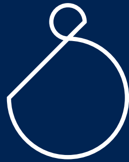

The Big Picture

Quarterly update

For professional investors only

Date
14 March 2017
Data as of 28/02/17

Taking credit
After a strong post-US election rise in equity-like asset prices and bond yields, we are boosting the allocation to credit, especially IG. This is done while maintaining the same allocation to both fixed income and equity-like groups: both sovereign debt and equities are reduced to make way for corporate debt. We still like emerging market assets.

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Multi-asset research

Taking credit

After a strong post-US election rise in equity-like asset prices and bond yields, we are boosting the allocations to credit, especially IG. This is done while maintaining the same allocation to both fixed income and equity-like groups in general: both sovereign debt and equities are reduced to make way for corporate debt. We still like emerging market assets.

Source Multi-Asset Portfolio

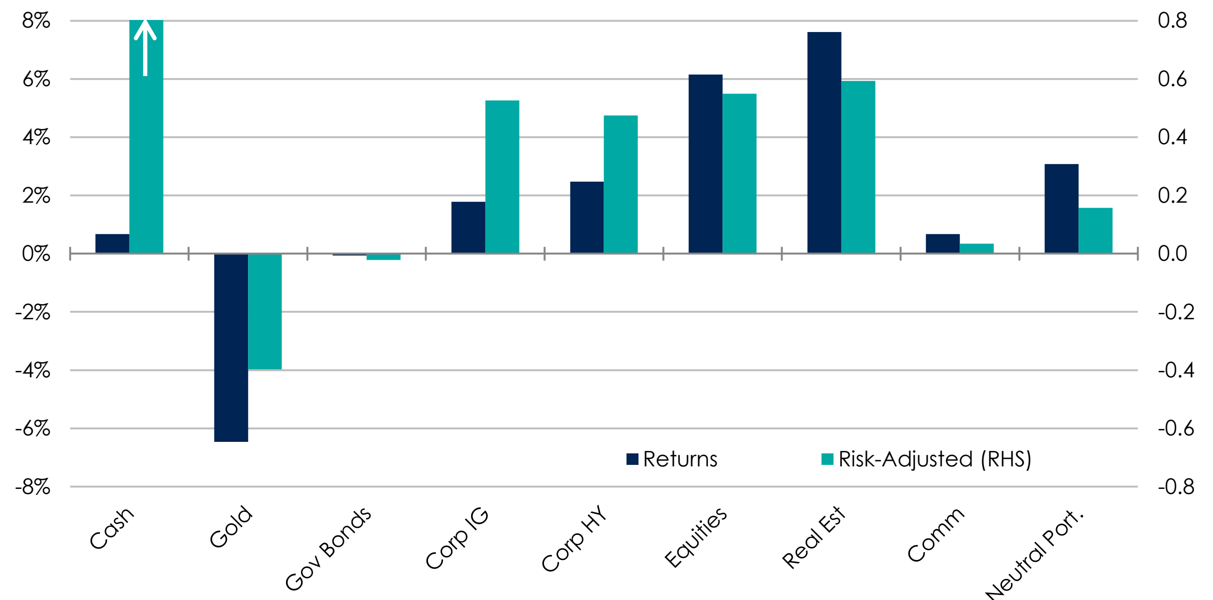
In our view:

- Equities offer a good total return but are volatile and correlated. Reduce to further Underweight.
- Real estate offers the best returns. Stay at Maximum.
- Corporate HY among the best fixed income assets. Increase to Neutral.
- Corporate IG preferred to sovereign debt. Increase to Maximum.
- Government debt unattractive but offers stability. Reduce to Underweight.
- EM is the only sovereign space with attractive risk/reward. Stay at Maximum.
- Cash returns low but stable and de-correlated. Stay at Maximum.
- Commodities have not bottomed. Remain Zero-weighted.
- USD uptrend will flatten. No currency hedges at the moment.

Source Top Picks

- Eurozone equities – estimated 10% 5yr annualised total return in USD
- EM real estate – estimated 10% 5yr annualised total return in USD
- EM sovereign debt – estimated 7% 5yr annualised total return in USD
- JPY cash – low projected total return (3% 5yr annualised in USD) but good in a crisis

Figure 1 – Projected 5-year returns for global assets and neutral portfolio



Returns are annualised in local currency. Risk-adjusted returns are projected returns divided by historical 5y standard deviations. See appendices for methodology and disclaimers. Source: Source Research

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Summary and conclusions

Asset groups have diverged since we published the 2017 Outlook in November: equity-like assets and industrial commodities have done well; sovereign debt, IG credit and gold have not. We are not changing the balance between equity-like and fixed income groups but are boosting credit within both (IG credit is increased to the maximum that we allow, financed by taking sovereign debt to Underweight, while HY credit is increased to Neutral, financed by taking equities further Underweight). Our Top Picks are Eurozone stocks, emerging market debt (local currency version), emerging market real estate and Japanese yen cash.

Recent all-time highs for US stock indices and the prospect of multiple Fed rate hikes suggest confidence is high. The election of Donald Trump seems to have been an important factor, with hopes of tax cuts, higher spending and de-regulation all playing a role. However, details are sparse and it is hard to see how he can deliver on that wish-list without swelling the budget deficit. We have covered this topic in detail elsewhere and, given the lack of new information, have chosen not to spend too much time on it this time (we have raised our dividend growth assumptions in the US and have nudged up our short term Fed forecasts).

However, despite the apparent blue sky (in the US and elsewhere), we suspect that market and Fed confidence will be tested at some stage during 2017. In particular, European politics could be a concern: we are more wary of Italy than of France.

We are now putting more emphasis on long term considerations and low yields continue to limit the potential for returns over the medium term. We believe the best returns over the next five years will be earned on real estate, equities and credit, with the lower volatility of the latter making it attractive.

Given that corporate investment-grade yields are higher than sovereign yields, and that spreads are close to normal, we suspect the returns on IG will be better than on government debt (for the same volatility). We are therefore making a straight swap: the **IG** allocation goes from 4% to 20% (the maximum allowed), while the weighting in **sovereign debt** comes down from 40% to 24% (which is Underweight versus our Neutral portfolio – see **Figure 2**). In particular, we think IG returns will be attractive in the US and the UK. Within sovereign debt, we continue to believe that **EM** offers the best return potential and have maintained the maximum allowed allocation (see **Figure 3**).

Within the equity-like segment, **real estate** remains at the maximum 6%, while the **high-yield** portion is increased to Neutral (5%) at the expense of the **equity** allocation, which is taken further Underweight (to 35% versus a Neutral 45%). Within high-yield, we have reduced the assumed 12m US default rate to the historical norm of 5% (where we keep it for the full five year forecast period) but we still believe returns will be better than in the Eurozone. Within equities, we are now even more Underweight the US and have also gone Underweight the Japanese market. We have a clear preference for European and emerging market equities.

Cash remains the diversifier of choice and we maintain the maximum 10% exposure (due to the low returns expected on other assets, its low volatility and low correlation to other assets).

We suspect the **commodity** cycle has not yet bottomed and therefore continue to avoid that asset class, though the agriculture segment could rebound.

Figure 2 – Expected total returns (annualised, local currency) and Source Multi-Asset Portfolio*

	Expected Total Returns		Neutral	Policy		Source Multi-	Position
	1-year	5-year	Portfolio	Range		Asset Portfolio	vs Neutral
Cash & Gold	-6.2%	-2.9%	5%	0-10%		10%	Overweight
Cash	0.2%	0.7%	2.5%	0-10%		10%	Overweight
Gold	-12.5%	-6.5%	2.5%	0-10%		0%	Underweight
Government Bonds	1.4%	-0.1%	30%	10-50%	↓	24%	Underweight
Corporate IG	2.2%	1.8%	10%	0-20%	↑	20%	Overweight
Corporate HY	-1.9%	2.5%	5%	0-10%	↑	5%	Neutral
Equities	2.0%	6.2%	45%	20-70%	↓	35%	Underweight
Real Estate	8.7%	7.6%	3%	0-6%		6%	Overweight
Commodities	-28.9%	0.7%	2%	0-4%		0%	Underweight

*This is a simulated portfolio. See appendices for methodology and disclaimers. Source: Source Research

Source Multi-Asset Portfolio*

Figure 3 – Source Multi-Asset Portfolio (14/03/2017)

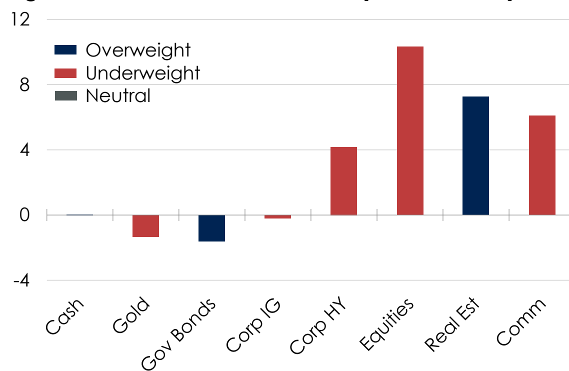
	Neutral	Policy Range	Allocation	Position vs Neutral	Hedged	Currency
Cash	**5%**	**0-10%**	**10%**			
Cash	2.5%		10%			
Gold	2.5%		0%			
Bonds	**45%**	**10-80%**	↑ **49%**			
Government	30%	10-50%	↓ 24%			
US	10%		↓ 16%			
Europe ex-UK (Eurozone)	8%		↓ 2%			
UK	2%		↓ 2%			
Japan	8%		↓ 0%			
Emerging Markets	2%		4%			
Corporate IG	10%	0-20%	↑ 20%			
US Dollar	5%		↑ 10%			
Euro	3%		↑ 6%			
Sterling	1%		2%			
Japanese Yen	1%		↑ 2%			
Corporate HY	5%	0-10%	↑ 5%			
US Dollar	4%		↑ 4%			
Euro	1%		↑ 1%			
Equities	**45%**	**20-70%**	↓ **35%**			
US	25%		↓ 8%			
Europe ex-UK	7%		↑ 12%			
UK	4%		6%			
Japan	4%		↓ 2%			
Emerging Markets	5%		↑ 7%			
Real Estate	**3%**	**0-6%**	**6%**			
US	1%		2%			
Europe ex-UK	1%		2%			
UK	0.5%		0%			
Japan	0.5%		0%			
Emerging Markets	0%		2%			
Commodities	**2%**	**0-4%**	**0%**			
Energy	1%		0%			
Industrial Metals	0.3%		0%			
Precious Metals	0.3%		0%			
Agriculture	0.3%		0%			
Total	**100%**		**100%**			
Currency Exposure (including effect of hedging)						
USD	49%		↑ 44%			
EUR	21%		↑ 26%			
GBP	8%		↓ 11%			
JPY	14%		↓ 4%			
EM	7%		↑ 14%			
Total	**100%**		**100%**			

*This is a simulated portfolio. Cash is an equally weighted mix of USD, EUR, GBP and JPY. See appendices for methodology and disclaimers.
Source: Source Research

Since we last spoke

We last published The Big Picture on November 16 (see 2017 Market Outlook), just after the US election. Subsequent returns have been largely positive and the talk has been increasingly of reflation and Fed tightening. **Figure 4** shows that the only assets to suffer since then have been gold, sovereign debt and, in a small way, corporate IG debt.

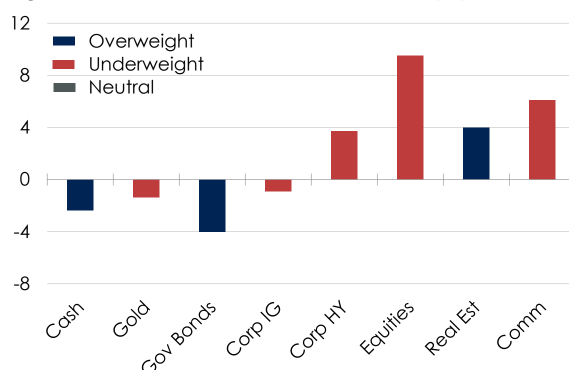
Figure 4 – Global 4m total returns (%, local curr.)*



*Colours represent the SMAP weightings during the period considered.
Source: Datastream and Source Research

Our favourite asset at the time was real estate, which has worked nicely for us. Apart from that, it has been a difficult period given that we tactically reversed our long-held preference for equity-like assets, a change that has not worked. The only saving grace was that we stuck with our preference for emerging markets across all asset classes and this has worked so far during 2017 (see **Appendix 3**).

Figure 5 – Global 4m total returns in USD (%)*

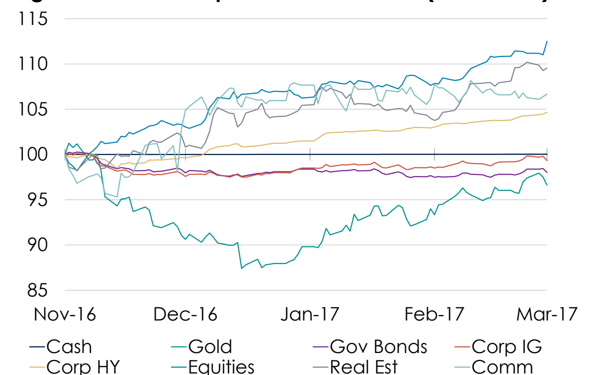


*Colours represent the SMAP weightings during the period considered.
Source: Datastream and Source Research

The slight strengthening of the dollar during the last four months (on the back of Trumponomics and Fed hawkishness) reduced global asset returns when converted to USD. The most noticeable feature of **Figure 5** is the negative cash return, which is largely due to yen and euro weakness (see **Appendix 3**).

As can be seen in **Figure 6**, the big contrast in the time path of returns was that between risk assets such as equities, real estate and commodities on the one hand and gold, on the other. The former group climbed steadily, while gold initially suffered after the election of Trump but has since recovered steadily since around the time of the Fed tightening in mid-December.

Figure 6 – The time path of total returns (local curr.)



Source: Datastream and Source Research

Surprises aplenty

The obvious surprises since we last published were:

- The election of Donald Trump and the positive market reaction. The change in market sentiment over the last 12 months is startling.
- The improvement in economic confidence indicators (both corporate and consumer). For example, the US ISM Manufacturing index is now 57.7 (February) versus 49.4 six months ago, while the JP Morgan Global Composite PMI is 53.5 versus 50.7 a year ago. According to the Conference Board, US consumer confidence is now higher than at any time since just before the 9/11 attack in 2001.
- The “reflation” interpretation that is being placed upon the rise in headline inflation. For the most part core inflation has been stable (the rise in headline inflation has been largely down to higher commodity prices).
- The change in rhetoric from the Fed. Six months ago the Fed was reluctant to raise rates and waited until December. The FOMC now seems keen to raise rates a number of times this year and recent communications suggest a hike on March 15 is all but certain.
- The ease with which markets dealt with the “No” vote in the Italian referendum and with the resignation of Renzi. Markets seem to have become immune to political events.
- The amount of support for Marine Le-Pen. A victory for the Front National candidate would test markets and it is surprising (to us) to see her doing so well in opinion polls.

Changes in valuation – risk assets become more expensive

There has been a clear separation of assets in the last four months: yields on equity-like instruments (including high-yield) have gone down, while those on fixed income assets have gone-up (see **Figure 7** with more detail in **Appendices 2** and **4**).

We believe this divergence is due to a combination of two factors, both of which are driven by improving economic sentiment: first, forecasts of earnings and dividend growth may have been revised upward, while those of default rates have been lowered; second, the risk premium applied to riskier assets has been reduced.

Of particular note was the 60bp decline in the yield on US high-yield, taking it to 6.00%, well below the 10% plus that was available in early 2016. On the other hand, the yield on European high-yield has barely changed. The decline in US yields came despite the climb in treasury yields.

The more modest decline in equity dividend yields occurred in all regions except EM where there was no change. The decline in real estate yields was concentrated in the US and the UK.

Not surprisingly, the gain in sovereign yields was particularly noticeable in the US, with the 10 year treasury yield rising by 56 bps over the last four months to 2.39% (as of February 28). There were two major driving forces: expectations of a stronger economy due to the Trump presidency and the Fed's December rate hike (and hawkish messages about the future path of rates).

Within the Eurozone, peripheral markets suffered the steepest gain in yields. For instance, the Italian 10 year yield was up 42 bps over the period considered, while that of Germany gained only 4 bps. Uncertainty about The Italian political situation perhaps explains that divergence. It is noticeable, however, that the French 10 year yield is up by exactly same amount as that of Italy and in many ways it may be fears about French politics that are driving peripheral spread widening.

The one obvious exception to the general rise in sovereign yields was the UK, with 10 year gilt yields down around 10 bps over the period considered (to 1.15%). To be fair, gilt yields had risen sharply since mid-August on the back of a weaker pound and concerns about inflation.

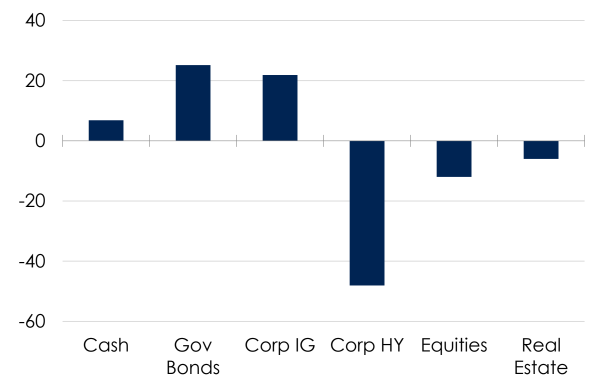
Though emerging market yields were up over the four months, there were some notable exceptions, such as Brazil where a weak economy, falling inflation and central bank rate cuts allowed 10 year yields to fall by around 120 bps to 10.2%.

The rise in IG credit yields is almost entirely a US phenomenon (with a 30 bps gain there) while, as happened with sovereign yields, those of the UK have fallen.

The rise in cash rates was down to the December Fed rate hike (we use a blend of USD, EUR, GBP and JPY rates).

Of course, the extent to which these changes in valuation impact our allocations depends upon the variation in our underlying assumptions about growth, inflation, policy settings etc. That is the subject matter of the next section (SMAP decision process).

Figure 7 – 4M change in global yields (bps)



Source: Datastream and Source Research

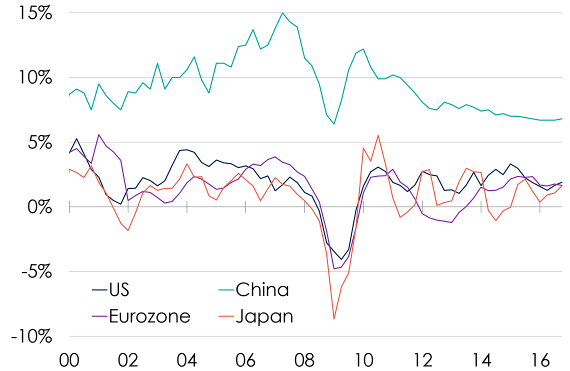
SMAP decision process

Has the bond bull market come to an end?

The global economy is expected to grow by around 3% in 2017, with inflation at about the same level (see consensus economic forecasts in **Appendix 1**). This is exactly the central scenario that we described in our 2017 Outlook document. We had the same view a year ago, when markets seemed to be concerned about recession/deflation. Now, it appears that the market is hoping for something much better (stronger growth/reflation).

Figure 8 gives an update of where we think the 10 largest economies are within their economic cycles. Economies are naturally advancing through their cycles, some accelerating and some decelerating. Though **Figure 9** gives no encouragement that a sharp global acceleration is in progress, it at least suggests the deceleration feared during early 2016 has not materialised. In particular, the Japanese economy has accelerated and it now seems to be in a mid-expansion phase (note that Japan seems to experience mini-cycles that last for only one or two years). India on the other hand seems to have passed into the "late-expansion" phase.

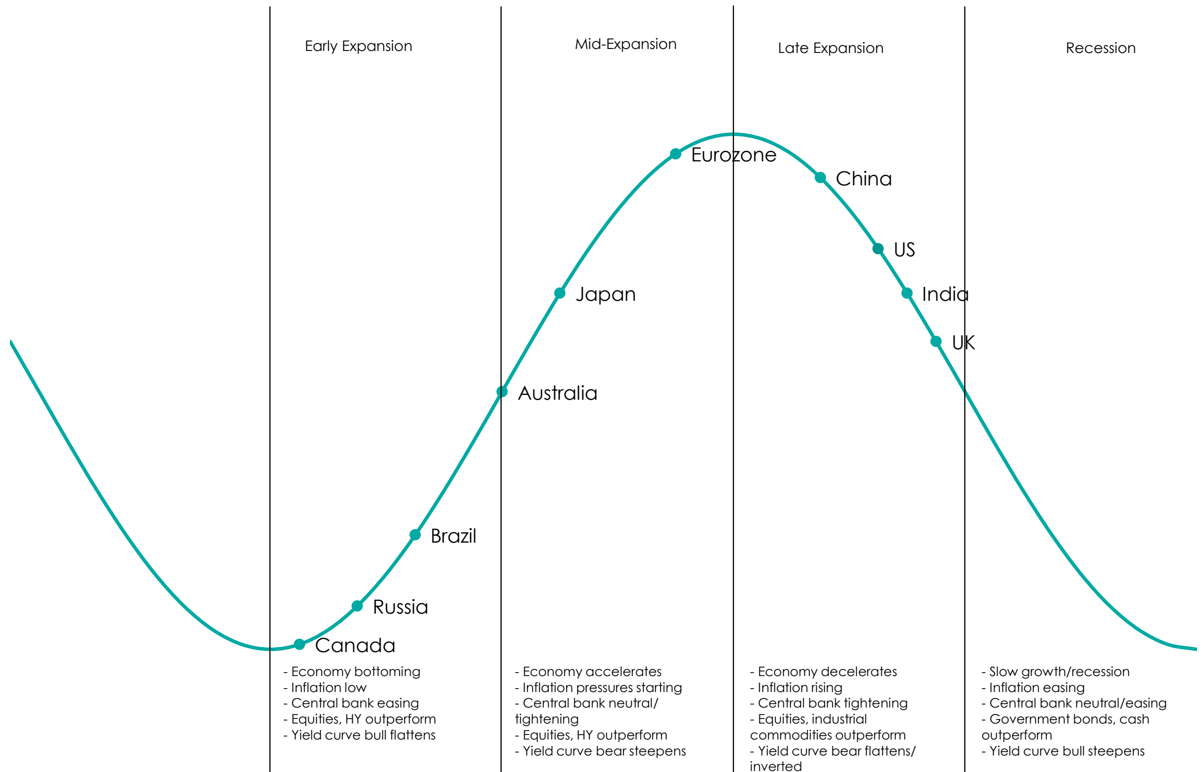
Figure 9 – GDP Growth (% y-o-y)



Source: Datastream and Source Research

The most obvious questions are: will Donald Trump be able to reinvigorate the US economy, thus prolonging what is already a longer than average upswing (based on post-WW2 norms); will China continue to avoid the accident feared by many and will Brexit weaken the UK and European economies?

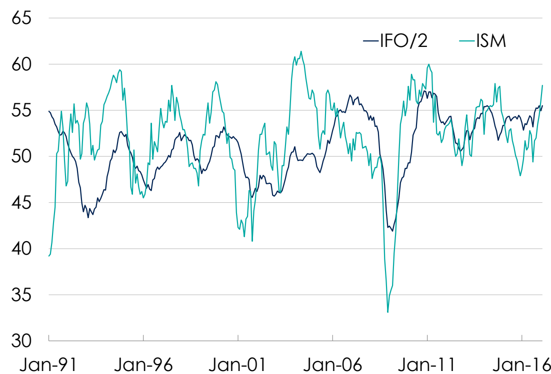
Figure 8 – The economic roller coaster



Source: Source Research

Perhaps the single most consistent indicator of an upturn in global economic fortunes has been the improvement in sentiment (both consumer and business). **Figure 10** shows that both the US ISM Manufacturing and German IFO surveys have improved markedly. Unfortunately, these are not always good indicators of future economic performance and we suspect the improvement is a reflection of the rebound in the US economy during 2016 H2 and the rally in stock markets. This has caused media commentary to become more positive and company managements read newspapers, just like the rest of us.

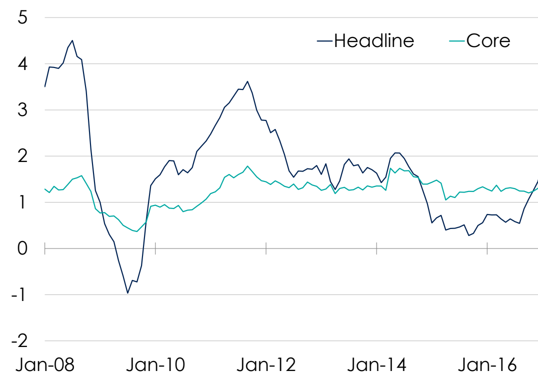
Figure 10 – US ISM Manufacturing and German IFO



Source: Datastream and Source Research

In part, the improved sentiment seems to be a result of the rise in inflation. However, this is largely the result of the rebound in commodity prices and has little to do with underlying trends (see **Figure 11**). Just as low/negative headline inflation persuaded market participants to become overly pessimistic about the likelihood of deflation a year ago, we suspect the uptick in headline inflation is now building a false picture of the scope for reflation.

Figure 11 – World headline and core inflation (average of US, Eurozone, UK, China and Japan)



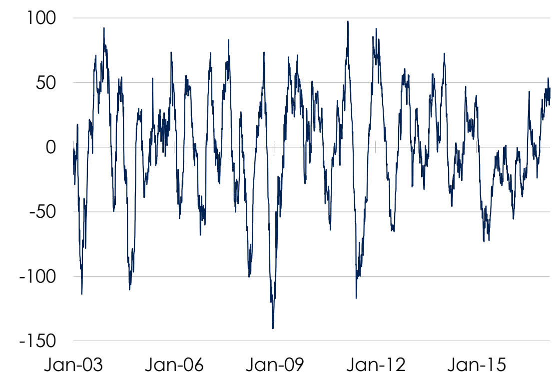
Source: Datastream and Source Research

As the oil price bottomed in January/February of last year, we suspect the peak in divergence between headline and core inflation is occurring right now. If so, and if core inflation does not rise in a meaningful way, headline inflation will fall back towards current core levels over the coming months and quarters.

In any case, the Fed is now convinced it should be raising rates (the Fed seems to be market driven these days and as long as markets are happy it will continue hiking). In all likelihood, the pace of Fed rate hikes will be no more than one per quarter and will quite possibly be less (the average pace of Fed rate hikes during previous cycles since 1983 was 21 bps per month).

Leaving aside the medium term effect of Trump's policies (previously covered here and here); there is plenty of historical precedent to suggest the current optimism about the US economy could be tested in the short term. The US economy surprised to the upside during H2 2016 and logic suggests those surprises cannot last forever. Indeed, we wrote last year about the tendency for economic surprise indicators to turn negative during the first and second quarters of the year and the Citi Surprise Index for the US seems to have peaked (see **Figure 12**).

Figure 12 – Citi US Economic Surprise Index



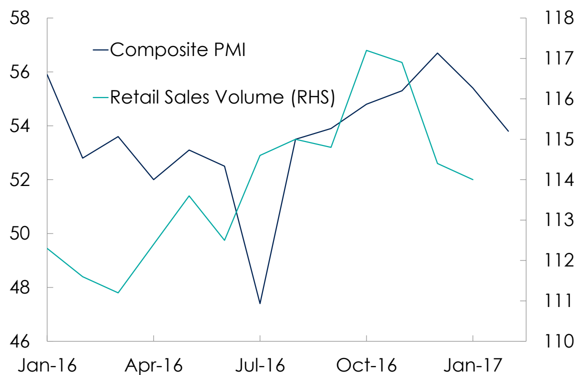
Source: Citigroup, Datastream and Source Research

A glance at recent US data reveals some pockets of concern: first, Q4 GDP growth was boosted by inventory accumulation (the 1.9% GDP growth would have been only 0.9% without inventories) and the stronger dollar seems to have taken its toll (the net export drag on GDP was 1.7% during Q4 and the trade deficit widened again in January to the highest in almost five years). Second, auto sales, new home sales and housing starts seem to have peaked (even if they do not decline, that is another source of growth that has disappeared). Third, core capital goods orders slipped 0.4% in January (admittedly after a strong few months). Despite what the surveys say, Q1 could be disappointing.

The situation in the UK looks even more worrying. The post-Brexit bounce was confusing for many economists but increasingly looks to have been the result of a temporary decline in savings (perhaps due to the drop in interest rates or alternatively to the bringing forward of purchases before the drop in sterling pushed up prices).

Unlike many other countries, confidence indicators have already weakened in the UK. For instance, the Markit Composite PMI peaked at 56.7 in December and then fell in both January and February (it is now 53.8 – see **Figure 13**). It is possible that the government's preference for a "hard" Brexit (as outlined in Theresa May's recent speech) has added to the general uncertainty that comes with the Brexit process.

Figure 13 – UK Composite PMI and retail sales



Source: Markit, Datastream and Source Research

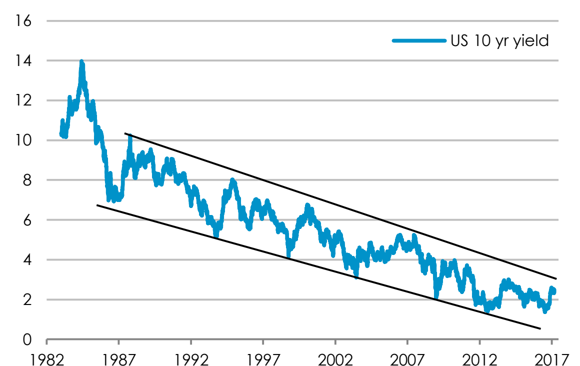
More tangibly, there appears to have been a slowing of consumer spending. After a nice bounce in October, retail sales volumes declined in each of November, December and January (see **Figure 13**). The BRC sales monitor detected similar weakness in February. At the very least, the UK consumer seems to be struggling to maintain spending volumes in the face of higher inflation (due to both the rise in commodity prices and the weakness of sterling). Having slipped into negative territory in late 2015, CPI inflation is now 1.8% and rising (Retail Price Index inflation is 2.6%). It also appears that consumer sentiment is slipping – having peaked in September, it has since been on a down trend.

Finally, it is that time of year when Chinese data flows become difficult to interpret but it is our suspicion that the economy has passed from a short acceleration phase back to the trend deceleration that should be expected over the medium term. The short term dampening factors are: the rise in commodity prices, the slight tightening by the PBOC and the fact the currency is no longer weakening. Indeed, the official target for GDP growth has been lowered to 6.5% in 2017 from 7.0% in 2016, partly in recognition that debt and housing problems need to be addressed (see here).

So, the promise of tax cuts and extra spending in the US offers hope that the US and global economies will move to a higher growth trajectory. However, the unwillingness to expand the budget deficit (on the part of both Trump and many Republicans in Congress), the fact that we have so far been given little in the way of detail, the potential negative effects on world trade and US consumer/investment spending from Trump's belligerence, along with the shorter term issues outlined above, suggest disappointment/impatience could set in at some stage.

The Fed is giving clear signs that it will hike on multiple occasions during 2017 (and rates remain well below the 2% that we now consider normal). Further, financial markets seem relaxed about that possibility and, if anything, are encouraging the Fed to get on with it. If the Fed does raise rates three times this year (including on March 15), we would expect 10 year treasury yields to be in the 2.60%-2.70% range by year-end. Interestingly, this would push yields closer to the point at which we could question whether the multi-decade downtrend is finally over (see **Figure 14**).

Figure 14 – US 10 year treasury yield (%)



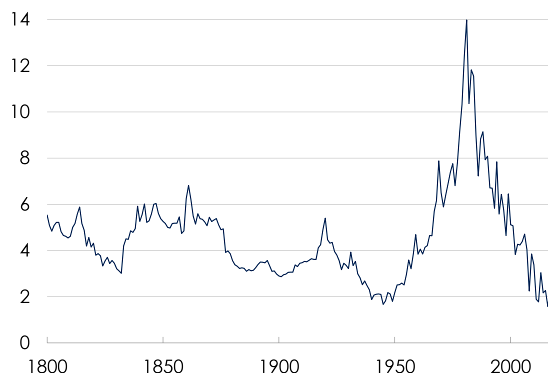
Source: Datastream and Source Research

We certainly believe that downtrend will be broken over the medium term (see our five year forecasts in **Figure 23**) but suspect that both the Fed and the markets will be given reason to question their bullish attitude at some stage during 2017. Hence, we doubt that the Fed will implement the full extent of its current rate hike plans. Therefore, we are currently allowing for just one more rate hike after March 15 and foresee the 10 year yield at 2.40% in one year (see **Figure 23**). On this basis, we are yet to be convinced that the bond yield regime has changed and suspect yields could take some time to break convincingly higher.

Valuations remain a limiting factor

Valuations are stretched for many important asset groups as a result of the extremely loose policies run by a number of big central banks. Nowhere is this more apparent than in sovereign debt (**Figure 15** shows that US yields were only ever this low during and after WW2, when the Fed was setting yields).

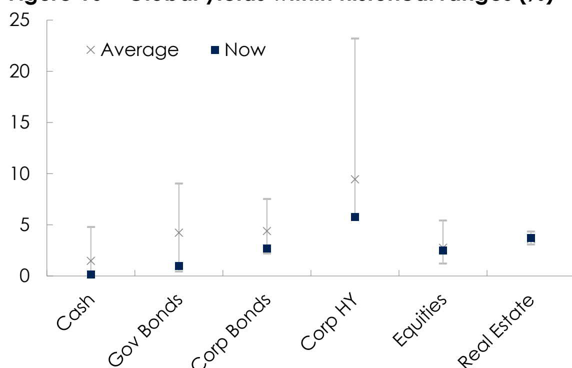
Figure 15 – US 10 year bond yields since 1800



Source: Global Financial Data, Datastream and Source Research

The depressing effect on yields has spread from government bonds to other asset classes, with yields at the lower end of historical ranges for most forms of debt (see **Figure 16**, with regional detail available in **Appendix 2**). This naturally limits the scope for future returns (see the full detail in **Appendix 4**).

Figure 16 – Global yields within historical ranges (%)



Source: Datastream and Source Research

High-yield and emerging markets offer yield

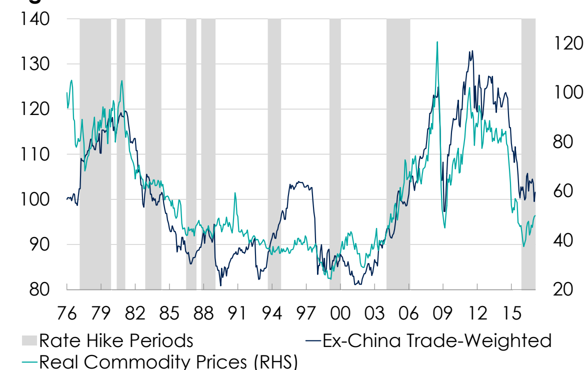
Those seeking yield will see from **Figure 16** that high-yield corporate debt is a good place to start. However, as noted earlier, those yields have fallen quite sharply and are no longer so compelling. Indeed, if we allow for a normalisation of default rate and the spread versus treasuries over the next year, the return on US high-yield would likely be negative (see **Appendix 5** for all assumptions).

We think default rates will be lower in Europe (2% over 12 months versus 5% in the US) but suspect the effect of the ECB on spreads will weaken as the ECB starts its tapering process. We expect returns to be better on European than US high-yield over the next year (though still negative).

Over a five year horizon, the higher starting yield on the US market (6.0% versus 3.7%), gives US high-yield a big advantage. Assuming that default rates and spreads are in line with historical norms, we expect the US market to generate an annualised return of 3.0% versus a loss of 0.4% in the Euro area).

We remain big fans of emerging market debt. Yields remain higher than in the developed world (**Appendix 2** shows that EM yields are close to historical norms). **Appendix 3** shows that EM government debt has outperformed most other regions over the last four months (except the UK) and over 12 months has delivered double digit returns, whether measured in local currency or in USD. It is often supposed that EM currencies suffer when the Fed tightens; however their fate is tied more closely to the commodity cycle (see **Figure 17**). Unfortunately, we remain cautious on commodities, a view that limits the envisaged short term potential on EM debt. However, over five years we think it will be the best performing government debt market, by some margin, with a projected annualised return of 7% (see **Appendix 4**).

Figure 17 – Real EM FX and commodities

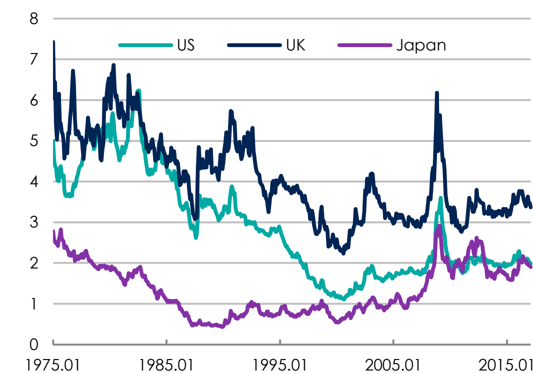


Source: China National Bureau of Statistics, IMF, OECD, Oxford Economics, GSCI, Bloomberg, Datastream, Source Research. Emerging currency indices are trade weighted averages of national currencies versus US dollar (trade weights are based on total trade flows for each country). There are 18 currencies in the EM basket – those of China, South Korea, Mexico, India, Russia, Singapore, Malaysia, Brazil, Thailand, Poland, Turkey, Indonesia, Czech Republic, South Africa, Hungary, Nigeria, Chile and Philippines (ordered by size of trade flows). Real adjustments are calculated using national CPI indices versus that of the US. "Real Commodity Prices" is the GSCI Spot Index in USD deflated by US CPI. All indices were rebased to 100 as of June 1976.

Equity valuations are mixed

The ongoing rally in equity markets has made them look marginally more expensive than at end-October (global yield down from 2.6% to 2.5%). This goes against the trend of the last 15-20 years, which has seen dividend yields move gradually higher, despite the decline in bond yields (see **Figure 18**). Our projections allow for a gradual continuation of that trend (though not as rapid as the rise in bond yields) which necessarily limits the return potential (see this for a discussion of the issues).

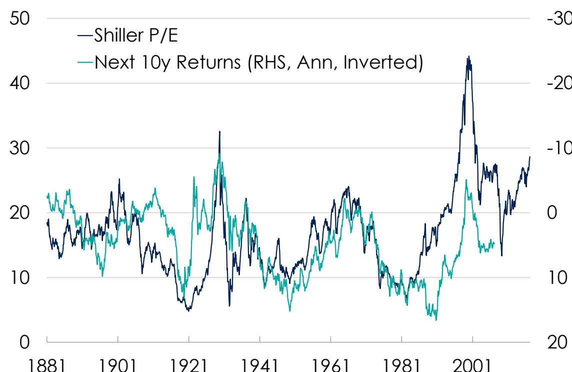
Figure 18 – Dividend yield (%)



Source: Robert Shiller, Global Financial Data, Datastream and Source Research

However, the only valuation problem that we identify is the US market (bloated by Fed QE activity, in our opinion). **Figure 19** shows the extent of the problem – the Shiller PE is now approaching 30, a level historically associated with low or negative returns over the following five to ten years.

Figure 19 – S&P 500 Shiller PE and future returns

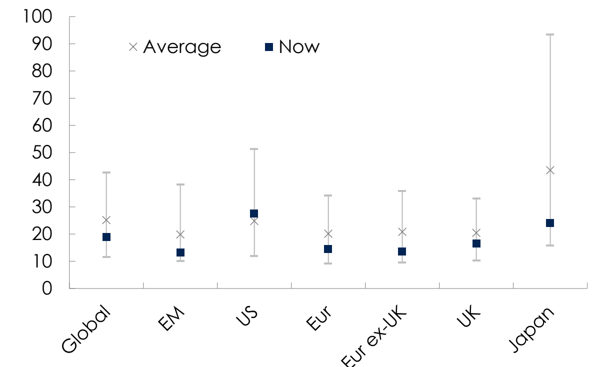


Source: Robert Shiller and Source Research

Of course, if corporate tax rates were cut in the way proposed by both Donald Trump and Congressional Republicans, the post-tax income of US corporates would be higher, perhaps justifying a valuation premium versus historical norms. However, the final outcome depends upon how many tax-breaks are eliminated at the same time (by definition, if these changes are not to increase the fiscal deficit, there can be no net giveaway). See here for our analysis of the winners and losers under such a change.

Other regions are more attractive in our opinion. First, their valuations are not as stretched (see **Figure 20**). In particular, EM and European stocks appear cheap, with CAPEs toward the lower end of historical ranges. Second, the economic cycles in most other regions are nowhere near as advanced as in the US, which gives the hope of better upside in earnings and dividends. In particular, the rebound in commodity prices has helped the EM region, which has given the best equity market returns over the last 12 months when measured in USD (see **Appendix 3**).

Figure 20 – Historical ranges for CAPEs



Note: CAPE = Cyclically Adjusted Price/Earnings and uses a 10-year moving average of earnings. From 1983 (except for EM from 2005).
Source: Datastream and Source Research

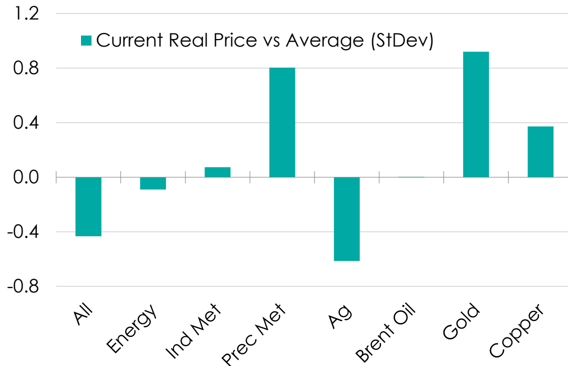
The Japanese market has recovered its poise and has produced a return of 20% over the last 12 months. It is hard to categorise the Japanese market from a valuation perspective. **Figures 18** and **20** suggest it is cheaper than its own historical norms (including the bubble) but in absolute terms it is more expensive than all regions except the US. Based on our projections, the local currency returns on Japanese equities will be roughly in line with those of the US over the next five years but will lag all other regions. When calculated in USD, the returns are projected to be ahead of the US but lower than elsewhere.

Over the last 12 months, among the markets that we monitor, the UK has been second only to the US when it comes to local currency equity market returns. However, that strong performance was on the back of the beneficial impact of sterling weakness upon non-domestic profits. When converted into USD, the 10.9% return on the UK is well behind the 20.9% return on the MSCI World Index. We suspect sterling may weaken a bit further in the very short term but expect it to be higher in one and five years, which should boost USD returns.

Commodities have normalised but not gold

Commodities have had a good four months, though it does depend where one looks. As can be seen from **Appendix 3**, energy and industrial metals have produced strong gains, while precious metals and agriculture are down slightly.

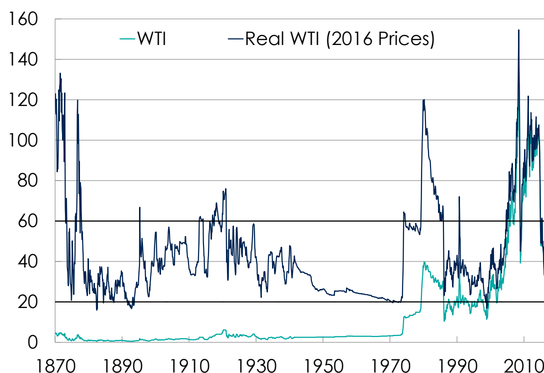
Figure 21 – Commodity prices deflated by US CPI versus historical norms



Source: GSCI, Datastream, Source Research

Figure 21 suggests that many commodities have returned to more normal prices when measured in real terms (with the notable exception of precious metals). However, it is based on information only since the 1970s. **Figure 22** shows a longer history for US oil and suggests oil tends to finish its cycles at around \$20 (in today's prices). OPEC and Russia have successfully capped and reduced production over recent months but US inventories remain high and US production is on the rise again. We doubt that oil has yet touched its bottom for this cycle.

Figure 22 – Real US oil price (US$ CPI adjusted)



Source: Global Financial Data, Datastream, Source Research

As for gold, it is interesting that it has held up so well during the recent climb in US yields and the US dollar. Our econometric model suggests it should be closer to \$1100 than to \$1200 and should fall to \$800-\$900 over the next five years, as yields normalise.

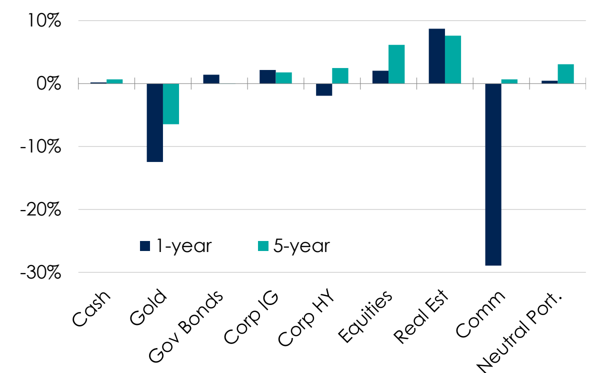
Our expected returns favour "equity-like" assets

Expected returns can be impacted by changes in asset prices and/or by changes in assumptions. As was shown in **Figure 7**, equity-like assets have become more expensive in the last four months, while most fixed income assets are now offering a better yield. All else being equal, that should improve the expected returns on fixed income assets relative to those on equity-like instruments.

However, all else is not equal. We are now more optimistic on dividends and rentals in a number of regions over the next year (especially the US and UK) and less pessimistic about defaults in the US high-yield market. We have also upgraded our Fed rate hike assumptions (two in the next 12 months) but remain less concerned than much of the market. This has a knock-on effect on our bond yield assumptions in the US and in EM. The full set of assumptions is shown in **Appendix 5**.

Nevertheless, the movement in our one year projections is pretty much as we would have expected given the change in yields available (projected fixed income returns are higher than they were, while equity-like returns are lower). However, in general, the expected returns are better on equity-like assets, especially if we focus on the five year projections (see **Figure 23** for the summary and **Appendix 4** for the regional detail).

Figure 23 – Expected total returns on global assets and neutral portfolio (local currency, annualised)



See appendices for methodology and disclaimers.
Source: Source Research

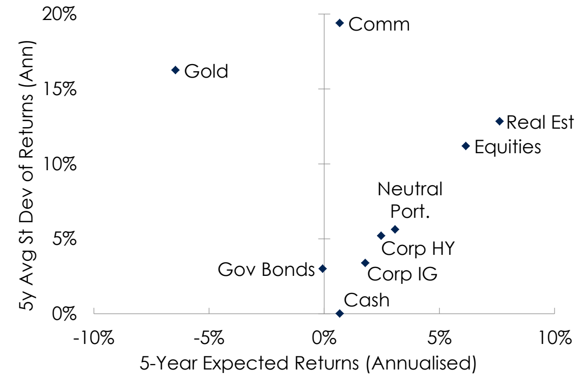
A short rationale of the five year projections is that central bank rates and bond yields are expected to rise; credit spreads are expected to normalise from current low levels; equity and real estate yields are expected to rise a touch (risk premiums versus government yields are expected to decline) but ongoing yield and historical average growth rates produce mid-single-digit returns. **Figure 24** shows how this translates into market forecasts.

Figure 24 – Source market forecasts

	Current	Forecast	
	(28/02/17)	1-year	5-year
Central Bank Rates			
US	0.75	1.25	2.00
Eurozone	-0.40	-0.40	1.00
China	4.35	4.50	4.50
Japan	-0.05	-0.20	0.50
UK	0.25	0.25	2.00
10yr Bond Yields			
US	2.36	2.40	3.25
Eurozone	0.21	0.20	1.50
China	3.36	3.30	3.00
Japan	0.05	-0.05	1.00
UK	1.07	1.00	2.75
Exchange Rates/US$			
EUR/USD	1.06	1.05	1.15
USD/CNY	6.87	7.25	8.00
USD/JPY	112.78	108.00	100.00
GBP/USD	1.24	1.30	1.40
USD/CHF	1.01	1.00	0.90
Equity Indices			
S&P 500	2364	2300	2650
Euro Stoxx 50	3320	3375	4300
FTSE A50	10440	10200	15600
Nikkei 225	19119	19000	21500
FTSE 100	7263	7200	8300
Commodities			
Oil (Brent)	54	30	40
Gold	1257	1100	900
Copper	5967	4000	5000

*See Appendices for methodology and disclaimers.
Source: GSCI, Datastream and Source Research

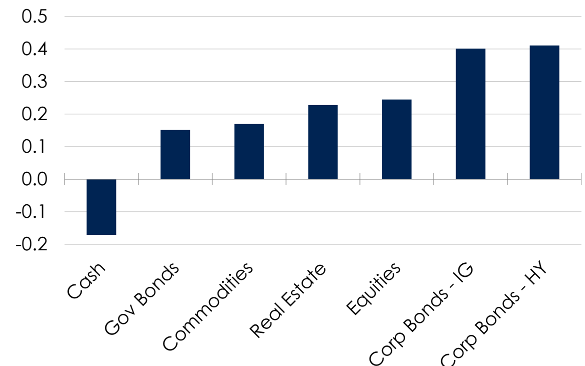
Figure 25 – Return versus risk for global assets



Based on local currency returns. See Appendices for methodology and disclaimers. Cash is an equally weighted mix of USD, EUR, GBP and JPY. Source: Datastream and Source Research

Correlations also play a role in the optimisation process. All else being equal, the optimiser will favour those asset classes that offer the most diversification (i.e. those that are the least correlated with other asset classes). **Figure 26** suggests that sovereign debt, cash and commodities are the most likely to be offered favourable treatment on this basis.

Figure 26 – Average pairwise correlations between global asset classes



Notes: We calculate correlations using monthly local currency total return in the last five years for global asset classes. We take an average of all pairs across each asset class.
Source: BAML, MSCI, GSCI, FTSE, Datastream, Source Research

Optimisation favours cash and credit

Taking the expected returns shown in **Appendix 4** and running them through an optimiser allows us to take account of observed volatilities and correlations (we limit the process to global asset classes and having decided those weights then allocate across the regions within each asset class). The optimiser is a useful tool but judgement is the final ingredient in constructing the Source Multi-Asset Portfolio.

Figure 25 compares our projected returns with historical volatilities (based on returns in local currency). The pattern is much as expected, with extra return coming at the expense of heightened volatility (the commodity outlier is due to our bearish price forecasts). Government debt stands out as offering too little projected return for the volatility inherent in the asset class.

The optimised allocations are shown in **Figure 27** (on the basis of local currency returns). When we published the 2017 Outlook document, we focused on maximising the Sharpe Ratio using one year returns (for obvious reasons). The current optimised allocations on that basis are similar to what they were then (maximum allocation to sovereign debt, underweight equities, maximum real estate, zero HY and zero commodities), though now IG credit is given a maximum allocation and cash is reduced (it was previously at the maximum). Essentially, the rise in IG yields is pushing us to boost our allocation.

Figure 27 – Optimised allocations for global assets (using local currency returns)

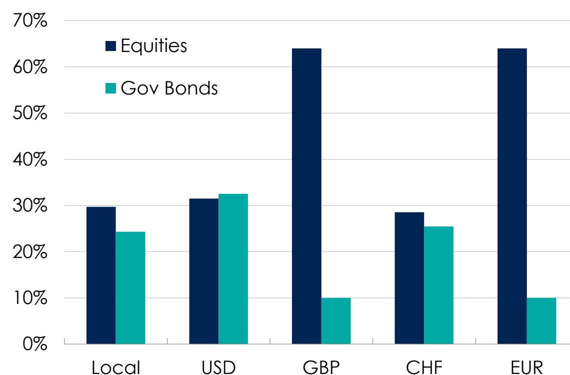
	Neutral Portfolio	Policy Range	Using 1y Return: Sharpe Ratio	Using 1y Return: Max Return	Using 5y Return: Sharpe Ratio	Using 5y Return: Max Return		Source Multi-Asset Portfolio
Cash & Gold	5%	0-10%	4%	0%	10%	10%		10%
Cash	2.5%	0-10%	4%	0%	10%	10%		10%
Gold	2.5%	0-10%	0%	0%	0%	0%		0%
Government Bonds	30%	10-50%	50%	30%	24%	14%	↓	24%
Corporate IG	10%	0-20%	20%	20%	20%	20%	↑	20%
Corporate HY	5%	0-10%	0%	0%	10%	10%	↑	5%
Equities	45%	20-70%	20%	44%	30%	40%	↓	35%
Real Estate	3%	0-6%	6%	6%	6%	6%		6%
Commodities	2%	0-4%	0%	0%	0%	0%		0%

Based on local returns (for both the projected returns and historical covariance matrix). Cash is an equally weighted mix of USD, EUR, GBP and JPY. "Sharpe Ratio" shows the results of maximising the Sharpe Ratio. "Max Return" maximises returns while not exceeding the volatility of the Neutral Portfolio. This is a simulated portfolio. See appendices for methodology and disclaimers. Source: Source Research

However, we recently wrote about the importance of lengthening time horizons and not getting caught up in too many short term changes (see All things come to he who waits). On that basis, we should focus more upon the results using our five year projections, which pushes us out of sovereign debt and into HY credit and cash (compare the 1yr and 5yr columns in **Figure 27**). Those five year results would push us to maximise the allocations to credit (IG and HY), real estate and cash, while being underweighted in sovereign debt and equities and zero weighted in commodities.

We use local currency returns in the optimisation process to avoid the bias that comes from our currency forecasts. However, we also run the optimisation from the point of view of investors using other currency bases (USD, EUR, GBP and CHF). The results are shown in **Appendix 6**.

Figure 28 – Optimal allocations by currency base



The chart shows optimal allocations for global equities and government bonds, depending upon the currency base of the investor (based on maximising the Sharpe Ratio when using 5yr projected returns). The expected returns and covariance matrix are translated into the relevant currency base (cash returns are those in the relevant currency).
Source: Datastream and Source Research

Figure 28 shows how the choice of currency base impacts optimal allocations to equities and government debt (the minimum for the latter is 10%). Interestingly, the translation of returns into another currency does make a difference (the Sharpe Ratios of asset groups are affected in different ways). Though some of the conclusions are similar to those shown in **Figure 27** no matter which currency base is chosen (preference for real estate and cash), there are some big differences (GBP and EUR based investors should look upon equities more favourably than other investors, for example, according to our models).

Source Multi Asset Portfolio – taking credit

In arriving at our allocations for the coming period, we are focused largely on the five year outlook in local currency terms. However, we do try to take account of where we think there could be short term risks or opportunities. For instance, political risk in Europe leads us to be a little more cautious than we might otherwise have been (see below), while the scope for President Trump to add to bullish sentiment in the US has the opposite effect.

Perhaps the easiest way to think about the changes we are making is that we have left the overall balance between equity-like and fixed income assets unchanged but have made changes within those categories in favour of credit instruments.

Within fixed income, we have reduced **sovereign debt** from 40% to 24% (going from Overweight to Underweight), while increasing **IG Credit** from 4% to 20% (from Underweight to the maximum allowed). Both assets have suffered in recent months but, as mentioned earlier, we think the risk/return trade-off is better for IG credit (see **Figure 25**). Within sovereign debt we maintain a strong preference for EM debt and among developed markets we prefer the US.

Among equity-like assets we are reducing **equities** (from 40% to 35%, which takes us further Underweight) and adding the balance to **HY credit** (going from 0% to 5%, which is Neutral). Though the optimisation process suggests a bigger allocation to high-yield, we are wary of going to the maximum allocation given recent strong performance and our belief that the oil price has not yet bottomed. We are now Neutral in both US and Eurozone high-yield.

Within the now reduced equity allocation, we are further accentuating the Underweight position in the US (taking the position to only 8% versus a Neutral 25%), while boosting the allocations to Europe (both UK and ex-UK) and emerging markets. On the basis of low projected returns, we are now reducing the allocation to Japanese equities to below Neutral (from 6% to 2%, versus a Neutral 4%).

We remain fully exposed to **real estate**. Many investors believe that higher bond yields will penalise the asset class. We agree that yields will rise but expect this to be more than balanced by stronger rental growth (based on improving economies). In particular, we like EM, US and Eurozone markets.

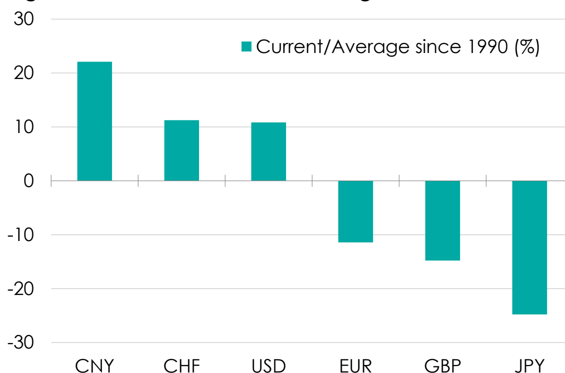
Cash continues to be a staple of the portfolio and the position remains at the maximum we allow ourselves (low volatility and lack of correlation with other assets is a big advantage).

We remain zero-weighted in **commodities**.

No currency hedges

There is a strong consensus in the market that the dollar will continue appreciating (Trump policies and Fed tightening). Though we understand the logic, we also believe that after six years of appreciation a lot is already in the price. Indeed, **Figure 29** shows that USD is more expensive than usual in real terms and Q4 GDP data suggests it continues to burden the US economy.

Figure 29 – Real effective exchange rates



Source: OECD, Datastream, Source Research

On this basis, we expect little short term movement in currencies and expect that over a five year period the currencies most likely to appreciate are GBP, EUR and JPY, with CNY, CHF and USD expected to weaken (see forecasts in **Figure 24**). The projected moves are not of an amplitude sufficient to entice us to hedge any exposures.

Politics – Italy is the risk

As outlined in [10 improbable but possible outcomes for 2017] there are a number of important political events awaiting us during 2017. The Trump presidency has boosted some risk assets but has also created a sense of unease, concerning both domestic and international politics. This is perhaps one reason why gold has remained so elevated in the face of higher bond yields and a stronger dollar.

The North Korean situation is also a concern. The constant provocative testing of missile technology risks spurring a stand-off between South Korea, Japan and the US on the one hand and North Korea and China on the other.

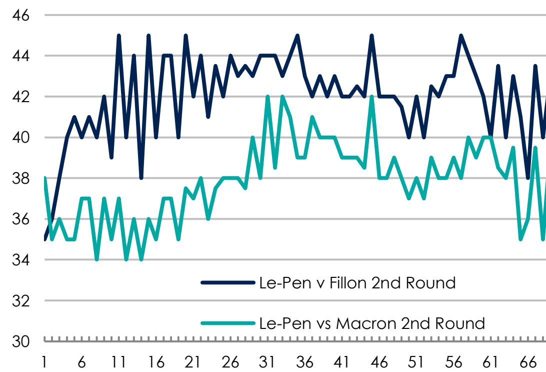
Also bubbling away in the background are tensions in the Middle-East, with the new White House stance towards the Israel-Palestine conflict, Russia's involvement in Syria (and perhaps Libya) and upcoming Iranian elections (May 19) all potentially adding to regional and global tensions.

However, the most obvious market concerns have centred on Europe. The Brexit process offers potential for conflict between the UK and the rest of the EU, while upcoming elections in important Eurozone countries could unsettle markets if the result is a referendum about another country's EU membership.

The first election is in the Netherlands (March 15). It always seemed unlikely that the Party for Freedom (Geert Wilders) would win enough seats to form the next government and recent opinion polls suggest it will not even be the largest party. So the risk of an EU referendum in the Netherlands seems to be fading.

Next up is the French presidential election (April 23 and May 7) and this is the one that seems to worry most investors due to the potential for a Marine Le-Pen victory. However, we have always doubted that she would win and recent opinion polls have strengthened that conviction. Though she may win the first round of votes, it seems unlikely she will win the second round, no matter who she faces (see **Figure 30**). At present, it looks as though Emanuel Macron will become President but much could change over the coming weeks.

Figure 30 – French presidential opinion polls – percent vote for Marine Le-Pen in second round



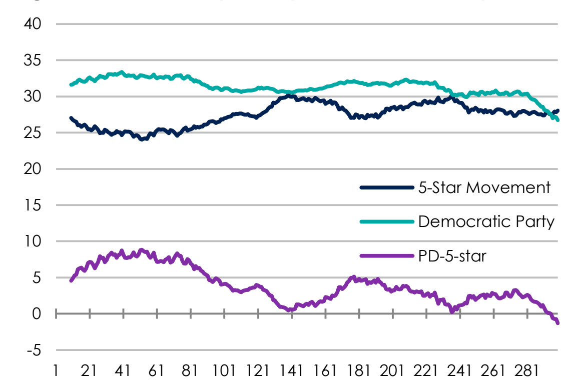
Note: Since December 2016. Source: Wikipedia and Source Research

German elections will take place on September 24. These are of less interest, in that there appears to be no risk of any outcome that could put into question Germany's membership of the EU. It also seems unlikely that there will be any meaningful change in the governing coalition – we suspect there will be a continuation of the grand coalition between the CDU/CSU and SPD, with perhaps the addition of the FDP which currently looks as though it will re-enter the Bundestag. What is at stake, however, is the leadership of the coalition. The SPD has enjoyed a notable surge in support since the appointment of Martin Schulz as leader. Indeed the CDU/CSU and the SPD are now closely tied in opinion polls, both with just above 30% of the vote. We suspect Angela Merkel will still be Chancellor after the elections but cannot be certain.

The real concern for us is the situation in Italy. We don't know when the next election will be, nor do we know the electoral system under which it will be fought (the current system is one that guarantees the winning party at least 54% of parliamentary seats but that is under review). What we do know is that opinion polls suggest the Five-Star Movement has a chance of winning (see **Figure 31**). We also know that they would be in favour of a referendum to leave the EU, that the ruling Democratic Party is in the process of splintering (between the moderate faction of Matteo Renzi and those more to the left) and that, if needed, Five-Star could perhaps join forces with Silvio Berlusconi's now EU-sceptic Forza Italia (which is currently polling at around 12%).

The departure of another large country from the EU would call the European project into question and, more importantly, the departure of Italy from the Eurozone could pose many dangers to financial markets (in our opinion). There are many steps before we get to that situation but we believe the path is more likely to be trodden in Italy than in any other large EU country.

Figure 32 – Italian opinion polls since January 2016



Source: Wikipedia and Source Research

Source Top Picks

Each quarter we publish a list of four Top Picks. We didn't include one in November with the 2017 Outlook, so must go back to what we published in September 2016. At that time we chose: USD cash, Eurozone equities, Japanese real estate and emerging market government debt (local currency version).

Those choices have enjoyed mediocre returns over the last six months (a period that included the surprise election of Donald Trump), with returns varying between -1.5% and +4.0% in USD. To put this into context, the best returns were on industrial metals (+22.4%) and US equities (+10.0%); the worst returns were on Europe-ex-UK real estate (-10.5%) and JPY cash (-9.7%).

Eurozone equity was the best performer among out Top Picks, with a return of 4.0% in USD (+8.3% in local currency). In truth, the Europe-ex-UK category that we monitor was one of the weaker equity markets over the period considered (the only market that produced a lower return was the UK).

Next in line was EM government debt, with a USD return of 1.5% (2.5% in local currency). Though this was a difficult period for emerging markets due to the election of Donald Trump, it turns out that EM was the best performing sovereign debt market. In fact, it was the only region to produce positive returns (in either local currency or in USD).

USD cash was included to dampen volatility, which tends to rise during the autumn (remember this list was published in September). With a return of 0.3% it certainly provided stability (compared to the negative returns on sovereign and IG debt). Also, from the perspective of an investor based in GBP or EUR, the return would have been above 5% and for those based in JPY it would have been above 8%. However, in the context of positive equity and commodity returns, it acted as a drag.

The worst performer among our selection was Japanese real estate, with a return of -1.5% (+6.6% in local currency). This was actually the best performing real estate market when measured in local currency terms and was only bettered by emerging markets when converted to USD. However, that is scant consolation.

Looking forward, we have used the return projections in **Appendix 4** to make our new selection (with two picks remaining unchanged and two new entries).

We are sticking with the best performers from last time (Eurozone equities and emerging market government debt). Eurozone equities start with a yield of 3.0%, which we expect to climb only marginally (to 3.1%) over the next five years (we expect the US yield to rise from 2.0% to 2.5%). This combined with annualised five year dividend growth of 6% should produce a total annualised return of 8% in local currency (or 10% in USD), according to our calculations. As outlined in the above section about politics, a clear threat would be an electoral shock in one of the larger economies. We doubt that the presidential elections in France will result in a Le-Pen presidency, to which extent markets will be relieved over the coming months. A bigger risk is represented by Italy, we think, but we do not yet know if an election will take place this year.

We are also persisting with emerging market sovereign debt, which has done surprisingly well despite the election of Trump and tightening by the Fed. Not only are yields attractive, we also believe that the fundamentals are better than in the developed world (demographics, growth and debt burdens). The obvious risk is a decline in commodity prices which could upset the currencies of commodity producing countries.

We continue to be committed to real estate as whole, though we understand the concern that it may underperform as rates rise. Within real estate, we are now switching our preference to emerging markets, where we foresee double digit annualised returns over the coming years (a stable 3.8% yield and annualised dividend growth of 5% over five years).

Finally, as a hedge against market sentiment turning sour, we are including Japanese yen cash. Gold is an obvious alternative but our model suggests gold is quite expensive at the moment, whereas we believe the yen is cheap (see **Figure 29**). Experience, suggests the Japanese currency is a good refuge in times of stress.

Hence, the Source Top Picks are:

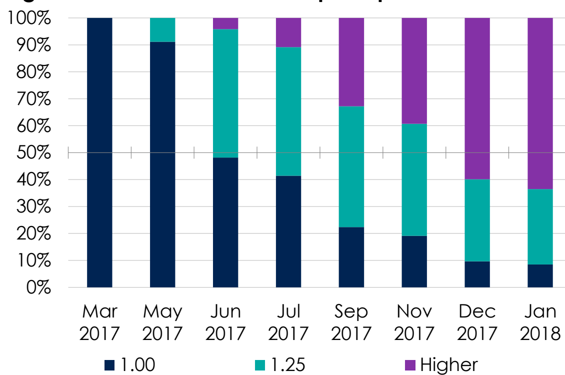
- Eurozone equities
- Emerging market real estate
- Emerging market government debt (local currency version)
- Japanese yen cash

Global Asset Classes

Cash (Overweight)

We keep the cash allocation at the maximum 10%, compared to the 5% neutral position. **Figure 35** shows weak expected returns (due to abnormally low central bank rates), with negative returns projected in the Eurozone and Japan in the next 12 months in local currency terms (we assume that current negative rates will continue). Nevertheless, we value the safety and diversification cash provides especially with a 5-year view.

Figure 33 – FED rate futures implied probabilities

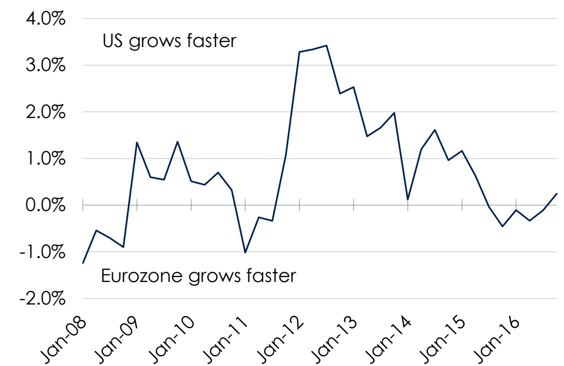


Note: Data as at 9th March 2017 close.
Source: Bloomberg and Source Research

Although there has been much enthusiasm about the Trump presidency so far, we have not noticed any impact on the real economy, yet. In fact, we fear there is a danger of growth losing momentum in the first half of the year. In our view, markets have run ahead of themselves pricing in three rate hikes this year (at the time of writing). Indeed, we expect two more 25 basis point hikes in the next 12 months. Although the labour market has remained strong, the pick-up in inflation may prove to be fleeting. We think that headline inflation has been impacted by rising oil prices, while core inflation has remained broadly stable.

The Eurozone economy has been improving in the background and annual GDP growth since the second quarter in 2015 has been close to that of the US (**Figure 34**). This followed the ECB's decision to extend their Asset Purchase Programme to the end of 2017. Still, markets took the slower planned pace of purchases after March as a sign of tapering. We think that the ECB's hand is forced partly by the lack of eligible securities and they have already done more than enough to support the economy.

Figure 34 – US versus Eurozone annual GDP growth



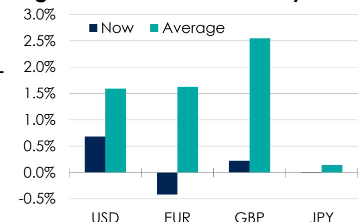
Notes: We show the spread between US minus Eurozone annual GDP growth in percentage points.
Source: Datastream and Source Research

Outside the Fed, and perhaps the PBOC, we do not expect any major central bank to tighten in the next 12 months. Japan and the Eurozone are still struggling to reach "exit velocity" and Brexit-related uncertainty will keep the Bank of England's stance loose, in our view, despite accelerating inflation. Headline rates are still relatively high in most major emerging markets and as inflation comes down, they will be able to loosen policy to support the economy in countries such as Brazil and Russia. Looking further out (5 years), we see rates rising closer to mid-cycle levels, but below pre-crisis norms.

Figure 35 – Projected returns (annualised)

	LIBOR Rates			Return		USD Return	
	Now	In 1y	In 5y	1y	5y	1y	5y
USD	0.7%	1.2%	1.9%	0.9%	1.4%	0.9%	1.4%
EUR	-0.4%	-0.4%	1.0%	-0.4%	0.1%	-1.1%	1.8%
GBP	0.2%	0.2%	2.0%	0.2%	0.9%	5.3%	3.4%
JPY	0.0%	-0.2%	0.5%	-0.1%	0.1%	4.3%	2.6%

Figure 36 – Rates vs. History*

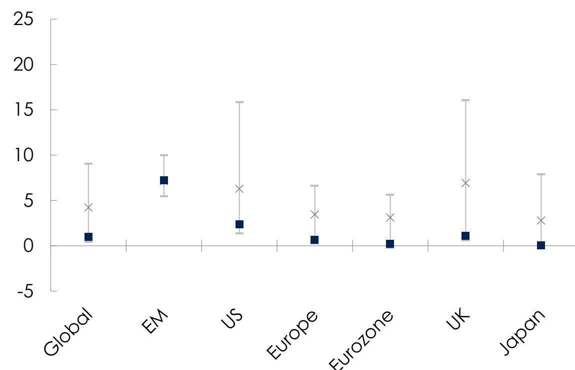


Source: Datastream and Source Research. See appendices for methodology and disclaimers. *The history starts in Jan 2001.

Government Bonds (Underweight)

We reduce our allocation to government bonds to 24% of the portfolio from 40% downgrading it to Underweight compared to the 30% Neutral position. As indicated in **Figure 39**, 5-year expected returns are negative in almost all developed markets as bond yields move higher (even in Japan). We remain Overweight in only two markets where starting yields will cushion against capital losses: the US and Emerging Markets.

Figure 37 – Government bond yield ranges



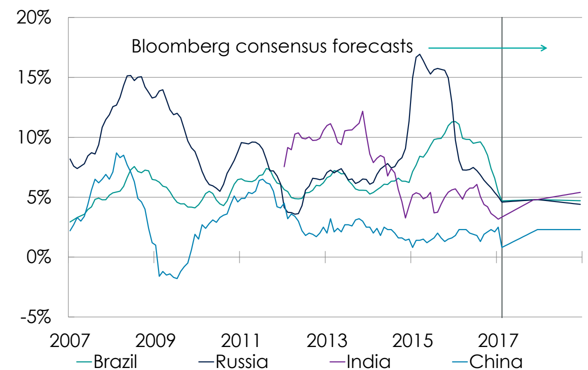
Source: Datastream and Source Research

Although political uncertainty will not abate this year, current yields do not justify maintaining an Overweight position, in our view. We worry that volatility may flare up around the French elections, especially if Marine Le-Pen gains in the polls, but we think other fixed income assets will provide better returns.

We suspect the US will be the best performing developed market, despite our assumption that the Fed will hike rates twice in the next 12 months. However, we reduce our Overweight allocation to Treasuries, and cut the Eurozone and Japan to Underweight. We expect plenty of volatility in the UK as Article 50 is triggered and prefer to move back to Neutral.

Emerging Markets look the best of the lot in sovereign debt with by far the highest starting yield (see **Figure 37**). Despite our expectation of renewed currency weakness in the short term, we expect attractive returns over the medium term. Moderate levels of inflation (see **Figure 38**) and improved sentiment should boost returns. Hence, EM remains our key Overweight among sovereigns.

Figure 38 – Annual inflation rates in selected emerging economies



Notes: Using consumer price inflation.

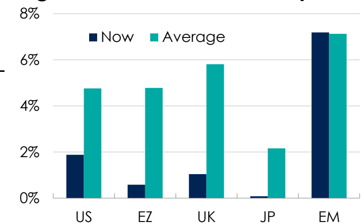
Source: Bloomberg, Datastream, Source Research

Despite expecting yields to rise from the current low levels, we maintain our historically low central bank rate expectations, as poor demographics, low economic growth and low inflation are likely to cap interest rate rises over the coming decades and central banks seem unlikely to disrupt that pattern (in our view). Nevertheless, improving economic data, a potential unwinding or reduction of QE and rising rates will be bearish for sovereign debt on a cyclical basis (we think).

Figure 39 – Projected returns (annualised)

	Redemption Yields			Return		USD Return	
	Now	In 1y	In 5y	1y	5y	1y	5y
US	1.9%	1.9%	2.9%	1.9%	0.9%	1.9%	0.9%
Eurozone	0.6%	0.5%	1.8%	1.2%	-0.6%	0.5%	1.1%
UK	1.0%	1.0%	2.7%	1.5%	-0.5%	6.5%	1.9%
Japan	0.1%	0.0%	1.0%	0.7%	-0.9%	5.2%	1.5%
EM	7.2%	6.8%	7.0%	9.5%	7.3%	-1.5%	7.3%

Figure 40 – Yields vs. History*

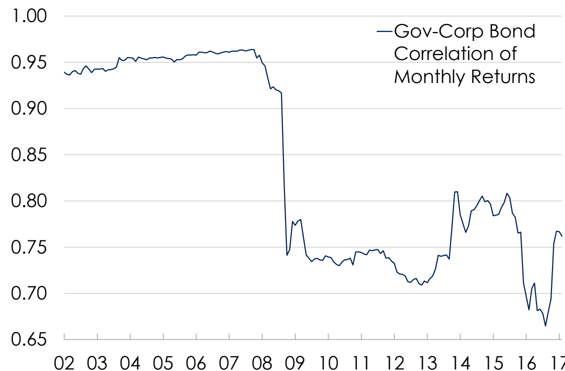


Source: BAML, Datastream and Source Research. See appendices for methodology and disclaimers. *Since 1978 for US, 1985 for Europe, 1989 for Japan and 2001 for EM.

Corporate Investment Grade Bonds (Overweight)

We increase our allocation to corporate investment grade credit to 20% (from 4%), the maximum allowed. We expect corporate investment grade returns to be higher than that on sovereign debt in both the next 12 months and five years. Their volatility is similar to government bonds, but their higher starting yields make them a more attractive proposition, in our view.

Figure 41 – 5y rolling correlations of total returns*



*Global indices. Source: BAML, Datastream, Source Research

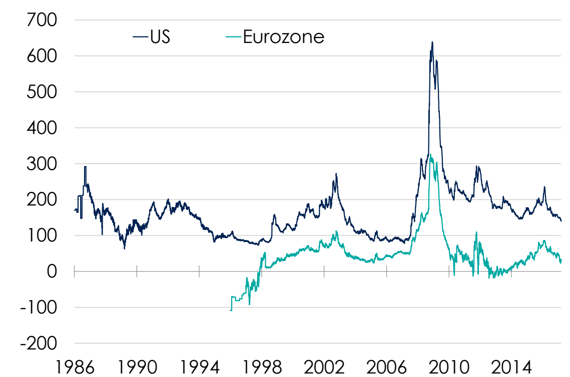
To be fair, if we focus on the next 12 months, it is really only in the US where we expect good returns (it is the only market where we predict that IG returns will be superior to those on sovereign debt).

Over that time frame we do not expect much movement in IG yields (even in the US where we assume the Fed will raise rates twice in that period). The Eurozone should continue to benefit from ECB buying, but this may have already been priced in.

We think that spreads will remain close to where they are, the UK being the market where we expect noticeable widening over the next year. The only region where they will tighten is Japan, in our view.

Looking more to the medium term, though yields are close to historical lows (within 25 and 16 basis points in the Eurozone and Japan, for example), spreads to government debt are in line with historical norms (see **Figure 42**). Hence, yields may rise but only in line with those of respective sovereign markets.

Figure 42 – Corporate bond spreads vs history



Source: BAML, Datastream, Source Research

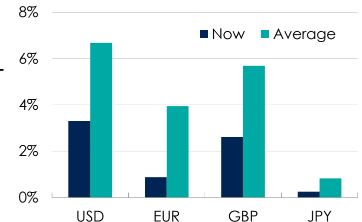
If there is little change in the spreads, the more generous yield on offer on IG credit will be a big advantage versus sovereign debt over the coming years (especially as the volatility profiles are similar (see **Figure 25**). Over a 5-year horizon, we believe the best returns will be available on US and UK debt (largely because the starting yields are higher).

Unfortunately, we project negative returns on Eurozone and Japanese IG debt, though we do expect a bit of help when those returns are converted into US dollars (due to slight dollar weakening).

Figure 43 – Projected returns (annualised)

	Redemption Yields			Return		USD Return	
	Now	In 1y	In 5y	1y	5y	1y	5y
US Dollar	3.3%	3.4%	4.6%	3.0%	2.5%	3.0%	2.5%
Euro	0.9%	1.0%	2.3%	0.3%	-0.1%	-0.4%	1.5%
Sterling	2.6%	3.0%	4.5%	0.8%	1.5%	5.9%	4.0%
Yen	0.2%	0.2%	1.1%	0.6%	-0.5%	5.1%	1.9%

Figure 44 – Yields vs. History*

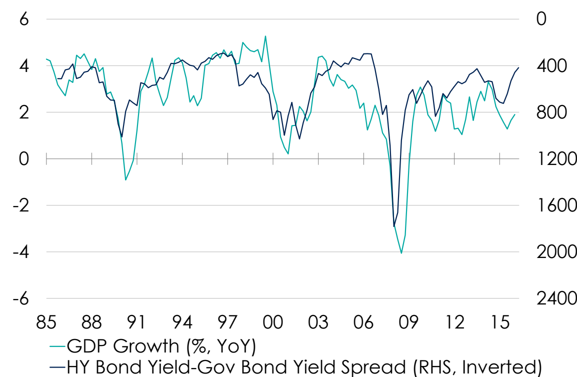


Source: BAML, Datastream and Source Research. See appendices for methodology and disclaimers. * Since 1973 in the US, 1996 in Europe and 2001 in Japan.

Corporate High Yield Bonds (Neutral)

We increase the allocation to corporate high-yield debt to 5% from the minimum 0%, upgrading it to Neutral. It has been the best performing fixed income asset in the last four months boosted by improved sentiment around the US economy. Yields are still high relative to other fixed income assets, but risks are clear, especially in the US energy sector.

Figure 45 – US GDP vs high-yield spreads

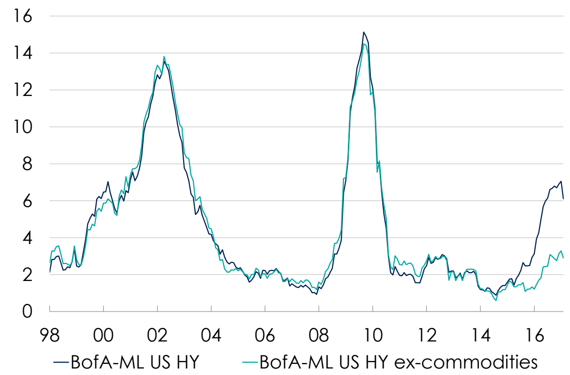


Source: BAML, Datastream, Source Research

As **Figure 45** shows, spreads have tightened of late as risk appetite has picked up after the US presidential election. They are now close to historical tights and we expect them to widen significantly in the next 12 months. Defaults in the oil & gas sector are still a threat, but we do not expect them to spread to the rest of the economy (see **Figure 46**). Therefore, we reduce our default rate projections to 5% for the next 12 months.

There is a stark contrast between projected returns for the US and the Eurozone over the next 12 months. We expect US yields to rise with treasuries as the Fed hikes and spreads to widen from current levels.

Figure 46 – US high yield default rates (%)



Source: BAML and Source Research

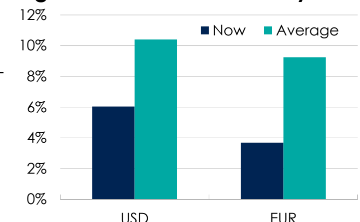
By contrast, we believe the ECB will keep rates at current levels and that should limit how much yields rise. We expect spreads to stay near current levels as economic growth picks up. Also, ECB purchases of corporate investment grade bonds might push yield hungry investors into the high-yield asset class. We think that Eurozone defaults will stay low compared to historical averages as the economy accelerates. Nevertheless, we expect slightly negative returns.

Over a five year time horizon, the US appears more attractive. Higher starting yields will offer a cushion against the capital losses that we project. We believe spreads will widen in the Eurozone and we expect yields there to double from current levels. Indeed, we suspect that Eurozone coupons will not protect against capital losses. Keeping duration short will help minimise those losses.

Figure 47 – Projected returns (annualised)

	Redemption Yields			Return		USD Return	
	Now	In 1y	In 5y	1y	5y	1y	5y
US Dollar	6.0%	7.6%	8.7%	-2.7%	3.0%	-2.7%	3.0%
Euro	3.7%	4.5%	7.9%	-0.5%	-0.4%	-1.3%	1.4%

Figure 48 – Yields vs. History*

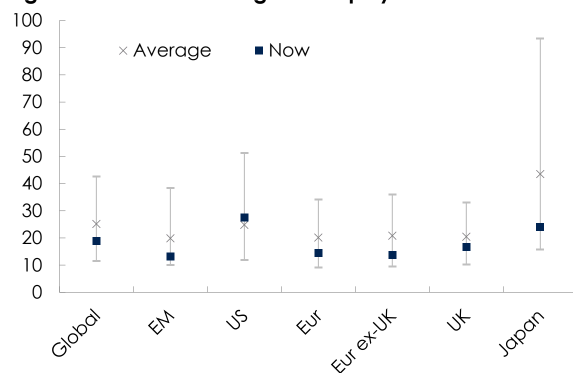


Source: BAML, Datastream and Source Research. See appendices for methodology and disclaimers. * Since 1986 in the US and 1997 in Europe.

Equities (Underweight)

We decrease the equity allocation to 35% (from 40%), maintaining our Underweight stance. The returns we expect do not necessarily compensate for their relatively high volatility and correlation to other asset classes (see **Figure 50**). We are reducing our positions in the US and Japan and raise them in Europe ex-UK and Emerging Markets. We think that decent global growth and central bank accommodation in the Eurozone and Japan will support equities in general, but we only want to focus on regions with the most attractive valuations.

Figure 49 – CAPEs for regional equity markets



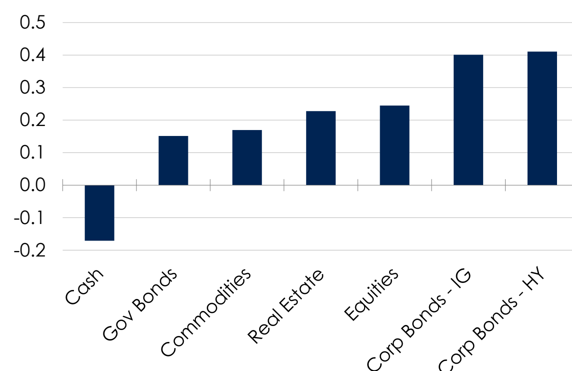
Source: Datastream and Source Research. Notes: CAPE = Cyclically Adjusted Price/Earnings and uses a 10-year moving average of earnings. From 1983 (except for EM from 2005).

Japan and the US have had a good run after the US presidential election, on the back of yen weakness and improved economic sentiment respectively. They also remain the most expensive markets on both cyclically-adjusted price/earnings (**Figure 49**) and dividend yield (**Figure 51**) and therefore we believe potential gains are limited from here.

We assume dividend growth of at least 5% in all regions in the next 12 months with the US higher at 7%. However, we expect a slight de-rating in all regions, which can limit the potential upside. Therefore, we expect global returns to be lower than both real estate and corporate investment grade bonds.

In our view, the best returns will be in Europe ex-UK and Emerging Markets both in the near- and medium-term. We expect their yields to stay near current, and relatively high, levels with only limited de-rating and decent dividend growth. The ECB is planning to supply stimulus until at least December 2017 and we expect many EM central banks to be able to loosen their policy stance, which should support equities in these regions.

Figure 50 – Average correlations across asset classes



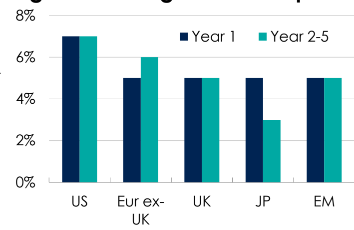
Notes: We calculate correlations using monthly local currency total return in the last five years for global asset classes. We take an average of all pairs across each asset class.
Source: BAML, MSCI, GSCI, FTSE, Datastream, Source Research

The UK stands in the middle, sandwiched between our key Overweights and our Underweights. It has done well recently in local currency terms, but most of that was driven by the weakness of sterling. We are optimistic on dividend growth and we also think the currency will strengthen in the next 12 months and 5 years. In our view, even though a de-rating will limit returns, they will still be better than on any other UK asset, especially with a 5-year horizon.

Figure 51 – Projected returns (annualised)

	Dividend Yields			Return		USD Return	
	Now	In 1y	In 5y	1y	5y	1y	5y
US	2.0%	2.2%	2.5%	-0.7%	4.7%	-0.7%	4.7%
Eur ex-UK	3.0%	3.1%	3.1%	4.7%	8.3%	4.0%	10.2%
UK	3.4%	3.6%	3.8%	2.7%	6.5%	7.8%	9.1%
Japan	1.9%	2.0%	2.0%	1.7%	4.4%	6.2%	6.9%
EM	2.9%	3.0%	3.0%	4.5%	7.4%	-5.9%	7.4%

Figure 52 – Div growth assumptions

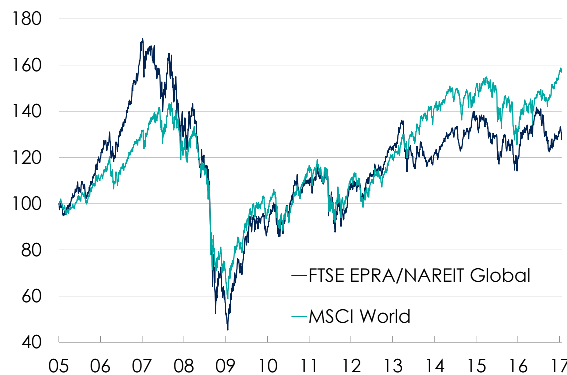


Source: Datastream and Source Research. See appendices for methodology and disclaimers.

Real Estate (Overweight)

We maintain the maximum Overweight allocation to real estate at 6%. We assume decent rental growth in all markets for the next year, but think that that will slow down later. Limited de-rating in most regions ensures that real estate will be the best performing asset class both in the near- and medium-term, in our view.

Figure 53 – Global REITs vs equities (Feb-05=100)

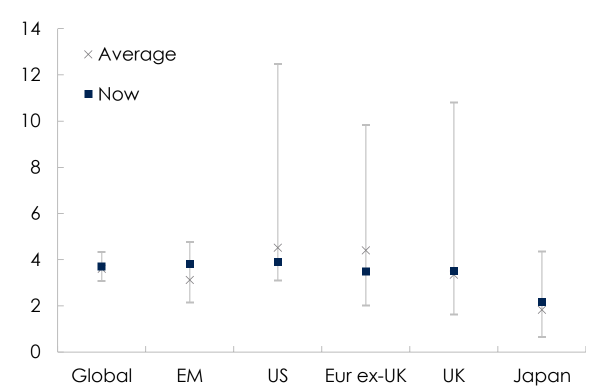


Source: FTSE, MSCI, Datastream, Source Research

Although we do not change our allocation to the asset class as a whole, we do rejig our regional positions. We increase our allocation to the US, upgrading it to Overweight. We also raise our allocation to emerging markets to the maximum allowed. Our positive stance is supported by valuations: the US is the cheapest compared to other regions (see **Figure 54**), closely followed by emerging markets. In our view, emerging markets will be the only region that will not experience any de-rating, while it will be limited in the US. We also expect cyclical tailwinds to support the asset class in these markets.

We think sentiment in Japan might have reached its limits as the BOJ's purchases of J-REITs pushed yields lower. Although valuations are still more attractive than historical norms, we think a further re-rating would require either significantly stronger economic growth, or a radical change in corporate attitudes to payout ratios. In our view, decent dividend growth will not be able to balance out the impact of a significant de-rating. Therefore we reduce our allocation all the way to 0%.

Figure 54– Historical REIT dividend yield ranges



Source: FTSE, Datastream and Source Research. Note: data since 2001, except for EM (2008) and Global (2010).

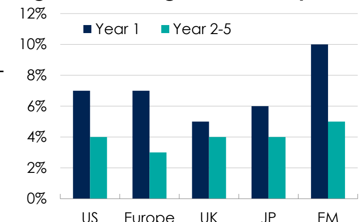
We maintain our zero weight in the UK as Brexit risk and the extended nature of the London property market make us cautious. We also assume dividend growth will be lower than elsewhere for the next 12 months, which coupled with de-rating, will make it the worst performing market. Although we expect 5-year returns to be better than in Europe ex-UK and Japan, near term risks worry us.

We keep our maximum Overweight exposure to Europe ex-UK, where strong dividend growth and no change in yield will result in double-digit returns in the next year, in our view. Accelerating economic growth and low rates will also support the asset class in the region.

Figure 55 – Projected returns (annualised)

	Dividend Yields			Return		USD Return	
	Now	In 1y	In 5y	1y	5y	1y	5y
US	3.9%	4.0%	4.0%	8.4%	8.2%	8.4%	8.2%
Eur ex-UK	3.5%	3.5%	4.0%	10.7%	4.8%	9.9%	6.6%
UK	3.5%	3.7%	4.0%	2.9%	5.3%	8.1%	8.0%
Japan	2.2%	2.3%	2.5%	3.7%	4.2%	8.3%	6.7%
EM	3.8%	3.8%	3.8%	14.1%	10.0%	2.7%	10.0%

Figure 56 – Div growth assumptions

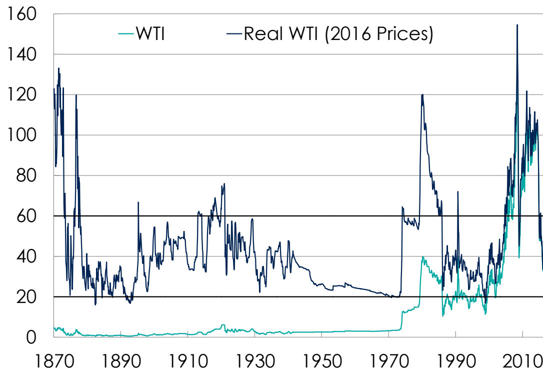


Source: FTSE, Datastream and Source Research. See appendices for methodology and disclaimers.

Commodities (Underweight)

We maintain our 0% allocation to commodities, versus a neutral position of 2%. We expect further weakness in almost all of the main commodity groups in the next five years. Due to the lack of comparable valuation measures for commodities, we base our views on real prices (US CPI-adjusted) relative to their long-run averages (see **Figure 21**).

Figure 57 – Real US oil prices (US CPI adjusted)

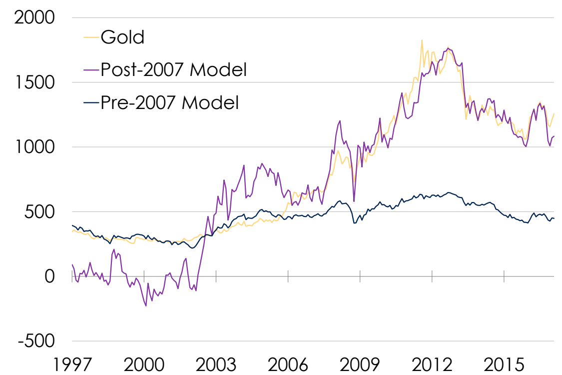


Source: Global Financial Data, Datastream, Source Research

Our chosen benchmark means that we have to pay the most attention to oil. We think that global imbalances in that market have not been resolved, yet, and we expect the rebound in prices to be short-lived. Indeed, the rally since the OPEC production cut announcement seems to be fading. In fact, any rally in oil could be self-defeating; the higher the price, the more suppliers return to the market, thereby depressing prices. OPEC has cut production as agreed, but a surge in US inventories suggest shale producers have seen it as an opportunity to restart extraction. **Figure 57** implies that the super-cycle is still deflating and prices tend to stay low for a long time.

The only commodity groups that have stayed close to recent highs are industrial and precious metals (including gold). This is despite fairly constructive economic data coming out of both the US and Eurozone and little sign of a "Brexit slump" in the UK. Real prices remain stubbornly high compared to historical norms, and our simple model also suggests that they should be lower based on real yields, inflation expectations and the US dollar index (see **Figure 58**). We think this might be because investors are more cautious about the Trump presidency and the "reflation trade" than the performance of other risk assets suggests.

Figure 58 – Modelling the price of gold (US$/ounce)



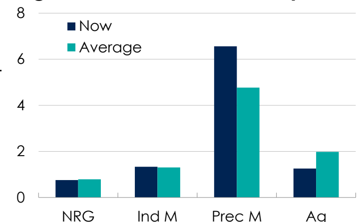
Notes: The price of gold is modelled as a function of: US 10 year real yields, US 10 year breakeven inflation and the trade weighted index of the USD. The "pre-2007" model is constructed using monthly data from 1997 to end-2006 and has an R^2 of 0.67. The "post-2007" model uses monthly data from start-2007 to July-2016 and has an R^2 of 0.90.
Source: Bank of England, Datastream, Source Research

On a 5-year view, we expect only agricultural goods to provide positive returns, and that will push commodity index returns above those of government bonds, in our view. However, the rest of the commodity space looks unattractive to us even in the long term and the volatility of the asset class is an added risk. At this point, we see no reason to hold commodities.

Figure 59 – Projected returns (annualised)

	Yields			Return		USD Return	
	Now	In 1y	In 5y	1y	5y	1y	5y
Energy	-	-	-	-44.4%	-5.8%	-44.4%	-5.8%
Ind Metals	-	-	-	-33.0%	-3.5%	-33.0%	-3.5%
Prec Metals	-	-	-	-12.5%	-6.5%	-12.5%	-6.5%
Agriculture	-	-	-	10.0%	20.0%	10.0%	20.0%

Figure 60 – Rates vs. History*



Source: Datastream and Source Research. See appendices for methodology and disclaimers. *Since 1969 for Agriculture, 1973 for Precious Metals, 1977 for Ind. Metals and 1982 for Energy.

Appendices

Appendix 1: Consensus economic forecasts

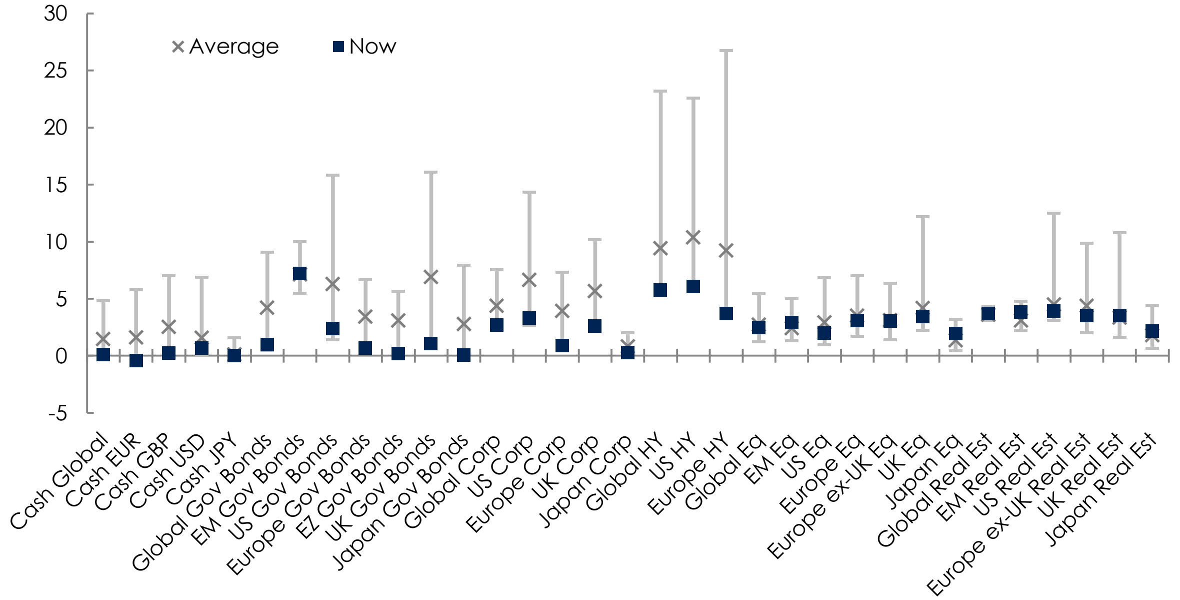
Figure 61 – Consensus economic forecasts

GDP Growth (%)				
	2015	**2016**	**2017**	**2018**
World	3.5	3.8	3.2	3.4
US	2.6	1.6	2.3	2.3
Eurozone	2.0	1.7	1.5	1.5
China	6.9	6.7	6.5	6.2
Japan	1.2	1.0	1.1	0.9
UK	2.2	1.8	1.5	1.3
Brazil	-3.8	-3.5	0.8	2.2
Russia	-2.8	-0.2	1.1	1.5
India	7.2	7.1	6.7	7.2
Canada	0.9	1.3	1.9	2.0
Australia	2.3	2.5	2.5	2.7
CPI Change (%)				
	2015	**2016**	**2017**	**2018**
World	3.2	3.3	3.2	3.1
US	0.1	1.3	2.4	2.4
Eurozone	0.0	0.2	1.5	1.5
China	1.4	2.0	2.3	2.3
Japan	0.8	-0.1	0.6	0.9
UK	0.0	0.7	2.5	2.5
Brazil	9.0	8.8	4.8	4.7
Russia	15.6	7.1	4.8	4.4
India	5.9	5.0	4.8	5.4
Canada	1.1	1.4	1.8	2.0
Australia	1.5	1.3	2.1	2.2
Nominal GDP (%)				
	2015	**2016**	**2017**	**2018**
World	6.8	7.2	6.5	6.6
US	2.7	2.9	4.8	4.8
Eurozone	2.0	1.9	3.0	3.0
China	8.4	8.8	8.9	8.6
Japan	2.0	0.9	1.7	1.8
UK	2.2	2.5	4.0	3.8
Brazil	4.9	5.0	5.6	7.0
Russia	12.4	6.9	6.0	6.0
India	13.5	12.4	11.8	13.0
Canada	2.0	2.7	3.7	4.0
Australia	3.8	3.8	4.7	5.0

Source: Bloomberg, except for India (provided by Oxford Economics)

Appendix 2: Global valuations vs history

Figure 62 – Regional yields within historical ranges



Source: BAML, FTSE, Datastream, Source Research

Appendix 3: Asset class total returns

Figure 63 – Total returns

Data as at 28/02/2017		Current	Total Return (USD, %)				Total Return (Local Currency, %)			
	Index	Level/RY	4m	YTD	12m	5y*	4m	YTD	12m	5y*
Equities										
World	MSCI	445	8.9	5.7	22.8	8.8	9.6	4.6	22.9	11.5
Emerging Markets	MSCI	936	4.0	8.7	29.9	0.0	3.7	5.7	22.7	4.7
US	MSCI	2251	12.0	6.1	25.3	13.9	12.0	6.1	25.3	13.9
Europe	MSCI	1515	6.4	3.3	12.8	5.3	7.7	2.4	18.4	10.1
Europe ex-UK	MSCI	1753	5.8	3.3	13.6	6.4	8.4	2.4	15.9	11.1
UK	MSCI	1096	8.0	3.3	10.9	2.9	5.9	2.6	24.2	8.2
Japan	MSCI	2958	3.4	4.9	20.7	7.5	10.1	0.6	19.6	14.6
Government Bonds										
World	BofA-ML	0.97	-4.0	1.6	-1.3	-0.5	-1.6	0.1	-0.3	3.1
Emerging Markets	JPM	7.19	-0.3	5.1	15.7	-2.5	1.5	2.4	10.3	7.2
US (10y)	Datastream	2.36	-3.5	0.8	-3.2	2.0	-3.5	0.8	-3.2	2.0
Europe	Bofa-ML	0.67	-3.1	0.3	-3.2	0.3	0.0	-0.5	-1.1	5.1
Europe ex-UK (EMU, 10y)	Datastream	0.21	-2.5	1.5	-1.4	0.6	0.6	0.8	0.8	5.4
UK (10y)	Datastream	1.07	3.9	2.4	-6.2	-0.3	2.0	1.7	5.0	4.8
Japan (10y)	Datastream	0.05	-6.9	4.2	0.2	-3.5	-0.9	-0.1	-0.6	2.9
IG Corporate Bonds										
Global	BofA-ML	2.66	-0.9	1.7	5.0	2.3	-0.2	1.3	6.0	4.3
US	BofA-ML	3.31	-0.6	1.5	6.4	3.9	-0.6	1.5	6.4	3.9
Europe	BofA-ML	0.88	-2.9	1.3	2.0	0.0	0.1	0.6	4.3	4.7
UK	BofA-ML	2.62	5.0	2.8	0.7	2.7	3.0	2.1	12.7	8.0
Japan	BofA-ML	0.25	-6.2	4.3	1.0	-5.2	-0.1	0.1	0.1	1.1
HY Corporate Bonds										
Global	BofA-ML	5.75	3.7	3.1	19.8	6.3	4.2	2.9	20.6	7.4
US	BofA-ML	6.04	4.5	2.9	22.3	6.9	4.5	2.9	22.3	6.9
Europe	BofA-ML	3.69	-0.5	2.5	10.7	3.4	2.6	1.7	13.2	8.2
Cash (Overnight LIBOR)										
US		0.68	0.1	0.1	0.5	0.2	0.1	0.1	0.5	0.2
Euro Area		-0.42	0.5	0.5	-3.6	-4.8	-0.1	-0.1	-0.4	-0.1
UK		0.23	0.4	0.4	-10.4	-4.5	0.0	0.0	0.3	0.5
Japan		-0.01	3.6	3.6	1.0	-6.5	0.0	0.0	0.0	0.0
Real Estate (REITs)										
Global	FTSE	1775	4.0	4.4	14.2	8.0	7.3	3.7	16.8	13.1
Emerging Markets	FTSE	1819	3.4	11.2	24.2	2.1	6.6	10.4	27.0	6.9
US	FTSE	3012	5.7	3.0	15.4	11.3	5.7	3.0	15.4	11.3
Europe ex-UK	FTSE	2925	-1.1	1.5	7.1	9.3	2.0	0.8	9.5	14.5
UK	FTSE	1018	9.7	2.5	-5.7	8.2	7.7	1.8	5.6	13.8
Japan	FTSE	2581	-1.4	1.5	2.3	6.7	5.0	-2.6	1.4	13.9
Commodities										
All	GSCI	2389	6.1	-1.2	18.4	-14.7	-	-	-	-
Energy	GSCI	413	7.1	-4.9	29.5	-19.1	-	-	-	-
Industrial Metals	GSCI	1238	15.2	10.3	27.4	-6.4	-	-	-	-
Precious Metals	GSCI	1541	-1.3	9.4	2.7	-7.4	-	-	-	-
Agricultural Goods	GSCI	445	-2.4	3.2	3.2	-9.0	-	-	-	-
Currencies (vs USD)**										
EUR		1.06	-3.7	0.6	-2.7	-4.5	-	-	-	-
JPY		112.78	-7.1	3.6	-0.1	-6.4	-	-	-	-
GBP		1.24	1.9	0.7	-10.7	-4.9	-	-	-	-
CHF		0.99	-1.7	1.2	-0.7	-2.1	-	-	-	-
CNY		6.87	-1.3	1.1	-4.6	-1.7	-	-	-	-

Notes: *annualised; **The currency section is organised so that in all cases the numbers show the movement in the mentioned currency versus USD (+ve indicates appreciation, -ve indicates depreciation)
Source: MSCI, Datastream, Source Research

Appendix 4: Expected returns

Figure 64 – Expected returns

	Historical				Projected							
	Total Return (USD)		Yield		Yield		Capital Return		Total Return		Total Return (USD)	
	10y	Overall	Now	Average	1y	5y	1y	5y	1y	5y	1y	5y
Cash	**-1.8%**	**1.8%**	**0.1%**	**1.5%**	**0.2%**	**1.4%**	**0.0%**	**0.0%**	**0.2%**	**0.7%**	**2.3%**	**2.3%**
USD	0.9%	1.7%	0.7%	1.6%	1.2%	1.9%	0.0%	0.0%	0.9%	1.4%	0.9%	1.4%
EUR	-1.5%	2.5%	-0.4%	1.6%	-0.4%	1.0%	0.0%	0.0%	-0.4%	0.1%	-1.1%	1.8%
GBP	-3.5%	1.5%	0.2%	2.5%	0.2%	2.0%	0.0%	0.0%	0.2%	0.9%	5.3%	3.4%
JPY	0.7%	0.2%	0.0%	0.1%	-0.2%	0.5%	0.0%	0.0%	-0.1%	0.1%	4.3%	2.6%
Gov. bonds	**3.3%**	**6.7%**	**1.0%**	**4.2%**	**0.9%**	**2.0%**	**0.5%**	**-1.4%**	**1.4%**	**-0.1%**	**2.7%**	**1.4%**
US	4.0%	7.3%	1.9%	4.8%	1.9%	2.9%	0.0%	-1.3%	1.9%	0.9%	1.9%	0.9%
Eurozone	2.6%	7.4%	0.6%	4.8%	0.5%	1.8%	0.7%	-1.6%	1.2%	-0.6%	0.5%	1.1%
UK	1.7%	7.8%	1.0%	5.8%	1.0%	2.7%	0.4%	-2.2%	1.5%	-0.5%	6.5%	1.9%
Japan	3.0%	5.9%	0.1%	2.2%	0.0%	1.0%	0.7%	-1.3%	0.7%	-0.9%	5.2%	1.5%
EM	8.4%	9.0%	7.2%	7.1%	6.8%	7.0%	2.1%	0.2%	9.5%	7.3%	-1.5%	7.3%
Corp bonds	**4.1%**	**5.3%**	**2.7%**	**4.4%**	**2.8%**	**4.0%**	**-0.6%**	**-1.4%**	**2.2%**	**1.8%**	**2.5%**	**2.4%**
US Dollar	5.4%	7.8%	3.3%	6.7%	3.4%	4.6%	-0.4%	-1.3%	3.0%	2.5%	3.0%	2.5%
Euro	2.2%	4.0%	0.9%	3.9%	1.0%	2.3%	-0.6%	-1.6%	0.3%	-0.1%	-0.4%	1.5%
Sterling	1.7%	5.7%	2.6%	5.7%	3.0%	4.5%	-1.9%	-2.0%	0.8%	1.5%	5.9%	4.0%
Japanese Yen	1.9%	1.7%	0.2%	0.8%	0.2%	1.1%	0.4%	-1.0%	0.6%	-0.5%	5.1%	1.9%
High-yield	**7.2%**	**6.8%**	**5.8%**	**9.5%**	**7.2%**	**8.8%**	**-5.7%**	**-2.4%**	**-1.9%**	**2.5%**	**-2.4%**	**2.6%**
US Dollar	7.4%	8.5%	6.0%	10.4%	7.6%	8.7%	-6.4%	-2.1%	-2.7%	3.0%	-2.7%	3.0%
Euro	5.1%	5.7%	3.7%	9.2%	4.5%	7.9%	-3.5%	-3.5%	-0.5%	-0.4%	-1.3%	1.4%
Equities	**4.9%**	**9.5%**	**2.5%**	**2.8%**	**2.7%**	**2.9%**	**-0.5%**	**3.3%**	**2.0%**	**6.2%**	**1.5%**	**6.2%**
US	7.7%	10.1%	2.0%	2.9%	2.2%	2.5%	-2.7%	2.3%	-0.7%	4.7%	-0.7%	4.7%
Europe ex-UK	1.5%	9.9%	3.0%	3.1%	3.1%	3.1%	1.6%	5.1%	4.7%	8.3%	4.0%	10.2%
UK	0.7%	9.6%	3.4%	4.1%	3.6%	3.8%	-0.8%	2.7%	2.7%	6.5%	7.8%	9.1%
Japan	0.7%	9.2%	1.9%	1.4%	2.0%	2.0%	-0.2%	2.3%	1.7%	4.4%	6.2%	6.9%
EM	3.2%	10.8%	2.9%	2.4%	3.0%	3.0%	1.5%	4.3%	4.5%	7.4%	-5.9%	7.4%
Real Estate	**1.8%**	**6.4%**	**3.7%**	**3.6%**	**3.8%**	**3.9%**	**4.8%**	**3.6%**	**8.7%**	**7.6%**	**7.9%**	**8.1%**
US	4.3%	13.0%	3.9%	4.5%	4.0%	4.0%	4.3%	4.1%	8.4%	8.2%	8.4%	8.2%
Europe ex-UK	0.7%	6.4%	3.5%	4.4%	3.5%	4.0%	7.0%	1.1%	10.7%	4.8%	9.9%	6.6%
UK	-6.1%	4.0%	3.5%	3.3%	3.7%	4.0%	-0.7%	1.5%	2.9%	5.3%	8.1%	8.0%
Japan	-1.0%	1.1%	2.2%	1.8%	2.3%	2.5%	1.4%	1.8%	3.7%	4.2%	8.3%	6.7%
EM*	11.0%	11.0%	3.8%	3.1%	3.8%	3.8%	10.0%	6.0%	14.1%	10.0%	2.7%	10.0%
Commodities	**-8.4%**	**7.0%**	**-**	**-**	**-**	**-**	**-28.9%**	**0.7%**	**-28.9%**	**0.7%**	**-28.9%**	**0.7%**
Energy	-11.0%	4.2%	-	-	-	-	-44.4%	-5.8%	-44.4%	-5.8%	-44.4%	-5.8%
Ind. Metals	-4.6%	6.5%	-	-	-	-	-33.0%	-3.5%	-33.0%	-3.5%	-33.0%	-3.5%
Prec. Metals	5.1%	6.4%	-	-	-	-	-12.5%	-6.5%	-12.5%	-6.5%	-12.5%	-6.5%
Agriculture	-3.8%	3.2%	-	-	-	-	10.0%	20.0%	10.0%	20.0%	10.0%	20.0%

Source: BAML, MSCI, FTSE, GSCI, Datastream, Source Research
Notes: *Less than 10y history for Emerging Market Real Estate. See Methodology in Appendix 4 and disclaimers.

Appendix 5: Key assumptions

Figure 65 – Key assumptions for 1-year projected returns

	US	Eurozone/ Europe ex-UK	UK	Japan	EM	China
Central bank rates (%)	1.25	-0.40	0.25	-0.20	-	4.50
Sovereign spreads vs rates (bps)	70	90	75	15	-	-
Corporate IG spreads vs sovereign (bps)	150	50	200	20	-	-
Corporate HY spreads vs sovereign (bps)	575	400	-	-	-	-
Corporate HY default rates (%)	5.0	2.0	-	-	-	-
Corporate HY recovery rates (%)	43	50	-	-	-	-
Equities dividend growth (%)*	7.0	5.0	5.0	5.0	5.0	0.0
Equities dividend yield (%)*	2.2	3.1	3.6	2	3.0	4
Real estate dividend growth (%)*	7.0	7.0	5.0	6.0	10.0	-
Real estate dividend yield (%)*	4	3.5	3.7	2.3	3.8	-

Source: Source Research. Notes: *assumptions for Europe ex-UK

Figure 66 – Key assumptions for 5-year projected returns

	US	Eurozone/ Europe ex-UK	UK	Japan	EM	China
Central bank rates (%)	2.00	1.00	2.00	0.50	-	4.50
Sovereign spreads vs rates (bps)	100	80	75	50	-	-
Corporate IG spreads vs sovereign (bps)	165	50	180	10	-	-
Corporate HY spreads vs sovereign (bps)	575	610	-	-	-	-
Corporate HY default rates (%)	5.0	5.0	-	-	-	-
Corporate HY recovery rates (%)	43	50	-	-	-	-
Equities dividend growth (%)*	7.0	6.0	5.0	3.0	5.0	6.0
Equities dividend yield (%)*	2.5	3.1	3.8	2.0	3.0	3.5
Real estate dividend growth (%)*	4.0	3.0	4.0	4.0	5.0	-
Real estate dividend yield (%)*	4.0	4.0	4.0	2.5	3.8	-

Source: Source Research. Notes: *assumptions for Europe ex-UK

Appendix 6: Optimised allocations for global assets for different currency bases

Figure 67 – Optimised allocations for global assets in USD

	Neutral Portfolio	Policy Range	Using 1y Return Sharpe Ratio	Using 1y Return Max Return	Using 5y Return Sharpe Ratio	Using 5y Return Max Return		Source Multi-Asset Portfolio
Cash & Gold	5%	0-10%	10%	0%	10%	10%		10%
Cash	2.5%	0-10%	10%	0%	10%	10%		10%
Gold	2.5%	0-10%	0%	0%	0%	0%		0%
Government Bonds	30%	10-50%	50%	50%	33%	18%	↓	24%
Corporate IG	10%	0-20%	14%	20%	20%	20%	↑	20%
Corporate HY	5%	0-10%	0%	0%	0%	0%	↑	5%
Equities	45%	20-70%	20%	24%	31%	46%	↓	35%
Real Estate	3%	0-6%	6%	6%	6%	6%		6%
Commodities	2%	0-4%	0%	0%	0%	0%		0%

Based on local returns (for both the projected returns and historical covariance matrix). Cash is an equally weighted mix of USD, EUR, GBP and JPY. "Sharpe Ratio" shows the results of maximising the Sharpe Ratio. "Max Return" maximises returns while not exceeding the volatility of the Neutral Portfolio. This is a simulated portfolio. See appendices for methodology and disclaimers. Source: Source Research

Figure 68 – Optimised allocations for global assets in GBP

	Neutral Portfolio	Policy Range	Using 1y Return Sharpe Ratio	Using 1y Return Max Return	Using 5y Return Sharpe Ratio	Using 5y Return Max Return		Source Multi-Asset Portfolio
Cash & Gold	5%	0-10%	10%	10%	10%	10%		10%
Cash	2.5%	0-10%	10%	10%	10%	10%		10%
Gold	2.5%	0-10%	0%	0%	0%	0%		0%
Government Bonds	30%	10-50%	10%	50%	10%	10%	↓	24%
Corporate IG	10%	0-20%	4%	14%	0%	11%	↑	20%
Corporate HY	5%	0-10%	0%	0%	10%	10%	↑	5%
Equities	45%	20-70%	70%	20%	64%	53%	↓	35%
Real Estate	3%	0-6%	6%	6%	6%	6%		6%
Commodities	2%	0-4%	0%	0%	0%	0%		0%

Based on local returns (for both the projected returns and historical covariance matrix). Cash is an equally weighted mix of USD, EUR, GBP and JPY. "Sharpe Ratio" shows the results of maximising the Sharpe Ratio. "Max Return" maximises returns while not exceeding the volatility of the Neutral Portfolio. This is a simulated portfolio. See appendices for methodology and disclaimers. Source: Source Research

Figure 69 – Optimised allocations for global assets in CHF

			Using 1y Return		Using 5y Return			
	Neutral Portfolio	**Policy Range**	**Sharpe Ratio**	**Max Return**	**Sharpe Ratio**	**Max Return**		**Source Multi-Asset Portfolio**
Cash & Gold	5%	0-10%	4%	0%	10%	0%		10%
Cash	2.5%	0-10%	4%	0%	10%	0%		10%
Gold	2.5%	0-10%	0%	0%	0%	0%		0%
Government Bonds	30%	10-50%	50%	50%	25%	23%	↓	24%
Corporate IG	10%	0-20%	20%	20%	20%	20%	↑	20%
Corporate HY	5%	0-10%	0%	0%	10%	10%	↑	5%
Equities	45%	20-70%	20%	24%	29%	41%	↓	35%
Real Estate	3%	0-6%	6%	6%	6%	6%		6%
Commodities	2%	0-4%	0%	0%	0%	0%		0%

Based on local returns (for both the projected returns and historical covariance matrix). Cash is an equally weighted mix of USD, EUR, GBP and JPY. "Sharpe Ratio" shows the results of maximising the Sharpe Ratio. "Max Return" maximises returns while not exceeding the volatility of the Neutral Portfolio. This is a simulated portfolio. See appendices for methodology and disclaimers. Source: Source Research

Figure 70 – Optimised allocations for global assets in EUR

			Using 1y Return		Using 5y Return			
	Neutral Portfolio	**Policy Range**	**Sharpe Ratio**	**Max Return**	**Sharpe Ratio**	**Max Return**		**Source Multi-Asset Portfolio**
Cash & Gold	5%	0-10%	4%	0%	10%	10%		10%
Cash	2.5%	0-10%	4%	0%	10%	10%		10%
Gold	2.5%	0-10%	0%	0%	0%	0%		0%
Government Bonds	30%	10-50%	50%	50%	10%	11%	↓	24%
Corporate IG	10%	0-20%	20%	20%	0%	20%	↑	20%
Corporate HY	5%	0-10%	0%	0%	10%	10%	↑	5%
Equities	45%	20-70%	20%	24%	64%	43%	↓	35%
Real Estate	3%	0-6%	6%	6%	6%	6%		6%
Commodities	2%	0-4%	0%	0%	0%	0%		0%

Based on local returns (for both the projected returns and historical covariance matrix). Cash is an equally weighted mix of USD, EUR, GBP and JPY. "Sharpe Ratio" shows the results of maximising the Sharpe Ratio. "Max Return" maximises returns while not exceeding the volatility of the Neutral Portfolio. This is a simulated portfolio. See appendices for methodology and disclaimers. Source: Source Research

Appendix 7: Source Multi-Asset Portfolio methodology

Portfolio construction process

The Source Multi-Asset Portfolio is a simulated and not a real portfolio. We use optimisation processes to guide our allocations around "neutral" and within prescribed policy ranges based on our estimations of expected returns and using historical covariance information. This guides the allocation to global asset groups (equities, government bonds etc.), which is the most important level of decisions. We then allocate across regions within each asset group. Currency hedging can be used. We use long term inputs but the portfolio is constructed with a 12-month time horizon. We intend to update the portfolio and publish on a quarterly basis.

Which asset classes?

We look for investability, size and liquidity. With that in mind, we have chosen to include: equities, bonds (government, corporate investment grade and corporate high-yield), REITs to represent real estate, commodities, cash and gold (all across a range of geographies). We use cross-asset correlations to determine which decisions are the most important.

Neutral allocations and policy ranges

We use market capitalisation in USD for major benchmark indices to calculate neutral allocations. For commodities, we use industry estimates for total ETP market cap + assets under management in hedge funds + direct investments. We use an arbitrary 5% for cash and gold together as their use as investment instruments is limited. We impose diversification by using policy ranges for each asset category (the range is usually symmetric around neutral).

Expected returns

The process for estimating expected returns is based upon yield (except commodities, of course). After analysing how yields vary with the economic cycle, and where they are situated within historical ranges, we forecast the direction and amplitude of moves over the next one and five years. Cash returns are calculated assuming a straight-line move in short term rates towards our targets (with, of course, no capital gain or loss). Bond returns assume a straight-line progression in yields, with capital gains/losses predicated upon constant maturity (effectively supposing constant turnover to achieve that). Forecasts of corporate and high yield spreads are based upon our view of the economic cycle. Coupon payments are added to give total returns. Equity and REIT returns are based on dividend growth assumptions, using probability-weighted historical rates and adjusting them as appropriate. We calculate total returns by applying those growth assumptions and adding the forecast dividend yield. No such metrics exist for commodities; therefore we base our projections on US CPI-adjusted real prices relative to their long-term averages and views on the economic cycle.

Optimising the portfolio

Using a covariance matrix based on monthly local currency total returns for the last 5 years, we run two optimisation processes: maximising the Sharpe Ratio and maximising returns with volatility no greater than that of the neutral portfolio. We repeat this process for both 1-year and 5-year expected returns and adjust the suggested allocation to diversify further if necessary. The optimiser is based on the Markowitz model.

Currency hedging

We adopt a cautious approach when it comes to currency hedging as currency movements are notoriously difficult to accurately predict and sometimes hedging can be costly. Also, some of our asset allocation choices are based on currency forecasts. We use an amalgam of central bank rate forecasts, policy expectations and real exchange rates relative to their historical averages to predict the direction and amplitude of currency moves

Important information

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