Five-Year Capital Market Outlook

Asset Research Team
Europe

February 2019

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Surviving and thriving in a late-cycle environment

Summary: A trilogy of challenges

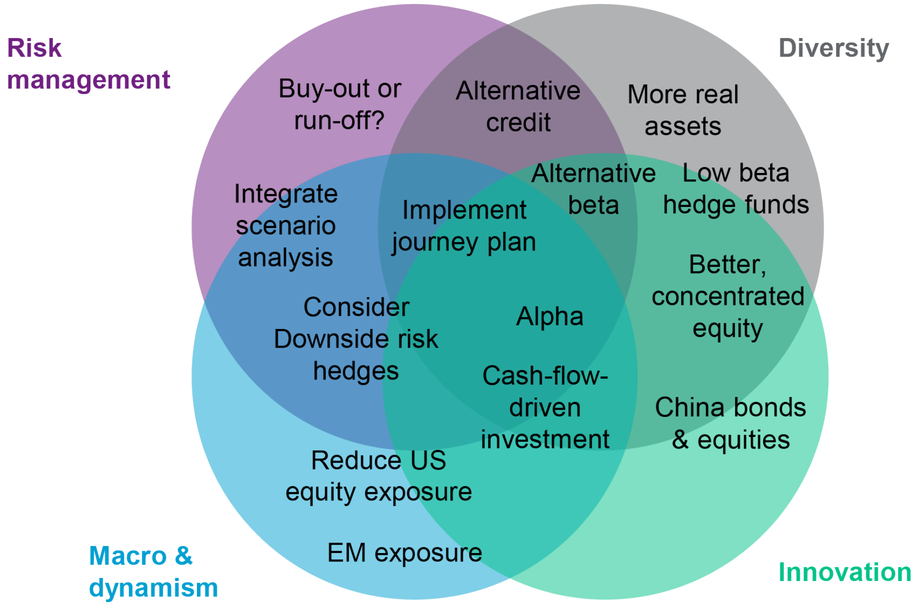
- **First,** we expect a material slowdown in growth in most of the major economies in 2019, with downside risks rising as we move into 2020, putting pressure on the operating environment of many corporate sponsors.
  - The main driver of weaker conditions is the gradual tightening of financial conditions, as the major central banks raise interest rates and/or withdraw money from the financial system.
  - We believe that a recession in one or more of the major economic regions is likely over the next three years – a more cautious view than in 2018.
- **Second,** relative to our medium-term outlook, we think valuations for growth-related assets are still high and expect low returns on average over five years, undermining defined benefit (DB) funded ratios and defined contribution (DC) members' account values.
- **Third,** lower bond yields could push projected benefit obligations/annuity costs higher, further undermining funded ratios and DC members' savings adequacy.

Five portfolio priorities for a surprise-free 2019/2020

- **Diversify:** Relative to equity-heavy peer groups, diversification is not always painless, but we remain firmly of the view it will prove correct.
- **Reduce unrewarded risks:** Manage liability risk, drive capital efficiency, and integrate scenario analysis to manage financial and extra-financial factors.
- **Macro and dynamism:** Dynamically managing risk is accessible; dynamism to create long-term value is hard.
- **Innovate through alpha:** In these conditions, the value of skilled active management is outsized; our track record shows it can be found.
- **Innovate to find diversity:** China – a new and diversifying set of assets for investors.

Key actions from a macro viewpoint also make sense through other portfolio construction lenses

At Willis Towers Watson, we believe no single approach to portfolio construction can yield 'the answer'. Therefore, we consider the problem through multiple lenses, four of which are displayed opposite – our delegated/outsourced-CIO portfolios capture more but we simplify for illustration. The diagram shows that ideas that make sense based on our macro views will tend to make sense anyway.



Section 1

At a glance – Asset performance in 2018 and our global outlook

2018 in review: Classic late-cycle moves

In our 2018 outlook, we noted that pricing for financial assets had a more optimistic view for future economic and corporate conditions than we thought likely.

In 2018, almost immediately, this view seemed to come to fruition with nearly all risky asset markets suffering a poor first quarter. However, strong economic growth – in the US especially – and improving risk sentiment led to a rebound in returns in Q2 2018. From mid-year, monetary tightening by central banks started to have a material impact on markets, with tightening global liquidity pushing up government bond yields and putting pressure on funding conditions for emerging countries, especially Argentina and Turkey. Tighter liquidity and concerns that this would slow growth caused a broader market sell-off in Q4.

Overall, a diversified portfolio of assets outperformed an equivalent risk comparator portfolio, 60% equity/40% government bonds, reversing the outcome in 2017. This asset price behaviour is fairly typical of late-cycle environments.

Our outlook in a nutshell

Despite the fall in most asset prices in 2018, we believe markets continue to misprice rising downside risks. Over the next few pages, we highlight our forward-looking views for all major asset markets by comparing the economic and fundamental conditions implied by market pricing and our outlook for conditions.

In summary, our global outlook is as follows:

- **Bonds:** After recent yield declines, developed world bond markets are now pricing-in that cash rates will remain at current levels (e.g., in the US) or rise very gradually. Based on our central outlook for an economic slowdown or recession, we expect policy rates to be cut in 2020/21 – below what is priced-in.
- **Credit:** Markets continue to price in an average at best level of default and downgrade risk over the medium term. Our outlook is for economic conditions, corporate cash flows and funding to be weaker than markets are pricing-in, given our forecast for slower economic growth in 2019 and recession likelihood over the next three years.
- **Equities:** While valuations have improved after 2018 price falls, investor expectations for future earnings growth are still moderate. We expect economic growth and earnings growth to be lower than market expectations.

Overall, relative to our medium-term outlook, we think valuations for growth-related assets are still high and expect low returns, on average, over five years.

Investors reappraised risk throughout 2018: Ranking asset returns in 2017/18

	14	13	12	11	10	9	8	7	6	5	4	3	2	1
2017	0.00%	US Gov bonds 1.20%	REITs 1.80%	TIPS 2.20%	Global Gov Bonds 2.50%	IG Credit 4.60%	Commodities 5.80%	High Yield 7.20%	Hedge Funds 7.40%	EMD (HC) 9.10%	Preferred portfolio 9.20%	60/40 Comparator 10.30%	DM Equities 15.50%	EM Equities 22.70%
Q1 2018	REITs -7.70%	DM Equities -3.00%	EM Equities -2.50%	EMD (HC) -2.10%	60/40 Comparator -2.00%	IG Credit -1.70%	US Gov bonds -1.50%	TIPS -1.20%	High Yield -1.10%	Preferred portfolio -0.90%	Hedge Funds -0.50%	Global Gov Bonds -0.50%	0.00%	Commodities 2.20%
Q2 2018	EMD (HC) -4.20%	EM Equities -3.10%	High Yield -1.70%	IG Credit -1.10%	US Gov bonds -0.50%	Global Gov Bonds -0.20%	0.00%	TIPS 0.20%	Hedge Funds 0.30%	60/40 Comparator 1.50%	Preferred portfolio 2.50%	DM Equities 2.50%	Commodities 7.80%	REITs 11.90%
Q3 2018	TIPS -1.50%	US Gov bonds -1.20%	EM Equities -1.00%	Global Gov Bonds -0.30%	Hedge Funds 0.00%	0.00%	IG Credit 0.20%	REITs 0.90%	Commodities 1.20%	Preferred portfolio 1.60%	High Yield 1.60%	EMD (HC) 1.70%	60/40 Comparator 2.60%	DM Equities 4.50%
Q4 2018	Commodities -23.00%	DM Equities -13.90%	60/40 Comparator -8.00%	Hedge Funds -6.40%	EM Equities -5.80%	Preferred portfolio -4.80%	High Yield -3.70%	REITs -3.30%	EMD (HC) -1.90%	TIPS -1.10%	IG Credit -0.50%	0.00%	Global Gov Bonds 0.80%	US Gov bonds 2.00%

Sources: Bloomberg/Barclays, JP Morgan, MSCI, HFRI, S&P, FTSE, ICE BofAML, Willis Towers Watson

Notes: The 60/40 comparator represents a portfolio of 60% DM equities/40% global government bonds in each period. Our preferred portfolio is represented by Willis Towers Watson's Partners' Fund, gross of top-level management fees; returns are excess returns above cash.

Section 1

At a glance – our outlook for markets

- Across developed markets, forward cash rates are pricing low levels of central bank tightening to achieve adequate GDP growth rates and inflation.
- The US, Australia and Canada have the most room for central banks to ease below current levels.
- Rates in Japan and Eurozone remain constrained by the lower bound.

- Yield curves are pricing-in small moves in intermediate yields over the next five years. In the near term, curves could modestly steepen.
- Our forecast for slowing growth over the next three years implies nominal bonds should offer attractive returns in markets with moderate yield levels.
- Japanese and Eurozone curves are hampered by the lower bound and do not offer much protection during a negative growth outcome.

- US real yields are the highest in developed markets; breakevens look low.
- UK real yields appear low, relative to economic conditions.

- Euro credit spreads remain low and underprice stagnation risk.
- EM sovereign spreads appear to price a reasonable probability of defaults in aggregate.

- Following spread widening, investment-grade markets are pricing an allowance for an average level of defaults (outside of the UK).
- We forecast the default environment to be skewed to the downside.
- At current levels, high-quality credit assets are unlikely to provide attractive returns above equivalent government bonds.
- Lower grade credit markets continue to imply a low level of defaults relative to historic average pricing.
- We believe risks are skewed towards a deterioration in defaults, particularly in the US leverage loan space in coming years, and continue to expect unattractive outcomes.

Sovereign bonds	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook
Nominal short rates			
US	Neutral	Negative	Positive
Japan	Negative	Negative	Highly negative
AAA-Eurozone	Negative	Negative	Highly negative
UK	Negative	Negative	Negative
Australia	Neutral	Negative	Neutral
Canada	Neutral	Negative	Neutral
Intermediate nominal bonds (10 year)			
US	Neutral	Negative	Positive
Japan	Negative	Negative	Negative
AAA-Eurozone	Negative	Negative	Negative
UK	Negative	Negative	Neutral
Australia	Neutral	Negative	Positive
Canada	Neutral	Negative	Positive
Intermediate inflation-linked bonds (10 year)			
US	Neutral	Negative	Positive
UK	Negative	Negative	Neutral
Credit spreads			
Sovereign credit			
Europe	Neutral	Negative	Negative
Emerging	Neutral	Neutral	Neutral
Corporate credit			
Investment grade	Neutral	Negative	Negative
US	Neutral	Negative	Negative
Eurozone	Neutral	Negative	Negative
UK	Positive	Negative	Negative
Canada	Neutral	Negative	Negative
High yield	Positive	Negative	Negative
US	Positive	Negative	Negative
Europe	Positive	Negative	Negative
Loans	Positive	Highly negative	Highly negative
US	Positive	Highly negative	Highly negative
Europe	Positive	Negative	Negative

Notes: The columns above disaggregate our view on forward-looking returns.

- The first column contains our assessment of the future economic conditions that markets are pricing-in relative to trend (green equates to above-trend conditions). Higher priced-in interest rates than our assessment of neutral imply a positive view of nominal GDP growth vs. trend. Similarly, higher priced-in real interest rates than neutral embed a positive view of real GDP growth vs. trend. Low credit spreads embed a positive view of expected credit losses (and therefore of GDP growth vs. trend). High discounted earnings growth in equities imply above-trend GDP growth. In FX, high interest rate differentials and/or spot rates above long-term measures of fair value imply positive economic conditions.
- The second column summarises how our economic outlook translates onto these economic conditions. In effect, this is our view of 'what should be priced-in'.
- The third column, compares the economic conditions that are priced-in with our outlook and summarises our view on market attractiveness (risk-adjusted returns relative to local cash). Note that, absent a strong view on inflation, if our view of economic conditions is more negative than that implied by market pricing, this is bad for equity returns but good for bond returns.

Key: Highly negative | Negative | Neutral | Positive | Highly positive

Global equities	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook
Developed	Positive	Negative	Negative
US	Positive	Negative	Highly negative
Eurozone	Neutral	Negative	Negative
Japan	Neutral	Negative	Negative
UK	Neutral	Negative	Negative
Australia	Positive	Negative	Negative
Canada	Neutral	Negative	Negative
Emerging	Negative	Neutral	Neutral

- Recent equity price falls have left levels of discounted sales growth at or slightly below average for the cycle.
- The major outlier to this picture is the US, where market prices imply a continued above average outcome.
- We expect earnings growth to come under pressure in 2019 and the next three years.
- Again, the US stands out as being the most likely to suffer poor growth relative to expectations due to downside risks from the 2018 fiscal stimulus rolling over, declining buybacks and pressure on tech earnings.

Foreign exhange (vs USD)	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook
Developed			
EUR	Negative	Neutral	Neutral
JPY	Negative	Neutral	Neutral
GBP	Negative	Neutral	Neutral
AUD	Neutral	Neutral	Neutral
CAD	Neutral	Neutral	Neutral

- Interest rate differentials between the US and other developed markets imply that the US dollar will depreciate against all major currencies.
- We see the dollar as modestly overvalued.
- However, the dollar provides tail risk hedging characteristics and we advise investors to retain a strategic weight, balancing these two points.

Liquid alternatives	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook
Alternate betas	Neutral	Neutral	Neutral
Low beta hedge funds	Neutral	Neutral	Positive

- Portfolios of well-constructed alternative beta strategies will, by design, be less sensitive to the macro cycle.
- Skilled, low beta hedge funds will add meaningful uncorrelated return.

Private markets (developed world)	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook
Illiquidity premium (avg.)	Positive	Negative	Negative
Core real estate	Positive	Neutral	Neutral
Core infrastructure	Positive	Neutral	Neutral
Private equity (US)	Positive	Negative	Highly negative
Direct lending	Neutral	Negative	Negative

- Years of liquidity creation has compressed illiquidity risk premia to low levels. In general, returns from taking illiquidity risk are unattractive.
- However, this is only part of the picture for illiquid assets. For example:
  - Despite historically rich pricing and some exposure to the economic cycle, core real estate and infrastructure benefit from exposure to declining risk free rates.
  - Large-cap private equity valuations are high, but there remains value in niche areas.
  - Direct lending spreads are low and under-discount the prospects for economic weakness driving credit losses higher.
- Note, the assessments opposite are the average across developed world markets. Important local differences will exist.

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Highly negative	Negative	Neutral	Positive	Highly positive

Section 2
Implications for portfolio strategy

Portfolio construction is a multi-dimensional problem. Not only are we seeking to maximise the return per unit of risk spent, we must also manage the impact of the plan on the sponsor and increasingly extra-financial impacts. The size of those impacts is one thing, but perhaps as important is minimising the chances of negative surprises.

A trilogy of challenges

The economic and market outlook implies a trilogy of challenges for pension plan management:

1. Slowing growth in 2019 and growing downside risks beyond threaten the operating environment of most corporations. Unexpected DB cash contributions will be even less palatable than normal in this environment. These forces also threaten DC members' real incomes and their ability to maintain contributions
2. A weakening macro environment is likely to cause return-seeking asset values to fall and undermine DB funded ratios and DC members' account values. For equities, in particular, there is a good chance of a 20-30% decline within the next three years.
3. Volatile bond yields could create further challenges to DB funding ratios and the savings adequacy of mature DC members. Slowing global growth will likely place downward pressure on nominal yields. Additionally, for the UK, Brexit and regulatory risks create considerable uncertainty for inflation and hence real gilt yields.

For DB plans, in particular, these challenges suggest an increased chance of large, unexpected funding requirements at a time when corporate earnings are less able to absorb that additional stress. Surprises like these are never popular, especially at times of wider corporate difficulty. But the good news is – portfolio strategy can help.

Surviving and thriving in a late-cycle environment

We summarise the key portfolio strategy actions we believe investors should take in the diagram below, with the following pages adding more detail. We position these through some of the lenses we use when constructing portfolios to indicate that: a) these actions are good ideas independent of the macro outlook, and b) are supported by it. What all these ideas share is a focus on achieving savers' objectives while reducing the impact of a pension plan on a sponsor's business – either outright or by increasing the certainty of that impact.

In closing, we repeat our observation from last year's outlook: doing some of these things should add value but may struggle to 'move the dial'. Building a portfolio that delivers all these things in combination is the key. For most, this requires more delegation – either to an internal sub-committee or to aligned external decision makers – but the rewards of doing so are significant.

Key actions from a macro viewpoint also make sense through other portfolio construction lenses

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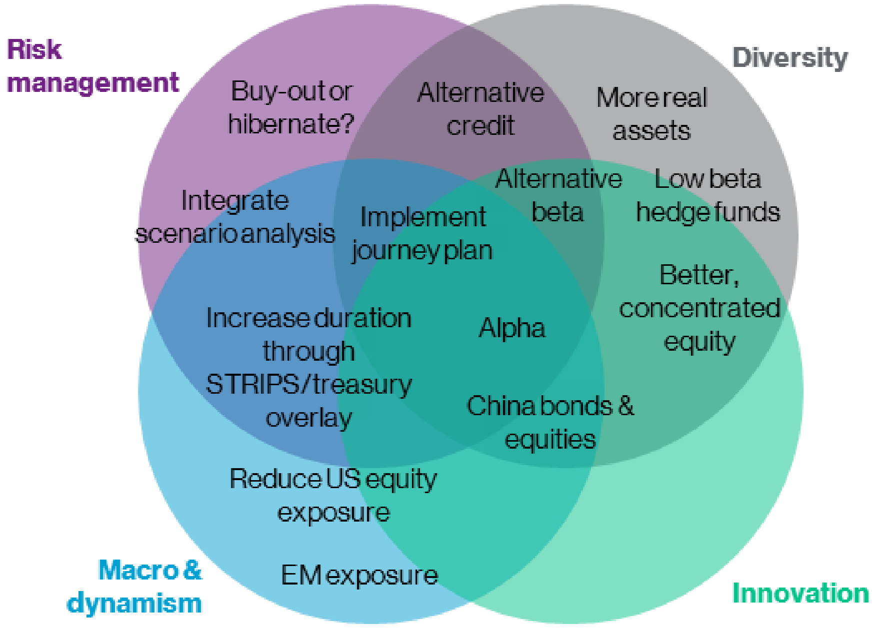

Five portfolio priorities for a surprise-free 2019

We think the chances of nasty surprises has grown. How can we deliver needed returns, whilst reducing the risk of unexpected events?

1. Diversify

Why? Diversification is always a good idea and is an especially good idea now. However, the perception, and often the reality, of doing so is costly, time consuming and complicated.

How? It doesn't (always) have to be. Ideas that are consistent with our macro outlook are discussed below.

Many investors could still benefit from **diversifying equity risk.** Simple ways of doing so include investing in:

- **Real assets:** Increasing exposure to skilled core real estate managers is an "easy win", but smart listed real asset (REITs and listed infrastructure) strategies are also a good diversifier. Well-sourced and managed Secure Income Assets are attractive to most European plans, particularly those considering long-term cash-flow-driven approaches.
- **Alternative credit:** Many institutions have added credit to their return-seeking portfolio through one variant of this: direct lending. Our approach looks beyond this and seeks to lend against assets we like in niche, undercapitalized areas of the market. Private debt (bridge financing) and parts of securitized markets are key examples.
- **Alternative beta:** Some hedge fund strategies are really just novel forms of beta. Over the years we have sought to strip away the complexity and fees, and provide these betas to investors cheaply. These strategies include reinsurance and momentum, which have the benefit of being much less macro-sensitive than equities. Selectivity, innovation and clout – if it doesn't exist, create it through networks – are required.
- US equities remain richly priced relative to economic prospects and other equity markets. Diversity may be as simple as temporarily **reducing US equity exposure in favour of non-US** or EAFE mandates, although this is governance-and price-dependent (see priority #3, Dynamism).

2. Reduce unrewarded risks

Why? Because risk should only be taken if it is rewarded.

How? Subject to the local regulatory environment, for maturing DB schemes, interest rate, inflation and longevity risk will become a dominant form of overall risk. Managing this liability risk in the current environment means considering:

- **Full hedge ratios:** Despite low starting bond yields, we believe the rational choice for many DB schemes is to target full liability hedge ratios*. This is particularly true now, when political risks introduce further uncertainty. One area to watch in the UK is the possibility of Retail Prices Index (RPI) reform.
- **Capital efficiency:** Efficient use of capital across the total portfolio is key: If an asset is not moving the risk or return dial, it likely has no place. Some form of derivative-based overlay may also be required.
- **Longevity risk management:** A priority may also be controlling longevity risk. A growing suite of instruments is available.

We also encourage investors to **integrate scenario analysis into risk management.** This has two dimensions:

- **Macro scenarios:** We believe we are approaching an inflection point in the business cycle and have passed it in the capital cycle. This creates additional uncertainty that traditional risk management approaches will struggle with. Considering the impact of, for example, a Japan-style deflationary equilibrium emerging in the US or Europe through deterministic scenarios is worthwhile.
- **Climate risk scenarios:** Climate change is, in our view, one of the most important forms of systemic uncertainty long-term investors face. Grappling with its impact on a portfolio is daunting, but we strongly believe scenario analysis can help. Even an approximate understanding of portfolio exposures can help indicate the easy wins to reducing financial exposures and, for those inclined, to improving the nonfinancial impacts that are likely to become more important.

* Liability hedge ratio: the proportion of interest rate and inflation risk embedded in the liabilities matched by exposures in the asset portfolio.

3. Macro and dynamism

Why? Understanding the range of outcomes is an important way to reduce uncertainty. That understanding can be used to dynamically manage risk or to create value. The latter is hard and should only be undertaken by those with the governance budgets and beliefs required. But using dynamism to manage risk is more widely accessible.

How? The easiest step towards dynamic risk management is implementing a **journey plan.** Where are you going and how will you get there? The analogue for DC is the length and nature of accumulation and retirement phases.

We also encourage investors to dynamically manage downside risk. Diversity is the first answer here, but there are others:

- **Levered high-quality bonds as a return-seeking asset:** Return-seeking assets tend to do well when GDP growth does well. The flipside is they don't when growth is weak. Adding a levered exposure to US bonds is capital efficient, positive returning in "normal" times and does well in the downside economic outcomes we expect.
- **Controlled unhedged FX exposure:** FX exposure adds risk but this can be rewarded. Unhedged exposure to currencies like the US dollar and Japanese yen can add downside protection.

In the UK, another dynamic risk management idea is **replacing index-linked gilts with US TIPS.** RPI-linked gilts are imperfect hedges against uncertain UK liabilities; therefore, an asset providing exposure to US inflation is not necessarily that inferior of a hedge. It provides more return though: The yield pickup is significant (c.1.5 – 2.0 ppts) and may overcome some investors' concerns about increasing hedge ratios. However, harvesting this yield requires exposure to the US dollar – if anything a little expensive on a long-term basis – which means this risk management position needs to be dynamically monitored and managed.

Ideas to dynamically create value, which we consider for the portfolios we manage, include:

- **Reduce macro risk temporarily:** Our outlook suggests taking less risk now in order to take more later. The difficulty of this decision is not to be underestimated, nor is the complexity of managing it. But underweighting equities in favour of less macro-sensitive assets (alternative credit, alternative beta, real assets) or temporary derisking through options should be considered.
- **Reduce exposure to tighter liquidity:** Some parts of emerging markets are vulnerable to tighter US liquidity, but US corporate debt is a key area of concern. For example, in our view, vanilla leveraged loans face a set of medium-term fundamental pressures.
- **Reduce exposure to "great expectations":** At the time of writing, earnings growth expectations in the US remain excessive. Consequently, forward-looking returns for US equities in particular are weak. We remain underweight.
- **Look to the next cycle:** Risk premia will not remain unattractive forever, creating an opportunity to redeploy capital when they are reasonable. While the near-term pathway for some emerging markets is risky, medium- and long-term prospects are strong. Understanding and managing the macro, in particular FX exposure, is critical though.

4. Innovate through alpha

Why? The reality investors face is, in our view, one of generally low returns – due to low cash rates and low starting risk premia – and elevated volatility as the business and capital cycles move through their late phases. In this environment, the value of genuinely skilled active management is outsized.

How? Finding skilled managers is not easy. However, it is possible as demonstrated by our track records. With alpha in your toolkit, you can consider the following:

- **Reduce beta risk by replacing foregone return with alpha.**
- **Better, more concentrated equity portfolios:** Diversifying exposure to specific risk premia or the economic cycle is one thing, but stock diversification is another and often goes too far within active equity portfolios. Provided you can find a number of truly skilled equity investors with complementary styles to run your portfolio, concentrating your holdings in their 10 to 20 best ideas and combining those portfolios together captures their alpha, moves the dial, controls costs and, we believe, delivers superior equity returns in most environments.
- **Skilled fixed-income managers** can help you navigate the late stages of the business and debt cycles in bond markets. Our approach is to own assets we like, provide capital where it is scarce and deploy it through skilled managers.

5. Innovate to find diversity: China

Why? The world economy can increasingly be simplified to three centres of gravity:

1. **The US:** a $20 trillion economy, growing at c.4% nominal
2. **The Eurozone:** a $14 trillion economy, growing at c.3% nominal
3. **China:** a $14 trillion economy, growing at c.8 – 9% nominal

These centres of gravity operate in economic terms (quantified above), political terms and, more recently, investment terms. Until now, locally listed Chinese assets have been hard for foreign investors to access. But China's gradual financial liberalization means this is no longer true. This third opportunity set is now open to European institutional investors and, in our view, cannot be ignored.

How? From an opportunity set perspective, it makes sense to access this large and growing set of cash flows. But, **the attraction of China's markets is not about stellar returns but stellar diversity.** Because its economy and capital markets are still relatively closed, its economy and its assets will operate on a different (albeit not entirely decoupled) cycle to the rest of the developed world economies and capital markets. Assets that behave differently mean diversity, – which is what makes China's local capital markets attractive to investors.

However, capturing that diversity is not that straightforward:

- China's economy will continue to liberalize and manage its reliance on debt growth, which creates a manageable but challenging economic outlook.
- That, and the wish to capture economic diversity and a broad range of asset risk premiums, means we want to own exposure to both positive Chinese economic outcomes and negative ones.
- Moreover, there are a variety of issues with existing equity and fixed-income benchmarks – concentration, patchy accounting disclosure, volatile prices – which means being highly selective when investing passively.

Therefore, we want exposure to both risky assets, (e.g., equities and private markets) and bonds. These assets also need some form of cost-effective active or smart beta management. This is possible to create separately, but is time-consuming and resource-intensive. Cost-effective 'one stop shops' combining well-structured equity portfolios plus bond exposure are rare but available. Investors will need to be somewhat brave and innovative to capture the early diversification benefits on offer.

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