Global Markets Overview

Asset Research Team

31 January 2023

The economic outlook for 2023

The US, Europe, and China

- Inflation remains too high in the major economies (outside of Asia) currently:
  - In Europe, energy markets have been a prominent driver of rising prices but inflationary pressures are becoming more widespread;
  - The US has had less of an energy problem, instead resilient spending growth and a labour demand/supply imbalance are causing uncertainty over how high interest rates will need to be to bring core inflation back to around 2%.
- In the US, Eurozone, and UK, monetary policy has been tightened aggressively in response to high inflation. While the pace of policy rate increases will slow, the size of the tightening that has happened already – plus in Europe the real income squeeze from much higher prices – is only beginning to impact the US and European real economies.
- In many countries, a material economic slowdown of some form has become necessary to reduce inflation to levels that are acceptable to central bankers. The critical questions for markets are how deep and how long that slowdown will be and if current monetary policy settings are enough to deliver that outcome:
  - In the US, the answer lies in how the labour market, wage growth, and inflation expectations evolve and we expect monetary policy to be highly reactive to these datapoints. A "soft-landing", e.g., US real GDP growth at around 1% in 2023, is a possibility. However, some form of economic and/or earnings recession in 2023 or 2024 is more likely in our view;
  - The expected path for US policy rates – a peak of 4.75% - 5.0% in the next few months and then a sequence of rate cuts – is plausible. However, we see the risks as more balanced towards policy rates being higher than markets are pricing-in over 2023/24 because core inflation may be "stickier" than expected and the Fed may not cut policy rates as quickly as expected.
  - Eurozone inflation and growth remains sensitive to the price of energy, geopolitical conflict, demand for energy elsewhere (see China's reopening below), and labour imbalances. The UK faces similar issues but these are compounded by weak exports relative to imports, a reliance on foreign capital, and a potentially weak currency.
  - Government spending can support household balance sheets and lower CPI inflation in the near term, but is likely to drive subsequent upward pressure on inflation and raises fiscal sustainability questions. A material slowdown or recession has already started in both the Eurozone and UK, alongside high inflation, so the risk of a more severe and/or protracted downturn is elevated vs. the US.
  - China is at an inflection point after the unwinding of its zero-COVID policy. The easing of health-related policies means aggregate demand should recover strongly in 2023, albeit after an initial negative economic impact associated with high COVID rates. There also appears to be a greater focus from policymakers on securing higher growth in 2023. While this would benefit global demand, it may also increase the total demand for commodities, adding to inflationary pressures in advanced economies.
- Economies are in a state of flux and policy is in reactive mode. It is uncertain how much and how quickly higher interest rates will weigh on both inflation and growth – which creates an uncertain and volatile environment for 2023.

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

26 January 2023

26 January 2023 % / %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	2.67	0.11	0.73	3.37	3.28	2.40	1.94	2.06
	5y	2.16	-0.21	0.25	2.58	2.76	2.05	1.99	2.14
	10y	2.17	-0.22	0.04	2.27	2.49	2.11	2.09	2.17
	US								
	1y/cash	4.78	0.11	0.20	4.09	3.26	3.76	3.29	3.22
	5y	3.65	-0.29	-0.62	1.93	2.11	3.30	3.22	3.45
	10y	3.44	-0.26	-0.56	1.58	1.74	3.43	3.43	3.63
Breakeven infl.	**US (CPI)**								
	3y	2.13	-0.08	-0.47	-0.90	0.65	-	-	2.09*
	5y	2.14	-0.04	-0.34	-0.59	0.57	-	-	2.12
	10y	2.13	0.03	-0.23	-0.40	0.49	-	-	2.21

Source: FactSet, Refinitiv, WTW *1y breakeven inflation rate, 5 years forward

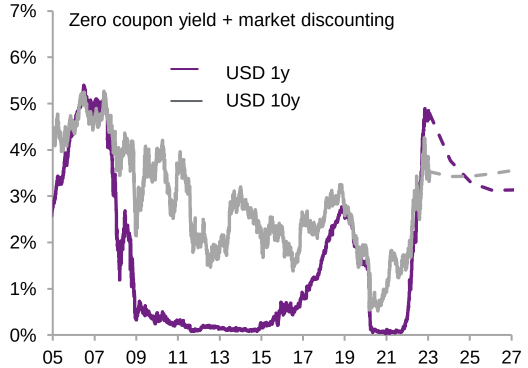
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		• Central bank guidance remains biased towards higher policy rates in the face of above-target inflation and acceptable growth, with key markets still engaged in hiking cycles. • The pace of asset purchases has also slowed and moved negative (via sales or redemptions) for some central banks. • In most developed markets, priced-in short-rates look plausible versus our assessment of economic conditions.
US		
UK		
AAA-Eurozone		
Developed 10-year nominal bonds		• Intermediate bond yields rose materially over the past year as inflation concerns grew, and central bank guidance shifted towards the need for aggressive tightening. • Following the rise in yields over 2022, we believe most bond markets are now trading within their neutral ranges. • In the US, the risks to bond yields are balanced. The key upside risk is sticky inflation forcing bond markets to revise the size of policy easing priced in from H2 2023 onwards. The key downside risk to yields is a more severe recession. • In Europe, inflation is higher and GDP growth is lower compared to the US, which increases the difficulties for both the ECB and Bank of England in setting the appropriate level of interest rates.
US		
UK		
AAA-Eurozone		

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

US Treasury bond yields imply further rate hikes over the next few months, with significant easing afterwards; this is plausible but requires inflation to fall rapidly – it may not

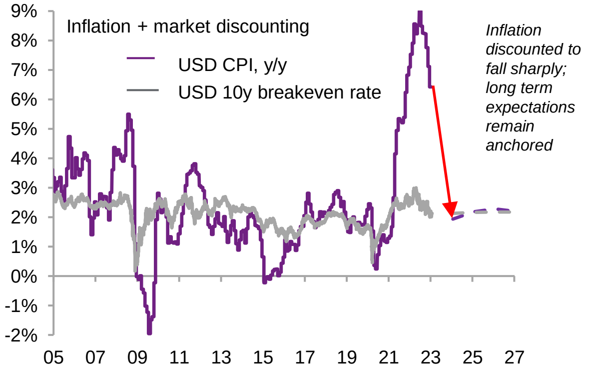
US cash rate and 10y nominal bond yield



Source: FactSet, Refinitiv, WTW, as at 26 January 2023

US inflation expectations have declined despite high current but falling inflation. We expect core inflation to slow gradually, and more slowly than markets are pricing

CPI inflation rate and inflation market pricing



Source: FactSet, Refinitiv, Federal Reserve, WTW, as at 26 January 2023

Asset Research Team

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)
26 January 2023

26 January 2023		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	134	-13	-48	30	31	0.9%	-0.3%	-1.2%	0.8%	0.8%
	US	126	-12	-42	23	22	0.7%	-0.3%	-1.1%	0.6%	0.6%
	Eurozone	149	-17	-70	45	56	1.2%	-0.4%	-1.8%	1.1%	1.4%
	UK	164	-28	-63	46	40	1.6%	-0.7%	-1.6%	1.2%	1.0%
	Canada	167	-7	-16	48	61	1.7%	-0.2%	-0.4%	1.2%	1.5%
	Australia	180	-11	-22	77	85	2.0%	-0.3%	-0.6%	1.9%	2.1%
Low grade	Global HY	456	-42	-109	68	56	2.2%	-0.6%	-1.6%	1.0%	0.8%
	US HY	424	-31	-52	99	21	1.8%	-0.4%	-0.7%	1.4%	0.3%
	Eurozone HY	440	-52	-160	89	107	2.7%	-0.7%	-2.3%	1.3%	1.5%
	US loans	517	-41	-48	109	100	3.1%	-0.6%	-0.7%	1.6%	1.4%
HC EMD	Hc EMD Corps	269	-25	-116	-20	15	3.6%	0.1%	-1.6%	0.5%	0.4%
	HC EMD Sov	328	6	-81	23	22	1.5%	-0.4%	-1.8%	-0.3%	0.2%

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

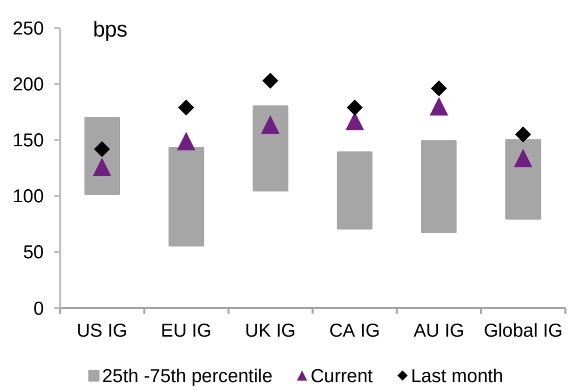
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		• US investment grade credit spreads are pricing in an average allowance for the level of credit losses over the medium-term; across the rest of the advanced economies investment grade markets provide an above average allowance. • We expect losses to be at or modestly above these levels, particularly in the nearer term, with risks tilted towards 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 over the medium-term • We retain a somewhat cautious outlook for developed market speculative-grade credit given shorter-term risks and recent falls in credit spreads. Current pricing implies a below average level of defaults relative to historic average pricing, in the US market especially. • Niche and securitized market pricing appears to be pricing-in similar 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 declined moderately in January and have fallen significantly over the last three months in all geographical markets, in Europe especially

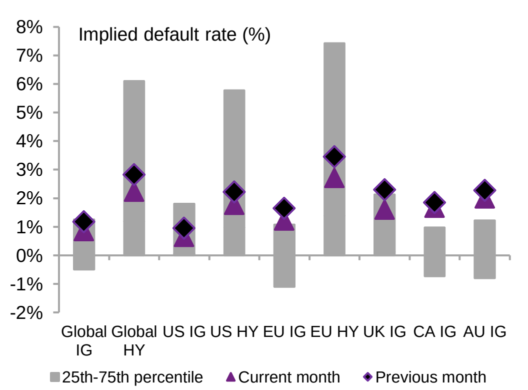
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, WTW, as at 26 January 2023

Market implied default rates have fallen in-line with the fall in credit spreads; the US high yield market is exposed to short-term economic and earnings risks

Estimated implied default rate based on current pricing



Source: FactSet, WTW, as at 26 January 2023

Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)
26 January 2023

26 January 2023	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	5.2%	0.1%	4.9%	9.3%	14.8%	19.7%	-8.7%	5.8%	7.7%	-5.2%
Canada	6.4%	-2.2%	7.8%	0.1%	3.4%	23.3%	-19.3%	9.2%	11.4%	-4.7%
Eurozone	9.5%	3.7%	7.6%	-2.0%	1.3%	13.2%	-16.8%	6.9%	6.7%	0.1%
Japan	4.6%	0.1%	4.4%	3.4%	6.2%	6.8%	-3.0%	8.4%	9.0%	-1.4%
UK	3.6%	0.3%	3.0%	4.9%	9.1%	59.9%	-34.5%	6.1%	12.3%	-9.3%
US	6.0%	-0.3%	5.0%	-7.3%	-5.7%	6.5%	-13.9%	9.5%	11.2%	-2.9%
China	17.7%	2.1%	9.4%	-8.3%	-6.2%	5.8%	-10.8%	-0.7%	-3.8%	-5.8%
MSCI World	6.0%	1.1%	4.6%	-5.0%	-3.0%	7.5%	-14.0%	8.5%	8.9%	-1.3%
MSCI EM	9.0%	2.0%	6.9%	-9.4%	-6.3%	-6.2%	-8.4%	4.5%	3.3%	-3.8%

Source: FactSet, Willis Towers Watson.

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

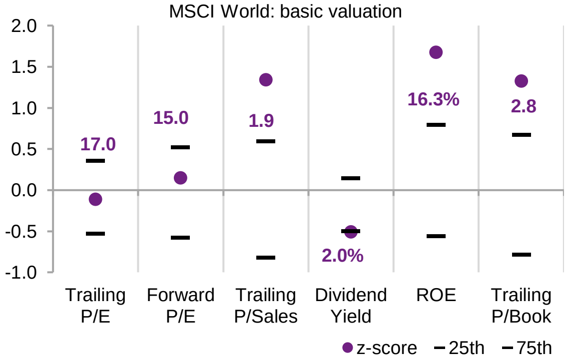
Global equities	Asset return outlook
Developed	
Emerging	

- Equity markets moved sharply higher in January, showing signs of optimism on falling inflation and resilient growth.
- However, earnings are now beginning to show signs of weakness as the world economy slows; despite this, the extent of short term risks are still not currently reflected in analyst earnings expectations for 2023.
- Two aspects are important: (1) future analyst earnings estimates are declining but remain at the higher end of our expectations over the next 1-2 years, considering rising risks to top-line growth and profit margins; and (2) our assessment of equity price declines in 2022 is that they have mostly been caused by rising interest rates, rather than lower growth expectations. Therefore, equities are not pricing-in possible future earnings weakness and face near term downside risks if growth weakens further and/or earnings expectations get revised down.
- We continue to see value in Japanese and UK equities, with valuations remaining low relative to broader DM equities.
- Overall, we retain a neutral view on equities over a five-year horizon but are cautious nearer-term, despite the fall in equity prices over the last year.

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

Basic developed market financial ratios remain high – due to the US – despite shorter-term economic risks

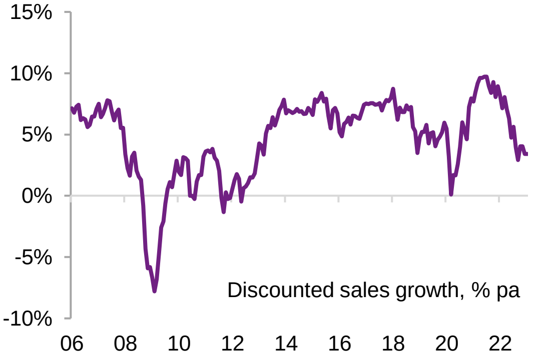
Valuation metrics for the MSCI World equity index



Source: FactSet, WTW; as at 26 January 2023

Sales growth priced-in to equities remains elevated – earnings risk is to the downside over the next year

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



Source: FactSet, WTW; as at 31 December 2022

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