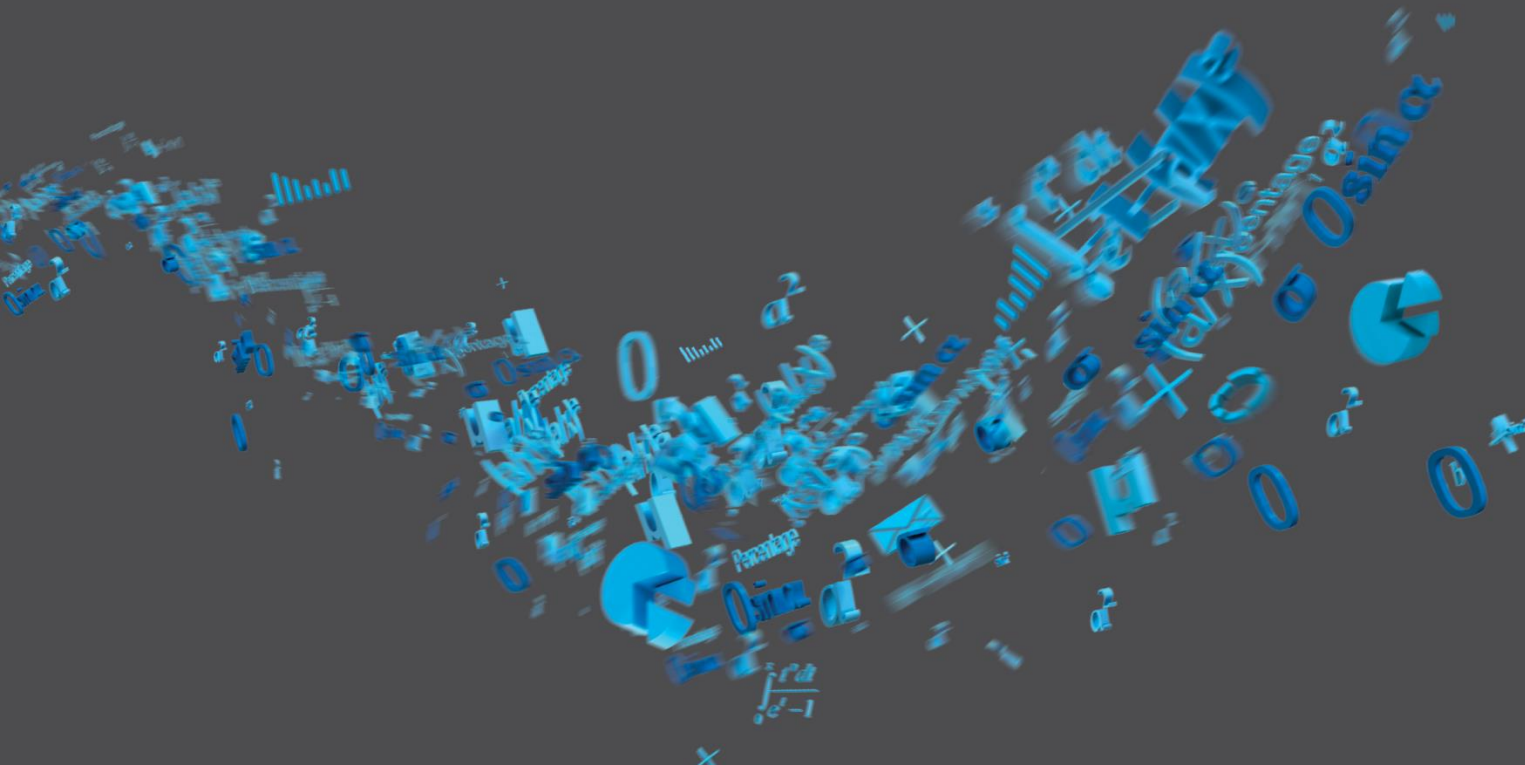


# Quarterly Investment Outlook

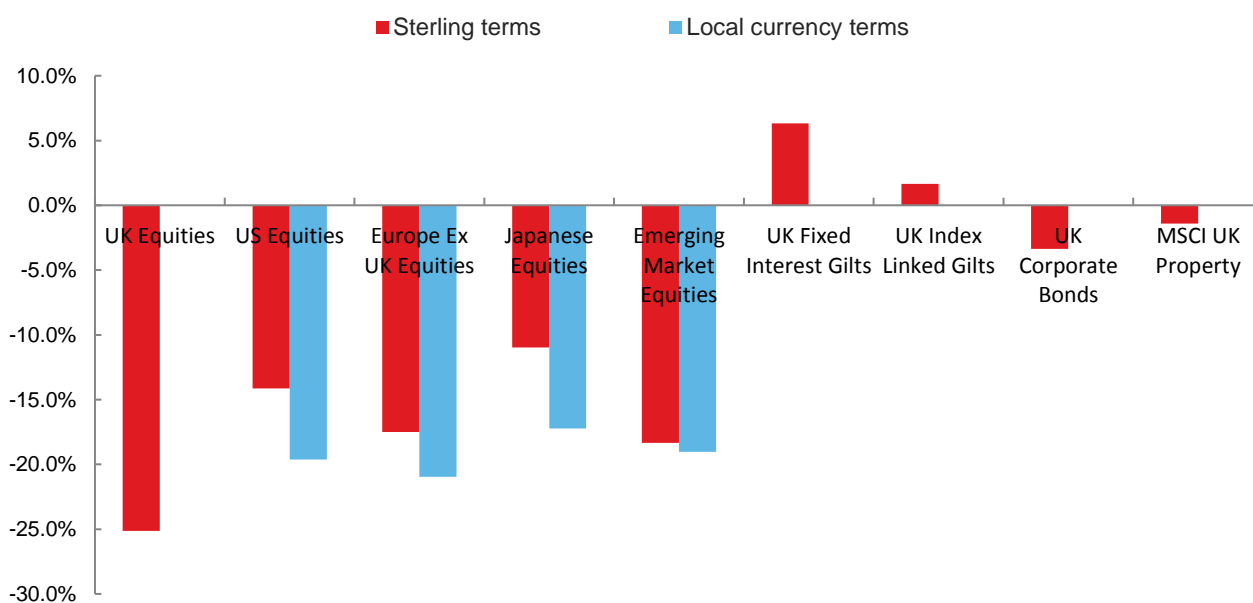
April 2020



## Summary

- The swiftest equity bear market on record has been followed by a strong snapback, helped by a vigorous policy response which has lifted investor confidence.
- The scale and range of global central bank and public finance support in fighting the Pandemic's economic effects is on an entirely different scale to the 2008-9 financial crisis. This seems appropriate now but is no free lunch given its risks and costs looking further out.
- UK interest rates and gilt yields will remain very low well beyond the immediate downturn. It is needed to help fund very large budget deficits and support continued subpar economic activity.
- A severe credit market sell-off, exacerbated by a large 'fallen angel' problem and illiquidity, has been eased by targeted US Federal Reserve buying. Valuations are less alluring now but still offer attractive entry points for investors looking through likely high volatility.
- Global equities have not cheapened much on a standalone basis. Looking versus bonds, by contrast, signals equities' longer-term attractions. For now, though the policy response has put a downside safety net on markets, the outlook is mixed and buying opportunities look limited.
- Portfolio diversifiers have helped shield portfolios recently and stay important. Should market weakness continue or resume, some diversifiers may become funding sources for adding risk.
- Commodity woes are long-term rather than just pandemic-induced. These secular drags look unlikely to lift. Gold remains on stronger ground.
- Hedging costs for overseas assets are much lower as global rates have fallen more than the UK. Sterling could wobble again, but hedging still looks reasonable for the medium-term.

## Q1 2020 Performance Summary



Source: FactSet, Aon



## Rapid bear market, strong snapback

As the pandemic scare broke in late February, equity markets broke down very rapidly. Bullish sentiment had been riding high and markets were caught unprepared. What seemed to be a contained and localised China health issue was suddenly seen differently as the transmissibility of the Corona virus dawned on markets. The swiftest bear market on record followed. Market falls were amplified by fear of the economic drawdown effects driven by the governmental lockdowns that swept the globe in early March. At its worst point the global equity market fall reached about 33%, well over the 20% threshold normally assigned to bear markets.

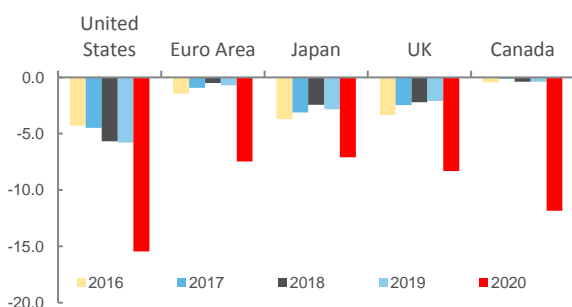
Policy intervention was swift too and brought much-needed support for markets by late March. At the time of writing, markets are still responding well to central bank liquidity injections and their direct intervention in markets, seen as alleviating the risk of some worst-case scenarios.

## Huge policy response on every front

The launch of quantitative easing (QE) monetary stimulus in 2008 was described as 'extraordinary' and 'unconventional'. What we have seen in the past few weeks is far more extraordinary in scale and range. The US Federal Reserve's balance sheet is already up from about \$4 trillion pre-virus-scare to over \$6 trillion now in just a few weeks; it is widely expected to reach \$9 trillion at year-end the increase alone being about a quarter of this year's likely US GDP. This is a colossal monetary expansion, quantitative easing on a radically different scale to all previous rounds. The US is leading, but rapid balance sheet growth can be seen in all the world's major central banks in a no-holds barred attempt to liquify the financial system and prevent another financial crisis. Earlier US QE rounds had mainly bought government bonds, but this now extends to areas which even recently would have been regarded as a no-go area for the Federal Reserve Bank. Astonishingly, it is now supporting the high yield bond market.

### Budget Deficits Soaring:

General government deficit forecasts as % of GDP



Source: IMF World Economic Outlook, April 2020

Equally dramatic changes have occurred on the fiscal front. Deficits always rise in economic downturns because the tax take falls and costs of social security rise. The difference this time is that the so called 'discretionary' fiscal outlays to cushion economies, have, like monetary policy, been on a far larger scale; the US is also on a stronger path here than elsewhere, but other economies are similarly likely to see deficit to GDP ratios triple and quadruple (see chart above).

## No immediate 'payback' required

Many will ask what the 'payback' will be for this kind of extraordinary support. The answer is that there is no obvious payback now. QE comes from central bank money creation, which has no obvious limits. Since central banks see monetary expansion now as warding off an immediate deflationary threat, the fear of inflation is not on the radar. Should inflation concern surface, central banks will argue they can withdraw stimulus. Inflation fear is an 'if'. Looking back, even though large-scale QE during and after the financial crisis has not been reversed, inflation has tended to stay stubbornly low in the US, Europe and Japan.

Fiscal stimulus is also not that different. You could argue that large deficits might push interest rates higher on bonds if investors require more incentives for buying government debt. Again, however, the past decade's experience is that large deficits and high debt have not posed a threat since bond yields have mostly fallen over this time. Very low interest rates and large - scale QE will, in case, help absorb a significant part of new government borrowing.

## ...but policies carry risks and costs down the road

However, such policies bring problems down the road for several reasons. These three are key.

- First, the scale of current QE and budget deficits are a multiple of that seen before. If reversed as the global economy normalises, there may be no long-term effects on inflation, interest rates or economic activity, but what if this does not happen? What then? The after-effects can still bring major risks later.
- Second, central banks' involvement in such a range of markets impairs normal market mechanisms. Prices may no longer reflect normal market forces, but the effects of central bank intervention. Markets then work less well, and everybody loses in the process.
- Third, central banks could be playing into 'moral hazard', encouraging risky behaviour. This happens if we always see expect the authorities to pick up the consequences, absorbing losses through taxes. Seen with bank rescues in the 2008 crisis, buying risky credit now could be argued as similar.

For the time being, these extraordinary policies are being regarded as appropriate for the pandemic emergency. Alleviating extreme economic risks has clearly helped rebuild some market confidence. However, the impact of such policies still imposes risks and costs on economic and market mechanisms that are hard to ignore.



## Interest rates and gilt yields

### Keeping rates and gilt yields very low

The severity of the recession unfolding in the UK is now becoming clear, though this is very much in line with that seen elsewhere. The downturn's duration is more important than its severity and clearly depends on when some semblance of economic normality resumes. We do expect the worst of the economic downturn to be over by the third quarter of this year as restrictions on economic activity start to be lifted. However, we acknowledge the high uncertainty involved in taking this as a high conviction view.

One element of the market environment that is least likely to change is the outlook for UK interest rates. Even on an optimistic view of economic recovery in late 2020 and into 2021, it seems unlikely that this will lead to much by way of interest rate moves from the Bank of England or a significant rise in depressed gilt yields. This is for two reasons. First, every monetary stimulus channel possible – zero interest rates and QE will continue to be employed so long as economic conditions are weak and inflation not a threat. These conditions will very likely hold in 2020-21. Second, the burden on government finances of supporting whole swathes of the economy is such that the monetary and gilt financing routes need to stay supportive. This involves keeping interest rates and gilt yields as low as possible. We expect gilt yields to stay very low for the medium-term because the (nearly) zero bank rate policy anchor and QE will together hold down much of the gilt yield curve. This is exactly what the Bank of England wants.



## Credit views

### Looking behind the credit sell-off

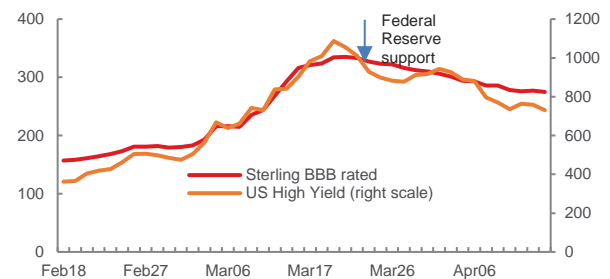
Credit matched equities in the speed of the sell-off last month, with US investment grade spreads above US treasuries reaching levels not seen outside the financial crisis. Fear of ratings agency downgrades of corporate bond issuers drove the reaction, but there were two additional factors making the impact more severe. As we have noted over several years, investment grade credit indices have dropped in credit quality in the past decade, shown in a growing proportion of BBB bonds (the lowest rate investment grade bonds on the S&P ratings scale, equivalent to Baa on the Moody's scale) relative to higher graded bonds. When BBB bonds are downgraded, prices fall by more because they fall into high yield indices as so called 'fallen angels'. Surging fallen angels - \$140 billion worth in the US in just five weeks to early April – explained the sharpness of the move in credit spreads. The second factor was illiquidity. Price reactions are more severe when transactions costs rise as bonds become difficult to trade.

Barclays estimated that in late March, 'round trip' (buy and sell together) costs in the US market had risen from 0.5% to about 2%. The decline in corporate bond liquidity has been creeping up on us for a decade and its effect was also to accentuate the sell-off.

### Credit opportunity

Calm in credit markets returned after the US Federal Reserve moved to prevent the market rout turning into a full-blown seizure. In late March the Federal Reserve announced a range of interventions, including direct support for fallen angels which had, by then, turned into a systemic threat. This rescue has had a steadying influence globally, especially on riskier credits like BBB rated bonds and High Yield, more so because it was unexpected (see chart).

#### Central bank buying helps riskier corporate bonds (Spreads (OAS) above government bonds, basis points)



Source: BAML Indices, ICE

What is the outlook for credit investors today? For buyers looking for an entry point into credit, valuations were very enticing in mid-March given the preponderance of sellers, even though buying was very difficult given acute illiquidity. Valuations are less alluring now on central bank moves, though still good versus historic norms, a sign of market concern about corporate casualties ahead. Such an uncertain economic outlook makes even central bank support no guarantee of risk reduction, though it makes extreme weakness less likely. Those looking through the periodic bouts of high volatility and weakness ahead will find this to be a better entry opportunity than we have had for some years. Large market dispersion, between different risk segments for example, argue for active approaches.



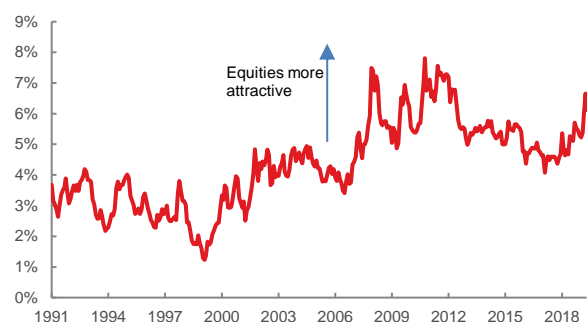
## Equities

### How attractive are valuations today?

Equities have benefited strongly from policy stimulus announcements in the past few weeks. The snapback has been impressive. At the time of writing, global equities have retraced broadly half the ground ceded in the market turmoil through March.

Have market valuations improved significantly to make equities more attractive? On a standalone basis, taking valuation ratios like (forward) Price-Earnings, or Price to Cash Flow, any improvement is marginal once we allow for substantial declines in corporate cash flow and profits (earnings per share could be 20-40% lower in 2020), which are now only appearing in analysts' forecasts. Of course, markets could be looking through this, assuming a big rebound in 2021, but this is a gamble. The valuation measure that does look good for equities is the equity risk premium, a measure of the estimated expected excess return that equities should earn over bonds. After another fall in bond yields, our equity risk premium calculations are once again suggesting longer-term attractions (see chart). This has been supportive of equities for much of the past decade, so it predates recent market moves, but it has been moving higher again this year. The equity risk premium can stay high without equities benefiting for some time but does suggest that such low cash and bond yields will probably draw equity investors in once the virus scare passes.

**US equity risk premium signals longer-term attractions**  
(Expected excess returns over ten-year US treasury bonds)



Source: Aon, FactSet

**Waiting to buy?**

What then should investors do now? Our view until recently, was that market falls, the strong policy response and support from lower bond yields made a good case for some cautious buying, a way to rebuild positions towards strategic target allocations. However, the strong snapback leaves global equities now only slightly below year-ago levels. Those needing to buy more are better off waiting. The market is likely to undergo further periods of weakness and high volatility offering more buying opportunities in time.



**Diversifiers**

**Coming into their own**

Recent market drawdowns in credit and equities have highlighted the benefits of diversifiers. They will have done a good job in protecting portfolios through the market declines. Of course, 'diversifiers' as a generic description of asset classes that offer less downside risk in poor market

conditions is a very wide spectrum. Purer forms, like cash and bonds offer zero or inverse correlations with risky assets; there are hedge fund/absolute return strategies that offer low correlations; illiquid asset classes, private real estate being a good example, offer a reasonable buffer, though this is partly to do with their infrequent mark to market valuations. It is too early to tell how some of these diversifiers have done. Bonds have clearly done well, as have global macro hedge fund strategies, but real estate has been less well-placed owing to the Covid 19 impact on real estate demand, even though they will very likely be found to have outperformed equities significantly when the dust has settled, and some valuation data come through.

What we can say at a high level is that the uncertainties we face in markets as we look ahead continue to argue the case for diversifiers. Equally, it is true that if market weakness in equities and credit resumes or persists, we will see their relative attractiveness over diversifiers improve. In this way, diversifiers will have proved their credentials and will become funding sources for adding risk to portfolios.



**Commodities**

**Price woes are not new**

Modern 'commodity-light' economic growth and muted inflation pressures have not been helpful to the commodity cause for many years. Now, the virus scare has compounded the commodity complex's woes. For crude oil, supply discipline had in earlier periods produced phases of price firmness, but this is now notably absent. Lurking in the background in the oil market is a regulatory-ESG risk premium limiting long-term usage of carbon-intensive energy. All these factors will weigh on the commodity complex on an ongoing basis. Prices may get some help from an economic recovery in 2021/2 but face formidable headwinds from these long-term secular depressive trends. Gold will, however, behave differently. Zero interest rates, the extreme economic policy environment and central bank buying gives it support. If inflation fears eventually revive, gold stands to benefit more than other commodities.



**Sterling**

**Hedging costs fall**

The large cut in US rates and lower rates elsewhere have reduced the costs of hedging overseas assets into sterling. A small cost exists, but a fraction of those seen for many years. The drag on overseas asset returns from hedging is far lower. Some downside risk for sterling still exists given Brexit and other uncertainties, but there is undervaluation from a longer-term viewpoint, favouring hedging.

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## Aon's Global Asset Allocation Team

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Our experts analyse market movements and economic conditions around the world, setting risk and return expectations for global capital markets.

The team use those expectations to help our clients set and, when it is right to do so, revise their long-term investment policies.

We believe that the medium term (1–3 years) has been under-exploited as a source of investment performance. Maintaining medium-term views that complement our expectations for the long term, we help our clients to determine when to make changes to their investment strategy.



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