

# Global Outlook

## Third Quarter 2015

Tensions are appearing in financial markets against the backdrop of Greece, a move towards higher interest rates in the US and continued QE or monetary easing in other countries. Within this environment, the House View continues to prefer a pro-risk portfolio, although some positions have been lowered on valuation grounds while a more activist approach to equity and bond selection is increasingly evident among the fund management teams.

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# Foreword



**Keith Skeoch**  
Chief Executive

As I write this foreword, financial markets and newspaper headline writers are fixated on the situation in Greece. We spent a considerable amount of time at the recent quarterly Global Investment Group (GIG) meeting discussing a number of scenarios for EMU. An important conclusion was that although disruption from Greece could affect the Eurozone recovery, we saw this as very contained. The European Central Bank has built up a considerable armoury in recent years, while the debt problems are now very much the responsibility of the public, not private, sectors.

More important for our GIG discussion was the forecast that the US Federal Reserve (Fed) looks set to increase interest rates for the first time since 2006. History shows that financial markets, not just bonds but also credit and equity, can suffer in the early stages of such a tightening cycle. However, history also shows that pro-risk portfolios can make progress in this environment as and when investors realise that the only reason the central bank is tightening policy is to prolong the business cycle by ensuring that inflation remains close to target. Nevertheless, much of our GIG discussion was about the longer-term path facing the Fed, rather than the timing of the first rate move. Whether rate increases are gradual or aggressive will depend on a complex interaction of inflation, productivity and investment trends.

A second risk facing investors concerns not the US but the world's second largest economy, China. As Chief Economist Jeremy Lawson explains, China is struggling with a difficult transition away from an economic model overly reliant on debt, infrastructure spending and exports towards one

focused more on services and consumption. Our forecasts are that policymakers can stabilise the situation, although the effects of slower growth will be seen in trade data and commodity prices across the world.

As Head of Global Strategy Andrew Milligan discusses, we remain cautiously optimistic about the outlook for equities and real estate, as long as there is a positive cashflow from the corporate sector. It is the case though that our longer-term returns analysis does warn that the best of the returns may have been seen in this cycle. This view is reflected as well in many of the equity and bond articles, which demonstrate that the fund managers are relatively defensive in their positioning. For example, the fixed income team do not believe that inflation will rear its head any time soon, while as companies undertake more share buybacks so credit investors are considering the implications for corporate balance sheets. As a number of emerging market countries are no longer accumulating reserves, so currency investors are examining individual growth prospects more. All in all, a sophisticated process for active stock picking is ever more important in this phase of the investment cycle.

# Global Overview

## Catching China's cold

The slowdown in China is partially offsetting the improvement in the US and European economies.



**Jeremy Lawson**  
Chief Economist

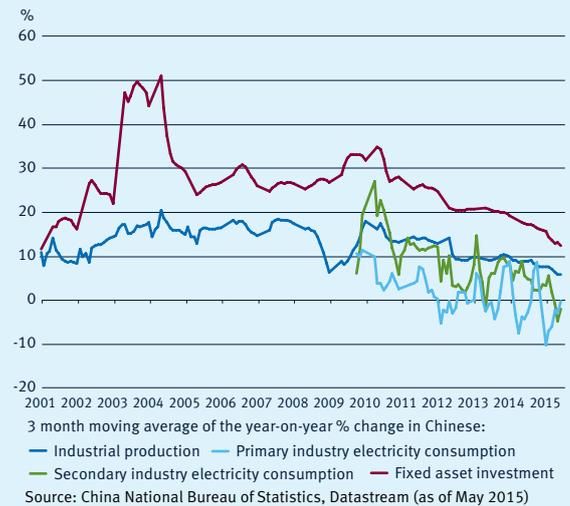
## China's problems

With Europe finally recovering after years of sub-par growth, the biggest threat to the global economy is arguably China. Real GDP growth moderated to an annualised rate of just 5.8% in the first quarter, which dragged year-on-year growth down to 7.0%. Both were the weakest outcomes since the global financial crisis. While real growth has slowed significantly in recent years, the deterioration in nominal activity has been even more dramatic. As late as the middle of 2011, nominal GDP was growing at an annual rate of 19%; in the most recent quarter nominal growth was just 5.2%, with growth in the GDP deflator slipping into negative territory. This economy-wide disinflation, and more recently deflation, has mostly been due to rapidly declining commodity prices, though non-commodity consumer price inflation has also slowed.

To get a more detailed picture of what is driving China's growth slowdown, it is necessary to look at a broader array of economic and financial indicators than simply the aggregate GDP figures. The epicentres of the economy's problems are the industrial and property sectors. Growth in real industrial output has declined from 14% in mid-2011 to 5.9% in April, growth in fixed-asset investment has halved over the same period and electricity consumption by primary and secondary industries is in outright decline (see Chart 1). China's trade with the outside world is also falling, though one has to interpret this data with care because it does not always match up with other countries' trade statistics. Meanwhile, real-estate investment, which had been the primary engine of growth up until last year, is going through a prolonged slump.

The two main components of activity preventing a deeper downturn in activity are private spending on services, particularly financial services, and government-led increases in transportation infrastructure. Retail sales, especially e-commerce sales, have been growing faster than the overall economy, and electricity consumption in the services sector is also expanding strongly. Meanwhile, growth in household incomes is now outpacing GDP growth. All this suggests that China has begun the necessary rebalancing towards a more sustainable, consumption-led growth model, although it is still too early to claim success.

**Chart 1**  
Chinese causes for concern



## Rebalancing China

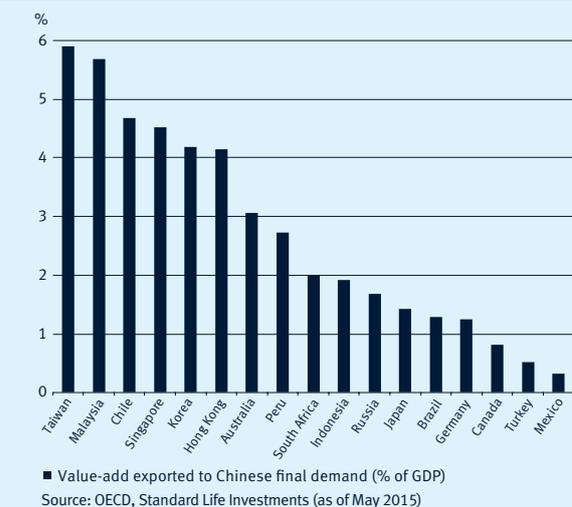
Some moderation of growth and rebalancing away from investment was intended by the authorities. Excess investment by property developers, encouraged by local governments focused more on the quantity than the quality of growth, had led to a significant oversupply of residential property and fuelled a dangerous build-up in leverage. State-owned enterprises had also joined this debt-driven party, leaving the heavy industrial sector with excess capacity and weak profits. Recognising these problems, the government has been stepping up the pace of structural reforms, including cracking down on corruption and liberalising the financial system. Monetary and fiscal policy is also being loosened but in a targeted way, managing the slowdown in growth and credit, rather than as a strong supporting impulse for the economy.

That measured approach to policy appears to have been cast aside more recently as the deterioration in economic activity has been too rapid for the authorities liking. Beijing has partially reversed its decision to limit Local Government Finance Vehicle (LGFV) lending, infrastructure spending is being ramped up, and further cuts to reserve requirement ratios and lending rates are in the offing. The aim is to push growth towards the government's target by continuing government support for directed credit before moving back towards more market-driven lending once current worries have abated. We expect the government to have some modest success in boosting GDP in the near term, though the long-term glide path is still down and most of the risks remain to the downside.

## China's impact

Although it is not our baseline expectation, a hard landing in China would obviously be a large negative shock for the global economy, representing as it does 12% of global GDP at market exchange rates and some 18% of global manufacturing exports. It has also been the dominant source of demand for global metal commodities and, according to the IMF, it has accounted for more than a third of global growth over the past seven years. Those figures provide a clue as to which countries stand to lose the most from any failure of the Chinese authorities to stabilise growth: commodity and manufacturing intensive economies that are closely integrated

**Chart 2**  
Potential major losers



with the Chinese property and industrial sectors (see Chart 2). On the commodity front, countries like Australia, Brazil, Canada, Chile and Peru stand out. In terms of manufacturing, it is Hong Kong, Korea, Malaysia, Singapore and Taiwan that are most exposed, while several important developed economies like Germany export a sizeable amount of capital goods to China.

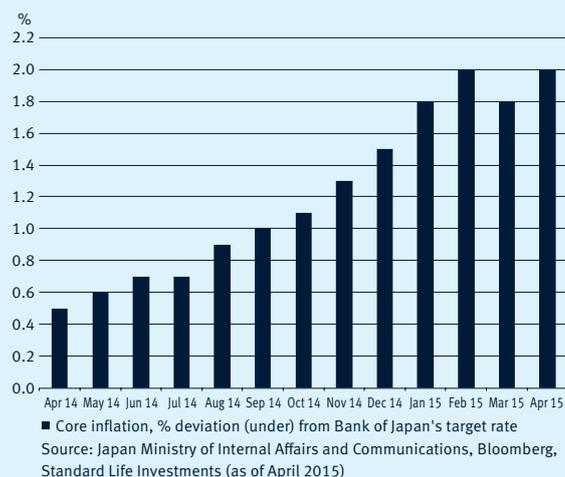
Navigating China's slowdown is of course only one of the challenges facing the emerging market (EM) complex. Even excluding the Chinese figures, aggregate EM GDP is growing at its slowest pace since the crisis, partly because two of the largest economies – Brazil and Russia – are both in recession. Productivity growth is also exceptionally weak, largely due to widespread failures to undertake domestic reforms. Slow growth and moderating inflation explains why many emerging economies have been loosening monetary policy in recent months. For the most part, this easing has been justified but for economies like Turkey, that still have large external imbalances, there is a danger in taking things too far at a time when most of the downward pressure on inflation from global sources is waning and the Fed is getting closer to raising its own benchmark interest rates.

There is good news. Our research shows that most emerging markets are in a much better position to withstand external shocks than they were in the 1990s, thanks to improved fiscal and monetary policy frameworks. One example is much greater willingness by most countries to allow their currencies to depreciate in the face of external shocks. Moreover, there are a number of positive growth stories to report. Eastern European members of the European Union, such as the Czech Republic, Hungary and Poland, are clearly benefiting from the turnaround in the Eurozone's growth prospects, while Indian growth is being propelled forward by lower energy prices, improved reform momentum and accommodative monetary policy.

### Developed market prospects

For once, the outlook for the developed economies is not plagued by considerable uncertainty. Europe is finally enjoying a broad-based recovery thanks to a reversal of previous policy mistakes, in turn allowing long-depressed domestic demand and corporate earnings to stage a rebound. Still, there is no room for complacency. The recovery is still young and fragile, the unemployment gap is large, and underlying inflation is too close to zero for comfort. Fortunately, the European Central

**Chart 3**  
Falling far short of target



Bank understands this equation and is signalling that its QE asset purchase programme will run at least until completion in September next year. A potential Greek exit is the main source of intra-European risk, though the institutional defences against contagion are stronger than they were in the past.

In absolute terms, the outlook is brightest in the UK and US. The UK general election has delivered a more stable government than most were expecting, which will provide an additional fillip to already rapidly growing business investment. As long as the new government does not tighten fiscal policy more than the Bank of England can offset with accommodative monetary policy, and Brexit remains an event-risk rather than a probability, the domestic recovery should continue apace. We are also confident that the US recovery is intact despite the contraction of GDP in Q1. This is not a stellar recovery by any means but some of the factors that dragged growth down in Q1, including falling energy investment, the West Coast port strike and poor winter weather, will prove temporary, leaving growth to be driven by the improving labour market. That of course means that the Fed is likely to raise the federal funds rate for the first time before the end of the year, but as long as the withdrawal of accommodation is gradual and data-dependent it need not derail growth.

We are a little more worried about Japan. Granted, growth is on a firm upward trajectory and the labour market is tight. However, there are still few signs that the central bank's radical monetary policy experiment is yielding much higher wage growth and inflation (see Chart 3). Indeed, once energy and food prices are stripped out of the figures, inflation is only up slightly over the past year. That leaves Governor Kuroda in a quandary. The Bank of Japan's (BoJ) balance sheet is already expanding rapidly and the benefits of further yen weakness are likely to be modest. But if the BoJ stands by while inflation continues to fall short of its forecasts, the promise of Abenomics could start to unravel. We think that the BoJ will decide to scale up its asset purchase programme in the coming months once it becomes clear that wage growth has undershot its expectations. We are less sure that the current policies will be enough to do the job. The policy tools that have not been tried yet include a helicopter drop of money directly into households' bank accounts, but that might be a bridge too far even for the BoJ.

# House View

## Liquidity concerns appearing

Financial markets are supported by the steady expansion in the global economy but there are some signs that central bank liquidity is creating over-valued assets.



**Andrew Milligan**  
Head of Global Strategy

## Cautiously optimistic

The House View remains cautiously optimistic about the outlook for equity and property markets. On the one hand, there is positive cashflow from the corporate sector, not only an attractive level of dividends but also the benefits of considerable share buybacks. Steady, if historically low, rates of economic growth can drive forward demand for real assets such as commercial property, especially in an environment where new developments are constrained in many – by no means all – markets due to constraints on the functioning of the banking system. On the other hand, there are some signs that excessive amounts of liquidity are causing the early stages of bubbles in some asset prices – Chinese equities and European government debt earlier this year were a prime example. On balance, the House View has modestly lowered the risk levels in its multi-asset portfolios, although it definitely remains pro-risk. Our analysis continues to find that imbalances, such as inflation, current account exposure or debt levels, are not yet building which would normally be serious enough to bring the current business cycle to an end.

A mix of risk-seeking and income-producing assets are still able to drive performance for client portfolios. The favoured equity markets are Europe and Japan. Both benefit from a cyclical recovery in their economies, central banks keen on creating the conditions for a depreciating currency, somewhat healthier banking systems and, in Japan's case, a shift in corporate governance so that a large number of companies are taking action to improve their return on equity. The situation in Greece is only expected to cause short-term disruption to the economic recovery. The Heavy position in US equities has been lowered to Light; the rationale is that company profits are coming under more pressure from a mix of the dollar's appreciation, deterioration in unit labour costs and the impact of lower commodity prices, especially in the oil sector. In the most recent earnings season, company profits were little changed from a year earlier, while Japanese and European firms could often generate 10% growth. The House View favours real estate due to a favourable mix of growth, income and duration factors; the main Heavy position is in UK property, but when parts of this become too

**Chart 1**  
Bubbling away?



expensive then opportunities are being sought in Europe. Among the major currencies, the dollar is still favoured, less so on dollar strength and more in terms of relative monetary policies as the European Central Bank and Bank of Japan are expected to continue with a significant degree of QE until at least late 2016. Emerging market (EM) assets are generally not favoured in periods when the US dollar is appreciating, as this puts pressure on the finances of too many EM governments and companies, while in addition the further slowdown in Chinese economic activity is an unhelpful backdrop. For some time, a turnaround in weak global trade data has been monitored in relation to this position.

In terms of the fixed income markets, the Heavy positions in corporate bonds and emerging market debt have also been taken back towards Neutral. Undoubtedly in an environment of low interest rates investors need to search more intensively for yield; however when spreads have tightened then much more selective purchases are required, especially against the backdrop of rising interest rate expectations in the US. Expensive valuations mean that the House View is Light in most sovereign bond markets; our previously Heavy weighting in European government bonds has been taken down to Neutral; we consider the benefits of QE have been priced in, while there are fewer benefits in terms of overall portfolio construction and risk controls, especially as the situation in Greece becomes ever more complex.

There are noticeable signs that in a world of slow economic activity, low interest rates and sizeable central bank intervention, so certain markets are in the early stages of forming a bubble. The most obvious example is the Chinese equity market, but residential property in some cities, such as London, and government bond prices are being inflated as well. At a time of limited trading liquidity and congested positioning, so air pockets can appear, enabling very sharp drops in prices; for example this occurred to German bonds in recent weeks (see Chart 1). Investors should beware that financial engineering does not mean that the prices of assets move too far from the underlying fundamentals.

# Global Equities

## The dawning of a new era

The drive for certainty in an uncertain world is leading to structural and technological change at both a country and company level.



**Mikhail Zverev**  
Head of Global Equities



**Donal Reynolds**  
Investment Director,  
Global Equities

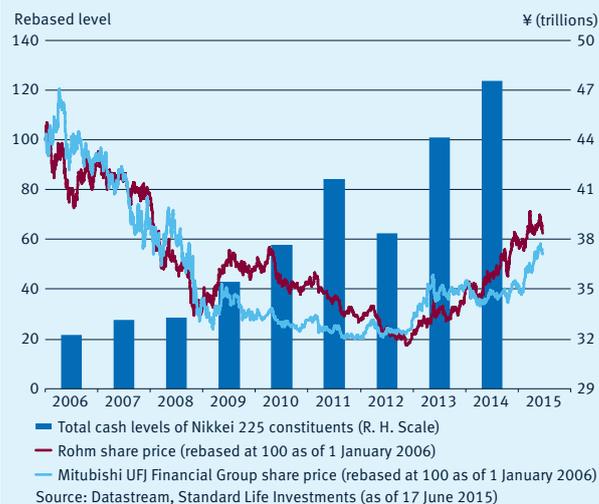
## Shedding light on new opportunities

As companies expand their global reach, they are frequently turning to technological developments in their quest to expand into new markets or secure a competitive edge. The lighting industry is one that is changing at an unprecedented rate. Customers are demanding more advanced technologies and design aesthetics, including LED bulbs, OLED panels or digital and wireless controls. The aim is to improve energy efficiency while creating suitably efficient lighting for all environments; accordingly technological developments need to take into consideration such issues as colour rendering, temperature and consistency, as well as lumen output and heat management. All these factors are important to the quality of lighting for the consumer, while additionally, households and companies are looking to reduce energy usage and labour costs. There are a number of major players in this field, including Cree, Osram, Phillips and Acuity Brands. We believe companies such as Acuity stand to benefit from this change, particularly from the acceleration of non-residential construction in the US, and has a strong channel presence compared to competitors that are multi-industry companies. Furthermore, LED components have come down the cost curve faster than expected, which should improve overall operating margins.

## Lock, stock and barrel

We have similarly been examining technological advancements in security solutions. This ranges from residential and commercial security to government buildings, airports or hospital management systems. There are strong demands for technological improvements as home ownership increases, driven by global urbanisation and higher standards of living. Companies such as Allegion stand to benefit; it is a leading security system company with over 25 brands sold on a global basis. The acceleration of the US non-residential construction cycle will also benefit Allegion given its strong market share in the US; it considers one of its strengths is helping developers differentiate properties by innovative and secure solutions. Margins in Europe are also showing signs of improvement now management has abandoned a pan-European approach to focus on Italy, Spain and Portugal where it has strategic advantages and a better market presence.

**Chart 1**  
Governance improvements coming through



## Is engagement in Japan hitting the target?

The third arrow of Abenomics, focusing on a series of structural reforms to improve economic growth, has started to take effect. Following the introduction of Japan's first corporate governance code at the start of June, there is hope that greater value will be unlocked for shareholders. In corporate governance terms, Japan lags many global rivals, even some of the major emerging economies such as China, India or South Korea. For many years, foreign investment has been lower in Japan relative to other countries partly due to the belief that the absence of independent directors often impacted business decisions and hindered long-term profitability. As one example, Japanese companies have been guilty of holding too much low-yielding cash on their balance sheets which has been an unprofitable asset. In many cases, there has been poor decision making when it comes to closing down areas of business that are clearly failing to deliver.

While resistance to reform has historically been strong, the appointment of external directors has been a key part of Prime Minister Abe's economic programme. As a result of better engagement, investors can now take a more active role and encourage cash-rich companies to consider share buybacks or dividend payments. This, in turn, will result in healthier balance sheets which will prove attractive for long-term investors. In particular, a number of companies have signed up to the 'stewardship code' – industry stalwarts such as Canon, Toyota and Nippon Steel have brought in outside directors. Last year saw the introduction of the JPX-Nikkei 400 Index, comprised of companies offering higher returns and better standards of corporate governance. We are seeing improving corporate governance through companies such as electronics company Rohm or Mitsubishi UFJ Financial Group (MUFG), both of which are focusing on shareholder returns (see Chart 1). Additionally, MUFG has a good overseas footprint providing opportunities beyond the low rate domestic business. Meanwhile, Rohm's solar SiC technology can be expanded to include factory automation, wind power and electric trains.

As engagement continues to improve, the differential in company and shareholder interests should become more aligned. This is not a panacea, but a growing number of external directors is certainly a step in the right direction.

# Global Emerging Markets

## Shopping around for the best names in Asia

Opportunities abound for investors able to spot areas of the market undergoing change - the key, however, is purchasing the right stocks.



**Alistair Way**  
Investment Director, Emerging Market Equities

### Positive change in China

The Chinese consumer staples sector is going through a period of change. Blighted by scandals of the past, many industry heavyweights have overhauled their businesses and improved their operations. Meanwhile, the Chinese economy is sputtering. In such a climate, consumer staples – goods that people buy steadily over the business cycle – tend to do well. There are other factors at work; these include ongoing monetary easing from policymakers in Beijing, a change to the regulatory environment (for example mainland Chinese investors can now buy shares on the Hong Kong stock exchange through a cross-border equity link) and the rapid growth of e-commerce.

An example is China Mengniu, the country's largest dairy processor by sales volume, controlling approximately 40% of China's liquid milk market. Management changes and M&A deals are transforming the firm. Indeed, the company recently negotiated a potentially lucrative multi-year strategic alliance with Disney to supply its Chinese parks. Another consumer staples name going through positive change is HengAn, the leader in China's feminine-hygiene market and tissue and toilet-paper category. The company is seeing the benefits of weak petrochemical prices, while global pulp costs – an important variable – remain stable. In addition, its new products are gaining traction, which should lead to good secular growth in a fragmented market.

### Made in Taiwan

Big changes are also afoot in the global consumer electronics sector, notably within a number of mid-cap Taiwanese stocks. One example is Hermes Microvision, a manufacturer of electronic beam inspection tools. Within its field, there is an ongoing drive to manufacture ever-smaller nodes as a way to offer better semiconductor chips at cheaper costs. With each change in the process, the need for more accurate inspection equipment grows. Hermes' e-beam tools (as opposed to standard optical tools) are proving equal to this task. Demand for its machinery therefore looks set to grow, especially as companies like Samsung and Intel increasingly migrate towards smaller semiconductors. Indeed, according to Hermes, the inspection market is set to increase 10% annually from around \$1.5 billion today. Another mid-cap player, Chipbond, provides background assembly processing services. It is positively exposed to the growing popularity of high-definition 4K2K TVs.

# Developed Asia

## A capital idea for Asian banks

Developed Asian banks face new regulatory pressures to bolster their capital positions from already fairly comfortable levels.



**Alistair Veitch**  
Investment Director, Asia Pacific Equities

### Global banking pressures

Since the global financial crisis (GFC), banks have been operating under increasingly stringent regulatory controls. Although banks in developed Asia survived the GFC relatively unscathed, rightly or wrongly they are still obliged to comply with the increased capital and liquidity requirements outlined in Basel proposals. At the same time, banks are under pressure from investors who are concerned that higher capital requirements may reduce return on equity and their ability to pay dividends. However, in a global context, most of the banks in developed Asia are better placed than their international peers to satisfy the demands of both regulators and investors.

### Robust not bust

The core Equity Tier 1 (CET1) ratios set by the Asian regulators vary from bank to bank but are targeting levels that are at least equivalent to the global requirement. The banks in developed Asia start from relatively comfortable positions. Major Asian banks already hold some of the highest levels of capital in the world, but their regulators are more determined than ever for them to be in the top quartile of highly capitalised global banks, which they see as a competitive advantage.

Among the more conservative banks is DBS in Singapore, which is using its retained earnings to increase its capital strength organically. In Hong Kong, we are seeing more aggressive action from banks such as Hang Seng Bank, which is in the process of selling off its entire stake in China Industrial Bank (CIB). By disposing of CIB, we could see Hang Seng's CET1 rise to 18%, leading to the potential of excess capital being returned to shareholders.

Meanwhile, Australian banks are adopting a mix of methodologies. Westpac has announced a AUD\$2 billion dividend reinvestment plan to bolster its capital, with shareholders able to reinvest their dividends at a discount. National Australia Bank has a longer 'to do' list to raise its CET1 levels, but lots of options to exercise. It is disposing of non-core assets, including its commercial real estate book and its life insurance business, spinning off the Clydesdale Bank in the UK, and has announced an AUD\$5 billion rights issue.

# European Equities

## Food for thought

While markets question top-down valuations in Europe, we prefer to chew on demographics as a key driver of bottom-up growth.



**Kay Eyre**  
Investment Director, European Equities

## Low fat, high return

Demographics are changing in the US; 16-35 year olds, known as ‘millennials’, are now the largest generation. A new consumption pattern is being defined which differs from past generations; favouring organic, natural, sustainable and ethnically diversified goods. Interestingly, the fastest-growing US food categories in the last three years have been ready-to-drink iced coffee, organic packaged salads, plant-based beverages and non-dairy ice cream. Ready-to-eat desserts, cereals and margarine are in decline, demonstrating the shift in demand. Naturally, this will have an effect on food producers, as they scramble to change their product offerings.

We believe most companies in the US are yet to catch up with their European counterparts in terms of removing artificial additives, such as salt and sugar, from product ranges. This suggests that they are not immediately able to benefit from this growth area. In this regard, large European firms such as Danone, Nestle and Unilever are further ahead of the game versus the US-based players. Another company which has seen these trends is Aryzta, which focuses on speciality bakery products, supplying Starbucks and McDonalds, which are facing growing competition from the fresh approach of companies like Shake Shack.

Similarly, Glanbia operates internationally and offers nutritional products, dairy and other foods and ingredients. Our view is that Glanbia stands to benefit from the current move by consumers to use performance-enhancing supplements as part of their fitness regimes. It has already developed a range of performance nutrition, which is a good fit for current trends, as this is biased towards the premium end and perceived by consumers as ‘natural’. Likewise, we believe that Glanbia could benefit from substantial opportunities for growth through expanding its channel exposure (speciality and internet) as well as at an international level. Glanbia also has the advantage of being able to self-supply ingredients and self-manufacture, unlike many competitors.

As millennials begin to form households of their own, we believe these trends will become more apparent. Opportunity may be found for substantial growth among the firms that are prepared for this movement in spending power.

# UK Equities

## Responsible investing

Responsible investing continues to evolve, and is increasingly relevant to all investors. Here, we examine the rise and growing reach of ‘impact investing’.



**Lesley Duncan**  
Investment Director, UK Equities

## Impact investing

Responsible investing is no longer confined to traditional ethical investors who favour investment products based around positive or negative screening. Increasingly, all investor types have reason to care about responsible investing issues, calling into question old certainties and the relevance of traditional ethical investment criteria. Investors certainly remain discerning about climate change and fossil fuel scarcity, but are increasingly interested in capturing more societal issues. This has led to the emergence of impact investing, investments made on the basis of the social or environmental benefits the investment accrues in addition to any financial return.

Millennials are largely driving this phenomenon as they mature and assume greater responsibility for investments. Their concerns include the scarcity of human capital and its welfare. With access to medicines and healthcare less pervasive in developing economies, impact investors are concerned whether citizens are being provided with the means by which to improve health and wellbeing. Companies helping to meet these needs include United Arab Emirates firm NMC Health. New regulations there mandating healthcare insurance allow it to expand its operations while fulfilling a wider societal good.

Employment and the fair treatment of employees rank equally high among impact investors’ priorities. Here, cinema operator Cineworld has come under scrutiny in the past, and is the type of company with which we seek to engage. Our contact has highlighted to management the increased importance investors are placing on good human capital management practices and is resulting in better disclosure in this area. Skills shortages are also attracting increased attention. This has been an issue for housebuilding, where the lack of skilled workers in planning, bricklaying and sales is contributing to the UK’s limited housing supply. The entire industry has responded to this, with Crest Nicholson a particularly good example of the investments made in apprenticeships and training initiatives. These issues demonstrate the ever-expanding reach and complexity of responsible investing – something that all companies and investors increasingly need to embrace more systematically both to avoid potential reputational damage and mitigate any related financial risk in the future.

# Focus on Change

## On the road again

European auto sales have lagged other regions, but recovering volumes and fresh cost-saving initiatives suggest there could be more mileage in the sector.



**Stan Pearson**  
Head of European Equities

### Tiger in the tank?

The global financial crisis hit the auto sector hard, yet the subsequent recovery has been patchy as different regions recovered at varying speeds. The US and Asia have led the way, while Europe has lagged. However, the continent's auto industry is gradually returning to growth, suggesting the cycle trough is now behind it. Rather than merely seek to exploit a cyclical upswing, we prefer to identify those companies able to control their own destinies whatever the operating environment. Happily, certain European manufacturers continue to innovate while also extracting fresh efficiencies. This alone provides significant investment merit, to which any volume recovery in Europe would add further appeal. Indeed, with volumes rising at a time when operating leverage is increasing, there are potentially material implications for profitability. We have identified Renault and Volkswagen as possible beneficiaries (see Chart 1).

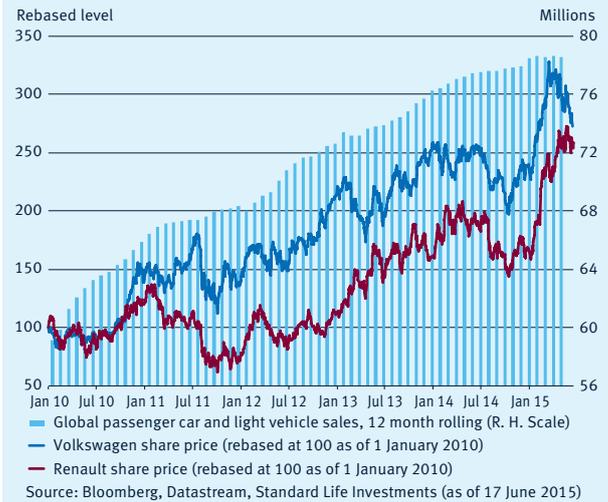
### What are the key drivers?

Global auto demand is an obvious driver for the industry, particularly Volkswagen, the largest car manufacturer in the world. At around 50-60% of pre-tax profit, trends in China particularly matter. However, Europe still accounts for over 30% of its car volumes. It is also exposed to the European truck market. By contrast, Renault's high legacy exposure to France makes it more geared to the continent's recovery – Europe is 80% of its profits, ex Nissan. New model trends are clearly critical drivers of sales momentum and, here, Volkswagen and Renault are well-placed, with a number of product launches scheduled. Both have made significant progress on producing more models using common manufacturing platforms, bringing greater economies of scale, higher parts commonality and, ultimately, lower unit costs.

### What is changing?

Volkswagen has invested heavily in its brands, and has numerous new launches planned for 2015 and 2016. These leave it better positioned in the model cycle than premium rivals, like BMW and Mercedes. Renault boasts an equally strong new-product roster for 2015/2016, which will be manufactured on the common platform it shares with Nissan for over 20% lower costs. The partnership is longstanding, but still brings significant cost-base transformation potential, as the savings are only now coming through. Renault's parts commonality is still only around 10% and should rise as

**Chart 1**  
Motoring ahead



management leverages Nissan's scale. The French firm has a growing track record here, having surpassed and upgraded previous synergy targets.

Production efficiencies are a potentially rich source of savings for Volkswagen, where brand margins remain subpar. One model currently uses 200 different wing-mirror variants. Management targets some €5 billion of savings and 25% of production from its own common production platform by 2016. Meanwhile, both companies are exposed to markets where some fundamental dubiety has emerged. For Renault, investors are monitoring soft sales trends in Russia, Brazil and Argentina closely. Slowing, yet still-high, Chinese growth rates are also a potential complication for Volkswagen, although much higher local production levels than peers is an important advantage in mitigating price pressure. Nevertheless, delivery of products and efficiencies should still allow margin expansion for both.

### What is priced in?

We believe Renault's share price valuation is cheap relative to its peers, although various cross shareholdings disguise its true extent. Excluding these to value the core business reveals the discount is larger still. This is despite Renault's consistency in improving auto margins – something that consensus expectations for 2015 and 2016, implying 36% and 25% earnings-per-share growth, suggest will continue. However, estimates partly reflect product momentum and cost savings, in our view, not a European cyclical recovery. Should this transpire, earnings can rise further. Volkswagen's valuation is also below sector levels, despite expectations for modest margin expansion and double-digit operating profit growth. Forecasts ignore margin recovery at its Volkswagen marque, making any success there a source of further upside: our view is that only a 1% margin improvement could boost group profitability by 7%.

### What are the triggers and why would the market change its mind?

Both investment cases rest as much on internal product and efficiency efforts as any European cyclical recovery. Consequently, results and trading updates will be key performance yardsticks. These will also be especially important opportunities for management to deliver their qualitative assessments on strategy delivery, and will be important junctures for gauging the signs of any improvement in European sales. Then, the true extent of both companies' operating leverage should become much more apparent.

# Country In Focus

## Key themes in the US

Despite recent strong market performance, ongoing economic recovery ensures there remain plenty of US companies with significant potential.



**Jeff Morris**

Senior Vice President, US Equities

### M&A all the way

Investor appetite for corporate deal-making has been resurgent in 2015. Merger & acquisition (M&A) activity in the US is at a level not seen since the dotcom bubble. According to Dealogic, some \$243 billion of deals were struck in May alone. This compares to \$213 billion witnessed in the same period during 2007. This pattern looks set to continue for the remainder of this year.

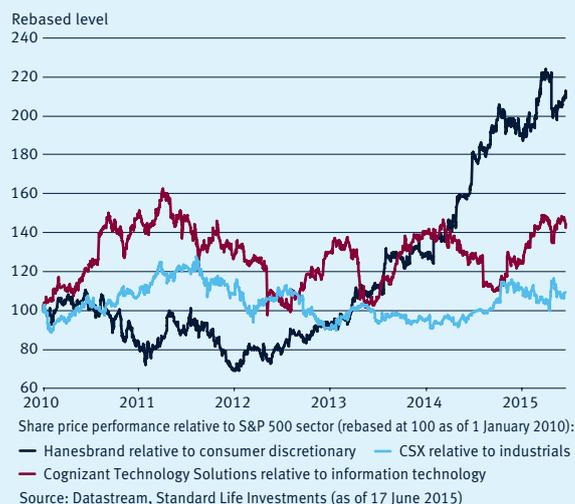
What is behind this renewed vigour? Undoubtedly, low interest rates and attractive funding levels are encouraging company management teams to put capital to work. With the Federal Reserve set to raise rates later in the year, many US corporations are looking to lock into cheap, long-term funding while it is readily available. Meanwhile, activist investors are becoming increasingly emboldened. Pressurised chief execs have responded by snapping up rivals in order to meet heightened growth expectations. Finally, the US economy continues its steady recovery, bolstering confidence in boardrooms across the country.

### Shopping around

Clothing firm Hanesbrands has made a number of acquisitions in recent years and is starting to benefit as a result (see Chart 1). In 2013, it acquired lingerie rival Maidenform for \$581 million and followed this up with the purchase of French company DBApparel for \$550 million in September last year. So far, Hanesbrands has proven adept at leveraging its supply chain, successfully completing the integration of Maidenform, with DBApparel underway. Both of these acquisitions provided a significant boost to 2014 results, contributing sales of \$491 million and \$291 million respectively. This helped Hanesbrands to complete its debt reduction and establish a quarterly dividend programme. Despite this, we believe investors are yet to price in the full potential impact of either deal. More significantly, we expect Hanesbrands to make another acquisition within the next 12 months, which should have a positive impact on 2016 results.

IT consulting and technology services company Cognizant Technology Solutions also made a significant acquisition in September 2014, buying healthcare IT solutions company TriZetto for \$2.7 billion. This strengthens Cognizant's position in the healthcare sector, where regulatory changes, such

**Chart 1**  
Benefiting from inorganic growth



as the Affordable Care Act, are forcing increased IT spend. Currently, TriZetto software manages the health benefits for around half of the US population that has medical insurance. Cognizant management sees tremendous opportunities to marry TriZetto products with its own services, expecting cumulative revenue synergies of \$1.5 billion over the next five years. We also see potential for significant results from this acquisition, as well as the master services agreement it signed with managed healthcare company Health Net, and would not be surprised to see more deals in the next couple of years.

### Consolidate to accumulate

A by-product of increased M&A in the US is consolidation within industries that leads to increased pricing power for the remaining players. At a time when inflation is very subdued, companies that display genuine pricing power are a scarce and valuable commodity.

Rail is an example of an industry where pricing is rational because of a limited number of big companies. Typically, only a few firms compete against each other in a given region. An example is CSX, which operates the largest railroad network in the east of the country. While there are concerns over weaker coal prices, this only accounts for 20% of CSX's business. The bulk of its business is in merchandise, where pricing rose around 2.5% in 2014 and should accelerate again this year. Before the financial crisis, CSX was an aggressive price raiser and it may be reverting to this stance. In our view, pricing will surprise on the upside over the next couple of years, driving better-than-expected margin expansion.

The hard disk drive industry is another where pricing and margins have stabilised following a round of consolidation, which left just three major players. Of those, we believe Western Digital should start to see the potential benefits of its purchase of Hitachi's hard disk drive business. Following the deal, there was a two-year waiting period before Western Digital could apply to China's Ministry of Commerce for full integration. This is now over and while we await further news, we believe potential costs savings could be in the region of \$400 million. In our view, this is not fully reflected in the company's share price, while increasing pricing power and potential for further capital return should provide further upside.

# Government Bonds

## Moving towards higher rates

The US bond market is starting to price in the first Fed interest rate increase and the pace of monetary tightening into 2016.



**Liam O'Donnell**  
Investment Director, Government Bonds

## The Fed to move

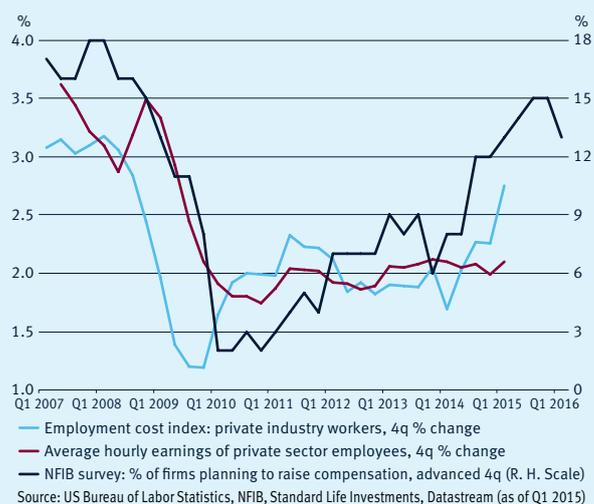
After many years of extraordinarily accommodative monetary policy, bond investors are looking towards the US Federal Reserve (Fed) as the most likely candidate to start tightening. Despite weaker economic activity in Q1, recent messages from key Fed members have reassured markets that expectations are for a strong pick-up in activity in the second half of 2015 and hence that "it will remain appropriate at some point this year to take the initial step to raise the federal funds rate". Until that time comes, markets will remain nervous and locked in debate about what that initial step means for US bonds. Despite assurances from Fed Chair Janet Yellen that any rate hiking cycle would be very gradual, recent price action suggests that even small moves in the policy rate are likely to be accompanied by bouts of higher market volatility.

US economic statistics are being examined in minute detail in the run up to the Fed decision. Q1 GDP was close to unchanged from Q4. While the labour market proved remarkably resilient, the trade sector was much weaker. Activity was undoubtedly disrupted by the west coast port closures, although the US dollar's sharp appreciation also exerted a significant drag on exports as domestic firms faced increasing international competition. Another consequence of the dollar's move was weaker import prices, which in turn helped suppress inflation measures and thereby supported demand for US fixed income. Falling energy costs failed to boost output meaningfully, either as lower oil prices weighed heavily on domestic shale production and investment, or US consumers chose to use the income boost to increase savings or pay down debt. Extraordinary weather also played a part, as a harsher winter again impacted activity in the manufacturing, construction and retail sector.

## Better prospects ahead

With US consumer and business confidence elevated, and financial conditions extremely supportive, it is reasonable to assume a stronger picture will emerge, thus allowing the Fed to act. May's employment and payrolls reports were sufficiently strong to suggest Q2 GDP growth could be 2.5-3.0% per annum. The task facing Janet Yellen and her colleagues is to assess how this domestic impetus drives

**Chart 1**  
Wage pressures building in the US



higher inflation, led by stronger wages, offsetting disinflationary pressures from overseas, aided by the strong US dollar. The objective for the Fed is to be reasonably sure that inflation will move back towards its 2% target. While average hourly earnings growth remains below levels seen pre-crisis, the more comprehensive Employment Cost Index is showing a tighter labour market (see Chart 1), helping to explain the recent hawkish rhetoric from some Fed Governors.

## Our strategy within government bonds

In recent weeks, the Treasury market has begun to price in the first Fed move. US benchmark 10-year yields have approached 2.5% and, while by no means attractive from an historical perspective, there are various factors which will offer support to bonds even as Janet Yellen begins her attempt to re-normalise policy. Global bond yields are in general close to all-time lows, and on a relative basis the US market offers attractive carry and roll opportunities for reserve managers. Treasuries are likely to be well supported as a risk-off, 'safe haven' asset should growth shocks or geopolitical risks rattle equity markets. Lastly, quantitative easing in both Europe and Japan will provide additional support, preventing the yield gap between bond markets becoming too wide.

Our view is that these factors should see US bonds fare reasonably well compared to previous hiking cycles, such as 1994 and 2004, when the market exhibited an overreaction to the threat of policy tightening, after initially underestimating the proximity of the first hike. With the market currently pricing a December rate hike, a September move does not necessarily mean a more aggressive pace of hikes. The Fed may simply want to get policy 'off the floor'. In any event, doubts will remain for some time around the economy's reaction function to policy hikes after an unprecedented period of zero rates.

Turning to other markets, the House View prefers long exposure in Australia where external vulnerabilities and weaker domestic demand force the Reserve Bank of Australia to keep policy accommodative, underpinning bond yields. Later in the year, we will assess whether German bunds offer value on a cross market basis versus gilts as the monetary policy committee looks set to follow the US in tightening monetary policy.

# Corporate Bonds

## Focusing on fundamentals

After years of strong returns from corporate bonds, corporate balance sheets hold the key to investors' valuation dilemma.



**Craig MacDonald**  
Head of Credit

## Choosing between the US and Europe

As corporate bonds have produced strong returns for the last six years, it is increasingly important to focus on the underlying fundamentals of corporate balance sheets and ask if current profitability and creditworthiness warrant present valuations. Investors will want to assess whether the market is nearing a change in the corporate balance sheet cycle that will eventually be detrimental to bondholders.

Our analysis begins by considering the difference in profitability and leverage trends between investment grade (IG) S&P 500 companies and their European counterparts. Using a broad-based IG bond index as a sample source, leverage in US corporates has been relatively flat over the last two years. While recognising that sector composition has shifted, for example there are more cash rich, lowly levered technology companies, using a bond-based benchmark does support the view that a material increase in leverage has not yet occurred. While gross debt has increased, it has not surged and shareholder returns have not generally been enhanced to the detriment of maintaining solid credit profiles.

In Europe, IG balance sheets generally exhibit strong fundamentals. With many European economies showing some signs of a recovery, profits (e.g. EBITDA) growth has supported an improvement in leverage metrics, although margins are still historically low. Given that the economic recovery is still in its early stages, management teams remain prudent. This is evidenced in a number of ways, including a lower rate of M&A transactions relative to the US. Another trend is the increased use of corporate hybrid instruments, the majority of which are accounted for as 100% equity in financial statements.

So, should credit investors favour European or US companies? We think the answer is that both are worthy of consideration. While there are multiple variables in making this decision, in the context of corporate balance sheets the answer is to focus on stock selection. While some sectors are further along the business cycle, especially in the US, broader fundamentals suggest we are not as far down the path of debt-fuelled M&A activity and shareholder returns as many think. However, markets can change rapidly and we believe the best way to position for this is to look at how individual companies and sectors adjust their strategies, structures and balance sheets

**Chart 1**  
Gross leverage across Asian credit



as the economic climate evolves. A key trigger to examine will be share buybacks, whether they turn back up again and whether they are financed by corporate debt, in turn causing balance sheet stress.

## Challenging consensus

European high yield (HY) markets display far greater differentiation, despite much talk of improving credit metrics. Indeed, a 'cosy consensus' has now formed around the subject of balance sheet repair. However, we think the significant change in the composition of the market in recent years warrants caution. There are now many more BB rated credits and, unsurprisingly, higher-rated companies have had a better time of it of late. Lower-rated companies, on the other hand, have actually seen leverage and interest cover deteriorate. This suggests that the overall improvement in credit quality has been driven by the appearance of more BB rated companies rather than a recovery in riskier parts of the market.

While funding costs have been driven down by investor demand for yield, current funding levels do not reflect what has been happening in the companies themselves. If we examine free cash flow (FCF) data we can see that, as a percentage of debt, FCF has decreased among B and CCC rated borrowers. Such a trend raises concerns over this part of the market's vulnerability to rising interest rates, when a reduced appetite for HY and increased funding costs could stretch their liquidity. This caution leads us to believe investors may be best served by running a highly active or focused portfolio, where companies with weak cashflow can be avoided completely.

Emerging market corporate debt is another area where there is far greater differentiation than one might initially expect. For many years, Asian corporate balance sheets grew faster than Asian GDP. However, the recently slower economic environment has led to a marked difference between those IG companies that are using their strong business profile and cashflow generation to reduce leverage, and Asian HY issuers that are struggling to reduce debt given profit pressures (see Chart 1). This could prompt a rise in defaults, emphasising, as in other credit markets, the importance of diligent security selection.

# Inflation Linked

## The sustainability of inflation

Although markets are pricing in an upturn in growth and therefore inflation, we remain of the view that structural headwinds will dampen inflation pressures.



**Adam Skerry**

Investment Director, Inflation Linked Bonds

### Can inflation recover?

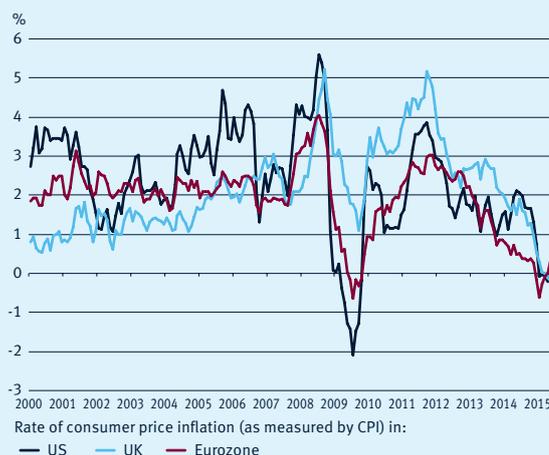
The recent sell-off in core bond markets and subsequent steepening of yield curves has been dramatic in its scale. A central explanation has been the global reflation theme, whereby the improvement in the macroeconomic backdrop has combined with technical factors to create an environment in which inflation can pick up from its current depressed levels (see Chart 1). From an inflation investor's perspective, it is crucial to judge whether these perceived improvements are sustainable and, if so, how do they impact both realised and anticipated inflation?

The major drivers behind this reflation argument are two-fold. The first is that global demand is improving following several years of loose monetary policy, generally more supportive fiscal policy and a more robust financial system. Secondly, as current oil prices are unprofitable for a large section of producers, so lows in the oil price should be seen as new supply will be reduced. In aggregate, these drivers create an environment in which both economies and inflation can grow, causing yield curves to steepen and inflation breakevens to widen.

Market participants must now focus their attention on the sustainability of this upturn, particularly if US interest rates start to rise as we expect. Nowhere is this more crucial than in the Eurozone where a cyclical recovery needs to be put alongside the context of the many structural issues that continue to weigh on the currency bloc. In our view, until these flaws are confronted and addressed, it is unlikely that inflation will pose a significant problem for the European Central Bank. For example, while the banking sector has improved significantly in recent years there are still too many small, inefficient banks that have been supported at a national level but have undermined developments on a cross-border basis. Likewise, there are structural barriers in countries like Japan and Sweden, such as demographic trends or labour market rigidities, that will continue to depress the emergence of inflation and prevent the authorities from achieving their long-term price objectives.

China remains at the centre of the global inflation debate, partly due to its pool of cheap labour and partly as it has created such significant demand for global commodities.

**Chart 1**  
Inflation on a downward trajectory



Source: National sources, Datastream (as of May 2015)

The authorities have loosened fiscal and monetary policy, and liberalised capital flows, but, given widespread excess capacity, there does not seem to be an imminent threat of inflation. Indeed, their dovish approach looks increasingly necessary to arrest the decline in the growth rate rather than as a means of generating additional economic output.

### Global not local

Global as well as local themes need to be considered when evaluating inflation markets and potential value. Output gaps are notoriously difficult to quantify accurately but a key theme in the global recovery has been the large degree of slack, despite a lower assumed trend rate of growth. This is obvious in a number of advanced as well as developing economies, those countries that have struggled to adapt to demographic changes, technological advances and changing worker skills. A question we are considering is whether it is right for markets to assume that traditionally 'tight' labour markets now have sufficient slack to dampen latent wage inflation pressures, thereby allowing companies to maintain margins in a growing economy without recourse to significantly higher pay. This poses an ongoing dilemma for many central banks, especially the UK and US.

Developed inflation markets have been almost universal in embracing the global reflation theme. While this is justified in some cases, we do not see inflation accelerating to such a degree that central banks will be forced into excessive monetary tightening or a dramatic reversal of the loose policy to which the market has become accustomed. This is likely to create cross-market opportunities as markets embrace the key global themes but also look to incorporate specific influences on each individual economy. For example, the structural issues inherent in Europe support our arguments for being short of French 2-year, 2-year inflation, while the lack of inflation term premium in the US justifies our desire to receive long end US inflation. The inflation story is likely to be front and centre as we reach a potential crossroads in monetary policy; the paths chosen by central banks will create the next set of opportunities in inflation markets as the global reflation story plays out.

# Emerging Market Debt

## The risks of sovereign default

Sovereign defaults are rare. Emerging market countries such as Ukraine and Venezuela facing questions about the ability to pay are the exception not the norm.



**Richard House**  
Head of Emerging Market Debt

## General risk of default

There are two emerging market (EM) countries currently facing the prospect of a sovereign default, namely Ukraine and Venezuela. We examine the causes and the consequences of such an event.

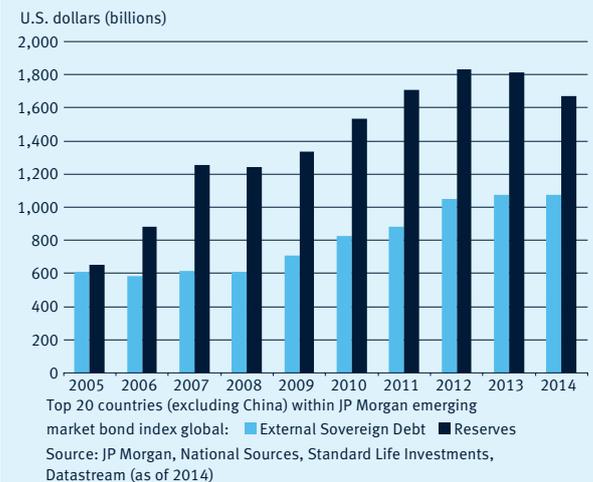
When examining a country's overall debt burden, it is important to make the distinction between external and domestic debt. The former is debt issued in a foreign currency (with the US dollar being the most common) while domestic debt is denominated in the local currency. Since any government can print its own currency, domestic debt defaults are rather rare. If we look back over a history of sovereign external debt defaults since the early 1980s, we see that a sovereign defaulting on its debt is very rare. Since 1983, only seven countries have defaulted on external debt. With the exception of Argentina, these defaults have been from relatively small EM countries with limited debt outstanding.

There are few examples where a country has willingly defaulted on its sovereign debt. However, defaults mostly occur when ability to pay is an issue, so poor economic policymaking is usually a precursor to a default. Examples include how countries manage their exchange rate, which often has implications for their balance of payments. Management of fiscal policies can also matter significantly for the build-up of debt. Exogenous factors are another important factor, for example if a country is overly reliant on a key commodity to generate hard currency. When a country faces difficulties in repaying sovereign debts, it is rarely a surprise. There are many measures of sovereign solvency (such as external debt to GDP or short-term debt to foreign exchange reserves) which usually highlight potential issues.

## Current candidates

Ukraine is in the process of restructuring its external debt. Its inability to pay is a combination of both internal and external factors. While previous governments had a poor record of reform and policymaking, they were still able to issue large amounts of external debt. However, the conflict with Russia has led to significant capital flight, which has further impaired an already weak balance of payments position. Ukraine faces short-term debts coming due that far exceed central bank reserves. Hence, it is currently negotiating with its creditors to restructure its debts.

**Chart 1**  
Room to manoeuvre



Venezuela's problems are largely endogenous. It has the largest proven oil reserves on the planet and relies on oil for much of its fiscal revenue and balance of payments support. Most oil-rich countries save when oil prices are high to protect themselves when prices fall. Unfortunately, Venezuelan macroeconomic policy has been short sighted, and at best can be described as poor. The economy is therefore very vulnerable to falling oil prices. As a result, and despite its vast oil wealth, Venezuela is rapidly running out of foreign exchange reserves to pay its sovereign debts.

A key focus on change question is: what is in the price? US dollar-denominated sovereign debt of both countries largely reflects the prospect of a default; sovereign bonds trade at prices of between 40 and 50 cents (as a comparison, recovery value on Argentine debt was 35 cents post its default). It is also worth highlighting that the combined market weight of both countries in the main sovereign debt index is just 3.2%. The impact on the broader asset class is therefore minimal.

## Our strategy within EM debt

Most EM countries are not facing the same solvency issues currently experienced by Ukraine and Venezuela. This is a consequence of the significant improvement in macro policy making frameworks undertaken by the vast majority of EM countries. In particular, most currencies are now fully flexible, central banks are independent and most countries follow strict fiscal rules. Such policy improvements have served to prevent the build-up of the macro imbalances currently faced by both Ukraine and Venezuela.

As a result, we do not see any other EM sovereign facing ability to pay issues. EM central bank reserves, while falling recently, remain significant. Most countries have pursued a policy of switching their funding from external to domestic sources. Therefore, sovereign external debt outstanding has not grown in recent years. As Chart 1 highlights, in terms of capacity to pay EM sovereign balance sheets are very healthy. All in all, we still believe sovereign external debt spreads offer an attractive pick up over US Treasuries; albeit a careful selection of the issuers is necessary in the current environment. We prefer Mexico, Brazil, Kazakhstan and Hungary to Russia, Turkey and South Africa on fundamental and valuation grounds.

# Currency

## The rise and fall of emerging market reserves

We analyse the implications of a marked slowdown in emerging market foreign exchange reserves growth.



**Ken Dickson**  
Investment Director, Currency

### Where does reserve growth come from?

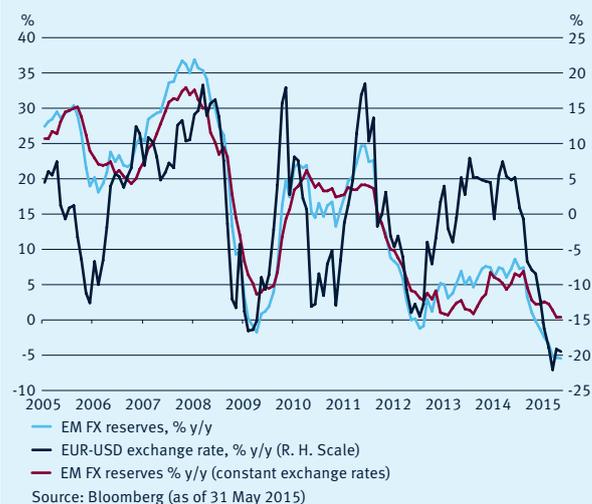
Changes in foreign exchange reserves happen due to normal moves in trade and capital flows but also, on occasion, because of central bank policymaking. As one example, in pegged exchange rate systems or semi-floating regimes, if a central bank sells some domestic currency and buys foreign currency then it adds to the country's foreign exchange (FX) reserves. Some central banks sell domestic and buy overseas currency to try and improve competitiveness and thus exports, or to intervene in currency markets if they consider that the exchange rate has overshot fair value. Lastly, FX intervention can be favoured over other unconventional monetary policy measures such as QE if it is considered to have a lesser impact on the bond market, which might result in a smaller risk of asset price bubbles.

The stock and flow of foreign currency reserves does need to be differentiated. While the flow often forms part of monetary policy decision-making, the size of the stock of FX reserves has traditionally been driven by an insurance or safety motive. For example, emerging market (EM) countries that have high levels of foreign currency debt usually need significant stocks of FX reserves in order to mitigate the risk of an unexpected drop of international capital flows. Crises can also trigger a response; after the 1997 Asian financial crisis many EM countries revised up this insurance level of reserves significantly. Indeed, as EM economies improved and their markets became more attractive, FX intervention increased causing reserves to grow at an average 30% rate during early 2000s.

### A slowdown in reserves growth

Recent reports, citing the IMF COFER dataset, suggest a fall in the level of EM foreign currency reserves. However, these reports fail to adjust for the fact that not all reserves are held in US dollars (USD) while the data is measured in USD terms. Therefore, as the USD value rises, the holdings of non-dollar reserves fall in value. After adjusting for valuation effects, we can see that the annual growth rate in EM FX reserves has disappeared but is not yet significantly negative (see Chart 1).

**Chart 1**  
Reserves heading towards reverse



Headlines about falling reserves worried some investors that parts of the EM bloc were stepping closer to a new crisis. However, we argue that emerging markets are generally far from the point that a sudden stop in international capital flows would cause significant vulnerabilities. Firstly, reserves are not sharply falling, while the cumulative growth of reserves since 1998 has created a substantial insurance buffer. Secondly, in aggregate EM trade current account positions are still in surplus, albeit more due to lower imports than improving exports. The prospect of higher US interest rates and global bond yields may cause additional EM currency volatility but, so far, EM central banks have largely allowed currencies to adjust without resorting to depletion in reserves. Holding sufficient reserves meaningfully mitigates the output loss costs of a sudden stop in capital flows.

Of course, looking at aggregated data will obscure potential winners and losers. Our approach to choosing currency positions to include in portfolios includes an active heat-map approach tracking deterioration and improvement in the vulnerabilities of each emerging market. Big swings in terms of trade through falling commodity prices can highlight these risks. Some countries (such as South Africa, Brazil and Russia) have chosen to offset deteriorating fundamentals by allowing currency weakness. Of these three, Brazil and Russia still have significant reserves while South Africa's insurance policy is much less secure. Countries like Malaysia and Turkey have not used the currency safety valve and their insurance level of reserves is also lower than optimal, suggesting greater risks to future economic stability. In developed markets, reserves management is less of an issue but there can still be implications for currencies. As Chart 1 highlights, the period of consistently growing reserves combined with a policy of diversification provided a substantial support for currencies like the euro. In a new era of low growth, rates for FX reserves dollar recycling has unwound, forming part of our weak euro view. This analysis will also lead us to adjust EM currency positions in appropriate portfolios. For example, we believe that the Korean won will weaken as policymakers seek to restore Korean export competitiveness, while the reform agenda in India reduces its economic vulnerability and opens the way for an improved currency performance.

# Real Estate

## Buying value in Europe

Gaining exposure to commercial real estate increasingly requires analysis of currency trends as well as underlying fundamentals.



**Anne Breen**

Head of Real Estate Research and Strategy

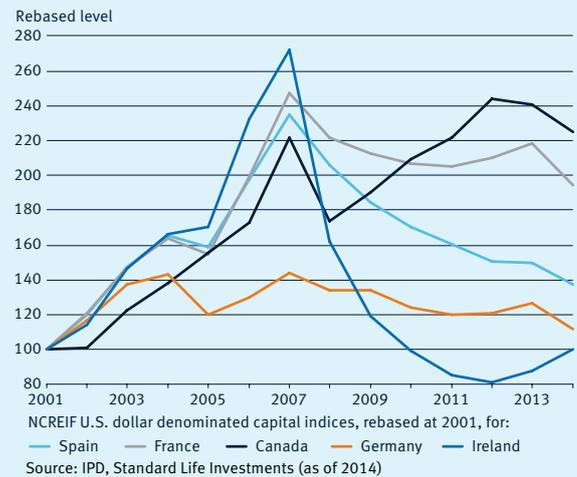
### Currency hedging

While the global real estate market is well supported by the broadening economic recovery, from the US and UK towards Japan and Europe, cross-border investing is made more complex by the volatility of currencies. The good news is that shifts in global currencies have deepened the opportunity set for opportunistic real estate buyers. For example, UK real estate investors accessing the Australian market would historically have invested into an attractive 6% plus income yield, but have paid a significant margin for hedging their currency exposure. This margin has reduced substantially in the last year. Equally, such sterling-based investors historically might have been repelled by the low-yielding Tokyo real estate market, while now the differential in swap rates means the return net of hedging provides some compensation for this lower local yield.

Most notable has been the presence of US buyers in Europe. Risk-tolerant American buyers have acquired certain Spanish assets for yields in excess of 6% when, according to NCREIF, value-weighted cap rates for office and apartment and properties nationwide were 4.5% and 4.6% respectively. While the expansive US market allows commercial real estate fund managers to move along the risk curve within the same currency, they do not have full access to varying market cycles. Indeed, there may be less valuation upside in the US than peripheral Europe as the Fed tightens. Consequently, American interest in Western European real estate is notable; \$29 billion of deals were placed in 2014 and, after \$24 billion has been allocated year-to-date, so 2015 is on track to rival the 2007 peak of \$42 billion. Nearly a third of the money went to Germany, France, Nordic and Benelux countries while nearly 15% went to Spain, Ireland and Portugal.

An important issue for cross-border investors is whether to hedge the currency or not, especially if the US dollar continues to appreciate versus the euro. Hence, across the Eurozone, US dollar-denominated capital values fell 11% in 2014, according to index provider IPD (see Chart 1), and that trend has continued this year. Interestingly, the impact is less in markets with a sturdy capital recovery, such as Spain and especially Ireland, where an incredible escalation of

**Chart 1**  
Counteracting currency concerns



capital values generated returns of roughly 40% in 2014. This motivated the Dallas-based Loan Star fund to sell its Irish mortgage portfolio to Starwood Property Trust. Conversely, the impact of the dollar's rally has been greatest in core European markets, such as France, where capital growth has only been steady. We expect that US funds that have crystallised recent gains will recycle the capital back into a recovering Eurozone rather than repatriate it to the detriment of performance. The impact of dollar strength is not ubiquitous across the region as expectations for a Bank of England interest rate hike following in the steps of the potential US move means there is little discount in the vibrant London marketplace. Bearing in mind that the House View expects the US dollar to continue to rise against the euro, so US real estate funds seeking to benefit from Europe's recovery may consider raising hedging levels; the same detailed analysis is needed for investors in other countries.

### Our strategy within global real estate

Given the relevance of currency movements, we construct a currency-adjusted real estate House View. We are equipped to hedge on behalf of clients, based on their risk tolerance, and some cashflows are hedged at the broader fund level. Currency issues aside, real estate as an asset class offers an attractive income yield premium, in a yield-starved, zero interest rate world. Generally, we have a preference for prime and good secondary assets in a range of different countries. In the UK, Grade A Regional and South East offices remain attractive in the near term, as well as higher yielding assets in core areas. On the Continent, a fundamental recovery within peripheral markets is expected to drive the best performance. Expectations for continued US economic expansion amid low supply growth will drive sturdy growth in cyclical office markets. 'Gateway' office markets continue to attract well-heeled foreign buyers and support pricing. Monetary policies are driving performance in the Asia Pacific region. High interest rates in Australia are supporting double-digit returns in non-commodity based cities. 'Abenomics' is propping up Japan's relative performance in the region by bolstering asset values and reviving occupier demand from cash-rich corporations.

# Absolute Return Strategies

## Strategies of interest

UK real yields provide upside in a downside scenario, while Korean government bond futures stand to benefit from tardy policymaking.



**Sebastian Mackay**  
Investment Director, Multi-Asset Investing

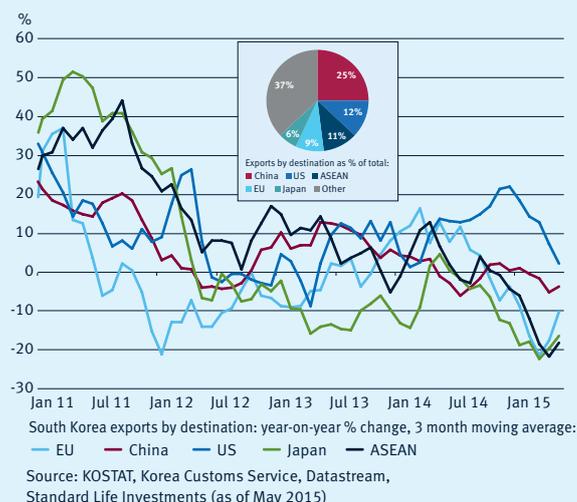
At Standard Life Investments, our absolute return strategies approach operates in a multi-asset framework, aiming to deliver returns above the UK six-month LIBOR cash measured on a rolling three-year time horizon. Our absolute return process combines a broad mix of ideas across the major asset classes. Two recent strategies seeking to profit from downside risk are the UK real yields strategy and the Korean government bonds strategy.

## Keeping it real in the UK

The recent sell-off in bond yields has been aggressive in most markets. In the UK, the move in real yields has been much more subdued than the move in its nominal counterpart, as a result of UK breakevens having performed so well. Comparatively speaking, this has not been the case in either the US or Europe, where the nominal sell-off has been almost entirely driven by real yields. We consider that market commentary attempting to explain the recent bond sell-off as an effect of a reflationary environment has not been backed up by a move higher in US or European inflation breakevens. Liability-driven investment demand is largely behind the demand for UK real yields due to improved funding positions, higher yields and a lack of supply so far this quarter.

UK breakevens are now back to the levels traded at before disinflationary fears took hold towards the end of 2014 and beginning of 2015, indeed at levels that are more in line with long-term averages. There are reasons to believe UK breakevens are now too rich given the strength of sterling and the downward pressures coming from input prices. Our strategy is articulated by selling the real yield and also selling the inflation breakeven. The spread between these two measures has become very stretched, as UK breakevens have normalised while real yields remain extremely low. Upside economic surprises should result in real yields rising relative to inflation breakevens. Alternatively, this strategy should also perform well in the event of economic disappointment, which should lead to elevated inflation breakevens versus the move in real yields.

**Chart 1**  
Eating into Korea's share



## It's going down...

The South Korean economy is facing significant pressures from a step-change in the medium-term sustainable growth rate. As a result, inflation should continue to surprise to the downside. Our central case is that the Bank of Korea will have to lower interest rates in order to stimulate growth, which will bring bond yields down. Our strategy is to be long short-dated Korean bonds that will benefit from such interest rate cuts.

The Korean economy faces headwinds from the external environment and rising export competition (see Chart 1). Japan's aggressive currency policy raises the potential for retaliatory action from other countries struggling to stimulate their economies. This may be less of an option for Korea, however, as it already has a sizeable current account surplus, which is boosted by the lower oil price suppressing the costs for the country's sizeable import bill. At the same time, the structural slowing of the Chinese economy has acted as a headwind from Korea's most important trading partner accounting for 25% of exports. In addition, there is evidence to support the thesis that linkages between a recovering US economy and the Asia Pacific region are providing less traction than in previous cycles.

Furthermore, the domestic economy is somewhat fragile; 87% of all employment is in the service sector, which the government continues to cosset; real estate prices have flattened; and private sector leverage has climbed relentlessly. This is a key reason why the central bank is loath to cut rates more aggressively. The government won the election with a promise of 4% GDP growth and has attempted to stimulate the economy by increasing demand for mortgages by lowering loan-to-value ratios. It plans to run a 2.7% fiscal deficit in 2015, substantial by historic standards. Although government debt to GDP is just 40%, it is limited in the scale of deficit it regards as prudent, as pension provision is scant while the working age population is set to begin to decline from 2016. Consumers are saving more as a consequence, reducing the impact of stimulatory measures. Inflation has been below the target band for two years, while weakness in the oil price has yet to fully feed through; despite the 80% increase in tobacco tax, inflation numbers for 2015 will come under pressure. Accordingly, we expect further action from the Bank of Korea to ease monetary policy.

# Corporate Governance

## How should boards deal with the activist investor?

We provide advice to boards on how to deal with the growing phenomenon of activist investors.



**Jonathan Cobb**

Investment Director, Governance and Stewardship

### More active investors

Over the last decade, asset owners and investors have been increasing their investment in activist strategies as they provide an opportunity to optimise portfolio returns while diversifying risk. For example, money invested in activist hedge funds around the world is estimated at \$120 billion. Members of UK plc boardrooms should note that activist campaigns outside the US have increased over the past five years. Presently, the UK accounts for nearly two-thirds of those conducted in Europe.

A typical activist strategy involves the purchase of a non-controlling stake in a publicly listed company followed by agitation for change. Increasingly, activists seek to include other shareholders in their efforts to persuade boards that their proposals enjoy wider support. The records show that just over half of activist demands relate to governance issues such as board representation, egregious or unjustified remuneration, 'poison pill' defences and the ousting of executive directors judged to be underperforming.

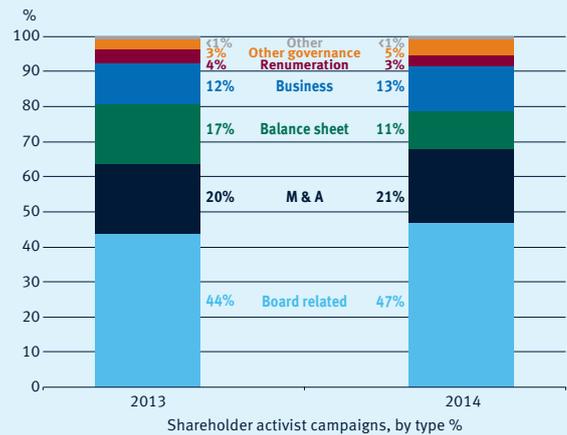
In the US, where shareholders arguably have fewer rights to direct or influence the governance of their investee companies, activists have successfully posed as the friend of the disenfranchised investor. In the UK, the Corporate Governance Code, Listing Rules and UK company law make it easier for minority shareholders to effect change at companies without having to resort to the tactics used by activists. UK boards, however, cannot be complacent as evidenced by the range of UK plcs that have received the attention of activists over the past decade. In each case, the primary driver for intervention was management deficiency or a perceived strategic deficit which has, in the view of the activist, impeded the creation of shareholder value (see Chart 1).

### Advice for board members

As the current economic cycle matures, activists are likely to get a sympathetic hearing where they identify lacklustre company performance combined with generous rewards for insiders. We see the following considerations as key for board members.

- ▶ Is the board doing everything it can to create value within a realistic timeframe? Strategy should be clearly articulated for shareholders and other stakeholders.

**Chart 1**  
'Sack the board' is an old favourite



Source: Activist Insight (as of 2014)

- ▶ The indicators used to evaluate performance should be reviewed to ensure continued relevance. Benchmarking can also identify potential weaknesses.
- ▶ The board has a duty to consider activists' proposals with the long-term future of the company at the front-of-mind.
- ▶ Where activists propose candidates for the board, the Nominations Committee can evaluate these constructively and provide assurance to other investors.

Although governance issues are often the starting point for campaigns, they are rarely the sole objective. Poorly performing conglomerate structures have proven to be an attractive target, while some of the most successful campaigns have resulted in a sale of the entire business. In activist campaigns, boards can have more difficult decisions to make than the simple assessment of a bid for corporate control. Activists may be proposing a fundamentally different strategy for the company or pressing for the sale or de-merger of subsidiary businesses. Boards need to bear in mind that the changes proposed by an activist are likely to be felt long after that activist has relinquished boardroom seats or left the share register. The longer-term interests of all shareholders must be considered when an assessment of an activist proposal is made.

As members of a UK board, activist representatives will be expected to act in the interests of all shareholders and an effective chairman will ensure that they are held to this standard. It should go without saying that the chairman should maintain a preponderance of independent directors on the board. The board needs to ensure that the company's purpose, values and strategy are clearly articulated, and aligned with the long-term interests of all shareholders. This will assist companies to get the shareholders that it wants to support the sustainable long-term value of the business rather than the shareholder that it least expects.

What is the approach of the corporate governance team at Standard Life Investments to activist investors? While we are always minded to support incumbent management, we will evaluate the perspective of other investors in line with *Focus on Change*. In the specific case of an activist investor, we will evaluate the NPV of their proposals where our opinion is sought. In the case of board nominees, we are inclined to let the company's Nominations Committee make decisions.

# About Standard Life Investments

Standard Life Investments is one of the world's leading investment companies, offering global coverage of investment instruments and markets.

In a diverse, dynamic world we use our insight and intellect to seek out investment opportunities. Our ability to predict, react and adapt rapidly helps us to maintain our position as a leading investment house.

We are active fund managers, who place significant emphasis on research and teamwork. After in-depth analysis, our Global Investment Group forms a view of where to allocate assets, based on the prevailing market drivers and on forecasts of future economic indicators. The Global Investment Group 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.

**Global Outlook**, a quarterly summary of the House View, is partnered by **Global Perspective**, a monthly article on topical issues, **Global Horizons**, an occasional report on thematic and structural trends, and **Global Spotlight**, web-only articles commenting on current events. **Weekly Economic Briefing** examines the latest statistics from all the major economies. Copies are available on the Market View section of our website [www.standardlifeinvestments.com](http://www.standardlifeinvestments.com).

Standard Life Investments is a dedicated investment company with global assets under management of approximately £245.9 billion (as at 31 December 2014) – this equates to \$383.6 billion, C\$444.2 billion, A\$468.4 billion and €316.8 billion.

## Global Outlook Team

The production of Global Outlook draws on the ideas and insights of many of our investment professionals around the world within the framework of our *Focus on Change* investment philosophy. Below are the contributors to the publication, in addition to those mentioned within the document.

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# House View

The following asset allocation is based upon a global investor with access to all the major asset classes. For regional versions of the House View, please contact your Standard Life Investments representative.

July 2015 House View		
Risk	The Global Investment Group emphasises moderate levels of risk, focusing on assets either with sustainable yield or those able to provide sustainable earnings expansion in a moderate growth environment.	NEUTRAL
<b>Government Bonds</b>		
US Treasuries	The economy's strength, especially a tighter labour market, should enable the Federal Reserve to start raising interest rates in the second half of 2015, although it will use forward guidance to control the pace of yield movements.	LIGHT
European Bonds	Bonds are supported by an environment of low inflation, modest economic growth and especially ECB QE. The Greek situation requires careful monitoring as this could lead to a major reassessment of peripheral bond risks.	NEUTRAL
UK Gilts	The asset class is vulnerable to interest rate increases as economic growth remains firm. Manageable inflation pressures and central bank guidance can anchor rising bond yields.	NEUTRAL
Japanese Bonds	The long-term inflation outlook is deteriorating as the government aims for reflation, although the Bank of Japan's sizeable bond-buying programme should prevent yields rising significantly.	LIGHT
Global Inflation Linked Debt	Inflationary conditions are subdued in many developed economies, although valuations require careful examination. Investor worries remain about future inflation due to ultra-easy monetary policies.	NEUTRAL
Global Emerging Market Debt	Dollar-denominated bonds are Heavy, as spreads show better value, while local currency bonds are Neutral as careful examination is required of individual currency and spread factors.	HEAVY/NEUTRAL
<b>Corporate Bonds</b>		
Investment Grade	US credit spreads have widened substantially, creating an attractive opportunity thanks to very low yielding US Treasuries. European corporate debt benefits from improving cashflows, but is expensive.	NEUTRAL
High Yield Debt	Overcrowding in a leveraged US market threatens a rush for the exit when policy is tightened; European debt is supported by yield seekers, but vulnerable to systemic risks.	NEUTRAL
<b>Equities</b>		
US Equities	Valuations are stretched and margins are likely to compress due to the strong dollar's effect on overseas earnings. Lower oil prices are also weighing on investment.	LIGHT
European Equities	Corporate competitiveness is improving, and earnings should receive a lift from further euro depreciation, an improvement in domestic demand and lower energy costs.	HEAVY
Japanese Equities	Many structural reforms remain outstanding, but management focus on return on equity and a planned corporation tax cut are helpful. The Bank of Japan is taking action to reach the inflation target.	HEAVY
UK Equities	Economic data is a positive driver, but margins are coming under pressure from a mixture of currency strength and commodity price weakness. Meanwhile, political uncertainty surrounds potential EU exit.	NEUTRAL
Developed Asian Equities	Slowing commodity demand, particularly from China, is affecting some countries, such as Australia. However, supportive monetary policy and the spill over from the mainland Chinese equity boom are boosting share prices.	NEUTRAL
Emerging Market Equities	Commodity-export-dependent markets have deteriorated while those with strong domestic fundamentals are improving. Policy, current account positions and central bank actions are other drivers of divergence.	NEUTRAL
<b>Property</b>		
UK	The robust growth environment continues to bolster prices in the near term, and yields remain attractive compared to other assets, suggesting reasonable returns over a three-year holding period.	HEAVY
Europe	Prime assets in core markets offer attractive relative value given QE and the low interest rate environment. Meanwhile, parts of the periphery are starting to show consistent value growth.	NEUTRAL
North America	Canadian property faces headwinds from an interest-rate sensitive consumer and significant office construction. The US should benefit from continued economic growth but pricing is quite aggressive.	NEUTRAL
Asia Pacific	Yields are broadly stable, while the attractive yield margin and recovering rents are driving pricing. Japan remains ahead in the property cycle, followed by Australia.	NEUTRAL
<b>Other Assets</b>		
Foreign Exchange	While the US dollar will benefit from eventual monetary policy tightening, the currency has appreciated sizeably already. ECB QE and uncertainty surrounding Greece will weigh on the euro.	HEAVY \$, LIGHT €, NEUTRAL £ AND ¥
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions, influence the outlook for different commodities. Supply issues and OPEC inaction will keep prices constrained in 2015.	NEUTRAL
<b>Cash</b>		
	Unconventional monetary policy is ending in the US and UK; some emerging markets are also tightening. QE in Europe and Japan will keep interest rates there low.	NEUTRAL

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