welcome to brighter

May 2023

Lessons from past recessions

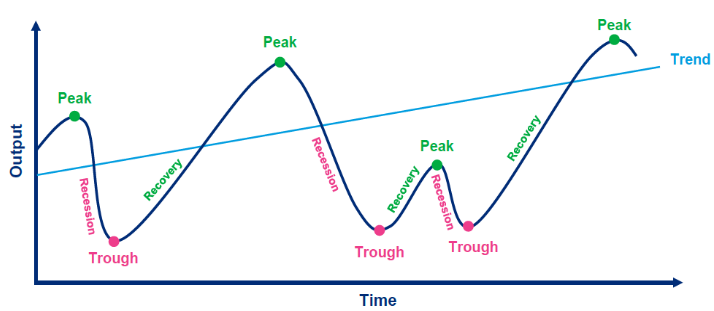
The best offence is a good defence

"History doesn't repeat itself, but it tends to rhyme." As such, general principles from past recessions can help investors in their portfolio positioning. While not possible to 100% accurately predict the next recession, adherence to the importance of offence and defence regarding investment strategy and asset allocation can aid investors in preparing for what lies ahead. Investors need a well-diversified portfolio that includes downside protection assets and a solid governance framework, which allows for implementation at short notice. It is also more effective to predefine the price at which an asset is deemed sufficiently attractive, rather than trying to time the market by shifting the portfolio in and out of cash. Investors who cannot allocate to downside protection assets can still add value through a solid rebalancing framework and potential out-of-cycle rebalancing during extreme market dislocations.

What is a recession?

Carrying a few definitions, a recession is essentially the down leg in the naturally occurring business cycle. There are several causes of recessions, including monetary and fiscal policy, changes in consumer and business confidence, shocks to the financial system, and exogenous events like natural disasters or military conflicts. Historically, monetary tightening has been the most frequent cause.

Figure 1. The Business Cycle



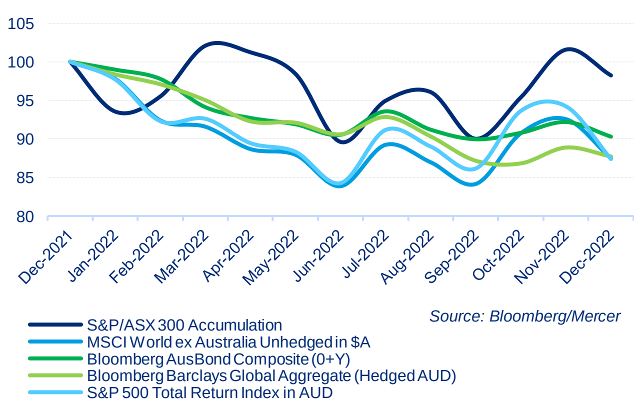
Source: Mercer. For illustrative purposes only.

As a simplified description, the business cycle begins with periods of central banks stimulating the economy by forcing interest rates below the level set by the free market. Credit expansion, malinvestment, asset bubbles, and inflation ensue as material and labour supply are constrained. Central banks then reverse course by lifting rates, the economy contracts, many investments need to be written off, and the economy enters a recession. Recessions are then followed by a period of abundance as the economy expands again, with the speed and strength of recovery depending on the severity and cause of the prevailing recession.

Where are we now?

The deep recessions of the 1970s and 80s resonate, as both were driven by high inflation, geopolitical shocks, and rate hikes going into a weakening economy. However, the current situation also has commonalities with recessions triggered by sharp exogenous shocks, i.e., Covid in 2020, the 2001 9/11 terror attacks, and the Gulf (1990/1991) and Korean (1953/1954) wars. These recessions were shorter and less severe. Given this, the current outlook is for a mild, shallow contraction as the market looks to be pricing in a soft landing. Since the end of 2022, most of the 'hard landing' rhetoric has given way to 'no landing' or a continuation of the inflationary boom of the last two years, which makes a hard landing further down the road more likely.

Figure 2. Equities & Fixed Income Indices over 2022



Source: Bloomberg/Mercer

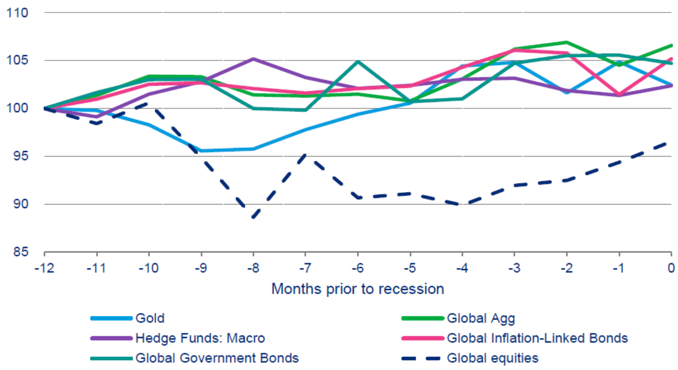
2022 was the worst year for US markets in over 150 years as both equities and fixed income tanked simultaneously, with the S&P500 and S&P US Aggregate Bond Index falling 18.11% and 12.0% respectively. Australia was better off, as the ASX300 and the Bloomberg AusBond Composite 0+Yr indices closed the year down 1.77% and 9.71%. The rerating in equities seems to have been driven from rising discount rates rather than changes in earnings expectations, which seem to be overly optimistic given the macroeconomic backdrop. So while inflation remains well above target, financial stability takes centre stage. Mercer's view is more negative for developed market (DM) equities than emerging market (EM) equities due to tighter financial conditions and rising bond yields, whereas the EM index is largely bolstered by China reopening (which poses a tailwind for DM equities too) – however, geopolitical issues and the slowing growth in DM may pose headwinds. As anyone can see, the global economy is very interlinked, with a chicken and egg scenario coming to mind. Global IG credit, High Yield, and Australian government bonds are poised to outperform global sovereign bonds and EM credit, in our view.

Lessons from previous recessions

"It's not about timing the market, but about time in the market." Investors who remain fully invested through periods of market stress tend to outperform those that sell out and attempt to seek a lower re-entry point, as trying to time the market is extremely challenging with little margin for error.

The best offense is a good defence. A) Stay invested with a diversified portfolio which aims for long-term growth and has built-in mitigants against recessionary outcomes. B) Have rebalancing policies and tactical deployment of dry powder into asset classes whose valuations have become more attractive.

Figure 3. Median performance in the 12 months pre-recession



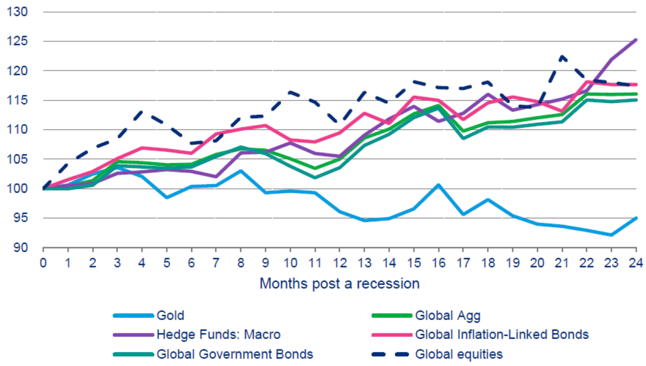
Source: Refinitiv, National Bureau of Economic Research and Mercer analysis. Data as of January 31, 2023. Median performance is rebased to 100 in the 12 months prior to GDP growth hitting the trough. The asset class lines show the median performance in each individual month. Gold and Global equities are the median return of the prior seven US recessions. Hedge Funds: Macro is the median return of the prior four US recessions. Global Agg, Global Inflation-Linked Bonds and Global Government Bonds are the median return of the prior three US recessions.

Public market equities are expected to rally as the business environment improves and optimism returns post-recession. The same can be said for both investment and sub-investment grade public market credit. In a recession, credit spreads typically widen as the credit risk premium and default expectations increase. As markets begin to price in a recovery and risk sentiment turns positive, spreads tighten, and credit performs well. While defaults do indeed increase during recessions, the widening of credit spreads has historically been disproportionally high, which gives an opportunity for buy-to-hold investors to lock in attractive spreads for the long term. If approached correctly, private equity and private debt can also provide fruitful opportunities in the years following a recession.

Historically, staying invested (or playing defence) paid off for long-term investors by preventing them from making the wrong call. At the same time, these returns are further magnified by rebalancing whenever the equity allocation deviates ±5% from its target allocation, or through deploying dry powder when equity valuations become more attractive.

By deploying dry powder during the GFC from a 60/30/10 portfolio (the 10% allocation to downside protection asset classes) to reallocate back into equities (creating a 70/30 portfolio), investors could have enhanced returns by 1.9% p.a. throughout the cycle (Oct 2007 – Dec 2019). When deployment began, the PE ratio had dropped from 15.3x to 10x. This was not a case of timing the market but rather tactically taking advantage of more attractive valuations (being nimble). Even if you are buying into falling markets in the short term, buying at attractive valuations still led to enhanced returns in the long run.

Figure 4. Median performance in the 24 months post a recession

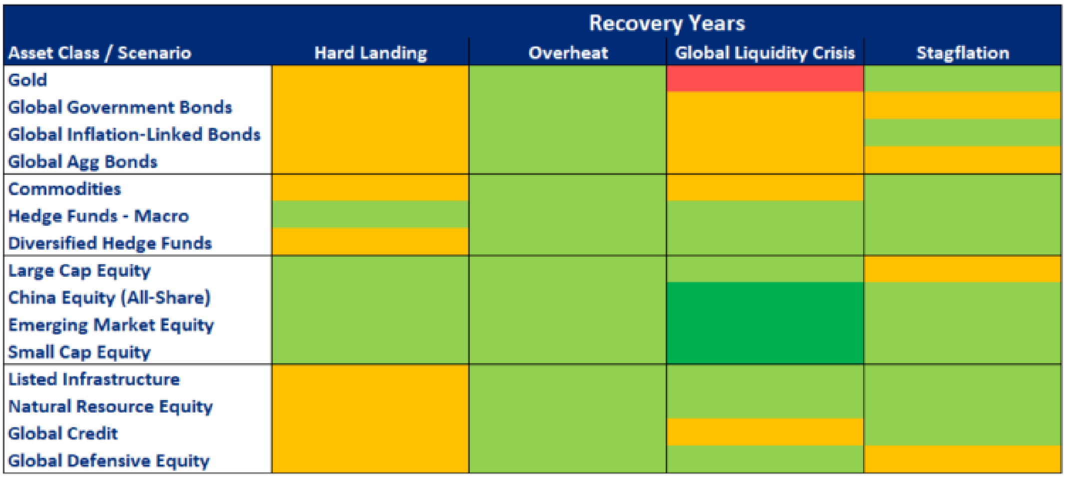


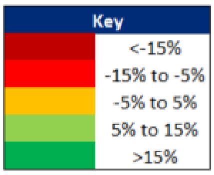
Source: Refinitiv, National Bureau of Economic Research and Mercer analysis. Data as of January 31, 2023. Median performance is rebased to 100 at the point of the trough in GDP growth. The asset class lines show the median performance in each individual month. Gold and Global equities are the median return of the prior seven US recessions. Hedge Funds: Macro is the median return of the prior four US recessions. Global Agg, Global Inflation-Linked Bonds and Global Government Bonds are the median return of the prior three US recessions.

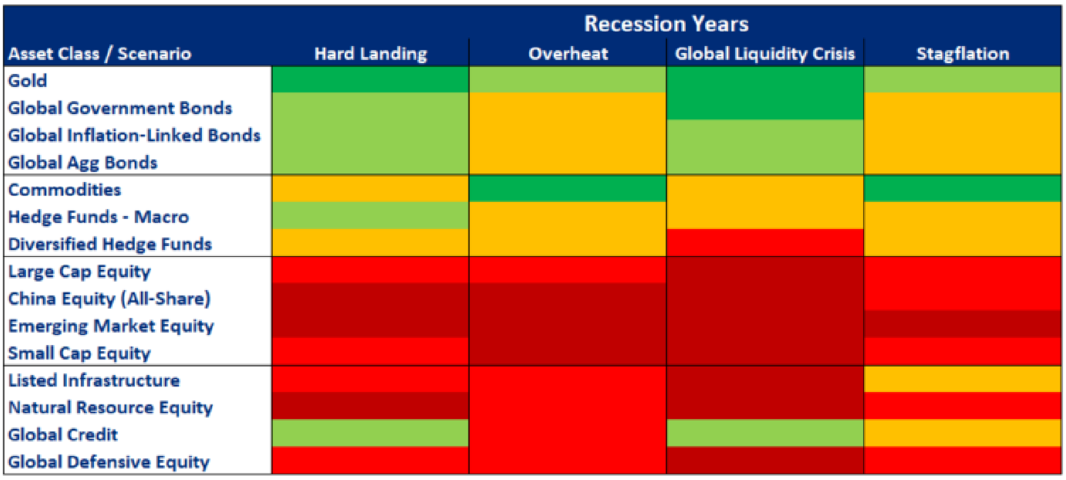
Recession playbook

1. Have a strategic allocation to liquid downside protection assets (i.e., cash, gold, hedge funds, short-duration bonds) that become dry powder in times of market drawdowns.
2. Set valuation triggers for out-of-cycle rebalancing or deployment of dry powder:
   - If equities fall by x% or if yields go above y%, allocate all or some dry powder to this asset class.
   - Once markets recover, rebuild dry powder by taking profits from risk assets to prepare for next downturn.
3. Set up a governance framework that allows for the monitoring of opportunities and swift execution.
   - Assign or outsource clear responsibility to individuals to identify when pre-determined triggers are hit (for deployment of dry powder) or to execute the agreed rebalancing accordingly.

Appendix







Source: Mercer scenarios. Data as of December 31, 2022. The returns shown in the table are the p.a. returns for each asset class in the years when growth bottoms and turns positive, returning to equilibrium.

Scenario	Description
Global Liquidity Crisis (financial crisis)	Global markets are roiled by a financial crisis similar to 2008/09, with sharp losses from equities and other risky assets in a short period as liquidity rapidly disappears as financial entities default.
Overheat	A "mini-Volcker", with US interest rates peaking around 5-6% in the medium term and rising much faster than is currently being discounted by markets, with the aim of countering persistent rising inflation. This leads to a recession in the medium term and weak bond performance. Note that expected bond performance would be even weaker if we were still in the beginning of the tightening cycle like in early 2022.
Stagflation	Aggressive monetization of debt driven by rising debt levels, supply shortages, structural inflationary pressures arising from a slowdown in globalization, a commodity shock and/or geopolitical event driving higher structural inflation and/or a sudden inflationary shock. Initially, central banks allow inflation to rise above targets for sustained periods, bond vigilantes drive rates higher and a wage-price spiral sets in. At some point, central banks scramble to tighten monetary policy. Economic growth remains considerably below long-term consensus for the foreseeable future as a consequence.
Hard Landing	Global growth continues to disappoint over the next few years, with weak overall growth, descending into a hard recession as de-leveraging intensifies. Unemployment and deflation risks are at the forefront of central bankers' concerns, leading to real rates remaining very low or becoming negative again. This scenario can be driven by either an involuntary return to austerity due to political gridlock, a monetary tightening cycle, a sudden exogenous shock such as the emergence of another virus or other events that have a deflationary rather than inflationary impact.

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