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The market bears: Portfolio robustness in uncertain markets

The market bears

The first nine months of 2022 were difficult, both for investors and the world as a whole. With central banks tightening financial market conditions to fight rampant inflation, financial assets across a broad spectrum suffered. Rapid growth gave way to outright recession concerns in numerous countries. Looking forward, what will happen over the remainder of 2022 and into 2023 has been the subject of great debate amongst market participants. Unfortunately, given how divergent the plausible outcomes are in the current environment, that debate has yet to provide much in the way of concrete actions for investors to pursue.

In this piece, we stay above the fray[1] and instead shed light on what the plausible outcomes could mean for financial assets. We then look at what is being priced into markets right now and what developments might hint at one scenario becoming more likely than the others. With this playbook in hand, seeking to ensure a portfolio remains robust, so it is able to (1) withstand and (2) respond to whatever transpires in the economy and financial markets, will be more manageable.

Too hot, too cold, or just right?

While there are numerous possible outcomes for overheated developed market economies and markets from here, you can generally group them into three main scenarios[2] based on the combination of central bank policy and inflation: too hot, too cold and just right.

- Too hot – **Stagflation** due to inadequate central bank tightening despite stimulus-boosted demand outstripping constrained supply. Wage inflation becomes engrained, leading to persistently high inflation
- Too cold – Central banks aggressively tighten financial market conditions, which leads to a deep recession or **hard landing** that eventually cools inflation pressures
- Just right – A **soft landing** or a mild recession as central banks thread the proverbial needle, supported by healthy consumer and corporate balance sheets

For asset prices, the winners and losers are different for each scenario. **Stagflation**[3], where central banks tighten enough to slow economic growth but not enough to get inflation under control, is characterized by high inflation, high unemployment and sub-par economic growth. Financial assets, such as equities and bonds, would be expected to struggle as higher discount rates pull forward the inflation-driven erosion of their future cash flows (Figure 1). On the other hand, stagflation might lead to bumper returns in some commodities and gold, as the reduced value of fiat currencies benefits hard assets.

Consumers would struggle, as captured by the aptly named Misery Index (Figure 2), which combines inflation and unemployment. Case in point: despite recent high nominal wage growth, real wage growth has actually turned negative in many countries. We are already

[1] For more on our central case, please see our 2022 mid-year outlook.

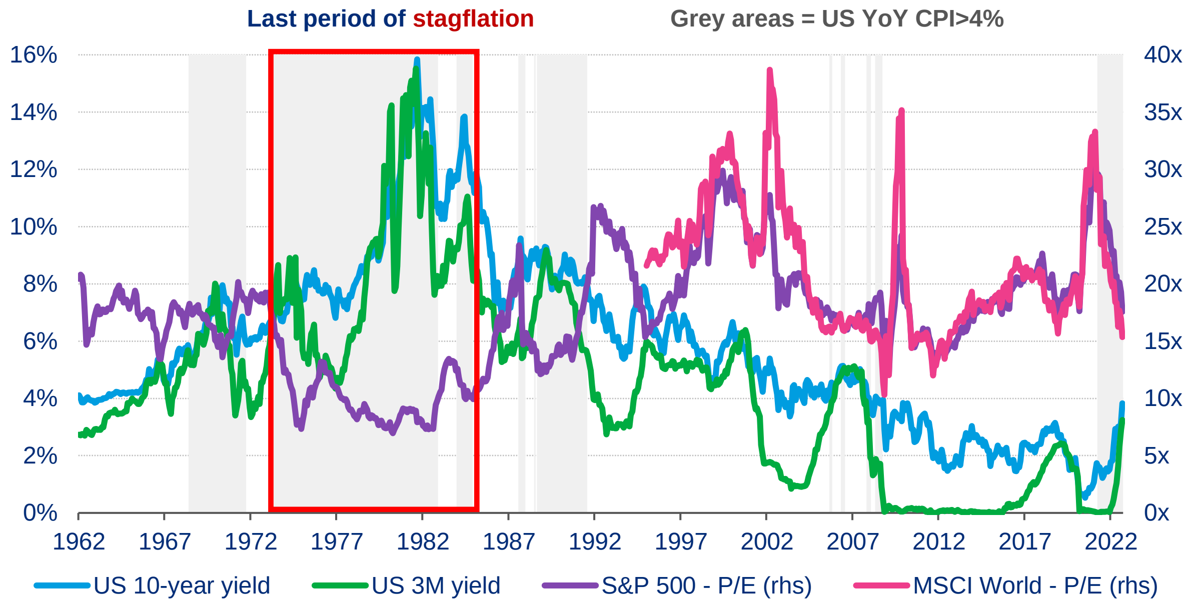
[2] The broader scenario suite includes over ten scenarios and aims to cover the entire distribution of market outcomes.

[3] For more on stagflation risk, see our article from earlier in 2022: Inflation turning up the heat

seeing early warning signs of stress in lower income brackets, where pandemic savings have been exhausted and inflation continues to bite.

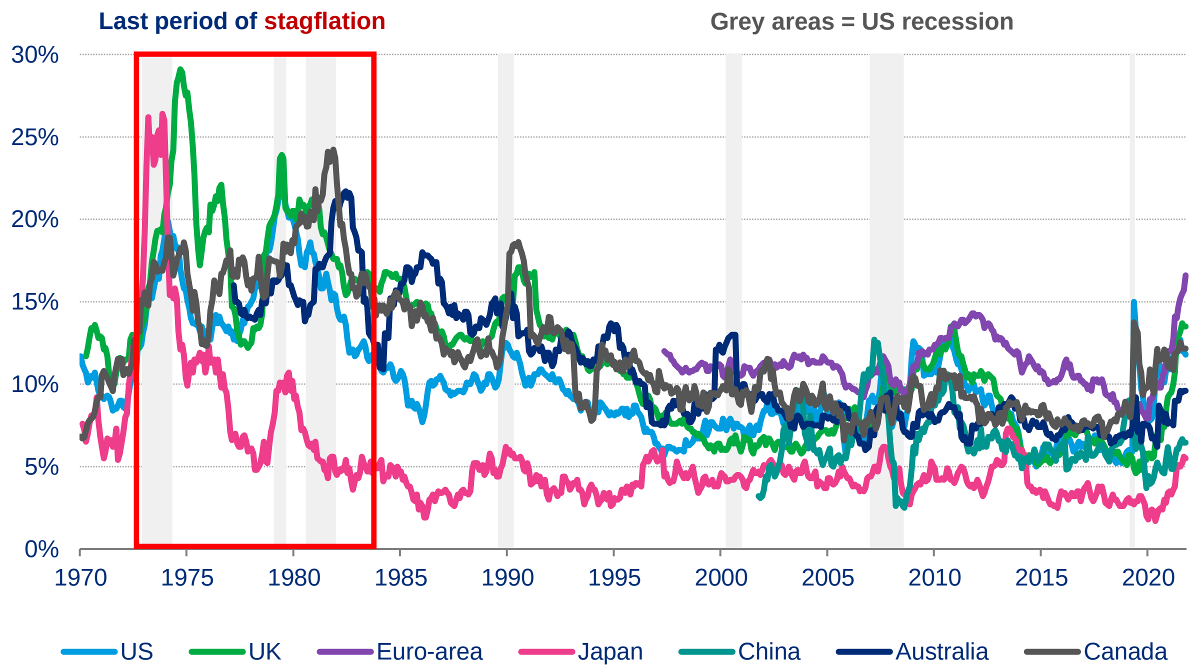
As a final kicker, the longer stagflation lasts, the more painful the eventual tightening required to break the psychology around the inflationary cycle will be.

Figure 1. Stagflation's impact on nominal rates and price-to-earnings ratios



Source: Bloomberg, Mercer. Data as of September 2022.

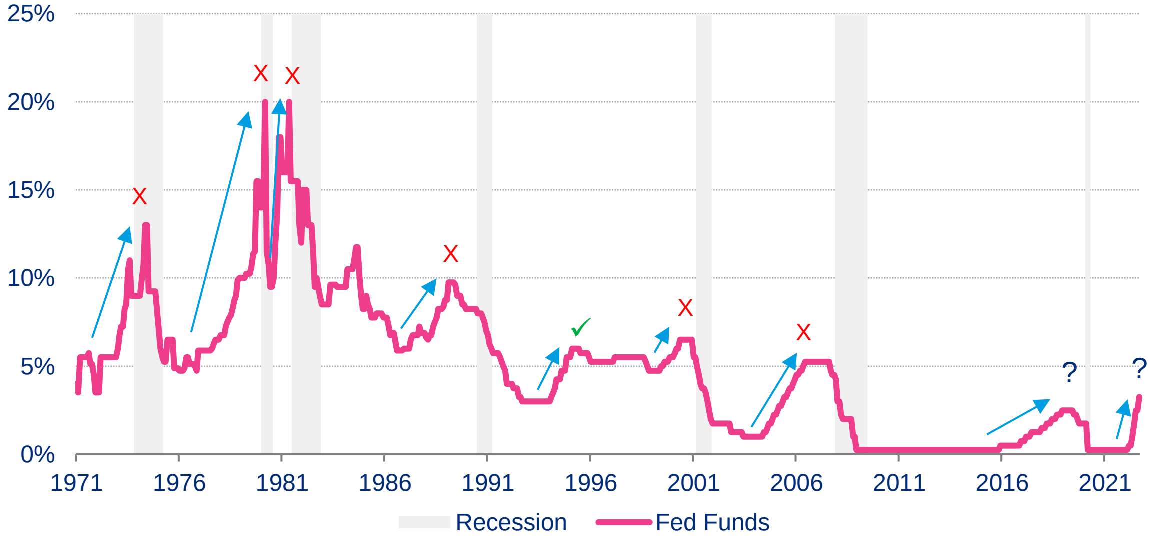
Figure 2. "Misery" increasing around the globe (headline inflation + unemployment rate)



Source: Bloomberg, Mercer. Data as of September 2022. The misery index is the sum of headline inflation and unemployment rate. Grey bars indicate US recessions as determined by the National Bureau of Economic Research (NBER).

Stagflation is a truly awful outcome for economies and financial markets, as anyone who lived through the 1970s in developed countries or more recently in some emerging countries can attest. As such, central banks are expected to do everything in their power to avoid it. In fact, they might well err on the side of caution, leading[4] to a **hard landing**. Even if we ignore the extreme starting point of the current cycle, most rate hiking cycles, as we explored earlier this year, do lead to a recession[5] (Figure 3). The consequences for financial assets of a hard landing will be familiar to most investors. While the pain starts in rates due to hikes, it quickly rotates to equities and credit spreads as the recession weighs on earnings and ability to pay. Commodities would also likely suffer due to the shortfall in demand. Normally, rates would be a safe haven once the economy rolled over, but given inflation concerns, the ability of central banks to respond aggressively in the next recession remains a subject of debate. Gold, which feeds off the monetary policy response, could be weak for similar reasons.

Figure 3. Federal Reserve fed funds rate and US recessions



Source: Bloomberg, NBER, Mercer. Data as of September 2022. Grey bars indicate US Recessions as determined by the National Bureau of Economic Research (NBER).

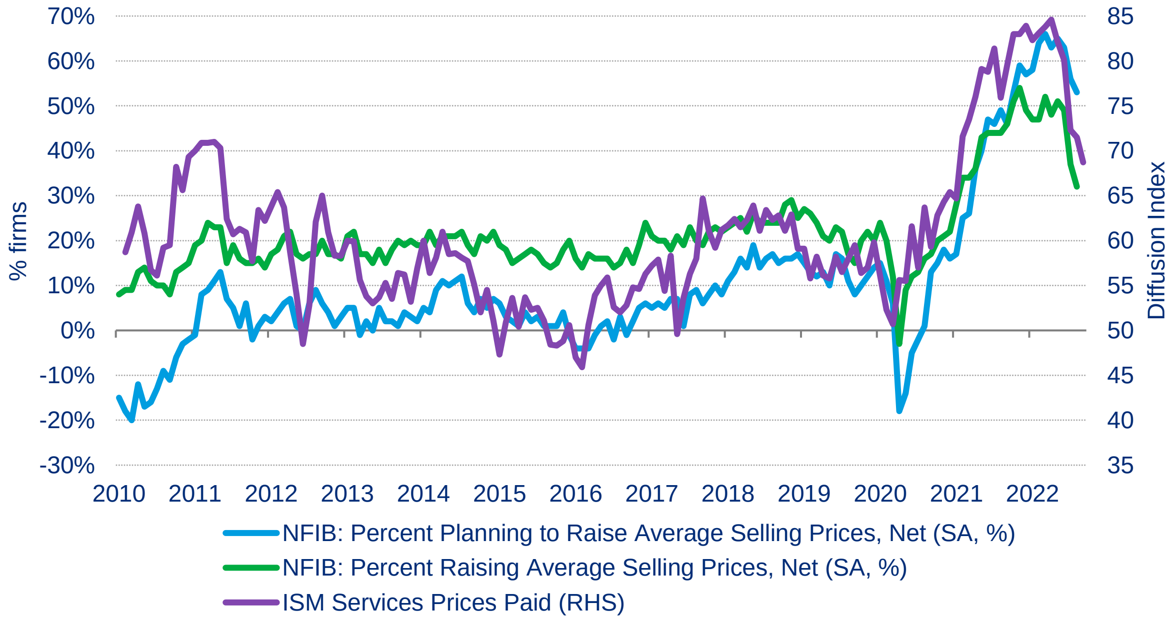
Of course, there is still the possibility that central banks manage to achieve a **soft landing**. The economy muddles through or only experiences a mild recession while inflation is brought under control. Risk assets would be expected to do well, while downside protection assets, particularly those linked to inflation and/or fear, would lag.

[4] See FOMC Chair Jay Powell's Jackson Hole speech as an example

[5] Six of the last eight hiking cycles have ended in recession. One ended in a soft landing. One is uncertain as a non-economic factor (COVID) pushed the economy into recession rather than the impact of a rating hiking cycle. See Figure 3.

This, of course, might sound like a fantastical central banker's dream given the doom and gloom permeating economies and markets currently[6]. However, there are indeed a few reasons to believe a meaningful recession could be avoided, at least in some countries. First, both consumer and corporate balance sheets look healthy – much healthier than they normally would be at the onset of a recession. Second, some of the major drivers of inflation appear to be rolling over or at least moderating. Broad commodities and oil are down 14% and 32% from their peaks[7] respectively. Supply chain metrics are improving and freight costs are down[8]. While the labor market as a whole remains tight, declining job openings may be a sign that wage growth could begin softening in the coming months. The combined effect is reflected in a rollover in expectations for and actual price increases (Figure 4). Additionally, market and survey indicators of longer-term inflation expectations have not shifted meaningfully higher as stagflation has yet to enter our collective mind set[9].

Figure 4. Pricing pressures starting to roll over (NFIB – Consumer /ISM - Business)



Source: Bloomberg, Mercer. Data as of September 30, 2022.

A summary of the potential impact of each of these scenarios on **real** returns[10] over a three-year horizon is in Figure 5. Given the uniqueness and uncertainty of today's environment, the relative shading provides a better comparison than focusing on specific numbers. Also, it is important to recognize that some asset classes (e.g. High Yield) will evolve over the course of a scenario, while others (e.g. Gold) will depend on your base currency and hedge ratio.

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[6] As indicated for the economy by consumer sentiment (University of Michigan) and markets by positioning and equity outflows (BoA Fund Manager Survey).

[7] BCOM Total Return Index. USD return. Data as of September 20, 2022.

[8] As measured by NY Fed Global Supply Chain Pressure index and Freightos Baltic Index, respectively.

[9] As indicated by market, 5y5y breakeven inflation, and survey, University of Michigan Survey of Consumers long-run inflation expectations, measures.

[10] As the inflation level varies significantly between scenarios, using real returns helps with comparability.

Figure 5. 3-Year expected real return by scenario (USD)

Asset class	Year-to-date	Possible paths forward		
	Extreme overheat	Stagflation	Hard landing	Soft landing
Inflation (annual rate)	8%	7%	2%	4%
2Y US Treasury Rate (EOP)	4%	4%	1%	3%
Developed equities	-30%			
Emerging market equities	-31%			
High yield*	-20%			
Sovereign bonds*	-19%			
Inflation-linked bonds*	-18%			
Listed real assets**	-14%			
Private real assets**	1%			
Commodities	6%			
Gold	-16%			

Key (real annualized returns)						
-10%+	-10% to -6%	-6% to -2%	-2% to 2%	2% to 6%	6% to 10%	10%+

*Source: Mercer, MSCI, ICE, Bloomberg, S&P, Burgiss, LBM; scenarios as of 6/30/2022 with definitions in appendix. Year-to-date real returns through 9/27/2022 for listed, 6/30/2022 for private. *Using US High Yield, Treasuries and TIPS **Real assets are equal weighed across real estate, infrastructure and natural resources. Private assets are modelled as core. Listed real assets suffer more than private assets in stress scenarios due to their correlation with equities in the near term. As the periodicity increases, the correlation increases with their private counterpart and decreases with equities.*

Plot points

As we find ourselves at an uncertain inflection point, it helps to evaluate what markets are pricing in right now. As mentioned before, if forward breakeven inflation[11] is any indication, markets are not putting much weight on **stagflation**. While equity valuations have fallen, the equity risk premium remains lower and P/Es above what you would expect if we were headed for a **hard landing**. So right now, markets, at least in the US, appear to be leaning towards a **soft landing** with potentially a mild recession that pulls down inflation but only gets in the way of growth temporarily.

Of course, different scenarios may befall different regions [Figure 6]:

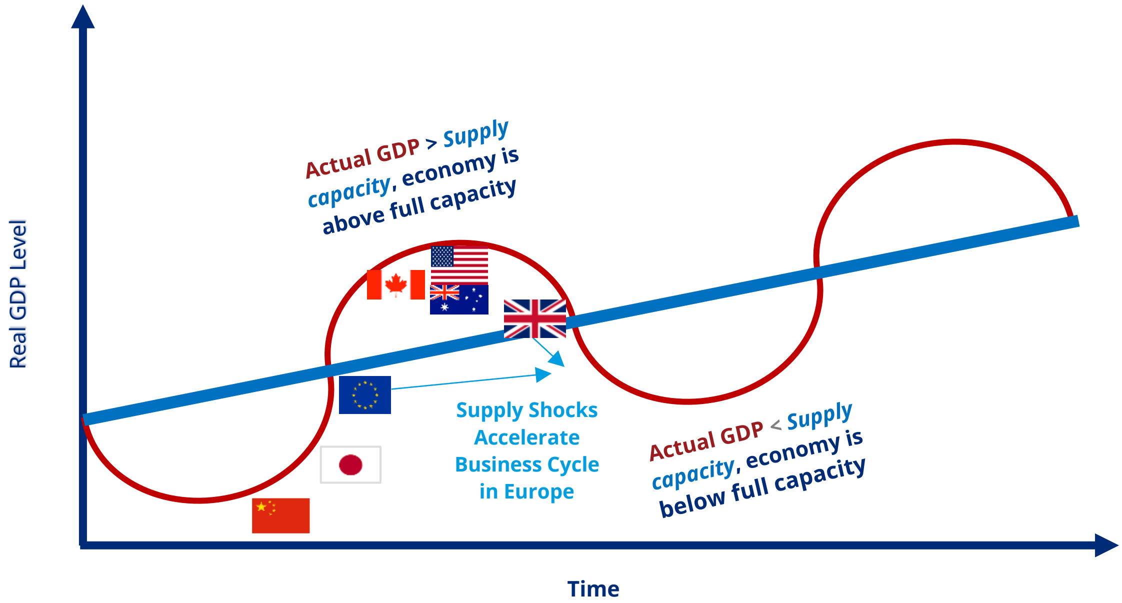
- Continental Europe faces greater issues with both inflation and growth than the US, as energy costs and potential shortages loom large over the winter months.
- Adventurous fiscal policy in the UK on top of many of the same issues facing the rest of Europe has seen markets react negatively.
- On the flip side, China has not experienced the same inflation issues, as COVID lockdowns among other factors have kept demand weak.

Overall, volatility remains high across the globe, as market participants continue to look for more direction on the path of inflation, central bank policies, and economies.

[11] Also, the median three-year ahead expected inflation rate in the New York Fed Survey of Consumer Expectations has fallen in recent months from over 4% to 3.2% in July.

Adding to this, different parts of financial markets tell different stories. For example, the (relative) optimism currently in equity and credit markets contrasts with inverted yield curves, a sky-high US dollar and falling economist projections of economic activity.

Figure 6. Location of economies in a stylized business cycle



Source: Mercer. For illustrative purposes only.

Shifting the probabilities of our three scenarios can have a meaningful impact on expected returns. While sovereign bond returns improve as we move from **stagflation** towards **hard landing**, commodities, excluding gold, do the opposite. Equities, on the other hand, suffer in the tails, but historically perform better in the case of a **soft landing**.

The takeaway is that, with the proverbial central bank put under threat, a diversified portfolio seeks to provide you with a smoother ride than one reliant on equity risk.

Sniffing out the right direction

Taking all the information from the prior sections, below we provide, in short, what might represent a plausible data-driven narrative for each of the scenarios:

Soft Landing: (1) Rising labor market participation along with tighter financial conditions slows wage growth. (2) Corporate margins are maintained or soften mildly as consumption continues, albeit at a slower pace. (3) Supply chain issues improve, helping balance supply and demand, lessening inflation pressure.

Hard Landing: (1) Tightening financial conditions lead to falling consumer demand and corporate margins. (2) Companies cut jobs and capital expenditures, pushing the economy into recession and bringing demand below supply. (3) Inflation slows and central banks cut rates to restart the economy, but not as quickly or forcefully as in previous downturns.

Stagflation: (1) As the economy starts to slow, central banks and fiscal authorities lose their nerve. (2) Wage inflation and fiscal handouts support nominal consumption, despite weak consumer confidence. (3) Supply chain issues resurface due to exogenous factors preventing supply and demand from balancing. (4) High nominal growth but low or zero real growth. Rising rates push down P/Es.

Stay diversified!

In the above sections, we have provided a framework using three main scenario paths to help investors think about markets as they await nervously every economic data release and new policy development. Using this framework in conjunction with our dynamic asset allocation guidance will help investors be nimble over shorter time horizons. Shifting to the long run, our strategic guidance is designed to construct portfolios that are robust in a broad range of scenarios, some of which we have discussed above.

As markets appear to be pricing in a **soft landing** in some countries, it is not too late to add diversification. If a hard landing or stagflation scenario occurs, traditional equity and financial asset-heavy portfolios will be challenged. Rather than placing all your eggs in one basket, this exercise demonstrates the importance of maintaining a well-diversified portfolio. Adding real assets, such as infrastructure, natural resources, or real estate, listed or unlisted, will add robustness and help in **stagflation**, especially over longer time horizons. While no guarantee[12], adding gold can help diversify your downside protection options in a **hard landing** scenario. Of course, every investor's portfolio is unique. Mercer, through its advisory and investment solutions capabilities, stands ready to help you find the path that is right for you.

[12] Gold has had positive returns during 60% of MSCI World corrections of over 10% and in 67% of two-year periods following an MSCI World correction of over 10%. Performance this year has disappointed in USD terms as rising yields and the strongest USD in decades have outweighed other factors. Performance in other currencies has been stronger. Monetary policy remains the key driver of gold's performance. During loose periods, gold typically gains; during tightening, gold typically suffers.

Appendix: Scenario definitions

Stagflation – Rising debt levels, supply shortages, a commodity shock, geopolitical event and/or central banks allow inflation to rise above targets for sustained periods and bond vigilantes drive rates higher. Economic growth remains considerably below long-term consensus for the foreseeable future. Central banks are reluctant to curb inflation due to high unemployment.

Hard landing – Global growth continues to disappoint over the next few years, with weaker overall growth than under the base case, perhaps descending into a meaningful recession. Unemployment and deflation risks are at the forefront of central bankers' concerns, keeping policy rates very low (or negative). This scenario can be driven by the aftermath of a sharp tightening by central banks, an involuntary return to austerity due to political gridlock, the emergence of a virus or other similar events that have a deflationary rather than inflationary impact.

Soft landing (Base Case) – Economic growth and inflation are consistent with consensus expectations and gradually fall back to their respective long-term equilibria from current elevated levels. Short dated interest rates and yield curves move towards equilibrium levels (around a 2.5%-3% cash rate and 3%-3.5% long bond yield in the US).

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