Bitterroot
CAPITAL ADVISORS

CAPITAL MARKETS REVIEW

2023 Quarter 3

October 23, 2023

118 East Main St
Bozeman, MT 59715
406-556-8202

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All public market data are as of 10/10/23 unless indicated otherwise.

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Capital Markets

Equity markets (ACWI Index) declined by 3.4% in Q3 but remain up 11.2% YTD through October 10, 2023.

Declines were widespread with major indexes (S&P 500, MSCI EAFE, MSCI Emerging Markets) all down 3%-4% in USD terms.

US stocks declined due to surging longer-term bond yields as a) economic data remained robust and b) the Fed revised its outlook for interest rates in 2024 higher (a higher for longer narrative).

International equities declines were driven by a combination of still rising yields coupled with weak economic data in Europe and China.

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

The Barclays US Aggregate Index was down 3.2% during Q3 with both US Treasuries and investment-grade corporate bonds down more than 3% during the quarter. The AGG index is down 1.5% for the year.

10-Year US Treasury bond yields surged by 75bps during Q3 and ended the quarter at 4.57% vs. 3.82% at the end of Q2.

High-yield bonds and leveraged loans (riskier corporate credit) were up 0.5% and 3.4% during Q3 and are now up 5.4% and 10.5% YTD.

YTD high-yield bond performance has been driven by coupon income and spread tightening. However, rising interest rates have detracted from these positive factors.

Leveraged loans have benefitted from high coupon income (driven by high base rates) and from spread tightening. Rising base rates (SOFR have increased from 4.3% to 5.3% since the beginning of the year) has helped performance through higher coupon payments as loans are floating-rate instruments.

Credit spreads have tightened despite increasing signs of credit stress (corporate bankruptcies reaching the highest levels YTD since the GFC). In fact, high-yield bond spreads of 403bps are now below historical averages (430bps) and are well-below the 800bps level normally seen during recessions.

Hedge funds were up 0.5% in Q3 and +1.3% YTD.

Convertible arbitrage strategies performed best (+4.6% YTD) while directional strategies such as equity-hedge and credit performed well (+3.2% and +2.9%). Event-driven and macro / trend-following strategies performed worst at -0.8% and -0.2% respectively.

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Capital Markets (Continued)

Private equity was up 2.7% in Q1 2023 and likely up another 3.0% in Q2.

Private equity managers report with a 60-to-120-day lag. As such, Q2 and Q3 benchmark data is not yet available. However, most PE firms are reporting increases of low-SD during Q2 driven primarily by underlying EBITDA growth at portfolio companies.

New deal activity across buyout strategies remains well below 2021 peaks but is roughly comparable to pre-pandemic levels. Entry multiple valuations have modestly declined from 12.7x to 12.0x EBITDA and leverage has declined to 42% debt to capital vs. 53% debt to capital at the end of 2021.

Private credit performed well through Q2 2023 (latest data available given lagged reporting)

The Cliffwater Private Credit Index was up 2.8% in Q2 and is up 5.6% YTD as portfolios benefitted from high current yields with stable pricing.

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, defaults and markdowns may increase and offset some of this return.

Some analysts are projecting that private debt defaults in 2024 may exceed those experienced by loans traded on the syndicated loan market.

Private real estate pricing continued to decline in Q2 2023 (latest data available) although transaction volumes remain exceedingly low.

The NCREIF Index was down 2.0% in Q2 2023 (third consecutive quarterly decline) and is down 3.7% YTD. Cap-rates have begun to stabilize although there is very limited data following the recent uptick in rates.

Underlying property fundamentals remain strong across industrial properties but have stagnated for multi-family properties (rents down 1.2% YOY in September on a national level). Office fundamentals are generally under significant pressure except for the highest-quality, best location properties.

The outlook for new private investment funds (currently raising money for 2023 vintage) is bright as valuations and leverage utilized in deals are both lower, and in certain cases like private credit, there is less capital chasing opportunities.

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Capital Markets (Continued)

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, the range of outcomes (especially for public equity markets) remains wide 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
- Adding duration in safe fixed income via 10-year Treasury maturities
- Continued allocations to new private investment strategies especially private equity secondaries and private credit.

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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 remain at higher levels for longer versus the past ten-year average.

Labor shortages persist in service-oriented industries and may constrain margin expansion.

Energy prices are likely to be higher versus the prior cycle given structural supply shortages.

Geopolitical uncertainty is increasing with regards to the US-China relationship and potential for episodic military conflicts.

With equity valuations increased YTD but having eased in Q3, we expect mid-to-high single digit nominal pre-tax annual equity returns (6.5%-8.0%) 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).

As such, expected returns are likely driven by earnings growth and dividends rather than multiple expansion.

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

“Safe” fixed income is highly attractive, with compelling shorter-term and mid-term maturities.

US and Canadian 1-year government bond yields are yielding 5.3% to 5.4% and 2-year government bonds are yielding 4.9%-5.1%

US 10-Year Treasuries are yielding 4.6%. These yields are highly compelling as we believe the Fed rate hike cycle is close to over and inflation is subsiding. If 10-year yields were to decline to a 3.5% level (which we think is reasonable if either inflation subsides faster than expected or if a recession ensues), the capital appreciation potential for these bonds is strong.

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 very compelling relative to equities.

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Strategic Asset Allocation View (7-years)

Riskier credit assets (high-yield bonds and leveraged loans) are also reasonably attractive over a mid-term time frame (and on a relative basis to equities).

US high-yield bonds are now yielding 9.0% with 7-year forecasted annual returns of 7.5% (relatively close to US Equities). Leveraged loans are currently yielding 10.2% (based on 3-year takeout convention) with expected mid-term annualized returns in the 7.0% range.

These high yields are primarily due to high base rates. Spreads remain near historical averages and could easily widen in a recession.

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 (7-years)

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 Treasury		
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)		

* 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 highly 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

The US economy continues to perform much better than expected with strong consumer spending and high fiscal spending on construction projects associated with onshoring manufacturing capacity as part of the Inflation Reduction Act.

H1 Real GDP annualized growth was upwardly revised to 2.2% and is poised to accelerate at a much faster pace in Q3 according to GDPNow models. Consumer spending remains high, employment remains strong, fiscal spending on a variety of infrastructure project initiatives remains robust, and there are even nascent signs of improving manufacturing data with industrial production growth at the highest level since October 2018.

Most economists expect Real GDP to slow substantially in 2024 to 1.0% from 2.3% in 2023 as excess consumer savings bleed down, wage growth slows, bank lending slows, and unemployment ticks up modestly. However, analysts have consistently underestimated the strength of the US economy since the pandemic.

Canada's economy likely rebounded from the modest contraction in Q2, but trends are showing signs of weakness.

Employment continues to weaken more than expected with the unemployment rate increasing by 0.5% over the past four months (slower hiring relative to surging population and labor supply growth). Consumer spending flattened and business investment has slowed as well.

The slowing economy coupled with declining core inflation makes it likely that the Canadian Central Bank will not raise interest rates further.

Europe's economy is under pressure with Germany, Spain, France, and Italy all flirting with recession.

Bank lending and money supply are declining, reflecting the impact from the ECB's rate hikes.

Manufacturing remains weak with PMI surveys near 43 (well below the 50-level which indicates neither growth or contraction). Worryingly, services PMIs have also breached 50, indicating that services may no longer buoy Europe's economy.

China's economic growth accelerated from Q2 driven by strong consumer spending.

GDP accelerated to 1.3% Q/Q, up from 0.9% in Q2. Retails sales increased by 5.5% YOY in September, the fastest pace in five months.

The property market remains extremely weak despite various measures of government support.

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Macroeconomic Conditions (Continued)

The largest property development company, Evergrande, recently filed for bankruptcy and the country's largest homebuilder appears close to defaulting.

Government stimulus is expected to increase in Q4 2023 and into 2024 which should help reinvigorate growth. In addition, to monetary stimulus, the government is weighing lending directly to local governments. Also, the government is considering strengthening fiscal stimulus aimed at increasing domestic consumption.

Inflation has clearly peaked across most major economies with both headline and core inflation down meaningfully from 2022 highs.

However, core inflation remains well above central bank targets. In the US, core inflation was 4.1% YOY in September and 0.3% MOM (an increase from previous months of 0.2%). Services inflation remains sticky, and recent oil price increases have led to increases in producer prices paid (which can be harbingers for future increases in core CPI).

On a positive note, wage growth has slowed considerably in the US despite the labor market remaining very strong.

Most analysts agree that the rate hiking cycle has either been completed or is very close to completion across most central banks. Rather the debate centers around: a) when do central banks start cutting rates and what is the magnitude of those rate cuts and b) what happens to yield curves and rates for longer-dated maturities?

We believe that the Fed is more likely to hold the Fed-funds rate higher for longer as the US economy appears robust (as of 10/10/23).

Other central banks (ECB) may be more inclined to cut rates faster if economic weakness persists or intensifies.

While we acknowledge a wide range of possible outcomes, our current thinking is for Fed rate cuts of 50bps-75bps and a decline in 10-year US Treasury yields to 3.50%-3.75% from 4.6% today.

The recent sharp rise in longer-term bond yields should tighten financial conditions and help slow the economy which should further reduce inflation.

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Shorter-term View

Thus far in 2023, equity markets have rallied sharply, especially in the US. The trajectory of equity markets over the next 6-12 months will be driven by a) outlook for corporate earnings and potential for recession and b) trajectory of inflation and interest rates.

The case for a soft-landing or Goldilocks-like pause in growth with falling inflation has increased. Inflation has clearly slowed in most major regions, and core inflation is falling significantly in the US. It is widely expected that the Fed is close to ending its rate hike campaign. However, it is unclear how quickly the Fed will begin to cut rates.

Most economists now estimate a 20%-40% chance that the US experiences a recession over the next 12 months (down from 40%-60% six months ago).

Thus far, continued strong US consumer spending has defied economist projections. Consumers still appear to have $1 trillion in excess pandemic savings and are willing to take on increasing levels of debt (bolstered by strong employment prospects). US unemployment remains exceedingly low at 3.8%.

Equity markets may continue to appreciate in a scenario where unemployment remains low and inflation continues to fall.

However, several significant risk factors remain.

Geopolitical tension is high with two current armed conflicts in Russia / Ukraine and now the tragic events in the Middle East and with increasingly strained US-China relations.

Should war in the Middle East spread to involve larger parties such as Iran, oil prices would likely increase significantly which in turn could speed up the onset of recessionary conditions.

European macro economic data remains weak with slowing now seen in services PMI surveys as well as in manufacturing surveys. If Europe was to weaken further, this could spill over to the rest of the world.

The US Treasury yield curve (10-year vs. 3 months) has been inverted for almost a year. This yield curve inversion has preceded every recession over the past 50 years, with an average time from inversion to recession of 11 months (but not every yield curve inversion has resulted in recession).

Rising interest rates have led to tightening underwriting standards across loan types and less willingness to make consumer and commercial loans. Historically, when credit creation and money supply growth has slowed significantly, recession has followed.

US government shutdown risks have increased given the elevated level of political infighting.

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Shorter-term View (Continued)

We see multiple potential paths for equity returns over the next 9-12 months (with reference to the S&P 500 which stands at 4,358 as of October 10, 2023).

Scenario A: (Optimistic Case) – Core inflation continues to moderate faster than expected with a soft landing. Fed does not raise rates anymore and begins to trim rates in 2024 as inflation drops toward its 2% target.

Under this scenario, S&P earnings could expand to $250 in 2024 and $270 for 2025 (vs. $218 in 2023). Equity multiples may expand to 19x-20x forward earnings. The S&P 500 index could appreciate to 5,000 to 5,300 by YE 2024 (15%-21% price appreciation).

Scenario B: (Base Case) – Fed holds rates steady until well into 2024 causing a mild recession.

Under this scenario, the US economy enters a mild recession with 2024 S&P 500 corporate earnings down 5% to up 5% followed by a strong recovery in 2025. In this scenario, the market may initially decline by 5% to 10% over the next six to nine months before recovering to close 2024 in the 4,300 to 4,700 range (up 3% at the midpoint from Oct 10, 2023 levels).

Scenario C: (Pessimistic Case) – Core inflation reaccelerates or remains higher for longer leading to additional Fed hikes. Consumers exhaust remaining excess savings and layoffs intensify.

European weakness may exacerbate the swiftness of a global recession. 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%-15% in 2024 with equity markets declining by 15%-20% from current levels over the next 6-12 months. 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 increase in equity valuations YTD coupled with significant remaining macroeconomic risk factors, we would recommend that investors do not add substantially to equities at these levels.

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Equity Markets – Performance

Global equity markets (MSCI ACWI Index) declined by 3.4% during Q3 but remain up 11.2% YTD through Oct. 10, 2023.

During Q3, declines were widespread across regions with most major regions down 3% to 4%.

Globally, value stocks (-1.8%) materially outperformed growth stocks (-4.9%) during Q3. However, on a YTD basis, growth stocks are up 20.7% vs. value stocks up only 2.3%.

Technology (-6.2%) and consumer discretionary (-4.9%) stocks underperformed during Q3 but have performed well YTD (+32.4% and +18.3% respectively). Communication services stocks which have a high digital and internet presence were up +0.5% in Q3 and are up 30.1% YTD.

Defensive sectors such as utilities, consumer staples and healthcare performed poorly in the quarter and were down -8.6%, -6.2% and -2.7% respectively. YTD, these sectors were down -10.0%, -3.8% and – 0.9% respectively.

Cyclical sectors posted mixed performance during Q3 with the energy sector up +10.7%, financials down -0.9% and industrials down -5.2%. YTD, these sectors have trailed the broader market (+11.2%) with energy +6.5%, financials +2.9% and industrials +8.4% respectively.

US large-cap equities (S&P 500) were down 3.4% during Q3 but remain up 14.5% YTD.

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 is only up 2.2% YTD.

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

The US S&P technology and consumer discretionary sectors gave back some gains in Q3 (-5.7% and -4.8% respectively) as interest rates increased and some of the AI excitement dissipated. However, they are still up 39.5% and 27.9% YTD.

In the US, energy was the best S&P sector performer in Q3 at +12.2% as oil prices rallied driven by unexpected OPEC supply reductions. YTD, however, S&P energy is up 3.8% and has significantly trailed the broader S&P 500 (which rose +14.5%).

US small cap stocks performed worse than large caps and were down 5.1% in Q3 and are only up 2.0% YTD as investors are concerned that higher interest rates and the effects from a potential recession would have a greater impact on small-cap earnings than on large cap stocks.

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Equity Markets - Performance (Continued)

Additionally, small-cap stocks tend to have higher leverage and may experience declining profits resulting from sharp increases in borrowing costs.

International developed stocks (MSCI EAFE) were down 4.1% during Q3 and up 7.4% YTD in USD.

The quarterly declines were primarily driven by the -5.1% return of European equities. Europe's macroeconomic fundamentals continued to weaken, especially in Germany.

Emerging markets were down 2.9% during Q3 and +0.9% YTD.

Chinese equities were down 1.9% during the quarter and are down 8.0% YTD. 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.

We anticipate that China will increase its stimulus efforts during Q4 2023 and during 2024, which could provide uplift to Chinese equities and emerging markets broadly.

On a YTD basis, EM performance has essentially consisted of divergent China and non-China stories. Chinese equities (33% of index) are down 8% YTD while most other EM countries such as India, Taiwan, Korea, Brazil and Mexico have all delivered positive returns (with Mexico and Brazil delivering +12% returns).

Analysts are forecasting an improving trajectory for US corporate earnings (S&P 500) beginning with Q3 2023 and accelerating into 2024.

S&P 500 earnings declined 4.4% during H1. Analysts are forecasting flat growth in Q3 2023, 9.4% in Q4 2023, and 12.0% growth in 2024. Notably, as confidence regarding achieving a soft landing has increased, the number of positive analyst earnings estimates revisions has increased steadily.

We believe the outlook for 2024 corporate earnings remains quite uncertain. On the one hand, certain sectors are experiencing resumptions in demand, manufacturing surveys are improving, input and other cost inflation has subsided, and consumer spending remains strong. On the other had, the economy could stall as the effects of higher interest rates ripple through with a lag, especially once excess pandemic savings are largely depleted. Additionally, the risk of spillover from weakening European macroeconomic conditions or an unexpected geopolitical event remains high.

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Equity Markets - Performance (Continued)

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, given the massive YTD outperformance of growth stocks (especially technology stocks that have benefitted from AI sentiment), we would not be surprised to see value stocks outperform over the next 6-9 months (or at least more balanced performance between growth and value).

The NASDAQ 100 and Russell 1000 Growth indexes are up 39.2% and 28.8% YTD. Valuations have increased and are well above historical norms.

While technology stock price performance did decline in Q3 as treasury yields appreciated sharply, the test for technology-oriented growth stocks remains in terms of Q3 earnings releases and commentary. These stocks may be susceptible to a pullback should AI be less of a near-term revenue and earnings driver than currently expected by investors.

Certain value stocks such as financials have materially underperformed YTD, and valuations appear attractive. Bank stocks may rebound if loss provisions remain relatively low and CEO commentary regarding the macro economy becomes more bullish. Energy stocks may continue to rally if oil prices strengthen due to ongoing volatility in the Middle East.

Equity Indices (as of 10/10/23)

Total Returns (%) – USD

	YTD	Sept. 2023 Qtr	Annualized Returns			
			1Y	3Y	5Y	7Y
US Large Cap (S&P 500)	14.5%	-3.4%	22.1%	9.0%	10.7%	11.9%
US Small Cap (Russell 2000)	2.0%	-5.2%	6.6%	4.1%	3.8%	6.6%
MSCI EAFE	7.4%	-4.1%	25.2%	4.8%	4.2%	5.4%
MSCI Emerging Markets	1.0%	-2.9%	9.6%	-3.2%	1.6%	2.9%
MSCI ACWI	11.1%	-3.4%	21.1%	6.0%	7.7%	8.8%
MSCI ACWI - Equal Weight	0.5%	-3.5%	12.2%	1.1%	3.1%	4.2%
US Style Factors						
MSCI US Quality	24.7%	-1.5%	35.5%	9.1%	13.6%	14.4%
Russell 1000 Growth	28.8%	-3.1%	31.4%	7.9%	14.7%	16.2%
Russell 1000 Value	1.8%	-3.1%	12.7%	9.5%	6.7%	7.9%

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Equity Markets - Valuation

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

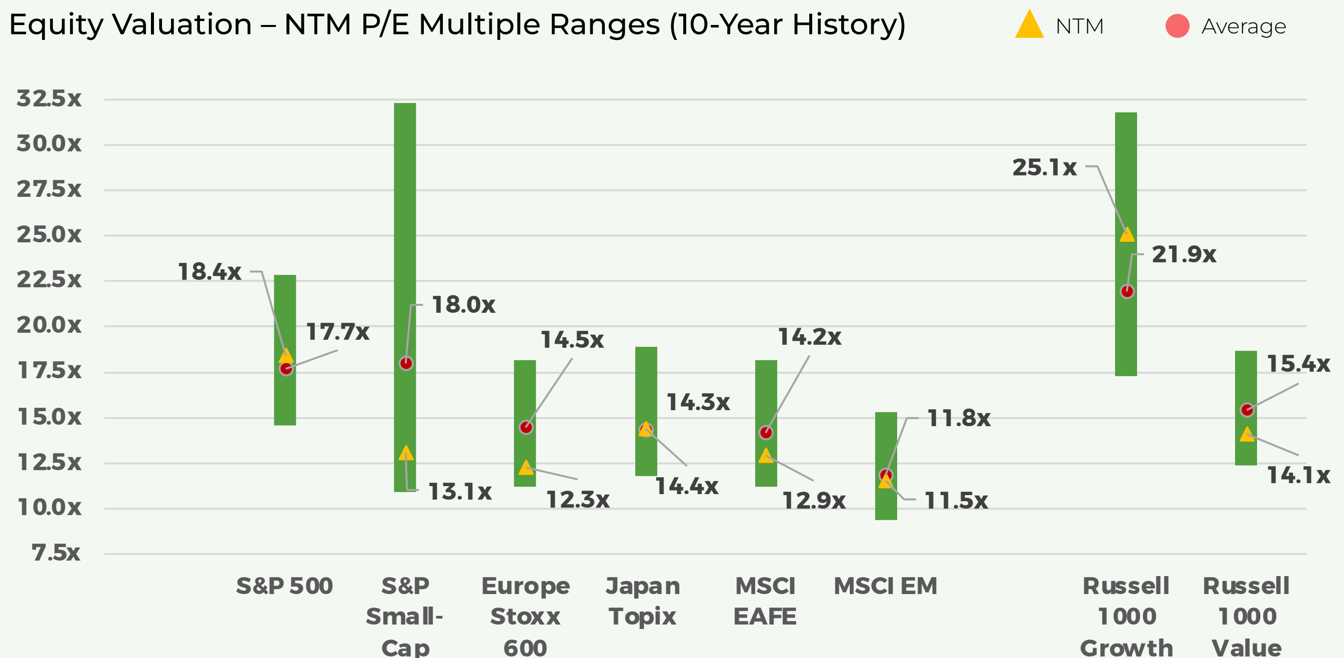
In the US, equity market valuations are expensive relative to government bonds. The S&P 500 presently trades at 18.4x consensus NTM earnings (which may be too high)

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

With 10-year Treasuries yielding 4.6%, at first glance, a 13.5x-15.5x 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 4.6% 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.

Additionally, our mid-term return outlook for risky corporate credit (high yield bonds and leveraged loans) is similar to that for equities, with lower risk.



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Fixed Income Markets - Performance

Safe fixed income (government bonds and corporate investment grade bonds) declined significantly during Q3 as interest rates sharply increased.

Yields rose across the US Treasury yield curve, with the curve becoming less inverted during the quarter. Yields on shorter-term bonds (2-to-3-year maturities) stayed rose 15bps to 30bps while yields on longer-term bonds (10-to-30-year maturities) rose by 70bps to 85bps.

This occurred as the probability of achieving a soft landing continued to rise. Core inflation data has continued to moderate while employment data, consumer spending, and several other economic metrics remain strong.

Both high yield bonds and leveraged loans have appreciated YTD.

HY bonds have primarily benefitted from high coupon rates coupled with spread tightening. These positive factors have been offset by increases in Treasury base rates.

CCC-rated (the riskiest) high-yield bonds have performed best thus far this year (+12.0%) 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 10/10/2023)

	% Ret YTD 10/10/23	% Ret Sep-23 Qtr.	Annualized % Returns				Duration (yrs)
			1Y	3Y	5Y	7Y	
US Treasury	-1.8%	-3.1%	-0.6%	-5.7%	0.0%	-0.4%	5.9
US Corp. IG	-0.4%	-3.1%	3.1%	-5.1%	1.1%	0.8%	6.8
US Corp HY	5.4%	0.5%	8.2%	1.2%	3.1%	3.7%	3.5
US Corp Lev. Loans	10.1%	3.4%	12.0%	5.9%	4.4%	4.6%	NA
Barclays US Aggregate	-1.5%	-3.2%	0.6%	-5.2%	0.2%	-0.1%	6.2
Barclays Canada Agg. *	-1.3%	-3.8%	0.3%	-4.9%	0.3%	0.0%	7.0

** Barclays Canada Aggregate Index returns in CAD*

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Fixed Income Markets - Valuation

Safe fixed income (government bonds and investment grade corporate bonds) yields remain at highly attractive levels

US Treasuries are yielding roughly 4.9%-5.5% for 1-to-2-year maturities and 4.6% for 10-year maturities.

US corporate investment grade bonds are now yielding 6.0% (with risk of default very low).

Investment grade corporate bond spreads have modestly declined YTD while high yield bond spreads have tightened more significantly.

IG spreads are presently at 125bps (vs. 141bps at YE 2022) and HY spreads are at 403bps (vs. 469bps at YE 2022).

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).

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

S&P expects defaults rates to increase to 4.5% by June 2024 versus 3.2% in June 2023.

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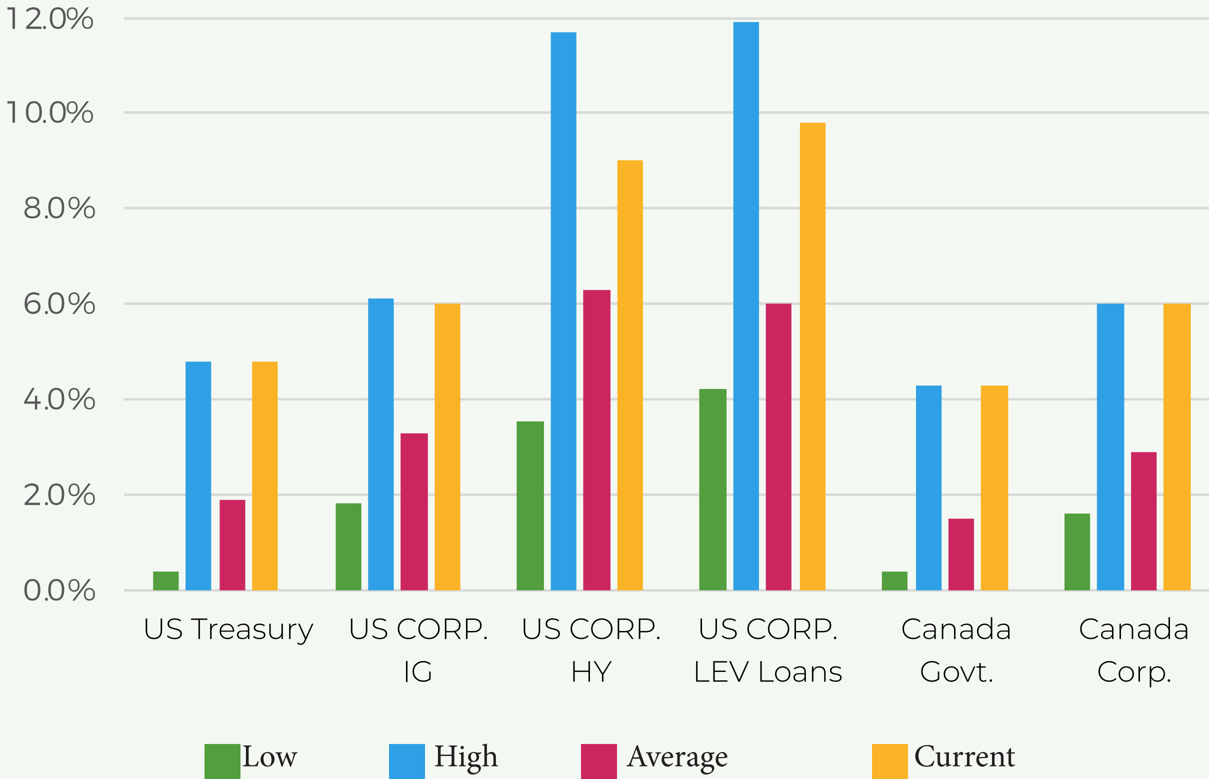
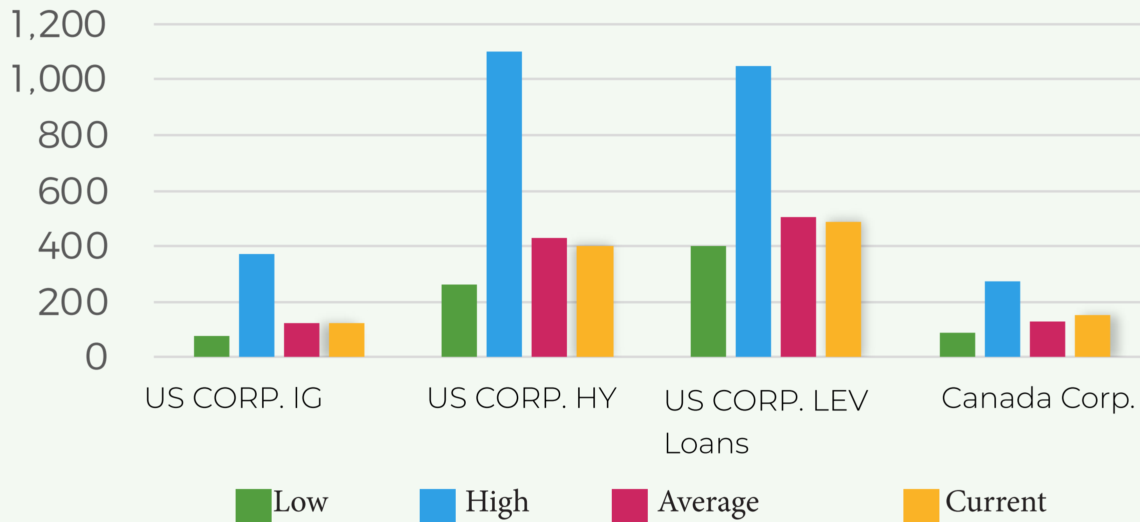
Fixed Income Markets - Valuation (Continued)

Fixed Income **Yields** – 10-year History



Fixed Income **Spreads** – 10-year History



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Alternatives and Private Investments

The HFRX Hedge Fund Index was up 0.5% in Q3 and 1.3% YTD.

Convertible arbitrage strategies performed best (+4.6% YTD) while directional strategies such as equity-hedge and credit performed well (+3.2% and +2.9%). Event-driven and macro / trend-following strategies performed worst at -0.8% and -0.2% respectively.

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

Apartment fundamentals remain relatively strong, but YOY rental growth was -1.2% on a national basis (this varies significantly across property types and regions).

Industrial fundamentals remain very strong especially for smaller property types with in-place rents still lagging market rents by north of 20%.

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.

In many cases, debt dilutes equity returns as the cost of funding is higher than the cap-rate.

Pricing has continued to decline with the NCREIF index down 2.0% in Q2 2023 (latest data available) and 3.7% YTD. The June quarterly decline represents the third 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.

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Alternatives and Private Investments (Cont.)

Private equity has performed well thus far in 2023 with most PE funds experiencing positive YTD performance.

According to Cambridge Associates, US PE returned 2.7% in Q1 2023 (latest data available). Anecdotally, PE returns likely improved by another few hundred basis points in Q2 2023.

PE buyout returns thus far 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 value declined to roughly $170bln in Q3. This is well below the $380mm Q4 2021 peak, although generally in-line with pre-pandemic levels.

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

Valuations for new deals have contracted somewhat and were at 12.0x trailing EBITDA vs. 12.7x in 2022. However, valuations for the highest-quality businesses remain robust and have not experienced material declines.

Leverage levels on deals have reduced by 1.0x-1.5x turns of cash flow thus far with debt accounting for 43% of total capitalization vs. 53% at the end of 2021.

Exit activity remains highly depressed – now below pre-COVID levels.

Exits (in $ value terms) fell by 40% from Q2 levels and are now 81% below Q2 2021 peak levels.

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

According to Cambridge Associates, US VC returned -0.9% in Q1 2023 (latest data available). Anecdotally, VC returns suggest flat to modestly higher returns in Q2 2023.

The unknown at this point is what valuations may be for companies requiring new funding rounds. Most VC 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.

Having said that, the frequency of down-rounds is steadily increasing with down-rounds accounting for 20% of financings in Q2 and Q3 of 2023, the highest amount in several years.

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Alternatives and Private Investments (Cont.)

Deal count has stabilized over the past few quarters, but Q3 deal value fell to the lowest levels since Q3 2018.

Exit activity increased materially in $ terms to $35bln in Q3 vs. $12bln in Q2.   However, these figures were greatly buoyed by the IPOs of Instacart and Klaviyo.

Both of these IPOs occurred at lower valuations relative to their prior financing rounds despite both companies being solidly profitable.

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Actionable Investment Opportunities

Short-term US and Canadian government debt

We favor a barbell approach of shorter-duration maturities of less than two years (yielding 5.0%-5.5%) and mid-duration maturities (10-year US Treasuries) that yield 4.6%. 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 12%-13% with lower leverage levels and better covenants.

The opportunity set is especially interesting for middle-market borrowers as regional banks are likely to pull back on lending and private credit can increasingly capture share.

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

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

While discounts have narrowed recently, they remain higher than normal, and buyers increasingly have options to cherry pick certain desired funds from multi-fund portfolios available for sale.

Given low exit activity and nearing maturity walls for several PE fund vintages from 2007-2011, we 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.

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