



Global Outlook

July 2016

Global Outlook is a monthly publication that contains a series of articles examining markets and key investment trends. In this edition, we examine the impact of the EU referendum result on the UK and other economies, and set out our 10-year forecast returns for the major asset classes. We also analyse the implications of negative interest rates in the context of currency intervention and the Japanese bond market, and consider the role of equity income investing in a world of continued low interest rates.



Standard Life
Investments

This document is intended for institutional investors and investment professionals only and should not be distributed to or relied upon by retail clients.

House View

The following asset allocation is based upon a global investor with access to all the major asset classes.

July 2016 House View		
Risk	The Global Investment Group retains a cautious medium-term outlook, as a variety of drivers point to greater financial volatility in the coming year. While there are particular areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
Government Bonds		
US Treasuries	While the upward trend in wages and tighter labour markets gives the Federal Reserve the rationale to raise interest rates gradually, market stress and safe-haven flows into US assets support Treasuries.	MOVED TO NEUTRAL
European Bonds	Bonds are supported by an environment of low inflation, modest economic growth, further QE and negative official rates. Political pressures affecting peripheral bond markets would trigger a quick ECB response.	MOVED TO NEUTRAL
UK Gilts	Political uncertainty related to the outcome of the EU referendum will cause the UK economy to slow into 2017. We expect further Bank of England easing will be required.	MOVED TO HEAVY
Japanese Bonds	The Bank of Japan's sizeable bond-buying programme and negative interest rates have driven valuations into expensive territory, as the authorities continue to try to reflate the economy.	NEUTRAL
Global Inflation-Linked Debt	While inflationary conditions are globally subdued, markets may react to a rise in headline inflation as the impact of previous commodity price weakness becomes less marked over time.	NEUTRAL
Global Emerging Market Debt	Dollar-denominated bonds are Heavy, as spreads show better value, while local currency bonds are Neutral as careful examination of individual currency and spread factors is required.	HEAVY/ NEUTRAL
Corporate Bonds		
Investment Grade	Our preference is to be higher up the corporate capital structure. Widening US credit spreads create an attractive opportunity over low-yielding Treasuries. ECB bond-buying programmes support euro debt.	HEAVY
High Yield Debt	Recent sell-offs have improved valuations modestly, but overcrowding remains a risk in the US market when monetary policy is tightened. European debt remains supported by yield-seeking investors.	NEUTRAL
Equities		
US Equities	Weaker revenues in key sectors such as energy pose a concern, so earnings management is key. Dividends and share buybacks are still supportive, while valuations have become more attractive.	NEUTRAL
European Equities	Corporate earnings in many European countries will be adversely affected by the uncertainty resulting from the UK's referendum, offsetting the improvement in domestic demand seen in the spring.	NEUTRAL
Japanese Equities	The asset class is affected by further yen appreciation but supported by improving corporate governance, lower corporate taxes and the QE programme. Decisions on fiscal policy and structural reforms over the summer are key.	NEUTRAL
UK Equities	The economy was already slowing before the EU referendum result created additional business uncertainty. Movements in sterling will determine the relative attractiveness of domestically or overseas-exposed companies.	NEUTRAL
Developed Asian Equities	Trade flows are increasingly a headwind, with a strong Australian dollar affecting its terms of trade. China's economic slowdown is harming commodity producers as well as regional trade.	LIGHT
Emerging Market Equities	There are pockets of deterioration within emerging markets, with the commodity price slump badly affecting Brazil, political uncertainty in Eastern Europe and large behavioural shifts affecting the Chinese market.	NEUTRAL
Real Estate		
UK	While property yields are still relatively attractive, the result of the EU referendum will discourage overseas flows into UK-located assets for some time.	NEUTRAL
Europe	Core markets continue to offer attractive relative value in light of the low interest rate environment supported by QE, while recovery plays are showing consistent capital value growth.	HEAVY
North America	Canadian property faces headwinds from an interest-rate sensitive consumer and significant office construction. The US should benefit from continued economic growth but pricing is quite aggressive.	NEUTRAL
Asia Pacific	An attractive yield margin remains, but markets are divergent. Returns are being driven by rental and capital value growth in Japan and Australia, but weakening elsewhere. Emerging Asia markets are risky.	NEUTRAL
Other Assets		
Foreign Exchange	The US dollar has risen considerably but benefits from safe-haven status; European and Japanese central banks aim to keep their currencies weak. The EU referendum is negative for sterling.	HEAVY \$, NEUTRAL €, ¥ & £
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions influence the outlook for different commodities.	NEUTRAL
Cash		
	The US and some emerging markets have started to raise interest rates. Policy should remain easy in Europe and Japan, and the next rate move in the UK is expected to be a cut.	NEUTRAL

Foreword

Editor



Andrew Milligan
Head of Global Strategy

In this issue of Global Outlook, we concentrate on two key aspects of the current investment environment, namely the rise of political risk, as demonstrated by 'Brexit', alongside the growing prevalence of negative interest rates and bond yields. In the Global Overview article, Chief Economist Jeremy Lawson explains how uncertainty following the outcome of the UK's referendum on EU membership will seriously affect economic activity not just in the UK but globally. We expect policymakers will need to respond with another round of monetary and eventually fiscal easing – early and aggressive easing is a precondition for a better outcome.

In their articles on currency and Japanese government bonds, investment directors Ken Dickson and Jack Kelly explore some of the complex effects that central bank policies of negative interest rates have on these markets. Meanwhile, in a world

of low growth, low inflation and low yields, there are still opportunities for equity income investors. However, equity fund managers Thomas Moore and Will James warn about the need for very careful examination of companies' business models to ensure that payouts to shareholders are truly sustainable in the current complicated environment.

What do these trends mean for long-term investors? An important article in this Global Outlook is a summary of our exercise to forecast 10-year asset class returns across the major economies. Strategy Analyst Carolina Martinez explains our framework for making those estimates; once again, we have lowered our forecasts. This reflects the environment for more subdued growth and inflation, while also taking into account important drivers such as the outlook for policymaking, productivity trends and risk premia.

Our industry-leading publications

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

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

Economic Overview

Political risks to the fore

Political uncertainty created by the UK's vote to leave the EU will dampen already weak global economic activity and force policymakers to be more supportive, not only through monetary but especially fiscal means.



Jeremy Lawson
Chief Economist

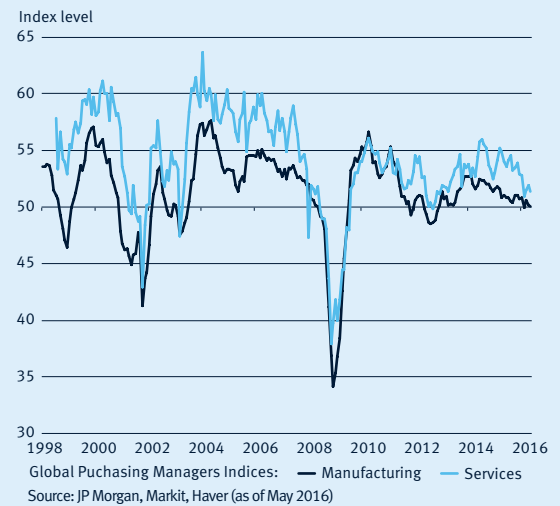
Downgrading growth forecasts

How was the world before the shock of the UK's EU referendum? For the second year running, the global economy started the year with a whimper rather than a bang. First-quarter global GDP growth was about 2.5% in annualised terms, well below our estimates for trend, leaving the global economy close to the weakest it has been since the 2011-12 Eurozone crisis. Coincidentally, it is now Europe that is helping to hold up the global economy; the Eurozone grew at a 2.2% annualised pace in Q1, led by domestic demand, which was faster than Japan (1.9%), the UK (1.6%) and the US (0.8%). Across the large emerging markets, measured Indian growth improved to 9.2% annualised, though we have doubts about the veracity of the data, while the Chinese economy appears to have slowed to 4.4% annualised despite the recent rebound. Meanwhile, the Brazilian and Russian economies continued to contract, albeit at a slower pace. While global headline inflation dropped again, thanks to the precipitous decline in commodity prices, core inflation was under pressure.

Business confidence indicators suggest this subdued trend in global growth continued into Q2. The global purchasing managers' index (PMI) produced by JP Morgan is about its lowest for three-and-a-half years. Subdued sentiment has been broadly based; the global manufacturing PMI is about the expansion/contraction level of 50 (see Chart 1), while the new orders component suggests stagnant industrial conditions ahead. The global services PMI is a little better at 51-52 but this is well below its long-term average. Within the developed and emerging world, particular areas of weakness include contractionary conditions in Japan, the substantial drop in the US non-manufacturing sector's sentiment, and weaker manufacturing activity in East Asia.

Despite these subdued near-term growth signals, we had been confident that global activity would strengthen through 2016 into 2017 – and then the UK voted to leave the EU (see Chart 2). The main factors that have been weighing on US growth – declining energy investment, inventory destocking, tighter financial conditions and the stronger dollar – were expected to fade. Though China's monetary policy is unsustainable over

Chart 1
Losing confidence



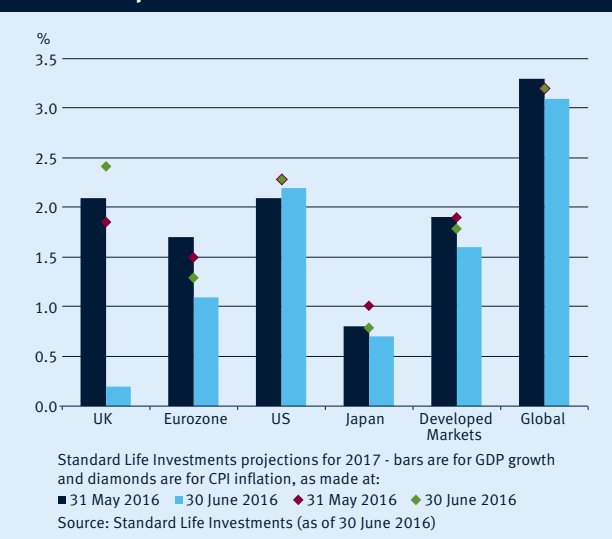
the longer term, the recent credit stimulus has helped activity, while Japan should benefit as the Abe administration has put off raising consumption taxes and is set to loosen fiscal policy. There are also growing signs that the Brazilian and Russian recessions are drawing to a close, helped by a current account improvement.

The impact of Brexit

The EU referendum result requires a much more cautious outlook, especially in the UK but also the Eurozone. Close to 50% of UK trade is carried out with EU member states and 7% of UK employees are (non British) EU nationals. Moreover, the UK financial sector is heavily integrated with the rest of Europe, as are a huge range of professional services. With no clear template for a post-exit relationship with the EU, businesses with ties to the continent are likely to face uncertainty for at least two years during Article 50 negotiations and probably longer. This increases the risk that investment and hiring plans for those companies sensitive to EU trade will be shelved, which will rapidly pass through to connected sectors of the economy. Consumer sentiment will take a smaller hit in the first instance, although this is likely to increase as the shock feeds through to the labour market. Real incomes will also be squeezed as inflation responds to the much lower currency. There will also be an increase in financial stress while credit conditions are likely to tighten – depending on the degree of policy action. We expect these effects to be powerful enough to provide a marked drag on activity.

The Bank of England (BoE) will need to be proactive against this recessionary backdrop. It has already added liquidity to support the banking system and we expect a rate cut of at least 25 basis points during the summer, most likely followed by the recommencement of asset purchases. The trajectory of fiscal policy is also likely to alter as fiscal tightening gives way to easing, initially via automatic stabilisers that allow for higher spending and eventually through structural measures. The combination of looser fiscal and monetary policies should provide some support for the economy, although this is unlikely to offset completely the near-term shock.

Chart 2
Material impact



The economic impact on the Eurozone will be less pronounced but still noticeable. We are especially conscious of the political ramifications in the wake of increased anti-EU/Eurozone sentiment across many member states. The Italians have their own referendum on constitutional matters in October, with potential implications for the Renzi administration, while France, Germany and the Netherlands all go to the polls in 2017. Like the BoE, the European Central Bank (ECB) has already injected liquidity into the Eurosystem and signalled its willingness to do more. Triggers for further action include severe stress in the banking sector, pronounced widening of peripheral bond spreads and signs of weaker growth in core economies.

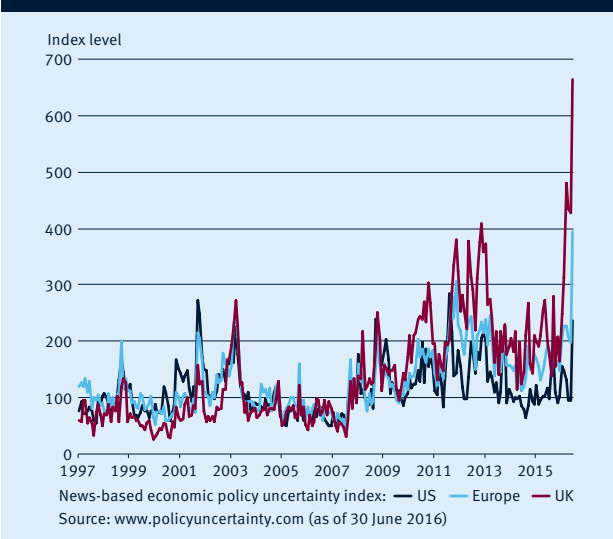
Effects outside of the UK and Europe should be more moderate, although risks require central bank vigilance. The referendum result has sparked renewed stress in global financial markets (see Chart 3), through the appreciation of safe-haven currencies such as the yen and dollar, lower equity prices, especially for financials, wider corporate bond spreads and various pressures on emerging market assets. All this comes at a difficult time for the US Federal Reserve (Fed). After a period of surprisingly resilient US employment growth, the combination of poor corporate earnings and deteriorating credit availability meant employment growth in May was the slowest in more than six years. The unexpected softening in the labour market had already led the Fed to mothball plans to lift interest rates before September; Brexit and the associated increase in financial stress probably delays any tightening until 2017.

Where next for bond yields?

Even if the Fed is able to lift interest rates before the year is out, we remain very cautious about the outlook for long-term interest rates. Ten-year government bond yields have fallen to a four-year low in the US and to historic lows in the UK, Germany and Japan, with the Japanese yield curve trading negative all the way out to 15 years. US inflation expectations are lower than in March despite oil prices having increased by 15% since then.

Politics is one driver; the Brexit vote has reinforced investors' broader concerns about political risks, strengthening the desire for safe-haven assets. Yields also continue to be ground down by the relentless flow of ECB and Bank of Japan bond

Chart 3
Far from certain



purchase programmes; both central banks are purchasing more government bonds than their governments are issuing, and many of the institutions selling their bonds need to re-invest the proceeds into other markets with a positive yield. In the US Treasury market, these factors have helped to push term premia – the premium bond owners require to take on long-term interest rate risk – deeply into negative territory. Meanwhile, there is little evidence that the global saving glut that has been suppressing real interest rates is fading. Easy monetary conditions have been successful in limiting stress in financial markets, but not sufficient to trigger increases in desired private investment or persuade governments to launch large-scale infrastructure investment programmes. Investors may have become less worried about recession risks in recent months, but they are also yet to be convinced that growth and inflation will move much higher, or that markets and economies have become any less dependent on low interest rates.

The Fed also appears to be losing confidence in the economy's ability to absorb high real interest rates. In June 2015, the median FOMC member was projecting a fed funds rate of 2.875% by end-2017, and a longer-run average of 3.75%. This optimistic view was predicated on the expectation that the neutral real interest rate would recover from just above zero today to around 1.5% in the medium term. In June 2016, members' end-2017 projections have dropped to 1.6% and their long-term projection to 3% – a hefty change in just 12 months.

The only realistic trigger for a meaningful lift in real interest rates is a shift in firms' willingness to invest in productive capita, that in turn lifts productivity growth, corporate profits and real wages. There is little sign of that in the data, political uncertainty makes that less likely, and it is beyond the ability of central banks alone to deliver. What the world needs is a coordinated loosening of fiscal and monetary policy amidst widespread structural reforms designed to return productivity growth to historic norms. Economists have been recommending such action for some time but governments have yet to receive the message. We can only hope that global growth does not need to decelerate much further before political pressures force policymakers to listen.

Currency

Negative rates: do they drive currencies lower?

Negative rates were expected to be a central part of the easy-money policy armoury, but currency implications have surprised the market.



Ken Dickson

Investment Director, Currency

Negative rates as a driver of currencies

The relationship between negative rates and currencies is not well understood, as this phenomenon has a rather limited history. Ahead of recent central bank policy decisions, investors expected that negative rates would be a means of directly attacking currencies – an extension to the easy-money policy armoury that included quantitative easing (QE), forward guidance and zero interest rate policy (ZIRP). One important issue to highlight is that the mandate of some central banks means they are unable to hold assets earning negative rates. This might indeed be a significant factor in the euro's relative weakness in 2014, for example. However, our analysis suggests that currencies react more to QE and to interest rate differentials rather than to whether one country's interest rate is positive or negative.

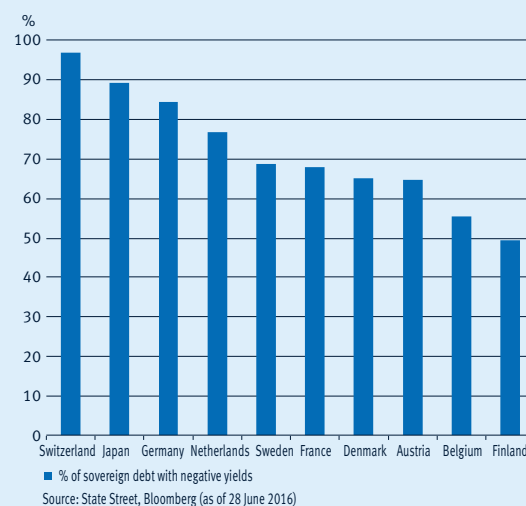
Extraordinarily low global interest rates

Nominal and real bond yields across the world are still falling, with Australian, German and Swiss yields recently breaking new lows. At face value this is surprising, given historically high public sector debt-to-GDP ratios. However, other factors such as low inflation, QE, regulatory-driven buying and global savings and investment imbalances have proven more important. As negative government bond yields have become more common (see Chart 1), interest rate curves have flattened and interest rate differentials between currencies have moved lower. This has meant that foreign exchange carry portfolios have continued to underperform. Moreover, when so many countries operate a negative interest rate policy, investors understandably suspect an element of desperation in economic policy. This has often led to an increase in risk aversion in trading, irrespective of the available carry.

Different monetary policy tools

In many cases a conventional monetary approach of rate cuts was followed by ZIRP and then QE before a move to negative rates was tried. However, this path has not been followed by everyone. The Bank of Japan (BoJ) adopted a QE policy as far back as 2001, although more relevant is the re-start date for more aggressive QE in December 2012. The ECB had negative rates before QE, the Riksbank announced QE and negative rates at the same time, and the Swiss National Bank has never had QE. While the journey through the monetary policy maze differs across countries, there is a clear tendency for fixed income markets to pre-empt policy as negative bond yields became the norm ahead of any official announcement.

Chart 1
Going underground



Mixed currency reactions to negative rates

Different announcements have different effects. The euro fell substantially on a trade-weighted index when interest rates turned negative. Yet since QE was announced the euro has become more stable. In contrast, Swedish policymakers tried QE first and then had a number of iterations of negative rates and QE packages. The Swedish krona fell in anticipation of these moves, but then the policy announcements merely created additional volatility with no directional impact.

Safe-haven currencies are more interesting. The Swiss franc (CHF) had a currency floor in place alongside negative short-dated yields for a few years before the EUR-CHF floor was breached in January last year – just after official rates also went negative. The Swiss franc remains 10% stronger versus the euro than in January 2015. Elsewhere, the yen weakened against the US dollar after BoJ QE programmes were announced in December 2012, April 2013 and October 2014 – culminating in a currency depreciation totalling almost 50%. However, since the announcement of negative rates in February this year, the yen has actually moved about 12% higher. So it appears that negative rates are currently having the opposite effect to policymaker and market expectations; as global carry returns are reduced and investors become more risk averse, this pulls safe-haven currencies higher, not lower.

Our currency views

At the end of last year we suggested that range trading would become increasingly prevalent as carry returns fell and currency volatility increased. In developed markets, negative rates have hurt investor confidence and, in combination with a more cautious outlook from the Fed, have undermined the case for monetary policy divergence within a gradual global recovery. This has hurt the performance of the US dollar in the major markets, but the risk-averse regime has also led to the underperformance of some emerging market currencies. Our longer-term preference for the US dollar reflects safe-haven flows post the UK's vote on the EU, as well as higher US interest rates, so weaker Asian and commodity currencies are the best way to play these themes. Our favoured approach is to be short the Korean and Taiwanese currencies.

Government Bonds

The oddities of demand for Japanese government bonds

Although Japan's negative interest rate experiment has not been a success, we expect a steeper yield curve in Japan as the central bank explores more unconventional policies.



Jack Kelly
Investment Director, Government Bonds

Currency basis and wafer-thin mints

The Bank of Japan's (BoJ) decision in January to cut interest rates into negative territory was meant to be a constructive game-changer. The playbook suggested this should weaken the currency and signal the central bank's intent to create inflation. Yet, in a nation of savers, debate has raged about the efficacy of negative rates. However, policymakers have become bolder out of necessity, with new policy approaches being tested. After the Eurozone, Switzerland and Sweden embarked on the experiment of negative rates, the stigma of more radical non-conventional policy was partially removed. One particular reason for the BoJ going down this path was to challenge the view that its policy action would be incremental at a time when its ongoing bond purchase programme, buying 80 trillion yen's worth a year, was already seen as unsustainable. As the free float of bonds available to sell to the BoJ dries up, unwanted volatility has been the result.

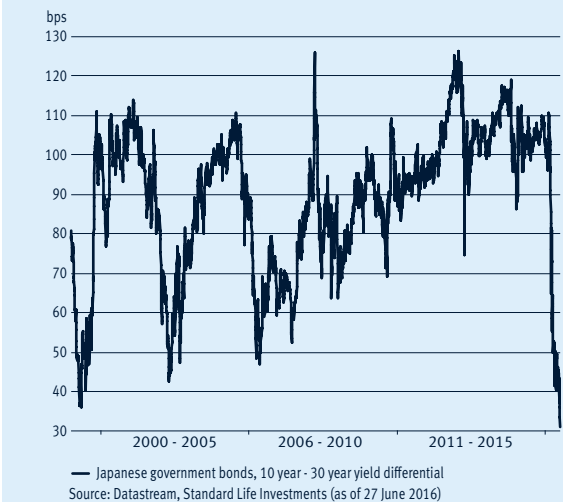
The immediate reaction to negative interest rate policy (NIRP) in Japan was adverse. Lower share prices, heightened bond volatility, an appreciating currency, and hence lower inflation expectations, all reflect market pessimism about the policy's effectiveness. The realisation is growing that on its own, NIRP is not the answer. One concern is that it hits banks' profitability, which counter-productively reduces their willingness to lend. There is a growing awareness that any further monetary easing should be multi-pronged, with improved measures to ease the pressures on banks.

A particular concern for the Japanese government bond (JGB) market is a technical aspect called 'currency basis', which is the difference between covered interest rate parity and the price. This can increase the attractiveness of a bond market to external investors. In Japan, US-based investors can take advantage of the dollar/yen basis to enhance returns above US Treasuries by buying JGBs, despite their negative yields. This is one explanation for the continued growth in foreign investment in JGBs, which has only served to dampen yields further.

New alternatives

The BoJ is searching for alternatives to its bond purchase programme. Domestic investment banks are now pulling out as primary dealers of JGBs because of the sheer unprofitability of that market. Accordingly, the Bank should turn to other assets to do some of the heavy lifting in Japan and take some

Chart 1
Fast flattening of the yield curve



of the buying pressure off the bond market. While some commentators have become disillusioned about any Japanese recovery, we observe that central banks are unwilling to give up the fight, exploring novel approaches as and when their usual measures become exhausted. The BoJ simply does not have the luxury of inactivity, demonstrated by the recent appreciation in the yen/US dollar exchange rate towards its highest levels in two years. In turn, this has suppressed inflation and hampered competitiveness.

All of this points to the possibility that the BoJ becomes the first central bank to embark on a 'helicopter money' policy. Even a broad discussion of such an extreme policy option could begin to steepen the yield curve, as inflation expectations alter. Of course, helicopter money has many variants, such as retail vouchers for households to spend within a set time period. Therefore, it would be faster and looser than any balance sheet expansion attempted previously. We think this development is currently too radical for politicians. Other options could include tailoring some European Central Bank-style policies, such as a direct lending programme providing loans to Japanese banks against an increase in specified domestic loans.

What will happen to the yield curve?

Many owners of JGBs are constrained into holding them for regulatory and collateral reasons and are therefore price insensitive. Nevertheless, there are multiple investor bases in the 10-year (negative yield) and 30-year (positive yield) parts of the curve (see Chart 1). Differing levels of price insensitivity would drive a partial bull steepening in the event of a 'sellers strike' environment, following a failed BoJ reverse auction or another rate cut. Looking ahead, once the upper house elections are out of the way this summer, we expect the next phase to include widening the scope of asset purchases away from JGBs to other assets, such as equities. The net effect should be a steeper yield curve. Governor Kuroda may have originally wanted to pursue the portfolio substitution effect by driving investors out of bonds into riskier asset classes. However, the reality of stalling growth, a moribund stock market, unwanted currency strength and falling inflation expectations will jumpstart the requirement for a fresh policy mix in coming months.

10-year forecasts

Long-term return estimations: adjusting to the structural changes

Estimating long-term returns is particularly challenging in the face of major structural changes to the global economy. A recalibration of future likely asset returns is appropriate.



Carolina Martínez
Strategy Analyst

Long-term return estimations

When building a portfolio, it is important to consider different time periods. Long-term portfolios can take advantage of time-varying investment opportunities by searching for financial assets that can protect them from wealth shocks. An estimation of long-run returns can support the strategic asset allocation decisions of investors looking to finance a stream of consumption over time, and can be appealing to those who want positive returns across potentially very different economic scenarios.

Our asset valuation framework

Our approach to estimating long-run returns across different asset classes starts with estimates of cash returns and then builds on those projections using term and risk premia estimates (see Chart 1). Cash returns are intrinsically related to official policy rates set by monetary authorities. Hence our estimates reflect our expectations about the evolution of monetary policy in each of the major countries considered. One important factor that we take into account is the neutral or natural real interest rate; the real rate consistent with stable inflation and the economy growing in line with its potential. Estimates of the natural rate help central banks calibrate the stance of monetary policy with current and expected macroeconomic conditions.

Sovereign bond market returns can be decomposed into inflation expectations, the expected future path of real short-term policy rates, and a term premium. The term premium is the compensation investors require for holding a long-term bond instead of a series of short-term bonds. For corporate bond returns we incorporate expectations for credit spreads, the premium required for investing in corporate securities that are intrinsically riskier than sovereign bonds with the same maturities. Duration is more relevant when assessing investment grade bond returns, while repayment risk is more relevant for high yield bonds. We estimate equity returns by projecting stock market prices under a growth model that takes into account the effects of our long-term economic scenario over equity valuation metrics such as earnings and dividend yields. The returns estimated using this method allow us to form our view on the equity risk premium; conceptually the return required for investing in an asset riskier than sovereign bonds.

Finally, commercial real estate returns estimates require a more comprehensive analysis. In addition to national economic conditions, like population or income, regional specific factors, such as building regulation and land availability, play an important role in determining returns.

What is changing? Transitioning to a new state

Most of the standard approaches to estimating long-term returns assume that asset prices converge to their historical averages over the longer-term. However, this is inappropriate when the structural drivers of returns are changing as they have in the post-financial crisis period. Although we do not think the global economy is yet trapped in secular stagnation, we do think the main developed economies are transitioning to a new equilibrium of lower growth requiring permanently lower interest rates. This is primarily because there is a global excess of savings relative to desired productive investment (see Chart 2). This is related to deteriorating demographics, high public and private debt levels, weak private sector demand and fiscal austerity. Heightened uncertainty about future growth is also weighing on returns, aggravated by political shocks such as UK voters' decision to opt out of the European Union.

Our starting point: estimating cash returns

The median estimate for cash returns in developed markets has been revised down to 1.3% from the 2.3% return estimated during the previous two years (see Chart 3). The UK was subject to the largest revision, with returns falling to 1.6%, down from 2.9%. These changes are mostly explained by our assessment that policy rates will need to remain lower for longer to support growth and push up inflation. Europe's returns have been subject to an especially large revision, down to 1% from 1.9% thanks to the implementation of negative short-term interest rates and our expectation that quantitative easing and accommodative monetary conditions will be necessary for many years. We have also revised down our expectation for Japanese returns as interest rates have turned negative and easy monetary policy has been shown to be less effective than expected.

Moving forward - adding premia layers

Term premia have collapsed across developed markets during the post-crisis period, with the correlation between short-term policy rates and term premia becoming more sharply negative. Low current and expected inflation has helped to lower term premia over the past 12 months, as have the aggressive bond purchase programmes of the European Central Bank (ECB) and Bank of Japan. We expect term premia to remain compressed for much of the next decade. All in all, our median estimate for sovereign bond returns in the main developed markets is only expected to reach an annual 1.6% during the next 10 years, 0.7% below the last two years' estimates.

The slow growth/low rates environment constrains credit returns in the long-run, although the spread over safe assets is mostly expected to be in line with its longer-term average. The main exception is the UK, where we assume that the UK's exit from the EU leads to a widening in spreads. The long-term effects of the inclusion of corporate bonds in the ECB's asset purchase programme are the main game changer for European credit spreads.

Equity and real estate

Extremely easy monetary conditions since the financial crisis, exemplified by zero or even negative interest rates, have encouraged investors' search for dividend yield, in turn driving equity prices up. Some aspects of firms' balance sheets have also become healthier, although companies' ability to finance themselves at low cost has also helped. Among the developed markets, a key return differentiator has been the

variable earnings performance of companies since the financial crisis; for example, US companies were able to cut labour costs more easily than in Europe, where less flexible labour markets did not allow companies to easily adjust to changes in economic conditions. In the long run, equity returns still look attractive relative to cash returns, with higher returns in the US reflecting the country's greater productive potential. Meanwhile, the healthy returns in Japan are mostly supported by the growth scenario in the US, and by internal factors such as our expected path of positive inflation figures in the long-run as a result of monetary stimulus. We have downgraded projected equity returns in the UK and Europe partly due to lower expected trend growth, but also due to the likelihood of increased political uncertainty in a post-Brexit environment.

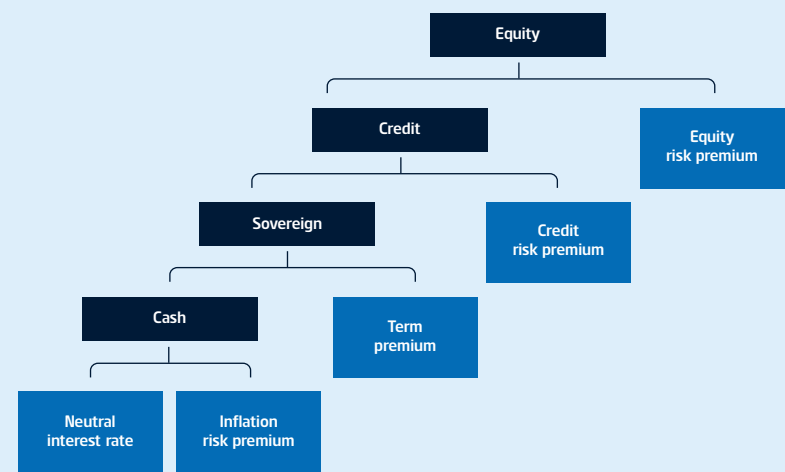
Finally, we have also revised down our forecasts for UK real estate returns thanks to a more challenging environment for institutional inflows from international investors. Elsewhere long-term returns should remain healthy, supported by positive rental growth, subdued supply dynamics, an attractive yield spread over sovereign bonds and supportive monetary conditions.

Key risks and triggers to change our view

The major upside and downside risks to these long-term returns estimates relate to four factors: global growth disappointments, persistently high political uncertainty, productivity and inflation policy. For example, our current projections assume that over time monetary policy will be successful in delivering a return to target inflation in the developed markets, so more persistent inflation misses and inflation volatility will put downward pressure on asset returns. Meanwhile, the decision of a majority of UK voters to leave the EU highlights the political risks to policies and institutions that underpin productivity growth in both the short and longer term. Pressure points are clearly appearing in a number of developed market countries.

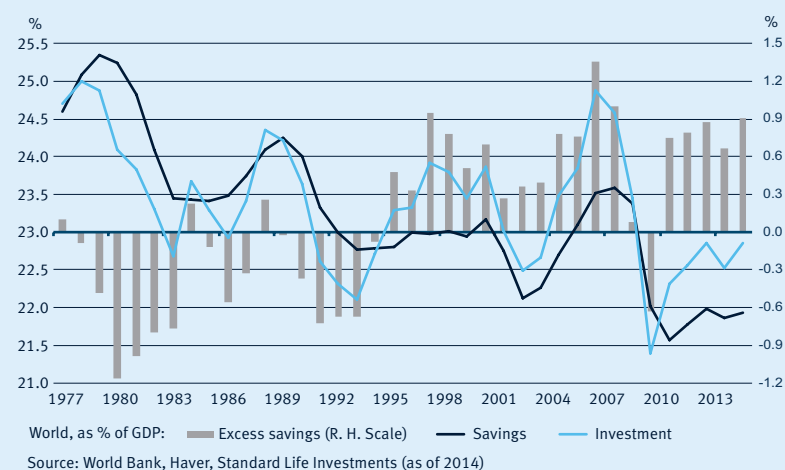
On the flipside, a decisive shift away from a world of low growth, low interest rates and low inflation would cause us to upgrade our returns forecasts significantly – at least in nominal and, perhaps, in real terms. A key trigger would be a future strong pick up in productivity growth, probably related to a successful series of structural reforms in one or more of these economies, or perhaps more favourable trends in innovation. Better co-ordination between monetary and fiscal policy might also contribute to future growth, especially if accompanied by increased infrastructure spending to enhance private or public sector productivity growth. Lastly, the long-term outlook for inflation needs to be considered. Against the current backdrop, it is understandable that there is growing speculation about monetary financing of either government spending or tax cuts (i.e. the appearance of helicopter money) as a plausible solution for excessively low inflation. In practice, the impact on asset returns is less certain. While there could be positive effects from this policy on nominal GDP that would affect risk asset returns, there could be mixed effects on bond returns depending on how term premia and inflation components react.

Chart 1
Risk premia approach



Source: Standard Life Investments

Chart 2
Savings glut



Source: World Bank, Haver, Standard Life Investments (as of 2014)

Chart 3
10-year return projections and comparisons

	% per annum	10-year return projection	Average of 2014-2015 projections
Cash	US	2.2%	2.7%
	UK	1.6%	2.9%
	Japan	0.3%	1.1%
	Europe ex. UK	1.0%	1.9%
Government Bonds	US	2.2%	2.5%
	UK	1.5%	2.4%
	Japan	0.5%	1.4%
	Europe ex. UK	1.8%	2.3%
Corporate Bonds	US	3.2%	3.5%
	UK	3.0%	3.5%
	Japan	1.8%	2.0%
	Europe ex. UK	3.2%	3.4%
Equities	US	5.6%	6.4%
	UK	5.2%	6.8%
	Japan	5.2%	5.8%
	Europe ex. UK	5.0%	5.7%
Property	UK	5.0%	6.7%
	Europe ex. UK	5.0%	6.8%

Source: Standard Life Investments (as of 30 June 2016)

Equity Income

Finding sustainable dividend yields

While political uncertainty can cause market turmoil, this can allow active fund managers the opportunity to find attractive companies with good 'sustainable yield' properties.



Thomas Moore and Will James
Investment Directors, UK and European Equities

Politics and markets

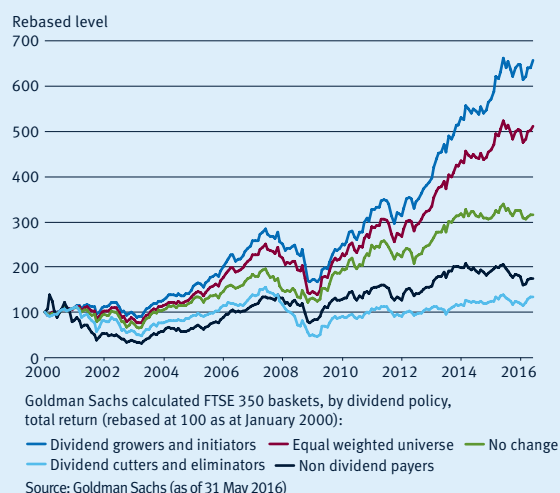
While recent tense market action following the UK's vote on EU membership may have shaken some investors' faith in equities as a long-term investment, it is worth remembering that geopolitics tends to dominate corporate earnings only temporarily as a key driver of share prices. Our fundamental belief is that active stock-pickers will be rewarded for identifying companies which can grow cashflows and dividends over time, particularly in a world of slow economic growth, low inflation and low interest rates. Macro-factors usually only dominate for short periods in times of crisis. Companies with the ability to grow and pay out dividends to shareholders tend to produce strong share price performance over time (see Chart 1).

This process requires careful analysis of a company's business model though, to determine not only whether a company can invest, grow its corporate revenues and pay out cashflow through dividends or share buybacks, but also whether it can do so on a sustainable basis. This is particularly so bearing in mind the normal rigours of the business cycle, let alone extra risks related to politics, regulation, the commodity cycle or emerging markets to name but a few. Essentially, fund managers and shareholders want to be able to maximise the cashflow return while minimising the cashflow risk, which suggests aligning portfolios with companies that can deliver value wherever they are in the investment cycle.

Sustainable yield

When searching for income ideas, it is important to focus on dividend sustainability. In a slow-growth, low-yield world, it is tempting for investors to be lured into high-yield stocks without questioning the durability of those dividends. Recent high-profile dividend cuts – examples range from Tesco, Rolls Royce and Barclays in the UK to EDF in France and TDC in Denmark – are a reminder of the perils of equity income investing. Companies from a broad range of sectors – including banks, mining, industrials, food retailers and utilities – have disappointed investors with savage dividend cuts in recent years. What did these companies have in common? The answers were high payout ratios, stretched

Chart 1
Paying dividends



balance sheets and declining cashflows, all warning signs for investors that trouble lay ahead. The key for income investors is to make sure they avoid companies that are forced to cut dividends, and to identify the risk early.

Rather than just focus on high yield, investors wanting to maximise total return need to focus on dividend sustainability and dividend growth. This requires a differentiated and robust understanding of both the opportunities and the risks for the companies we analyse; what are the growth opportunities – be it growth in an industry with high barriers to entry or market share gain; what pricing power do they have; how cost competitive are they; or does their balance sheet give opportunities to benefit from the travails of other companies. The good news is that investors can currently find a wide range of companies with solid balance sheets and growing cashflows, which can underpin sustainable dividends and growth in the years ahead.

One example is UK-based Saga, where post IPO, there is a large growth opportunity as its business model is focused on the over-50s demographic. In addition, its capital allocation strategy is shifting from a motor insurance business into a 'broker panel' model. This means Saga is becoming less capital intensive and so may be able to return more capital to shareholders. Turning to Continental Europe, take Novo Nordisk as an example. Given its business model and strength of its diabetes franchise, Novo has been able to grow its dividend progressively (ahead of market expectations) over time – indeed it grew its dividend by 28% in 2015! As a result, the compounding impact of that cash delivery and dividend growth on the share price should continue to be impressive.

In summary, with low interest rates and worries about the global growth dynamic, dividends are set to continue to be a key driver of the total return from equities. The goal is to find defensible business models that generate cash and can pay out and grow a healthy and sustainable dividend stream. Market volatility presents an opportunity for active income investors with a focus on cashflow to capture those opportunities.

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Standard Life Investments is one of the world's leading investment companies, offering global coverage of investment instruments and markets. We currently have global assets under management of approximately £253.2 billion – this equates to \$373.3 billion, C\$518.4 billion, A\$512.8 billion and €343.5 billion (all figures as at 31 December 2015).

We are active fund managers, placing significant emphasis on research and teamwork. After in-depth analysis, our Global Investment Group (GIG) forms a view of where to allocate assets, based on the prevailing market drivers and on forecasts

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