

Global Markets Monthly

Asset Research Team, March 2016

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In this issue

Feature article: Cyclical economic outlook

In February, we published our *Five-Year Outlook*. Our *Five-Year Outlook* attempts to describe the plausible distribution of outcomes that investors face over the coming five years. Our Global Markets Monthly, in comparison, focuses on a three-year cyclical horizon. In February, the Feature Article set out our three-year view on capital markets. In this month's Feature Article, we elaborate with a tour of our cyclical views on the major economies, the risks, and what the views imply for capital markets and investors.

Government bonds

Negative interest rate policies have been implemented by several central banks recently. We argue that these are likely to be less effective in practice than in theory but note that the advent of such policies means that bond returns in a downside scenario could be strong despite low starting yields.

Credit markets

In this month's article, we review our outlook for US RMBS. We currently hold a neutral outlook for agency and non-agency RMBS, reflective of our outlook for: moderating US house price appreciation over the medium term; fundamentals which remain benign but have not improved materially; and pricing which, in our view, fairly reflects these fundamentals.

Emerging market debt

The cyclical outlook for Latin America remains weak and economic imbalances still persist. In this month's article we discuss whether these conditions and associated risks are adequately discounted in hard and local currency debt markets.

Global Equities

We focus on the banking industry which makes up the majority of the financials sector in most markets, discussing the major determinants of bank profit margins.

Foreign exchange

Since the last communication, sterling has depreciated further against the dollar (and other trading partners) breaching 1.40 before recovering somewhat in early March. In this month's article, we provide further details on our outlook, updating for the latest data points.

Commodities

This month we review metals market performance and specifically discuss supply-demand dynamics in Copper and Aluminium as they are the largest components of the S&P GSCI and DJ UBS metals sub-index. Slowing Chinese and EM growth has been the key overarching driver of demand over the past two years. However, the position of a metal in its commodity cycle and other idiosyncratic factors also play a crucial role in determining price action. We discuss all of these in our article.

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

Asset class ratings

March 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		
<i>Investment grade</i>	US (all maturities)	Moderately underweight
	US (long credit)	Moderately underweight
	Euroland	Moderately underweight
	UK	Moderately underweight
<i>High yield</i>	US	Neutral
	Euroland	Moderately underweight
<i>Leveraged loans</i>	US	Neutral
<i>Emerging markets</i>	External currency	Moderately underweight
<i>Securitised markets</i>	Non-Agency RMBS	Neutral
	Agency RMBS	Neutral
Sovereign bonds		
	Maturity	
<i>Nominal</i>	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
<i>Inflation-linked</i>	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
<i>Emerging markets</i>	Local currency	Moderately underweight

Source: Willis Towers Watson

Global Markets Monthly
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Asset class ratings

March 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
Cash		
	Developed world cash	Moderately overweight
Property		
	Commercial real estate	Neutral

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

March 2016

Interest rates

- Despite medium-term declines in yields, we believe downside economic risks have increased - we have lowered 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 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.
- 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 have widened significantly and now appear to offer reasonable risk premia, particularly when compared to other risky assets. The sharp moves wider, to a large degree, reflect a necessary reappraisal of required risk premia by market participants. We retain our *Moderately underweight* position on global IG 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.
- The concerns laid out above continue to be prevalent in high yield markets. However, we observe that starting spreads in US HY markets are now at levels which provide investors with sufficient compensation for undertaking these risks even in environment where downside risks have increased. As a result, we have upgraded our outlook on global HY markets to *Neutral*.

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 have negative exposure to weaker EM growth prospects, tightening US liquidity, and lower oil prices. These factors are expected to continue to affect EMs and especially those countries heavily reliant on foreign capital and those that are 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 - 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 29 February 2016

Interest rates

10yr yields, % pa	Latest	3 months prior	12 months prior
US nominal	1.84	2.31	2.10
UK nominal	1.41	1.87	1.86
German nominal	0.11	0.49	0.33
Aus nominal	2.30	2.76	2.41
US Real	0.44	0.71	0.24
UK Real	-1.03	-0.87	-0.89
German Real	-0.65	-0.95	-0.88

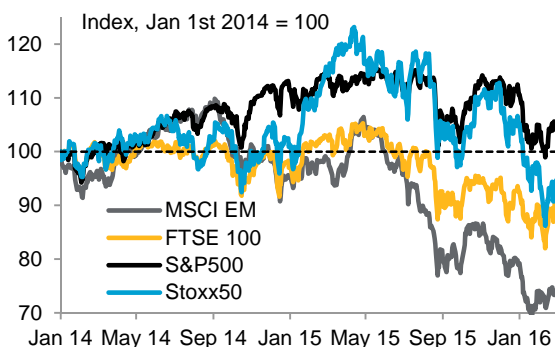
Source: Bank of England, Deutsche Bundesbank, Federal Reserve, European Central Bank, Reserve Bank of Australia, Barclays

Credit markets

Option-adjusted spread, bps	Latest	3 months prior	12 months prior
US IG Corp	205	163	132
EU IG Corp	156	129	90
US HY	775	638	446
EU HY	608	485	375
CDX NA IG	108	84	61
ITRAXX IG	100	70	50

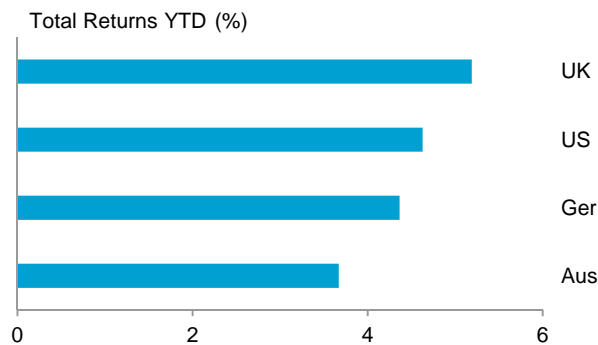
Source: Bloomberg LP, Willis Towers Watson

Global equity price action



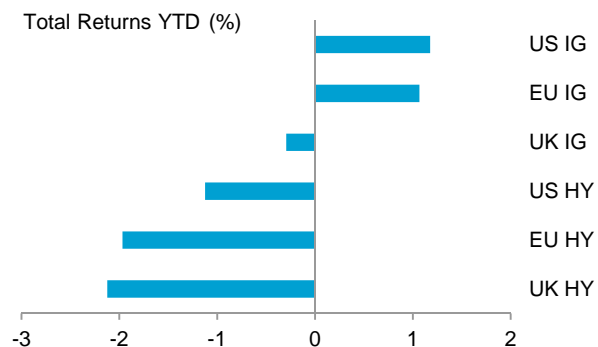
Source: Bloomberg LP

7-10 year nominal bond return



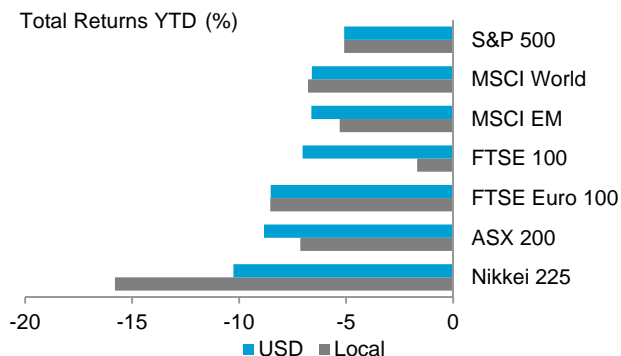
Source: Bloomberg LP

Credit market returns



Source: Bloomberg LP

Global equity returns



Source: Thomson, Willis Towers Watson

Cyclical Economic Outlook

Our three-year economic views

In February, we published our *Five-Year Outlook*. Our *Five-Year Outlook* attempts to describe the plausible distribution of outcomes that investors face over the coming five years. Our *Global Markets Monthly*, in comparison, focuses on a three-year horizon. In February, the Feature Article set out our three-year view on capital markets. In this month's Feature Article, we elaborate with a tour of our cyclical views on the major economies, the risks, and what the views imply for capital markets and investors.

Our mental model of the world

Readers will be familiar with the mental model of the world that we developed in the *2015 Secular Outlook* and have persisted with in the *2016 Five Year Outlook*. This simple framework characterises three plausible scenarios, demonstrated in *Fig. 01*.

We use a consistent framework for thinking about our outlook over a three year horizon. The key features of the framework are similar, so we will not repeat them in full and rather point the reader to the *2016 Five Year Outlook* that discusses them in some detail. Suffice to say, in 2016, we continue to see a central case of moderate growth with risks skewed to the downside. These risks detailed in *Fig. 01* taken in isolation and combination mean downside risks are elevated and growing.

Linking our Five Year Outlook to our cyclical view

Fig. 02 shows how our Five Year Outlook links to our cyclical views. This plots the position of each country on a business cycle "clock", which summarises the capacity utilisation, growth and policy environment for a particular country. This inevitably over-simplifies what is a complex assessment, e.g., movement on the clock may not always be clockwise, while policy conditions and growth do not

always correspond to the conditions on the clock face. Nevertheless, we think it is a helpful summary for the major economies. On the following pages, we will discuss the cyclical outlook for the major countries in more detail.

US – a late expansionary phase, growing risks

The US is experiencing a late expansionary phase of the business cycle (*Fig. 02*). Growth has been robust and we think under our most likely scenario, can sustainably remain around or just below potential. Household demand is supported and credit channels are open. Capital allocation processes work, i.e., distribute funds and allocate risk, while risk is more or less in the right hands.

Recent growth was driven by household demand on the expenditure side and service sector output on the production side (*Fig. 03*). However, manufacturing output has been declining as measured by changes in industrial production. We believe this reflects a growing drag on US demand from weaker global growth conditions. This has also manifested in weaker US investment growth.

Lower oil prices have stimulated the household sector but weakened the industrial sector. This effect has – roughly – offset each other. We are concerned that a continued period of low prices will shift this effect to a net negative. Our outlook for lower oil prices implies that distressed corporates will finally capitulate to the lower for longer oil environment through defaults, cuts in capex and wage and employment cuts.

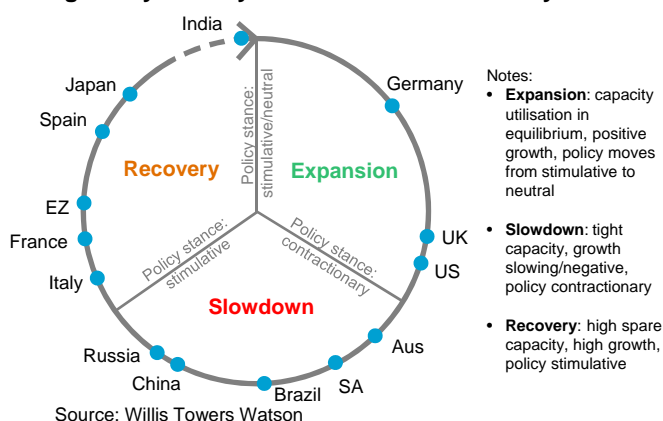
Growth drags from weak external demand, contracting manufacturing output and oil-related stress are all concurrent with tightening US financial conditions via a stronger US dollar, recent declines in equity markets and

Fig. 01 A simplifying framework for our outlook

Scenario	Description	Prob
Downside risks	Risks are skewed to the downside and include China, low oil prices, emerging markets, US\$ liquidity and geopolitics	40%
Debt overhang	Low but acceptable rates of growth and low interest rates sustainably persist for the three year horizon and beyond	50%
Upside: a better world	Productivity or demand less weighed down by persistent debt overhang than we assumed	10%

Source: Willis Towers Watson

Fig. 02 Cyclical dynamics on the business cycle "clock"



Cyclical Economic Outlook

Moderate growth but downside risks

increases in corporate bond spreads. Our concern is these factors could combine to weaken growth in the US.

To be clear there are offsetting positives – employment growth is solid, wage growth is increasing and house price fundamentals remain robust. We simply want to reiterate that our previous expectation for US growth to be at or above potential on a cyclical horizon, has modestly shifted to be at or slightly below potential.

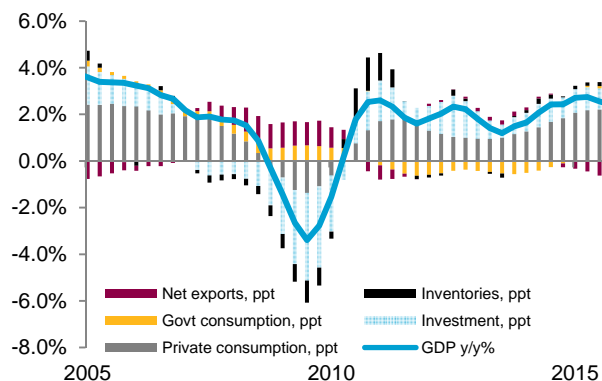
Euroland – recovering with financial risks

Recent growth in Europe has been around or above potential, supported by the boost to incomes from lower oil prices, monetary stimulus from the European Central Bank (ECB), and the improved competitiveness position brought about by the lower euro (*Fig. 04*)

Fig. 02 shows that the major economies within Europe are dispersed around the business cycle clock. Germany is in the earlier phase of an expansionary cycle, supported by record high employment and rising real wages. We expect this and support from government spending to offset a potential drag from slower external demand.

Outside of Germany, highly accommodative monetary policy is necessary to support a continued recovery. Persistent and significant slack in economies is disinflationary. Additionally, there are risks related to European financial institutions. There has been a push to regulate banks to hold more capital against the sovereign debt that has been accumulated with cheap funding from the ECB. This could offset the impact of more accommodative policy somewhat. NPLs are also likely to be a persistent drag as small to medium enterprises struggle to make repayments. This is particularly true for Italian banks where NPLs are large, the policy environment is volatile and average foreclosure

Fig. 03 GDP growth has slowed recently in the US



Source: Thomson, Willis Towers Watson

proceedings take multiple years.

UK – Brexit risks a key uncertainty

Despite strong trade and capital linkages to slowing European and emerging economies, the UK continues to grow at close to potential. Along with these external drags, contractionary fiscal policy continues to weigh on growth, which has been supported by household consumption and service sector output. Expectations of monetary policy tightening have been pushed back towards 2017. In our central outlook we expect the Bank of England to raise rates slowly, so as not to derail the growth picture.

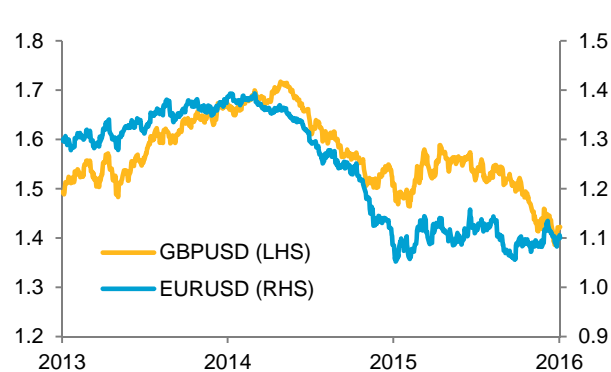
On a forward looking basis, the key risk to our central scenario is provided by uncertainty around the UK's EU referendum and the potential for capital flow disruptions.

Asia Pacific

The business cycle clock shows **China** has progressed somewhat into the slowdown phase of the cycle. In fact, we think China is at the start of a major credit loss cycle. Debts have grown very rapidly, a bad debt problem has been created and losses must be realised. China's longer-term policy difficulties are detailed in the Five Year Outlook. In the near term, China will need to balance the need for more accommodative monetary policy settings against the need to slow credit growth. We expect further interest rate cuts and other stimulative monetary policy measures may be announced. However, but this may only delay credit losses for a short period and will not reduce the downside risks materially.

Japan's economic outlook continues to be supported by accommodative monetary policy (including negative interest rates) and a competitiveness boost from a weaker yen, although this has waned in recent months.

Fig. 04 Weaker euro and sterling vs the USD



Source: Factset, Willis Towers Watson

Cyclical Economic Outlook

Expected asset returns are low relative to history

Supply side reform continues. Labour market reforms have improved female participation and governance reforms are helping corporate efficiency. However, we are still concerned about demand growth. The government is still committed to a consumption tax hike in 2017, despite a chronic excess savings problem both at household and corporate level which is depressing spending. We think a low-growth recovery is sustainable but think the 2% inflation target is unlikely to be met over a three-year horizon (Fig. 05).

Australia's economy has been supported by rebounding government spending. However, household consumption is soft and historically slow wage growth is likely to prove a cyclical drag. Weak commodity prices will likely depress investment growth and incomes, which could be a risk to households' ability to service growing mortgage debt. Currency weakness helped to offset commodity price falls and support net exports, but further support will be limited as the currency is now closer to fair value. We expect economic rebalancing away from mining investment and low commodity prices to continue to be a risk to our central outlook, with the possibility that the RBA needs to cut rates further.

Emerging markets

The emerging market outlook illustrates the divergence theme. 'Weak' countries are suffering from some combination of commodity price sensitivity, overcapacity, disinflation, weak growth and wide current account deficits. Many are in a slowdown phase and prospects are poor over the three year outlook. This includes countries such as Brazil, South Africa and Turkey. Emerging Asian economies, predominantly oil importers,

have been supported by generally improved external balances, accommodative monetary policy and more competitive currencies. However, credit growth has been rapid and balance sheets look stretched, which is likely to drag on cyclical growth outcomes. Clear risks also exist from slower Chinese growth and from tighter USD liquidity.

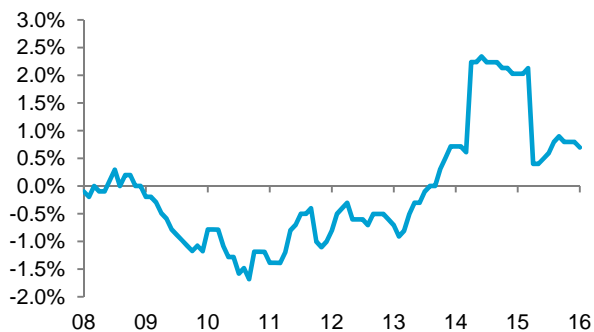
Implications for asset markets

Our central cyclical view posits mediocre but sustainable growth over a three-year horizon as the most likely outcome. Risks are skewed to the downside, although judging the timing of potential downside risks is difficult. While our specific outlook varies by region, in general, we think if downside risks do occur, they are likely to occur at some time during the next three years.

This still leaves us expecting low returns on average because of the combination of low expected cash yields and average at best risk premia. We also emphasise that the prospect for low average returns hides the risk of significant drawdowns at some stage.

As a result, we did not think falls in risky asset markets in early 2016 were an attractive opportunity for investors to add significant amounts of growth-linked asset risk over the medium term. Nor do we now, following a short term market rebound. We believe prospective cyclical returns on offer from risky assets do not fully compensate investors for the cyclical risks. Similarly, we do not believe bond yields are poor value, despite their low levels. To that end, we continue to think there is still time to reduce risk or diversify concentrated macro exposures over a medium-term horizon.

Fig. 05 Japanese core inflation remains stubbornly low



Source: Thomson

Fig. 06 3-year expected returns are low relative to history

Asset Class	3-year return range (Feb 2016)	Plausible move in downside
US Cash	0.6% - 1.1%	-
US 10-yr Treasury	1.2% - 2.1%	+10%
US Investment grade credit	1.7% - 2.9%	-10%
Global equities	1.8% - 3.8%	-22%

Source: Willis Towers Watson

Government bonds

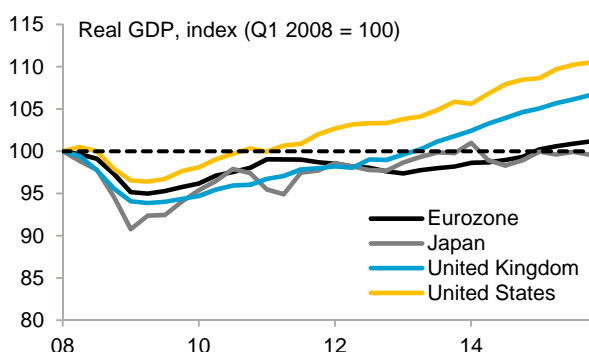
Effects of negative interest rates not all positive

Since the Global Financial Crisis, developed economies have endured a sluggish recovery, especially in Japan and the Eurozone (Fig. 07). In addition to cyclical factors, longer-term forces have depressed growth and inflation rates: waning demographic tailwinds; high debt levels and deleveraging pressures; and ongoing globalisation. It is with this backdrop that policymakers have the difficult task of stimulating aggregate demand. Relative to the scale of stimulation, results have been underwhelming. In addition, central banks are running out of tools to boost their respective economies, rates are at historic lows and the size of central bank balance sheets have ballooned (Fig. 08). Negative interest rate policies (NIRPs) are an unconventional tool that have been experimented with in a number of economies more recently (Fig. 09).

Negative rates a further form of monetary easing

Negative rates have been implemented for one or both of the following reasons: (i) to further ease monetary policy to stimulate spending, investment and economic activity; and (ii) to reduce capital inflows to prevent undesired currency strength, as was the case in Switzerland and Denmark. The ultimate aim in both instances is to lift inflation to target and growth to potential. The rationale behind the implementation of negative rates is that by charging commercial banks to hold deposits at the central bank, they will be incentivised to lower the rates they offer depositors or reduce excess reserves held at the central bank. If part or all of the rate cuts are passed on to savers, consumers may be incentivised to spend more because with a negative deposit rate they are being penalised for holding cash at a bank.

Fig. 07 Weak recoveries in Japan and Europe



Source: Willis Towers Watson, Thomson

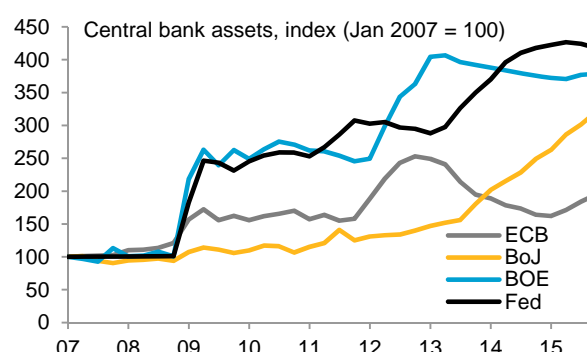
Impact of negative rates uncertain

Since the introduction of negative rates in Europe, growth and inflation rates have disappointed. Importantly, this reflects wider effects such as lower oil and related investment declines. However, it may also suggest that either negative interest rates are not as effective in practice as in theory, or have not yet been implemented for a sufficiently long time for full effect to be felt. We expect that it is a combination of the two.

We believe there are difficulties related to NIRPs that limit their effectiveness. Firstly, banks seem unwilling to pass negative rates to consumers, obscuring the transmission channel through which negative rates impact the real economy. By not passing these rates on, banks harm their own profitability and increase the risk of financial instability, especially if lower rates lead to risky lending. Alternatively, banks may actually increase lending rates in order to offset this loss in profitability, exactly the opposite of the desired effect.

Moreover, one of the intended effects of negative rates is to facilitate currency depreciation in order to boost competitiveness and inflation (via higher import prices). However, it is the interest rate differential between two economies that drives FX pressures. Therefore, if both economies cut rates into negative territory, there is no net change and the anticipated effect on the exchange rate is unclear. Finally, lower rates have benefited financial asset owners at the expense of depositors. As wealthy financial asset owners have a lower marginal propensity to consume, aggregate demand and spending has not meaningfully improved.

Fig. 08 Central bank balance sheets have ballooned



Source: Willis Towers Watson, Thomson

Government bonds

Effects of negative interest rates not all positive

Rates can go lower from here

Given these concerns, we believe that in order for NIRPs to be successful in boosting economic activity in the long term, they need to be backed by fiscal stimulus and structural reforms. However, in the Eurozone we view this scenario as unlikely because of political resistance to fiscal expansion and the misalignment of political and economic interests within the region. We also believe that this scenario is unlikely in Japan, where the focus is on fiscal consolidation over the long term. As a result, we believe that rates in Japan and Europe could remain negative and may even be pushed lower, especially in a downside scenario. But how negative can rates go?

The true lower bound is arguably considerably lower than the current levels of -10 to -30 bps in Japan and Europe. There are explicit and implicit costs to physically storing cash, including insurance against theft and fire, the physical storage system, transport and the inconvenience of transacting in cash, especially given the volume of transactions now made online. Furthermore, a tiered rate system, where banks are charged different amounts depending on the extent of their excess reserves, implies that the overall charge as a proportion of total assets will be lower and more manageable than the headline negative number may suggest. This means that banks can tolerate more negative rates before having to pass this cost on to savers.

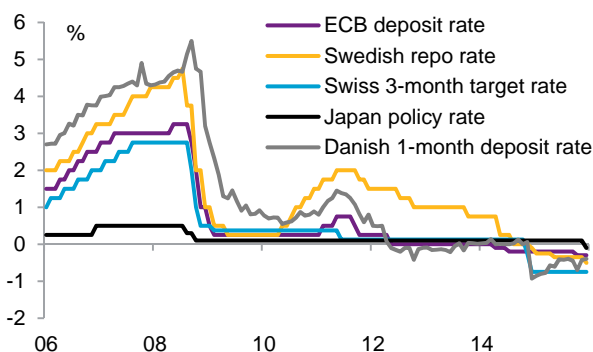
Bond returns strong in a downside, even at current yields

NIRPs suggest rethinking what constitutes 'low' yields in affected economies. Bond yields reflect expected cash

rates plus a risk premium over the term of the bond – if the former is expected to be sufficiently negative, the bond yield may also be negative. Ten-year yields have fallen sharply since negative rates were introduced, especially in Europe (Fig. 10). The upshot of this analysis is that the distribution of future yield changes is less asymmetric than seen at first glance and, in a downside scenario, yields could fall even lower. A sharp fall in yields would lead to strong bond returns from capital appreciation as a bond's price is inversely related to its yield. Furthermore, while not our central outlook, there is clearly the possibility that negative rates could be implemented in the US and UK, or at least investors could discount this possibility in the future. Therefore, yield declines could be marked in these markets where starting yields are much higher, if economic conditions worsen significantly.

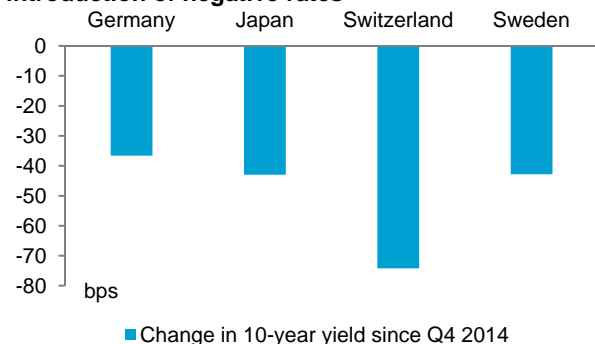
In conclusion, NIRPs have been introduced in Europe and Japan as another unconventional monetary policy tool to stimulate aggregate demand. However the efficacy of such policies is uncertain and likely lower in practice than in theory. Furthermore, these economies face structural headwinds to growth and inflation. Consequently, we expect rates to remain at similar (negative) levels in these regions for an extended period. Moreover, in a downside scenario cash rates and longer-dated yields could fall materially further, meaning that government bonds would act as a good downside hedge, even at current yields. This is particularly pertinent given the weight we assign to a downside scenario (40%) in our *Five-Year Outlook*.

Fig. 09 Negative rates experimented with in Europe



Source: Thomson

Fig. 10 Yield falls have been significant since introduction of negative rates



Source: Willis Towers Watson, Bloomberg LP

Credit Markets

US RMBS: refreshing our outlook

A cautiously neutral outlook for RMBS

Our recently published *Five-Year Outlook* is dominated by two scenarios: a *debt overhang and growth moderation* scenario; and a *medium term downside risk* scenario. The outcome for RMBS is potentially quite different under these two potential outcomes.

Under the *debt overhang* scenario, RMBS are potentially better placed than other credit assets in our view. As the debt burden for US households moderates, continued improvements in foreclosure levels, loss severities and supply and demand characteristics will support a moderate level of returns in our view.

Under our *downside risk* scenario, RMBS are likely to suffer mark-to-market losses, as default risks rise and asset prices suffer. However, stricter underwriting standards and increased regulation relating to US mortgage lending in recent times may well insulate assets against the very significant default losses seen during the financial crisis. This stands in contrast to riskier lending practices which have become prevalent in other parts of the corporate credit universe.

We currently hold a *neutral* outlook for agency and non-agency RMBS, reflective of our outlook of: moderating US house price appreciation (“HPA”) over the medium term; fundamentals which remain benign but have not improved materially; and pricing which, in our view, fairly reflects these fundamentals. Overall, we expect returns from RMBS to be modest at best going forwards, justifying a neutral outlook over the medium term. However, we do apply a level of caution around our current outlook. In recent times, spreads in US corporate credit markets have

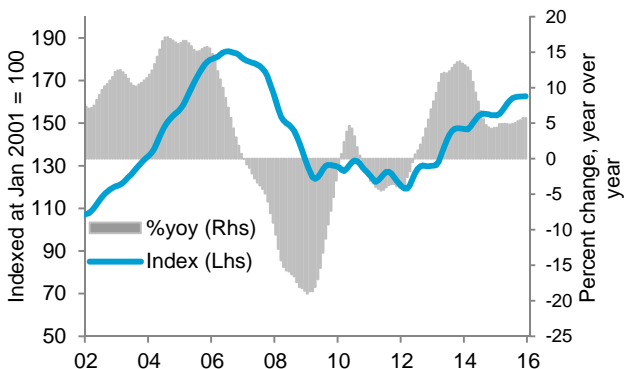
widened materially. Spread widening has to an extent been reflective of a downward reappraisal of global growth dynamics by market participants. We remain concerned that RMBS markets may be negatively impacted by wider market sell offs. Moreover, as natural supply and demand dynamics (in legacy liquid non-agency assets in particular) point to a shrinking opportunity set, we consider that investors can access greater alpha opportunities in other more niche areas of the securitised credit universe. Our coverage of securitised credit assets is likely to reflect this transitioning opportunity set going forwards.

We expect US HPA to remain at moderate levels going forward

Following a period of rapid appreciation between 2012 and 2013, HPA has cooled over the last two years towards mid-single digit levels and was ~5.7% y.o.y. in 2015 (*Fig. 11*). That HPA has slowed to more normal levels is not surprising. Affordability measures still appear stretched for US households as nominal income growth rates have lagged house price appreciation materially over the past two decades. Moreover, tighter lending conditions since the financial crisis of 2008 have shown little sign of abating and have only started to ease modestly in recent times.

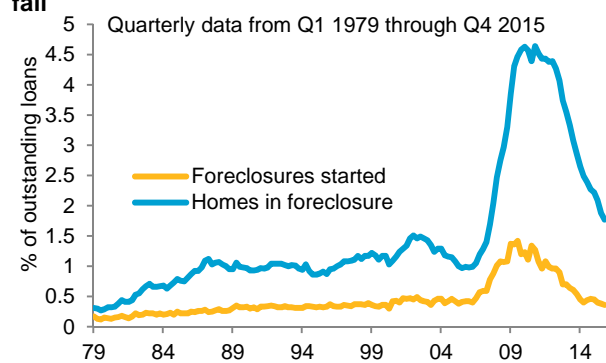
However, a number of positive drivers of HPA also remain. Construction activity is anaemic and has lagged desired household formation rates for many years. Moreover, levels of US homes in foreclosure and new foreclosures continue to fall (*Fig. 12*). In our view, a combination of declining ‘shadow’ inventory and lack of new housing additions will aid a continued recovery in house prices. We expect US HPA to remain at mid single digit levels over the medium term.

Fig. 11 Case-Schiller House price index



Source: Thomson, Willis Towers Watson

Fig. 12 Home foreclosure levels in the US continue to fall



Source: Thomson, Willis Towers Watson

Credit Markets

US RMBS: refreshing our outlook

Agency RMBS: low pre-payment premiums

Option adjusted spreads on agency MBS assets remain at relatively tight levels relative to history (Fig. 13). A number of factors are driving current spread levels and our expectations for returns.

Prepayment speeds have remained relatively slow, due to tighter lending standards. The decline in refinance responsiveness since the financial crisis of 2008 has substantially changed the relationship between interest rates and MBS prices, effectively removing the cap on agency bond prices. In the pre-crisis period, when refinance rates were high, prices on MBS seldom traded above \$106 when rates fell, since borrowers could easily pay back their mortgage at par and trade into a new, lower-rate mortgage. By comparison, during 2013-2015, certain higher quality MBS traded above \$112, as in-the-money borrowers persistently failed to refinance. It is reasonable to expect tight lending standards to persist at least over the medium term, keeping prepay speeds suppressed.

Secondly, US interest rate volatility followed a downward trend between 2012 and 2015. This reduced the cost of the refinance option embedded in US mortgages and placed downward pressure on spreads. In recent quarters interest rate volatility has increased as bond markets have reappraised future interest rate and inflation uncertainty. If this dynamic continues, as is possible under our base case, this would serve to raise the cost of this refinance option, putting pressure on spreads to widen from current levels.

Thirdly, the relative scarcity of mortgage bonds has helped

to keep mortgage spreads tight. Federal Reserve holdings represent a strong technical support for agency assets (the Fed currently own around 30% of the amount outstanding). Given the profile of the Fed's holdings (large proportion of lower-coupon mortgages, 30-year fixed rate loans and Fannie Mae securities) and the positive externalities associated with maintaining stability within this market, MBS assets are likely to remain on the Fed's balance sheet for some time yet.

Non-agency RMBS: fundamentals have stalled

Many of the fundamental tailwinds for non agency assets have moderated in our view. Default rates on non-agency RMBS have declined substantially since 2009, but gains have stalled since and there is limited room for further compression from here.

Within riskier sectors of non-agency RMBS, voluntary prepayment rates remain relatively low as refinancing outlets are limited. Meanwhile, as interest rates rise over the medium term, prepayments on fixed-rate structures are likely to come under pressure. Finally, severity rates on defaulted loans have remained elevated despite improvements in the US housing market. Homes backing defaulted loans have typically experienced worse than average gains and elongated foreclosure timelines. Absent a large positive house price surprise, severity rates are unlikely to improve materially over the near term.

That being said, the positive supply technical (limited new issuance) favouring non-agency assets is difficult to overlook in our view, despite fundamentals stalling. This dynamic is likely to continue to provide a support for non-agency prices for the foreseeable future.

Fig. 13 OAS spreads on agency MBS are tight

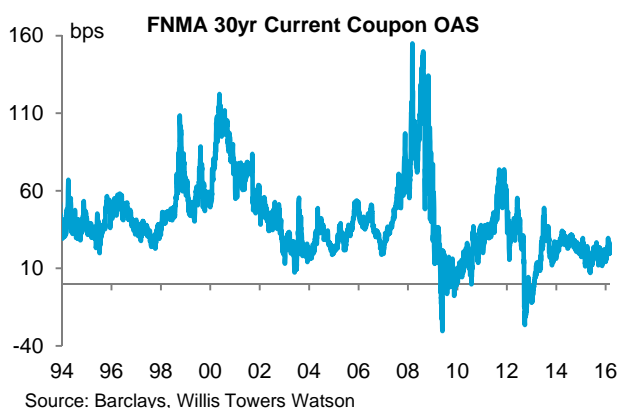
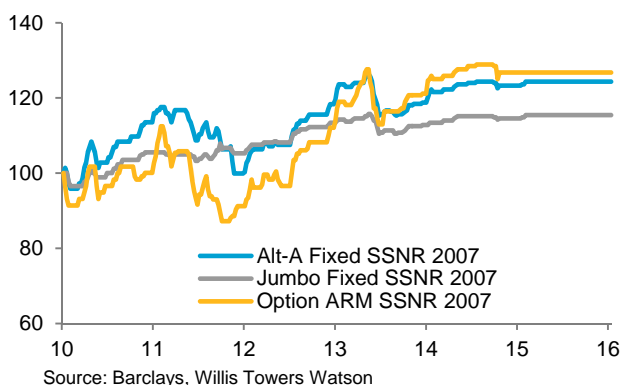


Fig. 14 Legacy non-agency RMBS tranches have traded infrequently in recent times



Emerging Market Debt

An overview of Latin America

In aggregate, the Latin American economies of Brazil, Mexico and Colombia represent ~20% of and ~16% of Barclays benchmark local and hard currency sovereign debt indices respectively. As discussed in our feature article, the cyclical outlook for the region remains weak and we expect growth to be below potential across Latin American economies as a whole. In this month's article we discuss what the economic outlook implies for local and hard currency debt markets.

Although, not covered in depth in this month's article, Venezuela and Argentina are two hard currency debt issuers which account for approximately 5% of the Barclays index. Spreads for both countries remain relatively high (~3050 bps and ~460bps respectively) and volatile, and so can have a meaningful impact at the wider index level. Particularly in the case of Venezuela, a heavy reliance on oil exports has put pressure on sovereign debt spreads in recent times.

Brazil

The Brazilian economy is shrinking, inflation has climbed to over 10% (Fig. 15) and the central bank has hiked the policy rate significantly. Domestic and external economic imbalances, the widespread nature of indexation to past inflation in price and wage-setting, and the significant depreciation in the Brazilian real, all mean that inflation is expected to remain high despite the weak labour market. Brazil's fiscal position has deteriorated sharply and the political situation remains toxic, raising the risk of a further rating downgrade.

These external, fiscal and inflationary pressures are reflected in local currency debt markets where yields are very high; the 5-year spot rate is ~16%. In addition, the

currency is now closer to long term fair value and so returns in an upside scenario could be very strong, especially if inflation converges to target, enabling the central bank to ease monetary policy and support the domestic economy.

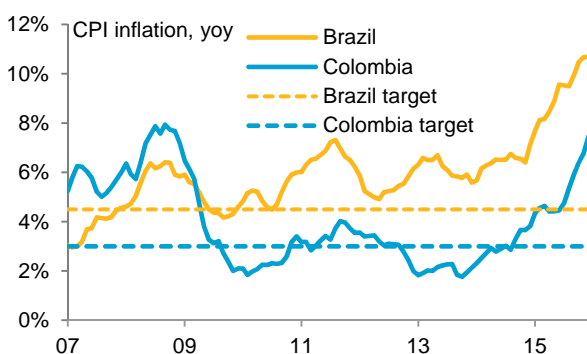
However, the economic situation is likely to get worse before it gets better and there are large sources of downside risk: inflation expectations could de-anchor; the fiscal position and creditworthiness of the sovereign may deteriorate further, especially given the political situation. Each of these risks would negatively impact local currency debt returns through higher local rates and a weaker currency. Therefore, despite high local rates and bond risk premia, on a risk-adjusted basis we would not advocate an overweight position in Brazilian local currency debt at this time given the highly uncertain economic outlook.

Spreads on hard currency Brazilian debt stand at ~473 bps as at the end of February and have widened ~ 216bps over last the 12 months (Fig. 16). Brazil's poor debt dynamics are hard to overlook in our view. Despite relatively healthy FX reserve levels, material external debt levels and government exposure to a fragile corporate sector are likely to put external spreads under further pressure. Under our central scenario, we expect Brazilian hard currency spreads to remain elevated at the very least with a risk of further widening.

Colombia

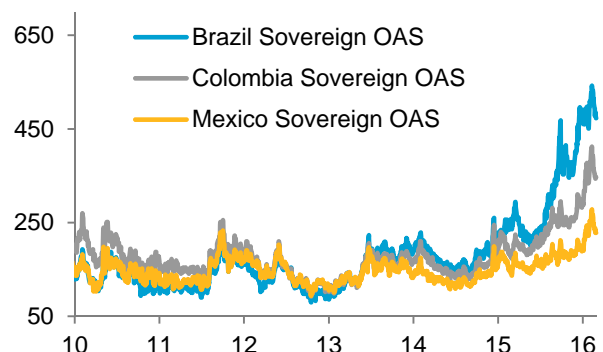
Whilst in a stronger position than Brazil, external and domestic imbalances are present in Colombia, inflation is above target (Fig. 15) and the current account deficit is particularly wide at 7% of GDP (Fig. 17).

Fig. 15 Brazil and Colombia are battling inflation



Source: Thomson

Fig. 16 Hard Currency spreads have widened most abruptly in Brazil



Source: Bank of America Merrill Lynch

Emerging Market Debt

An overview of Latin America

A further depreciation of the peso may be necessary to facilitate external rebalancing, especially if China slows more than expected, given the importance of commodity exports to Colombia's current account. This risk to local currency returns is offset to some degree by moderately high starting rates (the 5-year spot rate is ~9%). A modest tightening cycle is discounted in local currency debt markets which appears sensible to us. Furthermore, our estimates of Colombian bond risk premia are in the range of 2-4%, which is roughly appropriate given an economic outlook where the risks that inflation and local rates rise further than expected are not immaterial. These include: pass-through from currency weakness; El Niño's impact on agricultural yields and food prices; and the effect that above-target inflation has on inflation expectations and subsequent formal and informal price and wage-setting.

At approximately 3.5% of the Barclays hard currency index, Colombian external debt represents an important proportion of LatAm issuance. Poor debt dynamics, exposure to weaker commodity prices and a slowing China lead us to remain cautious on the outlook for Colombian external debt spreads currently.

Mexico

The economic outlook in Mexico is more positive and there are fewer economic imbalances. Inflation is contained and the current account deficit is manageable.

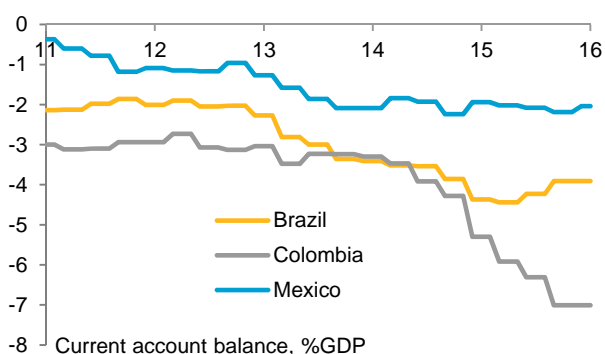
A lower inflation outlook and a stronger external position mean that lower bond risk premia in Mexico relative to Brazil and Colombia are justifiable and reasonable in our view (Fig. 18). Risks that local currency yields rise faster

than discounted in Mexico come from two key sources. Firstly, fiscal reliance on oil revenues in an environment where we expect oil prices to remain low, although reforms do aim to diversify this risk. Secondly, there is a not insignificant possibility that inflation rises faster than expected due to substantial currency weakness. Again, this risk is mitigated to some degree by the proactive nature of policymaking, as evidenced by the 50 bps hike in the policy rate in February. Strong, proactive and credible macro policy frameworks reduce economic uncertainty and will benefit the economy moving forward, as should the extensive set of structural reforms passed over the last couple of years. These factors should support the currency which is currently near multi-year lows.

From a hard currency perspective, we hold a stable outlook on Mexican sovereign debt. Whilst the country does have higher levels of external debt than Brazil and low oil prices provide continued downside risks to planned investment, Mexico boasts a fairly strong policy framework and we expect Nieto's reform agenda to boost structural growth and help to diversify fiscal revenues. This seems to be broadly reflected in relative pricing in our view.

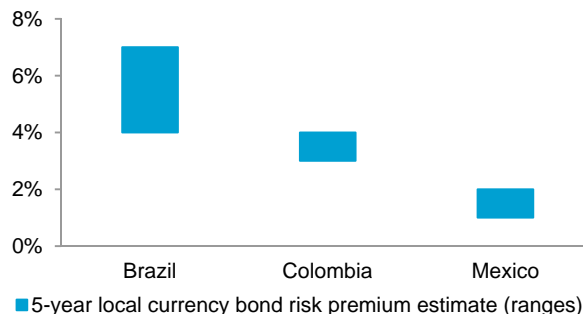
In summary, despite weaker currencies and higher interest rates across the region, the poor cyclical outlook and widespread nature of downside risks prevalent in Latin America result in us adopting a cautious outlook for the region. Pricing in both local and hard currency markets is largely consistent with this outlook and risk premia are appropriately lower in Mexico than in Brazil, where the outlook is most uncertain and where downside risks are greatest.

Fig. 17 External imbalances vary across LatAm



Source: Willis Towers Watson, Bloomberg SP

Fig. 18 Local currency bond risk premia appropriate given outlook



Source: Willis Towers Watson, Bloomberg LP

Equities

Developed market banks

Financials comprise about 20% of global equities. Many major indices have material biases towards the sector. Amongst developed markets, Australia, Canada, Italy and Spain stand out. Performance in the sector has been poor since the beginning of the year, driven in large part by banking sector declines. This month we focus on the banking industry which makes up the majority of the financials sector in most markets, discussing the major determinants of bank profit margins.

Banking sector performance

Global banks have garnered increased attention recently, as the sector has underperformed broader indices. In fact, the sector has been a drag on aggregate equity performance for some time. Most developed banking indices are still trading at less than half their pre-crisis price levels (Fig. 19).

Basic valuation metrics are low to boot. Price to book values are at the lower end of historic ranges indicating concerns about banks' future earnings and their ability to raise return on equity/assets from current levels. These concerns have deepened as policymakers have grown more comfortable with negative cash rates and risks of an economic slowdown have increased – banks are leveraged to both of these. Additionally, new regulation on capital requirements are likely to constrain upside in a good outcome, akin to our upside scenario.

What drives bank profitability?

Bank interest revenues are driven by a combination of loan book size and lending margins. Loan growth depends on GDP growth and leverage cycles, whilst margins are linked to monetary policy. Banks also generate non-interest

income from activities like M&A advisory, trading and asset management that tend to be pro-cyclical. From an expense standpoint, in addition to employee salaries, factors like regulatory shifts, loss provisions, fines and litigation also impact costs. Below we concentrate on income from banks loan books as the largest component of aggregate banking income and make some comments on regulation.

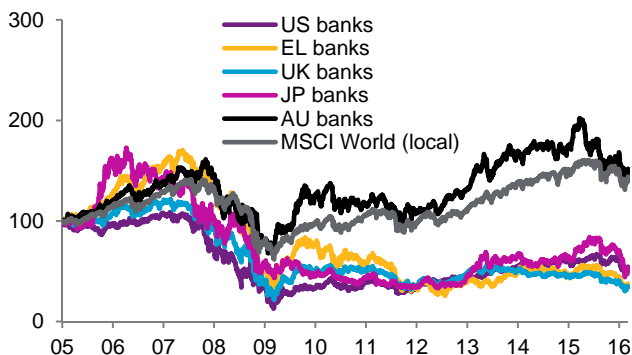
Net interest income

As the largest component (on average) of banking industry revenues, net interest income is driven by the amount of lending undertaken by an institution and the differential between what a bank can earn on its loan book and what it has to pay on its deposits or other forms of financing.

In the US, loan books have seen robust growth over recent years, supported by corporates and the commercial real estate sector. In Australia, mortgage lending has been a prominent growth area for a number of years but is perhaps cooling somewhat. Other markets are more mixed, in Europe (particularly the periphery) banks have warehoused their risk capital in government bonds. One aim of the ECB's credit easing policies has been to improve lending to small and medium sized enterprises, which perhaps has occurred at the margin. Overall, given our outlook for the growth cycle and high starting debt levels, it is unlikely that loan growth will pick up materially across developed markets from current levels.

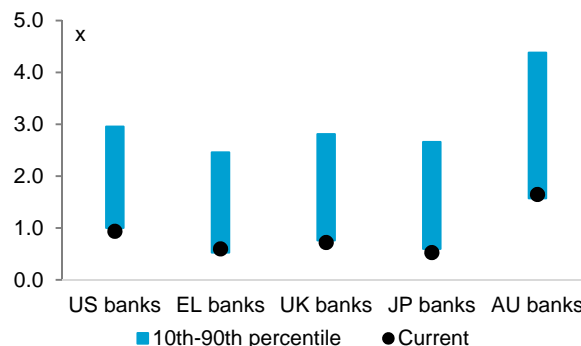
Given moderate loan growth the spread between interest income and expenses is likely to be important in retaining reasonable levels of revenue growth. Here we can split

Fig. 19 Banks have been a drag on aggregate equity returns



Source: Bloomberg LP, Willis Towers Watson
Notes: prices rebased to 100 1/1/2005)

Fig. 20 Valuations are trading at the lower end of price-to-book ranges



Source: Bloomberg LP, Willis Towers Watson

Equities

Developed market banks

this into two components: the difference from borrowing at the short end of the yield curve and lending at longer maturities; and a credit spread component.

In recent years, liquidity provision from central banks' increased borrowing through capital markets and the lack of demand for loans have all contributed to aggregate declines in the size of credit spread on offer to the banking sector. Working against these factors has been the consolidation of the sector post financial crisis. Overall, in the near term we do not expect major changes to this component of interest income.

Therefore, net interest income is likely to remain reliant on the maturity transform element. This component has come under pressure as central banks across the world have adopted loose monetary policy and government yield curves have flattened. In Europe, where the ECB has moved to negative interest rates, banks have been reluctant to pass on the negative rate to their depositors and so margins are likely to erode further. In the US, whilst interest margins may tick up from historically low levels, the force of this tailwind is likely to be contained by our expectation for a slow tightening of monetary policy. Other markets sit between these two examples. Overall, our outlook for net interest income is therefore weak.

Credit losses

In making loans, the banking sector also takes on significant credit risk. Here we can proxy losses on loan books to our outlook for losses in credit markets. We expect a moderate worsening in corporate credit losses over coming years as profit margins tighten, the effects of

commodity prices wash through commodity linked sectors and demand remains moderate at best. In the household sector we are generally sanguine on high quality credit risk but note the potential for recession. Overall losses relative to provisions provide a downside risk to our outlook for bank profits.

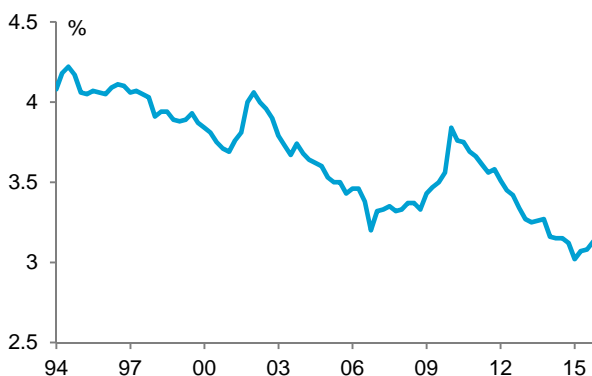
Regulation

The above provides a mediocre outlook for one of the major components of bank income, another key driver is regulation. Regulators have increased their scrutiny of banks since the financial crisis. Though uncertainty around regulation has diminished in a few cases (for example pertaining to Dodd-Frank in the US), risks of increased capital and compliance costs remain in place. Additionally, Brexit poses considerable uncertainty relating to the costs of implementing new regulation for UK banks as this will depend on the terms of the exit in the event of Brexit actually going ahead. Not only do banks now face more stringent capital and liquidity requirements, regulators are also increasingly pursuing banks for past breaches. We expect the effects of regulation will continue to be a headwind for bank profitability for the foreseeable future.

Summary

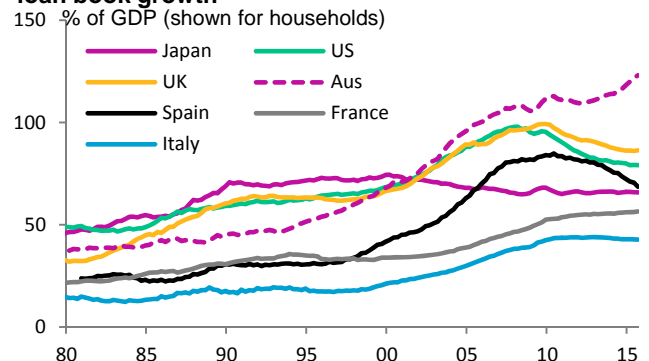
Whilst valuations are low, we have outlined some concerns we hold for the banking sector that may explain a portion of this potential under-valuation. Net interest income is likely to remain constrained in our central outlook and our downside scenario implies significant credit risk. On this evidence the prospects for bank earnings remain constrained at best.

Fig. 21 US net interest margins have fallen



Source: Bloomberg LP, Towers Watson

Fig. 22 debt levels are high and likely to constrain loan book growth



Source: Thomson, Willis Towers Watson

Foreign Exchange

Anything but a 'sterling' outcome

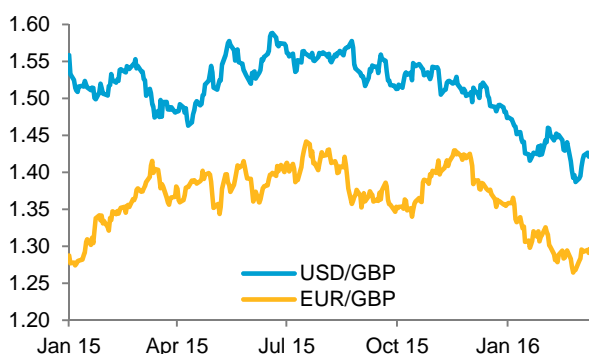
In last month's article, we provided a high level overview of our outlook for sterling. Since this communication the currency has depreciated further against the dollar (and other trading partners) breaching 1.40 before recovering somewhat in early March. Below we provide further detail on our outlook, updating for the latest data points.

Brexit hits the headlines but dynamics are worthy of further consideration

In recent months sterling's decline against its major trading partners has hit the headlines. Towards the end of February the pound fell below a 'key' (in terms of sentiment) threshold of 1.40 against the dollar, its lowest level since the doldrums of the financial crisis. Financial press headlines have pointed towards uncertainty surrounding the UK's planned EU referendum as the key catalyst for this decline. Before concluding that 'Brexit' is priced into markets, a more considered view of underlying fundamentals is required.

Since the beginning of the year a key driver of FX rates has been working against sterling – the Bank of England has moved to a more dovish view on monetary policy. This has been evident in the various speeches and comments provided by Mark Carney (the Governor of the BoE) and market pricing adjustments. Since the turn of the year the UK 2-year swap rate has fallen nearly 30bps, which is around 10bps more than the US rate (with similar moves in other markets). Indeed, UK rate curves are now implying monetary policy tightening will be forestalled until the end of 2016 or even into 2017. This relative loosening in monetary policy stances has undoubtedly contributed to the depreciation in sterling in recent months.

Fig. 23 Sterling depreciation has been marked



Source: Bloomberg LP

At the beginning of the year we noted that monetary policy divergence would likely be a significant driver of FX rates. Our initial assessment was that monetary policy divergence would take place between the US and Europe and/or Japan, with the UK sitting somewhere in the middle. As such, rate divergence and sterling weakness versus the US is not a surprise. However, significant short term sterling weakness versus the euro is.

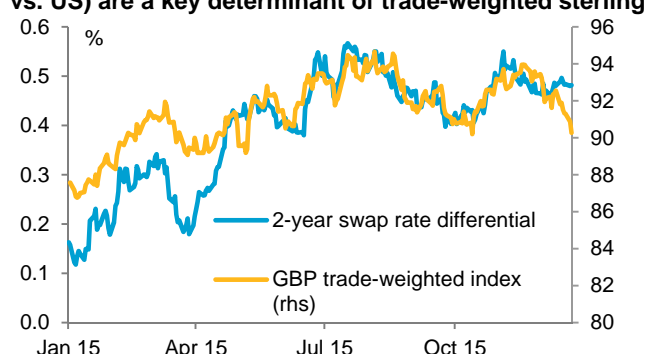
Brexit risks have also contributed

Whilst rate expectations have undoubtedly impacted sterling in recent months, it is also likely that risks around the UK's membership of the EU are also weighing on the currency. This is particularly true against the euro, where relative moves in rate curves have been more modest than the example used above for the US. However, we believe, it is unlikely that the level of depreciation seen year-to-date and during the last quarter of 2015 represents a 'full pricing' of Brexit risks. We explain our reasoning below.

The UK's structural current account deficit

The UK has run a structural current account deficit since the mid-1980's (with a brief respite in the late 90's). Historically, much of this balance has reflected a goods trade deficit, following an erosion of the UK's manufacturing capacity in the later 70's and early 80's. However, since the turn of the millennium the income balance has become increasingly large and volatile leading to this component driving much of the headline movement in the overall current account balance over the past 16-years. Both the trade balance and transfers

Fig. 24 UK monetary policy expectations (here shown vs. US) are a key determinant of trade-weighted sterling



Source: Bloomberg LP, Willis Towers Watson

Foreign Exchange

Anything but a 'sterling' outcome

balance have remained stubbornly in deficit over this period despite varying economic growth and currency environments, e.g., trade-weighted sterling has moved within a range of ~35%. As the UK has effectively outsourced its goods production to the rest of the world, we believe that the deficit is unlikely to be unwound, except in the most extreme demand erosion scenarios. Given the need to achieve external financial balance the UK either requires significant net income or continued capital inflows to fund these external purchases and support the price of sterling.

Income balance dragged down by low global growth but also increasing liabilities

When compared to other developed nations the UK runs a large gross international investment position of about 150% of GDP (locally-owned foreign assets plus liabilities owed to foreigners). This large international balance sheet reflects the UK's significant financial sector and implies that capital flows are a key driver of sterling views, perhaps more so than in other developed markets.

Foreign investments produce income, whilst liabilities results in debits (or a negative impact on the income balance). Two factors are important in determining an economy's income balance. Firstly, the stock of assets relative to liabilities and secondly the composition of each stock.

In recent years, the UK's net international investment position (assets minus liabilities) has become an increasingly large liability as sales of foreign assets have outweighed reductions in liabilities owed to foreigners. In addition to this deteriorating balance sheet, the UK holds a

greater proportion of equity abroad, relative to foreign holdings in the UK which have a greater debt component.

In recent quarters, the recovery in foreign equity earnings has improved the UK's income account deficit somewhat, following a significant decline earlier in the decade. Our moderately poor outlook for global corporate profits implies that there may well be a cap on this recent movement, implying the income balance will remain a drag on the overall current account deficit in the medium term.

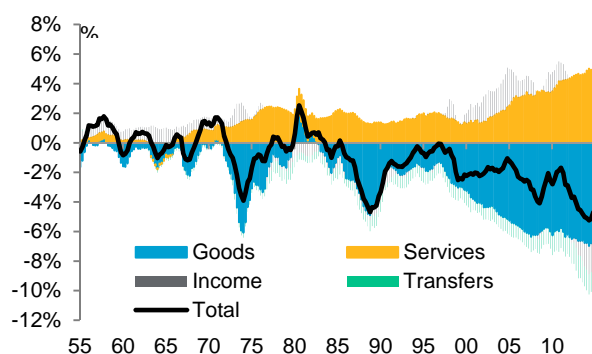
Capital inflows likely affected by risk sentiment

Therefore, the UK will remain reliant on capital inflows to fill its structural deficit. In recent years both foreign direct investment and net portfolio inflows have filled this gap. Both of these flows are likely highly reactive to risk sentiment surrounding the UK economy. Much of the FDI flows into the UK economy are M&A based and are highly cyclical, whilst portfolio flows are more volatile by nature. We are concerned that these flows will be disrupted if an exit from the EU occurs. As the UK is a net borrower from the rest of the world, we expect that the impact of this risk scenario would be very negative for sterling. It is difficult to place a number on this downside but we see a 15-20% trade-weighted depreciation as a possible outcome.

Overall moderate outlook

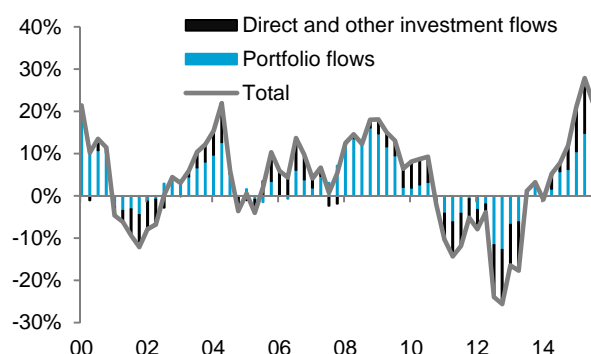
Despite these downside risks, our base case expects the UK to remain in the EU. Therefore, we believe the most likely path for sterling is appreciation versus the euro. However, given the skew of risk to the downside we suggest investors consider their hedge ratios and liquidity positions.

Fig. 25 UK current account balance



Source: Thomson, Willis Towers Watson

Fig. 26 Major UK capital flows



Source: Thomson, Willis Towers Watson

Commodities

Overview of the metals market

The S&P GSCI total returns index fell 33% and DJ UBS total returns index fell 25% in 2015, continuing the streak of price declines which commenced in 2014. Industrial and precious metals constitute a sizeable portion of these commodity indices (~10% of S&P GSCI and ~32% of the DJ UBS index) and along with oil, have been one of the key drivers of poor performance in these indices. The S&P GSCI metals spot price index fell by close to 20% in 2015 (Fig. 27). However, prices have rebounded since the start of the year by ~10%. Below, we examine aluminium and copper markets in detail, as they have the largest components of the metals sub-index.

Key drivers of the metals market

Over the past couple of years slowing Chinese (Fig. 28) and EM growth has been a key dynamic in driving demand in all major metals markets. Over the past decade, China has grown to consume between 40 – 45% of base metal demand, most of which was as a result of booming property and infrastructure construction demand. However, in recent times demand for investment related commodities has waned.

In part this is due to an overdue correction in the property market as credit becomes more scarce and new building contracts – this effect is cyclical (if a long cycle) in nature. Demographics and economic restructuring are likely longer lasting effects on metal demand. Over the next 10-years the level of Chinese household formation will fall markedly, leading to a lower need for house building. Additionally, the rebalancing of the Chinese economy from manufacturing led growth toward services is likely to lead to a rebalancing of demand from commodities that are

inputs into ‘capital investment’ type projects (such as steel or copper) towards those that are used as inputs in ‘operating’ processes (such as oil and chemicals).

A potential cross-current is a second wave of emerging market demand. Countries such as Nigeria and India have more favourable demographics and a real need for infrastructure investment. It remains to be seen whether these economies can pick up the Chinese mantle and become drivers of global metal demand over the longer-term.

With this overarching picture in mind we move to discuss some of the cyclical dynamics affecting prices in each individual market.

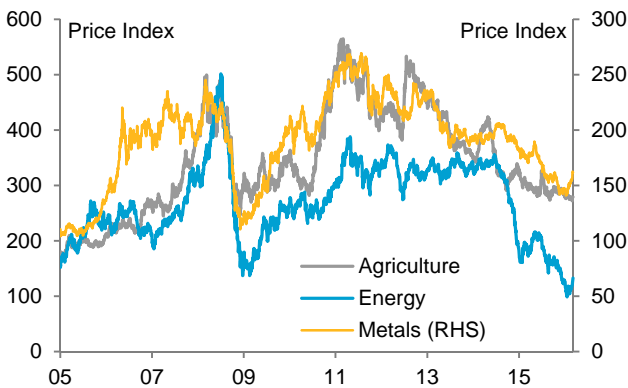
Copper markets: mixed signals

After reaching a six year low in December 2015, copper prices have rebounded by close to 10% since the start of 2016. Despite the recent recovery, prospects for the metal remain uncertain due to the number of opposing forces at play.

Tighter shadow banking related activities in China has led to a crackdown on operators who used to use copper as collateral to gain multiple low cost loans. This has resulted in lower loan-related demand for copper. In addition, property-related copper demand has been flagging.

However, copper is also used extensively in infrastructure, telecommunications, power generation and transportation equipment, and there have been reports of increased Chinese investment in these areas. This represents additional demand for the metal over coming years.

Fig. 27 S&P GSCI commodity sub-indices



Source: Thomson, Willis Towers Watson

Fig. 28 Slowing Chinese industrial production growth



Source: Thomson, Willis Towers Watson

Commodities

Overview of the metals market

Another source of demand has been the fairly opaque stockpiling exercises conducted by China's State Reserve Bureau (SRB). If the SRB builds up its reserves aggressively over this year, there is a potential that the global surplus may be eroded.

The supply growth of copper has been reasonable despite major disruptions in mines. Issues with mining production are quite common in the copper industry and most analysts incorporate 5 to 10% of supply disruptions a year. Supply disruptions due to strikes and operational issues in Chilean and Zambian mines have been offset by additional output flowing through from projects based on legacy investments. However, declining ore grades and resource exhaustion from existing projects stand to increase the costs of extraction for producers over the medium term.

Aluminium: Chinese supply remains resilient

Aluminium faces very different cyclical pressures from the rest of the metals markets. A decade ago when Chinese authorities adopted a resource-intensive model of growth, they matched rising aluminium demand by investing heavily in new smelters. China now produces close to half of the world's aluminium supplies.

With demand for the commodity flagging and prices declining, Chinese operators have chosen to cut costs and increase efficiency rather than curb production. China is now able to produce aluminium at one of the lowest costs of production in the world. This does not bode well for international competitors who, as effective swing producers of the market, face challenging business conditions. Restructuring and consolidation is likely

needed to reduce costs and increase synergies bringing the market back towards balance.

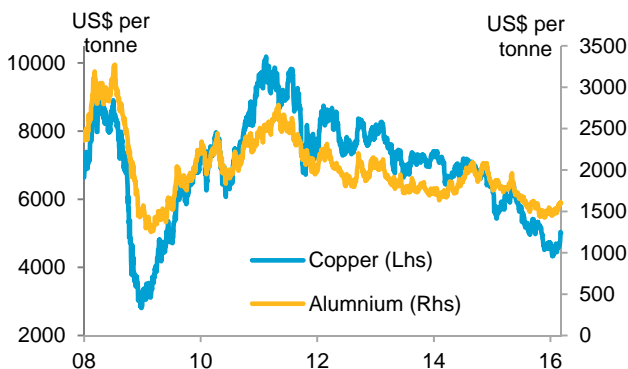
The resilience of Chinese supply despite low prices has meant that the required adjustment in the market may well be slow, leading to a bearish outlook for the metal in the near term.

Developments in the oil market

During January Saudi Arabian and Russian authorities announced that they had reached an agreement to cap oil production at current levels in an effort to reduce excess supply conditions in the market over the medium term. Other national oil producers such as Qatar and Venezuela have also agreed to follow suit. Therefore, at a headline level, it would appear that a significant proportion of global production will remain at current levels.

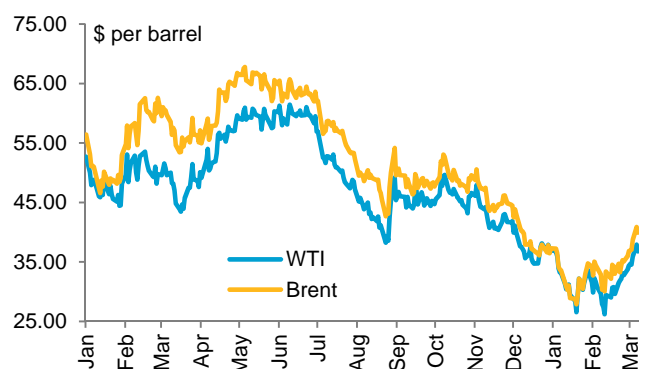
However, we view this development with caution as the programme needs wide support from all players over an extended period in order to be successful. Crucially, the nations have not agreed to reduce production, fearing that they will lose market share to other swing producers if prices rise in the short-term and make investment in new production more appealing. Therefore in order for this agreement to make a difference to the current conditions in the oil market it will need to remain binding for a number of years, during which demand erodes the current oversupply picture. This uncertainty is further clouded by the need to coral 'privately' owned companies in countries such as Russia. Therefore, we view this development with caution and retain our price targets as set out in last month's article.

Fig. 29 Copper and Aluminium prices



Source: Bloomberg LP

Fig. 30 WTI and Brent oil prices



Source: Bloomberg LP

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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