Global Outlook

February 2017

Cash flow generation is the lifeblood of every business. It is also the currency in which bond and equity holders are paid. In this edition of Global Outlook, we examine where cash flow is being generated at a regional and sector level, and determine its sustainability. We then explore corporate cash deployment, in particular capital spending, and what the use of cash can tell us about the credit cycle in developed markets.

This document is intended for institutional investors and investment professionals only and should not be distributed to or relied upon by retail clients.

House View

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

	February 2017 House View	
Risk	The Global Investment Group retains a cautious medium-term outlook, as a variety of political and economic drivers point to higher levels of financial market volatility. While there are particular areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
Government Bonds		
US Treasuries	While market stress and safe-haven flows support Treasuries, tighter labour markets, rising inflation and the upward trend in wages give the Federal Reserve the rationale to continue hiking rates throughout 2017 and 2018.	LIGHT
European Bonds	Bonds are not as well supported as growth and inflation pick up, meaning the ECB is considering how long to keep monetary policy accommodative. Political pressures could periodically affect peripheral bond markets.	MOVED TO LIGHT
UK Gilts	The Bank of England has delivered significant easing measures as uncertainty related to the EU referendum outcome is expected to cause the economy to slow. However, valuations are expensive.	NEUTRAL
Japanese Bonds	The central bank is attempting to reflate the economy with its QE and yield curve control policy alongside negative short-term rates. The absence of yield makes this asset class relatively unattractive.	LIGHT
Global Inflation-Linked Debt	Inflation levels are expected to increase across developed markets as expansive fiscal policy in the US and Japan, currency weakness in the UK, and the rise in commodity prices all feed through into headline rates.	NEUTRAL
Global Emerging Market Debt	US dollar-denominated debt is our preference, both on valuation grounds and also the protection from currency movements it provides. Yields remain attractive although the asset class is vulnerable to aggressive US rate rises.	HEAVY
Corporate Bonds		
Investment Grade	QE supports UK bonds, but has driven European yields to unattractive levels. US credit spreads are less attractive as Treasury yields increase, and riskier assets are preferred.	NEUTRAL
High Yield Debt	The hunt for yield is driving more investors to this asset class, although overcrowding remains a risk in some sectors, especially in the US when monetary policy is being tightened.	HEAVY
Equities		
US Equities	Equities are buoyant on the back of promised fiscal easing and business deregulation. While valuations are not historically attractive, dividend payments and share buybacks plus expected tax cuts support cash flows.	VERY HEAVY
European Equities	Corporate earnings are improving on the back of a widespread pickup in economic growth across the region. Concerns remain over some banking systems, the lack of strong credit growth and the upcoming election cycle.	NEUTRAL
Japanese Equities	The market looks more attractive as easy monetary policy and fiscal stimulus for 2017 are helped by a cheaper yen driving forward corporate earnings and business investment.	NEUTRAL
UK Equities	The UK economy has been resilient but uncertainty remains surrounding its future relationship with the EU. Sterling remains the primary driver of the relative attractiveness of UK companies with overseas exposure.	NEUTRAL
Developed Asian Equities	The improvement in the global economy will have a positive feed through due to trade linkages. However, expected US interest rate rises, a stronger dollar and protectionist policies may all offset this effect.	NEUTRAL
Emerging Market Equities	The outlook for Asia is dependent on US trade policy and the degree of monetary tightening or US dollar strength. Those emerging markets that can benefit from higher oil prices are attractive after the change of policy by OPEC.	NEUTRAL
Real Estate		
UK	The referendum fallout continues to affect liquidity and cause capital depreciation. Income remains attractive versus other asset classes although risks are elevated should conditions turn recessionary or political uncertainty persists.	LIGHT
Europe	Core markets continue to offer attractive relative value in light of the low interest rate environment supported by QE, while recovery plays are showing consistent capital value growth.	MOVED TO HEAVY
North America	The US market should benefit from an improvement in economic growth, although some Canadian property faces headwinds from an interest-rate sensitive consumer and significant office construction.	HEAVY
Asia Pacific	An attractive yield margin remains, but markets are divergent. Returns are driven by rental and capital value growth in Japan and Australia, but weakening elsewhere. Emerging Asia markets are risky.	NEUTRAL
Other Assets		
Foreign Exchange	The US dollar has rallied following the US election and can benefit from a steady tightening of monetary policy. Europe looks less well placed than Japan to cope with the next phase of currency pressures, while sterling acts as a shock absorber after the EU referendum.	HEAVY $, NEUTRAL ¥ & £, LIGHT €
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions, OPEC decisions, and climatic conditions, influence the outlook for different commodities.	NEUTRAL
Cash		
	The US election result may mean a faster pace of interest rate rises is necessary should fiscal policy expansion lead to inflationary pressures. Easy policy is still expected in Europe, Japan and the UK to revive economic activity.	MOVED TO NEUTRAL

Foreword

Editor

Craig Hoyda
Multi-Asset Investing Quantitative Analyst

Cash flow generation is a fundamental goal of every business. The providers of capital pay great attention to the ability of the firm to maintain, and grow, a sustainable stream of income. In this Global Outlook, we examine the generation and sustainability of cash flow through various lenses, and then proceed to analyse how corporates are deploying this cash and what it can tell us about markets.

There are many narratives which distract investors from diving deeper into the drivers of corporate earnings. Andrew Milligan, Head of Global Strategy, advises that investors must look through the noise of bygone or upcoming political events and try to gain an understanding of these factors. He suggests that an uptick in capital spending in the energy sector, supportive consumer spending and US fiscal policy can provide a positive backdrop for earnings going into 2017. However, the effects of inflation should be monitored closely.

Earnings, however, are not wholly cash based. In the Global Spotlight article, we encourage investors to pay more attention to free cash flow metrics. We examine which regions and sectors have been generating cash, and drill down deeper to analyse whether this cash flow has been sustainably created, thus supporting both bondholders and equity holders, or whether corporates have been untenably borrowing money to buy back shares. We then drill further down to examine who has been investing and, more specifically, if this spending has been channelled into expanding productive capacity.

Corporate cash flow deployment can give us signals as to the set of investment opportunities available to firms, and also can tell us where we are in the credit cycle. Will James, Investment Director, European Equities, reasons that investors must look through the dividend paid by a firm, analyse the priorities for the use of corporate cash, and determine the value the market is pricing in. He highlights that the low growth environment has led to companies conducting M&A or returning cash to shareholders due to a perceived lack of investment opportunities. However, now the market is rewarding those firms that are allocating cash towards investment. Sefton Kincaid, Credit Analyst, attests that corporate cash uses are indicating a late-stage credit cycle in developed markets. His conclusion is based on examination of fundamental, monetary, political and behavioural factors that have been driving the market. He notes that the decline in US capital spending is starting to fade, and financial aggression indicators further back up this inference.

Real estate investment trusts (REITs) are an asset class that has been managing the cost of cash flows. Jon Stewart, Fund Manager, Real Estate, details that REITs have taken advantage of the interest rate environment to lock-in low borrowing costs for a number of years. Inflation can be a positive driver for this asset class as rents in most parts of the world are linked to the cost of living. Despite the recent sell-off in the market, the diversity within the asset class means that an uptick in economic and price activity should bolster cash flows for specific sectors.

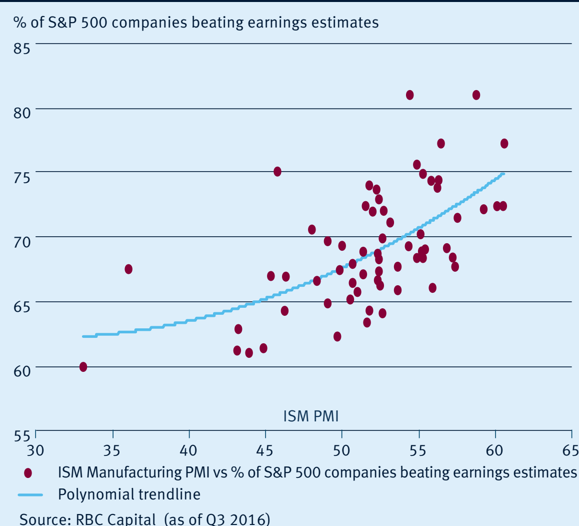
House View

Earnings not elections are the essential element

Although many investors are concentrating on the complex political timetable in 2017, they will gain more from understanding the drivers of the corporate earnings cycle.

Andrew Milligan
Head of Global Strategy

Chart 1
Economic surprises support earnings



Source: RBC Capital (as of Q3 2016)

Sentiment is mixed

Surveys show rather mixed levels of sentiment among investors. It is certainly the case that in recent months capital has generally flowed away from bonds into equities, and from emerging into developed market assets. However, cash levels remain high, and flows outside US markets rather modest. One explanation for this is high levels of political uncertainty. This is focused on the spate of elections and referenda in Europe but also encompasses geopolitical tensions in Asia and the Middle East, as well as the 'bedding in' challenges faced by the new Trump administration.

Although it is certainly the case that politics can spark short-term market volatility, and political developments require careful monitoring, not all risks will crystallise and, at least in the short term, some may be growth accretive. As a result, our House View is focused on understanding the deeper macro drivers that will determine successful asset allocation for investors. Despite the obvious political shocks of 2016, equity markets and bond yields both ended higher as investors began to price in a cyclical improvement in global activity that would be sufficient to allow the Federal Reserve to renew monetary tightening.

Prospects for 2017

Three factors should allow the business cycle to continue to improve in the coming year. The change of stance by OPEC, which has stabilised oil prices above $50 per barrel, marks the start of a positive cycle for capital spending in the important energy sector. This should be positive for overall global growth, as long as energy costs do not rise too much further. Secondly, the inventory overhang is coming to an end, as consumer spending in many countries is supported by improving labour markets and accommodative financial conditions. Lastly, the clean sweep by the Republicans in the US elections opens the door for a mix of tax cuts and regulatory overhaul. Combined with the pro-cyclical benefits of operational leverage, the net effect should be a return to positive corporate profits growth.

Analysts are forecasting 0-5% annual earnings growth for S&P 500 companies in the coming quarterly reports. This follows -0.8% per annum in the last session. Much of the increase comes from a stabilisation in the energy sector, while a steeper yield curve supports financials. However, economic surprises also support earnings outturns (see Chart 1). Consensus growth forecasts of 12% per annum in 2017 look on the high side, but the key issue will be the nature of the corporate tax reform enacted by the Republicans.

Companies certainly do face pressures on profits as well. Inflation can be seen as 'good' or 'bad' for firms. While better top-line sales are good for corporate cash flows, other factors to consider include rising wage costs as unemployment rates decline; higher raw material prices (especially oil); and the impact of sharp currency movements, particularly in the US dollar. Companies will need to raise productivity levels sufficiently to offset the impact of higher input costs on their margins. Corporate pricing power will be a key issue to monitor in coming months.

The House View

The House View is balancing a search for growth opportunities with a recognition that interest rates globally will remain low for some time to come against the backdrop of well-documented structural headwinds. This reinforces our Heavy positions in US high yield bonds, emerging market debt and European REITs for income purposes. There are also moderate overweight positions in global equities. These are centred on the US, Japan and emerging European markets, and reflect underlying profits trends. Factors moderating our risk appetite include mildly stretched equity valuations, further expected increases in discount rates and the potential for major political risks to crystallise in Europe and the US, especially in relation to trade matters. We are also conscious that emerging equities will face headwinds in the form of higher US borrowing costs and an appreciating dollar – possibly trade restrictions too.

We have Light positions in government fixed income markets, focused on the US and Europe. Headline inflation will trend up through the course of the year as higher energy costs feed through; a key issue is whether core inflation responds, which would have more impact on central bank decisions. In our view, investors need to price in at least two interest rate increases in the US in 2017 and again in 2018, with more hikes probable if fiscal policy is loosened substantially. Together with legislation on cash repatriation, this should provide a positive backdrop for the US dollar.

Spotlight

Profit is an opinion; free cash flow is a fact

Free cash flow metrics are important measures of companies' ability to generate cash for their providers of capital. A drill down into markets indicates which sectors have generated cash flow and if they are investing to maintain sustainability.

Craig Hoyda
Multi-Asset Investing Quantitative Analyst

Never judge a book by its top line

Finance theory suggests that the intrinsic value of a security is the sum of the present value of its future cash flows. However, intrinsic value does not tell the whole story. Crucially, neither revenues nor earnings are wholly cash based; there are multiple accrual and other subjective assumptions, such as those surrounding the amount of depreciation to recognise and management's desire sometimes to smooth periods of volatility. However, putting aside scrip dividends, the providers of capital to firms are paid in cash, not accruals or assumptions.

This supplies the motivation to examine another set of metrics, namely free cash flow (FCF). FCF gauges the amount of cash a corporation is able to return to its bond and equity holders after spending on expanding or maintaining its asset base has been accounted for. Specifically, free cash flow to the firm (FCFF) measures the capital available for distribution to both bond and equity holders, while free cash flow to equity (FCFE) is the cash remaining for distribution to shareholders after accounting for interest payments and net borrowings.

Our approach to calculating FCF aggregates up from the single stock level using annual data from financial statements to obtain sector and regional estimates (the latest available data is for fiscal year 2015/2016). We then break this down by region: the US, UK, Europe ex-UK, Japan and global emerging markets (GEM). For growth rates, we examine the five-year average, as this corresponds to the length of the typical business cycle. Due to the nature of financial corporations' accounts, they are omitted from the analysis.

Environmental effects

Over the past few years, the interest rate and economic environment has been very supportive for corporate cash flow. Low rates and credit availability have allowed corporations to use the bond market as a significant source of funds. Meanwhile, expansive fiscal policy should be supportive for nominal growth which, in turn, should feed through into higher operating cash flow for corporations. The investment environment is a key component in measuring the sustainability of FCF, which leads us to the question of how corporates use their cash flow.

Polling data is mixed regarding deployment of corporate resources. The Bank of America Merrill Lynch Fund Manager Survey indicates that a majority of investors want companies to increase capital investment and three-quarters of all respondents believe companies are under-investing. However, Deloitte's survey of FTSE 100 Chief Financial Officers found that a mere 14% thought that increasing capital expenditure was a key priority for 2017; barely a fifth of them believed that the current environment was a good time to increase risk on their balance sheets, while nearly half indicated that cost reduction was a key priority for the coming year.

Generally, companies tend to follow a hierarchical structure as to where to source funds for capital investment. The preferred source is internally generated cash flow, followed by the bond market, with the equity market being the least favoured. On the first source, corporates appear not to have a problem as cash balances are still very high. Furthermore, EY estimate that $1.2 trillion of excess working capital sits on US and European balance sheets, or 7% of their combined sales – a ratio that has remained relatively unchanged over the past five years. This is a significant amount that could be used in the form of capital spending or alternatively returned to shareholders.

In the US especially, this lack of investment highlights that earnings only tell part of the story of performance. Share buybacks are a factor in artificially propping up earnings-per-share (EPS) and can make a company appear healthier than it actually is. However, in our view, the focus should shift to return ***on*** capital through disciplined investment rather than return ***of*** capital through dividends and buybacks.

Indian summer for cash flow?

We now consider areas where FCF has been generated and discuss the sustainability of those flows. In aggregate, FCFF has been positive across nearly all sectors, an exception being the oil & gas sector in a number of regions which have had negative cash flow since 2014. The FCFE breakdown differs only in that negative cash flows are not concentrated in the oil & gas sector.

However, growth rates within the two metrics paint a different picture: a majority of global sectors are expanding FCFE at a pace faster than FCFF. Chart 1 shows the five-year average annual growth rates for both measures of FCF. As mentioned before, access to cheap credit has resulted in a great deal of issuance by non-financial corporations. A substantial proportion of the funds raised, especially in the US, have been used for buybacks, which is neither a productive nor sustainable use of cash.

In aggregate, two-thirds of global sectors have expanded their FCFE at a faster rate than FCFF. As FCF figures are volatile when compared to individual annual growth rates, the figure dips to (a still significant) 55%. If we dive deeper into the numbers, the suspicion that companies are borrowing to fund equity holders is confirmed; across most regions and sectors equity FCFs exceed those to the whole firm, both within developed markets (DM), where the five-year average is 125%, and GEM (see Chart 2).

However, this does not tell the whole story, as within GEM, cash flows to equity holders has oscillated between positive and negative in Eastern Europe and Latin America. On an index level, only the UK has failed to see growth in aggregate FCFF since the financial crisis, although this can again be explained by the composition of the index. FCFF in GEM has more than doubled, US and Japan is up 60%, while Europe ex-UK is up 40% (see Chart 3). Without analysing the compositions of cash flows in considerable detail, it is clear that FCFE exceeding FCFF is unsustainable. If this was the case over a long period, then the firm becomes more indebted, which has consequences for the cost of equity and the cost of debt. Over a period of time, these measures are generally expected

to merge. This will be supportive for bondholders, as flows to repaying debt interest should improve. We also need to consider the trends in capital spending and whether companies have been expanding their asset base. This can allow us to determine whether cash flows are sustainable or not.

Investing for growth...

Companies that increase capital spending are signalling that they expect improved future opportunities for growth and are adding capacity to take advantage of this. At a fundamental level, this should lead to increased revenues, while over the long term, higher recognised depreciation charges provide a boost to cash flow from operations when computed via the income statement – this is supportive for both FCFF and FCFE.

This leads to the question of which regions and sectors have been investing. Chart 4 details aggregate investment over the past five years (smoothing out volatile year-on-year data). Consumer-goods capital expenditure has been growing strongly across all regions. This is unsurprising given consumptions' large share of GDP and the, albeit sluggish, global economic recovery. Capital spending growth as a general rule has been strongest among the fastest growing economies (US, UK and GEM), and weakest among those growing most slowly. From a pure capital investment perspective, this is not supportive for future FCF as asset investment is insufficient.

... and looking at depreciation

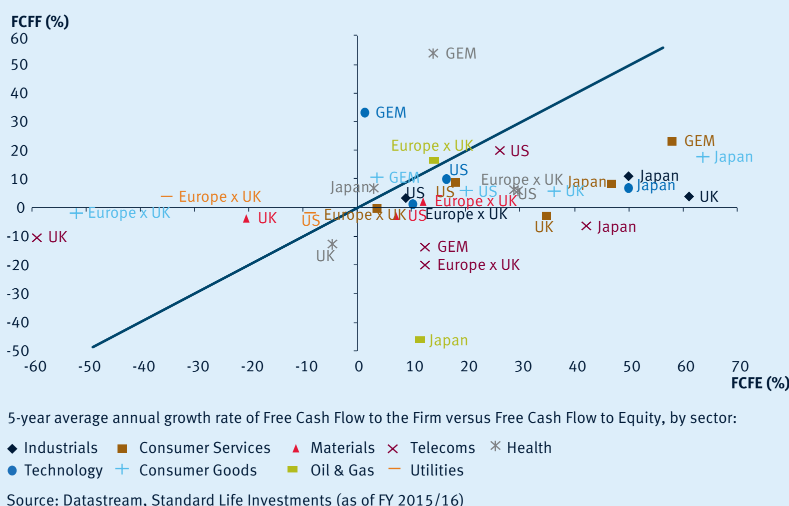
Investment as a proxy for future growth is contingent on funds being channelled into productive assets rather than cash being diverted into less fruitful enterprises. Distinguishing between maintenance capital spending versus growth capital expenditure is usually very difficult, unless a company provides details of the split in its accounts. The depreciation charge on the income statement can be used as a proxy for maintenance capital expenditure; examining this, as expected we find a key split between emerging and developed market corporates. In aggregate, GEM companies have been investing to grow, hence the large capital expenditure in the infrastructure-related sectors. DM firms have been far more disciplined, with a key example being the telecoms sector (see Chart 5).

There is a debate surrounding the accuracy of using the depreciation charge as a proxy. Depreciation can be highly subjective and subject to many assumptions made by company management whose incentives might not be aligned with recognising economic reality. This implies that the recorded figure on the income statement may not truly reflect the amount of maintenance capital spending needed.

The search for yield

In a world of low and negative rates, investors have been increasing their risk exposure as they invest in markets or assets that offer a reasonable dividend/payout. For many years, sustainable yield has been a key investment theme, and this is expected to morph into a yield-plus-growth theme in coming years. On both FCF metrics, however, there is still value to be found in DM, although low/negative levels of growth capital expenditure can be seen in the higher-yielding telecoms and technology sectors. Contrast this

Chart 1
Growing in different areas



5-year average annual growth rate of Free Cash Flow to the Firm versus Free Cash Flow to Equity, by sector:

◆ Industrials ■ Consumer Services ▲ Materials × Telecoms ✳ Health
● Technology + Consumer Goods ■ Oil & Gas — Utilities

Source: Datastream, Standard Life Investments (as of FY 2015/16)

Chart 2
Differences across sectors

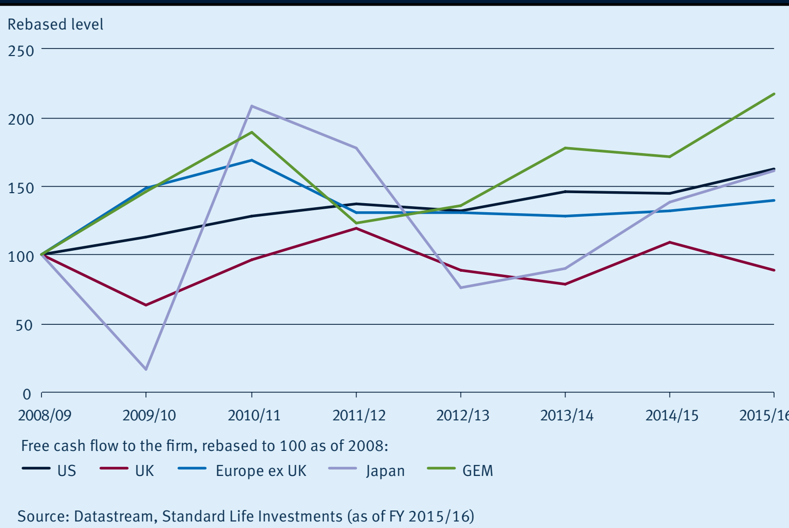
Free Cash Flow to Equity as % of Free Cash Flow to the Firm, 5 year average

	Industrials	Consumer Services	Materials	Telecoms	Healthcare	Technology	Consumer Goods	Oil & Gas	Utilities	Index ex-fin.
US	75.4	128.4	108.7	147.5	146.9	122.0	138.8	69.5	202.0	127.2
UK	145.0	103.1		76.5	110.2	88.0	107.3	120.4	39.1	114.4
Europe ex UK	83.1	96.1	102.6	158.3	109.5	113.6	183.7	332.3	30.7	111.5
Japan	161.8	94.0	75.1	190.6	115.6	85.5	186.2	143.2	39.7	141.5
GEM		131.7	62.7	69.8	232.8	41.0	113.8	308.8		137.3

■ indicates not meaningful data

Source: Datastream, Standard Life Investments (as of FY 2015/16)

Chart 3
Free cash is (mostly) flowing



Free cash flow to the firm, rebased to 100 as of 2008:
— US — UK — Europe ex UK — Japan — GEM

Source: Datastream, Standard Life Investments (as of FY 2015/16)

with the traditional dividend yield metric: telecoms yielded more than 5% over most of 2015, while the tech sector's yield never exceeded 1.8%. Chart 6 details that GEMs have been hampered by negative FCFE across multiple sectors, although the lowest-yielding sectors largely contain the global oil majors and miners. Here, cash flows to equity have been restricted by less favourable access to financing via the bond market, as investors have demanded that their balance sheets be repaired. Conversely, in the UK, firms access to capital markets and dependency on overseas earnings has caused pricing to move in a way that gives certain sectors an attractive yield relative to that in other regions.

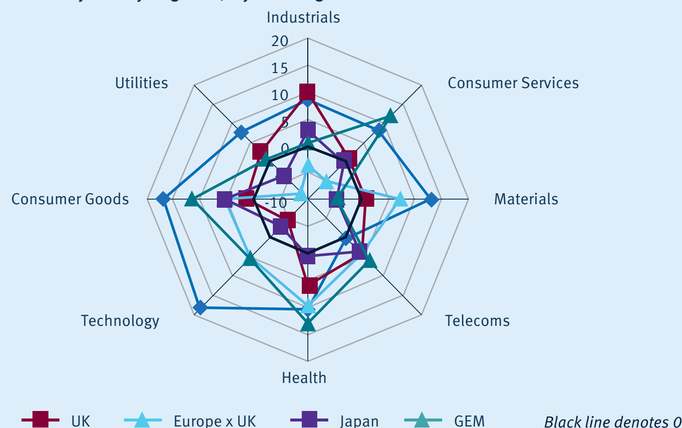
The higher-yielding sectors are not necessarily always more attractive than their lower-yielding counterparts. Higher-yielding sectors have differing levels of sustainability – UK basic materials and US telecoms have attractive yields under both metrics. However, miners have been disciplined in expanding their growth capital expenditure and have seen FCFE fall faster than FCFF despite the tough environment. Conversely, US telecoms have invested to maintain their current asset base and have been growing cash available to shareholders at a faster rate than cash available to the firm.

A fix of free cash flow

An examination of FCF is an important tool in investment selection and should be used in combination with other methods of analysis. Cash flow generation has generally been positive in most regions and sectors. However, the higher growth rate in FCFE over FCFF is an issue investors should monitor closely – over-distribution is a risk. In areas where equity holders have benefited from debt issuance funnelled into share buybacks rather than into productive enterprises, tightening credit conditions will dry up this support and we suggest a position further up the capital structure is merited on a relative-value basis. While credit spreads may widen in the short term, they will be supported over the medium-to-long term should FCFF be sufficient and sustainable. Equity investors looking for a sustainable cash flow source should be wary of sectors which are shrinking their fixed asset base by under investing. Examining growth capital expenditure should give insight into those regions and sectors which are investing sufficiently.

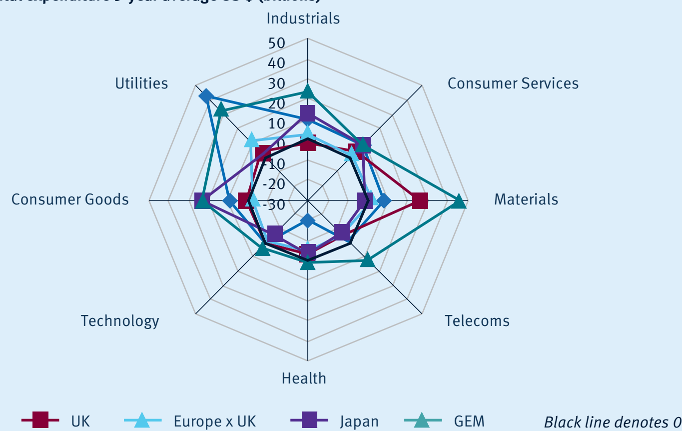
This is an aggregate level conclusion, so on a bottom-up basis it will vary from company-to-company. Drilling down and undertaking a forensic analysis of individual securities within sectors is advisable for those investors willing to increase levels of idiosyncratic risk. Yield differentials provide an indication on the relative expensiveness of markets and sectors. However, attention must be paid to the underlying reasons why the market is indicating a higher premium on that yield. Investors need to assess whether pricing has moved away from the intrinsic price that fundamental cash flow generation suggests, or whether FCF is unsustainable.

Chart 4
Spending patterns



Source: Datastream, Standard Life Investments (as of FY 2015/16)

Chart 5
Investing to stay still



Source: Datastream, Standard Life Investments (as of FY 2015/16)

Chart 6
Some yields are more equal than others

Free Cash Flow to the Firm yield (FCFF/Enterprise Value)

	Industrials	Consumer Services	Materials	Telecoms	Health	Technology	Consumer Goods	Oil & Gas	Utilities	Index ex-fin
US	4.63	4.86	4.22	6.80	4.66	6.32	4.04	0.58	1.03	4.48
UK	4.24	3.74	6.47	4.56	2.52	3.44	4.55	1.36	4.08	3.79
Europe ex-UK	5.10	4.20	3.79	3.14	4.19	4.14	2.70	0.35	4.49	3.62
Japan	3.19	2.64	4.59	4.23	3.87	5.70	2.17	5.64	2.48	3.20
GEM	0.47	3.27	4.72	4.92	3.58	4.83	3.09	4.75	5.26	4.09

Free Cash Flow to Equity yield (FCFE/Market cap)

	Industrials	Consumer Services	Materials	Telecoms	Health	Technology	Consumer Goods	Oil & Gas	Utilities	Index ex-fin
US	1.17	9.11	2.87	17.99	12.28	10.54	7.28	1.65	2.91	7.93
UK	4.07	3.56	6.61	12.58	18.61	21.12	17.59	16.18	6.57	8.13
Europe ex-UK	5.50	2.60	4.88	15.50	10.05	5.72	11.95	4.10	9.91	8.47
Japan	5.86	3.55	5.94	11.86	3.26	5.20	5.93	1.84	-1.00	5.53
GEM	1.15	6.05	-7.22	-4.61	-5.08	7.93	3.39	-9.26	-7.04	0.91

Source: Datastream, Standard Life Investments (as of FY 2015/16)

European Equities

Cash is king

Corporate cash flows have been deployed for M&A activity or returned to shareholders due to a perceived lack of investment opportunities. Investors are now rewarding firms that are reallocating cash towards investment.

Will James
Investment Director, European Equities

In order for us to effectively take advantage of the opportunity presented by a company's ability to invest, grow and pay cash flow out to the ultimate owners of the stock, we require a combination of our *Focus on Change* analysis, with additional rigour around cash creation capabilities. It is important to identify whether a firm can generate and expand earnings, and also afford to pay that income to the holders of both debt and equity.

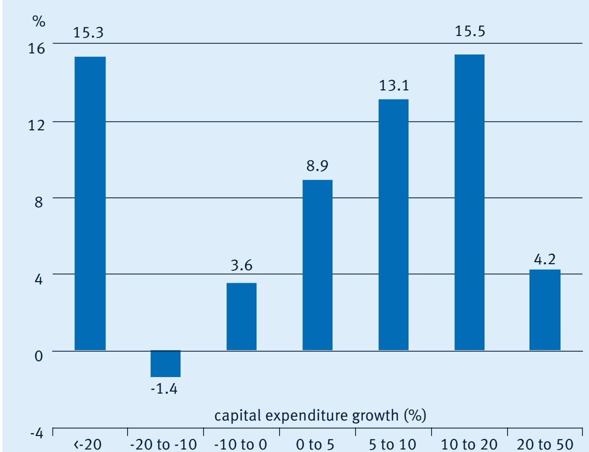
The key to an approach that has cash flow at its heart is to attempt to maximise returns while minimising risk, and finding companies that can deliver that value through the cycle. This does not limit the choice to companies that pay a dividend or those that deliver all of their return through better-than-market/industry growth. We have to take into account the ability of the firm to generate cash and identify what the priorities are for that cash. Is the company able to invest, service debt and pay dividends, and how is its ability to do so valued by the market?

Dividends before investment

Central banks have been throwing everything at markets in an attempt to stimulate economic growth. However, finding decent, attractive or even growing returns was, until recently, perceived to be more problematic than in the past. It is clear that a combination of factors such as low growth, QE and risk aversion have contributed to this challenge. As a result, the market has wanted the surety of return (a somewhat woolly concept) and up until the summer of 2016 markets were rewarding anything with a 'safe' yield. The usual suspects benefited, from government bonds to infrastructure and, somewhere among them, dividend-paying equities. Slower growth, excess capacity in some industries and a perceived lack of investment opportunities meant that surplus capital (and cheap credit) was either being used for M&A or returned to shareholders. In some instances, shareholders demanded it be returned.

It is interesting that corporate profitability and cash flow have remained relatively healthy in spite of the lower growth environment. Indeed, there is scope for companies to start allocating more to investment as well as continuing to pay attractive and growing dividends.

Chart 1
Paying for investment



2016 performance of Stoxx Europe 600 index stocks with band of 2017 estimated capital expenditure growth

Source: Goldman Sachs, Datastream (as of 31 December 2016)

A change is coming?

The appeal of equities as an asset class lies in the opportunity to grow one's investment and income if the analysis is done correctly. This requires a comprehensive understanding of business models, management, balance sheets, cash flow statements and capital allocation policies. The following stage is to identify and/or anticipate the change that is not being effectively priced by the market. Focusing on the next event or the fact a company happens to pay a dividend is not good enough. Where firms are not investing, or do not have the capacity to do so, also raises questions. Paying away capital, whether surplus or not, does not necessarily generate value for investors, and it could be said that there are companies shrinking into the future.

Investors reward companies that address overcapacity issues in a low growth environment. However, finding firms that can invest, service debt and pay dividends will become ever more important if growth is better than consensus estimates.

Take Umicore, the Belgian specialty chemical business. It was highly unfashionable a couple of years ago because it was investing counter cyclically. Umicore took a view that value creation is a multi-year opportunity and invested in its businesses accordingly. Last year was when investors finally recognised the company's effective capital allocation. In addition, Umicore grew its dividend by 20% in 2016, the first time in three years. In fact, in 2016 investors were early in identifying the need to reallocate corporate cash flow towards investment (see Chart 1).

So, what if economic growth surprises on the upside? Inflation could seep back into the system as a result of a pick-up in demand, or US fiscal policy could make corporates think again about buyback policies and dividend distributions, in favour of increasing investment. Looking at European firms as an example, there seems ample scope for some to invest, grow, and accelerate cash generation while maintaining and/or growing dividends.

Credit

The sun also sets (but have all the clocks changed?)

Corporate cash use is telling of a late-stage credit cycle in developed markets. However, we do not foresee a recession approaching, especially with the prospect of US fiscal stimulus.

Sefton Kincaid
Credit Analyst

Credit market fundamentals

Recent developments suggest fundamentals in established credit markets are puttering along. Over the past two quarters, non-financial members of the S&P 500 Index have elected to reduce debt-financed buybacks or dividends. There are telling signs that the decline in corporate investment is starting to fade. For the first time in six years, firms have increased capital expenditure as a percentage of total cash use. However, it is too early to conclude that there is a renaissance of organic investment. There is general optimism that capital expenditure could start to rise, helped by higher commodity prices and associated feedthrough effects, changes to US tax policy, and improving global industrial production.

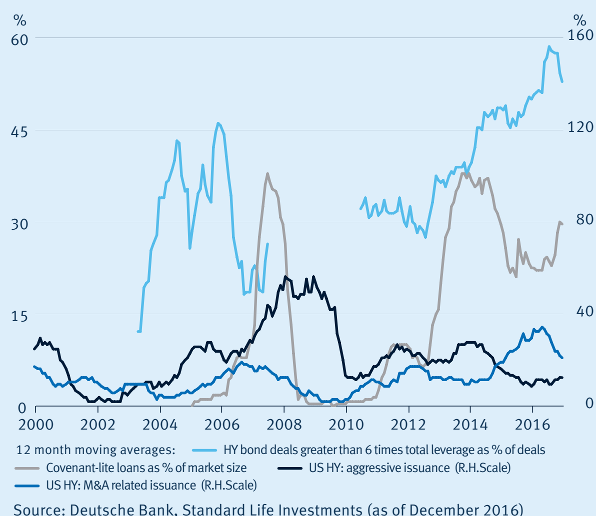
US debt-financed M&A peaked in 2015 at around $3 trillion which, adjusted for inflation, exceeded the previous high in 2007. Activity has declined in 2016, but remains at historically elevated levels. Although M&A is not expected to grind to a halt in 2017, it is reasonable to expect large financially driven deals to decline. Higher financing costs from recent rate moves and elevated equity multiples could keep purely financial buyers on the sidelines. Still, risk appetite abounds. The average premium paid across the North American M&A market in the third quarter of 2016 was 50%, just shy of the previous cycle high. Areas where we see elevated M&A risks remaining are in industries undergoing secular disruption, such as healthcare, media, pharmaceuticals, technology and telecoms. Finally, with leverage at cyclical peaks across many credit markets and greater cash dependency on supporting higher debt burdens, we see increased risk in vulnerable areas of credit, like CCC rated issuers.

Counter to developed markets, emerging market (EM) corporate fundamentals have stabilised. This follows active credit repair that has resulted from declines in capital expenditure and firms paying down debt. Because of this, net leverage has stabilised and we see room for improving fundamentals on the back of steady commodity prices and the prospect of better global and domestic growth. Nevertheless, key risks to fundamentals over the next year stem from the actions of developed market policymakers.

Credit cycle wildcards

Monetary policy and real interest rates remain highly supportive of current credit conditions. The low growth and stable inflation of recent years have provided a highly accommodative backdrop to US credit. Still, the risks of a policy error have increased. One area of uncertainty is President Trump's trade and foreign policy agenda, while another is fiscal policy. Fiscal policy should support growth, especially over the next one to two years; however, it could lead to a more rapid policy normalisation from the Federal Reserve. Based on historical trends, the next year could see additional risks to the broader economy and a turn in the credit cycle. It is interesting to note that nine of the past 14 US recessions have started in the first year of a new presidency. To date, tightening credit spreads and increasing equity multiples are indicative of investors believing potential changes to regulation, tax and trade will be positive. Yet, very little is certain, and the risks of unintended consequences are on the rise.

Chart 1
Late cycle behaviour



Source: Deutsche Bank, Standard Life Investments (as of December 2016)

Proceeding without caution

Various indicators of risk-taking and investor sentiment are also signalling late-stage credit cycle behaviour. In terms of financial aggression, US high yield appears entrenched in this part of the cycle. We examined the proportion of aggressive deals as a percentage of the total, defining aggressive deals as those with CCC rated issuance, payment-in-kind, zero-coupon, leveraged buyout, or dividend recapitalisation issuance. While these have trended lower (12% of the total versus a prior cycle peak of 57%), M&A issuance reached an all-time high of 34% in April 2016. Also at a record high is the percentage of deals of greater than six-times leverage, while the percentage of covenant-lite loans remains elevated (see Chart 1).

Remaining vigilant

We are modestly constructive on credit markets, albeit positioned conservatively given our belief that we are in the later stages of the cycle. We are less constructive on vulnerable areas of the market like CCC rated issuers, but see room for modest spread tightening in higher-quality credit. Traditionally, high-quality credit tends to outperform in the late stages of the credit cycle and strong technical support from foreign investors due to yield differentials versus other international bond markets should provide tailwinds to US credit. EM corporate fundamentals are looking increasingly attractive, but unappealing valuations and increasing developed market tail risks mean we hold a neutral position in the asset class.

Real Estate

Changing mood music

Despite the recent sell-off due to the rise in bond yields, some REIT sectors are well-placed to benefit from improving economic conditions and higher levels of inflation.

Jon Stewart
Fund Manager, Listed Real Estate

Real estate investment trusts (REITs) are listed instruments that allow investors to access the traditionally illiquid direct property market at a lower cost. They possess a unique feature in that 90% of their earnings must be paid out in dividends to their shareholders.

Bond market headwinds

It is not hard to see why REITs have been a popular asset class during the recent years of low interest rates – few equity sectors can boast the kind of cash flow resilience, underpinned by long-duration lease income, that REITs can offer, while the spread remains attractive compared with government bonds. This makes it unsurprising that the REIT sector has sold off in recent months as an improved outlook for global growth and higher inflation expectations have led to a rise in global bond yields.

However, in our view it is too simplistic to see REITs as mere 'bond proxies' – there is a great amount of diversity within the asset class. While some subsectors might struggle in an environment of rising bond yields, others should benefit from higher inflation and stronger economic growth.

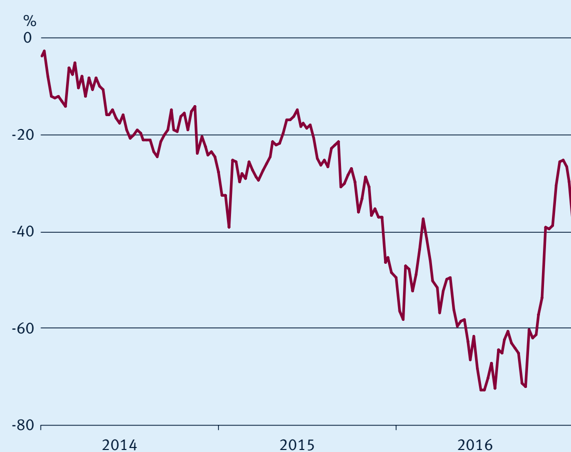
REITs in a reflationary world

One of the key attractions of REITs is the requirement to pay out the majority of property rental profits in dividends, making them a liquid route to access the high-quality cash flows of direct property markets. However, it is important to recognise that REITs are not fixed income instruments; their lease structure might shelter cash flow from downside risks when times get tough, but it can also capture the upside of economic growth.

Rents are to varying extents a function of the business cycle, determined by the supply of space on the one hand and demand for it on the other. If economic growth improves and inflation picks up then this should be accompanied by rising rents that in turn should drive growth in earnings and dividends. Moreover, in many parts of the world rents are explicitly linked to inflation, further helping to protect real returns.

The degree to which REITs can benefit from reflation will vary by country and sector, as will the valuation impact as growth trajectories change. Consider, for example, US lodging REITs, whose hotel properties are generally more sensitive to short-term economic changes. While they have outperformed strongly since the US presidential election, their valuation discount to the more interest-rate-sensitive net-lease REITs has only partially corrected and remains elevated in a historic context (see Chart 1).

Chart 1
Room at a discount



Observed premium/discount to NAV: — Lodging REITs relative to net lease REITs

Source: Green Street, Standard Life Investments (as of 6 January 2017)

Managing the transition

The main risk to REIT cash flows in an environment of higher bond yields is that the cost of credit – the single largest cost item for most REITs – increases, dampening the benefit of higher rents. In the long term, this might be inevitable; however, the years of low rates were not wasted on the REIT sector. REITs have greatly reduced the cost of their debt facilities and also pushed out maturities, locking in the benefit of negative real rates for years – and in some cases decades – to come.

This means that any impact of rising rates on cash flows should be gradual. We therefore expect that global REITs will continue to offer an attractive and sustainable dividend yield with strong cash flow backing. Furthermore, a world of stronger economic growth and higher inflation will create opportunities to improve cash flow and dividend growth.

Our strategy within global real estate

In the UK, we prefer high-quality, higher-yielding industrial-type assets and resilient, high-quality retail assets that are located in areas with a lack of competition. Elsewhere in Europe, expectations have not changed dramatically following the UK's EU referendum; core markets are forecast to produce attractive risk-adjusted returns supported by low development and accommodative monetary policy. Meanwhile, recovering markets continue to experience a rebound, generating higher absolute returns. Expectations for continued US economic expansion amid low supply growth should drive sturdy growth in cyclical office markets. 'Gateway' office markets continue to attract well-heeled foreign buyers and support pricing. Japan has been at the top of our House View since the second quarter of 2012 and while we continue to see an attractive year ahead for returns in Japan, it will lose its dominant position in Asia. Relatively high property yields in Australia and healthy fundamentals are supporting double-digit returns there.

About Standard Life Investments

Standard Life Investments is one of the world's leading investment companies, offering global coverage of investment instruments and markets. We currently have global assets under management of approximately £269.0 billion – this equates to $359.6 billion, C$518.4 billion, A$483.0 billion and €323.6 billion (all figures as at 30 June 2016).

We are active fund managers, placing significant emphasis on research and teamwork. After in-depth analysis, our Global Investment Group (GIG) forms a view of where to allocate assets, based on the prevailing market drivers and on forecasts of future economic indicators. The GIG is made up of senior investment managers from the strategy and asset class teams and is responsible for providing the overall strategic focus to the investment process.

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

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Publication	
Weekly Economic Briefing	A regular analysis of major cyclical developments and structural themes in leading advanced and emerging economies.
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Global Horizons	An occasional report that captures the in-depth research of longer-term themes that help to form our House View. We also periodically examine the major changes that are likely to influence financial markets in the coming years.

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