Global Outlook

Fourth Quarter 2015

Financial markets have suffered further volatility on concerns over the extent of the slowdown in China and other emerging market economies as well as worries about the impact of any tightening of US monetary policy. Pressures are growing on policymakers to respond, in order to ensure that global economic expansion is sustained and inflation continues to return towards official targets. The sharp fluctuations in asset prices mean our fund managers have many more opportunities to use the *Focus on Change* approach to assess whether or not markets are correctly priced.

Standard Life Investments

Summary

Foreword

Keith Skeoch
Chief Executive

The world economy has reached a critical juncture. As we discussed at the quarterly Global Investment Group (GIG) meeting at the end of September, tensions are growing along a number of dimensions. The most acute is the deterioration in emerging markets' economic and financial conditions– centred on China – that has put further downward pressure on commodity prices and inflation, and exacerbated the structural slowdown in global trade and manufacturing activity. This, together with heightened uncertainty surrounding the outlook for Fed policy, has triggered a spike in financial market volatility and a re-pricing of global risk assets despite resilient domestic demand trends in the advanced economies.

Consistent with our *Focus on Change* process, it is important to ask ourselves what are the drivers of current markets and why will investors change their mind. We used our quarterly GIG meeting, therefore, to step back from the noise and examine in detail some of the key assumptions underpinning the House View. Can economic recoveries become more self-sustaining? Will corporate profit growth remain positive? Do policymakers have the tools to generate stronger inflation? Will the political environment create undue volatility? On balance, we concluded that our portfolios would benefit from changes to their duration exposure. As explained by Jeremy Lawson (Chief Economist) and Andrew Milligan (Head of Global Strategy) in their economic and market overview articles, although the global economy should continue to grow, the pressures on a significant number of emerging markets will not dissipate quickly and recoveries will continue to be driven by the services sector. Corporate earnings growth will remain constrained in this environment, supporting our neutral stance on equities. While sustainable yield, in the form of credit, equity or real estate, remains an attractive investment theme, the duration risks from any fixed income exposure needs to be handled carefully.

Our GIG discussions also considered the longer-term picture. One aspect of the strategy team's economic analysis has been looking at drivers of nominal growth. The outlook depends on a series of cyclical and structural factors: the evolution of spare capacity, wage growth and hence inflation, prospects for a stronger capital spending and productivity cycle, not to mention demographics. The implications for global investors of a lengthy period of low nominal growth would be considerable: low returns on bonds, cash and equities, as well as pressure on central banks to adopt more radical reflationary policies. Policymakers have the tools to drive growth higher and underpin a stronger return environment. The question is whether they have the will to use them.

Global Overview

Containing EM (fluenza)

The global economy can expand into 2016, as long as financial stress does not rise further and emerging market countries avoid a major slowdown.

Jeremy Lawson
Chief Economist

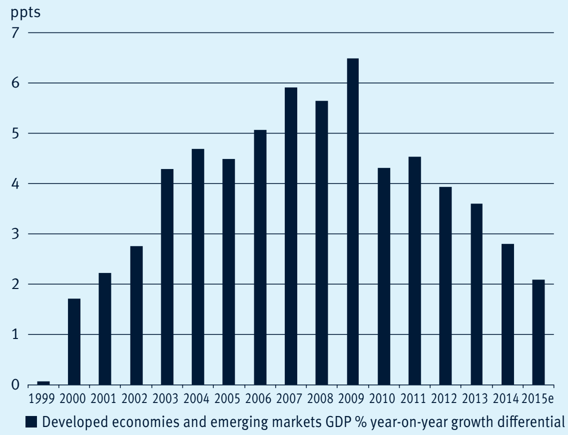
James McCann
UK/Europe Economist

Stress is rising

August and September brought a considerable amount of financial market volatility, largely led by concerns about the economic slowdown in China. Global share prices have periodically staged a recovery but financial stress is elevated. It is tempting to argue that the latest bout of volatility has few implications for either the economic or policy outlook. Outside of emerging markets (EM), which for some time have struggled against cyclical and structural headwinds, there have been few signs of a broader deterioration in global economic conditions. Indeed, the developed economies are growing at quite a healthy clip. For example, US Q2 GDP growth was 3.7% annualised. There are strong indications that long-moribund credit demand in the Eurozone is stirring. However, we advise caution for two reasons. Firstly, economic statistics are released with a lag and thus it is possible that the gyrations in financial markets partially reflect a deceleration in global economic activity that we are yet to see in most official data. Some businesses are already reporting weaker order books or higher inventory levels. Secondly, lengthy periods of financial stress can themselves cause economic activity to slow as consumer or business sentiment is affected. It is therefore an opportune time to re-assess our views on the underlying health and stability of the global economy.

Weakness in emerging markets into the second half of the year implies that global growth will be modestly lower in 2015 than 2014. Activity has been dampened by a range of issues including lower commodity-related investment, subdued global trade and industrial production, as well as idiosyncratic headwinds in individual countries. Moreover, the recent pick-up in financial stress poses further downside risks, say through higher borrowing costs. Global GDP growth is still expected to improve next year, but only to a relatively muted 3.3%, little different therefore to 2013 or 2014. This small rebound should be driven by a further strengthening in developed market activity alongside some stabilisation in the worst performing parts of the emerging world (see Chart 1). Our forecast assumes no further falls in commodity prices, while consumer spending benefits from past commodity price declines. The evolution of financial stress and its impact on activity provides huge uncertainty. If stress builds further then there is a large risk that growth will not rebound. In this environment, monetary policy easing in the developed economies will quickly come back onto the agenda.

Chart 1
Growth gap closing



Note: e denotes IMF estimate

Source: IMF, Datastream, Standard Life Investments (as of April 2015)

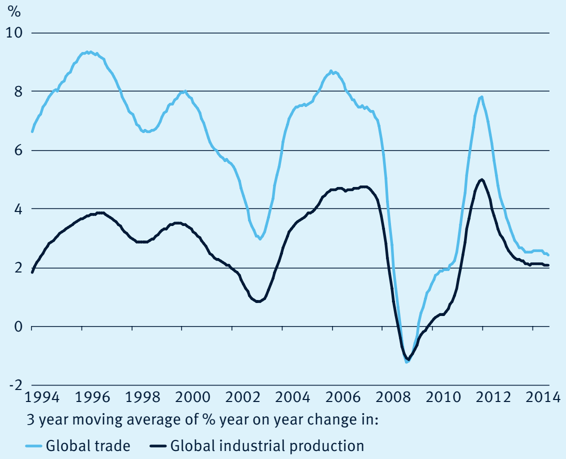
In general, the global economic environment is likely to support activity outside of the manufacturing, energy and mining sectors, while durable goods consumption and production should continue to benefit from persistently low energy prices. Global productivity growth is likely to remain subdued in the absence of widespread reforms and a more growth-friendly mix of government spending. The effects of lower commodity prices weighing on global headline inflation should start to dissipate. Indeed, base effects mean that headline CPI will return back towards core CPI around year-end and into early 2016. Although global deflation fears are overblown, spare capacity remains meaningful and is likely to erode only slowly over coming years, keeping underlying inflation subdued. Investors are likely to remain nervous about the ability of central banks to meet their inflation targets.

Pressures on China

It is increasingly clear that the Chinese economy is slowing and policymakers are struggling to deal with a range of competing objectives: stabilising growth, managing the newly liberalised renminbi, supporting the export market, rebalancing the economy and correcting financial imbalances. GDP growth is almost certainly slower than officially acknowledged by the authorities. A hard landing is not our central scenario, as we expect extra fiscal stimulus, but the transition to a new growth model will remain bumpy and unfriendly for commodity producers. A further deceleration in growth cannot be ruled out and the Chinese currency is likely to weaken moderately against the dollar.

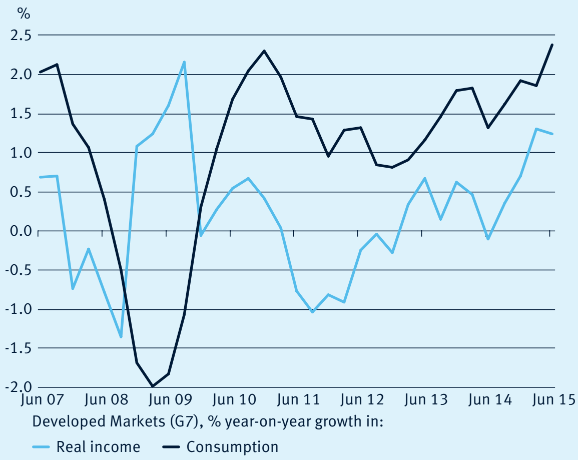
There have been a lot of wild claims regarding the implications of China's currency depreciation for the global economy. We make two observations. Firstly, looking across a broad range of models, it is far from clear that the renminbi is significantly overvalued. While the real effective exchange rate is well above its long-run average, our analysis suggests that it is broadly in line with the country's strong productivity growth relative to other countries. The current account surplus has also remained fairly stable around its sustainable level. Secondly, the change in currency regime does not imply that China is entering a so-called currency war. This involves competitive devaluations that artificially suppress a currency below its fair value in order to gain export market share and shift the burden of adjustment to imbalances on to other countries. That is not

Chart 2
Structurally weaker trade flows



Source: CPB World Trade Monitor, Standard Life Investments (as of July 2015)

Chart 3
Advanced economy consumption holding up



Source: National sources, Datastream, Standard Life Investments (as of July 2015)

what China is engaged in. Instead, its policy regime became increasingly untenable in light of the divergence between Chinese and US macro fundamentals. Pegging to the US dollar was to some extent importing US monetary policy given that the capital account is only partially closed. Allowing a more flexible (although still managed) exchange rate regime gives the authorities more monetary scope, as well as allowing the currency to find its more natural level given the complex adjustment the economy is experiencing. Moreover, as long as any further depreciation is gradual, modest and, most importantly, in line with the evolution of Chinese macro-fundamentals, it need not be particularly destabilising or deflationary for the rest of the world.

Commodity producers in the emerging world are faring badly in the current environment. Exporters have to contend with a number of headwinds. Global trade growth has become structurally weaker (see Chart 2) due to a slowdown in the pace of outsourcing and global supply chain development, as well as the completion of China's integration into the global economy. A number of countries also have idiosyncratic issues with rising leverage, political instability and insufficient structural reform. Meanwhile, the rising dollar ahead of US monetary tightening is leading to capital outflows in countries with economic and financial imbalances. Brazil and Russia are experiencing deep recessions, in part due to the deterioration in commodity prices, but also due to their own policy mistakes and political missteps. Growth can stabilise next year – if commodity prices do not decline sharply and financial stresses do not increase. More broadly, we remain of the view that a widespread, systemic EM financial crisis is unlikely, given the institutional progress made over the past two decades. However, crises cannot be ruled out in those countries with the largest imbalances, like Brazil, Malaysia, South Africa or Turkey.

The response in developed economies

Aside from an early 2015 speed bump in the US, and more persistent weakness in the commodity exporting Australia, Canada and New Zealand, the developed economies have had a better year. Domestic demand has been picking up with housing and services activity resilient to EM weakness. Lower oil prices, highly accommodative monetary policy, improving labour markets and healing credit conditions have all been important in supporting growth, and should continue into next year. In the US, the positive effects of lower oil prices were initially more than offset by weaker energy investment, but consumption is now responding to the improvement in real incomes, while the worst of the investment shock now appears to be behind us (see Chart 3).

In the absence of further negative shocks, developed market trade links to the most badly affected emerging markets are not in themselves large enough to derail these recoveries, although they will have an effect on the externally orientated manufacturing sector. We are carefully monitoring signs that this is feeding through to the larger services sector. Listed equities will also be sensitive to developments in global activity given that they tend to have larger external exposures than do economies as a whole. The bigger threat comes through financial stress; any further rise would feed through to local activity via lower consumption and investment.

If financial stress dissipates and economic data stabilises, we still think that the Federal Reserve can raise rates before year-end, and the UK not long after. Both, however, are likely to maintain gradual tightening paths, particularly if their currencies continue to appreciate in trade-weighted terms. The ECB is on high alert, but will probably only ease policy if growth and inflation prospects deteriorate further. There is already a strong possibility that the ECB's QE programme will extend beyond September 2016. Recent developments strengthen our conviction that the Bank of Japan will take further action in coming months, although it is constrained in how much more it can do given the size and composition of the current asset purchase programme. An alternative, therefore, would be another supplementary budget.

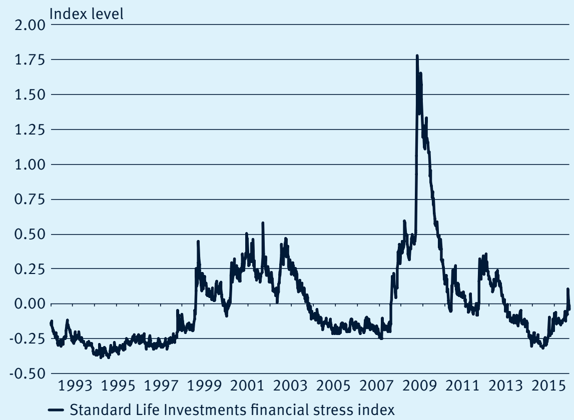
House View

Managing volatility

Worries about global growth are overblown, but continued pressures on company balance sheets suggest a preference for corporate bonds rather than equity within diversified portfolios.

Andrew Milligan
Head of Global Strategy

Chart 1
Beginning to stress?



Source: Standard Life Investments (as of 21 September 2015)

Market vulnerabilities

The marked jump in market volatility, especially equities and exchange rates, in recent weeks, matches in many respects the extent of the dislocation seen at the time of the 2011-12 Eurozone crisis. Sizeable gains in share prices year to date were given back in short order, while a number of countries saw their currencies come under considerable pressure.

Investor sentiment has been noticeably affected by these events, which built on existing nerves about a worsening outlook for global profits growth into 2016. The epicentre of the latest crisis is China, which faces a complicated series of problems: a bursting stock market bubble, slowing activity as the economy shifts away from investment and manufacturing towards services and consumption, and volatile capital outflows partly reflecting greater financial liberalisation. The decision to break with the previous policy of a US dollar peg is quite understandable, but has to be handled extremely carefully because of the adverse impact on other, already weak, emerging market (EM) currencies. Poor communication and the lack of transparency surrounding the shift in regime has generated an uncertainty shock for investors who are struggling to understand policymakers' intentions and their ability to stabilise activity. They are building higher risk premia into assets as a result. Meanwhile, volatile financial markets are also being driven by concerns about the broader EM economic complex: recessions in large economies such as Brazil and Russia or funding pressures on oil producers. Investment decisions also depend on understanding the various supply and demand factors causing a lengthy bear market in most global commodities. The impact has been seen, for example, in the pressures on the cashflows and investment plans of UK or Australian mining companies, or the credit spreads on debt issued by US energy stocks.

Taking risk down

As our *Focus on Change* approach identified these drivers, so the House View steadily reduced its risk levels during the year. For example, the Heavy position in equities became Neutral, while there has been a clear preference for assets in developed markets, focused on European and Japanese equity, as opposed to exposure to emerging markets. More recently, we have reduced our underweight position in global bonds to reflect the increased near-term tail risks to the global economy. Our longer-term analysis continues to find that traditional imbalances, such as high rates of inflation or excessive current account exposure, are not yet serious enough to bring about a 1997-98 style crisis. Nevertheless, the world economy is at an important juncture. On the one hand, growth in most of the large advanced economies should be sufficient to allow corporate profits (excluding those derived from oil, raw materials and trade with emerging markets) to make modest positive progress into 2016. On the other hand, the profits cycle has turned down in many emerging market economies, feeding back into many western companies' order books. China is not the sole cause of this weakness. We remain concerned, for example, about the vulnerability of Latin American countries to the effects of Brazil's credit rating downgrades, while lower commodity prices and associated cutbacks in capital spending feed through into a range of EM stocks.

A key feature for the House View in coming months is how such constraints on business and household cashflows might interact with the corporate or sovereign debt exposure which has built up in many emerging economies. One trigger would be an aggressive tightening of US interest rates, and therefore a sharp appreciation of the US dollar, which could create serious strains for some companies and countries; in fact the latest Fed decision confirms the House View expecting only a moderate uptrend from a circumspect central bank reassured by low rates of headline inflation. Another trigger would be a worsening level of financial stress which fed through into credit availability (see Chart 1). Conversely, a strong upturn in global trade and improvements in credit or EM bond spreads would be a helpful trigger when valuations of some emerging market equities are looking more attractive.

Policy decisions by a range of countries will also be significant triggers for the House View in coming weeks. Investor confidence is already responding to speculation that the ECB or the Bank of Japan might ease policy in coming months to try and ensure that inflation eventually reaches its target. However, China will remain the centre of attention; a key issue is not only the extent but also the manner of the policy easing. Stronger public infrastructure spending would be more beneficial for the rest of the world than a further drop in the currency. Further efforts to ease monetary policy globally would, of course, support a key House View theme – sustainable yield – hence encouraging the search for suitable opportunities in credit, equity and real estate markets. The House View sees attractions from corporate bonds within portfolios, as it is more senior in the capital structure but also because valuations for this asset class are more attractive. However, the duration exposure also needs to be handled carefully depending on the extent of Federal Reserve tightening into 2016.

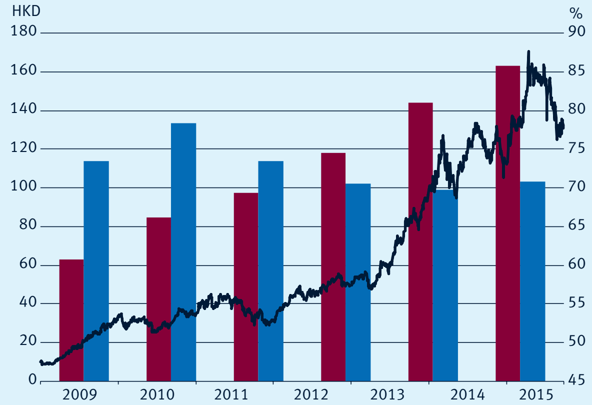
Global Equities

The technological age

As consumers and corporations become increasingly demanding, companies are striving to become more technologically sophisticated in the quest to be leaders in their field.

Donal Reynolds
Investment Director, Global Equities

Chart 1
Upwardly mobile



China - proportion of mobile internet users in total internet users (R. H. Scale)
China - proportion of PC internet users in total internet users (R. H. Scale)
Tencent share price
Source: China Internet Network Information Centre, Datastream (as of 25 September 2015)

Shop around the clock

Despite the continued slowdown in the Chinese economy, online retail sales there are expected to surpass those of the US and Europe combined by 2018 – reaching around US$610 billion. Consumers, particularly in lower-tier 3 and 4 cities, are becoming ever more price conscious. Meanwhile, retailers are aware that e-commerce platforms are becoming increasingly valuable, especially those with limited physical stores.

To have an effective e-commerce business, scale is important in order to be able to offer the service levels that consumers demand. This has resulted in the growth of platforms in China such as TMall and JD.com. For example, JD has a fully integrated logistics company with about 20,000 staff and 100 warehouses. Consequently, a key differentiator of its business is that 80% of orders receive a same/next day delivery service. JD is currently the second largest e-commerce company and growing faster than market leader Alibaba. Its reputation for reliability, service and the quality of goods on offer has supported this growth. Furthermore, it has managed to build on its original electronics platform by expanding into higher-margin segments, such as cosmetics.

JD's deal with Tencent, the leading social-media player, has also been a significant development. We consider that the combination of Tencent's traffic and JD's e-commerce expertise could challenge the Alibaba/Weibo dominance. China's shopping habits are evolving to require an integrated SoLoMo strategy, where social media, location services and mobile marketing are combined. China currently has more mobile internet users than PC internet users (see Chart 1) and this differential is set to grow even further. Those companies that have strategies combining these key elements are more likely to become leaders in the online shopping revolution.

Additionally, the growing transition to mobile internet aids flash marketing which works considerably better on smartphones than on PCs. VIPShop is a prime example of a company that uses a SoLoMo strategy to drive sales. The flash sales nature of its business allows the firm to have 900 brand partners and dispose of excess inventory at reduced prices without damaging their brands' value. In fact, during the most recent quarter 76% of its sales came from mobile users. What is clear is that for the platforms that find their niche and deliver on their proposition, the scale of the opportunity is significant. This is irrespective of the highly competitive environment and potential for a further slowdown in economic growth.

Staying connected

Computing and microprocessor developments have made significant strides in recent years. However, a number of challenges face technology companies as social and technological trends continue to emerge. Connectivity at both a corporate and consumer level is increasing and the requirement for improvements in microprocessors shows no sign of abating. The demand for processors that deliver high performance with limited interruptions is likely to increase further as users in the developing world seek greater connectivity. Internet usage will also have to exhibit limited delay tolerance, driving processing power on a global basis.

At the same time as performance requirements increase, power management has also entered the equation. As devices become smaller and networks more sophisticated, energy conservation becomes an increasingly important consideration. Power and heat are important considerations, as any improvement in processor performance leads to a dramatic rise in power and heat output. This puts considerable strain on R&D costs as companies strive to deliver high levels of performance while managing these issues.

One option for semiconductor manufacturers is to turn to companies such as ARM, a leading semiconductor intellectual property supplier. Semiconductor businesses are able to maintain their manufacturing base while paying ARM a licensing fee. This has proved especially desirable in the high-end smartphone sector where ARM is a particularly strong player. It is now looking to make progress in networking as the market is demanding high-value/low-volume servers and networks. Also competing in the networking arena is Cavium, a provider of semiconductor processors for networking and storage. It has a broad customer base that extends from the enterprise market and data centres through to the broadband and consumer markets. Cavium has a number of products that are experiencing increasing customer adoption and sampling. Despite rising technological demands, the global customer base for microprocessors continues to grow. This provides an opportunity for truly innovative companies to become leaders in their field.

Global Emerging Markets

Rising above the gloom

The oil and technology sectors have come under pressure but our analysis highlights companies with the ability to thrive in the current environment.

Alistair Way
Head of Emerging Market Equities

Not oil bad

While falling commodity prices have put pressure on the beleaguered oil sector, some companies give scope for optimism. Refiners in global emerging markets (GEM), for example, offer better returns than their developed market counterparts which suffer from overcapacity. This is less of an issue in GEM because of better industrial growth and higher entry barriers. An example is Turkish refiner Tupras, which is undergoing a major facilities upgrade that should boost capacity utilisation (from 75% in 2014 towards 95%) and refining margins as it shifts towards higher-value products. Despite this, its share price remains relatively range bound, suggesting to us a re-rating towards industry peers as investors appreciate its potential.

In India, oil marketing company BPCL benefits from government reforms. Deregulation of diesel prices, for example, provides advantages including the ability to manage marketing margins freely, plus lower interest costs, which increase profits/cashflow. This could herald a new era for BPCL. Increased focus on non-fuel revenue sources, such as convenience stores and ancillary services, offers further potential. For oil marketers elsewhere, non-fuel revenues can account for 30-60% of gross profits, compared to 1% currently for BPCL.

Vision for the future

Technology hardware weakness, reflected in Apple's iPhone shipments, sent shockwaves through the whole supply chain. Taiwan was notably exposed but there are still mid-cap growth opportunities. Semiconductor company Himax Technologies has been hit by cyclical weakness in its core display driver business. However, we see better prospects following the release of Microsoft's Hololens. Himax supplies a microdisplay and sensors for this augmented-reality 3D headset, which allows users to interact with holograms. If this technology takes off, with good visibility on orders already, we believe it could add significant corporate value.

Richtek Technology is in a potentially strong position amid pressure for Type C connectors – a uniform charging/data transfer connector for phones and other devices – to become the global standard. Indeed, the EU has made it mandatory for handsets to adopt Type C connectors from 2017. Richtek dominates the market for these connectors and therefore stands to gain meaningful share. We believe analysts have been slow to recognise this potentially material new revenue stream, which should change if Richtek announces order wins in coming months.

Japan Equities

Mixing things up

Volatility in commodities is prompting some Japanese companies to change their business mix, while a new ID-card system brings opportunities for others.

Shigeru Oshita
Investment Director, Japanese Equities

A taste of things to come

Volatile commodity prices have encouraged some Japanese companies to reform their businesses, using differentiated technologies to produce higher-margin, niche products while limiting the impact of their commodity-related businesses on profitability.

Ajinomoto is a food producer and market leader in amino acid fermentation. Less than five years ago, more than 20% of profits came from its bulk business (animal nutrition, Umami seasoning for processed food manufacturers, and sweeteners), which are vulnerable to price volatility. However, management has ambitions to be a top-ten global food manufacturer and is aggressively expanding overseas. The growing middle classes in Thailand, Vietnam, Indonesia, Philippines and Brazil are strategic sales targets for its flagship seasoning products and new condiments suited to local palates. As its retail food business has expanded, its price-sensitive bulk business has shrunk to around 10% of profits, and these reforms should be positive for Ajinomoto.

Mitsui Chemical is similarly rebalancing. It is reducing its price-sensitive basic materials business by closing domestic petrochemicals plants, while focusing more on strategic growth products such as functional polymers, food packaging and medical components. Our view is that these reforms should lead to more stable long-term growth.

Japan's got My Number?

My Number, a national ID card system, is being introduced in January 2016. Every resident in Japan will be assigned a unique number for social security and tax purposes. This is creating demand for related IT and security services. Nomura Research Institute (NRI), a systems-integrated firm, which already has a strong footprint in the financial services sector, stands to benefit from this initiative. We expect NRI to be actively involved in My Number-focused projects as companies adapt their own systems to accommodate it, and for ongoing support and maintenance as it embeds.

Data management standards around My Number are expected to be stringent for organisations throughout the public and private sectors. Penalties will be imposed for leaking the ID numbers and this will likely drive increased demand for security services. Sohgo Security is one company we believe can leverage its existing capabilities in data access, storage and sensitive data disposal, to meet these new challenges.

US Equities

Re-inventing the wheels

Mobile connectivity and technological innovations are revolutionising the automotive industry to the benefit of a select band of technology specialists.

Jeff Morris
Senior Vice President, US Equities

The car of the future

Electronic componentry in vehicles is not new, but the rapid pace of development means more technologies are lending themselves to automotive applications. These range from user experience enhancements to life-saving safety features. Combined with the arrival of mobile connectivity and demand to be always connected, electronic content per vehicle is rising fast.

Cockpit electronics are therefore an important consideration for automakers, helping to transform dated dashboards into interactive 'infotainment' systems. Touchscreens and voice-activated functions are becoming must-have features. However, stringent certification standards are a major barrier to market entry. This narrows the opportunity to companies with the necessary technological capabilities. Visteon, in particular, is emerging as a key player after recent acquisitions. Now a pure-play cockpit electronics firm with expertise in merging car consoles with driver information, we expect it should benefit from this long-term secular growth market. New technologies have also given rise to the trend of active safety. Camera and sensor miniaturisation opens up various possibilities, including lane-departure warnings. Crucial here, though, are safety agencies, which increasingly deem such functionality obligatory for the highest safety ratings. Mobileye's camera sensing system is being used to reduce accidents. A first mover in this area, it benefits from many years of data from its installed base, which we consider should allow it to exploit substantial growth in advanced driver-assistance systems and the ultimate destination, fully autonomous driving.

Wagons roll

While technology can enhance safety and the consumer experience, it can have compelling economic attractions for businesses. Fully automated transmission systems for commercial vehicles, for instance, are commonplace in the US, but not overseas. They allow significant gains in fuel efficiency (5-20%), improve acceleration, reduce vehicle life-cycle costs and consequently boost residual values. Importantly, greater vehicle automation requires less driver training, allowing less-skilled workers to operate them and at reduced wage costs. Allison Transmission Holdings manufactures drivetrains for commercial trucks. It has particular proficiency in the fast-growing natural gas vehicle market and offers sophisticated software analytics enabling fleet managers to optimise vehicle use. In our view, it looks well placed in a specialist market that is really only starting to internationalise.

UK Equities

Great expectations

Creative founders, strong brands and edgy new products can often prompt significant investor excitement, but they do not necessarily translate into investable businesses.

Wes McCoy
Investment Director, UK Equities

Focus on quality not width...

Investors are sometimes dazzled by new products or 'category creators' breaking new ground. The appeal is understandable; getting in at basement level on the next big idea can be richly rewarding. However, not all creative concepts fulfil their potential. Hands-on founders sometimes overlook the complexities of managing the business side of their brands.

Clothing retailer Ted Baker demonstrates the management attributes that avoid this pitfall. Founded in the late 1980s, it quickly became known for a quirky product range that departed from the usual high-street fare. New outlets followed but, crucially, only in small numbers over time to preserve brand distinctiveness. The company has made a virtue of this incrementalism, extending product lines only when existing merchandise became established. Womenswear was not introduced until nearly 10 years after launch, while a franchise model was adopted for US expansion to limit risk. This considered style extends to procurement and inventory management. Both are tightly controlled to safeguard quality, manage working capital and limit overstocking and discounting. Such a steady approach usually runs counter to the impatience growth-hungry investors can exhibit, but has been a remarkable success as its current share price attests.

Style over substance?

By contrast, peer SuperGroup chose to expand its Superdry brand rapidly, but ultimately overinvested in the UK, prompting fears that ubiquity may cheapen it irreparably. US distribution licence problems and a lack of operational readiness for internet sales and an omni-channel approach contributed to erratic profitability. Happily, these missteps have been acknowledged by the founders who have reverted to design roles and have charged a new management team with curating brand integrity. Despite its travails, the appeal of the apparel does not appear to have been damaged, and efforts to focus on what it does best seem to be creating a virtuous cycle. More stable demand and reduced sales volatility are allowing better planning, stock management and sourcing. With encouraging early results, the type of discipline that made a good business of Ted Baker may yet make one of Superdry. Indeed, self-help, combined with the stark share price performance differential between the two, suggests SuperGroup may finally be adding investable substance to its style.

Focus on Change

Deja vu?

Some of the positive economic trends and investment themes observed in the US are now replaying in Europe, where recovery has lagged.

Will James
Investment Director, European Equities

Another bite at the cherry

The continuing US economic recovery has offered a good source of positive returns in recent years. With emergent signs that Europe is following suit, we sought to identify clear parallels that could replicate some of the patterns seen across the Atlantic. One example that we found is corporate M&A (see Chart 1). In the US, leading financial advisory and asset management firm Lazard has been a principal beneficiary of increased M&A activity. Profitability has been magnified by high operational leverage, the result of stringent cost overhaul. Moreover, Lazard has benefited from a structural market share shift that favoured smaller specialist M&A advisers over larger investment banks. The latter have been hampered by a combination of weaker finances, greater regulatory hurdles and sullied reputations in the wake of the global financial crisis.

Turning to Europe, portents of M&A activity are emerging in Italy. For instance, within the financial sector itself, banks are being actively encouraged to consolidate, in order to meet regulatory requirements and overcome organic growth challenges. We believe M&A potential in Italy is significant; current activity is just one-third of its peak value, and only one-half of its 15-year average. As in the US, we foresee smaller specialist M&A advisors winning business at the expense of larger European incumbents like Credit Suisse and UBS.

What are the key drivers and what is changing?

Italy's economy is tentatively picking up, owing not only to supportive ECB monetary policy but also to the Renzi government's pro-growth, pro-reform initiatives. These include labour market and tax changes, as well as measures aimed at strengthening Italy's financial system – for instance, facilitating easier bad debt recovery, traditionally an arduous process that has impeded efforts to purge bank balance sheets. This creates an environment more open to privatisations and industry consolidation than in the past. Additionally, new shareholder rules are likely to spark M&A across the financial sector, which is one of Europe's most fragmented. Italian banking stocks as a group will benefit from the regulatory improvements and from economic recovery. This should manifest in falling non-performing loans, loan growth and greater profitability. We consider that better-capitalised banks like Intesa Sanpaolo and Banca Popolare di Milano could offer the possibility of additional upside from shareholder returns.

Chart 1
Banking on M&A

Source: Datastream, Standard Life Investments (as of 25 September 2015)

Regarding prospective M&A, companies such as Mediobanca occupy a similar role to Lazard in the US. It is widely regarded as Italy's best-of-breed incumbent financial advisory firm, placing it at the sharp end of the M&A growth opportunity. As one of the country's top three financial advisory businesses, the bank has forged strong relationships with Italian corporates. Possible tie-ups from which Mediobanca might expect to benefit include the eventual consolidation of Popolari banks across Italy. Similarly, a merger between Italian mobile providers Wind and Three is in the works. Besides its advantageous market positioning, and echoing Lazard, prudent cost rationalisation leaves Mediobanca with strong operational leverage, which we believe should allow top-line growth to feed through more readily to earnings.

What is priced in?

Market forecasts fall below Mediobanca's own business plan targets (year to end-June 2016) and in our view understate the bank's full growth potential. In particular, there is scepticism over management's revenue projections – the market consensus expects a return on equity rather lower than the figures put forward by the company's management. Our detailed analysis suggests that, if M&A activity increases from one-third to two-thirds of its cyclical peak, headline group earnings would rise significantly, without allowing for further benefits from operating leverage.

Current market valuations place Mediobanca's core banking business at sub-10x earnings (year to end-June 2016), and under 1x price/book, near historic trough levels. Notwithstanding a severe China-led global slowdown, we believe the underlying assumptions on which these numbers are based are not aggressive and do not take account of Mediobanca's full opportunity set.

What are the triggers and what would cause the market to change its mind?

The investment case hinges on the acceleration of M&A activity amid a general improvement in Italy's economic situation, banking environment and regulatory change. This, in turn, would translate into higher-than-expected fee income at Mediobanca. Additionally, the bank has reaffirmed its intention to divest a 3% stake (part of its 12.5% holding) in Italian insurer Assicurazioni Generali, by mid-June 2016. In our view, this should drive a reappraisal of the banking franchise and support the case for returns of capital to shareholders.

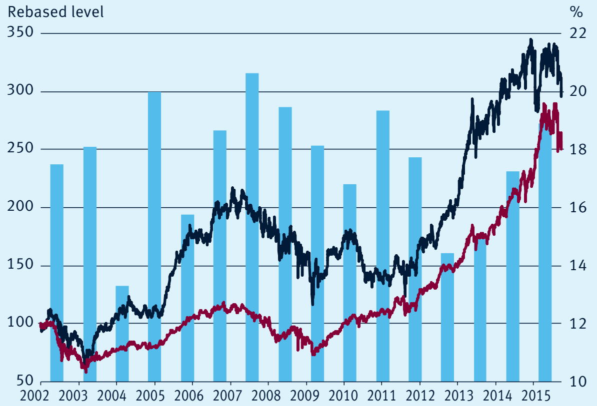
Region in Focus

Europe

As cash flows back into a recovery, stock-specific considerations are sometimes being overlooked. This means investment opportunities across multiple sectors are being missed.

Stan Pearson
Head of European Equities

Chart 1
Investing for success



Roche capex as % of total Stoxx 600 health care sector total capex (R. H. Scale)
Roche, total return performance (rebased at 1 January 2002)
Stoxx 600 Health Care index, total return performance (rebased at 1 January 2002)
Source: Datastream, Standard Life Investments (as of 25 September 2015)

Diverse opportunities

The European economy has started to recover, on the back of highly supportive monetary policy, with leading indicators and business surveys suggesting that this uptrend can continue into 2016. Together with a more favourable relative valuation for European equities versus other stock markets, this encouraged a significant reallocation of cross-border capital by global investors seeking some growth opportunities. One risk which has become apparent is indiscriminate buying, as shown by the heightened interest in index, passive or ETF investing across Europe. In our view, by ignoring the regional and sector nuances and complexities of the many different countries and sectors making up the European stock market, investors can miss a diverse range of investment opportunities – even within a single industry.

Media darlings

Media is one of the more diverse stock-market sectors. The trend is for households to consume a huge variety of content, through a growing number of means, from fixed to mobile devices. US companies dominate much of the internet space, so much so that many people think of US firms as the trend-setters, both in the new digital media and traditional media such as TV.

In TV, it appears that younger generations are abandoning so-called fixed-schedule programming for self-selected viewing, via the likes of Netflix. As such, the impact of changing viewing habits and fears of lost advertising revenues has adversely affected media companies on both sides of the Atlantic. However, this ignores the nuances within the European marketplace. For example, there is a heritage of free TV in many nations. This means competition from cable operators has not been as fierce as it has in the US. It also means that the potential for lost advertising revenue is not as pronounced in Europe as the US. The recent sell-off in media companies could therefore create buying opportunities.

Another factor is the ongoing migration to pay-to-view TV. One misconception is that all European media companies are highly regulated and constrained by national governments. This assumes that the sector as a whole does not have the financial or political will to compete with new entrants on all-important, and increasingly expensive, content. However, while true for some corporations, notably Mediaset in Italy, TF1 in France and RTL in Germany, we consider several European companies can compete in this space.

Media business activities are also extremely varied, with Europe boasting world leaders in professional publishing, music and advertising. For example, family-owned JC Decaux is the dominant global company in outdoor advertising. The company started in France with simple billboards and has grown to offer street furniture such as bus shelters, bike-hire schemes and advertising in transport hubs (airport and train stations). The company has secured prime locations across the globe, including China where it does 20% of its business. It benefits from high barriers of entry as well as long-term demographic trends for greater urbanisation and increased travel.

Pharma invests for the future

Pharmaceuticals are another area where we see opportunities from the imbalances created by less discriminate investor activity. In our view Roche is an example of this (see Chart 1). While drug pipelines and research productivity in the pharma sector have increased in recent years, this innovation has come at a price. A course of the latest immuno-oncology treatment can cost upwards of US$100,000. Despite this, demand for such advanced treatments remains. However, with governments deciding many nations' health budgets, such costs may not always easily be met. Accordingly, companies willing to invest in long-term R&D and address these cost pressures are in a good position. Roche has one of the largest diagnosis divisions in the sector, which allows it to utilise biomarker techniques to develop targeted treatments for individual patients. Such an approach is in its infancy in the field of immuno-oncology but could eventually lead to good cost-effective treatments – and increased demand – over the longer term.

Generating profits

Even within areas of the European market which have structural pressures, there are interesting stock-level opportunities, for example within utilities. The power generation sub-sector has come under pressure thanks to oversupply and energy efficiency hitting power demand. It also faces cyclical challenges, thanks to weak commodity prices. However, we still believe there is potential in segments of the sector, for example Enel in Italy which reflects its management's efforts to refocus the company on improved returns.

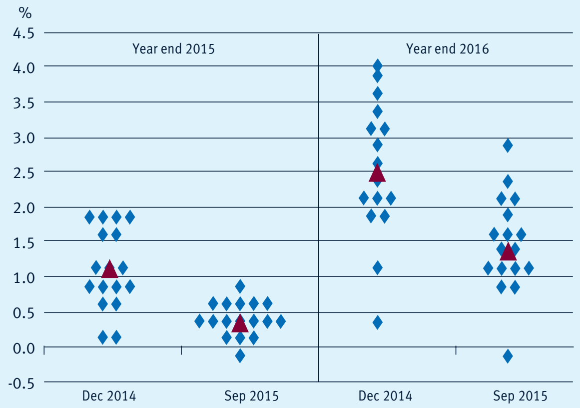
Government Bonds

Diverging signals

When global bond markets in general, and US Treasuries in particular, are priced for perfection, what is the outlook for yields as and when inflation does re-appear?

Philip Laing
Investment Director, Government Bonds

Chart 1
FOMC members mostly looking up



Blue diamonds denote midpoint of FOMC participants Federal Funds rate at year end.
Red triangles denote median of the midpoints

Source: Federal Reserve (as of September 2015)

Mixed signals from the Fed

2015 has proved to be a year of chopping and changing across global bond markets as the impatient spotlight of investor attention has flitted between different factors. No sooner had the all-encompassing risk of Grexit been messily averted than the disinflationary breeze again blew in from China. The nervousness of Asian and emerging market equities has rippled back into western economies, triggering a general loss of confidence and a shift into safe haven assets such as bonds.

For US bond investors in particular this has proved an awkward period. They have been faced with mixed signals: a generally benign domestic recovery, a subdued short-term inflationary backdrop and the possibility of a rise in interest rates in coming months if the labour market tightened enough. Recently, the situation has become even more complicated. The communique explaining the recent Federal Reserve (Fed) decision not to raise interest rates may mark a significant and potentially confusing shift. A somewhat blinkered domestic agenda is now more marginalised by a much broader global economic focus. In effect, an explicit link to Chinese activity, and an unwillingness to express any degree of confidence that inflation would return to the 2% objective, has layered an extra degree of uncertainty onto policy change. The latter not only contrasts notably with Vice Chair Fischer's early vigilance message at the Jackson Hole conference but also leaves limited credible scope for a radical rethink in the short term, even if an upward move on rates in 2015 is still being outlined as the majority expectation by FOMC members (see Chart 1).

Fed Chair Janet Yellen may well be attempting to steer a 'vigilant' path of letting the economy run hot. 'Global developments', a strong dollar and downward pressure on goods price inflation are understandable camouflage to allow the Fed Chair to get a splintered committee to follow her lead. Conversely, a resilient surge in wages or employment cost data could quickly see such external concerns abandoned. This could well be a game of convenience.

A muted market reaction

However, the lack of a US rate rise and a surprisingly dovish Fed statement was greeted by slippage across equity and other risk markets – something that hints at weariness and more worryingly an indication that policymakers' lack of confidence is transferring to investors. We appear to have reached a point where zero interest rate policy (ZIRP) has been milked dry and investors now want their expectations on GDP to be met by reality. We are increasingly of the belief that ZIRP in itself should be ignored as a catalyst for change, and that monetary policy is best judged on a narrow focus of whether GDP is sustainable and inflation targets look achievable.

In these narrow terms under which bonds now operate, a delay in rate hikes could well be sufficient to sustain yields at eye-wateringly low levels. At best, this is an understandable experiment bearing in mind the fragility of growth, with no immediate inflationary impetus in sight. At worst it is an active policy to ensure inflation is pushed higher using global cross-currents as a smokescreen. At this stage of the business cycle there is no margin for any sort of error built into either bond or yield curve pricing.

Our strategy within global government bonds

Against this background, our strategy is to be pragmatic – a confusing economic picture has just become more opaque, pressures may well prompt an extension of ECB or Bank of Japan QE, and despite six years of unprecedented stimulus inflation remains well below target levels across the major economies. However, all core bond markets remain exceptionally expensive on a number of historical relationships. Ultimately, without a re-emergence of anything approaching quasi-forward guidance we consider that the proximity of a cyclical turn will continue its recent dampening influence on the US Treasury market, leaving it a laggard. The Yellen Fed is increasingly, and understandably, trying to boost inflation back towards target, but this leaves both the yield curve too flat and long-term inflation pricing offering value. In our view, the UK economy shares many of the characteristics of the US and so the bond market is equally as vulnerable as the US if capacity pressures emerge. We see Europe as the best supported and, under an extension of policy by an emboldened ECB, peripheral debt markets could perform relatively well.

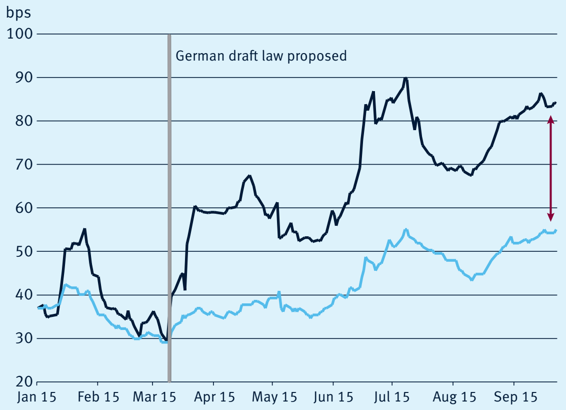
Credit Markets

Regulating the banks

The EU Bank Recovery & Resolution Directive has considerable implications for pricing correctly a large part of the European corporate bond market.

Andrew Fraser
Investment Director, Corporate Bonds

Chart 1
German bail-in law driving spreads wider



Asset swap spread for:
— Deutsche Bank 1.25%, 2021 Corporate Bond
— Bank of America Merrill Lynch Senior Banking Index (rebased at Deutsche Bank bond's spread level as of 2 January 2015)
Source: Bank of America Merrill Lynch, Bloomberg (as of 23 September 2015)

The EU Bank Recovery & Resolution Directive

In December 2014, the European Commission reviewed the scale of government support to the banking system following the financial crisis. Over six years, European banks received state guarantees on liabilities of up to €836 billion (bn), €447bn in recapitalisation measures, asset relief support of €188bn and direct short-term liquidity support of €70bn. While crucial to restore confidence in the financial sector, this intervention left taxpayers exposed to potential losses should the measures fail (plus the risks from significantly higher levels of public indebtedness).

In order to avoid a recurrence, European governments have established a banking union framework. New rules include placing the supervision of the region's largest banks and resolution of failing banks under the ECB rather than national regulators, plus a single rulebook which includes minimum capital requirements. A key part, the Bank Recovery and Resolution Directive (BRRD) will become operational in most countries from January 2016. The BRRD establishes a framework for the recovery and resolution of banks in the EU, with rules aimed at preventing bank failure and enabling early interventions when an institution is under stress but not at the point of failure. It emphasises that creditors rather than taxpayers fund the resolution of failed banks, stating that a minimum of 8% of liabilities must be bailed in before external contributions can be made.

There is discretion though; for example national authorities can exclude various liabilities from bail-in, subject to a 'no creditor worse off' principle. In addition, the BRRD's bail-in tool needs to be implemented at a national level since insolvency laws vary from country to country. This has allowed individual countries to give preference to certain unsecured liabilities over others in the event that a bail-in is required. For example, Germany has suggested tradable senior unsecured bonds would rank below other unsecured liabilities, and would therefore bear initial losses once capital and subordinated debt are depleted. Italy and Spain have chosen different approaches: the former prefers large corporate and interbank deposits to other unsecured liabilities such as derivatives and tradable bonds, while the latter seeks to introduce a new class of liabilities often referred to as senior subordinated or Tier 3.

The implications for credit markets

BRRD has important implications for bank ratings, debt spreads, future issuance trends and investor sentiment. Prior to the new framework, rating agencies had assumed that there would be no support to subordinated debt instruments in the event of a crisis. More recently, agencies have extended this assumption to include senior debt. This has resulted in a number of ratings downgrades across the European sector, with the prospect of further negative revisions when the bail-in tool is formalised into national laws from 2016.

Although the introduction of BRRD does not change the probability of default across the industry, the fact that it introduces depositor preference and additional layers of subordination increases expected losses when bail-in occurs. This has negative implications for spreads and funding costs for European banks (see Chart 1). Conversely, spreads have often compressed between senior unsecured bonds and subordinated debt instruments, as recovery rates in the event of a bail-in are unlikely to be materially different across the capital structure.

On the positive side, as senior unsecured bonds become subordinated via statutory or contractual legislation, they are likely to become eligible to fill banks' loss-absorbing capacity. This will make it easier to comply with future regulations such as Minimum Required Eligible Liabilities in Europe and Total Loss Absorbing Capital which is championed by the Financial Stability Board for the largest global banks. Banks should therefore have lower issuance needs than would have been the case if existing senior unsecured debt was excluded from their loss-absorbing capacity.

While the drive towards banking union is laudable in many respects, the varying layers of subordination being proposed by national authorities again highlights the fact that having standardised rules when it comes to the rule of law across 28 countries is difficult to achieve. This provides risks and opportunities for credit investors in the banking sector; not only will it be necessary to understand the contractual complexity of capital securities documentation but knowing where you stand in the creditor hierarchy will be key to pricing bank debt correctly.

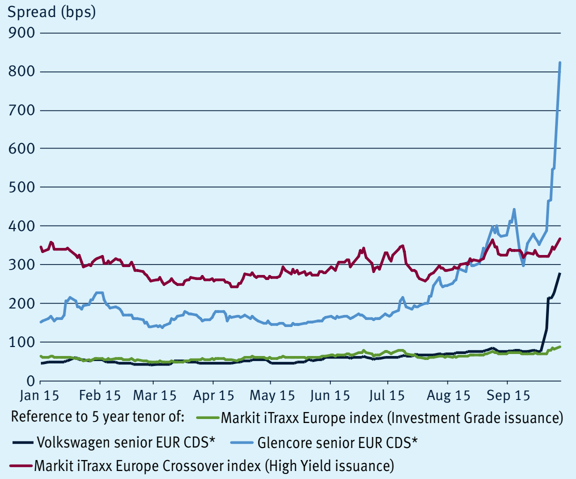
Corporate Bonds

Torrid times

Corporate debt offers potentially greater returns as compensation for higher risk. However, recent market events exposed those who accepted too little reward for the real risks involved.

David Ennett
Head of European High Yield

Chart 1
Heading to high yield?



Source: Markit, Bloomberg, Datastream (as of 28 September 2015) *CDS denotes Credit Default Swap

Challenges to credit

European credit investors are having a torrid time. For an asset class which, since the financial crisis in 2008, has mainly concerned itself with the more cerebral questions about central bank policy making and the waxing and waning of financial conditions, 2015 has seen sector and company-specific challenges come to the forefront.

Many investors have formed their investment strategies around a small number of apparent certainties, chief amongst which has been 'China is growing strongly'. Although the economy has clearly been slowing for some time, the unexpected devaluation of the currency by the Chinese central bank in August shocked many, sparking the realisation that perhaps this welcome certainty was not so certain after all. This had a profound impact on market sentiment, demonstrated by pressures on European exporters, notably auto and machinery manufacturers. Germany's DAX, the market most representative of Europe's China exposure, slumped nearly 10% in August alone as such certainties were questioned. When markets are finely balanced, little room is given for shocks.

Linked to the China growth question has been a significant re-pricing of global commodities as demand and supply dynamics have been questioned. Bloomberg's Commodity Price Index has slumped by nearly a third since the beginning of 2014, gathering pace in the summer. This had a large impact on the share prices of the mining and resources sector, with the FTSE 350 Mining Index declining about 40% so far in 2015, as well as affecting the corporate bond position of selected stocks. Most notably, market stalwarts such as Glencore have seen the price of their bonds fall sharply lower, with the value of their 10-year bonds dropping by a quarter in value for example. Although the company announced a significant response – including a dividend cut and major cutbacks to capital expenditure – the response of credit investors was rather muted. This again tells us that market-wide assumptions have changed in response to recent events (see Chart 1).

The VW scandal

Perhaps the most dramatic illustration of event-risk hitting credit markets was the news of the Volkswagen (VW) diesel emissions scandal. In recent years, VW had been on something of a charmed run. It overtook Toyota as the world's largest car manufacturer and was making inroads into the fast-growing Chinese market, while all the time continuing to dominate the domestic European market. Its scale gave it an ever-growing advantage in technology and cost control. As far as the credit markets were concerned, an A rating, near the top of the corporate credit spectrum, meant that its corporate bonds traded as little as 40 basis points above government bonds. This reflected the market perceptions of a rock-solid balance sheet and business prospects.

The news of the scandal had an immediate and significant impact on VW's debt. In March of this year, VW was able to issue an €1.4 billion investment grade hybrid bond at par, i.e. 100. The bond had come under pressure from June, falling around five points as the Chinese auto market began to slow. Worse was to come, however, and reaction to the scandal saw the bond price plunge to around 76 cents. Given the bond came with a modest 3.5% coupon, investors demonstrated that such low yields simply did not begin to compensate for major 'real world' risks. To be sure, such scandals are all but impossible to predict or position for; however what it does demonstrate once again is that investors should have a diverse portfolio.

Our strategy within high yield bonds

These examples emphasise that, as the credit cycle develops, investors need to pay attention to a wide range of risks: macroeconomic, policy making and corporate governance to name a few. After a period when central bank decisions dominated investor attention, with QE driving demand for sustainable yield which significantly narrowed corporate bond spreads, so investors need to consider more sector and stock-specific risks. The next phase of the cycle looks set to be dominated by China, commodity and company idiosyncratic risks. We consider that credit investors are best served by careful, active portfolio construction with an emphasis on bottom-up stock selection. Our high yield portfolios favour cashflow generative companies with strong business models in core European or US markets and are light in more macro emerging market or commodity-linked issuers as a consequence. Now that more risk has been priced in, we see better risk/reward and have taken small positions in both VW and Glencore credit.

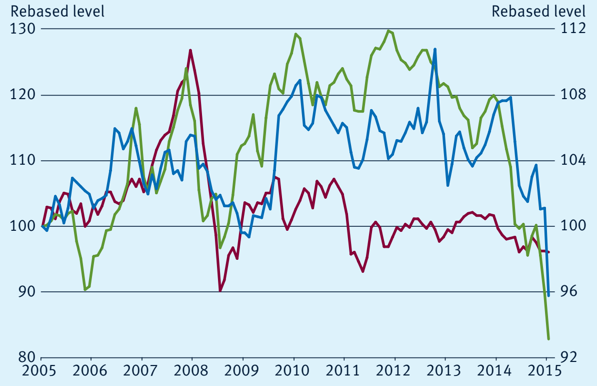
Emerging Market Debt

Drivers of emerging market debt

After sustained weakness, emerging market currencies now look cheap. While fundamentals do not necessarily suggest an immediate turnaround, opportunities are revealing themselves.

Kieran Curtis
Investment Director, Emerging Market Debt

Chart 1
EMbracing decline



Real Effective Exchange Rate, rebased at 100 as of August 2005:
Polish Zloty — Colombian Peso — Malaysian Ringgit (R. H. Scale)
Source: Bank for International Settlements, Datastream (as of August 2015)

Slowing pains

Emerging markets (EM) have endured an eventful 2015. A series of well-documented problems in China's economy, especially worries about the impact of renminbi depreciation, combined with concerns about US monetary policy and the effects of a drawn out bear market in commodity prices have all played their part. As far as emerging market debt is concerned, returns for investors have been affected by two issues: a steady widening of bond spreads over the benchmark US sovereign bond, until a recent snap back, and a marked decline in a number of emerging market currencies. The questions for investors now are whether EM currencies have become cheap enough, and is credit spread widening on local EM bonds justified given the theoretically fixed income-friendly economic conditions that exist around much of the emerging world.

Looking at EM currencies in more detail, these have been in a bear market since Q2 2011, falling almost 40% against the US dollar from the peak in April of that year (see Chart 1). Bond returns in local currency terms have been more respectable, but even a hedged allocation to EM local currency bonds has underperformed a similar allocation to global developed government bonds over the period by a couple of percentage points per year. This has largely been driven by the relative outperformance of European fixed income in recent years, helped of course by the ECB's decision to adopt a QE policy.

In the case of EM currencies, weakness has been driven by a number of factors including the strong dollar, falling commodity prices in the case of exporters, and persistently disappointing global growth even as the US and Europe have begun to recover. Given overall EM weakness, it should be unsurprising that currency declines in some specific cases have been very dramatic. For example, measured in real-effective terms (that is against trade partners and adjusted for inflation rates relative to those trade partners), the Colombian peso has fallen from an all-time high in 2012 to a decade low in the summer of 2015, with the bulk of the falls coming in the past 12 months. Latin America is far from the only region to experience weakness, although in Asia, where most countries have more balanced export baskets, the declines have not been quite as dramatic and a more recent phenomenon. In central Europe, there has simply been very little recovery at all from the huge devaluations experienced during the global financial crisis.

The next trend in EM debt

Should investors expect a rapid recovery in EM local currencies? We advise caution, as the short-term situation remains nuanced. The EM growth outlook generally remains weak, suggesting that cross-border flows are likely to stay low. A genuine recovery right across the global economy, demonstrated for example in better trade flows, is a necessary driver. On a medium-term basis, there are reasons to start becoming more optimistic about currency returns due to improved valuations, albeit the path may be volatile as it will take time for capital outflows from EM assets to turn around. Hence, the rewards for taking currency risk in EM debt are high compared with history.

For bonds, the current macroeconomic environment ensures that the prospect of central bank interest rate cuts remain on the agenda – a situation which may support bond spreads. Like currencies, there is a positive medium-term case for debt. Bonds with very long trading histories in EM local markets are hard to come by, but the South Africa 2026 bond, issued back in 1998, is a useful barometer. It currently yields 6.3% points more than a US Treasury bond with the same maturity. A spread as high as this has not been seen since 2001. Comparing broad market indices gives similar signals of improved valuations.

With some notable exceptions, such as Brazil, EM inflation has generally been falling across most areas; alongside expectations that GDP growth will remain subdued, this should keep domestic bond markets well supported. In many countries, yield curves are steep, giving protection against any interest rate hikes that are required to protect currencies from capital outflows. However, any rate increases in the US mean that market stress will continue. Our broad approach is to buy on dips in EM local bond markets. Our favoured countries at present include Hungary, the Philippines and Dominican Republic, while we are Light in Turkey, Russia and South Africa.

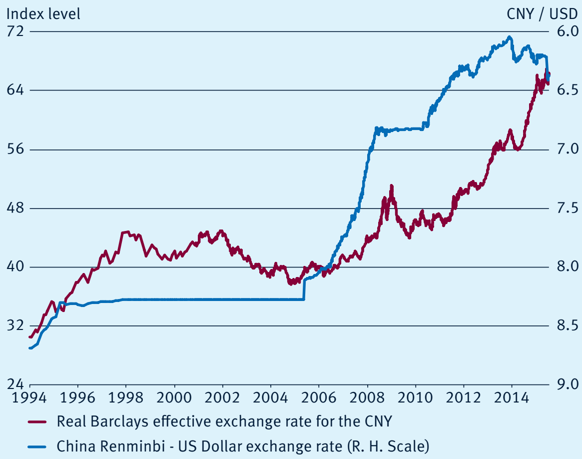
Currency

Chinese currency policy matters

Analysing the drivers of a more flexible renminbi (RMB) exchange rate shows implications for both developed and emerging market currencies.

Ken Dickson
Investment Director, Currency

Chart 1
Chinese authorities take action



Source: Barclays, Bloomberg (as of 15 September 2015)

China's currency policy change

On 11 August, the People's Bank of China (PBoC) announced a new fixing mechanism for the Chinese exchange rate versus the US dollar (USDCNY). Chinese bank dealers are now required to provide quotes based on the last market close, supply and demand conditions and changes in the major currencies' exchange rates. The USDCNY fixing on that day was higher by 1.9% and at the time of writing the renminbi (RMB) has depreciated a further 0.8% against the dollar.

The Chinese decision to adopt a new fixing methodology has been subject to considerable analysis. Is it related to their objective of including the RMB in the IMF Special Drawing Rights (SDR) basket, together with the US dollar, yen, euro and sterling, or did it signal a competitive devaluation marking a dangerous extension to the 'currency war' theme? Although the economic benefits of the SDR are debatable, membership has been a long-term prestige project for the Chinese; greater currency flexibility and transparency is thought a basic requirement for SDR inclusion. The new fixing mechanism is a big step toward meeting the IMF's demands.

Nevertheless, Chinese authorities may also be reacting to a strong trend in the trade-weighted RMB (see Chart 1). Lately, PBoC Governor Zhang Xiaohui has noted that the RMB real effective exchange rate has appreciated by 10% this year. The main economic implication of these policy moves is therefore to promote stability in the trade-weighted RMB currency index rather than a narrow focus on the USDCNY spot rate. Such stability in USDCNY when the broad US dollar has become overvalued means that the Chinese currency has become overvalued too, a trend inappropriate to current Chinese macroeconomic conditions.

Shock announcements and wider volatility

As we have seen in many developed nations, it is quite difficult to introduce new currency policy measures without creating unwanted volatility and unintended consequences. Speculators clearly assumed that devaluation was the main aim of the policy announcement, and capital outflows grew dramatically after the announcement with the monthly outflow in August over three times the average outflow of the previous 12 months. Initially, Chinese authorities were prepared to smooth the weaker currency trend through currency intervention but it is now clear that even China's enormous reserves were being spent too quickly given the growing speculative outflows. The authorities have instead imposed new regulations to restrict these speculative flows temporarily, and then had to intervene heavily in the offshore market to correct the wider CNH/CNY spread. None of this will accelerate the chances of SDR inclusion.

Flexibility + control = no currency war

The events of the past few weeks are certainly not the actions of a central bank trying to gain competitive advantage through currency devaluation. If currency weakness was the main aim then the policy change has been a spectacular failure. Focusing on currency stability on a trade-weighted basis merely means that USDCNY can also strengthen within the context of a broad dollar uptrend. Greater flexibility in daily pricing fits with China's very long-term policy goals but we do not anticipate that Chinese policymakers will lose control over their currency nor do we expect the Chinese to seek a major competitive devaluation of the RMB.

Currency conclusions

As long as stability remains a policy goal, the near-term implications of recent moves are likely to be limited to the workings of the local onshore and offshore curves. Indeed, after an initial lurch lower the CNY trade-weighted index has retraced back up to levels seen in early August. Nevertheless, in the future, the currency will exhibit a higher structural volatility than has been seen historically. For other EM currencies, the impact of a weaker exchange rate will feed through both the trade as well as the deflation channels. Countries with the highest trade linkages and with already low inflation (such as Singapore, Taiwan and South Korea) are likely to consider currency depreciation themselves.

The policy change also suggests that the trade-weighted USD will continue its upward path and this will consequently tighten US financial conditions and lessen future inflationary pressures relative to an unchanged Chinese policy. However, unless the USDCNY rate increases significantly, the extent that this policy change will influence the FOMC's expected interest rate path is likely to be modest. Widening monetary policy divergence between the US and other developed and emerging market economies is likely to remain the main currency driver in the months ahead – which the House View is positioned for.

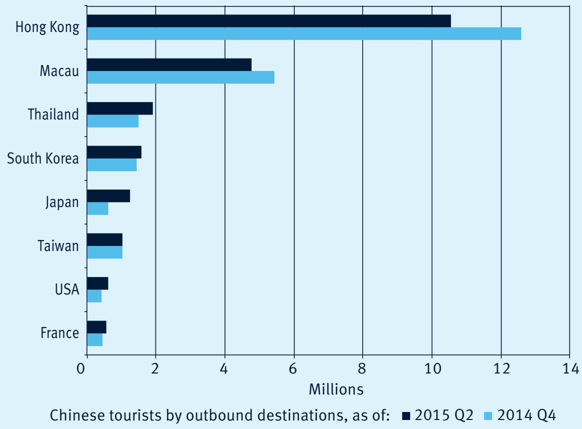
Real Estate

The Chinese consumer

Rising affluence, favourable policies and currency arbitrage are driving the phenomenal growth of Chinese outbound tourism, benefiting the retail markets of key global cities.

Anne Breen
Head of Real Estate Research and Strategy

Chart 1
Seeing the world



Source: Bloomberg, Standard Life Investments (as of Q2 2015)

The Chinese consumer and tourism

One of the key drivers of real estate markets in several countries is the rise of the Chinese consumer. Wealth in China grew by over 200% between 2000 and 2008, while China's share of the global middle class population has doubled since 2000 and is currently about one-third of the total. With this new-found wealth, luxury brands flocked to China. More recently, as Chinese consumers became more sophisticated, world travel became more alluring. While Chinese now represent close to a third of all luxury sales around the world, about two-thirds of their spending is overseas.

Key drivers that facilitated the expansion in Chinese outbound travel were policy changes and currency movements. For example, there has been a steady easing of visa restrictions by the Chinese government for outbound travel, in tandem with countries such as Japan, the EU and the US easing restrictions on inbound travel. Weaker currencies in Japan and the Eurozone versus a stronger renminbi have also underpinned the growth in Chinese tourism.

By far the top destination for Chinese tourists is Hong Kong; while South Korea, Thailand and Taiwan have seen their share of Chinese arrivals rise and Japan is becoming a preferred destination (see Chart 1). Together with the US, France, Singapore, Malaysia, Germany and Australia these countries complete the most popular destinations for Chinese tourists. The growth in outbound tourism from China to these destinations was over 12% in the 18 months to June 2015. Globally, of all outbound tourism, China is the world's top spender with a 28% increase in expenditure in 2014, reaching a total of $165 billion.

The implications for global real estate

The retail offering in China is improving but lacks critical mass and e-commerce is often hampered by a lack of infrastructure. International retailer expansion in China has reached a point of saturation. While China did not feature in the top target markets for new retail entrants in 2014, made up of Japan, Singapore, Germany, Taiwan, Hong Kong and France according to CBRE, there is in fact a strong correlation with those destinations where Chinese tourist numbers grew substantially in the past 18 months.

Real estate markets are reacting to these trends. Hong Kong, with its well-developed retail infrastructure, has long been reliant on mainland Chinese tourists. As sales have fallen sharply, partly due to the clampdown on corruption, so retail rents have plummeted. Conversely, Japan had the highest number of foreign visitors in its history in 2014, and inbound tourism from China has grown 26% per quarter in the last six quarters. The Japanese government is targeting 20 million foreign visitors per year by 2020 in the run up to the Tokyo Olympics and has eased visa restrictions and duty-free rules to facilitate this. Retail rents have grown by an average of 3% per quarter over the past six quarters and increased demand is expected to drive rents further.

Europe has also benefited: Chinese tourists now account for 40% of all luxury sales in France, 35% of luxury sales in Italy and 25% of luxury sales in the UK, according to HSBC. France, especially Paris, is by far the most popular European destination for Chinese tourists; departures to France from China totalled over one million in the first half of 2015 and inbound tourism from China has grown 17.5% per quarter in the last six quarters. Retail rental growth has historically been limited by lease structures with a strong tenant bias, but a recent change in legislation helped high street rents grow by 16.7% in Q1 2015, according to CBRE.

Our strategy within global real estate

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. In Continental Europe, 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. Prime Minister Abe's policies are propping up Japan's relative performance in the region by bolstering asset values and reviving occupier demand from cash-rich corporations.

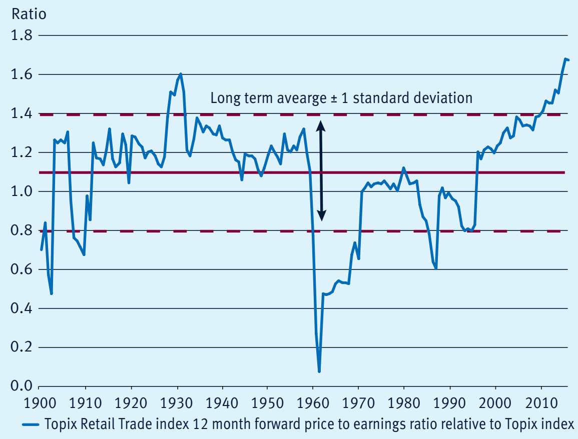
Absolute Return Strategies

Strategies of interest

The retail sector, in both the UK and Japan, faces underestimated headwinds. Two of our strategies stand to benefit, against housebuilders in the UK and the Topix in Japan.

Neil Richardson
Investment Director, Multi-Asset Investing

Chart 1
Retail reverting to rule



Source: Bloomberg, Standard Life Investments (as of 31 August 2015)

At Standard Life Investments, our absolute return strategies approach operates in a multi-asset framework, aiming to deliver returns above 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 seek to profit from dynamics in UK and Japanese retail sectors.

Safe as houses

In the UK, our strategy of long housebuilders versus short retailers benefits from industry change and a squeezed retail environment. The UK has the highest online retail penetration of any major economy, a function of high internet penetration rate and a densely packed English-speaking population. The drivers of price and convenience continue to expand markets at risk, forcing incumbents to stretch their business models to adopt defensive and often expensive internet strategies of their own. Negative operational leverage and greater pricing pressure present a challenging future for the sector. The disruptive change the internet is bringing to the high street has been obscured by expectations of a strong cyclical recovery in consumer demand, providing an opportunity to play the increasingly powerful structural change in retail. The food retail sector is subject to the same pressures, but without the cyclical upside of general retailers. Between the move online and the market-share gains of the discounters, the growth in demand may be more than accounted for.

Meanwhile, the fundamentals of the housing market are attractive. There are some important changes to the industry which suggest that it will continue to perform as monetary policy is tightened. The government is trying to address the shortage of new housing by loosening planning restrictions and, at the same time, is enabling demand through schemes such as Help to Buy. We view increasing supply as the long-term answer to house price inflation and the boom/bust with which it is associated. As a consequence of the lack of credit available to private/SME developers and the greater discipline from the returns-focused quoted sector, land price inflation has remained subdued – a key difference to previous cycles. Furthermore, companies are experiencing robust demand and generating return on capital employed in the mid-teens to low-twenties. We consider this is likely to continue for some time, while the prospect of a high return, high yielding and disciplined industry operating in a less cyclical environment is not reflected in valuations.

Not buying into Japanese retail

The retail sector in Japan has re-rated in anticipation of an improving trading environment engendered by the success of Abenomics and quantative and qualitative easing (QQE) in dragging the economy out of deflation (see Chart 1). This is despite flat earnings growth over the last three years, in marked contrast to the Topix index, and forecasts of pedestrian earnings growth. With low unemployment and labour shortages in some sectors, it seems likely that wage inflation will eventually accelerate, and the assumption is that consumption will increase. However, the sector faces several challenges to growing profitability. Yen weakness, a boon to exporters, necessitates increasing the price of imported goods. Retailers have been adept at seeking out cheaper sources of supply, and cheaper specifications, but it remains a headwind. Internet penetration of retail sales is low by developed market standards at circa 5% but is growing rapidly, and traditional retailers have done little to develop a presence themselves.

Should wage inflation accelerate, the benefit will be muted by the consequent increase in the cost base for retailers. Furthermore, it is not a given that consumption habits will be the same as in the last ‘consumer boom’ of 11 years ago. The transmission of wage increases to retail sales may also be more muted than in the past. The fragility of the domestic economy and consumer confidence was exposed by last year’s consumer tax increase, so the prospect of another increase should temper sentiment in the medium term. Operating margins and return on equity are already relatively elevated, suggesting that although there is some operational leverage it is limited. If policy develops greater traction in the domestic economy, the level of optimism already priced into valuations suggests that it will be unlikely that the sector will re-rate further. Indeed, over time the sector should de-rate to its long-run average (see Chart 1). If retail sales do not accelerate meaningfully, and there is no evidence yet that they are, the sector’s underperformance will be greater.

Responsible Investing

Tackling climate change and slavery

Responsible investment issues continue to rise in importance for investors, notably climate change and the increase in modern slavery.

Amanda Young
Head of Responsible Investing

Climate change

The issues surrounding climate change continue to dominate headlines within the responsible investment (RI) sector. This scrutiny will only intensify approaching the United Nations climate talks – the Conference of Parties – to be held in Paris in November. The goal of this important meeting is to reach a legally binding agreement from all nations on climate change. While a challenging objective, a deal remains attainable. Indeed, world leaders had already made verbal commitments towards achieving this goal at the New York Climate Summit in 2014. Since then, US President Obama has proposed a far-reaching plan to tackle climate change; other countries have followed. The outcome of the Paris summit will have important implications for corporations and individual investors alike.

Of course, while climate issues will remain to the fore, there are numerous other important issues in the responsible investment space. These include privacy in a digital age, the importance of 'real-world' testing on automobiles and access to medicine in developing markets. There have also been questions over the changing employment landscape in the UK and beyond. This included the rise in the use of zero-hours contracts, conversations around a 'living wage' and the increase in modern slavery in supply chains.

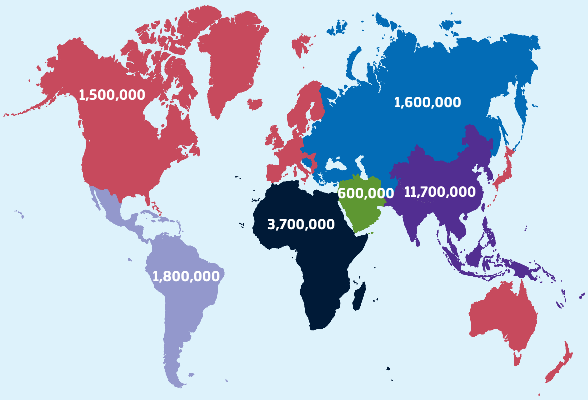
Modern slavery

The last issue is increasingly important for investors to consider. Modern slavery includes forced labour, bonded labour, human trafficking and child slavery. There is a widely held belief that slavery was abolished in the UK centuries ago. In reality, however, modern day slavery still exists and can affect UK-listed companies. The Home Office Chief Scientific Adviser estimated that there were between 10,000 and 13,000 potential victims of modern slavery in the UK in 2013. Globally, the International Labour Organization estimates this figure to be over 20 million (see Chart 1).

Companies exposed to modern-day slavery in their direct businesses, or through their suppliers, face significant reputational risks that could harm shareholder value. Association with slavery may result in reduced sales, affect a company's license to operate, increase risk of fines and prosecution, and divert management efforts from adding value

Chart 1
Prevalence of slavery around the world

Victims of forced labour by region – International Labour Organization



As at 30 September 2015

to the business. The core sectors exposed to this issue include electronic goods, construction, mining, hospitality, food retail, food producers and clothing retail. Modern slavery can occur at different stages of the supply chain, from production of raw materials to the manufacturing of goods.

Drivers of modern slavery within business

The risk of being involved in forced labour and modern slavery for companies has increased due to the extension and complexity of their supply chains, as well as the extensive use of vulnerable people such as migrant workers in Asia and the Middle East. Poverty, military conflict, oppressive regimes and the desire for a better life are all key drivers in the growth of the migrant populations. However, this also increases the vulnerability of migrants, which often results in them being subjected to modern slavery.

Modern Slavery Act 2015

Many governments are looking to strengthen laws and regulations to combat modern slavery. These include the United States Government Procurement rules; US Trafficking Victims Protection Act; Conflict Mineral Disclosure under Dodd-Frank Act; EU Directive on Disclosure of Non-Financial Information; and The Commonwealth Criminal Act Code 1995.

In the UK, the Modern Slavery Act 2015 makes human trafficking, exploitation, slavery, servitude and forced or compulsory labour an offence under UK law. Those found guilty of an offence face a range of penalties, including fines and imprisonment (with a top sentence of life behind bars). The Act will require over 12,000 UK companies to report on the steps they are taking to eradicate slavery and human trafficking in their business and supply chains.

The Modern Slavery Act 2015 is the first of its kind in Europe and one of the first in the world that specifically addresses slavery and trafficking in the 21st century. As such, in our view it has considerable implications for UK companies. Given the increased legal scrutiny around modern slavery, corporations will need to be extremely diligent to ensure they are not exposed along their supply chains or through their contractors and partners. Our RI team is raising these issues with management at company meetings.

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

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

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.

Standard Life Investments is a dedicated investment company with global assets under management of approximately £250.0 billion (as at 30 June 2015) – this equates to $393.1 billion, C$490.8 billion, A$511.5 billion and €352.9 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.

	October 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
Government Bonds		
US Treasuries	The economy's strength, especially a tighter labour market, should enable the Federal Reserve to start raising interest rates from late 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.	HEAVY
UK Gilts	The asset class is vulnerable to interest rate increases as economic growth remains firm while valuations are expensive. 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
Corporate Bonds		
Investment Grade	US credit spreads have widened substantially, creating an attractive opportunity over low-yielding Treasuries. European corporate debt benefits from improving cashflows and a modest correction in valuations.	NEUTRAL
High Yield Debt	Recent sell-offs have improved valuations modestly, but overcrowding and exposure to commodities remains a risk in the US market. European debt is supported by yield seekers.	NEUTRAL
Equities		
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 and commodity price factors, while uncertainty surrounds a potential EU exit.	NEUTRAL
Developed Asian Equities	Trade is often a headwind, with Korea's export share eroded by Japanese competition and a strong Australian dollar affecting terms of trade. China's slowdown has harmed commodity producers.	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
Property		
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	Core markets continue to offer attractive relative value in light of the low interest rate environment supported by QE, while recovery plays are showing consistent capital value growth.	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	Attractive yield margin remains, but markets are divergent. Returns are driven by rental and capital value growth in Japan, but limited to capital growth in Australia, Hong Kong and China. Emerging Asia markets are risky.	NEUTRAL
Other Assets		
Foreign Exchange	While the US dollar will benefit from upcoming monetary policy tightening, it has appreciated sizeably already. QE will weigh on the euro. Japanese authorities fail to see further yen weakness.	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.	NEUTRAL
Cash		
	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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