

Steady and synchronised

In this quarterly outlook we outline our asset allocation views and address three key questions on equities, US monetary policy and emerging markets.



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Our global views in a snapshot:

Equity market outlook

1.
How has the equity outlook evolved?

Delayed Chinese risks improve global outlook

US monetary policy

2.
What are the implications of quantitative tightening?

Liquidity withdrawal favours long US dollar stance

Emerging market growth

3.
A new dawn for the developing world?

Emerging outlook still uncertain, but the best for some time

Over the last few months, global growth has broadened and inflation has remained low. During September we upgraded our medium-term view on equities from cautious to neutral. We have increased risk across the board by gradually increasing equity exposure where we see value, using cashflows to do so and in some cases reducing cash balances in funds with excess cash. This change was largely triggered by our view on systemic risks becoming less negative. Despite the ever-present short-term risks bringing uncertainty, we believe that it is unlikely that any of them escalate materially at the moment, or at least that they are appropriately priced into markets. These risks include the US debt ceiling, Chinese growth and geopolitical tensions with North Korea.

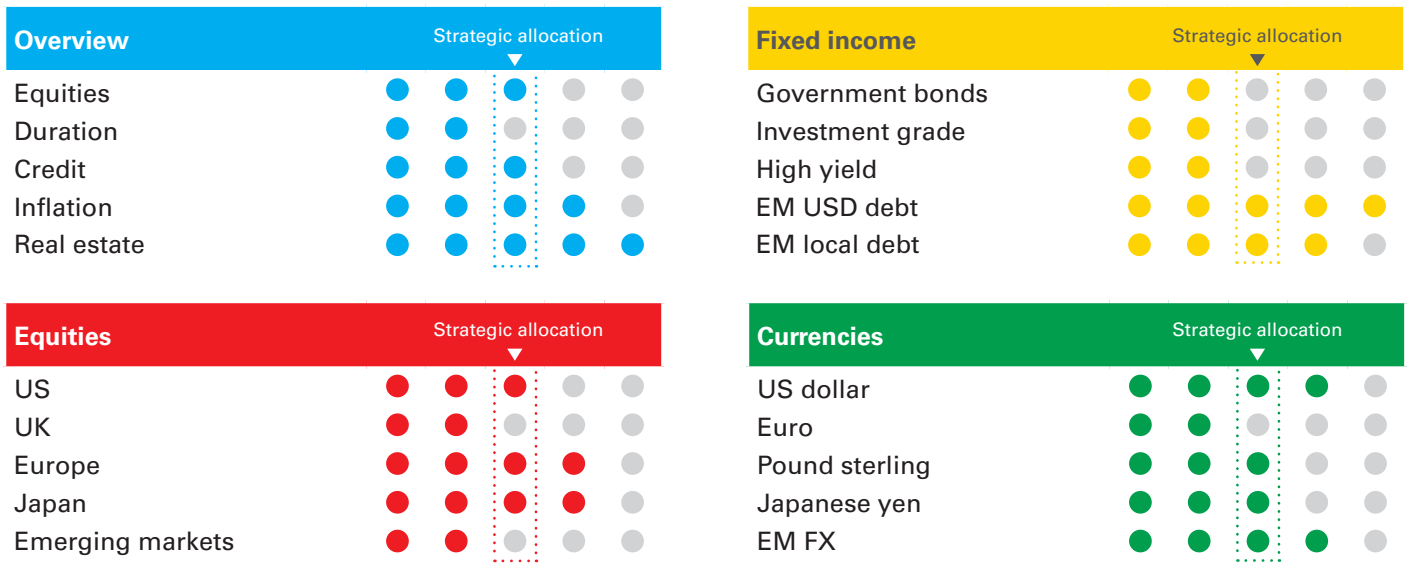
Whilst we remain negative on emerging market (EM) equities relative to developed markets, we have upgraded our view on local currency emerging market debt and

EM currencies on the basis of the favourable economic backdrop and limited recession probability. We also retain our positive view on emerging hard currency debt. In contrast, we are still negative on the prospects for European investment grade debt and high yield given the tightness of credit spreads.

We reduced from neutral our global duration exposure just ahead of the recent rise in yields. On a relative basis, we are negative on US treasuries and gilts and positive on German and Australian government bonds. We also remain positioned for strength in the US dollar.

SUMMARY OF LGIM ASSET ALLOCATION VIEWS

This schematic summarises the combined medium-term and tactical views of LGIM’s Asset Allocation team.



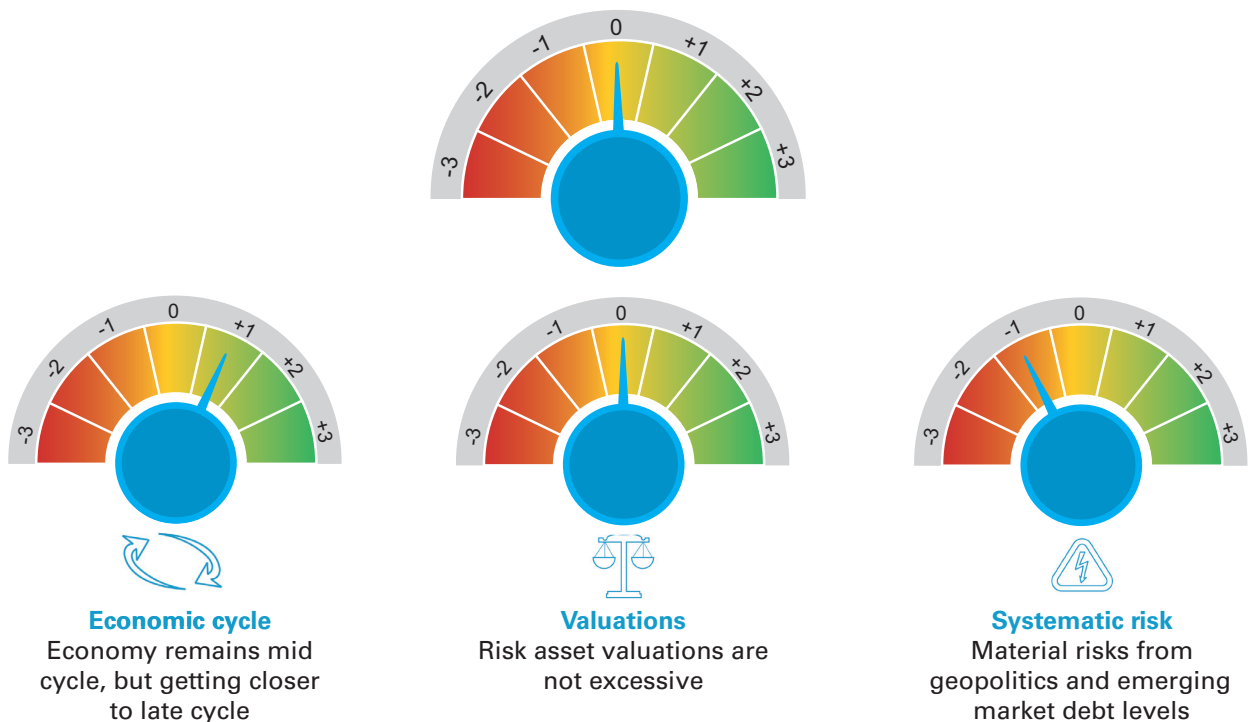
The mid-point of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.



1. How has the balance of risks around the equity outlook evolved?
Lars Kreckel,
Global Equity Strategist

We have raised our medium-term view on risky assets from cautious to neutral. Our medium-term view is based on the dials in Figure 1: economic cycle, valuations and systemic risk, which we score from -3 to +3, based on key structural trends, themes and risk factors.

Figure 1: Our core medium-term views. Neutral overview



Source: LGIM

A BALANCED APPROACH

Our current positioning is neutral to slightly positive on risk assets (most positive on real estate, and EMD bonds), hedged with long dollar and long US inflation positions. We believe this balance in the portfolio is especially important as we see two main transition mechanisms that will derail the risk trade: a stronger dollar or rising inflation.

Dollar strength could cause the sort of domino effect that starts with emerging market weakness, commodity weakness, credit weakness translating into general risk aversion. Inflation would lead to rate hikes, awakening the bond vigilantes. This would imply the economy would move to late cycle (with increasing risk of a recession) and structural weaknesses would be brought out into the open. Hence we like our portfolios to be long risky assets while hedged with long dollar and long inflation.

WHAT'S CHANGED?

This change was largely triggered by our view on systemic risks becoming less negative, moving from -2 to -1.

Our China view has been the main driver of the change. The risks that stem from the large and fast build-up of debt in some EMs, and particularly in China, have been in our sights for a long time and have not disappeared. But recent data and developments suggest that over the next two to three years these risks should be relatively manageable.

- China still has important defences in the form of fiscal space. As large as government debt to GDP is, it does not look unsustainable for China given its size, savings rate and state assets
- Most of the debt is owned by state-owned enterprises and also owned by the state via state-owned banks. With one state organ borrowing from another, we believe that rollover risks are greatly reduced
- The latest data suggest a modest de-leveraging of the Chinese corporate sector. While this does not solve the problem, it is a notable move in the right direction
- On balance we do not place a high likelihood on a Chinese property meltdown happening yet. Nationwide housing prices have been broadly flat in real terms since 2010, which is at odds with what you would expect of a country at the peak of a property bubble

WHAT HAS NOT CHANGED?

The other two dials remain unchanged. We continue to see the global economy in a mid-cycle phase where the excesses that typically bring an economic cycle to an end have not yet built up. Equities tend to deliver some of the best risk-adjusted returns in this phase of the cycle.

Our valuation score remains in neutral territory. While asset prices are high across the board, aside from some pockets valuations are not at excessive levels where they become a dominant medium-term driver. The relative valuation of risky assets like equities to fixed income assets remains at historically attractive levels in our view.

WHAT DOES IT MEAN FOR PORTFOLIOS?

As a result we have increased risk across portfolios by gradually increasing equity exposure where we see value, using cashflows to do so and in some cases reducing cash balances in funds with excess cash.



2. How will quantitative tightening work? What are the potential implications for asset prices?

Chris Jeffery,
Strategist Asset Allocation

The mystery of quantitative easing (QE) is that no-one really knows how it works. Ben Bernanke, the former head of the Federal Reserve, once quipped: “The problem with QE is that it works in practice, but it doesn’t work in theory”. In principle, the public sector is simply swapping one kind of government liability (bonds) for another (money). Under the expectations hypothesis of the determination of interest rates, this kind of financial engineering should have no impact on yields. So it’s a bit of a puzzle why it seems to have such powerful effects.

Given that economic theory is pretty silent on the benefits of this kind of liability transformation exercise, it is no wonder that there are a series of unanswered questions. Is it the flow of asset purchases that matters? Is it the stock of bonds held by the central bank that matters? Is it the act of creating additional money to finance those purchases? Or is it the signal about interest rate intentions?

This debate is crucial given that the Federal Reserve is now beginning the multi-year process of winding down its balance sheet. After nearly a decade of quantitative easing, we are now entering the era of US quantitative tightening (QT). The September meeting delivered the plan laid out in detail in June. Over the next twelve months, the Fed’s balance sheet will therefore shrink by \$300bn as maturing securities are not fully reinvested.

There is only limited historical precedent we can draw upon when thinking about the impact on asset prices and the broader economy. A 2015 working paper from Niall Ferguson (among others) suggests we should be cautious: “Historically, balance sheet reduction episodes have gone hand-in-hand with lower growth rates, somewhat lower inflation rates and substantial slowdowns in financial sector lending activities.”

However, there are a couple of caveats.

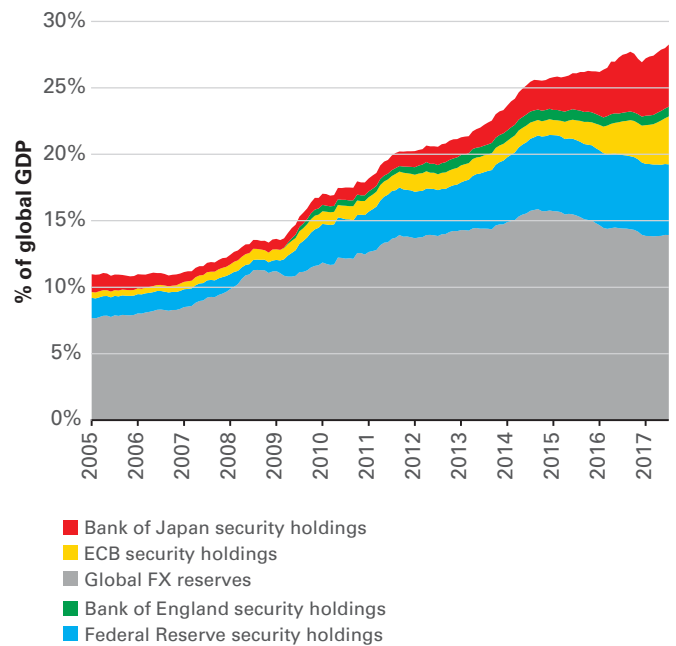
First, estimates of the impact of QE on government bond yields are in the range of 50-100bps. That mixes up the ‘pure flow’ effect of asset purchases with the ‘signalling’ effect of ‘lower-for-longer’ interest rates. As asset purchases unwind, the signalling effect is still in place given the central bank mantra that interest rate hikes will be “limited and gradual”. Removing the flow only removes the signal if inflation rears its ugly head again.

Second, we question the extent to which equity markets (in particular) have been puffed up by QE. We believe that the majority of the equity price appreciation since 2009 can be explained by earnings growth and normal bull market multiple expansion. You don’t need a QE-based ‘deus ex machina’ to explain equity returns.

Third, the Fed’s balance has already been shrinking as a share of GDP for the last three years. From that perspective, we’ve been living with QT since late 2014 and it hasn’t exactly been a difficult period for risky assets.

Fourth, at the global level, this is definitely not the end of the story. On our estimates, the European Central Bank and Bank of Japan will collectively purchase the equivalent of \$1 trillion of assets over the next year. On top of that, we may have some reserve accumulation in emerging

Figure 2: The pace of quantitative easing is starting to slow



Source: Bloomberg

markets. If those purchases are funded by money printing (rather than sterilised by issuing domestic debt), then it will add further to the global QE flow.

From a global perspective, the QE train is starting to slow down (Figure 2). However, it is not likely to come to a standstill until the third quarter of 2018 at the earliest. It looks set to be over a year before it goes into reverse.

So, for QT to have a big impact (at least in the next twelve months), it needs to be because of problems that are specifically associated with a shrinking in the nominal value of the US dollar narrow money supply. We believe those stresses could be seen first in short-dated dollar funding markets (eg. the spread between short-term borrowing rates for the US government and US banks, the spread between the cost of ‘on-shore’ US dollars and ‘off-shore’ US dollars), and the price of the dollar itself.

Consistent with our ‘policy divergence’ investment theme (and despite little success on this front in 2017) we therefore think it is prudent to continue holding long US dollar positions as a hedge against unexpected strains due to the normalisation of US monetary policy.



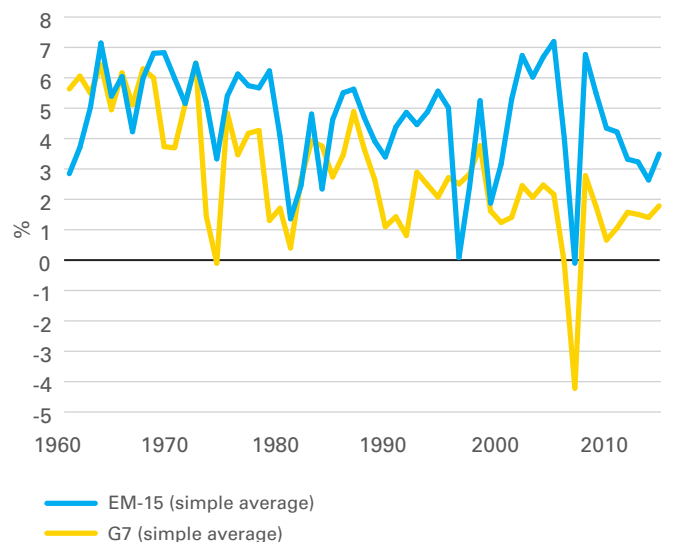
3. A new dawn?—Emerging market growth outlook
Magda Polan,
Global EM Economist

2017 looks set to mark the first year of an EM growth pick-up after six years of successive slowdowns (Figure 3). The growth acceleration has not only been driven by the high-profile recoveries of Russia and Brazil; it comprises about 70% of the EM universe. We take this opportunity to ask what lies in store for EM both in the short and medium term.

The short-term EM outlook is closely linked to China’s growth prospects, given their implications for commodity markets. We expect China’s growth to slow very gradually from currently 7% to around 6.5% in 2018 and 6% in 2019. We are worried about China’s debt but, as discussed in various [blogs](#), see state-owned banks and ample fiscal space as potential safeguards against a financial crisis and rapid slowdown.

EMs more broadly have sufficient fiscal and monetary space, which bodes well for short-term growth. Average government debt stands at 45% of GDP compared to 55% in the early 2000s and 65% in the late 80s. Real policy rates are still far from levels where they constrain growth, providing a sufficient buffer against higher Fed rates.

Figure 3: Emerging markets: the end of a multi-year growth slowdown



Source: Macrobond

Most encouraging from a short-term angle is that EMs have started to deleverage since early 2016. By this we mean that their credit gap – the gap between debt-to-GDP and its long-term trend – is falling. This means no more negative growth impulse as long as the pace of deleveraging does not pick up unnecessarily.

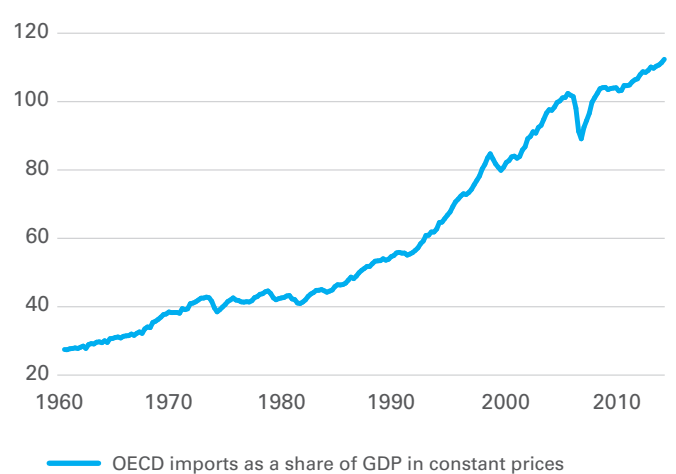
EM credit ratings which fell since end-2014 have been rising again in 2017. They are still firmly in investment grade territory putting EM in a better place than they have been for most of their rating history.

Globalisation which stalled in the five years following the global financial crisis is advancing again (Figure 4). The pace has come down from the heydays of 1993-2008, but is comparable to earlier historical episodes. This is good news for EMs, many of which are integrated into the global production chain and rely on exports for development.

The picture of emerging markets’ manufacturing prowess, their motor of industrialisation, is more mixed. We observe a difference between incumbents like Korea, Mexico or Poland which are gaining market share, and latecomers like Brazil, South Africa or Philippines who are losing market share. If not reversed, this trend could hold back the latter’s convergence with advanced economies.

While “new dawn” is probably too strong, we believe that the outlook for emerging market growth has not been this good in a while. How do we express this view? The firmer growth outlook should support emerging market assets. With the equity outlook clouded by some of our risk scenarios and the potential impact of a strengthening US dollar on earnings, we prefer to express that currently in emerging market debt.

Figure 4: Globalisation



Source: Macrobond. Index, 2010=100.

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