CHINA'S FUTURE

AIQ

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THE CHAIRMAN

How Xi Jinping is shaping China's future

AVIVA INVESTORS

Xi-Man: Master of the Universe?

During the Cultural Revolution of the 1960s, Xi Jinping was among millions of privileged urban youths sent to the Chinese countryside to work the land. The idea was to teach them lessons about the earthy authenticity of rural life. Unused to physical labour, Xi struggled; his fellow farmers rated his contribution a lowly six out of ten.

Over the last half-century, this scrawny teenager has risen through the ranks of the Communist Party to become China's feared strongman. In October, the National Party Congress in Beijing will inaugurate Xi's second five-year term as president and enshrine his status as the country's most powerful leader since Chairman Mao. The question now is what he will do with that power.

In our two-part cover story, we explore how Xi's administration is shaping China's future at home and abroad. Domestically, his biggest challenge will be to rebalance the economy away from risky debt-fuelled investment towards more-sustainable consumer-driven growth. Abroad, Xi is seeking to project Chinese influence through trade, investment and – if necessary – military force.

China is in a category all by itself when it comes to emerging markets. Elsewhere in this issue, we look at some of the major themes impacting other countries in the EM universe. Two external commentators, John Harrison of Trusted Sources and JS Smith of Ecstrat, offer opposing views for the outlook for emerging markets; while we also explore how reform and education impact economies and investment.

In our Big Interview, influential economist Pippa Malmgren shares her thoughts on Trump, Brexit and why technology can solve growing global inequality. Malmgren is not alone in linking inequality to the extraordinary monetary policy environment of the past decade. By fuelling asset price inflation, these policies have inadvertently widened the gulf between the haves and the have-nots. We look at both inequality and the risk of asset bubbles in separate features.

Other articles look at the illiquidity premium, global debt, and whether responsible investment is finally moving into the mainstream.

We welcome your feedback, so please send any comments to me at the email address below.

I hope you enjoy the issue ●

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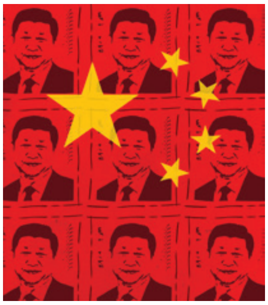


POLITICS AND THE FINAL FRONTIER

AARON GREHAN
Emerging Market Debt Fund Manager

A recent trip to Central America and the Caribbean revealed much about the attractions and pitfalls of frontier markets, explains Aaron Grehan.

Investing in frontier markets*, which are smaller and less liquid than established emerging markets, is not for the faint of heart. While the prospect of rapid growth is an obvious allure, understanding and monitoring the complex political issues that mould each country's outlook is critical, as I discovered during a recent visit to Costa Rica, El Salvador and the Dominican Republic.

> *"Understanding and monitoring the complex political issues that mould each country's outlook is critical"*

All three countries share a Spanish colonial heritage; are similarly endowed in terms of natural resources; and have relatively small populations.

Costa Rica, the most economically advanced with GDP per capita almost three times that of El Salvador, has enjoyed political stability and economic prosperity since a 44-day civil war in 1948. That led to the dissolution of the army, with military spending diverted into education.

The Dominican Republic, with GDP per capita around half of Costa Rica, has a tumultuous history but has been largely peaceful for the past 20 years, with governments generally following pragmatic and pro-business policies.

Meanwhile, El Salvador is a still-fragile democracy that bears the economic and political scars of the 12-year civil war that ended in 1992.

Cautious optimism over Costa Rica

Costa Rica has much to admire. A well-educated population – the constitution requires a minimum eight per cent of GDP to be spent on education – has helped create a flourishing service sector, as well as a value-add manufacturing industry. Annual GDP growth has averaged four per cent for the past decade, while foreign direct investment flows have averaged 7.5 per cent of GDP per annum since 2005.[1]

However, a lack of political cohesion has led to credit deterioration in recent years. Public sector debt has risen from 24 per cent of GDP in 2008 to nearly 50 per cent today; reflecting a deep, structural fiscal deficit that has remained unaddressed for years. Any adjustment is difficult given 95 per cent of expenditure is mandatory.[2] A fiscal adjustment of between 3.5 and four per cent is required to stabilise the debt, but an adjustment of only half that level can realistically be expected.

Presidential and congressional elections will take place in 2018. While it seems unlikely measures to address the deficit will be passed before the elections, finance ministry officials have warned that politicians need to act quickly before the situation becomes unsustainable.

Despite concerns over the deficit, state-owned entities in Costa Rica appear attractive given government guarantees and strong local investor participation. Long-dated government bonds also present opportunities given the steepness of the yield curve.

Dominican Republic: the safe bet?

The Dominican Republic has been a bright star in the frontier markets universe for some time. Unlike El Salvador and Costa Rica, the country benefits from a supportive political environment. The Partido de la Liberación Dominicana (PLD) has large majorities in both houses and President Danilo Medina was re-elected for a four-year term in 2016.

Growth is expected to reach over five per cent in 2017, according to the International Monetary Fund (IMF). Foreign direct investment, mainly channelled to tourism (which generated $25 billion in 2016) and increasingly

FIGURE 1: ECONOMIC INDICATORS 2016

	Costa Rica	Dominican Republic	El Salvador
Population (m)	4.86	10.65	6.34
GDP per capita (US$)	11,824.64	6,722.22	4,223.58
GDP growth rate (%)	4.3	6.6	2.4
Inflation (%)	2.3	0.8	0.5
Total debt service (% of exports of goods, services and primary income)	16	29.9	17
FDI (US$ m)	3,180	2,523	486

Source: World Bank 2016.

mining, is sufficient to comfortably cover the current account deficit of around three per cent of GDP. Meanwhile, a well-capitalised banking sector helps maintain financial stability.[3]

The construction of Punta Catalina, a coal-based electricity plant due to come online in 2018, will lower the country's dependency on oil and gas. By reducing transfers from central government to electricity companies, it should also boost public finances.[4]

The government is considering alternative financing for the project, which could result in lower debt issuance, a development that should support bond prices.

Risks worth watching include the rivalry between two main factions in the PLD and any further fallout from an ongoing corruption scandal. Around a dozen people, including current and former top officials, were arrested in May in relation to $92 million in bribes paid by the Brazilian construction company Odebrecht to obtain public works contracts in the country.

A political analyst warned me there is a danger the PLD, having enjoyed three consecutive terms, could lack the will to press ahead with further reforms.

On balance, however, the Dominican Republic continues to appeal to investors given its positive mix of economic fundamentals and attractive yields.

Political pact key to El Salvador's prospects

The political environment in El Salvador remains polarised. A former rebel leader, Salvador Sánchez Cerén, won the 2014 presidential election by a tiny margin over the right-wing ARENA party candidate. Ceren's left-wing Farabundo Marti Liberation Front had previously emerged as the largest party in parliamentary elections.[5]

A lack of trust between the main parties, internal party divisions and ideological differences are frustrating attempts to resolve fiscal and financing issues caused by an unsustainable pension system. Certainly, El Salvador faces the greatest challenges of the three countries I visited.

The government missed a payment to a local pension fund in April, due to a political stalemate in Congress that prevented the passage of a key finance bill. The default led to credit-rating downgrades by both Moody's Investors Service and Standard & Poor's.

The political standoff, exacerbated by legislative elections next year as the parties jockey for support, threatens a potential IMF deal that would provide both much needed financing and policy discipline to correct the fiscal issues.

I learned that high-level negotiations between the main parties, brokered by an international agency, are underway to find a way forward on improving the fiscal position. The willingness of the parties to participate is encouraging and likely stems from the negative external reaction to the recent default, which they had underestimated.

A positive outcome from these discussions could cause spreads to tighten. However, recent developments highlight the extent of the political divide. The parties are currently at loggerheads over pension reform. Without an agreement, the government's fiscal position will become even more challenging next year ●

* Frontier markets are smaller, sub-investment grade and less accessible than larger emerging markets. To be eligible for inclusion in JP Morgan's Next Generation Markets Index (NEXGEM) – a subset of its Emerging Markets Bond Index Global (EMBIG) – the country must have a rating of Ba1/BB+ or lower from Moody's and S&P, and cannot be a European Union member or be in the process of seeking EU membership.

1 *Costa Rica: 2017 article IV consultation*, IMF, June 2017
2 Ibid
3 *Dominican Republic: 2017 article IV consultation*, IMF, August 2017
4 'Moody's upgrades Dominican Republic's issuer rating to Ba3 from B1, outlook stable,' Moody's press release, June 2017
5 'El Salvador's new president faces gangs, poverty and instability,' *National Public Radio*, March 2014

IN SEARCH OF THE ILLIQUIDITY PREMIUM

JOHN DEWEY
Head of Investment Strategy, Global Investment Solutions

> *Research suggests the yield uplift is available across a range of assets*

A growing number of investors are looking to private assets to provide higher yields than liquid alternatives, but few are targeting illiquidity premia explicitly, writes John Dewey.

Although trends in asset market returns have been generally positive since the global financial crisis, this trend could reverse as economies normalise and the era of extraordinary monetary easing ends. With fundamentals likely to once again drive asset prices, it might prove a challenging period for pension schemes, insurers and other long-term investors; many of whom are stretched to meet their return requirements through traditional investment strategies.

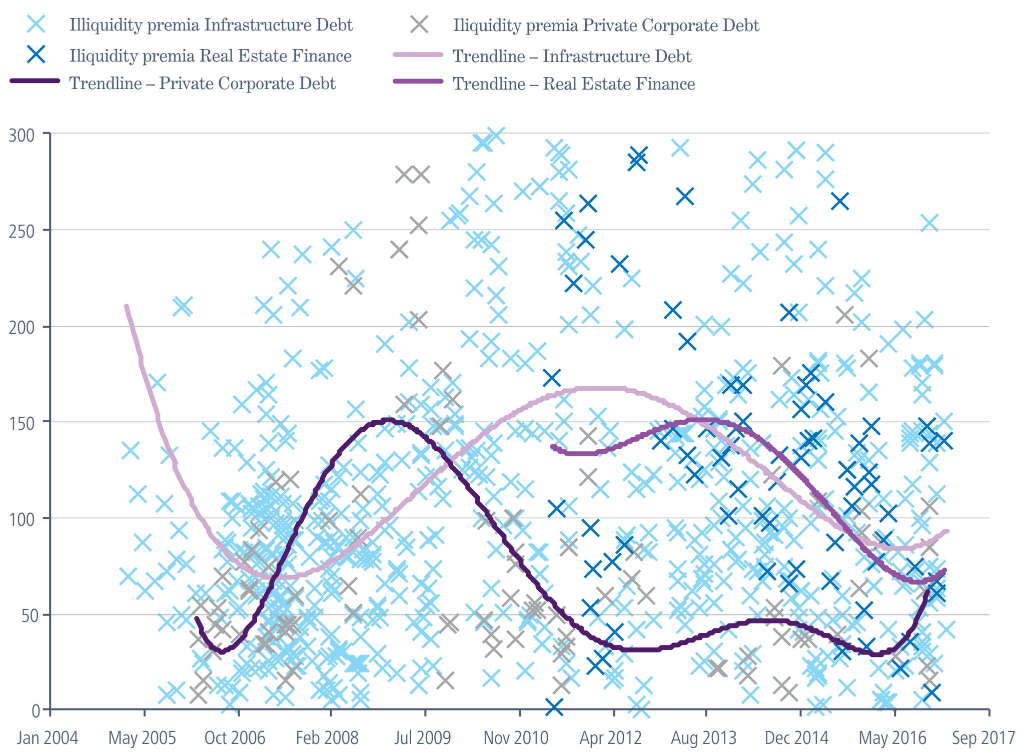
Already, more are turning to private assets – including infrastructure debt, private corporate debt, commercial real estate, structured finance and unlevered infrastructure – as alternatives to assets listed and traded on public markets.

A key driver for this is the higher expected returns that might be achieved from private assets over publicly-traded ones of broadly similar credit quality, in addition to other benefits they can provide such as diversification and downside protection. The yield uplift is loosely known as the illiquidity premium, which research suggests is available across a range of assets.

Strictly speaking, any premium from investing in alternatives may not reflect a reward purely for additional illiquidity risk.

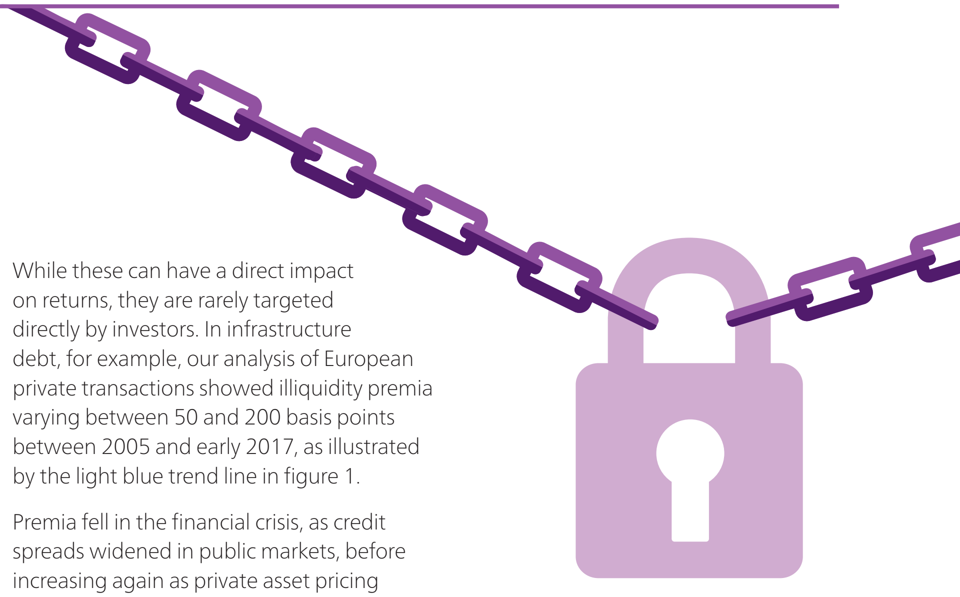
Figure 1: Expectations of how investment will change in the next three years

- Significant dispersion of illiquidity premia across individual transactions
- Few investors explicitly assess and target illiquidity premia
- Broad trends can be inferred from trend lines



Source: Aviva Investors, as at 31 March 2017

Note: Axes have been truncated above 300bps and below 0bps



Other factors may also drive the premium, including complexity and regulatory treatment, both of which might affect an asset's relative appeal. The ability to source, analyse and structure complex assets without access to public research are often key requirements for successfully generating illiquidity premia for investors.

Whatever the case, investors in alternatives need to accept a degree of illiquidity. Given their private and idiosyncratic nature, it may be difficult to find alternative buyers during their lifetime without a meaningful reduction in value. For this reason, once invested, most will seek to reap the benefits of the premia and hold assets to maturity.

Measuring illiquidity premia

The first challenge for those seeking insights into illiquidity premia is to understand their scale. This is not necessarily straightforward, as most alternative assets do not have a close parallel in public markets. Nevertheless, a pragmatic approach to valuations can give a deeper understanding of how an asset is expected to perform, both in absolute terms and relative to other assets.

One way to do this is to compare private deals to a public benchmark, adjusting each deal spread to give a reasonable comparison with the benchmark's characteristics. Adjustments can be derived from data sets of spreads on corporate non-financial bonds with different ratings profiles. Typically, the publicly-traded asset used as a comparator is not as liquid as risk-free assets and may itself provide some reward for illiquidity.

In infrastructure debt, for instance, the process might mean assessing rated and unrated euro and sterling deals from private issuers against an appropriate benchmark. It might be necessary to make adjustments for credit ratings and expected recovery rates if those metrics are not aligned with liquid benchmarks.

Drilling down in this way reveals a range of illiquidity premia in different asset classes. While these can have a direct impact on returns, they are rarely targeted directly by investors. In infrastructure debt, for example, our analysis of European private transactions showed illiquidity premia varying between 50 and 200 basis points between 2005 and early 2017, as illustrated by the light blue trend line in figure 1.

Premia fell in the financial crisis, as credit spreads widened in public markets, before increasing again as private asset pricing adjusted. And while the recent trend has been for illiquidity premia to narrow, they now appear to have stabilised and significant opportunities persist.

Sensitivity to public markets

Monitoring a range of illiquid assets reveals how their sensitivity to public markets varies. Private corporate debt, for example, tends to adjust faster to spread changes in public markets than infrastructure debt due to its shorter investment cycle. Although private assets may offer attractive returns relative to traditional listed assets, they are not immune to factors that influence yield dynamics in public markets, or supply-demand imbalances.

This highlights the need to take a flexible approach to constructing portfolios; looking across the premia available to identify opportunities that can collectively contribute to meeting investors' long-term requirements. It could mean monitoring and investing in multiple markets simultaneously.

Given that each asset type has diverse drivers of return, and that corresponding listed markets also move largely independently, illiquidity premia opportunities can be volatile. Analysing each transaction in detail is the only way to understand opportunities and help investors meet their objectives, while keeping a carefully-calibrated tolerance for illiquidity in mind. A well-established network, significant expertise and a depth of resources are needed to identify and exploit opportunities as they arise

> “*A pragmatic approach to valuations can give a deeper understanding of how an asset is expected to perform*”

TRUMP, TRADE AND TECHNOLOGY

In a wide-ranging interview, influential economist Pippa Malmgren considers the Trump presidency, Brexit and the future of capitalism.

As an advisor to former US president George W. Bush and a current non-executive director of the Department for International Trade, Pippa Malmgren is better placed than most to opine on two of the main sources of uncertainty in the global economy – Donald Trump and Brexit.

While she does not discount the risks presented by both, Malmgren is less pessimistic than many. Of Trump, she argues he could "reach a complete standstill in the Oval Office, accomplish absolutely nothing and the economy will still probably get better because the US is more competitive again". As for Brexit, Malmgren is amazed that "people here [in the UK] and in Europe think the fifth largest economy in the world is about to slide into the North Sea and simply sink".

In addition to serving on several advisory boards, Malmgren founded her own economic advisory firm, DRPM Group, and commercial drone manufacturer, H-Robotics.

She spoke to *AIQ* about the interplay between politics, policy and economics, and why technology is the key to solving, rather than exacerbating, inequality. The views she expresses are her own.

The Donald Trump presidency has been more of a rollercoaster than perhaps anyone could have anticipated, with the threat of impeachment continuing to hang over him. Do you expect Trump will see out a full term in office and run again in 2020?

As long as the Senate is Republican, it seems almost impossible to imagine an impeachment will occur. We'll see what happens in the mid-term elections. If the Senate goes Democrat, then all bets are off.

Yes, there are allegations of collusion with the Russians prior to the 2016 election, but it remains doubtful if these will result in legal actions against the president. It is really interesting that Vice President Mike Pence is now operating as the effective president. He's the one holding the meetings and doing the day-to-day work while Trump swans in and out.

Pence is already doing fundraising dinners at $5,000 a head. Now why would he be doing that if he weren't preparing to run for office in 2020? I suspect the more likely outcome is that although things get messier, Trump makes it to the end of his first term but Pence becomes the Republican nominee in 2020.

Could the US economy suffer if things get 'messier' for Trump?

The economy is doing fine and will continue to do so regardless of who is president. I don't buy the story that the only reason the stock market is up is because of the promise of tax cuts. The reality is that some $18 trillion was thrown into the world economy in the aftermath of the financial crisis and that money is finally starting to come off the side-lines and go to work. That has made the economies of the world perform better than anyone expected.

Furthermore, the US is remarkably competitive again, with wages in China having increased. Trump can claim "It's all my doing", but it isn't really; the economy was getting better anyway. So he can reach a complete standstill in the Oval Office, accomplish absolutely nothing and the economy will still probably get better.

Do you expect the populist forces that put him into power to dissipate?

As the economy gets better you would assume they would dissipate, but American society has become so splintered; creating gaps between the haves and have nots. An improving economy can help, but I'm not sure that will be enough to fix the divisions that are so evident now.

Could an even more extreme candidate emerge victorious either on the left or right?

An even more extreme version of Trump is a real risk. The American public elected Barack Obama because he stood for change, but when he left most people had the feeling he didn't change things enough. Then they elected a guy who said "I'm really about change", and for those who supported him, their feeling is that he's not being permitted to change things enough. They think he is hamstrung by the system.

So one wonders what version three of this is going to look like. It is possible that we don't go back to normal, but keep electing candidates who promise radical change. Bernie Sanders is a good example. His version of change is on the left but it's equally radical. The right would call him a communist; he's all about giving away free money to everybody and nationalising everything, but equally it's just radical change. So we could be in a period where we keep electing radical-change leaders but they all want change in different directions.

I don't see us veering back towards the centre ground for some time. It's an existential period in American history when people are not just questioning the left or the right; they're questioning the entire system. They're questioning capitalism; they've lost their faith and trust in government and the courts. They've lost trust in the media; they've even lost trust in the Church. This is a global phenomenon. We certainly see the same breakdown of trust in Europe.

In fact, there's only one institution left where we still see a high level of public trust and that's the military.

My book *Signals* was about how debt is causing this. Debt is like a silent wrecking ball that breaks the promises holding society together. Every time a promise is broken – as people are told you have to retire later than expected or you're not going to get the NHS service you thought, or your trash isn't going to be picked

up as frequently as promised – that's when the whole society starts to question the system, not just the players in it.

Given Trump's statements about institutions such as NATO and the World Trade Organisation, could the global architecture created by the US following World War II begin to disintegrate?

Globally we see a huge questioning of these structures. You could argue that is what the Chinese are doing with their Belt and Road initiative. They're saying: "Look, we tried to reform and repair the IMF, World Bank and these other institutions that are supposed to prevent massive global financial crises, but it turns out the US wouldn't let us do it so we're creating our own." They created the Asian Infrastructure Investment Bank, which opened last May with a balance sheet larger than the World Bank.

Trump is no fan of free trade. So we're absolutely at risk of seeing the erosion of the rules systems that have been in place over many years. On the other hand, maybe part of this happened because we took it for granted that everybody understood why those rules were such a good thing and this is the opportunity to go back to the public again and explain again why it serves their interest.

It's unlikely the West descends into chaos. I'm optimistic about the ability of the public to continue innovating and building tomorrow's economy, whether governments get their act together or not.

This is the thing; when people realise governments, pensions and social security are all underfunded, they start to say: "I'd better go and build my own future and not depend on the government to save me." One of the weird outcomes from this is that you get more innovation, not less.

Trump and 'Brexit' to some extent reflect people's questioning of the merits of capitalism, with particular concern about rising inequality. What can countries do to tackle that?

There's only one way to address inequality, which is to open up opportunity. We pushed people to go to university and follow that with a white collar career, but that is not the only path to success. We have not given people any practical or vocational skills. This leaves them unable to make a living, which is a shocking and terrible mistake.

If you put vocational skills back into schools, I believe inequality would diminish and you'd get a lot more innovation. That doesn't just come from the computer scientists at Berkeley: it also comes from people just making things and working with engines and knowing how to weld metal.

There is a rising risk of geopolitical conflict. We definitely see this between the US/NATO and Russia; and between the US and China as they spar over the South China Sea; and we see it between India and China in the Himalayas.

You have written and talked extensively about the benefits of technology. Do you have any concerns that technological advancement is exacerbating inequality?

The reality is that the economy constantly forces us all to change. But the speed at which this is happening, against the backdrop of inequality, is definitely going to make people agitated. We've got to get people into the new technology faster because it will create new jobs and new things to do.

In fact, I think it's incredibly democratising and empowering, because you won't need to be an 'expert' to employ this technology or benefit from it. It has the ability to narrow inequality, and raise the incomes of the people at the low end. But it can be sold the other way too, so it's a big discussion that society has to have about how it gets deployed and who gets access to it. Again, it's about creating opportunity.

Wages are rising for the first time in a long time. The question is whether they are rising enough. Wages as a percentage of GDP have been at an all-time low and profits at an all-time high. Even in a capitalist system, that's not sustainable. So the fact that wages are beginning to rise for lower-income people is a symptom of the fact that change is beginning to happen. And that's why inflation is starting to pick up.

I think this is the beginning of the reversal of the longer-term trend, but the question is will it narrow the difference between low incomes and high incomes enough to make the problem go away. I think it can but it's going to take some care.

TRUMP, TRADE AND TECHNOLOGY

continued

> *Everyone thinks populism is a local phenomenon, but it isn't; it's global and unfortunately I think it has more life in it*

Turning to Brexit, what's the risk of the UK leaving the EU with no deal and how damaging would that be for the economy?

My views on this are my own and don't reflect the department I work for. But as an American and an outside observer, I find it fascinating that people here and in Europe think the fifth largest economy in the world is about to slide into the North Sea and sink. It makes no sense given that money is like water and it always flows to wherever it faces the least resistance. So where you have the lowest taxes, least red tape and most profitable opportunities, that's where it's going to go.

What I hear from investors around the world is that they're deploying more capital into Britain because they think the British are never going to raise taxes above the EU level; it's definitely not going to have more red tape than the EU; and the economy has become competitive again, in no small part because its currency has devalued.

So you don't think it's naïve to think the UK will be able to negotiate favourable trade deals with the likes of China and India?

I think the current trade frameworks are sufficient for Britain to be able to export to the world much more successfully than it does today and that's the key point. After all, fewer than 20 per cent of British businesses export at all. This can be improved. The British are used to exporting to the EU because it was easier. But there's a whole world out there and there is a rules system governing that trade. It may not be as favourable as the trade rules under the EU, but it's not necessarily unfavourable either. So I'm optimistic British exporters will figure out how to make money.

As for Europe, has populism disappeared?

I don't think so. I was surprised people thought the election of Macron had ended it. What we're actually seeing is that Macron's popularity has fallen twice as fast as Donald Trump's in a shorter period of time. So pinning all your hopes on that seems unwise. Everyone thinks populism is a local phenomenon, but it isn't; it's global and unfortunately I think it has more life in it. We can neither ignore it nor pretend it will go away: we need to deal with what's causing it.

In your book Signals, you talked about the negative consequences of quantitative easing. Is there any alternative?

I didn't say central banks shouldn't have done QE, but they ought to have started reversing it a lot sooner. The problem is we've put $18 trillion into the world economy and now they're saying: "We created an ocean of liquidity and we're going to take two cups of water out of it." Tiny and well-broadcasted rate hikes don't really change anything. The policy of keeping liquidity in the system is working. Inflation is starting to appear, which is the purpose of QE. But inflation, even if it is small, brings adverse social consequences. So we should start to think how are we going to reverse out of this.

My view is that they're just not really doing that. Central banks are trying to pretend one or two rate hikes fixes it but it doesn't. They haven't even normalised policy, let alone tightened.

Are economies and markets capable of weaning themselves off central bank support?

I believe so. Once you start hiking rates (too late) and inflation is already starting to rise, investors decide they can't hold cash any more and need to invest in the real economy. That's why people are buying stocks; they're buying real assets like property; they're investing in businesses, which was exactly what central bankers had hoped for. I'm just saying you can have too much of a good thing.

Let's say you're wrong and there's another recession around the corner. What can policymakers do in that eventuality?

The consensus view is that we're about to have a stock market crash, we're going into a serious recession and policymakers will have no tools this time. But what the market doesn't understand is that the best tool a policymaker has is a pen in his hand and a flag at his back. With these, policymakers can write legislation; you can invent assets out of nothing; you can increase the size of the government's balance sheet many times over. The power of government is almost endless when it comes to this.

If you were an investor right now, where would you be putting your money?

The real economy is performing better than financial assets. Owning real businesses with real cash flows makes a lot more sense to me than owning stocks and shares in big, established businesses just because they're big. I think there are more returns to be had in building real businesses than just investing in them, which is a big change. We are seeing almost a reversal of the predominance of finance. We've had 30 years of financial markets producing the best returns. I'm arguing this will get you something if you invest in stock markets, which, contrary to the consensus, I believe will keep going up. But the building of companies will get you more. So let's just say sweat equity is now more valuable than financial equity. That's one reason I am building a British manufacturing company in robotics that makes commercial drones: I am guessing the payoff will be far better than anything the stock markets can offer ●

IT'S THE EDUCATION, STUPID!

The positive link between education and economic growth is well established. Bryony Deuchars explores what this means for emerging-market investors.

It is difficult today to appreciate the optimism that surrounded Africa in the late 1950s and early 1960s as the "winds of change" swept vibrant independence movements to power. By contrast, Asia was racked by war and famine. Many at the time expected Africa to grow rapidly over the next half-century and Asia to stagnate.[1]

When Ghana became the first African country to gain independence in 1957, its GDP per capita was approximately the same as South Korea's, at around $490. But 60 years on, Ghana is one of the poorest countries on earth; its GDP per capita of around $1700 dwarfed by that of Korea ($27,000) and most other East Asian countries.[2]

IT'S THE EDUCATION, STUPID!

continued

> *Investments in human capital are integral to economic growth – not a luxury that can be postponed*

So what happened? Economic mismanagement, corruption and political instability have undoubtedly played a role in the failure of Ghana and other African nations to achieve their potential. But there is another salient factor: the continent's woeful record in educating its people. Research from the United Nations finds that disparities in early-years educational standards account for about half of the difference in overall growth rates between sub-Saharan Africa and East Asia since 1960.[3]

Education is essential to the growth of developing countries. According to the Organisation for Economic Co-operation and Development (OECD), providing every child with access to the education and skills needed to participate fully in society would boost GDP by 28 per cent in lower-income countries and 16 per cent in high-income countries over the next 80 years.[4]

So which countries are successfully implementing educational programmes to improve the lives of their citizens, lift prosperity and boost growth? And what are the investment implications of the correlation between superior educational outcomes and economic success?

Education and growth

Education drives economic growth in a number of ways, according to the UN: it tends to lead to lower rates of childbirth and fewer dependents per family, and directly equips people with competencies that increase their income. On average, one year of education is associated with a 10 per cent rise in wage earnings.

With these benefits in mind, it makes sense for emerging economies to allocate capital to educational programmes, although the advantages may only be realised over the longer term and will vary project-by-project, according to Franziska Ohnsorge, chief economist at the World Bank's Development Prospects Group.

"Investment in education will raise potential growth because it involves investment in human capital," she says. "You see clear correlations between education, life expectancy and labour force participation. The question is how much it costs relative to the benefit obtained. That calculation is not made at the macro level; it is determined project-by-project."

For countries that do take the long-term view and make the necessary investments, however, the gains can be enormous. Consider the divergence between India and China. The economist Amartya Sen has argued that China's superior record in educating its people goes some way to explaining why its growth has outpaced India's by an average of one percentage point per year in recent decades.[5]

Like Japan at a similar point in its development, China's government in the early 1980s acknowledged that investments in human capital are integral to economic growth – not a luxury that can be postponed until some later date while other development needs such as hard infrastructure are prioritised.

India's record on education has been comparatively poor. Its literacy rate of just over 71 per cent lags well behind China's 96 per cent; in fact, India's literacy rate now is lower than China's was in 1990. Perhaps it is no coincidence that China's citizens, who earned less than India's as recently as the early 1980s, now earn on average $8,250, far higher than India's per-capita earnings of $1,718.[6]

Quality, not quantity

The quality of education systems varies enormously across emerging markets. In 2015, the OECD conducted the biggest-ever survey of global schooling, ranking 76 countries on how well 15-year olds performed in maths and science. East Asian countries occupied all of the top five places; South Africa and Ghana were ranked 75th and 76th, respectively.[7]

These vastly different outcomes partly reflect relative levels of government investment in education – but not entirely. South African public schools, for example, do not suffer from a dearth of government investment – public spending on education amounts to 6.4 per cent of GDP, far higher than the 4.5 per cent average across OECD countries[8] – but the poor quality of teaching and misallocation of resources are real problems.

Teacher absenteeism is rife in state schools, and yet the political clout of the South African Democratic Teachers Union is such that these teachers command higher salaries than their peers in the private sector, where the quality of teaching is higher. A 2007 study found that 79 per cent of state-school teachers tested in basic mathematics could not achieve the score expected of their pupils.[9]

The disruptive power of unions is also a reason for underperformance in other countries, such as Mexico. The country's militant teachers' union, SNTE, which is the largest union in Latin America, has wrested control of the education budget from the government in some parts of the country. In 2013, SNTE members went on strike for weeks at a time in protest against the government's introduction of merit testing for teachers.[10]

Investment implications

Given the proven correlation between good educational outcomes and economic growth, it is logical for long-term investors to take a country's record on education into account when appraising its economic prospects.

Progress is being made in Poland, for example, which recently overhauled its education system and improved results. Once considered below average among the OECD group of economies, Poland is now ranked in the top 10 of nations for reading and science and the top 15 for maths.[11]

Brazil is another good example. While much has gone wrong in the country over the last 10 years, the social investment made under President Lula's government led to substantial growth in the number of students enrolled and improvements in educational standards, which could bring economic dividends over the longer term.

In countries where education systems are failing, parents are increasingly turning to the private sector, which may open up more direct opportunities for emerging-market investors. In Indonesia, for example, consumer spending on education increased by 52.8 per cent in real terms between 2010 and 2015.[12]

Although private education is often perceived to be a luxury available only to the privileged few, low-cost private education providers are starting up across emerging markets. Those that have been successful tend to provide better education than the public equivalent – sometimes at a fraction of the cost.

Private demand

Private education providers must overcome considerable obstacles in order to succeed. Governments can be hostile towards enterprises that generate a profit from services in direct competition with the state, and teachers' unions tend to regard non-unionised education outfits as a threat to their membership. Businesses also face regulatory and political uncertainty; one government may take a benign view of private education, only to be replaced by another opposed to it.

Then there are operational issues. Finding and gaining access to suitable sites – and hiring adequately-trained teachers – can take a frustratingly long time. Sizable expenses will be incurred ahead of the school opening; sites must be leased, teachers hired and trained, books and equipment purchased and so on.

However, once operational, private-education companies can benefit from negative working capital; school fees are paid in advance while teachers' salaries are paid in arrears, resulting in healthy bank balances. The annuity nature of tuition fees gives a comfortingly long-term perspective on future revenues.

Currently, only a few such companies offer the size and scale that enables a public listing. One exception is ADvTECH in South Africa. The company offers both school-level and tertiary education, and the fees are affordable; parents of children attending ADvTECH Academies can expect to pay around R40,870 annually ($3,100) or just over R3,400 a month ($260). This is relatively affordable in a country where average monthly earnings stand at R18,687 ($1,416).[13,14]

ADvTECH is growing fast: in 2016 it added a further five sites to its portfolio, taking the total to 98, and now has over 53,000 students enrolled compared to 30,000 in 2013, representing growth of 77 per cent. Over the same period, the company has generated considerable value for its shareholders, almost trebling its market capitalisation and growing earnings 89 per cent.[15]

Kroton of Brazil is another fast-growing educational provider. Brazil is the biggest market for primary and secondary education in Latin America with 58 million students. Over half of Kroton's undergraduate students study via distance learning courses, which allow students to combine study with work, as well as giving those in remote locations access to education.[16] Kroton believes there is still potential for growth, particularly at the post-secondary level, given the market's relatively low penetration rate compared to other emerging markets.

Private providers are set to play a more influential role over the coming years, bringing economic benefits and a broader range of opportunities for investors. In a recent report, US think tank the Brookings Institution argues that "tremendous possibilities [lie] in developing new innovative models for investment that would enable private sector firms to invest in education while meeting their larger business goals and needs".[17]

Filling the gap

Slowly but surely, educational standards in emerging economies are improving. Adult literacy rates have been rising: on average, 93.3 per cent of the population aged 15 or older across all emerging markets was literate in 2015, according to the most recent available data. More than half of the population aged 15 or older in these economies benefited from a secondary education, up from 49.6 per cent in 2010, while the share of the adult population with a higher education was 10.2 per cent, up from 9.5 per cent in 2010.[18]

However, unequal access to education and a lack of educational quality will continue to hamper progress in these countries unless improvements are made. In many cases governments are now recognising the need for investments in education to tackle poverty, lift prosperity and boost growth.

But in those countries where governments fail to design and implement robust education policies, the private sector can step in and make a difference. For companies brave enough to take the risk, the rewards from private education in emerging markets can be substantial for all involved ●

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EMERGING-MARKET REFORMERS: HOPE AND HYPE

Emerging-market investors often greet reformist governments with a euphoric response, but reformers don't always deliver on their promises.

> *Reformists do not always deliver on their promises and investors must be wary of getting carried away with the hype*

In 2015, Brazil was plunged into turmoil. Millions took to the streets in protest after allegations of money laundering against the former president Luiz Inácio Lula da Silva escalated into a scandal that engulfed huge swathes of the country's political and business elites. President Dilma Rousseff was removed from office the following year after the Senate found her guilty of breaking budgetary laws.

You might have expected investors to react to this political chaos with dismay. In fact, the Brazilian equity market soared: the MSCI Brazil Index rose a remarkable 66.2 per cent in 2016, compared with only an 11 per cent rise in the wider MSCI Emerging Markets Index. Meanwhile, bond investors ploughed more than $15 billion into Brazil-focused fixed-income funds last year.[1]

The reason for Brazil's outperformance can be attributed partly to its improving current-account balance and the stabilisation in commodity prices since 2015. But there may be another, more intangible factor: the promise of reform. Investors believe the country's current woes will provide the impetus for further changes to Brazil's dysfunctional political and economic system.

"The performance of equity markets in Brazil suggests investors are confident the country will not let its crisis go to waste, and that more fundamental economic and political reforms will now be forthcoming," says Ed Wiltshire, Portfolio Manager, Emerging Market and Asia Pacific Equities at Aviva Investors.

Reform is the great hope of emerging-market investors. Reformist administrations can bring transparency, open up markets and reposition economies on a more sustainable footing. But reformists do not always deliver on their promises and investors must be wary of getting carried away with the hype.

Which reforms?

Structural reform is a prerequisite for long-term growth and poverty reduction in emerging economies, according to Franziska Ohnsorge, chief economist at the World Bank's Development Prospects Group. "Reform is critical," she says. "Although fiscal and monetary policy can address short-term shocks, structural reform is the only way to permanently lift potential growth."

As well as improving a country's long-term prospects, reform can bring immediate benefits. A recent World Bank study found emerging-market economies that implemented reform packages – that is, simultaneous reforms across a number of

areas – saw growth of one percentage point higher than the average over a four-year period, largely thanks to improved investor confidence and stronger capital inflows. Countries that lagged their peers on reform grew by four percentage points less than the average.

Despite these evident benefits, many emerging economies have been dilatory in implementing reform. The so-called 'commodity super cycle' between 2000 and 2014 brought buoyant exports, strong growth and ample liquidity, which meant many countries were able to put off necessary structural adjustments. But the commodity-price crash of 2014 refocused attentions on the need for deeper reforms to lay the foundations for sustainable long-term growth.

"Since the crisis, a large number of commodity exporters have brought in fiscal reforms such as subsidy reform and tax reform, as well as other structural reforms such as greater exchange-rate flexibility," says Ohnsorge. "The commodity-price drop has nudged countries to take steps that were long overdue."

Research from the International Monetary Fund (IMF) finds three main areas of reform are key to boosting productivity and overall growth in the emerging markets: real-sector reforms (including reducing trade barriers, liberalisation of foreign direct investment (FDI), boosting agricultural productivity, strengthening institutions); financial-sector reform (reforming the banking sector and developing capital markets); and boosting productive capacity (investments in human capital and infrastructure).[2]

Different reforms will be appropriate at different stages of a country's development: the IMF refers to 'first-generation' and 'second-generation' reforms. In South Korea, for example, first-generation reforms included market liberalisation, the introduction of flat-rate taxes to replace industry-specific levies and deregulation of small-and-medium-sized firms from the late 1970s onwards.

After the Asian Financial Crisis of 1997, Seoul implemented a second round of reforms to restructure the business and banking sectors and improve transparency and accountability, along with changes to bring more flexibility to the labour market. These reforms helped propel the country's 'growth miracle' over the past 40 years. South Korea's GDP per capita, at more than $27,000, is now higher than many developed economies.[3]

India and Indonesia

India and Indonesia are now in the process of implementing the kinds of economic reforms that brought gains in South Korea. Since his Bharatiya Janata Party won a landslide victory in the elections of 2014, Indian Prime Minister Narendra Modi has leveraged his control of the Lower House of the Indian parliament to drive through an ambitious programme to privatise and liberalise the economy, opening it up to more FDI.

Many of Modi's proposed changes tally with the IMF's three-part template for productivity improvements. For example, Modi has moved to liberalise the domestic market by implementing a nationwide Goods and Services Tax (GST). Effective from the start of July, the GST has removed the separate taxes, tariffs and barriers imposed by different states and effectively turned India into a single economic market for the first time.

Modi has also moved to clamp down on the black market by removing high-denomination rupee notes from circulation, and pledged to make the Indian labour market more flexible. An overhaul of India's complicated and restrictive labour laws – some of which date back to the colonial era and contain such anachronistic requirements as the provision of spittoons in the workplace – is long overdue.[4] The productivity gains could be significant, as economic research shows a high correlation between low productivity and restrictive labour laws.[5]

India's GDP expanded 7.1 per cent in 2016, and many equity investors seem confident Modi's reforms will continue to propel growth and boost asset prices. As of August 28, 2017, the MSCI India Index was up 27 per cent since Modi's election victory in May 2014; by contrast, the MSCI Emerging Markets Index had risen 14.1 per cent. Yields on India's benchmark 10-year sovereign bond tightened 211 basis points over the same period, according to Bloomberg data.

"Some of Modi's measures have met resistance in the Upper House of Parliament, which is not controlled by his party, but for the most part he has made considerable progress with his promised reforms. The Indian economy continues to grow at a rate that outstrips most other countries in the region," says Wiltshire.

Indonesia's Joko Widodo was also elected with much fanfare in 2014, but he has found it more difficult than Modi to deliver on his reform agenda. Unlike his Indian counterpart, Widodo has been constrained by his lack of control over parliament; indeed, much of the opposition to his proposed reforms has come from within his own party. His successful measures were generally implemented by presidential decree, a less permanent solution than legislation. Opposition to the president has also meant certain areas crying out for reform – such as the need to end restrictions on foreign investment in certain sectors – have not been tackled at all.

But Widodo's success in reforming the tax system may give his programme a second wind. From July 2016 to March 2017, Widodo implemented a tax amnesty to boost receipts in the short term and bolster the tax base. The amnesty resulted in the declaration of $336 billion of previously-hidden assets, significantly improving the government's fiscal position.

This development has been welcomed by fixed-income investors in particular. In May 2017, credit-rating agency Standard & Poor's followed the other major agencies in upgrading Indonesia's sovereign rating to investment grade, lifting it from BB+ to BBB- with a stable outlook.

"You have seen a positive reaction in the hard-currency market in Indonesia; the country has done well in meeting investors' expectations," says Aaron Grehan, Fund Manager in Aviva Investors' Emerging Market Debt team. "The continuation of reforms and the delivery of longer-term improvements will be key to maintaining the current level of spreads Indonesia has in the hard-currency market."

Rupiah-denominated sovereign bonds attracted the equivalent of $7.4 billion from overseas bond funds over the first half of 2017, offering total returns of 9.2 per cent, according to Bloomberg data. Bond investors are bullish on India, too, whose rupee sovereign bonds have attracted $11.1 billion of foreign flows in 2017.

Despite the strength of demand, government bonds from India and Indonesia continue to offer the highest yields among major Asian economies; outstripping China, South Korea, Malaysia, Thailand and Taiwan. This suggests there

EMERGING-MARKET REFORMERS: HOPE & HYPE

continued

are still opportunities for fixed-income investors hoping to profit from further reforms in the two economies.

Political reform

While India and Indonesia have made some progress on the path to reform, many other reformist administrations have failed to deliver on their promises. Professor Anne Krueger, former deputy managing director of the IMF, has cited several ostensibly reformist governments that "meant well, tried little, failed much", notably Turkey in the 1980s and Argentina in the 1990s.[6]

In 2003, Francisco Gil Diaz, then Mexican minister of finance under President Vicente Fox, criticised Latin American governments for promising market economics without delivering. "The policies that have been undertaken are not even a pale imitation of what market economics ought to be, if we understand market economics as the necessary institutional framework for a sound economy to operate and flourish," he said. "What has been implemented throughout our continent is a grotesque caricature of market economics." [7]

But the problem is often not so much an aversion to market dynamics as a failure to lay the necessary political groundwork for economic liberalisation to take hold. Take the current Mexican government. President Enrique Peña Nieto's election victory in July 2012 returned his centrist Institutional Revolutionary Party (PRI) to power after a gap of 12 years. During his first two years in office, Peña Nieto introduced reforms in education, the financial sector, energy and telecoms; triggering euphoria in the Mexican equity markets.

The MSCI Mexico index rose 19.6 per cent between July 2, 2012 and March 31 the following year, strongly outperforming the wider emerging-market index. Nevertheless, the economic effects of the reforms proved negligible – GDP growth has struggled to reach 2.75 per cent during Peña Nieto's presidency – and investors are becoming disillusioned.

Part of the reason for this is that political reform has failed to keep pace with the administration's economic adjustments. Corruption has eaten away at the government's legitimacy – the PRI voted down a package of anti-corruption bills last year – and a populist left-wing regime could be set to replace it. Mexican equities have underperformed the MSCI Emerging Markets Index since late 2016 (see figure 3) and Mexico's benchmark 10-year sovereign bond yield has risen by more than 100 basis points over the same period.

"With the next presidential election due in 2018, the political window for further bold reforms may already be closed. It is unclear whether the PRI can see off the growing challenge of the left-wing opposition; in any case, the constitution requires Peña Nieto to stand down," says Wiltshire.

Recent events in South Korea further emphasise the necessity of political change if reformist governments are to maintain the confidence of the electorate and win support from overseas investors. One reason South Korea is still deemed to be an emerging market, despite its relative affluence, is that it continues to struggle with corruption. The country is placed a lowly 52 out of 150 countries on Transparency International's Corruption Perceptions Index, which ranks countries from the least corrupt to the most corrupt. Korea is far below its Asian peers Taiwan (32nd), Japan (20th) and Hong Kong (15th).[8]

Korean President Park Geun-hye was impeached in December 2016 following cash-for-influence allegations and removed from office in March this year. Her departure triggered elections and the new leader, Moon Jae-in, was sworn in. As in Brazil, the prospect of greater transparency in the political system, and a crackdown on collusion between political and corporate elites, has prompted tentative optimism among investors.

"Moon is regarded as a 'clean pair of hands', untainted by his predecessor," says Wiltshire. "If he can use the strength of public opinion to confront vested interests and improve corporate governance it would greatly benefit minority investors, who have not always received full reward for their participation in the South Korean market."

Grehan cites South Africa as another emerging market where reforms could deliver radical benefits to the economy and significantly improve investor returns. The IMF has said South Africa needs "a comprehensive package of reforms, including greater product market competition, more labour market inclusiveness, better education and improved governance", although such policies do not look to be forthcoming under the scandal-hit presidency of Jacob Zuma, whose term runs until 2019.[9]

Reform at the frontier

As in South Korea, the emergence of a reformist administration in Argentina seems to be winning the confidence of overseas investors. President Mauricio Macri was elected in 2015 and his *Cambiemos* ('Let's Change') coalition promised to clean up corruption and enact pro-business policies. Macri has successfully tightened up Argentina's fiscal position and restored the country's access to international debt markets. In June the country successfully sold a 100-year bond – only the second Latin American country to do so.

If Macri is to capitalise on these successes and win more FDI he will need to deliver deeper reforms, such as streamlining the country's baroque tax code. To do this, he needs to face off the electoral challenge posed by former president Cristina Fernandez, who is seeking to overcome the taint of a corruption scandal to stage a populist comeback at Senate elections in October.

Despite Macri's reform efforts, Argentina is still classed as a frontier market country by MSCI. Frontier markets tend to be smaller, sub-investment grade economies that are more difficult for foreign investors to access, and riskier places to invest in. But it is in these markets that reformist leaders can have the most dramatic impact, says Grehan.

"Relatively small adjustments can lead to quite significant economic and asset-price gains in frontier markets. But clearly the reform efforts there come with far more volatility, and there are deeper structural issues that make it difficult for frontier markets to reform in the way that India and Indonesia have done over the last few years."

Nevertheless, reform is happening in many frontier markets. Ohnsorge picks out Colombia, Ghana and Nigeria as countries that have made progress in recent years, in areas such as tax and revenue-administration reform. Egypt and Iran, meanwhile, have successfully implemented monetary reforms, such as exchange-rate liberalisation.

Frontier-market countries that are carrying out structural reforms under the watchful eye of international organisations such as the IMF may have particularly good prospects. Take Ukraine. Earlier this year, the IMF agreed to pay out $1 billion of a $17.1 billion financing agreement after the country showed progress on reform under President Petro Poroshenko. Since the severe crisis of 2014-'15, the central bank has successfully tamed inflation – which was running at 60 per cent – significantly reduced the fiscal deficit and reformed the banking system. Anti-corruption institutions were set up and senior officials are now required to disclose their wealth, bringing much-needed transparency.[10]

While the IMF is urging the country to go further, faster with its reform programme – and the conflict between government forces and pro-Russian militia continues in the east of the country – bond and equity investors seem confident Ukraine is moving in the right direction. The MSCI Ukraine equity index had risen more than 16 per cent in the year to end-August 2017, while the country's sovereign bond yields have tightened considerably since January. "With an IMF deal and following the debt restructuring, Ukraine is on a path to continued improvement. Investor perceptions have radically changed thanks to sustained economic improvement over a relatively short period of time," says Grehan.

Hope and hype

Ukraine's rapid improvement shows that reform efforts often generate a virtuous circle by attracting foreign investment: greater investment gives the government more fiscal room to enact reforms, which in turn boosts the confidence of international investors.

But there is a risk that with macroeconomic conditions relatively benign and financing easy to come by, some emerging-market governments may be tempted to put reform efforts on the backburner again, Grehan warns. Investors must focus on countries that are truly delivering reform, rather than simply talking about it, as the former will deliver more-sustainable returns over the longer term.

Wiltshire also stresses the need to guard against complacency. "Even in those countries where reform appears to have stalled, it can take some time for equity investors to become disillusioned with the direction of travel," he says. "There is no reason to believe emerging-market investors will stop backing economic reformers any time soon. Investors and voters are alike: they never really lose their hope in reform"

Figure 1: MSCI India Index versus MSCI Emerging Markets Index

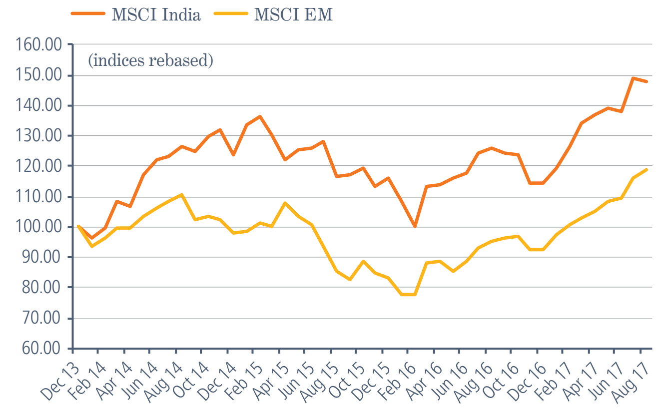


Figure 2: MSCI Indonesia Index versus MSCI Emerging Markets Index

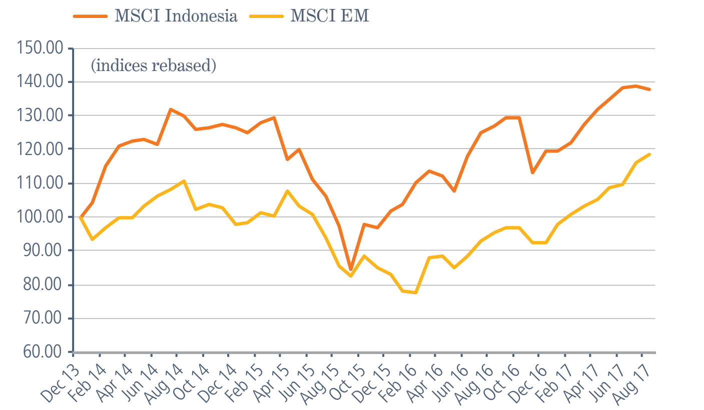
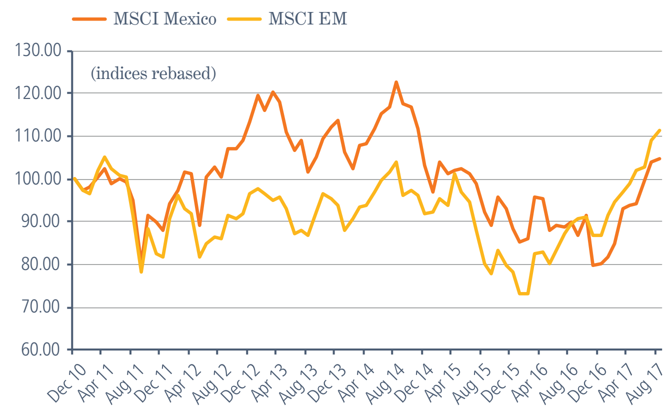


Figure 3: MSCI Mexico Index versus MSCI Emerging Markets Index



Sources: Bloomberg as at August 31, 2017 Past performance is not a guide to future performance

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EMERGING

THE BULL &

Jon Harrison of Trusted Sources and JP Smith of Ecstrat offer contrasting views on the outlook for emerging markets.

"One man's meat is another man's poison," as the old saying goes. This could be applied to the emerging markets, where contrasting assessments of the same inputs can lead to opposing forecasts for a country's economic and investment prospects.

Currently, the two biggest factors investors are watching when looking at emerging markets are the value of the dollar and the strength of the Chinese economy. This reflects the prevailing economic models of many emerging markets: export-driven and increasingly dependent on China as an off-taker of both goods and commodities.

THE EM CYCLE HAS FURTHER TO RUN

JON HARRISON

The positive emerging-market cycle has further to run. This is because more balanced growth in China boosts sentiment and supports world trade. Furthermore, a weak dollar raises risk appetite and contributes to lower inflation in emerging markets. We also note that emerging-market economic cycles are behind those in developed markets; suggesting asset prices have further to go.

In recent months, industrial profits in China have accelerated, reflecting buoyant private sector sentiment. This will help to allay investors' fears of a slowdown and is an indication that growth is becoming more balanced. China is one of three locomotives driving global reflation, along with recovering economies in the US and Europe, which are helping to lift world trade volumes.

The dollar has depreciated this year as the so-called Trump trade has unravelled and market expectations of US monetary tightening have been scaled back. A weak dollar raises risk appetite and exports disinflation to EM economies, many of which have also benefited from sound monetary policy, helping to push EM inflation to record lows. Major EM economies are at different stages in their economic and monetary policy cycles, but are on average behind those of the US and Europe. Political risks magnify the differences between EM economies.

At this stage of the economic cycle, US monetary policy is already tightening and the prospect of this is also extending to the euro zone, but EM policy is still bottoming out. In that scenario, EM assets are likely to outperform DM. The relatively benign external conditions for EM mean the significance of traditional EM vulnerabilities has subsided. Open economies will benefit from rising world trade, while a weaker dollar will reduce the pressure of financing needs, and an improved outlook for China will help support commodity prices.

"The relatively benign external conditions for EM mean the significance of traditional EM vulnerabilities has subsided"

India is among our strongest EM equity-market calls, backed by solid GDP growth, structural reform and political stability. Prime Minister Modi looks set to return with an increased majority at the 2019 general election, thereby delivering policy continuity. We see potential for Indonesian equities to outperform, driven by strong growth, progress on structural reform and gradually rising inflation. In Brazil, we prefer local debt to equities. The deteriorating fiscal outlook will weigh on investor sentiment, but disinflationary economic fundamentals are supported by orthodox monetary policy.

We have a tactical positive view on Turkish assets, despite longer-term institutional risks. Fiscal stimulus is driving a more-positive outlook for Turkish growth and tighter monetary policy has reined in inflation expectations. In Mexico, inflation is set to peak in September, providing a boost to local debt and equities. The renegotiation of the North American Free Trade Agreement is a risk factor, but we believe that there is unlikely to be a fundamental change to trade linkages between Mexico and the US

MARKETS

BEAR CASE

Here we present arguments both for and against investing in emerging markets at this stage of the cycle. The bull case is presented by Jon Harrison, managing director, EM macro strategy at Trusted Sources, a specialist EM investment research house and part of the TS Lombard group. The bear case is provided by JP Smith, founder of Ecstrat, a consultancy that advises on asset allocation between global equity markets.

EM OUTPERFORMANCE BUILT ON SHAKY GROUND

JP SMITH

There are three reasons why emerging-market stocks have done so well this year – all of which look fragile. Firstly, the weakness in the US dollar has driven this leg of the bull market. This has slowed capital outflows from China, thereby alleviating the downward pressure on foreign exchange reserves and the renminbi that was a feature of 2015-'16. Dollar weakness relative to most emerging-market currencies, together with the premium yields over sovereign bonds in developed markets, has attracted large-scale inflows into EM debt funds. But the strength of currencies such as the rand and rouble appears fragile as investors have chosen to ignore fundamental factors such as the political problems in South Africa and the impact of the weak oil price on the Russian economy.

Secondly, the Chinese economy now appears much more stable after the huge corporate imbalance that nearly led to a financial crisis towards the end of 2015. The government has launched both a monetary stimulus and a fiscal stimulus focusing mainly on infrastructure. One effect of the better Chinese economy has been to help commodity-exporting countries, especially metals exporters such as Chile, Brazil and South Africa.

Finally, those emerging markets with a relatively high weighting in technology stocks have benefited from the very positive sentiment towards this sector across all global equity markets. The main beneficiaries have been in North Asia, namely Taiwan (TSMC), Korea (Samsung) and China (Baidu, Alibaba and Tencent).

These three factors are fragile, built mainly on the weakness in the dollar, and rest on over-stretched valuations. The most successful approach to equity investment since the financial crisis has been to adopt a contrarian strategy, because of the increasing dominance of momentum-chasing investors. After the massive rally, the long emerging trade looks very crowded and over extended. There is a real risk that these trades could unwind and unwind quickly.

> *“There is a large structural risk because of the causes of the dollar weakness”*

There is also a large structural risk because of the causes of the dollar weakness. The last eight months have shown that there is very little President Trump can do to affect the inherent strength of the US economy. The US corporate sector continues to be strong, with good earnings growth. Overall GDP is good and the country benefits from a low oil price. There are no obvious recession indicators. I am still a dollar bull, albeit there is now heightened event risk due to the erratic nature of the Trump presidency.

As for China, this feels to me very much like 2010, in the aftermath of the massive 2009-'10 credit stimulus, with its legacy of corporate and local government debt leading to a period of very poor performance from Chinese equities from 2011 to 2014. Following another round of monetary and fiscal stimulus, China's ratio of credit to GDP growth has risen even further, while productivity growth continues to fall. Contrary to popular perception, China is not becoming more market driven; it is becoming more state driven, implying the sustainable rate of economic growth is still falling

CHINA'S FUTURE: PART ONE

THE GREAT REBALANCING

The National Party Congress will leave Chinese President Xi Jinping more powerful than ever before. What does this mean for China's domestic reform agenda over the next five years?

> *After the Congress is finished, the president will emerge with more power than any Chinese leader since Chairman Mao*

In October, the Great Hall of the People on Tiananmen Square will host the National Congress of the Communist Party, a meeting held every five years to reshuffle the higher-ups in the Chinese government. The lavishly-appointed building will host thousands of delegates from across the country, mostly middle-aged men whose ideological conformity is symbolised by their dress: unfussy suits, plain ties and identical black hair dye.

For all the pomp, the Congress is a glorified rubber-stamping exercise. The real political work takes place in the months leading up to the event, at Zhongnanhai, a secluded compound located a few hundred yards north of the Great Hall. Here, in government buildings set amid tranquil gardens, President Xi Jinping has been honing his team in preparation for his second five-year term, promoting allies and casting rivals into political oblivion.

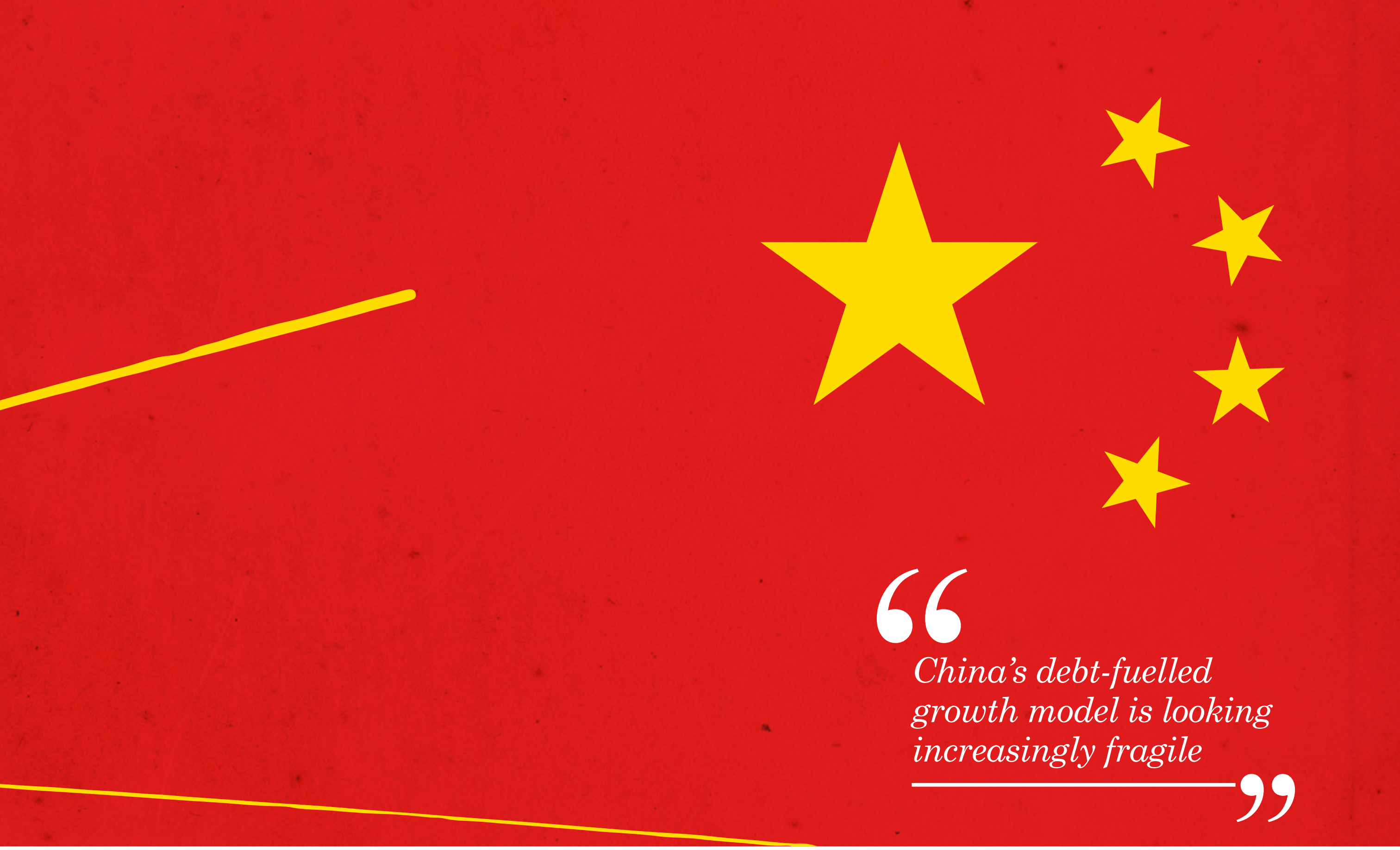
After the Congress is finished and Xi's decisions are given the imprimatur of the top party committees, the president will emerge with more power than any Chinese leader since Chairman Mao. But will he take advantage of his strengthened position to push for reform, or continue to tighten the government's grip on the economy?

"The political transition will give Xi Jinping more power to do what he wants to do; the question is what he wants to do," says Jonathan Anderson, principal at Emerging Advisors Group, a consultancy. "There's a debate over whether Xi is at heart a 'go-for-growth' guy or a reformer. He's delivered the usual liberal reform mantra, but he is also very much about strengthening the stability of the state."

Reform 2.0

Xi's political career may hold clues as to his priorities. Like Vladimir Putin in Russia, Xi's ascent from unremarkable bureaucrat to powerful strongman took many by surprise. Although he was born into communist royalty – he is the son of Xi Zhongxun, vice-premier in Mao's government – he had to work his way up through provincial Party structures after his father was imprisoned as a reactionary during the upheaval of the Cultural Revolution in the 1960s.

Xi Zhongxun was rehabilitated under Deng Xiaoping in the 1980s and became governor of Guangdong, where China was undertaking its first free-market experiments. Meanwhile, Xi Jinping climbed the political ladder to become Party chief of the affluent province of Zhejiang in the 2000s, where he promoted private business



> *China's debt-fuelled growth model is looking increasingly fragile*

and supported the rise of Geely, the car company that later bought Volvo.[1]

After he became president in 2013, Xi initially presented himself as a Deng-style reformer. That year, the Third Party Plenum – a meeting of the Communist Party's Central Committee – laid out an ambitious reform agenda dubbed 'Reform 2.0' in the state media, a deliberate allusion to China's original round of market reforms in the 1980s.

The official title of the policy document that came out of the meeting was more long-winded: 'Decision on Major Issues Concerning Comprehensively Deepening Reforms.' It pledged to allow market forces to play a 'decisive role' in the economy and to encourage the development of non-public sectors. The intention was clear: to rebalance the economy away from state-led, debt-fuelled investment towards a more consumer-driven growth model.[2]

However, this reform programme took a back seat over the next few years as Xi set about centralising political power – mainly through a massive anti-corruption drive – and prioritising vigorous, state-led growth. He signalled his intention to fulfil his predecessor Hu Jintao's pledge to double the size of the economy between 2010 and 2020, unleashing massive fiscal stimulus packages whenever growth looked set to slip below its target of 6-7 per cent.

The question now is whether Xi will belatedly attend to the Third Plenum reform agenda once the Autumn conference is concluded and his political hand is strengthened. "I think we can all agree that Xi will emerge from the Party Congress with more political capital," says Evan Medeiros, Asia director at Eurasia Group and former special assistant to President Obama at the White House's National Security Council (NSC).

"Top of Xi's agenda is economic management. And I use the term 'management' very deliberately. It doesn't mean a complete embrace of the Third Plenum programme. It will basically be a mix of embracing supply-side structural reforms while also using the state, especially when it comes to industrial policy," Medeiros adds.

Tackling the debt mountain

Whether Xi is willing and able to push ahead with reform will become clearer as his revamped administration addresses the key issues facing the Chinese economy over the next five years. Beijing will need to tackle an enormous debt mountain, reform sluggish state-owned enterprises and spur consumer demand if it is to successfully rebalance the economy.

China's debt-fuelled growth model is looking increasingly fragile. The country's overall debt has risen by 130 percentage points of GDP since the global financial crisis, much faster than in other large economies. In its latest *Global Financial Stability Report*, published in April, the International Monetary Fund (IMF) drew parallels with the conditions that caused the crises in Japan in the late 1980s and the US in 2007-'09. In May, Moody's Investors Service hit China with its first sovereign debt downgrade since 1989 by knocking the country's long-term local currency and foreign currency issuer ratings to A1 from Aa3.[3]

If China is to curtail the flow of new credit and reduce the debt load, it is likely that Xi will have to sacrifice his growth targets. Yanmei Xie, China policy analyst at Gavekal Economics, a consultancy, believes the government may indeed refocus on deleveraging and allow growth to slow once the Autumn conference is concluded.

"It is quite possible the government will be willing to see GDP growth slow to attend to its supply-side restructuring, including

THE GREAT REBALANCING
continued

> *The government will have to start putting more pressure on state-owned enterprises*

The Great Hall of the People, Beijing

deleveraging, reducing excess capacity, and cutting inventory, as well as managing and controlling financial risks," she says. "There has been ample evidence that the latter has become a top priority for Xi."

In fact there are signs the credit cycle has already begun to turn. One of the few market reforms Xi's government has enacted thus far has been to partially liberalise the financial sector, with a view to extending credit to more businesses and boosting overall growth. But this also led to a rise in shadow lending, as banks and other financial institutions started marketing so-called wealth-management products to shift loans off their balance sheets and circumvent rules over credit ratios and capital-adequacy requirements.

Initially relaxed about this activity, Beijing is now taking steps to crack down on it. In its quarterly monetary-policy report published in February, the People's Bank of China (PBC) drew attention to the risks associated with banks' shadow-lending activity and introduced new rules on the sale of wealth-management products linked to illiquid assets. The PBC has also been raising interbank rates since January to stem the flow of credit: the benchmark overnight repo rate in Shanghai has risen from 2.2 per cent at the beginning of January to 2.9 per cent as of August 25.

These measures appear to be taking effect. Approximately RMB 1.1 trillion flowed out of commercial-bank investments with mutual funds and brokerages between April and July, according to PRC Macro, a consultancy. Meanwhile, the 'credit impulse' – a measure of broad credit growth – is estimated to have fallen by an amount equivalent to 17.5 per cent of GDP over the first quarter of 2017. A drop of this magnitude has only previously been recorded in 1994, 2004-'05 and 2010.[4]

The PBC will aim to strike a delicate balancing act to ensure the growth slowdown is gradual, and it is likely to continue to extend credit to commercial banks through its Medium-term Lending Facility while putting pressure on financial institutions to rein in shadow banking. This is a necessary process, even if some asset classes are likely to suffer in the short term as the credit cycle turns, according to Will Ballard, Head of Emerging Market Equities at Aviva Investors.

"Over the long run, deleveraging is vital. By cutting its massive debt load, China will make its economy safer and more resilient, and remove the Sword of Damocles from above investors' heads. But there will be some negative consequences. Chinese equities are likely to suffer as cheap credit becomes more difficult to come by, and bond yields will probably rise as interbank rates are pushed higher," he says.

SOE reform

Although Xi may be willing to let growth slow while China attends to its debt burden, this is not necessarily a sign he is ready to use his power to enact deeper economic reforms. Indeed, some argue Beijing's crackdown on the financial industry is actually more about reasserting government control over private institutions that had grown too big and too greedy – and threatened to form alternative power bases.

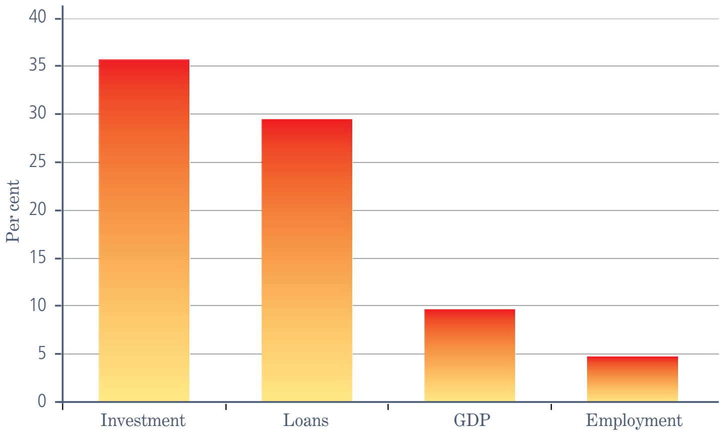
If the government is serious about cutting the debt burden, it will have to start putting more pressure on state-owned enterprises. Xi has promised to do this. Speaking at the National Work Conference in July, a meeting of China's top financial regulators convened every five years, the president said "deleveraging at SOEs is of the utmost importance". He urged regulators to "get a grip" on "zombie" companies fuelled by cheap credit.[5]

Xi's administration recognises the continued preponderance of unwieldy and uncompetitive SOEs is hampering the transfer of capital and resources to more productive sectors and ultimately undermining economic stability. Under Xi and his predecessors, China's investment-led growth has been channelled through an opaque tangle of SOEs; not just lumbering Mao-era conglomerates but newer local-government entities established to finance infrastructure projects, of which there are tens of thousands.

"These entities were only created two or three years ago in many cases, but many of them have disastrously bad balance sheets and are involved in white-elephant projects," says Anderson. "Reversing course would mean identifying where the problems are, shutting down these quasi-corporate structures and transferring the bad debts to local governments to pay for the residual cost."

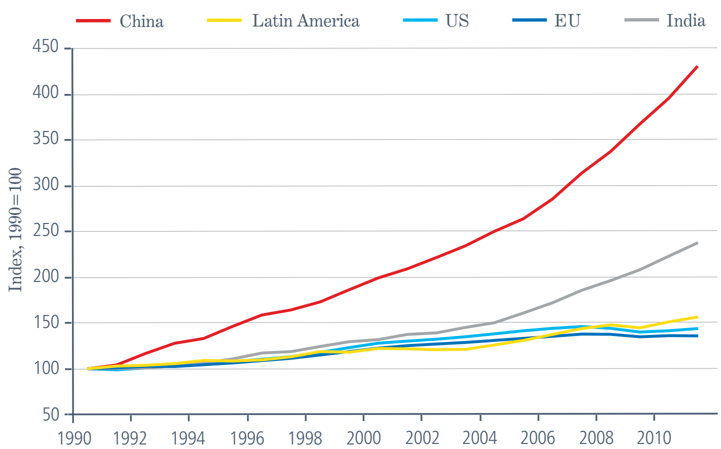
Xi's administration has already taken steps to privatise state-owned enterprises in non-strategic industries. In 2015, the

Figure 1. State-owned enterprises: share of economic aggregates



Source: Official data, Gavekal/Macrobond, July 2017

Figure 2: China's consumer boom



Source: Gavekal, 2013

government began reclassifying SOEs as 'for profit' or 'welfare or public service' firms; the idea was that the more commercially-oriented enterprises could be restructured, sell stakes and start hiring from the private sector.

Earlier this year, the government sold 50 per cent of Chinese medicine-manufacturer Yunnan Baiyao to a private investor, in a deal that has been hailed in the state media as proof positive it is making headway in pushing so-called 'mixed-ownership' of SOEs.[6] This follows the partial privatisation of state-controlled oil company Sinopec Corp., which sold a $17.5 billion stake in its low-margin retail business in 2014. The company issued new shares to a group of investors including Harvest Fund Management Co., one of China's largest asset managers, and technology giant Tencent Holdings.[7]

Nevertheless, the reclassification process has been fitful and many of the changes implemented during the latest round of SOE reform have actually expanded the role of the state. For example, the regulator has promoted the creation of 'national champions' through mega-mergers; joining railway companies, shipbuilders and energy firms into massive conglomerates. This is partly so they can project China's influence abroad via the Belt and Road programme (see China's future: part two). Consolidating state entities also makes it easier to track and control them. As an old Chinese management slogan put it: *yi zhang zhi* – or 'I only want to see one head'.[8]

Spurring consumer demand

This is not 'reform' in the commonly-understood sense of market-led change. But if you take reform more broadly to mean an economic rebalancing away from inefficient debt-fuelled growth towards a more stable, consumer-led model, Xi's increasing power over SOEs may offer a way forward.

One aspect of SOE reform that has seen significant change under the current administration is the creation of 'state-capital investment corporations', which are extending the government's reach into new industries such as biotechnology and IT. While there is a risk these corporations will crowd out private companies, they may also be able to direct government investment more efficiently, clear away bottlenecks to private capital and unlock new sources of consumer demand, which will be crucial if China is to rebalance its economy.

"China needs to start making higher-return investments—and such investments will be those that successfully anticipate or create demand from the growing middle and upper classes," according to Andrew Batson, China research director at Gavekal, who points to healthcare, education and logistics as areas the government should focus on.[9]

Contrary to the received wisdom, consumer spending is not artificially repressed in China; it has been growing rapidly for the past two decades, albeit from a low base (see figure 2). In order for China's economy to rebalance, it needs to transfer wealth from the government sector to households to amplify the economic impact of improved consumer spending. And Xi's centralised model may actually be conducive to pushing through such transfers, says Michael Pettis, professor of finance at Peking University in Beijing.

"There are still people out there who say China has got the highest savings rate in the world because Chinese people save lots of money. It's nonsense: China has the highest savings rate in the world because it has the lowest household income share of GDP in the world. China has to raise the household income share – and the only way to do that is to transfer wealth from the government sector. The problem is a political one."

THE GREAT REBALANCING
continued

This offers one way of looking at Xi's massive centralisation of power over the last five years, aided by an anti-corruption campaign that has seen thousands of provincial officials – many of them senior figures, or 'tigers' – thrown into prison. Until now, China's growth model has been based on channelling resources through local-government infrastructure investment, which enabled corruption and enriched local elites. If China is to effect an economic rebalancing towards consumer-led growth, it will need strong leadership to tackle these vested interests and redistribute wealth to households.

After the National Congress enshrines his position as China's 'core leader', Xi will be well-placed to deliver such redistribution and advance the agenda of the Third Plenum.

"Back in 2009, before Xi became president, I wrote down what would be the optimal process for economic rebalancing and adjustment in China, and item number one on the list was that the next president would have to centralise power dramatically," says Pettis. "The historical precedents are very clear; in cases where these kinds of reforms were successfully implemented it was always either in democracies or highly-centralised autocracies, not those in-between. It seems to me Beijing understands it has to centralise power in order to implement reform."

Market reforms?

There is, of course, another perspective on Xi's centralisation of power: he is simply entrenching his own position in an attempt to cling on as president after 2022. "Xi wants to create favourable conditions so he can extend his term," says Minxin Pei, professor of government and director of the Keck Center for International and Strategic Studies at Claremont McKenna College in California. "He wants to prevent the appointment of a successor and to gain more control over the Politburo Standing Committee. A third term is almost a foregone conclusion."

For Xi to stay on as president he would need to change the state constitution, which would be politically difficult. There is, however, no limit on terms for General Secretary of the Communist Party. It is possible Xi may remain as the Party's 'core leader' even after he steps down as president, pulling strings from behind the scenes as Deng – who was never officially China's head of state – did to great effect.

Whether Xi will use his power to push through the economic rebalancing process over the next five years, or merely to further his own political interests, remains to be seen. Both Pettis and Medeiros believe that, for at least the next five years, China will continue promoting the consumer economy while bolstering the political strength of the centralised Party state. This may be enough to correct China's economic imbalances in the short term, but the longer-term outlook for the Chinese system is less certain.

China will not become a fully modern economy until it is able to unleash the private sector and encourage entrepreneurial innovation, which would require a loosening of Party control and an enforceable rule of law. While China has a robust private sector it remains subject to political fiat – witness the regulatory crackdown on Anbang Insurance, whose powerful and outspoken chairman Wu Xiaohui has reportedly been detained by the anti-corruption squads.[10]

Pei believes the case may suggest how Xi's government will rein in other private companies, such as China's technology giants Baidu, Alibaba and Tencent (the so-called BATs), as they become bigger and more powerful. "Anbang is tied to Deng Xiaoping's family. So Xi has accomplished several objectives with one move. It was politically-motivated. With the BATs we

THE IMPLICATIONS FOR INVESTORS

Over the next five years, China looks set to promote the consumer economy and cut the debt load, while bolstering the political strength of the centralised Party state. Growth is likely to decline – if not dramatically – because even if consumer spending increases it will not be able to compensate for the drop in overheated, debt-fuelled infrastructure spending that hitherto drove GDP expansion.

This development will have implications for countries far beyond China. The country was becoming ever more closely entwined with the global financial system before the introduction of the 'Bond Connect' scheme in June, which grants overseas investors more access to onshore credit markets, and the incorporation of Chinese A-shares into the benchmark MSCI Emerging Markets Index, which will take effect in 2018.

In its *Global Financial Stability Report*, the IMF warned: "It is likely China's spill overs to global financial markets will increase considerably in the next few years".

> *China will not become a fully modern economy until it is able to unleash the private sector*

are likely to see variations on the same theme; they may be asked to bail out state-owned companies or become minority shareholders in these large state companies," says Pei.

Under this authoritarian regime, it seems likely that deeper market and political reforms will be limited, and the government will retain control over the renminbi exchange rate and capital outflows. This will deter foreign companies, which are already growing frustrated at protectionist measures that compel them to transfer technology to Chinese counterparts in return for market access.

"Rolling back the emphasis on state-led champions, liberalising the market, allowing foreign participants to compete on an equal footing; these things would help a lot – but I'm not sure that's where we're going," says Anderson. "If you look at what's happening in China now, it's all about sidelining the role of foreign ideas, of foreign money, and re-emphasising the primacy of state-owned capital in the system. Market liberalisation is one part of the reform agenda that is not going to get done in the second half of Xi Jinping's term."

Pei believes the contradictions in the Chinese system between the state and a vibrant private sector will result in a political reckoning within the next decade, with economic stagnation convincing the government, business and the public of the need for deeper reform.

For now, however, the fate of China rests largely with Xi Jinping and his inner circle. Xi wields immense power, and whether he uses it to drive reform or to cement his own position, the implications will be felt far beyond China's borders. When the president takes to the podium to address the gathered cadres at the Great Hall of the People, the eyes of China, and the world, will be on him ●

1 See 'Born Red,' *The New Yorker*, April 2015
2 See 'The party's new blueprint,' *The Economist*, November 2013
3 'Moody's downgrades China's rating from A1 from Aa3 and changes outlook from stable to negative,' Moody's Investors Service, May 2017
4 'China's credit squeeze sends warning on global growth,' *Financial Times*, July 2017
5 'China's Xi orders debt crackdown for state-owned groups,' *Financial Times*, July 2017
6 'Reform of China's ailing state-owned firms is emboldening them,' *The Economist*, July 2017
7 'Sinopec to sell $17.5 billion retail stake in privatization push,' *Reuters*, September 2014
8 'Big is beautiful? State-owned enterprise mergers under Xi Jinping,' European Council On Foreign Relations, November 2016
9 *Don't wait for consumption-led growth*, Gavekal Dragonomics, September 2013.
10 'Wu Xiaohui: China "detains" Anbang Insurance chairman,' *BBC News*, June 2017

So how will other markets be affected? With less debt-fuelled growth among state-owned enterprises, demand for commodities seems likely to fall, and this could affect export-oriented emerging markets in Asia and Latin America.

"Recent history indicates how this may play out," says Will Ballard, Head of Emerging Market Equities at Aviva Investors. "Many commentators attributed Brazil's economic travails in 2015 and 2016 to the corruption scandal engulfing former president Dilma Rousseff, which eventually resulted in her impeachment. But the impact of a decline in Chinese demand for raw materials following its economic slowdown in 2015 was arguably more important. It is no surprise Brazil started to emerge from its slump when demand in China – its biggest trading partner – began to rise again towards the end of last year."

That resurgence also coincided with a recovery in global inflation. Indeed, the return of Chinese demand was arguably more of a factor in propelling a global rebound in commodity prices and inflation than the commonly-cited cause: the election of Donald Trump as US president, which investors hoped would bring less regulation and more fiscal stimulus. This shows China's credit cycle is of relevance to developed-market investors too.

For the moment, commodities markets are holding up – give or take some softening in iron-ore prices since the beginning of the year. Nonetheless, emerging-market investors should keep a close eye on signs of weakening demand as the government's deleveraging project proceeds. "These signs will not necessarily be evident in debt and quarterly growth figures, but in less-obvious metrics. Freight movement and electricity-generation patterns, for example, tend to be reliable indicators of industrial activity in China's rustbelt," Ballard adds.

Within China, the economic rebalancing process is likely to restrict the flow of credit to businesses that previously enjoyed easy access to financing, particularly those involved in infrastructure construction projects, although the Belt and Road programme (see China's future: part two) is likely to spur demand for commodities among other Asian countries.

If China succeeds in using its new state capital investment corporations to spur consumer demand, consumer-facing industries such as healthcare, education and logistics – sectors that have obvious bottlenecks that targeted investment could help clear away – could benefit, according to Gavekal.[9] ●

CHINA'S FUTURE: PART TWO

THE LONG ROAD TO RULE

Xi Jinping wants to restore China to its historic status as the world's pre-eminent political and economic power. Will he succeed?

> *Beijing – not Washington and its allies – is now leading the charge for greater Asian integration*

In May 2017, China's President Xi Jinping welcomed 29 foreign heads of state to Beijing to discuss the 'Belt and Road' programme, a vast network of infrastructure projects intended to facilitate "more open and efficient international cooperation". *CNN*'s report on the event put it more bluntly: these leaders were "ringing in a new world order"; a model of global trade led by the East rather than the West.[1]

But were they ringing in a new world order, or reviving an old one? Xi began his speech at the opening of the Belt and Road Forum by looking back 2,000 years to the origins of the Silk Road, with its "friendly emissaries" and "camel trains".[2] His explicit message was that Belt and Road will renew historic trade links between Europe and Asia. Implicit was the idea that China is seeking to restore its rightful status as the world's richest and most powerful nation, the position it occupied when the Silk Road was at its height.

"China has pursued a much more active and aggressive foreign policy under Xi Jinping," says Evan Medeiros, Asia director at Eurasia Group and a former special assistant to President Obama and senior director for Asian affairs at the National Security Council (NSC). "You see that reflected in his behaviour towards territorial disputes in the East China Sea and the South China Sea and in big initiatives such as the Asian Infrastructure Investment Bank and Belt and Road."

Since it underwent its first market reforms in the 1980s, China has mostly followed Deng Xiaoping's dictum on foreign policy: "Hide your capacities, bide your time." By contrast, Xi's presidency has been marked by an eagerness to flaunt China's capabilities and demand recognition on the world stage. As the US turns inwards under President Trump, Xi sees an opportunity to project China's power abroad. So what are the implications of his global ambitions for China and the world?

Trade

During Xi's second five-year term in office, China's foreign policy is likely to be geared around three main themes: trade, development and security. Xi's appearance at the World Economic Forum in Davos in January showed trade is high on the agenda. His speech positioned him as a vociferous advocate of globalisation, in contrast to Trump's protectionist tendencies.

"Economic globalisation has powered global growth and facilitated movement of goods and capital, advances in science, technology and civilization, and interactions among peoples," Xi said. "Pursuing protectionism is like locking oneself in a dark room. While wind and rain may be kept outside, that dark room will also block light and air. No one will emerge as a winner in a trade war," he added, drawing enthusiastic applause.[3]

THE LONG ROAD
TO RULE
continued

> *China is more likely to rely on economic diplomacy to settle disputes*

1700

freight trains left China for Europe in 2016, double the figure for 2015

Chinese companies generated

$76bn

in revenues in Belt and Road countries last year

Despite these sentiments, China has been pursuing protectionist policies itself. Most notably, Beijing requires foreign firms to transfer research and technology to domestic enterprises in exchange for market access. Earlier this year, Robert Atkinson, president of the Information Technology and Innovation Foundation, told US Congress that 'Made in China', Xi's technology investment initiative, is an "aggressive by-hook-or-by-crook strategy that involves serially manipulating the marketplace and wantonly stealing and coercing transfer of American know-how".[4] President Trump has ordered a review of China's intellectual-property practices, which could result in punitive unilateral sanctions under the Section 301 authority.[5]

Nevertheless, Trump's own protectionist turn, including his cancellation of the Trans-Pacific Partnership (TPP) in January, has provided China with an opening to assume economic leadership in the Asia-Pacific region and position itself as the guardian of free trade. China has been touting a separate trade deal, the Regional Comprehensive Economic Partnership (RCEP).

"US withdrawal from TPP clearly gives China an opportunity, and it is trying to seize that opportunity," says Medeiros. "That is reflected in the statements Xi Jinping has been making about his support for globalisation. China put a lot more energy into RCEP under the Obama administration because they saw TPP gaining traction. As the US steps back under Trump that process has only accelerated."

Many of TPP's intended members, including Australia and Japan, are now in talks to join RCEP. It's an ambitious project: RCEP includes the Association of Southeast Asian Nations, a 10-member bloc, plus India, Japan, Australia, South Korea and New Zealand, which together account for 40 per cent of global GDP. With the demise of TPP, there is significant political momentum behind the agreement, which promises to improve economic integration across Asia and give China a public-relations boost.

"Following President Trump's decision to withdraw the US from TPP, Beijing – not Washington and its allies – is now leading the charge for greater Asian integration," says Tom Miller, managing editor of the *China Economic Quarterly* and author of *China's Asian Dream: Empire Building Along the New Silk Road*. "Sceptics will scoff, but China is on course to replace the United States as the leading power in Asia."

Development

China is doing more than assuming economic leadership through trade in Asia as the US withdraws. It is also challenging the traditional role played by the US as the go-to provider of development finance, facilitating more efficient trade and establishing new markets for its exports. It is also developing useful geopolitical alliances in the process.

In January 2016, China launched the Asian Infrastructure Investment Bank (AIIB), widely seen as a rival to the US-led World Bank. The launch of the AIIB represented a diplomatic coup for China; several US allies, including the UK, Germany and Australia, signed up to the initiative despite Washington's opposition. In total, the AIIB has 57 signatory countries from Asia and elsewhere and is developing transport infrastructure across the continent.

But the Belt and Road initiative (formerly 'One Belt, One Road', or OBOR) is the true centrepiece of China's overseas development efforts. It is a mind-bogglingly huge project, or series of projects, that

Chinese firms signed construction contracts worth **$126bn** in Belt and Road countries in 2016

encompasses two main trade routes: the 'belt', which loosely follows the ancient Silk Road through central Asia, and the 'road', a string of maritime connections between Southeast Asia, South Asia and East Africa (see map).

Belt and Road comprises 65 countries, accounting for 29 per cent of global output and 63 per cent of the world's population. Progress has been slow but is now picking up, especially in two key parts of the network: the China-Pakistan Economic Corridor, a $50 billion series of infrastructure and agriculture projects that connects landlocked provinces in Western China to the Arabian Sea, and the New Eurasian Land Bridge, which takes in roads and railway lines linking China and Europe.

Critics have given the programme another name, 'One Belt, One Trap'; suggesting China is becoming embroiled in commercially disastrous 'white-elephant' projects. Much of the financing for Belt and Road is coming from China's policy banks, which will only exacerbate their existing debt problems if they finance uncommercial infrastructure. "The lack of commercial imperatives behind OBOR projects means that it is highly uncertain whether future returns will be sufficient to fully cover repayments to Chinese creditors," rating agency Fitch warned in January.[6]

The programme has also aroused suspicions about China's intentions. India has pointedly refused to participate in Belt and Road, which it views as a Chinese strategic ploy.[7] Meanwhile, some of the participant countries are wary of the problems that have afflicted Sri Lanka, whose government has had to swap debt for equity in Chinese-financed infrastructure projects to pay back unaffordable high-interest loans agreed under the previous administration.

Despite this scepticism, the benefits of the programme for both China and the wider region are becoming evident, says Miller. "China is still not trusted: Belt and Road is stirring up as much fear as hope, and few countries buy its diplomatic mantra about delivering 'mutual benefits'. Yet China's economic diplomacy is bold, forward-looking and practical. No doubt it will deliver some costly boondoggles along the way, but Belt and Road will also bring useful infrastructure, new trade routes and better connectivity to Asia and Europe."

According to data from the Chinese Ministry of Finance, there was a significant jump in overseas construction contracts and revenues in 2016, showing the initiative is helping to mop up some of China's spare industrial capacity. Significantly, Chinese firms signed construction contracts worth $126 billion and earned revenues of $76 billion in Belt and Road countries last year. More than 1700 freight trains left China for Europe in 2016, double the figure for 2015.[8]

"Chinese outbound direct investment (ODI) has increased dramatically, aided by initiatives like Belt and Road. ODI can be seen as a starting point for China increasing its involvement with the global economy," says Will Ballard, Head of Emerging Markets and Asia Pacific Equities at Aviva Investors. "Investment is being focused on developing countries; for instance, setting up shared manufacturing facilities."

As the Belt and Road initiative develops there will be opportunities for investors in China and its partner countries, says Maulshree Saroliya, Macro Strategist at Aviva Investors. "The programme promises exciting opportunities for Chinese companies in sectors such as high-speed rail manufacturing and telecommunications. And there will be investment opportunities in China's partner countries, some of which are frontier markets with potentially high rates of return."

A 'China Connectivity Index' developed by ICBC Standard Bank and Oxford Economics shows that China has already significantly improved its connections with nations including Thailand, Cambodia, Vietnam, the Maldives and the Philippines, where tourism-related sectors are likely to benefit from more Chinese visitors.[9] Further afield, Eastern Europe is now far better connected to China thanks to new rail routes through Central Asia, and Belt and Road nations including the Czech Republic, Bulgaria and Estonia will see improved trade links and inward investment from Chinese companies.[10]

China will not allow unlimited investment abroad. Concerned about rising debt, Beijing has tightened outbound capital controls and clamped down on foreign deals among China's more-acquisitive conglomerates in recent months. In August, China's State Council outlined new rules to restrict "irrational" overseas investments, but said it would continue to encourage Chinese firms to invest in Belt and Road projects, particularly in sectors such as agriculture and high-tech manufacturing.[11]

Security

From China's point of view, the benefits of Belt and Road are more than just economic. By helping to spur the development of

THE LONG ROAD TO RULE

continued

> *China remains hungry for raw materials to propel its growing economy*

neighbouring countries, China is winning friends and influence in other nations and improving security along its vast borderlands; places where the 'mountains are high and the Emperor is far away', according to an old Chinese proverb.

"Belt and Road is a great propaganda effort," says Jonathan Anderson, principal at Emerging Advisors Group, a consultancy. "If you step away from the pure economics and look at the geopolitical issues, China has a lot of underdeveloped and potentially dangerous neighbours. It's very much in China's interests now to develop a sphere of influence and a sphere of friends. That will help improve security."

Security is the third plank of China's foreign-policy agenda. In July, Xi donned fatigues to attend a massive demonstration of China's military might at a training base in Inner Mongolia to mark the 90th anniversary of the foundation of the People's Liberation Army. More than 12,000 troops and 600 heavily-armoured vehicles were arrayed on the central Asian plains, while 130 fighter jets roared overhead.

Reforming the army to make it fit for purpose and able to support China's overseas objectives has been one of Xi's main priorities in office, says Medeiros. "There has been a very significant and underappreciated effort to discipline the military and to bring about radical reforms of the military command structure. This gets underemphasised in financial markets, because everyone is focused on anti-corruption and economic reform."

China is increasingly deploying its military to secure its trade routes. This year it set up its first overseas army base since the Korean War, on the coast of Djibouti, a strategically-important location on the Horn of Africa, to defend its interests on the continent. And Chinese forces are increasingly participating in multilateral peacekeeping missions in South Sudan, Mali and the Democratic Republic of Congo.

"In parts of Africa, Chinese peacekeepers are going out on quite aggressive mandates and getting into firefights, rather than just defending static sites as they used to," says Raffaello Pantucci, director of international security studies at the Royal United Services Institute (RUSI), a security and defence think tank. "You are seeing a general change in China's projection of power. The base in Djibouti is part of a broader Chinese security presence around the world."

Many countries in Asia have become concerned over China's growing militarism. Under Xi, China has vociferously pressed its sovereignty of the Senkaku Islands (known in China as Diaoyu), a set of rocky outcrops currently controlled by Japan, and made a vigorous show of displeasure over Trump's contact with Taiwan's president Tsai Ing-wen in November 2016, which broke with US adherence to the 'One China' protocol. One of the practice targets the PLA Army uses for drills at the Inner Mongolia training base is a replica of the Presidential Palace in Taipei.[12]

Most notably, China has sought control over trade routes in the South China Sea, to which it believes it has historic claims. China has been building artificial islands in waters also claimed by Brunei, Malaysia, the Philippines and Vietnam. These vast sandbanks house military equipment, landing strips and – in one case – a cinema to entertain the troops. In his speech at the Belt and Road Forum, Xi cited the exploits of Zheng He, a fourteenth-century admiral who led vast exploratory fleets to Southeast Asia and East Africa, as a tacit justification for China's presence in these waters.

Nevertheless, the risk of a confrontation between China and the US or its allies has "fallen significantly in 2017", says Medeiros. Tensions were inflamed in July 2016 when a tribunal at The Hague ruled in favour of the Philippines, which had brought a case against China's island-building activity, but Filipino President Rodrigo Duterte has been mostly silent on the issue since a state visit to Beijing in November last year, when the two countries signed trade deals worth $13.5 billion.[13]

This shows that China is more likely to rely on economic diplomacy rather than military might to settle disputes. And it is economic means that might yet prove decisive in defusing the region's most pressing security threat: the volatile nuclear-armed regime in North Korea (see boxed text). In August, China signalled its growing impatience with Kim Jong Un by supporting US economic sanctions against Pyongyang.

The new hegemon?

While China is enjoying increasing influence through its economic and military prowess, there are limits to its ambitions. Unlike the US, China has little desire to become embroiled in conflicts that have no direct bearing on its domestic security or overseas economic interests, which means America is likely to remain the dominant global diplomatic and military power even if China wields increasing clout in Asia.

"I'm not a huge buyer of the idea that China wants to be a global superpower or police the world," says Mary Nicola, Investment Strategist and Senior Asia Economist at Aviva Investors. "China is more focused on Asia. China has not been active in many political initiatives globally, such as brokering peace in the Middle East."

Moreover, China remains a largely poor country, despite its growing share of global wealth. In 1950, the US generated almost 30 per cent of global GDP; now that figure is less than 16 per cent. China's share has grown from 4.5 per cent to 17.2 per cent in purchase-power parity (PPP) terms over the same period – a striking reversal. But China still lags far behind the US in per capita income: the average salary in China is just over $8,000, compared with almost $60,000 in the US.[14]

As a developing country, China remains hungry for raw materials to propel its growing economy. That means it will continue to prioritise trade links with emerging economies that can provide these resources, such as those in sub-Saharan Africa, rather than seeking increasing influence at the diplomatic top table. Ballard notes the composition of China's trade is still starkly different from that of the US.

"China is a big country, but remains a poor one. And that shapes its demand. Meanwhile, the US is a big country and a relatively rich one. Around three-fifths of Chinese imports are in crude commodities – like soya beans and iron ore – fuel and machinery and transport equipment. By contrast, around two-fifths of US imports emanate from the same sectors."[15]

The composition of China's trade will shift as it makes the transition towards consumer-led growth. And although China will not supplant the US as global hegemon any time soon, it looks set to greatly expand its regional influence through the AIIB, Belt and Road and RCEP. Over the longer term, the trade and infrastructure links it is forging may pay handsome economic and political dividends. Container ships and freight trains may have replaced camels and donkeys, but China's path to global pre-eminence still lies along the Silk Road ●

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DESTINED FOR WAR?

An interview with Harvard Professor Graham Allison

A country with growing economic, political and cultural influence demands its due recognition; the established power feels threatened and seeks to contain its rival. This was the volatile state of affairs in the fifth-century BCE, when Athens rose to challenge Sparta, the dominant city-state in Greece. The result was the Peloponnesian War, which lasted for a quarter of a century. The historian Thucydides wrote that "it was the rise of Athens and the fear that this instilled in Sparta that made war inevitable".

Professor Graham Allison is director of Harvard University's Belfer Center for Science and International Affairs and founding dean of the Kennedy School of government; he advised the secretaries of defence under presidents Ronald Reagan, Bill Clinton and Barack Obama. He coined the term 'Thucydides's Trap' to describe the hazardous dynamic that occurs when a rising power threatens to displace a ruling one, as in Ancient Greece. Allison's research shows this pattern has recurred 16 times in the past 500 years – and in 12 of those cases, the result was war.

In his book *Destined for War*, Allison argues the growing rivalry between China and the US is a modern example of Thucydides's Trap. "If leaders in Beijing and Washington keep doing what they have done for the past decade, the US and China will almost certainly wind up at war," according to Allison. The Thucydides Trap concept has gained currency at the highest levels of government, and Xi and Obama discussed it at their summit in 2015, although they could not agree on a course of action to escape it.

So what can history teach us about the likely outcome? And how can the risk of war between the US and China be mitigated? Allison spoke to *AIQ* to explore the various possibilities.

AIQ: How does Thucydides's Trap occur, and why is it so dangerous?

Graham Allison: Thucydides's Trap is the dynamic that occurs when a rising power threatens to displace a ruling power, as when a rising Athens challenged Sparta, and when a rising Germany challenged Britain before World War 1. It is occurring today as a rising China challenges the US. The special danger of Thucydides's Trap is not that the rising power thinks: "This is a good time to attack the leading power," or that the leading power thinks: "We better cap the rising power before it gets stronger." It is that, as each of the countries becomes more entangled with third parties, third-party actions that would otherwise be inconsequential can serve as triggers for cascades of actions and reactions on the part of the principal protagonists.

AIQ: Which is the closest historical analogy for the current dynamic between the US and China?

GA: If I was to pick just one, it would be the run up to WW1. Britain had been the dominant power globally for 100 years; Britain ruled the

THE LONG ROAD TO RULE

continued

> *Kim Jong Un could drag the US and China into a war neither country wants*

waves and had an empire on which the sun never set. Germany in 1870 had a GDP about half the size of Britain's, but by 1913 its economy had become larger than Britain's. Each country wanted to defend its own interests. Under these conditions, certain triggers led to a war that nobody wanted.

AIQ: What does history teach us about China's intentions? Does it want to supplant the US as the dominant power in Asia and the world?

GA: In Chinese society, Chinese history and Chinese consciousness, China has been the guardian power in the world – at least in the world they can see, Asia – for close to five millennia. China is accustomed to being the dominant power in its region.

When Xi became president he said: "The greatest Chinese dream is the great rejuvenation of the Chinese people." Are Xi and his colleagues serious about displacing the US as the predominant power in East Asia in the foreseeable future? I put that question to the world's premier China watcher, [statesman and former prime minister of Singapore] Lee Kuan Yew, who spent many thousands of hours with Chinese leaders, including Xi, who saw Lee as a mentor. He said: "Why not? How could they not aspire to be the leader in Asia and a power in the world?" So is that a serious ambition for Xi? Absolutely.

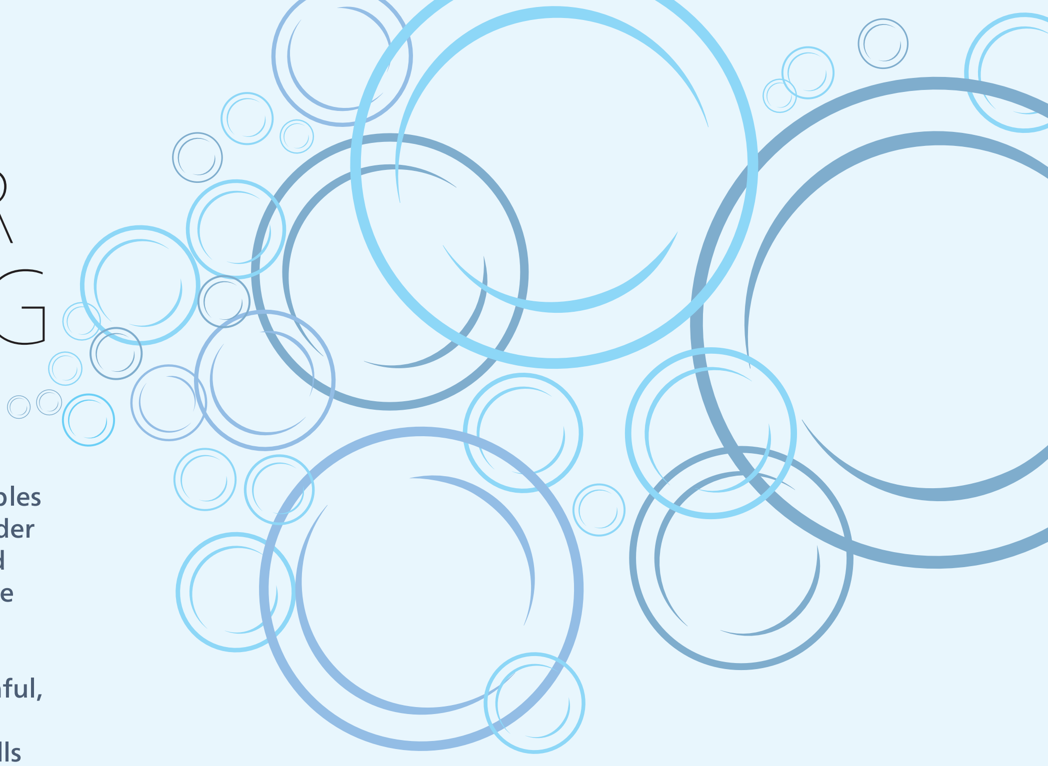
AIQ: In Destined for War, you outline various triggers that could lead to war between China and the US, including an accidental collision between US and Chinese vessels in the South China Sea; a conflict provoked by a third party such as Taiwan or Japan; the escalation of a trade war; or the collapse of the North Korean regime. Which are you most concerned about?

GA: The North Korean scenario has become the most worrying. It is possible that Kim Jong Un could drag the US and China into a war neither country wants. It's quite easy to get from where we are now to a situation in which America attacks North Korea to prevent it firing an intercontinental ballistic missile [ICBM] that could hit the American homeland. North Korea might respond by shelling Seoul, killing 100,000 people very quickly, drawing retaliation from the US and South Korea; this means you now have a second Korean War. Under this scenario, if China acts to preserve a buffer state between it and South Korea, that could lead to a direct confrontation between Chinese and American troops.

AIQ: Can war be avoided?

GA: That is certainly my hope; the book is not meant to be fatalistic; I don't think we have to accept our destiny. But those who don't study history are doomed to repeat it. Thucydides's Trap is extremely dangerous; in 12 of 16 previous cases it has resulted in war. We need to closely attend to how third-party situations could drag us into war, starting with North Korea. We need serious joint US-Chinese efforts to address this challenge, and the development of strategic alternatives under which each of the protagonists can defend their own interests without stumbling into a war. More strategic imagination is required ●

FOREVER BLOWING BUBBLES



Warnings of asset price bubbles have been growing ever louder thanks to the unprecedented monetary policy easing of the past decade. With the global economy improving, central banks need to be ever watchful, and tighten policy in good time, to ensure these siren calls continue to ring hollow, says Michael Grady.

In recent weeks, several officials at the US Federal Reserve (Fed) have sounded concern about asset prices, which in the words of the central bank's chair, Janet Yellen, appear "somewhat rich".[1] So far, financial markets have been content to turn a blind eye. Stock markets in the US and elsewhere have continued to power to new highs, while US Treasury bond yields are below where they began the year.

While the Fed is probably not unduly alarmed by the level of asset prices just yet, the remarks from Yellen and others add another element to the debate around the pace at which US interest rates should rise over the coming years. It reinforces our belief that market expectations rates will be hiked just three times over the next four years are likely to prove misplaced. The Fed itself expects to raise rates on four occasions – by a cumulative one percentage point – by the end of 2018. It says tighter financial conditions are required to ensure unemployment does not fall too far and inflation rise too much. But when making that assessment, the Fed rightly also says it needs to take into account the overall state of financial conditions and the risks to financial stability.

In a speech in March 2017, William Dudley, the head of the Federal Reserve Bank of New York and a permanent member of the Fed's rate-setting panel, said there are five main variables the central bank watches in determining overall financial conditions: short- and long-term Treasury rates, credit spreads, the foreign exchange value of the dollar, and equity prices.[2]

The Fed traditionally implements monetary policy by adjusting short-term interest rates. The problem for policymakers is that the response of overall financial conditions to changes in short-term rates is unpredictable, and there have been times when they have moved in opposite directions.

As Dudley noted, beginning in June 2004 the Fed raised its target Federal Funds rate in 25-basis-point increments at 17 consecutive meetings, pushing the rate up from a starting point of one per cent to a peak of 5.25 per cent. And yet over the same two years, financial conditions failed to tighten as the rise in short-term rates was offset by a decline in long-term yields, a rise in equity prices and narrower credit spreads.

Fatal amount of leverage

With the benefit of hindsight – leaving aside all the additional problems created by complex financial engineering – it is clear the Fed let overall financial conditions remain far too loose. As a result, a fatal amount of leverage built up within the economy. There were classic signs of bubbles in various markets and yet the Fed failed to react to them.

It is also easy to see why it was lulled into a false sense of security. From an economic perspective, growth was decent but not outstanding and inflation was broadly around target. The period was not coined 'The Great Moderation' by economists without reason.

Fast forward to today and the Fed is faced with a not dissimilar situation. Despite having raised rates by a quarter point on four occasions since December 2015, financial conditions have become easier over this period, thanks to soaring equity valuations and plunging credit spreads – both the dollar and long-term interest rates are little changed. Furthermore, it seems many investors believe the central bank will be unable to tighten policy much further without negative repercussions for the economy.

We do not share this view. Monetary policy remains highly accommodative, with negative real rates still prevailing. Failing to raise rates expeditiously poses a greater risk to the economic outlook as it could mean the Fed having to hike more aggressively down the track.

Risk of new bubbles

We are confident the US economy will be able to cope with higher rates; albeit we do

FOREVER BLOWING BUBBLES

continued

> *The dilemma facing the Fed at present is unusually acute*

not expect them to rise to pre-financial crisis levels. Given the extent to which the labour market has tightened over the past eight years, it seems certain further job creation will eventually feed through into more rapid wage growth and hence inflation. On top of this, it seems the Fed is increasingly aware that if it fails to tighten policy enough it risks fuelling an unsustainable bubble in various asset markets, both at home and abroad.

There is little doubt the monetary policy medicine of recent years was necessary to revive the economies of the US, euro zone and UK, which were in extremely distressed states.

However, there are other countries, such as Canada, Australia, Sweden and New Zealand, which were far less affected by the global financial crisis. Cheap global money has for some time been finding its way into these countries' property markets. They now appear over-inflated (figure 1), while household debt has reached record levels (figure 2).

Even in the US, while there are no obvious flashing lights indicating any particular market is in bubble territory, with some degree of economic normality having returned there is a clear danger that if monetary policy is not tightened sufficiently the Fed runs the risk of creating problems for itself.

While household finances in the US are in reasonable shape, corporate balance sheets are more stretched. Although one could argue US companies have simply taken advantage of the low-interest-rate environment of the past decade to refinance their debt and buy back equity, it has created a new vulnerability should the economy turn sour or the Fed delay raising rates and subsequently find it has to hike them more aggressively. Commercial real estate is one sector where valuations might already be stretched, which has been highlighted by officials such as Eric Rosengren of the Boston Fed.[3]

Talk is cheap

While there have been plenty of occasions in the past when Fed officials have talked about frothy asset markets, they have shied away from actually taking the necessary steps to prevent bubbles expanding, preferring to try and clean up the mess after they burst.

As former Fed Chairman Ben Bernanke said in 2002: "Understandably, as a society, we would like to find ways to mitigate the potential instabilities associated with asset-price booms and busts. Monetary policy is not a useful tool for achieving this objective."[4]

Like the global financial crisis, the origins of the dot-com bubble of the late 1990s can be traced back to loose monetary policy. To be fair to Alan Greenspan, Bernanke's predecessor, he had voiced concern about stock prices long before they had peaked in a famous speech in December 1996. Furthermore, transcripts of subsequent meetings of the committee that sets US interest rates revealed several officials had expressed anxiety about a possible bubble in 1998 and 1999.

While discussing the stock market at the Fed's December 1999 meeting, Greenspan warned: "It is only a question of how much of a bubble there is."[5]

The bottom line, however, is the Fed did precious little to deflate it until it was too late. At 4.75 per cent, the Federal Funds rate was 50 basis points lower in June 1999 than it had been fully two and a half years earlier when Greenspan first warned of the stock market's "irrational exuberance".

In the past, Fed officials advanced three main arguments for not using interest rates to control asset prices. First, they said the best way to achieve economic stability was to focus on inflation and growth when setting monetary policy. Asset prices only mattered to the extent they impacted wider economic activity and consumer prices. Second, one can never be sure that what looks like a bubble really is a bubble. And third, interest rates are too blunt a tool to control asset prices. A modest rise in rates is unlikely to halt rising asset prices, but an increase sufficient to pop a bubble would slow the whole economy. They concluded it was safer to wait for a bubble to burst by itself and then ease monetary policy to moderate its after-effects.

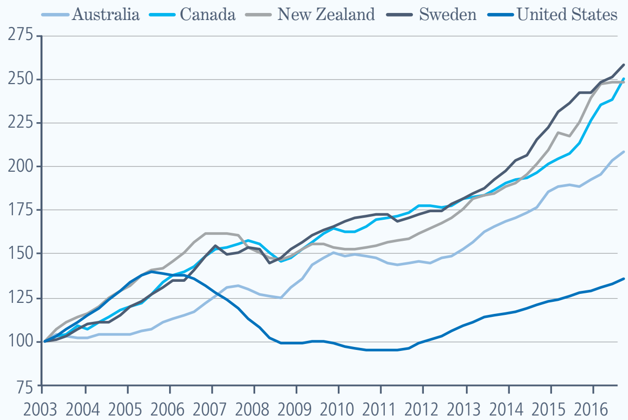
Taking each of these arguments in turn, excessive asset-price inflation can lead to a misallocation of resources – either too little saving or too much investment in a particular area of the economy. Furthermore, if the asset bubble is accompanied by excess credit growth, systemic financial risk rises as well. As was seen in 2008, the cost of such a debt-fuelled bubble bursting may simply be too great for monetary policy to be able to effectively clean up. Arguably over the past 20 years or so, weak goods-price inflation has led central banks into keeping rates so low that excess liquidity has encouraged excessive speculation.

As for the second argument, determining whether a bubble exists is difficult enough. Predicting when it might burst is harder still. But that is not an excuse for doing nothing. While it may be impossible to identify bubbles with total certainty, there are indicators that provide some level of warning. When certain asset prices are clearly out of line with underlying fundamentals or there is a rapid expansion of credit growth, questions need to be asked. Policymakers live in an uncertain world. Uncertainty is a reason for responding cautiously; not for failing to respond at all.

Insurance policy

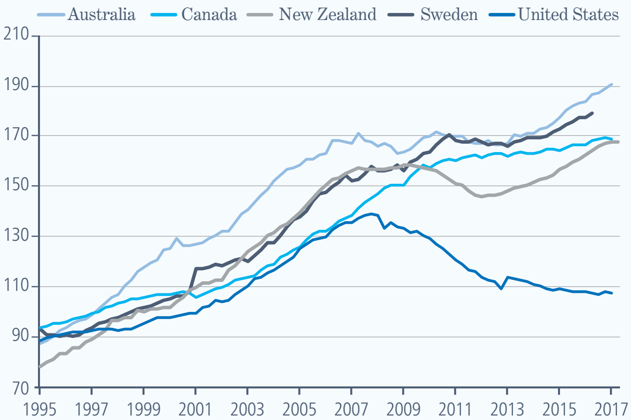
While interest rates may be too blunt a tool to deal with asset prices, nobody is suggesting central banks should target a particular level of asset prices. Most economists would accept that aggressive action to prick bubbles is risky. Rather, the

Figure 1: House prices surge



Source: Aviva Investors, Macrobond, August 2017

Figure 2: Household debt rises to record levels



Source: Aviva Investors, Macrobond, August 2017

debate revolves around whether central banks should 'lean against the wind' when debt and asset prices appear dangerously out of line with fundamentals.

As former Fed Governor Jeremy Stein argued, monetary policy has the advantage of getting "in all of the cracks", something that 'macro-prudential' policies may not succeed in doing.[6] Tightening monetary policy in an asset boom is akin to buying insurance against a later risk of a larger economic bust. The cost of some short-term loss of output must be set against the risk of larger future losses.

In any case, perhaps the biggest argument for central banks to respond to excessive asset-price inflation is that failing to do so risks creating a moral hazard. If a central bank's behaviour is such that it always cuts interest rates when asset prices tumble, but is reticent to raise them when financial markets recover and risk premia fall back, investors will be encouraged to take ever bigger risks. While the Fed was no doubt sensible to ease policy aggressively when the credit bubble burst in 2008, after almost a decade of extraordinarily loose policy there is a risk of inflating another.

With many laying the blame for the last two stock market crashes at the Fed's door, there have been signs policymakers have shifted their views in recent years. By the end of his tenure, Bernanke suggested the central bank may be more open minded in its approach to the next bubble, or at least consider using a different set of tools.

"I think that given the problems we had – not just in the United States but globally – in the last 15, 20 years that we need to at least take into account these issues as we make monetary policy… If you're in an expansion and there's a credit boom going on, the case in that situation for making policy a little bit tighter might be better," he said in 2013.[7]

The Fed's dilemma

While the conduct of monetary policy is never straightforward, there is little doubt the dilemma facing the Fed at present, with monetary conditions still so accommodative, is unusually acute. Since a given change in interest rates could have a much bigger impact than in the past, it would not be an exaggeration to say the Fed is walking a tightrope.

On the one hand, rate setters are surely keen to get on with 'normalising' interest rates, to ensure the bank meets its dual mandate of full employment and price stability. But on the other, they are no doubt troubled by the risk higher interest rates pose both to the economy and financial markets, which in recent years have become so accustomed to easy credit.

All of which begs the question: will the Fed be willing to tighten policy in a timely fashion, partly in order to reduce the risk of a future credit-fuelled asset price bubble, or will it err on the side of caution and continue to raise rates at a slow pace as the market believes; potentially creating an even bigger problem down the track?

Determining the Fed's likely course of action is far from easy; not least because recent statements have been inconsistent. Furthermore, we believe officials will be far more comfortable trying to talk prices down than taking concrete action were they to suspect the formation of bubbles.

However, we would draw a distinction between the last two stock market crashes. Arguably, Greenspan was unfairly maligned for having created the so-called 'Greenspan put' in the late 1990s. After all, since the rally in stock prices was not accompanied by excessive amounts of leverage, the recession which followed the bursting of the dot-com bubble was quite shallow.

The same could not be said for the housing market bubble eight years later. Since it was accompanied by the build-up of unsustainable amounts of debt, its bursting had devastating effects on the economy. The lesson here is that the Fed will need to be on its guard for any signs of excessive leverage building up in the system. While we don't believe that yet to be the case, there are areas of concern which merit close attention. Yellen and her colleagues have little room for complacency ●

Michael Grady is a Senior Economist and Macro Strategist at Aviva Investors

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3 'Trends in commercial real estate,' Eric S. Rosengren speech, May 9, 2017
4 'Asset-price "bubbles" and monetary policy,' Ben Bernanke speech, October 15, 2002
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7 Ben Bernanke press conference, March 20, 2013

FOR RICHER, FOR POORER

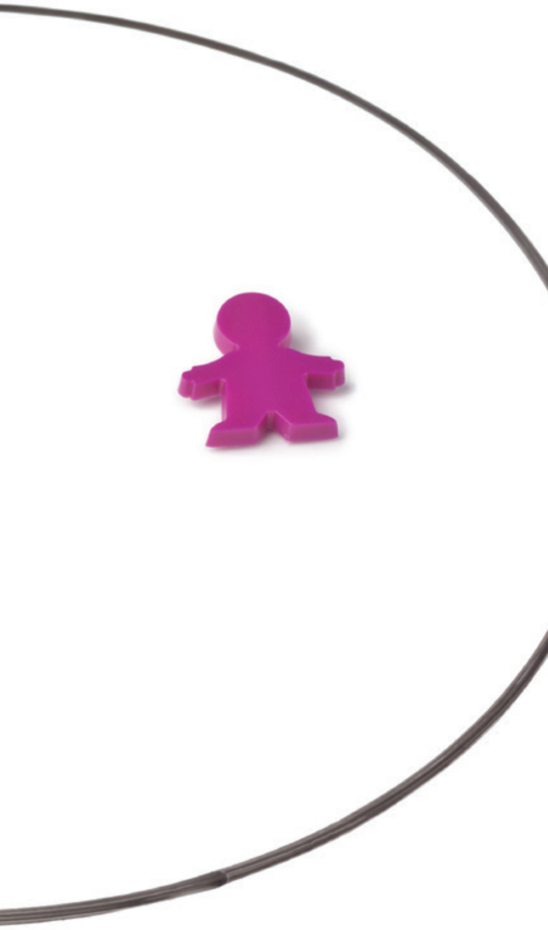
Income inequality is rising across developed countries. What are the implications for economic growth?

> *Income inequality has been linked to all manner of social ills*

The spectre of inequality is haunting developed economies. According to research from the Organisation for Economic Cooperation and Development (OECD), the gap between the highest and lowest earners in rich countries is greater than it has been for 30 years.[1]

The key metric for measuring income inequality is the 'Gini coefficient', on which 0 marks a society of perfect equality and 1 a society in which all income is hoarded by one person. The average Gini score across developed economies is 0.31, but some countries are far more unequal than others. Denmark has a Gini of 0.25, while the US score now stands at 0.39 – higher than at any time since the Great Depression of the 1930s.

So why does this matter? Income inequality has been linked to all manner of social ills: unequal societies have a shorter life expectancy and higher crime rates.[2] Inequality also harms long-term economic growth: the rise in inequality between 1990 and 2010 is estimated to have knocked 4.5 percentage points off cumulative growth in OECD countries.[3] And there are political implications too, as evidenced by the resurgence of populism in Western Europe and the US.



"Because US income inequality has risen so much, the bottom 50 per cent of the adult population has been shut out from economic growth since 1980," says Emmanuel Saez, professor of economics and director of the Center for Equitable Growth at the University of California, Berkeley. "An economy that does not work for such a large fraction of the population is bound to generate discontent and anger, as we have seen in the last political cycle."

To have and have not

Saez and his colleague Thomas Piketty – whose 700-page book on inequality *Capital in the 21st Century* became an unlikely bestseller after its publication in 2014 – have studied US income data going back to the 1920s. Their research shows that inequality rose sharply in the 1970s and has continued to worsen up to the present day.

Piketty and Saez's work has shed light on how the top one per cent of earners have streaked ahead (see figure 1), partly due to a rise in executive compensation and a fall in marginal tax rates over that period.[4] The top one per cent earns nearly 20 per cent of all US personal income.[5]

While America has seen the most dramatic rise in inequality, the trend has been observed across the developed world. And there are reasons for this that go beyond inflated executive pay. In a globalised economy, skills in technology-driven sectors such as IT are richly rewarded, while the wages of workers in sectors with less in-demand skills have stagnated.

"Over the last 30-40 years, globalisation and technological change are the two main drivers of the rise in income inequality," says Michael F. Förster, senior policy analyst at the OECD's Income Distribution, Inequality and Poverty department. "Changes in institutions, regulations and policy reforms in the 1980s and 1990s were another important driver."

Since the financial crisis of 2008-'09, policymakers have implemented quantitative-easing (QE) programmes to spur growth. Such policies were necessary to curb mass unemployment, but in raising asset prices they brought some unwelcome side effects. For example, research from credit-rating agency Standard & Poor's shows QE has hurt the incomes of those who do not own property in the UK; as buying a home becomes ever more expensive, they are forced to shell out more of their take-home pay in rent. This has exacerbated income inequality.[6]

No society in history has ever been completely equal and studies show a certain amount of inequality is beneficial for growth, especially in emerging economies. A gap between rich and poor, it is argued, acts as an incentive for people to earn more and to take risks in doing so, spurring entrepreneurialism and job creation.

Past a certain point in an economy's development, however, income inequality is more likely to impose a drag on overall growth. This happens through a number of mechanisms. At issue is not so much the gap between the top one per cent and the rest – the haves and the have-yachts – but the chasm between the bottom 40 per cent and everyone else.

Savings and consumption

Since richer households are more likely to save an additional dollar of their income than poorer ones, skewing the economy towards the latter hampers consumer industries and may contribute to the world's 'savings glut'. Higher savings tend to lead to lower interest rates and higher asset prices, which makes it more difficult for central banks to manage the economy, according to economists such as Ben Bernanke and Larry Summers.[7]

Research from Morgan Stanley shows that in the run-up to the financial crisis, many poorer US households borrowed to maintain consumption levels, mitigating the impact of inequality on the economy but also feeding an unsustainable build-up in debt that contributed to the eventual crash. Debt as a share of disposable income peaked at 135 per cent in 2007.[8]

Although employment growth has recovered since 2008, many of the jobs being created are low-paying ones. The US had the joint-highest share of low-paying jobs among developed countries in 2015, with 25 per cent of full-time employees earning below two-thirds of full-time median pay.[9] Disproportionately hit by the aftermath of the crisis, poorer households have subsequently found it harder to borrow, and they are spending less. This has big implications for investors in the retail sector, according to David Bucolo, Senior Research Analyst at Aviva Investors in Chicago.

"The average US consumer is not spending like they used to, at least not throughout this current expansion. Retail sales have not accelerated as much as one may expect given the growth in GDP. In any expansion, you would expect a closer correlation between retail and GDP growth, given the large contribution personal consumption has on the overall US economy," says Bucolo.

US inequality appears to be mirrored in the deepening bifurcation of the country's retail sector. Luxury goods retailers have performed well during the recovery since the crisis, as has e-commerce, which research shows is largely driven by higher-income earners.[10] 'Dollar' retailers and off-price apparel stores, which offer

FOR RICHER, FOR POORER
continued

> *Poorer households have found it harder to borrow and are spending less*

bargains to those willing to do a bit of treasure hunting, have also performed well, whereas middle-market retailers have underperformed.

Human capital

Another problem with inequality is that it leads to a lack of opportunity. Research shows that as inequality rises, fewer people go to university: a rise of six percentage points on the Gini coefficient lowers the probability of poorer people graduating from university by four percentage points.

"Our research shows there are growth-hampering effects of rising inequality, mainly due to the effect on human capital. High inequality leads to reduced investment in human capital on the part of the middle- and lower classes, damaging the economy as a whole," says Förster.

Because the poorest 40 per cent of the population are less able to invest in skills and education, they are less able to compete for jobs in an economy increasingly geared around technological savvy; the gap becomes even wider and overall productivity declines. Higher inequality is also linked to deteriorating health among poorer households, exerting a further drag on growth.[11]

Lower productivity is bad news for investors, says Stewart Robertson, Senior Economist for the UK and Europe at Aviva Investors. "If you look at the dividend discount model of equity valuation, the return you receive is the dividend yield plus the rate of growth over time. If the rate of growth is linked to nominal GDP, that's going to be lower in an environment of sluggish productivity growth."

The populist threat

Another way in which inequality affects growth is through propelling the rise of politicians whose policies damage the economy.

Branko Milanovic, a professor at City University of New York, produced the so-called 'elephant' curve that shows how the gains from globalisation were unevenly spread between 1988 and 2008 (see figure 2). The elephant curve reveals some of the economic drivers behind populist political outcomes such as the UK's vote to leave the European Union and the election of Donald Trump as US president, according to Milanovic.

"No chart can totally explain political developments, which are multifaceted," he says. "But the narrative you can make from the chart is not inconsistent with what we have observed politically."

The middle earners on the chart (the elephant's 'back') represent the rising middle classes of emerging-market economies such as China, who greatly benefited from the rise in global trade and investment. The dip in the elephant's trunk represents those in developed economies whose wages have all but stagnated over the same period. The tip of the trunk represents the world's richest, the highest earners in developed economies, who have continued to see their incomes soar.

"Large groups of the lower parts of the income distribution in rich countries – which you can variously call working class, or lower-middle class, or even the middle class – have had very little real income growth over the last quarter century.

"They can be perceived – and maybe they perceive themselves – as being squeezed by both sides. On the one hand, they were squeezed by emerging Asia; from people who could do the same jobs much more cheaply and who benefited from outsourcing. And on the other hand, they were squeezed by their domestic one per cent; people who actually did well during globalisation," Milanovic adds.

By fostering resentment against policies such as free trade – witness the protectionism of Trump and populist European counterparts such as the Five Star Movement in Italy – the political consequences of inequality can harm growth. And they may not do much to remedy inequality either. Many of Trump's policies, from tax reform to his attempted repeal of Obamacare, are more likely to increase inequality than reduce it, according to the Nobel Prize-winning economist Angus Deaton.[12]

As inequality grows yet further, there are risks that the political outcomes could become even more extreme, according to Pippa Malmgren, former advisor to US president George W. Bush and currently a non-executive director of the UK Department for International Trade. "It's an existential period in American history when people are not just questioning the left or the right; they're questioning the entire system," she says. "And this is a global phenomenon. We certainly see the same breakdown of trust in Europe."

Where next?

The rise of artificial intelligence and automated technologies over the coming years may make the problem even worse. These technologies promise to deliver economic productivity gains, but if the proceeds only enrich those at the top, depriving the rest of the society of the means to adapt to a quickly-changing economy, inequality is likely to rise still further.[13]

So what can we do about rising inequality? Piketty argues ever-worsening inequality is a logical outcome of advanced capitalist systems, whereas earlier economists such as Simon Kuznets argued capitalism inevitably reduces inequality by spreading wealth around as economies develop, fostering inter-class harmony.

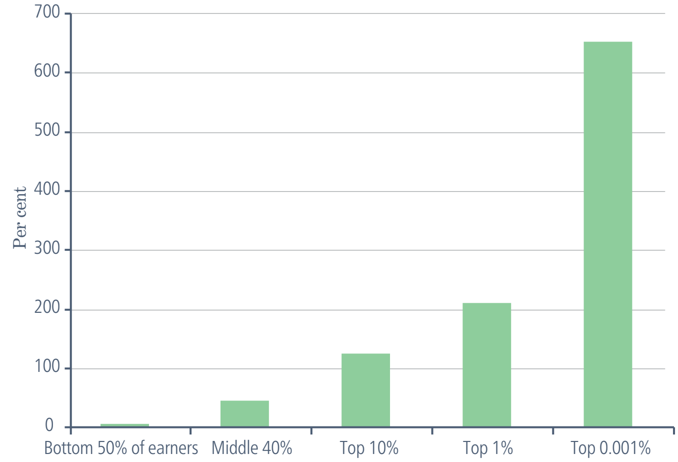
For his part, Milanovic believes inequality moves in what he calls 'Kuznets waves'; ever-growing inequality triggers social and economic dislocations that cause inequality to fall. The historian Walter Scheidel argues only the 'four horsemen' – mass warfare, revolution, state collapse and pandemics – can substantively reduce inequality in his book *The Great Leveller*.

But governments are not hostages to economic fate, stresses Förster at the OECD. He says there is plenty policymakers can do to remedy inequality, from implementing redistributive tax policies, to increasing the participation of women in the workforce, to widening access to education and training.

"The most direct impact would be progressive taxation and benefit policies. But that would be a short-term solution and would not impact on pre-redistribution incomes. So this measure should be complemented by policies to improve labour-market participation and more investment in education."

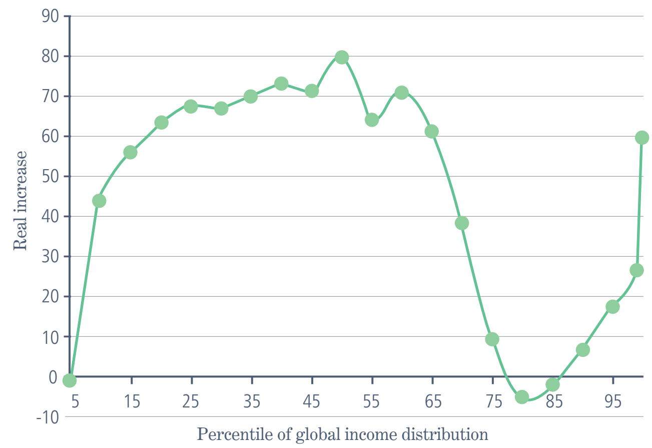
If properly enacted, redistributive policies can reduce inequality without harming the economy.[14] And the gains could be significant. For example, raising living standards for the poorest 40 per cent in the UK to the relative level of France would boost annual GDP growth by 0.3 per cent every year for 25 years, according to the OECD – the equivalent of a 13 per cent rise in the current growth rate.[15] Such an improvement would be good news for rich and poor alike

Figure 1: Pretax income growth in the US, 1980-2014



Source: Thomas Piketty, Emmanuel Saez and Gabriel Zucman, 2016.[16]

Figure 2: The elephant curve: percentage change in real income by global percentile, 1988-2008



Source: World Bank, 2012.

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THE ELEPHANT IN THE ROOM?

Ten years on from the largest financial crisis in a generation, it seems curious that global debt is even higher today. So why is this getting so little attention? Pauline Skypala takes a closer look.

Global debt levels reached a record $217 trillion in the first quarter of this year, according to the Institute of International Finance,[1] pushed by a $3 trillion borrowing spree in emerging markets, with China as the main player. The debt stock amounted to 327 per cent of the world's annual economic output, or GDP. Advanced economies continued to pay down debt, cutting total public and private debt by more than $2 trillion in the year to the first quarter, while developing countries added to their debt pile, taking it to $56 trillion, or 218 per cent of their combined GDP.

The Bank for International Settlements (BIS) also flagged the issue, warning in its annual report, published in June, that high and rising debt levels in a number of countries are cause for concern.

"Leading indicators of financial distress point to financial booms that in a number of economies look qualitatively similar to those that preceded the GFC [global financial crisis]," said Claudio Borio, head of the monetary and economic department at BIS, which is often referred to as the central bankers' central bank. These include some emerging markets, notably China, and advanced economies that escaped the 2008 crash, where household and corporate debt has grown significantly as a proportion of GDP since 2007.[2]

The International Monetary Fund (IMF) has similarly warned of the potential for the debt overhang to act as a drag on recovery and growth and pose a risk to financial stability. Global debt has more than doubled since the turn of the century, with private sector debt accounting for about two-thirds of liabilities, it notes. "High private debt not only increases the likelihood of a financial crisis but can also hamper growth even in its absence, as highly indebted borrowers eventually decrease their consumption and investment," the IMF says.[3]

A (not-so) private problem?

Central banks and other institutions are more focused on the level of private debt (household and corporate) post-crisis, having been sanguine about it in the past. BIS, which released a centralised database on private sector debt in 2014, giving greater visibility into the problem, notes: "Excessive indebtedness has been one of the root causes of financial crises and the ensuing deep recessions. In recent years, the focus has been on household debt, as excessive leverage by the household sector was at the heart of the Great Financial Crisis."

Rather than viewing debt simply as a transfer of savings from more patient to less patient people, with little aggregate effect on demand or the economy, there is increasing acknowledgment that bank lending creates new money that expands the money supply and adds purchasing power to the economy.[4]

Much of the private credit created over the past 50 years has been lent on existing real estate, pushing up property prices and encouraging more borrowing. This cycle keeps going until people lose confidence, according to Adair Turner, former chairman of the Financial Services Authority.

> *The extent to which debt is a problem depends on the region concerned*

If the cycle of increasing lending against real estate pops in a situation where there is already a large amount of debt in the system, "then we enter the situation we have been in for the past 10 years where the debt never goes away", said Turner, speaking at an event in Parliament in July.[5] "It just moves around the system from the private to the public sector and to different parts of the world. Households and companies become determined to pay down debt, even if interest rates go close to zero. The government runs a deficit, automatically and usefully. But the net effect is the debt never goes away. It just slowly goes up. It happened in Japan in the 1990s, and has been the same since 2008 in the advanced economies."

Household debt in advanced economies reached 95 per cent of GDP by the end of 2016, according to BIS data, a rise of seven percentage points since the end of 2007. Borrowing has risen notably in Canada, Switzerland, Sweden and Australia, while in Germany, Spain and the US, deleveraging has reduced household debt.

The extent to which this debt is a problem depends on the region concerned. Even though household debt is now growing again in the US and this year surpassed its 2008 peak of $12.7 trillion, it is still less of a concern "because deleveraging has gone further", according to James Vokins, Senior Fixed Income Portfolio Manager at Aviva Investors. "In the UK, however, it is more of an issue, and one to monitor."

The Bank of England in July warned of potential dangers in the strong growth of consumer credit in the UK, which rose 10 per cent over the past year while incomes rose only by 1.5 per cent. Lenders can enter a "spiral of complacency" in periods of good economic performance and low loan losses, believing they can reduce prices and make terms easier, said Alex Brazier, the Bank director for financial stability.[6] "Lending standards can go from responsible to reckless very quickly. The sorry fact is that as lenders think the risks they face are falling, the risks they – and the wider economy – face are actually growing."

Auto loans and credit cards are the main focus for investors, but "there is no evidence these are systemic issues", says Vokins. Banks have raised capital and strengthened their balance sheets since the crisis, so default risks are manageable.

Corporate debt: credit where credit's due

If there is an area of concern over rising indebtedness in the US, it is on the corporate side, where there has been "an explosion of debt", Vokins says. However, corporate debt is only at risk if it can't be rolled over at maturity. "Are we at the point where there is enough tension in the market to suggest those pressures? No, is the answer. The borrowers most at risk are high-yield names, but they have been actively raising money recently so there is no refunding risk for three or four years. It is hard to see a bubble about to burst, although you can argue there is a heavy debt burden that could act as a brake on useful economic activity."

The important factor to consider when assessing the dangers of growing debt is where the debt sits and who owns it, says Vokins. In 2008, the debt largely sat on bank balance sheets, and much had to be written down with a knock-on effect on other markets. "Now, the quantum of debt is rising, but where it is held by corporates, it is offset by the cash on their balance sheets. Moreover, a lot of that debt has gone into buybacks and M&A. That is less risky than if it had been invested, with the potential for misallocation and consequent low return."

The question is whether the authorities can contain any upswing in credit risk across the board, where rising defaults lead to pressure on bank balance sheets. "They have done a good job so far," says Vokins, citing as an example the various bank bail-ins and bailouts in Europe, which proved sufficient to prevent contagion. "We will get pockets of weakness but they could be contained."

China crisis?

Another question is whether countries that have seen strong private credit growth in

THE ELEPHANT IN THE ROOM?

continued

recent years can avoid their own financial crises, with China at the forefront of concern. The BIS annual report shows household and corporate debt in China has risen by 95 percentage points to 211 per cent of GDP since 2007, a huge expansion compared to most other developed or emerging economies.

Investors may have taken their eye off China in the past year or two, in the belief that the economy is performing reasonably well and Beijing has things under control. "In 2014-'15 they were worried about growth and debt," says Diana Choyleva, chief economist at Enodo Economics. "Now even some of the bears say China has somehow pulled a rabbit out of the hat, so they are not worried. I am more negative. China's debt-to-GDP is approaching uncharted territory and the authorities can no longer sweep bad loans under the carpet because growth is much weaker. Beijing's priority is to rein in financial risks, but they are walking a tightrope between cleaning up the debt mess, allowing some defaults and preventing a sharp loss of confidence."

Any financial distress in China is unlikely to lead to a global financial crisis, though, says Choyleva. China's financial institutions are not integrated globally, and foreign currency debt is not a big issue.

Economist Steve Keen labels China as one of the economies most at risk of following the US, UK and others hit by the 2008 crisis down the path of a credit binge and bust, followed by lengthy stagnation, in his book *Can We Avoid Another Financial Crisis?* The book also puts Ireland and Hong Kong in the danger zone, marked by a high level of debt and substantial reliance on credit as a source of demand for the past five years. Others at risk are Australia, Belgium, Canada, South Korea, Norway and Sweden. They cannot avoid crises "because the economic perquisites of excessive private debt and excessive reliance on credit have already been set". Their inevitable crises "between now and 2020, and the plunge in their credit-based demand will take what little wind remains out of the sails of global commerce".

Government takes the strain

High levels of public sector debt also remain a worry for many commentators. If Japan is any guide, there is little hope of cutting debt levels and every reason to expect them to climb. Japan's debt-to-GDP ratio has been rising since its credit bubble burst in 1990 and currently sits at 250 per cent. The ratio is 106 per cent in the US, 89 per cent in the UK, and 68 per cent in Germany.

There are four ways of reducing the debt mountain: economic growth, inflation, cutting public spending, and reform of public finances. Central banks have been unable to produce much of the first two through their unconventional monetary policies, spending cuts are self-defeating, and there has been little reform, says Amin Rajan, chief executive of Create Research.

Government infrastructure projects would help kick-start growth but an obsession with balanced budgets gets in the way. "There are supply-side things they could do but governments are too ideologically oriented. Neither governments nor the private sector are investing enough to push economic growth back to its long term potential. We could be blindly walking into another crisis unless growth picks up," Rajan says.

An end to cheap money

Despite the growing debt burden, or perhaps because of it, central banks are beginning to withdraw monetary stimulus. The US Federal Reserve has raised rates four times by 25 basis points since December 2015 and announced plans to begin reducing its $4.5 trillion balance sheet, possibly from September, by slowing the reinvestment of coupons from its bond holdings. It is taking action while inflation is still below its two per cent target rate, but commentators point to a need to act as a means of building resilience.

"It is the right time for the Fed to move because otherwise it has no policy tools to use in the event of another crisis," says Rajan.

The European Central Bank (ECB) is still spending €60 billion a month on bond purchases, reduced from €80 billion in April, and markets expect a formal tapering announcement in September or October. However, the effects will be offset to some extent by the reinvestment of money from maturing debt back into the euro zone bond market, which commenced in March.

See no evil

Investors appear anything but concerned by the move to tighten. Stock markets have reached new highs and bond yields remain stubbornly low. Volatility is notable by its absence. Setbacks are still viewed as opportunities to 'buy the dip', in the expectation that central banks do not want a repeat of the 'taper tantrum' of 2013, when the Fed announced plans to cut its bond-buying programme.

There has been talk of a bubble in bond markets for nearly five years, but rising yields have soon turned back down again. Indeed, the 10-year US Treasury bond yield has not gone above three per cent since the first quarter of 2011. Meanwhile, nearly a quarter of fund managers (22 per cent) polled by Bank of America Merrill Lynch for its August survey consider a policy mistake by the Fed or ECB to be the biggest tail risk to the market, while a fifth (19 per cent) worry about a crash in global bond markets. This echoed the July survey findings, but with a lower proportion of managers citing these concerns.

Central bank unwinding is unlikely to precipitate a debt crisis, however. "A massive normalisation of yields is unlikely," says Charlie Diebel, Head of Rates at Aviva Investors. "Valuations

> *Government bonds don't offer much value, but very little does*

are high, but that is true of every asset class. Government bonds don't offer much value, but very little does.

And as baby boomers retire, they will need to swap equities for bonds, providing underpinning for the market.

"What is more, governments have been doing a good job of spending their way out of the financial crisis, helped by central banks buying their bonds," adds Diebel. "Now we are in the opposite situation where some of the debt is going to come back to the market. The ECB and the Bank of Japan are still doing QE but at a slower pace, so there is likely to be some tightening of global liquidity, which is the reason bond investors are fearful. But Fed unwinding isn't a bubble bursting."

The Fed will be constrained by the prevailing conditions. US inflation has been falling back rather than rising, and wages are stagnant even as job numbers rise. It is an equilibrium that relies on low yields, low interest rates and benign inflation, according to Diebel, and conditions put a ceiling on how high interest rates can go. "The more normalisation in interest rates we get, the stronger will be the impact on the real economy compared to previous cycles, because of the leverage in the system. So the extent to which interest rates can rise is limited," he says.

Mark Dampier, head of research at Hargreaves Lansdown, agrees. "As long as there is liquidity to support the market, I don't think we will get a market crash," he says. "There is too much debt because we have not had a proper recession, where companies go bust and people lose their jobs. There has been a vast amount of over-investment in unproductive assets, which takes a long time to wear off."

Add demographic pressures and the pace of technological change to the mix and it is no surprise central banks are unable to get inflation up to target rates, further limiting the scope for interest-rate rises.

Lower for longer

Wider expectations are of the 'lower for longer' scenario prevailing for the foreseeable future.

"The base case is that inflation will not run away as there just isn't the overheating we have seen in previous cycles," says Vokins. "We are going through a long technological revolution and it will be prudent for central banks to take a wait and see approach." Rather than focus solely on inflation and employment, they should also check there aren't too many bubbles bursting or too many areas overheating, he adds.

So while the growing debt pile does pose risks, a credit crisis on the scale of 2008 does not look imminent.

In Vokins's words: "The key factor is who owns the debt and how it is financed, rather than the quantum" ●

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2 Media briefing on annual report, Bank for International Settlements, June 2017
3 Speech by Vitor Gaspar, director, Fiscal Affairs Department, October 2016
4 *Quarterly bulletin*, vol. 54, No. 1, Bank of England, Q1 2014
5 See positivemoney.org/2017/07/crisis-central-banks/
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EUROPE'S DIFFICULT ROUTE TO A BANKING UNION

The prospects for closer European integration seem better than ever following recent political events. However, the bailout of two Italian lenders highlights that progress towards banking and fiscal union will be far from straightforward, argue Stewart Robertson and Oliver Judd.

Critics of European monetary union have long argued the single currency project was doomed to failure without accompanying fiscal union. Their warnings seemed particularly prescient during the euro zone's sovereign debt crisis at the start of the decade.

However, the crisis also revealed that a fiscal union, in and of itself, was unlikely to be a sufficient remedy for monetary union to work over the long term. With the euro zone's difficulties having been partially caused, and considerably exacerbated, by national banking crises, it became apparent a banking union was also needed to break what had proven to be catastrophic links between banks and their countries' government bond markets.

In April 2012, with the euro zone sovereign debt crisis in full swing, European Central Bank (ECB) President Mario Draghi said: "Ensuring a well-functioning EMU (Economic and Monetary Union) implies strengthening banking supervision and resolution at (the) European level".[1]

Three pillars

Although there is no strict definition of what a banking union entails, the European Union says its will be built on three pillars.[2] The first involves the establishment of a Europe-wide supervisory authority to apply the same rules to banks in different countries and supervising compliance with them in a common manner. The second sets out rules as to when troubled banks are put into 'resolution' – a legal process that hands sweeping powers to regulators to decide how to safely wind them down without taxpayer funds – while the third entails a common deposit guarantee fund to backstop national insurance schemes.

The first pillar was erected in November 2014 with the creation of the Single Supervisory Mechanism, comprising the ECB and the national supervisory authorities of euro zone nations. Under that regime, the ECB directly supervises the 124 most systemically important institutions, which collectively hold almost 82 per cent of banking assets within the euro area.[3]

However, recent events in Italy suggest there is little prospect of the next two steps being completed in the near future. The Italian government on June 25 wound down stricken lenders Veneto Banca and Banca Popolare di Vicenza, with some of their assets and liabilities sold to Intesa Sanpaolo, Italy's largest bank, for a nominal amount. In doing so, Rome committed to using around €17 billion of taxpayers' money to take on the two banks' bad loans – shielding not only depositors, but senior bondholders too, from losses.

SRB flunks its first test

Although Italy secured the European Commission's approval, it is hard to avoid concluding the Single Resolution Board (SRB) – the EU agency responsible for dealing with bank crises – flunked arguably its first big test. After all, the winding up of the Veneto banks flies in the face of EU law, as established with the Bank Recovery and Resolution Directive (BRRD).

It charges the SRB with ensuring 'an orderly resolution of failing banks with minimum impact on the real economy, the financial system, and the public finances of the participating member states'. In other words, one of the main aims of the BRRD was to transfer the cost of bailing out a bank from taxpayers to shareholders and creditors.

The Italian government found a loophole – a public interest clause – which allowed it, with the permission of the European Commission, to avoid wiping out senior bondholders. Rome argued the banks' failure would have wrecked the economy in the Veneto region and potentially beyond. However, the decision sparked anger among German politicians, who claimed the liberal interpretation of the rules aimed at making sure taxpayer money is not used to deal with banking crises had destroyed the credibility of the bloc's banking union.

German anger

Markus Ferber, an ally of German chancellor Angela Merkel and vice-chair of the EU parliament's economics committee, said the promise that the taxpayer will not stand in to rescue failing banks any more was "broken for good", and that with its decision the European Commission had accompanied the banking union "to its deathbed".[4]

Meanwhile, Carsten Schneider, a Social Democrat Bundestag whip and budget policy expert, warned the decision moves the common deposit-guarantee scheme "into the distant future".[5]

It is unclear what these sound bites were designed to achieve, beyond grabbing headlines in the domestic media and possibly appealing to those German voters who remain wary of the likely cost to them of further European integration. We are inclined to agree with Fabio Panetta, the vice director-general of the Bank of Italy, who defended the way the banks had been dealt with, saying it was the only option to avoid a shock to the country's financial system. It would have been dangerous to do anything that threatened to derail Italy's nascent economic recovery, which remains fragile.

It is true the situation in Italy was in marked contrast to what happened in Spain earlier in the month, when failing lender Banco Popular was bought by larger peer Santander, protecting Spain's taxpayers. However, in that instance Santander was a willing buyer, whereas Intesa was not. Allowing the two Italian banks to collapse, separating the good assets from the bad and ensuring that senior bondholders – many of whom were retail investors – were protected, all seem like sensible steps to have taken, even if it did mean EU rules were flouted. If government intervention is needed to

> *Recent events underline more needs to be done to recapitalise the banking system*

clean up the system and give up the good assets back to the private sector, this would seem to be a price worth paying. It is unclear how a crippled Italian banking system would be in anyone's interests, including Germany's.

As for the German politicians' argument that senior bondholders should have been forced to accept losses, it is difficult to see the logic here either. In Italy, much of this debt is held by retail investors. Although one can argue retail investors should never have been allowed to buy these bonds in the first place, the fact is they were.

Italy keen to avoid bank run

Italian authorities quite rightly feared that forcing retail investors to accept losses could scare off a big source of funding for Italian banks, and potentially trigger bank runs. In any case, such a solution was never going to be palatable to Rome after pensioner Luigino D'Angelo hanged himself in 2015, when the €110,000 he had put aside for his retirement evaporated with the failure of Banca Etruria. That sparked public outrage over the government's handling of the situation.

The rationale for a banking union is twofold: to help free up banks across Europe by removing crisis-era bad loans from their books, and to cut the dangerous link between banks and sovereign issuers. But the idea that Italy's banking system, which according to some estimates is still weighed down by around €325 billion of bad loans,[6] was going to be able to clean itself up without public intervention was unrealistic.

Nevertheless, while it is hard to see a better solution to the Italian situation, recent events have served to underline just how much more needs to be done to

EUROPE'S DIFFICULT ROUTE TO A BANKING UNION
continued

> *There is a danger of moral hazard if banking union is more complete than fiscal union*

recapitalise the banking system in Europe in general, and Italy in particular. There is an urgent need for a way to be found to remove more of this toxic debt from banks' balance sheets. The sooner this process is concluded the faster the credit spigots will be unlocked.

Consolidation challenges

The EU would like to see Europe's banking sector more closely resemble that of the United States, with fewer, bigger, and hence more profitable and stronger, banks. However, history suggests the process of consolidation is likely to be tortuous, especially in Italy. It appears most big banks, rather than buying smaller operations while they are solvent, would rather wait for them to fail and then cherry pick the bits they want.

As for cutting the link between banks and governments, it is clear much more needs to be done here too by ensuring banks hold a more diverse range of sovereign debt. Under current law, banks' exposures to their own sovereign debt can be exempt both from risk weights and from large exposure limits. However, as the Commission itself notes, government bonds are far from riskless and the 'home bias' of national banking sectors to their own sovereigns is a fundamental source of asymmetry in the degree of risk facing national banking sectors.[7]

This demonstrates there is a danger of a moral hazard developing if banking union is more complete than fiscal union. With banks already major holders of debt issued by their own governments, it is easy to envisage that in the event banking union is completed first, it will become tempting for governments to push ever more debt onto the balance sheets of their banks.

The Commission is calling for more flexible approaches consisting of the application of gradually increasing risk weights to exposures concentrated on individual sovereigns, beyond certain thresholds. It argues the result need not be a decline in the total amount of sovereign bonds held by banks, but rather greater diversification by issuer. But the fact the Commission itself concedes this will require an "appropriately long phasing-in period" is another reason to believe a banking union will not be completed in a hurry.

Slow progress to fiscal union

The significance of all of this is that Europe is unlikely to make rapid progress towards co-ordinating national fiscal policies as it moves towards a fiscal union. While banking and fiscal union are often seen as distinct processes, in reality it is hard to see how one can be achieved without the other.

A fiscal union would involve mutual debt guarantees for at least a portion of national liabilities and/or the creation of a European finance ministry with debt-raising capabilities. Such a drive would necessarily intersect with a banking union in several important areas. Most obviously, national governments would need to provide fiscal support to any common deposit-guarantee fund and assist in the resolution process for other countries' banks.

Germany and other northern EU states will need to be persuaded of the merits of establishing a common fund to protect bank depositors having last year refused to do so. They feared that in setting up a European deposit insurance scheme that would cover individual deposits of up to €100,000 they may have ended up paying to rescue depositors in other countries. The likelihood is that these nations will continue to resist a common deposit insurance scheme while worries over the state of other countries' banking systems persist. In the meantime, government support will continue to be needed.

Optimism over the prospects for closer European integration is riding high following this year's political developments, most notably the election of the staunchly pro-European Emmanuel Macron as French president. However, investors may be in danger of jumping the gun.

In truth, creating a fully-functioning banking union along the lines envisaged by Brussels was never likely to be straightforward. But until Germany and others can be assured banking systems across Europe have been cleaned up to their satisfaction, they seem certain to resist efforts to move to a full banking, and hence fiscal, union.

All of this is not to deny there have been encouraging noises emanating from Berlin with regards to the prospects for closer integration of fiscal policy across Europe. For instance, Wolfgang Schäuble, the normally hardline finance minister, recently told German news magazine *Der Spiegel* there was a need for transfers between wealthier and poorer EU states, arguing that "a community cannot exist without the strong vouching for the weaker ones". But as ever with Europe, it is important to recognise that progress towards closer integration still faces multiple obstacles and will not move in a straight line ●

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3 ECB
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5 'Italy bank deal makes Germans wary of Macron's Euro agenda,' *Bloomberg*, June 2017
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RESPONSIBLE INVESTMENT THE NEXT BIG THING?

As doing the right thing rather than saying it becomes a commercial imperative for companies, will responsible investment move into the mainstream? Pauline Skypala reports.

Doing well while doing good is the essence of responsible investing. It is hard to fault the logic of channelling finance to companies that behave responsibly and have the potential to generate better risk-adjusted returns. Recent strong growth in the industry suggests investors increasingly agree.

> *The younger generation is leading the retail push into SRI*

In 2016, $21.89 trillion of assets were managed under the socially responsible investment (SRI) label, according to the Global Sustainable Investment Alliance (GSIA).[1] That is a rise of 25 per cent since 2014, and represents a quarter of all professionally-managed assets. Europe is the biggest contributor to the global total, accounting for just over half of global SRI assets, and grew by 12 per cent between 2014 and 2016.

"I would point to a steadily increasing understanding and acceptance of the need for and advantages of SRI at all parts of the investment chain," says Simon Howard, chief executive of the UK Sustainable Investment and Finance Association (UKSIF).

Adoption by institutional investors remains the main driver of growth, but retail investor interest is also increasing. Data from Eurosif's biennial market study[2] shows a huge jump in the proportion of retail SRI assets, from three per cent in 2014 to 22 per cent in 2016. Much of this was due to an impressive surge in Belgium, where retail SRI assets comprise more than 60 per cent of the total. They don't go much above 40 per cent in any other European market, and only account for more than 20 per cent in six of them. Eurosif attributes retail growth to "the launch of new products by asset managers and the growing trend to focus on private clients, like high net worth individuals".

Retail growth is also a feature in the United States, where more than a third of SRI assets are retail, according to GSIA.

Evidence suggests the younger generation, also known as millennials, is leading the retail push into SRI. A study by Morgan

THE NEXT BIG THING?

continued

Stanley[3] shows 38 per cent of US millennials are "very interested" in sustainable investing and 48 per cent "somewhat interested". The comparable figures for the general population are 23 per cent and 52 per cent. Millennial interest in SRI has risen appreciably in the past two years. In 2015, 28 per cent of millennials were very interested, against 19 per cent of the general population.

"Millennials will be the richest generation yet when their parents die," says Amin Rajan, chief executive of Create Research. They will inherit an estimated $30 trillion in the next 10 to 15 years, and "if they are true to their word, they will put that money into socially-responsible investments".

The Morgan Stanley study shows there is also a gender split, with more women (84 per cent) than men (67 per cent) showing interest in sustainable investing. The gap closes somewhat for implementation, though, at 40 per cent for women and 36 per cent for men.

Institutional demand

Demand from pension funds and other institutional investors is expected to remain the main driver of growth. The Eurosif report shows it has nearly doubled in importance since 2012. Legislative change is the second most influential factor, while materiality remains a key aspect.

The change in institutional demand noted by Eurosif is one of two "seismic shifts" in the past three or four years, according to Steve Waygood, Chief Responsible Investment Officer at Aviva Investors, the second being intergovernmental policy conversations.

On the first shift, Waygood says environmental, social and governance factors (ESG) are no more or less important for investors now than they have been in the past; they have always been material and worth taking into account in investment decisions. The difference is the market now recognises this. "There is greater recognition that we have to do things, and be seen to do things, that are more sustainable as a result of getting things wrong in the past." Few, if any, large longer-term investors would now say ESG factors are not material.

"It is no longer considered odd to take them into account," Waygood adds.

Fiduciary duty

Taking account of ESG factors may be the norm for big pension funds, but Howard of UKSIF points to a large tail of small pension funds that remain unconvinced. A poll by Professional Pensions[4] in 2016 showed 53 per cent of trustees, scheme managers and pension professionals did not consider climate change to be a financially-material risk.

Some trustees may have been wary in the past of integrating ESG factors into investment decisions on the basis their fiduciary duty required them to maximise short-term returns. This prevented the consideration of longer-term factors that might affect company performance or the wider interest of savers, as taking account of ESG issues was believed likely to have a negative impact on returns.

Performance concerns remain the biggest deterrent to adopting SRI strategies, even though the theory that ESG integration can damage returns "can now be considered largely disproved", according to the Eurosif report. But views on fiduciary duty have clearly changed, as the report also shows such considerations have become the main driver for SRI strategies in Europe. In the UK, this change is possibly attributable to the influence of the *Kay Review*,[5] published in 2012, and the consequent recommendations and guidance from the Law Commission[6] and The Pensions Regulator (TPR).[7]

"The Pensions Regulator has come down firmly in favour of sustainable investment," says Howard of UKSIF. "Its language is quite imperative."

TPR has issued guidance in the past 18 months that builds on the Law Commission's 2014 report on fiduciary duties and "requires" pension fund trustees to take into account factors that are financially material to investment performance. It states: "Where you think ESG factors or ethical issues are financially material, you should take these into account." Trustees may also take non-financial factors into account provided "there is no risk of material financial detriment to the fund".

More recently, the Law Commission issued a report on pension funds and social investment that made a series of recommendations aimed at the Financial Conduct Authority. "If implemented, these would have the effect of aligning trust-based and contract-based pension approaches by getting the FCA to act," says Howard. "Logic would suggest that if that approach is applied to an individual's defined contribution pension savings, it should be applied to other savings where a financial adviser is involved."

The work by the Law Commission and TPR has had the effect of accelerating growth in the value-driven approach to sustainable investment, where the focus is on financially-material issues, rather than the values approach, where ethical considerations come into play. The ethical sector remains buoyant though, says Howard. This is clear from the Eurosif report, which shows exclusion-based SRI strategies as the largest category across Europe. In the UK, it is the second-largest strategy after engagement and voting.

Markets need governments

The push coming from regulators is part of the second seismic shift identified by Waygood, which is a growing recognition that sustainability cannot be delivered by actors in financial markets alone.

"Markets are structured by governments, through law, fiscal measures, standards

> *Few longer-term investors would say ESG factors are not material*

and regulation, and some in financial services have called on governments over the past five years to do more to make sure the financial system is sustainable," says Waygood.

"There is a recognition that if the system is unsustainable, we need to change the system; not by investors individually making decisions but by governments acting. There is no longer a consensus that we can leave it to markets to sort these things out."

The Paris Agreement on climate change adopted in December 2015 was a landmark in terms of governments collectively looking to address a market failure. This has had a huge effect on investors, according to Rajan of Create Research. Because governments are signatories, investors are now pricing in climate change risk in a way they didn't before.

Other notable milestones include the announcement of the UN Sustainable Development Goals and the Financial Stability Board Task Force on Climate-related Financial Disclosures. "Governments are looking for alliances with investors and businesses," says Hugh Whelan, managing editor at *Responsible Investor*.

The US withdrawal from the Paris Agreement, announced in June, is a backward step and "unequivocally the wrong decision", according to US SIF: The Forum for Sustainable and Responsible Investment. While other leading signatories were quick to reaffirm their own commitment to the agreement, the US' decision highlights the need for investors to continue to push the sustainable investment agenda, and for initiatives that bring investors and companies closer together.

Greater engagement by the financial community with government institutions on sustainability issues is the next wave emerging, says Waygood. Aviva Investors has had a strong focus on this since 2007, particularly with its work on the Sustainable Stock Exchanges Initiative, and regards it as a competitive advantage.

The secular shifts that can harm or help companies' cash flows include government policies. "Understanding how regulation impacts certain industries, whether that's autos or chemicals, means being ahead of the curve," says Waygood. "We can use this understanding to shape our portfolios and take advantage."

Further to go

While it has become commonplace to see investors talking up their ESG credentials, the reality can often be different. "The rhetoric around responsible investing has arrived, in terms of a significant number of long-term investors claiming to integrate ESG factors into portfolios," says Waygood. "But of the asset managers who collectively manage $63 billion that are signed up to the PRI [UN Principles for Responsible Investment], maybe 20 per cent are really doing it. There is still a lot further to go. ESG integration delivers better alpha and a better outcome, but it doesn't get to a sustainable outcome in a world where markets are failing."

Take climate change, for example. Until there is a price mechanism that works to keep oil and gas in the ground, there is little chance of meeting the Paris accord target of keeping global warming well below two degrees Celsius.

Investors also need to examine how the financial services business model contributes to systemic risk, although they may finally be beginning to recognise this, according to Whelan of *Responsible Investor*. For example, the approach taken by Canadian pension funds, of bringing investment management in-house and focusing more on investment in infrastructure and private markets, is being gradually copied around the world. The corollary of that approach is to consider what investors' optimal time horizons are and what they should be doing.

"Then you change the terms of the debate and SRI is less of an ethical imposition on funds and more about how consumers, investors and society are best served," says Whelan.

Even so, economics professor John Kay is concerned the financial services industry remains too focused on short-term returns to make a significant contribution to sustainable development. Capital markets "are much more part of the problem than they are of the solution" to the problems of sustainable finance, he said at the launch event[8] in July for the interim recommendations made by the European Commission's High-level Expert Group on Sustainable Finance.[9]

"I think it's important that we realise the short time horizons which everyone in this room is concerned about – in business and in the environment – are not those of the underlying investors: they're the time horizons which are introduced into the process by intermediaries. We have far too many intermediaries and far too much intermediation," Kay said.

"Market-based capital allocation and long-term decision making are not things that fit very well together," he added.

Education, education, education!

End investors can also do more, according to Waygood. "Few understand markets well enough to hold financial institutions to account for shaping the environment they will retire into," he says, describing this as the biggest market failure in finance.

The *Kay Review*, for example, called for greater stewardship by investors. "But when you have such low demand from the end investor, you won't get the necessary quality of stewardship," Waygood says.

THE NEXT BIG THING?
continued

> *Investors are pricing in climate change risk in a way they didn't before*

"It would help if investors were more demanding," agrees Howard. "Larger investors are more cognisant, but the more clients who say they want this [ESG integration], the better." However, he believes it is "unrealistic" to expect end clients to ask for socially-responsible retail products such as ISAs. The impetus is more likely to come through regulation, he says, particularly if the FCA takes up the Law Commission's recommendations for contract-based defined contribution schemes and extends them to financial advisers.

Retail investment funds may already by doing good sustainability and stewardship work, Howard adds, even though they are not being sold on that basis.

Waygood is adamant investor demand is a vital ingredient in moving the dial on sustainable outcomes. He wants "radical change" in financial education; a kite mark to identify financial institutions of a high standard; and public league tables ranking companies on sustainable development goals, allied with technology enabling investors to see how the companies they invest in are doing against the benchmarks.

Active versus passive

One further area of interest concerns the extent to which the active versus passive debate in asset management could be influenced by responsible investment credentials.

Active managers will have to be "more explicit about what they do and how they add value" to differentiate themselves, says Whelan, who claims they face an "existential crisis" because of the rise of passive investing. "Active asset management performance has a big question mark hanging over it. Managers are having to review what time period they should look to perform over." One answer is to adopt a buy-and-hold strategy based on conviction rather than on relative value. "That brings in longer-term trends, which you can call ESG integration."

Raj Thamotheram, co-chair of Preventable Surprises, a think tank, agrees active managers should compete with passive by adopting a high concentration, high conviction approach. "They would probably then become more interested in ESG, even if they didn't label it as such," he says.

Stewardship is also a crucial ingredient, Thamotheram adds. "If you don't do that well, there is no point in doing ESG. You are part of the problem if you don't do stewardship properly."

It is notable that big passive players are stepping up their shareholder engagement activities and voting against company management more often than in the past. For example, BlackRock, State Street and Vanguard in May were among the 62 per cent of shareholders who supported a shareholder resolution requiring Exxon Mobil to report on the impact of measures designed to limit climate change. This was a departure for BlackRock and Vanguard, which have not previously voted in favour of a climate-related proposal.

Nonetheless, a greater focus on ESG factors is one area where active managers have the edge on their passive counterparts, and something they should look to capitalise on.

"An increasing number of active managers recognise they can differentiate themselves and find alpha via sustainable investment," says Howard. While there is no agreement on how SRI should be done, "that is what gives the sector its dynamism – there is plenty of opportunity to look for the next big thing", he adds ●

1 *Global Sustainable Investment Review 2016*, Global Sustainable Investment Alliance
2 'Strong growth in sustainable and responsible investment across Europe,' Eurosif, November 2016
3 'Millennials drive growth in sustainable investing,' Morgan Stanley, August 2017
4 'Climate change is "overblown nonsense" and not a material risk, says industry,' *Professional Pensions*, August 2016
5 *The Kay review of UK equity markets and long-term decision making*, Professor John Kay, July 2012
6 *Pension funds and social investment*, Law Commission, June 2017
7 See investment guidance for defined benefit pension schemes, www.thepensionsregulator.gov.uk/guidance/db-investment-two-strategy.aspx
8 Launch event for the interim report of the High-level Expert Group on Sustainable Finance. Webcast available at webcast.ec.europa.eu
9 'High-Level Expert Group on Sustainable Finance delivers early recommendations,' European Commission press release, July 2017

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