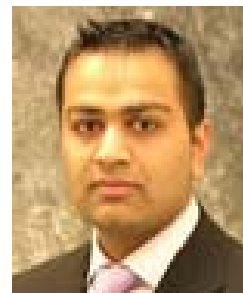


Where Next? The Cyclical Framework and Asset Allocation



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Introduction

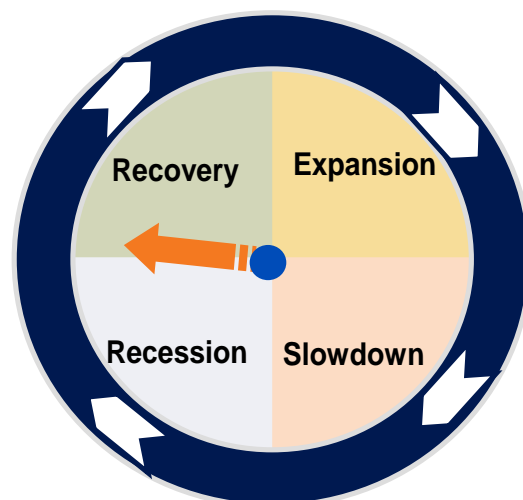
In this article we share the results of our Cyclical Framework that we use to assist our investment professionals with their top-down asset allocation strategy.

The Cyclical Framework is an investment tool that uses high level economic data to provide an indication as to where we are in the economic cycle, and which asset classes have historically performed well during this phase.

This framework also aims to identify different factors that are important drivers of returns through each stage of the cycle.

Summary of the results of our cyclical framework model

- In mid-April this year, our model suggests we transited from the **Recession** into the **Recovery** phase.
- In this phase we expect an environment of **low inflation** and **rising output** with a **loose policy stance**.
- If history is any guide, the first policy rate rise tends to occur 10 months into the recovery phase (i.e. around February 2011).
- Historical analysis suggests equities tend to be the best performing asset class in this phase regardless of the path in interest rates. Meanwhile, the key switch in asset allocation is from corporate bonds into equities.
- Growth in company earnings is an important driver in equity performance in this stage of the cycle.



Schroders

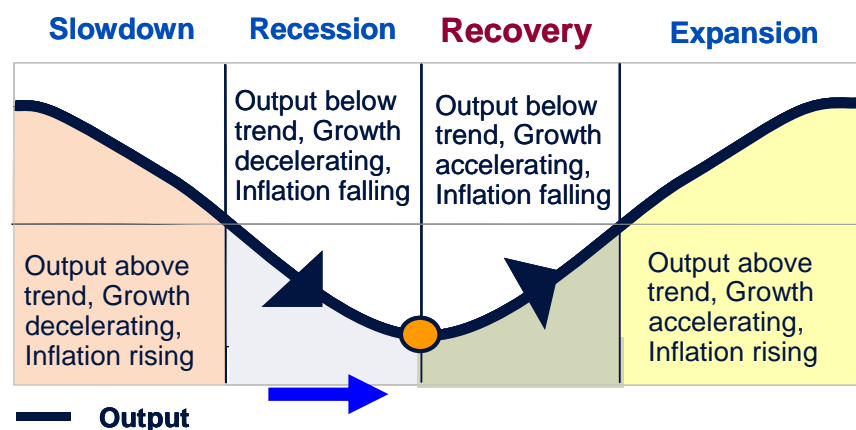
The Cyclical Framework

Cyclical Framework: An overview

Four distinct phases and the output gap¹

We define the economic cycle with reference to the position of the US economy relative to its long-term trend. We use the US economy as a lead indicator due to the strong relationship between the US and other equity markets (such as the UK for example). This enables us to specify four distinct phases depending on where the economy is in relation to the output gap and whether growth is above or below its long-term trend.

Each phase is characterised by different behaviour of interest rates, inflation and activity.



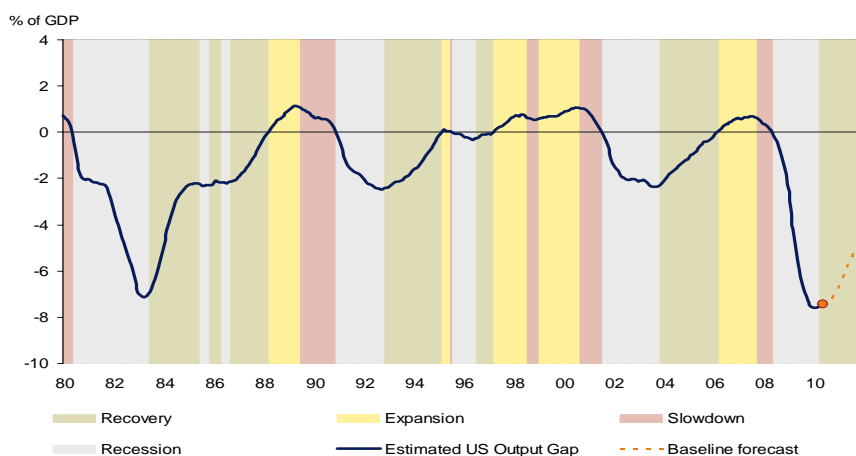
Source: Schroders, for illustration only

Chart 1: Schroders Economic cycle

Where are we in the cycle?

In mid-April this year, our model suggests we transited from the **Recession** into the **Recovery** phase. The last time we were in this phase was between October 2003 and April 2006. The model is calibrated on US monthly data back to 1950.

Based on our analysis this phase tends to be the longest and on average lasts for 17 months. In general, the average length of a completed economic cycle is between 5/6 years. The last completed cycle seems to have been 6.5 years long resulting from a longer than expected recovery phase as well as the deepest recession experienced since 1950.



Source: Thomson Datastream, Congressional Budget Office, Schroders

¹ The output gap is a measure of how far behind or ahead the economy is from its long-run trend level of output. We measure output based on unemployment data and capacity utilisation rates for the US economy.

Table 1: Details of full cycle and transition

Transition to	Date of transition	Length (in yrs)
Recovery	Oct-03	2.6
Expansion	May-06	1.4
Slowdown	Oct-07	0.7
Recession	Jun-08	1.8
Length of complete cycle		6.5
<i>Start of new cycle</i>		
Recovery	Apr-10	

Source: Schroders, Datastream

Table 2: Drivers of the cycle**Behaviour of the economy in different phases of the cycle.**

We find that each phase is characterised by the varying behaviour of economic factors. Thus, investors should focus on different factors at different times, in order to build a picture of potential drivers of markets in each stage of the cycle.

What drives equity market returns?

We gain insights into the drivers of the equity markets by breaking down equity returns into changes in earnings per share and changes in the ratings of those earnings measured by the price/earnings ratio (PE²). (Note that this is labelled Valuations in the table).

	Slowdown	Recession	Recovery	Expansion
Output level vs trend	Above	Below	Below	Above
Growth vs trend	Trend downwards	Trend downwards	Trend upwards	Trend upwards
Inflation	Rising/High	Falling	Falling/Low	Rising
Policy stance	Tight	Loosening	Loose	Tightening
Interest rates	Stable	Falling	Stable	Rising

	Slowdown	Recession	Recovery	Expansion
Equity Fundamentals	Earnings/Valuations	Valuations	Earnings	Earnings

Source: Schroders, for illustration only.

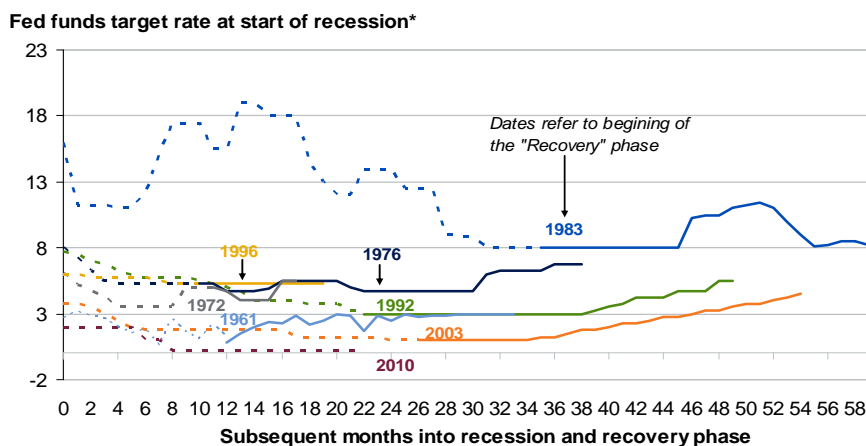
Historically, a sustainable **recovery** is usually accompanied by a **low inflation** environment and a relatively **loose/stable policy stance**. As a result, positive growth in earnings is the main driver equity market returns during the recovery phase. The re-pricing of markets normally occurs in the recession phase, which we have already seen.

² The PE ratio is the price of a share divided by its earnings per share. It provides a measure of how much you have to pay to buy an earnings stream.

Chart 3: When to expect interest rate rises in the recovery phase?

Examining past transitions from recession to the recovery phase, we learn that on average interest rates tend to start rising after the tenth month in the recovery phase. After this we see a gradual increase in interest rates.

This analysis is an average based on five cycles where we saw rates remain stable as we switched into the recovery phase.



*Recession and Recovery definition based on Schroders economic cycle. Dotted line refers to the Recession phase and solid line refers to Recovery
Source: Thomson Datastream, Schroders

Market Performance and the Recovery Phase

Financial markets and the economic cycle

Equity market performance is strong in the recovery phase

As mentioned previously, the changes in the pricing of earnings tend to drive equity market returns in the recession phase. In contrast, growth in earnings drives equity gains in the recovery phase.

Are rises in interest rates good for markets in the recovery phase?

Our analysis shows that when interest rates fall, markets produce their best returns as compared to when interest rates rise. However, the historical return in the recovery phase is still strong compared to other phases of the economic cycle during periods of rising interest rates.

Table 3: Equity market performance by stage

	Statistics	Recovery	Expansion	Slowdown	Recession
Equity	Excess Return ¹	8.6	8.4	-8.4	7.5
	Volatility	13.7	12.4	17.4	16.2
Success rate ²		100%	83%	22%	80%
Average length of the phase	Months	17	15	9	15

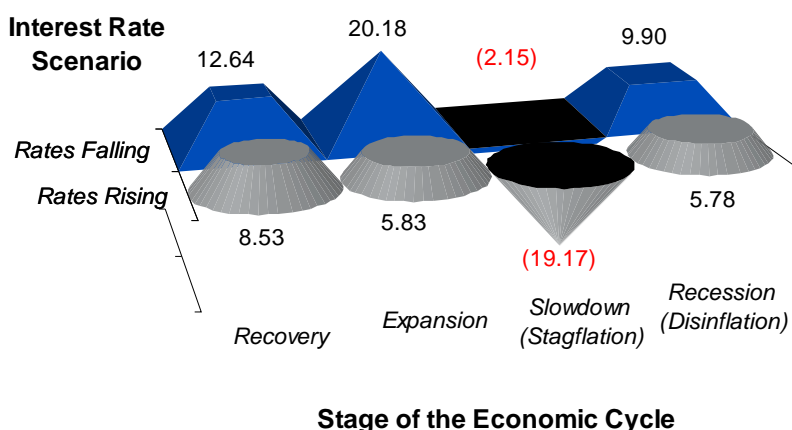
Source: Thomson, Datastream, Schroders

S&P 500 TR (1950-2010), excess over cash.

Success rate measured as the number of times equity market outperformed cash over a complete phase based on 9 recovery cycles.

Volatility in table refers to annualised standard deviation.

Chart 4: Equity market performance by stage and interest rate cycle



Source: Thomson, Datastream, Schroders

Asset Allocation and the Recovery Phase

Adjusting portfolio exposure for the recovery phase

We find that asset performance varies in each stage of the economic cycle and successful active allocation can be achieved by:

- Identifying the current stage of the cycle.
- Increasing(decreasing) exposure to the assets expected to outperform (underperform) in the current stage.

As we move into the recovery phase, equity markets become the top pick from a broad range of asset classes. Property could also perform well as investors seek assets with a link to inflation. Nominal assets such as bonds tend to underperform. This analysis implies a switch from corporate bonds to equities in the current economic environment.

Asset performance ranked by preference and stage of the cycle

Slowdown	Recession	Recovery	Expansion
Treasury inflation protected securities (bonds)	Corporate Bonds	Equities	Private Equity
Commodities	Hedge Funds	Property	Commodities
Government Bonds	Equity	Hedge Funds	Property
Cash	Government bonds	Private Equity	Hedge Funds
		High Yield	Emerging Market Debt
		Infrastructure	Infrastructure
			Equity

Other sub-asset classes

Slowdown	Recession	Recovery	Expansion
Large Cap equities	Small Cap Equities	Value Stocks	Growth Stocks
Defensive sectors	Cyclical Sectors	Financials and Energy Sectors	Cyclical Sectors
Energy/Precious metals Commodities	Energy/Precious metals Commodities	Industrial Commodities	Industrial and Energy Commodities

Source: Schroders, DataStream

Data: S&P 500, GSCI commodity, CSFB hedge fund, US 10 year Government bonds, UK IPD property, Barclays (ML) credit bonds, US DS Sectors, LPX50 Private equity index, MSCI world Infrastructure index

Conclusion

Schroders' Cyclical Framework is an investment tool that helps Schroders' investment professionals determine where we are in the economic cycle and what assets have historically outperformed. Its role is to support top-down asset allocation decisions.

As of April 2010 the model has indicated that we have transitioned from the recession phase of the economic cycle to the recovery phase. Based on our analysis of historical recovery phases, equities tend to be the top performer, even with rising interest rates. It is however important to note that the key driver of equity performance during the recovery phase is earnings growth and lack thereof may affect equity performance.

Finally, as with any investment model, it is only as valid as the factors it includes. Furthermore, every economic cycle is different and investors should therefore include a qualitative assessment of market conditions and other exogenous variables.

Important Information

The views and opinions contained herein are those of Harish Vekaria, Quantitative Analyst - Multi-Asset, Schroders Economics and Strategy Team, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds.

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