

How economic analysis feeds into investment decisions

Royal London Asset Management launched the Global Multi Asset Portfolio (GMAP) range in 2016. To mark ten years of the GMAP funds, we are looking at how a modern, actively managed multi asset solution is designed and managed.

In the first article of this multi-part series, **Melanie Baker, Senior Economist** at Royal London Asset Management, discusses how economic analysis feeds into investment decisions.



Economic analysis and forecasting plays an important but constrained role in the active management process. While economic trends and turning points can be crucial for financial markets, the decision to buy or sell a specific investment will always be determined by a wider range of factors.

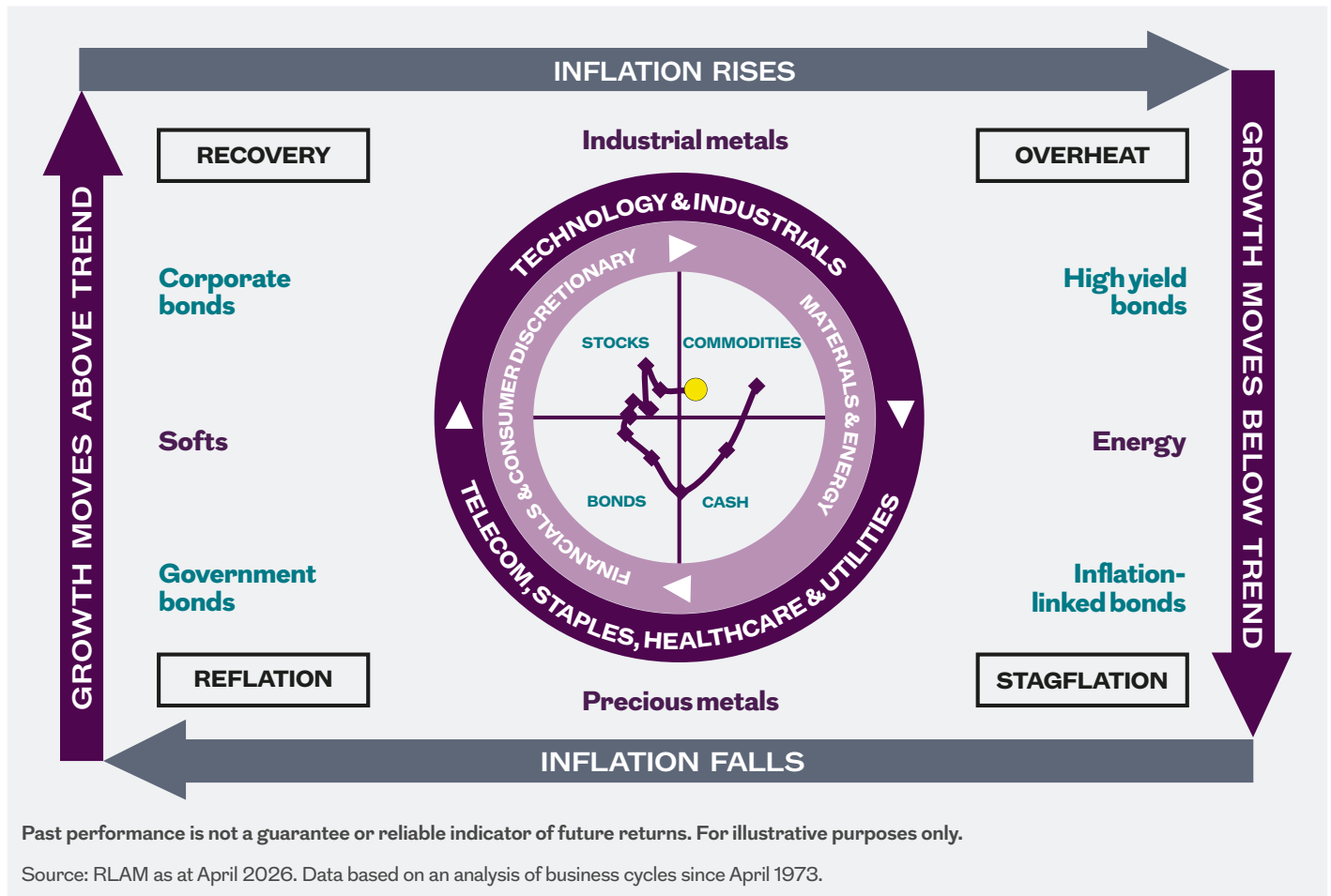
Understanding the relationship between the economy and markets

Our [Investment Clock](#) model links the economy to financial markets and helps inform tactical investment decisions. Created by Head of Multi Asset, Trevor Greetham, in the 1990s, the Clock is our team's tool for working out where we are ('telling the time') in the business cycle.

It depends on a large number of global growth and inflation indicators. Crudely, if global growth is weak and inflation is falling, you would expect that to be negative for equities (as expected earnings fall) and positive for government bonds (as the market anticipates interest rate cuts). In a recovery phase, equities tend to do well. When inflation starts to rise and interest rates are hiked, commodities come into their own. In stagflation, an inflationary slowdown, both stocks and bonds tend to struggle but cash and, again, commodities outperform. This pattern is based on historical observation, but it's a fair starting point to assume that these patterns will repeat themselves in one form or another.

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The Investment Clock Model



In practice

Every business cycle has unique features. Markets don't just reflect economic fundamentals and that is a key reason why the Investment Clock is only one of several building blocks used in making our tactical investment decisions.

Economic fundamentals don't always neatly map onto market conditions, as the risks of certain economic outcomes can change very quickly. Markets can price in changes and expected changes in tariff rates, geopolitical developments and tax policy, for example, much faster than they will be reflected in economic data. Sometimes the markets price these risks in and then back out again as the scare is averted. There's an old saying that says something like 'the stock market has predicted ten out of the last three recessions.'

Market movements can also reflect more technical factors, from seasonality to supply announcements or earnings reports. Asset prices can sometimes just 'get ahead of themselves' – fuelled by sentiment or herd behaviour.

Country-by-country, the mapping can vary too. UK economic fundamentals have a relatively tenuous link with movements in the UK equity market as many UK-listed companies are multinationals that derive much or most of their earnings from overseas.

What role do you play on the multi asset team?

While my long-term forecasts inform some of our strategic asset allocation views, my main role in the team is contributing to tactical decision making.

For the Investment Clock, deciding where we are on the clock is not a judgement call by me. It is arrived at by systematically mapping how various economic and related indicators are moving. I think that is a very good thing. What I can do is play my part in maintaining the Investment Clock and helping explore whether improvements can be made. There's also a lively debate on where we think the Investment Clock may be heading next.

More broadly than that, I keep the team up to date with economic and political developments and highlight upcoming events, e.g. central bank meetings, that we might want to build into our thinking and risk controls.

The often criticised 'on the one hand...on the other' answers of economists are partly a recognition that economies and markets are complex and ever changing. Solely focusing on a central case is not helpful from an asset management risk control perspective. I try to highlight alternative scenarios and emerging risks as well as sharing with the team how I think the economy and policy is most likely to evolve over the near term and beyond. Focusing on how things are evolving away or towards my base case can help the team decide where to focus extra attention when making adjustments to the portfolio, especially in fast-moving markets and an uncertain world.

The secular inflation backdrop has changed

I like to think that economists are good at asking questions too (even if they are not always so great at pin-pointing the answer!). The Multi Asset team at Royal London Asset Management includes people with a wide range of different backgrounds and training. All contributions are welcome. Sometimes, seeing things from an economist's perspective means you can add value well beyond a defined role.

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 Strategy losses and gains. The impact to the Strategy can be greater where they are used in an extensive or complex manner, where the Strategy could lose significantly more than the amount invested in derivatives.

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

Exchange Rate Risk: Investing in assets denominated in a currency other than the base currency of the Strategy means the value of the investment can be affected by changes in exchange rates.

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 strategies 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 Strategy to financial loss.

Strategy investing in strategies risk: The Strategy is valued using the latest available price for each underlying investment, however it may not fully reflect changing stock market conditions and the Strategy 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 Strategy itself, may be deferred or suspended.

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