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Market Environment Report

July 2023

A business of Marsh McLennan

Market review & outlook

Stocks move higher as the Fed appears to be near the end of its hiking cycle

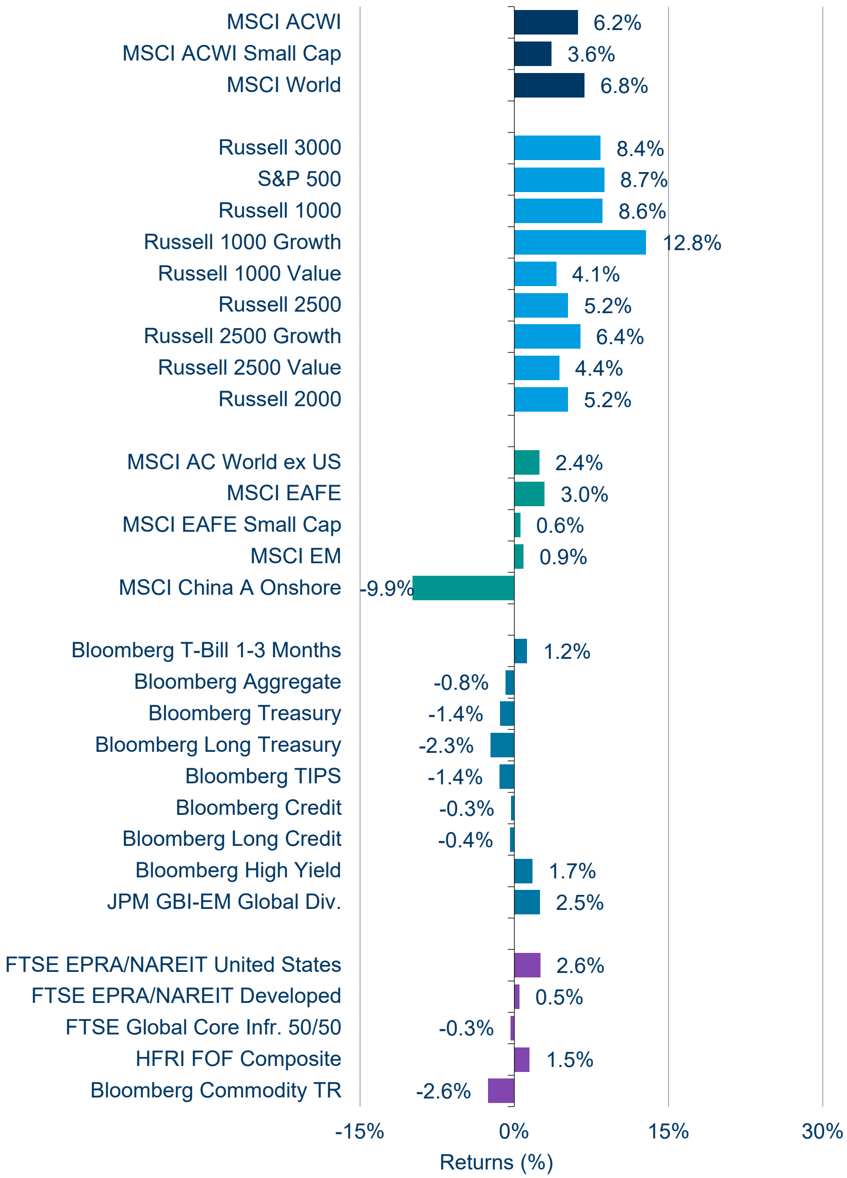
- Global markets moved higher during the quarter as slowing inflation, the pause in the Federal Reserve's hiking cycle, an agreement on the debt ceiling and enthusiasm over artificial intelligence supported investor optimism. Volatility remained relatively subdued throughout the quarter, despite issues in the banking sector and difficult negotiations over the debt ceiling.
- Treasury yields generally rose during the quarter. Longer-term yields ended the quarter near where they started the year. The 10-year Treasury yield rose 33 bps from 3.5% to 3.8% during Q2.
- The Bloomberg Aggregate Bond Index fell 0.8% in Q2, while the MSCI ACWI index rose 6.2%. During the second quarter, a traditional 60/40 portfolio rose 3.4%. Through the first half of 2023, a 60/40 portfolio has gained 9.2%.

Outlook Remains Uncertain

- Economic growth, particularly in the US, has been more resilient than most economists expected. In the US, GDP grew at an annual rate of 2.0% during the first quarter, with economic data and corporate earnings surprising to the upside during the second quarter. Combined with slowing inflation and excitement around artificial intelligence, this led to a strong run for equities. However, a large portion of those gains occurred in a small number of mega-cap tech stocks, increasing index concentration and presenting risks if sentiment toward those companies were to reverse.
- Consumer strength has continued to support the economy, as a strong jobs market and residual COVID-era savings and stimulus continue to drive spending. However, the accumulating impacts of higher prices and interest rates are depleting excess savings. While the jobs market remains strong, the pace of jobs gains is slowing.
- Inflationary pressures continue to weaken, with headline CPI for June falling to 3.0%. The Core CPI rate, which is closely watched by policymakers, also declined meaningfully over the quarter, but it remains elevated at 4.8%. The continued downtrend in inflation should take some pressure off the Federal Reserve, although the market continues to expect a 25 bp rate hike in July.
- A mild recession in the US later this year or in 2024 remains possible, as the Federal Reserve's tightening cycle impacts the economy with a lag. However, if inflation continues to trend lower, we do not expect a mild recession to be especially bearish for equities because the Fed would have some flexibility to ease, potentially offsetting the impact of weaker earnings. However, if inflation were to remain sticky or move higher, it could require the Fed to tighten more aggressively than the market is pricing, which could result in a deeper recession and further weakness for stocks and bonds.

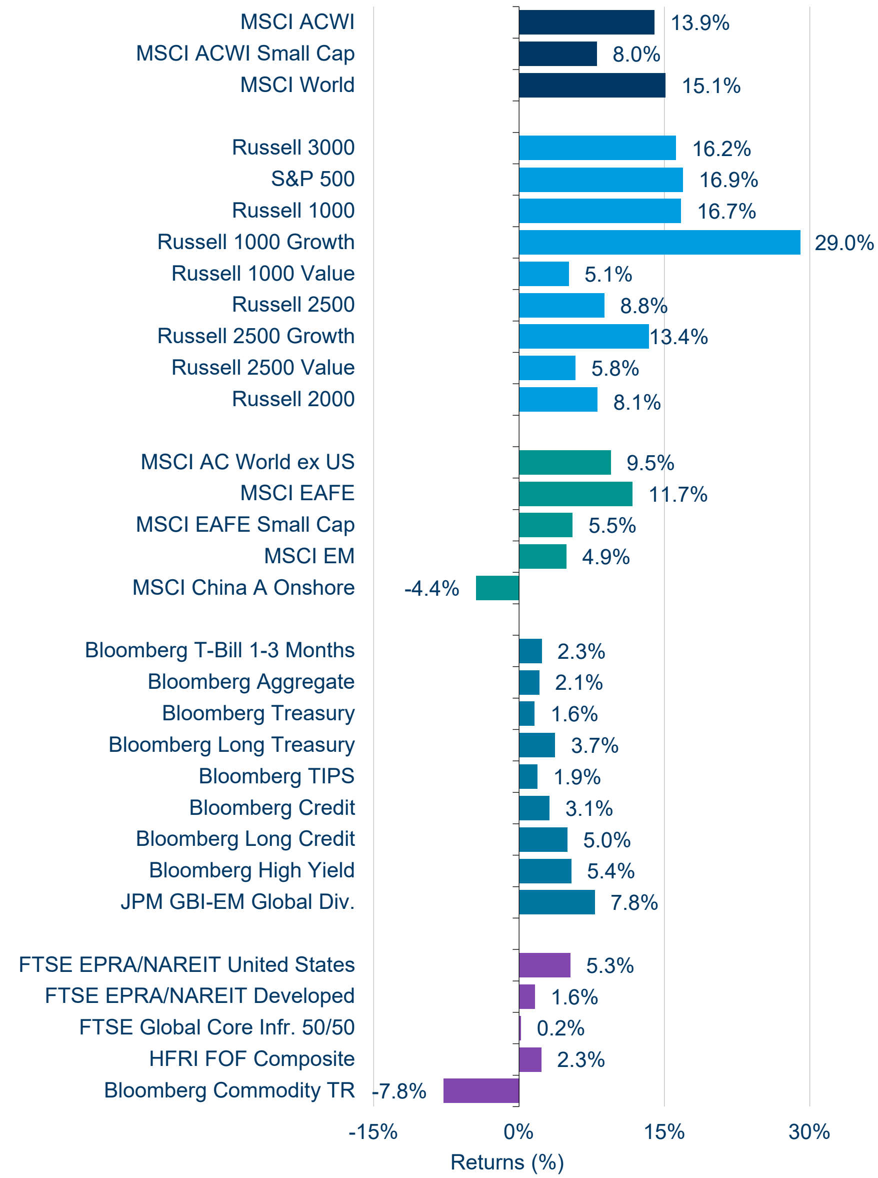
Performance summary

Market Performance
Second Quarter 2023



Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 6/30/23

Market Performance
Year-to-Date (as of 6/30/23)

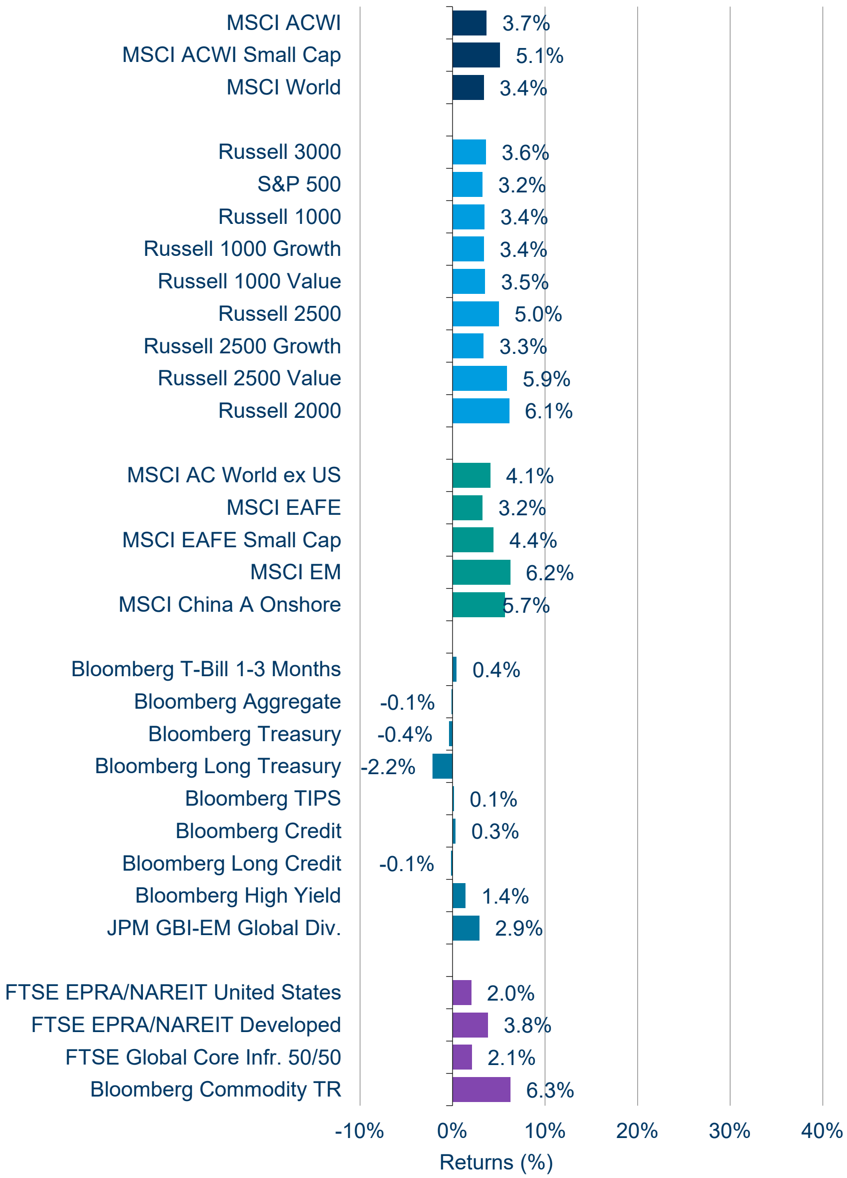


Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 6/30/23

Past performance is no guarantee of future results

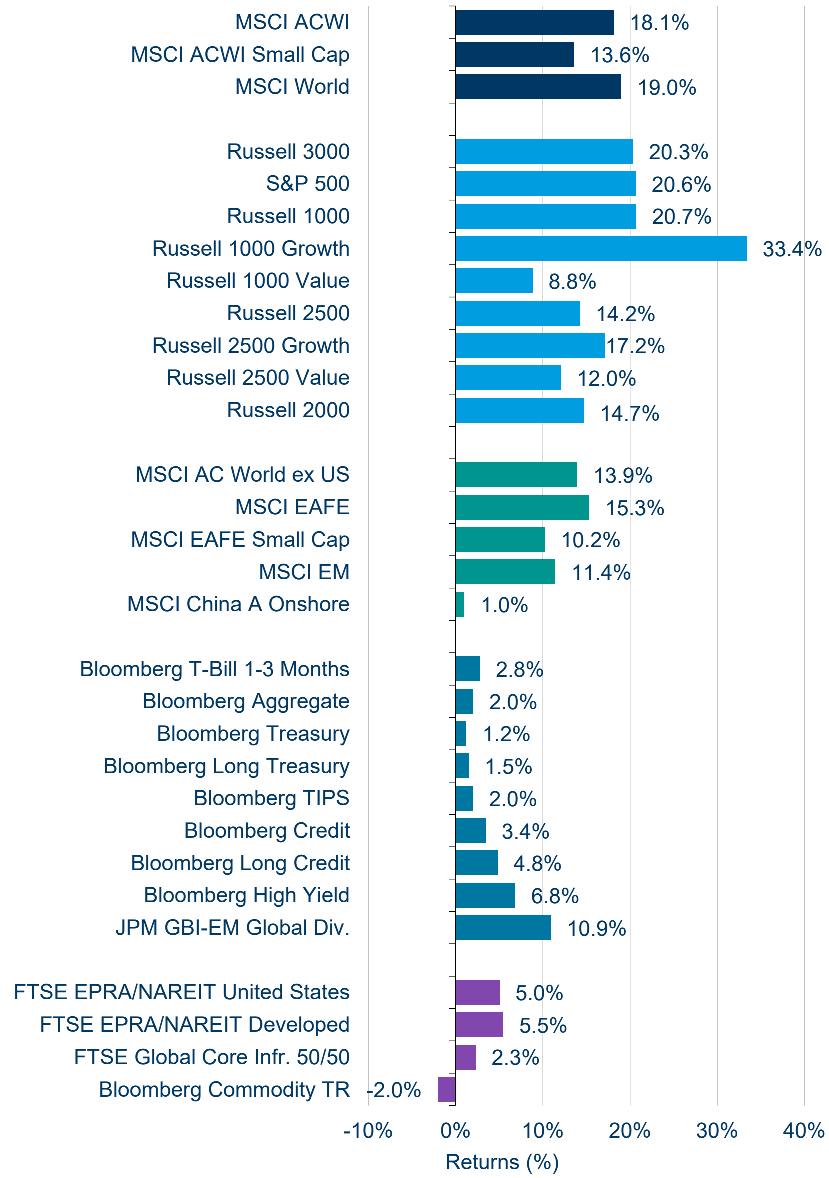
Performance summary

Market Performance
July 2023



Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 7/31/23

Market Performance
Year-to-Date (as of 7/31/23)



Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 7/31/23

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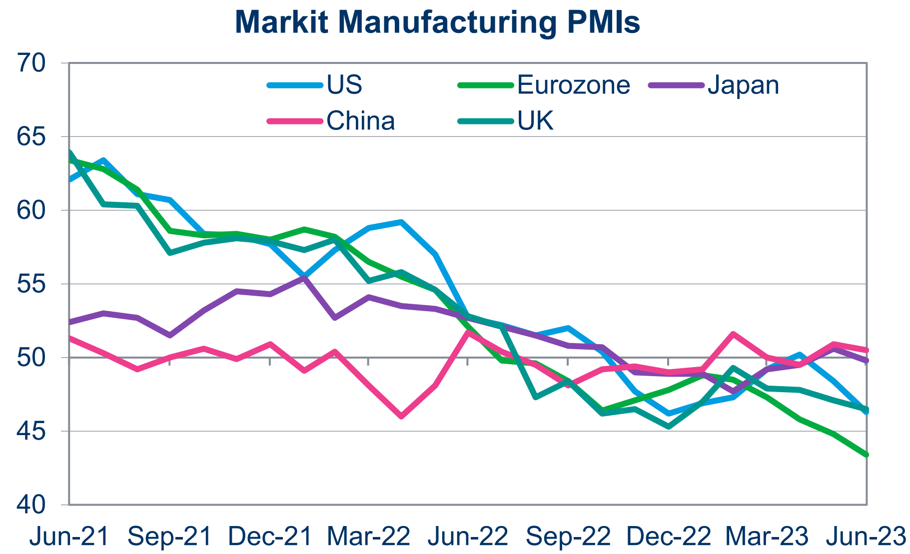
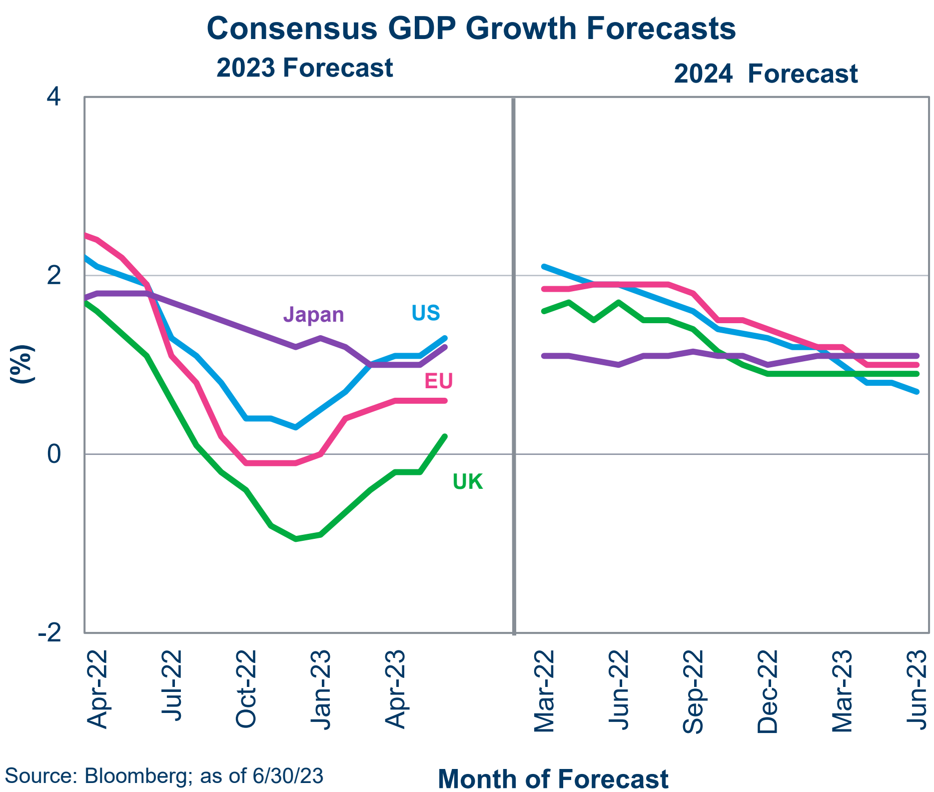
Past performance is no guarantee of future results

Economic growth continued to surprise to the upside

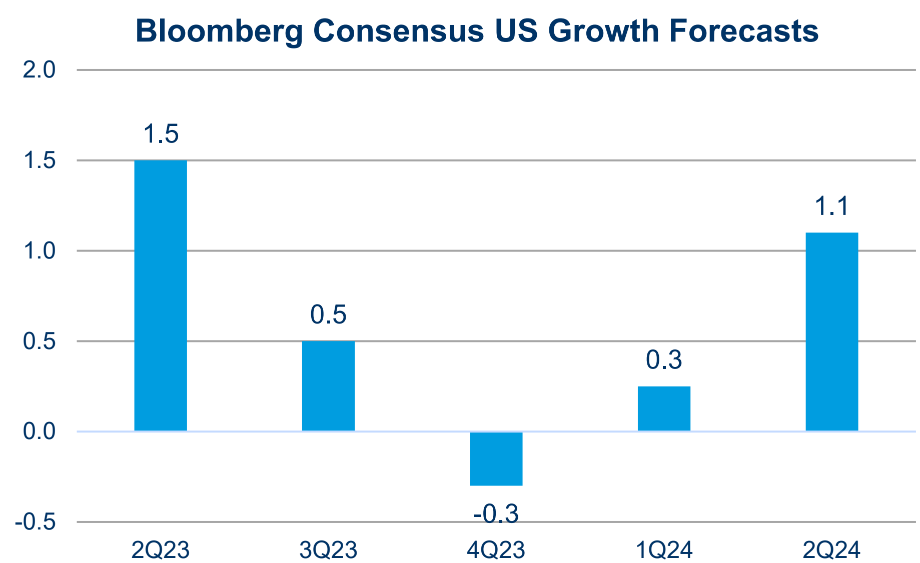
The global economy remained resilient in the second quarter, despite the slowdown in China. The US economy defied predictions of a recession, as activity remained strong and job creation continued. Growth in Europe softened, although UK growth forecasts ticked higher. After a strong start to the year Chinese economic growth faltered. Looking forward, we continue to expect high interest rates and tighter credit conditions to eventually weigh on economic activity in the US and the rest of the world. However, we expect a hard landing will be avoided.



Source: Bloomberg; as of 6/30/23



Source: Bloomberg; as of 6/30/23



Source: Bloomberg; as of 8/1/23

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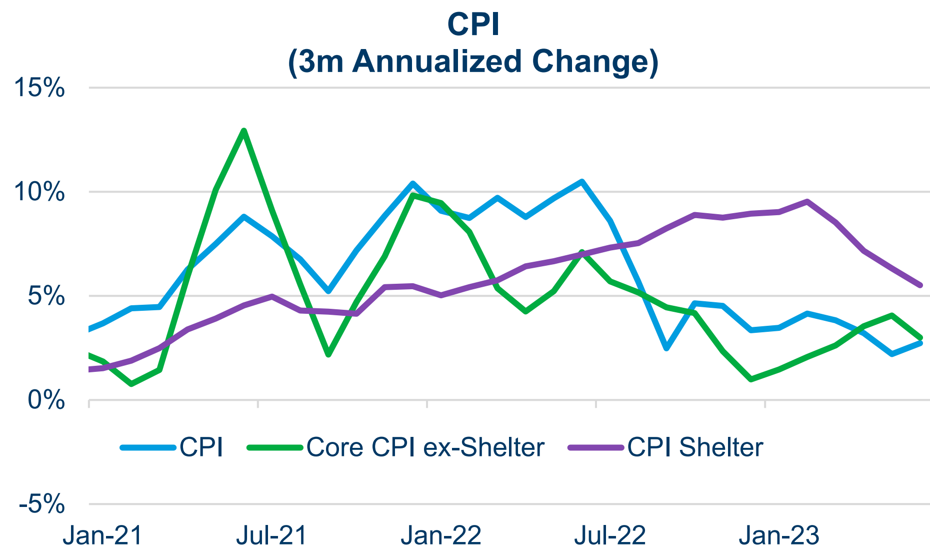
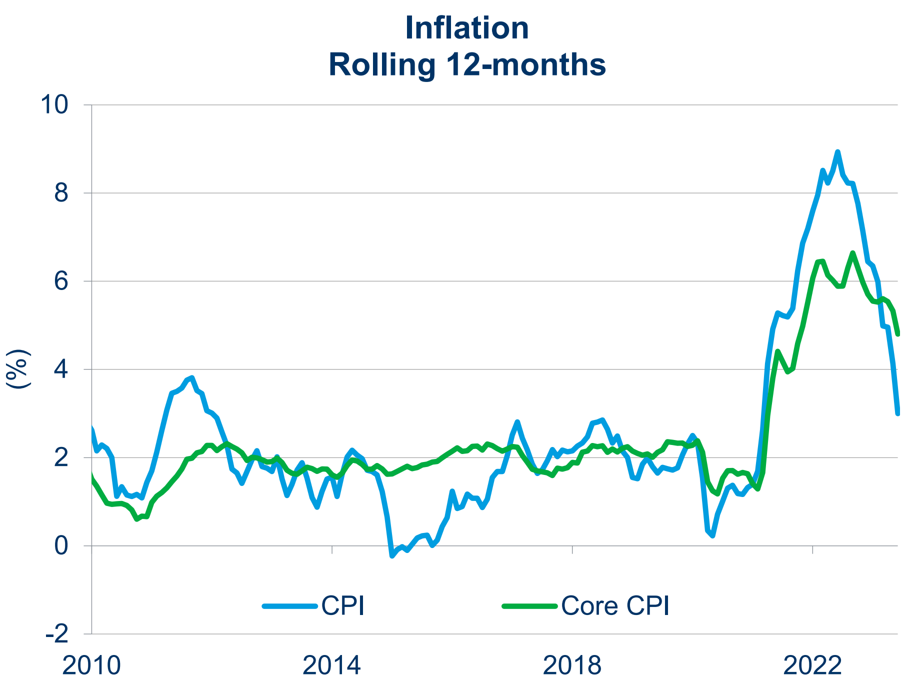
Headline inflation fell to 3%, but core inflation remains high

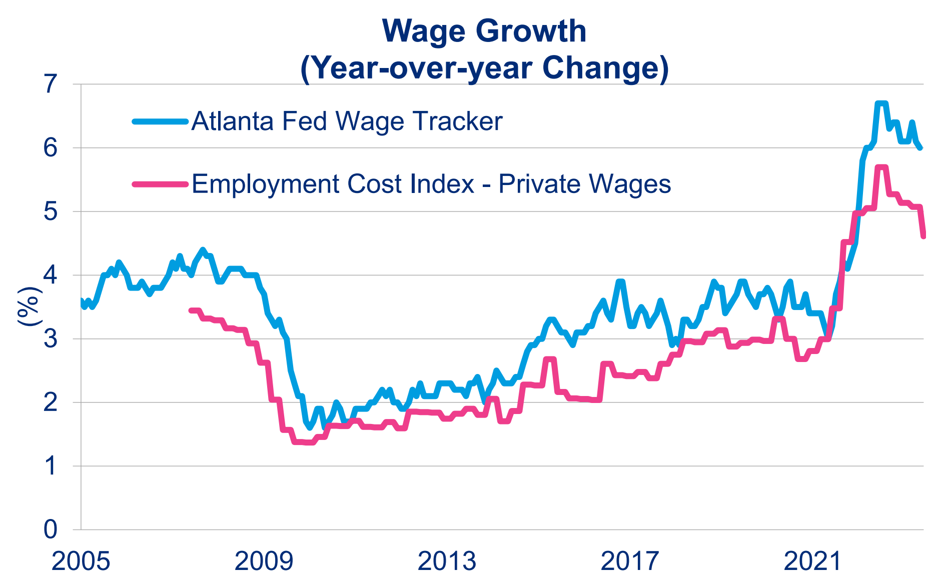
US inflation has continued to trend downward despite strong economic growth. The headline CPI inflation rate fell to 3% in June, helped by softer energy prices. However, core CPI, which excludes food and energy, remains at nearly 5%. With the job market still tight, wage growth will continue to be an important factor to watch. Wage growth has turned lower but remains above the 3-4% rate implied by the Fed's inflation target. A further weakening in wage growth will likely be required for the Fed to cut interest rates.



Source: Bloomberg; through 6/30/23



Source: Bloomberg; through 6/30/23



Source: Bloomberg; through 6/30/23

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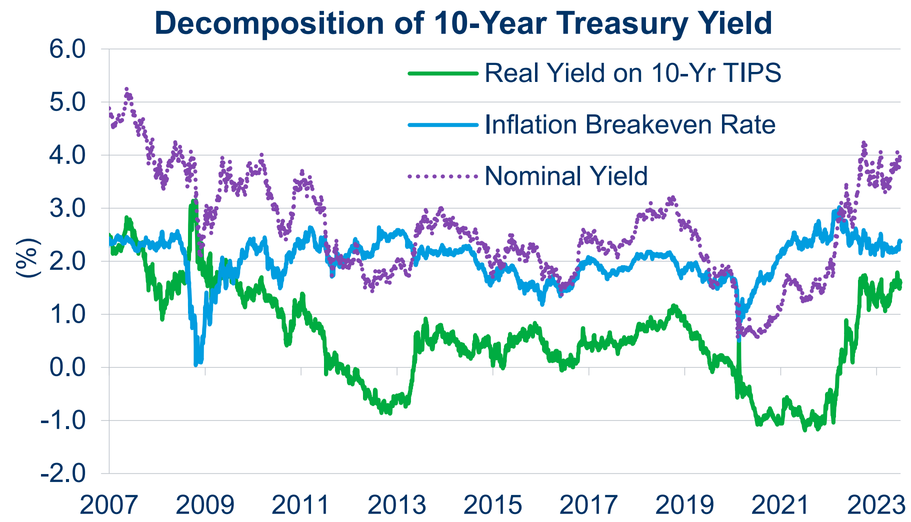
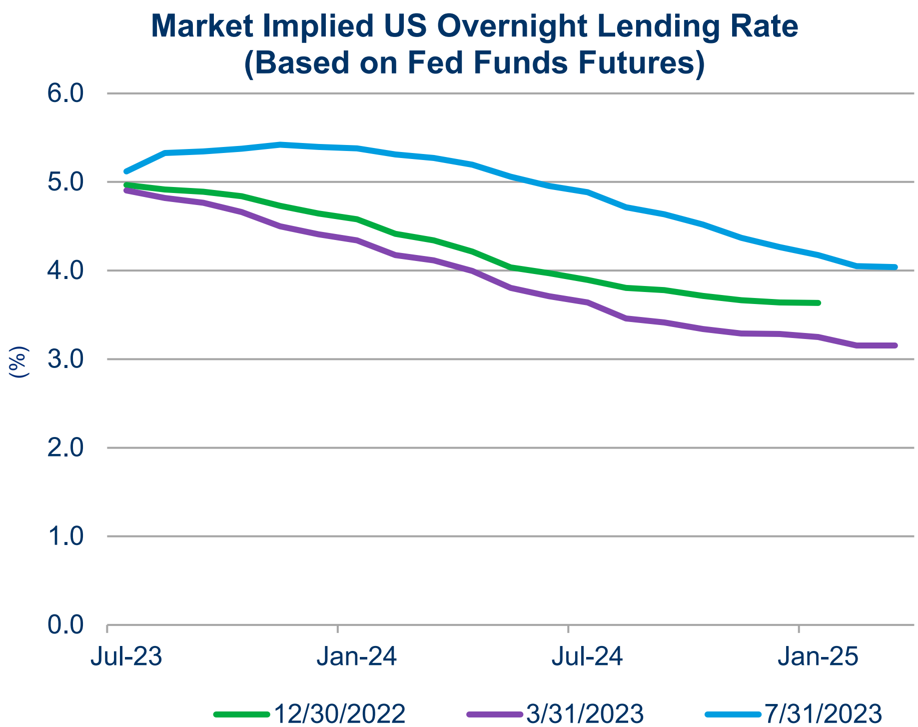
Bond markets priced higher rates for longer as banking fears eased

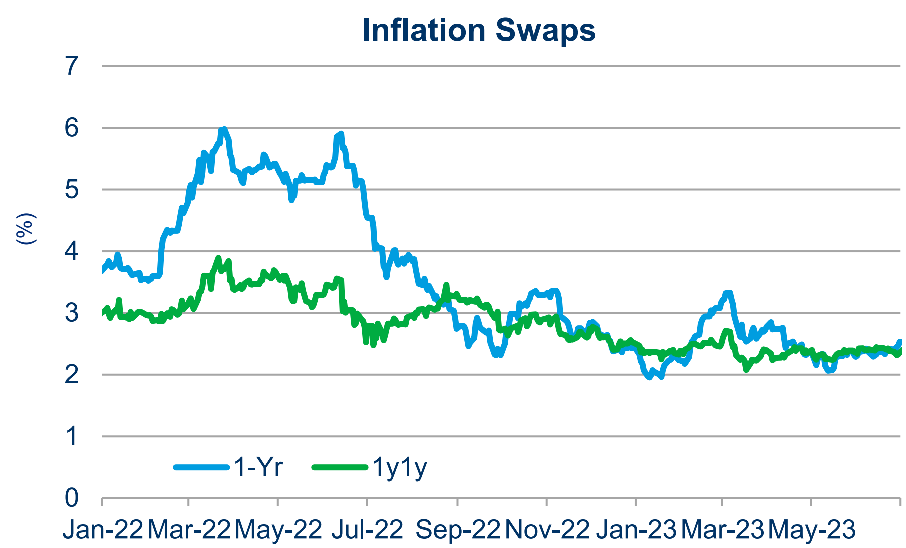
Strong economic growth and job gains contributed to the Fed lifting interest rates by 25bps in July to a range of 5.25%-5.50%. The market is no longer pricing additional hikes for 2023 and it expects the Fed to cut the overnight lending rate to 4% by the end of 2024. Inflation expectations remain well-anchored with swaps pricing inflation near the Fed's target over the next year. A risk for both stocks and bonds is that inflation remains stickier than expected, causing the Fed to remain tight for longer.



Source: Bloomberg; through of 7/31/23



Source: Bloomberg; as of 7/31/23

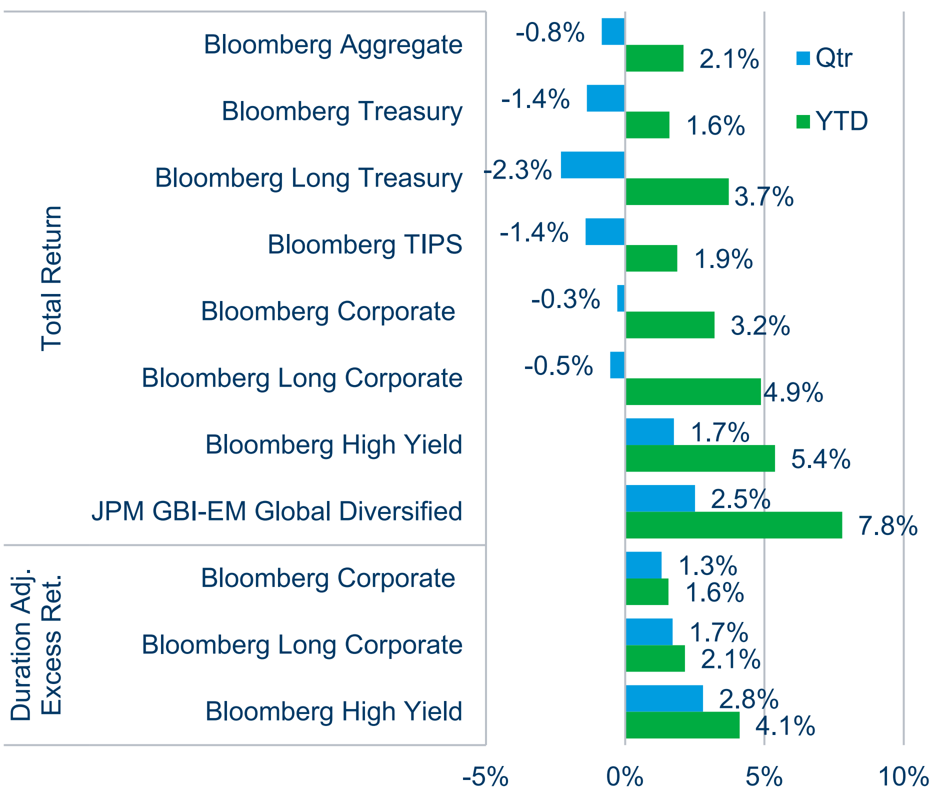


Source: Bloomberg, Mercer; as of 6/30/23

What happened in fixed income in Q2?

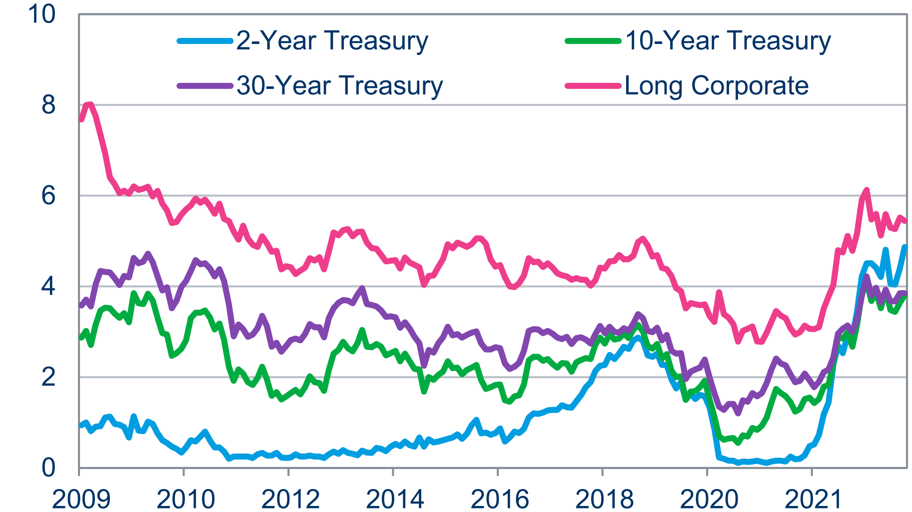
Most segments of the fixed income market delivered modest declines in Q2. The Bloomberg Aggregate Index fell 0.8% during the quarter. Longer-term yields rose to roughly their levels at the start of the year. The 10-year Treasury yield rose from 3.5% to 3.8% during Q2. Credit spreads narrowed during the quarter. Investment-grade spreads fell by 15 bps, while high yield spreads fell by 65 bps. TIPS underperformed Treasuries due to a decline in inflation-breakeven rates.

Fixed Income Performance



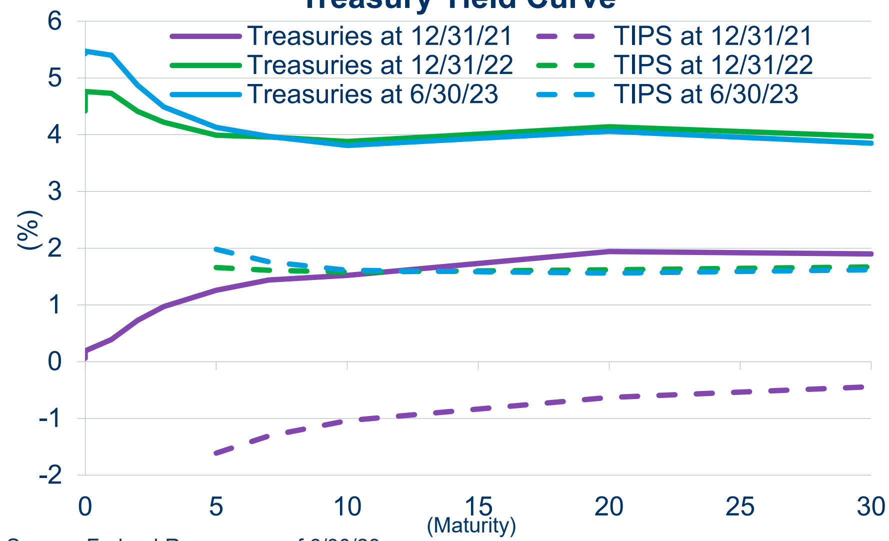
Source: Bloomberg, Datastream; as of 6/30/23

Yield History



Source: Bloomberg, Federal Reserve; as of 6/30/23

Treasury Yield Curve



Source: Federal Reserve; as of 6/30/23

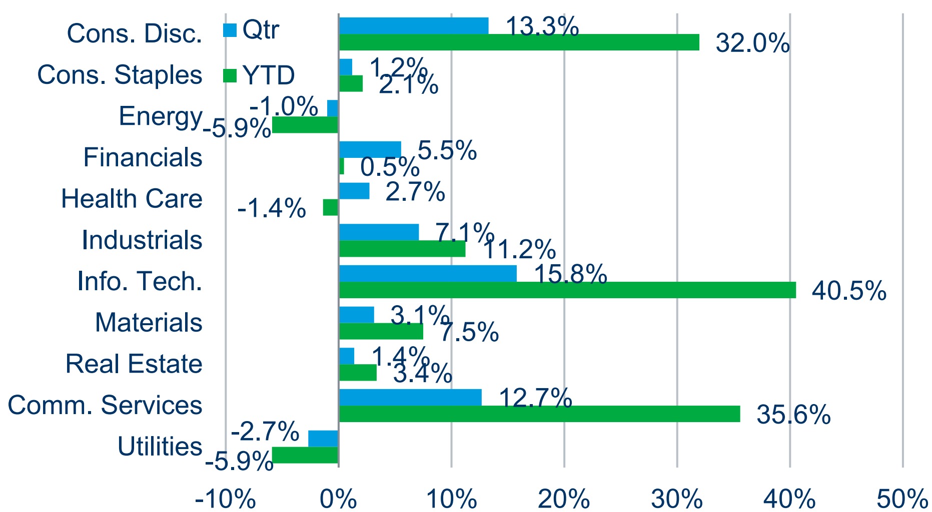
What happened in equity markets in Q2?

Equities delivered strong gains in Q2, with the MSCI ACWI rising 6.2%. Growth stocks outperformed during the quarter, and large-cap stocks outperformed small-caps. Technology, communication services and consumer discretionary were the best performing sectors during Q2, while the energy and utilities sectors lagged. MSCI EAFE gained 3.0% during Q2, with US dollar strength detracting 130 bps from US$ returns.

2Q23 US Style Performance (%)

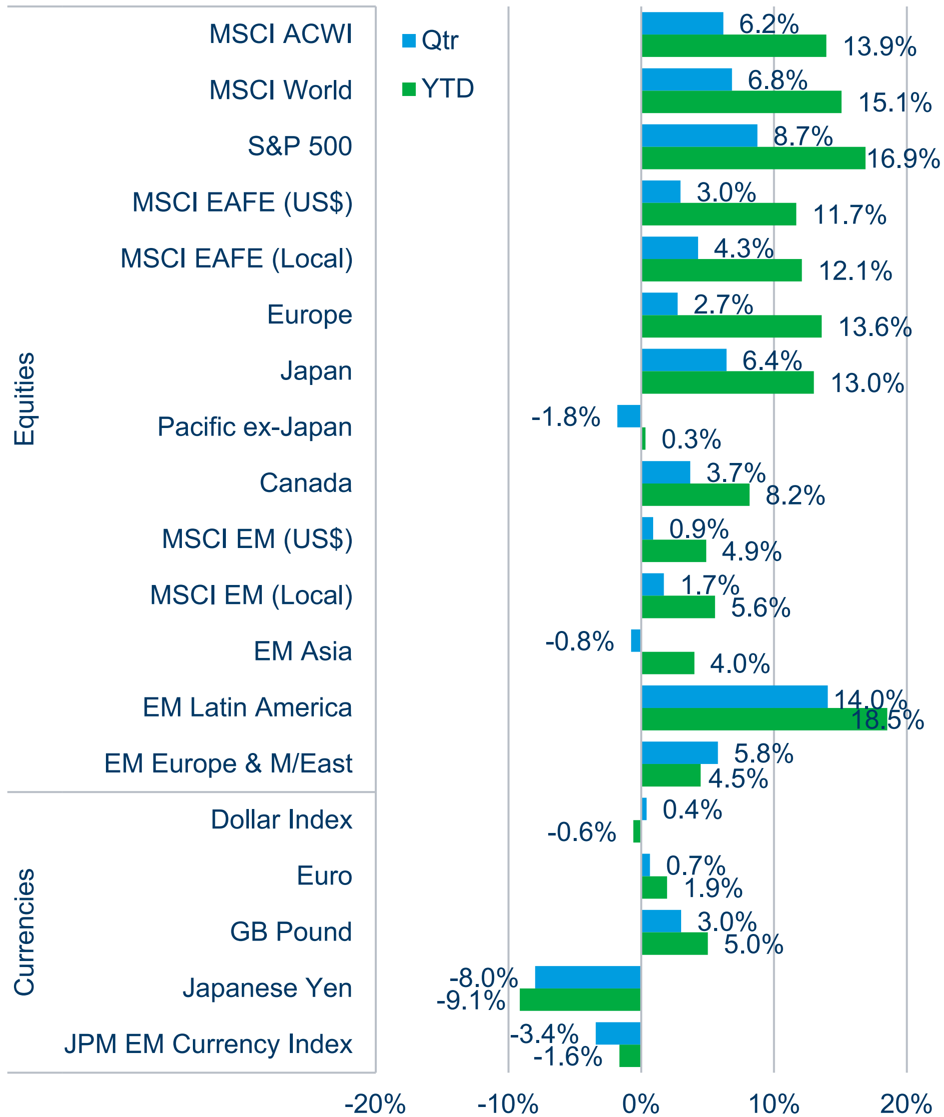
	Value	Blend	Growth
Russell Top 200	4.09	9.89	14.36
Russell Midcap	3.86	4.76	6.23
Russell 2000	3.18	5.21	7.05

MSCI USA Sector Returns



Source: Bloomberg; as of 6/30/23

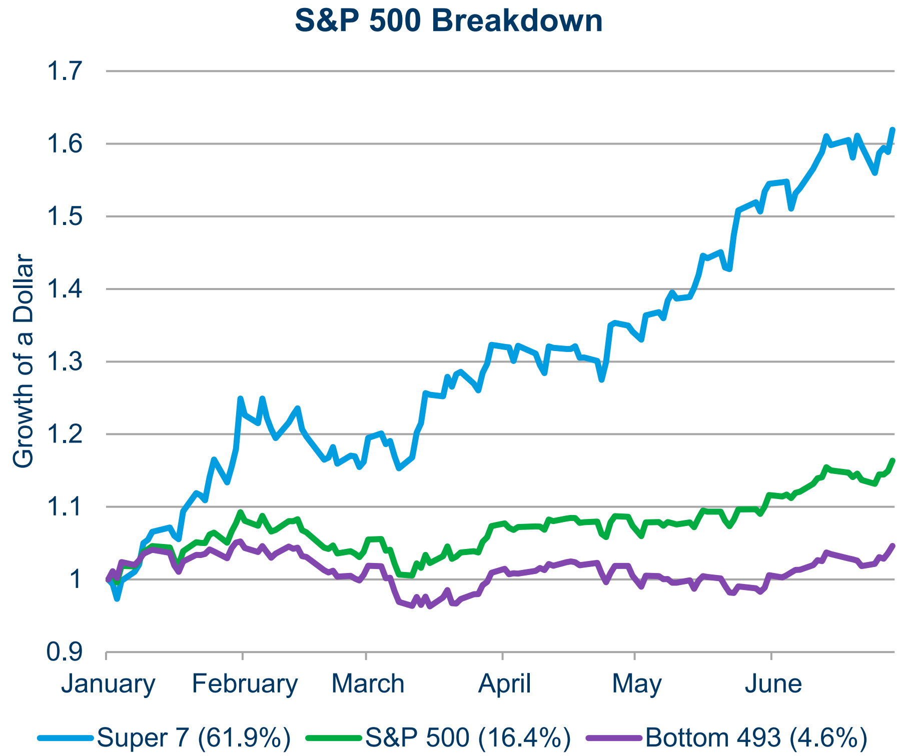
Global Performance



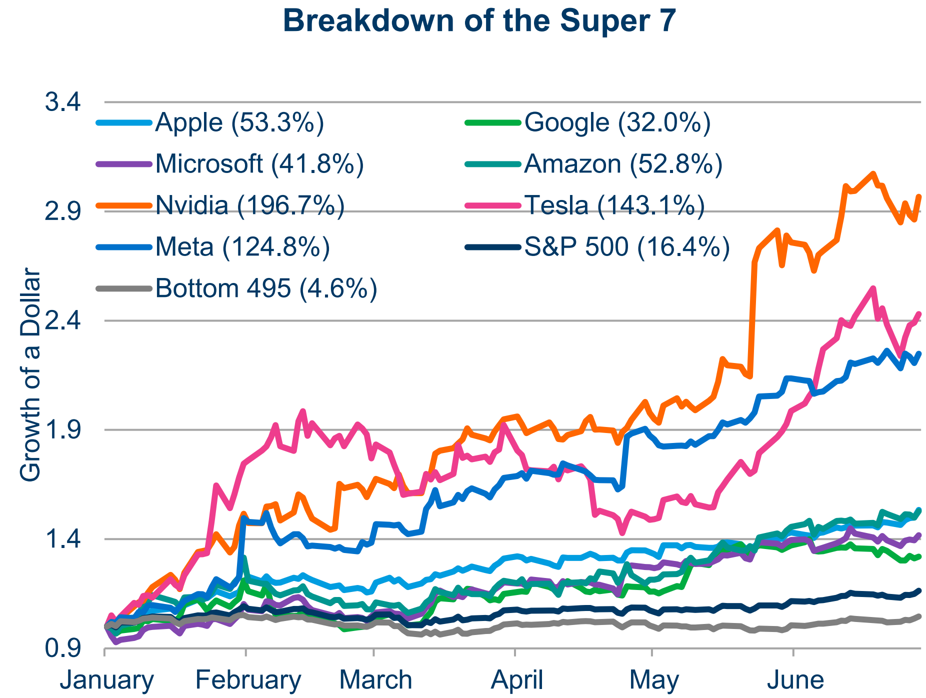
Source: Bloomberg, Datastream; as of 6/30/23

Narrow leadership within US equities in 1H23

Seven mega cap tech stocks have dominated the performance of the other 493 stocks in the S&P 500. Those mega cap tech names returned between 40-150% in 1H23, while the rest of the index earned less than 5%. A consequence is that US stock market concentration is again reaching all-time highs. The top five stocks in the S&P 500 make up nearly a quarter of the index, with Apple alone at a 7.5% weight.



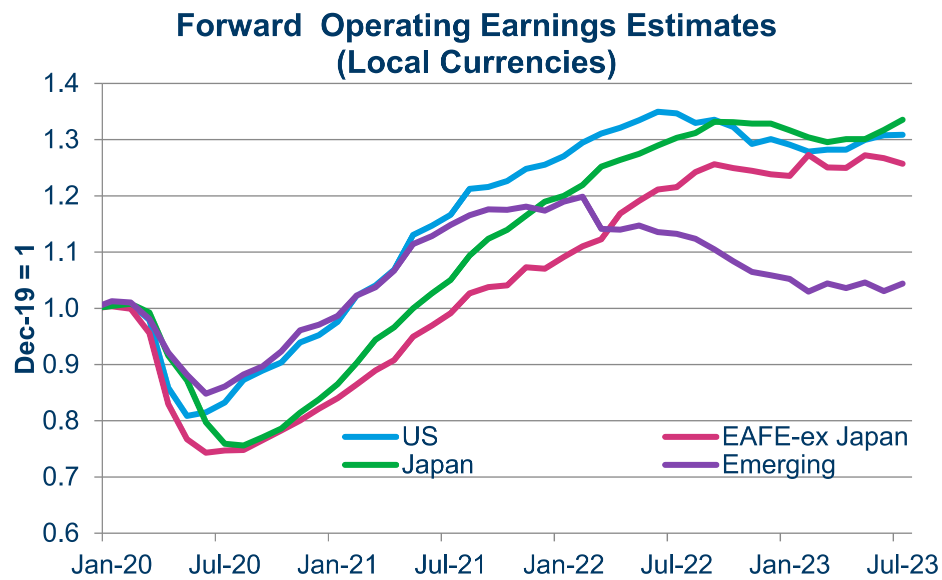
Source: Bloomberg as of June 30, 2023.



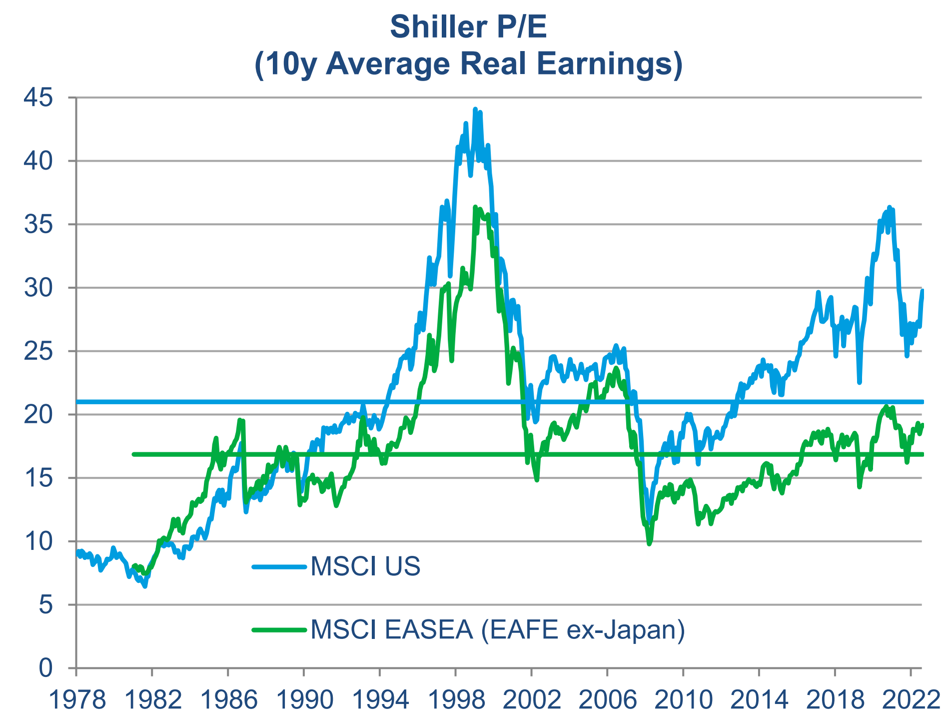
Source: Bloomberg as of June 30, 2023.

Valuation expansion driving performance this year

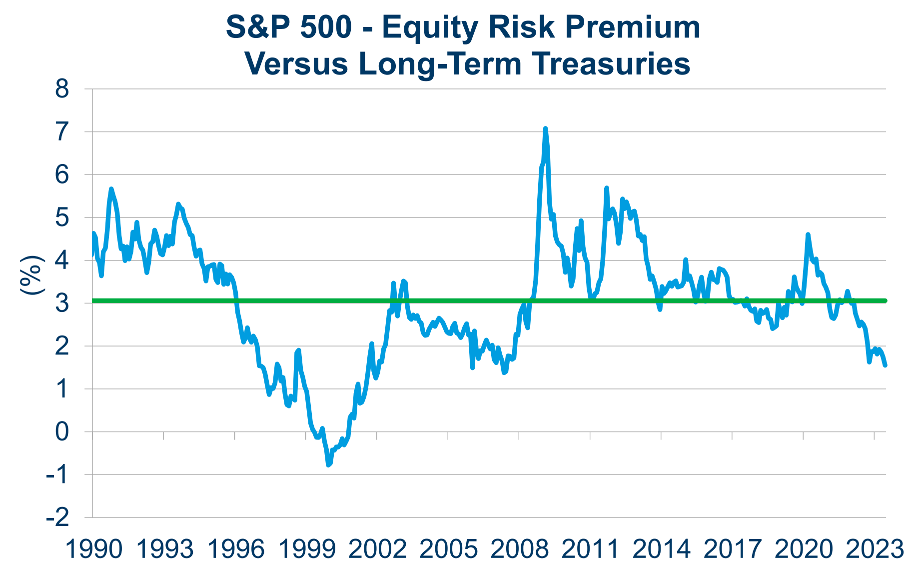
Strong economic growth and enthusiasm over AI have helped drive the market higher. However, the bulk of gains in 2023 have come from valuation expansion even as interest rates have moved higher. The forward P/E on the US equity market has expanded by 19% since the start of the year, from 17 to 20, while forward 12m earning estimates have been virtually flat. Higher equity valuations with higher interest rates have further squeezed the expected return on stocks versus bonds. We estimate the equity risk premium is at the lowest level since 2007.



Source: Datastream, through 7/31/23



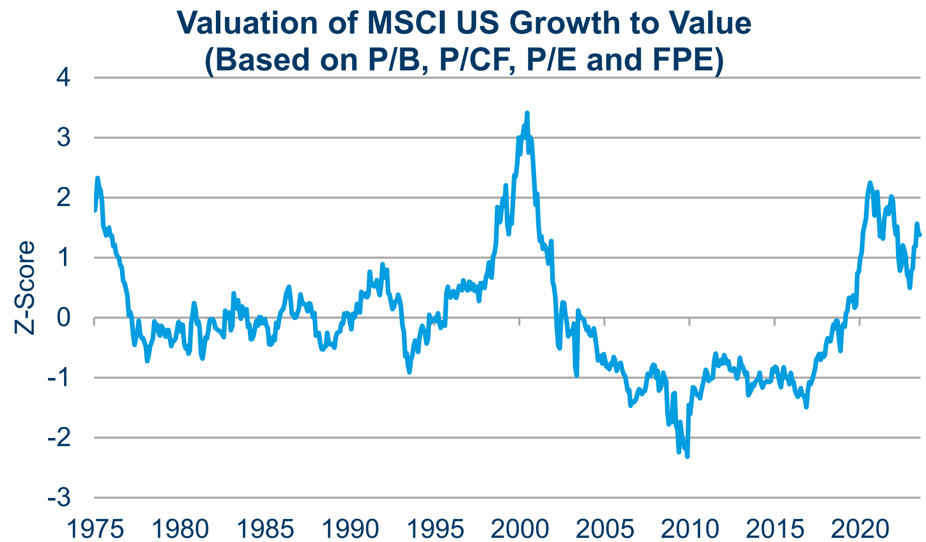
Source: Datastream, MSCI, Mercer, as of 7/31/23



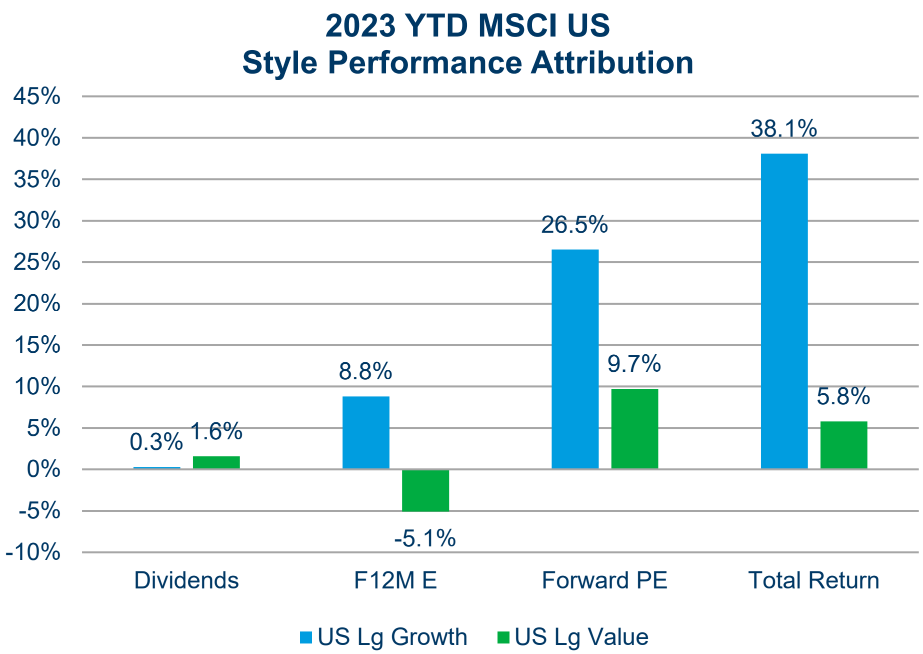
Source: Bloomberg, Datastream, Mercer; as of 6/30/23

Growth outperformance driven mostly by rising valuations

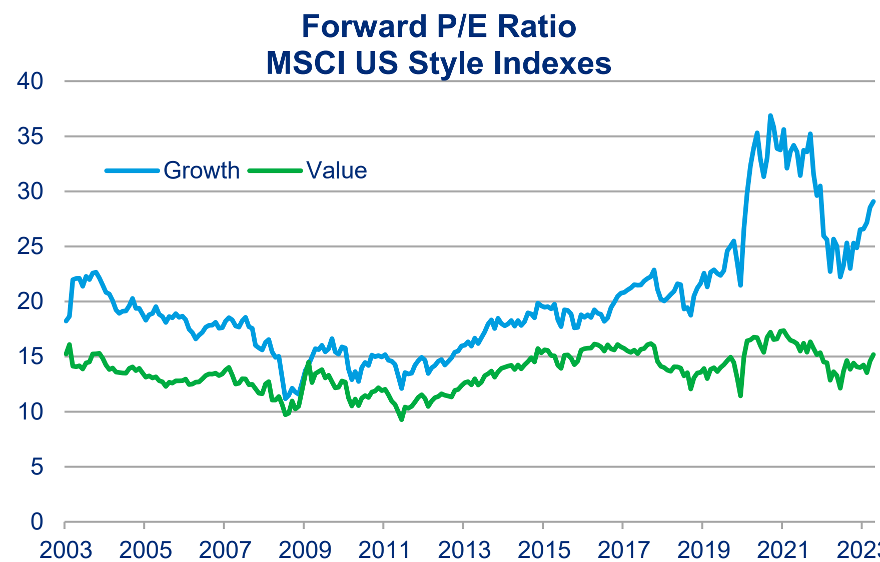
The dominance of mega cap tech stocks has led to substantial outperformance of growth versus value stocks. Fundamentals explain some of this. Forward earnings for growth stocks were revised 9% higher this year, while value company earnings estimates have been marked down by 5%. Still, the forward PE for growth has been bid up from 23 to 29 this year, a 27% increase. Growth stocks again appear very expensive relative to value. We continue to favor a tilt to value stocks. This is a way to manage index concentration as well. The top 10 stocks in the Russell 1000 Value total around 17% of the index, versus 29% for the S&P 500.



Source: Datastream, through 7/31/23



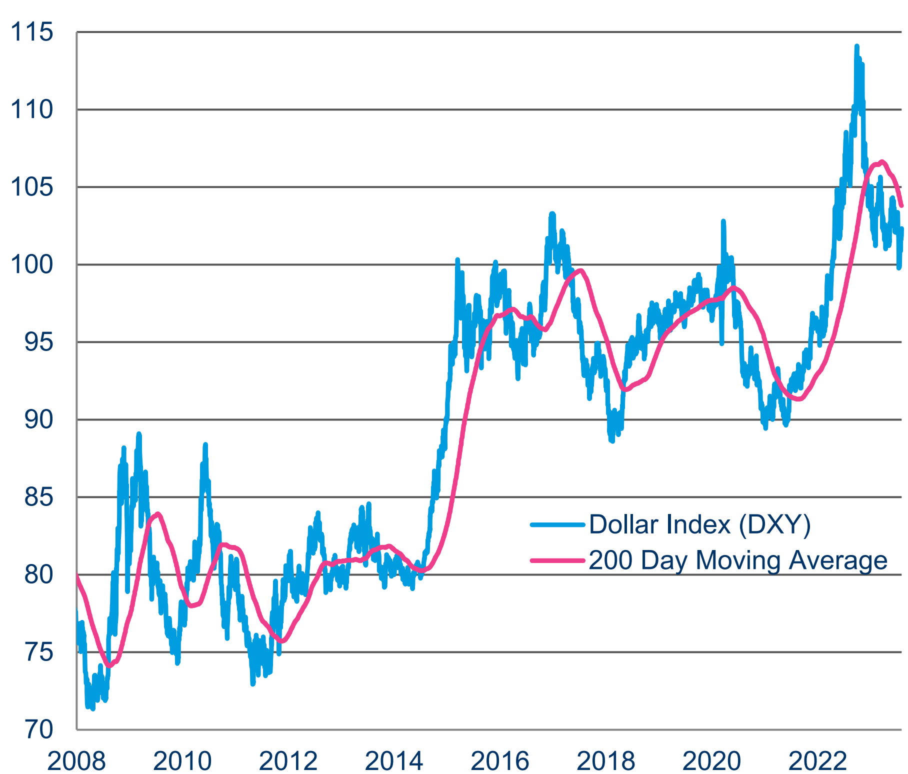
Source: Datastream; as of 7/31/23



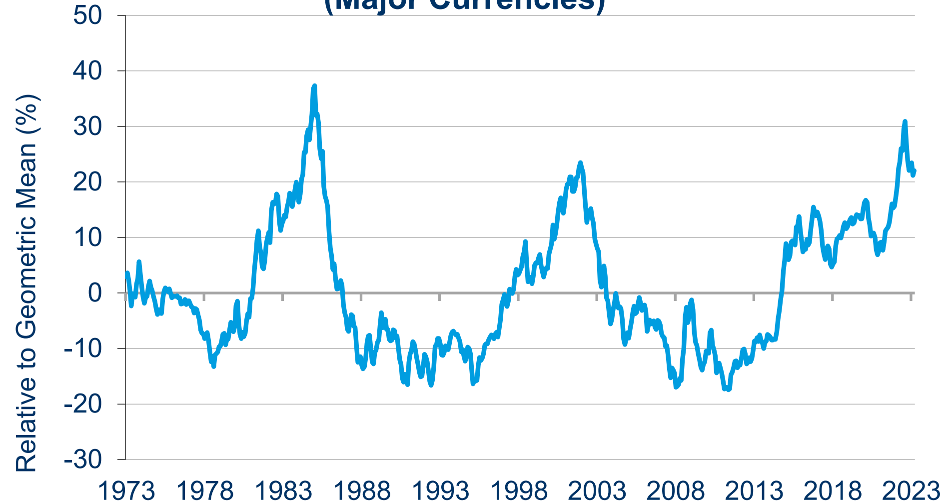
Source: Datastream; as of 7/31/23

The dollar stabilized in 2Q, but further weakness may lie ahead

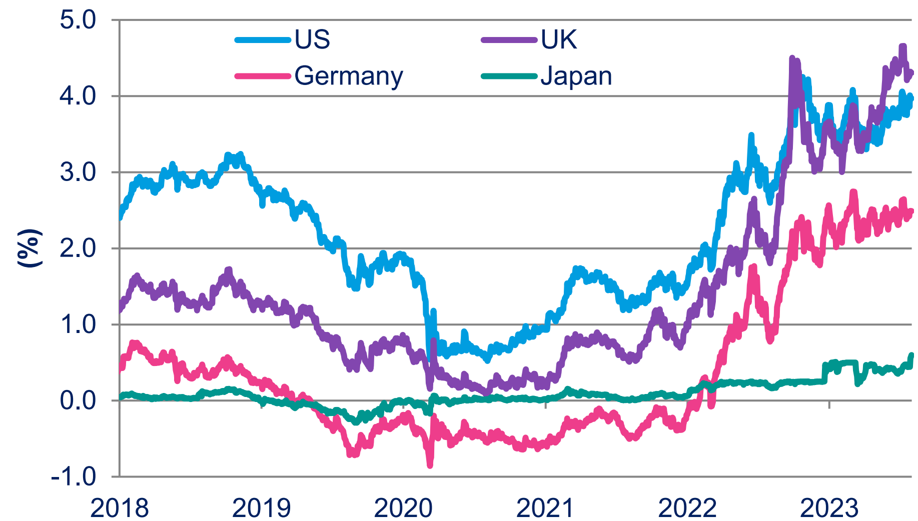
After plunging 10% from its high in September through the end of 1Q23, the US Dollar Index (DXY) stabilized in 2Q23 as US Treasury yields moved higher against most other developed markets. We remain bearish on the dollar over the intermediate term. Its real effective exchange rate remains about 20% overvalued, and the US has a wide current account deficit. A weak US dollar should support emerging market assets, including emerging market local currency debt.



Source: Bloomberg, through 7/31/23



Source: Bloomberg, Mercer calculations; through 3/31/2023

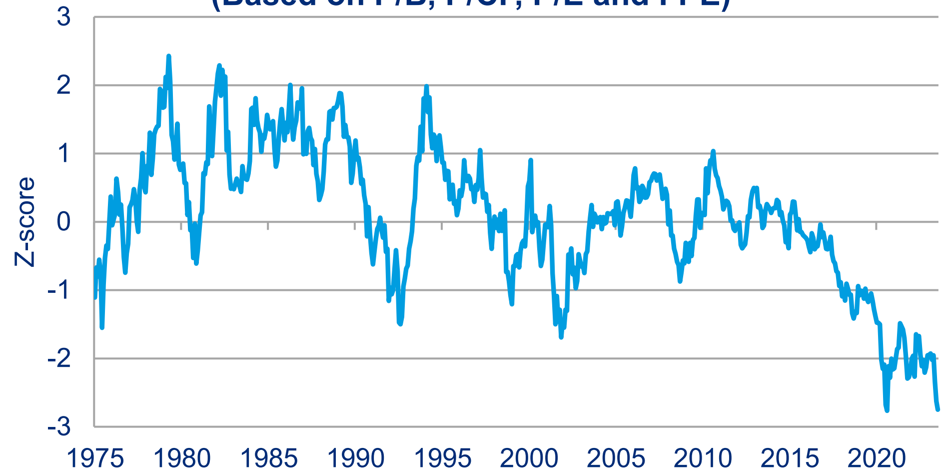


Source: Bloomberg; as of 7/31/23

International developed equities have performed well, but have lagged the US

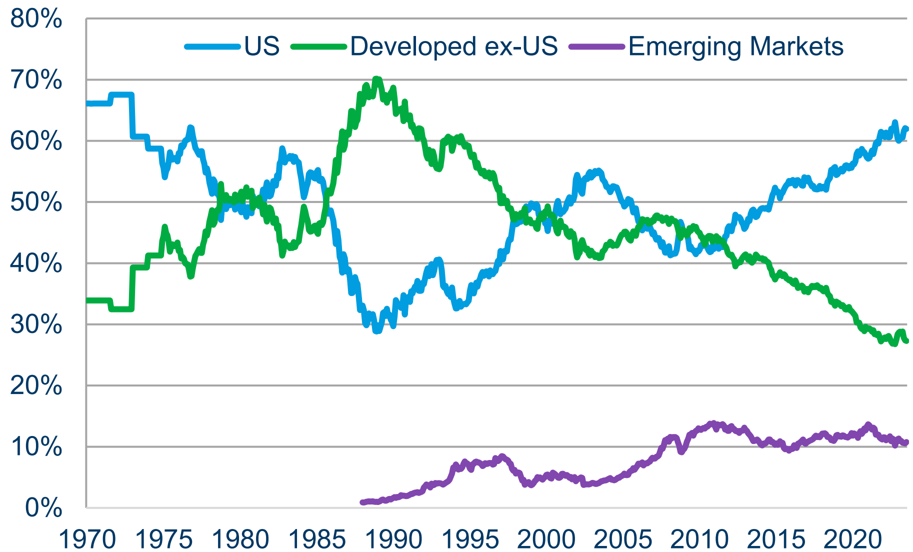
International developed equities performed well 2Q and in July, but lagged the mega cap tech-driven gains of the S&P 500. EM equities lagged developed equities as enthusiasm over China's reopening waned. We continue to favor international developed and emerging market equities to US equities over the intermediate-term. Valuations are attractive versus the US, and the dollar remains expensive. While China's reopening has been underwhelming compared to early expectations, there remains potential for a growth pickup as policy support gains momentum. This would also help Europe and Japan, which are more sensitive than the US to the Chinese economy.

Valuation of Int'l Developed (ex-Japan) vs. US (Based on P/B, P/CF, P/E and FPE)



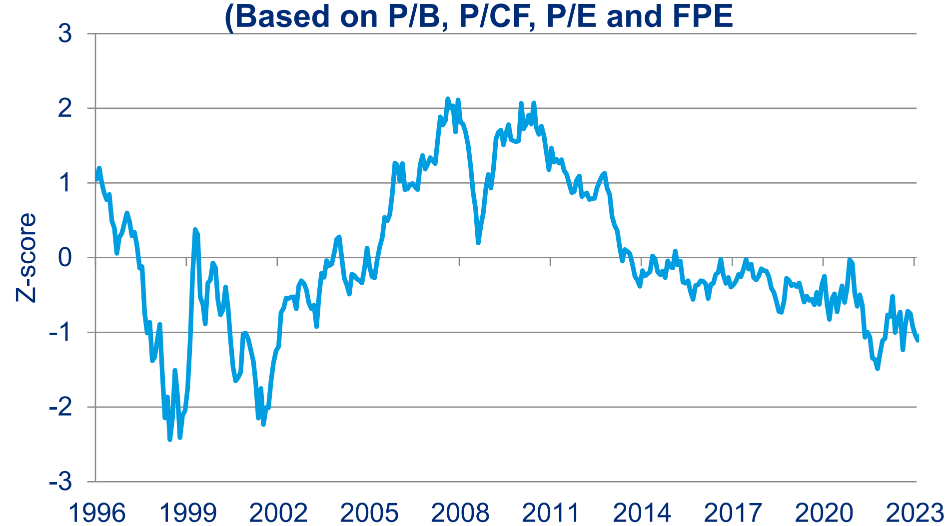
Source: Datastream, through 7/31/23

MSCI ACWI Weights



Source: Datastream, through 7/31/23

Valuation of Emerging Markets vs. US (Based on P/B, P/CF, P/E and FPE

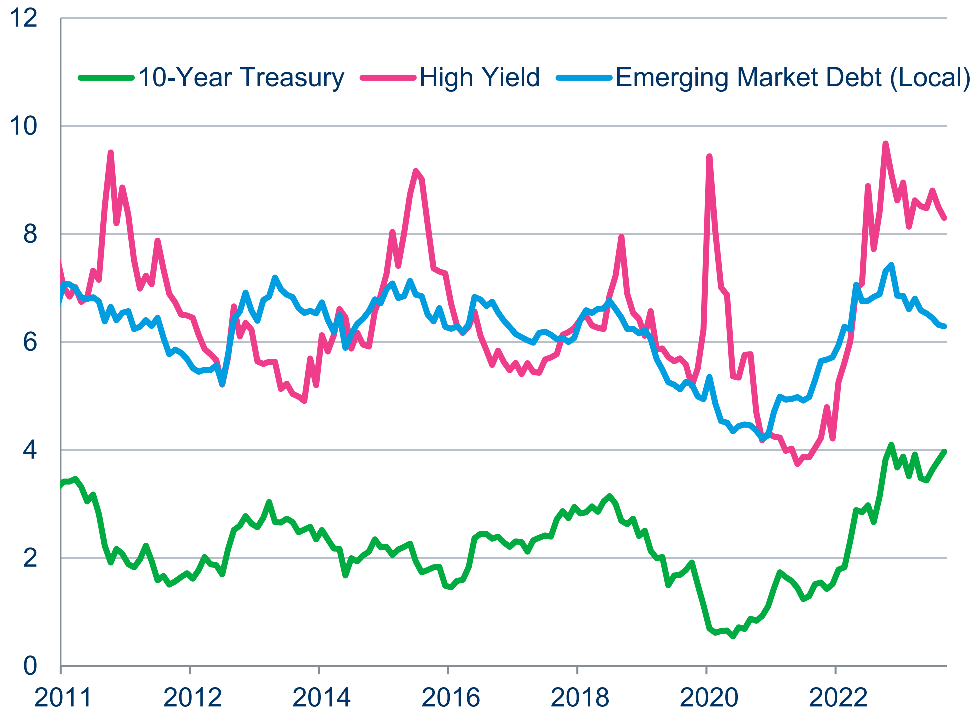


Source: Datastream, through 7/31/23

Narrowing credits spreads have reduced attractiveness of riskier credit

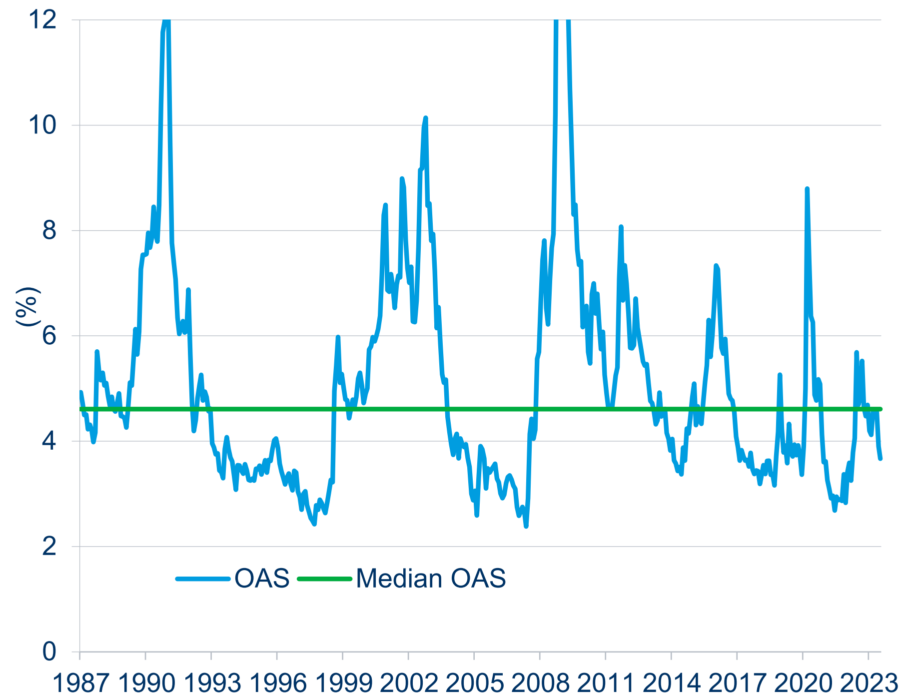
The increase in interest rates since the start of last year has improved the return outlook for fixed income relative to equities. High yield bonds offer a yield over 8%. However, the spread to Treasuries has narrowed to just 3.8% as of July, which is below the long-term median and significantly below recessionary levels. Default rates for high yield bonds have begun to tick higher. Overall, we still believe high yield bonds offer a better reward-to-risk than equities. In the event of a recession, spreads and defaults will spike, but the rising credit quality of the universe should provide more cushion than in past recessions. A weaker dollar and easing monetary policy offer upside potential for local currency emerging market debt.

Yield History



Source: Bloomberg, Federal Reserve; as of 7/31/23

High Yield Bond Option Adjusted Credit Spread



Source: Bloomberg; through 7/31/23

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