Standard Life

August 2017 market review

For financial advisers only

Andrew Milligan, Head of Global Strategy at Standard Life Investments, looks through the political noise, economic uncertainty and expensive valuations that are spooking some investors to the fundamental factors that matter to markets.

Despite some encouraging signs for the global economy, high valuations and political headlines have spooked many investors into taking profits, causing global market fluctuations over the summer. Meanwhile, in the UK, the markets face a complex set of variables. Andrew Milligan, Head of Global Strategy at Standard Life Investments, looks past the confusion to the real factors that could impact clients' investments.

Headlines caused some investors to ignore strong fundamentals

- Major market indices waxed and waned over the summer with many investors deciding to take profits from their holdings. A combination of factors caused this trend.
- Investors are in an environment where share prices are in some cases over-valued, and where we're between the quarterly reporting seasons that shed light on corporate earnings. So any concerning political headlines, of which there were many (such as North Korea or events in the White House), were enough to spook investors into raising some cash.
- But this is a short-term reaction to market 'noise' rather than to fundamental economic and business indicators.

> **"We continue to believe that profits growth will be buoyant in 2017 and 2018 on the back of decent, if not robust, expansion in the global economy."**

- And so we remain overweight in equity markets. That said, we need to look more carefully for good value in the current environment.

Finding value in an expensive market

- Currently none of the investment asset classes look cheap in absolute terms, with a few exceptions such as some of the emerging market economies. But on a relative value basis we favour the US, European and some Asian equity markets over and above Japan and the UK.
- In fixed income markets we continue to look for yield opportunities, so we prefer emerging market debt and some high yielding bonds to standard government bond markets.
- However, the fact that we're now neutral in asset classes which we previously liked, such as commercial property or investment grade corporate bonds, does show how important valuation signals are within our house view process at present.

Brexit and a bemusing UK economy

- Brexit negotiations are now into complex territory, as we saw from the spate of position papers from the UK government over the summer.

> "News headlines and much commentary are likely to follow the various meetings with EU officials – which in turn may encourage short-term currency volatility."

- What about the longer-term picture? It still shows a slowing UK economy, which is being reflected in the prices of domestic sectors of markets. Two adverse trends are driving the slowdown:
  - the impact of the lower pound on inflation, and
  - the effect of weaker business confidence on investment.

  It will take time for these trends to reverse.
- We're focused carefully on using scenario analysis to determine the potential risk to markets and investments if Brexit negotiations falter or break down.
- But for investors, I'd say the key takeaway is that we expect slow growth in the UK into 2018. This is one reason why we prefer companies in other countries; unless it's a UK company that can benefit from strong exports growth or which has a considerable overseas operation.

And finally... investors need an answer to this China question

- We all know China's might as a global growth engine and the ripple effect it can have on other economies or commodity markets. But according to the IMF, China has a massive debt of around £22 trillion – up from £4.6 trillion in 2008. So does this debt now threaten the global economy or is China well placed to control it? It's one of the most important questions for investors over the next few years but also one of the most difficult to answer.
- On the one hand, most emerging market economies which have suffered this pace of debt expansion have had problems afterwards; remember the Asian crisis of 1997-98 for example. However, China is different – it runs a current account surplus, its overseas debt is low; the government still largely controls the banking system, and is taking many more steps to regulate the so-called 'shadow' banking system.
- The question facing President Xi, therefore, is where next? In 2018 does he regulate the economy more or liberalise more, reform key sectors more or expand the economy more? Interested investors should pay attention to the results of this autumn's Chinese Communist Party Congress.

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