Outlook on Global Bonds and Global Equities

Towers Watson Research Article

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

If you have any questions please come back to one of the undersigned persons below.

Global Government Bonds

Intermediate bonds offer attractive downside protection and some selective value

Developed world sovereign bonds have rallied significantly over the course of this month. Since their peak values in September, US and UK 10-year nominal bonds yields have fallen by around 35bps, while German 10-year bond yields have fallen by around 20bps. Most of the moves were driven by falling real yields as breakeven inflation rates remained more or less stable.

Stepping back from the recent gyrations in markets, we continue to hold the view that central banks will move towards a reduction in their extraordinary monetary policy measures over the coming years. In the US, we expect asset purchases to end soon and the Federal Reserve will move to raise rates towards the middle or end of 2015. In the UK we expect rate rises to broadly mirror the US. In the Euro area, we expect a significantly slower exit, due to the need for further easing to support ailing economic growth outside of Germany.

Current bond yields are now pricing expectations which are similar to our outlook. Overnight interest rate swaps (one measure of market cash rate expectations) appear to be discounting rate rises from 2015 onwards in the UK and US and later in Europe. At medium maturities US and UK markets appear to be pricing a rough normalisation in cash rates, adjusted for underlying debt conditions, over around seven years – a position which seems reasonable.

In addition to these cash rate expectations, investors appear to be rewarded with a moderate but positive bonds risk premium in the US and UK at intermediate maturities, although the size of these premia differ significantly by maturity and country.

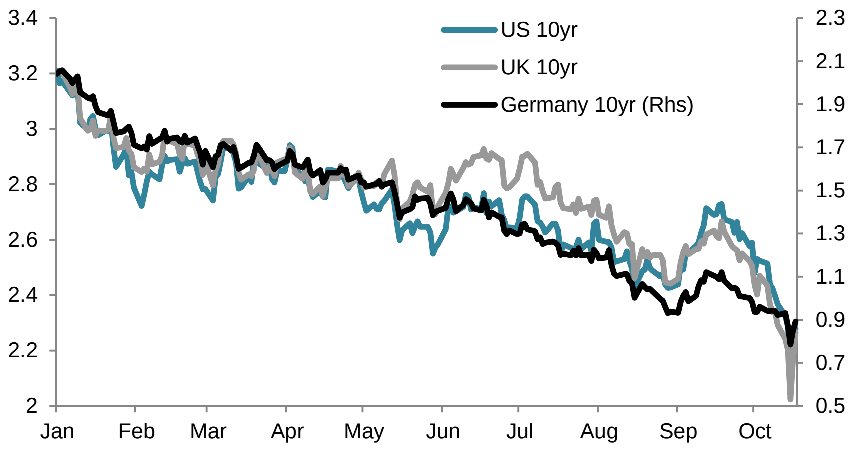


Figure 1. Developed market sovereign 10-year bond yields (%).

Our base case outlook is conditional on a slow pace of interest rate normalisation across the developed world. To a degree this is now reflected in current intermediate bond yields, which now price-in average cash rates that are close to our outlook over the medium term.

While the *average* cash rate path discounted in US and UK five-year bond yields is appropriate in our view, recent price action in short-dated rates has pushed the priced-in path for central bank rates over the next two years to levels that are slightly too low. In summary, this means that US and UK intermediate bonds remain reasonable value over the medium term but short-term performance risks are now higher, i.e. intermediate bonds are still broadly fair value but a bit more expensive than they were a few weeks ago. This said, we continue to assign a moderately unattractive rating to global sovereign bonds in aggregate due to the unattractive pricing of European and Japanese bonds.

At the long-end of developed market yield curves, market expectations and risk premia look on the low side of plausibility.

Therefore, under our base case, the expected return from intermediate bonds is low but reasonable relative to very low-yielding cash. Importantly, bonds provide attractive returns in scenarios where growth or inflation disappoint expectations on the downside, which we consider more likely than upside surprises. As a consequence, whilst bonds provide low expected returns under our base case, they are still above cash and offer attractive downside protection.

The main risk to our outlook comes in the form of an unexpected and sustained rise in inflation in each of these markets. Whilst both the Federal Reserve and Bank of England have stressed their current emphasis on sustaining economic growth, a period of above target inflation may mean that their current policy-mix becomes unpalatable.

This risk appears low at the current time – core personal consumption expenditure inflation (the Federal Reserve's preferred inflation metric) remains below target (2%) and medium-term inflation expectations remain well anchored. This picture is consistent across developed markets, with deflationary pressures still prevalent in Europe.

Global Equities

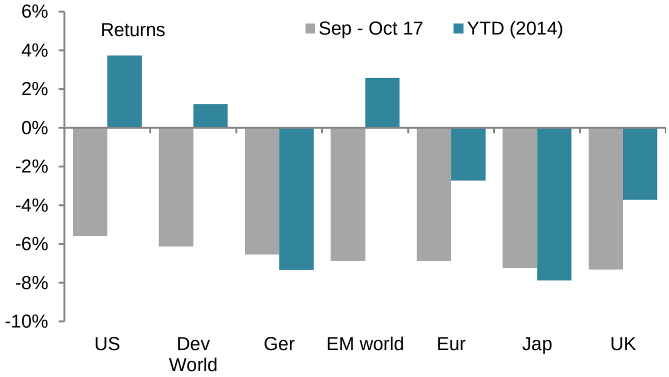
Developed market equities slightly cheaper but still broadly *neutrally* valued.

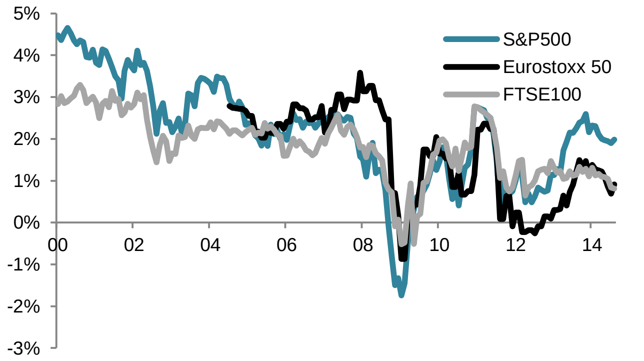
***The article was written prior to the strong late month market rally**

Both developed market and emerging market equities were heavily sold in recent weeks, more than offsetting the positive year to date returns in the case of Europe and Japan. Increased uncertainty has been reflected in volatility markets with implied and realised levels rising meaningfully.

Emerging market equities have rebounded from the poor returns experienced at the start of the year. Movements towards structural reform in certain countries along with cheaper valuations appear to have encouraged a modest reallocation to emerging markets. Looking forward, we believe emerging markets appear moderately attractive over the medium term. Markets are currently discounting a pessimistic level of earnings growth relative to our view. Under this scenario, a rise in cyclically low profit margins and the potential for re-rating support our return expectations.

Over the long term, developed equity returns are generated from earnings prospects and any starting mis-valuation as a result of over or under-discounting of those prospects. The continued expansion of the business cycle and relatively muted wage growth pressures should provide support to revenue growth and maintain profit margins for the next two years. Our expectation for only a gradual normalisation of risk-free rates is also supportive of equities, as the rate at which those earnings are discounted rises more slowly than under a faster normalisation.





Sources: Thomson, Towers Watson

Sources: Bloomberg LP, Factset, Federal Reserve, Bank of England, Bundesbank

***Left*: Figure 2. Selected local currency equity return.**

***Right*: Figure 3. Long-term discounted real earnings growth across various developed markets.**

However, this forecasted set of conditions is generally already priced into equity markets, despite their recent falls. In the US we expect profit margins to moderately decline over the medium term given their current elevated starting point. Given we see greater downside risks to growth and inflation around our base case over the medium term, the distribution of five-year equity returns around our central outlook is also more tilted to the downside.

It is important to emphasise that we still have a positive outlook for US and broader developed market earnings for the next two years at least. However, as equity prices have risen, investor expectations for future earnings priced-in to equity markets have moved closer to our economic forecasts – i.e. where at the start of 2013 the market was discounting a more pessimistic outlook than our base case (i.e. equities were somewhat expensive), market expectations are now broadly in line with our own and hence equity prices are close to fair value. This means that our forecasts for equity returns over the next two years and medium term are now significantly lower than was the case 12-18 months ago. The recent price falls moderately improve this assessment of low expected returns over the medium-term but only at the margin.

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