Global Investment Outlook

The investment outlook from Aberdeen's Multi-Asset team

July 2013

Executive Summary

The point of maximum policy accommodation may now be in sight

- Markets volatile as investors forced to contemplate Fed exit strategy.
- Slowing growth in China is putting pressure on Asian and emerging markets to develop domestic led demand.
- This time really could be different for Japan - however reflating the economy was never going to be easy.

The latest US Federal Reserve meeting and the pronouncements of Chairman Ben Bernanke on the future direction of monetary policy have had an immediate impact on financial markets across the world. We still however believe that any rise in official interest rates in the US is still a long way off, perhaps not until 2015, or maybe even 2016. All that Mr Bernanke said was that the pace of additional monetary policy support could be gradually reduced, with no new purchases after the middle of next year. In his own words "any slowing in the pace of purchases will be akin to letting up a bit on the gas pedal as the car picks up speed, not beginning to apply the brakes".

So the good news is that risks of a return to recession have diminished to the point that policymakers can think about easing off some of the insurance against it. But as the outgoing Governor of the Bank of England put it in his recent speech at Mansion House, "although there are indeed signs that a modest recovery is underway there is still a need to support it". And recent market moves should not be confused with a return to economic normality, however desirable that might be.

'Abenomics' within Japan has provided another demonstration of monetary policies ability to alter the value of financial assets, causing Japanese government bonds, equities and the Japanese yen to fall sharply over the second quarter. In reality, the true economic effects of the unprecedented actions will probably take six to 12 months to be felt. The real test will be whether these policies will be able to meet expectations and stimulate demand as well as inflation.

Emerging markets suffered outflows in the second quarter in reaction to the US Federal Reserve's commitment to taper easing measures. Fundamentally, wider Asian and emerging market growth slowed in real and nominal terms at the start of this year, although not all constituent economies' growth rates have fallen. Indonesia and Brazil, for example, have shown some signs of strength recently, although the overall global climate has led to increasing speculation of easing measures being implemented by central banks. China remains the key driver of growth for the region although weak manufacturing and stresses to its financial system have negatively impacted commodity exporters. We do not see inflation posing a major threat to the economy, given that Chinese policymakers have significant room for manoeuvre.

Some progress has been made in Europe with the Eurogroup approving the transfer of a tranche of aid to Cyprus. Economic indicators have gradually turned less negative recently suggesting the region may be gradually coming out of recession. Political risk had subsided in Italy after Giorgio Napolitano was eventually re-elected as Italy's president. Major issues still linger though with harmonised austerity hurting aggregate demand and the final amendments to the single supervisory mechanism yet to be finalised. Recent events in Greece also highlight the ability for things to develop unexpectedly, so a cautious outlook is still warranted.

So whilst there are encouraging signs economically it is also fair to say some uncertainties remain. Public sector debt issues in the US and Europe are likely to take several years to resolve therefore growth is likely to remain low for some time. A pause at least in risk assets is therefore understandable, especially given the Federal Reserve's most recent statement and the seemingly inexorable rise of markets so far this year. Fortunately though, investment opportunities do remain. However, a discerning and nimble approach is probably prudent in the near term as markets digest and reflect on the latest news.

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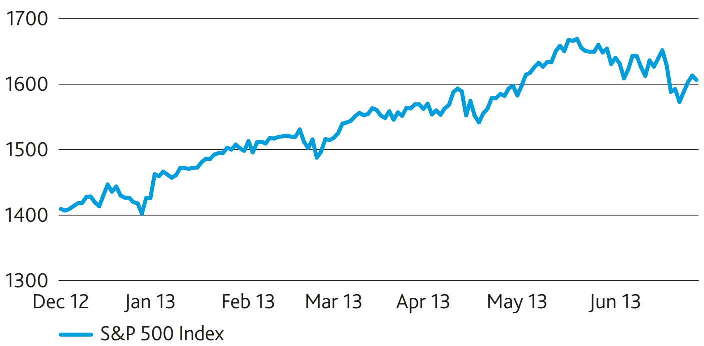
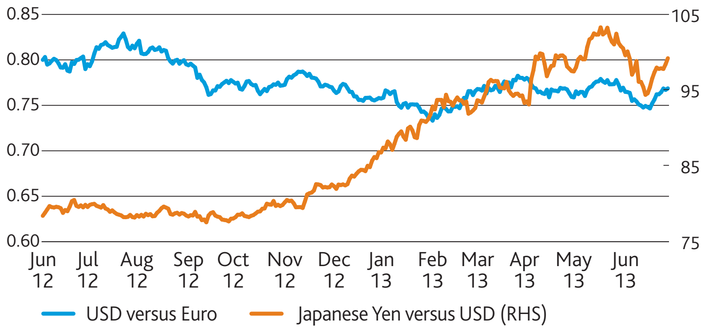
US Federal Reserve comments have impacted risk assets



Source: Aberdeen Asset Management, Bloomberg, 30 June 2013.

The Yen has weakened while the Euro has strengthened



Source: Aberdeen Asset Management, Bloomberg, 30 June 2013.

Key	US	Japan	Euro- zone	UK	China	Global
GDP rolling 12m forecast	2.4	1.2	-0.3	1.4	6.6	2.0
Consensus	2.4	1.7	0.2	1.4	7.6	2.4
CPI rolling 12m forecast[A]	1.7	1.7	0.5	2.6	3.0	1.6
Consensus	1.7	1.2	1.5	2.6	3.0	1.8
Current Base Rates	0 - 0.25	0.10	0.50	0.50	6.00	-
Monetary Policy (3m)	0.25	0.10	0.50	0.50	6.00	-
Monetary Policy (12m)	0.25	0.10	0.50	0.50	6.00	-

[A] Headline rate B PBOC 1 year Yuan Lending Rate
Source: Aberdeen Asset Managers Limited, 30 June 2013.

Economic and monetary policy outlook

The US Federal Reserve announced that it aims to taper its asset purchase program in the autumn with no new purchases by the middle of next year subject to the recovery progressing in line with forecasts, specifically unemployment. Global financial markets deteriorated in reaction to the news and concerns have been raised whether the announcement will now serve to derail any recovery in growth. This serves to show a fine line needs to be met between balancing the potential for growth with fiscal consolidation and balance sheet repair. The role of politicians providing support to struggling economies continues to be as important as ever.

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Intense political pressure is likely to continue to cast traditional central bank 'price stabilising' policies to one side and policymakers will be obliged to carry out an ever increasingly complex juggling act of increasing growth and lowering unemployment, while keeping inflation low. The UK, Japan and the US until now have all been particularly active, although it will take time for Japan's actions to fully take effect. The European Central Bank has been reluctant to expand its balance sheet so far however signs of weakness from Germany may induce a moment of reflection.

The tough balancing act between monetary and fiscal policy will continue to challenge policymakers and the risk of policy error remains high.

US

America's resilience to fiscal tightening in the form of a payroll tax hike and spending sequestration has highlighted the economy's underlying strength. Positive indicators arguably led the Federal Reserve to comment that they intend to reduce their asset purchasing program from as early as autumn this year, with no new purchases after the middle of next year. It should be noted however that official interest rates are likely to stay low, possibly until 2015 or potentially even 2016 according to the Federal Reserve's own forecasts.

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The strong performance of risky assets at the beginning of this year indicated that the Federal Reserve's asset purchase program appeared to be fulfilling one of its key goals. Rising stock market values helped to strengthen companies' balance sheets and increase employee incomes as compensation linked to the stock market increases. Economic activity may play a role in the timing of the tapering. The selloff in risk assets subsequent to the announcement could arguably be detrimental to the US economic recovery and potentially lower any future growth prospects.

Dividend and bonuses late in 2012 helped to minimise the impact of payroll tax increases and offset the payroll tax effect forecasted to impact retail sales in the first quarter. The latest core retail sales have been positive aided by lower gasoline prices. April was a positive month for the budget deficit with many households making their final tax returns for the previous fiscal year. Tax revenue was up by 16.3% over the 6 months to April, which was the highest pace since 2005. Most recently, encouraging housing starts data and the ISM manufacturing index moving into expansionary territory has aided market confidence.

Europe

The currency bloc remains mired in recession although the latest economic indicators have improved. Fiscal austerity plans have continued apace, although the European Commission has granted marginal increases in the time horizon of selective economic reform programmes, including that of France and Spain. On another positive note, once the cyclicality effects of growth is removed from the latest data releases some Eurozone economies have made progress to control primary deficits, albeit much work remains for policymakers to improve secondary deficits.

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Monetary policy conditions have been eased with the ECB surprising the market with a 25 basis point cut in the refinancing rate and hinting at the possibility of a deposit rate cut at the beginning of May. A cut to the deposit rate would, in effect, turn rates negative causing commercial banks to be charged to leave deposits at the ECB. Policymakers hope these actions will encourage lending in the region, however many banks may still be reluctant to increase lending before their existing non-performing loans are recognised. Raising the level of lending will, in effect, mean lower quality loans will be granted to the detriment of the quality of bank balance sheets.

Progress has been made in drafting key directives such as the bank resolution and recovery scheme and national deposit guarantee scheme ahead of the launch of the Single Supervisory Mechanism (SSM) once it is finalised. Over the next few weeks focus may turn to the damage recent flooding has had on core European economic activity, particularly within Germany.

UK

The latest Monetary Policy Committee (MPC) minutes noted signs that a recovery in economic activity could be underway. A number of data releases have been firmer recently including retail sales which showed a strong rebound in May. Falling external price pressures and a rise in the labour participation rate are expected to put downward pressure on inflation, while the economic growth figures are expected to benefit from the effects of the recent policy stimulus and signs of recovery within the euro area.

"Mark Carney took the helm of the Bank of England at the start of July."

In a bid to reignite growth the length of the Funding for Lending Scheme (FLS) was increased by one year to January 2015 in April. The expansion is set to include lending which involves certain non-bank providers of credit, while incentivising banks further to lend to small and medium sized enterprises. To date, the FLS does not appear to have had quite the level of success it was thought it might have had. Despite the promise of easy credit, companies remain apprehensive about increasing debt on their balance sheet should economic conditions remain morbid in the medium to long term.

UK Chancellor, George Osborne, delivered the UK government spending review for 2015 and 2016 in late June. The Chancellor announced a fifth year of austerity plans which included a number of new saving measures focused on welfare payments, reducing public sector jobs and ending automatic pay rises for public sector pay. Osborne said that the UK economy was moving to a recovery stage however the state of the wider global economy meant that the UK needs to continue to make savings.

Mark Carney took the helm of the Bank of England at the start of July. Although expectations are high he has inherited a more

Bank of England

positive starting point than expected. Forward guidance is expected to prove central to his tenure. It is unlikely Carney will have to write a letter in his first month in charge as the latest CPI print revealed inflation rose less than expected.

Japan

Japanese growth started the year on a positive note with GDP growth increasing to 4.1% quarter-on-quarter, topping G7 growth for the first quarter. The encouraging figures were attributed to private final consumption and strong net exports. Infrastructure spending after the earthquake and tsunami last year also influenced growth, as did disaster prevention measures aimed at upgrading the economies aging infrastructure. Unprecedented quantitative easing that began at the end of the first quarter had a strong negative impact on Japanese government bonds, equities and the Japanese yen.

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Looking ahead the real test for Japan, and indeed one of the aims of Abenomics, will be to reflate the economy and produce positive real and nominal growth by delivering on its 2% inflation target. It is only once the economy records positive nominal GDP government revenue can increase and longer-term fiscal issues such as the current deficit and the huge debt to GDP ratio can be tackled. A fast approaching demographic problem is placing a large degree of importance on achieving this goal.


Taiwan

Asia and emerging economies

Emerging markets were a key beneficiary of the US Federal Reserve's asset purchase programme however the threat of the strategy being tapered in the autumn has caused emerging market assets to come under pressure. Moreover, slowing global growth has heightened the pressure on Asia and emerging economies to consider monetary easing, although asset price inflation is likely to limit some central banks' options somewhat.

Policy in China continues to be focused towards improving the underlying quality of domestic demand and lessening the reliance on exports. Investment spending has become more selective and large projects to build new cities and towns are beginning to fall. In our view, monetary policy will continue to be accommodative to encourage growth however any new policies will need to be monitored closely to ensure inflation is contained.

India's economic performance continues to dawdle. Growth momentum is now close to five year lows and recent leading indicators including exports have disappointed. However, slowing growth and falling global commodity prices have caused India's headline inflation figures to fall. The Reserve Bank of India continues to offer cautious guidance on monetary policy, yet further disappointment may offer reasoning for further easing.

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Elsewhere in Asia, there are strong signs of an economic revival in South Korea and Taiwan and the solid growth trends in Malaysia and Indonesia look set to continue into 2013.

In Latin America, private consumption has become an ever increasing component of GDP since 2010. In an environment of slowing global exports, private consumption is likely to be a key driver of the region's growth in the short to medium to term. A number of stimulatory policy tools are at government's disposal, which could be used to promote sustainable, long-term economic development.

In general, this private consumption trend occurring across Asia and emerging markets will cause these economies to become increasingly dependent on middle class, domestic-led demand. However, despite this they still remain heavily reliant on exports and therefore demand from the West. The IMF's latest World Economic Outlook projects healthy emerging market growth of 5.6% in 2013, up slightly from 2012 and far ahead of the 1.5% growth projected in the "advanced" economies.

Equities

In assessing asset classes we use three key metrics, namely, valuations, growth momentum and liquidity. Equity valuations are challenging given the earnings outlook and current pricing. Growth momentum is more mixed for global equities at present. Conversely, comments from the US Federal Reserve that it aims to taper its asset purchasing programme has perhaps been interpreted

by investors as the likely removal of liquidity support from the system. Global equities performed poorly in June as a result. Furthermore, the prospect of the asset purchase programme being withdrawn may impact the global growth cycle, which will in turn affect company revenues and earnings.

Rising bond yields have caused the equity discount rate to rise, making equity valuations look less attractive although current values may in part still be justified by strong balance sheets. Attractive opportunities still exist on a number of other valuation metrics and we believe equities will continue to offer value over the long term.

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Curious trends have emerged in equity market returns with individual stock performance becoming dislocated from sector performance. Strong trends towards defensive sectors such as utilities and healthcare are beginning to fade and investments are now being made across all sectors based upon individual company strength.

Bond and currencies

US Federal Reserve Chairman Bernanke's announcement that further easing is expected to be phased out from the autumn caused a high level of volatility in bond and currency markets, with US treasury securities selling off sharply. Market confidence which relied heavily on the abundant liquidity provided by the Federal Reserve's programme is likely to diminish as a result.

Emerging market bonds and currencies have re-priced significantly. The Federal Reserve's desire to withdrawing monetary stimulus led to concerns that emerging markets financing costs could rise and fund flows into emerging markets may reverse. In the short-term, sentiment will remain data dependent, with much of the focus on the US growth indicators. In the medium to long-term, the fundamentals of emerging markets remain constructive. Balance sheets at a country, company and individual level remain in good shape, but may deteriorate on the margin as growth slows. Debt sustainability in emerging markets will also remain intact amid rising borrowing costs, with debt levels on average one third of those in developed markets.

Japan's new Bank of Japan governor, Kuroda's, announcement of new policy initiatives in April designed to meet the 2% inflation target in two years has caused the yen to fall dramatically versus the US dollar. The total package surpassed market expectations and while the effects of the measures will only come to fruition within the next six to 12 months, expectations are high. Naturally, Asian currencies have been affected by yen weakness. We do, however, remain of the belief that those Asian currencies with supportive economic dynamics should appreciate over time. On another note, a prominent shift has emerged in the number of investors short the Japanese yen, which could be to their detriment should a bout of risk aversion occur and the yen appreciate as a result.

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Giorgio Napolitano's eventual re-election as Italy's president in April did provide a small degree of respite for political risks with Europe, however many problems remain unresolved such as sluggish German GDP growth. The loss of the UK's AAA credit rating by Fitch had no meaningful market impact.

Comments from the US Federal Reserve that it aims to taper its asset purchase programme in the autumn have helped to strengthen the US dollar. Accordingly the US dollar has gained in status recently as monetary policies favour the US in the long term when compared to the UK, Europe and Japan.

Commodities

The commodity complex has somewhat adjusted to slower global growth expectations, with prices falling to the detriment of many emerging market commodity exporting economies such as Chile (Copper) and Russia (Oil).

The possible withdrawal of abundant liquidity by the US Federal Reserve will likely reduce anxiety over future inflation and therefore the upside potential for future growth in precious metal values. Assets such as Gold and Silver are likely to come under pressure as demand for their inflation shielding properties fall.

The oil price has recovered recently although it is still significantly below its 2011 and 2012 highs. We could see some short-term market weakness with global growth likely to remain sluggish and healthy supply levels resulting from high prices over recent years. Should China's economic growth rate shift upwards this picture would reverse though. For largely the same reasons our outlook for base metals is very similar.

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The broad-based declines in soft commodities experienced over the last two years could reverse somewhat this year as any supply shock would tip the supply and demand dynamics significantly. However, strong overall supply levels are likely to keep prices relatively suppressed over the longer term.

Looking further ahead, driven by growing demand from Asia and emerging markets, we continue to believe that the long-term commodity bull market remains intact, to be interrupted only briefly by the cyclical influence of the global economy's performance.

Commercial property

Core institutional property in major market locations offers poor long-term value but that is not to suggest that a drop in capital values is imminent. Outside of major cities, under-priced markets and segments are more apparent as these have been largely bypassed by global capital. Central banks have kept their liquidity taps on full, and a thaw in real estate lending markets is taking place after a long deep freeze. Our short-term indicators point to current upward momentum in capital values being maintained, and this is likely to spread in the next 12-18 months to some market segments so far ignored by investors. The stage is potentially set for a further rally in property prices.

"If a significant economic recovery can be engendered, overpricing may correct without any meaningful drop in prices."

If a significant economic recovery can be engendered, overpricing may correct without any meaningful drop in prices. We question whether a generalised gain in property income can materialise while governments are implementing growth impairing austerity, while the private sector is yet to fully deleverage from the previous boom. As such, we see an increase in risk appetite as an opportunity to de-risk portfolios. For investors deploying capital, the opportunity today lies in identifying good quality under-priced assets which can take advantage of a partial opening up of property funding markets. By region, parts of the Eurozone and Asia Pacific look attractive for medium-term global investors, whereas the US is clearly overpriced and should be underweighted.


Chilean copper mine

The value of investments and the income from them can go down as well as up and your clients may get back less than the amount invested.

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