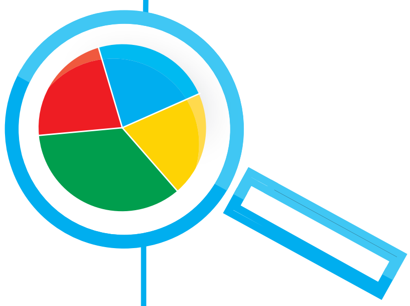
ASSET ALLOCATION **VIEWS**

US takes centre stage

The global equity rally gathered steam in the fourth quarter of 2016, with markets moving higher despite a backdrop of rising political uncertainty.



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 opportunities to add risk at attractive levels
- Possible dollar strength as Trump's reflationary policies come into focus and the Fed potentially responds
- Asset purchases by central banks could keep asset prices supported

Overview	Views
Equities	Mild dislike
Govt. bonds	Neutral
Credit	Neutral
Real estate	Mild bias
Commodities	Mild dislike

Equities	Views
US	Neutral
UK	Mild dislike
Europe	Mild dislike
Japan	Neutral
Emerging markets	Mild dislike

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

Currencies	Views
US dollar	Mild bias
Euro	Neutral
Sterling	Mild bias
Yen	Neutral
EM FX	Moderate dislike

Key						
Strong dislike ◆◆◆	Moderate dislike ◆◆	Mild dislike ◆	Neutral ◆	Mild bias ◆	Moderate bias ◆◆	Strong bias ◆◆◆

*Asset allocation views represents the viewpoint of the asset allocation team at LGIM

Legal & General INVESTMENT MANAGEMENT

The US took centre stage, with the twin drivers of the Federal Reserve's interest rate policy and November's presidential election shaping market movements. President-elect Trump's victory led investors to anticipate rising domestic growth and inflation given his plans for a significant fiscal stimulus package.

Western stock markets and bond yields moved notably higher in response. This trend continued into December, even as the Fed took the decision to raise US interest rates for only the second time since the global financial crisis, with the FTSE 100 reaching an all-time high in the final days of 2016. However, emerging markets had a weak quarter despite higher commodity prices, as concerns grew about the potential knock-on implications from a Trump presidency given his 'America first' rhetoric and focus on favouring domestic production over global imports.

SHORT-TERM OUTLOOK

Is Trumpflation already priced in?

We have closed our tactical long equity position as market performance has been notably strong, investor sentiment is currently too bullish for our liking and we fear investors will look for a new theme in early 2017. The most likely candidates for this are geopolitical risks, protectionism and/or China. We have now moved back to our cautious medium-term view, which is driven by elevated systemic risks. Even if Trump's fiscal plans happen in size, they arrive at the wrong point in time. Although they could result in short-term economic acceleration, any cyclical upturn is likely to push the economy to 'late-cycle' more quickly and increase recession risks.

Is the US dollar rally set to continue?

The Fed raised US interest rates as expected in December. The surprise, however, was a more hawkish trajectory for the 'dot' forecasts, with three rate hikes now projected for next year. The US dollar soared, while bond yields also rose. With two and a half hikes priced in for next year, we believe the market is fairly priced, with risks in both directions. Significant fiscal stimulus could move markets higher, but excessive dollar strength and negative knock-on effects (both domestically and abroad) from the tightening in financial conditions since the US election could cause another delay in rate hikes.

We believe that current momentum could push the euro towards parity with the dollar, although we are aware that this is the consensus trade for 2017.

China fears could come back to the fore

China has been out of the market limelight as investors have focused on Brexit, Trump and the Italian referendum / banking crisis. We believe investors will soon re-focus back on China and yuan weakness. There are plenty of warning signs on the horizon and we know from January 2016 that it doesn't take much to create a Chinese economic scare. We expect a cyclical slowdown in China in the first quarter of 2017. Although we do not see this as the start of a hard landing, we do expect China risk premia to widen considerably in the coming months and have placed shorts in Asian currencies and hold an underweight in commodities and other China proxies.

OUR MEDIUM-TERM VIEWS

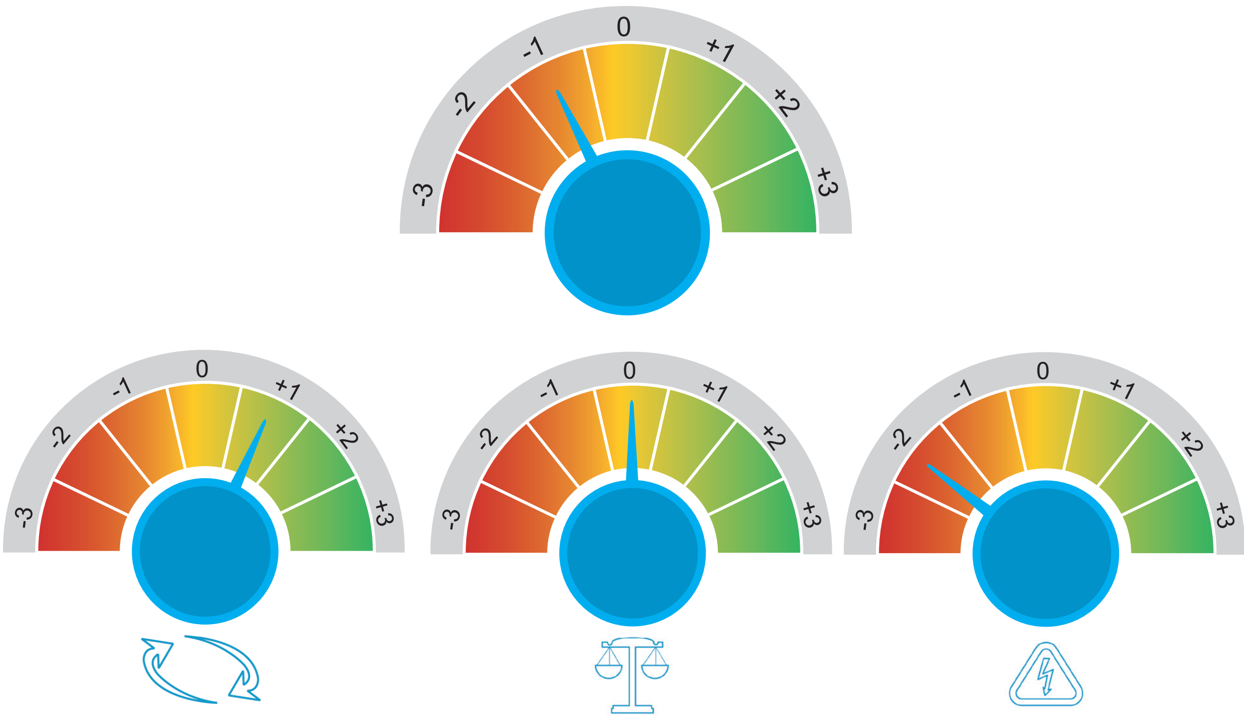
We are underweight risk assets as part of our medium-term views. As the dials indicate, this is primarily driven by concerns about systemic risks. In particular, we are focused on the repercussions of 2016's political turmoil (Brexit, Trump) and the potential for further shocks in the year ahead (the French, Dutch and German elections). Elsewhere, the build-up of debt in emerging markets increases the vulnerability to debt service shocks just as the US Federal Reserve is embarking on a multi-year process of normalising interest rates.

By their nature, such risks are difficult to quantify and timing their eruption is extremely challenging. However, we have little doubt that systemic fragilities are high. These have largely been masked by repeated central bank interventions over the last few years, such as QE, negative interest rates and yield curve control. This monetary support becomes harder to sustain with inflation starting to rise around the world.

On the cyclical front, the indications that we are progressing from the middle to the latter stages of the economic cycle are spreading. This comes with growing concerns about downside market risks. We have long held the view that US trend growth has slowed dramatically compared to before the financial crisis. Global growth of around 2% has been enough to deliver steadily falling unemployment rates and, more recently, upward pressure on wage growth. This implies that any short-term efforts to drive growth up towards 4% for political reasons are likely to be both ill-advised and short-lived. There are considerable risks inherent in driving growth meaningfully above its trend rate: capacity pressures are likely to drive wage and price inflation higher, while excessive risk-taking could lead to increasingly overheated financial markets.

With limited upside for corporate earnings, any equity re-pricing has to come from higher valuations. However, valuations are towards the higher end of the range with which we feel comfortable. Moreover, with government bond yields having risen sharply in Q4, the 'valuation cushion' relative to fixed income assets has been eroded.

Core views for risk assets



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

Valuations
Risk asset valuations are not excessive

Systematic risk
Material risks from Brexit/Trump/Europe and emerging market debt

EQUITIES

The fourth quarter was clearly dominated by the US election, with both the run-up to the event and the fall-out thereafter driving investor sentiment. The profile of equity returns reflects this pattern as well, with the US election marking a turning point in global equities.

October was dominated by uncertainty heading into the election, with newsflow leading to large changes in probabilities of either candidate winning. The election itself played out in some respects like the Brexit vote. Consensus was wrong on the election outcome, the reaction of risk assets was much better than expected but the relative performance of affected sectors (the winners and losers) was in line with expectations. Within equities the top performers over the quarter included mostly election winners: defence, US small caps, infrastructure and cyclical companies. On the other side of the spectrum we find bond proxies and emerging markets. The latter, however, rallied again into the end of the year as concerns about China continued to fade on the back of stronger growth and credit data.

In general, we have been neutral on equities in Q4. We changed a short equity position into neutral ahead of the US election and ran a tactical long in December in expectation of a year-end rally. On the regional side we were long Japanese equities and short euro zone equities for most of the quarter. We went short emerging market equities after the election in expectation of Donald Trump's policies hurting global trade and the expectation of a Chinese growth scare in Q1/Q2 2017.

FIXED INCOME

Fixed income markets repriced significantly in the fourth quarter on expectations of a major change in fiscal and regulatory policy from the new US administration. Large fiscal stimulus (tax cuts and infrastructure spending) has the potential to break the secular stagnation trends that have gripped the bond market for the last couple of years. Nominal bond yields moved up by around 80bps in the US and 40bps in the UK / euro zone. Other market-moving events (the OPEC deal to cut oil production; the Italian referendum) pale into insignificance relative to that fundamental reset of inflation expectations.

We introduced a significant underweight in nominal government bonds in the immediate aftermath of the US election before moving back to neutral in December after yields moved up by around 80bps in less than two months. To sustain recent pricing, we will need to see the transition from rhetoric to action. We are sceptical that fully-fledged tax reform will survive the pivot from campaigning to governing, implying a significant risk of a fall back in real yields. The move in inflation expectations seems more sustainable given evidence of firming US wage growth. We have therefore reduced, but not closed, our long-standing overweight in US inflation-linked debt.

Credit markets were also heavily influenced by the political news. Scrapping interest deductibility is on the political agenda. Alongside a reduction in corporation tax, this would represent a significant change to the incentives of corporates to issue bonds. Forecasts of dramatically reduced supply have therefore helped to sustain the rally in corporate bonds. The moves have been most dramatic in the US high yield market where spreads tightened by around 75bps over the course of Q4, with smaller echoes in investment grade markets.

Emerging market debt spreads held near multi-year lows for the second quarter in succession despite the protectionist rhetoric of the President-elect. We continue to view emerging market sovereigns as an interesting place to source healthy risk-adjusted yields and remain overweight over the medium term.

CURRENCIES

Political developments once again took centre stage in driving currency prices in the fourth quarter. At the Conservative conference in early October, Theresa May made it clear that "Brexit means Brexit" and that ending the jurisdiction of EU law and free movement from Europe were priorities. Sterling took a pounding as financial markets priced in a harder Brexit amid free trade not being the government's top priority.

The remainder of the fourth quarter was all about the US presidential election. Going into the election Donald Trump was feared by financial markets with the US dollar down in the first week of November. Following his win, financial markets didn't need much time to swing towards a reflation theme amid the expectation of increased fiscal spending and tax cuts in the US. Higher growth and inflation expectations propelled both interest rates and the US dollar higher. A potential tax break for US corporates repatriating foreign earnings and a higher likelihood of the Fed needing to respond with more rate hikes led to a sustained US dollar rally during the remainder of 2016.

However, with expectations elevated and many investors being long the US dollar, we have chosen to close some of our currency trades. Currently, we are fairly neutral on the US dollar against other developed currencies, including the euro and Japanese yen. In the fourth quarter, we have instigated a long position in the sterling against the US dollar as we believe the market has caught up with the idea of a hard Brexit and the currency has weakened sufficiently. We continue to be more worried about emerging market currencies, as global trade would be a clear victim of a move towards more protectionism.

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