TOWERS WATSON

Global Markets Overview

Global Investment Committee, August 2012

In this issue

Risky assets approach the upper end of their recent range trading range

Assets largely range-traded in July, although the last fortnight has seen a continuation of the rally in risk assets since June. Towards the end of the month assets were buoyed by comments from policymakers regarding further aid to ailing European economies. In particular, the European Central Bank hinted that it may restart its bond purchase programme – noting that its mandate is to ensure the smooth transmission of monetary policy to the real economy.

Assessing the state of the European crisis continues to be important to forming views on markets. Policymakers are only able and/or willing to take action in a limited and piecemeal fashion and still lack a concrete plan for resolution. We therefore expect further market and economic volatility over the coming months and years.

Aside from the issues in Europe, the following developments merit further consideration by investors:

- *Global growth indicators remain weak:* Globally, business surveys continued to indicate a sub-trend economic growth picture, although some tentative improvements were seen in the US housing market and July payrolls report. Our overall assessment is that the global economy has slowed but is likely to improve moderately towards the end of the year.
- *Additional monetary stimulus appears primed:* Recent European Central Bank comments have indicated a move towards providing further liquidity to the Eurozone economy. In the US, the Fed noted the “frustratingly slow” progress in achieving its dual mandated economic goals but chose not to provide any further stimulus before its September meeting. The Bank of England has cut its expectations for UK growth (which at the margin indicates possible further easing). We believe further asset purchases will be required to aid economic recovery but note that these policies are subject to diminishing marginal returns.
- *US presidential race heats up:* One of the main focuses of the campaign is likely to be the Federal government’s budget deficit. Uncertainty surrounding the incidence or delay of the automatic “sequester” (spending cuts) legislated for the start of 2013 are likely to add to market uncertainty in the coming months.

We have noted in the past that global credit spreads are moderately attractively priced. Over the next pages we set out our views on the structural levels of risk premiums available to investors in this asset class.

Figure 01. Our current views

Real and nominal duration risk is highly unattractive at intermediate maturities

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

Changing structure of corporate bond markets

- **Corporate credit spreads remained elevated after the credit crisis of 2008/2009.**
- **We find that the asset class now offers a structurally wider spread than previously.**
- **As regulatory changes and capital shortage force investment banks (broker-dealers) to reduce their inventory of corporate bonds, trading volumes have fallen and credit has become a less liquid asset class.**
- **Investors can now earn a much higher liquidity premium which appears attractive for those who do not require the ability to trade in and out of credit on a short-term basis. Thus, the "beta" return in credit markets is higher than before.**
- **The changing structure of the credit market also has implications for various strategies of active managers[1]. Approaches that focus on short-term trading and have high turnover face stronger headwinds while more fundamentally driven managers can benefit from the inefficiencies that a less liquid market may offer.**

1. We discuss the implications of this and other trends on various corporate bond management styles and market segments in detail in this recently published paper: http://www.towerswatson.com/assets/pdf/7637/Liquidity-Perspectives-NA-2012-26682.pdf

Corporate bonds pay higher yields than their benchmark (minimum risk) government bonds. The difference between the yield of both asset classes is the credit spread and it compensates investors for a number of risks and disadvantages that corporate bonds have. Our own assessment and rating of corporate credit is based on a detailed analysis of the credit spread and its attractiveness.

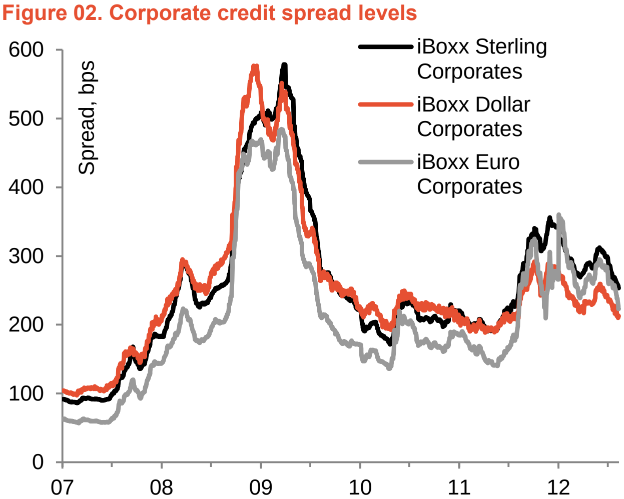
Default risk and credit losses

Corporate bonds are generally less credit-worthy than government bonds. Whilst historically the default rates for investment-grade bonds have been very low, the risk outcome is a downgrade of the bonds together with a mark-to-market loss as instruments get repriced for a lower credit quality. For sub-investment grade (high-yield) bonds, default rates can be significant. Losses tend to follow credit cycles which are closely linked to the business cycle and default rates have reached around 10% in the last three episodes.

Credit spreads need to compensate for the likely credit losses (calculated from an expected rate of defaults, less recoveries). Given the uncertainty around future default experience, investors also require an additional risk premium on top of the likely credit losses.

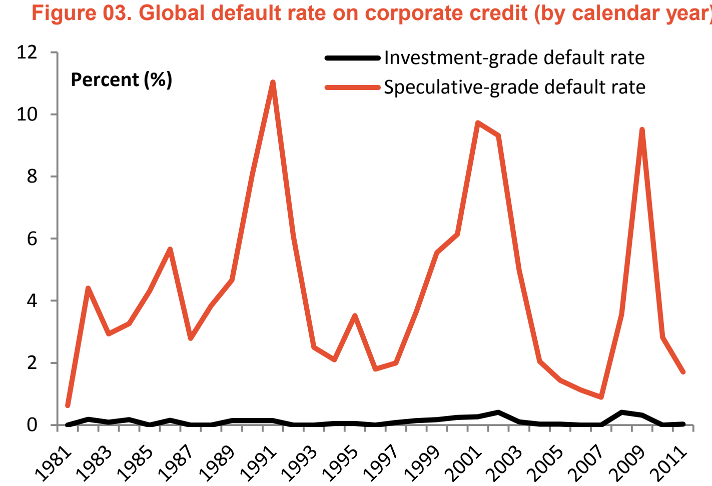
The pure credit risk component of the corporate bond market is traded in the form of credit default swaps (CDS). The spread of these derivative contracts encapsulates the sum of likely credit losses and the credit risk premium that compensates for the volatility of credit losses.

Figure 02. Corporate credit spread levels



Source: Barclays Capital

Figure 03. Global default rate on corporate credit (by calendar year)



Source: Credit Suisse, Towers Watson

Liquidity: conditions and premium

For investment grade credit, compensation for the embedded credit risk can only explain a part of the credit spread. A variety of our own estimates of the expected credit loss (actuarial spread) and the credit risk premia (see for example Figure 04) as well as CDS market pricing highlight that credit considerations reflect around half of the current spread on cash-credit in current markets.

The remaining share of the credit spread is due to the relative illiquidity of credit mandates when compared to government bonds. Corporate credit investments typically require a cash investment and funds typically consist of a large number of individual bonds. In particular, smaller issues can be quite difficult and costly to buy and sell. As a result, corporate bonds need to offer a liquidity premium on top of government bond yields to compensate for their relative illiquidity.

Current conditions

Over the past few years, we observed a marked change in the structure of corporate bonds markets. Before the credit crisis, liquidity premia were very low. It was a key characteristic of the pre-2008 credit boom that market participants – especially investment banks – had seemingly unrestricted access to liquidity. In their role as market makers for corporate bond markets, investment banks used their access to liquidity and "warehoused" corporate bonds on their balance sheet. This facilitated a very efficient buyer and seller market for corporate bonds – effectively, the market maker no longer had to match buyers and sellers and would use its warehouse instead. As a result, liquidity premia were extremely depressed during the period from around 2004 to 2007 (see Figure 04).

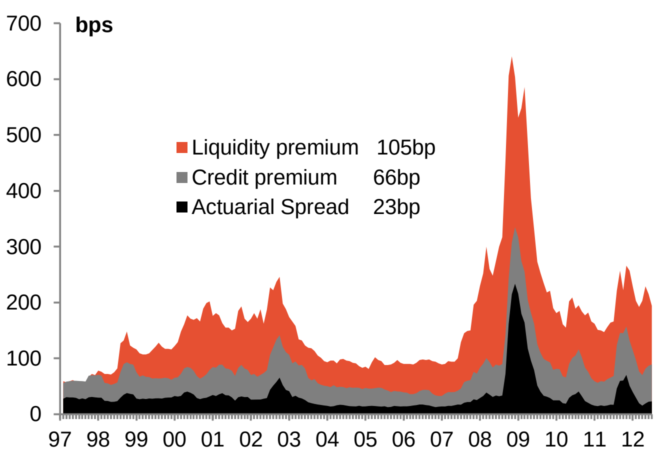
Liquidity conditions have changed dramatically since 2008 and investment banks now face greater demands on scarce capital. As a response, banks have sold-off their warehoused holdings of corporate bonds (see Figure 05). Market trading of corporate bonds has fallen significantly in response and corporate credit is now a much less liquid asset class than it was before the credit crisis. Not surprisingly, our estimate of the liquidity premium has gone up significantly and stands at around 100bp (=1%) for the US at the current point in time.

Any view on credit will depend on the liquidity requirement of an investor. Those who can tolerate the reduced ability to trade into and out of credit markets at short notice will find that corporate credit is now structurally more attractive than previously. If current market conditions prevail, investors will benefit from the higher level of spreads through a higher carry and thus higher returns over time. We do not expect the illiquidity element of the credit risk premium to revert to pre-2008 levels within the medium term.

Outlook for active managers

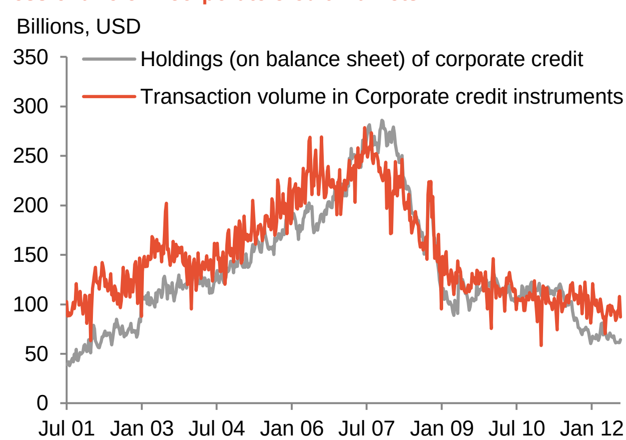
The changing structure of corporate credit markets will have an impact on which manager styles and which active strategies should perform well. Trading managers that operate with a high-turnover approach may struggle as they are faced with a limited universe of tradable corporate bonds, and/or must pay away a significantly greater proportion of alpha as transaction costs. On the other hand, managers that use a more fundamental, bottom-up approach to selecting corporate bonds should generate higher absolute returns, and skilled managers should be able to generate higher alpha from a less traded and hence more inefficient market.

Figure 04. Decomposition of US corporate credit spreads



Source: Merrill Lynch, Bloomberg LP, Towers Watson

Figure 05. Investment banks ("Primary dealers") are playing less of a role in corporate credit markets



Source: Federal Reserve Bank of New York

Summary of market views

	Outlook
Interest Rates	• Yield curves in all major nominal and real bond markets have range-traded in recent months – consistent with our forecasts. • Heightened risk-aversion and monetary easing continues to specifically and significantly benefit perceived safe haven bond markets, including US Treasuries, UK Gilts and German Bunds. • The depressed long-term path (10 years plus) of interest rates currently priced into yield curves is inconsistent with our medium-term 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 bonds are at risk of significant mark-to-market losses in the medium 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 moderately above central bank targets (with a chance of very high or low outcomes). This is due to a combination of likely excessively easy policy, currency intervention and medium-term commodity price pressures. • Forward breakeven rates remain modestly below our forecasts, but not significantly so. We therefore do not differentiate our views between inflation-linked and nominal bonds.
Credit	• Corporate credit offers modest value, with investment grade offering spreads broadly in line with previous recessions despite declines in 2012. Liquidity premiums are elevated relative to history, which we believe will remain the case for the foreseeable future. • We favour UK credit to other regions.
Equities	• On average, developed world equities are pricing in an outcome of relatively weak real earnings growth 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. However, this needs to be set against the significant near-term downside risks, especially related to systemic risks in Europe. • We remain neutral on equities overall. On a regional basis, our highest conviction overweight is to Asia ex-Japan relative to the developed world.
Foreign Exchange	• Our 12-to-24 month outlook for the euro is moderately bearish, although this has lessened given recent euro declines. A combination of low or no growth in Europe in 2012 and “lower-for-longer” ECB policy is likely to weaken the euro against the dollar. • Over the longer term our dollar outlook is moderately bearish relative to selective currencies – in particular steady dollar depreciation versus its main emerging market trading partners.
Emerging Markets	• China and other key emerging countries appear on track for modest economic recoveries after their recent slowdowns. • EM fixed income (local currency sovereign bonds and especially sovereign credit) remains moderately attractive in the near term, with local markets supported by central banks in an easing phase. Inflationary pressures and low real interest rates are important risks fro local bond performance one to two years out. • Our positive outlook for EM (ex-Eastern Europe) growth and selectively cheap valuations underpin our forecast for continued EM currency appreciation.
Commodities	• Over the longer term we think there is upside potential in selective commodity markets – those facing supply constraints (e.g. oil, copper, soybeans) – albeit with high volatility.

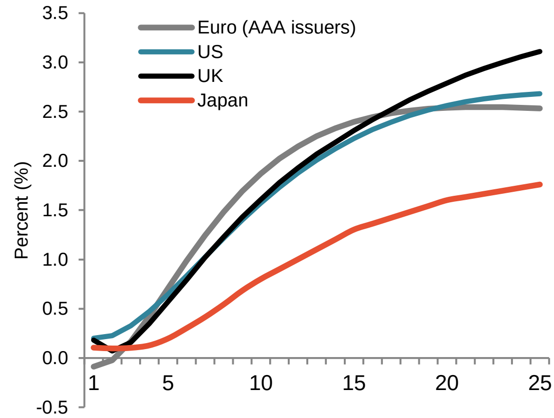
World markets statistics

Figure 07. Interest rates

	Latest	3 months ago	12 months ago
3-month US LIBOR	0.45	0.47	0.25
10 year US Treasury	1.57	2.03	3.02
10 year US Real	-0.57	-0.44	0.38
10 year UK Nominal Bond	1.61	2.25	3.18
10 year UK Real	-0.69	-0.55	-0.03
10 year German Bunds	1.45	1.80	2.80
10 year German Real	-0.68	-0.50	0.41
10 year AAA EUR Nominal Bond	1.87	2.47	3.06

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

Figure 08. Bond Yield Curves



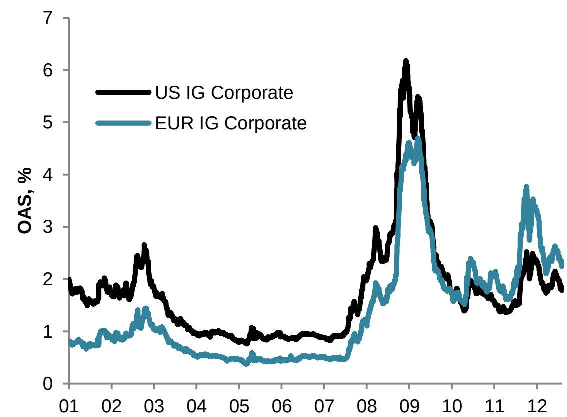
Source: Bank of England, European Central Bank, Federal Reserve, Bank of Japan

Figure 09. Credit markets

	Option adjusted spread (bps)		
	31/07/2012	30/04/2012	29/07/2011
Barclays Global Aggregate	82.5	86.2	77.6
Barclays US Aggregate	66.1	70.5	60.5
Barclays EM Aggregate	374.2	368.2	310.8
Barclays US Corporate IG	178.0	185.4	152.6
Barclays EUR Corporate IG	224.0	236.2	216.0

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

Figure 10. Investment grade (IG) credit spreads



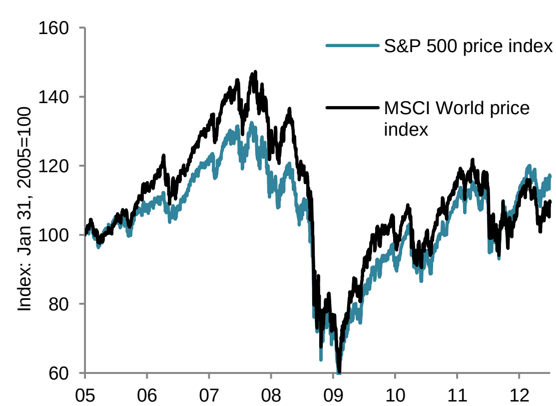
Source: Barclays Capital

Figure 11. Global equities

	Index	Current price/index level	Total return (12 month % change) Local Curr	USD
Global	MSCI AC World	336.0	1.7%	-3.1%
Developed	MSCI World	882.5	2.5%	-1.4%
Emerging	MSCI EM	42931.0	-6.6%	-13.6%
United States	S&P 500	1379.3	9.1%	9.1%
Euro area	FTSE Euro 100	2202.2	2.4%	-12.3%
Japan	Nikkei 225	8695.1	-11.6%	-12.6%
UK	FTSE 100	5635.3	0.7%	-3.9%

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

Figure 12. Global Equity Markets: Price changes



Source: MSCI, S&P

Distribution of ratings

We provide market views which rate the investment outlook for the market as Highly Attractive, Moderately Attractive, Neutral, Moderately Unattractive or Highly Unattractive (see definitions below). A list of all markets covered is available.

Definitions

Market Views:

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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