Mercer

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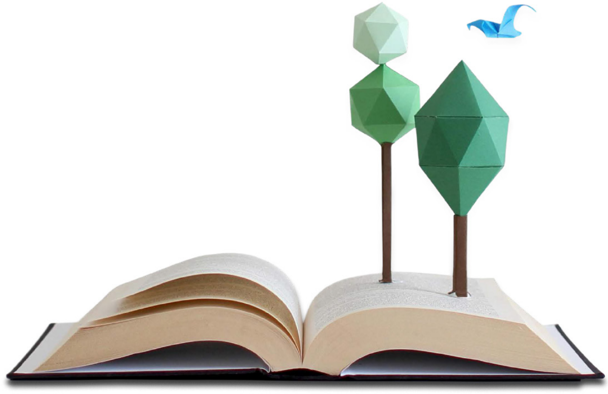
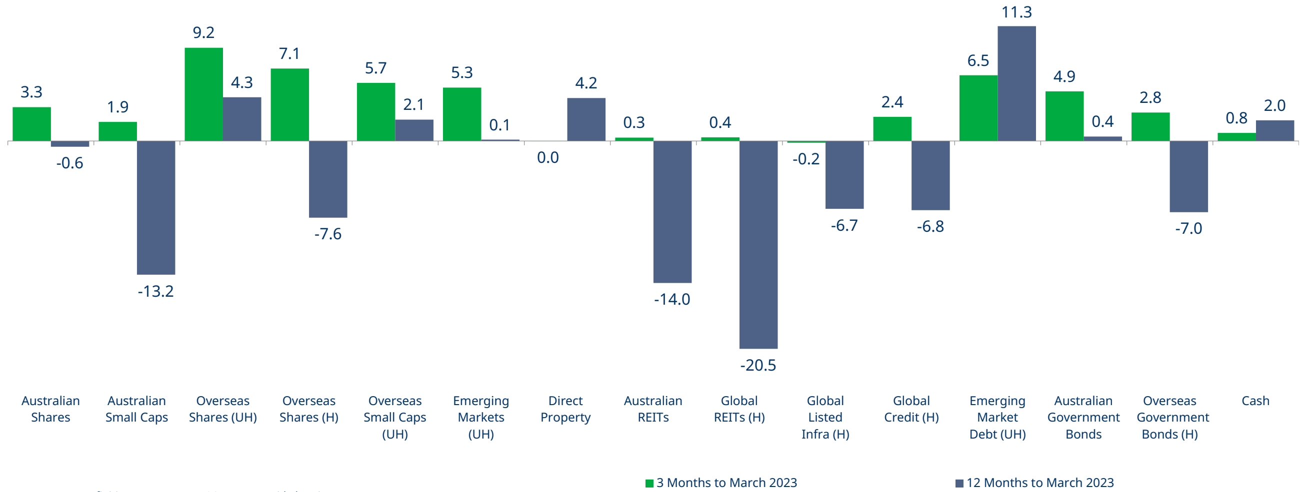
Q1 2023

Market and economic conditions



Selected market indicators commentary

Asset class returns as at March quarter 2023



Data source: Refinitiv Datastream; MSCI. Data provided 'as is'
Please see Notes for details.

Market Recap

The first quarter of 2023 began on a positive note in January followed by mixed results through February and March.

Inflation continued to fall and has seemed to peak in most developed countries. The focus firmly remains on how much more monetary tightening we will see, or if central banks will begin to pause and assess the impacts on the economy. Financial distress at a California-based regional bank culminated in the second biggest US bank failure in history. Two other regional banks also went into administration. Outside the US, investors digested UBS's takeover of Credit Suisse and subsequent turmoil in bond markets.

Hedged Developed Market Overseas Shares returned 7.1% over the quarter as inflation receded. Unhedged Overseas shares gains were better yet, adding 9.2%. Australian Shares also posted gains of 3.3% over Q1 with most sectors being positive, however, the large weight to financials detracted. Emerging market equities returned 5.3%, most of the gains coming from Chinese equities in January and March.

Hedged Overseas Government Bonds returned 2.8% over the quarter. Bond yields fell sharply in March across most developed countries as distress emerged in the financial sector, potentially acting as an inhibitor to further tighten monetary conditions. Over the quarter inflation expectations for the US were unchanged, as measured by the 10-year inflation breakeven rate which ended March at 2.3%.

Australian shares underperformed hedged overseas shares over the quarter with the ASX 300 gaining 3.3%. The strongest performing sector was Consumer Discretionary (10.8%) followed by Communication Services (9.5%), whilst the worst performing sectors were Financials (-2.7%) and Energy (-1.0%).

Significant Developments

- Australian seasonally adjusted employment decreased by 53,000 in March, above expectations for an increase of 20,000 and below the prior month's decrease of 64,600. The unemployment rate remained the same in March at 3.5%, below expectations of 3.6%. The participation rate increased to 66.7%, above expectations of 66.6%. Part time jobs decreased by 19,200 and full time jobs increased by 72,200.
- The CoreLogic House price index indicated Australian residential house prices increased by 0.8% MoM to March. Australian building approvals increased by 4.0% month-on-month to February, compared to the decrease of -27.1% (revised) for January.
- The Institute for Supply Management (ISM) Manufacturing Index recorded 46.3 in March, below consensus for 47.5 and below the 47.7 recorded in February. Of the 6 manufacturing industries that reported growth in March, the top performers were Printing & Related Support Activities; and Miscellaneous Manufacturing. There were 12 industries that recorded contraction in March compared to February. The ISM Services Index recorded 51.2 in March, below consensus for 54.4 and below the 55.1 recorded in February. Of the 13 services industries that reported growth, the top performers were Other Services; and Arts, Entertainment & Recreation. There were 5 industries that reported a decrease in the month of March.
- US Non-Farm Payrolls increased by 236,000 in March, below the 311,000 increase recorded for February. The unemployment rate decreased to 3.5% over March, below expectations of 3.6%.
- US GDP third estimate for Q4 2022 is 2.6% quarter on quarter (QoQ) annualised, below expectations of 2.7%.
- US headline consumer price index (CPI) increased to 0.1% MoM and increased to 5.0% YoY in March.
- The Caixin Manufacturing PMI in China recorded 50.0 in March, below expectations of 51.4, as manufacturing production growth slowed over the month.
- Chinese GDP increased 2.9% YoY for Q4 2022, above expectations for 1.6%. Seasonally adjusted GDP was at 0% QoQ for Q4 2022, above expectations for -1.1%.
- The preliminary estimate of the European Core CPI recorded 5.7% over the year to March, in line with expectations. The unemployment rate increased over the month at 8.1% in March.
- The Eurozone composite PMI increased to 53.7 in March, below expectations for 54.1.
- The first estimate recorded for Q4 2022 Eurozone seasonally adjusted GDP is 0.0% QoQ and 1.8% YoY.

Market Outlook

Looking ahead, global economic activity is likely to remain weak this year as the effects of the interest rate hikes over the past year or so take their toll. There have, however, been a number of important developments recently including (i) the re-opening of China's economy and (ii) the easing of energy prices in Europe, which should provide some support to global growth. The global economy, however, remains in a fragile state and further adverse shocks could lead to worse outcomes compared to our base case. Whilst the recent banking crisis has been a timely reminder of the potential for episodes of stress, we believe that a broader financial sector collapse is very unlikely. However, further defaults and bouts of volatility cannot be ruled out, particularly following the rapid rise in interest rates over the past year from a very low base.

Domestically we continue to view a mild recession outcome in Australia as our base case, with likely headwinds to consumption given the high level of indebtedness of Australian households and the rapid rise in mortgage rates over the past year. Whilst the rate of expiring fixed rate mortgage are expected to rise notably in the June quarter, it may still be some time before such effects on consumption come through in the data. We, however, believe that should conditions contract more sharply than expected the Reserve Bank of Australia (RBA) is well positioned to respond quickly and effectively.

From a markets perspective, whilst there have been a number of positive developments, we believe that earnings growth expectations appear somewhat optimistic and equity markets appear to be pricing in a benign outlook for economic conditions. However, risks remain in our view and consequently we favour retaining a neutral view on global equities. We also favour retaining a neutral view on Australian equities with the re-opening of China's economy and relative valuations providing some offset to our base case of a mild recession. Within fixed income, we maintain a slight preference to growth fixed income over defensive fixed income in light of the total yields on offer.

Australian Equities

Australian shares were positive over Q1 2023 as the S&P/ASX 300 Index returned 3.3% for the period. The S&P/ASX 50 Accumulation Index was the strongest performer for the quarter returning 4.0%, while the S&P/ASX Mid 50 Accumulation was the weakest performer, producing a flat return.

The best performing sectors were Consumer Discretionary (10.8%) and Communication Services (9.5%), while the weakest performing sectors were Financials (-2.7%) and Energy (-1.0%). The largest positive contributors to the return of the index were Newcrest Mining, BHP and Woolworths with absolute returns of 30.8%, 5.9% and 14.4% respectively. On the other hand, the most significant detractors from performance were CBA, NAB and Westpac with absolute returns of -2.1%, -6.7% and -6.0% respectively.

Global Equities

The broad MSCI World ex Australia Accumulation Index increased 7.1% in hedged terms and 9.2% in unhedged terms over the quarter, as the AUD weakened against most major developed market currencies. The strongest performing sectors were IT (22.7%) and Communication Services (19.6%), while Energy (-2.3%) and Healthcare (-0.4%) were the worst performers. Other global shares indices produced positive results as the MSCI Small Caps Total Return Index returned 5.7% and the MSCI Emerging Markets Accumulation Index returned 5.3% over the quarter.

Over the March quarter, the S&P 500 Composite Index (7.5%), the Dow Jones Industrial Average (0.9%) and the NASDAQ increased (16.8%), all in USD terms. European markets experienced positive returns, as the FTSE 100 (United Kingdom) (3.6%), the CAC 40 (France) (13.4%) and the DAX 30 (Germany) (12.2%) increased, all in local currency terms. Equity returns were mostly positive across Asia as the SSE Composite (China) (5.9%), Hang Seng (Hong Kong) (3.5%) and TOPIX (Japan) (7.2%) increased, while the S&P BSE 500 (India) (-5.9%) decreased, all in local currency terms.

Real Assets

Domestic listed property experienced a modestly positive performance over the quarter and returned 0.3%. Global REIT's returned 0.4% (in AUD hedged terms) over the March quarter. The Australian unlisted property sector (NAV) increased 0.2% over the quarter and the FTSE Global Core Infrastructure 50/50 Index returned -0.2% for the quarter in hedged AUD terms.

Fixed Interest

Global sovereign bonds produced positive returns over the March quarter as ten-year bond yields decreased in the US (-35bps to 3.48%), Germany (-27bps to 2.30%), Japan (-8bps to 0.33%) and the UK (-18bps to 3.49%). Two-year bond yields decreased in the US (-39bps to 4.15%), the UK (-27bps to 3.44%) and Japan (-9bps to -0.06%), while increasing in Germany (7bps to 2.75%). In terms of Global Bond indices, the Barclays Capital Global Aggregate Bond Index returned 2.4% and the FTSE World Government Bond (ex-Australia) Index increased by 2.8% over the March quarter, both on a fully hedged basis.

Domestically, the Australian 10-year bond yield (-76bps to 3.30%), five-year bond yield (-67bps to 3.03%) and two-year bond yield (-34bps to 3.08%) decreased. The Bloomberg Ausbond indices returned broadly positive results over the quarter, with the Bloomberg Ausbond Inflation Index producing the highest quarterly return, returning 6.7%, and the weakest being the Bloomberg Ausbond Bank Bill, returning 0.8%.

Currency Markets

The Australian Dollar (AUD) depreciated against the major developed market currencies over the March quarter. The AUD depreciated against the US Dollar (-1.2%), the Pound Sterling (-3.9%), the Euro (-3.0%), and the Japanese Yen (-0.4%). On a trade-weighted basis, the local currency depreciated by 1.8% over the quarter.

Commodities

The S&P GSCI Commodity Total Return Index decreased by 3.7% over the quarter. Gold prices finished the quarter at US$1,976.50 per ounce, increasing by 8.9%. Meanwhile, Iron Ore prices increased by 8.1% to US$127.00 per metric tonne over the period and Oil decreased by 6.1% to US$79.76 per barrel.

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Chart Constituents

Notes

- *Currency: AUD.*
- *UH: Unhedged.*
- *H: Hedged.*
- *Net Index: Total Return (Net Dividends Reinvested).*
- *Total Return: Total Return Index with Gross Dividends.*
- *Where a lag exists, the performance period start and end dates are shifted accordingly.*

Asset class	Benchmark	Data type
Australian Shares	S&P/ASX 300	Total Return
Australian Small Caps	S&P/ASX Small Ordinaries	Total Return
Overseas Shares (UH)	MSCI World ex Australia	Net Index
Overseas Shares (H)	MSCI World ex Australia 100% Hedged	Net Index
Overseas Small Caps (UH)	MSCI World Small Cap	Total Return
Emerging Markets (UH)	MSCI Emerging Markets	Net Index
Direct Property (one month lag)	MSCI/Mercer Australia Core Wholesale Monthly PFI	NAV Post Fee
Australian REITs	S&P/ASX 300: Industry Group: A-REIT	Total Return
Global REITs (H)	FTSE EPRA/NAREIT Developed Hedged	Total Return
Global Listed Infrastructure (H)	FTSE Global Core Infrastructure 50/50 Hedged	Total Return
Global Credit (H)	Bloomberg Global Credit	Hedged Return
Emerging Market Debt (UH)	JP Morgan GBI EM Global Diversified Composite	Total Return
Australian Government Bonds	Bloomberg AusBond Treasury 0+ year	Total Return
Overseas Government Bonds (H)	FTSE WGBI Non Australia	Hedged Return
Cash	Bloomberg AusBond Bank Bill	Total Return

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- Investments denominated in a foreign currency will fluctuate with the value of the currency.
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- Certain investments, such as illiquid, leveraged or high-yield instruments or funds and securities issued by small capitalization and emerging market issuers, carry additional risks that should be considered before choosing an investment manager or making an investment decision.
- For higher volatility investments, losses on realisation may be high because their value may fall suddenly and substantially.
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