Global Markets Overview

Asset Research Team

September 2019

Revisiting our bond outlook in light of market moves

1. Monthly overview

- **The US Federal Reserve has cut rates by 25bps for the second time this year** (with policy rates now between 1.75 – 2.0%). The Fed noted the lack of inflationary pressures, slow business investment growth and a struggling exports sector as the primary reasons for this move. The Fed stated that it is willing to cut rates even further if economic conditions weaken further. It is noteworthy that the US bond market is pricing-in roughly a further 50 - 75bps in Fed policy rate cuts.
- **Mario Draghi, The President of the European Central Bank,** introduced a fresh round of monetary stimulus in an effort to bolster growth and inflation expectations. He relaunched a quantitative easing programme which will purchase $20bn of bonds a month, cut the main deposit rate from -0.4% to -0.5% and introduced a third round of targeted longer-term refinancing for banks (TLTRO). As well as these stimulus measures, notable in Mr Draghi's remarks was the emphasis placed on the importance of fiscal spending and the associated limits of monetary policy from here.
- **The Bank of Japan** has stated its intention to ease monetary policy further by reducing policy rates lower than -0.1% and taking its deposit rates into negative territory.
- **The House of Commons in the UK** passed a law last forcing Prime Minister Johnson to seek a delay on Britain's departure date by three months if the government failed to secure a deal with the EU by 31st October. In addition, Parliament also rejected the government's proposal to hold a snap election in October to break the current impasse in Parliament.

2. Our Five-Year Outlook

A summary of our updated Five-Year Outlook is provided below:

- **First**, over the next two years, we continue to forecast that the Eurozone, UK and Japan have the highest risk of recession. However, for the US we think monetary easing so far has been enough to stabilize economic growth at average levels. Over five-years, our outlook of downside risk being greater than upside risk is unchanged.
- **Second**, developed world central banks started the year with relatively limited firepower via their monetary policy to offset any shocks that arise – this situation has worsened given the easing of financial conditions this year, especially the significant fall in US bond yields.
- **Third**, relative to our medium-term outlook, we believe valuations for growth-related assets are still high and expect low returns on average over five years, …
- … which would put pressure on savers' wider financial positions.
- **Finally**, achieving investment return targets – and hence meeting savers' expectations – is expected to be difficult in this environment.

Five portfolio priorities for a surprise-free 2019/2020

- Diversify;
- Reduce unrewarded risks;
- Macro & dynamism;
- Innovate through alpha;
- Innovate to find diversity, e.g., China now offers a new and diversifying set of assets for investors.

Revisiting our bond outlook in light of market moves

In this month's issue, we highlight recent moves across major developed sovereign bond markets, explore the reasons behind these shifts and discuss economic conditions relative to market discounting.

Recent market moves (as of 18th Sept)

Since the start of September there has been a broad-based increase in nominal bond yields. 10-year bond yields within the US, UK, Germany and Australia have risen 30bps, 25bps, 21bps and 23bps, respectively. Moves in Japanese 10-year nominal bonds have been less pronounced at around 12bps (see chart below).

We believe that the rebound in US bond yields has placed upward pressure on global risk premia and has caused nominal bond yields to rise in other major markets. Yields remain far below where they stood at the beginning of the year, however.

US bond market

At the beginning of September, US 10-year nominal bond yields stood at around 150bps, which was close to post financial crisis lows. This was consistent with policy rates falling to around 1% by the end of 2021, i.e., three or four additional rate cuts. In other words, bond markets were pricing in weak growth conditions for the US economy over the next few years.

By contrast, our assessment of US growth fundamentals is no longer so pessimistic for the next 12 to 24 months. Our central outlook for the US accounts for the policy easing we have seen from the Federal Reserve – the Fed Funds Rate was cut again by 25bp this month – and the substantial falls in US bond yields this year. In our view, these have eased financial conditions sufficiently to support growth conditions over the next 12 months. Various "nowcast" models (figure below) and current activity indicators point to a moderate rebound in current US growth to mediocre levels. If growth does stabilise in the 1.5% - 2% range as we expect, then it is likely that there will be fewer policy rate cuts than the US bond market is pricing-in.

Given this misalignment, our view is that US bond yields will face upwards pressure in the shorter-term and recent moves have been in line with this expectation.

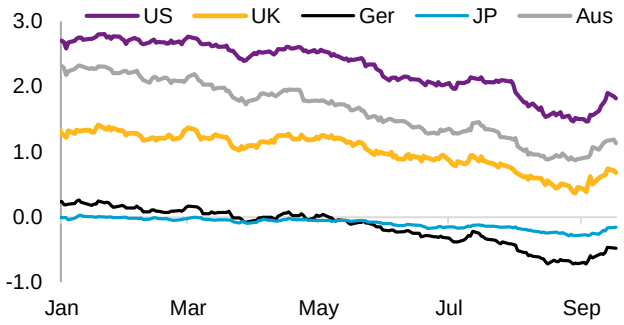
From a five year perspective we continue to believe that a recessionary outcome is most likely, which would result in reasonable returns from US bonds over this horizon.

UK bond market

UK 10-year nominal bond yields had fallen to historical lows of 37bps at the end of August. Since then, yields have rebounded as UK growth conditions have stabilised and global bond risk premia have normalised somewhat.

Bond yields in the major developed markets have risen significantly in September

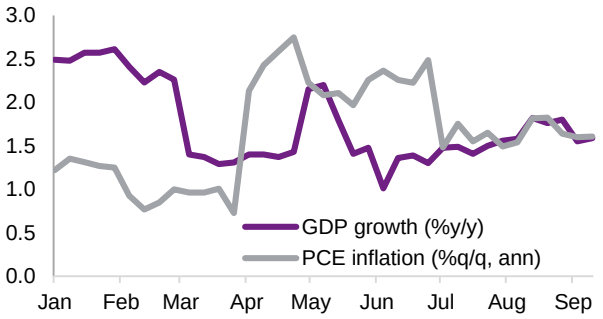
10yr nominal bond yields, %



Source: Factset, Willis Towers Watson

The New York Fed nowcast model shows a marginal improvement in current growth conditions due to easier financial conditions

GDP growth and PCE inflation, %y/y



Source: New York Federal Reserve, Willis Towers Watson

Asset Research Team

Revisiting our bond outlook in light of market moves

Brexit uncertainty remains high and we expect bond markets and other UK-economy correlated assets to exhibit volatility linked to political developments. This raises the hurdle to form a high conviction view on UK bonds. However, given current 10-year bond yield levels, we think yields are most likely to rise above forward rates over the longer-term.

Eurozone and Japanese bond markets

Eurozone and Japanese bond markets continue to price poor economic conditions over the medium to long term – in-line with our outlook. We forecast weak returns due to low starting yields.

There is a high likelihood of a recession in both economies over the next 12 to 24 months. Inflation pressures remain significantly below central bank inflation targets despite years of aggressive monetary policy easing. Both central banks have also significantly exhausted their current monetary policy toolkit.

Both economies have an important export sector and have been hit by the ongoing US-China trade dispute, which has compounded the problems that the Eurozone and Japan face domestically.

The European Central Bank (ECB) announced a new monetary stimulus package, but we believe this will not be enough to stave off a recession in the shorter-term. Mario Draghi, the president of the ECB, has urged member countries to loosen their fiscal purse strings in order to further support growth prospects – but the political hurdle to achieve this is high.

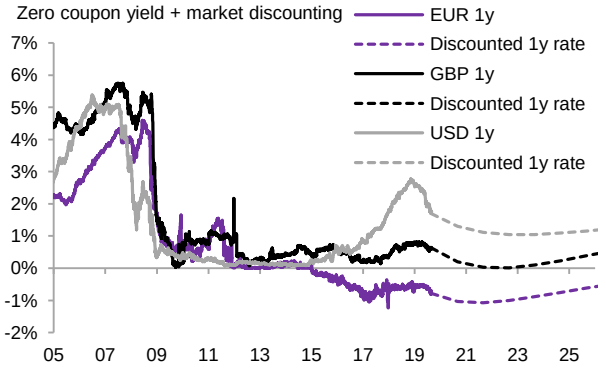
In Japan, a consumption tax hike from 8 to 10% in October will further weigh on private consumption. The relative caution of the Bank of Japan, despite weak growth conditions, is making its monetary policy tighter relative to the US and Eurozone. Consequently, the Japanese Yen faces appreciation pressures at a time when Japan's export market is being hit by rising protectionism.

Australian bond market

The Reserve Bank of Australia decided to keep policy rates on hold this month at 1% after cutting rates by a cumulative 50bps since June. The central bank believes that a combination of easier monetary policy, government spending, tax cuts and exposure to a stronger Chinese economy should be sufficient to manage the household deleveraging which is underway in the economy.

We believe that additional fiscal and monetary stimulus will be required over the shorter-term to keep downside risks in check. Bond prices largely reflect this outlook and we expect returns close to starting yields over five years. However, we note increased downside risks to this outlook due to the chances of a more disorderly deleveraging process over the next five years.

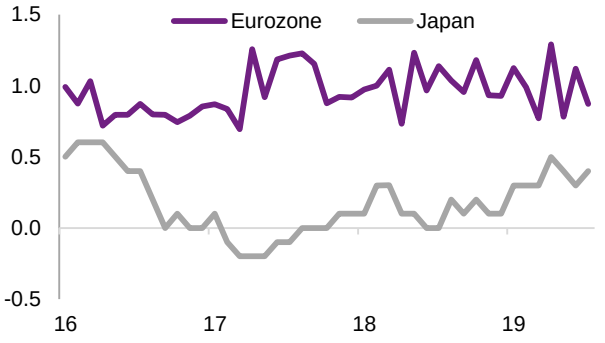
Bond market pricing is consistent with recessionary conditions for Europe over the short term – in-line with our outlook



Source: Factset, Willis Towers Watson

Inflation rates remain chronically low in the Eurozone and Japan despite years of monetary easing

Core inflation, %y/y



Source: Factset, Willis Towers Watson

Disclaimer

Disclaimer

Willis Towers Watson has prepared this material for general information purposes only and it should not be considered a substitute for specific professional advice. In particular, its contents are not intended by Willis Towers Watson to be construed as the provision of investment, legal, accounting, tax or other professional advice or recommendations of any kind, or to form the basis of any decision to do or to refrain from doing anything. As such, this material should not be relied upon for investment or other financial decisions and no such decisions should be taken on the basis of its contents without seeking specific advice.

This material is based on information available to Willis Towers Watson at the date of this document and takes no account of subsequent developments after that date. In preparing this material we have relied upon data supplied to us by third parties. Whilst reasonable care has been taken to gauge the reliability of this data, we provide no guarantee as to the accuracy or completeness of this data and Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any errors or misrepresentations in the data made by any third party.

This material may not be reproduced or distributed to any other party, whether in whole or in part, without Willis Towers Watson's prior written permission, except as may be required by law. In the absence of our express written agreement to the contrary, Willis Towers Watson and its affiliates and their respective directors, officers and employees accept no responsibility and will not be liable for any consequences howsoever arising from any use of or reliance on this material or the opinions we have expressed.

Towers Watson Limited (trading as Willis Towers Watson) is authorised and regulated by the Financial Conduct Authority in the UK.

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 40,000 employees in more than 140 countries. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

Towers Watson Limited is a limited liability company registered in England and Wales under registered number 5379716.
Registered address: Watson House, London Road, Reigate, Surrey, RH2 9PQ, United Kingdom

willistowerswatson.com

Willis Towers Watson