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# Market Environment Report

April 2023

A business of Marsh McLennan

# Market review & outlook

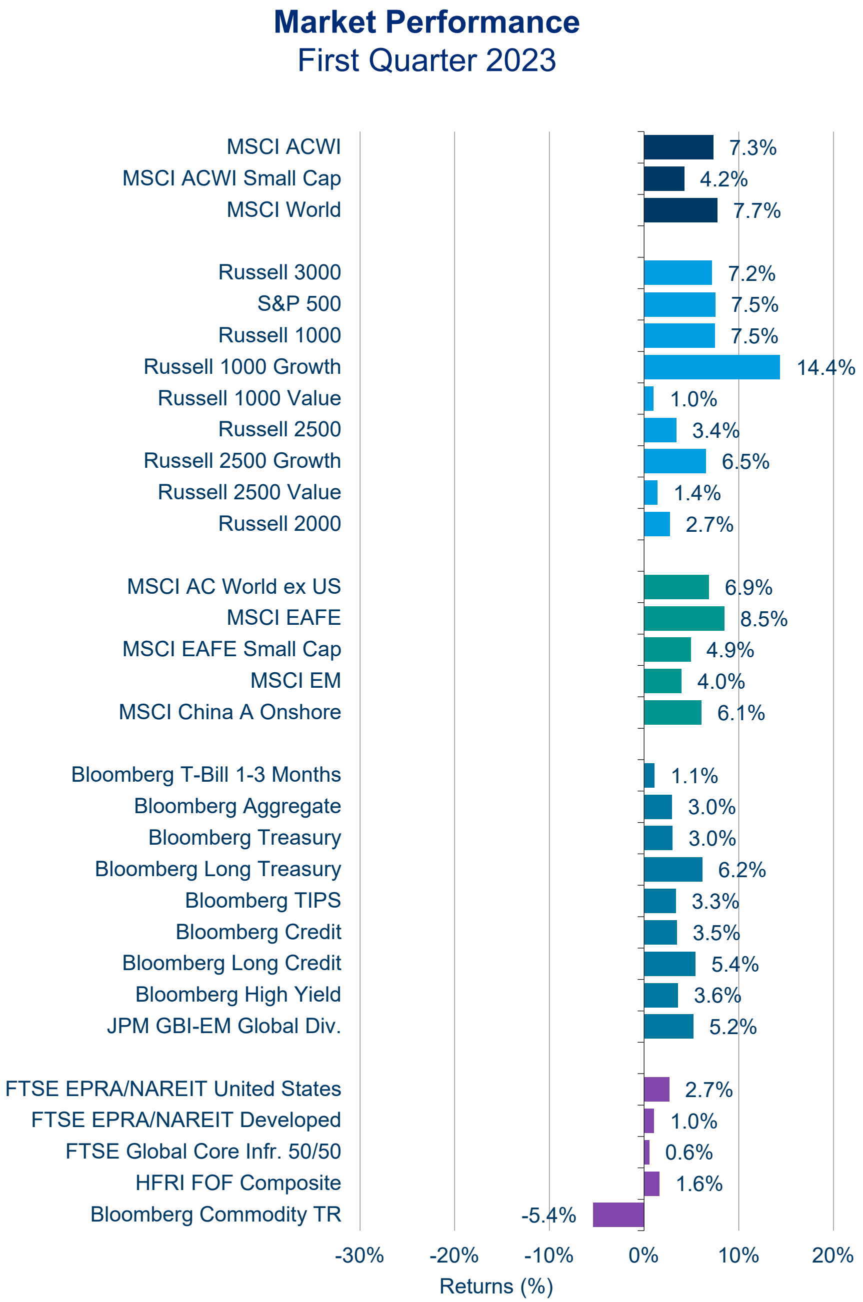
## Stocks and Bonds start the year higher, despite banking stress

- Global markets moved higher during the quarter as investors appeared to remain hopeful for a soft landing. However, volatility was elevated at times as stresses in the banking sector and uncertainty over monetary policy weighed on markets.
- Treasury yields generally finished the quarter lower than where they started the year, as markets repriced the outlook for monetary policy following the banking scare. The 10-year Treasury yield reached 4.1% in early March, but ended the quarter at 3.4%.
- The Bloomberg Aggregate Bond Index rose 3.0% in Q1, while the MSCI ACWI index rose 7.3%. During the first quarter, a traditional 60/40 portfolio rose 5.6%, but it remains down 6.1% over the past year.

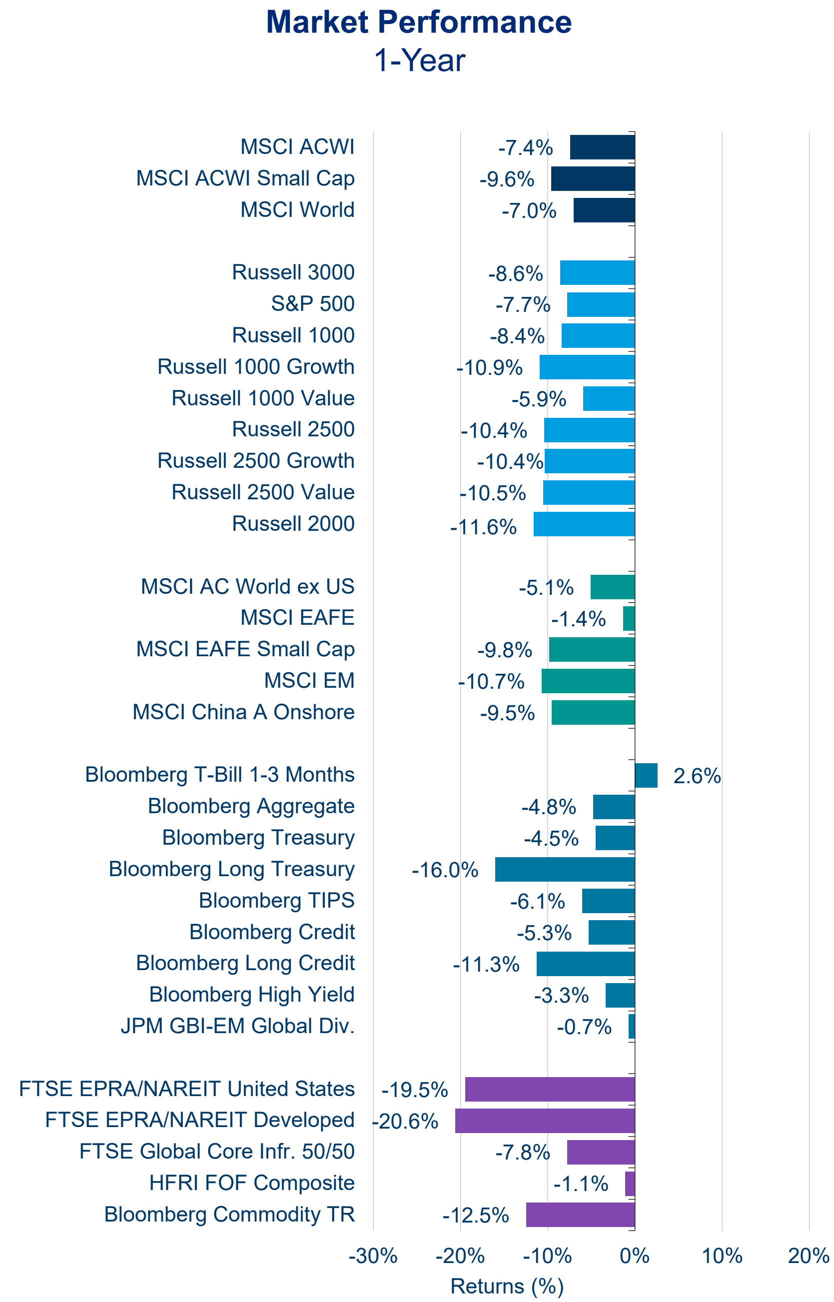
## Outlook Remains Uncertain

- Global economic growth has been more resilient than most economists expected. In the US, GDP grew at an annual rate of 2.6% during the fourth quarter, and economic data tended to surprise to the upside during the first quarter. This led the market to price the Fed to stay higher for longer into early March.
- However, in March signs of a potential banking crisis began to unfold. Silicon Valley Bank became the first in a string of banks to come under stress. Regulator intervention looks to have contained the crisis for the time being. The causes appear to be poor management at the affected organizations and it appears unlikely to develop into a broader, systemic issue. One potential result could be tighter lending standards, increasing the risk of a recession. It could also reduce the need for the Fed to tighten policy further. While the bond market has priced the potential for one more rate hike, it has priced an easing cycle to begin in the second half of 2023.
- Encouragingly, inflationary pressures have maintained their downward momentum. The gradual easing of supply chain issues and weaker demand resulting from tight policy should slow core inflation. One ongoing area of concern for the inflation picture is the continued strength of the labor market, although increases in average hourly earnings appear to be moderating.
- A mild recession in the US later in 2023 still appears likely. As long as inflation continues to fall towards the target, we do not expect a mild recession to be especially bearish for equities because it will allow the Fed to ease policy. Easier monetary policy could offset the negative impact of weak earnings for equities. The biggest downside risk we see for balanced portfolios is if inflation remains sticky amid a slowing economy. This could require a far more forceful Fed response than what is currently priced by markets and a deeper recession. This could result in further weakness in stocks and bonds.

# Performance summary




Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 3/31/23




Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 3/31/23

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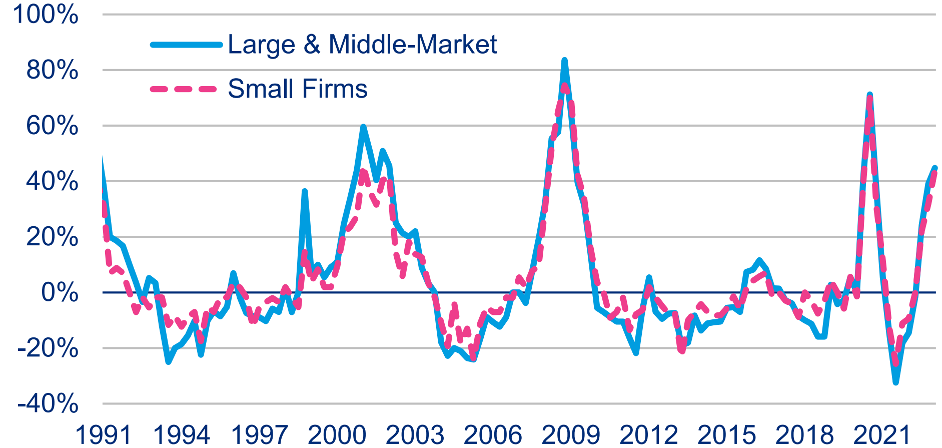
Past performance is no guarantee of future results

# Banking stresses may further tighten lending conditions

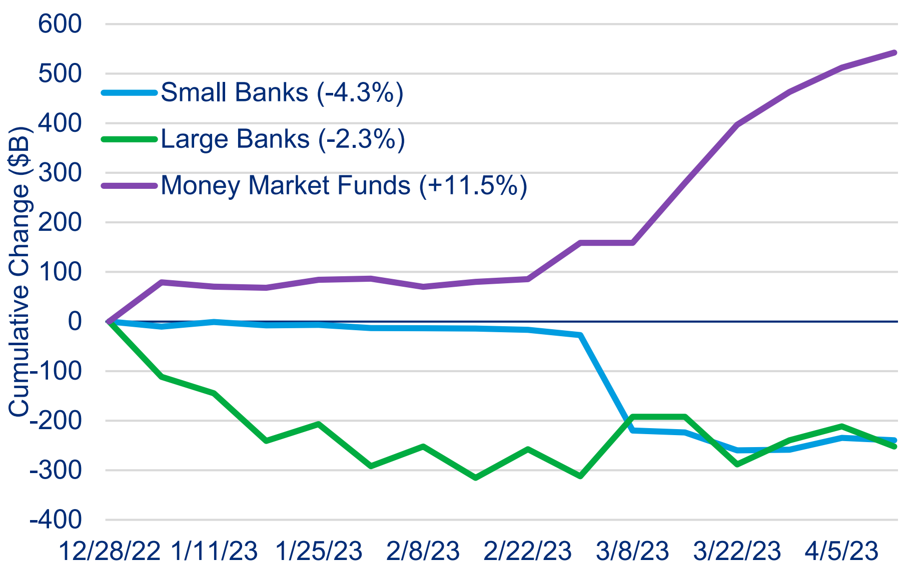
**The bank failures of March largely represented idiosyncratic issues rather than a systemic crisis, but these closures exacerbated deposit flows and increased risk aversion for smaller institutions. There was a shift of deposits out of small banks, as the stress unfolded. Some of these deposits found their way into larger banks, but money market funds appear to be the key benefactor, as depositors sought higher yields. Overall, the banking industry remains well capitalized, and contagion risks similar to the financial crisis are unlikely. The reduction in deposits, however, may further tighten lending standards, particularly for these smaller institutions.**

**Net Percent of Domestic Banks Tightening Standards for Commercial and Industrial Loans**



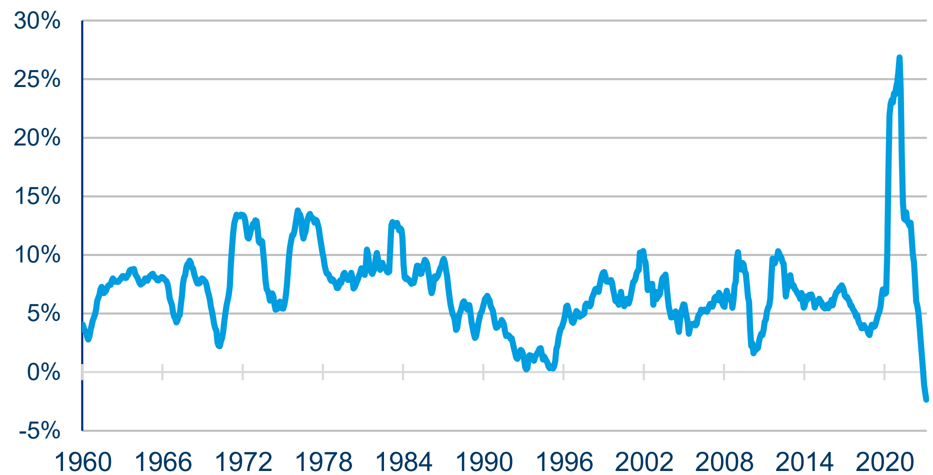

Source: Bloomberg, through 1/31/23

**Cash Movement**




Source: St. Louis Federal Reserve, ICI, through 4/12/23

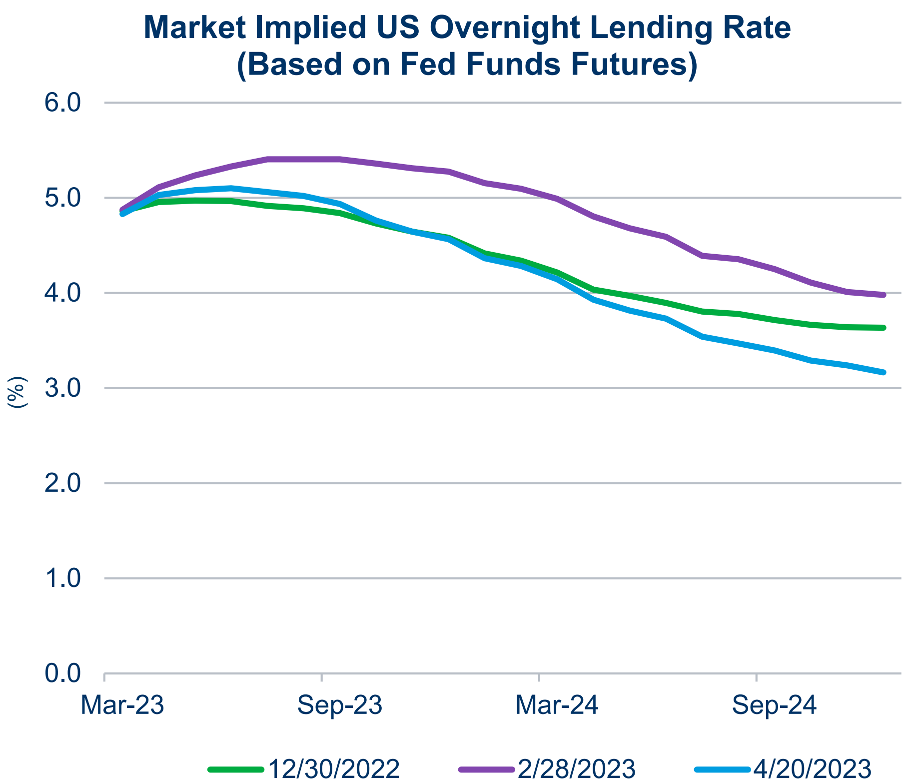
**Broad Money Supply (M2) Year-over-year Change**



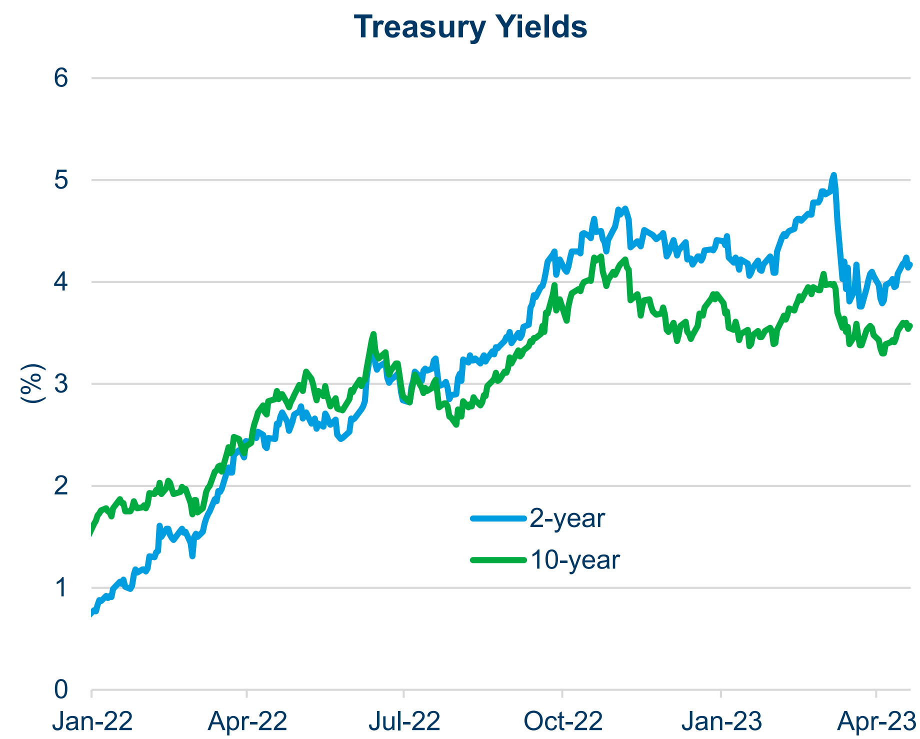

Source: Bloomberg, through 2/28/23

# Tighter lending conditions may reduce the need for further Fed tightening

**Positive economic data led the market to price in more Fed tightening in the first two months of the quarter, with the 2y yield briefly topping 5%. Banking stresses, however, led to a sharp reversal. The 2y yield fell by more than 100 bps from its early-March peak. The impact on lending could reduce the need for the Fed to tighten policy further. While the market expects one additional rate hike at the May meeting, it has priced more than 200bps of rate cuts by the end of 2024. A risk for both stocks and bonds is that these rate cuts do not materialize due to sticky inflation and/or stronger than expected growth.**



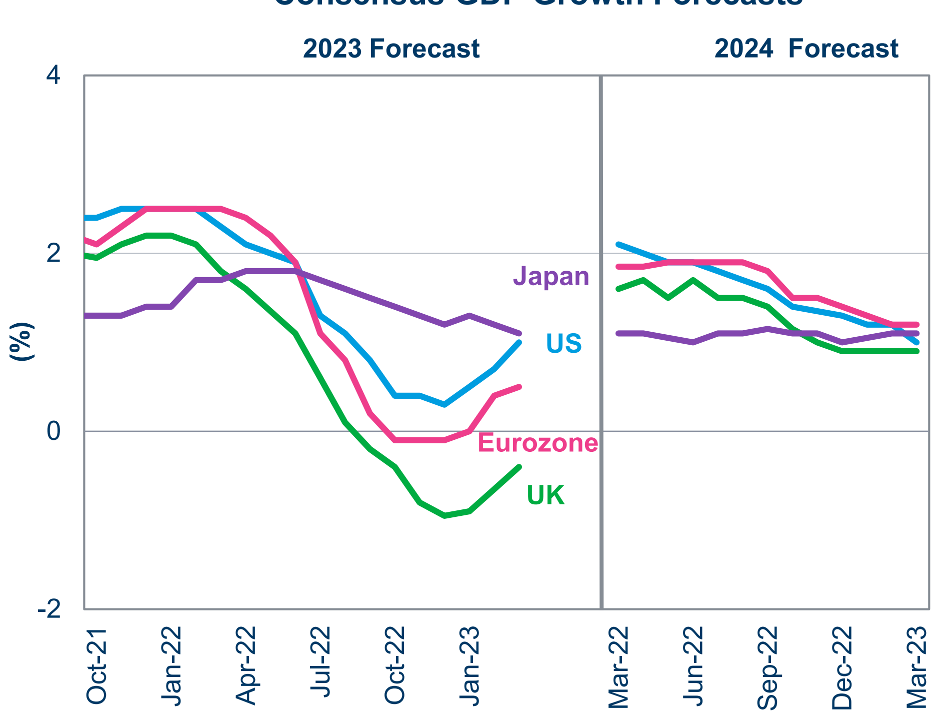

Source: Bloomberg



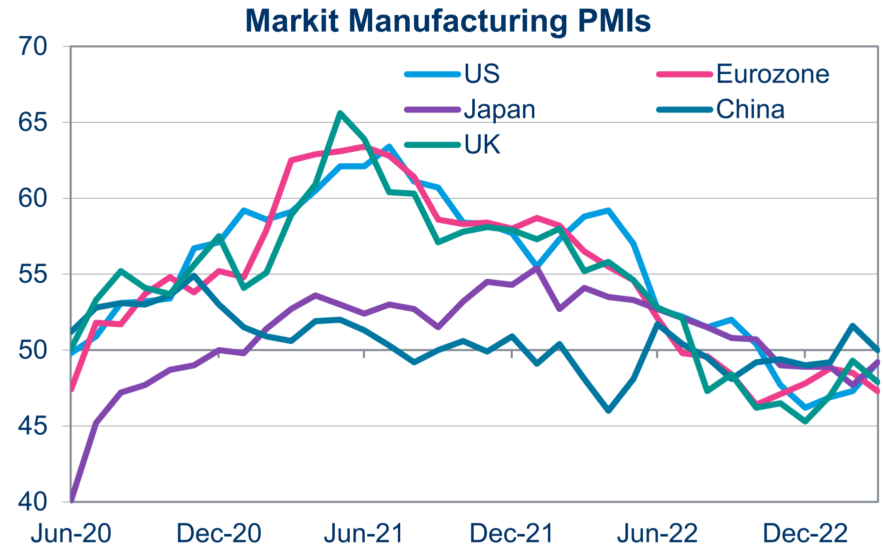

Source: Bloomberg, through 4/20/23

# Economic growth has been surprisingly resilient, but a mild recession still appears likely

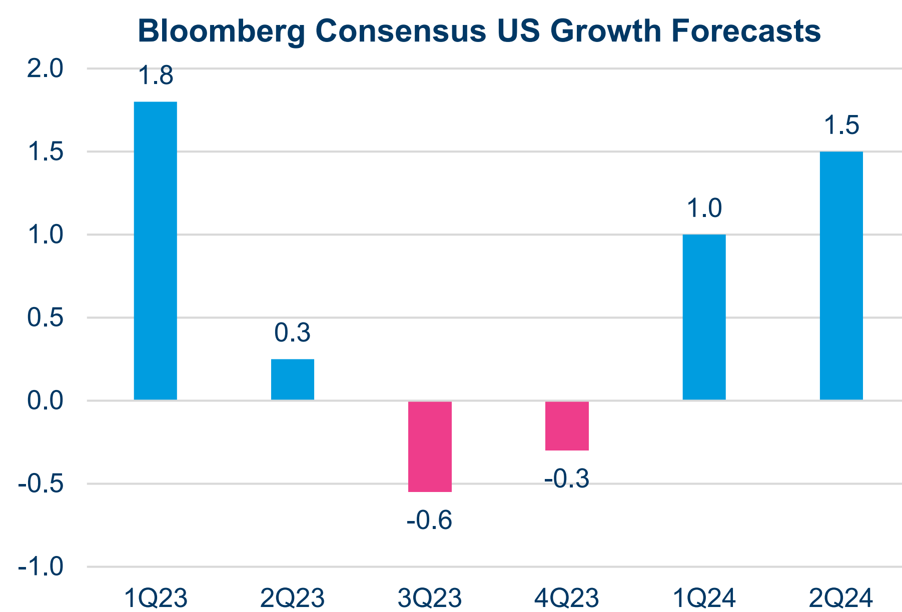
**Economic growth expectations coming into the year were weak. A warmer than expected winter, China's reopening, and resilient consumer spending have helped moderate the expected slowdown in 2023. As a result, economists have ratcheted up 2023 growth forecasts. While expectations have improved, significant uncertainty remains. The probability that the economy slips into a mild recession later in 2024 remains elevated. We think a hard landing is unlikely given the financial strength of US households.**




Source: Bloomberg; as of 3/31/23



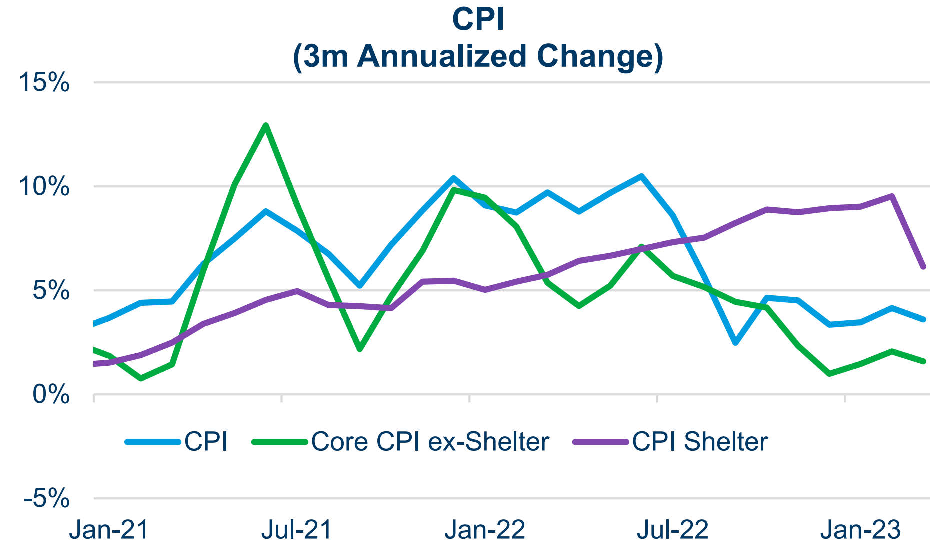

Source: Bloomberg; as of 3/31/23



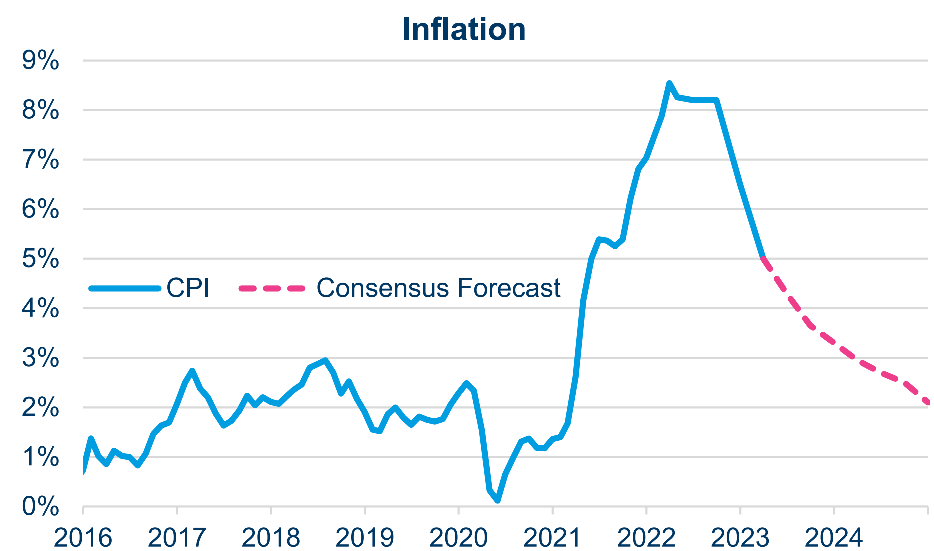

Source: Bloomberg; as of 4/21/23

# Inflation pressures have eased, but the labor market remains tight

**Inflation has continued to fall, with prices showing a 5% year-over-year increase through March. The housing component, which is heavily lagged, has kept the core CPI elevated at 4.5%. Encouragingly, core inflation ex-housing has increased at only a 1.6% annualized rate over the last three months. Wage growth has eased, but remains elevated. With the labor market remaining tight, wage pressures could take some time to return to more normal levels, which might keep the Fed cautious even if the CPI falls back to target in 2023.**




Source: Bloomberg; through 3/31/23




Source: Bloomberg; CPI through 3/31/23, forecasts as of 4/14/23


Source: Bloomberg; through 3/31/23

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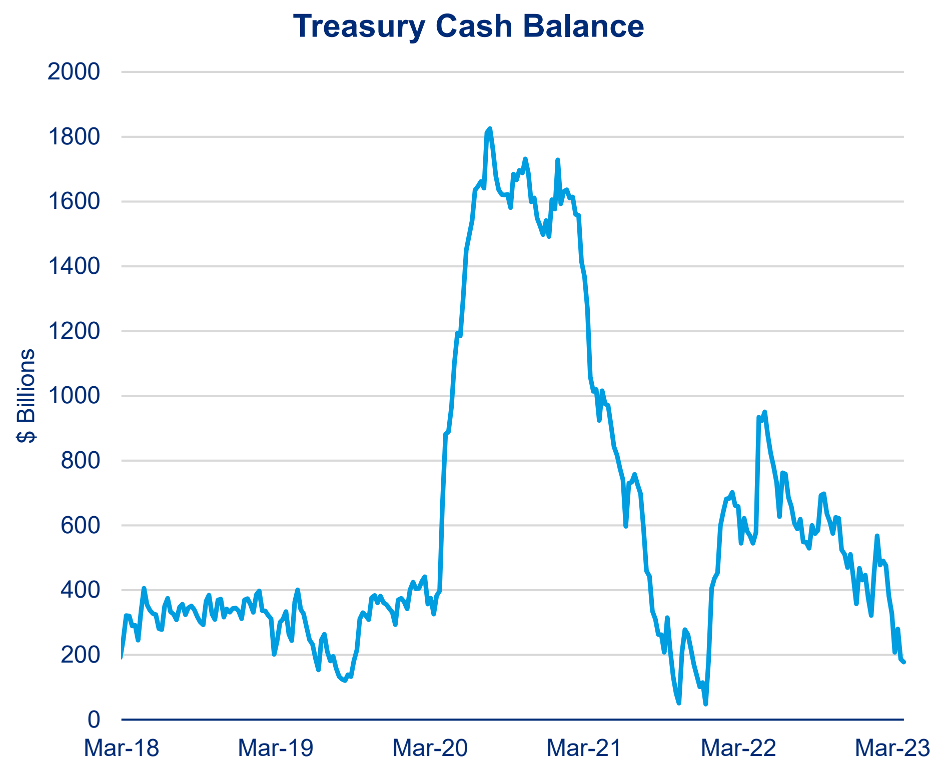
# The debt ceiling debate may lead to higher volatility in the coming months

**The US reached its debt ceiling in January; however, the Treasury department is employing measures to meet current payments and spending.  Recent statements from Treasury officials suggest that these measures could run out as soon as June 1. The lack of an agreement will likely breed uncertainty and volatility. This has resulted in the costs to insure US debt rising in 2023 to near 2011 levels when the US government debt rating was downgraded. Failure to raise the limit could force a US government shutdown or potential default which would likely generate a material shock for markets and the economy.**

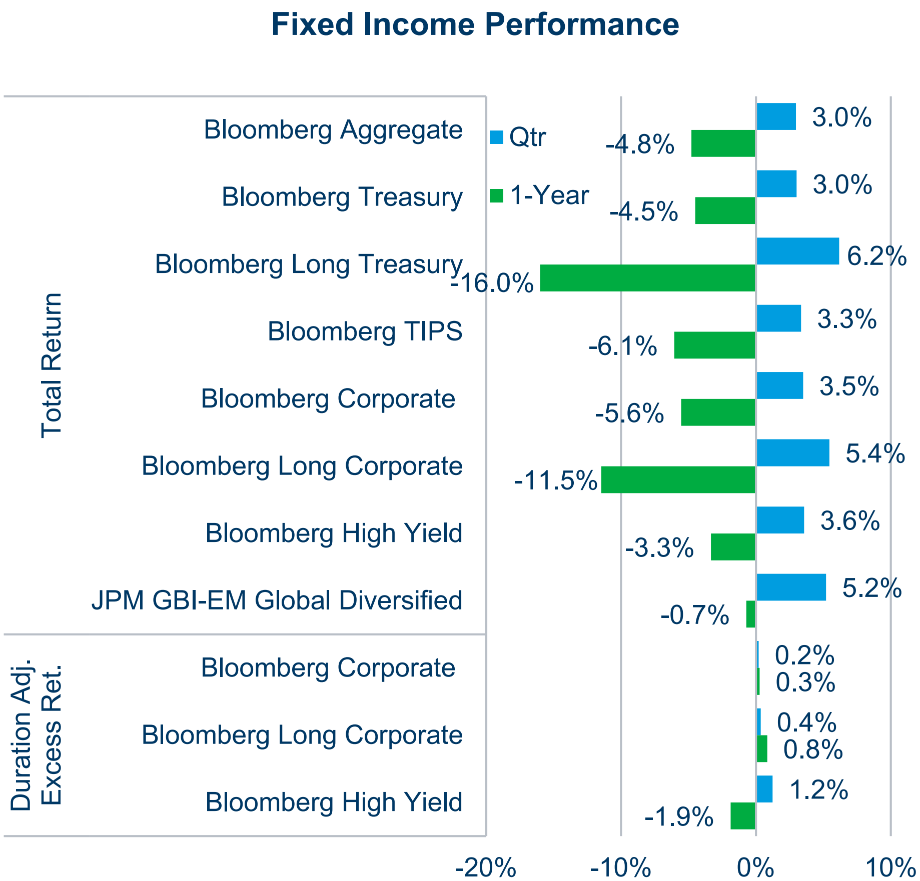

Source: Bloomberg; through 3/31/23



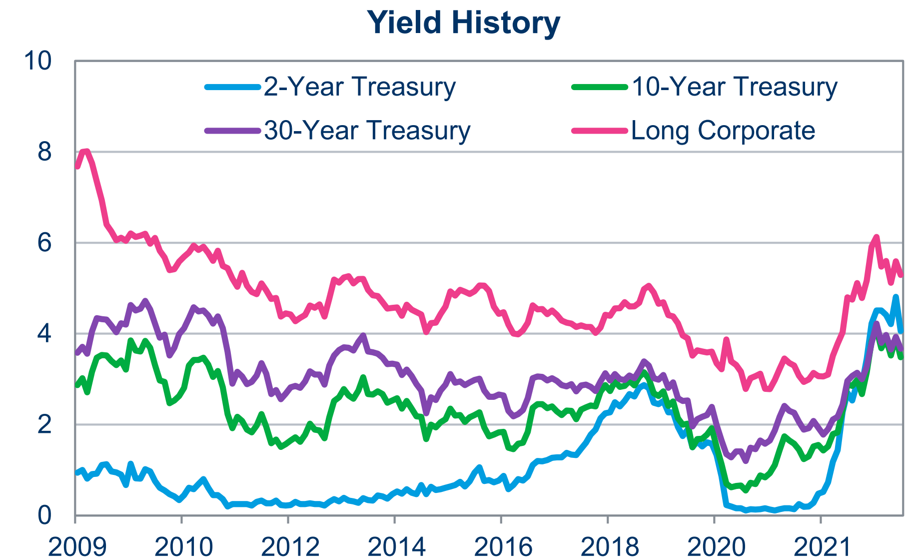

Source: Bloomberg; through 3/31/23

# What happened in fixed income in Q1?

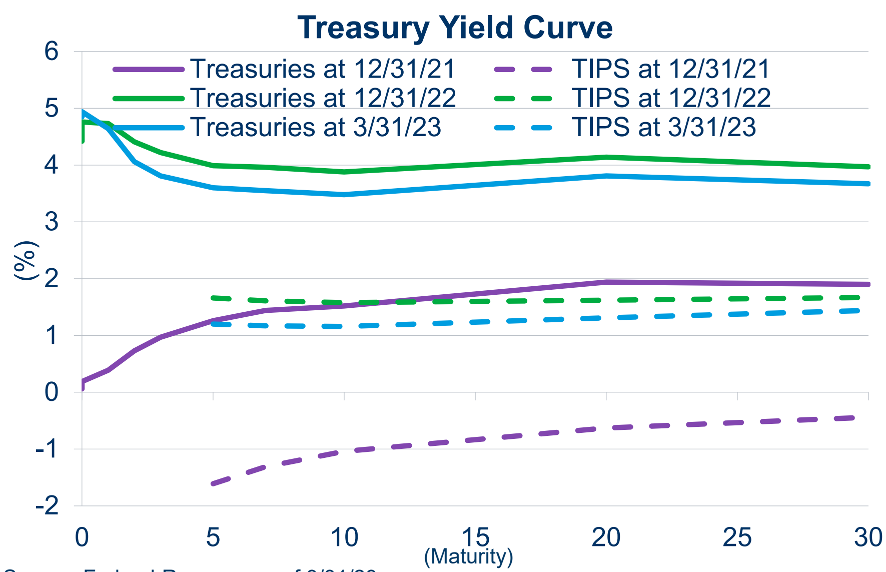
**Fixed income delivered solid gains in Q1, although the Bloomberg Aggregate remains down 4.8% over the past year. Longer-term yields moved lower during the quarter, but remain significantly higher than pre-2022 levels. The 10-year Treasury yield fell from 4.1% to 3.8% during Q1. Credit spreads experienced mixed results during Q1, with investment-grade spreads rising 8 bps, while high yield spreads fell by 14 bps. TIPS outperformed Treasuries due to a modest increase in inflation-breakeven rates.**




Source: Bloomberg, Datastream; as of 3/31/23




Source: Bloomberg, Federal Reserve; as of 3/31/23




Source: Federal Reserve; as of 3/31/23

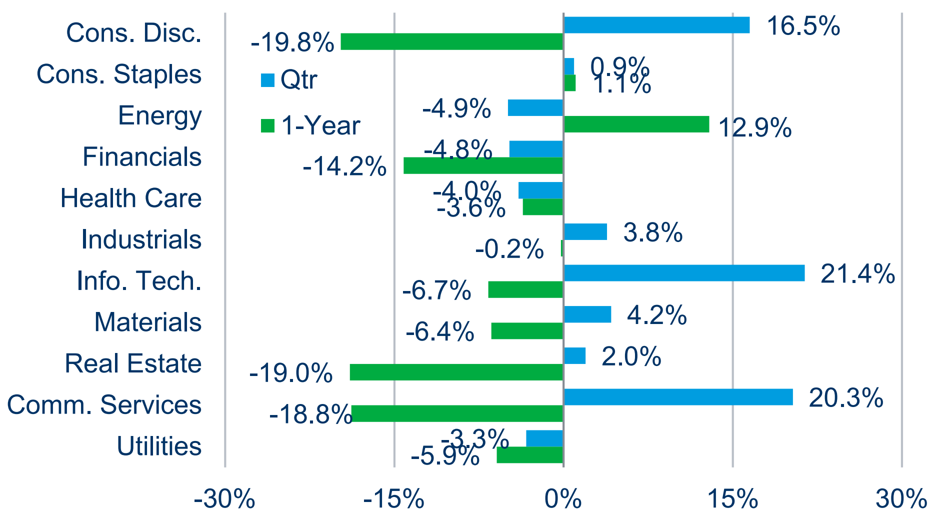
# What happened in equity markets in Q1?

**Equities delivered strong gains in Q1, with the MSCI ACWI rising 7.3%. Growth stocks outperformed during the quarter, and large-cap stocks outperformed small-caps. Technology and communication services were the best performing sectors during Q1, while Energy remains the best performing sector over the past year. MSCI EAFE performed similarly to the S&P 500 in local terms during Q1, with US dollar weakness adding 100 bps to US$ returns.**

### 1Q23 US Style Performance (%)

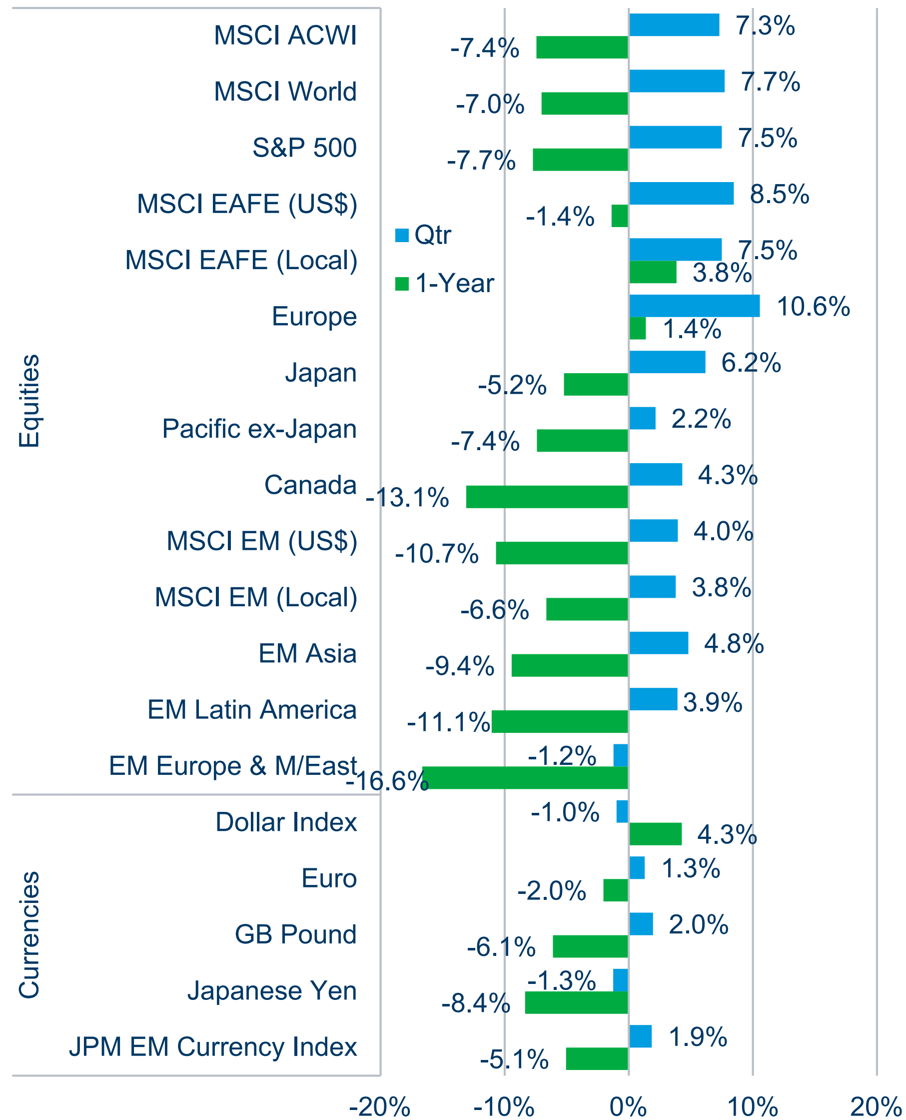
| | Value | Blend | Growth |
|---|---|---|---|
| Russell Top 200 | 0.85 | 8.67 | 15.6 |
| Russell Midcap | 1.32 | 4.06 | 9.14 |
| Russell 2000 | -0.66 | 2.74 | 6.07 |

### MSCI USA Sector Returns




Source: Bloomberg; as of 3/31/23

### Global Performance

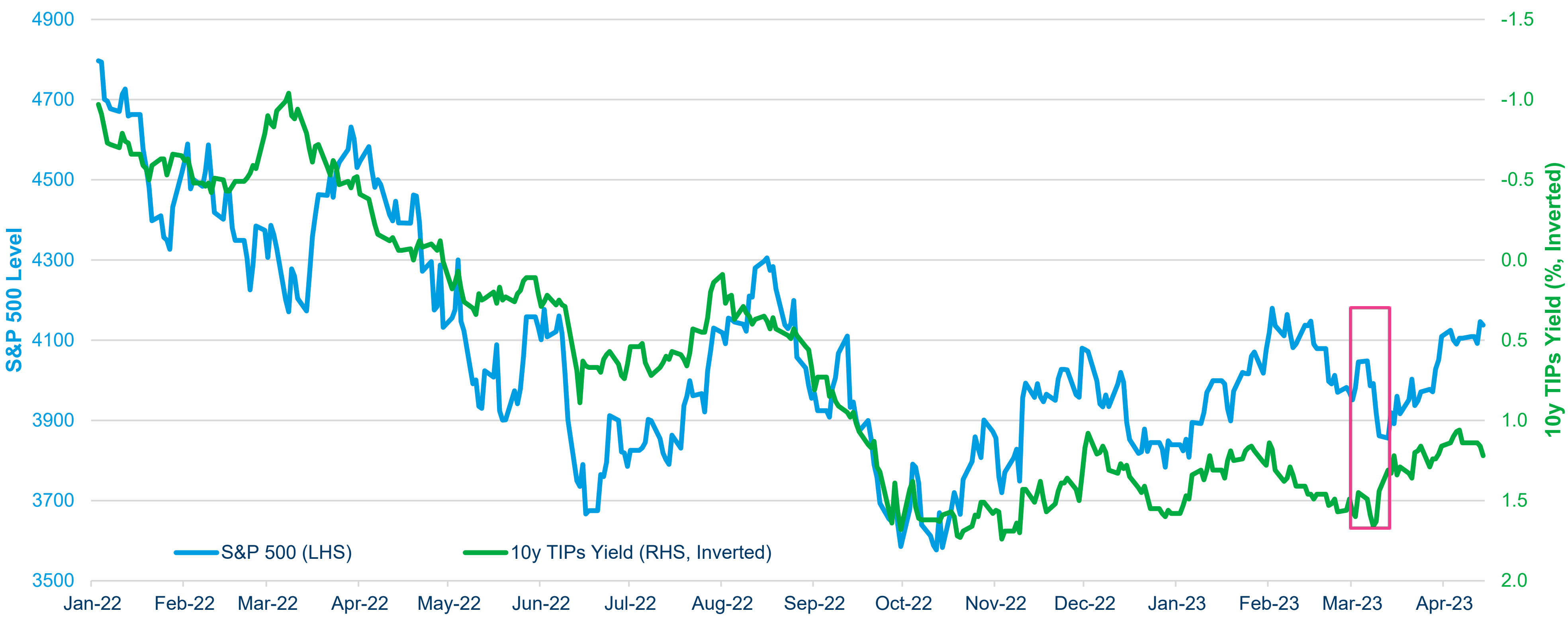



Source: Bloomberg, Datastream; as of 3/31/23

# The outlook for inflation and monetary policy is likely to continue to drive equity markets

**The S&P 500 continues to be sensitive to the real yield on TIPS. The recovery in markets since October 2022 has generally tracked a reduction in the real yield, although this broke down briefly in early-March on banking concerns. Looking ahead, the outlook for inflation and its impact on Fed policy likely will remain the key driver of the market's direction. A reversal in market pricing for Fed rate cuts is a risk for equities.**

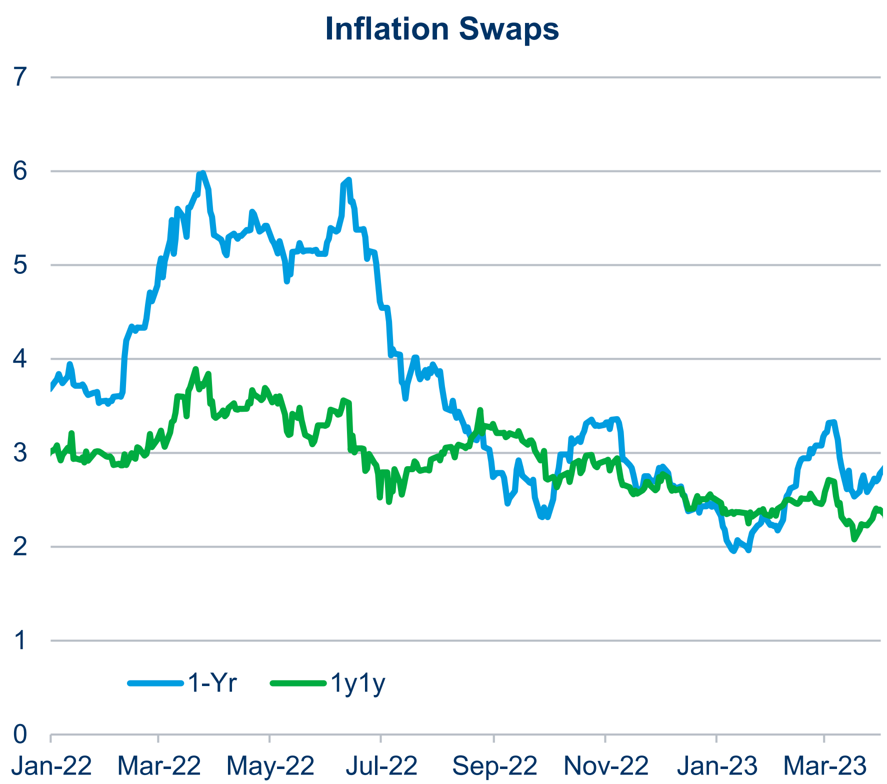
**S&P 500 and 10y TIPs Real Yield**



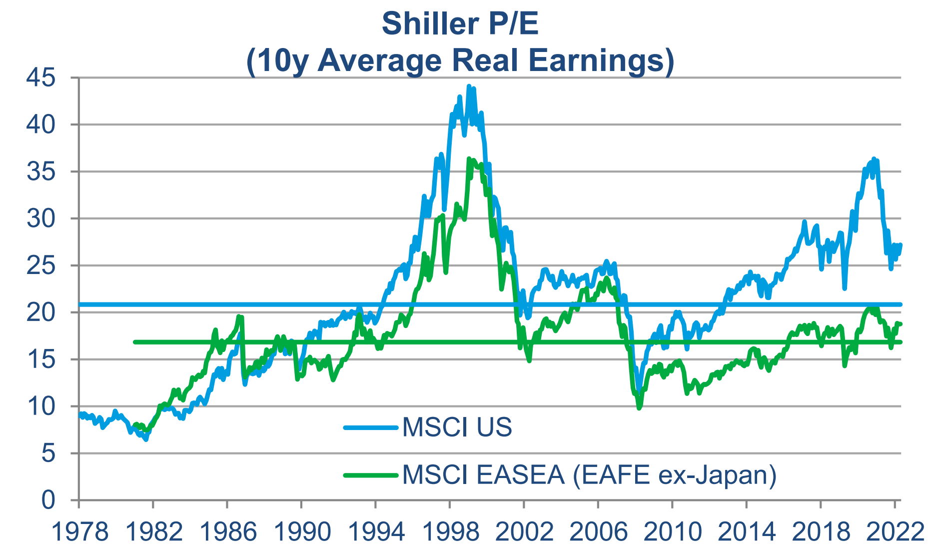

Source: Bloomberg; through 4/14/23

# Equity markets appear priced for a mild recession and weaker monetary policy

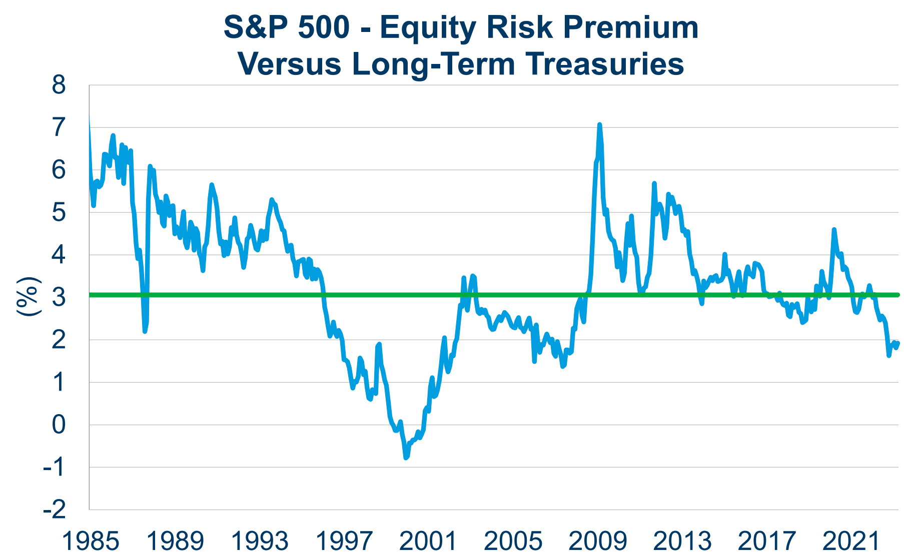
**Equity valuations ticked higher in Q1 due to appreciation. However, the prospective equity risk premium was close to flat amid lower long-term interest rates. Still, the equity risk premium is thin by historical standards, especially considering elevated recession risks. Historically, the equity risk premium has tended to rise going into recessions. Valuations could also come under pressure should inflation prove stickier than markets expect, requiring the Fed to keep rates higher for longer.**




Source: Bloomberg, Mercer; as of 3/31/23




Source: Datastream, MSCI, Mercer, through 3/31/23

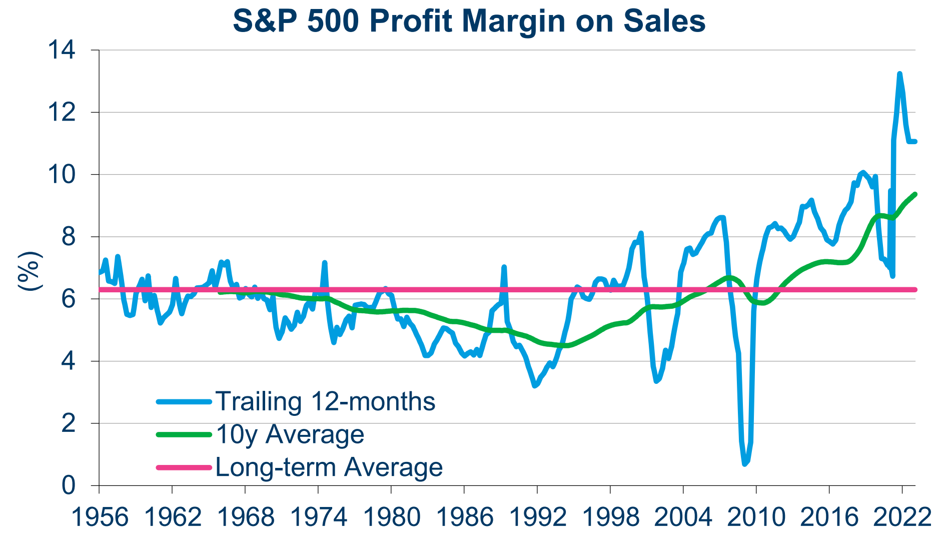



Note: the equity risk premium represents a normalized earnings yield on the S&P 500 less the real return on 30y Treasuries.

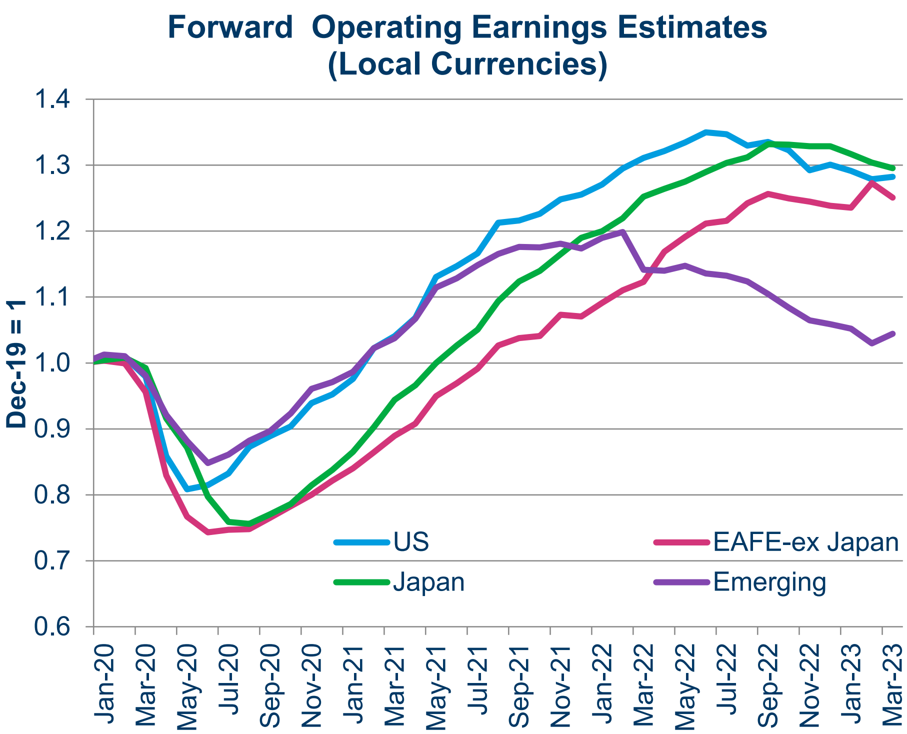
Source: Bloomberg, Refinitiv, Mercer, through 3/31/23

# Earnings estimates likely have further to fall

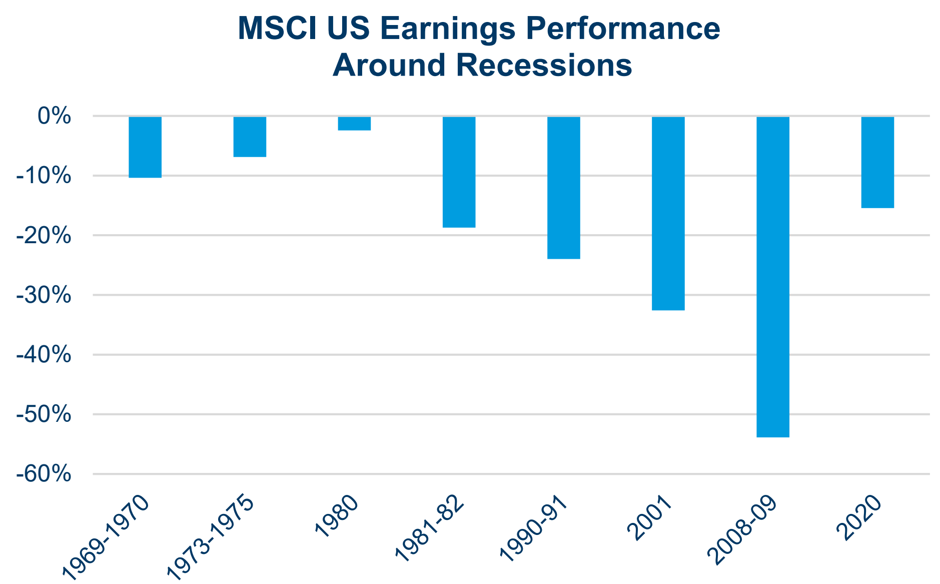
**Analysts have slowly been trimming earnings expectations. Forward earnings estimates have been marked lower by 5% since peaking in mid-2022. Even a mild recession could lead to more significant cuts. Wage growth has moderated, but could still cut into profit margins as inflation-adjusted wages remain positive. The market might, however, look through a period of weak earnings in a mild recession, especially if it is accompanied by a reduction in interest rates.**




Source: S&P, through 3/31/23




Source: Datastream, through 3/31/23




Source: Datastream, Mercer calculations

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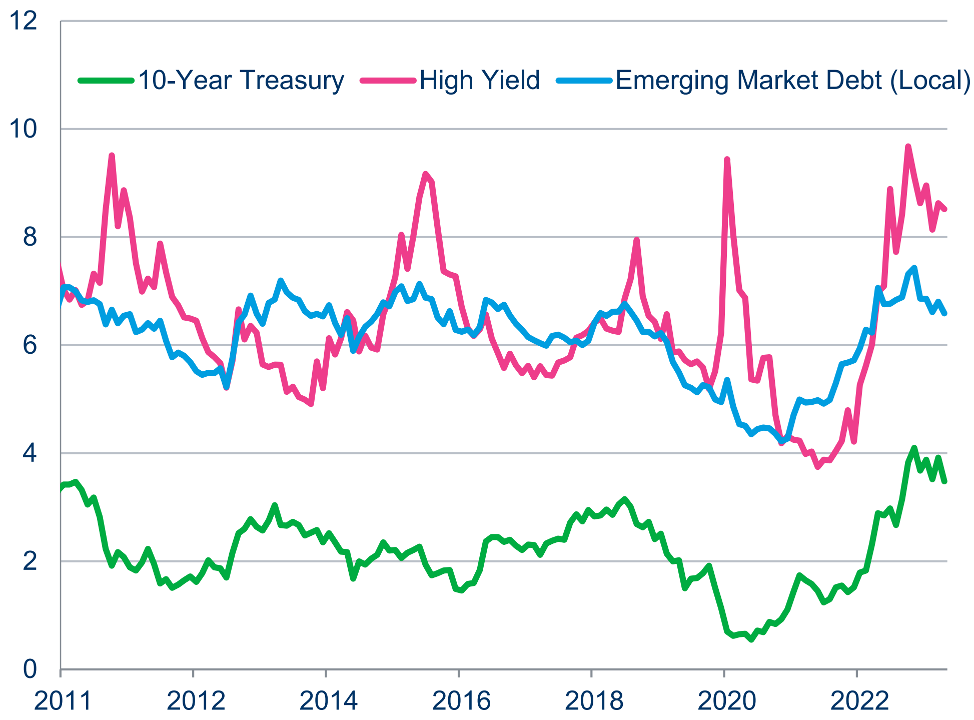
# We prefer riskier credit over equities

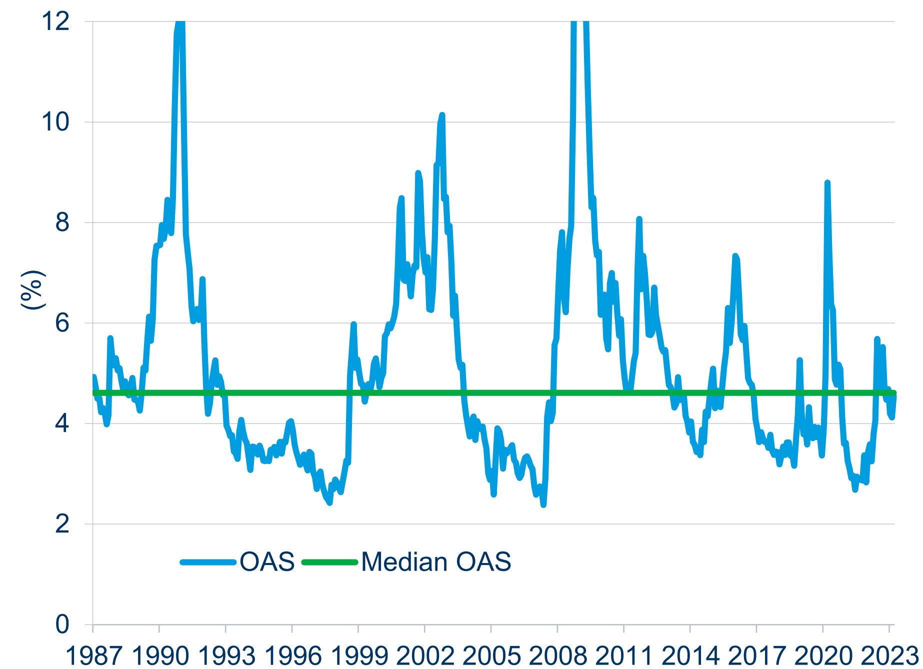
**The increase in interest rates has improved the return outlook for fixed income. High yield bonds offer a yield around 8.5%. The spread to Treasuries of 4.5% isn't compelling considering recession risks. However, we think high yield bonds offer a better reward-to-risk than equities. The 8.5% yield provides a healthy cushion against rising defaults should the economy experience a hard landing. We expect equites would perform much worse in such a scenario. In the event of a mild recession, we expect high yield to perform competitively with equities.**

**Yield History**




Source: Bloomberg, Federal Reserve; as of 3/31/23

**High Yield Bond Option Adjusted Credit Spread**

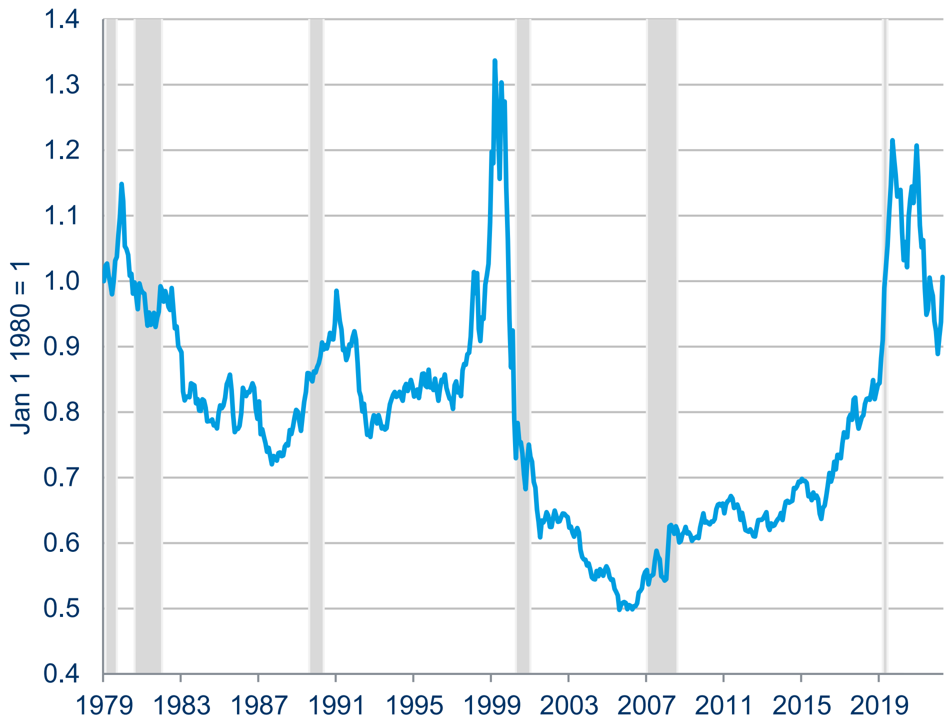



Source: Bloomberg; through 3/31/23

# We continue to favor value over growth

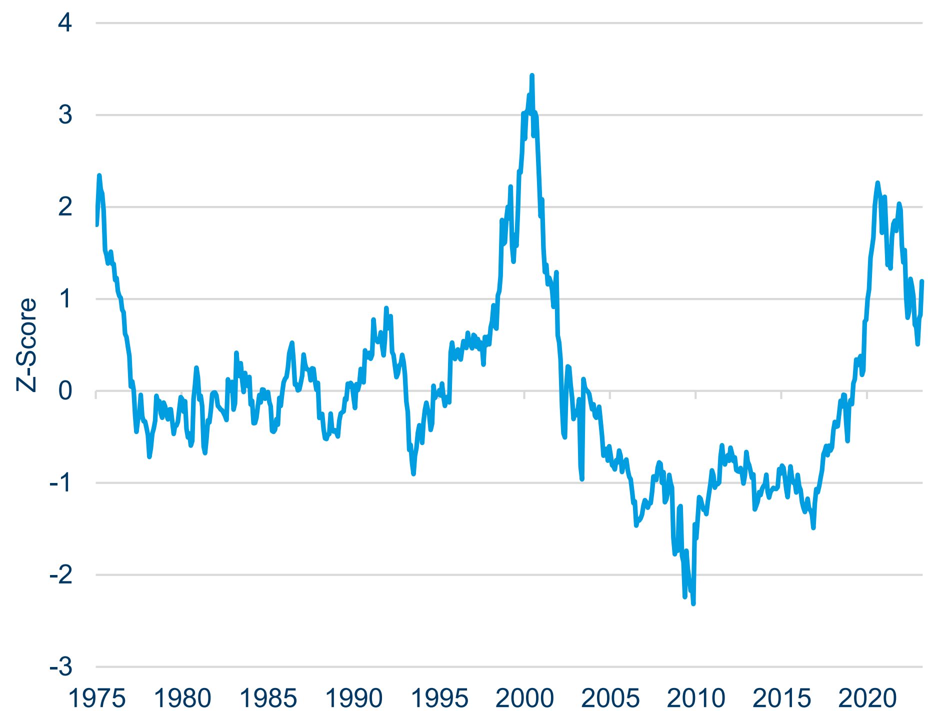
**US growth stocks performed strongly in the first quarter. The Russell 1000 Growth index outperformed its value counterpart by more than 13 percentage points. The decline in interest rates and banking woes likely contributed to growth's outperformance. Still, value has outperformed by roughly 12 percentage points since the start of 2022. We continue to favor value stocks. Growth's strong quarter has re-widened its valuation gap to value. Moreover, style performance tends to exhibit long, multi-year cycles, with momentum eventually causing an overshoot. As such, growth's outperformance this quarter could prove to be a cyclical snap-back within a potential value cycle.**

**Relative Performance**
**Russell 1000 Growth / Value**




Source: Bloomberg; as of 3/31/23

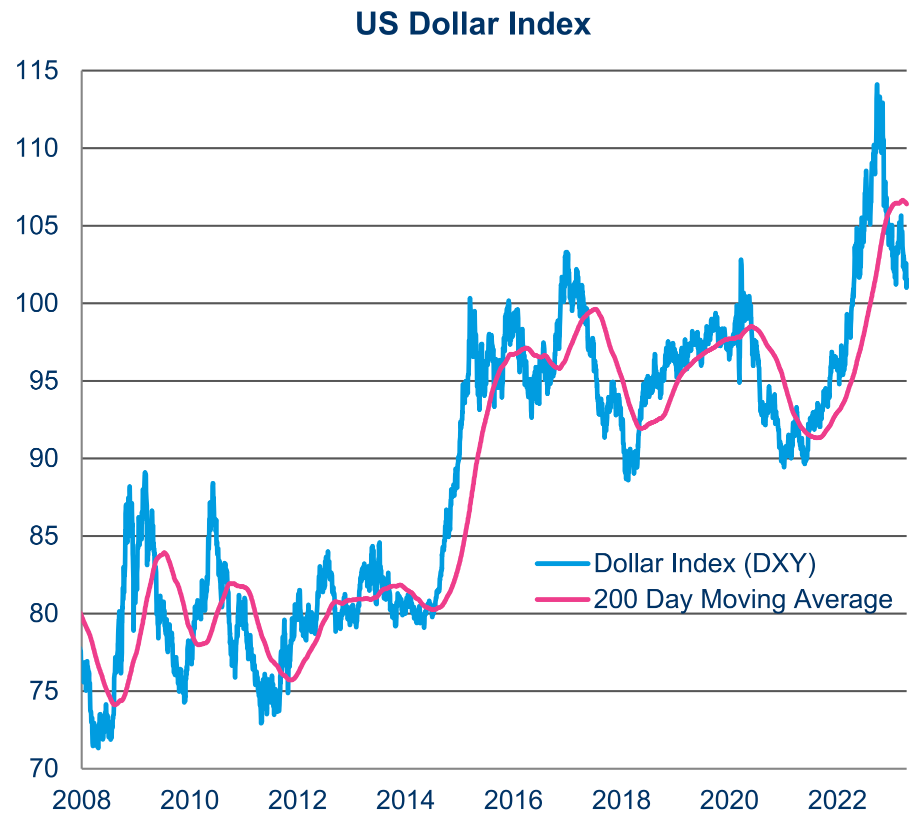
**Valuation of MSCI US Growth to Value**
**(Based on P/B, P/CF, P/E and FPE)**



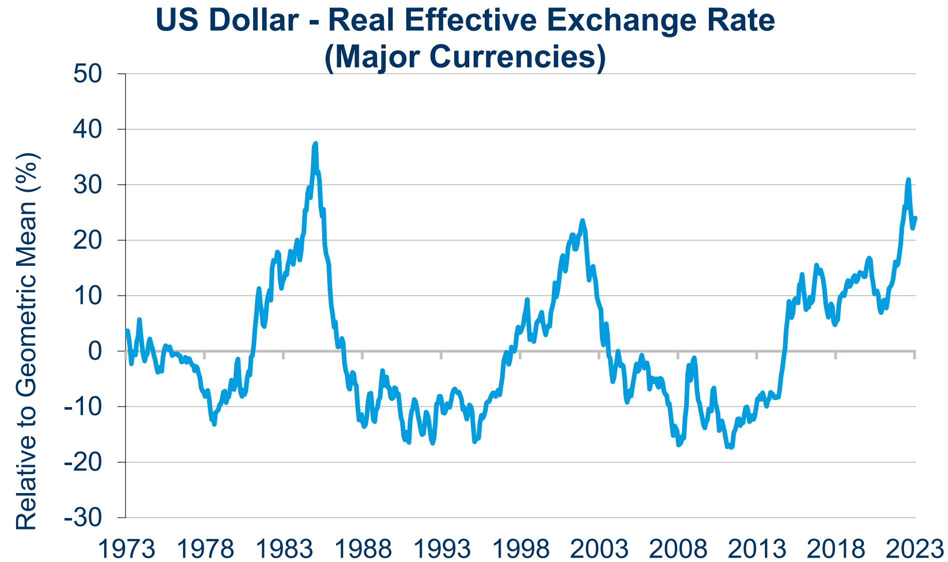

Source: Datastream, through 3/31/23

# The dollar is showing further signs of weakness

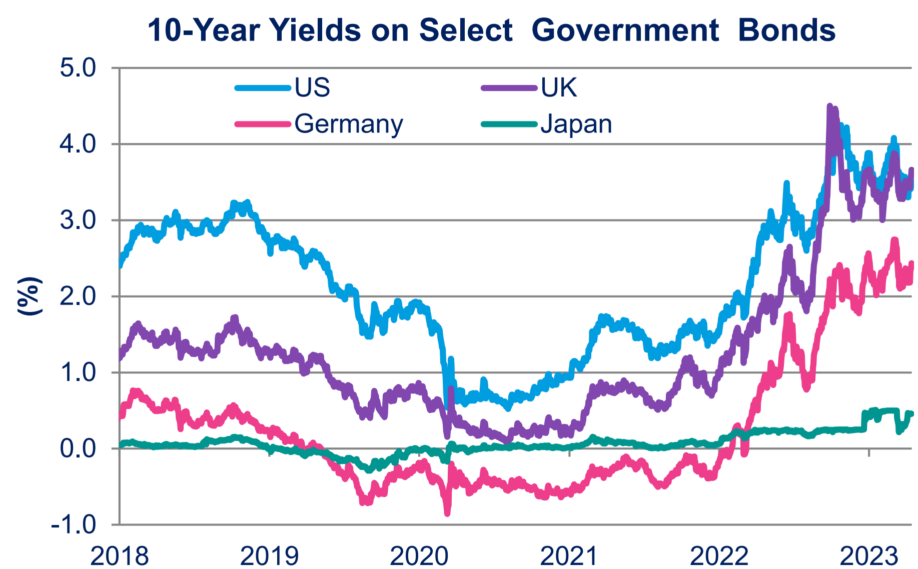
**Since peaking in September 2022, the dollar index (DXY) has tumbled more than 10%. This has been influenced by improving economic prospects outside the US and narrowing interest rate differentials. Nevertheless, the dollar's real effective exchange rate remains more than 20% above the long-term average, suggesting the potential for further weakness. With the wide US current account deficit and improving international fundamentals, the dollar could come under further pressure.**




Source: Bloomberg, through 4/14/22




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

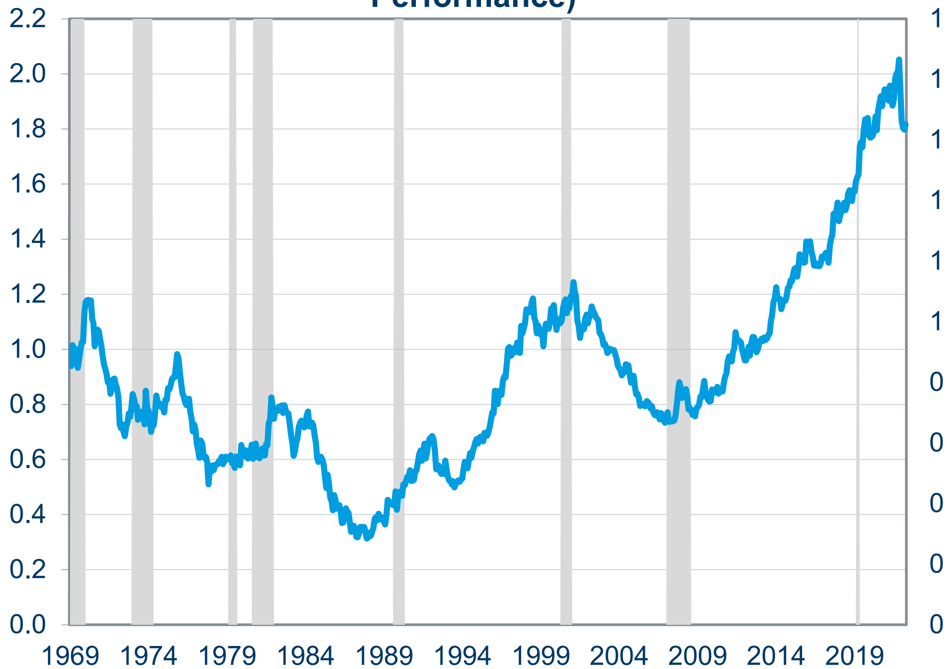



Source: Bloomberg; as of 4/14/23

# International equities continued to show positive momentum

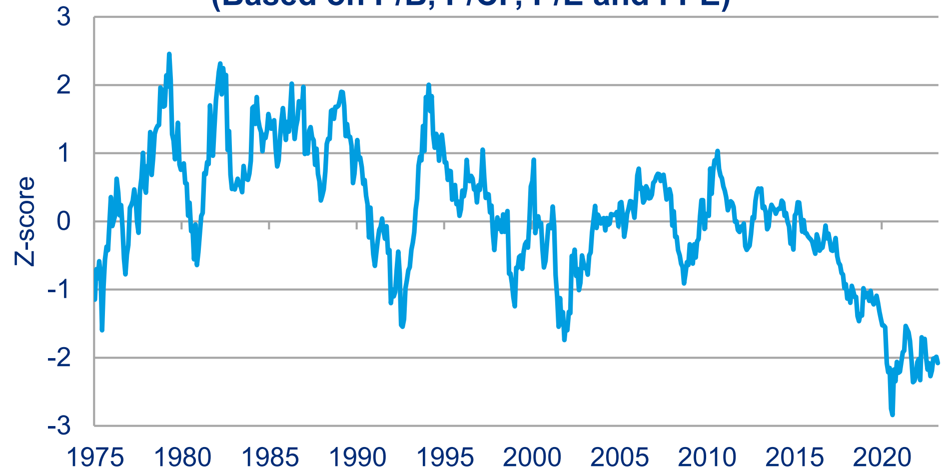
**The MSCI EAFE index narrowly outperformed the S&P 500 during Q1, adding to its performance advantage since the start of 2022. EM equities, however, underperformed as enthusiasm over China's reopening waned. We continue to expect international developed and emerging markets to outperform the US over the intermediate-term. Valuations are attractive versus the US. In addition, the dollar remains expensive. The reopening of China should also provide a tailwind to not only emerging markets, but also Europe and Japan.**

**Ratio of MSCI US to MSCI EAFE (Relative Performance)**



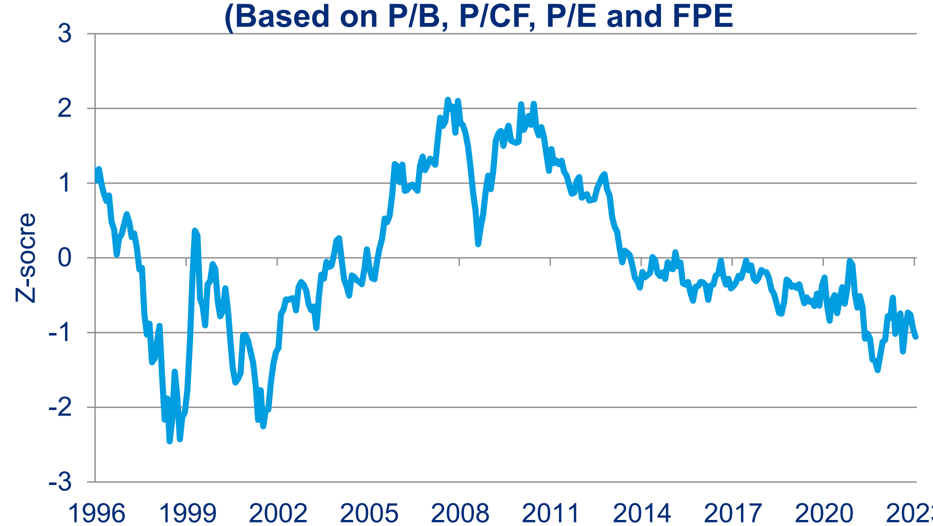

Source: Datastream; as of 3/31/23

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




Source: Datastream, through 3/31/23

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




Source: Datastream, through 3/31/23

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