L&G Mixed Investment Funds

MONTH IN FOCUS

THE HEADLINES

- **Trump re-escalates trade wars**
- **…which de-escalates investor enthusiasm…**
- **…and opens the door to central bank support**

MARKET OVERVIEW

Risk assets made an about-turn in May following four strong months since the beginning of the year. The US-China trade war came sharply back into focus as it became clear that the talks were about far more than just trade, and concerned the US taking steps to protect itself from a geo-political rival.

The escalation of the conflict was encompassed by higher tariffs on both sides and a US ban on business with Chinese telecommunications giant Huawei. The market responded to this by appearing to anticipate further escalation and negative impacts to the wider economy, and a consequent reaction from US Federal Reserve, pricing in 0.75% worth of cuts by September 2020.

Equities were down, across the board, falling between 3% and 7% (in local currency terms). Japanese, US and emerging market equities were hit hardest and commodities, listed infrastructure and global high yield bonds also fell. By contrast, both nominal and inflation-linked sovereign bonds performed well over the month. Index-linked gilts, US Treasuries and Australian bonds particularly strong. In the credit markets, falling yields outweighed the impact of credit spread widening. Continued Brexit uncertainty following the European elections and the announcement of Theresa May's departure date saw the pound weaken against the euro.

FUND PERFORMANCE REVIEW

Only the Mixed Investment 0-20% Fund delivered positive returns in May as it has the lowest allocation to equities, with negative returns for all other funds, increasing in magnitude with greater equity exposure. Nonetheless, year-to-date returns across all funds are strongly positive.

As developed market equities were the stand-out negative performers, they were also the largest contributor to the funds' negative performance. Offsetting the negative contributors, most bond assets contributed positively to returns, including sovereign bonds, corporate credit and emerging market debt. Listed alternatives, real estate and infrastructure also helped performance.

Over the month we reduce our tactical long equities position, moving back to a more neutral holding. Regionally, we also reduced Mexican equities as sentiment swayed against and later in favour of Mexico as they negotiated with the US to avoid tariffs. We also took profits on our European sovereign bond holdings as yields continued to decline, and topped up emerging market bonds in both hard and local currency.

RECENT PORTFOLIO CHANGES

CASH
EMERGING MARKET DEBT

EUROPEAN SOVEREIGN BONDS
MEXICAN EQUITIES
EQUITIES

MARKET OUTLOOK

The strength of the US economy has emboldened President Trump to be tough on China, but there are small signs of the cost of this strategy with US economic data weakening at the margins. As such, we have reduced our equities position while remaining reasonably constructive on this asset class for the medium term.

Our analysis suggests the recent increase in US tariffs on Chinese imports should only take a couple of tenths off US GDP growth. We believe the US central bank is unlikely to react at this stage, especially ahead of the G20 at the end of June where Trump and Xi might at least agree a truce. Indeed, our base case is that we will eventually get a deal on the trade war, but should the situation deteriorate, sentiment fall further, engendering a material slowing of US growth, the Fed has scope to respond. Further, we have downgraded our probability of recession in the next 12 months. On the negative side, we have adapted our outlook on China to expect "stabilisation rather than reflation" .

In the medium term, we are still in a "goldilocks world" of reasonable growth, no inflation and accommodative central banks. If the markets wake up to a deal between the US and China, the market narrative will switch in a blink and China growth worries will melt away quickly.

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