Global Markets Overview

Asset Research Team

December 2023

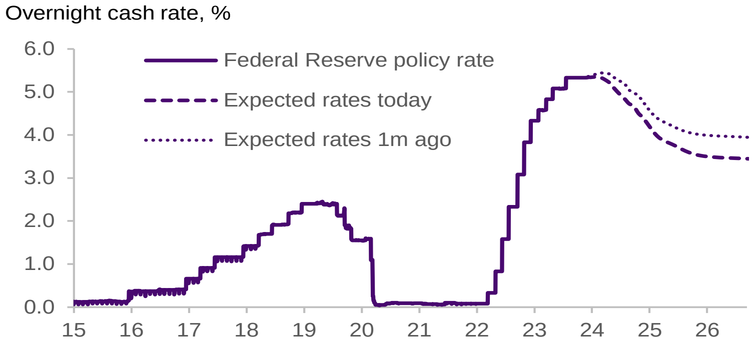
Major markets at a glance

- **Both equities and bonds have performed strongly over November but, on a risk-adjusted basis, the moves in bonds have been most significant.** Sharply lower bond yields in the US, in particular, reflect building expectations of interest rate cuts. Over the past month, the market has moved from pricing no cuts in Federal Reserve policy rates by its July meeting, to pricing 50-75bps of cuts as the most likely outcome by July. Without a significant slowdown in US growth over this period, this expectation looks questionable.

- **Equity markets climbed close to the highs established in July this year.** While the earnings outcomes of some large and important companies have been strong, an important driver of recent equity price strength through November probably lies in bond markets. Lower bond yields can support equities by creating easier financial conditions for businesses and their customers more generally, and also make equities relatively more appealing investments.

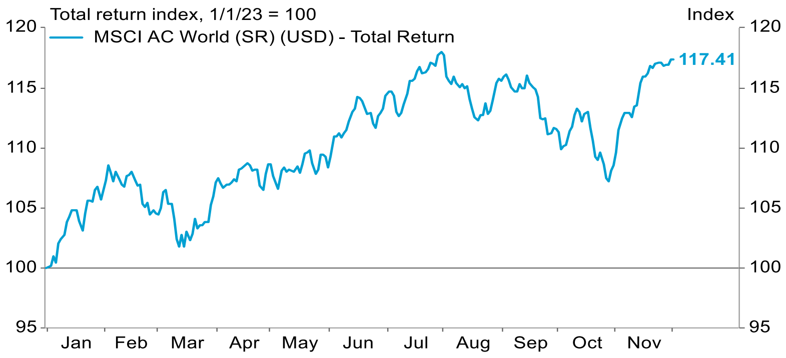
- **Lower bond yields in the US have also impacted currency markets, in particular the US dollar.** The past month has seen the US dollar weaken against many currencies, including the yen, euro, sterling, Australian dollar and the renminbi, as US risk free cash and bond holdings become relatively less appealing for foreign investors.

US bond markets are expecting more and earlier cuts to policy rates compared to a month ago



Dashed lines are as at 30/11/2023, dotted lines are as at 31/10/2023

Equities remain close to their summer highs



Sources: FactSet, WTW

Government bonds

At current yield levels, we believe that selective government bonds are attractively priced

What's happened over past month:

November was one of the strongest months for government bonds since 2008. US 10y Treasury yields declined over 50bps, with other developed markets following suit. This trend has continued month-to-date. US 10y Treasury bonds are currently trading at around 4.2% and Eurozone AAA yields at around 2.2% (as of 6 December).

Factors influencing market trends:

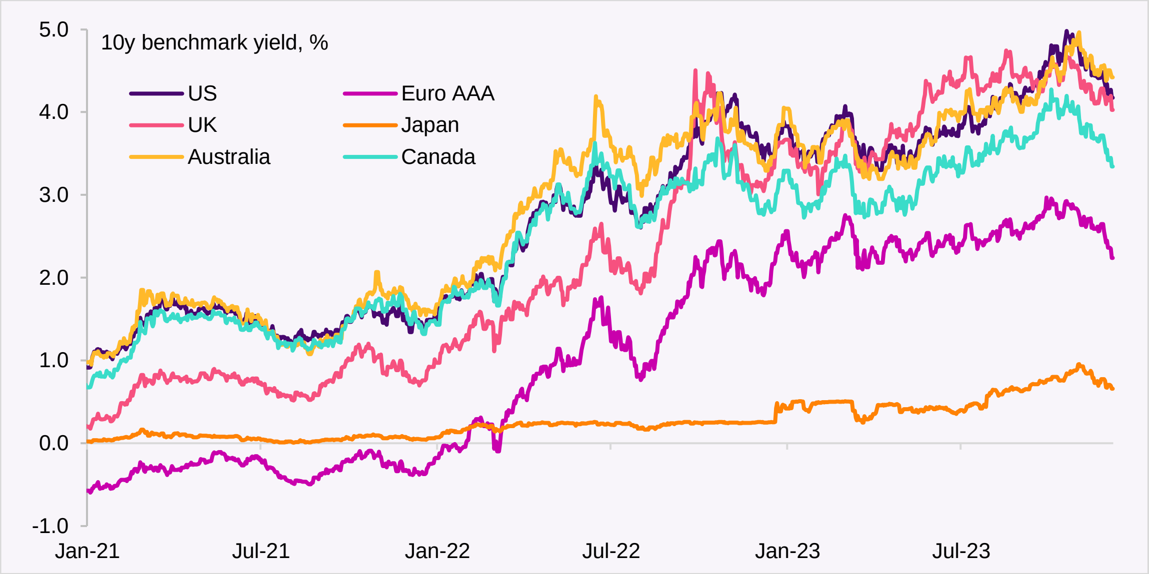
The bond market continues to show significant sensitivity to economic data and announcements. At the start of the month, the US Treasury announced that it would be issuing less debt at longer maturities. This created a relative scarcity that pushed up (down) prices (yields). Since then, inflation data in the US and Europe has come in lower than expected, the manufacturing sector has remained in contraction, and labour markets have shown some signs of cooling. Additionally, the language used by central banks, while still cautious, has become more dovish. These factors have brought forward the expectation of future rate cuts – a key determinant of bond yields – driving them lower.

Looking ahead:

Yield volatility is likely to continue in the near-term. Having fallen so sharply, there is a growing chance yields correct higher. However, as more consumers and businesses are confronted with higher borrowing costs, we expect economic headwinds ultimately to dominate, pushing yields lower. **Over 2 to 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.

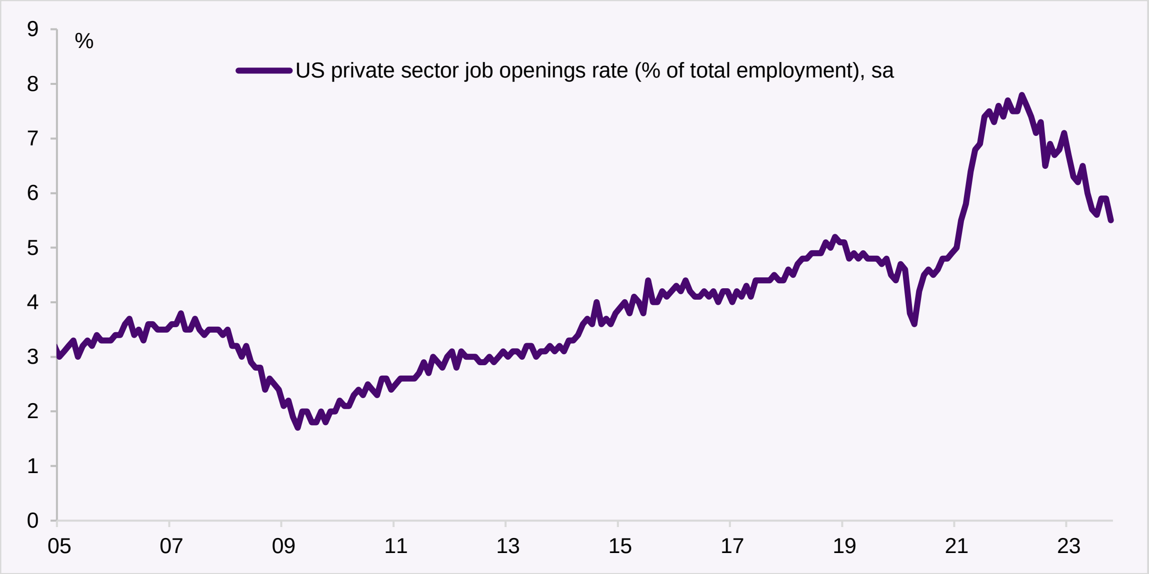
For under-hedged liability-driven-investment portfolios current pricing provides a good opportunity to return towards target levels. This will help to maintain funding levels in a scenario where yields adjust down. This is a risk, particularly in the UK, given high starting yields and signs of economic weakening.

Global 10-year benchmark nominal bond yields



Sources: Refinitiv Eikon, WTW

US job openings have continued to trend lower



Sources: Refinitiv Eikon, WTW

Credit

At current credit spreads, high quality credit assets are likely to provide only moderate returns above equivalent government bonds

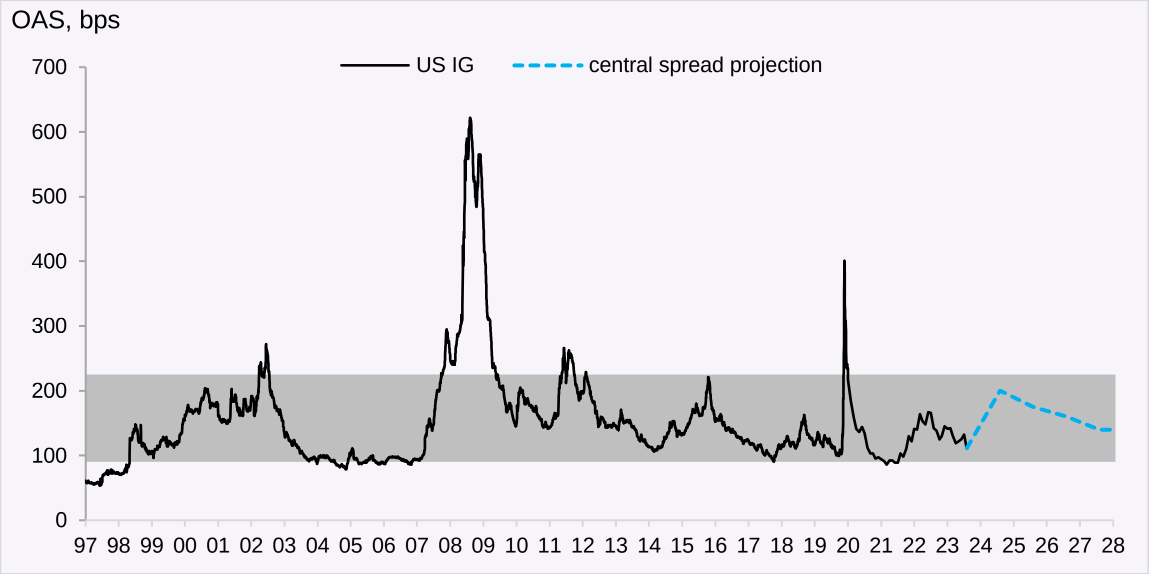
What's happened over past month:

Global investment grade and speculative grade credit spreads tightened moderately, led by the US. US investment grade spreads tightened by c. 21bps to 111 bps; US high yield spreads also tightened by c. 58bps over the month to 384bps. In Europe, corporate credit spreads followed a similar trajectory.

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 on the global economy. The **corporate default cycle has been more muted** as a result.

U.S. investment grade spreads



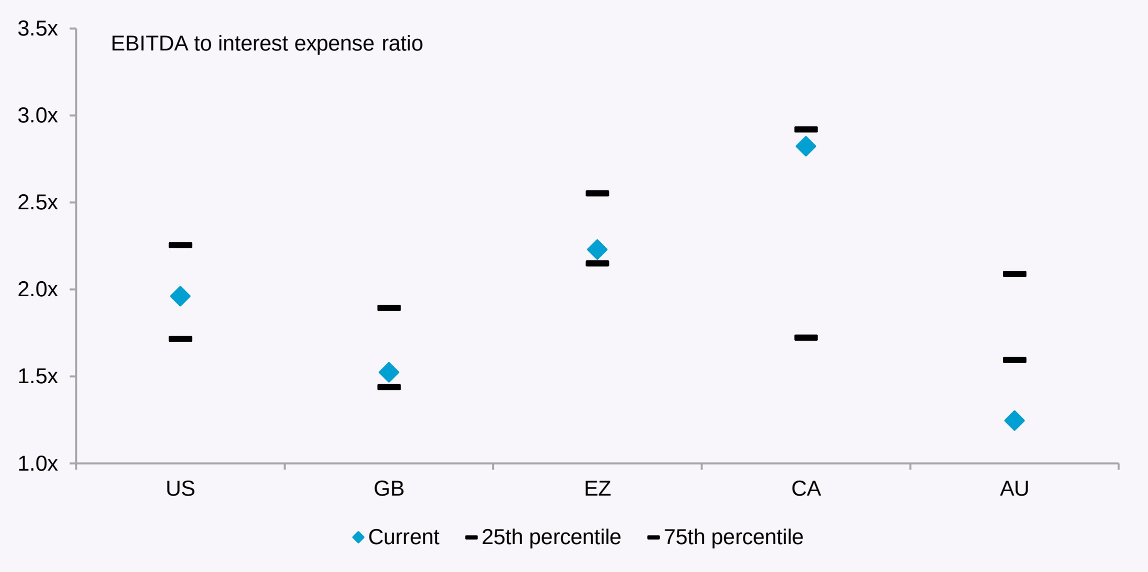
Sources: FactSet, WTW

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 high yield credit** given the prevalence of nearer-term cyclical risks.

For the time being, cashflow-based measures show little sign of corporate stress in the headline numbers – we expect this to adjust negatively going forward



Sources: FactSet, WTW

Equities

Markets rallied in November, extrapolating dovish policy expectations to a continuation of the cycle

What's happened over past month:

Global equities rebounded by 11% in November, the strongest month-on-month gain this year. Despite ongoing economic resilience and falling inflation, the major central banks maintained their policy rates at current levels. Due to Chinese equity weakness, developed markets outperformed emerging markets for the month. Notably, Japanese equities remain a top performing market year-to-date.

Broad market trends:

Equity earnings have been weaker than usual over the year to date. Looking to forward earnings, equity pricing and analyst forecasts for future earnings growth both show an expectation that earnings will pick up significantly in 2024, in the US especially. Our assessment of economic fundamentals leads us to a more cautious view based on weak leading economic indicators.

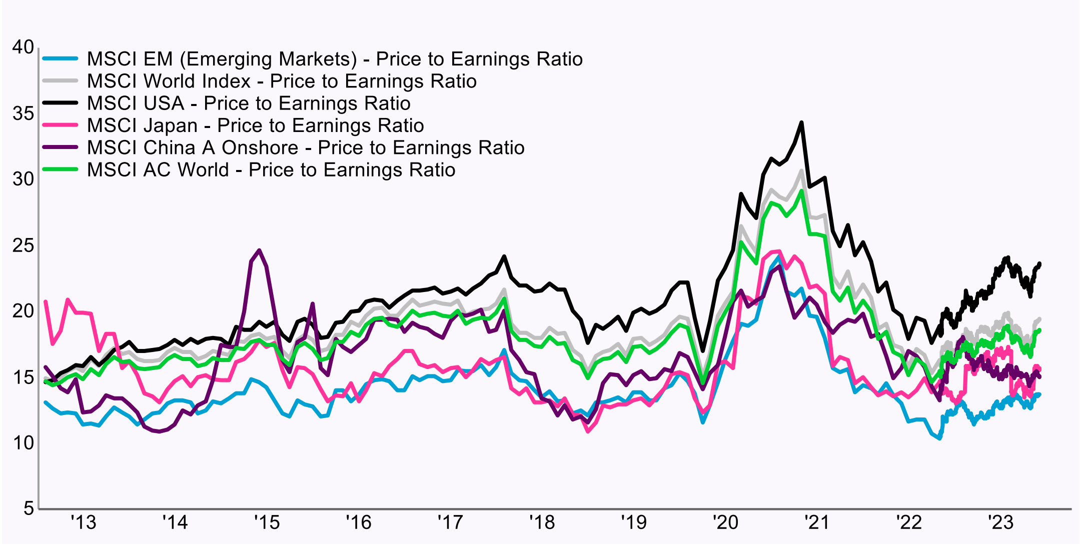
Currently, changes in interest rate policy and yield curve levels are a key driver of broad equity market pricing and valuations In November, equity markets extrapolated an expectation of falling interest rates to be a positive for stock prices. However, we expect that from here, a more accommodative central bank stance would be more consistent with weaker economic fundamentals. That is, equities will continue to face near-term downside risks if we see more evidence of growth weakness and/or a downside revision to earnings expectations.

Looking ahead:

We continue to see value in Japanese equities, given the positive impact on fundamentals of a push to improve corporate governance, stimulative policy, and good cyclical economic growth conditions.

Overall, we retain a neutral view on equities over a five-year horizon but remain cautious in the nearer-term.

Global equity valuations



Sources: FactSet, WTW

The Equity Risk Premium has meaningfully contracted since the end of July

Sources: FactSet, WTW

FX

We hold a neutral view across most developed market crosses relative to the US dollar

What's happened over past month:

Most major currencies rallied against the dollar last month. The biggest movers were the UK pound and Australian dollar, which were both up around 4%.

Factors influencing market trends:

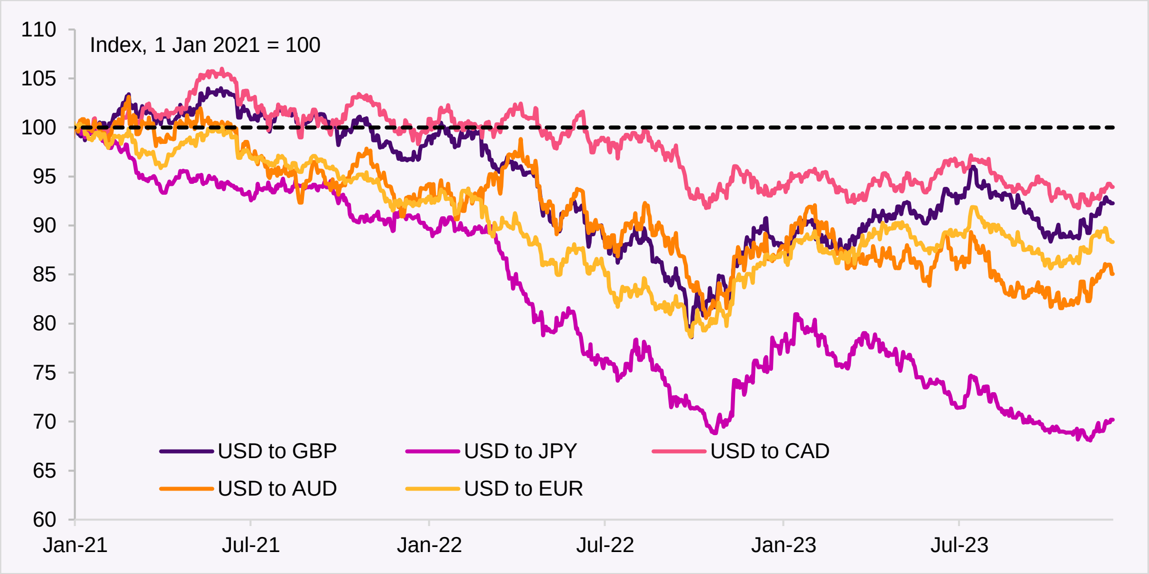
Carry dynamics – **changes in interest rate differentials between countries** – continue to play a key role. The recent depreciation of the US dollar has coincided with a dip in US yields vs. peers. This reduces the relative attractiveness of US risk-free investments, pushing capital flows outwards.

Over a two-to-three-year horizon, the US dollar still remains significantly stronger. Carry has favoured the currency over this longer period. Additionally, **growth and terms-of-trade have been supportive**. The fact that the US economy has been as resilient as it has been – many were predicting a recession this year – has meant carry has improved not just in nominal terms but when adjusting for inflation as well. Additionally, the US is energy independent and has been less impacted by energy price shocks emanating from the Ukraine conflict than net-importing regions like Japan and most of Europe.

Looking ahead:

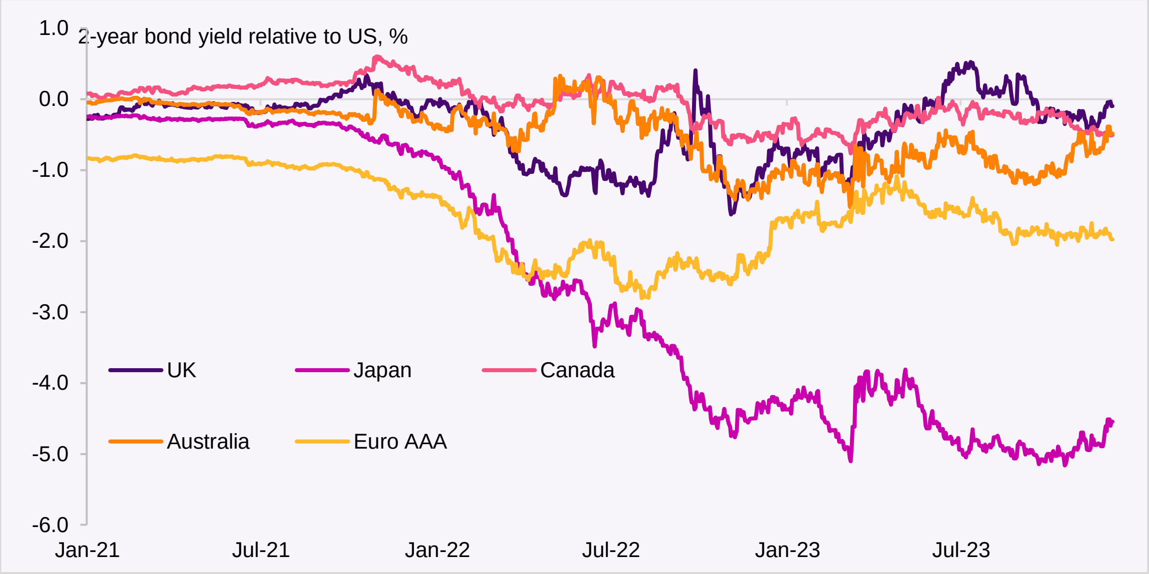
Following its appreciation, the US dollar has become more expensive (less competitive) against other major currencies on our preferred medium-term fair value metrics. This may suggest downwards pressure over a 3-to-5-year horizon. In the near term, however, the relative strength of the US economy and/or its safe-haven status could lead to further appreciation. On balance, **we hold a neutral view on most developed market crosses against the dollar, with the exception of our positive view on the Japanese yen.**

Developed spot exchange rates versus the dollar



Sources: Refinitiv Eikon, WTW

To a significant degree recent exchange rate dynamics have been driven by interest differences



Sources Refinitiv Eikon, WTW

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