Global Markets Overview

Asset Research Team

April 2022

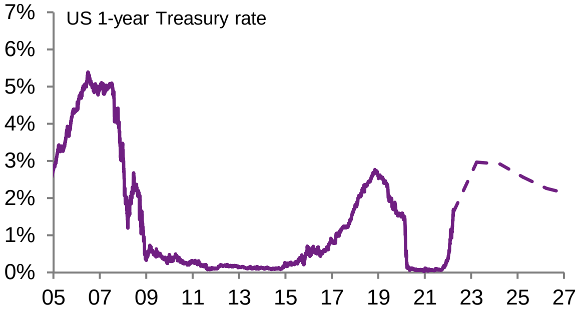
Our 2022 Investment Outlook vs. what markets are pricing-in

Overview

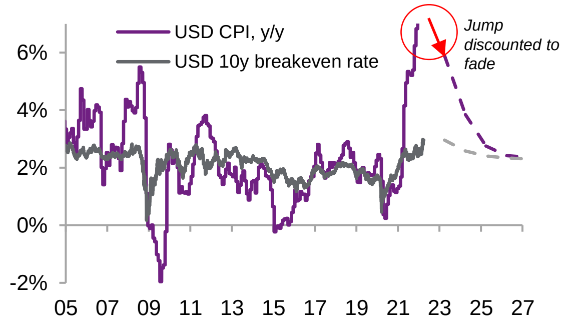
- Financial markets are at a pivotal point in the capital cycle. In advanced economies, the major central banks are beginning to tighten monetary policy and governments are slowing their pace of spending. Keeping track of how economic policy "pivots" (tighter) in 2022/23 in response to strong growth and high inflation, and whether this is offset by household and corporate spending, is key for portfolio strategy.
- For investors tracking the key features of the economy and understanding the future risk-and-return environment, we suggest focusing on the following three categories:
  - **Economic policy**: strong aggregate demand is placing pressure on policy to "pivot" tighter. Keeping abreast of both the pace and type of this policy pivot is the first key category of indicators. For example, in the US, our baseline is for the Fed funds target rate/range to reach 2.00-2.25% at end-2022 and 2.75-3.00% at end-2023.
  - **Inflationary pressures**: high current inflation – due to rising energy and food prices, high demand for goods, and supply chain bottlenecks for those goods – is putting pressure on monetary and fiscal policy. In the US, our baseline is for CPI inflation to fall gradually from the second half of this year and reach 2.5% in the second half of 2023. However, there is an unusually high level of uncertainty around this outlook. In particular, the risk of high inflation being sustained for longer needs to be watched closely.
  - **Capital cycle**: how the capital cycle responds to demand and pricing conditions will be a key factor in determining inflation and growth outcomes over the next two to three years. Household and business balance sheets have high levels of cash from policy support. If, how much, and where they spend will be key to both growth and inflation outcomes. In the US, our baseline forecast is for household spending and business investment to underpin real GDP growth rates of c. 3.0% in 2022 and c. 2.0% in 2023.

What US markets are pricing-in

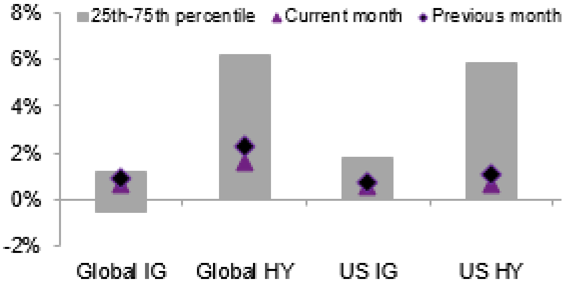
US short-interest rate markets are pricing-in for the Fed funds rate to increase to a little above 3% by the end of 2023



US breakeven inflation markets are pricing-in for inflation to fall gradually and long-term average inflation to remain stable



US credit markets are pricing-in slightly below average credit losses from defaults / downgrades, consistent with good economic growth



Source: FactSet, Refinitiv, Federal Reserve, WTW

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

31 March 2022

March 31, 2022 % / %pts		Spot yields					What's priced-in		
		Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	1y fwd	2y fwd	5y fwd
Developed nominal yields	**Eurozone**								
	1y/cash	-0.48	0.19	0.21	0.18	0.07	0.31	0.62	0.65
	5y	0.36	0.51	0.81	1.01	0.81	0.58	0.64	0.65
	10y	0.48	0.38	0.67	0.80	0.54	0.61	0.65	0.65
	US								
	1y/cash	1.65	0.63	1.29	1.59	-0.75	2.97	2.92	2.11
	5y	2.51	0.73	1.25	1.56	0.27	2.56	2.39	2.17
	10y	2.25	0.40	0.71	0.43	-0.18	2.40	2.36	2.38
Breakeven infl.	**US (CPI)**								
	3y	4.20	0.60	1.13	1.65	2.34	-	-	2.35
	5y	3.52	0.45	0.68	1.00	1.67	-	-	2.33
	10y	2.96	0.31	0.34	0.48	1.10	-	-	2.27

Source: FactSet

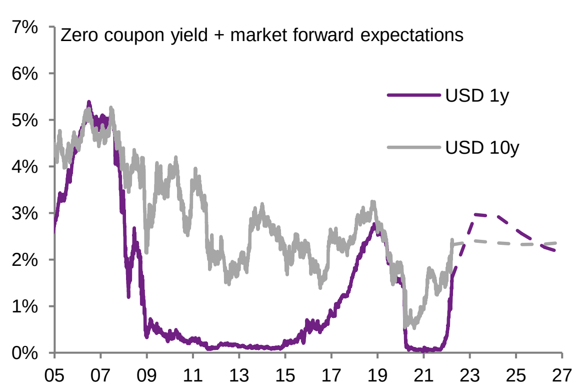
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		• Central bank guidance has become more tilted towards higher policy rates in the face of above-target inflation and robust growth, with key markets engaged in hiking cycles. • The pace of asset purchases has slowed, with the Fed expected to begin shrinking its balance sheet soon, and forward short rates are notably higher than a year ago. • In most developed markets, priced-in short-rates look plausible versus our assessment of economic conditions. This remains true for the Eurozone and Japan, but negative/zero cash rates embed poor returns and/or an asymmetric risk profile.
US		
UK		
AAA-Eurozone		
Developed 10-year nominal bonds		• Intermediate bond yields have shifted materially higher since the start of the year, alongside short rate moves, as inflation concern and central bank guidance have shifted. • We believe that risks are still skewed to the upside in the near term given ongoing global supply chain risks, low unemployment and rising wage costs, particularly in the US. However, following recent increases in yields, we believe most bond markets are now trading within their medium-term neutral ranges. • Under our base case, we expect a combination of tightening monetary and fiscal policy, and stabilizing commodity prices, to help lower inflation gradually. This will likely limit the degree to which yields need to rise from current levels over the medium term.
US	↑	
UK		
AAA-Eurozone		

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

US Treasury yields are more fairly valued following their recent increases, though some upside risks remain in the near term

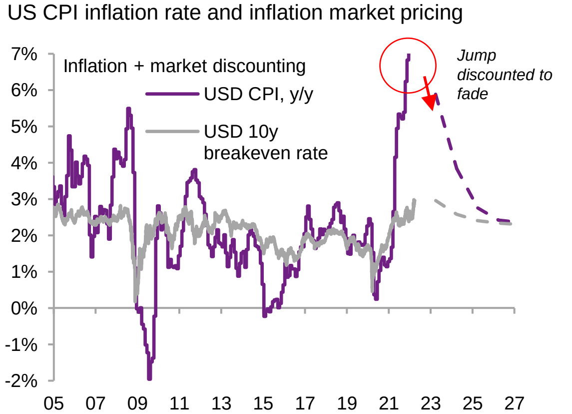
US cash rate and 10y nominal bond yield



Source: FactSet, WTW

Expectations for future US inflation over the medium- and long-term remains anchored. Markets envisage inflation to fall gradually

US CPI inflation rate and inflation market pricing



Source: FactSet, Refinitiv, WTW

Asset Research Team

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)
31 March 2022

31 March 2022		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	125	-11	25	27	-3	0.6%	-0.3%	0.6%	0.7%	-0.1%
	US	122	-8	24	25	-5	0.6%	-0.2%	0.6%	0.6%	-0.1%
	Eurozone	129	-19	31	38	4	0.7%	-0.5%	0.8%	1.0%	0.1%
	UK	145	-8	30	32	-15	1.1%	-0.2%	0.8%	0.8%	-0.4%
	Canada	147	16	27	30	16	1.2%	0.4%	0.7%	0.8%	0.4%
	Australia	137	21	32	43	18	0.9%	0.5%	0.8%	1.1%	0.5%
Low grade	Global HY	412	-46	39	39	-9	1.6%	-0.7%	0.6%	0.6%	-0.1%
	US HY	343	-34	33	7	-62	0.6%	-0.5%	0.5%	0.1%	-0.9%
	Eurozone HY	400	-45	69	86	8	2.1%	-0.6%	1.0%	1.2%	0.1%
	US loans	430	1	19	16	13	1.9%	0.0%	0.3%	0.2%	0.2%
HC EMD	Hc EMD Corps	303	-61	21	32	35	3.4%	-1.3%	0.5%	1.0%	0.8%
	HC EMD Sov	322	-64	24	51	38	2.0%	-0.9%	0.3%	0.5%	0.5%

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

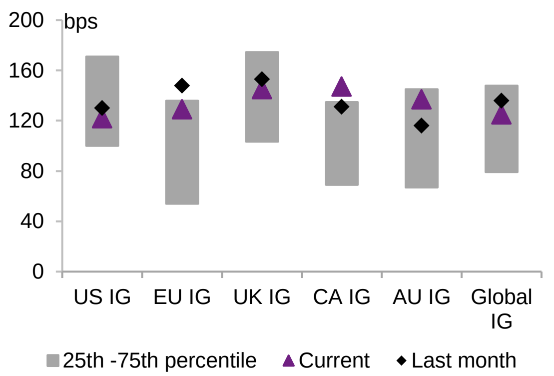
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		• Increases in investment grade spreads this year mean markets are now pricing in a broadly average allowance for the level of credit losses over the medium-term. • We expect losses to be modestly above these levels, particularly in the nearer term, 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 moderate returns above equivalent government bonds. • 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. • Niche and securitized market pricing appears to be pricing-in only 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 tightened over the past month but are still broadly towards the upper end of their historic interquartile ranges

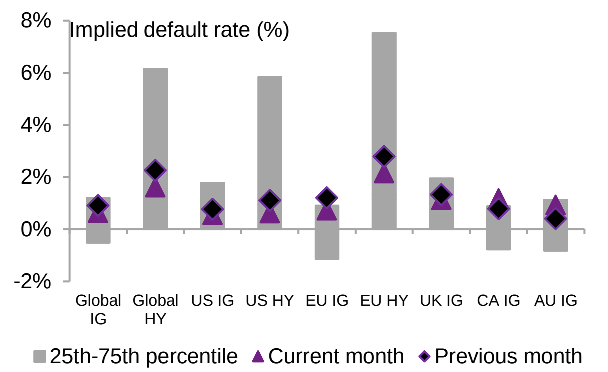
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, WTW

Market implied default rates also generally declined over the month; overall, investment grade bonds currently offer better value than high yield bonds

Estimated implied default rate based on current pricing



Source: FactSet, WTW

Asset Research Team

Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)

31 March 2022

31 March 2022	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	7.3%	-0.3%	7.2%	10.2%	15.2%	100.3%	-45.0%	10.2%	6.7%	-2.9%
Canada	3.8%	1.9%	1.5%	17.1%	20.3%	66.8%	-29.8%	13.6%	12.9%	1.6%
Eurozone	-0.7%	0.2%	-2.0%	0.3%	2.7%	73.2%	-45.0%	7.9%	3.1%	0.4%
Japan	5.0%	1.5%	2.4%	0.7%	3.1%	74.3%	-42.2%	10.6%	4.4%	-1.1%
UK	2.0%	-0.4%	1.7%	14.4%	19.1%	85.7%	-38.4%	5.0%	-0.8%	1.3%
US	3.5%	0.0%	3.4%	12.6%	14.1%	66.9%	-32.6%	19.1%	10.4%	0.9%
China	-7.7%	-0.6%	-6.9%	-33.4%	-32.4%	-2.3%	-34.0%	-3.2%	-4.5%	-5.8%
MSCI World	3.2%	0.2%	2.3%	10.1%	12.1%	68.1%	-35.4%	15.6%	8.4%	1.5%
MSCI EM	-2.0%	-7.7%	5.6%	-11.8%	-9.6%	30.3%	-33.4%	6.6%	0.5%	-1.5%

Source: FactSet, Willis Towers Watson.

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

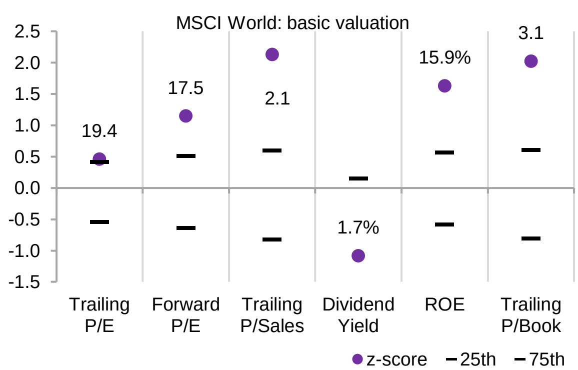
Global equities	Asset return outlook
Developed	
Emerging	

- Equity markets were volatile in the last month as investors assessed the implications of the Russia-Ukraine conflict and high inflation.
- Company earnings in advanced economies have risen significantly over the last year – in line with our expectations – which has also reduced core valuation metrics, e.g., price/earnings ratios, relative to a year ago.
- With earnings having broadly recovered from their falls last year, for 2022, the path of inflation and its impact on margins is key for equity markets. Leading growth indicators have weakened recently as confidence has been impacted by the cost of living squeeze caused by rising prices.
- US valuations remain higher than broader developed markets. This has been mostly concentrated in mega-cap tech stocks. We think the outlook for US stocks over the coming five years is less attractive relative to broader markets. Current valuations price-in a continuation of a regime of outsized earnings, inconsistent with a changing policy dynamic in the US, which is less supportive of very high margins and corporations taking an outsized share of profits relative to labour. 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.
- Overall, we retain a neutral view on equities.

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

Basic developed market financial ratios are high but falling as corporate earnings continue to recover

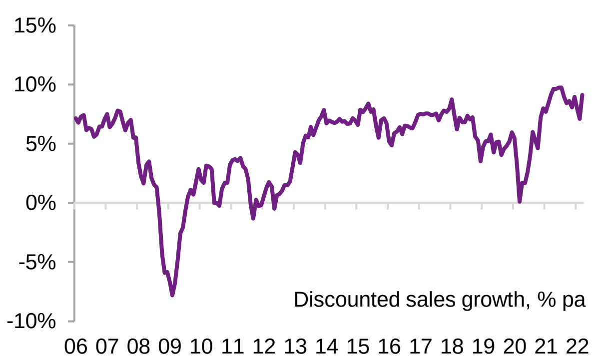
Valuation metrics for the MSCI World equity index



Source: FactSet, WTW

Earnings growth priced-in to equities is somewhat elevated, but we think achievable in the next few years

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



Source: FactSet, WTW

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