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Market Environment Report

October 2022

A business of Marsh McLennan

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Market review & outlook

Another Difficult Quarter for Stocks and Bonds

- Global markets continued their downtrend in the third quarter. Fed Chair Powell's speech at Jackson Hole in August dashed hopes that the Fed would consider pausing its tightening cycle. After recovering in July, both equity and bond markets broke through June lows.
- As a result of hawkish Fed guidance, bond markets ratcheted up expectations for this cycle's terminal interest rate from 3.25% at the end of July to 4.5%, which rippled through the yield curve. The 10-year Treasury yield briefly reached 4% in late-September, ending the month at 3.8%[1].
- The Bloomberg Aggregate Bond Index fell a further 5% in Q3, leaving it down 15% this year. The MSCI ACWI index fell 7% for the quarter and 25% this year. The simultaneous drawdown in both stocks and bonds has left a traditional 60/40 portfolio down 21% year-to-date[1].

Outlook Remains Uncertain

- The drawdown in stocks and bonds this year appears to be a reasonable response to the shift in Fed policy to combat inflation and the resulting uncertainty for economic growth. The decline in equities can be explained by the rise in interest rates putting downward pressure on valuations. The outlook for inflation and its impact on Fed policy likely will remain the key driver of the markets' direction.
- Encouragingly, inflationary pressures appear to be easing. The decline in energy prices in the US from their peaks should lead the headline inflation rate lower in the coming months. The gradual easing of supply side constraints and weaker demand could also slow core inflation. Easing inflation could mean that Fed hawkishness is near the peak.
- US economic activity has been nearly flat in 2022 and the tightening of financial conditions is only just beginning to be felt. The drag likely will intensify into 2023, increasing the risk of at least a mild recession. The good news is that household balance sheets remain strong, which should cushion household spending and prevent a deep downturn.
- A mild recession that reduces inflation could prove supportive of both stock and bond markets. The prospect of the Fed halting rate increases and a fall in longer-term interest rates could more than offset the negative impact of weak earnings for equities in a mild recession. The biggest downside risk we see for balanced portfolios is if inflation remains sticky even as the economy slows. This could require a more forceful Fed response and a deeper recession. This likely would result in continued weakness in stocks and bonds.

[1]Source: Bloomberg; as of 9/30/22

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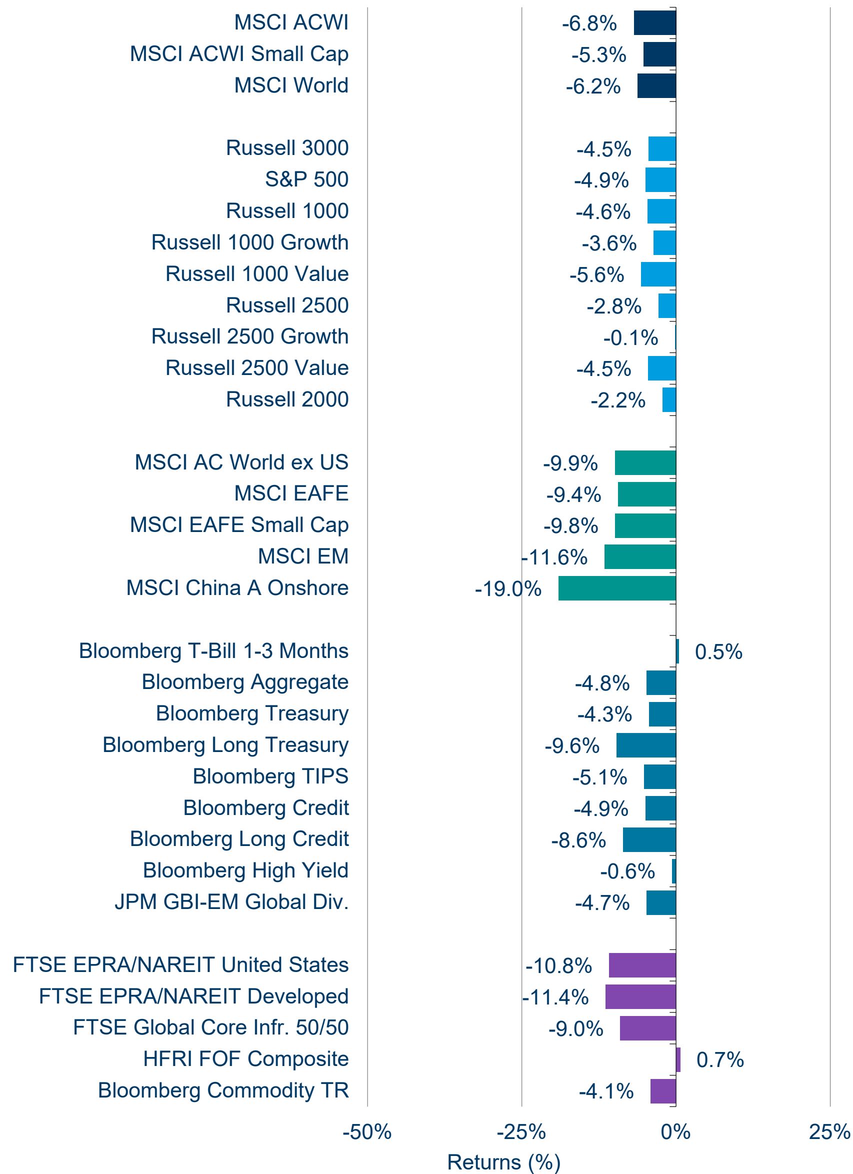
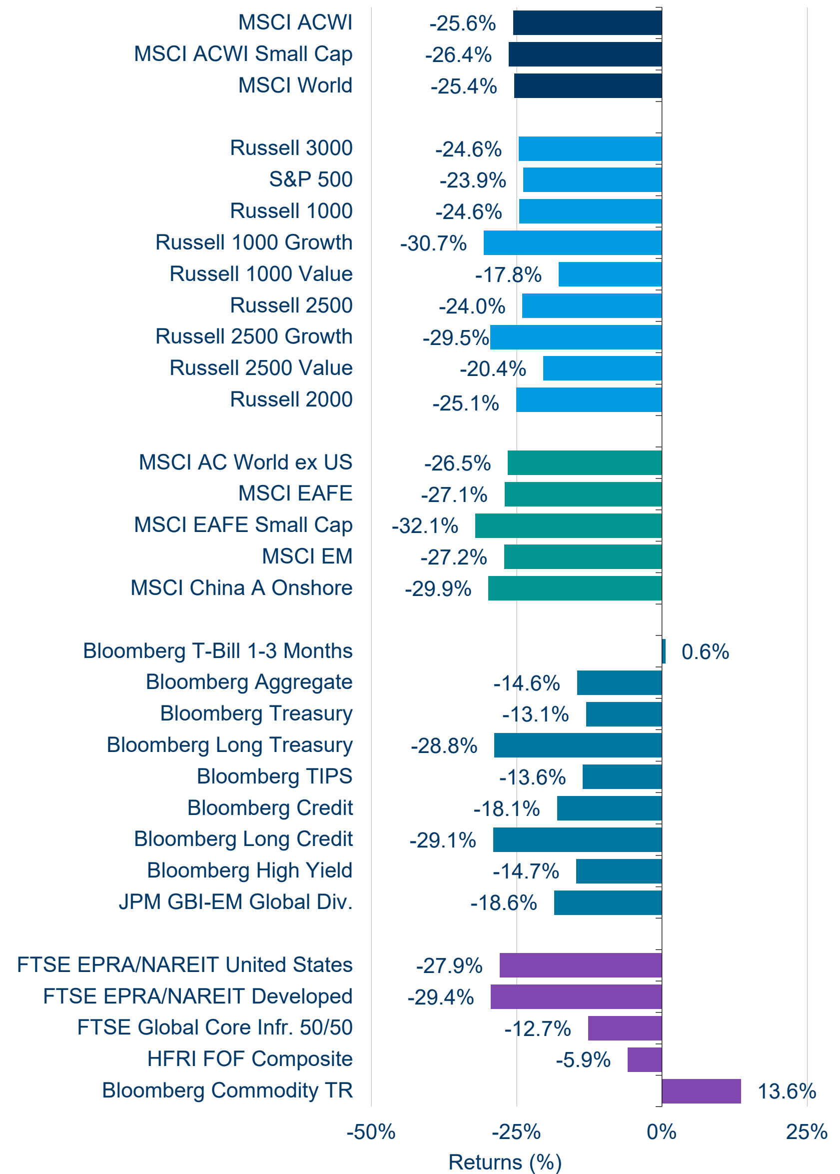
Performance summary

Market Performance
Third Quarter 2022



Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 9/30/22

Market Performance
Year-to-Date



Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 9/30/22

Past performance is no guarantee of future results. One cannot invest directly in an index.
Please see the following link for information on indexes:
https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-investment-management-index-definitions-mercer.pdf

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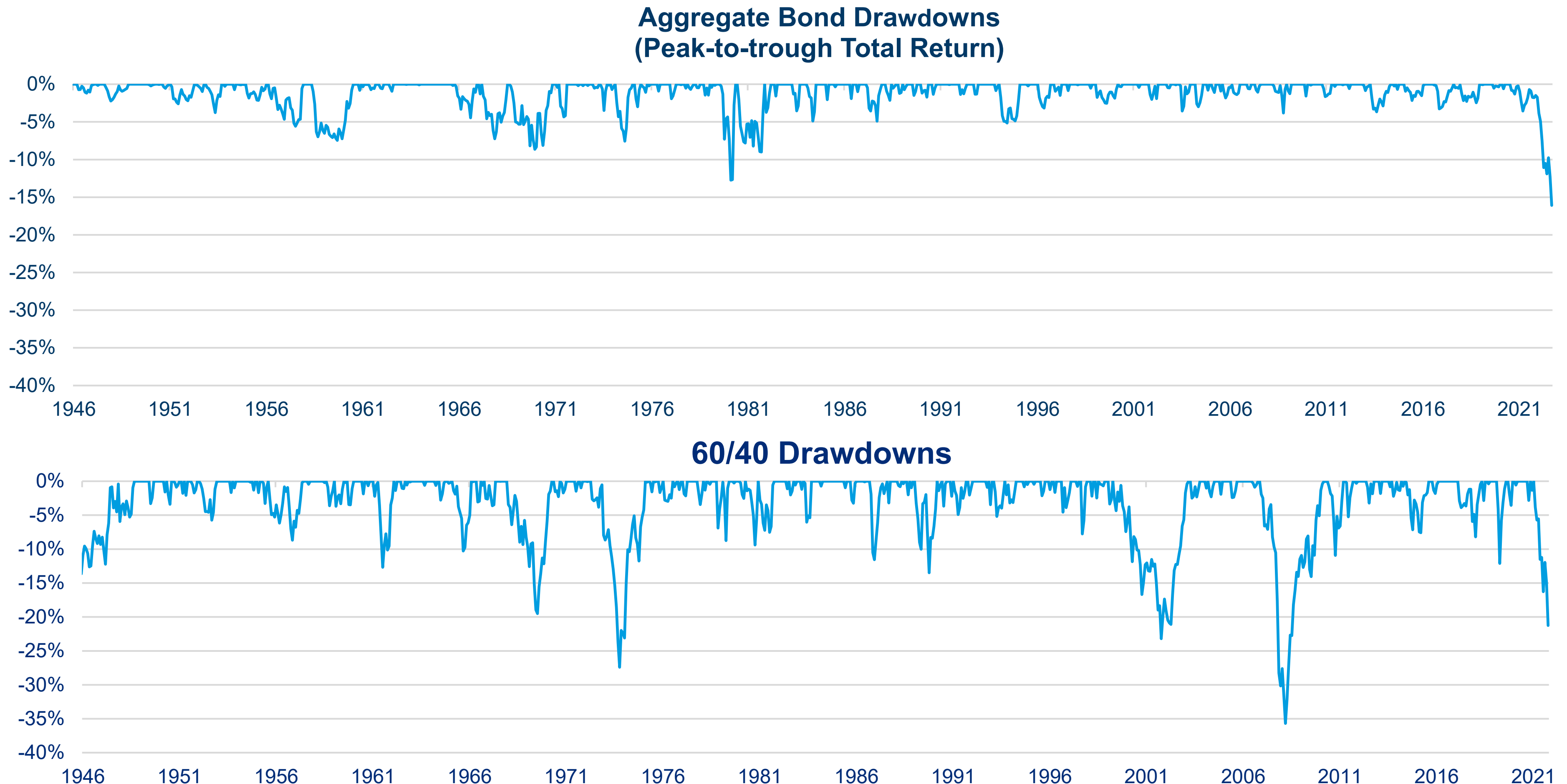
The drawdown in a 60/40 portfolio is among the worst since WWII

The 16% drawdown in the Bloomberg Aggregate Bond index is the worst in the post-war period, surpassing the 1979/80 bond decline driven by Fed Chair Volker's sharp increase in rates to tame inflation. While the equity bear market has been typical to this point, the simultaneous decline in bonds has made this the fourth worst drawdown for a 60/40 portfolio since WWII.



Source: Ibbotson: Stocks, Bonds, Bills and Inflation, Refinitiv, S&P, MSCI, Bloomberg, through 9/30/22

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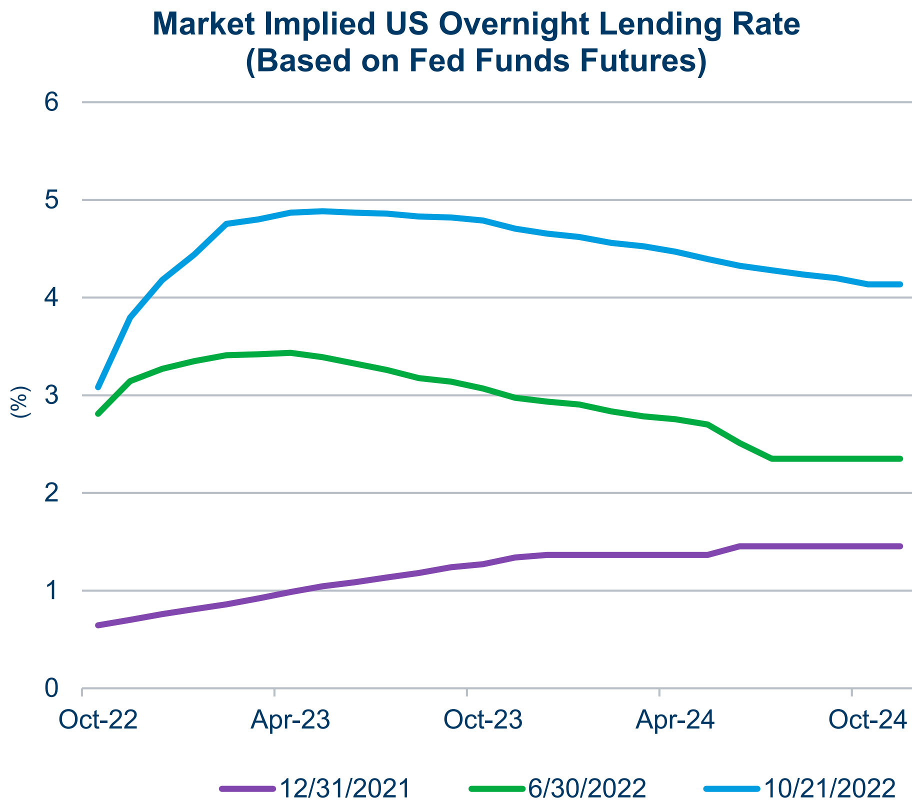
The market has priced a 5% peak Fed Funds rate, staying higher for longer

Fed Chair Powell's speech at Jackson Hole in late August and upside CPI surprises have contributed to a sharp increase in tightening expectations. Markets price the Fed to lift the overnight lending rate to nearly 5% in early 2023 and remain above 4% into late 2024. This has rippled through the yield curve as the 10y yield reached 4.25% in mid-October.



Source: Bloomberg

Source: Bloomberg, as of 10/21/22

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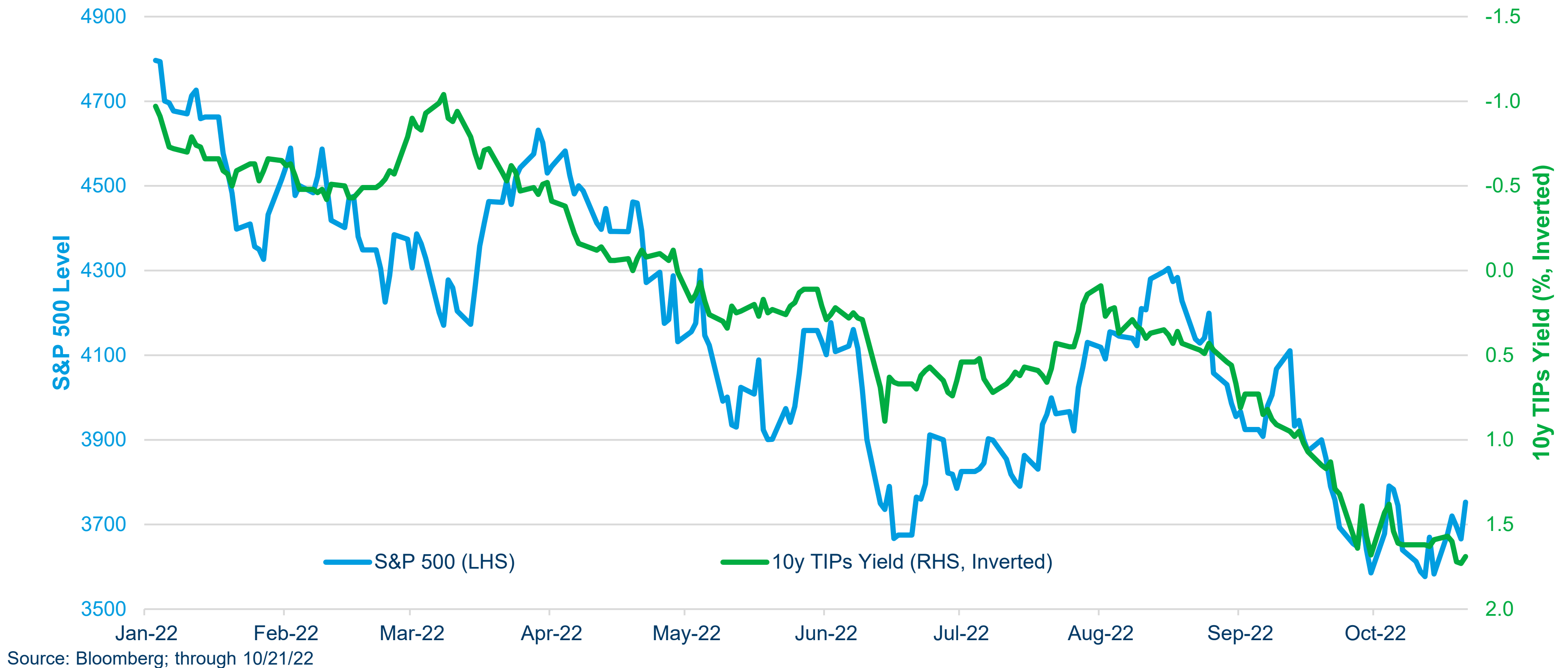
The equity bear market has mostly been driven by higher interest rates

The surge in interest rates has been the primary driver of the bear market in equities. The S&P 500 has been particularly sensitive to the real yield on TIPS. Looking ahead, the outlook for inflation and its impact on Fed policy likely will remain the key driver of the markets' direction.



Source: Bloomberg; through 10/21/22

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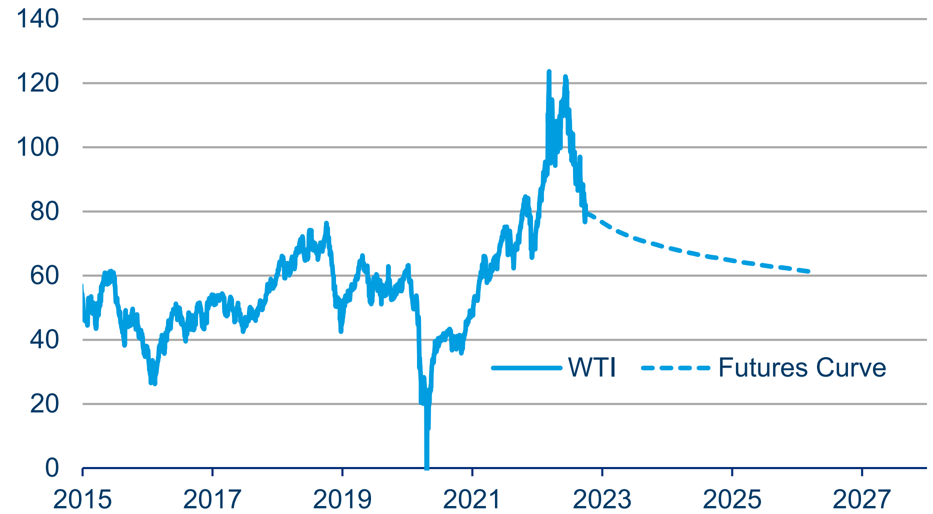
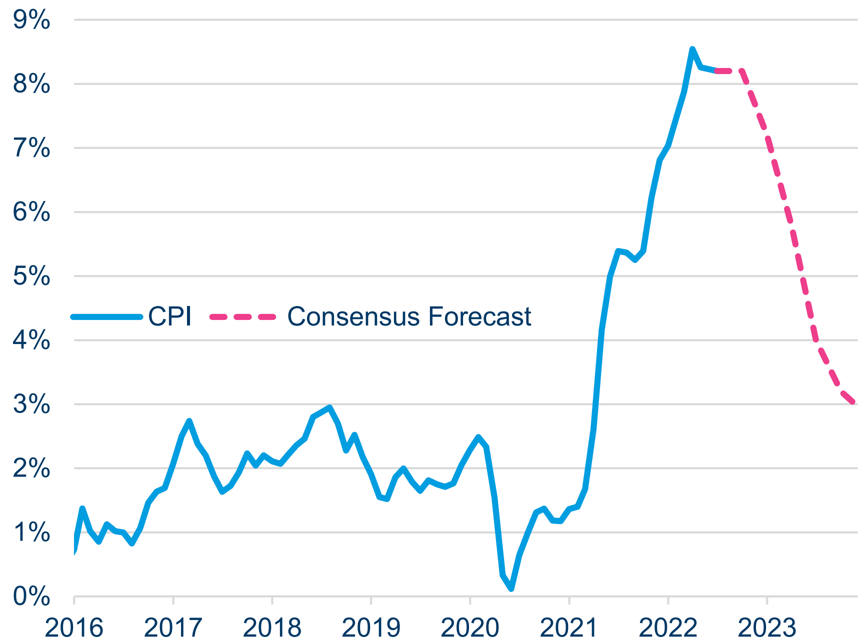
Inflation pressures have eased, but remain too high for the Fed's comfort

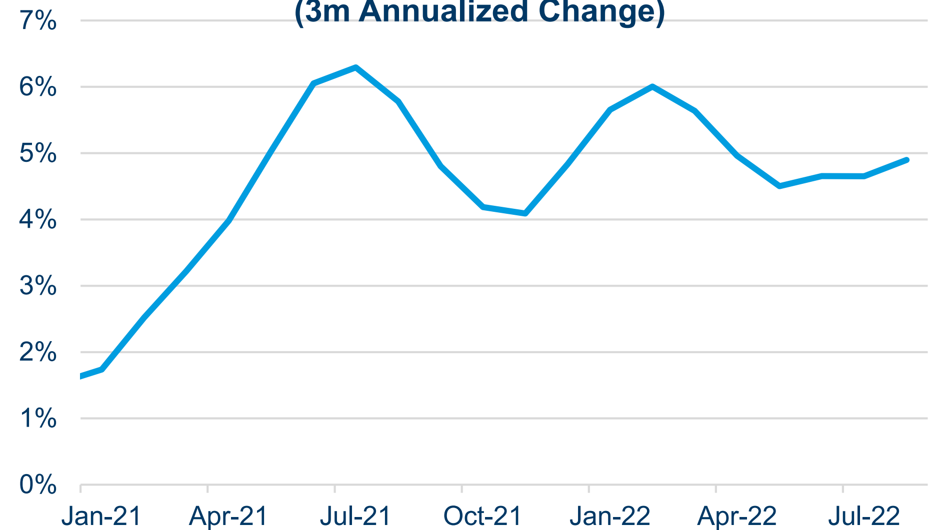
Inflation peaked at 9% in June on a year-over-year basis. It has slipped to 8.2% through September as energy prices have weakened. The Fed will likely be paying closer attention to core inflation. Its preferred measure, the core PCE deflator, has improved slightly, but remains well above the Fed's target as services inflation has accelerated. Some relief could be ahead as the weakness in the housing market rolls into owner equivalent rents. Economists polled by Bloomberg expect inflation to fall below 3% by the end of 2023.



Source: Bloomberg; as of 9/30/22



Source: Bloomberg; CPI through 9/30/22, forecasts as of 10/21/22



Source: Bloomberg; through 8/31/22

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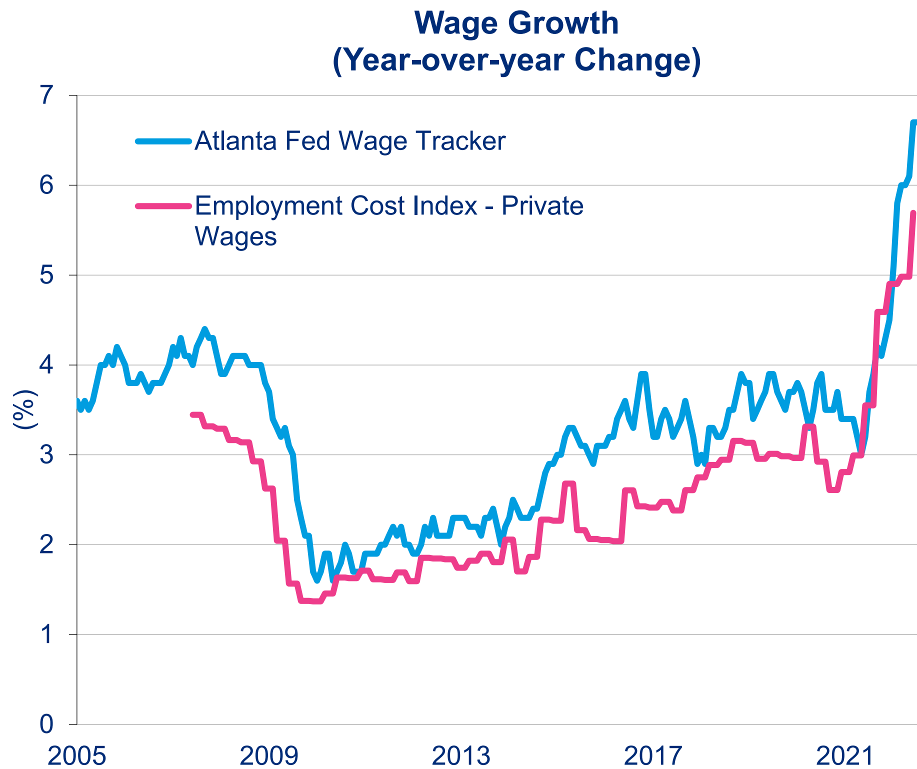
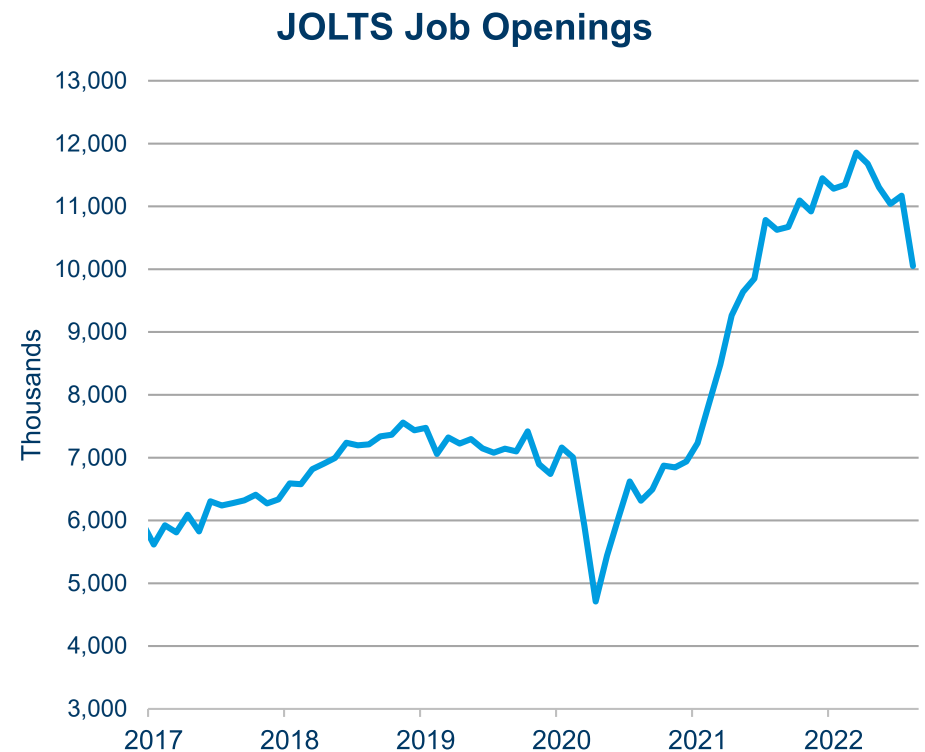
The labor market remains hot, but with some signs of cooling

The tightness of the labor market is keeping upward pressure on wages even as the economy slows. This could eventually lead to a wage-price spiral, which could make inflation stickier. The decline in job openings over the past few months suggests the job market is cooling. The Fed is likely hoping that a decline in job openings can ease tightness in the labor market without a big rise in unemployment.



Source: Bloomberg; through 9/30/22



Source: Bloomberg; through 9/30/22

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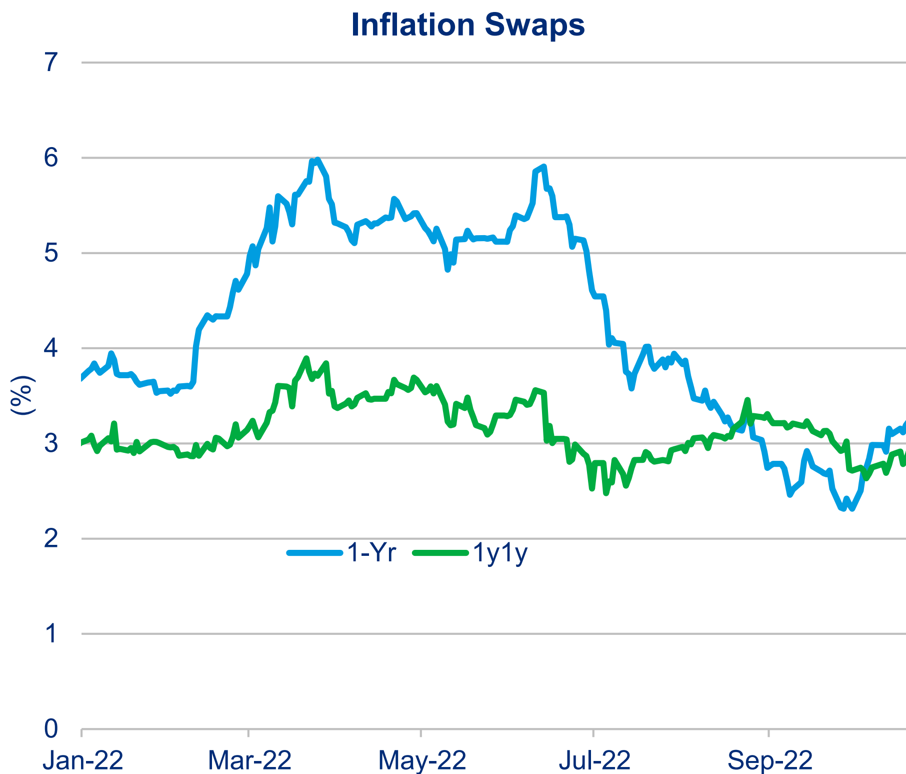
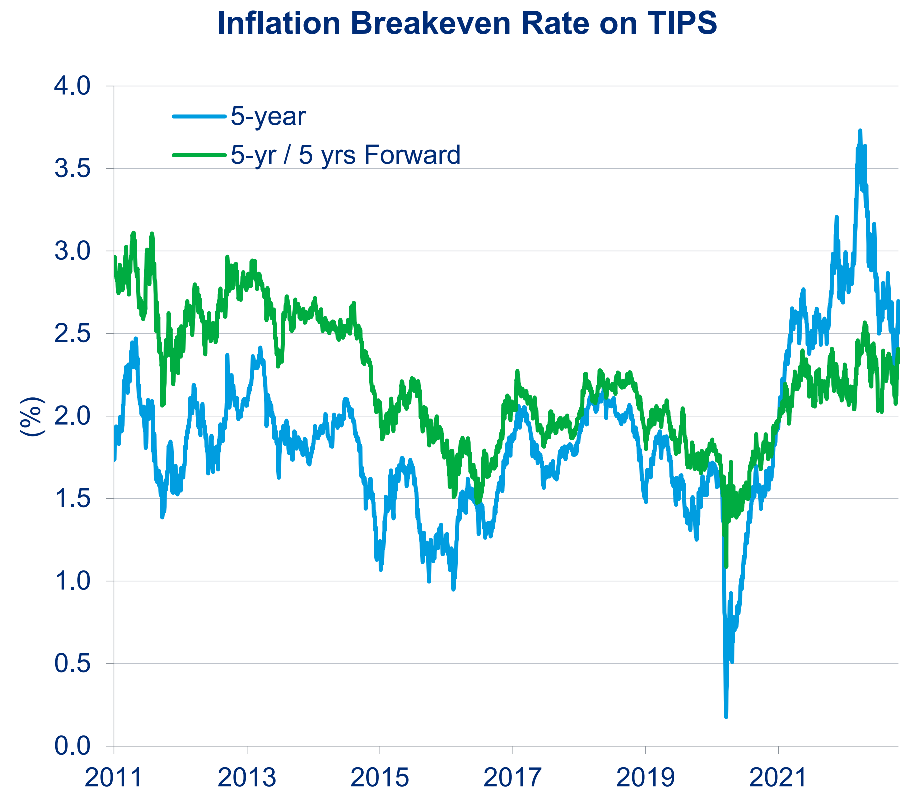
Markets are pricing a rapid decline in inflation

Consistent with economists' consensus forecasts, markets are pricing a rapid decline in inflation over the next year. Longer-term inflation expectations also remain in check. It suggests that the tightening priced by markets will be enough to bring inflation lower. This also highlights the risk to the outlook. If inflation is stickier than what markets expect, then it could induce the Fed to tighten further, which would be negative for both stocks and bonds.



Source: Bloomberg, Mercer; through 9/30/22



Source: Bloomberg, Mercer; as of 9/30/22

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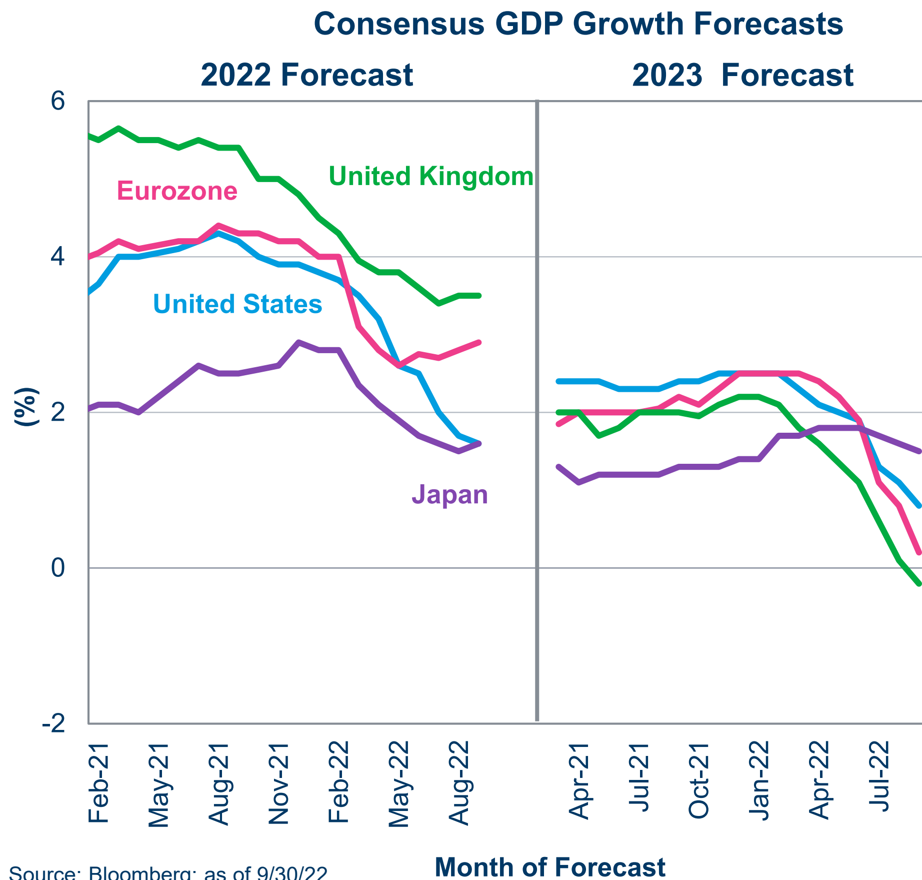
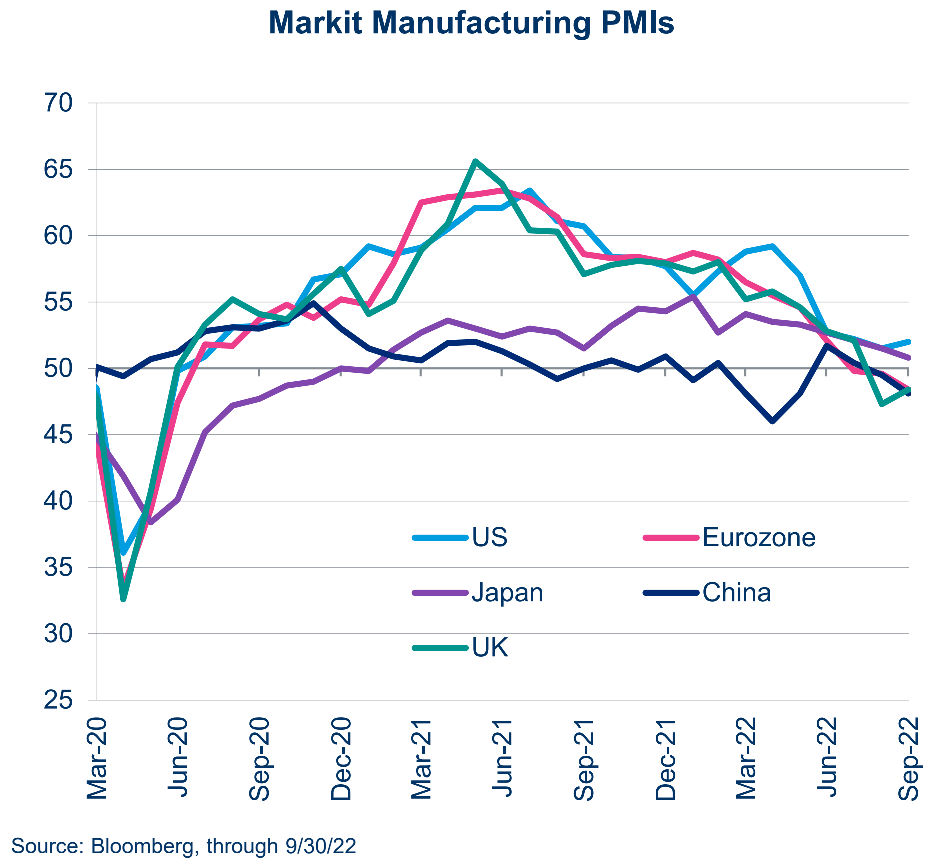
The UK and Eurozone might already be in a recession

Economists have continued to slash growth forecasts for 2023 as central banks have increased rates, tightening financial conditions. Economists polled by Bloomberg assign a 70% chance to the US entering a recession within the next year. The UK and the Eurozone may already be in a recession as high energy prices have added additional strains. China's manufacturing PMI fell further below 50.



Source: Bloomberg; as of 9/30/22



Source: Bloomberg, through 9/30/22

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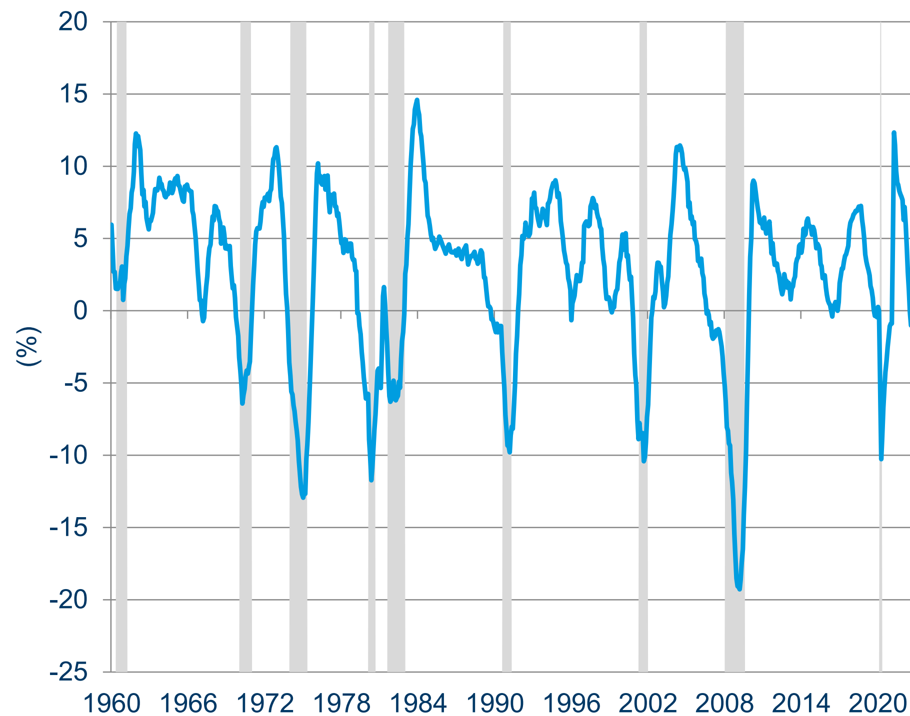
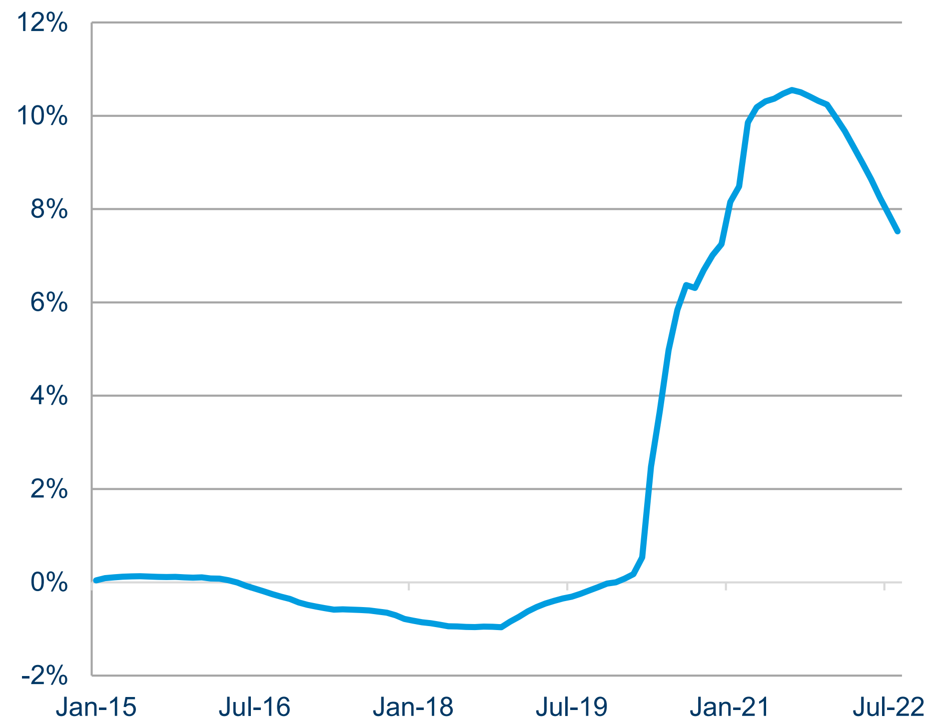
The odds of a mild US recession have increased

The odds of the US entering a recession have increased as financial conditions tightened. However, the health of household finances should keep any recession relatively mild. Households are still sitting on excess cash, and debt loads have fallen since the GFC. The high prevalence of fixed rate mortgages in the US will cushion the impact of Fed rate hikes. This should help support household spending and prevent a deep downturn. The health of household balance sheets, however, might eventually prove a double-edged sword. Demand could stay too strong even as financial conditions tighten, requiring a more forceful Fed response.



Source: Bloomberg, through 8/31/22



Source: Bureau of Economic Analysis, through 8/31/22

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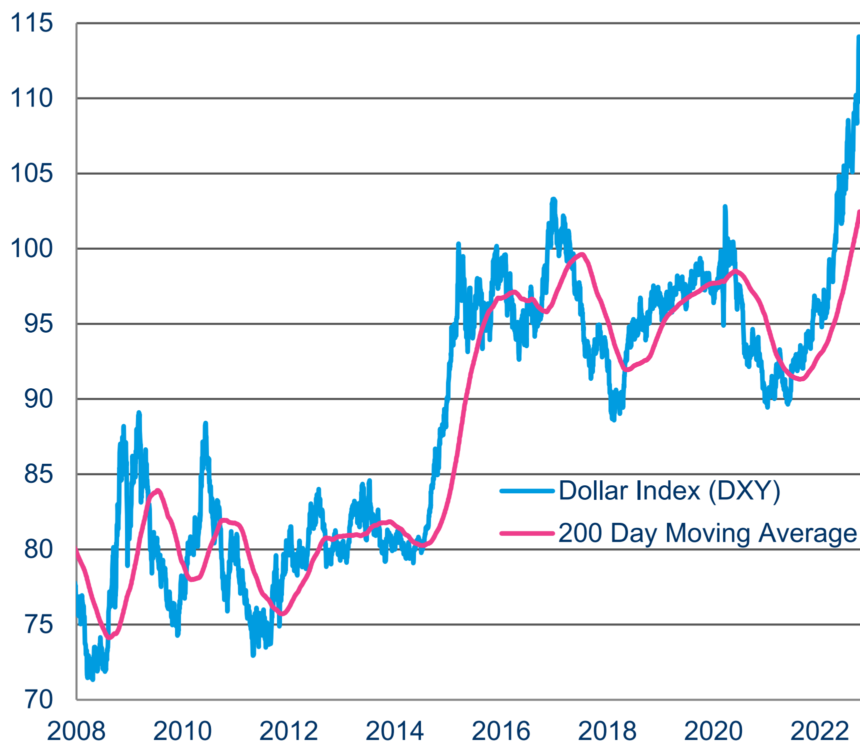
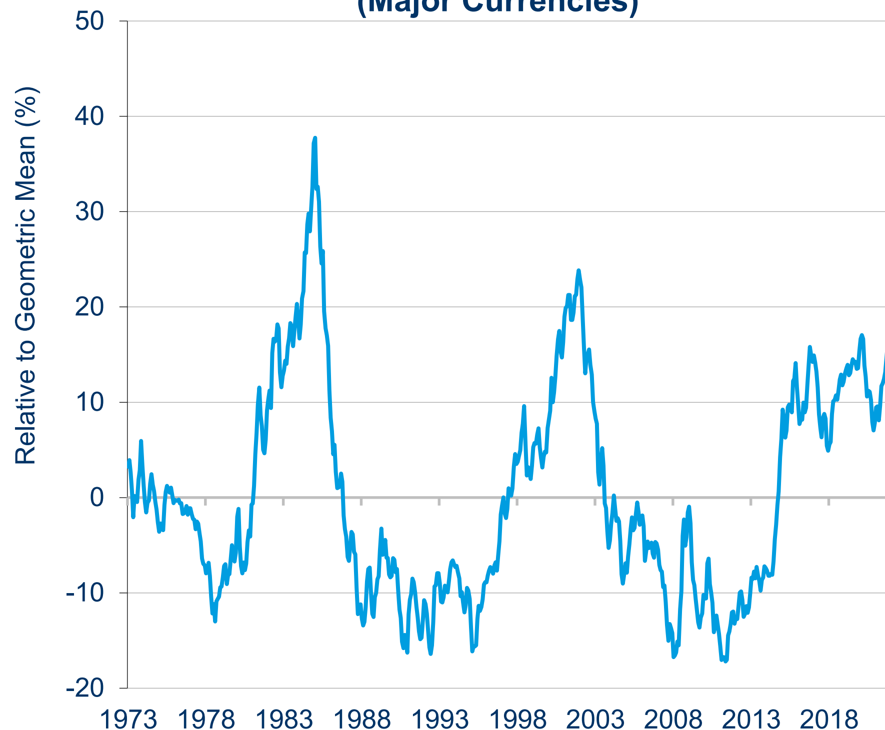
The dollar continued its rally, weighing on returns for non-US assets

The Dollar (DXY) index surged 7% during the quarter, lifting its 2022 gain to nearly 17.2%. The dollar has benefited from the Fed's aggressive monetary policy relative to other central banks. The US has also been relatively insulated from the energy price spike resulting from the Ukraine conflict. However, the dollar now appears very expensive on a valuation basis, approaching its 1985 high. Over the short-term, the performance of currencies is difficult to predict. Over the longer-term, currency valuations tend to mean revert, suggesting the dollar is likely to depreciate.



Source: Bloomberg, through 9/30/22



Source: Bloomberg, Mercer calculations; through 9/30/2022

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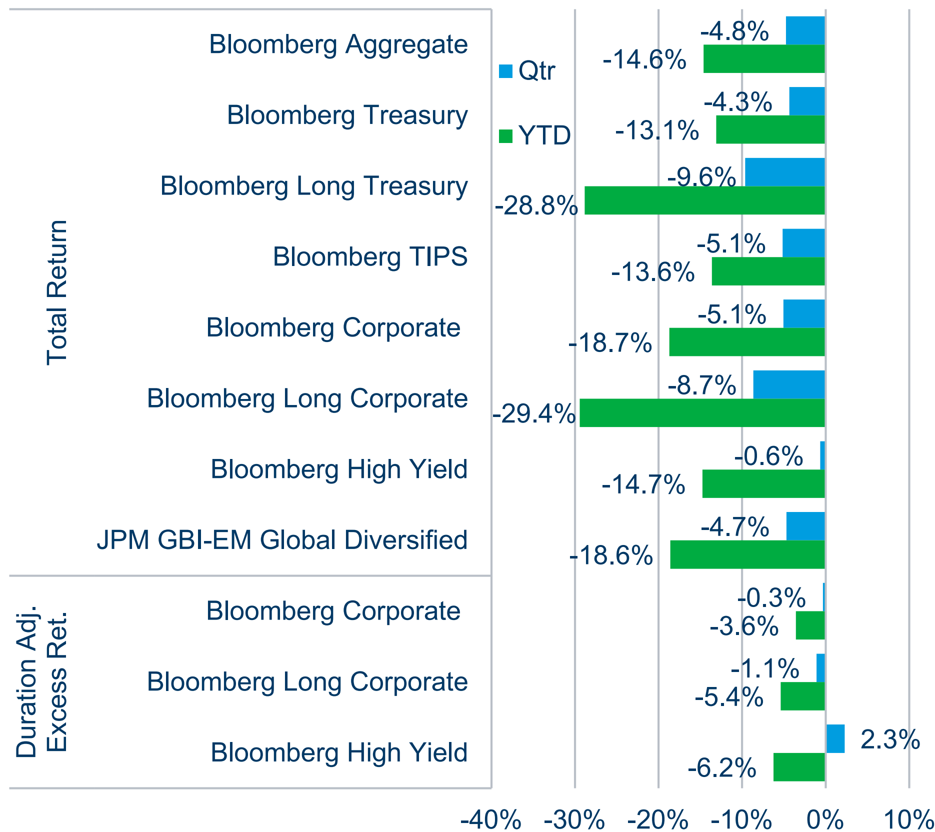
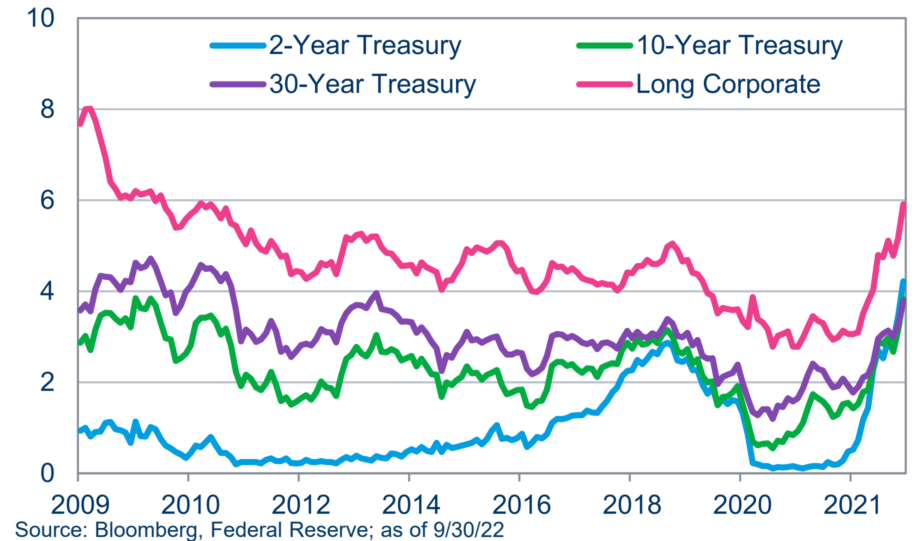
What happened in fixed income in Q3?

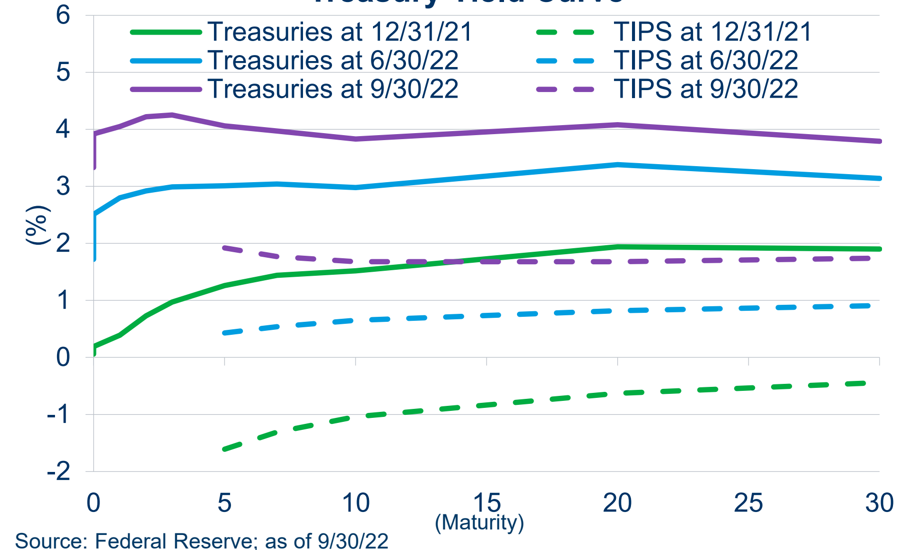
Fixed income posted another quarter of declines in Q3 due to rising rates. The Bloomberg Aggregate declined by almost 5% during the quarter and is down 14.6% year-to-date. Credit spreads were mostly unchanged during the quarter, with investment-grade spreads widening by 4 bps, while high yield spreads narrowed by 16 bps. TIPS underperformed Treasuries due to falling inflation-breakeven rates amid fears of an economic slow down.



Source: Bloomberg, Datastream; as of 9/30/22



Source: Bloomberg, Federal Reserve; as of 9/30/22



Source: Federal Reserve; as of 9/30/22

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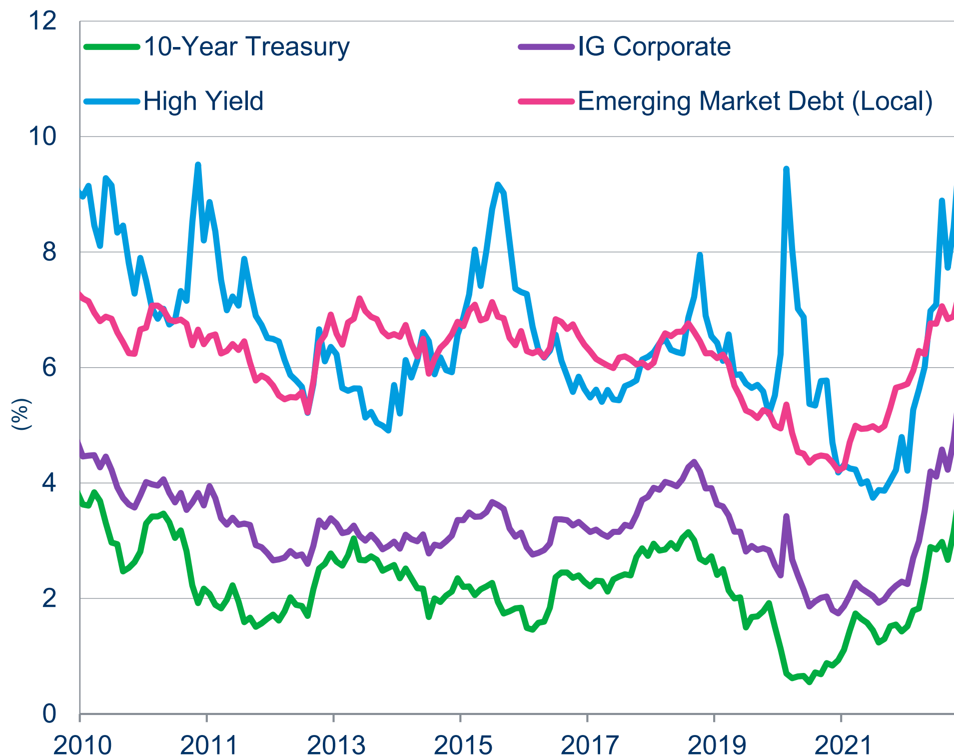
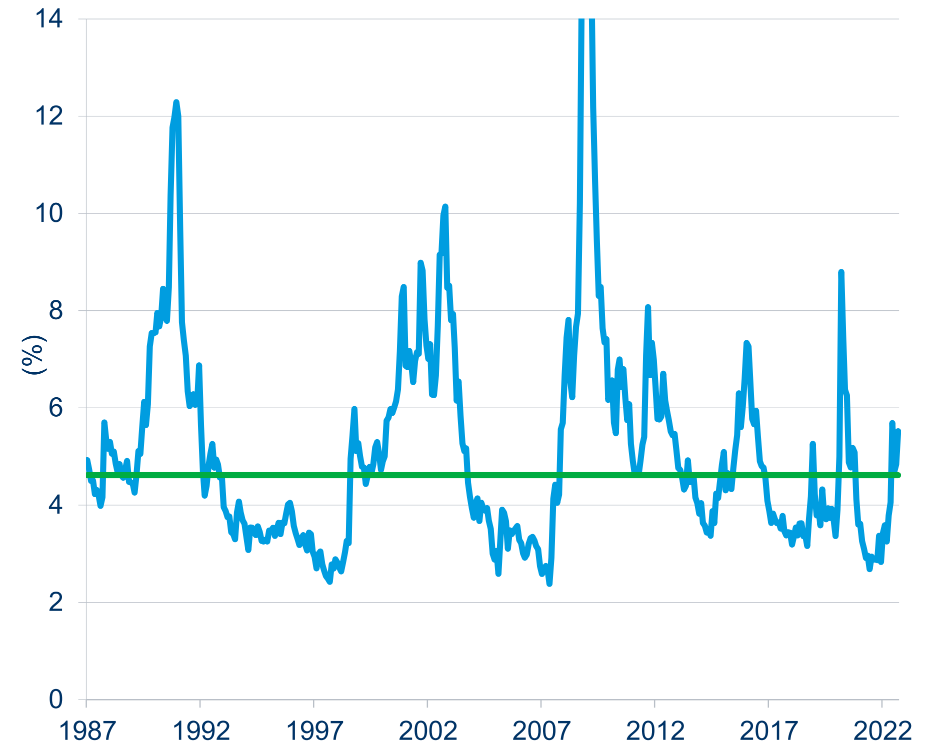
The reward-to-risk of fixed income has improved

The increase in interest rates has improved the return outlook for fixed income. A 4% Treasury yield provides reasonable income to offset potential further increases in rates, while offering downside protection should the economy suffer a hard landing. TIPS have an inflation-protected yield of 1.7%, the highest in more than a decade. Some riskier fixed income securities have yields competitive with equity expected returns. High yield bonds finished the quarter with a yield of nearly 10% and a spread of 5.5% to Treasuries. Although high yield spreads are likely to rise further if the US enters a recession, providing a potentially better entry point.



Source: Federal Reserve, Bloomberg; as of 9/30/22



Source: Bloomberg; through 9/30/22

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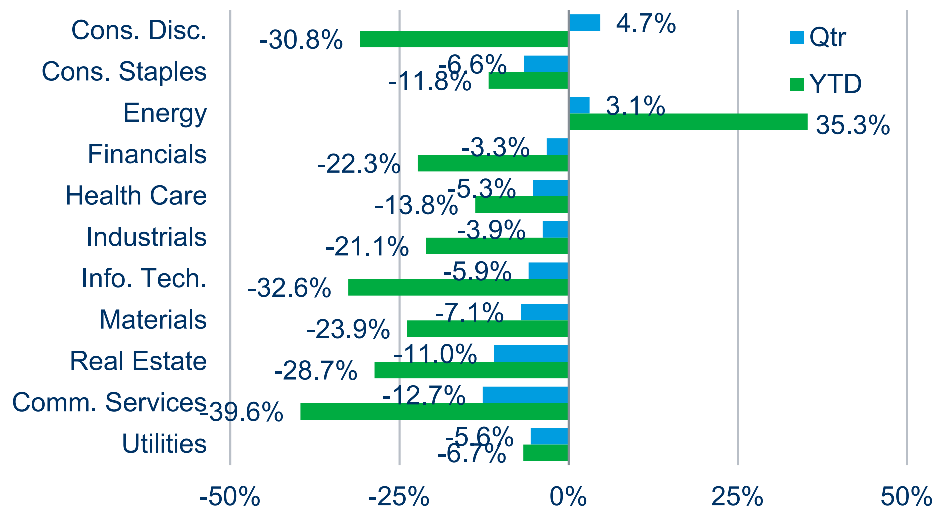
What happened in equity markets in Q3?

Equities continued their downtrend in Q3, with most regions ending the quarter back in bear market territory on a year-to-date basis. Growth stocks generally held up better during Q3, particularly among small-caps. Consumer discretionary and energy were the only sectors with positive results during the quarter. MSCI EAFE outperformed the S&P 500 in local terms during Q3, but currency weakness detracted 580 bps from US$ returns.

3Q22 US Style Performance (%)

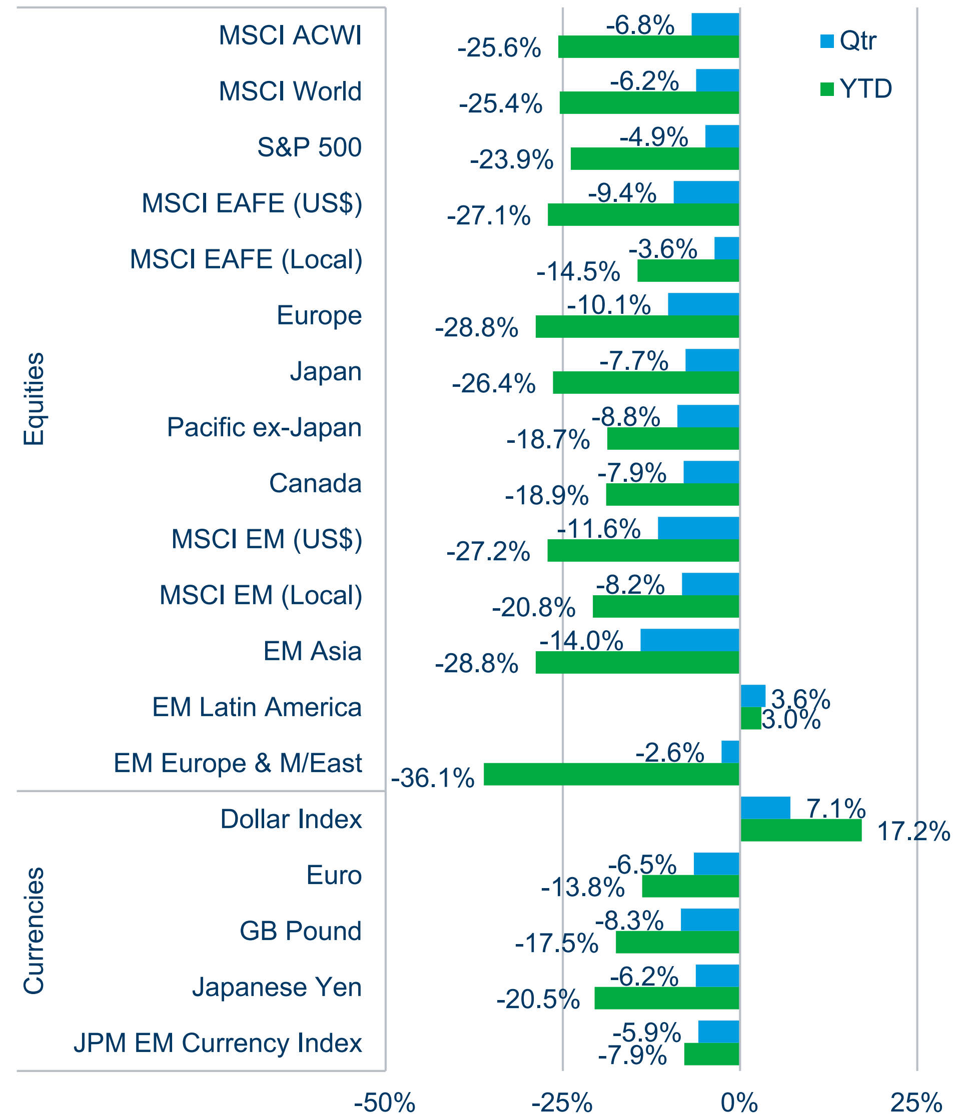
	Value	Blend	Growth
Russell Top 200	-5.97	-5.02	-4.24
Russell Midcap	-4.93	-3.44	-0.65
Russell 2000	-4.61	-2.19	0.24

MSCI USA Sector Returns



Source: Bloomberg; as of 9/30/22

Global Performance



Source: Bloomberg, Datastream; as of 9/30/22

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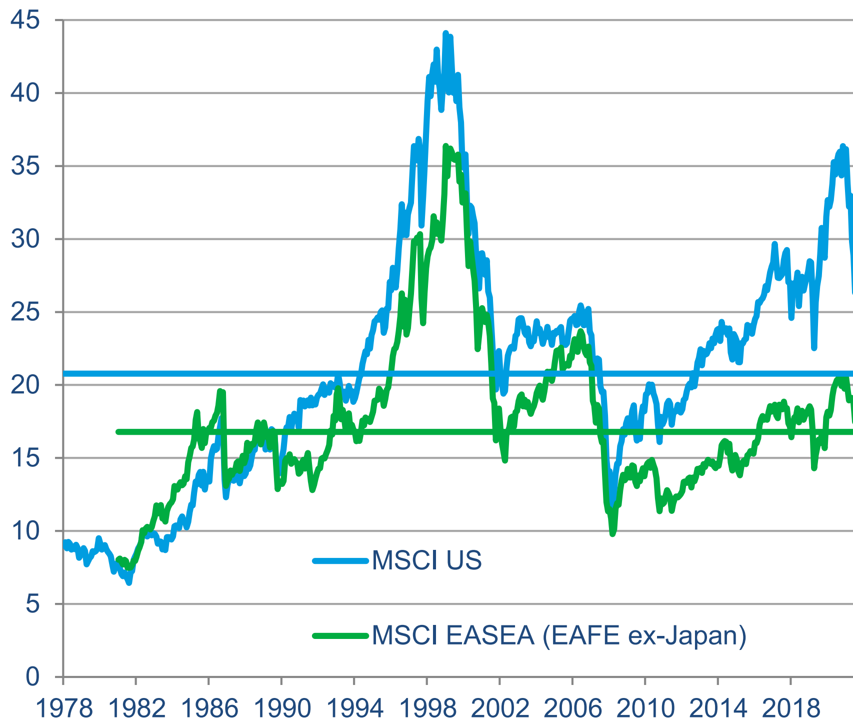
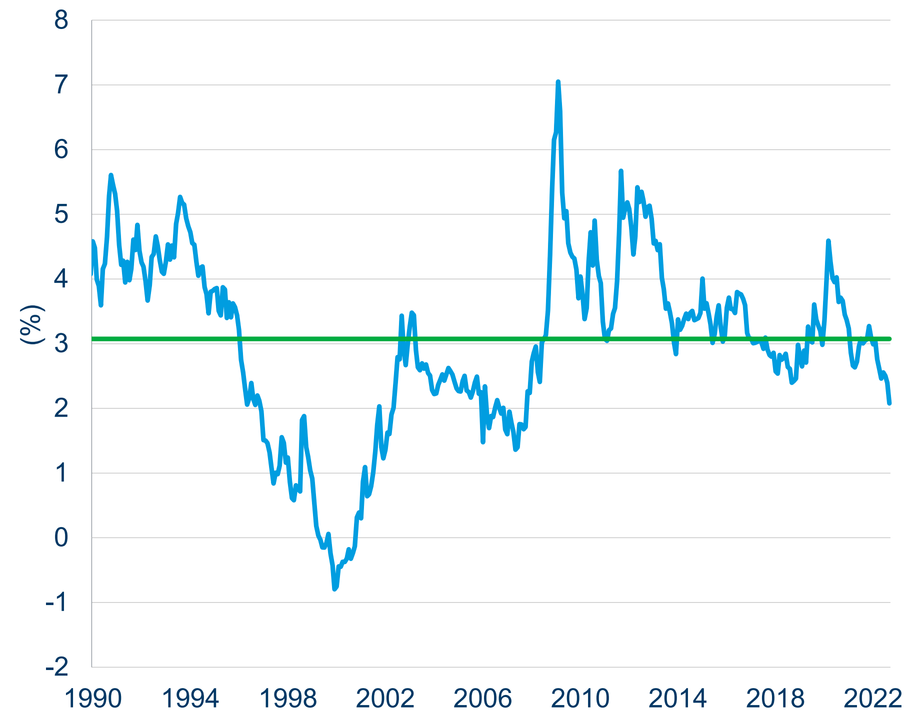
Equity valuations have improved, but less so than bonds

Equity valuations have come down significantly this year. The Shiller P/E on the MSCI US has fallen from 36 to 25. However, the prospective equity risk premium over long-term Treasuries has slipped as a result of higher interest rates. Equity valuations could come under further pressure should inflation prove sticky.



Source: Datastream, MSCI, Mercer, through 9/30/22



Note: the equity risk premium represents a normalized earnings yield on the S&P 500 less the real return on 30y Treasuries.

Source: Bloomberg, Refinitiv, Mercer, through 9/30/22

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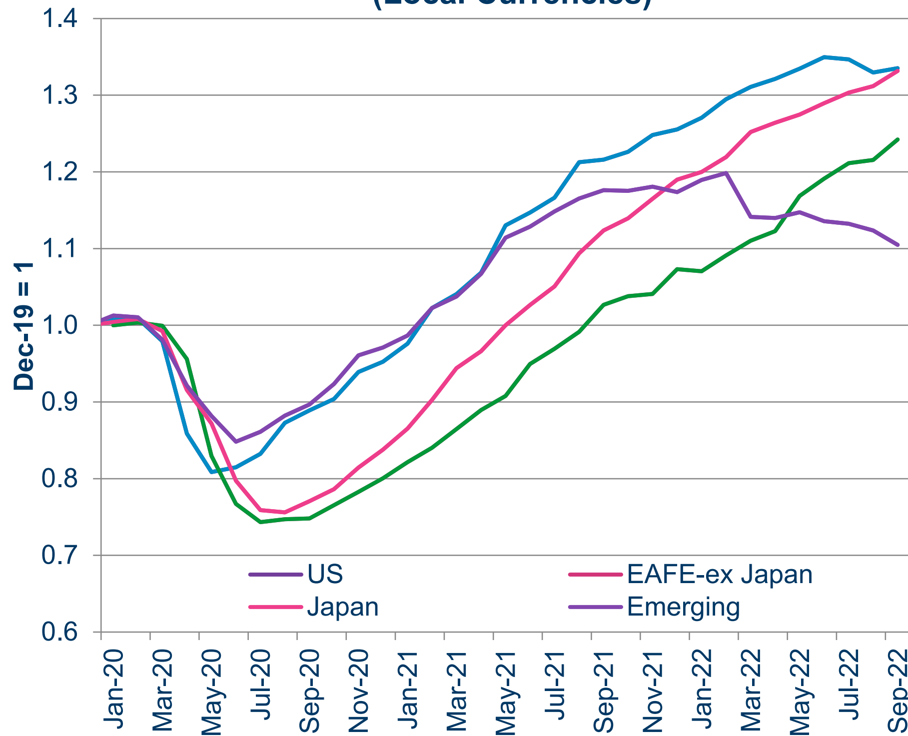
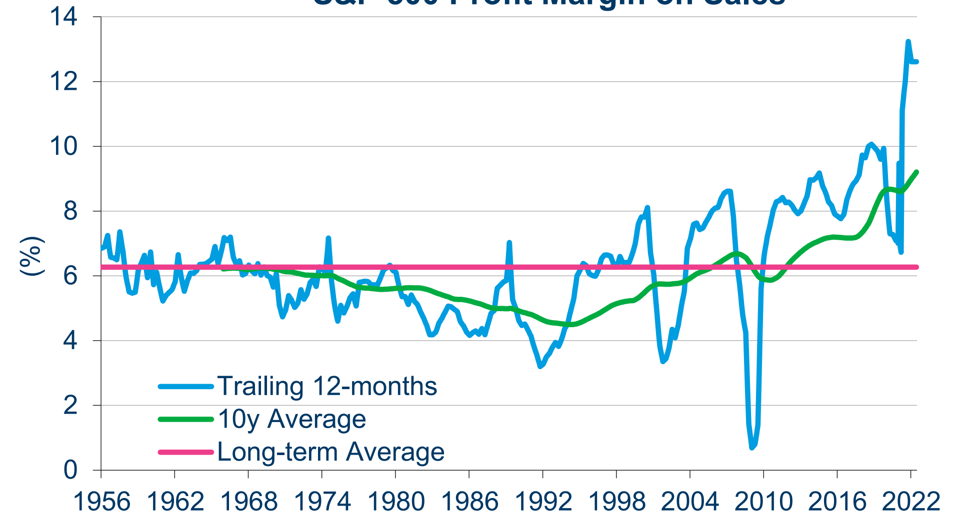
Headwinds to earnings intensifying

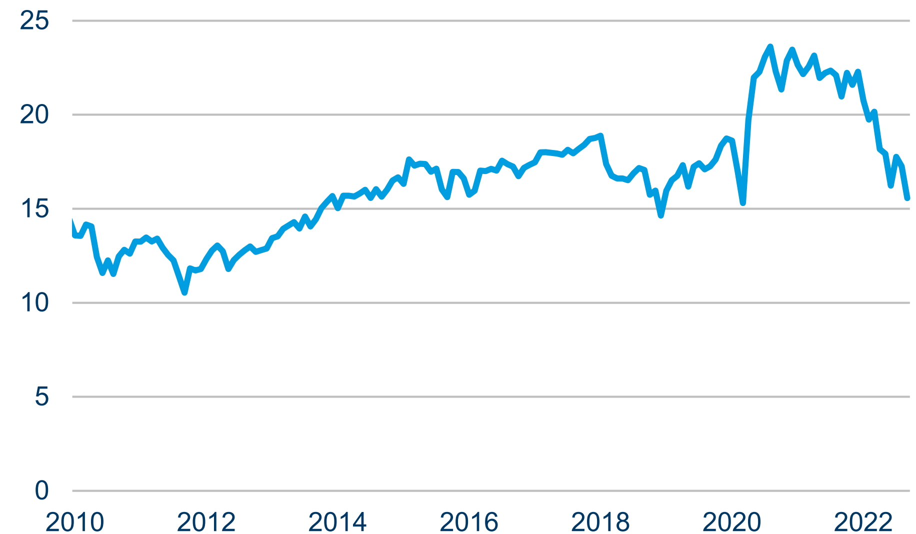
While economists see rising odds of a global recession in 2023, stock analysts have been slow to adjust earnings estimates downward. However, margins are likely to come under pressure in the coming months as a result of rising wages and slowing growth. US companies also face a drag from the strength of the dollar. The market might, however, look through a period of weak earnings in a recession as long as it is accompanied by a reduction in interest rates.



Source: Datastream, through 9/30/22



Source: S&P, through 9/30/22



Source: Refinitiv, through 9/30/22

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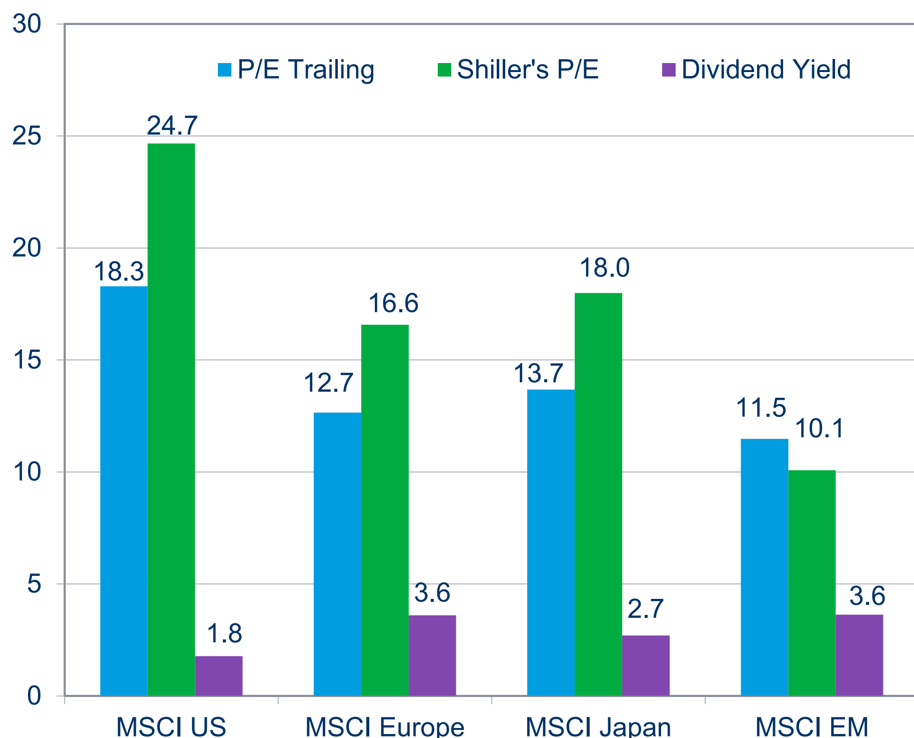
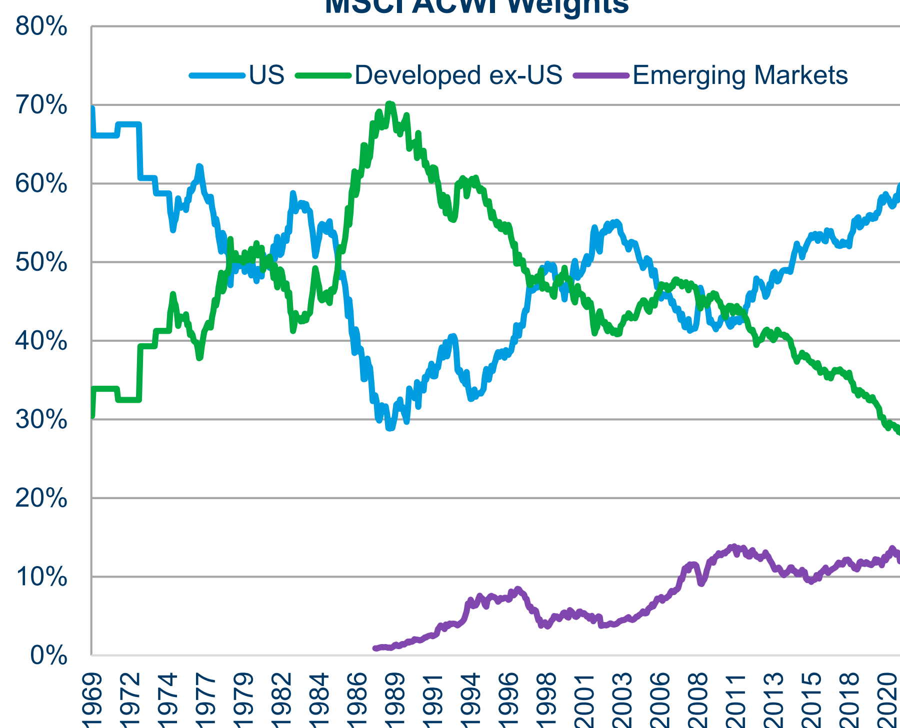
Dollar strength weighed on international equities

International developed equities have held up well relative to the US on a local currency basis so far in 2022. This is due in large part to the value orientation of international indexes. However, the strength of the dollar has led to modest underperformance for international equities in US$ terms. Looking forward, economic risks are higher outside the US, particularly in Europe. However, valuations for internationals remain more attractive than for the US. Over the longer-term a reversal in the dollar could provide a tailwind.



Source: Bloomberg, Datastream, Mercer; as of 9/30/22



Source: Datastream, through 6/30/22

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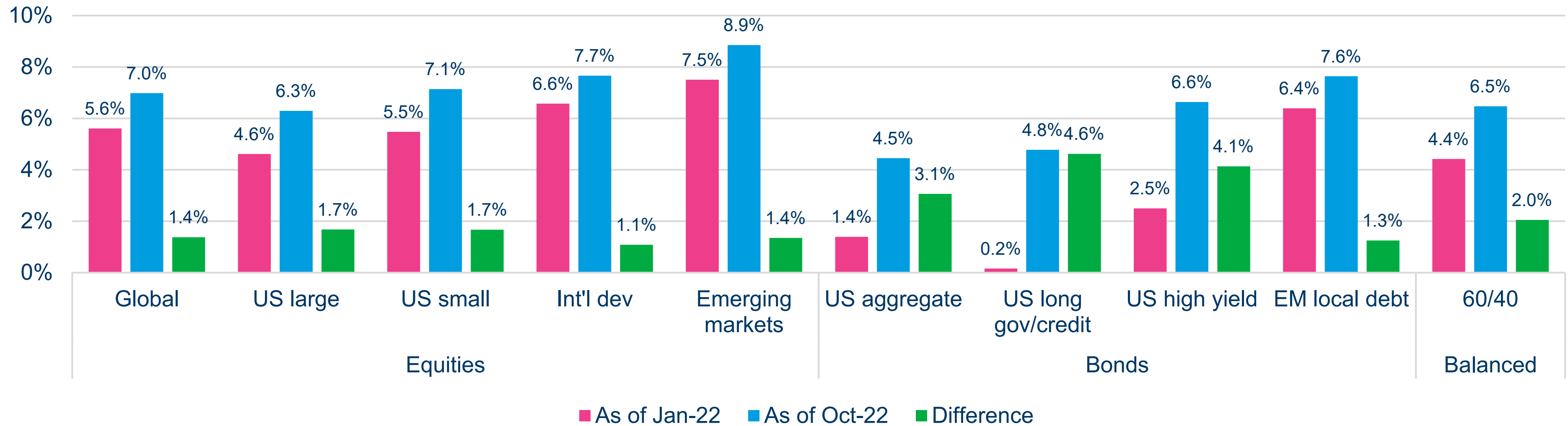
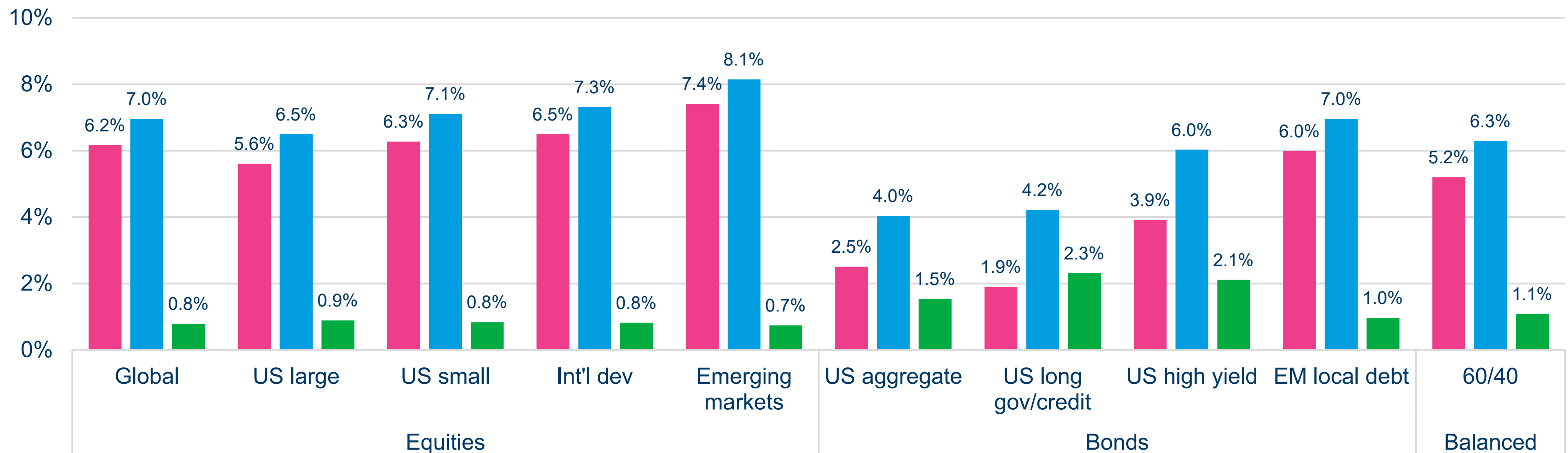
Our long-term expected return forecasts have increased materially since the beginning of the year





Source: Mercer's capital market assumptions; assumptions are gross of fees
Expected return, volatility, and correlation are hypothetical projections and are derived using Mercer's forward-looking Capital Market Assumptions methodology. There can be no assurance that these results can be achieved. Actual results are likely to vary. Please see Important Notices for further information on Risk and Return Expectations.

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Download a guide on key index definitions

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Important Notices (continued)

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Expected return, volatility, and correlation are hypothetical projections and are derived using Mercer's forward-looking Capital Market Assumptions methodology. Actual return, volatility, and correlation may be lower or higher than the data quoted. The expectations for the modelled portfolio are a compilation of return, volatility, and correlation expectations of the underlying asset classes.

Portfolio expectations are forward looking and reflective of Mercer's Capital Market Assumptions, as defined by asset class and incorporating return, standard deviation, and correlations. Our process for setting asset class expected returns begins with developing an estimate of the long term normal level of economic growth and inflation. From these two key assumptions, we develop an estimate for corporate earnings growth and the natural level of interest rates. From these values, we can then determine the expected long term return of the core asset classes, equity and government bonds. We combine current valuations with our expectations for long term normal valuations and incorporate a reversion to normal valuations over a period of up to five years. Volatility and correlation assumptions are based more directly on historical experience except in cases in which the market environment has clearly changed. Manager impact on performance is not incorporated into expectations. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future returns.

Expected return is shown [gross] of [investment advisory, investment manager fees, brokerage and other commissions] and [assumes/does not assume] the reinvestment of dividends and other earnings. Periods over one year are annualized.

Hypothetical performance results [and related statistics] do not represent the results of actual trading using client assets.. Actual results may significantly differ from the hypothetical returns being presented. Investors may experience loss. The time periods shown represent a variety of economic and market conditions, including the unpredictability of such conditions and includes periods of market volatility. There are limitations with the data presented below as each client would have its own investment objectives, risk tolerance, goals and benchmarks for its portfolios. Performance results for individual client portfolios will vary due to possible inclusion of cash and cash equivalents, reinvestment of dividends, interest and other earnings including timing of investments, withdrawals among other reasons.

Actual returns would be reduced by advisory and other expenses as brokerage commissions, custodial costs and other expenses. Actual fees would vary depending on, among other things, the applicable fee schedule, portfolio size and/or investment management agreement. Further information regarding investment advisory fees are described in our Form ADV, Part 2A.

There are substantial risks associated with investments classified as alternative investments. Investors should have the ability, investing sophistication and experience to bear the risks associated with such investments.

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