Global Markets Overview

Asset Research Team

June 2017

United States economic and government bond outlook

- In March, we published our *Five-Year Outlook* which described the plausible distribution of outcomes that investors face.
- We extend that discussion by focusing on our shorter-term and five-year outlook for US economic conditions.
- The US economy is currently at full employment, with slack in the labour market more or less eroded.
- We expect GDP growth to remain moderately above potential for the next two years, …
- … with rising wage growth driving a gradual increase in inflation.
- We expect the Federal Reserve to react by steadily hiking interest rates over the next three years, which will slow the economy.
- Economic risks over the medium-term lie to the downside.
- Recent falls in US government nominal bond yields do not reflect our cyclical outlook and we have downgraded our US 10-year nominal bond rating to moderately underweight.

1. Monthly overview

The UK election of the 8th June resulted in a hung parliament. The election result has had no material immediate impact on asset prices or our central outlook of moderate growth in the UK economy.

The Fed raised its policy rate by 25bps at its meeting on the 14th June. This decision to increase the policy rate comes as no surprise – we expected the Fed to raise rates by 25bps three times this year including the first rate hike that occurred in April.

Saudi Arabia and the United Arab Emirates severed ties with Qatar creating a divide among energy exporting US allies in the region. While we do not view the developments so far as likely to have a major impact on global markets, we continue to monitor events.

2. Our Five-Year Outlook

- Accommodative monetary policy (despite Fed rate hikes) and continued fiscal easing are likely to produce moderately above trend global growth and lift developed world inflation in the next two years.
- However, we expect monetary tightening to slow real growth over our five year horizon.
- Global economic policy uncertainty remains elevated - this widens the distribution of global growth and inflation outcomes.
- Central bank liquidity injection and declining interest rates witnessed over the past few years increased asset prices considerably. However, this impact is waning. We expect positive but low long-term asset returns, with rising downside risks over time.
- In this situation, we recommend that investors (1) understand portfolio exposure to downside and upside risks; (2) phase strategic risk changes over time; (3) diversify and consider tail risk hedging; (4) maintain liquidity and wait for major market over/undershoots; and (5) use active management.

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Economy currently at full employment; Fed to continue to tighten policy rates

3. United States economic outlook

The US Federal Reserve (Fed) hiked the Fed funds rate in June. The Fed noted the moderate economic expansion in its decision and described risks as roughly balanced over the next two years. We expect moderate economic growth to cause inflation to gradually rise. The Fed is likely to respond with a steady series of rate hikes over the next three years, which will slow the economy. This is an important driver of our view that medium-term risks are skewed to the downside and has important implications for global asset markets.

One to two year US outlook

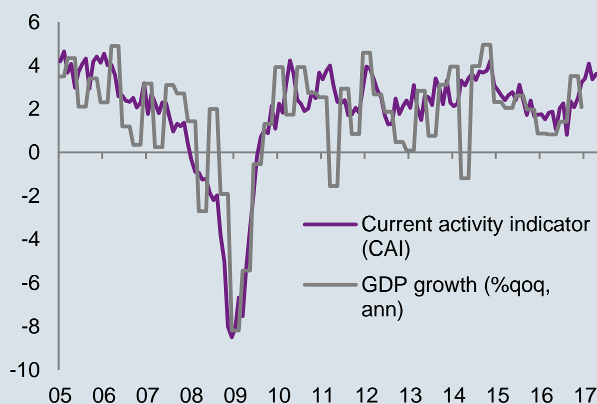
The US economy is currently in the late expansionary stage of its economic cycle. Economic capacity has more or less been eroded and the unemployment rate has fallen to pre-crisis levels of 4.7%. The economy was already experiencing strong growth before Trump's victory in November 2016 and we expected this economic momentum to continue. There are a few reasons for this: first, we predicted that rising incomes (due to labour market tightening) and reasonable strength in the housing market would bolster household spending over the next two years. Second, we forecasted that weak investment growth in 2015/16 would recover, due to an increase in commodity prices and a pick up in trading partner growth. Third, despite the Fed commencing it's tightening cycle, we forecasted financial conditions to remain easy and supportive for growth over the next 6 to 12 months.

In our view, Trump's proposed spending and tax policies are still likely to be largely expansionary in nature and are expected to provide a further boost to the economy in 2018/19. More specifically, we estimate the Trump administration's fiscal stimulus and other policies to add c. 0.5ppt to US growth. The ultimate size of the stimulus will be impacted by the likely reluctance of Republicans to materially increase the government deficit and debt ceiling. But in aggregate, we forecast GDP growth to be above trend over the next two years.

Inflation rates rose from very low levels in 2016 because of a fading drag from both lower commodity prices and a stronger trade-weighted dollar. We now expect inflation to reach 2.3% by end-2018 due to growing wage pressures and above-trend economic growth. We hold this view despite somewhat lower inflation data reported over the past two months.

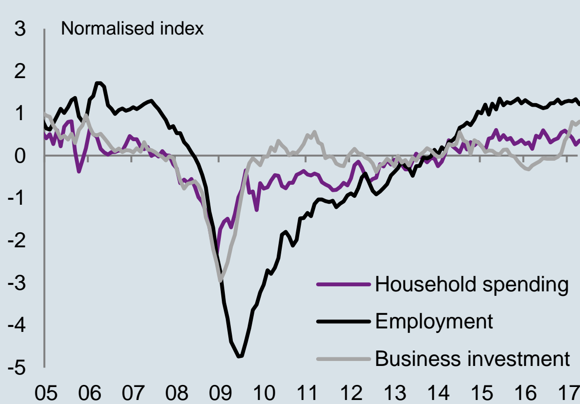
We expect the Fed to make three 25bps policy rate hikes in 2017 and 2018 as it responds to rising inflation and a tightening labour market. Indeed, the Fed Open market committee has already hiked twice this year, with the latest decision taking place on 14th June. Janet Yellen, the Fed chairman, continues to highlight that the Fed's decision-making will depend on the strength of economic data.

Fig 01: Activity indicators point to above-trend growth prospects over 6-12 months



Source: Goldman Sachs, Willis Towers Watson

Fig 02: Cyclical indicators from the main economic sectors clearly show the ongoing CAPEX recovery



Source: Goldman Sachs, Willis Towers Watson

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Five-year US outlook

We remain concerned about increased downside risks over the medium term. The average US business cycle as measured by NBER from 1945 - 2009 has been just under six years. The current business cycle (trough in mid-2009) has now lasted around eight years. More importantly, aggregate debt levels still remain high, making the economy more sensitive to rising interest rates. Additionally, despite expected hikes in policy rates, the potential monetary policy response to a possible downturn remains more constrained compared to previous recessions.

We expect the Federal Reserve to react to moderately above-trend growth rates and a gradual rise in inflation by steadily hiking interest rates over the next three years, which will slow the economy.

Inflation will be hit by cross currents from a tight labour market (i.e., stronger wage growth) and possible protectionist trade policies on the one hand, and higher policy rates on the other. This should leave inflation slightly below the Fed's inflation target at the end of the five year period.

Risks around our US outlook

We think risks are broadly balanced over one to two years. However, uncertainty – both to the upside and downside – is elevated due to the range of fiscal, trade and social policies that could be implemented by the US government. The skew of risks around our growth outlook informs our perception of the risks around our inflation and policy rates outlook - which are also elevated but broadly balanced.

Over a five year horizon, we think the balance of risks to growth, inflation and rates are tilted to the downside. The asymmetry of risks rises as labour markets tighten, wages and inflation increase and interest rates move higher. An excessive tightening of financial conditions risks slowing the economy too aggressively causing a recession and low inflation.

Implications for investors

At a broad level, our central US economic outlook leaves us expecting positive but low asset returns over the medium-term. Our view of rising downside risks over time in the US also suggests investors consider several broad responses. These responses were set out in our Five-Year Outlook publication and remain unchanged. They are: 1) understand portfolio exposure to downside *and* upside risks; 2) align investment strategy with low expected returns; 3) diversify and consider tail risk hedging strategies; 4) use dynamic asset allocation and active management; and 5) maintain liquidity and wait for major market over/undershoots.

4. We recommend a moderate underweight to 10y US nominal bonds

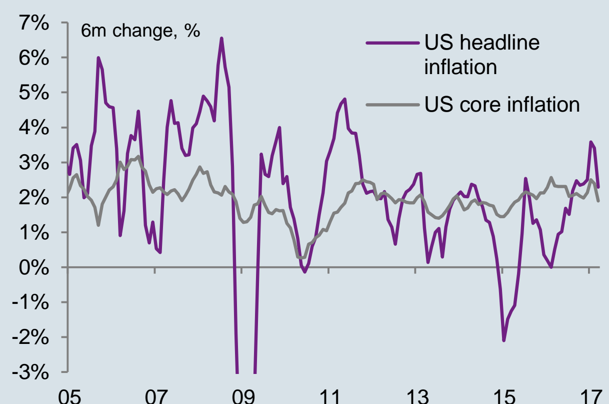
We have downgraded our US 10y nominal bond rating to **moderately underweight** this month. Since

Fig 03: Key forecasts for the US economy

% y/y or end of period	2017	2018	2019	2020	2021	5y avg
Real GDP growth	2.1	2.3	1.8	1.6	1.6	**1.9**
Trend GDP growth	1.9	1.9	1.9	1.9	1.9	**1.9**
CPI inflation	2.5	2.3	2.3	2.3	2.3	**2.3**
Policy rate	1.5	2.3	2.8	3.3	3.0	**2.6**

Source: Willis Towers Watson

Fig 04: Moderate inflationary pressures expected over the medium term



Source: Thomson, Willis Towers Watson

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the middle of March, our expected return range for intermediate US treasuries has shifted down alongside their declining yields. We had maintained a neutral rating, given rising recession risks over our five year horizon. However, given recent yield declines we no longer believe that these more medium-term risks are sufficient to maintain a current neutral view.

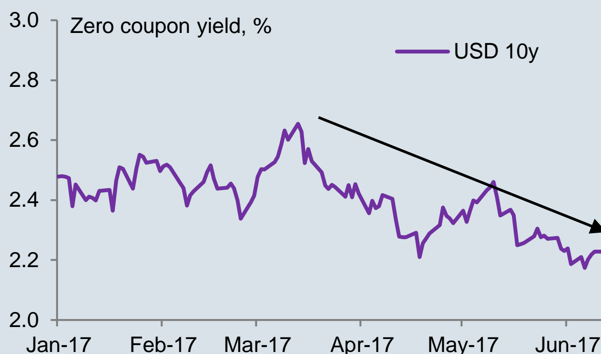
As covered in the economics article, our outlook for the US economy remains largely unchanged. This is also true of our expected pathway for bond yields. Over the next two years, we expect US bond yields to rise as the Fed continues its hiking cycle, risk premia expand, and policy rate expectations adjust upwards. The shorter-end of the yield curve, which in our opinion is under-discounting rate hikes over the next five years, should rise more sharply. However, we now expect both 5y and 10y zero to underperform cash.

Over 2019/21, we predict that downside risks will rise, helping to contain further yield rises and improving return outcomes. Overall, across five years, we expect nominal 10y zero coupon bonds to return 1.6% to 2.6% p.a..

TIPS are likely to outperform

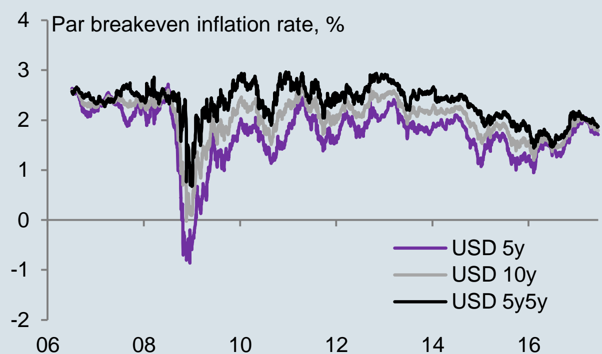
Within inflation-linked bond markets, we continue to believe that US CPI inflation prospects are being moderately under-reflected in market pricing. We expect breakeven inflation rates to rise over the next two years as market expectations are surpassed and adjust upwards. While part of this correction is likely to occur through higher nominal yields, we expect some contraction in real yields. We forecast 10y zero coupon TIPS to provide a return pick-up of over 2% p.a. relative to equivalent duration treasuries *over two years*, and suggest a relative overweight. We think risks to inflation, and hence this trade, are fairly evenly balanced over this horizon as US policy is likely to be fairly simulative.

Fig 05: Recent 10y US nominal bond yield moves



Source: Bloomberg LP, Willis Towers Watson

Fig 06: US breakeven inflation rates



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