At Standard Life Investments, our investment philosophy is *Focus on Change*, where we look to anticipate and react to market inefficiencies brought about by changing fundamentals. In this edition of Global Outlook, our investment philosophy is front and centre as we consider how fundamentals are changing across a range of economies and how markets might be impacted. With that in mind, we take an in-depth look at the US-China relationship in light of the recent meeting between the two countries' leaders. We explore how the relationship might change as both try to balance co-operation with rising tensions.
The following asset allocation is based upon a global investor with access to all the major asset classes.

<table>
<thead>
<tr>
<th>April 2017 House View</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk</strong></td>
</tr>
<tr>
<td><strong>Government Bonds</strong></td>
</tr>
<tr>
<td>US Treasuries</td>
</tr>
<tr>
<td>European Bonds</td>
</tr>
<tr>
<td>UK Gilts</td>
</tr>
<tr>
<td>Japanese Bonds</td>
</tr>
<tr>
<td>Global Inflation-Linked Debt</td>
</tr>
<tr>
<td>Global Emerging Market Debt</td>
</tr>
<tr>
<td><strong>Corporate Bonds</strong></td>
</tr>
<tr>
<td>Investment Grade</td>
</tr>
<tr>
<td>High Yield Debt</td>
</tr>
<tr>
<td><strong>Equities</strong></td>
</tr>
<tr>
<td>US Equities</td>
</tr>
<tr>
<td>European Equities</td>
</tr>
<tr>
<td>Japanese Equities</td>
</tr>
<tr>
<td>UK Equities</td>
</tr>
<tr>
<td>Developed Asian Equities</td>
</tr>
<tr>
<td>Emerging Market Equities</td>
</tr>
<tr>
<td><strong>Real Estate</strong></td>
</tr>
<tr>
<td>UK</td>
</tr>
<tr>
<td>Europe</td>
</tr>
<tr>
<td>North America</td>
</tr>
<tr>
<td>Asia Pacific</td>
</tr>
<tr>
<td><strong>Other Assets</strong></td>
</tr>
<tr>
<td>Foreign Exchange</td>
</tr>
<tr>
<td>Global Commodities</td>
</tr>
<tr>
<td>Cash</td>
</tr>
</tbody>
</table>
As the global economic rebound continues to gather pace, investors and policymakers alike are trying to adapt to a new set of fundamentals, often with incomplete information. In this edition of Global Outlook, change is the consistent theme as we look at how changing market dynamics and policymaker reaction functions could affect markets. Jeremy Lawson, Chief Economist, sets the stage with an economic update that highlights the continued improvement in global trade and manufacturing, while identifying policy risk as the largest near-term risk to the global rebound.

In our Global Spotlight, we examine the political and economics dynamics challenging the US-China relationship, specifically through the prism of Chinese President Xi Jinping’s ‘China Dream’ and US President Donald Trump’s ‘America First’ policies. The US-China relationship has remained stable under numerous leaders. However, this is set to change as Trump looks to recalibrate what is increasingly viewed to be an unbalanced economic relationship, and Xi Jinping aims to increase China’s influence in the world. As the bilateral relationship faces a wider range of pressure points – North Korea, trade, South China Sea – to name a few, we look at how nationalist policies and domestic political pressures could make co-operation more difficult.

Jack Kelly, Investment Director, Government Bonds, then examines changing economic fundamentals and political risks in Europe and how they might affect the reaction function of the European Central Bank (ECB). Jack highlights how strong growth, political risks and legal restrictions present a complicated set of challenges as the ECB considers its monetary policy stance. Meanwhile, Ken Dickson, Investment Director, Currency, looks at potential changes to the NAFTA agreement. He uses our in-house BEER framework in an attempt to measure how much change the market is expecting based on current Mexican peso valuations. Ken concludes that the peso is pricing in minor NAFTA changes and in the event nothing changes, it could be deemed undervalued. However, in the event the US pulls out of NAFTA or seeks a more damaging renegotiation, the peso looks decidedly overvalued.

Lastly, Fujun Wu, Senior Vice President, US Equities, writes about improving US shale production and increasing efficiencies out of the Permian Basin. While uncertainty around OPEC policy clouds the market outlook, US producers have firmly put themselves in the position of swing producers. As technology and production efficiency improves, Fujun is optimistic for the outlook of selected US exploration & production and oil service companies.
**Spotlight**

**A critical juncture for the US and China**

Can the ‘China Dream’ coexist with ‘America First’? How competing world views could increase tensions in Asia and what it means for the global economy.

Alex Wolf  
Senior Emerging Markets Economist

**Delicate diplomacy required**

The US–China relationship is at a crucial juncture requiring delicate diplomacy to overcome strains, while also maintaining peace and stability in Asia Pacific. Growing tensions across a wider range of issues, coupled with domestic political pressures, leave little room for compromise. Furthermore, potential misunderstanding could open the door to miscalculation and policy mistakes. Nevertheless, there is still room for a mutually beneficial outcome. The range of scenarios is wide. A best-case scenario would be a continuation of the current state of peaceful strategic competition, where negotiations compel China to further open its domestic markets, sparking a new round of reforms. A worst-case scenario would be an increase in tensions that causes a reduction in the flow of goods, services and capital through the region. With US President Donald Trump having met his Chinese counterpart Xi Jinping for the first time in April, we try to outline what investors can expect from the world’s most consequential relationship as the two countries grapple with a number of pressure points. Initial indications are positive – the two leaders established a framework for continued dialogue and China signalled a willingness to improve the trade relationship. However, a number of key issues remain unresolved and the gaps between the countries remain wide. Will the competing agendas of Xi’s ‘China Dream’ and Trump’s ‘America First’ cause turmoil in the US-China relationship? Or will the leaders find a path for win-win co-operation?

**Competing agendas**

President Xi’s ‘China Dream’ policy was borne out of slowing economic growth and rising domestic imbalances. Following years of staking the ruling Communist Party’s legitimacy on rapid growth and rising incomes, Xi is rebasining its legitimacy on restoring China as an influential global superpower. As part of the ‘China Dream’, Xi has pledged not only increasing prosperity but also turning the country into a military, political and cultural power. It is decidedly a foreign policy-oriented vision that aims to increase China’s influence over international affairs. It is this ‘Dream’ that has sparked China’s more assertive foreign policy as exemplified by the ‘One Belt, One Road’ agenda (building stronger links with its neighbours along traditional trading routes including the Silk Road to the west and maritime routes to the south), island building in the South China Sea and the creation of the Asian Infrastructure Investment Bank (AIIB). Positioning the Party as the only body that can restore Chinese prominence allows Xi and the Party to claim legitimacy even as the economy slows. While this added source of legitimacy can improve domestic stability by giving the public a unifying goal apart from rapid growth, it could risk disrupting regional stability. Disputes with neighbours, including Vietnam over oil drilling, Japan over the Senkaku/Diaoyu islands, South Korea over the deployment of the Terminal High Altitude Area Defense anti-missile system, or Taiwan for electing a president viewed as sympathetic to Taiwan independence are a risk to further Asian economic integration (see Chart 1) that has underpinned decades of peace and prosperity. Historically, this would have pushed these countries closer to the US orbit, but uncertainty over America’s commitment to Asia Pacific leaves regional countries with few options. Beyond foreign affairs, Xi’s ‘China Dream’ also includes elements of protectionism aiming to return the country to a position when it had little dependence on foreign entities. The ‘Made in China 2025’ initiative exemplifies this goal by explicitly aiming to substitute imported goods with domestic production; China’s goal is to raise domestic content of core components and materials to 40% by 2020 and to 70% by 2025.

How will ‘America First’ interact with the ‘China Dream’? While the Trump administration has yet to detail fully its China policy, the US president has defined ‘America First’ as foremost ‘buy American and hire American’, a decidedly protectionist policy that aims to reduce US reliance on foreign goods, production and labour. In addition, ‘America First’ has undertones of a unilateralist foreign policy; one that pursues American interests with less regard to global implications. Movements towards eliminating former President Barack Obama’s climate agreements could be the first step of a more inner-looking ‘America First’ foreign policy. This primarily inward-looking strategy has the potential to impact China profoundly (see Chart 2). Any attempts to restore America’s manufacturing base, reduce the US trade deficit with China, or further restrict Chinese investments in the US all come into direct conflict with the ‘China Dream’.

**Out of sync**

In addition to conflicting agendas, the political cycles in Washington and Beijing are out of sync, making co-operation more difficult. The Chinese central government is in the midst of a once-every-five years political reshuffling. As many as five senior Chinese leaders will change positions this autumn as Xi prepares to solidify his power going into his final five years as president. In advance of the leadership transition, Xi is trying to secure stability at all costs – socially, economically and financially – both within and outside of China. In years leading up to large political changes, the Chinese government has historically been less dynamic and less willing to engage in large-scale reforms. This is occurring at the same time that the Trump administration may be set to challenge the status quo; there is widespread belief within the US foreign policy establishment that the current relationship with China is unbalanced (see Chart 3) and that North Korea has become a threat that can no longer be ignored. As calls to take action and fulfil campaign promises gather steam, US pressure on China is increasing at a time when China’s political system is striving for quiet stability.

**Why this time might be different**

There have been flash points in the US-China relationship in the past. The 1989 Tiananmen Square protests, the US Navy’s EP-3 surveillance plane crash in the Southern Chinese island of Hainan and the US bombing of the Chinese embassy in Belgrade all had the potential to escalate into larger conflicts. Two conditions prevented escalation: first, the American business community effectively lobbied the US government to take a less severe and more co-operative approach,
even during hawkish administrations. Second, under past administrations, the US would not link policies; for instance, America would pursue cooperation on climate change, anti-piracy and counter proliferation despite dissatisfaction with cyber-attacks, developments surrounding the South China Sea, North Korea or currency manipulation. Chinese Foreign Minister Wang Yi described this simultaneous friction and co-operation as the ‘new normal’ in US-China relations. These two forces combined to create a stable and peaceful environment for growth and competition. However, both conditions may be fading. Parts of the American business lobby, which has so steadfastly pushed for constructive US-China relations, are now lobbying Washington to take a more assertive approach protecting US businesses from perceived unfair competition policies in China. Furthermore, the Trump administration appears willing to break from the past and make co-operation conditional on Chinese concessions. Although the White House backed down on using the ‘One China’ policy as a bargaining chip, it was perhaps the first indication that everything is negotiable and mutual co-operation may only occur if China yields to US demands. In the absence of a strong pro-China business lobby, and a change in US policy framework, the relationship risks moving from one of co-existent friction and co-operation to one where friction dominates.

The optimistic case
Despite considerable disagreements, there are still reasons to believe that negotiations between the two leaders can result in changes with positive spillover effects. For years, the US has been urging China to become a ‘responsible stakeholder’ by constructively supporting the rules and institutions that underpin the global economy. If the US begins to encourage, rather than oppose, Chinese initiatives such as the AIIB or the New Development Bank (set up by the BRICS group of major emerging economies) as well as support China to play a greater role at existing multilateral institutions, it could provide China the strategic space it desires to exert greater influence, while also persuading it to assume more responsibility in upholding the existing order. Tying this to a US goal, such as a freeze on militarisation in the South China Sea, would be a beneficial outcome for Asia. In addition, if US pressure on trade imbalances results in greater liberalisation of the Chinese economy, this could serve to increase American services exports while also jump-starting a stalled domestic reform process. China has a long history of using external pressure to increase domestic support for reforms – joining the World Trade Organization and including the renminbi in the International Monetary Fund’s special drawing rights basket are two examples. If pressure to reduce the US trade deficit with China results in further progress on Chinese domestic reforms, the effects from increased Chinese productivity and rebalancing towards consumption-led growth would benefit the global economy. Indeed, the US decision between pushing for greater liberalisation in China or increasing tariffs on China, may be one of the most important policy choices facing the global economy. Inability to overcome geopolitical hostilities would result in the reduced flow of goods, services and investment between the world’s two largest economies. Constructive negotiations, on the other hand, could open a new phase of reform and fairer competition.
Economic Outlook

Better mood music

As the recovery broadens out across more economies, central banks face difficult decisions about the correct monetary policy response.

Jeremy Lawson
Chief Economist

Better near-term outlook

It has been a positive start to the year for the global economy. The simultaneous acceleration in industrial sentiment and a run of positive data surprises across the advanced and emerging economies has left our forecasts for a broad-based pick up in global growth firmly intact. Markets comfortably absorbed the US Federal Reserve’s (Fed’s) March rate hike and the likelihood of more to come. Even the political environment has been more favourable than many had feared, with the march of populism receiving a set-back in the Dutch election and the Trump administration taking a more compromising stance on trade and foreign policy. However, legislative setbacks on healthcare forced investors to reconsider the likelihood of the Trump administration succeeding in its legislative agenda, while we are monitoring the recent moderation in US services activity and employment. All in all, the near-term global outlook is better than it has been for years even if the structural factors weighing on longer-term growth have not gone away.

On the economic front, we have been encouraged by the upturn in the global trade cycle. World export volumes increased at a 7.75% six-month annualised rate in December, with both emerging and developed market trade volumes accelerating. Leading indicators, including port activity in Los Angeles, have also improved. For this pick-up to be sustained, we need to see an improvement in global capex – non-residential investment is the most trade-intensive component of aggregate demand. Fortunately, conditions are improving here. In the US, the modest recovery in non-residential fixed business investment that began in Q4 is set to continue in 2017, as sentiment in the tech cycle advances and energy-related investment recovers in line with improving commodity prices.

The Chinese driver

Importantly, this is not just a US story. Capital goods orders have also picked up in Germany and Japan, while Chinese capital spending continues to be supported by the strong policy stimulus that took place through 2016. Indeed, the pick-up in Chinese industrial activity over the past year has been an underappreciated driver of the improving global cycle (see Chart 1), especially through its impact on commodity prices. Large-scale monetary and fiscal stimulus, directed mostly toward the commodity-hungry property and infrastructure sectors, led the rebound. Although both are expected to slow through 2017, policymakers are unlikely to tolerate any more than a mild slowdown with the National Party Congress looming in the autumn. The authorities will be helped in these endeavours by the fact that property imbalances are less acute than in past cycles (see Chart 2). Price bubbles, which developed through 2016, were narrowly focused on a few regions while the construction response was also muted. Although household mortgage growth was very rapid last year, household debt ratios remain very low by international standards. This year’s Congress represents an opportunity for President Xi Jinping to consolidate his power. The open question is whether Xi will use that power to renew reform efforts or continue with the current policy status quo. If the latter path is taken, the longer-term risks to the economy and financial system will increase. Perhaps recognising this, the authorities have tightened capital controls to prevent an acceleration in outflows, reducing the pressure on the currency to depreciate further, while also allowing reserves to stabilise.

Whither deflation risks

Another positive feature is the fading of deflationary risks. Developed market CPI inflation is forecast to hit 1.9% this year, markedly higher than 0.7% in 2016 and 0.3% in 2015. The shift in global inflation dynamics largely reflects the impulse from higher commodity prices. Looking forward, energy price inflation is expected to peak, leaving inflation to be primarily driven by trends in core inflation. Here, signs of improvement are patchy. Although a modest upward trend is evident in some measures of core US inflation, muted labour cost growth suggests that an inflation breakout this year is unlikely. The UK is expected to see a more significant rise in inflation, although this mostly reflects the impact of sterling depreciation. Indeed, the slowing in the domestic economy that we anticipate should dent domestic inflationary pressures. Meanwhile, the neighbouring Eurozone continues to struggle to generate core inflation, with spare capacity still abundant.

Market implied inflation expectations reflect the twin trends of higher headline inflation, but more uneven underlying price pressures. Continued above-trend growth in many markets should help support inflation dynamics over coming years as domestic slack is eroded and unit labour cost pressures start to build. However, evidence from the US, Germany and UK, which have been at the vanguard of labour market recoveries, suggest that this may be a slow process due to flat Philips Curves (which shows the relationship between unemployment and inflation in an economy) and entrenched below-target inflation expectations in many markets. Certainly, it is critical that central banks bring price growth back to target before the next global downturn. If this is not achieved, the risk of more permanent damage to inflation expectations would be significant.

Monetary policy still supportive

With the macro backdrop clearly improving and near-term deflation risks receding, the waves of developed market central bank interest rate cuts and asset purchase announcements are likely behind us. The Fed raised its policy rate for the third time in March, just three months after its previous increase. The strength of the labour market appears to have persuaded officials that policy was too accommodative. We expect rate increases in June and September, followed by the announcement of gradual balance sheet reduction through a slowing of Treasury and MBS reinvestment from December. The Bank of England’s asset purchase programme ended in February and a deterioration in growth will be necessary to bring forth new easing. The European Central Bank (ECB) reduced its monthly rate of asset purchases for 2017 and another leg down is likely in 2018.

Nevertheless, it is important to recognise that the tightness of monetary policy is determined not by the level and change in nominal policy rates, or the pace of asset purchases, but...
by the level and change of real interest rates relative to their neutral level. Indeed, it is possible for the stance of monetary policy to become easier even when central banks are lifting their policy rates if those increases are not keeping pace with changes in inflation or the neutral real rate.

Applying that logic to the year ahead as outlined above, headline inflation will increase in most of the major developed economies, suppressing real policy rates. Moreover, the upswing in global activity that is currently underway, amid ongoing healing from the global financial crisis and selective fiscal loosening, may at the same time be pulling the neutral real rate higher. In practice then, it is the performance of growth, inflation and asset prices that will ultimately tell us whether the stance of monetary policy is becoming less accommodative or not.

Avoiding policy mistakes

The main risks to the developed market monetary policy outlook emanate from politics and government policy. A large loosening of US fiscal policy would only boost growth temporarily and likely induce a more aggressive monetary response through 2018. We will monitor the US president’s appointments to fill the current vacancies at the Fed, not to mention any signals about who will replace Janet Yellen when her term expires next February. A hawkish tilt to appointments could cause a re-pricing of duration assets, though the administration also has incentives to keep monetary conditions accommodative while other policies pull in capital from the rest of the world. Economic risks do remain, such as a potential credit crunch and inventory drawdown in the auto sector if interest rates do rise quickly.

In Europe, the bar for the ECB to increase the pace of its asset purchases seems very high. There has been little reaction to the widening in peripheral bond spreads this year, though it would be difficult for them to stand on the sidelines if an anti-euro government was elected in France or Italy. Otherwise, the ECB is hoping that a gradual pick-up in underlying inflation allows it to taper asset purchases over the next few years. Support for that view comes from the Eurozone’s recent consistent above-trend growth, bringing unemployment steadily down. That said, with wage and broader labour cost growth remaining stubbornly weak, the ECB has to be careful about prematurely tightening financial conditions. The Bank of Japan faces similar incentives to keep real interest rates very low, although they are pursuing this objective through the use of more unconventional policy instruments.

In China, risks are plentiful but we think the biggest is that the People’s Bank of China could over-tighten monetary policy. In our discussions with Chinese policymakers, they expressed confidence in underlying demand and the self-sustaining nature of the current business cycle. This has persuaded them that the economy can now withstand a reduction in monetary policy support. However, we think the current recovery is still heavily reliant on housing sector activity and state-led infrastructure investment. Both would likely suffer if policy support is lifted. Reducing leverage is undoubtedly positive over the longer term, but it needs to coincide with reforms that spark new growth drivers. Given the current state of housing-led growth, policy tightening could depress growth more than expected.
US Equities

North American shale taking over the world?

The growth of US shale has an important effect on global oil supply and hence the profitability of large parts of the industry.

Fujun Wu
Senior Vice President, US Equities

A rocky journey

There is never a dull moment in the oil market. From 2003 to 2008, oil markets went through the age of resource scarcity when demand was driven upward by Chinese growth and supply was constrained by underinvestment and contracting OPEC spare capacity. In June 2008, these conditions drove oil prices to $140 per barrel. Shortly thereafter the global financial crisis brought demand and prices crashing down. As the economy recovered in 2009, the US shale oil industry started blossoming. The rig count grew from 876 in June 2009 to 1,931 in November 2014 and US oil production nearly doubled from 5.1 million barrels per day (mb/d) in January 2009 to 9.5mb/d in December 2014. US shale has been a game changer for the US oil industry and turned the US into a crucial player in global oil supply. Pad drilling, longer laterals and increased intensity led to better well productivity and lower cost per barrel for US shale producers.

Increasing US importance in global oil

US shale has become the world’s swing producer because it sits lower on the cost curve and has a shorter lead time than other global producers (six to eight years versus three years). For these reasons, US exploration and production (E&P) companies are becoming more important in global oil supply and will provide significant production growth. Within US shale, the Permian Basin has been at the forefront of the revolution. In fact, Rystad Energy stated that the US could now hold more oil reserves than Saudi Arabia due to the potential resources in the Wolfcamp area of the Permian Basin; estimates suggest more than 150 billion recoverable barrels of oil equivalent remain. Indeed, from a cost curve perspective, the Permian Basin was the only US major shale formation to see production growth since the downturn began in November 2014. We continue to expect strong growth out of the Permian Basin, from around 2mb/d today to some 4mb/d in 2019. As a result, we are increasingly positive on US E&P companies.

For this reason we hold CXO, which owns considerable acreage in the Delaware Basin and looks set to contribute significantly to the production growth from the Permian Basin. One prominent Permian-focused E&P company commented that despite significant gains in well productivity we are “still in the early days” of productivity gains (see Chart 1). For example, most E&P companies are just beginning to use predicative analytics and artificial intelligence across their operations.

A battle between OPEC cuts and North American shale ramps up

The outlook for oil prices is constructive due to a tightening supply and demand balance in the near term. This tightening is driven both by strong demand and slower growth in supply. On the demand side, reporting agencies revised their global demand growth estimates upwards, expecting an increase of 1.6mb/d in 2016 and 1.4mb/d in 2017. On the supply side, there is a battle between how accurately OPEC complies with its cuts and the magnitude and speed of the US shale recovery. So far, OPEC compliance has been good at 90-100% and the likelihood of extending the deal is high. The Energy Information Administration (EIA) estimated US production was 8.9mb/d in 2016 and forecasts it to grow to 9.2mb/d in 2017. We believe US production will be greater than the EIA’s estimate, as the EIA underestimates improvements in shale productivity. In addition, weak investment internationally paints a bullish picture in the medium term – most international production today is depleting reserves without reserve replacement, creating a hole in production that could emerge by 2018. In the long term, prices may be range-bound around $55-$65 per barrel given the ample runway of low-cost US shale.

In our US equities portfolio, we own E&P companies EOG and CXO, which are at the forefront of the shale revolution and in our view can deliver significant multi-year production growth. We also own Halliburton, a “best in class” oil services company that is squarely positioned to benefit from production growth and service intensity increases in US shale.
Government Bonds

Tapering and politics don’t mix

As pressure grows on the ECB about the next steps in monetary policy, there appear a range of scenarios in which yields could rise. We favour underweight positions in semi-core and peripheral European bonds.

Divergent paths for bond markets

After a period in remission, Europe has been at the heart of recent stresses in developed sovereign bond markets, with sharp divergence in the relative performance of German, French and Italian bonds (see Chart 1). There are several causes of this stress. The decision in December by the European Central Bank (ECB) to begin tapering bond purchases, from €80 billion per month to €60 billion, sent out a clear impression that peak quantitative easing (QE) was behind us. It also led investors to question the reaction function of the ECB, not least because core inflation in December was running around the same rate as it was at the onset of QE in March 2015 (0.8% versus 0.6% a year). The reasoning behind that decision was understandable. The ECB is getting very close to physically exhausting its government bond-buying programme, particularly if it wants to stay within its self-imposed 33% limit per issue of any bond purchased. To breach this rule, it would face stiff legal challenge, not least because it would be perceived to contradict Article 123 of the Lisbon Treaty regarding debt monetisation. The range of options available to the ECB to allow it to prolong the programme are all problematic. This is true whether it involves altering the capital key, and thus being perceived to reward more fiscally lax countries, or whether it is dropping the maturity limits on bonds and thus potentially exacerbating the scarcity issue.

New challenges

As we are also seeing strong economic growth by recent European standards, so the ECB now faces a different set of challenges. Prior to the European debt crisis, the current growth numbers in Europe (close to target headline inflation, albeit flattered by commodity price trends) and expectations for rising underlying inflationary pressures would have led to calls for the start of a rate hiking cycle, particularly in certain member states. Faced with lobbying from the Netherlands and Germany, the ECB seems keen on floating the idea of raising rates from the current -40 basis points on the deposit rate, while maintaining its QE programme. The idea is that this would placate Northern European member states. However, this is a fragile exercise; it would mean further divergence from the ECB’s forward guidance and risk an erosion of confidence in its commitment to its inflation target.

Political risks

Alongside this tapering issue another factor is rising political risk, as France, Germany and Italy face elections. The European narrative began 2017 with a more benign ‘rate normalisation’ type of core bond sell-off. However, this has evolved into a less orderly re-pricing of political risk in the periphery and semi-core of the Eurozone. As a result, European bonds have begun to diverge in yield, and both peripheral and French bonds have come under sustained pressure. At the same time, German bonds have become a safe haven, with investors immune to the extremely negative yields they currently offer. While the likelihood of a shock French electoral result remains low, it is not immaterial, so uncertainty will persist at least until the presidential election in May.

In light of this, the ECB is faced with a dilemma. Some of the underlying economic data points to it moving away from maximum easing, but at the same time it is acutely aware that its policy and forward guidance brings respite to debt in the periphery and sufficiently protects it from increased political uncertainty. With ever more apparent limitations to the ECB’s monetary policy tools, the case for fiscal policy expansion taking on the baton grows. However, there is scant evidence of that happening soon. Volatility is likely to rise in the European bond market as these cross currents remain active. Ratings are vulnerable to changes in the political backdrop.

The case for active management in this environment has never been clearer. Our portfolios are underweight European bonds on aggregate, and we view the risk/reward of being underweight France and Italy outright as compelling. These positions can perform in at least two distinct scenarios. The first is when European growth continues to improve and the inflation profile moves up in line with the ECB’s target. In this scenario, duration should broadly sell off in anticipation of the eventual tightening of monetary policy. In another scenario, QE fatigue and legal hurdles mean tapering of the Public Sector Purchase Programme is inevitable, with or without the much-needed growth and inflation figures. In this scenario, the spreads of France and Italy will likely widen relative to Germany as ECB support dwindles, and poor fundamentals raise credit questions. We are highly active in our management of these positions, given the significant negative carry costs and idiosyncratic political event risks.

Source: Datastream (as of 31 March 2017)

Chart 1

Going their separate ways?

Total return performance of 10 year bond index, rebased to 100 as of 3 November 2016:

France | Germany | Italy

Source: Bank for International Settlements (as at August 2010)


UK | Australia | US | Canada | New Zealand | Ireland

Jack Kelly
Investment Director, Government Bonds
NAFTA and currencies: a Mexican stand-off?

President Trump has threatened to renegotiate or pull-out of NAFTA. We investigate the main currency implications for the US dollar and the Mexican peso.

What is NAFTA and how has it impacted North America?

The North American Free Trade Agreement (NAFTA) was created just over 20 years ago to expand trade between the US, Canada and Mexico, and to make these countries more competitive in the global marketplace. Most economists agree that NAFTA has been a success as regional trade increased from $290 billion (bn) at its start to $1.1 trillion in 2016 and cross-border investment has also surged – for example, US foreign direct investment to Mexico leapt from $15bn to more than $100bn in the same period. However, the aggregate benefits have been modest for many households and workers, and, as with all trade agreements, there are winners and losers. Some US industries suffered job losses and stagnant wages after manufacturers moved to Mexico to take advantage of lower labour costs. The difficulties associated with the rise of automation and global impact of China joining the WTO make such analysis more difficult. While economists agree NAFTA has been, on the whole, beneficial, the degree of benefit is hard to measure. Certainly, the distribution of winners and losers within regions and sectors of each country’s economy has created newfound political pressures. The loss of manufacturing jobs in the US is one of the reasons that led President Donald Trump to sign an executive order to renegotiate NAFTA. The suggestions from the new president are that the agreement could be significantly altered, especially with respect to Mexico.

Modelling the best and worst case

We looked at the economic impacts regarding possible changes in the NAFTA agreement and worked through how these changes might affect the components of our Behavioural Equilibrium Exchange Rate fair value model (BEER). The model’s estimates are based on terms of trade, relative productivity and net international investment position (see Chart 1). We made assumptions as to how policy changes would impact the underlying variables. In the unlikely case that NAFTA remains unaltered, the model output using current economic data suggests the Mexican peso (MXN) is currently 12% undervalued. At the other extreme, we have modelled the economic outcome for Mexico if the US pulls out of NAFTA altogether and reverts to World Trade Organization (WTO) rules.

More likely outcomes suggest the worst could be behind the peso

These two scenarios are the least likely of our expectations. The most likely are those we term ‘good’ and ‘bad’ versions of a genuine NAFTA renegotiation. The less severe version implies only changes to rules of regional content to ensure production chains contain a slightly larger share of value generated in the US, perhaps with a limited number of quota restrictions. Even for this relative sanguine option, our modelling suggests fair value moving towards the current market levels and therefore we no longer expect the current rally in the peso to continue. The more damaging NAFTA renegotiation would include the above changes but also a much larger required share of value generated in the US – perhaps with additional non-tariff barriers restricting US offshoring and investment in Mexico. In this case the peso may be overvalued. While our more likely scenarios look like good news for the Mexican peso, any renegotiation of NAFTA will bring substantial uncertainty. The recent rally suggests further progress will be difficult at least until greater certainty on the outcome of NAFTA discussions are forthcoming.

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Ken Dickson
Investment Director, Currency

Source: Bloomberg, Standard Life Investments (as of 27 March 2017)
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.

<table>
<thead>
<tr>
<th>Publication</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weekly Economic Briefing</td>
<td>A regular analysis of major cyclical developments and structural themes in leading advanced and emerging economies.</td>
</tr>
<tr>
<td>Global Outlook</td>
<td>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.</td>
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<tr>
<td>Global Horizons</td>
<td>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.</td>
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</tbody>
</table>

Contact Details

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