Global Outlook

First Quarter 2013

Several years on from the great financial crisis, the world economy is adjusting. We examine the state of the global economy looking into 2013-14, and set out some key assumptions that enable 10-year return forecasts to be made for cash, bond, equity and real estate markets. In the corporate space, we illustrate our best stock picking ideas and explore the importance of long-term stewardship among investors.

Standard Life Investments

Summary

Foreword

Keith Skeoch
Chief Executive

Times (and returns) are a changin'

Tempus fugit, we are several years on from the financial crisis, yet its destructive force still dominates the policy and regulatory agenda, as well as continuing to shape social and political attitudes. As a consequence, the post-crisis return environment — characterised by risk aversion and myopic investment horizons, with superior returns generated by low-yielding, safe-haven assets — has persisted as long as some complete investment cycles. In the immediate future, the strong headwinds created by the slow-moving depression over the financial and credit markets will continue to buffet both growth and confidence. Sustainable yield, the theme that has served our asset allocation strategy very well over the last five years, is likely to continue to do so as we move through the first half of 2013, and cope with the machinations of US fiscal policy, the next twist in the euro saga and the other uncertainties that clouded much of the last couple of years.

Time is also supposed to be a great healer. Mood often improves as the memory of the pain recedes. Time taken to reflect and analyse may also reduce the impact of past uncertainties and engender a greater focus on the future. The experience of the second half of 2012 suggests that these processes are finally starting to get underway. Volatility, one measure of market fear, remained remarkably subdued, despite plenty of policy noise, perhaps suggesting that investors' fears about another extreme or tail event are starting to recede. The second half also saw positive momentum in the return environment. While the S&P 500 was one of the few leading indices to hit a new all-time high, the total-return index for UK equities was helped to a new peak by income growth. Indeed, out of the leading 20 equity markets, 15% have reached a new high and a further 40% are within 10% of an all-time high for their total-return indices. Furthermore, in 2012, we believe stock picking was rewarded as investors started to look through the big picture. Robust equity returns at a time when macro concerns remain high may be a sign of complacency but equally may also be a sign that the nature of returns are changing, back to a focus on the fundamentals and the importance of research in the investment process.

Finally, the policy consensus around inflation targeting is starting to be questioned; a realisation that, monetary policy stretched to its technical limits, a new approach is required. If the focus on risk-based prudential solvency remains high, which it surely will, then removing inflation targeting as the principal focus of policy would be an important step in improving the supply of long-term capital and ending the short-run focus on yield. The long-run signals suggest that the return environment shaped by the post crisis world is starting to change. It was never a question of simply 'risk on, risk off', but more 'where is risk likely to be rewarded?' History and common sense suggest that this is unlikely to be the safe-haven assets, where prices are still close to 100-year highs.

It will take time for the new return environment to emerge. However, we believe there is an increasing probability that it will do so in 2013, with truly sustainable business models and income important elements driving returns.

Global Overview

Slower for longer

Global growth prospects are slowly improving for 2013 on the back of successful rebalancing, productivity efforts, credit creation and very supportive monetary policy.

Douglas Roberts
Senior International Economist

Reviewing 2012, outlook for 2013

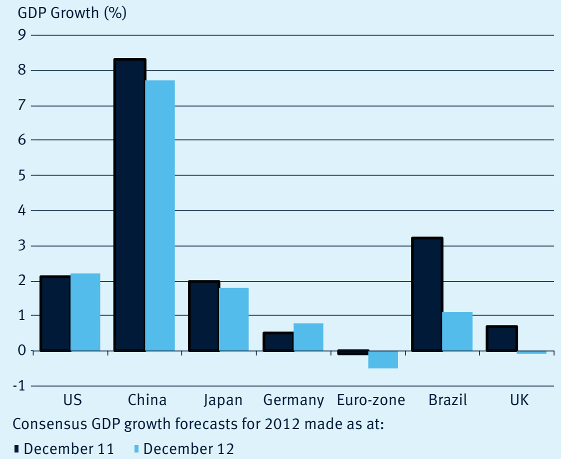
It may not have felt like it, but the world's major economies performed pretty close to expectations in 2012. Chart 1 shows the forecasts made a year ago and the outcome for the larger countries. Despite that outcome there has been disappointment that, over the three years since the end of the global recession, most economies still require extremely supportive official help to prevent a relapse. Will 2013 be any better? There is certainly a wide spread of economic growth forecasts for the coming year, with both the Euro-zone and Japan expected to continue to struggle. Elsewhere, the dominant theme is sub-trend economic growth as all the major economies face significant headwinds, be it deficit reduction, re-balancing or fundamental economic restructuring. While most economies have moved some way towards tackling the challenges that they face, material headwinds will continue to dampen growth prospects in 2013 and beyond. All in all, there does not look to be a major risk of a renewed global recession, although certain economies are more at risk than others.

Better established growth in the US

The US economy more or less met market expectations last year, but that is likely to have been an under-achievement. In the approach to November's presidential election, and December's fiscal cliff debate, there was clear apprehension about whether to invest, recruit and spend. While it is difficult to quantify the impact, it seems likely that GDP growth would have been closer to 2.75% per annum (p.a.) than 2.25% p.a., if such uncertainties had been absent.

The election is now past and the politicians did manage to fudge a compromise over the cliff – at least until February. However, corporate sentiment may not improve quickly, given the likelihood that a re-elected President Obama will probably step up the raft of regulatory measures that were put on hold last year. At least, though, companies will know the business environment in which they will be expected to operate. One anchor of that environment will be the prevailing level of interest rates. The FOMC has made it clear that it is likely to keep rates on hold until mid 2015, or until the unemployment rate gets down to below 6.5%, providing inflation remains becalmed.

Chart 1
Accurate consensus



Source: Consensus Economics (as of 31 December 2012)

This easy monetary stance will be an important offset to the tighter fiscal regime going forward — the latter will inevitably eat into growth prospects. Already, record low mortgage and auto rates have helped give a significant boost to activity in those two important areas of demand. Not only that, the notable housing market recovery has contributed to a jump in household wealth levels.

To sum up, despite a likely drag from fiscal policy initiatives and extra regulatory intrusion, the US economy should still maintain a decent pace of expansion in 2013. The consensus of 1.9% p.a. should prove too low, with GDP likely to be closer to 2.5% p.a. (Chart 2). Unfortunately, this is not enough to make meaningful inroads into reducing the unemployment rate, which the Fed expects to linger above 6.5% at least until 2015.

Slow progress in Europe

The other major area of uncertainty that dominated 2012 was the Euro-zone, which had started the year on a note of optimism as the Longer-Term Refinancing Operation (LTRO) initiative promised to bring a welcome relief from crisis. Unfortunately, the relief was short-lived, and pressures on peripheral European bond yields resumed.

From July, however, European Central Bank (ECB) President Draghi went about restoring the situation by promising to do "whatever it takes" to save the euro. The key element in his initiative was the Outright Monetary Transactions (OMT) programme, which is designed to provide bail-out monies to distressed governments, upon request and conditional on the introduction of necessary structural reforms. Although no funds have actually been deployed, the initiative has already effectively removed one area of doubt, with bond yields in troubled peripheral countries well off peak levels (Chart 3). This provides a surer base from which politicians and central bankers can address the areas' more structural problems.

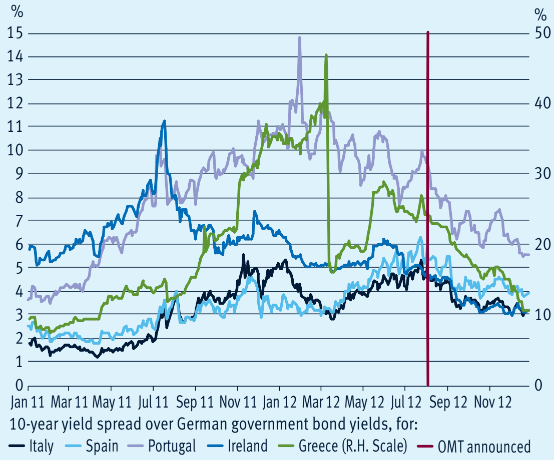
While the ECB looks to have provided a certain underpinning, economic growth prospects for the region remain unpromising. Most economies are engaged in deficit reduction programmes, and credit creation is restrained for the private sector. These factors will remain a drag on growth throughout 2013, but the intensity of the squeeze is likely to wane as we go through the year. A significant problem is that unemployment levels still look set to rise higher, with a peak of around 12% compared to the present 11.7%.

Chart 2
Positive prospects

GDP	2013 Forecasts	
	Consensus Economics	Standard Life Investments
US	1.9%	2.8%
China	8.1%	7.5%
Japan	0.6%	1.5%
Germany	0.7%	1.5%
Euro-zone	-0.1%	0.5%
Brazil	3.4%	3.5%
UK	1.1%	1.5%

Source: Consensus Economics, Standard Life Investments (as of 31 December 2012)

Chart 3
Yields decline



Source: Bloomberg, Datastream, Standard Life Investments (as of 31 December 2012)

As with last year, economic performance in 2013 will be very disparate, with the European periphery struggling to restore any growth. Germany is generally expected to repeat last year's 0.8% GDP expansion, but that should prove pessimistic. With expectations of more robust global activity, 1.25% to 1.5% growth for Germany may be achievable. For the region as a whole, a stronger German outcome allied with more trade momentum could see a flat economy, or possibly a modest upturn.

Re-balancing out east

The new leadership in China will be charged with redirecting the economy towards a fresh growth model. Although last year's slowdown was as much a result of policy at home and slowdown elsewhere, it was becoming quite clear that the prevailing investment/export model is approaching its sell-by date. Rising wage levels are reducing competitiveness, due to both slower workforce growth and policies designed to encourage greater consumer spending.

The problem for the authorities is that improving competitiveness from here is much more difficult. Previously, the abundance of rural workers could be transferred to the cities, providing a cheap supply of labour, the backbone of China's export competitiveness. While the new leaders have promised to support greater urbanisation, it is not clear whether this will be compatible with increasing consumption's share of GDP. Increased urbanisation implies large development projects and investment spending, which is already around 50% of GDP.

Assuming that the authorities resist the temptation of the quick fix of re-stimulating property and infrastructure projects, reported economic growth is likely to settle in to a range of 6.5% to 7.5% over the next few years. That would not be a disaster given that the workforce is close to peaking, although the move away from public towards private ventures will entail the shedding of much unproductive resource. While the process is going on, however, it will be a drag on growth.

A less depressed global economy this year, though, should alleviate some of the pressures on the Japanese economy, which slumped sharply over the second half of 2012. Exports were hit, while imports of alternative fuel sources have rocketed, following the crippling of the nuclear industry. Despite that, growth last year still came in close to beginning-of-the-year expectations. That, however, was down to very strong first quarter growth – the rest of the year was weak. Last month's election result promises a more aggressive policy stance, with both monetary and fiscal policy expected to be eased further. Yet another supplementary budget is expected to boost public works spending, but most of the stimulus will come from a more expansionary monetary stance. What is not clear, however, is what the new government will do about the nuclear industry and consumption tax plans. It seems likely that present growth forecasts for 2013 of around 0.8% p.a. will be revised up as more details of the government's policy intentions come to light. That should address the near-term challenge, while leaving deficit reduction and economic restructuring until some time in the future.

A less eventful year for the UK

The UK economy is unlikely to be as distorted as it was last year, with royal weddings, Jubilee celebrations and the two Olympic games. The soft phase in global trade, which now looks to be ending, added to the downward pressures, while buoyant employment data led to questions about just how weak conditions actually were. Market expectations are that the economy will rebound by over 1% p.a. in 2013, although that could prove to be a bit on the low side. Construction activity, which accounted for much of the weakness last year, looked to have bottomed in quarter four, boosted by infrastructure projects and a firming in the housing market. Looking ahead, manufacturers and exporters should get a lift from a less austere year for the global economy. However, with growth still sub-trend, the policy stance will remain ultra accomodative.

Conclusion

Towards the end of last year, economic growth forecasts for 2013 were still being trimmed back by international bodies, such as the IMF, by national central banks and by investment banks. However, pessimism seems to be more driven by recent soft economic numbers and less by the more forward-looking indicators, which have picked up lately. In particular, business sentiment looked to be bottoming out in many economies, while credit creation is, at best, improving and, at worst, stable. In particular, the avoidance of the fiscal cliff in the US should nurture expectations of decent growth in the world's largest economy. Consequently, despite extending the present lengthy period of sub-trend activity, there are good prospects that growth this year will exceed present gloomy expectations.

Focus on Change

The sweet spot for investing

We set out a process for estimating 10-year returns across a range of asset classes in the major economies. Global equity and real estate are attractive versus global government bonds.

Andrew Milligan
Head of Global Strategy

Chart 1
Backtests of valuation measures

Valuation measure	Adjusted R2 %		
	1 year	5 years	10 years
UK Trailing PE*	5	30	61
UK Dividend yield*	20	44	57
US Tobin's Q**	6	26	52
US Price to book***	11	23	47

* = Real returns for the UK equity market using data since 1962
** = Real returns for the US equity market using data since 1900
*** = Real returns for the US equity market using data since 1952
Source: Nomura (as of 31 December 2012)

Long-term returns

At year end, it is common place for many investors to make forecasts for stock markets and other asset classes in the coming 12 months. Experience has shown that in most cases such estimates are no better than a random walk. Unexpected shocks can throw markets away from fundamentals. However, there are benefits in examining longer-term, say 5 to 10-year, return numbers. To quote the academics Ang and Kjaer, "the turmoil we have seen in capital markets in the past decade has increased the competitive advantage of a long time horizon". Advantages include the ability to profit from periods of short-term mis-pricing as well as pursuing illiquid investment opportunities.

There are many potential ways of making long-term return estimates. At its simplest, one could extrapolate recent history, e.g. the total return for US equities was around 7% p.a. in the decade to end 2012, or to extrapolate longer-term history, e.g. the real return for global equities since 1900 has averaged about 5% p.a. In this article, we combine several key assumptions to illustrate how the current economic environment could alter, with the sensitivity illustrated via upper and lower bands for projected returns.

Assumptions – the key drivers

What are the key assumptions which underpin our 10-year return numbers? The starting point is the current yield for each asset, say 1.4% for Euro-zone government bonds or 4.0% for Euro-zone equities. Secondly, an inflation assumption needs to be made as assets perform differently in a lower or higher inflation environment. Our base case for the UK, for example, is that the Bank of England achieves its 2% p.a. target, while the alternative scenario is neither dis-inflation nor deflation but that inflation is allowed to move higher, averaging 3% p.a. over the whole decade. Clearly, the figure could be rather higher or lower in individual years. Thirdly, equities and real estate are closely related to the global macroeconomic cycle, through the worldwide earnings which companies generate and then either return to shareholders through dividends or use to finance rents on their commercial property. We make a key assumption that despite a lengthy period of deleveraging, fiscal austerity and slow economic growth, companies are able to generate positive if low earnings growth over the coming decade. The corporate balance sheet also needs to be examined; share buybacks can be an important mechanism for returning extra cash to shareholders, although again allowance needs to be made for share issuance and options to produce a net figure. The US and UK currently benefit most in this regard.

Valuations matter considerably for longer-term investors. Forward-looking estimates can benefit from an assessment of where a market is in relation to its cycle. Chart 1 summarises a backtest of valuation measures for US and UK equity markets. Over periods of a few years, few broad stock market ratios have much predictive power. Over longer periods, however, such valuation measures as Tobin's Q, price to book (P/B) ratios or dividend yield ratios have considerable predictive power for inflation-adjusted returns. As an example, in 2000 at the time of the TMT bubble, the P/B ratio of the US and pan-European equity markets reached expensive levels (5.9 and 3.6 respectively); subsequent 10-year returns averaged 1.3% p.a. and -0.1% p.a. respectively. Similarly, the Japanese stock market became very expensive in the decade to 1990, returning 21.5% p.a. but -4% p.a. in the subsequent decade.

In Chart 2, we set out as examples key assumptions about future inflation, real dividend growth and rental growth for the major economies which we are covering. Entry and exit costs need to be included; they matter a little for government bonds, more so for equities and corporate bonds, and particularly are a factor for directly held real estate, where depreciation and maintenance charges also need to be taken into account. Combining all these with valuation analysis enables us to generate a range of estimates for 10-year returns for the major asset classes (Chart 3).

What is priced into cash and bonds?

Several of these assumptions need to be considered in more detail. The first concerns cash, a particularly mis-priced asset. While the UK dividend yield is only one standard deviation away from its 10-year moving average, cash rates are 1.75 standard deviations. Put another way, when will the US Federal Reserve, the European Central Bank (ECB) or the Bank of England raise interest rates? How long will interest rates remain 'lower for longer'? The central case is that the official statements are correct, i.e. that the Fed will keep policy unchanged until 2015 as it has recently announced. We assume that the Bank of England will raise rates from 2016, the same year that the Office for Budget Responsibility (OBR) assumes that QE will begin to be reversed. As the financial crisis is longer lasting in Europe than the US, we assume that the ECB will also tighten policy in 2016. Lastly, our central

Chart 2
Assumptions

Assumptions (% p.a.)	US	Europe	Japan	UK
Inflation	1.5 to 3	1.0 to 2.0	-1.0 to 1.0	2.0 to 3.0
DPS growth	0.0 to 3.0	0.0 to 3.0	-1.0 to 3.0	0.0 to 2.0
Rental growth	0.0 to 1.0	-1.5 to 1.5	-1.0 to 1.0	-1.5 to 0.0
Government bond exit yield	-1.0 to 3.0	-1.0 to 2.0	-0.5 to 1.0	-0.8 to 3.0

Footnotes: Inflation = CPI, DPS = real dividend growth, rental growth is in relation to the local eg IPD index , exit yield = potential upside or downside move in benchmark rates

Source: Standard Life Investments (as of 31 December 2012)

Chart 3
10-year inflation-adjusted return forecasts

10-year inflation-adjusted return projections (% p.a.)	US	Europe	Japan	UK
Cash	-0.25 to 1.5	0.5 to 1.75	-0.75 to 1.25	0.75 to 2.5
Government bonds	-4.0 to 1.25	-2.5 to 1.25	-1.25 to 2.0	-3.75 to 0.5
Credit	-3.0 to 3.25	-2.75 to 3.0	-1.75 to 2.5	-3.5 to 2.5
Equity	-1.0 to 8.0	0.75 to 9.5	-1.75 to 10.0	1.0 to 9.0
Real estate	0.25 to 8.75	1.0 to 9.5	-1.0 to 7.5	0.0 to 8.0

Footnotes: the figures are the higher and lower ranges for 10 year returns on the basis of selected assumptions. Different scenarios are possible. Europe = Eurozone cash, Europe ex UK equities and German government bunds. Real estate = IPD indices. Credit = investment grade corporate bonds.

Source: Standard Life Investments (as of 31 December 2012)

assumption is that the Bank of Japan does not raise rates over the coming decade. The speed with which rates move will reflect, among other matters, the inflation assumption. In the lower inflation environment, we assume monetary policy is tightened earlier, while in the higher inflation situation rates need not rise as fast. In other words, central banks will be more or less encouraged by governments to keep policy loose in order to help the recovery become entrenched.

The movements in short-term rates and inflation clearly have an impact on government bond yields. Again, it can be demonstrated that many markets are expensive; for example at end 2012 the 10-year gilt yield of 1.8% was close to the lowest benchmark yield for over 100 years. In the decade prior to the 2008-09 financial crisis, the 10-year gilt yield oscillated between 4% and 6%. Where next? The upper and lower bands in this exercise reflect either central banks continuing with QE for some time, to ensure that yield curves do not steepen too quickly and cause major debt servicing problems for governments, or that eventually a sustainable economic recovery discourages safe-haven flows into government bonds. A simple way of considering these issues is to consider a range for the 'exit yield'. In most bond markets this is asymmetric, i.e. 10-year UK gilt yields might fall a further 0.8%, from 1.8% to 1.0%, in an environment of stagnant growth and dis-inflation. Conversely, the upside for yields could be, say, 3%, i.e. taking the benchmark back up to 4.8%, broadly in the middle of the previous range. It must be emphasised that other scenarios are entirely possible, that the sell off in bonds could be considerably greater, repeating for example the unfortunate experience of 1994.

What is changing?

Combining all of this analysis, what are the implications? As Chart 3 shows, portfolios for a longer-term investor should be orientated more towards the riskier end of the spectrum, equities and real estate, and less towards government bonds. Cash and bonds should give rather different returns to their recent history. The expensive starting point for government bonds has a major impact on their longer-term returns. Averaging the US, Euro-zone, UK and Japanese bond markets, the inputs suggest a range of 10-year returns from -2.75% to +1.25%. To put this into context, the US Treasury market has posted a calendar year negative total return on only three occasions in the past 30 years, namely 1994, 1999 and 2009. Higher government bond yields clearly affect returns from corporate bonds (averaging the four regions, investment grade corporate bond returns are -2.75% to +2.75% (Chart 3) although higher-yielding debt would be protected to some extent. A central assumption of this exercise is that central banks outside Japan will be able to retreat from their 'close to zero' official rates. After a period when many savings accounts have given negative returns in real terms, moderately positive inflation-adjusted returns for cash are more likely.

The two asset classes with the best prospects for the coming decade are global real estate and global equities. This is a combination of the relatively high initial starting yield and our assumptions about future moderate dividend and rental growth. Even in Japan, we expect equities to outperform other asset classes, although clearly the range of potential outcomes is rather wide, reflecting the build up of political and corporate pressures in that society and the economy. Averaging the UK, US and European markets, the range of returns from equities varies from +0.25% to +9%. Such estimates do not, of course, suggest that these returns would be seen year in, year out. There is every reason to expect considerable volatility during the decade, as a variety of imbalances – fiscal, private sector debt, current account – and deteriorating trends – demographics, healthcare, disruptive technology – let alone geopolitical flash points, periodically affect market sentiment. Nevertheless, after a period when the equity risk premium (the excess return from holding shares versus safe-haven bonds) was minimal or even negative, a return to positive risk premia is appearing.

Similar arguments hold for real estate, again with the proviso that the returns from individual properties or cities can behave very differently from a wider index. In broad terms, we calculate that the central assumption is for 4.25% p.a. returns over the coming decade, a little higher in the Euro-zone and the US than Japan and the UK due to market dynamics.

Conclusions: triggers for investors

In the past 15 years, global investors have had to deal with two major bear markets in financial assets, as well as unprecedented interventions by governments culminating in QE policies that have pulled government bond yields down to historical lows. Looking forward, the 10-year figures in this article are illustrative; the key point is that a combination of initial valuations and sustainable moderate profits growth would enable equity and real estate markets to deliver a sweet spot of investment returns at some point in the coming decade. Conversely, investors must beware the dangers of holding too many assets with not only a low nominal but a poor inflation-adjusted return in their portfolios.

Global Sectors

Driving change

A focus on consumer preferences and product innovation is proving a winning recipe for companies within the autos and semiconductors sectors.

Mikhail Zverev
Head of Global Equities

Chart 1
Dividend yield support

Source: Datastream (as of 31 December 2012)

Head-turning performance

The global auto industry is facing a number of challenges, ranging from overcapacity and rising demand in emerging markets to more diverse consumer preferences. This presents significant challenges for some industry stalwarts, but also creates opportunities for those firms capable of exploiting changing trends. Tata Motors has thrived in recent years through having a clear brand leader with its Jaguar Land Rover business, whose success is likely to continue as the company seeks to diversify and broaden its model range. This helps to drive the expansion of its customer base, with new models targeting younger age groups. Additionally, the company is striving to bring in product innovations, starting production on its new car platform from late 2012. The introduction of aluminium frames on this production line will produce lighter and more fuel-efficient models. The new platform also gives Tata the flexibility required to offer a greater variety of engine sizes, helping it to meet an ever-widening dispersion of demand specifics. This extension and more flexible model strategy should allow Tata to increase its market share significantly, particularly in the rapidly growing emerging economies. At present its sales only account for 6-8% of SUV sales in China, and low single digits in India and Brazil. To exploit the improved modifications of the product, management is also looking to increase the number of dealerships in these countries.

Another automaker that is rising to the challenges facing the industry is French giant Renault (Chart 1). There is still a mindset that Renault is a European, French-focused car maker. However, it has been quietly shrinking its European capacity, with a 20% cut expected by the end of this year. At the same time, it too is increasing its presence within the emerging markets via its Dacia subsidiary in Romania. As well as a growing demand for cars and cheap labour forces, emerging economies are still relatively underdeveloped from a supply point of view and so are attractive for new developments.

Semi success

The consumer's love affair with smartphones, tablets and other mobile devices is feeding through to semiconductor markets, where volumes and pricing are both improving. These fundamentals are further supported by consolidation within the industry and greater price discipline. One company that is benefiting from the improving trading environment is US semiconductor firm Micron Technology. The company's investment in NAND flash memory technology appears to be paying off, with prices supported by the proliferation of smartphone usage as well as capacity discipline from industry players, and indeed the increased complexity of this technology. An additional factor is the potential impact of a dispute between Apple and Samsung, which may see the US firm look to source a greater portion of its NAND memory requirements elsewhere. The company's DRAM business is also showing signs of improvement, with profitability rising as global inventory levels display signs of returning to normal.

However, the opportunity in the semiconductor market is not just one of improving global market dynamics. There are also companies winning market share by focusing on technology innovations. One such example is UK-listed specialist chipmaker ARM Holdings. The company designs low-power, high-performance chips for various consumer and communications applications. It licenses these designs to semiconductor customers, which then manufacture the chips and pay ARM a royalty for each chip produced. ARM is currently expanding its business outside its traditional stronghold of mobile handsets and is making inroads into a wide variety of consumer and enterprise technology sectors.

Our strategy within global sectors

Markets will remain vulnerable to intermittent sentiment swings while investors are nervous about global growth prospects. This volatility will provide investment opportunities, as we consider many stocks with strong company-specific drivers are being underrated in sectors that are sold on generic concerns. We still see many companies with powerful niche positions and pricing power to offset slowing demand. One example is Finnish marine equipment firm Wartsila. The company's servicing business continues to make progress, while new environmental restrictions are likely to boost demand for its engine scrubbers as well as its dual-fuel engines. Another example is Borgwarner, a global supplier to the auto industry, whose main product is turbochargers. It is benefiting from tighter emission standards and high fuel prices driving a shift towards smaller engines.

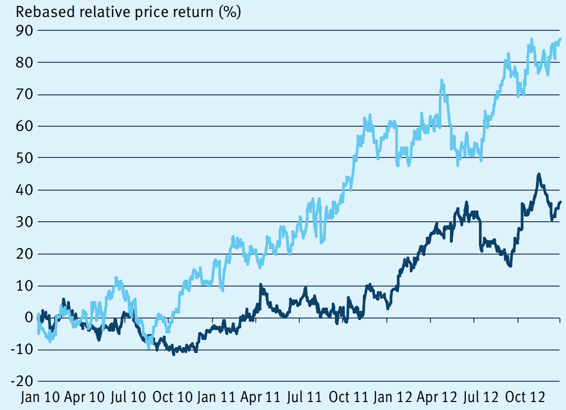
US Equities

One of a kind

Certain businesses in the technology and transport sectors are bucking industry-wide trends and benefiting from their unique access to structural growth opportunities.

Euan Sanderson
Senior Vice President, US Equities

Chart 1
Transport chugs away



Rebased price performance as at 4 Jan 2010, relative to the S&P 500 transportation index, for:
— JB Hunt — Kansas City Southern
Source: Bloomberg, Standard Life Investments (as of 31 December 2012)

Technology trailblazers

In an environment where ongoing macroeconomic uncertainties have generally resulted in scant growth in capital spending, and corporate technology in particular, some technology companies are managing to buck this trend. Low cost software provider SolarWinds has proved a beneficiary of constrained technology budgets. It has developed a valuable market niche with its ‘no frills’, affordable offering, winning particular favour with smaller companies that have traditionally been under-served by larger technology players. Sales of SolarWinds’ core network management products have been growing steadily. The company is now expanding into new geographies, including Japan, Germany, China and Brazil, and also into new product areas, such as systems and applications management. In our view, the market is underestimating SolarWinds’ capacity to sustain its impressive growth track record as it continues to penetrate new regions and roll out new offerings.

Software company Salesforce.com has also established an attractive market position, emerging as the dominant force in the provision of customer relationship management (CRM) software. Salesforce.com has embarked upon a series of potentially valuable acquisitions, enabling it to widen its product suite to encompass social media applications and also to expand into the cloud computing space. Against this backdrop, we expect Salesforce.com to enjoy revenue growth in excess of current market expectations. In particular, the company’s Marketing Cloud offering looks poised to gain from increased traction within larger businesses.

Travelling in the right direction

Given a backdrop of sluggish economic expansion, many transport companies are struggling to grow volumes significantly. While rebuilding initiatives in areas affected by Hurricane Sandy are creating some near-term demand, this is not having a significant impact on industry-wide activity levels. Nonetheless, selected transport companies are managing to deliver impressive rates of volume growth as they benefit from structural shifts in the industry.

Transport and logistics company JB Hunt (Chart 1) is migrating away from commoditised forms of trucking and is increasingly concentrating on intermodal transport, i.e. transport involving more than one type of carrier in a single journey. Intermodal activity is seeing strong growth given its cost advantages relative to freight trucking. We consider that JB Hunt is exposed to a secular growth opportunity, which the broader market has yet to recognise.

Railroad operator Kansas City Southern appears exposed to attractive growth opportunities given its focus on routes into Mexico as the so-called ‘NAFTA railroad’. This focus has enabled it to benefit from a surge in freight traffic between the US and Mexico, which has been driven by a growing trend towards ‘near sourcing’ as US businesses have moved manufacturing facilities once based in Asia and relocated them in Mexico. This relocation has been prompted by rising wage costs in many Asian economies, which have narrowed their differential versus wage costs in Mexico, and also the lower fuel and transport costs associated with facilities closer to home. The near sourcing trend is particularly strong within the autos industry and Kansas City Southern is consequently benefiting from significant increases in the volumes being transported on cross-border routes. This growth is having a spill-over effect into other industries, such as steel, with a sizeable number of new steel plants expected to be opened south of the border in 2013. This should further underpin Kansas City Southern’s longer-term growth prospects, which we believe are not yet being fully recognised.

Our strategy within US equities

Although the broad US equity market has recently been reacting on a day-by-day basis to the ‘fiscal cliff’ debate in Congress, an important feature has been signs that investors are becoming more willing to reward and punish individual stocks based on company-specific newsflow. In this environment, which is more conducive to stock selection and unconstrained investing, we look for opportunities in businesses whose current valuations do not appear fully to reflect their true potential. One such example is Ford Motor. In our view, the market is undervaluing Ford’s capacity to sustain strong sales growth in the US, and is also failing to recognise its potential profitability gains as a result of manufacturing efficiencies implemented in recent years. There are also indications that Ford will press ahead with long-awaited restructuring of its operations across Europe, which would reap further profitability gains.

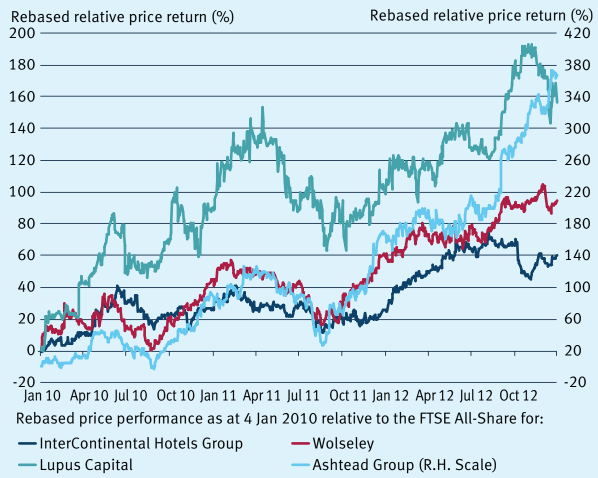
UK Equities

Opportunity in adversity

In demanding economic conditions, weak companies will suffer, creating opportunities for stronger competitors. A recovery in some final markets also merits consideration.

David Cumming
Head of UK Equities

Chart 1
Benefits of US exposure



Source: Bloomberg, Standard Life Investments (as of 31 December 2012)

Planning for low growth

UK economic growth is proving elusive and this looks set to continue given ongoing debt deleveraging. While this makes the investment environment complex, it provides opportunities for those companies whose competitors are struggling or who enjoy a structural advantage, whether in terms of access to credit or stronger capital, to gain market share. For example, the environment has improved for electrical retailer Dixons. Financial pressures resulting in the exit of a major competitor, Comet, should bring market share gains and a better balance of power between retailers and manufacturers in an industry that is currently benefiting from significant new product development, despite price deflation. Added to management's restructuring initiatives, we believe investors are too fixated on the macroeconomic environment and are underestimating Dixons' potential future profitability.

We are also positive on Howdens Joinery, the kitchen cabinet designer and installer. Despite a difficult market, we expect the company's focus on trade buyers to ensure growth, as demand shifts from do-it-yourself to done-for-you. Howdens is also improving operational efficiency and adding new depots while gaining market share from competitors such as Magnet, where credit rationing is causing difficulties and forcing capacity reduction.

A lack of credit is an issue for many industries. In the US, limited financing is constraining new hotel supply growth, despite strong corporate demand and revenue per available room returning to 2007 levels. Therefore, UK-listed Intercontinental Hotels Group (Chart 1), owner of Holiday Inn and Crowne Plaza, is able to capitalise on high occupancy rates by charging more for its rooms. The company can also use its relatively advantageous position to develop new brands that will help broaden penetration in the US and Asia. Ashtead, a plant hire company with significant business in the US, is another firm we expect to continue to perform well, as capital-constrained customers increasingly hire rather than buy machinery. With their smaller competitors also struggling for financing to replace and upgrade their fleet inventory, we expect Ashtead to gain market share. Significant earnings upgrades demonstrate that carefully selected companies can thrive in a difficult economic environment.

End-market recovery

With so much focus on the domestic economy, it is easy to assume all industries are experiencing depressed conditions and also to forget that many UK companies have significant overseas growth avenues. One end market where we see signs of recovery is US housing. Construction materials supplier Wolseley (Chart 1) has significant American exposure and is in a strong position to exploit this positive change. Our interest extends beyond a cyclical US housing market recovery; the company is also a beneficiary of the UK Green Deal and boiler scrappage schemes intended to improve household carbon emissions. In addition, we believe investors are currently underestimating management's self-help strategy, which could be a potentially significant source of additional profitability. This initiative is designed to improve operational performance through more efficient procurement, pricing reforms in the US, where 60% of branches have yet to implement the preferred pricing structure, and better use of its customer database to target sales efforts. Lupus Capital is another holding with exposure to this recovering market through its energy efficient doors and windows, as well as its locks and electronic security controls business.

Elsewhere, economic growth in Eastern Europe and Mexico is providing companies such as International Personal Finance the opportunity to realise the significant potential in its consumer credit business. In addition, the company is focused on operational improvements, particularly training of employees and reducing staff turnover, in order to accelerate loan growth. We believe this will supplement the already strong market potential by creating a sound basis from which to grow more sustainably over the longer term.

Our strategy within UK equities

UK equities suffer from broader downbeat perceptions of the UK economy as a whole. However, while several industries are suffering, we continue to identify strong investment opportunities. These include, for example, significant, underestimated industry or stock-specific changes in end markets showing signs of recovery. One area where we are increasingly positive is banking. The sector is approaching the end of its capital rebuilding phase and many peripheral businesses have been sold. Companies such as Lloyds Banking Group and Barclays have enjoyed earnings upgrades from improved net interest margins, while the sector's low valuation relative to international peers could lead to a further re-rating as risk perceptions subside.

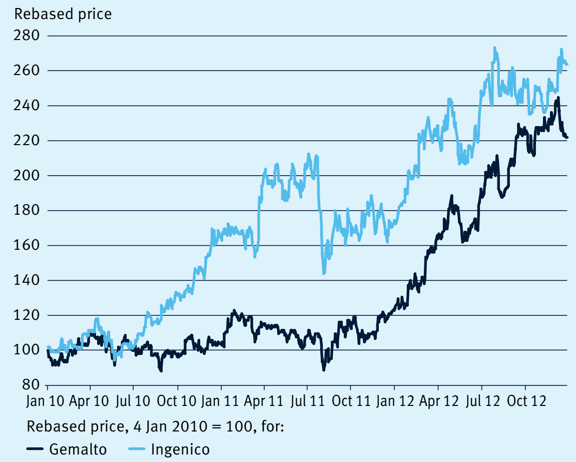
European ex-UK Equities

Stepping up

Structural change opens the door for innovative companies to grow and take market share, while in the offshore construction sector encouraging signs herald recovery.

Chris Haimendorf
Investment Director, Europe

Chart 1
Innovation pays



Source: Bloomberg, Standard Life Investments (as of 31 December 2012)

New ways to pay

Structural shifts in the way we all purchase goods and service — using mobile phones for contactless purchases, for instance — require new technology to deliver secure and convenient payment systems. We look for innovative companies able to offer credible solutions and exploit these societal changes. One such firm is Gemalto (Chart 1), which produces the secure component of SIM cards (used in mobile phones) and the chips used in bank cards for chip-and-pin. Gemalto's latest generation of SIM cards provide additional functionality for 4G phones, while also incorporating the secure element needed for future use of mobile phones for contactless payments. As 4G adoption accelerates, we expect Gemalto to benefit from sales of these new generation, higher value SIM cards as they help to drive up margins. On top of this, the forthcoming roll out of chip-and-pin in the US and increasing usage of contactless payments worldwide will boost demand for Gemalto's bank card chips, further enhancing growth.

The same trends in electronic transactions are driving growth and earnings at Ingenico, manufacturer of card reading machines. Ingenico, too, stands to benefit from the introduction in the US of chip-and-pin and contactless payment over the coming two years. The company is also gaining market share with its new generation of machines, while the continued penetration of electronic transactions in emerging markets, especially Latin America, provides an additional source of growth.

Oil is not lost

Detailed analysis suggests that offshore oil and gas exploration is recovering at a faster pace than is generally appreciated. Specifically, new orders and backlogs have reached record levels, providing good earnings visibility into 2013. Additionally, vessel utilisation is rising, despite new capacity having been added, while oil industry majors are lifting their capex projections. Offshore construction and equipment companies are direct beneficiaries of these trends. Disappointment arising from delayed projects in 2012 has left a number of offshore services stocks attractively valued.

Following its recent merger with Acergy, Subsea 7 is now the largest subsea construction company and so should be a principal beneficiary of a recovery in offshore prospects. We view concerns over a possible delay to one of its projects as already discounted in forecasts. Moreover, the company is well placed to win new contracts in the North Sea and in Africa, which will drive margin expansion.

Seismic exploration is another area that will benefit from the cyclical upturn in oil and gas exploration. CGG Veritas is particularly highly levered to the seismic cycle. Already the company is seeing a pick-up in orders from smaller independent oil companies for its latest, more advanced seismic surveying solutions. This trend is likely to be sustained, as we expect the oil majors will follow suit given the evident success of this new technology.

Our strategy within European ex-UK Equities

In our search for value, we continue to look for signs of sustainable positive change that the market may have overlooked. As an example, Europe's largest diversified luxury goods retailer LVMH offers sustainable, high quality earnings growth. We particularly like the company's enduring brand franchise and independent distribution network, which will underpin long-term growth. For instance, high-growth emerging markets now account for about 50% of LVMH's group revenues and nearer 60% of operating profit. In our view, market concerns about slowing demand from China appear overplayed. We see the shares as attractively priced, considering LVMH's favourable long-term growth prospects and, moreover, the diversity of that growth across a range of sectors and geographies.

Leading global cosmetic firm L'Oreal continues to gain share from rivals, despite the overall slowdown in demand for luxury cosmetics. However, sales performance has been mixed of late, prompting fears about L'Oreal's perceived over-reliance on the luxury business, exposure to Europe and a repeat of the firm's historic margin volatility. We believe the market does not fully appreciate the value of L'Oreal's brand and is overlooking the potential for growth to accelerate. In particular, we find reassurance in management's stated intention to focus on R&D. This renewed commitment to product innovation will support brand re-launches and drive growth in both developed and emerging economies. We are also encouraged by the company's pledge to stabilise and optimise marketing expenditure, and so achieve its margin expansion targets.

Japan and Developed Asia

Australia's consumers bounce back

Consumer-oriented businesses in Australia should benefit from stronger household confidence, while 'best in class' firms in Japan are well positioned to thrive.

Matt Harris
Investment Director, Asia Pacific

Recovering Australian consumer

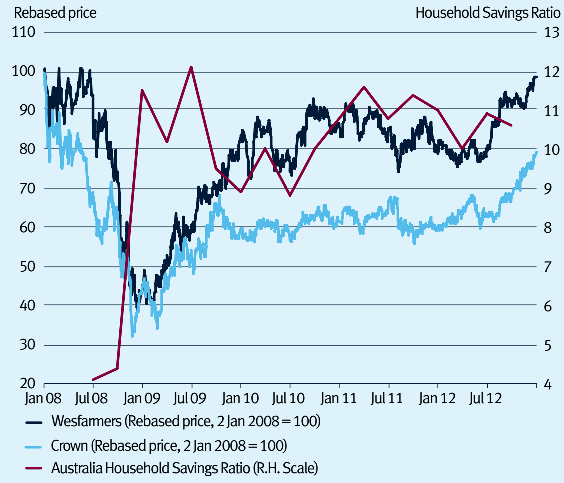
Concerns about economic weakness in Europe and a potential slowdown in China have curbed levels of consumer spending in Australia over the last year or so. Many consumers have been increasing savings rates and paying down debt rather than spending on discretionary items. However, there are signs of an increased propensity to spend, with consumer confidence bolstered by lower domestic interest rates and stability on the employment front. Against this backdrop, we have been increasing our exposure to selected stocks that we expect to profit from a recovery in consumer confidence in Australia.

One likely beneficiary of the trend is entertainment group Crown (Chart 1), which owns and operates two of Australia's leading casino-oriented vacation resorts in Melbourne and in Perth, as well as operations overseas. Gaming volumes at Crown's Australian resorts have been growing year-on-year and it now dominates the domestic casino market. Crown appears poised to build on its solid growth track record with a bid to open a new casino in Sydney, Australia's most important gambling centre. The firm also enjoys valuable exposure to Macao, which has become the largest gambling centre in the world.

Treasury Wine Estates, the world's second-largest wine producer, cut back domestic wine production in response to softer demand levels as consumers conserved their cash. It is now witnessing a recovery, to the extent that demand levels in Australia look set to outstrip existing supplies for the first time in many years. Treasury Wine Estates' international operations, with significant production centres in the US and Italy, have allowed it to reallocate wine stores to meet this demand. In addition, growing conditions in 2012 were excellent and have resulted in a superior 2012 vintage, which bodes well for future inventory levels. We also believe the group enjoys promising opportunities in the cellar door market – sales to tourists who visit its wineries.

Retail group Wesfarmers, which owns Australia's Coles supermarket, also appears to have potential to increase sales volumes as consumption trends recover. Coles recently upgraded its distribution warehouse network and has invested in new warehouse and inventory management technology, which should help it meet stronger demand. Coles has scope to increase sales volumes further as it enhances the physical layout of its existing stores.

Chart 1
Consumers rediscover appetite



Source: Bloomberg, Standard Life Investments (as of 31 December 2012)

Japan's 'best in class' firms

In Japan, we are finding promising opportunities among 'best in class' players that should thrive despite structural or cyclical pressures on the sectors in which they operate. Domestic demand for gasoline is slowing for a range of factors, including the introduction of more fuel-efficient cars and demographic pressures due to the declining birthrate. As a result, domestic oil refining capacity is being cut back. Oil refining group JX Holdings enjoys a more attractive business portfolio than its competitors. This portfolio encompasses petrochemical and copper production, which should provide a buffer against weaker demand for refined petroleum products. We also believe that the market may be taking an overly pessimistic view on likely profit margins on its core refining business, given the impact on supply levels from industry-wide capacity reductions.

Regional banking group Suruga Bank is focused on consumer lending and has been reporting growing loan growth despite an industry-wide decline in the domestic banking sector's loan-to-deposit ratios. The business has also managed to improve profit margins on its mortgages and personal loans. We believe that Suruga's capacity to sustain solid consumer loan growth is not yet fully appreciated.

Our strategy within Japan and Developed Asia

Our focus on stock specifics continues to offer us attractive entry points in businesses that have been oversold because of generic concerns about the industries in which they operate. One such example is South Korean technology group Samsung. The technology sector as a whole remains under pressure as a result of weak demand for personal computers. Samsung is the market leader in NAND (flash memory used for long-term storage). The key driver of NAND demand is the smartphone market, which continues to grow. We believe that Samsung's valuable exposure to NAND, where both demand and pricing levels look set to improve, is not being fully recognised.

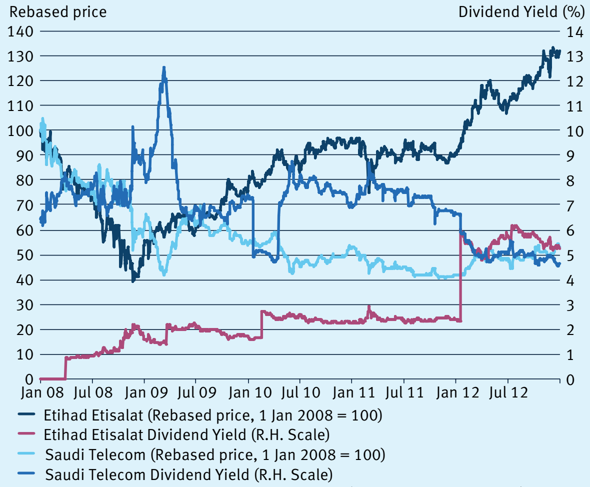
Emerging Market Equities

Staying in touch

The development of telecommunications and mobile device technology opens up attractive opportunities both in developed and emerging market economies.

Alistair Way
Investment Director, Emerging Market Equities

Chart 1
Crossed wires



Source: Datastream, Standard Life Investments (as of 31 December 2012)

Telephone calls

In the developed world, the telecoms industry is often perceived as a defensive sector with relatively limited growth opportunities. However, the structural changes occurring in emerging market economies gives this sector far more appealing dynamics. This is certainly the case in Middle Eastern markets, such as Saudi Arabia, where underlying fundamentals and favourable regulatory conditions are proving supportive for telecoms firm Etihad-Etisalat, better known as Mobily (Chart 1). The company is the second largest mobile operator in Saudi Arabia with a 40% mobile voice share and a 76% mobile data share. It is expected that its data business is likely to see further strong growth as residential demand continues to increase, while there are also opportunities to improve market share in the corporate sector. Importantly, competitive conditions appear relatively benign as the company shares an effective duopoly with the other major domestic telecoms provider Saudi Tel. We believe this attractive trading environment is likely to continue as Saudi Tel appears to be more focused on defending its existing client base and expanding overseas, rather than taking a more aggressive strategy on price or service. One final attraction of Mobily is its dividend payout ratio, which has significant scope to increase, something that may be more in keeping with the traditional view of the telecoms sector.

Another telecoms company that is benefiting from the strong structural growth drivers within emerging market economies is Thai-listed mobile operator DTAC. While the market has focused heavily on the much-delayed third-generation, 3G, licensing process, the company has continued to expand its 2G subscriber base and data business while maintaining both price discipline and profit margins.

Smart moves

The global growth of smartphones is boosting component makers within the Asian supply chain. Korean chipmaker Hynix is one such example. The company has seen improving demand for its NAND flash memory chips on the back of a surge in sales of mobile devices. At the same time, the company and its two larger rivals, Samsung and Toshiba, have been reducing production capacity and capital expenditure in this area. This has had the double effect of helping to stabilise prices while allowing inventory levels to be reduced significantly. It is expected to result in an improvement in profitability in this part of Hynix's business. There are also encouraging signs for the company's DRAM memory operations. Having endured a number of years of oversupply and relatively weak volumes, DRAM technology is now increasingly being used in mobile devices. Indeed, the proportion of Hynix's revenue coming from mobile DRAM increased from 21% in the second quarter of 2012 to 32% in the third quarter and the company expects it to hit 40% by the final quarter of 2012.

The proliferation of smartphone usage is not just helping export-oriented firms within the region. There is also a strong domestic growth story as Asian consumers adopt smartphone technology at a prodigious pace. The rapid take-up of smartphones in China is particularly noteworthy and this has been a positive driver for US-listed Chinese firm Spreadtrum. The company designs semiconductors for use in mobile devices based around the China-specific TD-SCDMA mobile-telephony standard. While there have been some concerns about the overall uptake of this technology, there are a number of reasons to be positive going forward. Firstly, the longevity of the company's TD-SCDMA technology is likely to be extended as customers such as China Mobile look to migrate low and mid-end users to this platform. In addition, the Chinese government remains committed to the development and export of telecoms technology and is likely to continue to offer subsidies to support Spreadtrum's business. Finally, the company's latest smartphone chipset is increasingly being used in new product launches and appears to have overcome some of the reliability issues experienced when first launched.

Our strategy with global emerging markets

In addition to the focus on capital growth opportunities, global emerging market equities are also increasingly being considered as an attractive source of dividend income and dividend growth. Importantly, such opportunities in these markets are not restricted to just traditional income-paying sectors. We are also seeing dividend growth in capital intensive industries such as energy and materials. Canada-listed miner Mart Resources and China-listed aluminium firm China Hongqiao are examples of this trend.

Government Bonds

A crisis contained

The ECB's latest bond-buying programme is designed to contain the recurring sovereign debt crises, allowing the authorities more time to push through necessary structural reforms.

Jack Kelly
Investment Director, Government Bonds

Central banks begin to restore confidence

Despite a degree of scepticism, the European Central Bank (ECB) President Mario Draghi successfully won broad acceptance for his proposed Outright Monetary Transactions (OMT) programme. The potential impact of the initiative has effectively stemmed the weakness in peripheral government bonds. Volatility has diminished, immediate systemic risks have reduced markedly and sentiment has improved across European bond markets. However, politicians and central bankers need to take advantage of the improved conditions to push through necessary structural reforms.

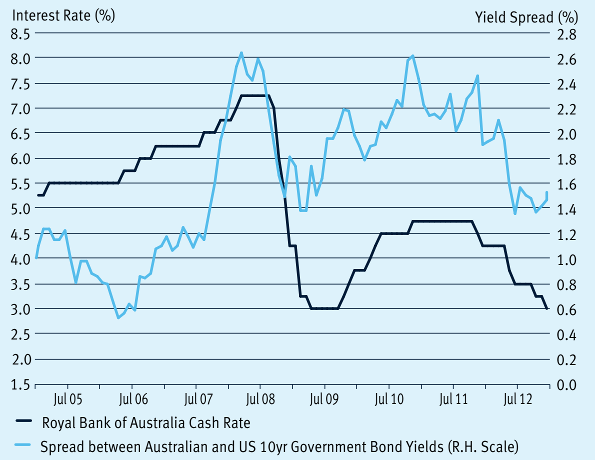
While the positive impact of the initiative is welcome, it is not necessarily the outcome that Draghi wanted. Spain has benefited from the implicit OMT guarantee, without yet being subject to the conditionality associated with the scheme itself. Fiscal discipline and structural reforms are more responsive to rising funding costs (higher bond yields). So, as with the previous Longer-Term Refinancing Operation (LTRO), while immediate financial strains are reduced, the imperative to push through change is also reduced. Containment of the crisis is only part of a more lasting solution to the region's problems. The Euro-zone needs stronger economic growth, but it is not easy to see where that will come from. With synchronised austerity, Europe faces a prolonged period of low growth and low interest rates.

Some of the reasons given by Spain for not yet requesting a bail-out involve concerns about the prospective conditionality, and doubts about the firepower of the OMT. It is clear that, despite Draghi's success in getting the scheme accepted, there are those within the ECB that have worries about the scope of the programme. One criticism is that it constitutes monetary financing of deficits, and removes the market pressure driver of reform. The more that a hardline approach emerges, the more the potency of the initiative will be reduced and hence a return to crises becomes more likely. For now, the implicit firepower of the OMT is doing its job.

Finding value in global bond markets

With diminished bond market volatility in the Euro-zone, the drivers of core European bond markets have become more closely aligned to those of US Treasuries in recent weeks, and both have been fixated on the 'fiscal cliff' discussions.

Chart 1
Australian borrowing costs



Source: Datastream (as of 31 December 2012)

In the event, the compromised 'cliff' agreement provides a temporary fix, at least until February, which is likely to avert another recession. However, despite the likelihood that the US economy will see stronger growth this year than most other developed economies, the short end of its bond market may remain steady. The Fed has explicitly signalled that interest rates will continue to be on hold until unemployment falls much further, generally understood to be 2015 at the earliest.

Among AAA issuers, the fiscal metrics in Australia are in stark contrast to the rest of the developed world, particularly the US and Europe. Australian government bonds have a unique appeal, benefiting from the positive combination of scarcity premium and strong fiscal dynamics. The Australian government has one of the most solid AAA ratings of the G20 countries and Australian bond yields are attractive in a global bond context. While no longer at extreme levels, the yield difference against developed-world issues is still historically wide. However, there is some suspicion that the interest rate-cutting cycle may be close to a trough. Interest rates have been lowered by 1.75 percentage points, but the recent sharp improvement in employment numbers may cause the Reserve Bank of Australia to pause (Chart 1).

Our strategy within global government bonds

The US yield curve is likely to steepen as the impact of the Fed's Operation Twist diminishes and we have been switching from 30-year bonds to 10-year in anticipation of this. As part of our strategy to diversify risk in light of uncertain market conditions, we have been buyers of Australian government bonds. We remain Heavy in core European markets and have a preference for Germany over the US or UK with their fiscal worries. While the imminent risks to European break-up have receded, the argument for protracted weak growth and yet more monetary easing, whether conventional or through QE, has become stronger, which is a net positive for German bonds. For Europe, the most likely scenario is a Spanish bail-out request and subsequent OMT start-up over the next three months. That would have an initially positive impact on Spanish and Italian spreads before differences over implementation become apparent. Therefore, we are neutral on Italy and Spain for these technical considerations.

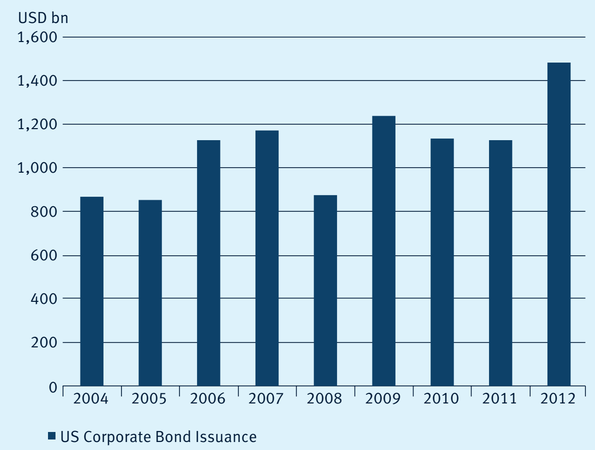
Corporate Bonds

Value in Europe, but US preferred

Even though peripheral European credit has rallied, we continue to find value. Among financials, early redemptions of bank debt provide the opportunity to enhance performance.

Andrew Sutherland
Investment Director, Corporate Bonds

Chart 1
Issuance rebounding



Source: Bloomberg, Standard Life Investments (as of 31 December 2012)

Peripheral Europe: where to now?

After the strong rally in peripheral European credit, most of the upside would seem to be priced into spreads in this segment of the market. However, there is still long-term value to be found in some credits. We focus on higher-quality, internationally-diversified credits, many of which are trading at elevated spreads purely because of their association with weak sovereigns.

In Spain, for example, Amadeus, the global travel transaction processor, and Iberdrola, the utility operator, have sound credit fundamentals and significant overseas earnings. Amadeus is a leading transaction processor for the global travel and tourism industry. Its customers include travel providers, such as airlines, hotels, car rental firms and cruise operators, as well as travel agents, both online and offline. Amadeus provides a full array of software solutions to automate mission-critical activities like ticketing, reservations and airline scheduling. The firm also acts as a global communications and distribution network, facilitating transactions between travel agents and travel providers. As an indication of the company's international profile, over 1,250 hotels in over 40 countries use Amadeus' Revenue Management System. Although yield spreads have come in, the credit still looks under-rated.

Similarly, Iberdrola is highly diversified in terms of both activities and geographic penetration. The company is vertically integrated along the value chain, with operations in generation (including a large renewables business), transmission, distribution and supply. Iberdrola operates throughout Spain, but also has a presence in the UK (Scottish Power), and in both the US and Latin America. This spread of business helps diversify the regulatory risk inherent in each national market.

Time to call

Among financials in Europe, a prominent theme of late has been the frequency with which banks have been calling their subordinated debt. Identifying those banks most likely to tender may be problematic, but successfully doing so can add material value. Stronger banks have been calling their subordinated debt as part of a broader exercise to raise capital ratios, with the aim of meeting new Basel III targets. The object has been to replace subordinated bonds, which are unlikely to be considered as capital under the new Basel rules, with senior notes which likely will qualify.

However, the calls on lower-tier bonds have not been confined to strong banks; weaker banks have also been tendering their debt, although for different reasons. The intention of weaker banks is generally to maintain the support of their bondholders. Interestingly, weak banks may feel less inclined to make calls on their debt at times when market sentiment is already favourable, and the pressure to curry favour is lessened. Italian bank Intesa Sanpaolo, for instance, caused much disappointment during the October 2012 rally, when it declined to call its lower-tier two bond. As a result, its spreads widened markedly.

Our strategy within corporate credit

Despite the outperformance of European versus US credit over recent months, we retain our preference for US investment grade credit. The momentum in Europe has largely been driven by the peripheral markets and by cyclicals, but both of these segments now appear close to being fully valued. The slow progress in resolving the sovereign debt situation, and the languid growth rates in much of the region, are a concern. The Spanish economy, in particular, gives cause for concern, with impaired loans and unemployment levels continuing to rise, whereas in Italy there is the added uncertainty of an election in February 2013.

Turning to the US, firstly the heavy bond issuance (Chart 1) and ETF trading that temporarily distorted the US credit market now seems to be waning. Moreover, the uncertainty surrounding the 'fiscal cliff' looked to have been overdone, and so it proved. Meanwhile, there is mounting evidence that the US economic recovery is broadening out, with improvements in construction, jobs and consumer confidence. In European portfolios, we have gained US exposure through banks such as JP Morgan and domestic retailers like Macy's and Walmart. However, there is growing evidence that shareholder-friendly actions, such as share buybacks and special dividends, are increasing in corporate America. These are being financed from debt issued at current low yields, and is a theme to be watched closely as it is negative for the credit of the companies concerned.

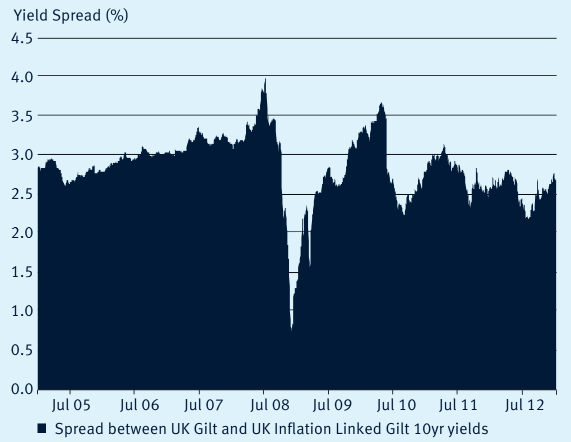
Inflation Linked Bonds

The changing of the guard

We consider the vocal debate about monetary policy, whether it might herald a new style of policy making, and the impact on bond markets.

Jonathan Gibbs
Investment Director, Fixed Interest

Chart 1
Inflation expectations



Source: Bloomberg, Standard Life Investments (as of 31 December 2012)

Pursuing a target of lower inflation

The recent history of monetary policy saw a fairly single-minded pursuit of lower inflation. The damaging inflationary periods of the 1970s to 1980s were never to be repeated, and lower inflation was always considered better. Central banks targeted, some formally, some less so, a level of price inflation close enough to zero to be called stability. For the Bank of England (Chart 1), it was the sole formal target in its mandate, for other central banks a key part of it. For several decades this was seen as a success, with stable inflation and strong growth – before the financial crisis blew this policy regime out of the water. Emergency unconventional policies were introduced to deal with the bursting of the debt bubble.

Investors hope we are now emerging from the worst of the crisis. The US economy appears to be nearing a self-sustaining recovery, and there are even signs that the recessions in the Euro-zone may not be protracted. So, will we see a return to conventional rate setting and inflation targeting, or is a new regime needed? In the short term, at least, there is certainly no likelihood of interest rates returning to normal levels. The Fed has a commitment to keep rates near zero until 2015 and, as long as global growth remains weak, it seems that further unconventional stimulus is more likely in many economies. In addition, there will be considerable turnover of senior policymakers in the near future. We already know that in 2013 Mark Carney will replace Sir Mervyn King as governor of the Bank of England, while a new Bank of Japan governor is expected in spring and Obama will announce a replacement for Ben Bernanke at the Federal Reserve.

Foraging for a higher yield

One of the effects of a prolonged period of low interest rates is that it gradually pushes yields lower along the yield curve. Investors seeking income are then forced to reach into either longer maturity or lower quality securities to gain some yield. This search for income is to an extent what the authorities want: monetary stimulus leads to higher investment in riskier assets. However, if the clock is wound back just a few years, it can be argued that a search for yield, and an ever lower appreciation of risk, was a key contributor to the recent crisis.

The implication is, therefore, that a new policy regime may be necessary, and it will most probably be a more holistic one than a simple inflation target. In an environment where much is highly uncertain, such a shift would potentially make the future inflation path even less certain. As the world becomes riskier, we should expect insurance premiums to go up. While in a normal investment environment we could mix risky real assets like equities and real estate to protect our savings against inflation, this time around we may need a safer mix including inflation linked bonds. The good news is they still price in relatively little long-term inflation, with implied inflation expectations lower than they have been since 2005. This suggests that the insurance premium for inflation has not yet accounted for the extra risk in the future.

Finally, the type of inflation we expect should influence investment choices. If it is growth and earnings driven inflation, that will help riskier assets like equities. However, cost or commodity driven inflation could damage such assets, so including protection via inflation linked bonds remains an attractive option. Whether the new brooms in central banks will sweep in a different policy paradigm remains to be seen, but investors should continue to seek protection where it is cheap.

Our strategy within inflation linked bonds

We remain Light in US Treasury inflation protected securities versus Australian and New Zealand inflation linked bonds. We anticipate good demand for UK inflation protection after the RPI formula announcement in the New Year and are positioned for long-term inflation expectations in the UK to rise. Conversely, we believe that US inflation expectations now price in too much of a rise relative to Europe, and have inflation swap strategies in place to benefit from this correcting. We are maintaining a Light position in France versus Germany as we expect semi-core government bonds to underperform as Euro-zone tensions increase.

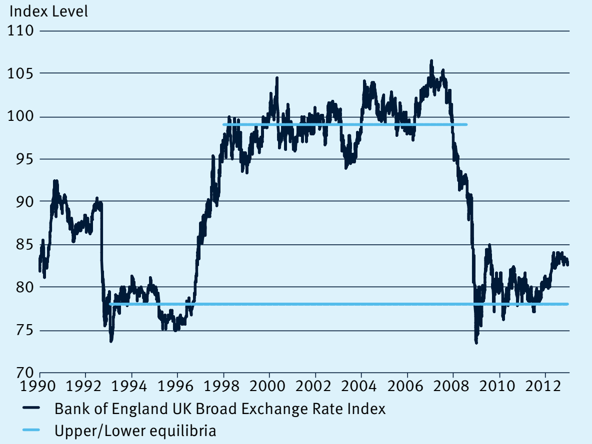
Currency

Sterling's outlook

We discuss our neutral stance on sterling, irrespective of whether or not the UK loses its AAA rated status.

Ken Dickson
Investment Director, Currency

Chart 1
Twin regimes for sterling



Source: Bank of England, Bloomberg, Standard Life Investments (as of 31 December 2012)

Sterling – two fixed exchange rate regimes

In the 20 years after the Bretton Woods fixed exchange rate regime ended, sterling's exchange rate was allowed to depreciate at an annualised pace of about 2.5%. However, since the early 1990s the pattern of movements in sterling's trade weighted index has resembled two distinct, but relatively fixed, exchange rate systems. In recession or crisis, when growth concerns usurp inflation risk, the UK authorities seem to engineer a stable but low exchange rate (around 78 on the Bank of England UK broad effective exchange rate). In more normal times, especially in the boom years when tighter financial conditions are deemed more appropriate, then the exchange rate stabilises at a level almost 30% above this lower equilibrium (Chart 1).

Economic prospects still look gloomy . . .

Immediate economic prospects do not look particularly strong for the UK. Its trend rate of economic growth has been declerating and the continued high level of public, financial and consumer debts are acting as a headwind to future growth prospects. Demand (both international and domestic) remains weak, partly due to higher inflation affecting household incomes, while austerity measures are keeping sentiment levels muted and employment gains in the private sector are only moderately outpacing public sector redundancies. It is an environment that requires a continuation of the existing easy money policy stance by the Bank, and suggests interest rates will be lower for even longer plus opportunities for further QE. Any market led upward pressure on the pound that does not reflect an improvement in economic prospects is likely to be resisted by the authorities through an extension to their accommodative policy stance and verbal foreign exchange intervention.

. . . but we have a neutral outlook on sterling

We are Neutral on the prospects for the pound. This is partly the result of the picture painted above but our views also reflect two other drivers. Many of the economic problems noted above for the UK are also being suffered by other developed economies. As the UK economy is heavily aligned to its major trading partners in the EU, so its prospects relative to Europe are a major driver for sterling's trade weighted value. Europe's economy is now deteriorating at an increasing pace while austerity measures there look set to linger long. Moreover, deleveraging in the banking sector in Europe is lagging behind that of the UK so the monetary transmission mechanism will be ineffective for longer across in the continent. Secondly, since sterling is within 2% of its fair value calculations, and with market positioning relatively light, so a major change in the pound's fundamentals would be required before a meaningful currency move will be seen. Our economic forecasts suggest that this is not expected.

No downgrade to sterling's outlook

One of the risks to our view is the possibility that the UK will lose its AAA credit rating. This risk has increased measurably of late as Chancellor George Osborne had to announce in his latest autumn statement that he would be missing some of his fiscal targets, leading several rating agencies to place a negative outlook on the UK. However, we do not believe that sterling will suffer significantly even if this downgrade is followed through. There is a big difference, in terms of currency outlook, between a ratings downgrade in isolation and one in an environment where many countries ratings are being lowered. Moreover, the risk that sterling will no longer benefit from safe-haven flows is somewhat mitigated by the sharp reduction in foreign exchange reserves growth that we are now witnessing relative to recent years. Indeed, since the global financial crisis spread to Europe post 2009, the correlation between reserves growth and sterling has reversed, further casting doubt over the rating downgrade risk.

Our strategy in currencies

In summary, with much bad news in the UK already discounted and with the UK's main trading partners also suffering economic woes we do not expect a change from the pound's recent stable trade weighted performance. Nevertheless, we would expect a little strength against the Japanese yen as policy there becomes more accommodative in the spring, and conversely modest weakness against the US dollar as the US economy's recovery gathers pace later in 2013. In our portfolios in general, we are Very Light in the Japanese yen and Very Heavy in the US dollar, and moderately Light in the euro.

Real Estate

Rising demand for real estate

The quest for real estate assets is heightened in an environment of low interest rates and prevailing macro uncertainty.

David Paine
Head of Real Estate Investments

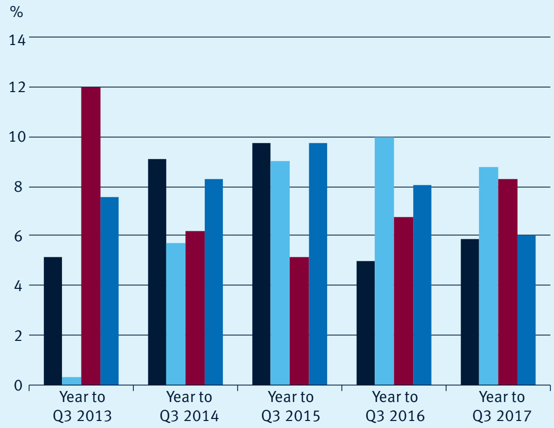
'Buy land, they're not making it anymore.'

The outlook for the real estate market continues to be a battle between fundamentals, which remain attractive around the globe, and policy uncertainty, which still discourages some investors from putting capital to work in an illiquid asset. Politics will periodically affect investor sentiment; 2013 will include further debate on US fiscal issues, potentially profound changes to economic policymaking in Japan, elections in Italy and Germany, plus the slow evolution of the reform process in China 'crossing the river by feeling for stones'. Against this background, we consider real estate as an asset class should maintain its safe-haven status, while in a low interest rate environment the quest for real assets should further drive the performance of real estate (Chart 1).

The supply/demand imbalance in the mature real estate markets is likely to continue into 2013. Limited development finance curbs new construction, while voids and vacancies are expected to decline as a result of a moderate improvement in economic activity. The disparities in rental growth are expected to be more nuanced, as weak growth is evident in even the most constrained markets, such as London, Paris and Munich. Rents are expected to continue to fall in southern European markets, where economic contraction is set to persist throughout 2013. The US markets are poised to benefit from notable tailwinds supporting the housing, energy and manufacturing sectors, which in turn have the potential to generate significant job growth. This will translate into real estate demand and hence rental growth. Looking elsewhere, softer energy markets are creating uncertainty in Western Canada and the Australian office markets of Perth and Brisbane. The commercial real estate cycles there are in the process of peaking, evidenced by tight vacancy rates, aggressive pricing and high levels of new development. The emerging Asian markets, such as Beijing, Shanghai and Jakarta, are expected to enjoy robust tenant demand and rental growth, while the more mature markets of Tokyo, Singapore and Hong Kong are likely to show more muted rental growth.

The lack of debt finance from banks is a common theme around the globe, and so the growing appetite for real estate debt among insurers and other alternative lenders is expected to continue in 2013. Performance will also be supported by an increased weight of money into the sector as domestic and international pension funds increase their commercial real estate allocation in the pursuit of yield. Their interest is primarily focused on prime income-producing assets, so such investors are expected to continue to target prime office assets in core markets such as Central London.

Chart 1
Real estate growth continues



Total return projections for each year from Q3 2012 for:
UK Europe North America Asia
Source: Standard Life Investments (as of 31 December 2012)

Risk aversion is set to continue but there may be a modest improvement in risk appetite as the year progresses, encouraging some selective buying of good-value secondary opportunities to materialise. Market transparency remains an important factor, despite the move to total return strategies, and a number of index and data providers are working hard to enhance further the transparency within the market. This must be seen as a positive in a historically opaque asset class, with more data available more frequently, on different metrics and across more jurisdictions.

Our strategy within real estate

Our global investment recommendations for 2013 are for investors to examine core prime locations, better-quality assets and turnaround opportunities. The Central London office market remains a key favourite, as well as regional shopping centres and retail fashion parks in the UK which continue to attract the bulk of retail spending. We favour northern and core European markets, such as Paris, Munich and Stockholm offices, where healthy real estate market fundamentals and strong investor interest are expected to drive capital growth and hence returns. In Asia, we hold a preference for the higher-yielding logistics markets where new supply is modest, such as Australia and China, and also the fast growing office markets of Shanghai and Beijing. The Tokyo office market is preferred for 'move to core' opportunities. We see value in the US and prefer the markets with the most robust underlying fundamentals, such as high technology in San Francisco and Seattle. Taking a three-year view, we still anticipate healthy outperformance against cash from global real estate as a whole.

Absolute Return Strategies

Profiting from shifting horizons

Divergent European and US growth outlooks, and uncertainty caused by the UK RPI review, are presenting opportunities for absolute return investors.

Ian Pizer
Investment Director, Multi-Asset Management

Absolute return strategies

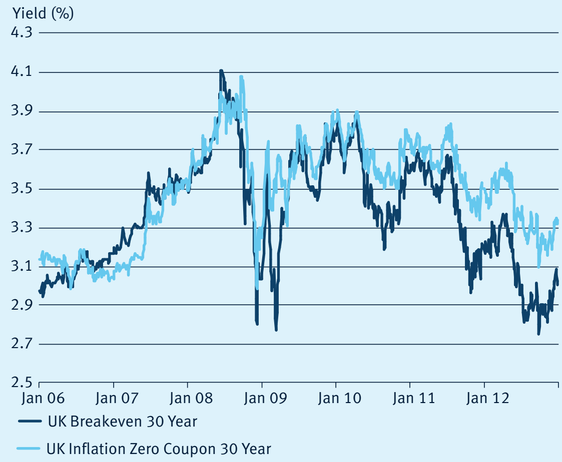
At Standard Life Investments, our absolute return strategies approach operates in a multi-asset framework, aiming to deliver returns above UK LIBOR cash measured on a rolling 3-year time horizon. Our process combines a broad mix of ideas across multiple asset classes. A divergence in global growth trends, and speculation regarding changes in the measurement of UK inflation, has prompted us to introduce two new strategies. The first is a relative value trade that incorporates a long position in European rates versus a short position in US rates. This strategy should reward our view that interest rates are likely to rise in the US before they do so in Europe. The second strategy is a long position in 30-year UK inflation swaps. A fall in the long-end of the UK inflation market in the second half of last year has presented an attractive entry point. When the trade was implemented, we considered that inflation linked bonds were close to levels at which pension fund demand would increase.

Transatlantic trade

Noticeable contrasts between the outlook for the US and European economies open up an interest rate opportunity. While the US has made progress in correcting its imbalances, and indeed the economy has recently seen encouraging signs in terms of employment, the housing market and credit growth, in contrast Europe still has numerous significant issues to address. Much of Europe is experiencing conditions that are worsening rather than improving, with weak credit conditions a particular worry. The differing philosophies of the Federal Reserve and the European Central Bank (ECB) exacerbate this divergence in performance. The former is increasingly willing to run the risk of stoking inflationary pressures in order to improve employment levels, but the latter maintains its focus on price stability. While the ECB's Longer-Term Refinancing Operations (LTRO) Programme has calmed the markets, it has also increased governments' reliance on their domestic banks for funding. In a period of bank deleveraging this will crowd out the private sector, creating tighter monetary conditions for some time to come.

Our strategy looks to benefit from interest rates on hold longer in Europe than the US. The Fed's conditional commitment to holding rates low has distorted the level of volatility at the front end of the US Treasury market, making swaptions a particularly attractive way of accessing. We have structured our exposure at zero cost, which means that if conditions worsen everywhere the strategy will expire out of the money with no underperformance. The strategy looks to benefit from a rising yield environment with the return enhanced further should US yields rise faster than those in Europe.

Chart 1
UK breakevens have fallen



Source: Bloomberg (as of 31 December 2012)

Long UK inflation

Since the start of the review into the Retail Price Index (RPI) formula by the Consumer Prices Advisory Committee (CPAC) in June 2012, UK breakevens (broadly the difference between real and nominal yields of bonds of similar maturity) have fallen (Chart 1). The CPAC's review raised the possibility of a major alteration of the calculation methodology for the RPI, towards one in line with the harmonised Consumer Price Index (CPI) formula. If this occurred, then the wedge between annual rates of RPI and CPI inflation should have narrowed to around 30 basis points a year. This was due to components, such as mortgage interest payments and depreciation costs, which are included in the RPI but not the CPI basket. With a 2% CPI target and a 30 basis point historic variance resulting from the different components, shorter-term breakevens appeared to be fairly valued. Therefore, we saw the 30-year part of the curve as more attractive, due to its being more dependent on structural flows than on inflation expectations.

In the event, the CPAC unexpectedly did not recommend any change to the RPI index methodology, although it has been agreed that new versions of the RPI index will be produced. As a result of the announcement, inflation breakevens quickly gapped. Uncertainty over the future of the RPI formula has been seen as holding pension funds back from liability-hedging activity. However, once this uncertainty has been removed, so demand is likely to increase significantly.

Another reason inflation breakevens have remained low is the Bank of England's QE programme. The fact that the programme has not been extended provides some support to breakevens. Should the policy be extended at a future date, it is possible that the Bank of England may include index linked bonds in future rounds of QE. While this is not the most likely outcome, it would be hugely supportive of long-dated inflation linked bonds.

Corporate Governance

Long-term stewardship

The debate on long-termism is evolving. The promotion of stewardship should lie at the centre of financial and economic life.

Keith Skeoch
Chief Executive

Chart 1
Timescales of market participants

Measurement Timescale

	1d - 1m	1m - 1y	1y-10y	10y-50y
Traders	☯	⊘	⊘	⊘
Fund Managers	↑	☯	⊘	⊘
DMRA	↑	↑	☯	⊘
WP funds, etc	↑	↑	↑	☯
Source of added value	Pairs trading Convert arbitrage	Earnings upgrades Recovery stocks	Value Funds Flow	Economics Demographics
The Money Pool				

DMRA = Dynamic Market Risk Allocation
☯ Investors active in this timeframe
⊘ Investors not active in this timeframe
↑ Opportunity passed to shorter term investors

Source: Standard Life Investments Global Horizons, 2006

Time horizons and trust

In the aftermath of the financial crisis, most of the debate on long-termism has focused on investor behaviour. There are some signs of positive progress: the Shareholder Spring, the reaction to the Kay Report and the recent exercise of shareholder power in the Glencore-Xstrata deal. However, from the perspective of a long-term investor, winning this intellectual debate is only half the story. An equally important issue is reconciling the inconsistency between the time horizons of asset owners and the time periods over which superior returns are available. Our research (Chart 1) has suggested there is no predictable persistency in returns beyond eight years, and that the sweet spot for an investment horizon is between two and five years. Bridging the gap between the long-term needs of savers and shorter-term predictable returns is what fund management is about. Building investment processes and portfolios to achieve this is difficult, of course, but very important if savings are to be perpetually connected with the corporate investment that sustains growth and employment, and delivers a decent income in retirement. It is the pursuit of these goals that makes fund management an honourable profession – good outcomes have a positive impact on peoples' lives and society at large.

However, these goals are being made more difficult by three factors which shorten investment horizons:

1) the inevitable increase in risk aversion that follows a financial crisis
2) ageing populations — more assets are being held in liquid instruments ahead of capital being returned as income
3) the feedback loops between the regulatory architecture and macroeconomic policy, constraining both the supply of funds for long-term investment and its investment freedom.

The rise in risk aversion will fade with time; indeed there was some evidence of this in 2012. There is little we can do about demographics. We can, however, influence the policy environment and use to it promote the supply of long-term patient capital and increase its investment freedom in a prudent manner. This is necessary for a much-needed improvement in productive potential, plus bridging the gap between available savings and the paucity of investment opportunities. We also need to ensure that the investment industry has the capacity to meet the rapidly changing needs of savers and asset owners and their growing appetite for income. Much of the current conversation between fund managers and clients is about how we deliver outcome-orientated and/or risk-based solutions to generate sustainable, well-diversified returns. This results in more complexity in the manufacture of returns at a time when demand for transparency and simplicity in retail products is increasing. This gap between growing client needs for complex solutions and the regulatory need for simplicity and transparency can only be bridged by improving trust.

How do we rebuild trust? There is no short-term fix, but we have become convinced that the way forward is the promotion of stewardship, which should lie at the centre of financial and economic life. Asset gatherers are the stewards of savers' funds and need simple, transparent and cost effective propositions to deliver returns that allow individuals to cope financially with life's trials and tribulations. Investors are the stewards of the assets they manage and have fiduciary responsibilities to their clients about their ability to deliver a return to help meet savers' needs. Auditors are the 'stewards' steward'. As well as ensuring reliable information for the allocation on capital, they play an important role in providing professional assurance about the quality of corporate reporting. This is why investors are right to embrace recent efforts to improve reporting by auditors and audit committees with open arms. Boards of directors are stewards of the capital they are allocated, the assets they acquire, the return delivered to investors and, their ultimate clients', savers. Finally, policymakers are stewards of the economic and financial system, and need to take a long-run approach to its health, avoiding the risk of responding to shorter-run issues. In our view, as stewards we all have a role to play in ensuring that savers have the opportunity to invest for their long-term needs through advisers and managers who have their interests at heart, and in companies that are well run to deliver long-term growth, all in an environment that points capital towards the delivery of a sustainable return.

About Standard Life Investments

Standard Life Investments is one of the world's major investment companies. Responsible for investing assets on behalf of over five million retail and corporate customers, including the Standard Life Group, we offer global coverage of investment instruments and markets.

In a diverse, dynamic world we use our insight and intellect to seek out investment opportunities. Our ability to predict, react and adapt rapidly helps us to maintain our position as a leading investment house.

We are active fund managers, who place significant emphasis on research and teamwork. After in-depth analysis, our Global Investment Group forms a view of where to allocate assets, based on the prevailing market drivers and on forecasts of future economic indicators. The Global Investment Group 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.

Global Outlook, a quarterly summary of the House View, is partnered by **Global Perspectives**, a monthly article on topical issues, **Global Horizons**, an occasional report on thematic and structural trends, and **Global Spotlight**, web only articles commenting on current events. The weekly Macro Digest examines the latest statistics from all the major economies. Copies are available on the Market View section of our website www.standardlifeinvestments.com.

Standard Life Investments is a dedicated investment company with global assets under management of approximately £157.6 billion (as at 30 June 2012) – this equates to $247.1 billion, C$252 billion, A$241.1 billion and €194.9 billion.

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The production of Global Outlook draws on the ideas and insights of many of our investment professionals around the world within the framework of our *Focus on Change* investment philosophy. Below are the contributors to the publication, in addition to those mentioned within the document.

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House View

The following asset allocation is based upon a global investor with access to all the major asset classes. For regional versions of the House View, please contact your Standard Life Investments representative.

	January 2013 House View	
Risk	The Global Investment Group emphasises moderate levels of risk, focusing on assets with high, yet sustainable, yield in view of the outlook for subdued global growth over the medium term.	NEUTRAL
Government Bonds		
US Treasuries	QE, prolonged low policy rates, muted inflation pressures and safe-haven purchases will prevent yields from rising much. Fiscal concerns remain amid considerable policy uncertainty.	NEUTRAL
European Bonds	European bond markets offer negative real yields at the core, while ongoing fiscal and political problems overshadow the region despite the latest ECB measures.	LIGHT
UK Gilts	Although the weak economic recovery and continued fiscal tightening provide support for the gilt market, valuations are expensive plus QE worries some investors about future inflation risks.	LIGHT
Japanese Bonds	Japanese government bonds are not exhibiting the same levels of volatility as other markets, although low yields and an uncertain inflation outlook deter many global investors.	NEUTRAL
Global Inflation Linked Debt	Valuations in individual countries warrant careful examination; the asset class is underpinned by investor worries about future inflation triggered by easy monetary policies.	NEUTRAL
Global Emerging Market Debt	Dollar denominated bonds are Heavy as spreads can narrow, while local currency bonds are Neutral as careful examination is required of individual currency and spread factors.	HEAVY/NEUTRAL
Corporate Bonds		
Investment Grade	Attractions such as positive corporate cashflows are increasingly priced in; volatility of the underlying government bond markets will periodically affect total returns.	HEAVY
High Yield Debt	Although spreads have come in moderately, the outlook for defaults remains supportive. Yields are still attractive but the market is vulnerable to any sizeable asset class rotation.	VERY HEAVY
Equities		
US Equities	Policy uncertainty remains over the nature and extent of fiscal tightening, although the underlying fundamentals in terms of consumer spending, housing and business confidence are slowly improving.	NEUTRAL
European Equities	Valuations and corporate competitiveness have improved considerably, which could be released by ECB actions to improve credit creation, but fiscal programmes remain a serious constraint.	NEUTRAL
Japanese Equities	The recent election may lead to major policy changes, focused on inflation targets and the yen, while corporate earnings should benefit from a more competitive currency.	MOVED TO NEUTRAL
UK Equities	Companies face tough export markets, but cashflow is positive and being put to work: a measure of confidence is seen in rising private sector job creation.	NEUTRAL
Developed Asian Equities	Slower economic growth in key economies such as China still affects the wider region; currency strength has hampered economic rebalancing in some countries.	LIGHT
Emerging Market Equities	Performance is divergent; while some markets benefit from upgrades to sovereign debt ratings, others face growing inflationary pressures, credit concerns and valuation issues.	NEUTRAL
Property		
UK	The weak growth environment is expected to impact prices in the near-term but yields remain attractive compared to other assets, suggesting returns above cash over a three-year holding period.	HEAVY
Europe	The market remains polarised with northern European centres and good quality assets expected to be relatively robust, offsetting weakness in much of southern Europe.	NEUTRAL
North America	We see the best prospects in under-developed industrial locations in Canada and the cyclical US office markets where future supply is at 30-year lows.	HEAVY
Asia Pacific	Excess supply in several key markets, e.g. China, will hold back growth, but offices in Australia, for example, remain supported by a good demand/supply balance.	NEUTRAL
Other Assets		
Foreign Exchange	Cross-border flows favour the relatively cheap US dollar while the euro is relatively expensive. We await monetary policy decisions in Japan to reinforce the yen's recent path.	VERY HEAVY \$, VERY LIGHT ¥, NEUTRAL £ and LIGHT €
Global Commodities	Different drivers, such as Middle Eastern tensions, drought in the US and infrastructure initiatives, influence the outlook for different commodities.	NEUTRAL
Cash		
	Central banks have pledged to keep rates lower for longer.	LIGHT

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