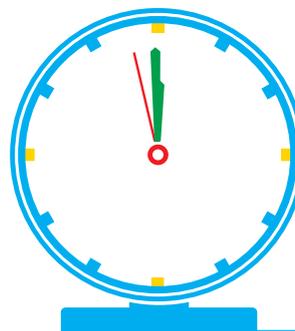


Asset allocation countdown to 2018



DINOSAURS

At the end of 2017, there are ten companies in the FTSE 350 index where the board of directors is entirely male. On average, 24.5% of directors for FTSE 350 companies are women. An improvement from 11.5% five years ago but still below where LGIM believes it should be. As part of LGIM's active ownership approach we use our scale and influence to bring about positive change and we have been engaging with companies to meet a target of at least 30% female directors by 2020.

BEZILLIONAIRE

Amazon chief Jeff Bezos is worth an estimated ninety billion US dollars, with the recent jump in the Amazon share price seeing him rise to be the wealthiest individual in the world. The Asset Allocation team rarely focuses on individual companies, but the power of Amazon and its technology counterparts like Google and Netflix are special cases. These companies are having profound effects on whole sectors such as retail and property, and

macro-economic developments by creating lower inflationary pressure. Tech stocks performed well in 2017 exceeding other sectors though have recently seen some setbacks. We can see the positive earnings growth story supporting the sector in 2018. However, there are increasing threats of greater regulatory scrutiny.

FORTUNE COOKIE

The number eight has been long regarded as the luckiest number in Chinese culture, meaning prosperity or fortune. But will 2018 bring luck and prosperity to this giant of the modern world economy? High levels of debt are concerning, swelling in the last few years as it did in developed markets before the 2008 financial crisis. Though there are some key differences in China. Most of the debt is both owed and owned by state run organisations which makes the situation less precarious. Decelerating debt growth and economic growth lies ahead for China and its policy makers. While a "slow landing" is possible, a Chinese "hard landing" remains one of our key tail risks that we are nervous about for 2018 and beyond.

YEAR ITCH

It has been seven years since the start of the Eurozone crisis. Centred on Greece, it also dragged in the likes of Spain, Portugal, Italy and Ireland. Looking back, these countries have made significant progress; returning to growth and improving their financial situation. While unemployment remains elevated (especially youth unemployment), it is coming down. Spreads on government bonds issued by these countries have likewise come down, when compared to German bonds. In 2017, we bought Spanish, Portuguese and Italian debt in the Mixed Investment Funds, benefiting from rising prices. We still hold some of the bonds going into 2018, but the return opportunity, while still positive, has become less attractive.



FEELING LUCKY?

Like rolling a six on a dice, there is an approximate one-in-six chance of a recession in any given year. While our economists think a recession is less likely to occur next year, we expect that the global economy is heading towards late cycle. Recession probabilities will pick up in 2019 as inflation pressures start to rise. The asset allocation of the Mixed Investment Funds is dynamic. It can evolve over the year as the team identify emerging threats and potential triggers for corrections.



STAR RATING

The 5 Star Movement is Italy's largest anti-establishment political party. It will remain the focus of markets in the run up to the Italian elections (held before May). They no longer have a comedian as their leader, though would still ruffle a few EU feathers if they gained power. Despite polling well, electoral reform in Italy means that it currently looks unlikely that 5 Star could come to power. That may leave victory for more conventional candidates... or Silvio Berlusconi.



YEARS OF PRESIDENT TRUMP (OR MAYBE LESS)

We will be one year through the four year Trump presidential term in January 2018. Of course, given the ongoing Russia investigation, there is a non-trivial risk he resigns

or is impeached before the end of his term. Bookmakers put that chance at around 40%. For most of 2017, Trump has failed to deliver his legislative agenda, especially healthcare reform. However, his tax cut plans stand on the verge of being passed by Congress, setting up a boost for growth prospects but at the cost of approximately \$1 trillion to the national debt.



FEET HIGH AND RISING

We have seen three interest rate hikes by the US Federal Reserve in 2017 and markets are expecting another three in 2018. Jerome Powell, who will take over from Janet Yellen as chair of the Fed, has played his cards safely so far and does not appear to be intent on dramatically changing the path for future interest rate hikes. The pace of rate hikes is what interests markets, less so than the timing. Right now, anything more frequent than one hike per quarter would spook markets and could lead to weaker returns on US fixed income assets.



FOR THE PRICE OF 1

All of the G10 developed economies have an inflation target that is either 2% or quite close to 2%. Yet many of these 10 regions have managed struggled to get inflation anywhere near that over the last few years. In fact, it averaged only 1% over the past five years. That is about

to change - over 2018 we expect the average to be closer to 1.8%. Inflation in the UK has started to rise as a result of sterling weakness after the Brexit vote. In the US, lower unemployment should see a cyclical pickup in inflation. The Mixed Investment Funds hold an increased allocation to US inflation-linked bonds to benefit from any rising inflation expectations in the US.



TEAM, 1 DREAM

There is approximately a one-in-fifteen chance of England winning the 2018 World Cup if bookmaker's odds are to be believed. In another game of to and fro, the UK will be hoping to secure a positive outcome from Brexit negotiations. The aim will be to secure a result to suit all the Home Nations, without the need of a penalty shootout against the EU.

This will be the main factor that sways the value of sterling in 2018, as it has in the past 18 months. Negotiations that lead to a so-called "soft" Brexit and clean transition are likely to see the pound rise, while a "hard" Brexit will be seen as negative for the pound. Good luck to David Davis and Theresa May, to Gareth Southgate and Harry Kane, and good luck to you all for the New Year!

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