Global Markets Overview

Asset Research Team

October 2019

Tracking recent price action and our outlook in corporate credit markets

1. Monthly overview

- **In the latest round of escalating trade disputes, the Trump administration has announced that it will impose tariffs on $7.5bn worth of Eurozone imports from mid-October,** after a WTO ruling found that subsidies given by the EU to Airbus (a European company) were illegal and unfair in its competition to Boeing (an American company). Airbus will face tariffs of 10%, whereas certain EU agricultural and industrial import products will face tariffs of 25%. So far there has been no statement from EU authorities on whether they will retaliate or not.
- **The ongoing trade disputes between the US and China/Eurozone continues to depress the global manufacturing sector.** China's manufacturing sector shrank for two straight quarters and Eurozone PMIs dropped to their lowest levels in 7 years. Germany in particular has been exposed to the global growth slowdown. Manufacturing surveys in the US, Japan and UK have also experienced a similar weakening. Globally, trade tensions are likely to remain a feature of the medium-term political and economic context.
- **The Reserve Bank of Australia (RBA) announced another rate cut of 25bps** in its latest monetary policy meeting, taking its policy rate to 0.75%. The RBA is confident this round of monetary policy stimulus, combined with recent tax cuts, infrastructure spending and support to the resources sector should be sufficient to support economic recovery. The main economic risk remains high household debt levels, which diminish the ability of low interest rates to stimulate demand and introduce a downside skew to economic risks.

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 or below neutral 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.

Tracking recent price action and our outlook in credit markets

Summary

Tracking recent changes in corporate credit markets

- Investment grade markets are pricing-in an allowance for a below-average level of credit losses. This is primarily due to a low level of expected credit ratings downgrades given out-and-out defaults by investment grade companies are relatively rare
- We expect credit losses to be above these levels, with risks skewed towards the upside, i.e., higher losses
- At current levels, high quality credit assets are unlikely to provide attractive returns above equivalent government bonds
- We retain a cautious outlook for developed market vanilla speculative-grade credit. Current pricing implies a low level of defaults for high yield bonds and leveraged loans relative to their historic average
- We believe risks are skewed towards an increase in defaults, particularly in the US. We continue to expect unattractive outcomes for this portion of the credit universe, both in absolute terms and relative to niche opportunities within securitized credit.

Note: our credit ratings and return outlook relate to excess credit returns (i.e. from spread) only.

Changes to credit market pricing
30 September 2019

		Pricing - Option adjusted spreads, bps					Implied credit losses (due to defaults & downgrades)				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	121	-2	-1	6	-14	0.5%	-0.1%	0.0%	0.2%	-0.4%
	US	122	-4	0	9	-21	0.6%	-0.1%	0.0%	0.2%	-0.5%
	Eurozone	112	2	-2	-3	-3	0.3%	0.1%	-0.1%	-0.1%	-0.1%
	UK	153	4	4	6	8	1.3%	0.1%	0.1%	0.2%	0.2%
	Canada	126	-1	4	12	-25	0.7%	0.0%	0.1%	0.3%	-0.6%
	Australia	103	1	-5	-5	-28	0.1%	0.0%	-0.1%	-0.1%	-0.7%
Low grade	Global HY	425	-15	7	61	-77	1.8%	-0.2%	0.1%	0.9%	-1.1%
	US HY	402	-11	-5	74	-95	1.5%	-0.2%	-0.1%	1.1%	-1.4%
	Eurozone HY	366	7	-5	11	-50	1.7%	0.1%	-0.1%	0.2%	-0.7%
	US loans	436	2	22	80	-44	1.9%	0.0%	0.3%	1.1%	-0.6%

Source: Factset, Willis Towers Watson

Note: Shading represents retrospective returns – i.e. red indicates widening spreads/increased implied defaults.

Source: Factset, Willis Towers Watson

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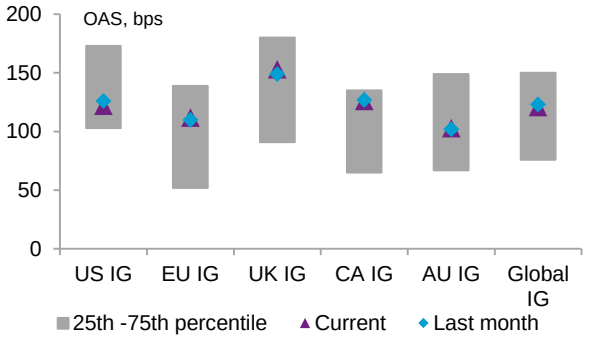
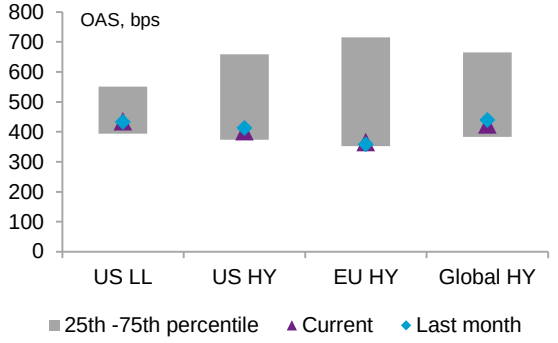
Tracking recent price action and our outlook in credit markets

Key indicators: Developed market corporate credit

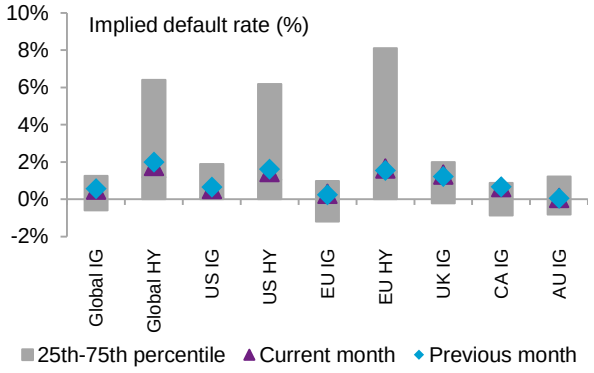
Outside of the US, investment grade (IG) spreads are broadly at the upper end of their interquartile ranges…



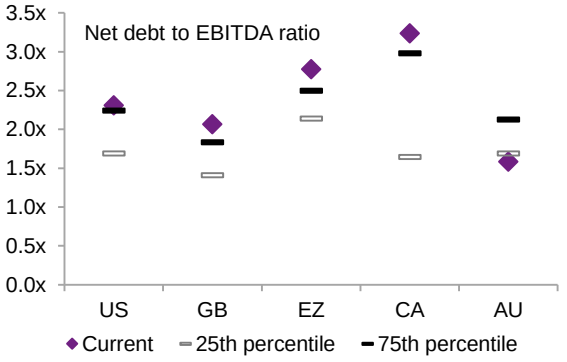
…however, low grade spreads remain compressed relative to history



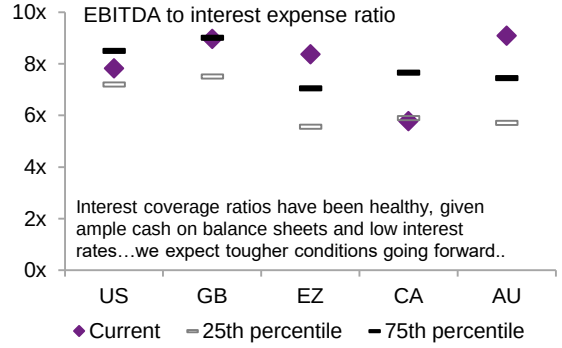
Markets are implying defaults notably below average levels for high yield *



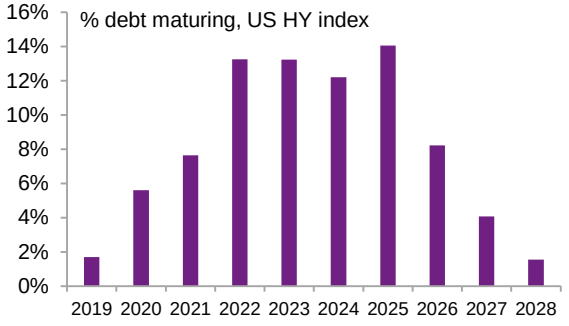
Synonymous with late cycle dynamics, corporate leverage is generally high across DM economies …



However, cash flow based measures show little sign of corporate stress in headline numbers for the time being



Near term refinancing obligations remain modest; corporate earning distress is needed for defaults to increase



Sources: Factset, Willis Towers Watson
* Notes: calculations assume a: 30-60% recovery rate for corporate; 100bps credit and illiquidity risk premia for IG markets; a 250-300bps risk premia for HY markets.

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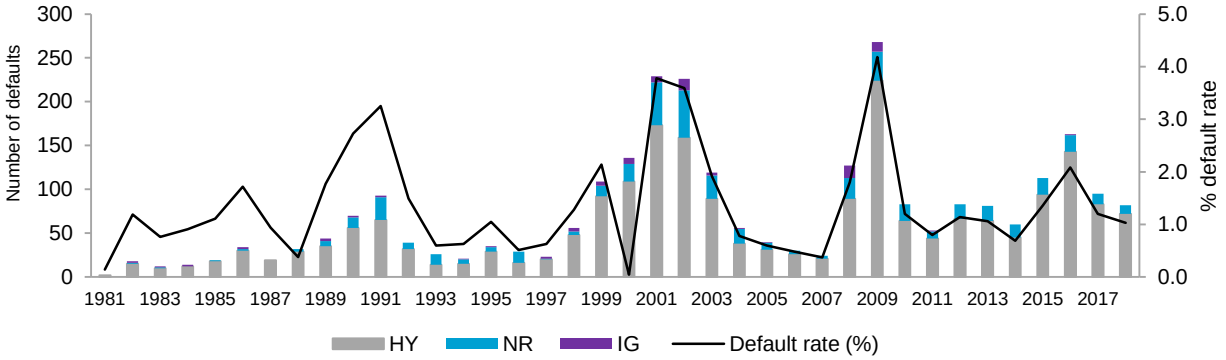
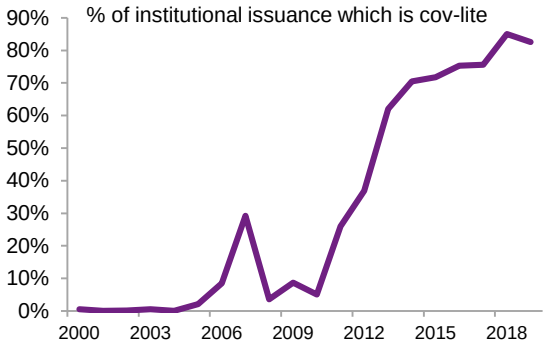
Tracking recent price action and our outlook in credit markets

Key indicators: Developed market corporate credit

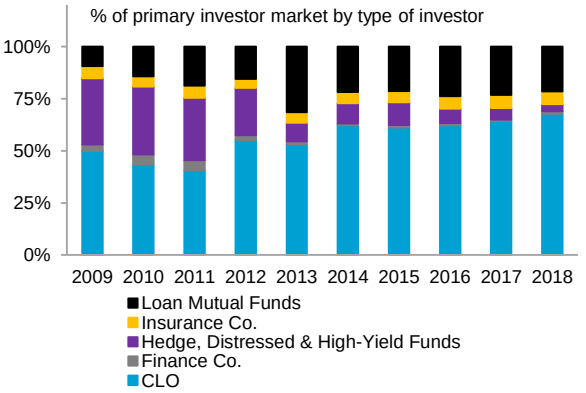
We believe that an episode of corporate distress is more likely than not over the next five years, driven by a downturn in the economic cycle. Our expectation is that defaults will rise materially if this is the case.
HY = High Yield; NR = Not Rated; IG = Investment Grade



We think leveraged loans are susceptible to a slowdown. Lending standards are weak



Leveraged loans are exposed to sharp liquidity withdrawals – CLO demand as a % of issuance is high and retail investors have entered the market



Sources: Factset, Willis Towers Watson, SP LCD

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