

A scan of monetary policy settings for the major advanced economies

United States

- **No change in the US Fed Funds Rate but a hawkish message.** In its September meeting, the Federal Reserve kept its target range for the U.S. policy rate unchanged at 5.25-5.5%. However, it emphasised there may be another rate increase this year and it expects to keep rates higher for longer to bring inflation down. The Fed's 20 September dot plot – its guidance for future rates – shows fewer cuts in 2024 and 2025 compared to its June outlook.
- Inflationary pressures remain marked, while economic growth signals were mixed – the job market remains strong but an S&P Global survey of business conditions indicated a broad stagnation in economic activity. 10-year Treasury yields rose sharply in September (+ c. 0.46% to 4.57%). U.S. and world stock indices ended the month lower.
- As we moved into October 10-year Treasury yields reached 4.89%, levels last seen in 2007, and 30-year yields touched 5.05%. This tightening of US financial conditions, through higher bond yields, may lower the likelihood of an additional 0.25% Fed rate hike.

Japan

- **In a sign of increasing pressure to unwind its yield curve control, the Bank of Japan made an unscheduled purchase of \$12.7 billion of Japanese government bonds** to prevent yields from rising excessively. This has the potential to create further volatility in bond markets as Japanese investors are the largest foreign holders of US Treasuries; with the risk that they may choose to repatriate these given improved domestic yields.

Euro Area

- In the Eurozone, the ECB increased its policy interest rates by 25bps in September. While this was not fully priced-in by money markets, it had little impact on short-term bond yields so, ultimately, it did not

represent a major surprise. Persistently high inflation in the Eurozone remains the ECB's focus, despite a weakening economy.

United Kingdom

- **5-4!** In a close decision, the Bank of England kept its benchmark rate unchanged at 5.25%. However, the policy committee also agreed unanimously to sell GBP 100 billion of its holdings of UK government bonds over the next year, a further tightening of broader monetary policy and an increase over the prior annual pace of GBP 80 billion.
- This is consistent with their statement that "monetary policy would need to be sufficiently restrictive for sufficiently long to return inflation to the 2 percent target." This restrictive stance is bringing inflation down – U.K. core inflation fell to 6.2% in August from 6.9% in July. However, it is also slowing the economy, which we expect to continue. September's U.K. composite PMI fell to a 32-month low of 46.8, a level that indicates contraction. UK 10-year gilt yields rose slightly in September, while sterling fell sharply versus the dollar.

Canada

- In early September, the Bank of Canada announced it had held its target for the overnight rate at 5%. The Bank is also continuing its policy of quantitative tightening. This is despite economic growth slowing sharply in the 2Q'23, with output contracting by 0.2% at an annualized rate. The Bank's statement highlighted "broad-based" inflationary pressures, with wage growth remaining around 4% to 5%.

Australia

- The Reserve Bank of Australia maintained interest rates at 4.1% at their October meeting. While goods inflation has eased, the bank noted services and fuel prices remain concerning, leaving the door open to further tightening.

Government bonds

At current yield levels we believe government bonds offer downside protection

What happened over the past month:

Global bond yields surged higher, led by the US. 10-year US Treasury yields are at cyclical highs (c. 4.6%) as are real rates (c. 2.2%), which adjust for expected inflation. Among other markets, Canadian and Australian bonds moved roughly in line with the US while Japanese and UK bonds moved less.

Factors influencing market trends:

Continued strength in labour markets and inflation data have led investors to raise their expectations for how long policy rates need to remain elevated – a key driver of bond yields. These have been reinforced by central bank policymakers. US Fed members revised up their policy rate forecasts last month.

Bond supply and demand dynamics have also played a critical role. Central banks have gone from buying bonds to unwinding past purchases. At the same time, fiscal deficits remain historically wide. This has meant more government bond issuance needs to be absorbed by private investors placing downwards (upwards) pressure on prices (yields).

Looking ahead:

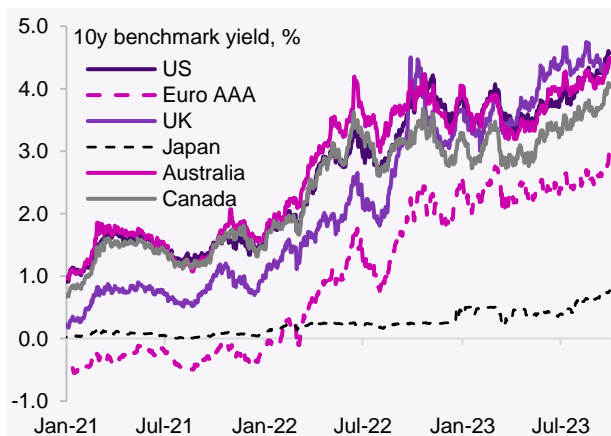
Yields may continue to trend higher in the short run given the above drivers. However, as more consumers and businesses are confronted with higher borrowing costs, we expect economic headwinds and downside risks. **Over 2-3 years, we think it is probable that bond yields (prices) fall (rise) relative to current levels were these risks to materialise**, protecting return-seeking portfolios.

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 volatility in Q1. While they acknowledge uncertainty, central banks see the wider system as being resilient. 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.
UK		
AAA-Eurozone		
Developed 10-year nominal bonds		<ul style="list-style-type: none"> 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.
US		<ul style="list-style-type: none"> 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. 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.
UK		
AAA-Eurozone		

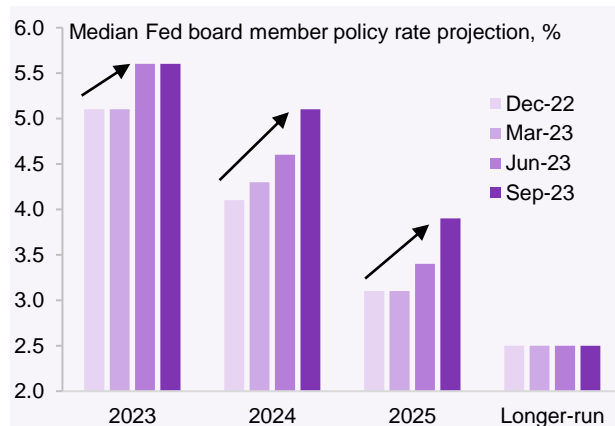
Key: Highly negative Negative Neutral Positive Highly positive

Global 10-year benchmark nominal bond yields



Source: Refinitiv Eikon, WTW

US Fed FOMC members raised their projections of future policy rates again in September



Source: Federal Reserve, WTW

Corporate credit

High quality credit assets are likely to provide moderate returns above equivalent government bonds over the medium term

What's happened over the past month:

Global investment grade and speculative grade credit spreads widened modestly, led by the US. US investment grade spreads widened by c. 3bps to 125 bps; US speculative grade spreads followed a similar trajectory widening by c. 18bps over the month to 403bps. In the UK and Europe, corporate credit spreads were flat over the month with European high yield spreads tightening very modestly.

What has influenced recent market dynamics?

Relatively healthy interest coverage ratios and a notable phase of corporate issuers terming out their debt maturities (prior to the recent rate hiking cycle) has, somewhat, cushioned corporate credit markets from cyclical pressures to the global economy. The corporate default cycle has been more muted as a result. Recent economic data surprises to the upside have reinforced the optimism built into corporate credit pricing.

Our forward-looking expectations:

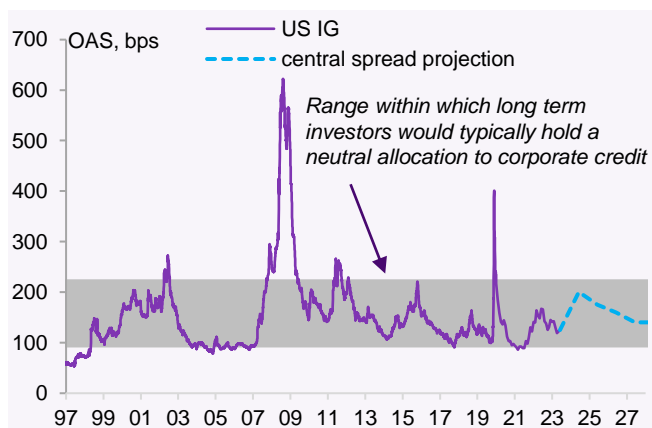
We expect corporates to feel the pain of higher borrowing costs eventually. Investment grade spreads are pricing in a moderately above average allowance for the level of credit losses over the medium-term, with important differences between tighter US and higher world ex-US spreads. We expect losses to be at or modestly above these levels, particularly in the nearer term, with risks tilted towards higher losses. We retain a cautious outlook for developed market speculative-grade credit given the prevalence of nearer-term cyclical risks.

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

Credit	Asset return outlook	Comments
Corporate credit		
Inv. grade		• Investment grade spreads are pricing in a moderately above average allowance for the level of credit losses over the medium-term. We expect losses to be at or modestly above these levels.
High yield		• 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		• We retain a 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		
US		• Niche and securitized market pricing appears to be pricing-in similar outlook in aggregate, relative to traditional corporate credit markets.

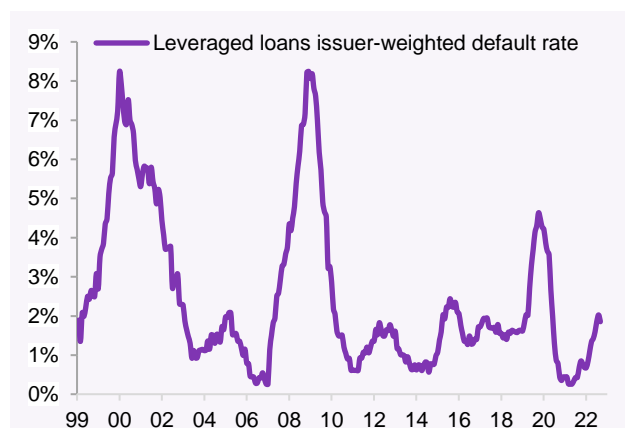
Key: Highly negative Negative Neutral Positive Highly positive

Global investment grade spreads



Source: FactSet, WTW

Despite cyclical risks, actual defaults have remained relatively muted



Source: SP LCD, WTW

Equities

Equities look expensive

What happened over the past month:

Global equities declined significantly in September, the worst month of the year. Emerging markets fell but outperformed developed markets for the month and quarter despite economic weakness in China. In our view, market concern over hawkish Central Bank rhetoric was the primary driver of risk-off sentiment and the price decline.

Factors influencing broad market trends:

Equity earnings have been weaker than usual over the year to date. Looking to forward earnings, both analyst earnings estimates and market pricing imply that earnings have troughed in aggregate. Our assessment of economic fundamentals leads us to a more cautious view: while a "soft landing" is possible, we see estimates and current pricing as on the optimistic side of our expectations.

Two aspects are important: (1) future earnings estimates are at the higher end of our expectations over the next 1-2 years, considering rising economic risks; and (2) increased interest rates in recent weeks may begin to place downward pressure on valuations as well as wider economic activity. Overall, equities are likely to continue to face near term downside risks if growth weakens and/or earnings expectations get revised down.

Looking ahead:

We continue to see value in Japanese equities, with valuations remaining low relative to broader DM equities. Overall, we retain a neutral view on equities over a five-year horizon but remain cautious in the nearer-term.

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

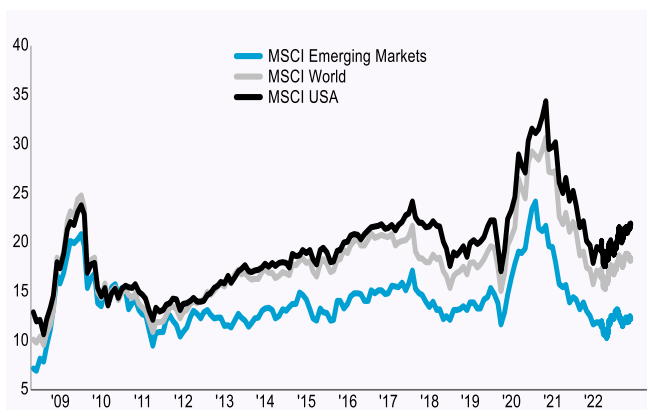
Global equities	Asset return outlook
Developed	
Emerging	

- Equity markets fell sharply in September, reversing some of the strong gains from equities in the first half of 2023.
- Overall, we retain a neutral view on both developed and emerging market equities over a five-year horizon but are cautious nearer-term.

Key: Highly negative Negative Neutral Positive Highly positive

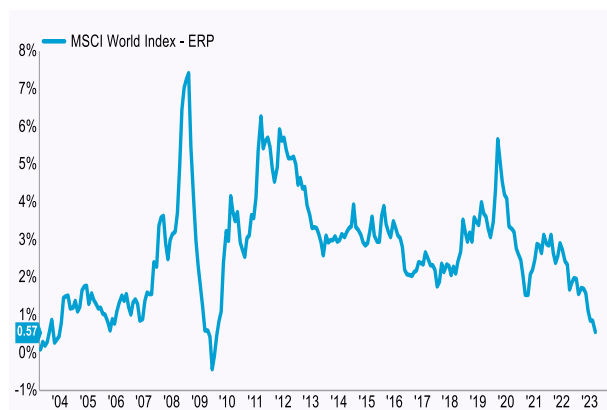
Global and major market equity valuations

12m trailing price / earnings ratio



Source: FactSet, WTW

Our estimated global equity risk premium has dipped significantly, as real and nominal interest rates have risen, although it remains above pre-GFC levels



Source: FactSet, WTW

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