Global Outlook

December 2016

In this edition of Global Outlook, we examine the market consequences of a year of political upheaval. We also consider where we are in the global economic cycle and what this means for the House View as we move into 2017.

Standard Life Investments

House View

The following asset allocation is based upon a global investor with access to all the major asset classes.

	December 2016 House View	
Risk	The Global Investment Group retains a cautious medium-term outlook, as a variety of political and economic drivers point to higher levels of financial market volatility. While there are particular areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
Government Bonds		
US Treasuries	While market stress and safe-haven flows support Treasuries, tighter labour markets and the upward trend in wages give the Federal Reserve the rationale to raise interest rates steadily into 2017.	LIGHT
European Bonds	Bonds are supported by an environment of low inflation, modest economic growth, further QE and negative rates. Political pressures could periodically affect peripheral bond markets, requiring a quick ECB response.	NEUTRAL
UK Gilts	The Bank of England has delivered significant easing measures as uncertainty related to the EU referendum outcome is expected to cause the economy to slow. However, valuations are expensive.	NEUTRAL
Japanese Bonds	The introduction of yield curve control alongside negative rates and QE is the central bank's latest attempt to reflate the economy. The absence of yield makes this asset class relatively unattractive.	NEUTRAL
Global Inflation-Linked Debt	Inflationary conditions are globally subdued but markets may react to a rise in headline inflation due to expansionary US fiscal policy, while commodity prices are starting to move higher once again.	NEUTRAL
Global Emerging Market Debt	We prefer dollar-denominated to local currency debt, both on valuation grounds and on expected dollar movement. On a selective basis, higher yields are attractive in an environment of easier monetary policy.	HEAVY
Corporate Bonds		
Investment Grade	Preference is to be higher up the corporate capital structure. QE supports UK bonds, but has driven European yields to unattractive levels. US credit spreads are less attractive as Treasury yields increase.	HEAVY
High Yield Debt	The hunt for yield is driving more investors to this asset class, although overcrowding remains a risk in some sectors, especially in the US where monetary policy is being tightened.	HEAVY
Equities		
US Equities	Equities are buoyant on the back of promised fiscal easing from President-elect Trump; while dividends and share buybacks are still supportive, valuations have become less attractive.	MOVED TO HEAVY
European Equities	Corporate earnings may be adversely affected by the uncertainty shock from the Brexit process and other political events. Concerns remain over some banking systems and a lack of strong credit growth.	NEUTRAL
Japanese Equities	Markets have priced in high expectations for monetary loosening and a fiscal stimulus so yen moves remain a primary driver of corporate earnings and business investment.	NEUTRAL
UK Equities	The UK economy has remained resilient post-EU referendum but the uncertainty surrounding its future relationship with the EU remains. Sterling remains the primary driver of the relative attractiveness of UK companies with overseas exposure.	NEUTRAL
Developed Asian Equities	The macroeconomic improvement in emerging markets will have a positive feed through due to trade linkages, but expected US interest rate rises may offset this effect.	NEUTRAL
Emerging Market Equities	Pockets of deterioration remain in the region, such as the unstable political environment in Brazil. The outlook for Asian corporate profits is dependent on US trade policy and the degree of monetary tightening.	MOVED TO LIGHT
Real Estate		
UK	The referendum fallout continues to affect liquidity and cause capital depreciation. Income remains attractive versus other asset classes although risks are elevated should conditions turn recessionary or political uncertainty persists.	LIGHT
Europe	Core markets continue to offer attractive relative value in light of the low interest rate environment supported by QE, while recovery plays are showing consistent capital value growth.	MOVED TO VERY HEAVY
North America	Canadian property faces headwinds from an interest-rate sensitive consumer and significant office construction. The US should benefit from continued economic growth but pricing is quite aggressive.	HEAVY
Asia Pacific	An attractive yield margin remains, but markets are divergent. Returns are driven by rental and capital value growth in Japan and Australia, but weakening elsewhere. Emerging Asia markets are risky.	NEUTRAL
Other Assets		
Foreign Exchange	The US dollar has rallied following the US election result but continues to benefit from safe haven status in times of uncertainty; Europe looks less well placed than Japan to cope with the next phase of currency pressures; sterling has acted as a shock absorber after the EU referendum.	MOVED TO HEAVY $, NEUTRAL ¥ & £, LIGHT €
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions, influence the outlook for different commodities.	NEUTRAL
Cash		
	The US election result may mean a faster pace of rate rises is necessary should fiscal policy expansion lead to inflationary pressures. Easier policy expected in Europe, Japan and the UK to revive economic activity.	MOVED TO VERY LIGHT

Foreword

Editor

Jeremy Lawson
Chief Economist

2016 will go down as a year of major political upheaval after the British and American electorates voted to overturn the established order. This month's Global Outlook finds our investment teams grappling with the market consequences of this crystallisation of political risk. Neil Matheson, Market Strategist, argues that Donald Trump's US election win should enable fiscal and monetary policy to both be pointed at generating stronger growth. As long as the President-elect avoids a disruptive increase in trade protectionism, this should reinforce the improvement in global growth, inflation and corporate earnings trends that was already underway before the US election, and was supporting the rotation towards a heavier equity and lighter government bond exposure in the House View.

Jennifer Catlow, Investment Director, Multi-Asset Investing, then shows how our multi-asset funds are positioned to take advantage of this fiscal-led reflation theme through exposure to longer-dated inflation in the US, as well as a long equity position in US banks relative to a short position in consumer staples. Meanwhile, Fraser Duff, Investment Director, Credit, demonstrates that recent political shocks and an aggressive sell-off in government bond markets have been absorbed well by the European high yield bond market, thanks in part to the conservative way in which many companies are now managed. That said, the large depreciation in sterling since the UK referendum in June is taking its toll on consumer discretionary firms in the UK that source most of their stock from overseas.

Continuing the micro theme, Amanda Young, Head of Responsible Investing, highlights how a growing number of investors and asset managers are recognising the value of taking environmental, social and governance factors into account when assessing the sustainability of companies' earnings and performance. While Trump's victory could be seen as a setback for tackling issues like climate change, the social awareness and increasing clout of millennials mean that socially responsible investing will continue to grow in importance.

Although risk assets have generally been resilient in the face of the US election result, local currency emerging market bonds have taken a hit. This is mostly due to the significant appreciation of the US dollar since 8 November, but the perception that a more mercantilist and inward-facing US government may be negative for emerging markets has also played a part. While this short-term reaction is unsurprising, in the latest update to our emerging markets heat map, Nicolas Jaquier, Investment Director, Emerging Market Debt, reveals that external and internal imbalances have diminished across a wide range of countries since the 2013 taper tantrum and the 2014-15 growth and commodity price shock. In part, this is due to improved policy frameworks that put countries in a better position to withstand another round of tightening in US dollar liquidity conditions should the dollar rally continue.

Our industry-leading publications

Our global strategists combine valuable experience, thorough research and analysis to tackle major issues of the moment.
To provide first-hand insight into the issues that are currently driving markets, we produce a global series of flagship publications.

Publication	
Weekly Economic Briefing	A regular analysis of major cyclical developments and structural themes in leading advanced and emerging economies.
Global Outlook	A monthly publication which includes a series of articles that examine investment trends and developments in each of the major asset classes, rotating between macro, country and sector or company-specific insights.
Global Horizons	An occasional report that captures the in-depth research of longer-term themes that help to form our House View. We also periodically examine the major changes that are likely to influence financial markets in the coming years.

Spotlight

Climbing the wall of worry

Although political events will periodically cause market volatility, the global economic cycle is improving due to supportive policies, opening the door for investors to take moderately more risk in portfolios.

Neil Matheson
Market Strategist

Navigating the path into 2017

Over the past year, markets have oscillated between periods of despair and relief. A number of uncertainties appeared, posing questions including: will the US Federal Reserve (Fed) tighten aggressively? Will China careen into a world-shaking banking crisis? Will European banks implode? Will Britain vote to stay in or come out of the EU? Will America elect Clinton or Trump? The underlying worry has been that something will go wrong, spurring many investors to build up high levels of cash.

Given the muted economic backdrop since the global financial crisis, and a wide range of structural issues dampening activity, these worries are understandable. However, while commentary has been dominated by the downside risks, risk assets have been quietly grinding higher. This is not just related to central bank QE, the rally has spread across credit, equities and global real estate. What has changed?

An improving economy

The first driver is the global cycle. Since 2014, the world economy has slowed due to several factors: the rapid rise in the dollar, which led to a significant tightening in global liquidity conditions, the collapse in energy prices due to fast-growing supply against a backdrop of sluggish demand, and policy tightening in China amid a broader structural slowdown and rebalancing. As these factors stabilise or reverse, global growth is improving and feeding into better corporate earnings.

Against a backdrop of rapid expansion in global oil production through 2013 and 2014, oil prices subsequently dropped by two-thirds, reinforced by a sharply appreciating dollar. This led to a collapse in oil and gas drilling, and a sharp fall in total capital spending, especially in North America. However, falling exploration led to production cuts, while ballooning budget deficits among major producers pushed OPEC to negotiate supply caps. The net result has been a gradual rebalancing of the market; oil prices have rallied to around 40% of their previous highs. As cash flows recover, exploration budgets and overall capital spending look set to improve modestly into 2017.

In China, the political cycle has encouraged a shift in policy towards growth. Rates have been cut, the renminbi continues to devalue gradually, and lending conditions have been eased, while easier fiscal policy supports infrastructure spending and broader commodity prices. As an example, the real estate market has recovered sharply over the past year, while tighter lending standards look set to slow but not stop the cycle. This has helped drive a partial recovery in metal prices, benefiting non-oil commodity exporters.

The second change in the investing environment is policy. During the past six years a series of ill-timed tightening moves - both monetary and fiscal - sideswiped the global recovery. While the policy discussion is now more pro-growth, the Brexit vote, Trump's warnings about trade policy and rising anti-immigration sentiment in Europe have increased tail risks. It is important that the Fed is signalling that it will follow a very gradual rate hiking path, even discussing the merits of running a "high pressure" economy. Elsewhere, the Bank of Japan has strengthened its commitment to hold real short and long-term interest rates at negative levels. The European Central Bank (ECB) is committed to extending QE amid healthier domestic demand. The Bank of England has undertaken emergency measures which led to a weaker pound and lower mortgage rates, helping to stabilise housing and domestic spending. Countries like Brazil can envisage lower interest rates as inflation declines.

Not only are global monetary conditions the most supportive of growth in three years, but there is now active discussion about fiscal easing globally. In the US, a 'unified' Republican government makes large individual and corporate income tax cuts increasingly likely, which would help boost the economy and corporate profits, at least in the short-term. Meanwhile, much of China's growth this year has been delivered through fiscal actions. Japan is also loosening fiscal policy, while the UK is relaxing its budget rules to smooth the Brexit adjustment. This all points to an improved cyclical rebound in corporate cash flows, if not escape velocity for the global economy (see Chart 1).

The House View for 2017

One of the biggest drivers of markets between mid-2014 and mid-2016 was the relentless drop in long-term bond yields. However, in recent months, global rates have risen due to the changing outlook for fiscal easing and growth. This has been accelerated by the electoral victories of Donald Trump and the Republican Party. Global yields have moved from pricing in significant weakness, and are now more appropriately priced for solid growth - at least in the US. However, QE remains firmly in place in Europe; the Bank of Japan is endeavouring to manage longer-dated yields in Japan, and the Bank of England is still leaning against Brexit risks amid de-facto fiscal tightening. Barring a lurch into global recession, we have likely seen the low point for rates in this cycle. We expect only modest returns from government bonds in 2017, but they are no longer as overvalued as they were immediately following the UK's EU referendum.

We still find better value in credit. This has paid off handsomely in investment grade, with strong absolute and risk-adjusted returns from our portfolios. However, spreads are now tight (see Chart 2), while the level of absolute yields at 2-3% leaves relatively little protection from a more general back up in sovereign debt yields. We find better prospects in higher yielding credit, such as non-investment grade and emerging market (EM) debt. Absolute yields are 6-7% and spreads are still attractive. In high yield, while there has been a raft of issuance (not all of it of acceptable risk) there is still value across much of the market. We see opportunities in hard currency EM debt as we expect the balance of payments to continue to improve, commodity prices to stabilise, and global growth trends to support emerging market assets as long as there is not a significant rise in US-led protectionism.

Furthermore, carry is strong and, absent very aggressive Fed tightening, local currency returns in a number of markets look appealing.

In real estate, we find more attractive opportunities outside the UK. In the US and Europe, yields are attractive, rental growth is positive, and commercial development remains constrained during this In high yield, while there are some decent prospects in Asia. Property combines both yield with some growth, a ‘sweet spot’ in terms of investment preferences.

Investing in equity

Market participants continue to wrestle with their exposure to equity. Equities are frequently seen as expensive, and indeed valuations are high when considered in isolation. Compared to government or corporate bonds, though, relative yields suggest equities are still cheap (see Chart 3). The corporate profits recession and then recovery of 2015-16 has meant that global equity values have only returned to where they were back in the spring of 2015.

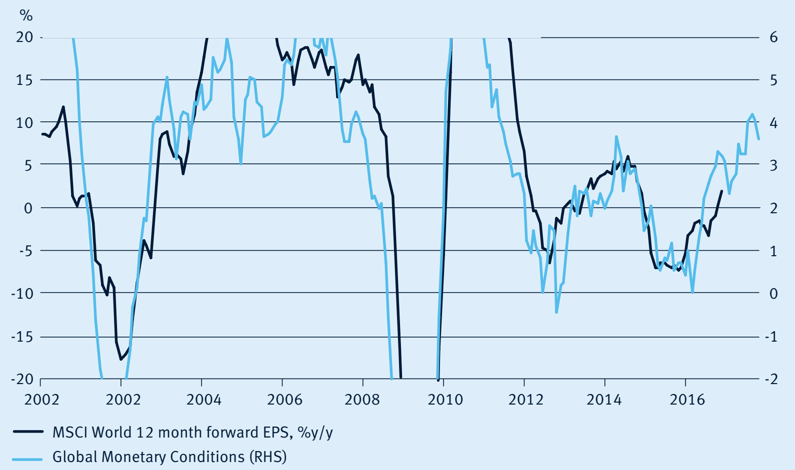
Most importantly, equities benefit from the operating leverage of the corporate sector. Better global growth translates into better volumes and pricing. Corporate cash flow at the aggregate level is still closely tied to the commodity cycle; as this turns back up, it will enhance top line growth even if the economic recovery is modest. Corporate operating leverage remains strong, with single-digit revenue gains capable of powering close to double-digit earnings gains. Our analysis suggests that such an improvement is not in the price; the recovery we have seen in 2016 essentially takes out the recession risk discounted in credit and equities, but does not fully reflect the better outlook for 2017.

Within equity markets, the US looks the most dependable but also commands the highest valuation. EM and commodity-related markets have performed well this year; the deep discount has narrowed but still remains. The key triggers for EM will be for Chinese policy to remain supportive, the Fed to ‘go slow’ and no trade shocks from the Trump administration. Europe and Japan have been the biggest disappointments in 2016, due to weak domestic profits, European banking issues, and currency swings. Here we are expecting support from stable-to-slightly weaker exchange rates, plus the higher operating leverage of these markets to global growth.

In foreign exchange, we remain positive on the US dollar given the underpinnings of relative growth and therefore tighter monetary policy versus the rest of the world. We believe that sterling provides asymmetric risks: a small upside if EU negotiations are resolved favourably in the eyes of investors but material downside if current account pressures mount up.

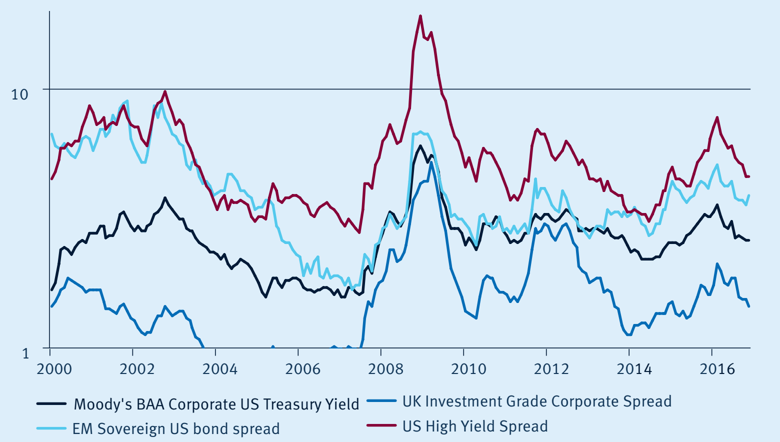
In summary, global economic and profits cycles are turning up, helped by a more supportive monetary and fiscal landscape. At long last, authorities appear to understand that continued, sustained expansion is required to get the world out of the stop-and-go cycle it has been in since the Great Recession. Investors have only begun to anticipate these developments.

Chart 1
Global earnings and monetary conditions



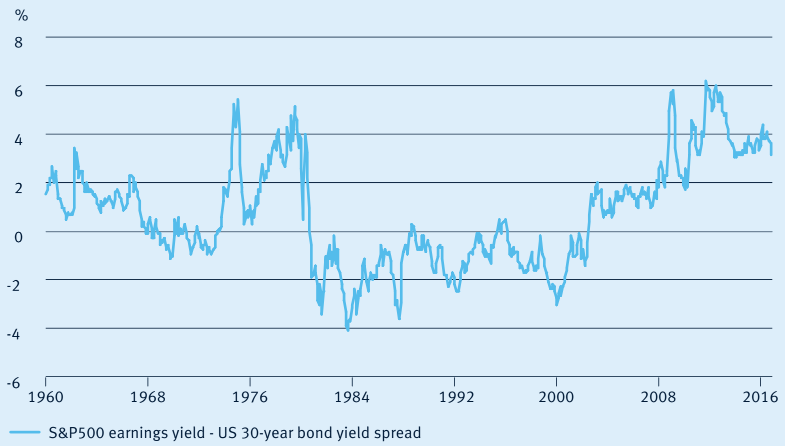
Source: Datastream (as of November 2016)

Chart 2
Credit spreads



Source: Datastream (as of November 2016)

Chart 3
S&P500 earnings yield - US 30-year bond yield



Source: Datstream (as of November 2016)

Emerging Market Debt

An orderly adjustment

Emerging markets (EM) have experienced significant adjustments in recent years. Our updated heat map of EM vulnerabilities shows that risk has now stabilised after a couple of years of improvements.

Nicolas Jaquier
Investment Director, Emerging Market Debt

Rebalancing economies

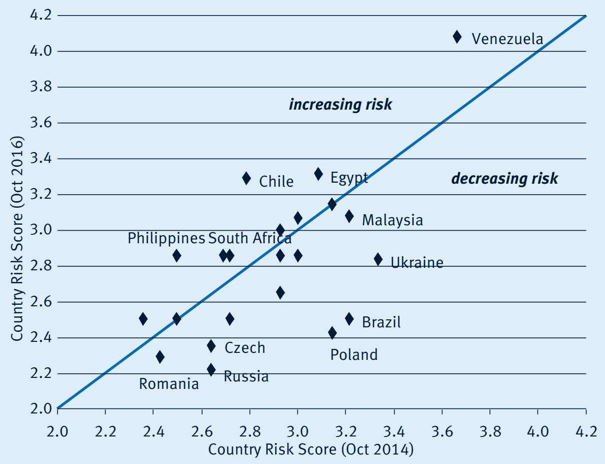
Many EM economies were forced to rebalance during the period of falling oil prices, tightening US dollar liquidity conditions and slowing growth in China. The latest update of our heat map of vulnerabilities (see Table 1) shows that in a number of countries, imbalances continue to be adjusted in an orderly manner, with aggregate risk now moderate and stable (see Chart 1). With a few exceptions, such as Ukraine and Venezuela, the absence of classic EM crises suggests that improved policy frameworks have served their economies well.

Russia and Brazil: the big improvers

Two cases in point are Brazil and Russia, where vulnerabilities have been reduced markedly. In Brazil, external balances have improved significantly. The Central Bank retained foreign currency reserves and let the exchange rate depreciate from overvalued levels, which helped cut the current account deficit. While the recession has been severe by historical standards, the country managed to avoid a large-scale financial crisis and instead experienced a controlled adjustment. In addition, maintaining a tight monetary policy for an extended period allowed a gradual reduction of domestic imbalances: after years of strong growth, credit is now contracting and house prices are declining. Fiscal policy, admittedly Brazil's greatest vulnerability, still needs to adjust, but some encouraging measures are being taken, such as putting a cap on public expenditure growth. Improving external balances and the reduction in domestic imbalances are now allowing the Central Bank to lower its policy rate, which should help fiscal accounts, given the large share of revenues used to service debt.

Russia had a much stronger starting point, but the authorities also undertook a controlled adjustment. This resulted in a recession, but not a crisis. The exchange rate depreciated sharply following the collapse in oil prices and the imposition of financial sanctions. Often, during past episodes of EM stress, a rapidly falling exchange rate was the trigger for second-round effects through companies with leveraged balance sheets and large exchange-rate exposures. This was not the case this time, as the Central Bank of Russia made use of its large foreign exchange reserves to provide liquidity to corporates, which in turn repaid a significant share of their external debt early.

Chart 1
Moderating risk



Source: Standard Life Investments (as of November 2016)

Increasing vulnerabilities in Chile and the Philippines

While most emerging economies have gradually adjusted over the last two years and reduced their vulnerabilities, a few have moved the other way. Chile saw an increase in its risk score, mainly due to rising domestic imbalances. The country has experienced one of the fastest rates of credit accumulation over the past five years, house-price inflation outpaced the rise in incomes and corporates have been increasing leverage. Thanks to policy stimulus, China provided a positive impulse to Chile this year. However, the country remains one of the most vulnerable to a slowdown in Chinese activity through its direct trade links and its dependence on one commodity.

The Philippines was one of the least vulnerable countries on the heat map two years ago, but this has been changing. A fast-growing economy is accelerating housing prices, corporates have increased leverage and strong domestic demand is translating into rapidly deteriorating external balances. Turkey also failed to adjust in a meaningful way and vulnerabilities remain elevated. In particular, Turkey is one of the countries that is most susceptible to a pullback in global liquidity. It is possible that Turkey follows the path of Brazil and Russia and undergoes a gradual adjustment. However, given the lack of buffers and the large foreign currency debt of the corporate sector, sustained currency depreciation could lead to a sharper correction.

Reduced exposure to rising US yields

The unexpected result of the US election brought renewed volatility to EMs, driven by outflows from dedicated funds. While it is too soon to assess any potential changes in US trade policy, which would be expected to target Mexico specifically, the increase in US bond yields is tightening financial conditions for emerging economies. In this respect, thanks to the orderly adjustment that most countries experienced over the past two years, EMs are now in a better position to face the new, potentially more challenging environment.

Table 1
Heat-map of emerging market countries' vulnerability to a crisis

	External				Domestic				Public		China exposure		Policy Framework		
	Basic Balance (% GDP)	FX Reserves (% Reserve Adequacy Measure)	Net non-FDI Capital Flows (5y sum, % GDP)	REER (5y change)	Credit % GDP (5y change)	Monetary Policy Gap	House Price to Income (5y change %)	Corporate Net Debt / EBITDA	Primary Balance (% GDP)	Average maturity of debt (years)	Value-add exported to Chinese Final Demand (% GDP)	Commodity exports (% of total exports)	Fiscal Rule / Countercyclical	FX / Monetary	Aggregate Risk
Argentina	-2.3	84	1	NA	0.0	-11.4	16	1.3	-5.6	9.1	0.9	71	N / Y	Managed Float / Other	2.86
Brazil	2.1	254	-0	-30	5.5	7.6	-7	7.8	-2.8	7.0	1.4	62	Y / N	Managed Float / IT	2.50
Chile	0.5	96	-1	-12	21.1	-3.1	29	2.9	-3.0	8.6	4.1	86	Y / Y	Float / IT	3.29
Colombia	-1.8	151	7	-26	13.6	-1.6	11	4.3	0.2	8.7	0.7	82	Y / N	Managed Float / IT	3.14
Mexico	-0.7	114	9	-19	4.0	-2.8	2	2.2	-0.3	9.4	0.6	17	Y / Y	Float / IT	2.50
Peru	0.3	256	-2	3	9.5	-2.5	44	2.5	-1.3	13.8	3.7	85	Y / N	Managed Float / IT	3.07
Venezuela	-10.3	21	6	568	5.6	-94.5			-24.8	8.2	4.4	98	N / N	Peg / ER Anchor	4.08
Czech Rep	2.7	169	-15	-12	4.1	-4.7	-7	1.0	0.2	4.9	1.2	11	Y / N	Managed Float / IT	2.36
Egypt	-2.9	52	14	22	-4.3	0.9		1.5	-4.4	2.1	0.3	49	N / Y	Peg / ER Anchor	3.31
Hungary	8.7	100	-32	-13	-21.0	-3.3	-10	1.8	1.2	3.8	1.4	15	Y / N	Float / IT	2.50
Israel	3.5	234	-27	3	-4.9	-3.8	12	2.2	-0.4	5.7	1.4	7	Y / N	Managed Float / IT	2.64
Poland	2.6	146	-3	-12	5.1	-1.8	-18	1.5	-1.1	5.1	0.6	21	Y / N	Float / IT	2.43
Romania	-1.0	195	-12	-6	-9.6	-4.9	-35	0.3	-1.4	5.4	0.5	22	Y / N	Managed Float / IT	2.29
Russia	1.6	229	-9	-28	19.0	6.6	-26	1.5	-3.4	7.4	1.6	79	Y / N	Managed Float / Other	2.21
South Africa	-3.8	91	18	-32	3.6	-0.3	-2	1.3	-0.4	13.0	3.2	51	N / Y	Float / IT	2.86
Turkey	-3.4	122	22	-10	23.7	-0.7	23	2.0	0.3	6.1	0.5	21	N / Y	Float / Discretion	3.14
Ukraine	0.8	36	11	-30	-16.6	3.1			0.9	4.9	1.2	45	N / N	Managed Float / Other	2.83
India	1.9	171	7	-3	0.3	-2.9	27	2.7	-2.1	9.6	1.3	29	N / Y	Managed Float / IT	2.86
Indonesia	-0.1	112	6	-9	7.3	-2.1	-10	2.2	-1.0	8.7	2.7	59	Y / N	Managed Float / IT	2.86
Korea	8.6	145	-23	9	17.4	-2.7	-6	1.6	-0.3	6.0	5.3	13	N / Y	Float / IT	2.50
Malaysia	2.5	95	-11	-13	16.7	-3.1	25	1.2	-1.5	6.2	7.7	33	Y / Y	Managed Float / Other	3.07
Philippines	-1.5	216	-10	14	11.5	-5.6	7	2.5	1.6	9.8	3.3	15	N / Y	Float / IT	2.86
Thailand	10.0	224	-12	-0	21.5	-1.5	2	2.0	0.2	6.3	4.5	22	N / N	Managed Float / IT	3.00

High Risk | Moderate Risk | Neutral | Light Risk | Very Light Risk

Source: Standard Life Investments (as of October 2016)

Absolute Returns

Coming up Trumps

The transition to the new US administration proffers many questions and possibilities for longer-term investors. With less 'absolute' political gridlock in the US, is there potential for change to be enacted?

Jennifer Catlow
Investment Director, Multi-Asset Investing

Regime change

The US election resulted in a clean-sweep victory for the Republican Party which, as well as the presidency, also won majorities in the House of Representatives and the Senate. That in itself is not ground-breaking, but it has been six years since there was unified government at the Federal level. However, it is worth acknowledging that there are significant fractures within the Republican Party. As such, policymakers may not be as united as first appears.

One possibly less contentious policy area concerns tax cuts. In the relatively short period of time since the election on 8 November, global markets have begun to reflect the prospect of greater fiscal stimulus. Inflation expectations and nominal yields have risen, while the US dollar has strengthened versus almost every other currency. At the same time, equity markets have been moving higher, with rotation from defensive to cyclical sectors.

It is likely that the fiscal loosening will begin affecting the economy towards the end of 2017 and more so in 2018. Therefore, in our view, the impact of the new administration and a unified Congress will be realised over the long term. For example, long-term, market-implied inflation expectations in the US had become extremely depressed over the past couple of years. This is best illustrated via the 30-year inflation swap level, which reached a low point of 1.7% in February 2016 versus a 5-year average of 2.5%. Even before the election, US growth indicators were showing signs of turning up. Additionally, wage pressures were beginning to emerge as the labour market edged closer to full employment. Consequently, we saw some normalisation of longer-term inflation expectations as the growth outlooks improved. Indeed, since late-June, 30-year inflation expectations have retraced all of their year-to-date decline (see Chart 1). With the prospect of a large fiscal boost now on the horizon, inflation markets are contemplating a more inflationary outlook. Even after some retracement, inflation expectations are still below their mid-2014 level. We therefore believe there is potential for long-term inflation breakevens to rise further.

Chart 1
Greater expectations

Source: Bloomberg (as of November 2016)

As yet, we have no concrete details around fiscal actions. Therefore, current projections are based on the views expressed by President-elect Trump during his campaign and the views of House Republicans. It is likely, though, that certain sectors of the equity market will be more impacted than others. Some sectors have already re-priced to an extent; for example, healthcare stocks have moved higher as the threat of potentially negative changes to the US drug pricing system has receded. Similarly, banks have benefited from a steepening of the US interest rate curve and the potential loosening of regulations in future.

Positioning for inflation

Within our absolute return portfolios, we believe there is an opportunity to position for an increase in longer-dated inflation expectations, both on an outright basis and relative to shorter-dated inflation expectations. As the normalisation in inflation has impacted both short-term and long-term expectations so far, we would expect that longer-dated expectations have room to continue to increase as a higher 'term premium' becomes embedded in market pricing.

Another strategy which we believe will benefit from a more inflationary environment and potential deregulation is our relative value US equity position favouring the banking sector versus consumer staples. The banking sector has been suffering amid tighter regulatory controls. However, a steeper interest rate curve combined with easier regulations should help lift profitability. A better economic environment within our forecast horizon should also encourage greater credit demand. On the other hand, consumer staples had benefited enormously in the 'lower for longer' interest rate environment and from investors' pursuit of relative safe havens within the equity market, despite increasingly expensive valuations. Now, they are victims in this reversal of fortunes.

Although significant uncertainties remain, especially around the direction of US trade policy, we believe that, overall, the change in the US administration presents longer-term investment opportunities within asset classes. With the ability to invest over a longer time horizon, there is substantial upside for portfolios able to exploit risk premia and market mispricing as part of a globally diversified portfolio.

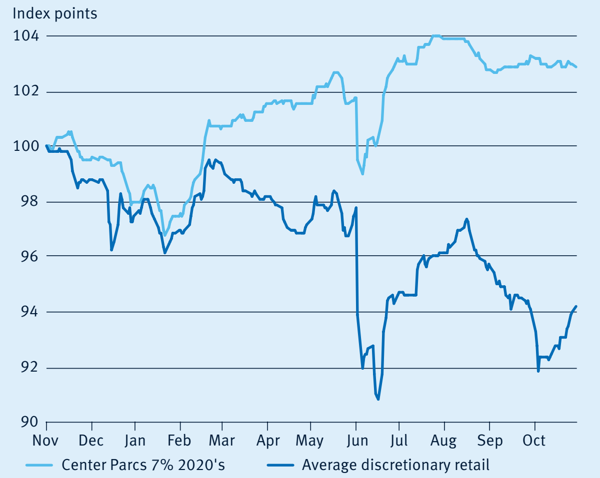
High Yield Bonds

Credit withstanding political tremors

Political and policy upheaval is affecting bond yields and currencies. So far, conservatively managed companies are absorbing the stress well.

Fraser Duff
Investment Director, Credit

Chart 1
Benefits of being local



Source: Bloomberg (as of November 2016)

Political winds are changing

If 'a week is a long time in politics' then 2016 has felt like an epoch. While the relative severity of the political changes need to be put in the context of the broadly stable times (compared with past decades) in which we live, 2016 will still be remembered as a year when Western democracies took a surprising step towards the populist right. A key feature of this new political rhetoric is a promise to roll back some aspects of globalisation. Brexit and the election of Donald Trump are the two most obvious manifestations of this, but they have not happened in isolation; continental European countries have seen their electoral pendulum move in the same direction. Moreover, this uncertainty is set to continue as France, Germany and the Netherlands go to the polls over the next 12 months.

While the outcomes of the UK referendum and US election surprised the market, neither induced the general 'risk off' pricing reaction in European high yield bonds that many anticipated. In the case of the latter, the benign market reaction is probably because investors view Trump's promise to loosen fiscal policy as being 'pro-growth', as evidenced by the noticeable rise in government bond yields since the election. So far, the main effect on European high yield has been some softness in longer duration bonds. Overall, high yield bonds with higher coupons and shorter maturities are less sensitive to interest rate moves compared to other types of bond. We would therefore expect them to continue to offer additional yield in what is still a low yield environment.

Closer to home, the European Central Bank's (ECB) programme of purchasing corporate bonds (CSPP) has proved a strong driver of European high yield performance since it launched in June. Critics of quantitative easing argue that it has failed to stimulate the economy and worsened inequality, although the positive trajectory of sentiment, employment and GDP growth belie that. Nevertheless, perceptions matter, and it is possible that rising European populism could lead to a shift in policy emphasis from monetary easing to fiscal easing. Thus, although we still expect the ECB to extend the CSPP, the point of maximum stimulus is probably now behind us. This points to further volatility ahead for fixed income markets, including European high yield.

Currency losers and winners

Recent political upheaval is also impacting currencies, which is in turn influencing European high yield companies when they convert their overseas earnings back to either euros or sterling. Commodities in particular are frequently priced in US dollars, so this has margin implications if finished goods are ultimately sold in a different currency. Domestically-focused businesses have also been caught in the firing line. In the UK for example, weaker sterling is detrimental to consumer discretionary businesses, such as clothing retailers, because they purchase most of their stock from overseas suppliers. The negative effects of this will become even more pronounced once currency hedges 'roll off' and companies face the difficult choice of whether to absorb higher costs into their margins or pass them on to customers, squeezing consumer real incomes and potentially their spending activity too. However, those companies with a high proportion of revenues and costs in their domestic currency should fare better. Holiday park operator Center Parcs is a good example and Chart 1 shows how its bonds have performed compared to a selection of UK consumer discretionary companies that have been impacted by currency movements.

The benefit of conservative firms

When company management teams are faced with uncertainty their inclination is to be conservative and maintain balance sheet strength. This has been noticeable among European high yield issuers, where expansionary business investment remains at low levels and capital has not been returned to shareholders to the same extent as it has in the US. With increased political risks on top of sluggish economic growth, we see reasons why this bond-friendly conservatism should continue. Default rates are low and despite political risk we expect the credit metrics of most European high yield companies to remain stable. In the longer term however, tail risks have clearly increased. If the surge in political populism ultimately leads to isolationist policies and trade barriers, then this will be to the detriment of all asset classes, including high yield.

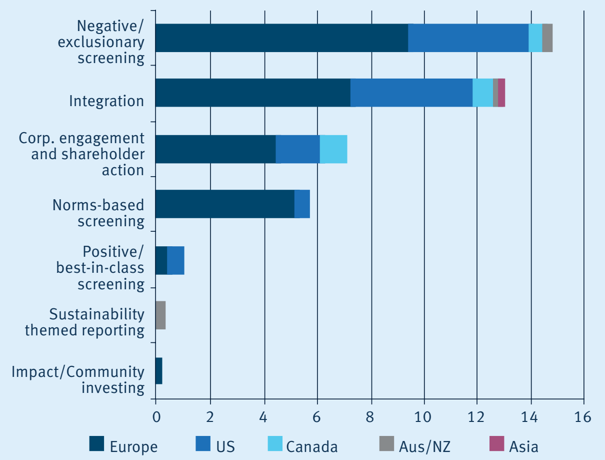
ESG Investment

Good money equals positive impact

With the UK's Good Money Week having taken place in November, it is a good time to reflect on the changing landscape of the values-based investing marketplace.

Amanda Young
Head of Responsible Investment

Chart 1
ESG assets by strategy



Source: UN PRI, Global Sustainable Investment Review (as of 2014)

Raising the awareness of socially responsible investing (SRI)

Good Money Week is the annual campaign to raise awareness in the UK of sustainable, responsible and ethical finance. The event seeks to ensure people know they have sustainable and ethical options when it comes to their financial decisions. In today's investment world, the consideration of environmental, social and governance (ESG) issues is commonplace. An ever-growing number of asset managers recognise how ESG factors can have a bearing on company performance and represent key value drivers for sectors. However, there is still a demand for investments that reflect an investor's values beyond this integration. There is an increasing number of options for investors in the ethical, green, sustainable or impact investment space. In the UK market alone, around £15 billion is invested in ethical, green or SRI funds. Such developments reflect important changes in societal views.

The millennial factor

In particular, this trend is being partly driven by the growing influence of the millennial generation (those born between the early 1980s and 2000). This generation is changing the traditionally held view that investors should forgo financial returns when investing alongside their values. Such a tech-savvy group understands the social and environmental challenges the world currently faces, and how these challenges can be destructive to a company's reputation or license to operate. These changes in views are being supported by easier access to information. Issues such as environmental resource constraints, climate change, modern slavery and evidence of poor corporate behaviour are easily shared through social media and digital technology. This ability to see the impact companies have on the world is shaping the way millennials view investments. Although they do not currently have a significant amount to invest, auto-enrolment and the future passing down of the baby-boomer generation's assets will make millennials a significant investment group over the next decade.

Ethical funds have been around for over 25 years. They grew in popularity in the 1990s, when investors demanded options that allowed them to avoid certain 'unethical' sectors, such as tobacco or gambling. While there are still plenty of investors who want hard screens of companies, values-based investment products have evolved to reflect positive social impacts, as well as avoiding corporate pariahs. In other words, investors are actively seeking companies that make a measurable positive contribution to the environment or society. A recent UK survey, suggested that younger investors are more likely to make values-based investments than older investors. In addition, younger investors were more interested in selecting investments that made a positive difference to the world, as opposed to avoiding companies that were associated with negative events.

Measuring social contribution

One way for investors to measure a company's contribution to society is to use global principles, such as the UN's Sustainable Development Goals. These goals were published in 2015 and address 17 of the most pressing challenges facing society and the environment. Designed as part of a collective plan of action for governments, companies and civil society to work towards eradicating poverty, the goals are becoming an increasingly popular method by which companies and investors can assess a corporate's impact on the world.

An example of a company helping to address social and environmental challenges while still making a healthy financial return is Safaricom, a leading player in wireless telecommunications in Kenya. The company's advantage over the competition continues to increase, as it invests in the quality of its network while its competitors lag and withdraw from the Kenyan market. There are substantial growth opportunities in Safaricom's mobile wallet and money transfer service M-Pesa, which already accounts for 20% of the company's operating profit and is growing rapidly. At the same time, M-Pesa's mobile wallet offering has been transformative for the financial inclusion of its under-banked Kenyan customers, giving economic opportunity and lowering transaction costs to a broader population than the banking system could serve. As a result, 75% of Kenyans now have access to a bank account, of which over half are helped by Safaricom. The company is also enabling around 120,000 small businesses to accept non-cash payments.

About Standard Life Investments

Standard Life Investments is one of the world's leading investment companies, offering global coverage of investment instruments and markets. We currently have global assets under management of approximately £269.0 billion – this equates to $359.6 billion, C$518.4 billion, A$483.0 billion and €323.6 billion (all figures as at 30 June 2016).

We are active fund managers, placing significant emphasis on research and teamwork. After in-depth analysis, our Global Investment Group (GIG) forms a view of where to allocate assets, based on the prevailing market drivers and on forecasts of future economic indicators. The GIG is made up of senior investment managers from the strategy and asset class teams and is responsible for providing the overall strategic focus to the investment process.

The House View delivers a consistent macroeconomic framework to our investment decisions. It generates the market and thematic opportunities for us to add value to our clients over the timescales they use to measure our success. It is formulated in such a way as to make timely investment decisions but to also allow all members of the investment teams to influence its conclusions.

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