STRATEGY UPDATE

INVESTMENT CLOCK

FED EASE TO TRIGGER NEW UPSWING

Issue #17

July 2019

ROYAL LONDON

ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £123.4 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 31/03/2019

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As of July the current US economic expansion, as measured from the end of one recession to the start of the next, became the longest on record.

The previous record holder was the expansion of the 1990s, which was supported by pre-emptive Fed rate cuts in 1995 and again in 1998.

We expect the current dovish shift from the Fed to provide fuel for a renewed upswing going into 2020.

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

This is the longest US economic expansion since records began, so it's not surprising that the current trade-led slowdown raised fears of recession. Business cycles don't die of old age, however. With inflation surprisingly muted, central banks are set to ease policy again as they did after business confidence dipped in 2012 and in 2015. Risks remain and summer markets are often volatile. We look to add further to equities on a dip or on more convincing evidence of global recovery.

The Longest US Expansion on Record

This is the longest US economic expansion since records began (see chart), now surpassing the ten year boom of the 1990s. Post war expansions have been long in major part due to the pre-emptive action of central banks raising interest rates when inflation looks likely to rise above its target and cutting them again or printing money to avert a descent into deflation.

Investment Clock Points to a New Mini-Cycle Upswing

If it wasn't for central banks, business cycles would be dominated by shorter term cycles linked to companies building up and then liquidating inventories. These mini cycles average about three years in length and explain recessionary false alarms in 2012 and 2015. In both cases a lack of inflationary pressure allowed central banks to ease policy and trigger a recovery in the world economy and in stock markets. The same fundamentals are in play today. The US Federal Reserve (Fed) is about to cut rates and an improvement in lead indicators has moved the Investment Clock into equity-friendly Recovery.

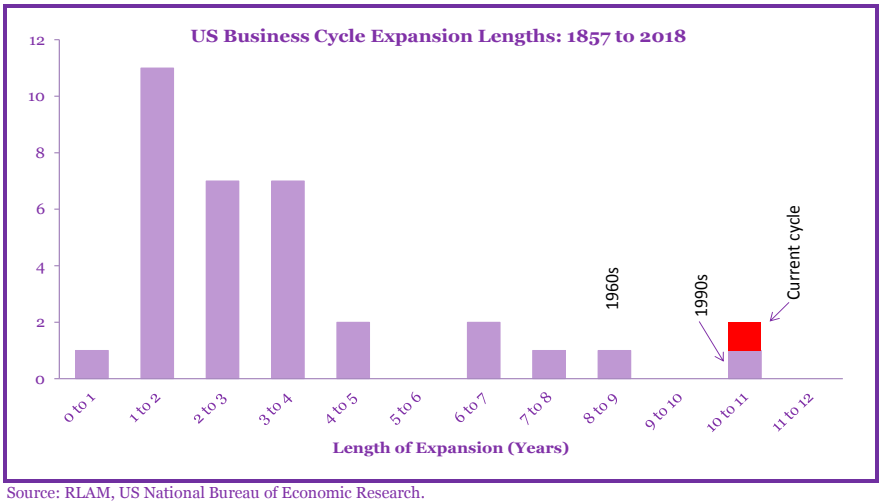
Buying Dips over the Summer

We are moderately overweight equities and high yield bonds in the multi asset funds we manage. However, a flare up in US trade rhetoric, fears of a No Deal Brexit or Middle East tensions could trigger summer corrections. We will look to buy equities on a dip in markets or on more convincing evidence of global recovery.

Volatility Likely to Return

More serious bouts of volatility are likely to return as the business cycle matures. Equity markets offer their best returns when volatility is low and suffer their worst losses when it is high. Investors looking for upside but with limited downside risk could consider our new Multi Asset Strategies Fund which seeks to exploit positive market trends while trimming exposure during periods of market turbulence.

Chart 1: US Economic Expansion Lengths since 1857



Source: RLAM, US National Bureau of Economic Research.

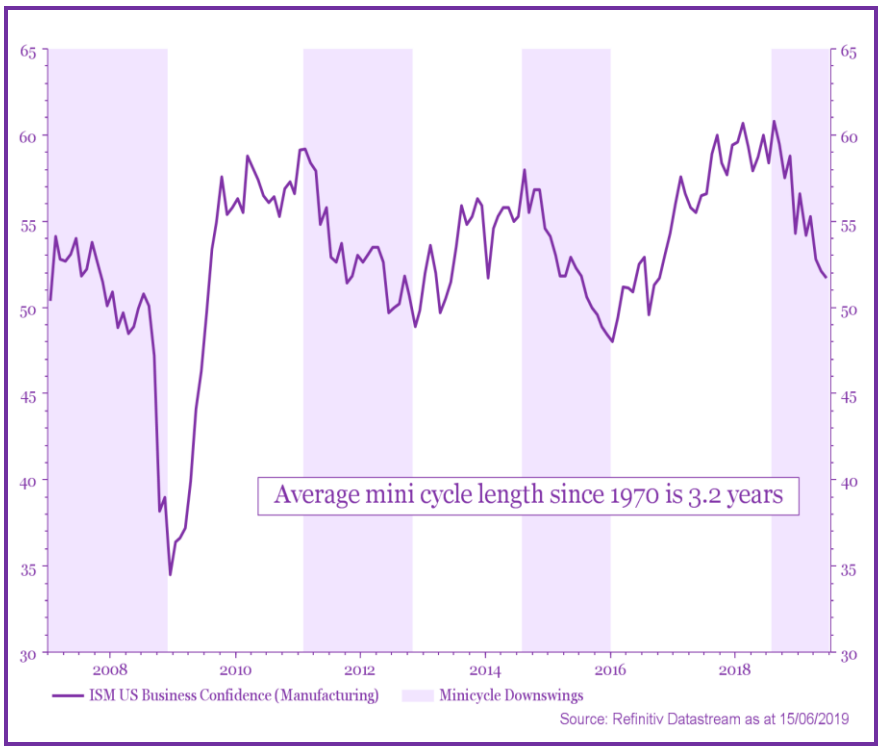
ECONOMIC EXPANSIONS DON'T DIE OF OLD AGE

This is the longest US economic expansion since records began in 1857, now surpassing the ten year boom of the 1990s. Post war expansions have been long because central banks have operated pre-emptive monetary policy to keep demand on track.

If it wasn't for central banks, economic cycles would be dominated by shorter term cycles linked to companies building up and then liquidating inventories. These mini cycles average about three years and explain recessionary false alarms in 2012 and 2015 when business confidence was at a low ebb.

In both cases a lack of inflationary pressure allowed central banks to ease policy and trigger a recovery in the world economy and in stock markets.

Chart 2: US Business Confidence with Downturns Shaded



Source: RLAM and Refinitiv Datastream as at 15/06/2019.

In 2012, in the midst of the European debt crisis, European Central Bank (ECB) President Mario Draghi said he would do "whatever it takes" to keep the euro area together and the Fed embarked on open-ended quantitative easing. In 2015, China devalued its currency and engaged in significant domestic stimulus that boosted global growth in 2016/17.

The same fundamentals are in play today. Inflation is surprisingly muted despite a tight US labour market. The Fed is about to cut US interest rates and a range of developed and emerging market central banks will probably follow suit, China included. Renewed monetary easing looks likely to provide fuel for a renewed upturn in global growth and stock prices into 2020.

Chart 3: Global Stocks Versus Bonds with Downturns Shaded

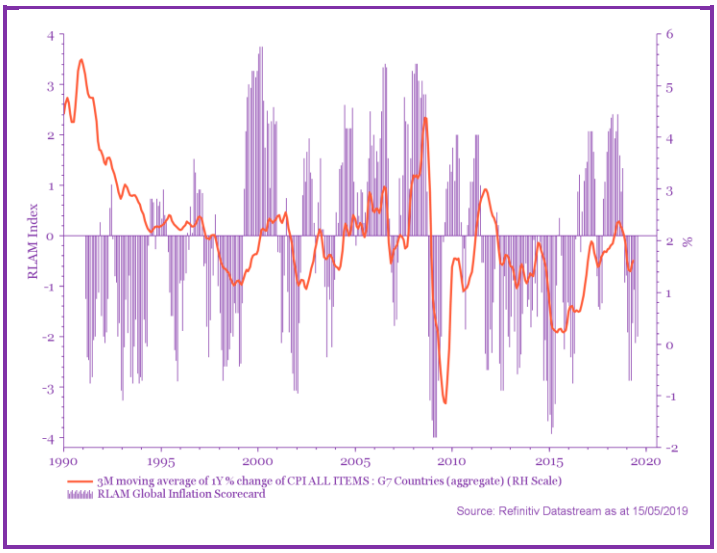
Source: RLAM and Refinitiv Datastream as at 12/07/2019.

INVESTMENT CLOCK IN EQUITY-FRIENDLY RECOVERY

The Investment Clock model links asset class returns to the evolution of the global business cycle and the scorecard indicators we use to 'tell the time' pick up on the shorter mini-cycles.

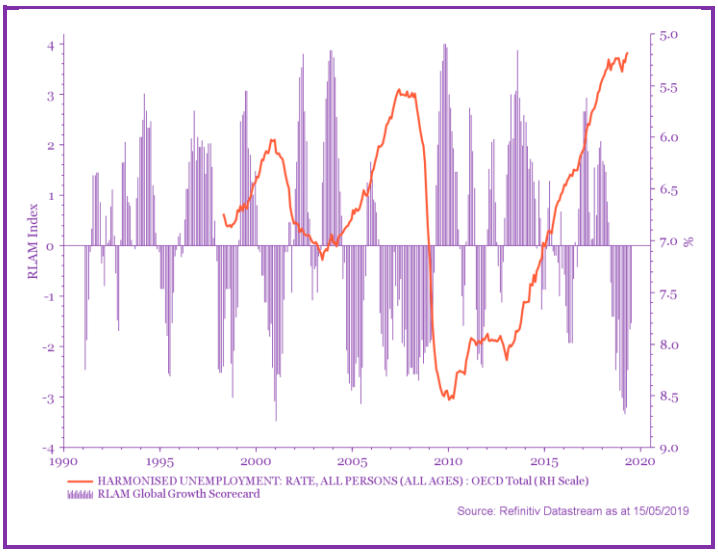
- Our global inflation scorecard is a six month lead indicator for the global Consumer Price Index (CPI). It remains negative after the sharp drop in the oil price late last year.
- Meanwhile, our global growth scorecard is starting to recover from very low levels on the back of an improvement in lead indicators such as housing and financial market conditions. If sustained, this suggests a pick-up in growth into 2020.

Chart 4: Global Inflation Scorecard Pointing Down



Source: RLAM and Refinitiv Datastream. The Global Inflation Scorecard includes measures of spare capacity, oil prices, prices paid surveys and economist consensus inflation forecasts.

Chart 5: Global Growth Scorecard Picking Up

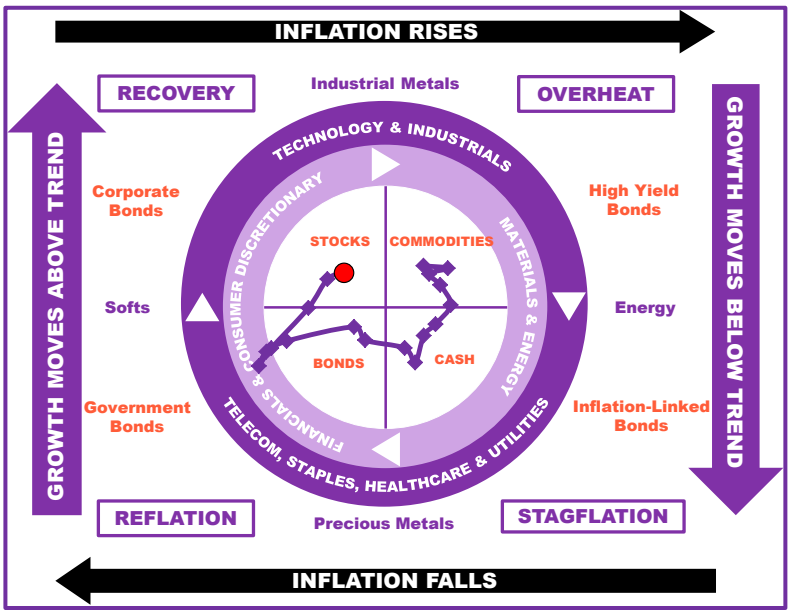


Source: RLAM and Refinitiv Datastream. The Global Growth Scorecard includes measures of central bank policy, The Organisation for Economic Co-operation and Development (OECD) lead indicators, business confidence surveys and economist consensus growth forecasts.

We've come almost full circle on the Investment Clock over the last couple of years.

- In early 2018 we were in Overheat with growth strong and inflation rising. The Fed was hiking rates and commodities were beating bonds.
- As the year progressed, global growth slowed, led by China, but inflation continued to rise. By Q4 we were in Stagflation and Wall Street had its worst December since the 1930s.
- Early in 2019 the drop in the oil price took inflation out of the system and moved us into bond-friendly Reflation. The Fed paused.
- Taken together, our scorecards show we are now moving into the equity-friendly Recovery.

Chart 6: The Investment Clock is in Recovery



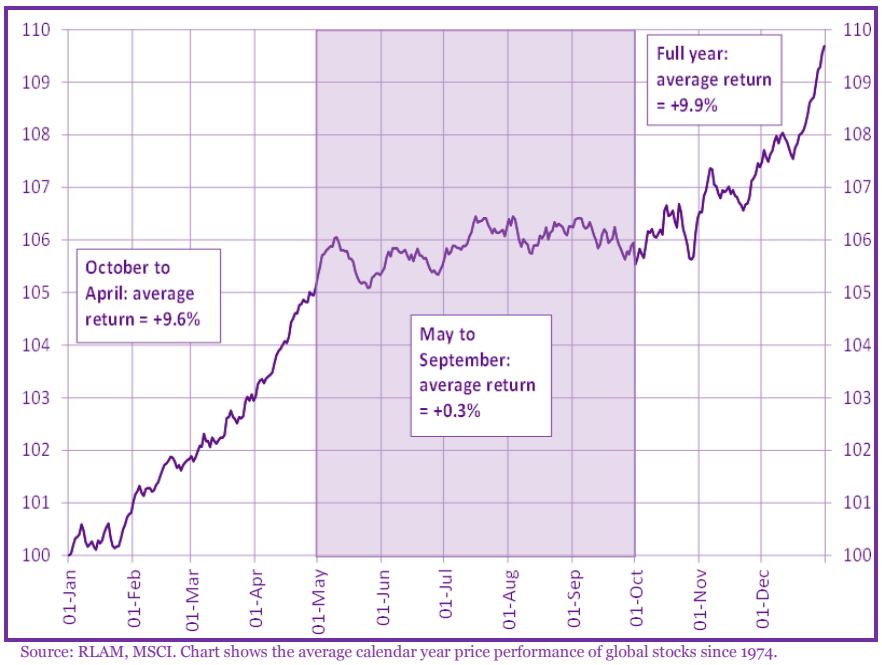
Source: RLAM. The position on the clockface is derived from RLAM Global Growth and Inflation Scorecards. The red dot is the current reading and the trail shows the previous 18 months.

BUY DIPS IN SUMMER VOLATILITY

We see positive signs, but we would prefer to add to equity exposure on a dip in prices or on more convincing evidence of a recovery in global growth.

Stock markets exhibit a high degree of seasonality, posting most of their returns historically between the months of October and May. Over the summer, markets tend to move sideways and are prone to shocks.

Chart 7: Global Stock Performance Over the Calendar Year

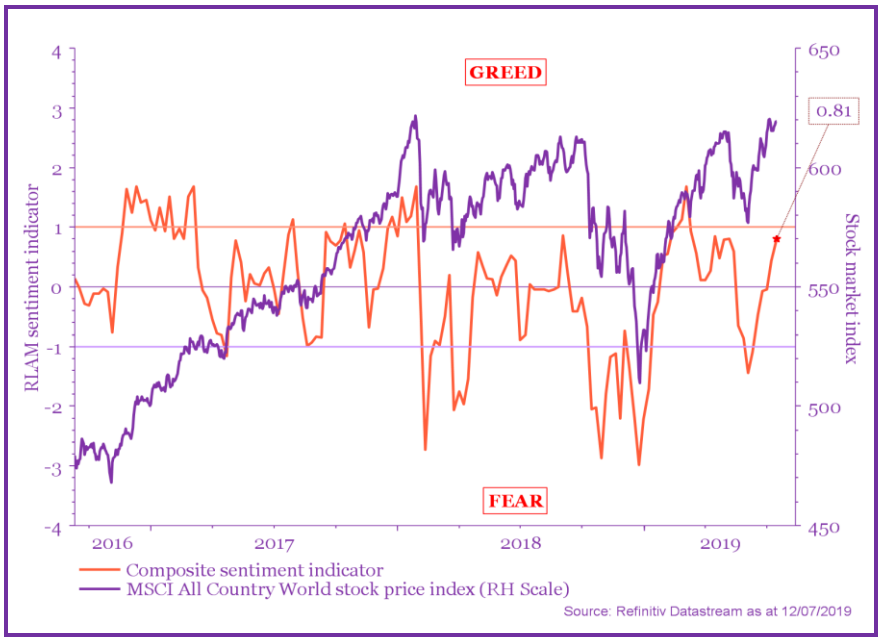


Source: RLAM, MSCI. Chart shows the average calendar year price performance of global stocks since 1974.

History shows that it pays to buy equities when markets are fearful and not when they are complacent.

Our investor sentiment indicator helped us to go against the herd, buying stocks in Q1 and Q4 last year. It also signaled a short-term buying opportunity in May this year. As of now, it is nearer overbought than oversold and we are willing to be patient.

Chart 8: Global Stock Prices and RLAM Sentiment Indicator



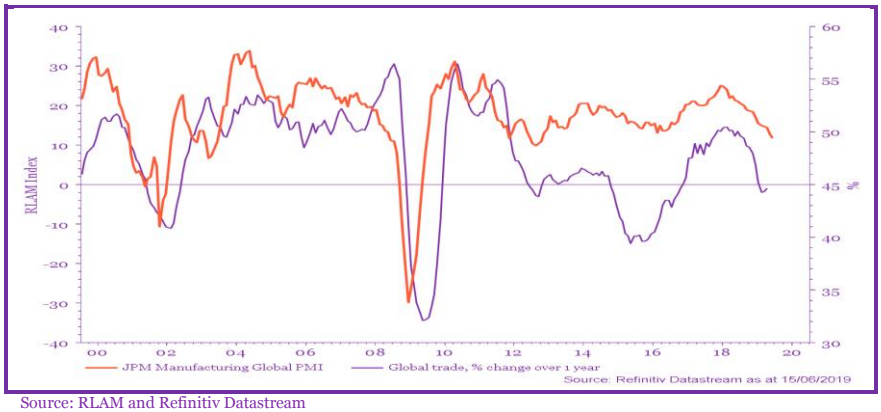
Source: RLAM. Composite sentiment indicator includes factors related to market volatility, retail investor bullishness and US director dealing in shares in their own companies. A reading of -1 or lower indicates a market panic and contrarian buy signal.

THREE POTENTIAL RISKS TO MARKETS

It's not hard to think of some potential risks to markets over the summer.

Global growth is still fragile and international trade has slowed to a standstill since China tariffs were imposed. A stepping up of US trade war rhetoric could trigger a relapse in market sentiment.

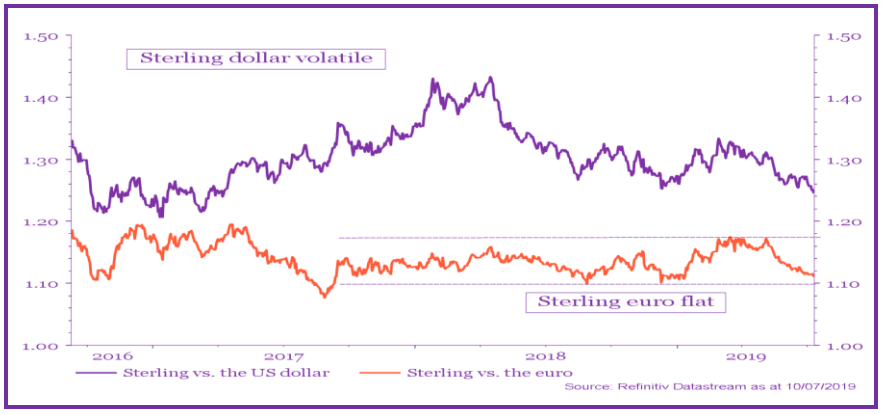
Chart 9: Trade Risk



Source: RLAM and Refinitiv Datastream

Market volatility could also pick up towards October when a new British Prime Minister engages in brinksmanship with the European Union over Brexit. We continue to see two-way risk for sterling. A chaotic No Deal Brexit would see the pound drop sharply, but any political move towards a second referendum would be seen as positive.

Chart 10: No Deal Brexit Risk

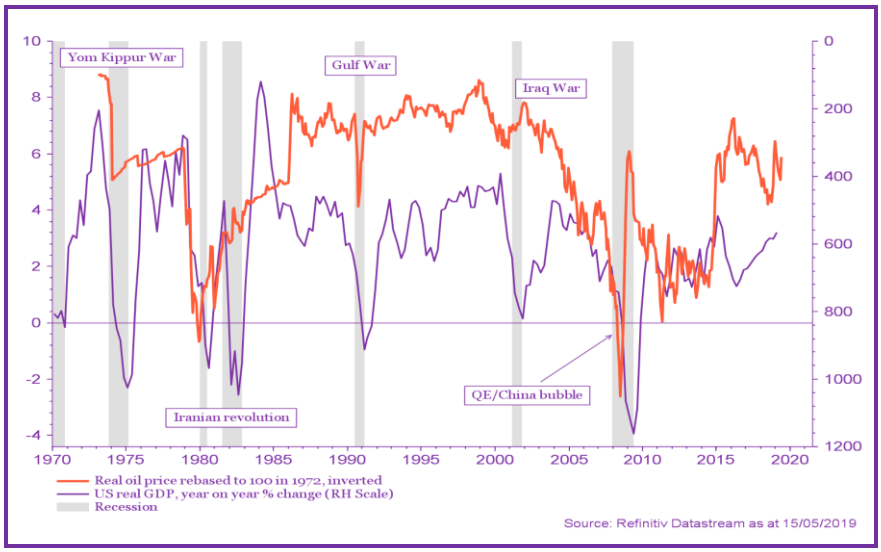


Source: RLAM and Refinitiv Datastream

Markets could also take fright if the war of words between President Trump and the Iranian regime spills over into armed conflict.

Every single US recession in the last fifty years was either caused by or worsened by a spike in the oil price in the preceding year. This is one reason why we include a strategic allocation to commodities in all of our multi asset funds.

Chart 11: Middle East Risk



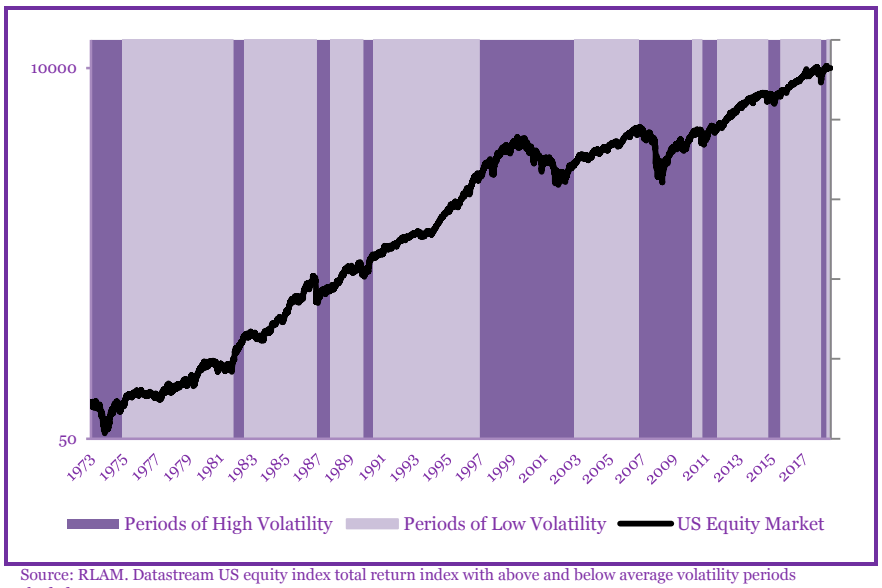
Source: RLAM and Refinitiv Datastream

STRATEGIES FOR WEATHERING VOLATILE MARKETS

Equity markets have historically posted their best returns when volatility is low and they have generated their greatest peak to trough losses when volatility is high.

Investors looking for long-term growth but with a limited appetite for loss could hedge their bets by investing in a volatility managed portfolio which can scale back its equity exposure when market volatility rises above a pre-set level.

Chart 12: Stock losses are greater when volatility is high



Source: RLAM. Datastream US equity index total return index with above and below average volatility periods shaded.

Our new Multi Asset Strategies Fund ('MAST') takes this approach, applying tactical asset allocation positions to a core portfolio of diversified and volatility capped risk premium strategies.

We have simulated MAST returns using our tactical models since 1995. Table 1 shows that in bull market trends, such as a mini-cycle expansion, the fund was able to capture about half of the market upside. Whereas in bear markets, when volatility capping reduced equity exposure, it took a more market neutral approach and moved broadly sideways.

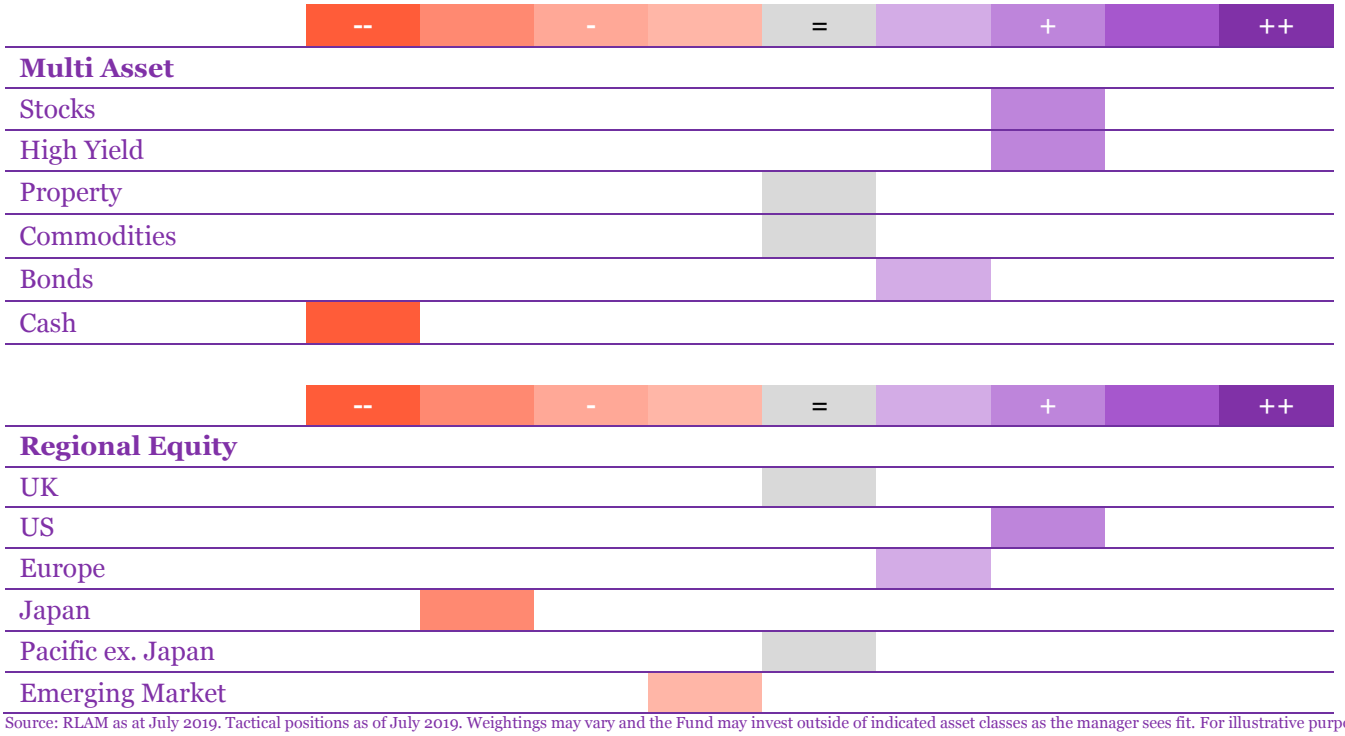
Table 1: MAST simulation in up and down markets

1995 Q2 to 2018 Q1	Quarters when Stocks Rose	Quarters when Stocks Fell	Average Quarter
FTSE All World (£)	5.9%	-7.6%	2.1%
Risk Premium Strategies	2.4%	-1.0%	1.5%
Tactical Asset Allocation	0.7%	1.1%	0.8%
RLAM MAST	3.1%	0.0%	2.3%
% Time	73%	27%	100%

Source: RLAM as at 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. Position sizes simulated using the Investment Clock and other tactical models. The above table contains simulated performance data. Simulated performance data is not a guide to past or future performance. The returns implied in the above chart are gross of fees and transaction costs which would have had the effect of reducing the actual returns that may have been received.

WHERE WE STAND

We are modestly overweight stocks, tilting towards US and European equities and away from Japan. We also have an overweight position in short duration high yield bonds. We are underweight cash.



Source: RLAM as at July 2019. Tactical positions as of July 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; neutral commodities

- We bought stocks at attractive levels during Q4 2018 and increased our exposure following the May 2019 panic. We remain moderately overweight and would like to add exposure on a dip or on more convincing evidence of a global recovery.
- 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 but Brexit remains a risk.
- We are broadly neutral on commodities. Global growth is weak but Middle East tensions are rising.

Equity regions: overweight US and Europe; underweight Japan

- We are overweight US equities. US equity markets include higher quality sectors that tend to outperform when bond yields are falling. The US is also seeing the most positive earnings revisions.
- We are most underweight Japan where earnings revisions are negative and a strong yen is hampering exporters.