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Market Environment Report

July 2022

A business of Marsh McLennan

Market review & outlook

A Rough Start to 2022

- High inflation, an increasingly hawkish Federal Reserve and economic uncertainty have weighed on markets. Global equities reached bear market territory with the MSCI ACWI Index down 20% year-to-date through June.
- The simultaneous decline in bonds has made this year particularly painful for balanced portfolios. The Bloomberg Aggregate Bond Index was down 10% year-to-date through June, leaving a 60/40 portfolio down 16%.
- Longer duration bond portfolios often favored by defined benefit plans are down around 20% year-to-date through June[1], although the silver lining for defined benefit plans is that funded status has generally held up well as a result of declining liability values.

Outlook - Uncertainty Abounds

- Market behavior this year appears to be a mostly rational response to the increase in longer-term interest rates, along with the rise in economic uncertainty from inflationary pressures, Ukraine-Russia conflict, Chinese lockdowns and policy tightening.
- Our base case view is that the monetary policy response priced by markets should curb inflation with only a sharp economic slowdown or a mild recession. However, the risk of downside scenarios has increased.
- Should Fed tightening prove too much for the heavily-indebted US economy to bear, inflationary fears could give way to fears of a deeper recession. However, interest rates could decline in this scenario, providing some cushion to balanced portfolios.
- A more worrisome outcome is that inflationary pressures stay high even as economic growth slows, requiring the Fed to respond even more forcefully. We expect this would be negative for stocks and bonds.

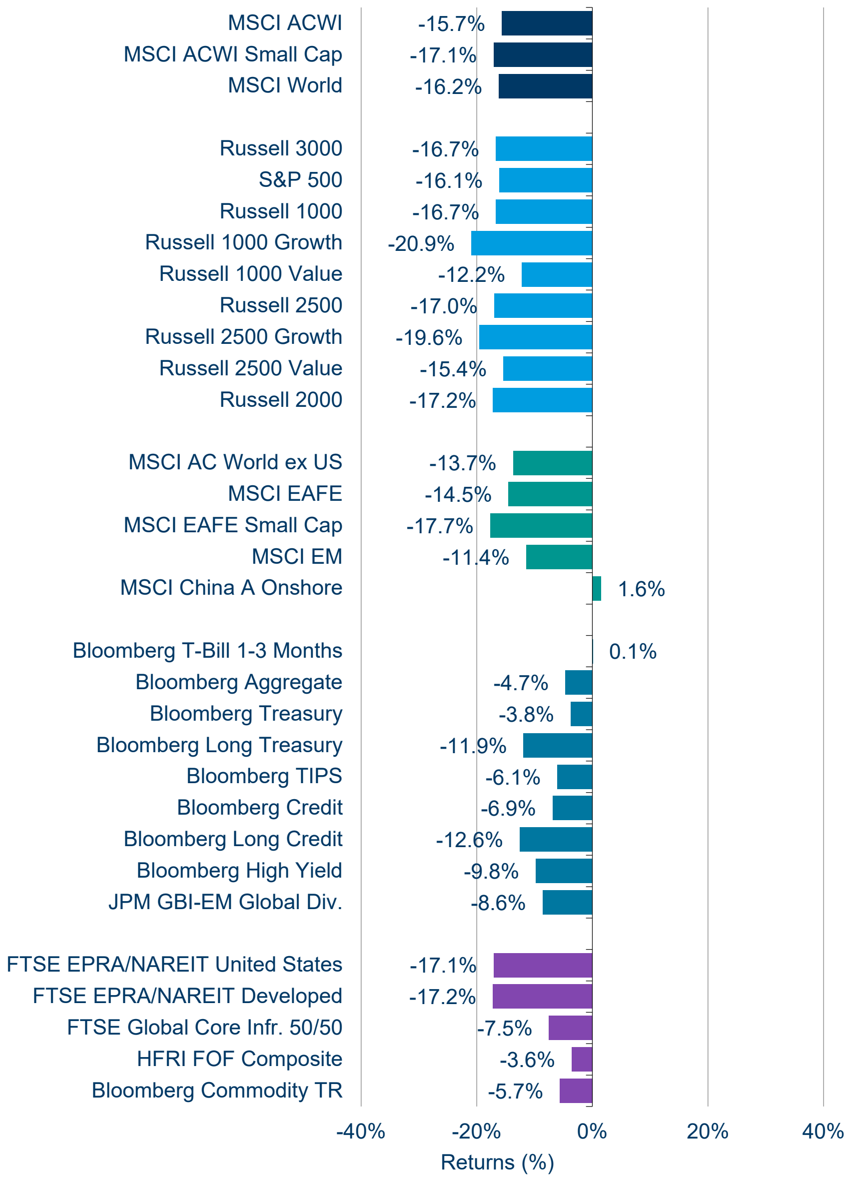
Portfolio Actions

- We do not yet view this correction as a good point to increase equity exposure and would maintain neutral exposure relative to benchmarks. Within equity portfolios, we continue to favor value over growth. High yield spreads widened to attractive levels during the second quarter, but contracted towards average in July. There could be a better entry point later this year if economic data continues to weaken.
- We continue to suggest investors follow rebalancing policies. We believe defined benefit plans should stick with an interest rate hedge ratio and funded policy triggers.
- Clients should assess short-term liquidity needs and consider how best to meet those, should the environment worsen.

[1] Source: Bloomberg Long Government/Credit Index

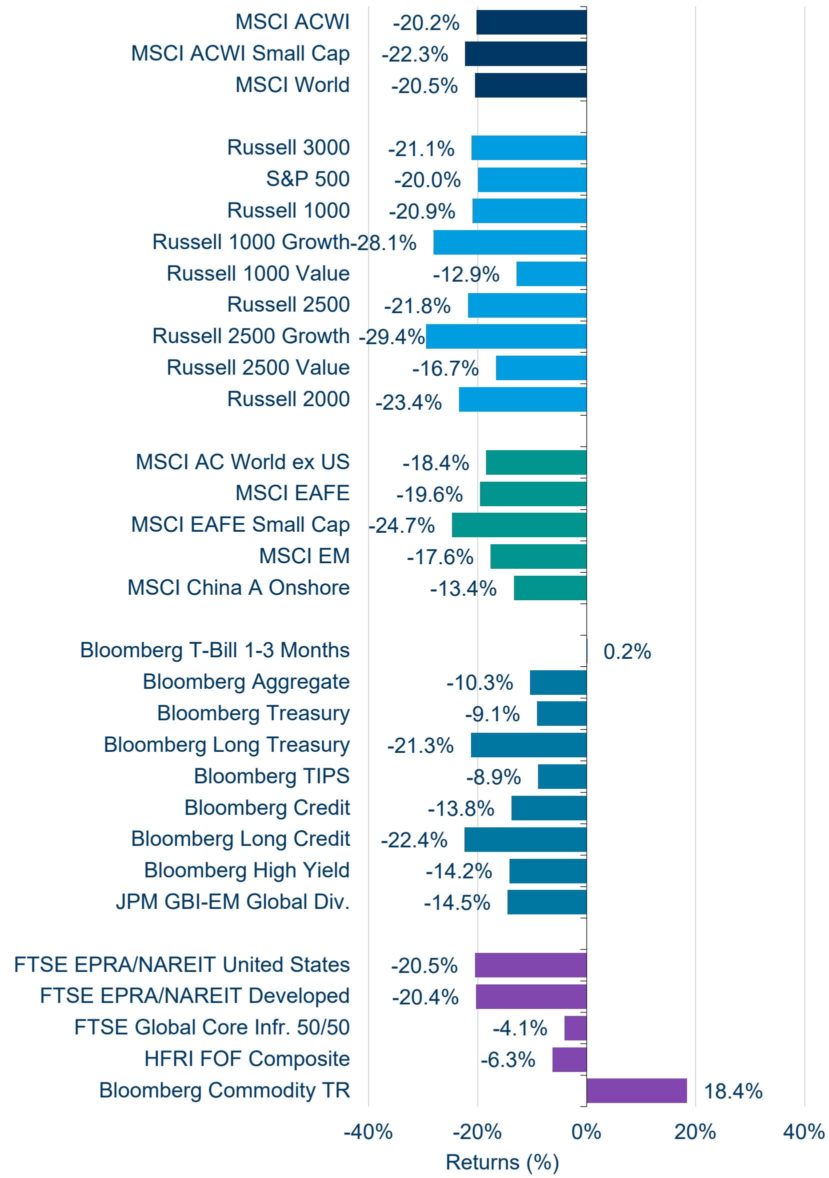
Performance summary

Market Performance
Second Quarter 2022



Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 6/30/22

Market Performance
Year-to-Date



Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 6/30/22

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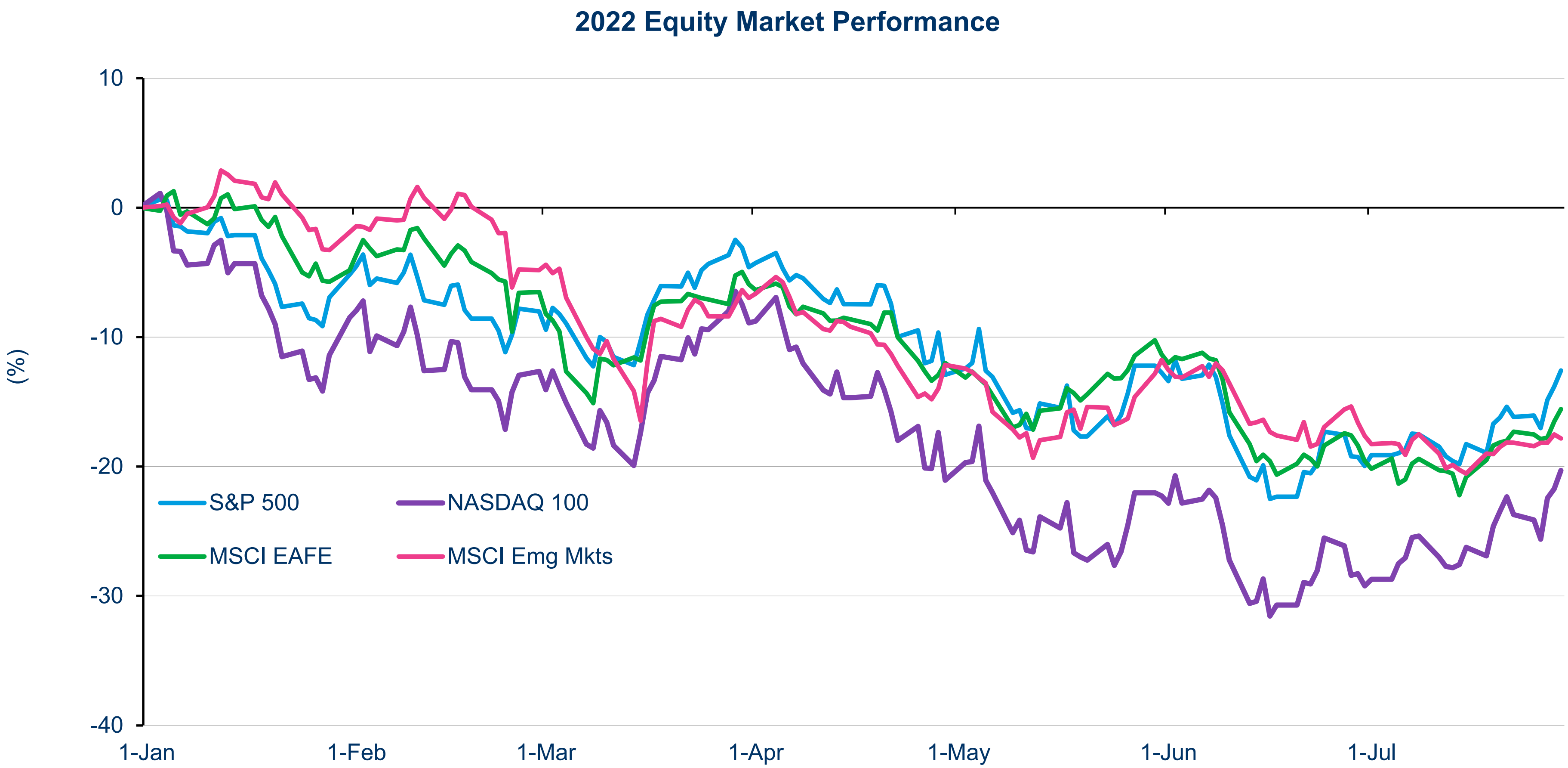
Past performance is no guarantee of future results

Markets Rebounded in July

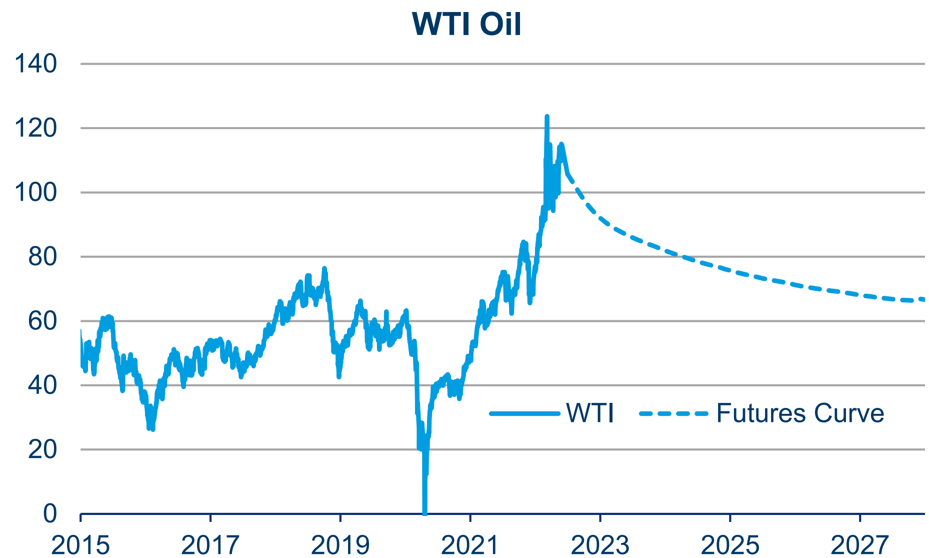
Both stocks and bonds rebounded in July as interest rates fell on softer economic growth and falling inflation expectations. The MSCI ACWI index returned 7%, trimming its year to date loss to 14.6%. The Bloomberg Aggregate earned 2.4%, but is still down 8.2% in 2022.



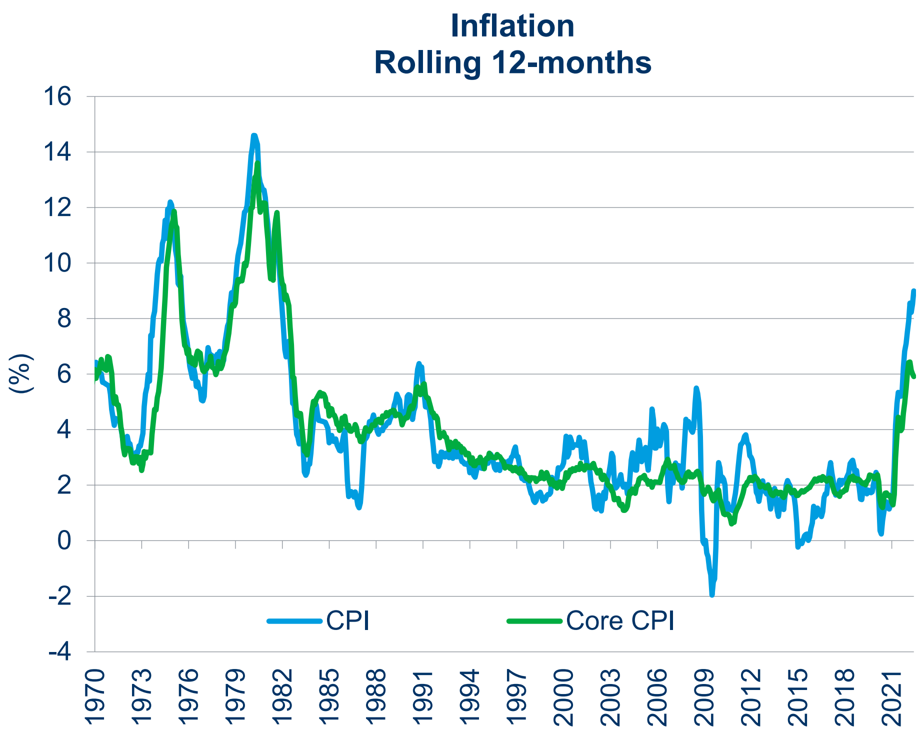
Source: Bloomberg; through 7/31/22

Inflation at a 40-year high

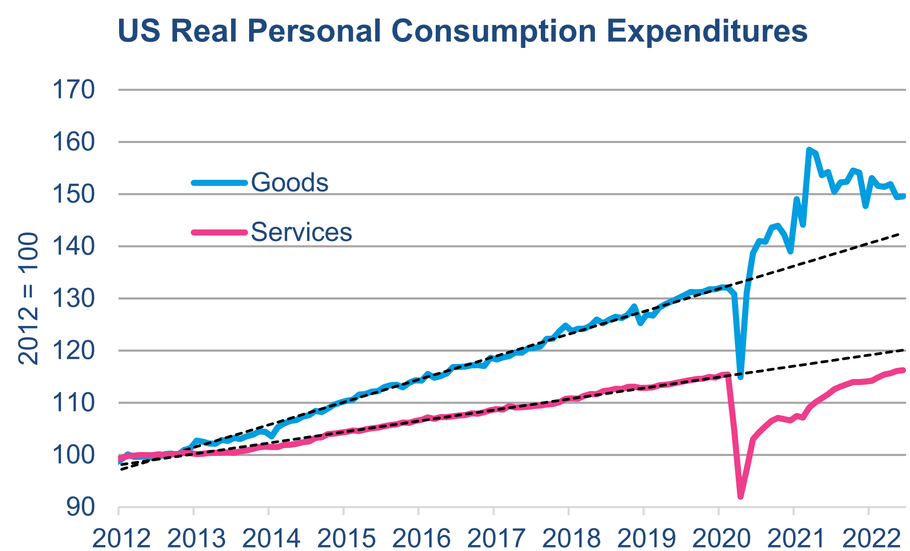
Inflation was 9% on a year-over-year basis through June. The biggest drivers of the inflation surprise appear to be energy and other commodity prices and excess demand in the reopening boom. Rising energy contributed nearly 3% to inflation in June, although prices have eased recently. Demand was significantly bolstered by the fiscal support provided through the pandemic.



Source: Bloomberg; as of 6/30/22



Source: Bloomberg; through 6/30/22



Source: Bloomberg, through 6/30/22

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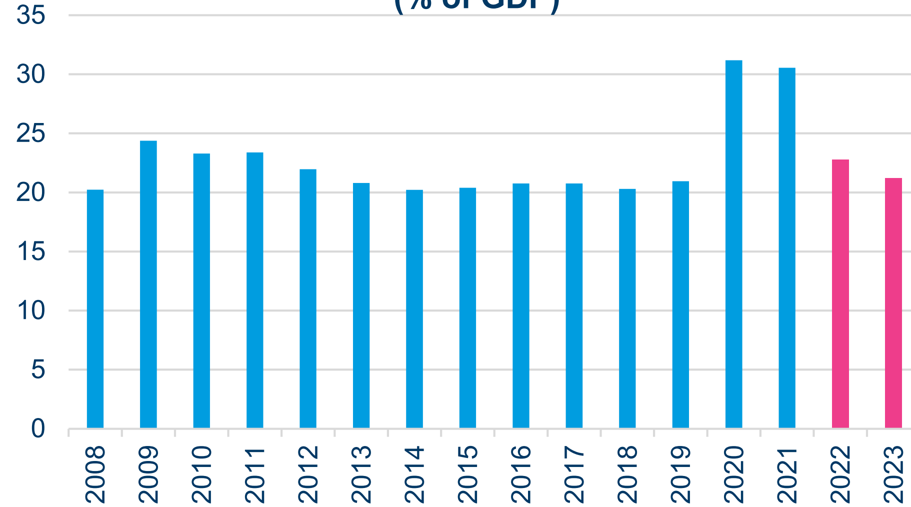
Inflationary impulse from fiscal policy has eased, but households still have excess cash

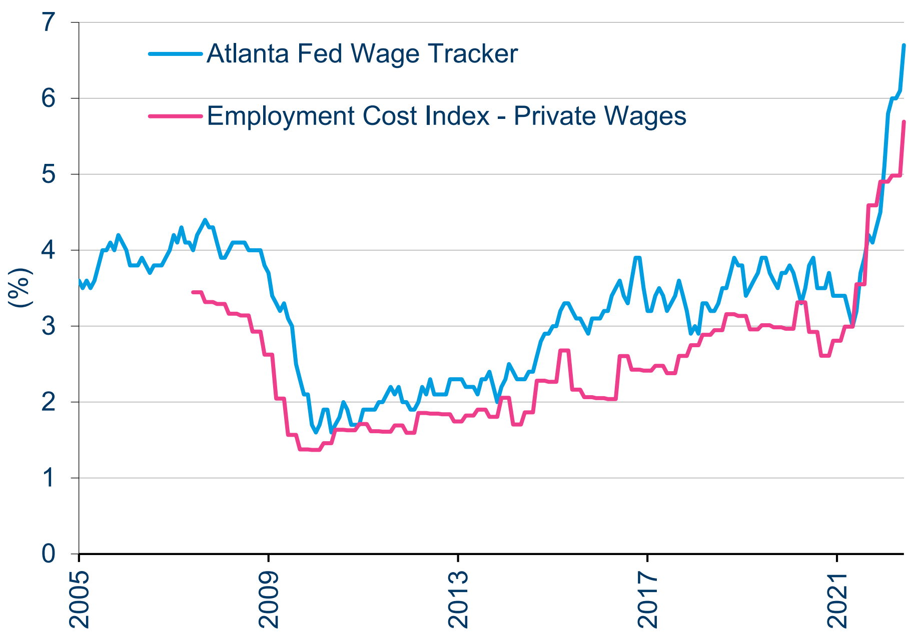
Fiscal support appeared to be a significant driver of the inflation surprise. Government spending in 2023 is projected to return to pre-Covid levels, suggesting its inflationary impact should recede. Fed tightening could dampen demand further. However, US households still have significant excess savings, which could keep demand too strong even as other segments of the economy slow. Wage inflation also risks making this inflation cycle self-reinforcing.

US Federal Government Spending (% of GDP)



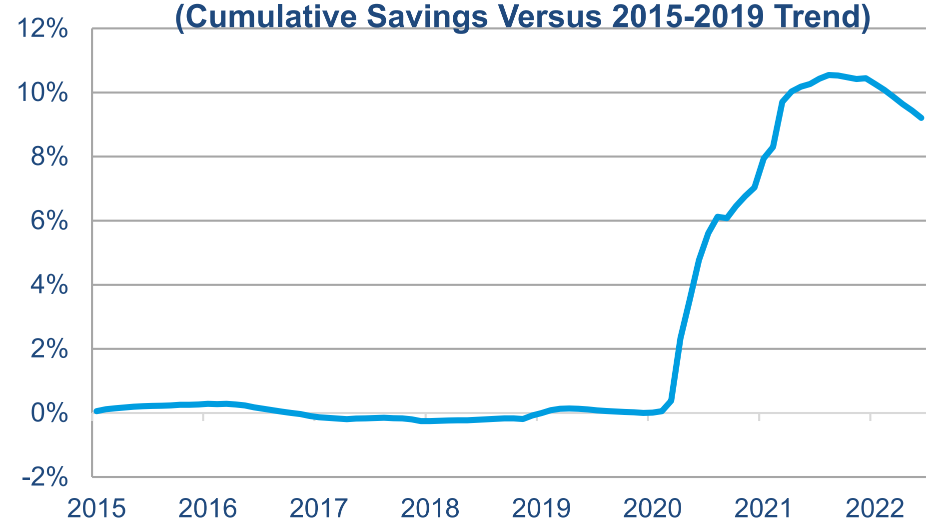
Source: Bloomberg, actual through 2021, forecasts as of 6/30/22

Wage Growth (Year-over-year Change)



Source: Bloomberg; through 6/30/22

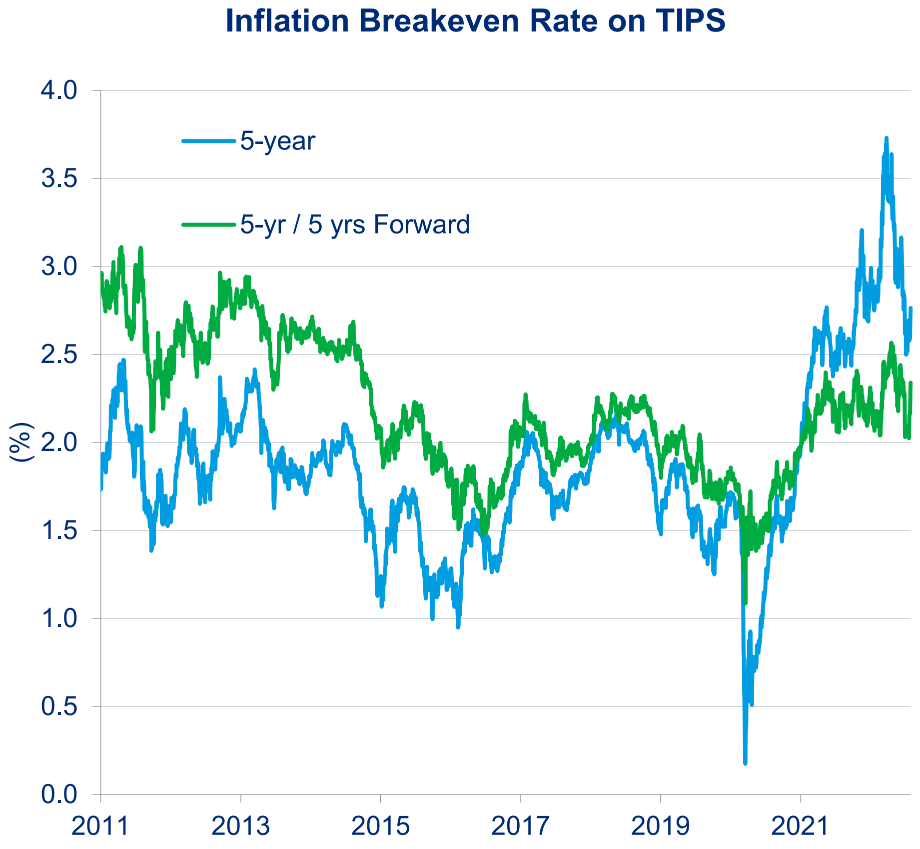
Excess Household Savings as Share of GDP (Cumulative Savings Versus 2015-2019 Trend)



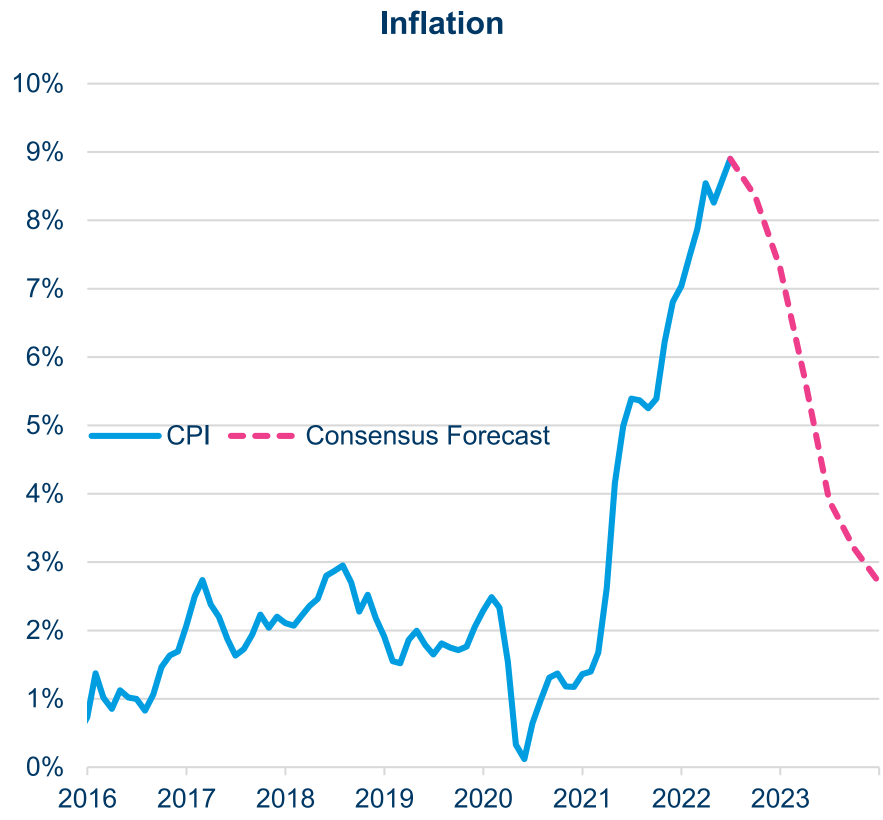
Source: Bureau of Economic Analysis, through 6/30/22

Inflation expectations fell sharply in 2Q

Despite inflation reaching nearly 9% in June, market-based inflation expectations have fallen sharply since early-May. This could reflect moderating energy prices and the expected impact of a slowing economy. However, it also implies the potential for stickier inflation to surprise the market, which would likely be negative for both stocks and bonds.



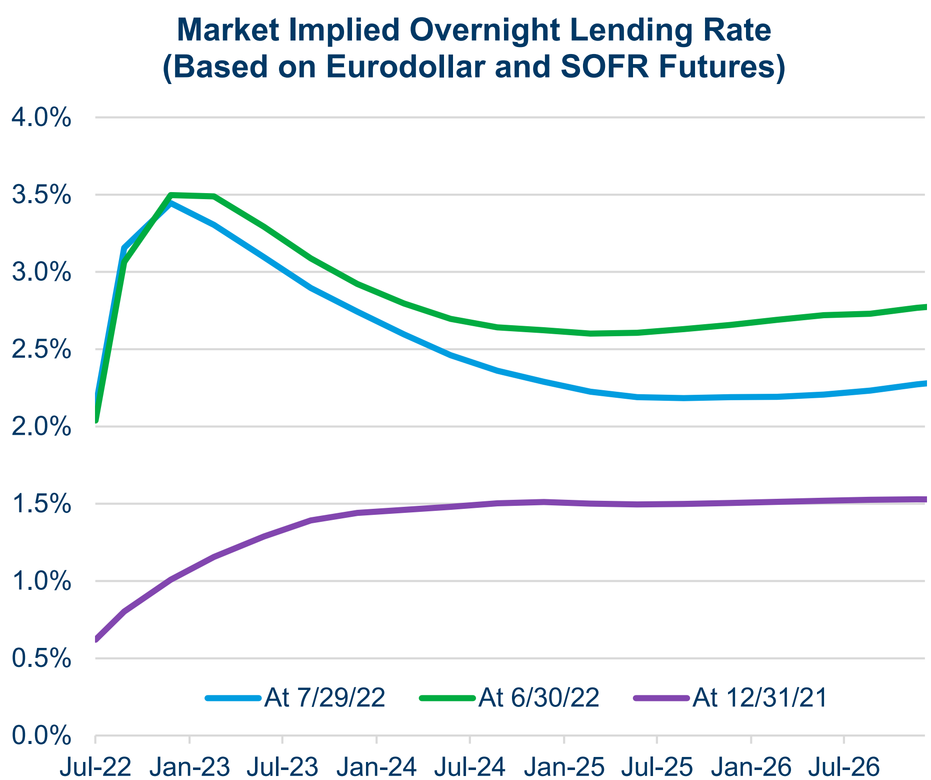
Source: Bloomberg, Mercer; as of 7/29/22



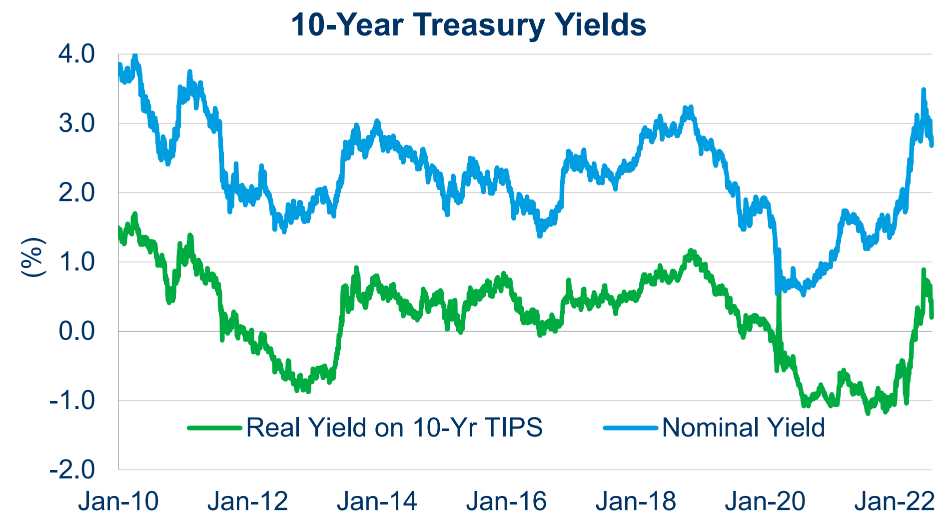
Source: Bloomberg; CPI through 6/30/22, forecasts as of 7/31/22

The market expects the tightening cycle to end early in 2023

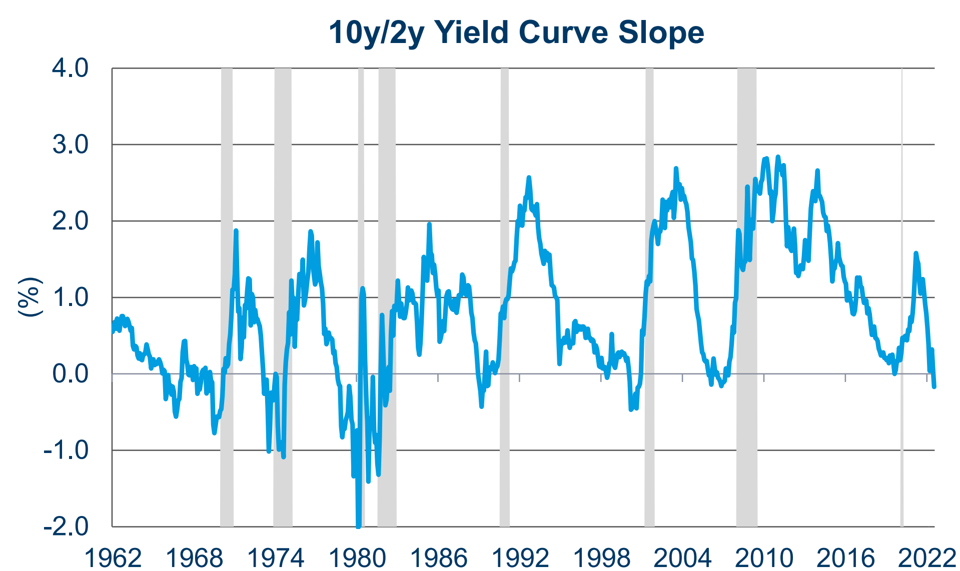
After 75 bp increases in May and July, the FOMC has a 2.00% to 2.25% target for the Fed Funds rate. The market is pricing the Fed Funds rate to top at 3.5% early in 2023. However, the market expects rate cuts soon thereafter, likely reflecting the impact of weaker growth and anticipation of falling inflation. The risk to this outlook is if inflation remains sticky through a slowdown, the Fed would need to become more aggressive.



Source: Bloomberg; as of 7/31/22



Source: Bloomberg, as of 7/29/22

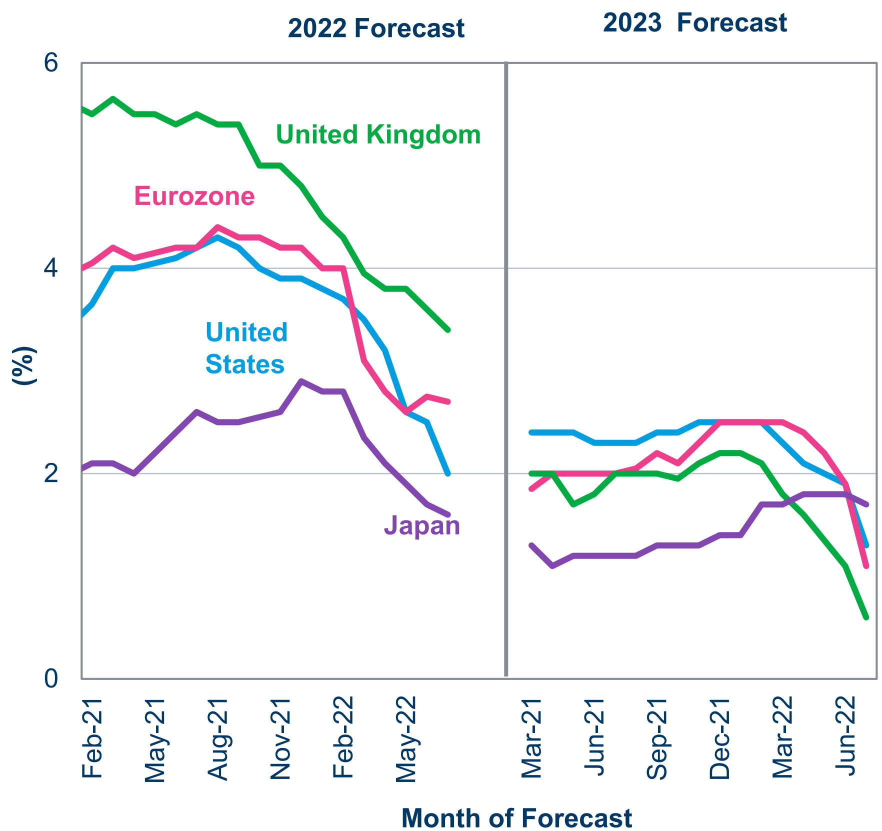


Source: Bloomberg, as of 7/29/22

The global economy is in the midst of a sharp growth slowdown

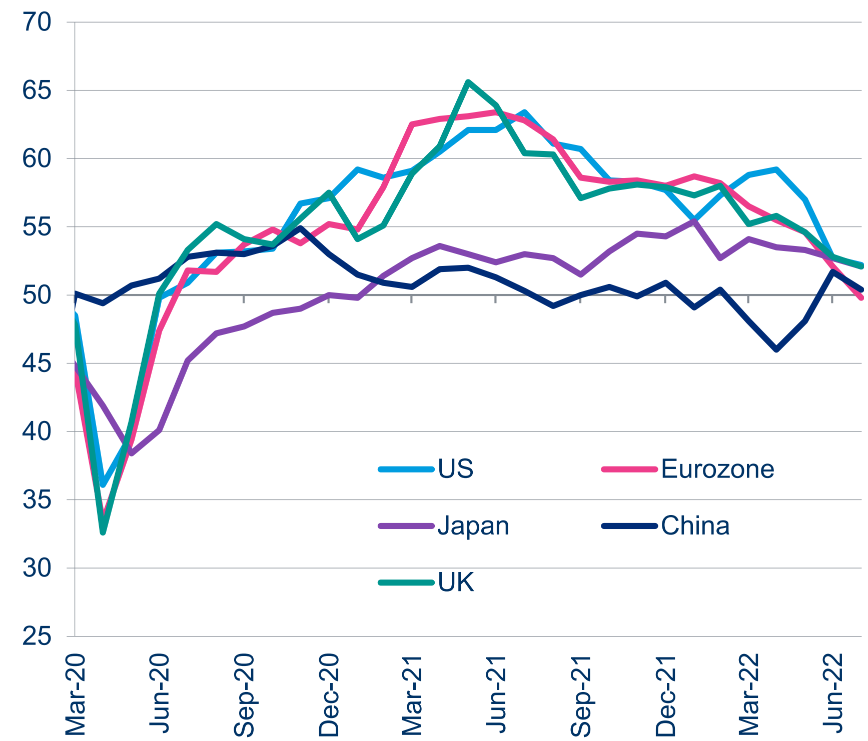
Global GDP forecasts have been slashed this year and will probably come down further. The biggest reductions in growth have come in Europe where rising energy prices have been most impactful. Global manufacturing PMIs have also fallen in 2022, indicating a slowdown in growth, although most remain in expansionary territory (above 50). One bright spot has been in China where the manufacturing PMI has moved back above 50 after dipping below earlier in the year.

Consensus GDP Growth Forecasts



Source: Bloomberg; as of 8/1/22

Markit Manufacturing PMIs

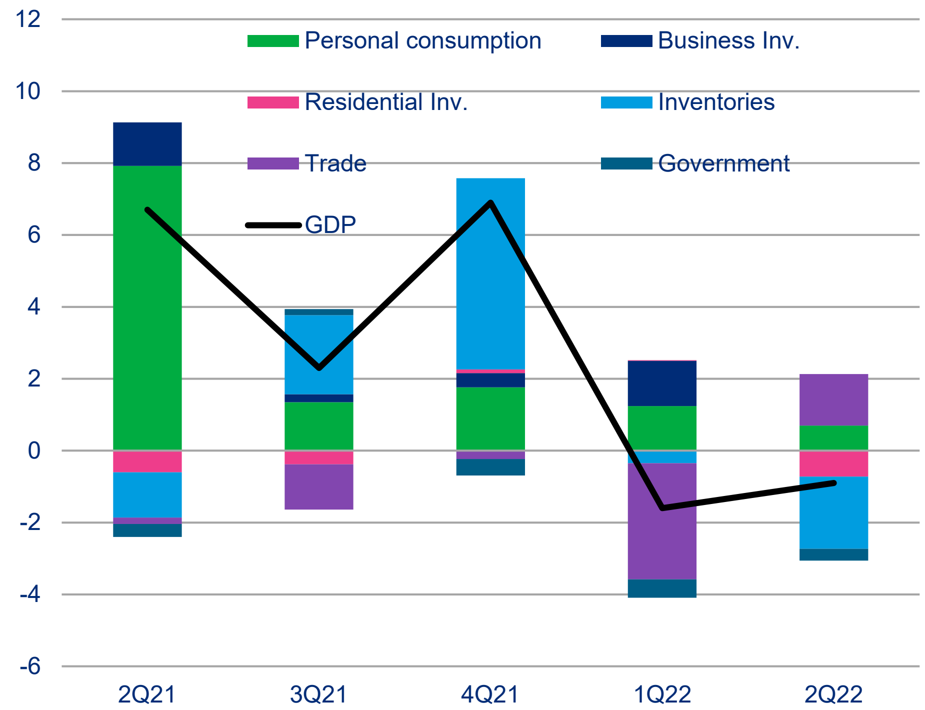


Source: Bloomberg, through 7/31/22

US growth has decelerated sharply, but too soon to call a recession

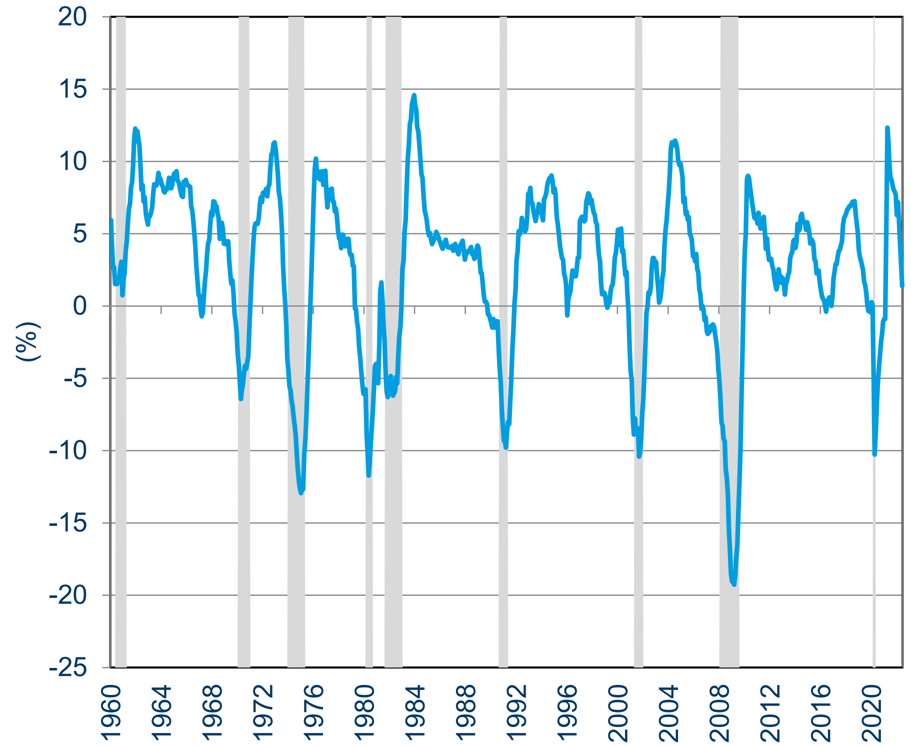
Based on advanced Q2 estimates, the US has posted two consecutive quarters of negative GDP growth. Much of this was driven by trade and inventories. Household spending, which makes up over 75% of economic activity, has continued to increase. Regardless, economic activity has decelerated sharply and the risk of a recession has risen. If there is a recession, we expect it to be mild as household spending should be supported by healthy balance sheets.

Quarterly GDP Contribution



Source: Bureau of Economic Analysis; as of 6/30/22

Conference Board Leading Economic Indicators (Year-over-year Change)

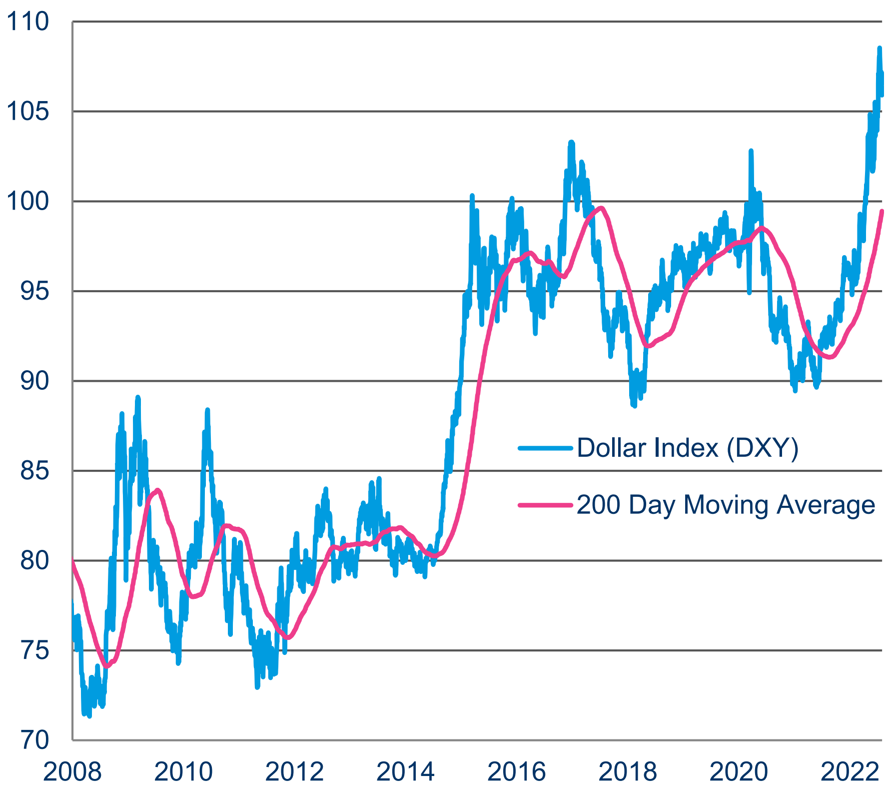


Source: Bloomberg, through 6/30/22

Relative interest rates and growth have given the US dollar a boost

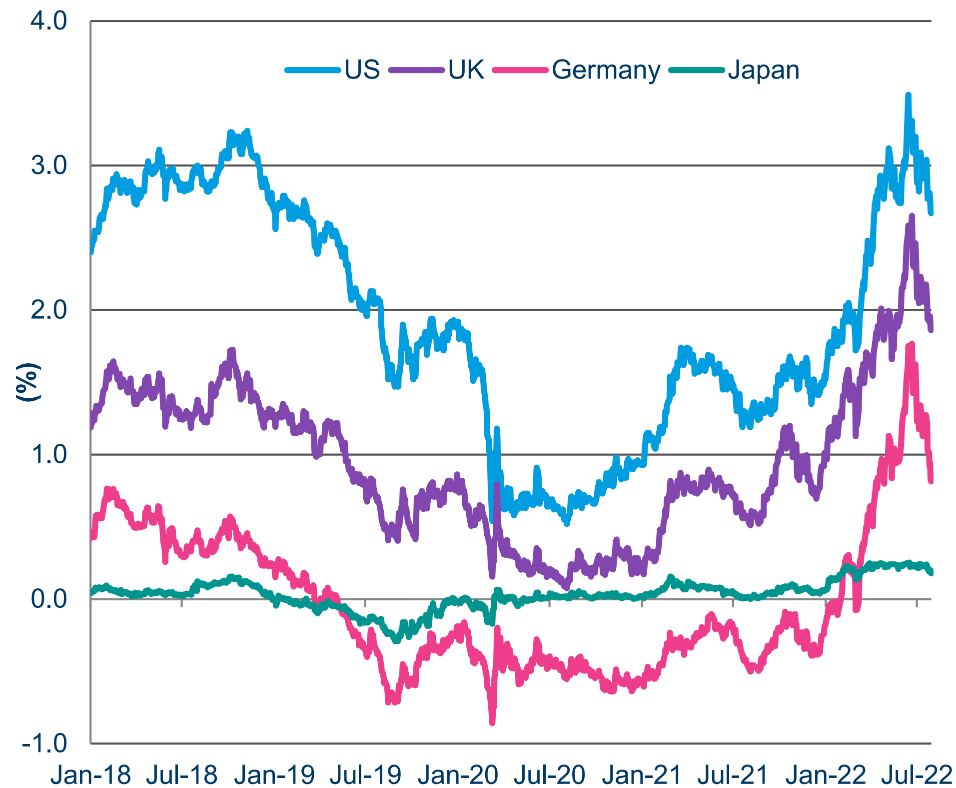
The Dollar Index has surged nearly 11% so far in 2022 through July. The dollar benefited from US interest rates rising more than in other developed economies as the market priced in more aggressive Fed tightening. In addition, the European economic outlook has worsened relative to the US. While the dollar appears expensive on a valuation basis, it may take a reversal from the Fed to end the dollar's upswing. Excessive dollar strength tends to be destabilizing to global markets because of the large volume of dollar-denominated debt issued by non-US entities, particularly in emerging markets.

US Dollar Index



Source: Bloomberg, through 7/31/22

10-Year Yields on Select Government Bonds

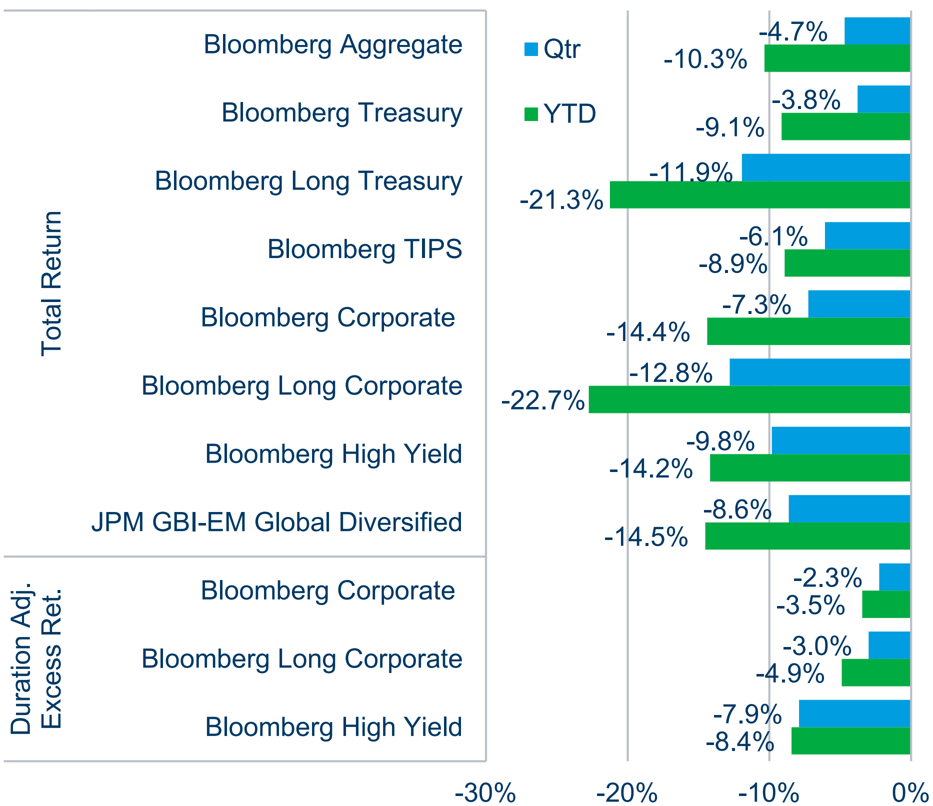


Source: Bloomberg, through 7/31/22

What happened in fixed income in Q2?

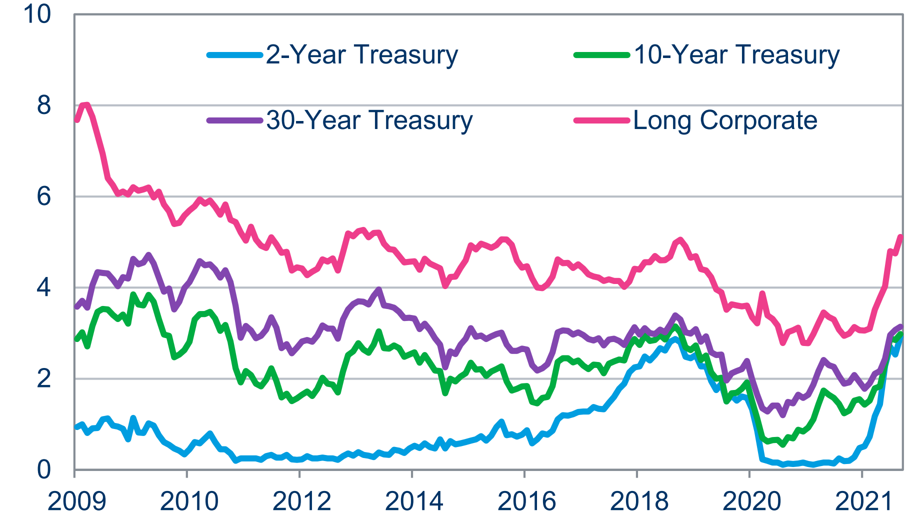
Fixed income continued its slide in Q2 amid rising rates and widening credit spreads. The Bloomberg Aggregate declined by almost 5% during the quarter and is down over 10% year-to-date. Widening credit spreads led corporates to underperform Treasuries. TIPS also underperformed Treasuries as inflation-breakeven rates fell.

Fixed Income Performance



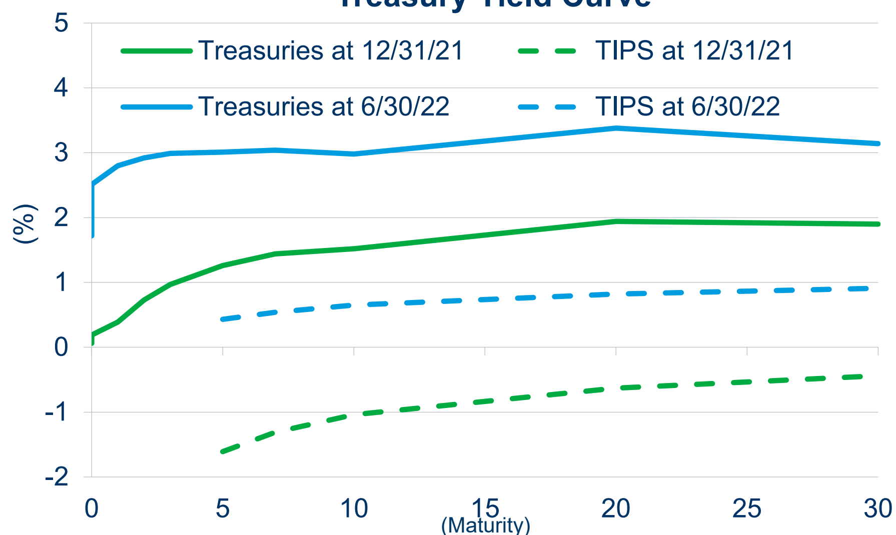
Source: Bloomberg, Datastream; as of 6/30/22

Yield History



Source: Bloomberg, Federal Reserve; as of 6/30/22

Treasury Yield Curve

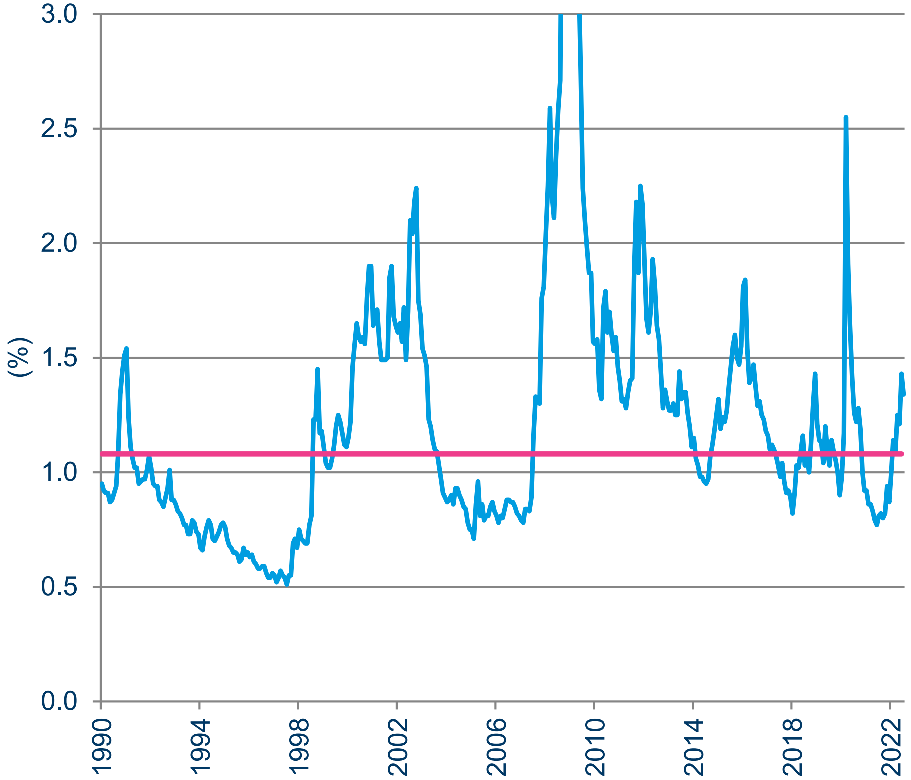


Source: Federal Reserve; as of 6/30/22

Credit spreads widened during the quarter

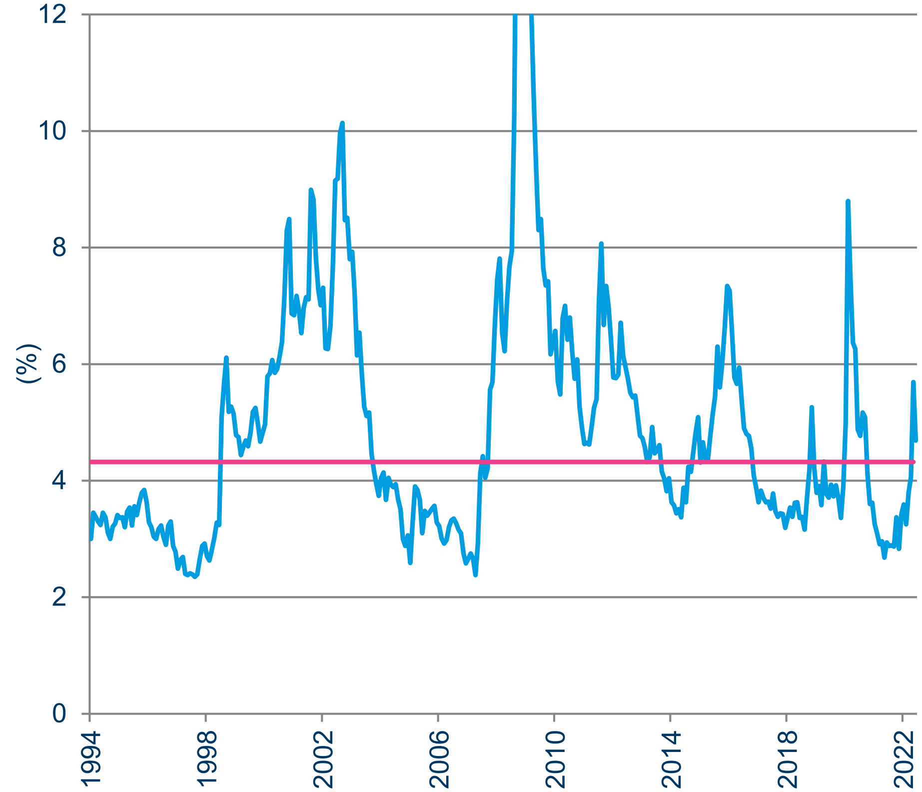
Credit spreads widened in Q2 as markets priced a weaker growth outlook. We believe high yield spreads in particular are attractive, although they declined in July with the broader rally in riskier assets. Spreads could widen if the economy enters a recession, but we expect defaults would be contained versus prior recessions. A recession would likely be mild and many high yield issuers have extended their maturities, reducing refinancing risk.

Investment-grade Corporate Spread



Source: Bloomberg, through 7/31/22

High Yield Bond Spread



Source: Bloomberg, through 7/31/22

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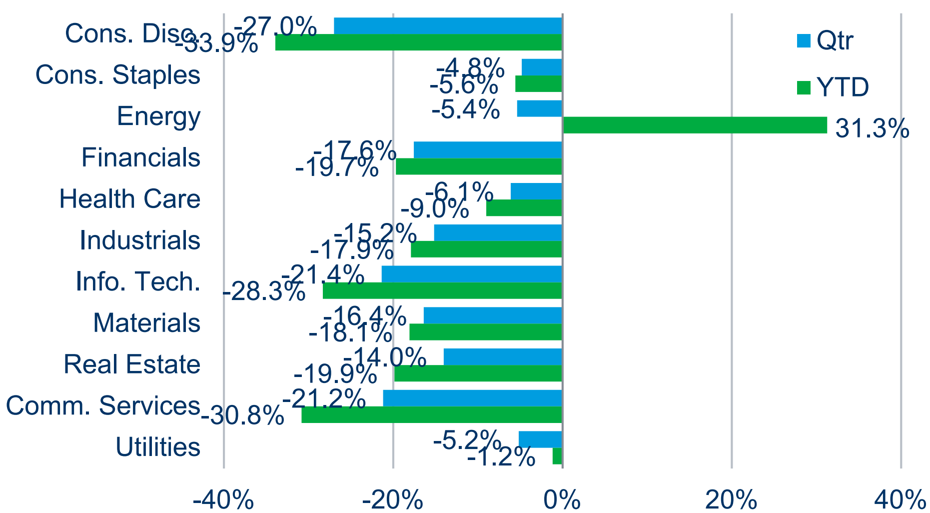
What happened in equity markets in Q2?

Equities posted steep declines in Q2, with most regions ending June at or near bear market territory on a year-to-date basis. Value held up much better than growth across capitalization ranges. Consumer staples was the best performing sector. Non-US stocks outperformed the US by a wide margin in local currency terms. The strength of the dollar led to more modest outperformance in dollar terms.

2Q22 US Style Performance (%)

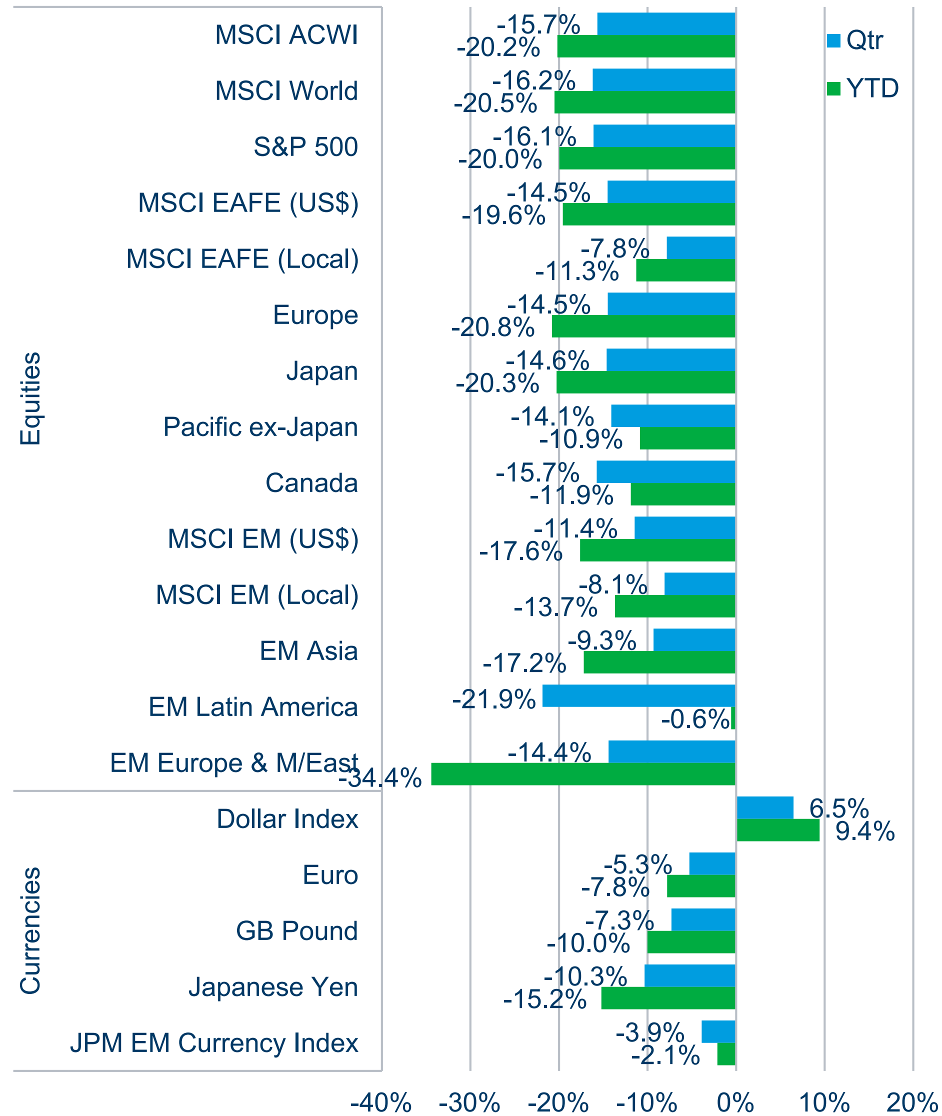
	Value	Blend	Growth
Russell Top 200	-10.9	-16.6	-20.9
Russell Midcap	-14.7	-16.8	-21.1
Russell 2000	-15.3	-17.2	-19.3

MSCI USA Sector Returns



Source: Bloomberg; as of 6/30/22

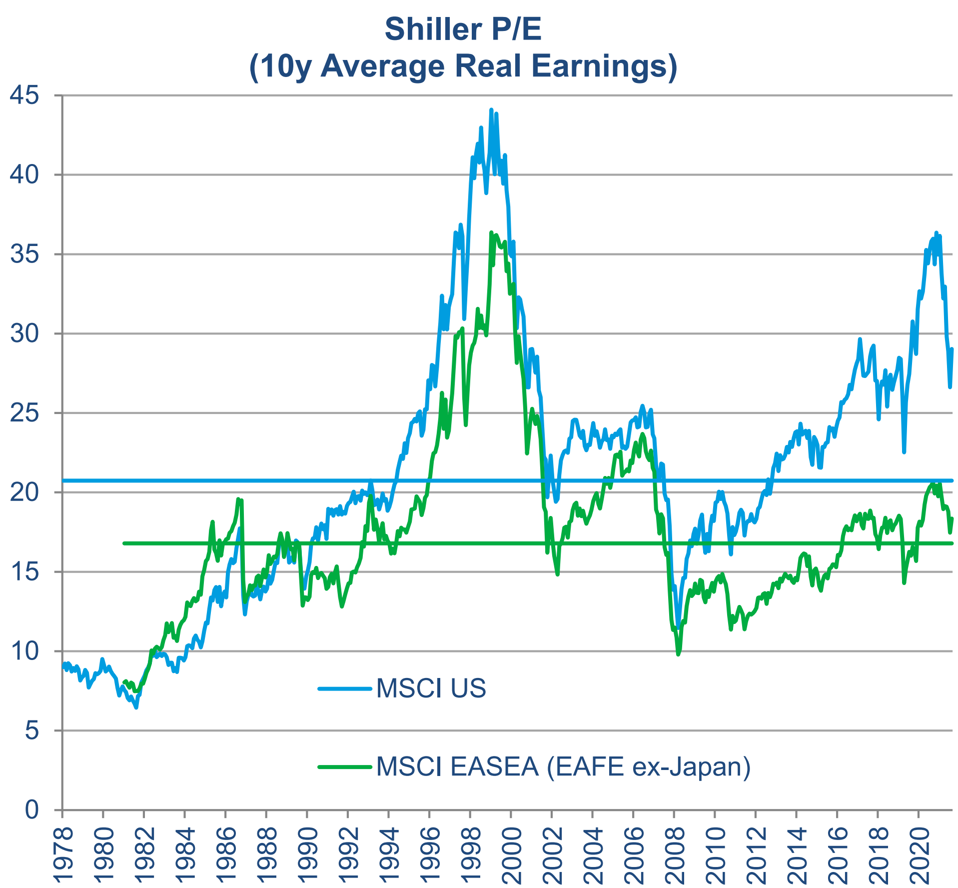
Global Performance



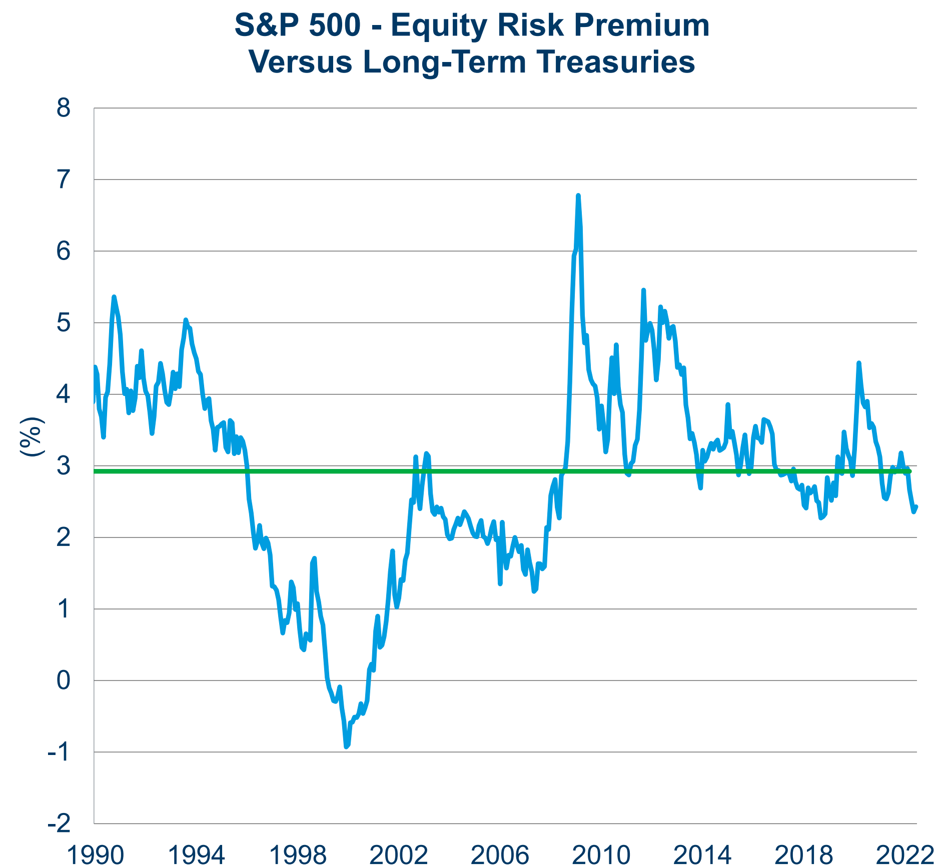
Source: Bloomberg, Datastream; as of 6/30/22

The equity drawdown can be explained entirely by the increase in long-term interest rates

Equity valuations have fallen this year, but the decline can be fully explained by the increase in longer-term real yields. The prospective equity risk premium over long-term Treasuries has slipped as a result of higher interest rates, albeit remaining in the fair value range. The risk is that interest rates rise further in response to inflationary pressures, exerting further downward pressure on valuations.



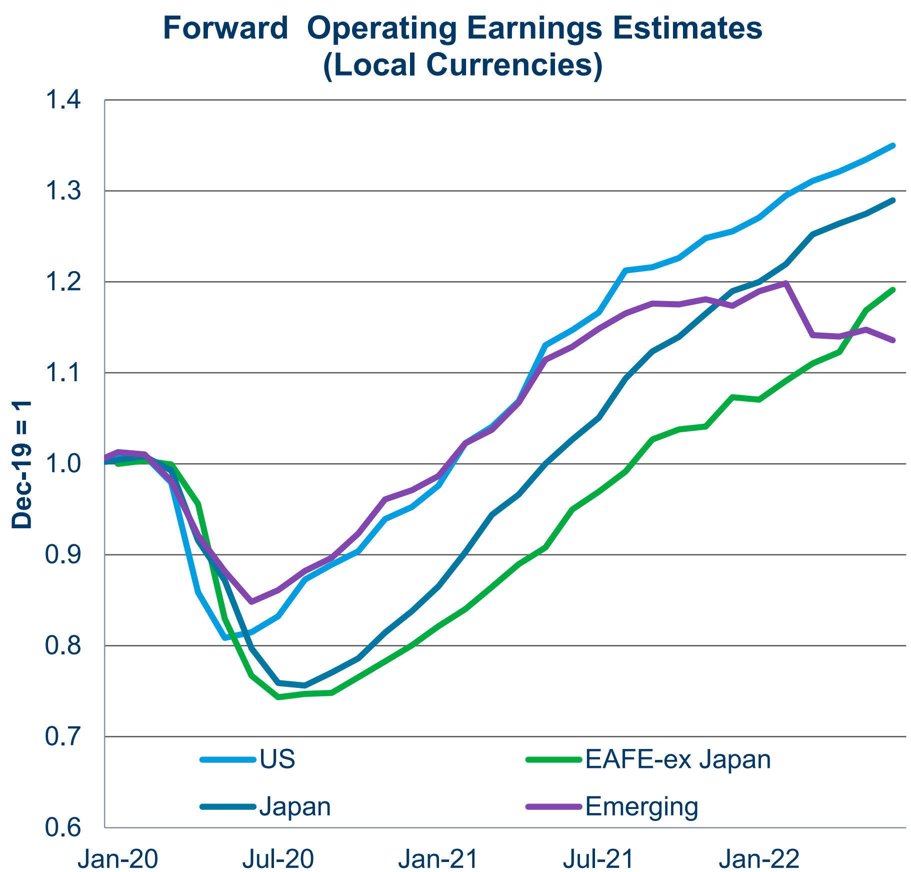
Source: Datastream, MSCI, Mercer, through 7/31/22



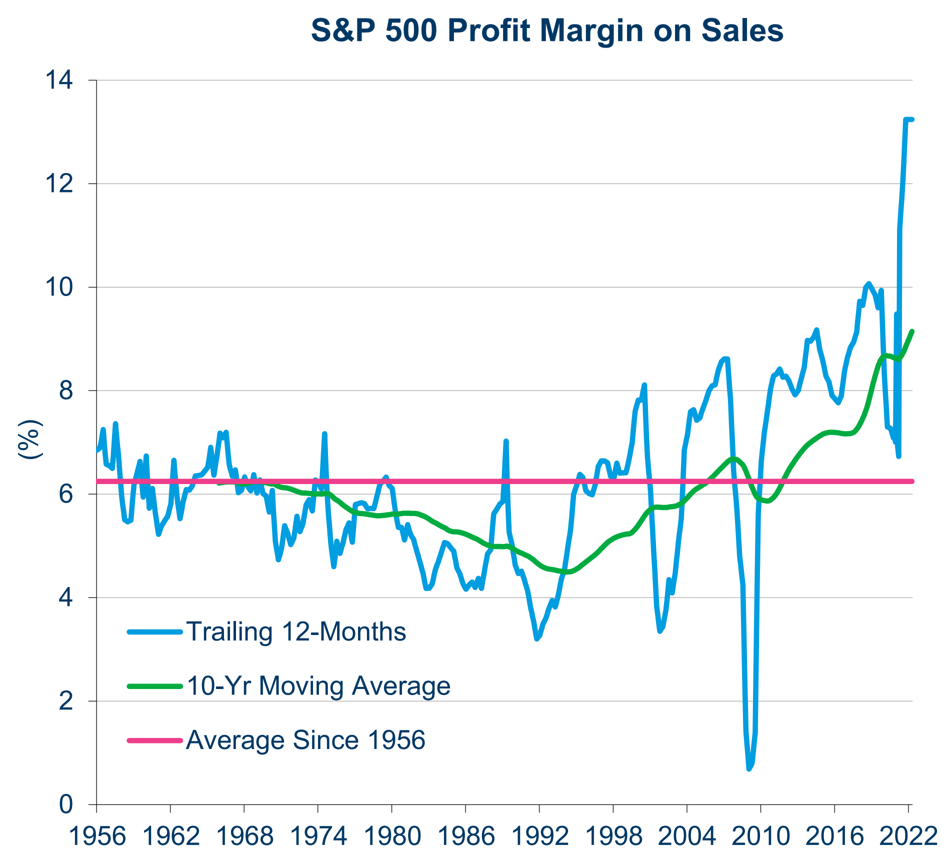
Source: Bloomberg, Refinitiv, Mercer, through 6/30/22

Headwinds to earnings intensifying

Analysts remain optimistic for earnings growth despite the sharp slowdown in economic growth. Earnings still have a tailwind from high nominal growth, but margins may begin to come under pressure in the coming months as a result of rising wages and slowing growth. US companies also face a drag from the strength of the dollar.



Source: Datastream, through 6/30/22

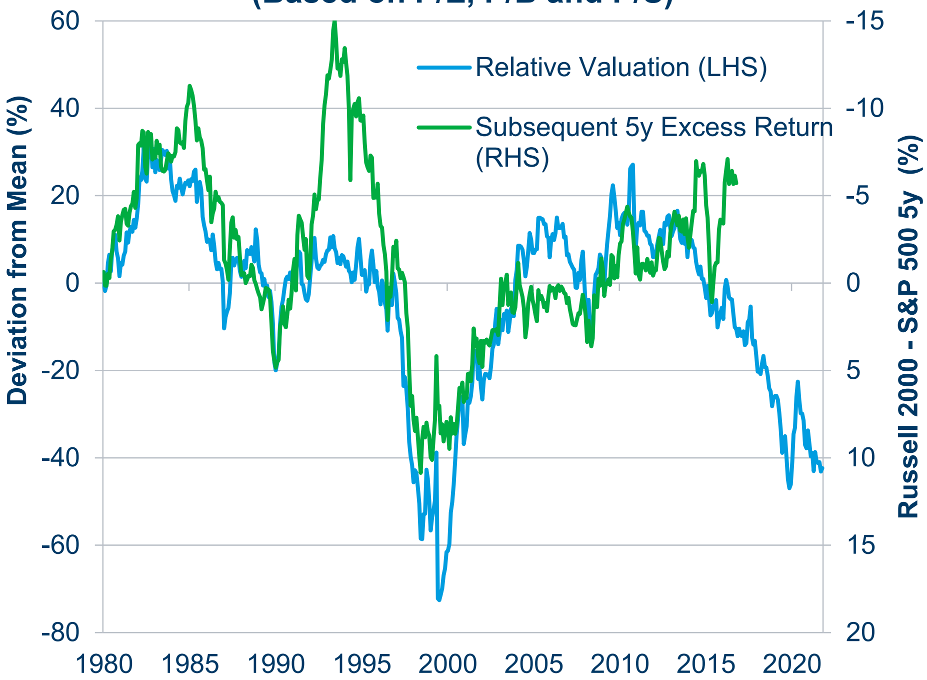


Source: S&P, through 6/30/22

Continue to favor value stocks over growth

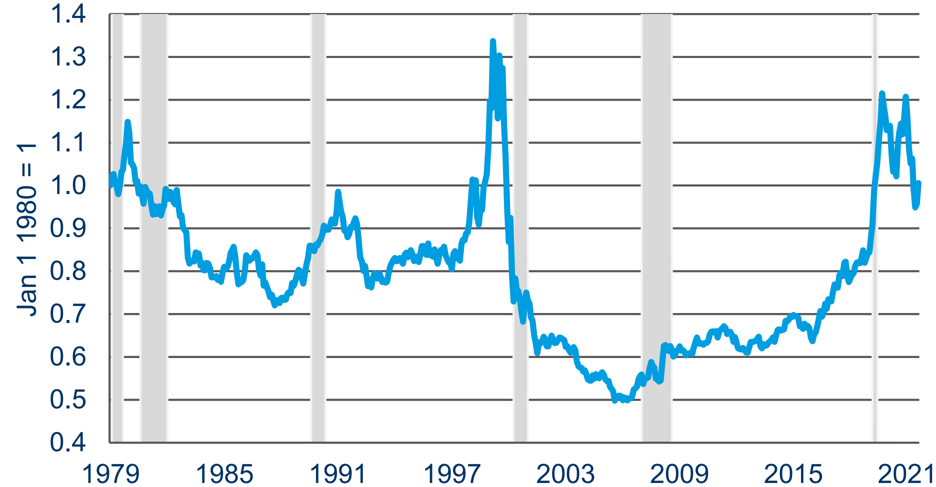
Value outperformed growth again in Q2, although growth outperformed in the July recovery. On a valuation basis, value still appears attractive versus growth. We continue to favor a value bias. Small caps also trade at a discount to large caps, although we are cautious on small caps over the short-term because they tend to underperform late in the economic cycle and during recessions.

Small-caps / Large-caps Valuation and Subsequent Return (Based on P/E, P/B and P/S)



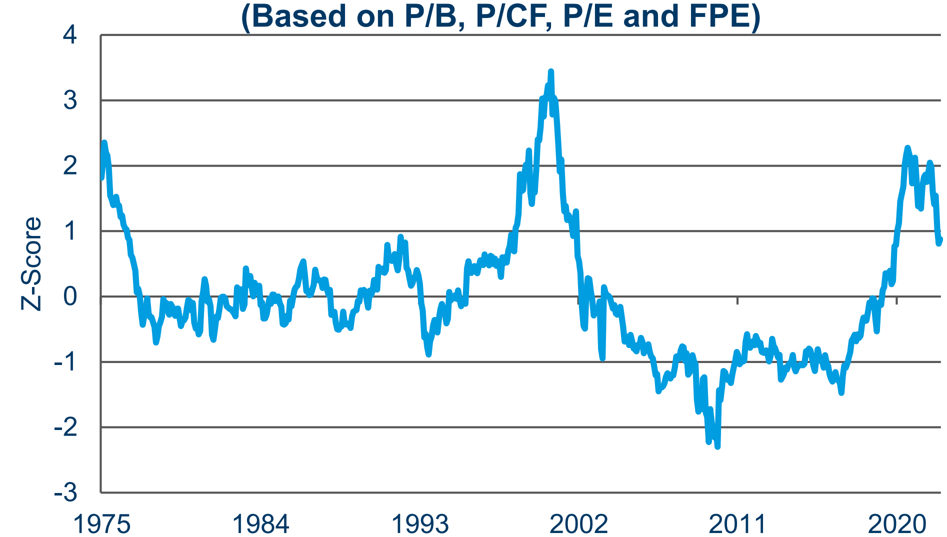
Source: Ned Davis Research, Bloomberg, Datastream, Mercer; as of 7/31/22

Relative Performance Russell 1000 Growth / Value



Source: Bloomberg; as of 7/31/22

Valuation of MSCI US Growth to Value (Based on P/B, P/CF, P/E and FPE)



Source: Datastream; as of 6/30/22

Mercer's latest strategic investment insights

Market Environment

Monthly capital market monitor: April 2022 | May 2022 | June 2022

Quarterly market environment report – April 2022

Quarterly Alternatives report – Q2 2022

Real Estate Global Market Summary – Q1 2022

Mercer periodic table of index returns – Q1 2022

Strategic research

Listed equities: A perfect storm for active management?

Listed natural resource equity – Inflation protection at a reasonable price?

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June 28 LinkedIn Live: Climate investing: How can investors deliver on their global climate ambitions?

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Offloading Russia - Investment implications of Russia being removed from indices

Russia-Ukraine Conflict: Investment Management Operational Risk Considerations

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