Aberdeen Standard Investments

Global Outlook

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This document is intended primarily for investment professionals.

Foreword

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After a month when we were reminded that markets can fall as well as rise, and volatility spikes delivered a salutary lesson to those who backed a one-way trade, investor behaviour is at the forefront of attention again. In the Spotlight article of this edition of Global Outlook, Frances Hudson, Global Thematic Strategist, examines a variety of ways in which investor responses could influence outcomes in financial markets; examples include how corporates use cash, the regulatory backdrop, political events or changes to QE. In particular, attention is paid to valuation measures; which are preferred now and what could alter.

Unintended consequences prove to be a major theme of this issue. In particular, the recent Tax Cuts and Jobs Act in the US was noteworthy as the first piece of major legislation passed into law by the Trump administration. Investors should not assume, however, that all tax cuts are necessarily positive. James McCann, Senior Global Economist, has misgivings; from a macro perspective, he describes the act as "poorly designed" and together with the recent boost to public sector spending warns that "growing imbalances threaten to knock over the US economy". While tax cuts will boost the US economy in the short term, investors should be aware that abusing the fiscal accounts has detrimental implications on long-term public debt sustainability.

How will financial markets react to the legislation? For credit investors, Christopher Heckscher and Jon Curran, Senior Vice Presidents, Credit, think the Act incorporates uneven benefits across sectors and corporates depending on the characteristics of their operations and the leverage used. Some of these benefits will also be short-lived, meaning how companies utilise this extra cash is what will make the difference; management teams that fail to grasp this will be disadvantaged when the relief comes to an end. Moreover, investors should also remember that tax benefits do not guarantee future profitability. Ralph Bassett, Deputy Head of North American Equities, and Douglas Burtnick, Senior Investment Manager, North American Equities, comment on the importance of a company's ability to manage rising wages and other input costs irrespective of the fiscal policy in place.

However, the US and other major economies are not just faced with fiscal pressures. Andrew Mason, Responsible Investment Analyst, writes about the long-term toll from the lack of controls for legally prescribed opioids. The epidemic of opioids abuse is a major issue in the US and investors should engage with companies producing the drugs and those offering treatments to work towards better outcomes.

Finally, Sean Phayre, Global Head of Quantitative Investment Strategies, and David Clancy, Head of Quantitative Investment Strategies – Portfolio Construction, describe the innovative work being undertaken in factor investing and the different methodologies available for addressing unwanted exposure in order to enhance targeted exposure, such as Smart Beta. They caution that while factors are increasingly a part of the language used to describe investment processes, care is needed to interpret what is meant, as not all factors are created equal.

James McCann

Senior Global Economist, Aberdeen Standard Investments

Macro View

Making (corporate) America (feel) great again

The Republican tax plan fails to address the shortcomings in the tax code and risks overheating the economy as it enters the latter stages of its cycle.

The bill widely referred to as the Tax Cuts and Jobs Act, and signed into law at the end of 2017, represents a significant change to the US tax code. It will add just under $1.5 trillion to the federal deficit over 10 years, before economic feedback effects are taken into account. The legislation creates a host of relative winners and losers across the economy, and is large enough to shift the dial on growth, inflation and monetary policy.

Big headline changes

Corporates will be the biggest long-term beneficiaries of the package. The Act permanently lowers the federal headline rate by 14 percentage points (ppts) to 21%, broadens the tax base by eliminating or reducing a number of deductions (including a cap on interest deductibility) and allows for the immediate expensing of investment spending until 2022. It also changes the US from a global to a territorial tax system, and levies a modest repatriation holiday on profits from overseas subsidiaries held offshore.

These changes will lower the average effective corporate tax rate, albeit by less than the reduction in the statutory rate, and reduce the dispersion in rates across sectors and firms. They may also reduce the benefits of tax inversions created by the previous combination of high statutory rates and the global tax system, though incentives to shift profits offshore remain. The benefits of corporate tax cuts, as well as the repatriation holiday, are likely to largely accrue to shareholders and other owners of capital, rather than average wages.

Enjoy it while it lasts

Many households will also receive a tax cut, albeit temporarily. Indeed, although reductions in taxes paid through the individual code make the largest contribution to deficit increases over the next decade, personal tax cuts are due to expire by 2025. The Act also increases standard deductions, while capping other deductions like mortgage interest and state, local and property taxes. Moreover, it repeals the Obamacare individual mandate. Those reporting business income as pass-through entities receive an additional tax break.

All together the Act represents a missed opportunity to more thoroughly reform the tax code

The upshot of these changes is a regressive package (see Chart 1). Most income groups receive a net tax cut in the short-term, but Congressional Budget Office analysis suggests that by 2027 anyone earning less than $75,000 would be contributing to deficit reductions. Moreover, Tax Policy Center analysis implies that 99% of the benefits accrue to the top 5% of taxpayers in 2027.

Wide of the mark

All together the Act represents a missed opportunity to more thoroughly reform the tax code. The tax cuts do not adequately broaden the tax base, they reduce the progressivity of the tax system and there are still too many legal opportunities for firms and higher income tax payers to avoid paying their fair share of tax.

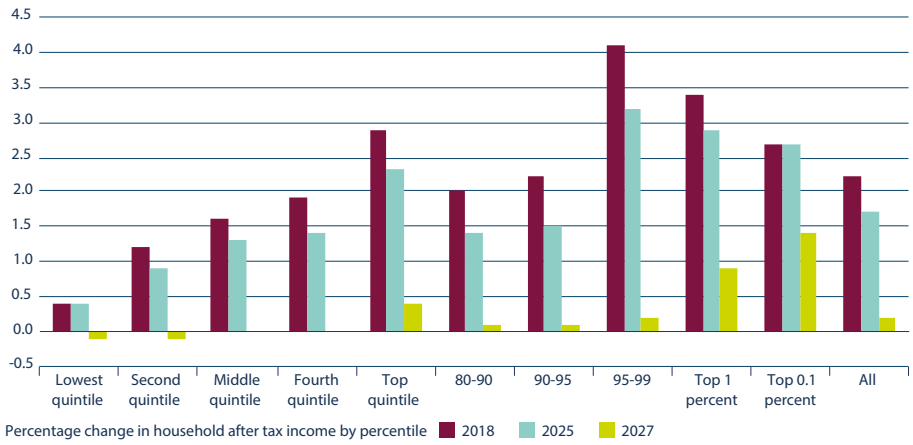
The poor design of the package will attenuate its benefits to the economy, while adding to the stock of public debt. Regressive business and personal income tax cuts have modest short and long-term multipliers, and the Federal Reserve (Fed) will likely lean against the stimulus at a time when the economy is approaching full employment.

Opening the fiscal taps

The recent bipartisan budget deal will add further fuel to this fire. This increases discretionary expenditure caps by close to $300 billion in aggregate over the next two years and provides additional disaster relief funding. The multiplier effects from these types of spending are typically higher, although again these will likely be blunted by crowding-out effects in an economy operating close to full employment.

The upshot of larger scale tax cuts and higher expenditure is that we have raised our forecast for GDP growth by 0.6ppts in 2018 to 3%, and 0.5ppts in 2019 to 2.7%. Thereafter, growth is expected to slow as the short-term stimulus fades and tighter monetary policy starts to bite. The combination of tax cuts and higher spending will worsen the fiscal position. The federal deficit could rise to almost 6% of GDP next year, reducing fiscal ammunition to fight future downturns.

Chart 1
A regressive package



Source: FRED (as of January 2018)

Overall, we have seen dramatic changes to fiscal policy over recent months. In aggregate, these will serve to accelerate the US cycle as it enters its latter stages. While the Fed is expected to resist the stimulus through tighter monetary policy settings, this is unlikely to prevent a degree of overheating in coming years. This raises the risk that a short-term growth spurt gives way to rising recession risks later in our forecast horizon, as growing imbalances threaten to knock over the US economy.

Global Spotlight

Winds of Change

Frances Hudson
Global Thematic Strategist, Aberdeen Standard Investments

Behavioural responses of investors to a range of stimuli have shaped current aspects of the financial market place, and will carry longer term implications beyond the 'volatility' storm at the start of the year.

Winds of change are blowing across the investment landscape. The business cycle is progressing, while regulation, policy and politics see changes in direction. Further complications could arise from external disruptors, say new technologies. Some activities that had been suppressed or curtailed in the aftermath of the financial crisis are re-emerging, so imbalances are growing again, albeit in different spheres and involving different parties. This article examines various 'winds of change' and how different behavioural responses from investors could influence future market outcomes.

Re-cycling

One example is movements in the interest rate cycle. Policy divergence has the European Central Bank (ECB) and the Bank of Japan still practicing QE, albeit with taper timing on the ECB agenda, while policy rates at the Federal Reserve (Fed) and the Bank of England have edged off the bottom. Ultimately, the widening yield differentials between different countries could have major implications for cross-border flows.

Some European central banks have charged interest to depositors while the Fed and the Bank of England pay interest on excess reserves deposited with them by banks. This interest rate creates an effective floor for interbank lending, equivalent to the upper bound of the Fed Funds rate in the US and the Bank Rate in the UK. This is important at a time when the London Interbank Offer Rate (LIBOR) is in the process of being superseded by Risk-Free Reference Rates as interest rate benchmarks. Chart 1 illustrates the Fed's policy.

Recent political events , such as the Catalan independence referendum, have had limited contagion, encouraging investors to assume few knock-on effects. However, other events could spark a behavioural response. For example, market complacency around the recent Italian election was high, having received reassurance that even the populist parties, Five Star and Northern League, are committed to the EU and the euro. Now that the election is over and only when a workable coalition is formed can negotiations over domestic policy and Italy's future relationship with the rest of the EU begin. Noticeable divergence of fiscal policy could worry investors. The US mid-term elections in November could see sizeable shifts in the political balance as the electorate gets the opportunity to judge the Trump administration. Given limited success on translating campaign promises into policy, despite both the House and Senate nominally on-side, any rebalancing towards the Democrats will further impede the President's progress on domestic matters and could pave the way for more action on trade or foreign policy matters.

For what it is worth

The role of QE in inflating asset values while indirectly encouraging economic growth is well understood, but its influence on how investors consider valuation metrics has received less attention. Post the financial crisis, ultra-low interest rates on bonds prompted investors to embark on a hunt for yield across other asset classes. In part, this was because traditional fixed income investments were not doing the job, just as interest rates at or close to the zero bound failed to ration credit demand. It also reflected investor preference for the certainty of income streams in an environment perceived as uncertain.

Against this backdrop, it makes sense that free cash flow (FCF) emerged as the equity valuation metric of choice. Investing consistently according to forward price/earnings (P/E), price/book, dividend yield or cyclically adjusted P/E over the long cycle, starting in 1995, would have yielded negative returns. In terms of asset allocation, the US appears expensive to varying degrees on all the metrics mentioned, except FCF. Sector-wise, FCF favours telecoms, healthcare, materials, consumer staples and tech, and suggests short positions on utilities and energy – albeit looking ahead, the impact

of the changes in US tax policy need to be considered at a company level

From a company perspective, a higher share price as reward for distributing cash to shareholders is not new. Of the four main uses of cash - capex, R&D, buybacks and dividends - the latter two represent more immediate gains for shareholders and often feed through to higher compensation for company management. The gains from capex and R&D take longer to materialise, even if they are well judged. In a bull market environment with QE as the backdrop, companies have been incentivised to pay out and pay up – repurchasing shares, and buying rather than building capacity. Where cash flows have fallen short, there was an opportunity to fund activities by borrowing at historically low rates. This in turn underpinned consolidation and a supercharged M&A cycle. Of course, the behaviour also reinforces short-termism in both investment and company horizons, and limits future growth potential. Recent company failures, such as Carillion, show how such a singular focus on enhancing shareholder value by using excessive debt can represent a lack of balance with the interests of other stakeholders. The ensuing fallout demonstrates that complex webs of inter-relationships and contagion are not solely the province of the financial sector.

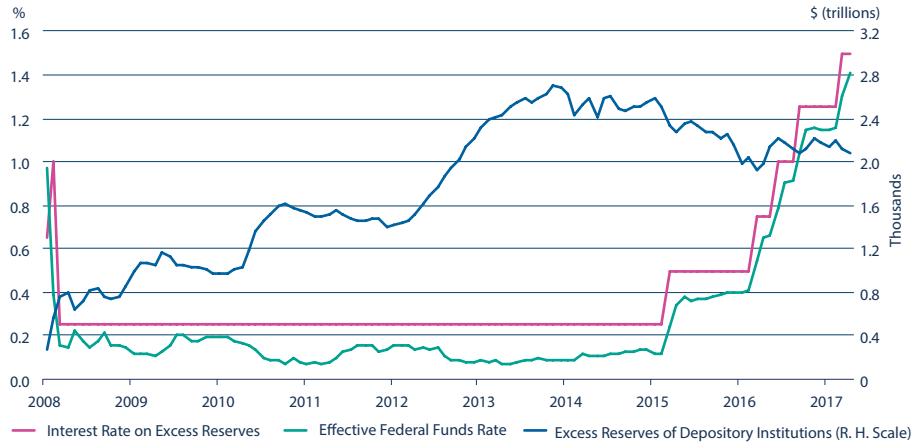
A question of balance

As the economic cycle matures, with the US leading the way, there has been a subtle change in investor responses to companies' use of cash. In the US, traditional home of the (often leveraged) share repurchase, companies announcing buybacks, especially when funded with debt, have recently been marked down. Conversely in Europe, Japan and emerging markets, buybacks have stayed well below 2007 peak levels and companies announcing buybacks here are still rewarded in the market place.

Within sectors, the use of cash has also varied in different geographies. An interesting example is technology (see Chart 2). In Asia, cash has been deployed towards capex and R&D, whereas investors in US tech have been treated to dividends and substantial buybacks thanks to high cash

Chart 1

Fed reserves interest



Source: Federal Reserve Bank of St Louis (as of January 2018)

generation. In effect, the US tech giants have outsourced both manufacturing and hard capex to Asia for some years. However, that could be set to change with the administration's incentives to US companies to repatriate cash held overseas and build domestic capacity as part of tax reforms and its 'make America great again' programme. There is also a case for keeping manufacturing close where it involves processes with significant intellectual property

> ***At this stage of the cycle some classic bubble candidates are appearing***

to protect. Concurrently, activist US investors have been targeting increased pay-outs from Asian tech companies, either in dividends or buybacks.

Normal service resumed?

Since 2009, US companies have been the largest buyers of single stocks in the main market, spending $3.3 trillion (tn) on shares, significantly reshaping the market. Buybacks have also played a part in dampening market volatility. With some discretion over timing, market corrections provide companies with an opportunity to intervene, supporting valuations while repurchasing their shares at lower prices. The sell-off in early February, amid rising correlations and volatility spikes, coincided with the close (or blackout) period for buybacks that occurs around earnings announcements. This prevented many companies from reacting quickly to the initial falls and arresting the downwards momentum. At the same time, US$1.5tn of derivatives linked to short volatility suffered whiplash before indices edged up and volatility subsided.

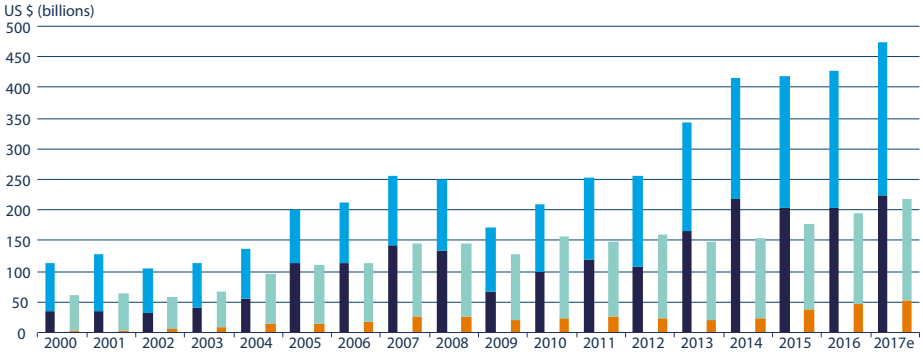
We view recent events as a modest correction rather than the start of a longer-term reversal, but also a shift towards higher levels of market volatility which will affect investor behaviour. Intimations of inflation, together with the loosening of the QE tether, may see a return to a more normal market environment characterised by rising risk premia, changing correlations and bouts of volatility. This will have implications for asset allocation and portfolio construction as the 'Goldilocks' era gradually fades. Company profits are generally supported at this stage of the cycle but a more discriminating and granular approach is warranted. US fiscal policy that brings increased spending and belated infrastructure investment into a mature cycle against a backdrop of tighter labour markets looks highly pro-cyclical. If public infrastructure or private capital spending is funded by bond issuance, it will tighten liquidity at the same time that short-term rates are rising.

No going back

Some political decisions, say Brexit, are very difficult to reverse. Until key

Chart 2

How to train your IT company

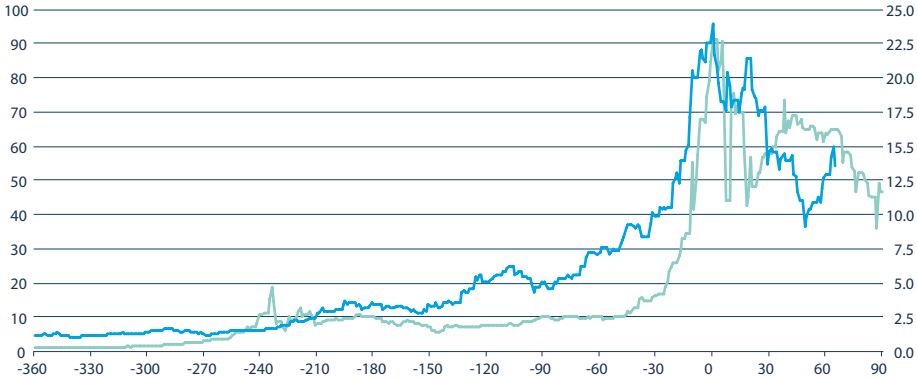


Technology sectors: US Buybacks and dividends Asia Buybacks and dividends US R&D and Capex Asia R&D and Capex
e denotes Citi estimate

Source: Citi (as of 2017)

Chart 3

Bitcoin forever blowing bubbles?



Bitcoin price rebased to 1 as of: 365 days before peak of:

First bubble (peak 29 November 2013) Second bubble (peak 18 December 2017) [R. H. Scale]

Source: Bloomberg, Standard Life Investments (as of 21 February 2018)

issues are settled investors will apply an uncertainty discount, usually through the currency if free floating, or in other marketable assets if the currency is not independent. That discount should diminish over time. Meanwhile, the outcome for UK domestic assets is priced somewhat pessimistically, so contrarian investors should be looking for potential upside surprises.

We view recent events as a correction rather than the start of a longer-term reversal

Elsewhere, regulatory changes, such as MiFID II, bring potential for significant and disruptive unintended consequences. The new regulatory environment in Europe represents an opportunity for the buy-side investor to assess the quality and quantity of external research, with the added focus of having to put a price on it. MiFID will accelerate some trends evident since the financial crisis. For instance, after investment bank activities relating to proprietary trading, commodities and real estate lending were curtailed, related research was cut. Subsequently, more analysts were employed by asset managers and large institutional investors. If the investment banks do not feel adequately compensated for research, they will further reduce analyst numbers; research coverage, particularly of smaller companies, is likely to fall. Paradoxically, the resultant inefficiencies in markets for smaller companies represent opportunities for fund managers in that space. Far from promoting a level playing field, which is a perennial goal for European regulations, under MiFID II smaller asset managers will lack negotiating power over research prices, and may be pushed into consolidation or niche operations.

Canards and canaries

At this stage of the cycle some classic bubble candidates are appearing; Bitcoin is one, having gone through the classic stages of hype, euphoria, crash and revulsion at least twice now (chart 3). Looking ahead to possible bubble candidates, the recent market correction that saw developed equity markets sell off while emerging markets held their ground probably indicates that equities are not where the dangers are most acute. The test will be whether there is a broader reaction – say in credit - as and when bond yields rise further. Different trigger levels have been nominated, for example, US Treasuries reaching 3.5%. A broader question is does a phase of 'risk off' necessarily equate with 'liquidity off' or, put another way, are markets headed for another crisis based on imbalances? The canaries in the coal mine this time might comprise Canada, Australia, New Zealand, Norway and Sweden, or CANNs. They are all economies with substantial leverage linked to the housing market, as well as higher than average advanced economy levels of household debt. This makes them vulnerable to a rising interest rate environment, while four of the five are also commodity-linked.

In summary, we have tried to illustrate how investor behaviour may change as certain factors that shaped the returns and volatility environment during the last decade begin to unwind. Markets grew used to synchronised monetary policies and as these start to diverge across developed markets so, for example, may cross-border flows. As QE is withdrawn this may alter the valuation metrics which investors have been using, and their preferences for how companies use cash. Political events, such as Brexit or Italian and mid-term US elections, look only partially digested. Regulatory changes, such as MiFID II, bring potential for significant and disruptive unintended consequences. The danger will be whether these winds of change pick up and become a future storm, encouraging a more aggressive investor response.

Quantitative Investing

Not all factors are created equal

Factors are increasingly part of the language used to describe investment processes; however, care is needed to interpret what is meant, as not all factors are created equal.

Sean Phayre
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Factor investing, where investors seek to generate superior risk-adjusted returns by systematically capturing risk-premia, or factors, has been part of the investment landscape in different forms for many years. The most recent incarnation of this is Smart Beta, a type of factor investing which, due to its combination of active and passive management approaches, has proved attractive to cost-conscious investors. Factor investing has also been seen as a natural way to incorporate industry trends such as embedding ESG considerations and Artificial Intelligence into investment processes. However, not all factor investing is created equal - different approaches to constructing factors and portfolios can produce different outcomes, not all of them intentional or desirable.

What is a factor?

In an investment context, a factor is simply a common theme or characteristic that links a set of companies. It may take the form of country of domicile or economic sector, or more commonly an investment style such as Value or Size. Dividend Yield is an example of such an investment style and income investors often buy stocks which have high dividend yields as a way of targeting regular income. Like other factors, stocks defined by high dividend yields are likely to move together in certain circumstances; for example, rising interest rates often negatively impact this group due to them being viewed as bond proxies. In general, factor investors target themes which are expected to provide outperformance over the long term – those favoured by Aberdeen Standard Investments include Value, Quality, Momentum, Small Cap and Volatility.

Factor portfolios

Factor investors create portfolios based on investment styles. However, there is divergence in approaches to constructing such factor portfolios. The simplest, and most common, way, is to rank stocks on a metric such as Value (defined, for example, by book yield) and buy those stocks with the highest scores while avoiding, or short-selling, those with the lowest scores. Although this process generally results in a high exposure to the desired factor, it may also lead to other unintended factor biases. Some factors constructed this way may have large positions in certain sectors – Value factors are generally

overweight banking stocks. Or there may be unintended exposures to styles other than the target factor – a naive Momentum factor is often underweight Value by nature of their relative compositional biases.

Purer factors

One attempt to control for unintended exposures is to make the factor sector or industry neutral. While this may eliminate concerns around economic grouping biases, the resultant factor may still have some sensitivity to overall market moves. A further attempt to purify the factor would be to hedge out this market risk and make it beta neutral. In extremis, the purest factor is one which has exposure only to the targeted factor, while having no exposure to other factors. Such factors are termed orthogonal and are absent all unintended factor exposure (see Table 1).

Caveat emptor

Different factor approaches to construction can lead to different outcomes – Chart 1 shows the exposures of a US Value factor constructed using different methods.

While all the factors are positively exposed to the target, in this case Value, all but the pure factors have other non-targeted exposures in their make-up. These unintended exposures, such as underweight Quality and Momentum and overweight Small Cap, will influence the performance of the factor and could in some cases lead to it performing quite differently from expectations.

Historically, the practical implementation of such factors, and factor portfolios, is to translate into active portfolio weights and then overlay those weights upon a market cap index to produce a tilted long-only active portfolio.

Smart Beta and multi-factor

Smart Beta has become a popular flavour of factor investing in recent years. This particular approach seeks to gain concentrated factor exposure in a systematic way, while avoiding using market capitalisation as a starting point. As with single factors, issues of construction also impact Smart Beta methodologies which seek to simultaneously target multiple factors. Additional considerations arise due to alternative methods of combining multiple factors in one portfolio and the use of optimisation or alternative weighting schemes to assist construction. Chart 2 shows two well-known Smart Beta multi-factor offerings. Despite ostensibly targeting similar factor sets, the resultant portfolio exposures are quite different.

Different approaches to constructing factors and portfolios can produce different outcomes, not all of them intentional or desirable

Understanding the details

Factors are increasingly a part of the language used by investment professionals to describe their investment processes. It seems reasonably clear that this will continue to be the case as the growth of Smart Beta continues and investors look to ESG and Artificial Intelligence as areas which could naturally be incorporated within a factor-investing framework. But how these factors are constructed and the contents of those portfolios which purport to target these factors are aspects requiring clear optics. As always, the investor should take care to understand what they are buying as not all factors are created equal.

Table 1

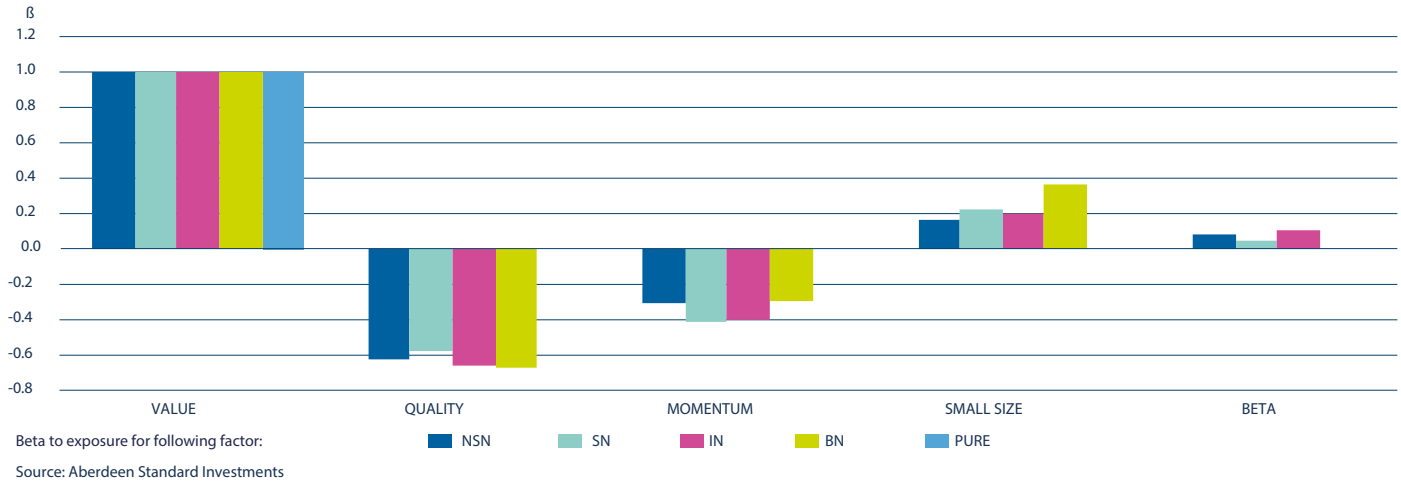
Controlling for unintended exposures

Name	Simple Factor	Sector Neutral	Industry Neutral	Beta Neutral	Orthogonalised
Abreviation	NSN	SN	IN	BN	PURE
Construction	Constructed across universe, long high factor scores, short low factor scores	Constructed within sectors to avoid sector bias	Constructed within industries to avoid industry bias	Constructed to hedge market risk	Constructed to have only (unit) exposure to target factor and zero others
Complexity/Pureness of factor					

Source: Aberdeen Standard Investments

Chart 1

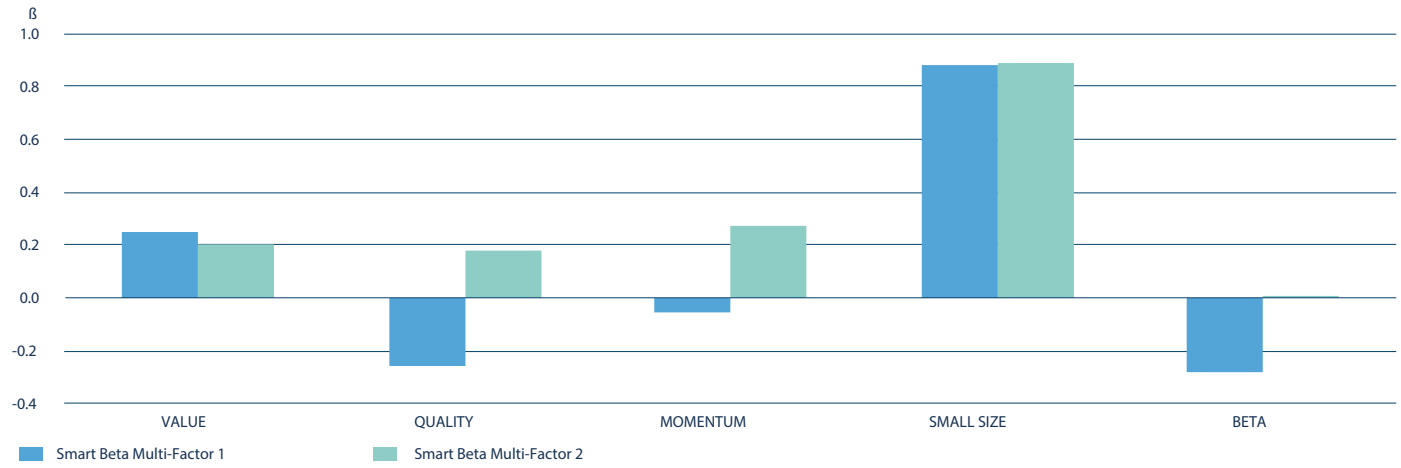
US value factors exposure



Source: Aberdeen Standard Investments

Chart 2

Smart beta multi-factor exposures



Source: Aberdeen Standard Investments

US Corporate Bonds

More or less taxing times for credit

Tax reform, though widely welcomed, warrants careful analysis. Within credit, some investment-grade companies clearly benefit while many high-yield corporates do not.

Christopher Heckscher
Senior Vice-President, Credit
Aberdeen Standard Investments

Jon Curran
Senior Vice-President, Credit
Aberdeen Standard Investments

As the US finally passed the much-anticipated tax reform legislation in December, credit and equity markets rallied in response to the prospect of better US corporate earnings. For us, the reaction in credit markets seems broadly rational. Lower corporate taxes for some, and the opportunity for others to repatriate significant cash holdings from overseas at a lower tax rate, should both help corporate cash flows.

Benefits vary depending on how companies operate

As Table 1 shows, the implications of the tax reforms will vary depending on factors such as how much of a company's operations are international, how capital intensive its operations are, and how much leverage it has. For those companies that have operations in the US, the lower corporate tax rate will be positive. Meanwhile, cash repatriation will benefit a handful of companies in the technology and healthcare sectors that hold large cash balances overseas; Apple and Microsoft, for example, hold an estimated $269 billion (bn) and $136 bn respectively overseas. These companies are big issuers in the credit market and should they move these cash balances back to the US due to a lower tax rate, they are less likely to issue debt.

However, tax reform is less favourable for high yield-rated companies than it is for those with an investment-grade rating. Previously, the former had benefited from tax shields, such as interest expense and net operating losses (NOLs) that reduce taxable income. In future, these tax shields will be more limited. Investment-grade companies are generally profitable so do not have NOLs available to reduce their taxable income. They are also less leveraged and so do not bump up against the interest deductibility limit in the new tax law.

Same industry, different impacts

Healthcare companies are a good example of how this legislation can affect companies differently within the same sector. HCA, the largest for-profit hospital company in the US, will benefit from the lower corporate tax rate for its hospitals, most of which are located in the US. HCA, which is levered at four times debt/EBITDA, does not incur enough interest expense to breach the interest deductibility limit. By contrast, Community Health Systems is levered at seven times debt/EBITDA, with interest representing 53% of EBITDA for 2018. Almost half of Community Health's interest expense will not be deductible from taxable income in 2018 and its ability to use NOLs to reduce future taxable income will be limited.

Banks are another sector to benefit from tax reform. However, large US banks first had to write down the value of their deferred tax assets (DTA) to take into account the new laws. During the credit crisis, US banks racked up billions in losses from impaired mortgages and other toxic assets, amassing DTAs they could use to defray future taxes. Struck at tax rates of 35%, the DTAs' new value at 21% has to fall in tandem. Citigroup, with the largest DTA, wrote down its value by $19bn and took the largest paper loss among peers in the fourth quarter of 2017. As a group, US banks do not have a significant level of earnings to repatriate. With the exception of Goldman Sachs and Citigroup, most major US banks conduct the lion's share of their business in the US.

Ultimately, banks see the tax law as favourable for them. Most had tax rates of 30% or higher - and now have effective rates of circa 20%. As financial intermediaries, any economic activity ignited by tax reform would eventually find its way onto banks' balance sheets. Concurrently, rates are rising, moving margins higher. Along with

lower taxes, less regulation and higher rates, bondholders should sleep well, knowing that governors of capital and liquidity remain in place. While banks will presumably pass some of their new profits along to shareholders, their capital levels stand strong at double what they were during the financial crisis. This gives bondholders the protection of a substantial equity cushion.

A positive impact across the economy

In summary, tax reform will be good for healthcare companies, banks and a host of other sectors - as well as the economy as a whole. Still, some sectors and individual companies will benefit more than others depending on how much debt they issue and/or where their operations are located. Also, while it will lead to better cash flows for corporates, as bondholders we are wary of excess cash just being returned to shareholders. Nonetheless, not only will the new law bring about lower taxes and boost companies' bottom lines, it should also spur new innovation and productivity — making America a more welcoming place to do business.

Table 1

Tax reform has mixed implications across companies

Tax Reform	Current Law	Final Law	Credit Impact
Corporate tax rate	35% tax rate	21% tax rate	Positive - improves cash flow
Pass through business rate	Taxed as ordinary income	20% deduction on pass through business income	Positive for REITS and MLPs - lower cost of equity
Net operating losses	Can be carried back two years or forwarded twenty years	Carrybacks eliminated and carryforwards indefinite but limited to 80% of taxable income	Negative for HY companies - NOLs have been used by HY companies - encourages investment
Accelerated depreciation	Capital expenditures depreciated according to useful life	Allows for full expensing of capital expenditure	Positive for industrial and technology companies - encourages investment
Repatriation	Foreign earnings are taxed when repatriated to the US	All existing deferred forreign profits will be taxed at 15.5% for investments held in cash and 8% for profits invested in illiquid profits	Positive - source of cash for companies with large overseas operations (technology and pharma)
Territorial taxation	Foreign earnings are taxed when repatriated to the US	Foreign earnings will not be taxed in the US. However, a base erosion avoidance tax will be phased in starts at 5% in 2018, rising to 10% through 2025, 12.5% thereafter	Modest positive - may increase taxes for some companies with foreign operations but companies will have more access to global cash flows
Deductability of interest	Fully deductible as interest expense	Limited to 30% of EBITDA the first four years, limited to 30% of EBIT thereafter	Mixed - limited impact on investment grade companies. Negative impact on highly levered, lower quality HY companies. Leveraged transactions among corporates are less likely

Source: Wells Fargo Securities

US Smaller Companies

Bigger is not always better

Ongoing economic strength and tax reform are fuelling corporate profits in the US for companies large and small. Meanwhile, wage growth and rising input costs are putting pressure on margins.

Ralph Bassett
Deputy Head of North American Equities
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Douglas Burtnick
Senior Investment Manager,
North American Equities
Aberdeen Standard Investments

One of the central strands of the tax reform package that recently made its way through the US Congress is a lowering of the corporate tax rate from 35% to 21%. US small-cap companies stand to benefit more than larger ones from this reduction given a higher proportion of their revenues and earnings are generated domestically when compared to big multi-nationals. Consequently, small-caps will see some of the largest reductions in ongoing tax rates. Accelerating GDP growth tends to favour them as well. Consequently, we expect profits growth of as much as 20% net of tax in 2018 for US smaller companies, with non-tax affected operating income rising by about 8% (see Table 1).

However, it is important to note that the broad-based benefit of low inflation appears to be coming to an end. This bolstered corporate margins over the past decade, pushing them through 2007 peak levels, but now looks set to fade given wage growth is starting to accelerate and raw material prices started 2018 at much higher levels than in 2017.

Table 1
Small caps but big earnings expectations

Calendar year EPS Growth	Russel 2000 Index	Russell Mid Cap Index	S&P 500 Index
2014	17.9%	15.2%	13.2%
2015	15.1%	9.4%	5.0%
2016	11.0%	8.8%	10.2%
2017E	13.0%	14.1%	13.4%
2018F	21.6%	22.0%	17.0%

EPS: Earnings per share
Source: Bloomberg, Aberdeen Standard Investments (February 2018)

Pricing power rules

We look for companies that can pass along input cost hikes; pricing power as a theme should be more important in coming years. A key characteristic of such companies is that their customers cannot do without them. Take Lippert Components Inc (LCI) as an example. LCI manufactures components and after-market parts for trailers and RVs, and acts as a distributor for some specialized RV and marine products. As one of the largest component makers for the industry, its share of dollar content per new RV has risen every year of this century. LCI is indispensable to its customers.

Based in a small town in Indiana where the labour market is extremely tight, LCI is experiencing wage pressures as it tries to service 15+% volume growth from customers. While LCI is vital to the ability of its customers to make and sell products, the original equipment manufacturers (OEM) who are the customers raise prices only infrequently

during a model year. Historically, OEMs have taken up to five months to acknowledge and be willing to pay for input cost shifts that start suddenly. As a result, LCI's margins are under pressure from both wage and input cost hikes – for now. That leads to some volatility in margins as prices rise, but not to permanent margin compression.

While the path may not be a straight one, we believe LCI should shortly be able to push pricing and margins higher, allowing earnings to rise on much higher revenue. In addition, LCI's tax benefits will partly fund higher wages and materials costs, helping to create more stable net margins for a company that has increased its reach over the past decade. Despite short-term challenges, LCI's story is attractive partly because of the significant improvement in its customers' end markets. RVs are becoming popular with younger people and the industry forecasts growth well in excess of automobile growth for the next few years.

Nursing wages and margins higher

Another example is AMN Healthcare, a temporary staffing company supplying nurses into a market struggling with a dearth of qualified staff. Given the shortage of nurses, temporary staffing services have become important providers of flexible labour. We like AMN Healthcare's much more direct approach to dealing with wage inflation and it has been able to pass wage hikes for temporary workers through to end customers, usually hospitals. As a result, AMN's core employees have enjoyed wage gains well ahead of those in the general economy in recent years and the company's gross margins have expanded every year since 2008.

Solid conclusions

In addition to having businesses that sound decidedly low-tech and even unexciting, both LCI and ACM share other characteristics, such as solid balance sheets and high conversion of earnings into cashflow. Those things matter in any environment, but in one where interest rates might rise further our preference is for higher-quality business models that are sustainable even in the case of a policy mishap.

Recently, we have observed markets quickly and somewhat indiscriminately adjusting stock prices, presuming higher earnings as a result of the Tax Cut and Jobs Act. Now there is a more thoughtful reassessment of the real winners and losers of the evolving environment. We view small-cap companies as somewhat undervalued relative to the longer-term premium to large-caps which they deserve. We also recognise the need to be selective about which smaller companies to own. After all, the impacts of inflation, tight input markets and increased competition from companies "reinvesting their tax windfall into price competition" differ across companies. As a result, we look for a smaller and carefully selected group of companies that share strong financial characteristics and the ability to deal with the changes in an economy that has already been expanding for nearly nine years.

Responsible Investing

Opioids - when the remedy is the tragedy

Andrew Mason

Responsible Investment Analyst, ESG, Aberdeen Standard Investments

Opioid overuse is taking a financial toll on the US economy; investors should engage with companies producing the drugs and those offering treatments and working towards better outcomes.

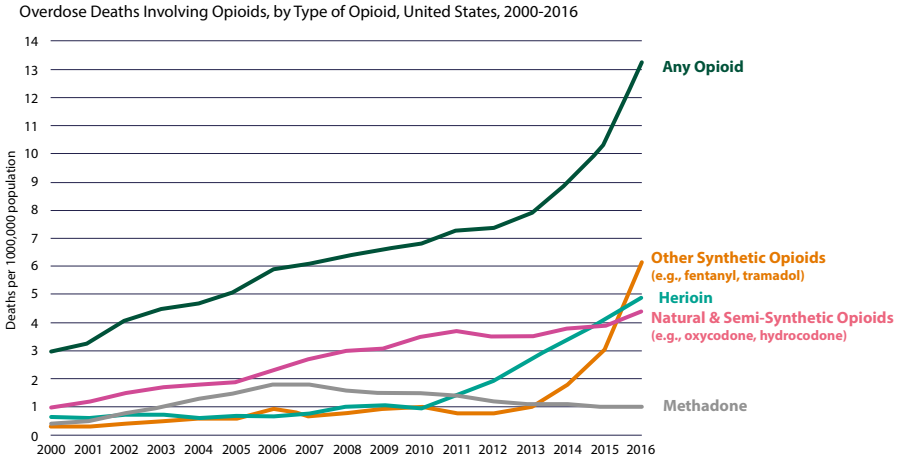
Opioids are a class of drugs that includes heroin, synthetic fentanyl and legal pain relievers that are available with medical prescription. The misuse of opioids has been an ongoing issue in the US since the late 1990s; however, it has recently begun to escalate rapidly. Opioids act upon opioid receptors and provide pain relief to patients. The original use of opioids in the US was largely focused on cancer patients.

Thanks to the availability of affordable generic drugs, the use of opioids has now spread to primary care and prescription pain killers. Prescription opioids and illegally obtained opioids can be highly addictive.

Between 1999 and 2013, the volume of prescription opioids dispensed in the US nearly quadrupled. As a result, the country currently uses more opioids than the rest of the world combined. Overdose deaths from prescribed opioids have increased considerably. Legal opioids use has also led to the increased use of other drugs, such as heroin and fentanyl.

Chart 1

The lethal consequence of opiods abuse



Source: Centers for disease control and prevention (as of December 2016)

A social and economic tragedy

The economic burden of opioid abuse in America is estimated to be $78.5 billion a year. According to a report in the Journal of Medical Care, the majority of these costs are met by the public purse. These figures are set to rise, with profound long-term economic implications. Already, greater attention is being given to opioid business risk and the potential impact on labour force participation and productivity. In 2014, 27 million Americans aged 12 or older, or 10% of this part of the population, were users of illicit drugs.

However, companies are starting to respond to the crisis. In January 2018, insurer Cigna dropped coverage for oxycodone from its group health plans in an effort to reduce opioid misuse. Individual states and regulators have also acted, spurred by the US Food and Drug Administration's request in June 2017 that Endo Pharmaceuticals remove an opioid medication from the market.

Recently, a US court ruled that a generic form of Indivior's Suboxone Film, an opioid addiction treatment, does not infringe on the British pharmaceutical firm's patents, some of which will not expire until 2024.

A legal drug

Opioid makers and distributors are coming under heightened legal and legislative scrutiny. A growing number of US jurisdictions have filed lawsuits against opioid companies, citing negligence. Corporations facing legal action include Allergan, Endo, Johnson & Johnson and Cardinal Health. Allegations relate to failure to adequately disclose the addictive potential of opioids, and failure to report suspicious spikes in the sale or distribution of opioids to drug enforcement authorities, as mandated under US federal law.

In addition to this drive from regulators, companies may also face further headwinds from investors. Investors for Opioid Accountability is a coalition of 30 treasurers, asset managers, faith-based institutions, and public and labour funds with over $1.3 trillion in assets. It is filing multiple shareholder proposals with various opioid manufacturers and distributors relating to board oversight of the business risks related to opioids.

Given the size and nature of these class action lawsuits, they have understandably been compared to previous cases brought against tobacco companies – including the prospect of sizeable compensation payouts. However, unlike tobacco, opioids have a positive impact for millions of sufferers with a range of illnesses. The availability of generic drugs has also made this pain treatment more affordable. As such, the various lawsuits and shareholder motions may have unintended consequences. For example, producers may stop making those medications that have been the target of lawsuits, thereby depriving access to affordable pain relief for genuine users.

Much more to do

Of course, pharmaceutical companies that have been judged to have acted inappropriately should be held to account. However, we should not lose sight of the fact that through the production of new medicines and by offering support to those facing addiction, the sector can play a significant role in tackling the epidemic. In addition, addressing the crisis should not only rest with pharmaceutical companies: we believe the regulator, lobbyists, distributors, point-of-care providers and users all have a role to play.

Opioid addiction is a social tragedy. For investors, its economic consequences cannot be ignored. Investors need to use their influence to encourage companies to adopt best-practice social and governance standards. Acting in the interest of society ultimately protects and enhances the value of clients' investments. This means not only understanding the financial implications of this crisis, but also encouraging companies to strengthen their opioid risk management programmes.

As investors, we have commenced engagement and will continue to talk with investee companies that produce and distribute opioids. We recognise the positive steps that the sector has already taken and will encourage companies to monitor the size of orders; educate users and prescribers; ensure board oversight of opioids sales; and keep in mind the rising economic and social costs of opioid overdoses and long-term recovery treatments.

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