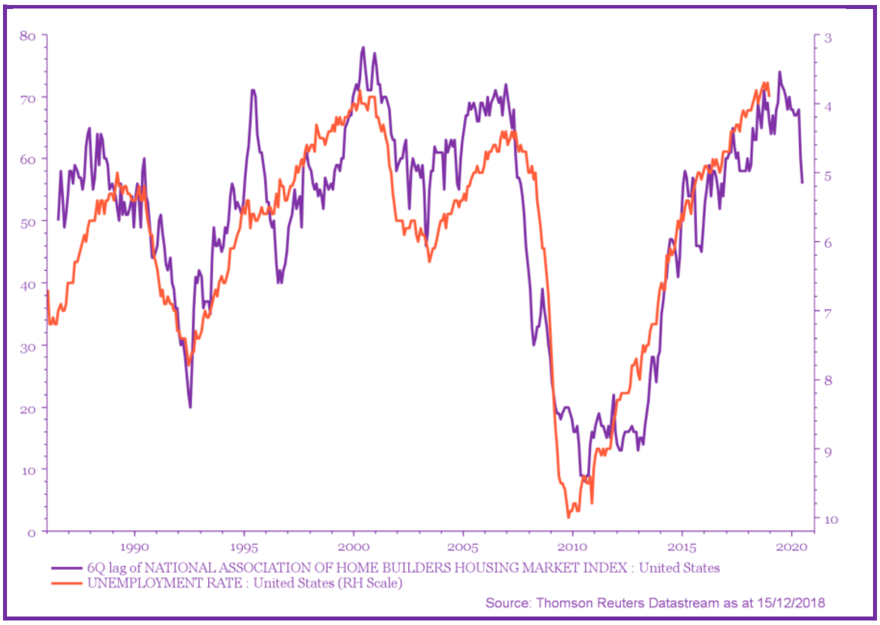
Source: RLAM, NBER. Shaded bars represent US recessions. Forecast 1 is based on RLAM economic forecasts.

US DATA INCONSISTENT WITH RECESSION

Global growth has been slowing for a year or so, led by China but with European data also weakening markedly. The US economy remains relatively strong on the back of Trump's tax cuts and spending increases. Jobs are still being created and real interest rates are low.

The softening in US housing market indicators is a concern as housing can be a good lead indicator for the broader US economy. The lags are long however. If recent deterioration continues the usual relationship suggests a recession with rising unemployment going into 2020, not in early 2019.

Chart 4: Housing as a lead indicator for unemployment rate

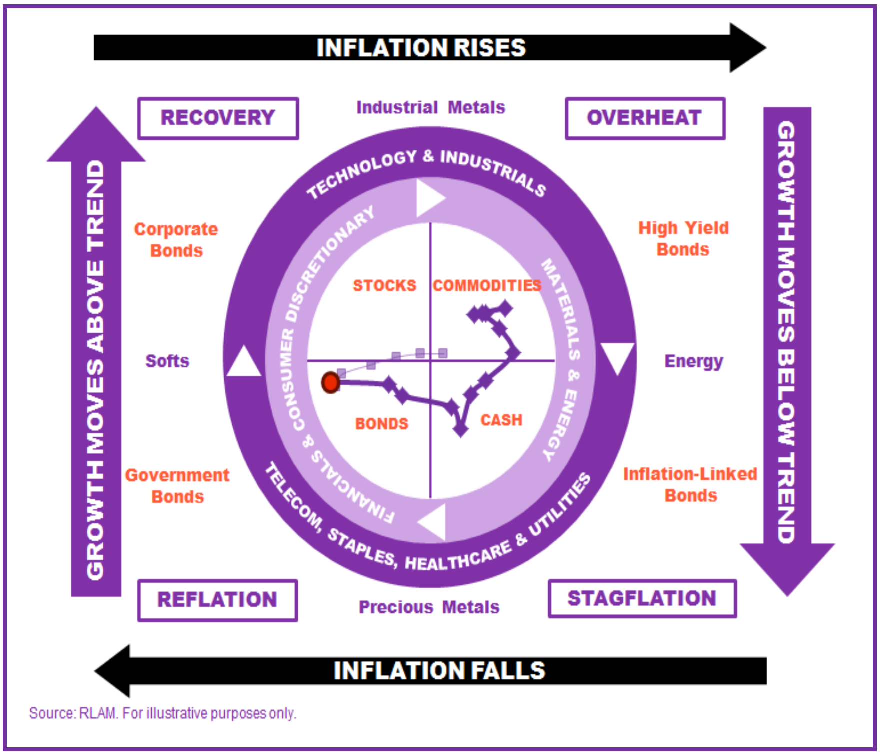


Source: RLAM.

The Fed may also be close to pausing their rate hikes as their intention is more to normalise rates than move to a restrictive monetary stance.

Market volatility clouds the outlook, business confidence is dropping and a plunge in the oil price is taking inflation out of the system. Our Investment Clock model has moved out of Stagflation into bond-friendly Reflation, the phase of the business cycle in which central banks tend to cut not raise interest rates.

Chart 5: The Investment Clock out of Stagflation



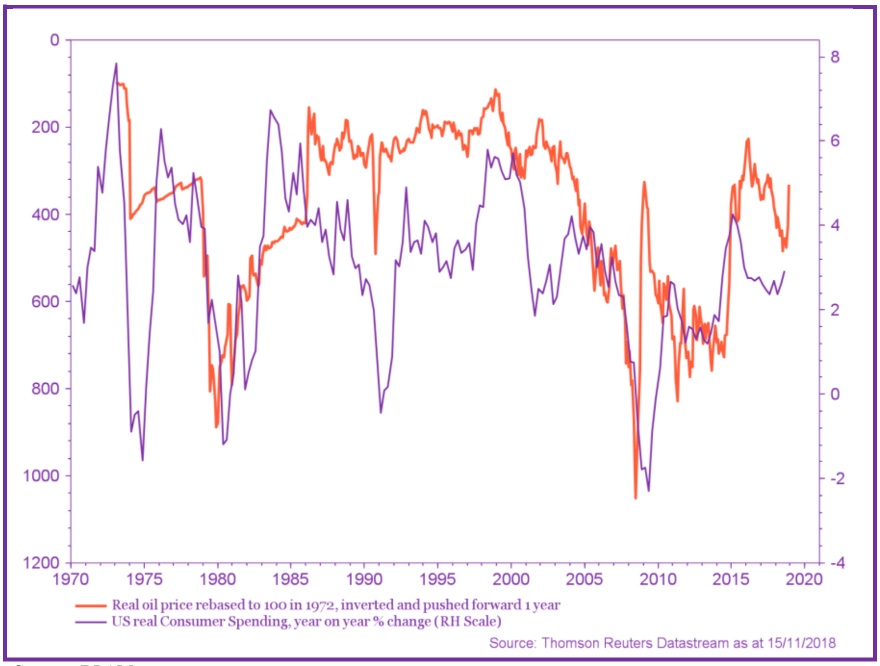
Note: Trail based on monthly evolution of RLAM growth and inflation indicators. Red dot shows current month.

GROWTH COULD STILL SURPRISE POSITIVELY

We believe expectations are so low it's worth asking where growth could surprise positively.

The collapse in energy prices in late 2018 sets the scene for a strong US consumer in 2019. The oil price (shown here in real terms and inverted) is a good one year lead indicator for US consumer spending. A lower oil price was part of the reason for the sharp upturn in growth in 2016/17.

Chart 6: Oil price and US consumer spending

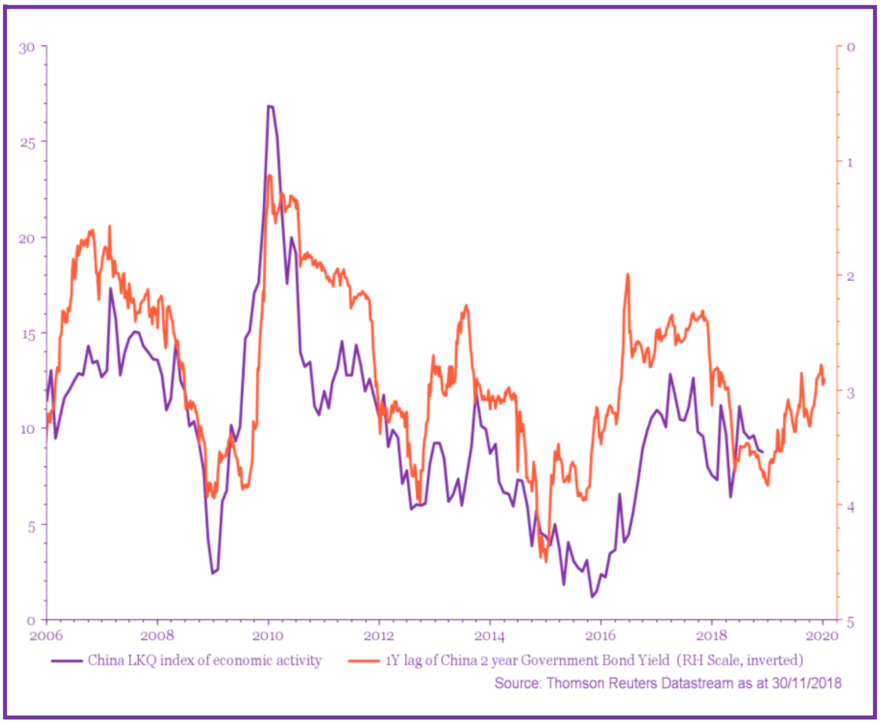


Source: RLAM.

Chinese authorities have been stimulating the economy and have sent signals of more stimulus to come, to counter the slowdown and offset the impact of US tariffs. Alongside repeatedly cutting banks' reserve requirements, Chinese authorities have been quietly easing monetary policy over the last year judging by the drop in Chinese bond yields (shown here inverted). Fiscal stimulus appears to be underway. Tax cuts and further stimulus measures are widely expected.

China was the swing factor that turned a soggy 2015/16 into a strong 2017/18 so bears close watching.

Chart 7: Chinese economic activity and bond yields



Source: RLAM.

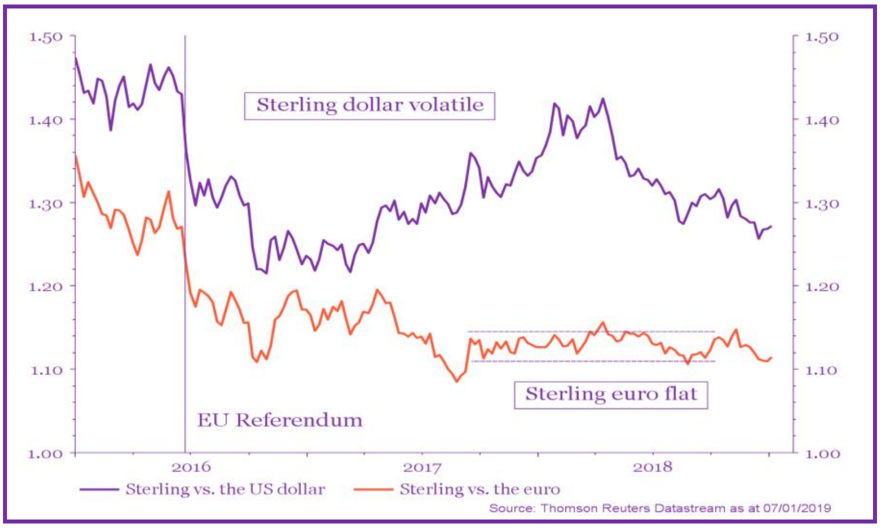
It usually pays to be bold when others are fearful. We start the year constructive on stocks but we expect to become more cautious as the year progresses. There just isn't much spare capacity in the US economy. A sharp recovery in China could lead to Fed over-tightening, raising the risk of a full blown recession in 2020.

HOW TO PREPARE FOR BREXIT - OR FOR NO BREXIT

The Brexit situation remains deeply uncertain. There are many possible outcomes ranging from a No Deal exit to a referendum on the final deal that could see the UK remain in the EU on current terms. Sterling could go either way.

Investors may try to hedge risks by investing across assets that will perform well in a range of different scenarios rather than positioning for any particular development.

Chart 8: Sterling vs the US dollar and the euro

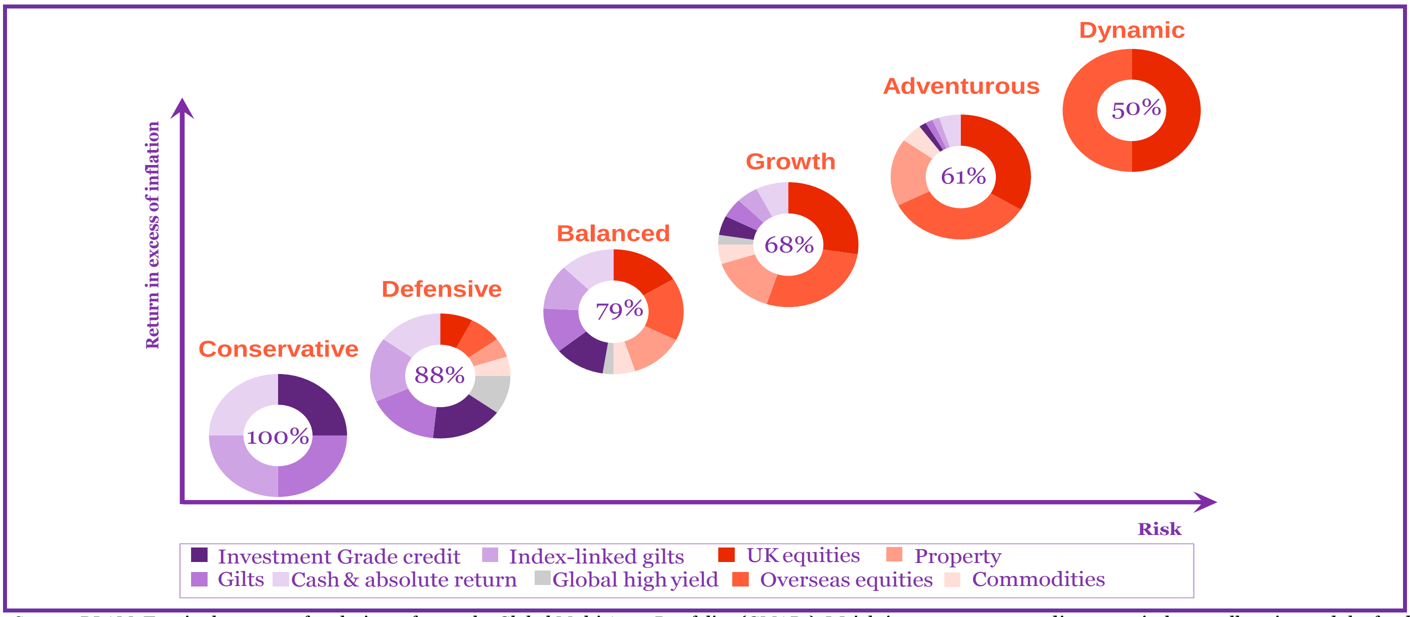


Source: RLAM, Thomson Reuters Datastream as at 05/10/2018.

We have three pragmatic suggestions when preparing portfolios for Brexit risk.

1. Resist the temptation to forecast. A final decision may come very late and involve unexpected developments.
2. Investors with a lower risk appetite may wish to consider investing in lower risk portfolios with a higher proportion of their assets in sterling-denominated investments, reducing exposure to potential currency volatility.
3. Consider investing in growth-seeking assets that would do well in different scenarios. We include commercial property alongside equities. Property may do well if the UK ends up in a closer relationship with the EU. Equities may potentially do better in a more distant relationship, accompanied by a weaker pound inflating the value of overseas earnings.

Chart 9: RLAM GMAP range with percentage sterling exposure for each benchmark (in centre)



Source: RLAM. Text in the centre of each ring refers to the Global Multi Asset Portfolios (GMAPs). Weightings may vary according to tactical asset allocation and the fund may invest outside of indicated asset classes as the manager sees fit.

WHERE WE STAND

We are overweight stocks, tilting towards emerging market equities. We have a modest overweight position in high yield bonds. We are underweight European stocks and underweight commodities.

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

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

Source: RLAM. Tactical positions as of January 2019. Weightings may vary according to tactical asset allocation and the Fund may invest outside of indicated asset classes as the manager sees fit.

Multi asset: overweight equities and high yield; underweight commodities

- We cut the size of our overweight in equities at the late January 2018 highs and bought back aggressively during the February/March market panics. We took profits in the subsequent recovery and our overweight in equities was at its lowest level since 2012 before the October stock market crash.
- With investor sentiment beaten up, we have been buying stocks on weakness once more and we are now overweight. We are very much aware of the short-term risks but we think markets are premature to price in a US recession and we have been buying stocks at lower prices in the expectation of a more positive first half of 2019.
- We remain overweight short duration high yield as near-term recession risk is still low.
- We are neutral UK property. A positive supply / demand backdrop and a rental yield cushion make UK property relatively resilient at the moment but Brexit risks to the City of London remains a worry.

Equity regions: overweight emerging markets (EM); underweight Europe

- We have been underweight emerging markets which has been beneficial in 2018. We have been buying back. Emerging markets have been beaten up and could benefit from the lagged impact of Chinese stimulus and potential dollar weakness if the Fed blinks further.
- European data have so far been worse than expected and some of the weakness is due to internal issues with Brexit and other political risks growing. Despite the weakness, the European Central Bank could be quite far from altering its course.