

# Global Outlook

February 2016

Global Outlook is a monthly publication that contains a series of articles examining markets and key investment trends. In this edition, we consider what could be some of the key market calls for the rest of the year following a turbulent start to 2016.

**Standard Life**  
Investments

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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.

February 2016 House View		
Risk	The Global Investment Group has tempered its near term outlook, as a variety of drivers point to greater financial volatility in the coming year. While there are certain areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
<b>Government Bonds</b>		
US Treasuries	Continued economic growth, especially tighter labour markets and rising wages, should enable the Federal Reserve to proceed with further interest rate rises throughout the year, once financial stress dies down.	VERY LIGHT
European Bonds	Bonds are supported by an environment of low inflation, modest economic growth, further QE and negative official rates. Political pressures may affect peripheral bond markets on occasion.	HEAVY
UK Gilts	Domestic economic strength should give the Bank of England flexibility to raise rates in the leeway of the US decision. Inflation pressures remain manageable while valuations are expensive.	LIGHT
Japanese Bonds	The Bank of Japan's sizeable bond buying programme has driven valuations into expensive territory, as the authorities continue to try to reflate the economy.	NEUTRAL
Global Inflation-Linked Debt	While inflationary conditions are globally subdued, markets may react to a rise in headline inflation as the impact of previous commodity price weakness becomes less marked over time.	NEUTRAL
Global Emerging Market Debt	Dollar denominated bonds are Heavy, as spreads show better value, while local currency bonds are Neutral as careful examination of individual currency and spread factors is required.	HEAVY/NEUTRAL
<b>Corporate Bonds</b>		
Investment Grade	Preference is to be higher up the corporate capital structure. Widening US credit spreads create an attractive opportunity over low yielding Treasuries; improving cash flows benefit euro debt.	HEAVY
High Yield Debt	Recent sell-offs have improved valuations modestly, but overcrowding remains a risk in the US market when monetary policy is tightened; European debt remains supported by yield seeking investors.	NEUTRAL
<b>Equities</b>		
US Equities	Valuations are expensive on some metrics and margins likely to compress with higher wages and stiffer import competition, but stock buybacks and dividend payouts are still supportive.	NEUTRAL
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	Supported by earnings upgrades from a weaker yen, improving corporate governance, lower corporate taxes and the central bank's QE programme. Abenomics' structural reform components must be implemented.	NEUTRAL
UK Equities	Domestic economic backdrop is supportive, but certain corporates have large exposure to overseas earnings which are under pressure from previous sterling strength and commodity price pressures.	NEUTRAL
Developed Asian Equities	Trade flows are increasingly a headwind, with a strong Australian dollar affecting its terms of trade. China's economic slowdown is harming commodity producers.	NEUTRAL
Emerging Market Equities	Pockets of deterioration within emerging markets with the commodity price slump badly affecting Brazil, political uncertainty in Eastern Europe, and large behavioural shifts affecting the Chinese market.	NEUTRAL
<b>Real Estate</b>		
UK	The robust growth environment continues to bolster prices 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 real estate 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
<b>Other Assets</b>		
Foreign Exchange	US dollar has already sizably appreciated despite upcoming rate rises; QE in Japan and Europe will keep their currencies under pressure. Sterling supported by eventual UK rate rise.	HEAVY \$, NEUTRAL £, ¥, LIGHT €
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions influence the outlook for different commodities.	NEUTRAL
<b>Cash</b>		
	The US and some emerging markets have started to raise interest rates while the UK waits for the opportune moment. Policy to remain easy in Europe and Japan.	NEUTRAL

# Foreword

## Editor



**Jeremy Lawson**  
Chief Economist

In this edition of Global Outlook, Robert de Roeck, Head of Multi-Asset Structuring, and Mark Foster, Investment Director Pension Solutions, outline the nature of liability-aware investing (LAI). This describes an investment framework that takes into account the regulatory and market risks faced by investors with significant future financial liabilities, such as defined benefit pension schemes and insurance companies. They also show how the activities of LAI have been influencing the market for government bonds and swaps, highlighting the importance of all fixed income investors understanding its intricacies.

Elsewhere, Andrew Milligan, Head of Global Strategy, explains how investors might generate returns in a turbulent 2016. A key assumption of the House View is that the world economy will not fall into recession, despite the recent market crisis. However, the slow and uneven growth environment will persist. Careful portfolio construction, relying on relative value investing, and identifying the right trade-offs between assets such as European and emerging market equity, will be crucial

in another challenging year for investors caught between higher US rates and lower commodity prices. One sector under extreme pressure recently has been high yield debt. Craig MacDonald, Head of Credit, analyses how there has been significant dispersion in performance across regions and investment grades, which provides selective opportunities for savvy investors.

Meanwhile, Anne Breen, Head of Real Estate Research, forecasts that solid growth in rents combined with constrained construction dynamics should ensure a growing and resilient real estate income stream going forward, even under a modest economic growth path. Lastly, Jonathan Fearon, Investment Director European Equities, examines some of the key drivers of European banks. Although they have underperformed the stock market, partly due to regulatory uncertainty, investors now risk overlooking a range of positive drivers for corporate earnings, such as digitalisation.

## Our industry-leading publications

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

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

# House View

Generating returns in a turbulent 2016



**Andrew Milligan**  
Head of Global Strategy

This is another challenging year for investors who are caught between higher US rates and lower commodity prices. Careful portfolio construction, relying on the right trade-offs across assets, will be crucial.

## Portfolio construction is the key

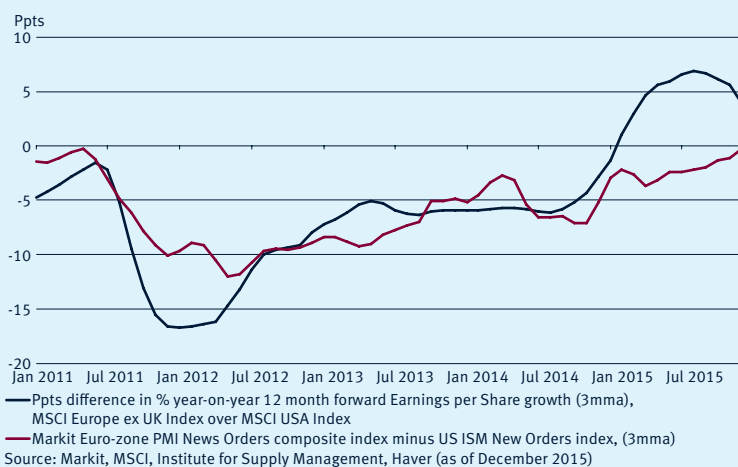
Mirroring the challenges of 2015, conditions are ripe for another year of soggy—and volatile—market returns. The underpinnings for most risk assets are on soft ground: the earnings outlook is mixed, while bonds are already richly valued. Economies are also at divergent points in the business cycle. Europe and Japan are early in their recoveries and benefiting from low commodity prices. Meanwhile, the US is much further along in its expansionary phase—with the US central bank likely to continue raising rates. Elsewhere, emerging markets are grappling with the steady headwind of China's growth slowdown and economic rebalancing. If economic uncertainty were not enough, the political calendar is full of potential catalysts to roil the markets, from Europe (the Brexit vote, Spanish elections and the refugee crisis) and the US (presidential elections) to simmering geopolitical turmoil (upheaval in the Middle East).

As a result, investors must resist the natural temptation to chase returns; careful portfolio construction becomes ever more paramount. For the House View, we see a benefit from a continued focus on relative value investments. In a volatile environment, relative value investing—when done well—pairs off two risks and uses their correlation to mitigate volatility. While generating excess returns is not easy in this manner (as it involves foregoing returns in the asset being underweighted), the bulk of the House View's returns over the past 18 months have come from such relative investments. Indeed, the current mid-to-late stage in the global economic cycle, where markets diverge or are choppy, can lend itself well to this approach. In terms of our portfolio asset allocation, we are running modest-to-low levels of risk, but with strong tilts in selected asset classes and regions. Consistent with our economic view, we have moved up the capital structure to invest in credit over equities and are wary of crowded trades. We have modest-to-low levels of equity allocations, balancing markets we favour (in Europe and Japan) versus those we do not (in the US and selected emerging markets). Additionally, we are light bonds and underweight duration in the US and UK, because we expect their central banks to raise rates and investors to move out of low yielding long-term government bonds to shorter-duration assets and higher yielding alternatives.

## Diverging cycles driving return opportunities

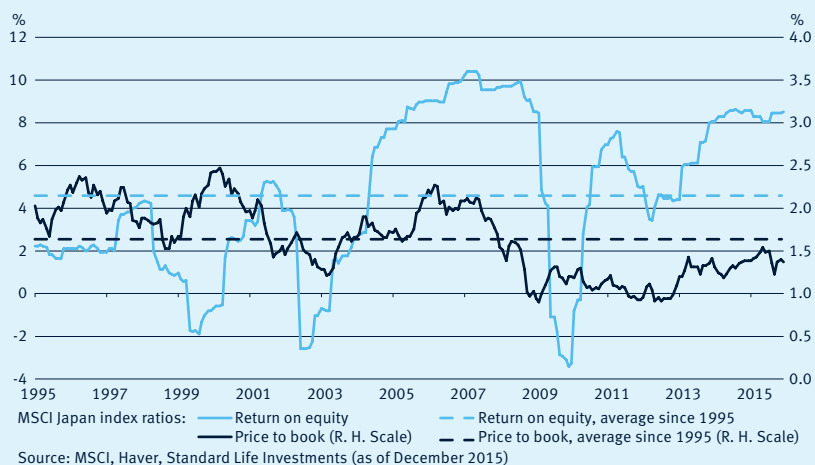
We continue to favour two equity markets: Japan and Europe, but for different reasons. What's changing in Europe? The ongoing economic recovery should permit an improvement in earnings—a missing ingredient in many markets. Analyst estimates for 7% earnings growth in Europe are more modest—and realistic—than for US corporates. In Europe, margins are still cyclically depressed, and the economic recovery is gaining momentum; witness stronger survey results for new business orders and earnings outlooks (see Chart 1). By contrast, the US profits picture is glum: one-quarter of earnings growth is from share buybacks; sales are falling outright; and margins are likely to get squeezed through the strong dollar (increased import competition, lower export revenue and remitted profits from abroad) and higher wages. The US index's higher relative exposure to the resource sector (nearly 10% by market cap versus 6% in Europe ex UK and Japan) also does not help in an environment of sharply falling commodity prices.

**Chart 1**  
Europe accelerating faster than the US



Additionally, we have a modest preference for Japanese equities, not only for economic reasons—but also because equity valuations are more attractive and there is a stronger behavioural support from corporate governance reforms. Unlike bourses across the world, Japanese stocks are cheap; both on an historic and absolute basis (see Chart 2). Why should Japanese markets re-rate? The government's push to reform the corporate sector and encourage higher payouts through a focus on return on equity should provide a fundamental underpinning for higher valuations, structurally, over time. Japanese corporates are sitting on \$2 trillion in cash that could be distributed to shareholders. Furthermore, margins have improved to record levels—even in the domestically oriented non-manufacturing sector, where the translation benefits from a lower yen should matter less.

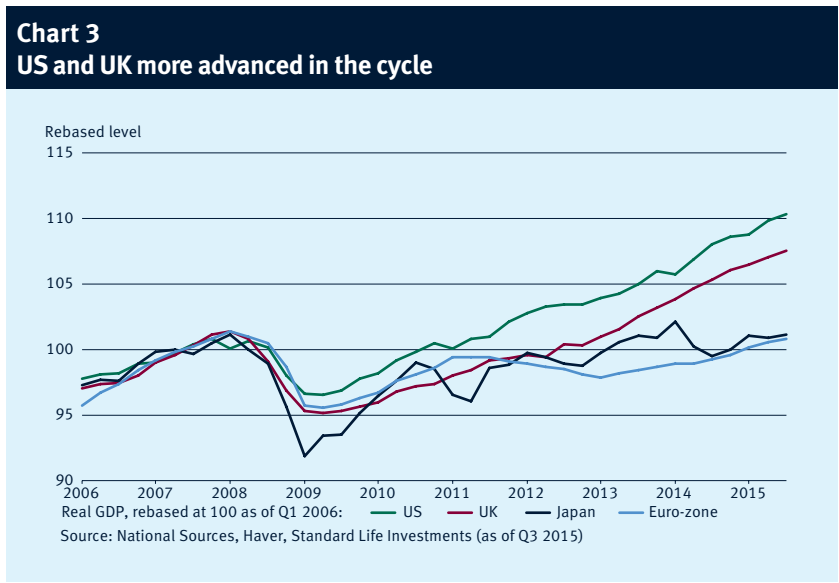
**Chart 2**  
Japan trading below long term levels



While we expect the US economic expansion to continue, this appears to already be in the price of richly valued equities. As a result, we are achieving US exposure by seeking returns higher up the capital structure through investment grade (IG) corporate credit spreads. At around 180 basis points (bps), current spreads are at levels typically found during recessions. However, we view this risk premium as largely reflecting transient behavioural factors, particularly from high issuance of IG-rated debt in 2014 and 2015 from an M&A boom. Also, selected IG issuers have also been caught up in concerns over lower energy and commodity prices. Even in the face of these pressures, the high level of spreads offer a margin of safety for investors, because firms are still generating profits, so debt repayment is not threatened. A strategy that overweights credit and underweights government bonds helps to generate modest levels of income with lower volatility than equities.

### Normalising rates pushing the dollar higher

After a nearly a 100bp decline in 10-year government bond yields, US Treasuries and UK gilts look exceptionally expensive, with much of the news on low inflation, growth, and other special factors priced in. In both the UK and the US, labour markets are tightening, which should help put upward pressure on wages and inflation. While the market believes only a muted path of rate hikes will emerge, we believe it will be forced to take heed of what the US central bank is telling investors. The US Federal Reserve (Fed) said it would raise rates in 2015, and it did. It is telling that the market still takes a sanguine view; a view we do not share. The UK rates markets are likely to lag the US markets, but the UK is also in a stronger cyclical position than Japan or Europe, with a smaller output gap and an economy that has largely recovered. That is unlike Japan and Europe, which have yet to see real GDP meaningfully exceed pre-crisis peaks (see Chart 3).



However, to add balance to the portfolio, the House View finds euro area government bonds attractive. One year ago, the European Central Bank announced its quantitative easing policy, purchasing €60 billion in euro area government bonds per month. While the 10-year German bund yield has increased slightly since then, policy has had a significant impact on peripheral spreads, compressing them to nearly the lowest levels since the financial crisis. With the purchase programme only recently extended, we see scope for further gains and a benefit to holding duration as a low volatility, income-generating opportunity.

As monetary policy continues to diverge between the major central banks, the US dollar also looks set to continue its rally. Versus developed markets, the US expansion and higher rates are likely to fuel inflows in search of higher risk-adjusted returns. Emerging markets are likely to also continue to struggle with Chinese rebalancing, the lagged effect of low commodity prices, weak global trade and deleveraging pressures. This leads us to be long USD, especially versus the EUR and emerging market economies.

### What could cause a change in asset allocation?

If the global economy proves not to be mid-to-late cycle, or if the cycles converge, then we would revisit our current portfolio allocations. Much of our view relies on trading off returns between the relative valuations across markets. However, if the US economy reaccelerated and the Fed were modestly behind the curve, then equities would likely rally substantially—requiring a more pro-equity tilt to the portfolio. Conversely, if the global economy were to slow more sharply, then duration assets would also move sharply higher.

There is also considerable uncertainty over the signposts of a bottom forming in emerging market assets. While prices have fallen sharply, valuations are stretched in selected markets. Meanwhile, foreign ownership is broadly stable, with outflows from markets in line with a decline in prices and a fall in domestic holdings. Even within ‘cheap’ markets, the valuations are attractive in only the worst of the assets, such as Chinese banks that face the prospect of rising non-performing loans and rights issues. That said, it would not take much to spark a short covering rally, as pessimism is so extreme.

As we see either scenario as unlikely, the House View portfolio is positioned defensively for what seems set to be another challenging year for investors.

# Spotlight on Liability-Aware Investing

The importance of being liability aware



**Robert de Roeck**  
Head of Multi-Asset Structuring



**Mark Foster**  
Investment Director, Pension Solutions

Liability-Aware Investing has become an important consideration for pension schemes and insurers. Increasing liability-driven investing activity and regulatory changes are impacting bond and swap markets, making it essential for fixed income investors to become more liability-aware.

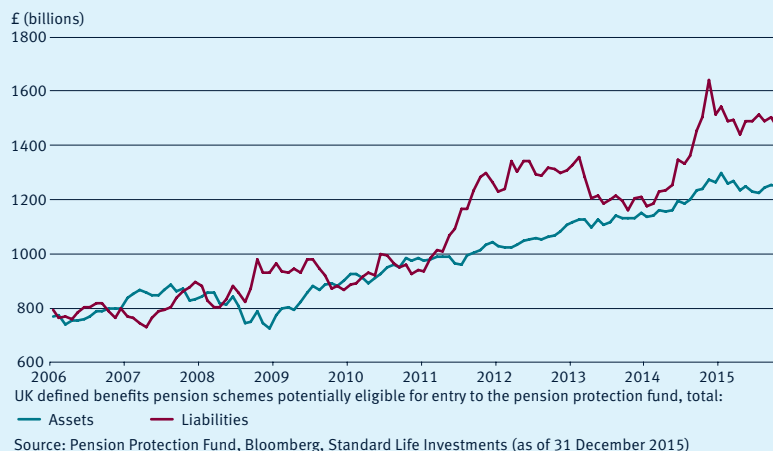
## What is Liability-Aware Investing?

Liability-Aware Investing (LAI) is an investment framework that explicitly takes into account the regulatory and market risks faced by investors with future financial liabilities, such as defined benefit (DB) pension schemes and insurance companies.

For many years, pension schemes' investment strategies have focused on maximising asset returns, with less consideration given to how their assets perform relative to their liabilities. The principle was that the scheme's future asset returns and income from contributions would fund the liability outflows as they fell due, which relied on their ability to harvest long-term risk premia. Any deficit in the scheme due to asset underperformance would require additional contributions from the sponsor. At the heart of LAI is the desire to increase the certainty with which pension schemes can meet their payment obligations, without compromising expected returns or raising their long-term funding costs.

The number of pension schemes adopting a LAI framework has increased significantly over the past 15 years, driven by a range of factors. Legislation aimed at strengthening scheme funding and the move to 'fair value' accounting principles has encouraged a greater focus on risk management. The requirement for pension liabilities to be 'marked to market' in line with high-quality bond yields has obliged sponsors to consider the volatility of their balance sheets more carefully. Beyond regulatory considerations, low long-term interest rates and changing expectations for asset returns, coupled with increased longevity assumptions, have greatly increased the anticipated cost of providing guaranteed pensions. The result is that many schemes now have funding deficits (see Chart 1).

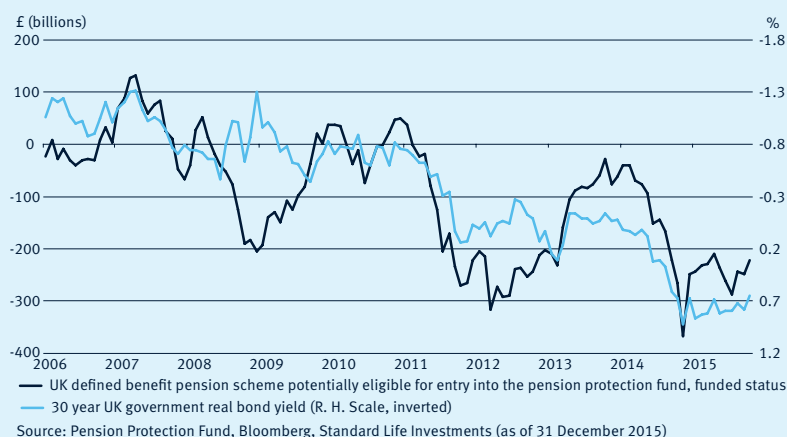
**Chart 1**  
Assets failing to keep up with liabilities



## The rise of Liability-Aware Investing

Traditionally, sovereign and high-quality corporate bonds have been used as liability 'matching' assets within schemes' investment strategies. By broadly replicating the nature of the scheme's liability cash flows, the matching bonds also have comparable risk dynamics (see Chart 2). Accordingly, a change in the value of the liability cash flow profile resulting from movements in interest rates is partially offset by changes in the value of the matching bond assets. In practice, however, very few schemes hold enough bonds to fully match all benefit cash flows, often leaving the majority of the liability interest rate risk unhedged.

**Chart 2**  
Low rates undermine funding



One of the strongest areas of growth involves the use of Liability-Driven Investing (LDI) strategies. LDI has allowed for the more efficient management of risks inherent to scheme liabilities, and increased the number of solutions available to scheme sponsors and trustees. The LDI toolkit makes heavy use of inflation and interest rate derivatives, which are implemented as liability hedging assets. Either purchased as direct investments within the scheme, or accessed through the purchase of pooled products, the use of derivatives allows for bespoke hedging of a scheme's liabilities. Furthermore, a key advantage for pension schemes is that, unlike investments in 'matching' bonds, derivatives are unfunded; there is typically no purchase invoice to pay to implement the hedge at inception.

The unfunded nature of derivatives means that pension schemes are able to simultaneously hedge their liabilities, while preserving the majority of their capital for investment in return seeking assets. The level of liability hedge is usually sized to protect the scheme's funding ratio. If a funding ratio hedge is implemented, changes in the value of the scaled liability cash flows are matched by the hedging derivatives, with any positive performance from the return seeking assets directly improving the scheme's funding ratio. The ability to simultaneously implement a hedge to the value of the scheme's liabilities, and invest the scheme's capital in return seeking assets, is commonly referred to as leverage.

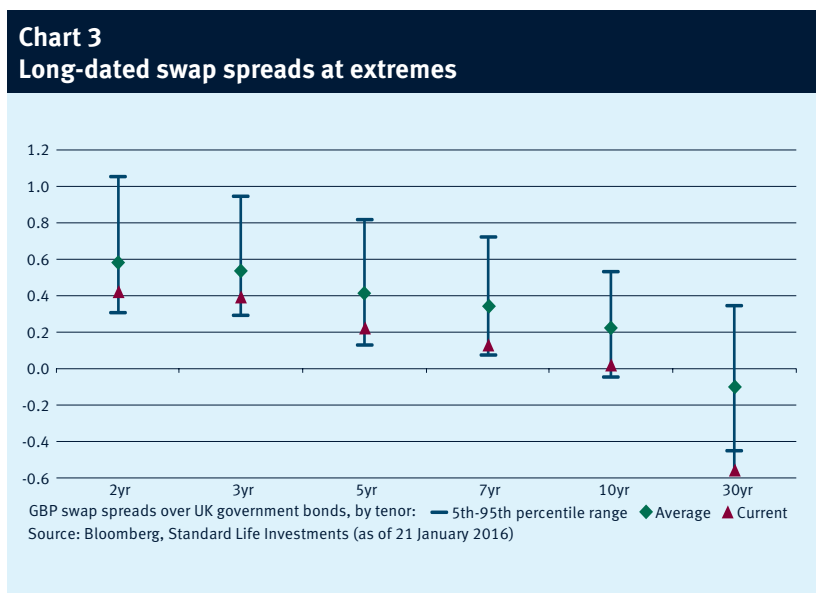
The Netherlands and UK have been at the forefront of adopting LDI, although it is also gaining traction elsewhere. A recent 'Navigating the UK LDI market' KPMG survey reported that, during 2014, the total notional value of liabilities hedged by LDI strategies continued to increase from £510bn to £657bn, with the number of LDI mandates increasing by 208 to 1,033. This compares to estimates for total UK pension liability figures of £1.5–2 trillion across 6,000 schemes.

### Liability-Driven Investing and the yield curve

The impact of LDI investors on the long end of the yield curve in recent years has been well-documented. In the UK market, the hedging activity of LDI investors has increased the demand for both long-dated bonds and fixed rate exposure in the swap market. Indeed, empirical analysis suggests that it has been a key driver of persistently low yields at the long-end of the UK yield curve, while also contributing to episodes of curve inversion. Given that the majority of UK pension liabilities embed some form of inflation exposure, LDI hedging activity can also be observed in the real interest rate market. As with nominal rates, a strong bid for inflation-linked assets has suppressed real yields and resulted in persistently high inflation 'break-evens' on long-dated index-linked gilts. As a result, the UK inflation curve appears to contain less information about inflation expectations than other markets, such as the US.

### Swaps versus bonds

In addition to influencing long-term nominal and real interest rates, LDI activity can also affect the relative demand for swaps and government bonds. Before the financial crisis, long-dated gilts generally traded at a premium relative to long-dated swaps. This was primarily because gilts were perceived to be risk-free assets whereas swaps carried counterparty risk. At the same time, gilts were scarce because of the paucity of long-end government bond issuance and LDI investors were smaller participants in the market than they are now.



Things changed dramatically in the wake of the financial crisis (see Chart 3). The demand for swaps relative to bonds increased as they became more acceptable as a risk-free benchmark. Meanwhile, larger budget deficits and the Debt Management Office's decision to increase the maturity of issuance significantly increased the supply of gilts relative to swaps. As a consequence, swap yields have been

persistently below gilt yields since late 2008. The financial crisis also altered LDI activity. Both equity prices and government bond yields plunged during the crisis, leaving big gaps in pension schemes' funding ratios, highlighting the importance of de-risking and a liability aware approach. Although pension schemes have had a preference for higher-yielding longer-dated gilts because it was cheaper to source unfunded debt from the synthetic gilt market, this has not been sufficient to drive gilt yields back below swap yields.

More recently, the spread between swaps and gilts has increased further, mostly due to regulatory changes. As a result of Solvency II, the benchmark for European insurance companies' hedging activity is switching from gilts to swaps, increasing LDI demand for the latter. In addition, Basel III regulations have made it more expensive for banks to lever their own balance sheets to provide unfunded protection to LDI investors, impacting the gilt market much harder than the swap market.

Looking forward, our expectations are that swaps and government bonds will continue to move more freely relative to each other, driven by changes in liquidity premia, balance sheet availability and regulatory incentives. Financing synthetic gilt exposure will be especially challenging, given the threats from rising funding costs and roll risk (the ability to renew unfunded gilt exposure at the expiry of the contract). Moreover, intense regulatory pressure implies that banks will need to set aside additional long-term funding for repo transactions. Any further increase in repo use would be quite expensive for banks, raising funding costs, increasing the risk that they stop offering such services altogether and undermining liquidity during periods of market stress.

### Ever more regulatory challenges

Changing regulations are influencing more than just gilt and swap pricing. The Dodd Frank Act in the US, and the European Market Infrastructure Regulations directive in the EU have led to more onerous collateral requirements for the use of derivatives. At the same time, banks, the traditional suppliers of hedging instruments, can no longer offer the same pricing and liquidity terms on derivative instruments under Basel III.

The consequence is that, in order to mitigate some of the negative impacts of the evolving derivative market, LDI asset managers need to adopt a more sophisticated approach to the management of their LDI derivative overlays. Asset managers' ability to access derivative exposure at competitive prices will increasingly become a function of strong market relationships with counterparties, as well as asset managers' ability to quickly adapt to new execution platforms as they evolve. Beyond the sourcing of derivative exposure, efficient collateral management will be critical to mitigating the performance-reducing effects of holding large quotients of low-yielding eligible collateral. What is clear to LDI asset managers is that the fixed income derivative market is in the midst of significant change.

# European Equities

## Do not discount the banks

European banks have underperformed the market against the backdrop of easing monetary policy and heightened regulatory uncertainty. Investors now risk overlooking a range of positive drivers of earnings that are not priced into the market.



**Jonathan Fearon**

Investment Director, European Equities

## Banking on interest rates

European banks underperformed the market in the second half of 2015. The primary catalysts appear to have been fears that lower policy rates in Europe would drive down top-line growth for the sector (see Chart 1), and uncertainty over the outlook for regulation, leaving investors worried that banks will disappoint on dividends. At 0.5% for this year, consensus expectations for revenue growth are close to a record low, while analysts anticipate up to a 70% increase in regulatory requirements. It is therefore unsurprising that bank valuations have fallen to the lowest level relative to the market since the depths of the financial crisis.

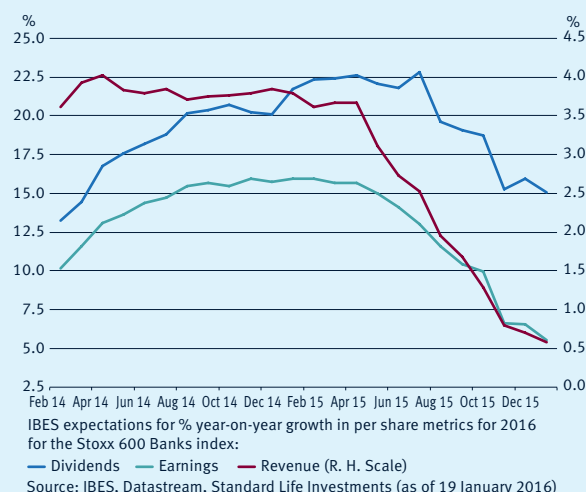
Nevertheless, there are some important reasons to push back against this extreme pessimism. Take interest rates. Although the ECB and Norges Bank are both likely to lower their policy rates further in 2016, the Danish central bank managed to raise deposit rates by 10bps in January. Similarly, the outlook for policy in Sweden is becoming more balanced in the wake of healthy domestic data.

Investors should also keep in mind that persistently low long-term interest rates can have positive externalities for the banking sector. Falling interest rates have driven down debt servicing costs for households and corporates just as domestic demand is improving. This process is already well established in heavily leveraged economies, such as the Netherlands and Denmark, where SME loan books have already seen a significant improvement in credit quality.

Lower interest rates can also create opportunities for the asset management arms of banks, particularly in France. Lower front book rates on traditional savings products and a steady back book of maturing deposits present a significant reinvestment problem to the investor. However, it provides an opportunity for those firms able to offer low-risk innovative investment products. In return for this service, asset managers like Amundi can attract a higher fee than its parent company Credit Agricole managed when it was offering plain vanilla savings products.

Meanwhile, banks are adapting their structures to the low interest rate environment. Consolidation is the most obvious response to a world of weaker top-line earnings growth. While regulators are unlikely to permit the creation of more 'too big

**Chart 1**  
Not so great expectations



to fail' banks in the wake of their experience during and after the financial crisis, we do expect them to allow consolidation in some targeted sectors such as the Popolare banks in Italy. This would positively impact the domestic Italian banking market. Similarly co-operation between banks is increasingly being discussed in areas like investment banking – the idea being that shared service platforms in the middle and back office would open up significant opportunities to take out costs without increasing the balance sheet of the banks.

## Keeping up with technology

In the absence of large-scale consolidation the best opportunity for self-help in the sector is digitalisation, which allows the headcount in banks' retail branch networks to be reduced. The Nordic banks have been the first movers in this area, having taken out around half of their branch network over the last 10 years. This has yielded a significant improvement in their cost to income ratios. Critically, the benefits go beyond lowering costs; some of the dividend can be recycled into investment in relationship managers who can facilitate greater cross-selling of high value-added products like investments and insurance products. Within the Eurozone, Dutch banks are already advanced along the digitalisation track and it is now spreading into markets like France as well.

The European banking sector may now be cheap, but the key for unlocking that value will be banks following through with dividend payouts in an increasingly income hungry world. Dividend forecasts for 2016 look highly attractive; however, so were 2015 expectations before regulatory uncertainty restrained bank management teams. So will 2016 be different? For the first time since the financial crisis, European regulators seem to be publically linking increasing regulation of the system to lower economic growth. This may not apply to investment banking, where the desire for retribution for the financial crisis remains strong, but it is gaining traction for retail banks that are critical for transmitting easy financial conditions to lending activity and the real economy. In short, the omens are better here, and there is little good news in the price.

# Corporate Bonds

## Are credit markets predicting recession?

Credit spreads widened in 2015 and have remained under pressure in early 2016. However, there has been significant dispersion in performance across regions and investment grades. This provides selective opportunities for savvy investors.



**Craig MacDonald**  
Head of Credit

### What is going on in credit?

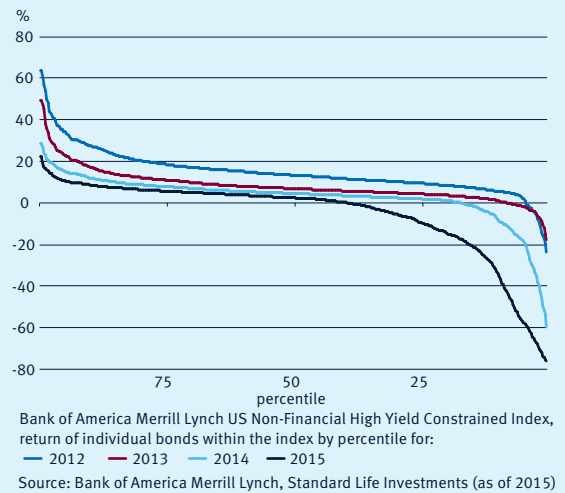
Although credit markets came under general pressure last year, there was still considerable dispersion in regional performance. European high yield significantly outperformed US high yield; sterling investment grade outperformed euro investment grade and Asian emerging market (EM) credit was a strong performer despite the world's concerns over China. However, there has been a weak and much more correlated start to 2016. Therefore, the question for the next six months is whether investors should expect another year of a volatile but dispersed range of regional performance outcomes, or if we are about to enter a broader bear market that anticipates a global recession.

Aside from direct forecasts of GDP growth, some of the indicators we use to assess where we are in the credit cycle include trends in bank lending standards, corporate leverage levels and the flatness of government yield curves. On the first criteria, lending standards have tightened in emerging markets and there are nascent signs of tightening in the US, but European lending standards are still loosening. On the second, corporate leverage is relatively high in the investment grade sector, but remains lower than during the 1990s once the energy and commodity sectors are stripped out. Finally, although yield curves have flattened, they are steeper than has traditionally been associated with recessions. Meanwhile, defaults have been rising, but only from historically low levels and are generally a lagging indicator.

### High yield action

What has been particularly interesting is the price action in US high yield, one of the worst performing credit markets in 2015 with a circa -5% return. If we look at the range of returns for individual bonds within this market over the past four years we find that in 2012, the vast majority were positive (see Chart 1). However, the variation in performance has increased in each subsequent year, culminating in 2015, when close to 50% of bonds produced negative returns and a reasonable number of bonds entered distressed levels. Just over 20% of US high yield issuers are in energy and commodities and were therefore highly vulnerable to the fall in commodity prices. However, distress has also been seen in some other areas such as retail and certain parts of telecommunications. Greater risk aversion has caused more general dislocations which will need to be watched to see if they subside as we get more clarity on the economic outlook in 2016.

**Chart 1**  
High yield under pressure



While global high yield is now offering a 9% yield, this would still have some way to go before it reached normal recessionary levels. This is different to US investment grade, where credit spreads have already reached the peak levels for two out of the past three US recessions, although they are still some way off 2008 levels. We need to be careful about simplistic comparisons over time: there are more BBB rated bonds now in the benchmark; the average duration has increased and there is some commodity exposure and so we would expect spreads to widen further if there was a global recession. However, good-quality issuers now look cheap and while you would not want to own a number of smaller regional US banks because of their over exposure to commodities, it is a different story for the large US banks such as JPMorgan, which have strong balance sheets with low book exposures to commodities.

### Other worries

Leaving aside commodities, the other source of market worry has been EM. However, many of the areas with the most negative headlines were actually some of the better performers in 2015 because the market had priced too much in by the end of 2014. For example, Russian corporate credit had a very strong performance in 2015 despite Russia's myriad problems. Similarly, the Chinese economy may have slowed, but Chinese credit has outperformed, particularly property bonds. The lesson is that there are opportunities and not just risks in EM credit.

The upshot is that we expect another year of volatility in credit markets, but the risk of recession appears lower than the market is pricing in. This is an environment of selective opportunities. In high yield for example, our Funds benefited from a materially reduced exposure to the most risky CCC rated debt in 2015, but it is still too early to reverse this position despite the wider yields on offer.

# Real Estate

## Resilient real estate

Although there are a few examples of oversupply, real estate construction globally remains modest. Solid growth in rents combined with constrained construction dynamics should ensure a growing and resilient real estate income stream even under a modest economic growth path.



**Anne Breen**  
Head of Real Estate Research

## Unlike previous cycles, future construction remains well balanced

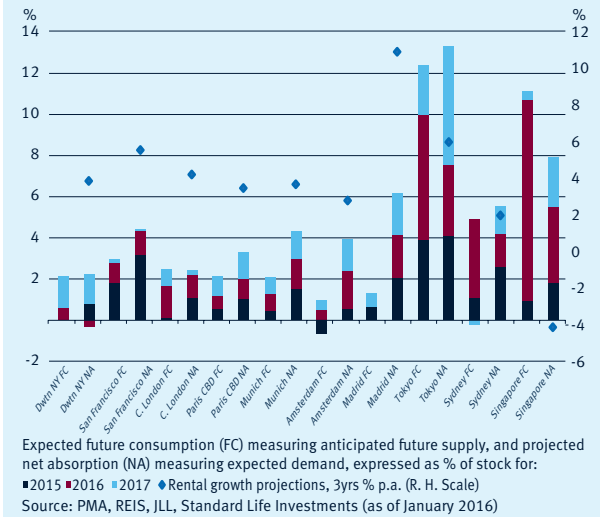
Typically in real estate markets there is a pronounced cycle whereby developer confidence increases sharply the longer an upturn progresses and construction generally picks up markedly as the cycle becomes more mature. In the current real estate cycle, construction has been much more constrained. This is largely due to increased regulatory pressure on banks, limiting their ability to engage in speculative development, as well as increased developer caution following the financial crisis, resulting in the requirement for a tenant pre-let before build activity commences. This cycle has also been impacted by the proliferation of REIT structures in public markets which, by their nature, are focused on income generation. This is unlike historic cycles, pre-REIT structures, where listed property companies were active developers.

Despite the maturity of the current real estate cycle, the construction pipeline remains well balanced in most major global real estate markets (see Chart 1). There are some examples of potential oversupply risks that may materialise further into a three-year forecast horizon, such as in Central London. However, activity to date is still well balanced and most large global cities, such as Paris, New York, Munich, San Francisco and Madrid, look to be undersupplied particularly in new Grade A space. High-level statistics suggest a risk of oversupply in Tokyo emerging in 2018, however, a high percentage of the existing stock is old and no longer meeting modern standards. Despite a significant amount of near-term supply due in the shape of the large Barangaroo development, Sydney is expected to be well balanced towards the end of the three-year forecast horizon. The city is starting from a position of undersupply and the pipeline is effectively switched off post-delivery of this development.

## Projections are for solid rental growth across all regions

As a result of the well balanced supply and demand dynamics, our projections are for reasonable rental increases in most key cities. On average, across the markets shown, we anticipate rents growing by approximately 3% over the next three years

**Chart 1**  
Real estate returns well supported



on an annualised basis. Tokyo is expected to generate the highest rental growth as tenants move to newer space and are prepared to pay a premium for the higher-quality, higher-specification, earthquake-resilient new buildings. At the other end of the spectrum, Singapore rents are expected to suffer further declines due to the anticipated significant oversupply.

As the cycle matures in most global markets, the yield premium enjoyed so far by real estate is narrowing. Income should become the key driver of returns going forward and, fortunately, the prospects for rental growth are encouraging. Supply is relatively well contained and projections are for reasonable economic growth in most developed markets, supporting tenant demand. An uplift in rents will be translated into stronger income returns for real estate.

A key risk to our projections would be any unexpected demand shocks dampening future tenant requirements, leading to lower rental growth materialising. Similarly, another risk is future construction accelerating more rapidly than we anticipate. Given the regulatory pressures limiting 'risky' bank lending, this seems unlikely.

## Our strategy within global real estate

Generally, we prefer 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 Europe we expect a fundamental recovery within peripheral markets 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. Low interest rates in Australia are supporting double-digit returns in non-commodity based cities. 'Abenomics' is propping up Japan's relative performance in the region, bolstering asset values and reviving occupier demand from cash-rich corporations.

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## Contact Details

For further information on Standard Life Investments visit [www.standardlifeinvestments.com](http://www.standardlifeinvestments.com) or contact us at one of the following offices.

### Europe

#### Standard Life Investments

1 George Street  
Edinburgh  
United Kingdom  
EH2 2LL

Telephone: +44 (0)131 225 2345

#### Standard Life Investments

90 St. Stephen's Green  
Dublin 2  
Ireland

Telephone: +353(0) 1 639 7000

#### Standard Life Investments

31st Floor  
30 St Mary Axe  
London  
EC3A 8BF

Telephone: +44 (0)207 868 5700

#### Standard Life Investments

21 Rue Balzac  
75008 Paris  
France

Telephone: +33 158 05 22 70

#### Standard Life Investments

Taunusanlage 11  
60329 Frankfurt am Main  
Germany

Telephone: +49 (0) 69 665721764

#### Standard Life Investments Limited

Engelbrektsgatan 9-11  
114 32 Stockholm  
Sweden

Telephone: +46 (0) 707 507353

#### Standard Life Investments Limited

4th Floor 10 Via Mazzini  
20123 Milan  
Italy

Telephone: +39 0249 543 231

#### Standard Life Investments Limited

3rd Floor Rennweg 22  
8001 Zurich  
Switzerland

Telephone: +41 44 522 00 55

#### Standard Life Investments Limited

Office 23 Wing D Level 0 The  
Crescent  
Parc Scientifique  
Route de Lennick 451  
1070 Anderlecht  
Brussels  
Belgium

Telephone: +32 470 991 668

### North America

#### Standard Life Investments (USA) Ltd

One Beacon Street, 34th Floor  
Boston  
USA  
MA 02108

Telephone: +1 617 720 7900

#### Standard Life Investments (USA) Ltd

299 Park Avenue, 6th Floor,  
Room 55  
New York, NY 10171  
USA

Telephone: +1 617 720 7900

#### Standard Life Investments (USA) Ltd

11601 Wilshire Boulevard,  
5th Floor, Room 505  
Los Angeles  
USA  
CA 90025

Telephone: +1 310 235 1408

#### Standard Life Investments (USA) Ltd

First Canadian Place  
100 King Street West  
Suite 2525, PO Box 252  
Toronto, Ontario, M5X 1C8  
Canada

Telephone: +1 (647) 726 1424

### Australia

#### Standard Life Investments Limited

Level 33 Chifley Tower  
2 Chifley Square  
Sydney NSW 2000  
Australia

Telephone: +61 2 9947 1500

### Asia

#### Standard Life Investments (Hong Kong) Ltd

30th Floor LHT Tower  
31 Queen's Road Central  
Hong Kong

Telephone: +852 3589 3188

#### Standard Life Investments Limited

Beijing Representative Office  
Room A902-A903, 9th Floor,  
New Poly Plaza  
No.1 Chaoyangmen Beidajie  
Dongcheng District,  
Beijing 100010  
People's Republic of China

Telephone: +86 10 8419 3400

#### Standard Life Investments (Hong Kong) Ltd

Korea Representative Office  
21/F Seoul Finance Center  
84 Taepyungro 1-ka, Chung-ku  
Seoul, 100-101  
Korea

Telephone: +82 2 3782 4760

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