Global Markets Overview

Asset Research Team

11 April 2023

Observations on the recent banking turmoil

What is next?

Background

- What started with a large but relatively unknown US bank – SVB – which focused on lending to technology companies, spread to Credit Suisse, and then back to First Republic Bank in the US.
- **What caused this?** Each troubled bank had its own specific issues but one common factor is losses on longer duration fixed interest assets. As central banks have increased policy interest rates, bond yields around the world have increased causing the value of these bonds to fall. Many banks, US especially, used a big influx of deposits during the pandemic to buy these bonds, and are now sitting on losses.
- Importantly, these losses are an immediate solvency issue only to the extent that banks are forced to realise them due to a rapid withdrawal of cheap deposits and/or if they exceed capital bases. So far, policymakers have stepped in to guarantee the deposits of the troubled banks. Although, the stock and bond holders in these banks are still exposed to losses.

What are the implications?

- It is not surprising that the rapid tightening in monetary conditions over the last year is continuing to cause funding, profitability, or solvency strains. These were already evident in various sectors, e.g., residential property, technology companies, and some emerging countries.
- The big macro question from the financial events of the last month is if this is likely to repeat or spread into a system-wide banking crisis. While uncertainty is high, our view is this is unlikely.
- Bank capital positions are stronger than they were in 2008, as a direct result of the actions taken after the financial crisis. While some banks will have losses from sharply higher bond yields, this is only a solvency issue if they don't have the capital to tolerate those losses and/or they are forced to sell those bonds before redemption. The most recent datapoints on bank deposit flows and use of emergency funding are encouraging and supportive of this view.
- In this case, investors holdings of bank stocks and bonds, will give them direct exposure to the potential risk of weaker profits from some banks. Although, this exposure should be small in a well diversified portfolio.
- The indirect implications for investors through economic growth, interest rates, and broader market channels are likely to be more significant.
- We expect the ability or willingness of banks to supply credit to fall. Implications? An optimistic take is that this is helpful to central banks as it slows demand and inflation, and allows them to adopt lower policy rate pathways than they otherwise would.
- We need to keep monitoring the datapoints but our recently published Global Investment Outlook provides a scenario framing to help analyse the plausible outcomes:
  - Scenario A: a smooth rebalancing, in which inflation and interest rates fall, and growth slows only moderately. Asset market prices, i.e., bond yields and equity prices, have broadly responded in line with this;
  - Scenario B: macro volatility, in which inflation and interest rates are higher than expected, with weaker growth and/or greater financial instability. We think this is most likely in the short term;
  - Scenario C: a major recession; if this is just the start of a wider banking or liquidity crisis, the policy battle will be to limit the severity of the recession and equity/credit drawdowns which would surely result.

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

31 March 2023

March 31, 2023 % / %pts		Spot yields Level	∆ 1m	∆ 3m	∆ 1y	∆ 3y	What's priced-in 1y fwd	2y fwd	5y fwd
Developed nominal yields	**Eurozone**								
	1y/cash	2.86	-0.28	0.37	3.34	3.59	2.46	2.17	2.11
	5y	2.32	-0.36	-0.15	1.96	3.00	2.17	2.11	2.22
	10y	2.27	-0.31	-0.20	1.78	2.71	2.21	2.20	2.28
	US								
	1y/cash	4.62	-0.42	-0.12	2.96	4.50	3.60	3.23	3.41
	5y	3.59	-0.53	-0.35	1.08	3.13	3.34	3.33	3.61
	10y	3.59	-0.38	-0.33	1.34	2.87	3.52	3.54	3.73
Breakeven infl.	**US (CPI)**								
	3y	2.22	-0.45	-0.02	-1.63	2.29	-	-	2.27**
	5y	2.20	-0.28	-0.04	-1.05	1.82	-	-	2.25
	10y	2.23	-0.21	0.03	-0.58	1.41	-	-	2.17

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

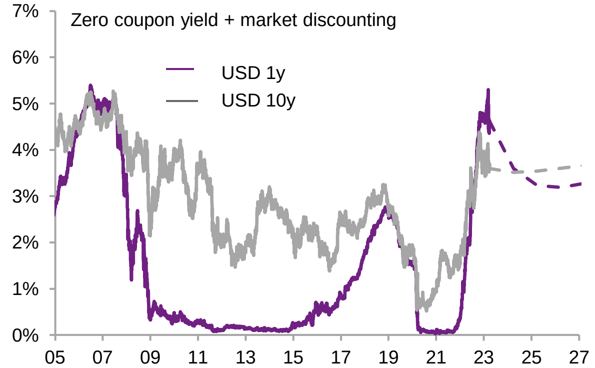
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		• Central bank guidance remains biased towards keeping interest rate policy restrictive in the face of above-target inflation and tight labor markets. • Policymakers were quick to extend support to the banking sector following recent volatility. While they acknowledge uncertainty, central banks see the wider system as being resilient. • Short rates have fallen significantly in recent weeks. We think they under-reflect how high interest rates will need to stay to bring inflation down sustainably.
US		
UK		
AAA-Eurozone		
Developed 10-year nominal bonds		• Intermediate bond yields have also dropped sharply. Rates markets have reacted, first, to banking sector concerns catalysed by SVB's collapse and, second, to weakening economic data, e.g., recent manufacturing surveys. • Though we believe rates are trading in a neutral range from a medium-term perspective, we believe that they currently lie in the lower half of that range, with risks skewed towards bond yields rising in the near term. • Cooling growth, post-covid supply-chain bottlenecks fading, and lower gas prices in Europe should benefit global inflation dynamics. However, labour markets are tight and wages and services inflation remain high across key markets. Our view is that inflation is likely to prove stickier than markets expect, which may place upwards pressure on yields.
US		
UK		
AAA-Eurozone		

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

US Treasury bond yields are now pricing-in significant rate cuts during the second half of this year and next year. This is only likely if inflation and economic growth slow quickly

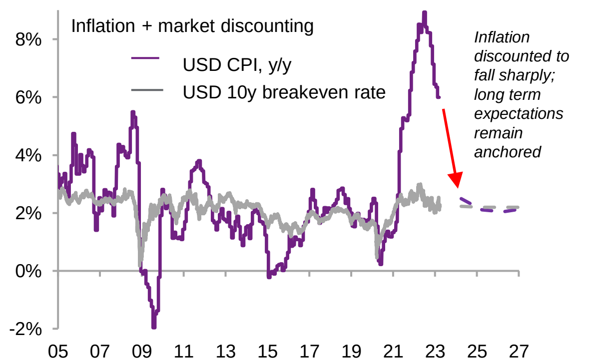
US cash rate and 10y nominal bond yield



Source: FactSet, WTW

US inflation expectations have fallen in recent weeks. We believe that risks are tilted towards stickier inflation than markets are pricing-in

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 2023

31 March 2023		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	153	19	5	28	-129	1.3%	0.5%	0.1%	0.7%	-3.2%
	US	145	20	7	23	-160	1.1%	0.5%	0.2%	0.6%	-4.0%
	Eurozone	168	17	1	39	-70	1.7%	0.4%	0.0%	1.0%	-1.8%
	UK	191	26	-3	46	-74	2.3%	0.7%	-0.1%	1.2%	-1.9%
	Canada	180	14	6	33	-75	2.0%	0.4%	0.2%	0.8%	-1.9%
	Australia	184	11	-6	47	22	2.1%	0.3%	-0.2%	1.2%	0.6%
Low grade	Global HY	501	41	-14	89	-414	2.9%	0.6%	-0.2%	1.3%	-5.9%
	US HY	458	28	-23	115	-419	2.3%	0.4%	-0.3%	1.6%	-6.0%
	Eurozone HY	474	33	-24	74	-280	3.2%	0.5%	-0.3%	1.1%	-4.0%
	US loans	524	16	-35	94	-294	3.2%	0.2%	-0.5%	1.3%	-4.2%
HC EMD	HC EMD Corps	310	38	15	7	-287	4.1%	0.4%	0.4%	0.7%	-4.4%
	HC EMD Sov	355	19	22	33	-218	2.2%	0.6%	0.2%	0.1%	-4.4%

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

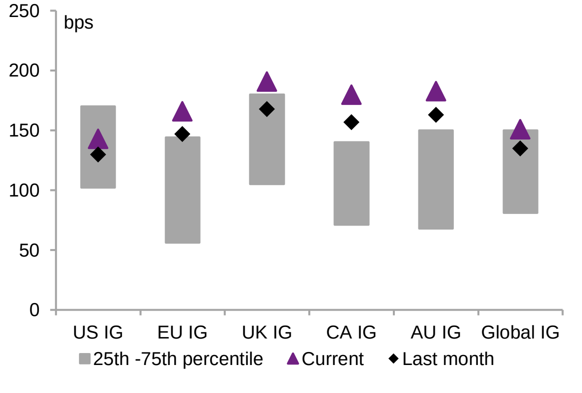
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		• Spreads widened in all aggregate corporate and sovereign credit markets in March. High grade spreads are now pricing an average allowance for the level of credit losses over the medium-term in the US, with an above average allowance in non-US markets. • 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. • We retain a somewhat cautious outlook for developed market low-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 a similar outlook in aggregate, relative to traditional corporate credit markets.
Inv. grade	Neutral	
High yield	Neutral	
US	Neutral	
Europe	Neutral	
Loans	Neutral	
US	Neutral	

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

Investment grade spreads widened over the past month, as bank and economic risks rose. Outside of the US they remain at or above their typical historic ranges

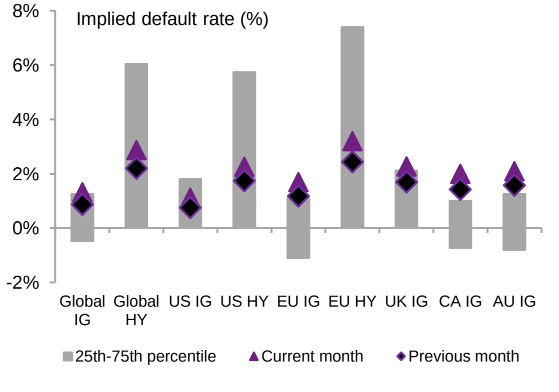
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, WTW

Market implied credit default rates also increased moderately, across all geographies and credit qualities

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 2023

31 March 2023	∆ 1 month			∆ 1 year				∆ 3 years (pa)		
	Total return	EPS	Trailing P/E	Price return	Total return	EPS	Trailing P/E	Total return	EPS	Trailing P/E
Australia	0.0%	-0.1%	0.0%	-2.0%	1.8%	14.4%	-14.3%	16.7%	8.1%	-6.0%
Canada	0.1%	-0.2%	0.3%	-7.3%	-4.5%	17.8%	-21.3%	17.7%	11.0%	-5.4%
Eurozone	-0.5%	0.1%	0.0%	5.5%	8.9%	1.7%	-0.5%	17.5%	10.7%	-0.9%
Japan	0.2%	-0.1%	0.3%	1.1%	2.8%	-11.1%	13.8%	15.0%	3.6%	3.2%
UK	0.5%	-0.1%	0.5%	5.6%	9.0%	42.2%	-25.8%	15.9%	12.9%	-8.3%
US	-0.5%	-0.3%	-0.2%	-13.4%	-12.0%	-3.3%	-10.4%	16.9%	9.5%	-2.6%
China	4.5%	0.3%	3.6%	-5.1%	-2.9%	3.3%	-1.8%	-2.1%	-6.4%	-7.1%
MSCI World	-0.3%	-0.3%	0.1%	-9.4%	-7.6%	-4.2%	-7.4%	16.2%	7.6%	-1.1%
MSCI EM	1.9%	0.7%	1.4%	-9.3%	-6.5%	-1.0%	-12.9%	9.1%	3.7%	-6.3%

Source: FactSet, Willis Towers Watson.

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

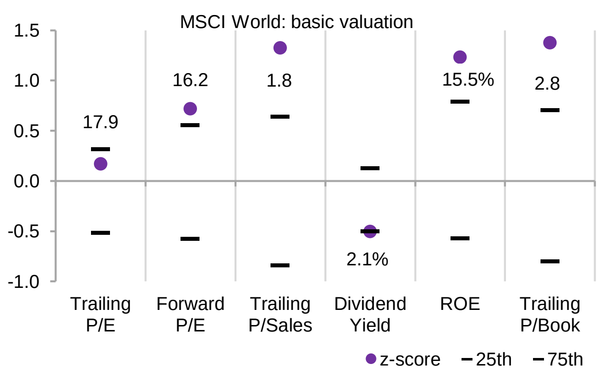
Global equities	Asset return outlook
Developed	
Emerging	

- Equity markets were broadly flat over March, despite the intra-month volatility caused by US and European banking stresses, with emerging markets outperforming developed markets.
- Earnings are now beginning to show some signs of weakness as the world economy slows; however, the extent of short term risks are still not currently reflected in analyst earnings expectations for 2023.
- 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

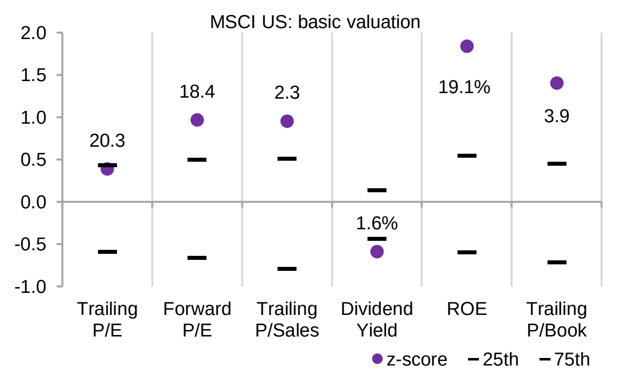
Valuation metrics for the MSCI World equity index



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

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