

Global Markets Overview

Asset Research Team

June 2021

Key developments to watch

Headline inflation in the US rises to 5.0% y/y, with core CPI rising by 3.8% y/y

Rising inflation is partly being driven by sectors which are experiencing a supply-demand mismatch due to supply-side bottlenecks as economies open further.

For example, used cars have seen prices increase by c.30% y/y, partly due to a shortage of semiconductor supply, which has caused new car production to slow.

Energy, other raw materials, tourism and travel (e.g., hotel prices and airline fares), and transportation industries have also experienced big price rises.

Our central outlook projects that the jump in inflation will be temporary and will fade over the next year. However, it is important to monitor the likelihood of, and portfolio risks from, sustained higher inflation.

An important part of the rise in current inflation is due to very high price increases in selective sectors, which are unlikely to be sustained

Category	Weight	%y/y increase
Food	14%	2.2%
Energy	7%	28.5%
Used Cars and Trucks	3%	29.7%
Apparel	2.8%	5.6%
Transportation services	5.2%	11.2%

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](#)

Policy is underpinning a strong rebound in global spending on services

- A strong recovery in the services sector in the US and Europe is underway, reflecting both public health policy (the further opening of economies) and economic policy (high levels of government and central bank support).
- The services component of the Purchasing Managers' Index (PMI) is a useful measure for the strength of spending on services. The latest global PMI reading has come in at 59.4 – a number above 50 implies spending is growing and 59.4 suggests a rapid expansion.
- Looking at some of the major regions, the US PMI for services came in at 70.4 for May, the UK at 62.9, and the Eurozone at 55.2.
- These point to rapid growth in services-related spending, supporting strong aggregate GDP growth over 2021/22.

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 provides selective investment opportunities, potentially broadens the sources of diversity available to investors, and can aid downside risk management.
- 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.

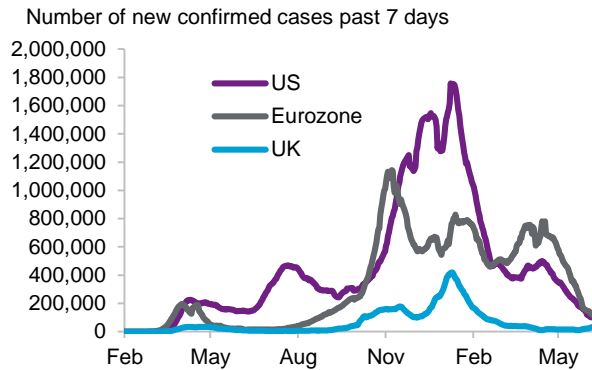
We suggest investors focus on eight key priorities in 2021

- 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

Economic conditions monitor

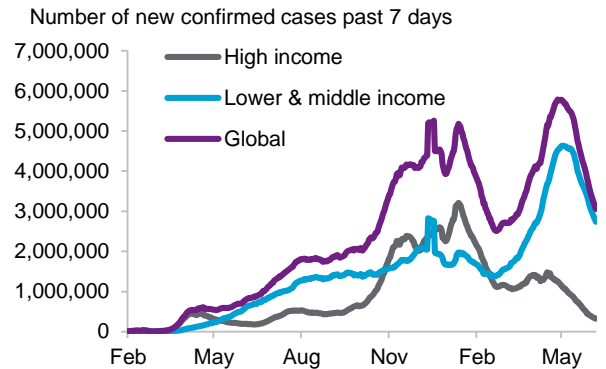
Tracking economic activity in the major economies

Exhibit 1: The number of COVID-19 cases have been declining globally



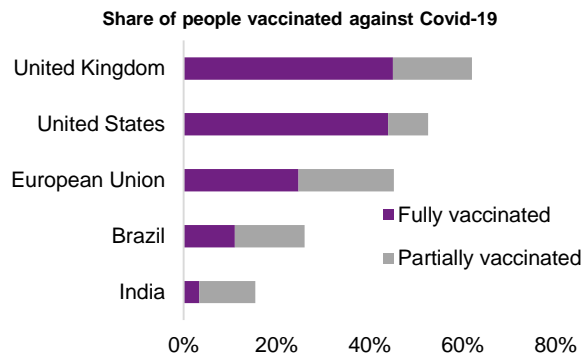
Source: FactSet, Willis Towers Watson

Exhibit 2: Global COVID-19 cases have been declining, especially in hot spots like Brazil, India



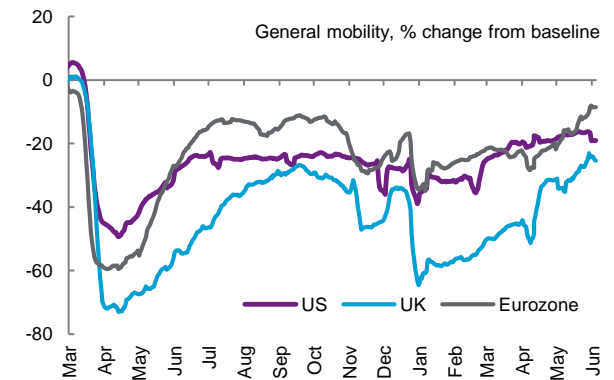
Source: FactSet, Willis Towers Watson

Exhibit 3: Developed economies, especially the US and UK, have higher vaccination rates



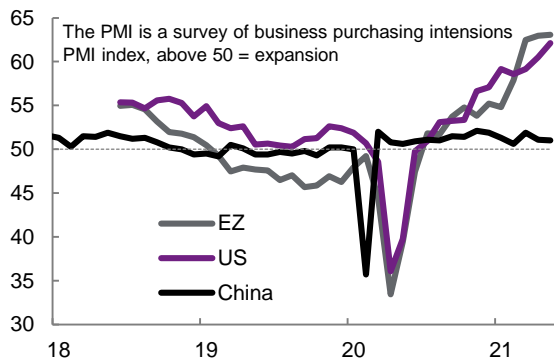
Source: Our world in data, Willis Towers Watson

Exhibit 4: Shelter-at-home and mobility restrictions are easing in the US, Eurozone and UK



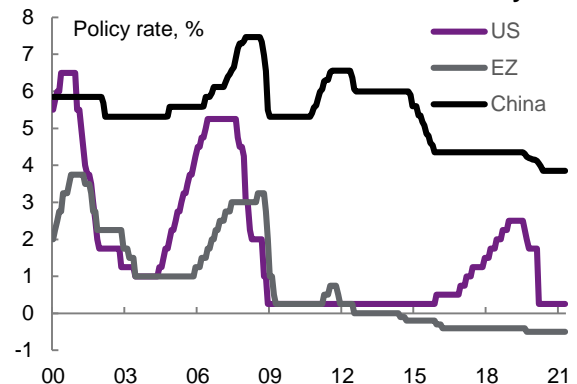
Source: Google mobility report, Willis Towers Watson

Exhibit 5: Manufacturing sectors in the US and Eurozone are experiencing a strong recovery ...



Source: FactSet, Oxford Economics, Willis Towers Watson

Exhibit 6: ... but we still expect policy rates in the US and Eurozone to remain on hold for several years



Source: FactSet, Willis Towers Watson

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)

31 May 2021

31 May 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	-0.66	0.00	-0.04	-0.03	-0.05	-0.69	-0.67	-0.14
	5y	-0.58	0.01	0.01	0.07	-0.31	-0.48	-0.33	0.19
	10y	-0.19	0.02	0.08	0.23	-0.56	-0.07	0.05	0.41
	US								
	1y/cash	0.05	-0.01	-0.02	-0.04	-2.19	0.24	0.71	2.17
5y	0.82	-0.06	0.05	0.44	-1.86	1.24	1.68	2.51	
10y	1.66	-0.04	0.11	1.01	-1.18	1.93	2.18	2.64	
Breakeven Inflation	US (CPI)								
	3y	2.80	0.08	0.40	2.24	0.77	-	-	2.30
	5y	2.64	0.01	0.30	1.79	0.56	-	-	2.31
	10y	2.51	0.01	0.25	1.39	0.44	-	-	2.25

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

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		<ul style="list-style-type: none"> Across major developed markets, guidance from policymakers remains accommodative. Benchmark rates are at or near perceived lower bounds and central banks are engaged in asset purchases.
US		
UK		<ul style="list-style-type: none"> Priced-in short rates have picked up materially year-to-date, consistent with improving economic conditions. However, this partly reflects rising bond risk premiums, and we expect cash rates to remain low as policymakers wait for inflation consistently at or above target before tightening.
AAA-Eurozone		
Developed 10-year nominal bonds		<ul style="list-style-type: none"> As optimism around the economic recovery has grown, intermediate bond yields have risen. US 10-year bond yields are c. 60bps higher than January.
US		<ul style="list-style-type: none"> Yields are now approaching levels they were trading at before the pandemic struck and are priced to rise slowly over the next few years.
UK		<ul style="list-style-type: none"> Near term, we think that risks to yields are still skewed upwards. Stimulus measures, excess savings, pent up demand and base effects could elevate inflation concerns.
AAA-Eurozone		<ul style="list-style-type: none"> We think that risks are more balanced over the medium term. Fiscal stimulus will roll-off in future years, while structural forces, such as high corporate debt levels, are also likely to constrain the future level of bond yields.

Key: Highly negative Negative Neutral Positive Highly positive

US yields have risen sharply YTD. Upside risks to yields remain but pricing is credible over the medium-term

US cash rate and 10y nominal bond yield



Source: FactSet, Willis Towers Watson

US breakeven inflation rates are roughly in line with the mid-point of the Fed's average inflation mandate

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 May 2021

31 May 2021		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	93	-2	-2	-91	-29	-0.2%	-0.1%	-0.1%	-2.3%	-0.7%
	US	91	-3	-4	-96	-31	-0.2%	-0.1%	-0.1%	-2.4%	-0.8%
	Eurozone	86	1	-3	-80	-33	-0.4%	0.0%	-0.1%	-2.0%	-0.8%
	UK	109	1	2	-88	-40	0.2%	0.0%	0.1%	-2.2%	-1.0%
	Canada	115	0	9	-82	2	0.4%	0.0%	0.2%	-2.1%	0.1%
	Australia	93	3	11	-57	-12	-0.2%	0.1%	0.3%	-1.4%	-0.3%
Low grade	Global HY	362	2	-21	-314	-21	0.9%	0.0%	-0.3%	-4.5%	-0.3%
	US HY	334	6	-23	-320	-29	0.5%	0.1%	-0.3%	-4.6%	-0.4%
	Eurozone HY	303	-1	-21	-254	-67	0.8%	0.0%	-0.3%	-3.6%	-1.0%
	US loans	402	-5	-5	-197	42	1.5%	-0.1%	-0.1%	-2.8%	0.6%
HC EMD	Hc EMD Corps	268	-3	2	-184	7	2.1%	-0.1%	-0.2%	-3.5%	-0.2%
	HC EMD Sov	255	-5	-10	-174	-9	1.5%	0.0%	0.0%	-2.8%	0.1%

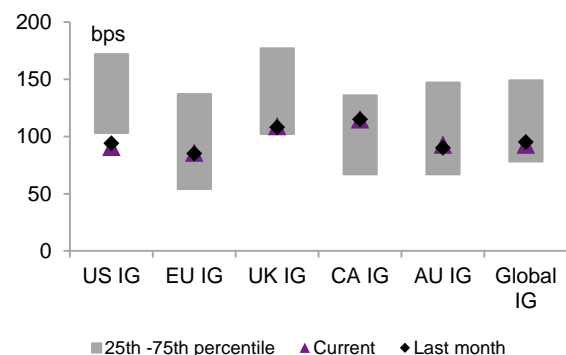
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		<ul style="list-style-type: none"> Investment grade markets are pricing-in an allowance for a below average level of credit losses
Inv. grade		<ul style="list-style-type: none"> We expect credit losses to be close to these levels, particularly in the nearer term
High yield		<ul style="list-style-type: none"> 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		<ul style="list-style-type: none"> We retain a somewhat cautious outlook for developed market speculative-grade credit given shorter-term risks. Current pricing implies a below average level of defaults relative to historic average pricing. As such, pricing has moved somewhat to pricing-in an optimistic outlook for corporate credit
Europe		
Loans		<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 traditional corporate credit markets
US		

Key: Highly negative Negative Neutral Positive Highly positive

Investment grade spreads were largely unchanged over the past month and remain broadly at the lower end of their interquartile range (excl. EU and Canadian markets)

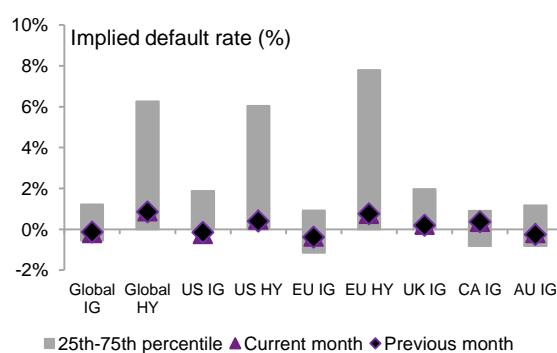
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, Willis Towers Watson).

Market implied default rates remained low 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 May 2021

31 May 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	3.3%	6.9%	-3.8%	26.2%	30.4%	-29.5%	78.9%	10.0%	-11.0%	18.2%
Canada	4.4%	17.1%	-11.0%	30.1%	34.1%	0.1%	29.9%	10.0%	-2.1%	10.8%
Eurozone	3.6%	13.4%	-8.4%	34.2%	37.9%	-6.7%	57.6%	8.3%	-13.5%	21.2%
Japan	2.9%	26.2%	-18.5%	26.3%	29.1%	5.1%	20.2%	7.5%	-7.6%	10.0%
UK	1.3%	17.6%	-14.1%	14.5%	18.7%	-19.9%	42.9%	0.2%	-15.6%	15.0%
US	0.5%	15.4%	-13.0%	39.6%	41.8%	1.7%	37.3%	18.6%	3.2%	11.8%
China	-0.9%	4.1%	-6.4%	32.8%	35.1%	-14.9%	40.8%	7.4%	0.0%	6.3%
MSCI World	1.3%	15.1%	-11.9%	35.2%	37.9%	-1.1%	40.2%	14.6%	-2.6%	14.4%
MSCI EM	0.3%	10.5%	-8.6%	39.5%	42.8%	8.0%	35.4%	10.8%	-5.0%	10.6%

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

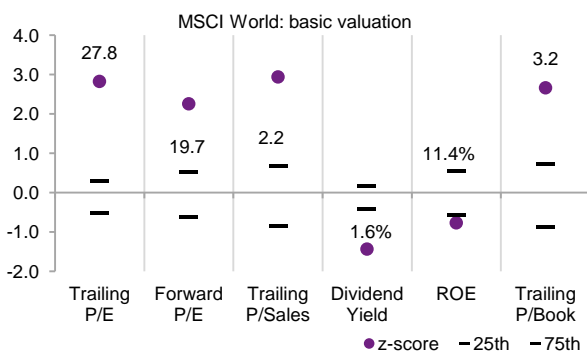
Global equities	Asset return outlook
Developed	
Emerging	

- 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 and monetary policy responses
- US valuations are higher relative to broader developed markets. While this is consistent with higher US fiscal and monetary stimulus, we view European and Japanese equities as moderately more attractive
- 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 high as investors expect medium term earnings potential to remain relatively unimpacted

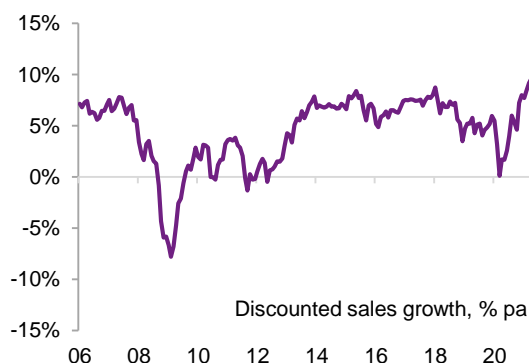
Valuation metrics for the MSCI World equity index



Source: FactSet, Willis Towers Watson).

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

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



Source: FactSet, Willis Towers Watson).

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