Q3 Commentary & Outlook – September 2024

Key Takeaways

- ***Equities:** A few noticeable changes in the US equity market behavior: 1.) Investors are weary of paying excessive premiums for a big payoff in AI, 2.) There has been a noticeable rotation into stocks outside the Mag 7 and 3.) Current economic data indicates that earnings may continue to grow at healthy annual rates (especially for undervalued profitable companies outside the Mega Tech stocks.*
- ***Bonds:** We believe it is best to focus on bonds that provide the best unit of potential return for the lowest level of duration risk. Short term credit including lower than investment grade credit would be considered the sweet spot in today's environment. We are still hesitant to take excessive duration risk given the forces in place that we believe may contribute to higher inflation down the road, such as expansionary fiscal programs indicated by both parties.*
- ***Alternatives:** We continue to focus on independent sources of return and diversifiers to traditional equity and bonds. The elevated nature of global economic uncertainty has centered focus on inflation risks due to higher energy costs and a weakening dollar. Geopolitical risk is at an all time high, and the potential market volatility associated with that uncertainty warrants exposure to risk hedges such as precious metals and long short commodities.*

Markets Review and Outlook:

Equities:

- Performance during the 3rd quarter was widely influenced by the larger-than-expected Fed rate cut of 50 basis points on September 18th. This risk-on event favored a noticeable rotation into value-oriented and dividend-paying stocks.
- Overseas developed and emerging market equities also benefited from a global bias toward monetary easing. The strength of the overseas markets ignored the turmoil in the Middle East and Ukraine, and investors focused on relatively attractive valuations and earnings prospects. A weakening US dollar also contributed to gains for US-based investors.
- Economic indicators suggest that economic growth is trending near the long-term trend rate and that core inflation has come down from its previous highs. The labor has also surprised on the upside, suggesting that the long-expected recession may be further off than many had previously expected.

Bonds:

- Bond markets rallied on lower interest rates resulting from the Fed's first rate cut since COVID. Even higher-yielding credits posted strong results despite narrow spreads over Treasuries.
- Longer term yields declined on lower inflation expectations during the quarter but most recently reversed that trend when the US job numbers posted a much stronger result than consensus expectations.

Alternatives:

- Liquid alternative assets lagged both equities and bonds as investor's expressed a renewed interest in risk assets after the larger than expected Fed rate cut. REITs continued to post strong results, with managed futures and commodities lagging.
- A general lack of trending in the futures market has hurt many managed futures and commodity programs.

Market Performance

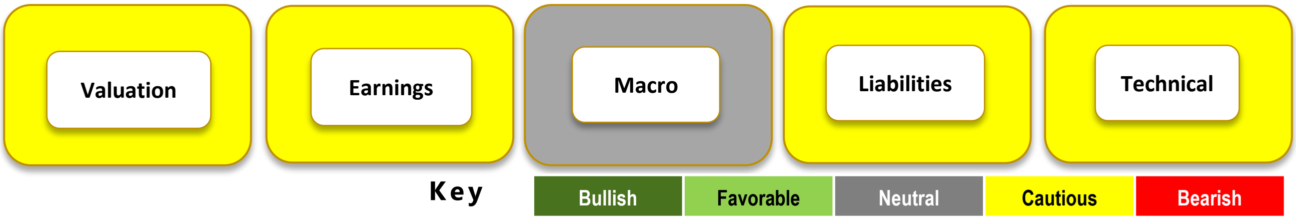
Bullish | Favorable | Neutral | Cautious | Bearish

`	QTR	YTD	1 Year	Current View
U.S. Large Cap	5.86	21.96	36.16	Neutral
U.S. Mid Cap	6.83	13.26	26.30	Favorable
U.S. Small Cap	10.12	9.33	25.84	Neutral
U.S Momentum	4.26	29.70	46.00	Cautious
U.S Growth	3.71	28.09	40.99	Cautious
U.S.Multi Factor	6.84	14.84	28.33	Neutral
U.S. High Beta	5.85	9.07	28.48	Cautious
U.S. Quality	5.42	22.69	37.60	Favorable
U.S. Buyback	10.45	16.41	28.63	Cautious
U.S. Equal Weight	8.92	14.66	29.26	Favorable
U.S. Value	9.02	15.29	30.96	Favorable
U.S. Dividend Aristocrats	11.62	13.86	23.22	Neutral
U.S. Low Volatility	10.94	16.31	24.79	Neutral
U.S. Low Volatility High Di	14.79	22.50	34.34	Neutral
U.S. Select Dividend	13.02	18.48	30.40	Neutral
International Developed	7.70	12.91	25.27	Neutral
Emerging Markets Equity	9.32	17.33	25.03	Neutral
Fixed Income				
U.S. Total Bond	5.21	4.56	11.55	Neutral
U.S. Government	4.73	3.97	9.68	Neutral
U.S. Corporate	6.60	5.22	15.59	Neutral
U.S. High Yield	5.32	7.62	15.32	Neutral
U.S.Leveraged Loans	2.09	5.78	8.94	Neutral
Non-U.S. Developed	4.10	3.57	10.33	Cautious
Alternatives				
REITs	17.19	13.60	34.20	Neutral
Commodities	-5.44	4.48	-6.92	Neutral
Managed Futures	0.17	1.50	-9.99	Neutral
Hedge Funds	2.79	4.98	8.69	Favorable

Source: Morningstar, data as of 09/30/2024

Risk Examination – September 2024

A quarterly update on our views of the complex risk factors in global markets



Valuation

- U.S. equity valuations remain highly over-valued, especially on a cap-weighted basis. Outside of momentum and Mega Cap growth stocks, valuations are relatively attractive. This is crucial for long-term investors because beginning valuations matter for long-term investors, not short-term speculators (a case in point would be in the early 1980's when equities were trading at less than 10x earnings).

Earnings

- Earnings expectations are near the long-term average into 2025. The caveat will depend on the path of overall real economic growth. We believe that the market is still too optimistic with respect to earnings growth for the remainder of 2024, into 2025.

Macroeconomic

- There are mixed signals of growth in the US economy evidenced by weakness in the household and private services sector, but surprisingly strong growth in the labor market. Lower rates may also catalyze higher growth, especially in the housing market. The downside of this is that the bottom half of the economy is struggling to pay bills, while inflation continues to dampen growth at the retail level.

Fundamental, Economic & Geopolitical Risks

- Our view is that balance sheet risk has risen due to higher debt ratios and elevated interest rates. The number of zombie companies (insufficient operating cash flow to service existing debt) is increasing along with credit default risk, especially the lower-end spectrum of high-yield debt. Economic risks include slower growth, rising debt costs, and sticky inflation. Uncertainty is elevated due to politics both at home (election year) and abroad (Israel/Hamas war, Russia/Ukraine war, China, etc.).

Technical/Sentiment

- The uncertainty from the effects of the crisis in Ukraine, the Middle East, and its broader geopolitical impact (i.e., the new Axis of Evil: Russia, China, and Iran), elevated inflation rates, and lower economic growth ahead will most likely continue to feed higher volatility in the public markets. Consumer households are starting to feel the headwinds of constraints on consumption that should lead to lower growth.

2024-2025 Economic and Investment Scenarios

Our assessment of potential macro scenarios

	Recession	**K – Shaped Recovery**	**Return to New Normal**	**Robust Recovery**
Economy / Geopolitical	▪ Negative growth precipitated by elevated interest rates, inflation, lower growth ▪ Civil unrest, election outcome ▪ Demand slowdown	▪ Weakness in consumer discretionary ▪ Strength in E-commerce/innovation ▪ Fed focus on 2% inflation & no room for fiscal stimulus	▪ Gradual recovery with radically different labor market ▪ Inward focus ▪ Steady growth/low inflation	▪ Inflation reverts to Fed target ▪ Job growth/higher consumption ▪ Infrastructure spend
Markets	▪ Prolonged sell-off in risky assets ▪ Rush to safe-haven assets such as the U.S. dollar, gold and cash	▪ Negative effect of elevated inflation ▪ Volatility dominates ▪ Highly valued & concentrated markets ▪ Focus on risk	▪ Extended recovery puts focus on value, small cap & higher inflation ▪ Pressure on Big Tech	▪ Negative real rates, a flood of new money = continued asset inflation ▪ Alternative assets & equities prosper
Focus	▪ Flight to quality: Short duration U.S. Treasuries, U.S. Dollar, & Gold benefit	▪ Premium on asset diversification = liquid alts ▪ Commodities & non-directional investments	▪ Focus shifts from sentiment driven markets to fundamentals	▪ Fully invested, but highly diversified
Probability	**40%**	**25%**	**25%**	**10%**

< < < Downside < < < | **> > > Upside > > >**

Risks

Downside:

- Geopolitical risk of a misstep with Russia, China, Iran
- Sustained high-interest rates and higher energy prices
- Runaway debt growth on pace to equal Japan
- Higher rates of poverty and social displacement
- Higher unemployment – weaker demand

Upside:

- Effective use of fiscal stimulus spurs economic growth
- Globalization returns
- A shift in focus and higher productivity
- Strong real economic growth and productive use of credit
- Raises the wealth effect across multiple sectors
- Lower rates of inflation, above-trend real growth

Portfolio Asset Class Positioning

PORTFOLIO SEGMENT / SEGMENT OBJECTIVE	SEGMENT CONSTITUENTS	SEGMENT COMMENTS
Equity *Diversified risk factor exposure with an emphasis on quality, value, & innovation*	▪ Global exposure to high-quality companies and innovators in their field ▪ Continued exposure to emerging market equities with a cutback in smaller cap non-US equity markets. ▪ Entry point into US large-cap value stocks as we migrate into the next phase of the business cycle.	▪ Systematic exposure in U.S. equity to an equal-weighted market index, & high-quality stocks with low debt ratios across global markets ▪ Diversified non-US exposure to high-quality in developed markets and passive and active exposure to emerging market stocks ▪ Continued emphasis on actively managed beta exposures
Fixed Income *Seek to Preserve Capital, and Diversify Equity Exposure*	▪ Emphasis on short to intermediate duration & and high credit quality issues ▪ Reduction in credit risk (ABS & senior bank loans) ▪ Not a time to "reach for yield," be selective	▪ Reduction in cash exposure to high-quality credit (short-intermediate term duration) ▪ Favor high-quality credit over duration ▪ Issuer selection critical for active management
Opportunistic *Highest Conviction Ideas Based on 12-24 Month Proprietary Forecasts*	▪ Slight overweight in the energy sector; Middle East tension = higher energy prices ▪ Focus on risk management via our dynamic innovation overlay process to lessen the risk of large drawdowns ▪ Continued exposure to selective innovation themes	▪ Reflects our short-term model (value and momentum) ▪ Seeking participation in select themes with attractive return potential based on innovative technologies such as 3D printing, gene therapies, digital wallets, renewable energy, and AI ▪ Innovation: monthly rebalance of risk (high beta and risk-off low beta) based on momentum
Alternative *Anticipated Risk Mitigation with Alpha Opportunities*	▪ Opportunistic Commodities ▪ Hedged equity ▪ Global macro–credit ▪ Carbon credits ▪ Systematic L/S managed futures ▪ Gold	▪ Lower than average return and higher risk expectations for equities and bonds present the challenge of providing uncorrelated sources of risk and return. ▪ We favor exposure to risk-managed approaches to investing in liquid alternatives with an emphasis on actively managed long/short commodities, carbon credits, hedged equity, gold & managed futures

For additional information, please refer to the Disclosures at the end of this report.

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Index definitions:

"U.S. Large Cap" represented by the S&P 500 Index.
"U.S. Small Cap" represented by the Russell 2000 Index.
"International" is represented by the MSCI Europe, Australasia, Far East (EAFE) Net Return Index.
"Emerging" represented by the MSCI Emerging Markets Net Return Index.
"U.S. Aggregate" represented by the Bloomberg U.S. Aggregate Bond Index.
"U.S. Government" represented by the Bloomberg U.S. Government Bond Index.
"U.S. Corporate" is represented by the Bloomberg U.S. Credit Bond Index.
"U.S. High Yield" represented by the Bloomberg U.S. Corporate High Yield Index.
"Non-U.S. Developed" represented by the S&P International Treasury ex U.S. Index.
"Emerging Market Debt" represented by the JP Morgan GBI-EM Global Core Index
"REITs" are represented by the FTSE North American Real Estate Investment Trust (REIT) Equity REITs Index.
"Commodities" represented by the Dow Jones Commodity Index.
"Managed Futures" represented by the Credit Suisse Managed Futures Index.
"Global Macro" represented by the Credit Suisse Global Macro Index

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