Mercer

welcome to brighter

6 August 2024, 11am ET

Recent market movements

What happened?

Over the past few trading days, a series of weaker than expected data readings on the US labor market and the US manufacturing sector led bond markets to begin pricing in a more aggressive rate cutting cycle by the Federal Reserve. In addition, while expected by Mercer, the Bank of Japan surprised the markets with a rate hike, bringing their interest rate to 0.25%. Fear of a US recession, coupled with a global unwinding of popular trades, have triggered substantial moves in global markets.

What has been the impact?

Over the past few days, global financial markets have exhibited a broad risk-off tone. A sell-off that began in the US, following the jobs data, quickly consumed global financial markets. US equities declined sharply (S&P 500 -6%) and technology stocks were down even more. A major sell-off in Asian stocks saw Japanese equities enter bear market territory (Nikkei 225 and Topix down ~20%). All of these moves led to large increases in implied volatility. The VIX index, often referred to as the *fear gauge of Wall Street*, broke through the 60 level intraday on Monday, last witnessed during the pandemic and the global financial crisis. The yen, which had been increasing steadily through July, also slumped. After trading in the ¥152-155 per USD range over the past number of days, it has gapped down to sub-¥145 per USD. Finally, as alluded to above, government bond yields have also moved considerably over the past few days. Two-year US Treasury bond yields declined 0.27% on Friday following the jobs report. Ten-year yields also fell, but to a lesser extent.

We believe these market movements are likely attributable to three main causes; a generalized fear of the US going into recession, the unwinding of overstretched positions such as overweight US tech, and the unwinding of short Japanese yen as a carry trade. The sell-off appears to be largely technically driven, especially given the large presence of leveraged investors in these markets, which has been further amplified in August, when liquidity is generally low. However, at the time of writing (August 6th), the broad risk-off tone appears to have subdued somewhat and the sell-off embroiling markets has cooled. This is consistent with our view that the sell-off on Friday and Monday had largely been driven by fast money and short-term repositioning, rather than an outright change in fundamentals.

Mercer response

The Global Economics & DAA team believes that **fundamentally, not a lot has changed** and the latest economic data from the US and elsewhere is consistent with cooling in a soft-landing fashion. The US payroll data was weaker, but still reasonable and may have been distorted by Hurricane Beryl. US GDP growth appears to be slowing but is still close to 2%, and corporate and consumer balance sheets are in good shape, adding to broad resilience. Banks are not severely limiting credit creation. We think these factors should underpin US economic resilience and enable inflation to return to the 2% targeted by the Fed without going through a recession. Recessions typically occur when the corporate sector is in deficit and when banks are constricting credit growth/stop lending. We are not seeing this dynamic play out today.

Having said that, compared to early in 2024, we believe the risk of US economic overheating has come down and **the risk of the US economy cooling too much has risen**. If the market reaction over the last week or so is to continue, we are cognizant that growth could weaken due to the tightening in financial conditions (driven by lower equity prices, and higher credit spreads).

As a result of the market movements, in particular the sharp leg downwards in Japanese equities and lower government bond yields, we are making the following changes in our global unconstrained portfolio:

© 2024 Mercer (US) LLC. All rights reserved.

1. **Increasing overweight to Japanese equities**: The fundamental thesis, which rests on an improving nominal growth outlook and solid earnings growth, remains intact. Valuations have become more attractive following the sell off. Furthermore, the market is now technically oversold.
2. **Initiating the underweight to global government bonds:** We do not think current market pricing of rate cuts by the Fed is reasonable. Our central case is a soft landing, which implies gradual cooling and gradual cuts. We expect the Fed to cut 25bps in September and thereafter until they get below 4%. Right now, market pricing is for the Fed to get to sub-3% in two years and to cut 125bps by the end of this year. We view that as overdone and not consistent with the data, mostly driven by market technicals. We aim to capitalize on this mispricing of Fed cuts by underweighting global government bonds (largely a treasury view).
3. **Trimming our underweight to the New Zealand Dollar (NZD) to 1%:** Following a large move in NZD we have decided to take some profits on the position, while retaining a modest underweight.

© 2024 Mercer (US) LLC. All rights reserved.

Important notices

References to Mercer shall be construed to include Mercer (US) LLC and/or its associated companies.

© 2024 Mercer (US) LLC. All rights reserved.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

This does not constitute an offer to purchase or sell any securities.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

Past performance does not guarantee future results. The value of investments can go down as well as up, and you may not get back the amount you have invested. Investments denominated in a foreign currency will fluctuate with the value of the currency. Certain investments, such as securities issued by small capitalization, foreign and emerging market issuers, real property, and illiquid, leveraged or high-yield funds, carry additional risks that should be considered before choosing an investment manager or making an investment decision.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary, and actual results may differ materially.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see http://www.mercer.com/conflictsofinterest.

Information contained herein has been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.

Not all services mentioned are available in all jurisdictions. Please contact your Mercer representative for more information.

Investment management and advisory services for US clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, New Jersey, North Carolina, Oklahoma, Pennsylvania, Texas and West Virginia; as "Mercer Investments LLC (Delaware)" in Georgia; as "Mercer Investments LLC of Delaware" in Louisiana; and "Mercer Investments LLC, a limited liability company of Delaware" in Oregon. Mercer Investments is a federally registered investment adviser under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Mercer Investments' Form ADV Parts 2A and 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 99 High Street, Boston, MA 02110.

Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited and Mercer Limited. Mercer Global Investments Europe Limited and Mercer Limited are regulated by the Central Bank of Ireland under the European Union (Markets in Financial Instruments) Regulation 2017, as an investment firm. Registered officer: Charlotte House, Charlemont Street, Dublin 2, Ireland. Registered in Ireland No. 416688. Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU.

Investment management services for Canadian investors are provided by Mercer Global Investments Canada Limited. Investment consulting services for Canadian investors are provided by Mercer (Canada) Limited.

August 2024.

© 2024 Mercer (US) LLC. All rights reserved.