Global Markets Overview

Asset Research Team

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Five-year capital market outlook: Q4 update

- We have updated our five-year outlook …
- … with little change in our main messages.
- Generally, global economies remain in their mid-cycles, with spare capacity, low inflation rates and no pressures on central banks to tighten.
- The US economy has recovered the most from the global financial crisis and is nearing the point when the Fed will start tightening again.
- We think the Fed will only raise interest rates gradually, and can adjust policy if economic weakness transpires.
- Global liquidity has pushed up asset prices to high levels and yields are low.
- Comparing the pricing to economic conditions, we expect positive but low asset returns over the next five-years …
- … with risks more tilted to the downside than the upside.
- Currencies currently provide a good example of the asset price distortions caused by high global liquidity. The cost of dollar hedging has increased and we recommend reviewing US dollar exposure, especially against the yen and euro.

1. Monthly overview

There were no major monetary policy changes by developed world central banks in the last month, with the Fed, ECB and Bank of England all maintaining existing policy stances. The Bank of Japan also kept its negative policy rate and asset purchase programme unchanged. However, its announcement was noteworthy in that the BoJ introduced new and unconventional tools which could potentially be adopted by other central banks in the future. The new policy framework targets a specific yield for 10yr Japanese government bonds and a commitment to keep printing money until annual inflation exceeds 2%.

Chinese authorities announced the rollout of a credit default swap market, with the aim of improving risk management flexibility for domestic and foreign investors. Ultimately, we think that China is gradually adopting a more market-oriented approach to pricing and handling rising credit risks. The announcement follows years of rising public and private sector debt, and increasing strain in the financial system.

The US presidential election on 8 November is a key risk to short-term market pricing, over the next month. A victory for Sec. Clinton is most likely and the outcome markets are discounting. A victory for Mr. Trump is still a material probability – perhaps 30% in our view. Markets appear too sanguine about this risk. The volatility of polling data and the patchy track record polls have of capturing populist surges suggest watching this closely. If Mr. Trump wins, or looks more likely to win, we expect the immediate market impact of this surprise to roughly be: a fall in US equities (5-10%); bond prices to be volatile but no clear direction; volatility to rise across the board.

2. Five-year market outlook: Q4 update

Each quarter we will be publishing our five-year return expectations for the asset classes we cover.

Our big picture macro outlook is unchanged. The low but acceptable rate of global growth, low inflation and interest rates that have been seen in recent years are sustainable for a few more years.

Global spare capacity and high debt levels remain an important constraint on demand and policy. In large parts of the world, households, governments and central banks have adjusted to the macro settings and economic equilibrium is more or less operating. In particular, the steady healing of the US economy means it is nearing the point when the Fed will start tightening again. However, there are important

exceptions. Both China and the Eurozone have significant excess capacity, an important headwind to global wage growth and inflation. These constraints on global aggregate demand and the fact that monetary policy cannot easily be made more stimulative in response, means that risks are more tilted to the downside.

Global liquidity has pushed up asset prices to high levels and yields are low. Comparing the pricing to economic conditions, we still expect positive but low asset returns over the next five-years, with asymmetric risks. These return forecasts are summarized in Table 1.

Developed world bonds

10-year nominal bond yields have risen in all major developed world markets in the last three months by c. 20-35 bps. Nevertheless, yields remain low – c. 1.8% in the US and close to 0.0% in Germany and Japan. The low starting level of yields is the major driver of low future returns from government bonds.

Low policy rates and significant ongoing asset purchases by the Bank of Japan, ECB and Bank of England have been necessary to support adequate rates of economic growth. Easy monetary policy has driven nominal rates lower through falling real rates in recent years, although short and long-term inflation expectations are also generally lower.

Weak expected returns from bonds, somewhat below starting yields, largely reflect our view that the US is moving into the late stage of its business cycle, with inflation gradually rising. We expect the Fed to resume tightening in December and to gradually increase interest rates. Currently, US treasury yields are discounting a weaker path for the Fed Funds rate and US inflation. Which means we expect rising bond yields as market expectations for nominal short rates adjust upwards. Given global bond correlations this could impact other markets, via a small rise in the global bond risk premium.

We think the Fed will avoid raising interest rates too quickly, and can adjust policy if economic weakness transpires. Therefore, while near-term increases in Fed rates might cause short-term volatility in bond and broader asset markets, we do not think they will derail the cyclical expansion.

Corporate credit

Global corporate credit spreads have also been driven tighter by direct purchases of corporate bonds by central banks and more broadly by high global liquidity. This means that returns are likely to be limited to accruing the credit risk premium at best.

Our central outlook over five years is for a gradual widening of spreads and a pickup in defaults and downgrades to slightly above average levels. This

Table 1: Five-year nominal return forecasts, %pa

Asset class	5-year return, %pa
GOVERNMENT BONDS	
10yr US treasuries	0.9% to 1.9%
10yr German bunds	-0.8% to 0.2%
10yr Japanese bonds	-0.8% to 0.2%
10yr UK gilts	-0.2% to 0.8%
EM local currency debt	3.0% to 4.5%
10yr US TIPs	2.2% to 3.2%
10yr UK inflation-linked	-0.3% to 0.7%
FX vs 5 YEAR FORWARDS	
USDJPY	-2.4%
EURUSD	-1.9%

Asset class	5-year return, %pa
EQUITIES	
Global	2.7% to 5.2%
EM	2.7% to 6.0%
US	2.5% to 4.7%
Euroland	3.5% to 6.3%
Japan	2.5% to 5.8%
CREDIT	
US IG	1.0% to 2.5%
US HY	2.0% to 3.0%
EUR IG	0.0% to 0.5%
EM external currency debt	2.1% to 3.7%

Source: Willis Towers Watson; a table of forecasts and ratings for all markets we cover is available on request

is driven by specific regional and credit sector analysis but, broadly speaking, we think that rising levels of corporate leverage and a slow tightening of US dollar liquidity will be a moderate drag on returns.

Equities

The combination of falling government bond yields – which reduce the rate at which company payouts are discounted – and high central bank liquidity – which pushes investors out the risk curve – has increased equity valuations. We continue to forecast low returns for global equities over the medium-term.

Equities are currently pricing-in long-term earnings growth that is close to average levels in the US and lower than historic averages in most other developed markets and emerging markets. This is broadly in line with our outlook, with two exceptions:

- In the US, global economic growth is likely to support revenues. However, we expect profit margins to come under increasing pressure, driven by an expected increase in labour costs relative to productivity. This will lead to earnings disappointments relative to market expectations. Additionally, shareholder returns have also been boosted by 'financial engineering' – i.e., issuing debt to pay dividends or repurchase stock – which is unlikely to continue at the same rate.
- In the Euro area, we expect a moderate profit recovery from current low levels. This is still sufficient for positive earnings surprises, given the pessimistic outlook priced-into Euro area equities, and should lead to reasonable returns.

Emerging market rates and USD credit

Emerging market debt yields are also low, in general, relative to history.

Our estimate of the current risk premium for US dollar denominated EM debt is lower than historic levels. We think this is underpricing the funding risks faced by large deficit countries, e.g., Columbia, South Africa and Turkey. In addition, spreads (adjusted for quality and duration) do not look wide against US corporate credit – a highly correlated asset class that we also view as moderately unattractive. Overall, we expect returns of 2.1% to 3.7%, moderately unattractive when adjusted for risk.

In local currency debt, our central view is that policy rates will be kept on hold or eased across most core markets over the near term.

In terms of FX, while a number of countries have strengthened their external positions and have more competitive exchange rates than three years ago, we expect depreciation in aggregate over the medium term. This is due to tightening dollar liquidity and continued reliance on foreign capital in a number of markets.

Market discounting matches our expectations over the near term, with two year bonds offering an adequate risk premium. Aggregate consensus estimates also line up with our forecasts. At longer maturities risk premia look somewhat compressed, particularly after the recent yield falls and given the risks facing the universe. As a result, we expect bond yields to face upwards pressure over five years.

3. FX: Consider increasing USD exposure

The simplest method of gaining exposure to a currency is by using a forward contract. Arbitrage should ensure that currency forwards are priced so that investors are indifferent between the available interest rates in two countries, e.g., the forward exchange rate should ensure the dollar return on dollar deposits is equal to the dollar return on foreign deposits. Currently, a combination of new regulation and abundant central bank liquidity is affecting USD forward market pricing.

First, recent changes to money market regulations have led to a reduced level of demand for short-term US dollar denominated commercial paper. This in turn has led to rising USD LIBOR rates (Fig 1) and widening interest rate differentials with other markets (which are used to price currency forwards). This has lowered the price of US dollar forwards relative to other currencies.

Second, regulation has increased the costs of leverage for arbitrageurs (i.e., banks, hedge funds), meaning they are unable to close small mispricing opportunities in the same way as prior to the financial crisis.

Third, the demand for dollar hedging contracts has increased markedly since the Bank of Japan and European Central Bank started their quantitative easing programmes. We believe that this demand is a product of yield-seeking investors moving capital in

Five-Year FX Outlook

Consider increasing USD exposure

to the US, in order to take advantage of the higher yields available on US treasuries, and hedging their currency exposure. This means that US dollar forwards have moved lower than would be implied by changes in money market interest rates alone.

Overall, these effects mean that hedging USD currency exposure has become more expensive, while hedging currency risk into USD is cheaper.

Over and above these structural factors, we continue to forecast moderate USD strength – i.e., appreciation but at a slower pace than 2014/15 – against most developed market currencies, as we expect the Federal Reserve to raise rates faster than other developed market central banks. In particular, the Euro area and Japan are the key economies where we expect widening monetary policy differentials with the US over the medium-term and gradual currency weakness (Table 2).

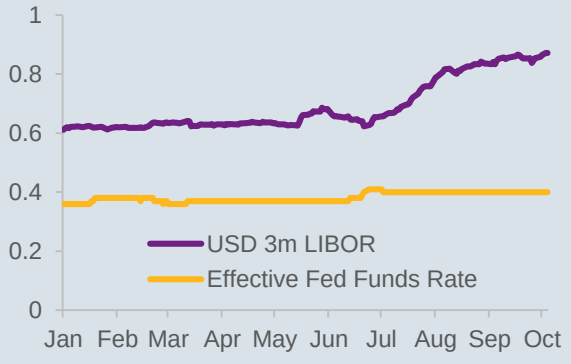
On average, over five-years, we forecast investors will receive an attractive risk-adjusted return from taking a long position in the US dollar relative to the yen and euro. We recommend that euro and yen based investors consider reducing US dollar hedge ratios. US clients should review their FX exposure to these locations and implement non-dollar hedges where appropriate.

4. Summary of our five-year recommendations

Portfolio strategy

1. *Adjust to the "new world"*: investors should consider if their current objectives and policies are consistent with this "new world" of both low future interest rates and asset returns.
2. *Work your assets harder and control costs*: think holistically, i.e., in which part of the portfolio do you want to target higher returns to compensate for low or negative yields.
3. *Increase skill*: potential alpha is a more important component of returns in an environment of low rates and compressed risk premia.
4. *Manage currency market distortions*: On a 5-year basis dollar forward contracts appear expensive for a number of developed world ex-US investors. We recommend increasing USD exposure relative to EUR and JPY.

Fig 1: Movements in 3m US$ LIBOR relative to the Fed Funds rate



Sources; Bloomberg LP, Willis Towers Watson

Table 2: Our spot FX outlook and expected returns to hedging USD exposure

FX cross	Current spot	Expected spot (30/9/2021)	Implied 5-year return (%-pa *)
USDJPY	103.6	105.0	-2.4%
EURUSD	1.11	1.11	-1.9%
GBPUSD	1.22	1.32	0.7%
AUDUSD	0.75	0.71	-0.4%
CADUSD	0.76	0.77	0.0%

* 5-year return is WTW's best expectation of the return achieved by an investor who agrees to sell dollars forward for 5-years using forward markets

Source: Bloomberg LP, Willis Towers Watson

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