Global Markets Overview

Asset Research Team

May 2019

Tracking recent price action and our outlook for listed real assets

1. Monthly overview

- The **US-China trade war** has escalated as the US has announced additional tariffs on Chinese goods. The $200bn of Chinese goods which were subject to a 10% tariff hike in Sept 2018, will now face an additional hike to 25% by the end of this month. The computer, electronics and automotive components are the Chinese sectors most at risk from this move. China is expected to retaliate in equal measure through the imposition of tariff and non-tariff barriers. The Trump administration has also announced that it intends to impose 25% tariffs on an additional $325bn worth of Chinese goods over the next few months if Chinese authorities do not acquiesce to its demands.
- Certain **Eurozone (EZ) members announce moderate fiscal stimulus** (around 0.4 – 0.5% of GDP) over this year in an effort to stave off a slowdown. This domestic fiscal stimulus combined with positive spill-over from Chinese fiscal easing should improve EZ's growth outlook at the margin, although political constraints and a lack of coordination limit efficacy and persistence.
- The **Bank of Japan (BoJ) has provided further clarification on its forward guidance** and has stated that it will keep policy rates at -0.1% and 10 year rates capped at 0% till at least Spring 2020. This isn't a drastic shift from its earlier communication of keeping rates at low levels for "an extended period" and the latest announcement has not had a major impact on our outlook for the economy. More interestingly, the BoJ has also acknowledged that it will fail to reach its 2% inflation target till at least 2022

2. Our Five-Year Outlook

In January, we published our Five-Year Outlook. A summary of this is provided below:

- **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.
- The main driver of weaker conditions is the gradual tightening of financial conditions, as the major central banks have raised interest rates and/or withdrawn money from the financial system.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, …
- … putting pressure on savers' wider financial positions.
- **Third**, achieving investment return targets – and hence meeting savers' expectations – is going to be difficult in this environment in our view, even over longer time periods.

Five portfolio priorities for a surprise-free 2019/2020

- Diversify;
- Reduce unrewarded risks;
- Macro & dynamism;
- Innovate through alpha;
- Innovate to find diversity, e.g., China now offers a new and diversifying set of assets for investors.

Tracking recent price action and our outlook for listed real assets

Summary

Tracking recent changes in listed real assets

- Similar to other risky assets, listed real assets are richly priced with risk premia likely approaching cyclical lows. Spreads between real asset initial yields and (low) corporate yields are narrowing.
- However, the greater reliance on income returns means risk adjusted returns of listed real assets are likely to be better vs. equities more generally.

Changes to liquid real estate pricing

30 April 2019

	Premium/Discount to NAV (%)				Unlevered initial yield* (%)				Unlevered initial yield minus IG corporate YTM (%)			
	Latest	Change over one quarter	Change over one year	15y average	Latest	Change over one quarter	Change over one year	15y average	Latest	Change over one quarter	Change over one year	15y average
US	3.09	-0.61	11.89	1.50	4.21	-0.01	-0.59	5.59	0.53	0.32	-0.29	1.26
UK	-23.60	3.10	-9.90	-12.03	5.71	-0.17	1.16	6.17	3.01	0.07	1.23	1.53
EZ	-10.00	-1.10	-8.20	-0.55	4.01	-0.03	0.22	5.36	3.18	0.35	0.41	2.43
AUS	4.00	-0.50	9.60	-4.15	5.09	0.02	-0.81	6.72	2.48	0.60	-0.07	1.40
JPN	18.02	2.62	14.12	15.08	3.93	0.00	-0.91	4.62	3.55	0.03	-0.99	3.85

unlevered initial yield of listed real estate is calculated as cap rate/(1+Premium/Discount to NAV(1-Loan to Asset Value)). It can be viewed as the implied cap rate of listed unlevered real estate assets.

Changes to liquid infrastructure pricing

30 April 2019

	Price to book ratio				Unlevered initial yield** (%)				Unlevered initial yield minus IG corporate YTM (%)			
	Latest	Change over one quarter	Change over one year	15y average	Latest	Change over one quarter	Change over one year	15y average	Latest	Change over one quarter	Change over one year	15y average
N. America	2.46	0.15	0.30	2.02	3.23	-0.23	-0.52	4.62	-0.31	0.10	-0.22	0.41
EZ and UK	1.96	-0.01	0.06	1.77	3.82	-0.31	-0.40	4.53	2.36	0.03	-0.25	1.03
Asia	1.23	-0.03	0.02	1.30	2.72	-0.32	-0.69	3.17	1.22	-0.02	-0.36	0.13

**unlevered initial yield of listed infrastructure is calculated as EBIT/EV * (1-tax rate). Tax rate is assumed to be 30%.

Source: MSCI, UBS, PMA, FactSet, Willis Towers Watson

Shading represents favourable returns either prospectively (high current yields or wide spreads to corporate bond yields) or retrospectively (falling yields or narrowing spreads).

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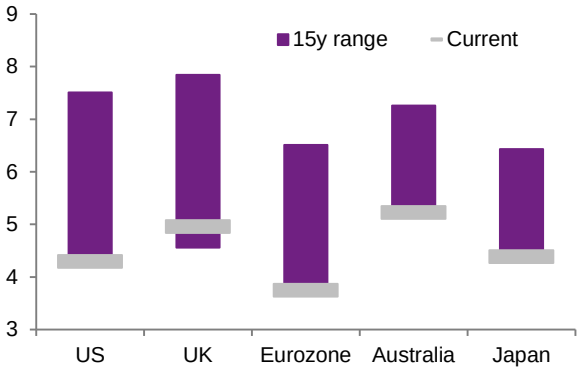
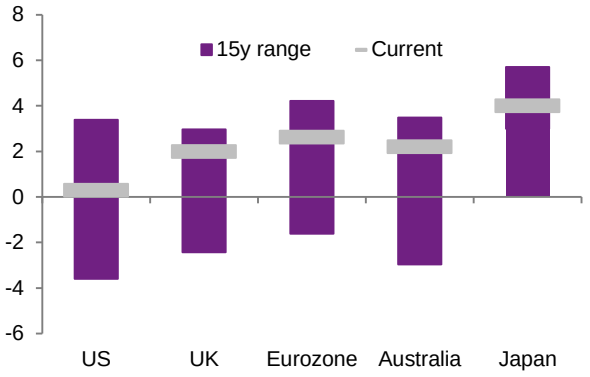
Tracking recent price action and our outlook for listed real assets

Key indicators: listed real estate

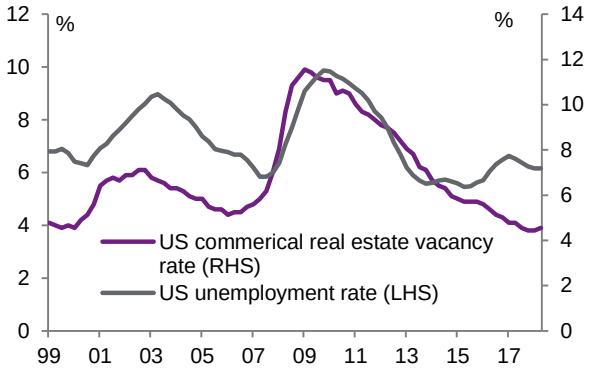
Global unlisted cap rates are right at the bottom of their 15 year ranges, apart from in the UK.
Cap rate, %



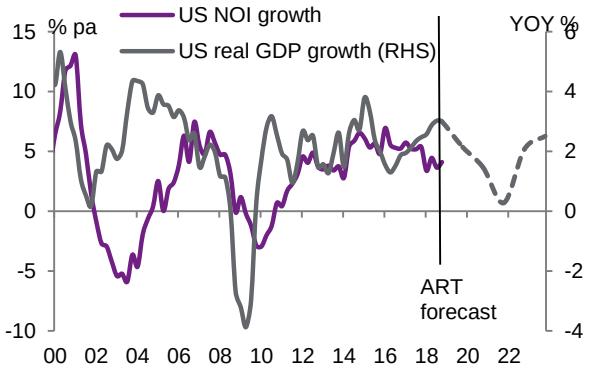
When compared with corporate bond yields, cap rates look more reasonable.
Cap rate minus IG corporate yield to maturity, %



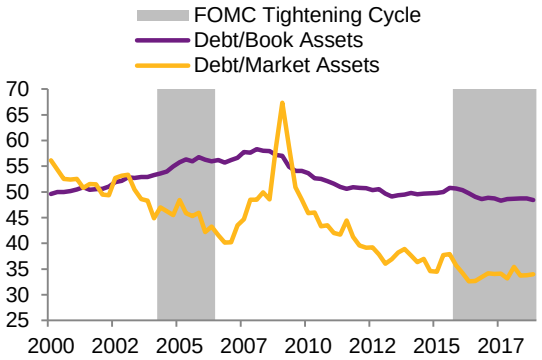
Tight labour markets underpin demand for commercial real estate in the near term.
US unemployment rate and vacancy rate, %



However, weak global growth prospects cast a shadow on real estate fundamentals.
Rolling annual US rental growth, %



So far, real estate leverage seems reasonable when compared with previous cycles.
Debt to total assets, %



Outside the US and some parts of Asia, REITs are priced at a higher discount than historical average.
Real estate securities discount to NAV

Premium/Disc. to NAV	Current	Average	Difference
Global	-9.41%	-5.12%	-4.29%
US	3.09%	1.50%	1.59%
UK	-23.60%	-12.03%	-11.57%
Eurozone	-10.00%	-0.55%	-9.45%
Australia	4.00%	-4.15%	8.15%
Japan	18.02%	15.08%	2.94%
Hong Kong	-8.98%	-9.79%	0.81%

Sources: Factset, Willis Towers Watson

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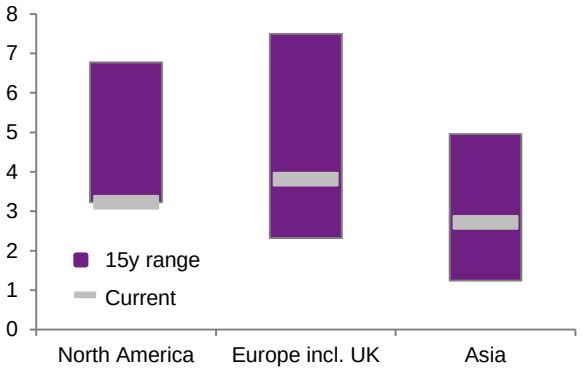
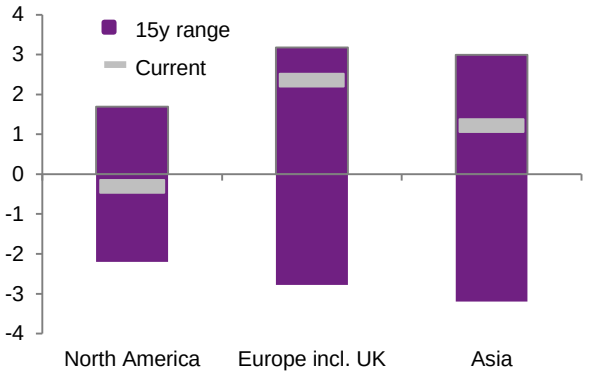
Tracking recent price action and our outlook for listed real assets

Key indicators: listed infrastructure

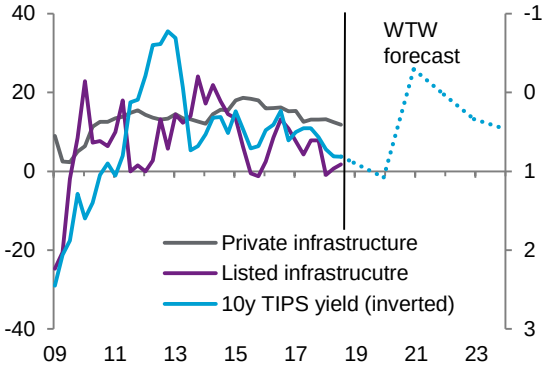
On a yield basis, North American infrastructure assets look richly priced vs. history.
Unlevered initial yield, %



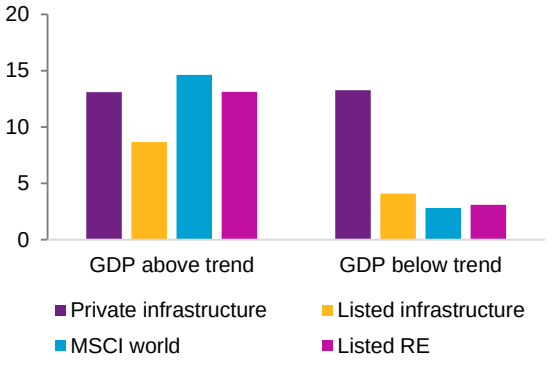
This is partially explained by low bond yields. European assets look good value on this basis.
Unlevered initial yield minus IG corporate YTM, %



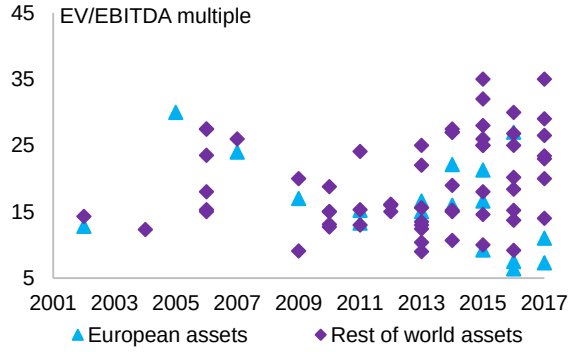
Infrastructure tends to perform well after real yields fall, which we think is likely in the next few years.
Infrastructure total return (LHS) & US 10y real yields (RHS), %



Weak global growth should weigh on listed infrastructure returns, but not relative to wider equities.
Average total return (2009 – 2018), %pa



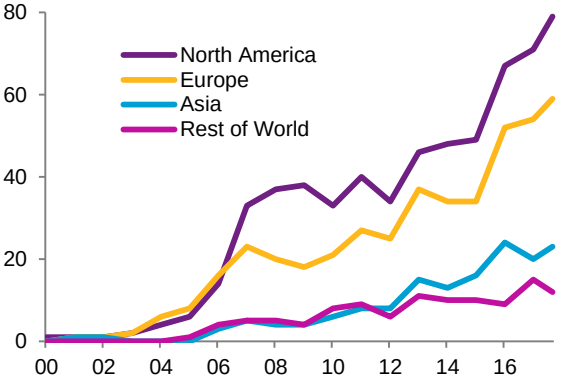
Generally high but disperse valuations provide opportunities for disciplined asset selection.
Select global unlisted infrastructure transactions*



*Excludes energy assets

Sources: Factset, Willis Towers Watson

Capital awaiting investment is at a record high, reflecting strong investor demand for infrastructure.
Unlisted infrastructure funds dry powder, US$ billion^



^GDP above trend is defined as G20 real GDP yoy growth above its five year rolling average.

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