

Global Markets Overview

Asset Research Team

August 2020

Tracking recent asset price moves and our outlook

1. Our Outlook

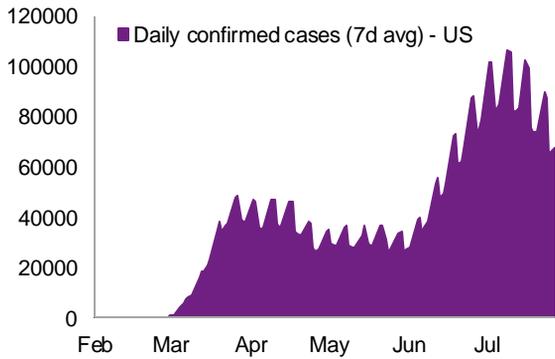
A summary of our outlook is provided below:

- **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 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 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 two months.
- 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 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.

COVID-19 case tracker

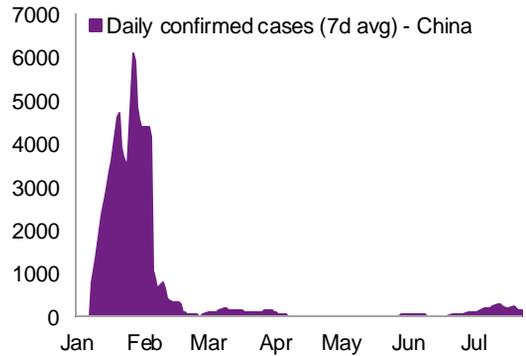
Daily cases: elevated in US; rising but low in Europe; flat and low in China

Exhibit 1: The number of daily confirmed cases in the United States has fallen to around 60,000



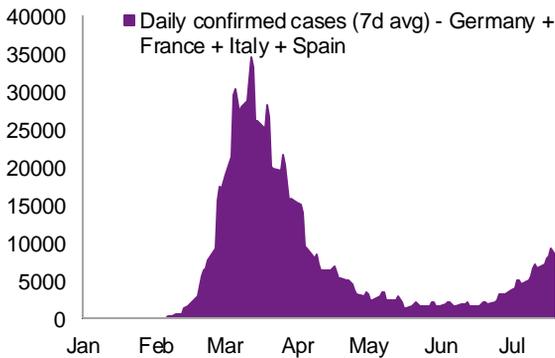
Source: Factset, Willis Towers Watson

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



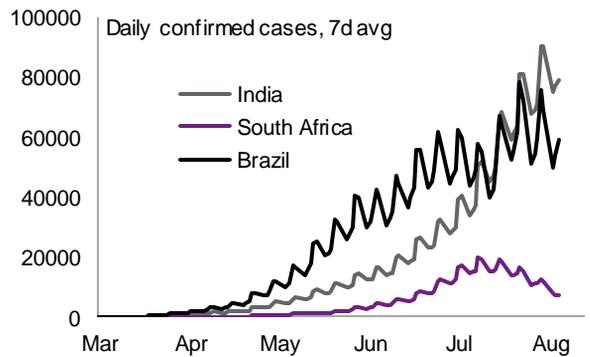
Source: Factset, Willis Towers Watson

Exhibit 3: In aggregate, Eurozone cases are at low levels; there are some recent localised increases



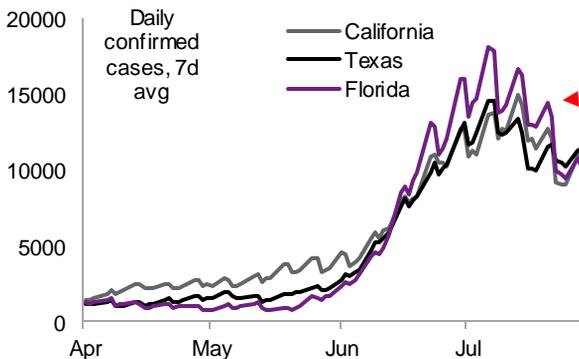
Source: Factset, Willis Towers Watson

Exhibit 4: Large emerging markets, e.g., Brazil and India have had high and rising daily cases



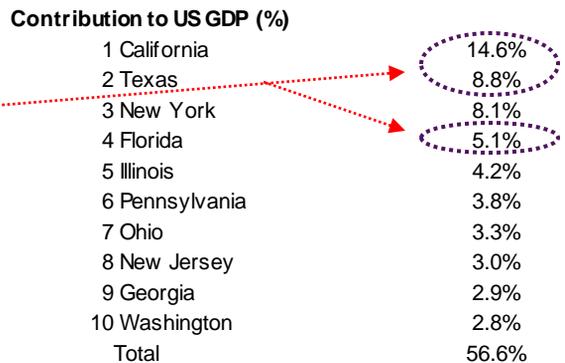
Source: Factset, Willis Towers Watson

Exhibit 5: Within the US, cases have started to fall gradually in some large states from high levels



Source: Factset, Willis Towers Watson

Exhibit 6: These states contribute significantly to US GDP, creating downside risks to the US recovery



Source: Factset, Willis Towers Watson

Economic conditions monitor

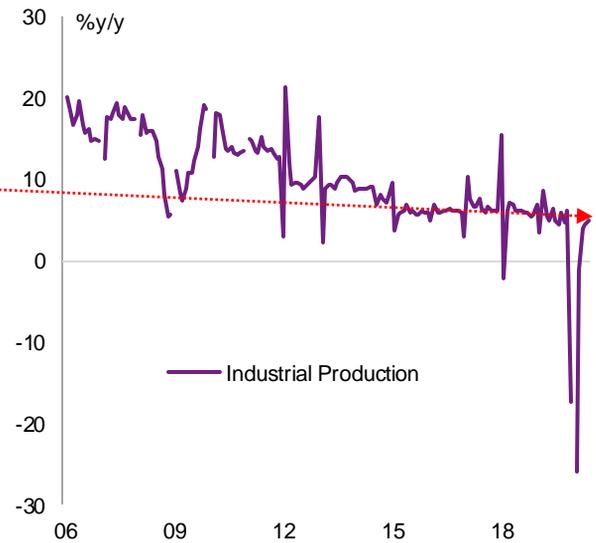
Tracking economic activity in the major economies

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-June |
|---------------|---------------------------------|----------------------------|--|
| China | -25% | February | -2% |
| United States | -15% | April | -7% |
| Germany | -15% | April | -10% |
| France | -20% | April | -15% |
| Spain | -20% | April | -13% |
| Italy | -25% | April | -20% |

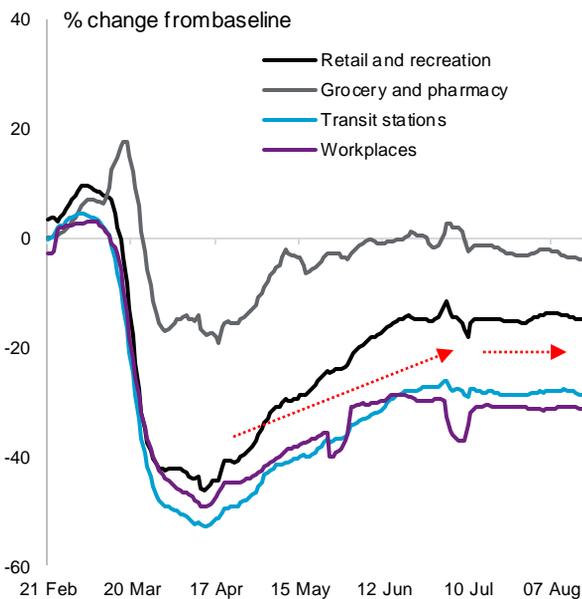
Source: Willis Towers Watson

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



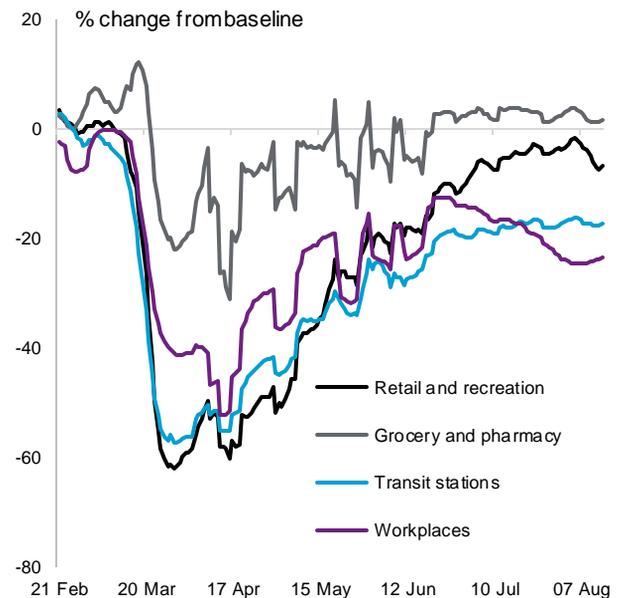
Source: Factset, Willis Towers Watson

Exhibit 9: US: mobility of people in various economic areas rose from April, supporting spending, but has slowed as virus cases have risen



Source: Factset, Willis Towers Watson

Exhibit 10: Germany: A steady increase in economic mobility (and likely spending) since April; with some evidence of a slowing in the pace of recovery



Source: Factset, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

31 Jul 2020

| 31 July 2020 | | Spot yields | | | | | What's priced-in | | |
|--------------------------|-----------------|-------------|-------|-------|-------|-------|------------------|--------|--------|
| % / %pts | | Level | Δ 1m | Δ 3m | Δ 1y | Δ 3y | 1y fwd | 2y fwd | 5y fwd |
| Developed nominal yields | Eurozone | | | | | | | | |
| | 1y/cash | -0.69 | -0.02 | -0.04 | -0.02 | 0.03 | -0.75 | -0.82 | -0.56 |
| | 10y | -0.53 | -0.06 | 0.02 | -0.10 | -1.08 | -0.46 | -0.39 | -0.13 |
| | US | | | | | | | | |
| 1y/cash | 0.06 | -0.03 | -0.06 | -1.92 | -1.17 | 0.20 | 0.32 | 0.61 | |
| 10y | 0.55 | -0.11 | -0.10 | -1.49 | -1.79 | 0.64 | 0.74 | 1.00 | |
| Breakeven infl. | US (CPI) | | | | | | | | |
| | 3y | 1.28 | 0.22 | 1.06 | -0.18 | -0.34 | - | - | 1.33 |
| | 10y | 1.43 | 0.14 | 0.40 | -0.27 | -0.35 | - | - | 1.35 |

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 | | | | <ul style="list-style-type: none"> 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 low er 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 | | | | <ul style="list-style-type: none"> 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



Source: FactSet, Willis Towers Watson).

US inflation pricing has moved up, but may still over-reflect cyclical and secular disinflationary forces.

US CPI inflation rate and inflation market pricing



Source: FactSet, Willis Towers Watson).

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)

31 July 2020

| 31 July 2020 | | Pricing - Option adjusted spreads, bps | | | | | Implied defaults | | | | |
|--------------|--------------|--|------|------|-----|-----|------------------|-------|-------|------|------|
| | | Current | Δ1m | Δ3m | Δ1y | Δ3y | Current | Δ1m | Δ3m | Δ1y | Δ3y |
| High grade | Global | 140 | -19 | -69 | 27 | 34 | 1.0% | -0.5% | -1.7% | 0.6% | 0.9% |
| | US | 141 | -19 | -76 | 27 | 32 | 1.0% | -0.5% | -1.9% | 0.6% | 0.8% |
| | Eurozone | 128 | -20 | -55 | 26 | 34 | 0.7% | -0.5% | -1.4% | 0.6% | 0.9% |
| | UK | 157 | -18 | -50 | 13 | 31 | 1.4% | -0.5% | -1.3% | 0.3% | 0.8% |
| | Canada | 148 | -18 | -56 | 32 | 35 | 1.2% | -0.5% | -1.4% | 0.8% | 0.9% |
| | Australia | 116 | -17 | -55 | 15 | 7 | 0.4% | -0.4% | -1.4% | 0.3% | 0.2% |
| Low grade | Global HY | 547 | -96 | -236 | 140 | 180 | 3.5% | -1.4% | -3.4% | 1.9% | 2.6% |
| | US HY | 516 | -128 | -247 | 123 | 155 | 3.1% | -1.8% | -3.5% | 1.6% | 2.2% |
| | Eurozone HY | 487 | -34 | -147 | 118 | 219 | 3.4% | -0.5% | -2.1% | 1.7% | 3.1% |
| | US loans | 529 | -48 | -176 | 120 | 145 | 3.3% | -0.7% | -2.5% | 1.7% | 2.1% |
| US EMD Debt | Hc EMD Corps | 369 | -34 | -149 | 111 | 115 | 4.4% | -0.5% | -2.7% | 2.1% | 2.0% |
| | HC EMD Sov | 370 | -25 | -134 | 106 | 100 | 3.1% | -0.5% | -2.3% | 1.6% | 1.8% |

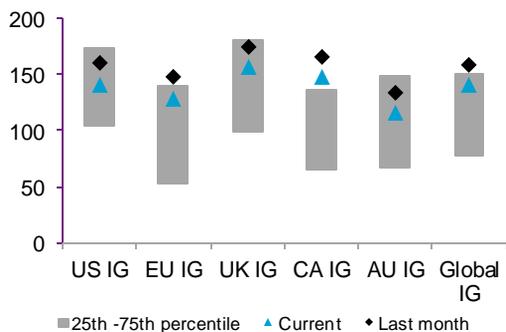
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

| Credit | Economic conditions priced-in | Our outlook for economic conditions | Asset return outlook | Comments |
|------------------|-------------------------------|-------------------------------------|----------------------|--|
| Corporate credit | | | | |
| Investment grade | Highly negative | Neutral | Neutral | <ul style="list-style-type: none"> 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 |
| High yield | Highly negative | Neutral | Neutral | <ul style="list-style-type: none"> At current spreads, high quality credit assets are approaching the levels at which they are likely to provide only modest returns above equivalent government bonds |
| US | Highly negative | Neutral | Neutral | |
| Europe | Highly negative | Negative | Neutral | <ul style="list-style-type: none"> 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 pricing-in a pessimistic outlook for corporate credit |
| Loans | Highly negative | Neutral | Neutral | |
| US | Highly negative | Neutral | Neutral | |
| Europe | Highly negative | Negative | Neutral | <ul style="list-style-type: none"> Niche and securitized market pricing appears to be pricing-in a somewhat more pessimistic outlook (in aggregate) relative to vanilla corporate credit markets |

Key: Highly negative Negative Neutral Positive Highly positive

Investment grade spreads continued to contract over the past month but remain at the upper end of their interquartile ranges

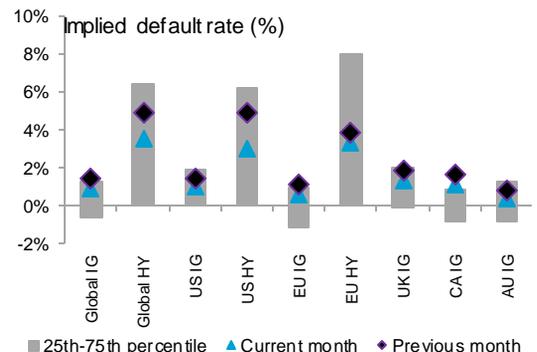
Investment grade corporate option-adjusted spreads, bps



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

Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)

31 July 2020

| 31 July 2020 | Δ 1 month | | | Δ 1 year | | | Δ 3 years (pa) | | | |
|--------------|--------------|-------|--------------|--------------|--------------|--------|----------------|--------------|-------|--------------|
| | Total return | EPS | Trailing P/E | Price return | Total return | EPS | Trailing P/E | Total return | EPS | Trailing P/E |
| Australia | 0.3% | -0.1% | 0.4% | -14.8% | -11.5% | -8.5% | -6.9% | 4.7% | 4.0% | -3.6% |
| Canada | 4.3% | -0.2% | 4.3% | -2.7% | 0.6% | -13.2% | 12.6% | 5.0% | 3.8% | -2.1% |
| Eurozone | -1.4% | 0.3% | 3.1% | -9.5% | -7.3% | -26.8% | 30.4% | -0.3% | -0.8% | -2.4% |
| Japan | -3.6% | -0.5% | -3.1% | -3.5% | -0.9% | -19.1% | 20.1% | 0.6% | -2.1% | 0.3% |
| UK | -4.5% | 0.0% | -4.7% | -23.8% | -20.7% | -27.0% | 4.5% | -4.1% | 6.1% | -13.5% |
| US | 5.9% | -0.3% | 6.1% | 10.9% | 13.1% | -9.3% | 22.5% | 12.4% | 6.1% | 3.8% |
| China | 9.3% | -0.8% | 8.3% | 21.5% | 23.9% | 2.4% | 18.8% | 8.8% | 7.2% | 0.1% |
| MSCI World | 3.4% | 0.0% | 4.7% | 3.7% | 6.1% | -12.6% | 20.6% | 8.2% | 4.3% | 1.1% |
| MSCI EM | 8.2% | -0.3% | 8.7% | 8.1% | 11.1% | -19.2% | 28.3% | 5.9% | -3.9% | 4.3% |

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 | Neutral | Neutral | Neutral |
| Emerging | Negative | Negative | Neutral |

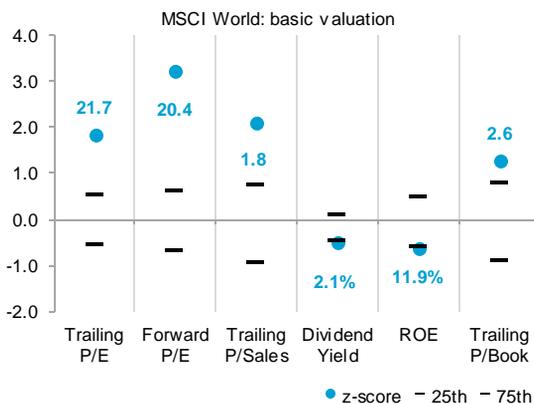
Comments

- 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 draw down 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 only gradual 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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