Q3 2018

CIO Newsletter

Overlapping Cycles

Current Environment

The CIO Newsletter warned a year ago that late cycle is a challenge for investors: "We fear the next downturn, but we know there can be a steep opportunity cost to reducing risk exposure too early." That is very much how the third quarter of 2018 played out. The S&P 500 stock index reached a new all-time high and set a record for the longest bull market yet (although not the largest), producing a return above 10% for the first nine months of 2018 while most bond indices had negative returns in the same period.

> GDP growth has now picked up pace in 2018 – 4.2% annualized real growth reported for the second quarter – thanks to fiscal stimulus from tax cuts and budget expansion.

In the background the fear of the next downturn remains, especially as tightening monetary policy, growing fiscal debt and trade wars all continue. Economic expansions and bull stock markets do not die of old age; they typically founder because of unsustainable imbalances (e.g. inflation requiring monetary tightening or large fiscal debt eventually reducing government expenditure or requiring higher taxes) or else because of an external catalyst that slows economic activity (e.g. a trade war).

> September saw the eighth rate hike in this tightening phase of the monetary cycle, with another expected in December and more forecast for 2019.

When we talk about the late stage of the cycle, there are really several interlocking cycles at play. The primary ones are economic, monetary, equity and credit. The economic cycle has seen a very long expansion since June 2009, which was mainly a slow burn widely described as a new normal of secular stagnation, but which looked sustainable precisely because it was not overheating. GDP growth has now picked up pace in 2018 – 4.2% annualized real growth reported for the second quarter – thanks to fiscal stimulus from tax cuts and budget expansion. But that stimulus is also warming up inflation, with CPI at 2.9% in July and 2.7% in August (PCE inflation was 2.02% and 2.01%), which is prompting the Federal Open Market Committee (FOMC) to maintain its monetary tightening. September saw the eighth rate hike in this tightening phase of the monetary cycle, with another expected in December and more forecast for 2019. This monetary tightening has been felt already in emerging markets this year (discussed in the CIO Newsletter last quarter) as the global supply of dollars shrinks, and is also starting to affect the U.S. housing market as higher mortgage rates challenge affordability.

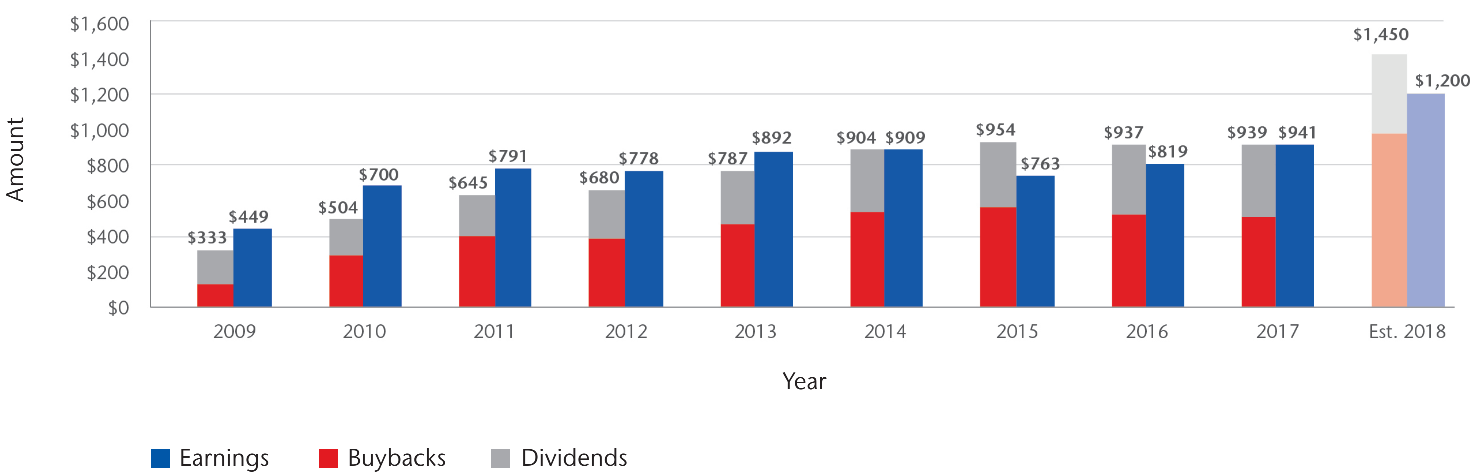
Empower Results®

Current Environment (cont'd.)

Lately corporations are reporting greater pressure from wage inflation and cost of inputs, and some are passing those along in price increases – all signals that inflation will continue to push monetary tightening.

The tightening monetary cycle will eventually threaten the high valuations of stocks and other risk assets. So far the strong fundamentals for stocks, especially the strong growth in corporate earnings and stock buybacks on course for an estimated $1 trillion in 2018 across the S&P 500 (see chart below), has prolonged the bull market phase of the equity cycle, but any decline in earnings would quickly draw focus back to the valuation levels relative to rising bond yields. Lately corporations are reporting greater pressure from wage inflation and cost of inputs, and some are passing those along in price increases – all signals that inflation will continue to push monetary tightening. Alongside this, the credit cycle is heavily influenced by the monetary cycle – low yields encourage more credit – and supports the economic cycle as debt expansion stimulates economic growth, plus it helps to pay for stock buybacks. While credit growth has not accelerated or become over-leveraged in ways that would be as dangerous as 2007, the credit cycle will be challenged by monetary tightening and growing fiscal debt absorbing more capital, which will soon leave fragile borrowers exposed. The ongoing reliance of the global economy on very high levels of debt means the economic cycle will turn toward recession if there is any significant slowdown in the credit cycle.

Earnings vs. Dividends + Share Buybacks (in billions)



Data from: Standard & Poor's / GSAM / CME

Sources cited in text: CIO Newsletter Q3 2017 and Q1 2018, Bureau of Labor Statistics (CPI), St. Louis Federal Reserve (PCE and GDP), Goldman Sachs (estimated buybacks in 2018), FactSet (level of yields and stock indices)

Longer-Term Outlook

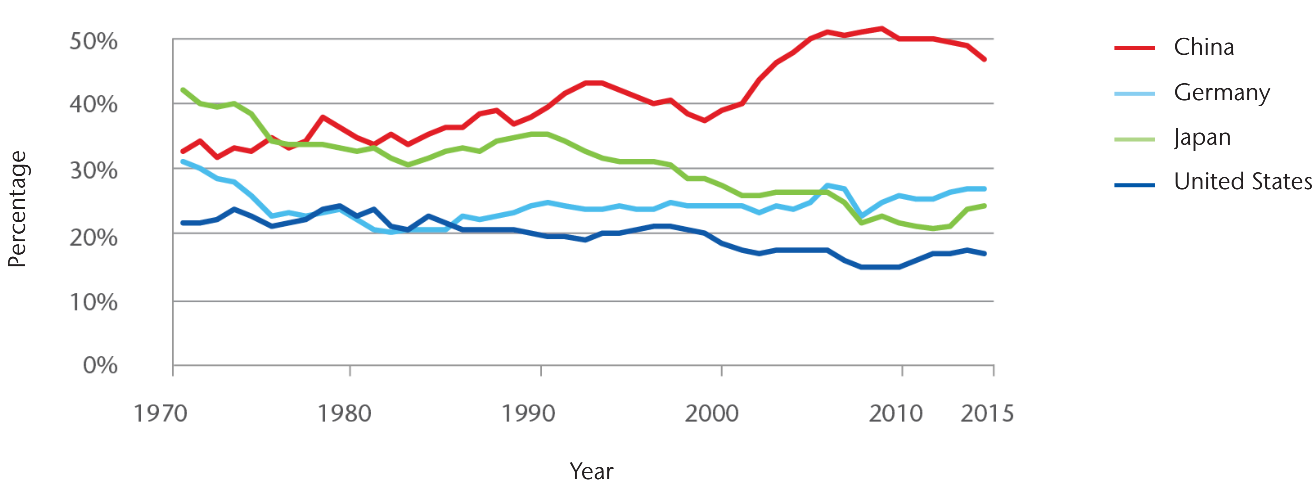
Shrinking a trade deficit can be difficult to achieve when a growing fiscal deficit requires more capital in the U.S.

Six months ago the CIO Newsletter looked at how a trade war to reduce a trade deficit could interact with capital markets. A quick recap is that a trade deficit is the primary component of a current account deficit, which is equal to a capital account surplus, whereby more foreign capital is invested into the economy than domestic capital is invested abroad. The flow of trade in goods and services has an equal and opposite balance in the flow of capital.

Therefore shrinking a trade deficit, which requires an equal reduction in the capital account surplus, can be difficult to achieve when a growing fiscal deficit requires more capital in the U.S. to finance government expenditures. This was illustrated too by the higher national savings rate in the mercantilist nations that run a large trade surplus, and therefore a large capital deficit, with the rest of the world. That chart is repeated below. The Q1 2018 CIO Newsletter has a fuller explanation of these dynamics.

The national savings rate reflects national economic policy rather than the individual decisions of households.

Gross Domestic Savings (% of GDP)



Source: The World Bank, data as of December 31, 2016

But the national savings rate is not as simple as it sounds. It gives an impression of virtuous, thrifty workers in creditor nations, contrasted with irresponsible, profligate consumers in debtor nations, and that is misleading. The national savings rate reflects national economic policy rather than the individual decisions of households. Without diving into the equations of macroeconomists, the national savings rate is measured by the excess of national income over consumption and government expenditures. Mercantilist nations use economic policies that suppress household consumption and/or government expenditure in order to support their export sector, usually in pursuit of employment objectives. The most common example is artificially weakening the currency (true of Germany, China and Japan in different ways over different periods in history), which reduces household spending power while making exports more competitive. Another example is reducing household consumption by suppressing real wage growth, which we can see in German "labor market reforms" — starting after Reunification in 1990 — favoring workforce participation over wage growth, and in the very low long-term real wage growth of Japan alongside extremely low unemployment (just 2.4% in August 2018). Wage growth was sacrificed to ensure maximum employment. A different type of economic policy to boost the national savings rate is Germany running a fiscal surplus, which limits the growth in government expenditure. This stands in stark contrast to the U.S. fiscal

Longer-Term Outlook (cont'd.)

deficit, which the CBO projects at 4.6% of GDP for fiscal year 2019 – the largest in the developed world.

Over the longer term, the U.S. capital account surplus will probably persist until the dollar's role as global reserve currency and basis for most international trade is diminished.

We can see that this balance between trade and capital, visible in the national savings rate, is not as simple as spending and saving choices by individual households. Instead it reflects long-term national economic policies, which themselves reflect social contracts around employment security taking priority over improving the spending power of households. Those will not be reversed by an external trade war. Over the longer term, the U.S. capital account surplus will probably persist until the dollar's role as global reserve currency and basis for most international trade is diminished, which China and Europe are already actively pursuing by trying to shift international contracts away from dollar pricing. The U.S. may eventually see a smaller capital account surplus, but that would be an expensive loss of the famous "exorbitant privilege" received in the form of lower interest rates, which suppresses the cost of debt for the U.S. government, corporations and consumers.

Current Positioning

During the third quarter we have been at target weight for return-seeking assets, with an overweight to U.S. equity and liquid alternatives, while underweight return-seeking credit and non-U.S. equity. Just recently, non-U.S. equity and emerging market assets generally have risen slightly in our estimation as their underperformance in 2018 starts to make them look cautiously appealing for lower valuations and mean reversion. Within equity, at the time of writing (9/30/2018), our U.S. view now prefers quality and value, while our non-U.S. view prefers quality, value and defensive. Growth is not currently preferred in either region after being broadly in favor for a very long period and may have over-run. But these preferences are re-evaluated frequently and can change with technical conditions.

As hoped for in last quarter's Newsletter, U.S. corporate long bond spreads tightened in the third quarter after initially continuing to widen. We have used that as an opportunity to continue trimming a long-standing overweight to credit back to a neutral allocation weighting. We are evaluating whether and at what point to go underweight credit relative to government bonds.

We have remained slightly underweight duration relative to target hedge ratios, which saw a benefit as yields rose in September. As mentioned last quarter, we expect the yield curve to steepen at some point ahead and therefore see value in collecting more yield for duration at the short end of the curve than the long end while the yield curve is so flat, and to capture a relative gain if/when the yield curve does steepen, even if it flattens further or inverts first. This is the reverse of our general overweight to the long end of the yield curve for the past several years while anticipating the flattening that has occurred.

U.S. high-yield bonds have benefited in 2018 from a technical tailwind as supply tightened after new issuance migrated instead into the bank loan Collateralized Loan Obligation

(CLO) sector. Unfortunately, the declining covenant terms, more loan-only structures, and agency risk of growing CLO securitization have reduced our faith in bank loans as a defensive alternative to high-yield bonds late in the credit cycle, even if the floating-rate structure has still been helpful in protecting their absolute returns as interest rates rose.

Contacts

David Kelly, CFA, FIA, FSA
Partner, Chief Investment Officer (CIO), North America
+1.312.381.1214
David.Kelly1@aon.com

Legal Disclosures and Disclaimers

Investment advice and consulting services provided by Aon Hewitt Investment Consulting, Inc. ("AHIC"). The information contained herein is given as of the date hereof and does not purport to give information as of any other date. The delivery at any time shall not, under any circumstances, create any implication that there has been a change in the information set forth herein since the date hereof or any obligation to update or provide amendments hereto.

The information contained herein is for informational purposes only. Nothing contained herein should be construed as legal or investment advice; please consult your investment professional for any such advice. This information has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. This document is not intended to provide, and shall not be relied upon for, accounting, legal, or tax advice or investment recommendations. Any accounting, legal, or taxation position described in this presentation is a general statement and shall only be used as a guide. It does not constitute accounting, legal, and tax advice and is based on AHIC's understanding of current laws and interpretation.

This document is intended for general information purposes only and should not be construed as advice or opinions on any specific facts or circumstances. The content of this document is made available on an "as is" basis, without warranty of any kind. AHIC disclaims any legal liability to any person or organization for loss or damage caused by or resulting from any reliance placed on that content. AHIC reserves all rights to the content of this document. No part of this document may be reproduced, stored, or transmitted by any means without the express written consent of AHIC.

Aon Hewitt Investment Consulting, Inc. is a federally registered investment advisor with the U.S. Securities and Exchange Commission. AHIC is also registered with the Commodity Futures Trading Commission as a commodity pool operator and a commodity trading advisor, and is a member of the National Futures Association. The AHIC ADV Form Part 2A disclosure statement is available upon written request to:

Aon Hewitt Investment Consulting, Inc.
200 E. Randolph Street
Suite 1500
Chicago, IL 60601
ATTN: AHIC Compliance Officer

About Aon

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.

The information contained herein and the statements expressed are of a general nature and are not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information and use sources we consider reliable, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

www.aon.com

Empower Results®