

Global Markets Overview

Asset Research Team

7 March 2023

Portfolio priorities for a surprise-free 2023/24

How can we deliver needed returns, whilst controlling the impacts from economic volatility?

Background

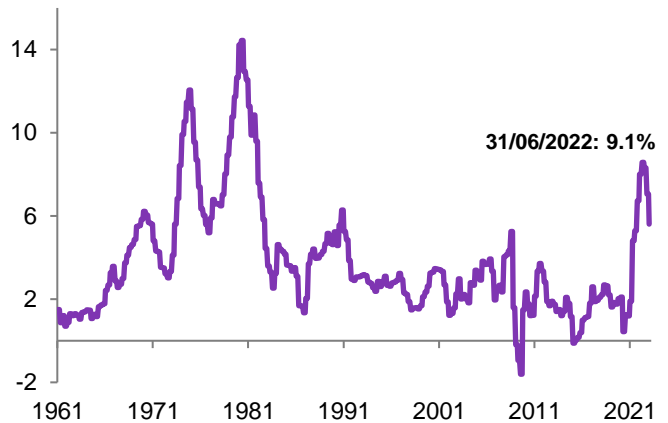
- Demand and supply conditions in the major advanced economies remain out of balance; inflation, interest rates, and growth are likely to remain volatile in 2023/24.
- Asset market pricing implies a rapid fall in inflation to central bank targets, cuts in policy rates, and only a moderate slowdown in economic and corporate earnings growth.
- We think this understates the potential for higher than expected inflation, higher than expected interest rates, and/or lower than expected growth.

Portfolio priorities

- A high return from an equity-bond portfolio over the decade to 2021 was driven by low macro volatility – low and stable inflation, low and stable interest rates, high levels of global liquidity as major central banks ‘printed money’, and steady GDP growth rates across most advanced economies. These macro drivers lowered bond yields and risk premia, supporting returns from both bonds and equities.
- Economic conditions changed abruptly in 2022 – excess demand relative to supply caused high inflation, monetary policy has been tightened aggressively, central banks are withdrawing liquidity, and economic and corporate earnings growth has slowed. The size of these moves has been large. The major economies remain imbalanced; the path back to balance is likely to be volatile; and portfolio responses need to adapt.
- We believe diversity with downside protection and active management continues to be the best way to maximise the chance of investment success.

US headline CPI inflation.

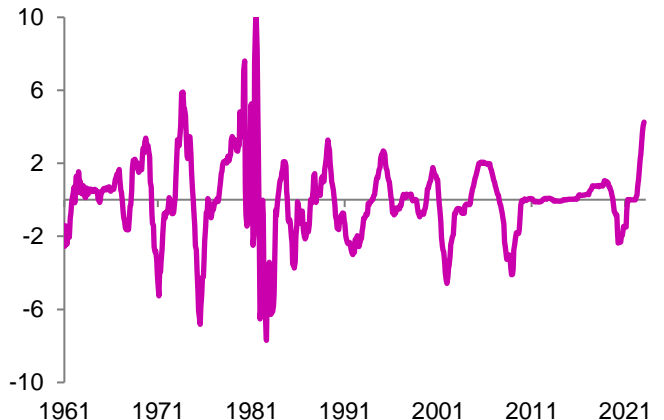
Year-over-year, %



Sources: Refinitiv Eikon, WTW

Rolling 12-month change in the US Federal Funds Rate.

%



Sources: Refinitiv Eikon, WTW

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

28 February 2023

February 28, 2023		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	3.13	0.53	1.10	3.82	3.86	3.00	2.55	2.41
	5y	2.68	0.50	0.72	2.84	3.49	2.54	2.43	2.47
	10y	2.58	0.37	0.61	2.47	3.16	2.51	2.47	2.49
Developed nominal yields	US								
	1y/cash	5.04	0.35	0.30	4.02	4.02	4.66	3.86	3.63
	5y	4.12	0.54	0.27	2.34	3.16	3.84	3.66	3.83
	10y	3.98	0.41	0.18	2.12	2.82	3.87	3.80	3.92
Breakeven infl.	US (CPI)								
	3y	2.55	0.29	0.28	-1.05	1.33	-	-	2.35**
	5y	2.41	0.16	0.15	-0.65	1.12	-	-	2.40
	10y	2.41	0.16	0.26	-0.25	1.05	-	-	2.34

Source: FactSet, WTW; note: **discounted 1y rate, 5 years forward

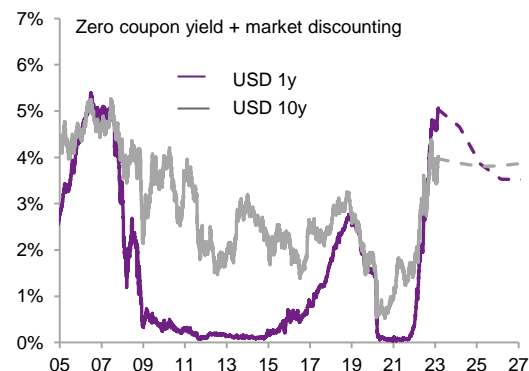
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		<ul style="list-style-type: none"> Central bank guidance remains biased towards higher policy rates in the face of above-target inflation and acceptable growth; key markets are still engaged in hiking cycles.
US		<ul style="list-style-type: none"> 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.
UK		
AAA-Eurozone		
Developed 10-year nominal bonds		<ul style="list-style-type: none"> Intermediate bond yields have risen materially over the past month – reversing their falls in January – as resilient nominal spending and labour market imbalances have led investors to price-in a higher level of policy rates for 2023/24.
US		<ul style="list-style-type: none"> We believe most bond markets are trading within their neutral ranges. In the US, post-covid supply-chain bottlenecks are fading and goods prices have started to decline. However, the labour market remains extremely tight, with the number of open jobs ticking higher in recent months – the opposite of what is required to slow core inflation. Europe has benefited from a material improvement in gas storage levels and a sharp decline in prices, although uncertainty remains. In the UK, inflation is higher and GDP growth lower, which increases the difficulties for the Bank of England in setting policy rates.
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 gradual cuts afterwards; this is plausible but requires inflation to fall rapidly – it may not

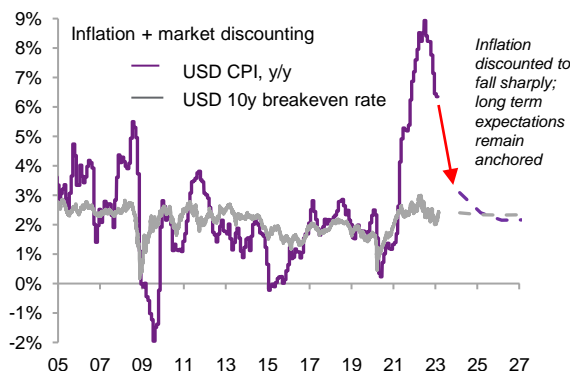
US cash rate and 10y nominal bond yield



Source: FactSet, WTW

US inflation expectations have risen over the past month. We still expect core inflation to slow gradually, and more slowly than markets are pricing

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)

28 February 2023

28 February 2023		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	135	1	-20	-1	8	0.9%	0.0%	-0.5%	0.0%	0.2%
	US	130	5	-12	0	-1	0.8%	0.1%	-0.3%	0.0%	0.0%
	Eurozone	147	-4	-32	-1	33	1.2%	-0.1%	-0.8%	0.0%	0.8%
	UK	168	3	-35	15	25	1.7%	0.1%	-0.9%	0.4%	0.6%
	Canada	157	-9	-22	26	40	1.4%	-0.2%	-0.6%	0.6%	1.0%
	Australia	163	-10	-33	47	66	1.6%	-0.3%	-0.8%	1.2%	1.7%
Low grade	Global HY	454	-6	-54	-4	-44	2.2%	-0.1%	-0.8%	-0.1%	-0.6%
	US HY	422	-8	-33	45	-82	1.7%	-0.1%	-0.5%	0.6%	-1.2%
	Eurozone HY	421	-20	-85	-24	10	2.4%	-0.3%	-1.2%	-0.3%	0.1%
	US loans	507	-1	-41	78	56	3.0%	0.0%	-0.6%	1.1%	0.8%
HC EMD	Hc EMD Corps	270	-2	-52	-94	-37	3.5%	-0.2%	-0.3%	-1.2%	-0.7%
	HC EMD Sov	326	-10	-16	-60	-33	1.5%	0.0%	-0.8%	-1.4%	-0.6%

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

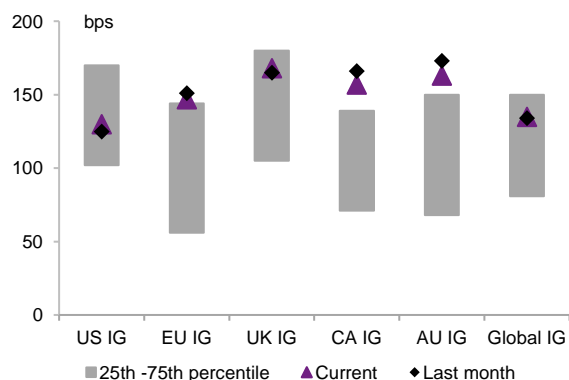
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		
Inv. grade		• The fall in investment grade spreads this year means global corporate credit markets are now pricing in a below average allowance for the level of credit losses over the medium-term, driven primarily by US credit pricing.
High yield		• We expect losses to be at or modestly above these levels, particularly in the nearer term, with risks tilted towards higher losses.
US		• 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.
Europe		
Loans		• We retain a somewhat more 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 especially.
US		• Niche and securitized market pricing appears to be pricing-in a similar outlook, in aggregate, relative to traditional corporate credit markets.

Key: Highly negative Negative Neutral Positive Highly positive

Investment grade spreads rose slightly in the US and fell slightly in Europe over the past month; outside of the US they remain at the higher end of their typical trading range

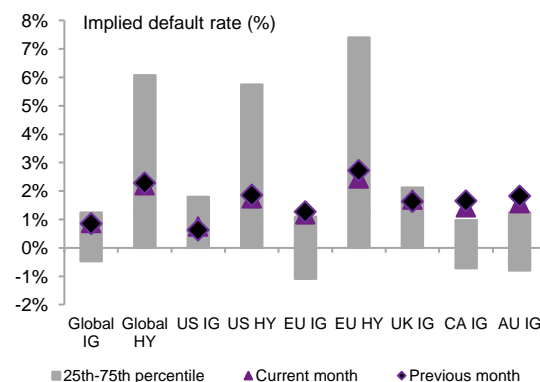
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, WTW

Market implied default rates were relatively unchanged over the past month, with the largest falls in European, Australian, and Canadian markets

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)

28 February 2023

28 February 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	-2.4%	-0.1%	-2.9%	4.7%	9.3%	14.3%	-8.4%	7.9%	8.0%	-6.0%
Canada	-2.1%	0.4%	-2.7%	-4.2%	-1.0%	20.3%	-20.4%	10.7%	11.2%	-5.5%
Eurozone	1.5%	2.4%	-3.1%	5.1%	8.6%	1.6%	-2.3%	10.6%	10.7%	-0.9%
Japan	0.1%	-12.4%	14.3%	4.9%	7.7%	-9.7%	16.2%	12.2%	3.7%	3.1%
UK	2.1%	-0.9%	2.5%	6.5%	10.8%	42.9%	-25.5%	10.3%	13.0%	-8.5%
US	-2.3%	-2.3%	-0.1%	-10.0%	-8.5%	-2.8%	-7.4%	12.0%	9.5%	-2.6%
China	-14.0%	-3.3%	-9.4%	-16.3%	-14.3%	3.1%	-12.5%	-5.8%	-7.1%	-8.1%
MSCI World	-1.5%	-2.2%	-0.3%	-6.4%	-4.4%	-3.6%	-5.5%	11.1%	7.8%	-1.1%
MSCI EM	-6.4%	1.3%	-9.5%	-13.1%	-10.1%	-9.1%	-9.4%	3.5%	3.5%	-6.8%

Source: FactSet, Willis Towers Watson.

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

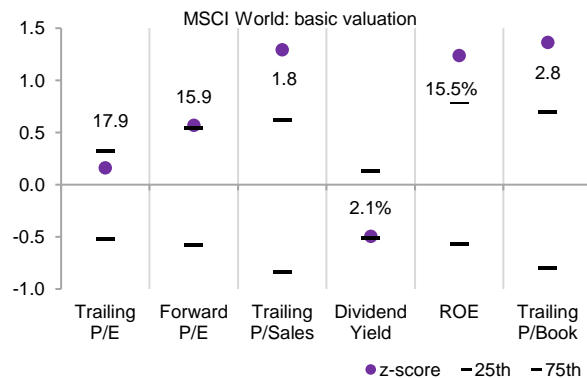
Global equities	Asset return outlook
Developed	
Emerging	

- Equity markets showed more signs of volatility in February, as interest rates rose, in-line with our outlook.
- Earnings are now beginning to show signs of some weakness as the world economy slows. However, the extent of short term risks are still not currently reflected in analyst earnings expectations for 2023, in our view.
- Two aspects are important: (1) future earnings estimates are declining but remain at the higher end of our expectations over the next 1-2 years, considering rising economic risks; and (2) our assessment of the equity price falls in 2022 is that they were mostly caused by rising interest rates, rather than lower growth expectations. Therefore, equities are not pricing-in 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

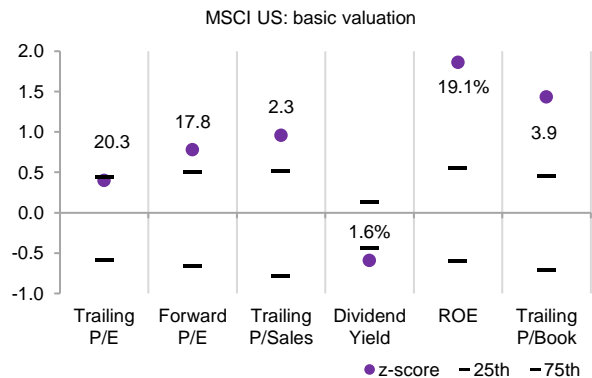
Valuation metrics for the MSCI World equity index



Source: FactSet, WTW

US equity trailing and forward valuations remain high, relative to history, despite the index price fall in 2022

Valuation metrics for the MSCI US equity index



Source: FactSet, WTW

Asset Research Team

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