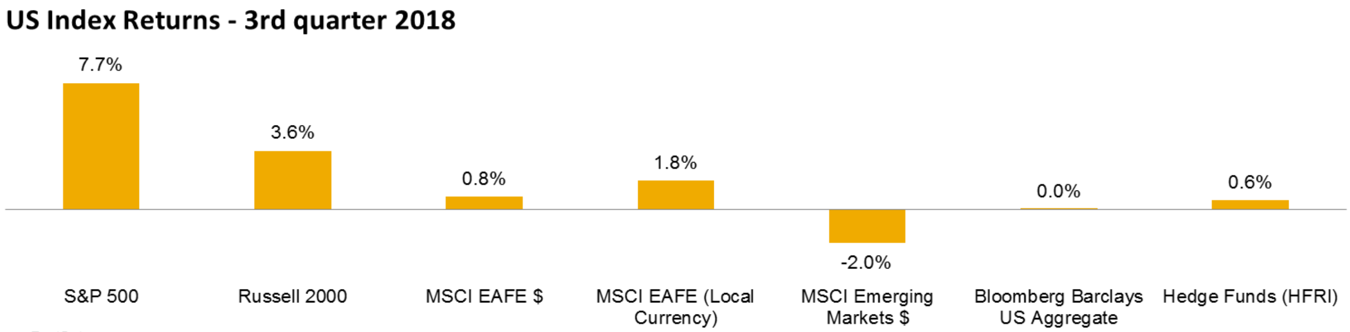
Quarterly Investment Outlook

October 2018

October 26, 2018



Source: FactSet

Indices cannot be invested in directly. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect fees or expenses. **Past performance is no guarantee of future results**

Summary

- Renewed volatility and large divergence between the US and other markets confirm our view that risky assets are on rougher ground.
- A robust US expansion is an outlier in a mediocre global economy facing headwinds of rising rates, high oil prices and trade uncertainty.
- The US bond market's price reset largely reflects a move in expected interest rates over time. Inflation expectations remain contained.
- Current bond yields are close to our fair value estimates, taking us towards a duration neutral stance. There is some risk, however, that yields go above our fair values for a time.
- The deterioration in credit quality brings dangers. At current investment grade spreads, overweight credit positions are inappropriate.
- Emerging market pressures, especially in currency, are bringing value for investors looking to build positions on a multi-year horizon.
- Bank loans are a bit overbought now even though their strategic value is intact. Buying high yield bonds now is too risky.
- The transition to less friendly conditions for equities continues to point towards incremental de-risking. Large scale de-risking can wait.
- High geopolitical risk and economic uncertainty can no longer be ignored in valuing investments. It may help to apply an uncertainty discount to valuation metrics used to assess attractiveness.

Q3: US versus rest of the world?

Equities delivered well in the third quarter. Large US and non-US market divergence continued, reflecting relative economic performance; US activity stayed buoyant, while the rest of the world struggled. Emerging markets lagged badly, impacted by higher US interest rates and currency weakness. US bond yields rose during the quarter, denting returns. Coming into October, the market mood for taking risk is much more nervous. Volatility is back again.

Global growth losing steam?

A key cause of the volatility spikes this year is concern over the global economy. The US economy has been growing strongly, with the fiscal stimulus at the end of last year spurring growth momentum. However, the rest of the world has been less fortunate. Europe has given up the buoyancy seen last year, growth returning to much more modest levels. Much the same is true of Japan. China remains in 'deleveraging' mode; as it goads enterprises to be more efficient and less reliant on debt, growth could stay subdued. For emerging economies at large, the strength of the US dollar and rising US interest rates have brought strains as currencies are pulled lower and dollar debt financing turns more expensive. Even as the US economy stays robust, creeping weakness elsewhere is weighing – a key indicator of global economic activity is losing ground (see chart).

Seen glass 'half full' rather than 'half-empty', the growth picture could be seen as a 'plateau' rather than a slowdown. After all, growth in absolute terms is still better than the low in 2015/16. Even so, markets see grounds for concern. First, the US economy will likely slow going into 2019 as fiscal stimulus will have passed through and the impact of higher interest rates is felt. Second, higher crude oil prices which lower spending power will have an effect. Thirdly, though the direct impact of higher trade tariffs is still small, it could become a much bigger issue over time. This is because business will respond to growing trade policy uncertainty. Much as Brexit uncertainty has already slowed investment in the UK, the chances are that investment intentions will cool elsewhere, as companies hesitate to commit new capital not knowing what tariff regime awaits them. All told, these factors point to a rising risk that the current growth plateau turns into an outright slowdown in 2019.

Global growth loses some momentum

Source: FactSet, as at 25 October 2018

A reset to US interest rate expectations

The past year has seen the largest US interest rate rises in a very long time. The US Federal Reserve raised interest rates four times, in effect doubling short-term interest rates. The Federal Reserve's language in explaining monetary policy has shifted significantly, policy being no longer described as 'accommodative'. While expectations for the so-called long-term neutral policy interest rate from the Federal Reserve's senior policy makers does not seem to have risen beyond 3%, under Jerome Powell (the chair of the Federal Open Markets Committee), the key message for markets is that the central bank is willing to raise rates *above* this neutral level should economic conditions demand it.

For these reasons, and because the Federal Reserve has demonstrated by its actions that it is willing to follow through on its own projections for policy rates, the bond market is now much less sceptical of the bank's resolve. As a result, expectations for where the key Federal funds policy rate will reach by 2020 have shifted markedly upwards, as the chart below shows.

Expectations shift on where U.S. Fed Funds rate will be by 2020

Source: FactSet, as at 25 October 2018

Bond yields driven higher mainly by changed expectations for 'real' rates

The overall impact of this is a reset to interest rate expectations many years ahead, transmitted to the US yield curve. The bigger change, coming as it does from a reset to views on the Federal Reserve's interest rate path, has been to the front end of the yield curve. The long-end has responded far less, flattening the curve considerably. Even so, 30 year yields moved up close to 50bps in a matter of a just a few weeks from late August onwards.

When we look at how long duration bond yields move in this way, it is revealing to look at the key drivers in the move. Yield changes come from three sources. First, it could be a change in inflation expectations coming through in higher yields. Second, it can be a change in expected 'real', i.e. after inflation, interest rates. The third and final element, labelled a 'bond risk premium' or 'term premium' could also be at play; this is an additional element of longer-dated yields to compensate investors taking on interest rate and inflation risk on a long duration bond.

Strikingly, almost the entire move in yields seen recently has come from the 'real' interest element. The inflation element has barely moved, and neither has the term premium. Long-dated inflation as priced by the bond market is still around 2% or even lower, suggesting ample confidence that the Federal Reserve will achieve its 2% inflation target. The term premium also has not moved either staying in negative territory. The lack of a move here is surprising. Given the Federal Reserve is now actively withdrawing its support to the bond market through its balance sheet contraction policy, less support from such a (previously) big buyer might have been expected to move the term premium into modest positive territory. This has not happened.

Duration views near neutral

With these yield moves, our duration views have approached much more neutral levels, suggesting a case for reducing government bond underweights. At the time of writing, market volatility has been lowering yields again, but assuming this trend does not continue, it appears reasonable now to argue that yields are much nearer to where they should be. This is in contrast to what we had seen for a number of years. The yield curve moves through September and early October, and the implied signalling of where yields would move to in the next few years had closed the gap with our views very significantly.

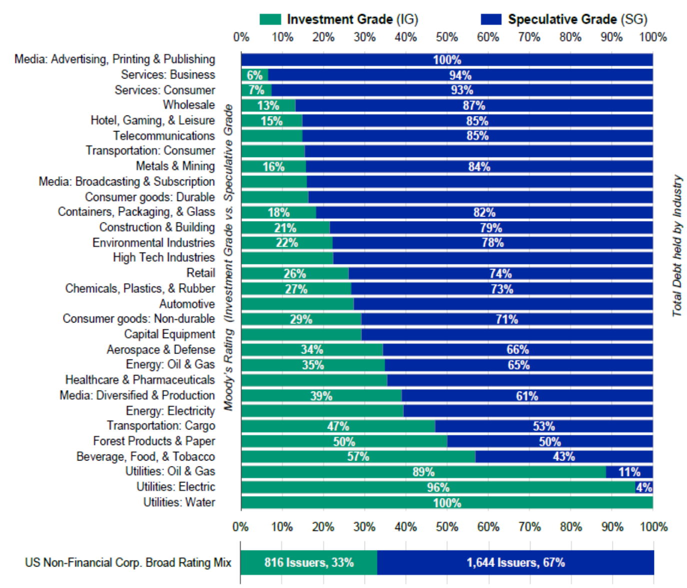
There is some hesitation, however, in arguing for being fully duration neutral. This is to do with near-term risks that still, on balance, suggest that yields might have more to climb. Even though fundamentals suggest that further yield rises might be an 'overshoot', the risks from inflation expectations moving higher given the risks of a pick-up in US wage inflation, or from a rise in the still negative term premium cannot be ignored. Both still point towards some upside risk on yields.

Where does that leave us? Our view sees it reasonable to move towards being duration neutral now. It may pay to phase the move to take advantage of possibly still higher yields for a time.

US credit quality has frayed

US credit spreads are expensive against our long-term fair value estimates, though the valuation appears better for longer durations. The difficulty with credit is less this than the difficulty that is likely to be caused by a likely credit market downturn. This could be caused by weak economic conditions or a sharp rise in interest rates, and particularly, both. Spreads at current levels are not allowing for the credit outlook over the next two to three years during which we would expect spreads versus US treasuries to widen. Leverage levels among many corporate issuers have moved considerably higher, and many sectors are now dominated by speculative grade issuance (see Moody's data below). As we know, the average credit quality even within investment grade indices has been migrating towards the lowest (BBB) grade.

Some sectors' debt dominated by speculative grade



Source: Moody's, as at September 2018

This deterioration in credit quality keeps us cautious on prospects. While there is still little near-term danger for credit markets, it is also clear that it would be prudent to rein credit overweight positions down towards neutral. The next move we make will probably be to prefer government bonds to credit.

Emerging currencies now attractive for the longer-term …

The sell-off in emerging market assets this year has brought much value back. Given the twin challenges of US dollar strength and rising bond yields, we had turned a bit more cautious in local emerging debt in the Spring. However, a widely used basket of emerging currencies has dropped 10% since April (see chart below) and many now look undervalued. We still hesitate to take an outright positive stance because broad market conditions are making it hard for risky assets to realise value yet. That said, for those strategically building positions and taking multi-year return views, this is an opportunity to start buying. Separate to the currency issue, valuations in emerging market equities are now particularly attractive relative to their developed counterparts.

Emerging market currencies at historic lows

Source: J.P. Morgan, as at 25 October 2018

… We are reining loans back

Elsewhere, we stay wary of high yield, given stretched valuations. It is definitely too late to buy but it may also be too early to sell. Enthusiasm for secured loans has waned too. US loans have done well, in line with our view, but now look 'overbought' given strong retail interest. Longer-term attractions of secured loans in portfolios remain intact.

Transition environment confirmed

Recent market conditions of spiking volatility confirm our view that we are in a market transition moving between conditions that favour risk taking to the next phase when risk assets are likely to fall sharply. As expected, equities are oscillating in mini-cycles of optimism and pessimism. The classic hallmark of such transitions is that equities find it harder to ascend, the underlying trend moving flatter. We have already seen strains appear, with most non-US markets struggling to make gains. A full blown 'bear market' with equity market falls exceeding 20% does not appear to be likely just yet, though it has become more likely over the medium-term.

… Incremental rather than full de-risking is better

What should the response be? At this stage, a fully de-risked approach still appears premature, as conditions for large-scale capital losses are not yet in place. It is prudent, however, to de-risk incrementally, taking profits on market strength, taking advantage of portfolio diversifiers where practicable, favouring conservative strategies within asset classes and potentially using overlay or other protection strategies. In short, priorities need to shift gradually from return-seeking to capital protection.

Commodities remain a good equity diversifier

Having taken a positive energy-driven stance on commodities through 2017/18, our view moderated a few months ago after a period of considerable price strength. The thinking is that crude oil price gains from here do not look sustainable. That said, price risk is still tilted to the upside given the risks of geopolitical supply disruption and inflation surfacing at the end of a long economic expansion. We continue to see commodities as a useful diversifier for equities in current markets.

What to do about geopolitical risk?

It is hard to ignore the uncertainty over the current international economic order, given trade and other conflicts, alongside shifting political currents that challenge the economic status quo.

What should be done? It may be that markets are now beginning to factor these bigger picture risks into asset prices, even though the risks of disruption are very difficult to assess. Our view is that where appropriate, some level of 'uncertainty discount' needs to be taken into account in assessing relative and absolute value across asset classes. If an investment opportunity appears to offer good value on the standard valuation metrics, the question is whether it still appears attractive once potential impact from big picture risks such as trade conflicts is allowed for.

Legal Disclosures and Disclaimers

This document has been produced by Aon Hewitt's Global Asset Allocation Team, a division of Aon plc and is appropriate solely for institutional investors. Nothing in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. It should not be taken as financial advice and action should not be taken as a result of this document alone. Consultants will be pleased to answer questions on its contents but cannot give individual financial advice. Individuals are recommended to seek independent financial advice in respect of their own personal circumstances. The information and opinions contained herein is given as of the date hereof and does not purport to give information as of any other date and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice. The delivery at any time shall not, under any circumstances, create any implication that there has been a change in the information set forth herein since the date hereof or any obligation to update or provide amendments hereto. The information contained herein is derived from proprietary and non-proprietary sources deemed by Aon Hewitt to be reliable and are not necessarily all inclusive. Aon Hewitt does not guarantee the accuracy or completeness of this information and cannot be held accountable for inaccurate data provided by third parties. Reliance upon information in this material is at the sole discretion of the reader.

This document does not constitute an offer of securities or solicitation of any kind and may not be treated as such, i) in any jurisdiction where such an offer or solicitation is against the law; ii) to anyone to whom it is unlawful to make such an offer or solicitation; or iii) if the person making the offer or solicitation is not qualified to do so. If you are unsure as to whether the investment products and services described within this document are suitable for you, we strongly recommend that you seek professional advice from a financial adviser registered in the jurisdiction in which you reside. We have not considered the suitability and/or appropriateness of any investment you may wish to make with us. It is your responsibility to be aware of and to observe all applicable laws and regulations of any relevant jurisdiction, including the one in which you reside.

Aon Hewitt Limited is authorized and regulated by the Financial Conduct Authority. Registered in England & Wales No. 4396810. When distributed in the US, Aon Hewitt Investment Consulting, Inc. ("AHIC") is a registered investment adviser with the Securities and Exchange Commission ("SEC"). AHIC is a wholly owned, indirect subsidiary of Aon plc. In Canada, Aon Hewitt Inc. and Aon Hewitt Investment Management Inc. ("AHIM") are indirect subsidiaries of Aon plc, a public company trading on the NYSE. Investment advice to Canadian investors is provided through AHIM, a portfolio manager, investment fund manager and exempt market dealer registered under applicable Canadian securities laws. Regional distribution and contact information is provided below. Contact your local Aon representative for contact information relevant to your local country if not included below.

Aon plc/Aon Hewitt Limited
Registered office
The Aon Center
The Leadenhall Building
122 Leadenhall Street
London
EC3V 4AN

Aon Hewitt Investment Consulting, Inc.
200 E. Randolph Street
Suite 1500
Chicago, IL 60601
USA

Aon Hewitt Inc./Aon Hewitt Investment Management Inc.
225 King Street West, Suite 1600
Toronto, ON
M5V 3M2
Canada

Appendix: Index Definitions

S&P 500 Index – The market-cap-weighted index includes 500 leading companies and captures approximately 80% of available market capitalization.

Russell 2000 Index - The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

MSCI EAFE Index $ - The MSCI EAFE Index is designed to measure the performance of the large and mid-cap segments of developed European Australasian and Far East Markets. The index covers approximately 85% of the free float-adjusted market capitalization and is measured in USD dollar terms.

MSCI EAFE Index (Hedged) - The MSCI EAFE hedged Index is designed to measure the performance of the large and mid-cap segments of developed European Australasian and Far East Markets. The index covers approximately 85% of the free float-adjusted market capitalization and is measured in hedged dollar terms.

MSCI Emerging Markets Index – The MSCI Emerging Markets Index captures large and mid-cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country and is measured in USD terms.

Bloomberg Barclays Capital Aggregate Index - The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

HFRI: The Hedge Fund Research, Inc. Monthly Indices (HFRI) are fund-weighted (equal-weighted) indices. Unlike asset-weighting, the equal-weighting of indices presents a more general picture of performance of the hedge fund industry. Any bias towards the larger funds potentially created by alternative weightings is greatly reduced, especially for strategies that encompass a small number of funds. All single-manager HFRI Index constituents are included in the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database.

Contact Information

Tapan Datta
Aon Hewitt
Retirement and Investment
Global Asset Allocation Team
+44 (0)20 7086 9076
tapan.datta@aonhewitt.com

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For further information on our capabilities and to learn how we empower results for clients, please visit http://aon.mediaroom.com.

Aon Hewitt Limited
Registered in England & Wales No. 4396810
Registered office: The Aon Centre | The Leadenhall Building | 122 Leadenhall Street | London | EC3V 4AN