Global Outlook

July 2017

The global economy may be bubbling along nicely but inflation pressures are as distant as ever. In this month's Global Outlook, we ask whether central banks are in danger of making a policy error and look more closely at the bond and equity market implications of policy normalisation. We also identify which economies are most at risk of painful deleveraging if the benign growth outlook we are forecasting does not come to pass, and argue that sterling is only cheap if one is confident of a positive outcome to Brexit negotiations.

Standard Life Investments

House View

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

	July 2017 House View	
Risk	The Global Investment Group retains a cautious medium-term outlook, as a variety of political, financial and economic drivers point to higher levels of financial market volatility. While there are particular areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
Government Bonds		
US Treasuries	Tighter labour markets and rising wages give the Federal Reserve the rationale to continue tightening policy. Inflation pressures are not being fully priced in by markets.	MOVED TO LIGHT
European Bonds	Bonds are not as well supported, as the improvement in economic growth could force the ECB into tightening policy while political pressures could resurface. Markets, however, are over-pricing future inflationary pressures.	LIGHT
UK Gilts	The Bank of England has delivered significant easing measures as the impact of rising inflation on household incomes is expected to cause the economy to slow. Long-term valuations are expensive, especially after the recent moves in sterling.	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	While we see inflation as generally well-contained globally, there are varying opportunities in different markets. In particular, UK breakeven rates look relatively high and US rates relatively low.	NEUTRAL
Global Emerging Market Debt	Local currency yields are more attractive due to emerging market sensitivity to the pickup in global growth. US dollar-denominated debt is supported by attractive spreads over Treasury debt.	HEAVY
Corporate Bonds		
Investment Grade	QE supports UK bonds, but has driven European yields to unattractive levels. US credit spreads are less attractive as Treasury yields increase, and riskier assets are preferred.	LIGHT
High Yield Debt	The hunt for yield has driven investors to this asset class, although overcrowding remains a risk in some sectors, especially in the US when monetary policy is being tightened or oil prices are under pressure.	NEUTRAL
Equities		
US Equities	Equities have rallied on the back of improved global economic conditions and potential fiscal easing and deregulation. While dividends and buybacks are supportive, valuations are fairly full.	HEAVY
European Equities	Corporate earnings are improving on the back of a widespread pickup in economic growth across the region, while investor sentiment becomes more positive. Concerns remain over some banking systems, and the lack of strong credit growth.	HEAVY
Japanese Equities	The market looks more attractive as easy monetary policy and fiscal stimulus for 2017 are helped by efforts to improve corporate governance, share buybacks and business investment.	NEUTRAL
UK Equities	The UK economy is weakening and Brexit remains a longer-term threat. Sterling remains the primary driver of the relative attractiveness of UK companies with overseas exposure.	MOVED TO LIGHT
Developed Asian Equities	The improvement in the global economy supports this market, but Chinese tightening risks property curbing demand, which is a large driver for the region.	NEUTRAL
Emerging Market Equities	While emerging markets are attractive in the face of a global pickup, the current Chinese tightening bias makes us neutral on this asset class at the moment.	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.	NEUTRAL
Europe	European property continues to perform well in a global context. Yield compression is essentially over as spreads have tightened, while stronger economic growth and low levels of supply are supporting healthy income growth.	HEAVY
North America	The US market has low vacancies across most sectors and markets, with the notable exception of retail malls. Construction is mostly in check, providing a prolonged window for rental growth.	HEAVY
Asia Pacific	An attractive yield margin remains, but yields have bottomed in most markets. Income returns are driven by modest rental growth on the back of low vacancies, healthy tenant demand and resilient economies.	NEUTRAL
Other Assets		
Foreign Exchange	Better global growth tends to encourage flows out of the US dollar; the euro is no longer a sell while the yen is cheap. Sterling acts as a shock absorber for Brexit.	NEUTRAL $, €, £, HEAVY ¥
Global Commodities	While global growth is generally supportive of commodities, these are very sensitive to Chinese policy, which is trying to slow that economy. Some commodities, particularly oil, face excess supply.	NEUTRAL
Cash		
	With global yields still extremely low, we still see better opportunities in risk assets.	LIGHT

Foreword

Editor

Jeremy Lawson
Chief Economist

In this July edition of Global Outlook, I outline my team's forecasts for the global economy. These show that there has been a meaningful and broad-based pickup in global economic growth over the past 12 months, with forward-looking indicators suggesting that above-trend growth is likely to continue in the year ahead. However, there has been little accompanying improvement in wage growth and underlying inflation. Because of this, the world's major central banks need to tread carefully as they withdraw monetary accommodation in case they again misjudge the inflation outlook and end up locking in low inflation for longer.

Continuing the central banking theme, Liam O'Donnell, Investment Director for Government Bonds, takes a closer look at the Federal Reserve's (Fed) plans to reduce the size of its balance sheet by year-end. He observes that there has been remarkably little reaction in bond markets to the prospect of a faster-than-expected shrinking of the balance sheet, in part because investors are sceptical of the Fed's ability to deliver. While some upward pressure on US yields should emerge as run-off begins, he does not expect a repeat of the 2013 taper tantrum. Meanwhile, Jonathan Fearon, Investment Director for European Equities, finds that there are many reasons to like Scandinavian banks in a rising interest rate environment.

A key plank of my optimistic near-term growth view is that there are few large credit imbalances outside of China that threaten to disrupt the global expansion. Nevertheless, because downturns cannot always be predicted, myself and James McCann, Senior Global Economist, take a closer look at where debt may have increased too much since the crisis and, hence, where deleveraging is likely to be concentrated when the next downturn comes. We find that private sector credit imbalances increased in countries that were not epicentres of the financial crisis, such as Australia, Canada, Hong Kong, Singapore, Sweden and Switzerland, and benefited from either rapid Chinese growth or very loose global monetary policy settings. Public sector leverage has increased substantially in most countries since the financial crisis, but institutional weaknesses leave us most concerned about the economies in the Eurozone periphery.

The final article also relates to risks, with Ken Dickson, Investment Director for Currency, investigating the implications of Brexit for the fair value of sterling. He finds that although the UK's real effective exchange rate is well below its long-term average, only if there is a fairly smooth and non-disruptive outcome to Brexit negotiations can the currency be regarded as cheap.

Economic Overview

Mind the inflation gap

The global economy is growing at an above-trend pace, but underlying inflation rates are not responding in kind. Central banks should take note if they want to avoid the policy mistakes of the past.

Jeremy Lawson
Chief Economist

Real economy in cruise control

Over the past 12 months, there has been a healthy recovery in global economic activity, concentrated in the industrial sector. Global industrial production increased by more than 3% in volume terms in the year to April, up from 1.6% in the year to April 2016. The growth rate of global export volumes has also picked up (see Chart 1). Most parts of the world have enjoyed better industrial growth over this period, though there have been leaders and laggards. Among the large advanced economies, Japan witnessed the biggest acceleration, though US industrial growth also picked up noticeably. In the emerging world, Latin America improved the most but Emerging Asia remains the fastest growing region, led by China. The latest PMI data have moderated a fraction from their Q1 highs but still imply healthy growth through to at least the summer.

Broader GDP growth was also mostly solid in Q1, with a few notable exceptions. Japan and the Eurozone grew above their potential growth rates, and Chinese growth was also strong in the quarter. Meanwhile, the Brazilian and Russian economies finally returned to growth in Q1 after their deep recessions. Preliminary Q1 GDP estimates were more disappointing in the US and UK; both grew well below trend in the quarter. We consider the US outturn to be an aberration. Measured growth in the first quarter of the year has been systematically lower than for other quarters during the current expansion and Nowcasts for Q2 growth are currently tracking above 2%. There are more hurdles to a pick-up in UK growth, as the fragile minority government that has emerged from last month's general election enters what will be very difficult Brexit negotiations, and consumers are squeezed between sluggish nominal wage growth and higher inflation.

Overall, we have left our forecasts for global growth broadly unchanged over the past three months at 3.4% in 2017 (up from 2.9% in 2016), and 3.5% in 2018 and 2019. Although the hard economic data are not tracking quite as strongly as the softer business survey data, the gap is modest and we had not built all of the survey strength into our forecasts. Critically, outside of China and a few smaller advanced and emerging economies, we are also not currently observing the types of macroeconomic and financial imbalances that typically bring business cycles to an end. Meanwhile, our in-house indicators of financial conditions and financial stress are consistent with modestly above-trend global growth over the coming 12 months, even if that trend remains soft compared with pre-crisis norms thanks to persistent structural constraints on growth.

Inflation pressures remain weak

While the real economy continues to tick along nicely in most economies, the same cannot be said for inflation. Almost all of the pick-up in headline consumer price inflation in the advanced economies through 2016 and early 2017 was attributable to the rebound in energy price inflation. With the Goldman Sachs Commodity Price Index currently down around 10% since February, energy and materials price effects will continue to fade over the next few months, bringing headline inflation down with it.

For headline inflation rates to rise sufficiently to meet central banks' inflation objectives, underlying inflation will need to accelerate. Yet there is scant evidence of this occurring. In the US, where the business cycle is most advanced, core CPI inflation has surprised to the downside in each of the past three months, leaving the annual growth rate at just 1.7%; this is around 0.6 percentage points lower than the rate consistent with the Fed's core PCE inflation target (see Chart 2). Some measures of labour cost growth did edge up in the first quarter but there are downside risks to the Fed's inflation forecasts.

Looking through the noise in erratic components, core Eurozone inflation appears to be stuck in a channel a little below 1%, a full percentage point below the ECB's target. Unless there is a substantial pick-up in average monthly core inflation outturns through the rest of the year – unlikely in the context of sizeable excess capacity – the ECB will also have to revise down its current end-year forecasts. Japan is in an even worse position, as underlying inflation is presently in negative territory.

Unlike the majority of the other advanced economies where consumer price inflation is currently moderating, inflation in the UK is still rising thanks to the pass through of the post-Brexit depreciation of the pound. In May, core inflation hit 2.6%, its highest level since November 2012. That said, we expect headline inflation to peak in the second half of this year before moderating slowly as the pace of exchange rate pass through slows and purely domestic inflation pressures remain modest amid sluggish economic growth.

In the major emerging economies, disinflationary pressures are also more common than inflationary pressures. Headline inflation has declined precipitously in both Russia and Brazil thanks mostly to the reversal of their currency collapses but also their prior deep recessions. Indian consumer price inflation has declined to the lowest rate in almost 12 years as the RBI has maintained a tight policy stance despite last year's demonetisation wobble. China's consumer price cycle is more moderate than in other countries, but there too headline inflation has slowed over recent months and is sitting close to multi-year lows.

Understanding lowflation

Why is there so little inflation in the global system at present? In our view, there are a number of mutually reinforcing forces at play. One is that there is still a global output gap, which is closing only gradually. Although global growth has picked up over the past year, there is still spare capacity in most of the world's labour and product markets, which is acting to keep inflation pressures down. While there is less slack in places like the US, Germany and Japan, global spare capacity is exerting more influence over domestic inflation than it did in the past.

Another factor is the disruptive effect of globalisation and technological changes that are lowering firms' cost structures and making it more difficult for them to pass on any increases in costs to consumers. Both are reinforcing the declining responsiveness of wage growth and inflation rates to changes in slack itself – the so-called flattening of the Phillips Curve. Underlying inflation rates should still rise over time as long as above-trend growth continues but the process is likely to be painfully slow.

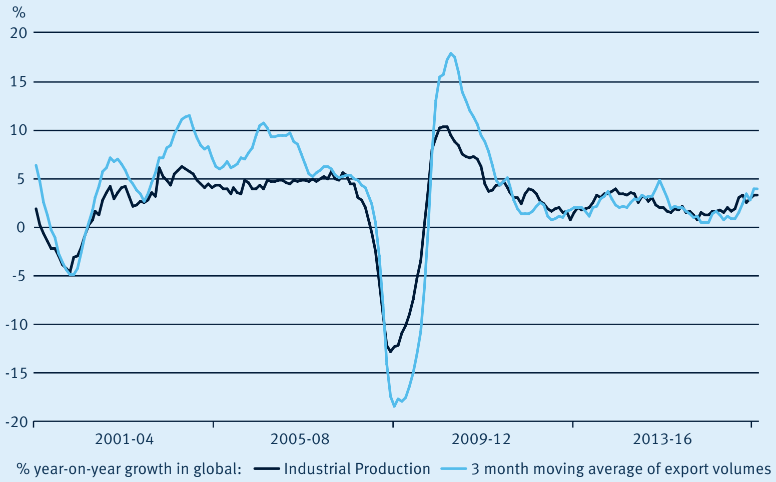
Avoiding policy errors

In the fight against 'lowflation', central banks may also be scoring own goals. Over recent years, they have shown a consistent tendency to overestimate the underlying inflation pressures in economies. The Fed is a case in point. In January 2012, the median FOMC core PCE inflation forecast for end-2013 was 1.75%; the final reading was 1.55%. Fed officials similarly overestimated two-year-ahead core inflation at the start of 2013, 2014 and most probably 2016 as well. Only at the start of 2015 when the oil shock was at its peak did officials gauge the inflation outlook correctly.

The Fed has not been the only central bank to make these errors. The Riksbank, RBNZ, RBA, ECB and BoJ have also all had to downgrade overly ambitious inflation forecasts over recent years and in many cases reverse course once their policy mistakes were realised. These misjudgements have had two main consequences. First, it has meant that policy has been too tight and real interest rates too high for most of the post-crisis period. Second, it has undermined people's faith in the ability of central banks to meet their inflation objectives at all, with low inflation expectations becoming increasingly embedded into the pricing of government bonds and wage-setting decisions.

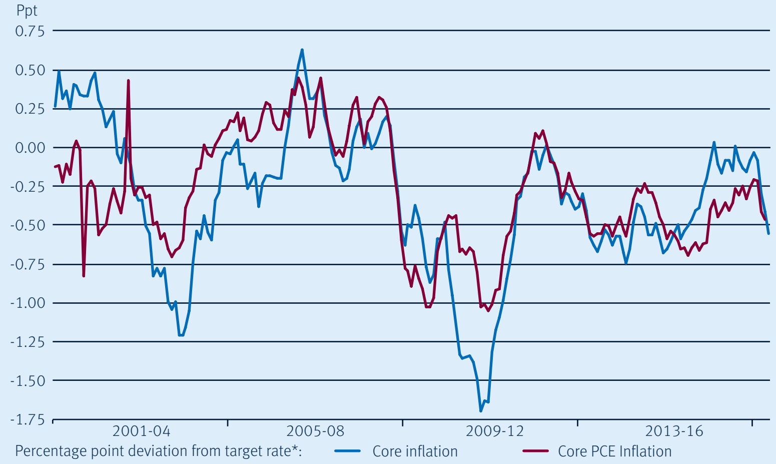
The current direction of global monetary policy appears to be dictated more by the above-trend growth seen across most economies than recent inflation trends. The Fed has raised its policy rate three times over the past six months and is signalling further rate rises ahead and a desire to begin reducing the size of its balance sheet before the end of the year. The ECB and BoJ will be a long way behind the Fed on lifting policy rates, but both are looking to slow their asset purchases down over the next 18 months (see Chart 3). Finally, the PBOC also wants to reduce the amount of accommodation in the system given the rising risks from excess lending growth. However, with the risks to most central banks' inflation forecasts still to the downside, they all need to tread carefully in case they once again miscalculate and risk locking in low inflation for good.

Chart 1
The upswing continues



Source: CPB, Datastream (as of April 2017)

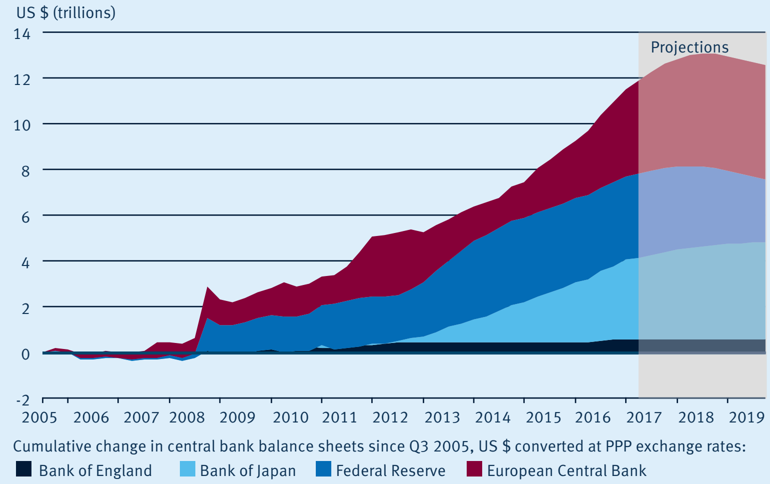
Chart 2
Falling short of target



*Note: CPI target rate is adjusted to take into account of average gap between CPI and PCE inflation

Source: BLS, BEA, Datastream, Standard Life Investments (as of May 2017)

Chart 3
The great unwind approaches



Source: National Sources, Datastream, Standard Life Investments (as of June 2017)

Global Spotlight

Who is the weakest link?

Although aggregate global financial imbalances are less extreme than on the eve of the financial crisis, some economies and business sectors are more vulnerable to recession than others.

Jeremy Lawson
Chief Economist

James McCann
Senior Global Economist

Fewer aggregate private sector imbalances

Our benign outlook for the global economy over the next 12 months hinges on three main factors: the continuation of the favourable trends in forward-looking business and consumer indicators; our expectation that loose monetary policy will be withdrawn only gradually, with the aim of accommodating a stronger economy rather than slowing it down; and an absence of the extreme private sector financial imbalances that characterised the pre-crisis global economy. The last of these is especially important when we consider the balance of risks around our central forecasts.

Our starting point for assessing private financial imbalances is to look at how financial and non-financial private sector credit-to-GDP ratios have evolved since the crisis. In aggregate, the advanced economies have undergone a meaningful adjustment from past excesses; with financial, non-financial corporate and household sector debt ratios falling from their crisis peaks, before stabilising more recently (see Chart 1). The drop in the ratio of non-financial private sector to GDP has been driven by declines in the US, UK and Germany, though peripheral Eurozone economies such as Spain and Portugal have also undergone substantial deleveraging.

The emerging market (EM) cycle has been somewhat different. Officially, China's non-financial private sector debt ratio has increased by almost 100 percentage points (ppts) since 2008, though much of this increase has actually been in state-owned enterprises. Critically, and unlike most other EM credit booms in history, China's has been financed internally rather than externally. This protects the country from the kind of sudden-stop induced crisis that hit the Asian economies in 1997 and 1998 – although a severe economic slowdown would test that resilience. Excluding China, the increase in private sector EM leverage has not only been more modest but is funded more safely than during the 1990s credit booms.

Pockets of country-specific private sector vulnerability

While this headline story sounds benign, economic downturns can be difficult to predict ahead of time. As such, it is still worth asking which countries do have the sorts of financial imbalances – private or public – that leave them vulnerable to a big shift in the global economic or policy environment. Armed with this knowledge, investors can then choose where their risk-adjusted returns are likely to be greatest over the coming years.

To assess where private sector vulnerabilities lie, we make use of a very simple two-dimensional scoring system based on data collected by the Bank for International Settlements (BIS). This shows how the world's largest economies' non-financial private sector debt-to-GDP ratios have evolved over time. The first dimension identifies whether countries' end-2016 ratios are low, moderate or high along a five-point scale that takes into account countries' stage of economic development. The second dimension measures how much those ratios have changed since the quarter immediately before the global financial crisis, again along a five-point scale. A country's aggregate vulnerability is the simple sum of the two sub-components.

The very highest scores are reserved for countries where private non-financial sector debt is currently above 200% of GDP, and where that ratio has increased by more than 20ppts since Q2 2008. Belgium, Canada, Switzerland, China, Hong Kong, Ireland, Norway and Sweden all meet these criteria (see Chart 2). Another set of economies is only slightly less vulnerable, either having a debt ratio between 150% and 200% of GDP (slightly lower if they are an emerging economy), or a more moderate increase in that ratio since 2008. Those economies are Australia, Chile, Finland, France, Korea, Thailand and Singapore. On the other end of the scale, displaying the lowest vulnerability according to our metric are countries like Germany, Italy, India, Indonesia, Mexico, Russia, Spain, South Africa, the UK and the US.

Setting aside the unique case of China, the countries with the greatest non-financial private sector imbalances have tended to have at least one of the following features: those that have very close trade links with China and hence benefited from that country's aggressive post-crisis stimulus and rapid growth (Australia, Chile, Hong Kong, Korea, Thailand and Singapore); large exporters of crude oil or metal commodities that accumulated debt as they rode the commodity super-cycle (Australia, Canada, Chile and Norway); and countries that were not epicentres of the financial crisis but effectively imported the very loose global monetary settings that followed (Australia, Canada, Hong Kong, Finland, France, Norway, Sweden and Switzerland). The vast majority of the vulnerable countries we have identified have also experienced rapid average house price and housing credit growth over the past nine years. While we are not implying that these countries must endure crises of their own when the next downturn hits, they are all candidates for more aggressive deleveraging than the average economy.

Some sector vulnerabilities too

In some countries, aggregate vulnerabilities appear low, but individual sectors display high vulnerabilities. The US is a case in point. Before the financial crisis, auto sector debt grew more slowly than mortgage sector debt. Although lending standards were too easy in both segments of the market before the crisis, 90-day delinquency rates on auto debt peaked at a little over 5% in 2011, worth around $36 billion, while mortgage delinquencies peaked at 8.5% in 2010, worth $750 billion.

These relative positions have reversed over the past seven years (see Chart 3). After a relatively brief period of tightening in auto lending standards during and immediately after the recession, significant easing followed. As of Q1 2017, lending to people with credit scores below 720 made up more than 50% of all auto loan originations and the level of auto lending is 64% higher than at the start of 2010 – double the increase in disposable incomes.

There is no doubt that auto lending has been excessive and underwriting standards sometimes lax. That helps to explain why auto delinquency rates have started to edge up, even though the unemployment rate is coming down and disposable incomes are growing at a healthy clip. We are now beginning to see a correction with auto lending standards having tightened for three quarters and auto demand dropping off, highlighted by weaker light vehicle sales over recent months. It therefore seems likely that the sector will be relatively hard hit when the next major downturn occurs.

However, the sector's challenges are not large enough to be systemic. The outstanding stock of auto debt is $1.1 trillion, less than 10% of total household debt. Auto debt rolls over more quickly than housing debt and, even if delinquency rates increased to double those seen in the aftermath of the financial crisis, the value of those delinquencies would be less than a seventh of the value of bad housing debts in 2010.

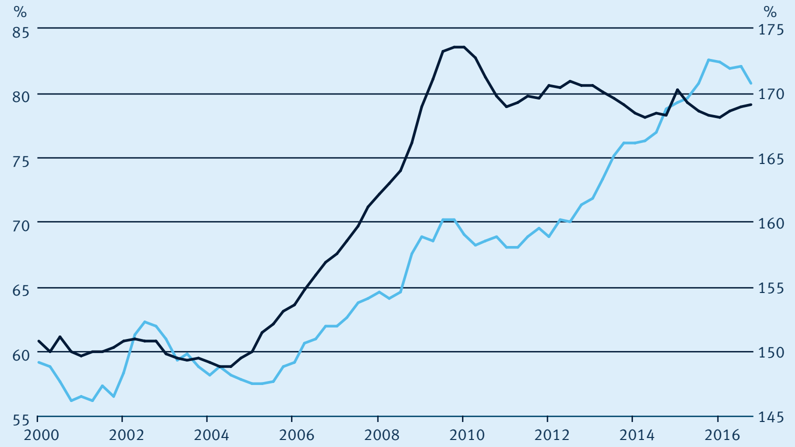
Don't ignore public sector debt

We have focused entirely on trends and vulnerabilities in private sector debt so far, but investors also need to monitor developments in those countries with large public sector debt burdens. Public sector debt ratios have uniformly increased since the financial crisis and some of the countries that fared comparatively well in our private sector analysis – Brazil, Greece, Italy, Japan, Portugal, Spain, the UK and the US – have the least sustainable public trajectories once one takes into account the potential impact of a recession. Indeed, many could see their current public sector debt ratios jump another 20ppts in another severe recession.

Of these economies, we are most concerned about those in the Eurozone. Other than monetary policy, the capacity of which is nearly exhausted, the Eurozone lacks cross-border automatic fiscal stabilisers to help cushion the growth impact of idiosyncratic shocks. Indeed, as was shown during the Eurozone crisis, current fiscal pacts often force pro-cyclical fiscal tightening that ultimately serves to undermine long-term debt sustainability. Moreover, although Eurozone institutions and backstops have improved in response to the crisis, the existing financial architecture remains inadequate. Without a full banking union and a better-funded European Stability Mechanism, the nexus between national banking sectors and national sovereign debt remains too close.

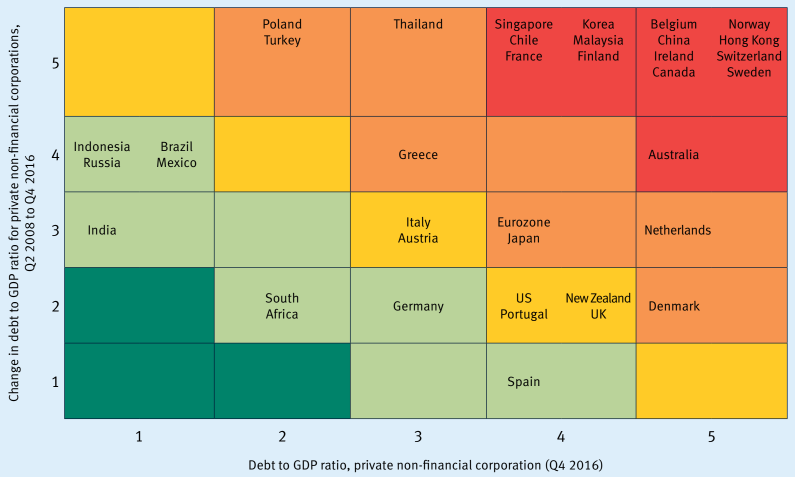
The political commitment to the Eurozone project and its existing membership is also not sufficiently strong. A Greek exit from the Eurozone is mooted each time debt negotiations are revisited and the euro's popularity has waned in those economies where household income growth has been weakest since the crisis. As a result, the prospects for much-needed institutional reform appear dim and peripheral sovereign debt spreads have been wider during periods of stress than one should see in an inviolable and well-functioning currency and political union. While the Eurozone economy currently looks healthier than at any time since before the twin crises, these vulnerabilities are likely to reappear when the next global downturn comes.

Chart 1
Emerging markets take the lead



Debt as % of GDP (DM = Developed Markets, EM = Emerging Markets):
EM ex. China private nonfinancial corporate — DM ex. US private nonfinancial corporate (R. H. Scale)
Source: Bank for International Settlements, Standard Life Investments (as of Q4 2016)

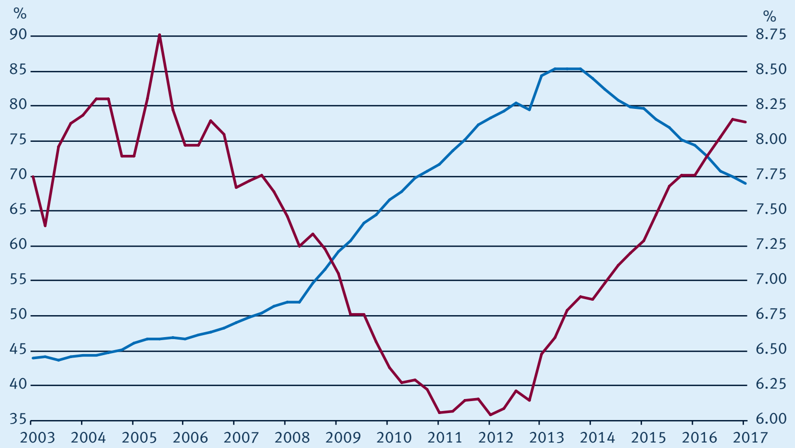
Chart 2
Debt vulnerabilities



Note: Data scored on 1 to 5 basis with 1 being the least vulnerable

Source: Bank for International Settlements, Standard Life Investments (as of Q4 2016)

Chart 3
US household debt reversal



US households, as % of disposable personal income: — Mortgage debt — Auto loans (R. H. Scale)

Source: Federal Reserve, Federal Reserve Bank of New York, Bureau of Economic Analysis, Standard Life Investments (as of Q1 2017)

European Equities

Falling back in love with Swedish banks

Investors have fallen out of love with Swedish banks but the investment case remains strong.

Jonathan Fearon
Investment Director, European Equities

Jilted banks

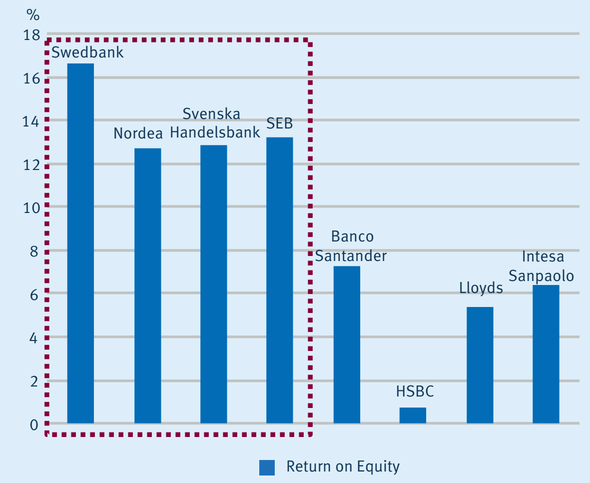
Swedish banks have fared much better than their Eurozone cousins over the past decade due to a reputation for being more prudent and better capitalised. That reputation has been well-deserved. Setting aside some problems with their Baltic loan books, default rates in their core domestic franchises were incredibly low in the aftermath of the financial crisis. The fact that some banks availed themselves of state aid to shore up their balance sheets after the crisis led to greater regulation and stronger capital requirements. The banks were able to pass on the costs of these regulatory-driven changes, unlike many of their global industry peers. This contributed to strong double-digit returns on equity (see Chart 1).

More recently, concerns have arisen over the impact of a new wave of global banking regulation emanating from the Basel committees. This is despite domestic economic trends that have been positive and monetary policy that has remained ultra-loose. Market enthusiasm has been driven elsewhere, notably towards more interest-rate sensitive European banks. We, however, believe that Swedish banks are now under-appreciated by the market and have therefore built-up substantial positions in Swedbank and Nordea. We are also enthusiastic about Danske Bank because of its growing market share in Sweden.

Building the investment case

One of the key reasons for our positive view is the outlook for interest rates. Because Swedish banks fared well when rates were declining, it is often forgotten that they are highly sensitive to changes in interest rates. For example, a 100 basis point (or 1%) change in policy rates is generally expected to lift earnings by 10-15%, although the gross sensitivity is higher. Admittedly, this is not significantly more sensitive than the average European bank. But Swedish banks are normally able to pass on policy rate increases to their end-customers more quickly due to more regular price resets. In contrast, banks in mortgage markets that are dominated by fixed-rate products, like France and the Netherlands, have to wait much longer to see the earnings benefits of higher interest rates. Moreover, the Swedish banks tend to capture a larger proportion of any rate increase because of the more oligopolistic structure of the local market.

Chart 1
Better returns in Scandinavia



Source: Bloomberg (as of 22 June 2017)

Our macro outlook for Sweden is also more favourable. Inflation is still too low and the Riksbank will be reluctant to facilitate a change in policy that leads to a sharp appreciation of the krona. However, the neutral policy rate is higher in Sweden than in the Eurozone. This leaves more potential upside for policy rates over the medium term. The Riksbank is expected to deliver a gradual rate hiking path, commencing next year. With Eurozone policy rates expected to remain anchored at a lower level for longer, Swedish banks should outperform their Eurozone peers. In our view, the Swedish economy is also in a better position to absorb higher policy rates than the Eurozone because it has fewer structural and institutional deficiencies.

Resilience to regulatory changes

Setting aside the macro and central bank policy outlook, the major appeal of the Swedish banks is their credentials as reliable distributors of capital to their shareholders. Indeed, our preferred names currently offer a dividend yield of around 6%, with dividends set to grow broadly in line with increasing earnings.

The biggest challenge to our positive view is the potential for further regulatory tightening. Proposed new rules alter the way that banks can assess the risks they are taking. However, it is our view that final proposals are likely to be watered down. We also expect that any resultant capital shortfalls will be offset by regulators shaving capital requirements in other areas, like the systemic risk buffers. Even in the worst interpretation of the new rules, Swedish banks remain among the most profitable and well-capitalised banks in Europe. This is despite an over-levered household sector. They should be able to protect their returns by passing on the costs of a higher regulatory burden to consumers. Indeed, in the case of Nordea, they even have the option of re-domiciling their headquarters to Helsinki where capital requirements are likely to be lower.

Government Bonds

Tapering but no tantrum

The Fed's impending move to begin shrinking its balance sheet should put some upward pressure on long-term interest rates but we do not foresee a sell-off on the scale of the 2013 taper tantrum.

Liam O'Donnell
Investment Director, Government Bonds

Balance sheet reductions are coming

The Federal Reserve (Fed) took further steps toward policy normalisation at its June meeting, lifting the federal funds rate target by another 25 basis points. It also released a statement effectively pre-announcing that it will begin reducing the size of its balance sheet before the end of the year. Although the Fed will initially phase out the reinvestment of maturing securities slowly, by capping net Treasury runoff at $6 billion (bn) per month and net mortgage-backed security (MBS) runoff at $4bn per month, these caps will be raised quickly in quarterly increments until reaching $30bn and $20bn respectively. Fed officials want the process of balance sheet reduction to be almost mechanical, with the federal funds rate remaining the main tool of monetary policy above the zero lower bound.

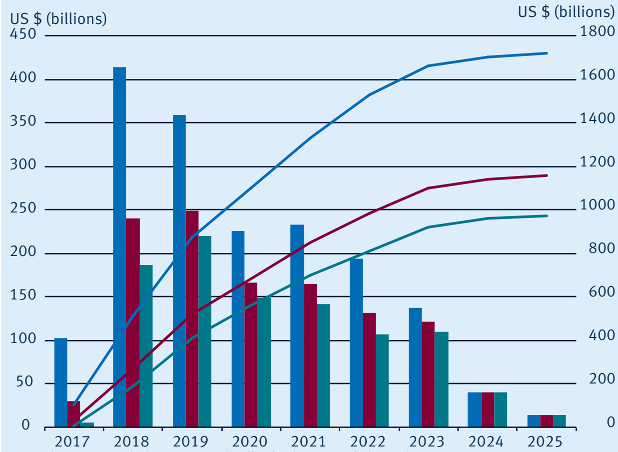
Rather surprisingly, these somewhat hawkish plans have been largely ignored by the bond market, with long-term US interest rates little changed over recent weeks and yields still significantly below where they began the year. This indifferent response partly reflects concerns that the Fed's plans are overly ambitious, given the continued weakness in underlying inflation. Nevertheless, as bond investors, we need to examine what balance sheet reductions could mean for Treasury supply before assigning research-based probabilities to outcomes for bond yields.

Both the cap and start date matter

The Fed currently holds about $2.4 trillion (trn) of treasury securities, with an average maturity of eight years. In what follows, we compare the extent to which the Treasury component of the balance sheet would shrink under a benchmark 'no cap' scenario in which all reinvestments cease, with a scenario that follows the Fed's latest guidance under both a September and December start date (see Chart 1).

The differences are significant. Under the 'no cap' scenario, the Fed's Treasury portfolio would decline by around $420bn in 2018 and $1.1trn over the next three years. But when the cap is reduced and the Fed begins phasing out reinvestments in September, net Treasury runoff would be $240bn in 2018 and $685bn over three years. And although the decision about when to delay phasing-out reinvestments until December may seem inconsequential, it would mean $60bn more net supply in 2018 and $80bn over three years.

Chart 1
Faster than expected runoff



Bars indicate rate at which Treasuries roll -off Federal Reserve's balance sheet, lines (R. H. Scale) indicate cumulative roll off levels assuming:
No cap · September Start · December Start
Source: Federal Reserve, Standard Life Investments (as of June 2017)

Minimising short-term disruptions

An increase of at least $600bn in net Treasury supply over a three-year period is not to be sniffed at. If concentrated in Treasury bonds, there would be a 20-30% increase in annual supply, which would have significant implications for yields. To avoid the risk of a large 'shock' to the bond market, the US Treasury could increase Treasury bill issuance by at least $200bn per annum without the market's ability to absorb that extra supply being compromised. Although this would reduce the average maturity of outstanding debt, we think that the Treasury is more likely to favour this approach because it would facilitate a smoother exit profile for the Fed.

An upward trend in yields but with limits

Over the medium term, the planned unwind of the Fed's balance sheet should put some upward pressure on bond yields. Including MBS run-off that is currently averaging more than $20bn per month, the cumulative balance sheet unwind being proposed would reach well over $1trn by the end of 2020. This would represent a headwind for fixed-income markets and questions may arise as to whether or not markets or the economy are ready for such a degree of liquidity withdrawal. Indeed, the reaction in bond markets so far suggests there is scepticism among investors about the ability of the Fed to follow through with its plans.

However, while it is possible that further inflation disappointments could delay the commencement of runoff until December, the Fed's plans are unlikely to be derailed completely. In that environment, we would expect US yields to drift higher, dragging global yields up as well, although we still see limits to how much US yields can increase in a world of structurally weak growth and high debt. Indeed, if US 10-year bond yields were to rise above 2.75% they will look very attractive to global investors. From a portfolio perspective, we are therefore positioned for only a modestly upward shift in the US rates structure due to the next phase of monetary policy normalisation.

Currency

Sterling in the age of political uncertainty

Sterling may seem cheap but our analysis suggests that markets are appropriately discounting the range of plausible Brexit outcomes.

Ken Dickson
Investment Director, Currency

Sterling stabilises but not far from historic lows

In the wake of last year's vote to leave the European Union (EU), sterling fell by over 15% on a trade-weighted basis as the market adjusted to the potential consequences for the UK economy and the external financing position. In the near term, increased uncertainty about future arrangements was expected to hurt companies' hiring plans, business investment, international capital inflows. These, together with a weaker pound, would cause real wages to fall and hence undermine consumption growth. Economists' forecasts for UK growth were slashed and there were also fears that the government's slim majority would not be sufficient for essential Brexit bills to pass through parliament smoothly.

2017 to date has seen the currency make modest gains, with cable (the British pound priced in US dollars) currently trading around 5% higher than its post-vote lows. A number of factors have contributed to this reprieve. Rather than enter into recession as economists had feared, on average, the UK economy has grown close to its forecast potential since the vote, allowing the Bank of England (BoE) to exit its asset purchase programme in February. At the same time, the US dollar fell against most major currencies as optimism about the ability of President Trump's administration to lift growth faded and capital flowed to other markets as the global recovery deepened and broadened. Meanwhile, political developments appeared to be encouraging until the UK government's decision to call a snap election backfired and the Conservative party were left without an absolute majority. The government must now negotiate Brexit from a weakened position, though that could serve to incentivise a more conciliatory approach.

Low does not necessarily mean cheap

With so many cross-currents, how can we assess fair value for the UK currency? A common starting point is to compare the real effective exchange rate with its long-term average or its value at purchasing power parity (PPP). On the first measure, sterling is around 10% undervalued and on the second it is 11% undervalued. However, both of these metrics are potentially misleading when a country is going through such a large economic and institutional adjustment. As a consequence, our preferred approach is to make use of scenario analysis within fair valuation frameworks that take into account economic and financial shocks of the type that Brexit may represent.

Table 1
Range of scenarios

		Fair Value range (US $ / £)	
Scenario	**Description**	**BEER***	**FEER†**
Current data	Q1 data implied fair value	1.29-1.35	1.25-1.32
Central case	Fudged Brexit deal within controlled timetable	1.22-1.28	1.21-1.27
Worst case	No deal is very bad deal; uncontrolled	1.18-1.25	1.10-1.15
Best case	Good quick Brexit; economic growth and interest rates rise	1.33-1.40	1.33-1.40

Current level is £ = $1.27

Note: Fair value estimates have large confidence intervals

* Behavioural equilibrium exchange rate model
† Fundamental equilibrium exchange rate model

Source: IMF, Bloomberg, Standard Life Investments (as of 23 June 2017)

The first valuation framework we use is a behavioural equilibrium exchange rate (BEER) model. This relates the fair value of the currency versus the terms of trade, interest rate differentials, relative productivity levels and the net international investment position (NIIP). The second is a fundamental equilibrium exchange rate (FEER) model that estimates the level of the currency that is required to bring the cyclically adjusted current account balance into alignment with its equilibrium level. In both cases, we apply alternative plausible scenarios to the variables that are likely to be most affected by Brexit and then compare the fair value estimates for cable with its current level.

Trading fairly given the balance of risks

Table 1 summarises the results of three indicative scenarios: a central case that assumes a fudged, but controlled Brexit outcome that allows for a mild deterioration in the UK's external position and terms of trade; a best case outcome that assumes minimal disruption to UK/EU trade and faster normalisation of growth and policy rates; and a worst case outcome that assumes no deal is reached and thus an uncontrolled Brexit takes place.

Under the central scenario, cable is currently toward the top of the average fair value range across the BEER and FEER models. In the best case scenario, strong capital inflows to the UK return, pushing the fair value range for the currency 5-10% above its current level. And in the worst case scenario, the fair value could fall as far as 1.1 mainly in the event that overseas investors are no longer prepared to finance a large current account deficit.

There are two main conclusions from our analysis. The first is that the fair value for the currency depends crucially on the outcome of Brexit negotiations. The second is that only in the best case scenario is the currency unambiguously cheap and only in the worst case is it unambiguously expensive. The upshot is that, unless one wants to take a very strong view on the outcome of what are highly uncertain Brexit negotiations, currency markets currently appear to be discounting the plausible outcomes fairly efficiently.

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

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

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