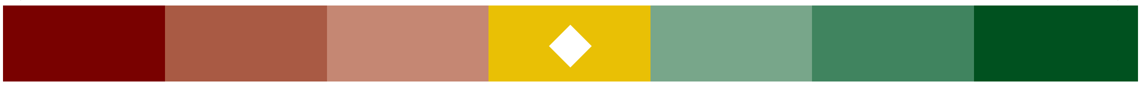
LGIM Asset Allocation Views.

For Investment Professionals only

The quarter began with a sharp correction in January and early February, driven by fears over the health of the Chinese economy, a perceived slowing of global economic growth and worries about the European banking sector. However, in March strong US economic data and recovering commodity markets sparked a rebound in global equities, which ended the quarter roughly where they began. Mirroring those equity trends, investors sought safe haven assets in the first half of Q1, driving down yields on government bonds and undermining emerging market currencies, before those flows reversed towards the end of the quarter.

NEGATIVE — OVERALL RISK POSITIONING — POSITIVE



RISKS

- Increase in political risks across most Western countries
- Global debt remains a concern in the medium term (notably in emerging markets)
- Difficulties in normalising monetary policy

OPPORTUNITIES

- Investor nervousness and volatility may present recurrent opportunity to add risk at attractive levels
- Potential dollar strength as Fed hikes come back into focus
- Asset purchases by central banks to keep asset prices supported

SHORT TERM OUTLOOK

Cutting equity risk back towards neutral

Towards the end of the quarter we reduced our tactical position in equities. The main reason for buying equities on a tactical basis was our view that the risk of a global recession was exaggerated by markets. Macroeconomic data has since validated that view and markets have recovered. There is potentially still some upside on the table, but we feel it is prudent to reduce risk into market strength.

Slippery oil

In a marked turnaround from last year, oil rallied over the quarter. Supply conditions are tightening with a potential OPEC production freeze around the corner, and unidentified non-OECD countries are taking advantage of low prices to add to their stockpiles. The dollar would need to keep weakening while the mysterious buying activity continues for oil to keep rallying. On that basis, the risk to oil prices seems to be to the downside, including a significant risk of prices falling to $20-25 per barrel. The current higher price increases the downside risks as it will delay production cuts, particularly in the US, and temper demand growth.

Keeping an eye on political risk

Overall, political risks to markets are increasing across most Western countries. The terrorist atrocities in Brussels, following on from the earlier attacks in Paris, increase pressure on the European political establishment. The pressure is most acute for Angela Merkel with the potential to swing public opinion and deliver a political shock. The UK referendum is on 23 June and the US presidential election primary season is producing worrying populist statements from leading candidates. All of these have factors are feeding into our decision to lower the risk levels across our portfolios.

Overview	Views
Equities	
Govt. bonds	
Credit	
Real estate	
Commodities	

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

Legal & General INVESTMENT MANAGEMENT

OUR MEDIUM-TERM VIEWS

Exercising caution before it's too late

Market cycles do not usually die of old age , but an increasing number of late-cycle features are appearing. While the global economy is dominated by the US, it's important we don't overlook the potential risks that exist in emerging markets. Brazil and Russia are already deep in recession, and the build-up of private sector debt in China is our biggest market concern.

Therefore, as the economy evolves, we believe this should make us more cautious towards our medium-term risk position. We have therefore pared back our medium-term risk towards neutral.

Reducing risk overweight on the market strength

Economic Cycle
Economy remains mid cycle, but getting closer to late cycle

Valuations
Risk asset valuations are not excessive

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

EQUITIES

The first quarter of the year has been quite a rollercoaster ride for global equities. While returns may show equities to be roughly flat, this hides a sharp correction of 12% through mid-February followed by a similarly sized recovery to the end of the quarter. On some measures that is the sharpest intra-quarter reversal since the 1930s.

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

The market sell-off was driven by fears of a sharp renminbi devaluation as the Chinese economy slowed more quickly than expected, alongside growing default concerns in both energy producers and European financials. These events increased the risks of both a spill-over into developed economies and a global recession – all in all a terrible backdrop for risky assets.

Our view was that the risk of a global recession was smaller than markets implied. We therefore bought equities from the middle of January through to the end of the quarter. That position has been reduced gradually as markets recovered. Looking ahead, we see limited scope for equities to rally at a similar pace going forward.

Our regional equity preferences of Europe and Japan are unchanged. Those positions struggled over the balance of the quarter as markets questioned the impotence of central banks to deliver growth.

FIXED INCOME

Fixed income investors suffered a similarly bumpy ride in Q1. During January and early February, nominal bonds yields (and inflation breakevens) crashed, while credit spreads widened as the market's perception of corporate defaults increased sharply.

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

However, in March, the ECB announced a corporate bond-buying spree alongside a commitment to pay Europe's beleaguered banks to borrow money over a four-year term. That helped circumvent worries about the circular loop between increasingly negative interest rates and increasingly impaired bank earnings. Moreover, the Federal Reserve slashed its interest rate forecasts for this year despite maintaining resolutely unchanged growth and inflation forecasts. That implied a changing reaction function which simultaneously placed greater emphasis on the struggles of the rest of the world and was more tolerant of higher inflation.

The renewed dovishness confirms many of our fixed income views: notably, an enthusiasm for high yield and inflation-linked debt. We have upgraded our outlook for emerging market debt to neutral (mainly due to better support for hard currency denominated debt) and retain a slight negative bias towards nominal government bonds.

CURRENCY

The weakness in sterling was the stand-out story of currency markets in the first quarter of the year. In part, this weakness has been driven by uncertainty associated with the June referendum on the UK's status within the European Union. However, it can also be attributed to a reappraisal of the prospects for interest rate increases from the Bank of England. Sterling weakened against every other major exchange rate as a result. Having been negative on sterling's prospects at the end of last year, we think a more balanced appraisal is now appropriate given the sharp fall which is already behind us.

Currencies	Views
US dollar	
Euro	
Sterling	
Yen	
EM FX	

Elsewhere, the US dollar defied widespread predictions of a rally and weakened notably against both the Euro and the Japanese Yen (by approximately 5% and 7% respectively). We expect both of these trends to reverse in the second quarter, as the market focus switches to the ongoing rapid balance sheet expansion (i.e. money printing) of both the ECB and Bank of Japan.

We remain worried about the risks in emerging market currencies given the potential for destabilising capital outflows from China to resume, and the precariousness inherent in rapidly expanding private sector debt.

CONTACT US

For more information, contact your usual LGIM representative or Adam Willis on 020 3124 3207.
www.lgim.com

IMPORTANT INFORMATION