Economic Outlook

What Next?

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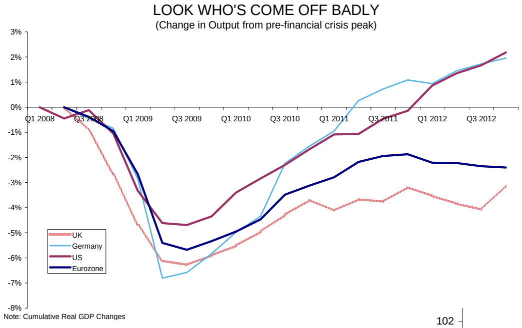
Global Asset Allocation
November 2012

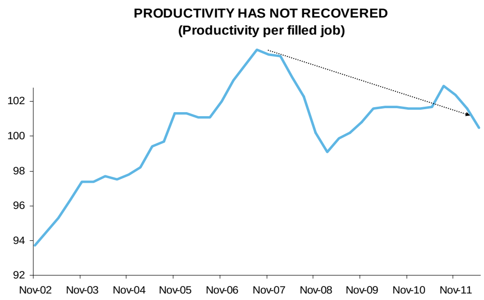
Order of play

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

The UK economy underperforms – weak recovery



UK has had a particularly torrid time..



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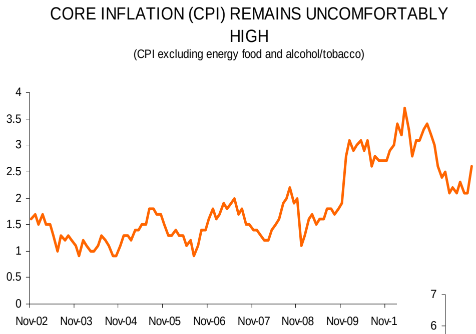
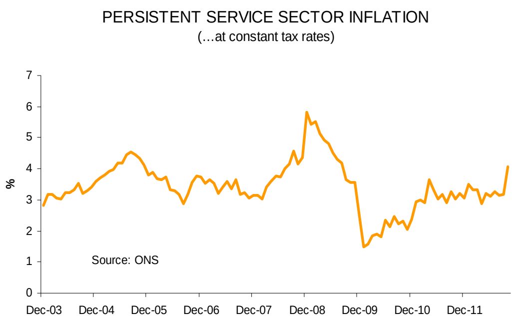
The UK economy underperforms – persistent inflation



…Makes it harder to argue for more monetary stimulus!



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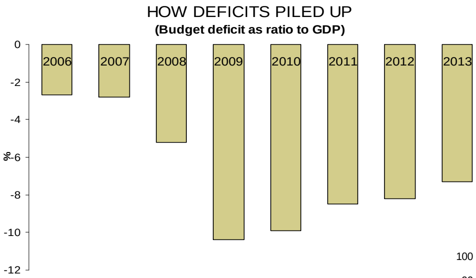
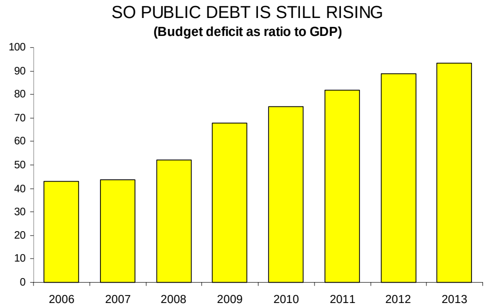
Budget pressures have followed





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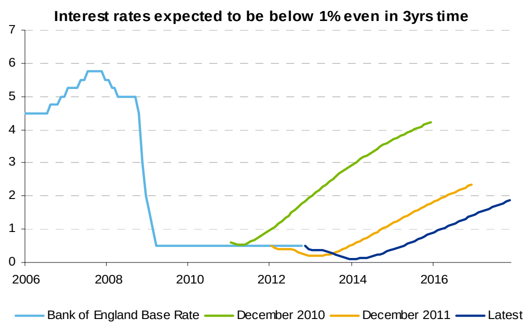
What this means for interest rates

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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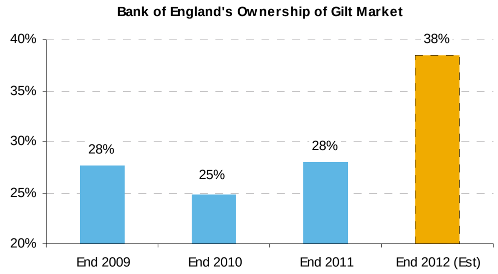
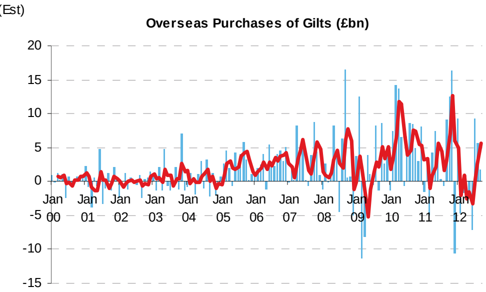
Key additional factors impacting gilt yields

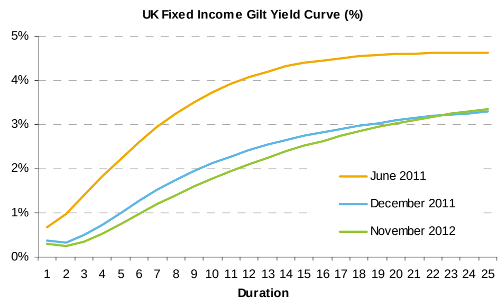


The Bank of England has mopped up significant proportion of issuance

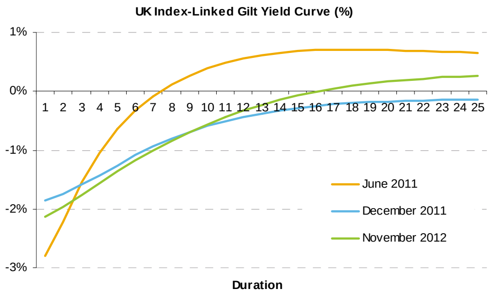


Foreigners have also been buying but UK's safe haven status is not guaranteed

Gilts: Extreme yield levels



- **Yields are exceptionally low**
  - **2nd half of 2011 was the time when…greatest damage done to liability valuations**
- **Yields are below expected RPI inflation for all but longest durations**



- **Index-linked gilt yields went to ludicrous levels, guaranteeing losses in real terms**
- **Have since increased though still very low**

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

- **Perfect storm ingredients**:
  - Will the collapse in short term rates expectations start to reverse?
  - Will the Eurozone crisis prompts safe haven bid on gilts get better?
  - Will quantitative easing continue to support gilts in the way it has?

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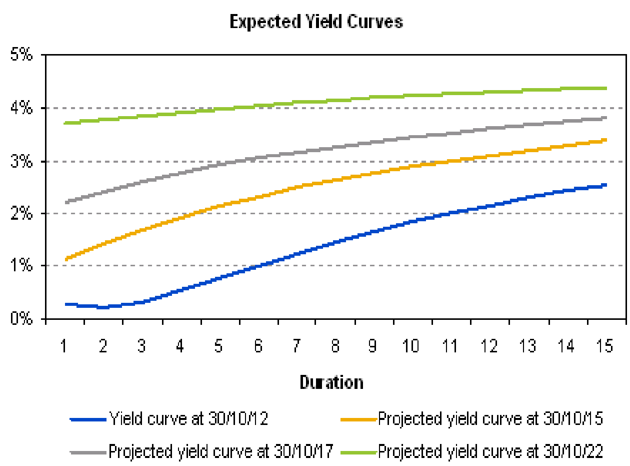
Market expects some of these supports to wane

- 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….

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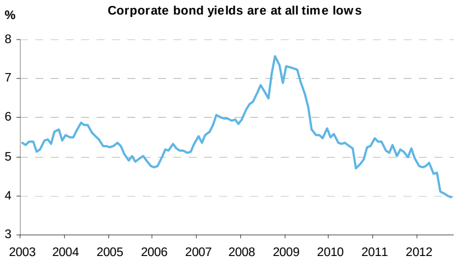
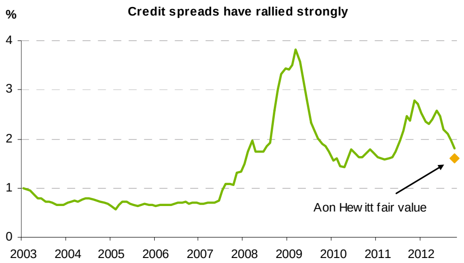
Corporate bonds to the rescue?

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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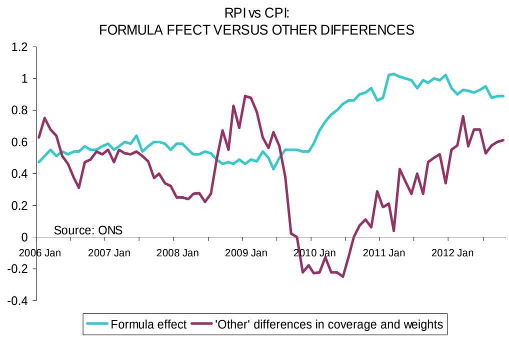
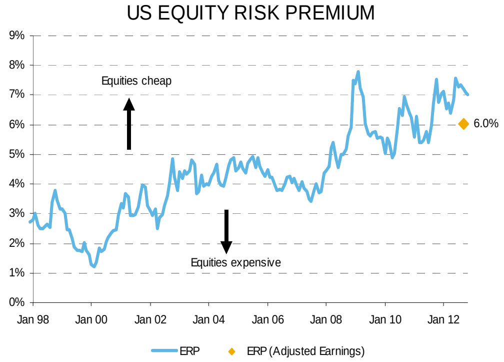
Inflation: Uncertain outcomes?

- 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!

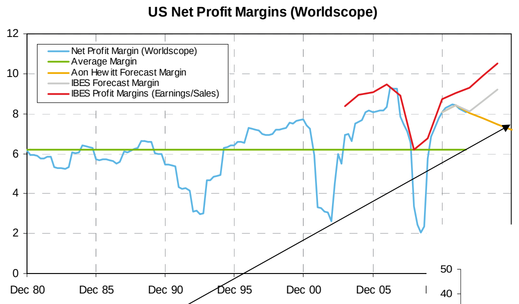


Equities should be preferred to Gilts…

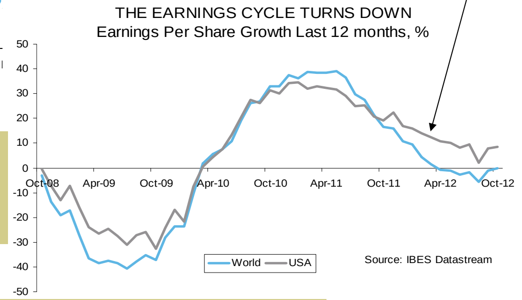
- Whatever the hurdles, equities are easy to like versus bonds.
- Equity risk premium, after our earnings adjustments, still looks good.
- The 'valuation problem' is with bonds, not equities.
- Equity valuation ratios (price-earnings, price to book etc) are fair.



Equities may not deliver 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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