Global Outlook

October 2017

Few regions epitomise the challenges of the post-financial crisis world better than the Eurozone. In the October edition of Global Outlook, we assess the region's rehabilitation efforts. We consider the broad-based improvement in the economic backdrop as well as the impact this improvement has had on both the euro and European Central Bank policy. We also take a closer look at one of the many legacy issues that the financial crisis has bequeathed the region: the rise of non-performing loans in the banking sector.

Standard Life Investments

House View

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

	October 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 a key signal for more aggressive action.	LIGHT
European Bonds	Bonds are not well supported, as the improvement in activity across more economies allows the ECB to plan policy tightening. 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 on multiple valuation metrics and monetary policy is neither a headwind nor tailwind. Fiscal reforms are supportive, although political uncertainty is not. The improving macroeconomic environment can feed corporate profits.	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 is a headwind for the asset class, but little is expected in advance of the party congress.	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 $, €, ¥ MOVED TO NEUTRAL £
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

Govinda Finn
Japan and Developed Asia Economist

Few regions epitomise the challenges of the post-financial crisis world better than the Eurozone. Indebted sovereigns, ageing demographics and ailing regulatory institutions have all placed pressure on policymakers, politicians and the populous. However, there are signs that the fog is starting to lift.

Jack Kelly, Investment Director, Government Bonds, points out that with 15 consecutive quarters of growth, there is no longer a requirement for emergency monetary policy settings, even if inflation remains below target. It is taking longer for the cent to drop among European bond market participants, making non-core debt relatively attractive.

A synchronised improvement in global growth is helping confidence in the upturn. Jeremy Lawson, Chief Economist, digs into the details here and highlights that while the recent impetus from factors such as China's large monetary and fiscal stimulus, highly accommodative monetary and financial conditions in the advanced economies and global inventory restocking is now firmly in the rear-view mirror, there are signs that global activity is becoming self-sustaining. This should facilitate a reduction in global liquidity provision even if below target inflation prevents a rapid withdrawal.

Ken Dickson, Investment Director, Currency, addresses some of the unintended side-effects of the policy normalisation process in Europe. He notes that the prospect of an announcement on tapering has coincided with a rally in the euro. However, it is not the only factor supporting the currency, auguring for further strength ahead.

Finally, Andrew Fraser, Investment Director, Credit, adds a note of caution regarding the legacy of non-performing debt that haunts the Eurozone. Even here, there appears to be light at the end of the tunnel. The application of bank recovery and resolution directives in Italy and Spain highlight a level of regulatory pragmatism that bodes well for the future.

Of course, there remain plenty of risks ahead such as Brexit, the upcoming Italian election and the challenges of building a unified Franco-German approach on European reform. However, with growth going from strength-to-strength and populist upsets avoided, 2017 is turning into a good vintage.

Economic Outlook

Everything in moderation

Global growth is becoming self-sustaining even if subdued inflation pressures present difficult decisions for policymakers. The risk of a policy mistake or a political upset disrupting markets remains.

Jeremy Lawson
Chief Economist

Stronger, broader and healthier growth

There has been a synchronised improvement in key economic barometers over the last 12 months. Global industrial production, trade and corporate earnings growth have all picked up significantly. The primary drivers of this cyclical upswing have been China's large monetary and fiscal stimulus, highly accommodative monetary and financial conditions in the advanced economies, and global inventory restocking. Although these supporting factors are beginning to fade, and no further acceleration in global growth is likely, there are tentative signs that activity is becoming more self-sustaining. In particular, firms' risk aversion appears to be moderating, which is starting to flow through into stronger capital spending intentions, while labour productivity growth is also edging up.

We are also encouraged by the breadth of growth in global activity. US growth snapped back strongly in the second quarter and though the impacts of hurricanes Harvey and Irma will weigh on third quarter activity, the effects are unlikely to linger. Eurozone growth has been going from strength-to-strength lately, supported by healthy domestic and external demand. The same factors have supported growth in Japan, though the exceptional growth recorded in the first half of the year is unlikely to be sustained. The UK's growth momentum is much weaker as the negative effects of the EU referendum continue to bite. However, there are few signs that the economy is set to contract.

The near-term picture in most emerging markets is no less positive. China's debt imbalances may be unusually large – and still growing – but the credit impulse is fading. The composition of that credit growth is less unhealthy than in the past, as the previously underleveraged household sector has been taking the lead. Elsewhere, Brazil and Russia are both emerging from deep recessions in 2015 and 2016. Meanwhile, India has the best long-term growth outlook of the major emerging economies, although the twin shocks of demonetisation and the transitional effects of introducing the new goods and services tax hit growth in the first half of 2017. More generally, average emerging market external and domestic imbalances have shrunk noticeably over the past three years.

Our indicator analysis is consistent with this positive growth picture. 'Nowcasts' (the science by which we look at the prediction of the present, the very near future and the very recent past) for the US and other major advanced economies point to further above-trend growth over the next two quarters at least (see Chart 1). Our recession probability models imply that the risk of a major downturn in the advanced economies is modest on both a one- and two-year horizon. And our index of financial stress, which has leading properties for the global business cycle, is hovering at levels only just above its post-crisis lows. Taking all of these factors into account, our central forecast is for the global expansion and labour market recovery to continue, with the run rate of aggregate GDP growth to be similar next year to this year.

Structural impediments to higher inflation

Although we are confident in our near-term economic outlook, the same cannot be said for inflation. Core inflation remains below target in most of the major advanced economies (the UK being the exception) despite widespread tightening in labour markets (see Chart 2). Some of the recent downside surprises to global inflation are likely to be due to transitory factors. Nevertheless, transmission of global and domestic slack to inflation is weaker and slower than in the past in most economies. Sector-specific structural factors are also likely to weigh on inflation dynamics over many years. There are also warning signs that inflation expectations are becoming unanchored after many years of inflation being below central banks' targets.

US inflation dynamics are a useful prism through which to observe these forces. Both core consumer price index (CPI) and personal consumption expenditure (PCE) inflation have decelerated significantly through 2017, defying economists' forecasts at the start of the year for a modest lift. Five categories of core CPI inflation – wireless telephony, other lodging away from home (hotels), college tuition and fees, physicians services and used cars and trucks – account for the bulk of the deceleration over the past year. However, of the 114 sub-categories of core inflation we looked at, the current one-year rate is below the 20-year average in 75 of them. Core inflation weakness has therefore been quite broadly based as well as persistent.

Although aggregate core goods inflation is further below the 20-year average than aggregate core services inflation, the median core services category (-0.9%) is further below the 20-year average than the median core goods category (-0.8%). The reason for this is primarily due to the current trends in private and owners' equivalent rent. These costs are currently running 0.7% and 0.6% respectively above their 20-year average and have 10.0% and 29.7% weights in the core CPI. Similar patterns are evident in the core PCE data that the US Federal Reserve (Fed) follows and targets most closely, with the important caveats that medical services have a much higher weight in the core PCE than in the core CPI, and owners' equivalent rent has a much lower weight in the core PCE than in the core CPI.

An amber light for central banks

The upshot is that inflationary pressures are unlikely to build quickly enough to force central banks into the type of rapid policy tightening that would threaten economic expansion, although the peak in stimulus is behind us. The 'wildcard' is that both the Fed and the European Central Bank (ECB) are about to embark on data-independent changes to their balance sheet policies (see Chart 3). These changes will see the annualised flow of their asset purchases decline by US$2 trillion by the end of 2018, while the Chinese credit impulse is also being scaled back.

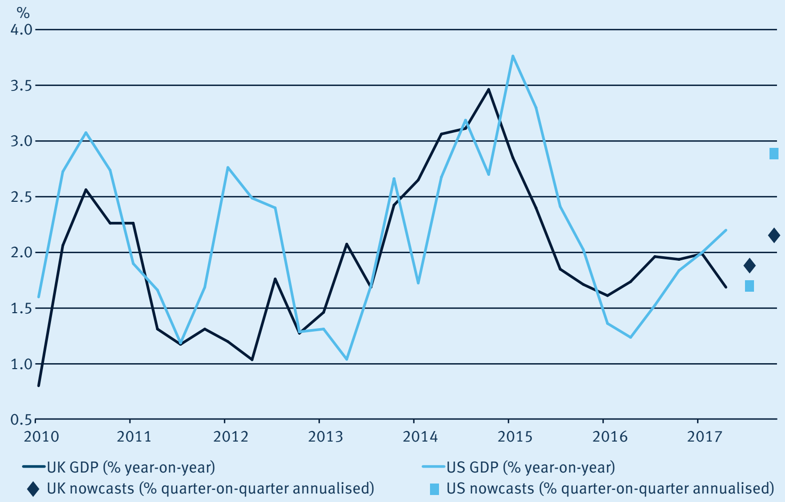
Our expectation is that global growth is now sufficiently self-sustaining to handle the reduction in global liquidity provision. However, we have to acknowledge the uncertainties, both for the economy and for markets, especially considering that core inflation is still well below target in most economies, aggregate public and private debt levels are very high, and geopolitical risks remain elevated. As a consequence, we think that central bank policy rates will have to be even more sensitive to changes in macroeconomic conditions, with neither the Fed nor ECB likely to be able to lift rates as much and as fast as they might hope to. Specifically, we think that the Fed is likely to lift the federal funds rate at most three times between now and the end of 2018 – one fewer than the Fed's projections imply – unless there is a decisive shift in fiscal policy over the same period.

In the Eurozone, policy normalisation is being complicated by the rapid appreciation of the euro, which on a trade-weighted basis is up 8.5% over the year-to-date. At its September policy meeting, ECB staff were forced to revise down their core inflation forecasts for the second time this year despite the continuation of stronger-than-expected growth. ECB President Mario Draghi stated that the currency would be taken into account in future meetings. He also reiterated that the return of inflation to a rate consistent with the ECB's price stability mandate would require the maintenance of very accommodative policy settings for a substantial period. In our view, this will push out the beginning of a proper rate hiking cycle until the end of 2019, though technical adjustments to the deposit rate are likely to come sooner as the ECB seeks to re-establish a more normal interest rate corridor with money market rates close to the refinancing rate.

A watchful eye on political developments

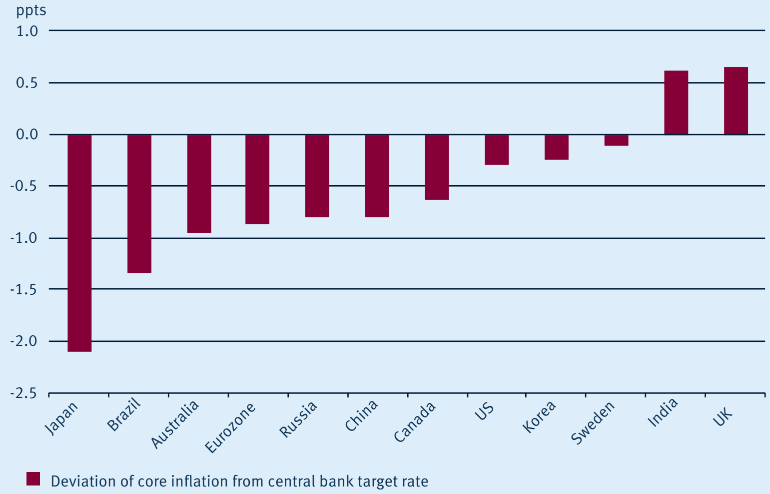
Other than the potential for a policy mistake, if the normalisation of central bank balance sheets causes term and risk premia to rise significantly, the other major source of risk in this environment emanates from politics. The fight over raising the US debt ceiling has now been put off until December but this timing, as well as President Trump's decision to deal with Democrats rather than Republicans, will significantly complicate the tax reform debate. On the Brexit front, there has been little progress in resolving issues such as EU citizen rights, the exit bill and the Ireland border that are preconditions for moving on to discussing the UK's future relationship with the EU. The most recent signals are that positions are hardening. Elsewhere, tensions on the Korean peninsula have escalated in the face of increased missile testing and launches by North Korea. Though our baseline view remains that a conflagration will be avoided because of the extremely high costs, the risk of miscalculation has risen. Of course, the political news has not been all bad. President Macron's election in France looks set to deliver significant structural reforms, and a strong commitment to reform European institutions, though German reticence towards unfettered fiscal union is likely to be reinforced by Chancellor Merkel's challenges building a new coalition government at home.

Chart 1
On the up



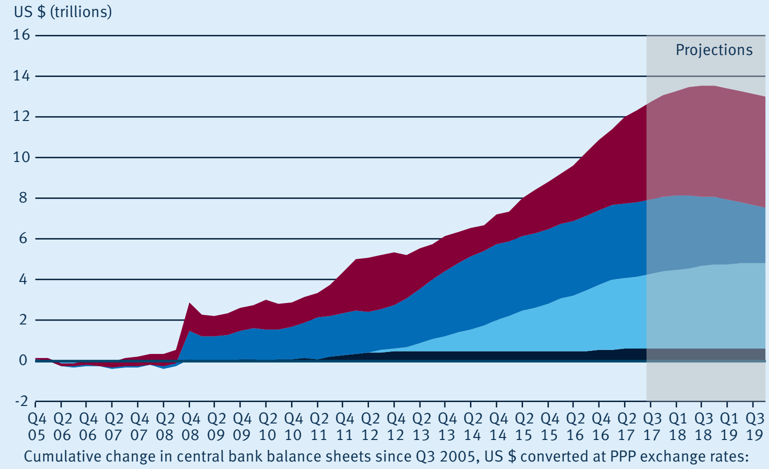
Source: ONS, US BEA, Haver, Standard Life Investments (as of September 2017)

Chart 2
Missing the target



Source: National sources, Haver, Standard Life Investments (as of August 2017)

Chart 3
Balancing act



Cumulative change in central bank balance sheets since Q3 2005, US $ converted at PPP exchange rates:
Bank of England   Bank of Japan   Federal Reserve   European Central Bank

Source: National sources, Datastream, Standard Life Investments (as of Q3 3017)

Global Spotlight

Europe's dirty secret

Resolving the legacy of non-performing loans is critical to the recovery of bank credit, investment and economic growth in Europe. Is it time to grasp the nettle?

Andrew Fraser
Head of Financial Research, Credit

One of the core functions of a bank is to provide loans that allow companies to invest or an individual to fund major purchases, such as a home. A bank can never be certain that the borrower will repay the loan on the agreed terms. If the borrower stops paying back the loan then the bank must classify the loan as non-performing, usually after a period of 90 days. A rise in bad debt is common in times of financial distress. However, two factors differentiate the Eurozone's non-performing loans (NPLs) problems. First is the size of the problem. Total NPLs ballooned after the onset of the global financial crisis, reaching €1.2 trillion in 2014 (see Chart 1) or a peak of 6.8% of total loans (known as the NPL ratio). Second is the persistence of Europe's NPL issue. As the macroeconomic recovery has taken hold, the absolute level of NPLs and the NPL ratio have declined to €948 billion (bn) and 5.0% respectively. However, the reduction in NPLs has been slow and unevenly spread given better growth and falling unemployment. The NPL ratio remains persistently above 10% in some countries, notably Italy, Portugal, Greece and Ireland (see Chart 2).

Encouragingly, tackling the issue of NPLs has garnered an increasing focus from regulators, authorities and politicians over the last 18 months. The European Central Bank (ECB) has identified the presence of high NPLs as a contributing factor behind weak economic growth and financial instability. NPLs are also a reason why there has been a relatively weak transmission of the accommodative monetary policies pursued by the central bank. The ECB's concerns have been supported by a number of studies looking at the impact of persistently high NPLs on economic growth. Perhaps of greatest significance to the ECB was a study by the International Monetary Fund, which found that the impact on economic activity was particularly pronounced in countries that mainly rely on bank financing, as is the case for the euro area.

High levels of NPLs can impact a bank's ability or willingness to supply credit or new loans in a number of ways. For example, the level of profitability a bank generates has a bearing on its willingness to create new loans. If profits are under pressure from high provisioning needs due to rising impaired loans, its willingness to offer further loans will be reduced. Second, NPLs consume much more of a bank's capital as the high risk-weighting of these assets reduces the ability to expand credit. Finally, where impaired loans remain elevated, bank funding costs will rise, potentially even to a level that questions the bank's viability, with a resulting negative impact on both the supply and cost of credit to the wider economy.

A call to arms

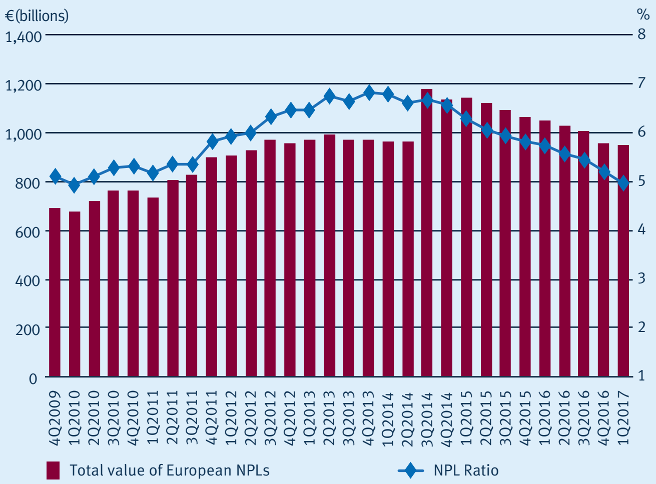
Tackling the NPL issue is not a new area of policy in Europe. To-date, however, the strategies used to deal with the problems have largely been idiosyncratic and have not been consistently applied. This is contrary to the direction of EU banking regulation, which is aimed at a full banking union. Examples of measures implemented during and immediately after the financial crisis include restructuring entire banking systems with a range of tools such as recapitalisation or asset guarantees and the transfer of impaired and high-risk exposures into asset management companies (e.g. in Spain and Ireland). At an individual country level, legal frameworks have been altered and improved (e.g. Greece), while in other countries tax systems have been reformed (e.g. Italy).

Work to address the NPL issue at a European level has increased over the last 12-18 months. This includes working towards a common definition of an NPL, specific guidance to banks on tackling NPLs, and proposals to modify insolvency frameworks aimed at facilitating the restructuring of bad debts. Recently, the European Council (EC) issued a further policy statement that outlined a mix of policy actions to help reduce stocks of NPLs in countries deemed to have currently unacceptably high NPLs and to prevent their future emergence.

The three main topics identified by the EC as areas for further policy development were banking supervision, insolvency reform and debt recovery frameworks, and the development of secondary markets for NPLs. On banking supervision, the EC agreed to increase powers for supervisors regarding the provision policy of banks:

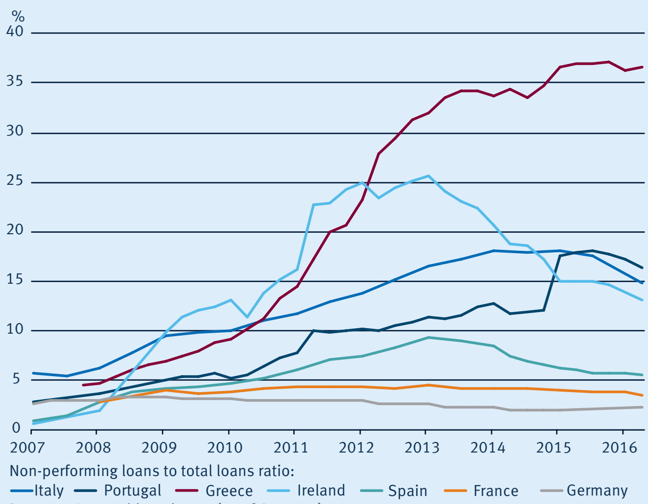
- introduce prudential backstops to address under provisioning, including deducting NPLs from capital

Chart 1
The build-up of non-performing loans



Note: NPL denotes non-performing loan; definition change in 3Q14
Source: European Banking Authority (as of Q1 2017)

Chart 2
Differing paths



Source: ECB, World Bank, IMF (As of Q1 2017)

- expand the powers of the Single Supervisory Mechanism (SSM) outside the largest banks in the EU to deal with NPLs at smaller banks
- and for the European Banking Authority to issue guidelines on NPL management outside of those banks that fall under the radar of the SSM.

The second area of focus – reforming insolvency and debt recovery frameworks – is perhaps the most challenging. The EC's approach is likely to involve a benchmarking process to compare insolvency regimes across the EU, including their efficiency. However, as the EC lacks specific powers to change local insolvency laws, it remains to be seen whether any recommendations in this area will make a material difference.

The final area of the EC's plan focuses on one of the major structural impediments to the NPL issue, i.e. the lack of a secondary market for NPLs in the region. Weak and inconsistent disclosure on NPLs as well as collateral valuations, inefficient debt enforcement frameworks and restrictions on the transferability of loans have all acted as impediments on the demand side. Meanwhile, an unwillingness or inability to realise losses due to weak capital positions continues to create a material gap in the bid-ask spread in NPL markets.

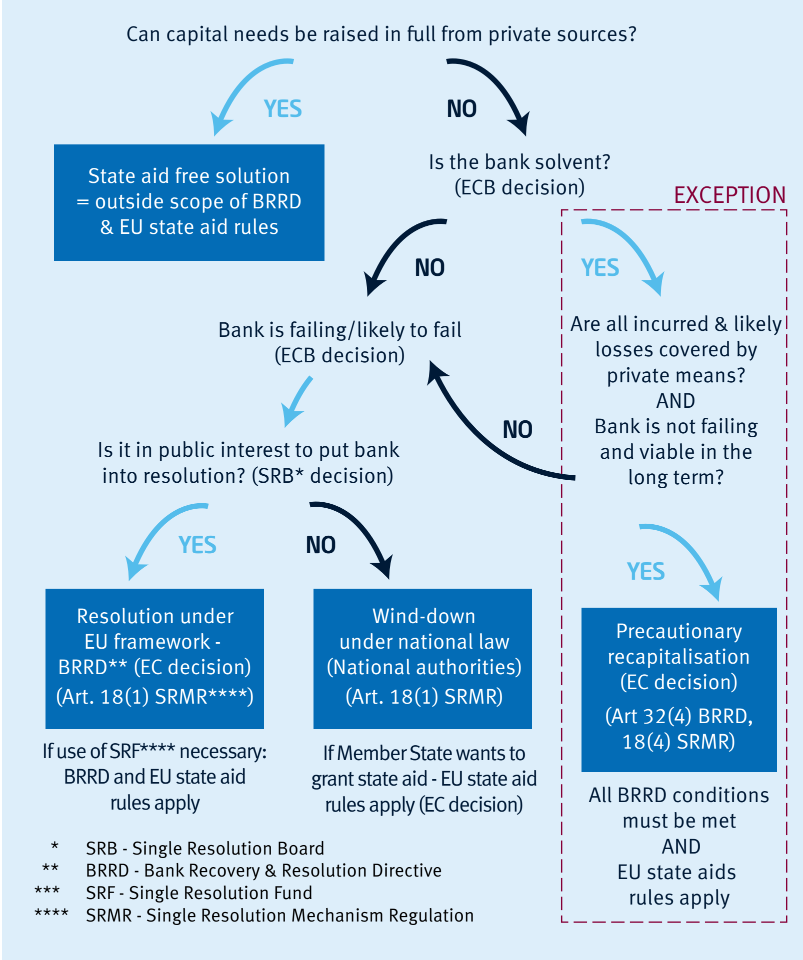
The market solution

Discussions on market-based solutions to the NPL problem have also been wide-ranging. Any panacea is likely to be a combination of options. These include an internal workout process on a bank-by-bank basis, use of asset protection schemes, establishing a Europe-wide asset management company, and initiatives to further develop the securitisation market.

The outcome when a private sector solution can be reached is relatively clear cut for stakeholders and usually only involves some dilution or losses for shareholders. The recognition of specific NPL issues through a private sector solution also leaves the requirement for state aid out of the equation. However, success here does require the combined efforts of market participants and regulators. There have been some recent successes. Bank of Cyprus announced that it was taking a €500 million (m) provision to increase NPL reserves in order to accelerate its balance sheet de-risking following ongoing discussions with the ECB. In Italy, BPER Banca stated that it intends to book a further €1bn in provisions to speed up the improvement in asset quality. More recently, Liberbank in Spain said that it would launch a €500m rights issue in order to significantly reinforce its NPL reserve ratio, which will facilitate a further reduction in NPLs. Finally, Irish Permanent appears to be re-thinking its NPL strategy following guidance from the ECB, which may require a faster resolution and increased loan loss provisions to address its high level of NPLs. In all instances, the rhetoric from the ECB is clear – maintaining a large stock of NPLs or a pedestrian approach to reducing the problem will no longer be tolerated.

This issue becomes more complicated when the NPL problem is too large to deal with because the bank's balance sheet is not strong enough to reach a viable solution without the use of public funds. In these circumstances, the Bank Recovery and Resolution Directive (BRRD) and SSM come into play (see Box 1).

Chart 3
If a bank has a capital shortfall in the Banking Union



Box 1

Key aspects to the BRRD

1. The rulebook requires banks and authorities to draw up recovery and resolution plans.

2. Regulations permit for the early intervention by the SSM when a bank has, or is likely to, breach capital requirements, effectively forcing banks to use their recovery plans to restore financial health.

3. The regulator to use a range of powers and tools when other remedies are exhausted. These tools include the sale of business tool, setting up a bridge bank, the ability to separate assets in the bank and the bail-in or debt conversion tool.

Although the ECB and SSM are now armed with a rulebook on how to deal with failing banks, the actual process of implementing the rules is never straightforward. Given the complexities in resolving problem banks, the presence of the rulebook can leave the regulators open to criticism that there is a lack of visibility in terms of the course of action taken when the available tools need to be used. This can lead to uncertainty in financial markets and leaves the resolution authorities open to litigation. It also means they can be challenged in instances where the decision-making process is unclear or appears inconsistent with the framework set out in the directive.

One of the key sticking points in the legislation is the concept that no creditor should be worse-off than in liquidation. Where liquidation is avoided as the solution to a problem bank, proving that this principle has been upheld is almost impossible. The EC recently issued a factsheet explaining in more detail how EU rules apply to banks with a capital shortfall (see Chart 3). This communique was issued to try and explain in more detail how the BRRD was applied in recent bank failures. Unfortunately, banks do not only fail because of a shortage of capital – liquidity is a more frequent cause of bank failure.

In recent months, some of the tools within the scope of the BRRD have been used to resolve problems at Banca Monte dei Paschi, Veneto Banca and Banca Popolare di Vicenza in Italy, and Banco Popular in Spain. These four institutions had among the highest NPL ratios in the European banking sector. The resolution process highlighted the generous flexibility included in the European rulebook, with Monte receiving public funds through a precautionary recapitalisation to avoid insolvency. With Veneto and Vicenza, the Italian government provided €17bn in public funds to Intesa via cash injections, and state guarantees so that Vicenza was willing to take over both entities. In this example, Italian authorities justified the decision on the basis of the significant negative impact on regional economic growth if the banks were allowed to fail. Only in the Popular situation were no public funds used (see Chart 4).

Although many commentators expressed concerns about the lack of visibility and bending of the BRRD rulebook in these four cases, there were common features of all the restructurings. Losses were shared across all shareholders and bondholders, and across all bank capital instruments, including Tier 1 and Tier 2 securities, and recovery rates should be negligible. Only senior bondholders were made whole, while retail investors of subordinated bonds are likely to receive some compensation to avoid any political backlash.

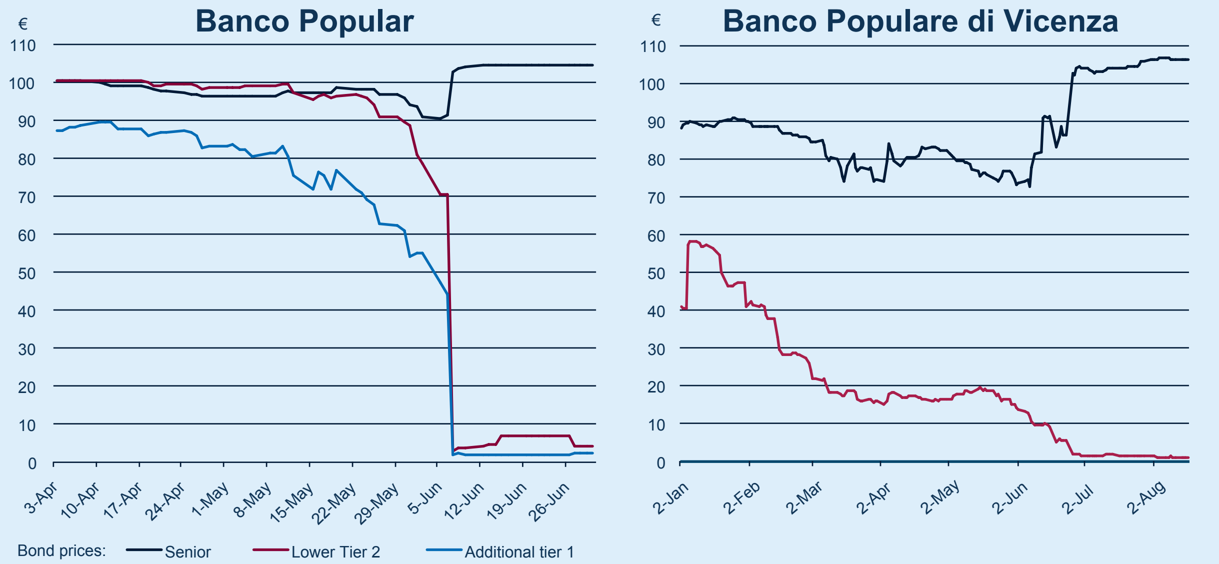
Looking ahead, it is unclear whether the regulator will be as generous towards senior bondholders. The focus is now turning to ensuring banks have sufficient going concern and gone concern capital – the former to absorb losses on a day-to-day basis, the latter in order to recapitalise a bank when other resources are utilised. These new rules are captured under the ECB's Minimum Required Eligible Liabilities regulation and they will require banks to issue a specific amount of loss-absorbing debt instruments.

This has given rise to the development of the holding company/non-preferred senior asset class over the last few years, a market which we expect to increase from around €180bn today to above €550bn over the next five years. These instruments rank as senior unsecured liabilities of the bank but are subordinated to other preferred senior liabilities either structurally, contractually or statutorily in the event of default. None of the banks that failed recently had issued this type of security. However, if debt instruments with these features had been outstanding, it would have been realistic to expect these senior liabilities to face losses.

Implications for credit investors or portfolios

For an investor in bank debt, it is clear that where NPL resolution results in bank failure, subordinated debt will be wiped out and holders of these instruments should expect to lose all their investment. For banks perceived to have an asset quality problem, this will likely have a clear negative impact on the valuation of their securities. With the development of the senior subordinated asset class and the willingness of the SSM to use the bail-in tool under BRRD, the risks of losses in the bank senior market have clearly increased. How much you might lose in a resolution will depend on the quantity of subordinated instruments sitting above you in the creditor hierarchy, as well as the volume of debt with the same ranking. The risks of investing in bank debt have risen but with a robust understanding of a bank's risk profile as well as its capital structure, there will continue to be opportunities to take advantage of mis-pricing of securities in the European banking sector.

Chart 4
Fail-in



Source: Bloomberg (as of 14 August 2017)

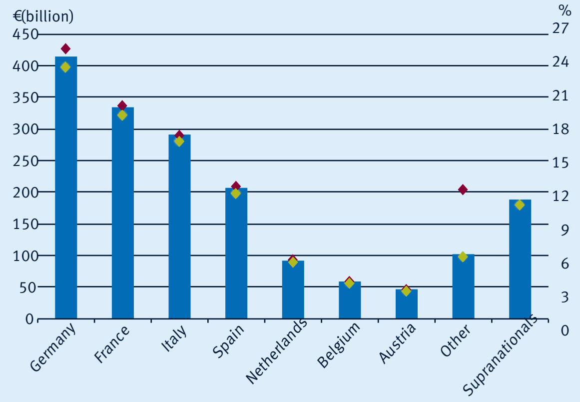
European Government Bonds

The ECB's thankless task

There is no longer a case for emergency policy settings in Europe. However, inertia in the bond market has complicated efforts to remove the stabilisers.

Jack Kelly
Investment Director, Fixed Income

Chart 1
Central bank action



Source: ECB, Bloomberg, Standard Life Investments(as of 31 August 2017)

European government bonds remain resolutely strong, even in light of the European Central Bank (ECB) signalling that an announcement on tapering of some of its extraordinary policy support is imminent. The quantitative easing (QE) programme will likely be brought to its natural end next year, with the ECB now owning nearly 20% of European sovereign debt. The dilemma for the ECB is that, while growth numbers have been positive for 15 successive quarters, inflation in any meaningful sense has been largely absent. However, we should remember that the ECB entered into much of its current policy settings when genuine deflation in Europe was a concern. Now that those fears have largely dissolved, the ECB is understandably preparing to remove some of that emergency policy. The problem is that by doing so, it risks signalling an imminent tightening of conditions while inflation is still well-below target. The preparation for transition is also problematic because it has put upward pressure on the currency, which feeds into the ECB's own inflation forecasts. It is a delicate balancing act, attempting to wean markets off an aggressively accommodative policy setting without disrupting growth and choking off a more healthy path of inflation.

Running out of runway

One of the key factors the ECB has to contend with is the physical unsustainability of the current QE programme. Under legal advice, it is loath to breach issuer limits on the proportion of any individual bond it owns. It also risks criticism by deviating too much from the capital key, which is the framework based on contribution from sovereigns that defines the proportion of each country's bonds it buys. So, while the ECB frets over deciding the least contentious way to extend the programme, the bond market marinates in scarcity and artificial technical demand, keeping German bund yields at multiple-year lows even as the signalling starts to change. This is unusual as typically bond markets tend to pre-empt major signposted changes to the environment.

It may be that the sheer scale of central bank ownership is inhibiting the normal ability of bonds to price forthcoming policy changes. Alternatively, bond markets in Europe may have become used to the idea that inflation will not reappear in any meaningful sense over the coming months. The longer the disconnect between the improvement in the labour market and the lack of wage inflation, the greater the fear that inflation-setting mechanisms have been permanently damaged. Certainly, conventional measures of price expectations are unusually low, with 10-year inflation breakevens in Germany languishing at 1.15%. As the ECB prepares to dismantle one plank of easing support, the consensus for a low-inflation outlook is further emboldened.

There are risks to this consensus, particularly as we consider the reaction of the more traditional hawkish elements within the ECB to any delayed upside surprise on inflation. We should also remind ourselves that growth remains broad-based. The question is, how long can the disconnect between growth and inflation persist? The market has already made up its mind that it can last indefinitely. ECB President Mario Draghi's brief departure from this narrative came from a speech at the June conference in Sintra. This is where he attempted to reawaken markets to the idea that bonds should have greater sensitivity to the changing economic backdrop. More importantly, a rapid rise in inflation is not a prerequisite for policy change. The change in communication has not lasted long. With the currency unhelpfully strengthening, Mr Draghi has reverted back to a dovish and patient tone.

Hunting for value

Still, the clock ticks on QE sustainability and, in averting near-term volatility, the central bank risks greater volatility later. Ironically, peripheral bonds in Italy and Spain, the area of the market where early weakness helped prompt the initiation of the bond purchase programme, are probably the more robust. Better growth numbers and a greater consensus among European partners keeps these bonds well-underpinned. Of course, any unforeseen political upheaval, such as the Italian elections or the Catalan debate, could potentially cause unwanted weakness for peripheral debt. In the meantime, it stays supported under the current policy settings. We are conscious of the dilemma facing policymakers but see risk/reward around core European bonds as asymmetric at 0.30%. We prefer peripheral debt to core on a spread basis and seek yield-versus-Germany in other developed bond markets such as Australia and the UK.

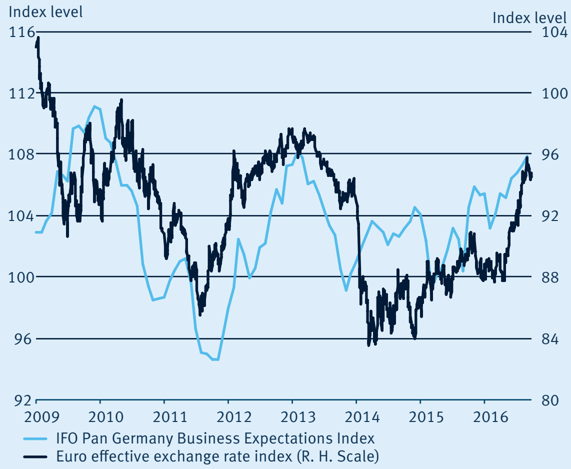
Currency

Will the euro rally continue?

The euro has been one of the biggest gainers in currency markets this year. We investigate what has been driving the trend and whether it is likely to continue.

Ken Dickson
Investment Director, Currency

Chart 1
Turning German (again)



Source: Bank of England, IFO, Bloomberg (as of 22 September 2017)

Since the end of last year the euro-dollar exchange rate has appreciated 15%. The rally is a noticeable divergence from the trend witnessed since the financial crisis. A decade ago, the euro traded as high as 1.60 to the dollar but has been subject to regular bouts of weakness, most noticeably during the 2014/2015 sovereign debt crisis when it slumped 23%. For the long-term investor, does the recent rally indicate that the persistent euro downtrend is over?

A historical comparison

The euro was established in 1999 at a value of 1.17 to the dollar. Although the average rate since then has been 1.20, there have been significant and persistent divergences from this level. While the early years of the euro were spent below the 'birth' rate, there was then an 11-year period where the euro traded above its average rate.

While the recent move is certainly at the top end of a normal range of up-moves, does it represent a structural break from the past? We do not think so. Firstly, our valuation survey suggests the euro is firmly within the reasonable 'fair value'. Secondly, the current rebound should be seen in the context of the lows of 2014 and 2015.

In the driving seat

That does not mean that the euro cannot sustain its rally, which is driven by a number of key factors. Firstly, fundamentals in the Eurozone have improved with output expanding and jobs created. This has prompted the European Central Bank (ECB) to signal that an announcement on the tapering of its quantitative easing (QE) programme is imminent. Furthermore, there is a sense that euro break-up risk is also on the retreat driven by lower European peripheral risk and the failure of populist upsets to materialise. It would be remiss to neglect the role of the dollar in the recent rally too. With growth differentials no longer clearly favouring the US, the dollar has weakened on a trade-weighted basis. This deterioration in the greenback is consistent with the 'dollar smile' theory that states that dollar strength coincides with either risk aversion or robust US growth but weakens when US growth is somewhat lacklustre.

Even given all these factors, our efforts to model the higher euro-dollar levels using daily financial data like yield curves, swap rates, commodity prices and equity markets suggest there may be a missing ingredient. One potential explanation is the recent increase in euro positioning, which appears to reflect a rebalancing into European assets and a reduction in overseas investor hedging of euro risk. There is anecdotal evidence of this across portfolio flows. We also see changes in correlations between currency returns and changes in European equity prices, which suggest the euro is losing its recent funding currency status. These developments are not usually short-term trends. However, positioning indicators tend to mean revert through time and so, even if the general trend continues, we would allow for a pause in the underlying price action.

Will the ECB counter the move?

Euro bears highlight increasing concerns from ECB council members about the strength of the euro. Fears of deflation have eased since euro area CPI rose to 1.5% in August, up from 0.2% in August 2016. However, the policy board as a whole does not think the job on inflation is fully done and staffers have already had to reduce inflation forecasts this year. A continued move towards 1.30 would put more downward pressure on the Bank's inflation forecasts. Further strength would also begin to hurt the European periphery relative to the core and potentially feed anti-euro populist politics again. However, it is difficult to see what the ECB can do currently. Technical constraints mean that there is a high bar for the ECB not to proceed with asset purchase tapering in 2018. Monetary policy changes will be limited to verbal intervention or potentially a slowing in tapering of the QE programme. Neither of these is likely to be a game-changer for the euro-dollar exchange rate.

The euro rally may have more mileage

We expect a limited continuation of euro strength this year, albeit at a much slower pace. The main risk to this scenario appears to be US-centric. The market is pricing out all good news in the US economy and it is now highly sceptical of President Trump's ability to deliver policy reform of any kind. Greater momentum on tax reform in the US could possibly be the best hope for the doves in the ECB.

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).

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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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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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