

The following article is taken from a recent publication by our global colleagues at Towers Watson.

Overview

For much of 2014 major market price volatility remained at low levels. This benign price activity in the short term has masked several underlying trends that shaped the course of markets throughout the year. However, during the final quarter this calm was shattered and the major trends of 2014 were in many cases exacerbated. By taking a step back and viewing market price action as a whole, we are able to review the forces that have been shaping markets throughout the year.

The major trends have been the decline in developed market bond yields, falls in oil prices and the associated risk, a strengthening US dollar, continued emerging market underperformance, moves in credit spreads and differentiation in the returns of developed equity markets. In this article we review these market moves and provide some explanation for their underlying drivers.

1 Declining developed market nominal and real yields

At the beginning of 2014, US, UK and German bond markets appeared to be reasonably priced relative to our economic outlook. That is, yield curves appeared to price a reasonable level of cash rates given our expectations for inflation and monetary policy over 2014 and beyond, even when making an allowance for modest expected risk premia. Consensus expectations and market pricing implied that yields would move higher over the course of the year, with rate rises starting in 2015 and proceeding at a slower pace than historical averages (with variation depending on market). However, contrary to expectations, bond yields have fallen considerably across all three markets over the course of the year, as investors in longer-dated instruments benefited from both rate declines and roll-down effects.

Moves have been most pronounced at the longer end of yield curves. US and UK 20 year zero coupon nominal bond yields declined approximately 110bps, while the German counterpart has fallen by close to 150bps. In the UK, the vast majority of falls at longer maturities have been in long-dated real interest rates, whilst in the US and Germany breakeven inflation rates have declined as well. At current levels, bond markets appear to price a depressed level for 'normative' (i.e. very long term) future cash rates, a point which is particularly true in the UK and Germany.

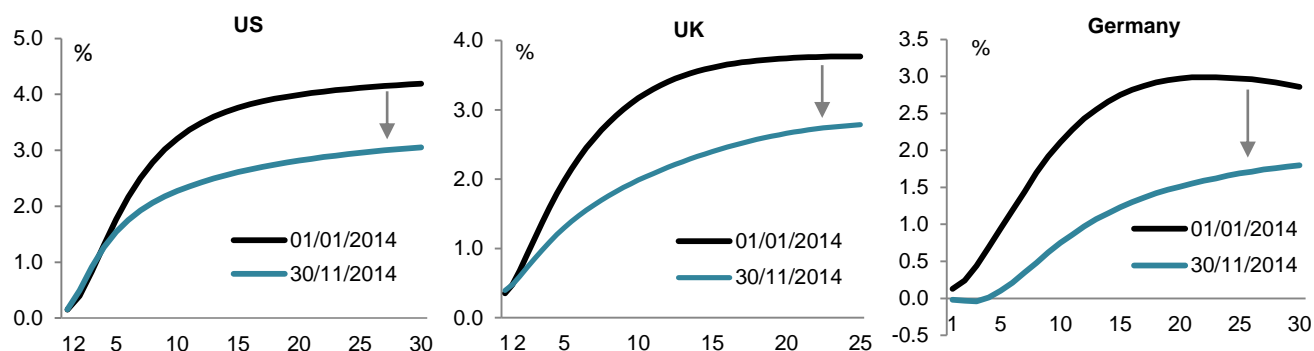


Figure 1. Spot nominal yield curves for US, UK and Germany.

Source: Federal Reserve, Bank of England, ECB, Towers Watson

Turning our attention to the intermediate portion of the curves, 10 year nominal yields fell by 70-80bps in the US, with moves moderating until the five-year point where nominal yields essentially range-traded over the course of the year. UK and German intermediate rates declined more significantly (120-130bps at the 10 year point). Again, in the UK yield declines were predominately driven by medium-term forward real rates, whilst in the US declines were split between break-even inflation and real components.

At the short end of the curves, US nominal rates have risen very modestly during the year as the Federal Reserve began to shift policy guidance and tapering of asset purchases was completed. However, rises were below those that were priced into markets at the beginning of the year so investors will have incurred mark-to-market gains. Real rates have increased significantly outweighing declines in break-even inflation levels as investors became concerned about near-term inflation dynamics. In the UK and Germany nominal rates have declined, again driven mainly by break-even inflation rates.

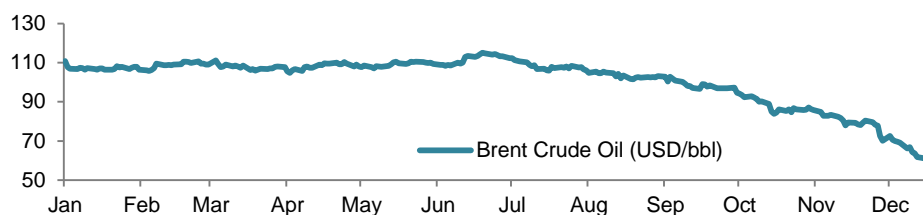
2 Falls in oil markets

Oil prices have declined considerably, falling over 50% since July. We believe that the major cause of this move is the significant increase in non-OPEC related supply during the year. In recent cases of oversupply in the markets OPEC has reduced its production in order to maintain price. However, at the end of November the organisation announced that it would not be reducing supply in the short term. In doing so, OPEC ensured that in the near term, oil markets were balanced not through supply reduction, but by price declines in the expectation that these declines would eventually lead to higher cost non-OPEC producers (such as from US shale) reducing supply in order to balance markets.

For now, strong supply from non-OPEC countries (e.g. Norway, Brazil and the US) shows no signs of abating. Even an immediate reduction in capital expenditure by oil companies in these countries would only result in production slowing over the coming years. Thus, excess supply conditions should create continued fragility (with downward moves even from here probable) for at least the first half 2015 and perhaps longer. The floor for oil is uncertain (and constantly moving) as supply decisions by companies and countries are not only based on their marginal costs of production but also political motivations.

Figure 2. Oil price declines.

Sources: Bloomberg LP, Towers Watson



3 A strengthening US dollar

Foreign exchange markets have been characterised by significant US dollar strength during 2014. This move has been driven by a secularly improving US balance of payment position, but in the shorter term differentiation in growth prospects, monetary policy and risk sentiment have driven markets at various points throughout the year.

Against the euro, US dollar appreciation was significant during the second half of the year. Differentiation in monetary policy, the Federal Reserve ending its quantitative easing programme, the European Central Bank reducing rates, expectations of continued easing and a move towards greater quantitative easing in Europe, combined with declining relative capital flows and expectations of increased growth differentials all drove the euro/dollar cross higher.

A similar story was witnessed in the yen/dollar cross. However, actual monetary policy actions drove yen depreciation to a greater extent. The Bank of Japan's monetary easing policies have had a significant direct depreciation impact on the yen. This was particularly true following its surprise announcement at the end of October to increase its asset purchase programme to a total of ¥80 trillion a year.

The US dollar has also appreciated against other currencies. This includes the vast majority of emerging markets and commodity currencies, sometimes irrespective of balance of payments pressures with worsening terms of trade positions and risk aversion driving many moves towards the end of the year.

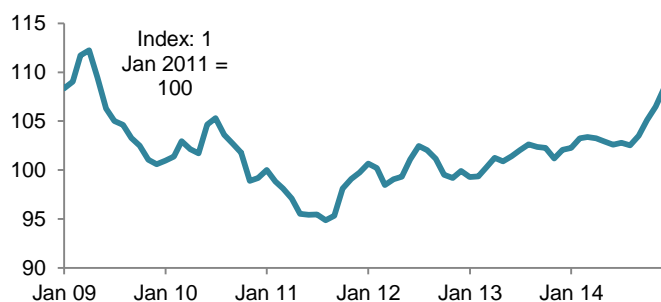


Figure 3. US trade-weighted dollar appreciation during 2014.

Sources: BIS, Bloomberg LP, Towers Watson

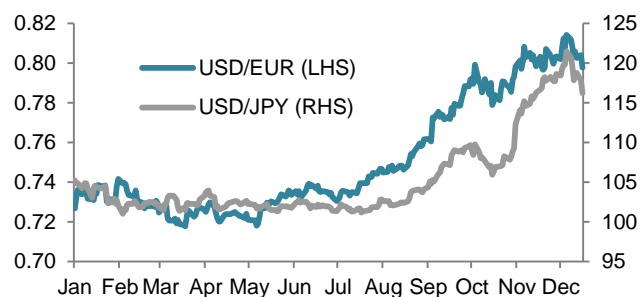


Figure 4. Major currency moves against the dollar.

4 Moves in credit spreads

Option-adjusted spreads in US and UK Investment grade (IG) and High yield (HY) markets ground down over the first half of the year reaching their lowest levels seen since prior to the financial crisis in 2008/9. US IG and HY spreads had fallen by 20 bps and 60 bps respectively by mid-June 2014, with high yield markets reaching a low of approximately 340 bps. Declines in spreads in the US were supported by continued healthy corporate fundamentals, investors searching for yield and monetary policy liquidity measures.

However, narrowing spreads meant that the ex-ante corporate credit risk premia also contracted, which is an indicator for low prospective returns over a medium term horizon. Tight spread levels not only capped future upside returns, but provided limited compensation for potential deteriorations in the default environment. This led us to downgrade our corporate credit rating to moderately unattractive from neutral in July this year.

In the second half of the year spreads widened from their summer lows, initially in US high yield markets. Explanations of this move appeared to lie away from corporate fundamentals as profit growth remained strong and interest payments were not burdensome for many entities. However, following the recent sharp drops in oil prices, market distress increased, particularly in the energy sector. In recent weeks spreads have widened across the whole US credit complex meaning that returns from credit are now negative for the year as a whole. However, total returns have been supported by underlying interest rate duration exposure.

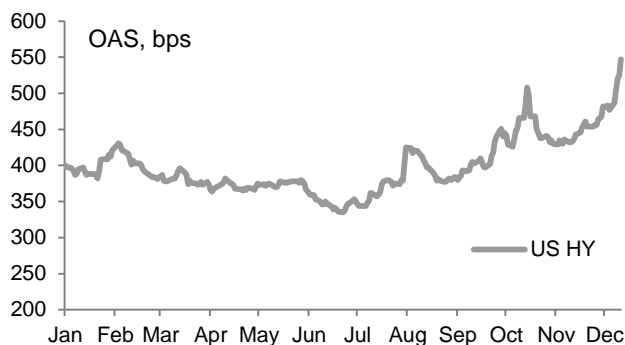


Figure 5. US high yield spreads

Sources: Bloomberg LP, Towers Watson

	Credit return	Underlying duration exposure	Total return
US IG	-0.8%	7.9%	7.1%
Eur IG	2.0%	5.6%	7.8%
UK IG	-0.2%	12.4%	12.1%
US HY	-4.3%	4.2%	-0.4%
EU HY	1.8%	3.1%	4.9%

Figure 6. US and European YTD credit returns

5 Underperformance in emerging markets

Coming into 2014, emerging market assets appeared to offer some of the most attractive risk premia on offer in global markets. Three years of underperformance had meant that equity markets appeared attractively priced on both a relative (to developed markets) and absolute basis. Yield increases during 2013 meant that local currency bond curves appeared to offer some value.

During the first three quarters of 2014 local currency returns on bond assets were reasonable. Reduced funding pressures on countries with poor balance of payment positions reduced sovereign risk premia, whilst deflationary impulses and slowing growth meant that central banks in economies with stronger external dynamics were able to reduce policy rates. This was particularly true in Eastern Europe. However, local currency bond returns were swamped by currency volatility during this period as US dollar strength negatively affected foreign currency outcomes.

Equity returns were more mixed as markets digested poor growth news from China, weak commodity prices and ongoing rebalancing needs in economies with weak balance of payment positions. In aggregate, equity markets continued to underperform US markets as earnings growth remained poor over the year.

The one brighter spot appeared to be provided by emerging market hard currency bonds. Spread declines in the first quarter and assistance from declines in underlying developed market interest rates, meant the asset class provided reasonable returns during the first two quarters of the year.

However, following the decline in oil prices, assets across the emerging market spectrum have underperformed significantly. Initially turmoil was limited to those markets with significant energy exports, but over the last week the whole emerging market has complex has been negatively impacted.

6 Differentiation in developed equity markets

In aggregate developed market equity performance has been towards the upper end of historic average ranges over 2014. The achieved equity risk premium (as measured against US cash rates) is approximately 6% year-to-date. Whilst aggregate returns have been reasonable on this metric, global statistics mask significant differentiation amongst markets. In general, performance followed strength in underlying fundamentals.

At the beginning of the year, the US equity market appeared to be one of the least attractive developed markets on valuation grounds. Market pricing was consistent with the expectation that earnings would grow at levels which were consistent with our economic outlook, implying that the equity risk premium was average at best. However, robust sales growth, muted wage increases and low interest rates meant profit levels increased at the aggregate level. These conditions exceeded expectations, driving markets higher over the year and meaning the US market is the best performing major developed market during 2014.

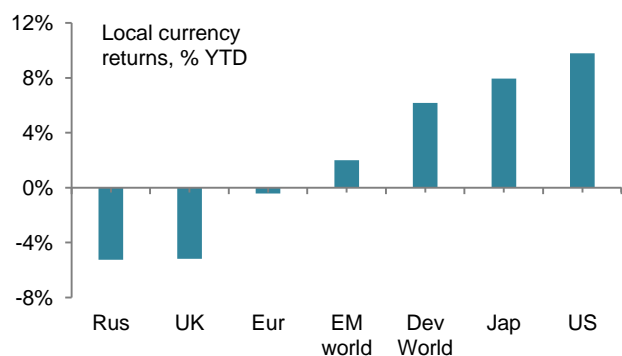


Figure 7. Equity returns across major markets

Sources: Bloomberg LP, Thomson, Towers Watson

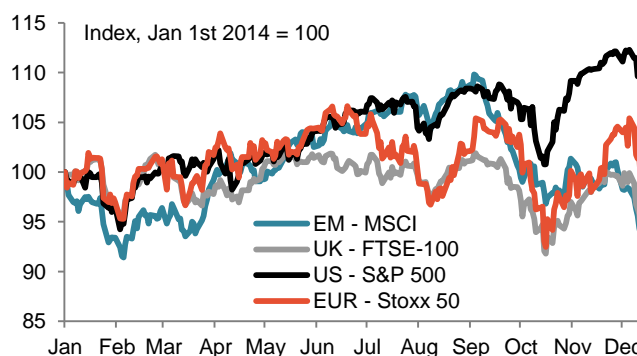


Figure 8. Equity market moves til 15 December 2014.

As with the US, returns in Japanese equity markets were driven by strong earnings performance relative to expectations. However, unlike in the US, local currency returns were driven by significant currency depreciation, rather than strong underlying final demand. The sharp depreciation in the yen increased foreign earnings relative to cost bases located in Japan, improving corporate profitability. As strong earnings growth was ahead of expectations, market returns were positive.

At the other end of the spectrum, fundamental performance in UK and European markets disappointed relative to expectations. In the UK large exposures to commodities and energy markets provided a drag on earnings growth, whilst continued deleveraging in the banking sector also led to downward pressure on markets. In Europe, continued meagre growth and banking system deleveraging led to a decline in sales that has flowed through to earnings. Consensus expectations implied that earnings would recover over 2014, and disappointment relative to these expectations has driven poor market returns

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