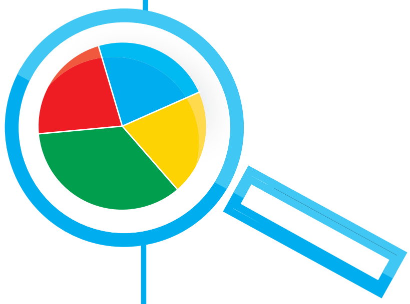
# Emerging markets lead the way

The global risk asset rally continued in early 2017, with emerging market investments the star performers.




## RISKS

- Increase in political risks across most Western countries: Europe's turn in the spotlight
- Global debt burdens (and associated servicing costs) remain a concern in emerging markets
- Difficulties in normalising monetary policy could only become apparent as policymakers unwind emergency measures
- Shrinking valuation buffers in most risk assets (i.e. higher equity multiples, tighter credit spreads)

## OPPORTUNITIES

- Bouts of investor nervousness and volatility may present recurrent opportunities to add risk at attractive levels
- Potential US dollar strength as Fed hikes come back into focus
- Potential for higher inflation not yet reflected in index-linked markets
- Asset purchases by central banks (outside of the US) could keep asset prices supported

| Overview | Views |
|---|---|
| Equities | Neutral |
| Govt. bonds | Mild dislike |
| Credit | Neutral |
| Real estate | Mild bias |
| Commodities | Neutral |

| Equities | Views |
|---|---|
| US | Neutral |
| UK | Neutral |
| Europe | Neutral |
| Japan | Neutral |
| Emerging markets | Mild dislike |

| Fixed Income | Views |
|---|---|
| Nominal govt. bonds | Mild dislike |
| Inflation-linked | Mild bias |
| Investment grade | Mild dislike |
| High yield | Mild dislike |
| Emerging market debt | Moderate bias |

| Currencies | Views |
|---|---|
| US dollar | Mild bias |
| Euro | Mild dislike |
| Sterling | Mild bias |
| Yen | Neutral |
| EM FX | Moderate dislike |

**Key**

| | | | | | | |
|---|---|---|---|---|---|---|
| Strong dislike | Moderate dislike | Mild dislike | Neutral | Mild bias | Moderate bias | Strong bias |

*Asset allocation views represents the viewpoint of the asset allocation team at LGIM

Legal & General INVESTMENT MANAGEMENT

Global equity markets extended their move higher in the first quarter of 2017. The Dow Jones index remained in the limelight, rising to new all-time highs above 21,000 as investors continued to anticipate lower tax rates and higher government spending following President Trump's election. Emerging market equities were the standout performers over the quarter as falling concerns over the geopolitical implications of a Trump Presidency and a cyclical upturn in the Chinese economy provided a tailwind for investor sentiment. A weaker dollar also supported appetite for emerging market investments.

A notable feature of global bond markets was a divergence in the performance of short and long-term interest rates. Short-term rates rose, particularly in the United States with the Federal Reserve (Fed) opting to hike US rates in March by 0.25%. The Fed took this decision amid continued strong economic and inflation data, as well as the ongoing rise in US stock markets. However, long-term rates actually fell, as investors bet on the tighter monetary policy to moderate longer-term growth. In terms of fixed income asset classes, global high yield bonds outperformed investment grade credit, with the increase in global risk appetite continuing to support sentiment.

## SHORT-TERM OUTLOOK

**Brexit becomes official: what now for sterling?**

The two-year window for official negotiations on Brexit has now started. In our view a 'hard Brexit' could be negative for sterling, but we only attribute a 30% probability to this scenario. For now, we are watching carefully whether the EU starts to move to a state where it allows parallel talks on both the exit and future relationships, or whether the UK starts to move behind the EU's view. Our base case is that there will not be enough time to negotiate a comprehensive deal, so a transitional arrangement is likely. We remain long sterling given our above-consensus assessment of economic growth and our belief that sterling is cheap on traditional PPP (purchasing power parity) valuations.

**Can markets continue to rally?**

Markets learnt in March what Geoffrey Chaucer already knew in the 14th century: "All good things must come to an end". For the first time since October last year, the S&P 500 fell by more than 1%.

The number of days without a 1% decline is a meaningless statistic in our view, and we find no relationship with subsequent performance. So, what's next? US equities have moved to the edge of what we would consider fair value. When equities rally beyond fair value it makes us more inclined to listen to tactical signals from our sentiment indicators. On that front we find no evidence of excessive investor bullishness, so for now we're happy to keep a tactically neutral view of equities.

**Let's not forget about China...**

The Chinese yuan has appeared to be stable over the last couple of months, giving the impression that capital outflows have been stemmed. However, we believe there is more to this than meets the eye. Chinese authorities had to tighten capital controls, introduce a trade-weighted basket to diffuse the attention from the US dollar peg, and intervene heavily in the yuan market. The side effects of government intervention are increasingly apparent in the Hong Kong dollar (HKD) market, and we believe that a short position in the HKD offers an interesting way for investors to seek to protect against the risk of another round of market stress stemming from potential yuan depreciation.

## OUR MEDIUM-TERM VIEWS

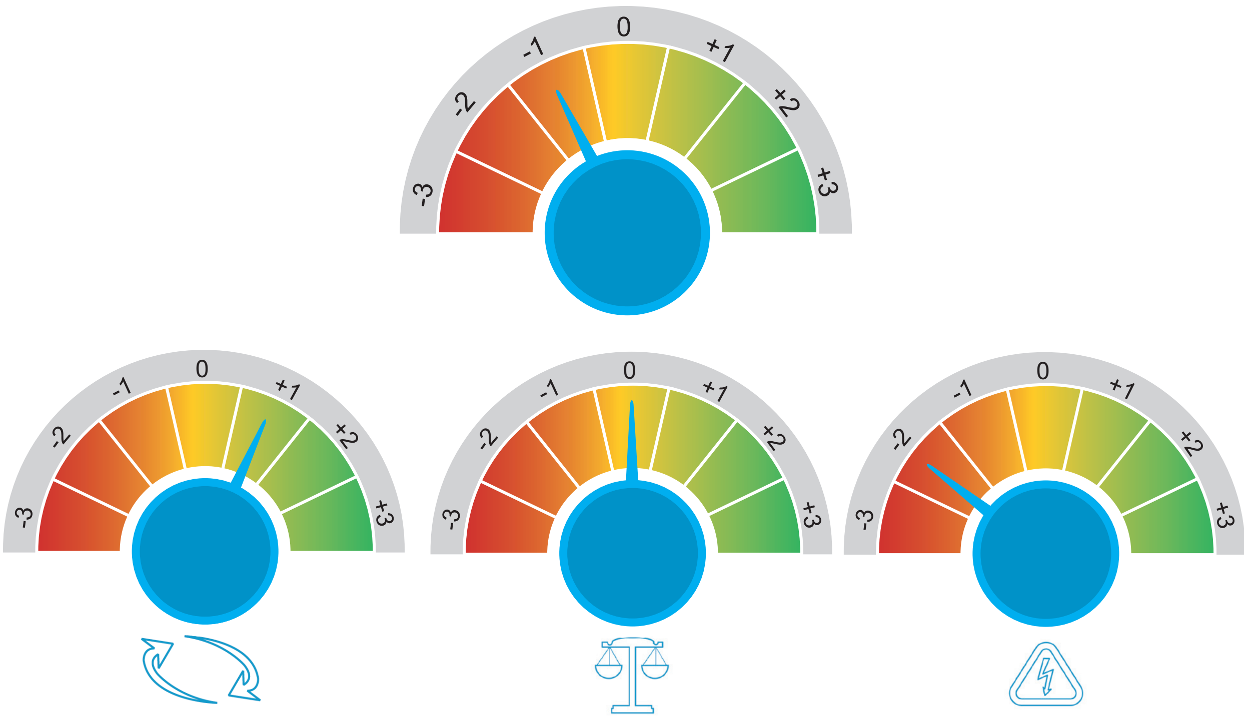
Next to our medium-term framework for risk assets, which continues to point to a mildly cautious stance (see dials), we have four themes that influence our medium-term thinking. First among those is our belief that interest rates are likely to be held down by the burden of poor demographics and heavy debt burdens. This "lower for longer" outlook does not imply being permanently bullish on bonds irrespective of the level of yields, but it does make us very sceptical about the "death of the bond market" and "great rotation" narratives. This gives us a bias to hold relatively stable, income-generating assets.

Second, policy divergence between the USA and the rest of the developed world is likely to persist. The Federal Reserve has already hiked interest rates three times while other central banks remain committed to easing. That puts secular upward pressure on the US dollar relative to other currencies and acts as a headwind to both commodities and emerging market equities.

Third, the new political paradigm is our recognition that politics now matters enough to have a first order impact on markets. Investors' obsessions with opinion polls and elections is warranted given the shocks of the last twelve months and implies that political shocks are likely to drive episodes of volatility.

Fourth, we need to remember the lingering risk of an extreme economic policy option in the form of helicopter money. We define helicopter money as temporary fiscal stimulus financed by permanent monetary expansion. It potentially puts an implicit floor under any significant sell-off in risk assets (especially in those countries, such as Japan, where it is most likely to be initiated).

## Medium term views for risk assets




**Economic cycle**
Economy remains mid cycle, but getting closer to late cycle

**Valuations**
Risk asset valuations are not excessive

**Systematic risk**
Material risks from Brexit/Trump/Europe and emerging market debt

### EQUITIES

The first quarter was a remarkable one for equities. After solid returns in 2016, global equities continued to rally, rising by almost 7%. Even more unusually, these returns have been delivered with record low volatility. Starting in October, the S&P 500 saw not a single day with a decline greater than 1% through mid-March, which was almost a record run.

How could this happen? Q1 delivered an equity friendly mix of improving growth data and declining risk factors. The 'Good Trump' or 'Bad Trump' debate developed very much towards the 'Good Trump' scenario, as the first foreign policy decisions were less chaotic than feared. At the same time China also stayed fairly quiet on the back of improving growth and a growing consensus that Chinese policymakers would avoid rocking the boat ahead of the autumn power shift. Improving macro growth data was the second equity-friendly development. This has given a particularly strong boost to cyclicals, which posted one of the strongest periods of outperformance over defensives on record.

While 'Bad Trump' risks were largely priced out during Q1, some of the 'Good Trump' optimism also faded later in the quarter. This was particularly evident with the failure of the healthcare bill which dampened hopes of legislative progress on other agenda items as well. Trump trades such as US small caps and banks both gave back some of their earlier gains, though both remain up on pre-election levels.

Looking ahead into Q2, we have relatively few strong views on equity regions. We are structurally and tactically cautious on emerging market exposure. Having cut our Japan equity long early in Q1, the recent underperformance is beginning to make the region look interesting again. The fundamental prospects for Eurozone equities have improved, but the tactical outlook remains driven by the French election. The recent rally seems to have priced out a significant amount of French election risk, eating into any potential post-election bounce should an extreme outcome be avoided

## FIXED INCOME

After the fireworks of the final quarter of 2016, bond markets were relatively quiet in the first quarter of 2017. Across global sovereign bond markets, the continental European market was the underperformer with German bund yields up around 10bps on the quarter. In contrast, we saw a small drop in both UK gilt yields and US treasury yields. With yields having dropped significantly since their peak mid-way through Q4, we once again moved to a bearish tilt on sovereign duration in the near term. In contrast, our structural outlook remains fairly constructive with 'lower for longer' as one of the anchor themes of our risk-taking.

Central bank policy was a key market focus in Q1, after the pivot in attention to fiscal plans in the preceding quarter. The Bank of England has stayed out of the limelight, but the Federal Reserve and European Central Bank (ECB) received attention for very different reasons. The Federal Reserve delivered the third increase in the current hiking cycle to bring the Fed Funds target range up to 0.75-1.0%, but markets remain extremely sceptical about whether they can deliver a sustained sequence of increases. Across the Atlantic, the tussle between hawkish and dovish factions on the ECB's Governing Council has again come out into the open. The latest battleground is over the explicit sequencing in their forward guidance which states that interest rates are expected to remain "at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases". We expect that sequencing to be respected, but the very fact that it is being questioned by policymakers has been enough to unsettle market expectations.

Credit markets continued to grind tighter. In particular, global high yield spreads dropped for their sixth consecutive quarter and are now down over 400bps from their peak in early 2016. Given that significant tightening is now behind us, we struggle to see ongoing value in the asset class and have reduced our exposure accordingly. The outlook for investment grade markets will be set by the impact of corporate tax reform on the supply of corporate credit. We have learnt little new on that front in Q1, with investment grade spreads quiet as a result.

Emerging market debt spreads were also little changed. We continue to view emerging market sovereigns as an interesting place to source healthy risk-adjusted returns and remain overweight over the medium term.

Looking ahead to the second quarter, the political agenda is set to dominate. In Europe, the outcome of the French presidential election (split over two rounds on 23 April and 7 May) could dictate the outlook for fixed income securities. A victory for an explicitly anti-European candidate on the far-left or the far-right of the political spectrum could pose a risk to financial stability. In North America, investors will be looking for clarity on whether the administration's talk of fiscal stimulus can morph into a tangible policy proposal.

## CURRENCIES

The first quarter started with a strong consensus on a continuation of the strong US dollar environment amid US reflation and Fed tightening. As often is the case when a strong consensus takes hold, it didn't materialise, despite another rate hike by the Fed. The US dollar lost some ground to G10 currencies, but lost meaningfully to emerging currencies. Investors learned once again that actions speak louder than words, and for President Trump's fiscal plans to be enacted it first needs to pass a 'go-slow' US Congress. On the issue of slapping tariffs on sectors and countries, Trump hasn't yet used this presidential power.

Reflation as a theme has not really disappeared, but it's not just a US story. The Fed has surprised markets by raising rates in March again, but at the same time the Bank of

England flagged concern over elevated inflation, while the ECB has started to taper and is expected to taper further at the end of the year. Monetary policy divergence has given way to convergence, at least for now, while the global (not only the US) economy is in a cyclical upswing.

However, we believe the market will swing back to expecting divergence. The Fed has embarked on rate hikes to tighten financial conditions, but in the first quarter has only seen conditions loosening amid a weakening US dollar, lower long-term interest rates, tighter credit spreads and rising equity markets. This forces the Fed to tighten monetary policy further, in the form of more rate hikes and/or shrinking its balance sheet by reducing the reinvestment of the proceeds from its bond holdings, which in turn could lead to a stronger US dollar.

We continue to expect sterling to show resilience against the US dollar and to gain against the euro on valuation grounds, but with a fair amount of volatility on the back of the ebb and flow of the Brexit negotiations. On the Japanese yen we keep a neutral position for now. The Bank of Japan, targeting a zero yield on 10-year Japanese government bonds, has made monetary policy dependent on global yields. In doing so it has made monetary policy pro-cyclical resulting in even more volatile swings in the Japanese yen. As such the yen may weaken in a strong US dollar environment, only to appreciate strongly during periods of heightened risk aversion.



## CONTACT US

For more information, contact your usual LGIM representative or Adam Willis on 020 3124 3207.

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