Quarterly Investment Outlook

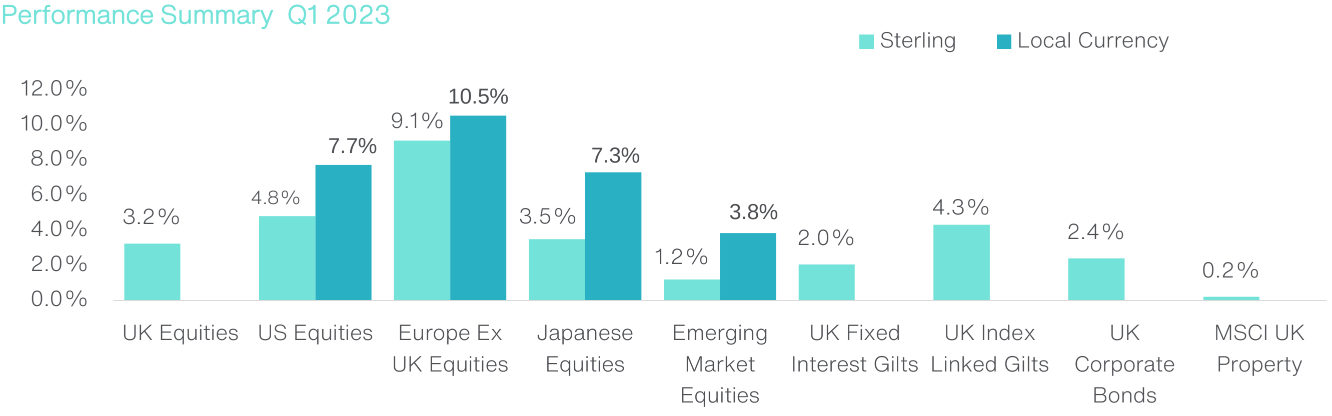
April 2023

21/4/2023

Summary

- Expectations of an US interest rate pivot later this year have supported markets, but this view of coming rate cuts looks increasingly premature.
- The economic follow-through effects from last year's large interest rate rises and recent credit tightening by banks does point to the likelihood of the global slowdown turning into recession over the coming year.
- Persistently high underlying UK inflation keeps upward pressure on interest rates. Even taking a longer-term (five-year) view, a return to the ultra-low UK interest rate environment of earlier years looks unlikely.
- Gilt yields continue to be in a range with relatively high trading volatility, common to global fixed income, as interest rate uncertainties continue. Limited reversion prospects mean that index-linked gilt yields could now remain positive over time.
- Credit's worth is in its ability to earn excess returns over equivalent duration government bonds. This could still be a struggle near-term, but credit spreads are fair value for longer-term strategically positioned investors.
- Equities are unlikely to go anywhere fast given multiple headwinds and we continue to prefer other return sources less dependent on rising markets. Insurance-linked securities and macro strategies are two places to look.
- It should be obvious that last year's big market upheavals have raised the reward and preference for liquidity for many. For those less liquidity-constrained, this could in time start to present opportunities.

Performance Summary Q1 2023



Source: FactSet, MSCI (Equities, Property), FTSE (Gilts), iBoxx (Credit)

Past performance is no guarantee of future results. Indices cannot be invested in directly. Unmanaged index returns assume reinvestment of all distributions and do not reflect fees or expenses

Markets stay resilient

By and large, bonds and equities have stayed resilient in the early months of this year. Government bond yields fell, as some easing of inflationary pressures and the travails of US regional banks in March helped build expectations of interest rate cuts to come from the US later in the year. Equities and credit benefited. Just as faster than expected rises in interest rates had hurt all assets in 2022, so this year, this key market driver has worked in reverse, offsetting fears of a coming recession. Our sense is, however, that the global inflation outlook makes early or large rate cutting difficult to do, risking market disappointment.

Bank credit tightening and its effects

The small handful of bank failures in the US in March was met with a forceful response from regulators who appear to have successfully stopped contagion effects from sweeping more widely through the US banking system. However, these developments do look likely to lead to more credit tightening, already in evidence before this year's bank troubles arrived. The large rise in interest rates in 2022 had already led to increased risk aversion by US banks. Willingness to take more credit risk in loan books is likely to have reduced further since then, bringing more headwinds for the US economy.

Though Europe and the UK have not experienced the same banking difficulties seen in the US, it is clear from bank lending data in both regions that credit growth to both businesses and consumers is slowing markedly as higher interest rates and bank caution take hold. This is both 'demand' and 'supply' working together; lenders becoming more wary (credit supply) and borrowers less able or willing to take on debt (credit demand).

Recession likely though not inevitable

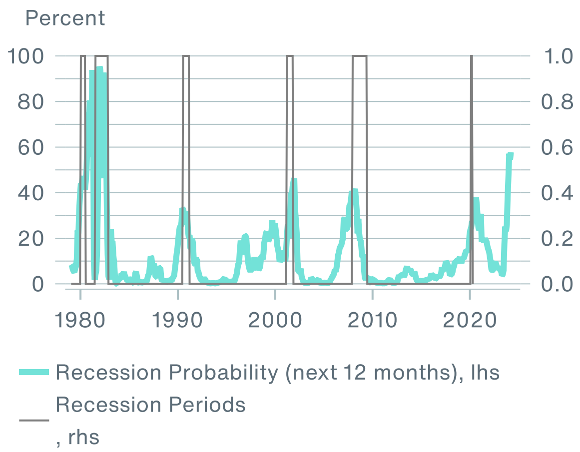
It is still a matter of conjecture as to how deep the current economic slowdown will be. This economic cycle is quite different to those of the past few decades, with interest rates and monetary tightening

Market data source FactSet, Macrobond, Bloomberg
The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

having come from a starting point of near-zero interest rates, and relatively high inflation, the likes of which have not been seen for several decades.

Economic data confirm an unfolding economic slowdown in the US and Europe, but this is not telling us much about what lies ahead. Some of the traditional leading indicators of an eventual fall in output are, however, flashing red. The New York Federal Reserve recession predictor sees the current inverted shape of the yield curve implying a near 60% risk of recession on a 12-month view. The indicator has never been anywhere near this level without a recession having followed (see chart). Credit and money supply data, also used as a forward indicator, are also pointing this way. These indicators do not imply that a recession is inevitable, but the likelihood is high. The US Federal Reserve's policy committee has already stated recently that it expects a mild recession later this year.

US Recession Probability Rises



Source: New York Federal Reserve, NBER, Macrobond

UK inflation and the rates outlook

UK inflation is currently still hovering at around double digits, though it should be on its way down in the next few months, helped by the dropping out from inflation indices of the big energy price rises seen in the second quarter of 2022. While this should help headline inflation to eventually get closer to the Bank of England's 2% inflation target, underlying inflation (i.e., excluding energy and other volatile items) will be slower to fall. Wages, the main element of service sector inflation are rising relatively quickly, reflecting a tight labor market, and this makes it more difficult for the Bank to keep inflation at its target as we look ahead (a forthcoming note will discuss in more detail). The continued Ukraine war, the impact on global supply chains of US-China tensions and Brexit-related effects on UK supply costs could also keep inflation higher for longer. In turn, this may constrain interest rate cuts even in a recession and limit the extent of any reversion to earlier levels, when the bank rate averaged 0.5% for about a decade. Rates markets currently show an expectation of the bank rate at close to 3.5% even in five years' time (see chart).

Markets see UK interest rates unlikely to return to earlier low levels (SONIA 1 month interest rate futures)

Source: ICE, Macrobond

Gilts - range-bound and uncertain

Our expectation that gilt yields would be choppy but largely range- bound in 2023 has so far largely been met. Although yields are close to the levels at which they started the year, the trading volatility in yields has been high, as seen in large day-to-day moves. Both UK and US government bond yield trading volatility is at present much higher than the longer-term average, reflecting elevated uncertainty over inflation and interest rates. While we have some confidence that we should avoid a repeat of the acute gilt market stress of last autumn, our view is that the subsequent strengthening of collateral buffers in liability-matching portfolios is appropriate for a very uncertain world for gilts and broader fixed income.

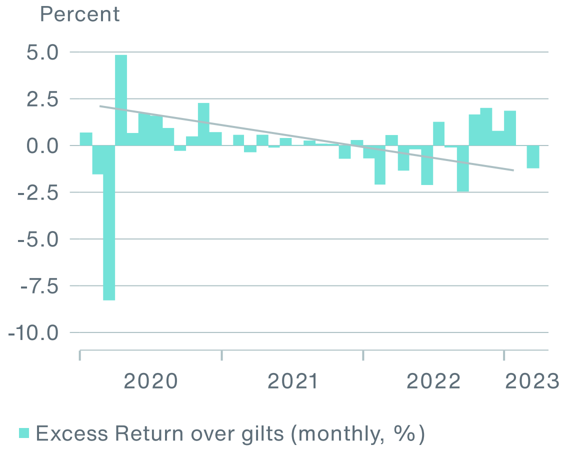
A key change for the UK is the way index-linked gilt (real) yields are behaving. We had learnt to live with deeply negative real yields on index-linked gilts since 2014, odd though they seemed at first. Now, after the events of 2022, much like UK bank rate settling into a higher range than previously, it should not surprise that gilt yields will also be in a range that is also higher and unfamiliar for us. This means that real yields may remain positive, rather than staying negative, a big break with the past.

Credit – when will it deliver 'excess' return' again?

The key performance test for credit is whether it is delivering positive excess (duration-adjusted) returns over safe government bonds, a key consideration for funds looking to earn excess returns on their liability benchmarks. Without this excess return, there is little point to taking the additional (credit and liquidity) risk in credit investing. With cash and even shorter-duration gilt yields now far higher than in earlier years, this also becomes a question for absolute return investors who could be choosier on taking credit risk.

The run up in interest rates and fragile economic conditions have turned corporate bond excess returns mildly negative, on average, vis-a-vis gilts through 2022/23 as credit spreads have risen (see chart). Will this continue? On a longer-term fair value basis, credit spreads now look reasonable on our calculations, so that excess returns should in time turn positive again. For longer-term buy-and-hold investors who have strategic reasons for growing their credit portfolios, current spreads are therefore not an obstacle. That said, in the medium-term, spreads still look likely to face headwinds from current economic conditions, so it would not be a surprise to see choppy excess return performance continue for the time being as upward pressure on credit spreads periodically resurfaces.

When will credit outperform gilts again?
(Excess returns of sterling corporates over gilts)



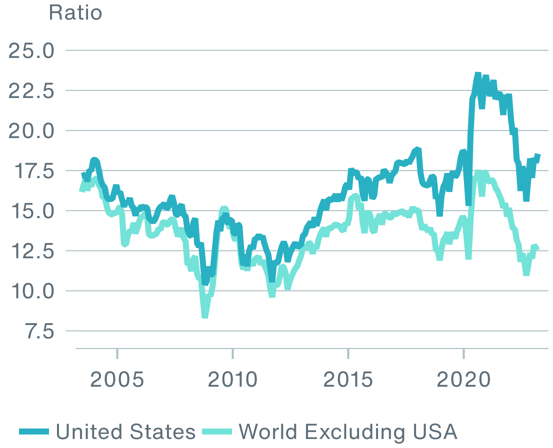
Source: ICE BofA, Macrobond

Equities – going nowhere - emphasis on other sources of return

Though global equity markets have been making some gains of late, we still find it hard to work up enthusiasm for at least three reasons. First, the combination of pressure on interest rates and slowing growth is likely to turn recessionary as we noted earlier. Earnings growth has turned negative now, and a further slowdown in the economy is likely to mean more pressures emerging. Second, multi-decade high US profit margins, a key support for the US market, have been eroding slowly. Lastly, our equity risk premium indicator relative to bonds continues to be lower than the average over the past decade, showing the loss of support vs cash and bonds. Allowing for these headwinds, current valuations do not suggest a good base on which to build further gains. We continue to look for other diversified return sources, emphasizing capital preservation. Insurance-linked securities, where premiums are now at attractive levels, and macro strategies which benefit from market volatility, are two viable alternatives.

Non-US equities should hold their own vs the US

Record valuation gap between US and non-US equities (12-month forward P-E ratios)



Source: MSCI, Macrobond

For most of the past year, non-US equities, led by Europe and the UK have been in the novel position of mildly outperforming the US. On a standard valuation basis, non-US equities are at their most attractive in the past two decades, the valuation gap having hit a record high in March (see chart above). Whether this valuation advantage will spur more non-US equity market performance is a difficult question to answer, partly because in difficult macroeconomic and market conditions the US tends to outperform, and this remains a clear risk ahead. This leaves us broadly neutral US vs non-US currently, though long-suffering emerging markets have a window to outperform.

Liquidity - 'price' and 'preference'

Last year's big market upheavals produced significant changes to expected longer-term returns across asset markets. Liquidity and relative safety (cash and bonds) saw the biggest gain in expected returns in Aon's 10-year capital market assumptions during the year, even though all asset return projections did benefit from the bad year. For example, expected returns for longer-duration UK investment grade corporate bonds rose by some 3.2% p.a. during 2022 compared with a far smaller 0.3% p.a. in UK commercial property (the difference is somewhat overstated given the lag in commercial property valuations). Another way of putting this is to say that liquidity is being 'paid' better than in earlier years.

In the UK, illiquid private assets have another set of headwinds, which is the greater need for DB scheme liquidity after the LDI troubles, alongside the overallocation to strategic targets in which many schemes find themselves in after the large 2022 falls in liquid asset markets. There are some countertrends – regulatory innovations may allow illiquid assets to make their way more easily into pension portfolios, but these will take time to be road-tested and reach scale. For now, liquidity preference will remain strong for many. For those less liquidity constrained, the weaker demand for illiquid assets could, in fact, present an eventual buying opportunity.

Data Definitions

MSCI UK Index – The MSCI United Kingdom Index is designed to measure the performance of the large and mid-cap segments of the UK equity market. With 80 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the UK.

MSCI USA Index - The MSCI USA Index is designed to measure the performance of the large and mid-cap segments of the US equity market. With 626 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

MSCI Europe Ex UK Index - The MSCI Europe ex UK Index captures large and mid-cap representation across 14 Developed Markets (DM) countries in Europe. With 344 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across European Developed Markets excluding the UK.

MSCI Japan Index - The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese equity market. With 237 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

MSCI Emerging Markets Index - The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries. With 1,379 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

FTSE Actuaries UK Conventional Gilts All Stocks Index - The FTSE Actuaries UK Gilts Index Series is a broad-based family of indexes and related bonds data (e.g., duration) based on all eligible British Government Securities. The index consists of all securities from the conventional index family of the FTSE Actuaries UK Gilts Index Series, which includes all British Government Securities quoted on the London Stock Exchange.

British Government Index-Linked All Stocks - The FTSE Actuaries UK Gilts Index Series is a broad-based family of indexes and related bonds data (e.g., duration) based on all eligible British Government Securities. The index consists of all securities from the index-linked family of the FTSE Actuaries UK Gilts Index Series, which includes all British Government Securities quoted on the London Stock Exchange.

iBoxx Sterling Non-Gilts – The Markit iBoxx GBP index represents the investment-grade fixed income market

for GBP-denominated bonds. The iBoxx GBP Benchmark spans an array of sectors, including corporate, gilt, sovereign, sub-sovereign and collateralised (inclusive of covered) bonds, with a history dating back to December 1997

MSCI UK Monthly Property Index - MSCI's IPD UK Monthly Property Index measures unlevered total returns of directly held property Standing Investments from one open market valuation to the next. Standing Investments Indexes include completed and lettable properties only, often described as operating properties.

Data Disclaimers

The information, materials and opinions contained in this document, enclosures or attachments are for general information purposes only, are not intended to constitute legal or other professional advice and should not be relied on or treated as a substitute for specific advice relevant to particular circumstances. We make no warranties, representations, or undertakings about any of the content of this document and any enclosures or attachments (including, without limitation, any as to the quality, accuracy, completeness or fitness for any particular purpose of such content). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility or duty of care in respect of this document, enclosures or attachments to any party including a Aon client.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process, and it should be noted in particular that we cannot research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies, and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time, and they should not be relied upon to capture future uncertainty or events.

Aon Solutions UK Limited is authorized and regulated by the Financial Conduct Authority. Registered in England & Wales No. 4396810. When distributed in the US, Aon Investments USA Inc. ("AIUSA") is a registered investment adviser with the Securities and Exchange Commission ("SEC"). AIUSA is a wholly owned, indirect subsidiary of Aon plc. In Canada, Aon Hewitt Inc. and Aon Investments Canada Inc. ("AIC") are indirect subsidiaries of Aon plc, a public company trading on the NYSE. Investment advice to Canadian investors is provided through AIC, a portfolio manager, investment fund manager and exempt market dealer registered under applicable Canadian securities laws. Regional distribution and contact information is provided below. Contact your local Aon representative for contact information relevant to your local country if not included below.

The Aon Centre
The Leadenhall Building
122 Leadenhall Street
London EC3V 4AN

Aon Investments USA Inc.
200 E. Randolph Street
Suite 700
Chicago, IL 60601
USA

Aon Hewitt Inc./Aon
Investments Canada Inc.
20 Bay Street, Suite 2300
Toronto, ON M5J 2N9
Canada

Contact Us

Tapan Datta
Aon
+44 (0) 20 7086 9076
tapan.datta@aon.com

About

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

For further information on our capabilities and to learn how we empower results for clients, please visit http://aon.mediaroom.com.