Global Outlook

June 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 stresses on emerging market economies, updating our heat-map approach, analyse the pressures facing the US retail sector, outline some of our latest absolute return ideas, describe recent research of the Investment Leaders Group and consider the outlook for Swedish government bonds.
The following asset allocation is based upon a global investor with access to all the major asset classes.

<table>
<thead>
<tr>
<th>June 2016 House View</th>
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<tbody>
<tr>
<td><strong>Risk</strong></td>
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<tr>
<td>The Global Investment Group retains a cautious near-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.</td>
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<tr>
<td><strong>Government Bonds</strong></td>
</tr>
<tr>
<td><strong>US Treasuries</strong></td>
</tr>
<tr>
<td>Tightening labour markets and rising wages can give the Federal Reserve reason to raise interest rates gradually, although it is wary of market stress and global economic conditions.</td>
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<tr>
<td><strong>European Bonds</strong></td>
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<tr>
<td>An environment of low inflation, modest economic growth, further QE and negative official rates supports European bonds. Political pressures may affect peripheral bond markets on occasion.</td>
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<tr>
<td><strong>UK Gilts</strong></td>
</tr>
<tr>
<td>The positive economic growth backdrop is supportive for eventual rate increases. The Bank of England will examine how the US tightening cycle progresses and monitor inflation pressures.</td>
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<tr>
<td><strong>Japanese Bonds</strong></td>
</tr>
<tr>
<td>The Bank of Japan’s sizeable bond-buying programme and negative interest rates have driven valuations into expensive territory, as authorities continue to try to reflate the economy.</td>
</tr>
<tr>
<td><strong>Global Inflation-Linked Debt</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Global Emerging Market Debt</strong></td>
</tr>
<tr>
<td>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.</td>
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<tr>
<td><strong>Corporate Bonds</strong></td>
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<tr>
<td><strong>Investment Grade</strong></td>
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<tr>
<td>Our preference is to move 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.</td>
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<tr>
<td><strong>High Yield Debt</strong></td>
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<tr>
<td>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.</td>
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<tr>
<td><strong>Equities</strong></td>
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<td><strong>US Equities</strong></td>
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<tr>
<td>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.</td>
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<tr>
<td><strong>European Equities</strong></td>
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<tr>
<td>Corporate earnings should receive a lift from an improvement in domestic demand, good cost control and cheaper commodities, but a variety of political issues overhang the markets.</td>
</tr>
<tr>
<td><strong>Japanese Equities</strong></td>
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<tr>
<td>The asset class is affected by yen appreciation but supported by improving corporate governance, lower corporate taxes and the QQE programme. Decisions on fiscal policy and structural reforms over the summer are key.</td>
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<tr>
<td><strong>UK Equities</strong></td>
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<tr>
<td>Domestic economic strength is offset to some extent by political uncertainty. A large portion of the market is exposed to weaker commodity prices, emerging market pressures and greater banking regulation.</td>
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<tr>
<td><strong>Developed Asian Equities</strong></td>
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<tr>
<td>Trade flows are increasingly a headwind, with a strong Australian dollar affecting its terms of trade. China’s economic slowdown is harming commodity producers.</td>
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<tr>
<td><strong>Emerging Market Equities</strong></td>
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<tr>
<td>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.</td>
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<tr>
<td><strong>Real Estate</strong></td>
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<td><strong>UK</strong></td>
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<tr>
<td>The economic growth environment is supportive for the asset class and yields are still attractive, but the market is more advanced in the cycle than continental Europe.</td>
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<td><strong>Europe</strong></td>
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<tr>
<td>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.</td>
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<tr>
<td><strong>North America</strong></td>
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<tr>
<td>Canadian real estate faces headwinds from an interest-rate sensitive consumer and significant office construction. The US should benefit from continued economic growth but pricing is quite aggressive.</td>
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<tr>
<td><strong>Asia Pacific</strong></td>
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<tr>
<td>An attractive yield margin remains, but markets are divergent. Returns are driven by rental and capital value growth in Japan, but limited to capital growth in Australia, Hong Kong and China. Emerging Asia markets are risky.</td>
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<tr>
<td><strong>Other Assets</strong></td>
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<td><strong>Foreign Exchange</strong></td>
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<tr>
<td>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.</td>
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<tr>
<td><strong>Global Commodities</strong></td>
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<tr>
<td>Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions influence the outlook for different commodities.</td>
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<tr>
<td><strong>Cash</strong></td>
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<tr>
<td>The US and some emerging markets have started to raise interest rates while the UK waits for the opportune moment. Policy should remain easy in Europe and Japan.</td>
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Foreword

Editor

Alex Wolf
Emerging Markets Economist

Standard Life Investments is a founding member of the Investment Leaders Group (ILG), a global network of pension funds, insurers, asset managers and academics from the University of Cambridge. The article from Andrew Mason, Responsible Investment Analyst, summarises a recent report from the ILG and explains how its work informs our investment philosophy and influences our environmental, social and governance approach. Elsewhere in this edition of Global Outlook, Nicolas Jaquier, Investment Director, Emerging Market Debt, updates our heat-map approach to flagging up early warning signals of a potential crisis. Nicolas then explains some of the latest developments, both economic and political, currently affecting Brazil. Many developed and emerging market economies need to undertake structural reforms. Our absolute returns strategy looks to take advantage of multiple sources of risk and reward, including an examination of the reform agenda driving change in Italy and Indonesia, as described by Jennifer Catlow, Investment Manager, Multi-Asset Investing. Sweden is a prime example of the complex domestic and foreign issues driving central bank policy making in a small open economy. Ross Hutchison, Investment Analyst, Government Bonds, explains how and why the house view has approached this issue. Lastly, US retailers have faced a difficult time since the 2008 recession, and Jeff Morris, Senior Vice President, US Equities, explains in particular how such firms are coping with the inexorable rise of online sales.

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.

<table>
<thead>
<tr>
<th>Publication</th>
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<tbody>
<tr>
<td>Weekly Economic Briefing</td>
<td>A regular analysis of major cyclical developments and structural themes in leading advanced and emerging economies.</td>
</tr>
<tr>
<td>Global Outlook</td>
<td>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.</td>
</tr>
<tr>
<td>Global Horizons</td>
<td>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.</td>
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Emerging Market Debt

Emerging market risks are becoming more dispersed

Crisis risks in Brazil have moderated, but significant fiscal and political challenges remain elsewhere.

Nicolas Jaquier
Investment Director, Emerging Market Debt

Risk on the rise

The update to our emerging market (EM) heat-map signals a modest increase in risk since October last year, with a significant dispersion across metrics and countries (see Table 1). Risk increased the most on our measures of domestic imbalances, driven by rising house price-to-income ratios and non-financial corporates leverage (net debt-to-EBITDA). Depreciating exchange rates are partly responsible, as they boost the value of corporate debt denominated in foreign currency in some places. However, the continued slowdown in domestic income growth, reflecting slower GDP growth, plays a larger role and affects both measures. Changes in external risk metrics have been more mixed. The medium-term trend in real effective exchange rates continued to weaken, even after the rally in EM currencies over the first quarter of this year. However, basic balances deteriorated slightly, especially in Latin America (apart from the largest economies: Brazil and Mexico). This is largely a reflection of lower commodity prices (Argentina, Chile, Peru and Venezuela). However, domestic demand also remained healthy in some cases, which kept imports up.

Across regions, risks increased at the margin in every Asian economy on rising measures of domestic vulnerabilities. Levels of risk were already the lowest in Eastern Europe and decreased further by a small amount. Risks increased on average in Latin America, but this hides diverging trends: an increase in risk in Andean economies, but a marked decrease in Brazil.

Brazilian risks decrease

The decrease in risk in Brazil, from ‘moderate’ to ‘light’, at first seems surprising given the heightened sense of economic crisis, but it goes back to the purpose of the heat-map. The usefulness of this approach is to flag early warning signals of a potential crisis rather than assess the magnitude of a crisis that is already happening. As was the case in Ukraine last year, crisis vulnerability will tend to mean revert while the country is in the midst of a painful adjustment. In Brazil’s case, external metrics are improving, highlighted by the turnaround in the basic balance (see Chart 1). While global demand remains subdued, the severe recession is taking its toll on Brazilian domestic demand, which is evidenced through contracting imports. In addition, foreign direct investment has remained stable. While the contracting economy dims the allure for foreign investment, the large depreciation of the Real has helped domestic assets cheapen. There is also anecdotal evidence that some foreign companies have perceived the current state of affairs as an opportunity to buy Brazilian assets on the cheap.

Fiscal risks remain high

So far, signs of adjustment in Brazil are still mainly concentrated on the external front, but there are tentative improvements in terms of domestic imbalances as well. Thanks to rapidly declining credit growth our credit-to-GDP measure has fallen into the neutral level of risk, with the latest credit figures for March showing a monthly contraction in total lending for the first time in several years. As banks retrench, nominal GDP growth will continue to outpace credit growth, bringing further improvement.

However, Brazil’s main challenge is still its gaping fiscal account. No meaningful reform has been undertaken and targets for the primary fiscal balance continue to be revised downward. Therefore, the heat-map has seen no correction of Brazil’s score for public balance sheet risk. Although there has been a measured improvement in the conduct of fiscal policy as it turned counter-cyclical, we consider this misleading because it stems from a continued rise in government spending over the last couple of years while the economy fell into deep recession. In theory, increasing public expenditures to smooth out the effect of an economic downturn where fiscal space exists is the right policy prescription. However, in Brazil, the large degree of indexation and earmarked spending has led to a ballooning deficit and contributed to the loss of confidence that tipped the economy into recession.

Given the unsustainable path for public debt, spending will need to be cut back considerably. Acting President Michel Temer has already formulated his intention to tackle these longstanding issues, such as reforming the social security system. It remains to be seen whether he will have the political capital to see these measures through.
### Heat-map of emerging market countries' vulnerability to a crisis

<table>
<thead>
<tr>
<th>Country</th>
<th>External</th>
<th>Domestic</th>
<th>Public</th>
<th>Policy Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Basic</td>
<td>Basic</td>
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<td>2.7</td>
</tr>
<tr>
<td>Brazil</td>
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<td>2.7</td>
<td>1.2</td>
<td>3.6</td>
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<tr>
<td>Chile</td>
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<td>2.7</td>
<td>1.2</td>
<td>3.6</td>
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<tr>
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<tr>
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<tr>
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<tr>
<td>Venezuela</td>
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<tr>
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<td>2.7</td>
<td>1.2</td>
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<tr>
<td>Egypt</td>
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<td>1.2</td>
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<tr>
<td>Hungary</td>
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<tr>
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<td>3.6</td>
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<tr>
<td>South Africa</td>
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<td>2.7</td>
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<tr>
<td>Turkey</td>
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<tr>
<td>Ukraine</td>
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<td>India</td>
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<td>Indonesia</td>
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<tr>
<td>Korea</td>
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<td>Malaysia</td>
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<tr>
<td>Philippines</td>
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<tr>
<td>Thailand</td>
<td>7.3</td>
<td>2.7</td>
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<td>3.6</td>
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**Source:** Standard Life Investments (as of May 2016)
up using word of mouth, a salesperson and the merchant to curate the goods they bought. Today retailers’ added value is less clear. Brands are the key. Brands are big business

Brands should and will play a larger role in the fate of retailers. They hold the key to innovation and will increasingly have a stronger voice in distribution. The optimisation of those two key variables will greatly improve the retailers’ footing. When innovation is strong so are sales. Tesla is a prime example of an innovative product offering (12-24 months out) but one where consumers were willing to queue up and deposit $1,000 for the option of buying Tesla’s new mass market car model.

Not everyone can develop a revolutionary vehicle but brands can have a more symbiotic relationship with retailers. By carefully co-ordinating offerings on the brand’s and the retailer’s e-commerce sites, and subdividing unique inventory for the retailer’s bricks & mortar store, an optimal sales and distribution solution may be found. Each partner will gain from the best mix of product, location, cost and convenience provided to the shopper. Recently, Coach and Burberry both commented that they are reviewing plans to curtail distribution to department stores to control pricing better and improve the brand’s perception as a premium product. Essentially, retailers in prime locations with a branded/differentiated product will be more likely to provide the consumer reasons to visit their store.

The downside to these efforts will be the vast excess of square footage dedicated to retailing that will need to be repurposed. This will be painful but not without precedent. Walmart largely displaced millions of smaller merchants with a value proposition of low price, wide selection and convenience. Merchants will adapt again. It is unclear what the optimal ratio of bricks & mortar to e-commerce sales is for any given level of revenue but, for most, it is clear that retailers are over indexed to the physical world. In simplistic terms, those who sell undifferentiated products will be the most negatively impacted and those with differentiation and the ability to adapt will be positioned best.

Changes in consumerism

In the last decade, the retail sector has experienced a profound change. Gone are the days of indiscriminate growth through expansion and stores packed with consumers spending beyond their means. Instead, a new value-minded shopper confronts retailers, keen to reduce debt and augment their savings. Amazon is the new bully on the block, providing speed, value, assortment and, most of all, the elimination of wasted time shopping in a physical store.

Shifting sands

Quick to embrace e-commerce, most retailers have spent heavily on IT, shifting funds from new store fronts to build-out the backbone and systems for e-commerce. Amazon put traditional retailers under a pressure they have not experienced since Walmart’s rise 25 years ago. Out of this challenge, the omni-channel retailer has been the preferred solution. Omni-channel seeks to use a variety of channels in a customer’s shopping experience, including mobile, online, retail and others. This type of shopper spends 2-3 times what a bricks & mortar-only shopper spends. And while sales from e-commerce helped offset slowing and then declining bricks & mortar sales, it has not become the saviour originally envisioned. On average e-commerce accounts for approximately 7-8% of total retail sales (see Chart 1) but it comes with a lower operating margin at a time of rising operating costs (primarily higher wages and depreciation expenses attached to the higher IT spend).

Retail will not fall like a house of cards, but the ground rules have been altered to such an extent that adaptation is paramount. It is instructive to view the changes by segment as an illustration. Book retailers were the first to fall victim to e-commerce while home improvement stores may be the last. With careful consideration, a full spectrum of retailers with varying levels of susceptibility could be assembled and assigned a probability of survival. Regardless of where any particular retailer may fall on that line, there are relevant actions merchants should consider to improve their expected outcome. The internet provides the consumer a tool to educate themselves and pre-select a collection of possible items to buy prior to ever entering a store. Our parents grew

As retailers emerged from the destruction of the 2008 recession, they quickly learned that the old rules of retail no longer applied.

Jeff Morris
Senior Vice President, US Equities

Chart 1
Electronic payments escalation

<table>
<thead>
<tr>
<th>Q2 06</th>
<th>Q2 07</th>
<th>Q2 08</th>
<th>Q2 09</th>
<th>Q2 10</th>
<th>Q2 11</th>
<th>Q2 12</th>
<th>Q2 13</th>
<th>Q2 14</th>
<th>Q2 15</th>
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<td>%</td>
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<td>6</td>
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<td>8</td>
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</table>

US retail sales: e-commerce as % of total

Source: US Census Bureau, Datastream (as of Q1 2016)
Spicing things up

After decades of dictatorship, corruption and political instability, the Indonesian economy underwent a landmark change in 2014. President Joko Widodo was elected in the summer of that year with grand ambitions of tackling corruption and enacting reform. Since taking office, he has implemented 12 economic policy packages aimed at stimulating economic growth. These packages have focused on deregulating industries, improving the ease of doing business and increasing the attractiveness of Indonesia from a foreign investment perspective. Public expenditure has been reshaped and redirected away from wasteful fuel subsidies, instead moving towards much-needed infrastructure spending. These reforms gathered momentum and government spending began to accelerate in the second half of 2015. The central bank also gained credibility through prudent policy action, waiting for inflation and currency moves to stabilise before easing interest rates this year. Importantly, recent monetary policy framework changes have been directed at lowering the cost of funding for the financial sector without engendering a lending boom or overheating the economy, which investors have taken favourably. With apparent stabilisation on the political front and progress on the reform agenda now evident within economic data, investors have begun to recognise the potential. As well as enjoying some tangible reform success, Indonesia is at a different stage in the credit cycle versus its peers. Leverage ratios in the banking sector remain low and the economy has not suffered from an excessive accumulation of debt, unlike a large number of its emerging market and Asian peers. The end of Q3 2015 marked a bottom for the Jakarta Stock Composite Index; since then it has registered a total return of 16.7% (in local currency terms). In comparison, the broader MSCI Emerging Market Index has delivered a total return of 3.6% (in US dollar terms). This return for Indonesian equities is despite volatility and periodic concerns from investors around the sustainability of global growth. Valuations remain attractive and, alongside the macro improvement, our analysis leads us to believe there is further upside potential to owning Indonesian equities.

A pizza perfection

In economic growth terms, Italy has been a persistent underperformer relative to other major global economies for many years. However, since Matteo Renzi was elected prime minister in early 2014, prospects have turned. For example, in 2014 Italy ranked 65th out of 189 on the World Bank’s ‘ease of doing business’ index but the latest 2016 survey shows a significant improvement, with Italy coming in at 45th. In large part, reforms around bankruptcy resolution, contract enforcement and property registration have contributed to an improved environment for business activity. Now that some significant reforms have been made in relation to the labour market and electoral system, the overall commitment is more widely accepted. The current focus is on public sector efficiency, bankruptcy reform, banking sector consolidation and the constitutional referendum due to be held in October. Italy has been able to capitalise on a more general relaxation of fiscal policy in Europe, achieving a more stimulatory stance than may have been previously expected. The ongoing issues within the banking system have generated some volatility in markets. However, the establishment of the €5 billion ‘Atlante’ fund, which can bailout struggling banks and purchase non-performing loans, has allayed fears somewhat.

In addition to an improved macro outlook, substantial ECB easing has borne fruit in Europe; borrowing costs have broadly come down, credit standards have eased at the margin and the demand for borrowing looks reasonably positive (see Chart 1). Given that a higher proportion of the Italian economy is concentrated in the small and medium-sized enterprise sector relative to other developed countries, these measures have been especially beneficial. Ongoing monetary easing supporting a general recovery in Europe should be positive for small-cap Italian equities. We believe that investors have not priced in the idiosyncratic political change story and the potential improvement in corporate profitability. Over the medium term, we would expect the valuations of domestically focused small-cap companies to reflect this.

Jennifer Catlow
Investment Manager, Multi-Asset Investing
After years of persistently low inflation, Sweden’s Riksbank is finally taking its inflation mandate seriously.

Ross Hutchison
Investment Analyst, Government Bonds

The benefits of hindsight

Lars Svensson probably feels vindicated. He left the Riksbank as deputy governor in 2013 following a series of high profile disagreements. First, he vehemently opposed the decision taken by the majority of the Executive Board to raise interest rates through 2010 and 2011, as he felt the balance of risks favoured waiting to see if inflation forecasts realised. Second, Svensson repeatedly argued for more aggressive rate cuts in 2013, after the Riksbank had changed course. Interestingly, elements of these disagreements were driven by concerns over financial stability, with many Executive Board members favouring a tighter monetary policy in order to ‘lean against the wind’ of rising house prices, credit growth and household debt.

In hindsight, both the 2010/11 hiking cycle and the 2013 decision to keep policy on hold appear to have contributed to the persistent undershooting of Sweden’s 2% inflation target. In defence of the other Executive Board members, this critique is a slight oversimplification. The information available to the Riksbank when it started to tighten did suggest that the output gap was closing and inflationary pressures building. Furthermore, the underlying cause of the subsequent inflation disappointments cannot be wholly attributed to the policy rate increase. However, this experience has discredited the school of thought that rate hikes should ‘lean against the wind’, with policymakers increasingly relying on macroprudential regulation to address these risks.

The Riksbank has learnt its lesson. The central bank has proven willing to loosen policy radically over recent years and continues to do so, even as the data show substantial improvement. Following years of low inflation, it is finally taking its inflation mandate seriously. However, critics claim that it is acting irrationally and that loose policy will overheat the economy and further exacerbate financial imbalances. However, given the risks to the global economy, persistently low inflation and unprecedented easy policy across major markets, Swedish monetary policy settings look justified.

Changing priorities

The recent actions of the Riksbank reflect a shift in its reaction function to prioritise its inflation mandate at the expense of concerns over debt levels. Not long after the financial crisis, the Riksbank began a hiking cycle in 2010, with the repo rate reaching a peak of 2%. Initially in response to the Eurozone sovereign debt crisis, the Riksbank changed direction and started cutting rates in late 2011. It was not until 2014, however, that the central bank started to ease policy aggressively, citing a prolonged undershoot of its inflation target (see Chart 1). Speeches by Governor Ingves and the rest of the Executive Board began to place less emphasis on household indebtedness and focus more on price stability. This was partly down to a government decision in 2013 that Finansinspektionen (Sweden’s financial supervisory authority) was responsible for macroprudential policy, as well as growing concerns over persistent inflation undershoots. As inflation continued to disappoint, expansionary policy was increased to include a QE programme in February 2015. This was recently extended and will run into the second half of 2016, with government bond purchases reaching a total of 245 billion krona. Finally, given that the exchange rate plays an important role in domestic activity and inflation, the Riksbank has pre-authorised, but not yet used, foreign exchange interventions.

The recent data prints from Sweden have been impressive. An expansionary policy stance has achieved a significant loosening in monetary and financial conditions, as well as a substantial depreciation of traded-weighted krona (see Chart 2). This has supported activity, with GDP growth for 2015 hitting a robust 3.9%. The labour market has also improved with the unemployment rate down from a peak of 8.9% at the beginning of 2010 to 6.7% as of April 2016 (see Chart 3). Inflation has also come in above the expectations of both market participants and the Riksbank’s own forecasts. Core CPIF inflation has most recently printed at 1.8% year-on-year for April, with the headline rate at 1.4%. The trend is broadly upwards, but the next six to nine months will be crucial for determining if domestic price pressures can strengthen sufficiently to compensate for a fading effect from past krona depreciation.

While this momentum is encouraging, the Riksbank’s job is not done yet. The global economy remains fragile and Sweden would be vulnerable in the case of another global downturn. Furthermore, as highlighted above, the longer-term inflation outlook remains uncertain. Indeed, despite tightening labour market conditions we have yet to see wage growth come through strongly. The latest round of wage bargaining concluded a one-year agreement, setting increases at 2.2%, which is still below pre-crisis rates. This number is responsible for approximately 600,000 workers directly, but sets a benchmark for further wages, as the central bank will hope to see evidence that wages are drifting higher than this baseline settlement.

Uncertainty remains, but risks favour current policy

There has been criticism of Riksbank policy recently. In general, there are three main objections: the effect of loose policy on household debt and financial instability; the risk that the economy is overheating; and broader concerns over the distortions from negative rates and unconventional policy.

The first argument reflects the view that expansionary policy should be curtailed in order to deter credit growth and house price increases. However, monetary policy can be too blunt a tool for stifling debt growth, as the Riksbank learnt during its recent policy missteps. Indeed, the traditional ‘leaning against the wind’ argument has been discredited. Instead, policymakers should use macroprudential tools as a first line of defence against building risks in the financial sector.
On the second point, Sweden is growing quickly but there are few signs of overheating as yet. While changes in the policy rate operate with a lag, current evidence suggests a gradual build in inflationary pressures as opposed to any surge. Furthermore, precarious global conditions and a long period of inflation undershoots warrant waiting for inflation to become entrenched around target. Any early reversal could undermine the success achieved thus far.

On the third point, Sweden is an interesting test case for the negative rate experiment. Rates have been negative for more than a year (at the time of writing) without cataclysmic consequences, although they may have added some impetus to housing market activity. The long-term consequences of negative rates are as yet unknown and indeed may change depending on how negative interest rates become. However, the evidence so far suggests that the difference between a positive base rate at 10 basis points or negative 10 basis points does not automatically create stress throughout the financial sector and wider economy.

There are certainly risks associated with keeping policy loose. However, on balance, the Riksbank should continue to take all necessary action to meet its inflation target. Despite signs of progress on this front, the inflation outlook remains uncertain and the central bank should be particularly cautious given a long period of low inflation. Furthermore, global risks look to be clearly skewed to the downside, even if an immediate global recession looks unlikely. Indeed, any early withdrawal of policy support would risk jeopardising the progress that the central bank has made over recent quarters.

**Long duration**

From a bond fund perspective, we are overweight Swedish government bonds and our preferred expression is via a receive position in 5-year 5-year interest rate swaps. Despite a (rightfully) activist central bank, we do not believe that conditions are in place for a sharp and isolated sell-off in Swedish rates. Positioning here favours long exposure to duration given global downside risks and priced-in optimism. Furthermore, with a heavy reliance on the exchange rate, particularly the euro, to influence EU inflation and export competitiveness, Swedish monetary policy will be sensitive to ECB policy, which is expected to remain loose for a long time.

Our view has been implemented both as an outright long duration position as well as a relative spread to euro 5-year 5-year swaps, based on fund mandates and our existing mixture of positions. The Swedish curve is the steepest in the G10 universe, reflecting optimism about the economic outlook, for the reasons discussed above. The position therefore provides significant positive carry to hold. Exposure in the belly of the curve, with a flattening bias, also dampens the downside from a possible shift towards hiking in the Riksbank’s rhetoric or actions.
Responsible Investing
Value creation within a sustainable framework

Standard Life Investments is a founding member of the Investment Leaders Group (ILG). The aim of the ILG is to examine ways to generate long-term investment returns within a sustainable economic, social and environmental framework.

Andrew Mason
Responsible Investment Analyst

Lower risk

In January 2013, the ILG, a global network of pension funds, insurers, asset managers and academics from the University of Cambridge, started to develop an intellectual model to demonstrate how responsible investment creates value in the real economy, with a view to strengthening its application within markets. Following extensive research, the group produced a report highlighting the key facets of responsible investment including its definitions and purposes, the moral and investment case, and the potential actions that can bolster its application. Importantly, it also found that good environmental, social and governance (ESG) practices can serve to reduce the risk within investment portfolios. In addition, it was revealed that investee companies with sound ESG practices often enjoyed lower firm-level risk and lower cost of capital.

Building upon this work, the ILG focused on social and environmental risk factors affecting financial markets. The first area of enquiry pertained to the future risks posed by climate change, notably in creating economic shocks. This project was conducted by three Cambridge research groups in conjunction with various ILG members. The group produced its findings in a report called “Unhedgeable Risk”. This details the potential economic shocks that could adversely affect investors and the annual growth rates required to ensure long-term growth in the face of these risks.

Moving from concept to implementation

The ILG subsequently moved from concept to implementation, with a focus upon three key areas: the issues arising from short-termism in financial markets, the development of a model to measure the impact of climate regulation on companies and portfolios, and the creation of a framework which calculates and communicates the social and environmental impacts of portfolios.

Short-termism has been identified as a cause for economic instability. To address this, the group created a toolkit of investment strategies which could be used to help create long-term responsible and sustainable investment. This was defined as investments that promote long-term value creation within companies and the economy as a whole. The toolkit offers 10 design features, which can be adjusted and applied by asset owners to suit investment time horizons. This work also contributed to new guidance issued by the US Department of Labor on economically targeted investment practices and the benefits they create for society.

Modelling the impacts of climate regulation on portfolios broke from traditional measures of climate risk and sought to measure the short-term impact of environmental change. The group recognised that while investors have access to top-down macroeconomic research on the likely impacts of climate change, there has been a lack of bottom-up company-level tools that could support improved stock-picking. The model was applied across three high-risk sectors (electric utilities, oil refining and natural gas) in five key countries, namely the UK, Spain, Germany, Canada (Alberta province) and the US (California). The findings reveal that carbon and energy regulation can impact companies’ margins; companies’ risk mitigation activities are significant; and energy and carbon risk assessments can facilitate stock-picking.

The ILG considered the influence investments have upon social and environmental structures. Understanding these impacts and encoding their characteristics into mandates could deliver investment opportunities that have positive social and environmental effects in addition to offering strong returns. A framework was developed which clustered and prioritised the United Nations Sustainable Development Goals into a set of six impact metrics. These metrics can be applied by any portfolio to assess how portfolios impact social and environmental systems. The aim of the work is to enable and facilitate consumer choice and to allow asset owners to understand both the financial and societal benefits of their assets.

We believe that to ensure long-term prosperity, financial, social and environmental systems need to work in unison (see Chart 1). The belief that stable economies often rely upon stable social and environmental systems informs our investment philosophy – and our work with the ILG has served to develop and inform our approach.

Chart 1
Inflows and outflows from an economy

Source: ILG ‘In search of impact; measuring the full value of capital’
About Standard Life Investments

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 of future economic indicators. The GIG is made up of senior investment managers from the strategy and asset class teams and is responsible for providing the overall strategic focus to the investment process.

The House View delivers a consistent macroeconomic framework to our investment decisions. It generates the market and thematic opportunities for us to add value to our clients over the timescales they use to measure our success. It is formulated in such a way as to make timely investment decisions but to also allow all members of the investment teams to influence its conclusions.

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