L&G Mixed Investment Funds

MONTH IN FOCUS

THE HEADLINES

- **Boris Johnson moves into No.10...**
- **…Sending sterling further south…**
- **…While the US cuts interest rates…**

MARKET OVERVIEW

During July, falling yields and Brexit fears continued to dominate market pricing. Bond yields across the globe collapsed. Disappointing economic data in Europe suggested that the European Central Bank and the Bank of England may need to loosen monetary policy in the near future. This fall in yields saw index-linked gilts and EU peripheral debt as the strongest performing assets during the month. Additionally, the market perceived there to be an increased likelihood of a hard Brexit, and as a result the pound was down over 4% versus the US dollar. The weaker sterling supported large-cap UK stocks which performed strongly during the month.

Broadly positive performance from other asset classes was also driven by the easing bias of central banks, with REITs, local currency emerging market debt and Australian government bonds all performing well. The worst performing asset class over the month (in local currency terms) was emerging market equities, which suffered as a result of escalating trade tensions.

FUND PERFORMANCE REVIEW

All of the Mixed Investment funds posted positive returns in July. Equities were the largest contributors for the higher risk funds, whereas credit was a bigger driver for the lower risk funds. The overweight position in emerging market debt also helped performance across the board as the asset class reacted well to lower interest rates in the US. Overseas currency exposures added to performance as they rose relative to sterling on the back of heightened fears about a hard Brexit.

An increase in sovereign bond exposure was the most significant change over the month, reversing the direction of travel from the last couple of months. We have held a negative view on sovereigns for a while, given the low level yields have been at. However, the recent shift we have seen from many central banks towards looser monetary policy has led us to ease the negative view and add back some exposure to sovereigns.

We also directed flows towards cash and emerging market hard currency debt, while we reduced some of the UK credit exposure after strong performance.

RECENT PORTFOLIO CHANGES

CASH
SOVEREIGN BONDS

UK CREDIT

MARKET OUTLOOK

Our recession indicators have worsened and the economic outlook is darkening somewhat. Corporate profit margins have fallen and the corporate financing gap flashes a warning sign as well. The yield curve is also in the “danger zone” as the US 2yr/10yr approaches inversion, which is typically – but not always – a good predictor of recession. While the majority of our recession indicators remain in neutral territory, around one-third of them now show warning signals and only one out of 20 remains as a positive signal: US households are in great shape, aided by the decrease in US interest rates. The latter gives some comfort as we’ve seen examples in the past where consumer strength has been able to offset weakness elsewhere.

Overall, our recession probabilities in the coming 12 months have increased mainly due to trade war concerns. This could be temporary, as predicting geopolitics under President Trump is clearly very difficult. However, we now believe part of the trade war’s impact will be semi-permanent in the US as uncertainty around Trump’s erratic US trade policy will remain. Moreover, we believe that Trump has successfully introduced an uncertainty premium into China supply chains. This impact will be semi-permanent too, dragging down US investment in China in the medium term and increasing the China risk premium for foreign investors. As such we are more inclined to sell equities on strength, and the hurdle rate to buy on market dips is now higher.

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