Global Markets Overview

Asset Research Team

September 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., 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 market liquidity.

  One of the main economic risks we are focusing on is whether fiscal policy and government support is continued at a sufficient scale. For example, whether the "Phase 4" fiscal stimulus package currently being discussed in Congress is agreed or not is critically important for the speed of the US recovery over the next four months. Jay Powell, the chair of the Federal Reserve, has emphasised that lower income households and small-and-medium sized businesses still need support. These economic sectors are inter-linked – 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 other recent economic datapoints and allowing for uncertainty, our outlook is as follows: China GDP reached its low point in February and has recovered sharply, led by its manufacturing and investment sectors – we expect a broad economic recovery to continue. The US and Europe experienced a major recession in Q1 and April. GDP growth in these and other advanced economies started to pick-up notably in May and June. Although, the latest economic data points indicate the pace of recovery has slowed in the last three months.

  However, the shape of recovery in the world economy from Q4 2020 and beyond remains uncertain – we expect large divergences between countries given large differences in the number of virus cases, the size of fiscal and monetary policy responses, and other political (e.g., US election) and geopolitical factors (e.g., global trade relations).

- **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.

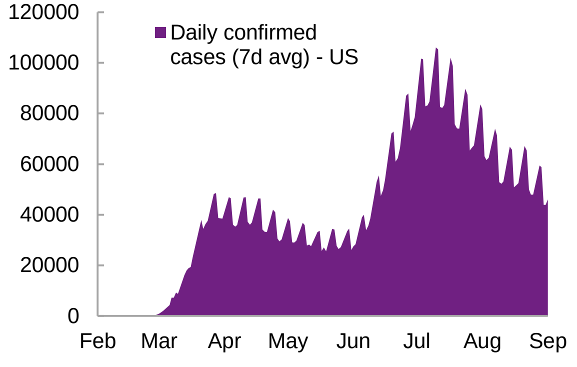
- **Fourth**, recent market moves have been severe but, in our view, provide a reminder about the regular actions investors can undertake. We will always face systemic risks, whether they are economic, societal (such as COVID-19) or environmental. Thinking carefully about the following actions will provide 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.

COVID-19 case tracker

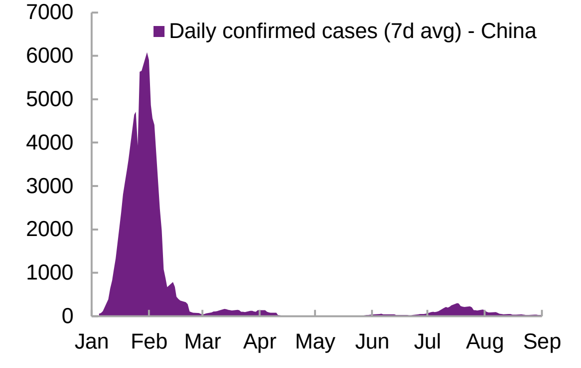
Daily cases: declining in US; rising rapidly in Europe; flat and low in China

Exhibit 1: The number of daily confirmed cases in the US has gradually declined to around 48,000



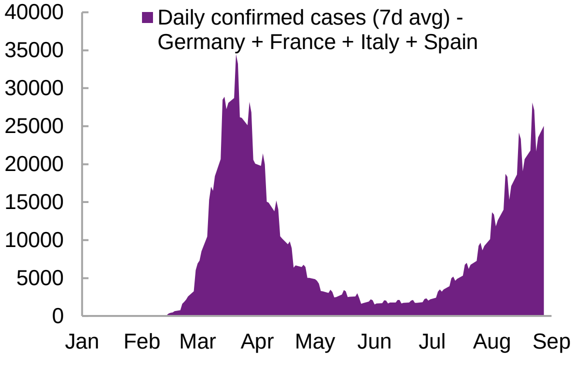
Source: Factset, Willis Towers Watson

Exhibit 2: China reduced its case number significantly before reopening its economy



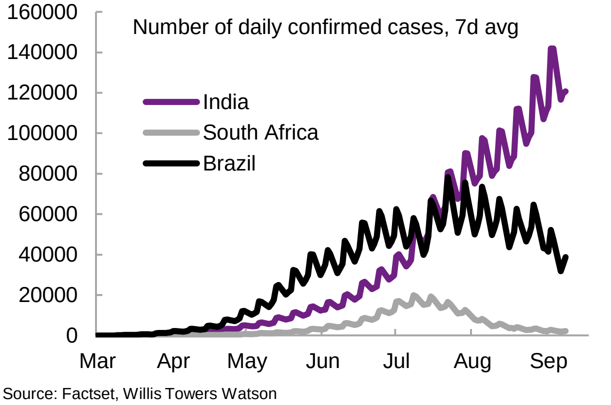
Source: Factset, Willis Towers Watson

Exhibit 3: Eurozone cases are quickly rising to their previous peak, led by France and Spain



Source: Factset, Willis Towers Watson

Exhibit 4: Large emerging markets: India is seeing a daily rise; Brazil and South Africa seeing declines



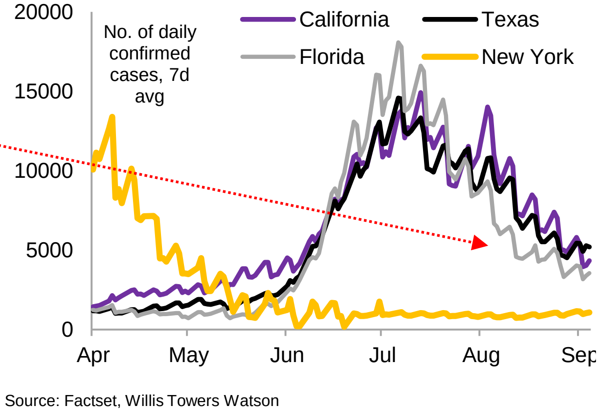
Source: Factset, Willis Towers Watson

Exhibit 5: The US states which contribute significantly to US GDP…..

Contribution to US GDP (%)	
1 California	14.6%
2 Texas	8.8%
3 New York	8.1%
4 Florida	5.1%
5 Illinois	4.2%
6 Pennsylvania	3.8%
7 Ohio	3.3%
8 New Jersey	3.0%
9 Georgia	2.9%
10 Washington	2.8%
Total	56.6%

Source: Factset, Willis Towers Watson

Exhibit 6: …are seeing their cases decline; reducing downside risks to US recovery



Source: Factset, Willis Towers Watson

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Economic conditions monitor

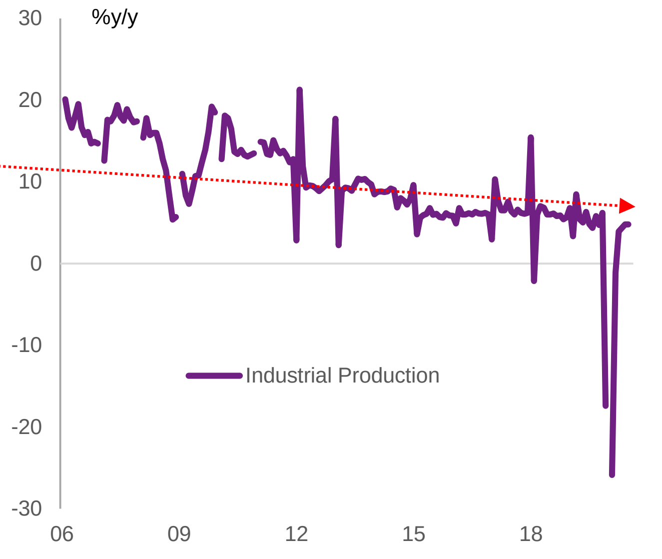
Tracking economic activity in the major economies

Exhibit 7: Levels of real GDP in US, Europe and China relative to end-2019

	Peak-to-trough fall in real GDP	Date of real GDP low-point	Estimates of current fall in real GDP at 30-August
China	-25%	February	-1%
United States	-15%	April	-5%
Germany	-15%	April	-8%
France	-20%	April	-9%
Italy	-25%	April	-10%
United Kingdom	-25%	April	-13%
Spain	-20%	April	-15%

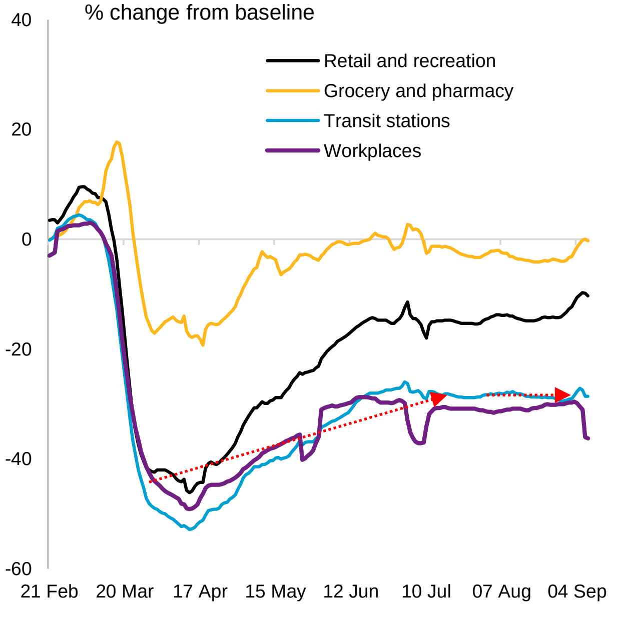
Source: Willis Towers Watson

Exhibit 8: China: manufacturing output has fully recovered to end-2019 levels from February lows



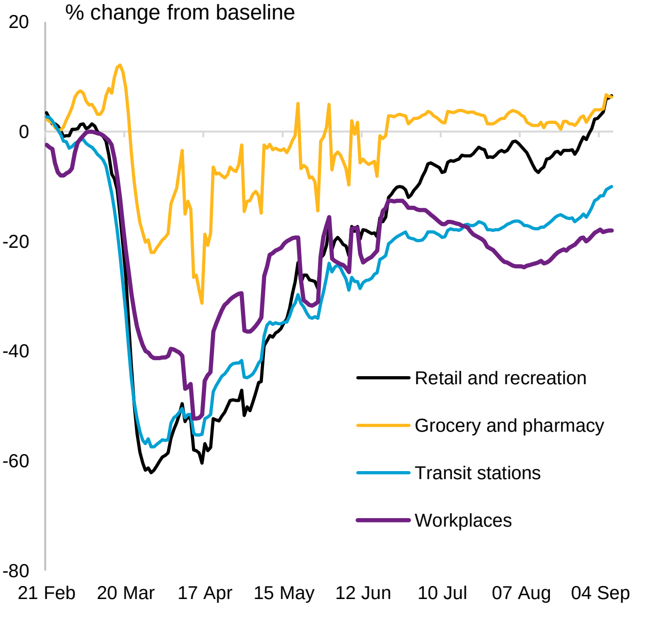
Source: Willis Towers Watson

Exhibit 9: US: mobility of people in various economic areas rose from April, supporting spending and recovery. More recently mobility has stalled as cases picked up



Source: Factset, Willis Towers Watson

Exhibit 10: Germany: Mobility has recovered relatively sharply in Germany, albeit at a faltering rate



Source: Factset, Willis Towers Watson

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Tracking recent asset price moves and our outlook

Summary: government bonds

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

31 August 2020 % / %pts		Spot yields: Level	Spot yields: Δ 1m	Spot yields: Δ 3m	Spot yields: Δ 1y	Spot yields: Δ 3y	What's priced-in: 1y fwd	What's priced-in: 2y fwd	What's priced-in: 5y fwd
Developed nominal yields	**Eurozone**								
	1y/cash	-0.64	0.05	-0.01	0.14	0.15	-0.67	-0.72	-0.40
	10y	-0.39	0.14	0.04	0.33	-0.76	-0.31	-0.22	0.06
	US								
	1y/cash	0.07	0.00	-0.03	-1.69	-1.16	0.26	0.42	0.80
	10y	0.70	0.16	0.05	-0.80	-1.45	0.83	0.94	1.25
Breakeven infl.	**US (CPI)**								
	3y	1.47	0.14	0.91	0.26	-0.13	-	-	1.47
	10y	1.58	0.10	0.45	0.08	-0.14	-	-	1.46

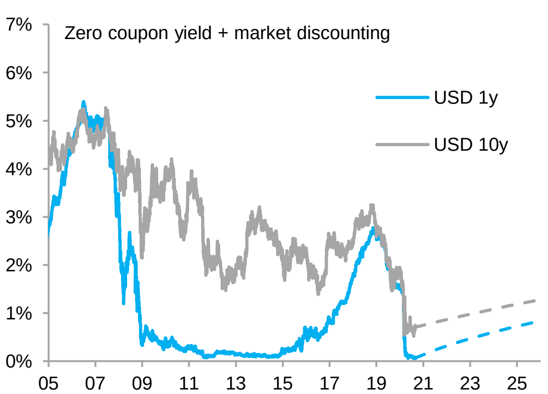
A summary of our assessment of government bond pricing and prospective medium-term outcomes

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 mitigating the impact of the virus and spurring a quick recovery, 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

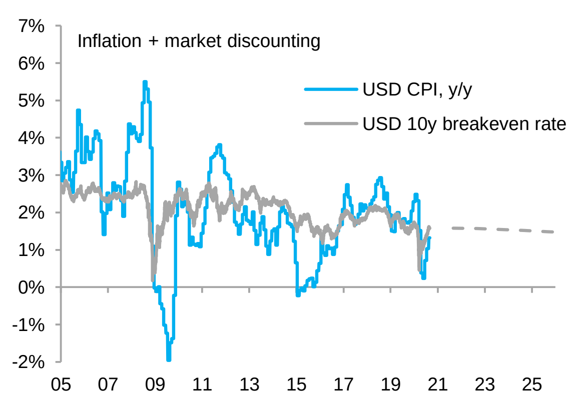
US cash rate and 10y nominal bond yield



Source: FactSet, Willis Towers Watson).

US inflation pricing has moved up but is still pricing-in a long term environment of below Fed target inflation

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 August 2020

31 August 2020		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	132	-8	-52	9	19	0.8%	-0.7%	-1.3%	0.4%	0.5%
	US	136	-5	-51	10	20	0.9%	-0.6%	-1.3%	0.5%	0.5%
	Eurozone	114	-14	-52	4	13	0.4%	-0.9%	-1.3%	0.2%	0.3%
	UK	145	-12	-52	-4	15	1.1%	-0.8%	-1.3%	0.0%	0.4%
	Canada	140	-8	-57	13	25	1.0%	-0.7%	-1.4%	0.6%	0.6%
	Australia	110	-6	-40	8	3	0.3%	-0.6%	-1.0%	0.2%	0.1%
Low grade	Global HY	520	-27	-156	80	138	3.1%	-1.8%	-2.2%	1.5%	2.0%
	US HY	502	-14	-152	89	117	2.9%	-2.0%	-2.2%	1.4%	1.7%
	Eurozone HY	446	-41	-111	87	173	2.8%	-1.1%	-1.6%	1.1%	2.5%
	US loans	499	-78	-100	66	108	2.8%	-1.1%	-1.4%	0.9%	1.5%
US EM debt	Hc EMD Corps	342	-27	-110	40	88	3.8%	-1.1%	-1.8%	1.5%	1.6%
	HC EMD Sov	340	-30	-89	21	78	2.6%	-0.9%	-1.7%	1.2%	1.4%

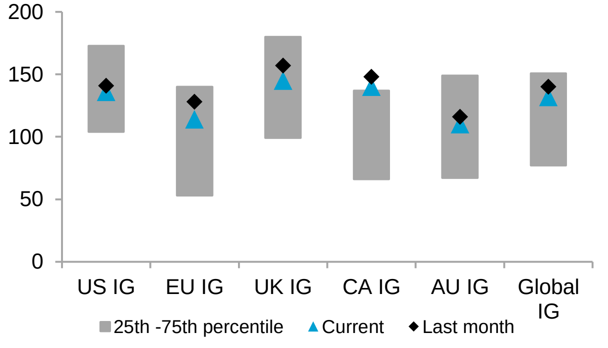
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

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 an 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 levels, high quality credit assets are approaching levels at which they are likely to provide only modest 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 average level of defaults relative to historic average pricing. As such, pricing has moved closer to fairly discounting a more optimistic outlook for corporate credit. • Niche and securitized market pricing appears to be discounting a somewhat more pessimistic outlook (in aggregate) relative to vanilla corporate credit markets
Investment grade				
High yield				
US				
Europe				
Loans				
US				
Europe				

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

Investment grade spreads contracted modestly over the past month but remain elevated and broadly at the upper end of their interquartile ranges

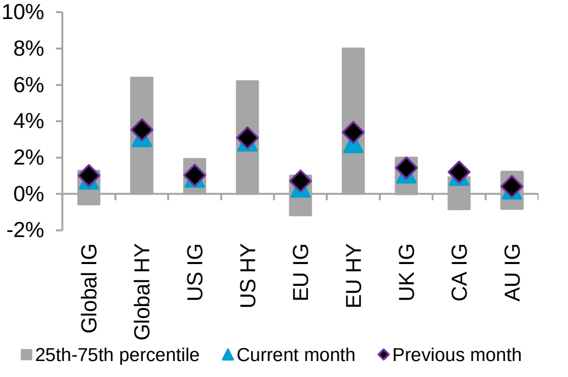
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, Willis Towers Watson).

Market implied default rates have moved closer towards their long term averages over the past month

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 August 2020

31 August 2020	Δ 1 month			Δ 1 year				Δ 3 years (pa)		
	Total ret	EPS	Trailing P/E	Price return	Total ret	EPS	Trailing P/E	Total ret	EPS	Trailing P/E
Australia	2.4%	-15.5%	20.8%	-10.7%	-7.5%	-24.5%	18.6%	5.4%	-5.3%	6.7%
Canada	2.5%	-15.5%	22.6%	-0.3%	3.1%	-30.6%	46.0%	5.7%	-5.0%	8.2%
Eurozone	3.3%	-25.6%	41.3%	-5.2%	-2.8%	-45.4%	90.4%	1.0%	-13.2%	13.4%
Japan	7.9%	-20.8%	35.1%	7.7%	10.5%	-35.7%	67.1%	3.4%	-10.7%	12.6%
UK	1.5%	-54.5%	121.4%	-19.0%	-16.0%	-66.9%	143.9%	-4.1%	-21.5%	17.1%
US	7.5%	-9.2%	18.3%	21.4%	23.8%	-17.8%	48.0%	15.1%	1.9%	10.7%
China	5.4%	-0.8%	6.2%	33.4%	36.0%	-1.3%	32.0%	9.2%	5.6%	2.7%
MSCI World	6.3%	-14.7%	25.0%	12.5%	15.0%	-26.0%	55.4%	10.3%	-2.8%	10.8%
MSCI AC World	5.8%	-12.9%	22.0%	12.6%	15.2%	-25.0%	53.1%	9.8%	-2.9%	10.1%
MSCI EM	2.2%	-2.5%	6.6%	13.4%	16.4%	-20.6%	43.3%	5.9%	-5.6%	6.8%

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			

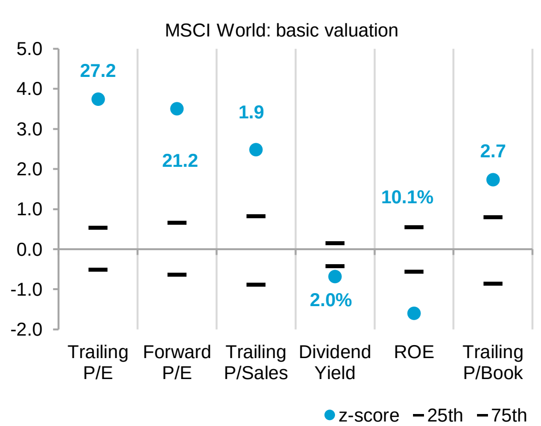
Comments

- Prices and valuations remain high, though volatility increased in the month of August
- Q2 showed a material earnings trough in developed and emerging markets in 2020; in line with our view
- A further price correction is more likely than not over the next 6 months
- 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

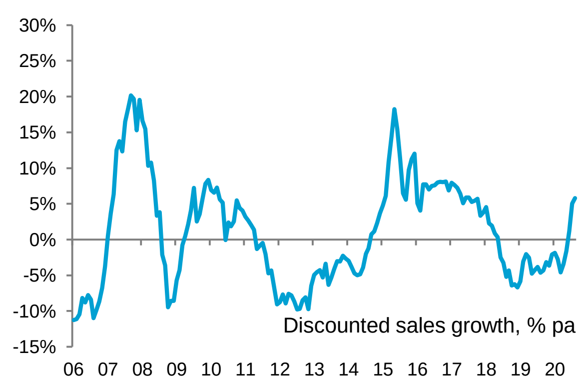
Developed market valuations are high as investors expect medium term earnings potential to remain relatively unimpacted

Valuation metrics for the MSCI World equity index



Market pricing implies low-to-average 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



Source: FactSet, Willis Towers Watson).

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