Global Markets Overview

Asset Research Team

June 2020

Tracking recent asset price moves and our outlook

1. Our Outlook

A summary of our outlook is provided below:

- **First**, unpredictability and uncertainty are important factors in gauging the current outlook – it's important to understand what we don't know. We are not scientists or medical experts and, therefore, we are not trying to forecast the pathway for the number of COVID-19 cases. However, we are tracking the things we know are important on the medical side, e.g., time to implement social distancing, the number and rate of change of cases and deaths, test count per million people, utilisation of hospital capacity, etc. And, of course, we are also tracking key short-term economic and financial indicators – travel reduction, claims for unemployment, spending on durable goods, recovery speeds in countries such as China and Taiwan, and market liquidity. One of the main economic risks we are focusing on is whether the fiscal policies and government support can be successfully implemented at the individual small-and-medium sized business level. These companies make up a high proportion of employment, which means any significant rise in liquidity and default risk would add materially to falls in incomes and spending.
- **Second**, based on these metrics and allowing for uncertainty, our outlook is as follows: China GDP growth will start to recover in Q2. The US and Europe will experience a major recession in Q1 and Q2. GDP growth in advanced economies has started to pick-up in May and June; although the shape of recovery in advanced economies in Q3/Q4 2020 and beyond remains uncertain – we expect large divergences between countries given large differences in the number of virus cases and the size of fiscal and monetary policy responses. Small and midsize companies in advanced economies will likely be more negatively impacted. Less developed economies will suffer more than advanced economies in the nearer term. Not all sectors are affected equally in this scenario, e.g., service sectors, including aviation, travel, and tourism, are likely to be hardest hit – it could take several years for all parts of economies to fully normalise.
- **Third**, from a five-year investment standpoint, given the acute changes in bond, credit, and equity pricing, we forecast that we have moved to a higher return and higher risk regime, from a low return/low-to-medium risk regime.
- **Fourth**, recent market moves have been severe but, in our view, provide a reminder about the regular actions investors can undertake. We will always face systemic risks, whether they are economic, societal (such as COVID-19) or environmental. Thinking carefully about the following actions will provide more resilient and, ultimately, more successful portfolios over time:

  1. The level of risk one can tolerate;
  2. Maximising the amount of diversity;
  3. Removing unrewarded risks;
  4. Carefully thinking through and managing liquidity needs.

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Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)
31 May 2020

31 May 2020 % / %pts		Spot yields					What's discounted		
		Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	1y fwd	2y fwd	5y fwd
Developed nominal yields	**Eurozone**								
	1y/cash	-0.55	0.04	0.11	0.01	0.32	-0.71	-0.73	-0.46
	10y	-0.44	0.12	0.18	-0.26	-0.79	-0.40	-0.32	-0.09
	US								
	1y/cash	0.20	0.05	-0.79	-2.01	-0.95	0.23	0.34	0.68
	10y	0.66	0.03	-0.50	-1.50	-1.59	0.73	0.84	1.15
Break-even Infl.	**US (CPI)**								
	3y	0.46	0.24	-0.75	-1.05	-1.25	-	-	1.14
	10y	1.08	0.05	-0.28	-0.66	-0.74	-	-	1.26

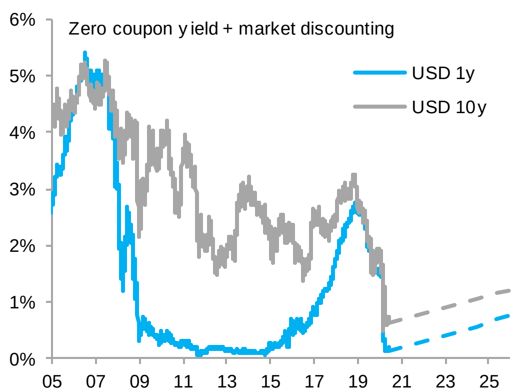
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook	Comments
Developed short interest rates				• Central banks have eased aggressively to provide liquidity and help manage a massive shock to incomes • Advanced economy policy rates are at or around their perceived lower bounds and central banks are engaged in asset purchases • Markets are pricing short interest rates to remain on hold for the next two to five years, depending on the market • Low interest rates imply low returns on cash holdings
US				
Japan				
AAA-Eurozone				
Developed 10-year nominal bonds				• Intermediate bond yields have fallen alongside short rates • Looking ahead, yields are priced to remain close to historic lows over the next five years, only increasing slightly over the horizon • Given how low yields are, bonds offer limited protection if economic conditions worsen • Conversely, if policy is effective at offsetting the economic impact of the virus, with a recovery starting in Q2/Q3 2020, yields could rise faster than is priced
US				
Japan				
AAA-Eurozone				

Key: Highly negative | Negative | Neutral | Positive | Highly positive

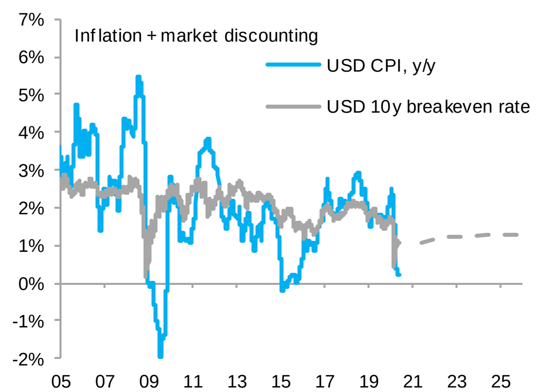
US short interest rates and bond yields are expected to remain low over the next 10-years

US cash rate and 10y nominal bond yield



Inflation markets are pricing-in that US inflation will be far below central bank target for the next decade

US CPI inflation rate and inflation market pricing



Source: FactSet, Willis Towers Watson).

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Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)
31 May 2020

31 May 2020		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	184	-25	57	50	66	2.1%	-0.6%	1.4%	1.3%	1.7%
	US	187	-30	57	52	68	2.2%	-0.8%	1.4%	1.3%	1.7%
	Eurozone	166	-17	51	37	56	1.7%	-0.4%	1.3%	0.9%	1.4%
Low grade	Global HY	676	-107	176	207	294	5.4%	-1.5%	2.5%	3.0%	4.2%
	US HY	654	-109	148	195	280	5.1%	-1.6%	2.1%	2.8%	4.0%
	Eurozone HY	557	-77	148	125	254	4.4%	-1.1%	2.1%	1.8%	3.6%
	US loans	600	-105	149	193	201	4.3%	-1.5%	2.1%	2.8%	2.9%
USD EMD	Hc EMD Corps	452	-66	144	163	191	5.6%	-1.5%	1.4%	2.3%	3.2%
	HC EMD Sov	429	-75	69	114	161	4.3%	-1.0%	2.2%	2.5%	2.9%

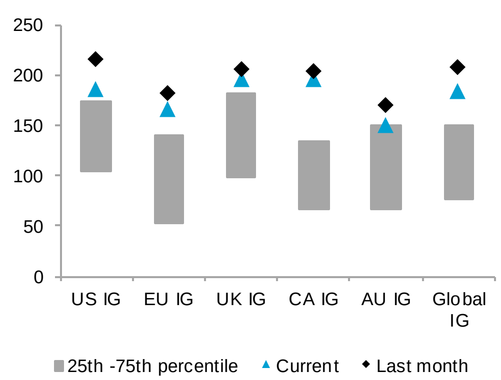
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook	Comments
Corporate credit				• Investment grade markets are pricing in an allowance for above-average level of credit losses • We expect credit losses to be close to these levels, particularly in the nearer term with risks skewed to the upside • At current spreads, high quality credit assets are approaching the levels at which they are likely to provide reasonable returns above equivalent government bonds • We retain a somewhat cautious outlook for developed market vanilla speculative-grade credit given shorter-term risks. Current pricing implies an above average level of defaults relative to historic average pricing. As such, pricing has moved closer to fairly pricing-in a pessimistic outlook for corporate credit. • Niche and securitized market pricing appear to be pricing-in a somewhat more pessimistic outlook (in aggregate) relative to vanilla corporate credit markets and offer more opportunistic value in our view
Investment grade				
High yield				
US				
Europe				
Loans				
US				
Europe				

Key: Highly negative | Negative | Neutral | Positive | Highly positive

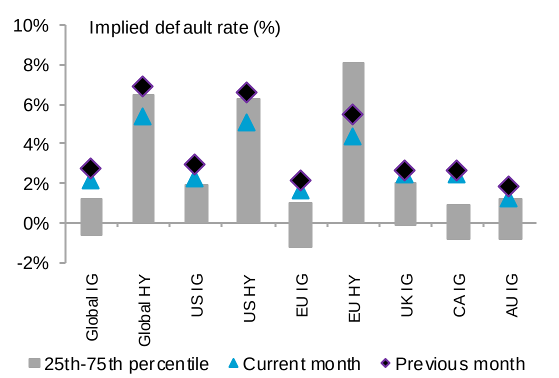
Despite recent falls in corporate spreads, the income shock has significantly increased spread levels

Investment grade corporate option-adjusted spreads, bp



Consequently, market implied default rates have risen to levels materially above long term averages

Estimated implied default rate based on current pricing



Source: FactSet, Willis Towers Watson).

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Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)

31 May 2020

31 May 2020	Δ 1 month			Δ 3 months			Δ 1 year			
	Total ret	EPS	Trailing P/E	Total ret	EPS	Trailing P/E	Price return	Total ret	EPS	Trailing P/E
Australia	3.1%	-5.4%	8.9%	-12.3%	-5.7%	-7.7%	-12.4%	-8.9%	-6.9%	-5.8%
Canada	2.8%	-18.7%	26.2%	-6.0%	-18.4%	14.0%	-6.4%	-3.2%	-10.0%	4.0%
Eurozone	5.1%	-8.5%	15.8%	-7.7%	-10.2%	2.9%	-7.9%	-5.9%	-25.0%	22.6%
Japan	6.7%	-17.2%	28.9%	3.7%	-16.8%	23.3%	3.8%	6.6%	-20.3%	30.3%
UK	3.1%	-20.6%	29.3%	-7.7%	-20.8%	15.7%	-16.5%	-13.1%	-24.3%	10.3%
US	5.2%	-6.1%	11.8%	3.9%	-6.1%	10.1%	11.3%	13.4%	-7.3%	20.0%
China	-0.3%	-3.3%	3.9%	-1.2%	-4.4%	5.3%	9.6%	11.8%	10.3%	3.3%
MSCI World	4.8%	-9.0%	14.9%	1.1%	-9.4%	10.8%	5.0%	7.4%	-11.3%	18.3%
MSCI EM	0.7%	-8.4%	9.8%	-4.6%	-9.8%	2.6%	-3.0%	-0.2%	-14.5%	9.0%

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

Global equities	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook
Developed			
Emerging			

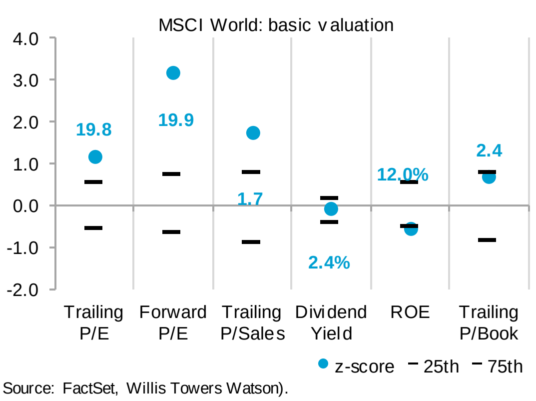
Comments

- Rising equity prices and falling earnings expectations in the last two months have increased forward P/E and other valuation ratios notably
- We expect a material earnings recession in developed and emerging markets in 2020; a subsequent earnings recovery will depend heavily on the effectiveness of fiscal and monetary policy responses
- US valuations are higher relative to broader developed markets, which we see as consistent with higher US fiscal and monetary stimulus
- EM valuations are lower vs. developed markets, which we see as consistent with higher virus and economic related risks, e.g., income falls in EM-ex China have been large and their level of economic stimulus much lower
- Current equity prices are consistent with good expected 5-year returns in a scenario where earnings begin to recover in Q3/Q4 2020. This is contingent on effective policy, with material drawdown risk and uncertainty remaining

Key: Highly negative | Negative | Neutral | Positive | Highly positive

Developed market valuations are high as investors expect medium term earnings potential to remain relatively unimpacted

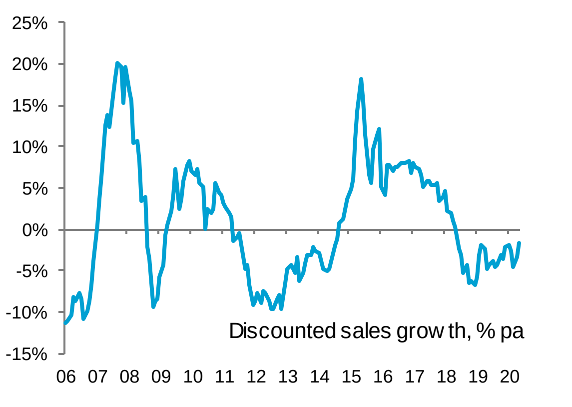
Valuation metrics for the MSCI World equity index



Source: FactSet, Willis Towers Watson).

Market pricing implies negative earnings growth prospects for Chinese equities over 5 years. This overstates downside risks in our view

Medium-term growth priced-in by current equity price, % pa



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