



# Investment Clock – Strategy Update

Issue #26, June 2022

## Multi asset views from RLAM

Royal London Asset Management manages £159.4 billion in life insurance, pensions and third-party funds\*. The multi asset team manages the Governed Range pension portfolios as well as the Global Multi Asset Portfolios (GMAPs) and Multi Asset Strategies Fund (MAST) available on third party platforms.

\*As at 30/3/2022

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Please visit [www.investmentclock.com](http://www.investmentclock.com) for our blog and information about the multi asset range

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Stocks usually outperform government bonds in an economic expansion when unemployment rates (shown inverted here) are trending lower. They tend to underperform in a recession when unemployment is rising.

The first stage of the bear market was caused by a rise in real interest rates. If history is any guide, a second earnings-led stage is yet to start and may not end until unemployment is close to peaking.

## The Return of Boom and Bust

The post-Covid boom is almost certain to end in bust with central banks belatedly and aggressively raising interest rates to bring inflation back down. The Investment Clock has been in Stagflation for the last nine months, a stage of the cycle that is bad for both stocks and bonds, but good for commodities. At some point, possibly quite soon if recent commodity price weakness persists, we may swing around to the next stage of the cycle: bond-friendly Reflation. We're expecting stocks to see a second phase of bear market driven by earnings weakness, with a trough likely only when unemployment rates are close to peaking, which could still be a year or more away. Broad diversification, active tactical asset allocation and disciplined downside risk management will be key to navigate the bumpy road ahead.

### Back to the 70s

In the deflationary four decades to 2020, central banks were willing to cut rates at the first sign of a slowdown and, as a result, business cycles were long. The onset of the pandemic marked a regime shift to a high inflation world with reactive policy and short cycles. Pandemic fiscal stimulus was left in the system and central banks printed money long after lockdowns ended. A surge in consumer demand hit a supply-constrained world economy, pushing inflation to multi decade highs. Russia's invasion of Ukraine made matters worse. Central banks are woefully behind the curve and need to create spare capacity to bring inflation back towards target levels. Recessions in major economies are almost certain. Investors should respond to this new 1970s-style era of macro uncertainty with broad diversification, active tactical asset allocation and an explicit approach to managing downside risk.

### Broad diversification to provide resilience to inflation

While it should drop in a recession, we expect to see recurring bouts of inflation over the medium term due to a chronic under-investment in commodity capacity as we transition to net zero, massive public spending programmes, de-globalisation (including Brexit) and geopolitical risk. We improve resilience to inflation in our Governed Range and GMAP funds by including the likes of commodities and commercial property alongside stocks and bonds. We also opt for more of a value tilt within equities than standard global indices would give you, reducing our reliance on a few expensive growth sectors.

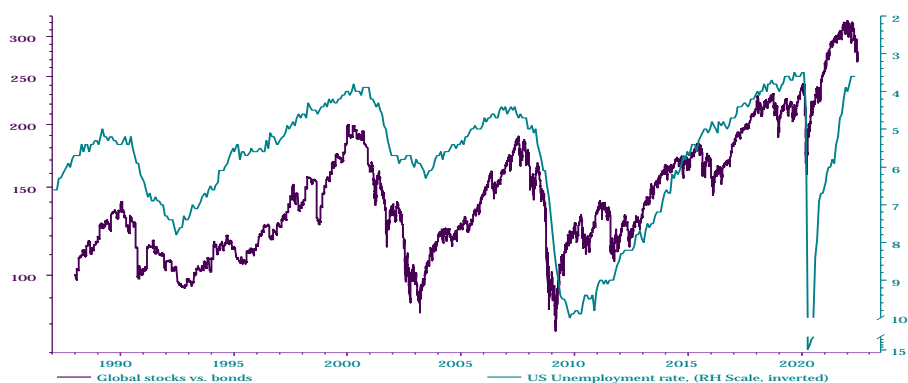
### Active tactical asset allocation as the cycle evolves

The return of short business cycles makes tactical asset allocation critical. We have been overweight commodities in our multi asset funds since 2020 Q4. We could find ourselves overweight government bonds when inflation starts to fall. Stocks could see a second phase of bear market driven by earnings weakness. A trough is likely to come only when unemployment rates are close to peaking. With sentiment depressed we are currently close to neutral, but our exposure is tilted towards defensive sectors and less expensive markets like the UK which are weathering the bear market better.

### Managing downside risk in a bear market

For investors looking for a more explicit approach to managing downside risk, the Multi Asset Strategies Fund ('MAST') seeks to limit losses by trimming equities when volatility is high. The fund has been resilient this year and simulations suggest it would have risen over the 2001-3 and 2007-9 bear markets.

Figure 1: Bear markets end when unemployment is close to peaking



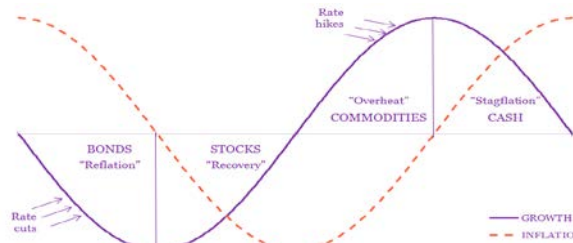
Source: Refinitiv DataStream as at 27 June 2022.

## An Inflationary Boom-Bust?

We use an Investment Clock approach to guide our asset allocation. Different asset classes offer their best performance at different stages of the business cycle, as identified by trends in growth and inflation:

- 'Reflation' is defined by weak growth and falling inflation. Central banks cut rates and bonds perform well.
- 'Recovery' starts when monetary stimulus takes effect. Growth and profits rebound, but spare capacity keeps inflation low and policy loose. Stocks outperform.
- In 'Overheat', growth is strong and inflation is rising. This environment usually sees central banks hike rates. Commodity prices are rising.
- 'Stagflation' is when growth slows but inflation continues to rise, as we've seen this year. It's a time to be defensive, with cash doing better than either stocks or bonds. Commodities often continue to perform well.

Figure 2: Phases of the business cycle and associated asset returns



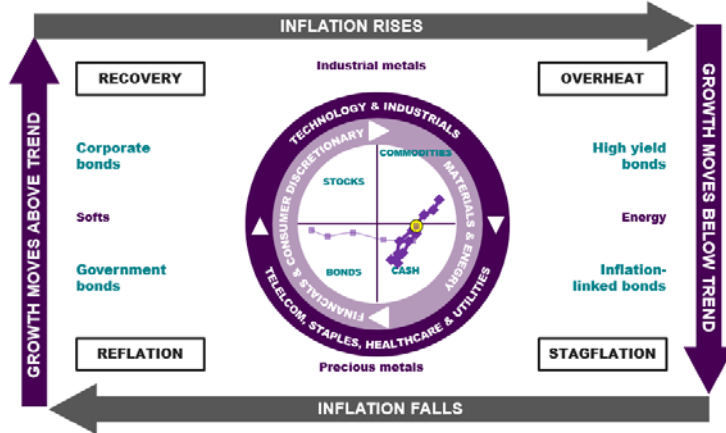
	Bonds	Stocks	Commodities	Cash
Reflation	9.3%	-1.5%	-30.1%	2.7%
Recovery	4.5%	17.9%	-9.3%	1.0%
Overheat	-0.4%	8.9%	17.6%	-0.2%
Stagflation	-2.4%	-14.2%	40.6%	-1.0%
Average return	2.4%	6.7%	2.2%	0.6%

Source: RLAM. For illustrative purposes only. Real US dollar returns for stocks, bonds, commodities and cash in Investment Clock phases from April 1973 to May 2022.

The Investment Clock is the same business cycle drawn as a circle. Shown this way, growth is the vertical axis and inflation is the horizontal axis. A normal business cycle starts at the bottom left in Reflation and proceeds clockwise.

We track the real time position on the Investment Clock using a wide range of global growth and inflation indicators. We have been in Stagflation for the last nine months, with asset class returns fitting the typical pattern. However, if recent commodity price weakness persists, we may swing into bond-friendly Reflation.

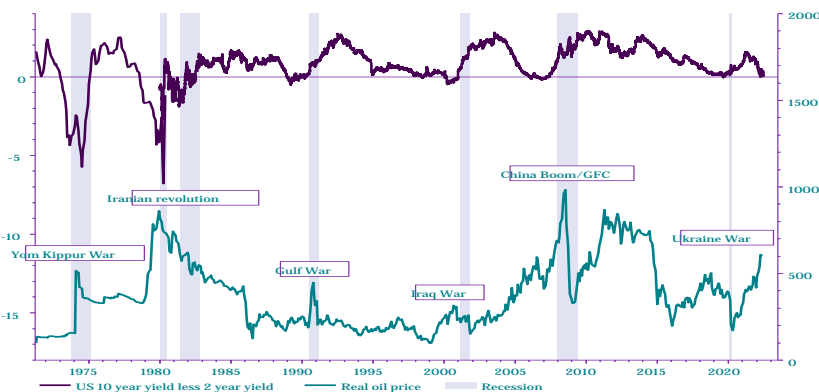
Figure 3: Investment Clock still on the cusp of Stagflation



Source: RLAM. For illustrative purposes only. Trails shows monthly readings based on global growth and inflation indicators with an RLAM projection in light purple. As at June 2022.

Central banks need to create spare capacity to bring inflation back down again. The sharp rise in energy prices and inverting yield curve suggest a US and global recession is likely.

Figure 4: High commodity prices add to risks of hard landing



Source: Refinitiv DataStream as at 27<sup>th</sup> June 2022. Vertical grey bars show US recessions.

## Broad Diversification to Provide Resilience to Inflation

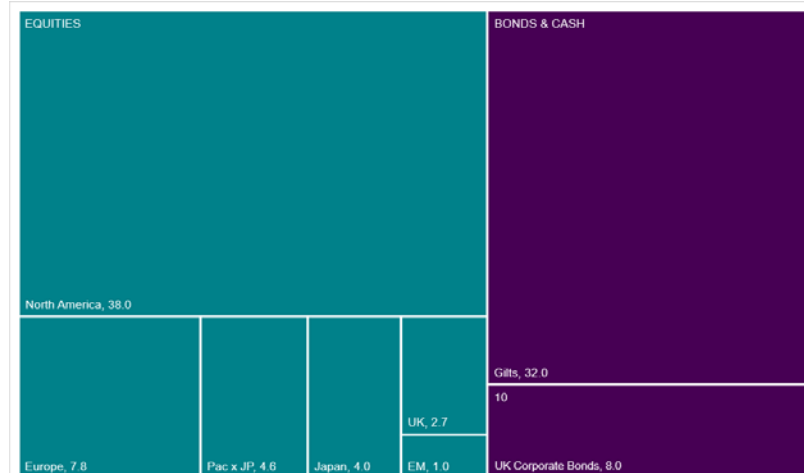
While inflation should drop in a recession, we expect to see recurring bouts over the medium term due to a chronic under-investment in commodity capacity as we transition to net zero, massive public spending programmes, de-globalisation and geopolitical risk. Interest rates could be higher than we are used to on average.

A traditional 60/40 balanced fund is poorly equipped for this environment, with the 60% invested in equities heavily skewed towards the expensive US market and the 40% invested in bonds unlikely to offer meaningful protection if interest rates trend higher over the medium term.

Our Governed Range and GMAP funds aim to maximise long run returns after inflation for a given level of risk. As a result, we improve resilience to inflation by including the likes of commodities and commercial property alongside stocks and bonds. Our equivalent of a 60/40 fund in risk terms also has less exposure to investment grade bonds and a greater allocation to UK equities as a specific asset class, which tend to perform better when inflation is rising, as we've seen over the last year.

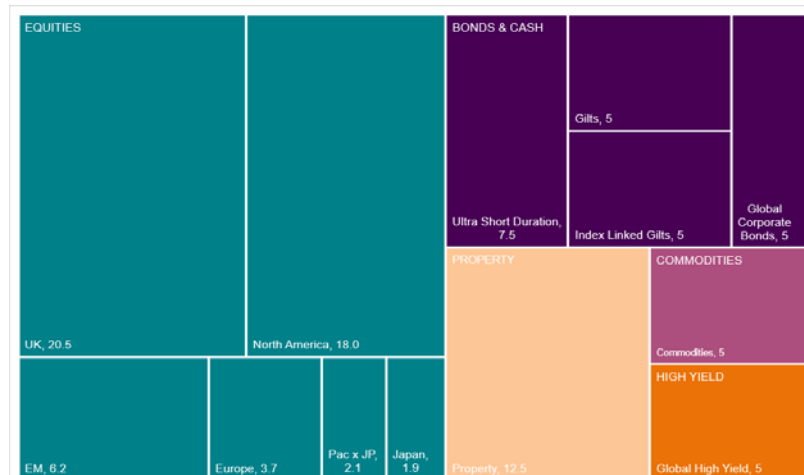
Market capitalisation based indices are heavily biased towards the US market and, consequently, the expensive technology sector. Our strategic equity mix has 35% in UK equities, 55% in global equities and 10% in emerging markets. This gives us more of a value tilt than standard global indices and reduces reliance on a few expensive and interest rate sensitive growth sectors to generate returns.

**Figure 5: Old style passive Balanced Fund Strategic Mix**



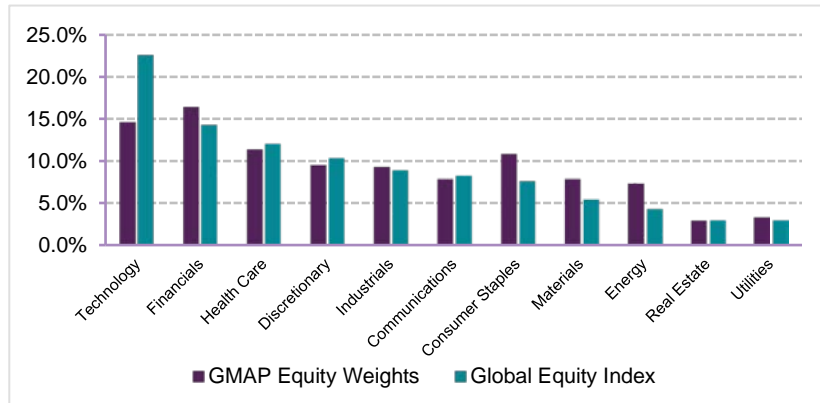
Source: RLAM, for illustrative purposes only. As at 29 June 2022.

**Figure 6: GMAP Growth mix / Governed Portfolio 5**



Source: RLAM, for illustrative purposes only. As at 29 June 2022.

**Figure 7: Sector Weightings in GMAPs and Passive Balanced Funds**

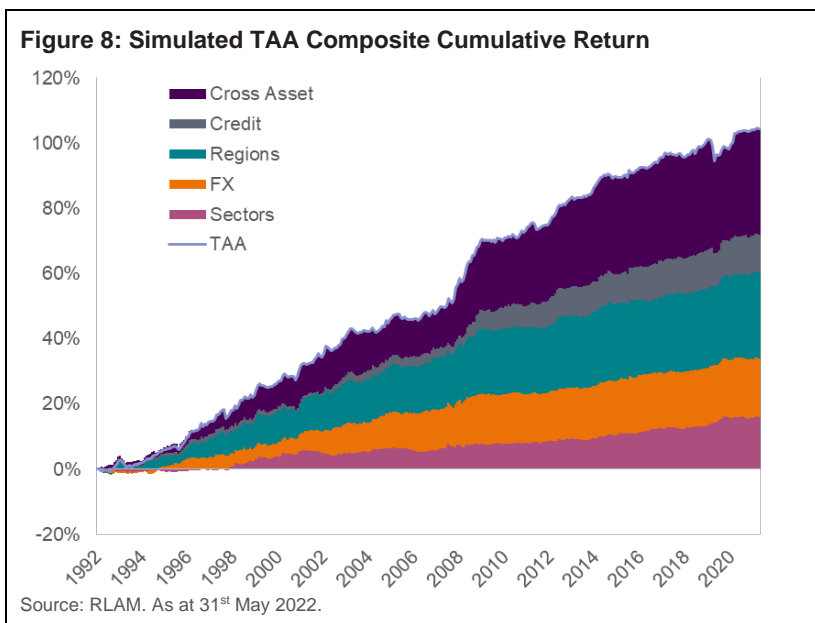


Source: Bloomberg. Global Equity Index showing the GICS sector weighting for FTSE World Index. GMAP Equity Weights show the GIC sector exposure of the strategic asset allocation of the GMAP fund equity portion. GMAP Equity weights show 10% in MSCI EM Leaders, 35% in FTSE All Share and 55% in FTSE World.

## Active Tactical Asset Allocation as the Cycle Evolves

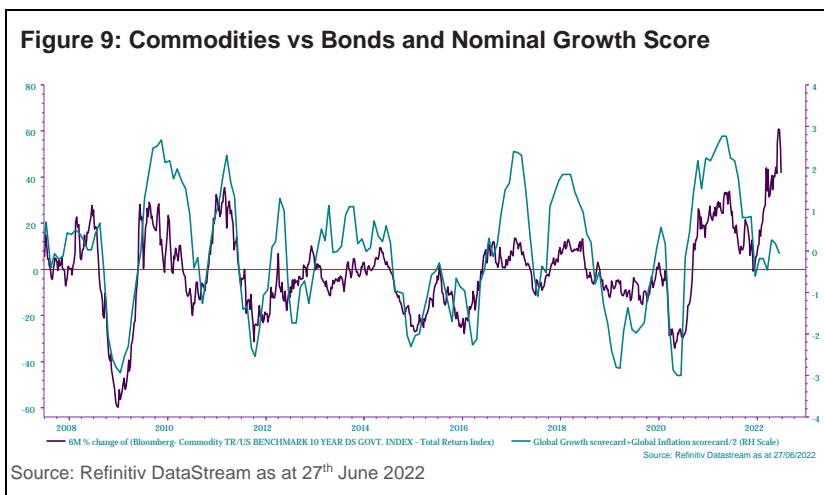
The return of short business cycles makes tactical asset allocation critical. Our research-led approach makes use of proprietary tactical models to support each of five core strategies. Each model combines several intuitive factors, including the Investment Clock. We backtest the models over multiple decades to ensure consistency over time and we review them on a daily basis when positioning the funds.

We can simulate the added value had we applied these strategies in their current form since the early 1990s. You can see the dip in added value when Covid hit and the subsequent recovery. You can also see strong performance going into and coming out of 'normal' recessions, 2007-9 in particular.



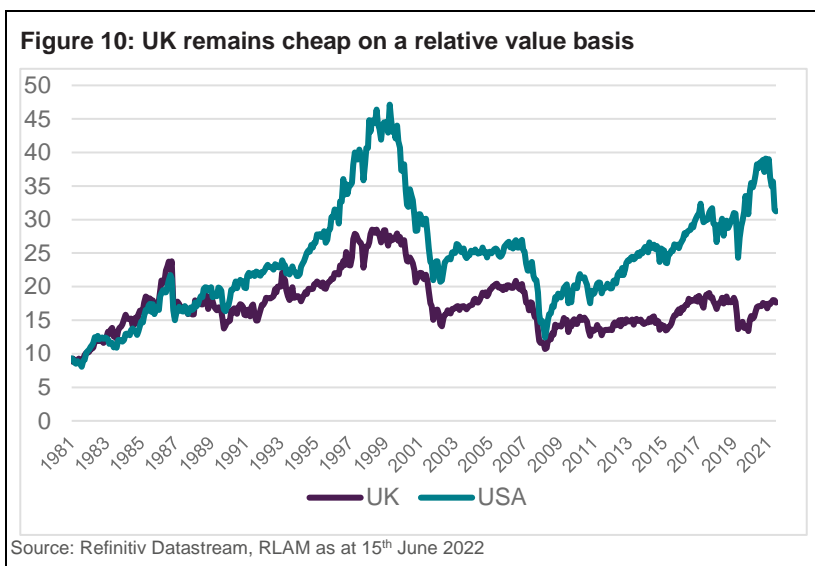
We have been overweight commodities since 2020 Q4 but have taken some profits in recent weeks on signs global growth may be faltering. We have been underweight government bonds but could find ourselves overweight when inflation falls.

If history is any guide, stocks could see a second phase of bear market driven by earnings weakness. A trough is likely to come only when unemployment rates are close to peaking, which could be a year or more away given the long lags of monetary policy.



With sentiment depressed, our tactical position on equities is currently close neutral, but our exposure is tilted towards defensive sectors and less expensive markets like the UK which are weathering the bear market better.

UK equities didn't share in the tremendous upward re-rating the US market enjoyed after the Global Financial Crisis. However, this stands the market in good stead should an earnings-driven bear market see a further de-rating of growth sectors, as can often be the case.



## Managing Downside Risk in a Bear Market

Diversification and tactical asset allocation can mitigate losses in a bear market. For investors looking for a more explicit approach to managing downside risk, the Multi Asset Strategies Fund ('MAST') seeks to limit losses by trimming equities when volatility is high.

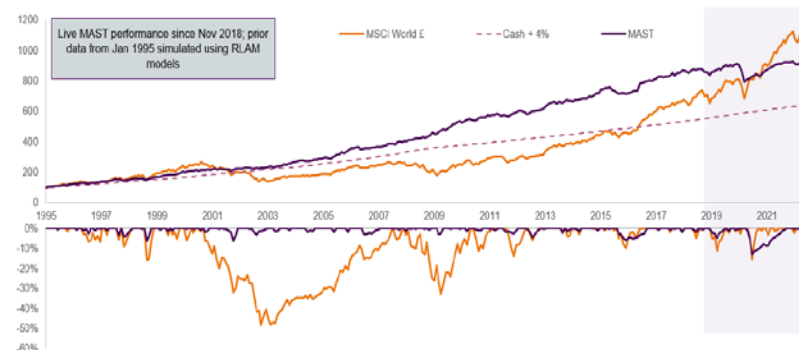
The investment objective is to generate annualised returns of 4% over cash, gross of fees, over rolling five-year periods, while limiting downside risk. There are two sources of return:

1. A diversified and volatility-capped core portfolio to capture positive market trends but limit losses in a bear market.
2. A tactical asset allocation overlay seeking to add value irrespective of market direction.

We simulated the strategy from the mid-1990s in order to investigate how it would have fared in a wide variety of market conditions. We found it tended to capture a good proportion of upside (51%) in calendar quarters when stocks rose but was much less exposed on average (9%) when stocks fell.

The fund has been resilient year to date when compared to more traditional diversified growth funds. Simulations suggest it would have risen in the 2001-3 and 2007-9 recessions, helped by a volatility-capped core portfolio and strong added value from tactical asset allocation.

**Figure 11: Multi Asset Strategies Fund long-term performance**



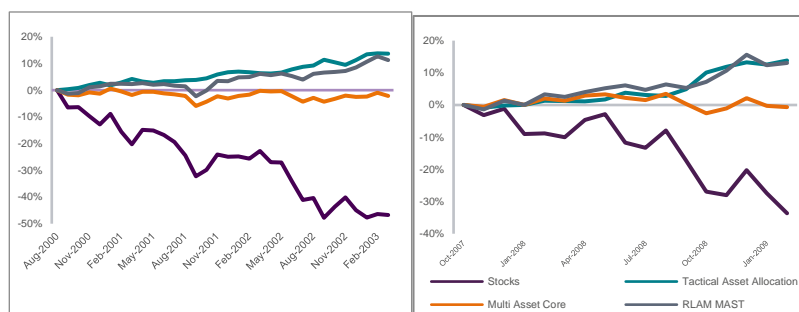
Simulated data is used prior to the inception date of 23rd November 2018. The simulation assumes fixed weight allocations to Multi Asset Core, with volatility management and constant risk budget for tactical asset allocation. The simulation for MAST is calculated using historical positions generated by RLAM's in-house tactical asset allocation models and signals from our volatility management process. Net of estimated fees and transaction costs. Simulated data or historical data are not a guide to future performance. The views expressed are the author's own and do not constitute investment advice. Source: RLAM as at 14 June 2022.

**Figure 12: Capture tables**

1995 Q2 to 2022 Q1	Quarters when stocks rose	Quarters when stocks fell	Average quarter
% Time	74%	26%	100%
Global equities (E)	5.9%	-7.7%	2.2%
<b>MAST</b>	3.0%	-0.7%	2.0%
Multi Asset Core	2.3%	-1.4%	1.3%
Tactical overlay	0.7%	0.7%	0.7%
Equity return capture	51%	9%	92%
Correlation	0.7	0.5	0.7

Simulated data is used prior to the inception date of 23rd November 2018. The simulation assumes fixed weight allocations to Multi Asset Core, with volatility management and constant risk budget for tactical asset allocation. The simulation for MAST is calculated using historical positions generated by RLAM's in-house tactical asset allocation models and signals from our volatility management process. Net of estimated fees and transaction costs. Simulated data or historical data are not a guide to future performance. Quarterly returns calculated from Q2 1995 to Q1 2022 comparing MAST to equities (MSCI World Index)

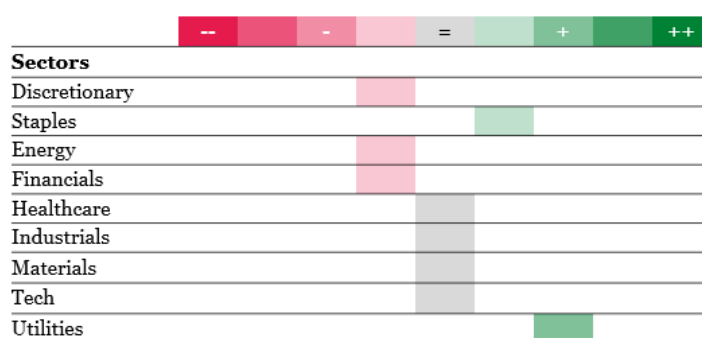
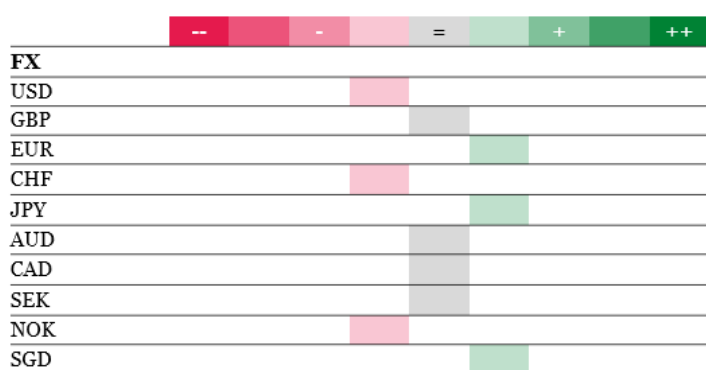
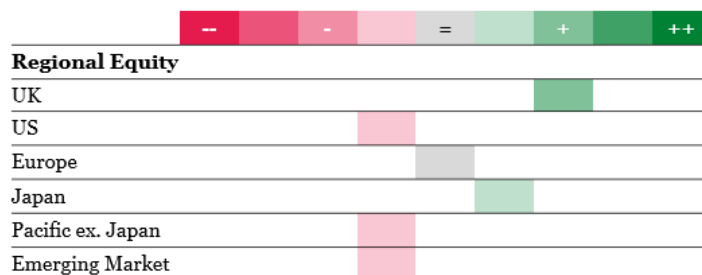
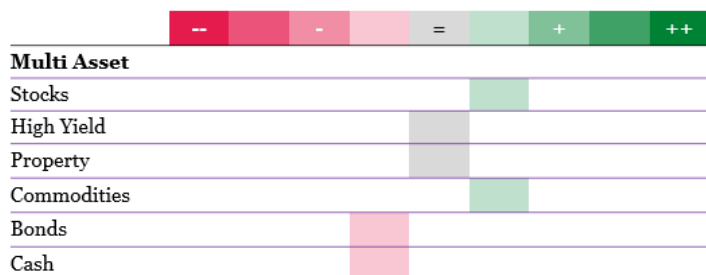
**Figure 13: Historic simulation of MAST during 2001 and 2008 recessions**



Source: RLAM. For illustrative purposes only. Note: The above chart contains simulated performance data. The data presented in this chart does not represent the actual performance of any past or present fund / strategy offered either by RLAM or any other firm. The returns implied in the above chart are gross of fees and transaction costs which would have had the effect of reducing the actual returns that may have been received. Simulated performance data is not a guide to past or future performance.

## Where We Stand: Overweight UK and defensive stocks, underweight bonds for now

We are overweight UK equities but have trimmed our overweight in commodities in recent weeks. We remain underweight bonds and growth stocks, as we expect policy to tighten considerably over the year.



### Cross Asset: Overweight commodities versus government bonds

- We are moderately overweight commodities, having taken profits on our overweight position in recent weeks on signs that global demand is slowing, which could be a headwind for the asset class following a strong start to the year.
- We are broadly neutral in equities, despite a more cautious long term view. This is because markets have fallen sharply and our measure of investor sentiment is at very pessimistic levels.
- We maintain an underweight in government bonds given our view that policy will continue to tighten over the year. However, we have bought back some bonds over recent weeks on signs that inflation could soon be peaking.

### Relative Value: Overweight UK and Japan, underweight US & Consumer Discretionary stocks

- We have been running a large overweight in UK equities; the relative earnings picture is strong, and valuations are at low levels even after a strong relative performance in 2022.
- At the sector level, we are underweight consumer discretionary, which has historically underperformed in stagflationary periods and could continue to struggle as growth slows.
- We are overweight the euro, given its cheap valuation and the yen, which has moved to deeply oversold levels and could rebound if global bond yields stop rising.

## Investment risks

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

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

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

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

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

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

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

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

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

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

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

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