Global Outlook

March 2017

For investors, the welcome evidence of an increasingly entrenched global economic recovery is offset somewhat by the gathering clouds of political uncertainty. In this edition of Global Outlook, we consider how the pick-up in the global cycle is affecting markets, while also examining how policy developments might impact this positive trend. With political risks in mind, we take an in-depth look at the complicated issue of UK-EU negotiations through the Article 50 process, and use game theory to explore the relative likelihood of the numerous potential settlements on offer.

Standard Life Investments

House View

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

	March 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	While market stress and safe-haven flows support Treasuries, tighter labour markets, rising inflation and the upward trend in wages give the Federal Reserve the rationale to continue hiking rates throughout 2017 and 2018.	LIGHT
European Bonds	Bonds are not as well supported as growth and inflation pick up. This means the ECB is considering how long to keep monetary policy accommodative. Political stress could periodically affect peripheral and core bond markets.	LIGHT
UK Gilts	The Bank of England has delivered significant easing measures as uncertainty related to the EU referendum outcome is expected to cause the economy to slow. However, long-term valuations are expensive.	NEUTRAL
Japanese Bonds	The central bank is 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 levels are expected to increase across developed markets as expansive fiscal policy in the US and Japan, currency weakness in the UK, and the rise in commodity prices all feed through into headline rates.	NEUTRAL
Global Emerging Market Debt	US dollar-denominated debt is our preference, both on valuation grounds and the protection from currency movements it provides. Yields remain attractive although the asset class is vulnerable to aggressive US rate rises.	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.	NEUTRAL
High Yield Debt	The hunt for yield is driving more investors to this asset class, although overcrowding remains a risk in some sectors, especially in the US when monetary policy is being tightened.	HEAVY
Equities		
US Equities	Equities are buoyant following promised fiscal easing and business deregulation. While valuations are not historically attractive, dividend payments and share buybacks plus expected tax cuts support cash flows.	VERY HEAVY
European Equities	Corporate earnings are improving following a widespread pickup in economic growth across the region. Concerns remain over some banking systems, the lack of strong credit growth and the upcoming election cycle.	NEUTRAL
Japanese Equities	The market looks more attractive as easy monetary policy and fiscal stimulus for 2017 are helped by a cheaper yen. This is driving forward corporate earnings, share buybacks and business investment.	NEUTRAL
UK Equities	The UK economy has been resilient but uncertainty remains surrounding its future relationship with the EU. 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 will have a positive feed through due to trade linkages. However, expected US interest rate rises, a stronger dollar and protectionist policies may all offset this effect.	NEUTRAL
Emerging Market Equities	The outlook for Asia is dependent on US trade policy and the degree of monetary tightening or US dollar strength. More emerging markets are seen as attractive as the improvement in global growth feeds into commodity prices.	NEUTRAL
Real Estate		
UK	The UK real estate cycle is at a mature stage and we expect limited further capital growth. Income remains attractive, although risks are elevated should conditions turn recessionary or political uncertainty persist.	LIGHT
Europe	Core markets continue to offer attractive relative value in light of the low interest rate environment supported by QE, while recovery plays are showing consistent capital value growth.	HEAVY
North America	The US market should benefit from an improvement in economic growth, although some Canadian property faces headwinds from an interest-rate sensitive consumer and significant office construction.	HEAVY
Asia Pacific	An attractive yield margin remains, but markets are divergent. Returns are driven by rental and capital value growth in Japan and Australia, but weakening elsewhere. Emerging Asia markets are risky.	NEUTRAL
Other Assets		
Foreign Exchange	The US dollar has rallied following the US election and can benefit from a steady tightening of monetary policy. Europe looks less well placed than Japan to cope with the next phase of currency pressures, while sterling acts as a shock absorber after the EU referendum.	HEAVY \$, MOVED TO HEAVY ¥, LIGHT €, MOVED TO LIGHT £
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions, OPEC decisions and climatic conditions influence the outlook for different commodities.	NEUTRAL
Cash		
	The US election result may mean a faster pace of interest rate rises is necessary should fiscal policy expansion lead to inflationary pressures. Easy policy is still expected in Europe, Japan and the UK to revive economic activity.	NEUTRAL

Foreword

Editor

James McCann
UK/European Economist

Investors face a conundrum at present. It is clear the upswing in the global economy is becoming more entrenched, deflationary risks have faded and monetary policy settings remain accommodative. However, the clouds of uncertainty around policy and politics are building. This ranges from a lack of clarity over US trade and tax policy to the busy European political calendar. It is not difficult to see a scenario where policy shifts pose risks to the global upswing, and have significant macro and micro implications across markets. Therefore, investors need to carefully monitor triggers around politics and policy risks. They also need to understand how economies and markets might fare in these environments, in order to position accordingly. This month's Global Outlook reflects this nuanced outlook, focusing on how an improving global cycle is impacting markets, while also trying to peer through the political fog.

Global shipping represents the classic benchmark for the global cycle. Mikhail Zverev, Head of Global Equities, examines how the improving outlook for global trade has affected an industry that has been in the doldrums in recent years. Critically, there is a structural change taking place in this sector, which makes us more confident that the recent cyclical improvement is not just a flash in the pan. Nicolas Jaquier, Economist, Emerging Market Debt, takes a slightly different angle on the global upswing. While growth prospects look to be improving across emerging markets, he highlights the very different trends in inflation. Some markets are seeing high inflation rates recede, while others are experiencing building price pressures. The Emerging Market Debt team is positioning to take advantage of shifts in relative policy settings that these inflationary trends suggest.

This month's spotlight article, written by our Political Economist Stephanie Kelly, tackles the complicated issue of UK-EU negotiations through the Article 50 process. Stephanie sets out the menu of different institutional relationships that the UK and EU could choose from, and examines how these might satisfy the economic and political priorities that both parties have flagged at this early stage. Stephanie uses game theory to try and identify the relative likelihood of different settlements.

Meanwhile, Samantha Lamb, Investment Director, Credit, examines the investment opportunities presented by political risk in emerging market credit. Concerns over US trade policy and a stronger dollar had been interpreted as negative across the board for emerging markets. However, a more nuanced focus on country and company fundamentals can help to identify compelling investment stories. Finally, in Japan there is evidence that significant corporate governance reform is underway, driven by a desire to revitalise the economy. However, Alison Kennedy, Governance and Stewardship Director, highlights that there remains considerable work to be done.

Spotlight

Political and economic incentives driving the UK-EU trade negotiations

With Article 50 set to be triggered, we consider the options for a new UK-EU relationship. We can use game theory to try and assess which outcome is most likely based on the signals that both parties are sending at present.

Stephanie Kelly
Political Economist

The long-awaited triggering of Article 50 is a key step in the process of the UK leaving the EU. It will allow both parties to negotiate the UK's exit, while possibly establishing a skeleton for a new trading relationship in tandem. Article 50 allows two years for the initial exit agreement process, but an extension to this period can be granted if the European Council (excluding the UK) unanimously agrees. The UK is deeply entrenched in the EU economic and regulatory infrastructure, which makes the process of leaving extremely complicated. Therefore, we expect a transitional agreement to be required.

Setting up the new trade agreement is likely to be a long process. The final agreement on the terms for the UK *leaving* the EU can be agreed by a qualified majority of the European Council. However, any *new* trade deal that requires treaty change, or that qualifies as a 'mixed agreement', would necessitate unanimous approval by all 27 remaining members. Countries may opt to, or formally require (i.e. Ireland), a domestic referendum. Others may need regional legislative approval before being able to provide ratification (i.e. Belgium).

There is clearly a great deal of uncertainty over the eventual outcome of this complicated process. In this article, we consider what each party is looking to achieve in these negotiations and examine the different types of possible institutional arrangements between the UK and EU. We then use game theory to try and establish the relative likelihood of different outcomes at this admittedly early stage.

The rules of the game

To start, we make an assumption that the EU and UK are two single negotiating parties. Of course, the reality is that the EU is made up of 27 disparate members (excluding the UK), all of whom have their own individual priorities and red lines which could lead to a breakdown in negotiations. In Germany, this could be a certain tariff level on auto-manufacturing, while in Ireland the red line may literally be a border line between the Republic of Ireland and the UK. However, sorting these interests into an overall negotiating position will be part and parcel of setting the overall EU negotiation objectives, such that national and transnational interests are represented satisfactorily by a single player. The need for unanimous agreement among EU member states should ensure that the ultimate deal does not cross any individual red lines.

So, what are the key issues? We think there are four major points of contention.

Free movement of labour

Controlling immigration was the dominant issue for the 'Leave' campaign in the run-up to the UK's EU referendum and has become a central tenet of the government's rhetoric around the future of the UK's relationship with the EU. Given that free movement of people is a key pillar of the EU, changes to this principle are likely to be met with stern resistance by EU negotiators.

UK political sovereignty

The perceived democratic deficit in EU membership was another key message of the Leave campaign. The supremacy of the European Court of Justice and the requirement for the UK to adopt EU rules and regulations were particular gripes. However, there is a natural trade-off between the degree of sovereignty in these areas and access to the single market. A European Economic Area (EEA) or Swiss-style solution would still require the UK to comply with EU laws and regulations in return for access to the single market. In addition, such countries have no say in writing these laws or regulations.

Services access and the single market

The UK is a large exporter of services, particularly financial services. At present, financial institutions based in the UK can operate easily in the EU without onerous additional regulation, partly through passporting. Single market exit would raise the risk of non-tariff barriers to these types of activity. The government is seeking 'the freest possible trade' in financial services with the EU, which could come in the form of mutual recognition or tailored equivalence in regulation. The economic importance of the sector and the role of London as a financial centre make this a key issue.

Future of the Eurozone and EU

There has been significant political capital invested in the European project. Brexit constitutes a threat to the sustainability of this union, especially given signs of growing EU scepticism in other countries. A fear is that the UK will be the first domino to fall in the unravelling of the European project. So, EU negotiators are incentivised to maintain the integrity of the EU and deter future rebellions. This must be balanced against a desire to maintain trade and political relations with a strategically important economy.

Let's make a deal

EU exit is not as binary as sometimes portrayed. The new UK trading relationship with the EU could come in a number of shapes, sizes or consistencies; not just 'hard' or 'soft'. Indeed, there is a spectrum of options for the new trading relationship, ranging between full EEA membership and a World Trade Organisation (WTO) relationship (see Table 1).

Overall, the closer that UK relations with the EU resemble actual membership, the less disruptive it will be for trade and associated activity. EEA membership would imply relatively modest changes in the UK's relationship with the EU, with firms still able to access the single market and the free movement of labour enshrined. The Swiss model of bilateral trade agreements would allow access to large parts of the single market, but again comes with strict rules around migration. A more distinct separation would see the UK negotiate a Free Trade Agreement (FTA) with the EU. This sounds attractive, but in practice it would imply a rise in trade frictions. Tariff levels would depend on complex sector-by-sector trade-offs across member states. Moreover, we would see increased non-tariff barriers to trade with the single market. The most disruptive outcome would be a fall back on WTO rules, which would imply material rises in both tariff and non-tariff barriers.

Deal or no deal

Using a variation on the famous 'prisoner's dilemma' in game theory, we can try to establish how likely these outcomes might be depending on the degree of compromise required on each side around key issues (see Table 2). A high level of compromise implies that domestic politics takes a back seat to what is necessary to secure the least economic disruption. At the other end of the spectrum, low levels of compromise imply that short-term domestic political considerations take precedence over economic considerations. Moderate levels of compromise are a hybrid of the two.

Although EEA membership would produce less disruption for both sides, it is only politically desirable for the EU. The lack of control over migration and sovereignty makes this the worst political outcome for the UK. According to current signals, it looks highly unlikely at present.

The 'Brexit Ideal' creates little economic disruption, particularly for the UK, but it is politically untenable for the EU. It would compromise the four freedoms and increase the likelihood of future member departures. Therefore, we also deem this as highly unlikely.

If neither party is prepared to compromise, a fall back to WTO trade rules could emerge. Although this would produce the worst outcome economically, we see it as modestly more likely than either the EEA or Brexit Ideal because each side's approach would mirror the other.

On balance, we believe that both sides will be prepared to compromise to some extent. This makes an FTA the most likely post-Brexit arrangement. The differences between types of FTAs depend on how much each party is willing to sacrifice political capital for economic benefits. Overall, we think the most likely outcome is the middle-ground 'Regular FTA'. This allows both parties to retain political reputations along their key-issue red lines, while also building an effective, if not comprehensive, free trade relationship. We place 'FTA Max' in a similar probability range to a WTO relationship because it requires a higher degree of compromise on both sides than has been displayed thus far. The remaining and more plausible solutions are less inclusive versions of an FTA, where tariffs, regulations, immigration and taxes are used as the primary bargaining chips.

Of course this could all change. The red lines that are emerging from both the EU and UK are not set in stone. Similarly, the negotiations could proceed in a more or less constructive manner than we have assumed. We will need to watch carefully for triggers over coming months and quarters that tell us in which direction we might be heading. However, this game theory approach provides a solid framework in which to analyse the forthcoming discussions.

Table 1
Potential options

Agreement	Precedent	Structure
Status quo	Existing UK EU membership	Full access to single market Financial contributions to EU Accept EU legislation and principles (inc. free movement) Seat at negotiating table Perceived democratic deficit
EEA membership	Norway Iceland Lichtenstein	Full access to single market Financial contributions to EU Accept EU legislation and principles (inc. free movement) Financial contributions to EU without negotiating power Perceived democratic deficit
Bilateral agreement	Switzerland	Sectoral bilateral trade agreements Uncertain market access for financial sector Financial contributions to EU without negotiating power Some EU regulations and principles (inc. some free movement)
Customs union	Turkey	No tariffs or quotas on sectoral goods trade Tariff-taker on goods imported from outside EU No financial contribution to EU Not bound to EU principle of free movement of labour Perception of democratic deficit reduced
Free-trade agreement	Canada	Wide range of possible outcomes across trade and services Tariffs, quotas, services access and regulations all negotiable, determined through complex negotiations Perception of democratic deficit reduced
WTO		Most favoured nation treatment market access across WTO members Not bound to EU legislation/principles (inc. free movement) Perception of democratic deficit reduced

Source: Standard Life Investments

Chart 2
Likely outcomes from negotiations

		EU		
		High compromise	Moderate compromise	Low compromise
UK	High compromise	FTA Max (no tariffs, generous services agreement, generous UK work visa programme)	Swiss-style agreement	EEA
	Moderate compromise	FTA (no tariffs, generous services agreement, immigration controls)	Regular FTA (no tariffs, some service sector agreement, immigration controls)	Limited FTA (no tariffs but no services access, immigration controls)
	Low compromise	Brexit Ideal	Limited FTA (no tariffs, some service sector agreement, tight immigration controls)	WTO

High likelihood
Moderate likelihood
Low likelihood
Extremely low likelihood

Source: Standard Life Investments

Global Equities

Container shipping weathering the storm

The container shipping sector has been through a tough time as overcapacity and stuttering demand sent freight rates plummeting. However, the structural and cyclical outlook for the sector looks more encouraging.

Mikhail Zverev
Head of Global Equities

Choppy waters

Container shipping is the life blood of global trade. Therefore, it will not be a surprise to hear that the sector has faced structural and cyclical challenges over recent years. Global trade has been structurally weaker since the financial crisis, partly reflecting a stall in globalisation. Worse, a collapse in commodity prices, a slowdown in Chinese and broader emerging market growth, and a US inventory build provided additional headwinds in 2015 and into 2016. Even taking this into account, the performance of shipping has been remarkable. Indeed, the industry had one of the worst years in its history in 2016.

This was not just a trade issue. Shipping lines and ship owners had expanded their fleets aggressively over a number of years, resulting in structural overcapacity. Excess supply contributed to a dramatic drop in freight rates. Against this backdrop, leading players like Maersk Line looked to defend their market share, triggering a price war. The Shanghai Containerized Freight Index, which combines spot freight rates on major routes, declined by over 60% between early 2015 and 2016. As a result, even the best run companies sustained losses in the first half of 2016.

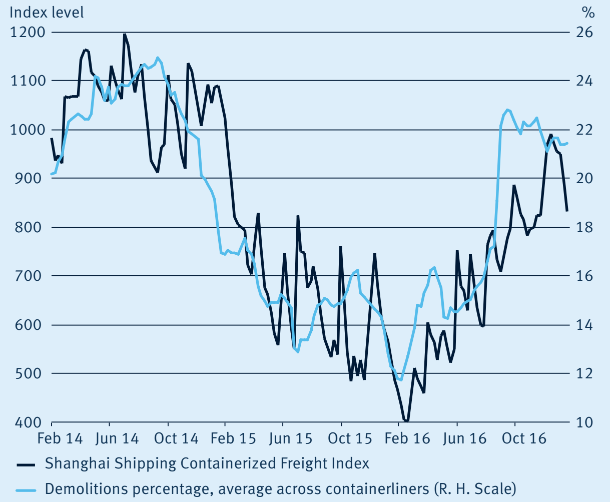
Taking remedial action

There has now been a supply response. We have seen increased idling, vessels taken out of active operation and increased scrappage. Indeed, we have even heard reports of 10-year old container vessels being scrapped – the typical useful life of a container ship can be 25-30 years. Additionally, shipping lines have become more disciplined on their pricing, and freight rates have been rising.

This looks set to continue. The widening of the Panama Canal means that Panamax ships – the largest that could squeeze through the old locks – have become uncompetitive and more likely to be scrapped. Similarly, new environmental regulations that impose stricter controls over ballast water management and treatment are coming into force. Investing in this new technology does not make economic sense for older ships and many are likely to be scrapped.

We are also seeing structural change in the sector. There is consolidation underway: Denmark's Maersk Line is in the process of buying Germany's Hamburg Sud; Japanese companies K Line, MOL and NYK have announced the merger of their container shipping operations; and German shipper Hapag-Lloyd merged with Middle-Eastern UASC. The industry is also forming new alliances that will control an increasing share of the global container trade, and potentially make competition more disciplined and rational.

Chart 1
Scrapping around over prices



Source: Shanghai Shipping Exchange, VesselsValue, Bloomberg (as of 22 February 2017)

Another interesting dynamic relates to the ownership of ships. Shipping lines like Maersk Line or Orient Overseas own and operate their own fleet. Financial owners of ships, often groups of highly leveraged private investors, rely on shipping lines to charter their vessels. They have neither the scale nor expertise to do this themselves. Following a poor 2016, the financial stability of this class of owner is in question and it is likely that we will see financial distress. Indeed, Hanjin, a Korean container shipping line, filed for bankruptcy in August last year. This resulted in cargoes being stranded en route to their destination. In response, shipping line clients are becoming more selective. Getting the best price is no longer enough – they need to be confident over the stability of their provider. This should contribute to improving pricing power for the industry.

Better times ahead?

Freight rates have doubled from their bottom in 2016. This bodes well for long-term contract pricing, which will be negotiated in the first few months of 2017. Will the recent improvement in rates prove temporary, or will underlying improvement in capacity and pricing discipline, consolidation, and change in industry structure lead to a sustained recovery?

We think this will remain a risky, volatile and cyclical industry, but the positive structural changes taking place have further to run. Moreover, there is cyclical help on the way. Our economic outlook is for an acceleration in global growth and Maersk management suggests container shipping volumes will grow 2%-4% this year. That said, we do not expect trade growth to return to its pre-crisis glory days.

We own AP Moller-Maersk, the Danish-listed owner of Maersk Line, in our European and global equity portfolios, and its Hong Kong-listed peer Orient Overseas International in our Asia and GEM portfolios.

Emerging Market Debt

Inflation convergence

While we are seeing a broad-based upswing in emerging market growth, inflation trends are moving in different directions. This will have important implications for monetary policy settings that we do not think are fully reflected in asset prices.

Nicolas Jaquier
Economist, Emerging Market Debt

Inflation cycles out of synch

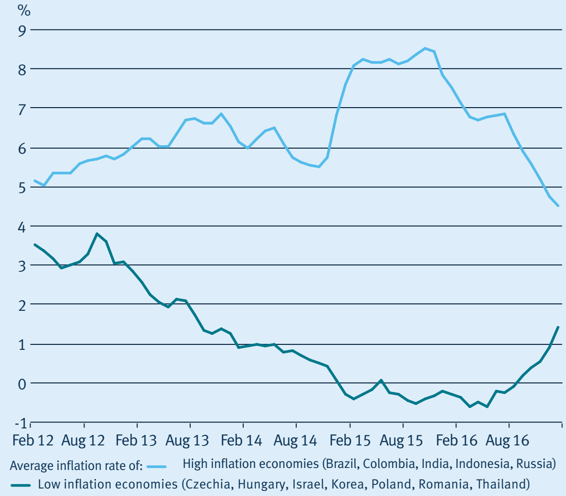
The start of 2017 has showed signs of a sustained pick-up in growth across both emerging and developed markets. Apart from a few notable exceptions, most emerging market (EM) Purchasing Managers' Indices (PMI) are now above 50, indicating expansion. Indeed, in January, the average PMI for EM reached its highest level in two years. While the growth uplift is fairly uniform across the emerging world, inflation trends are looking very different. In the handful of countries where inflation was high in 2015 and early 2016, it is now coming down rapidly. Meanwhile, in low inflation economies, including those that even experienced deflation for a period of time, price growth is gradually gaining momentum (see Chart 1).

Meeting in the middle?

Elevated inflation rates in Brazil, Colombia and Russia are now abating rapidly. In all of these cases, we are seeing the lagged effect of tight monetary policy help to ease price pressures. Another common factor, and one that is related to tight policy settings, is the effect of exchange rate appreciation, which is weighing on domestic import prices. Falling inflation is pushing real interest rates higher, providing room for central banks to loosen policy. There are exceptions, of course. In Turkey, we have not seen sufficient monetary policy tightening to weigh on high inflation rates, which are a perennial problem. This is being compounded by weak lira, one of the worst-performing EM currencies in 2016. With inflation expected to return to double-digit rates this year, further policy tightening is required.

Interestingly, it is in those economies where inflation has been almost non-existent for the past couple of years where price pressures are starting to emerge. A number of Asian economies are participating in this trend. For instance, in both South Korea and Thailand, inflation had been stuck below 1 and 0% respectively, but is now heading towards 2%. The trend is even more marked in Eastern Europe, with a general rise in inflation towards 2% in the Czech Republic, Hungary, Poland and Romania. Certainly, the recovery in energy prices, coupled with large base effects at the start of the year, has helped. However, this is not the whole story. Core measures of inflation, which exclude energy and food, have also been trending upward in these economies. This is likely a signal that strong domestic demand, after several years of subdued inflationary pressure, is finally having an impact on price growth.

Chart 1
Inflation mean reversion



Source: National sources, Datastream, Standard Life Investments (as of January 2017

Different policy directions

The convergence of high and low inflation across EM economies has significant implications for relative monetary policy settings. We have positioned portfolios to take advantage of these trends. Central banks in Brazil and Colombia have already started lowering their policy rates. However, we expect the easing cycle in Brazil to be deeper than that currently priced by investors, and have therefore added duration in local bonds. The decision by the Brazilian central bank to accelerate the pace of rate cuts to 75 basis points in January makes us more confident that this is the direction of travel.

Conversely, the rise of inflation in Eastern Europe has the potential to shift markets in the other direction. Indeed, the prospects for policy tightening on account of higher inflation are still perceived to be distant. However, expectations for rate hikes are likely to build and we have positioned our portfolios to be underweight bonds in Hungary, Poland and Romania. This trend toward reflation, and a shift in policy settings, should also lead to currency appreciation in these markets, especially since most currencies in the region are showing up in our analysis as undervalued. We have therefore increased exposure to these currencies in our EM debt funds, in particular to the Polish zloty as Poland's central bank looks to have the strongest 'hawkish' bias.

Finally, while inflation pressures in Israel remain muted for the time being, the trend looks to be upward. In this case, policymakers are likely to allow the shekel to appreciate given the favourable current account position and the high pass through of currency moves to domestic inflation. In contrast, exposure to Turkey is minimal as the central bank will eventually be forced to increase rates forcefully to break the cycle of currency weakness and high inflation.

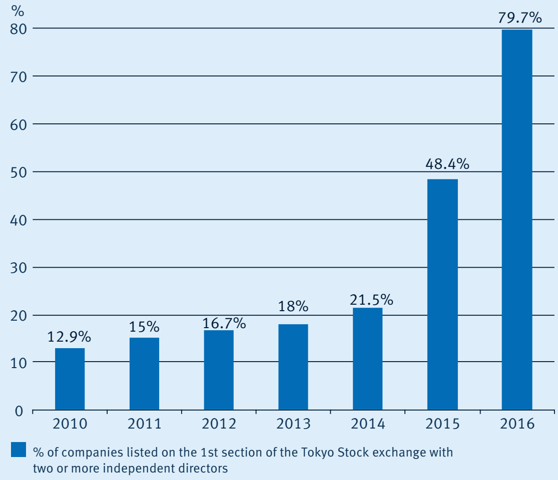
Governance

A slow revolution in Japanese governance

There has been significant change in the governance environment in Japan, driven by a desire to revitalise the economy and push companies to improve capital efficiency.

Alison Kennedy
Governance & Stewardship Director

Chart 1
Rise of the independents



Source: Tokyo Stock Exchange (as of July 2016)

Rewriting the rulebook

The governance architecture in Japan has undergone a major restructuring in recent years. There have been a number of important changes, including the introduction of a Corporate Governance Code for companies and a Stewardship Code for investors. Companies have to report on compliance with the Corporate Governance Code in their governance report and over 200 institutions have signed the Stewardship Code. There was also the launch of the JPX-Nikkei 400 Index, which uses governance data as one of the inclusion criteria, and the restructuring of the giant Government Pension Investment Fund, which now rates its external managers on their environmental, social and governance activities.

The response of corporate Japan to the new regulatory landscape has been emphatic. Board composition has changed markedly: almost 80% of the 1,400 companies listed on the Tokyo Stock Exchange (TSE) First Section now have two or more independent directors, compared with 21% just two years ago (see Chart 1). 350 of these 1,400 companies have moved to the new 'company with audit committee' governance framework. This was introduced as a halfway house between the traditional 'company with statutory auditor' system and the 'company with three committees' system widely used in Europe and America. Although not ideal, this new framework provides improved accountability and board independence.

However, the benefits of these various changes are not always easy to measure. For example, the contribution from newly appointed independent directors is difficult to judge; as many are academics or were formerly statutory auditors their commercial experience is limited. The lifetime employment culture presents Japan with a real problem in finding suitably qualified individuals ready and willing to become independent directors. In addition, the widespread practice of companies retaining the services of former CEOs as 'advisors' can stifle innovation and hinder change. Another major hurdle is the lack of real understanding among investors as to what governance engagement is and what it can realistically achieve. Investor engagement and disclosure is reminiscent of the UK ten years ago.

Governance revolution has further to run

In spite of these challenges, the pace of change remains high and further developments are planned. One specific example is the recent consultation by the TSE on the reporting requirements for listed companies. The objective of the proposals was to allow companies more freedom in choosing the format that they use for the 'earnings digest', which is used for reporting quarterly. These changes would potentially remove the requirement for companies to produce full financial statements before the AGM and so reduce the amount of information available when making voting decisions. To us, this seemed a retrograde step and so, along with Legal & General Investment Management and the UK's railways pension scheme, Railpen, we co-ordinated over 40 global investors in support of a letter to ask the TSE to reconsider this change. We await the outcome of this consultation.

On a more positive note, the Stewardship Code is being reviewed and there are proposals that would require investors to disclose voting decisions at individual company meetings. Such disclosure is routine in many markets but not in Japan, where investors normally only disclose their votes in aggregate. Requiring full voting disclosure would be a significant and welcome development. Also, this year will see the government reviewing the amendments made to the Companies Act two years ago, including consideration of whether the appointment of an outside or independent director should be made compulsory. This was not in the previous amendments but could well find support now.

Still work to do

We are undoubtedly still in a period of transition. The risk is that Japanese companies now think they have done enough, so investors need to keep the pressure on to ensure further progress. There is still a great deal of education required, both of directors and investors. We need to see an improvement to the quality and diversity of independent directors and an end to the unhelpful practice of appointing former CEOs to advisory roles. Only then will we see a change in the role of the board from simply a rubber-stamping body to a genuine forum for discussion and challenge. Ultimately, this may take generational change but there is no doubt that momentum continues.

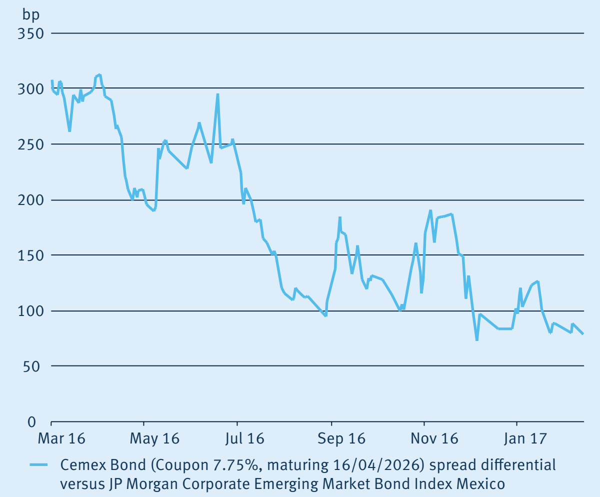
Emerging Market Credit

Building a beautiful investment case

Following President Trump's election, many assumed that a stronger dollar and risks around trade policy would be negative for emerging markets. However, the underlying picture is more nuanced and we have seen a recovery from the initial sell-off.

Samantha Lamb
Investment Director, Credit

Chart 1
Cementing good opportunities



Source: TRMT, JP Morgan, Bloomberg, Standard Life Investments (as of 22 February 2017)

Known unknowns

2017 will be an interesting year for emerging market corporates. They worked hard during the recent period of slower growth and should now, in theory, benefit from an upswing in the global economy. And yet, question marks remain. The most obvious of these centres on the uncertain path of US trade policy. However, other concerns should not be ignored, including the risk of rising defaults in China and a more fragile geopolitical backdrop. This changing environment will create some exciting opportunities when we have conviction in both the country and the company.

Mexico faces challenges

The acceleration we are seeing in US growth and the prospect of looser fiscal policy would in normal times be positive for Mexico; a country in which 38% of the economy is export driven and 73% of this trade goes to the US. However, the biggest near-term issue remains uncertainty around the new US administration's trade policy and the associated feedthrough to business investment decisions. Mexican corporates had enjoyed a good run in recent years, having been a favourite of investors during the turmoil over sanctions in Russia and political distress in Brazil. Therefore, the newfound caution around some Mexican corporates represents a clear turnaround. However, this is a long way from saying that there are no opportunities in Mexico. Take Cemex for example, a cement company with sizeable operations in Mexico, the US and Spain. The company had a near-death experience during the financial crisis but now, with strong earnings and falling debt, its net leverage is tumbling. This was reflected in a credit rating upgrade by Standard & Poor's at the end of January.

Is Brazil past the worst?

Brazil has experienced the reverse of Mexico; it was a market pariah throughout 2015, before a tentative stabilisation in its political situation in 2016. However, investors now seem to believe that most of the corruption scandals have washed through. This improvement in the political situation has been accompanied by signs that the Brazilian economy is also starting to stabilise after a deep recession. There was only a temporary weakening in the Brazilian Real following the US election, before it resumed the upward trend that it had been on through much of 2016. This might reflect the fact that Brazil's trade links with the US are much smaller than Mexico's. Overall, while Brazil still has challenges with both growth and politics, the worst seems to be over for now. Despite this, careful company selection is critical following a severe economic downturn that left a number of companies limping on. Indeed, many companies remain over-leveraged and reliant on resurgent growth to improve their balance sheets – something that is not part of our central view.

However, in our view, investors are being well compensated for taking risk in Brazil, and this creates a number of interesting opportunities; the petroleum giant Petrobras, for instance, continues on its path towards recovery.

Better fundamentals in the price

Meanwhile, Russian corporates were pushed into a number of self-help measures in 2014, as sanctions and deteriorating investor sentiment reduced their access to capital markets. For many, this involved conserving cash and paying down debt, particularly among those companies that benefited from a weaker rouble. Examples of this were metals and mining companies, such as Metalloinvest, and steel manufacturers, such as NLMK. From a fundamental, balance-sheet perspective, Russian companies now look in good shape. Moreover, the current uptick in growth gives additional momentum to improving credit stories. However, better fundamentals have been recognised by investors and valuations are no longer as attractive. There is speculation that the Trump presidency could be positive for Russia and lead to sanctions being lifted sooner than expected. However, this is as yet unknown. Therefore, Russian companies continue to trade with a political and governance risk premium. However, they can offer attractive carry opportunities if investors are comfortable with the risks involved.

Absolute Returns

Difficulties down under

The Australian economy has remained remarkably immune to a stuttering global economy since the financial crisis. However, it still faces challenges both at home and abroad, even in the midst of a global cyclical upturn.

Gerry Fowler
Multi-Asset Strategist

Dodging bullets

Australia has enjoyed an extraordinary 26-year period of sustained economic growth, even skirting recession during the bursting of the tech bubble and the Great Financial Crisis. Certainly, a decade long mining boom helped Australia weather this storm, although activity in the sector peaked in 2012. The most recent threat to Australia's multi-decade run came from a slowdown in Chinese growth and investment in 2015 and into 2016. However, the economy managed to chug along, helped in part by a strong residential construction cycle.

Changing fortunes

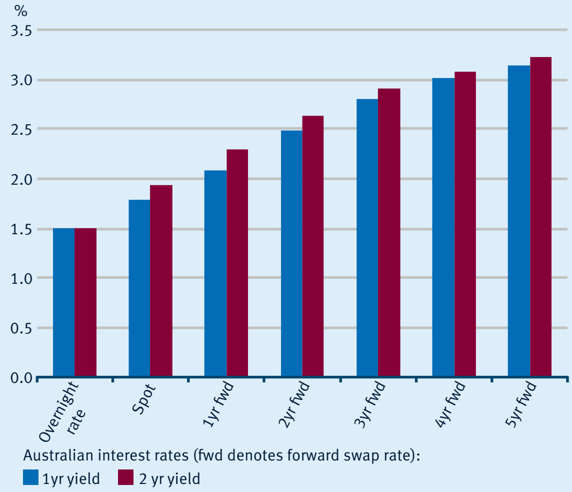
The performance of the Chinese economy will remain important for Australia. China's 19th National Congress of the Communist Party (held once every five years) is due this autumn. It is assumed that President Xi will be reappointed as General Secretary, but there may be a break with convention in terms of signalling his successor. The administration has prioritised supporting short-term growth over reform efforts for a year now, and this is expected to continue until the Congress.

This shift in priorities helps Australia in the near term. Indeed, the resurgence of demand from China and government-mandated supply restrictions caused a sharp bounce in commodity prices in 2016 (coal and iron ore in particular). The benefit to Australia's terms-of-trade has been significant and this has been reflected in the Australian dollar.

Thinking further ahead; the cost of supporting Chinese growth has been escalating. Achieving the target growth rate of 6.5% is requiring more and more credit, at the risk of destabilising the financial system. It is widely expected that this growth target will need to be reduced and perhaps very soon after the Congress. If this is not the case, then we fear that financial imbalances will continue to build. This means that Australia may not be able to rely on strong Chinese demand indefinitely. Lower growth targets in China would mean lower investment and less demand for resources.

Australia also will not be able to rely on residential construction to provide the same degree of support as seen recently. There are early signs that dwelling commencements peaked in late 2016 and that completions would therefore peak in the next 18 months. This peak, at over 200,000 completions, is more than 30% higher than the average over the previous 30 years, implying a material drag on construction activity is on the horizon. Additional pressure may come from a tightening of lending standards domestically as well as restrictions on capital outflows from China that, at the margin, were supportive of Australian residential investment.

Chart 1
Positioning for disappointment



Australian interest rates (fwd denotes forward swap rate):

Source: Bloomberg as at 23 February 2017

The Australian asymmetry

Fading residential investment and a less reliable impulse from Chinese demand certainly do not mean that Australia's 26-year run of growth is set to imminently draw to a close. However, they make us cautious over the outlook for already subdued growth and inflation trends in this economy. Indeed, we think it is unlikely that the Reserve Bank of Australia will need, or want to, tighten policy in the near term. Moreover, Australia's dependence on Chinese growth and foreign capital make it vulnerable to global shocks. This could come from aggressive policy tightening in the US or a wobble in China. Our multi-asset funds maintain exposure that reflects this asymmetry.

Accessing this asymmetry in the potential interest rate outlook is most appealing to us through an investment that receives forward yields on Australian government bonds. Despite overnight rates of 1.5%, the market is pricing short-term yields as if there will be a hiking cycle of 100-150 basis points in the coming years – optimism we see as having little upside and potential downside. Positioning to receive these forward yields has attractive curve roll-down; with the possibility of additional performance should rate hike expectations abate as we expect they could.

Our investment in Australia represents a liquid and relatively low-risk way to express our caution over domestic Australian conditions, while also providing some extra protection around global risks, such as a China slowdown.

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 £277.9 billion – this equates to $343.5 billion, C$460.5 billion, A$474.2 billion and €325.5 billion (all figures as at 31 December 2016).

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

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

Our industry-leading publications

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

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

Contact Details

For further information on Standard Life Investments visit www.standardlifeinvestments.com or contact us at one of the following offices.

Europe

Standard Life Investments
1 George Street
Edinburgh
United Kingdom
EH2 2LL
Telephone: +44 (0)131 225 2345

Standard Life Investments
90 St. Stephen's Green
Dublin 2
Ireland
Telephone: +353(0) 1 639 7000

Standard Life Investments
30 St Mary Axe
London
EC3A 8BF
Telephone: +44 (0)207 868 5700

Standard Life Investments
1 Rue de Berri
75008 Paris
France
Telephone: +33 158 05 22 70

Standard Life Investments
Taunusanlage 11
60329 Frankfurt am Main
Germany
Telephone: +49 (0) 69 665721764

Standard Life Investments Limited
Engelbrektsgatan 9-11
114 32 Stockholm
Sweden
Telephone: +46 (0) 707 507353

Standard Life Investments Limited
4th Floor 10 Via Mazzini
20123 Milan
Italy
Telephone: +39 0249 543 231

Standard Life Investments (Schweiz) AG
3rd Floor Rennweg 22
8001 Zurich
Switzerland
Telephone: +41 44 522 00 55

Standard Life Investments Limited
The Crescent
Parc Scientifique
Route de Lennick 451
1070 Anderlecht
Brussels
Belgium
Telephone: +32 470 991 668

Standard Life Investments Limited
Piet Mondriaanplein 13
3812 GZ Amersfoort
The Netherlands
Telephone: +31 6464 14172

North America

Standard Life Investments (USA) Ltd
One Beacon Street, 34th Floor
Boston
USA
MA 02108
Telephone: +1 617 720 7900

Standard Life Investments (USA) Ltd
299 Park Avenue, 6th Floor,
Room 655
New York, NY 10171
USA
Telephone: +1 212 739 0792

Standard Life Investments (USA) Ltd
11601 Wilshire Boulevard,
5th Floor, Room 505
Los Angeles
USA
CA 90025
Telephone: +1 310 235 1408

Standard Life Investments (USA) Ltd
First Canadian Place
100 King Street West
Suite 2525, PO Box 252
Toronto, Ontario, M5X 1C8
Canada
Telephone: +1 (647) 726 1424

Australia

Standard Life Investments Limited
Level 33 Chifley Tower
2 Chifley Square
Sydney NSW 2000
Australia
Telephone: +61 2 9947 1500

Asia

Standard Life Investments (Hong Kong) Ltd
30th Floor LHT Tower
31 Queen's Road Central
Hong Kong
Telephone: +852 3589 3188

Standard Life Investments Limited
1201-01 China Resource Building
8 Jianguomenbei Avenue
Beijing 100005
People's Republic of China
Telephone: +86 10 5811 1701

Standard Life Investments (Hong Kong) Ltd
Korea Representative Office
21/F Seoul Finance Center
136 Sejong-daero
Jung-gu
Seoul, 100-768
Korea
Telephone: +82 2 3782 4765

Standard Life Investments (Japan) Limited
18F Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku,
Tokyo 100-0004
Telephone: +81 3 45407930

Important Information

All information, opinions and estimates in this document are those of Standard Life Investments, and constitute our best judgement as of the date indicated and may be superseded by subsequent market events or other reasons.

This material is for informational purposes only and does not constitute an offer to sell, or solicitation of an offer to purchase any security, nor does it constitute investment advice or an endorsement with respect to any investment vehicle. This material serves to provide general information and is not meant to be legal or tax advice for any particular investor, which can only be provided by qualified tax and legal counsel.

This material is not to be reproduced in whole or in part without the prior written consent of Standard Life Investments.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by Standard Life*. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, Standard Life* or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Past performance is no guarantee of future results. Neither the Owner nor any other third party sponsors, endorses or promotes the fund or product to which Third Party Data relates.

*Standard Life means the relevant member of the Standard Life group, being Standard Life plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

INVBGEN_16_1516_GS_OUTLOOK_MAR_2017_TCM **0317**