Bitterroot
CAPITAL ADVISORS

CAPITAL MARKETS REVIEW

2024 Quarter 2

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All public market data are as of 7/11/24 unless indicated otherwise.
All return data are in USD unless indicated otherwise.

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Executive Summary

Capital Markets

Strategic Asset Allocation View (7-years)

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EXECUTIVE SUMMARY

Capital Markets

Equity markets (ACWI Index) appreciated by 2.9% in Q2 and are up 14.5% YTD through July 8th.

During the quarter, all regions gained, but US large-cap stocks (+4.2%) and EM stocks (+5.1%) significantly outperformed international developed equities (+0.4%).

Strong corporate earnings coupled with better-than-expected inflation data drove continued strong equity market performance in Q2, with appreciation continuing through early July.

US government and investment-grade corporate bonds were relatively flat in Q2 and YTD.

The Barclays US Aggregate Index was up 0.1% during Q2 and +0.1% YTD.

Flat performance masked high underlying bond yield volatility during the quarter. The US 10-year Treasury yield increased from 4.2% at the end of March to near 4.7% by the end of April before falling to 4.4% by end of June. As of July 11th, the 10-year yield is at 4.2%.

US high-yield bonds and leveraged loans (riskier corporate credit) performed well during Q2 and YTD.

High yield bonds were up 1.1% in Q2 and 3.5% YTD. Leveraged loans were up 1.9% and 4.7% during Q2 and YTD respectively.

Q2 high yield and leveraged loan returns were driven by high coupon yields and modest spread compression.

Credit spreads have remained in a tight range as corporate earnings performance has accelerated from the latter half of 2023. In fact, high-yield bond spreads of 310bps are now below historical averages (430bps) and are well-below the 800bps level normally seen during recessions.

Hedge funds were up 0.3% in Q2 and 2.9% YTD through the end of June.

YTD, long-short equity hedge funds (+5.1%) and macro / trend following (+4.6%) strategies performed best. Merger-arbitrage strategies performed worst (-3.3%).

Private equity performance was up 3.0% in Q4 2023 and 9.3% for FY 2023.

Private equity managers report with a 60-to-120-day lag, so H1 benchmark data are not yet available. However, most PE firms are estimating low-to-mid-single digit returns during Q1 2024 driven primarily by underlying EBITDA growth at portfolio companies.

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CAPITAL MARKETS (CONTINUED)

New deal activity accelerated sharply in Q2 at $225bln vs. several quarters in the $140bln-$160bln range. Entry valuations continue to increase globally from trough levels (12.4x vs. 10.6x) but have remained relatively steady in the US (13.1x vs. 13.8x peak levels in 2021). Leverage has continued to decline and now averages 5.2x Debt/EBITDA (representing 45% of total deal value) vs. 5.9x Debt/EBITDA in 2021 (52% of total deal value).

Exit activity improved in Q2 which led to H1 exits up 16% YOY in terms of $ value. Exit pipeline activity continues to accelerate with GPs increasingly prepping portfolio companies for exit.

Private credit performed well in Q1 2024 (latest data available).

The Cliffwater Private Credit Index was up 3.1% in Q1 2024 as portfolios benefitted from high current yields with stable pricing. Anecdotal reports point to 3%+ returns for Q2 2024.

The near-term outlook for existing funds is relatively positive. High SOFR base rate (+5.3%) has led to unlevered current yields north of 11%. However, the percentage of loans with non-accrual status is starting to rise and may foreshadow increased defaults or markdowns for legacy loan books.

While competition has increased significantly among private credit lenders (vs. the broadly syndicated market) across the larger borrower segment, conditions remain relatively benign in the middle market or lower middle market where spread compression has been much less pronounced.

Although public market credit spreads are very tight, private credit funds are indicating increasingly robust pipelines for bespoke credit solutions.

Private real estate performance continued to decline in Q1 2024 (latest data available) but is showing signs of stabilization.

The NCREIF Index was down 1.0% in Q1 2024 (fifth consecutive quarterly decline). Cap-rates have begun to stabilize, although transaction data is still limited.

Pricing appears to be stabilizing, but reported data remains mixed with some indexes still showing price declines while others show modest gains.

Industrial pricing continues to accelerate while multi-family continues to decline. Office properties continue to experience the highest price declines.

Operating fundamentals remain mixed across property types.

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CAPITAL MARKETS (CONTINUED)

Rents remain flattish for industrial and multi-family with strong demand offset by large supply coming online. Office vacancies have reached 20% for the first time in history.

We continue to see a favorable outlook for new private investment funds (currently raising money for the 2024 and 2025 vintages) with lower valuations and reduced leverage use, and in certain cases less capital is chasing opportunities.

While the first half of the year has seen strong returns across risk assets, we expect higher volatility in H2.

Economic data has slowed in the US, geopolitical uncertainty remains high, the US presidential election looms, and US equity valuations are very stretched.

As such, we see a wider than normal range of possible outcomes (especially for public equity markets) over the next 6-12 months.

We are incorporating these views into portfolio positioning by:

Adding duration to portfolios by purchasing Treasury bonds of intermediate maturities (5-10 years), especially if 10-year US Treasury yields are near 4.5%.

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

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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 (especially in the US).

Geopolitical uncertainty is increasing regarding the US-China relationship and potential for other episodic military conflicts.

With equity valuations having materially increased over the past 18 months, we now expect mid-single digit nominal pre-tax annual equity returns (6.0%-7.0%) over a seven-year forecast period.

While we expect US stocks to outperform international markets, we anticipate greater convergence between US and International equity market returns given highly elevated US valuations.

In addition, while we expect quality and growth stocks to outperform value stocks over the next seven years, the rate of outperformance is likely to be lower than that over the past seven years.

US equity market valuations are stretched while international equity market valuations are generally in-line with historical averages. Thus, earnings growth and dividends, rather than multiple expansion, are likely to drive returns.

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

“Safe” fixed income remains attractive on a relative basis.

Base yields across the curve are greater than 4.0% for maturities ranging between 2 and 10 years.

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STRATEGIC ASSET ALLOCATION VIEW (CONTINUED)

US 10-Year Treasuries are yielding 4.18% (up from 3.87% at YE 2023 but down from 4.7% at the end of April). We expect that the 10-year will trade within a 3.75% to 4.75% range over the near-term, although we believe that the lower-end of the range is more likely to be breached vs. the upper end.

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 attractive relative to equities.

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

US high-yield bonds are now yielding 7.8% while leveraged loans are currently yielding 9.3%. Expected returns for both assets classes are roughly 6.5%.

High base yields provide attractive total current yield for both asset classes.

However, high yield spreads of 310bps 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 price returns (although total returns should remain cushioned by high starting yields).

On a relative basis, riskier credit is less attractive vs. safe government bonds based on lower spreads. However, relative to equities, riskier credit remains attractive on a pre-tax basis.

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).

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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.

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Macroeconomic Conditions & Key Issues

Macroeconomic Conditions

Shorter-term View: Key Issues & Scenarios

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MACROECONOMIC CONDITIONS & KEY ISSUES

Macroeconomic Conditions

United States

The US economy remains healthy but slowed considerably in Q2 2024.

Real GDP increased at a 1.4% annualized level in Q1 2024, and most economists are forecasting similar levels of growth for Q2.

Consumer spending has moderated from torrid levels in 2023 as excess pandemic savings are wound down and the effect of higher interest rates work their way through the economy.

Credit card and auto loan delinquencies have steadily increased over the past several quarters, especially for lower-income consumers.

The labor market is well-balanced but is showing signs of cooling.

Job creation has been healthy, averaging over 200K per month thus far in 2024. However, from April-June, monthly job creation has decelerated to 177K.

Wage growth has moderated to roughly 3.9% annually, and the job market appears in better balance with job openings down to 8mm relative to 12.7mm during the 2022 peaks. Furthermore, quit rates have declined to pre-pandemic levels.

Inflation has resumed it disinflationary trajectory after a brief resurgence earlier this year.

The core PCE (favored by the Fed) declined to 2.6% annually in May and has also averaged 2.5% annually over the past three months.

June CPI (-0.1% MOM) and Core CPI (+0.1% MOM) both came in below expectations. Importantly, both shelter and non-shelter services cost inflation receded sharply.

The Fed has begun to signal that interest rate cuts are likely sooner rather than later. Market participants are pricing in two cuts in 2024 beginning in September.

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MACROECONOMIC CONDITIONS (CONTINUED)

Canada

Canada's economy remained stable in Q2.

Real GDP is forecast at 1.7% annualized Q/Q, a similar figure to that achieved in Q1.

Strength has been broad-based, with 15 out of 20 sectors registering growth. Growth was balanced between goods and services sectors.

Consumer spending remained robust in H1, but economists expect this to slow in H2 2024 and into 2025. The unemployment rate has climbed a full percentage point to 6.7%, and mortgage renewals will begin in earnest in 2025 amidst a backdrop of significantly higher rates.

As inflation has continued to subside, the Bank of Canada enacted its first rate cut in June.

Europe

Europe's economy remains in the early stages of recovery from last year's mild recession. However, the recovery remains fragile, with signs of stalling.

Eurozone Real GDP expanded by 0.3% Q/Q in Q1 after 5 quarters of stagnation.

Economists are optimistic about accelerating growth given the receding energy crisis, substantial employment, healthy consumer savings, and likely continued interest rate cuts given slowing inflation.

Services PMIs have been positive for several months following an H2 2023 lull.

However, manufacturing remains weak, with PMI surveys remaining below the 50 level, which indicates neither growth nor contraction.

Furthermore, recent business surveys point to a potential stalling of recovery momentum as Chinese consumer activity (a key export market for Europe) remains weak and recent election results in France have led to policy uncertainty and a pause in business spending.

The ECB cut rates in June, and economists forecast several further rate cuts given the steady slowdown in core inflation (core CPI at 2.8% YOY).

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MACROECONOMIC CONDITIONS (CONTINUED)

China

China's Q2 2024 growth missed consensus expectations. The government is likely to increase stimulus measures in H2.

Real GDP grew 4.7% YOY during Q2, missing consensus expectations for 5.1% growth, and slowing from Q1's 5.3% growth figure.

A protracted property market downturn and job insecurity knocked the wind out of a fragile recovery.

The property market remains weak despite various government support measures. New home prices fell at the fastest pace in nine years, significantly denting consumer confidence.

Retail sales growth remained weak but bounced back modestly in June.

Deflationary pressures remained as businesses slashed prices on a wide range of goods.

To counter weak domestic demand, China increased infrastructure investment and is focusing on high-tech manufacturing.

China is still targeting around 5% Real GDP growth for 2024. Achieving this goal is highly dependent on the levels and efficacy of government fiscal and monetary stimulus.

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MACROECONOMIC CONDITIONS & KEY ISSUES

Shorter-term View: Key Issues

We revisit vital issues that we have outlined in previous reports below.

Issue #1: Inflation Trajectory

US inflation has resumed its disinflationary trend following a brief spike earlier in the year. June CPI was at -0.1% MOM, with core CPI at +0.1% MOM (both lower than expectations). The Fed's favored gauge Core PCE was up 2.6% YOY in May, with further progress towards 2.0% YOY likely in June. Barring any material changes in fiscal policy, we believe that inflation will continue to trend down over H2 2024 and into 2025.

Bond yields have retreated sharply from April highs. Ten-year Treasury bonds are now yielding 4.2%, down from 4.7% in April.

The Fed is likely to begin cutting rates in September of this year, and economists are now forecasting two cuts in 2024 with further reductions in 2025.

Issue #2: Economic Growth – no landing, soft landing, mild recession, or hard landing?

In the US, our base case forecast is for a softer landing with sub-2 % GDP growth in H2 and decelerating inflation. However, the risks of a recession are increasing.

On the one hand, employment remains historically healthy, with the unemployment rate at 4.1%. On the other hand, the unemployment rate has increased to 4.1% from its 3.4% prior lows. In previous instances where the unemployment rate has risen by 50bps of earlier lows, recession has ensued in 6-12 months.

Spending by upper-middle-class and wealthy consumers remains robust, and consumer and corporate balance sheets are generally healthy. There is apparent stress for lower-income consumers with credit card and auto loan delinquencies picking up meaningfully. Rate cuts as inflation recedes should mitigate slowdowns in economic activity.

Europe's economy is experiencing nascent growth in H1 after emerging from a mild recession in 2023. Q1 GDP was better than expected, and service PMIs have remained solidly positive for several months. However, the recovery shows signs of stalling as French and German data for May and June has disappointed expectations.

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SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Issue #3: Corporate Earnings

Corporate earnings continue to perform well. Several Magnificent Seven have delivered impressive YOY earnings growth of 50%-100% in Q1. Excluding the Magnificent Seven, S&P earnings growth would have been down YOY in Q1.

Analysts are forecasting a broadening of corporate earnings growth in Q2. Analysts are forecasting 10% YOY growth for the S&P 500 and are projecting that S&P 500 ex-Magnificent 7 companies are expected to deliver their first YOY quarterly earnings growth since Q4 2022 (+6.7%).

Comparisons become more onerous for the Magnificent Seven in H2 and into 2025. For the S&P to meet consensus expectations in H2 2024 and 2025, earnings growth of sectors beyond technology and communications services will need to improve.

Interest rate cuts may lead to broadening earnings growth across various sectors, assuming recessionary conditions do not emerge.

Issue #4: AI Adoption

AI and its actual or perceived beneficiaries continue to play a significant role in stock and sector-level performance thus far in 2024.

Certain sectors (semiconductors) have benefitted substantially in operating results from AI spend to date. It remains to be seen whether their torrid earnings growth is sustainable.

Several companies are perceived to have strengthened their long-term business moats due to their AI leadership, even if actual benefits are yet to materially affect reported financial results (Apple, Microsoft, Alphabet).

The biggest AI winners have been semiconductors (Nvidia, Micron, Broadcom, etc.) and hyper scalers / cloud companies (Amazon, Meta, and Google). Software companies thought to have AI leadership positions have demonstrated muted performance early in the year.

Earnings reports from early AI winners this upcoming earnings season will be heavily scrutinized for demand sustainability, cost creep from expense and capital expenditure pressures, and changes in competitive dynamics.

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SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Issue #5: China Government Policy

China's growth disappointed in Q2 after exceeding expectations in Q1. Manufacturing growth has been strong, while consumption remains weak. The property sector shows weakness with continued YOY price declines for new homes across major cities.

Stabilization has been a key goal for policymakers this year, leading to a slew of supportive policy measures. These include lowering interest rates, subsidies for EVs, and numerous moves to shore up the property market.

We expect the government to increase policy support in H2, especially as the tariff environment around manufacturing remains unclear and has the potential to worsen. Policy support measures may exceed expectations and lead to a short-term rally in Chinese stocks.

Issue #6: Geopolitical Conflicts

The war between Israel and Hamas seems to have reached somewhat of a stalemate. However, there have been increased skirmishes between Israel and Iran or Iranian proxies. A widening conflict would negatively affect global equity market confidence, likely leading to surging oil prices that may reignite inflationary pressures.

As of now, both Israel and Iran have shied away from significant escalations. The Russia / Ukraine war seems to be in a stalemate, as well, with outcomes uncertain.

Outcomes in the US presidential election could markedly alter the direction of US policy towards Ukraine and, thus, the trajectory of the conflict.

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SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Issue #7: US Presidential Election

The US equity market has generally experienced higher-than-normal volatility during presidential election years. It remains to be seen whether either Trump or Biden will make unexpected policy changes.

Policy proposals espousing more widespread tariffs (favored by Trump) would negatively affect equity markets.

Biden favors letting some of the tax cuts enacted under Trump expire in 2025. If that happens, it may negatively affect consumer and business spending.

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MACROECONOMIC CONDITIONS & KEY ISSUES

Shorter-term View: Scenarios

We see multiple potential paths for equity returns over the next 6-12 months (with reference to the S&P 500 which stands at 5,585 as of July 11, 2024).

Scenario A: Optimistic Case

As the Fed cuts rates by 50bps or more over H2 2024 and into 2025, economic growth accelerates (Real GDP growth of 2.0%+) yet core inflation continues to fall faster towards the Fed's 2% target. Fed continues cutting rates in H1 2025. Consumer spending remains healthy, wage growth remains modest, and companies enact productivity measures to restrain costs resulting in margin improvement.

Under this scenario, S&P earnings could expand (from $222) in 2023 to $248-$255 in 2024, $270-$285 for 2025, and $300mm-$315mm in 2026. Equity multiples hold at 21x-23x forward earnings. Under those assumptions, the S&P 500 index could appreciate to 6,200 to 6,700 by mid-year 2025 (12%-20% total return from today).

Scenario B: Base Case

Fed cuts by 50bps in H2 2024 (starting September 2024). Economic growth slows, but the US avoids a recession. Real GDP growth ranges between 1.0%-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 $240-$248 in 2024, $260-$275 in 2025, and $280-$300 by 2026. Equity multiples range between 19x-21x forward earnings, with the S&P index between 5,300 and 5,800 (total return of -3.5% to +5.0%).

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SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Scenario C: Pessimistic Case

Consumers exhaust remaining excess savings, causing the economy to slow faster than expected and leading to intensified layoffs. European weakness may speed the onset 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. Either scenario leads to faster and deeper equity market declines followed by a sharp rebound once Fed policy pivots.

Under this scenario, the resultant recession will likely be more profound. S&P 500 earnings may reach $238-$243 but decline 10% in 2025 before rebounding in 2026. In these scenarios, the S&P 500 could fall 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 a swift Fed pivot with declining interest rates, ultimately leading to sharp equity rallies.

At this stage, while Scenarios A or B look more likely than Scenario C, markets are increasingly pricing in the Goldilocks scenario of robust earnings growth coupled with declining interest rates. However, several uncertainties and external variables make this scenario difficult to predict.

Given the significant increase in equity valuations over the last 18 months, coupled with significant remaining macroeconomic risk factors, we recommend that investors avoid adding substantially to equities at these levels.

7-year expected returns of 6.0%-7.0% are lower than historical averages.

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Capital Markets

Equity Markets: Performance & Valuation

Fixed Income Markets: Performance & Valuation

Alternatives and Private Investments

Actionable Investment Opportunities

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CAPITAL MARKETS REVIEW

Equity Markets: Performance

Global equity markets (MSCI ACWI Index) appreciated 2.9% during Q2 and are up 13.6% YTD through July 11th.

US large-cap stocks (S&P 500) were up 4.2% and 17.5% in Q2 and YTD, respectively. Both international developed (-0.4% Q2 and +9.4% YTD) and emerging market (+5.0% Q2 and +11.7% YTD) stocks have trailed US large-cap stock performance.

Globally, growth stocks (+6.2%) significantly outperformed value stocks (-0.6%) during Q2 and YTD (+20.7% vs. +6.8 %).

During Q2, technology (+11.4%), communication services (8.1%), and utilities sectors (+3.6%) performed best, while materials (-3.8%) and industrials (-1.8%) performed worst.

YTD, the technology (+30.4%) and communications services (+23.9%) sectors have performed best.

US large-cap equities (S&P 500) were up +4.2% during Q2 and +17.5% YTD.

Q2 and YTD stock performance has primarily been driven by several stocks (NVIDIA, Meta, Apple, Microsoft, Google) with solid exposure to AI tailwinds.

On an equally weighted basis (as opposed to market-cap weighted), the S&P 500 was down 2.8% in Q2 and is only up 6.6% YTD.

This 13.1% difference in YTD performance is the most significant mid-year differential in history and follows a similar trend in full-year 2023, where the market-cap weighted index substantially outperformed the equal-weight index (+25.7% vs. +13.1%).

Sector performance was mixed during Q2, with strong performance from the technology (+13.7%) and communication services (+9.3%) offset by weaker performance from financials, energy, and industrials sectors (-2% to -3%).

Exceptionally strong earnings and forward guidance as well as continued positive AI sentiment drove the performance of technology and communication services stocks.

Slowing inflation coupled with a still-strong but cooling labor market has led to a reduction in bond yields since the spike in April.

The S&P 500 is now highly concentrated.

The Magnificent Seven now comprise 33% of the S&P 500 in terms of weighting (well above previous highs of 29% at the end of 2021).

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EQUITY MARKETS: PERFORMANCE (CONTINUED)

US small cap stocks have continued to underperform large cap stocks in Q2 and YTD.

Small caps were down 3.3% in Q2 and are only up 5.7% YTD.

Small cap performance has been hindered by a) less exposure to AI tailwinds, b) higher interest costs associated with higher leverage, and c) more recently, fears of economic slowdowns.

However, small caps may be poised to outperform under a Goldilocks scenario of rate cuts and modest growth as valuations are far cheaper than large cap valuations.

International developed stocks (MSCI EAFE) were down 0.4% during Q2 and +9.4% YTD.

European stocks appreciated by 0.6% in Q2 and 8.9% YTD.

Corporate earnings have held up better than expected and inflation is continuing to decline.

However, European stocks have been weaker over the past month as political uncertainty (French election results) has increased and doubts regarding the pace of the nascent economic recovery have emerged.

Japanese stocks declined by 4.8% in Q2 and are up 13.4% YTD.

Yen weakness detracted from USD stock returns as Japanese stocks were up 1.8% in Q2 and 27.4% YTD in Yen terms.

In local markets, Japanese stocks have benefitted from a) reforms and increasing shareholder friendly actions on behalf of large corporations, and b) Yen weakness driving increased local currency revenues and profits as many Japanese corporations have large overseas revenues coupled with largely domestic cost bases.

Emerging markets were up 5.0% (+6.3% local currency) during Q2 and 11.7% YTD (+15.1% local currency).

During Q2, Indian equities were up 10.2%, Taiwanese equities were up 15.1% and Chinese equities were up 7.1%.

Indian equities benefitted from strong economic data, corporate earnings and a relatively stable currency.

Taiwan equities benefitted from strong results from semiconductor companies driven by robust AI spending.

Chinese equities rallied upon government measures undertaken to stimulate local demand and support the property sector.

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EQUITY MARKETS: PERFORMANCE (CONTINUED)

The MSCI USA Quality and Russell 1000 Growth Indexes outperformed the broader S&P 500 Index and have substantially outperformed the Russell 1000 Value Index over the past 12 months.

Both indexes have benefitted from over-weights to the US technology and communication services sectors (mainly internet companies).

However, there has been a significant bifurcation of performance within Quality stocks. Non-technology quality stocks have materially underperformed their quality stock counterparts in technology sectors. Since active managers have high active shares, they tend to underweight exposure to the Magnificent Seven and, in some cases, to the broader technology sector. As such, US active managers focusing on quality companies(but underweight tech) have generally underperformed their respective US benchmarks over the past three years, and especially over the past 12-18 months.

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.

Over shorter-term time frames, these companies may underperform given their recent strong outperformance (especially technology and communication services stocks) and elevated investor expectations which may prove challenging to exceed.

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Equity Indices **(as of 07/11/24)**

Total Returns (%) – USD

	YTD	Qtr	Annualized Returns 1Y	3Y	5Y	7Y
US Large Cap (S&P 500)	17.7%	4.2%	27.2%	9.7%	14.5%	14.0%
US Small Cap (Russell 2000)	5.6%	-3.3%	12.8%	-0.9%	7.6%	7.4%
MSCI EAFE	9.4%	-0.4%	17.1%	4.0%	7.3%	6.3%
MSCI Emerging Markets	11.7%	5.0%	16.0%	-2.6%	3.8%	4.0%
MSCI ACWI	14.5%	2.9%	23.1%	6.2%	11.1%	10.4%
S&P 500 - Equal Weight	6.6%	-2.8%	11.7%	4.5%	10.4%	10.4%
MSCI ACWI - Equal Weight	3.5%	-1.1%	6.7%	-2.2%	4.2%	4.2%
US Style Factors						
MSCI US Quality	20.7%	5.4%	33.8%	11.1%	16.9%	16.9%
Russell 1000 Growth	23.9%	8.3%	37.6%	11.0%	19.0%	18.7%
Russell 1000 Value	8.1%	-1.9%	13.5%	5.2%	8.4%	8.2%

CAPITAL MARKETS REVIEW

Equity Markets: Valuation

US markets are expensive relative to history and relative to government bonds.

There is nuance to the S&P 500's valuation however. While the market-cap-weighted S&P 500 Index trades at 21.8x NTM P/E, the equal-weighted S&P 500 trades at 16.5x NTM P/E (in line with historical averages).

The S&P 500 has a high concentration among a relatively narrow set of stocks, and the technology and communications sectors account for 43% of the index. Although the S&P 500's valuation may look expensive relative to history, this increase seems mainly due to the changing composition of the index and its shift towards much higher quality companies that have exhibited staying power, have tailwinds from secular end market growth and are consistently delivering attractive earnings growth.

US growth and quality stocks appear modestly expensive relative to historical averages.

Operating fundamentals for the technology and communication services (internet) sector have been robust over the past 12 months. Revenue growth has accelerated while cost reduction continues, leading to outsized earnings growth.

However, YOY comparisons become more difficult in H2 2024 and 2025. Higher valuations coupled with lofty investor expectations may cause these stocks to face pullbacks if results falter.

Investors will especially scrutinize expense levels and capital spending regarding AI plans, which seem to be accelerating.

US value stocks (healthcare, energy, financials, and consumer staples) appear fairly valued relative to history.

Operating fundamentals appear mixed across sectors regarding underlying demand and cost pressures.

International developed markets are valued in line with historical averages.

US large-cap equity market valuations are highly expensive relative to government bonds.

The S&P 500 presently trades at 21.8x consensus NTM earnings.

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EQUITY MARKETS: VALUATION (CONTINUED)

Historically, the S&P 500 earnings yield (inverse of multiple) has averaged 200-300bps over 10-year Treasuries. With 10-year Treasuries yielding 4.2%, at first glance, a 13.5x-16.0x 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 4.2% for an extended period. If the 10-year was to retreat to 3.5%, a fair valuation of 16.0x-18.0x forward EPS is more reasonable (based on historical relationships).

Again, we can debate whether these historical relationships should hold given the changes in sectoral composition for the S&P 500 and the sustainable secular growth trajectories associated with several stocks within the technology sector (largest weighting in the S&P 500).

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CAPITAL MARKETS REVIEW

Fixed Income Markets: Performance

Performance of safe fixed income (government bonds and corporate investment grade bonds) was relatively flat during Q2 and modestly up YTD.

The bond market experienced high volatility throughout the quarter as bond yields surged upwards in April (given higher-than-expected inflation and job market data) before sharply retreating as inflation data proved more favorable in May and June, and the labor market cooled considerably.

Yields increased by 40bps-50bps across parts of the Treasury curve in April from March levels before retreating 50bps-60bps through July 11th.

Both high-yield bonds and leveraged loans performed well in Q2 and YTD.

HY bonds benefitted from high coupon rates in Q2 with relatively stable spreads.

BB and single-B-rated bonds outperformed CCC-rated (lower quality) bonds during Q2. YTD and CCC-rated bonds have outperformed BB and B bonds by 125bps.

Leveraged loans (floating rate) have benefitted from high coupon rates (driven by high SOFR base rates of 5.3% coupled with stable spreads).

Fixed Income Indices – Characteristics and Performance in USD (as of 07/11/2024)

			Annualized Returns				
	YTD	Qtr	1Y	3Y	5Y	7Y	Duration yrs
US Treasury	0.3%	0.1%	3.5%	-3.1%	-0.3%	0.6%	5.9
US Corp. IG	1.0%	-0.1%	7.1%	-2.7%	1.0%	2.0%	7.0
US Corp HY	3.5%	1.1%	11.5%	1.8%	4.1%	4.4%	3.1
US Corp Lev. Loans	4.7%	1.9%	10.7%	6.2%	5.5%	5.2%	NA
Barclays US Aggregate	0.6%	0.1%	4.8%	-2.7%	0.1%	1.1%	6.1
Barclays Canada Agg. *	0.0%	0.9%	6.0%	-1.7%	0.2%	1.2%	7.3

** Barclays Canada Aggregate Index returns in CAD*

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CAPITAL MARKETS REVIEW

Fixed Income Markets: Valuation

Safe fixed-income (government- and investment-grade corporate bonds) yields remain attractive.

US Treasuries are yielding roughly 4.9%, 4.4% and 4.2% for 1-year, 2-year, and 10-year maturities.

US corporate investment grade bonds are now yielding 5.3% (with risk of default very low).

Both investment grade (IG) and high-yield bond spread premiums remain tight, reflecting strong corporate earnings performance despite high interest rates.

IG spreads are currently at 90bps, and HY spreads are at 310bps. These levels are well below the 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).

Competition is intensifying for lenders to the large-borrower segment while competitive dynamics remain more benign for middle-market lenders.

Large corporate borrowers have ample access to credit availability via banks or large private lenders.

Following a pause in late 2022 through mid-2023, large banks have increasingly re-entered the leveraged loan market, and new issuance spreads at the large end of the market have contracted by 125bps to 150bps. Covenant packages are weakening again.

On the other hand, lower-middle-market and middle-market companies face constraints regarding capital access.

Regional banks have pulled back substantially from lending to these companies. As such, spreads to these borrowers have not contracted as much (only 50bps-75bps) relative to the larger borrowers.

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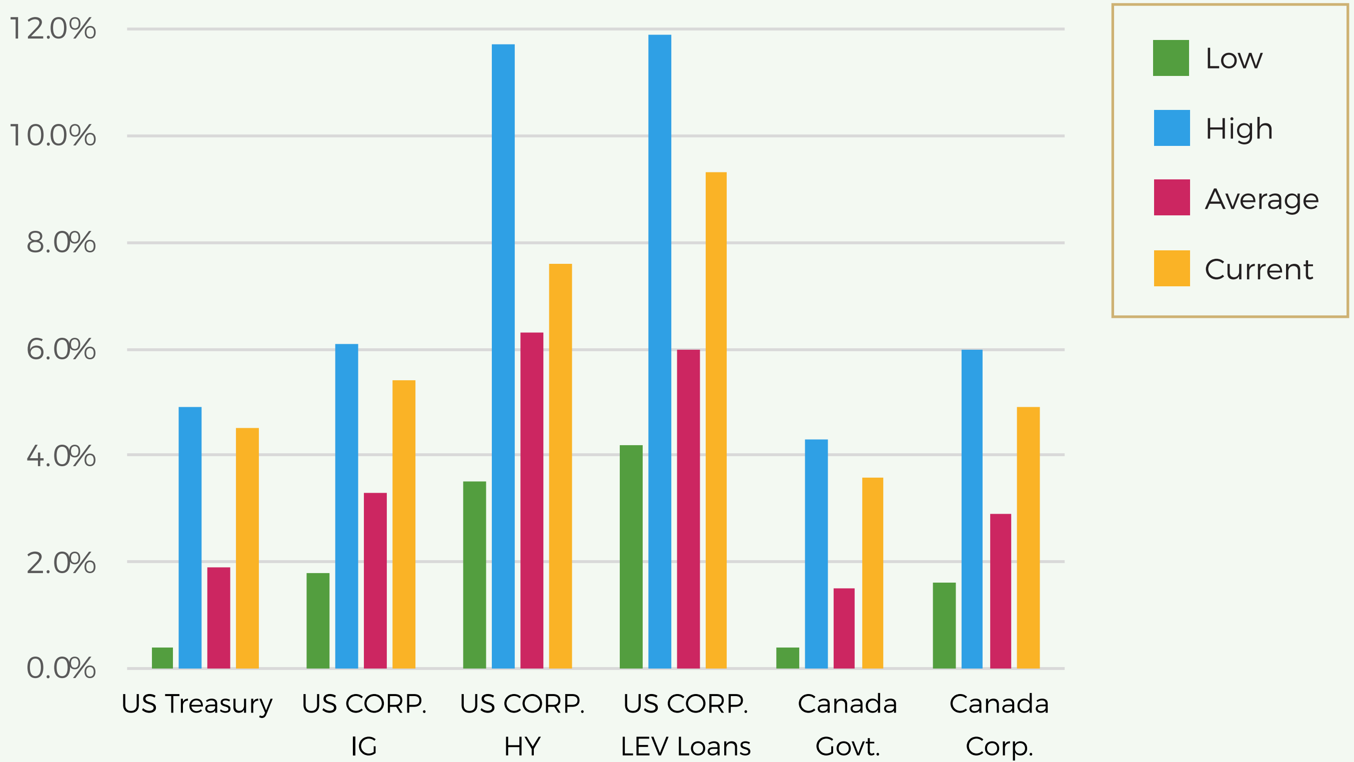
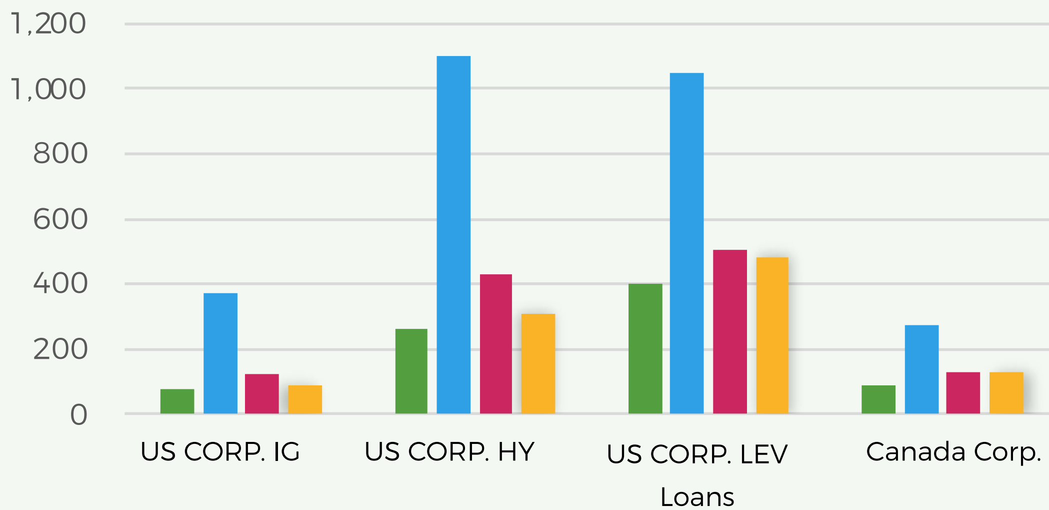
FIXED INCOME MARKETS: VALUATION (CONTINUED)

Fixed Income Yields – 10-year History



Fixed Income Spreads – 10-year History



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CAPITAL MARKETS REVIEW

Alternatives and Private Investments

The HFRX Hedge Fund Index was up 0.3% in Q2 and +2.9 YTD.

YTD, long-short equity hedge funds (+5.1%) and macro/trend following (+4.6%) strategies performed best. Merger-arbitrage strategies performed worst (-3.3%).

Commercial real estate (NCREIF Index) was down 1.0% in Q1 2024 (latest data available), the 5th straight quarter of performance declines.

Given low transaction volume, pricing data varies across index providers.

According to Green Street, a weighted index of commercial real estate values is down 20% from its 2022 peak and 5% over the past 12 months.

However, prices stabilized towards the end of 2023 and have been modestly higher for higher-quality properties over the past three months. Cap rates have also stabilized and are likely at peak levels for most property types.

Pricing has varied significantly across property types according to the RCA Commercial Property Index.

Across various property types, pricing was down 0.1% MOM in May and 2.3% YOY.

Industrial pricing continued to accelerate, up by 0.9% MOM and 8.9% YOY.

Apartment prices dropped 8.9% YOY and 1.0% MOM, the 5th straight month of double-digit annualized pricing declines.

Office prices continue to decline markedly and are down 16.9% YOY and 0.9% MOM with central-business district pricing down significantly more than suburban office properties.

Operating fundamentals vary considerably across property types.

Office vacancies have crossed 20% for the first time in history and asset values continue to fall.

Apartment demand remains strong with record absorption in Q2. However, large supply additions continue to constrain rents with rent growth remaining at flattish levels.

Industrial vacancy rates have increased to 6.5% (from lows of 3.7%) but are still well below pre-pandemic averages. Demand remains strong with record absorption, but increased supply has led to flat asking rents on a Q/Q basis.

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ALTERNATIVES AND PRIVATE INVESTMENTS (CONTINUED)

Private equity continues to perform well regarding fund returns and portfolio company operating performance. New deal and exit activity is picking up from depressed levels.

According to Cambridge Associates, US PE returned 9.3% for FY 2023 (the latest data available). Anecdotally, PE firms are estimating low-to-mid-single-digit returns for Q1 2024 (PE reports with a lag).

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

In Q2 2024, US PE buyout deal activity increased substantially (projected at $225bln) after several quarters that ranged between $140bln-$160bln per quarter.

Platform LBOs remain scarce given their high dependence on leverage while add-on acquisitions have seen increased activity.

Globally, PE deal valuations have ticked back up on a trailing twelve-month basis to 12.4x EV / EBITDA vs. 10.6x in 2022 and 13.3x peak levels in 2021. US deal valuations have remained relatively stable at 13.1x vs. 13.8x in 2021.

Valuations for Tier 1 high-quality assets remain high. However, valuations for lower-quality assets have declined by 20% to 30% (if these assets are even brought to market).

New deal Debt / EBITDA multiples remained stable at 5.2x in Q2 2024 from 5.9x in 2022, with debt / total capital at 46% versus 51% in 2022 and versus the 10-year average of 55%.

Exit activity improved modestly off depressed levels in Q2.

H1 exits improved 16% YOY in dollar terms, driven by enhanced sequential activity in Q2 2024.

GPs are reporting increasing pipeline activity regarding portfolios being prepped for exit.

With exit values still far below 2020 and 2021 levels, we expect PE firms to continue seeking liquidity through increased activity in the secondary market.

Venture capital fund performance stabilized towards the end of 2023 and 2024.

According to Cambridge Associates, US VC returned -3.5% in 2023 (the latest data available), and valuations stabilized as of Q4.

However, down rounds are more frequent, and companies increasingly implement investor-friendly provisions.

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ALTERNATIVES AND PRIVATE INVESTMENTS (CONTINUED)

Deal activity $ volumes accelerated in Q2 to $55.6bln from $37bln in Q1 and deal count climbed to the highest level since Q2 2022.

It is unclear whether this marks a true rebound in deal activity or whether companies that raised funds two to three years ago are tapping the market for follow-on financings.

Public market valuations for VC-backed companies remain close to trough levels (4.9x EV / sales vs. 12.6x during the 2021 peak).

The performance of recent VC-backed IPOs has been lackluster and has trailed broader markets.

As such, VC firms will likely continue holding better-performing companies for longer and wait until public market valuations for fast-growth companies improve.

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CAPITAL MARKETS REVIEW

Actionable Investment Opportunities

Mid-term US government debt

We favor adding duration to fixed-income holdings if US Treasury yields approach 4.5% for maturities of 5-to-10 years (yields are currently at 4.2% for 10-year maturities).

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 Equity

Secondary volume remains strong 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 high-quality assets.

The quality of LP portfolios and GP continuation vehicles offered via secondaries continues to improve as buyer and seller expectations converge.

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

Valuations are more reasonable than during frothy conditions in 2021 / H1 2022.

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

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ACTIONABLE INVESTMENT OPPORTUNITIES (CONTINUED)

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%, 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 have tightened meaningfully 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 financial and maintenance covenant protections.

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

Interestingly, on the one hand, credit spreads for publicly traded corporate and high-yield debt are at tight levels. Yet, credit funds are reporting increasingly robust pipelines, indicating wide dispersion regarding borrower access to credit.

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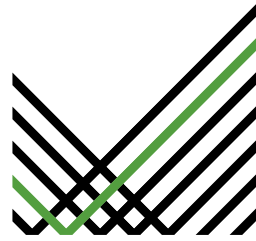

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