Outlook 2015

December 2014

Aberdeen

Foreword

This booklet is a collection of themes which we think will be important in 2015. Many of them are not necessarily new and will be relevant beyond then as well – this is a reflection of our approach to investing. We prefer to take our time when making decisions about where to put our clients' money. Any new year will inevitably contain uncertain events. Rather than guess what those events might be, we prefer to think about the longer-term trends which will have a bearing on the investments we make. Those looking for crystal ball predictions will probably be disappointed but we at least hope to give pause for thought.

Contents

Is there more debt, less debt? And does it matter?	3
US: it wasn't supposed to be like this	4
Growth pains…	6
Back to normal: why Asia shouldn't be afraid of normalisation	8
A taxing issue	10
What harm does rising inequality do?	11
Horizon gazing	12
Eurozone lessons: the good, the bad and the structural	14
M&A: the bulls are back in town	15

Is there more debt, less debt? And does it matter?

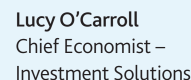
Has the world economy become addicted to credit?

Looking over the past 25 years, it might appear so: the collapse of the Japanese credit boom after 1990 was swiftly followed by the Asian crisis of 1997; ten years later, the global financial crisis hit the economies of the US and Europe hard; and China continues to face challenges from debts built up in its attempt to offset the loss of export earnings following the 2007-08 crisis. The overall impression is that without an unsustainable credit boom somewhere in the world, the global economy is incapable of generating enough growth to absorb all the available supply. Credit, it seems, is like running water. If you let it build up, the dam will eventually burst.

In the aftermath of the global financial crisis, there has been much talk of deleveraging: the slow process of paying off debts built up in previous years. This may be the talk, but it is not the reality. Looking at the world economy overall, the total burden of global debt (private and public), which rose from 160% of national income in 2001 to nearly 200% in 2009, has now reached 215% according to a recent Geneva Report on the world economy. Until 2008, this expansion was led by the advanced economies; since then, the emerging economies have picked up the baton. Even within the developed world, the burden of debt has shifted rather than fallen. In the US and UK, financial sectors have deleveraged, as (to a lesser extent) have households. Public debt has, however, risen sharply as a share of national income. Rather than lowering the credit waters, we have simply diverted the flow to back up behind another dam.

Does this matter?

Arguably, if the government's balance sheet is more robust than that of the private sector, such shifts can make sense if they prevent recession becoming depression. But the lack of global deleveraging is troubling, given the damage that credit cycles can cause. The 2007-08 financial crisis, for example, has resulted in not only a drop in output but also a fall in the potential growth rate of the eurozone (and possibly also the US and UK) that could prove durable. Such a permanent loss of future growth could reflect the fact that the pre-crisis trend was unsustainable; that falls in investment and innovation that tend to occur during deep recessions have impaired potential growth; and, importantly, that debt overhangs weigh on growth by increasing policy uncertainty and tax burdens. This could result in a vicious cycle of rising debt and weakening growth. Indeed, the recent Geneva Report on the world economy warned of a "poisonous combination of high and rising global debt and slowing nominal gross domestic product, driven by both slowing real growth and falling inflation".



Lucy O'Carroll
Chief Economist –
Investment Solutions

This lack of deleveraging has implications for the global economy in the years ahead. Policy-makers still have much to do to minimise the risk of future crises through (for example) the use of macro-prudential policies and banking-sector recapitalisation. In addition, the chronic effects of high leverage are likely to continue to hamper the world economy, underpinning its steady rather than stellar recovery path.

The global debt position is, by definition, a global issue that requires a co-ordinated response from international policymakers if it is going to be managed effectively. If you like, a way of channelling credit in such a way that avoids dams building and blowing up. Their challenge is a substantial one, however: water is not an easily controlled substance.

> "The chronic effects of high leverage are likely to continue to hamper the world economy"

US: it wasn't supposed to be like this

Modern-day slumps in countries with stable political systems are supposed to last for a couple of years, before policy makers step in to ease financial conditions and return countries to strong and steady expansion.

Modern-day slumps in countries with stable political systems are supposed to last for a couple of years, before policy makers step in to ease financial conditions and return countries to strong and steady expansion. But despite its spurt in mid-2014, the US economy shows little sign that it can go back to the 3%-plus average growth it enjoyed before the 2008 crash – without, at least, extremely low interest rates. The slow-flowing river of US economic performance has sparked talk that secular stagnation – a situation of permanently lower growth – is lurking somewhere in the depths.

That talk is probably right. We can no longer blame America's problems on a series of unfortunate events that started with the bursting of its housing bubble. Its difficulties are much more profound.

Investors should also understand that the sinister beast of secular stagnation has two heads. The supply head of this hydra – the slow increase in the capacity of the economy to produce – is scary. But it's the demand head that we should really be nervous about – the possibility that low investment is hitting demand, and hence output and employment.

There is some evidence that the US is beset by secular stagnation of supply. Its productive capacity has ceased to grow fast. Most women have now entered the workforce, four in ten young Americans are college-educated, and the great outsourcing of production to China has run its course. Because these tailwinds no longer exist, the potential growth rate – the speed at which the US economy can expand without stoking inflation, after it's used up the capacity left idle after the 2008 crash – is a mere 2 or 2.5% according to central bank figures.

If the US Federal Reserve (Fed) only had to fret about supply stagnation, then you could expect at least one rate rise in 2015, as it acted to prevent demand from outpacing the economy's rather limited ability to produce.

This would, however, be the worst possible thing to do if the Fed is worried about stagnation in demand. This occurs when the desire to save is high and the financial system is in some way impaired leading to money sitting on the sidelines as savings, rather than being invested in the real economy to build factories, hire workers and so on.

"We can no longer blame America's problems on a series of unfortunate events"

There are certainly global forces reducing the incentive to invest in the US economy. The world is awash with savings, from the eurozone, China and elsewhere. This reduces investment returns, since there is too much money chasing too few opportunities. The growth of the virtual economy is also restricting outlets for investment. How much money will it take to develop Snapchat, the photo messaging service, into a huge global player? Much less, in real terms, than it took to build IBM.

Moreover, the curious behaviour of the US economy is consistent with stagnation in demand. Inflation has remained low for decades, despite falling interest rates. Although unemployment has declined, there is considerable 'underemployment' – people not able to work as many hours as they want.

Luke Bartholomew
Global macro investment manager

There is, therefore, a strong chance that demand stagnation exists. That should be enough to make the Fed concentrate on this hydra head, because the distressing thought is that if the US is stuck in demand stagnation, it will be very hard to get out of it. The conventional way is by cutting interest rates, to make investors take their money out of the bank or government bonds, and invest it in companies instead – but Fed rates are already close to zero. If the Fed raises rates, demand will be damaged even more. That could lead to deflation, which lands economies like the US with high debts, into trouble, since the decline in income makes it harder to pay them.

The Fed probably realises that demand stagnation is Public Enemy Number One – and that it will respond by keeping rates low for a long time.

What does this mean for investors? Bond yields will remain slim. Low interest rates will support equity prices, by putting a cap on corporate borrowing costs. However, there is not much further for debt yields to drop or equity prices to rise, because values are already at such high levels. The era of outsized returns is over – making good individual security selection all the more important.

Growth pains…

Richard Dunbar
Deputy Head of
Global Strategy –
Investment Solutions

The end of 2014 saw equity markets wobble as investors pored over poor economic data from Europe and Japan, and as terms such as 'disinflation' and 'secular stagnation' started to appear more regularly in the investment lexicon.

However, history has shown that strong gross domestic product (GDP) growth does not necessarily translate into healthy investment returns. Equally, as investors it shows us that we need not fear some of the gloomy scenarios noted above.

The link between GDP growth and investment returns (or lack thereof) has been examined extensively in the world of academia. Jay Ritter in his 2004 paper, and Dimson et al in their 2002 paper, both analysed returns over the preceding century. Ritter says most investors believe that economic growth benefits shareholders. But his study finds that the cross-country correlation of real stock returns and per capita GDP growth is actually negative.

Growth ≠ profits

Looking back over past decades, empirical illustrations of Ritter's observations are easy to find. In virtually every corner of the world, higher savings rates have led to an application of new capital, resulting in economic growth. In the emerging markets, growth has been generated by the more efficient utilisation of

labour (mainly via urbanisation, a phenomenon mentioned in virtually every developing-market strategy note). But that growth has not always translated into higher returns for the original owners of equity capital.

Fellow academic Jeremy Siegel did similar research over a shorter time period – from 1970 to 1997 - finding the same negative correlation. One reason, he suggests, is that the largest firms on an exchange may be multi-nationals. Such companies' profits depend on worldwide, rather than domestic, economic growth. This is certainly the case in the UK, where two-thirds of FTSE 100 company profits are generated overseas.

So who's reaping the benefits of economic growth?

Substantial shares of economic growth often also accrue to companies' management and staff rather than to shareholders. Should you doubt this, ask any long-term investor in the investment banking industry – or read the weekly *How To Spend It* supplement in the Financial Times.

Ritter also emphasises the importance of corporate governance. Poor governance is a plausible explanation for GDP growth failing to feed through to investor returns. Russia's a good example. Investors in the world's largest kleptocracy only need to head to the marinas of Monaco and St Tropez to see where much of the return from that country's growth story ended up.

Ritter is not asserting that growth is bad – far from it. He cites a close correlation between higher per capita incomes and longer life spans and lower infant mortality. But he is reminding us that shareholders may not be the beneficiaries of this forecast growth. It's a heads-up to investors – do your homework, and don't assume that all this GDP growth will end up in your investee companies' profit and loss accounts.

Impact on our portfolios

So as we head into 2015 we will watch with interest the efforts of central bankers and legislators around the world, as they continue to pull the levers of this massive monetary experiment, which is quantitative easing. As in 2014, there will undoubtedly be periods where investors believe, and periods where they disbelieve in the efficacy of these policies.

And as ever, past performance is no guide to the future. But as Ritter and others argue, the performance of the economy in which a company is doing business may not be much of a guide either.

Back to normal: why Asia shouldn't be afraid of normalisation

Flavia Cheong,
Investment Director,
Equities - Asia

Earlier this year Steve Forbes co-authored a book called *'Money: How the destruction of the Dollar Threatens the Global Economy – and What We Can Do About It'*. Prominent on the cover is the image of a battered one dollar bill with a savage tear that threatens to consume the portrait of George Washington at its centre.

And yet, as we look towards 2015, the prospect of a US dollar in terminal decline is far from our thoughts. The dollar has strengthened against most major currencies this year. Within six months we expect the dollar to trade at its strongest levels against the euro since Europe's sovereign debt crisis. Against the yen, we forecast the US currency to be the strongest since December 2007.

Behind this call is an expectation the US will recover faster than other major economies which will allow the central bank to raise interest rates in mid-2015. This would be the first time the US central bank has raised rates since 2006 and represents the so-called 'normalisation' of US monetary policy following the end of quantitative easing – the controversial financial stimulus programme designed to support shaky markets after the global financial crisis.

What also makes the dollar (and assets denominated in the currency) more attractive is the divergence of US central bank policy from that of the European Central Bank (which is contemplating further stimulus that will weaken the euro) and the Bank of Japan (where a weak yen forms a central component of Prime Minister Shinzo Abe's economic policies).

With US assets in favour once again, the argument goes, international investors will pull money from so-called 'riskier' investments in emerging markets. We saw a dress rehearsal last year after former Fed chairman Ben Bernanke raised the prospect of an end to stimulus policies.

As long time fund managers in Asia, we are carefully watching the anticipated shift in US central bank policy. Uncertainty over the exact timing and questions surrounding the strength of the global recovery has already triggered the return of market volatility after a prolonged period in which volatility had been notably absent.

However, we're quietly confident Asian markets will prove to be resilient. One of the most important consequences of last year's 'tantrum' was that emerging markets underwent an adjustment process: current account deficits – largely driven by the degree to which imports exceed exports – are now smaller (or at least not bigger); real interest rates are turning positive; and real exchange rates have depreciated (helping to curb imports and manage deficits).

For example, India's stocks and currency have recovered from sharp falls last year. Granted, much of this has been due to election euphoria on hopes Narendra Modi, the new pro-business prime minister, will champion much-needed reforms. However, the country has also made significant strides in addressing those signs of economic weakness that had been behind investor concerns.

Indonesia, another of the so-called 'fragile five' emerging economies most affected by last year's 'tantrum', has also managed to restore monetary policy credibility but still faces headwinds. While sentiment has improved Joko Widodo, the country's new president, must tackle political resistance to his reform agenda.

Higher interest rates and a stronger dollar may mark the end of the benign investment environment that has been a hallmark of much of the post-financial crisis era. However, it would be wrong to conclude that a stronger dollar is automatically bad for emerging market stocks.

A look at the relationship between emerging market equity performance (relative to developed markets) and the strength of the US dollar over the past quarter century shows long periods – in 1993, 1999, 2005, 2010 – when emerging markets outperformed despite dollar strength. Therefore the correlation is, at best, casual.

The normalisation of monetary policy is based on the assumption of a sustainable US economic recovery which bodes well for Asian exports growth. This is set to benefit almost every economy in the region. Despite a couple of high-profile exceptions, most run a current account surplus – one of the reasons we continue to like Asia as an investment destination.

We believe the long-term benefits outweigh the inevitable short-term pain. Due to the central bank policies of Hong Kong and Singapore, low US interest rates have been mirrored in both markets, encouraging speculation that helped create two of the most expensive property markets in the world. Interest rates at 'normal' levels should lead to more productive investments.

The end of financial stimulus policies isn't a bad thing. They have made a mockery of traditional methods of gauging value and risk. Their demise will drain markets of speculative capital and signal a return to investment fundamentals and the search for quality.

Markets will be better off in the long run.

"With US assets in favour once again, the argument goes, international investors will pull money from so-called 'riskier' investments in emerging markets"

A taxing issue

You don't often see the words 'tax' and 'interesting' in the same sentence, but the topic has been making more and more headlines of late.

Richard Dunbar
Deputy Head of
Global Strategy –
Investment Solutions

Starbucks was one of the companies to gain the most (unwanted) attention after it emerged that despite the millions of lattes bought from its ubiquitous coffee shops, it had not actually sold enough of the milky brew to necessitate the payment of any corporation tax. The fact that the justification for the low UK profitability was payments to a Dutch subsidiary for image rights and premium purchases from a Swiss subsidiary for its coffee beans, not surprisingly, did not engender much sympathy from the Great British public. In the end, the company "volunteered" to pay an extra £20m to the UK exchequer.

On the other side of the pond, 'tax inversion' has become the favourite phrase in the investment banking lexicon. This is a financial wheeze where one of the main pillars of the economic logic of an acquisition is the ability to re-domicile the new combined company in the (lower) tax jurisdiction of the target. Hence the recent deals between Abbvie/ Shire, Burger King/Tim Hortons et al. Not surprisingly, this strategy has not found much favour with the legislators on Capitol Hill. In fact their huffing and puffing has given some executives cold feet, as evidenced by AbbVie pulling its bid for Shire, the UK pharmaceutical company.

Tax, and the imaginative ways that companies find to avoid paying it, was top of the agenda at the G20 meeting in Brisbane – a meeting that has previously highlighted the public's growing hatred of multi-national corporations.

Despite the outrage expressed by politicians about the lack of tax paid by big companies, when they return home from these global talking shops they all seem keen to compete with each other to be 'business friendly'. The UK government has cut corporation tax from 28% to 20% this year to incentivise its companies and to perhaps attract some new ones to its shores. Ireland remains at the vanguard of low corporation tax rates in an attempt to re-awaken the Celtic Tiger, much to the chagrin of their eurozone 'partners' who continue to seek some economic awakening themselves. So politicians seem to have a bit of a split personality when it comes to taxation – albeit this is not a particularly unusual type of behaviour for our elected elite.

However, what seems certain as we look into 2015 is that the debate about what is a 'fair' rate of tax will continue to rage. The anger directed towards global multi-nationals is real and widespread. Their voluntary tax payments would seem to suggest that they acknowledge this and worry about it – particularly those who are vulnerable to the wrath of the end consumer (a la Starbucks).

This debate as to what is fair also chimes with the discussion raging on both sides of the Atlantic as to where the spoils of the nascent economic recovery currently reside and where they should be directed. The lack of real wage growth will remain an issue in 2015, particularly when many see economic growth as having been fuelled by a massive wealth transfer from the public to the private sector in the form of quantitative easing. It would appear that the majority of the populace who are seeing their living standards fall are not feeling that the word fair is one that chimes with their situation. Expect their elected representatives to do something about it.

This debate featured in the mid-term elections in the United States and it is certain to be one of the subjects at the core of the UK election in May. So expect 2015 to herald further debate about what is a fair rate of tax, the responsibilities of multi-nationals to the countries in which they do business and the appropriate distribution of the fruits of any economic recovery.

My confidence in these assertions is bolstered by reflecting on a year where (in my opinion) the most important and influential business commentator was not Sir Martin Sorrell or Lloyd Blankfein, but Justin Welby, the Archbishop of Canterbury – a churchman whose thoughts on subjects ranging from taxation to quantitative easing have been listened to with renewed interest, by public and policy makers alike.

What harm does rising inequality do?

Lucy O'Carroll
Chief Economist – Investment Solutions

Inequality in the developed world, particularly the United States, has risen more in recent decades than at any time since the 19th Century, according to a paper by the US central bank.

The same paper found that, after adjusting for inflation, the average income of the top 5% of US households rose by 38% between 1989 and 2013, whereas the real incomes of the remaining 95% grew by less than 10%. The distribution of wealth is even more unequal than that of household income, and wealth inequality has risen even faster. In 1989, the wealthiest 5% of US households held 54% of total wealth, but by 2013 this had risen to 63%; by contrast, the lower half of households held only 3% of total wealth in 1989 and a mere 1% by 2013.

Why has this happened?

Labour-market specialists have pointed to an increasing dispersion of wage rates between high- and low-earners, with fewer in the middle. A number of influences may be at work, including technological change that has been harnessed to the benefit of high-paid workers, while creating redundancy in mid-skilled jobs and dampening the pay prospects of the low-skilled.

Globalisation, declining union membership and tax policies may also have played a role. Quantitative easing (QE), the unconventional purchase of government bonds by a central bank, introduced in the wake of the 2007-08 financial crisis may have had an impact more recently, too. Central banks have created billions of US dollars, yen and sterling to buy financial assets; by raising asset prices, and therefore household financial wealth for those holding such assets, inequalities have arguably been exacerbated.

Maybe this does not matter. After all, a degree of inequality in income and wealth would occur even with completely equal opportunity because variations in effort, skill and luck will produce different outcomes. Indeed, some variation in income and wealth arguably creates incentives to work hard, get an education, save, invest and undertake risk – thereby contributing to economic growth. And central banks would argue that without QE, most people would have been worse off as deeper and longer-lasting recessions resulted in low growth and high and persistent unemployment.

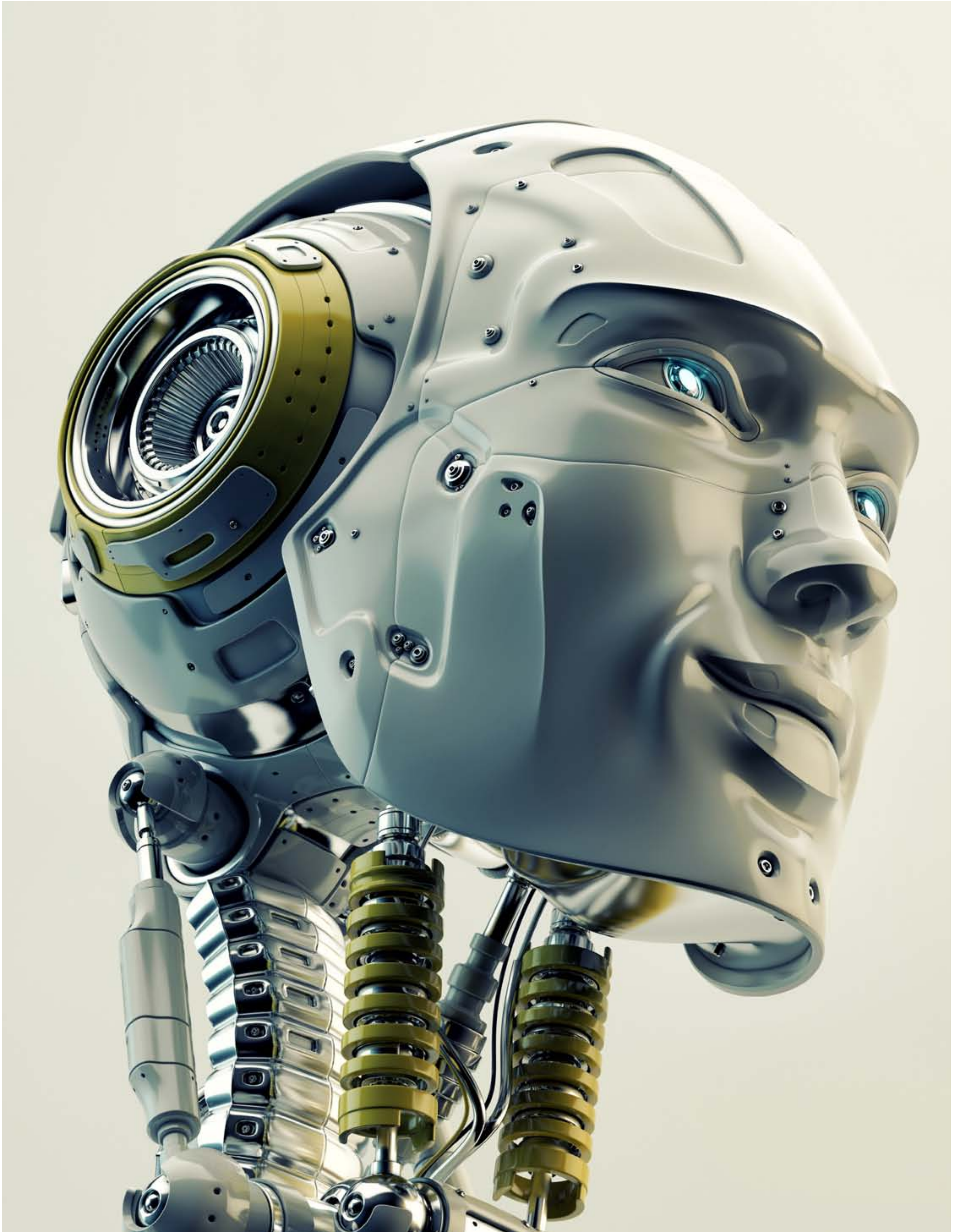
Beyond a certain point, however, inequality can harm longer-term growth prospects by weakening demand and lowering productive potential. On the former, households were able to fund consumption before the financial crisis by borrowing on the back of rising house prices, even at relatively modest incomes. Falling house prices and high debt levels have contributed to an unusually weak and prolonged period of recovery in the years since the financial crisis.

Looking further ahead, the demand base of the US domestic economy could be permanently weaker, in the absence of another credit bubble, since households with higher income and wealth tend to have a lower propensity to spend than their low-income counterparts. As for economies' productive potential, it may be weakened by rising inequality as access to education is constrained to those who can afford it - leading to a lower-skilled and less economically mobile labour force in the process.

Given the recent rise in inequality, the point at which it becomes detrimental to growth may be coming closer.

What can be done to arrest the trend? Four 'building blocks' – identified by Janet Yellen, Chair of the US Federal Reserve – provide a starting point: improving the resources available for children during their most formative years; ensuring affordable access to education; providing a positive environment for business creation, since business ownership can be a source of opportunity for households to improve their economic circumstances; and recognising that inheritances, while concentrated at the top of the wealth distribution, can also provide a helping hand to less wealthy households. While the first two of these building blocks are well-known and commonly prescribed, the final two are less so.

Looking ahead, policies to encourage entrepreneurship and inter-generational wealth flows may therefore have greater economic benefits than previously recognised.



Horizon gazing

In a world of economic debates centred on whether interest rates will change in one quarter or another, driven by the latest piece of labour-market data or central bank pronouncement, thinking can become very short term in nature.

This is a pity, since it overlooks the fact that the world economy will undergo huge changes in the decades ahead – and that these changes will have important implications for investors.

The developments will be many, but let us consider just four for now.

First, the composition of global gross domestic product (GDP) is likely to change substantially. Given their higher growth rates, activity appears set to move towards countries outside the OECD group of advanced economies, particularly those in Asia. The combined GDP of China and India, for example, is forecast to rise from 33% of the OECD level in 2010 to 73% by 2060 according to the OECD Economic Outlook 2014. And having accounted for around a quarter of global GDP at the beginning of the century, Asia's share is expected to stabilise at around 45% by the 2050s. This is reflected in the ranking of the top five countries by GDP by 2060, on the OECD's projections: China, the US, India, Japan and Indonesia (with China leapfrogging the US and Indonesia, currently ranked 15th, replacing Germany).

Second, countries in similar economic positions at present may experience contrasting fortunes on a longer-term horizon. Differences in labour efficiency and employment participation, capital intensity and access to education can all influence country outcomes. South Korea, for example, is projected to gain most in terms of GDP per head on the OECD's ranking by 2030, rising from 20th to 15th.This performance is mainly due to economic momentum built up as a result of improving labour efficiency and gains in human capital – the economic value of the population's skills, knowledge and experience. In contrast, Italy and Portugal are among those projected to slip down the ranking tables, given inertia from historically low labour efficiency and higher capital costs incurred during the eurozone crisis.

Third, the implications of the advanced economies' 'demographic time bomb' are overblown, since some of the challenges from ageing populations may be offset by greater labour-market participation. Over the next 25 years, this could be achieved in most OECD countries through already legislated increases in pensionable age; the positive effects of increased education; and established trends in female participation. Beyond 2030, however, further measures may be needed to ensure that retirement ages are keeping pace with trends in life expectancy.

> "The implications of the advanced economies' 'demographic time bomb' are overblown"

Finally, debate over the path of long-term interest rates tends to focus on 'renormalisation' of borrowing costs from current, exceptionally low, levels over the next three to five years. Looking a little further ahead, pressure on public finances in the advanced economies and the rise of high-saving, non-OECD countries suggest that the underlying trend is unlikely to be sharply upwards. Beyond 2030, however, the rise of high-saving countries relative to others could be outweighed by an anticipated decline in savings rates in all countries, as populations age; and by the 2050s the OECD expects a global saving shortage to put stronger upward pressure on global interest rates.

What are the messages for investors from such horizon gazing? First and foremost, these outcomes hinge on huge uncertainties. Long-term views on global saving and interest-rate trends are highly sensitive to

Lucy O'Carroll
Chief Economist –
Investment Solutions

future developments in China and India, since they account for more than one-third of global saving in aggregate. Indeed, the sheer economic size of these countries means that making correct economic 'calls' on them – no small challenge – is fundamental to meaningful long-term forecasting.

Our horizon gazing does highlight a number of potential economic and market opportunities, though. On the OECD's reckoning, for example, a faster-than-expected pace of regulatory reform could increase GDP in non-OECD countries by an average of 9% by 2030, and in the most restrictive advanced economies by 6% in the same period. Addressing structural labour-market rigidities in the developed economies could also produce substantial gains.

Other areas of potential gain include the benefits of improving access to education in the emerging markets, which could raise levels of GDP in China, India, Indonesia and South Africa by at least 10% – though such gains would inevitably take time to materialise.

Whatever the uncertainties, these potential shifts in global economic power suggest that the world will become a very different place over the next four or five decades. Acknowledging that such change will happen, rather than simply assuming that the current status quo will prevail, could provide long-term investors with a welcome edge.

Eurozone lessons: the good, the bad and the structural

Lucy O'Carroll
Chief Economist –
Investment Solutions

The eurozone has received a bad economic press in 2014, with concerns over its sluggish growth rates, the risk of deflation and scepticism over the ability of its policy makers to address its structural ills all contributing to negative market sentiment at various points during the year.

This year has certainly been a disappointing one for the region, in economic terms. While the vast majority of European economies returned to positive growth during 2013, raising expectations that the recovery was becoming more broad-based and self-sustaining, gross domestic product (GDP) growth struggled to gain momentum during the first half of 2014. Confidence indicators have fallen since mid-year, and are now back at their end-2013 levels, while hard economic data have been persistently weak. Growth appears to have been held back by a number of factors, including deleveraging pressures and a slow pace of structural and institutional reform.

Can the eurozone defy its critics and produce a robust recovery in 2015?

On paper, domestic demand in the region should increasingly benefit from very accommodative monetary policy, with European Central Bank (ECB) interest rates at floor levels and new asset-purchase programmes in place. These should improve the supply of credit. Alongside monetary stimulus, however, the eurozone's strategy – driven by Germany - consists of structural reforms and fiscal discipline. Both France and Italy are being encouraged to accelerate the first of these, structural reforms, to reignite growth in their lagging economies. Since they generate nearly 40% of activity in the region, their success would provide a substantial boost to the eurozone overall.

> "The rationale for structural reforms is clear cut but the outcomes and degree of political appetite for them are much less so."

Germany has a point. Its own 'Hartz reforms', introduced from 2003-05, are often cited by the likes of economic commantator Martin Wolf as a factor behind the country's improved labour-market performance. Germany's unemployment rate is currently 4.9%, less than half the average rate in the eurozone (11.5%). In addition, the post-crisis experience of both Ireland and Spain suggests that countries willing to swallow unpalatable reform medicine – including cuts in nominal pay, pension and other welfare provisions – can achieve stronger rates of economic growth. While the Eurozone overall grey by a modest 0.2% in the third quarter of 2014 according to Eurostat, the latest data from Spain's National Institute of Statistics shows a healthy 0.5% expansion and Ireland's Department of Finance confirmed an eye-catching 1.5%.

But can these economies really teach the eurozone's laggards a lesson?

Ireland may have closed the 'double Irish' loophole that allowed US companies to reduce their tax bills, but their strategy essentially remains one of competing on the basis of a low corporation tax rate; almost by definition, it is not an approach that all eurozone countries can (or would be able to) adopt. Spain's reforms have been pushed through by a government with a clear electoral mandate, a starting point of relative strength; the political backdrop in both France and Italy is complex and potentially more fragile. And while Germany's reforms may have improved its labour-market performance, they have not created dynamic demand. A contraction in GDP of 0.2% in the second quarter of 2014 may have been partly due to temporary factors, but Germany's domestic demand has expanded at a compound annual rate of only 1% in the past decade, as it has become increasingly reliant on demand from overseas to generate headline growth.

So while some of the eurozone's biggest players may need to undertake structural reforms, these alone will not generate stronger growth for their economies or the region as a whole. Indeed, structural reforms have a patchy record of success. Some countries have undertaken such reforms with mixed success (like Germany); some have made painful changes but ultimately appear to have benefited (like Ireland and Spain); while those who may need to reform the most appear unwilling to (Italy and France).

The rationale for structural reforms is clear cut but the outcomes and degree of political appetite for them are much less so. The weaker euro, continued monetary stimulus and a healthier global backdrop may help avoid deflation, but 2015 looks likely to be another year of sluggish recovery for the eurozone.

M&A: the bulls are back in town

Richard Dunbar
Deputy Head of
Global Strategy –
Investment Solutions

The world of mergers and acquisitions (M&A) enjoyed a frenetic burst of activity in 2014. Transactions reached $2.8 trillion in the first nine months of the year, a rise of 34% on the same period last year and the highest volume during this period since the heady days of 2007, according to Dealogic.

Healthcare, telecoms and real estate led the way, with an average deal size of $426m, $1.0bn and $241m respectively. So the poor investment bankers who have not had a Christmas for the last seven years have had a better time of things. But what is driving this and should the City's dealmakers be ordering in more champagne for 2015?

One of the driving forces behind the rise in dealmaking is that companies are awash with cash. US firms hold almost $2trillion of the stuff. Perhaps the recent desire to hoard folding ones should not have surprised us – the drying up of credit from banks and bond markets is still fresh in the minds of most company executives. A desire to be a little more independent of, what turned out to be, unreliable partners in the provision of capital is perhaps prudent. However, 2014 certainly saw finance directors loosening the purse strings.

There has also been real evidence of a pick-up in the fortunes of the US economy, a recovery that has been a long time coming. An uncertain economic outlook will, not surprisingly, have led to more caution in boardrooms. A steadier outlook for the world's largest economy has undoubtedly reduced the fear among executives that an economic downturn might make their M&A sprees suddenly look foolish. The US economy should continue its recovery. If this confidence takes hold, this nascent rise in boardroom confidence could well continue into 2015.

When it comes to M&A, company executives are as susceptible to the latest fad as any teenager. This often leads to an obsession with a particular sector. If one company heads off along the acquisition trail, its contemporaries often follow. And so in the revenue-challenged healthcare sector, M&A became the 'strategie du jour'. GSK, Novartis, Pfizer, Valient and AbbVie to name but a few, all embarked on transactions which, they assured us, would be value enhancing to their shareholders. This sheep-like (or lemming-like!) trend will certainly continue in 2015.

So which sectors might prove susceptible to the siren songs of the investment bankers in 2015? Revenue challenges may tempt some in the defence and oil sectors to buy some revenue and cut some costs. Perhaps even the banking sector, as it sees more capital and regulatory certainty, may see some activity. One certainty for 2015 is that the social media sector will continue to see deals at prices that I will leave to the connoisseurs, with more vision than I in this 'specialist' area, to justify.

Of course as we tip toe into 2015 we should remember that we have yet to see an M&A presentation by company management that did not promise nirvana for the acquiring shareholders. But the academics, and indeed painful experience, remind us that it will be the minority that take us to this heavenly plane. My most confident forecast is that the need for caution will not feature prominently in the bullish investment banking presentations being readied for their clients' January board meetings.

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

Important information
For Professional Investors only.
The above is strictly for information purposes only and should not be considered as an offer, or solicitation, to deal in any of the investments mentioned herein. Aberdeen Asset Managers Limited does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. Any research or analysis used in the preparation of this document has been procured by the Aberdeen Asset Managers Limited for its own use and may have been acted on for its own purpose. The results thus obtained are made available only coincidentally and the information is not guaranteed as to its accuracy. Some of the information in this document may contain projections or other forward looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document and make such independent investigations, as he/she may consider necessary or appropriate for the purpose of such assessment. Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither idem nor any of its servants or agents have given any consideration to nor have they or any of them made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document. Idem reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Issued in the EU by Aberdeen Asset Managers Limited ("AAML"). Registered in Scotland No.108419. Registered Office: 10 Queen's Terrace, Aberdeen, AB10 1YG. Authorised and regulated by the Financial Services Authority in the United Kingdom.

Registered in Scotland No. 82015. Registered Office 10 Queen's Terrace, Aberdeen AB10 1YG
121017925

Aberdeen