2017 | GLOBAL ANNUAL PERSPECTIVES

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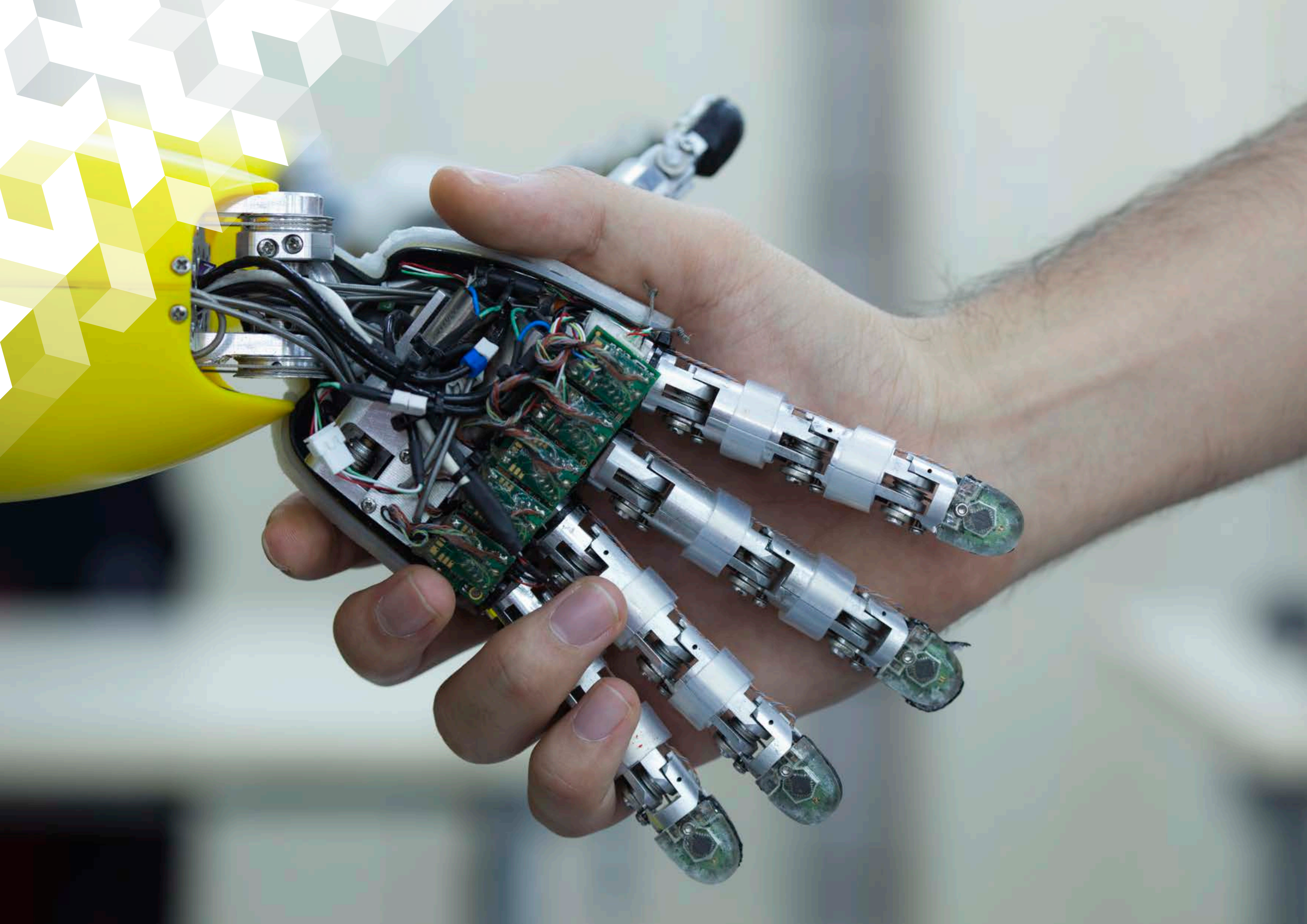

DISRUPTION AND INNOVATION: A CATALYST FOR OPPORTUNITY

Digital and demographic trends hold the promise of change for asset management firms and financial advisers. It's an opportunity – after all, when things become complex, good management and advice are more valuable than ever.

Colin Moore,
Global CIO

These trends are causing disruption and innovation across broad areas of politics, business and social interaction; they are not limited to the asset and wealth management industry. When change affects us, we tend to believe that things are shifting more often than they used to. In part, that is the perception the media has given us, because innovations in media technology allow us to find out about events more readily, as they happen in real time. If there's a natural disaster on the other side of the world, we see the images and footage immediately – and then multiple times on a loop the following day. And while our awareness of global events is higher than before, it doesn't necessarily mean that disruption has become more common.

Disruption versus innovation

When change is happening, it's important to understand it and how it affects you. You also have to understand the nature of the product or service you offer. Disruption is a complete change in the demand for the product or service offered that affects an industry's long-term growth. If you start to believe that people will not need your services anymore, then there is no point in continuing to offer them.

Innovation changes how a product or service is delivered, priced or used… Disruption is a complete change in the demand for the product or service offered that affects an industry's long-term growth.

For example, gaslamp lighters have been replaced completely – that is a true disruption. On the other hand, innovation changes how a product or service is delivered, priced or used, but does not necessarily put the long-term growth of an industry as a whole at risk. Individual industry participants could be at risk if they fail to adapt to the innovation.

I believe very strongly that many of the global demographic trends are supportive of the growth of asset management and advice. However, some of the trends in generational preferences, coupled with innovations in technology affecting risk management, communications, product design and pricing, mean industry participants must adapt.

Behavioural responses: flexibility is key

There are really only a few approaches you can take to deal with disruption and innovation: you can panic, bury your head in the sand or make a plan. And only one of these actually works. The key to a successful plan during periods of significant change is flexibility. It is critical to understand what clients want to achieve and how they want services provided to them. We have all heard the legendary story of Henry Ford's statement, "You can have any colour you want as long as it's black." We should ask ourselves how much we have progressed past that thinking, or are we still largely pushing our concept of what our clients should want onto them?

Technology is creating more time for delivering insights and client service

New technology means there's more data for us to analyse. In the past we spent a lot of time collecting data and collating it into useful information, and then from there we garnered insights. A computer system like IBM's cognitive technology 'Watson' is showing us how a traditional research process can benefit from innovative technology. In a recent case study a woman had a very unusual form of cancer. Watson read all the data, produced a couple of scenarios, and then an experienced doctor was able to determine a more specific diagnosis.

And that's key. This technology doesn't replace us as asset managers, and it doesn't replace financial advisers. It enables us to spend more time developing and delivering insights, provided we are prepared to alter or give up some of the daily routines we take comfort in. Innovative technology allows research teams to spend less time on the basic functions of collecting information, arranging it and carrying out a basic analysis, and more time on developing insights.

For advisers, technology can help concentrate on the most valuable aspects of what they do and expand what they do into areas thought to be less profitable. Working with technology-driven approaches like robo-advisers mean human advisers will be able to spend more time on client contact.

Pitfalls to avoid

Corporate giants in other sectors can offer cautionary tales about what can go wrong for those who fall victim to two behavioural hurdles: overconfidence and the innovator's dilemma.

Nokia was once the number one mobile phone company in the world and is now essentially out of business. It was confident that it could continue with its approach; a cell phone was a device used by people to talk to each other and the great innovation was to make it mobile and small. Meanwhile, Apple understood that an integrated approach to communication and content delivery created a different buzz, and created the smartphone.

Apple's success was less about technology innovation as creating a new ethos: the flexibility for people to communicate and be entertained how, when and where they chose. By the time Nokia caught on, it was too late and it saw its market share collapse.

Similarly if asset managers take too narrow a view of their business, such as a provider of mutual funds rather than providing a broad and flexible set of investment solutions that are vehicle agnostic, they may face the same future as Nokia.

Kodak thought it was in the celluloid film business. It fell victim to the innovator's dilemma: companies with a strong, established market share are often the most reluctant to accept change. Kodak was so successful at selling celluloid film it was reluctant to push innovation in digital photography. Its real mission was to help people capture memories, but it didn't want to put its profitable celluloid business at risk to pursue that goal.

Adapting to investors' changing demographics

Both the age and the attitude of investors are evolving – Generation-Xers and millennials have different approaches and priorities than baby boomers, and these nuances need to be reflected in the services and advice they receive. But baby boomers also face changes. Many have not faced rising interest rates in their adult lives. The shifting proportion of various ethnic groups in the overall population might be a catalyst for change as well.

Partly as a result of changing demographics and partly because new technology makes choice readily available, people want to pick and choose what they're paying for and they expect full transparency. It's leading to an unbundling of services, and the cable TV industry is a good example. Older generations have grown accustomed to paying upwards of $200 per month for hundreds of channels and they may only watch a handful. Younger generations are choosing to unbundle these packages and instead buy the highest speed internet and then purchase extra services to target the shows they want. Ultimately, they may not save money, and they certainly don't save time, but they prefer having transparency into what they're paying for.

This unbundling of services is happening in advice and asset management, too. Traditionally, the investment returns and investor services offered by mutual funds were bundled together, and the individual cost of each element was too complicated to discern within the overall fee. Increasingly, people can now pick and choose what part of a product's investment performance they want to pay for. The performance can include beta, strategic beta (or factor exposure) or alpha. Investors can increasingly access each one individually instead of in a package.

History shows that change represents a risk, but also an opportunity if you're more prepared than the people around you.

It's unclear how far this trend will go in the financial services industry, but the cost of services is going to become more transparent and flexible. The prices that financial advisers pay large investment firms and the prices they charge to their clients are going to be on the table, giving clients more control to get exactly what they want.

Traditional revenue streams may get disrupted for a while, but as in the case of Nokia and Kodak, it was the failure of business leaders to take a holistic view of the service they provided and to adapt to innovation that led to their demise.

There are more mobile communication devices and more photographs taken today than ever before, illustrating that innovation can present longer-term opportunities if it is embraced.

A strategy for the future

The financial services industry has dealt with huge upheavals in the past – from stock market crashes and recessions to the rise and fall of currencies and countries. History shows that change represents a risk, but also an opportunity if you're more prepared than the people around you. At a time of uncertainty and change, a clear head and good advice are more valuable than ever. Having a strategy, rather than panicking or burying our heads in the sand, will help us succeed, together.

Growing assets in Trump's world

As we consider Trump's proposed policies, we must remember they will have global implications outside the US. Despite the uncertainty we're facing, we can go around the world to highlight growth opportunities in key regions.

Mark Burgess,
CIO EMEA and Global Head of Equities

Europe: geo-politics to take centre stage

The US markets have become increasingly important for eurozone exports – and changes in President Donald Trump's stance on international trade could affect Europe. But the more pressing issue is the upward trend of support for European populist parties. The potential for political instability in Europe is rife, with a number of elections and referendums in 2017. The resignation of Italian prime minister Matteo Renzi – after an overwhelming majority voted against his referendum – threw Italy into uncertainty at a time when its banking system was already particularly vulnerable. Dutch, French and German elections take place in 2017. If there were to be a move toward populism in any of these countries and if a significant member state were to leave the euro currency, it could cause a destabilisation of an already fragile economy.

While a weaker euro would benefit the region, with the bulk of sales generated overseas, there are many other moving parts to consider.

> The tide of global quantitative easing that had previously lifted all boats will begin to ebb in some regions and flow in others. In that environment, it will make sense to differentiate within and across asset classes.

And while 5%-10% earnings growth in 2017 seems achievable for the market as a whole, three scenarios could pose challenges: a change in European Central Bank policy, sharp rises in US bond yields and European politics. These are the key things that investors should look out for.

Emerging markets: the Trump Effect will create opportunities for investors

The Trump administration could have a significant impact on emerging markets. Mexico, Colombia, Malaysia, Korea and Thailand are the most exposed to a US policy shift toward protectionism. If the point of Trump's rhetoric is to skew future investments away from emerging markets, then we may have witnessed an overreaction – and this can create good opportunities for investors. The obvious concerns are Mexico and China, where most of Trump's negative rhetoric has been focused. But the hope is that Congress and the Senate will reach a middle ground by leveraging their system of checks and balances.

On the emerging market equity side, earnings revisions have been improving for the first time in quite a number of years. Valuations are low compared with developed market equity markets, and on an outright basis, they're in line with 20-year averages.

Asia: attractive valuations

It's uncertain what a Trump presidency will bring when it comes to the future of Chinese exports and the threat to impose punitive tariffs. The US has once again become China's largest trading partner (18% of total exports), but it's worth noting that the Chinese economy has already rebalanced significantly away from exports. In fact, net exports as a share of GDP had fallen to 3.4% from 8.6% before the global financial crisis. If the US becomes a less attractive trading partner, China is likely to accelerate its push towards emerging markets, diversifying its export markets.

More uncertainty surfaces as we try to predict whether Trump will label China as a currency manipulator and what that will mean for the yuan in the face of a stronger US dollar. As far as equities go, this means domestically-oriented stocks in China should be favoured, particularly in the services space and with the companies that are in a position to build multinational business platforms.

Generally, in Asia we see opportunities to invest. Valuations are more attractive, currencies more competitive and earning revisions are trending upward – all of which are reflected by the increased flows into the region. But with downward revisions to global growth forecasts, we're likely to experience heightened volatility. The more export-orientated markets of North Asia are most likely to be directly impacted in the short term, which will postpone the anticipated trough in their export performance. On the other hand, the more domestically-orientated markets of Southeast Asia may prove more resilient given the supportive domestic demand trends and the scope for further monetary easing.

UK: reasons for optimism amid Brexit uncertainty

Arguably, Brexit is just a symptom of excessive global debt and the inequalities that have widened in a quantitative easing world. Now the UK needs to embrace free trade outside the EU. Since the June referendum, UK GDP and other data have been positively surprising, although this could simply be because Brexit hasn't actually happened yet.

In 2016, the UK had one of the best rates of economic growth among the G7 (though with expectations of earnings at 1% in 2017, the outlook will be more challenging). Nevertheless, factoring in the sterling collapse has helped with the current account deficit and has also contributed to the UK's overall appeal, though its full benefits are yet to be felt. Perhaps it could attract foreign investment back into a country from which some investors have fled.

GDP forecasts 2016 vs 2017

GDP forecasts	End 2016 (%)	End 2017 (%)
US	1.5	2.0
Eurozone	1.6	1.1
Japan	0.7	1.0
UK	2.0	1.0
Brazil	-3.2	1.2
Russia	-0.4	1.5
India	7.3	7.4
China	5.5	5.0

Source: Columbia Management Investment Advisers, LLC as of December 2016. GDP forecasts represent the EMEA investment team view.

There's still a cautiously optimistic case for UK equities, despite the ever-looming uncertainty of how Brexit will come to pass. In the meantime, there are plenty of opportunities for skilled active managers to find quality investments in the UK.

Bottom line: deciding which regions to invest in is an active decision

We expect opportunities for active, discerning investors to increase. Amid rising political uncertainty, fundamental analysis and expert asset allocation will be critical in order to achieve long-term returns. The tide of global quantitative easing that had previously lifted all boats will begin to ebb in some regions and flow in others. In that environment, it will make sense to differentiate within and across asset classes. In today's world, a focus on valuations and fundamentals – old school investing, if you like – should be more important than it has been in recent years when markets were backstopped by abundant and growing liquidity.

What does the future hold? No one can tell for sure. But if you look at the world holistically, there are opportunities to be uncovered.

Europe: the scene is set for an(other) historic year

Predicting politics is difficult, but we can prepare to take advantage from it.

Philip Dicken,
Head of European Equities

2016 will be remembered as the year when the populist vote triumphed. While Britain's vote to leave the European Union in the June referendum could have been dismissed as a one-off, Donald Trump's victory in the US presidential elections showed that a shift in the West towards protectionism is here to stay. These votes reflect a fundamental shift in public sentiment and a profound dissatisfaction with ruling 'elites'. How governments respond will have material implications for global economies.

The Brexit vote and Trump's victory both triggered market rotations, which are still playing out today. In the case of Brexit, investors have bought international earners in the UK and sold off domestic stocks. In the US, prior to the presidential election, cautious investors were favouring low volatility stocks. Following Trump's win, this trend reversed. The new president and his team have signalled their intention to create a programme designed to stimulate the US economy. The stimulus package is expected to take the form of tax cuts and a sharp increase in infrastructure spending.

> The rise of the populist vote will continue to dominate the political agenda in 2017 elections across Europe. The risks and uncertainty involved in these elections is far more material than it has been in recent cycles.

Bond yields rose accordingly, and many construction related stocks saw an increase in value. Financials also benefited from expectations that a steepening yield curve and stronger credit formation would improve profitability.

December 2016's Italian referendum was another decisive victory against a ruling party. However, the vote rejected Matteo Renzi's reforms, retained the constitutional status quo and prompted Renzi's resignation as prime minister. Italy now has a new prime minister and the technocratic government is likely to adopt different voting reforms before a general election expected in 2018.

The rise of the populist vote will continue to dominate the political agenda in 2017 as we see elections across Europe. The risks and uncertainty involved in these votes are far more material than in recent cycles. Will anti-establishment, protectionist rhetoric be victorious in the French presidential election, the Dutch general election or the German federal elections? Or will we see pro EU, pro capitalist right wing governments elected or re-elected?

Either way, we are likely to see changes in the way the EU is run as the electorates' mood has shifted in multiple ways. We should also be mindful of the resilience of the UK economy (at least thus far) to the Brexit vote and the positive market reaction to the Trump election.

Other related unknowns that lie ahead are the negotiations around Brexit, the reality of the Trump presidency and his specific policy plans, Europe's monetary policy direction and how inflation develops.

Growth and attractive valuations

Against such an uncertain political backdrop, we would point to the positives in Europe. We see reasonable economic growth of 1.0% in the UK and a continuation of the weak European recovery, with Eurozone GDP rising by 1.1%. Inflation of around 2% in Europe should help companies' top lines and we see growth of around 10% in earnings for the European market in 2017.

Another area of comfort is that European valuations are relatively attractive today. Risk aversion to upcoming political events has led to a surge in outflows from European stocks and left the equity market at a material discount to the US, in particular. For example, the European market dividend yield is around 3.5% and many good quality stocks are yielding much more. We also see attractive valuations in the small and mid-cap space as investors focus on the risks rather than the exciting growth prospects on offer.

> The stocks we own in our diversified portfolios are those that are strong enough to withstand the short term buffeting of markets and politics.

Investment tenets

As investors, we focus on higher-quality companies with positive long-term prospects. We are firmly focused on the business models of the companies we invest in, as well as the broader merits of their respective sectors, using Porter's Five Forces analysis to evaluate the strength of a company versus its competitors.

This can mean that many of our stock picks are intrinsically lower beta within their respective sectors. We also continue to invest in disruptors and companies that can benefit from various changes in market themes. Currently these factors include the improving underlying economics noted above and the enduring changes in financing conditions with the recent changes bond yields. The improving European macro-economic situation should help a number of areas including construction, chemicals and industrials, where some of our investee companies are beginning to enjoy some revenue tailwinds. Within financials, the steepening of the yield curve has significant benefits for insurance companies and traditional banks, which should help earnings in the financials to improve during 2017.

Opportunities in an unstable world

Our approach does not change as we enter 2017, a year of diverse risks. The stocks we own in our diversified portfolios are those that are strong enough to withstand the short term buffeting of markets and politics and can prosper on a multi-year view.

In the changing environment, we continue to search for new opportunities. Macro-economic uncertainty may be unsettling but it can give the active manager real opportunities when new news wrong-foots the market. The short-term reactions to geopolitical events do not necessarily reflect the way that the situation will play out longer term and we will aim to take advantage of market volatility to buy good quality stocks at unwarranted discounts.

US small caps look for a Trump earnings revival

Improved earnings growth will matter most in 2017, whereas in 2016 cyclical and growth companies led stock performance.

Nicolas Janvier,
Portfolio Manager, US Equities

2017 will create opportunities for active managers in the US small caps space, as interest rates rise and if economic growth speeds up as expected. This environment will be different from 2016, when the factors that drove stock performance shifted between the first and second half of the year.

2017: The year of outperformance for US small caps?

Donald Trump's win in November 2016 is a game changer for the US – economically, politically and for its stock markets. After his election, investors increased their expectation that US interest rates would rise. The Federal Reserve's Open Market Committee followed through on this anticipation with its December rate rise and promise to tighten three times more in 2017.

Donald Trump's win in November 2016 is a game changer for the US – economically, politically and for its stock markets.

Investors also expect to see the pace of GDP growth escalate, given the degree of fiscal stimulus Trump talked about injecting while on the campaign trail. Infrastructure and consumer-related stocks, as well as basic materials and industrials, have outperformed since the election. While we anticipated that infrastructure stocks would rise in the event of Trump's election, the magnitude of the moves we witnessed, in the range of 20-40%, came as a surprise to all active managers.

This was also true for other sectors, such as financials. The small cap index overall rose by 8% from 8 November, the day of the election, to 1 December.

Since any infrastructure spending will focus on the domestic economy, with the possibility of new bridges, roads, schools and hospitals being built, this will positively impact construction, engineering, and materials. There will also be second-order effects that help industries such as banks, given increased loan demand, and for companies who sell to US consumers.

Trump's pledge to lower US corporate taxes will also benefit smaller companies, since they typically pay higher effective tax rates than multinationals. His protectionist stance meanwhile will have less of a negative impact on smaller companies, which tend to be more exposed to the domestic economy.

The increase in the value of the dollar, which will likely continue through 2017 if incremental rate rises are introduced as planned, is more favourable for smaller firms than their larger counterparts which tend to rely more on exports. And a stronger dollar could be beneficial for the US consumer, as import prices will fall. Combined with cuts to personal income tax, this would empower the consumer further and across all income brackets. Such developments would be positive for domestic firms selling their goods to local consumers.

Return of active management

2016 was a somewhat challenging year for active managers, as markets wobbled on concerns about growth in China, plunging oil prices and the path of US Federal Reserve policy. This saw a continued rally in income-oriented stocks used as bond substitutes. At the time we recalibrated our interest-rate exposure, which provided a good base for subsequent performance.

> Over the last five years, US small cap returns have been driven more by increases in valuations than earnings. We think earnings growth will matter much more through 2017, as there does not appear to be greater scope for price increases based on valuations.

Until the UK's Brexit vote in June, there was little differentiation in the movement of stocks. Following the vote, markets fell for a few days but then quickly rebounded. This gave an early indication of a more positive environment for active management, which amplified as investors shifted their attention to the US election. The prospect of higher interest rates came to the fore after the Federal Reserve signalled this possibility. Expectations for some degree of inflation also rose, as signs of wage inflation emerged off the back of strong domestic job creation. This brought a regime change in markets: the more economically and rate-sensitive stocks, such as financials, industrials, and to a lesser degree materials, began to outperform both defensive and growth stocks. Meanwhile, the healthcare sector suffered in the light of Hillary Clinton's campaign pledge to introduce healthcare price regulation.

Going into 2017, US small cap active managers must respond to a number of questions. One is whether there is room for further outperformance in financials and other cyclicals, given that the future performance they are likely to deliver may have already been priced in. In the weeks following the election, some banks and construction stocks saw share price rises of 20% to 30%. And after OPEC's November announcement that it planned to cut production, several energy companies also saw their share prices rise substantially.

Over the last five years, US small cap returns have been driven more by increases in valuations than earnings. We think earnings growth will matter much more through 2017, as there does not appear to be greater scope for price increases based on valuations. We think this environment will create an opportunity to outperform both the market and our peers, as it will be a richer context for stock pickers.

Positioned for change

From early summer through to late October, we added specific stocks incrementally within financials and other cyclical sectors. This decision was the result of our house view on the macroeconomic situation complementing where we had already identified value, rather than being based on the expectation of a particular outcome from the US election. After Trump was elected, we continued to add to our positions in banks and industrials. We also lowered our exposure to Real Estate Investment Trusts (REITs), combining our stock-specific views with expectations for the macroeconomic backdrop.

We have increased our positions in companies with higher exposures to the domestic economy, as we expect these firms will fare best in the event of stronger growth and favourable tax policies. Since some areas of the market have already run a long way, we may see an adjustment as the political realities of 2017 are digested. In this context, a stock-picking approach will be key.

Emerging markets: diverging fortunes ahead

Those countries that have rebalanced their economies are best prepared for the challenges of rising US rates and a Trump presidency.

Irina Miklavchich,
Head of Emerging Market Equities, EMEA

Just as emerging market equities performed well in 2016, so we expect further gains in 2017. In 2016, improving fundamentals in some of the larger markets such as China and Brazil drove equity prices higher. In 2017, those countries without large current account imbalances should perform relatively well.

Emerging markets rose over 2016, although the asset class had to contend with periods of high volatility. A considerable sell-off occurred at the beginning of the year, amid investors' concerns about the continuing slowdown in China and the possibility of higher US interest rates. Both fears dissipated, as data from China improved over the course of the year, supported by a surge in property sales, and the US Federal Reserve communicated its intention to raise rates gradually.

Investors also zeroed in on Brazil. Despite the political turmoil, the new government has been positive for emerging markets. It issued fresh sovereign debt and promised to pursue a reformist agenda, aiming to steady the economy and address Brazil's structural challenges. We think that capping fiscal expenditure will help to stabilise the country's finances over time, and other measures will also relieve economic pressures. Although the risk premium for investing in Brazil has already contracted, growth will take some time to pick up as the deficit still needs to be reduced.

Donald Trump's election as President of the United States and the likelihood of further rises in US interest rates in 2017, present the clearest threat to emerging markets. But several countries are in a good position to manage the resulting macroeconomic challenges.

Focusing on rebalanced economies

Donald Trump's election as President of the United States and the likelihood of further rises in US interest rates in 2017, present the clearest threat to emerging markets. But several countries are in a good position to manage the resulting macroeconomic challenges. A number have already undergone a high degree of rebalancing, forced by weaker currencies, lower levels of consumption and higher interest rates.

Underlying structural trends will continue to drive domestic consumption across several emerging market economies, as the emergent middle classes will support demand for goods and services. We are focusing our portfolio on countries that have already undertaken the necessary rebalancing, where current accounts and overall fiscal positions are healthier, such as India, Indonesia and Russia. These changes should give consumers the confidence to start spending again.

Even after Trump's inauguration in late January, the exact shape of US trade policy will remain unclear and how it will impact the rest of the world. Historically, global growth, and in particular US growth, has been a key driver of emerging market exports. During his election campaign, Trump pledged to raise tariffs on Mexican subsidiaries of US companies and renegotiate or end the North American Free Trade Agreement.

Given that 80% of Mexican exports go to the US, that would be a significant drag on the Mexican economy. We hope that US policy implementation will be more pragmatic. The US automotive industry relies heavily on Mexican supply chains, leading us to believe that they are unlikely to be disrupted. Yet we remain cautious: the Mexican peso underperformed by a wide margin in 2016, and we have priced in an even gloomier scenario based on Trump's comments during the election campaign.

> While emerging market economies that do not have large current account imbalances should perform reasonably well, China continues to cause us some concern.

Another area of concern is Trump's policy towards Asia Pacific. He has stated that he will pull the US out of the Trans-Pacific Partnership trade agreement on his first day in office. If that promise is kept, Asian exports will suffer over the long term. But since the US technology sector relies on Asian supply chains, any significant trade barriers would first hurt US companies such as Apple.

China remains a concern

While emerging market economies that do not have large current account imbalances should perform reasonably well, China continues to cause us some concern. Although the economy performed better in 2016 once property sales recovered, in 2017 that impulse could turn negative and affect the overall performance of the Chinese equities market.

Given the weakening of the renminbi, we expected Chinese exporters to perform relatively well. But Trump's policies may harm companies that sell products to the US.

Nevertheless, positive structural developments in China should support the performance of some companies in the long run. Internet and e-commerce businesses are gaining market share, as a shift is underway from traditional sales models to online. This is also the case in other emerging market economies.

Rebalancing, where it has taken place, will support an improving non-performing loan cycle and boost financials. Demand for credit has recovered steadily in Eastern Europe, and if European economic data overall continues to improve then that will be a boon to Eastern European banks.

The oil price stabilising over the course of 2016 has, meanwhile, helped exporters such as Russia, where the currency has undergone a significant adjustment. Colombia has also benefited, as the collapse in the oil price caused a large depreciation in the value of the peso, and government spending suffered because of lower revenues from the energy sector. If the oil price stays within the current range, then those markets that have been hurt by lower prices should recover. In Mexico, although oil exports have become less important to the economy, the impact of lower oil prices on the government's ability to spend remains significant.

While the prices of other commodities such as iron ore, steel and coal have risen, the level of demand within the Chinese property market will continue to affect demand for them. Should property sales weaken next year, which is likely given that the Chinese authorities have intervened to control the surge in prices that took place in 2016, this could negatively impact related commodities in the second half of 2017. Property sales have already begun to slow in China and economic data coming out of the country will become more important as a gauge of the overall health of emerging markets as 2017 advances.

Asia's resilience to falling global trade

If the world enters a period of deglobalisation then Asia will suffer, but the diversity of its economies means there will still be opportunities.

Natasha Ebtehadj,
Portfolio Manager, Asian Equities

The first half of 2016 saw negative sentiment weigh on Asian equities. The region's performance was hampered by concerns surrounding lower commodity prices and the expectation of US Federal Reserve rate hikes. Slowing growth in China as it continues its transition from a manufacturing to a service-based economy was another key investor concern, exacerbated by faster capital outflows as mainland Chinese investors moved their money offshore in response to a gradual weakening of the renminbi.

In the second half of 2016, the outlook improved as it became evident that the Chinese economy was stabilising on the back of government initiatives to support growth, mainly through infrastructure spending. Commodity prices also began to recover leading to an improvement in PPI deflation, which had been acting as a depressant on corporate profits and pricing power across the region.

> A full-on US/China trade war, unexpected strength in the US dollar and/or more US rate rises than anticipated would likely hurt sentiment towards the Asian region.

Geo-political challenges

As we enter 2017, the main challenges facing Asia are external. The crucial ones are what 'Trumponomics' might mean for the region such as the nature of US policy particularly with regard to the imposition of import tariffs, along with the impact of further planned US interest rate rises on the dollar. If we were to see a gradual slowdown in trade, Asian economies should manage to withstand the blow, given their growth drivers are predominantly domestic consumption and investment. By contrast, a full-on US/China trade war, unexpected strength in the US dollar and/or more US rate rises than anticipated would likely hurt sentiment towards the Asian region.

Domestic bright spots

In India and Indonesia, we expect structural reforms to translate into higher growth in 2017, which will continue to underpin opportunities in those markets.

India's recent demonetisation – an event in which 86% of the country's bank notes were declared invalid overnight – is the latest in a series of high impact economic reforms. During the course of 2017 we expect the initial shock to economic growth from this demonetisation to peter out and for consumption to recover. In the longer term, the withdrawal could prove positive for India as it represents an attempt to eradicate black money from the economy and may well bring more companies and individuals into the taxable system.

Indonesia has also been busy with its own domestic reform. A recent tax amnesty has given the government more headroom to focus on infrastructure spending, which should reverberate with a multiplier effect on the economy. Like India, Indonesia is less vulnerable to a global liquidity crunch than in previous years, having reduced its current account and fiscal deficits. Its position as a commodity exporter also means that it is positioned to benefit from the recent recovery in the prices of its key exports such as coal and palm oil. We continue to like quasi-consumer entities such as telecoms companies where data usage is improving, as smartphone penetration increases in the country.

Korea has also started to present some interesting opportunities. Momentum has begun to build behind some more shareholder-friendly policies as some companies have started to look at simplifying complex structures and paying out higher dividends. Should there be a backlash against international trade led by the US, Korea would be less vulnerable than its neighbours China and Taiwan. Korea also has a sizeable tech sector, offering an alternative to Taiwan's industry.

Asian equities markets are relatively attractive from a valuation perspective, trading at about half a standard deviation below long-term price-to-earnings averages. The catalyst for a rerating is likely to come from earnings growth, which is expected to pick up in 2017.

Valuations and earnings growth

Asian equities markets are relatively attractive from a valuation perspective, trading at about half a standard deviation below long-term price-to-earnings averages. The catalyst for a rerating is likely to come from earnings growth, which is expected to pick up in 2017 having been weak since 2010 and we have already begun to see an earnings growth recovery in hitherto unloved cyclical stocks. Using a bottom-up approach, we have added companies to our portfolio that have responded positively to the challenging macroeconomic environment – particularly those in the materials and energy sector – through cost-cutting or debt-reduction initiatives and that are generally seeking to improve their cash flow. This hard work has already begun to pay off, translating into better profits, and we expect this trend to continue and boost earnings growth in 2017.

In other areas, we have added to our positions in financials, which stand to benefit from a steepening yield curve. Our funds have also maintained their long-term exposure to structural growth stories such as internet stocks in China and domestic consumption names in ASEAN that we regard as having strong, visible earnings. We have unwound some of our positions in bond proxies such as REITs, telecoms and utilities; these have delivered good performance based on decent cash flows and yields. But as earnings growth returns elsewhere in the region, we have been recycling profits into other areas which offer better relative value.

Asian equities are currently trading a little below their historical averages, reflecting a lack of clarity surrounding the impact on the region of ‘Trumponomics’. Asia's main vulnerability is sensitivity to global trade. Should we enter a period of ‘deglobalisation’ and protectionism, then its markets are likely to suffer a further de-rating. If Trump’s extreme trade rhetoric does not turn into reality, however, investors are likely to regain their confidence in Asia.

It is important to also avoid lumping together and treating all emerging markets as one asset class. Yet different dynamics drive Asia’s economies, and this gives us access to a wide range of opportunities.

Asian Equities: A Firm Finish, A Hopeful Start

The year 2016 will be remembered for its political events, and Asia contributed its fair share.

Soo Nam NG,
Head of Asian Equities, Asia

Taiwan's pro-independence Democratic Progressive Party returned to power with Tsai Ing-wen as its new president. South Korea's President Park Geun-hye was suspended from duties amidst impeachment proceedings, while a decision to deploy THAAD, a US anti-missile system, met with strong Chinese protests. In the Philippines, Rodrigo Duterte was elected President for the next six years - his first six months shocked the world with a violent anti-drug campaign, followed by a China visit that turned around bi-lateral relations. In Thailand, King Bhumibol finally passed away after a 70 year reign. The shock of Brexit and the US presidential election added to the uneasiness that prevailed throughout the year.

Nonetheless, Asia Pacific ex Japan equities has had a good year, with the MSCI AC Asia Pacific ex Japan Index outperforming the S&P 500 until Trump's election victory. Despite a correction thereafter, the Index still ended the year up 7% in USD terms. The discussion below explores the anchors for the firmness in 2016, and seeks to draw insights for 2017.

> Our preference entering 2017 is for oil over metals, as OPEC discipline should work its way into the supply-demand balance.

Confidence improvement towards China

China's GDP growth of 6.7% exceeded the consensus forecast. The year went with few policy errors, despite the gradual weakening of the yuan against the US dollar. On the ground, confidence was visibly stronger although the economy remained dual-tracked – broadly, the slow track 'old economy' and the fast-track 'new economy'. Importantly for sentiment, the 'old economy' continued to stabilise and find a base – notably, the listed banks managed to maintain earnings, and paid handsome dividends. Industry restructuring to manage excess capacity progressed apace, such as in the telecommunications and cement sectors. Government infrastructure spending kept its focus on useful areas such as urban rail transit. President Xi Jinping displayed a good grip on power which bodes well for pushing through reforms in 2017 and beyond. We expect the positive dynamics to cycle into the coming year to help hold confidence intact for the equity market.

Faster regional integration

China continued to step on its 'One Belt, One Road' initiative to serve up a leadership role in fostering regional integration. If the Trans-Pacific Partnership (TPP) is not ratified by the US as Trump has vowed, we expect the China-led Regional Comprehensive Economic Partnership (RCEP) free trade proposal, involving 16 nations in the Asia Pacific, to take on more importance in 2017.

President Duterte's approach towards China is reflective of the lure of market access and financial aid, signalling the increasing recognition that China can be a better partner and a lesser threat if managed well. Even with Taiwan, President Tsai has been careful not to upset China (except for her telephone call to congratulate Trump). Without the noise of cross-straits tensions, the Taiwan equity market staged a smooth rally in 2016, on the back of strong tech and financial sector performances. The risk for 2017 will be how Tsai may choose to play the 'Trump' card, albeit her approach hitherto has been to maintain the cross-straits status quo.

Strong performing sectors

2016 saw strong performances from the commodities and technology sectors, anchoring market performances in Australia, Taiwan, South Korea and Thailand. Our preference entering 2017 is for oil over metals, as OPEC discipline should work its way into the supply-demand balance.

Banking stocks rebounded well towards the close of 2016 on the back of a recovery in sovereign bond yields as this should help with their net interest margins. Valuations in the sector remain reasonable at the close of 2016, and our preference is for large cap stocks that offer good dividend yields, found mostly in Australia, Singapore, China and Thailand.

On metals, we prefer a 'wait-and-see' approach to assess the impact of Trump fiscal spending, given the related bullish expectations that had already taken the sector up since his victory. For exposure to the sector, we prefer Australian stocks with ongoing cost reduction initiatives to help drive cash flow.

The technology sectors in Taiwan and South Korea benefitted from a strong iPhone 7 launch in 2016. Some mid-cap iPhone supply chain plays have corrected in Q4, 2016 as the excitement of the launch subsided, presenting the opportunity for their rebound into 2017 as we cycle closer towards the iPhone 8 launch in September. Valuations of large caps such as TSMC and Samsung Electronics are also by no means expensive, despite a steady climb through the year.

The eCommerce and online sector remained vibrant in 2016, especially in China where heavyweight players such as Alibaba and Tencent have built formidable ecosystems to extend their reach into the economy. The Q4, 2016 correction in the sector has opened up buying opportunities among those with well-anchored growth.

Banking stocks rebounded well towards the close of 2016 on the back of a recovery in sovereign bond yields, which should help with their net interest margins. Valuations in the sector remain reasonable at the close of 2016, and our preference is for large cap stocks that offer good dividend yields, found mostly in Australia, Singapore, China and Thailand.

What about India?

A badly implemented decision to withdraw circulation of 500 and 1000 rupee notes left the Modi administration with a large credibility gap. The ensuing shortage of cash will weigh on economic data as we enter 2017. Implementation of the GST regime will be another critical test; yet meeting the April 1st deadline is looking increasingly bleak with the Center and the States unable to agree on the sharing of administrative powers. The proposed 4-tier rate structure will also add much implementation complexity. We foresee further confidence erosion and downside risk to Indian equities, especially with many fund managers still holding overweight positions at the close of 2016.

Still a fertile field

Over the last few years of adjusting to slower growth, we have seen divergences in performances among sectors and stocks in the Asian equities region. The net outcome is lacklustre index performances which masked strong performances in many innovative, well-adapted companies. We expect the same fertile stock-picking field in 2017, boding well for our active, high tracking error approach to portfolio construction. With the foundations for sustainable growth stronger than before, we also believe Asian equities hold scope for re-rating in the coming year.


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SO LONG, BOND BULL MARKET

Key drivers shaping bond markets have changed. Keeping a global perspective and knowing which macro signals to watch for can help you prepare for changes in bond yields.

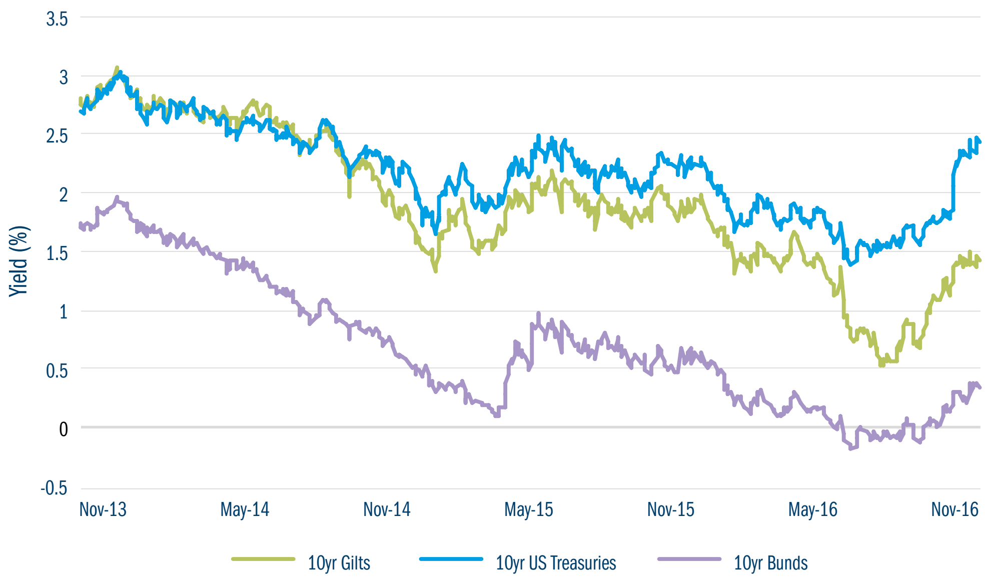
Jim Cielinski,
Global Head of Fixed Income

During an unprecedented period of political change across the globe, from the UK referendum on EU membership to the election of Donald Trump and the Italian Referendum, 2016 was a year where the key drivers shaping markets irrevocably changed.

It was a year of two halves. The bond rally in the beginning of the year was bigger than expected, with deflationary pulses continuing to hit the market, reminding investors that geo-political risk was alive and well. This led to an impressive rally where, capped off by Brexit, ten-year gilt yields rallied from 2% at the beginning of the year to nearly 0.5% in July, before moving back to 1.5% at year-end.

In hindsight, the extra dose of post-Brexit quantitative easing looks increasingly like the last hurrah for monetary policy. The odds are high that the sell-off in the latter half of the year was an inflection point that marked the end of the long-running bull market in bonds, triggered by a combination of extreme over-valuations colliding with the expectation that the rules going forward will be different.

10-year core government bond yields



Source: Bloomberg 2016

In our view, the bond-bubble was likely to burst, not because of a sudden acceleration in growth or inflation, but because a change in policy would change the rules and shatter the complacency. The world is slowly adjusting to the idea that monetary policy will transition to stimulative fiscal policy. Trump's victory appeared an unlikely place for this trend to start, but it has set down a marker that will be difficult to contain.

The disenfranchised middle-class has voted – negative rates and quantitative easing are inadequate ways of raising their living standards. They want a new rule book. And if the current political establishment is unwilling to rewrite the rules, they will soon be voted out of office in favour of someone who will. For some time, markets have become accustomed to thinking that any disappointing data on growth and inflation would be met by lower rates or quantitative easing.

But these tools have been increasingly used as last-ditch efforts to spark economic growth. As we reach the end-game for monetary policy, there is now an acknowledgement that central banks soaking up a dwindling supply of bonds has a number of detrimental side effects. More spending and tax cuts appear to be the way forward, yet fiscal stimulus is inflationary. This would be negative for bonds in a normal environment. Coming from a bubble-like starting point, it's even more ominous.

With the collapse of long-dated interest rates in mid-2016, bond markets had been pricing in little inflation risk for at least the next decade. But with the rule change we expect, term premia is likely to normalise and the idea that investors should price-in permanent disinflation will fade into obscurity. In that environment, a continued sell-off in bonds is likely.

> The bond bubble is bursting. How spectacular will it be? That remains to be seen, as there are many deflationary forces still bubbling just beneath the surface.

If all of Trump's agenda becomes law, the bear market will have much further to run.

With this in mind, we believe investors should look out for three key signals that might tell us just how far bond yields might rise.

One: Inflation expectations

If fiscal stimulus becomes the policy lever of choice, we would expect an inflationary reaction. 'Fiscal' means more spending, which should boost growth as well as increasing deficits. Growth and inflation, if combined with deregulation (which we expect with a Trump presidency), spurs corporates to spend more and that can create a virtuous circle that's very bond-negative. But inflationary expectations are also a function of wage pressures and trade protectionism. We're at close to full employment in the US, and wage gains could start to push higher given that labour markets are tight and a high number of people that have left the workforce are not coming back. Wage pressures, along with fiscal stimulus and a more protectionist agenda (which is itself inflationary through trade tariffs and immigration), will see inflation expectations continue to rise from what are still depressed levels.

Two: China

China should be watched very closely. Long-dated global rates reflect a decade-long series of capital outflows from China. The central bank has purchased hundreds of billions of foreign bonds. This bond-buying programme is a function of years of over-investment in plants and equipment, which itself led to over-production and excess capacity. China's capital outflows put immense downward pressure on global real rates and term premia.

China's economy has been slowing. A savings glut, sluggish business investment and worries over potential devaluation in the yuan have all provided the impetus to move money offshore. But if the Chinese economy were to merely stabilise, it would provide yet another catalyst for bonds to sell off. A surprise reacceleration in China would force foreign flows to rapidly recede, leaving global government bonds without a key source of demand. Somewhat worrying is that there are some signs that this is happening, just as Donald Trump is set to enact some of his policy proposals, though this is something of a coincidence.

Three: Europe and geo-politics

What happens in Europe, from a geo-political point of view, will be critical. In 2016, we have already seen the UK vote to leave the EU and the electorate reject the Italian prime minister Matteo Renzi's referendum proposal. In 2017 we have elections in France and Germany, not to mention Article 50 being invoked.

A continued political shift to the right would imply that more populist policies will continue to be enacted. There are limits in Europe as to the scale of any tax cuts and increases in spending that can be delivered, because fiscal policy is limited by the Maastricht Treaty, which caps member state government deficits to 3% of GDP (and

> If fiscal stimulus becomes the policy lever of choice, we would expect an inflationary reaction.

public debt levels to 60%). However, if populist parties who claim they will breach these rules are elected, this raises the risks surrounding the eurozone project. Ironically, in Europe, this is a recipe for higher rates overall, rather than lower rates.

Conclusion

The bond bubble is bursting. How spectacular will the sell-off be? That remains to be seen, as there are many deflationary forces still bubbling just beneath the surface, and a plethora of policy uncertainties. Trump will almost certainly succeed in getting tax cuts through and a scaled down version of his defence and infrastructure spending package passed. China is stabilising and with it comes less of a reliance on their easy monetary policy. Capital outflows will likely diminish as the yuan reprices and the powerful force of central bank buying – either through investment or QE channels – will recede. With respect to Europe, it is very difficult to forecast, but it would be wrong to extrapolate what happened in the UK with Brexit (as well as the election of Donald Trump and the Italian referendum). Nonetheless, the previously unthinkable is now possible.

We believe inflation expectations will continue to rise from what are still depressed levels. The US economy is near-full employment. Wage inflation coupled with even modest protectionism and the prolonged recovery should create elevated inflation expectations.

We envisage policy rates staying lower for some time in Europe as there is still enough uncertainty – not just geo-political risk, but also concerns over the strength of some economies in the region – for central banks to continue with a 'lower for longer' policy. Rate rises are also unlikely in Japan, which leaves the US as something of a focal point. On the back of increasing wage pressures and fiscal spend, we expect rate hikes in 2017 to follow the December Fed hike. The tide has turned.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Currencies face an uncertain 2017

How policy makers react to high debt levels and the possibility of significant political change will determine whether the FX environment is benign or not.

Matthew Cobon,
Head of Government and FX

As we start 2017, numerous unresolved issues threaten to disrupt global markets. The stark reality is that the world has the largest debt burden it has ever had as a percentage of GDP. A range of stimulus measures have failed to generate the level of growth and inflation we need to reduce this burden. We are a long way into this cycle of stimulus and the question is: what next?

Seismic political changes are adding to the fundamental uncertainty that the world faces at the start of 2017. The new US administration has promised to embrace protectionism, while deploying fiscal policy in a bid to stimulate the economy. However, the exact nature of the new government's policies and how much will pass through Congress is still unknown.

The market expects the impact of the new US administration to be significant. It has repriced rates and currency, with the dollar getting stronger. Thus far, there has been little clarity as to whether Donald Trump's avowed protectionism was election rhetoric, or whether it will translate into hard policy reality.

The stark reality is that the world has the largest debt burden it has ever had as a percentage of GDP. A range of stimulus measures have failed to generate the level of growth and inflation we need to reduce this burden.

In fact, well before Trump's election, global trade was slowing down anyway. The structural forces driving global trade are probably worsening rather than getting better. Those cyclical uncertainties, coupled with unanswered structural questions, create an interesting potential mix of outcomes for investors.

Avoiding a crisis

While the US dollar strengthened in the wake of the US election, the strength came about as investors revised both their US growth and inflation expectations higher. At the same time, unfunded dollar liabilities – the net sum owed to the United States by other countries – stand at a weighty $10 trillion. At some point, this could become a big issue for markets. Those dollar liabilities, coupled with how the Trump dynamic plays out in markets, could help determine the shape and feel of 2017.

Governments worldwide must strike a difficult balance. They must ensure inflation rises sufficiently to start devaluing some debt, but not so much that it destabilises markets and causes them to implode.

As if the US election and ongoing debt issues weren't enough, we must add another factor to the equation: the rise in populism and what this could mean for Europe in 2017. Populism triumphed in two elections in 2016; we must factor in a relatively high possibility that more is to come. There is a possibility that the European Union project will be disrupted in 2017. Clearly, that would have ramifications for the euro.

The year ahead

Sterling has already been significantly repriced because of Brexit. It's probably not enough. My forecast is for a lower sterling over the course of 2017. I expect the dollar to stay strong in 2017. After the Chinese renminbi fell to a six-year low in 2016, I anticipate that the currency will continue to depreciate in 2017. Other currencies face similar challenges. Why? While debt levels have increased globally, the causes of this uptick vary.

Unfunded dollar liabilities – the net sum owed to the United States by other countries – stand at a weighty $10 trillion. At some point, this could become a big issue for markets.

Countries whose expansion has been driven by ever larger consumer balance sheets are vulnerable. Australia and New Zealand are examples of countries that have relatively low government debt ratios, but their private sector balance sheets are highly levered. A real estate-funded debt binge combined with a very poor productivity record has created problems for both economies. Should the focus shift to debt sustainability and away from reflation, these currencies will become vulnerable once more. Both countries could see a significant rebalancing in their currencies in 2017.

All outcomes are possible

While I expect the dollar to strengthen in 2017, a great deal of uncertainty remains. For one, the dollar does not start 2017 as a cheap currency. Most measures suggest it is moderately overvalued. We believe the next phase in the dollar's evolution will see it further overshoot fair value, but there is always a risk of violent pullbacks.

The global economy's elastic is stretched on many metrics as we enter 2017. Animal spirits are high for a fiscally-inspired extension of the eight-year-old bull market in risk. How rates and currencies adjust will be critical in defining the overall macro-economic landscape. It is imperative that real rates remain low to underpin the highly-levered global economy.

Markets enter 2017 pricing in a lot of hope and expectation. Reality could taste quite differently.

Should policymakers succeed in this, then the focus will likely remain one of reflation. Failure, however, to generate the required nominal growth leaves foreign exchange markets vulnerable to rapid re-pricings. Markets enter 2017 pricing in a lot of hope and expectation. Reality could taste quite differently.

European credit depends on the QE drip

European companies are expected to remain in reasonably sound financial health going forward. A material widening in credit spreads as result of a potential reduction in central bank purchasing is not, therefore, considered to be that likely.

Jonathan Pitkanen,
Head of Investment Grade Research

Policy support including the provision of low and negative interest rates and quantitative easing (QE) has been a major prop for investment grade corporate bonds in the last few years. This has been evidenced by tightening credit spreads in general and the creation of a skew between those issuers eligible for central bank purchase and those not.

As we enter 2017, the possibility of the ending or reduction of some of this support raises its head more from a QE perspective than any likelihood of rising interest rates. Inflation in Europe is still well below the targeted level.

When QE does end, any spread widening should be reasonably limited, at least what is warranted from a bottom-up fundamental perspective, as we see corporate health being in reasonably good shape going forward.

Corporates are in reasonably good health, despite the anaemic appearance of results over the last year, with sales growth relatively flat, and even declining in some sectors.

Demand for corporate bonds will remain

A key difference between QE being used for government or corporate bonds is that the corporate bond market is a much shallower and narrower market. Consequently, the impact has been larger and has left fewer bonds available for the general market to buy. This has left many of the corporate bond market's traditional investors looking for new asset classes where they can pick up yield without taking on significant additional risk. In particular, insurance companies with long-term liabilities are looking to match them with higher-yielding long-term assets. They are looking increasingly at alternative asset classes such as private placements, loans, infrastructure funding and direct investments. The problem is that these asset classes are small compared to the corporate bond market. It is hard for investors to transfer a material amount of their assets into these markets, which means that they remain captive in the corporate bond market, thus providing on-going support for spreads.

At the same time, investors that would have historically invested in government bonds are entering the investment grade corporate bond market. With ultra-low yields in the government bond market, and bank deposits attracting negative interest rates, investors remain attracted to the investment grade corporate bond market as it is still offering a positive yield.

Corporate issuers will remain in reasonable health – though there are risks

The key credit ratios that our investment analyst team considers are free cash flow, leverage and interest cover. Over the last couple of years, leverage has increased somewhat but we forecast that it will plateau and even decline marginally in the coming years. By the same token, we expect an improvement in the profit margins for both UK and European companies. Notably, interest cover has been strong and stable, despite increasing leverage.

> New investors that would have historically invested in government bonds are entering the investment grade corporate bond market. With yields even tighter in the government bond market, and bank deposits attracting negative interest rates, investors are attracted to the investment grade corporate bond market as it is still offering a positive yield.

The cost of borrowing has fallen to the extent that companies have easily been able to service their debts. The companies that we analyse will generate enough earnings to cover interest costs by on average a comfortable 11 times.

From a sector perspective, the ‘sick man’ of the UK and European corporate grade universe was the mining sector. Faced with declining commodity prices and heightened leverage, it has endured a couple of very challenging years but through self-help produced an improvement last year. There was a material cut back in capital expenditure and the cancellation of dividends. Since then, balance sheets have been repaired, supported by a slight uptick in commodity prices. For example, Glencore has announced that it will pay a US$1 billion dividend next year and pay out 25% of profits after that.

A major current source of uncertainty is the Italian banking crisis. If it is not resolved, it risks dragging down peripheral European corporate bond markets as well as some core markets. This would start with the banks and insurers, extend to Spanish and Portuguese corporates, and then even German financials and corporates.

Geographically, the UK's position stands out from the rest of Europe because it has the additional uncertainty of Brexit on the horizon.

Outlook

After a thorough bottom-up appraisal of the issuers that make up the European investment grade universe, we conclude that the outlook is sufficiently robust to offset the structural risk that reducing policy support affords.

Though the risks of a changing policy outlook will doubtless provide challenges in the coming year, fundamental demand for income and corporate bonds from elsewhere and mostly supportive credit metrics will mitigate most of this risk.


ASSEMBLEE NATIONALE

Political risks will dominate credit markets in 2017

Considering the looming political events and the fact that government bond yields have room to rise, credit faces some headwinds in 2017.

Alasdair Ross,
Head of Investment Grade, EMEA

Populist politics will be a big theme for corporate credit markets in 2017. At a time when electorates have been rejecting the status quo, there are elections in the Netherlands, France and Germany. There are also questions surrounding the shape and impact of the Brexit negotiations, and potentially whether President Trump follows up on his rhetoric and increases protectionism at the expense of free trade.

The likelihood is that the outcome in each of these areas will be fine. Marine Le Pen will probably not win the French presidential elections; Angela Merkel will probably win again in Germany. And it's unlikely that Trump will start a trade war. Furthermore, the market is concerned about all of these to differing degrees so, if we navigate each without a crisis, the market should respond well. However, politics is unpredictable, events can change popular opinion quickly, and at current spread levels the market is vulnerable to these multiple hurdles.

Populist politics will be a big theme for corporate credit markets in 2017. At a time when electorates have been rejecting the status quo, there are elections in the Netherlands, France and Germany.

Rejecting the status quo

If parties are elected that are explicitly anti the EU or the euro, the next step could be further Brexit-type referendums. Could relatively young and untested European institutions deal with that kind of challenge? The UK has its own central bank and currency to take some of the strain. The eurozone, on the other hand, is a partially-formed thing lacking, for instance, centralised budgets, pooled debt issuance and fiscal transfers. As a result, political challenges can result in economic and financial stress such as when Syriza won Greece's 2015 election and rejected the IMF programme. Even though Greece is just a small part of Europe's GDP, this event plunged Greece into turmoil and reverberated throughout European credit markets. If, next time, the country in question is larger then there is a commensurately higher level of risk.

So, as we go into 2017 there are a few political risks out there. Additionally, the economic policy consensus seems to be moving away from fiscal austerity and loose monetary policy and towards fiscal stimulus and tax cuts, which will potentially result in a more inflationary environment. Central banks may have to end the extraordinarily loose policy which has benefitted many risk assets, including corporate credit.

At a micro level, corporate behaviour is becoming increasingly equity-friendly, which tends to strain balance sheets and is not good for credit. Dividend payout ratios and share buybacks are increasing. At the same time, companies are gearing up their balance sheets to undertake M&A. Various sizeable deals have been announced recently, for instance: AT&T buying Time Warner, BAT bidding for the equity in Reynolds it doesn't own and Fox bidding for the equity in Sky that it doesn't own. Throughout the last year we saw continual M&A announcements, many of which resulted, or will result, in more highly-leveraged balance sheets; for instance Bayer-Monsanto, AB InBev-SAB Miller, or Shell-BG Group. This activity is being undertaken with one eye on balance sheets and credit ratings, but nevertheless leverage is creeping up. We expect this theme to continue.

As ever, there are some possible positive events as well. If US corporate taxes are cut from 35% to 15%, as the Trump team has suggested, that will make using debt less attractive from a tax perspective. As a result, corporates might run with less debt in their capital structures. Trump has also flagged a tax amnesty to allow US companies to repatriate overseas cash, which would result in a lower supply of new corporate bonds. This outcome would be helpful to corporate credit.

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Implications for returns

When all these significant possible political changes are taken together, we see the balance of risks to be on the downside. Following the tightening of corporate credit spread levels in 2016, the extra income earned from corporate credit compared to government bonds is at long-run averages. Investors are, therefore, compensated for some of these risks, but any one of them could end up derailing the market.

Putting all these factors together, we think it is a year to be close to home in terms of spread risk. Our overall credit risk has come down through 2016 as spread levels have tightened. We can always pick different issuers, companies and sectors that we like or dislike, but if there is a more positive macroeconomic scenario driven by reflation and fiscal stimulus, there are probably better places to invest from a risk-adjusted perspective. Examples would include leveraged credit or equities.

How will the market perform? Total returns for investment grade are made up of government bond returns and then the excess return generated from the credit spread. In 2016, global corporate investment grade credit had returned 4.7% at the time of writing in late December. Of this, 1.1% came from the return on government bonds, with the balance coming mainly from the capital gain (+2.0%) associated with holding investment grade bonds as spreads have tightened, and the remainder as the income from the credit spread (+1.6%).

Going into 2017, spreads are lower than they were at the start of 2016. We consider it difficult for spreads to tighten much further. Furthermore, on the government bond side, very loose policy has resulted in bond yields being substantially above their long-term average, even after the correction following Trump's election. If there is any normalisation in government bond yields, that will negatively impact the total return for investment grade credit as well.

On balance, we think investment grade credit returns will be positive, but lower than in 2016. But given the looming political issues, and the fact that government bond yields have room to rise much higher, the asset class faces some headwinds in 2017.

Asian fixed income: can Asian buyers conquer all?

The investment environment for the Asian fixed income market couldn't be any more exciting than it was in 2016.

Clifford Lau,
Head of Fixed Income Asia

At one point last year, the Asian bond market returned as much 14-15% as rates raced to the bottom, credit spreads tightened and Asia FX rallied against the dollar. But it fell back to high single digits after broader interest rates sold off in the last quarter, following the surprise US election result which raised global inflation expectations.

While there has been much speculation, nothing has been delivered yet. Nevertheless our hypersensitive financial markets have already priced in positive outcomes (equity rallying) and negative outcomes (bonds selling off). The Asian local currencies market was hardest hit, driven by interest rates in Asia falling to an all time low, strong foreign investor flows and rich Asian FX valuations against the dollar. Adding fuel to the fire was the fact that protectionist policies generally would be bad for Asian growth given the region's high dependency on export trades.

The resiliency of Asian credit spreads is not without good reason, as Asian fundamentals definitely rank as the most stable and predictable (China included).

However, Asian economies have experienced many volatile periods historically, (including the Asian financial crisis in 1997) in part due to them prioritising policies such as shoring up their FX reserves and developing their onshore capital markets. Regardless, if a reversal to the mean is correct for medium-term repositioning, the market correction journey has probably just started.

Local markets which demand special focus are Korea, Malaysia, Thailand, and Singapore. Asian dollar credit spreads were as resilient as ever throughout last year's market challenges. The resiliency of Asian credit spreads is not without good reason, as Asian fundamentals definitely rank as the most stable and predictable (China included). Asian spreads still appear reasonable from within and continue to look cheap in a global context (the Asian spread premium is 50bps cheaper than the US, for example), suggesting opportunities to increase investment in Asian dollar credits remain.

Of course, China is the big driver of Asian growth in the bond market, as it is a major supplier of issuance and demand (from Chinese offshore investors). Indeed 2016 was a landmark year in terms of the amount of new issues and their diversity. Next year, if it is to keep optimism afloat China needs to step up its 'self-help' infrastructure spending and battle the property market slowdown and overcapacity, while also deleveraging.

Of course, China is the big driver of Asian growth in the bond market, as it is a major supplier of issuance and demand (from Chinese offshore investors).

As 2017 is likely to be another year of uncertainty, where bond yields might pick up further, the strong demand from Asian buyers that we have seen in recent years (due to optimism towards the region) should not be taken for granted, and investors need to choose carefully. Outside of China, we shall seek further diversification based on the diverging economic performance of different Asian countries against a backdrop of changing macro-economic policy.

Last but not least, higher risk-free rates make Asian investment grade increasingly attractive against high yield, so the deepening depth of Asian buyers would perhaps benefit the investment grade market more than high yield. As a matter of fact, if the taper tantrum was anything to worry about, the vulnerability of the high yield market will be exacerbated if short-term rates continue to climb. We therefore are particularly clear in our mind about what Asian high yield names we are investing in.

Asian spreads still appear reasonable from within and continue to look cheap in a global context, suggesting opportunities to increase investment in Asian dollar credits remain.

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Navigating market volatility with diversification as the cornerstone

A well-diversified portfolio has been a time-tested strategy that helps investors manage risks in a volatile market. But as we prepare for the future, it's important to remain alert and focused.

Jeff Knight,
Global Head of Investment Solutions, Co-Head of Global Asset Allocation

There have only been four years since 1970 when a diversified portfolio has had a negative return, the most recent of which was in 2015 – but it was short-lived. Time and time again, diversification has proven its benefit to investors concerned with the never-ending trade-off between risk and return. The thinking behind this strategy is well known across the industry. Because some investments surge as others struggle, diversification can balance the risks of a portfolio and improve its efficiency.

Balancing risks is not something to be taken lightly; losses require a substantial gain to bring a portfolio back to its original value. And when losses grow larger, the gain necessary to get them back to their starting point becomes even harder to achieve. For example, if a portfolio loses half of its capital, an investor needs a 100% return on what's left to replace what they've lost.

Portfolio Return (%)	Gain Required to Break Even (%)
-5	5
-10	11
-20	25
-30	43
-40	67
-50	100

It's really just mathematics, but when you think about it in terms of an investor who's trying to reach a long-term goal, that maths can be very consequential and even leave a lasting impact. In general, the higher a portfolio's expected return relative to its volatility, the more effective it can be at navigating a roundtrip of portfolio losses and gains.

Markets tangled up with monetary policy

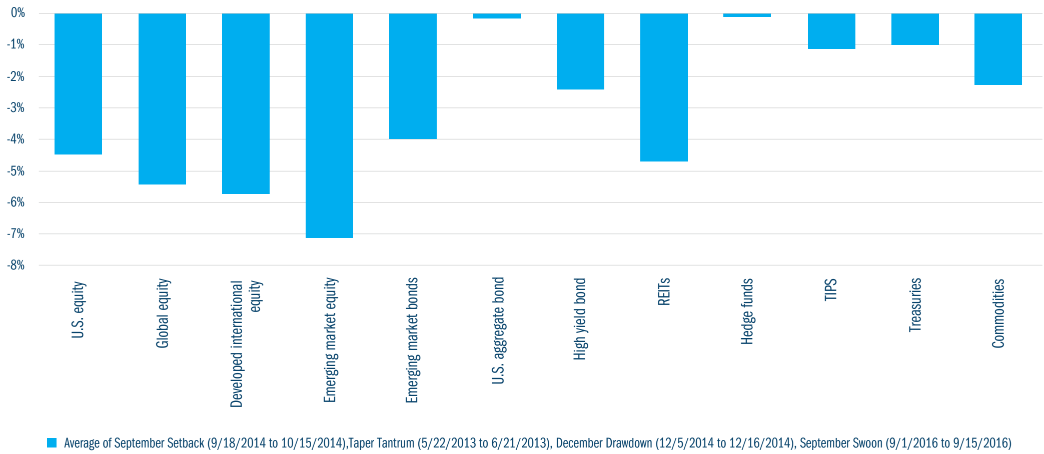
The struggle to make up lost ground has become especially worrisome as of late. A pattern has emerged: during periods of significant and acute market stress, all assets move down together at an increasing degree. And it isn't difficult to identify the reason for this correlation. The monetary policy adopted around the world at the end of the 2008 financial crisis was designed to help all assets. The combination of low interest rates and quantitative easing has created a rally in nearly every major asset class. While this has been generally positive for most markets, the flipside is that once monetary policy changes, it's probable that there will be an opposite (and therefore negative) effect across these same asset classes. Of course, monetary policy is bound to stabilise at some point. Central banks rightly regard their current positions as a response to the unique circumstances brought on by the financial crisis. But as more time passes, it's increasingly difficult to see these measures as appropriate – after all, the financial crisis ceased to be an outright emergency quite some time ago. The benefit of the policies to the real world – outside the financial markets – has been difficult to comprehend.

The recent US election could likely be a swift catalyst for the normalisation of monetary policy, and with the increased likelihood of fiscal policy expansion, the Federal Reserve has more room to normalise rates faster than they may have otherwise. It's reasonable to expect that policy change could be upon us in the future.

The market tantrum risk management challenge

These patterns of market stress have been seen in four separate episodes in the past four years. On each occasion, there was a simultaneous decline across multiple asset classes when monetary policy changed, or in some cases when there was a hint at a change. The impact was significant with, on average, all equity asset classes losing 4% or more. Even fixed-income and alternatives experienced negative returns.

Asset class performance during tantrums



Source: Columbia Threadneedle Investments, December 2016.

Let's take a look at the events of 9 September 2016. Over the preceding 40 days, the markets had been stable, with the S&P 500 Index barely moving by more than a full percentage point, up or down, in a single day. But on 9 September, the S&P 500 Index fell by almost 2.5%. At the same time, the yield on the 10-year Treasury bond benchmark rose from 1.60% to 1.68%, driving bond prices down. Commodities fell by several percentage points and Real Estate Investment Trusts (REITs) also lost ground, as did several other asset classes. The trigger for 9 September was not an actual change in monetary policy – it was merely the suggestion that there may be a change in monetary policy. The entire event highlighted just how tantrum-happy markets have become.

Planning for what's possible

Investors need to have a plan in place that alters their risks at the prospect of a tantrum. There are several things to look out for, the first of which may already be happening. If fixed income falls below a fair value range, the role bonds play in a portfolio changes. When things went poorly in the past, advisers could rely on bonds to stabilise portfolios. But when they're already priced for unfortunate scenarios, they lose their potency as risk diversifiers. This dynamic leaves investors at a crossroads, forcing them to either shrink their assets that have sensitivity to interest rates or diversify in a different way.

For instance, they can choose to include finding holdings that are less correlated to other holdings, such as precious metals or alternative investments. Diversifying differently can also mean treating diversification as a dynamic process – loosening the ranges that have historically limited the percentage of a portfolio that could be invested in a particular asset class. Another catalyst to look out for is one that would cause a tightening in monetary policy, such as stronger than expected macroeconomic data or hints from the Fed or global central banks that monetary policy might be changing or normalising. We've been in an environment of gridlock for the past four to six years, and now changes to monetary, tax and fiscal policy might increasingly come into play.

Diversification remains one of the best options for investors and it's certainly the best route to take for anyone trying to navigate the roundtrip of market volatility across losses and gains.

A continued commitment to diversification

Diversification remains one of the best options for investors and it's certainly the best route to take for anyone trying to navigate the roundtrip of market volatility across losses and gains. But at a time of positive correlations between so many asset classes on volatile days, even well-diversified investors will need to avoid complacency in the period that lies ahead.

Will 2017 herald a commodity bull market?

After commodity prices bottomed in early 2016, demand is outstripping supply once again, suggesting the next bull market may be approaching.

David Donora,
Head of Commodities

2016 was the year when the commodities bear market ended. It capitulated in January when crude oil fell below $30 a barrel and a number of commodity-producing companies in the energy and metals sectors were in a battle for survival, selling off assets and desperately restructuring their balance sheets.

As commodity prices fell below the cost of production, these companies were losing money at a rapid rate. If oil stayed below $40, then 20% of global capacity would have gone out of business. Similarly, major mining companies Glencore and Anglo American were forced to liquidate significant parts of their overall businesses to reduce debt and to shore up their balance sheets.

The market recognised that prices were unsustainably low and there was a small bounceback. As we enter January 2017, prices are rising further. This is because, although prices fell in 2015 and the beginning of 2016, demand for commodities continued to increase; not at an extremely strong rate but fairly consistently. And so the requirement for increased production over the medium term remained.

> The question for 2017 is whether the market bounces along the bottom or prices increase significantly. My view for 2017 is that we will have significantly higher prices.

The Bloomberg Commodities Index rose 11.8% in 2016. That does not signal a bull market. In my view, a commodity bull market is when we experience a doubling or tripling of commodity prices. In the bull market of 2000-2008, the index tripled in value. That was a full commodity bull market. 2016's rise is just bouncing along the bottom.

So, prices have risen, significantly in base metals and in energy. In oil, OPEC countries and a number of non-OPEC countries led by Russia have agreed to take 1.8m barrels per day of production off the market to reduce excess inventories more quickly than they would otherwise have been depleted.

Demand outstrips supply

The question for 2017 is whether the market bounces along the bottom or prices increase significantly. My view for 2017 is that we will have significantly higher prices for a number of reasons:

Firstly, the supply side is not in a position to respond to significant demand growth. While commodity producers have spent the last three years dealing with very low prices, focusing on balance sheet restructuring and saving cash, they have not brought on new projects. Also, in mining they have been 'high grading' (only producing the highest grade ore) to just stay cash-neutral or cash-positive.

Secondly, I expect there will be significant demand growth. Emerging markets demand will be greater than the market expects, especially in Asia. China has been going through economic restructuring for a number of years. We believe that it is coming through that and there will be stronger consumer-led demand from China and all Asian emerging markets.

Thirdly, we think that in the developed and emerging markets, consumers have enjoyed low food and energy prices for two years, and that has shored up their finances and now they are also receiving higher wages. So, we expect consumer demand for commodities to increase. For example, for two years the oil price has been around $50 rather than $110. That halving in the price of oil was worth $2 trillion per year to the benefit of consumers, at the expense of oil-producing companies and countries.

Longer term we are bullish about precious metals as well. Gold is likely in the short term to continue to be weak while bond yields are rising. Commodities, in general, are negatively correlated with bonds but gold at the moment is behaving more like a low-yield reserve currency and less like a commodity.

Fourthly, governments of both developed and emerging countries are signalling a shift in focus from monetary policy to fiscal policy and fiscal stimulus. They recognise that quantitative easing has not materially helped consumers and consider that fiscal stimulus is more likely to do so. We expect to see the US, Europe and Japan turning to fiscal stimulus, while China continues to deploy it. That will increase demand for commodities.

A widespread trend

The increase in demand is likely to be most acute in base metals. Copper, zinc, nickel and aluminium should benefit from a substantial increase in consumer demand for metals.

We think the growth rate for oil demand will continue to be strong in 2017. The return of supply discipline will keep the oil price on an upward trajectory. It is worth noting that there is very little spare capacity globally. If the OPEC agreement holds and 1.8 million barrels are taken off the table globally, that accounts for almost all surplus inventory, leaving the world vulnerable to a supply disruption. We have concerns about this given the security situation in the Middle East. The new US administration is unlikely to want to be the region's peacekeeper. And while the Russians have become more involved, it is not clear whether this will contribute to stability or not. It is likely that the boundaries drawn up in the Sykes-Picot Agreement 100 years ago will be redrawn.

Longer term we are bullish about precious metals as well. Gold is likely in the short term to continue to be weak while bond yields are rising. Commodities, in general, are negatively correlated with bonds but gold at the moment is behaving more like a low-yield reserve currency and less like a commodity. Gold will be weak when bond yields are going up and bond yields have some way to go. Once bond yields plateau we would expect to see gold strengthen again.

Turning to agricultural commodities, there have been two years of abundant harvests as the El Niño weather cycle's stable weather pattern has prevailed. But this has ended, so weather is likely to be more variable in growing regions and so crop yields are likely to fall. Our view is that despite having two great years to rebuild stocks, they are only adequate. If the next Northern Hemisphere harvest is compromised, we will see upward pressure on agricultural prices.

Start of the bull market?

Across the commodity markets as a whole, we expect 2017 to be another positive year. Inventories are tightening. Commodity curves are flattening, which supports prices and returns for investors. Producers are likely to have difficulty keeping up with demand over the next couple of years.

We have had the end of the bear market, after which there is normally a period of bouncing along the bottom. While this historically has persisted for two to five years, we think that a focus on improving the lot of consumers could bring this forward to 2017.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Brexit clouds the outlook for UK supermarkets

As sterling's post-Brexit depreciation threatens to make a tough, competitive environment even harder, the sector is in a stronger position to weather the storm.

Arabella Duckworth,
Senior Credit Analyst

When Tesco emerged victorious in October 2016 after a public battle with Unilever over the consumer group's attempt to impose a 10% price increase on some of its goods or face having its supplies cut off, the scene was set for the currency-related pressures supermarkets will face in 2017 and beyond. The sharp fall in the value of sterling since the Brexit vote will increase the cost of imported goods, and someone must absorb it. While Sainsbury's and Tesco kept the price of Unilever's Marmite spread unchanged with Asda cutting it, this raises concerns about how pricing policies will evolve over time.

While the full impact of Brexit's currency depreciation and any economic slowdown won't be felt until next year, and into 2018, the discussions with suppliers have clearly been going on and pose uncomfortable questions. Will Brexit cause a consumer slowdown in food? If prices of food and non-food go up will retailers pass them on to the customer? Who has the pricing power?

Just as 2016 was a tough year for supermarkets with operating margins declining, the expectation of stable to growing margins for 2017 will be hard to achieve. Last year, the 'big four' made significant price investments, particularly Morrisons and Tesco which benefited from reduced prices and improved its product lines/offering to grow volumes. When combined with a benign operating environment for the past 6-9 months, this has improved revenue growth and increased operating margins. The Brexit impact, however, is likely to reverse this trend and will be a long-term process.

> Competition is particularly intense in the UK given the growth potential of the discounters (Aldi and Lidl) whose combined market share is expected to rise from 10.8% to 14% by 2020.

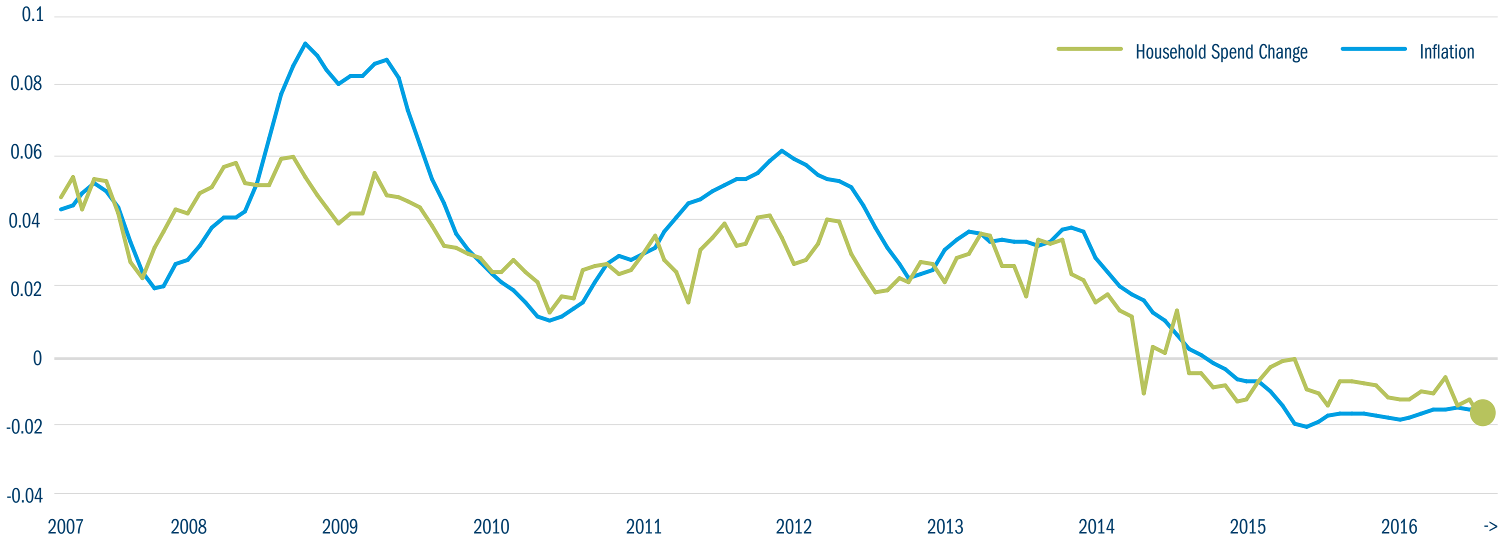
But not all areas will be affected equally. It is important to distinguish between food and general merchandise such as clothing. Food is likely to be less affected by Brexit, both because it is an essential item and because more of it is sourced from within the UK – 40% of food in the UK is imported according to Kantar. That said, the impact on food will come earlier as hedging contracts are shorter than for non-food players.

Fiercely competitive environment

The pressures of 2016 remain in 2017 with the added uncertainty of Asda's new strategy, what the discounters may do and the likely pressures of Brexit. A supermarket price war started in 2014 and deflation ran at -1/-1.5% annualised in 2016, as the 'big four' tried to close the gap with the discounters by cutting prices. Since 2012, Asda has lost 2.3% of market share and its US parent, Walmart, has hinted that investing in price is likely at the expense of higher margins (c.6% EBIT margins significantly higher than its peers). Similarly, the discounters are unlikely to allow for further slower growth and may choose to cut prices further.

Add in the pressures of Brexit and the outlook appears difficult. The chart below shows that in inflationary periods there is a trend of consumers trading down and it is difficult to see why Brexit would prove to be otherwise. That said, a bit of inflation is no bad thing and in times of austerity food should perform better than non-food. Getting the offering and pricing right will be key.

Consumer response to inflation



Source: Kantar 2016

Competition is particularly intense in the UK given the growth potential of the discounters (Aldi and Lidl) whose combined market share is expected to rise from 10.8% to 14% by 2020, according to Kantar. Whereas in other markets, such as Germany or France, value-oriented independents have a large proportion of the market – c.45% for France (Leclerc, Intermarche & System U) and c.60% for Germany (Edeka, Rewe, Schwarz) – in the UK, the 'big four' represent 70.9% of the market. Obviously market share must be taken from somewhere and although Tesco and to a lesser extent Morrisons have benefited from Asda's weakness in the last year and taken share from the discounters, we would expect the discounters to bite back.

Despite the challenging environment, credit spreads have performed well for the food names that we follow. They have introduced successful turnaround strategies, with innovation in private labels and a simpler product range leading to stronger volume growth that has gradually offset price deflation.

Although margins have deteriorated as companies have invested in price, margin stabilisation is expected in 2017, but the second half will be tough given the cost inflation impact from Brexit. Indeed, only Tesco gives EBIT margin guidance at 3.5%-4% by the end of 2019, in contrast to Morrisons and Sainsbury's whose management teams remain cautious. This ties in with more conservative financial policies.

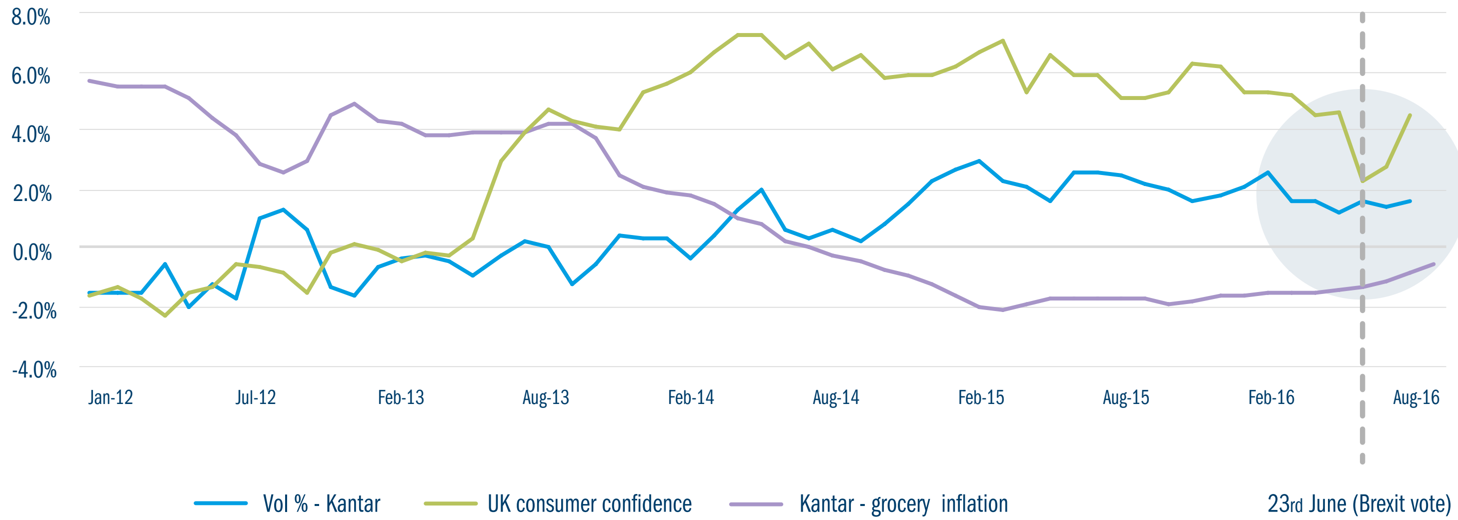
Morrisons is focused on the balance sheet, with net adjusted leverage of 2.4x expected for 2016/17 (3.2x 2015/16) following a peak of 3.4x in 2014/15. Arguably, leverage was previously too high in a sector that was and still remains challenged by competition but positively, it is trending lower except for Sainsbury's.

The supermarkets' share prices over 2016 (to the time of writing in late December) tell the story of which have done well. Morrisons has risen +50% and Tesco +40%, while Sainsbury's has fallen -4% and Marks & Spencer -22%. M&S has fallen furthest, largely due to its failure to turn the general merchandise segment around.

2017's winners and losers

Turning to 2017, I continue to expect the respective recoveries driven by stronger management teams in Morrisons and Tesco to continue to deliver volume growth. These will be the winners. Using Kantar data, retail sales volumes have remained firm as consumer confidence has picked up despite the Brexit vote on the 23rd June 2016 as you can see in the chart below.

UK retail sales volumes



Source: Kantar, BBG, Columbia Threadneedle Investments, 2016.

The implications of Brexit-related rising inflation means that the outlook has never been murkier. It is going to be tough. The impact will be greater on the clothing retailers than the food retailers because they source a much higher proportion of goods from outside the UK. Morrisons, for example, says it sources less than 30% from abroad and hedges for typically six months whereas the clothing retailers hedge foreign exchange 18 months in advance, and so the effect won't be felt until the end of 2017 and 2018. The clothing retailer, Next plc has already said that it will pass the costs through to the consumer, while M&S has said that it intends to keep prices stable for the time being and absorb the costs. The question, however, for the food retailers is whether they will be able to pass price rises through to the consumer?

The food retailers will try to limit inflation as much as they can in order to protect volumes, although a little inflation is no bad thing. What they absorb themselves will try to be largely offset by cost cutting and by having clearly-defined pricing tiers that show value for money. We also can't forget the discounters – privately-owned German companies which may choose to absorb any cost rises and to push through loyalty and targeted events, particularly at Christmas time. The discounters are also likely to be long-term winners. Not being listed companies means that they can seek to win long-term market share at the expense of short-term profit.

The effect on food retailers' margins remains the main risk given that they are already so low, with Morrisons' and Tesco's more than halving in the last five years. As an example, Morrisons' is currently at 2.1%, having come down from 5.5% in 2010. Before the Brexit vote, operating margins were expected to start to recover but now little margin improvement is expected and further cost savings will be required. There will have to be burden-sharing throughout supply chain, with the long-term result skewed to the negative.

The loser will continue to be Marks and Spencer, which has announced a large restructuring to turnaround the general merchandise business. This will take time to implement at a time when the stronger names get stronger and the food business, which until recently was outperforming, could come under pressure as the 'big four' roll out their cheaper premium own-labels. Asda is also likely to continue to suffer until management introduces a turnaround strategy, which in any event will take 12-18 months to implement.

Weathering the storm

When the pressures of Brexit are felt, they are likely to put pressure on consumers' disposable incomes, although we don't expect a UK recession. The foundations of the UK economy remain relatively stable for now and, in the event of a slowdown, retailers will continue to maintain appropriate pricing policies to prevent significant margin pressure. Even so, the retailers that we cover have strong enough balance sheets to weather the storm, which is why we have a market weight in the sector.

What is more, the Tesco / Unilever spat over prices suggest that, when foreign exchange pressures do come through, pricing power will be in the hands of the retailers rather than the manufacturers. To my mind, it would be a buying opportunity if credit spreads widened and priced the risks mentioned above more appropriately.

Insurers balance investment against regulation

As insurers look forward to 2017, they must view different assets' investment prospects through the prism of Solvency II.

Eugene Dimitriou,
Head of Insurance Solutions

With the implementation of Solvency II in January 2016, this has been a big year for insurers in Europe. There has not been such fundamental change to the regulation of European insurance markets since Solvency I was enacted in 1973. The introduction of new laws on how insurance companies report their assets and liabilities and calculate the overall risk that they take, with particular asset classes being placed into different risk buckets, has changed the quantitative framework used by insurers themselves and for us as asset managers servicing their needs.

In this context, asset managers must choose whether to become immersed in the changes that insurance companies are going through or not. We have opted to invest in building up our insurance solutions capabilities with three key hires over the course of 2016. It is our belief that, in five years' time, an asset manager that does not understand insurers' specific needs will struggle to service them. Every insurer's balance sheet is different, as are their promises to policyholders, and so too are the investment constraints.

In a world where liquidity is decreasing and many other investors must factor this in as a risk, insurers are in the unusual position of having liabilities on their balance sheets which are illiquid.

Looking ahead, effectively managing regulatory constraints will, in many ways, be more important for insurers than generating excess returns. So asset managers must integrate a more compliance-focused approach into investment processes to serve them effectively.

The bedding down of new insurance regulations will continue to be important through 2017 and beyond. Even in the event of a hard Brexit or other political change, Solvency II is unlikely to fall away – although some of its more cumbersome features, such as the provisions on matching adjustment, could be softened in future. Ironically, Brexit may impact continental insurers more than their UK peers. The short- to medium-term uncertainty caused by the vote in June that led the Bank of England to lower policy rates, has had the knock-on effect of exacerbating 'lower for longer' expectations about fixed income yields. German, Norwegian and Swiss insurers are likely to be more affected than their UK counterparts due to substantial mismatches between asset and liability durations.

Asset allocation challenges

Insurance companies are meanwhile in the process of interpreting the regulations that have already come into effect. While most insurers have chosen to use the standard formula for calculating their solvency capital during the first year of Solvency II's implementation in 2016, some may wish to shift to the use of an internal model instead in future. This aspect of the regulation brings its own challenges, as even when following the standard model not every insurer uses the same set of calculations. The use of internal models brings an additional layer of complexity, although the implications for asset allocation are unlikely to vary widely as both approaches restrict investment strategy.

Achieving a higher return on capital in Solvency II's highly constrained environment is a major challenge. Some asset classes receive more favourable treatment than others under the framework. For example, the 25% capital charge on property assets is modest when compared to a roughly 49% charge on illiquid equities. In the UK, commercial property is yielding approximately 5%, making it a compelling investment when the capital charge is considered.

> The bedding down of new insurance regulations will continue to be important through 2017 and beyond. Even in the event of a hard Brexit or other political change, Solvency II is unlikely to fall away – although some of its more cumbersome features, such as the provisions on matching adjustment, could be softened in future.

Within fixed income, there are also substantial differences: securitisations are viewed more harshly than covered bonds, and short-dated credit receives better treatment than long-dated. As an asset manager servicing insurance clients, we sometimes discuss with specific trade ideas with them to double check compliance implications.

Capturing the illiquidity premium

Even given the regulatory constraints, specific asset classes offer interesting opportunities. In a world where liquidity is decreasing and many other investors must factor this in as a risk, insurers are in the unusual position of having liabilities on their balance sheets which are illiquid. This places them in a potentially advantageous position to exploit liquidity mismatches and capture the illiquidity premium offered on assets such as infrastructure debt and commercial real estate debt. But choosing the right assets is a challenge both for insurers and us a service provider, as some of these will evolve into bona fide niche asset classes while others will not.

In recent years, regulators have provided incentives to insurers to allocate more of their portfolios to infrastructure, as a way of meeting their obligation to invest responsibly. While on a theoretical level it is attractive for these long-term investors to allocate to such long-term assets, most of the assets that are presently available are currently financed via the public purse. Without a step-change in how governments fund these projects, the supply of investable projects will remain relatively small. Investors rightly expect a decent return for investing over the long term, but the degree of crowding that is taking place over a limited supply of assets has pushed down yields. While we expect more insurers to own infrastructure assets 20 years from now, today the asset class remains in its infancy.

2017's favoured investments

We favour US municipal bonds as a compelling proposition for European insurance companies. Capital charges on some US municipal bonds (munis) may be lower than those of similarly rated bonds, making them attractive from a returns-per-capital-charge perspective. Revenue-backed munis also represent a way of insurers accessing infrastructure as an asset class.

European insurers tend to underweight Asian fixed income and we think this is another segment with potential in an otherwise squeezed asset class. Asian creditors have been less affected by central bank quantitative easing than those in Europe, leading to the prospect of a better return profile from these debt investments.

Another opportunity for insurers interested in diversified growth funds is our Dynamic Real Return strategy which we believe to be attractive from both investment and regulatory capital perspectives. This strategy makes continual changes in strategic asset allocation, while also carrying some insurance-friendly features. As a 'long-only' strategy, insurers can benefit from clarity that the capital charges incurred are likely to be lower than for some other investment products.

Columbia Threadneedle Investments has partnered with three insurance companies globally to provide a fully outsourced model. These are long-term partnerships which require insight and flexibility on both sides as commercial, regulatory and capital pressures have direct implications on insurers' approaches to investments.

Generating income with a multi-asset approach

When it comes to generating income, most people think of bonds and little else, but they're not the only option. A range of income-generating assets may offer more yield and the time-tested benefits of diversification.

Anwiti Bahuguna,
Global Asset Allocation Team and Senior Portfolio Manager

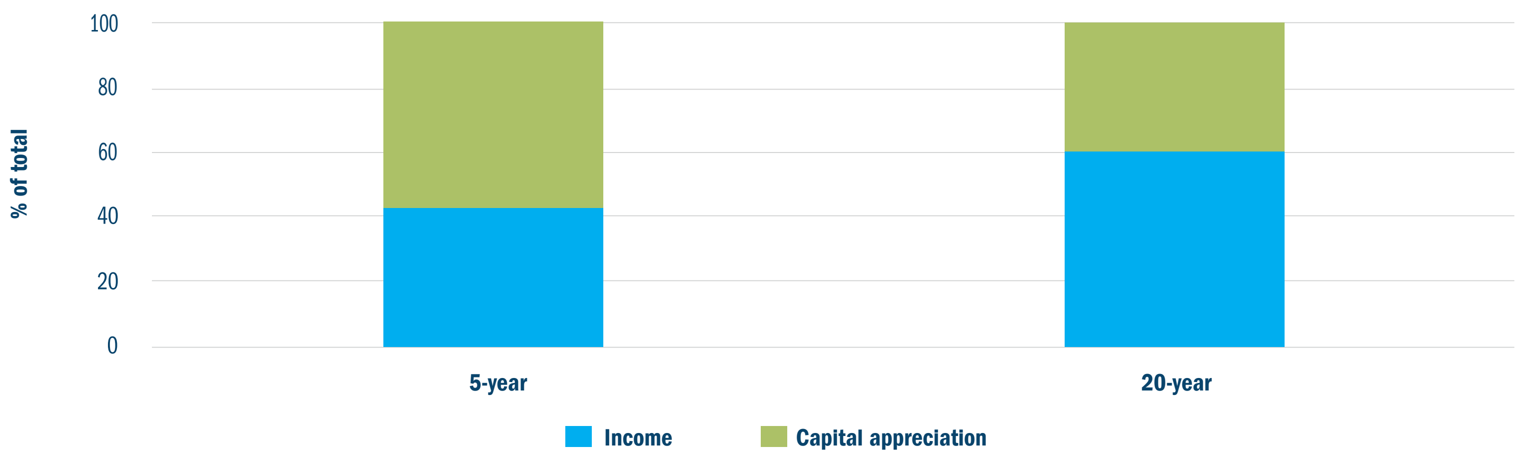
Financial advisers use income-generating investments for clients who are near or in retirement. Such investments represent a source of reliable income that retirees can count on. But reliable income isn't the only attractive feature of this strategy. Studies have shown that income can be an important driver of total returns for most asset classes – not just bonds. While bonds are a traditional source of income, they can be risky and overvalued at times, underscoring the potential benefit of a multi-asset approach that includes stocks.

Income drives investment returns

It may come as a surprise to some, but income is a significant component of equity returns. In the short term equity market, returns are driven by movement in stock prices, but a study by the Brandes Institute going back to the 1920s shows that over longer periods of time, dividends – the income-generating component of equities – can provide even greater returns than stock price appreciation. If fact, the study found that dividend income accounted for over 40% of the returns from equity over rolling five-year periods and more than 60% of returns over 20-year periods. A 20-year period is in line with many investors' retirement time horizons.

Diversification is as important for an income-generating strategy as it as for any other investment goal. A well-diversified multi-asset portfolio may generate more income for the risk taken compared to stocks or bonds alone. It's the result of thoughtfully combining asset classes with low correlation to each other. As many of us know, too much exposure to one part of the market can be dangerous.

US equity market returns: Income vs. capital appreciation



Source: Columbia Threadneedle Investments, December 2016.

Melda Mergen, Head of US Equities, often discusses that finding income in equity markets doesn't mean you need to focus solely on the sectors that tend to deliver higher dividends, such as consumer staples or utilities. As the Brandes study showed, income is an important component of equity returns across the entire stock market.

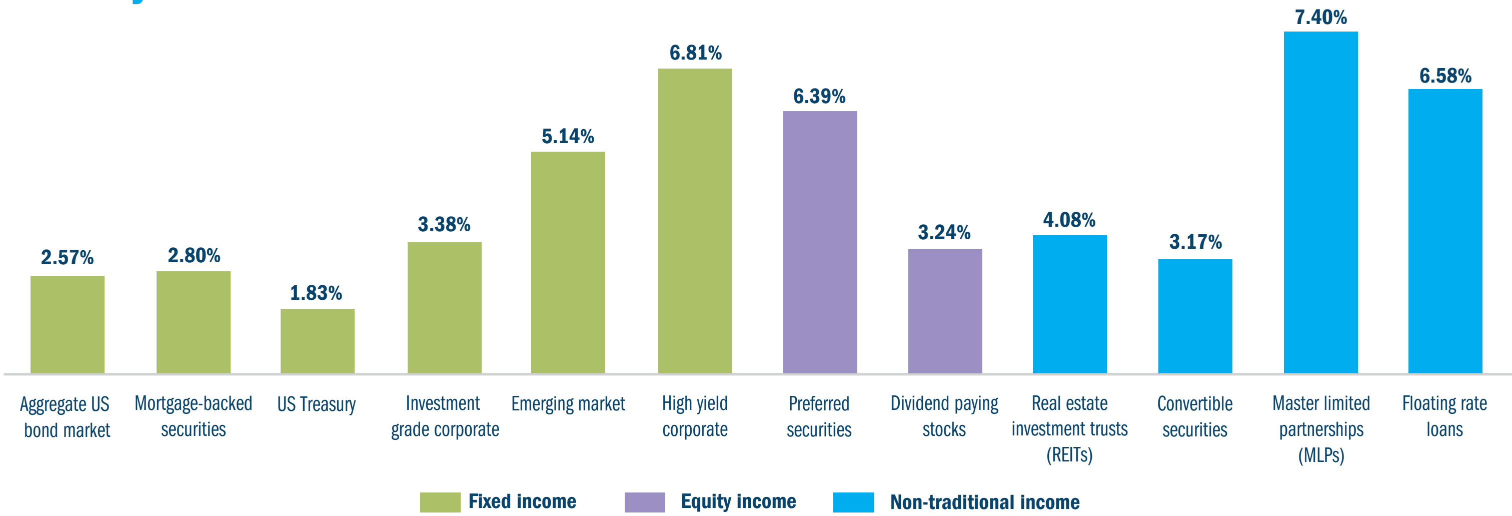
For fixed income, over a period as short as five years, well over 90% of the returns come from the coupon, which is the income component of bonds. Since this will primarily determine returns, the focus within fixed income tends to be on finding sectors that provide the best value.

Diversify your income sources

Diversification is as important for an income-generating strategy as it as for any other investment goal. A well-diversified multi-asset portfolio may generate more income for the risk taken compared to stocks or bonds alone. It's the result of thoughtfully combining asset classes with low correlation to each other. As many of us know, too much exposure to one part of the market can be dangerous.

Advisers often gravitate toward parts of the financial market that have an attractive yield component, even though these areas can contain significant underlying volatility. This is true within the fixed-income portion of a multi-asset income portfolio. As Colin Lundgren, Head of US Fixed Income says, "I worry that investors are stretching for yield at the wrong time. They're taking a risk in some of the lowest quality rungs of the corporate bond market, or investing in emerging market countries they can't point to on a map."

Current yield across asset classes



Source: Columbia Threadneedle Investments, December 2016.

It's critical to recognise the potential for volatility when it comes to a portfolio focused on single asset classes. A portfolio based around a multi-asset framework can achieve higher income and lower its overall volatility by holding bonds, equities and less traditional asset classes.

Tactical portfolio management

There are other, less conventional ways of eking out more income. One strategy is to invest in preferred and convertible securities, which over the long term may improve the performance of portfolios while potentially reducing the level of overall risk. Indeed, a well-structured multi-asset portfolio can access income from across the entire capital structure of a company's balance sheet.

> It may come as a surprise to some, but income is a significant component of equity returns.

Active management of an income portfolio is critical. Our preference is to be thoughtfully tactical so you're able to capitalise on compelling opportunities as and when they arise – for example, underweighting bonds when they appear overvalued and overweighting other assets in higher yielding parts of the market when they've reached a desired value.

A multi-asset approach that's tactically managed may give your clients access to a more secure, less volatile income stream.

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