

Global Markets Overview

Asset Research Team

May 2022

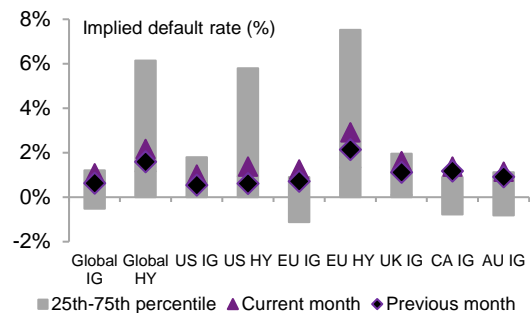
Our 2022 Investment Outlook vs. credit pricing and fundamentals

Overview

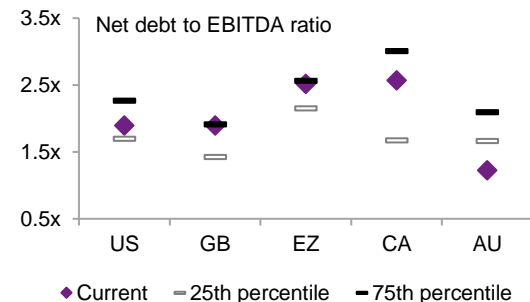
- Financial markets are at a pivotal point in the capital cycle. In advanced economies, the major central banks are beginning to tighten monetary policy and governments are slowing their pace of spending. Keeping track of how economic policy “pivots” (tighter) in 2022/23 in response to strong growth and high inflation 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 but for growth to slow to c. 1.0% - 2.0% in 2023.

What credit markets are pricing-in

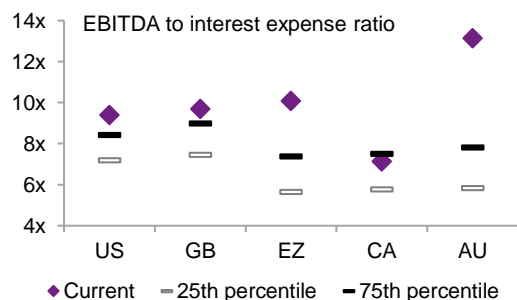
Investment grade credit is pricing in moderately above average losses from downgrades; consistent with moderately below trend growth in the future



Corporate leverage is average-to-high across advanced economies; this is typically consistent with the later stage of the business cycle



However, cash flow measures – earnings minus debt service costs – show few signs of stress currently; we expect these to weaken in 2023



Source: FactSet, WTW

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

30 April 2022

April 30, 2022		Spot yields					What's priced-in		
% / %pts		Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	1y fwd	2y fwd	5y fwd
Developed nominal yields	Eurozone								
	1y/cash	-0.26	0.18	0.42	0.41	0.28	0.73	0.97	1.02
	5y	0.69	0.21	1.02	1.28	1.08	0.94	1.01	1.06
	10y	0.88	0.28	0.98	1.09	0.83	1.01	1.05	1.10
	US								
	1y/cash	2.03	0.35	1.27	1.97	-0.36	3.37	3.36	2.79
5y	2.98	0.43	1.33	2.10	0.70	3.10	2.98	2.87	
10y	2.85	0.57	1.05	1.14	0.32	3.01	2.98	3.00	
Breakeven infl.	US (CPI)								
	3y	3.88	-0.10	0.81	1.15	2.00	-	-	2.25
	5y	3.33	0.00	0.54	0.70	1.46	-	-	2.29
	10y	2.85	0.01	0.34	0.35	0.90	-	-	2.34

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		<ul style="list-style-type: none"> Central bank guidance is emphasising material increases in policy rates in the face of above-target inflation and robust growth, with key markets engaged in hiking cycles. The pace of central bank asset purchases is also changing, with the Fed due to begin reducing the size of its balance sheet soon.
US		
UK		
AAA-Eurozone		<ul style="list-style-type: none"> In most developed markets, the future path for short-rates that are priced-into bond markets 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.
Developed 10-year nominal bonds		<ul style="list-style-type: none"> Intermediate bond yields have risen materially since the start of the year, alongside short rate moves, as inflation and central bank guidance have changed. In the near term, we believe that the risks are still biased towards higher bond yields, given ongoing global supply chain risks, low unemployment and rising wage costs, particularly in the US. However, over the medium term, we believe most bond markets are now trading within their neutral ranges. Under our base case, we expect a combination of tighter monetary policy, slower growth, and less commodity price pressure, to slow 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

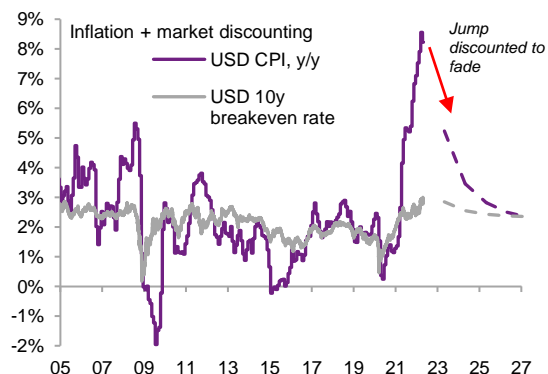
US cash rate and 10y nominal bond yield



Source: FactSet, WTW

Expectations for future US inflation over the medium- and long-term remain anchored; markets expect inflation to fall gradually

US CPI inflation rate and inflation market pricing



Source: FactSet, Refinitiv, WTW

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)

30 April 2022

30 April 2022		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	143	18	33	48	26	1.1%	0.5%	0.8%	1.2%	0.7%
	US	141	19	31	47	24	1.0%	0.5%	0.8%	1.2%	0.6%
	Eurozone	150	21	43	65	40	1.3%	0.5%	1.1%	1.6%	1.0%
	UK	165	20	41	57	18	1.6%	0.5%	1.0%	1.4%	0.5%
	Canada	155	8	33	40	30	1.4%	0.2%	0.8%	1.0%	0.8%
	Australia	146	9	39	56	30	1.2%	0.2%	1.0%	1.4%	0.8%
Low grade	Global HY	452	40	34	92	57	2.2%	0.6%	0.5%	1.3%	0.8%
	US HY	397	54	34	69	24	1.4%	0.8%	0.5%	1.0%	0.3%
	Eurozone HY	454	54	87	150	89	2.9%	0.8%	1.2%	2.1%	1.3%
	US loans	416	-14	7	9	26	1.7%	-0.2%	0.1%	0.1%	0.4%
HC EMD	HC EMD Corps	300	-3	3	29	39	4.1%	0.7%	0.9%	1.9%	1.4%
	HC EMD Sov	355	33	47	95	71	2.0%	0.0%	0.0%	0.4%	0.6%

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

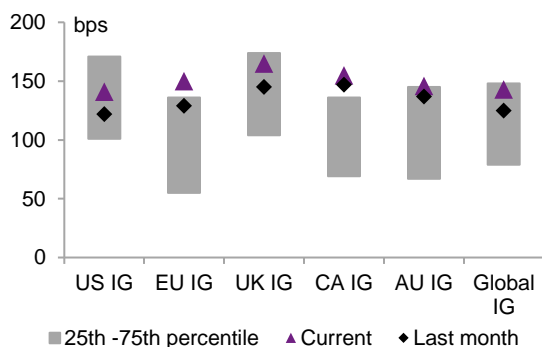
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		<ul style="list-style-type: none"> Increases in investment grade spreads this year mean markets are now pricing in a broadly above average allowance for the level of credit losses over the medium-term.
Inv. grade		<ul style="list-style-type: none"> We expect credit losses from downgrades to be close to these levels, particularly in the nearer term, with risks more biased towards higher losses.
High yield		<ul style="list-style-type: none"> At current credit spreads, high quality corporate bonds are at levels at which they are likely to provide 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 given shorter-term risks – current pricing implies a below average level of defaults relative to historic averages.
Europe		<ul style="list-style-type: none"> 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 averages.
Loans		<ul style="list-style-type: none"> Niche and securitized market pricing appears to be pricing-in only a modestly more pessimistic outlook in aggregate, relative to traditional corporate credit.
US		<ul style="list-style-type: none"> Niche and securitized market pricing appears to be pricing-in only a modestly more pessimistic outlook in aggregate, relative to traditional corporate credit.

Key: Highly negative Negative Neutral Positive Highly positive

Investment grade spreads widened over the past month and have moved broadly towards the upper end of their interquartile historic ranges

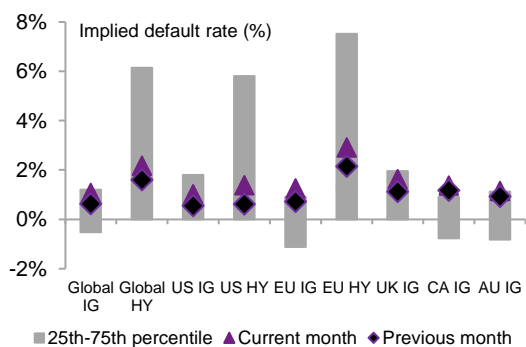
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, WTW

Market implied default rates also increased generally over the month

Estimated implied default rate based on current pricing



Source: FactSet, WTW

Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)

30 April 2022

30 April 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	-0.5%	0.0%	-0.4%	4.1%	8.9%	84.9%	-48.0%	8.8%	6.7%	-3.4%
Canada	-4.0%	0.2%	-4.4%	9.0%	12.0%	62.9%	-33.1%	10.9%	11.3%	1.1%
Eurozone	-2.0%	0.3%	-6.9%	-5.3%	-2.8%	77.8%	-53.6%	5.0%	4.2%	-3.3%
Japan	-2.8%	0.3%	-4.1%	0.0%	2.3%	74.9%	-42.9%	8.9%	4.5%	-2.1%
UK	1.2%	0.6%	0.3%	10.7%	15.4%	77.7%	-41.3%	4.4%	-0.8%	1.2%
US	-6.5%	0.0%	-6.6%	0.6%	2.0%	66.3%	-39.5%	15.3%	10.1%	-1.1%
China	-7.5%	0.5%	-5.3%	-40.8%	-39.9%	1.3%	-40.6%	-6.7%	-3.0%	-8.6%
MSCI World	-5.0%	0.0%	-6.5%	0.6%	2.5%	67.7%	-42.5%	12.4%	8.3%	-0.8%
MSCI EM	-4.1%	0.7%	-7.0%	-18.7%	-16.6%	33.0%	-41.7%	3.9%	1.1%	-4.7%

Source: FactSet, Willis Towers Watson.

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

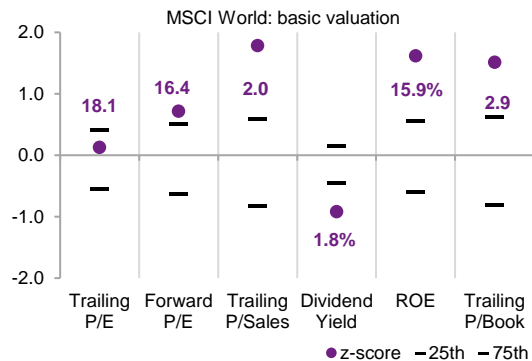
Global equities	Asset return outlook
Developed	Neutral
Emerging	Neutral

- Equity markets have been volatile in recent months as investors assess the implications of the Russia-Ukraine crisis, high inflation, and rising interest rates.
- 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

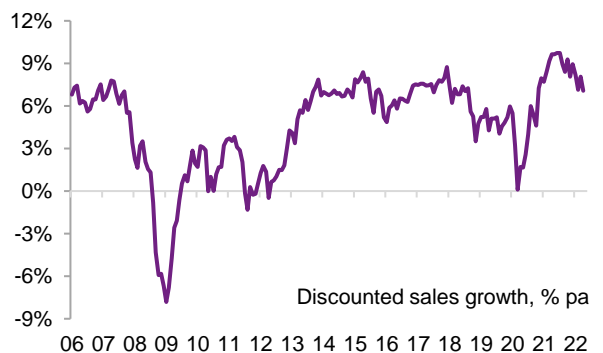
Valuation metrics for the MSCI World equity index



Source: FactSet, WTW

Earnings growth priced-in to equities is elevated; it is achievable over the medium-term but with short-term risk

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



Source: FactSet, WTW

Disclaimer

WTW has prepared this material for general information purposes only and it should not be considered a substitute for specific professional advice. In particular, its contents are not intended by WTW to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. As such, this material should not be relied upon for investment or other financial decisions and no such decisions should be taken based on its contents without seeking specific advice.

This material is based on information available to WTW at the date of this material and takes no account of developments after that date. In preparing this material we have relied upon data supplied to us or our affiliates by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and WTW and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors, omissions or misrepresentations by any third party in respect of such data.

This material may incorporate information and data made available by certain third parties, including (but not limited to): Bloomberg L.P.; CRSP; MSCI; FactSet; FTSE; FTSE NAREIT; FTSE RAFI; Hedge Fund Research Inc.; ICE Benchmark Administration (LIBOR); JP Morgan; Markit Group Limited; Russell; and, Standard & Poor's Financial Services LLC (each a "Third Party"). Details of the disclaimers and/or attribution relating to each relevant Third Party can be found at this link <https://willistowerswatson.com/en-GB/Notices/index-vendor-disclaimers>

This material may not be reproduced or distributed to any other party, whether in whole or in part, without WTW's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, WTW and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any use of or reliance on this material or any of its contents.

About WTW

At WTW (NASDAQ: WTW), we provide data-driven, insight-led solutions in the areas of people, risk and capital. Leveraging the global view and local expertise of our colleagues serving 140 countries and markets, we help you sharpen your strategy, enhance organizational resilience, motivate your workforce and maximize performance.

Working shoulder to shoulder with you, we uncover opportunities for sustainable success—and provide perspective that moves you.

Learn more at wtwco.com.

Towers Watson Limited is a limited liability company registered in England and Wales under registered number 5379716. Registered address: Watson House, London Road, Reigate, Surrey, RH2 9PQ, United Kingdom

To unsubscribe, email eu.unsubscribe@towerswatson.com with the publication name as the subject and include your name, title and company address.