Global Markets Overview

Asset Research Team

December 2021

Key developments to watch

A summary of financial market performance over the last 12-months

- The performance of different credit markets has been mixed; high yield bonds and bank loans in the US have been the strongest performers in the last 12-months.

Changes to credit spreads
(bps change)

30 November 2021		Credit spreads, bps		
		Current	Δ1y	Δ3y
Investment Grade	US	103	-9	-42
	Euro	111	17	-38
Low grade	US high yield	367	-66	-62
	Euro high yield	371	2	-109
	US loans	411	-56	14
USD-denominated EM debt	Corporate	324	17	13
	Sovereign	316	30	12

Source: FactSet

- World equity returns have been high as earnings have recovered; the US has been the top-performer in the major markets, driven by mega-cap tech stocks.

Changes to equity index prices
(% change)

30 November 2021	Δ 1 years (pa)		Δ 3 years (pa)
	Total return	EPS	Total return
Australia	13.4%	40.9%	11.7%
Canada	25.5%	68.4%	14.4%
Eurozone	20.2%	73.7%	11.8%
Japan	13.0%	80.7%	9.2%
US	29.1%	53.9%	21.9%
MSCI World	25.4%	58.6%	18.0%
MSCI EM	3.3%	53.4%	11.1%

Source: FactSet

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

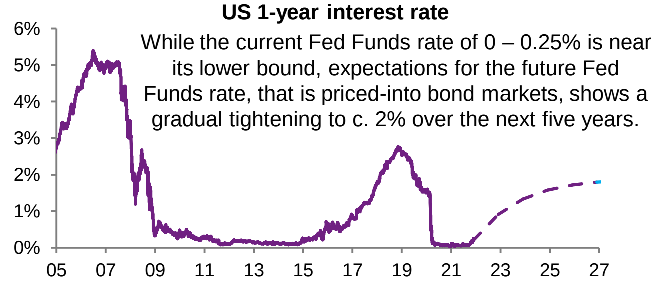
Helping you to monitor macro changes

- **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

The future path for policy rates

- Central bank guidance has become more tilted towards increasing policy rates, especially in the US and UK, in the face of above-target inflation and robust growth.
- Consistent with this, the Bank of England raised its official rate to 0.25% in December – two months earlier than our forecasts; the Federal Reserve announced it will most likely stop its asset purchase programme in March 2022 – in-line with our forecasts.

US 1-year interest rate



Source: FactSet, Willis Towers Watson

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

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)
30 November 2021

Nov 30, 2021 % / %pts		Spot yields Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	What's priced-in 1y fwd	2y fwd	5y fwd
Developed nominal yields	**Eurozone**								
	1y/cash	-0.79	-0.11	-0.09	-0.08	-0.31	-0.77	-0.66	-0.25
	5y	-0.62	-0.25	0.11	0.15	-0.37	-0.51	-0.39	-0.10
	10y	-0.36	-0.25	0.09	0.20	-0.71	-0.28	-0.20	-0.03
	US								
	1y/cash	0.22	0.04	0.16	0.17	-2.49	0.91	1.33	1.79
	5y	1.16	-0.03	0.38	0.67	-1.69	1.47	1.65	1.85
	10y	1.49	-0.14	0.15	0.64	-1.53	1.67	1.77	1.89
Breakeven infl.	**US (CPI)**								
	3y	3.19	0.18	0.56	1.64	1.44	-	-	2.22
	5y	2.91	0.05	0.33	1.24	1.06	-	-	2.21
	10y	2.59	0.04	0.20	0.84	0.67	-	-	2.16

Source: FactSet

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

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		• Central bank guidance has become more tilted towards increasing policy rates, especially in the US and UK, in the face of above-target inflation and robust growth. Consistent with this, the Bank of England raised its official rate to 0.25% in December. • Bond markets have adjusted accordingly – while current policy rates remain near their lower bounds, expectations for future policy rates that are priced-into bond markets are notably above their start of year levels. • In most developed markets, this increase leaves expected short-rates in line with our assessment of economic conditions and risks.
US		
UK		
AAA-Eurozone		
Developed 10-year nominal bonds		• Intermediate bond yields have faced downwards pressure of late due to Omicron. Our outlook is that risks to yields remain biased upwards, given the combination of strong growth and price pressures which looks likely near-term. Therefore, we retain our negative outlook for returns from most developed bond markets. • Over time, policymakers are likely to "lean-in" to limit yield increases and keep financial conditions easy, thus preventing yields from rising rapidly in an unmanaged way. Nevertheless, we still expect bond yields to rise gradually from current levels.
US		
UK		
AAA-Eurozone		

Key: Highly negative Negative Neutral Positive Highly positive

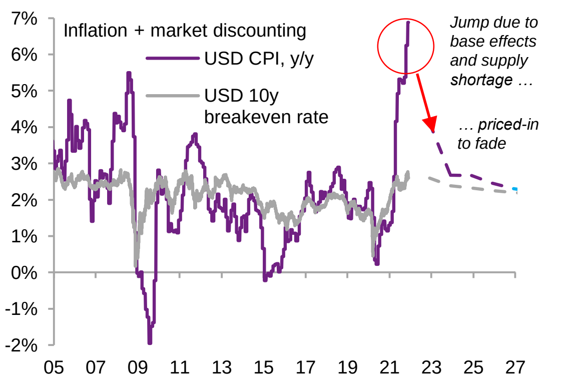
US bonds look more fairly valued at shorter maturities after recent increases in short-dated yields; we think 10-year bond yields look too low and are more likely to rise than fall

US cash rate and 10y nominal bond yield

Source: FactSet, Willis Towers Watson

Expectations for future US inflation over the medium- and long-term remains anchored. Markets envisage the recent jump in prices to be temporary

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 November 2021

30 November 2021		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	106	14	13	-4	-41	0.2%	0.4%	0.3%	-0.1%	-1.0%
	US	103	14	11	-9	-42	0.1%	0.4%	0.3%	-0.2%	-1.1%
	Eurozone	111	23	25	17	-38	0.3%	0.6%	0.6%	0.4%	-1.0%
	UK	117	10	12	-2	-63	0.4%	0.3%	0.3%	-0.1%	-1.6%
	Canada	112	0	-3	-13	-20	0.3%	0.0%	-0.1%	-0.3%	-0.5%
	Australia	110	8	18	15	-4	0.3%	0.2%	0.5%	0.4%	-0.1%
Low grade	Global HY	437	50	71	-15	-28	2.0%	0.7%	1.0%	-0.2%	-0.4%
	US HY	367	52	46	-66	-62	1.0%	0.7%	0.7%	-0.9%	-0.9%
	Eurozone HY	371	49	68	2	-109	1.7%	0.7%	1.0%	0.0%	-1.6%
	US loans	411	11	6	-56	14	1.6%	0.2%	0.1%	-0.8%	0.2%
HC EMD	Hc EMD Corps	324	20	51	17	13	3.3%	0.7%	1.0%	0.6%	0.2%
	HC EMD Sov	316	36	51	30	12	2.4%	0.3%	0.8%	0.3%	0.2%

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

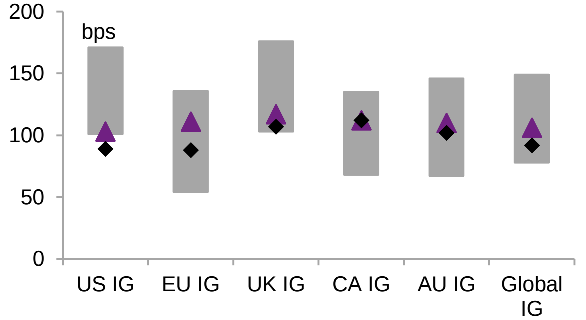
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		• Investment grade markets continue to price-in an expectation for a below average level of credit losses over the medium-term. • We expect credit losses to be close to or 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 in our view. • We retain a somewhat cautious outlook for developed market speculative-grade credit. Current pricing implies a below average level of defaults relative to historic averages. As such, high yield markets are pricing-in an optimistic outlook for corporate credit. • Niche and securitized market pricing appears to be pricing-in a modestly 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 widened modestly over the past month but remain broadly in the mid-to-lower end of their historic interquartile range

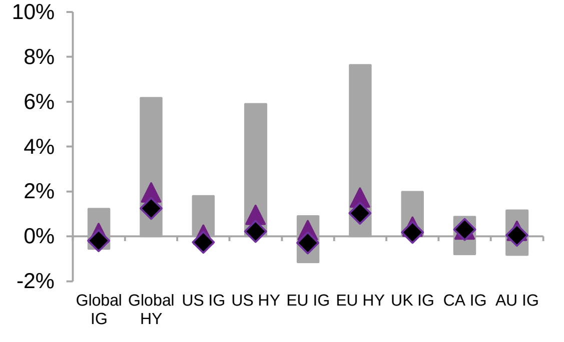
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, Willis Towers Watson.

Market implied default rates remain low relative to history, despite the small widening in spreads

Estimated implied default rate based on current pricing



Source: FactSet, Willis Towers Watson.

Asset Research Team

Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)

30 November 2021

30 November 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	-0.9%	8.0%	-8.6%	8.8%	13.4%	40.9%	-22.7%	11.7%	1.5%	2.6%
Canada	0.8%	4.9%	-4.1%	22.1%	25.5%	68.4%	-27.5%	14.4%	7.9%	3.1%
Eurozone	-2.7%	5.4%	-10.2%	17.4%	20.2%	73.7%	-36.2%	11.8%	-2.2%	6.3%
Japan	-1.8%	7.3%	-8.5%	10.6%	13.0%	80.7%	-38.8%	9.2%	-0.2%	1.0%
UK	-1.3%	0.3%	-1.9%	11.9%	16.5%	121.8%	-49.5%	3.8%	-5.9%	3.0%
US	0.9%	9.2%	-7.7%	27.3%	29.1%	53.9%	-17.2%	21.9%	9.4%	4.7%
China	-4.8%	-4.3%	-0.9%	-19.4%	-18.2%	-0.4%	-21.6%	6.8%	-5.4%	-1.0%
MSCI World	0.2%	7.3%	-7.3%	23.1%	25.4%	58.6%	-23.5%	18.0%	5.5%	5.7%
MSCI EM	-2.6%	6.9%	-9.9%	0.9%	3.3%	53.4%	-35.5%	11.1%	2.9%	-1.5%

Source: FactSet, Willis Towers Watson.

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

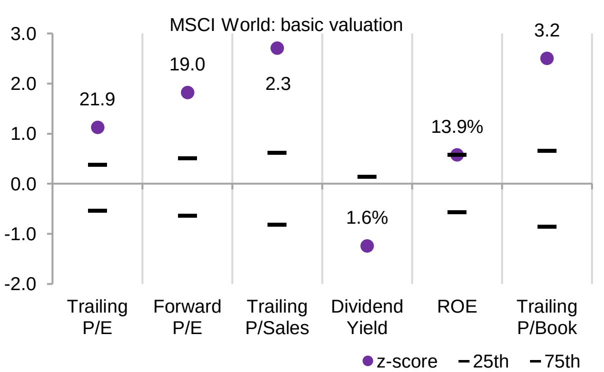
Global equities	Asset return outlook
Developed	
Emerging	

- Earnings in advanced economies have risen significantly over the last year – in line with our expectations – which has reduced core valuation metrics, e.g., price/earnings ratios, relative to a year ago.
- With earnings broadly recovering from their falls last year, future earnings growth in each country will depend heavily on how effective fiscal and monetary policy is at underpinning private sector demand.
- One-year US equity returns and valuations are higher than broader developed markets. This has mostly been driven by mega-cap tech stocks, although there has been some recent reversal of this. While this is consistent with higher US fiscal and monetary stimulus, we continue to think there is moderately better value on offer in European and Japanese markets.
- EM valuations are lower vs. developed markets. We expect relative EM valuations to rise as the global economic recovery broadens further.
- 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 continue to recover quickly. 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 but falling as corporate earnings continue to recover

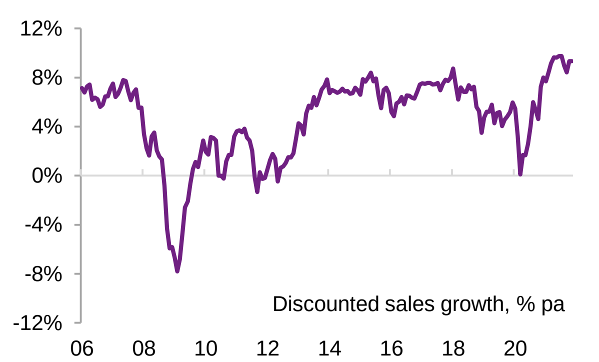
Valuation metrics for the MSCI World equity index



Source: FactSet, Willis Towers Watson.

The earnings 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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