Global Markets Overview

Asset Research Team

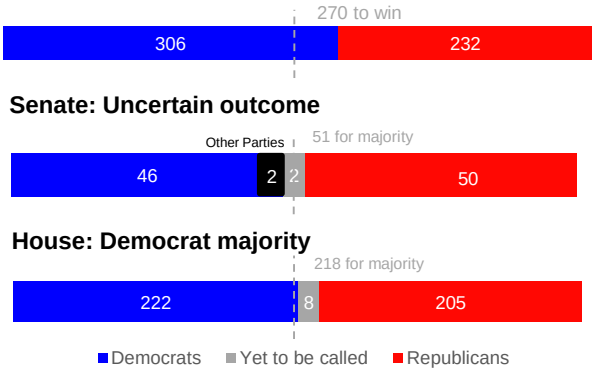
November 2020

Key developments to watch

The US presidential election has been called for Biden; it is likely that the chambers of Congress will be split between Republican and Democrat majorities

- The next key date is 8 December – the governor of each state must compile the results currently being certified and send them to Congress
- What are the likely policy implications of a Biden presidency and split Congress?
  - We expect a new pandemic relief fiscal package of $1-2 trillion in January, irrespective of the election outcome
  - Net positive fiscal stimulus over four years but less than expected under a Democrat sweep; lower likelihood of major corporate tax increases
  - Use of executive actions, e.g., to re-join the Paris climate accord, re-join the World Health Organisation, etc.

Presidential election: Results called



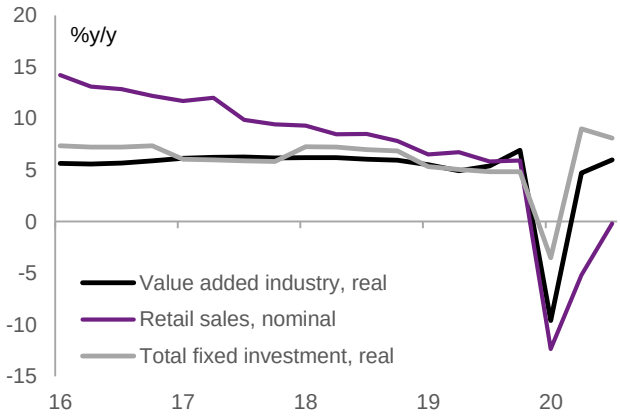
Source: The Associated Press, Willis Towers Watson

China's policymakers met to consider the draft proposal for their 14th Five-Year Plan (2021-2025) and overall economic policy to 2035

Selected key areas for progress

- An average annual economic growth target of around 5% for the next five years
- Double the total economic volume or per capita income by 2035
- Strengthen domestic innovation and self-reliance in key technologies and increase R&D spending
- Form strong domestic demand and markets
- Open up markets to non-China companies and investors, e.g., further opening of the capital account and a more prominent role for the Renminbi
- A net-zero carbon emissions economy by 2060

Capital investment and manufacturing have driven China's rapid recovery. We expect household spending growth to accelerate in 2021



Source: Factset, Oxford Economics, Willis Towers Watson

Five-year investment outlook

Summary of our outlook

Economic Outlook:

- 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, when the next US fiscal stimulus package is agreed, and its size, are critically important for the speed of the US recovery over the next four months. 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.
- 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.
- The recent announcements of effective vaccines increase the likelihood of them being produced and distributed at scale in the first half of 2021. This reduces uncertainty over the shape of recovery in the world. Nevertheless, we still expect large divergences between countries given large differences in the number of virus cases in the short-term, the size of fiscal and monetary policy responses, and other political and geopolitical factors (e.g., global trade relations).

Capital-market outlook:

- 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.

Portfolio Recommendations:

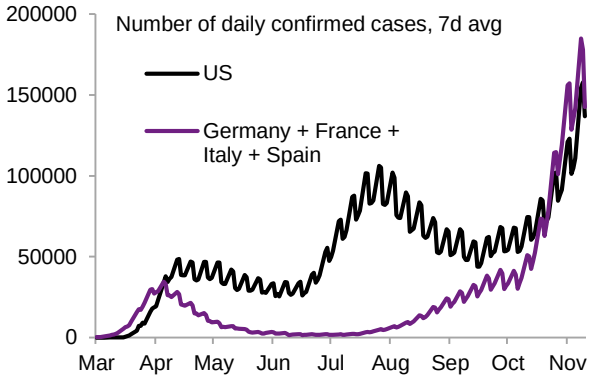
- Recent market moves have been severe but, in our view, provide a reminder about the regular actions investors can undertake. We will always face systemic risks, whether they are economic, societal (such as COVID-19) or environmental. Thinking carefully about the following actions will provide more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

Asset Research Team

Economic conditions monitor

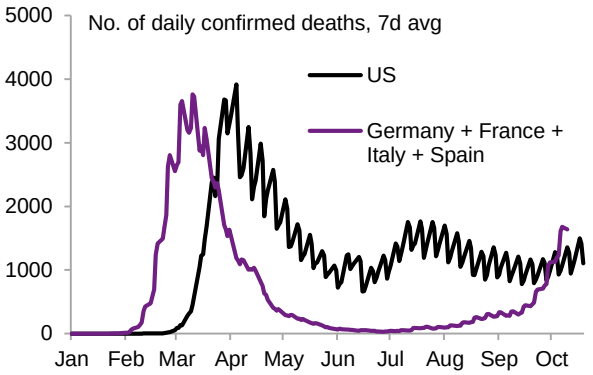
Tracking economic activity in major economies

Exhibit 1: The number of COVID-19 cases are high and rising in the US and Eurozone



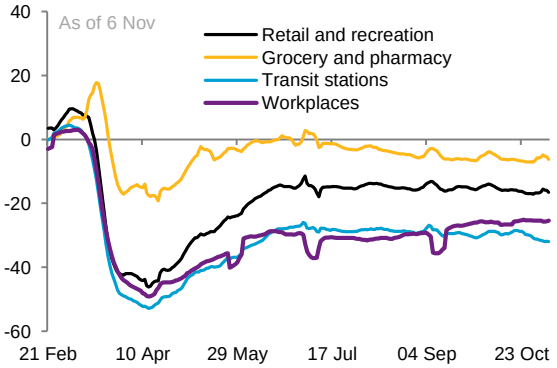
Source: Factset, Willis Towers Watson

Exhibit 2: Daily deaths are below the previous peak due to improvements in treatment measures



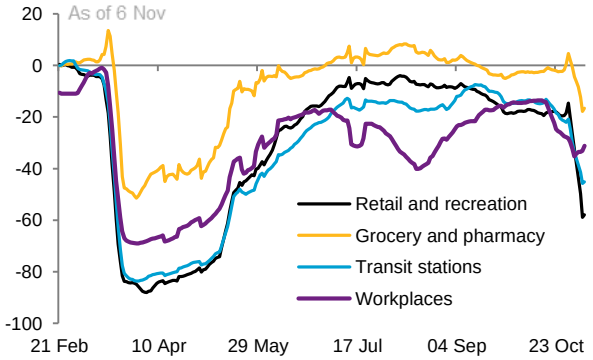
Source: Factset, Willis Towers Watson

Exhibit 3: US mobility has been relatively constant since June despite higher virus cases reported



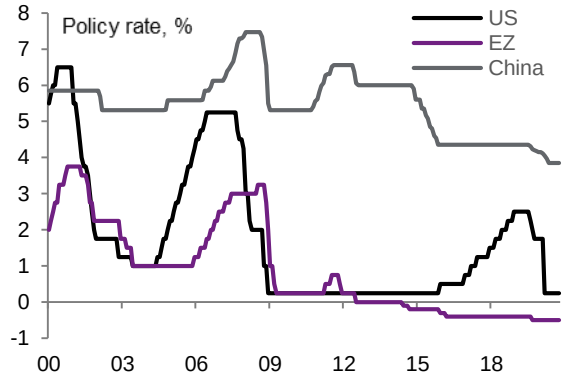
Source: Google mobility report, Willis Towers Watson

Exhibit 4: New stringent containment measures in France will cause a new economic contraction



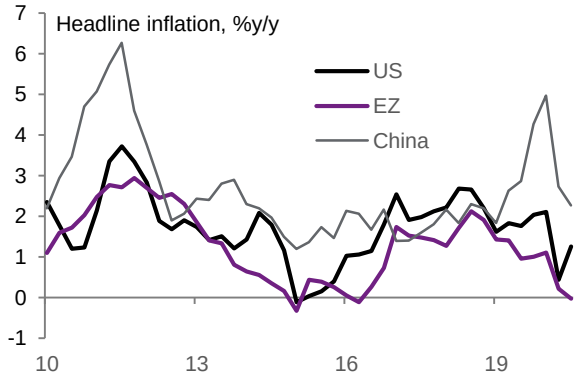
Source: Google mobility report, Willis Towers Watson

Exhibit 5: US and EZ policy rates are expected to remain at current levels until at least 2023



Source: Factset, Willis Towers Watson

Exhibit 6: The Eurozone is expected to experience low inflation over the short and medium-term



Source: Factset, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

30 October 2020

30 October 2020		Spot yields					What's priced-in (yield)		
% / %pts		Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	1y fwd	2y fwd	5y fwd
Developed nominal yields	**Eurozone**								
	1y/cash	-0.75	-0.08	-0.06	-0.16	-0.09	-0.85	-0.91	-0.64
	10y	-0.61	-0.10	-0.09	-0.21	-1.01	-0.55	-0.48	-0.23
	US								
	1y/cash	0.07	0.01	0.00	-1.46	-1.39	0.31	0.53	1.02
	10y	0.87	0.19	0.33	-0.83	-1.54	1.03	1.16	1.49
Breakeven inflation	**US (CPI)**								
	3y	1.36	-0.07	0.03	0.12	-0.43	-	-	1.65
	10y	1.69	0.09	0.22	0.21	-0.14	-	-	1.71

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 drives a quick recovery, yields could rise faster than is priced
US				
Japan				
AAA-Eurozone				

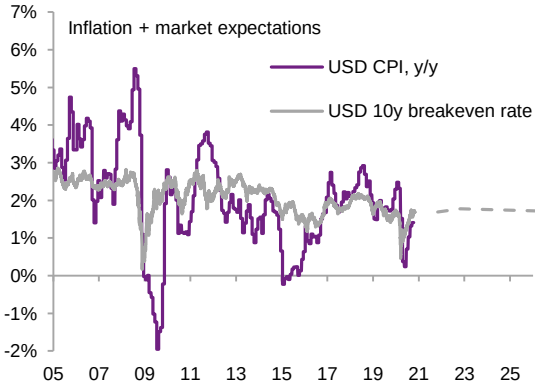
Key: Highly negative | Negative | Neutral | Positive | Highly positive

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

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

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)
30 October 2020

30 October 2020		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	131	-7	-9	16	32	0.8%	-0.2%	-0.2%	0.4%	0.8%
	US	134	-10	-7	17	33	0.9%	-0.3%	-0.2%	0.4%	0.8%
	Eurozone	116	-2	-12	13	27	0.4%	-0.1%	-0.3%	0.3%	0.7%
	UK	144	-6	-13	0	21	1.1%	-0.2%	-0.3%	0.0%	0.5%
	Canada	141	1	-7	16	30	1.0%	0.0%	-0.2%	0.4%	0.8%
	Australia	112	-6	-4	8	13	0.3%	-0.2%	-0.1%	0.2%	0.3%
Low grade	Global HY	552	-7	5	126	209	3.6%	-0.1%	0.1%	1.8%	3.0%
	US HY	532	-9	16	117	181	3.3%	-0.1%	0.2%	1.7%	2.6%
	Eurozone HY	482	10	-5	110	243	3.3%	0.1%	-0.1%	1.6%	3.5%
	US loans	516	-62	-84	60	132	3.1%	-0.9%	-1.2%	0.9%	1.9%
US EM debt	Hc EMD Corps	346	-11	-23	69	121	3.5%	-0.2%	-0.9%	0.2%	1.5%
	HC EMD Sov	326	-9	-44	9	77	2.7%	-0.2%	-0.4%	1.1%	1.9%

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

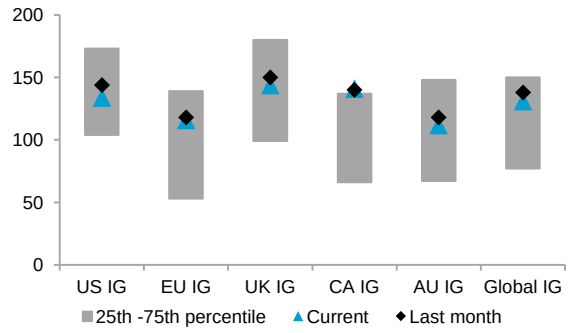
Credit	Economic conditions priced-in	Our outlook for economic conditions	Asset return outlook
Corporate credit			
Investment grade			
High yield			
US			
Europe			
Loans			
US			

- 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
- At current spreads, high quality credit assets are approaching levels at which they are likely to provide moderate returns above equivalent government bonds
- We retain a somewhat cautious outlook for developed market speculative-grade credit given shorter-term risks. Current pricing implies an average level of defaults relative to historic average pricing.
- Niche and securitized market pricing appears to be discounting a somewhat more pessimistic outlook (in aggregate) relative to vanilla corporate credit markets

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

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

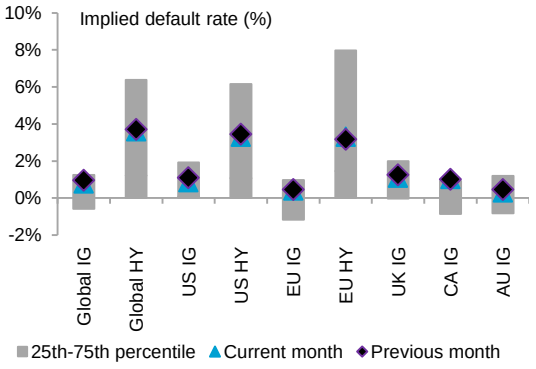
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, Willis Towers Watson).

Market implied default rates for lower grade credit remain close to their long term averages

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)

30 October 2020

30 October 2020	Δ 1 month			Δ 3 months			Δ 1 year			
	Total ret	12m EPS	Trailing P/E	Total ret	12m EPS	Trailing P/E	Price return	Total ret	12m EPS	Trailing P/E
Australia	2.1%	0.2%	1.8%	-1.5%	-16.4%	16.7%	-14.3%	-11.3%	-25.2%	14.6%
Canada	-3.4%	0.1%	-3.8%	-4.3%	-17.8%	15.5%	-7.3%	-4.1%	-32.6%	38.0%
Eurozone	-5.9%	2.8%	-9.2%	-5.7%	-23.0%	20.7%	-17.0%	-14.9%	-42.5%	51.6%
Japan	-2.5%	-0.3%	-2.3%	3.0%	-19.9%	27.5%	-4.9%	-2.5%	-33.9%	44.9%
UK	-5.1%	-1.8%	-3.5%	-6.7%	-56.7%	113.2%	-25.7%	-23.0%	-69.0%	139.1%
US	-2.6%	0.2%	-2.9%	1.6%	-9.6%	11.9%	9.2%	11.2%	-18.5%	34.0%
China	5.2%	-1.0%	4.6%	7.8%	-7.2%	11.4%	31.7%	34.2%	-9.0%	37.8%
MSCI World	-3.0%	0.8%	-3.9%	0.2%	-14.5%	16.3%	1.3%	3.5%	-25.6%	37.8%
MSCI AC World	-2.5%	0.6%	-3.1%	0.4%	-13.2%	15.0%	2.2%	4.5%	-24.9%	37.1%
MSCI EM	1.5%	-0.5%	2.5%	1.8%	-6.2%	8.7%	8.4%	11.2%	-22.6%	36.7%

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			

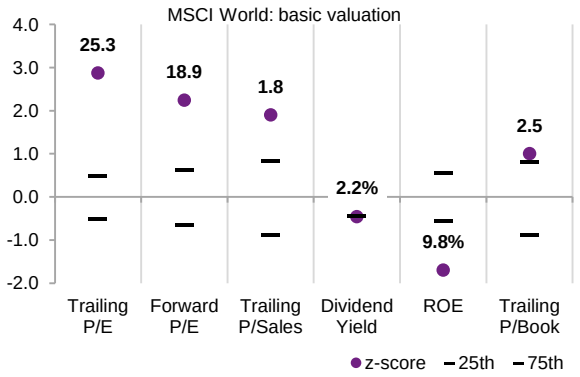
Comments

- Price to Earnings ratios have risen over the last three-months and are high, as investors look through the trough in earnings that was caused by COVID related mobility restrictions
- We have seen a material earnings recession in world equity markets but expect a subsequent recovery in 2021 – the pace of recovery will depend heavily on the effectiveness of fiscal/ 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 short-term virus and economic related risks
- Current equity prices are consistent with good expected 5-year returns in a scenario where earnings recover quickly in 2021. This is contingent on effective policy, with 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

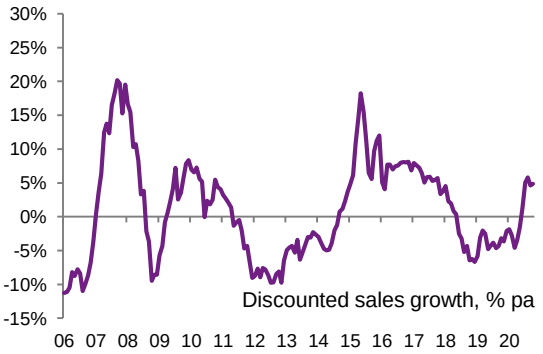
Valuation metrics for the MSCI World equity index



Source: FactSet, Willis Towers Watson).

Market pricing implies 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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