TOWERS WATSON

Global Markets Overview

Global Investment Committee, April 2013

In this issue

Figure 01. Our current views

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

Source: Towers Watson

Note: Changes from previous month indicated in bold

Short term: Mixed economic data and volatile market price action

Medium term: Our outlook is unchanged

Summary

- A combination of economic and policy events in the last two months has driven some quite volatile market price action, especially in government bond and commodities markets.
- Ultimately, we think most of these events have little bearing on the medium term fundamental outlook for asset markets. Therefore, our outlook is unchanged and the price moves in selective markets provide a modest opportunity to buy these assets a little more cheaply.

Economic and policy events

In the last two months, long maturity government bond yields have fallen by as much as 30-40 basis points across most major markets. Gold fell by around 15%, including a one day fall of 10%, causing knock-on negative returns in other commodities markets.

As always, we never know exactly why markets have moved, but the key factors for bonds appear to be:

- Some “flight to quality” because of sovereign risks in Cyprus. This was definitely an important factor for gold as Cyprus indicated it was planning to sell gold reserves to plug funding gaps, while other periphery European sovereigns did sell some gold, which led to “hot money” flowing out of the asset class
- More mixed short-term economic data, suggesting a slowing of US, Euroland and Chinese economies
- The start of an aggressive quantitative easing programme by the Bank of Japan. This has caused further significant declines in the yen, with the possibility that large Japanese institutions and corporations may move cash abroad given the risk of further yen weakness
- Some idiosyncratic technical factors, for example increased de-risking activity from UK pension schemes and other institutions, given the resolution of the calculation of RPI and equity price rises.

An unchanged outlook

We are now five years into the deleveraging and significant progress has been made in reducing debts relative to incomes. This is especially true in the US, although there is still significant further deleveraging required in Euroland.

Indeed, the recent minutes from the last Federal Reserve meeting show a careful discussion of the appropriate way and time to start tightening policy. They also gave an indication that, subject to healthy economic conditions, the rate of asset purchases may slow and then stop by the end of 2013. This is a useful indication that economic and policy conditions are unlikely to be the same in the next five years as they have been in the last five years. This is important because bond and equity markets are still discounting a very extended period of deleveraging. We continue to strongly favour equities over government bonds over the medium-term.

US economic growth

Acceleration in US housing to support US growth

Recent US growth statistics have become more mixed after a strong first quarter. This is expected, given the US is facing a major drag on activity for the next four-to-six months from the government sector, due to tax hikes at the start of the year and recently announced spending cuts. However, once you account for this drag, underlying growth in the private sector appears robust and likely to accelerate as the negative impact from government tightening fades in the second half of the year. In addition, the Federal Reserves is likely to keep policy highly stimulative.

While most sectors in the US economy look to be normalising and now appear more capable of a "normal" cyclical expansion, there is now strong evidence that the important US housing market bottomed during the first quarter of 2012. Short of a further significant shock, we now believe house prices are following a sustainable upward trend. Alongside declining mortgage rates, the continued work-through of defaulted and underwater loans has led to a significant improvement in the credit quality of many American homeowners. We believe that the recent trend improvement in the US mortgage market is sustainable and will continue to be a support to US growth for the next few years. Fundamental determinants of house prices all point towards improved demand and a reduced supply pipeline.

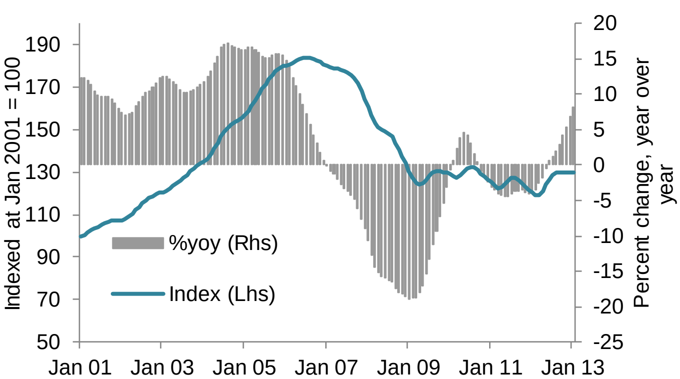
There are various asset classes that are leveraged to improving US housing fundamentals. One example is US non-agency residential mortgage-backed securities ('RMBS'). We cover some aspects of these in this report. We emphasise that they are complex securities so, if you are interested in them, please do contact your investment consultant for more detailed information.

US housing market dynamics, driving growth

Whilst recent US growth indicators have been a little weaker than the strong first quarter activity measures, we believe that the current expansion is on track. The recent outperformance of the US economy, relative to other developed markets, is partly due to the stabilisation and subsequent improvement in the housing market.

House prices appeared to reached a sustainable low during the first quarter of 2012. Since then housing-related activity has added approximately 0.4% points to the 1.6% of US real GDP growth. We expect this driving force to continue in the coming years.

US house prices – Case-Shiller index



Source: Bloomberg LLP, Towers Watson

US mortgage rates

Source: Bloomberg LLP

US economic growth

Housing market reaches a sustainable low

Improving housing market dynamics

Several dynamics are driving the recent pick-up in US housing. Whilst the increase in household net new borrowing has not been that significant since the 2008 financial crisis, near-record low mortgage rates have helped to sustain gross borrowing (even at low levels). On the supply side, the significant reduction in house inventory levels has become a support to prices, whilst supply from foreclosures appears to be in decline. A modest pick-up in leverage will continue to support an improved housing outlook in the coming years.

Housing is important because positive and negative housing trends tend to be self-reinforcing. As house prices appreciate, household wealth and perceived credit quality improves, allowing for increased borrowing against collateral leading to greater housing turnover, demand and further price increases. This trend is also true in the reverse (ie with declining prices). Currently, we believe the fundamentals discussed above are likely to provide steady tailwinds to the current 'up-trend'.

Wider economic recovery expected to be broad-based over coming quarters

In addition to our expectation for further housing market improvement, we also expect the wider US economy to reaffirm its improving trend over coming quarters. As part of this view, we expect employment levels to increase which will lower home defaults and delinquencies.

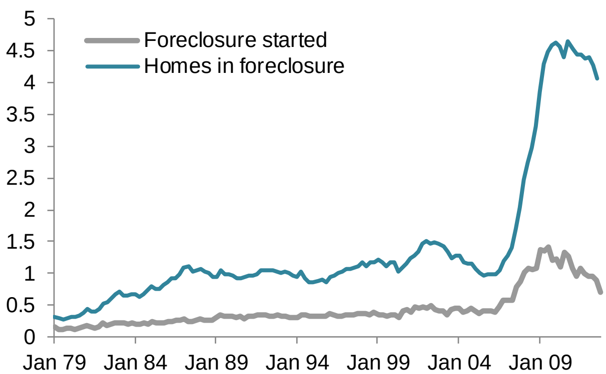
Feedback loops provide positive fundamental underpinning to non-agency RMBS markets

The US RMBS market provides exposure to this positive dynamic. In particular, as the housing market improves, borrower credit quality increases reducing potential losses and enhancing the potential of prepayments. Whilst we expect the last factor to remain muted in the coming year, house price appreciation provides direct price stimulation to the market.

Complexity implies governance requirements are significant

An investment in RMBS is not appropriate for all investors. RMBS instruments tend to be complex in nature and therefore investors should consider carefully whether they have the appropriate governance requirements to make such an investment.

US foreclosures have declined since peaking in 2009



Source: Bloomberg LLP

US unemployment continues its recent decline

Source: Bloomberg LLP

US economic growth

Non-agency RMBS offer an attractive investment opportunity

Whilst we believe there is important top-down fundamental support for an investment in RMBS, we also note that a top-down analysis cannot hope to capture many of the idiosyncratic risks associated in investing in the asset class.

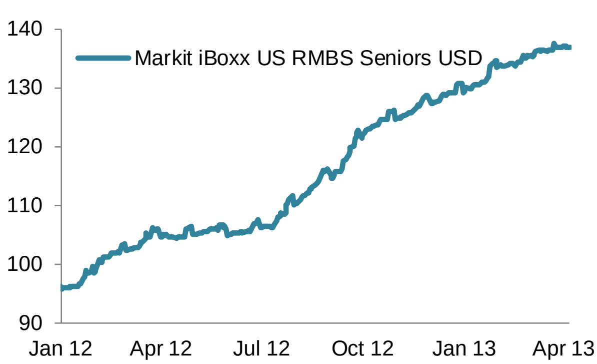
In particular, a bond-by-bond analysis is crucial to consider the impact of such issues as regional differences, regulation, servicing differences (including litigation risks/returns), underlying loan pool differences, modifications, securitisation structure and cash flow mismatch. Therefore, we expect a skilled active manager that is able to understand and value risk at a bond level to add significant value in this area.

Underlying US growth remains reasonable, non-agency RMBS offers an attractive investment

In conclusion, we believe underlying private-sector growth in the US remains solid. Government tightening will likely have a small negative effect in the next few months but will fade towards the end of the year and economic activity is likely to be supported by continued improvement in the housing sector.

As an asset class which is levered to house prices, we believe non-agency US RMBS provides an investment opportunity to capture this dynamic. RMBS performed very strongly last year, along with most other lower quality credit markets. Going forward, given lower starting yields, upside returns will be more moderate. However, we think the risk of credit losses is also low given the sustainability of the recovery in US housing, which makes the asset class moderately attractive. However, the appropriateness of an investment must be carefully considered due to complexity and the requirement for active management.

US RMBS total return index



Source: Markit

Definitions:

- *Residential Mortgage Backed Securities (RMBS)*

Securitisation involves bringing together a set of claims on cash flows and issuing bonds against these pooled claims. In the case of the above a number of residential mortgages are pooled together.

- *Agency / Non-agency*

The US mortgage market is essentially split into two main segments, agency and non-agency. Agency mortgages, also called conforming, have been purchased by one of the government sponsored enterprises (Fannie Mae, Freddie Mac and Ginnie Mae) and benefit from an explicit credit guarantee. That is, if the mortgage payer defaults, the GSE will insure the owner of the mortgage bond against loss. Non-agency mortgages do not benefit from this enhancement and therefore come with greater risk of loss.

Summary of market views

No major changes

Interest rates

- Policy guidance, global central bank asset purchases, large holdings of bonds by investors for “safe haven” purposes and muted inflation pressures have all helped to keep yield curves low in major nominal bond markets over the past year. In the last month, yields have fallen back to below start-of-year levels.
- The depressed long-term path for interest rates that is currently priced into yield curves is inconsistent with our three-to-five year forecasts for an economic recovery that starts to accelerate in 2014 in the developed world. Equivalently, yield curves currently offer a very low or negative bond risk premium. Both factors suggest that nominal bonds are at risk of losses relative to cash in the medium term, initially as risk aversion continues to moderate and then as short rates eventually rise, driving bond yields above current forward rates. We retain a highly unattractive rating on both nominal and real safe-haven bond markets.
- For cash-benchmarked investors our negative bond stance suggests reducing duration risk in portfolios. For investors using long bonds to hedge liability risk, these views should be implemented by underweighting relative to a full hedge.

Inflation

- Our base case for developed world inflation over the next five years is for moderately higher inflation in countries with limited economic slack (US and Germany), with a still higher than normal chance of very high or low outcomes.
- Breakeven inflation rates continue to discount an inflation environment broadly in-line with central bank targets. With moderate economic growth likely to contain inflationary pressures in 2013 and inflation-pricing broadly in-line with our expectations, there are only modest opportunities to differentiate between nominal and inflation-linked bonds.

Credit

- Price action has been supported by both liquidity provision from central banks and strong underlying company balance sheets over the last year. High returns across the credit spectrum have lowered spreads significantly and reduced prospective excess returns to broadly average levels.
- We retain our neutral stance on investment grade corporate credit markets.
- High yield markets offer modestly more risk-adjusted value than investment grade. However, given the sizeable spread narrowing in the last five months, our advice is nuanced. For investors with an overweight allocation we recommend gradually reducing this as spreads narrow further. For those who are neutrally positioned we recommend maintaining this exposure, give the more limited scope for above average excess returns from here.

Equities

- The recent equity rally has pushed-up equity valuations from a low starting point. We estimate that about 20-30% of our three-year valuation case for world equities has been re-priced year-to-date. Despite this re-pricing, equities continue to discount excessively weak future earnings and economic conditions.
- Given the positive valuation case, our forecasts for accelerating growth in the second half of 2013, easy policy conditions and significant scope for investors and corporations to switch out of cash and into equities we retain our moderately attractive stance. We continue to strongly favour equities over bonds.

Foreign exchange

- Our primary view amongst the major currencies is an expectation of moderate future euro weakness, reflecting the debt imbalances that still exist within the Euro area and our forecast for weak growth over the next two years. This has, in part, been observed in the last two months.

Emerging markets

- EM currencies have appreciated significantly over the last few years, removing part of their previous strong valuation case. However, selective cheapness relative to what is discounted by currency forwards and improving economic growth and capital flow prospects continue to drive our moderate overweight position.

World market statistics

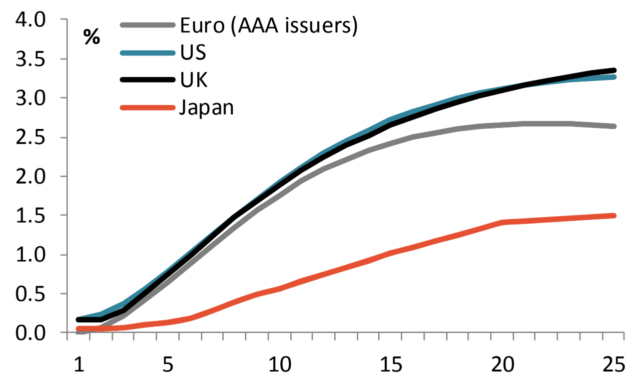
As at 31 March 2013

Interest rates

% pa	31/3/13	3 months prior	12 m'ths prior
3-month US LIBOR	0.28	0.31	0.47
10 year US Treasury	1.92	1.81	2.35
10 year US Real	-0.68	-0.68	-0.09
10 year UK Nominal Bond	1.89	1.88	2.33
10 year UK Real	-1.39	-0.74	-0.57
10 year German Bunds	1.32	1.38	1.99
10 year German Real	-0.93	-0.73	-0.35
10 year AAA EUR Nominal Bond	1.76	1.72	2.60

Source: Bank of England, Deutsche Bundesbank, Federal Reserve, European Central Bank, JP Morgan

Bond yield curves



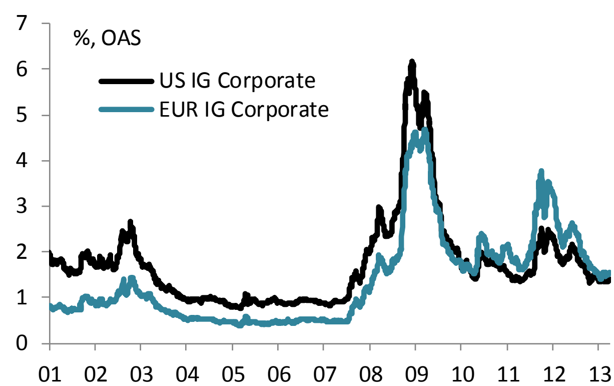
Source: Bank of England, European Central Bank, Federal Reserve, Bank of Japan

Credit markets

bps	Option adjusted spread		
	31/3/13	3 months prior	12 m'ths prior
Barclays Global Aggregate	65.1	62.9	79.1
Barclays US Aggregate	55.7	53.3	63.7
Barclays US Corporate IG	139.1	141.4	176.3
Barclays EUR Corporate IG	156.4	150.6	220.0

Source: Barclays Capital

Investment grade credit spreads



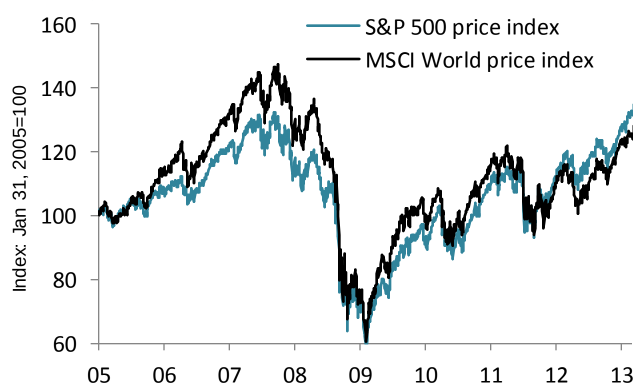
Source: Barclays Capital

Global equity price action

	Index	Current level	Total return prior 12 months: Local currency	Total return prior 12 months: US dollars
Global	MSCI AC World	386.6	13.7%	11.2%
Developed	MSCI World	1024.7	14.9%	12.5%
Emerging	MSCI EM	46357.0	2.5%	2.3%
United States	S&P 500	1569.2	14.0%	14.0%
Euro area	FTSE Euro 100	2431.4	14.8%	10.7%
Japan	Nikkei 225	12397.9	23.0%	7.6%
UK	FTSE 100	6411.7	15.4%	9.7%

Source: FTSE, MSCI, S&P

US and global equity moves



Source: MSCI, S&P

Disclaimer and rating explanation

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.