# Economic Outlook

***What Next?***

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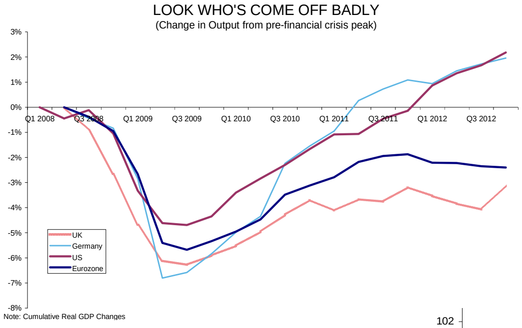
**Global Asset Allocation**

**November 2012**

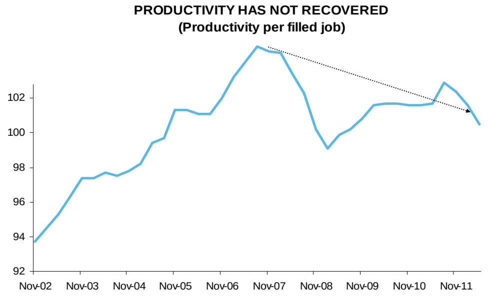
## Order of play

- UK economic outlook – focusing on growth and inflation
- Budget constraints and impact on monetary policy
- Gilts, gilts and more gilts
- Asset side – quick review

## The UK economy underperforms – weak recovery




**UK has had a particularly torrid time..**

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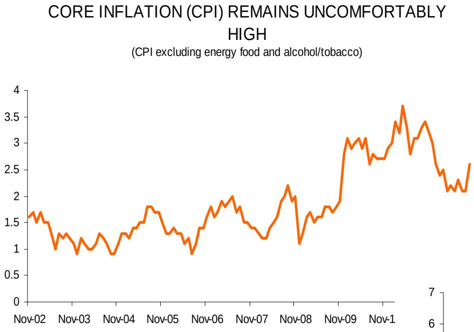
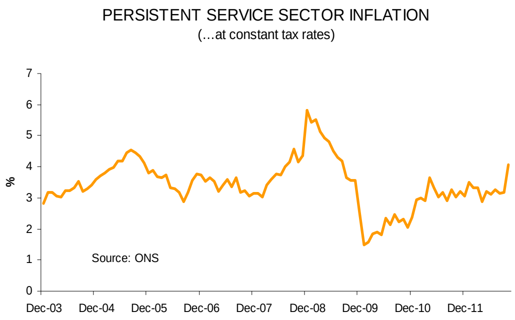
## The UK economy underperforms – persistent inflation




**…Makes it harder to argue for more monetary stimulus!**

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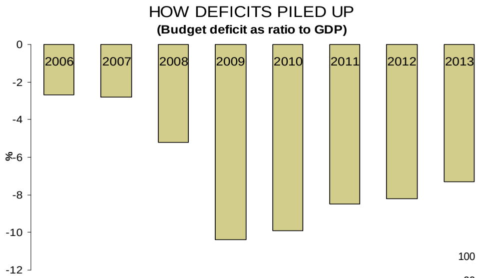
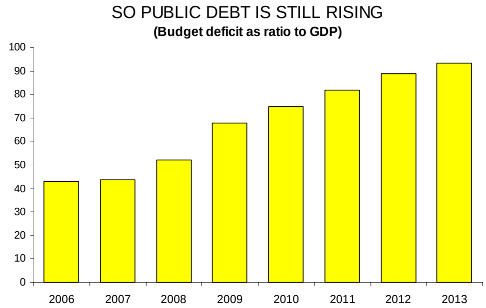
# Budget pressures have followed

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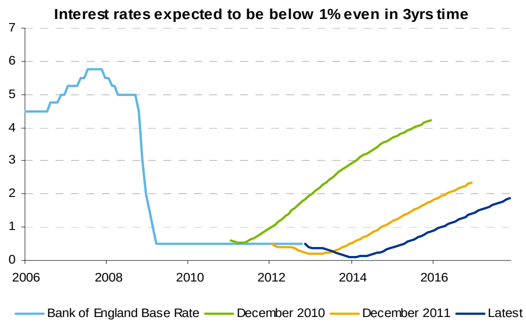
# What this means for interest rates

**FISCAL POLICY: LOCKED INTO TIGHTENING**
**What it will take to get Debt/GDP down to 60% by 2030**

| % | Debt/GDP current | Required adjustment (2012-20) |
|---|---|---|
| G20 countries | 90.2 | 12.1 |
| Japan | 126.6 | 18.2 |
| UK | 82.5 | 7.5 |
| USA | 102.9 | 10.9 |
| Germany | 81.5 | 0.3 |
| Spain | 68.5 | 10 |

Source: IMF

**With fiscal tightening inevitable, 'easy money' is the only way to support growth?**

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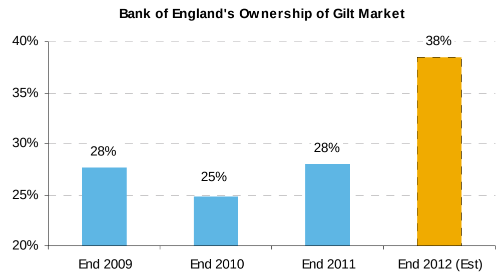
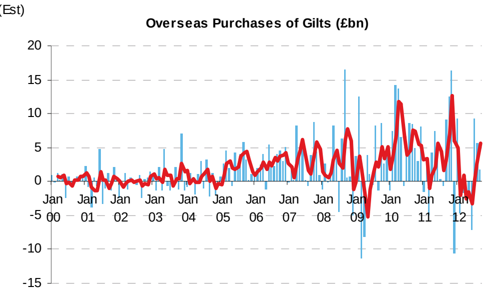
## Key additional factors impacting gilt yields




**The Bank of England has mopped up significant proportion of issuance**

**Foreigners have also been buying but UK's safe haven status is not guaranteed**

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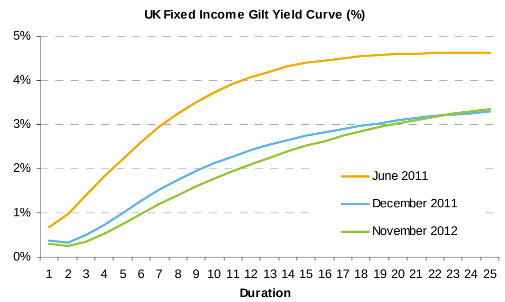
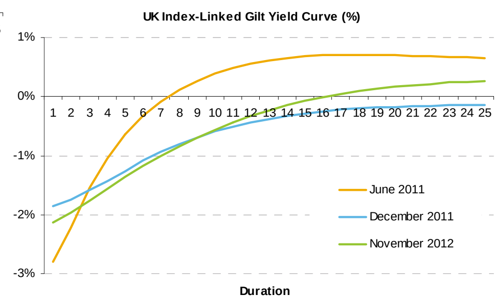
## Gilts: Extreme yield levels




- **Yields are exceptionally low - yields are below expected RPI inflation for all but longest durations**
- **Priced for no discernible economic improvement at all.**

- **Real yields have risen some – mainly on account of RPI news**

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## The gilt perfect storm through 2011/12…will it change in 2013/14?

- **Perfect storm ingredients to ease gradually?**
  - Will the collapse in short term rates expectations reverse?
  - *…..**Yes, very gradually, so long as the economy is going in the right direction***
  - Will the Eurozone crisis gilts get better?
  - *…..A **qualified YES. A crisis atmosphere to continue but no break-up***
  - Will quantitative easing continue to support gilts in the way it has?
  - *…..**More QE could come, but less coming over time…***

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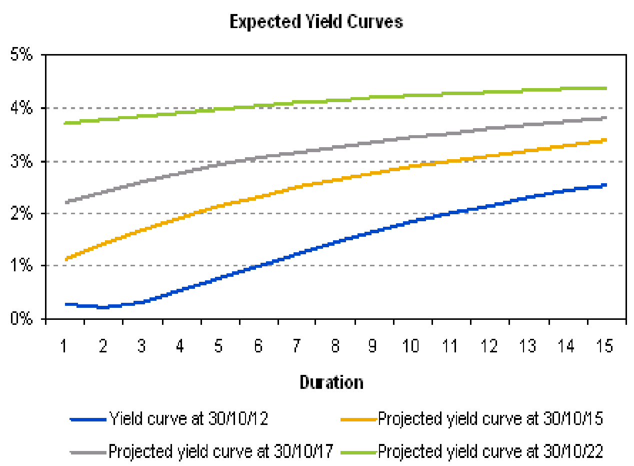
## Market expects some of these supports to wane

- What will cause current low yields to rise?
  - Gradual rise in short-term interest rates – as economic growth expectations improve
  - Cessation of Bank of England purchases
  - Change in inflation expectations

Market expects rates to rise, but very gradually.

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## Gilt Yields: Market Views vs Aon Hewitt

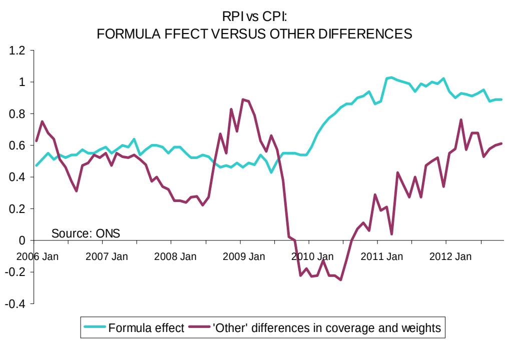
| What's Driving Yields? | Market View | Our View |
|---|---|---|
| **Bank Of England Interest Rates** | The Bank of England keeps bank rate where it is till 2014 and rates rise very slowly after that | Inconsistent view - even with weak growth, the Bank cannot keep rates so far below inflation for such a long time. Slow to start raising rates, yes, but they will move up more quickly than market currently expects |
| **Quantitative Easing** | Quantitative easing will still support gilts | Less support from QE over the coming year as limits now apparent |
| **Eurozone Crisis Led Demand For Gilts** | Eurozone crisis and search for safe haven carry on supporting gilts | Helping gilts here and now but don't expect to rely on this indefinitely |
| **Pension Fund, Banks, Insurance Company Buying** | Pension fund, banks and insurance companies buy more, preventing yields from rising | We doubt that this stops yields from rising. Pension funds are not the only players in fixed gilt market, though they do influence index-linked more. Banks have already bought a lot and their gilt needs from here are lower. |

Our view is that yields will rise more quickly and further than the market expects….



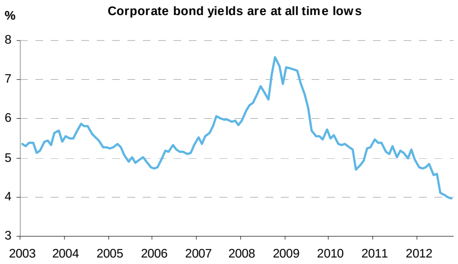
## Inflation: Uncertain outcomes?

- RPI to CPI inflation differential predictions now even more uncertain.
- Unknown course of formula effect not the only factor.
- Bigger issue is where inflation will end up as a whole – given economic policy environment!

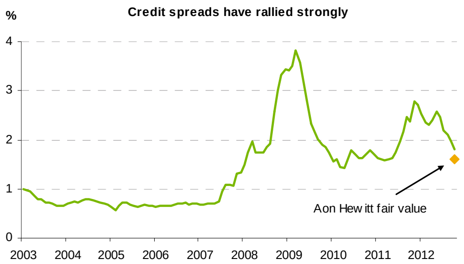


# Corporate bonds to the rescue?

*Not Any More*




- **A big squeeze on expected returns is on.**
- **Credit has rallied big time, driving yields down to very low levels.**
- **Interest rate (duration) risk here now a problem should government bond yields rise.**




**Recent strong performance means more limited room for reduction in credit spreads**



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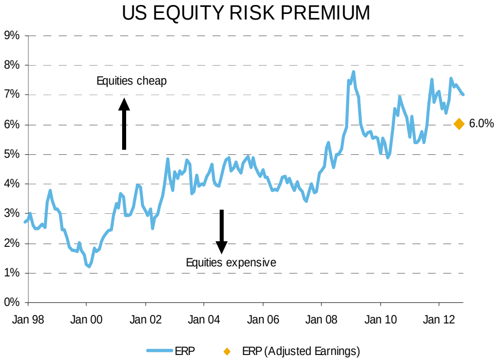
# Equities should be preferred to Gilts…

- Whatever the hurdles, equities are easy to like versus bonds.
- Equity risk premium, after our earnings adjustments, still looks good.
- The 'valuation problem' is with bonds, not equities.
- Equity valuation ratios (price-earnings, price to book etc) are fair.



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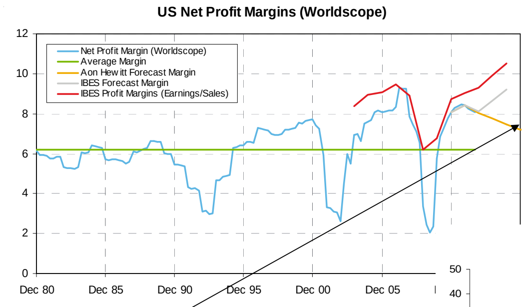
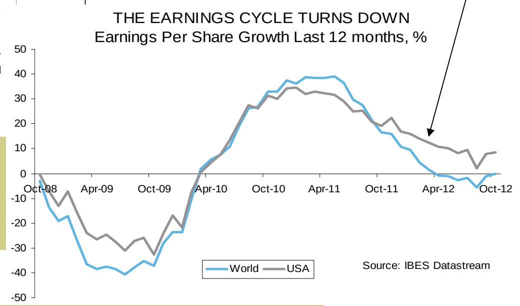
## But equities may not deliver quite yet




**Earnings growth**
**Globally has already slowed markedly**




**As the one-off cost cutting and benefits of low interest rates drops out US profit margins likely to be pressured – Market consensus is now figuring this out!**

**And…global economic and financial fragility is still likely to hold equities back**

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## Alternatives

- Superior risk-adjusted returns to conventional asset classes?
- But diversification benefits are more limited if there is any serious market dislocation
- Property, Infrastructure and some Hedge Fund strategies favoured

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# Conclusions

- Weak economy and public finances will be with us for some time
- Gilts still have support now, but look to lose some over time given current extreme yield levels
- Gradual gilt yield rises the likely result – probably more than market currently expects so long as worst case scenarios are avoided.
- Inflation uncertainty goes beyond RPI-CPI
- Corporate bond returns are fading
- Equities to do better than bonds but may not deliver quite yet. Alternatives are, for now a better hiding place…