Mercer

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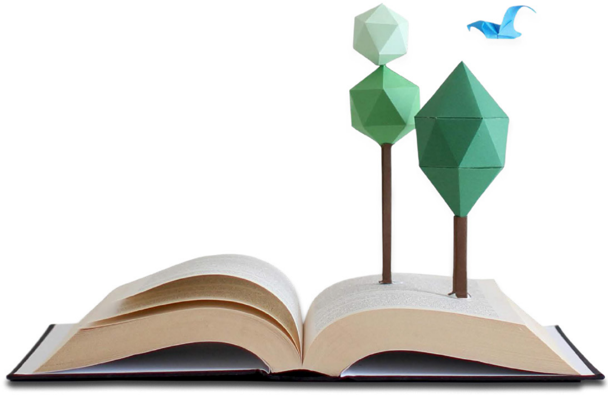
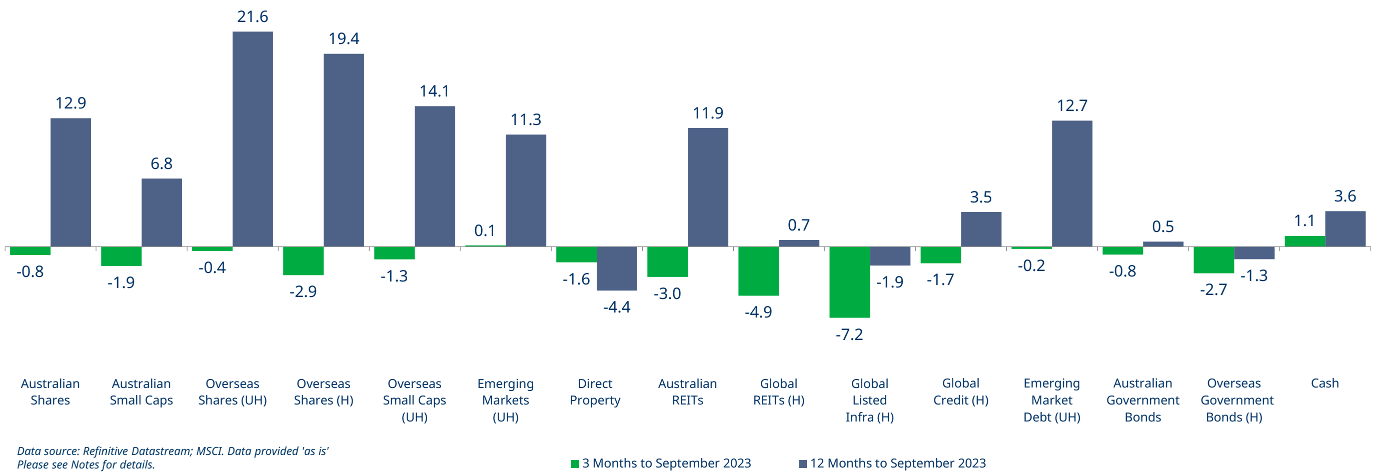
Q3 2023

Market and economic conditions



Selected market indicators commentary

Asset class returns as at September quarter 2023



Economic overview

Australian economic growth remained nuanced in Q3 as economy activity continues to rebalance post-COVID. Despite softer momentum in the manufacturing sector, business activity expanded across the services sector. A rebound in house prices (+2.2%), a tight labour market and positive wage pressures have helped support an increase in consumer spending despite softening in Westpac's Consumer Sentiment indicators for the period. Notably, inflation reportedly declined to 6.0% p.a. for Q2, with the most recent monthly indicators of price growth in August showing further softening to 5.2% p.a. As a result, the Reserve Bank of Australia (RBA) left interest rates steady at 4.1%, noting the need to consider the implications of further lagged effects from previous increases in interest rates on household spending and inflation.

Globally, the economic landscape varied in the major regions during the September quarter. In the United States, Q3 displayed robust economic activity, driven by the drawdown of pent-up savings, private investment, and expansionary fiscal policies. In other regions however such as the Eurozone, economic activity has slowed, with manufacturing sector momentum at its lowest since the global financial crisis. Economic momentum was also soft in China, marked by weak consumption, high youth unemployment and increasing concerns about further defaults in the domestic property sector. Despite stimulus measures announced by the Chinese government, pass through effects have remained limited. Other emerging market economies, having raised interest rates earlier, are now positioned to support further softening in domestic growth through lower rates.

While inflation has peaked, price pressures remained sticky across regions in Q3. In the US, inflation declined to 3.7% in August, driven by base effects, but core inflation remained elevated, influenced by higher housing costs and strong wage growth. Signs of labour market rebalancing suggest slower wage growth which will help ease price pressures into next year. In Europe, inflation remained elevated, with Germany's core inflation above 4.0%, expected to decrease in the coming months. Japan experienced its highest inflation since the early 1990s, supported by labour markets and changes in corporate behaviour, marking a positive shift for Japanese policymakers.

The US Federal Reserve raised rates to 5.25 - 5.50%. while emphasising a commitment to bring inflation back in line with the 2.0% target. Interest rates in the Eurozone and the UK moved higher to 4.5% and 5.25% respectively, though both the European Central Bank (ECB) and the Bank of England (BoE) were more dovish, signalling a likely pause in interest rates going forward. Elsewhere interest rates remained unchanged in Japan (-0.1%).

Market review

Equities declined in the third quarter of 2023, having rallied in the first half of the year as the US Fed signalled no immediate end in the current high level of US rates. The rally in the so-called 'magnificent seven' (e.g. US Tech stocks Nvidia, Microsoft, Meta et al.) also cooled in Q3. The Australian share market was no exception, declining by 0.8% despite the RBA keeping interest rates unchanged over the quarter. Other major events of the quarter included the downgrade of the US credit rating by Fitch, while Moody's downgraded their outlook for US regional banks. Global equities declined 0.4% while emerging markets were relatively unchanged (+0.1% (Unhedged)). Weakness was broad based regionally, but there were some bright spots. Norway returned 11.6% amid rising oil prices. China continued to perform poorly, returning -2.0%, as sentiment remained weak as its property sector woes deepened. Small-cap equities declined as cyclical assets generally performed poorly. Government bond yields continued their upward path worldwide following the re-setting of higher US interest rate expectations. The US 10-year government bond rose by 77 basis points to 4.57% the highest level since 2007 and the Australian 10-year yield increased by 46 basis points to 4.48%. The move higher in US yields resulted in a stronger USD globally with the Australian dollar (AUD) declining to just above 64 US cents. Commodities were mixed however, oil prices were strong up more than 28% to above US$95/barrel, following supply cuts announced by the Organization of the Petroleum Exporting Countries (OPEC). Iron Ore prices were also stronger (+5.3%) following the announcement of a number of stimulus measures in China, while gold prices fell over the quarter (-3.1%) with markets reducing their expectations for interest rates cuts in 2024 following the US Fed's comments over the quarter.

Market outlook

Looking ahead, in Australia, we continue to expect economic conditions to moderate in the coming quarters as the impact of increases in interest rates flows through to households. While overall inflation may ease over the year, core inflation is likely to remain elevated given tight labour and housing markets. Elsewhere, we expect modest growth in other major developed economies as financial conditions are expected to remain tight. We don't foresee a severe economic downturn as both household and corporate balance sheets remain healthy for now. In China we continue to believe authorities have room to implement additional targeted stimulus measures in the absence of inflationary pressures. Thus our outlook for the region remains optimistic.

From an asset class perspective, we continue to maintain a cautious view on Australian equities. Adding to this, our approach to global developed market equities remains somewhat cautious, as current market valuations appear to reflect a relatively optimistic short-term economic outlook, despite potential downside risks. We have a favourable view of emerging markets in comparison to developed markets, based on attractive relative valuations and an optimistic macroeconomic outlook. We also have a slightly preference for emerging market debt, given its relatively higher yields and prospects for further interest rate cuts likely across the regions.

Asset class comments

Australian Equities

Australian shares declined over the September quarter, the S&P/ASX 300 Index returning -0.8%, following a softening in risk sentiment from global markets over the period. The S&P/ASX Small Ordinaries was the weakest segment of the local indices returning -1.9% over the quarter.

Best performing sectors were Energy (11.6%), following a rebound in oil prices after OPEC cut its daily production target, and Consumer discretionary (5.6%) where strong FY23 results by Wesfarmers were among the positive contributors. While Healthcare and Consumer Staples underperformed during the quarter (-9.0% and -5.8% respectively) with markets rotating back into cyclical sectors following better-than-expected earnings reports over the quarter. The largest positive contributors to index returns were NAB (11.6%), ANZ (9.9%) and Woodside (8.6%). On the other hand, significant detractors were CSL (-9.3%), Telstra (-9.6%), and Transurban Group (-10.0).

Global Equities

The broad MSCI World ex-Australia Accumulation Index returned -2.7% in hedged terms and -0.4% in unhedged terms over the quarter as the AUD weakened against the USD and other major developed market currencies. The strongest performing sectors were Energy (14.9%) and Communication Services (4.7%), while Utilities (-6.4%) and Real Estate (-4.4%) underperformed during the quarter. The MSCI Small Caps Total Return Index (-1.4%) was also weaker though emerging markets where relatively flat for the period (0.1%, MSCI Emerging Markets Index).

Regionally, the September quarter was challenging quarter for US equity market with the S&P 500 Composite Index (-3.3%), the Dow Jones Industrial Average (-2.1%), and the NASDAQ Composite Index (-4.1%) all lower in USD terms. European markets were mostly negative (in local currency terms), with the CAC 40 (France, -3.4%) and DAX 30 (Germany, -4.7%) indices lower, while the FTSE 100 Index (UK, 2.2%) recorded an increase with growth in the nation holding up better-than-anticipated. Better economic performance was a theme in Asia as well with positive returns recorded for the TOPIX (Japan, 2.5%) and S&P BSE 500 (India, 5.1%) whilst the SSE Composite (China, -2.9%) and Hang Seng (Hong Kong, -4.2%) decreased, all in local currency terms.

Real Assets

Domestic listed property generated a negative performance over the September quarter and returned -3.0% (S&P/ASX 300 A-REIT Accumulation Index), underperforming broader equity markets with the rise in bond yields more adversely impacting this asset class. Similarly, Global REITs returned -4.9% (FTSE EPRA/ NAREIT Developed, in AUD hedged terms) over the period. The MSCI/Mercer Australia Core Wholesale Monthly PFI NAV Post Fee returned -1.6% and the FTSE Global Core Infrastructure 50/50 Index returned -7.2% for the quarter (in hedged AUD terms).

Fixed Interest

Following the repricing of expectations for interest rates to remain elevated for longer, combined with the continued resilience of US economy and a surge in energy prices that fuelled further inflation concerns, global sovereign bonds had negative returns over the September quarter as 10-year bond yields increased in the US (77bps to 4.57%), Germany (45bps to 2.84%), Japan (36bps to 0.76%) and the UK (7bps to 4.46%). Two-year bond yields increased in the US (20bps to 5.14%), Germany (9bps to 3.29%), and Japan (13bps to 0.05%), while it decreased in the UK (-36bps to 4.90%).

In terms of global bond indices, the Barclays Capital Global Aggregate Bond Index returned -2.1% and the FTSE World Government Bond (ex-Australia) Index returned -2.7% over the September quarter, both on a fully hedged basis.

Domestically, yields across the curve rose in line with the moves seen in global bonds, the 10-year bond yield rose 46bps to 4.48% and the five-year bond yield increased 19bps to 4.14%. Shorter term yields however declined with a lowering in the expected number of future interest rate hikes by the RBA after the Bank left interest rates steady at 4.1% for the quarter. As a result, the Bloomberg Ausbond Treasury Index was weaker over the three months to September (-0.8%), while the domestic credit market tracked by the Bloomberg Ausbond Credit Index returned (1.3%).

Currency Markets

The Australian Dollar (AUD) depreciated over the September quarter, declining against the US Dollar (-3.0%) given the shift higher US interest rate expectations providing a positive interest rate return for USD based assets. On a trade-weighted basis, the local currency depreciated by 1.0% over the quarter, largely attributable to the USD strength.

Commodities

The S&P GSCI Commodity Total Return Index increased by 19.6% over the quarter.

Gold prices finished September at US $1,856.75 per ounce, falling 3.1% over the three months. Meanwhile Iron Ore prices were stronger, increasing 5.3% to US$119.50 per metric tonne over the period, with optimism around Chinese demand increasing following stimulus announcements in China. Oil was another key commodity that rose over the quarter, up 28% to US$95.00 per barrel driven by OPEC production cuts.

Contact: Mercer >IS<

Tel: 1800 512 947

Email: merceris@mercer.com

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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MarshMcLennan