

Imbalances rebalancing? Inflation falling faster than growth over 2023 so far

In recent months and quarters, developments in the range of economic indicators we track suggest that most advanced economies are rebalancing supply and demand in a gradual manner, allowing a steady decline in underlying inflation pressure. Whilst growth is also cooling, it has been doing so at a slower rate than inflation. This is a positive development for the economic outlook because it suggests the chance of a smooth decline in inflation without the need for a recession – an economic “soft landing” – have increased somewhat.

To be clear, risks remain elevated of a more significant slowing in economic activity given the rapid increase in central bank policy rates seen over the past 18 months. There also remains a risk of more persistent inflation in this cycle than seen in recent decades.

So, whilst the global economy is not yet “out of the woods”, the direction of travel is encouraging at the margin. What follows is a review of a few key indicators to illustrate this, with a focus on the critical US economy.

Labour market

- Labour markets in most advanced economies have remained resilient but show signs of moving back into balance. In the US, recent data show a tick up in the unemployment rate, driven not by layoffs but a return of individuals to the labour market. Employment growth in many advanced economies suggests strength. Wage growth is still high, but in many places declining.
- While conditions remain robust which could keep inflation high, the imbalance between supply and demand in labour markets is generally adjusting towards balance. In the US, the supply of labour has been increasing while job openings have declined. Similar trends are playing out in other markets.

Economic growth

- GDP growth in the US over 2023 has been bolstered by robust consumer spending and improving sentiment, consistent with the strong labour market.

- Surveys of businesses across developed western economies are suggesting a slowing in growth to low levels, and in the US, the boost to growth from running down excess savings may have largely played out..

Inflation

- The cooling of headline inflation has progressed steadily in most advanced economies over 2023, driven by energy and goods prices.
- However, despite this decline, in advanced economies underlying inflation dynamics still have a way to go before central bankers will be content.
- This can be observed in US core inflation (ex food and energy), which has been driven by services and particularly shelter costs in the recent past. Shelter inflation will likely continue to decline, but services ex shelter inflation has shown early signs of becoming “stuck” in the 3-4% range. The outlook for the labour market and wages is critical in this regard, given wages are a key component of services ex shelter costs.
- There remains a risk of more persistent inflation in this cycle than seen in recent decades, so whilst inflation may feature less in the headlines in the near term, it is something we will keep watching closely.

Implications for portfolio strategy

Despite incrementally positive developments, in our view the economic and market backdrop continues to support a slightly cautious approach to risk:

- Current equity prices appear to be discounting a benign economic outcome and leave little room for a more significant slowing in activity to allow inflation to normalise.
- In the near term, developed bond yields face some upside risks despite being relatively elevated, but this represents a pathway risk in our assessment. With a medium-term horizon, building exposure to bonds at these levels, particularly to protect portfolios from downside shocks, looks sensible.

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

31 August 2023

August 31, 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	3.29	-0.04	0.32	2.54	3.93	2.59	2.17	2.22
	5y	2.44	-0.05	0.20	1.10	3.09	2.22	2.17	2.43
	10y	2.43	-0.02	0.18	0.92	2.82	2.37	2.38	2.56
	US								
	1y/cash	5.30	-0.01	0.18	1.81	5.23	4.52	3.80	3.91
5y	4.19	0.08	0.49	0.96	3.79	3.91	3.83	4.16	
10y	4.18	0.17	0.44	0.87	3.47	4.08	4.06	4.26	
Breakeven infl.	US (CPI)								
	3y	2.20	0.00	0.14	-0.40	0.58	-	-	2.22**
	5y	2.24	-0.02	0.15	-0.38	0.52	-	-	2.27
	10y	2.26	-0.04	0.08	-0.16	0.51	-	-	2.41

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

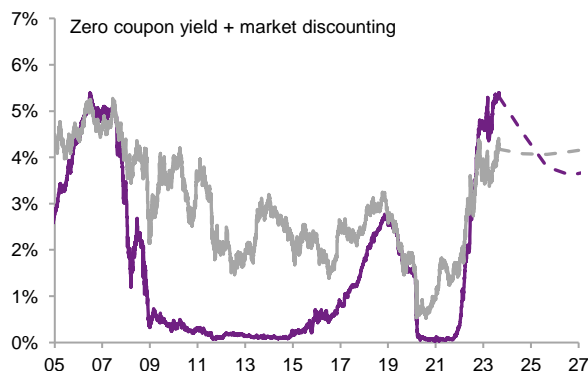
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		
US		• Central bank guidance remains biased towards keeping interest rate policy restrictive in the face of above-target inflation and tight labor markets.
UK		• Policymakers were quick to extend support to the banking sector following volatility in Q1. While they acknowledge uncertainty, central banks see the wider system as being resilient.
AAA-Eurozone		• Short rates in the US have risen notably in recent months. While there is a risk that they climb further, pricing appears more consistent with inflation pressures.
Developed 10-year nominal bonds		
US		• Bond markets have been volatile in the face of falling but sticky inflation and weakening, albeit mixed, economic data. However, the net trajectory of yields has been upwards over the past few months. Major central banks have reiterated the potential for further hikes.
UK		• We expect volatility to continue, although the pricing of 10-year bonds (ex. UK) appears to be in a neutral range from a medium-term perspective. Cooling growth, post-covid supply-chain bottlenecks fading, and lower energy prices should benefit global inflation dynamics, but labour markets are tight, and wage and services inflation remain high.
AAA-Eurozone		• In the UK, we expect hiking-induced growth stresses to eventually lower longer-term rates. In the US, we have a bias towards TIPS as breakeven pricing under-reflects inflation risks.

Key: Highly negative Negative Neutral Positive Highly positive

US Treasury bond yields are pricing-in significant rate cuts next year. This is possible, but requires inflation and economic growth to slow

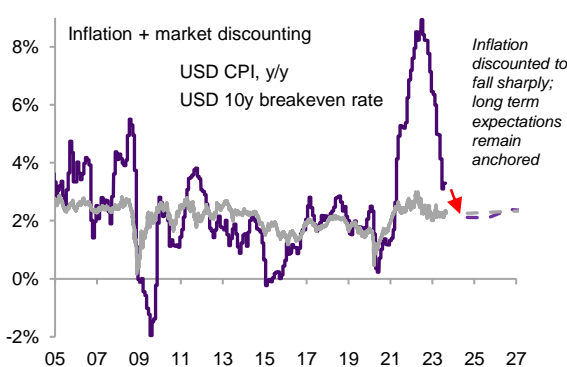
US cash rate and 10y nominal bond yield



Source: FactSet, WTW

US inflation expectations imply a sustained return to target. 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)

31 August 2023

31 August 2023		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	133	4	-17	-28	1	0.8%	0.1%	-0.4%	-0.7%	0.0%
	US	122	3	-20	-26	-14	0.6%	0.1%	-0.5%	-0.7%	-0.4%
	Eurozone	155	8	-14	-43	41	1.4%	0.2%	-0.4%	-1.1%	1.0%
	UK	159	4	-16	-43	14	1.5%	0.1%	-0.4%	-1.1%	0.4%
	Canada	161	2	-8	-5	21	1.5%	0.0%	-0.2%	-0.1%	0.5%
	Australia	152	-11	-20	-20	42	1.3%	-0.3%	-0.5%	-0.5%	1.1%
Low grade	Global HY	430	7	-80	-132	-90	1.9%	0.1%	-1.1%	-1.9%	-1.3%
	US HY	385	6	-84	-118	-117	1.2%	0.1%	-1.2%	-1.7%	-1.7%
	Eurozone HY	450	12	-33	-103	4	2.9%	0.2%	-0.5%	-1.5%	0.1%
	US loans	480	-7	-61	#N/A	-19	2.6%	-0.1%	-0.9%	#N/A	-0.3%
HC EMD	Hc EMD Corps	264	8	-36	-70	-78	3.3%	0.4%	-0.7%	-1.3%	-0.5%
	HC EMD Sov	317	18	-35	-64	-23	1.4%	0.1%	-0.6%	-1.1%	-1.2%

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

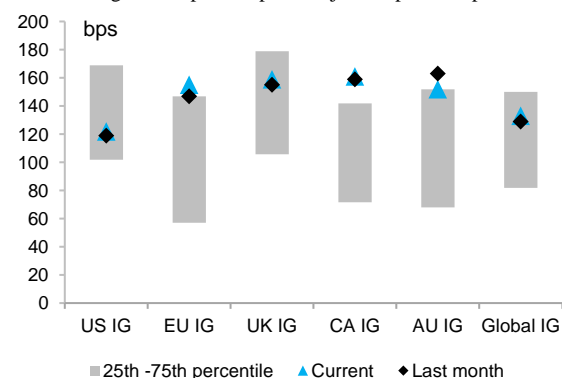
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		<ul style="list-style-type: none"> Investment grade spreads are pricing in a modestly below average allowance for the level of 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 broadly widened over the past month, outside of the US they remain beyond the upper end of their interquartile ranges

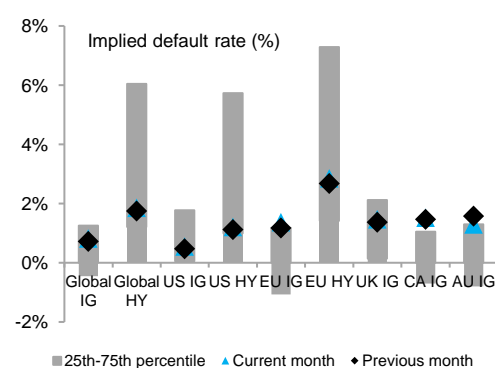
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, WTW

Market implied default rates increased 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)

31 August 2023

31 August 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	-0.4%	-9.5%	9.2%	5.7%	11.2%	-7.5%	14.2%	11.7%	13.9%	-3.0%
Canada	-1.4%	-2.0%	0.2%	5.9%	9.6%	-7.0%	13.9%	10.6%	22.1%	-1.5%
Eurozone	-3.3%	0.7%	-5.5%	19.5%	23.4%	12.2%	14.9%	12.3%	31.8%	-2.9%
Japan	0.0%	21.4%	-17.7%	18.4%	21.6%	25.2%	-5.5%	15.9%	29.3%	-0.7%
US	-1.7%	0.6%	-2.4%	13.8%	15.8%	-6.4%	21.6%	9.9%	16.2%	2.3%
China	-8.3%	-0.9%	-6.3%	-8.8%	-6.6%	3.7%	-7.8%	-13.5%	-3.2%	-8.0%
MSCI World	-1.7%	2.4%	-4.9%	12.7%	15.3%	0.3%	13.3%	10.3%	19.6%	0.8%
MSCI EM	-4.7%	-5.3%	-1.1%	-0.3%	2.8%	-13.0%	13.3%	1.0%	8.3%	-3.2%

Source: FactSet, Willis Towers Watson.

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

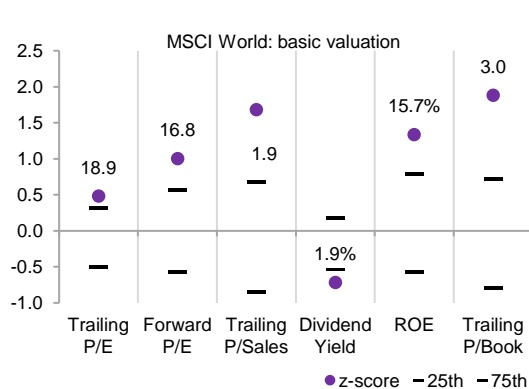
Global equities	Asset return outlook
Developed	Neutral
Emerging	Positive

- Equity markets generally moved higher over the month and were up strongly over the first half of 2023.
- Earnings are showing signs of gradual weakness in response to rapidly tighter monetary policy and deteriorating fundamentals. However, valuation increases more than offset this earnings weakness suggesting the market believes this deterioration is temporary.
- 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) increased interest rates in recent months may begin to place downward pressure on valuations as well as the wider economy. Overall, equities continue to 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.

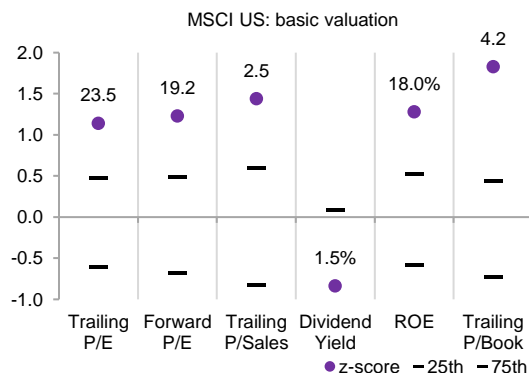
Key: Highly negative Negative Neutral Positive Highly positive

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



Source: FactSet, WTW

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