Global Markets Overview

Asset Research Team

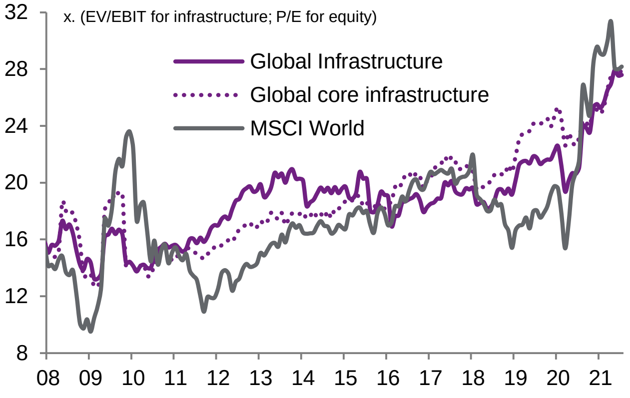
August 2021

Key developments to watch

Monitoring key macro indicators to assess pricing, opportunity, and risk in illiquid credit, real estate, and infrastructure markets

- As the major advanced economies recover from the COVID shock, illiquid asset prices are also adjusting.
- Our forward-looking analysis of pricing and fundamental conditions in illiquid asset markets, suggests that implied illiquidity risk premia – the compensation we estimate you can receive for bearing illiquidity risk – have settled at close to fair value *in aggregate*.
- The correlation between *liquid* asset prices during the economic and capital market recovery phase of the last 12-months has been high (see the exhibit on the right).
- However, digging deeper into specific *illiquid* asset markets, we find that selective credit, real estate, and infrastructure assets still appear to offer good compensation for illiquidity.

Global listed infrastructure valuations have risen above recent historical highs and are roughly equivalent to wider equity valuations



Source: 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

Stimulus, stimulus, stimulus!

- On 10 August, the US Senate passed a bipartisan $1trn infrastructure investment bill. Of this, $550 bn is new Federal spending, to be allocated over the next five years.
- There are differences of opinion as to whether the stimulus is fully paid for through higher economic growth, existing money (e.g., unspent Covid-19 relief funds), and revenue-raising measures. For example the US Congressional Budget Office estimates the plan would add $256bn to the US national deficit over the next ten years.
- The Biden administration is also developing separate plans for a $3.5trn budget package, currently at the proposal stage. For context, the size of the US economy was c. $21trn in 2020.
- Our outlook for bond, credit, equity, and private markets, summarised in this report, accounts for the likelihood and size of different stimulus plans and the range of their impacts on growth, prices, and taxes.

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

Asset Research Team

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)
31 July 2021

31 July 2021 % / %pts		Spot yields: Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	What's discounted: 1y fwd	2y fwd	5y fwd
Developed nominal yields	**Eurozone**								
	1y/cash	-0.68	-0.02	-0.02	0.01	-0.11	-0.87	-0.89	-0.43
	5y	-0.77	-0.18	-0.17	-0.02	-0.62	-0.72	-0.60	-0.15
	10y	-0.46	-0.23	-0.25	0.07	-0.91	-0.38	-0.27	0.04
	US								
	1y/cash	0.07	-0.02	0.01	0.00	-2.38	0.34	0.70	1.61
	5y	0.71	-0.17	-0.17	0.40	-2.15	1.01	1.30	1.93
	10y	1.31	-0.21	-0.40	0.76	-1.67	1.53	1.73	2.12
Breakeven infl.	**US (CPI)**								
	3y	2.72	0.06	0.00	1.39	0.80	-	-	2.16
	5y	2.59	0.08	-0.04	1.14	0.55	-	-	2.08
	10y	2.37	0.00	-0.13	0.89	0.29	-	-	2.05

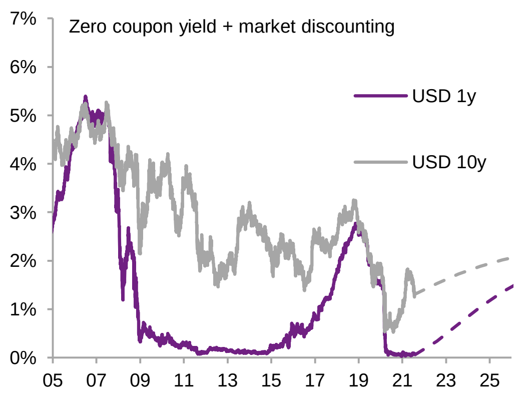
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		• Across the major developed markets, guidance from central banks remains accommodative. Policy rates are at or near perceived lower bounds and central banks are engaged in asset purchases. • Despite some recent moderation, forward short rates remain notably above their levels at the start of the year, which is consistent with an improved economic outlook. This partly reflects rising bond risk premiums. We expect cash rates to remain low as policymakers wait for core inflation consistently at or above target before tightening.
US		
UK		
AAA-Eurozone		
Developed 10-year nominal bonds		• As optimism around the economic recovery has grown, intermediate bond yields have risen year-to-date. However, more recently, yields have fallen due to a combination of public health and economic growth concerns and technical demand factors. • In the short run, we believe that risks to yields remain skewed upwards. Our outlook for high GDP growth in advanced economies in both 2021 and 2022 is consistent with a higher level of real and nominal bond yields, especially in the US.
US	↓	
UK	↓	
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 near term

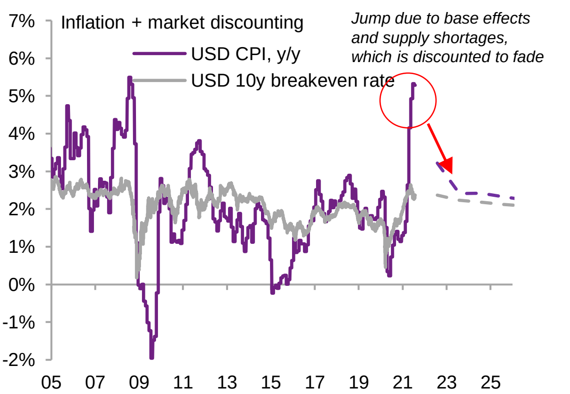
US cash rate and 10y nominal bond yield



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)
31 July 2021

31 July 2021		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	93	4	-2	-47	-24	-0.2%	0.1%	-0.1%	-1.2%	-0.6%
	US	92	6	-2	-49	-24	-0.2%	0.2%	-0.1%	-1.2%	-0.6%
	Eurozone	85	1	0	-43	-26	-0.4%	0.0%	0.0%	-1.1%	-0.7%
	UK	107	1	-1	-50	-40	0.2%	0.0%	0.0%	-1.3%	-1.0%
	Canada	115	1	0	-33	0	0.4%	0.0%	0.0%	-0.8%	0.0%
	Australia	88	-2	-2	-28	-20	-0.3%	0.0%	0.0%	-0.7%	-0.5%
Low grade	Global HY	382	35	22	-165	13	1.2%	0.5%	0.3%	-2.4%	0.2%
	US HY	332	28	4	-184	-14	0.5%	0.4%	0.1%	-2.6%	-0.2%
	Eurozone HY	313	17	9	-174	-38	0.9%	0.2%	0.1%	-2.5%	-0.5%
	US loans	407	6	0	-123	50	1.5%	0.1%	0.0%	-1.8%	0.7%
HC EMD	Hc EMD Corps	295	29	24	-74	42	2.5%	0.3%	0.3%	-1.9%	0.6%
	HC EMD Sov	277	16	17	-93	29	1.9%	0.4%	0.4%	-1.1%	0.6%

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

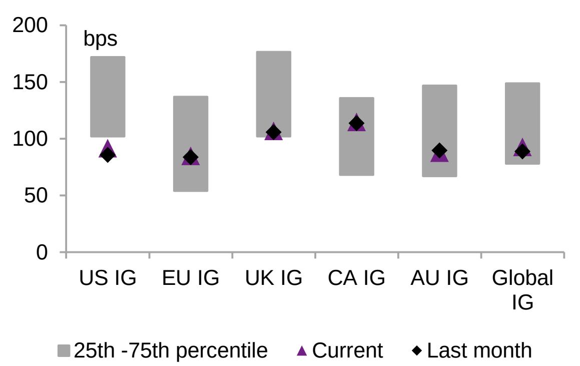
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		• Investment grade markets are pricing in an allowance for a below average level of credit losses • We expect credit losses to be close to/modestly above these levels, particularly in the nearer term ,but with risks more tilted to higher losses • 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 • 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 someway to pricing-in an optimistic outlook for corporate credit. • Niche and securitized market pricing appears to be pricing-in a somewhat more pessimistic outlook in aggregate, relative to traditional corporate credit markets
Inv. grade		
High yield		
US		
Europe		
Loans		
US		

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

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

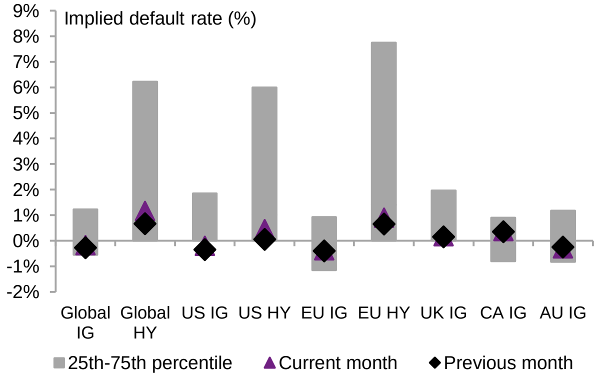
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, Willis Towers Watson.

Market implied default rates remained low relative to history over the past month

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 July 2021

31 July 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	0.8%	-0.3%	1.1%	22.2%	26.2%	-27.8%	69.1%	8.9%	-10.9%	18.8%
Canada	0.8%	-0.2%	0.7%	24.1%	27.9%	12.7%	10.2%	9.8%	0.3%	9.0%
Eurozone	1.2%	1.5%	-0.5%	30.3%	33.3%	0.4%	30.5%	7.8%	-11.5%	19.9%
Japan	-2.4%	0.5%	-2.8%	24.2%	26.9%	-5.9%	32.0%	6.3%	-11.2%	13.8%
UK	0.3%	-1.1%	1.2%	17.1%	21.4%	-18.8%	44.2%	0.0%	-15.9%	15.7%
US	2.4%	0.9%	1.4%	36.7%	38.7%	6.4%	28.5%	19.0%	3.7%	12.7%
China	-13.8%	-1.6%	-12.8%	-1.7%	-0.3%	-9.0%	0.3%	5.5%	-0.1%	1.6%
MSCI World	1.7%	1.1%	0.6%	32.8%	35.3%	2.4%	30.1%	14.8%	-1.7%	15.0%
MSCI EM	-6.0%	0.8%	-7.8%	15.7%	18.2%	16.3%	1.6%	9.4%	-3.3%	7.3%

Source: FactSet, Willis Towers Watson.

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

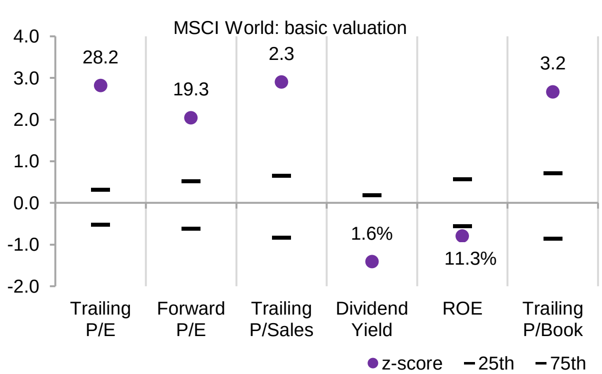
Global equities	Asset return outlook
Developed	
Emerging	

- 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 2021/22 – 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
- Despite rapid equity price rises year-to-date, current equity prices are still consistent with good expected 5-year returns in a scenario where earnings recover quickly in 2021/22. This is contingent on effective policy, with some 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

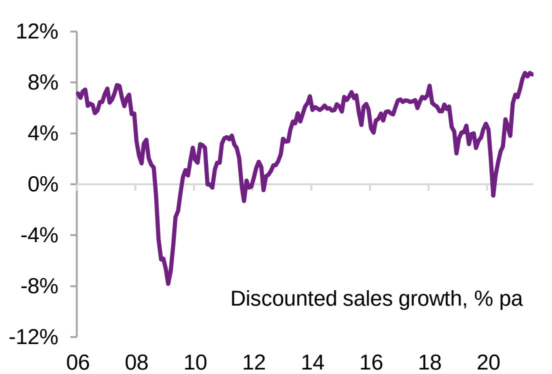
Valuation metrics for the MSCI World equity index



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 world equity price, % pa



Source: FactSet, Willis Towers Watson.

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