



Five-Year Capital Market Outlook

Asset Research Team
North America

February 2019



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Surviving and thriving in a late-cycle environment

Summary: A trilogy of challenges

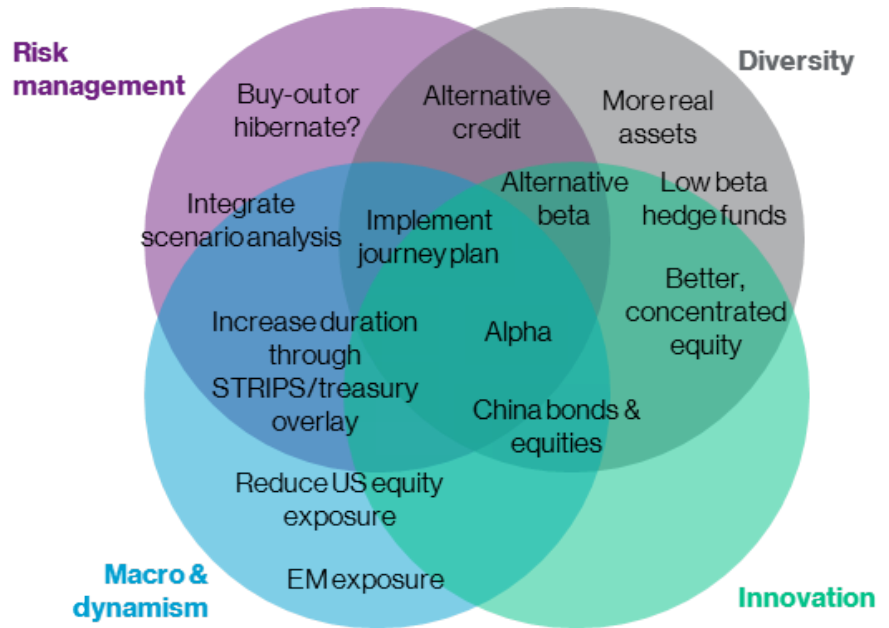
- **First**, we expect a material slowdown in growth in most of the major economies in 2019, with downside risks rising as we move into 2020, putting pressure on the operating environment of many corporate sponsors.
 - The main driver of weaker conditions is the gradual tightening of financial conditions, 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.

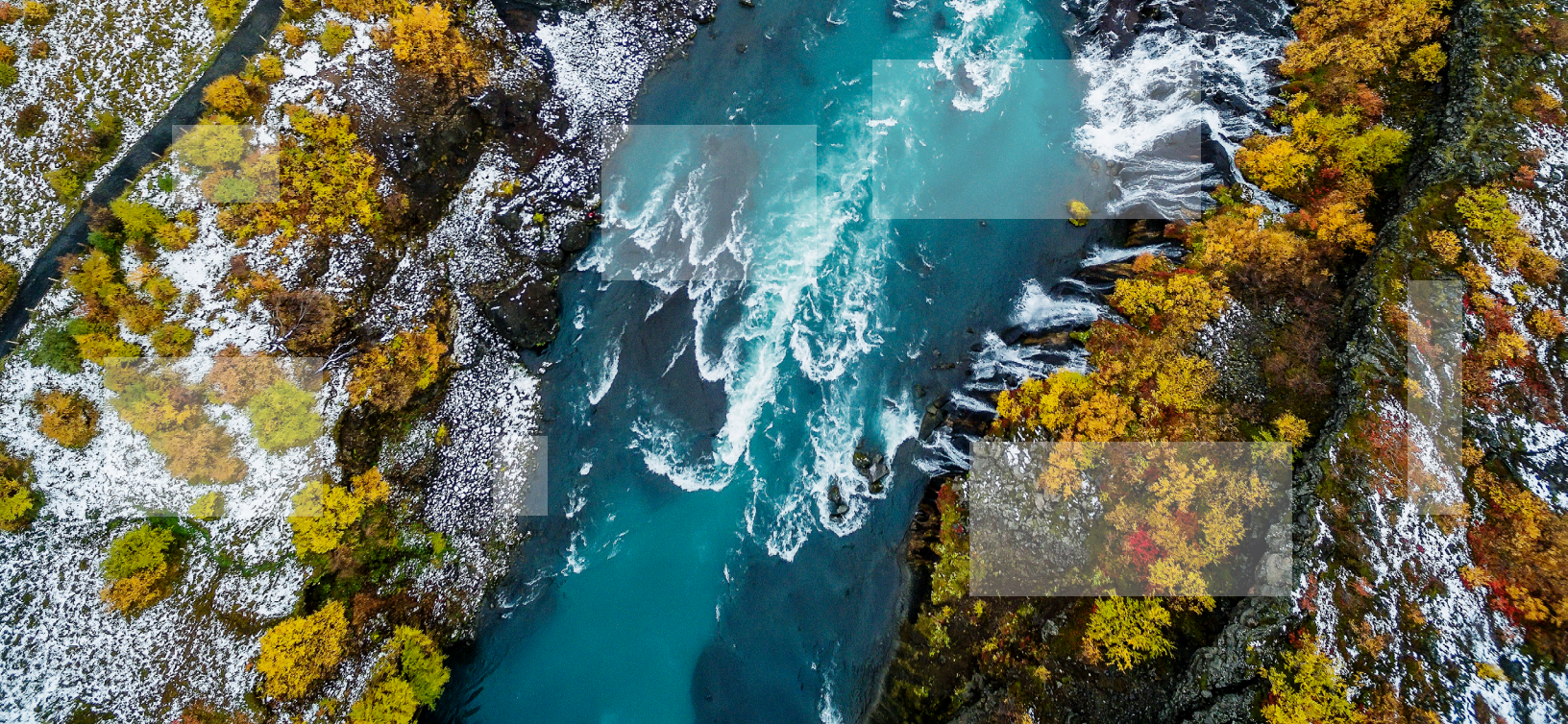
Five portfolio priorities for a surprise-free 2019/2020

- **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 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. 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.

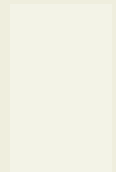
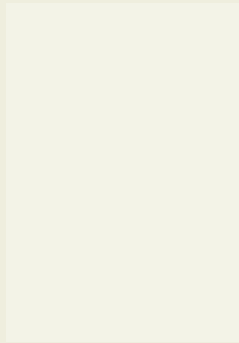
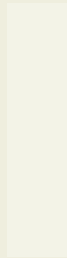
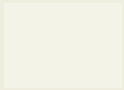
Our outlook in a nutshell

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.



Section 1

At a glance – Our outlook for markets

	Sovereign bonds	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook
Nominal short rates				
<ul style="list-style-type: none"> 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. 	US			
	Japan			
	AAA-Eurozone			
	UK			
	Australia			
	Canada			
Intermediate nominal bonds (10 year)				
<ul style="list-style-type: none"> 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			
	Japan			
	AAA-Eurozone			
	UK			
	Australia			
	Canada			
Intermediate inflation-linked bonds (10 year)				
<ul style="list-style-type: none"> US real yields are the highest in developed markets; breakevens look low. UK real yields appear low, relative to economic conditions. 	US			
	UK			
Credit spreads				
Sovereign credit				
<ul style="list-style-type: none"> Euro credit spreads remain low and underprice stagnation risk. EM sovereign spreads appear to price a reasonable probability of defaults in aggregate. 	Europe			
	Emerging			
Corporate credit				
<ul style="list-style-type: none"> 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. 	Investment grade			
	US			
	Eurozone			
	UK			
	Canada			
	High yield			
	US			
	Europe			
	Loans			
	US			
	Europe			

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

	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook	
Global equities				
Developed				<ul style="list-style-type: none"> 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.
US				
Eurozone				
Japan				
UK				
Australia				
Canada				
Emerging				
Foreign exchange (versus USD)				
Developed				<ul style="list-style-type: none"> 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.
EUR				
JPY				
GBP				
AUD				
CAD				
Liquid alternatives				
Alternate betas				<ul style="list-style-type: none"> 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.
Low beta hedge funds				
Private markets (developed world)				
Illiquidity premium (avg.)				<ul style="list-style-type: none"> 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: <ul style="list-style-type: none"> 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.
Core real estate				
Core infrastructure				
Private equity (US)				
Direct lending				

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Key	Highly negative	Negative	Neutral	Positive	Highly positive
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Section 2

Implications for portfolio strategy

Portfolio construction for a North American pension plan is a multi-dimensional problem. Not only are we seeking to maximize the return per unit of risk spent, we must also manage how the plan impacts on the sponsor. Of interest, is minimizing the size of the plans impact on the sponsor's earnings, on cash demands or on the balance sheet. Perhaps as important is minimizing, as far as possible, 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.
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. At the same time, monetary easing prompted by falling inflation/rising unemployment will likely drive lower bond yields and projected benefit obligations/annuity costs higher, further undermining funded ratios and DC members' savings adequacy.

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.

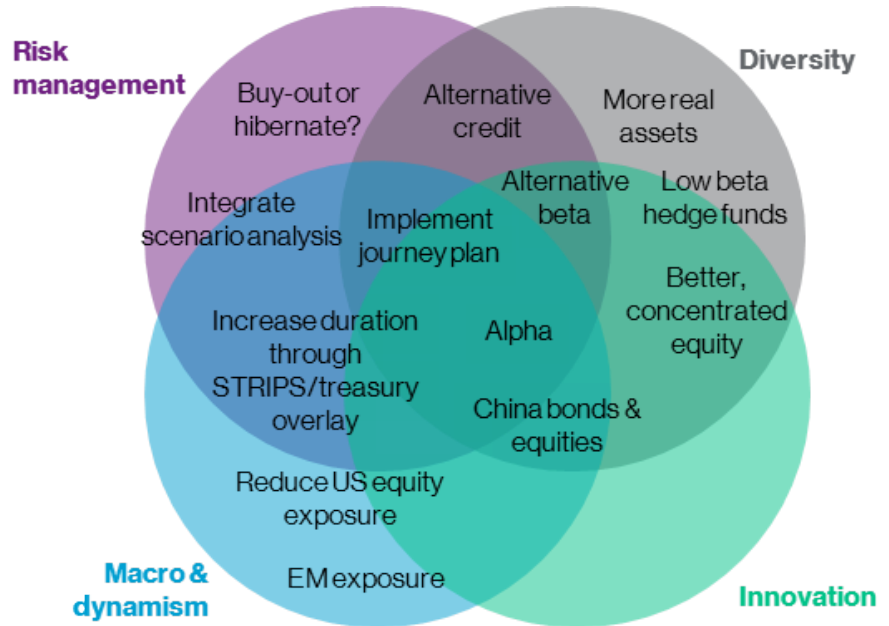
Surviving and thriving in a late-cycle environment

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

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. This shows that ideas that make sense based on our macro views will tend to make sense anyway.





Five portfolio priorities for a surprise-free 2019

We think the chances of nasty surprises has grown. How can we deliver needed returns but in a way that reduces 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? Diversification doesn't (always) have to be burdensome. Ideas which are consistent with our macro outlook are discussed below.

Most North American pension plans could benefit from **reducing exposure to equities outright**. Simple ways of selling equities while not sacrificing too much return 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 diversifying.
- **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 and hedge funds:** Skilled hedge fund managers can provide diversification benefit within a total portfolio context (see priority #4, Alpha). For clients with more of a focus on cost and simplicity, we have sought to strip away the complexity and fees of certain hedge fund strategies, which are really just novel forms of beta, and provide them to investors cheaply. These alternative beta 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 favor of non-US** or EAFE mandates, although this is governance and price-dependent (see priority #3, Dynamism).

Finally, while diversity doesn't always have to be complicated, sometimes complexity is the price to pay for attractive assets. The governance required to cope can be acquired through delegation.

2. Reduce unrewarded risks

Why? Because risk should only be taken if it is rewarded. From a corporate perspective, reducing risk means improving certainty while maintaining return – a win-win. However, once again, the perception and often the reality of doing so is costly, time consuming and complicated.

How? Again, reducing risk doesn't have to be burdensome. We encourage DB investors to think about their approach to Liability Driven Investing (LDI). In particular:

- **Increasing duration through STRIPS or a treasury overlay.** Despite recent falls in yields and the possibility of near-term increases, we believe the balance of risks over the next few years is for lower yields. This could cause pain for some pension plans, which can be mitigated by increasing the duration of existing hedges. STRIPS are an easy way to do this.
- **Do you need so much long credit?** Unless you are very well funded and have a low target return, there are likely better things to do with at least part of your capital

allocation. Long credit takes up a lot of capital, for not much risk reduction/duration and low starting spreads deliver little return, with the likelihood of rising spread levels from here. We would consider reducing long credit in favor of more capital-efficient assets (see above, see below).

- In our view, LDI is a total portfolio paradigm, not an allocation. **Consider how other assets contribute to LDI** as well as serving return-generation objectives (e.g., alternative credit can serve a return and LDI purpose but realizing this efficiency requires a close partnership between your actuarial and investment teams).

We also encourage investors to integrate scenario analysis into risk management. Investigating specific macro risks – such as the possibility of a Japan-style deflationary equilibrium – and what to do about them makes sense if we are close to an economic inflection point. The impact of key disruptive megatrends, such as demographics, technology or environmental risks, can also be assessed this way.

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. There is no disguising it: creating value through dynamism is a complicated, time- and resource-intensive process and should only be undertaken by those with rich governance budgets and appropriate beliefs. Whereas using dynamism to manage risk is more widely accessible.

How? Dynamic risk management in practice means implementing a journey plan. Where are you going and how you will get there? Surprisingly few plans have solid answers to these questions and, as a consequence, are likely running a sub-optimal strategy. This is more relevant now because funded ratios will have improved significantly over the past few years and our outlook suggests now might be an attractive time to de-risk.

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. Equities and long credit together are likely a dominant risk for many plans, so less equity in favor of less macro-sensitive assets (e.g., alternative credit, alternative beta, real assets or outright derisking to cash or through options) should be considered, as should reducing credit risk in LDI portfolios.
- **Reduce exposure to tighter liquidity:** 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.
- **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.

4. Innovate through alpha

Why? The reality investors face is, in our view, one of generally low returns – due to low cash rates and 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? Again, we will not pretend finding skilled managers is easy. However, it is possible, as demonstrated by our track records. With alpha in your toolkit you can consider the following:

- **Reducing 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 10-20 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.

- **Differentiated, low beta hedge funds:** In general, hedge fund performance disappointed during and after the Global Financial Crisis. However, we remain committed to our approach to hedge fund investment, which prioritises differentiation, low beta and value for money as well as all-out skill. In our view, many portfolio would benefit from exposure to these managers.
- **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 centers 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 centers 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 North American 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 cashflows. 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 – this 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 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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