Global Outlook

December 2017

By the standards of the recent past, the global economy is currently moving ahead at a healthy pace. With this in mind, we use this edition of Global Outlook to consider some of the changes at the micro level that are helping drive this positive momentum. Given the accompanying rally in global risk markets, we also look at the importance of security selection and forecasting valuations.

Standard Life Investments

House View

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

	December 2017 House View	
Risk	The strategy remains focused on a pro-cyclical stance favouring risk assets. However, as valuations have become more extended and the economic cycle has matured, portfolios have sought diversification in specific asset classes.	NEUTRAL
Government Bonds		
US Treasuries	US rates largely price in federal fund rate hikes, unless there is a major deterioration in inflation, and hence are expected to continue range trading.	MOVED TO NEUTRAL
European Bonds	While the economy is expanding steadily, the European Central Bank has signalled a slow approach to tapering bond purchases against a backdrop of muted inflation.	MOVED TO NEUTRAL
UK Gilts	The interest rates outlook remains mixed while the economy faces both higher inflation and slower economic activity. Yields are supported by regulatory driven flows but there are valuation concerns.	NEUTRAL
Japanese Bonds	Our portfolios are funding other risk positions out of Japanese bonds, reflecting the market with the lowest yield yet strict yield curve control from the Bank of Japan.	LIGHT
US Inflation-Linked Debt	This asset class provides both downside protection to any risk-off moves, as well as a degree of protection against any future increase in inflation.	MOVED TO HEAVY
Global Emerging Market Debt	Local currency yields are attractive due to emerging market sensitivity to the pickup in global growth, solid balance of payments, and attractive spreads to global government bonds.	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	US yields are attractive and the asset class can deliver a positive total return even with moderate spread widening. European spreads are approaching their pre-crisis lows. The asset class can be subject to over-crowding.	HEAVY
Equities		
US Equities	The market is expensive and faces political uncertainty; for example, over trade policy, but the improving economic environment supports company profits while monetary tightening is well priced in and proposed tax cuts could be supportive.	NEUTRAL
European Equities	Corporate earnings are improving given a widespread pickup in economic growth across the region plus stronger international trade flows. The stronger euro has slowed gains this year.	MOVED TO NEUTRAL
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.	OVERWEIGHT
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	The asset class is supported by global growth improvements, especially for key sectors such as Asian technology. A tightening bias in China may prove to be a headwind for the asset class.	HEAVY
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 while valuations are supported by the European Central Bank policy stance.	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.	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 can act as a diversifier against the risk of a decline in global activity or a serious political shock.	NEUTRAL $, €, ¥ AND £
Global Commodities	While commodities are supported by the slow improvement in global growth, they are very sensitive to Chinese policy tightening. 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

Alex Wolf
Senior Emerging Market Economist

With global growth currently running at its fastest pace in six years, we use the edition of Global Outlook to look beneath the healthy macro backdrop and understand what changes at the micro level are driving the global economy. As global markets rally, careful security selection becomes increasingly important. In addition to understanding sectoral trends, we also examine how we forecast valuations and how to find value in today's markets.

Euan Stirling, Global Head of Stewardship and ESG Investment, and Deborah Gilshan, Governance and Stewardship Director, consider the role of asset managers as active stewards of good governance. As governance scandals increasingly make headlines, we demonstrate the important role asset managers play in holding to account the companies in which they invest.

As global equity markets have continued to rally, a systematic way of forecasting returns is important as this economic cycle nears its end. With this in mind, Gerry Fowler, Multi-Asset Strategist, explains how we forecast equity valuations. He concludes that valuations remain attractive relative to bonds but downside risks are growing.

Continuing the theme of finding value through careful security selection, Matthew Kence, Senior Vice President, High Yield Credit, and Adam Dmochowski, Fixed Income Investment Specialist, look at the global high-yield market. While valuation cushions are small, the fundamental and technical backdrop for many high-yield companies is sound. Nevertheless, choosing the right issuer, and seeking the most attractive bonds within the capital structure are increasingly important to capture the best risk-adjusted return.

Turning to corporate trends, Mikhail Zverev, Head of Global Equities, looks at new entrants in the consumer space and the increasing popularity of 'private labels' which are eroding the once dominant position big brands held among consumers. This creates risks and opportunities for investors. On the theme of disruption, Alistair Way, Head of Asia/Emerging Market Equities, writes about the emergence of powerful tech companies in emerging markets (EM) and the reshaping of EM indices.

Finally, Kieran Curtis, Investment Director, Emerging Market Debt, examines Mexico's energy sector and highlights how reforms over the past few years are now bearing fruit in the form of higher investment. While most of the headlines focus on trade risks surrounding NAFTA negotiations, the energy sector is quietly transforming from a headwind into a tailwind for growth.

Global Spotlight

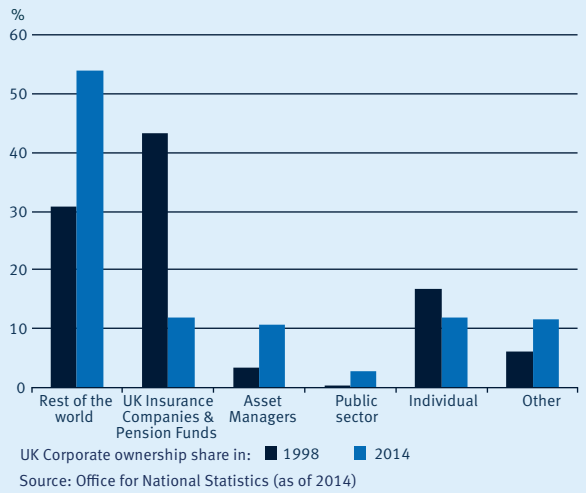
From vigilant shareholders to visible stewards

Twenty-five years on from the publication of the Cadbury report, the UK's corporate governance framework continues to evolve, with implications for asset managers as stewards of their clients' capital.

Euan Stirling
Global Head of
Stewardship and ESG Investment

Deborah Gilshan
Governance and
Stewardship Director

Chart 1
Diversified ownership



Source: Office for National Statistics (as of 2014)

The UK corporate governance framework

The UK corporate governance framework is held in high regard around the world. There is much to celebrate when reflecting on the 25 years since the publication of the Cadbury Committee's report in 1992, which led to the original Code of Best Practice. The recommendations of the original Code remain encapsulated in the current UK Corporate Governance Code. Its equivalent for institutional investors, the UK Stewardship Code, is now fully embedded into the UK governance framework.

The role of institutional investors as stewards is vitally important. With the changes in the make-up of investors in UK companies over the last 25 years, the role that asset managers play, on behalf of those who trust us to manage their money, is paramount. The corporate failings of recent years show there is room for improvement in the governance of some major UK companies and the actions of institutional investors in holding them to account. It is only fitting that the current versions of both codes are under further scrutiny, as societal expectations of companies, and those who act on behalf of providers of capital, evolves.

The original Cadbury report reflected on the "financial aspects of corporate governance". This is particularly important given the considerations of "financial" and "non-financial" factors in the debate about the materiality of the environmental, social and governance (ESG) characteristics of a company. For Cadbury, the key aspects of a company's corporate governance were financial factors and therefore material to any investment in a company. This chimes with the view that governance is the key issue on which investors should hold boards and management to account. If a company focuses on the long-term interests of its investors, with a strong emphasis on governance, the interests of other stakeholders should also be taken care of.

Vigilant shareholders

Whilst the focus of the original Cadbury report was the governance of companies, accountability of boards to shareholders was imperative to the success of the original Code. "Vigilant shareholders" were one of the "key safeguards" to reduce risks in the governance process and the "obligation on companies to state how far they comply with the Code provides institutional and individual shareholders with a ready-made agenda for their representations to boards. It is up to them to put it to good use." It referred to the "stewardship" of the board and noted that, given the delegation of many of the responsibilities of shareholders to the board, it was "for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use this power." There was strong endorsement of the annual general meeting (AGM) which "gives all shareholders, whatever the size of their shareholding, direct and public access to their boards."

These concepts of calling directors to book and the opportunity of the AGM to hold companies to account through direct and public access to their boards are key pillars of our approach to stewardship. Aberdeen Standard Investments* is the largest active manager in the UK, with £583 billion of assets[1], and as such we have a duty to rebuild trust in our own industry and to make a more coherent case about our contribution to the real economy. As guardians of huge sums of money for hard-working people, and by investing in areas of the economy best placed to put that capital to use, our position as an asset manager can help drive growth. With this comes great responsibility, including acting as stewards for those on whose behalf we invest. We exercise this responsibility through visible stewardship activities that hold to account the companies in which we invest our clients' money.

Visible stewards

The visibility of our stewardship work, and that of the investment industry as a whole, is increasingly under the spotlight at a time of continued public mistrust in the financial system. Through a stewardship approach that is evident to our clients, investee companies and the market as a whole, we seek to illustrate how we hold boards and companies to account on behalf of our clients. These clients comprise beneficiaries, such as members of pension funds, in whose interests we ultimately act. Such visible stewardship exerts influence over the companies in which we invest and helps to rebuild trust in the financial system. It must work, and be seen to work, more effectively for providers of capital and those who access that capital.

As part of our stewardship work, we regularly meet privately with companies, often at chairperson or CEO level, to discuss their long-term strategies and governance issues. But our stewardship goes well beyond private discussions. Utilising the power of the AGM is an effective way to visibly demonstrate our stewardship work, to escalate

concerns and to gain insights into board dynamics that may not always be apparent in private engagement meetings. Such interactions need not always be combative and we often seek to empower a board collectively to deal with our governance concerns. As a long-term shareholder, Standard Life Investments attended the AGM of WPP plc for three consecutive years to raise concerns around succession planning for the founder CEO. Its statement at the 2017 AGM sought to embolden further the Chair and the board to address this material risk to its long-term investment in the company. This was in addition to private engagement and collaboration with other shareholders undertaken on this specific issue.

Ownership of UK companies

One of the key developments in the stewardship chain in the last 25 years has been the change to the make-up of those who allocate capital to UK companies. In the 1990s, the majority owners of UK companies were UK insurance companies and pension funds. As seen in Chart 1 below, they owned, in combination, 43% of UK corporates. By 2014, this had reduced to around 10%, with significant increases in ownership by overseas investors and asset managers. This highlights the increased relative importance of UK asset managers to act as stewards on behalf of those for whom they invest and the society in which they operate. The role of asset managers as stewards must be part of the value they deliver to their clients.

Our stewardship commitment

Both Aberdeen Asset Management and Standard Life Investments have enormous experience of stewardship. These combined heritages provide opportunity for a more forceful stewardship that builds on past experiences and which harnesses our increased size and influence as a global investor to drive improved governance standards in the markets in which we invest our clients' capital.

The influence of shareholders is not a new concept and it existed well before the introduction of the UK Stewardship Code, which sought to codify already existent practices in a system that recognises that it takes two parties to steward a company: an active, independent and engaged board and active, engaged shareholders (see Chart 2). Stewardship is now a core expectation of investors and boards of directors. The Cadbury Committee envisioned a "constructive relationship between companies and their owners" where their proposals would "reinforce good governance without stifling entrepreneurial initiative."

Boards of major companies need to demonstrate they are meeting modern expectations in their stewardship of shareholder capital and in the treatment of other stakeholders. The government has a role to play, but there will always be a limit to what regulatory intervention can achieve. Major investors must do all they can to influence the behaviour of the companies in which they invest for customers and clients. At Aberdeen Standard Investments, we will not hesitate to do so.

*Aberdeen Standard Investments is a brand of the investment businesses of Aberdeen Asset Management and Standard Life Investments.

[1]Source: Standard Life Investments, Aberdeen Asset Management, as at 31 December 2016.

Table 1
The UK Stewardship Code for Institutional Investors (2012)

1	Publicly disclose their policy on how they will discharge the stewardship responsibilities
2	Have a robust policy on the disclosure of conflicts of interest
3	Closely monitor investee companies
4	Establish clear guidelines on when and how they will escalate their stewardship activities
5	Be willing to act collectively with other investors where appropriate
6	Have a clear policy on voting and the disclosure of voting activity
7	Report periodically on their stewardship and voting activities

Source: Bloomberg, Standard Life Investments (as of 2016)

Global Emerging Market Equities

Emerging markets transformed by tech

The historical dominance of traditional industries is fading as a new generation of emerging market technology companies comes to the fore. Chinese firms are at the centre of this shift.

Alistair Way
Head of Asia/Emerging Markets Equities

No longer just a developed market play

We have seen a massive transformation of the emerging market (EM) equity investment universe over the last decade. The historical dominance of traditional industries, such as oil, commodities and financials, has been reversed and now the technology sector dominates. Its 27% weighting in the MSCI EM Index (see Chart 1) is higher than in major developed market equity indices.

This has partly come from broadened index representation, most notably the inclusion of US-listed Chinese internet companies such as Alibaba; and partly from the relentless outperformance of the big tech stocks, such as Tencent, Samsung Electronics, TSMC and Hynix. Another driver has been the emergence of a large number of up-and-coming companies, which have taken advantage of the huge structural changes in EM economies to carve out promising niches.

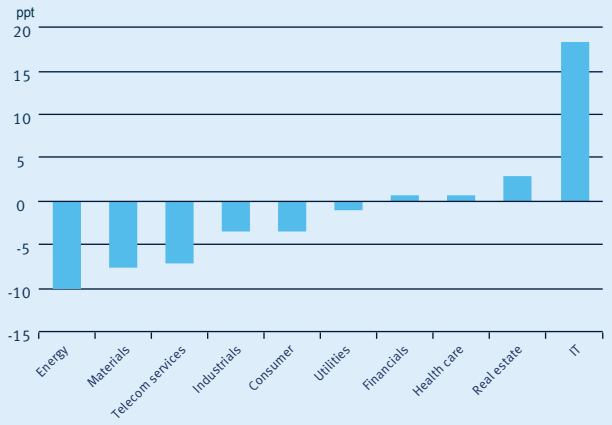
Tech sector outperformance has been one of the biggest factors behind the EM equity rally that began at the start of 2016. Initially, the rally was driven by a re-rating from historically low valuations, but more recently corporate earnings momentum has been the key driver.

Pricing power in the supply chain

One striking phenomenon has been the degree to which pricing power has shifted upstream within the technology supply chain. End products, such as smartphones, PCs and tablets, have seen considerable price pressure, bringing margins down towards zero for all except the premium players Apple and Samsung. At the same time, the margins for some of the important components in these devices, such as memory semiconductors and OLED displays, have risen sharply.

One contributing factor is the very high technology and capex barriers to entry. Another is the exit of many competitors over the years, leaving oligopolies operating in some segments, which have the incentive to be disciplined in new supply to maintain margins. A third factor is the surprising strength of demand as new markets and applications open up. Notably, the explosion of interest in cloud computing and artificial intelligence has been accompanied by huge investments in server facilities, which require relatively large amounts of DRAM and NAND.

Chart 1
Tech leading the way



Source: MSCI (as of November 2017)

Where is the Chinese threat?

A quick search for memory storage sticks on eBay, Alibaba or Amazon yields a wide range of Chinese USB drives with 1TB or 2TB capacity for remarkably cheap prices of around $10-$20. This might suggest to the casual observer that memory semiconductors are yet another technology sector which is being commoditised by emerging Chinese suppliers, following the examples of TVs, laptops, smartphones, LCD panels and so on. However, many of these products are fakes, and bargain hunters may swiftly discover that their data has disappeared.

It is especially interesting how little progress Chinese technology companies have made in breaking into some of these component sectors. Although the capex barriers to entry are not a problem, given access to cheap funding and the enthusiasm of the Chinese authorities to develop domestic supply chains, the technological barriers to entry are. It requires a wide range of knowledge, including advanced chemical processes, optical technology and high precision engineering, to be competitive here, and it is hard to build all this from scratch.

As a consequence, there has been a host of attempted acquisitions of Korean, Japanese and western technology companies by their Chinese counterparts. These have mostly failed so far, with significant resistance from national governments to the loss of important technological intellectual property. However, there is still a great deal of appetite in China to move up the technology curve, and it will be fascinating to see how the competitive landscape shifts over the next few years.

Small OLED screens, a segment currently dominated by Samsung Electronics, will be an important test case – Chinese display panel companies such as BOE are investing very aggressively, and Apple is incentivising rivals with the aim of reducing dependence on its long-standing competitor. This competition will only intensify; the interplay between national competition and technological innovation will shape EMs for years to come.

Emerging Market Debt

Energy to the fore in Mexico

Despite the uncertainty surrounding NAFTA renegotiations, a recent visit to Mexico found some reasons to be optimistic about the details of the domestic economy that investors should be paying more attention to.

Kieran Curtis
Investment Director, Emerging Market Debt

Headwinds become tailwinds

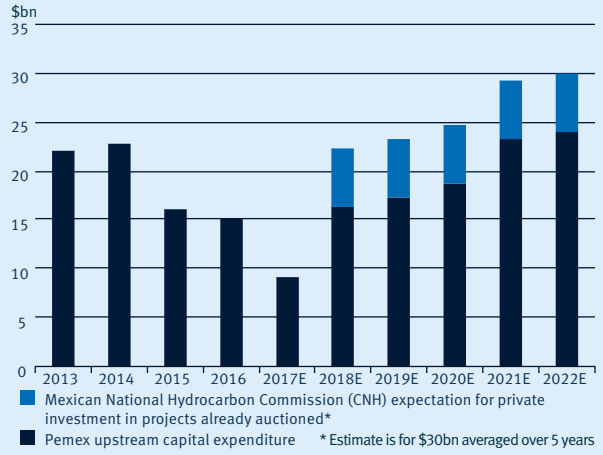
In recent years, Mexico has suffered from two negative dynamics that have affected GDP growth. One has been the continual loss of oil production capacity as large fields have been exhausted, and the other has been the periodic fiscal drag as taxes have had to rise, or spending cut, in order to compensate for lower government revenue realised from the energy sector. In fact, the situation was often self-fulfilling, with government-owned energy monopoly PEMEX* often having to cut investment to square the fiscal accounts, resulting in falling output and further falls in revenues. Cuts in investment in other infrastructure have also likely affected potential growth.

However, three years after the passage of major reforms to the energy sector (and others) that allowed for greater private sector participation, these dynamics are finally beginning to change. The fiscal consolidation that the government was forced to implement over the past year, along with the windfall from a weakening peso, means that Mexico now runs a small surplus before financing costs. This makes further cuts to public investment extremely unlikely in 2018, and some expansion is probable as the country heads into a presidential election in June.

Meanwhile, energy sector reform has given PEMEX enough operational independence to close down unprofitable projects, enabling some of the higher profits to be spent on investment in new productive capacity in more promising areas. The sale of some smaller producing wells to private companies by PEMEX also means there may be early signs of production growth in the private sector in 2018, as new investment and technologies are implemented. After several years of scepticism about its production forecasts, other arms of government are beginning to believe PEMEX's own estimates of stable rather than falling production.

However, the real prize in the upstream energy sector is the large fields where licences for exploration and production were sold to mainly foreign oil companies. The National Hydrocarbon Commission (CNH) estimates that over the next five years, investment totalling 50% of PEMEX's upstream capex budget is likely to be spent developing these fields by international oil companies (see Chart 1). Some important discoveries have already been made, boding well for future auctions of exploration and development rights and in turn for future investment. Investment in the downstream energy sector also represents a huge opportunity: Mexico has only half the number of gas stations per-mile-driven of Brazil or Guatemala. Officials expect billions of dollars to be invested in new networks to compete with the local chains, and foreign-branded stations competing with the PEMEX brand have already begun to open up.

Chart 1
Rebounding energy investment



Source: Pemex, CNH, Standard Life Investments (as of 2017)

Manageable political risks

Investors have been concerned that next year's election presents a risk to the outlook for the energy sector in Mexico. Andres Manuel Lopez Obrador, the current leader in the polls, has been a vocal critic of the energy reform and has been campaigning for a referendum to reverse the constitutional changes enacted by the current government and their allies in congress. However, courts have ruled that such a referendum would be illegal. Moreover, recent signals from MORENA (Lopez Obrador's party) have been more constructive, confirming that it would honour existing contracts in the sector while seeking to make some changes to future ones to encourage investment to be brought forward.

Critically, the party seems to be recognising that the sector can be a driver of both economic growth and government revenues, which can in turn be used to fund other parts of its programme. The signals are that the country needs higher levels of production and that MORENA will be pragmatic. While NAFTA risks should not be ignored and US trade policy presents a particularly acute level of uncertainty for the manufacturing sector in Mexico, we can be increasingly confident that the energy sector can be a driver rather than a drag on growth in Mexico over the coming years.

*We hold PEMEX bonds in some of our portfolios.

Global Equities

Big brands - the end of an era?

Branded consumer staples companies have long been loved by investors but their reliability can no longer be taken for granted as market structures and buying habits evolve.

Mikhail Zverev
Head of Global Equities

A favoured theme

Branded consumer goods, especially consumer staples, have been a favoured investment theme for many investors. Often these are profitable, predictable businesses, with compelling dividend yields, and some top line growth, especially for those companies with a meaningful exposure to emerging markets.

In particular, the dividend yield offered by these companies has appealed to investors. Lower yields elsewhere has resulted in these companies being seen as 'bond proxies', offering relatively safe, reliable returns and higher yields than the bond market. This has created a perception of capital protection. However, a number of challenges mean this perception might be starting to fade.

Fading advantages

Big branded consumer goods companies owe their strong market position to historical advantages over the competition – but many of these benefits are starting to erode.

In the past, these companies had the scale and financial muscle to advertise on national media and build brand recognition in a way smaller companies could not. Now, digital media and social media platforms allow consumer goods companies to generate brand awareness by targeting specific niche audiences on a smaller marketing budget.

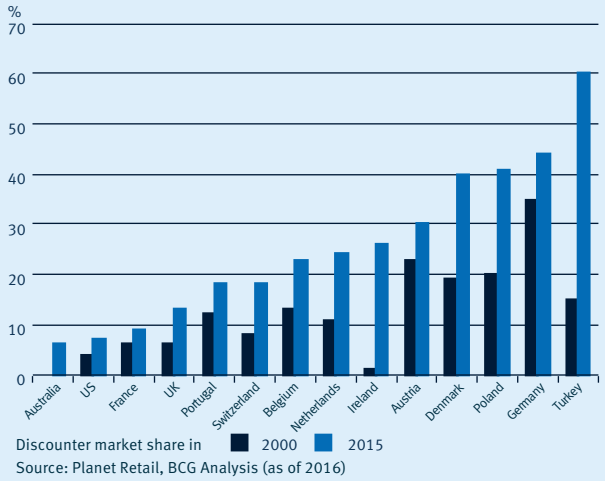
Formerly, these companies had a strong manufacturing advantage. Now contract manufacturers can produce goods that rival the quality of the big brands - from clothing to detergents to cosmetics – boosting discounters with strong private label brands (see Chart 1).

Once, these companies had strong relationships with retailers, allowing them to dominate shelf space. Nowadays, new entrants can ship direct to the consumer, using platforms like Amazon or T-Mall. Also, retailers themselves are busy launching their own 'private label' products at lower prices but comparable quality.

In the US shavers market, where Gillette has dominated for years, new entrants like Harry's Razors and Dollar Shave Club have gained 20% market share in four years – a feat which no challenger brand has achieved before.

This prompted Unilever, an incumbent big brand company, to acquire Dollar Shave Club for one billion dollars.

Chart 1
Discounters gaining share



Source: Planet Retail, BCG Analysis (as of 2016)

In Europe, private label food products now exceed 40% of sales in large markets such as Germany, the UK and Spain, and continue to grow rapidly at the expense of traditional established food brands (see Chart). In popular discounter supermarkets such as Aldi and Lidl, that percentage is even higher. The US has been late to adopt this trend – nationwide, only about 17% of sales are private label but leading retailers such as Costco are pushing this number higher.

Big brands forced to adapt

This change is now affecting the economics of big brand companies, with firms like Nestle, Reckitt Benckiser and others accepting that their growth is more challenged. To protect profitability, some are now cutting costs like advertising and promotion expenditure – a strategy sometimes referred to as 'zero base budgeting'. This move led to a series of disappointing results from ad agencies and TV broadcasters, the very channels that once helped build those mega brands.

This approach may be counter-productive. Stopping advertising activity can provide short-term cost savings, but may lead to a decline in the brand in the long term.

The lessons for stock-pickers

What does this mean for the global stock-picker? For one thing, the reliability of the big brands' revenue lines can no longer be taken as a given. Moreover, valuation multiples are still high, suggesting that investors do not fully appreciate this risk.

However, there are also opportunities. Some consumer staples companies were early to adjust. Kraft Heinz – a product of the merger between Kraft and Heinz, with backing from 3G Capital and Warren Buffet – was one of the first to introduce zero-based budgeting for lower-growth products.

Growth also continues in categories like functional and performance nutrition, thanks to well-being and health trends. Mead Johnson, a leading manufacturer of infant nutrition, was acquired by Reckitt Benckiser for $18 billion in June this year. Further down the market capitalisation spectrum, Glanbia, an Irish listed manufacturer of protein sports nutrition products, continues to grow and build a leading – if niche – brand.

As always, understanding the implications of a material industry change, and finding individual companies that benefit from that change is key to successful stock picking.

Global High Yield

Smaller cushions but opportunities abound

While valuation cushions are small, the fundamental and technical backdrop for many high yield companies is sound. Still, at the current point in the cycle, generating attractive returns requires careful stock selection.

Matthew Kence
Senior Vice President
Credit – High Yield

Adam Dmochowski
Global Investment Specialist
Fixed Income

Supportive fundamentals and technicals

Leverage within the global high-yield market is elevated, though it has come down recently as EBITDA growth has begun to pick up. More positively, low interest rates and a healthy new issue market have allowed companies to lock in lower coupons, and extend maturity profiles. This allows companies to generate more cash flow and gives them a longer runway until they need to revisit the market. Taken together, we think these fundamental factors will lead to a very benign default environment of 1.5% – 2% over the next 12 months

Technical factors in high yield have also remained supportive. A very active leveraged loan new issuance market has displaced some potential bond issuance. Furthermore, nearly 70% of new bond issuance has been for refinancing, simply replacing bonds that are already in the market (see Chart 1). This favorable supply picture means that reinvestment of coupons on outstanding bonds will more than offset the estimated 4% of existing US high-yield debt maturing next year.

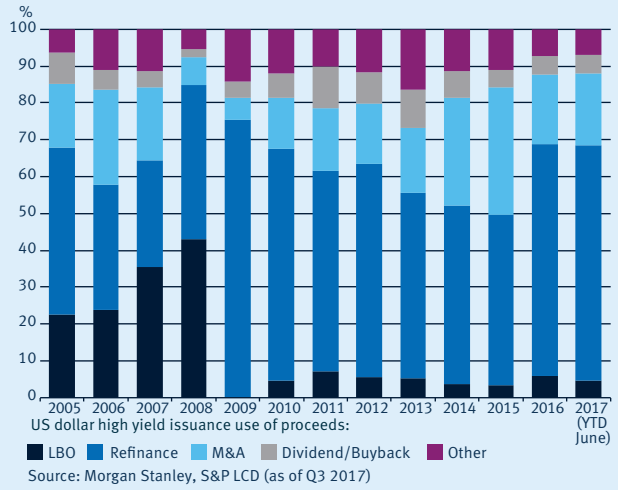
Rates a risk

One area we are monitoring is government rates. Historically, high yield returns have been negatively correlated with those in government rates markets. Moreover, the market tends to become more rates sensitive as spreads tighten – there is simply less room to compress and absorb increases in the risk-free rate. On top of this, central banks across the world are now looking to withdraw some of the stimulus they have injected via quantitative easing programs. While not our base case, a rapid increase in underlying government bond rates driven by a policy error could negatively impact the high-yield bond market. As a result, we believe it is prudent to keep a sharp eye on the duration sensitivity of high-yield portfolios.

Stock selection critical

Almost by definition, the upside potential in corporate bond investing is limited, while the downside can be substantial. In the current narrow-spread environment, this makes credit selection that much more important. We prefer to invest in companies that we believe can generate cash flow through the cycle. For healthcare companies, we seek to understand the payor mix so we can anticipate the effect of legislation on the credits. Within retail, we look for discrete buying opportunities where online competition may not be a risk, or is overestimated. For energy companies, we look for companies with quality of acreage to grow into their capital structures within a low commodity price environment.

Chart 1
New issuance increasingly for refinancing



Source: Morgan Stanley, S&P LCD (as of Q3 2017)

In addition to looking for the right issuer, we seek out the most attractive bonds within the capital structure to capture the best risk-adjusted return. For example, as bond prices rise, the risk of embedded calls within the structure can further limit upside price potential, making the risk profile of these bonds even more assymetric and something to avoid. With the margin for error relatively slim, the focus is on only taking risk where the upside can be quantified and the upside potential justifies the incremental risk.

By contrast, passive high-yield ETFs, which have underperformed active funds in both weak and strong markets, are even more disadvantaged in the current market. ETFs are typically biased towards higher-quality, liquid issuers due to the requirement to fund volatile flows. This results in a potentially more interest rate sensitive portfolio, while also missing out on capturing illiquidity premium from lower-quality issuers in 'risk on' markets.

As high-yield managers, we are stuck between risky credits that often do not adequately compensate us for moving further out the risk spectrum, and higher-quality credits that are more susceptible to rate increases. However, volatility can create opportunities, and with careful security selection we retain our belief that high-yield can provide an attractive total return given the fundamental and technical support the asset class currently enjoys.

Absolute Returns

When will it end?

As bull markets go, the current one remains one of the most unloved. As equity valuations rise and yield curves flatten, having a systematic method for forecasting equity returns is important as this cycle nears its end.

Gerry Fowler
Multi-Asset Strategist

Forecasting equity returns

In our multi-asset portfolios, we mainly invest in well-established indices, like the S&P 500, or some of the regional MSCI indices, such as the MSCI Emerging Markets Index. The returns we generate are still an aggregation of individual company returns, but much of this will be driven by systematic risk we can analyse from the top-down.

In our equity forecasting, we start with a simple breakdown of equity return drivers: revenue growth; margin changes; valuation changes; and dividends

Moderate global revenue growth likely to persist

In much the same way as GDP reflects the output of a country, so corporate revenue reflects the output of a company. The two are not identical but, outside of recessionary periods, nominal GDP growth closely aligns with corporate sales growth over our multi-year investment horizon.

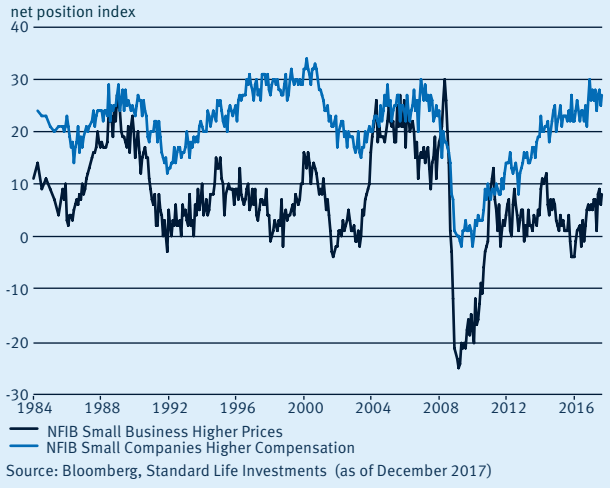
Because of this, we start our analysis by referring to our economists' forecasts for economic growth in the coming years. As the largest companies in equity indices increasingly earn as much, or more, from their foreign operations as their domestic ones, we adjust our forecasts for the nominal GDP growth that these equity indices are exposed to.

Currently, our forecasts for nominal GDP growth remain strongest in emerging markets (~9%) and firm in the US (›4%). Europe and Japan are somewhat lower (‹3%), due to ageing populations and low inflation. However, the large companies dominating regional equity indices have diverse sources of revenue, which means there is far less difference in corporate revenue growth at the index level (4-7%).

Margins stable or rising

Margin changes are possibly the hardest element of our framework to estimate, for two main reasons. First, a significant change in revenue is usually not immediately matched by a commensurate change in costs - so margin changes are usually pro-cyclical. Second, the dominant costs for business are labour and commodities.

Chart 1
Rising labour costs



Source: Bloomberg, Standard Life Investments (as of December 2017)

Thankfully, we can analyse trends in wages and commodity prices, and even access some survey data to help inform us. For example, the National Federation of Independent Business survey of small businesses in the US has two sub-components that focus on input and labour costs (see Chart 1). The difference tends to be correlated to US corporate margins, although other complementary inputs are also required.

Looking forward, we still expect margins to be supported or expand across all the major equity markets. Even in the US, where margins are highest relative to longer-term norms, corporate tax cuts will lower effective rates and bolster margins despite the tightening labour market.

Valuations remain attractive relative to bonds

Forecasting valuation change is also notoriously difficult. Investors often simplify valuations to a one-year forward price-to-earnings ratio or even a cyclically adjusted version (CAPE) but this becomes less useful over longer horizons when structural changes to profits occur and interest-rate regimes change.

Calculating the equity risk premium is the approach we tend to prefer, although this also comes with the need to make assumptions about terminal growth and fair discount rates. We view valuations as unlikely to expand in the US but, with bond yields remaining very low globally, we expect further valuation expansion across non-US equity markets.

Expected equity returns still healthy but downside asymmetry is growing

Putting it all together, we think recession risks are low over the next two years. We expect sales growth in the mid-single digits across major global equity indices, and varying but positive margin and valuation trends. As a result, our top-down total return expectations for equities range from 7-13% per annum, with emerging markets most favoured and US and UK equities least.

As global economies continue to close output gaps, we are watching wage inflation trends carefully as a warning signal that margins may decline. Combined with potentially tighter monetary policy and higher yields (impacting valuations), the downside risks to forecasts are substantial. We therefore manage portfolio risk with a range of diversifying strategies across asset classes and financial products.

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 £275.2 billion – this equates to $357.5 billion, C$464.2 billion, A$466.1 billion and €313.4 billion (all figures as at 30 June 2017).

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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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	
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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.

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