Bitterroot
CAPITAL ADVISORS

CAPITAL MARKETS REVIEW

2023 Quarter 4

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All public market data are as of 01/19/24 unless indicated otherwise.

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EXECUTIVE SUMMARY

Capital Markets

Equity markets (ACWI Index) appreciated by 11.0% in Q4 and 22.2% for full-year 2023.

Gains were widespread with major indexes (S&P 500, MSCI EAFE, MSCI Emerging Markets) all up 8%-11% in USD terms during Q4.

Faster than expected declines in inflation and swiftly falling bond yields drove the strong performance.

US Government and investment-grade corporate bonds appreciated significantly as interest rates declined sharply during the quarter.

The Barclays US Aggregate Index was up 6.8% during Q4 with US Treasuries up +5.7% and Investment Grade corporate bonds up 8.5%.

Bond yields declined by 70bops-80bps across the curve during the quarter, with 10-year US Treasury yields declining to 3.87% at YE 2023 versus 4.57% at the end of Q3 2023.

For full-year 2023, the Barclays AGG Index was up 5.5%.

US High-yield bonds and leveraged loans (riskier corporate credit) were up 7.2% and 2.8% during Q4 and were up 13.5% and 13.3% for full-year 2023.

Q4 high yield returns were driven by declining base rates, spread compression and high coupon yields.

Q4 leveraged loan returns were primarily driven by high coupon yields coupled with modest spread compression.

Credit spreads tightened throughout the year as corporate earnings held up better than expected and confidence in an economic soft landing increased. In fact, high-yield bond spreads of 338bps are now below historical averages (430bps) and are well-below the 800bps level normally seen during recessions.

Hedge funds were up 1.8% in Q4 and 3.1% YTD.

Convertible arbitrage strategies performed best (+10.1% YTD) while directional strategies such as equity-hedge and credit also performed well (+6.9% and +6.5% YTD). Event-driven and macro / trend-following strategies performed worst at +0.4% and -1.5% YTD respectively.

CAPITAL MARKETS (CONTINUED)

Private equity was up 5.6% in H1 2023 and likely up similar amounts in the second half.

Private equity managers report with a 60-to-120-day lag. As such, Q3 and Q4 benchmark data is not yet available. However, most PE firms are reporting increases of low-SD during Q3 and Q4 driven primarily by underlying EBITDA growth at portfolio companies.

New deal activity across buyout strategies remains well below 2021 peaks and is also below pre-pandemic levels. Entry valuation multiples declined to 12.3x in 2023 from 13.8x in 2021 and leverage has declined to 45% debt to capital currently versus 52% debt to capital at the end of 2021.

Private credit performed well through Q3 2023 (latest data available given lagged reporting)

The Cliffwater Private Credit Index was up 8.9% YTD as portfolios benefitted from high current yields with stable pricing. Q4 returns likely eclipsed 3.0%, bringing 2023 returns to north of 12%.

The near-term outlook for existing funds is relatively positive. Increases in SOFR base rates has led to unlevered current yields of north of 10%. However, increased defaults and markdowns may offset some of this return.

Some analysts are projecting that in 2024 private debt defaults may exceed those experienced by loans traded on the syndicated loan market, especially for those loans originated in 2021 during frothy credit conditions.

Private real estate pricing continued to decline in Q3 2023 (latest data available) although transaction volumes remain low.

The NCREIF Index was down 1.4% in Q3 2023 (fourth consecutive quarterly decline) and was down 5.1% YTD. Cap-rates have begun to stabilize, although there is very limited data following the recent uptick in rates.

Market rental growth has decelerated for almost all property types as high levels of supply have come online in 2022 and 2023. However, new supply is expected to decline considerably in 2025 and 2026.

Underlying property fundamentals remain reasonably strong across industrial properties but have stagnated for multi-family properties (rents flat YOY in December on a national level). Office fundamentals are generally under significant pressure except for the highest-quality, best location properties.

CAPITAL MARKETS (CONTINUED)

We see a favorable outlook for new private investment funds (currently raising money for 2023 vintage and 2024 vintages) with lower valuations and reduced leverage use, and in certain cases less capital chasing opportunities.

While the chances of a soft landing (especially in the US) have markedly increased, the level of economic and geopolitical uncertainty remains extremely high.

As such, we see a wider than normal range of possible outcomes (especially for public equity markets) over the next twelve months.

We are incorporating these views into portfolio positioning by:

Cash management via allocation to short-term US Treasuries and US investment-grade bonds.

Continued allocations to new private investment strategies, especially private equity secondaries and private credit.

EXECUTIVE SUMMARY

Strategic Asset Allocation View (7-years)

We consider the following factors when developing our 7-year forecasts.

Interest rates are likely to decline from current levels but will not return to the ultra-low-levels experienced between 2009-2021.

Corporate profit margins will be influenced by two opposing factors. On the one hand, onshoring and less labor flexibility may dampen margins. On the other hand, AI adoption may increase productivity and expand margins.

Geopolitical uncertainty is increasing with regards to the US-China relationship and potential for episodic military conflicts (especially a potential widening of the war in the Middle East).

With equity valuations having increased materially in 2023, we now expect mid-single digit nominal pre-tax annual equity returns (6.0%-7.0%) over a seven-year forecast period.

We anticipate greater convergence between US and International equity market returns.

While we expect quality and growth stocks to outperform value stocks over the forecast period, the rate of outperformance is likely to be lower than that over the past seven years.

Equity market valuations are generally fair (for international markets) to modestly overvalued (US). Thus, earnings growth and dividends rather than multiple expansion are likely to drive returns.

Potential wildcards (especially for tech-oriented US markets) include adoption pace surrounding generative AI and the resulting potential for above-trend revenue growth and margin expansion.

“Safe” fixed income is still attractive, with shorter-term maturities relatively more compelling.

US and Canadian 1-year government bond yields are yielding 4.8% to 4.9% and 2-year government bonds are yielding 4.1%-4.4%

US 10-Year Treasuries are yielding 4.1% (down from an early October peak of nearly 5%). At these levels, we view longer-term US treasuries with a more neutral lens. While our base case still envisions declines in the 10-year bond to 3.50% to 3.75%, the capital appreciation potential is certainly less now than a few months ago.

STRATEGIC ASSET ALLOCATION VIEW (CONTINUED)

We expect mid-single digit returns for US government debt and investment grade bonds over the forecast period.

On a risk-adjusted pre-tax basis, safe fixed income's return potential is still relatively attractive relative to equities.

Riskier credit assets (high-yield bonds and leveraged loans) are modestly attractive over a mid-term time frame (and versus equities).

US high-yield bonds are now yielding 7.8% with 7-year forecasted annual returns of 6.0%-6.5% (relatively close to US Equities). Leveraged loans are currently yielding 9.8% with expected mid-term annualized returns in the 6.5%-7.0% range.

However, high yield spreads of 338bps are below historical averages and are well below those seen during recessions (600bps-800bps). Should a recession occur, these spreads will likely widen and negatively affect near-term returns.

For new private market strategies (i.e., private equity and private credit,) we continue to forecast higher returns relative to public markets (over a multi-year timeframe).

STRATEGIC ASSET ALLOCATION VIEW (CONTINUED)

Asset Class: Strategic Outlook (7-year timeframe)		
	Expected Annual Return	**Relative Attractiveness***
	0% —— 20%	Negative – Neutral – Positive
Equities		
US Large Cap (S&P 500)		
US Small Cap (Russell 2000)		
MSCI Europe		
Japan Topix		
MSCI Emerging Markets		
Fixed Income		
US Treasuries		
US Corp Investment Grade		
US Corp High Yield		
US Corp Levered Loans		
Alternatives, Private Equity, & Real Estate		
Real Estate (Private) - Unlevered		
Alternatives (Hedge Funds)		
Private Credit (New Funds)		
Private Equity (New Funds)		

Note: The attractiveness of each asset class (as depicted by the positioning of the sliders) is based upon risk-adjusted returns when considering expected returns, volatility, and liquidity. Thus, US Treasuries with mid-single digit returns are shown as quite attractive given a low-risk profile whereas public equities are only rated modestly attractive despite their higher expected return as equities have much greater volatility.

EXECUTIVE SUMMARY

Macroeconomic Conditions

United States

The US economy performed strongly in 2023. Robust consumer spending and more significant than expected outlays from the Inflation Reduction Act supporting onshoring manufacturing capacity helped drive better-than-expected growth.

Real GDP grew by 4.9% in Q3 following 2.2% growth in H1. Preliminary Q4 growth was estimated at 3.3% annualized (well higher than expected) driven by healthy retail sales and consumer spending as the labor market remains strong.

Growth in 2024 is expected to slow to less than 2.0% as excess consumer savings bleed down, unemployment ticks up modestly, and the lagged effect of substantial interest rate increases are felt throughout the economy. However, the probability of a soft landing has increased markedly over the past few months.

Canada

Canada's economy has remained sluggish over the past several months with slightly negative growth in Q3 2023 and flattish growth expected in Q4.

Canada's economy was bolstered in 2023 by historically high population growth. On a per-capita basis, GDP declined for the past several quarters.

Higher household debt ratios will likely constrain consumer spending through H1 2024; 2.2mm households face mortgage renewals over the next two years.

On the flip side, with inflation rapidly falling, the Central bank is well poised to cut rates over the next few quarters.

MACROECONOMIC CONDITIONS (CONTINUED)

Europe

Europe's economy likely experienced a mild recession in H2 2023, but inflation is rapidly cooling which should set the stage for several rate cuts in 2024.

Manufacturing remains weak with PMI surveys near 44 (well below the 50-level which indicates neither growth or contraction). Manufacturing surveys have indicated contraction for 18 straight months but seem to have bottomed out. Worryingly, services PMIs have also breached 50, indicating that services may no longer buoy Europe's economy.

On the positive side, unemployment levels remain near historic lows and European consumers have spent less of their excess savings accumulated during the pandemic (in contrast to US consumers).

China

China's 2023 post-COVID recovery proved to be disappointing.

Real GDP grew at 5.2% in 2023 (against easy comparisons) and was below most economist forecasts.

The property market remains extremely weak despite various measures of government support.
China factories have suffered from deflation due to excess capacity and consumer spending remains restrained.

Most economists expect 2024 growth to be below the government's 5% official target. The level of government fiscal and monetary stimulus remains a crucial wildcard.

MACROECONOMIC CONDITIONS (CONTINUED)

Inflation

Inflation is declining quickly across most major economies and recent declines have been faster than expected.

The US Core PCE Index (Fed's preferred measure) grew at 3.2% YOY and 0.1% MOM in November. While the YOY growth was still higher than the Fed's 2% target, the index has averaged 1.9% annualized increases over the past six months.

Importantly, this growth rate is likely overstated as it includes shelter costs in its calculation (shelter cost inflation is artificially high due to the lagged nature of the calculation in inflation data).

The rapid fall in inflation has been driven by falling goods prices as supply chains have fully normalized while services inflation has remained stickier.

Core inflation in the Eurozone cooled to 3.4% YOY in December, the lowest annual rate since March 2022.

Additionally, government subsidies have also helped to lower energy and food costs through subsidies and other measures.

Interest Rates

The interest rate hiking cycle is clearly over for central banks (barring a surprise reacceleration of inflation). The current debate centers around x and magnitudes for rate cuts.

The Fed or ECB is unlikely to cut rates during the first quarter. However, with inflation falling faster than expected, central banks may cut rates more than they have targeted to stave off potential economic declines.

While we acknowledge a wide range of possible outcomes, our current thinking is for Fed rate cuts of 75bps-100bps in 2024 and a decline in 10-year US Treasury yields to 3.50%-3.75% by YE 2024 from 4.1% today.

EXECUTIVE SUMMARY

Shorter-term View: Key Issues

Following strong rallies in 2023, equity markets face several major issues in 2024.

Issue 01: Inflation Trajectory

Inflation has decelerated faster than expected over the last several months, leading to sharp declines in bond yields. Labor markets (especially in the US) have begun to loosen, although wage growth remains somewhat elevated. Core inflation measures are clearly showing signs of trending towards the Fed's 2% target (and may be artificially high given the lag in elevated shelter inflation data).

However, loosening financing conditions and robust consumer spending may restrain further progress on inflation reduction. If inflation continues to decline as, or faster than, expected, central banks are likely to cut rates more rapidly than they have signaled, which would be highly supportive for equity markets.

Issue 02: Economic Growth – soft landing, mild recession, or hard landing?

The chances for a soft landing in the US have markedly improved as inflation has fallen quickly without a corresponding surge in unemployment. Consumer spending appears robust, and enterprise technology spending has increased following a lull in 2022.

However, manufacturing data remains weak, and cracks are emerging in the job market (a significant majority of job creation occurs only within government and healthcare services sectors). It is also unclear how much excess consumer savings remain.

The European economy likely entered a technical recession in H2 2023. While excess consumer savings remain higher than the US, Europe is more exposed to global macro conditions and could tip into a deeper recession should macro conditions deteriorate meaningfully in the US or Asia.

SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Issue O3: Corporate Earnings

Corporate earnings held up much better than expected in 2023. In fact, S&P 500 earnings grew YOY in Q3 and Q4 after declining YOY in H1. A combination of steady demand, cost reduction initiatives, and a catch-up price increases coupled with stabilizing or declining input costs led to margin stabilization or increases.

Analysts are forecasting 5% revenue growth and margin expansion driving 10% earnings growth for the S&P 500.

While we think 7%-8% EPS growth in more likely in 2024, several wildcards including stability of demand and effects of AI on productivity could affect this figure meaningfully.

Issue O4: AI Adoption

50%-200% appreciation across a select group of US technology / internet companies (the Magnificent Seven) helped fuel the S&P 500 25.7% 2023 return (significantly outperforming international markets yet again). Many of these stocks benefitted due to actual or perceived AI benefits.

Continued outperformance for these companies and for semiconductor stocks in general will depend on the level and breadth of AI adoption.

Similarly, it remains to be seen whether broader AI adoption (outside of technology companies) can drive the next leg of corporate productivity growth and margin expansion.

SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Issue 05: China Government Policy

China's equity markets have declined 59% cumulatively (MSCI China Index) since their February 2021 peak versus a 13% cumulative increase in the MSCI ACWI Index over the same time frame. Significant changes in governmental regulation aimed at certain sectors, a large downturn in the property sector (accounts for 30% of China GDP), and a weaker-than-expected post COVID recovery all contributed to the decline.

China's weak equity market performance has dragged down emerging market indexes (-9.3% annualized over the past three years versus +6.7% for developed markets).

It remains to be seen whether China undertakes aggressive fiscal and monetary stimulus (as they did post GFC and in 2016). Thus far, stimulus has been modest and equity markets continue to sell off.

Large scale stimulus would likely lead to rallies in Chinese equity markets and emerging markets more broadly. Additionally, European markets may also benefit under this scenario as Europe is a large exporter to China.

Issue 06: Geopolitical Conflicts

The Middle East seems delicately poised with chances increasing that conflict may widen beyond Israel and Hamas.
A widening conflict would negatively affect global equity market confidence and likely lead to surging oil prices which may reignite inflationary pressures.

The Russia / Ukraine war seems to be in a stalemate with outcomes uncertain.

Issue 07: US Presidential Election

US equity market have generally experienced higher than normal volatility during presidential election years. It remains to be seen whether there may be unexpected policy changes from either the Republican nominee (most likely Trump) or the incumbent (Biden).

As a mitigating factor, both candidates are well-known, and markets have already experienced their economic policies. Policy proposals espousing a more widespread application of tariffs (favored by Trump) would negatively affect equity markets.

EXECUTIVE SUMMARY

Shorter-term View: Scenarios

We see multiple potential paths for equity returns over the next 12 months (with reference to the S&P 500 which stands at 4,840 as of January 19, 2024).

Scenario A: Optimistic Case

Core inflation falls much faster than expected and the Fed pre-emptively cuts rates by 100bps or more. 2024 real GDP growth ranges between 1.5%-2.0%. Consumer spending remains healthy and steady AI implementation drives corporate profit margin improvement.

Under this scenario, S&P earnings could expand to $245-$250 in 2024 and $270-$275 for 2025 (versus $220 in 2023). Equity multiples may expand to 19.5x-21.0x forward earnings. The S&P 500 index could appreciate to 5,250 to 5,700 by YE 2024 (10%-19% total return).

Scenario B: Base Case

Fed holds rates steady through Q1 or even through H1 2024 and then cuts by 75bps. Economic growth slows but the US avoids a recession. Real GDP growth ranges between 1.0% and 1.5%. Unemployment modestly rises and consumer spending slows but does not decline meaningfully.

Under this soft-landing scenario, S&P 500 earnings could expand to $235-$240 in 2024 and $255-$265 in 2025. Equity multiples range between 18.0x-19.5x forward earnings with the S&P ending 2024 between 4,700 and 5,100 (total return of -1.5% to +7.0%).

SHORTER-TERM VIEW: SCENARIOS (CONTINUED)

Scenario C: Pessimistic Case

Consumers exhaust remaining excess savings and the economy slows faster than expected leading to intensified layoffs. European weakness may exacerbate the swiftness of a global recession. Another pessimistic outcome could be a reacceleration in inflation which leads to additional fed hikes which then leads to a hard landing in late 2024 or early 2025. This scenario leads to faster and deeper equity market declines followed by an eventual sharp rebound once Fed policy pivots.

Under this scenario, the resultant recession is likely to be deeper. S&P 500 earnings may decline 10% from 2023 levels with the S&P 500 declining by 15%-20% from current levels over the next 6-12 months as investors grapple with where corporate earnings will trough. However, such events also increase the chance for an ultimate swift Fed pivot with declining interest rates, which would ultimately lead to sharp equity rallies.

At this stage, outcomes remain highly uncertain and may be influenced by several external variables that are difficult to predict.

Given the significant increase in equity valuations over 2023 coupled with significant remaining macroeconomic risk factors, we would recommend that investors do not add substantially to equities at these levels.

7-year expected returns of 6%-7% are lower than historical averages.

Capital Markets Review

Q4 & Full Year

Equity Markets: Performance & Valuation

Fixed Income Markets: Performance & Valuation

Alternatives and Private Investments

Actionable Investment Opportunities

CAPITAL MARKETS REVIEW

Equity Markets: Performance

Global equity markets (MSCI ACWI Index) increased by 11.0% during Q4 and 22.4% during 2023.

During Q4, all major geographic regions experienced material appreciation ranging from 7.9% to 11.5%.

Globally, growth stocks (+12.7%) continued to outperform value stocks (+9.1%) during Q4. Over full year 2023, growth stock outperformance was even more stark (+33.2% versus +11.8%).

However, this growth versus value outperformance was largely driven by US growth stocks (+42.7% versus +11.5% for 2023). International developed growth stocks modestly underperformed value stocks (+17.6% versus +19.0%) and emerging markets growth stocks materially underperformed value stocks (+5.8% versus +14.2%).

During Q4, technology (+17.6%), industrials (+13.2%) and financials (+12.5%) performed best while energy performed worst (-2.5%).

For full year 2023, technology and communication services (especially internet-oriented companies) dominated with +51.8% and +37.,7% performance. Several of the Magnificent Seven stocks were up 50%-200%.

Perceived defensive stocks such as healthcare and consumer staples performed poorly with +3.5% and +2.5% gains over full year 2023.

US large-cap equities (S&P 500) were up 11.6% during Q4 and +25.7% for full year 2023.

The YTD performance is deceptive however and has been driven by a select group of technology, consumer discretionary, and internet stocks (the Magnificent Seven comprised of Nvidia, Apple, Microsoft, Alphabet, Meta, Amazon and Tesla).

On an equally weighted basis (as opposed to market-cap weighted), the S&P 500 was only up for full year 2023.

These seven stocks now comprise 29.6% of the market cap of the S&P 500 (eclipsing the 29.1% peak seen in 2021).

In Q4, most sectors performed well with technology leading (+17.2%) and energy lagging (-6.7%).

On a full year 2023 basis, US technology and communication services sectors performed best (+57.9% and +55.8%) while energy (-1.5%) and defensive sectors such as healthcare(+2.1%) and consumer staples (+0.5%) performed worst.

EQUITY MARKETS: PERFORMANCE (CONTINUED)

US small cap stocks rallied by 14.0% during Q4 which brought 2023 gains to +16.9%.

Small caps are perceived to strongly benefit from lower interest rates as they tend to be more highly levered.

International developed stocks (MSCI EAFE) were up 10.4% during Q4 and up 18.2% during 2023 in USD.

During 2023, European stocks appreciated by 19.5% in USD as corporate profits remained high despite weak European macro fundamentals. Japanese equities appreciated by 20.6% in USD terms as companies benefitted from the weaker yen and demonstrated improved shareholder governance practices.

Emerging markets were up 7.9% during Q4 and +9.8% for full year 2023 in USD.

During 2023, EM performance has essentially consisted of divergent China and non-China stories. Chinese equities (now comprise 27% of the index) were down 11.2% in USD while most other EM countries such as India, Taiwan, Korea, Brazil and Mexico delivered very strong returns (ranging between 21% to 33%).

Chinese equities were down 4.8% during the quarter and were down 11.2% over 2023.

The underperformance was driven by a sharp slowdown in China's nascent post-COVID recovery coupled with continued concerns regarding the country's embattled property development sector.

Thus far, government fiscal and monetary stimulus has been relatively muted. The government will need to embark on much more aggressive stimulus for economic growth to accelerate and reach targeted 5% GDP growth levels in 2024 and beyond.

For investors with a mid-term time frame, we continue to believe that stocks of high-quality companies will outperform given their strong business models, superior revenue and earnings growth and strong returns on capital.

However, many of these quality growth stocks (especially technology stocks that have benefitted from AI spending and sentiment) appreciated massively in 2023 and in some cases, their valuations have become more expensive.

The NASDAQ 100 and Russell 1000 Growth indexes appreciated 55.1% and 42.7% in 2023. Valuations have increased and are well above historical norms (although lower than peaks seen at year-end 2021).

EQUITY MARKETS: PERFORMANCE (CONTINUED)

Operating fundamentals appear strong for many of these companies with healthy demand and restrained costs. However, as valuations have surged, these companies will likely need to beat earnings expectations to deliver double-digit stock price performance in 2024.

Certain value stocks such as healthcare and financials underperformed on a relative basis in 2023, and relative valuations appear attractive.

Bank stocks may rebound if loss provisions remain relatively low and CEO commentary regarding the macro economy becomes more bullish if the soft-landing scenario takes hold. Healthcare stocks may rally as the cost surge associated with increased post-pandemic utilization normalizes and as abnormally high COVID-related revenues / earnings (achieved in 2021 and 2022) no longer affect comparisons as they have settled at lower sustainable levels in 2023.

Equity Indices (as of 01/19/24)

Total Returns (%) – USD

			Annualized Returns			
	YTD	Qtr	1Y	3Y	5Y	7Y
US Large Cap (S&P 500)	1.5%	11.6%	25.6%	9.6%	14.0%	12.8%
US Small Cap (Russell 2000)	-4.1%	14.0%	7.6%	-2.0%	7.1%	6.7%
MSCI EAFE	-2.5%	10.4%	8.2%	2.4%	6.6%	6.1%
MSCI Emerging Markets	-5.1%	7.8%	-3.1%	-8.8%	1.5%	3.6%
MSCI ACWI	-0.3%	11.0%	17.5%	4.8%	10.3%	9.6%
S&P 500 - Equal Weight	-1.2%	11.7%	9.0%	7.1%	11.1%	10.1%
MSCI ACWI - Equal Weight	-4.3%	7.7%	-1.2%	-2.8%	4.0%	4.4%
US Style Factors						
MSCI US Quality	3.5%	11.9%	38.9%	11.2%	17.1%	15.8%
Russell 1000 Growth	3.1%	14.2%	43.8%	10.0%	18.6%	17.8%
Russell 1000 Value	0.8%	9.5%	8.9%	7.4%	9.3%	8.2%

CAPITAL MARKETS REVIEW

Equity Markets: Valuation

Equity markets are generally fairly valued relative to historical averages with US markets modestly overvalued and international developed markets fairly valued-to-modestly undervalued.

The S&P 500's valuation is nuanced however. While the market-cap weighted S&P 500 Index trades at 20.0x NTM P/E, the equal-weighted S&P 500 trades at 16.5x NTM P/E (inline with historical averages).

The "Magnificent Seven" now comprise 29% of the S&P 500 Index market capitalization. These stocks trade at 34.0x NTM P/E, certainly ahead of their pre-pandemic valuations but not egregiously so. The companies continue to demand a significant premium to the average S&P 500 stock given their superior business models, faster revenue and earnings growth profiles, and dominant leadership positions in secularly attractive end markets.

Hence, while the S&P 500's valuation may look expensive relative to history, this increase seems largely due to the changing composition of the index and its shift towards much higher quality companies that have exhibited staying power while delivering attractive earnings growth.

In the US, equity market valuations are expensive relative to government bonds.

The S&P 500 presently trades at 20.0x consensus NTM earnings (which may be too high).

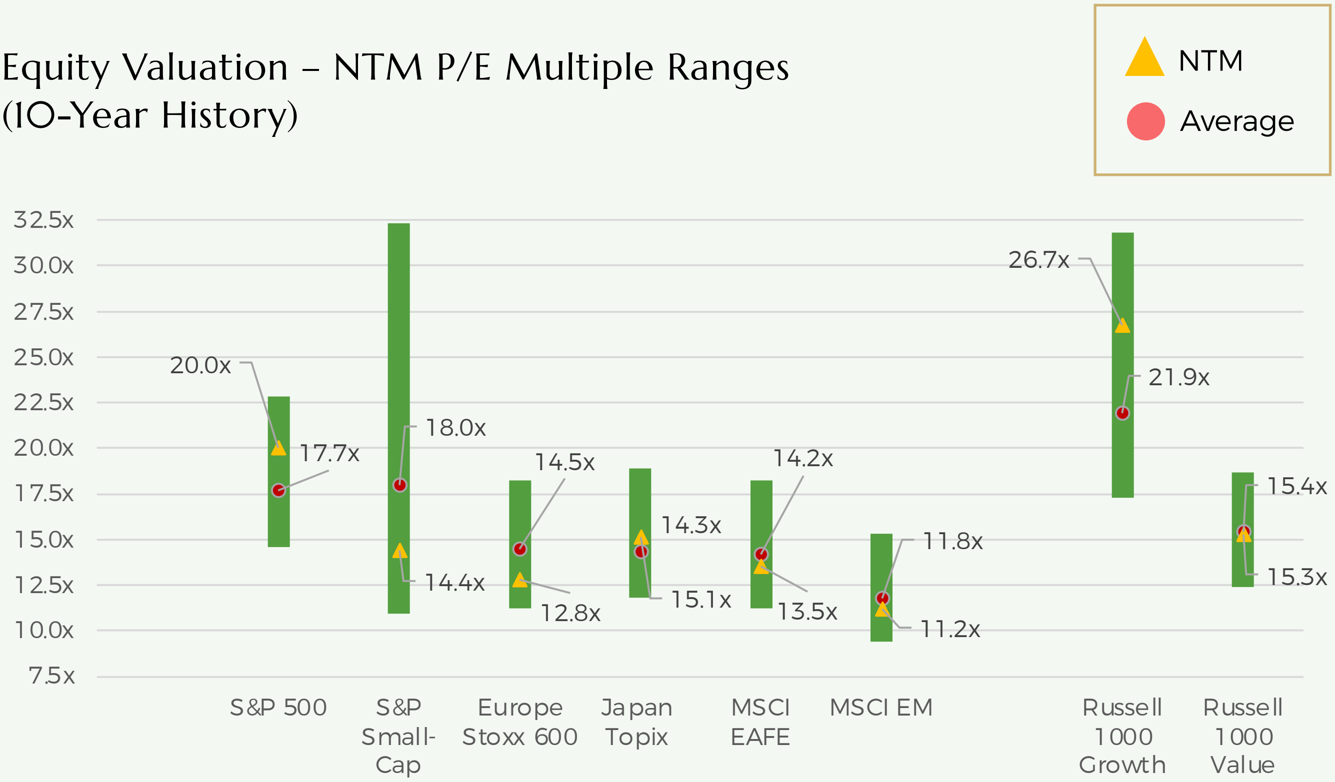
Historically, the S&P 500 earnings yield (inverse of multiple) has averaged 200-300bps over 10-Year Treasuries.

With 10-year Treasuries yielding 4.1%, at first glance, a 14.0x-16.5x forward EPS multiple is "fair" for the S&P 500 based on relative valuations to bonds.

However, most investors do not expect the 10-year Treasury to remain at 4.1% for an extended period of a time. If the 10-year was to retreat to 3.5%, a fair valuation of 15.5x-18.0x forward EPS is more reasonable (based on historical relationships).

EQUITY MARKETS: VALUATION (CONTINUED)

Equity Valuation – NTM P/E Multiple Ranges (10-Year History)



CAPITAL MARKETS REVIEW

Fixed Income Markets: Performance

Safe fixed income (government bonds and corporate investment grade bonds) appreciated significantly during Q4 as interest rates sharply declined.

Yields declined across the US Treasury yield curve by roughly 70bbps-80bps during the quarter. Thus far in 2024, yields have risen 10bps to 20bps across various maturities.

The sharp decline in yields was largely driven by highly favorable inflation data with inflation falling much faster than expected. Employment markets also showed signs of slowing with job growth concentrated in certain areas (government and healthcare services) rather than broad-based.

Both high yield bonds and leveraged loans appreciated strongly in Q4 and in full-year 2023.

HY bonds have benefitted sharply from declining interest rates in Q4. Additionally, high coupon rates coupled with spread tightening also drove strong performance.

CCC-rated (the riskiest) high-yield bonds performed best in 2023 (+20.4%) despite bankruptcy filings reaching the highest levels since the GFC.

Leveraged loans have benefitted from high coupon rates (driven by increases in the SOFR base rate) and from spread tightening.

Fixed Income Indices – Characteristics and Performance in USD (as of 01/19/2024)

			Annualized Returns				
	YTD	Qtr	1Y	3Y	5Y	7Y	Duration yrs
US Treasury	-1.4%	5.6%	-0.3%	-4.0%	0.3%	0.6%	6.1
US Corp. IG	-1.3%	8.5%	2.9%	-3.4%	2.2%	2.2%	7.0
US Corp HY	-0.7%	7.2%	8.7%	1.6%	4.4%	4.3%	3.3
US Corp Lev. Loans	0.6%	2.8%	11.6%	5.5%	5.4%	4.7%	NA
Barclays US Aggregate	-1.4%	6.8%	0.7%	-3.6%	0.8%	1.1%	6.3
Barclays Canada Agg. *	-2.8%	8.4%	-0.2%	-3.3%	0.7%	1.1%	7.1

** Barclays Canada Aggregate Index returns in CAD*

CAPITAL MARKETS REVIEW

Fixed Income Markets: Valuation

Safe fixed income (government bonds and investment grade corporate bonds) yields remain at attractive levels, albeit well lower than early October 2023 peak yield levels.

US Treasuries are yielding roughly 4.8%, 4.4% and 4.1% for 1-year, 2-year, and 10-year maturities.

US corporate investment grade bonds are now yielding 5.2% (with risk of default very low).

Both investment grade and high-yield bond spreads have compressed significantly over the past several months.

IG spreads are presently at 95bps (versus 141bps at YE 2022) and HY spreads are at 338bps (versus 469bps at YE 2022). These levels are well lower than 10-year averages of 125bps and 425bps respectively.

Spreads have generally widened further during prior recessionary periods (200bps for corporate bonds and 800bps for HY bonds).

However, the quality of the high yield index is much stronger now than in previous periods. When coupled with today's high base rates, it is unlikely that spreads will widen to those experienced in previous recessions (even if economic activity slows substantially).

Underlying borrower financial performance has been mixed.

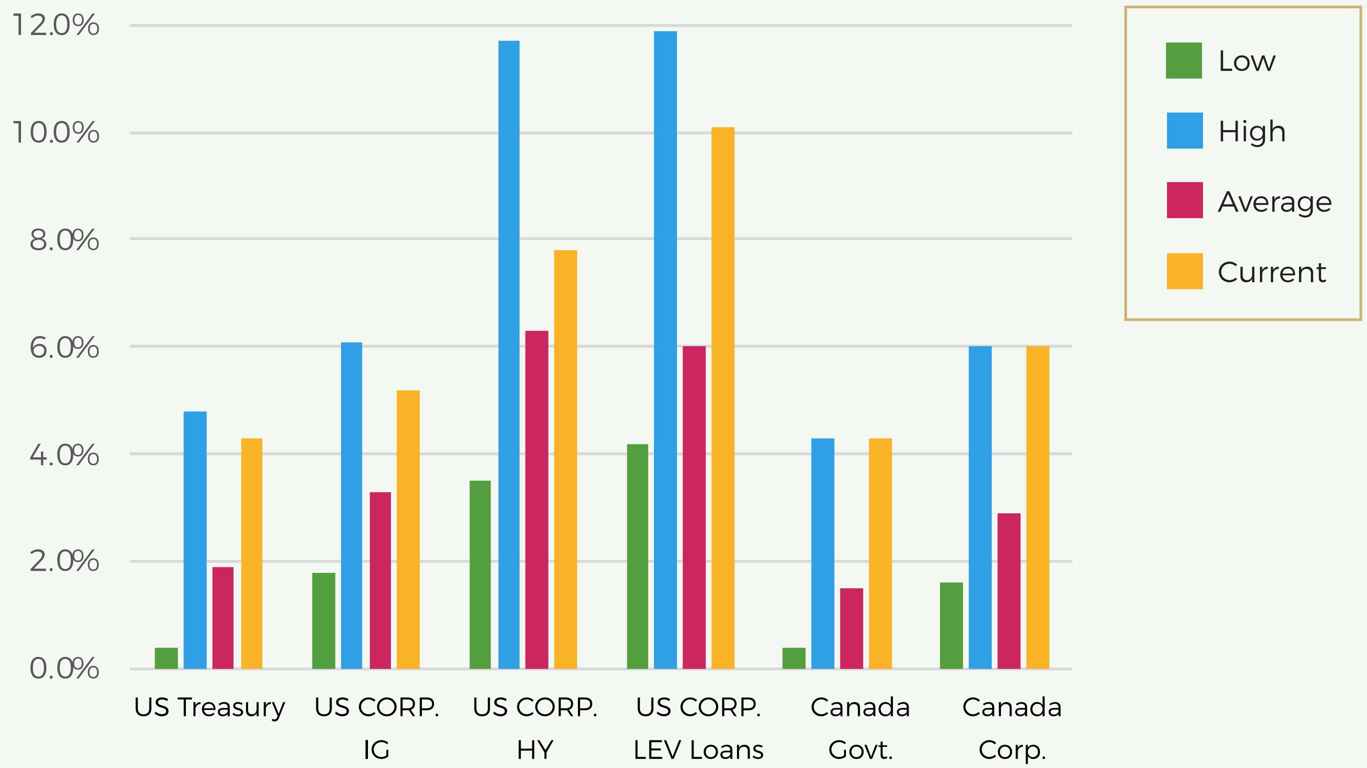
Signs of credit stress are emerging with default rates increasing (off low base levels) and corporate bankruptcy filings reaching levels not seen since the GFC.

S&P expects defaults rates to increase to 5.0% by September 2024 versus 4.1% in September 2023.

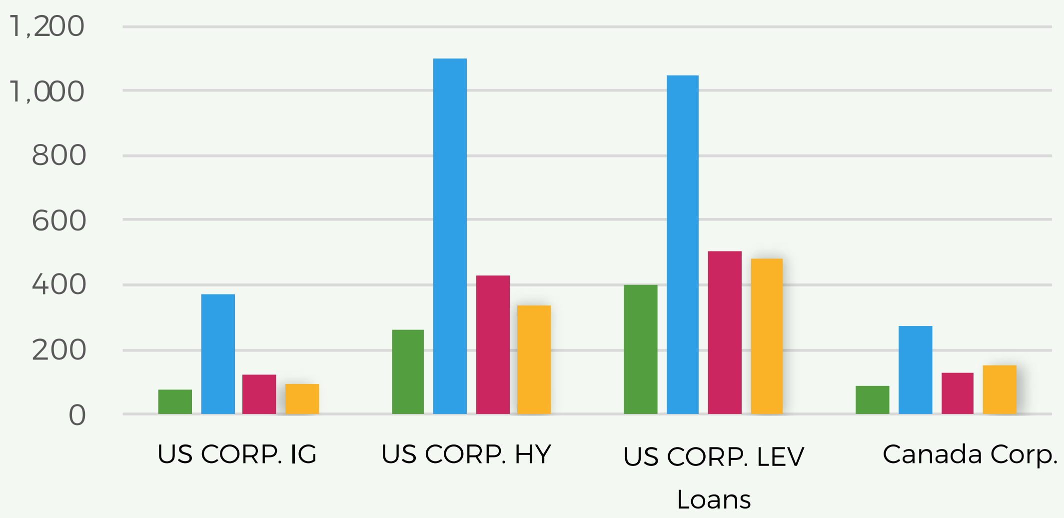
On the other hand, an index of middle market privately-held companies reported 16% YOY EBITDA growth in Q4 2023 (the highest quarterly YOY growth experienced during 2023).

FIXED INCOME MARKETS: VALUATION (CONTINUED)

Fixed Income Yields – 10-year History



Fixed Income Spreads – 10-year History



CAPITAL MARKETS REVIEW

Alternatives and Private Investments

The HFRX Hedge Fund Index was up 1.8% in Q4 and 3.1% for full-year 2023.

In 2023, convertible arbitrage strategies performed best (+10.1%) while directional strategies such as equity-hedge and credit also performed well (+6.9% and +6.5%). Event-driven and macro / trend-following strategies performed worst at +0.4% and -1.5% respectively.

US Private Real Estate

US private real estate operating fundamentals are mixed in terms of operating fundamentals and transaction prices.

Nationally, US apartment rents grew 0.2% YOY in December in line with several prior months of flattish YOY growth.

Apartment supply jumped to a 36-year high in 2023 with occupancy rates trending downward to 94% (well below 2021-2022 peaks of 97%-98% but inline with historical averages).

2024 is projected as another record supply year which should further constrain rent growth. However, the supply pipeline is expected to drop dramatically in 2025 and 2026 which could lead to a resumption in normal 2%-3% annual rent growth going forward.

Industrial fundamentals remain strong, but market rent growth is decelerating from peak levels.

In-place rent growth increased by 6.3% in 2023, but much of those gains were achieved earlier in the year. With significant supply entering the market in 2023, vacancy rates increased to 5.8% from 3.7% lows achieved in mid-2022 (but still below the 7.3% 20-year average).

Demand for small-bay industrial properties remains high with supply constrained. As such, the opportunity to drive rent growth within the small-bay segment is better than within the more prevalent large-bay segment.

Office fundamentals are clearly under pressure with increasing frequency of defaults on debt.

Cap-rates have risen, given rising interest rates and the sharp increase in debt funding costs.

However, cap-rates appear to be stabilizing with interest rates peaking. This stabilization may lead to increased transaction volume.

Pricing has continued to decline with the NCREIF index down 1.4% in Q3 2023 (latest data available) and 5.1% YTD.

ALTERNATIVES AND PRIVATE INVESTMENTS (CONTINUED)

The September quarterly decline represents the fourth straight quarter of declines beginning in Q4 2022.

Sales volumes remain depressed as cap rates have risen and property valuations have declined. The bid / ask spread remains high.
Refinancing risk is an area to closely monitor as substantial commercial real estate debt matures over the next few years.

The office sector and some pockets of retail are clearly under pressure and may see defaults pick up considerably over the next 18 months.

Private Equity (PE)

Private equity has performed well thus far in 2023 with buyout funds experiencing solidly positive performance despite the large rise in interest rates.

According to Cambridge Associates, US PE returned 2.8% in Q2 2023 (latest data available) and +5.6% YTD through H1. Anecdotally, PE returns likely improved by several hundred basis points in H2 2024.

PE buyout returns in 2023 are unlikely to match the broader public equity markets as PE held up much better in 2022 and given that most PE buyout exposure is not within the mega-cap technology space (other sectors in the public markets have rallied far less YTD).

US PE buyout deal activity continued to decline in Q4 in $ value terms although deal count is stabilizing. At roughly $140bln, deal value was down 23% YOY. For the full year, deal value was down to $645bln versus 2021 peaks of $1.2 trillion.

Platform LBO deals experienced the sharpest contraction in terms of $ value while add-on-deal value remained relatively stable.

Valuations for new deals have contracted and were at 12.3x trailing EBITDA versus 13.8x in 2021. However, valuations for the highest-quality businesses remain robust and have not experienced material declines.

Debt / EBITDA levels of new deals contracted to 5.0x from 5.9x in 2023 with debt / total capital declining to 46% in 2023 versus 51% in 2022 and versus the 10-year average of 55%.

Exit activity remains highly depressed but seems to have stabilized at low levels.

Q4 and full year 2023 exit activity ($45bln and $234bln respectively) remained well below pre-pandemic levels.

However, improved valuations and likely declines in interest rates should lead to improved exit activity in 2024.

ALTERNATIVES AND PRIVATE INVESTMENTS (CONTINUED)

If exit activity remains depressed, this could lead to a maturity wall for funds raised 10-12 years ago and drive increased levels of secondary activity.

Venture Capital (VC)

Venture capital funds (pooled returns) performance seem to have stabilized in 2023.

According to Cambridge Associates, US VC returned -0.5% in Q2 2023 (latest data available) and -1.4% YTD. Anecdotally, VC returns suggest flat to modestly higher returns in H2 2023.

The unknown at this point is what valuations may be for companies requiring new funding rounds. Most VC portfolio companies took advantage of frothy conditions in 2021 to raise substantial amounts of cash. This cash hoard has provided cash runway through 2024 and maybe into H1 2025.

Deal count has stabilized over the past few quarters, but Q4 deal value fell to the lowest levels since Q4 2019.

Public market valuations for VC-backed companies have modestly improved since trough levels seen in mid-2022 but remain well lower than peak levels.

As such, VC firms are likely to continue holding better performing companies for longer and waiting until public market valuations for fast-growth companies improves further.

CAPITAL MARKETS REVIEW

Actionable Investment Opportunities

Short-term US and Canadian government debt

We favor locking in yield through shorter-duration maturities of two years or less (yielding 4.0%-5.0%). If US 10-year Treasury yields return to the 4.5% level (from 4.1% currently), we would also add mid-duration maturities (10-year US Treasuries). Adding duration increases the chances of meaningful bond price appreciation should 10-year Treasury yields decline by 100bps+ either due to subsiding inflation or if recessionary conditions emerge.

Private Credit (offering potential returns from low double-digits to mid-to-high teens)

Senior direct lending strategies are offering asset-level gross yields of 11%-12% with lower leverage levels and better covenants.

The opportunity set is especially interesting for middle-market borrowers as regional banks are pulling back on lending and private credit can increasingly capture share. However, spreads are tightening on larger deals as investment banks have re-entered the market for large leveraged loans.

The demand for flexible junior capital – provision of flexible payment structures (mix of cash and PIK interest) is also increasing and offers asset-level mid-teens IRRs.

Additionally, these capital solutions can demand stronger protections in terms of financial and maintenance covenants.

Asset-backed credit solutions are seeing increased demand as companies seeking liquidity are pledging high-quality sources of collateral such as receivables, inventory, and certain fixed assets.

Private Equity (PE)

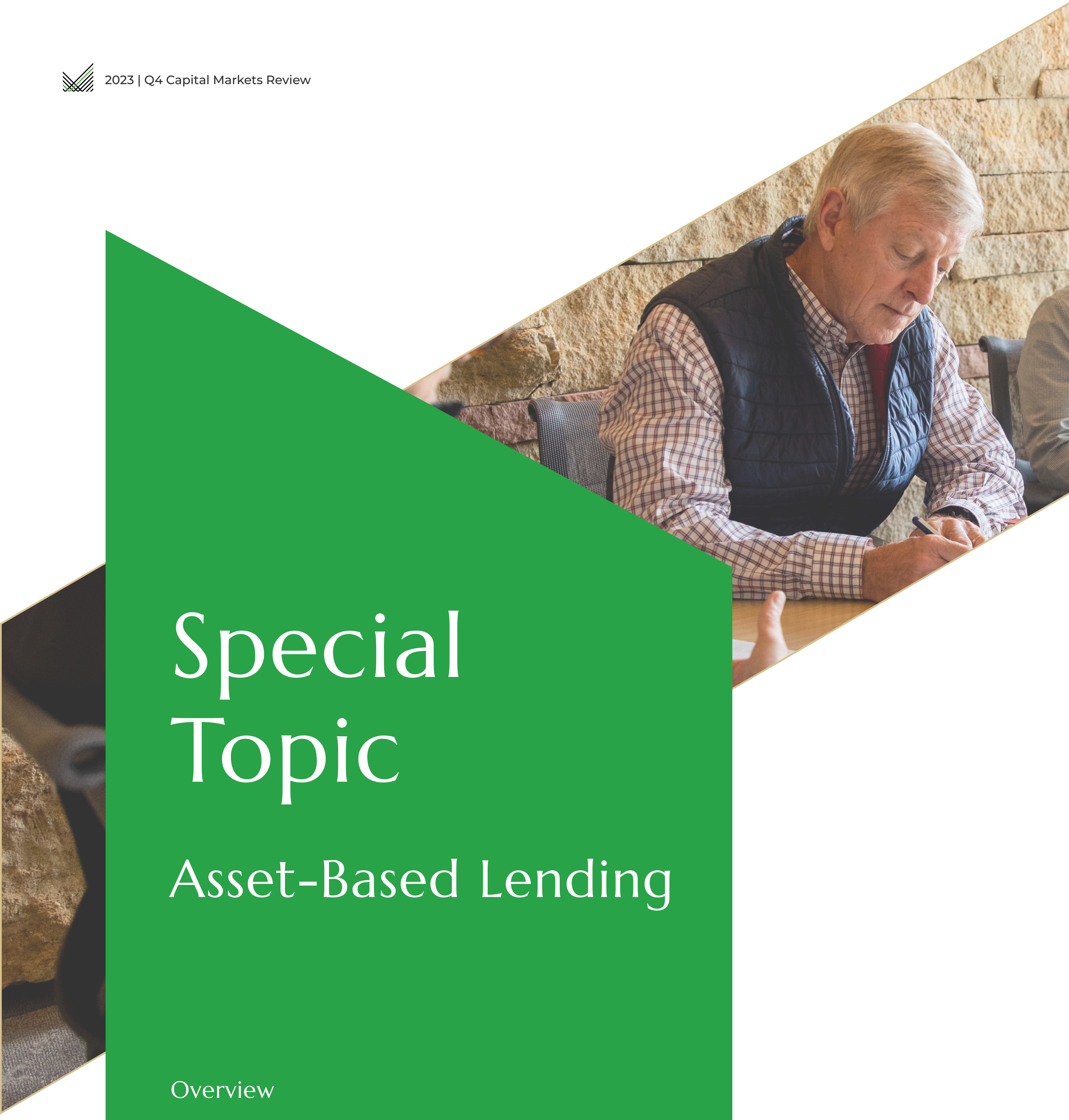
Secondary volume has been picking up throughout the year both for LP-led transactions and for GP-led deals.

Given low exit activity and nearing maturity walls for several PE fund vintages from 2007-2011, we expect LP-led secondary volume to increase. We also expect GP-led continuation vehicles to increase with transactions involving several high-quality assets.

Growth equity is becoming increasingly attractive as a subset of private equity

Valuations are more reasonable relative to frothy conditions in 2021 / H1 2022.

Additionally, companies are achieving better mix of revenue growth and profitability in terms of key metrics. In prior years, companies were far too focused on revenue growth at any cost.



Special Topic

Asset-Based Lending

Overview

Asset-Based Lending vs Cash-Flow Lending

Attractiveness of Asset-Based Lending

Investment Opportunities

SPECIAL TOPIC

Asset-Based Lending

Asset-based lending consists of senior loans that are secured by hard or financial assets. These assets include equipment, inventory, accounts receivables, and royalties among others across a variety of industries.

Borrowers may include corporations or individuals, or even lenders who lend to these borrowers.

Borrowers may seek asset-based loans for several purposes including acquisitions, recapitalizations or refinancing, bridge financing, and general corporate growth. Cash constrained borrowers may turn to these loans as a form of rescue financing during periods of stress.

When the borrower is another financial lending institution, the collateral includes pools of underlying assets.

These pools could be further segregated into lower-risk senior and higher risk junior tranches.

The loan-to-value (LTV) of asset-based loans is based on the liquidation value of the collateral. This is different from corporate cash-flow based direct lending where the loan-to-value is based upon the enterprise value of the business.

Recovery of asset-based loans is dependent upon the value of the borrowers' assets and not on their financial performance (i.e. EBITDA and Enterprise Value).

The market size for asset-based lending is very large at an estimated $30 Trillion.

Large sectors include residential mortgage loans, healthcare loans and royalties, transportation loans and leases, corporate asset-based lending, consumer loans, and commercial real estate loans.

SPECIAL TOPIC

Differences Between Asset-Based Lending and Cash-Flow Lending

	Asset-Based Lending	Typical Traditional Cash Flow Lending
Structural Protections	• Perfected interest of collateral via SPV • Asset-level	• Reliance on business value stability • Corporate level
Repayment	• Primarily Self-liquidating	• Large bullet payment due at maturity / Refinance
Market Risk	• Typically low correlation to overall market activity	• Low correlation, but reliant on stability of borrower EBITDA and enterprise valuation multiples
Sole Lender	• Predominantly sole lender status and not subject to syndicate risk	• Predominantly syndicated to multiple investors although large unitranche deals increasingly prevalent
Competition	• Lightly competitive & highly fragmented	• Highly competitive
Capital Opportunity	• Bank absence given complexity	• Sponsor driven

Source: Marathon Asset Management, LP.

SPECIAL TOPIC

Attractiveness of Asset-Based Lending

Strong cash flow generation with predictable income.

Asset-based lending strategies generate high levels of coupon income with higher cash flows as the loans amortize during their life (as opposed to corporate cash flow loans which have bullet amortizations upon maturity).

High complexity drives excess spread and better structural protections.

Given the expertise relied to assess collateral of individual or pooled borrowers and the complexity involved in asset-based structures, spreads tend to be higher relative to corporate cash-flow lending.

Private asset-based loan spreads may be 150bps-300bps higher for the same level of seniority relative to corporate direct lending.

Additionally, structural protections are better as collateral is clearly defined and lenders can enact stricter covenants and stronger documentation.

Asset-based lenders have much more real-time access to data (weekly or bi-weekly) and can take pre-emptive measures to rectify performance faster than corporate direct lenders (quarterly statements in most cases).

High diversification and low correlation compared to corporate cash-flow-based investments.

Large number of individual positions with a wide variety of collateral types.

Collateral values tend to be less volatile than corporate enterprise values. Additionally, collateral values are generally uncorrelated to enterprise values.

Less efficient markets drives higher potential for alpha.

Incumbent managers with sectoral expertise and deep relationships have sourcing advantages.

Many more opportunities to drive excess return or mitigate risk through structure design.

SPECIAL TOPIC

Asset-Based Lending Investment Opportunities

Asset-backed credit solutions are seeing increased demand as companies seeking liquidity are pledging high-quality sources of collateral such as receivables, inventory, and certain fixed assets.

BCA believes that asset-lending funds nicely complement corporate direct funds in investors' private credit portfolios.

In evaluating asset-based private credit managers, BCA assesses the following:

Expertise in certain asset-based categories such as receivables, inventory, consumer-backed loans, commercial real estate, etc.

Examples include White Hawk (receivables and inventory), Canyon (real estate). Marathon (multi-sector), and Atalaya (consumer)

Historical track record across credit cycles and underwriting performance (i.e. realized losses).

Depth of relationships and opportunities for competitive sourcing advantages.

Covenants, strengths of legal documents, protection afforded under asset-based structures (i.e. – level of collateral losses before impairments occur).

BCA has already identified several quality managers in the asset-based lending space and anticipates recommending one or more managers as part of our clients' 2024 commitment programs.

Bitterroot

CAPITAL ADVISORS