Global Markets Overview

Asset Research Team

July 2019

Tracking recent price action and our outlook for alternative beta

1. Monthly overview

- **US and China agreed to resume trade negotiations** at the G20 summit held at the end of June. President Trump announced that he will not place any more tariffs on Chinese goods whilst the discussions are in progress and President Xi agreed to purchase additional US agricultural goods. The US also relaxed some sanctions placed on Huawei and allowed US companies to sell to Huawei if certain criteria are met.
- **The Federal Reserve's forward guidance has become more dovish**, emphasising downside risks to growth and the building case for a rate cut before the end of the year. We are keeping track of economic data to determine the likelihood of a rate cut although note that falls in bond yields so far this year, bring them more into line with our cautious view.
- **The Reserve Bank of Australia has lowered cash rates** by another 25bps to historic lows of 1%. This move comes as authorities introduce a range of fiscal and monetary stimulus measures to stave off rising downside risks in the economy - we have already seen a rate cut of 25bps in June and an income tax cut package worth $106bn. The Central bank noted: i) uncertainty generated by trade and technology disputes negatively impacting investment; ii) house price declines and; iii) subdued consumption growth due to a protracted period of low income growth.
- Both the **European Central Bank (ECB) and the Bank of Japan (BoJ)** have stated that they are ready to ramp up monetary stimulus in response to growing downside risks and rising uncertainty. Both banks have stated that they will consider issuing new forward guidance, resuming some form of quantitative easing and deepening negative interest rates if a deteriorating growth outlook hurts inflation prospects. We continue to monitor the situation in both economies.

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is the gradual tightening of financial conditions, as the major central banks have raised interest rates and/or withdrawn money from the financial system.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 alternative beta

Summary

Tracking recent changes in alternative beta

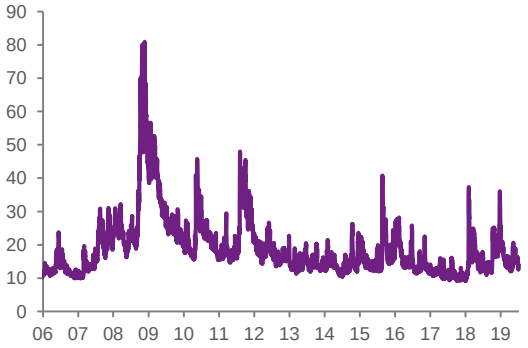
- The carry premium has been the strongest performer over the last 12 months. Despite spreads in fixed income and to a lesser degree developed market currency being low relative to history, we have seen spreads decline further (particularly in the fixed income space), contributing positively to returns. We continue to see these declining spreads as a headwind for the strategy.
- Emerging market currency and merger arbitrage performed strongly over the last year. We would note that relative to other alternative betas, these strategies are likely to exhibit a small to moderate beta during an equity down-market, and as a result consider this within our wider portfolio construction process. The merger arbitrage strategy was able to benefit from the macroeconomic environment, characterised by wide spreads and high levels of deal activity, which we continue to monitor closely.
- Reinsurance gave flattish returns over the last year given high industry losses. However, substantial aggregate losses over 2017 and 2018 have constrained capacity somewhat and encouraged reinsurers to harden pricing. We have observed a floor in pricing last year, as renewals in 2019 – particularly those in June – saw pricing increase modestly. Despite these increases, we still see premiums as moderately unattractive net of expected losses and cash rates.

Key indicators: market pricing

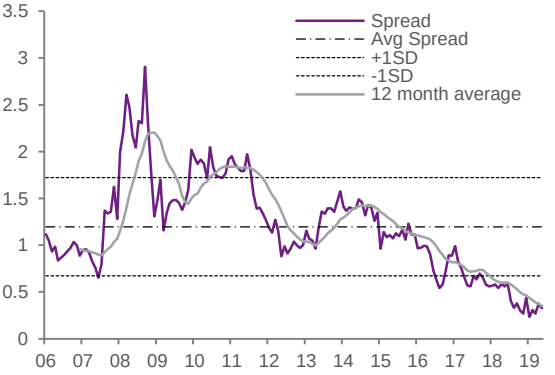
Q1 2019 M&A activity (to 22 March 2019) was weaker than Q1 2018, although still strong relative to longer history

Reinsurance: Yield spreads for secondary market Cat Bonds continued to increase in Q2
Secondary market yield spread (over cash) %

Vol has risen from 2017 lows, but remains supressed despite recent spikes
CBOE SPX Volatility VIX



Fixed income carry spreads have appeared to stabilise, albeit at very low levels
DM fixed income carry spreads (10Y-3M) (%)



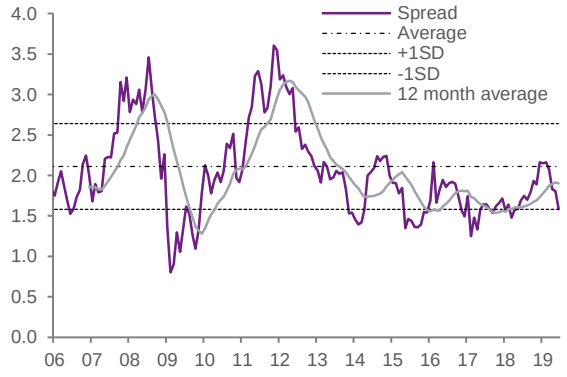
Source: Willis Towers Watson, Refinitiv, FactSet, Lane Financial, Thomson Reuters

Asset Research Team

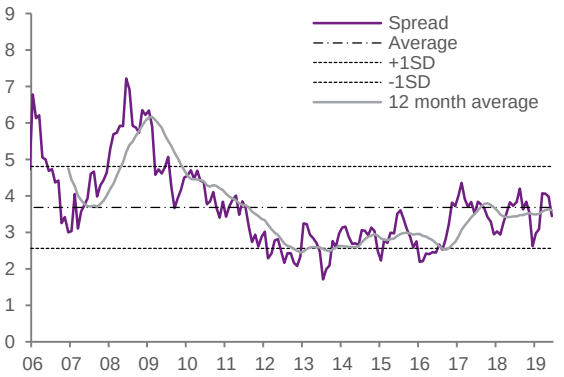
Tracking recent price action and our outlook for alternative beta

Key indicators: market pricing

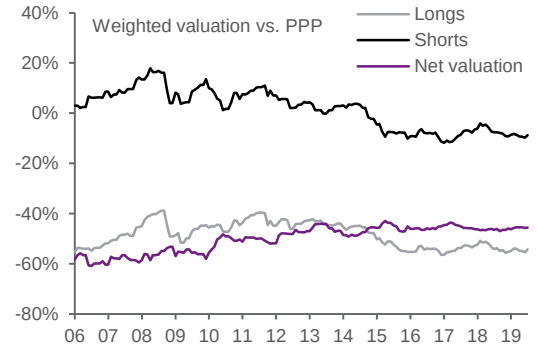
DM FX carry spreads, adjusted for inflation, increased in 2018, and has fallen back in 2019
DM FX carry spreads (real) (%)



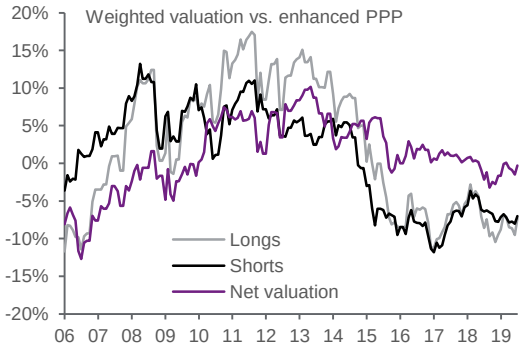
EM FX carry spreads, adjusted for inflation, appear reasonable relative to recent history
EM FX carry spreads (real) (%)



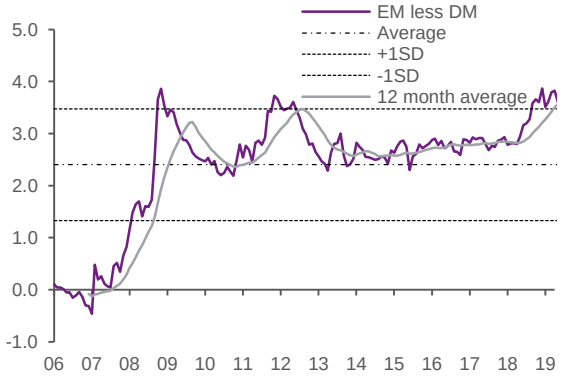
EM currencies are significantly undervalued relative to PPP, indicating long term attractiveness
EM basket (longs) and DM basket (shorts) vs. PPP



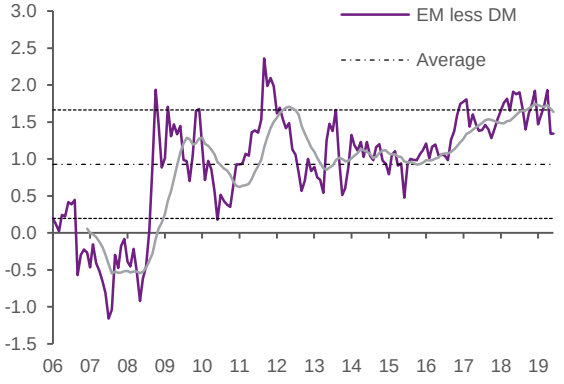
When an Enhanced PPP measure is used, a basket of long EM and short DM currencies is more neutrally valued



Short term interest rate differentials between EM and DM currencies are high historically
EM less DM 3 month nominal yield (%)



When adjusted for inflation differentials, interest rate differentials have been trending upwards
EM less DM 3 month real yield (%)



Source: Willis Towers Watson, FactSet, Goldman Sachs, State Street Global Advisors, OECD

Asset Research Team

Disclaimer

Disclaimer

Willis Towers Watson has prepared this material for general information purposes only and it should not be considered a substitute for specific professional advice. In particular, its contents are not intended by Willis Towers Watson to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. As such, this material should not be relied upon for investment or other financial decisions and no such decisions should be taken on the basis of its contents without seeking specific advice.

This material is based on information available to Willis Towers Watson at the date of this document and takes no account of subsequent developments after that date. In preparing this material we have relied upon data supplied to us by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors or misrepresentations in the data made by any third party.

This material may not be reproduced or distributed to any other party, whether in whole or in part, without Willis Towers Watson's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any use of or reliance on this material or the opinions we have expressed.

Towers Watson Limited (trading as Willis Towers Watson) is authorised and regulated by the Financial Conduct Authority in the UK.

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

Towers Watson Limited is a limited liability company registered in England and Wales under registered number 5379716.
Registered address: Watson House, London Road, Reigate, Surrey, RH2 9PQ, United Kingdom

willistowerswatson.com

Willis Towers Watson