Investment Clock – Strategy Update

Issue #23, May 2021

Multi asset views from RLAM

Royal London Asset Management manages £147.2 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 31/3/2021

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

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Global stocks and gilts performed very strongly in the deflationary Covid-19 shock. The markets have a very different feel this year with commodities and UK equities doing best while gilts have crashed.

We think these trends will continue as a more inflationary post-Covid recovery takes shape. Broad diversification can improve resilience to inflation.

An Inflationary Rebound

The Investment Clock is in the Overheat phase but interest rates in developed economies remain close to zero and President Biden's multi-trillion dollar spending plans have yet to take full effect. This could be a short and fiery business cycle if a surge of inflationary growth forces central banks to slam on the brakes once Covid-19 risks have passed. In the meantime, our funds are overweight commodities and underweight government bonds with equity exposure tilted towards value sectors and countries with most to gain from re-opening. Tactical asset allocation has been a strong contributor to returns over the last year and we continue to see good opportunities. Our broad asset mix is less exposed to interest rate risk than a typical balanced fund while allocations to commodities, property and UK equities suggest a greater resilience to inflation.

An Overheat Like No Other

The Investment Clock model that guides our asset allocation is in Overheat with global growth and inflation indicators pointing upwards. The rebound in activity was led by manufactured goods and housing. Mass vaccination raises the prospect of a powerful service sector recovery into 2022. Governments want to err on the side of generosity with the virus still surging around the world but these are the sort of circumstances in which policy mistakes can happen. This could be a short and fiery cycle, like those in the 1970s. Our funds are overweight commodities and underweight bonds.

Choppy Summer Rotation

Service sector re-opening is great for travel and leisure but it will tighten labour markets and push bond yields higher, which could rattle interest rate sensitive sectors. We expect the resurgence of value stocks that started with vaccine announcements to continue. We are overweight financials and energy but underweight technology. Our preference for last year's losers extends to equity markets where we are overweight the UK and Europe.

Diversify to Beat Inflation

The post-Covid recovery could be a challenging period for balanced funds. Our broader asset mix has been doing better this year. It is less exposed to interest rate risk while allocations to commodities, property and UK equities suggest more resilience to inflation. A wider asset class universe gives us more levers for tactical asset allocation, which has helped us to add value over the last year. We continue to see good opportunities.

Chart 1: A More Inflationary Feel to Markets in 2021

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD
1	Gilts +15.6%	EM Stocks +12.8%	Global Stocks +21.2%	Property +19.5%	Property +13.9%	EM Stocks +35.4%	EM Stocks +21.1%	Property +7.5%	Global Stocks +22.6%	Global Stocks +14.3%	Commodities +14.3%
2	Property +8.1%	UK Stocks +12.3%	UK Stocks +20.8%	Gilts +13.9%	Global Stocks +4.4%	Commodities +33.3%	Global Stocks +14.0%	Cash +0.6%	UK Stocks +19.2%	EM Stocks +11.9%	UK Stocks +9.7%
3	**Multi Asset +1.6%**	Global Stocks +12.1%	Property +11.0%	Global Stocks +12.2%	**Multi Asset +1.8%**	Global Stocks +30.3%	UK Stocks +13.1%	Gilts +0.6%	EM Stocks +15.9%	Gilts +8.3%	Global Stocks +7.9%
4	Cash +0.6%	**Multi Asset +7.1%**	**Multi Asset +7.3%**	EM Stocks +7.9%	UK Stocks +1.0%	UK Stocks +16.8%	Property +11.2%	**Multi Asset -1.2%**	**Multi Asset +8.9%**	**Multi Asset +2.2%**	EM Stocks +4.1%
5	UK Stocks -3.5%	Gilts +2.7%	Cash +0.5%	**Multi Asset +6.5%**	Gilts +0.6%	**Multi Asset +12.1%**	**Multi Asset +6.3%**	Global Stocks -3.1%	Gilts +6.9%	Cash +0.3%	**Multi Asset +3.2%**
6	Global Stocks -6.9%	Property +2.3%	Gilts -3.9%	UK Stocks +1.2%	Cash +0.5%	Gilts +10.1%	Gilts +1.8%	Commodities -5.7%	Commodities +3.5%	Property -1.0%	Property +3.1%
7	Commodities -12.7%	Cash +0.6%	EM Stocks -5.3%	Cash +0.5%	EM Stocks -10.3%	Property +2.6%	Cash +0.3%	EM Stocks -7.6%	Property +2.1%	Commodities -6.1%	Cash +0.0%
8	EM Stocks -18.4%	Commodities -5.4%	Commodities -11.2%	Commodities -11.8%	Commodities -20.3%	Cash +0.4%	Commodities -7.1%	UK Stocks -9.5%	Cash +0.7%	UK Stocks -9.8%	Gilts -6.7%

Source: RLAM, DataStream as at 30 April 2021. 'Multi Asset' returns are based on the benchmark weights of Royal London Global Multi Asset Portfolio (GMAP) Growth Fund / Governed Portfolio 5. Indices used are FTSE All World Ex-UK, FTSE All Share, FTSE British Govt Fixed All Stocks, JPM Cash UK 1 month Index, Bloomberg Commodity Index   MSCI UK Monthly Property Index and the FTSE Emerging Markets Index. Total returns in sterling terms.

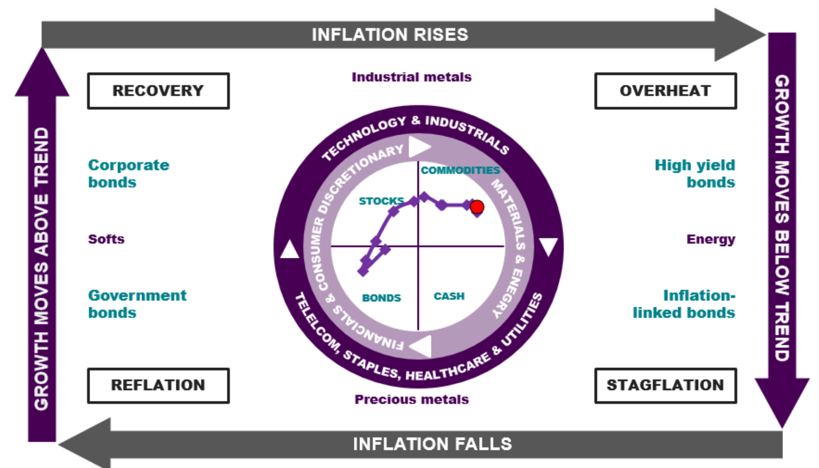
An Overheat Like No Other

The onset of the coronavirus pandemic plunged the Investment Clock into bond-friendly Reflation. It is now in the Overheat phase with global growth and inflation indicators both pointing firmly upwards.

Central banks and governments responded to the pandemic by slashing interest rates, printing money and moving fiscal policy to a wartime footing.

It worked. Growth rebounded led by manufactured goods, vehicle sales and housing. Mass vaccination raises the prospect of a powerful service sector recovery into 2022 as social distancing eases. Unemployment rates around the world are likely to fall sharply.

Chart 2: The Investment Clock Firmly in Overheat

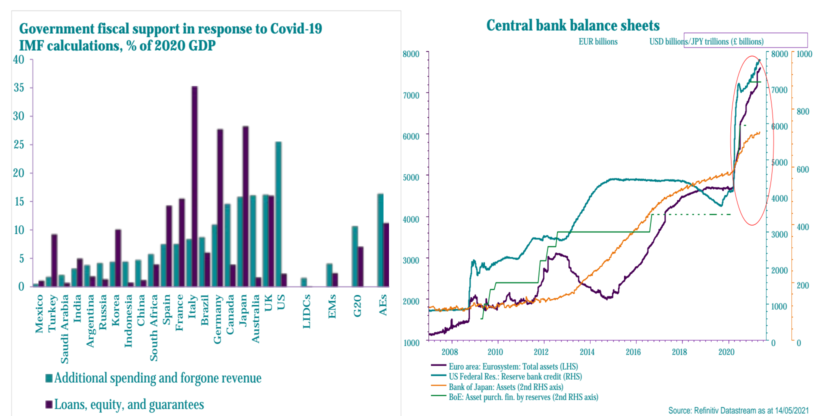


Source: RLAM as at May 2021. For illustrative purposes only. Trails shows monthly readings based on global growth and inflation indicators. Orange dot is the current reading.

Even before this second leg of recovery, capacity constraints and bottlenecks have pushed US inflation to its highest level in more than a decade. However, the Federal Reserve is still printing money and President Biden's multi-trillion dollar fiscal stimulus is yet to take full effect.

Governments want to err on the side of generosity while the virus is still surging around the world and vaccine-resistant variants pose a threat, but these are the circumstances in which policy mistakes can happen.

Chart 3: Policy Stimulus is Massive and Ongoing

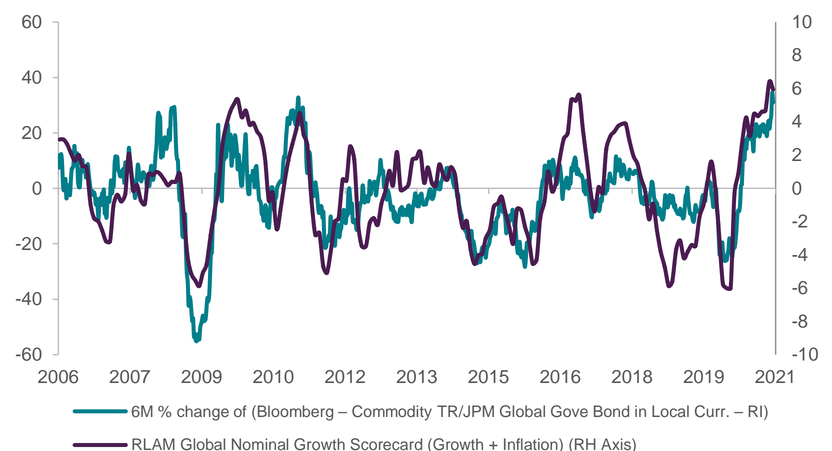


Source: IMF Fiscal Monitor, April 2021, Datasteam, RLAM. As 07/05/2021.

We are beginning to think this could be a short and fiery business cycle, like those in the 1970s. Real interest rates are increasingly negative and US government spending is kicking in when the world economy is already set to grow rapidly.

A flexible and active approach to asset allocation is important at times like this. Our multi asset funds are overweight commodities and underweight government bonds with equity exposure tilted towards value sectors and towards regions with most economic upside as Covid-19 gradually fades from view.

Chart 4: Nominal Growth Scorecard & Commodities vs Bonds

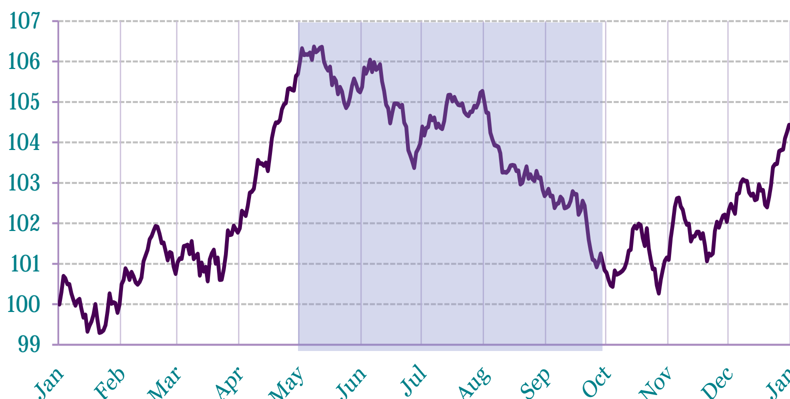


Source: Refinitiv Datasteam, RLAM. As 13/05/2021.

Choppy Summer Rotation

Stock markets are often choppy over the summer and this year may be no different. Prices have risen enormously in anticipation of the surge in company profits now under way. Service sector re-opening is great news for travel and leisure but it will tighten labour markets and push bond yields higher, which could rattle the more interest rate sensitive parts of the market.

Chart 5: The Seasonality of Global Stock Returns vs Bonds

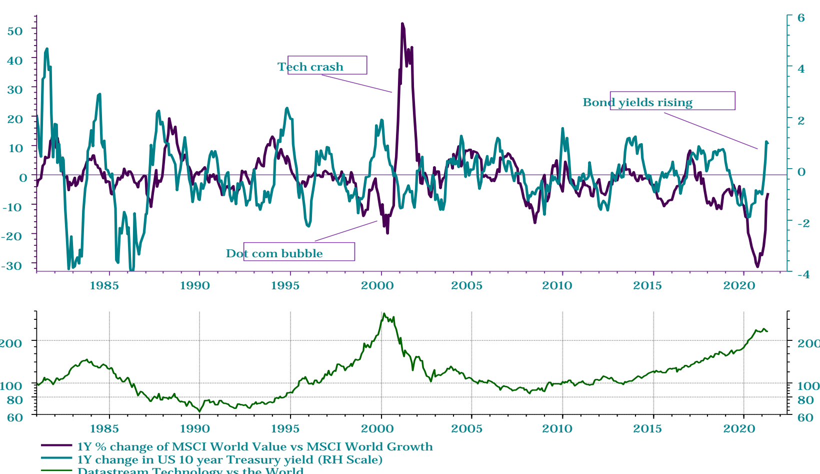


Source: RLAM. Chart shows the average seasonal profile of global stocks relative to US 10 year Treasuries over 1973-2021 using Datastream total return indices.

Technology stocks have outperformed significantly in recent years with the US sector coming close to relative highs last seen at the peak of the dot com bubble. Performance was supercharged in 2020 because people spent more money on tech while the collapse in long-term interest rates increased the valuation of companies with high growth potential.

Those forces are now pointing the other way, with value sectors seeing greater earnings upgrades while higher bond yields pressure heady growth stock valuations.

Chart 6: Global Value vs Growth and Bond Yields

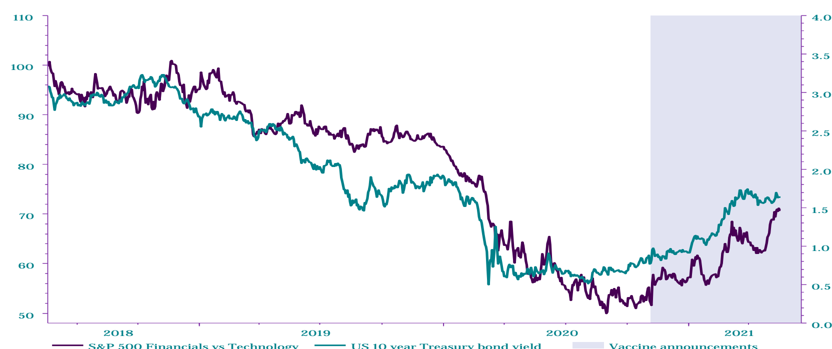


Source: Refinitiv Datastream, RLAM

We expect the resurgence of value stocks that started with last November's vaccine announcements to continue. We are overweight financials and energy versus the technology and consumer discretionary sectors.

Our preference for last year's losers extends to regional equity markets. We are overweight the UK and Europe, parts of the world that were hit hardest in 2020 and have most to gain heading into 2022.

Chart 7: US Financials vs Technology and Bond Yields

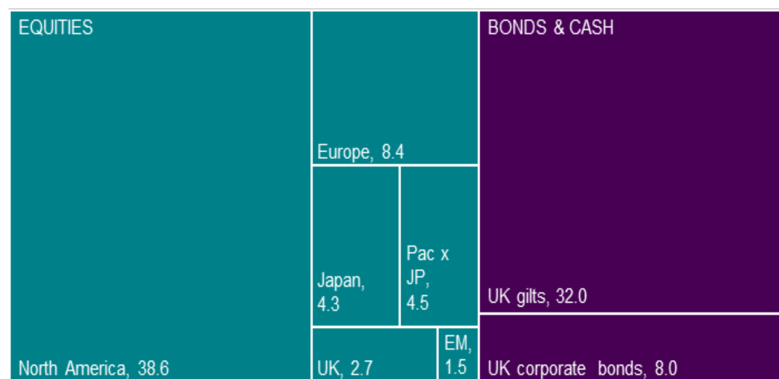


Source: Refinitiv Datastream, RLAM

Diversify to Beat Inflation

The post-Covid recovery could be a challenging period for traditional balanced funds. A notional portfolio with 60% in global equities and 40% in UK investment grade bonds would have done brilliantly in the deflationary shock of 2020. However, with almost 40% of its assets in the highly valued US equity market and another 40% in long duration bonds, it could struggle in a more inflationary period.

Chart 8: A Notional 60/40 Balanced Fund strategic mix

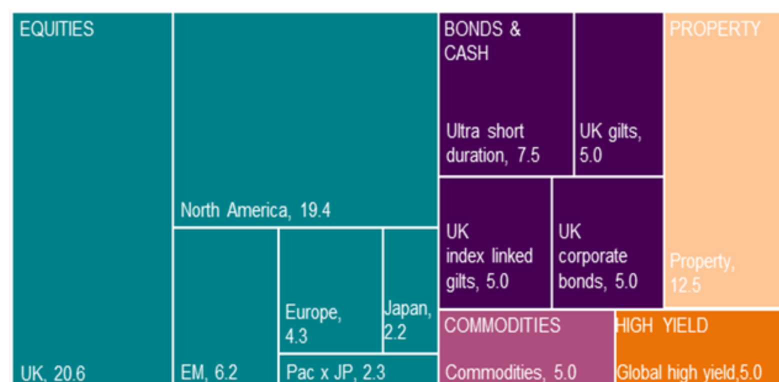


Source: RLAM. Illustrative purposes only.

The strategic weights of our multi asset funds are designed to help UK based investors beat inflation over the long run for a given level of risk. Our broad asset mix is much less exposed to interest rate risk and it has been more resilient in 2021.

The portfolio with volatility closest to a 60/40 balanced fund has only 20% exposure to US equities and 15% to long duration bonds in its composite benchmark. Strategic allocations to commodities, property and UK equities also suggest a greater resilience to inflation.

Chart 9: Our Broader Strategic Mix



Source: RLAM. Illustrative purposes only. Weightings are for the GMAP Growth fund, which shares strategic asset class weightings with Governed Portfolio 5.

Investors may come to question the degree of diversification they get from global indices giving greater weight to US tech stocks than to the entire UK and European stock markets combined.

Our risk-optimised strategic mix within equities has 35% in the UK, 55% in global developed markets and 10% in the emerging markets. This gives a more evenly distributed country exposure, with about the same amount in the UK as the US, and a more diversified sector exposure less reliant on a few big tech names.

Chart 10: Equity Sector Weights – UK vs World

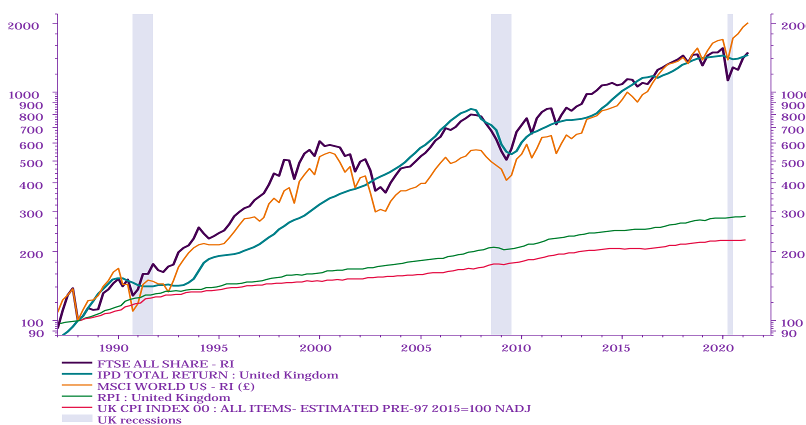
Source: RLAM, Blomberg. FTSE All Share used to show UK weights and FTSE All World Index used to show Global Weights as at May 2021

A Strategic Allocation to UK Equities Improves Resilience

We believe UK investors aiming to beat inflation should allocate more of their equity exposure to UK equities than the 5% or so the market represents in global indices. A strategic allocation to domestic equities reduces risk for sterling-based investors and should improve resilience to bursts of inflation.

Over the long run, UK equities (and property) have offered similar returns to global equities. Poor performance in recent years has been due to the UK's high weightings in financials and resources. This exposure was a disadvantage when interest rates and commodity prices dropped after the 2008 financial crisis and these sectors were hit especially hard in the deflationary onset of the Covid-19 pandemic.

Chart 11: UK Assets Offer Strong Long-Term Returns



Source: Refinitiv Datastream, RLAM. From Dec 1969 to Feb 2021. MSCI World Total Return Index (GBP), UK DS Market Total Return Index, MSCI EM Total Return Index (GBP) and UK RPI: All Items Retail Price Index used to represent Global Stocks, UK stocks, Emerging Market stocks and RPI respectively. EM stocks proxied with MSCI World Total Return (GBP) prior to index inception in 1988.

However, it's worth noting that the UK outperformed in the three decades before the financial crisis and we believe a value-oriented sector mix will stand the market in good stead in a more inflationary post-Covid recovery.

Historical data supports this view. Since 1969, UK equities have outperformed global equities during periods in which the rate of inflation has trended higher, while offering a similar return overall.

Chart 12: UK equities are more resilient to rising inflation

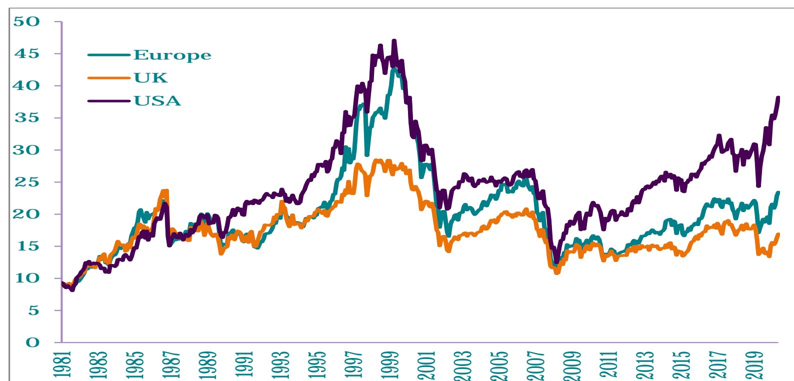
Annual return in excess of RPI

	UK	Global
Rising Inflation	5.0%	-0.2%
Falling Inflation	5.4%	9.7%
All Periods	5.2%	5.0%

Source: Refinitiv Datastream, RLAM. Returns classified into rising and falling inflation regimes based on trends in annual retail price inflation. Data from 1969 to 2021.

A period of underperformance means the UK equity market offers very good value on an international comparison and it isn't expensive versus its own history. This stands in stark contrast to the US, which is at its highest cyclically-adjusted valuation outside of the dot com bubble in data that goes back to 1890.

Chart 13: Long Term Valuation of UK, US and European equities



Source: Barclays. Chart shows cyclically-adjusted price earnings ratios ('CAPE'). Robert Shiller data calculated on this basis begins in 1890

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Where We Stand: Overweight Commodities

Our largest tactical position is an overweight in commodities. We maintain a small overweight in stocks, tilted towards value sectors such as financials and energy and we are overweight the US, Europe and UK markets. We are overweight high yield bonds but underweight government bonds.

Cross asset: overweight commodities versus government bonds

- We are positive on commodities. Demand expectations have surged, spare capacity is limited and OPEC+ are maintaining supply discipline for oil.
- We hold a small overweight in stocks. Stocks could continue to rise on the back of robust earnings reports but bond yields are rising, as is typical in the Overheat phase of the cycle, and this creates strong cross currents.

Equity regions and sectors: overweight Europe and US value sectors, underweight EM

- Our sector strategy is overweight financials and energy, which have surged this year on reopening optimism. We are underweight the technology and consumer discretionary sectors.
- We are overweight the US, UK and European markets, regions with most to gain from re-opening, but underweight Asia and the emerging markets which have either already recovered, in the case of China, or appear to be heading in the wrong direction.

For professional clients only, not suitable for retail investors.

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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