Global Markets Overview

Asset Research Team

August 2023

What does it mean if the U.S. is not 'AAA'?

Background

- On August 1, Fitch, one of the "big three" credit ratings agencies, chose to downgrade its US long term default rating from AAA to AA+.
- The shift comes on the heels of another US government debt ceiling standoff between the Democrat and Republican parties in May. Created by Congress in 1917, the debt limit, or ceiling, sets the maximum amount of outstanding federal debt the U.S. government can incur. Increasing the debt ceiling requires majority approval in the House and sixty votes in the Senate. Political brinkmanship has been a recurring feature of this decision over the last decade.
- According to Fitch, "the repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management". More generally, the firm pointed towards fiscal deterioration, rising government debt, and weaker governance than other AAA peers.

Is this new news? Is this a shock?

- In our view, this is not material new news. The bigger shock occurred in 2011, when S&P downgraded its US sovereign rating following a similar debt ceiling standoff and a weaker US government balance sheet after the global financial crisis in 2008/09. Fitch's ratings change brings it into line with S&P's.

Our perspective

- There is some basis to Fitch's concerns. The political road blocks that are created by the current fiscal framework are suboptimal for decision-making – there are far better ways to manage debt dynamics.
- From a US government debt sustainability perspective over the next five to ten years, our outlook remains unchanged and positive. While a higher government debt burden can weigh on growth, experience suggests there isn't a specific debt level which materially increases systemic financial risks, particularly when a country borrows in its domestic currency, from a large pool of domestic savings, like the US. There are a number of examples, notably Japan, that have been operating successfully with significantly larger sovereign debt burdens. And while it is true that more US debt than Japanese debt is foreign held, it is also the case that the US has the world's deepest and most liquid financial markets. One of many factors which ensures the dollar remains the world's premier reserve currency – this is unlikely to change anytime soon.
- At the time of writing, the market reaction appears consistent with this read: US 10-year bond yields are currently trading close to their July 31 levels; the S&P 500 is down about 1%, which is small in the context of equity volatility and is caused by a wide number of factors.
- Looking forward, from a macro perspective, this is another potential contributing factor to continued uncertainty and volatility in interest rates and markets more broadly. We continue to view Treasury duration as a useful risk management tool for portfolios (both for pensions and for other asset pools). Additional volatility around these types of events is inherently difficult to predict which is why we continue to advise clients to increase the diversity of their portfolios where possible.

Tracking recent asset price moves and our outlook

Summary: government bonds

Changes to market pricing (government bond yields)
31 July 2023

	July 31, 2023 % / %pts	Spot yields Level	Δ 1m	Δ 3m	Δ 1y	Δ 3y	What's priced-in 1y fwd	2y fwd	5y fwd
Developed nominal yields	**Eurozone**								
	1y/cash	3.33	-0.06	0.29	3.06	4.02	2.72	2.23	2.22
	5y	2.50	-0.04	0.22	2.03	3.25	2.27	2.19	2.41
	10y	2.45	0.09	0.15	1.63	2.98	2.38	2.37	2.52
	US								
	1y/cash	5.31	-0.04	0.53	2.40	5.25	4.54	3.72	3.67
	5y	4.11	0.05	0.63	1.46	3.80	3.78	3.63	3.91
	10y	4.01	0.12	0.46	1.26	3.46	3.89	3.84	4.02
Breakeven infl.	**US (CPI)**								
	3y	2.15	0.04	-0.04	-0.82	0.82	-	-	2.2**
	5y	2.22	0.06	0.02	-0.52	0.78	-	-	2.20
	10y	2.21	-0.01	0.06	-0.20	0.74	-	-	2.33

Source: FactSet, WTW Note: **discounted 1y rate, 5 years forward

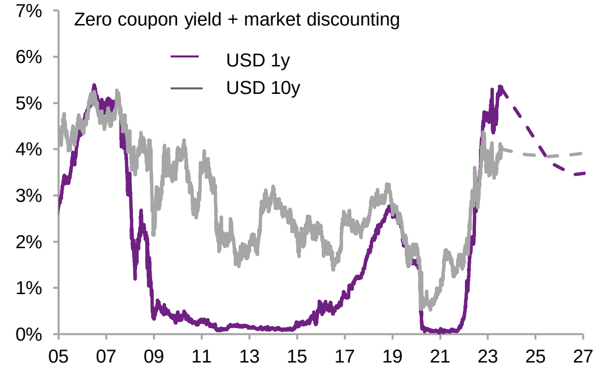
A summary of our assessment of government bond pricing and prospective medium-term outcomes

Sovereign bonds	Asset return outlook	Comments
Developed short interest rates		• Central bank guidance remains biased towards keeping interest rate policy restrictive in the face of above-target inflation and tight labor markets. • Policymakers were quick to extend support to the banking sector following volatility in Q1. While they acknowledge uncertainty, central banks see the wider system as being resilient. • Short rates in the US have risen notably over the past three months. While there is a risk that they climb further, pricing appears more consistent with inflation pressures.
US		
UK		
AAA-Eurozone		
Developed 10-year nominal bonds		• Bond markets have been volatile in the face of falling but sticky inflation and weakening, albeit mixed, economic data. However, the net trajectory of yields has been upwards over the past few months. Major central banks have reiterated the potential for further hikes. • We expect volatility to continue, although the pricing of 10-year bonds (ex. UK) appears to be in a neutral range from a medium-term perspective. Cooling growth, post-covid supply-chain bottlenecks fading, and lower energy prices should benefit global inflation dynamics, but labour markets are tight, and wage and services inflation remain high. • In the UK, we expect hiking-induced growth stresses to reduce longer-term rates. In the US, we have a bias towards TIPS as breakeven pricing under-reflects inflation risks.
US		
UK		
AAA-Eurozone		

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

US Treasury bond yields are pricing-in significant rate cuts next year. This is possible, but requires inflation and economic growth to continue to slow

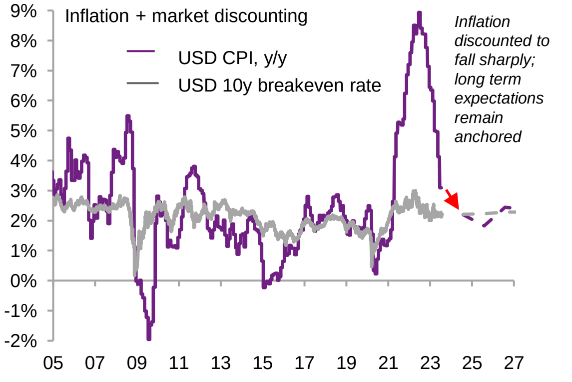
US cash rate and 10y nominal bond yield



Source: FactSet, WTW

US inflation expectations imply a quick return to target. We believe that risks are tilted towards stickier inflation than markets are pricing-in

CPI inflation rate and inflation market pricing



Source: FactSet, Refinitiv, WTW

Asset Research Team

Tracking recent asset price moves and our outlook

Summary: credit

Changes to market pricing (credit spreads)

31 July 2023

31 July 2023		Pricing - Option adjusted spreads, bps					Implied defaults				
		Current	Δ1m	Δ3m	Δ1y	Δ3y	Current	Δ1m	Δ3m	Δ1y	Δ3y
High grade	Global	129	-11	-18	-34	-11	0.7%	-0.3%	-0.5%	-0.8%	-0.3%
High grade	US	119	-11	-22	-34	-22	0.5%	-0.3%	-0.6%	-0.9%	-0.6%
High grade	Eurozone	147	-14	-14	-37	19	1.2%	-0.4%	-0.4%	-0.9%	0.5%
High grade	UK	155	-19	-18	-38	-2	1.4%	-0.5%	-0.5%	-1.0%	0.0%
High grade	Canada	159	-6	-9	-10	11	1.5%	-0.2%	-0.2%	-0.2%	0.3%
High grade	Australia	163	-3	-15	-11	47	1.6%	-0.1%	-0.4%	-0.3%	1.2%
Low grade	Global HY	423	-27	-78	-136	-124	1.8%	-0.4%	-1.1%	-1.9%	-1.8%
Low grade	US HY	379	-26	-74	-104	-137	1.1%	-0.4%	-1.1%	-1.5%	-2.0%
Low grade	Eurozone HY	438	-8	-41	-143	-49	2.7%	-0.1%	-0.6%	-2.0%	-0.7%
Low grade	US loans	487	-14	-29	-27	-43	2.7%	-0.2%	-0.4%	-0.4%	-0.6%
HC EMD	Hc EMD Corps	256	-17	-50	-111	-113	3.0%	-0.4%	-1.1%	-2.5%	-1.4%
HC EMD	HC EMD Sov	299	-22	-56	-123	-71	1.3%	-0.3%	-0.8%	-1.7%	-1.7%

Source: Credit pricing is from ICE Bank of America and FactSet

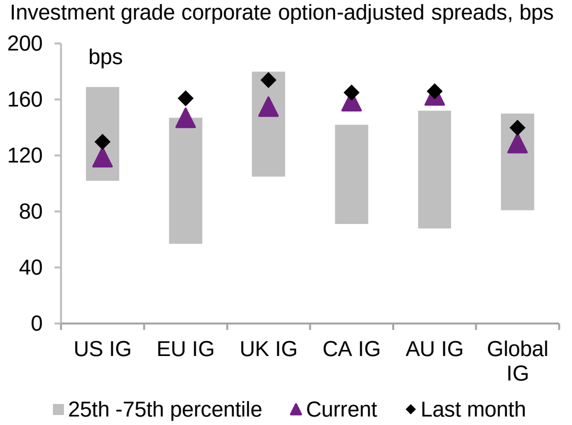
A summary of our assessment of corporate credit pricing and prospective medium-term outcomes

Credit	Asset return outlook	Comments
Corporate credit		• Global investment grade spreads are pricing in an above average allowance for the level of credit losses over the medium-term, with a big difference between US and non-US markets. • We expect losses to be at or modestly above these levels, particularly in the nearer term, with risks tilted towards higher losses, especially in the US. • At current credit spreads, high quality credit assets are at levels at which they are likely to provide moderate returns above equivalent government bonds over the medium term. • We retain a somewhat cautious outlook for developed market high yield grade corporate credit given shorter-term risks. Current pricing implies a slightly below average level of defaults relative to historic pricing, despite downside economic and corporate risks. • Niche and securitized market pricing appears to be pricing-in a similar 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 fell over the past month; outside of the US they remain at the upper end of, or above, their typical historic trading ranges

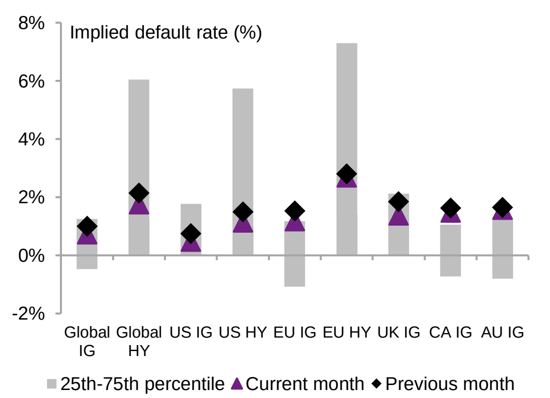
Investment grade corporate option-adjusted spreads, bps



Source: FactSet, WTW

Market implied default rates also fell over the past month, in-line with falling credit spreads

Estimated implied default rate based on current pricing



Source: FactSet, WTW

Asset Research Team

Tracking recent asset price moves and our outlook

Summary: equity

Changes to market pricing (equity)

31 July 2023

31 July 2023	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	2.9%	0.0%	2.7%	7.8%	13.3%	7.6%	0.2%	12.8%	11.2%	-5.8%
Canada	4.0%	0.0%	3.6%	6.1%	9.9%	-2.7%	9.0%	11.9%	16.2%	-1.8%
Eurozone	3.0%	-0.6%	4.8%	19.2%	23.1%	8.5%	19.4%	14.8%	20.4%	-0.9%
Japan	-0.4%	0.0%	-0.5%	17.6%	20.7%	-2.6%	20.7%	18.3%	12.6%	5.5%
US	4.9%	0.0%	4.8%	12.6%	14.5%	-9.8%	24.9%	13.1%	12.3%	3.2%
China	7.6%	0.5%	5.4%	-4.0%	-1.6%	-0.9%	2.4%	-9.7%	-4.4%	-6.3%
MSCI World	4.1%	-0.3%	4.8%	11.9%	14.4%	-4.0%	17.6%	13.2%	12.8%	2.5%
MSCI EM	5.0%	-0.6%	5.8%	4.6%	8.1%	-7.5%	13.0%	3.2%	8.5%	-2.9%

Source: FactSet, Willis Towers Watson.

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

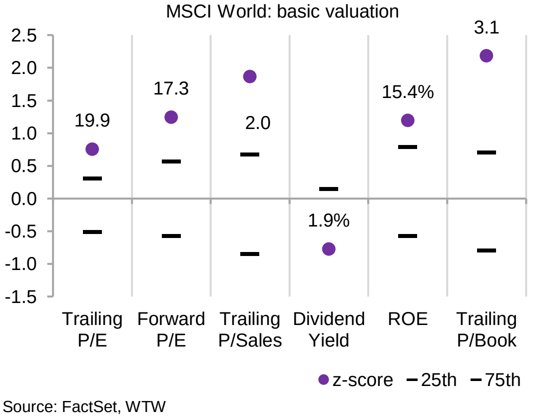
Global equities	Asset return outlook
Developed	
Emerging	

- Equity markets had positive gains over the month, with Emerging Markets outperforming Developed Markets.
- Earnings are showing signs of gradual weakness in response to rapidly tighter monetary policy and weaker fundamentals. However, valuation increases have more than offset this earnings weakness suggesting the market believes this deterioration is temporary.
- Two aspects are important: (1) future earnings estimates are declining but remain at the higher end of our expectations over the next 1-2 years, considering rising economic risks; and (2) increased interest rates in recent weeks may begin to place downward pressure on valuations as well as economic activity in the wider economy. Overall, equities continue to face near term downside risks if growth weakens further and/or earnings expectations get revised down.
- We continue to see value in Japanese equities, with valuations remaining low relative to broader DM equities.
- Overall, we retain a neutral view on equities over a five-year horizon but are cautious nearer-term.

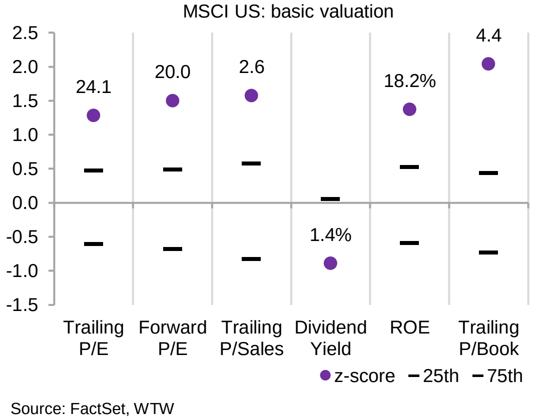
Key: Highly negative | Negative | Neutral | Positive | Highly positive

Basic developed market financial ratios remain high – due to the US – despite shorter-term economic risks

Valuation metrics for the MSCI World equity index (left) and MSCI US (right)



Source: FactSet, WTW



Source: FactSet, WTW

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