Key developments to watch

Services sector activity has rebounded strongly in US and China but remains weak in the Eurozone

- Successful vaccination rates and/or public health policies have led to improvements in mobility in China (in 2020) and, more recently, the US
- Physical consumer-facing sectors like hotels, restaurants, leisure, retailing, and travel are expected to benefit the most from this rebound
- However, a rising number of COVID-19 cases and slower pace of vaccine rollout in the Eurozone has led to further lockdowns, weakening the recovery in its services sector
- We expect economic activity in the Eurozone to accelerate in the second half of 2021

Economic activity has rebounded in the US and China as lockdowns are eased but remains slower in the Eurozone, where major mobility restrictions remain

What are the key market-related themes we think investors should focus on to position themselves for success during 2021 and beyond?

Helping you to monitor macro changes

- We think there are three standout market-related themes investors should focus on – policy shifts, the rise of China, and sustainability
- The nature of investing in a complex world is that change often happens slowly and then all at once. Our three themes are no different
- A practical means of coping with this slow but uncertain change is by systematically monitoring those themes through thoughtfully-curated data
- With this in mind we have developed three dashboards, which we will keep up to date and evolve over time. They are on the WTW website: United States, Europe, Hong Kong, Australia

Willis Towers Watson Investments has announced that it is targeting net zero greenhouse gas emissions by 2050 at the latest, with at least a 50% reduction by 2030, in its fully discretionary delegated investment portfolios.

- Being strategically ahead of a net zero transition can, in our opinion, significantly improve risk-adjusted returns for our clients
- We believe that this will come from two sources – ‘better beta’ due to more effective stewardship and ‘alpha’ as the mispricing of climate issues is resolved
- We think that understanding this transition will be one of the biggest sources of alpha across all asset classes and that this alpha opportunity is likely to be greatest in the next few years

For more information, please visit the WTW website United States, UK, Hong Kong, Australia, Canada
Investment outlook

Portfolio priorities for 2021

The high-level macroeconomic outlook

- Our economic outlook is split between a period of recovery and subsequent growth. Policy stimulus, in particular the ability to combine extremely easy monetary policy with highly reactive and historically sizeable fiscal stimulus, will determine how long the recovery phase lasts. It will also influence subsequent growth rates, although what ultimately drives this growth (productivity) is subject to a number of complex and overlapping factors.

- This new policy regime is likely to dominate the outcomes for the developed world in aggregate, with important differences between countries. In turn, this will impact market pricing and prospective returns. It also suggests less policy emphasis, relative to the past few decades, will be placed on controlling inflation and more on maximising employment, growth, and possibly the inclusiveness of both.

- Market pricing has generally responded to this policy regime but there remain profound implications for portfolio strategy.

With this outlook in mind, what are the key market-related themes we think investors should focus on to position themselves for success during 2021 and beyond?

We have narrowed down a potentially long list by assessing the risks and opportunities that are both highly material for current portfolio allocations and relatively more certain. From a macroeconomic perspective, we think three themes stand out:

1. **Policy shifts**: the post-COVID policy regime has shifted in important ways. Whilst much of this shift was evident before 2020, the policy response to the pandemic has accelerated it. This has important implications for return pathways and downside risk management in particular.

2. **The rise of China**: China’s financial system continues to open, which has material and near certain implications for the sources of diversity available to investors and how downside risk can be managed.

3. **Sustainability**: this encompasses three important topics:
   
a. **Climate**: we believe 2021 will prove to be a significant year for the climate transition, with the 26th UN Climate Change Conference of the Parties (COP26) due to take place in November.

   b. **Inclusive growth**: At the same time, the moral imperative to include diverse perspectives, races and life experiences in all spheres of society, including the professional, has been highlighted in 2020. It is also a financial imperative. Our view and hope is that inclusion will become a material influence on investors’ choices.

   c. **Stewardship**: in order to manage these imperatives, the need for better practices by governments, regulators, corporates, asset managers, and asset owners is clear and growing.

We suggest investors focus on eight key priorities in 2021

- Position for stronger near-term asset returns and lower long-term returns
- Revisit unlisted asset exposure
- Build a balanced exposure to China
- Maintain but evolve downside hedges
- Integrate climate risks & opportunities into portfolio construction
- Embedding inclusion and diversity in all levels of portfolio decision making
- Increase active management
- Monitor macro change
Economic conditions monitor

Tracking economic activity in the major economies

Exhibit 1: The number of COVID-19 related hospitalisations have risen in the Eurozone

Exhibit 2: Global COVID-19 cases continue to rise, driven by EM economies like Brazil and India

Exhibit 3: Developed economies, especially the US and UK, have higher vaccination rates

Exhibit 4: Shelter-at-home and mobility restrictions are likely to ease quickest in the US and UK

Exhibit 5: Inflationary pressures are slowly normalising across advanced economies ...

Exhibit 6: … but we expect policy rates in the US and Eurozone to remain on hold until at least 2024
Changes to market pricing (government bond yields)
31 March 2021

<table>
<thead>
<tr>
<th>31 March 2021</th>
<th>Level</th>
<th>1m</th>
<th>3m</th>
<th>1y</th>
<th>3y</th>
<th>1y fwd</th>
<th>2y fwd</th>
<th>5y fwd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurozone</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1y/cash</td>
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<td>-0.04</td>
<td>0.08</td>
<td>0.08</td>
<td>-0.15</td>
<td>-0.74</td>
<td>-0.76</td>
<td>-0.29</td>
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<tr>
<td>5y</td>
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<td>-0.07</td>
<td>0.09</td>
<td>0.02</td>
<td>-0.55</td>
<td>-0.59</td>
<td>-0.46</td>
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<td>10y</td>
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<td>0.26</td>
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<td>-0.83</td>
<td>-0.21</td>
<td>-0.09</td>
<td>0.26</td>
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<tr>
<td>US</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1y/cash</td>
<td>0.02</td>
<td>0.00</td>
<td>-0.02</td>
<td>-0.09</td>
<td>-2.09</td>
<td>0.44</td>
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<td>5y</td>
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<td>2.34</td>
<td>2.74</td>
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<tr>
<td>US (CPI)</td>
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<td></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>3y</td>
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<td>0.18</td>
<td>0.65</td>
<td>2.66</td>
<td>0.48</td>
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<td>-</td>
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<tr>
<td>5y</td>
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<td>0.56</td>
<td>2.13</td>
<td>0.43</td>
<td>-</td>
<td>-</td>
<td>2.34</td>
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<td>10y</td>
<td>2.46</td>
<td>0.20</td>
<td>0.51</td>
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<td>0.43</td>
<td>-</td>
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<td>2.23</td>
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</table>

Developed nominal yields

- Across major developed markets, guidance from policymakers remains accommodative. Benchmark rates are at or near perceived lower bounds and central banks are engaged in asset purchases.
- Priced-in short rates have picked up materially year-to-date, consistent with improving expectations for economic conditions. However, this partly reflects rising bond risk premiums, and we expect cash rates to remain low as policymakers wait for inflation above target before tightening.

Developed 10-year nominal bonds

- As optimism around the economic recovery has grown, intermediate bond yields have risen in recent months. US 10-year rates are c. 70bps higher than January.
- Yields are now approaching levels they were trading at before the pandemic struck and are priced to rise further over the next few years.
- Near term, we think that risks to yields are still skewed upwards. Stimulus measures, excess savings, pent up demand and base effects could elevate inflation concerns.
- We think that risks are more balanced over the medium term. Fiscal stimulus will roll-off in future years, while structural forces, such as high corporate debt levels and demographics, are also likely to constrain the future level of bond yields.

Sovereign bonds

- Developed short interest rates
- Developed 10-year nominal bonds

Key:
- Highly negative
- Negative
- Neutral
- Positive
- Highly positive

US yields have risen sharply YTD. Upside risks to yields remain but pricing is credible over the medium-term

US cash rate and 10y nominal bond yield

Zero coupon yield + market expectations

US breakeven inflation rates are roughly in line with the mid-point of the Fed’s average inflation mandate

US CPI inflation rate and inflation market pricing

A summary of our assessment of government bond pricing and prospective medium-term outcomes

- Across major developed markets, guidance from policymakers remains accommodative. Benchmark rates are at or near perceived lower bounds and central banks are engaged in asset purchases.
- Priced-in short rates have picked up materially year-to-date, consistent with improving expectations for economic conditions. However, this partly reflects rising bond risk premiums, and we expect cash rates to remain low as policymakers wait for inflation above target before tightening.

Source: FactSet, Willis Towers Watson
Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)
31 March 2021

<table>
<thead>
<tr>
<th>High grade</th>
<th>31 March 2021</th>
<th>Pricing - Option adjusted spreads, bps</th>
<th>Implied defaults</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current</td>
<td>Δ1m</td>
<td>Δ3m</td>
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<tr>
<td>Global</td>
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<td>-5</td>
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<td>-6</td>
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<tr>
<td>Eurozone</td>
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<td>2</td>
<td>-2</td>
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<tr>
<td>UK</td>
<td>113</td>
<td>6</td>
<td>0</td>
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<tr>
<td>Canada</td>
<td>117</td>
<td>11</td>
<td>-1</td>
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<tr>
<td>Australia</td>
<td>94</td>
<td>12</td>
<td>4</td>
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</table>

<table>
<thead>
<tr>
<th>Low grade</th>
<th>31 March 2021</th>
<th>Pricing - Option adjusted spreads, bps</th>
<th>Implied defaults</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current</td>
<td>Δ1m</td>
<td>Δ3m</td>
</tr>
<tr>
<td>Global HY</td>
<td>373</td>
<td>-10</td>
<td>-37</td>
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<tr>
<td>US HY</td>
<td>336</td>
<td>-21</td>
<td>-50</td>
</tr>
<tr>
<td>Eurozone HY</td>
<td>314</td>
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<td>-41</td>
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<tr>
<td>US loans</td>
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<td>7</td>
<td>-29</td>
</tr>
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</table>

A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

<table>
<thead>
<tr>
<th>Credit</th>
<th>Asset return outlook</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate credit</td>
<td></td>
<td>• Investment grade markets are pricing-in an allowance for a below average level of credit losses</td>
</tr>
<tr>
<td>Inv. grade</td>
<td></td>
<td>• We expect credit losses to be close to / modestly above these levels, particularly in the nearer term</td>
</tr>
<tr>
<td>High yield</td>
<td></td>
<td>• At current spreads, high quality credit assets are approaching levels at which they are likely to provide only moderate returns above equivalent government bonds</td>
</tr>
<tr>
<td>US</td>
<td></td>
<td>• We retain a somewhat cautious outlook for developed market speculative-grade credit given shorter-term risks. Current pricing implies a below average level of defaults relative to historic average pricing. As such, pricing has moved someway to pricing-in an optimistic outlook for corporate credit</td>
</tr>
<tr>
<td>Europe</td>
<td></td>
<td>• Niche and securitized market pricing appears to be pricing-in a somewhat more pessimistic outlook in aggregate, relative to traditional corporate credit markets</td>
</tr>
</tbody>
</table>

Key: Highly negative, Neutral, Positive, Highly positive

Investment grade spreads widened very modestly over the past month and remain broadly at the lower end of their interquartile range (excl. EU and Canadian markets)

Investment grade corporate option-adjusted spreads, bps

Market implied default rates fell modestly over the past month and remain low

Estimated implied default rate based on current pricing

Source: FactSet, Willis Towers Watson).
Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)
31 March 2021

<table>
<thead>
<tr>
<th>31 March 2021</th>
<th>Δ 1 month</th>
<th>Δ 1 year</th>
<th>Δ 3 years (pa)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>EPS</td>
<td>Trailing</td>
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<tr>
<td></td>
<td>return</td>
<td></td>
<td>P/E</td>
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<tr>
<td>Australia</td>
<td>2.4%</td>
<td>-0.4%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Canada</td>
<td>4.3%</td>
<td>0.2%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Eurozone</td>
<td>7.3%</td>
<td>-0.4%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Japan</td>
<td>5.0%</td>
<td>0.0%</td>
<td>5.3%</td>
</tr>
<tr>
<td>UK</td>
<td>4.1%</td>
<td>0.1%</td>
<td>4.3%</td>
</tr>
<tr>
<td>US</td>
<td>3.8%</td>
<td>-0.3%</td>
<td>3.5%</td>
</tr>
<tr>
<td>China</td>
<td>-6.0%</td>
<td>-1.3%</td>
<td>-3.1%</td>
</tr>
<tr>
<td>MSCI World</td>
<td>4.3%</td>
<td>0.1%</td>
<td>2.8%</td>
</tr>
<tr>
<td>MSCI EM</td>
<td>-0.8%</td>
<td>-0.4%</td>
<td>-1.1%</td>
</tr>
</tbody>
</table>

A summary of our assessment of equity pricing and prospective medium-term outcomes

Global equities | Asset return outlook

- **Developed**
- **Emerging**

- Price to Earnings ratios have risen sharply over the last year and are high, as investors look through the trough in earnings that has been caused by COVID related mobility restrictions.
- We have seen a material earnings recession in world equity markets but expect a subsequent recovery in 2021 – the pace of recovery in each country will depend heavily on the effectiveness of fiscal and monetary policy responses.
- US valuations are higher relative to broader developed markets, which we see as consistent with higher US fiscal and monetary stimulus. The impact of sharply rising US bond yields on US equity valuations and returns has been negative but small over the last few months, rather than disruptive.
- EM valuations are lower vs. developed markets, which we see as consistent with higher short-term virus and economic related risks.
- Current equity prices are consistent with good expected 5-year returns in a scenario where earnings recover quickly in 2021. This is contingent on effective policy, with drawdown risk and uncertainty remaining.

Key: Highly negative | Negative | Neutral | Positive | Highly positive

Basic developed market financial ratios are high as investors expect medium term earnings potential to remain relatively unimpacted

### Valuation metrics for the MSCI World equity index

- **MSCI World: basic valuation**
  - 30.2
  - 20.2
  - 2.1
  - 3.0

- **Discounted sales growth, % pa**

Source: FactSet, Willis Towers Watson).
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