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# Market Environment Report

October 2023

A business of Marsh McLennan

# Market review & outlook

## Stocks decline as markets price in a higher for longer interest rate environment

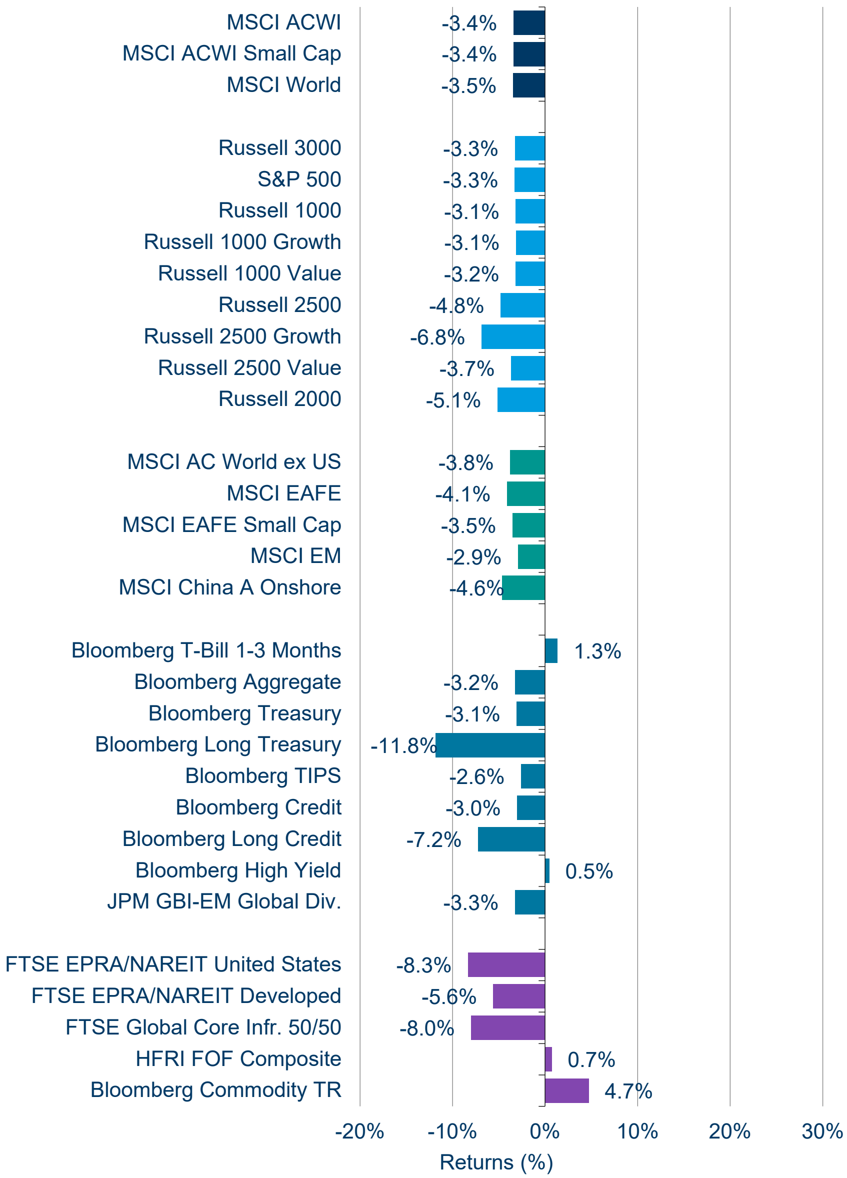
- Global equity markets experienced a decline in the quarter, primarily due to an increase in longer-term rates as markets anticipated a prolonged period of higher rates. Volatility remained low for most of the quarter but rose in the final weeks alongside the spike in rates.
- Treasury yields generally rose during the quarter, and the yield curve became less inverted. The 2-year Treasury yield rose 16 bps from 4.9% to 5.0% during Q3, while the 30-year Treasury yield rose 88 bps from 3.8% to 4.7%. Credit spreads remained relatively stable during the quarter for both investment-grade and high yield bonds.
- The Bloomberg Aggregate Bond Index fell 3.2% in Q3, while the MSCI ACWI declined 3.4%. Consequently, a traditional 60/40 portfolio fell 3.3%. Year-to-date, a 60/40 portfolio has gained 5.6%.

## Global growth to lose momentum, but policy rates have likely peaked

- Global economic growth has proved resilient so far in 2023 but is set to slow as several positive tailwinds fade. US economic activity has been remarkably strong, supported by the release of pent-up savings, strong private investment and expansionary fiscal policy. These factors should fade in Q4 and beyond, but we still expect the US to avoid a hard landing. Economic activity in the Eurozone slowed in Q3, but the bloc should slow less than the US in Q4 and strengthen in 2024. China's economy continues to face challenges, but policymakers have room to stimulate further without significant inflationary pressures due to excess capacity.
- US inflation has fallen significantly. Headline CPI was up 3.7% year-over-year through August, while core CPI stood at 4.3%. Inflation should continue to decline as remaining inflationary components such as shelter, stabilize. Labor markets remain tight and could exert upward pressure on inflation into 2024. A potential slowdown in US growth would likely ease labor market tightness and reduce wage pressures.
- With rates firmly in restrictive territory, central banks are cautiously transitioning from rake hikes to a pause. Federal Reserve officials suggest the possibility of further rate hikes, but bond market pricing suggests they have reached the peak policy rate for this cycle, albeit with rate cuts pushed further out. Most other developed market central banks are in a similar position, with the notable exception being the Bank of Japan, which still maintains a stimulative policy.
- Geopolitical risks have returned to the forefront due the conflict in Israel, resulting in tragic human consequences. While the initial market impacts have been limited, there is the risk of escalation that could affect oil markets.
- Our outlook for global equities has improved due to the recent pullback, negative investor sentiment, and the prospect for economic normalization, although high US equity valuations remain a concern. We believe the sell-off in Treasuries has brought yields into attractive territory. The biggest risk we see is if inflation remains sticky, leading to additional rate hikes and further weakness for stocks and bonds.

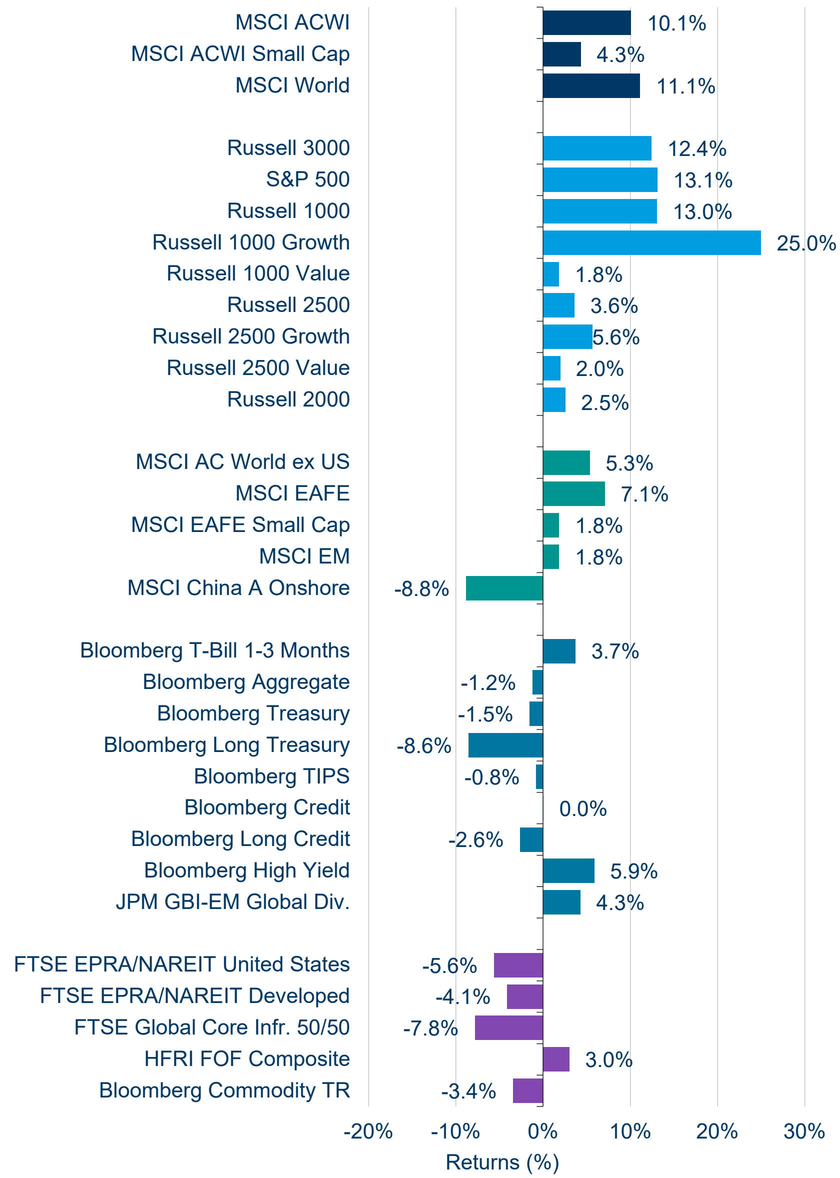
# Performance summary

**Market Performance**
Third Quarter 2023




Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 9/30/23

**Market Performance**
Year-to-Date




Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 9/30/23

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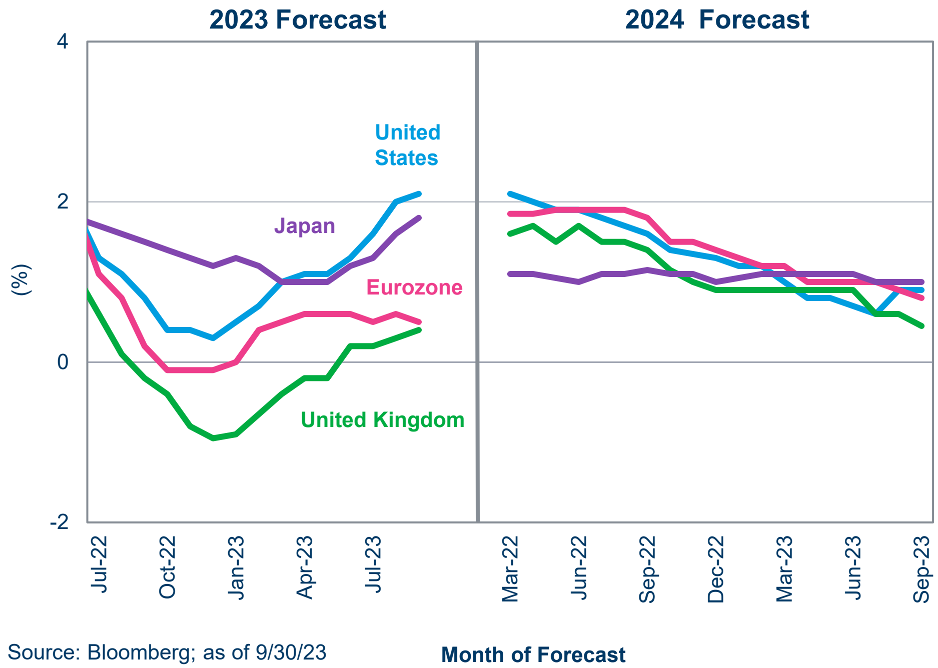
Past performance is no guarantee of future results

# Global economic growth remained resilient

**Global economic growth has proved resilient so far in 2023, but it is set to slow as several positive tailwinds diminish. US economic activity has been remarkably strong, supported by the drawdown of pent-up savings, strong private investment and expansionary fiscal policy. However, these should fade in Q4 and into 2024. Nevertheless, we still expect the US to avoid a hard landing. Economic activity in the Eurozone slowed in Q3. Looking ahead, the bloc should decelerate at a slower pace than the US in Q4 and strengthen in 2024. China's economy continued to struggle, but policymakers have ample capacity to stimulate further without significant inflationary pressures due to excess capacity.**

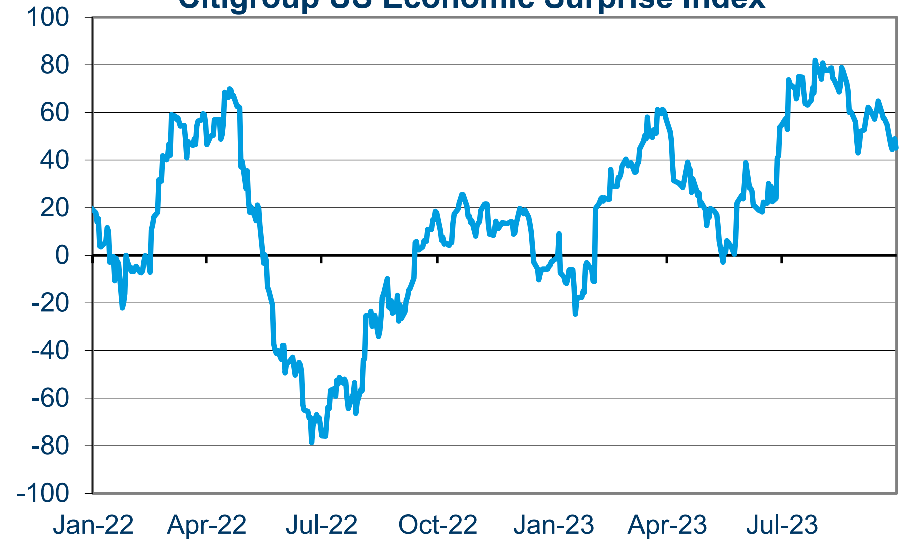
**Consensus GDP Growth Forecasts**




Source: Bloomberg; as of 9/30/23

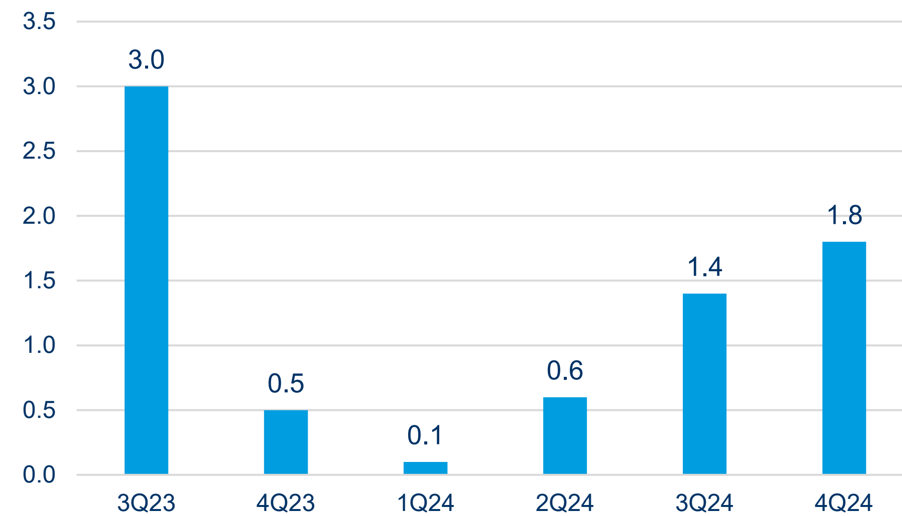
Forecasts provided by third party economists, there can be no guarantee that these forecasts will be accurate.

**Citigroup US Economic Surprise Index**




Source: Bloomberg; as of 9/30/23

**Bloomberg Consensus US Growth Forecasts**




Source: Bloomberg; as of 9/30/23



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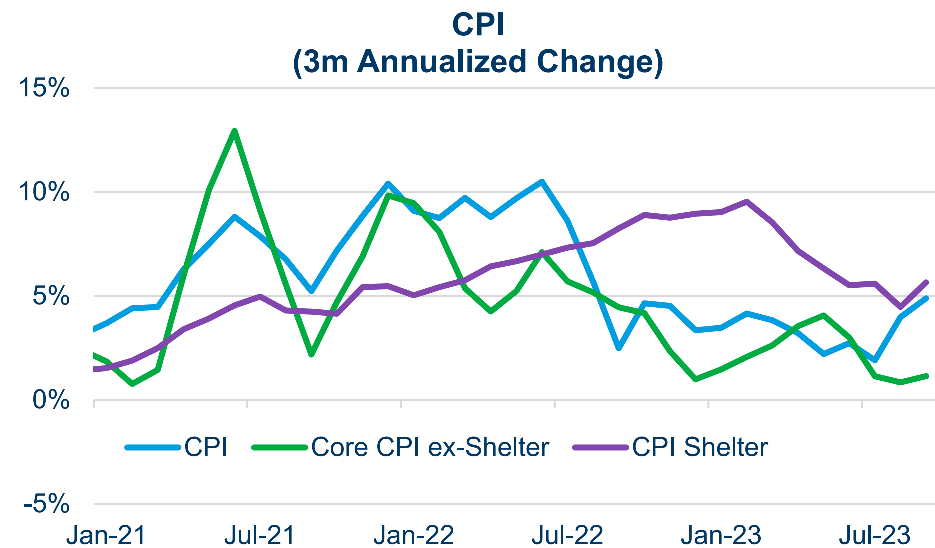
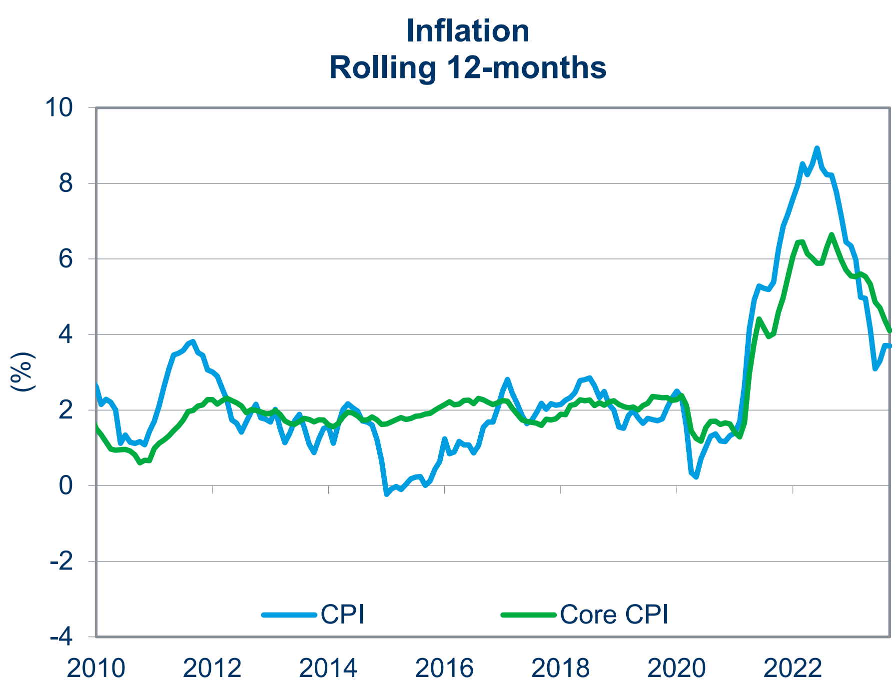
# Inflation continued to trend downward

**US inflation has fallen significantly this year. Headline CPI was up 3.7% year-over-year through September, while core CPI stood at 4.1%. The core CPI inflation rate is being kept high by the lagged shelter component. Core CPI ex-shelter has increased only 1.9% year-over-year. The primary risk to the disinflationary trend lies in wage growth. The employment market remains tight, and wage growth is above the 3-4% rate implied by the Fed's inflation target. However, a slowdown in US growth in 2024 should ease the labor market tightness and reduce wage pressures. As a result, we expect inflation will continue to trend towards the Fed's 2% target, eventually providing the Fed with the flexibility to ease policy.**




Source: Bloomberg; through 9/30/23




Source: Bloomberg; through 9/30/23


Source: Bloomberg; through 9/30/23

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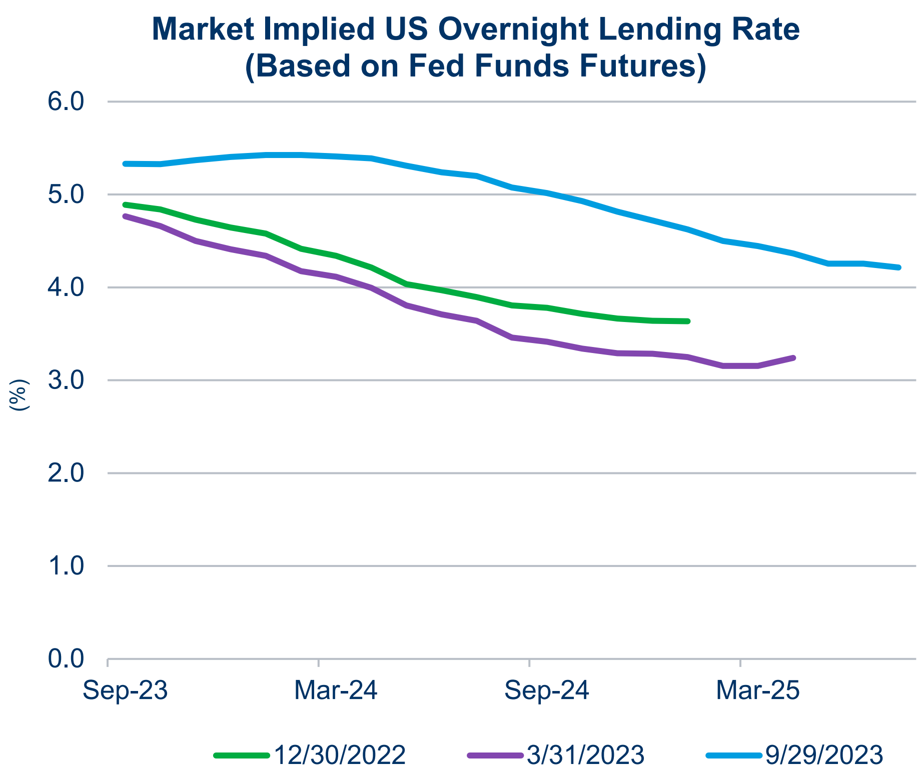
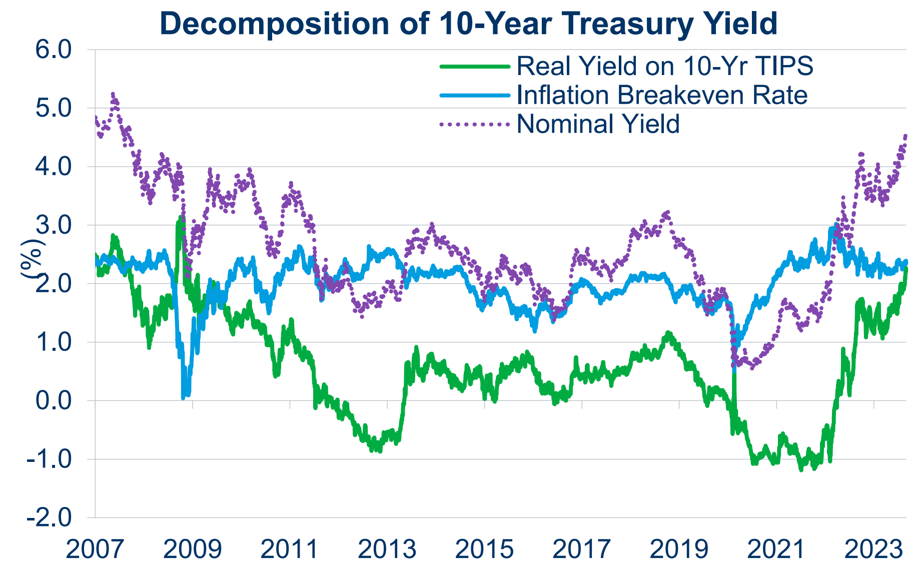
# The spike in long-term rates drove market volatility during the quarter

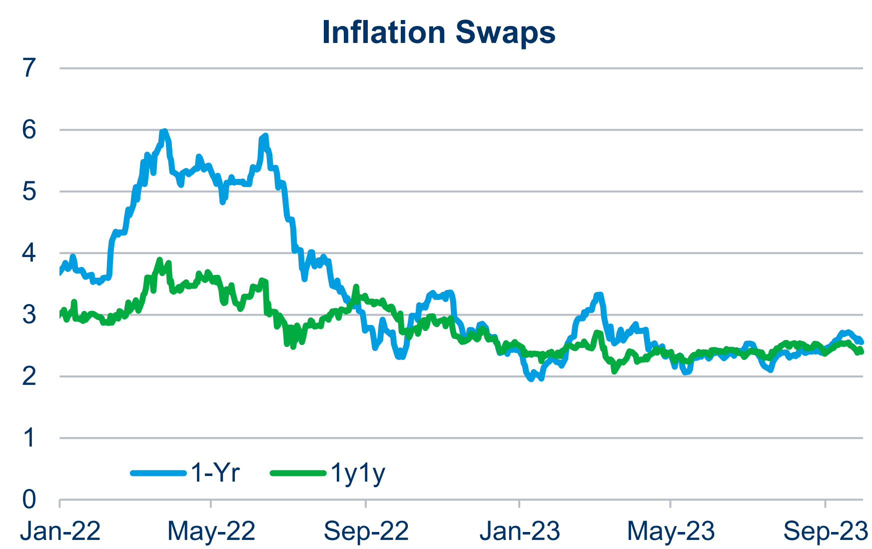
**Long-term interest rates spiked during the quarter, reaching their highest levels since before the GFC. Despite a downward trend in inflation, strong economic growth has postponed the anticipated start of the Fed's next easing cycle. Furthermore, the bond market had to absorb a growing supply of Treasury issuance resulting from high government deficits. With the 10-year Treasury yield nearing 5% and the real yield around 2.5%, we think Treasuries are now attractive versus cash.**




Source: Bloomberg; as of 9/30/23




Source: Bloomberg; through of 9/30/23

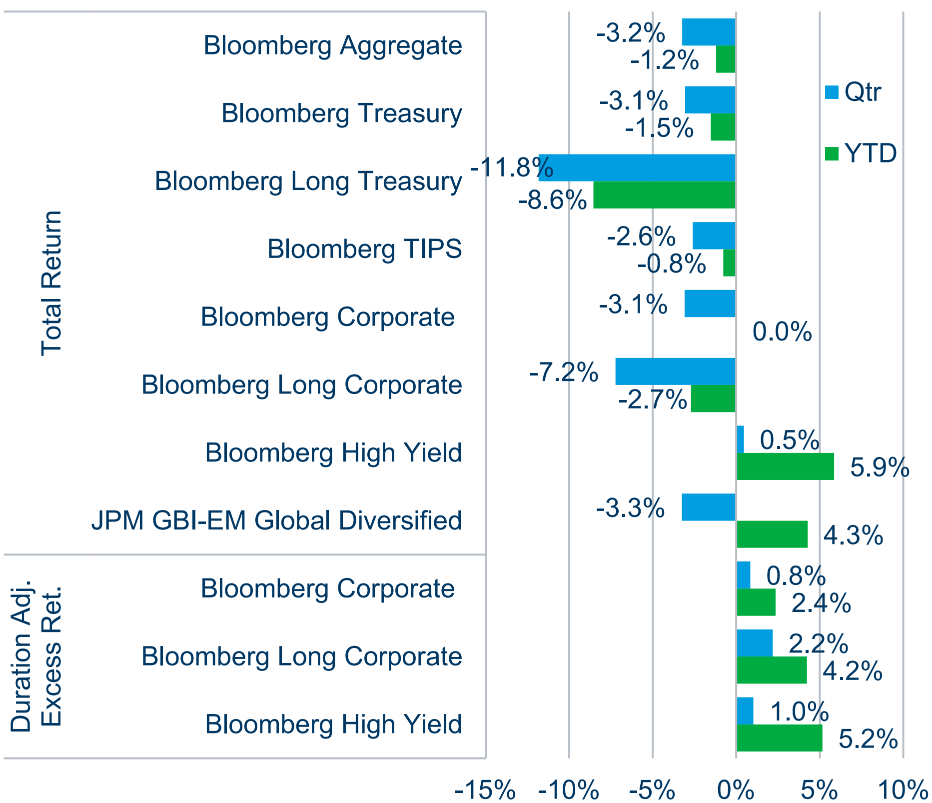



Source: Bloomberg; through of 9/30/23

# What happened in fixed income in Q3?

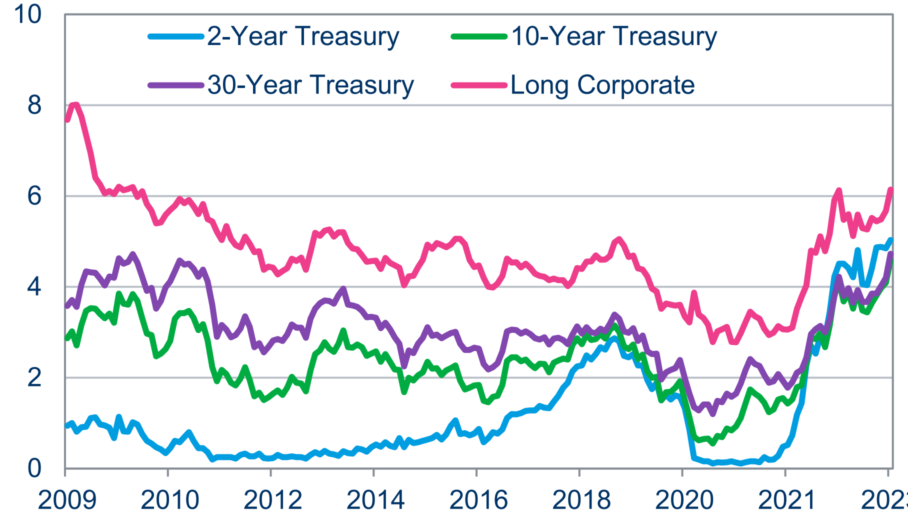
**Most segments of the fixed income market declined in Q3 due to rising interest rates. The Bloomberg Aggregate Index fell 3.2% during the quarter. The increase in yields during Q3 primarily affected intermediate and long-term maturities, resulting in a less inverted yield curve. The 10-year Treasury yield rose from 3.8% to 4.6% during Q3. Credit spreads were relatively stable, with investment-grade spreads decreasing by 2 bps and high yield spreads increasing by 4 bps. TIPS outperformed Treasuries due to an uptick in inflation-breakeven rates.**

### Fixed Income Performance



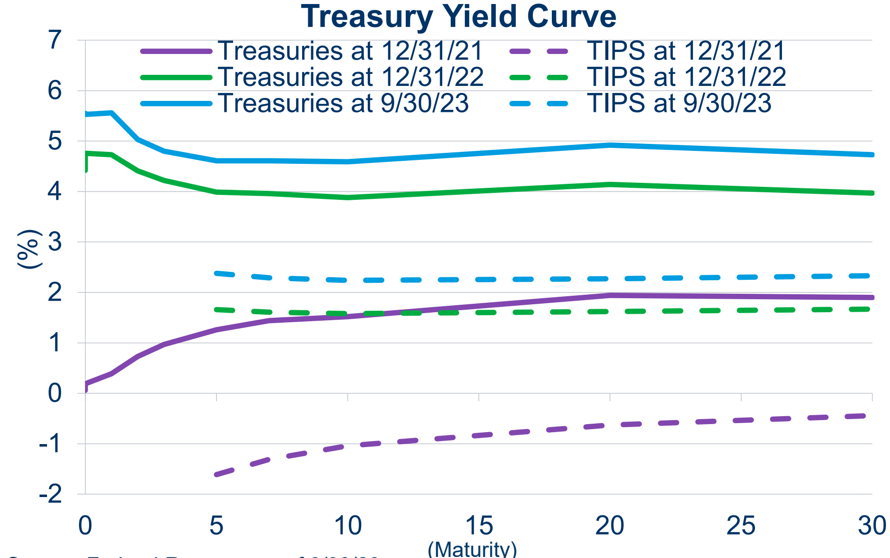

Source: Bloomberg, Datastream; as of 9/30/23

### Yield History




Source: Bloomberg, Federal Reserve; as of 9/30/23

### Treasury Yield Curve




Source: Federal Reserve; as of 9/30/23

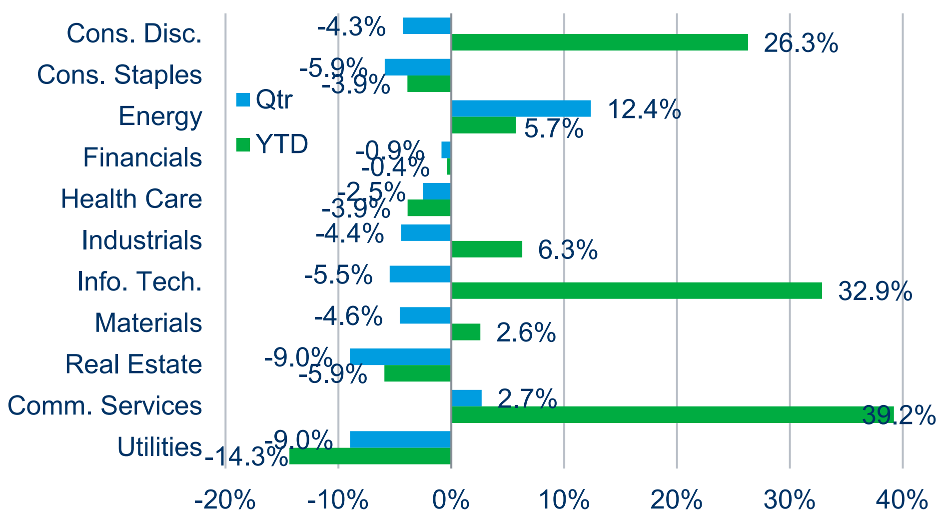
# What happened in equity markets in Q3?

**Equities experienced moderate declines in Q3, with the MSCI ACWI falling 3.4%. Within US large caps, value stocks slightly outperformed growth, but value showed a much larger advantage across small caps. Energy was the best performing sector in Q3, while the interest-rate sensitive real estate and utilities sectors lagged. MSCI EAFE declined 4.1% during Q3, with US dollar strength detracting 280 bps from US$ returns. Emerging market equities declined 2.9% during the quarter, slightly less than developed markets.**

### 3Q23 US Style Performance (%)

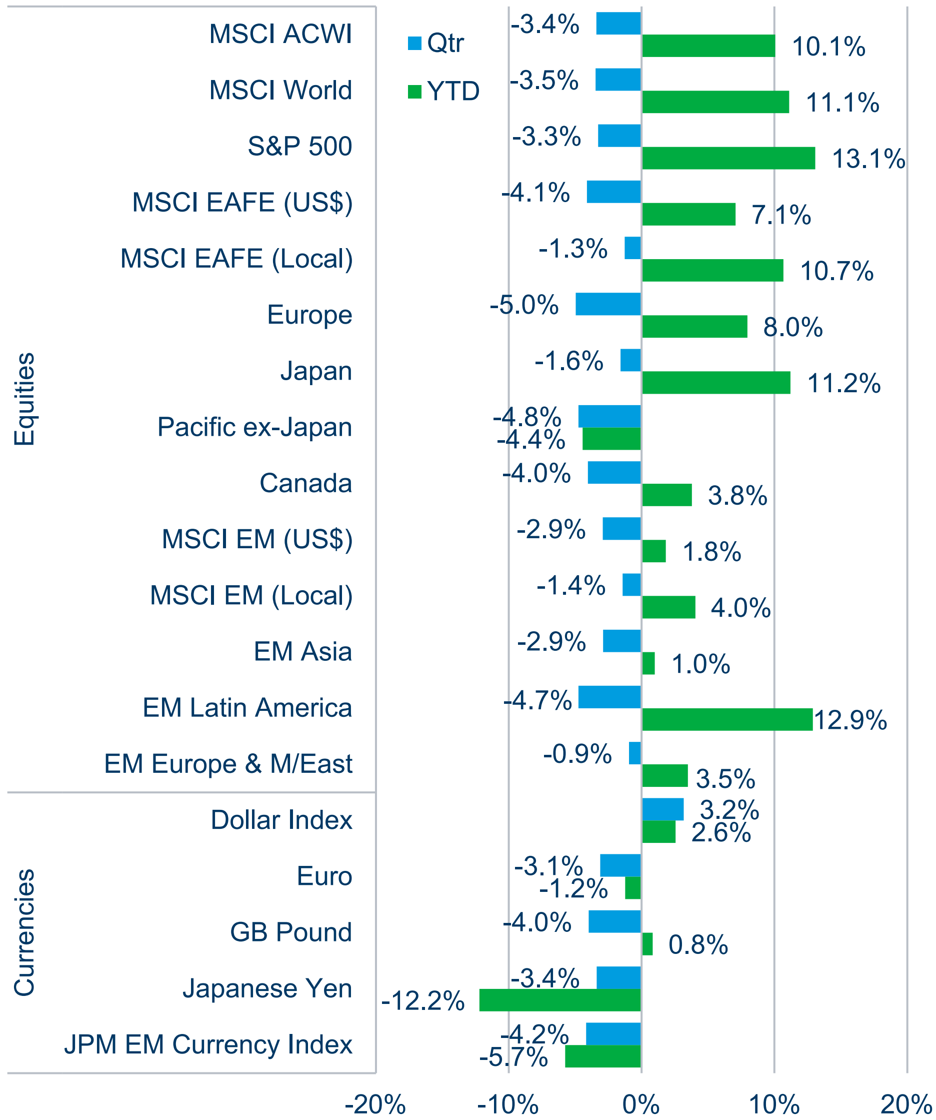
| | Value | Blend | Growth |
|---|---|---|---|
| Russell Top 200 | -2.42 | -2.65 | -2.80 |
| Russell Midcap | -4.46 | -4.68 | -5.22 |
| Russell 2000 | -2.96 | -5.13 | -7.32 |

### MSCI USA Sector Returns




Source: Bloomberg; as of 9/30/23

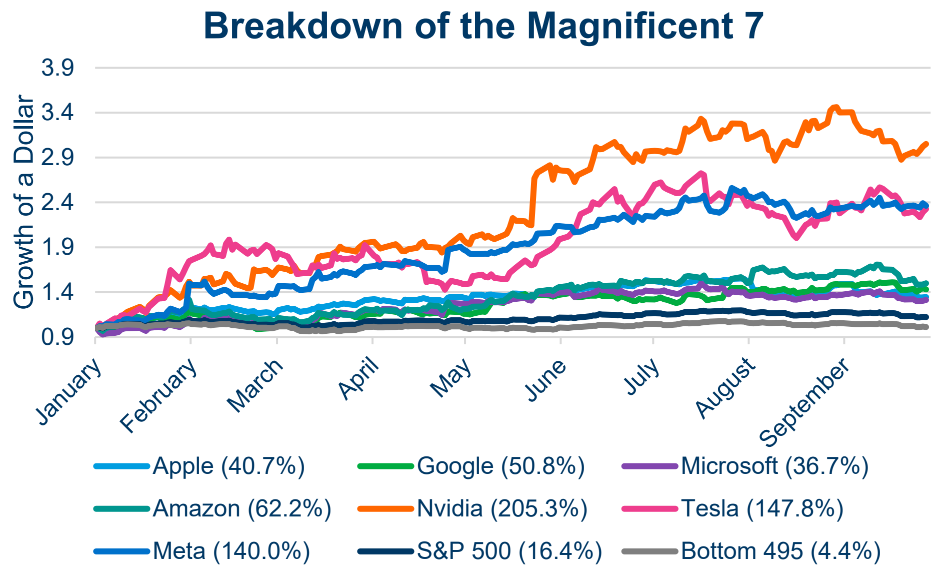
### Global Performance



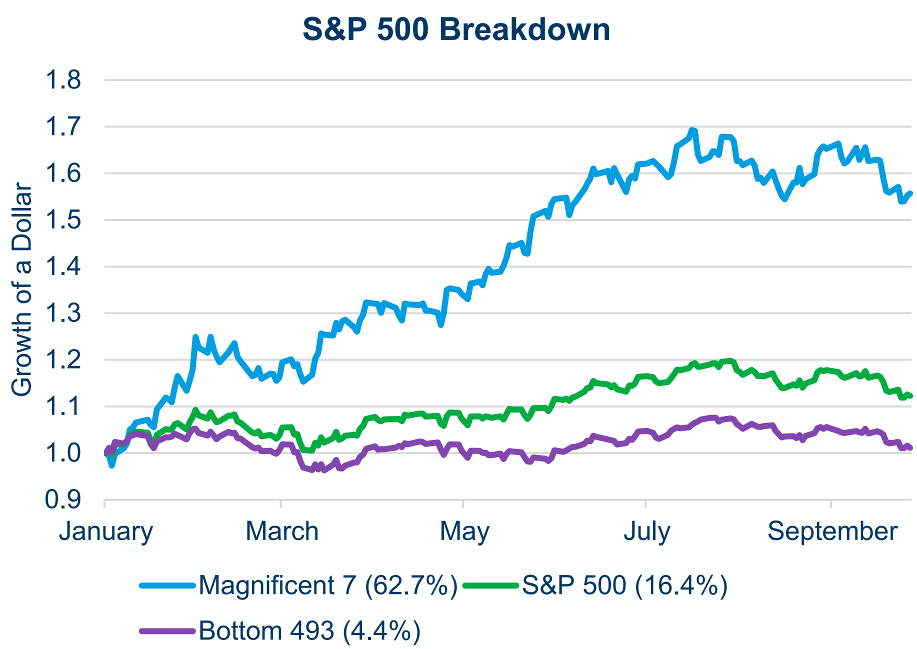

Source: Bloomberg, Datastream; as of 9/30/23

# The Magnificent 7 lost momentum in 3Q, but have still dominated in 2023

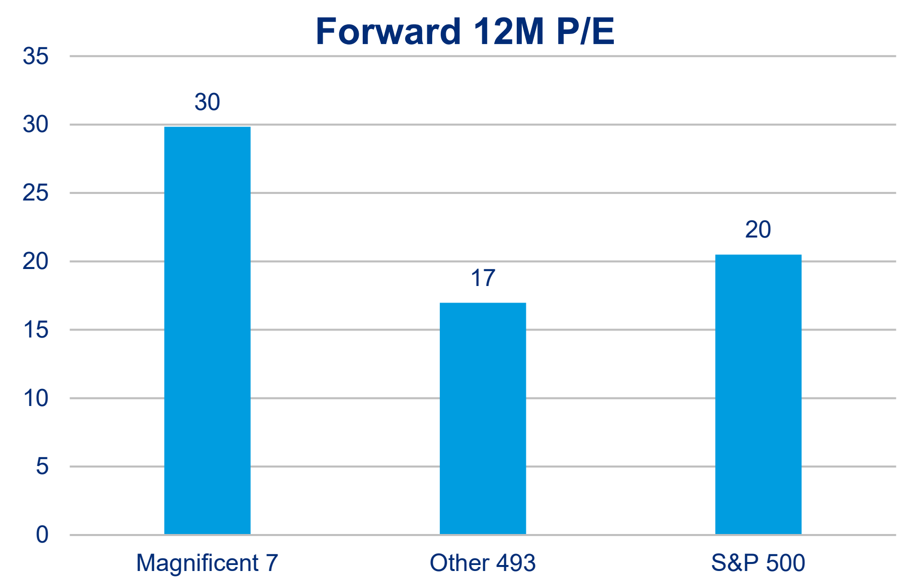
**The so-called Magnificent 7 mega cap tech stocks lost momentum over the quarter, performing slightly worse than the S&P 500. Despite generally strong earnings, these stocks tended to weaken after earnings announcements, hinting at overly optimistic investor expectations. However, they have still maintained their dominance this year, surging more than 50%. In contrast, the other 493 stocks in the S&P have only seen a 4% increase. The Magnificent 7 continue to trade at a substantial valuation premium to the broader market, suggesting valuation risk if earnings growth fails to meet high expectations in the future.**




Source: Bloomberg as of 9/30/2023.




Source: Bloomberg as of 9/30/2023.




Source: Bloomberg as of 9/30/2023.



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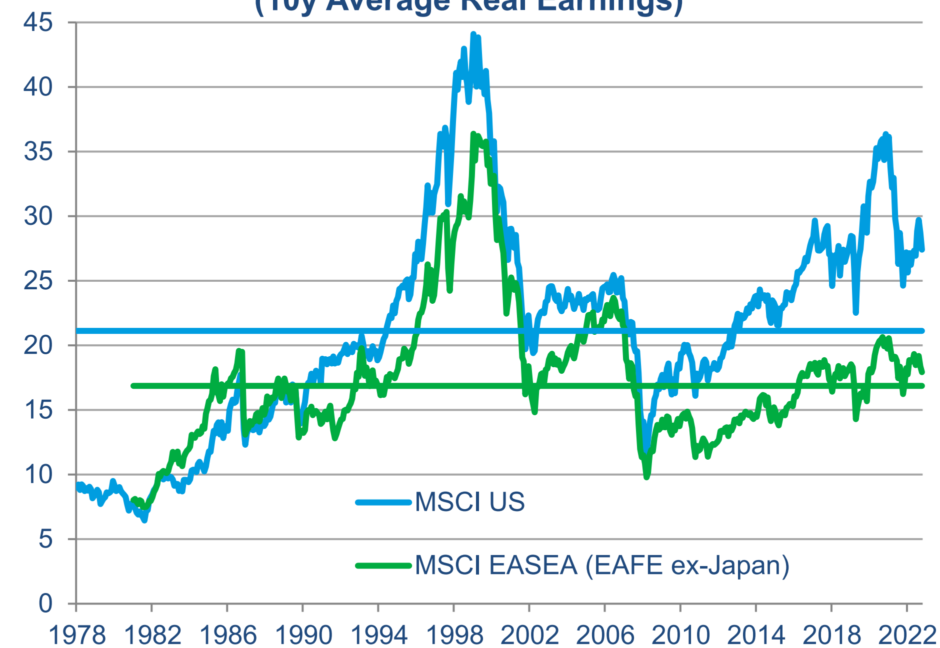
# Equities weakened on higher interest rates

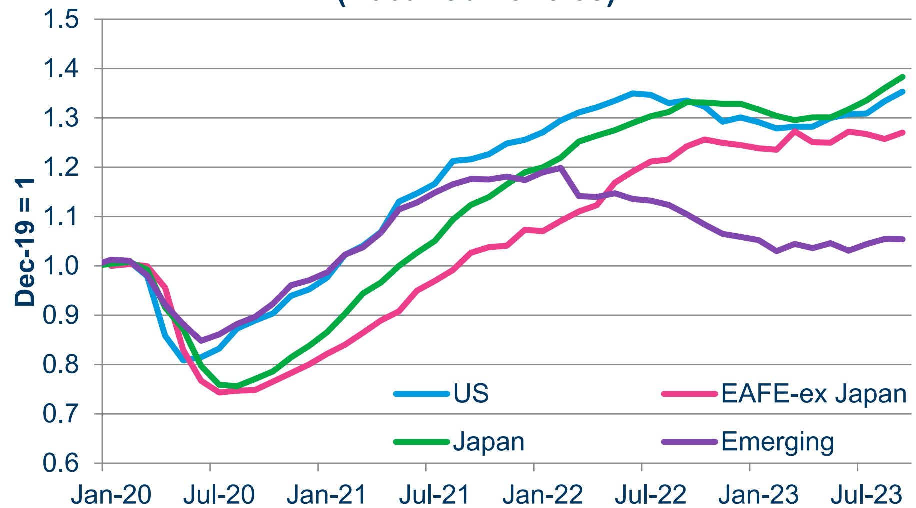
**The increase in interest rates during the quarter weighed on global equities, as the prospective return on bonds became more competitive. We estimate that the forward-looking equity risk premium on the S&P 500 against Treasuries is near the lowest level since 2007. Nevertheless, our shorter-term outlook for global equities has improved due to the recent pullback. While equity valuations (particularly for US tech stocks) remain lofty, negative investor sentiment and the prospect for economic normalization could provide tailwinds over the short-term. We believe the best opportunities lie outside the US.**

**Shiller P/E (10y Average Real Earnings)**



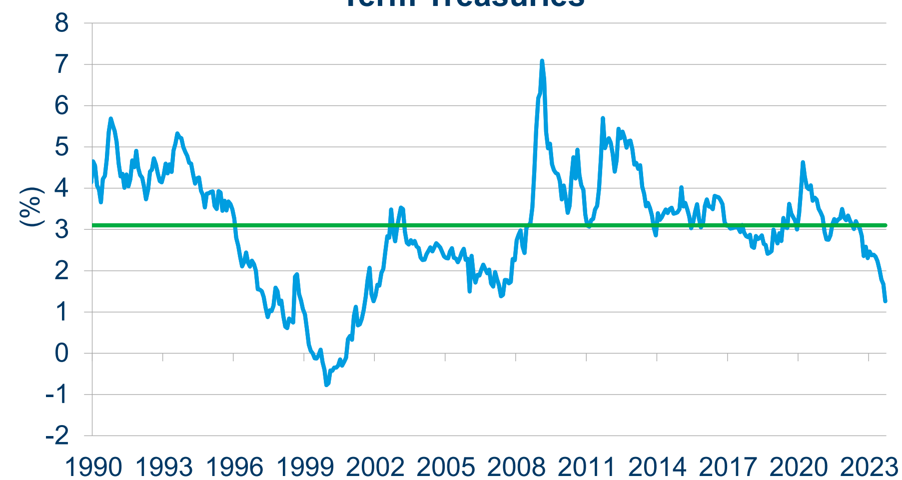

Source: Datastream, MSCI, Mercer, as of 9/30/23

**Forward Operating Earnings Estimates (Local Currencies)**




Source: Datastream, through 9/30/23

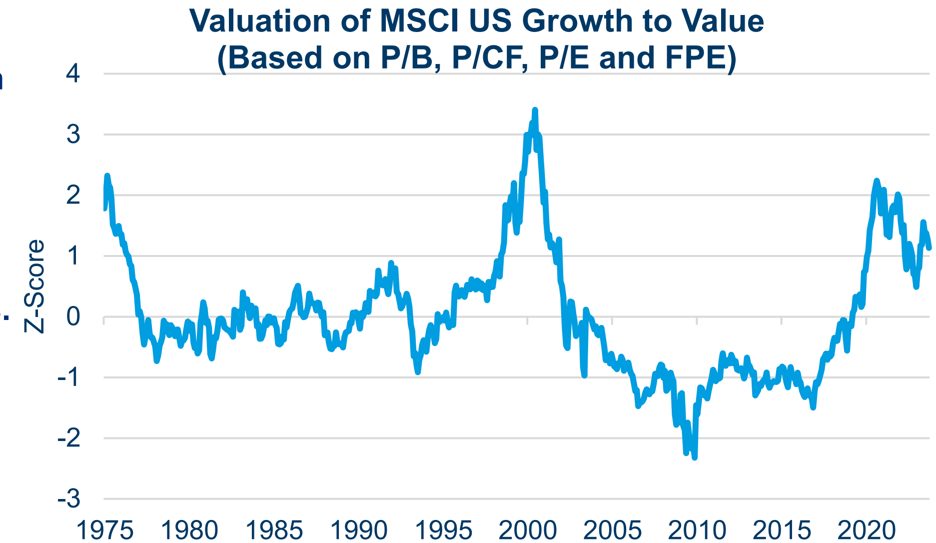
**S&P 500 - Equity Risk Premium Versus Long-Term Treasuries**



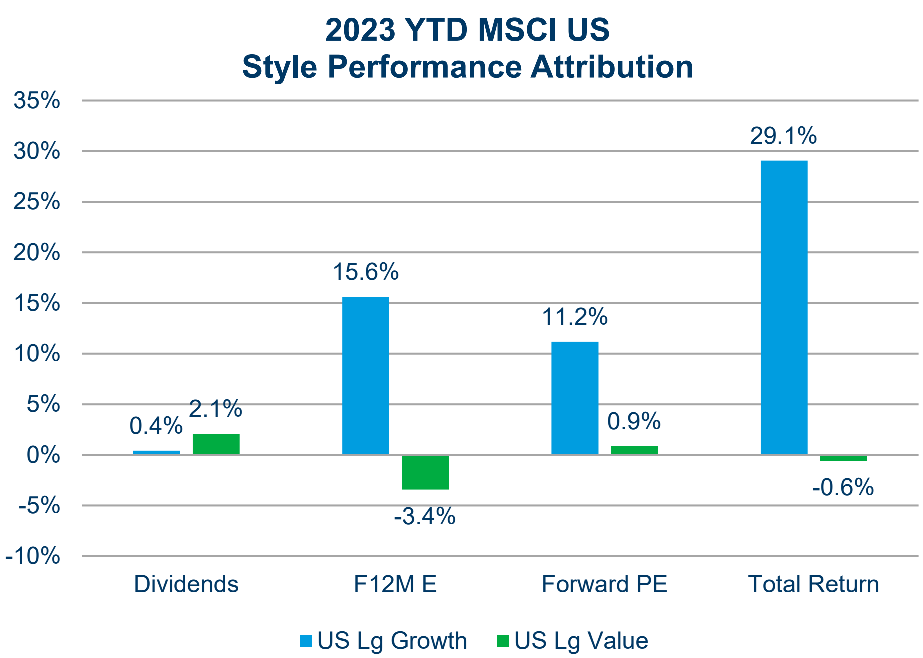

Source: Bloomberg, Datastream, Mercer; as of 9/30/23

# Growth stocks lagged slightly during the quarter, but still trade at a significant premium to value

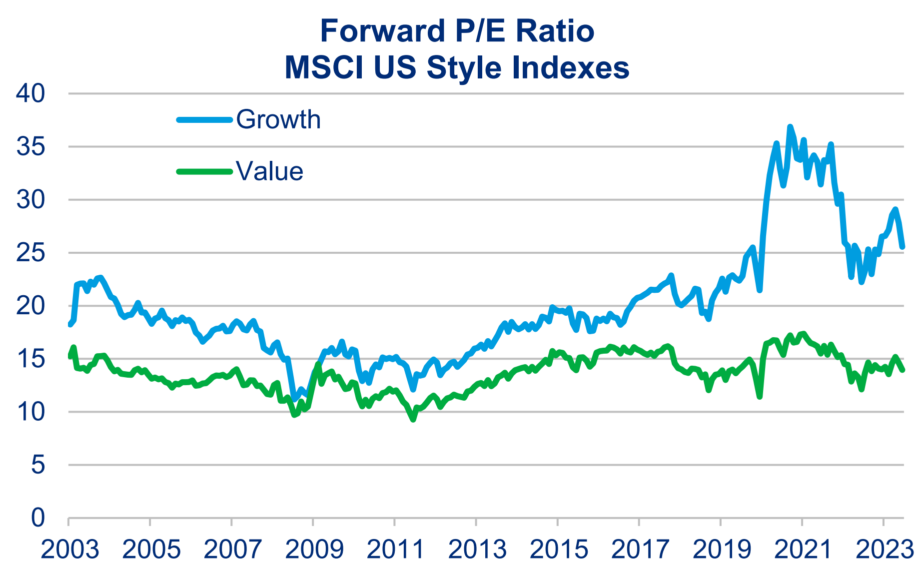
**While value slightly outperformed growth in Q3, the dominance of mega cap tech stocks has resulted in substantial outperformance for growth so far in 2023. This can be attributed, in part, to the enthusiasm surrounding earnings growth. Forward earnings expectations for large growth stocks have increased by 16% this year, while earnings estimates for value stocks have been revised downward by 4%. However, the forward P/E on growth stocks of 26 is stretched, especially considering the increase in interest rates. Value stocks are trading at relatively attractive valuations. Tilting to value stocks also helps manage concentration risk. The top 10 stocks in the Russell 1000 Value total around 17% of the index, compared to 29% for the S&P 500.**




Source: Datastream, through 9/30/23



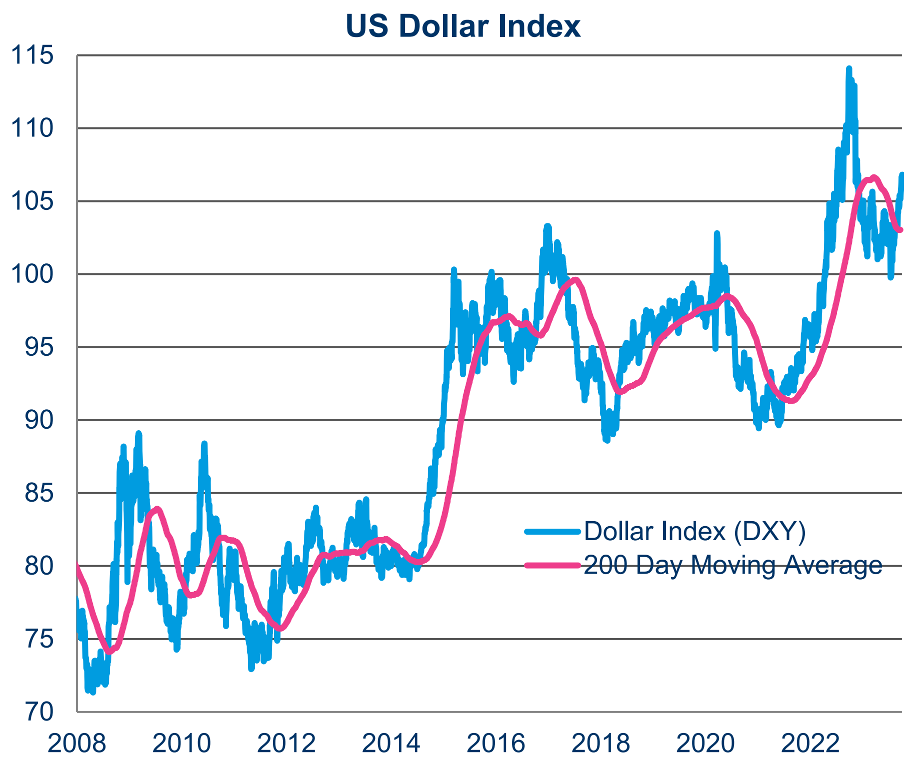

Source: Datastream; as of 9/30/23



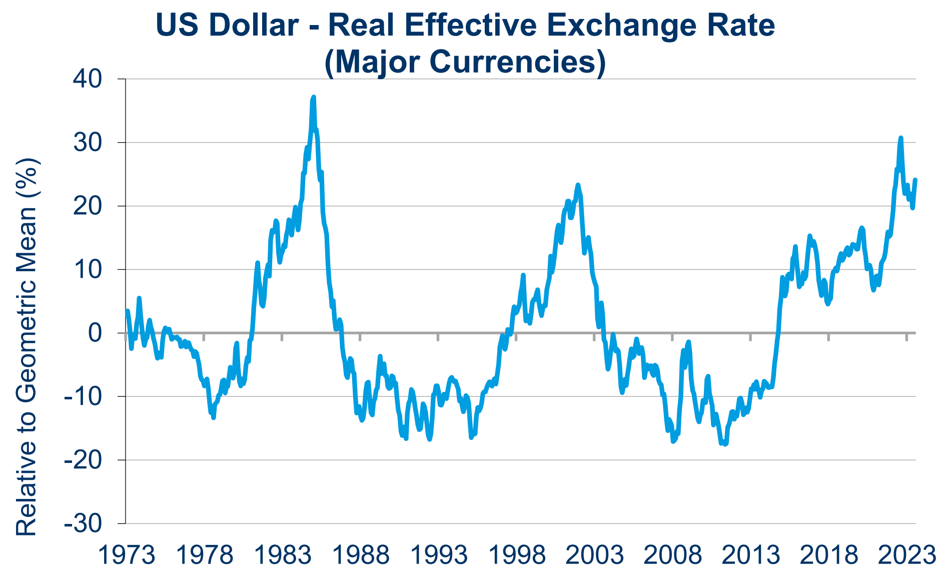

Source: Datastream; as of 9/30/23

# Rising US interest rates lifted the dollar

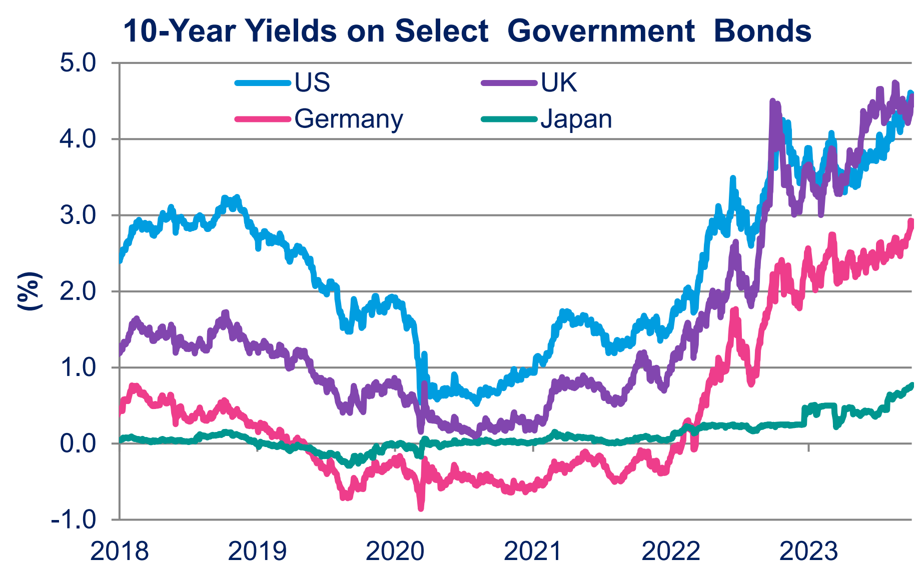
**After plunging 10% from its peak in September 2022 through the end of 1Q23, the US Dollar Index (DXY) has rebounded due to higher US yields compared to most other developed markets. We remain bearish on the dollar over the intermediate term. Large twin deficits (fiscal and current account) combined with a high real effective exchange rate pose a risk of a significant dollar depreciation over the intermediate term. A weak US dollar would support non-US assets, especially emerging market equities and local currency debt.**




Source: Bloomberg, through 9/30/23



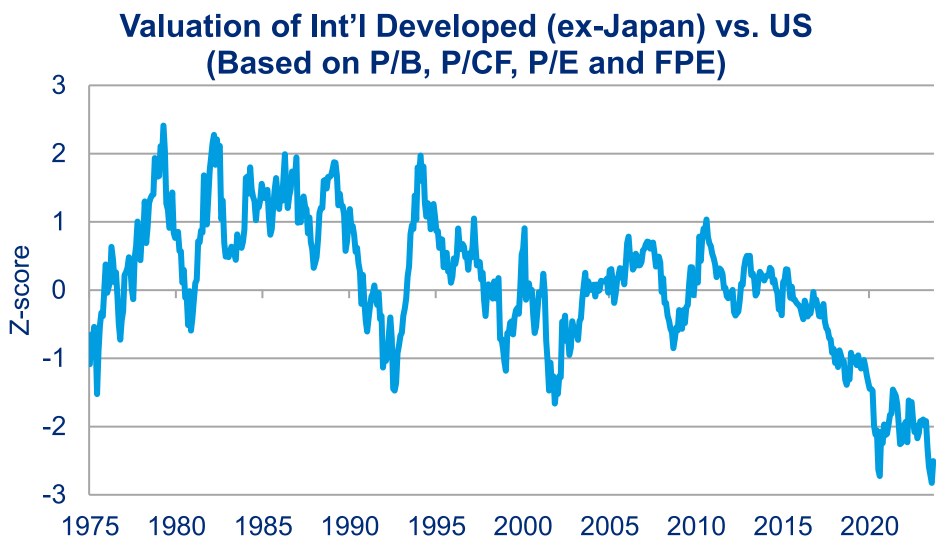

Source: Bloomberg, Mercer calculations; through 9/30/2023



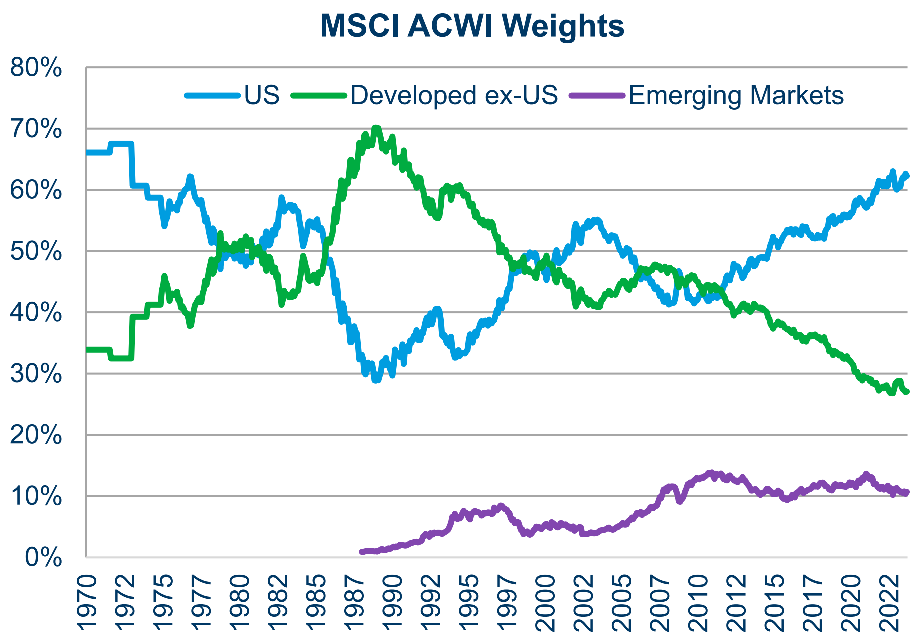

Source: Bloomberg; as of 9/30/23

# We continue to favor non-US equities

**International developed and emerging market equities performed in line with US equities during the quarter despite the strength in the dollar. However, they have lagged the tech-driven US market year-to-date. We continue to favor non-US equities versus the US. International developed equity valuations are very attractive versus the US, and earnings have remained solid. A weaker dollar could provide an additional tailwind. Within international markets, we have a particular preference for Japan. As for emerging markets, central banks are ahead of the curve, and with inflation easing, some are in the position to cut rates, especially China. EM valuations also remain attractive and sentiment towards EM is negative.**



Source: Datastream, through 9/30/23



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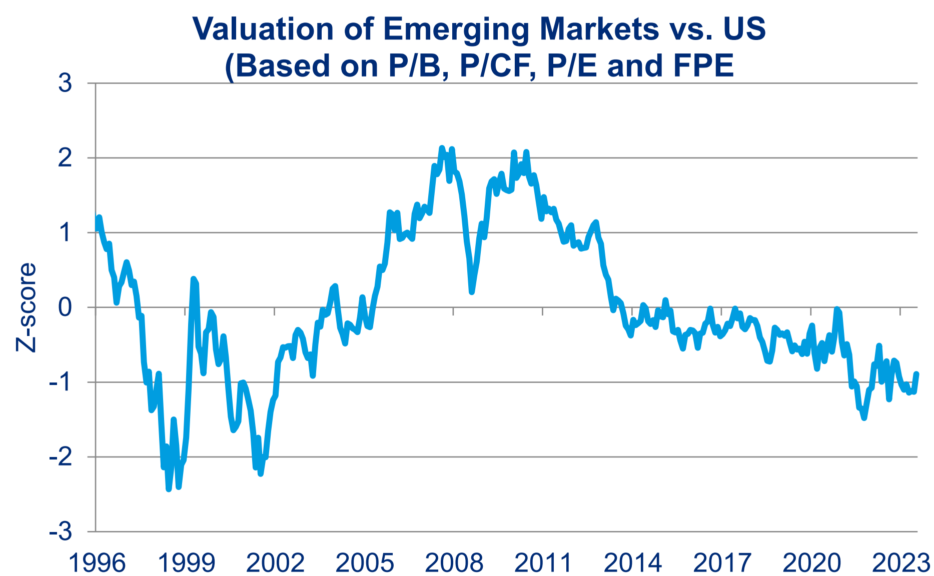
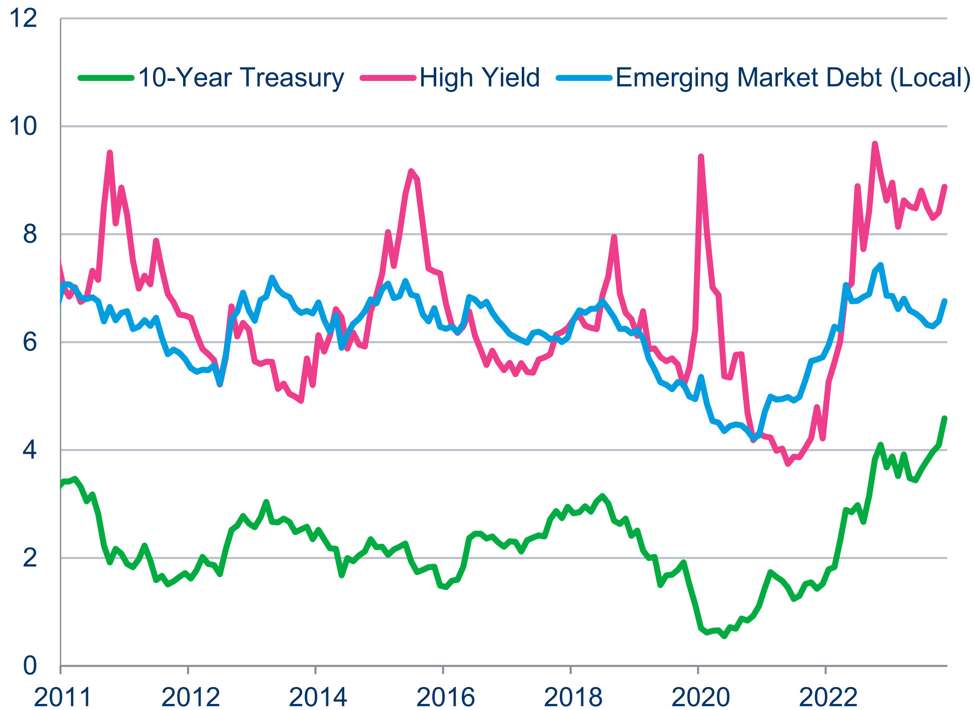


Source: Datastream, through 9/30/23

# High yield spreads appear too tight, more upside potential in local currency EM debt

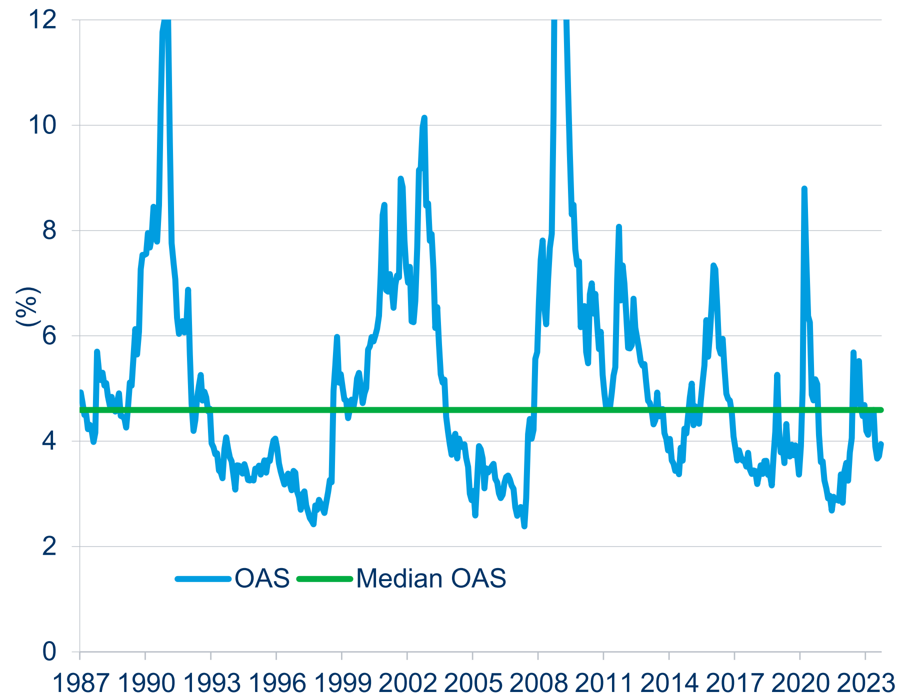
**The rise in interest rates since the beginning of last year has improved the return prospects for fixed income compared to equities. High yield bonds offer a yield of nearly 9%. However, the spread to Treasuries has narrowed to just 3.9% as of September. We think spreads are too tight and do not adequately compensate for the risk of defaults, especially as the US economy slows over the next 18 months. Default rates have already started to increase, and this trend could continue as more companies need to refinance at higher rates in the coming years. In contrast, the potential for a weaker dollar and a reduction in US interest rates present upside potential for local currency emerging market debt.**

### Yield History




Source: Bloomberg, Federal Reserve; as of 9/30/23

### High Yield Bond Option Adjusted Credit Spread




Source: Bloomberg; through 9/30/23

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