TOWERS WATSON

Global Markets Overview

Global Investment Committee, November 2012

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Risky asset prices have increased significantly since July as policymaker actions have removed some of the impending risks to near term global economic growth. In particular, markets linked to European risks have moved to discount an improved growth environment or equivalently lower risk premia following moves from the European Central Bank, i.e. its commitment to buy periphery sovereign bonds.

Developed market bond yields have increased only modestly since July, continuing their range trading pattern of the last 12 months. Both nominal and inflation-linked curves have remained low in the last five months and have not moved to discount improved growth prospects, which is evidence of financial repression at work. Monetary stimulation by the major central banks are keeping yields close to their lower bounds and, for the moment at least, improving investors growth expectations are insufficient to offset this large-scale bond buying by officials.

As discussed in this month's article, our assessment is that both equity and debt markets are pricing a long-term – five to ten year period of mediocre economic growth. This is a scenario that is more pessimistic than our base case and we therefore believe equity markets offer reasonable value over the medium term, especially relative to on-going negative real cash rates and likely negative returns from bonds.

Our views are not without risks. This has been illustrated in the last few weeks, with the so-called US "fiscal cliff" , uncertainty over the US election and the release of European rescue funds concerns for investors. Our base case is for a substantial amount of the planned government spending cuts and tax rises to be deferred, although enacted measures will still be sufficient to cause a drag on 2013 GDP growth of between 1-1.5%. However, the possibility of a severe policy-induced contraction cannot be ignored and delay in reaching agreement will add to near-term market volatility.

Figure 01. Our current views

Move to moderately attractive rating on global equities

Three-Year Horizon	
Asset Class	**View**
Global Government Bonds (10yr)	Highly Unattractive
Global Inflation-linked Bonds (10yr)	Highly Unattractive
Global Credit (Investment Grade)	Neutral
Global Equities	**Moderately attractive**
Commodities	Neutral

Source: Towers Watson

Note: Changes from previous month indicated in bold

Figure 02. Various asset prices

	31-Jul	31-Aug	30-Sep	31-Oct
US 2 year treasury yield, %	0.21	0.22	0.23	0.28
US 5 year treasury yield, %	0.58	0.59	0.63	0.72
US 10 year treasury yield, %	1.47	1.55	1.63	1.69
US IG corporate spreads, bps	178	172	156	137
US HY corporate spreads, bps	595	575	551	543
MSCI World index (price level)	316	322	332	329

Source: Bloomberg LP, Barclays, Towers Watson

Markets pricing a pessimistic growth outlook

Since the financial crisis equity markets have performed relatively strongly when compared to other major asset classes. This performance has been delivered despite the mediocre global economic recovery as monetary easing, supportive business conditions and a moderate recovery in investor risk appetite from very bearish levels have combined to drive markets higher.

On a forward-looking basis our models imply various asset markets (equity and debt) are pricing too pessimistic an outcome for future global growth. We therefore believe that equities, a pro-growth asset, are under-pricing our base case scenario and appear moderately attractive. On the opposite side of the coin bonds appear unattractive.

Equity markets have performed strongly relative to other asset classes

Despite several bouts of investor risk aversion and debt-related macroeconomic shocks, equity markets have provided attractive returns in recent years (Figure 03). These returns have been delivered despite macroeconomic conditions that have been less than supportive – low developed market household demand, government austerity and poor credit availability. In part this is due to the robust condition of corporate balance sheets. However, we believe monetary policy, weak wage growth, low financing costs and a moderate improvement in investor sentiment from very low levels have been just as important in driving equity returns.

Equity markets price a low growth environment

Through our dividend discount framework we are able to infer the level of long-term real earnings growth discounted by equity markets (Figure 04). Given current pricing, markets appear to be indicating that earnings growth will disappoint for many years, discounting low or no earnings growth. This low growth environment is also being priced by bond markets.

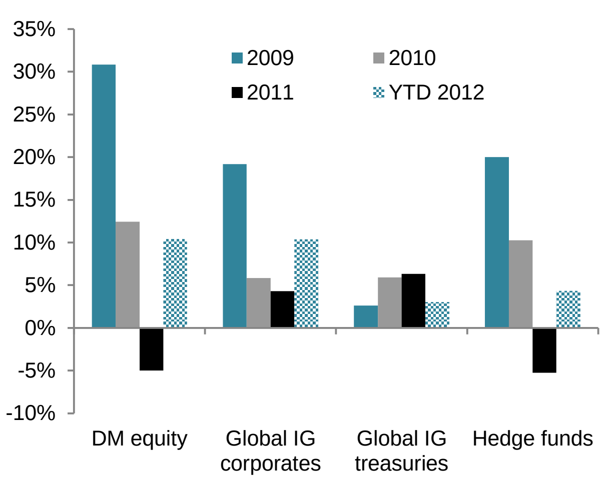
Our base case outlook is less pessimistic

Our base case outlook is one of moderate global growth acceleration over the coming years. In the near-term, several key economies appear to be responding to the autumn's round of monetary easing. Chinese data over the last month has picked-up, whilst the US is returning towards a moderate growth path. Europe remains in an on-going stagnation but global growth rates are modestly improving. We forecast weak growth in 2013 as developed economies continue to delever and the US begins to tighten fiscal policy. However, from 2014 onwards we could start to see the US household demand growth accelerate as the mortgage debt overhang unwinds. In combination with trend growth from China of around 8%, in our view this provides better prospects for earnings than markets are pricing-in.

Favour equity for pro-growth characteristics over the medium term

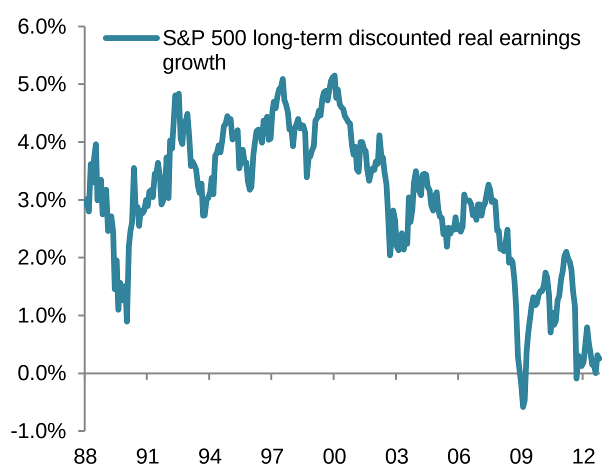
While equity markets are pricing a more pessimistic growth outcome than our expected base case and we see upside in equities, our moderately attractive stance is consistent with nominal annual return expectations in the mid to high single digits over the next five years. These prospective returns do not appear high – and indeed are not particularly high by historical standards – but they need to be set against close to zero

Figure 03. Equity markets have performed strongly since 2008



Source: Bloomberg LP, Towers Watson

Figure 04. Markets are discounting a low growth environment



Source: Bloomberg LP, Thomson, Federal Reserve, Towers Watson returns from nominal cash rates and likely negative returns from bonds.

We also expect these returns to be achieved in a reasonably volatile fashion, that is a grind higher in prices punctuated by deleveraging-related macroeconomic and market shocks. The equity price falls following the US election results are a useful illustration of the point.

Other valuation metrics confirm this view

To confirm our views we look across a range of alternative valuation metrics. Figure 05 plots developed market earnings yields (the inverse of price-to-earnings ratios) against various different bond and credit market yields. On a relative basis, earnings yields appear to be reaching attractive levels following the declines in bond and credit yields over the past two-and-a-half years. In Figure 06, we report various valuation ratios and compare the current metric with the historic distribution of values. Whilst each of these metrics is prone to signal error at different times, in aggregate they indicate that developed markets are moderately attractive.

A wrinkle – profit margins

Much has been written about the high levels of corporate profit margins in recent years. Whilst we agree that margins are high in some markets (Figure 07), we believe there are several reasons which help to explain this situation. Currently, large companies are able to control cost contribution effectively. Labour market slack in general remains high, whilst interest payments and tax contributions remain low. In addition, globalisation allows many large multi-nationals to produce in low-cost geographies and protect profit margins. Product demand is at moderate levels and is likely to remain so short of a recession. This combination has placed upward pressure on margins in recent years.

Looking forward, we expect moderate downward pressure on margins. Some of the more cyclical tail-winds for higher margins will decline, but we expect that this move will fall short of the wholesale reduction to average levels that some commentators have called for as longer-term drivers persist.

Downside risks

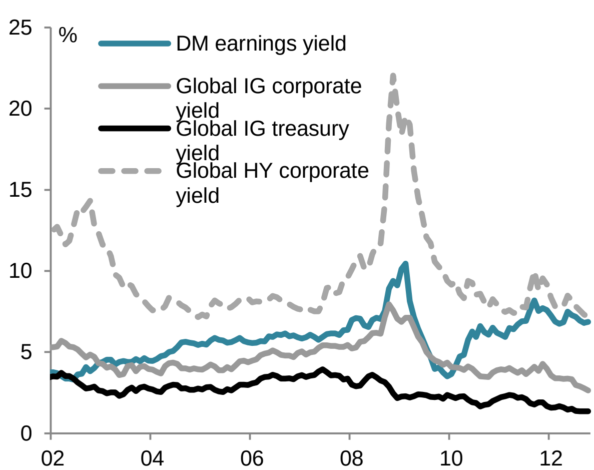
Whilst we believe recent policymaker moves have removed some of the “left tails” of outcomes we continue to believe the global economy remains susceptible to further shocks. Indeed, a further escalation in problems in the Eurozone, a bungling of the fiscal cliff negotiations in the US or a further growth downturn in China could all derail our base case. These risks are meaningful but remain low probability outcomes relative to our base case. However, it is worth reiterating that we do not expect these hurdles to be cleared without some further economic and asset volatility. Despite these concerns, embedded in our view is an assessment that, for the first time in many years, the medium term risks for equities are skewed to the upside.

Central scenario, moderate returns – attractive when compared to other asset classes

We believe that recent moves by policymakers have led to a reduction in near-term downside risks for the global economy. We continue to forecast further volatile, weak growth in the next year, but are more constructive over the medium term as deleveraging headwinds start to reduce (especially in the US). Markets appear to be discounting a more pessimistic path for growth than this view.

Overall, our central scenario calls for continued moderate returns to equity holders. This looks attractive when compared with our forward-looking return

Figure 05. Relative to bond and credit markets equities appear attractive



Source: Bloomberg LP, Towers Watson

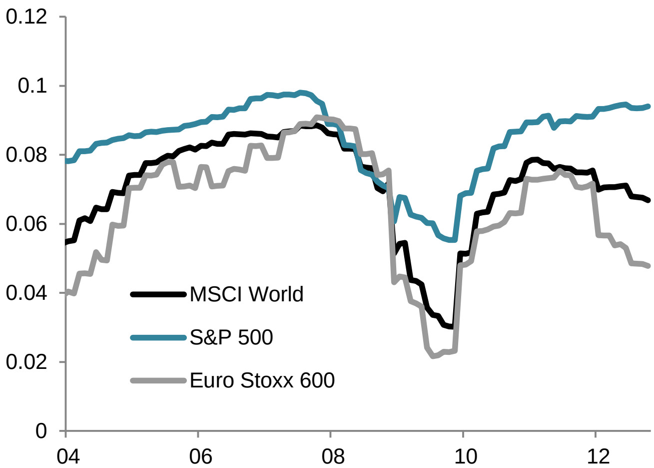
Figure 06. On an absolute basis developed equity markets appear moderately attractive

Ratio	Current Value	75th %-ile	25th %-ile	Current %-ile
Trailing PE	15.6	25.3	16.0	22%
Forward PE	13.2	15.2	12.8	44%
Price to c’flow	6.9	12.4	8.6	11%
Price to sales	1.1	1.4	1.1	27%
Price to book	1.7	2.7	2.1	13%
Dividend yield	2.8	1.8	2.4	12%
Rtn on equity	21.6	16.0	21.3	22%

Source: Bloomberg LP, Towers Watson
Notes: percentiles calculated on monthly data since 1 Jan 1995.

expectations for other asset classes such as cash, government bonds and, after their strong performance in 2012, high quality credit.

Figure 07. Various developed market profit margins



Source: Bloomberg LP, Towers Watson

Summary of market views

	Outlook
Interest rates	• Yield curves in all major nominal bond markets continue to move within a narrow range. • Risk-aversion and clear policy language of low rates for "extended periods" continues to keep perceived safe-haven bond yields (eg US treasuries, UK gilts and German bunds) at low yield levels. We expect bond yields to remain at low levels over the next year. • The depressed long-term path (10 years plus) of interest rates currently priced into yield curves is inconsistent with our three-to-five year forecasts for economic recovery (albeit a slow one). Additionally, yield curves appear to offer no obvious real term or inflation risk premium. Both factors suggest that nominal bonds in particular are at risk of mark-to-market losses in the medium to long term. • Implications of our bond views will depend on whether investors have a cash benchmark or a long bond liability benchmark. For the former, our negative bond stance suggests they should reduce duration risk in their portfolios. For investors using bonds to hedge liability risk, these views should be implemented by underweighting relative to a *full* hedge.
Inflation	• Our base case for the developed world over the next five years is for inflation to gradually rise above central bank targets (with a chance of very high or low outcomes). The policy reaction function of central banks (especially the Fed) appears to have shifted towards supporting growth and employment at the expense of higher inflation. The level of economic slack in most major economies is not large and extensive liquidity provision over the next few years risks pushing inflation higher. • Breakeven inflation rates continue to discount an inflation environment broadly in-line with central bank targets. While weak economic growth will likely contain inflation in 2013, we think breakeven rates are at risk of rising moderately thereafter and we modestly favour inflation-linked bonds over nominal bonds. Nevertheless ,we currently regard both nominal and real yields as offering highly unattractive risk premia to investors, and retain our highly unattractive rating for both. We have moved to neutral on UK inflation-linked bonds relative to other developed sovereign inflation linked bonds.
Credit	• Corporate credit has delivered exceptionally strong returns in 2012, with credit spreads narrowing significantly in industrial and financial sectors in both the US and Europe. • The increased provision of liquidity by central banks has pushed yields and expected returns on "safe-haven" assets to very low levels. This is encouraging investors out along the risk curve into other assets perceived as "safe". High quality (AA and A-rated corporate bonds) have been significant beneficiaries of this liquidity, with spreads hitting two-year lows. BBB-rated credit has performed well but not as strongly as the high grade sector. • We retain our neutral stance on investment grade credit markets in aggregate. Noting that there is still some value left in BBBs and advise taking selective exposure.
Equities	• On average, developed world equities continue to discount an outcome of relatively weak real earnings growth and economic activity over the medium to long term. Our forecasts are for more positive economic and earnings conditions to transpire, indicating equities are reasonably attractively valued over the medium term. The attractiveness of equity valuations still needs to be set against the economic and event risks that are still prevalent (especially related to systemic risks in Europe). • Recent central bank monetary stimulation has helped to reduce these near-term risks. Consequently, we are positive on medium-term prospects for equity returns and we move to a moderately attractive rating. In particular, we currently favour equities over both bonds and credit in the medium-term.
Foreign exchange	• Over the medium to long term we are bearish on the US dollar, particularly against select emerging market currencies.
Emerging markets	• Local currency debt has benefited from an easing stance from key central banks. The long-term strategic case for local debt is strong, but selectivity is required. We remain neutral. • EM FX has less of a clear valuation driver than in prior years. However, selective cheapness and better relative economic fundamentals continue to drive our overweight position
Commodities	• For commodity markets with actual or potential supply constraints (crude oil especially), we think there is still moderate upside potential, albeit with high volatility. • We remain neutral on the broader commodity complex and diversified indices.

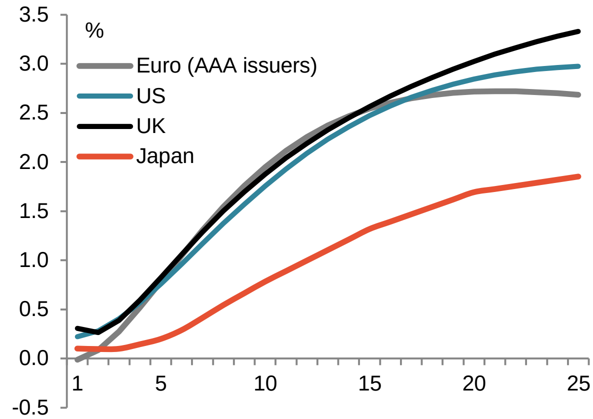
World markets statistics

Figure 09. Interest rates

	Latest	3 months ago	12 months ago
3-month US LIBOR	0.33	0.45	0.41
10 year US Treasury	1.76	1.55	2.31
10 year US Real	-0.79	-0.62	0.18
10 year UK Nominal Bond	1.88	1.61	2.56
10 year UK Real	-0.56	-0.69	-0.11
10 year German Bunds	1.60	1.45	2.32
10 year German Real	-0.57	-0.68	0.10
10 year AAA EUR Nominal Bond	1.95	1.87	2.79

Note: Updated as of COB 31 Oct 2012.
Source: Bank of England, Deutsche Bundesbank, Federal Reserve, European Central Bank, JP Morgan

Figure 10. Bond Yield Curves



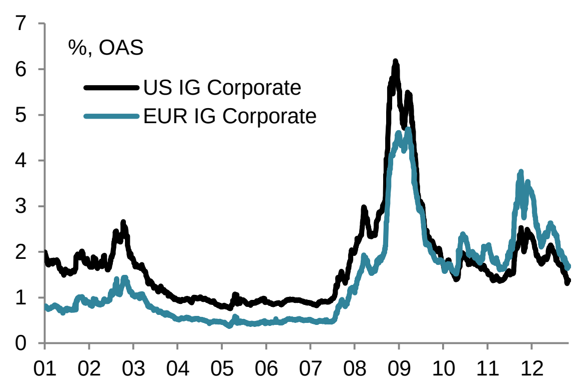
Source: Bank of England, European Central Bank, Federal Reserve, Bank of Japan

Figure 11. Credit markets

	Option adjusted spread (bps)		
	31/10/2012	31/07/2012	31/10/2011
Barclays Global Aggregate	63.8	82.5	97.0
Barclays US Aggregate	50.1	66.1	79.8
Barclays EM Aggregate	312.8	374.2	413.0
Barclays US Corporate IG	137.3	178.0	201.8
Barclays EUR Corporate IG	167.8	224.0	277.2

Note: Updated as of COB 31 Oct 2012.
Source: Barclays Capital

Figure 12. Investment grade (IG) credit spreads



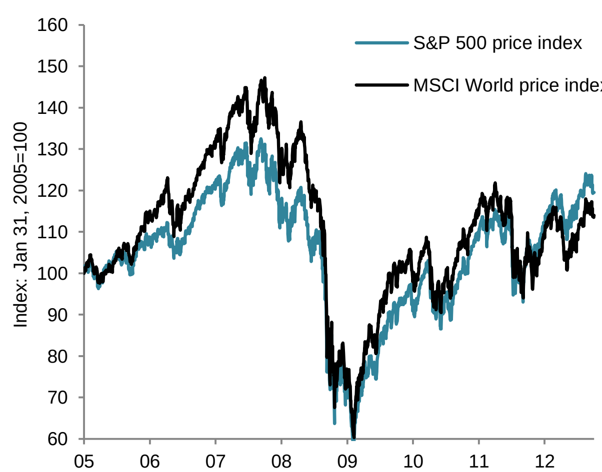
Source: Barclays Capital

Figure 13. Global equities

	Index	Current price/index level	Total return (12 month % change)	
			Local Curr	USD
Global	MSCI AC World	346.6	11.1%	9.2%
Developed	MSCI World	910.3	11.8%	10.1%
Emerging	MSCI EM	44335.1	3.7%	3.0%
United States	S&P 500	1412.2	15.2%	15.2%
Euro area	FTSE Euro 100	2255.8	13.3%	5.2%
Japan	Nikkei 225	8928.3	-0.7%	-3.1%
UK	FTSE 100	5782.7	8.5%	8.3%

Note: Updated as of COB 31 Oct 2012. Source: MSCI, S&P, FTSE

Figure 14. Global Equity Markets: Price changes



Source: MSCI, S&P

Distribution of ratings

We provide asset class views which rate the investment outlook based on the ratings below. A list of all markets covered is available.

Ratings definitions

- **Highly Attractive (HA).** The investment outlook is strongly favourable considering market valuations and fundamentals.
- **Moderately Attractive (MA).** The investment outlook is moderately favourable considering market valuations and fundamentals.
- **Neutral (N).** The investment outlook is neutral considering market valuations and fundamentals.
- **Moderately Unattractive (MU).** The investment outlook is moderately unfavourable considering market valuations and fundamentals.
- **Highly Unattractive (HU).** The investment outlook is strongly unfavourable considering market valuations and fundamentals.

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