L&G Mixed Investment Funds

MONTH IN FOCUS

THE HEADLINES

- **Sharp drop in temperatures!**
- **Sharp drop in equity markets!**
- **… both recover.**

MARKET OVERVIEW

With the exception of snow in the UK, only one thing dominated investors' conversations in February: the equity market correction. The US equity market declined 10.1%, peak to trough. Undeterred by the losses, investors pushed back and, as the month went on, markets recovered, finishing the month down 3.7%. Given the strong performance in January, US equities are still in positive territory year-to-date. Other equity markets experienced a broadly similar pattern, with the UK and Europe down 3.3% and 3.4% respectively for the month.

The initial cause of the sell-off was concern about rising bond yields, though once higher volatility was seen in equities this prompted some investors to sell, in turn causing even higher volatility and – in a spiral effect – leading to even more sellers. In terms of equity sector performance, the energy sector performed the worst, while cyclical sectors and technology continued to perform relatively well.

US 10-year bond yields continued marching higher, up from 0.16% to 2.86%, while gilts managed to fight the rising tide with unchanged yields. Corporate bonds could not escape the equity weakness though, with modest sell-offs across US and UK markets over the month.

The pound weakened from c. $1.42 to $1.38, driven in part by a stronger US dollar and by increasing signs of rifts within the UK government and with the EU.

FUND PERFORMANCE REVIEW

All of the Mixed Investment funds delivered negative returns in February, with equities and corporate bonds the main detractors. Interest rate sensitive assets like real estate and infrastructure again delivered underwhelming performance.

The relative strength of overseas currencies against pound sterling helped dampen some of the losses. Diversifying assets like emerging market local currency bonds and Australian bonds also helped fund performance and were among the few assets to deliver a positive return in February.

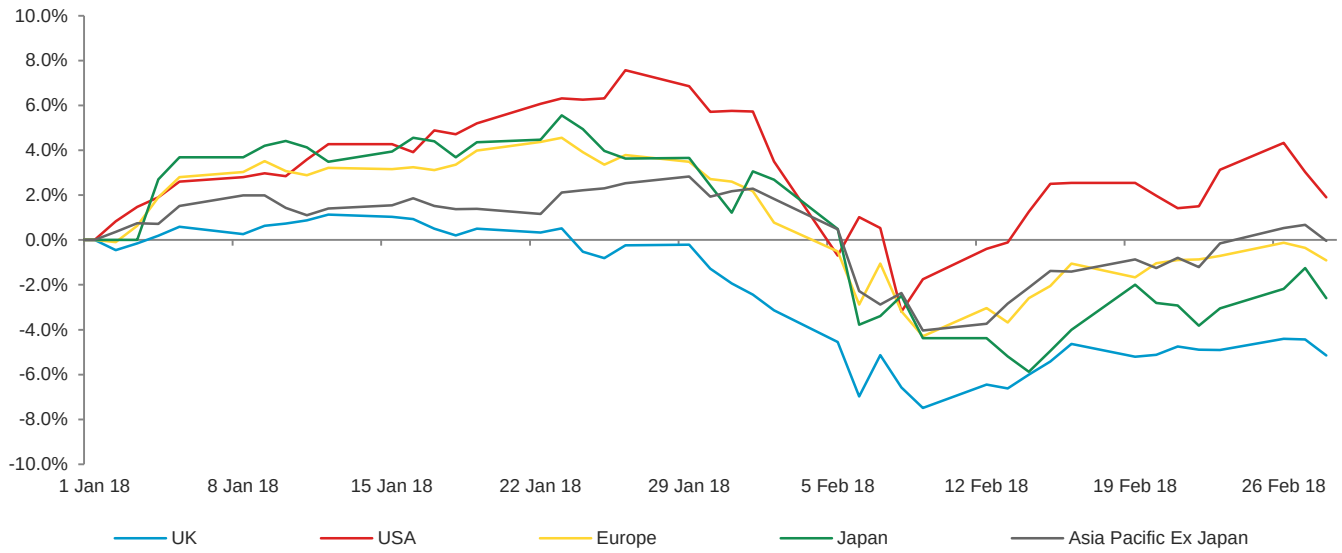
After the sell-off in equities, we decided to increase risk in the funds, buying equities and reducing cash and corporate bonds. We believe the outlook for the global economy is still positive over the next 12 months and the sell-off in equities was not supported by any deterioration in fundamentals. As such, we saw this as a buying opportunity rather than a time to panic and sell equities. For most funds in the range, we added to US and European equities. For higher risk funds, we added Japanese equities, including exposure to Japanese yen.

RECENT PORTFOLIO CHANGES

US EQUITY
JAPAN EQUITY
EUROPEAN EQUITY

GLOBAL CORPORATE BONDS
CASH

CHART OF THE MONTH – YEAR TO DATE EQUITY MARKET RETURNS



Source: LGIM, Bloomberg L.P.

Legal & General
INVESTMENT MANAGEMENT

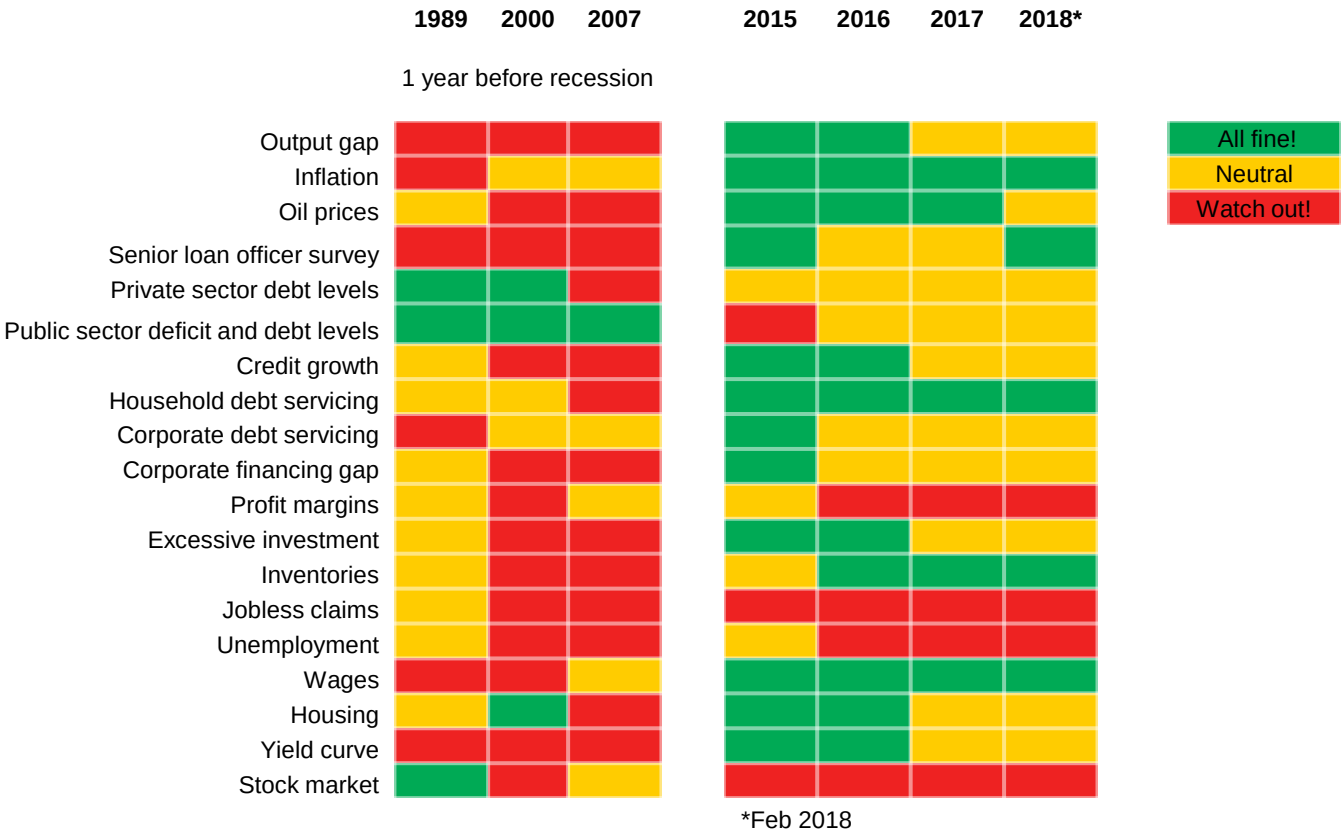
MARKET OUTLOOK

While credit and high yield bonds did not behave worse-than-expected during the recent equity correction, we do think they will perform relatively poorly if a fundamental risk such as recession materialised. We do not expect this over 2018, but as our Long-term View below explains, we are carefully watching for signs of such a risk on the horizon. We also see valuations on corporate bonds as relatively expensive compared to other asset classes. While we increased our equity exposure in February, we have stopped new inflows into credit assets in light of this medium-term view.

We also maintain our view that listed real estate and infrastructure should provide relatively stable returns through a combination of high yields, attractive valuations and a degree of 'built-in' inflation protection. While recent performance has been disappointing, the medium-term case remains sound.

THE LONG TERM VIEW – RECESSION WATCH

One of the most common questions our economists face is "when will the next recession be?". To help forecast the progression of the economy and summarise their views, they look at a number of proven indicators. The table below shows the indicators using a traffic light system. In the years preceding the last few recessions, there have been a notable number of red and yellow indicators across the board. In the last few years, however, there have been many more indicators flashing green, pointing to stronger economic growth and a low recession risk. Even now, our recession indicators do not flag much immediate danger, and the probability of recession appears low for this year. However, as the US is arguably now entering late cycle, we would expect our recession indicators to deteriorate next year as we see more compelling evidence of overheating and economic imbalances developing. That would mean more reds on the board into 2019, indicating an increasing risk of recession. On top of that, investors should note that markets usually anticipate a recession six to 12 months before it actually happens. Its important, then, that as the year progresses, we continue to monitor these indicators closely and reduce equity exposure as recession risks build.



Source: LGIM