Investment Clock – Strategy Update

Issue #24, July 2021

Multi asset views from RLAM

Royal London Asset Management manages £153.4 billion in life insurance, pensions and third party funds*. The multi asset team manages the Governed Range pension portfolios as well as the Global Multi Asset Portfolios (GMAPs) and Multi Asset Strategies Fund (MAST) available on third party platforms.

*As at 30/6/2021

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Please visit **www.investmentclock.co.uk** for our blog and information about the multi asset range

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Economic expansions since the 1990s have been unusually long with a disinflationary trend allowing central banks to cut rates whenever growth slows.

The current recovery feels more inflationary. If policy stays loose for too long we may see return to the boom-bust cycles of the past.

A scenario with rapid tightening over 2023 and recession in 2024 would be a return to 'normal', mirroring the average five year business cycle since 1857.

Risk of a shorter cycle

The longest expansion in the US economy since 1857 was followed by its shortest recession. Policy makers are erring on the side of generosity and a strong upswing is in train, one that raises the risk of a return to the shorter boom-bust cycles of the past. We diversify broadly and tilt exposures tactically towards asset classes likely to do best as conditions change using our Investment Clock approach. We are in 'Overheat', overweighting commodities and high yield bonds versus government bonds. The economic recovery has longer to run but stocks could pull back this summer on rising Covid-19 cases or signs of tighter policy and we have cut exposure to a small overweight. Our multi asset funds have performed well during the inflationary economic re-opening. Tactical asset allocation has been a strong contributor helping the Multi Asset Strategies Fund to move to new highs. The downside risk management in this fund will come to the fore when the economic expansion next hits wobbles or comes to an end.

An 'Overheat' like no other

The Investment Clock model that guides our asset allocation is in 'Overheat' for a tenth consecutive month, as global growth continues to come in strong and inflation rises. This is an 'Overheat' like no other though, as governments and central banks err on the side of generosity while the pandemic runs its course. The initial surge in US inflation is likely to ease over the balance of the year, but we expect loose policy to mean further strong growth after social distancing ends. This risks a short and fiery global business cycle when compared to the long, disinflationary expansions we've enjoyed in recent decades.

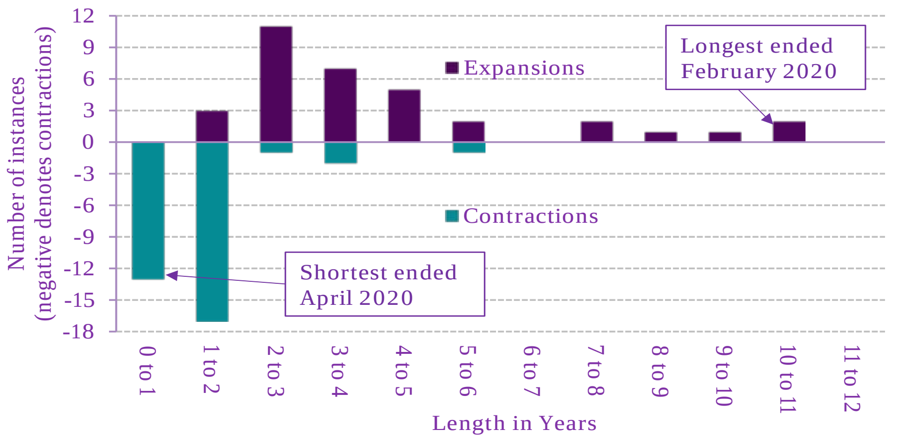
Potential for a choppy summer

We are overweight commodities, the best major asset class year to date. We favour high yield over government bonds and we are constructive on UK property. We have cut equity exposure to a small overweight however. Returns over the summer months are often poor and worries over rising Covid-19 numbers or tighter policy could trigger a correction as the rate of recovery slows. We are overweight the US and Europe where earnings upgrades are strongest and underweight the emerging markets.

Downside risk mitigation

Our broadly diversified multi asset funds have performed well during the inflationary economic re-opening and tactical asset allocation has been a strong contributor. This and the drop in volatility has helped the Multi Asset Strategies Fund to move back to its high-water mark. Downside risk management in this fund will be valuable when the economic expansion next hits wobbles or comes to an end.

Figure 1: US Business Cycle lengths since 1857 – a more normal expansion?

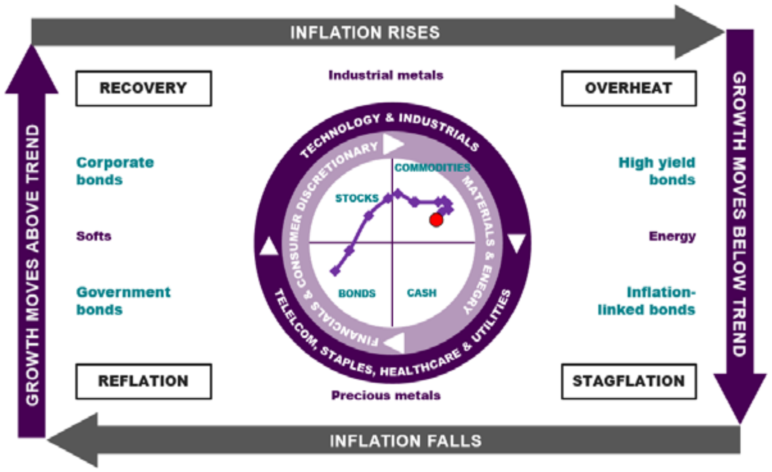


Source: NBER; data from 1857 to 2021; the current expansion began in April 2020

An ‘Overheat’ like no other

The Investment Clock model that guides our asset allocation is in ‘Overheat’ for a tenth consecutive month as global growth continues to come in strong and inflation rises. In normal circumstances, central banks raise interest rates at these times but this is an ‘Overheat’ like no other with policy makers erring on the side of generosity while the pandemic runs its course.

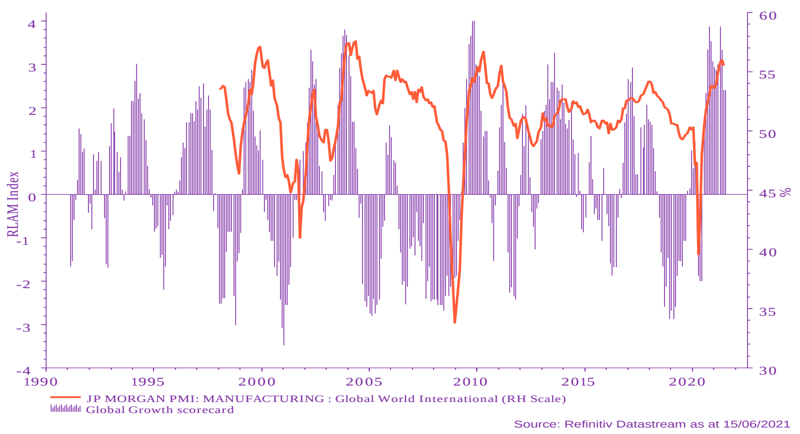
Figure 2: The Investment Clock in Overheat for a Tenth Month



Source: RLAM as at July 2021. For illustrative purposes only. Trails shows monthly readings based on global growth and inflation indicators. Orange dot is the current reading.

We have seen incredibly strong GDP growth over the last quarter, business confidence remains high and our global growth scorecard continues to point upwards. The break-neck pace of recovery will slow into 2022, but the lagged effect of loose policy should mean growth comes out the other side of the pandemic stronger than it went into it.

Figure 3: RLAM Global Growth Scorecard and Global PMI

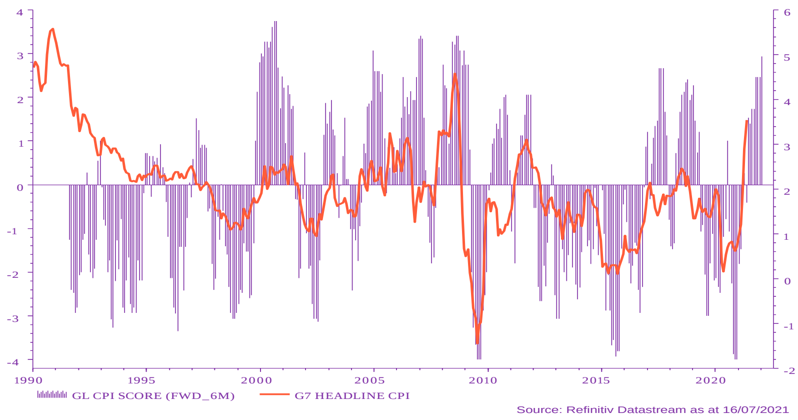


Source: Refinitiv Datasteam, RLAM. As 26/07/2021.

Capacity constraints and bottlenecks have pushed global inflation to its highest level in more than a decade and our inflation scorecard continues to rise. The initial surge in US inflation is likely to ease over the balance of the year, but we expect inflation to remain above central bank targets for some time to come.

This could make for a short and fiery business cycle when compared to the long, disinflationary expansions we’ve enjoyed in recent decades. In these circumstances it will be especially important to diversify broadly and tilt exposure tactically towards asset classes likely to do best as conditions change.

Figure 4: RLAM Global Inflation Scorecard and G7 CPI



Source: Refinitiv Datasteam, RLAM. As 26/07/2021.

Potential for a choppy summer?

Summers can be choppy and unrewarding for investors in stocks, with government bonds outperforming on average. Exceptions to this rule have been years like 2003, 2009 and 2020 which saw a strong rebound in growth or a dramatic easing in policy.

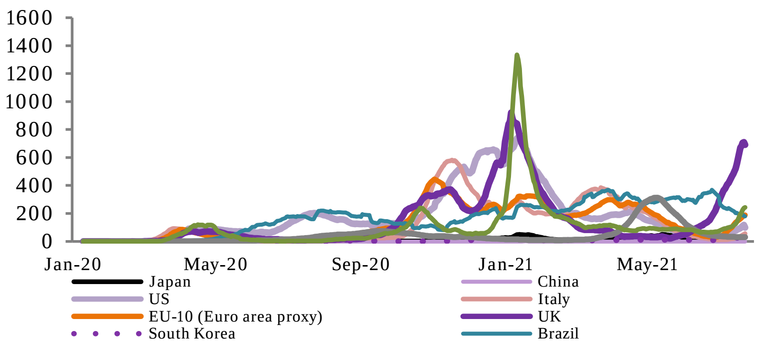
You could argue 2021 fits this description given the economic re-opening, but we suspect stocks are pricing in much of the good news and concerns over a slowdown in the pace of recovery could surface as the summer progresses. Arguably these concerns are already visible in lower US Treasury yields.

Figure 5: The Seasonality of Global Stock Returns vs US Treasuries

Source: Chart shows the average seasonal profile of global stocks relative to US 10 year Treasuries over 1973-2021 using Datastream total return indices..

We see two triggers for possible stock market weakness. First, the spread of the more infectious delta variant of Covid-19 could result in a further period of lockdown in Europe or the US, exacerbating concerns over a slowdown in the pace of recovery.

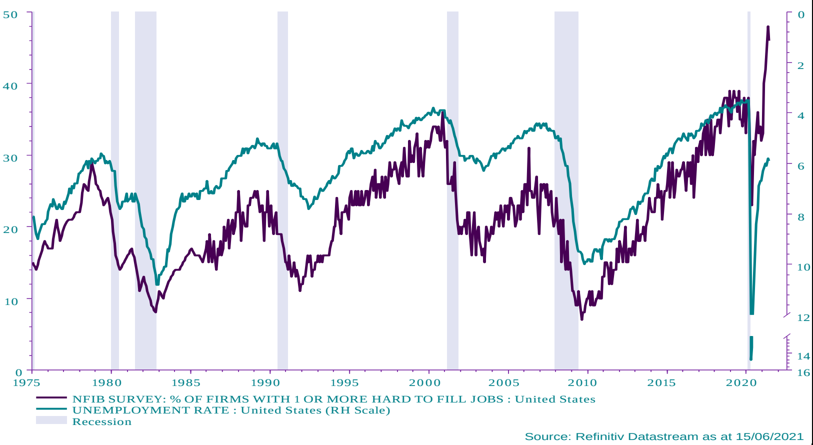
Figure 6: Covid Case Numbers Rising Again



Source: Refinitiv Datasteam, RLAM. As 26/07/2021.Y axis showing daily new cases, 7 day average, per million population

If Covid-19 fears don't return, fear of higher interest rates probably will. The US labour market could end up very tight indeed if small business surveys are any guide. Continued strong non-farm payroll reports would probably see the Federal Reserve announcing tapering measures and bringing forward rate hike expectations. Interest rate sensitive sectors like technology could de-rate.

Figure 7: NFIB Survey and US Unemployment Rate



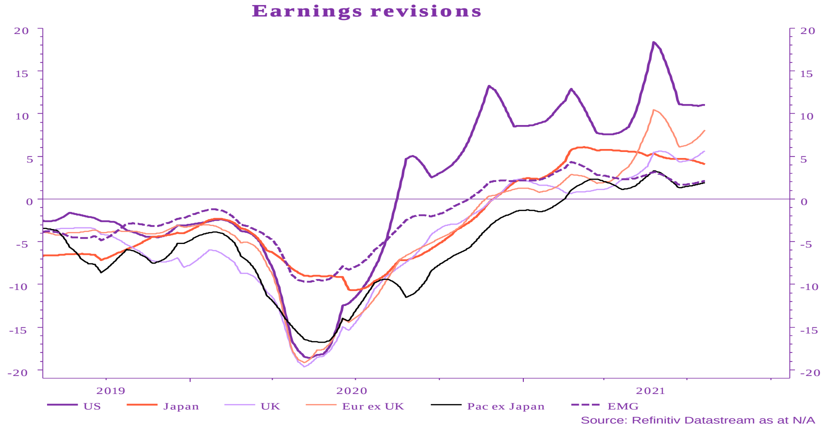
Source: RLAM. As at 26/07/2021.

Taking risk elsewhere

We have cut our equity positions to small overweight but we continue to see good opportunities elsewhere.

We are tilting our regional equity exposure towards the US and Europe where earnings upgrades are stronger as companies benefit from re-opening. We are underweight Asia and the emerging markets which have either already recovered, as in the case of China, or appear to be heading in the wrong direction, as with Japan.

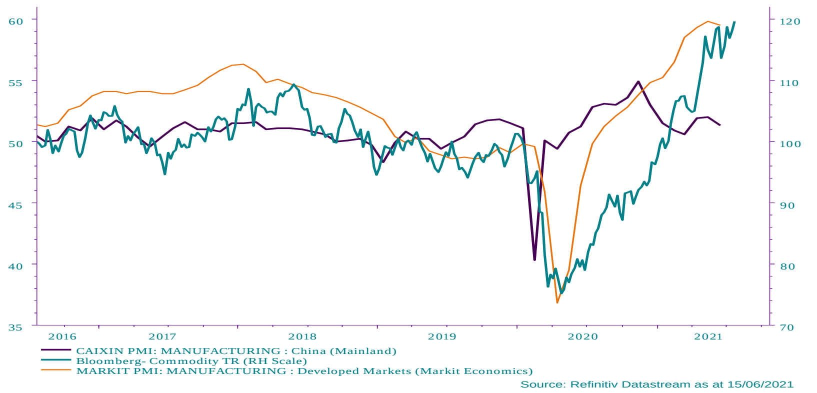
Figure 8: Earnings Upgrades Strongest in the US and Europe



Source: Refinitiv Datastream, RLAM. As 13/07/2021. Chart shows percentage of net upgrades for companies in an MSCI equity region.

We prefer commodities to stocks. Commodities have been the best major asset class year to date, pushed higher by rising demand expectations and on-going supply constraints. Unusually, commodities have been trading off the recovery in developed economies, not China which has been slowing. However, China has starting to ease monetary policy once more, and further commodity upside is likely, in our view.

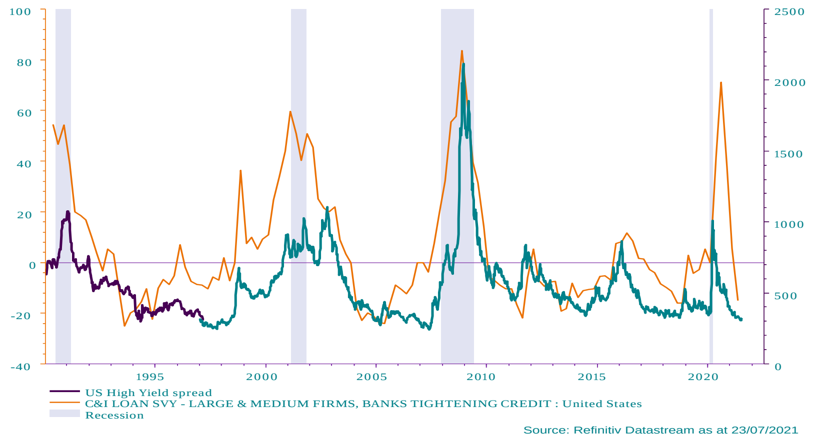
Figure 9: Commodities Benefitting from Developed Economy Recovery



Source: Refinitiv Datastream, RLAM. As at 26/07/2021.

We maintain a large overweight in high yield bonds, an asset class that should benefit from improving credit conditions and offers positive carry. Spreads are historically tight but most companies have taken advantage of central bank support to refinance their debt and, with cashflow surging, defaults are unlikely.

Figure 10: US High Yield Spreads and Senior Loan Officer Survey



Source: Refinitiv Datastream, RLAM. As at 26/07/2021.

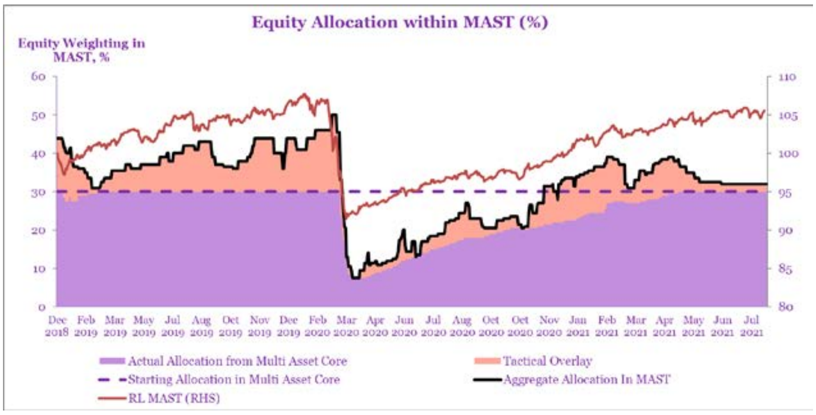
Multi Asset Strategies Fund: Mitigating downside risk

Our Multi Asset Strategies Fund (MAST) aims generate annualised returns of 4% over cash on a gross of fees basis over five year rolling periods, while limiting downside risk. We employ two sources of return:

1. A diversified and volatility-capped core portfolio to capture positive market trends;
2. A tactical asset allocation overlay seeking to add value irrespective of market direction.

When volatility spiked at the start of 2020, our investment process led us to cut equity exposure from a starting position of around 50% to a low of 7.5% to limit further downside. We added back to equities as volatility gradually declined, adding further through tactical asset allocation as we built conviction around the recovery. More recently we scaled back tactical equity positions to take profits.

Figure 11: Equity Allocation in MAST (%)



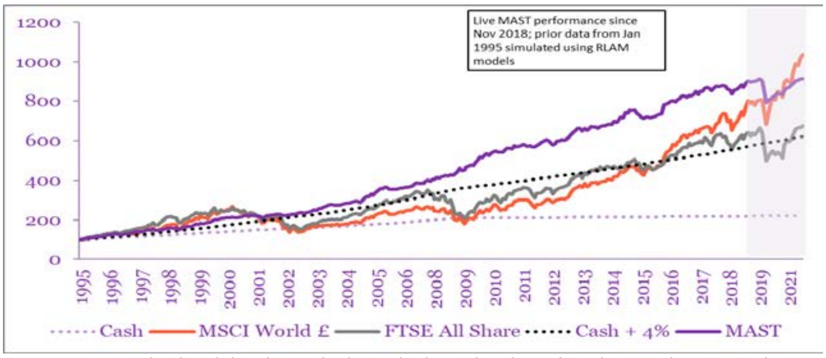
Past performance is not a reliable indicator of future results. Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation. For information purposes only. Source: RLAM as at 26 July 2021.

While the fund launched in November 2018, we can use our tactical asset allocation models to simulate returns back to the mid 1990s. The fund has steadily rebuilt performance since the Covid shock and has moved back to its high-water mark.

While there were no shocks as severe as the Covid crash in our backtest, there were a number of comparable smaller shocks where volatility spiked out of the blue. In each case, simulations suggest MAST would have moved back to a new high-water mark within around a year. In this instance the return took 18 months, a time consistent with our expectations given the size of drawdown.

Simple balanced funds generally returned to high water faster than MAST and many are now well ahead, but they would not have limited further losses had things turned out differently. In our view, MAST's disciplined downside risk management process will prove valuable when the current economic expansion next hits wobbles or comes to an end.

Figure 12: Long Term MAST Backtest



Source: RLAM. Simulated data is used prior to the inception date of 23rd November 2018. The simulation assumes fixed weight allocations to Multi Asset Core, with volatility management and constant risk budget for tactical asset allocation. The simulation for MAST is calculated using historical positions generated by RLAM's in-house tactical asset allocation models and signals from our volatility management process. Net of estimated fees and transaction costs. Simulated data or historical data are not a guide to future performance. As at 14 July 2021.

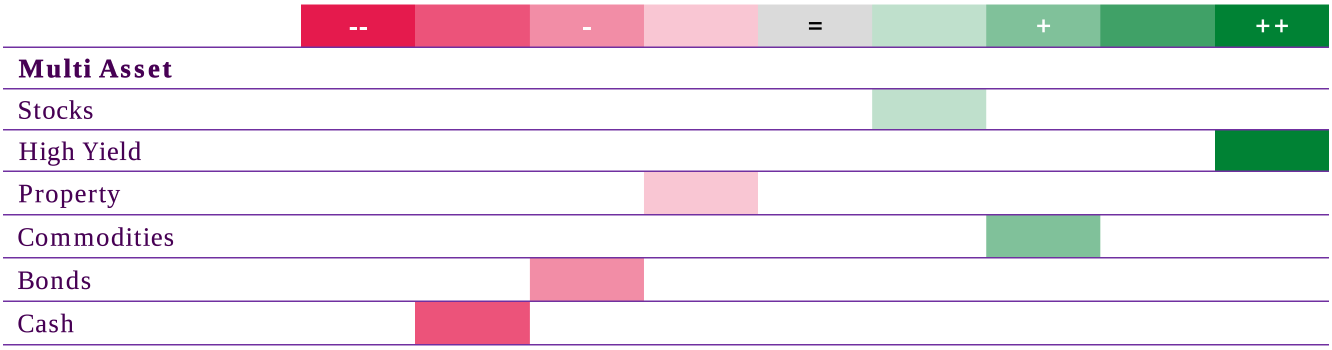
Figure 13: MAST and Equity Performance in Sudden Shocks

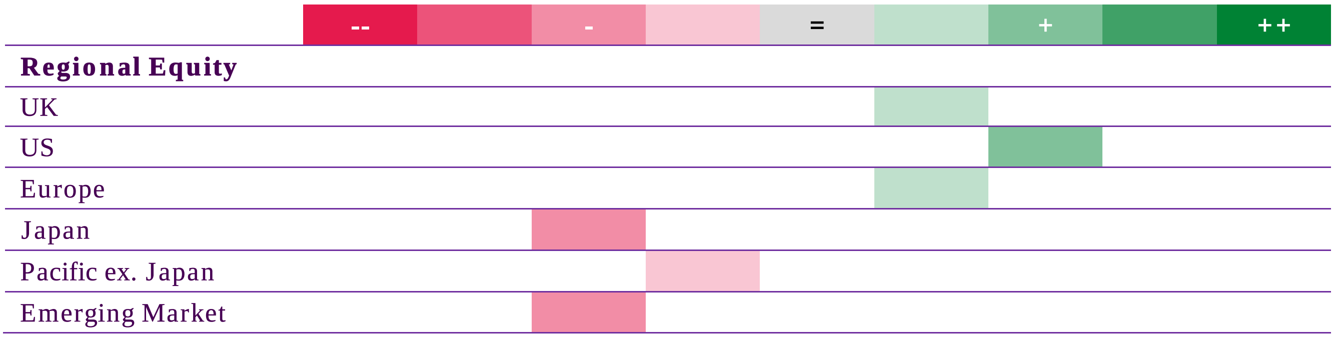
Max Drawdown (Peak To Trough Losses) and Months Taken to Return to High Water Mark ("HWM")	Year	Global Equities		UK Equities		RL MAST	
		Max drawdown	Return to HWM	Max drawdown	Return to HWM	Max drawdown	Return to HWM
Coronavirus	2020	-26%	6	-35%	17	-15%	18
Dot Com downturn	2001	-51%	85	-48%	63	-10%	6
China Devaluation Panic	2015/16	-16%	15	-19%	14	-9%	15
Russia crisis/collapse of LTCM	1998	-24%	6	-24%	7	-8%	4
Global Financial Crisis	2007/8	-38%	29	-46%	38	-5%	2

Source: RLAM. Simulated data is used prior to the inception date of 23rd November 2018. The simulation assumes fixed weight allocations to Multi Asset Core, with volatility management and constant risk budget for tactical asset allocation. The simulation for MAST is calculated using historical positions generated by RLAM's in-house tactical asset allocation models and signals from our volatility management process. As at 27/07/2021.

Where we stand: Overweight commodities and high yield bonds

We maintain a small overweight in stocks, tilted towards regions which continue to benefit greatest from the reopening, such as the US and Europe. We are positive on commodities as demand expectations continue to recover and inflation rises. We hold a large overweight in high yield bonds versus government bonds.





Cross asset: overweight commodities versus government bonds

- We hold a small overweight in stocks. Stocks should continue to rally during the economic re-opening but we see two way risk over the summer. Worries over tapering, resurging Covid-19 cases or a peaking in growth rates could see markets correct from their highs.
- We are positive on commodities. Demand expectations have increased and the tightening rhetoric from China appears to have turned to easing. Higher inflation continues to be a tailwind for the asset class in the reflation rally.
- We hold a large overweight in high yield bonds, an asset class that should benefit from improving credit conditions and offers positive carry through what could be a choppy summer for financial markets.

Equity regions and FX: overweight Europe and US, underweight EM

- We are overweight the US, European and UK markets, regions with most to gain from re-opening. We are underweight Asia and the emerging markets which have either already recovered, as in the case of China, or appear to be heading in the wrong direction, as with Japan.
- We hold an overweight position in the US Dollar. The US is leading the rest of the world in the post-Covid recovery and loose fiscal policy should keep interest rate expectations firm.

Investment risks

Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the fund could lose significantly more than the amount invested in derivatives.

EPM Techniques: The fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the fund to increased price volatility.

Exchange Rate risk: Changes in currency exchange rates may affect the value of your investment.

Interest Rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Emerging Markets risk: Investing in emerging markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Counterparty risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the fund to financial loss.

Fund investing in Funds risk: The fund is valued using the latest available price for each underlying investment, however it may not fully reflect changing stockmarket conditions and the fund may apply a 'fair value price' to all or part of its portfolio to mitigate this risk. In extreme liquidity conditions, redemptions in the underlying investments, and/or the fund itself, may be deferred or suspended.

Liquidity and Dealing risk: The fund invests indirectly in assets that may at times be difficult to value, harder to sell, or sell at a fair price. This means that there may be occasions when you experience a delay in being able to deal in the fund, or receive less than may otherwise be expected when selling your investment.

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