

Markets under the microscope

In this quarterly outlook we outline our asset allocation views and address four key questions on wages, sterling, trade and rates.



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Our global views in a snapshot:

1. Wage inflation puzzle

What has happened to wage inflation?

Waiting for global wage pressure may be like waiting for a bus

2. Sterling outlook

How vulnerable is the pound to capital outflows?

Demand for UK assets unlikely to disappear overnight

3. Trade volume pickup

How sustainable is the pickup in world trade growth?

Global trade recovery firming, but risks remain

4. Low nominal and real rates

What message should we take from low nominal and real interest rates?

Low interest rates have become a necessity and a vulnerability

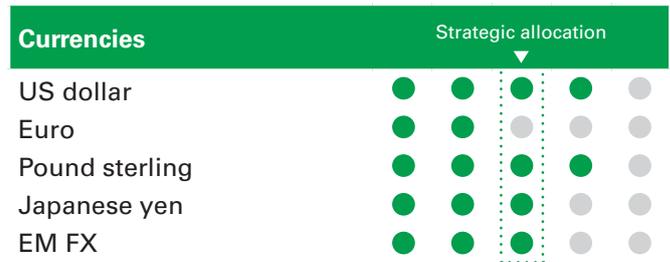
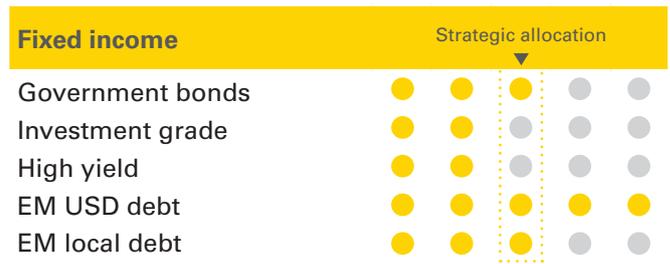
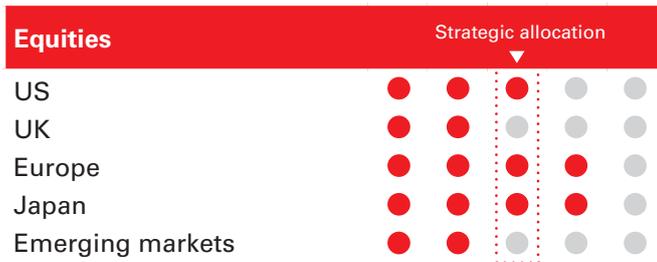
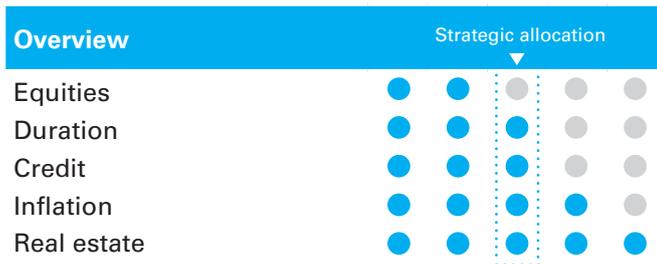
Over the last quarter, the core investment views of the Asset Allocation team have remained largely unchanged. Our economic outlook of mid-cycle expansion is consistent with steady but unspectacular returns, but we continue to worry about the latent systemic risks overlooked by the market, and accordingly we have a cautious stance on risk assets.

That is most clearly expressed via a medium-term underweight allocation towards equities. However, growing concerns about tight credit spreads also make us nervous about the return prospects in global high yield and European investment grade debt. Default rates are close to record lows, but so is the compensation for default risk.

We continue to look for inflation-protected cashflows offering positive real yields. US inflation-protected securities are one such asset, alongside alternatives (real estate and infrastructure) and pockets within the equity markets (European utilities). The yields on offer within emerging market debt (both local and USD) also look attractive relative to equivalent-rated risk elsewhere. We have upgraded our outlook on global duration after the recent back-up in yields and remain positioned for strength in the US dollar and British pound.

SUMMARY OF LGIM ASSET ALLOCATION VIEWS

This schematic summarises the combined medium-term and tactical views of LGIM’s Asset Allocation team.



The mid-point of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.

2017 Q3 – LGIM ASSET ALLOCATION INSIGHTS

This quarter, we’ve identified four big questions we believe are crucial towards understanding the economic and financial landscape:

- What has happened to wage inflation?
- How vulnerable is the pound to capital outflows?
- How sustainable is the pickup in world trade growth?
- What message should we take from low nominal and real interest rates?



1. What has happened to wage inflation?
Tim Drayson, Head of Economics

The lack of wage growth, despite an apparent return to full employment in a number of countries, is one of today’s biggest macroeconomic puzzles. We have seen lacklustre wages in the US, Germany, Sweden, the UK and Japan alongside falling unemployment rates and rising signs of recruitment difficulties.

This lack of wage inflation has allowed central banks to repeatedly defer aggressive monetary tightening and has given space for the steady expansion of corporate profits. In that sense, the lack of wage inflation has led to a goldilocks environment for global markets.

However, it is also something to worry about. If wage inflation cannot improve against a backdrop of falling unemployment and steady growth, what happens during the next global downturn? Does that make a Japanese-style drift into deflation a series concern?

In a recent [blog](#), I outlined 11 possible reasons for the lack of wage pressure. Some of these reasons are convincing in certain countries but don’t fit the facts in other countries. For example:

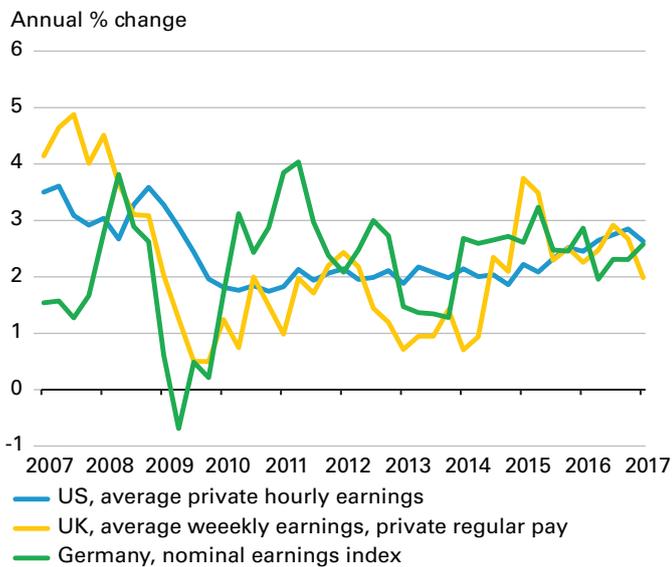
- Compositional effects have probably had the biggest impact in the UK where the rise of the ‘gig economy’ has led to compositional shifts within the workforce that have arguably held down overall pay growth (e.g. the sharp rise of self-employment)
- Hidden slack in the labour market resonates most in the US where falling unemployment has come alongside falling participation. Millions of people on the sidelines of the labour force represent a hidden slack that could be absorbed by continued strong employment growth

- Low inflation expectations look most appealing in Germany, Sweden and Japan. Given that inflation expectations are partially backward-looking, these expectations have been held down by weak commodity prices and low headline inflation

In addition, one common factor that helps explain the downshift in wage growth is the weakness in productivity growth. In a competitive labour market, workers are paid in line with their contribution to output. If weak capital investment has held down growth, then it is almost inevitable that it will map into weak real wage growth.

There is a lot of uncertainty about how long the puzzle will persist. But I'm not ready to abandon the basic premise that a tightening labour market will eventually lead to stronger wage pressure. In any market, there is upward pressure on prices when demand outstrips supply. To the extent that a common factor (e.g. weak productivity growth) has been the driver, waiting for signs of global wage pressure may be like waiting for a bus: although nothing may have happened for a long time, there is a risk that several come along at once.

Figure 1: Subdued wage growth everywhere



Source: Macrobond, LGIM



2. How vulnerable is the pound to capital outflows?

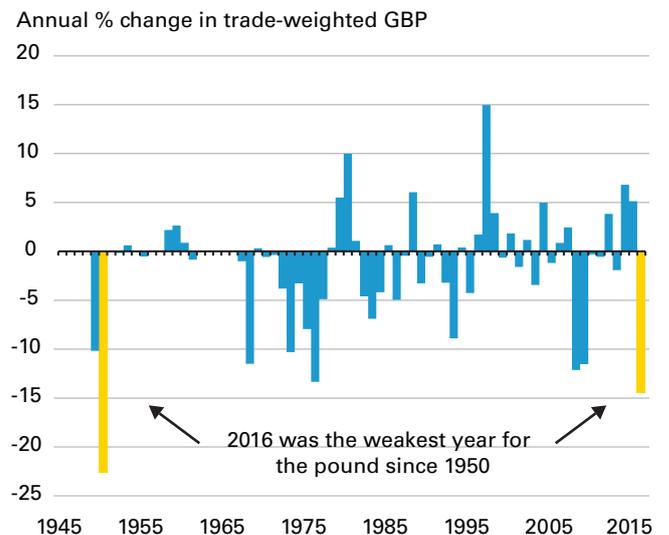
Willem Klijnstra, Asset Allocation Strategist

The UK's current account deficit has been described as large and unsustainable. Combined with a Brexit-induced slowdown of capital inflows, this could lead to a balance of payments crisis and a currency collapse. However, sterling has already weakened substantially. The fall in the value of the pound in 2016 was the largest in any calendar year since 1950.

In our view this sterling depreciation will turn out to be sufficient to make the current account deficit sustainable.

The UK's current account deficit can be broken into two components: the trade deficit and the primary income deficit. Trade doesn't respond quickly to a fall in sterling and this part of the deficit may turn out to be sticky, but the primary income balance will likely correct rapidly. Recently, the UK has received less income on its foreign assets than it pays out on its liabilities. This is hardly a sign of domestic weakness, and something that automatically adjusts with a weaker sterling.

Figure 2: The GBP collapse has already happened



Source: Bank of England, LGIM

So, the amount of foreign capital inflows necessary to support the pound is likely to be smaller in future years than it has been in the past. Brexit may temporarily reduce foreign direct investment (FDI) inflows, but demand for UK assets will not disappear overnight. The UK has a lot to offer, including a diversified economy and a robust legal system. A very hard Brexit (i.e. trade only under WTO rules) could do considerable damage to capital inflows, but it is our judgement that those risks are already reflected in the price.

Provided that the Bank of England keeps on targeting inflation in-line with its mandate, then there is always the prospect of interest rate support for the exchange rate. Recent communications suggest that they are quite close to limits of their tolerance for an extended overshoot in inflation. With market sentiment on sterling and the UK economy quite negative and investor positioning short, we are willing to be long sterling as a medium-term trade on valuation grounds.



3. How sustainable is the pickup in world trade growth?

Magda Polan, Global EM Economist

Global trade regained some vigour recently. After rising by an average of 2% between 2012 and mid-2016, the global volume of exports and imports jumped by more than 6% in early 2017 (compared with the same period one year earlier). The value of international trade (the monetary value measured in US dollar or national currencies) also expanded at a fast pace, up 15-18% in early 2017, compared with a mild contraction as recently as 2015.

This is very positive for the global economy. Exports are still an important growth driver for many economies, both developed and emerging. This is especially true for smaller economies where domestic consumption and investment can't compensate for swings in global demand. But what are the factors driving this recovery in trade? And can it last?

There is no single factor responsible for this pickup in global trade. One is a recovery in commodity prices. While

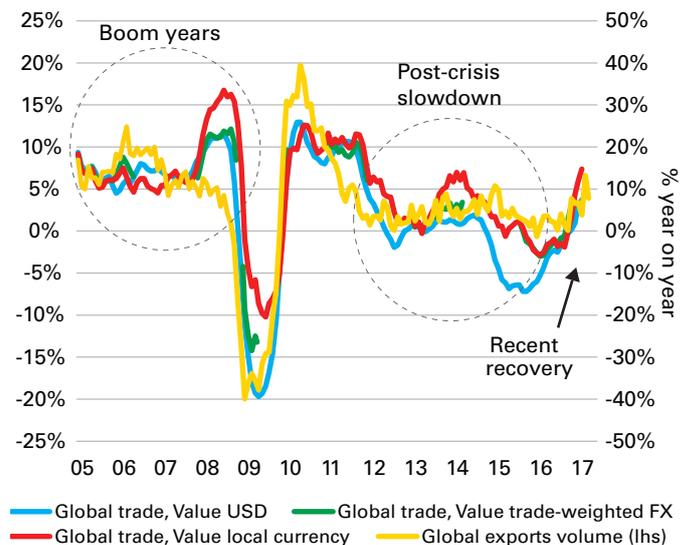
these also depend on global demand, higher prices and thus profits of producers often lead to higher volume in the commodities trade. But commodities – and especially fuels – do not explain all the recovery in global trade; in fact, other goods have contributed more to the increase in global trade.

The other factor is strong growth in China in 2016 and early 2017. But demand 'pull' from other countries – both developed and emerging – was as strong. It looks instead that the cyclical recovery in global demand was just as important in boosting global trade volumes. Consumer spending in the developed (and some emerging) markets has been recovering, thanks to strong employment and better sentiment. Manufacturers have been rebuilding their stocks, and capex increased as well, though at weaker pace. Both activities tend to be trade intensive.

But can it last? Global trade will likely continue to grow this year, provided that consumers are supported by more favourable labour market conditions and manufacturing continues to grow. Higher bank lending, especially in the euro area, should help too.

This recovery in consumer spending would be especially beneficial to emerging market exporters which are sensitive to changes in global demand. Any recovery in capital spending would also support global trade.

Figure 3: Global trade recovered in late 2016



Source: CPB WorldTrade Monitor, Goldman Sachs, LGIM

But there are headwinds too. The recent decline in oil prices will likely weigh on the fuels trade. Some slowdown in Chinese growth can also affect global trade in the second half of 2017. Any correction in now fairly buoyant asset prices could affect sentiment. In particular, rising protectionism and lower cross-border investment will likely prevent the return to pre-crisis growth rates. Any wholesale retreat from global integration would act as a structural headwind to trade with particularly negative implications for emerging markets.



4. What message should we take from low nominal and real interest rates?

Chris Jeffery, Asset Allocation Strategist

As detailed in our recent Market Insights *UK yields to stay low?*, we believe that real UK yields are likely to remain low for some time. However, low interest rates can be considered both a blessing and a curse.

Their blessing is that the government yield curve impacts discount rates used across almost all financial assets. Discounting using ultra-low interest rates helps to rationalise high equity multiples today.

From that perspective, asset valuations rest on the precarious ledge of low real and nominal yields and we should be wary of any developments that put low interest rates at risk. There are severe potential consequences for broader financial stability if monetary stimulus is withdrawn in a clumsy or haphazard fashion. In our multi-asset portfolios, that means we are constantly on the lookout for ways to protect against policy mistakes and rising yields.

More theoretically, low interest rates have been a great enabler. Despite the secular rise in private and public sector debt burdens since the 1980s, the debt service ratio (i.e. the amount of income necessary to cover debt repayments) has declined as interest rates have tumbled.

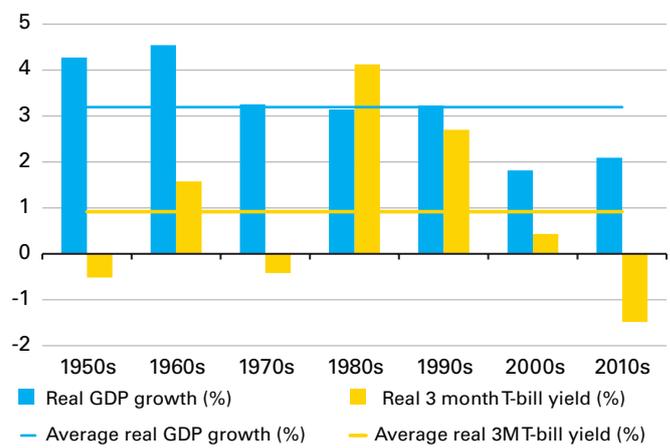
High debt levels increase the sensitivity to either rising rates or deteriorating income. The curse of low interest rates is therefore that they incentivise changes in economic structures (e.g. higher debt) which, in turn, make low

interest rates more entrenched. This dynamic is obviously especially troubling for those with long-duration liabilities, who suffer when interest rates stay low.

You can see a different form of the ‘blessing’ vs. ‘curse’ debate playing out at the Federal Reserve. Some policymakers (e.g. Bill Dudley, President of the New York Fed) argue that low interest rates represent a loosening in financial conditions and should accelerate the pace of rates hikes; others (e.g. Charles Evans, President of the Chicago Fed) argue that low interest rates are symptomatic of a weak growth environment and should decelerate the pace of rate hikes.

Perhaps the clearest message from low interest rates is that they have become a necessary, but not sufficient, condition for continued economic expansion. Over the last 70 years, the average real interest rate has been around 200bps below GDP growth in the US. With trend growth of below 2% today due to the downshift in demographics, it is hard to see why we should expect real interest rates to settle meaningfully above zero. This structural pressure gives us confidence that any significant back-up in yields is likely to be short-lived.

Figure 4: Real rates far below real growth



Source: Bloomberg LP, McCulloch and Shiller (1987) and LGIM
Real yields calculated using the GDP deflator

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