

Global Markets Overview

Asset Research Team

May 2023

Portfolio priorities for a surprise-free future

Coping with the current top-down environment

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. We believe **diversity** with **downside protection** and **active management** continues to be the best way to maximise the chance of investment success.

Diversify

Macro volatility remains an important theme, supporting portfolio diversification. The exceptional returns from a mix of equities and bonds over the decade to 2021 were driven by low macro volatility, whereas economic imbalances suggest ongoing market volatility. Many investors could still benefit from diversifying equity risk. Simple ways of doing so include investing in alternative credit, hedge funds, and real assets.

Downside risk hedging at the right price

Downside risk hedging is the process of analysing which tail events you would like to protect your portfolio against and adding exposures that will provide a payoff if such a tail event occurs. Using 'real world' scenario analysis to understand the range of outcomes is a useful approach. We think that such scenarios should focus on the next two years and cover:

- **Macro volatility.** Wages and inflation are more sticky and higher interest rates for longer are required, despite the negative impact on growth.
- **Major recession.** The size of monetary tightening causes a deep downturn; labour imbalances, inflation, and interest rates fall more quickly.

Taking advantage of downside risk hedging in an environment of high volatility should support strong return potential.

Opportunities for alpha

The macro outlook for 2023/24 is highly uncertain. High macro volatility typically leads to high return differentiation across and within asset classes. In these conditions, the return from skilled active management can be outsized. For example, multi-strategy hedge funds can take advantage of this macro divergence and add downside protection to portfolios during equity falls.

Diversifying exposure to specific risk factors and the economic cycle is one thing, stock diversification is another. High macro and policy uncertainty typically drives greater variation in industry and stock returns due to the different directional impacts of policy. In the US and Europe, cyclical wage and financial tightening pressures will also increase the importance of company-specific factors, e.g., profit margins or leverage. Over the longer-term, this will be compounded by the profound thematic changes that are underway, whether this is a transition to a lower carbon economy or extraordinary changes in computing related technologies, e.g., microelectronics, quantum computing, and artificial intelligence. Our outlook for lower average stock correlation and high volatility amplifies the gross potential alpha from concentrated high-conviction equity portfolios.

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

30 April 2023

April 30, 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	3.04	0.18	0.39	3.30	3.69	2.37	1.95	2.20
	5y	2.27	-0.10	-0.03	1.59	3.06	2.11	2.09	2.31
	10y	2.29	-0.02	0.03	1.42	2.85	2.23	2.23	2.35
	US								
	1y/cash	4.78	0.16	0.08	2.76	4.66	3.47	2.96	3.37
5y	3.47	-0.17	-0.16	0.49	3.07	3.18	3.20	3.64	
10y	3.54	-0.11	-0.06	0.70	2.90	3.46	3.50	3.76	
Breakeven infl.	US (CPI)								
	3y	2.29	-0.13	0.07	-1.61	2.07	-	-	2.26**
	5y	2.28	-0.09	0.05	-1.01	1.59	-	-	2.21
	10y	2.25	-0.08	0.03	-0.68	1.22	-	-	2.17

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

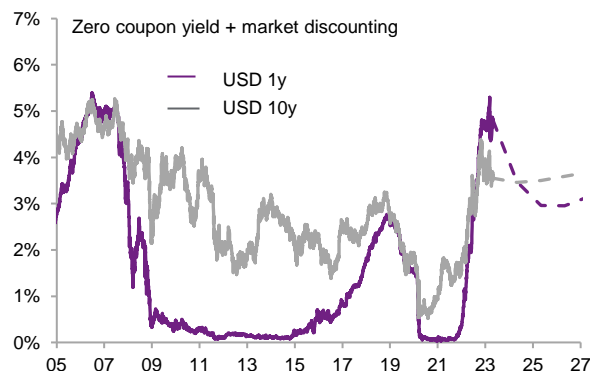
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		<ul style="list-style-type: none"> Central bank guidance remains biased towards keeping interest rate policy restrictive in the face of above-target inflation and tight labor markets.
US		<ul style="list-style-type: none"> 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.
UK		<ul style="list-style-type: none"> Short rates have shown a modest recovery in the past month. Absent a recession, we think they under-reflect how high interest rates will need to stay to bring inflation down sustainably.
AAA-Eurozone		
Developed 10-year nominal bonds		<ul style="list-style-type: none"> A downward trend has been observed in intermediate yields with some volatility. 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.
US		<ul style="list-style-type: none"> 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.
UK		<ul style="list-style-type: none"> 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.
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

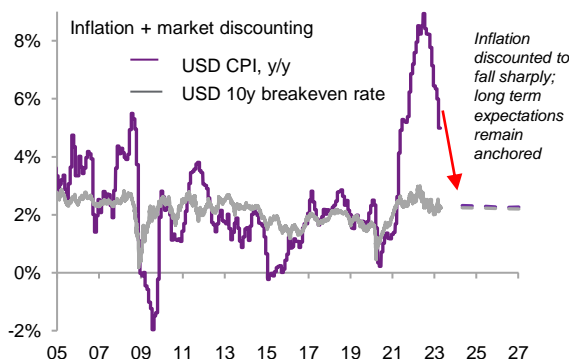
US cash rate and 10y nominal bond yield



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

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)

30 April 2023

30 April 2023		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	147	-6	13	4	-62	1.2%	-0.2%	0.3%	0.1%	-1.6%
	US	141	-4	16	0	-76	1.0%	-0.1%	0.4%	0.0%	-1.9%
	Eurozone	161	-7	10	11	-22	1.5%	-0.2%	0.3%	0.3%	-0.6%
	UK	173	-18	8	8	-34	1.8%	-0.5%	0.2%	0.2%	-0.9%
	Canada	168	-12	2	13	-36	1.7%	-0.3%	0.0%	0.3%	-0.9%
	Australia	178	-6	5	32	7	2.0%	-0.2%	0.1%	0.8%	0.2%
Low grade	Global HY	501	0	41	49	-282	2.9%	0.0%	0.6%	0.7%	-4.0%
	US HY	453	-5	23	56	-310	2.2%	-0.1%	0.3%	0.8%	-4.4%
	Eurozone HY	479	5	38	25	-155	3.3%	0.1%	0.5%	0.4%	-2.2%
	US loans	516	-8	7	100	-189	3.1%	-0.1%	0.1%	1.4%	-2.7%
HC EMD	Hc EMD Corps	306	-4	34	6	-212	4.1%	0.0%	0.4%	0.0%	-3.0%
	HC EMD Sov	355	0	19	0	-149	2.1%	-0.1%	0.5%	0.1%	-3.3%

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

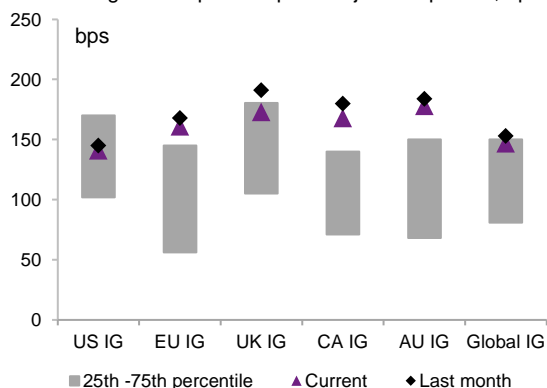
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		<ul style="list-style-type: none"> Investment grade spreads continue to price in a below average allowance for credit losses over the medium-term.
Inv. grade		<ul style="list-style-type: none"> We expect losses to be at or modestly above these levels, particularly in the nearer term, with risks tilted towards higher losses.
High yield		<ul style="list-style-type: none"> At current credit spreads, high quality credit assets are at levels at which they are likely to provide moderate returns above equivalent 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 average pricing.
Europe		
Loans		<ul style="list-style-type: none"> Niche and securitized market pricing appears to be pricing-in similar outlook in aggregate, relative to traditional corporate credit markets.
US		

Key: Highly negative Negative Neutral Positive Highly positive

Investment grade spreads came in slightly over the past month. Outside of the US, spreads above historic interquartile ranges

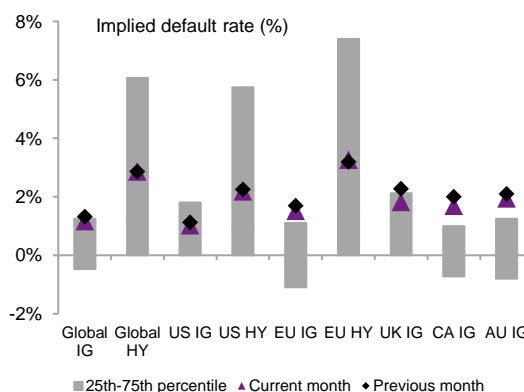
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, WTW

Market implied default rates decreased modestly over the past 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 2023

30 April 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%	0.0%	2.4%	-0.9%	4.1%	14.3%	-13.3%	14.5%	8.3%	-5.9%
Canada	4.1%	-0.2%	4.0%	-0.1%	3.3%	12.4%	-11.2%	15.1%	9.3%	-3.3%
Eurozone	2.4%	-0.5%	3.3%	11.7%	15.6%	2.4%	14.1%	16.7%	11.8%	1.1%
Japan	3.8%	0.3%	3.5%	7.1%	10.1%	-12.5%	22.4%	14.9%	3.0%	4.8%
UK	3.7%	0.6%	2.8%	4.3%	8.3%	47.2%	-29.2%	14.8%	14.8%	-9.8%
US	2.8%	-0.1%	2.8%	0.2%	1.9%	-3.4%	3.7%	14.2%	9.5%	-1.1%
China	-4.6%	-0.3%	-3.8%	-7.1%	-4.9%	-4.5%	1.5%	-5.8%	-9.1%	-6.2%
MSCI World	2.9%	-0.4%	3.2%	1.4%	3.7%	-4.5%	6.2%	14.1%	7.8%	0.4%
MSCI EM	-0.3%	-0.9%	0.0%	-6.7%	-3.5%	-3.0%	-6.5%	5.9%	3.8%	-6.1%

Source: FactSet, Willis Towers Watson.

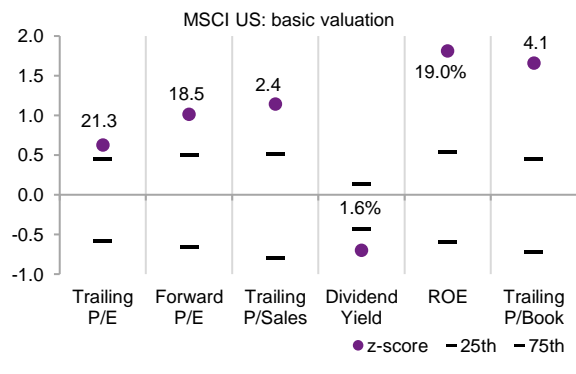
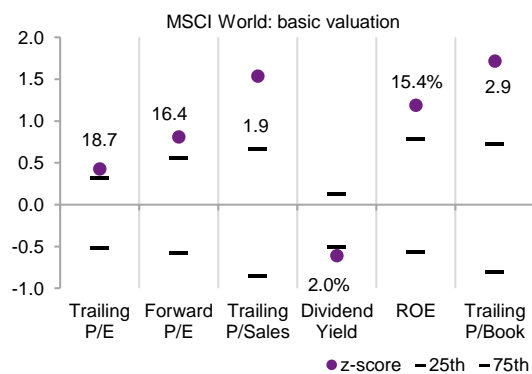
A summary of our assessment of equity pricing and prospective medium-term outcomes

Global equities	Asset return outlook
Developed	<ul style="list-style-type: none"> Developed equity markets were slightly positive over the month. Earnings are now beginning to show 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 equity price declines year-to-date is that they have mostly been 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.
Emerging	

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 (left) and MSCI US (right)



Source: FactSet, WTW

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