VOLATILITY IS HERE TO STAY

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ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £113.9 billion in life insurance, pensions and third party funds*. The multi asset team manages the Governed Range and well as Global Multi Asset Portfolios (GMAPs) and the Multi Asset Strategies Fund (MAST) available on platforms.

*As at 31/12/2018

This month's contributors:

Trevor Greetham
Head of Multi Asset
Hiroki Hashimoto
Fund Manager
Nersen Pillay
Investment Director
Jake Winterton
Assistant Multi Asset Analyst

We have seen large swings in stock markets over the last year and we think higher levels of volatility are here to stay.

Volatility is associated with economic weakness. We are late in the business cycle and two years of US interest rate hikes are starting to take effect.

Please visit www.investmentclock.co.uk for our blog and information about our multi asset range. For product details, contact: *multiassetsupport@rlam.co.uk*

Last October we warned of trouble ahead and said we'd neutralised equity exposure over the summer. This gave us firepower to buy stocks at lower prices in 2018 Q4, blaming the sell-off on premature recession fears. Stocks have since posted one of their strongest quarters in decades, allowing us to take some profits. There are positive near-term signs but volatility is a common feature late in the business cycle and we see two-way risk ahead. Active tactical asset allocation and sensible diversification will be key. Our new Multi Asset Strategies Fund (MAST) goes one step further, reducing equity exposure to cap volatility and limit losses over periods of sustained market turbulence.

Tentative near-term signs of improvement

Our Investment Clock model moved into bond-friendly Reflation at year-end after a sharp drop in energy prices took inflation pressure out of the system. Central banks have reacted by stopping or delaying rate hikes. Meanwhile, last year's slowdown and fears of a trade war prompted China to announce a new stimulus programme. Data is mostly still weak but the rise in Chinese business confidence bodes well.

Late stage of the cycle suggests concerns for 2020

We expect stocks to rise further but we see two-way risk longer term. In June this will be the longest US economic expansion since 1857, unemployment is low and the Federal Reserve has hiked rates for two years. Volatility typically rises at this stage of the cycle (see chart 1). Geopolitical risk, the inverting US yield curve and weak housing data suggest a rising risk of recession in the next 12-18 months.

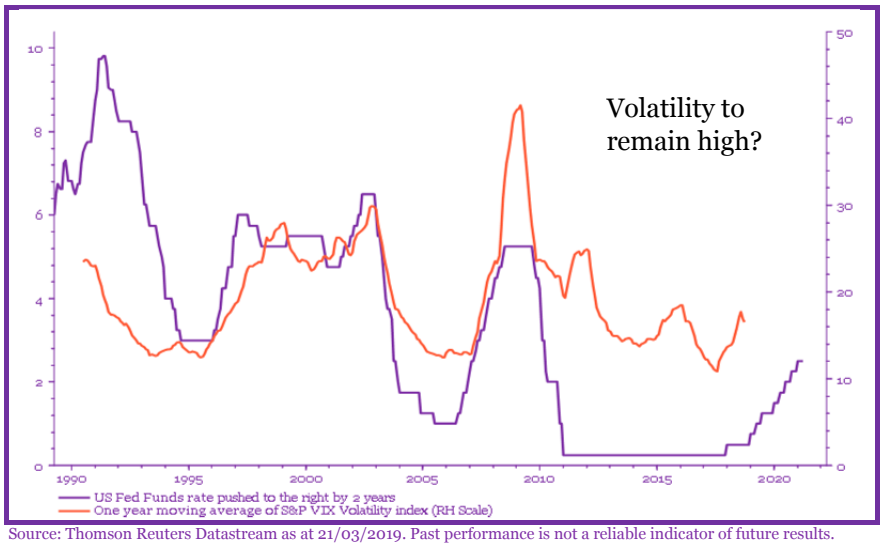
Brexit risks persist

Political uncertainty will keep Brexit a live issue for some time. Investors with a low appetite to risk should continue to limit overseas currency exposure. The more adventurous should look to own assets that should do well in different scenarios.

New Fund Launch: Multi Asset Strategies Fund (MAST)

Investors shouldn't have to choose between participating in rising markets and taking a more market-neutral approach when economic conditions deteriorate. Our new Multi Asset Strategies Fund is designed for investors looking to generate long-term growth with a particular focus on downside risk control. We designed it with institutional investors and those taking an income in retirement in mind.

Chart 1: Fed funds leads equity volatility by 2 years



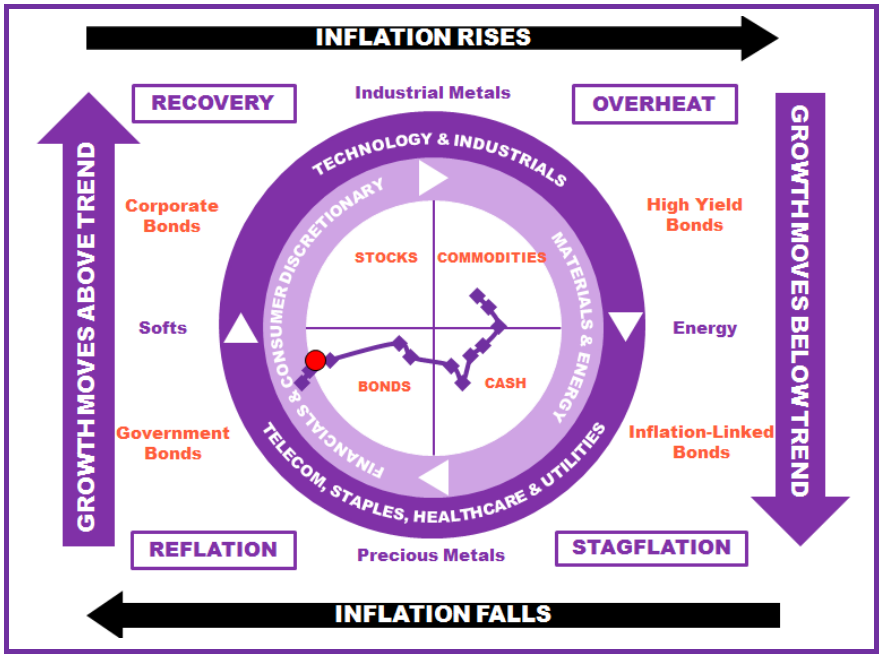
Source: Thomson Reuters Datastream as at 21/03/2019. Past performance is not a reliable indicator of future results.

TENTATIVE SIGNS OF IMPROVEMENT

This time last year the Investment Clock was in Overheat with strong global growth, rising inflation and US rate hikes. We moved South as growth indicators weakened and ended the year in equity-unfriendly Stagflation.

The Clock is now in bond-friendly Reflation (chart 2) after the sharp drop in energy prices took inflation pressure out of the system. Central banks reacted to the deflationary backdrop by stopping or delaying planned rate hikes. Meanwhile, last year's slowdown and fears of a trade war prompted China to announce a new stimulus programme.

Chart 2: Investment Clock in Reflation

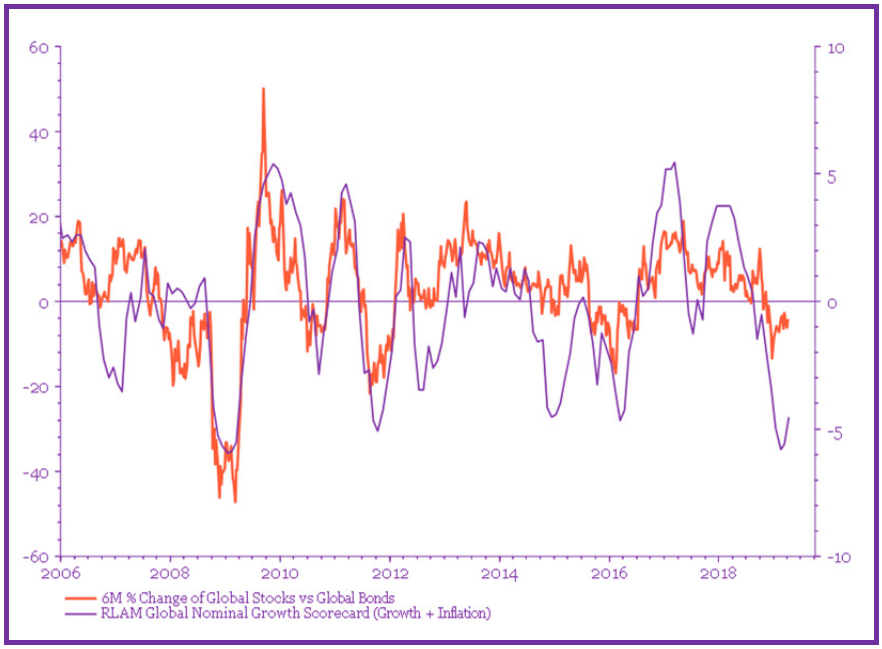


Source: RLAM as at April 2019. Note Trail based on monthly evolution of RLAM growth and inflation indicators. Red dot shows current month. For illustrative purposes only.

The latest readings from our indicators suggest a further move clockwise with stocks beating bonds (chart 3). Data is beginning to stabilise and there are some brighter spots such as the recent rise in Chinese business confidence. Oil prices have also risen from their December lows, causing a pick-up in inflation expectations.

We wouldn't rule out a relapse if economic data surprises negatively but our base case is that gradual China-led improvement continues and supports a further rise in stock markets. It's quite possible that the Investment Clock moves full circle, ending the year in Overheat once more with the Fed resuming its monetary tightening.

Chart 3: Stocks vs bonds and nominal growth scorecard



Source: Thomson Reuters Datastream as at 04/04/2019. Past performance is not a reliable indicator of future results.

YIELD CURVE ADDS TO CONCERNS FOR 2020

We expect stocks to rise further this year but we see two-way risk longer term. China may be showing signs of recovery but the US is very late into its economic cycle, unemployment is at a multi-decade low and spare capacity is limited.

It can take a year or two for changes in interest rates to filter through to economic activity and there are already two years of Fed rate hikes in the pipeline.

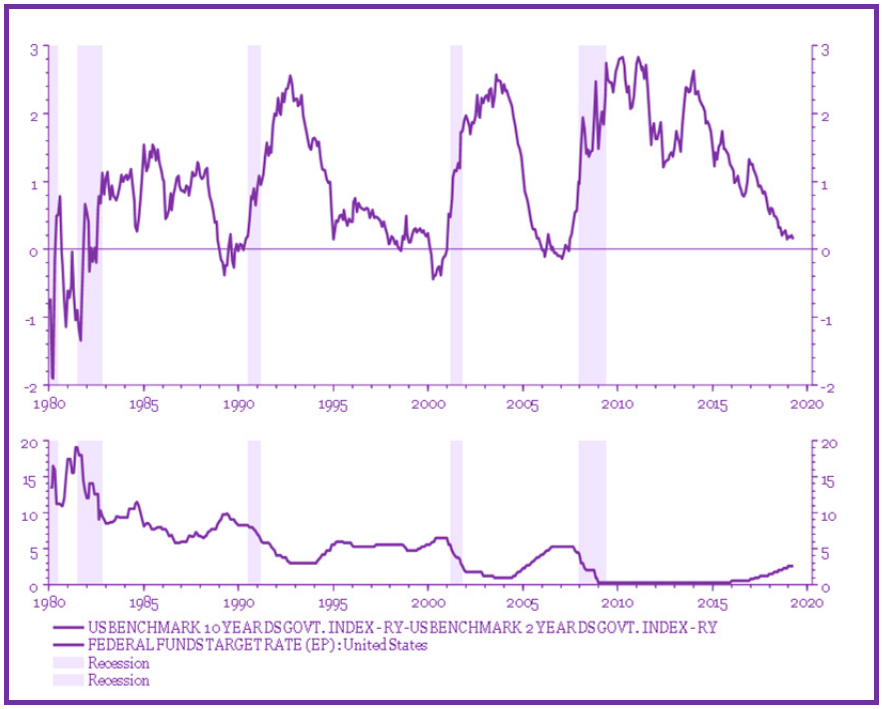
Weakness in the US housing market tends to predict a rise in US unemployment by about eighteen months (chart 4). Mortgage rates have fallen a touch since the Fed's decision to put a pause on rate hikes but the housing market indicators will merit close attention. A resumption of rate hikes later in the year could push it over the edge.

Chart 4: Housing market a lead indicator for unemployment

Source: Thomson Reuters Datastream as at 15/03/2019. Past performance is not a reliable indicator of future results.

Meanwhile, signals from the US bond market also suggest longer-term caution. In every business cycle there comes a time when short-term interest rates rise above long-term rates. Such an inversion in the yield curve can be a 12-18 month lead indicator of recession (chart 5), adding to concerns for 2020.

Chart 5: US 10Y/2Y yield curve spread with recession bars



Source: Thomson Reuters Datastream as at 04/04/2019. Past performance is not a reliable indicator of future results.

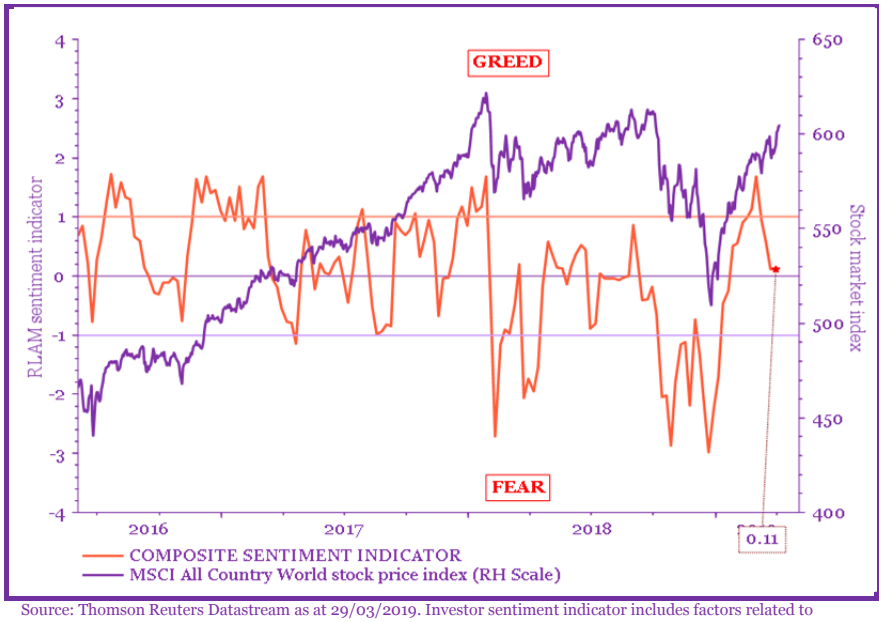
VOLATILITY CAN CREATE OPPORTUNITIES

Volatility can create opportunities for active investors willing to go against the crowd. We measure fear and greed in the markets using a proprietary investor sentiment indicator to help us recognise moments when the market is being too pessimistic.

Our indicator registered one of its ten most extreme contrarian buy signals in late December (chart 6) during what we called the "Trump Slump". This was a brutal sell-off exacerbated by a Christmas twitter storm of threats of a trade war with China and criticism of the independent US Federal Reserve.

Stocks priced in a recession prematurely and have since rallied strongly.

Chart 6: Global stock prices and RLAM sentiment indicator

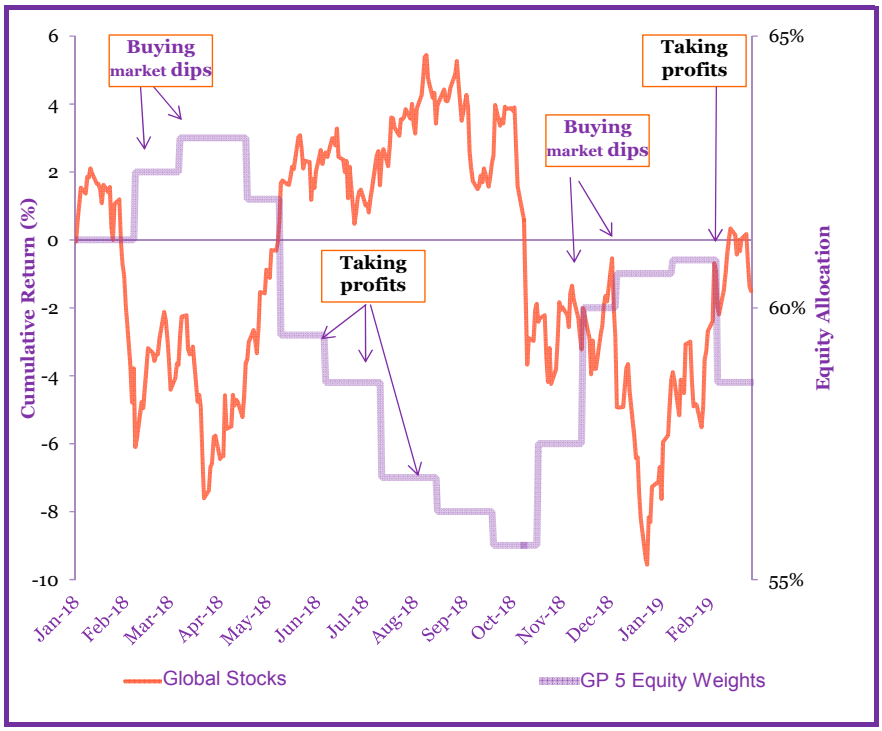


Source: Thomson Reuters Datastream as at 29/03/2019. Investor sentiment indicator includes factors related to market volatility, private investor bullishness and US director buying of shares in their own companies. Past performance is not a reliable indicator of future results.

If we are in a new regime prone to periodic spikes in volatility, we will benefit from an active strategy that can take advantage of it, buying on a market panic and selling when sentiment becomes too optimistic.

This process was in evidence in our tactical asset allocation strategies twice in 2018 (chart 7). We bought during Q1 weakness, sold over the summer and bought again during Q4.

Chart 7: Taking advantage of market volatility



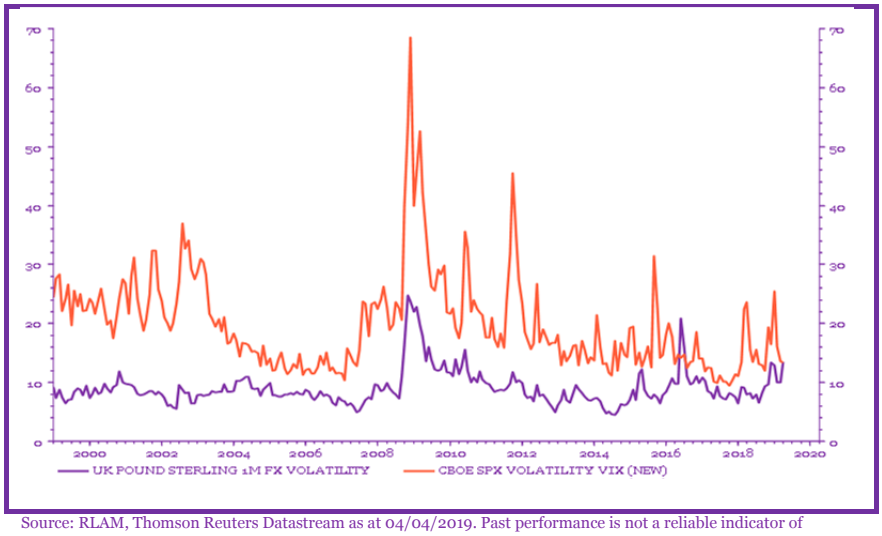
Source: RLAM as at February 2019. GP5 refers to Royal London Governed Portfolio 5, a mid-risk multi asset fund within our pensions proposition. Past performance is not a reliable indicator of future results.

BREXIT RISK PERSISTS

At the time of writing, the Brexit situation remains deeply uncertain and we still cannot rule out a No deal exit or a No Brexit scenario. Whatever happens in the next few weeks, political uncertainty will continue and we expect Brexit risk to persist for months.

This uncertainty has pushed sterling volatility up to a similar level as equity market volatility (chart 8). Investors should try to hedge Brexit risks by being careful about overseas currency exposure and investing across assets that will perform well in a range of different scenarios.

Chart 8: Sterling volatility and equity volatility

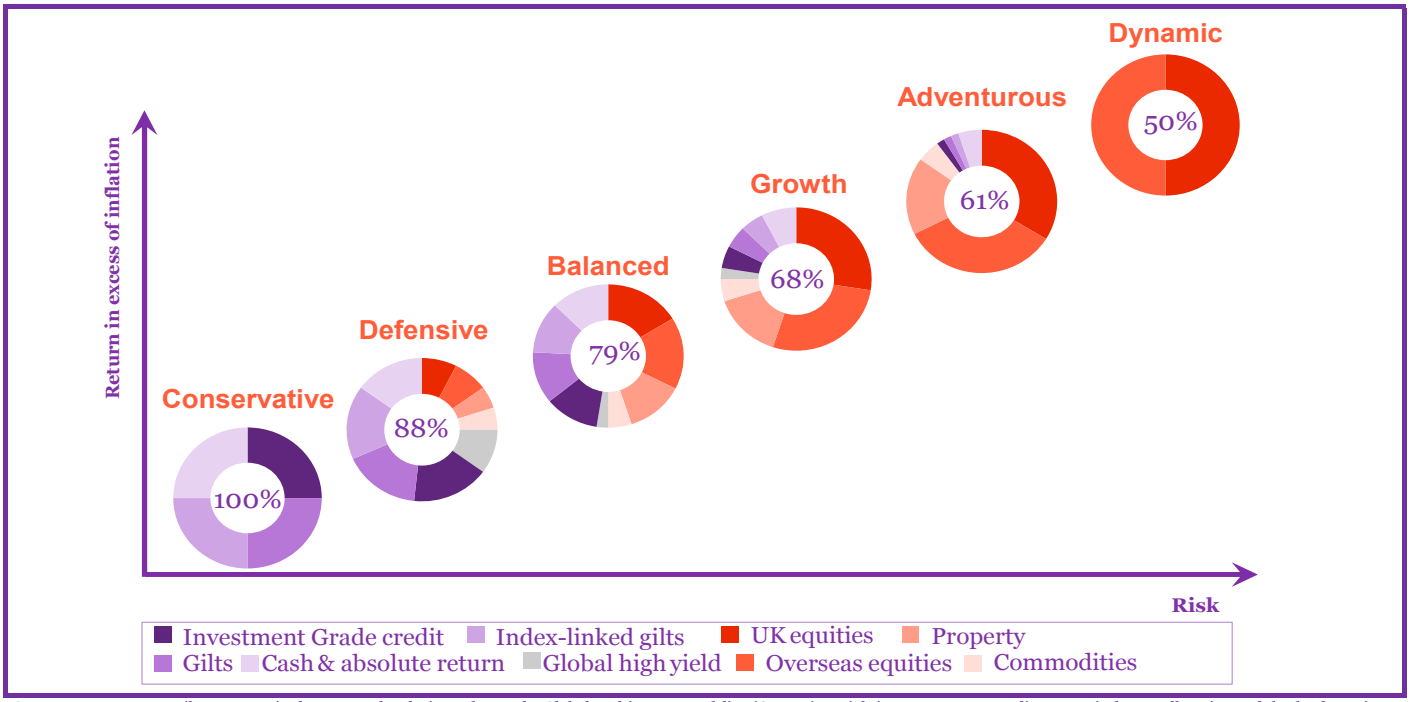


Source: RLAM, Thomson Reuters Datastream as at 04/04/2019. Past performance is not a reliable indicator of future results.

We have three pragmatic suggestions:

1. Resist the temptation to forecast. A final decision may come very late and involve unexpected developments
2. Investors with a low appetite for risk may consider investing in portfolios with a high proportion in sterling-denominated investments. This is the approach we take with our risk-rated GMAP funds (chart 9) and Governed Portfolios
3. Consider investing in growth-seeking assets that would do well in different scenarios. We include commercial property alongside equities. Property may do well if the UK ends up in a closer relationship with the EU. Equities would probably do better in a more distant relationship, with a weaker pound inflating the value of overseas earnings

Chart 9: RLAM GMAP range with % sterling exposure for each benchmark (in centre)



Source: RLAM as at April 2019. Text in the centre of each ring refers to the Global Multi Asset Portfolios (GMAPs). Weightings may vary according to tactical asset allocation and the fund may invest outside of indicated asset classes as the manager sees fit. For illustrative purposes only.

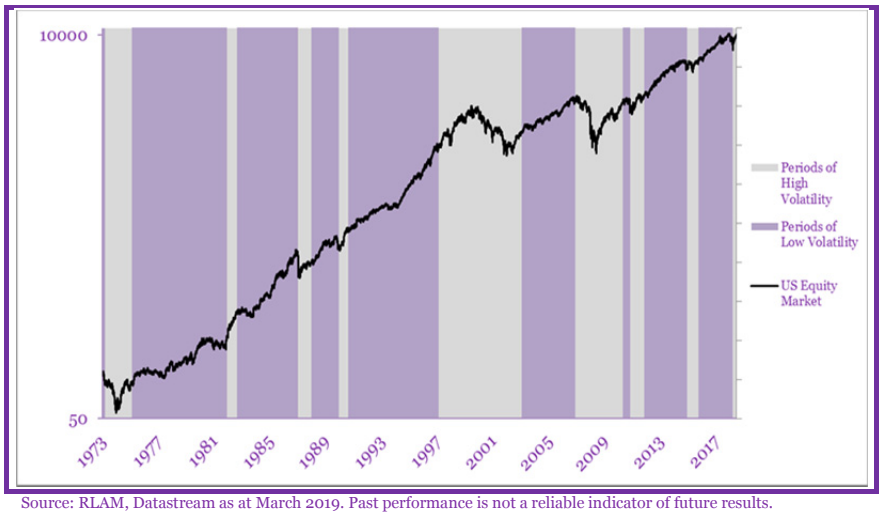
NEW: MULTI ASSET STRATEGIES FUND (MAST)

Stock market volatility is a common feature late in the business cycle but investors shouldn't have to choose between participating in rising markets and taking a more market-neutral approach when economic conditions deteriorate. We designed MAST for investors looking to generate growth through a diversified multi asset portfolio while limiting losses during periods of financial market turbulence.

Equity markets tend to post their best returns when volatility is low and generate their worst peak to trough losses when volatility is high. Since 1973, the average peak to trough loss for US equities when volatility was below average was generally in the range of 10-15%. During periods of above average volatility the market experienced much higher losses, more than 50% on two occasions (chart 10).

This observation – and our belief that volatility will be high for the next few years – led us to develop a multi asset fund that reduces equity exposure during periods of market turbulence in order to limit downside risk.

Chart 10: Losses have been greater when volatility is high



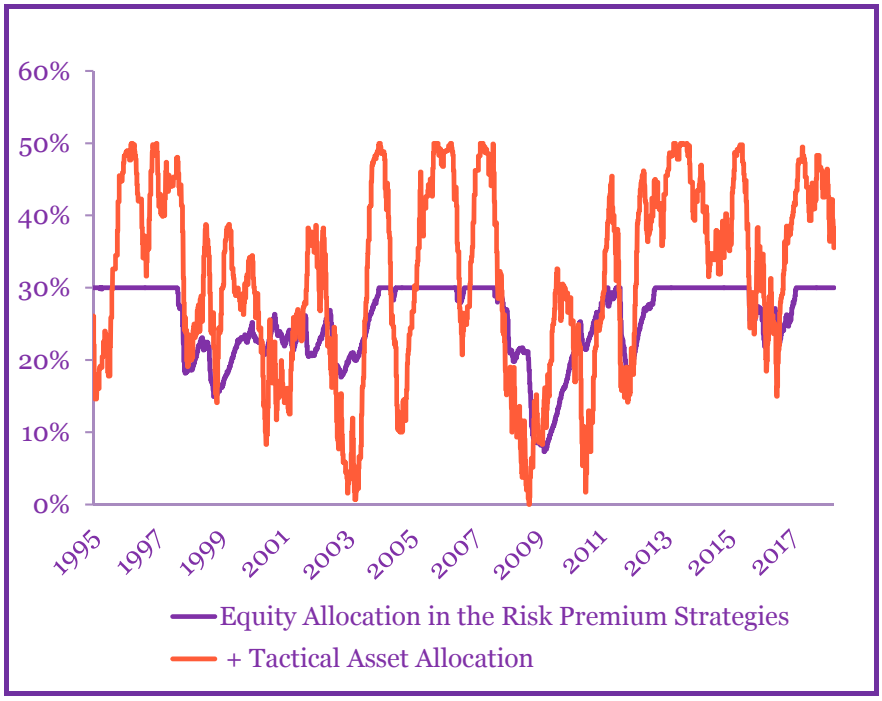
Source: RLAM, Datastream as at March 2019. Past performance is not a reliable indicator of future results.

The investment process we apply in MAST builds on the approach we have been using for the last ten years or more. It has three stages:

1. Build a core portfolio of risk premium strategies using an efficient mix of liquid assets – assumed to have 30% in equities in our simulation (chart 11)
2. Reduce equity exposure when necessary to cap volatility in this core portfolio
3. Add tactical asset allocation positions using a separate risk budget

Back-testing since 1995 suggests this approach can generate long-term growth consistent with a cash+4% return objective on a five-year rolling basis, while limiting peak to trough losses to less than 10%. Please get in touch if you'd like further details.

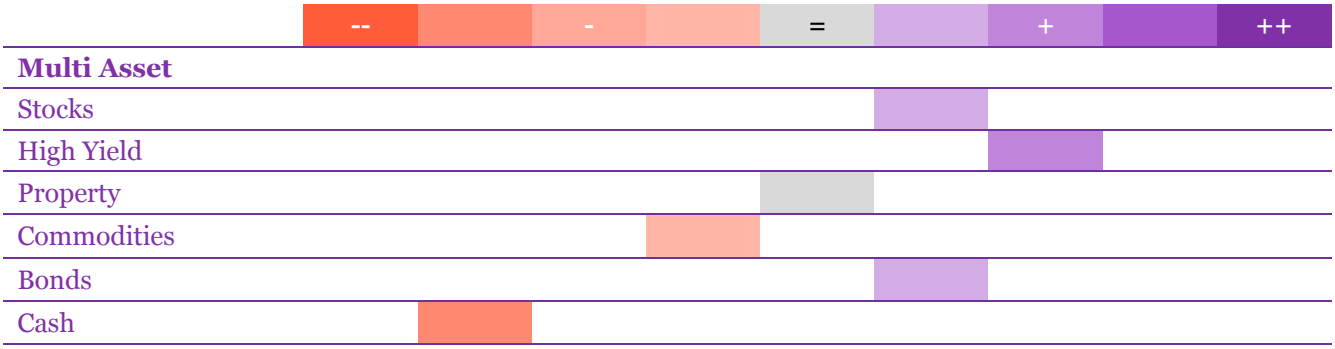
Chart 11: Simulated MAST equity weights since 1995

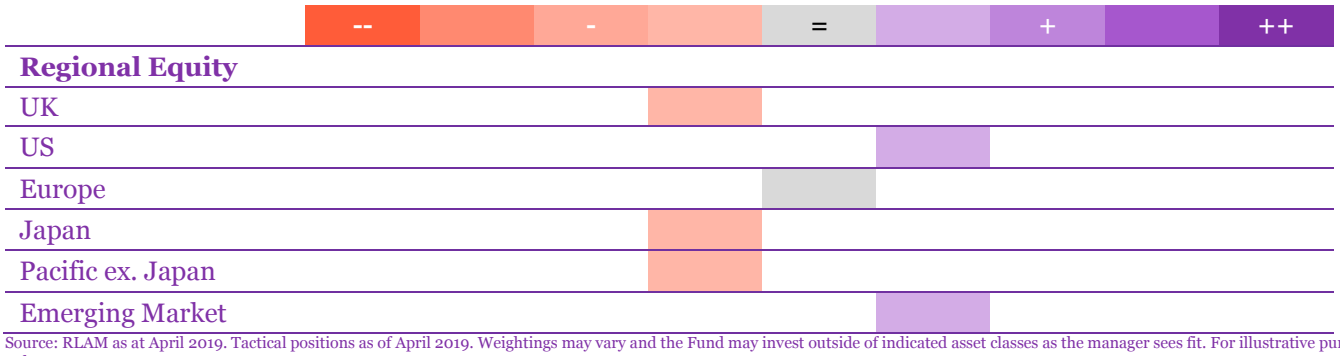


Source: RLAM April 2018. For illustrative purposes only – simulation assumes fixed weight allocations to Risk Premium Strategies, with volatility management and constant risk budget for Tactical Asset Allocation. Past performance is not a reliable indicator of future results. Position sizes simulated using the Investment Clock and other tactical models.

WHERE WE STAND

We are modestly overweight stocks, tilting towards US and emerging market equities. We also have an overweight position in short duration high yield bonds. We are underweight Japanese stocks, commodities and cash.





Source: RLAM as at April 2019. Tactical positions as of April 2019. Weightings may vary and the Fund may invest outside of indicated asset classes as the manager sees fit. For illustrative purposes only.

Multi asset: overweight equities and high yield; underweight commodities

- We entered Q4 2018 broadly neutral on stocks and bought during the panic at attractive levels, ending 2018 with a significant overweight in equities. Our sentiment indicator was oversold while our view on global growth was relatively constructive. Stocks have since rallied sharply, and in line with our risk-controlled process, we have steadily taken profits
- We remain overweight in short duration global high yield as a way to benefit from a 'muddle through' scenario
- We are neutral UK property. A positive supply / demand backdrop and a rental yield cushion make UK property relatively resilient at the moment but Brexit risk remains a worry.

Equity regions: overweight US and EM; underweight Japan

- We began buying back Emerging markets in Q4 2018, seeing value in the beaten-up region and expecting a rally to follow news of improvements to trade talks, a weakening dollar and the lagged impact of Chinese stimulus
- We went into 2018 with a modest overweight position in Japan as a hedge against a stronger dollar. The dollar was strong in 2018 but, unusually, Japan didn't benefit as concerns around Chinese growth, the US-China trade spat and auto sector problems grew. We started trimming Japan in February 2019 and we're now underweight, favouring more defensive US stocks