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AberdeenStandard
Investments

Global Outlook

August 2019



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.

TAA Model Allocation - as at August 2019

	Allocation	Comment
Government bonds	Negative	We see most government bonds as generally unattractive and they already price in a very weak global economy and cuts in policy rates.
UK Gilts	Neutral	While the economy is growing slowly, and this is priced into bonds, Brexit could keep yields extremely low for some time.
US Treasuries	Negative	US Treasury yields have fallen significantly over recent months. They are now near the bottom of a range, pushing them to unattractive levels.
European core	Neutral	Eurozone rates remain exceptionally low; European Central Bank (ECB) policymakers have become wary of recent European economic weakness, hinting at further easing.
European periphery	Neutral	The spread between peripheral and core European government bonds has narrowed dramatically without any corresponding improvement in fundamentals or political risk.
Japan	Negative	Japanese government bond yields are very low, still held down by very strict yield curve control from the Bank of Japan despite the new flexible target.
Australia	Positive	We remain long of government rates as recent Australian economic data shows signs of weakness and the Reserve Bank of Australia is signalling further cuts.
UK index linked	Negative	Recent sterling strength and uncertainty caused by lengthy Brexit negotiations imply inflation risks are to the downside. Meanwhile, the Bank of England has revised down growth and inflation forecasts.
US TIPS	Positive	This market provides downside protection as and when investors look for a safe haven, as well as a degree of protection against any future inflation surprises.
Corporate bonds	Positive	The spread between corporate debt and government bond yields are moderately attractive in a stable, low-yield environment.
UK investment grade	Neutral	Spreads have widened but we still see credit as vulnerable to economic shocks or upward surprises to gilt yields.
US investment grade	Neutral	Spreads are wider but only offer modest protection should the US economy weaken materially.
Euro investment grade	Neutral	Despite euro investment grade spreads tightening, the risk-adjusted returns still remain attractive.
US high yield	Positive	US high yield provides attractive carry and positive returns even if growth remains sluggish.
Euro high yield	Positive	While spreads have narrowed they are acceptable relative to risks. Furthermore, net leverage in high yield companies has fallen as they have deleveraged.
Emerging market (hard currency)	Positive	Dollar-denominated debt is at attractive spreads compared to Treasuries and all-in yields.
Emerging market (local currency)	Positive	A lot of bad news is now priced into local currency debt following sharp currency and spread corrections.
Equities	Positive	Global profit growth in the mid-single digits provides fundamental support. However, year-to-date performance has meant equity markets have recovered from oversold conditions in 2018.
UK	Neutral	The UK trades at cycle-low valuations. However, should a disorderly Brexit be avoided, sterling strength would dampen FTSE 100 Index returns.
US	Positive	Macroeconomic momentum supports this market; the change in the Federal Reserve's (Fed's) interest rate path supports growth. We have been trading the US tactically.
Europe ex. UK	Neutral	Economic expansion has faltered recently but valuations are supportive for corporate profits. Currency appreciation and peripheral political risks continue to restrain interest in stocks.
Japan	Positive	The market remains attractive as easy monetary policy and fiscal stimulus are helped by efforts to improve corporate governance, share buybacks and business investment. Yen strength periodically remains a concern.
Developed Asia ex. Japan	Negative	The market is vulnerable to policy errors in China and worries about trade tensions. The Australian market is relatively expensive, driven by commodities.
Emerging market equity	Positive	The asset class has discounted much of the China trade risks and investors are focusing on a recovery in China. Valuations remain helpful albeit the market is not as oversold as last year.
Property	Neutral	We prefer real estate investment trusts rather than direct investment in commercial property globally.
UK	Neutral	The real estate cycle is at a mature stage and limited further capital growth is expected. Brexit further complicates the outlook, as does pressure across the retail sector.
US	Neutral	Vacancies are low across most sectors and markets, although the sizeable retail sector is coming under more pressure from the rise in e-commerce.
Europe	Neutral	Supported by stronger economic growth and low levels of new supply support the market. The cautious ECB policy stance helps valuations. Property markets rallied significantly at the start of the year, so we are now neutral.
Commodities	Neutral	Commodities are very sensitive to Chinese policy tightening; some commodities, such as oil, face an uncertain demand/supply balance plus geopolitical risk.
Cash and currency	Negative	With global interest rates still extremely low, we still see better opportunities in risk assets.
Dollar	Neutral	We do not expect the US to outperform other economies; a turn up in global growth is unlikely to support the dollar. Fed easing is also a factor, especially if QE is restarted.
Euro	Negative	The euro is less attractive than other major currencies, with concerns over weak inflationary pressure and economic data.
Yen	Positive	An overweight position in the yen, traditionally a safe-haven currency, acts as a portfolio diversifier if global activity continues to disappoint.
Sterling	Neutral	Sterling has fallen on concern about a disorderly Brexit, where the outcome remains highly uncertain.

Foreword



Frances Hudson
Global Thematic Strategist

Far from halcyon summer days, August is shaping up to offer considerable uncertainty around the economic, policy and political outlook. At such times, we continue to believe that deep and diligent research and active asset, sector and stock selection will benefit investors.

August's Global Outlook offers insights into both long-term and current developments. Demographic trends and changing lifestyles impact the real estate markets. The transition from manufacturing to service orientation as economies progress means we need to be more adept in valuing businesses where fewer of the assets are tangible. The long, drawn-out cycle poses a variety of challenges to investors, whose investment choices reveal underlying risk preferences. Rigorous modelling can suggest sensible ways of viewing alternative outcomes in currency markets.

In his House View article, Andrew Milligan, Head of Global Strategy, identifies a number of risks for investors and advocates adopting a cautious and diversified approach to the extended investment cycle. He proposes a course to navigate the current global macro-environment in the face of looming headwinds.

This month's Spotlight has Craig Hoyda, Senior Quantitative Analyst, Multi Asset Investing, getting to grips with intangibles. The shift in the composition of corporate balance sheets depicts a move away from tangible assets and towards intangibles, as economies become less manufacturing and more service oriented. He analyses the difficulties in interpreting valuations of such capital-light businesses.

Gerry Fowler, Global Multi Asset Strategist, tackles the topical issue of what is currently priced into sterling. He discusses how our currency valuation models can inform investors' understanding of potential pathways for the pound under different Brexit scenarios.

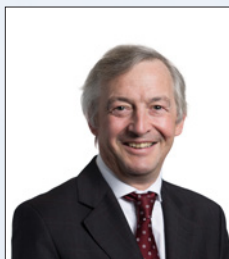
Ben Pakenham, Deputy Head of European High Yield, is struck by the varying relationship between risk and reward in the context of European high-yield bonds. He assesses how the economic climate influences outcomes and investor choices.

Svitlana Gubiry, Head of Global REITs, examines how digital, social and demographic transformations are being accommodated in the REITS markets, and what this means for future investment opportunities.

House View

Navigating turbulent times

We expect the investment cycle to be extended into 2020-21, with the support of significant central bank easing. Nevertheless, in the face of worsening valuations and political headwinds, a more tactical and opportunistic approach is required.



Andrew Milligan
Head of Global Strategy



Good performance into the summer

It is often the case that financial assets perform well after a period of intense disappointment. In mid-July, the US S&P 500 index broke through the 3,000 level, achieving a new high. This caps exceptional performance for both equity and bond markets. In many cases, these showed the best performance in the first half of a year since 1997. To put these figures into perspective, at its worst point in Q4 2018, the global stock market was back at levels last seen two years earlier.

It is no surprise therefore that many surveys of investor positions show a degree of profit-taking over the summer. Indeed, market valuations have encouraged a reassessment of the next phase of the investment cycle. It is true that valuations look stretched in certain parts of the bond and equity markets. Put another way, under what circumstances would current valuations be justified?

To consider a few examples, with benchmark US bond yields at about 2%, then to all intents and purposes the real return is likely to be zero unless a deflationary environment appears. The interest rate structure has altered yet again in Europe and Japan, so that roughly 40% of all government bonds and almost 25% of corporate debt is now negative-yielding.

Turning to equities, the price/earnings ratios of the major markets are high rather than extended, generally in a band of 15-20. However, this is against the backdrop of a noticeable slowdown in corporate profits growth and concerns about an approaching squeeze on company margins. Labour costs are the main issue, given very moderate top-line sales growth and, in many cases, a rising regulatory burden.

It may be a case of 'better to travel than arrive', but certainly the forthcoming easing of monetary policy by the major central banks is providing considerable support for both bonds and equities. For some time, the People's Bank of China (PBOC) has been easing, albeit via the interbank lending rate rather than the official PBOC rate, alongside a degree of fiscal support such as income tax

cuts. Stability matters significantly in this important anniversary year for the Communist Party.

The latest statements from the US Federal Reserve (Fed) show that it has accepted that it must align with the monetary easing priced in by the bond markets; we expect to see two rate cuts during the second half of 2019 (Chart 1). The Fed is talking in terms of insurance policy moves designed to extend the business cycle, especially in an environment where dis-inflationary pressures are apparent.

Market valuations have encouraged a reassessment of the next phase of the investment cycle.

In many senses, the most significant U-turn has been by the European Central Bank (ECB). Earlier this year it was strongly hinting at raising interest rates in 2020; now it is signalling not only at taking official rates further into negative territory but also restarting its quantitative easing (QE) programme. This has resulted in a considerable flattening of yield curves across Europe amid preparations for a sizeable amount of bond issuance by governments and corporates anticipating a borrower of last resort (Chart 2).

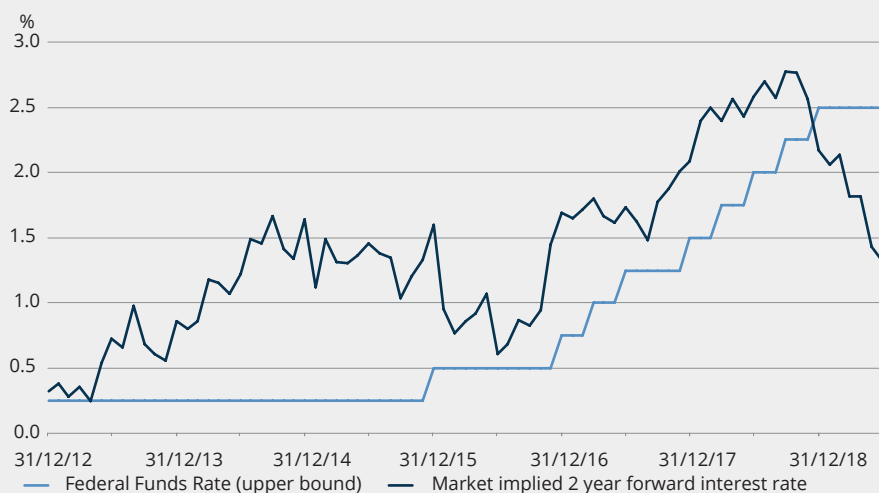
On top of a revaluation effect as the long-term discount rate has taken another step down, investor positioning and cross-border flows have supported financial market pricing. The recent unexpected announcement from President Trump that he was opening a new front with Mexico in the trade wars caused many equity investors to capitulate and rush into cash. A change of stance on trade, towards both Mexico and then China at the G20 conference, reassured investors that the US was not making a major geopolitical mistake. This was subsequently over-turned by the recent announcement of new tariffs of China. Earlier in the year, investor capital had flowed into money-market funds when the Fed appeared to be on the path of rising rates. Much of that capital appears to be moving into high-yielding fixed-income assets in a world of low or negative interest rates.

Mixed messages

Our portfolios remain risk-on but we have become both more cautious and more diversified into the summer. This reflects our assessment of what is in the price, the imbalances, strains and stresses in the world economy, and the likely efficacy of the monetary policy response.

Some risks are undoubtedly economic. In the first half of 2019, the mini-recession in the manufacturing sector has become very apparent (Chart 3). Global trade growth has fallen back to about zero, while poor business confidence is discouraging

Chart 1
Low expectations



Source: Bloomberg, Aberdeen Standard Investments (as of 15th July 2019)

capital spending. Surveys suggest little improvement in activity into the early autumn. The good news is that the world economy is holding up, thanks to solid consumer spending and expansion in the services sector. Our economic forecasts are for global GDP growth of about 3% per annum in both 2019 and 2020. In effect, as long as the credit and corporate bond markets remain open, then we see the flat or modestly inverted yield curve as a sign of slow growth rather than imminent recession. Looking ahead, a downside risk would be job cuts from manufacturing undermining household consumption. Upside risks would reflect improvements in business and consumer confidence, encouraging more spending on durable goods and capital expenditure.

Such a forecast for economic growth reflects our assumptions about how much monetary and fiscal easing will materialise in the major economies in coming months. A second concern, then, is how effective such steps will be. On the one hand, a reduction in borrowing costs should support, for example, the housing markets and real estate sectors in many countries. On the other hand, the benefits could be offset by a rapid reversal of the recent rapprochement in US-China trade tensions. There are very mixed messages from politicians in both countries about the final details of a difficult negotiation. At the same time, investors

are concerned that the US could open a new front with the European Union (EU) in an election year. Meanwhile, the trade tensions between Japan and South Korea are a reminder that other governments are now ready to use the threat of tariffs.

Our economic forecasts are for global GDP growth of about 3% per annum.

Even if the trade truce continues, investors are now increasingly aware of the growing strategic rivalry between the US and China. At one level, this dampens business and investor confidence. At a more granular level, it is encouraging firms with China operations to reconsider their supply chains. There will be winners – India, Korea, Taiwan and Vietnam are the most obvious among the emerging markets (EM) – but also losers. For example, higher costs and duplication of production lines would create another headwind to company profits growth.

Policy errors are dangerous late in the investment cycle. Currency stress would

be an obvious channel. Although most currencies have seen modest volatility so far in 2019, with the exception of sterling and some EM, we are analysing moves in the US dollar and Chinese renminbi closely. Sharp changes in either could once again put many EM assets under stress, at a time when a number of EM central banks hope to cut interest rates in coming months.

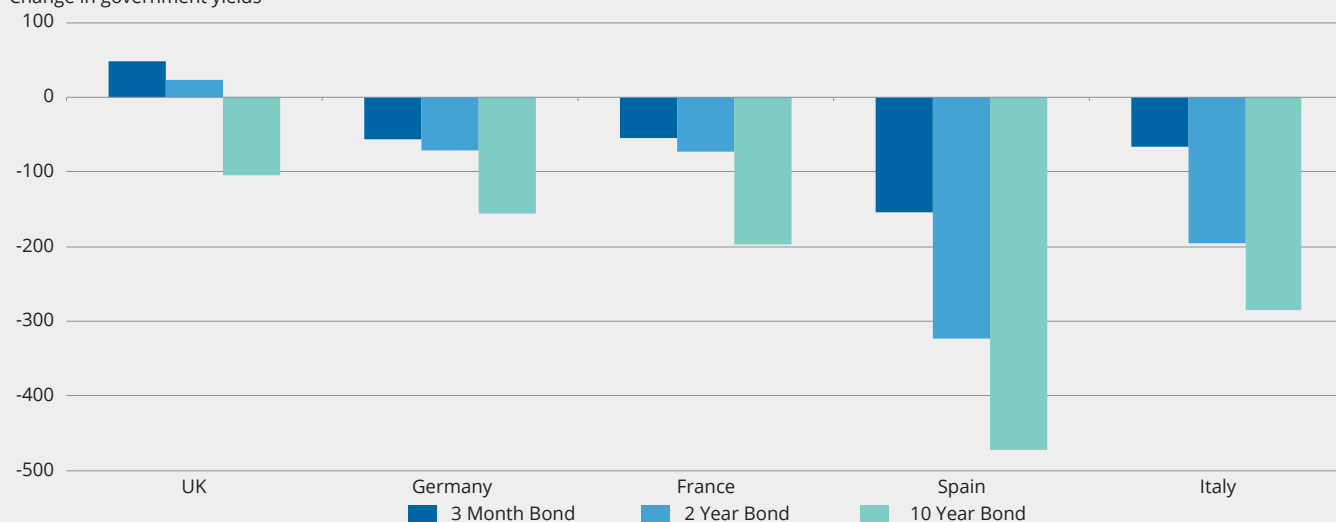
Despite the G20 accord on trade, we remain in a world of heightened political tensions. The EU Parliamentary elections have led to a more fractured situation, which reduces the likelihood of major structural reforms. Italy and Brussels have agreed that the budget outcome is satisfactory for 2019, but not for 2020 onwards. The decline in the dollar/sterling exchange rate towards 1.20 suggests that more investors are pricing in the risk of a 'hard Brexit' outcome. The price of oil is fluctuating, partly on normal supply/demand issues but especially on worries about growing tensions between the US, Iran and other countries in the Straits of Hormuz. Looking further ahead, significant policy changes are possible after the 2020 US elections in such areas as healthcare, technology and banking regulation, or the Green New Deal economic stimulus package.

Investment strategy for 2019-20

Although global equities form the core of our portfolios, we emphasise

Chart 2
Flattening curves

Change in government yields*



*basis points relative to 01/01/2013

Source: Bloomberg, Aberdeen Standard Investments (as of 15th July 2019)

that more diversification is required to gain the benefits of other risk premia. We prefer developed to EM equity. Positive profits growth will support both regions, but EM equities have greater risks related to trade barriers or currency volatility. Within EM equities, we favour Asia, on the grounds that any further stimulus from China should support that region.

Alternative assets can of course provide income in a world of low interest rates.

Interest rate cuts are a good backdrop for holding assets with yield, carry or spread. One approach is to hold high-yielding corporate bonds, which

we do in both the US and Europe. In addition, we have positions in EM debt. Investors need to be selective, but the problem countries like Venezuela or Turkey do not dominate those markets. However, taking too much risk in fixed-income markets does not make sense when bond valuations are rather stretched. Stronger-than-expected economic reports can significantly alter market expectations. Hence, we are underweight low-yielding Japanese and US government bonds in our portfolios.

Alternative assets can of course provide income in a world of low interest rates. Real estate is one example, although again care must be taken. The retail sector is under pressure in many countries, noticeably the UK and the US, owing to the inexorable rise of e-commerce. Conversely, there is strong demand for office space, data centres, logistics sites, hotels, and student and residential accommodation in many economies.

In relation to currencies, valuation models are not giving strong signals. Some EM currencies are expected to see moderate weakness in coming months, as interest rate cuts take effect. The dollar is likely to drift lower as fgrate cuts by the Fed reduce its carry attractiveness. The one currency that could prove volatile is sterling, of course. A Brexit shock could easily see the pound test previous lows against the dollar and euro in coming months.

In terms of investment style, we see the year ahead as one where more tactical decisions will make sense. We expect to see sharp rallies and sizeable sell-offs as global investors react to a complicated mix of economic, corporate and political signals. In these circumstances, a diversified portfolio makes sense, as does having cash to put to work as and when value appears in any asset class.

Chart 3
Manufacturing slump



Manufacturing Purchasing Managers Indices (PMI) as of: — January 2018 — June 2019 - - - index level of 50
Source: Markit, Bloomberg (as of June 2019)

Global Spotlight

Tangible value in a world of intangibles

Intangible assets are taking up a larger share of corporate balance sheets as economies transition away from asset-heavy manufacturing bases to knowledge-driven service sector-led ones. We examine the effect this has on valuations.



Craig Hoyda

*Senior Quantitative Analyst,
Multi-Asset Investing*

Valuation is both an art form and a science. Challenges in determining the worth of an asset are evident when that asset takes physical form. Take a machine for example: an accountant may calculate its value as its purchase price minus accumulated depreciation. However, an equity analyst would assess its value in context of the remaining productive capacity of the equipment – i.e. an estimation of future cash flow expected from the sale of goods it manufactures. This challenge becomes extremely difficult when we move out of the physical realm and attempt to value intangible assets.

Intangible assets such as goodwill, brands, patents, and software, are becoming an increasingly common constituent of corporate balance sheets. Since 2006, the value of intangible of assets as a proportion of aggregate S&P 500 balance sheets has risen from 20% to near 30%, with a similar story on Stoxx 600, a broad gauge of the European equity market (Chart 1). In absolute terms, these figures are near \$2tn and €1tn respectively.

The rise of intangibles can firstly be explained by the transition in economies from being geared towards manufacturing to a knowledge-based one which is led by the service and technology industries. To put it another way, the world economy is moving away from one which depends on tangible assets to produce, to one in which intellectual property (IP), including patents, trademarks, brands and software matter more. While intangibles have been used to describe certain assets since well before the 1970s, more importantly in recent times the take-off of the internet, smartphones and apps has moved business models away from physical assets to online. Examples include platform businesses – those which have business models centred on creating value by facilitating interactions between two or more interdependent groups (for example, market places such as Airbnb, eBay and Amazon). This is linked to current intergenerational trends to move away from material possessions to experiences. Furthermore, the location of physical assets is fixed and hence taxes can be levied in the appropriate jurisdictions. However, with online business it is in firms' (and hence

shareholders') interests to conduct business in the most tax-efficient domains.

However, accounting rules dictate that while intangibles acquired through mergers and acquisitions (M&A) can be capitalised, i.e. held as an asset on the balance sheet, those generated internally must be immediately expensed. Investors must be aware of what they are examining when it comes to intangibles. In this article, we discuss the potential effects intangible assets can have when assessing value.

Investors must be aware of what they are examining when it comes to intangibles.

Valuing the non-profits

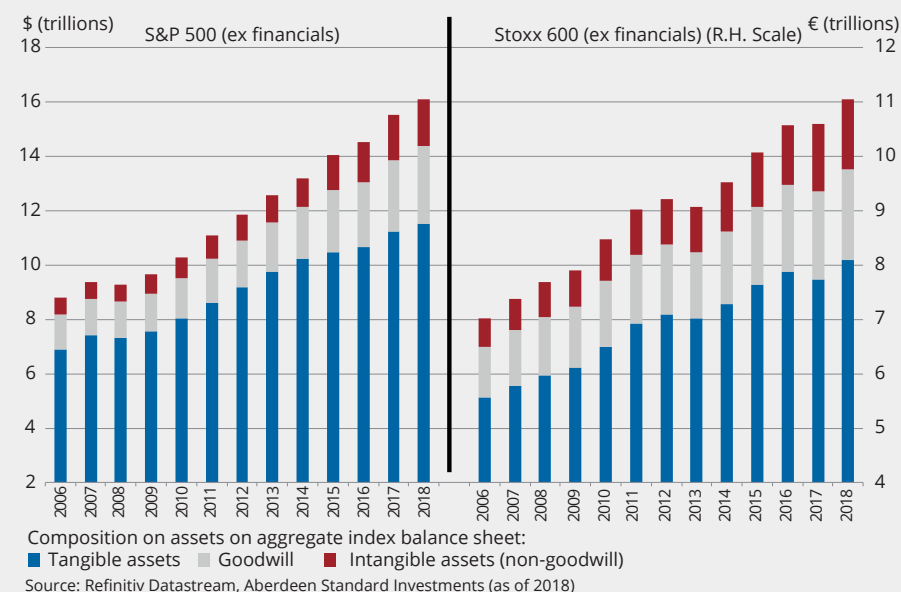
Traditionally, companies have issued stock or borrowed in order to fund expansion – by purchasing machinery, factories etc. However, with the rise of assets that require limited capex beyond investment in time and computer software and equipment and the low cost of borrowing, the need for such capital is reduced (also known as de-equitisation). This is illustrated by

the fall in the number of listed stocks. There were more than 8,000 listed on US exchanges in 1996 versus fewer than 4,500 today. A new stock market listing is now predominately used as a tool to spin off parts of companies, or to provide an exit strategy for venture capitalists and private equity.

The result has been the rise of the so-called 'non-profits' – a term in this case not applied to the charity sector. Instead this applies to technology-driven firms that have yet to realise a single year of profit in the run-up to their initial public offerings. The resultant mix has inflated valuation ratios of the market in aggregate. As the non-profits list (with, for example, price-to-forward earnings ratios of individual stocks exceeding 100x), capital-intensive firms are either exiting the market via M&A (especially takeovers by private equity) or engaging in large share buyback programmes. Investors must thus be cognisant of the composition of markets throughout time if comparing valuation metrics in absolute terms.

It is worth touching on goodwill, the largest intangible. This is an asset associated with M&A in which the purchase price is higher than the fair value of all assets purchased in the acquisition and the liabilities assumed in the process. We will not examine this asset in great detail due to its nature, as it is best analysed in the context of firms overpaying for the companies they have taken over.

Chart 1
Intangibles tangible impact



We will go on to discuss common valuation metrics and what signals investors can take from them in the context of intangibles.

PB or not PB

One key valuation metric for investors is the Price to Book (P/B) ratio. This examines how much the share price of a company differs from book value of that equity (where book value is calculated as total assets minus total liabilities on a per share basis). A value of 1 indicates investors value the company at the value of its net assets, or in other words, the view they are expressing is that it makes no difference if the company continues operating or winds up operations, disposes of all assets and returns all proceeds to shareholders once debt has been taken care of. The S&P 500 has generally traded at a P/B ratio of between two and four times, while the Stoxx 600 has spent most of its history with a P/B below 2. As such, on current readings for this metric in isolation, we suggest that the S&P 500 is slightly overvalued while the Stoxx 600 is close to fair value.

We can construct a similar ratio that considers only the book value of tangible assets. When comparing this new Price to Tangible Book value

per share ratio to the history of their respective indices, we get a different picture. The Stoxx 600 remains close to fair value, but on the expensive side as oppose to being cheap. The S&P 500, however, now screens as being significantly overvalued (Chart 2).

The S&P 500 also ranks as expensive on various other valuation metrics. While we are not near the same levels as the technology bubble of the late 1990s/early 2000s and during the melt-up of early 2018, both trailing and forward Price to Earnings (P/E) ratios are above long-term absolute averages and averages relative to other major global equity indices.

The S&P 500 ranks as expensive on valuation metrics.

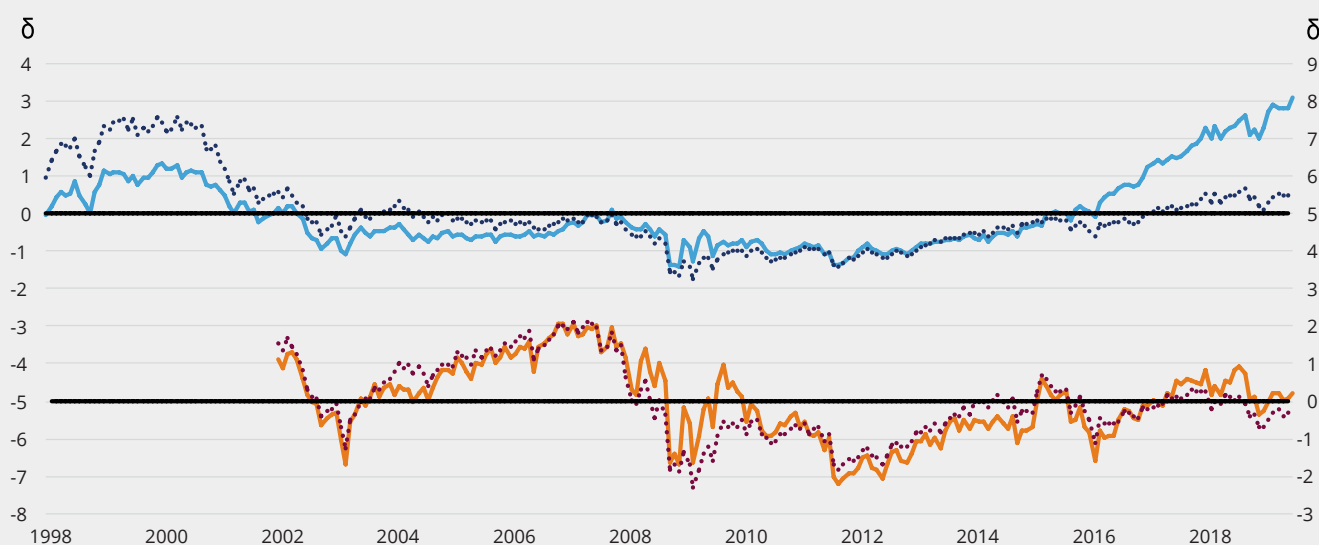
Capital light switched on

Investors should be careful about what they are actually valuing. While

the US market is indeed expensive when examining tangible assets only, the trend of businesses going light of physical capital means that elevated P/B and P/E ratios may be the new normal. The changing composition of the S&P 500 has already been alluded to – the communication services sector accounts for two-thirds of all rights & licenses assets. However, this sector is relatively new and its weight in the index has been growing over time, even when accounting for the old index classification. European markets do not have the same index composition changes as US counterparts, hence an explanation for why P/B ratios when including and excluding intangibles indicate the same story when it comes to over or under valuation.

One metric that cannot be ignored is cash flow. A shift towards capital-light business models contributes to higher free cash flow generation (Chart 3). Dividends and buybacks move in line with free cash flow over the long term. Capital-light business models are able to drastically increase the amount of capital they are returning to shareholders. This is in spite of the fact that the market trades at a discount when examining price to cash flow and price to return on capital metrics. This, in turn, suggests a question over

Chart 2
Throwing the book at tangibles



Standard deviation from long term average (January 1998 for S&P 500, January 2002 for Stoxx 600):

— S&P 500 P/TB* ratio S&P 500 P/B* ratio
— Stoxx 600 P/TB* ratio (R. H. Scale) Stoxx 600 P/B* ratio (R. H. Scale)

*P/TB denotes Price to Tangible Book value per share; P/B denotes Price to Book

Source: Bloomberg, Aberdeen Standard Investments (as of 11th July 2019)

persistence of this discount. Thus, the increase in capital light businesses should drive valuations higher. For investors with a tactical horizon, opportunities can be found in stocks or baskets of stocks where return of capital to shareholders lags free cash flow.

Intangible value

A follow on from the de-equitisation theme can be seen through the changing capital structure of companies. While global interest rates remain low, a firm can reduce its cost of capital by issuing debt and buying back equity.

There are three specific characteristics we can examine with respect to intangible capital: salvage value, certainty, and protection. Salvage value is especially prevalent for distressed debt investors – purchasing the debt of a corporate under duress for a fraction of its fair value, with the expectation that bankruptcy proceedings will pay out a higher fraction once finalised, is a well-known strategy. An asset that is at or near the end of its life can usually be sold for scrap. However, intangible assets can pose many different issues – for example if value is tied up in human capital then there is a real possibility that employees switch employers (i.e. lack of protection), making this asset

worthless. Furthermore, a patent that is near expiry cannot be sold for scrap as it is virtually obsolete.

The mis-valuation of intangibles by corporates can also work to investors' advantage. A savvy analyst can realise that an intangible does not reflect the correct value – e.g. a patent that has uses outside the industry of the firm in question.

The increase in covenant-lite issues is another increasing trend in markets. With firm assets used as collateral, corporate bond investors were more insulated to the negative effects of any potential default. However, the decreasing number of tangible assets held by firms may be a factor in forcing them to issue this type of security. The use of intangibles as collateral is less well defined – possibly because cash flow from intangible assets is generally more uncertain when compared to tangibles.

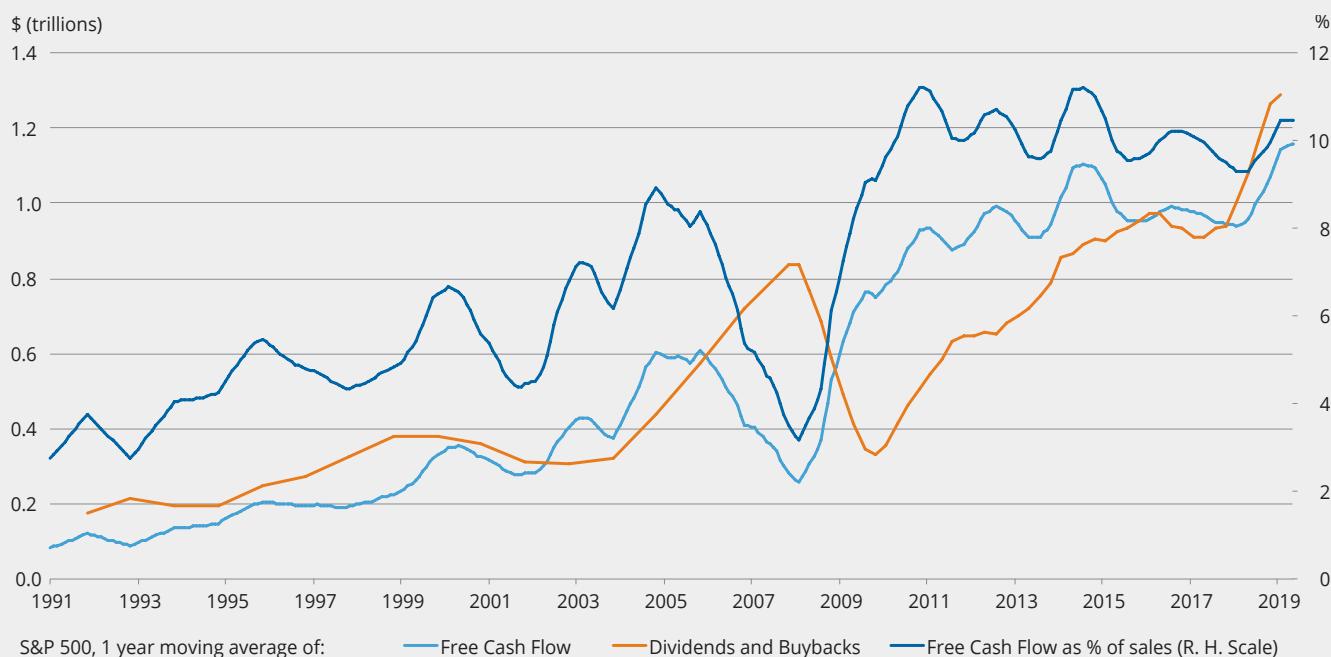
Perhaps this is already been priced in by the bond market. In both the US and Europe, the BBB proportion of investment grade indices has been rising steadily over the past five years. The market may be recognising the changing composition of balance sheets, although it must be noted that many other factors are also at play.

Caveat Emptor

The morphing of business models to those which are capital-light, hence intangible asset-heavy, mandates that investors analyse valuation signals in greater detail. Markets may screen as being near fair value on some metrics, but when examining tangible assets only they can scream as being overvalued. We continue to call for investors to monitor cash flow – the life blood of any business – as this is a true metric of profitability. However, markets can persistently trade at a discount to cash flow-based metrics.

Valuing individual assets on balance sheets themselves is also key – an intangible asset on one balance sheet may be worth a lot more if held by another company assuming that intellectual property can be utilised correctly. For example, consumer companies trading brands, or technology firms adding patents to their portfolios by buying smaller rivals or obtaining IP from defunct firms. There can be ulterior motives: IP raises barriers to entry. Sometimes the value of knowledge is just keeping hold of it, not utilising it.

Chart 3
Going capital light pays dividends



Source: Bloomberg, Credit Suisse, S&P Global, Aberdeen Standard Investments (as of 12th July 2019)



Gerry Fowler
Global Multi-Asset
Strategist

Currency

What the British pound tells us about Brexit

Sterling weakened as the Conservative leadership result meant that a 'no-deal' Brexit appeared increasingly likely. We assess what is in the price of the pound.

Using valuation models to assess the pound's value under binary Brexit outcomes

The UK is in a state of political turmoil. Parliament is struggling to find common ground on its desired relationship with the European Union (EU). At the same time, the governing Conservative party has welcomed Boris Johnston as its new leader and consequently, the country's latest prime minister.

Since the UK voted to leave the EU in 2016, Brexit-related uncertainty has had a creeping impact on the economy. UK growth has steadily weakened, compounded by a slowdown in the EU, its major trading partner. The British pound has also fallen, as it adjusts to offer a risk premium for investment in the UK.

Exchange rates have a variety of well-researched key economic drivers in the medium and long term. These can provide some indication of where sterling might settle under various scenarios.

Attracting capital

As a large but open economy, the UK exchange rate is impacted significantly over the medium term by the appetite for investment in the UK. Stable economic policy and a robust legal system have been two of the bedrock components of British success for centuries. Hopefully, those will remain intact over the medium term. Beyond

those factors, it is anticipated return on investment that will keep domestic capital at home and attract foreign capital into the country, either as FDI (foreign direct investment) or portfolio flows (purchase of financial assets). For the UK, the global business cycle and domestic interest rates are key drivers of capital flows. They are therefore important components we consider in assessing the value of the British pound.

Since the UK voted to leave the EU in 2016, Brexit-related uncertainty has had a creeping impact on the economy.

One of our currency valuation models is the Macro Monthly. This regresses historical currency rates against a mix of factors, namely commodity prices and global PMI business surveys together with relative real interest rates, industrial production, terms of trade and trade balances. We can also forecast these economic variables to see where the exchange rate might be valued in future.

A weakening global economic cycle and declining real interest rates in the UK have been dominant reasons for currency weakness recently. Our model suggests the fair exchange rate for

sterling versus the US dollar is around 1.25 – not far from the current level. We expect this could increase to 1.34 if monetary policy easing globally is sufficient to stabilise the economic cycle and reduce the rate differential between the US and the UK. This scenario relies on there being no additional shock to the UK economy, such as a no-deal Brexit outcome.

To consider what level the currency should be at in the event of a no-deal Brexit, we can stress this model for a sharp slowdown in industrial production and a material decline in real interest rates. Assuming few global spillovers from this scenario, the fair value for the British pound would feasibly be around US\$ 1.15.

Enforced equilibrium

Another approach to currency valuation involves estimating the level at which a country is in internal and external equilibrium, as measured by the current account balance. This tends to be more useful over much longer horizons. However, in the event of a shock, it can be a useful guide to the level of the currency that supports a more rapid adjustment to equilibrium.

Our analysis suggests that, for the British pound, this level is also around 1.15 versus the US dollar. However, this is a fair value estimate. It is reasonable to assume that a sudden adjustment would occur, with heightened volatility around – and likely below – fair value for some time.



There are some caveats to this model that we must understand. Firstly, the fair value is based on an estimate of the sustainable level of the UK's current account position versus the present level. It is unclear whether the UK would have the same sustainable current account deficit if the political and trade policy environment changes abruptly. If the sustainable current account deficit shifts closer to zero, the foreign exchange adjustment potentially required would be larger – that is, the pound would be lower.

One-third in the price

These models give quantitative support to fair value ranging from GBP/USD 1.15 to 1.34, depending on just two potential Brexit outcomes. With the exchange rate currently around GBP/USD 1.20, we could imply the market is pricing around a one-third risk of the UK leaving the EU without a deal. Of course, the same approach can be taken with other important currency pairs such as GBP/EUR.

It must be emphasised that if a deal is agreed and political stability returns, the appetite for investment in the UK could return quickly. This would generate better-than-anticipated economic data, leading to more upside to the fair currency valuation.

With so much uncertainty, we continue to carry out scenario analysis, and monitor all potential outcomes and their relative likelihood. These valuation tools are a key support in that process.

Chart 1
What's the deal with FX?



*FX1: GBP, FX2: USD

Source: Aberdeen Standard Investments (as of June 2019)



European High Yield

Challenging the norm with European high-yield bonds

Ben Pakenham
Deputy Head, European
High Yield and
Global Loans

Longer duration, higher quality offerings appear to be the high-yield bonds of choice for investors faced with accommodative central bank movements and a weak global economy.

Stimuli from the top-down

With the exception of May, financial assets posted exceptional returns in the first six months of the year. High yield returns in Europe and the US in this period have been the strongest since 2012 and 2009, respectively. What has caused markets to respond so favourably? It is not uncommon for high yield to perform strongly following a negative return year. As a starting point, valuations looked over-sold when considering the outlook for default rates, which are expected to remain low.

Moody's predicts the global rate one year from now will be 2.6% compared against 2.3% today and 3.2% a year ago.

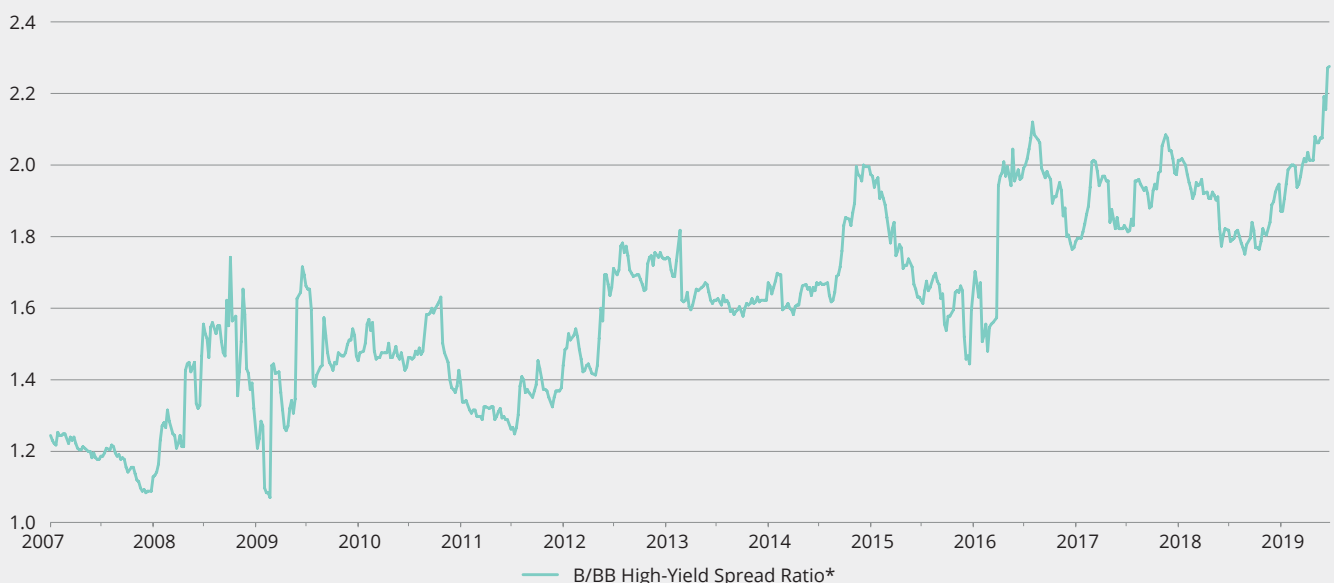
The biggest single factor, though, was undoubtedly the response from central banks to market weakness in the last quarter of 2018 and deteriorating economic data this year. Since June, expectations for monetary policy have changed materially. Markets had fully discounted July's cut in US interest rates, while as recently as March no change was expected. In Europe, Mario Draghi, outgoing head of the European

Central Bank (ECB), announced the tilt to a dovish stance. He proclaimed that nothing was off the cards when considering the tools available to combat falling inflation expectations. Markets interpreted this as quantitative easing reinstated by year end. Whilst inflation remains subdued, there is little reason to doubt central bank willingness to support financial markets.

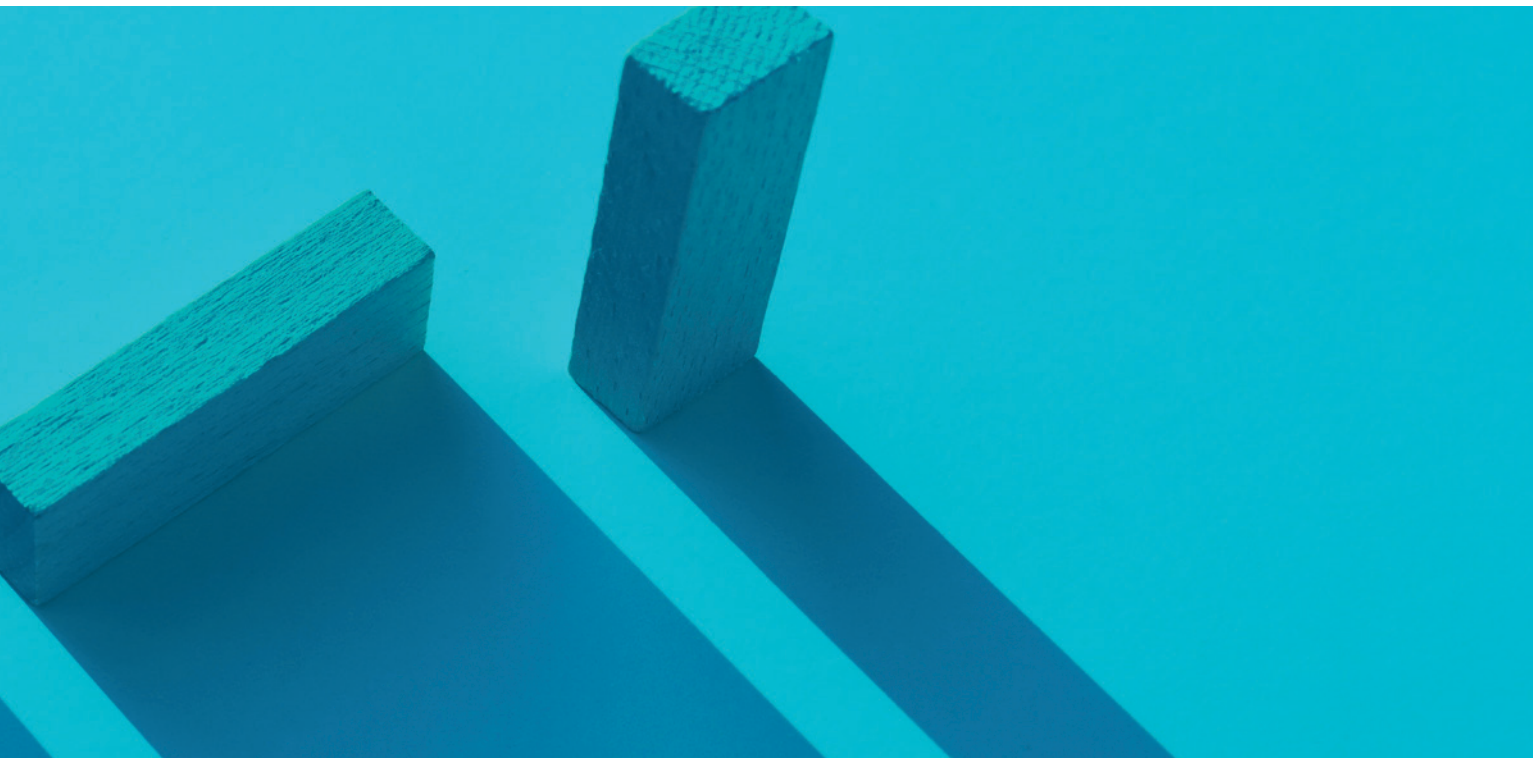
The other driver of improved sentiment, or market volatility, has been President Trump's somewhat unpredictable changes in stance regarding ongoing

Chart 1

Risk not always rewarded in risk-on markets



*ratio of yield to maturity of B rated bond index to BB rated bond index, using ICE Bank of America Merrill Lynch bond indices
Source: Bloomberg, Aberdeen Standard Investments (as of 15th of July 2019)



trade disputes with China, and elsewhere. Volatility in May stemmed from a negative shift in tone and the receding chance of an imminent deal but more recently the outlook has changed once again. Postponement of escalation was achieved at the G20 meeting. The US president also softened his position towards Mexico in June. There is some suggestion that trade disputes are being used to put pressure on the Federal Reserve, though it is difficult to test the validity of those claims.

From flows to fundamentals

So what does this mean for the remainder of the year and further for high yield assets? An ideal scenario in the short term, and one that markets are heavily discounting, is a potentially potent combination of improved global growth momentum and policy easing. This would follow a trade agreement between the US and China, supported by a looser monetary environment. The prospect of this has completely changed the technical picture for bonds. High-yield funds have received inflows of approximately €6bn year-to-date, which is substantial in proportionate terms, as investors anticipate such an outcome. The lack of issuance, only €47bn in the year to date, has further supported prices. European issuance is down by a fifth compared to last year, whilst reinvestment from bond redemptions and coupons further reduces the net supply.

The fundamental picture, however, is not as supportive. Many companies we

look at had been guiding to improved performance in the second half of this year. However, recent deterioration in economic data has led to downward earnings revisions, particularly in industrial sectors. One facet of the rally in European high yield this year is the unusual distribution of returns, suggesting that investors are not as sanguine about the outlook for the asset class as headline returns might imply. Given how strong the rally has been, one would expect to see compression (i.e. lower-quality bonds outperforming higher-quality bonds) but this has not transpired. Year to date, BB credits have returned 7.7% whilst single Bs have only returned 7%. This is more unusual because BBs outperformed by 3.1% in the fourth quarter of 2018. When looking at the relative spread between the two ratings bands, the ratio is clearly elevated (Chart 1).

High-yield funds have received inflows of approximately €6bn year-to-date.

Another surprising feature of the market today, given its firmness, is the heightened distress ratio. 7% of the market is 'distressed' (defined as the

percentage of the market trading with a spread of more than 10%), almost the same proportion at the end of last year. These aspects suggest that investors are increasingly wary of taking credit risk and perhaps concerned about the length of the current credit cycle.

Justified concern

In conclusion, it is perfectly reasonable to expect corporate bonds markets in Europe, and further afield, to perform respectably for the remainder of the year, assuming the key central banks deliver anything close to expectations. Longer term, however, it is clear that investors' concerns are beginning to build, as shown by their reticence to buy lower quality companies. The definition of beta seems to change depending on the direction of the market. In the downdraft of the final quarter of 2018, the classic beta definition of lower quality credits under-performing higher quality credits prevailed – but the opposite did not hold true in rising markets this year. Currently, beta is more correlated to duration with the lowest-yielding, highest-quality longer-dated bonds generating outstanding returns. Monetary policy is central to this phenomenon. In the longer term, the over-reliance on monetary support, and the lack of sustainable economic momentum this has generated, must be a worry for investors.



Real Estate

The changing landscape of global REITs

Svitlana Gubriy
Head of Global REIT Funds

Digital transformation, social connectivity and demographic shifts are changing the REIT (real estate investment trust) industry, challenging traditional real estate sectors and creating new investment opportunities.

The changing landscape of global REITs

Digital transformation, social connectivity and demographic shifts are changing the REIT (real estate investment trust) industry, challenging traditional real estate sectors and creating new investment opportunities.

The new economy

Real estate is a reflection of the economy, how people occupy the space and what kind of space they need. Anticipating those changes and being at the forefront of the change is key in this fast-moving world.

Increasing digitisation and social connectivity impact all aspects of business, society and the economy. They are fundamentally reshaping business models, changing how products are designed, produced and distributed. This in turn affects the way companies communicate with and provide services to their customers. More data needs to be transmitted, stored and analysed.

This transformation of all traditional industries creates a snowball effect on real estate. It affects how and where employees work, shop and live. Office and workplace requirements are shifting towards collaboration and connectivity. Physical retail is being refocused towards brand interaction and consumer experience. These global trends

challenge the traditional definition of real estate, change its function and create new types of real estate.

Increasing digitisation and social connectivity impact all aspects of business, society and the economy.

The face of change

While traditional real estate is embracing those trends and adapting as the business models of its tenants evolve, new types of real estate are becoming an integral and critical part of this transformation.

Omni-channel retailing is transforming retail and logistics real estate

With customers shopping 'anytime, anywhere', the role of the retail store is fundamentally changing. The store is becoming a focal point of brand building and face-to-face customer interaction, rather than just a distribution point. At the same time, retailers' focus on improving logistics and fulfilment strategies is transforming industrial and logistics real estate. In addition,

the direct 'brand-to-consumer' channel is becoming increasingly important in enabling manufacturers to market and sell products directly to consumers.

Demographic shifts are altering the types of accommodation people live in

Renting is increasingly becoming a favoured lifestyle choice. Millennials, also known as Generation Y or Gen Y, value flexibility. Many equity-rich 'empty nesters' whose children have grown up and left home are also looking for a vibrant urban environment and a sense of community. The market is responding to this demand. Over the last several years, single-family rentals have emerged as a new REIT sector in the US. Purpose-built, single-family homes for rent appeal to younger families who want more space but still value the flexibility of renting. A number of healthcare REITs offer senior serviced residences, bringing amenities-rich rental housing to an older generation of renters.

Rapid digitisation creates exponentially more data, transforming the data storage and cell towers sectors

Companies, governments and consumers are handling and consuming more data than ever before. Cloud storage and the rise of 'Big Data' and AI (artificial intelligence) for decision-making require a robust infrastructure for data storage, processing and transmission. Data users require reliable real estate solutions with network

connections and technical redundancies. The real estate focus is shifting towards creating connected campuses that combine all the critical data centre, network and cloud connectivity elements in a single, secure environment.

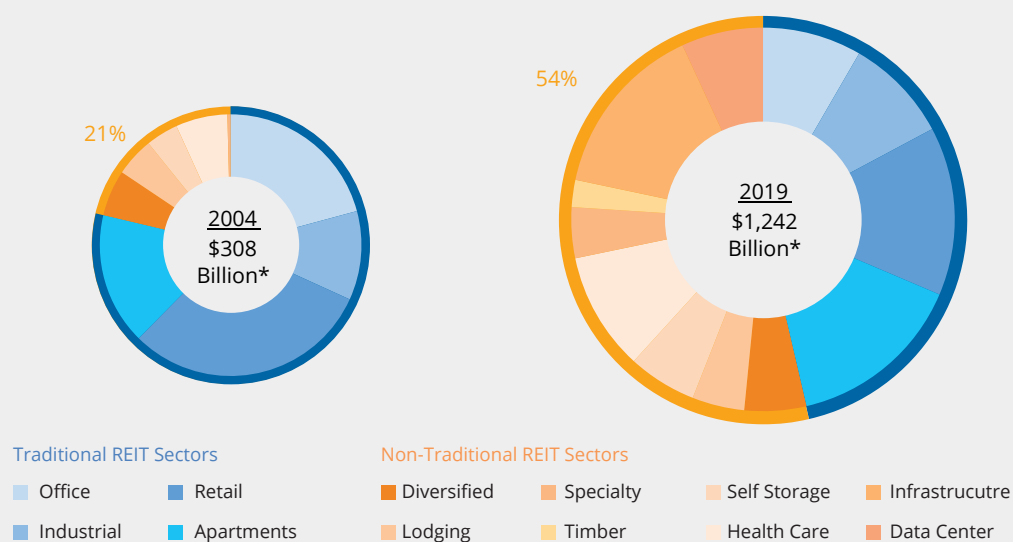
Technology and device evolution lead to the development of advanced applications that, in turn, require higher data consumption. Mobile data traffic is projected to continue growing exponentially as a result of the continuing global 4G network buildout, and 5G rollout in the future. Wireless carriers continue to invest in tower equipment and technology, driving secular demand for towers.

New sectors – new opportunities

There have been significant sector changes within real estate and the REIT industry over the last several years which have important implications for investors. Traditional core sectors have seen their share of the REIT index declining, while new sectors, especially data centres and towers, have become an important part of the investment opportunity set (see Chart 1). Digitisation, social connectivity and demographic changes will continue to be the main forces shaping REIT investment opportunities in the medium to long term.

These structural forces are already driving divergent performance among real estate sectors (see Chart 2). The new, growing sectors have outperformed traditional, 'bread-and-butter' real estate over the course of the full economic cycle and they continue to garner investors' favour. Stronger earnings growth also goes hand-in-hand with the ability of non-traditional sectors to grow dividends. We expect some of these sectors to continue delivering higher long-term growth than many traditional property types, allowing real estate investors to benefit from the secular growth trends in the economy.

Chart 1
Evolution of the US REIT Market

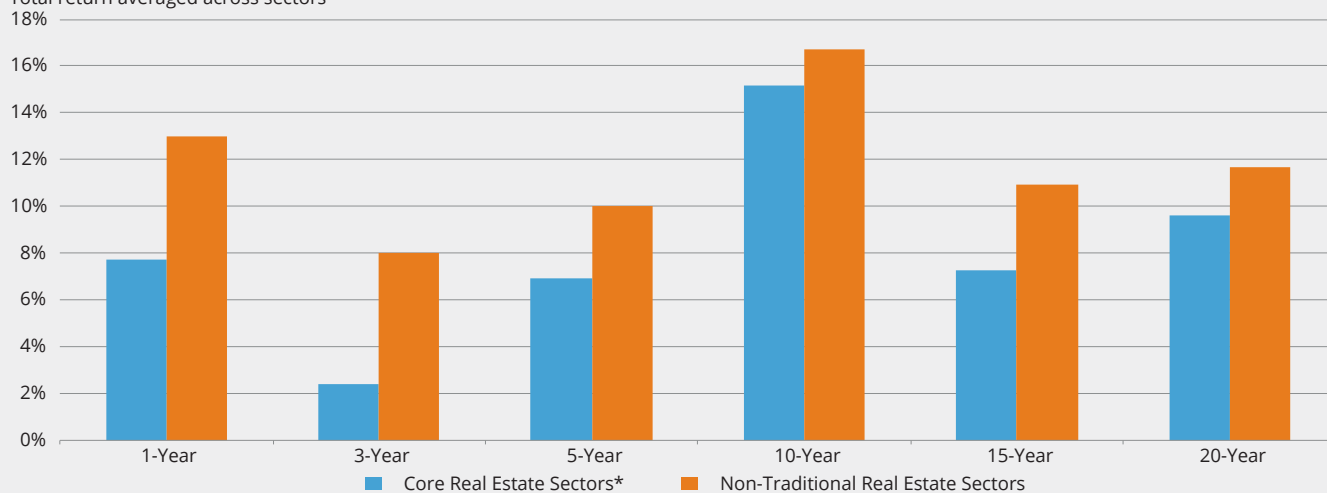


*market cap

Source: NAREIT, Aberdeen Standard Investments (as of 30th June 2019)

Chart 2
Different can often be better

Total return averaged across sectors



Source: NAREIT, Aberdeen Standard Investments (as of 30th June 2019)

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