Global Outlook

November 2017

A decade on from the financial crisis, the world appears to be entering a period of better growth, reduced financial stress and policy normalisation. However, in those ten years, a number of changes have emerged for investors to grapple with; whether economic, political or technological. In this edition of Global Outlook, we look at how deep and considered analysis can help turn these challenges into opportunities for investors to understand and embrace.

Standard Life Investments

House View

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

	November 2017 House View	
Risk	The Global Investment Group retains a cautious medium-term outlook, as a variety of political, financial and economic drivers point to higher levels of financial market volatility. While there are particular areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
Government Bonds		
US Treasuries	Tighter labour markets and rising wages give the Federal Reserve the rationale to continue adjusting monetary policy, with upward pressures on core inflation or major tax cuts key signals for more aggressive action.	LIGHT
European Bonds	Bonds are not well supported, as the noticeable improvement in activity across more economies allows the ECB to plan policy tightening into 2018. Markets, however, are over-pricing future inflationary pressures.	LIGHT
UK Gilts	The interest rates outlook remains mixed while the economy faces both higher inflation and slower economic activity. Yields are supported by regulatory driven flows but there are valuation concerns.	NEUTRAL
Japanese Bonds	The central bank is still attempting to reflate the economy with its QE and yield curve control policy alongside negative short-term rates. The absence of yield makes this asset class relatively unattractive.	LIGHT
Global Inflation-Linked Debt	Inflation is generally well contained globally with break-evens largely reflecting this. There is more potential downside for European inflation markets but that the US could re-price higher; UK inflation appears fully priced-in.	NEUTRAL
Global Emerging Market Debt	Local currency yields are more attractive due to emerging markets sensitivity to the pick-up in global growth. US dollar-denominated debt spreads over US Treasuries are no longer attractive.	HEAVY
Corporate Bonds		
Investment Grade	QE supports UK bonds, but has driven European yields to unattractive levels. US credit spreads are less attractive as Treasury yields increase, and riskier assets are preferred.	LIGHT
High Yield Debt	US yields are attractive and the asset class can deliver a positive total return even with moderate spread widening. European spreads are approaching their pre-crisis lows. The asset class can be subject to over-crowding.	HEAVY
Equities		
US Equities	The market is expensive and faces political uncertainty; for example, over trade policy, but the improving economic environment supports company profits while monetary tightening is well priced in and proposed tax cuts could be supportive.	NEUTRAL
European Equities	Corporate earnings are improving on the back of a widespread pick-up in economic growth across the region plus stronger international trade flows. Investor sentiment is positive, with sizeable inflows from overseas buyers.	HEAVY
Japanese Equities	The market looks attractive as easy monetary policy and fiscal stimulus are helped by efforts to improve corporate governance, share buybacks and business investment. However, yen strength periodically remains a concern.	NEUTRAL
UK Equities	UK economic growth expectations are weakening and Brexit remains a longer-term threat. Sterling remains the primary driver of the relative attractiveness of UK companies with overseas exposure.	NEUTRAL
Developed Asian Equities	The improvement in the global economy supports this market, but Chinese policy tightening risks curbing fixed asset investment and property demand, which is a large driver for the region.	NEUTRAL
Emerging Market Equities	The asset class is supported by global growth improvements, especially for key sectors such as Asian technology. A tightening bias in China may prove to be a headwind for the asset class.	HEAVY
Real Estate		
UK	The UK real estate cycle is at a mature stage and there is limited further expected capital growth. Income remains attractive, although risks are elevated should conditions turn recessionary or political uncertainty grows.	NEUTRAL
Europe	European property is supported by stronger economic growth and low levels of new supply but valuations are not as compelling against the backdrop of a less supportive stance by the ECB.	NEUTRAL
North America	The US market has low vacancies across most sectors and markets, although the sizeable retail sector is coming under more pressure. Elsewhere, new construction is mostly in check, providing a window for rental growth.	NEUTRAL
Asia Pacific	An attractive yield margin remains, but yields have bottomed in most markets. Income returns are driven by modest rental growth on the back of low vacancies and healthy tenant demand.	NEUTRAL
Other Assets		
Foreign Exchange	The major currencies are within broad valuation ranges. The yen can act as a diversifier against the risk of a decline in global activity or a serious political shock.	NEUTRAL $, €, ¥ AND £
Global Commodities	While commodities are supported by the slow improvement in global growth, they are very sensitive to Chinese policy tightening. Some commodities, such as oil, face a difficult demand/supply balance.	NEUTRAL
Cash		
	With global yields still extremely low, we still see better opportunities in risk assets.	LIGHT

Foreword

Editor

Stephanie Kelly
Political Economist

The post-crisis environment has been a tricky one for investors to navigate, but a decade on it looks like progress is being made: growth is back on track; financial stress is at low levels; and policy normalisation from extraordinary measures is on the cards. Nonetheless, the world is different than it was ten years ago economically, politically and technologically. Some of these changes have emerged in response to the crisis itself, while others are the results of decades of market evolution and demographic change. This creates both challenges and opportunities for investors.

One of the sectors that have seen the effects of technological evolution is retail, where online giants like Amazon have changed the shopping game. Violet McDonald, Investment Director, Real Estate, notes how this is playing out in Asia by creating real estate opportunities in the logistics sector that underpins modern online retail.

Meanwhile, fund managers more broadly are seeing more and more demand for impact investing. Dominic Byrne, Investment Director, Global Equities, highlights the role that demographics is playing as millennials demand value in both financial and ethical terms. As this space continues to evolve, effective measurement is key for fund managers to assess firms across these different forms of valuation.

Closer to home, a major political change has occurred in the past few years. The UK's exit from the European Union represents a significant challenge for policymakers and investors hoping for a trade deal that is both politically satisfactory and economically beneficial. James McCann, Senior Global Economist, highlights how game theory can provide a framework for balancing these political and economic incentives.

Against this backdrop of clashing political and economic forces, evolving investor incentives and technological development, understanding market behaviour is ever more complex. Frances Hudson, Global Thematic Strategist, and Johnny Liu, Global Strategy Intern, note the role and limitations that fund flows can provide in terms of behavioural signals about market behaviour, which forms a central input to our House View investment process.

While the times they are a changin', this month's Global Outlook illustrates how deep analysis can transform these challenges into opportunities for investors to understand and embrace. May you live in interesting times!

House View

Flows inform analysis

Fund flows are correlated with market performance; as a behavioural input to tactical asset allocation, they can serve as contrarian or momentum signals.

Frances Hudson
Global Thematic Strategist

Johnny Liu
Global Strategy Intern

Our Tactical Asset Allocation (TAA) process, which determines the House View for the next 12-18 months, divides the drivers of asset price returns into four key categories – monetary, valuation, macro profits and behavioural. Within the behavioural category, portfolio flows and positioning are a longstanding and readily available source of data about investor actions. They can be measured against market outcomes and are frequently used to enrich the narrative explaining asset price movements.

Flow potential

Investors can benefit from making use of fund flows analysis to gauge positioning, assess where consensus is and draw conclusions about whether there is crowding in particular markets or assets. Flows measured on a sectoral or style basis also provide tentative conclusions about investor views of the maturity of the macro profits cycle. Post financial crisis, flows into assets associated with 'risk-off' and 'risk-on' have been evident periodically, relating to external drivers such as geopolitics or regulation.

Flows are particularly useful in providing information about how investors are positioned, who is buying which markets and assets, and to what extent. For example, it is encouraging when rising stock markets in Japan and emerging markets (EM) are supported by domestic buying alongside flows of 'hot' money from international investors. Conversely, recent gains in US stock indices have taken place against a backdrop of retail outflows from US equities and less enthusiasm from institutional asset allocators, suggesting there are other drivers behind the recent rises in US equity prices. In this case, profits growth and share buybacks are the likely candidates. US equities are modestly overweight (within a neutral band) in the current House View given that valuations are not cheap. Equity markets in continental Europe and EM are preferred where economic growth has strengthened.

It's an ETF world

We recently undertook a project to evaluate the information available in the light of changes to the flows landscape. The ongoing shift from active to index-tracking allocations adds another dataset to analyse but assessing the relationship between the two also forms part of the analysis. The share of global assets assigned to passive management has risen substantially, first in equities – which have risen to around 40% of assets – and later in bonds, where the share for US funds approaches 25%. The number of equity indices being tracked by ETFs and similar vehicles now exceeds the number of large-cap stocks. Comparing flows into passive instruments, such as ETFs, with flows into active mutual funds, we found the former are more volatile, although volatility has declined since the financial crisis, possibly reflecting short-term positioning for asset allocation. Correlations between ETFs and active fund flows have risen since 2014 and have been higher during risk-off periods. For equity funds, the relationship has been negative at times, as investors have allocated away from active mandates towards index-tracking.

Go with the flow

A question naturally follows here: do flows follow returns or vice-versa? From longer-term data, such as annual flows into mutual funds, investors notably invest in last year's winners, despite warnings that previous performance is not a guide to the future. Weekly and monthly data suggested there was a strong relationship between flows and returns for equities. In bond markets, the evidence was mixed; correlation was evident between EM performance and flows but absent between UK gilt market returns and flows.

Unsurprisingly, we found that flows generally lag returns. In smaller or less liquid markets, where capacity may be constrained, inflows attracted by returns can push valuations to unsustainable levels, leading to subsequent underperformance. More generally, the momentum of flows may result in crowding. This suggests that at certain times or in less efficient markets, flows may be useful as a contrarian indicator. Persistence – the probability of inflows following inflows – was confirmed by autocorrelation calculations to be present in all asset classes. These results suggest that there is sufficient inertia in fund flows for them to be used as a gauge of investor sentiment such that a change in flow momentum is associated with a trend reversal in market returns.

Dominant voices

Flows from central banks, for example related to QE, reduced the signal between bond flows and investor actions, as well as distorting credit rationing and resource allocation. US bonds make up around half of the total world bond assets and flows in the US markets dominate the direction of flows.

Persistence is high for both bond and credit markets. During QE, flows into US bond funds were underpinned as investors reacted to the presence of a large, and largely price agnostic, investor trading one way and followed the momentum. It will be interesting to see if quantitative tightening, QT, results in persistent outflows from funds as the Federal Reserve starts to unwind its balance sheet. As far as European bonds are concerned, the QE picture is more complex because of the mix of government and corporate bond purchases. Banks are also major, price-insensitive holders of government bonds for regulatory capital reasons in this region. Reflecting both poor valuations and this crowding effect, the House View is underweight US, Japanese and European government bonds and investment-grade corporate bonds.

Cross checking

Survey results from predominantly institutional investors are a useful sense check on mutual fund and ETF flows, which are more retail in nature. There are well-established monthly reports covering expectations of economic growth, tail risks and asset allocation recorded for both global and regional respondents. Analysis of long and short positioning relative to the survey's history is used to determine contrarian trades. Bearing in mind that any survey data may reflect aspirational rather than real positions, we used global flows and market returns to gauge whether the survey's conclusions were supported or, indeed, if they influenced future flows and outcomes but found no compelling evidence. Equally, many other fund flow indicators we looked at were strong on narrative but weak when it comes to predicting turning points.

Emerging flow behaviour

The behaviour of flows in relation to emerging and frontier markets stands out for several reasons. There is a strong positive relationship between flows across all asset classes, with fund flows into EM accounting for a large proportion of the volumes traded, suggesting that they serve as a market driver. Many international investors prefer to gain exposure via funds rather than purchase individual stocks or bonds. This approach is designed to diversify idiosyncratic risk and may be a response to frictions in these markets, which tend to be relatively illiquid and expensive to trade. When inflows are relatively large, EM tend to underperform developed markets in the succeeding 12 months.

The House View is tactically overweight EM equities and local currency debt, and neutral on EM hard currency debt, conscious of the already steady inflows into these assets classes after years of disinvestment.

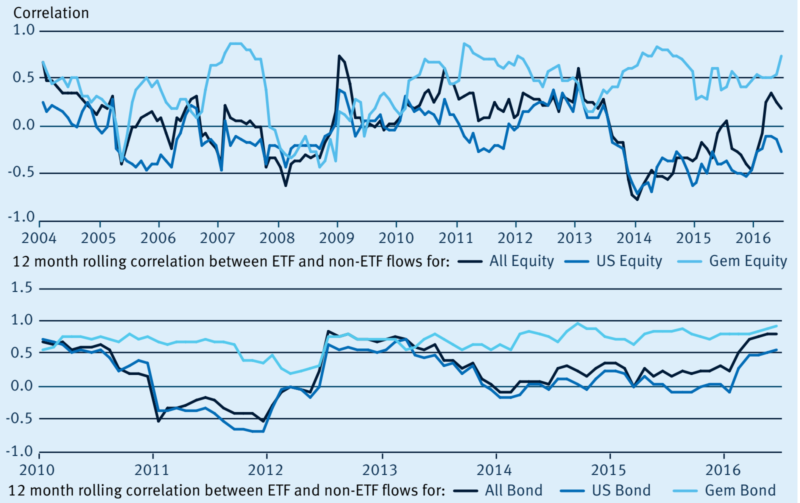
Mixed messages

For commodities and currencies, we looked at the Commodity Futures Trading Commission's Commitments of Traders reports. These provide a weekly breakdown of open interest for each instrument. A simple approach, plotting price movements against net positions was uninformative. However, assessing the change in net positions versus returns yielded a clear indication of a relationship that ties in with market movements (see Chart 2). For commodities, such as oil and gold, the regression coefficient is positive; for some currency pairs, including euro/US dollar and yen/US dollar, it is negative. In common with fund flows, when we tested for causality, positioning follows both current and lagged returns. The House View is neutral on commodities and foreign exchange.

A recurring theme in market commentary has been whether or not investors are complacent about the risks in markets. Our analysis suggests the observations are focused on measures which rise in falling markets, and hence can be associated with general risk-off conditions. In rising equity markets, low implied volatility readings, in the form of VIX and VStoxx, are interpreted as investors ignoring risks. However, this illustrates that even with an abundance of market data it is possible to be looking in the wrong direction where flows and positioning are concerned (see Chart 3).

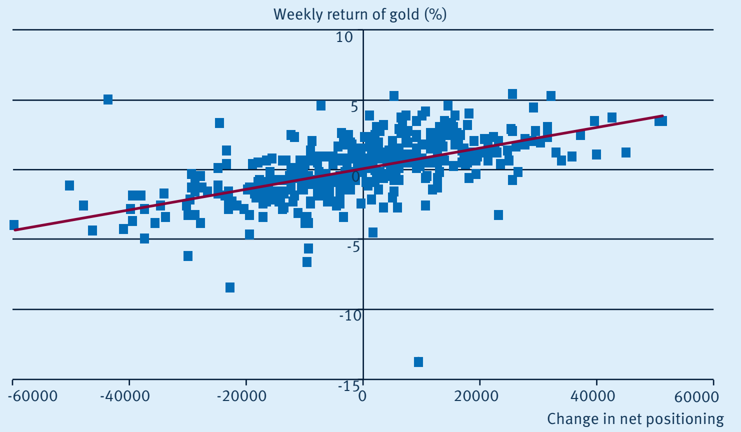
In conclusion, we believe that the most effective way to use flows data is in conjunction with fundamentals – monetary, macro profits and valuation. When inflows or outflows are persistent and substantial, it can represent a negative or positive contrarian signal. This contrasts with much of the market commentary that treats flows and positioning as a straightforward momentum indicator.

Chart 1
Couple's therapy



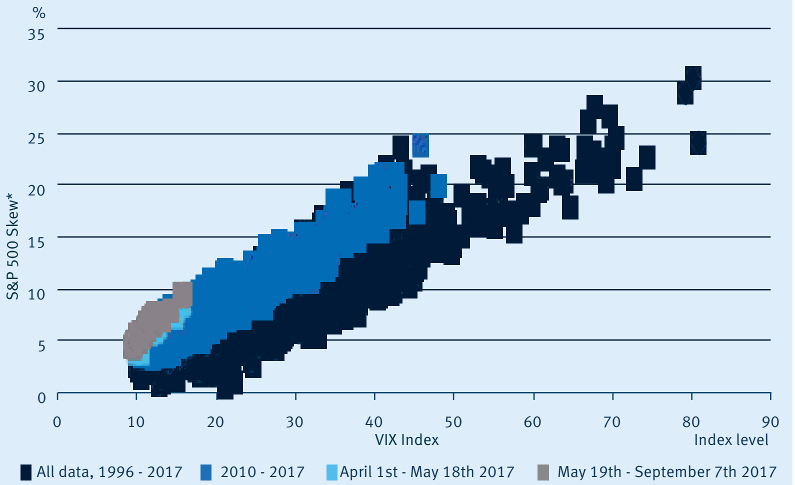
Source: EPFR Global, Standard Life Investments (as of May 2017)

Chart 2
The Midas touch



Source: CFTC, Bloomberg, Standard Life Investments (as of July 2017)

Chart 3
Skewed view of VIX



*skew is calculated using standardized and interpolated implied volatility curves as a function of delta with the addition of the skews from both calls and puts. Delta values of 50% and 20% (-50% and -20%) are defined as at-the-money and out-of-the-money points for calls (puts), respectively.

Source: MSCI (as of September 2017)

Global Spotlight

Making an impact

Impact investing is set to continue to grow, with many investors interested in making their money work for good, as well as for returns. To bring it into the mainstream, measurement is vital.

Dominic Byrne
Investment Director, Global Equities

A burgeoning trend

Since the launch of the first publicly available US ethical fund in 1971, values-based investing has evolved dramatically. This has included the rise in SRI (sustainable and responsible investment), green investing, climate funds, thematic investments (such as water funds) and sharia portfolios, to today's most intriguing proposition – impact investing.

Under its 'pure' definition, impact investing involves investing in social enterprises where the primary purpose is to achieve a positive social or environmental outcome, alongside an investment return. Here, the impact is more important than the return. However, while these endeavours are admirable, there are constraints around the size and availability of the investment opportunities for many investors. In addition, this 'impact-first' market remains niche and will be insufficient to address the scale of the social and environmental challenges facing the world.

Given this, we expect demand for solutions that invest in companies which seek positive financial returns as well as positive social or environmental impacts will increase dramatically over the next few years. A previous white paper from our Environmental, Social and Governance team – "The Rise of the Millennials and the Impact on Values-based Investing" – highlighted three very interesting trends. First, 75% of Millennials (those born between the early 1980s and 2000) say it is important that a company gives back to society instead of just making a profit. Second, when making investment decisions, Millennials are twice as likely to invest in portfolios or individual companies that seek to have positive environmental or social impacts. Finally, in the coming decades it is estimated that $30 trillion in financial and non-financial assets will be passed from so-called 'Baby Boomers' to Millennials in the US alone.

United in impact

In January 2016, global leaders came together to tackle issues of poverty, gender inequality, public health, environmental challenges and more. At the meeting, they laid out a framework to not only identify the world's challenges, but also propose solutions for them. The result was the United Nation's 2030 Agenda for Sustainable Development and its 17 Sustainable Development Goals (SDGs). Very shortly thereafter, in April 2016, 175 member states signed the historic Paris Agreement (COP21), which sets the stage for ambitious climate action by all to ensure that global temperatures rise no more than 2 degrees Celsius. This is the level seen as key to avoiding dramatically higher sea levels, changed weather patterns and food and water crises.

These SDGs and the complementary COP21 provide a framework for impact investing, helping to identify the problems, define potential impact solutions and, importantly, how to measure impact outcomes (see Table 1). It will cost an estimated $5-7 trillion of investment per annum to meet the UN's agenda and, to bridge this funding gap, buy-in is needed from every level of society: governments, regulators, consumers, private equity, social enterprise and listed equity.

Channelling assets

That is where global asset managers – with over $80 trillion (£59.5 trillion) of assets under management – come in. Through listed equity impact investing, asset managers can create a portfolio of financially attractive, mission-led companies that are delivering positive impact through their products, services or business strategies. These funds can have specific goals, such as concentrating on job creation, or be more broad-based, focusing

Table 1 Measuring impact

UN Global Goals	PILLARS	SUB-THEMES
9. Industry, innovation and infrastructure 11. Sustainable cities and communities 12. Responsible consumption and production	Circular economy	Resource efficiency Material recovery and reuse
7. Affordable and clean energy 13. Climate action	Sustainable energy	Access to energy Clean energy Energy efficiency
14. Life below water 15. Life on land	Food & Agriculture	Access to nutrition Food quality Sustainable agriculture
6. Clean water and sanitation 14. Life below water	Water & Sanitation	Access to water & hygiene Clean water Water efficiency
1. No poverty 2. Zero hunger 3. Good health and well-being	Health & Social Care	Access to healthcare & social care Enhanced healthcare Drug development
1. No poverty 8. Decent work and economic growth 10. Reduced inequalities	Financial Inclusion	Access to financial services
9. Industry, innovation and infrastructure 11. Sustainable cities and communities	Sustainable Real Estate	Affordable housing Eco-building
4. Quality education 5. Gender equality 8. Decent work and economic growth	Education & Employment	Access to education and skills development Quality employment and job creation

Source: United Nations, Standard Life Investments (as of 2017) on a range of social and environmental issues. It is clear that equity impact investing is only part of the solution. However, the SDGs are a call to action and a 'call to capital' from all stakeholders; whether it is governments or corporates, asset managers or individuals – we all have our role to play.

Therefore, listed equity brings scale to impact investing, but it also has it challenges. Chief among them is how to ascertain whether a company is having a genuine impact and not simply claiming to have one in order to attract capital (so-called 'impact washing'). Understanding a company's intention and its strategy is core to protecting this market. Impact does not happen by accident. The other key challenge for listed equity impact investing is the concept of 'additionality'. With regards to impact investing, additionality is the extent to which an investment directly enhances a project's outcomes, such as increasing the quality or quantity of the final output.

Within private markets, it is much easier to demonstrate additionality – "would this impact have occurred without my investment?" In listed equities, this is harder to assess as businesses are more mature and already have access to capital. However, additionality in listed equities comes from a different source. For example, thanks to the scale of investment and through active engagement with management, listed equity investment has the ability to shape and influence corporate strategy. It can also hold corporations to account and work to enhance disclosure around the impact a company's products or services are delivering.

A measure of success

By its very definition, impact investing across all asset classes aims to deliver quantifiable social and environmental impact. In our view, listed equity impact investing must also have intentionality. Quantification and intentionality go hand in hand. At the time of writing, the UN had identified 232 indicators to measure progress against the SDGs. While the indicators are set to track the progress at a national level, we believe they can be adapted and used to assess a company's contribution to a country's progress on meeting the SDGs.

For example, a business's commitment to sustainable energy can be gauged against factors such as the proportion of customers with access to clean energy or the size of investments made into developing clean energy research. The company in question must have the strategic intention to deliver impact; and second, this impact must be measurable. A company that simply reduces its carbon footprint or becomes more transparent about its supply chain would not be going above and beyond the call of duty in delivering the impact solutions we would expect. A true mission-led company will embrace transparency and sustainability throughout its operating model, but will also clearly articulate a strategy that at its core aims to deliver products and services that are solutions, designed to achieve a specific positive societal and/ or environmental impact.

These solutions should result in outputs that are measurable and quantifiable, which can then be translated into outcomes. In impact measurement, we believe the distinction between outputs and outcomes is a very important one, and key to identifying intentional impact. Outputs are short-term results, such as carbon emission reduction or total number of people provided with access to energy. However, outcomes are the consequences of these results. Where did the carbon emission reduction occur? How did it help reduce a country or region's carbon footprint? Who was provided with access to energy? Was it an already 'well-lit' urban city, or was it a new power grid in an undeserved area?

While this might seem like semantics, the distinction is key. If listed equity investment is to align with the SDGs, then we must demonstrate how the companies in the portfolio contributed to achieving the goals.

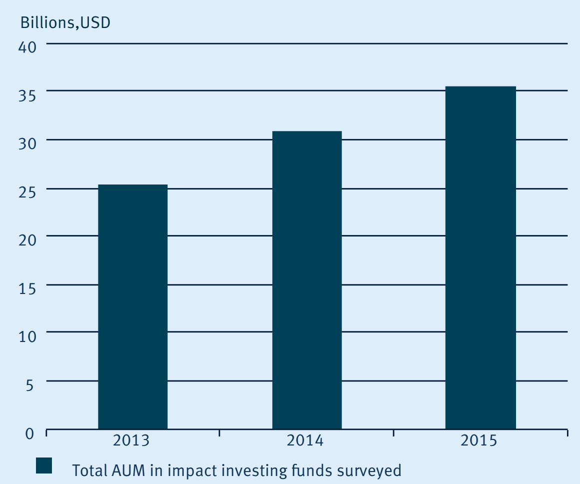
However, while measuring financial returns is fairly straightforward, the science of quantifying positive environmental or social impact is more difficult. Nonetheless, accurate impact measurement is necessary in order to develop and legitimise impact investing in equities. It is important that companies report accurately on their activities. We do not need more data, but better data. Again, reporting outcomes – not outputs – that align with the SDGs offers some uniformity to disclosure. In addition to increased transparency, disclosure on outcomes should help demonstrate accountability, and build investor confidence in impact investing. It will also create a verifiable track record for the impact investing sector, helping investors to both compare companies and review the businesses in which they invest.

A bright future

The outlook for mainstream impact investing is bright, as investors increasingly look for financially attractive investment solutions that make a difference to the world. There is an impetus behind the SDGs, that has galvanized a response from investors and corporates alike as they work together to find solutions. Further, we would expect the universe of investible companies for listed equity impact investing to grow as many in the corporate world shift to helping find solutions for the world's problems, rather than compounding them. We also expect to see a wider range of investment vehicles emerge as additional capital and expertise enter the market.

As impact investing across all asset classes gains traction, rigorous financial analysis will need to combine with rigorous impact analysis. This will allow investors to identify investment opportunities that have positive financial fundamentals as well as solutions that address a social or environmental need. Finally, active engagement will be necessary in order to understand and monitor strategy, ensure accountability through reporting and to encourage investment where it is needed most.

Chart 1
Growth in impact investing



Source: GIIN (as of 2015)

Follow the signs for Brexit

Brexit negotiations are increasingly viewed through a 'deal or no deal' prism. We consider the range of potential trade arrangements and the waymarks that might tell us which is most likely.

James McCann
Senior Global Economist

Show me the money

Article 50 was triggered more than six months ago; however, with over a quarter of the two-year timeframe for leaving the EU behind us, negotiators have little to show for their efforts. Indeed, there has been a failure to move beyond the exit issues of reciprocal citizen's rights, the Irish border and the UK's financial obligations upon exit. The latest attempt to drive these issues forward has floundered, with EU negotiators still to see the progress required to move discussions onto the future trading relationship and potential transition deal. In particular, the so-called exit bill remains a sticking point. Prime Minister Theresa May's promise in Florence to honour financial commitments "has not been translated into a firm and concrete commitment to settle all of these obligations" according to EU negotiators.

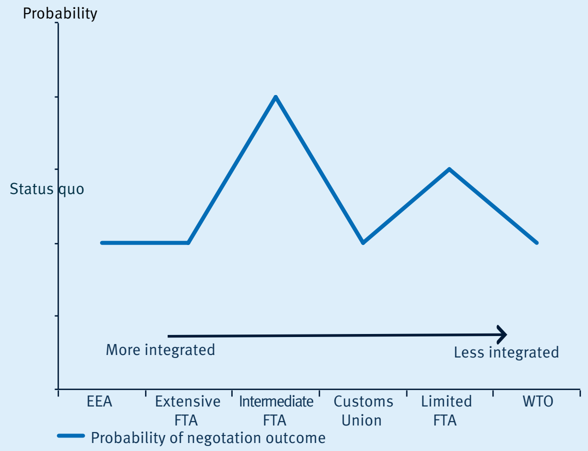
With the clock ticking, we have looked to identify in more detail the plausible scenarios for how Brexit might play out. Having previously carried out game theory work that looked to estimate the likelihood of different outcomes based on the political and economic incentives facing both sides, we have built on this in an attempt to identify the waymarks or signals that might tell us which scenarios are becoming more or less likely. Many of the signals will come from the negotiations themselves, although the performance of the economy, domestic UK politics and public/corporate opinion all provide potential triggers. Finally, we consider the impact of different outcomes on asset prices, with a wide range of potential settlements creating very different implications for performance.

Brexit signs: a user guide

Table 1 sets out the range of possible trade agreements that we believe are plausible and these are colour-coded according to their likelihood. The table is divided as follows.

- **Institutional framework** different types of trade agreement with the EU are laid out. This starts with the most integrated and finishes with the least; from a European Economic Area (EEA) agreement right down to World Trade Organisation (WTO).
- **Structure** – the structure sets out key features of each potential relationship; highlighting goods and services arrangements, labour market requirements and financial contributions to the EU, where relevant.
- **Transition agreement** – we note whether a transition agreement is necessary, and describe the form of arrangement and time limits applied for each of these.

Chart 1
Fat tails



Source: Standard Life Investments (as of October 2017)

- **Waymarks** – these provide an indication of the direction of travel for trade negotiations. They are not necessary or sufficient for any given trade agreement but, if they occur, we will consider them useful signals that negotiations are moving toward a certain outcome.
- **Indicative market implications** – we have worked with our investment colleagues across asset classes to try and establish the likely implications for markets should any of these scenarios take place. These are all set relative to current market pricing and should be read as broadly directional in the medium term rather than as point estimates. Indeed, the speed and timing of moves will likely vary by asset class.
- **Colour coding** – the colour coding in the table reflects our assessment of the probabilities of each possible outcome: green reflects the most likely outcome, grading down through yellow and orange before finishing with red. The last of these reflects extremely unlikely outcomes and the fact that no red appears on the table highlights that even the extremes of integration – EEA and WTO – cannot be ruled out at this point.

Fat tails

The first point to note is the wide range of potential trade arrangements following the UK's exit from the EU, most of which represent a material shift away from the current institutional status quo. Overall, we think an intermediate Free Trade Agreement (FTA) characterised by free goods trade and modest services sector access is the most likely outcome, closely followed by a more limited version of this agreement, which introduces significant barriers to services sector trade. This reflects our view that some level of compromise will be needed to balance the economic and political incentives of both sides. From the UK perspective, this would address some of the seemingly red lines around control of EU migration. However, it does imply a noticeable deterioration in UK access to the single market, with the EU unwilling to dilute the four freedoms that form a key component of full membership and access.

However, maybe the most interesting conclusion from this analysis is that there is still a wide range of plausible potential outcomes from this process (see Chart 1). Indeed, our scenarios include agreements that imply relatively limited changes to the status quo, such as an EEA style arrangement, to much more disruptive outcomes in which the UK is far less integrated with the EU. The classic example of the latter would be a fall back to WTO trading rules, or the no deal scenario discussed in the press. Chart 1 shows the indicative probabilities that we have assigned to each scenario. While some form of FTA looks most likely, the probability of significantly more, or less, integrated outcomes certainly cannot be ruled out.

Given these uncertainties, and the very different Brexit outcomes available, we have tried to identify waymarks that would give us some early indications of where we are heading. Some of these are directional, in that they may tell us if a more or less integrated outcome is likely. For example; greater stress in the domestic economy and changing public opinions around Brexit would be among the triggers that would potentially signal a more collaborative UK negotiating stance and make more integrated outcomes more likely. In contrast, an increased influence of Eurosceptics in the Conservative party and building hostility in negotiations would be signs that may predict a harder split. Other waymarks are more specific, and would point to one particular form of institutional arrangement. For example, if the Irish border issue proves particularly controversial, we could see a Customs Union arrangement become more likely as a potential solution for this challenge. As stated earlier, these waymarks do not provide guarantees, but rather clues as to where we are heading.

Policy responses

The six scenarios imply different paths for policy over short and long-term horizons. On shorter timeframes, the degree of disruption implied by the new relationship with the EU will be important in determining monetary, fiscal and industrial policy. In general, those scenarios that imply a material increase in tariff or non-tariff trade barriers with the EU – such as Customs Union, limited FTA and, particularly, WTO – are all likely to require greater short-term support. The one exception to this rule is the EEA and Extensive FTA scenarios, where we have specified that one potential waymark for these would be a noticeable economic downturn. Obviously, monetary policy would need to be loosened in the short term if a downturn materialised, before it can normalise more quickly thereafter.

The degree of integration with the EU will have an impact on where rates normalise to over the longer term. A deeper split will likely weigh on immigration, investment and productivity, all of which would depress potential growth and equilibrium interest rates.

In the EEA or extensive FTA scenarios, we would expect only a small deterioration in this equilibrium rate from the status quo (estimated at 2.75%), although more recent signs around potential growth suggest there is a risk of a more marked decline. Additional scenarios that imply larger barriers to trade (and potential restrictions on EU migration) all suggest even lower potential and equilibrium interest rates. The WTO scenario implies the deepest downgrade, which could imply a drop in equilibrium rates to around 2.25%.

Hard to price

Markets seem to be taking an understandably cautious view around the Brexit negotiations at present. Indeed, our analysis suggests that there is a premium built into many markets to reflect the risk that a very disruptive outcome occurs. If politics takes a backseat to economic interests and we see an intermediate or extensive FTA, or indeed EEA through extensive FTA membership, this would constitute a small upside surprise to consensus. We would expect this outcome to provide a small boost to sterling, push credit spreads a little tighter, lead to an underperformance in UK government bonds and trigger a sector rotation within UK equities, with domestic names outperforming.

If the ultimate agreement is more disruptive – for instance a Customs Union or WTO – the market would likely have to price in a more challenging short and long-term outlook. Indeed, this would likely put further downward pressure on the fair value of sterling, create stress in credit spreads, see a 'safe haven' flight to government debt and trigger an underperformance in domestically focused UK equities.

For the indicative market implications, we are grateful to the following:
Aaron Rock and **Liam O'Donnell** (UK Gilts)
Andrew Millington (UK Equities)
Daniel McKernan (Credit)
Ken Dickson (Sterling).

Table 1: Diverging paths

Scenario	Structure	Transition	Waymarks	Indicative market implications
Referendum Regret: EU membership or EEA via EFTA	Full access to single market, free movement of labour Financial contributions to EU EU legislation, regulation and principles Ability to negotiate bilateral trade deals ex-EU constrained (EFTA only)	If transition deal*: Transition agreement becomes permanent	Change in rhetoric from press, public and politicians in favour of EU/EEA Government changes hands during transition to become more pro-EU Recession hits, increasing the perceived damage from leaving the EU Repeal legislation stalls in Parliament	FX: Sterling appreciates Rates: Gilts underperform Credit: Spreads tighten Equities: domestics and financials outperform
Economics Trumps Politics: Extensive Free Trade Agreement	No tariffs or quotas on goods trade and few non-tariff barriers Significant but imperfect services sector access Limited control over migration with generous allowances for EU citizens No financial contributions to EU	Minimum 4 years EEA or status quo terms	Signs of willingness to make compromises on 4 freedoms and regulatory oversight Regions get more of a say in negotiations, e.g. led by DUP and Scottish Conservatives Change in rhetoric from press, public and politicians in favour of single market access Recession hits, increasing the perceived damage from leaving the EU	FX: Sterling appreciates Rates: Gilts underperform Credit: Spreads tighten Equities: domestics and financials outperform
The Art of Compromise: Intermediate Free Trade Agreement	No tariffs or quotas on goods but some non-tariff barriers introduced Modest services sector provisions with meaningful non-tariff barriers Control over immigration but with allowances for EU citizens No financial contributions to EU	Minimum 4 years EEA or status quo terms	EU & UK indicate will to compromise on 4 freedoms Regions get say in negotiations, e.g. led by DUP and Scottish Conservatives Cross-party collaboration gains traction Government change hands during transition amid EU-dominated campaign	FX: Modest sterling appreciation Rates: Gilts underperform slightly Credit: Spreads broadly unchanged Equities: Small rally in domestic names
Avoiding a Hard Border: Customs Union	Almost frictionless goods trade between the UK and EU High non-tariff barriers for services & agricultural sector No financial contributions to EU EU regulations for affected goods and EU determines external tarrifs UK immigration controls but with possible allowances for EU citizens	If transition deal*: EEA or status quo terms Maximum 2 years.	Constructive rhetoric follow initial goods trade negotiations. EU & UK indicate little willingness to compromise on labour and services. Conservative government stand but party hardliners hold more sway. Border issue in Ireland comes to the fore, pushed for by DUP Manufacturing firms threaten to leave UK unless soft border maintained	FX: Sterling modest depreciation Rates: Gilts outperform slightly Credit: Small spread widening Equities: Domestic names, particularly financials underperform
The Bare Bones: Limited Free Trade Agreement	No tariffs or quotas on goods trade but some non-some tariff barriers High non-tariff barriers to trade in services & agriculture sectors No financial contributions to EU EU regulations for affected goods UK immigration controls but with limited allowances for EU citizens	Intent: Good deal EEA or status quo (min 2-4 yrs) Intent: Basic deal Quasi- Customs Union (min 2-4 yrs)	Constructive rhetoric follow initial goods trade negotiations EU & UK indicate little willingness to compromise on labour and services UK government rhetoric focuses on immigration controls Conservative government stands, but party hardliners hold more sway	FX: Sterling modest depreciation Rates: Gilts outperform slightly Credit: Small spread widening Equities: Domestic names, particularly financials underperform
You Can Go Your Own Way: Trade on a WTO basis	High non-tariff barriers for services sector UK-determined regulation and legislation UK immigration controls with no special allowance for EU citizens	Only if initial intent is to negotiate an FTA or Customs agreement	Hostility between EU & UK as negotiations progress EU & UK indicate no will to compromise on 4 freedoms. Conservative government stands but party hardliners hold more sway	FX: Sterling depreciates markedly Rates: Gilts outperform Credit: Spreads widen Equities: Sharp rotation out of exposed sectors

Source: Standard Life Investments (as of October 2017)

Real Estate

Asia Pacific logistics path to growth

Large populations, rapid urbanisation, growing wealth and consumers that are willing and increasingly able to shop online are driving the logistics sector in Asia.

Violet McDonald
Investment Director, Real Estate

Rapid delivery is the Holy Grail

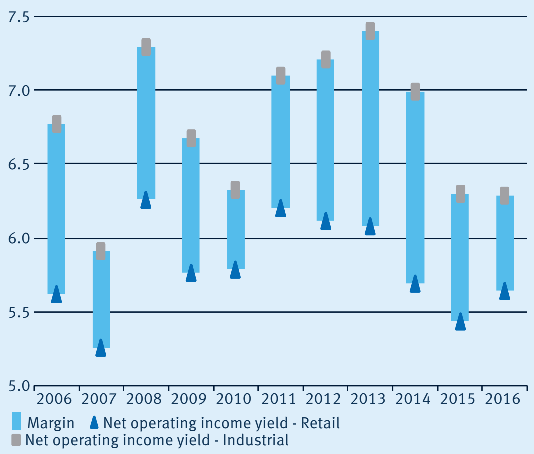
Asia is home to more than half the global population and more than half the world's urban population. Large, robust economies in the region underpin rising wealth and a desire to spend, supported by relatively high internet penetration. The success of the rapid and sustained growth in online sales rests on modern logistics infrastructure, as timely and efficient delivery is key to the success of online retailers. However, the region faces fundamental weakness in the transport infrastructure to support the delivery channels. The Logistics Performance Index (LPI), a benchmarking tool to identify the challenges and opportunities in performance on trade logistics, highlights the inadequacy of transport networks across the region. The Asia Development Bank estimates that between 2016 and 2030, an $8.4 trillion investment in transport infrastructure will be needed to address this shortfall. Countries have responded by upgrading ageing and/or developing new transport infrastructure, as well as more ambitious initiatives like China's 'One-Belt One-Road' initiative.

However, these developments often reduce the existing logistics stock to make way for new roads, railways and airports. At the same time, infrastructure projects are opening new areas for logistics developments as internal transport connections across countries spread outside urban areas. This fits neatly with the requirement for logistics real estate space, which ranges from less than 100,000 sq ft for small distribution hubs for last-mile delivery to large warehouses greater than 500,000 sq ft for the last 500 miles. Relative to major hubs elsewhere in the world, Asia is under-provided with modern logistics space; only Tokyo matches the supply elsewhere – and even then, only the smaller global hubs. Asia Pacific, and developing Asia in particular, lags the rest of the world in terms of logistics supply and sophistication, presenting a significant opportunity for real estate investors and developers.

Logistics an attractive investment

Technology is blurring the lines between traditional real estate sectors – office, retail and industrial. The logistics sector sits where industrial and retail intersect, with broadly three types of assets occupying the spectrum in between. Small distribution hubs for last-mile delivery are located inside or close to urban areas, and increasingly in what were historically retail submarkets. Yields for these assets are converging with secondary retail yields as intense competition drives their yields down (see Chart 1). Performance is underpinned by robust rental growth and yield compression. Medium-size warehouses located outside urban areas, with long leases and strong covenants, such as Amazon, trade like bonds and yields are similar to those commanded by the small last-mile distribution centres. However, the residual land value of the small urban assets is higher and risk lower than that of the larger assets.

Chart 1
Asia Pacific NOI yields are converging



Source: MSCI (as of 31 December 2016)

The third type of logistics asset is large distribution centres located in rural areas, operating on tight profit margins and hence rental growth is limited and performance is steady but modest. Over the last 10 years, the industrial sector in Asia has outperformed offices by an average of 133 basis points per annum on stronger income return. As the logistics sector matures in Asia, performance is expected to mirror that of sophisticated markets such as the UK, where distribution warehouse yields are now equal to London City offices and unit shops in major towns (ex-London). Additionally, capital values of small industrial units are nearly double that of large industrial assets. Given this outlook, we believe it is a favourable time for investment in Asian logistics.

Our strategy within global real estate

In the UK, we prefer high-quality, higher-yielding industrial-type assets and resilient, high-quality retail assets located in areas that lack competition. Elsewhere in Europe, expectations have not changed dramatically despite political uncertainty; core markets are forecast to produce attractive risk-adjusted returns supported by low development and accommodative monetary policy.

Meanwhile, recovering markets continue to rebound, generating higher absolute returns. Expectations for continued US economic expansion amid low supply growth should continue to drive rental growth across most property types and markets. 'Gateway' office markets continue to attract well-heeled foreign buyers and support pricing, although both tenant demand and asset performance are stronger on the West Coast than the East. In Asia, we prefer industrial assets underpinned by e-commerce. Developed Asia office assets are generally close to the peak of their cycle,

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 £275.2 billion – this equates to $357.5 billion, C$464.2 billion, A$466.1 billion and €313.4 billion (all figures as at 30 June 2017).

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.

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 periodically examine the major changes that are likely to influence financial markets in the coming years.

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