L&G Mixed Investment Funds

MONTH IN FOCUS

THE HEADLINES

- **Dollar in the doldrums**
- **Euphoria for the euro**
- **Equity markets enjoying lazy summer**

MARKET OVERVIEW

The key theme in markets during July was the ongoing weakness of the US dollar against all major currencies, particularly the euro which gained 3.3% in July, up 12.3% year to date.

What has been weighing on the dollar? Trump's difficulties with White House staff, his Attorney General, and with congress (the failure of health care reform) all added to the narrative that if he can't cross these hurdles then his spending and tax cuts plans are increasingly unlikely. In addition, inflation in the US has continued to surprise lower. All together, that has kept Janet Yellen at the Federal Reserve (Fed) leaning to the dovish side on further interest rate hikes, although the Fed did confirm that they will start reducing the size of government bond holdings relatively soon.

Outside of currencies, market movements were fairly contained, with measures of volatility falling to twenty-four year lows, markets swinging gently into what so far is shaping up to be a lazy summer for many assets. Most asset classes posted small gains, swatting away the small sell off at the beginning of the month like you would a pesky fly buzzing around your sun lounger.

In local terms most equity markets gained; the US by 2%, the UK gained 1.2%, while European and Japanese equities gained less than 0.5%. Emerging market assets performed well in a softer US dollar and lower US interest rate outcome, emerging market equities and emerging market local debt particularly so.

Alternative assets like real estate and infrastructure also posted small gains. Oil gained around 9% but has remained in a relatively narrow price range for the past year now, shadowed by OPEC attempted price interferences.

FUND PERFORMANCE REVIEW

All funds recorded positive returns in July, with higher risk funds with more equity exposure marginally outperforming lower risk funds. Return drivers were broad based, both geographically and by asset class. Equities boosted performance in all funds while lower risk funds still benefited from returns from corporate credit.

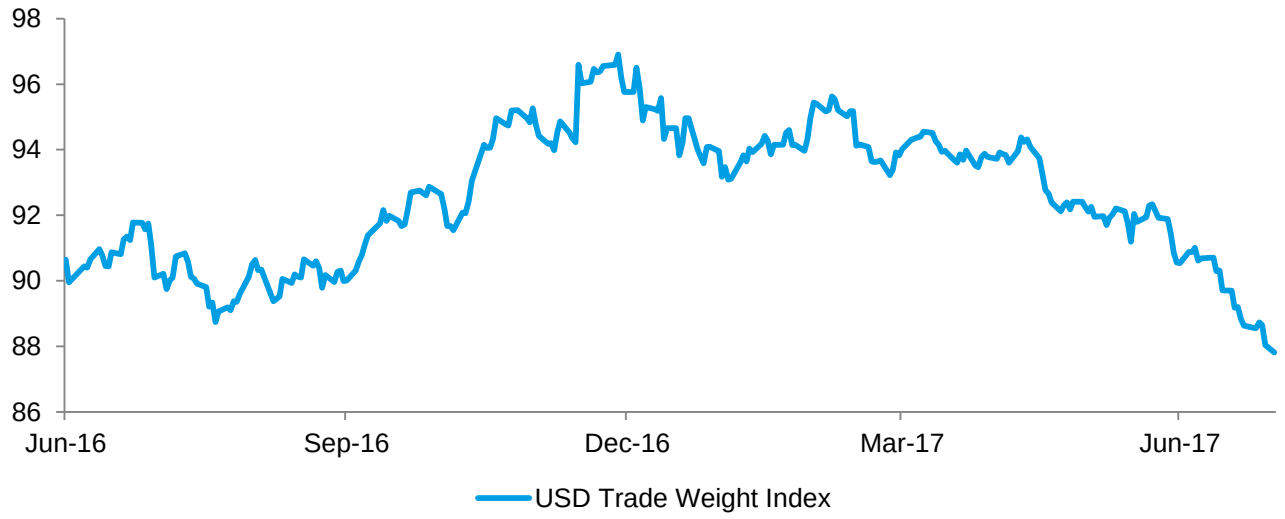
Despite the excitement around Macron's election in France, European equities have actually underperformed broader equity markets recently, presenting an opportunity to add to our allocation at an attractive point, at the expense of US equities. There are a number of reasons for liking European equities outside of their underperformance, such as stronger earnings prospects due to low starting margins, high operating leverage, an improved domestic growth story and less labour cost pressure than the US. In addition, political risk seem contained for now (at least until the Italian election) giving us a window to favour European equities.

RECENT PORTFOLIO CHANGES

EUROPEAN EQUITIES
JAPANESE REITS

US EQUITIES

CHART OF THE MONTH – THE RISE AND FALL OF THE US DOLLAR (TRADE WEIGHTED INDEX)



Source: Bloomberg L.P. LGIM

Legal & General
INVESTMENT MANAGEMENT

MARKET OUTLOOK

Over the recent months, 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 hold a cautious stance on risk assets. This 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 some investment grade debt.

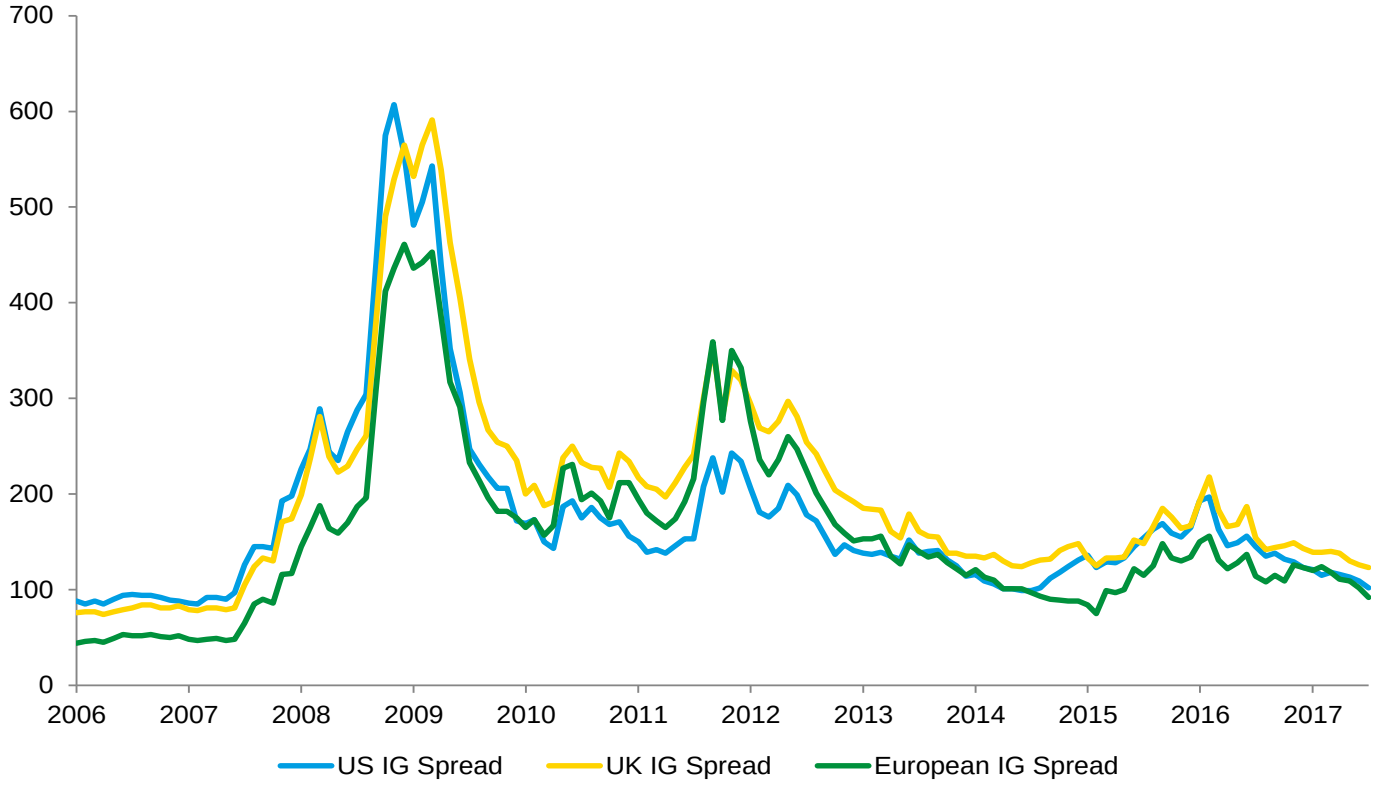
We continue to look for inflation-protection; US inflation-protected securities are one such asset, alongside alternatives (real estate and infrastructure) and pockets within the equity markets (European utilities). The yields on offer within emerging market debt (both local and USD) also look attractive 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.

THE LONG TERM VIEW – A TIGHT SQUEEZE

With no inflationary pressure in most developed economies, central banks have maintained loose monetary policy for almost a decade since the financial crisis, which has a good track record of boosting asset prices. This has helped equities grind higher, and credit spreads tighten towards post-crisis lows, as shown below. But while the sky is the limit for equities, its hard to imagine the spread on a broad index of corporate credits falling towards zero. In previous economic cycles spreads in the US, UK and Europe all went under 100 basis points and were able to stay that low for extended periods of time, however, when spreads become so tight there is little juice left to squeeze out of credit markets. Default rates are close to record lows, but so is the compensation for default risk.

The same has been happening in high yield credit markets and for the Mixed Investment funds that has led us to reduce our allocation to high yield credit throughout the first half of 2017. If investment grade credit spreads continue to tighten, we may be inclined to reduce our allocations there as well. At the moment, we still think emerging market debt presents an attractive opportunity while our sovereign bond allocations are being managed more tactically. Most recently, we reduced our exposure to UK gilts but added to peripheral European markets like Spain and Ireland.

INVESTMENT GRADE CORPORATE BOND SPREADS (BPS)



Source: Bloomberg L.P. LGIM