The Multi-Asset team’s view on bonds, equities, commercial property and other assets will affect asset allocation over the coming months. When making these asset-allocation decisions, we first consider the outlook for each asset class (e.g. government bonds), followed by views within that market (e.g. the US versus Europe, or European core economies against peripheral countries). The views of individual asset class teams may differ to this multi-asset view.

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<thead>
<tr>
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<td>Euro high yield</td>
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<td>Yen</td>
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<td>Sterling</td>
<td>Neutral</td>
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Foreword

Markets are being dominated by the US/China trade war and fears about slowing global growth. In this month's Global Outlook, we discuss how investment teams across ASI are addressing these issues.

Our investment managers explain how the current environment can lead to a decrease in risk appetite on the part of investors, and increases the need for diversification. Strategists and economists describe how they monitor the effects of evolving geopolitical issues on financial markets. We also include an article on how the housing crisis, and policy makers’ responses, is affecting European residential real estate in general, and its cities in particular.

The first piece, co-authored by Active Global Allocation and Research Institute colleagues, details our approach to analysing Chinese financial conditions and their effects on financial markets. Jeremy Lawson, Abigail Watt and Carolina Martinez discuss the collaboratively built proprietary model designed to facilitate this analysis.

Scott Smith, Head of Dynamic Multi-Asset explains how we think carefully about our approach to diversification in the context of our current positioning in the economic cycle. Scott argues that asset allocation needs to be dynamic throughout the cycle as relationships between asset classes change under different conditions. He suggests that using non-traditional instruments, can greatly improve the quality of multi-asset portfolio diversification.

In Headwinds Across Asia, our Asia-focussed Multi-Asset team describes how the economic and geopolitical backdrop is affecting Asia’s asset classes. They provide views on each asset class, and on portfolio diversification in the current economic and political climate.

Turning from the macro to micro, but sticking with government policy, the next article focuses on the European housing crisis and the role of rent regulation. Lars Flaoyen, Head of Real Estate Research in Europe, discusses the key drivers and impacts of rent regulation on European residential real estate. Lars also looks at how different types of rent regulation can positively, and negatively, influence the residential real estate market.

Finally, Paul Diggle, our Europe Economist, describes the potential Japanification of Europe’s economy. As a consequence of both lower-trend GDP growth and higher volatility around that growth, he concludes that Europe may fall into periods of negative growth more regularly than in the past. However, this does not mean European assets are uninvestible. Paul argues that Europe might be viewed in the same vein as Japan, where periods of negative growth are commonplace.

In summary, we believe it is necessary to continue to invest, but at the same time take care to deploy robust investment processes, coupled with thoughtful analysis and gradual evolution. This is especially true in times of political and market turbulence, such as those we are facing today.
Spotlight

Decoding the Chinese financial cycle

Our new proprietary measure of Chinese financial conditions allows us to extract better the signals from policy changes and movements in financial markets, and examine the spillover effects on key economic and financial variables. We then use this work to inform our outlook for the global economy and markets.

Abigail Watt
Senior Quantitative Analyst, Aberdeen Standard Investments Research Institute

Carolina Martinez
Senior Investment Strategy Analyst, Global Strategy

Jeremy Lawson
Chief Economist and Head of Research Institute, Aberdeen Standard Investments Research Institute
Understanding the Chinese economy requires a clear empirical framework

As China has risen rapidly to become the world's second-largest economy, its business cycle has become more closely aligned with the broader emerging market (EM) cycle. Indeed, the correlation between China and EM now rivals that between the United States (US) and EM. This makes it critical for economists, policymakers and investors to monitor and understand the likely effects of Chinese macroeconomic and policy developments.

In this article, we examine the Chinese financial cycle and its spillover effects. First, we present our newly developed proprietary indicator of Chinese financial conditions (ASICFI). This incorporates the variety of policy and regulatory tools deployed by the Chinese authorities. It also takes account of the complex ways in which changes to those tools are transmitted through the financial system over time.

Second, we develop an innovative model suitable for capturing the transmission and interconnections between Chinese financial conditions and the domestic economy, as well as foreign economic activity and asset prices. We then illustrate the usefulness of this framework for our forecasts and asset allocation decisions.

Measuring Chinese financial conditions

In most advanced economies, monetary policy decisions are transparent and conducted through a small number of instruments. However, Chinese policy and the financial system within which it operates is more complex and opaque. It is also subject to rapid cyclical and structural changes. This means that quantifying financial conditions in a single measure in China is no easy task. With this in mind, we have incorporated the information from 21 series of relevant data grouped into five key measures of financial conditions: policy & duration; money & credit; risk premia; volatility and foreign exchange.

We combine the results of our China Financial Conditions Index (CFCI) with our qualitative judgement and knowledge of the Chinese economy. This allows us to develop a more comprehensive understanding of how Chinese financial conditions have evolved over the past 12 years. In particular, as shown in Chart 1, we identify eight main phases of the cycle over this period. We also consider how the relative drivers have changed over the different phases.

As seen in Chart 1, policy & duration (which includes interest rates and bond yields), and money & credit factors have been the main drivers of the Chinese financial cycle since 2007. By contrast, risk premia or returns from risk assets have played a much smaller role, both in absolute terms and compared with financial cycles in the advanced economies.

During China's most recent policy loosening cycle, beginning in early 2018, there was a much weaker transmission from money and loan growth than during past financial cycles. This has lessened the effectiveness of policy stimulus. The natural question is, what might the likely implications of this be for the economy and financial markets?

Chart 1

Characterising the Chinese financial cycle

1Note that all the technical, modelling aspects of our research are outlined in the ASI Research Institute Working Paper published as a companion to this article.
2Please see our Research Perspectives paper “Decoding the Chinese financial cycle and its effects on the global economy and markets” for more details on this.
Capturing the spillover effects of changing financial conditions

Since the financial crisis, the composition and swings in the Chinese financial cycle have corresponded with the mini-cycles in domestic and foreign activity, as well as asset prices. To investigate these effects in more detail we built a model that captures their complex and changing interrelationships.

Using our framework we find that there are strong spillover effects from changes in Chinese financial conditions. As seen in Chart 2, looser conditions in China lift domestic activity and equity prices in the offshore Chinese market. Additionally, they boost global economic activity and asset prices. The extent to which monetary transmission lowers EM bond spreads is particularly large. We also find that there are positive spillovers to US growth and also declines in US financial stress.

That said we also uncover evidence that the majority of these effects have been declining over time by considering a time-varying version of this framework. This indicates the possibility that the efficacy of policy has diminished as China’s debt burden has increased. We also compare the relative effects of changes in US and Chinese economic and financial conditions, finding that US economic shocks have larger effects than Chinese economic shocks. However, Chinese financial shocks have more powerful spillovers than US financial shocks, particularly when looking at the implications for emerging markets.

Chinese financial shocks have more powerful spillovers than US financial shocks

Enhancing our forecasting process and better informing investment decisions

At any given point in time, our forecasts for Chinese and broader global GDP growth embed assumptions about the future evolution of the Chinese monetary and financial cycle. We then draw on these views to predict how this will be transmitted to the domestic and international economy. In turn, portfolio managers use this information, together with assessments about valuations and positioning in the market, to make asset allocation decisions.

The development of this framework enhances this process in a number of ways. When policy and financial indicators are changing rapidly, and by different amounts and sometimes in contrary ways, we are now able to more efficiently combine the signals, compare the realisations with what we were assuming in our forecasts and portfolio decisions, and make adjustments accordingly.

Equally important, our work provides us with crucial triggers to change these views if Chinese financial conditions and their composition evolve differently from our expectations. For example, the Chinese authorities may make a more concerted and aggressive attempt at stimulus. All other things being equal, this would lead us to revise up our global growth forecasts and increase...
our allocation to risk assets – although, from a longer-term perspective, it could also amplify already elevated financial stability problems.

The development of this framework has reinforced our caution about the Chinese and broader global economic outlook over the coming year. In the first half of 2018, amid signs that the domestic and global economies were slowing, the Chinese authorities began to cautiously reverse the policy tightening put in place during 2017. This involved cutting bank reserve requirement ratios (RRRs), allowing other market interest rates to fall, while also cutting taxes for corporations.

However, while the Policy & Duration component of the CFCI increased in response to these measures, the Money & Credit component of the index did not respond. In fact, it initially deteriorated further. That was both because the authorities remained reluctant to allow financial imbalances to increase again, and because credit demand remained soft in the sectors that were able to access lending. More recently, the CFCl has turned down again, signalling a modest tightening in conditions compared with earlier in the year.

The upshot is that although there has been a net easing of financial conditions since the start of 2018, it has been modest compared with previous episodes. Not only has the level of the index remained lower than at the peak of past episodes and more recently returned to a neutral level, but Money & Credit has made little contribution to the improvement.

How have we used this information in practice? During 2018 it became clear that the Chinese and global economies were slowing, and the trade war between the US and China was heating up. We took the view through the second half of 2018 that the authorities would continue to ease monetary policy settings. However, because we expected the authorities to continue to restrain the credit impulse, our judgment was that a moderate easing in financial conditions was the most likely outcome.

For the purposes of our forecasts, we also assumed that the efficacy of policy would be weaker than in the past. Financial conditions were easing along the broadly expected path, and there were other headwinds to take into account. We continued to take the view that Chinese growth would continue to trend down through 2019 and 2020. Indeed, with the renewed Chinese financial tightening and broader global growth headwinds building, we have recently been downgrading our Chinese and global economic forecasts, leaving them well below the consensus (see Table 1).

Looking forward, to upgrade our current subdued economic and market outlook we would need to see a combination of: a decisive and broad-based upturn in our CFCI; signs that the policy loosening in the US, Europe and other developed markets indications was being transmitted more powerfully; and indications that the US-China trade war and other geopolitical risks were fading significantly.

### Table 1

**Global economic forecasts below consensus and subdued**

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
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<td>2.8</td>
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<tr>
<td>DM</td>
<td>1.7</td>
<td>1.0</td>
</tr>
<tr>
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<td>1.1</td>
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<td>UK</td>
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<td>-1.5</td>
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<td>Japan</td>
<td>1.0</td>
<td>0.2</td>
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<td>Eurozone</td>
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<td>EM</td>
<td>3.7</td>
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</tr>
<tr>
<td>Brazil</td>
<td>0.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Russia</td>
<td>0.9</td>
<td>1.8</td>
</tr>
<tr>
<td>India</td>
<td>5.2</td>
<td>6.4</td>
</tr>
<tr>
<td>China</td>
<td>6.0</td>
<td>5.4</td>
</tr>
</tbody>
</table>

**Above consensus** | **Below consensus**

Source: Aberdeen Standard Investments, Bloomberg (as of September 2019)

Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.
Multi-Asset Solutions

Effective investing in a constantly changing world

Scott M Smith
Head of Dynamic Multi-Asset Investing

Multi-asset investing can be an effective way to navigate shifting market drivers and construct genuinely diversified portfolios.

One-size-fits-all is a misnomer

Most investors are familiar with the concept of a multi-stage economic cycle: the expansion phase progresses to a peak, before starting to contract, eventually reaching a trough. Given the significant variation in economic conditions and market drivers within each of the distinct phases, it is no surprise that the performance of asset classes also varies materially. What is more surprising is that many investors use a 'one-size-fits-all' approach to investing across the economic cycle – to the extent that they have relatively static allocations within, and across, the traditional asset groups of equities, government bonds and corporate bonds.

In reality, this approach could be better described as 'one-size-fits-none' given that the asset mix will be sub-optimal for all market phases. We can conclude that a more dynamic approach to investing should yield improved results. Returns can be further enhanced by broadening the investment universe to give access to more focused and reliable sources of diversification.

Geopolitics can Trump fundamentals

The importance of using a dynamic approach to investing has only grown over the last few years, as geopolitical factors have increasingly been the cause of volatility and asset rotation. This can create both opportunities and risks for investors. Therefore, it is not necessarily something to be entirely avoided but does require careful analysis and decisive asset allocation.

An early focus of Donald Trump’s presidency was to renegotiate the North American Free Trade Agreement (NAFTA) with Mexico & Canada. In response, Mexican assets weakened materially, reflecting Mexico’s dependence on trade with the US. This created an attractive opportunity in Mexican bonds given the improved valuations and the high likelihood of a new deal being agreed. Indeed, the United States-Mexico-Canada Agreement (USMCA) was subsequently established.

At the other end of the spectrum is the ongoing trade war between the US & China. This has resulted in the imposition of wide-ranging tariffs and rolling bouts of market volatility. Somewhat unorthodoxically, the US president uses Twitter as his preferred medium for announcing negotiation updates. Given the influence this has on markets, an index has now been developed: the Volfe index is a portmanteau of ‘volatility’ and ‘covfefe’ (a typo in one of President Trump’s tweets) to track the impact of his tweets. The fact that something so unpredictable as a tweet has such a market impact emphasises the need for dynamism in asset allocation.

The cost of Brexit – market conflict can create diversification

On the topic of geopolitical market drivers is one closer to home – the exit of the UK from the European Union. In recent times, the myriad factors informing discussions of the outcome has posed significant challenges to investors with exposure to UK assets such as equities or gilts. This is a prime example of when the use of a truly multi-asset approach provides significant benefits. The key risk in a situation such as this is that the behavior of traditional assets can be somewhat binary. A ‘good’ outcome would likely trigger a sell-off in bonds and cause the pound to strengthen. That would create a headwind for an internationally exposed equity market like the UK (over 70% of FTSE 100 earnings are from overseas). A ‘bad’ outcome could have the opposite effect.

One solution is to add new assets into the mix in order to balance the risks and help introduce asymmetry. In this case, we can consider UK inflation and sterling...
volatility as the missing pieces of the UK asset puzzle. The market can struggle to simultaneously price consistency across interconnected asset classes, creating an opportunity for diversification through their combination. In a ‘good’ outcome, inflation will likely fall because of currency strengthening. In a ‘bad’ outcome, the recessionary impact will also weigh on inflation, despite the short-term currency pass-through effects.

There is scope for sharp movements in sterling once the outcome is confirmed, and this will influence other asset class valuations. Finding a way to benefit, irrespective of the direction of that movement, will add significant diversification against other UK assets.

This is exactly what sterling volatility exposure provides. Putting all of this together can allow us to invest in attractive UK assets at a time when many other investors are deterred by uncertainty and are unable to diversify their risk.

**Reliable correlations in an unreliable environment**

Diversification is generally accepted by most investors as a good thing. What is less well understood is that achieving reliable diversification – the kind that actually works when you need it to – is increasingly difficult.

At the heart of this problem is the fact that the relationships between assets are unstable and can be distorted for extended periods by central bank and government policy intervention. Chart 1 confirms this to be the case, with some traditional assets such as investment-grade bonds and emerging market debt showing unstable correlations to global equities. This can result in misleading diversification assumptions if examined at the wrong period in time.

Broader multi-asset diversification strategies (such as the Japanese yen versus the Korean won or a US equity relative-value strategy) present material improvements in correlation stability, thereby offering more reliable diversification.

**Summary**

Each economic cycle presents new and unique challenges. Thus, the most important consideration for any investor is ensuring that they have a portfolio that will remain resilient through unexpected volatility and that can evolve to give exposure to the most attractive assets for the prevailing environment.

By diverging from the sub-optimal ‘one-size-fits-none’ approach and utilising both a dynamic investing style and the full multi-asset opportunity set, investors can navigate shifting market drivers and achieve truly reliable diversification.
Headwinds across Asia

We look at the implications for Asia of the US/China trade war, and monetary policy in developed markets versus emerging markets. What does it mean for our Asia-focused multi-asset approach?

Irene Goh
Head of Asia, Multi-Asset Solutions, and team
The global economy continues to falter as uncertainties surrounding US-China trade tensions persist. Trade negotiation has been volatile thus far and we fear that the tentative peace may not hold going into 2020. Moreover, there is increasing evidence of weaknesses in regional economies, with export and manufacturing bearing the brunt. Against this backdrop, we believe risks are tilted to the downside. We expect global growth to weaken to its lowest level since the global recession, barring any major resolution in trade negotiation. That said, we are not expecting a global recession, as central banks are increasingly turning more dovish to help cushion the slowdown in economic activity.

So, what does this mean for financial markets across Asia?
The global bond market has rallied year-to-date, supported by the expectation of central bank easing in response to slowing growth and trade worries. However, there are laggards in Asia Pacific, such as China government bonds (CGB), that appear to be undervalued. We believe these offer an interesting relative-value opportunity.

China is in a secular slowdown and the government has planned to deleverage the economy in a managed fashion. In the near future, growth faces downside pressure owing to the trade conflict with the US and the overhang of credit tightening. Money supply and credit growth bounced back in Q1 2019 but reverted to a sluggish pace in Q2 2019. Monetary policy is biased towards easing – recently the People’s Bank of China (PBoC) began a new round of RRR (required rate of return) cuts, along with other targeted easing measures. This was done to buffer the slowdown in growth and to lower funding costs for small and medium-sized enterprises (SMEs) and the private sector.

The dovish stance of the US Federal Reserve (Fed) has also created more room for the PBoC to loosen further and support the slowing domestic economy (see Chart 1). However, these measures can hardly change the fact that the credit cycle in China is peaking. Nevertheless, the Chinese government bond market offers positive yields of around 3% – an attractive premium in real and nominal terms to much of the developed world, where yields are already in, or close to, negative territory. It is also anticipated that the inclusion of Chinese government bonds – currently the world’s third-largest bond market – in global bond indices will pick up in coming years. This will likely boost its market liquidity, as policymakers seek to improve accessibility to domestic bonds by foreign investors. In this way, they can attract foreign inflows to an asset class that is still largely domestically owned. Indeed, there is potential for the Chinese bond market to be the second-largest bond market in the world. This structural demand for Chinese bonds, coupled with cyclical headwinds, would likely exert continued downward pressure on yields in China.

Having said that, we are cognisant of the risks to this view. First, Chinese policymakers have so far refrained from the massive stimulus of previous cycles. This is in line with the high-level objective of deleveraging. Second, rising inflation due to unexpected spikes in domestic food and hog prices is also a concern. Global inflation shocks resulting from energy market mishaps should also not be ignored.

Turning to geopolitics and the impact on the equity market, 2019 has been an eventful year for the technology sector. The US ban on Chinese communications firm Huawei added a new aspect to deteriorating US-China relations, exacerbating the impact of the trade war and disrupting the technology supply chain. The dispute between Japan and Korea also further disrupts the global technology supply chain and accentuates the existing weak semiconductor and product cycle. Korea and Taiwan are particularly sensitive to trade conflict centred on the technology sector, given their export

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**Chart 1**

Room to breathe

![Chart](chart.png)

*spread:* difference between US and Chinese 10-year yields

*Source: Bloomberg, Aberdeen Standard Investments (as of October 2019)*

Past performance is not a guide to future results.
and technology-driven economies. The information technology sector accounts for more than 40% and 60% of Korea and Taiwan’s local equity indices respectively. This vulnerability puts pressure on these markets, and leads to some interesting portfolio positioning questions. In Taiwan, sluggish growth and an earnings downdraft, especially in the technology sector, are the main drags on the equity market. There is mounting expectation of a second-half recovery founded on hopes of a technology sector turnaround. This would be driven by inventory rebuilding and a more positive iPhone product cycle in the fourth quarter. However, we believe that headwinds from trade-sensitive technology supply chain uncertainties have been understated. Taiwan is a key supplier to those technology products, from upstream semiconductors to downstream hardware components and assembly. The decline in global demand arising from increased trade tension has engendered caution and an unwillingness among risk-averse firms to increase investment capital expenditures. Thus, any technology-related inventory rebuilding might be short-lived. As such, we believe the market may be unrealistically optimistic – a V-shape recovery is unlikely in the immediate future.

Similarly, in Korea, macroeconomic growth continues to trend down and the government’s fiscal policy has offered limited stimulus to offset the overall weakness so far. More importantly, corporate profits are under pressure as a result of falling memory chip prices alongside trade uncertainties (see Chart 2). Although the equity market rebounded in September on expectation of a turnaround in memory chip pricing, this is not our base case, given the unfavourable supply/demand dynamics. These include slow inventory digestion and delayed restocking due to an anticipated price downtrend.

Moreover, the Japan-Korea trade dispute over export restrictions has further dented market sentiment. Despite the Bank of Korea turning more dovish against this backdrop, monetary policy alone is likely to be insufficient to fully offset the growth headwinds. The risk to our downbeat view on this market is that Korea has priced in a valuation discount to most other markets. The earnings expectation bar remains low and therefore not too challenging to beat.

Looking beyond the near-term weakness, the technology sector outlook may improve significantly from the current low base over the long run. There is opportunity ahead for the sector, driven by 5G deployment and network-building. This is expected to be rolled out more comprehensively starting in 2020 with enhanced mobility and connectivity for consumers. We are following developments in this area closely.

We are able to take advantage of other broader market trends. In China, corporate earnings are under pressure as growth slows. However, a few leading indicators such as PMI new orders and inventory cycles suggest that the trough is near. In fact, large-cap earnings have beaten expectations in 1H 2019, especially in the consumer sector. This is in line with the government’s initiative of cutting taxes to boost consumption and lower corporate burdens. Attractive valuations and easing monetary policy are also supportive.

Policymakers also undertook targeted easing measures to support interbank liquidity conditions, and have loosened restrictions on risk-taking in equity futures and margin trading. These factors, together with global equity index inclusions in coming years, have improved onshore domestic equity market sentiment.

China’s offshore equity market has underperformed onshore equity this year, owing to weak sentiment in Hong Kong. For companies listed on both onshore and offshore exchanges, the onshore premium is significant. At the time of writing, it is at the higher end of the past five-year range. The worsening Hong Kong economy will have limited impact on Chinese firms, as most of their revenues are derived onshore in the domestic Chinese market. We therefore believe a mix of onshore and offshore equity should play well to our overall constructive outlook on China equities.

![Chart 2](chart.png)

**Strong shipments are a distant memory**

<table>
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<tr>
<td>90</td>
<td>1</td>
</tr>
<tr>
<td>80</td>
<td>0</td>
</tr>
</tbody>
</table>

*Index rebased to 100 on 01/06/2016
Source: Bloomberg, Aberdeen Standard Investments (as of October 2019)
while catering for the potential onshore/offshore valuation convergence.

In Hong Kong, economic growth is expected to trend further downwards on the back of domestic social unrest and external headwinds, such as China’s growth slowdown and the trade war. We do not expect the protest in Hong Kong to end anytime soon and it could worsen before it gets better. International visitor flows to Hong Kong have plummeted, along with consumer, business and investor confidence.

The consumer discretionary sector and property developers are most affected by these developments, and have led the market down. Unsurprisingly, corporate earnings momentum continues to decline. Trailing earnings per share (EPS) growth has been in negative territory since the beginning of the year (see Chart 3). There still appears to be optimism in forward-looking earnings growth, relative to reality. While valuations are undemanding, they may get cheaper if earnings growth continues to decline. An increase in capital outflows is consistent with the continuing drop in Hong Kong equity markets.

In Australia, the Reserve Bank of Australia’s (RBA) three rate cuts from 1.5% to 0.75% since June have driven bond yields down. The RBA has left the door open for further cuts, as it waits to see if there is any meaningful progress in the labour market. The valuation is rich on a stand-alone basis after the recent rally. Nevertheless, it remains attractive relative to negative rates in certain developed markets. There is also more room for Australia bond yields to fall compared to other developed market bond yields, should growth remain sluggish.

In currency markets, the Japanese yen is likely to continue strengthening, given the risk-averse environment and falling US/Japan real yield spread. The Bank of Japan’s ability to ease further is limited and it appears less dovish compared to other leading central banks. Foreign investors have shunned Japanese assets for some time now. Any renewed interest in allocating to this market on grounds of structural improvement and perceived ability to weather macroeconomic headwinds could also encourage yen strength.

In India, we expect the rupee to remain underpinned by a stable oil price and balance of payments. The government’s recent surprise tax cuts to spur growth gives reason for optimism on this currency. By contrast, we expect the trade-sensitive and lower-yielding Korean won to underperform, given the country’s weakening current account and the prospect of further monetary easing. The divergence in fundamentals and drivers between the rupee and the won renders them an interesting currency pair to consider as a diversifying strategy in portfolios. It provides good net-yield pick-up and a useful dose of immunity against heightened US-China trade tensions.

**Summary**

The global trade environment continues to present challenges, and political tensions remain at extreme levels within and across geographic regions. This weighs on our outlook for global growth, and leads to a more conservative form of risk-taking than might otherwise be the case. Despite the considerable geopolitical uncertainties and weak global growth prospects, there remain opportunities to invest and to build robust portfolios of diversified exposures. In the near future, we are likely to err on the defensive side, given the less attractive risk-reward outlook. We position portfolios tactically to take advantage of market dislocations, while investing in diversifying strategies to better balance risks.

---

**Chart 3**

**Earnings decline on all sides**

![Chart showing earnings decline on all sides](image-url)

*Trailing earnings* per share YoY growth
*Forward earnings* per share YoY growth (RHS)

*earnings of the MSCI Hong Kong Index

Source: Bloomberg, Aberdeen Standard Investments (as of October 2019)
Most key cities in Europe are struggling to provide affordable housing for their inhabitants, with the increasing cumulative shortfall of housing units being a consistent trend across the region. With the level of new developments not matching the growth in demand for housing, house prices and rents have increased to levels that people on average salaries can’t afford. The rising cost of housing is creating cities where only the rich can live. A large proportion of workers, who are essential to the basic functioning of the city – such as police and fire officers, teachers and nurses – are being forced to move out due to unaffordable rents (see chart). They are becoming regional commuters, which raises issues of socio-economic efficiency.

Europe’s housing problem has been caused by long-term growth in demand that has exceeded supply in major cities. Urbanisation is driving this growth and the trend is expected to continue. The reasons why supply has not kept up with demand are more complex: limited land availability, slow or opposing political processes, high construction costs, and construction capacity constraints are some of the factors. Construction activity has picked up in some cities in recent years. But activity has typically been focused on delivering higher-end owner-occupied housing where profits are higher, rather than more affordable housing to buy or rent. Politicians across Europe are currently discussing various measures to fight this challenge, such as subsidised rents and developments, or more/less rent control. The recent introduction of a rental cap and freeze in Berlin has caused uncertainty among investors, but discussions regarding similar actions are now spreading to other cities and countries in Europe.

From an investor’s perspective, it’s easy to think that rent controls would be bad for investors as it reduces the short-term upside of frequent rent reviews. But this is only part of the story. There are actually benefits associated with rent controls – even from the landlord’s perspective. Indeed, rent controls can actually be helpful for core, income-focused investment strategies. A long/indefinite lease with annual uplifts linked to a domestic inflation measure, gives tenants a more predictable housing cost. This means that tenants are less likely to move out. For the landlord, this usually means lower political processes, high construction costs, and construction capacity constraints are some of the factors. Construction activity has picked up in some cities in recent years. But activity has typically been focused on delivering higher-end owner-occupied housing where profits are higher, rather than more affordable housing to buy or rent. Politicians across Europe are currently discussing various measures to fight this challenge, such as subsidised rents and developments, or more/less rent control. The recent introduction of a rental cap and freeze in Berlin has caused uncertainty among investors, but discussions regarding similar actions are now spreading to other cities and countries in Europe.

Increased residential rental regulation is not likely to solve the affordable housing challenge, but we argue that such interventions are not all negative for investors in European residential real estate.
operating costs and less volatility for their net income stream. It also leads to lower fit-out costs as refurbishment isn’t required as frequently. In addition, more tenant protection encourages more people to rent instead of owning a house, which creates a larger investment market.

Only eight markets in Europe have a substantial track record of historic market performance through the MSCI index. By looking at performance since the indices were launched or over the last 15 years, there is no evidence that rent controls necessarily lead to a lower total return on investments. In fact, Sweden is the market with the most rent control, yet it has delivered the highest total return historically.

That said, a rent freeze similar to the one in Berlin is dramatic for investors, and sudden changes in legislation will have a negative short-term effect on values. But the standard practice in most European countries is for existing leases to be indexed annually to some form of local inflation. We would argue that for an investor looking for core, income-focused returns, a net yield of 3-4% (with an inflation-linked cash flow and very limited vacancy risk) is very attractive. European residential real estate can offer that if approached in the right way.

The UK residential market stands out from the rest of Europe when it comes to lease structures and tenant protection. Investors in UK residential are expressing concern that controlled rents are an unacceptable barrier to entry for them. But it is actually the short lease lengths and the frequent rent reviews to market level that make the UK stand out. This naturally leads to higher tenant turnover as tenants can’t afford to pay the frequent uplifts in a rising market.

The industry is missing an opportunity to create a long-term leasing convention suited to all parties and one that is prevalent in many countries across Europe. The removal of uncertainty for the tenant and landlord should be an attractive proposition for the UK authorities to explore, especially where the tenant retains the ability to serve notice to the landlord if their circumstances change.

In conclusion

Whether rent regulation can fix the affordable housing challenge in Europe is a complex question. In order to work, the regulation needs to be fair and consistent. If it isn’t, it will discourage investors and developers from investing in the sector, and the fundamental problem of undersupply will just get worse. Rental regulation needs to be combined with measures that stimulate the supply of more affordable housing in order to tackle the underlying problem.

There can actually be benefits to long term investors associated with rent controls.
The Eurozone economy has experienced only two recessions – defined as two or more consecutive quarters of negative GDP growth – since its founding in 1999: the Great Recession of 2008-09, and the European Sovereign Debt Crisis of 2011-13. Two recessions in 20 years seems like good going.

Looking further back to before the founding of the Eurozone, the countries that today make up the single currency bloc collectively experienced only three recessions between 1970 and 1999: in 1974-75 during the oil price crisis, in 1980 when tight monetary policy in the US sent much of the world into recession, and in 1992-93 in the wake of another oil price shock and the US savings and loan crisis. Again, three recessions in almost 30 years seems like a reasonable record.

But as trend growth – the growth rate that economists expect on average most of the time – in the Eurozone grinds ever lower, recessions are going to become a much more frequent occurrence than they were in the past.

A novel way of showing this is to compare trend growth with the standard deviation of growth. Our estimate of Eurozone trend growth is a lowly 1.3% per annum, declining to 1.0% over the coming years. However, the 15-year rolling standard deviation of growth is 2.5% (see Chart 1).

The upshot of a trend growth rate that is below the standard deviation of growth is that a lot of quarters are – just mechanically – going to see negative growth.

Indeed, using a little bit of statistics, we can calculate that for a normally distributed probability function with a mean of 1.0% and a standard deviation of 2.5%, the likelihood in any given quarter to see negative growth is 31.7% (see Chart 1).

European recessions used to be few and far between. But as trend growth rates decline, recessions are going to become much more frequent. Investors need to get used to them – and perhaps even learn to look through them.

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quarter that growth is negative is 34% (see Chart 2). In the early 2000s, the equivalent calculation yielded a much lower 10% probability of a contractionary quarter.

Moreover – and for the real stats geeks out there – this calculation assumes that growth is normally distributed. In reality, the distribution of growth is ‘fat tailed’, so contractionary quarters could be even more frequent than this analysis implies.

The upshot is that investors may have to get used to a world in which Eurozone growth is negative in one out of every three quarters. Equivalent calculations for other developed market economies would yield similar results – as demographics become more of a drag and productivity growth slows, trend GDP growth is declining and contractionary quarters will only become more common.

In Japan, of course, contractionary quarters are already fairly run-of-the-mill – indeed, in the past decade, growth was negative in 32% of all quarters. But that hasn’t detracted from the attractiveness of investing in Japanese equities as a high-beta play on the global economy, or buying the Japanese yen as a safe-haven in times of stress.

Perhaps the mind-set change investors have to go through, therefore, is to stop treating European recessions as all that important. Instead of focusing on them as decisive end-points to the economic cycle, many of these contractionary periods should be seen as little more than regular statistical artefacts that reflect the broader low growth world in which we find ourselves.
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