



Global Outlook

August 2017

The August edition of Global Outlook provides a snapshot of how our fundamental analysis helps shape our investment decision making. This ranges from tools to better understand how economies are evolving in real time, to a deep dive into how structural change is reshaping individual markets and sectors. This combination of cyclical and structural analysis is critical for identifying where we can find the best risk-adjusted returns across the globe.



Standard Life
Investments

This document is intended for institutional investors and investment professionals only and should not be distributed to or relied upon by retail clients.

House View

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

August 2017 House View		
Risk	The Global Investment Group retains a cautious medium-term outlook, as a variety of political, financial 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	Tighter labour markets and rising wages give the Federal Reserve the rationale to continue adjusting monetary policy, with upward pressures on core inflation a key signal for more aggressive action.	LIGHT
European Bonds	Bonds are not well supported, as the improvement in activity across more economies allows the ECB to plan policy tightening. Markets, however, are over-pricing future inflationary pressures.	LIGHT
UK Gilts	The outlook for interest rates remains mixed while the economy faces both higher inflation and downward pressures on economic activity. Yields are constrained by regulatory driven flows. However, the asset class is expensive on long-term valuation metrics.	NEUTRAL
Japanese Bonds	The central bank is still attempting to reflate the economy with its QE and yield curve control policy alongside negative short-term rates. The absence of yield makes this asset class relatively unattractive.	LIGHT
Global Inflation-Linked Debt	Inflation is generally well contained globally with break-evens largely reflecting this. There is more potential downside for UK and European inflation markets but the US could re-price higher.	NEUTRAL
Global Emerging Market Debt	Local currency yields are more attractive due to emerging market sensitivity to the pick-up in global growth. US dollar-denominated debt is supported by attractive spreads over Treasury debt.	HEAVY
Corporate Bonds		
Investment Grade	QE supports UK bonds, but has driven European yields to unattractive levels. US credit spreads are less attractive as Treasury yields increase, and riskier assets are preferred.	LIGHT
High Yield Debt	The hunt for yield has driven investors to this asset class, although overcrowding remains a risk in some sectors, especially in the US when monetary policy is being tightened or oil prices are under pressure.	NEUTRAL
Equities		
US Equities	While stock market valuations are fairly full, equities can rally further on the back of improved global economic conditions feeding into strong profits growth, with the potential for fiscal easing and more deregulation.	HEAVY
European Equities	Corporate earnings are improving on the back of a widespread pick-up in economic growth across the region plus stronger international trade flows. Investor sentiment is positive with sizeable inflows from overseas buyers.	MOVED TO VERY HEAVY
Japanese Equities	The market looks attractive as easy monetary policy and fiscal stimulus are helped by efforts to improve corporate governance, share buybacks and business investment. However, yen strength periodically remains a concern.	NEUTRAL
UK Equities	UK economic growth expectations are weakening and Brexit remains a longer-term threat. Sterling remains the primary driver of the relative attractiveness of UK companies with overseas exposure.	NEUTRAL
Developed Asian Equities	The improvement in the global economy supports this market, but Chinese policy tightening risks curbing fixed asset investment and property demand, which is a large driver for the region.	NEUTRAL
Emerging Market Equities	Emerging market assets are attractive as global economic growth improves, especially for key sectors such as Asian technology. A tightening bias in China is a headwind for the asset class.	NEUTRAL
Real Estate		
UK	The UK real estate cycle is at a mature stage and there is limited further expected capital growth. Income remains attractive, although risks are elevated should conditions turn recessionary or political uncertainty grows.	NEUTRAL
Europe	European property is supported by stronger economic growth and low levels of new supply. However, valuations are not as compelling against the backdrop of a less supportive stance by the ECB.	MOVED TO NEUTRAL
North America	The US market has low vacancies across most sectors and markets, although the sizeable retail sector is coming under more pressure. Elsewhere, new construction is mostly in check, providing a window for rental growth.	MOVED TO NEUTRAL
Asia Pacific	An attractive yield margin remains, but yields have bottomed in most markets. Income returns are driven by modest rental growth on the back of low vacancies and healthy tenant demand.	NEUTRAL
Other Assets		
Foreign Exchange	The major currencies are within broad valuation ranges. The yen is preferred in portfolios as a diversifier against the risk of a noticeable decline in global activity or a serious political shock.	NEUTRAL \$, €, £, HEAVY ¥
Global Commodities	While commodities are supported by the slow improvement in global growth, they are very sensitive to Chinese policy tightening and some commodities, such as oil, face a difficult demand/supply balance.	NEUTRAL
Cash		
	With global yields still extremely low, we still see better opportunities in risk assets.	LIGHT

Foreword

Editor



James McCann
Senior Global Economist

As we move into the second half of 2017, it is useful to take stock of how markets and economies have fared thus far. On the economic front, the tone has been firmly upbeat, with a cyclical upswing boosting activity rates across the global economy. This has provided a supportive backdrop for risk assets, helped push volatility lower and added fuel to the debate in bond markets around how quickly central banks are likely to withdraw support. Andrew Milligan, Head of Global Strategy, casts his eye forward in the latest House View article, outlining where we expect the best risk-adjusted returns as we move through the second half of the year.

The impact of the recent economic upswing on markets illustrates the importance of accurately forecasting these turning points. However, this is easier said than done, especially when shocks cast additional uncertainty over the outlook. The difficulties that UK forecasters have encountered in the wake of the EU referendum provide a case in point. Abigail Watt, Statistical Analyst, has written this month's Spotlight article outlining a new suite of analytical tools that aim to help monitor activity across the UK economy in real time. These tools provide a useful input in helping form our economic, policy and market views.

Credit investors always need to be closely attuned to the state of the cycle. Mark Munro, Investment Director Credit, takes a look at valuations across the global credit market. While spreads are not at record lows, they look relatively tight in most markets. Indeed, there are some segments where we consider they are not providing sufficient compensation for the underlying risk. More opportunities are seen at a sector level, particularly in the financial sector, which continues to make progress in cleaning up its troublesome areas.

While the cycle is important, this should certainly not be an investor's only focus. Indeed, this needs to be complemented by an understanding of how structural changes are influencing economies, markets and sectors. Svitlana Gubriy, Head of Global REIT Funds, has written about technological change and how this is rapidly and dramatically impacting the real estate market. Critically, these trends look to have a lot further to run, providing exciting investment opportunities. Our commitment to fundamental analysis and research also helps unlock these opportunities in the small-cap market. Alan Rowsell, Investment Director Smaller Companies, discusses some of the most compelling investment cases he is finding in the diverse global small-cap universe.

House View

Steady as she goes

A broadening recovery supports risk taking. However, in some areas the danger of policy errors should not be ignored, while valuations are also important.



Andrew Milligan
Head of Global Strategy

Over the summer, there were several occasions when investors took profits in equity markets, before confidence resumed and markets reached new highs. Part of this can be explained by greater uncertainty about how rapidly monetary policy will alter over coming months, and partly because of shifts in newsflow from some key sectors. While the outlook for corporate profits growth remains very positive into 2018, the House View is also assessing such issues as the risk of policy errors, whether political uncertainty could revive, and the valuations of certain assets. All in all, the House View remains pro-risk, but is not looking to add extra risk to portfolios.

Profits progressing

The House View performed well in the first half of 2017. This reflects its exposure to global equities in an environment of slowly accelerating global growth and better corporate profits. The global Purchasing Managers' Index for services and manufacturing currently suggests that growth is running at around a two-year high in these sectors, corroborated by a clear pick-up in global industrial production (see Chart 1). Some financial imbalances are appearing and require monitoring, such as US sub-prime auto loans, peripheral debt levels in Europe and financial sector debt in China. However, conditions do not look to be falling into place that would bring about a sharp economic slowdown in the immediate future.

The combination of better top-line sales and strict cost control for most companies has benefited corporate earnings. Profits growth for the S&P 500 Index in Q1 2017 (using this as a global proxy) was up about 14% from a year earlier. Expectations for the Q2 earnings season are about 5-10% growth. Although the best of the improvement in company profits was probably seen over the first half of 2017, our analysis suggests only a moderate slowdown into 2018. Operational leverage looks to remain strong at this phase of the cycle, especially in Europe.

Diving beneath the surface, there are a number of drivers to monitor for individual sectors. These include the relative steepness of the yield curve, which will feed into expectations around net interest margins in the financial sector; the impact of the moderate slowdown in the Chinese economy on

commodities; the ongoing disruption from online shopping on the traditional retail sector; and the anticipated slow expansion of capital spending as businesses put cash to work. Indeed, sector analysis is becoming more useful in order to understand wider market movements. For example, a key feature of the US stock market in the second quarter was the underperformance of the technology sector, as we saw profit taking and a rotation into other cyclical and financial stocks. This underperformance then snapped back as earnings reports revived confidence.

Baffled bonds

Debate is growing about the medium-term outlook for bond markets, a debate spurred on by the differences between central bank rhetoric and the underlying economic data. In recent weeks, more central bankers have stated that they see the conditions falling into place for a withdrawal of some of the monetary support they have provided to the global economy. The European Central Bank (ECB), the US Federal Reserve (Fed), the Bank of Canada, the Bank of England and People's Bank of China could all move to tighten policy during 2018, either through higher rates or by tapering QE programmes. In response, we have seen yields back up – quite sharply in places such as Germany.

At the same time, core inflation pressures look to be very contained over the short and medium term (see Chart 2). Cyclical forces include excess Chinese industrial capacity and continued slack in the European labour market – although there is always uncertainty around these supply-side assumptions. On the structural front: changes in labour market wage negotiations, and therefore the shape of the Phillips curve; the impact of automation, globalisation and technology on pricing power; and enhanced price discovery for households and businesses have all been flagged as potential drags. Consequently, we expect core inflation to remain restrained in coming months. This means the Fed and the ECB should act in measured ways when they withdraw policy. Otherwise, our concern would be that a major policy error is appearing.

Problematical politics

A variety of political risks still exist, which can trigger or exacerbate cross-border flows. Some relate to events such as the unexpected UK election result or, looking ahead, a variety of scenarios for the eventual Italian elections. One example of a significant change in investor flows is while capital flowed into US assets at the time of the US presidential election, this has clearly moved into European assets more recently. President Macron's victory has supported hopes of reforms at the local and, indeed, Eurozone level, alongside a clear improvement in region-wide growth. Other risks are more structural in nature, such as the various pressure points facing the Eurozone in relation to banking and fiscal union, or for the Trump administration as it tries to press ahead with politically difficult policy changes. Nevertheless, we are reassured that investors are taking political risks in their stride and that tail risks are less worrying, even if, like the forthcoming debt ceiling debate, they can cause short-term market volatility. A concern remains that political challenges constrain the ability for many governments to make growth-friendly policy changes. However, this matters more for longer-term growth and asset returns than the potential for near-term cyclical upswings.

Less volatile volatility

Volatility remains generally low, notably so in equity markets (see Chart 3). Several factors are driving this. Firstly, the economic outlook looks to be relatively stable, over the near term at least. Secondly, the prior environment of 'risk-on risk-off', where most assets moved at the same time, say in response to US tapering or Chinese currency moves, has been replaced with a more fragmented environment. Now, share or corporate bond prices of different companies move higher or lower as they react to specific triggers. Technically, this leads to a situation where overall market volatility is lower.

The lack of volatility in bond, currency and equity markets is not of itself a concern but it is explicable in terms of the macroeconomic environment and the changing relationships between companies and sectors. Our House View would not be surprised if there was a pull back in risk assets given strong recent performance, especially when looking at relatively rich valuations. This would be an opportunity to consider whether to add more risk. In a world where economic growth is structurally low, and when the risks of a recession look to be muted in the near term, it is necessary to dial up the risk level to generate the higher returns required by investors. However, trading opportunities should only be seized if the risk of policy error still looks to be low.

The House View

Into 2018, we expect global equity markets to benefit from more confidence about a continued expansion, sustaining buoyant corporate cashflow. There is potential for fiscal policy to provide an additional boost to the short-term cycle. Much will depend on the US and the ability of the Trump administration to push through a stimulus, which would likely largely consist of income and corporate tax cuts, before the mid-term elections in autumn 2018. Our favoured equity markets are the US and Europe, and to a lesser extent various emerging markets, while we are neutral elsewhere.

We held overweight positions in commercial real estate, which benefited from economic acceleration, but have since moved towards neutral positioning. Although global real estate remains an attractive asset class in a world of slow growth, valuations mean that the bulk of the future return is expected to come from rents.

Turning to fixed income, valuations again remain an important consideration, despite the recent upward move in bond yields. The only market which we favour is emerging market debt, where spreads look to provide adequate compensation for investment risk, even if growth in China is constrained. Overall, the House View does not consider duration to be a dangerous position to hold in portfolios. It is practical to own some, whether through fixed income, real estate or certain equities, even though these assets are expensive. However, we consider that the benefits from doing so are likely to be limited. Accordingly, we are neutral to underweight in most government and corporate bond markets.

Chart 1
Producing returns

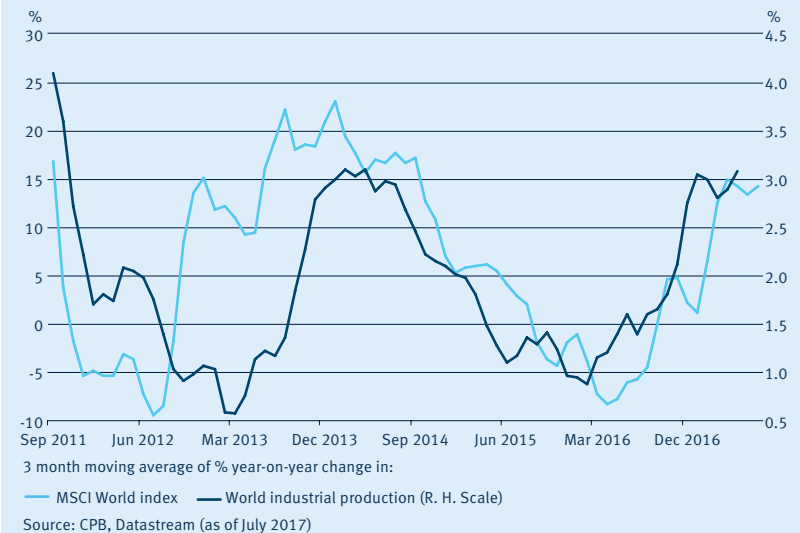


Chart 2
Falling short of target

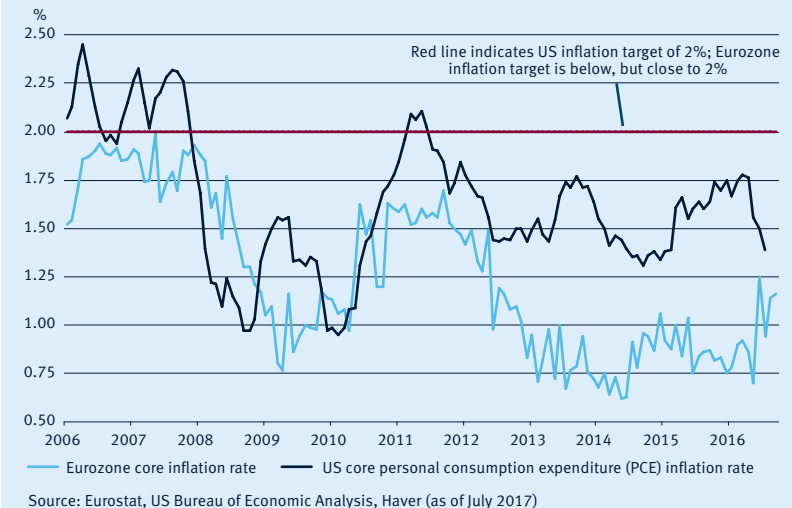
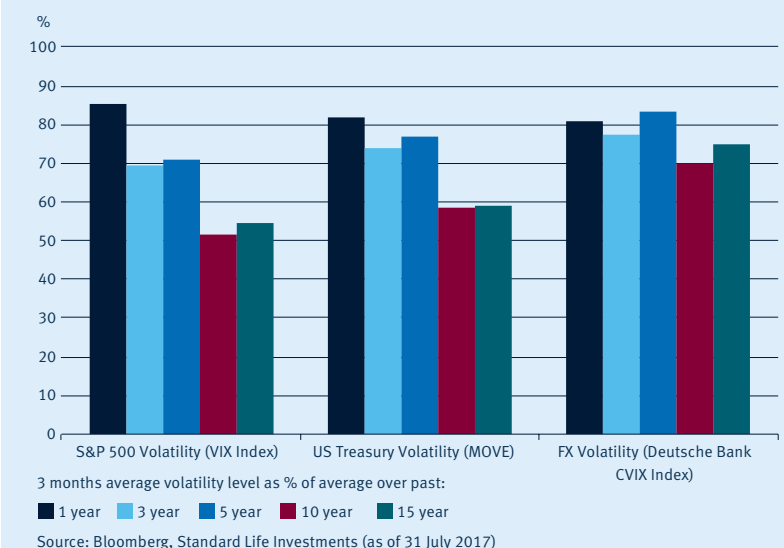


Chart 3
The great unwind approaches



Global Spotlight

Taking the temperature of the UK economy

The UK confounded expectations in the wake of the European Union (EU) referendum. We have therefore developed new tools to help us better understand how the UK economy is performing in real time.



Abigail Watt

Statistical Analyst, Global Strategy

The vote to leave the EU last June was expected by many, including ourselves, to generate an immediate shock to the UK economy. While the Bank of England (BoE) was among the more optimistic forecasters, it still expected the economy effectively to stall in the aftermath of the vote. This gloomy consensus was confounded, as the UK economy delivered growth of 2.3% in annualised terms over the second half of the year. The challenge for economists and investors alike during this period was how to accurately track developments in the economy, in a timely manner, in order to understand how activity was faring relative to expectations. One particular problem lies in the long lag times in the release of economic data. For example, the preliminary estimate of UK GDP is not released until approximately a month after the end of each quarter and this estimate only contains around 40% of the information incorporated in the final report. In response, we have developed a new set of analytical tools to help overcome these data issues and to provide a better estimate of economic activity in real time.

Speeding up, or slowing down?

The first of these tools is a dashboard which aims to provide a visual representation of activity across the different parts of the UK economy (see Table 1). The dashboard is compiled from over 100 different monthly data series, which we have normalised in order to make them more comparable. We split these data into 10 different sectors, and built a weighted aggregate indicator for each of these parts of the economy. For instance, the construction indicator draws upon a weighted aggregate of survey data such as the construction Purchasing Managers' Index (PMI) and expectations of construction output from the BoE's agents' survey. To determine the weights, we use principal component analysis to extract the contribution of each series to the common cyclical component in the data set as a whole. This is complemented by additional subjective judgement we use to weight the series to match the relationship with the economic cycle.

We have used colour coding for each of the individual indices to allow the reader to glance quickly across the dashboard and gauge the relative health of each sector, and the overall economy, through time. Red indicates that activity in a sector is running well below average, while green represents better-than-average growth. The first conclusion is that there was very little in the way of an activity shock to the UK economy immediately after the referendum. Indeed, while activity has been a little bumpy and uneven, the overall picture was still overwhelmingly green. Certainly, this would have been a useful signpost that the estimates of a fairly immediate growth shock after the referendum were too pessimistic.

Keep calm and carry on?

Diving deeper into the sector stories can provide insight into the drivers of growth. Perhaps the biggest surprise after the vote came from the consumer side, with our household spending indicator accelerating over the second half of 2016. This incorporates a mixture of hard economic data, such as retail sales, to survey data including consumer confidence measures and signals on expected retail sales from the CBI distributive trades survey. Launched in 1983, the CBI's widely followed survey covers questions on sales, orders, stocks, general business situation, employment trends and internet sales. Forecasters had anticipated that the uncertainty around the referendum result might deter spending, particularly

Table 1
Warning lights

	Monthly Average												YTD	Monthly																		E
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17		
Financial Markets																																
Monetary Conditions																																
Production																																
Construction																																
Housing																																
Household Spending																																
Fiscal																																
Labour Market																																
Services																																
Trade																																
Economic Aggregate																																

E= Estimated

The colour grading represents the strength of the indicator versus its history:

red cells indicate values lower than -1.5 standard deviations from the mean, green cells indicate data greater than 1.5 standard deviations.

Source: ONS, Bank of England, Haver, Standard Life Investments (as of June 2017)

Chart 1
Tracking UK activity



around ‘big ticket items’ such as car purchases. Not only did this not happen, but retail sales growth moved nearly two standard deviations above its longer-term average over the second half of the year.

Interestingly, the dashboard is now showing a moderation in this impulse. The softness in the indicator is largely driven by poorer retail sales data, which is being reinforced by weaker expectations around sales in survey data. This caution does not look to be related to the labour market, which continues to perform strongly across a number of measures according to the weighted index in our dashboard. Instead, it seems likely that a rapid increase in inflation is weighing on consumers’ real incomes, holding back spending. We will watch the dashboard closely for signs that soft spending is set to remain a drag on overall activity.

An opportunity to rebalance?

A potential flip side of currency-induced weakness in consumption was that a more competitive exchange rate for the pound versus other major currencies might help boost exports. Indeed, members of the BoE’s Monetary Policy Committee (MPC) have speculated whether rising net exports, production and investment could offset any drag from weakness in consumption. Our dashboard allows us to monitor developments in these sectors. On the trade side, our indicator has indeed strengthened given improving export order books data from the CBI industrial trends survey and an expansion in services exports.

However, while the production indicator increased in late 2016, it has gradually softened over the course of this year. This has been corroborated in official data, with the growth in total production contracting by 0.4% in the preliminary Q2 GDP estimate. Interestingly, survey indicators which feed into the production index have generally been more upbeat, particularly the latest CBI report. We will need to watch our dashboard closely to see how the differences in the signals given by sentiment indicators and hard data are resolved.

Money’s too loose to mention?

The dashboard signals extremely easy monetary conditions at present. This incorporates low mortgage rates, corporate lending rates and the trade-weighted sterling exchange rate. Monetary conditions were already loose going into

the referendum, and eased even more afterwards on account of two forces. First, we saw a large depreciation in sterling exchange rates as market participants looked to disentangle the long-term effect of the EU exit on the UK economy. Second, the BoE cut rates and launched a new round of quantitative easing in August 2016, which weighed on the domestic interest rate structure.

Easy monetary conditions have likely supported activity over recent quarters. There have been signs that certain members of the MPC are becoming uncomfortable with the degree of support on offer at present. Certainly, it is a difficult environment for policymakers as the economy shows signs of slowing, while inflation pushes above target and the labour market tightens. This perhaps puts more pressure on the Financial Policy Committee (FPC) to ensure that very accommodative monetary conditions are not creating financial imbalances. The FPC recently flagged its concerns over the trends in consumer credit. More regulatory action here could make the BoE more comfortable that its monetary policy is not creating risks to longer-term financial stability.

Putting the pieces together

Building on our analysis at the sector level, we have created an indicator to track overall activity in the economy. This uses principal component analysis to extract the common variation across our entire dataset, and regresses this on GDP. This monthly activity index is compiled through the quarter and ahead of the release of GDP statistics, providing us with some early guidance as to how activity levels in the economy may be changing.

The UK Activity Indicator has performed relatively well over time, with the pattern of quarterly growth in periods generally well captured by this tool (see Chart 1). However, one challenge to this framework is a heavy reliance on more timely survey data when estimating real time growth. Indeed, there have been periods in which these data have overreacted to uncertainty. For example, in the wake of the UK’s EU referendum we saw a sharp fall in sentiment surveys. This led our indicator to expect weaker growth than the 0.5% quarter on quarter that was delivered. Misleading signals from survey data can also run in the other direction. Indeed, over recent months the signals from business surveys have been decidedly more upbeat than the underlying growth rate reported in hard activity data. This has led to our indicator overestimating recent growth. With this in mind, this is a tool that we use alongside our dashboard and regular forecasting work in order to try and understand how the economy is performing.

Not finished yet

The dashboard and activity indicator allow us to track the performance of the UK economy in greater detail. With the ongoing uncertainty surrounding the UK’s future relationship with the EU, it is ever more important to gauge the health of the economy in a timely manner. Indeed, this will help us to assess better how the BoE sets both monetary and financial policy and the expected performance of local assets. However, more work is required to deepen our insights into measuring activity in real time. Indeed, we are working on incorporating dynamic factor analysis into our activity indicator in order to build a more robust ‘nowcast’ of prevailing growth rates. The quest to understand how economies are performing in real time continues...

Smaller Companies

A world of small-cap opportunities

For active investors, there is a huge range of compelling investment opportunities across the small-cap universe.



Alan Rowsell
Investment Director, Smaller Companies

New styles of investing

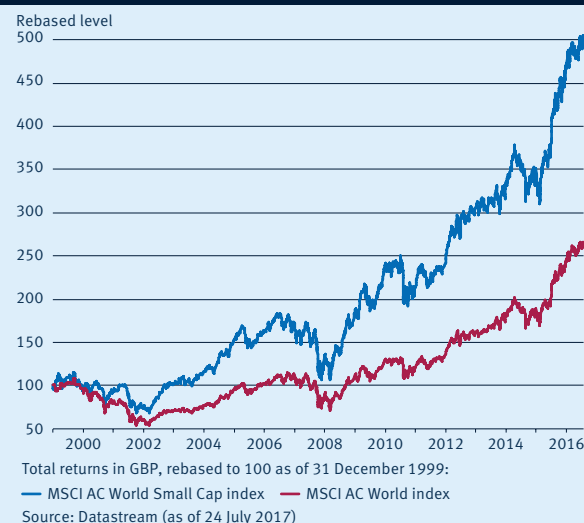
The rise in passive investing has been a major theme of this market cycle. Data in the US suggest that passive funds now represent about 22% of the total US stock market; at least 25% of its trading volume; and broadly 40% of US equity fund assets. Such a trend has been seen in both big and small company stocks, in the US and in many other countries too. Given the strong historical performance of small companies (the MSCI AC World Small Cap Index has delivered a return of 384% since 2000); it is easy to see why investors are looking for profitable ways to invest in this sector. The attractions of simply buying stocks contained in the small-cap index are understandable; however, we need to consider a number of characteristics of this particular market.

Diluted returns, higher risk

One issue with passive investing in global small caps is that the breadth of the investment universe can provide too much diversification. With an index containing 6,000 stocks, representing 70% of the world's publicly listed companies, the MSCI All Country World Small Cap Index is effectively a proxy for the global economy. An investment at the index level therefore lacks a clear focus. Moreover, exposure to all the index's companies, in all sectors, in all countries means that passive investors hold all the 'losing' stocks, as well as the 'winners'. At the small-cap end of the market, there are more firms losing money, namely 17% of the companies in the global small-cap index compared with only 8% in the global large-cap index, according to a Bloomberg article dated 30 June 2017. The discrepancy is even larger if we compare the Russell 2000 Index of smaller companies in the US, where 31% of companies are lossmaking, compared with only 6% of the S&P 500 Index. This large 'tail' of low-quality companies dilutes returns.

In addition, lower-quality companies tend to be more volatile. The higher proportion of these in small-cap indices raises volatility compared to large-cap equivalents. This might be tolerable for long-term investors who are prepared to weather ups and downs, but it can be painful during downturns. Indeed, this has created a perception among investors that small-cap investing is especially risky, when in fact it is mostly a function of the differences in index composition. The question for any investor is whether accepting this distortion means taking on unnecessary investment risk.

Chart 1
Good things come in small packages



Focus on quality companies

Our investment process aims to exclude low-quality, risky companies and focus only on identifying higher-quality companies. The breadth of the global small-cap universe provides a range of countries and sectors in which to seek compelling opportunities. We believe one such case is Sunny Optical, a Hong Kong-listed company that makes camera modules and lenses for smartphones and vehicles. The company is benefiting from the transition to dual cameras on the back of smartphones, which give sharper pictures. Sunny is also the world leader in vehicle lenses, with increased adoption likely in coming years due to legislation in Europe and the US, and the arrival of autonomous vehicles.

Another example that fits our criteria is US company Align Technology. It is the market leader in clear dental aligners under the Invisalign brand. Sales are growing in excess of 20% annually as these displace traditional fixed wire braces with less noticeable, more comfortable and more effective aligners. Technological innovation and patent protection provide barriers to entry, which should help provide sustainable market leadership and continued market penetration. Innovation such as the company's SmartTrack aligner material has enabled it to halve treatment time, extending its lead over the competition further.

Finally, Teleperformance, a French company that is the global market leader in call-centre operations, is gaining market share as more businesses outsource to specialist firms. The outsourcing trend has a long way to go, as 75% of call centres are still operated in-house according to a study by Everest Group, in our view providing ample room for growth.

Such firms provide good examples of the diverse range of investment opportunities to be found in the small-cap segment of the global equity market. When this approach is implemented successfully, it can lower portfolio volatility, especially during market downturns, and increase returns. In the small-cap universe, higher risk does not necessarily equal high return, and our view is that it is often in the lower-risk companies that we can find the best long-term investments.

Total Return Credit

Can you bank on it?

Careful stock selection is becoming increasingly important at this stage of the credit cycle.



Mark Munro

Investment Director, Total Return Credit

Taking stock

Investors have enjoyed robust returns from credit markets this year. Following a strong run, it is timely to look at where we stand from a valuation viewpoint. Chart 1 shows the level of current spreads for different markets (red dots), the 25th to 75th percentile range by daily observation that the spread has traded in since 2001 (blue boxes) and the full range of spreads over the same period (blue candle-stick lines). We can draw some broad conclusions from this snapshot.

First, spreads are generally approaching the tightest levels since the 2008 global financial crisis but are still above record lows. There are areas in which spreads no longer look to be providing sufficient compensation for the underlying risk. In particular, CCC-rated debt screens are 'unattractive', and we no longer have exposure to this market in our portfolios.

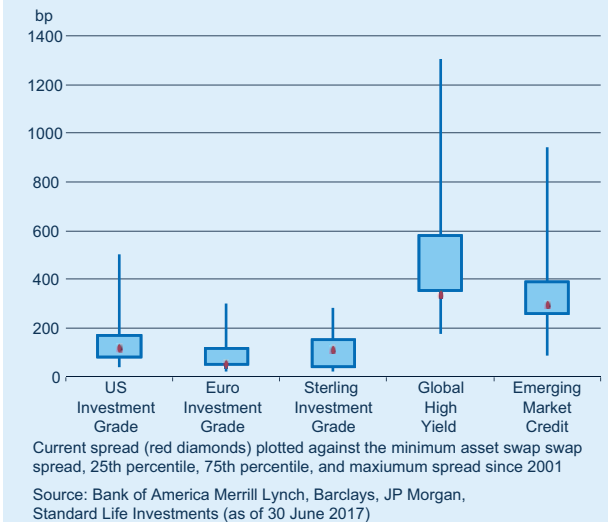
Second, spreads typically linger within a fairly constrained range through the cycle. This suggests that the opportunity to add strong returns from this point can best be exploited not through asset allocation between market segments, but rather by focusing on idiosyncratic risk and bringing together the highest conviction views at the stock level from around the globe.

Finding value in banks

On this note, one of the most pronounced trends in credit markets this year has been the outperformance of financial versus non-financial companies. Barclays' Contingent Convertible Banking Index delivered an impressive 8.5% return over the first half of 2017. Concerns over the outcome of the French presidential and legislative elections, and wider implications for the Eurozone, provided a good opportunity to add subordinated French and Italian bank risk at attractive levels. The market-friendly result supported a strong rebound in these banks and, in many cases, these have outperformed over the year-to-date.

Shifting perceptions of politics are not the only important development in the sector over recent months. Indeed, we witnessed three European banks fail during the second quarter. The first was Banco Popular in Spain, weighed down by a high stock of non-performing loans (NPLs).

Chart 1
Not spread that tightly



Equity and subordinated debt were wiped out while senior bond obligations were taken on by Santander, which will raise equity to fill the capital shortfalls. Similarly, Intesa Sanpaolo stepped in to rescue both Veneto Banca and Vicenza Banca in Italy, taking the good assets, deposits and senior unsecured debt.

What have we learned from these events? Certainly, it is clear that subordinated debtholders run the risk of suffering losses under the new bail-in regime. As such, stock selection and investing in the correct names will remain of utmost importance moving forward. Senior debt was not bailed-in, although none of the failing banks had 'non-preferred' senior debt outstanding. The direction of travel is for banks to issue such debt, which can trigger losses for bondholders in liquidation.

Interestingly, there was a glitch in the Italian case, with the state providing €17 billion to Intesa to deal with NPLs and restructuring charges. This has been controversial, but we interpret it as a sign at the European level that there is now a distinction between national champions and weaker banks. Indeed, the former is likely to be part of the solution to 'clean up' weaker sections of the financial system.

In the recent past, bank failures would have been viewed by the market as systemic, with negative consequences for credit across the sector. It is an important yardstick on the health of the financial system that three bank failures were shrugged off by investors, and instead viewed as further progress to fix troublesome areas. Progress on dealing with NPLs, still attractive relative valuations, strengthening balance sheets and the potential tailwind from rising interest rates all continue to make us favourably disposed to the sector.

Fail to prepare...

The final point to take from Chart 1 is that when the next global recession does hit, spreads can move swiftly and aggressively wider. While we do not anticipate a downturn in the short term, it is prudent to start exploring strategies that can tackle that eventuality at this stage of the cycle. In particular, strategies that benefit from rising volatility in equities and interest rate markets will be of increasing value to investors.

Real Estate

Facing the digital revolution

Technological change is transforming the real estate industry, creating new investment opportunities.



Svitlana Gubriy
Head of Global REIT Funds

Digital disruption and real estate

Digitisation is creating waves across the global economy. This trend is fundamentally reshaping business models; changing how products are designed, produced and distributed; and impacting how companies communicate with, and provide services to, customers.

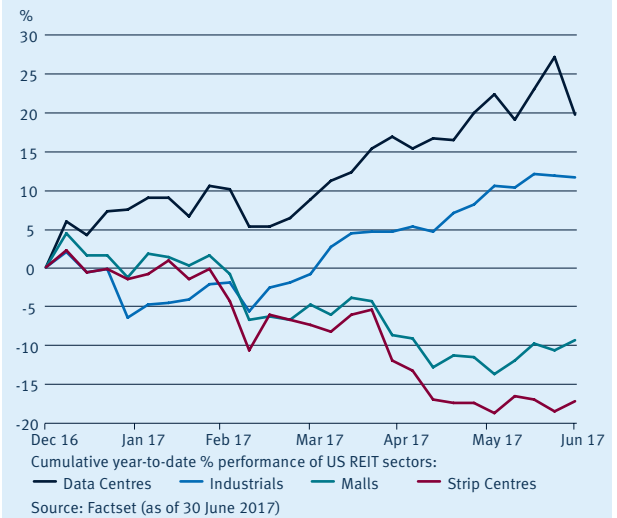
In real estate, this transformation is creating a snowball effect. It is changing how and where employees work, shop and live. In response, office and workplace requirements are evolving toward collaboration and connectivity. Physical retail is being refocused toward brand interaction and consumer experience. Moreover, the requirement for data analysis, storage and transmission has expanded enormously. These trends challenge the traditional definition of real estate.

The face of change

Traditional real estate is adapting as the business models of its tenants evolve. Moreover, new forms of property are becoming an integral part of this transformation. Omni-channel retailing provides a good example of these shifts. With customers shopping 'anywhere, anytime', the role of a retail store has evolved. The store is becoming a focal point for brand-building and face-to-face customer interaction, rather than just a distribution point. At the same time, retailers' focus on improving logistics and fulfilment strategies is transforming industrial and logistics real estate. Finally, the direct 'brand-to-consumer' channel is becoming increasingly important as manufacturers become more able to market and sell products directly to consumers. The fortunes of different retail and industrial sectors this year underline the importance of this shift for investors (see Chart 1).

We are also seeing over-the-top (OTT) content providers like Netflix and Amazon disrupt the traditional TV and movie industry. New media services streamed over multiple devices are changing the dynamics of broadcasting. OTT content providers require scalability and flexibility to produce original content. In 2015, Netflix announced it would shoot its new show completely at its own studio, leased in Los Angeles. This announcement challenged an established Hollywood paradigm. Since then, real estate components, including movie studios and production facilities, have become a crucial and differentiating part of the supply chain for the OTT content providers, as dynamics in the streaming space shifted more towards a battle for exclusivity.

Chart 1
Not going to the shops



Rapid digitisation creates data exponentially, transforming the requirements for data storage and data transmission. Corporates, government agencies and consumers are handling and consuming more data than ever before. Cloud storage and the rise of Big Data for decision making require a robust infrastructure for data storage, processing and transmission. Data users want reliable real estate solutions. As customers are focusing on getting the most value out of the data centre, the real estate focus shifts to creating connected campuses that combine the critical data centre, network and cloud connectivity elements together in a single, secure environment.

This trend has further to run. The evolution of technological hardware and the development of advanced applications for these require ever more data consumption. Mobile data traffic is projected to continue to grow rapidly, with the traffic from wireless and mobile devices expected to account for 67% of all internet traffic by 2021. Mobile carriers and telephone companies continue to invest in tower equipment and technology, driving secular demand for towers.

New sectors - new investment opportunities

There have been significant sector changes within real estate and the REIT industry over the last few years, which have important implications for investors. Traditional core sectors have seen their share of the REIT index declining, while new sectors, especially data centres and towers, have become an important part of the investment opportunity set. Digitisation and rising social connectivity will remain the main forces shaping REIT investment opportunities in the mid-to-long term.

These structural changes are already driving wide divergences in performance within those real estate sectors most affected. Data centres and towers continue to ride a rising tide. While there is some potential for pricing pressure on large-scale cloud deals in the near term, the internet and cloud continue to propel the longer-term demand for data centres. These tailwinds also continue to support sections of the industrial sector at the expense of more traditional parts of retail, as changing consumer preferences bring about a fundamental disruption of supply chains.

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