

Market Environment Standard Report

First Quarter 2023

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%. Over the past one-year a 60/40 portfolio remains down 6.1%.

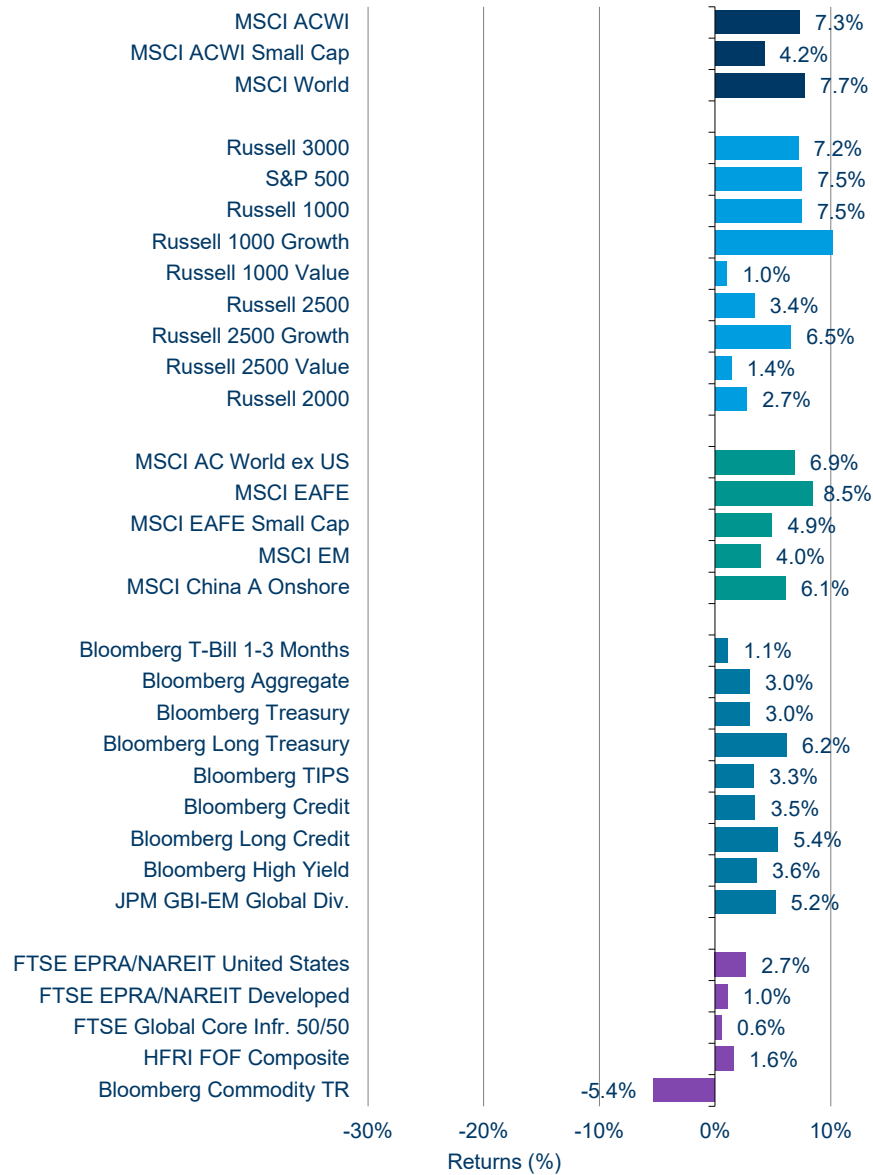
Outlook Remains Uncertain



- 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. 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.

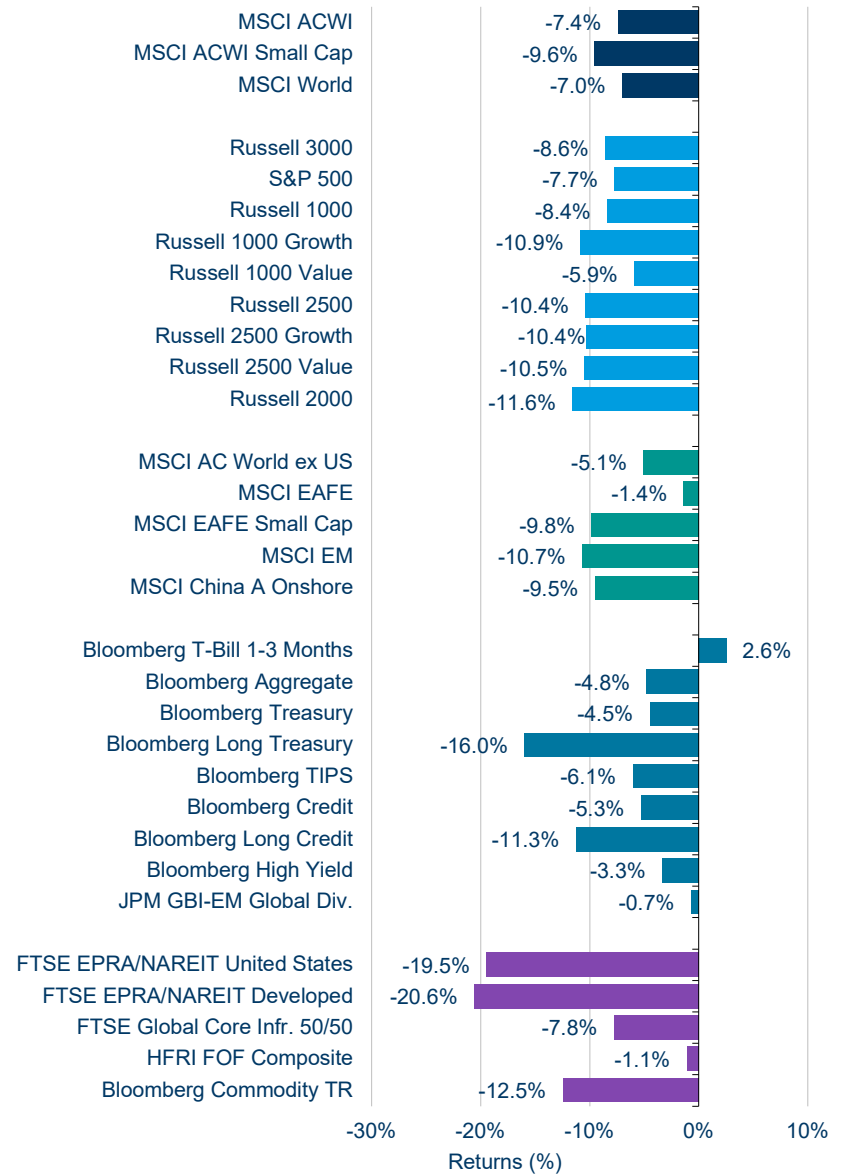
Performance summary

Market Performance First Quarter 2023



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

Market Performance 1 Year

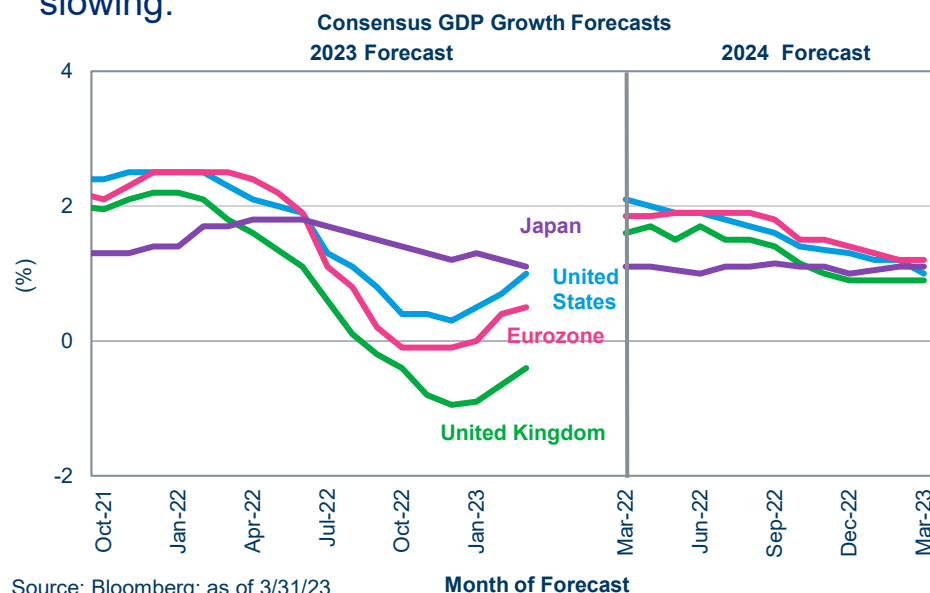


Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 3/31/23

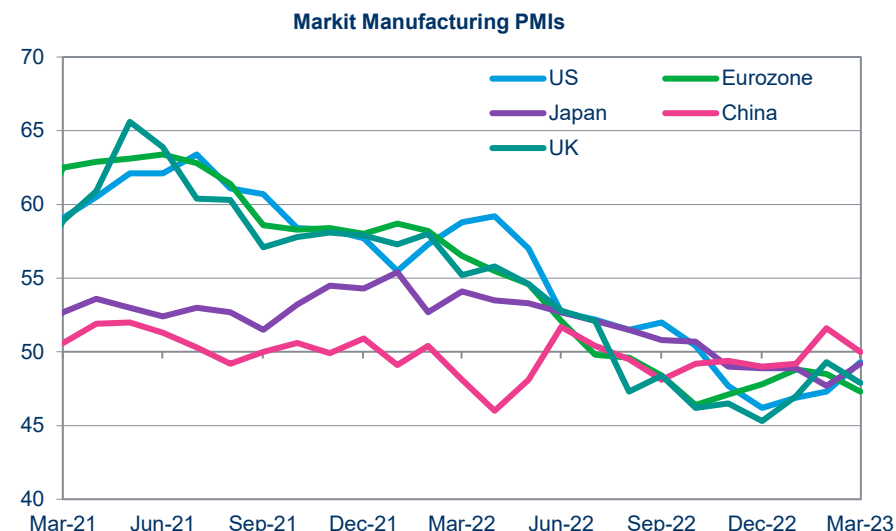
Economic fundamentals

Economic growth remains resilient amid a weakening outlook

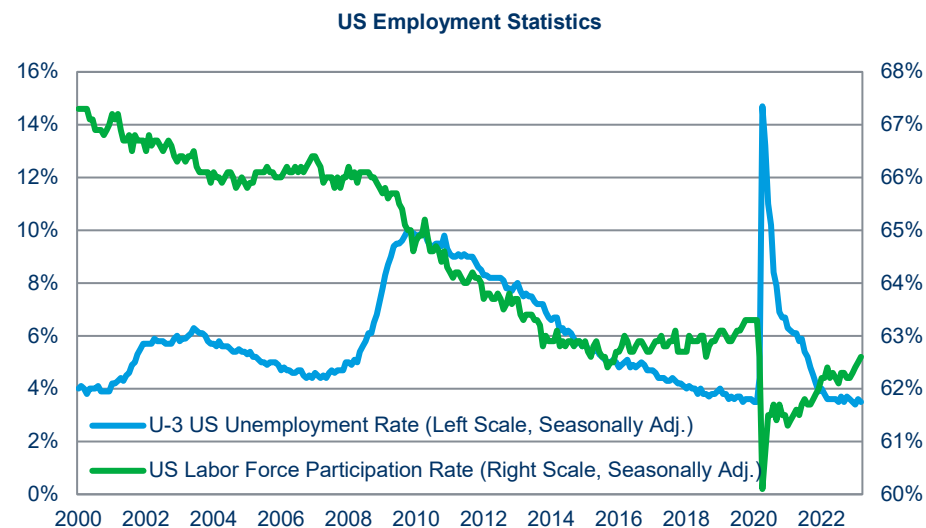
- Economic growth generally remained strong during the quarter, although the outlook continues to weaken as most developed market central banks maintain their hawkish stances. Consensus growth forecasts for 2023 improved for most regions, while forecasts for 2024 generally trended lower.
- Manufacturing PMIs remain at contractionary levels for most major regions as the demand outlook weakened.
- Despite recent layoffs that have primarily affected the tech sector, the US labor market remains tight. The unemployment rate (U-3)¹ ended the quarter at 3.5%, and the labor force participation rate is nearing pre-Covid levels. Wage growth, however, appears to be slowing.



¹ The U-3 unemployment rate represents the percentage of the civilian labor force that is jobless and actively seeking employment.



Source: Bloomberg; as of 3/31/23

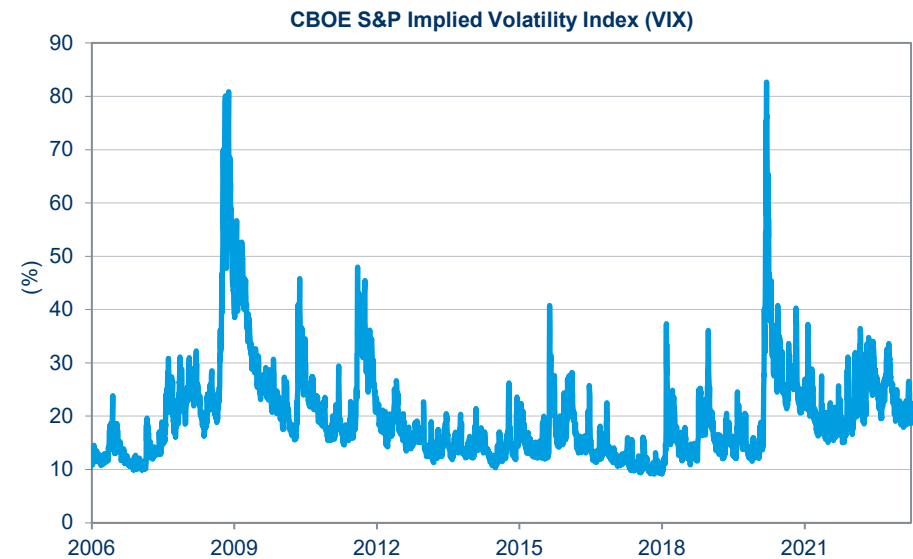


Source: Bureau of Labor Statistics; as of 3/31/23

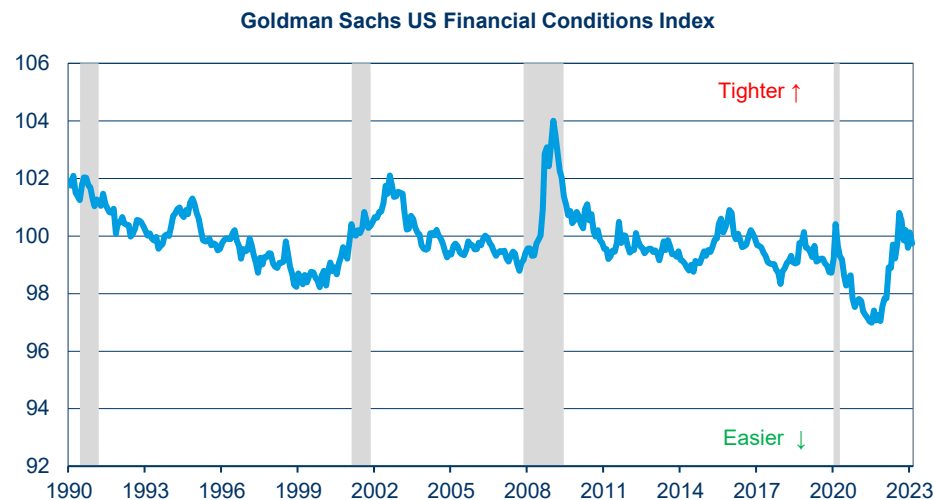
Risk factors

US inflation slows, but remains elevated. Banking risks appear contained for now

- The challenges in the banking sector that emerged in March appear to be contained for now. However, we could see tighter lending standards as a result, which would have a similar effect to tightening financial conditions.
- US inflation continued its downtrend during the quarter, but it remains above the Fed's targeted level.
- The VIX volatility index fell from 22 to 19 during the quarter, remaining fairly stable outside of a brief spike during banking concerns in March¹.
- The Goldman Sachs US Financial Conditions Index fell modestly during the quarter, suggesting easier financial conditions due to falling interest rates, but it may not yet fully capture any decline in credit availability from banks.

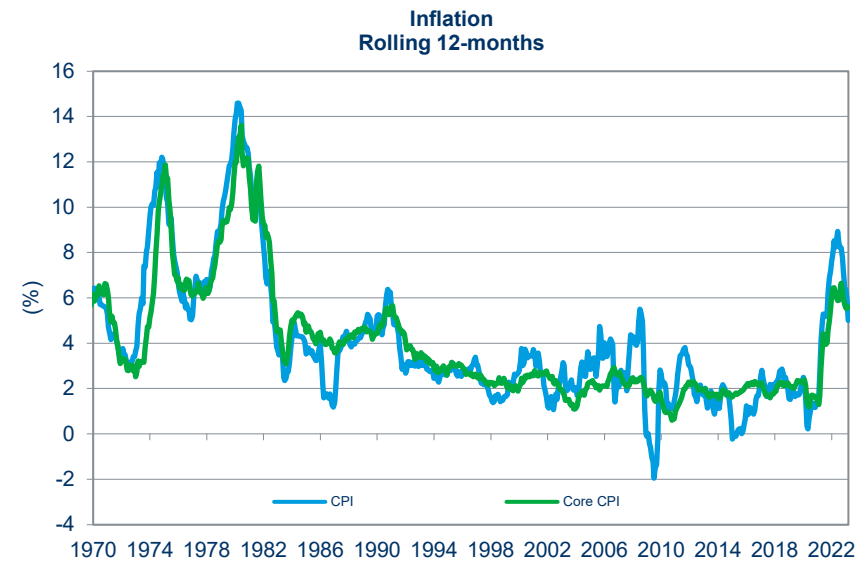


Source: Bloomberg; as of 3/31/23



Source: Bloomberg; as of 3/31/23

¹ Source: Bloomberg; as of 3/31/23

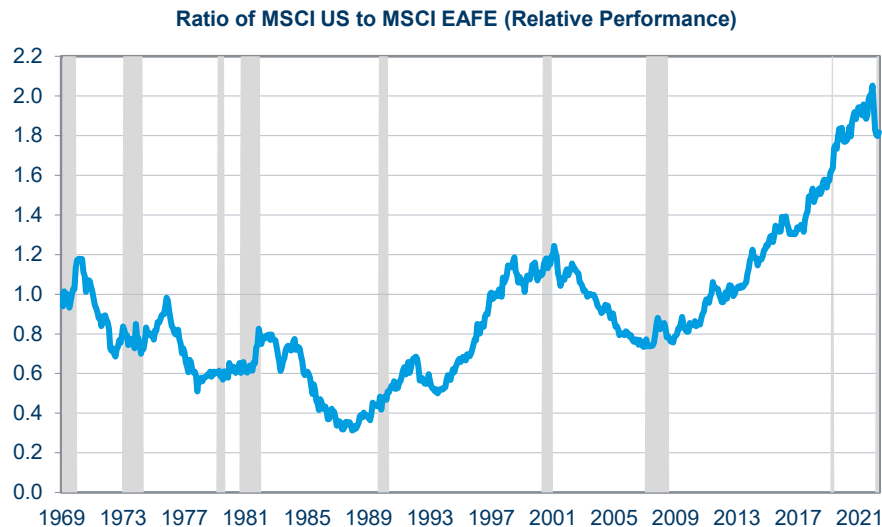


Source: Bloomberg; through 3/31/23

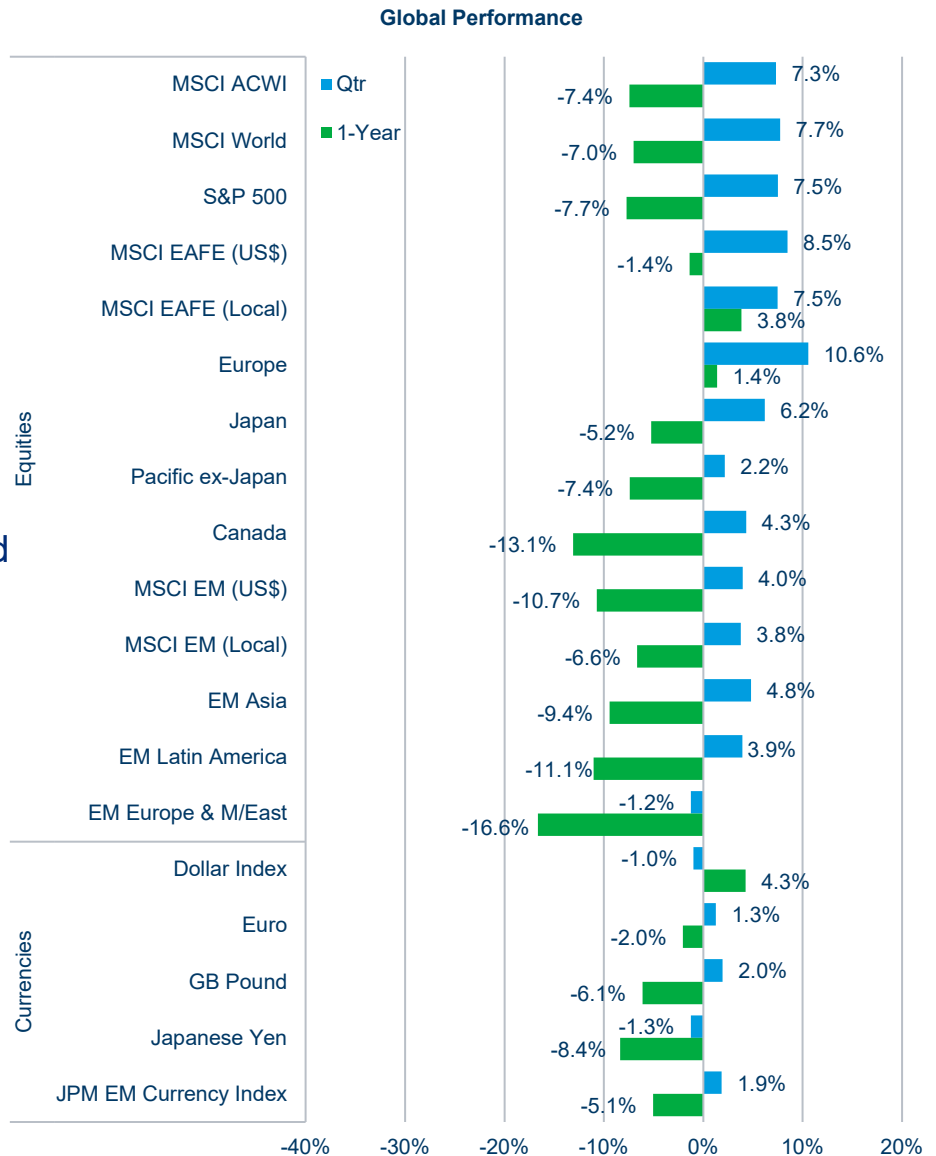
Regional equity returns

Global equities deliver another quarter of strong gains

- Global equities posted gains during Q1, with the MSCI ACWI index rising 7.3%. The index has declined 7.4% over the past one-year.
- The S&P 500 gained 7.5% during the quarter, but it remains down 7.7% over the past year.
- International developed stocks gained 8.5% in Q1, and are down 1.4% over the past year. A weaker dollar added 100 bps to US\$ returns during the quarter.
- Emerging market equities rose 4.0% in Q1, and have declined 10.7% over the past year. Asian emerging markets were the best performing EM region over the quarter and the past year, while emerging European and Middle Eastern countries have lagged.



Source: Datastream; as of 3/31/23

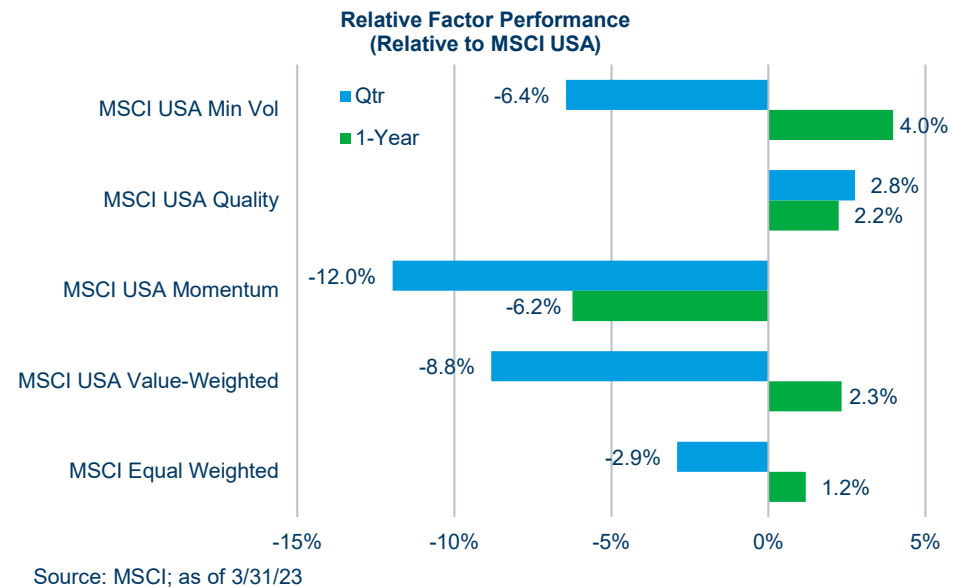
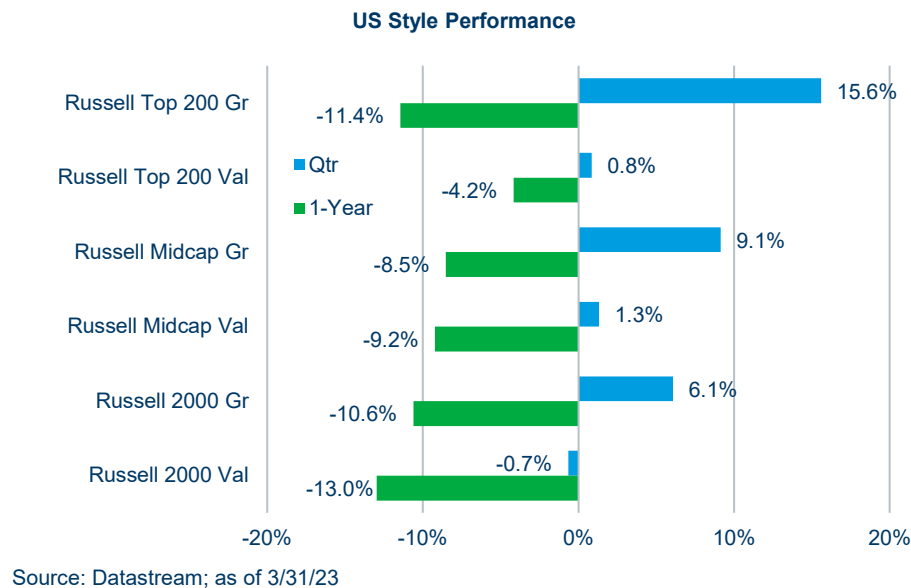
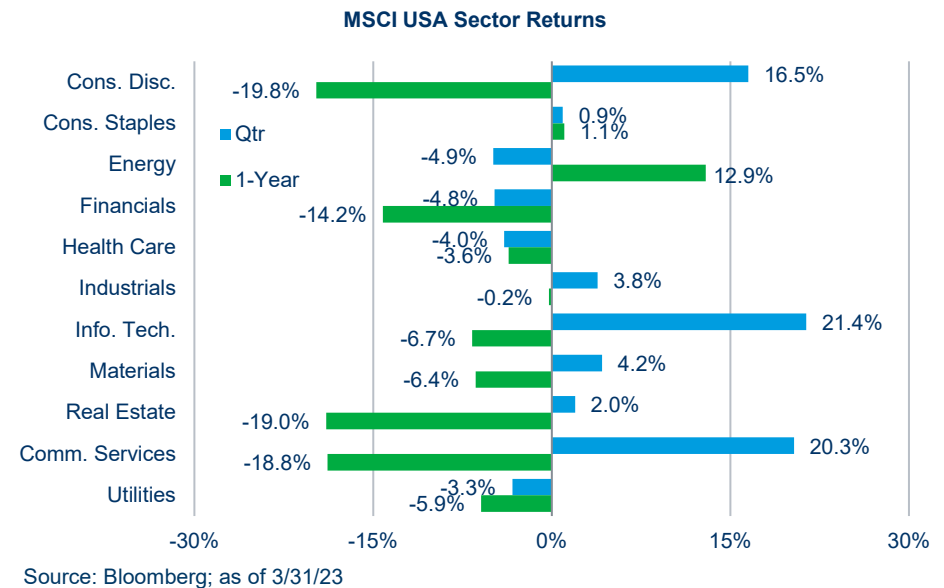


Source: Bloomberg, Datastream; as of 3/31/23

US equity factor and sector returns

Growth stocks rebound and outperform during Q1

- Small-caps underperformed large-caps during Q1 and over the past year. Growth stocks outperformed value stocks during the quarter. Large-cap growth was the best performing style segment during Q1.
- The quality factor produced the strongest results during the quarter, while the momentum and value factors lagged. Minimum volatility has been the best performing factor over the past year.
- Technology, communication services and consumer discretionary were the best performing sectors during Q1, while the energy and financials sectors lagged. Energy has been the best performing sector over the past year, returning almost 13%.

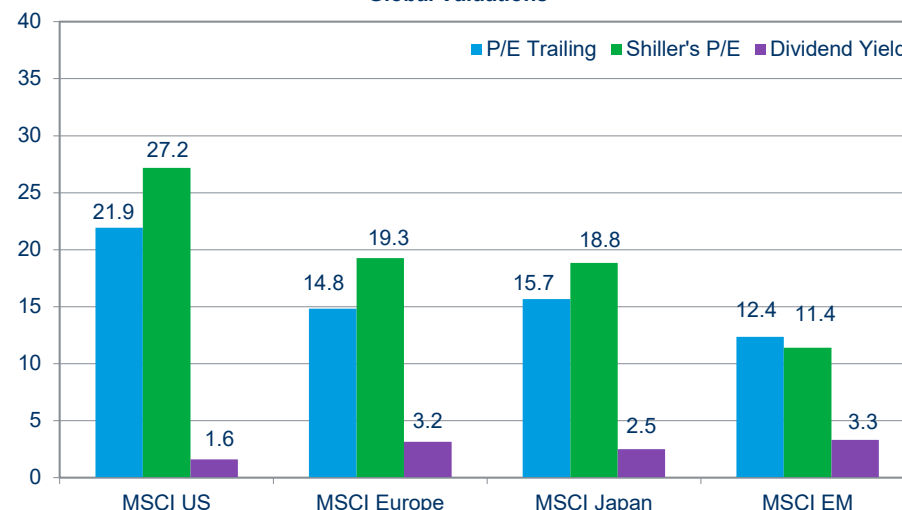


Equity fundamentals

Valuations worsened due to higher equity prices

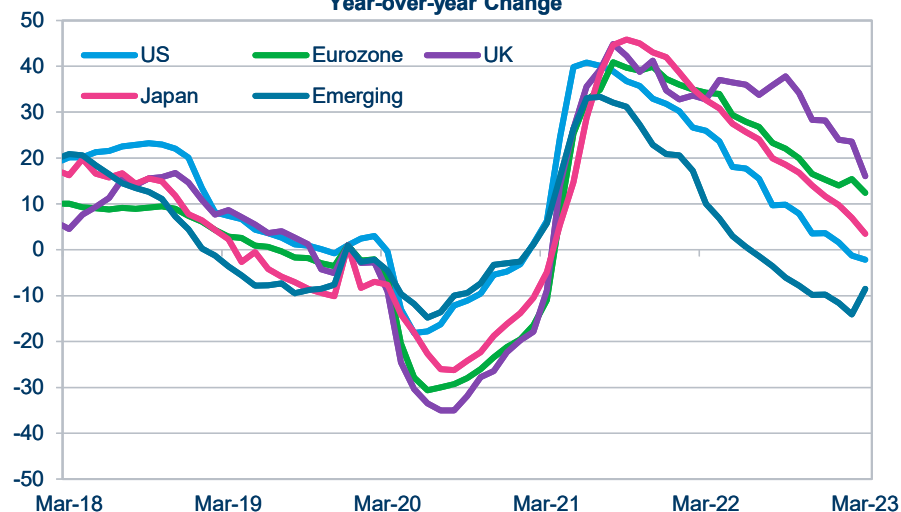
- Valuations worsened during the quarter due to the general increase in equity prices. The trailing P/E ratio on the MSCI US Index rose from 19.4 to 21.9¹. We estimate that the equity risk premium over long-term Treasuries rose slightly during the quarter², as declining rates outweighed the increase in equity valuations.
- International developed stocks remain more reasonably valued than US stocks in our view. Energy prices have continued to move lower in Europe, which should help to mitigate inflation concerns.
- Emerging market valuations continue to appear more attractive than developed markets.

Global Valuations



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

Forward Earnings Estimates
Year-over-year Change

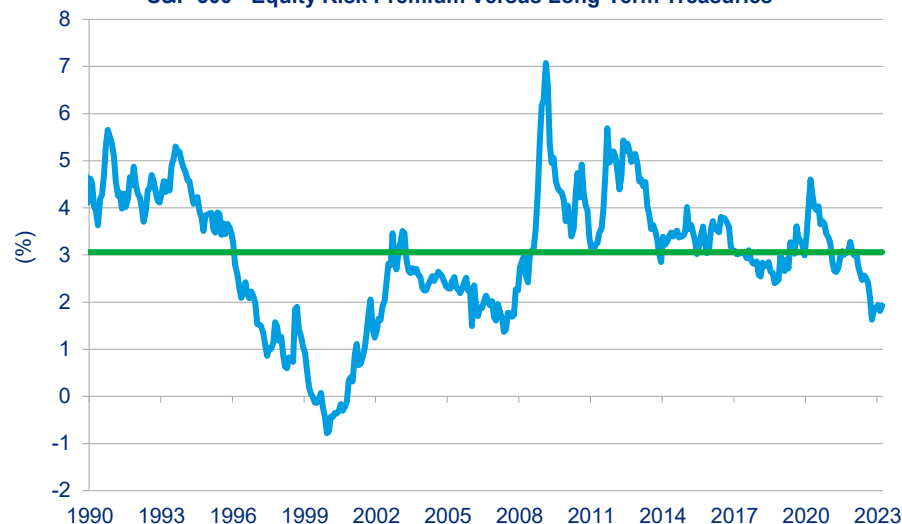


Source: Datastream; as of 3/31/23

¹ Source: Refinitiv; as of 3/31/23

² Source: MSCI, Refinitiv, Mercer; as of 3/31/23

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



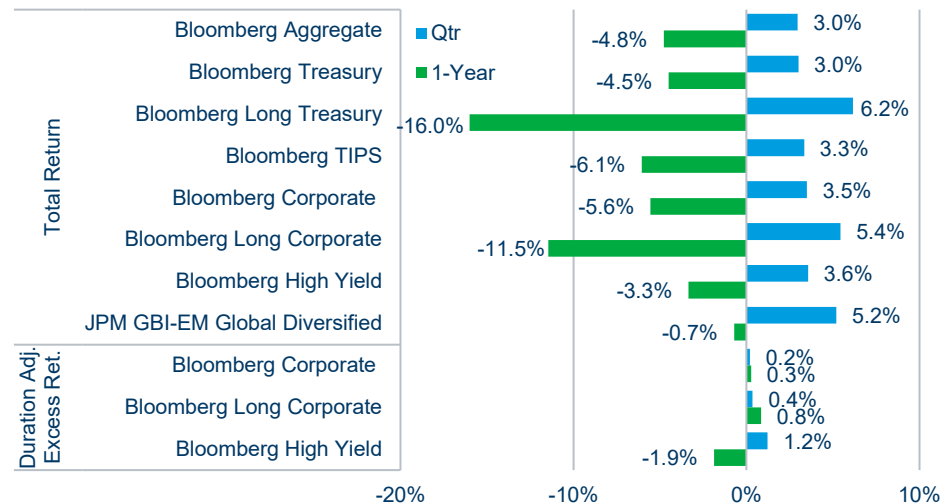
Source: Bloomberg, Datastream, Mercer; as of 3/31/23

Interest rates and fixed income

Fixed income posts gains as yields fall

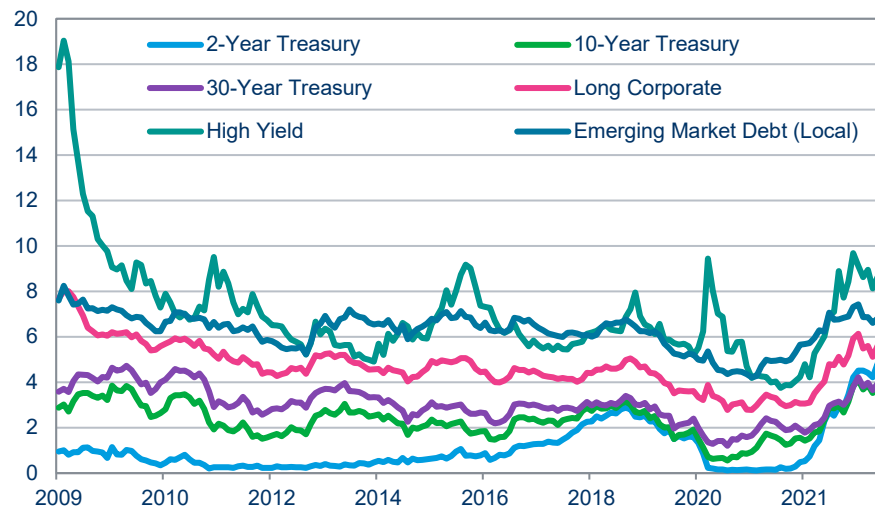
- The Bloomberg Aggregate gained 3.0% during the quarter. Treasuries gained 3.0%, lagging corporate bonds which gained 3.5%. With the exception of the short-end of the curve, the yield curve generally shifted lower during the quarter. The 2-year yield fell 35 bps, while the 30-year yield fell 30 bps¹.
- Credit spreads on investment-grade corporate bonds rose 8 bps during the quarter to 1.4%, which is roughly 25 bps above the long-term median level².
- High yield bonds gained 3.6% during the quarter, as credit spreads fell 14 bps to 4.5%. High yield spreads are 6 bps below the long-term median level of 4.6%². Local currency EMD gained 5.2% during Q1.

Fixed Income Performance



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

Yield History

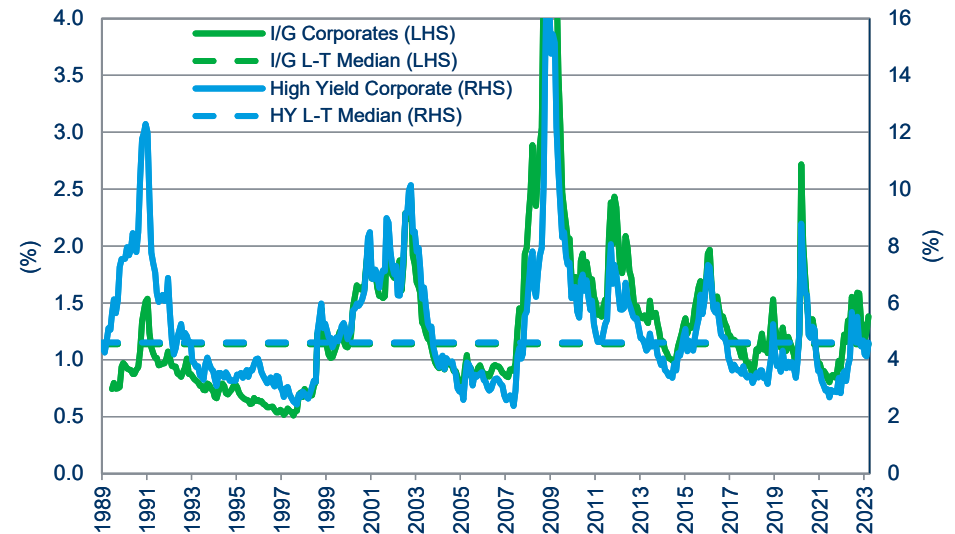


Source: Bloomberg, Federal Reserve; as of 3/31/23

¹ Source: Federal Reserve; as of 3/31/23

² Source: Bloomberg, Mercer; as of 3/31/23

Credit Spread to Treasuries

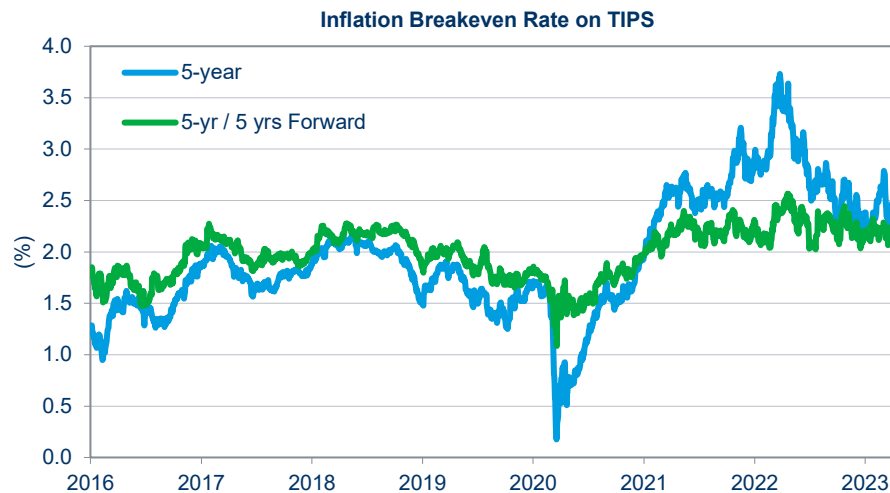


Source: Bloomberg; as of 3/31/23

Monetary policy

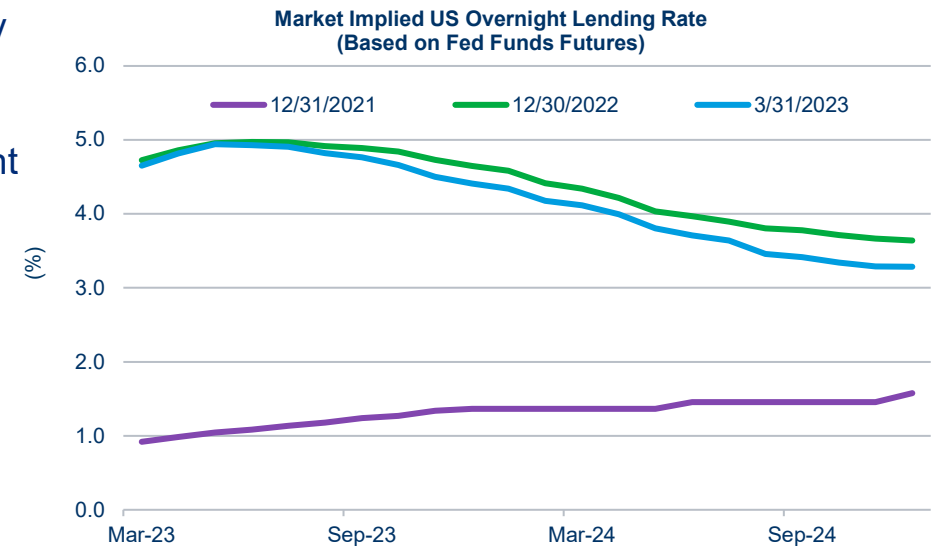
Central banks maintain their hawkish stances

- In both its February and March meetings, the Federal Reserve raised rates by 25 bps. This brought its policy rate to 4.75% - 5.0%. The market has priced the potential for one more rate hike. However, the market expects an easing cycle to begin in 2H23 with overnight rate falling to nearly 3% by late-2024.
- US inflation breakeven rates saw modest changes during the quarter, with 10-year inflation breakeven rates rising 2 bps to 2.3%, slightly below the Fed's target of 2% PCE (roughly equivalent to 2.5% CPI)¹.
- Overseas, most other central banks also raised rates, including the ECB and BOE. The notable exception was China, where easing was announced in March to stabilize borrowing costs. The BOJ kept rate targets unchanged during the quarter.

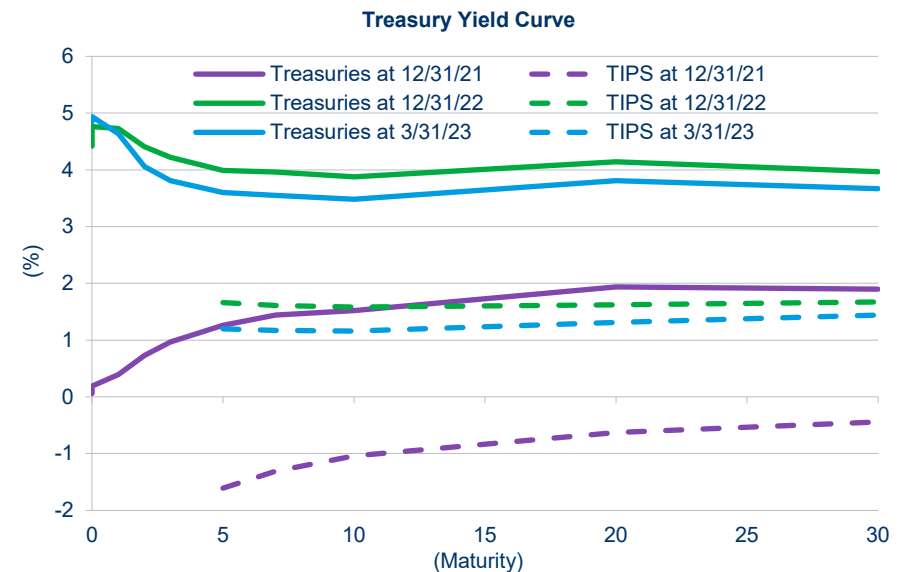


Source: Bloomberg, Mercer through 3/31/23

¹ Source: St. Louis Fed; as of 3/31/23



Source: Bloomberg; as of 3/31/23

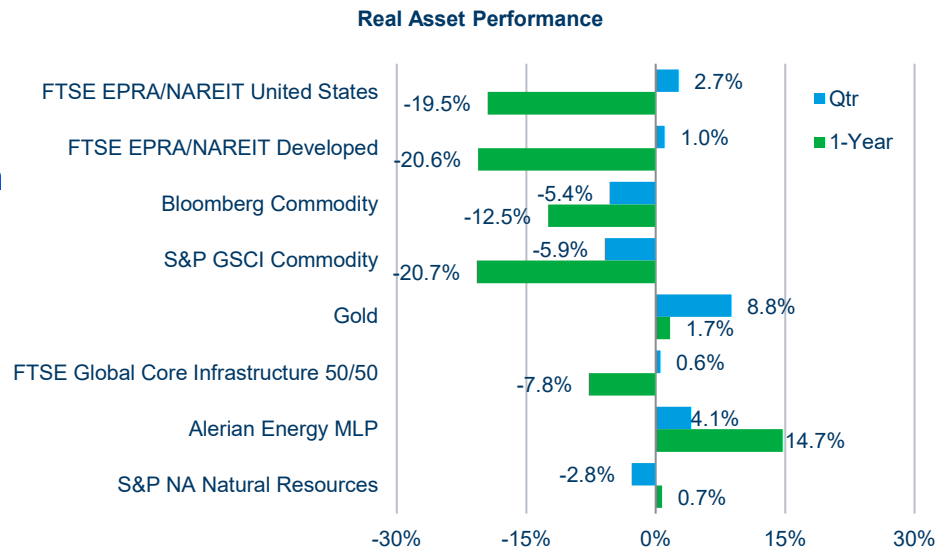


Source: Federal Reserve; as of 3/31/23

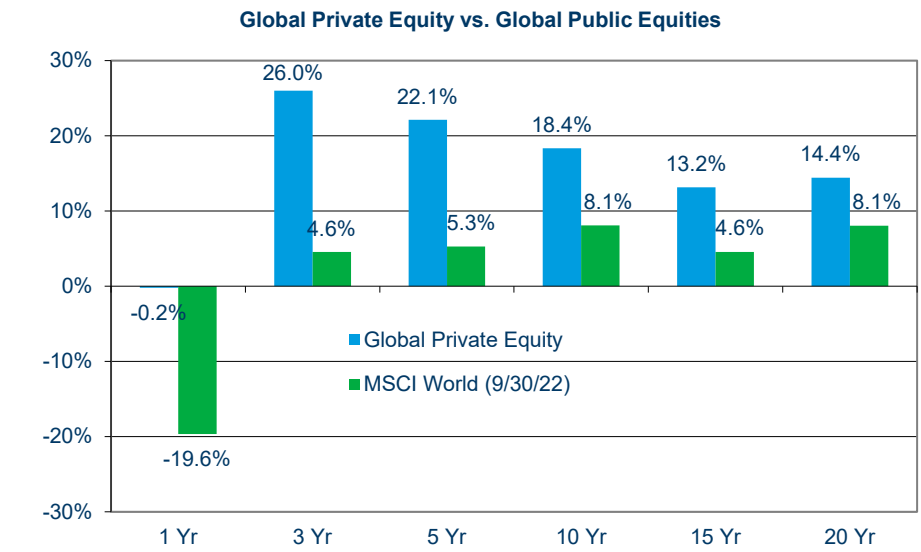
Alternative investment performance

REITs, infrastructure and natural resources lagged broader markets, hedge funds delivered gains

- Global developed REITs gained roughly 1% during Q1, lagging broader equity markets. Infrastructure stocks gained 0.6% during the quarter.
- Commodities generally declined during the quarter. Gold was an exception, rising almost 9% on safe haven demand during the banking scare and falling real rates. Natural resource stocks declined almost 3% during Q1, while MLPs gained over 4%.
- The HFRI FOF Composite Index gained 1.6% in Q1, leaving it with a 1.1% decline over the past year¹. Equity hedge strategies outperformed during the quarter, while macro strategies lagged.
- Global private equity outperformed global developed stocks over the most recent trailing periods².

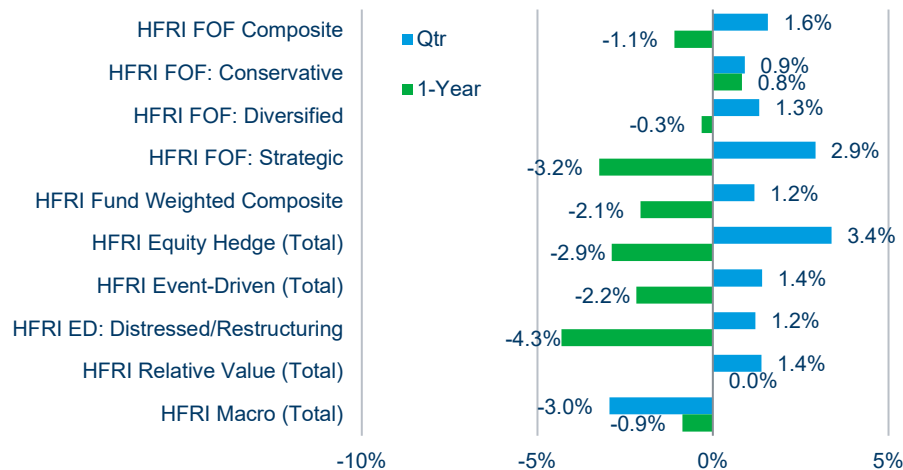


Source: Bloomberg, Datastream; as of 3/31/23



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

Hedge Fund Performance



Source: Hedge Fund Research; as of 3/31/23

¹ Source: Hedge Fund Research; as of 3/31/23

² Source: Burgiss, Bloomberg; as of 9/30/22

Valuations and yields

Ending March 31, 2023

Valuations

MSCI USA	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Index Level	18184.1	16879.3	15757.5	16534.2
P/E Ratio (Trailing)	21.9	19.4	18.3	18.9
CAPE Ratio	27.2	25.5	24.7	26.6
Dividend Yield	1.6	1.7	1.8	1.7
P/B	4.0	3.9	3.6	3.8
P/CF	14.4	13.0	12.6	14.1
MSCI EAFE	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Index Level	7140.7	6583.4	5610.4	6189.6
P/E Ratio (Trailing)	15.1	13.7	13.0	13.9
CAPE Ratio	15.4	14.7	14.0	15.6
Dividend Yield	3.1	3.3	3.6	3.4
P/B	1.7	1.6	1.5	1.6
P/CF	8.1	7.3	5.5	6.4
MSCI EM	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Index Level	505.3	486.1	443.1	501.1
P/E Ratio (Trailing)	12.4	12.2	11.5	12.5
CAPE Ratio	11.4	11.0	10.1	11.6
Dividend Yield	3.3	3.4	3.6	3.1
P/B	1.6	1.6	1.5	1.7
P/CF	7.5	8.2	6.7	7.6

Source: Bloomberg, Thomson Reuters Datastream

Yields

Global Bonds	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Germany – 10Y	2.29	2.57	2.11	1.34
France – 10Y	2.79	3.12	2.72	1.92
UK – 10Y	3.49	3.67	4.09	2.23
Switzerland – 10Y	1.25	1.62	1.23	1.07
Italy – 10Y	4.10	4.72	4.52	3.26
Spain – 10Y	3.30	3.66	3.29	2.42
Japan – 10Y	0.35	0.42	0.24	0.23
Euro Corporate	4.22	4.32	4.24	3.24
Euro High Yield	8.18	8.32	9.01	8.08
EMD (\$)	8.50	8.55	9.57	8.56
EMD (LCL)	6.59	6.86	7.31	7.06
US Bonds	3/31/2023	12/31/2022	9/30/2022	6/30/2022
3-Month T-Bill	4.85	4.42	3.33	1.72
10Y Treasury	3.48	3.88	3.83	2.98
30Y Treasury	3.67	3.97	3.79	3.14
10Y TIPS	1.16	1.58	1.68	0.65
30Y TIPS	1.44	1.67	1.74	0.91
US Aggregate	4.40	4.68	4.75	3.72
US Treasury	3.83	4.18	4.13	3.09
US Corporate	5.17	5.42	5.69	4.70
US Corporate High Yield	8.52	8.96	9.68	8.89

Source: Bloomberg, Thomson Reuters Datastream

Performance summary

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