

Global Markets Overview

Asset Research Team

July 2021

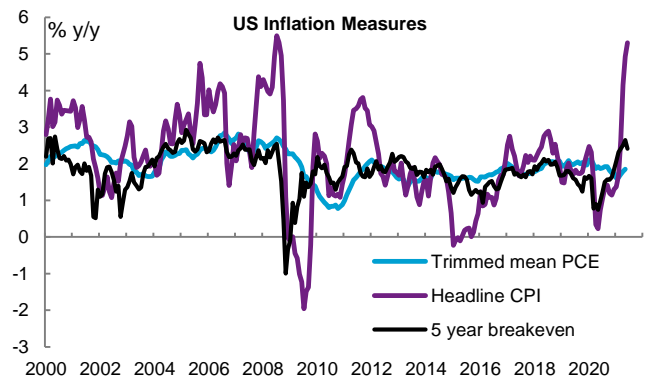
Key developments to watch

Central banks in the major economies adjust policy guidance; headline inflation in the US continues to rise

The Federal Reserve tightened its guidance for monetary policy slightly, at its June meeting, and now expects to raise interest rates by 0.5% in 2023 – previously no changes were expected. This small shift to tightening contributed to a decline in bond yields, as “squeezes” on short positions, the anchoring effect on inflation expectations and fears of “peak growth” (see below right) all offset any upward reassessment of the path of policy rates in the future. We note that, at the margin, the policy stance in the Eurozone and in China eased slightly over the month, which may also have contributed to global bond yield moves.

Inflation remains in focus. US and UK inflation rates once again exceeded expectations; in our view these continue to be driven by more transitory factors. However, we continue to monitor for signs of persistent high inflation. The “policy shift” dashboard discussed below is useful in this regard.

US headline inflation increased in June; in our view largely driven by transitory factors. Measures of underlying inflation and market-based inflation expectations are consistent with the Fed’s 2% target.



Source: FactSet, Willis Towers Watson

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](#)

High frequency indicators remain suggestive of strong growth, despite some datapoints suggesting slowing

- “Peak growth” concerns have been fuelled by two key factors over the past month. First, in the US, the closely-watched ISM Non-Manufacturing survey fell over the month and disappointed expectations, fuelling concern US growth may be slowing. Our observation is that these surveys are volatile, other similar surveys changed by less, and the levels of these surveys remain consistent with a continuation of the relatively rapid service-led expansion.
- Second, the rapid increase in Covid-19 cases in many countries, driven by beta and delta variants, has caused concern. Countries with high vaccination rates may be able to avoid widespread reinstatement of economically-damaging public health restrictions given the protection offered against hospitalisation. However, the variants may still have a dampening effect on voluntary mobility and economic activity – an area to watch closely.

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 provides selective investment opportunities, potentially broadens the sources of diversity available to investors, and can aid downside risk management.
- 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.

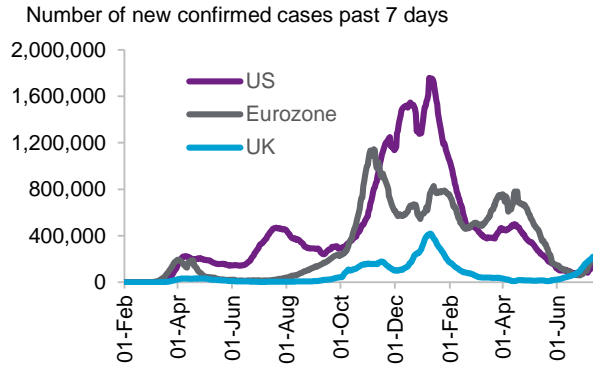
We suggest investors focus on eight key priorities in 2021

- 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

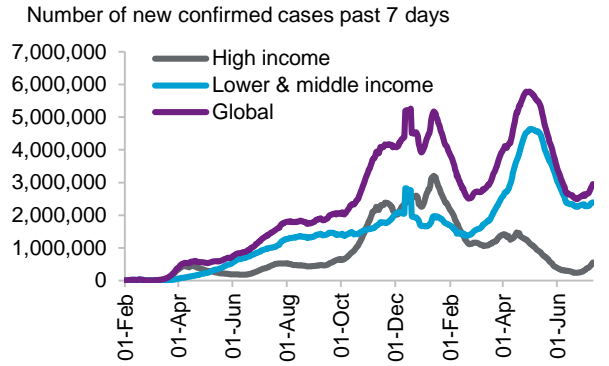
Tracking economic activity in the major economies

Exhibit 1: The delta and beta variants have driven an increase in the number of COVID-19 cases globally



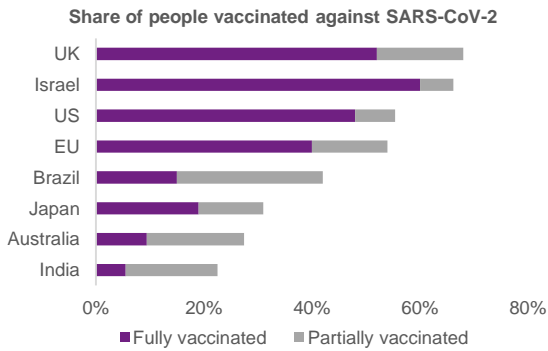
Source: Johns Hopkins/Github, Willis Towers Watson

Exhibit 2: In emerging economies COVID-19 cases have remained at high levels in the last month



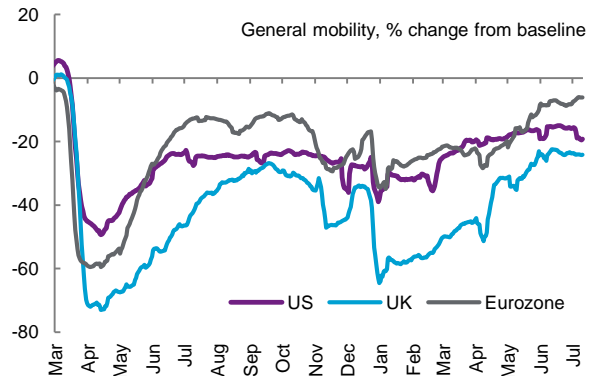
Source: Johns Hopkins/Github, Willis Towers Watson

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



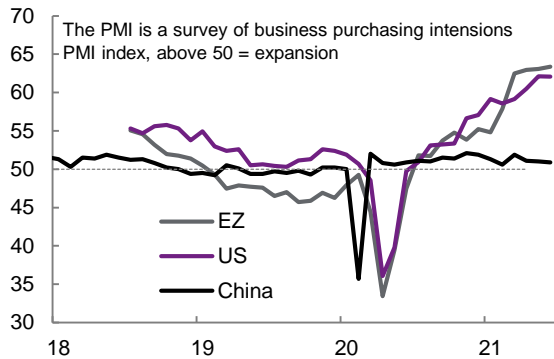
Source: Our world in data, Willis Towers Watson

Exhibit 4: Shelter-at-home and mobility restrictions are easing in the US, Eurozone and UK



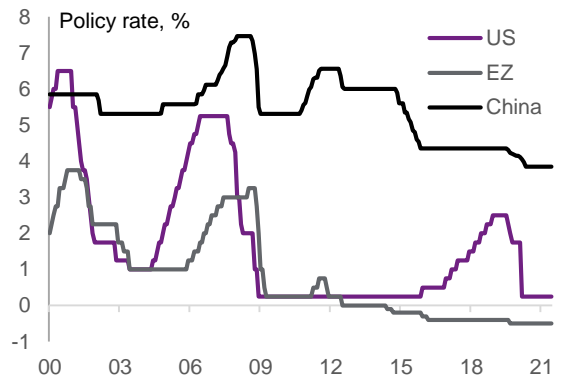
Source: Google mobility report, Willis Towers Watson

Exhibit 5: Manufacturing sectors in the US and Eurozone are experiencing a strong recovery ...



Source: FactSet, Oxford Economics, Willis Towers Watson

Exhibit 6: ... but we still expect policy rates in the US and Eurozone to remain on hold for several years



Source: FactSet, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

30 June 2021

30 June 2021		Spot yields					What's discounted		
% / %pts		Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	1y fwd	2y fwd	5y fwd
Developed nominal yields	Eurozone								
	1y/cash	-0.67	-0.01	-0.01	0.01	-0.07	-0.69	-0.66	-0.17
	5y	-0.59	0.00	0.06	0.12	-0.31	-0.49	-0.35	0.13
	10y	-0.23	-0.03	0.06	0.24	-0.57	-0.12	0.00	0.32
	US								
	1y/cash	0.09	0.03	0.03	-0.01	-2.25	0.46	0.90	1.89
5y	0.88	0.06	-0.05	0.50	-1.85	1.24	1.56	2.18	
10y	1.52	-0.14	-0.28	0.86	-1.34	1.76	1.96	2.33	
Breakeven infl.	US (CPI)								
	3y	2.64	-0.15	0.10	1.57	0.60	-	-	2.19
	5y	2.49	-0.12	0.00	1.28	0.39	-	-	2.20
10y	2.38	-0.13	-0.07	1.09	0.26	-	-	2.19	

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

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		<ul style="list-style-type: none"> 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.
US		
UK		<ul style="list-style-type: none"> Forward short rates have picked up year-to-date, consistent with improving economic conditions. This partly reflects rising bond risk premiums, and we expect cash rates to remain low as policymakers wait for core inflation consistently at or above target before tightening.
AAA-Eurozone		
Developed 10-year nominal bonds		<ul style="list-style-type: none"> As optimism around the economic recovery has grown, intermediate bond yields have risen year-to-date. This is despite yields falling from their end-Q1 / early-Q2 2021 highs in recent months.
US		<ul style="list-style-type: none"> Near term, we think that risks to yields are still skewed upwards in the US. Record fiscal and monetary stimulus, excess savings, and pent-up demand, underpin our outlook for strong economic growth and a higher level of bond yields.
UK		<ul style="list-style-type: none"> We think that risks are more balanced from a medium-term perspective. Fiscal stimulus will roll-off in future years, while structural forces, such as high corporate debt levels, are also likely to constrain the future level of bond yields.
AAA-Eurozone		

Key: Highly negative Negative Neutral Positive Highly positive

US yields have declined recently. Medium term pricing is reasonable but risks lie to the upside in the near term

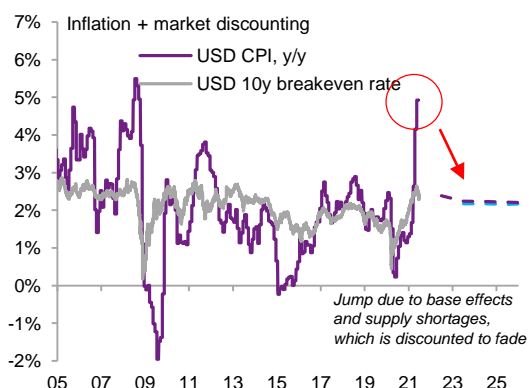
US cash rate and 10y nominal bond yield



Source: FactSet, Willis Towers Watson

US breakeven inflation remains anchored. Markets envisage the recent jump in prices to be transient

US CPI inflation rate and inflation market pricing



Source: FactSet, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)

30 June 2021

30 June 2021		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	89	-4	-9	-70	-39	-0.3%	-0.1%	-0.2%	-1.8%	-1.0%
	US	86	-5	-11	-74	-44	-0.4%	-0.1%	-0.3%	-1.9%	-1.1%
	Eurozone	84	-2	-7	-64	-38	-0.4%	-0.1%	-0.2%	-1.6%	-1.0%
	UK	106	-3	-7	-69	-46	0.2%	-0.1%	-0.2%	-1.7%	-1.2%
	Canada	114	-1	-3	-52	-1	0.4%	0.0%	-0.1%	-1.3%	0.0%
	Australia	90	-3	-4	-43	-18	-0.3%	-0.1%	-0.1%	-1.1%	-0.5%
Low grade	Global HY	347	-15	-26	-296	-52	0.7%	-0.2%	-0.4%	-4.2%	-0.7%
	US HY	304	-30	-32	-340	-67	0.1%	-0.4%	-0.5%	-4.9%	-1.0%
	Eurozone HY	296	-7	-18	-225	-92	0.7%	-0.1%	-0.3%	-3.2%	-1.3%
	US loans	401	-1	-13	-177	37	1.4%	0.0%	-0.2%	-2.5%	0.5%
HC EMD	Hc EMD Corps	266	-2	-5	-137	-10	2.2%	0.1%	-0.2%	-2.7%	-0.4%
	HC EMD Sov	261	6	-10	-134	-22	1.5%	0.0%	-0.1%	-2.1%	-0.2%

Source: Credit pricing is from ICE Bank of America and FactSet

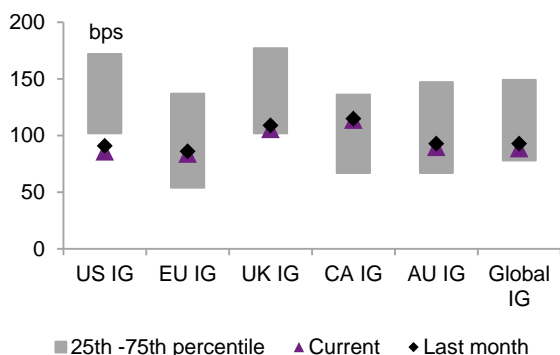
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		<ul style="list-style-type: none"> Investment grade markets are pricing in an allowance for a below average level of credit losses
Inv. grade		<ul style="list-style-type: none"> We expect credit losses to be close to/modestly above these levels, particularly in the nearer term, with risks more tilted to the upside
High yield		<ul style="list-style-type: none"> At current credit spreads, high quality credit assets are at levels at which they are likely to provide only moderate returns above equivalent maturity government bonds
US		<ul style="list-style-type: none"> We retain a somewhat cautious outlook for developed market speculative-grade credit. Current pricing implies a below average level of defaults relative to historic average pricing. As such, pricing has moved somewhat to pricing-in an optimistic outlook for corporate credit.
Europe		<ul style="list-style-type: none"> Niche and securitized market pricing appears to be pricing-in a somewhat more pessimistic outlook in aggregate, relative to traditional corporate credit markets
Loans		
US		

Key: Highly negative Negative Neutral Positive Highly positive

Investment grade spreads fell over the past month and are broadly at the lower end of their interquartile range (excl. EU and Canadian markets)

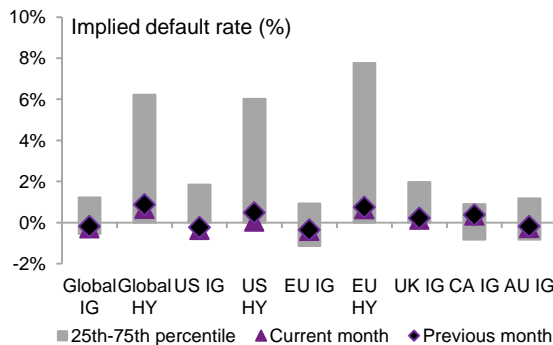
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, Willis Towers Watson.

Market implied default rates fell over the past month and, in most markets, are low relative to history

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)

30 June 2021

30 June 2021	Δ 1 month			Δ 1 year			Δ 3 years (pa)			
	Total return	EPS	Trailing P/E	Price return	Total return	EPS	Trailing P/E	Total return	EPS	Trailing P/E
Australia	1.4%	0.7%	0.6%	24.1%	28.2%	-27.5%	71.2%	9.2%	-10.8%	18.4%
Canada	1.8%	7.2%	-5.3%	29.6%	33.6%	12.7%	15.1%	10.1%	0.1%	8.7%
Eurozone	0.3%	0.7%	-3.2%	28.1%	31.3%	-0.9%	36.4%	8.6%	-13.1%	20.1%
Japan	0.0%	0.3%	-0.5%	26.1%	28.9%	-6.7%	35.1%	7.7%	-11.4%	14.9%
UK	0.4%	0.0%	0.2%	13.3%	17.5%	-18.0%	38.1%	0.4%	-15.6%	15.3%
US	2.8%	1.7%	1.0%	40.4%	42.5%	5.3%	33.2%	19.4%	3.8%	12.1%
China	1.8%	0.0%	2.6%	24.3%	26.4%	-8.6%	25.4%	10.0%	0.4%	6.7%
MSCI World	2.1%	1.5%	-0.2%	34.9%	37.5%	1.2%	35.4%	15.3%	-2.4%	14.8%
MSCI EM	1.9%	0.1%	0.9%	33.4%	36.5%	14.6%	20.6%	12.4%	-4.3%	10.4%

Source: FactSet, Willis Towers Watson.

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

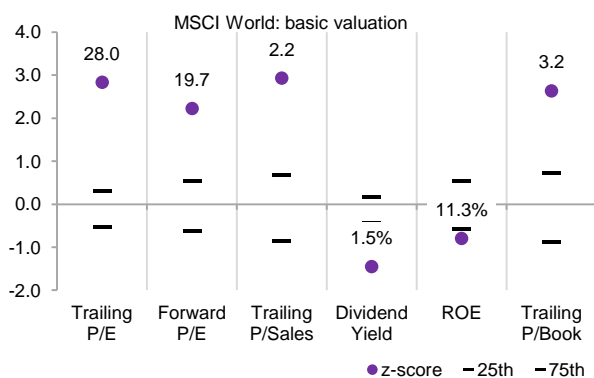
Global equities	Asset return outlook
Developed	
Emerging	

- 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. While this is consistent with higher US fiscal and monetary stimulus, we view European and Japanese equities as moderately more attractive
- 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

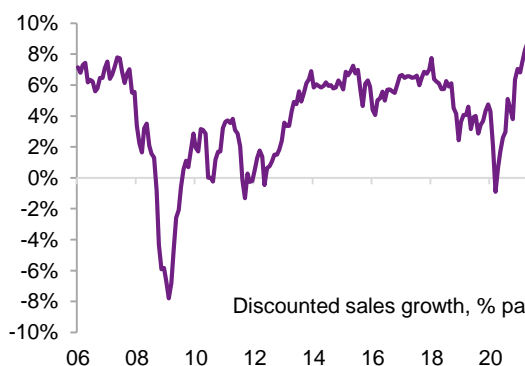
Valuation metrics for the MSCI World equity index



Source: FactSet, Willis Towers Watson.

The sales growth consistent with current equity prices is somewhat elevated, but we think achievable in the next few years – equities look reasonably valued

Medium-term growth priced-in by global equity price, % pa



Source: FactSet, Willis Towers Watson.

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