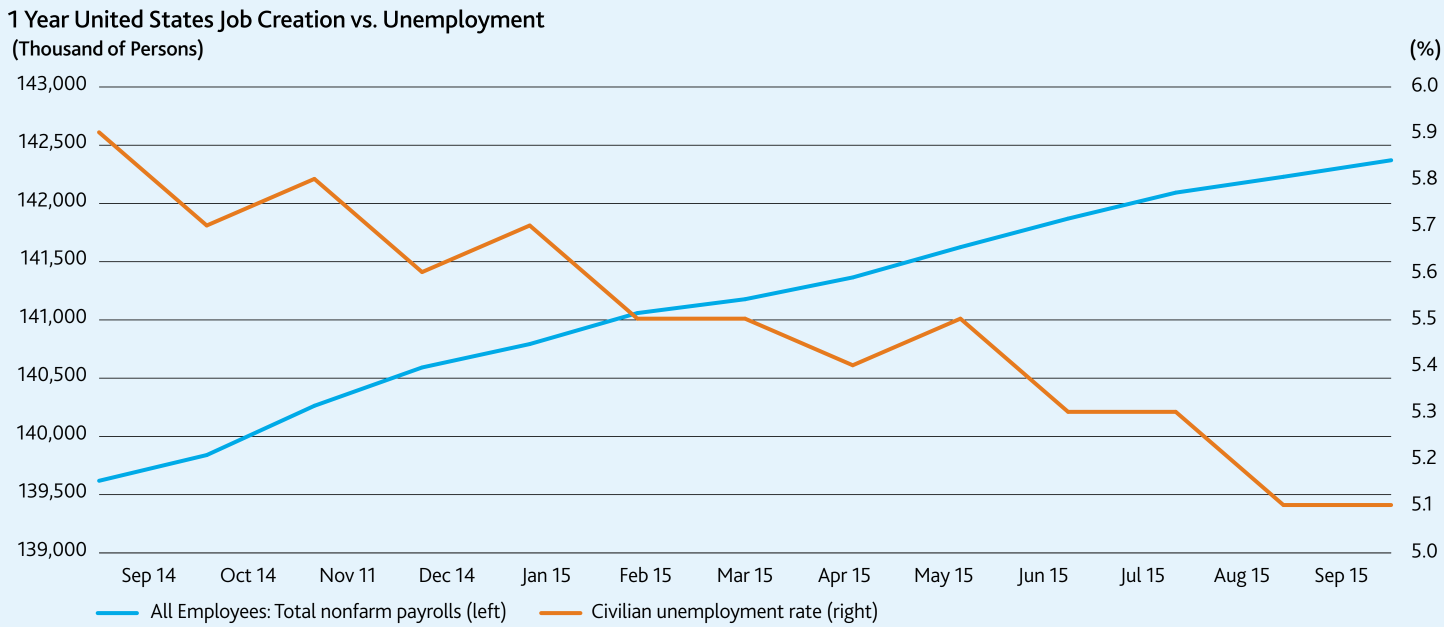
Global Investment Outlook

October 2015

US Interest Rates – where's the interest?



Source: Federal Reserve Bank of St. Louis (Economic Research Division), October 2015. For illustrative purposes only.

The chances of a U.S. rate rise this year have fallen sharply in recent months, and it's easy to see why. Disappointing trade data has lowered expectations for third-quarter gross domestic product (GDP) growth, while the latest Institute for Supply Management (ISM) manufacturing survey has confirmed that the sector is being squeezed by a strong U.S. dollar, falling commodity prices and slowing global activity. Additionally, September's labor market numbers–the most widely watched piece of economic news on the month–were significantly weaker than expected, raising fears that the resilience of U.S. domestic demand may no longer be offsetting the impact of financial market turbulence and disappointing global growth. So are these fears justified, and what is the outlook for U.S. interest rates?

September's jobs report was comprehensively downbeat. Non-farm payrolls rose by just 142,000, well below expectations of 201,000. Payroll numbers for previous months were also revised downward. The unemployment rate remained at 5.1%, but only because labor-market participation fell. Wage growth also stagnated on the month.

These factors, alongside subdued payrolls, flat earnings and a small drop in the length of the average working week, meant that aggregate income also fell for the first time since the end of 2013. We believe that if these trends continue, U.S. domestic demand would suffer given it is primarily driven by household spending.

In response, investors sharply marked down the chances of the Federal Reserve (Fed) raising rates this year, despite its declared desire to do so. Bloomberg futures trading data estimates the likelihood of a move at the end of this month is now only 8%, down from 18% before the jobs report was published. A 34% probability is placed on Fed action by the end of the year, and it is not until March 2016 that investors are judging the chances of a rate rise to be better than 55%.

The negative data is not the whole story. Jobless claims numbers, published on a weekly basis, are showing no signs of trending up.

The Conference Board confidence index rose last month, led by gains in its labor market components. Employment-based tax receipts are still expanding at a solid annual pace of around 5%. Light vehicle sales have just reached a new 10-year high, and home sales indicators are still generally rising. The ISM Index for the non-manufacturing sector – which accounts for over 80% of U.S. economic activity–remains in solid expansion territory. Taken together, the ISM indices point to an economy still growing at a perfectly respectable 2.5-3.0% annualized pace as it enters the final quarter.

It seems unlikely that the Fed will be able to reconcile all the conflicting evidence before its meeting at the end of October. Whether or not it will be in a better position to raise rates by December remains in the balance. By then, it will have had the benefit of two more jobs reports.

These should give some helpful clarity, not only by providing estimates for the expansion in payrolls in October and November, but also in revisiting and revising September's performance as new information becomes available. Because September's report is based on a less-than-full sample of data at this stage, it is subject to considerable uncertainty. The estimated pick-up in payrolls last month may be 142,000, but government statisticians admit that they can only currently be confident that the figure lies somewhere between 37,000 and 247,000. Even then, there is a one-in-ten chance that the true number sits outside this range. For Fed decision-makers, this means the difference between a jobs market in the doldrums and one that is booming.

Investment Strategy

There was no change to our investment strategy in October. We remain modestly overweight to equities relative to fixed income and cash. Regionally, we have a preference for European ex-UK equities, closely followed by Japan and the U.S. In fixed income, we maintain an underweight stance to the asset class comprised of an underweight position in domestic and overseas government bonds and slightly overweight positions in global high-yield corporates and UK investment-grade bonds. Although equity markets declined in September, we are not persuaded that they yet offer convincing levels of undervaluation and have not increased risk assets.

Market Commentaries

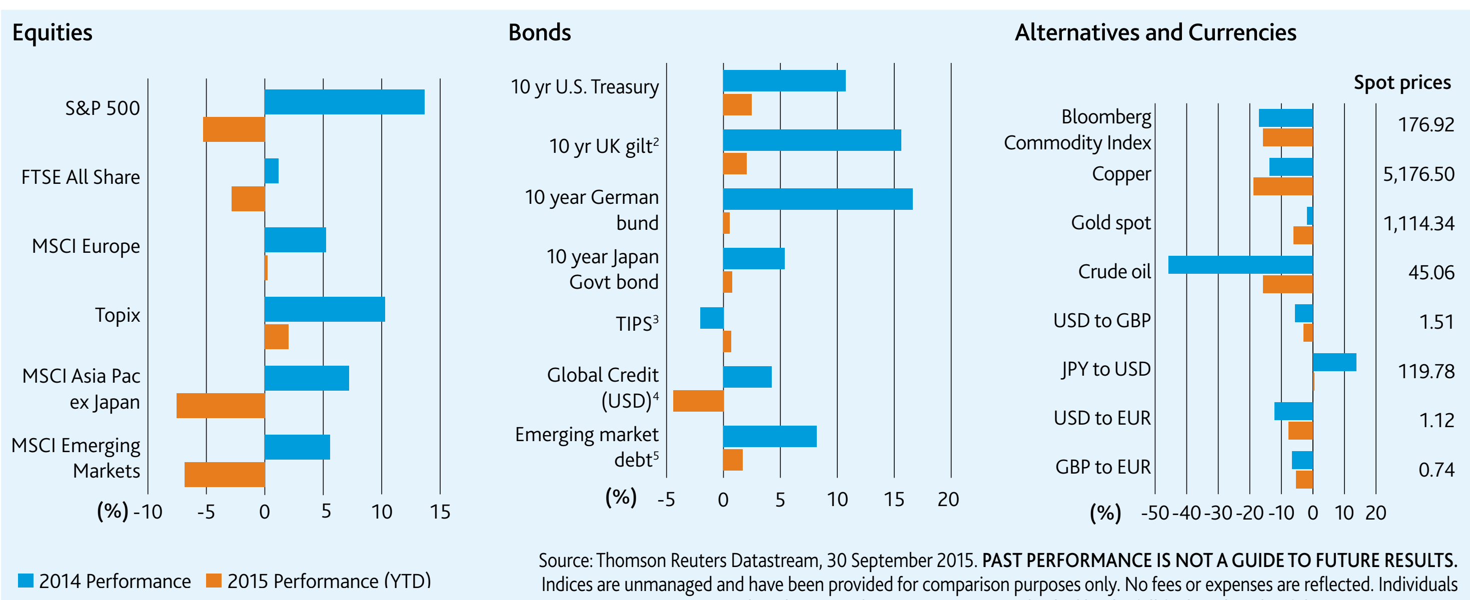
U.S.

All eyes were back on the Fed in September ahead of a potential interest rate rise. Alas, it was not to be. Although record low levels remain, Fed Chair Janet Yellen has refused to rule out the possibility of an increase before the end of the year.

U.S. second-quarter (Q2) GDP growth was revised up to 3.7% annualized from an initial 2.3%, reflecting a broad-based expansion. As a result, we have revised up our 2015 growth projection to 2.5% (from 2.3%) and remain at an above-consensus 2.8% for both 2016 and 2017.[1] Annual weekly earnings growth has rebounded to 2.4%, the strongest pace since February. Employment data delivered mixed messages as jobs added to the economy fell short of expectations, while the unemployment rate was at its lowest level since 2008. Wage growth should firm further, supporting consumption and the housing market, as well as business confidence. Domestic strength was outweighed by heightened market volatility, global slowdown worries, U.S. dollar strength and downside inflation risks in the minds of the Fed's rate setting committee, which left rates unchanged this month. We expect the pace of future rate increases to be very restrained relative to past experience.

U.S. equities fell over the course of the month, in line with other global markets. The U.S. healthcare sector took a particularly strong hit as politicians started questioning recent price hikes within the pharmaceutical industry.

Market returns (local currency, total return)



Source: Thomson Reuters Datastream, 30 September 2015. **PAST PERFORMANCE IS NOT A GUIDE TO FUTURE RESULTS.** Indices are unmanaged and have been provided for comparison purposes only. No fees or expenses are reflected. Individuals cannot invest directly in an index. U.S. Treasuries are backed by the full faith and credit of the U.S. Government.

[1] Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially

[2] Bonds that are issued by the British government and generally considered low risk. Gilts are the U.K. equivalent to U.S. Treasury securities.

[3] Treasury Inflation Protected Securities (TIPS) - A treasury security that is indexed to inflation in order to protect investors from the negative effects of inflation.

[4] As measured by the Barclays Capital Global Aggregate Bond Index provides a broad-based measure of global investment-grade fixed-rate debt markets.

[5] As measured by the JPM GBI-EM Global Diversified Total Return index

For the second month in a row, speculation over the timing of a U.S. interest rate rise dominated bond-market movements. The inconclusive U.S. employment report message and the mixed nature of U.S. data left most investors none the wiser as to the Fed's intentions. Fixed-income yields declined over the month, with the yield on the 10-year U.S. Treasury down from 2.20% to 2.06%.

Europe

In the Eurozone, the fallout from the Volkswagen emissions scandal continued to put pressure on regional markets. While European equities as a whole deteriorated over the month, the emissions scandal had particularly negative repercussions across the rest of the sector. In Spain, Catalonian separatist parties won a majority of seats in regional party elections, but crucially failed to gain an overall majority.

Data revisions have shown that the Eurozone recovery in the first half of this year was stronger than previously estimated. Survey-based activity measures point to continued momentum into the third quarter (Q3). Therefore, while risks remain, we have revised up our growth forecast for this year to 1.6% (from 1.5%) and retain our modestly above-consensus growth outlook for the Eurozone for 2016-17. Given recent energy price falls and the improving labor market, the outlook for household spending is supportive. Meanwhile, rising profit growth, improved access to bank finance and healthy business confidence all point to a continued investment recovery. However, global financial strains, inflation teetering on negative territory and the recent strengthening in the euro exchange rate are all concerns for European Central Bank (ECB) President Mario Draghi.

European equities continued to weaken following the August market turmoil. The Financial Times and the London Stock Exchange (FTSE) Europe ex-UK Index declined 2.1% in euro-denominated currency, total return terms. Swiss mining company Glencore, which has been under pressure to strengthen its balance sheet, faced renewed concerns about its creditworthiness.

Mario Draghi made comments that highlighted a policy divergence between the ECB and other world central banks. With one eye on the slowdown in China and emerging markets, Mr. Draghi stressed the ECB's willingness to increase the "size, composition and duration" of its bond- buying program to boost growth in the event the Fed stayed its hand, opting to postpone an interest rate increase until December at the earliest. The 10-year German bund yield fell from 0.79% to 0.59%.

UK

UK interest rates also remained unchanged this month at 0.5%. This was an unsurprising decision given that goods exports fell to their lowest levels since 2010. Total manufacturing output declined to negative levels for the first time in two years.

In the UK, our forecasts for GDP growth in 2015 and 2016 are unrevised at 2.6% and 2.8%, respectively.[6] The domestic economy should continue to perform strongly, driven by consumption and business investment. By contrast, the external outlook is challenging. After a one-off boost in Q2, net trade is set to become a drag on growth again.

We expect Consumer Price Index (CPI) inflation to remain close to zero until the latter part of this year. Thereafter, inflation should start to rise back above 1% as the base effects associated with lower oil and food prices drop out of the comparison. The tightening labor market is starting to put upward pressure on wages, but the pass-through to inflation has so far been muted as productivity has also rebounded.

With the Monetary Policy Committee split three ways (Ian McCafferty voting for higher rates; Martin Weale and Kristin Forbes biased to tighten but needing more evidence; and the majority still some way from voting to raise), the outlook is very uncertain. The first rise could come next February, but the risks of delay, perhaps until May, have risen.

The UK equity market, as represented by the FTSE 100 Index, remained relatively flat in September, gaining 0.1% in local currency, total returns terms. Building materials distributor Wolseley surprised investors by lowering its sales forecast for the first half of the year and cutting sales forecasts. The UK gilt yield was down from 1.95% to 1.76%.

Japan

Japanese GDP contracted by 0.3% in Q2, but should still expand by 0.8% over 2015 as a whole, and by 1.8% in 2016. Labor market earnings were disappointing in Q2 but prospects are better for the second half of the year and beyond. Alongside the bringing forward of spending ahead of the consumption tax hike in 2017, that should help consumption growth to strengthen. Robust corporate earnings growth means that business investment should also rebound later this year. By contrast, with 20% of goods exports going to China, net trade is likely to make little contribution to growth. The target measure of Consumer Price Index inflation stood at zero in July and there is a chance that it will turn negative in the coming months. Even after energy base-effects drop out of the annual comparison, the Bank of Japan is unlikely to achieve its 2% inflation target in the foreseeable future. We therefore expect the pace of quantitative easing to be stepped up, possibly as soon as November.

The Japanese equity market Topix index declined 4.5% in September, erasing most of the gains achieved earlier in the year leaving it just 0.7% higher year-to-date. Japanese Government bond yields declined from 3.73% to 2.74% in September in contrast with other core economies.

China

Downward pressures on the Chinese economy remain significant. Industrial production and investment growth slowed in August; expansion in the services sector may be easing; and capital flight is putting upward pressure on market interest rates, resulting in a tightening in financial conditions. In light of the poor export performance and downward pressure on the exchange rate, the authorities may allow the renminbi to weaken by up to 10% to 6.8 against the dollar over the next year. We also expect further interest rates cuts and a lowering of the reserve requirement ratio for commercial banks. That should help avert a 'hard-landing', but we still expect GDP growth to fall below 6% in 2016. Moreover, weakness in China is contributing to a generalised negative picture in wider emerging markets, predominantly through weaker commodity prices.

[6] Forecasts are offered as opinion and are not reflective of potential performance, are not guaranteed and actual events or results may differ materially

After the previous month's stock market rout, investors remained focused on China in September. Fortunately, news coming out of the country was received slightly more positively this month. An announcement by Chinese authorities of new economic policy measures helped to boost sentiment. Investors also took cheer from Premier Li Keqiang's statement that China is "not interested in a currency war".

Aberdeen Global Strategy Team, Investment Solutions

Aberdeen Asset Management Inc.
1735 Market Street, 32nd Floor
Philadelphia, PA 19103
Telephone: (800) 485-2294
aberdeen-asset.us

Aberdeen Asset Management Inc.
161 Bay Street, 44th Floor
Toronto, Ontario M5J 2S1
Tel: (416) 777 5570
aberdeen-asset.ca

Ref: 23776-051115-1
020064-1115-PHL
SEG-GIO