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MARKET ENVIRONMENT REPORT

Second Quarter 2014

MARSH & McLENNAN COMPANIES

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Executive Summary

- Interest rates declined slightly in the first quarter even as the Fed scaled back QE3, pushing the Barclays Aggregate index to a 1.8% return. Global equities shook off growth and geopolitical concerns with the MSCI ACWI index returning 1.1%. The most notable feature though was the reversal in relative regional, size and style performance in March.
- While growth in developed economies eased somewhat in the first quarter, this appears weather related, and consensus forecasts remain upbeat. The potential exists for further currency declines and a larger growth slowdown in emerging economies given imbalances, although this could be offset by stronger exports.
- The Fed appears likely to end QE3 in 2014. However, bond markets suggest that the Fed is likely to maintain its target rate at zero until mid-2015. Tighter US monetary policy could be offset by further easing in Europe and Japan. Overall, we characterize monetary policy as supportive of risky assets.
- While we have concerns about bullish sentiment, we continue to favor growth assets to defensive assets. The MSCI World index P/E is in-line with the long-term median and is priced to provide a healthy risk premium to bonds. US equities are expensive, but the macro environment remains supportive of profitability. Better values are available in foreign developed markets and there is greater potential for earnings growth.
- Emerging market equities appear to price a downbeat economic view, and valuations appear very attractive relative to the developed world. However, the cheap valuations are narrowly-based, driven by just a few sectors. We still favor EM stocks to developed equities, but it is too early to say whether the outperformance of emerging markets in March marked a shift or will prove temporary.
- Given the favorable economic outlook, we continue to prefer investment-grade corporate bonds over Treasuries, but tight spreads leave limited upside. We maintain a preference for high yield over Treasuries as economic conditions warrant a below average spread. However, high yield bonds have little upside, and we prefer the more symmetric return distribution of global equities. We continue to recommend a strategic allocation to local currency emerging debt, but further currency losses are a short-term risk.
- We believe the environment for active management should be favorable in the coming years. Easing macro risks have led to greater dispersion of security and asset class returns, a trend which we expect to continue. Divergences in global economies and policies should also provide scope for alpha. To capture these opportunities, we would advise a more flexible, high conviction approach to active management, such as unconstrained managers, multi-asset managers and hedge funds. With traditional assets priced to provide weaker returns, we think real assets and private equity investors should benefit from diversification and another source of alpha.

Market commentary

April 2014

Global equity markets rose modestly in the first quarter with the MSCI ACWI index returning 1.1%, although that masked an increase in volatility within the quarter. Markets declined in January before turning positive in February and March. Confounding the consensus, bonds enjoyed a rebound from a difficult 2013 as intermediate and long-term interest rates declined and credit spreads contracted. The Barclays Aggregate Bond index returned 1.8%, nearly recovering its 2.0% loss from 2013.

An interesting feature in the quarter was the sharp reversal in relative regional, size and style performance. January and February mostly marked a continuation of 2013: emerging markets substantially lagged domestic equities, small-caps outpaced large-caps, and growth (especially small and mid-cap) outperformed value. Those trends reversed in March. For example, through February, the S&P 500 was up 1.0% for the year, while emerging market stocks were down 3.4%. However, emerging markets outperformed the S&P 500 by 230 basis points in March, and this trend has continued into the first two weeks of April. Most of the performance advantage of small-caps in 2013 and early 2014 came from more speculative stocks (biotech, social media, etc.) in the small-cap growth universe. The Russell 2000 Growth index earned 47% from January 2013 through February 2014, 16 percentage points better than the Russell Top 200 (large-cap) Value index. The Russell 2000 Growth index fell 2.5% in March, while the large-cap value index rose 2.7%, recouping a third of the underperformance from the prior 14 months. As with emerging markets versus the US, this reversal has extended into April.

The reasons behind the relative shift in geographic and style and size performance are unclear, and it remains to be seen whether this represents a short-term blip or the beginning of new market leadership. There are indications that the moves have at least been amplified by long/short hedge funds unwinding positions, suggesting the potential for reversal. However, it also hints at a greater focus on valuations over momentum and growth—one theme that cut across geographies and styles was that cheap stocks performed better than expensive stocks. This could signal that patient, valuation-oriented investors will be better rewarded than they have been in the recent past.

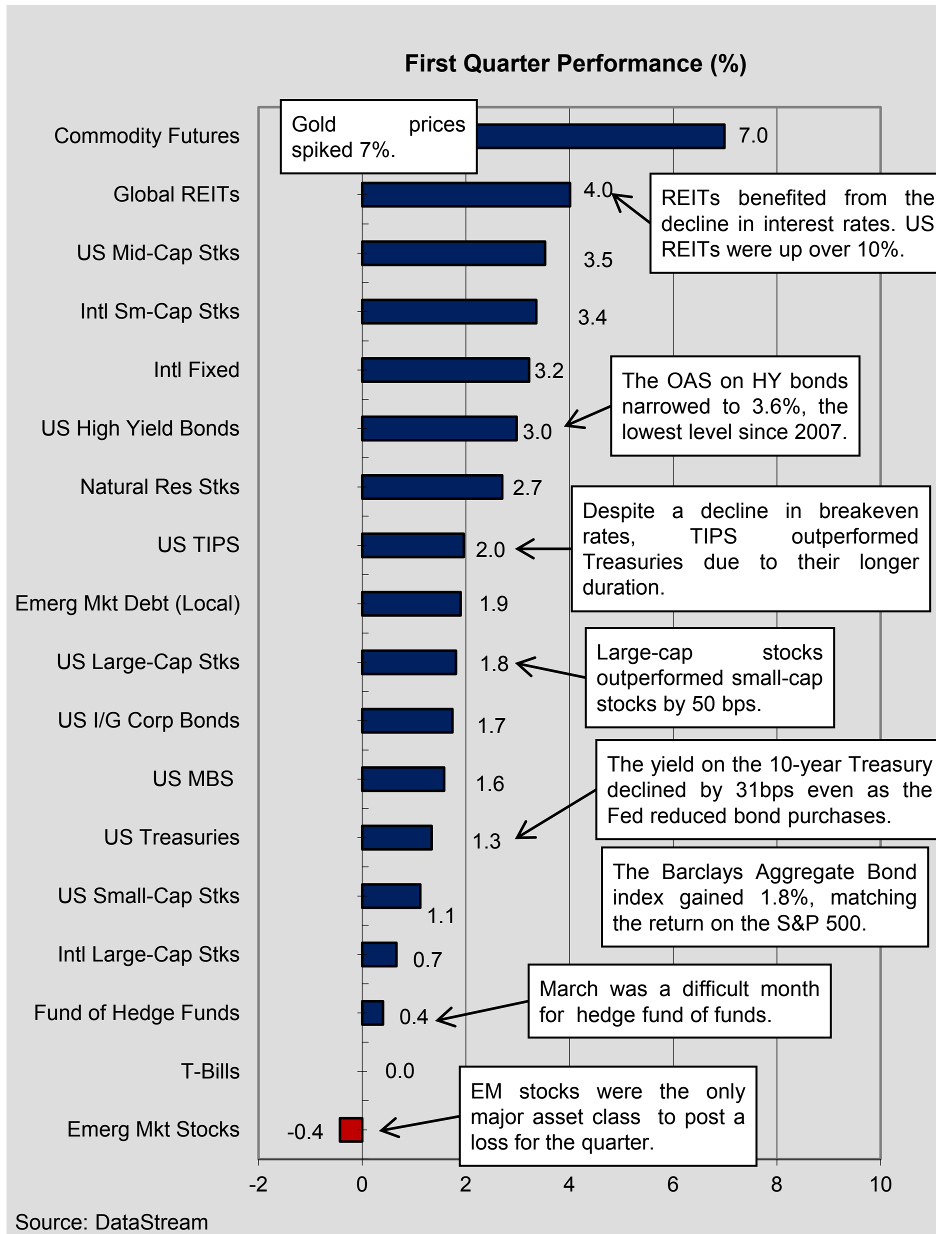
While we saw interesting divergences within markets, there was little in the way of surprises on the economic or monetary policy fronts. Growth in the US was slower than expected in the first quarter, but economists and markets seem to have attributed the underperformance to severe winter weather. Comments by Janet Yellen and other Fed members generated some volatility, but expectations for Fed tightening barely changed. The reduction in bond purchases, which began in January, did not appear to have a material impact on markets as indicated by the decline in longer-term yields. Outside the US, expectations for growth in the UK have improved significantly and the Eurozone should benefit from stable financial conditions and a smaller fiscal drag. There are growing hopes that the ECB will take more aggressive policy actions to address deflationary pressures and weaken the euro. In Japan, an increase in sales taxes may weigh on growth, but the weak yen should help support exports.

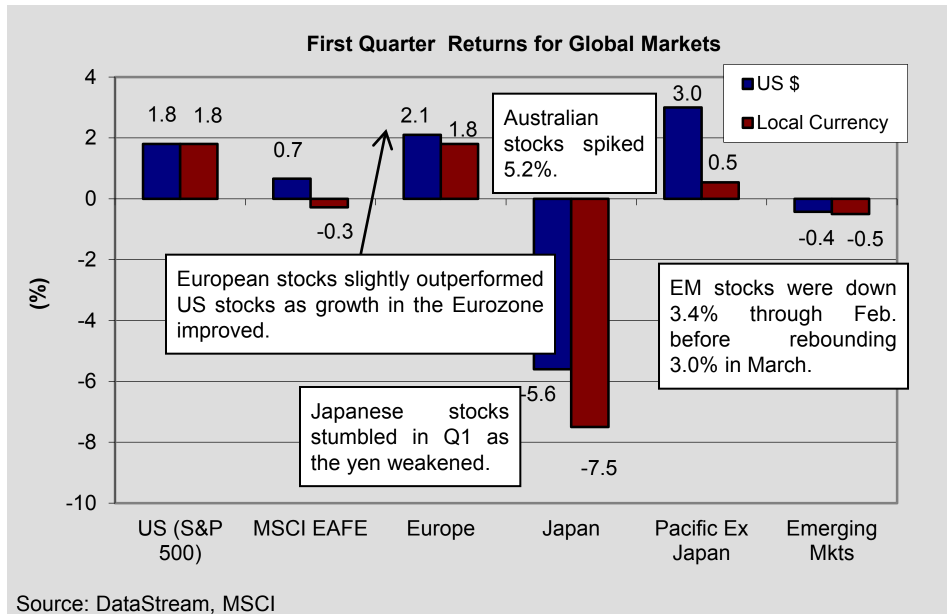
Given the muted returns from public equity markets during the quarter, valuations were close to unchanged. On a global basis, we continue to favor equities over fixed income. While valuations in the US are on the high side, we find valuations outside the US neutral to attractive. While we are uneasy with the bullish sentiment, the near-term risks of a bear market for equities appear low given improving GDP growth and the limited risk of a recession, although the potential for a hard landing in China is a worry. Equity markets could begin to focus on Fed rate hikes as we head into 2015, which would reduce the attractiveness of equities relative to bonds, but tighter US policy could be offset by additional easing in Europe and Japan, and the Fed may take longer than is assumed to normalize policy. The Fed and other central banks must eventually unwind their stimulus programs as economic conditions normalize. How markets will handle this liquidity reduction remains to be seen. While we remain positive on equities, investors should temper their expectations. Prospective returns are likely to be in the mid-single digits versus the double-digit returns experienced over the last several years.

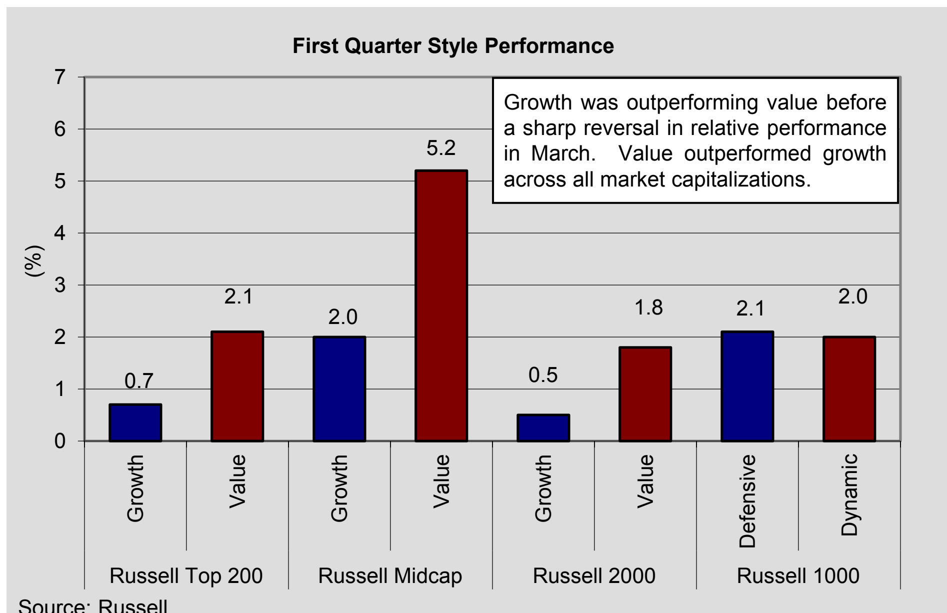
The return outlook for bonds remains subdued. Markets seem to have priced in the end of QE3 and bond yields fell even as the Fed reduced the size of its asset purchases. The FOMC is likely to maintain its zero target rate for an extended period of time after QE3 ends. This suggests that interest rates are likely to remain low and the process of normalization is likely to be gradual, but that absolute returns are likely to be meager. Credit spreads have normalized (and gone below normal in some cases). While we expect credit to outperform Treasuries, tight spreads and record low yields leave minimal upside.

With traditional assets priced to provide returns below equilibrium, we think institutions should continue to seek exposure to more return drivers. Hedge funds should benefit from greater differentiation on fundamentals and, in light of low expected returns on traditional assets, hedge fund investing has a lower potential opportunity cost. Strategically, we think real assets and private equity investors should benefit from diversification and another source of alpha. Returns are likely to be lower over the next several years since opportunities resulting from the financial crisis have been priced back to normal. However, we think it should be a rewarding environment for patient, valuation-minded, diversified investors.

Markets overcame growth and geopolitical concerns

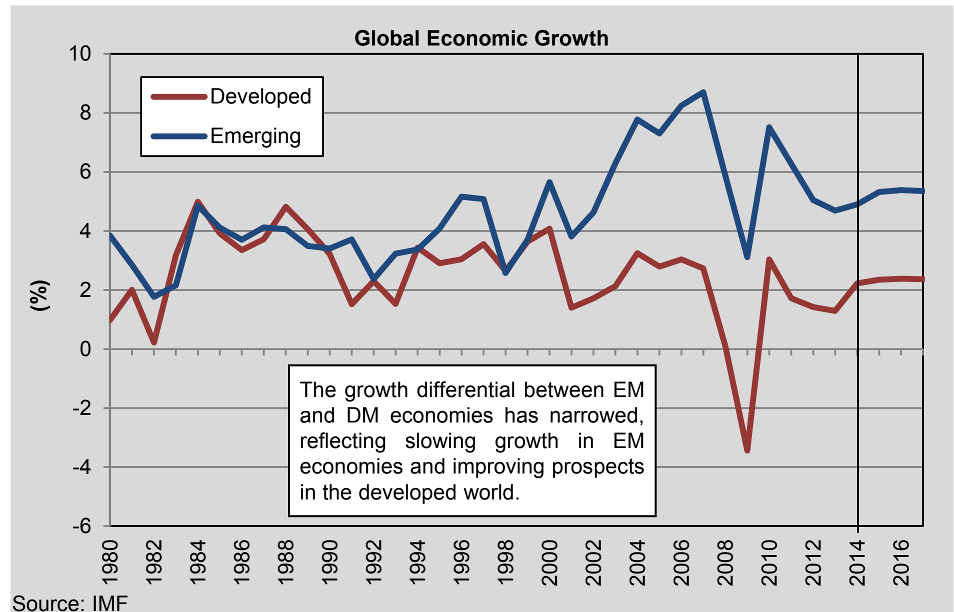




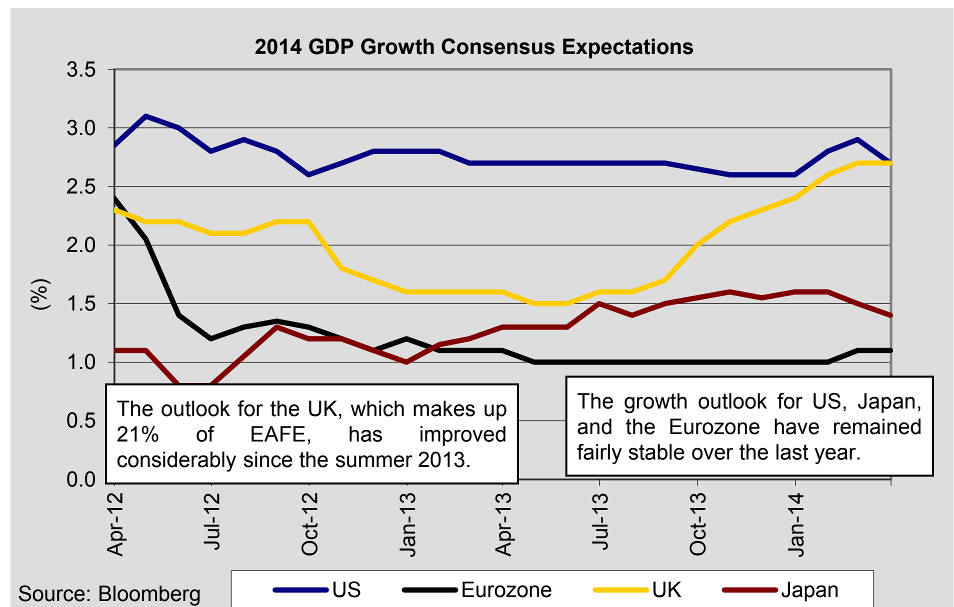


Global growth outlook remains upbeat despite first quarter slowdown

- While growth in developed economies eased somewhat in the first quarter, due in part to severe weather in the US, the consensus forecasts for 2014 and 2015 remain upbeat relative to the recent past. Monetary policy remains accommodative and downside risks to growth have fallen over the past several quarters. The IMF projects advanced economies will expand 2.2% in 2014 and 2.4% in 2015, a welcome improvement from the 1.5% average from 2011 to 2013. The strength of recoveries remain disparate with growth in the US and the UK nearing the long-term trend, while the Eurozone and Japan lag.
- There are signs that the recovery in the Eurozone has gained speed as a smaller fiscal drag and an easing of financial conditions reduces headwinds. Germany has experienced a slight uptick, modest growth returned to France and Italy, and recoveries appear to be gaining traction in the periphery. Bond yields in Italy and Spain have fallen below pre-crisis levels and fiscal and trade imbalances have improved significantly, although unemployment remains stubbornly high. Monetary policy in the Eurozone has been far less accommodative than in other regions, which has likely contributed to the strength in the euro. However, the ECB could take more aggressive actions to support the periphery and weaken the euro. A concern is that the continued lack of bank lending remains a drag on growth, but bank stress tests are scheduled to be finished in Q4.
- The upturn in the UK is gaining momentum. The housing and labor markets are buoyant, with the unemployment rate falling to a new cyclical low of 7.5% in February. Growth in Q4 was a healthy 2.8%, annualized. Economists have been consistently raising 2014 growth forecasts since the middle of last year, which are now at 2.7%, the same expectation as for the US.
- In Japan, an increase in consumption taxes on April 1 has dampened sentiment and raised downside risks. Indeed, 2014 growth expectations have slipped over the last few months to 1.4% and further downward revisions are possible. Inflation is expected to rise to 2.8% this year, the highest level since 1991, but it may not be able to hold at that level without further depreciation in the yen. While monetary policy is expected to remain accommodative, the secular growth outlook for Japan is dependent on additional structural reforms.



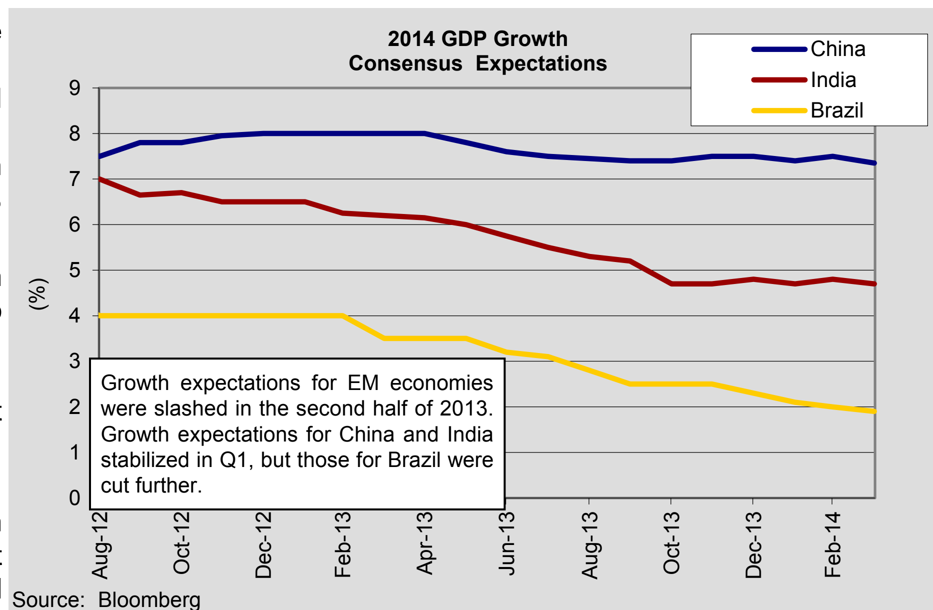
Source: IMF



Source: Bloomberg

Further adjustments ahead for emerging economies

- While developed economy growth appears largely on track, the slowdown in emerging markets extends a pattern in place for some time. Despite the continuing challenges, the prospects for a renewed strengthening of developed world growth has the potential to lift exports. The IMF projects that EM economies will grow 4.9% this year, an improvement from the 4.7% growth rate in 2013, but below the 7.7% average of the mid-2000s. Growth in 2015 is expected to reach 5.3%.
- Economic imbalances are weighing heavily on some economies. In particular, India, Indonesia, Brazil, South Africa and Turkey continue to suffer from sizeable current account deficits and elevated inflation, suggesting that monetary policy may need to tighten further. However, the risk of a 1997-styled panic appears low. Public and private debt levels are generally lower and currency reserves exceed 2014 external financing requirements in most large EM countries.
- Economic growth in China continues to slow, reflecting weakness in fixed investment and exports. The weakness in exports appears at least partially attributable to the deterioration in China's international competitiveness over the last few years, perhaps prompting the 3% downward revaluation of the yuan in Q1. The government has taken some steps to slow credit, property investment and local government spending. The combination of tougher credit controls and slowing income growth has resulted in a rising number of corporate loan defaults, although these are welcomed to some extent by the government.
- We do not expect a financial crisis in China because it has the capability to recapitalize the banking system. Additionally, unlike many other EM countries, China is running a trade surplus, so it is not dependent on capital inflows. Nevertheless, a reduction in credit growth could lead to further downside surprises for growth over the short-term; however, rebalancing the economy toward consumption and tackling structural reforms of the financial sector should help lead to more sustainable growth.
- The potential exists for further currency declines and a larger growth slowdown in emerging economies. Using the current period of weakness as an opportunity to push forward structural reforms should improve the secular growth outlook. From a markets perspective, it appears that emerging market equities and currencies have priced in a lot of the downside risks.



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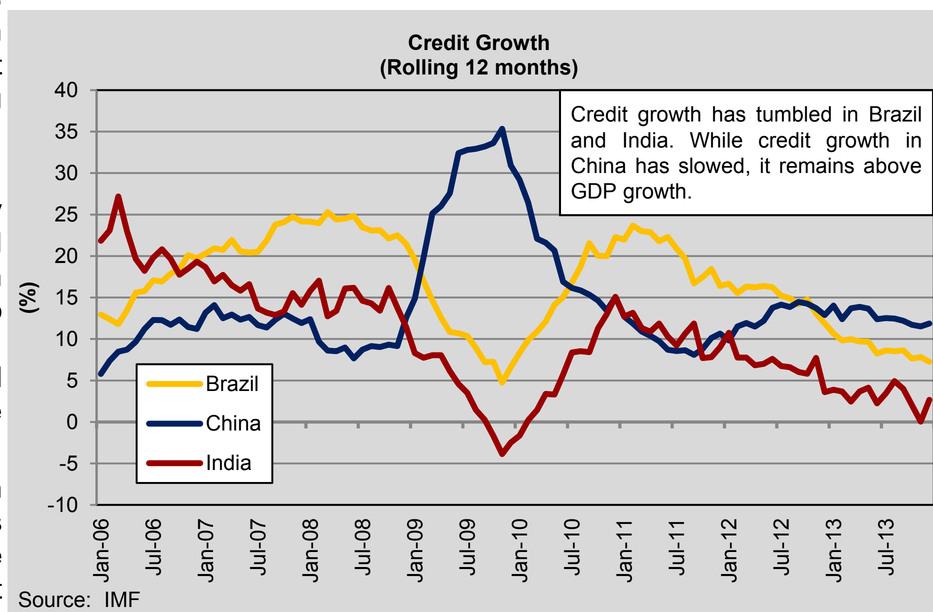
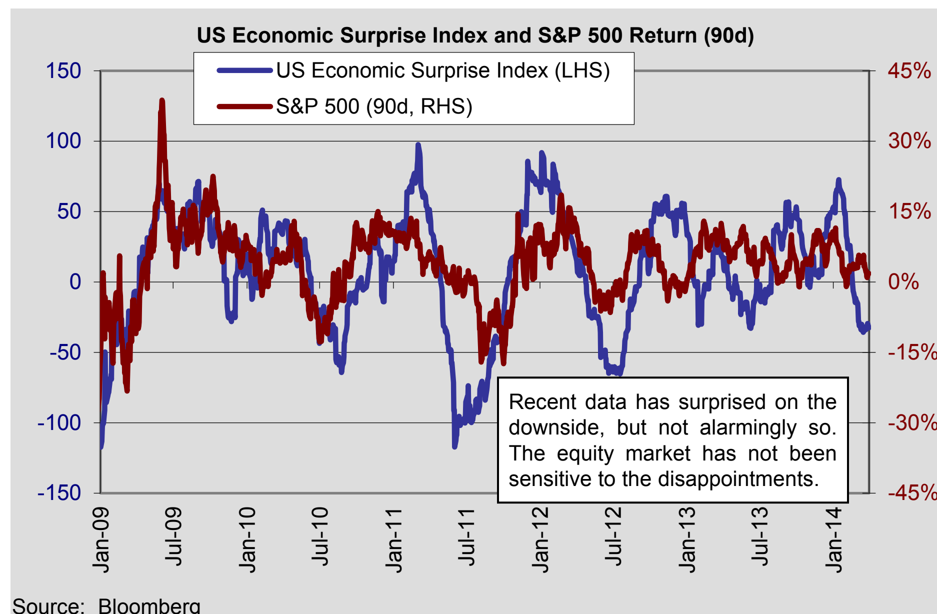


Source: IMF

US economy: The slowdown in the first quarter should prove temporary

- The US economy lost momentum in the first quarter, with weather deemed a leading cause by many economists. Economists polled by Bloomberg estimate that the economy expanded 1.6% in the first quarter.
  - 4Q13 growth was stronger than initially expected at 2.6%, part of which likely came at the expense of 1Q14 growth through inventory building.
  - Recent data releases have improved, supporting the case that weather dampened activity. The ISM manufacturing activity index plunged from 56.5 to 51.3 in January, but recovered to 53.7 by March.
  - Personal consumption, nearly 70% of the economy, is growing at a moderate pace (2% over the last year), but it is being supported by a reduction in the savings rate.
  - The combination of higher rates and severe weather has slowed residential fixed investment, but the housing market should remain a positive contributor to growth in 2014.
- GDP is expected to expand by 2.8% over 2014 and by 3% in 2015, near the long-term trend growth rate. From this point, an acceleration hinges on improving employment to support consumption and a sustained upturn in business investment.
- The job market remains fairly healthy. While gains were disappointing in January, February and March additions recovered to the recent trend. For the quarter, the economy added an average 178,000 jobs per month, down from the 198,000 average in 4Q13. The unemployment rate was unchanged at 6.7% for the quarter. Encouragingly, the labor force participation rate increased by 0.4 points, suggesting the healthier job market is drawing more workers into the labor force. Wages continue to improve at a tepid pace, with average hourly earnings up 2.2% year-over-year, slightly above inflation.
- While capital goods orders suggest little improvement in business investment, the fundamentals for an upturn appear in place. The US capital stock is aging, companies have mostly exhausted cost costing as a source of productivity growth and shareholders are no longer punishing companies favoring capital expenditures over shareholder distributions.
- From a financial markets perspective, growth in the 2% to 3% range could be the sweet spot—fast enough to improve sales but not so rapid as to put upward pressure on wages and induce the Fed to tighten.



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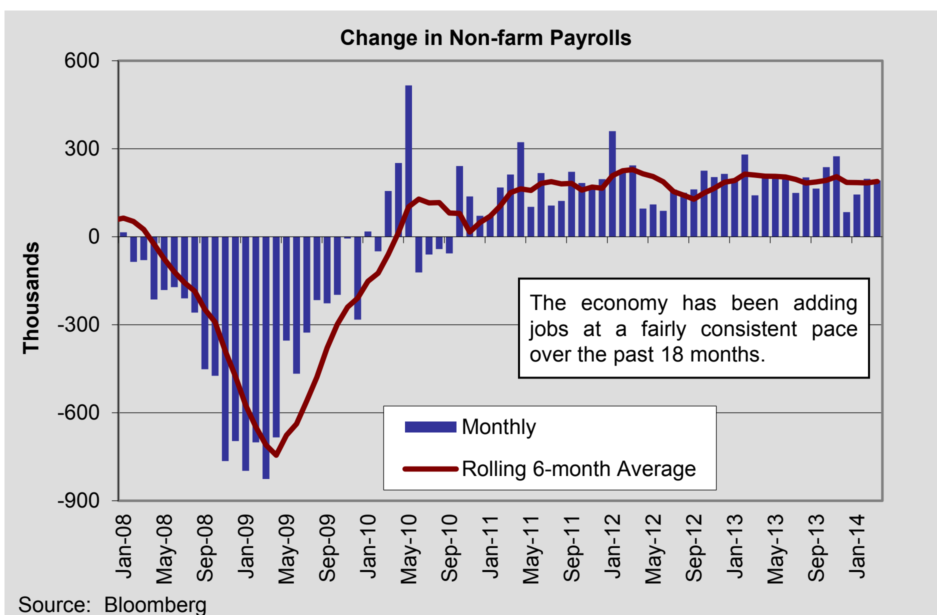
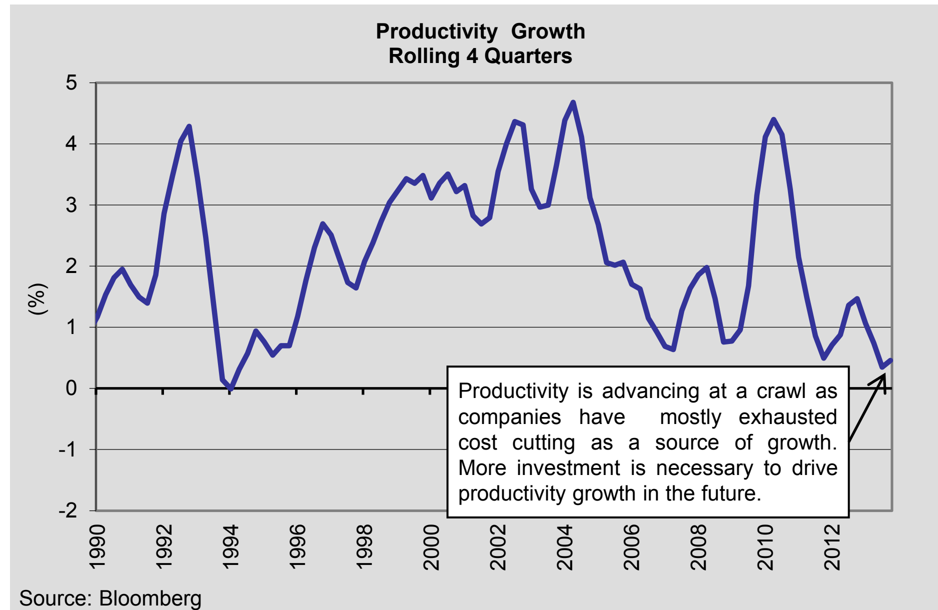


Source: Bloomberg

US economy: The slowdown in the first quarter should prove temporary (cont.)



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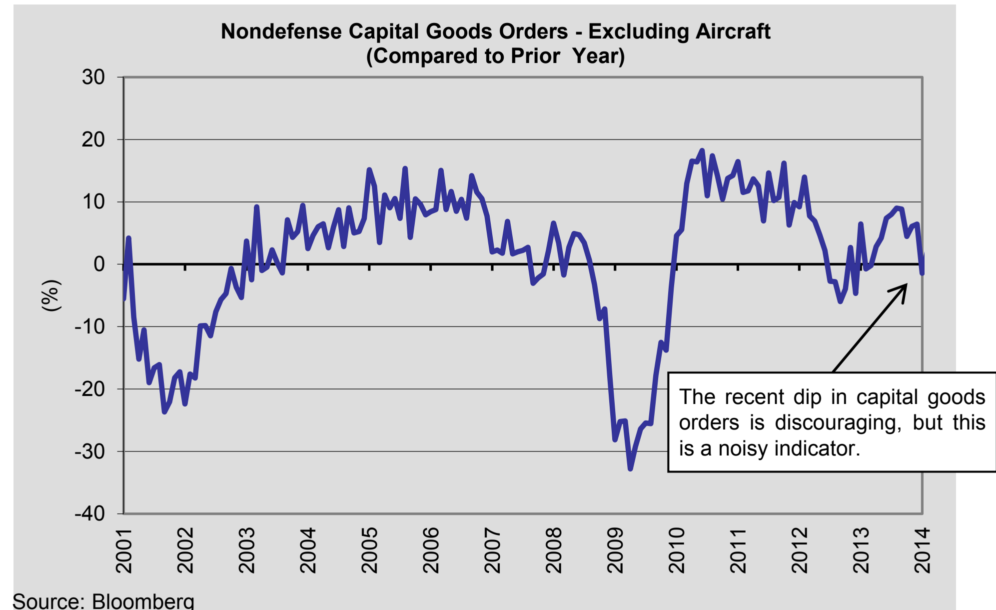

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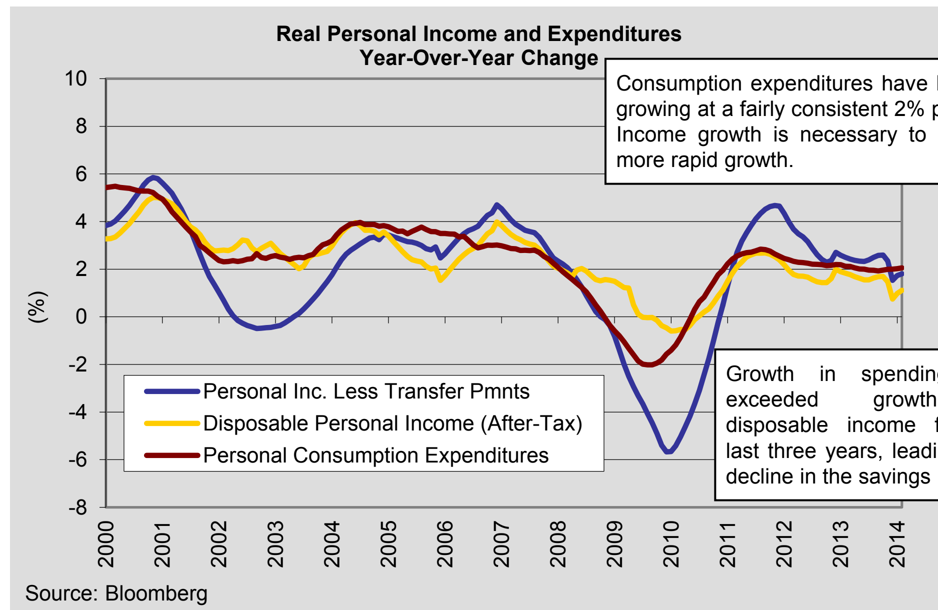

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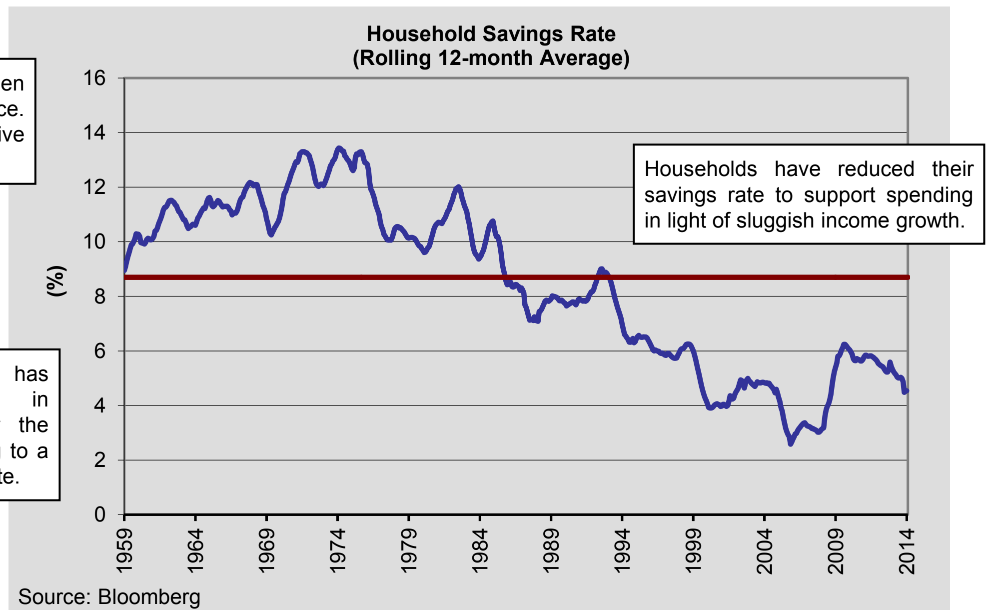
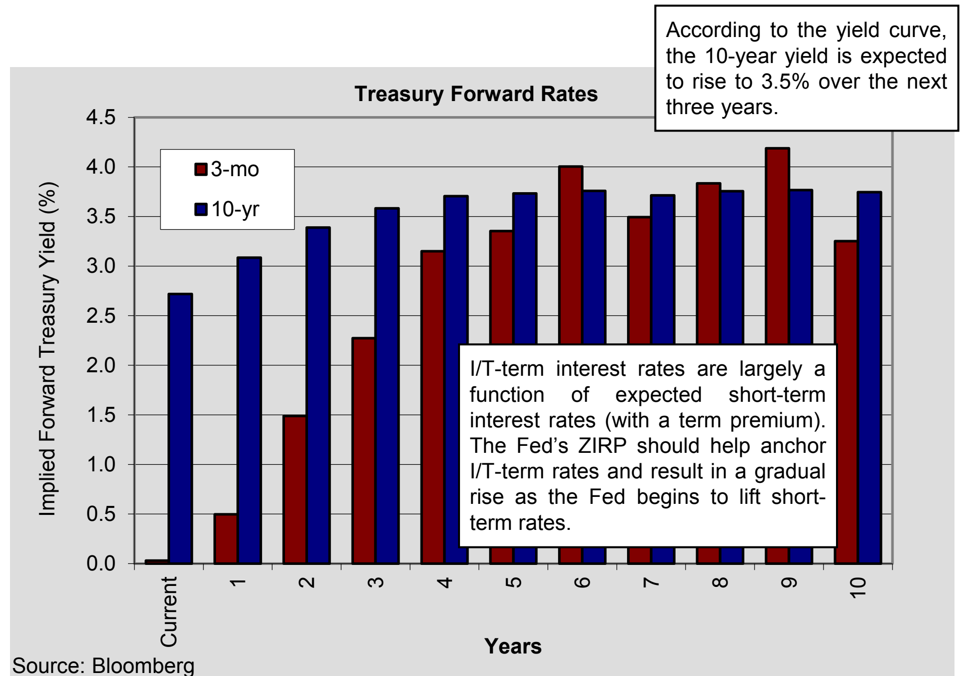


Source: Bloomberg

No surprises from the Fed during the quarter

- As expected, the Fed reduced its monthly bond purchases to $55B during the quarter and is on track to conclude the program this year. Markets likely priced its end in 2013, as indicated by the interest rate decline that has occurred after the Fed reduced purchases.
- More important for interest rates and markets is the timing and pace of short-term interest rate increases. Bond markets suggest that the Fed is likely to stay on hold until mid-2015 and gradually lift the target rate to 2% by the end of 2016. This is arguably a more rapid pace of tightening than is likely.
  - While the job market continues to steadily recover, broader measures of labor utilization remain weak relative to pre-crisis levels. Further, the housing market, which has been a key contributor to the uptick in growth, is particularly sensitive to rates.
  - Inflationary pressures remain very subdued with most measures of inflation running at or below the Fed's target. Given large output gaps and slack in the labor markets, the risk of inflation in the near-term remains modest.
  - A few factors to watch that could portend a more aggressive Fed are a sharp acceleration in wages, an increase in longer-term inflation expectations or evidence of excessive financial leverage.
- Since real short-term rates are likely to remain negative for at least a couple more years, if not longer, we still characterize monetary policy as very supportive of markets. Moreover, excessively loose polices have the potential to lead to asset bubbles. However, policy must normalize eventually to prevent further distortions in markets and inflation. While normalization is not necessarily bearish for equities over the longer-term, it is likely to lead to bouts of volatility as markets anticipate Fed actions.
  - Higher interest rates would reduce the relative attractiveness of equities versus bonds, placing downward pressure on valuations.
  - A reduction in liquidity from an unwinding of the Fed's balance sheet could lead to market upheavals, but this could be partially offset by actions of foreign central banks and an increase in the velocity of money.



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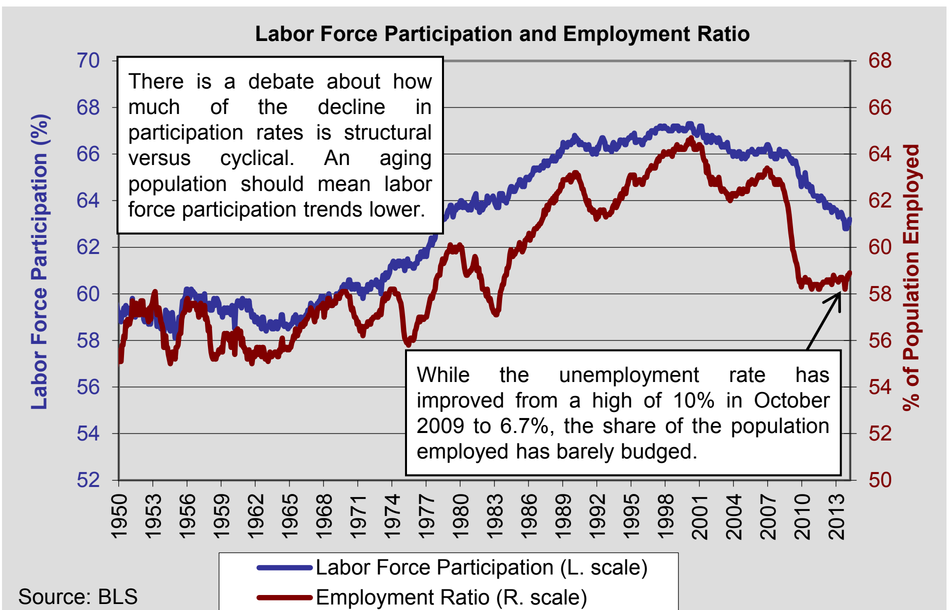
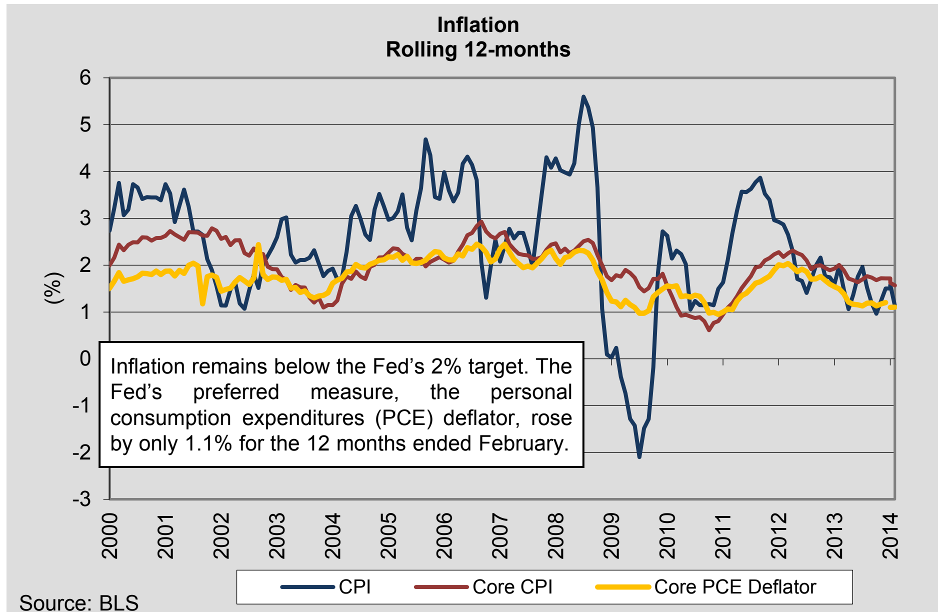
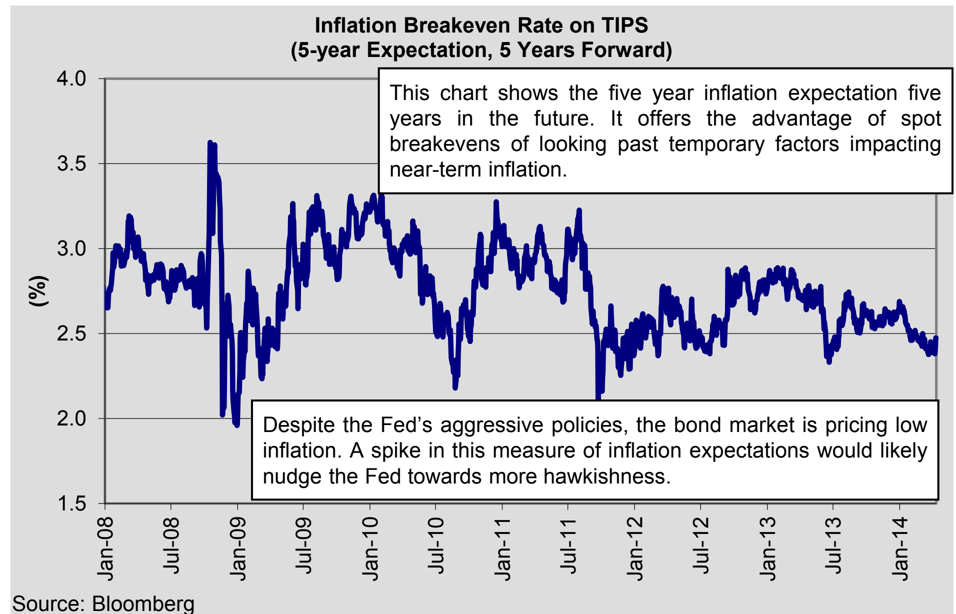
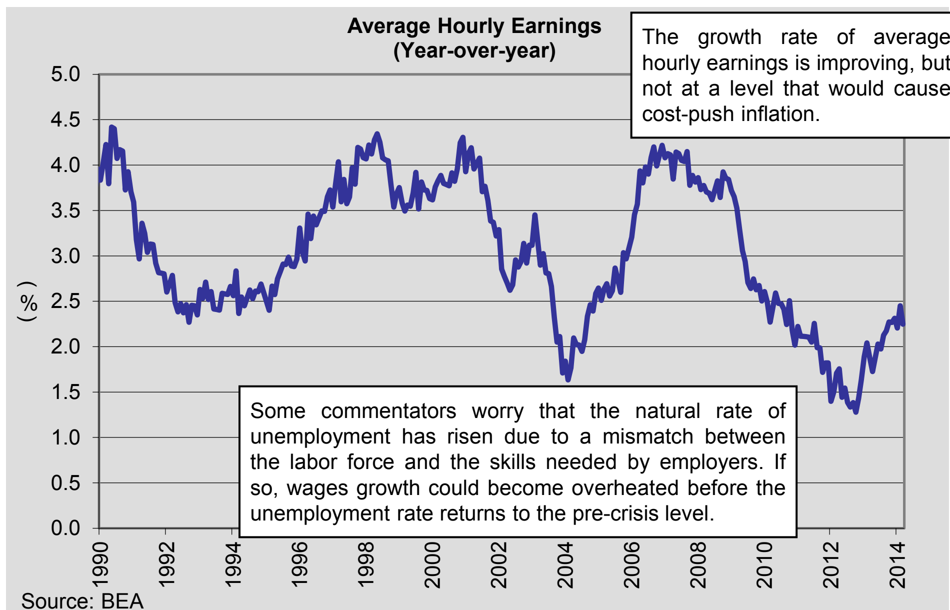


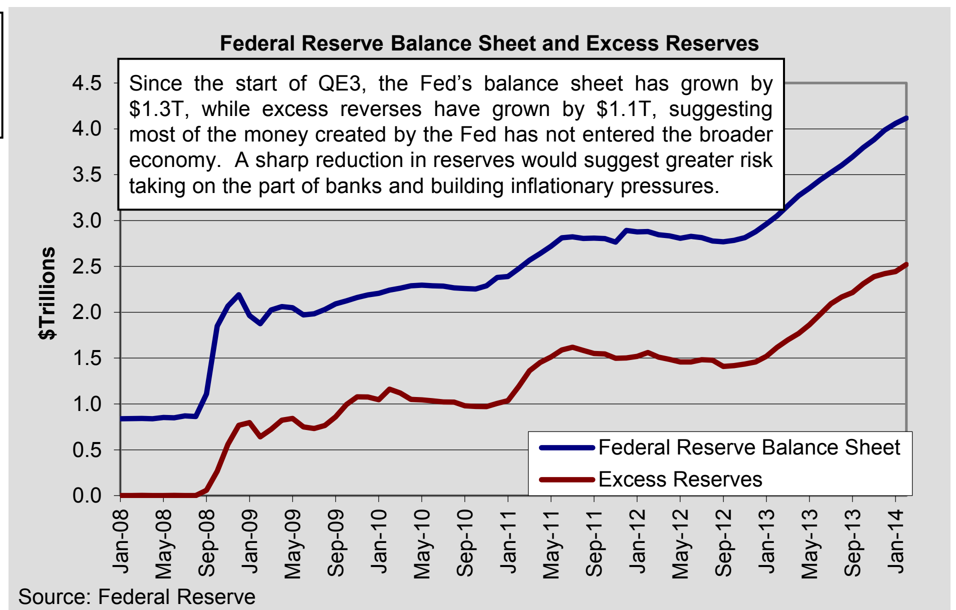
Source: BLS

No surprises from the Fed during the quarter (cont.)



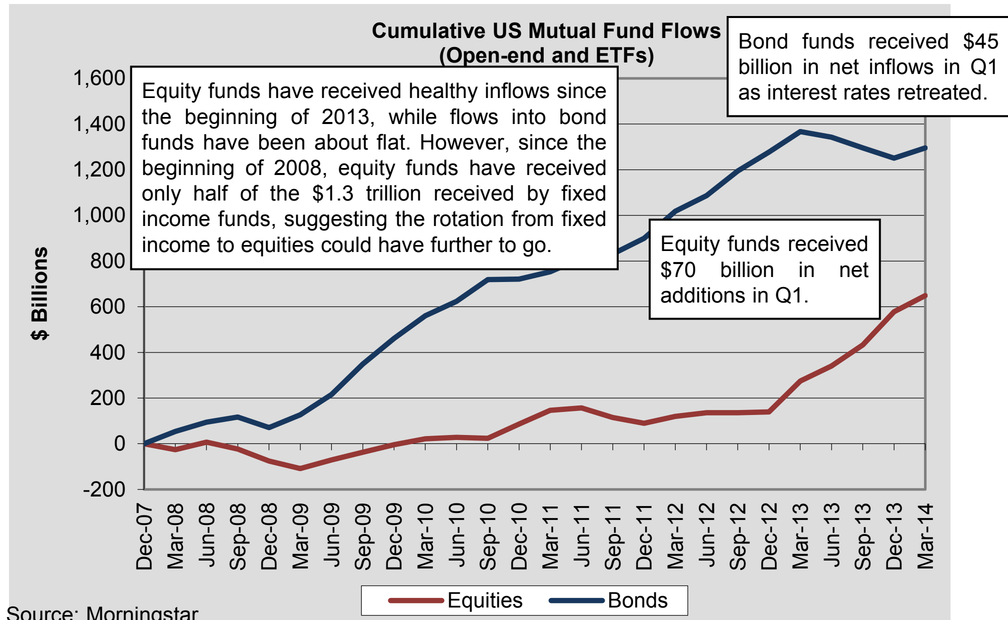




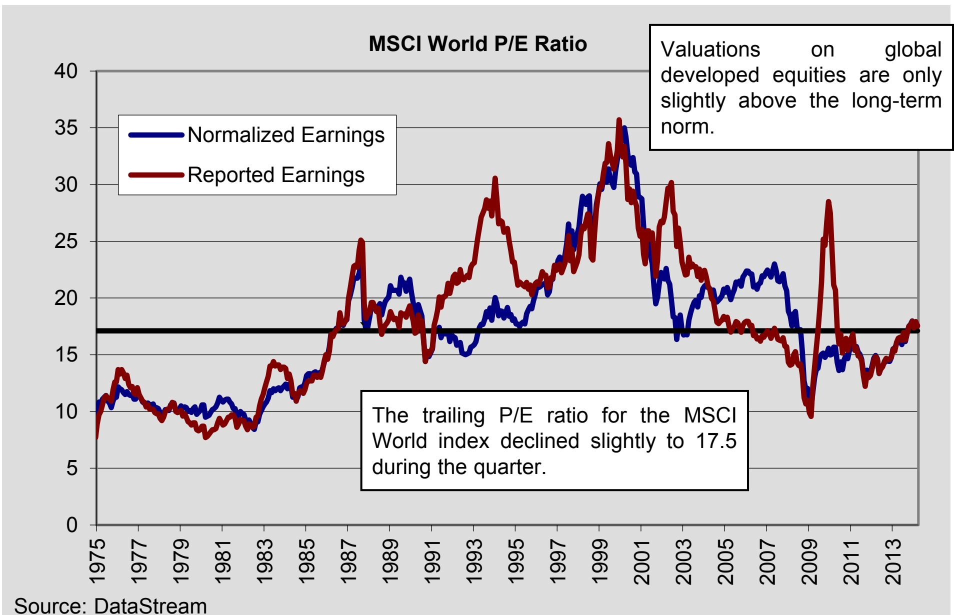


Investors looked past softer growth

- Global equity markets had a relatively quiet quarter, with the MSCI ACWI index posting a gain of 1.1%. While growth softened in the US, much of it was attributable to weather. The Fed continued to reduce bond purchases, but longer-term interest rates declined and accommodative monetary policies remain in place throughout the developed world. The turmoil in Ukraine led to a few rough days for equities, but markets largely looked past it. Bond markets surprised on the upside for the quarter, with the Barclays Aggregate index returning 1.8%.
- Credit spreads on investment-grade corporate bonds tightened further during the quarter and are essentially at the long-term median. High yield spreads now trade below the historical median. We continue to favor credit over Treasuries because losses from defaults and downgrades should be modest in the near future, but the potential for excess returns through further spread compression is limited.
- We continue to favor equities and other growth assets over Treasuries. With only modest returns from equities during the quarter, valuations were little changed. US equities are expensive by historical standards, but still offer reasonable risk premiums relative to bonds. Better values are available overseas, with the MSCI World index trading at a P/E ratio only slightly above long-term norms. Emerging equity valuations appear attractive, but they face stiffer earnings headwinds over the short-term.
- One concern we have is the bullish sentiment towards equities. While bonds performed better than stocks during the quarter, investor sentiment is still firmly on the side of equities. The wobbles in markets during the quarter appeared to do little damage to investors belief that equities offer better return prospects, and fund investors continue to favor equities over bonds. This combined with full valuations means a correction is possible, which could be used as a buying opportunity. However, the macro environment (improving growth / accommodative policy) makes a bear market unlikely over the next year.
- We believe the environment for active management should be favorable in the coming years. Easing macro risks have led to greater dispersion of security and asset class returns, a trend which we expect to continue. Divergences in global economies and policies should also provide scope for alpha. To capture these opportunities, we would advise a more flexible, high conviction approach to active management, such as concentrated managers, multi-asset managers and hedge funds.

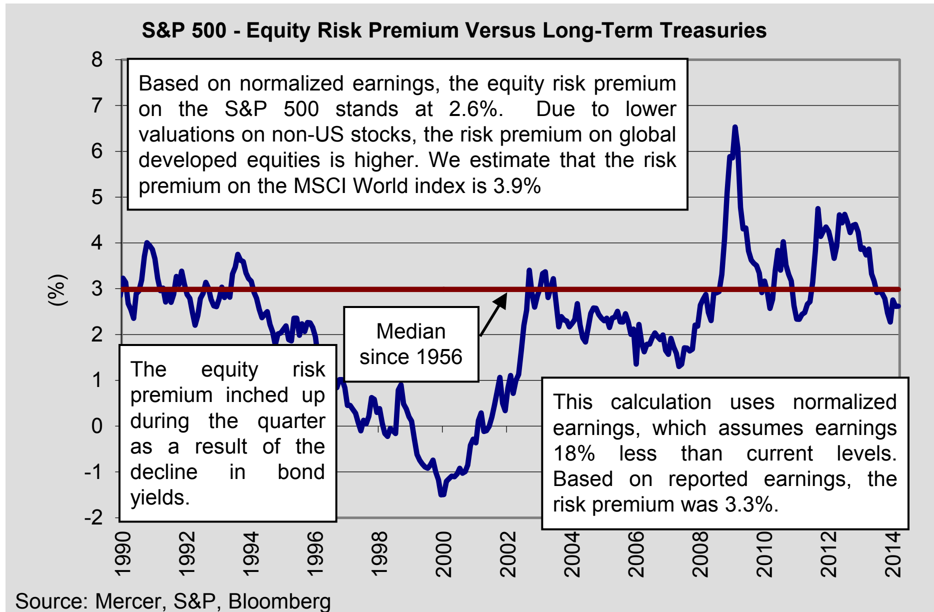


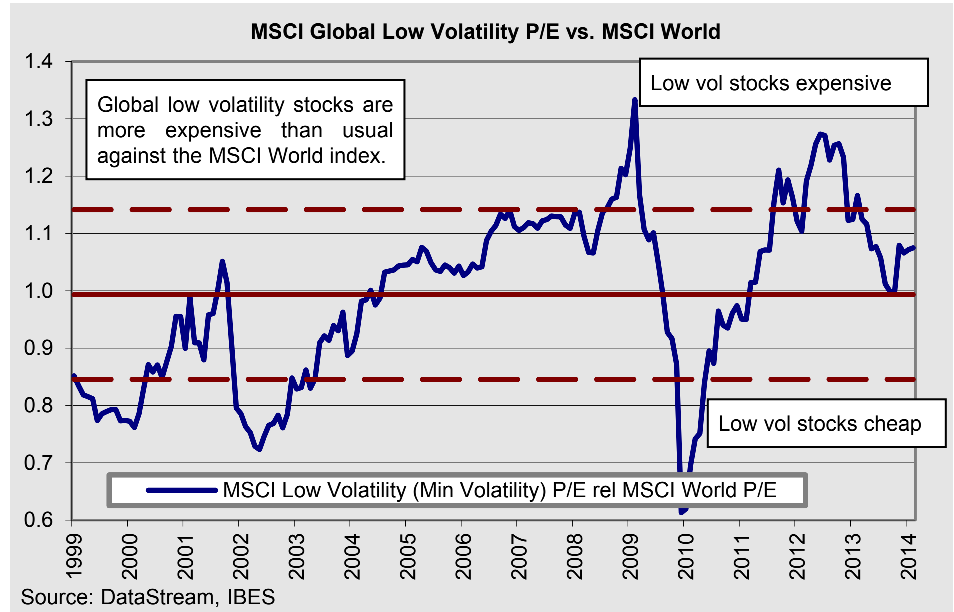
Source: Morningstar

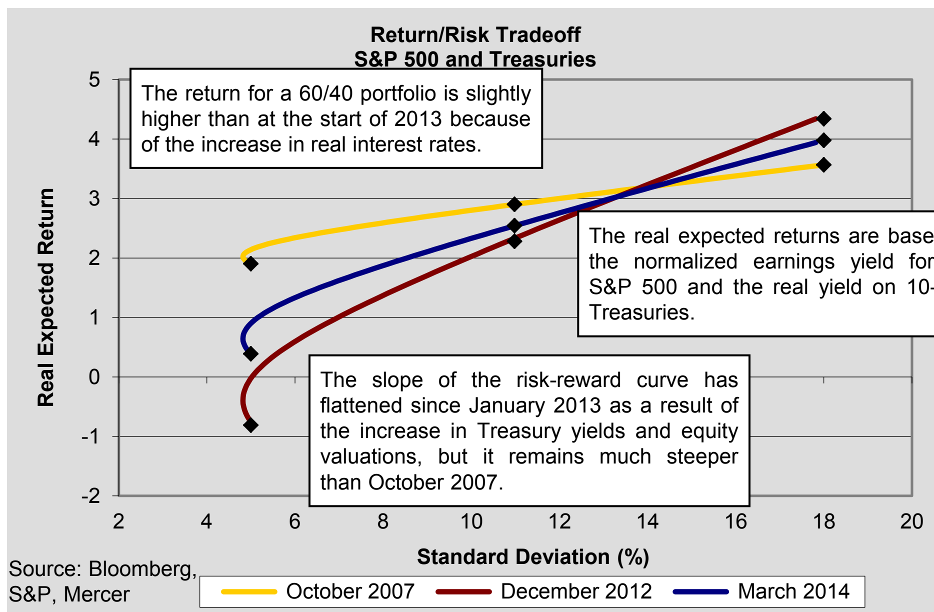


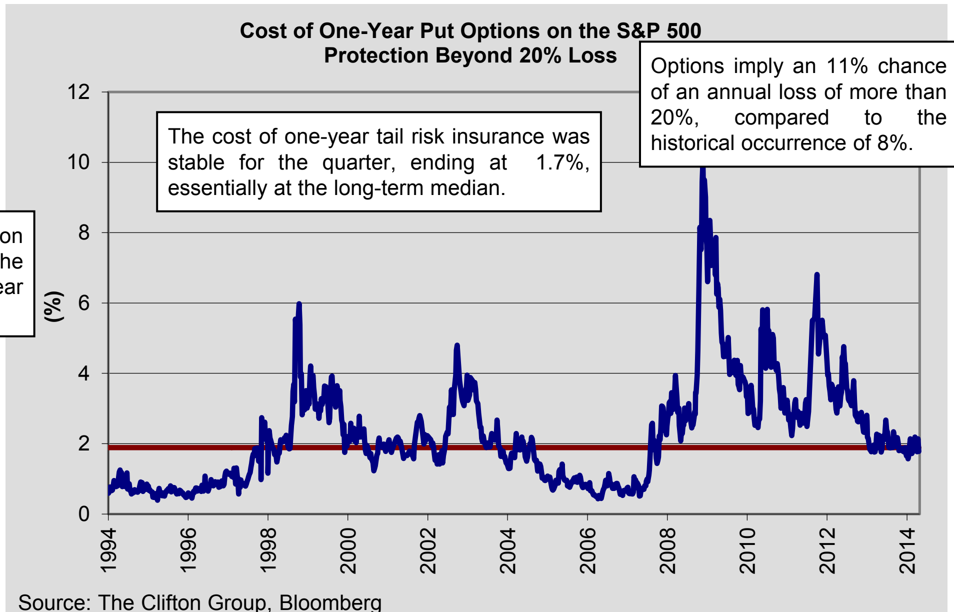
Source: DataStream

Investors looked past softer growth (cont.)



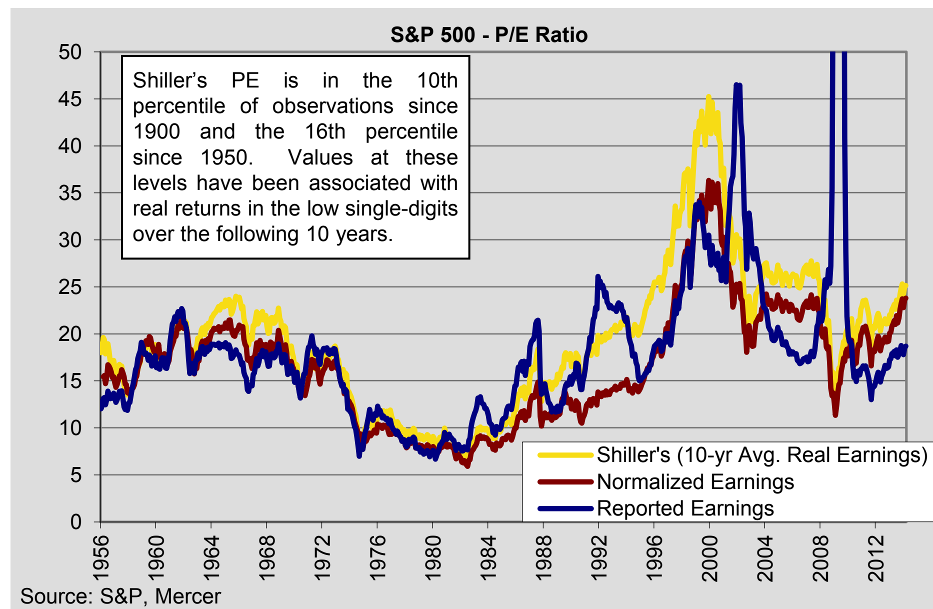




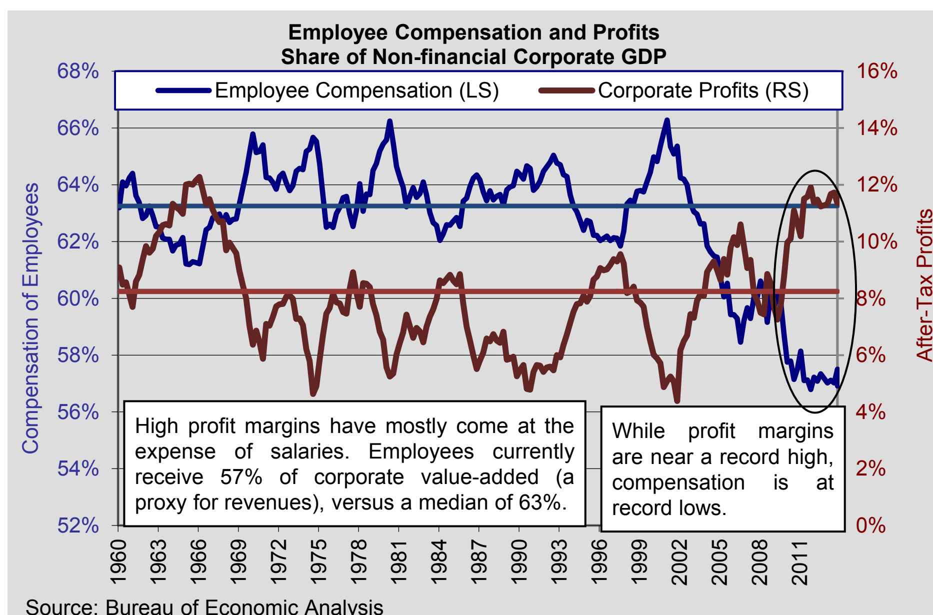


US equity valuations remain elevated, but are reasonable against bonds

- US equities got off to a volatile start in 2014, but recovered losses by the end of Q1. The S&P 500 ended the first quarter up 1.8%, setting new all-time highs along the way. On a total return basis, the S&P 500 has exceeded its pre-financial crisis high by 37.9%.
- Valuations were essentially unchanged during the quarter as earnings growth mostly offset price gains. The P/E ratio on trailing earnings moved from 18.5 to 18.7, which is above the 17.2 median since 1956. Valuations remain very high based on measures that adjust for record high profit margins. The P/E ratio based on normalized earnings stood at 23.8, 43% above the historical median of 16.7 (since 1956), while the P/E based on average 10-year real earnings (Shiller's methodology) finished the quarter at 25.1, compared to a median of 19.0 (since 1956).
- Shiller's P/E and the normalized P/E probably exaggerate the S&P's expensiveness. High margins are being driven in large part by a reduced share of revenue going to employees. A return to "normal" could take many years as the secular and cyclical forces that led to this will be slow to unwind.
- Nevertheless, we expect downward pressure on margins over the intermediate-term, which will make it increasingly difficult for companies to grow earnings even in a better economic growth environment.
  - Wages are now increasing marginally faster than productivity growth. If growth is as robust as expected in 2014, more of the slack in the labor market will be absorbed, putting further upward pressure on wages, meaning employees will garner a larger share of future sales growth.
  - Corporations have benefited from the Fed's accommodative policies through lower debt costs. While they have refinanced into lower rate debt and extended maturities, interest rates are likely to drift upwards, increasing interest expenses.
- While elevated in absolute terms, valuations look reasonable against bonds. We estimate that the equity risk premium over long-term Treasuries increased from 2.3% to 2.6% during Q1, moving closer to the historical median of 3%. We expect stocks will outperform bonds, but current valuations suggest long-term returns will be below normal, especially if profit margins get squeezed as we expect.



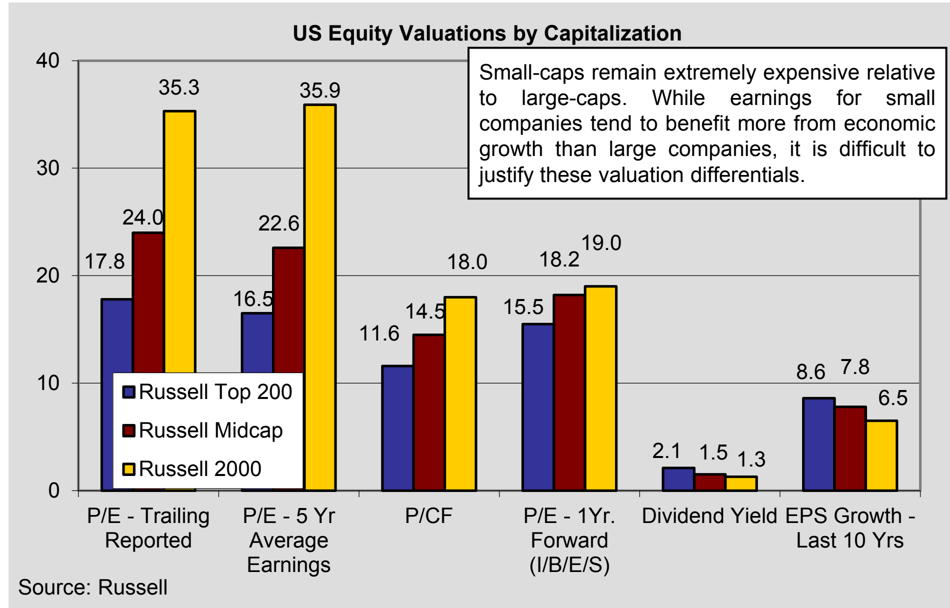
Source: S&P, Mercer

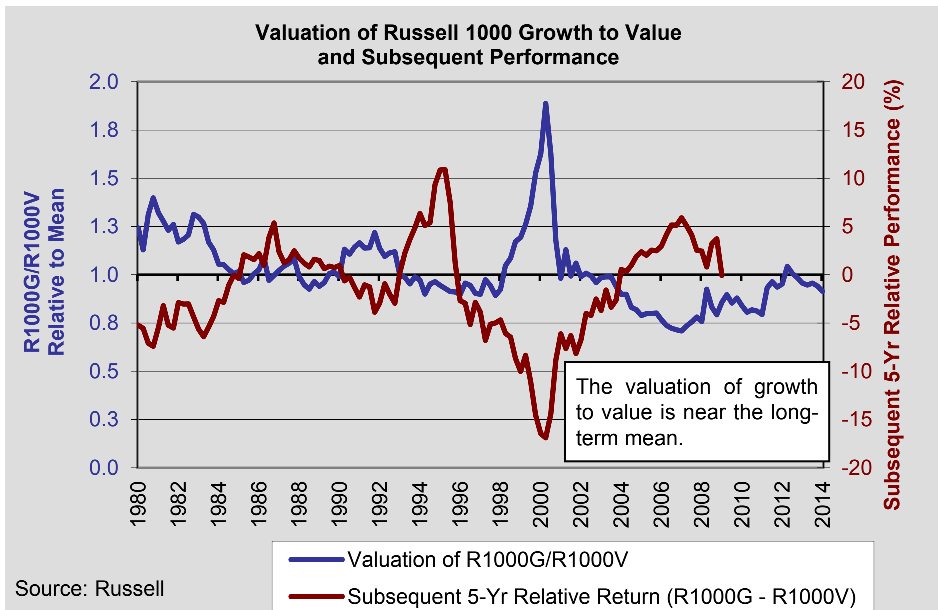


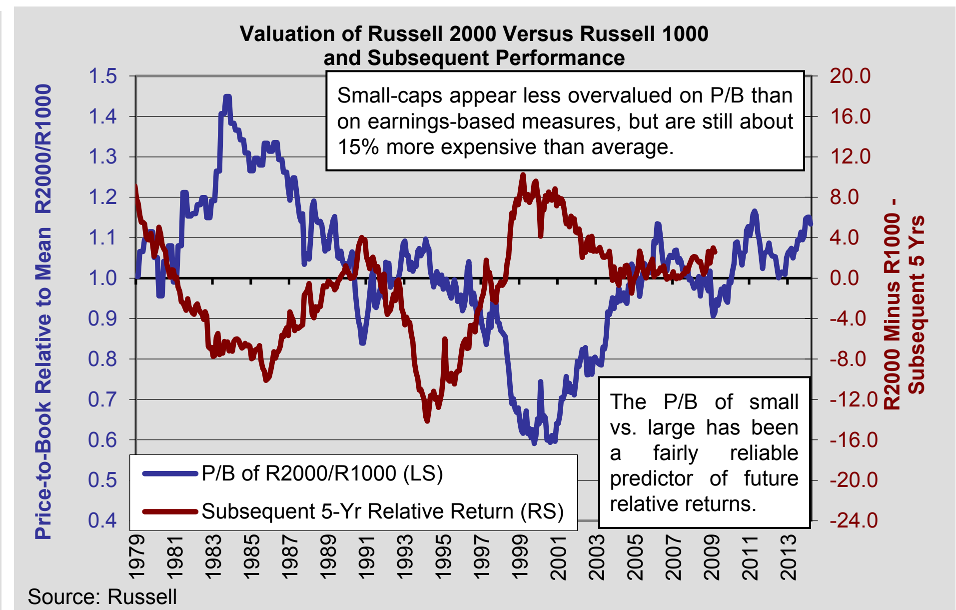
Source: Bureau of Economic Analysis

Will the reversal in US style performance persist?

- March marked a sharp reversal in style performance. Biotech stocks, social-media stocks and other speculative growth stocks had been leading the markets. For the twelve months-ended February, small-cap growth outperformed large-cap value by 15 percentage points based on Russell indexes. This flipped in March with large-cap value outperforming small-cap growth by 5.2 points, and this trend has continued into April.
- It's difficult to say whether this is a short-term reversal or a fundamental shift. There is evidence that these moves are being exacerbated by liquidation of positions by long-short hedge funds, which implies a technical component. Nevertheless, the valuations on some segments of the market have reached bubbly territory, and it wouldn't be surprising to see these stocks disappoint over the intermediate-term.
- While segments of the growth stock universe are overvalued, growth stocks more broadly appear fairly valued relative to value stocks, and we continue to recommend no style bias. The more speculative growth stocks have been the primary driver of small-caps outperforming large-caps recently, and valuations for small-caps continue to appear unattractive. We continue to suggest underweighting small-caps.

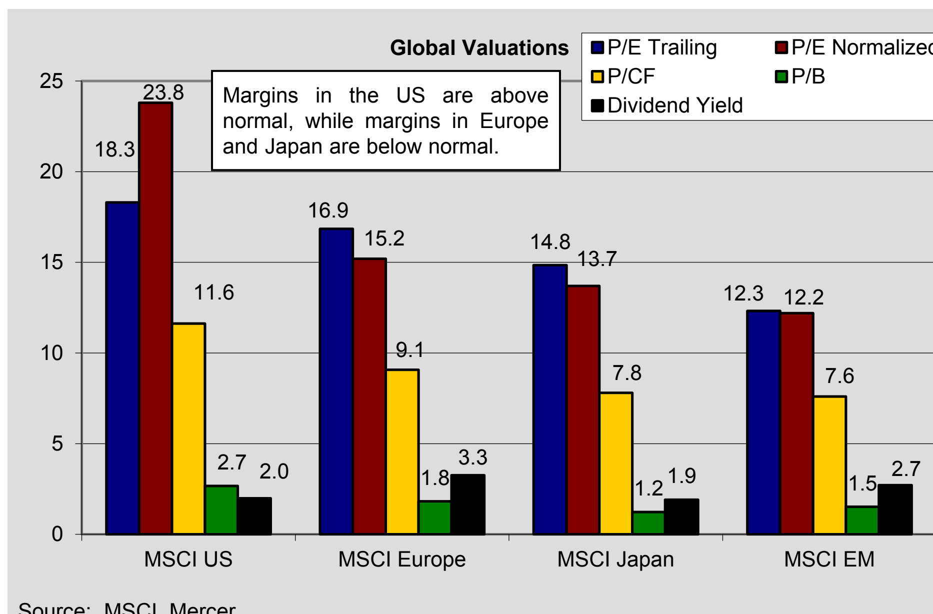




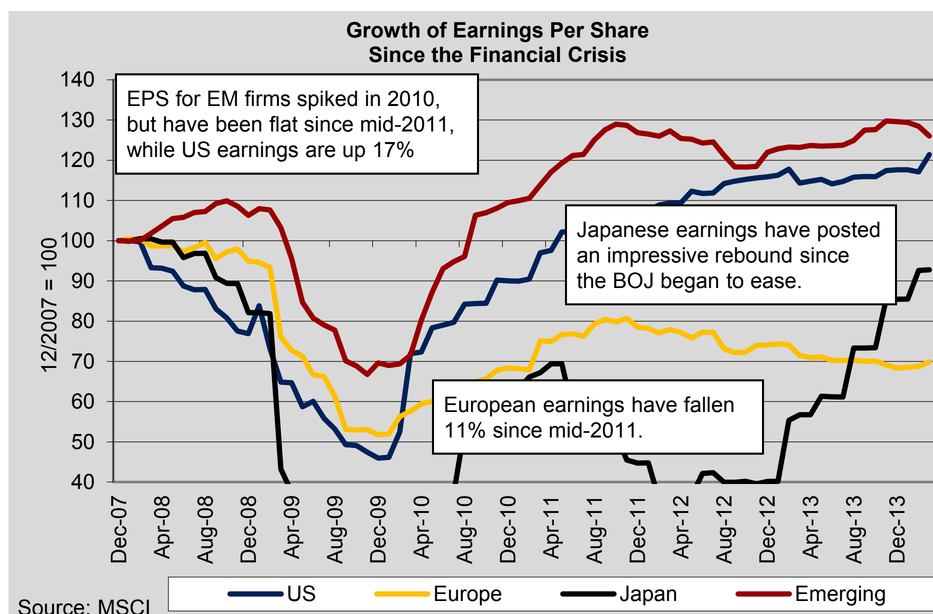


Stronger earnings growth should support international developed equities

- European equities gained 1.8% in local terms in Q1, performing in-line with the S&P 500. Over the last 12 months, European stocks have outperformed the S&P 500 (24.5% vs. 21.9%) thanks in part to euro strength.
- We remain optimistic on the outlook for Europe, especially relative to the US. The UK has enjoyed an impressive upswing in growth and the Eurozone has emerged from recession. However, given the rise in valuation that has already occurred, the key issue is whether this will translate into stronger earnings.
  - Based on trailing earnings, European stocks are no longer cheap following the gains of the past year. They trade at a P/E of 17, only a slight discount to the US. Based on Shiller's P/E, however, they trade at a 34% discount to US stocks compared to a historical average 13%. The case for Europe relies on a significant rebound in earnings.
  - Earnings for European companies have stopped falling, but have yet to show robust growth. They remain 30% below their pre-financial crisis peak, while US profits are 20% above the prior peak. The economic recovery should boost sales and improve margins. However, investors will soon want evidence that this is occurring.
- After gaining 55% in 2013 in local terms, Japanese equities stumbled in the first quarter, falling 7.5% locally, while an appreciating yen trimmed the loss to 5.6% in $US. Over the short-term, the performance of the Japanese equity market will be closely tied to the yen. Over the intermediate-term, the improved earnings power of corporate Japan should help their equities to respectable returns.
  - Japanese earnings have staged an impressive recovery surging 64% over the last 12 months, and there is room for further improvement if companies can continue with reforms and take advantage of improved competitiveness resulting from the depreciation in the yen.
  - As a result of the rally in earnings, Japanese equity valuations appear attractive relative to the rest of the world, trading at a P/E of 15.
- International developed equities appear reasonably valued in absolute terms and attractively valued relative to US stocks. There is greater room for earnings improvement overseas, which we expect to translate into higher returns over the intermediate-term.

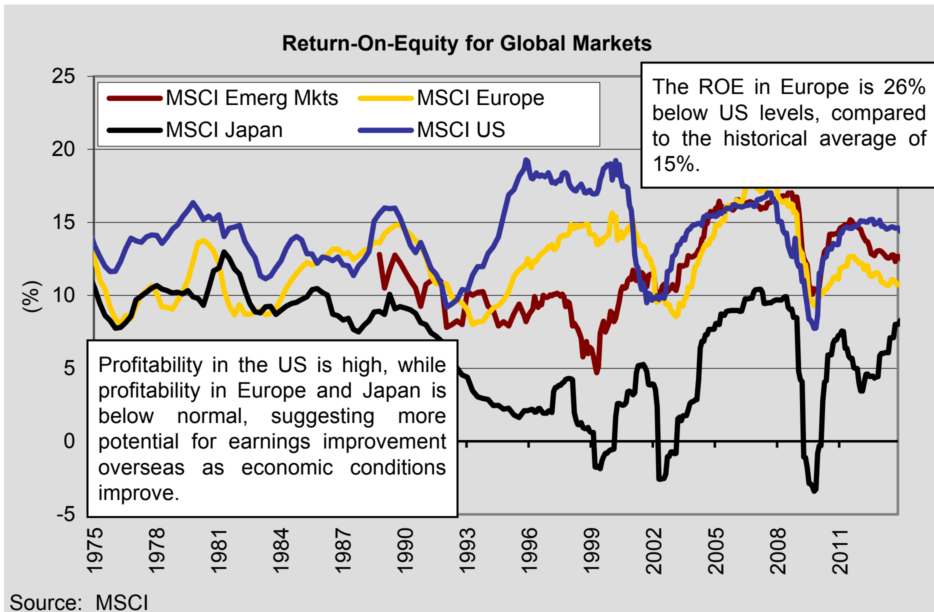


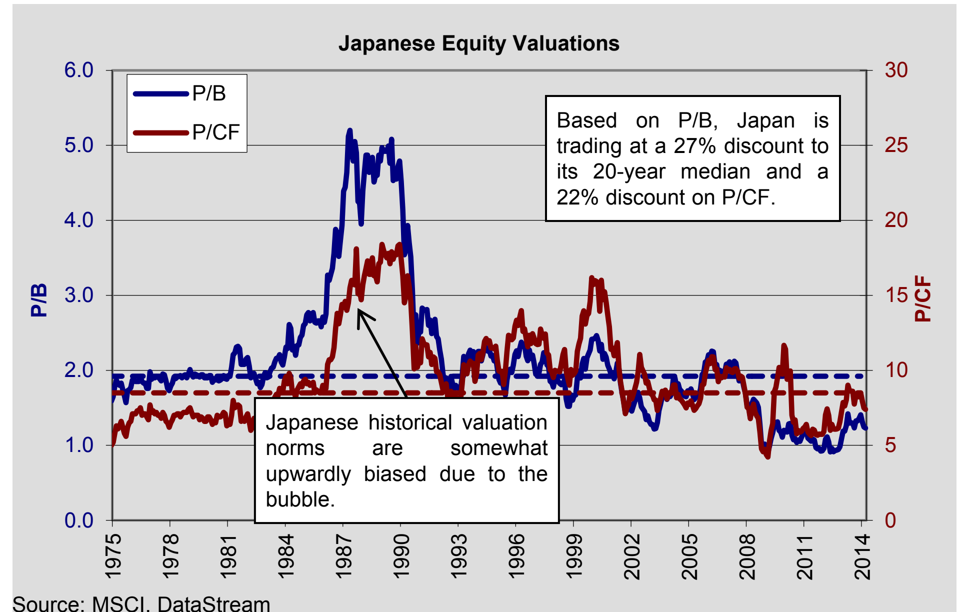
Source: MSCI, Mercer

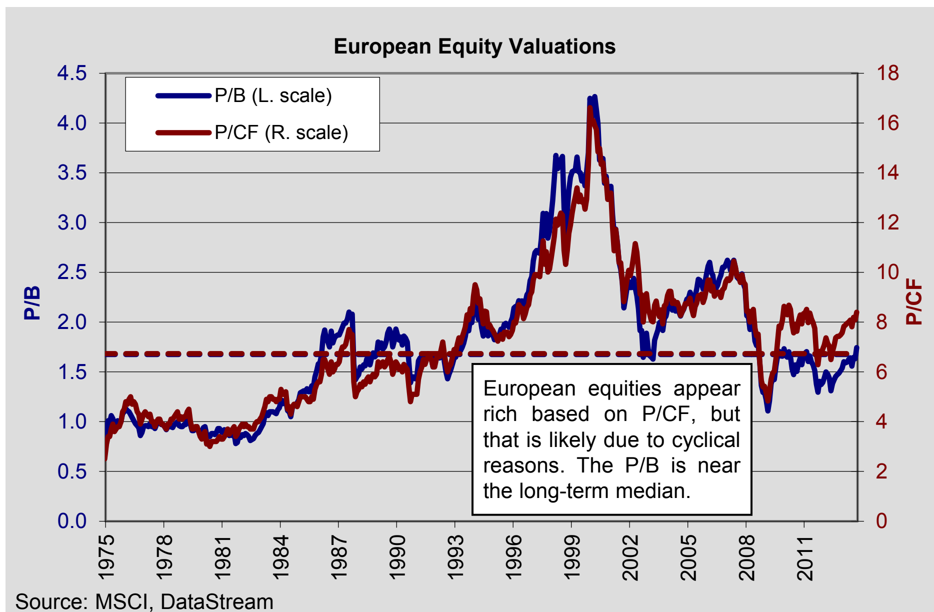


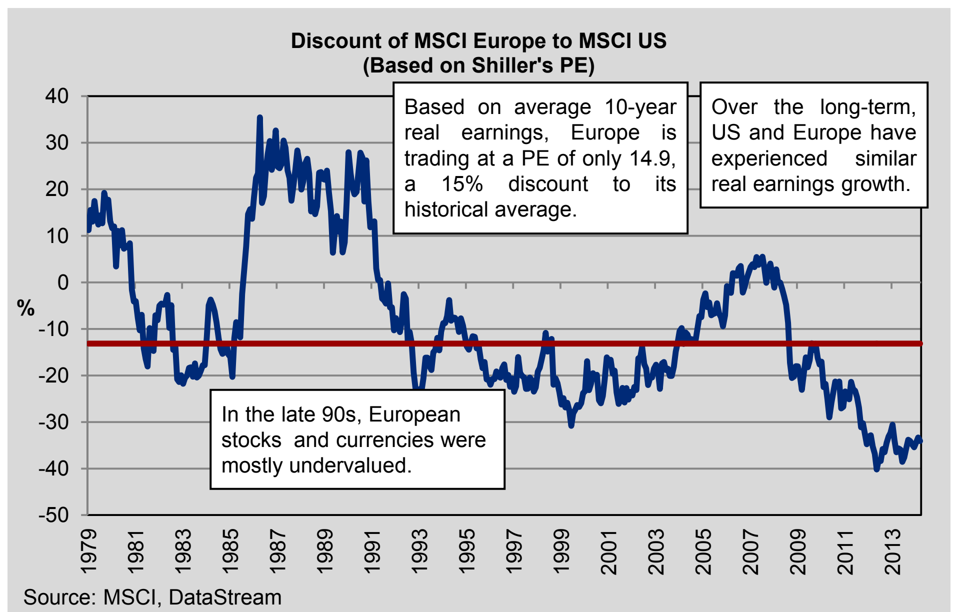
Source: MSCI

Stronger earnings growth should support international developed equities (cont.)



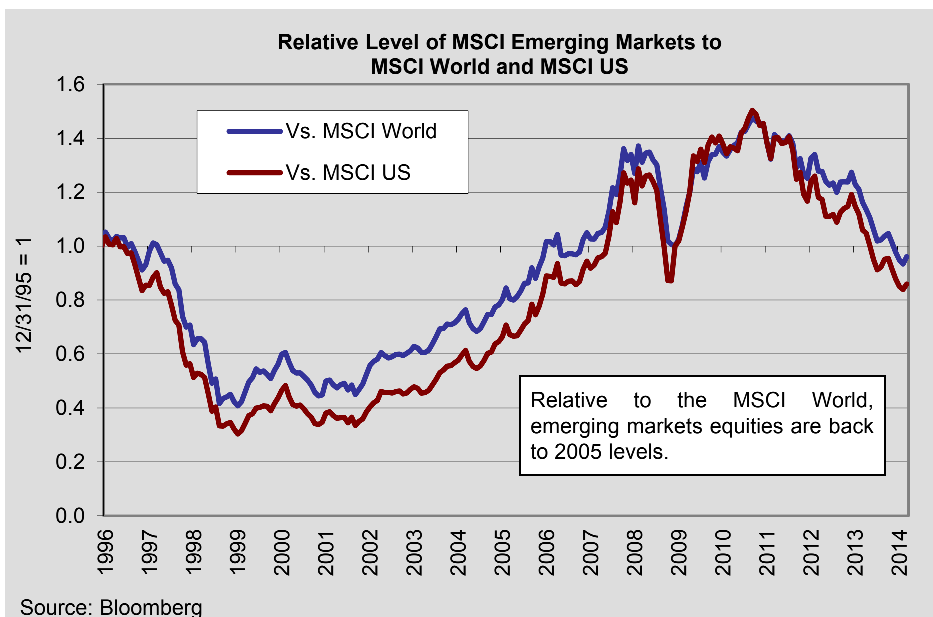


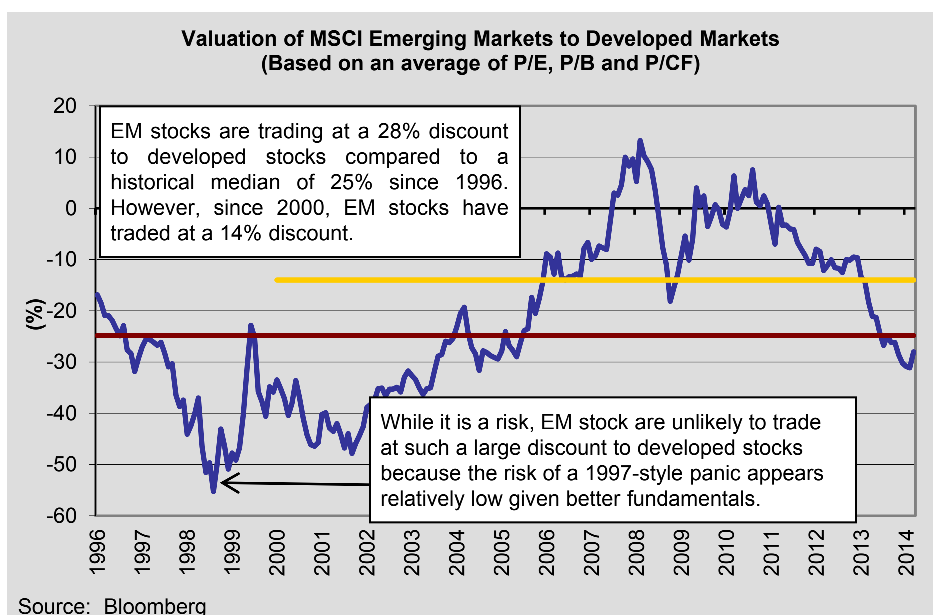




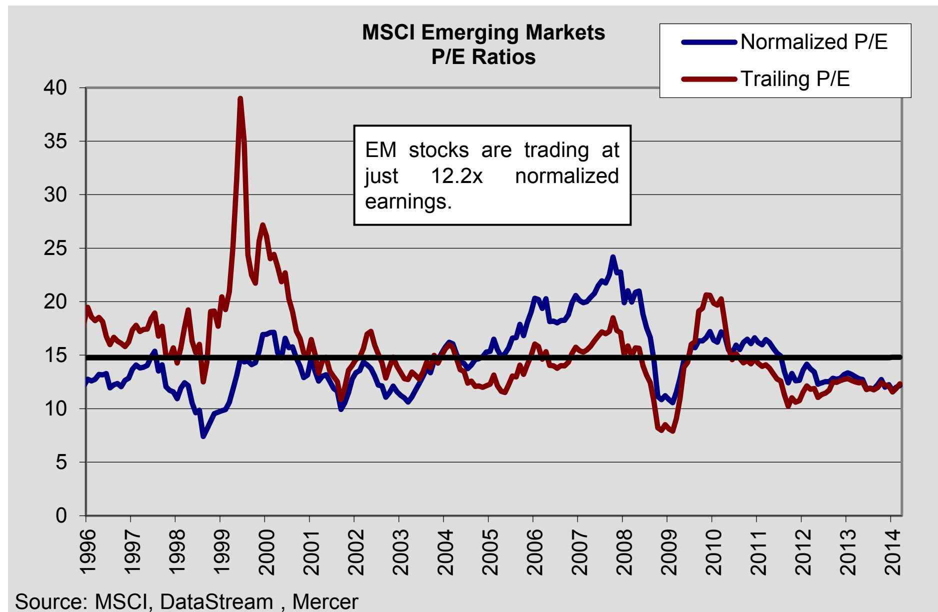
Is a reversal to emerging market underperformance in sight?

- In a continuation of 2013, emerging market equities struggled during the first two months of the quarter, falling 3.4%. However, they rebounded in March, rising 3.0%, outperforming developed stocks by 230 basis points and this trend has continued into mid-April.
  - There was a significant dispersion in regional performance. Latin American stocks rose 0.3%, while Asian stocks declined 0.3%. Eastern European (mostly Russia) stocks tumbled 10% on political tensions in Crimea.
  - Markets where there is a perceived potential for reform outperformed, suggesting a greater differentiation by investors on fundamentals.
- Slowing economic growth, wage inflation and tighter financial conditions have weighed on EM profits, with earnings declining 5% over the last 12 months. In the near-term, these pressures are likely to remain in place, putting further downward pressure on earnings. Earnings tend to suffer when companies overinvest relative to growth prospects so firms must adjust to a slower growth environment. Stronger growth in the developed world should help earnings over the intermediate-term.
- Emerging market equities appear to price a downbeat economic view, and valuations appear very attractive relative to the developed world. They trade at a P/E of 12, a 17% discount to the median since 1995. EM equities are trading at a 28% discount to developed stocks based on a blend of valuation measures.
- A note of caution on the valuation case is that the low valuations of EM are narrowly-based. Commodity sectors (especially Russian energy) and Chinese financials are extremely cheap, but probably for good reasons. Outside of these sectors, emerging markets trade at a P/E in the mid-teens, still attractive but closer to that of the developed world. Based on equal-weighted sectors, we estimate EM trades at a 10% discount to the developed world, rather than a 28% discount on cap weighted sectors.
- It is too early to say whether the outperformance of emerging markets in March marked a shift or will prove temporary. EM continues to face short-term headwinds due to the macro environment and souring investor sentiment. Nevertheless, we continue to recommend overweighting the asset class and think EM stocks are priced to outperform developed stocks over the intermediate-term. We also continue to maintain preference for active management given the potential for greater return dispersion between countries and sectors.

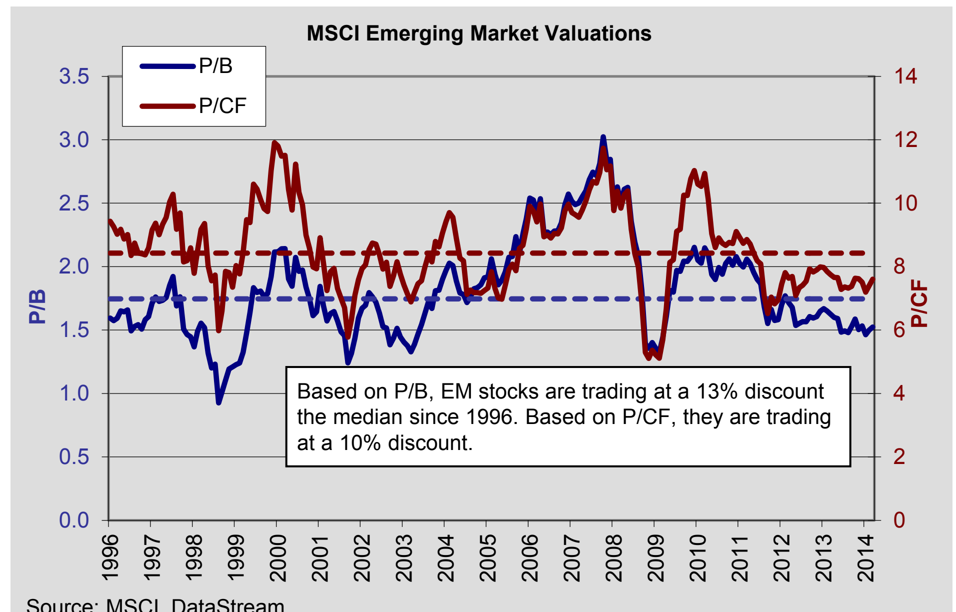




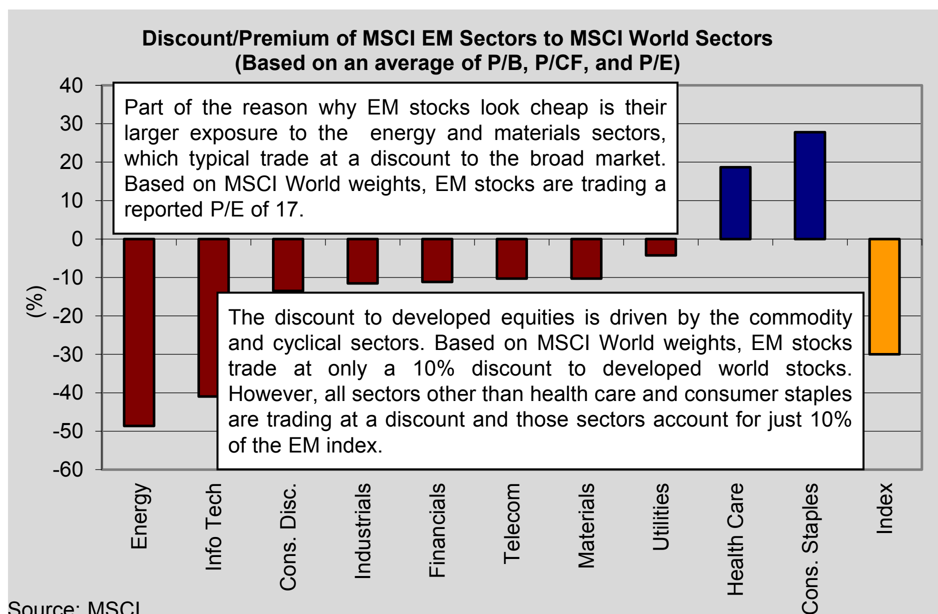
Is a reversal to emerging market underperformance in sight? (cont.)



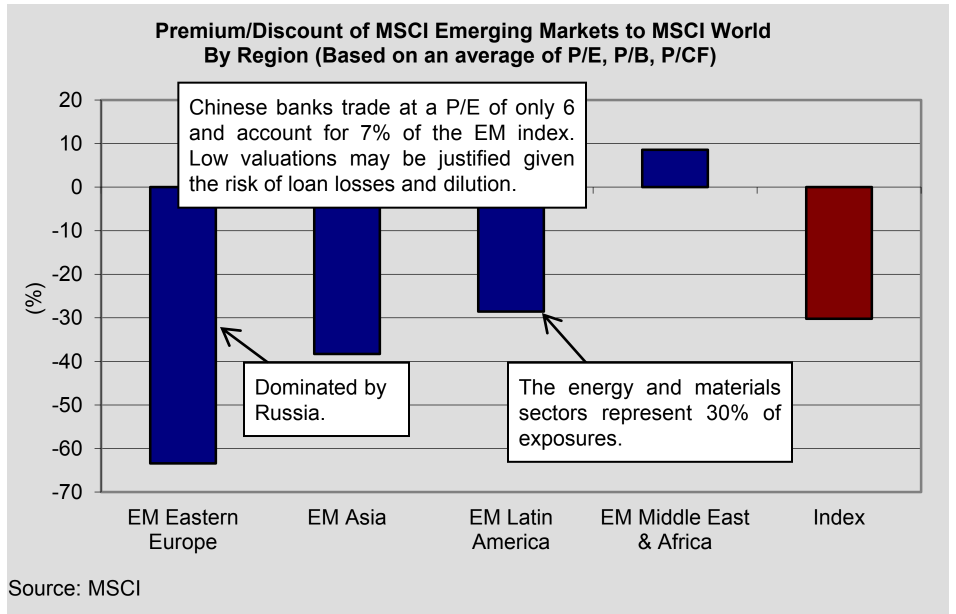
Source: MSCI, DataStream , Mercer



Source: MSCI, DataStream



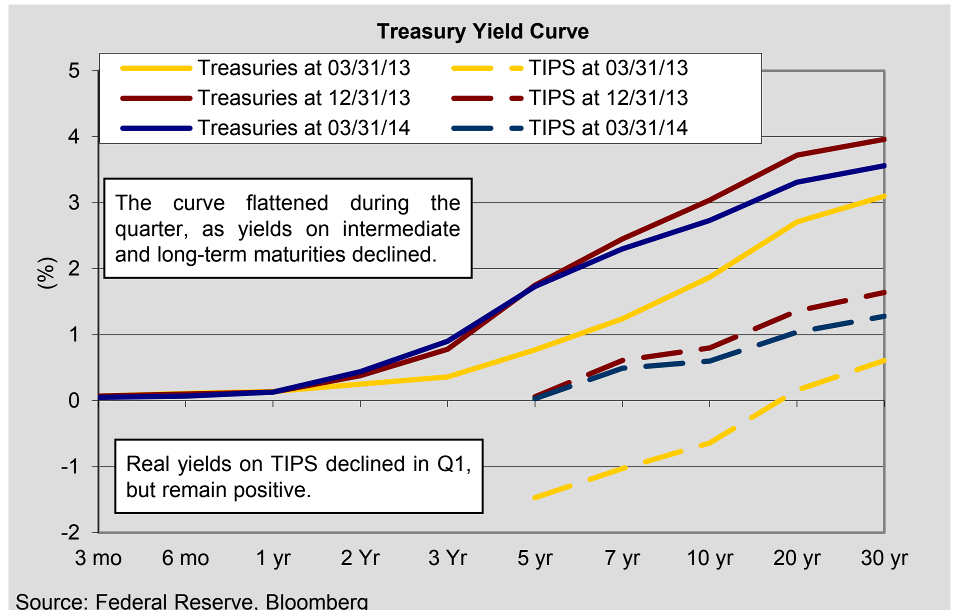
Source: MSCI



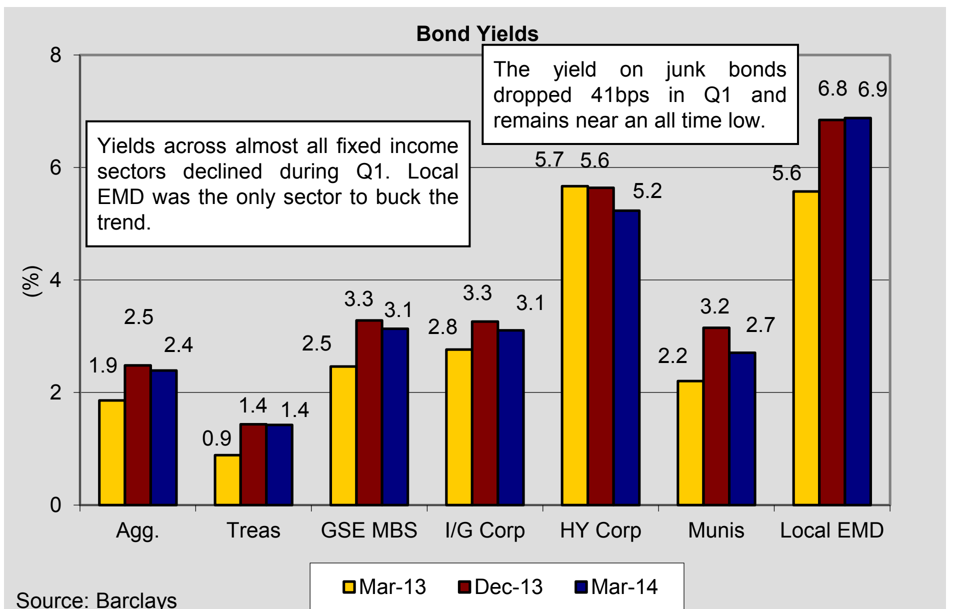
Source: MSCI

Treasuries rebounded in the first quarter

- After a difficult 2013, the Barclays Treasury index advanced 1.3% in the first quarter. Yields for maturities up to five years were close to unchanged, while longer yields declined. The yield on the 10-year Treasury dropped by 31 bps to 2.73%. The yield on 30-year Treasuries fell by 40 bps, and the Barclays Long Treasury index gained 7.1%.
- The bond market appears to have discounted the end of QE3. The key issue to watch is the course of the Fed's target rate. While we expect longer-term rates to move higher, the slow pace of Fed rate hikes should mean the process of normalization will be gradual. Intermediate-term bond yields appear fairly valued in light of this, and I/T Treasuries should provide a slight return premium to T-bills.
- TIPS outperformed Treasuries during Q1, advancing 2.0%. The TIPS index benefited from a longer duration than the Treasury index, more than offsetting a drag from a slight decline in inflation expectations. The inflation breakeven rate on 10-year TIPS moved from 2.2% to 2.1%, while the real yield declined by 20bps to 0.6%. With a 2.1% 10-yr breakeven rate, TIPS provide cheap insurance against an inflation surprise.
- The Barclays Corporate index gained 2.9% in Q1, outperforming Treasuries by 1.6%. The yield on the Corporate index dropped 16 bps to 3.1%, and the option-adjusted spread to Treasuries slipped by 8 bps to 1.1%, which is near long-term norms.
- Given the favorable economic outlook, we continue to prefer investment-grade corporate bonds over Treasuries. Downside risk for corporates relative to Treasuries is limited over the short-term. However, tight spreads leave limited upside from this point. A couple of trends worth watching are the increase in leverage ratios and the decline in credit quality of the investment-grade corporate bond universe. While this may not pose a significant risk over the short-term, it could make the next recession painful for investors.
- Given current yields, the expected return on bonds is low. However, we expect the Barclays Aggregate, which has a 5-year duration, to outperform T-bills because the yield advantage from duration and credit spreads should be sufficient to absorb the impact of rising rates.

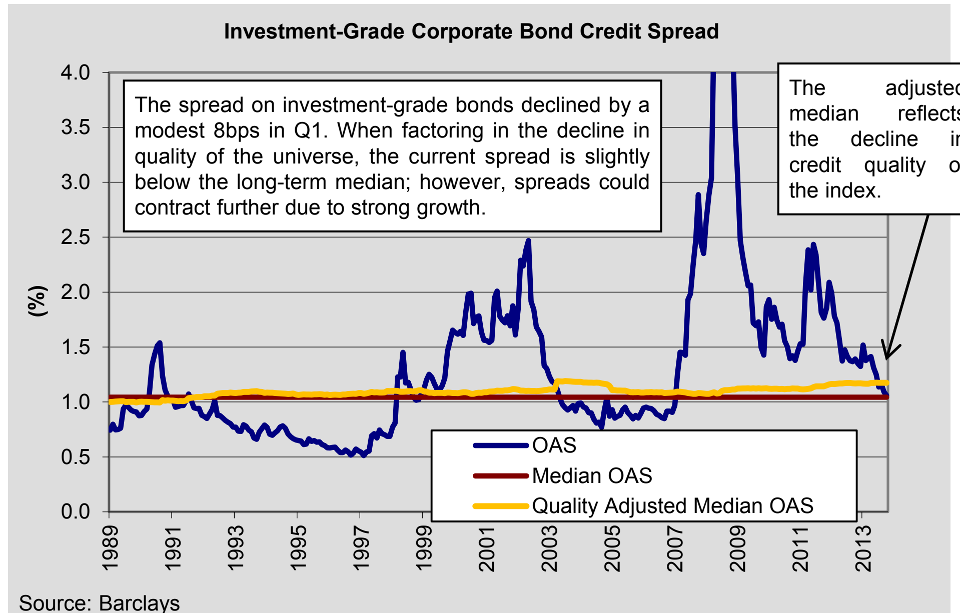


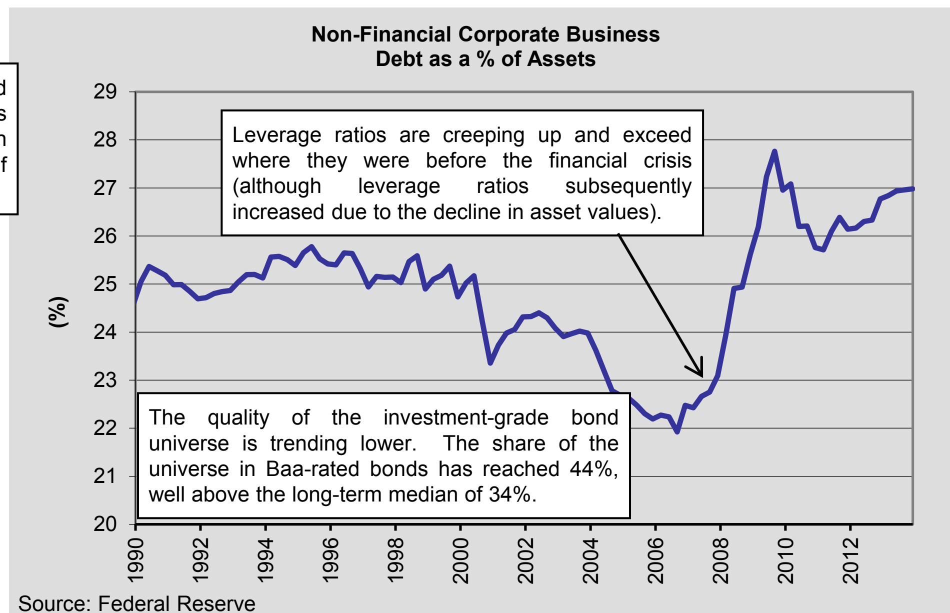
Source: Federal Reserve, Bloomberg



Source: Barclays

Treasuries rebounded in in the first quarter (cont.)





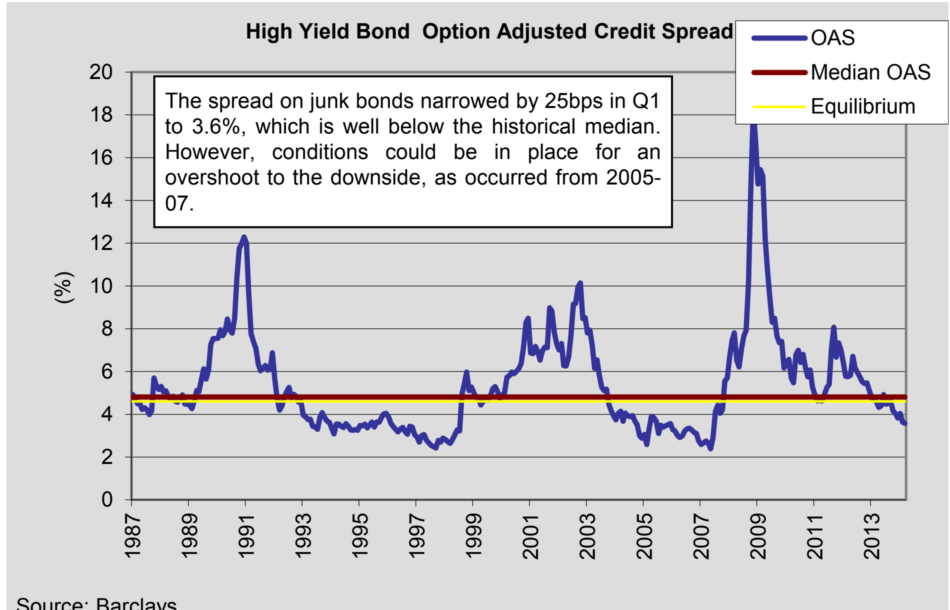
The yield on the 5-year gives some cushion to absorb rate increases. The 5-year yield would have to increase to over 2.9% for investors to experience losses over 2 years.

Source: Bloomberg, Mercer

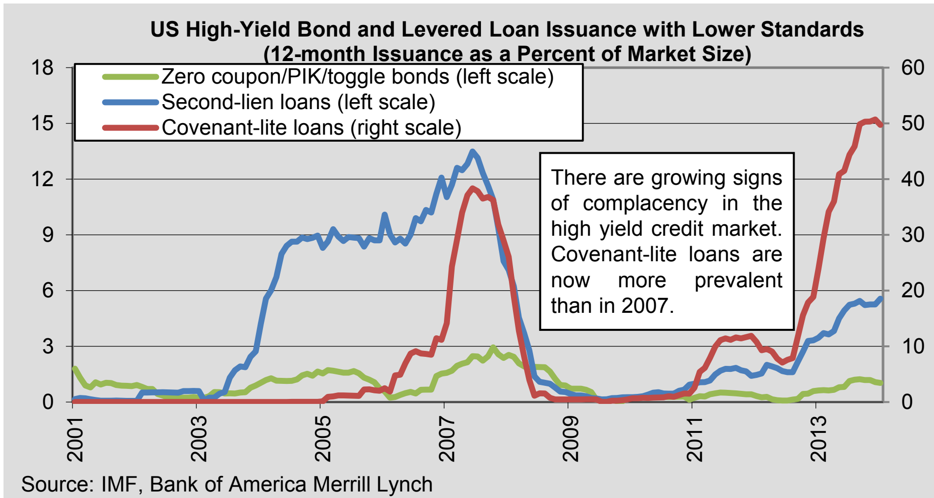
Ending Yield (%)	Annualized Return Over Period 1 Yr. (%)	2 Yr. (%)	3 Yr. (%)
5-Year Treasury (YTM = 1.73)			
1.0	4.6	2.8	2.2
1.7	1.7	1.7	1.7
2.0	0.7	1.3	1.6
2.5	(1.2)	0.6	1.2
3.0	(3.1)	(0.1)	0.9
3.5	(4.9)	(0.8)	0.6
Breakeven Yield	2.2	2.9	4.4
10-Year Treasury (YTM = 2.73)			
2.0	8.9	5.5	4.3
2.5	4.6	3.6	3.2
2.7	2.7	2.7	2.7
3.0	0.6	1.7	2.1
3.5	(3.3)	(0.0)	1.1
4.0	(7.0)	(1.8)	0.0
Breakeven Yield	3.1	3.5	4.0

Narrow high yield bond spreads are reasonable given macro conditions

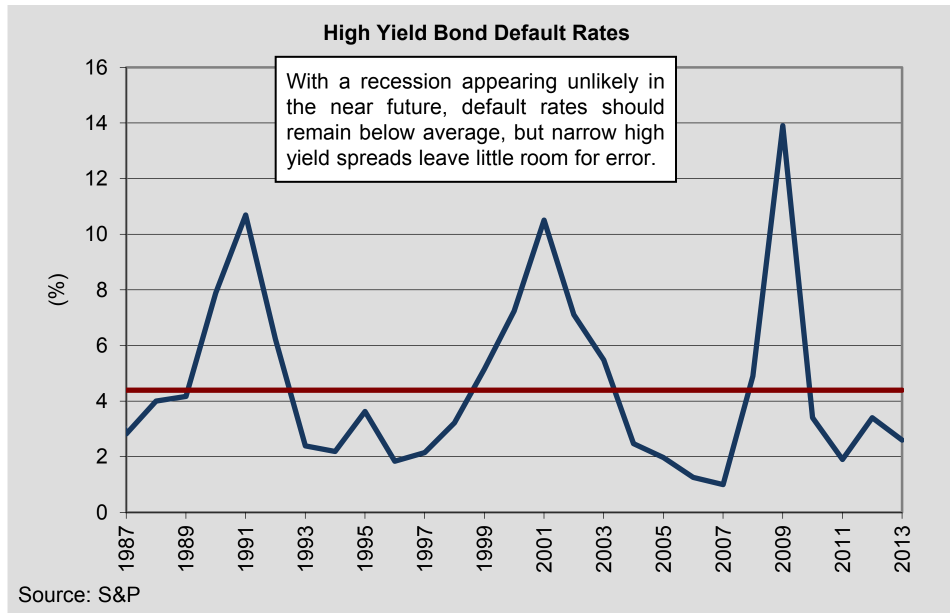
- High yield bonds continued to rally in the first quarter, returning 3.0%. The yield on the Barclays High Yield index declined from 5.6% to 5.2%, near record lows. The spread fell by 25 bps to 3.6%, its lowest level since early 2007 and below the historical median.
- The short-term default outlook remains favorable given fairly healthy economic conditions. Moody's forecasts a default rate of 2.4% in 2014, well below the long-term average of 4.0%. Given a typical recovery rate of 40%, default losses on high yield bonds would only be 1.5%, making the current spread of 3.6% to Treasuries appealing. We maintain a preference for high yield over Treasuries as economic conditions warrant a below average spread.
- High yield bonds have little upside, with an expected return limited to 5% under a *very* optimistic default scenario, but with downside risk if the economy weakens and spreads widen. With a 6.6 year average maturity on the high yield bond index, a recession and a cyclical spike in defaults is possible before the average bond matures. We prefer the more symmetric return distribution of global equities to high yield bonds.
- Issuance quality bears watching as the healthy demand for high yield paper is attracting dodgier borrowers and allowing weaker covenants. While issuance quality is not as weak as the credit bubble years (2005-07), seeds for the next distressed cycle are being sown.



Source: Barclays



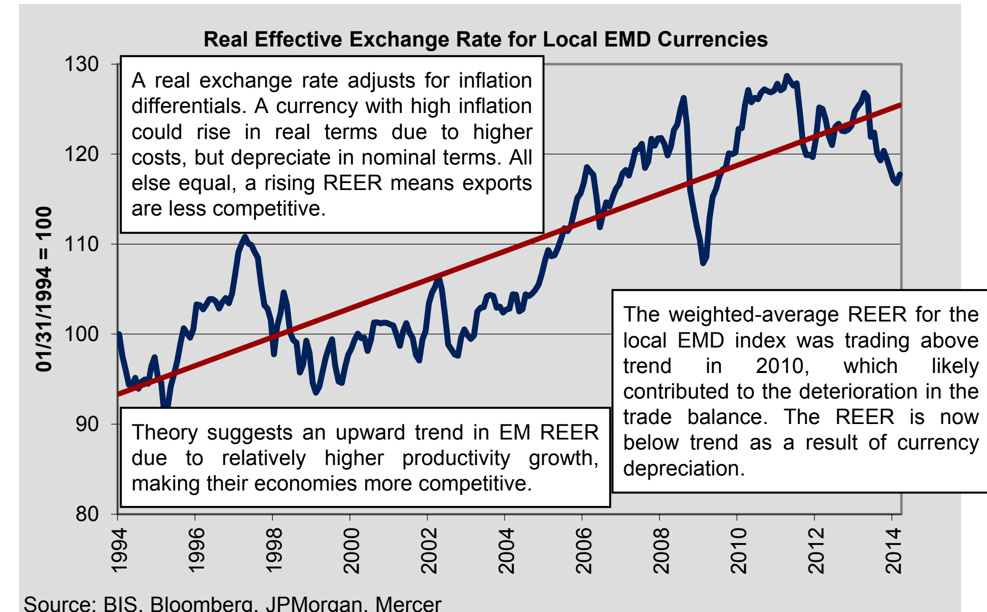
Source: IMF, Bank of America Merrill Lynch



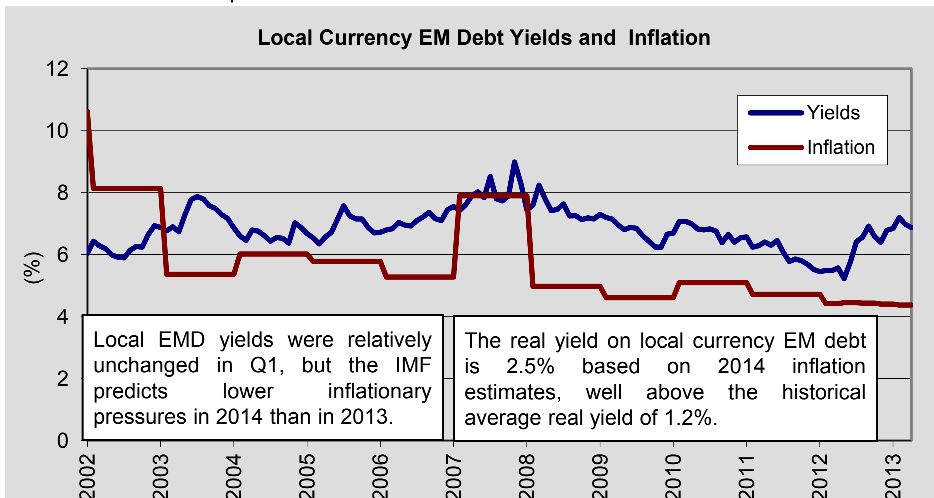
Source: S&P

Local currency EMD halted its slide

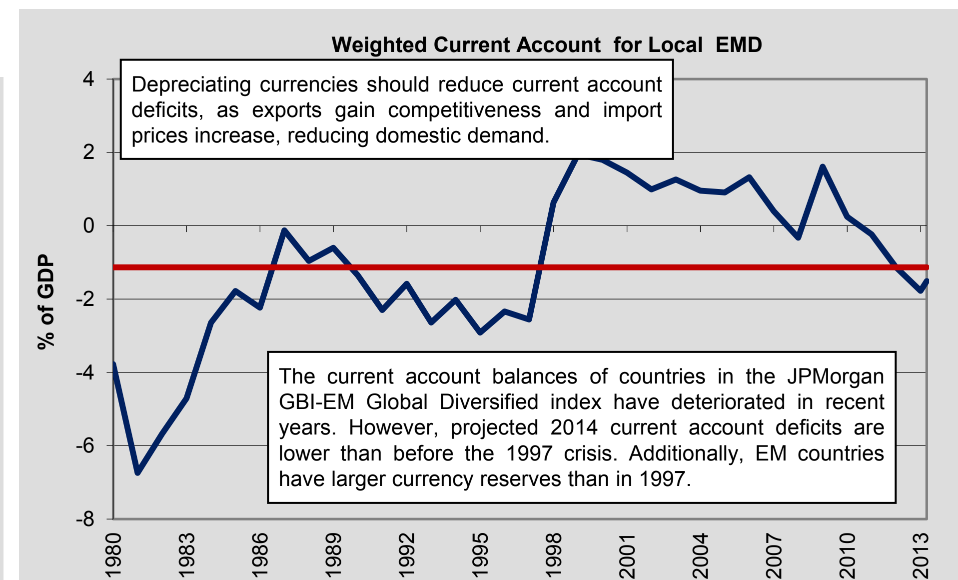
- Local currency emerging market debt (EMD) was one of the worst performing asset classes of 2013. After declining 4.6% in January, EMD rebounded to end the first quarter up 1.9%, roughly earning the coupon. Yields were essentially flat, and while currencies were mixed, they were close to flat in aggregate. Current real yields suggest prospective returns in-line with our equilibrium expectations.
- Currency depreciation was a key contributor to losses in 2013. While further currency losses are a short-term risk, we do not expect a repeat of 2013 because currency valuations have improved and US rate increases are likely to be more gradual.
- Improved EM fundamentals and persistently low yields in developed markets have contributed to a rising share of foreign investment in EMD. While we expect this trend to continue in the long-term, it leaves EMD more susceptible to short-term "hot money" flows, especially amongst retail investors, which could lead to increased volatility.
- We continue to recommend a strategic allocation to local currency emerging debt. Real interest rates are attractive relative to the developed world. For investors looking to increase emerging market exposure, we have a slight preference for equities over debt due to attractive valuations on equities.



Source: BIS, Bloomberg, JPMorgan, Mercer



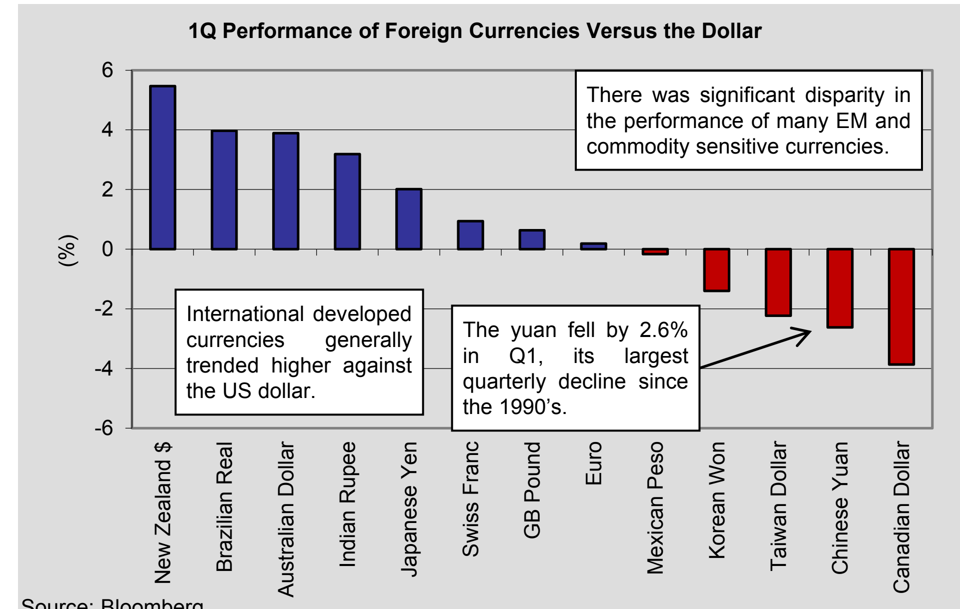
Source: DataStream, JPMorgan, IMF, Mercer



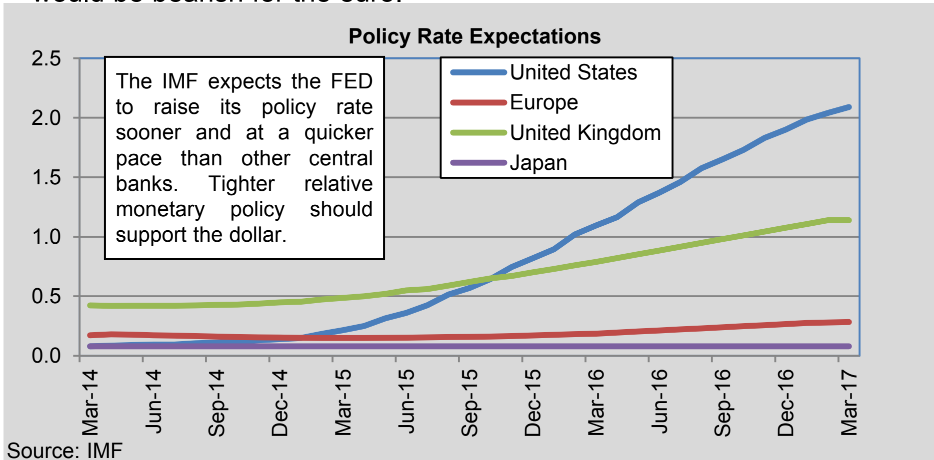
Source: DataStream, JPMorgan, IMF, Mercer

Policy normalization should support the dollar

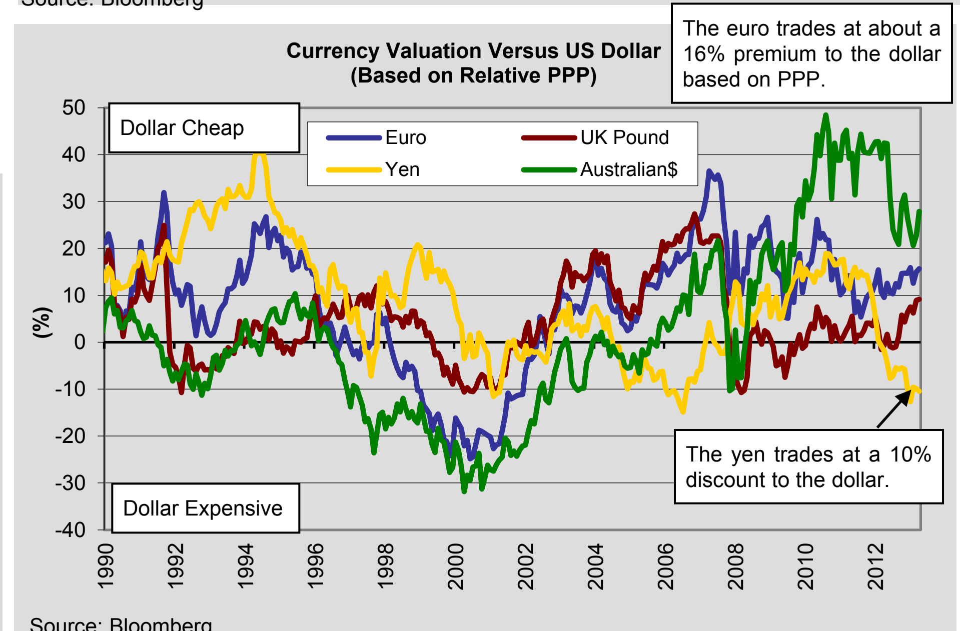
- On a trade-weighted basis, the US dollar appreciated 0.5% in Q1. The yen and euro advanced by 2.0% and 0.2% against the dollar, respectively, while emerging market and commodity sensitive currencies were mixed. Notably, the Chinese yuan depreciated by 2.6% as the government managed the exchange rate lower.
- On balance, the outlook for the dollar is positive against developed currencies over the next few years. While the Fed will likely be slow to normalize policy, it will do so before most other central banks. QE3 is on track to end in fall 2014 and the Fed will likely raise its policy rates ahead of others. Moreover, the dollar remains inexpensive against most currencies on relative purchasing power parity (PPP). A negative for the dollar is that the US continues to run a current account deficit, although it is improving due to falling energy imports.
- While the yen trades at a discount to the dollar on relative PPP, the BoJ will need to drive the yen lower to reach its inflation target. The bank will likely remain aggressive in expanding its balance sheet to fight deflation. While a short-term reversal is possible due to the high number of speculative yen shorts, the currency is likely to continue its decline.
- The euro has strengthened by 15% against the dollar over the past 20 months and appears rich on relative PPP, trading at a premium of 16%. This makes it more difficult for the periphery to recover. The ECB may take more aggressive actions to support growth and fight deflation, which would be bearish for the euro.



Source: Bloomberg



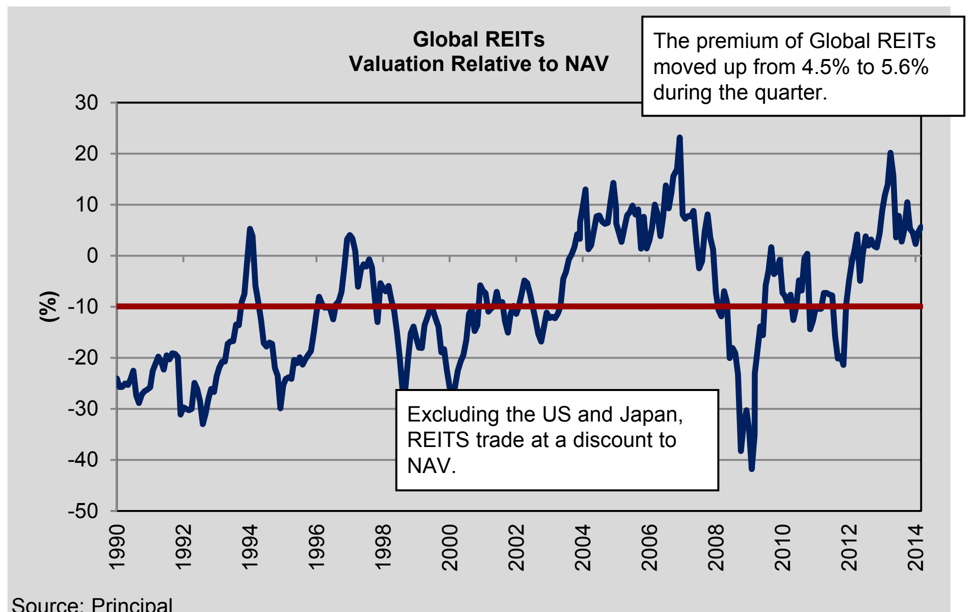
Source: IMF



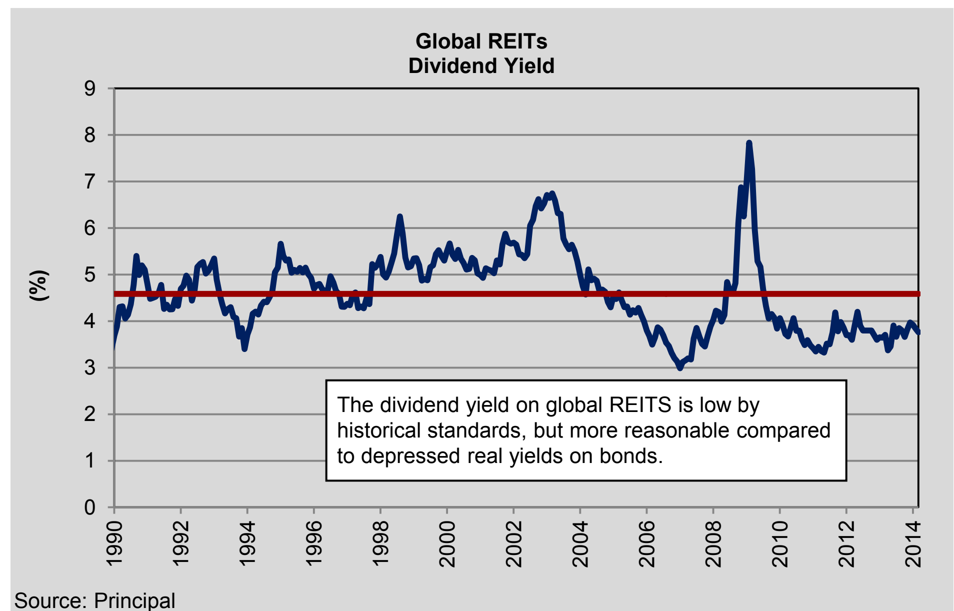
Source: Bloomberg

Global REITs rebounded off a disappointing 2013

- Global real estate stocks posted a gain of 4% for the quarter, outperforming equities and bonds. Within North America, the US REIT benchmark gained 10.2%. The UK and Continental Europe rose 7.4% and 5.0%, respectively, as the European recovery remained intact. Asian listed property securities generally declined.
  - At quarter end, the US REIT dividend yield stood at 3.57% while the global property securities dividend yield was 3.64%, down from 4.09% and 3.73%, respectively, at the start of the quarter.
  - In the US, REITs were trading at a 4% premium to NAV at the end of February, up from a 3-5% discount in the prior three months and in-line with the historical average of a 3.7% premium. However, relative to historical norms, REITs today still look expensive versus stocks. Valuations for the UK have lost attractiveness with its recent increase in value relative to the underlying NAVs. In Hong Kong, the overhang of China's slowing economy continued to pressure shares of certain commercial landlords with significant operations on the mainland.
  - At the end of the first quarter, global REITs traded at a P/E of 22.3, up from 18.5 at the start of the quarter and above the historical average of 14.2.
- In the private real estate market, the NCREIF ODCE total return before fees for 4Q13 was 3.2% (1.3% income and 1.9% appreciation) compared to 3.6% during the third quarter. Income remained stable while appreciation was off 34 bps from the prior quarter. Appreciation has fallen 64 bps since the second quarter of 2013.
  - Fed-driven asset reflation has resulted in cap rate compression; however, going forward, asset appreciation will need to be driven by NOI growth.
  - As interest rates normalize, we expect performance of core real estate to soften, although core properties should continue to provide solid cash yield with some appreciation.
  - Occupancy ended the fourth quarter at 91.2%, in-line with occupancy at the end of the third quarter but below the pre-recession peak level of 92.4% reported in the third quarter of 2007.
  - Leverage for the funds in the index rose in the fourth quarter to 22.3% from 21.9% last quarter.



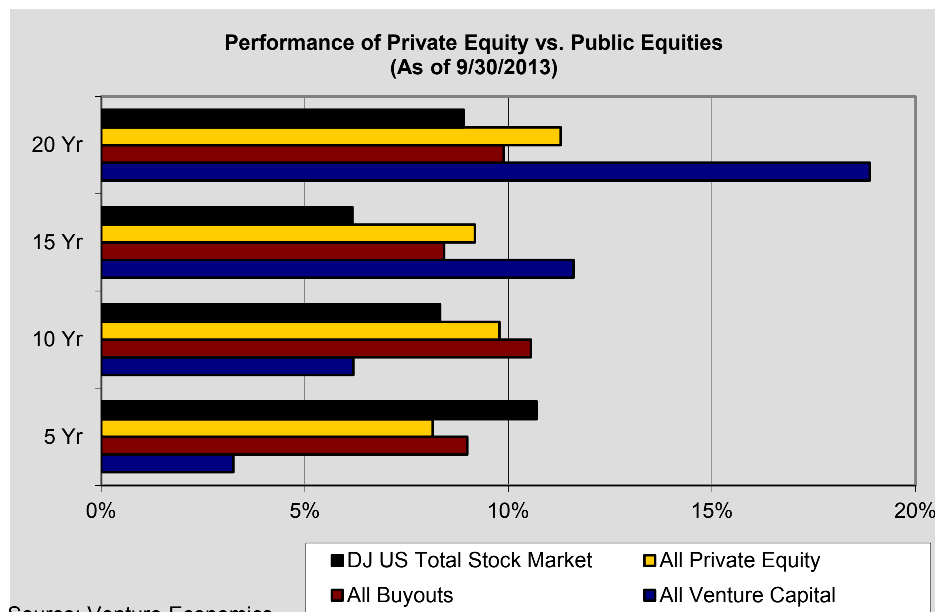
Source: Principal



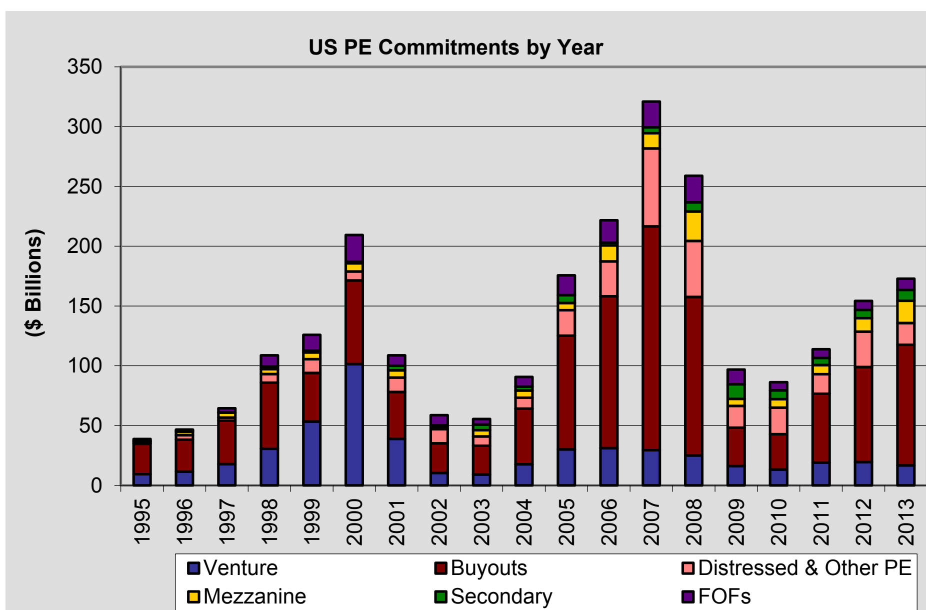
Source: Principal

Private equity has appeal in a lower return environment for public equities

- We maintain a positive view on the global private equity environment. Capital markets and credit availability have generally been supportive, and the modest levels of economic growth are sufficient to enable private equity firms to meet their return goals.
  - We favor middle market growth equity strategies globally and smaller buyouts in the US and Europe.
  - We remain positive on US venture capital with an overweight to life science strategies.
  - Mezzanine debt yields have fallen somewhat, but the spread to public corporate debt remains very wide.
  - The opportunity set in distressed investing is not robust given low default rates, which argues for an underweight position.
  - Secondary strategies are attractive as a beta play.
- Global private equity performance remains steady with Q3 returns coming in at 4.9% versus a public equity index return of 6.2%. The 1-year return was 17.4%, almost matching the 17.7% return of the MSCI ACWI. Private equity funds have produced attractive absolute returns over the last several years, but have trailed public equity markets. Relative long-term performance has been better and history would lead us to expect this performance gap to eventually close.
- The fundraising environment has been very active, but still remains below the peak years of 2006-2008. Whereas the prior cycle was dominated by very large funds from established firms, the current period is being led by some middle market firms simply unable to satisfy the demand. The $169 billion raised for buyouts globally in 2013 was up 42% over 2012 and was a close match for the total raised in 2005.
- The strong recent performance in venture capital may re-ignite interest in the space, but the fundraising total of $26.8 billion is the lowest total since 2004 when $26.7 billion was raised. The US is the largest VC market and has seen some high profile exits of late, but in 2013 the fundraising total was off 14% relative to 2012.
- The bright spots in the fundraising market include mezzanine debt where year over year totals were up 65%, and the $18.6 billion raised was the second best year ever. The 25% and 31% increases in funds of funds and secondary funds, respectively, would appear to signal a higher level of activity among smaller investors.



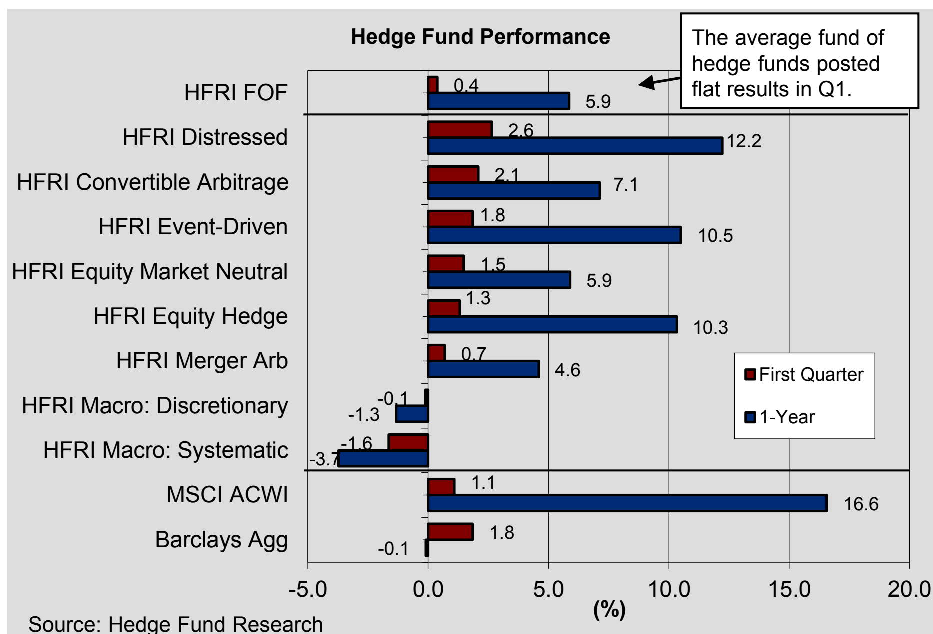
Source: Venture Economics



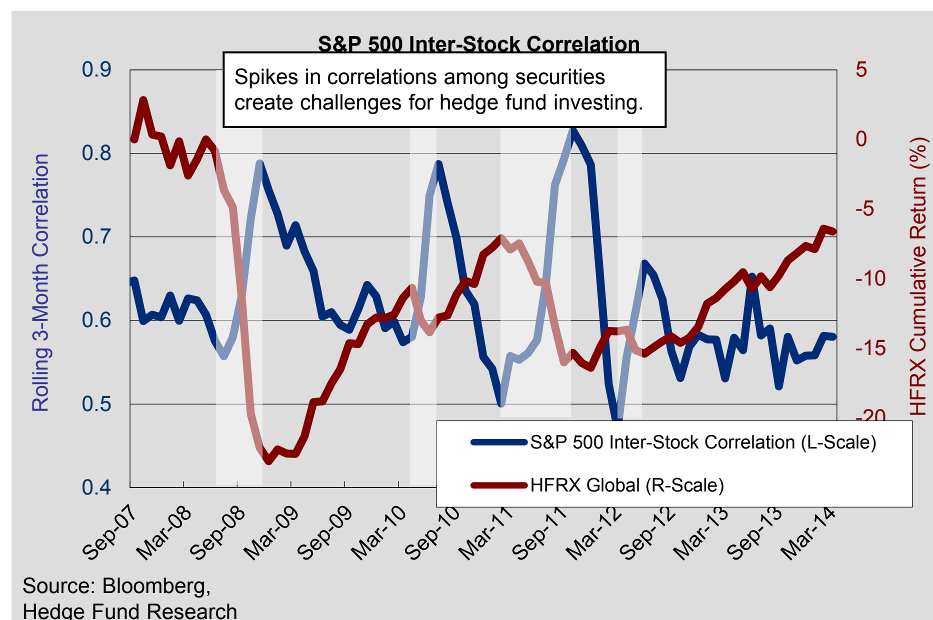
Source: Venture Economics

Hedge funds eked out a gain for the quarter after a difficult March

- While hedge fund returns were healthy during the first two months of Q1, a significant market rotation within equities in March hurt the performance of many portfolios. Overall, hedge funds produced slightly positive results for the quarter, with the HFRI FoF Composite earning just 0.4% and trailing a classic 60/40 mix.
- Event-driven and credit strategies performed well during Q1. Restructuring and liquidation holdings in particular continued to produce attractive results, which were aided by distributions and progress in a number of situations. Restructured equity exposure also benefitted from a positive event environment. Managers with exposure to structured credit investments, particularly RMBS, were also rewarded, as improvements in housing market sentiment and favorable mortgage-issuer settlements re-priced a number of asset-backed securities.
- Equity strategies posted modestly positive performance for the quarter, with only one month of positive returns (February) and substantial manager dispersion. Dispersion among stocks provided a favorable environment for alpha generation over the quarter, but what appeared to be a mass deleveraging of widely held hedge fund names over the last two weeks of March punished many portfolios, as many managers lost on both their longs and their shorts.
- Ample liquidity and periods of higher volatility provided a good backdrop for relative value investing during the quarter. Robust new issuance and favorable liquidity aided convertible strategies broadly. Merger arbitrage benefitted from increased deal volumes during the quarter, yet spreads remain well below normal. We continue to believe the foundation for an increase in merger activity is strong.
- Macro strategies as a whole struggled during the quarter, but manager and strategy dispersion were high. Systematic strategies broadly declined. Long exposure to commodities was beneficial to portfolios and Japan was again a differentiator of performance for the quarter, but in the opposite direction of 2013, as Japanese equities retreated.
- We've discussed in the past that we expect the occasional liquidity event within the markets. Previous examples have generally hit the markets across the board (2008, 2010, 2011). August 2007 and now March 2014 were more isolated versions that hit just segments of the equity markets, particularly areas trafficked heavily by hedge funds. We would continue to expect such events to occur on occasion and don't believe they impact the longer-term thesis on hedge funds.



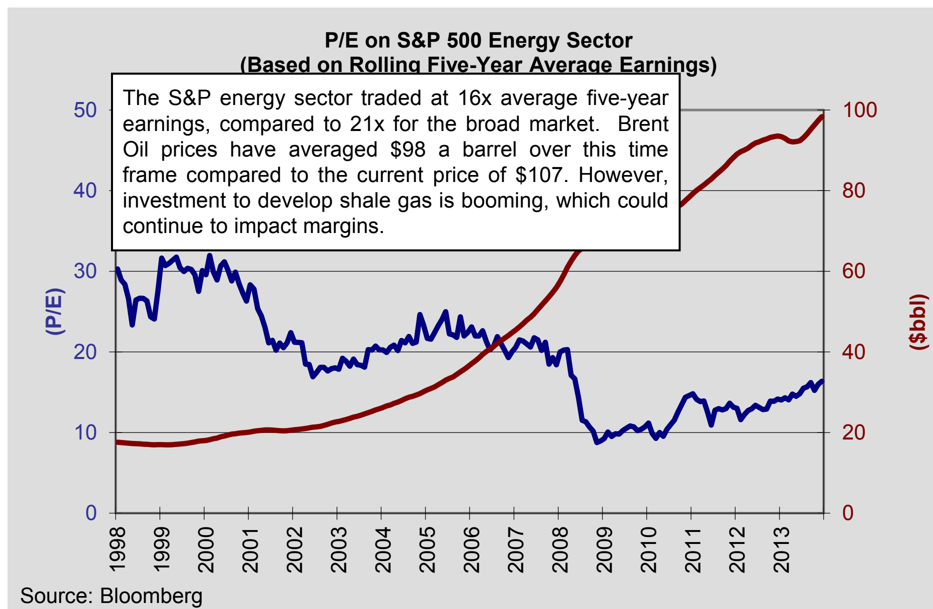
Source: Hedge Fund Research



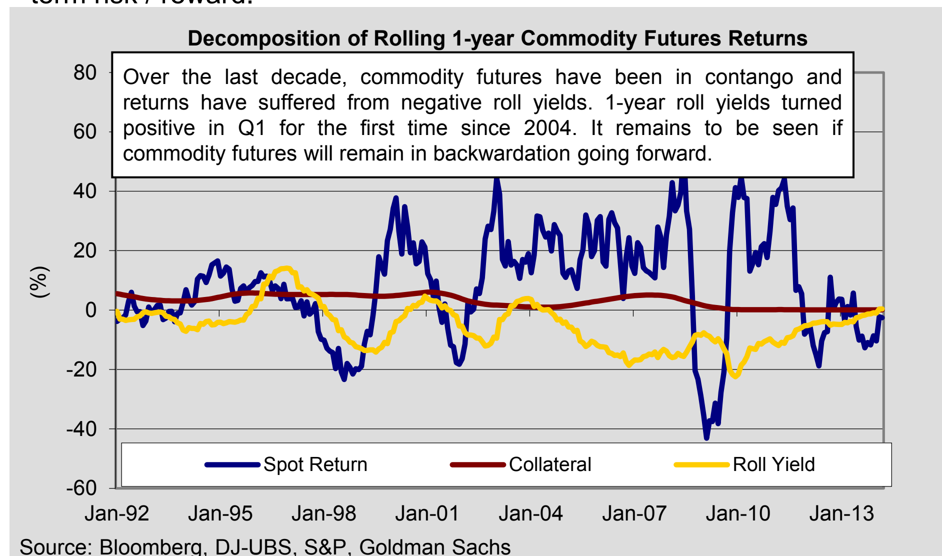
Source: Bloomberg, Hedge Fund Research

Commodities rebounded in the first quarter

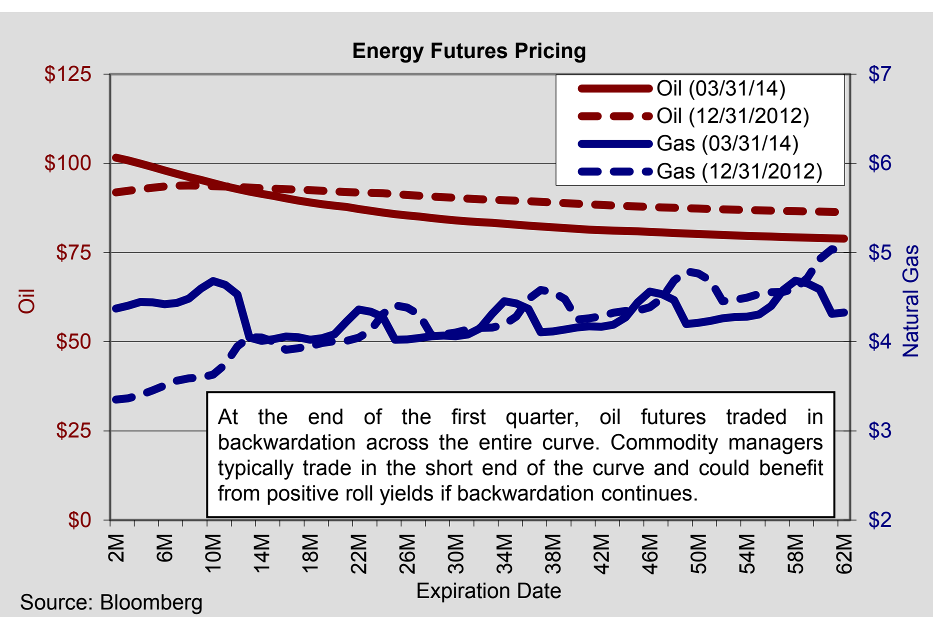
- Commodity investments advanced in the first quarter. The DJ UBS Commodity index gained 7.0%, while the S&P GSCI Commodity index, which has a larger weighting to energy, rose 2.9%. Natural resource stocks trailed commodities, but outperformed broader equity markets as the S&P North American Natural Resource index gained 2.7%.
- The outlook for energy and other economically sensitive commodities is mixed. In the short-term, stronger growth could lead to a rebound in demand and benefit commodity prices. Global demand will likely hinge on the state of the Chinese economy as China remains the marginal buyer of many resources. While Chinese growth has slowed, the government has announced large infrastructure investment programs and could ease monetary policies to further stimulate growth, which could benefit commodities. However, investments in new technologies and alternative sources of production could lead to more supply, while a stronger dollar would put further pressure on prices.
- We continue to favor obtaining commodity exposure through natural resource stocks over commodity futures. While trailing one year roll yields on commodity futures have turned slightly positive, energy stock valuations trade at a discount to the broad market and offer better long-term risk / reward.



Source: Bloomberg



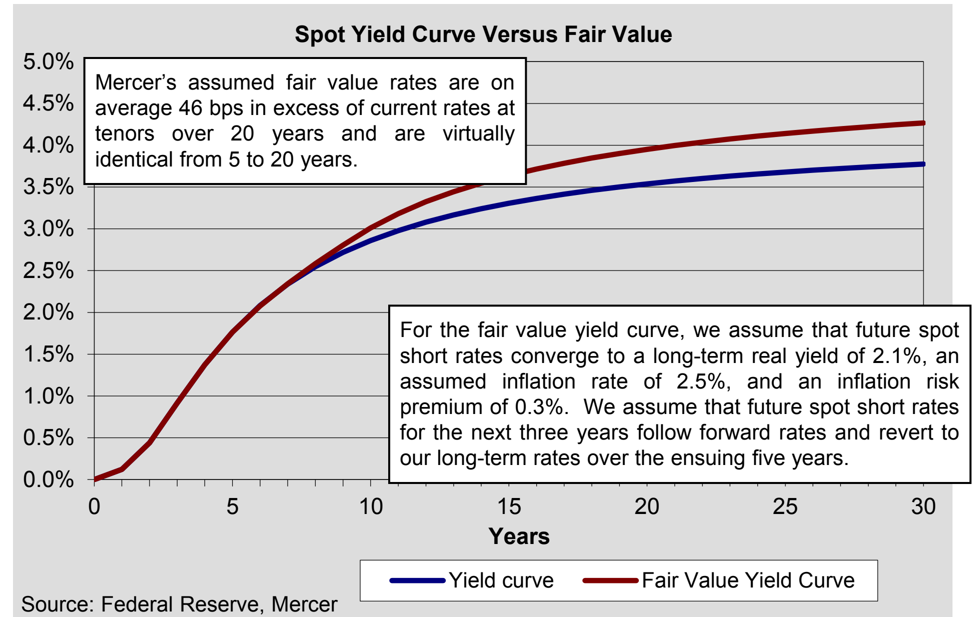
Source: Bloomberg, DJ-UBS, S&P, Goldman Sachs

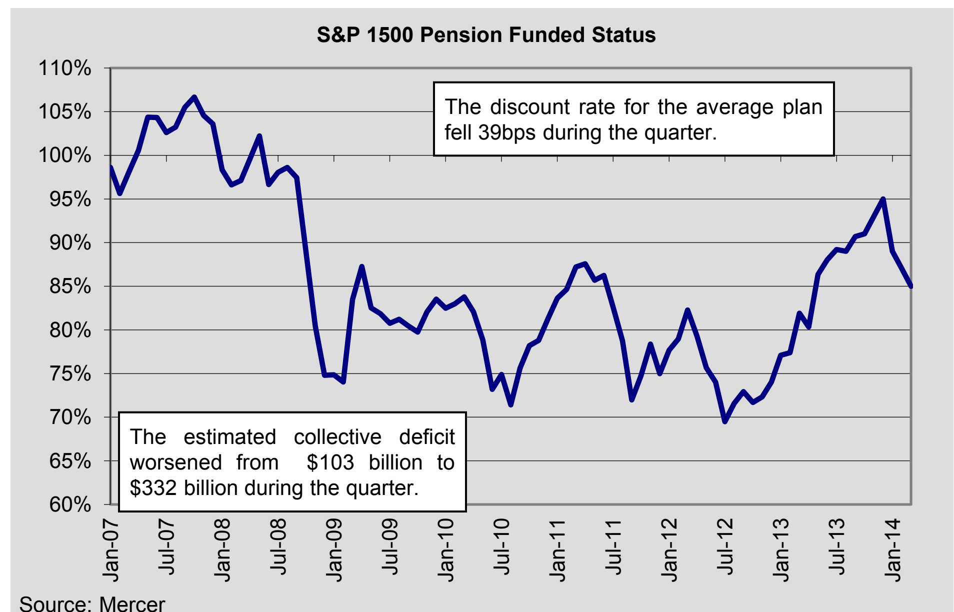


Source: Bloomberg

Liability driven investing: Maintain tactical underhedge

- We define fair value rates as those rates applying today that would allow a plan to lengthen duration with no change in expected return. At quarter end, Mercer's assumed fair value rates were on average 46 bps in excess of current rates at maturities over 20 years, up from 9bps last quarter. At the intermediate part of the curve, spot rates are 22bps below the fair value range versus at fair value at the end of last year
- Given the decline in rates during the quarter, for those plans that are currently under their target interest rate hedge ratio, the current level of rates does not warrant a move towards the strategic hedge target.
- Swap spreads over Treasury rates are negligible at the front and back end of the curve, and slightly higher at the belly of the curve. At these yields, and given that swaps are more capital efficient than Treasuries, sponsors looking to extend duration should consider using swaps. Treasury futures and STRIPS continue to offer slightly richer yields at the long end of the curve.
- Credit spreads declined during the quarter and are near historical averages. We still see these instruments as favorable for hedging purposes and favor an overweight credit spread exposure relative to the strategic benchmark, after taking note of any credit exposure the plan may obtain through its equities.
- Mercer estimates the aggregate funded status of plans operated by S&P 1500 companies. After improving from 74% to 95% in 2013, the average funded status fell back to 85% in the first quarter. The decline in rates and poor equity performance led to the deterioration in funding levels during the quarter.
- Recent legislation has been passed that would significantly raise PBGC insurance costs in the next two years. Furthermore, it is expected that mortality table standards across the industry will change, resulting in an increase in liability of 5-7%. These expected increases in carrying costs make lump sum offerings a more compelling tool to reduce risk.
- Our buyout index indicates that carrying costs and the buyout cost are both near 109% of accounting liability. Plans that have seen their funded status improve significantly are in a better position to explore transactions to reduce pension liabilities via lump sum offerings or buyouts / plan terminations.





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