Global Markets Overview

Asset Research Team

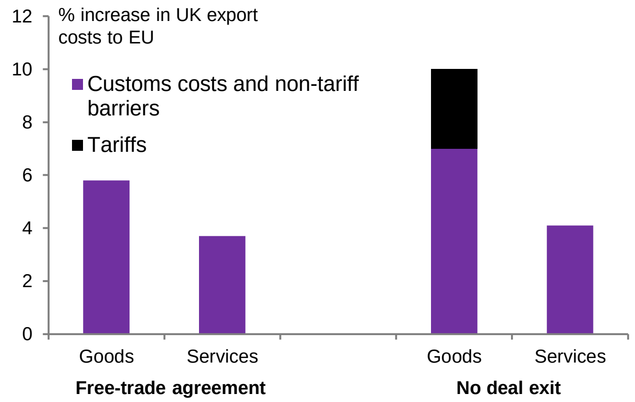
December 2020

Key developments to watch

The EU and the UK are finalising the terms on which the UK will leave the single market and customs union once the transition period ends on 31 Dec 2020

- There are two possible outcomes for the UK-European Union trading relationship: a free-trade agreement for goods or no trade deal
- What are the major economic implications of a deal or no deal?
  - Export costs for the UK-EU will rise under both free trade and no deal outcomes because of higher customs and non-tariff costs for goods and services
  - The impact on GDP of no deal is highest for the UK; the Eurozone impact is low overall but moderate for Ireland and the Netherlands
  - Sectoral impacts for the UK and EU vary – they are more pronounced in manufacturing, autos, extraction, and agriculture than services

The cost of trade between the UK and EU will rise irrespective of whether there is a trade deal



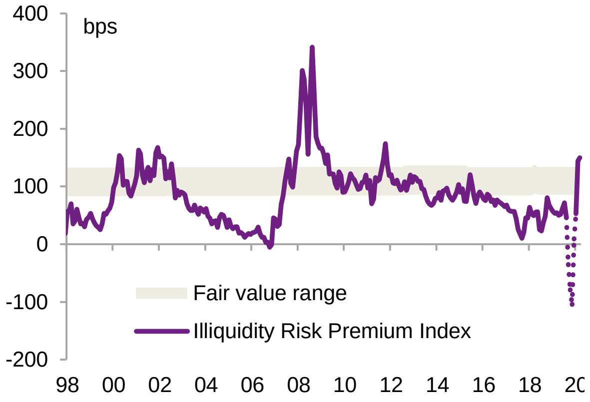
Source: Oxford Economics, Willis Towers Watson

Selective assets across niche alternative credit markets, private debt, and real estate provide good return prospects currently

Selected benefits and tailwinds

- **Help investors with a wide variety of objectives** – income generation, diversifying risk, investment grade replacement, or equity-like returns
- **An elevated illiquidity risk premium** – value has returned to segments of the market that have been competitive
- **Regulations can create opportunity** – identify where these will have the most impact
- **Complexity is better compensated** – co-investment deals are attractive

Illiquid asset prices have adjusted after the acute COVID and economic shock with the implied illiquidity risk premium settling at relatively elevated levels



Source: Factset, 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.

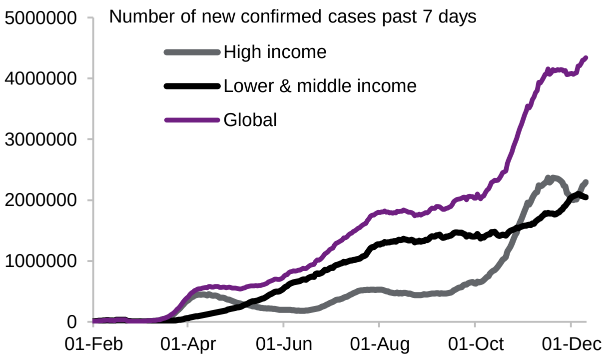
Portfolio Recommendations:

- 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.

Economic conditions monitor

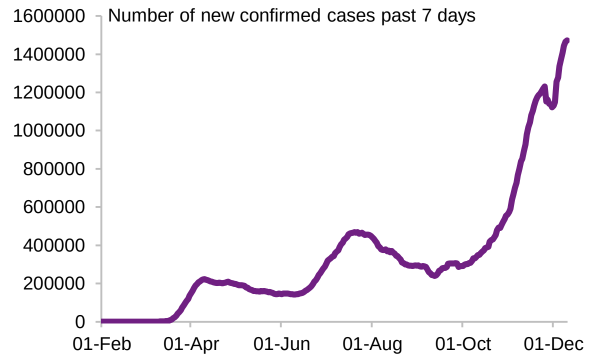
Tracking economic activity in major economies

Exhibit 1: The number of COVID-19 cases are high and rising in developed and emerging economies



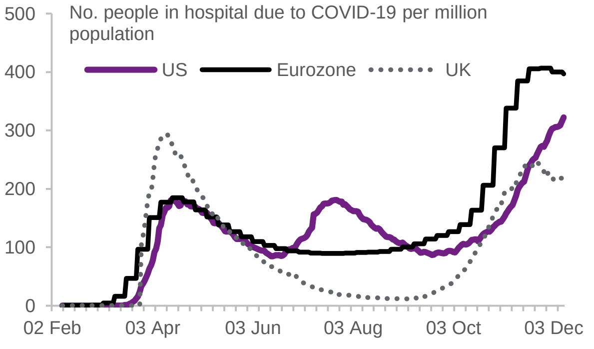
Source: Factset, Willis Towers Watson

Exhibit 2: Daily US COVID-19 cases have reaccelerated in recent weeks



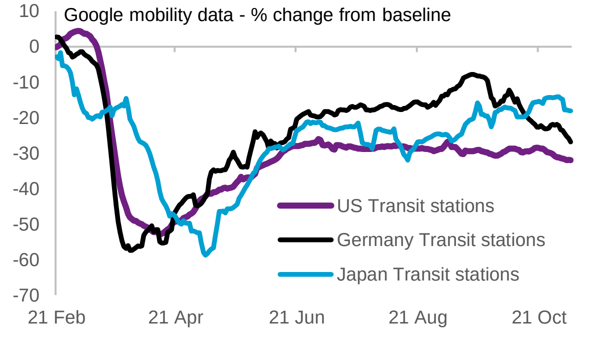
Source: Factset, Willis Towers Watson

Exhibit 3: High hospital admissions increase the likelihood of stringent shelter-at-home measures



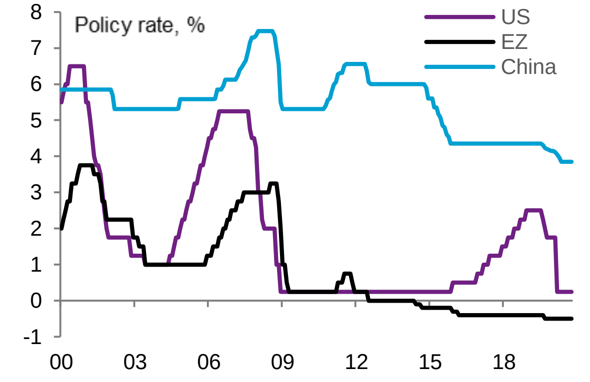
Source: FactSet, Willis Towers Watson

Exhibit 4: Mobility in the US and Germany is well-off previous levels – with implications for spending



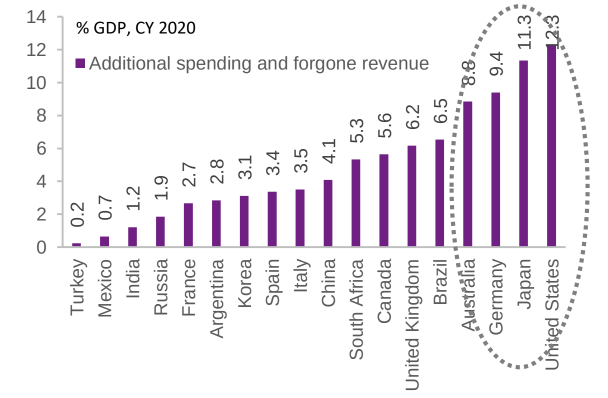
Source: Google mobility report, Willis Towers Watson

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: Economic recovery has been quicker in countries with higher government spending



Source: Factset, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)
30 November 2020

30 November 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	-0.71	0.03	-0.07	-0.15	-0.31	-0.77	-0.83	-0.59
	10y	-0.56	0.05	-0.16	-0.23	-0.97	-0.50	-0.43	-0.19
	US								
	1y/cash	0.05	-0.01	0.00	-1.54	-1.57	0.30	0.51	1.00
	10y	0.86	-0.02	0.12	-0.93	-1.58	1.01	1.14	1.46
Breakeven inflation	**US (CPI)**								
	3y	1.54	0.18	-0.07	0.20	-0.18	-	-	1.70
	10y	1.72	0.04	0.02	0.15	-0.10	-	-	1.77

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 – this is plausible • Given how low yields are, we expect bonds to offer limited upside potential 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

Markets expect US short interest rates and bond yields 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

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)

30 November 2020

30 November 2020		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	110	-21	-22	-2	10	0.3%	-0.5%	-0.6%	-0.1%	0.3%
	US	112	-22	-24	1	9	0.3%	-0.6%	-0.6%	0.0%	0.2%
	Eurozone	94	-22	-20	-10	5	0.0%	-0.6%	-0.5%	-0.3%	0.1%
	UK	119	-25	-26	-22	-7	0.5%	-0.6%	-0.7%	-0.6%	-0.2%
	Canada	125	-16	-15	6	15	0.6%	-0.4%	-0.4%	0.2%	0.4%
	Australia	95	-17	-15	-9	-4	-0.1%	-0.4%	-0.4%	-0.2%	-0.1%
Low grade	Global HY	452	-100	-68	39	100	2.2%	-1.4%	-1.0%	0.6%	1.4%
	US HY	433	-99	-69	31	72	1.9%	-1.4%	-1.0%	0.4%	1.0%
	Eurozone HY	369	-113	-77	21	96	1.7%	-1.6%	-1.1%	0.3%	1.4%
	US loans	467	-49	-32	18	82	2.4%	-0.7%	-0.5%	0.3%	1.2%
US EM debt	Hc EMD Corps	307	-39	-35	35	88	2.7%	-0.8%	-1.1%	-0.7%	1.1%
	HC EMD Sov	286	-40	-54	-35	55	2.1%	-0.6%	-0.5%	0.5%	1.4%

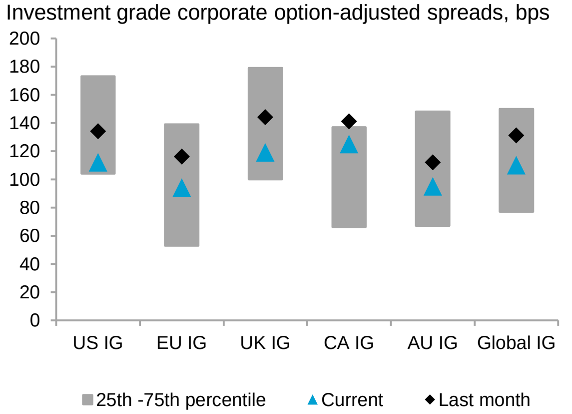
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

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 / modestly above 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 traditional corporate credit markets
Inv. grade	↑			
High yield	↑			
US	↑			
Europe	↑			
Loans	↑			
US	↑			

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

Investment grade spreads contracted moderately over the past month and (with the exception of the US) are broadly in the middle of their interquartile ranges

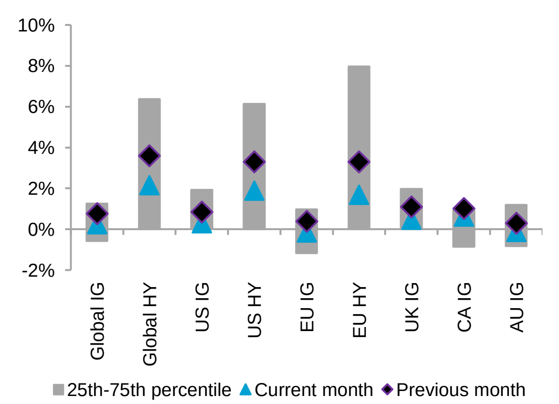
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, Willis Towers Watson).

Market implied default rates fell moderately over the past month

Estimated implied default rate based on current pricing



Source: FactSet, Willis Towers Watson).

Asset Research Team

Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)

30 November 2020

30 November 2020	∆ 1 month			∆ 1 year				∆ 3 years (pa)		
	Total return	EPS	Trailing P/E	Price return	Total return	EPS	Trailing P/E	Total return	EPS	Trailing P/E
Australia	10.5%	-6.6%	18.0%	-7.2%	-4.3%	-28.8%	30.3%	6.4%	-8.1%	10.9%
Canada	10.7%	0.7%	9.6%	-0.8%	2.7%	-33.1%	48.3%	4.7%	-6.9%	8.9%
Eurozone	17.5%	-1.9%	23.1%	-4.4%	-2.1%	-41.1%	76.1%	2.2%	-14.8%	16.6%
Japan	12.2%	-3.5%	16.3%	4.7%	7.3%	-33.4%	57.2%	2.8%	-12.0%	14.1%
UK	13.1%	-6.5%	20.6%	-16.3%	-13.5%	-69.6%	175.7%	-2.0%	-26.4%	27.6%
US	11.6%	-0.3%	11.7%	17.8%	20.0%	-16.8%	41.6%	14.0%	1.4%	10.3%
China	2.5%	-2.2%	3.2%	32.4%	34.9%	-12.6%	43.7%	8.6%	3.3%	3.1%
MSCI World	12.0%	-1.7%	14.6%	10.3%	12.7%	-25.1%	50.5%	9.9%	-4.2%	12.3%
MSCI EM	7.8%	0.0%	9.2%	16.2%	19.1%	-20.9%	46.4%	7.3%	-8.3%	11.7%

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	↑		

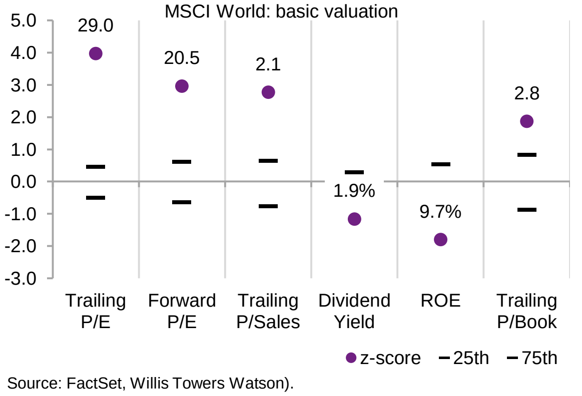
Comments

- Price to Earnings ratios have risen over the last three-months – especially in November – 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

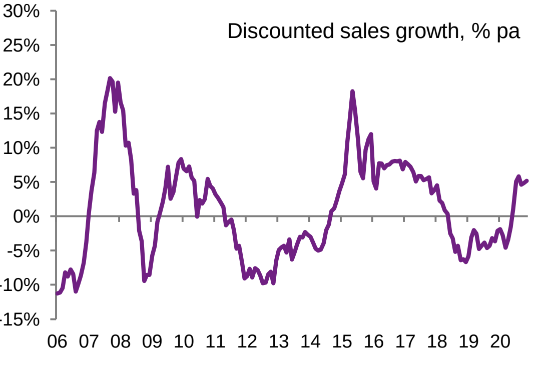
Valuation metrics for the MSCI World equity index



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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