LGIM Asset Allocation Views.

For Investment Professionals only

The UK referendum on membership of the European Union sparked some pretty wild and unpredictable market moves over the second quarter of 2016. The leave-remain poll dance pulled all assets in various directions right up until the referendum day, with the shock result itself triggering a mad dash out of risk assets, followed shortly by a stampede back in as the quarter drew to a close. Large-cap equities fully recovered their post-referendum losses; but UK mid-cap stocks, European banks, sterling, gilt yields and real estate are all yet to recover.

The medium-term outlook for risk assets (notably equities) has darkened as systemic risks start to build. The EU referendum vote in the UK is just the first of many political event risks over the months ahead. We have long-identified the potential for disruptive political dynamics to undermine market sentiment, but those risks are now starting to crystallise.

RISKS

- Increase in political risks across most Western countries (Brexit, Trump, Italian referendum)
- Global debt 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
- Asset purchases by central banks to keep asset prices supported for an extended period

SHORT TERM OUTLOOK

A mild winter is coming… maybe

Predicting the weather looks relatively straightforward compared to trying to discern the probable economic outcomes implied by Brexit. Mark Carney has announced that the Bank of England is set to ease policy in the summer. These soothing words, at least for now, have settled financial markets. While the immediate damage to confidence is hard to offset, the impact on next year and beyond will hinge on the type of trading relationships the UK can negotiate. For the UK, the balance of probabilities suggests a mild recession now, with only limited spill-over to the wider global economy.

A combination of increased uncertainty and tightening financial conditions would lead to the most adverse outcomes, but in the absence of a more severe financial market reaction, the global economy should continue to grow around the same pace of recent years. The euro area should see the most direct effect via reduced exports to the UK and increased concern around the future of the EU. So far we have seen very limited negative effects in Europe after the UK Brexit vote. This is a positive surprise so far, as we identified European contagion risk as the most important downside risk. Outside of Europe, and on the basis that the Fed decides to postpone any rate hikes this year, emerging markets could even benefit from the reduction in global interest rates.

As we believe the risk of a political or more systemic crisis dominates the already fragile global economy, we have moved tactically short equities. The combination of cautious medium-term and tactical views means we now hold the most bearish position in our portfolios for the last three years. The upside for equities seems limited to us, especially after the rally over the final week of the quarter.

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

Remaining cautious, looking for opportunities
We are now underweight risk assets as part of our medium-term views. On top of the increased political and systemic risks mentioned above, we see limited room for earnings growth beyond the impact of oil prices rebounding. Margins are already close to historic highs and at this stage of the economic cycle there is limited scope for an earnings surprise. Valuations are towards the higher end of the range we feel comfortable with, but not so high that they become an overriding negative factor. The most likely upside comes from the relative valuations against bonds.

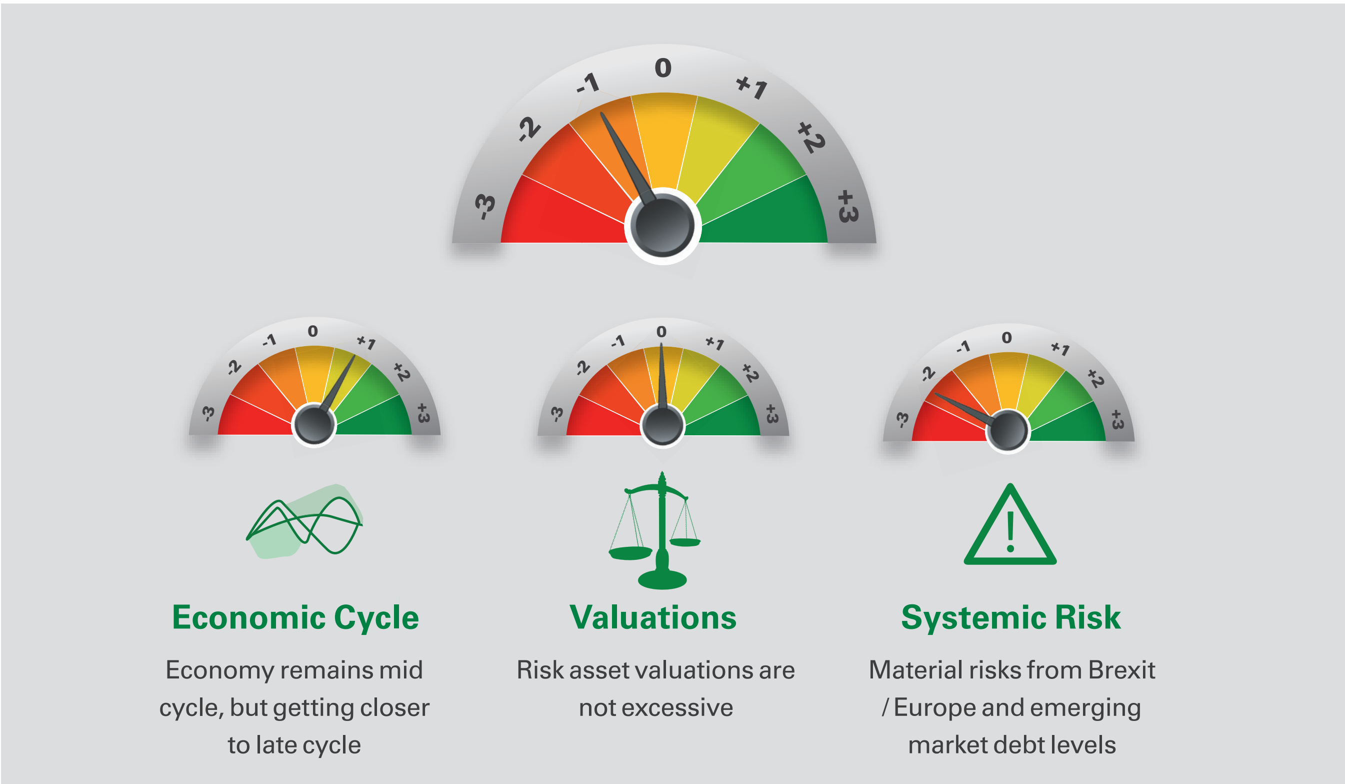
So, what sparked the post-shock rally?

- Cautious positioning by investors going into the referendum, leading to a kind of 'relief' rally
- Anticipation of central banks retreating from planned rate rises, like the US, or even move to provide even more liquidity
- Economic analysis, including our own, showing that the global economy isn't that badly affected by Brexit
- Hopes that Brexit will never actually happen (due to a 2nd referendum or new elections)

We are sceptical of these early market reactions and note that equities often trade higher after a shock before retreating again. We would be inclined to further decrease our equity exposure if markets rally all the way back to market highs.

We currently prefer so-called mid-risk assets, such as US real estate and hard-currency emerging market debt. Our view is of a weaker pound sterling based on the UK going into recession, the Bank of England easing more than the market expects, ongoing political turmoil, a possible Scottish referendum and a large current account deficit, leading us to sell more GBP on any strength.

Reducing risk overweight on market strength



EQUITIES

The second quarter of the year was a lot calmer than the rollercoaster ride of the first quarter. The global equity index remained in a tight trading range of 5%, only temporarily breaking out on the downside for a few days after the UK referendum.

Brexit aside, the quarter was dominated by equities pricing in a low-growth and low-rate environment, which is not necessarily a bad environment for the asset class. Earnings and dividend growth may be

Equities	Views
US	
UK	
Europe	
Japan	
Emerging markets	

uninspiring with limited top-line growth and already elevated margins in the US, but at the same time valuations are supported by the increasingly low yields on offer in fixed income assets.

Coming out of the first quarter we reduced equity positions back to neutral as markets had recovered and our growth views no longer differed materially from what equity markets were pricing in. We saw, and still see, limited upside risk for global equities from current levels and against the current backdrop of risks and expected growth. Post Brexit, we sold equities to an underweight position to reflect the view that the correction was not sufficient given the increased macro risks.

Our regional preference shifted away from Europe where we went underweight over the quarter, which resulted in cutting the underweight we had held in US equities. We remain positive on Japan in the expectation of further progress on the shareholder return theme and potential for Bank of Japan policy easing.

FIXED INCOME

Fixed income markets rallied sharply over the course of the second quarter, primarily on a surge in demand for safe-haven government bonds. That global phenomenon accelerated in the wake of the UK's vote to leave the European Union. In the most extreme example of this trend, investors now have to pay a couple of basis points for the privilege of lending to the Swiss government for 50 years. From here, it is tempting to argue that 'yields cannot possibly go any lower'. However, that has been a dangerous call given the prospects of further interest rate cuts in the UK, and central bank bond-buying in Japan, Europe and possibly the UK.

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

Riskier fixed income assets also enjoyed a strong quarter with both corporate and emerging market debt outperforming. Within the corporate bond market, Brexit has thus far created ripples rather than a tidal-wave of selling. The relative calm has been encouraged by the start of the ECB's corporate bond-buying spree. In the wake of the strong rally in high-yield debt, we have downgraded our outlook from positive to neutral.

However, we remain optimistic about emerging market debt. Despite the headwinds facing several emerging market economies, their debt markets have been notable outperformers. Local currency bonds have been buoyed by declining expectations of rate hikes from the US Federal Reserve. Bonds denominated in US dollars have rallied with firming commodity prices.

CURRENCY

Foreign exchange markets were well-behaved up to the EU referendum, with sterling slowly recouping its losses from the first quarter as markets slowly gravitated towards a 'remain' vote. The unexpected outcome to leave resulted in sterling nose-diving against all other currencies. With so many political and economic uncertainties, the Bank of England is expected to cut rates. There is also a risk of foreign inflows drying up, which are needed to finance the large current account deficit. In this environment, it is hard to find a fair value for sterling. We have been short sterling for most of the year, albeit reducing the short over the second quarter. However, we went straight back to a short position at the first possible moment after the referendum.

Currencies	Views
US dollar	◆◆
Euro	◆
Sterling	◆
Yen	◆
EM FX	◆

The European economy, with the UK as an important export destination, will be negatively impacted as well. However, it is mainly the political uncertainty about the future of the European Union and eurozone, stoked by many national elections and possibly more referendums across Europe, that has dragged the euro lower against the US dollar after the EU referendum. We remain short the euro against the US dollar.

The Japanese yen has acted as a beacon in the storm, helped by the Bank of Japan refraining from monetary loosening. This is despite disappointing economic growth and inflation drifting lower making the inflation target elusive. The yen has strengthened close to levels where we expect Japanese officials will be drawing a line in the sand through increased verbal or actual intervention.

CONTACT US

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IMPORTANT INFORMATION

Legal & General Investment Management Limited (Company Number: 02091894) is registered in England and Wales and has its registered office at One Coleman Street, London, EC2R 5AA ("LGIM").

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