Global Markets Overview

Asset Research Team

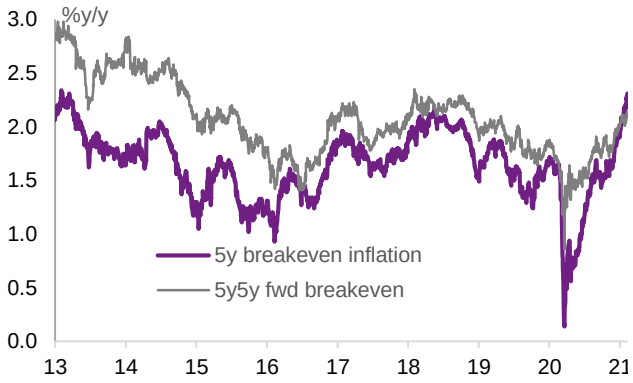
February 2021

Key developments to watch

Investor optimism over US growth prospects is being reflected in rising medium and long term inflationary expectations

- Investors are focused on a post-vaccine US economy, where consumer spending rebounds and strong fiscal stimulus boosts the pace of recovery over 2021 and beyond
- We believe that US inflation will rise in 2021 to moderately above Federal Reserve target levels but not to disruptive levels
- Positive base effects which will drive rising headline inflation this year, e.g., higher energy prices, will be temporary and will fade
- High levels of unemployment and spare capacity in many business sectors will keep wage growth and other aggregate inflationary pressures in check over the medium term in our view

Breakeven inflation expectations over the next 5-years and between 2026-30 provide a gauge for both inflation and growth conditions over the long-term



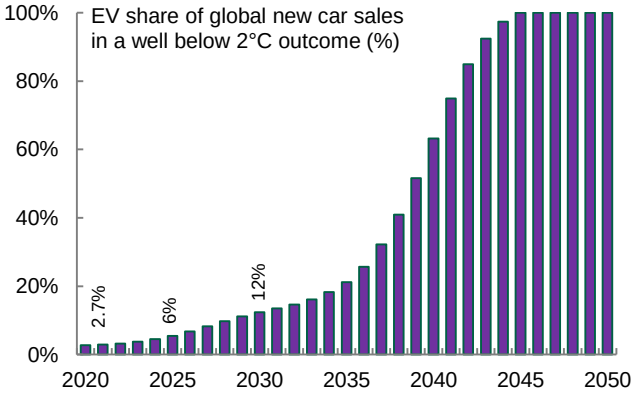
Source: FactSet, Willis Towers Watson

What are the key market-related themes we think investors should focus on to position themselves for success during 2021 and beyond?

Helping you to monitor macro changes

- **We think there are three standout market-related themes investors should focus on** – policy shifts, the rise of China, and sustainability
- **The nature of investing in a complex world is that change often happens slowly and then all at once**. Our three themes are no different
- **A practical means of coping with this slow but uncertain change** is by systematically monitoring those themes through thoughtfully-curated data
- **With this in mind we have developed three dashboards**, which we will keep up to date and evolve over time. They are on the WTW website: United States Europe Hong Kong Australia

Decarbonising transport: 2.7% - the share of new car sales from electric vehicles in 2020. This needs to double over the next 5-years under a well below 2°C pathway



Source: Willis Towers Watson

Investment outlook

Portfolio priorities for 2021

The high-level macroeconomic outlook

- Our economic outlook is split between a period of recovery and subsequent growth. Policy stimulus, in particular the ability to combine extremely easy monetary policy with highly reactive and historically sizeable fiscal stimulus, will determine how long the recovery phase lasts. It will also influence subsequent growth rates, although what ultimately drives this growth (productivity) is subject to a number of complex and overlapping factors.
- This new policy regime is likely to dominate the outcomes for the developed world in aggregate, with important differences between countries. In turn, this will impact market pricing and prospective returns. It also suggests less policy emphasis, relative to the past few decades, will be placed on controlling inflation and more on maximising employment, growth, and possibly the inclusiveness of both.
- Market pricing has generally responded to this policy regime but there remain profound implications for portfolio strategy.

With this outlook in mind, what are the key market-related themes we think investors should focus on to position themselves for success during 2021 and beyond?

We have narrowed down a potentially long list by assessing the risks and opportunities that are both highly material for current portfolio allocations and relatively more certain. From a macroeconomic perspective, we think three themes stand out:

1. **Policy shifts**: the post-COVID policy regime has shifted in important ways. Whilst much of this shift was evident before 2020, the policy response to the pandemic has accelerated it. This has important implications for return pathways and downside risk management in particular.
2. **The rise of China**: China's financial system continues to open, which has material and near certain implications for the sources of diversity available to investors and how downside risk can be managed.
3. **Sustainability**: this encompasses three important topics:
   a. **Climate**: we believe 2021 will prove to be a significant year for the climate transition, with the 26th UN Climate Change Conference of the Parties (COP26) due to take place in November.
   b. **Inclusive growth**: At the same time, the moral imperative to include diverse perspectives, races and life experiences in all spheres of society, including the professional, has been highlighted in 2020. It is also a financial imperative. Our view and hope is that inclusion will become a material influence on investors' choices.
   c. **Stewardship**: in order to manage these imperatives, the need for better practices by governments, regulators, corporates, asset managers, and asset owners is clear and growing.

We suggest investors focus on eight key priorities in 2021

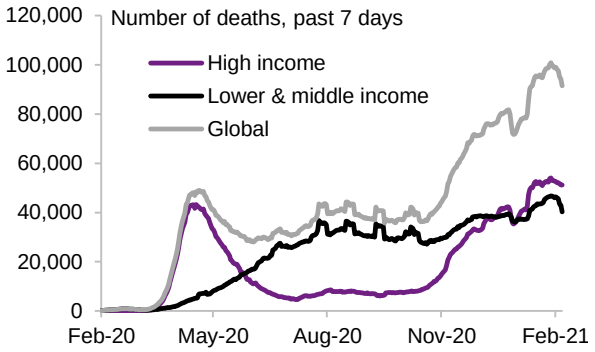
- Position for stronger near-term asset returns and lower long-term returns
- Revisit unlisted asset exposure
- Build a balanced exposure to China
- Maintain but evolve downside hedges
- Integrate climate risks & opportunities into portfolio construction
- Embedding inclusion and diversity in all levels of portfolio decision making
- Increase active management
- Monitor macro change

Asset Research Team

Economic conditions monitor

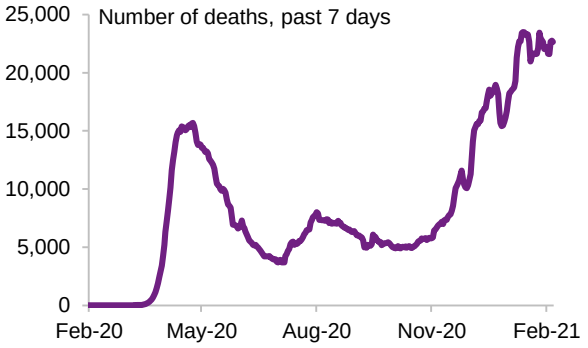
Tracking economic activity in the major economies

Exhibit 1: The number of COVID-19 related deaths are falling but high in developed and emerging economies



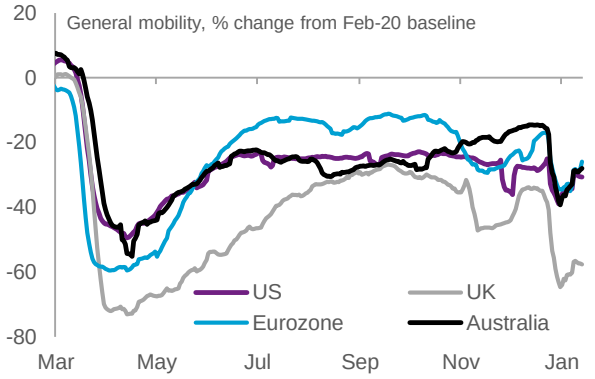
Source: FactSet, Willis Towers Watson

Exhibit 2: US COVID deaths have been high; vaccine rollout will aid economic "normalisation" from Q2



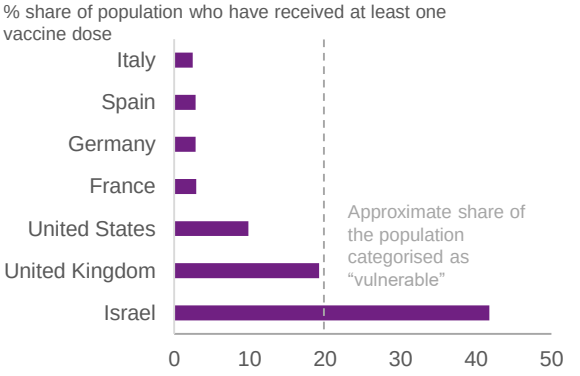
Source: FactSet, Willis Towers Watson

Exhibit 3: Restrictions on mobility are less stringent than last year – but have curbed short-term activity



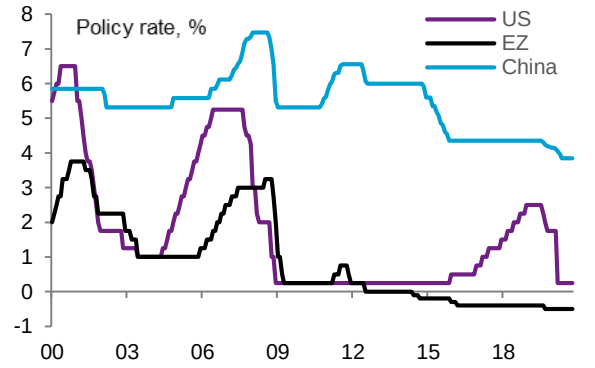
Source: FactSet, Willis Towers Watson

Exhibit 4: The pace of vaccine rollout is crucial to when economies can start to "normalise"



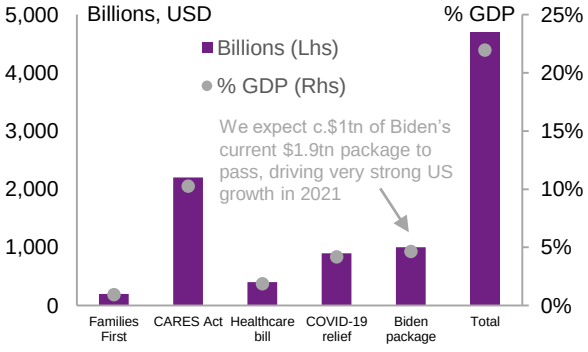
Source: FactSet, Willis Towers Watson

Exhibit 5: We expect US and EZ policy rates to remain at their current levels until at least 2023



Source: FactSet, Willis Towers Watson

Exhibit 6: US has spent $4.8tn in fiscal support since the pandemic start – the largest response globally



Source: FactSet, Oxford Economics, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

31 January 2021

31 January 2021		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	-0.68	0.06	0.07	-0.04	-0.01	-0.78	-0.85	-0.55
	10y	-0.52	0.04	0.09	-0.10	-1.23	-0.45	-0.37	-0.09
	US								
	1y/cash	0.02	-0.01	-0.04	-1.40	-1.88	0.35	0.65	1.33
	10y	1.12	0.19	0.24	-0.42	-1.62	1.31	1.48	1.86
Breakeven infl.	**US (CPI)**								
	3y	2.24	0.29	0.87	0.78	0.21	-	-	1.99
	10y	2.12	0.16	0.43	0.51	0.03	-	-	2.03

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

Sovereign bonds	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 close to their perceived lower bounds and central banks are engaged in asset purchases • Future expected short-dated interest rates have picked up slightly following positive vaccine news and US stimulus but still imply low rates for an extended period • Low interest rates imply low returns on cash holdings
US		
Japan		
AAA-Eurozone		
Developed 10-year nominal bonds		• Intermediate bond yields are low, alongside low short rates • Despite trending higher in recent weeks, yields are still 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 quicker recovery than expected, yields could rise faster than is priced
US		
Japan		
AAA-Eurozone		

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

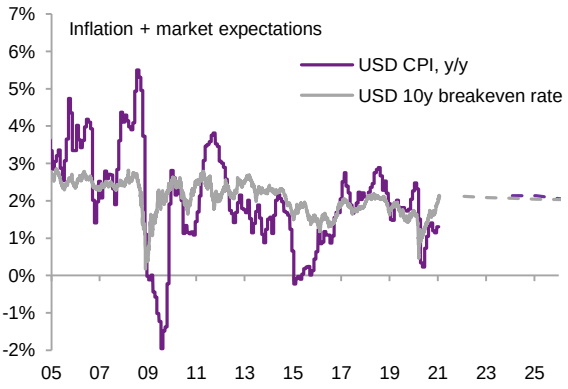
Markets expect US short interest rates and bond yields to remain low over the next 10-years

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)

31 January 2021

31 January 2021		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	103	0	-28	-4	14	0.1%	0.0%	-0.7%	-0.1%	0.4%
	US	103	0	-31	-6	12	0.1%	0.0%	-0.8%	-0.2%	0.3%
	Eurozone	94	1	-22	-1	19	-0.2%	0.0%	-0.6%	0.0%	0.5%
	UK	114	1	-30	-12	3	0.4%	0.0%	-0.8%	-0.3%	0.1%
	Canada	111	-7	-30	3	13	0.3%	-0.2%	-0.8%	0.1%	0.3%
	Australia	86	-4	-26	-10	-5	-0.4%	-0.1%	-0.7%	-0.3%	-0.1%
Low grade	Global HY	410	0	-142	2	93	1.6%	0.0%	-2.0%	0.0%	1.3%
	US HY	384	-2	-148	-19	55	1.2%	0.0%	-2.1%	-0.3%	0.8%
	Eurozone HY	350	-5	-132	15	94	1.4%	-0.1%	-1.9%	0.2%	1.3%
	US loans	421	-22	-95	5	59	1.7%	-0.3%	-1.4%	0.1%	0.8%
US EM debt	USD dollar EM corporates	283	-2	-63	16	90	2.3%	0.0%	-1.2%	-0.8%	1.3%
	US dollar EMD sovereigns	265	-1	-61	-41	63	1.7%	0.0%	-1.0%	0.2%	1.4%

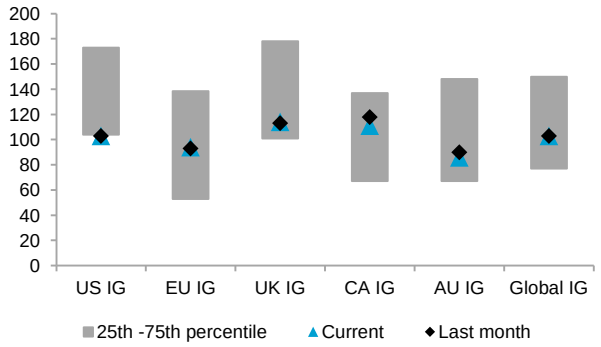
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		• Investment grade markets are pricing-in an allowance for a below average level of credit losses
Inv. grade		• We expect credit losses to be close to / modestly above these levels, particularly in the nearer term
High yield		• At current spreads, high quality credit assets are approaching levels at which they are likely to provide only moderate returns above equivalent government bonds
US		• 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
Europe		• Niche and securitized market pricing appears to be pricing-in a somewhat more pessimistic outlook in aggregate, relative to traditional corporate credit markets
Loans		
US		

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

Investment grade spreads remained broadly flat over the past month but are broadly at the lower end of their interquartile ranges (excl. EU and Canadian markets)

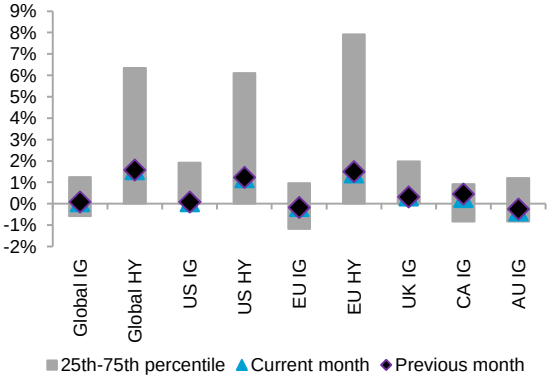
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, Willis Towers Watson).

Market implied default rates were broadly unchanged over the past month and remain low

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 January 2021

31 January 2021	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	0.6%	-0.4%	1.0%	-7.8%	-5.1%	-30.4%	32.5%	6.6%	-8.5%	11.8%
Canada	-0.7%	0.2%	-1.2%	-1.5%	1.9%	-32.2%	45.3%	5.1%	-7.2%	9.7%
Eurozone	-1.5%	0.3%	-2.5%	-3.5%	-1.2%	-37.8%	70.0%	1.6%	-12.9%	12.1%
Japan	0.4%	0.1%	0.3%	8.7%	11.4%	-33.0%	62.4%	3.1%	-11.7%	13.9%
UK	-0.7%	0.0%	-0.7%	-13.8%	-10.8%	-60.3%	117.0%	-2.2%	-18.9%	15.6%
US	-0.9%	0.5%	-1.5%	17.9%	20.0%	-16.6%	41.4%	12.7%	1.4%	8.9%
China	7.3%	-5.4%	12.1%	42.1%	44.7%	-19.0%	65.3%	7.1%	-0.5%	6.4%
MSCI World	-0.7%	0.6%	-1.7%	11.1%	13.5%	-24.3%	50.2%	9.2%	-3.6%	10.2%
MSCI EM	3.8%	-0.5%	3.4%	25.1%	28.3%	-23.2%	63.1%	7.5%	-8.9%	11.8%

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

Global equities	Asset return outlook
Developed	
Emerging	

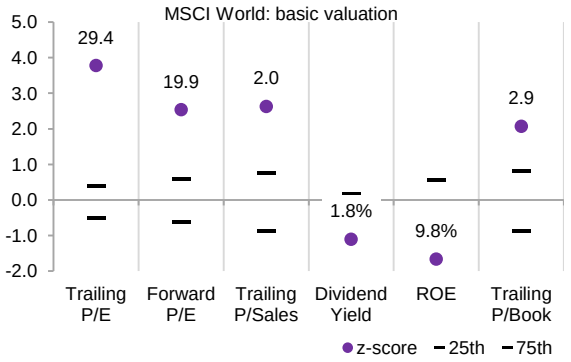
Comments

- Price to Earnings ratios have risen sharply over the last year and are high, as investors look through the trough in earnings that has been 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 in each country 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

Basic developed market financial ratios are very high as investors expect medium term earnings potential to remain relatively unimpacted

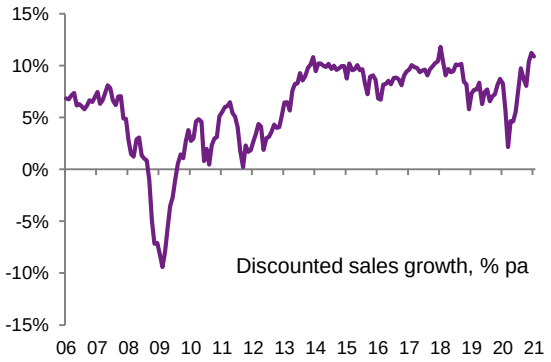
Valuation metrics for the MSCI World equity index



Source: FactSet, Willis Towers Watson).

Our valuation metric, which estimates the future sales growth that is priced-into equity markets is broadly in-line with the last decade – US equities are not expensive

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



Source: FactSet, Willis Towers Watson).

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