LGIM Asset Allocation Views.

For Investment Professionals only

The US Federal Reserve raised rates for the first time in nearly ten years, despite data showing that US economic growth had slowed somewhat in the previous quarter. With global consumer demand strengthening and investors encouraged by a positive tone from the US Federal Reserve, global equity markets rebounded in the final quarter of the year. A similar dynamic helped corporate bonds - having fallen sharply over the summer months as fears over global growth rose, credit markets rallied in October and November.

OUTLOOK

RISKS

- Increase in risks, particularly in emerging markets and China
- Global debt remains a concern in medium term
- Normalising monetary policy could prove disruptive

OPPORTUNITIES

- Investor nervousness and volatility may present opportunity to add risk at attractive levels
- Structural reform momentum in Japan is positive in the near term
- Oil price declines driven by oversupply may present opportunities to add risk on the back of market concerns

The balance of risks into 2016

We believe the ‘easy money’ has already been made in this seven-year bull market in risk assets and we are potentially nearing a late-cycle economy. As such, we are in the process of changing our systemic risk score to reflect increased credit worries and the negative feedback loop from the recent crash in commodities and emerging market currencies. On the optimistic side, investors across markets are likewise becoming more cautious and only expect modest equity returns for 2016, reflecting concerns over emerging markets, credit growth and the Chinese economy.

Fed hikes, growth and data

The US Federal Reserve finally raised the Fed Funds rate after nearly ten years and 80 unchanged meetings. Markets widely anticipated the move so it didn’t have a huge effect either way. In 2016 we anticipate slightly higher economic growth and a sharper fall in unemployment in the US than the Fed; however, our interest rate forecast closely aligns with the Fed’s median dots. A March hike is already partially priced in, so the Fed can let the data slowly make the case over the next few weeks.

Eastern disappointments

We have been long Indian equities and the Indian rupee, given its superior growth prospects, reform potential, expected interest in equities from Indian retail investors and the benefits from lower oil prices. However, the political impetus behind reform efforts has taken a hit and we have revised our view. The Modi government has failed to pass major reform bills, including the land utilisation bill, the bankruptcy code and the goods and service tax (GST). While we remain generally positive, we have reduced our exposure to Indian equities, maintaining our currency exposure.

Overview	Views
Equities	◆
Govt. bonds	◆
Credit	◆
Real estate	◆
Commodities	◆

Click on each asset class for more information

Tables reflect tactical views at time of publication.
Medium-term views/biases may be different.

Legal & General
INVESTMENT MANAGEMENT

EQUITIES

Equities	Views
US	◆
UK	◆
Europe	◆
Japan	◆
Emerging markets	◆

Though the weak start to 2016 has taken the shine off, Q4 2015 was a very strong period for global equity markets. October in particular stood out as fears around the negative side effects of falling commodity prices and Chinese growth eased, resulting in a sharp rally for the S&P 500. While some of the gains were given up, equity investors generally shrugged off the first Fed rate hike, a disappointing ECB meeting and weakness in global manufacturing.

Looking ahead we remain reasonably upbeat about the prospects for equity returns. After being neutral equities throughout Q4 2015, the correction at the start of the year is causing us to consider when to go long rather than cutting positions further.

We continue to believe we are in a mid-cycle environment, which should be supportive for equities. Our 2016 forecast is for decent, but unexciting, equity returns in the 5-10% range, driven mainly by earnings growth. Our preferences for European and Japanese equities over US and UK equities continues to suit the expected macro environment, given their low commodity exposure, above average earnings growth prospects and supportive central banks. Japan is also supported by the potential for further corporate governance reforms.

FIXED INCOME

Fixed Income	Views
Nominal govt. bonds	◆
Inflation-linked	◆
Investment grade	◆
High yield	◆
Emerging market debt	◆

Markets held their breath in Q4 2015 as the Federal Reserve raised interest rates for the first time since mid-2006. Against the backdrop of a rapidly declining unemployment rate, the US monetary authorities opted to start the process of policy normalisation. Government bonds sold off somewhat as yield rose, but the impact was fairly muted as markets are only expecting very gradual rate increases.

Elsewhere, the ongoing slide in commodity markets has kept inflation breakevens contained and triggered a rout in US high yield bonds. With oil prices having fallen by over 70% in 18 months, large segments of the credit market have to contend with the prospect of defaults and restructuring. Alongside this acute sector-specific weakness, the slowdown in emerging markets (notably China) has triggered broader concerns about the health of the US corporate sector.

Looking ahead, we have become less negative on government bond markets. Yields have adjusted off their lows earlier in 2015, and inflation risks have subsided with the slide in commodities. Policy-tightening may have started in the US, but it is an increasingly distant prospect in both the euro zone and UK. We remain constructive on inflation-linked debt (especially in the US) given the low cost of long-term inflation protection.

In the credit markets, global high yield bonds now appear to offer ample compensation for default risk. However, we remain wary of the risks lurking in emerging market debt, especially denominated in local currency.

CURRENCIES

Currencies	Views
US dollar	◆
Euro	◆
Sterling	◆
Yen	◆

Central banks still set the tone for currency markets. In Q4 2015 investors finally got the monetary policy divergence everyone was waiting for. The Fed hiked rates in the US, while the ECB lowered rates and extended its asset purchase program into 2017 and the People's Bank of China gradually fixed the Chinese yuan weaker alongside other easing measures. This policy divergence led to a continuation of the strong US dollar trend, against almost all other currencies.

The euro weakened amid low inflation, forcing the ECB into further action. However, the outcome of December's ECB meeting wasn't sufficient to satisfy the market's high expectations. With further ECB easing not imminent and a healthy current account surplus, the case to sell an already undervalued euro is no longer particularly strong.

Sterling was in the US dollar's slipstream until low inflation data (delaying expectations for the Bank of England's first rate hike) and Brexit concerns threw a spanner in the works in November. Sterling ended up flat to the euro and weaker against the US dollar over the whole quarter. Our medium-term view on sterling is not overly constructive, but Brexit fears can be easily over-priced, so we may reduce our sterling shorts on further weakness.

The Japanese yen initially weakened on the back of speculation of further easing by the Bank of Japan (BoJ), which didn't materialise, but the yen bounced back after broad risk aversion in financial markets reinstated its safe haven status in December. We believe the BoJ will look to eventually draw a line in the sand and start fighting any further currency appreciation, making holding yen less attractive in the medium term.

Emerging currencies remained under pressure and continued the last few years' very poor performance. Worries abound, which means we do not see this picture changing anytime soon and we therefore remain very cautious towards emerging currencies.

MEDIUM-TERM VIEWS

Staying positive in the New Year

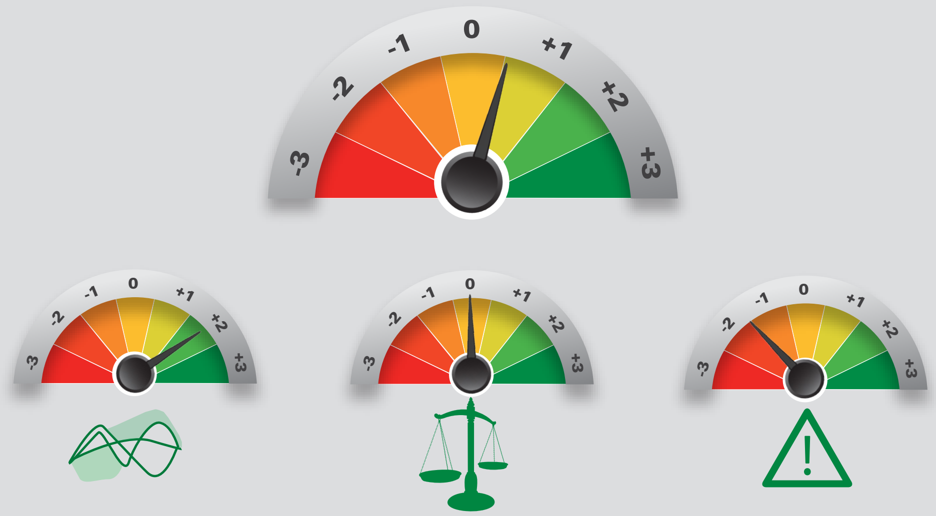
While we are potentially now nearing a late-cycle economy, for now we remain in a mid-cycle environment, and believe we will remain so into 2017. This, alongside our positive outlook for economic growth and our expectation for only small interest rate increases amid a benign inflation outlook, means that the environment remains constructive for equities in the medium term.

Handling China (and emerging markets) with care

Systemic risks in emerging markets look to have gradually increased and as a consequence we are looking to change our systemic risk score in response. China's economy continues on its bumpy deceleration and we expect it to slow further from an estimated 6.9% growth in 2015 to 6.3% this year. Weakness in the Chinese yuan also stokes fears of capital flight from China. While the risks of a large (>5%) devaluation against the US dollar in 2016 are material, it is not our base case. Our overall view is that the Chinese government will manage the situation for now.

Though valuations in emerging markets look better, they are not obviously attractive. With commodity prices dropping further in Q4 2015 (some of the large emerging countries are commodity exporters) and the large debt overhang, alongside worries around China, there remain a number of challenges. As a result, we are not yet inclined to increase our emerging market exposure.

Overall we remain constructive on risk assets



Economic Cycle
Economy remains mid cycle, with low recession risk

Valuations
Risk asset valuations are not excessive

Systemic Risk
Material risks from the US Federal Reserve and emerging market debt levels

CONTACT US

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IMPORTANT INFORMATION