Global Markets Overview

Asset Research Team

December 2019

Tracking recent price action and our outlook for alternative betas

1. Monthly overview

- **US and China appear close to finalising an agreement on one aspect of the trade deal**. China has agreed to: i) Buy $40bn worth of US agricultural products; ii) Protect US intellectual property rights; iii) Place restrictions on forced transfer of technology from US firms; iv) Improve access of US firms to Chinese financial services; and v) avoid RMB currency manipulation. In return, the US has pledged to not place levies on $160bn worth of additional Chinese goods and cut tariffs on $120bn worth of goods from 15% to 7.5%. The US would still maintain a 25% tariff on $250bn worth of Chinese goods.
- **The Conservative party, under Boris Johnson, secured a parliamentary majority in the UK general elections held on 12th Dec**. With a large majority, there is now a high probability that the withdrawal bill proposed by Johnson will be passed by the UK parliament and ratified by the European parliament before the deadline of 31st Jan 2020. Johnson and his cabinet will then have until end-2020 to negotiate a new trade agreement, with the possibility [at the time of writing] of extending the transition period to 2022. The overall impact on UK financial markets has been moderately positive with GBP rising to c. 1.33 against the US dollar.
- **The Japanese cabinet has announced an economic stimulus package of $240bn (including a $120bn fiscal stimulus)** to support flagging growth in the economy as it suffers from: i) Weak exports due to cooling global demand; ii) The recent consumption tax hike; and iii) Destruction from the recent typhoon.

2. Our Five-Year Outlook

A summary of our updated Five-Year Outlook is provided below:

- **First**, over the next two years, we continue to forecast that the Eurozone, UK and Japan have the highest risk of recession. However, for the US we think monetary easing so far has been enough to stabilize economic growth at or below neutral levels. Over five-years, our outlook of downside risk being greater than upside risk is unchanged.
- **Second**, developed world central banks started the year with relatively limited firepower via their monetary policy to offset any shocks that arise – this situation has worsened given the easing of financial conditions this year, especially the significant fall in US bond yields.
- **Third**, relative to our medium-term outlook, we believe valuations for growth-related assets are still high and expect low returns on average over five years, …
- … which would put pressure on savers' wider financial positions.
- **Finally**, achieving investment return targets – and hence meeting savers' expectations – is expected to be difficult in this environment.

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.

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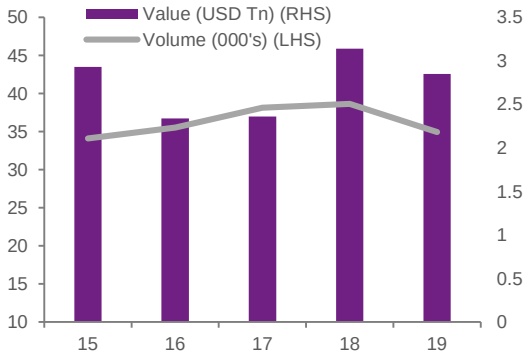
Summary

Our outlook for alternative beta strategies

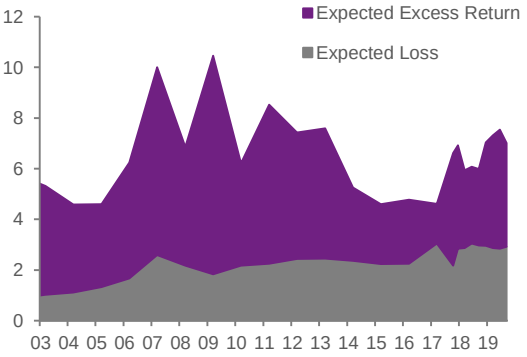
- Merger arbitrage has benefited from the M&A environment – characterised by wide spreads and high levels of deal activity. We expect high spreads and lower than expected failure rates to generate reasonable returns, while deal volumes have remained relatively robust albeit weaker than the past two years.
- Substantial aggregate insured losses over 2017 and 2018 have constrained reinsurance capacity somewhat and encouraged reinsurers to raise premiums. Consequently, income and expected loss multiples have risen steadily over the last two years and are now at fair levels, even after taking account of the return skew and illiquidity in reinsurance markets.
- Volatility and fixed income and developed market currency carry spreads, i.e., interest rate differentials, are at the low end of historical ranges – a headwind for these strategies.
- In EM currency markets, interest rate spreads relative to developed market currencies are moderately strong. We are now also somewhat less concerned about the near term risks from rising US interest rates for EM currencies, given we think the US Federal Reserve is likely to keep interest rates on hold in 2020 and US economic growth is picking up.

Key indicators: market pricing

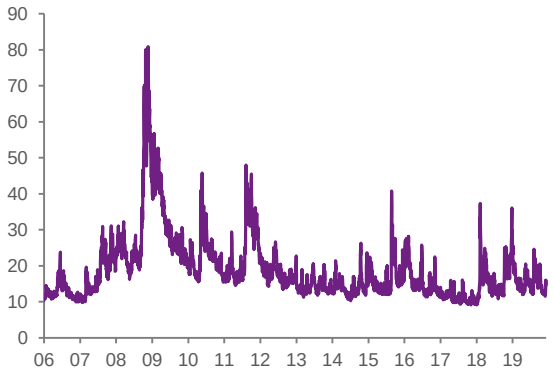
M&A deal value and deal volume have fallen from highs in 2018 but remain relatively strong
Global M&A deal value and volume – first 9 months



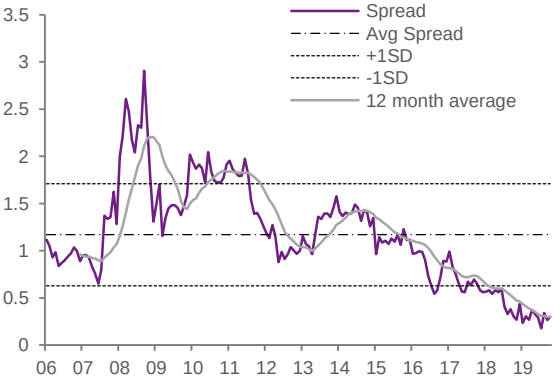
Reinsurance: Yield spreads for secondary market Cat Bonds remain strong in 2019
Secondary market yield spread (over cash) %



Volatility has risen from its 2017 lows but remains constrained despite recent spikes
CBOE SPX Volatility VIX



Fixed income carry spreads have broadly stabilised at historically low levels
DM FI carry spreads (10Y rates - 3M rates) (%)



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

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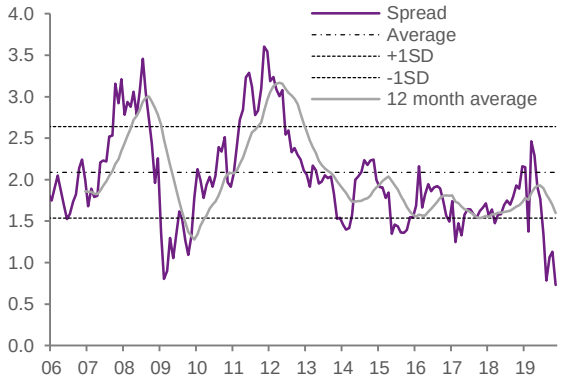
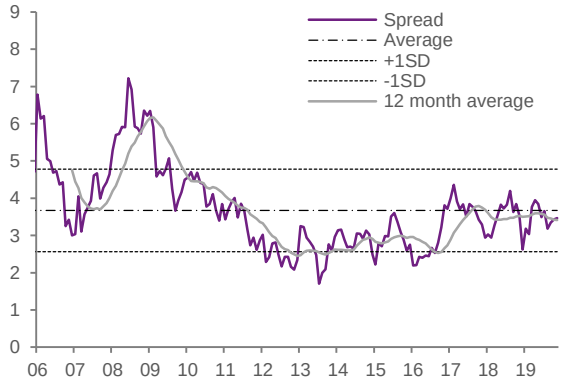
Key indicators: market pricing

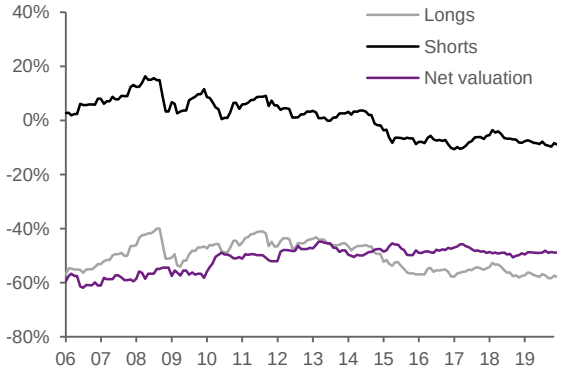
DM FX carry spreads – a measure of interest rate differentials – have fallen to unattractive levels …
DM FX carry spreads (real) (%)



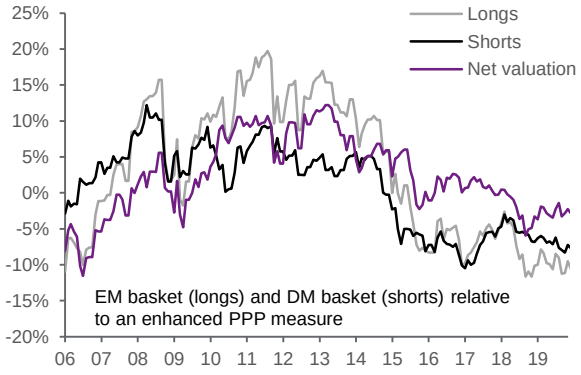
… whereas EM FX carry spreads are more neutrally priced relative to history
EM FX carry spreads (real) (%)



EM currencies are also significantly undervalued based on a long-term (15+ years) value metric …
EM basket (longs) and DM basket (shorts) vs. PPP



… however, when we adjust for medium term FX drivers, e.g., productivity differences and terms of trade – EM FX looks more neutrally valued



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

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