Willis Towers Watson

Global Markets Monthly

Asset Research Team, May 2016

Contents

Our current views

Three-year horizon	
Asset Class	**View**
Global government bonds (ten year)	Neutral
Global inflation-linked bonds (ten year)	Neutral
Global investment grade credit (spreads)	Moderately underweight
Global equities	Moderately underweight
Commodities	Neutral

Source: Willis Towers Watson

Changes from the previous edition are shown in bold

In this issue

Feature article: Inspecting the risky-asset rally

For some time, we have adopted a generally cautious approach to risk. In this month's feature article, we review recent market moves, assess what the likely drivers have been and ask: is our cautious outlook called into question by recent positive market action?

Government bonds

We currently hold a moderately attractive view on US Treasury Inflation Protected Securities (TIPS), whereas our stance on UK index-linked gilts is neutral. In this month's article we review this outlook.

Credit markets

Last month we revised down our three-year return expectations for corporate credit markets. This was reflective of lower starting yields across markets together with our cautious forward looking fundamental outlook. A below average return environment across corporate credit markets is reflective of the suppressed level of credit risk premia across geographies currently, in our view.

Emerging market debt

We currently hold a *moderately underweight* rating on both local and hard currency emerging debt markets. Our cautious stance is influenced by three key themes: concerns over China's slowing economy, weak commodity prices and tighter global financial conditions. This month we write on external rebalancing, focusing on India, Indonesia, Brazil, South Africa and Turkey – collectively labelled the "Fragile-5" after the taper tantrum-which ties in with the third theme.

Global Equities

This month we discuss our moderately underweight view on US equities. We briefly revisit the factors that have driven price action this year before turning our attention to the key issues facing both the US economy and US corporates which will put pressure on US equity returns in the medium term.

Foreign exchange

Since the start of the year, the trade weighted US dollar has depreciated by around 7%, reversing all of its 2015 appreciation. The Federal Reserve's more dovish rhetoric, following a slowdown in US and global growth, may have been the reason behind this. However, we also investigate whether the marked depreciation was caused by policy coordination agreed at the G20 summit in Shanghai.

Commodities

Oil prices have been fairly volatile in recent times. Failure to reach an agreement in Doha caused prices to dip, whereas the wildfires burning near Canadian reserves caused them to rise again. Over April and May, the net effect has been a moderate increase in oil prices. We also refresh our outlook for iron ore, as the price of the metal remains an important indicator for global manufacturing and construction.

Asset class ratings

May 2016

Equities			Three year horizon
	Developed markets		**Moderately underweight**
	US (large cap)		Moderately underweight
	US (small cap)		Moderately underweight
	Euroland		Neutral
	UK		Neutral
	Japan		Neutral
	Australia		Neutral
	Emerging markets		**Moderately underweight**
Credit			
Investment grade	US (all maturities)		Moderately underweight
	US (long credit)		Moderately underweight
	Euroland		Moderately underweight
	UK		Moderately underweight
High yield	US		Moderately underweight
	Euroland		Moderately underweight
Leveraged loans	US		**Moderately underweight**
Emerging markets	External currency		Moderately underweight
Securitised markets	Non-Agency RMBS		Neutral
	Agency RMBS		Neutral
Sovereign bonds		Maturity	
Nominal	US	5 year	Neutral
		10 year	Neutral
		15 year	Neutral
	Germany	5 year	Neutral
		10 year	Neutral
	UK	5 year	Neutral
		10 year	Neutral
	Australia	5 year	Neutral
		10 year	Neutral
	Japan	5 year	Neutral
		10 year	Neutral
Inflation-linked	US	5 year	Moderately overweight
		10 year	Moderately overweight
	Euroland	5 year	Neutral
		10 year	Neutral
	UK	5 year	Neutral
		10 year	Neutral
	Australia	5 year	Neutral
		10 year	Neutral
Emerging markets	Local currency		Moderately underweight

Source: Willis Towers Watson

Asset class ratings

May 2016

Commodities		Three year horizon
	Oil	Neutral
	Industrial metals	Neutral
FX (vs. USD)		
	Euro	Neutral
	Sterling	Neutral
	Yen	Neutral
	Australian $	Neutral
	EM currency (Rogge)	Moderately underweight

Source: Willis Towers Watson. Please see ratings definitions in the Appendix. **Upgrades in ratings from last month shown in green. Downgrades in red.**

Summary of market views

May 2016

Interest rates

- Despite medium-term declines in yields, they remain consistent with our central cash rate forecasts in a number of developed markets. Consequently, yields on developed market nominal bonds remain within our neutral range. We note that bonds continue to provide some downside protection (to a lesser extent in Germany and Japan) – an attractive attribute given our current cautious outlook. As such, we retain a *Neutral* view on developed market nominal bonds.

Inflation

- UK long-dated breakeven inflation rates appear elevated relative to our outlook for subdued inflation pressures going forward. This also suggests that UK long-dated index linked gilt yields are unattractive. However, given the weight of institutional demand for long-dated index-linked gilts for hedging purposes, the catalyst for a near-term re-pricing of breakeven inflation lower/real yields higher is not clear to us. We maintain a *neutral* outlook for now.
- Conversely in the US, we believe breakeven inflation rates are under-pricing inflation. While we recognise there are both current and long-term disinflationary forces, on a cyclical horizon we think inflation will stabilise at levels moderately above what inflation markets are discounting. As a consequence, we hold a *Moderately overweight* view on medium and long-term US inflation-linked bonds.

Credit

- Credit spreads are now generally below start of year levels and offer moderately below average risk premia-particularly when compared to other risky assets. Consequently, we assign a *Moderately underweight* rating to global corporate credit as downside macroeconomic risks and those specific to credit-creeping leverage, weaker underwriting and structurally lower liquidity-lower our central returns per unit of capital and increase the potential severity of a turn in the credit cycle.

Emerging market debt

- We downgraded our aggregate emerging market US dollar-denominated and local currency sovereign bonds to *Moderately underweight* in November of last year. We note that this view relates to passive exposure and we continue to regard the current environment as a fertile one for active management.
- We believe that risks to EM local currency debt returns are skewed to the downside given broad macro pressures: Chinese growth concerns, lower commodity prices and gradual US monetary tightening. In no region do our duration and FX views for local currency EM debt assets align to give a clear positive signal.
- Hard currency spreads also have negative exposure to weaker EM growth prospects, tightening US liquidity, and lower oil prices. These factors are expected to especially affect those countries heavily reliant on foreign capital and net commodity exporters. Consequently, we are *Moderately underweight* hard currency EM debt.

Equities

- We maintain our Moderately underweight view for global equities over a three year horizon. This reflects a combination of growing medium-term macroeconomic and fundamental corporate risks to equity markets and only an average global equity risk premium – expected returns from equities are low and vulnerable to significant downside risks.
- This rating encompasses both developed and emerging markets (and across countries). We believe that all markets are likely to provide moderate-to-low returns over the medium term.

Foreign exchange

- We still expect moderate US dollar appreciation against the euro and yen in the medium term and note that the dollar provides attractive characteristics should a downside event occur. However, our conviction in this outlook has lowered given our concerns about the strength of the US growth cycle and likely less acute monetary policy divergence relative to Europe and Japanese economies. We hold a neutral view on the euro and yen against the dollar.
- Our central outlook also points towards moderate sterling appreciation against the euro. However, risks of a poor outcome if the UK votes to exit the EU in its June referendum lead us to highlight risks to the downside. Clients with large sterling exposures (assets or liabilities) should reconsider their liquidity and hedging arrangements in light of this concern.

World market statistics

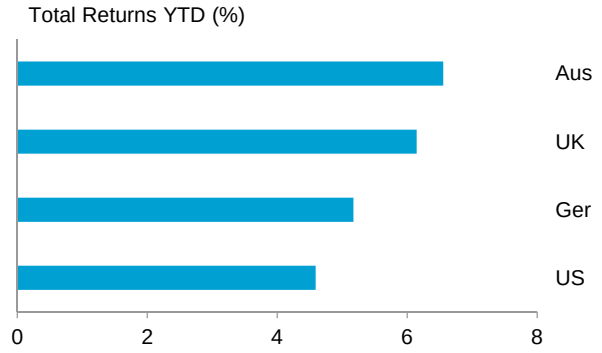
As of 30 April 2016

Interest rates

10yr yields, % p.a.	Latest	3 months prior	12 months prior
US nominal	1.89	2.02	2.14
UK nominal	1.69	1.64	1.94
German nominal	0.25	0.34	0.36
Aus nominal	2.43	2.52	2.61
US Real	0.21	0.62	0.20
UK Real	-0.87	-0.92	-0.96
German Real *	-1.15	-0.98	-0.83

Source: Bank of England, Deutsche Bundesbank, Federal Reserve, ECB, Reserve Bank of Australia, Bloomberg
*Data source changed to Bloomberg as at 31 March 2016

7-10 year nominal bond return



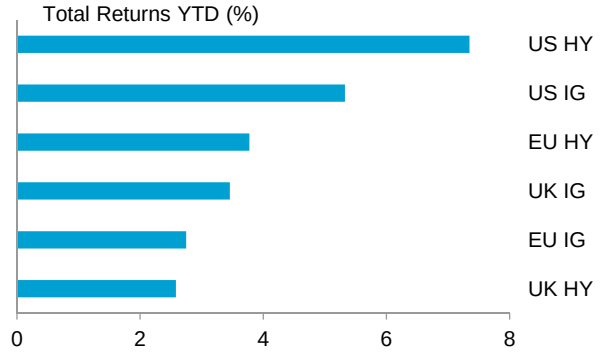
Source: Bloomberg LP

Credit markets

Option-adjusted spread, bps	Latest	3 months prior	12 months prior
US IG Corp	152	202	134
EU IG Corp	121	149	96
US HY	624	777	459
EU HY	456	571	384
CDX NA IG	77	102	63
ITRAXX IG	73	93	61

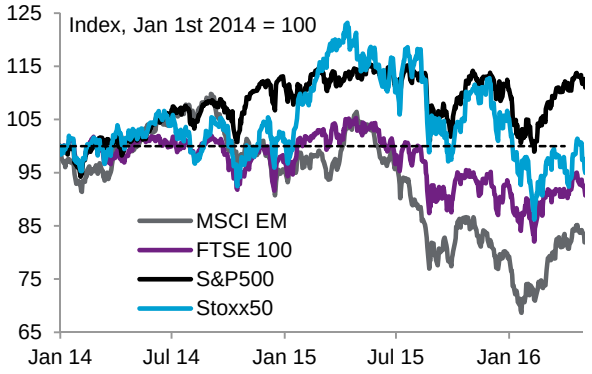
Source: Bloomberg LP, Willis Towers Watson

Credit market returns



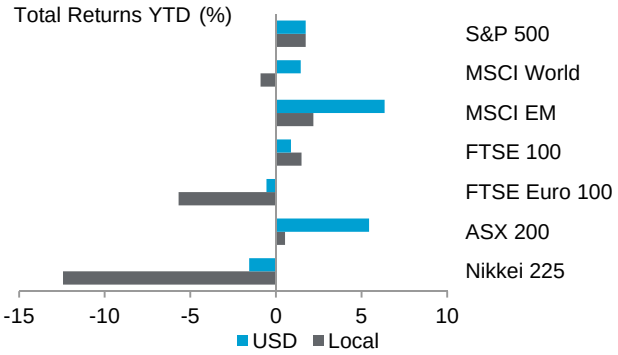
Source: Bloomberg LP

Global equity price action



Source: Bloomberg LP

Global equity returns



Source: Thomson, Willis Towers Watson

Inspecting the risky-asset rally

To what extent is our cautious outlook challenged?

For some time, we have adopted a generally cautious approach to risk. Our analysis suggests the forward-looking economic and asset return environment is one of low growth and low asset returns, with an emphasis on downside risks. The recent strong rally in risky-assets-particularly amongst cyclical corporates and commodity-related assets-may challenge this view. Below we review recent market moves, assess what the likely drivers have been and ask: is our cautious outlook called into question by recent market action?

Market action over the past few months

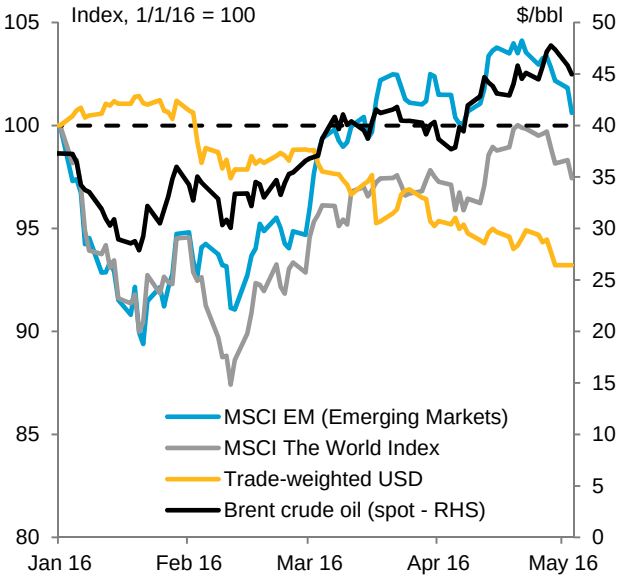
Following a weak start to the year, risky-asset prices have rallied strongly since early February. The first-mover was the oil price which, along with equities, started rallying in late January (*Fig. 01*). This appears to drive the strong performance of commodity-sensitive EM equities, although (as we discuss below) this may be evidence of correlation rather than causation. At the same time, the US dollar has weakened around 10% in trade-weighted terms, notably against the yen but also against commodity-reliant crosses such as the Aussie dollar, Canadian dollar, South African rand, Russian rouble and Brazilian real. Outperformance of commodity-sensitive assets extends to fixed income space as well, with US high yield spreads contracting almost 300 bps from late February peaks (*Fig. 02*). Investment grade spreads also rallied sharply and now lie below start of year levels. Despite the strong appetite for risky commodity-sensitive assets, risk-free assets remained buoyant. Bond yields in the US, Germany, Japan, UK and Australia all remain materially below start of year levels.

Policy shifts

As ever, caution is required in attributing market moves to individual drivers. Largely, the explanation for the risky-asset rally of the past two months rests in the stabilisation of oil and other commodity markets. Indeed, there has been progress on the supply side, with OPEC signalling production restraint (which may not materialise) and US shale production beginning to decline. However, we think two important policy shifts underlie this oil (and other commodities) move and the response of asset prices:

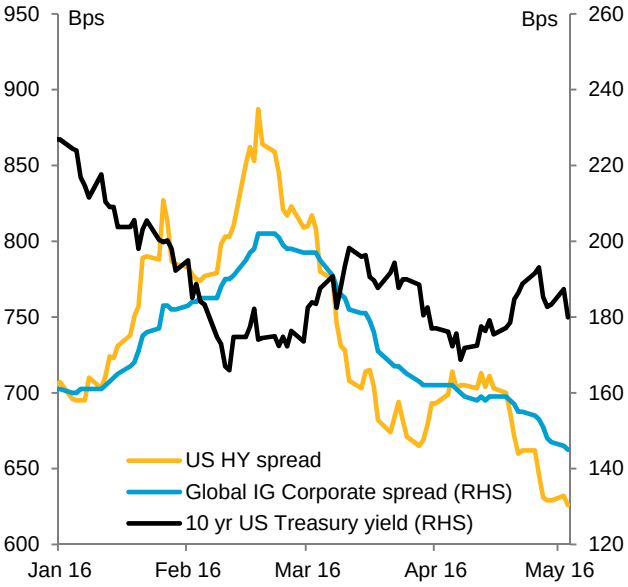
1. China fiscal and monetary stimulus: In February, the fiscal deficit was increased to 3% of GDP, and a relatively high 2016 growth target of 6.5%-7% emphasises near-term growth. On the monetary side reserve requirements were cut which stimulated credit growth. Industrial production increased and property prices rose.

Fig. 01 In recent months: equities and oil rallied strongly…



Source: Factset, Willis Towers Watson

Fig. 02 …along with credit spreads. Bond yields remain low.



Source: Factset, Willis Towers Watson

Inspecting the risky-asset rally

Underlying fundamentals remain mediocre to weak

2. Global monetary easing: There was a distinct shift in emphasis from statements, speeches and releases from the Federal Reserve starting in February. Gone was language emphasising normalisation of rates, with more weight being placed on the downside risks faced by the US and global economies and the constraining impact of USD strength on activity. Despite easing in Japan and the Eurozone, this took pressure off the US dollar, eased US dollar liquidity and allows other countries (particularly in EM) to potentially ease without fear of FX-related inflation.

Has there been an underlying pick-up in growth?

This taxonomy of the risky-asset rally omits a meaningful and sustainable multi-year pick-up in growth as a driver, for the following reasons. First, the pick up in oil prices and higher-frequency growth data in China looks directly related to the demand-side stimulus. Engaging in such stimulus may well be coherent from a short-term policy perspective but it is not sustainable in the sense that it does not address the long-term issues facing the economy. On the contrary, one of those long-term issues is excessive reliance on credit-fuelled investment in the state-owned industrial sector, which if anything has been made worse by the recent policy response. In short, recent policy has been about "bringing growth forward" rather than improving its long-term trend. A similar summary can be applied to the shift in policy stance in the US.

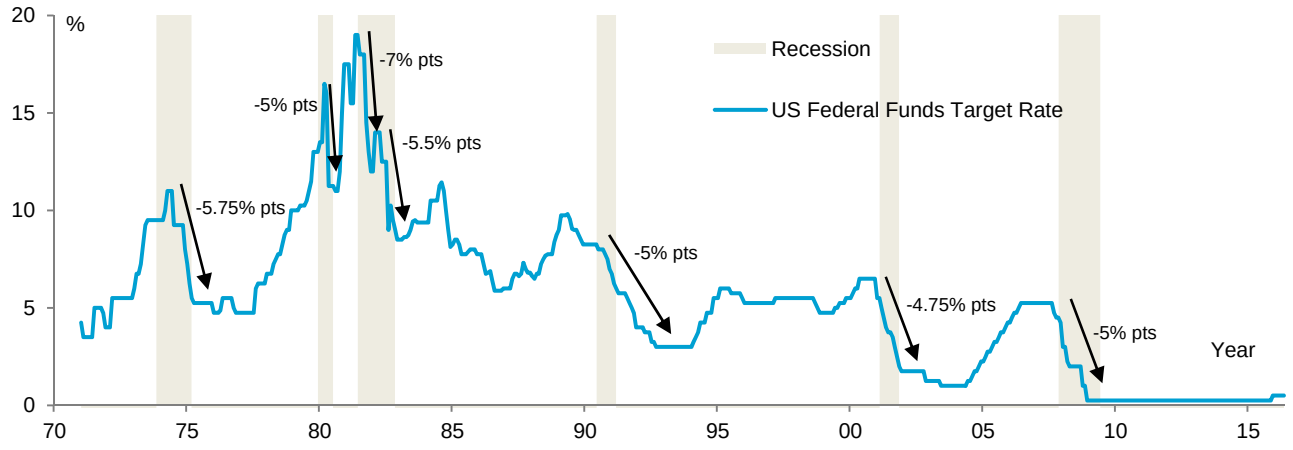
Second, there is no material evidence of a recent pick up in underlying growth. We will discuss the economic picture in next month's feature article but, as things stand, the latest data points tracks our outlook fairly well. The stimuli discussed above have reversed a worrying dip in high-frequency global activity data during February and March but leave growth rates at, or slightly below, our estimate of potential growth.

However, it is fair to say recent policy action has likely reduced the near-term risk of recession. In turn, for investors with a short-term focus, this justifies some contraction in risk premia. However, for investors with a medium-term focus, underlying risks have not diminished.

Impact on forward-looking returns

Financial assets provide a claim on some kind of cashflow profile-the asset is valued by discounting a cashflow profile at some discount rate. Increases in asset prices can occur due to: 1) falling discount rates (themselves a combination of risk free rates and risk premia); and/or 2) increases in future expected cashflows. The arguments above make the case that the recent risky-asset price increases have occurred due to policy shifts pushing down risk-free rates and risk premia, not because prospective cashflows have materially improved. In effect, recent price increases have "bought returns forward" and do not improve the medium-term expectation for total returns. This would require a pick-up in fundamental conditions-i.e., improved cashflow prospects-which at this stage we have not observed.

Fig. 03 Negative economic events have, historically, required 5% points or more of interest rate cuts



Source: Thomson, The National Bureau of Economic Research

Inspecting the risky-asset rally

We retain our emphasis on downside risks

Note also that the policy shifts that underlie the risky-asset rally are, in our view, examples of “can-kicking”. Resolutions to the key headwinds to asset returns-low cash rate, average to below average risk premia and a lacklustre growth outlook-require either a shake-out in asset prices, or concerted, slow-burn policy shifts. China cannot keep stimulating through credit-fuelled investment; indeed this recent round may be cut short due to rapidly increasing house prices (publicly unpopular and therefore politically undesirable).

The US has eased its rhetoric in response to a mild slowdown, but that policy stance maintains a weaker policy position. *Fig. 03* indicates the Fed has typically cut rates by 5% points or more in response to downside events-our question is where will the equivalent stimulus come from should anything happen this time? Unconventional policy tools still remain but the ability of central bankers to stimulate materially in response to any downside shocks is constrained in our view.

Therefore, we retain our generally cautious outlook for risky asset returns, in particular our emphasis on downside risks. Whilst recent policy shifts and the market response demonstrates the authorities are not toothless in the face of relatively minor slowdowns, our concern is that the economy and asset prices remain unusually exposed to more material shocks.

Government bonds

US and UK inflation and inflation-indexed bonds

Inflation-indexed bonds differ from conventional bonds in that coupon and principal payments are linked to national inflation rates. Amongst inflation-indexed bond markets, the US and UK are by far the largest and most liquid, comprising roughly 40% and 30% of the global universe, respectively. For US inflation-indexed securities, the inflation rate used is CPI, whereas in the UK, RPI is adopted. Interestingly, the central banks of both countries officially target different inflation rates-PCE in the US and CPI in the UK. Having said that, the inflation series for each country are highly correlated and the difference between them is generally predictable over time.

We currently hold a moderately attractive view on US Treasury Inflation Protected Securities (TIPS), whereas our stance on UK index-linked gilts is neutral. In this month's article we review this outlook.

Inflation dynamics

United States

The Fed officially aims for a core PCE inflation rate of 2%. In terms of CPI, the more common benchmark, we estimate that this translates into an equilibrium inflation rate of around 2.3%. This difference exists due to a number of factors, the biggest being different consumption category weights, most notably for shelter. Other key drivers of the gap are somewhat different consumption baskets and aggregation formulations.

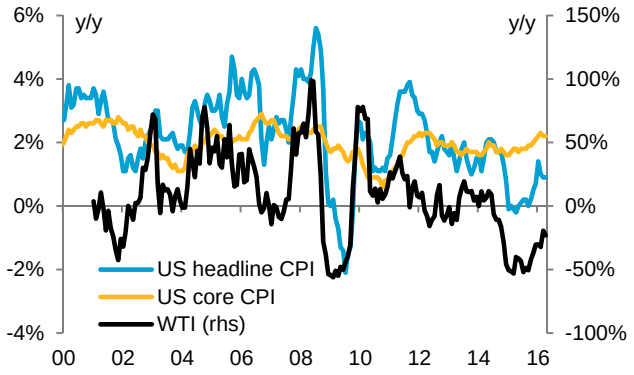
At present, annual headline CPI inflation in the US is 0.9%. This is well below our Fed target estimate of 2.3%. The primary reasons behind this are the large falls in oil prices that have occurred (*Fig. 04*) and the stronger dollar. Energy currently constitutes about 7% of US consumption baskets, down from nearly 10% two years back. Relative to headline, core CPI has been more stable and is running at 2.2% per annum. We expect the gap between the two series to narrow over the next 12 months as the impact from energy fades.

Typically, when headline inflation has dropped below core, it has been followed by an overshoot (*Fig. 04*). However, we expect CPI inflation to average less than 2% over the next 5 years in our central scenario. Firstly, we think that wage increases linked to falling headline unemployment will be moderate given part-time and discouraged workers, as well regional and sectoral labour market disparities. In addition, there is some evidence of falling inflation expectations and disinflationary impacts from China and other emerging nations via the imported goods channel. Finally, from a monetary standpoint, high leverage and deleveraging trends have been disinflationary and are likely to persist.

United Kingdom

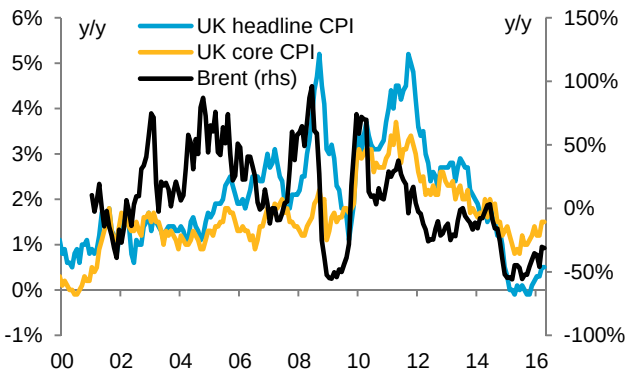
As with the US, CPI inflation in the UK has been low over the past couple of years. This has been led by the collapse in energy prices. The latest headline figure is 0.5%, compared to a core rate of 1.5%. Similar to the US, the base impact of energy prices should dissipate causing the gap to narrow. But deleveraging pressures (which are more acute than in the US), links to the Eurozone and labour market slack-wage growth has been slowing despite falling headline unemployment due to underemployment-should keep inflation lower than the Bank's 2% target over the next few years.

Fig. 04 US inflation dynamics



Source: Bloomberg LP, Willis Towers Watson

Fig. 05 UK inflation dynamics



Source: Bloomberg LP, Willis Towers Watson

Government bonds

US and UK inflation and inflation-indexed bonds

RPI inflation is the relevant rate for index-linked gilts. In the UK, this has historically been higher than CPI. This is due to alternate survey populations, different consumption baskets (notably RPI includes mortgage interest payments), and a formula effect resulting from the manner in which aggregates are calculated (arithmetic versus geometric means). Historically, the average difference has been 70bps but this has been higher more recently due to improved clothing data collection, which has amplified the formula effect in the category from 2010 (*Fig. 06*). Based on our anticipated pace of rate rises (which effects interest payments) and expected future basket weights, we predict a basis of 80bps-100bps to prevail going forwards.

Market pricing and our expectations

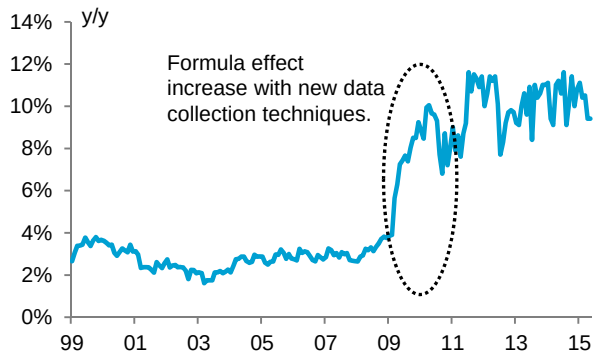
Fig. 07 depicts zero-coupon breakeven inflation rates in the US and UK over time. Whilst breakeven rates have been falling in both markets since the start of 2013, the fall in US breakevens has been especially striking. Markets are currently pricing far lower inflation going forwards than historically. Whilst there has been some upward revision in the past two months, and despite our relatively downbeat inflation view, we think that markets continue to over-extrapolate current disinflationary conditions in the US.

More precisely, *Fig. 08* compares the term structure of breakeven inflation rates to our central expectations. These are formed by taking the geometric average of our central inflation forecasts over different horizons, adjusted for relevant premia. Nominal yields have an embedded inflation risk premium which real yields do not. On the other hand, real yields may have an illiquidity premium. However, given that both the US and UK inflation-indexed markets are fairly large and liquid, we estimate the liquidity premium to be relatively small. US breakevens below our own, notably at longer maturities, indicate that markets are discounting inflation conditions that are too low. We have maintained our neutral stance on nominal bonds and reflect this misvaluation with a moderately overweight rating for 5 and 10 year US TIPS.

Return forecasts

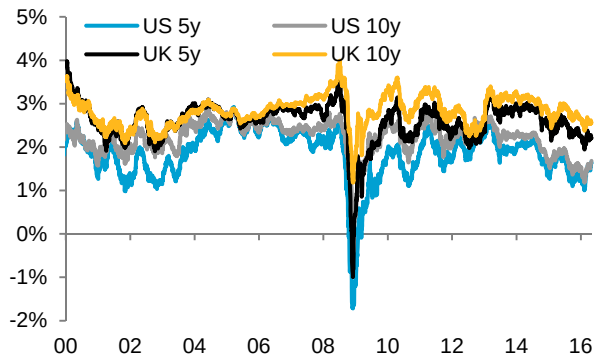
Our return forecasts are formulated by comparing market forward real yields to our own estimates, and assuming the market converges to our forecast. Based upon this, we expect 10 year US TIPS to return 2.4%-3.7% and UK index-linked gilts to return 1.3%-2.6% over 3 years.

Fig. 06 Clothing and footwear RPI-CPI basis



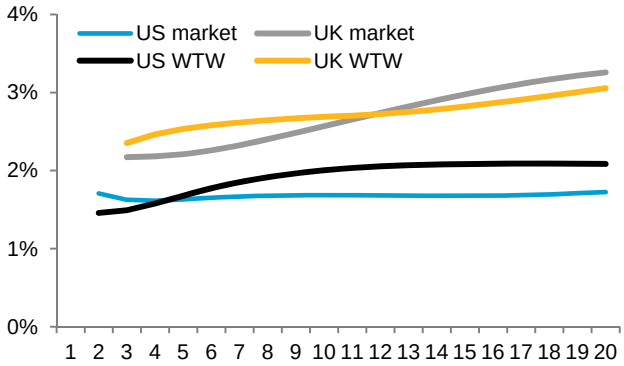
Source: Bloomberg LP, Willis Towers Watson

Fig. 07 Breakeven inflation rates in the US and UK



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

Fig. 08 Breakeven term structure vs. WTW modal forecasts



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

Credit Markets

Credit risk premia appear low across developed markets

Corporate credit spreads are now comfortably tighter over 2016

Since year-to-date highs in February, option adjusted spreads across US and European corporate credit markets have contracted relatively sharply. As discussed in the feature article, this has occurred against a backdrop of marginal improvement in near term US growth dynamics, higher oil prices and supportive central bank policy action. At the time of writing, US investment grade spreads are ~20bps tighter since the beginning of the year, with European IG spreads also narrowing ~10bps year-to-date. US and European high yield markets have witnessed the most notable spread contraction, with spreads contracting ~80bs over this period (*Fig. 09*).

Credit risk premia are low across markets; we expect them to rise over the medium term

Last month we revised down our three-year return expectations for corporate credit markets. This was reflective of lower starting yields across markets, together with our cautious forward looking fundamental outlook. A below average return environment across corporate credit markets is reflective of the suppressed level of credit risk premia across geographies currently, in our view (*Fig. 10*).

Over the medium term, we expect credit risk premia to rise towards or above long term historical average levels. On a forward looking basis, we think credit market fundamentals will weaken. As we traverse through a more mature phase in the credit cycle, we expect both a widening path for spreads and a pickup in defaults and downgrades (*Fig. 11*). Whilst we observe that some of this widening has begun to occur (in the energy and gaming sectors in particular), a marked pick-up in defaults, which we would expect to be reflected in widening spread levels, is not currently seen in other large sectors. In our view, there is still a material probability that such scenario could unfold. In such a scenario, corporate credit investors could witness significant mark-to market negative returns, through a combination of widening credit spreads and above average sector level defaults.

The most likely outcome is that option adjusted spreads in global IG markets will expand moderately from current levels, with global HY spread moves following a similar trajectory. In the US, losses from default are likely to pick up from the low levels witnessed in recent years. We forecast average annualised credit losses due to defaults and downgrades to be approximately 30–50bps p.a. for US IG markets and approximately 350-450bps p.a. in US HY markets, on average over three years. European and UK corporate credit markets are less likely to be impacted by some of the sector level stresses we currently see in US markets. Partly as a result we expect losses from defaults and downgrades to be lower for these markets, although still rising as the growth cycle matures. In such an environment we expect credit risk premia to rise.

Moreover, we have previously spoken of our observation of falling structural liquidity in corporate credit markets. One of the potential impacts of lower structural liquidity is for credit market sell-offs to be more severe during cyclical downturns than fundamentals would suggest-one could point to the sharp and material widening in HY spreads towards the end of 2015 and in early 2016 as an indication of such an effect.

Fig. 09 Recent spread moves across global corporate credit markets

Market	Spread moves over 2016 (bps)	Year-to-date total returns
US IG	-21	5.1%
US HY	-79	7.4%
US LL	-96	3.6%
EUR IG	-11	2.8%
EUR HY	-78	3.7%
UK IG	+2	3.5%

Source: Merrill Lynch, Bloomberg LP, Willis Towers Watson.
Note: leveraged loans spread moves are based on 4 year discounted spread moves of the S&P/LSTA Leverage Loans Index

Fig. 10 US credit risk premia appear low

	Current OAS	Expected losses	Premium (OAS)	Normative range (OAS)
Investment Grade	**152**	**30**	**121**	**100 - 150**
AAA	70	3	67	
AA	84	7	77	
A	117	19	98	
BBB	206	48	158	
High Yield	**616**	**404**	**212**	**300 - 450**
BB	376	150	226	
B	602	435	167	
CCC-C	1527	1247	280	

Source: Merrill Lynch, Bloomberg LP, Willis Towers Watson

Credit Markets

US IG assets offer higher starting yields than their European counterparts

In such scenarios, credit risk premia are likely to appear more attractive (perhaps only for short periods) as the risk of spread widening over-shooting fundamentals is greater.

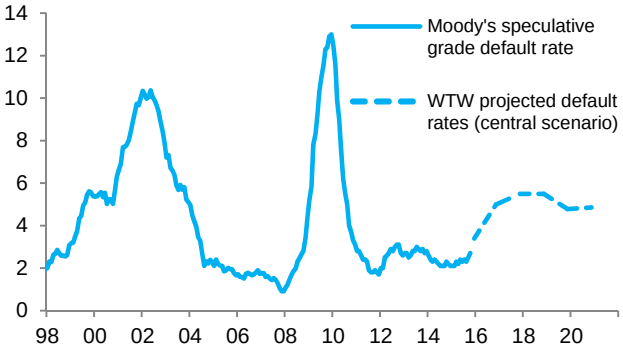
A key risk to our central outlook is a continued contraction in global credit spreads from current levels-which would likely result in further compression of credit risk premia. As set out in the feature article, recent central bank policy action has had the effect of masking a generally weaker set of credit market fundamentals. If such a high liquidity environment continues, credit spreads could compress further-in our view this is a plausible scenario over a three-year horizon. However, downside risks and generally weaker credit fundamentals are severe enough to warrant a cautious (and moderately underweight) central outlook for corporate credit markets.

US IG assets benefit from higher starting yields when compared to EU IG assets

On a forward looking basis, our forecasted excess returns for US IG and EU IG are similar. Whilst US spreads are ~30bps higher currently, the expected loss path for US IG credit is also higher and we expect spreads to widen in both markets. Moreover, once we account for differences in spread duration, both markets offer a similar level of spread per unit of spread duration at an index level (*Fig. 13*). Additionally, there are some noteworthy structural differences between US and European IG market indices. EU IG indices have a greater banking sector concentration (~10ppt more than US IG Indices), whilst energy sector exposure in EU IG indices is lower (~10ppt less than US IG indices).

However, when considered in total return space, US IG assets begin to appear modestly more attractive (in local currency terms) as underlying risk-free bond returns are more favourable in the US as a result of them offering higher starting yields and relatively longer duration (*Fig. 12*). Our central scenario is broadly depicted as one in which spreads begin to modestly widen from current levels, as we expect credit fundamentals to deteriorate somewhat over the medium term. Under this scenario, we would expect US IG assets to outperform their European counterparts in local currency total return space. We consider there to be a low probability of EU spreads outperforming US spreads by a wide enough margin to erase the underlying positive yield differential between US and EU IG credit assets. The more important risk to our central view is centred around underlying risk-free bond returns-a modest rise in intermediate US yields, ceteris paribus, would quickly erode the positive yield differential between US and European IG assets.

Fig. 11 We expect speculative defaults to pick up over the medium term



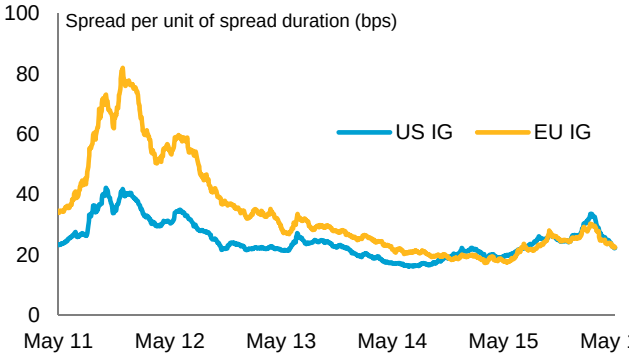
Source: Moody's, Willis Towers Watson

Fig. 12 3-year return expectations (% p.a.)

Market	Total Return (p.a.)
US IG	1.2% - 2.5%
US HY	0.95% - 2.95%
US LL	1.5% - 2.8%
EUR IG	0.2% - 0.5%
EUR HY	0.5% - 2%
UK IG	0.8% - 2.2%

Source: Willis Towers Watson

Fig. 13 US and European IG indices offer a similar spread per unit of spread duration currently



Source: Merrill Lynch, Bloomberg LP, Willis Towers Watson

Emerging market debt

Revisiting fragility

Emerging market assets have experienced several bouts of volatility in recent years. This began in the summer of 2013 following the Fed's announcement of its QE taper program. The so-called "taper-tantrum" resulted in a reversal of capital flows that had entered emerging economies during the years of easing monetary policies in developed markets. Assets belonging to countries that had become most reliant on foreign capital-countries typically characterized by large current account deficits unmatched by FDI flows-saw the deepest falls in price as yields rose and currencies dropped. Since then, several heavily impacted nations have fortified their external positions. However, this process has occurred unevenly, and has been complicated by the slowdown in China and the collapse in commodity prices. This month, we examine rebalancing developments in India, Indonesia, Brazil, South Africa and Turkey-countries that had been labelled as the "Fragile 5" following the taper-tantrum.

India

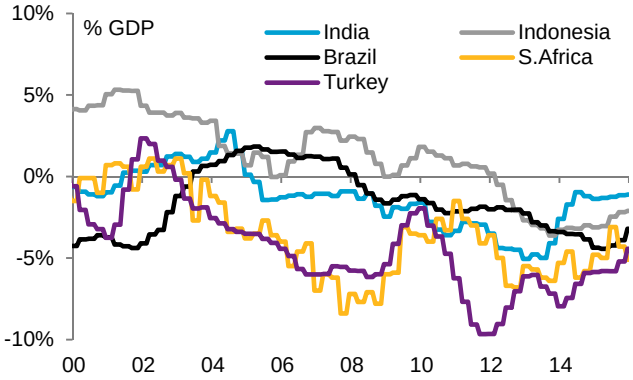
Amongst the 5 nations, we believe that India has had the most success at rebalancing. We now consider its external position to be fairly robust. Following the financial crisis, India's current account deficit widened from about 1% of GDP to 5% by mid-2013 (*Fig. 14*). At the same time, net FDI inflows were only 1% to 1.5% (*Fig. 15*) indicating much of the deficit was financed by volatile portfolio flows. This left Indian assets vulnerable to liquidity shocks such as those during the taper-tantrum. The deficit has since narrowed to about 1.1% of GDP and is now fully balanced by net FDI inflows. In addition, foreign reserves are at sound levels relative to overall external debt, which itself is small versus peers.

Following the taper-tantrum, Indian policymakers allowed the rupee to depreciate markedly (*Fig. 16*) which raised export competitiveness. This helped to strengthen the country's trade position along with government restrictions on gold imports and declines in petroleum prices-gold and oil being the nation's two biggest imports. Crucially, sustainable investment flows to finance the ongoing deficit have also risen, with FDI recently reaching all-time highs (in absolute terms). This has been supported by an improving policy track record, demonstrated by the government's fiscal prudence, a move towards inflation targeting and structural reform efforts such as liberalizing FDI flows and simplifying business regulations.

Indonesia

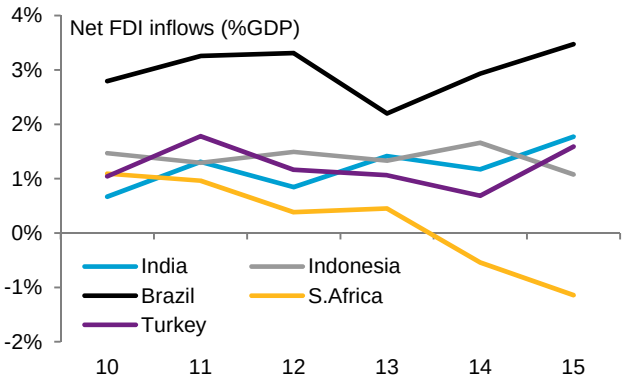
Relative to other economies in the Fragile 5, Indonesia generally possessed a stronger trade position in the years

Fig. 14 Current account deficits



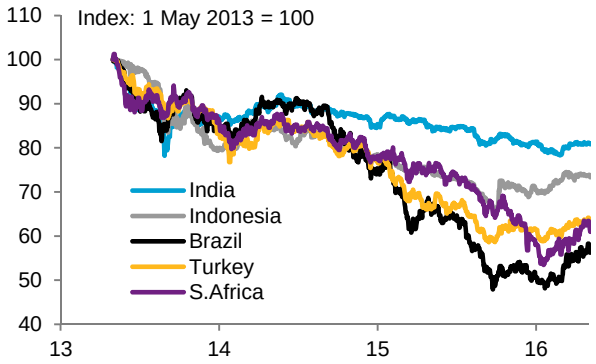
Source: Bloomberg LP, Willis Towers Watson

Fig. 15 Foreign Direct Investment



Source: OECD, IMF, Willis Towers Watson

Fig. 16 FX moves vs USD since May 2013



Source: Bloomberg LP, Willis Towers Watson

Emerging market debt

Revisiting fragility

prior to the taper-tantrum. From 2011 to 2012, the current account rapidly deteriorated from a 0.2% surplus to a 2.8% deficit as easy external funding fueled a jump in imports, with the deficit reaching roughly 3.5% of GDP by mid-2013. Like the rupee, following the tantrum, the rupiah saw marked depreciation that has helped improve competitiveness. However, unlike India, the country has major raw material exports including natural gas, coal and palm oil that has made the rebalancing process more drawn out and arduous, even though the country is a net importer of crude. The deficit now stands at around 2.1% of GDP and we believe that Indonesia has transitioned from a fragile position to a neutral one. Apart from the narrower deficit, this view is supported by policy initiatives such as augmenting infrastructure investment and deregulating retail trade that should provide an impetus to net FDI inflows.

Brazil

Brazil's current account position deteriorated from a fairly balanced one at the beginning of 2008 to a deficit of approximately 3.5% of GDP by mid-2013. Notwithstanding significant depreciation-the most amongst the Fragile 5-the country continued to experience deficit widening after the tantrum. More recently, the deficit has narrowed somewhat, currently standing at around 3.2% of GDP. Brazil's terms of trade has come under significant pressure in recent years due to its heavy reliance on commodity exports, notably iron ore, which has seen a price collapse in the face of a supply glut and slowing Chinese demand. Going forwards, we expect the Brazilian real's large depreciation to continue to support exports and weak domestic demand conditions to constrict imports. We also note that reserves as a percentage of external debt look reasonable relative to peers and FDI inflows are large (about 3.5% of GDP). The economy has made progress towards rebalancing, but we remain cautious for now. Brazil's sovereign debt was downgraded to junk status earlier this year, which could hinder future investment flows and further downgrades seem possible. The nation's political and economic environment remains weak, accentuated by Petrobras' (the state oil company) scandal, the related impeachment of president Rousseff, a deep recession and unanchored inflation expectations.

South Africa

The South African current account deficit widened from 1.5% of GDP at the beginning of 2011 to 6.2% by mid-2013. After the real, the rand has seen the largest depreciation since the taper-tantrum. Despite this, South Africa's deficit remains very wide at 5% of GDP. Rebalancing has been made more difficult due to weakness in metals prices and a drought in the agricultural sector which have hurt exports. Overall, we believe that the country's external position remains fragile. The country's deficit is largely financed by volatile portfolio flows, with FDI representing a net outflow. These portfolio flows could fall as stagflation, a weak budgetary outlook and political tensions mar the country's prospects and could result in a revocation of its investment grade status. Reserves are weak to boot. While flows may receive some support from a repatriation impact as rand depreciation has caused foreign investment limits to be breached, it does not affect the downside risks.

Turkey

Turkey has run the widest current account deficits amongst the Fragile 5, with the deficit reaching almost 10% of GDP at the start of 2012. Whilst the country has rebalanced somewhat since the taper tantrum, assisted by significant lira depreciation and the fact that the country is a net importer of commodities, the deficit remains wide at 4.4% of GDP. Roughly a third of this is financed by net FDI inflows. This means that the country continues to rely a fair bit on volatile external finance that is susceptible if funding becomes scarcer. This risk is elevated by deteriorating governance (the autonomy of key institutions, like the central bank, has been threatened), slowing economic growth (previously fueled by rapid credit growth), and a deteriorating civil environment (there has been a surge in political unrest and bombings recently). Additionally, Turkey generally has larger aggregate external debt to GDP, higher refinancing needs and weaker reserve buffers than counterparts. Given this, we continue to view Turkey as being fragile.

Summary

Whilst India's external position has improved markedly and others have made progress, most countries in the Fragile-5 remain susceptible to capital outflows. Liquidity could tighten, for example, if global downside risks emerge, resulting in weaker investment prospects and elevated risk aversion, or if Fed tightening discourages outward investment.

The risk of capital outflows is a key driver behind our moderately unattractive stance on emerging asset classes. South Africa, Turkey and Brazil remain large players in both hard and local currency debt markets. Additionally, they are not alone in their external vulnerability, with economies like Colombia and Nigeria sharing similar risks.

Equities

Moderately Underweight on US Equity

US equities, like most developed market equities, have had a turbulent year so far. Prices have recovered to start of year values after a considerable decline over the first month or so. In this article, we turn our attention towards the key issues facing the US Equity market in the medium term and reiterate our moderately underweight view we introduced around a year ago.

The story so far this year

In last month's article we discussed the V-shape price movement since the start of the year in major developed market equities. We noted that global growth concerns, the oil price drop and US monetary policy tightening led the initial decline in equity markets and that the subsequent recovery was driven by a partial reprieve in all three factors. For the US, global demand and the price of trade-weighted US dollars are particularly relevant. An improvement in global demand from accommodative policy shifts in a variety of countries (as discussed in the feature article), plus recent weakness in the US dollar have benefited the US equity market.

However, there remain significant structural pressures influencing US equities in the medium term. We now turn our attention to some of these issues.

Cautious Sales Forecast

Companies in the S&P500 generate about a third of their revenues from overseas sales. This means that the strength of the US dollar has a direct bearing on the demand for US goods and services. Although the surge in the US Dollar over the last five years is unlikely to continue (at least not at the current pace), the falls in the dollar since the start of this year is not something we view as the start of a weakening trend. Instead, as monetary policy divergence persists, we expect the US dollar to continue to strengthen at a moderate pace. This would continue to impact the competitiveness of US exports, putting pressure on sales revenues. Aggregate sales for the S&P500 shrank 4% in 2015- their first annual drop since 2009 when they fell by 15%. The technology sector, which generates 60% of its revenues from abroad was hit particularly hard.

Whether central banks still have enough tools to continue to employ monetary policy in supporting global demand is questionable, while we have already seen the effect of global growth concerns on equity markets this year. This reminds us of the significant downside risks in the event of a recession.

Profit Margins have peaked

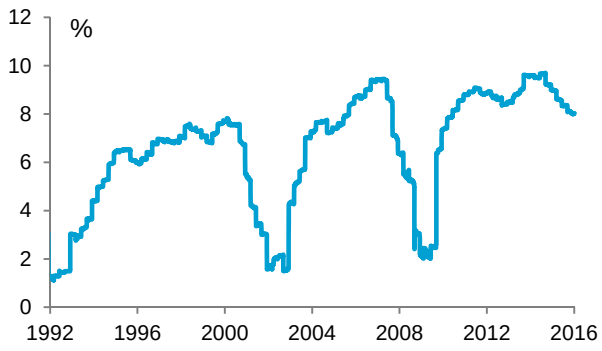
Profit margins for S&P500 are beginning to plateau at all time highs. During the financial crisis, earnings fell while risk premia shot up. This paved the way for the subsequent cyclical recovery as corporate margins rose owing to global central bank monetary policy stimulation and weak labour markets allowing companies to cut their costs. While we note that aggregate margins have since recovered to secular highs, their cyclicality is better currently understood by observing margins on a sector-by-sector basis.

Energy-related margins have unsurprisingly declined in the last year due to plummeting oil prices, drawing aggregate S&P500 margins down from their peak (see *Fig. 18*). As discussed in the commodity article last month, we believe the recent oil price recovery does not represent a

Fig. 17 S&P 500 Index

Source: Bloomberg LP, Willis Towers Watson

Fig. 18 S&P500 aggregate profit margin



Source: Bloomberg LP, Willis Towers Watson

Equities

Moderately Underweight on US Equity

sustainable rebalancing and that there are still considerable pressures limiting a sustained rally in oil prices in the medium term. This implies that energy related companies will continue to face challenges over the next few years. The information technology sector, which has been at the forefront of the aggregate corporate recovery since the crisis, is also expected to have muted growth prospects given margins are already at all time highs and are rising. The deflationary impact of new technology limits price-setting power. We have also recently commented on the challenges facing the financial sector in the wake of negative interest rates in Europe and Japan. US banks operating in those countries will similarly not be immune to those pressures.

These difficulties are further exacerbated when we superimpose the impact of the strong labour market in the US, particularly in high-skill sectors to which larger corporates are exposed. Unemployment has continued to decline since 2009 and now stands below 5% making it difficult for corporates to look towards cutting labour costs as a support to profit margins.

Leverage is high

Over the last 30 years, equity markets have been supported by corporate leveraging. Financial engineering has been a tool actively used by corporates to increase earnings per share through leveraged buybacks. As debt has accumulated in the system, this tool may become increasingly difficult for corporates to use. Although lower interest rates mean that more debt is affordable now, increasing leverage increases risk which is obviously not a perpetually sustainable trend. Using leverage to buy back shares also constrains the ability of corporates to invest in productive assets through capital expenditure. We have noticed in recent years that while total debt for S&P500 listed companies has increased marginally, capital expenditure has in fact slightly declined (see *Fig. 20*).

Putting it all together

The US equity market has benefited from the most favourable part of the business cycle since the financial crisis. As the US economy moves towards its late expansion phase, such support will begin to wane likely exposing the challenges to corporate profitability. Short term fluctuations in markets can be driven by sentiment as witnessed this year in most developed market equities – the US being no exception. Our moderately underweight view on US equities incorporates the challenges faced by US corporates in the medium term.

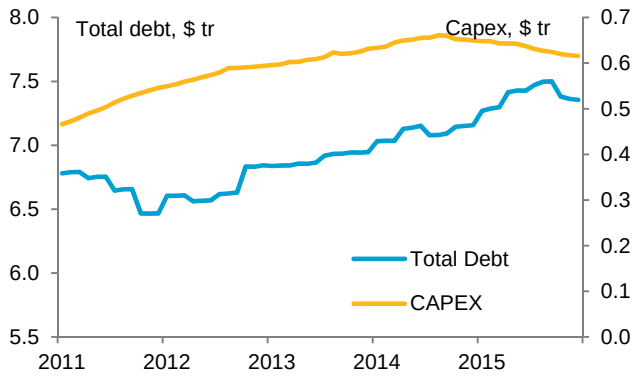
The risk to our view is that the "liquidity-can-kicking" that has been driving equity markets recently continues over the next few years. If the status quo is maintained and nothing materially bad happens, equities will continue to offer returns that are higher than credit, bonds or cash, albeit still low by historic standard. This, however, is an outcome that merely brings returns forward and is not sustainable forever. Therefore, we believe that caution is still warranted.

Fig. 19 S&P500 sector weights by market cap

Sector	Weight
Healthcare	17.29
IT	14.87
Consumer Discretionary	13.53
Consumer Staples	11.61
Industrials	10.37
Energy	10.53
Financials	6.67
Utilities	5.32
Materials	6.25
Telecom	3.57

Source: Factset, Willis Towers Watson

Fig. 20 S&P500 total debt and capex



Source: Bloomberg LP, Willis Towers Watson

Foreign Exchange

Did the dollar fall or was it pushed?

At the beginning of the year we expected further moderate dollar strength as the Federal Reserve continued its moderate tightening of monetary policy. Since the start of January the dollar has in fact depreciated by 5-10% (depending on index used). And in recent months some commentators have questioned whether this moves reflects the beginning of a new Plaza Accord agreement. Below we investigate this claim and other potential reasons for the dollar's decline.

The dollar's fall in perspective

Dollar depreciation has appeared marked when viewed in isolation. In recent months, against the major currencies, the trade-weighted dollar has reversed all of its 2015 appreciation. Looking over a longer period, the recent moves can be framed in the context of the three major cycles since the breakdown of the Bretton-Woods currency accord in the early 1970's. Over this longer horizon, the dollar appreciation from 2011 and decline this year appears smaller in magnitude. Despite this context, the marked fall during 2016 has led some commentators to question whether an agreement to weaken the dollar was reached at the recent G20 summit in Shanghai by policy co-ordination – in effect a new Plaza Accord, akin to that seen in the early 1980's.

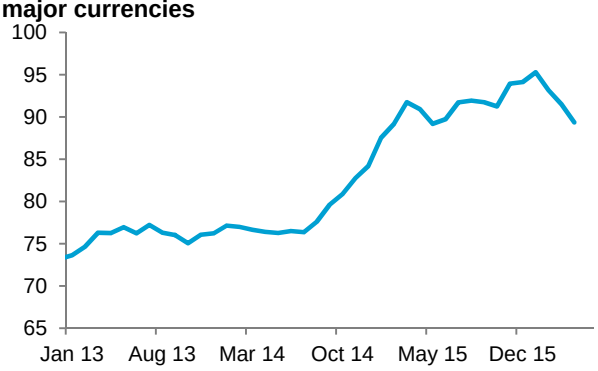
A new Plaza Accord?

We do not believe that the recent decline in the dollar reflects a new dawn in co-ordinated currency intervention from monetary authorities. Agreed economic theory states that five conditions must be fulfilled in order for an intervention to be permanently successful:

1. Authorities and market participants need to agree on the miss-valuation of the currency
2. Initial intervention has greater success than subsequent actions, so authorities should act forcefully
3. Operations are more effective when several central banks act in concert
4. The major effects from an intervention come through changing market participants' expectations, communication is important
5. Change in economic fundamentals are required to support the new level of the currency

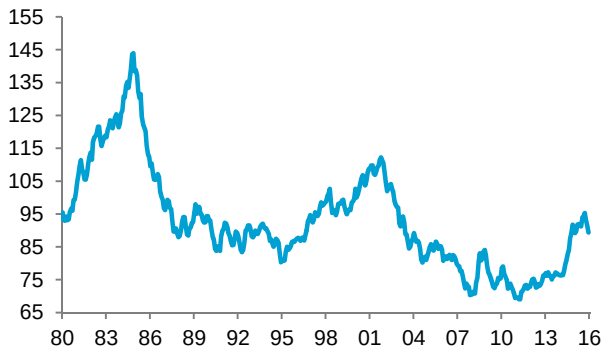
We believe that none of these five conditions are met. For instance in its 2013 communique, the G-7 noted that: "We, the G-7 Ministers and Governors, reaffirm our longstanding commitment to market determined exchange rates." They went on to explain that the use of monetary and fiscal policy for counter cyclical measures was to be limited to domestic instruments and not explicitly target exchange rates. The Shanghai meeting of the G-20 ministers continued to support the stance above, and violates condition three. Additionally, there has been little evidence of rhetoric around condition four, with the Federal Reserve noting dollar strength as a risk to the growth outlook, but not explicitly discussing miss-valuation. Whilst the sharp depreciation of the dollar could perhaps be taken as evidence of condition two, on a wide scale there is little evidence of developed market authority dollar sales that would be consistent with central bank action (except perhaps in China).

Fig. 21 Recent TW US dollar depreciation against major currencies



Source: Thomson, Federal Reserve

Fig. 22 Trade-weighted US dollar over the long-term



Source: Thomson, Federal Reserve

Foreign Exchange

Did the dollar fall or was it pushed?

Dollar over/undervaluation

Currently, there is no broad consensus that the dollar is significantly overvalued. Looking at a model that enhances relative-PPP for productivity and terms-of-trade indicates that on a broad basis the trade-weighted dollar is fairly valued. Other valuation approaches provide similar pictures, e.g. on a carry basis much of the dollar's recent moves track changes in 2-year swap rate differentials (Fig. 23). Therefore, we believe there remains ambiguity as to whether the US dollar is overvalued, unlike prior to the implementation of the Plaza Accord in the 1980's when there was generally agreement that the US dollar had appreciated ahead of underlying fundamental drivers.

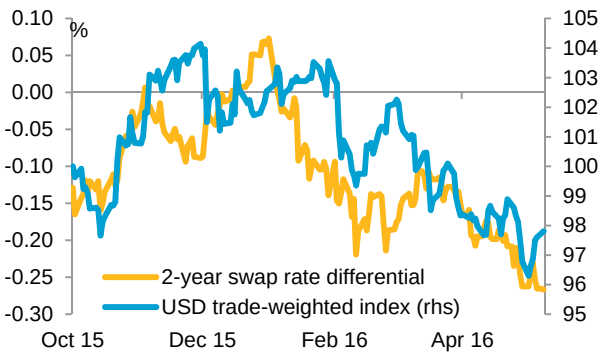
Economic fundamentals

For a significant currency move to remain sustainable, it is generally supported by a change in economic fundamentals. In the case of a depreciation either a narrowing in the trade deficit/widening of surplus or a corresponding reduction in capital inflows/increase in outflows is required. To date, we have seen little evidence of a material narrowing in the US current account deficit, with recent data reversing some of the positive trend experienced in 2013/14. However, evidence implies that economic fundamentals can react with significant lags and so we will continue to follow the trends in coming quarters. From a capital flows perspective, the aggregate of 'sticky' portfolio and direct investment flows again does not provide significant support for a sustainable decline in the dollar. This subset of the capital account has been fairly neutral over the past two years following a decline from the net inflow reached in 2011. Shorter-term measures perhaps point towards a net reduction in capital outflows from markets such as Europe and Japan, whilst China has been selling its US dollar reserves in order to keep its exchange rate stable. However, we believe these changes are linked to monetary policy rather than a sustainable shift in exchange rate fundamentals that could provide evidence of a new chapter of central bank intervention.

Monetary policy outlook likely the most significant driver

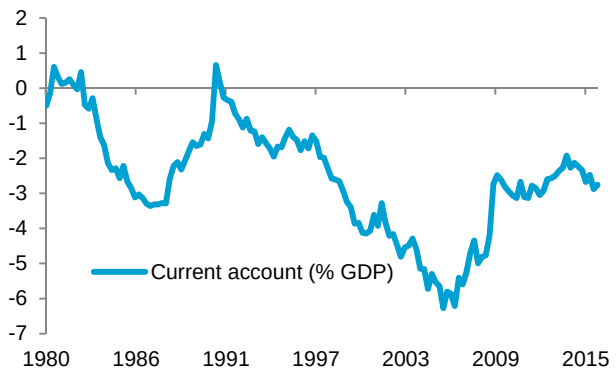
So what has changed? Here we believe the stance of domestic and international monetary policy has had a material effect on movements in the trade-weighted dollar. At the end of 2015 the Federal Reserve was the only major central bank to have adopted a tightening stance. The European Central Bank, Bank of Japan and the Reserve Bank of Australia were explicitly easing monetary policy. The Bank of England and the Bank of Canada were in a holding pattern. As global and particularly US growth slowed in the early part of the year, the Fed's rhetoric about its monetary tightening became more dovish-causing a flattening in the Treasury curve. By contrast, whilst easing policy, the ECB and BoJ appear to have undershot market expectations. We believe this change in expectations has been a key driver of the dollar's decline against many FX majors year-to-date. In the coming months we will write on our outlook for the US dollar against other major crosses.

Fig. 23 TW US dollar and 2-year swap differentials



Source: Thomson, Bloomberg LP, Willis Towers Watson
Note: the chart above uses a wider set of countries than those on the previous page, or is calculated on a broad basis

Fig. 24 US current account



Source: Thomson, Willis Towers Watson

Commodities

Breakdown in oil market supply deal in Doha

For much of April spot oil prices moved higher, sustaining gains experienced in March (Fig. 25). *However, at the end of the month prices dipped lower as news of the failure to reach an agreement in Doha spread. In recent days prices are again higher as wildfires burn near Canadian reserves. This price volatility is indicative of a fragile market balance. We discuss both issues below and note how they fit into our medium term outlook for oil markets.*

Doha deal breakdown

On April 17th, OPEC (Organisation of the Petroleum Exporting Countries) and several major non-OPEC countries failed to reach a deal to cap oil production during a meeting in the Qatari capital of Doha. The deal had been mooted since the middle of February and represented an attempt to mitigate the impact of oversupply, which has been prevalent over recent years. At the last minute, refusal from Saudi Arabia to agree to a supply limit without similar concessions from neighbouring Iran put a stop to attempts to limit supply from producers such as Russia, UAE, Venezuela, Kuwait and Libya. Iran refused to commit to a deal, instead intending to boost output after years of sanctions. Whilst some market commentators had believed the deal was imminent, we had remained sceptical given the competing interests and complex political relationships between the nations involved. Capping production was also unlikely to rebalance the market in the near-term.

Canadian wildfires

Large wildfires in Alberta, Canada are threatening production in this region, although they appear to be moving away from production. The region produces approximately 2.4mbb/d, of which about a fifth has been disrupted. Short-term impacts can move spot prices significantly. However, of more interest for our medium term outlook is the potential for a large disruption over multiple years. Here significant damage from fires could lead to companies reassessing their investment in the region. Oil sands projects tend to be at the higher end of the cost of production. Whilst the large levels of sunk costs and time to get projects online have not currently led corporates to reconsider their investment, significant destruction of capital could lead to this decision being reconsidered. Given the significant size of production in the region this could potentially go someway to speeding market rebalancing. We will continue to watch developments in this region.

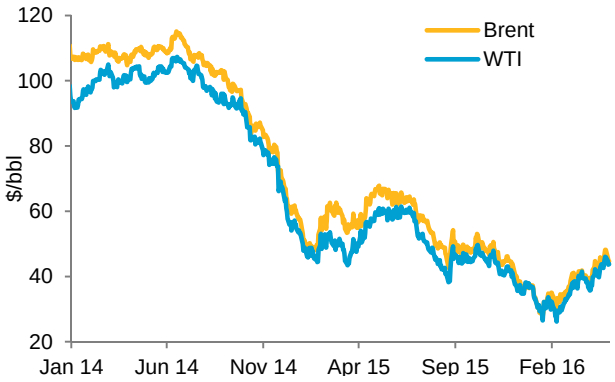
Current market conditions

Despite the situation, current oil market fundamentals remain weak, with supply continuing to outstrip demand globally. A persistent global oil supply glut is beginning to force rebalancing, but these moves are nascent. In the US, two further companies Energy XXI and Goodrich Petroleum filed for bankruptcy. Oil production has been falling in the US since the middle of last year *(Fig. 26)*. A reduction in US supply is beginning to impact market balance in light of continued reasonable demand growth.

Retaining our views

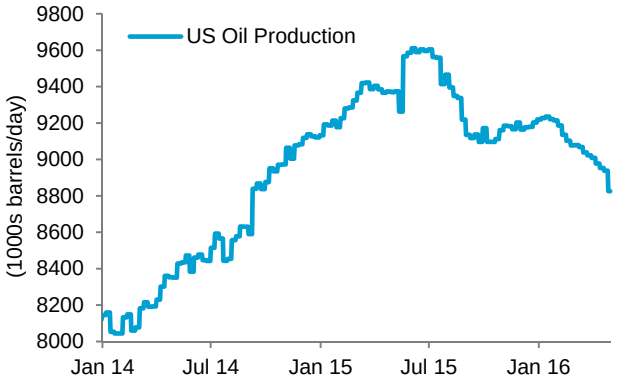
Looking forward, our view is still for oversupplied conditions to remain in late 2016 or early 2017. Low prices are required to force this rebalancing, absent disruptions discussed above. At this point oil prices are likely to find a more sustainable equilibrium level of $50-60 per barrel.

Fig. 25 Price of Oil



Source: Bloomberg LP

Fig. 26 US Oil Production



Source: Bloomberg LP

Commodities

Chinese commodities market open to external investors

Iron ore futures contracts are not currently included in commodity indices due to the immaturity of standardised markets. However, the price of the metal remains important for many global manufacturing and construction processes. The price of the metal is therefore indirectly key to a large number of asset prices.

A rebound in iron ore prices

Spot iron ore prices (as measured by Chinese domestic consumption prices) have rebounded significantly since the beginning of the year *(Fig. 27)*. Markets bottomed out at levels close to 40$/tonne and are now trading at close to 60$/tonne. Price movements appear to have been driven by Chinese fiscal and monetary expansion, which is supporting fixed asset investment and property markets in the near term. We do not believe that these moves represent a rebalancing of markets, as the significant oversupplied conditions remain largely intact. Indeed recent price increases, if they remain in place, are likely to exacerbate this imbalance as prices are now above the four major iron ore producers cost of production. We therefore retain our cautious outlook for spot prices over the medium term.

Development of Chinese futures markets

During April, Chinese policymakers moved to open its DaLian Commodities iron ore and steel futures contracts to external investment. This represents the latest step in policymakers drive to improve investor access to Chinese asset markets and ultimately open the capital account. This recent step can be thought of as akin to similar steps that are currently taking place in bond and equity markets, where Chinese assets are moving towards being included in international benchmarks as international investment limits are eased.

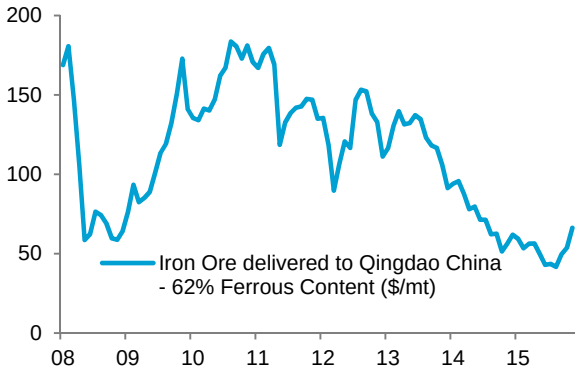
In the short-term the easing of investment rules has led to a large spike in volumes and an increase in speculative interest in both iron ore and steel contracts. This has potentially had a significant impact in driving prices higher in recent weeks.

Towards medium term balance?

As we stated earlier, we continue to believe that a sustainable balance has not yet been reached in iron ore markets. We currently view the increase in Chinese demand as temporary in nature and expect near term strength to make way for a more normal downward trend as economic rebalancing continues *(Fig. 28)*. With this outlook in mind, further supply-side reform is needed, likely in the form of high cost Chinese producers reducing output (with perhaps some modest assistance from developed majors).

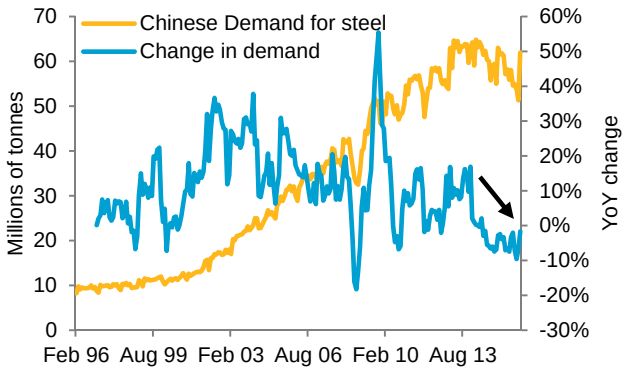
To this end we view the increased openness of Chinese futures contracts as a positive step along this road. A deep, liquid futures curve with international investment will allow producers to hedge forward production at a rate that reflects the supply and demand viewpoints of a diversified set of participants-allowing markets to drive supply to a greater extent than is currently the case.

Fig. 27 Iron ore price



Source: Bloomberg LP

Fig. 28 Chinese steel demand



Source: Bloomberg LP, Willis Towers Watson

Disclaimer and ratings explanation

Explanation of ratings

We provide ratings on the following scale:

- *Highly overweight:* expected returns and/or the balance of risks are strongly favourable considering market valuations and fundamentals. We suggest investors adopt an overweight position at full risk, relative to longer-term strategic allocations.
- *Moderately overweight:* expected returns and/or the balance of risks are favourable considering market valuations and fundamentals. We suggest investors adopt an overweight position at moderate risk, relative to longer-term strategic allocations.
- *Neutral:* expected returns and/or the balance of risks are around normal levels, considering market valuations and fundamentals. We suggest investors adopt a neutral position relative to longer-term strategic allocations.
- *Moderately underweight:* expected returns are weak and/or the balance of risks unfavourable considering market valuations and fundamentals. We suggest investors adopt an underweight position at moderate risk, relative to longer-term strategic allocations.
- *Highly underweight:* expected returns are very weak and/or the balance of risks highly unfavourable considering market valuations and fundamentals. We suggest investors adopt an underweight position at full risk, relative to longer-term strategic allocations.

These ratings are provided over a three to five year horizon. The three to five year ratings are expected to be relevant to dynamic investors with a more medium-term horizon, that require greater lead times to execute decisions and/or are mostly interested in significant misvaluation opportunities.

Within each of the ratings/time horizons, the intention is that if we are overweight an asset, we must be underweight something else in order to provide an indication of where we would fund a position from, or deploy capital to.

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