# Global Markets Overview

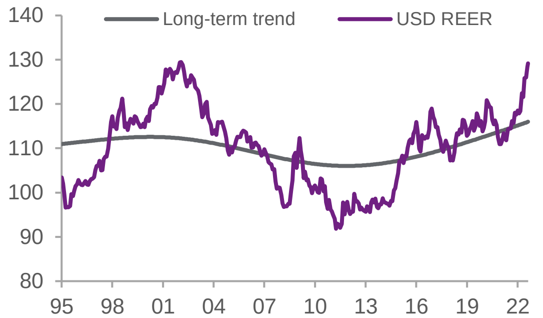
## Asset Research Team

**September 2022**

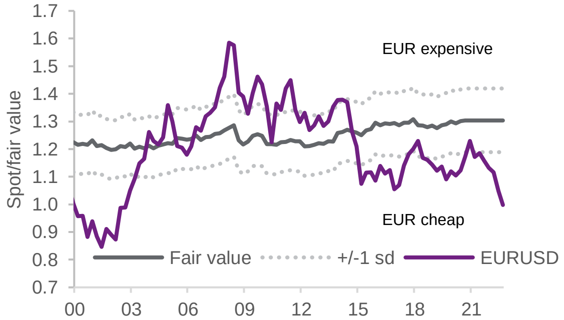
## Currency volatility will likely stay high given economic divergences

- **Cyclically**, currencies will likely continue to have an important impact on portfolios – in our view forward-looking asset returns face downside risks, currency volatility will remain high given monetary policy, fiscal policy, and economic divergences, and stock/bond correlations will be less stable.
- We are slightly negative on the US dollar over the medium-term after recent strong appreciation against all major currencies. However, in the shorter term, the dollar may continue to strengthen further given the relatively faster pace of Fed hikes and global recession risks, which both support capital flows into the US.

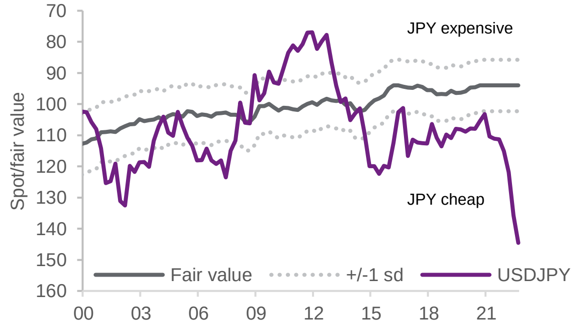
**The US dollar has become more expensive on a trade-weighted basis, i.e., against a basket of major currencies.**
US Dollar Real Effective Exchange Rate Index



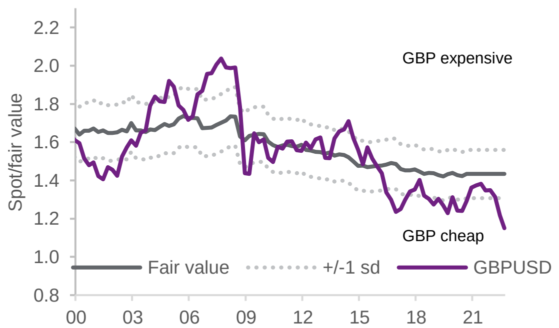

**Euro: somewhat cheap vs. long-term fair value but relatively easier policy and energy risks cloud the outlook**
Enhanced PPP fair value vs. USD



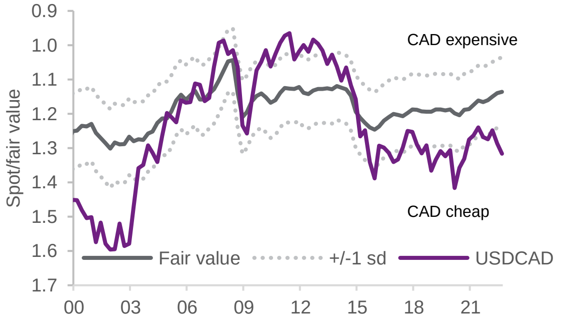

**Yen: despite much lower interest rates in Japan, the Yen's level of cheapness suggests medium-term attractiveness**
Enhanced PPP fair value vs. USD




**Sterling: GBP has depreciated sharply recently but it still faces a fragile external position and stagflation risk**
Enhanced PPP fair value vs. USD




**Canadian dollar: close to its fair value range; recent price action has been heavily driven by crude oil prices**
Enhanced PPP fair value vs. USD




Source: Factset, Refinitiv, Goldman Sachs, Thomson, WTW

# Tracking recent asset price moves and our outlook

## Summary: government bonds

### Changes to market pricing (government bond yields)

31 August 2022

| | Aug 31, 2022 % / %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 | 0.75 | 0.48 | 0.74 | 1.45 | 1.52 | 1.52 | 1.48 | 1.58 |
| | 5y | 1.34 | 0.88 | 0.50 | 2.04 | 2.28 | 1.51 | 1.53 | 1.66 |
| | 10y | 1.51 | 0.69 | 0.42 | 1.90 | 2.22 | 1.60 | 1.62 | 1.69 |
| | **US** | | | | | | | | |
| | 1y/cash | 3.36 | 0.45 | 1.33 | 3.29 | 1.60 | 3.75 | 3.35 | 2.95 |
| | 5y | 3.31 | 0.66 | 0.46 | 2.53 | 1.92 | 3.20 | 3.06 | 3.17 |
| | 10y | 3.17 | 0.42 | 0.23 | 1.81 | 1.66 | 3.24 | 3.21 | 3.35 |
| Breakeven infl. | **US (CPI)** | | | | | | | | |
| | 3y | 2.61 | -0.37 | -0.80 | 0.03 | 1.40 | - | - | 2.29 |
| | 5y | 2.62 | -0.12 | -0.29 | 0.08 | 1.26 | - | - | 2.15 |
| | 10y | 2.42 | 0.01 | -0.22 | 0.05 | 0.92 | - | - | 2.08 |

Source: FactSet

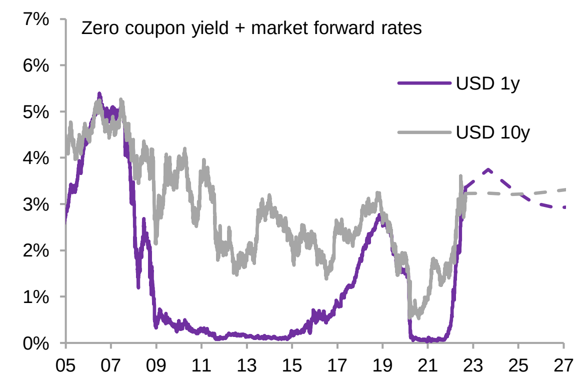
### A summary of our assessment of government bond pricing and prospective medium-term outcomes

| Sovereign bonds | Asset return outlook | Comments |
|---|---|---|
| Developed short interest rates | | • Central bank guidance has become more biased towards higher policy rates in the face of above-target inflation and acceptable growth, with key markets engaged in hiking cycles.<br>• The pace of asset purchases has also slowed, with the Fed gradually beginning to shrink assets on its balance sheet.<br>• In most developed markets, priced-in short-rates look plausible versus our assessment of economic conditions. While this is true for Japan, given yield curve control, their 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 risen materially year-to-date, alongside short rate moves, as inflation concerns have grown and central bank guidance has focused on tightening.<br>• We believe that risks are skewed to the upside in the near term given ongoing global supply chain risks (e.g., related to the Ukraine conflict), low unemployment and rising wage costs, particularly in the US. However, following recent increases in bond yields, we believe most bond markets are now trading within their medium-term neutral ranges.<br>• Under our base case, we expect a combination of tightening monetary 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 bond yields imply further rate hikes during H2 2022, with easing pressures further out; this is plausible but the range of upside and downside outcomes is wide**

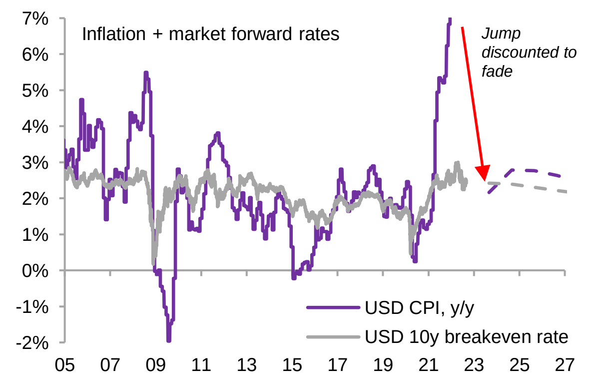
US cash rate and 10y nominal bond yield




Source: FactSet, WTW

**Expectations for future US inflation have declined, despite high current inflation. While we expect inflation to fall gradually, expectations may under-reflect inflation risk**

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 August 2022

| 31 August 2022 | | Pricing - Option adjusted spreads, bps | | | | | Implied defaults | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Current | Δ1m | Δ3m | Δ1y | Δ3y | Current | Δ1m | Δ3m | Δ1y | Δ3y |
| High grade | Global | 161 | -2 | 15 | 68 | 38 | 1.5% | 0.0% | 0.4% | 1.7% | 1.0% |
| | US | 148 | -5 | 8 | 56 | 22 | 1.2% | -0.1% | 0.2% | 1.4% | 0.6% |
| | Eurozone | 198 | 14 | 38 | 112 | 88 | 2.5% | 0.4% | 1.0% | 2.8% | 2.2% |
| | UK | 202 | 9 | 32 | 97 | 53 | 2.6% | 0.2% | 0.8% | 2.4% | 1.3% |
| | Canada | 166 | -3 | 4 | 51 | 39 | 1.7% | -0.1% | 0.1% | 1.3% | 1.0% |
| | Australia | 172 | -2 | 14 | 80 | 70 | 1.8% | 0.0% | 0.4% | 2.0% | 1.8% |
| Low grade | Global HY | 562 | 3 | 82 | 196 | 122 | 3.7% | 0.0% | 1.2% | 2.8% | 1.7% |
| | US HY | 503 | 20 | 81 | 182 | 90 | 2.9% | 0.3% | 1.2% | 2.6% | 1.3% |
| | Eurozone HY | 553 | -28 | 79 | 250 | 194 | 4.3% | -0.4% | 1.1% | 3.6% | 2.8% |
| | US loans | 496 | -18 | 13 | 90 | 62 | 2.8% | -0.3% | 0.2% | 1.3% | 0.9% |
| HC EMD | Hc EMD Corps | 334 | -33 | 16 | 61 | 32 | 4.6% | -0.8% | 0.4% | 2.3% | 1.2% |
| | HC EMD Sov | 381 | -41 | 19 | 116 | 62 | 2.5% | -0.5% | 0.2% | 0.9% | 0.5% |

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

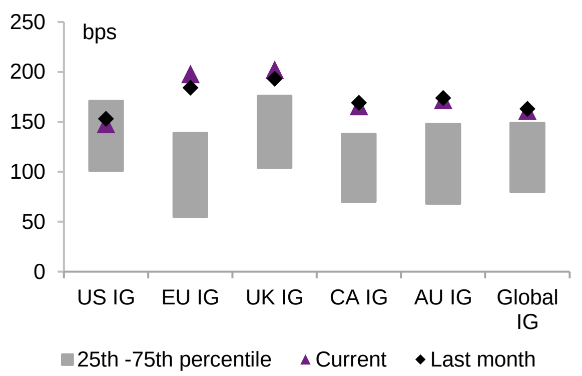
### A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

| Credit | Asset return outlook | Comments |
|---|---|---|
| Corporate credit | | • Increases in investment grade spreads this year mean markets are now pricing in a broadly above average allowance for the level of credit losses over the medium-term.<br>• We expect losses to be at or modestly above these levels, particularly in the nearer term, with risks tilted towards higher losses.<br>• At current credit spreads, high quality credit assets are at levels at which they are likely to provide moderate returns above equivalent maturity government bonds over the medium term.<br>• We retain a somewhat cautious outlook for developed market speculative-grade credit given shorter-term risks. After the falls in high yield spreads in July, current pricing implies only a slightly above average level of defaults relative to historic average pricing – again we think risks are more tilted towards higher losses in the shorter-term. |
| Inv. grade | | |
| High yield | | |
| US | | |
| Europe | | |
| Loans | | |
| US | | |

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

**Global investment grade spreads tightened slightly over the past month but remain at or above the upper end of their historic interquartile ranges**

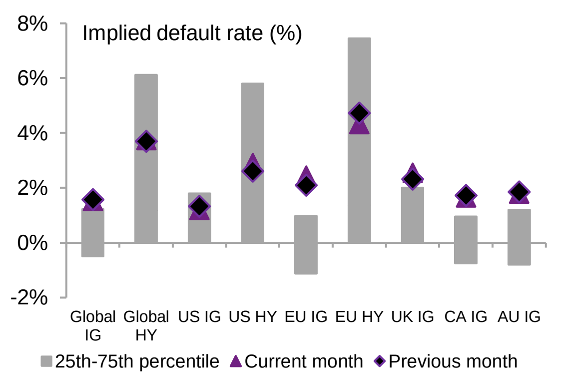
Investment grade corporate option-adjusted spreads, bps




Source: FactSet, WTW

**Market implied default rates across global investment grade and high yield markets were broadly unchanged over the past month**

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 August 2022

| 31 August 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 | 0.7% | 20.4% | -16.8% | -5.9% | -2.3% | 46.2% | -36.0% | 5.1% | 11.6% | -11.2% |
| Canada | -1.9% | 2.8% | -4.9% | -4.5% | -3.4% | 29.8% | -27.8% | 8.4% | 10.7% | -5.8% |
| Eurozone | -5.0% | 2.1% | -8.2% | -12.1% | -14.0% | 18.7% | -40.3% | 3.7% | 6.4% | -8.6% |
| Japan | 1.1% | -5.7% | 7.1% | -0.4% | 2.6% | 6.1% | -5.5% | 12.2% | 4.2% | 1.3% |
| UK | -1.3% | 20.9% | -19.1% | 7.3% | 9.2% | 41.9% | -26.0% | 4.3% | 7.9% | -7.7% |
| US | -3.9% | -3.1% | -1.0% | -10.2% | -13.1% | 18.6% | -27.8% | 12.4% | 11.3% | -4.1% |
| China | 0.6% | -5.6% | 8.6% | -28.5% | -26.7% | -13.1% | -13.6% | -2.0% | -5.4% | -5.3% |
| MSCI World | -3.4% | -1.2% | -3.2% | -9.0% | -10.8% | 15.8% | -27.8% | 10.2% | 8.9% | -3.5% |
| MSCI EM | 1.2% | 0.0% | 0.0% | -18.1% | -15.4% | 0.3% | -24.3% | 5.3% | 4.0% | -6.9% |

Source: FactSet, Willis Towers Watson.

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

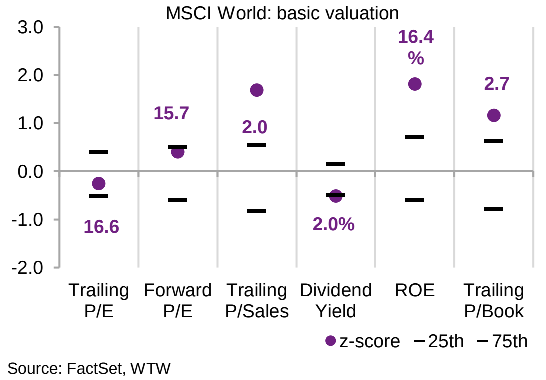
| Global equities | Asset return outlook |
|---|---|
| Developed | |
| Emerging | |

- Company earnings in advanced economies have risen significantly over the last year – in line with our expectations – which, along with higher bond yields, has 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 higher interest rates and the cost of living squeeze caused by rising prices.
- Our assessment of price declines over the last year is that they are mostly consistent with higher interest rate expectations, rather than material downward revisions in earnings growth expectations. Whereas, in our view, the growth outlook has declined with a material probability of recessions in developed markets.
- US valuations remain higher than broader equity markets. Over the medium term, we see moderately better value on offer in Japanese and UK markets.
- EM valuations are lower vs. developed markets – we expect relative EM valuations to rise and are neutral to moderately positive on EM.
- Overall, we retain a broadly neutral view on equities over a five-year horizon, with shorter-term risks to the downside.

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

**Basic developed market financial ratios are broadly in-line with historical averages but still face potential near term earnings risk**

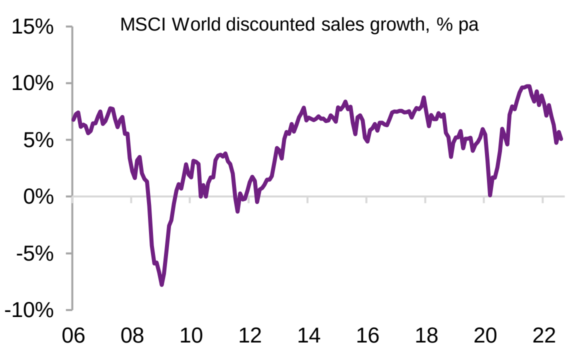
Valuation metrics for the MSCI World equity index




Source: FactSet, WTW

**Earnings growth priced-in to equities has fallen over 2022; over the short-term it remains somewhat elevated relative to expectations but is achievable over five years**

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




Source: FactSet, WTW

**Asset Research Team**

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