Bitterroot

CAPITAL ADVISORS

CAPITAL MARKETS REVIEW

2024 Quarter 3

October 14, 2024

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

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All public market data are as of 10/11/24 unless indicated otherwise.

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EXECUTIVE SUMMARY

Capital Markets

Equity Markets

Global equities, as measured by the ACWI Index, advanced 6.6% in Q3, bringing YTD gains to 18.8% through October 11. Gains were broad-based, with emerging markets (+8.7%) and international developed equities (+7.3%) outperforming U.S. stocks (+5.8%). Emerging markets were notably boosted by a sharp 23.9% rally in Chinese equities, driven by large-scale government stimulus announcements. Strong corporate earnings and better-than-expected inflation data further supported equity markets throughout Q3, with momentum continuing into early October.

Fixed Income

U.S. government and investment-grade corporate bonds saw significant appreciation in Q3, as interest rates declined. The Barclays US Aggregate Index rose 5.2% for the quarter, leading to a 3.0% YTD gain. U.S. Treasury yields dropped by 60 basis points (10-year) and 110 basis points (2-year) in Q3, reflecting favorable inflation trends toward the Fed's 2.0% target and a faster-than-expected cooling in the labor market. However, bond yields have risen by 35 basis points since the quarter's end, amid stronger-than-expected economic data.

High-Yield Bonds & Leveraged Loans

High-yield bonds and leveraged loans continued to perform well, with Q3 returns of 5.3% (7.5% YTD) and 2.1% (7.0% YTD), respectively. Returns were supported by high coupon yields, lower interest rates, and spread compression. With base rates having declined by 50 basis points in the last month and a further 150 basis points reduction expected by year-end 2025, leveraged loan coupon income may decrease moving forward. High-yield bond spreads have narrowed to 290 basis points, below the historical average of 430 basis points and far below recessionary levels (800 basis points).

Hedge Funds

Hedge funds posted a 2.1% gain in Q3, bringing YTD returns to 5.1% through September. Long-short equity strategies (+7.5%) and convertible arbitrage (+5.6%) have been top performers YTD, while merger arbitrage (-0.9%) has underperformed.

Private Equity

Private equity returns rose 1.8% in Q1 2024. following a 9.3% gain in 2023. With Q2 data pending due to reporting lags, low-single-digit returns are expected. Returns in 2024 have lagged public equities, largely due to lower exposure to AI and tech sectors.

CAPITAL MARKETS (CONTINUED)

Additionally, PE managers have been reluctant to mark up asset valuations during a period of still low exit activity. Q3 deal activity neared $250 billion, marking a second consecutive quarter above $225 billion. Entry valuations increased to an average of 12.7x, while leverage declined to 5.2x Debt/EBITDA (45% of total deal value). Exit activity showed improvement, with a 50% increase in dollar terms YTD.

Private Credit

Private Credit was up 3.0% during Q2 2024. Early indications suggest approximately 3% returns for Q3. While the outlook remains positive, returns will decline as interest rates fall. Unlevered yields currently exceed 10% at base rates of 4.8%. Although current credit quality remains solid, the percentage of loans in non-accrual is rising, indicating potential defaults or markdowns in legacy portfolios. Competition is intensifying among private credit lenders, but conditions remain favorable in the middle market, where spread compression has been less severe.

Private Real Estate

The private real estate market saw a slight decline in Q2 2024, with the NCREIF Index down 0.3%, marking the fifth consecutive quarterly drop. Signs of stabilization are emerging, as cap rates level off and transaction volumes increase. Operating fundamentals vary by property type: industrial and multi-family rents are flat despite strong demand, while office vacancies have hit a historic 20% high.

Outlook & Portfolio Positioning

Although 2024 has seen strong returns across risk assets, the remainder of the year and 2025 could bring increased volatility. U.S. economic signals are mixed, geopolitical risks are heightened, and the upcoming U.S. presidential election adds further uncertainty. With U.S. equity valuations appearing stretched, the potential outcomes for the next 6-12 months are broader than usual, especially for public equities.

We are incorporating these views into our portfolio positioning by:

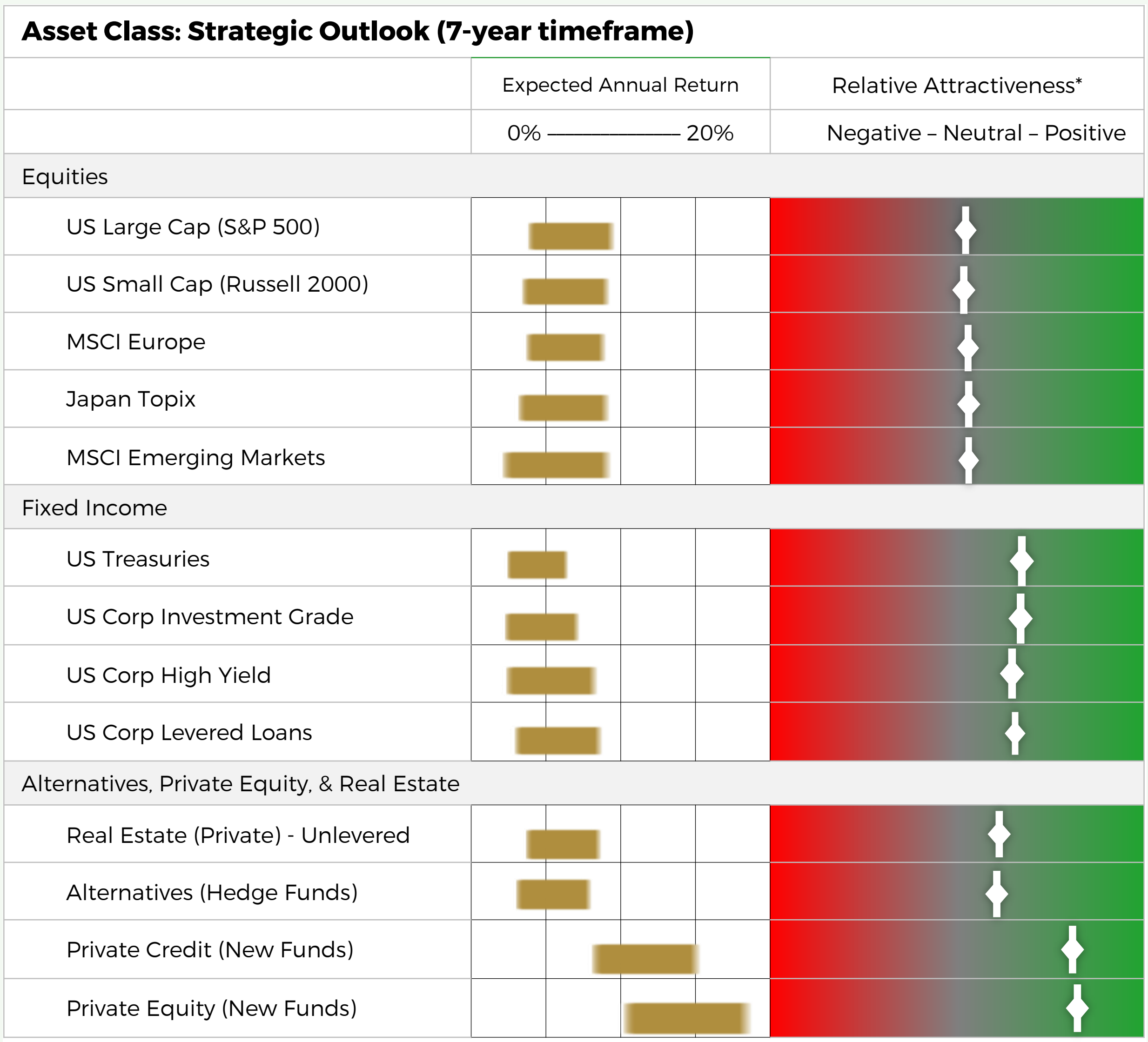
Extending Duration: Adding Treasury bonds with intermediate maturities (5-10 years), especially if 10-year U.S. Treasury yields rebound to 4.25% or higher.

Focusing on Private Investments: Continuing to allocate to new private investment strategies, with a particular emphasis on private equity secondaries and private credit, which offer compelling risk-adjusted return potential in the current environment.

EXECUTIVE SUMMARY

Strategic Asset Allocation View (7-years)

Our 7-year forecasts consider several factors that will shape the mid-term investment landscape.



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.

STRATEGIC ASSET ALLOCATION VIEW (CONTINUED)

Macroeconomic and Market Factors

Interest Rates Outlook: We anticipate that interest rates will decline from current levels over the forecast period, but they are unlikely to return to the ultra-low levels experienced from 2009 to 2021.

Corporate Profit Margins: Margins (especially in the US) will be affected by opposing forces. Onshoring and reduced labor flexibility may exert downward pressure, while AI adoption could significantly boost productivity and expand profit margins, particularly in the U.S.

Geopolitical Risks: Heightened geopolitical uncertainty—stemming from the U.S.-China relationship, conflicts in the Middle East, and the potential for other military tensions—will likely influence market volatility and investment strategies.

Equity Market Outlook

Expected Returns: With valuations having significantly increased over the last 18 months, we forecast mid-single digit nominal pre-tax annual equity returns (6.0%-7.0%) over the next seven years.

U.S. vs. International Markets: While U.S. stocks are expected to outperform international equities, we anticipate a greater convergence in returns due to elevated U.S. valuations. International markets are generally aligned with historical averages, making them potentially more attractive from a relative valuation perspective.

Growth vs. Value Stocks: Quality and growth stocks are expected to continue outperforming value stocks, though at a slower pace compared to the past seven years. For U.S. equities, earnings growth and dividends are likely to be the primary drivers of returns, rather than multiple expansion.

Potential Wildcards: The adoption pace of generative AI could significantly impact U.S. tech sectors, potentially leading to above-trend revenue growth and margin expansion. Conversely, should AI capex spend decline from extremely robust current levels or revenue monetization from AI prove lower than expected, several US large-cap technology stocks may experience muted stock performance. Given their high concentration in the index, S&P 500 performance might be heavily influenced by the performance of a select number of stocks.

Fixed Income Outlook

Attractive Base Yields: "Safe" fixed income remains appealing, with base yields across the curve above 4.0% for maturities between 2 and 10 years. U.S. 10-Year Treasuries currently yield 4.1%, down from 4.7% in April but higher than the 3.6% recent lows. We expect yields to remain within a 3.50% to 4.50% range in the near term, with a greater likelihood of falling below the lower end.

STRATEGIC ASSET ALLOCATION VIEW (CONTINUED)

Expected Returns: We project low-to-mid-single digit returns for U.S. government debt and investment-grade bonds over the 7-year horizon. On a risk-adjusted pre-tax basis, the return potential for safe fixed income remains attractive compared to equities.

Credit Market Outlook

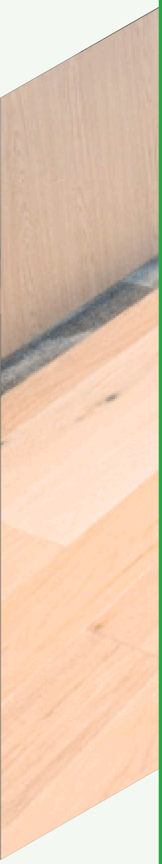
Riskier Credit Assets: High-yield bonds are yielding 7.2%, while leveraged loans offer 9.2% yields. Expected returns for these assets are in the range of 6.0%-6.5%. The high base yields make these options appealing for generating current income.

Spread Considerations: Current high-yield spreads (300 bps) are below historical averages and far below recessionary levels (600-800 bps). If a recession occurs, spreads may widen, negatively impacting near-term prices, but high starting yields could cushion total returns.

Comparative Attractiveness: Despite tighter spreads, risky credit remains attractive relative to equities on a pre-tax basis, though it is less compelling compared to safe government bonds.

Alternative Investment Outlook

Private Market Strategies: We expect private equity and private credit to deliver higher returns relative to public markets over a multi-year period. Private equity secondaries, specialty finance, and asset-backed credit remain appealing areas for new investments given their potential for superior returns and diversification benefits.



Macroeconomic Conditions & Key Issues

Macroeconomic Conditions

Shorter-term View: Key Issues & Scenarios

MACROECONOMIC CONDITIONS & KEY ISSUES

Macroeconomic Conditions

United States

The U.S. economy remains fundamentally strong, albeit with signs of a slowdown.

Real GDP grew at an annualized rate of 3.0% in Q2 2024, up from 1.6% in Q1. However, growth in Q3 may face headwinds from the impact of natural disasters and storms. The Q2 expansion was broad-based, driven by gains in consumer spending, business investment, and inventory accumulation.

Consumer spending has moderated from the rapid pace of 2023 but remains healthy, with September core retail sales increasing by 0.7% month-over-month (MoM), outpacing expectations. Encouragingly, revised government data indicated a boost in the consumer savings rate to 5.5%, reflecting solid financial health relative to historical averages.

However, not all economic indicators are positive. Credit card and auto loan delinquencies have been steadily rising over recent quarters, especially among lower-income households.

The labor market remains well-balanced but is showing signs of cooling. While September's job creation appeared strong at 254,000, recent months have seen job gains averaging below 200,000—significantly lower than the levels achieved during the robust 2022 and 2023 periods. Wage growth has moderated to approximately 3.9% annually, and job market dynamics appear more balanced, with job openings down to 8 million from the 12.7 million peak in 2022. Additionally, quit rates have returned to pre-pandemic levels.

Inflation is largely resuming its disinflationary trend after a brief resurgence earlier this year. The core PCE (the Fed's preferred inflation measure) fell to 2.7% annually in August, averaging 2.6% over recent months. Although September's CPI (+0.2% MoM) and Core CPI (+0.3% MoM) came in slightly above expectations, the annual CPI increase of 2.4% marked a three-year low.

The Federal Reserve initiated its first rate cut in September, reducing rates by 50 basis points (bps), with economists projecting an additional 150 bps of cuts by the end of 2025.

MACROECONOMIC CONDITIONS (CONTINUED)

Canada

Canada's economic growth has been relatively modest year-to-date, with real GDP slightly exceeding expectations, projected at 1.2% for 2024 and 2.0% for 2025.

However, on a per-capita basis, growth has declined due to substantial population increases.

The labor market is under pressure, with unemployment rising as rapid population growth outpaces job creation. Inflation has decreased significantly, with core inflation at 2.4% year-over-year (YoY) in August and headline inflation reaching the 2.0% target.

The Bank of Canada has reduced interest rates by 25 bps for three consecutive meetings, and many economists anticipate continued rate reductions over the next 12-18 months. There is concern that inflation could fall below the 2.0% target.

Despite declining rates, consumer spending may struggle to gain momentum in 2025 due to Canada's mortgage renewal system. Many homeowners will face significantly higher interest payments as a percentage of income in 2025 and 2026, compared to contracts set during the ultra-low-rate environment of 2020-2021.

However, economists forecast a notable uptick in business investment by 2025, as wage growth slows and interest rates decline.

MACROECONOMIC CONDITIONS (CONTINUED)

Europe

Europe's economy remains sluggish, with the Eurozone's real GDP expanding by 0.3% quarter-over-quarter in both Q1 and Q2.

Growth has been robust in Spain, moderate in France and Italy, and slightly negative in Germany.

Consumers are relatively more optimistic than businesses, driven by rising real incomes and high savings, which have bolstered sentiment. There is cautious optimism for accelerating growth due to factors such as the waning energy crisis, strong employment levels, substantial consumer savings, and the likelihood of continued interest rate cuts amid slowing inflation. The Services PMI has been positive for several months following a lull in the second half of 2023.

However, manufacturing remains weak, with PMI surveys still below the 50 threshold, indicating stagnation. The recent announcement of substantial stimulus measures by China may support European manufacturers, given China's significant import demand for European goods.

The European Central Bank (ECB) cut rates in June, and further reductions are anticipated as core inflation slows, with core CPI at 2.8% YoY.

China

China's economic performance year-to-date has fallen short of both consensus expectations and internal targets.

However, the government recently introduced the most extensive set of stimulus measures since the pandemic.

The property market remains severely weak, with several large developers defaulting, leaving a substantial inventory of unsold apartments and a growing number of uncompleted projects. New home prices fell at their fastest rate in nine years in August, and consumer sentiment and retail spending remain subdued. Youth unemployment is also a concern, standing at 18.8%.

Deflationary pressures persist, with companies cutting prices across various goods.

With its 5% annual GDP growth target at risk, the government unveiled extensive stimulus initiatives, including lowering reserve requirements, cutting interest rates, reducing minimum down payment requirements for home purchases, and providing incentives for stock buyback lending through a stabilization fund. The government has also suggested that fiscal stimulus is forthcoming, with economists widely agreeing that significant fiscal action is necessary to effectively stimulate domestic demand.

MACROECONOMIC CONDITIONS & KEY ISSUES

Shorter-term View: Key Issues

Below, we revisit vital issues that we have outlined in previous reports.

Issue #1: Inflation Trajectory

Inflation is moderating, with signs of continued disinflation into 2025

In September, CPI increased by 0.2% month-over-month (2.4% year-over-year), while core CPI rose 0.3% MoM (3.3% YoY). The Fed's preferred inflation measure, Core PCE, was up 0.1% MoM and 2.7% YoY in August. If fiscal policy remains stable, inflation is expected to continue easing throughout Q4 2024 and into 2025.

Bond yields have fallen sharply from their April highs, with the 10-year Treasury yield down to 4.1% from 4.7%, though still above the recent 3.6% low in September.

The Fed implemented a 50 bps rate cut in September, and economists project an additional 150 bps of cuts by the end of 2025.

Issue #2: Economic Growth

Economic growth is slowing, but a soft landing remains the base case.

GDP growth is expected to stay below 2% in 2025, with economic activity having rebounded in recent months despite earlier weakness.

The US labor market remains resilient, with unemployment at 4.2%, up from a low of 3.4%. However, historically, a 50 bps increase in the unemployment rate often signals a recession within 6-12 months. Spending among upper-middle-class and wealthy consumers is strong, while lower-income households face rising credit card and auto loan delinquencies.

As inflation continues to subside, rate cuts should help mitigate potential slowdowns.

In Europe, economic recovery is underway but uneven. Q2 GDP rose by 0.2% quarter-over-quarter (0.6% YoY), with Germany near contraction, while France, Spain, and Italy saw stronger growth.

Manufacturing PMIs have been negative since July 2022, showing renewed weakness in recent months despite earlier improvements. In contrast, services PMIs remain positive, and consumer confidence has strengthened with stable employment and lower inflation.

SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Issue #3: Corporate Earnings

Corporate earnings are robust, but 2025 poses tougher comparisons.

S&P 500 earnings grew 12% YoY in Q2, with growth extending beyond the "Magnificent Seven" tech firms.

Analysts forecast 4.1% earnings growth for Q3 2024 and 14.2% for Q4, though Q3 will likely exceed expectations sharply and Q4 projections may be revised modestly lower.

Analysts are currently forecasting 15% earnings growth for 2025. Analysts tend to be optimistic regarding future earnings and generally reduce their forecasts closer to earnings releases. In 2025, earnings growth comparisons for the Magnificent Seven become more challenging.

As such, non-Magnificent Seven companies will need broad earnings growth to deliver 2025 earnings near consensus expectations. Rate cuts could support recovery across sectors, assuming a recession does not materialize.

Issue #4: AI Adoption

AI is driving 2024 market performance, but future growth remains uncertain.

Sectors such as semiconductors and technology hardware have significantly benefited from AI-related spending.

While the near-term outlook for AI hardware is strong, sustainability beyond 2025 is uncertain. Some companies have strengthened their competitive positions through AI leadership (e.g., Apple, Microsoft, Alphabet), despite limited current impact on financial results.

The main beneficiaries thus far include semiconductor firms (Nvidia, Micron, Broadcom) and cloud companies (Amazon, Meta, Google). Software companies associated with AI have shown muted stock performance.

Upcoming earnings reports will be closely watched for signs of sustained demand, cost pressures, and shifts in competition.

SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Issue #5: China Government Policy

China's economy remains weaker than expected with several structural challenges. However, the government recently announced large scale stimulus measures that may restore consumer confidence and drive improved growth.

The property sector remains weak, with ongoing declines in new home prices and consumer spending.

In response, the government has implemented significant stimulus measures, including lower borrowing rates, property incentives, and efforts to stabilize equity markets through a stock stabilization fund and share buyback incentives.

Chinese equities surged 40% over three weeks through early October on optimism about the stimulus, but momentum has faded as policy details fell short of expectations. Further large-scale fiscal measures are needed to boost domestic consumption.

Issue #6: Geopolitical Conflicts

Geopolitical risks are intensifying, with conflicts in the Middle East and Ukraine.

Israel is engaged in escalating conflicts with Hamas and Hezbollah, with the risk of a direct escalation involving Iran.

The Russia-Ukraine war appears to be in a stalemate, with uncertain outcomes. The U.S. presidential election could significantly influence U.S. policy toward Ukraine, potentially altering the conflict's trajectory.

Despite Middle East turmoil, oil prices have remained stable due to muted global demand amid weak European and Chinese economies and rising U.S. supply. However, a sustained increase in oil prices could reignite inflation and raise the risk of a global recession.

SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Issue #7: U.S. Presidential Election

The upcoming election could increase market volatility and alter policy directions.

Historically, equity markets experience higher fluctuations during election years, particularly around the election.

So far, market volatility has been lower than expected, possibly because both Trump and Harris are well-known figures with familiar policy positions. Nonetheless, unexpected policy shifts remain a risk.

For instance, broader tariffs favored by Trump could negatively impact equity markets and drive up bond yields, while Harris's proposal to let certain tax cuts expire in 2025 and raise corporate taxes could weigh on consumer spending and corporate earnings.

MACROECONOMIC CONDITIONS & KEY ISSUES

Shorter-term View: Scenarios

We envision multiple potential trajectories for equity returns over the next twelve months, with the S&P 500 positioned at 5,815 as of October 11, 2024.

Scenario A: Optimistic Case

The optimistic scenario assumes aggressive Fed rate cuts will accelerate economic growth without aggravating inflation.

In this case, the Fed cuts rates by 50 bps or more through the end of 2024, followed by an additional125+ bps in 2025, spurring economic growth above 2% while core inflation continues to decline toward the 2% target.

Rate Cuts and Economic Growth: The easing cycle supports healthy consumer spending, modest wage growth, and improved profit margins as companies continue to manage costs effectively.

Earnings Outlook: AI demand remains robust and the Magnificent Seven continue to generate strong earnings growth which is accompanied by improving earnings growth across the broader market.

S&P 500 earnings could grow from $222 in 2023 to $248-$255 in 2024, $270-$285 in 2025, and $300-$315 in 2026, with equity multiples holding at 21x-23x forward earnings.

Market Implications: Under these conditions, the S&P 500 may reach 6,300-6,800 by mid-2025, delivering a total return of 10%-18% from current levels.

Scenario B: Base Case

The base case projects slowing growth but no recession, with the Fed continuing gradual rate cuts.

The Fed is expected to cut rates by 50 bps through the rest of 2024, followed by a 100 bps reduction in 2025. Economic growth slows to 1.5%-2.0%, with unemployment rising modestly, but significant economic contraction is avoided.

Economic and Employment Trends: Consumer spending is projected to slow without substantial declines, while GDP growth stays between 1.5%-2.0%.

Earnings Outlook: AI demand modestly slows from current levels. Magnificent Seven earnings growth cools from torrid 2023 levels while broader market earnings growth continues to improve.

S&P 500 earnings may reach $240-$248 in 2024, $260-$275 in 2025, and $280-$300 in 2026, with equity multiples at 19.5x-21.5x forward earnings, resulting in an S&P 500 index level between 5,500 and 6,000 and a total return of -4.0% to +4.5%.

SHORTER-TERM VIEW: KEY ISSUES (CONTINUED)

Scenario C: Pessimistic Case

The pessimistic scenario anticipates a deeper economic slowdown, possibly leading to a recession.

Economic deterioration accelerates due to depleted consumer savings, triggering layoffs, or external factors like a European recession or resurgent inflation that could prompt new Fed rate hikes.

Recession and Market Decline: The recession would be more profound, with S&P 500 earnings forecasted at $240-$245 in 2024, followed by a 10% decline in 2025 before potential recovery in 2026.

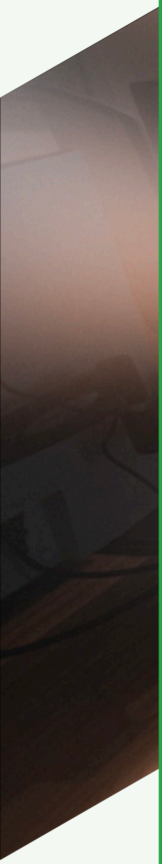
Market Implications: The S&P 500 could drop by 20% within 6-12 months as expectations adjust, but a quicker Fed pivot to easing may trigger a strong market rebound.

At present, Scenarios A and B appear more plausible than Scenario C, with markets increasingly pricing in a "Goldilocks" scenario—characterized by robust earnings growth alongside declining inflation and interest rates.

Supporting Factors: The U.S. consumer remains generally healthy, with unemployment still at historically low levels, strong AI-related demand reamins robust and corporate earnings growth remains strong. Additionally, easing cycles by the Fed and other central banks provide a favorable macroeconomic backdrop. Historically, the fourth quarter has tended to be a strong period for equity markets.

Caution Advised: Despite these positive dynamics, the significant increase in equity valuations over the past 18 months, coupled with ongoing macroeconomic and geopolitical risks, suggests caution. We recommend avoiding substantial new equity allocations at current levels.

Longer-term Outlook: 7-year expected returns for equities are in the range of 6.0%-7.0%, which is lower than historical averages, reflecting elevated valuations. There is potential for heightened volatility.



Capital Markets Review

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, as tracked by the MSCI ACWI Index, rose 6.6% in Q3, bringing year-to-date (YTD) gains to 18.8% as of October 11, 2024.

Equity Indices (as of 10/11/24) Total Returns (%) – USD

			Annualized Returns			
	YTD	Qtr	1Y	3Y	5Y	7Y
US Large Cap (S&P 500)	22.9%	5.8%	34.1%	11.3%	15.7%	13.8%
US Small Cap (Russell 2000)	11.4%	9.3%	27.8%	1.2%	9.6%	7.2%
MSCI EAFE	10.7%	7.3%	21.5%	4.9%	7.6%	5.5%
MSCI Emerging Markets	15.8%	8.7%	24.2%	-0.3%	5.3%	3.0%
MSCI ACWI	18.8%	6.6%	30.0%	7.8%	12.2%	10.0%
S&P 500 - Equal Weight	15.1%	9.4%	27.8%	7.1%	12.4%	10.8%
MSCI ACWI - Equal Weight	10.4%	12.0%	19.1%	0.2%	6.0%	4.3%
US Style Factors						
MSCI US Quality	26.3%	4.8%	36.1%	13.3%	17.8%	16.7%
Russell 1000 Growth	26.1%	3.2%	38.5%	12.2%	20.0%	18.1%
Russell 1000 Value	17.7%	9.4%	28.8%	8.7%	11.1%	9.5%

Regional & Style-Factor Performance

U.S. large-cap equities (S&P 500) advanced by 5.8% in Q3, achieving a strong 22.9% YTD return. While international developed equities (+7.3% in Q3, +10.7% YTD) and emerging market stocks (+8.7% in Q3, +15.8% YTD) outperformed U.S. large caps during the third quarter, they have lagged behind on a YTD basis.

Globally, value stocks surged by 9.8% in Q3, significantly outperforming growth stocks, which gained 4.1%. Despite this recent trend, growth stocks have led the way YTD, up 21.0% compared to 17.0% for value stocks.

During Q3, the financials (+10.7%), industrials (+10.2%), and consumer discretionary (+9.4%) sectors were top performers, while energy (-2.2%) and technology (+1.1%) lagged. YTD, the technology (+28.7%) and communications services (+25.1%) sectors have delivered the best results.

EQUITY MARKETS: PERFORMANCE (CONTINUED)

U.S. Equities

Encouragingly, Q3 saw a broadening of performance within the S&P 500, extending beyond just the Magnificent Seven. The S&P 500 Equal Weight Index posted a 9.4% gain, outperforming the market-cap weighted index (+5.8%) for the first time since 2022.

During Q3, industrials (+11.4%) and financials (+10.5%) sectors performed best, while energy (-2.3%) and technology sectors (+1.6%) performed worst. Technology and internet stocks faced mixed outcomes following Q2 earnings, as lofty expectations weighed on investor sentiment. In particular, stocks of companies with ambitious capital expenditure plans for AI saw enthusiasm cool.

U.S. small-cap stocks finally outpaced large caps in Q3, delivering a 9.3% gain, compared to 5.8% for large caps.
However, YTD, the primary drivers of equity gains have still been several large-cap technology companies (NVIDIA, Meta, Apple, Microsoft, Google) with significant exposure to AI-driven growth (as was the case in 2023). The Magnificent Seven accounted for nearly half of the S&P 500's YTD gains, with NVIDIA alone contributing 23% of the index's returns.

On an equal-weighted basis, the S&P 500 was up 15.1% YTD, trailing the market-cap weighted index by approximately 7.8%, one of the largest differentials in history, echoing a similar trend from 2023.

YTD, small caps are up only 11.8%, significantly underperforming large caps (+22.9%). Their lagging performance has been due to lower exposure to AI, higher interest costs from greater leverage, and prior concerns over economic slowdowns. Looking ahead, small caps may be well-positioned to outperform if a "Goldilocks" scenario materializes, with rate cuts and better-than-expected economic growth, especially given their relatively cheaper valuations.

International Developed Market Equities

The MSCI EAFE Index climbed 7.3% in Q3 and 10.7% YTD. European stocks rose 6.5% in Q3 and 10.3% YTD. Favorable currency translation helped U.S.-based investors, as European equities were up only 1.6% in local terms during Q3. Within Europe, energy and automotive sectors were detractors, with the latter especially hit by weak luxury sales in China. Outside of these sectors, corporate earnings were generally resilient. In addition, inflation continued to fall.

Japanese stocks gained 5.7% in Q3 (10.8% YTD), but local currency returns declined 6.0% due to the Yen's 10.7% appreciation against the USD. The stronger yen poses a challenge for stocks as a significant portion of Japanese corporate profits come from overseas. YTD, currency movements have hurt U.S. investors, with the USD up 5.7% vs. the yen. In local terms, Japanese equities appreciated 17.0%, supported by robust earnings growth and structural reforms.

EQUITY MARKETS: PERFORMANCE (CONTINUED)

Emerging Markets

Emerging market equities climbed 8.7% in Q3 (6.6% in local currency) and 15.8% YTD (18.6% in local currency). Chinese stocks, which surged 23.9% in Q3, were the largest contributors to EM performance. This sharp rally was driven by the announcement of broad and substantial stimulus measures as the government took a more pro-growth stance to address slowing economic growth. While the stimulus is expected to bolster growth, some economists caution that further large-scale fiscal measures may be needed to offset structural challenges, including aging demographics, excess capacity, and weakness in the property sector.

Outlook - Style Factors

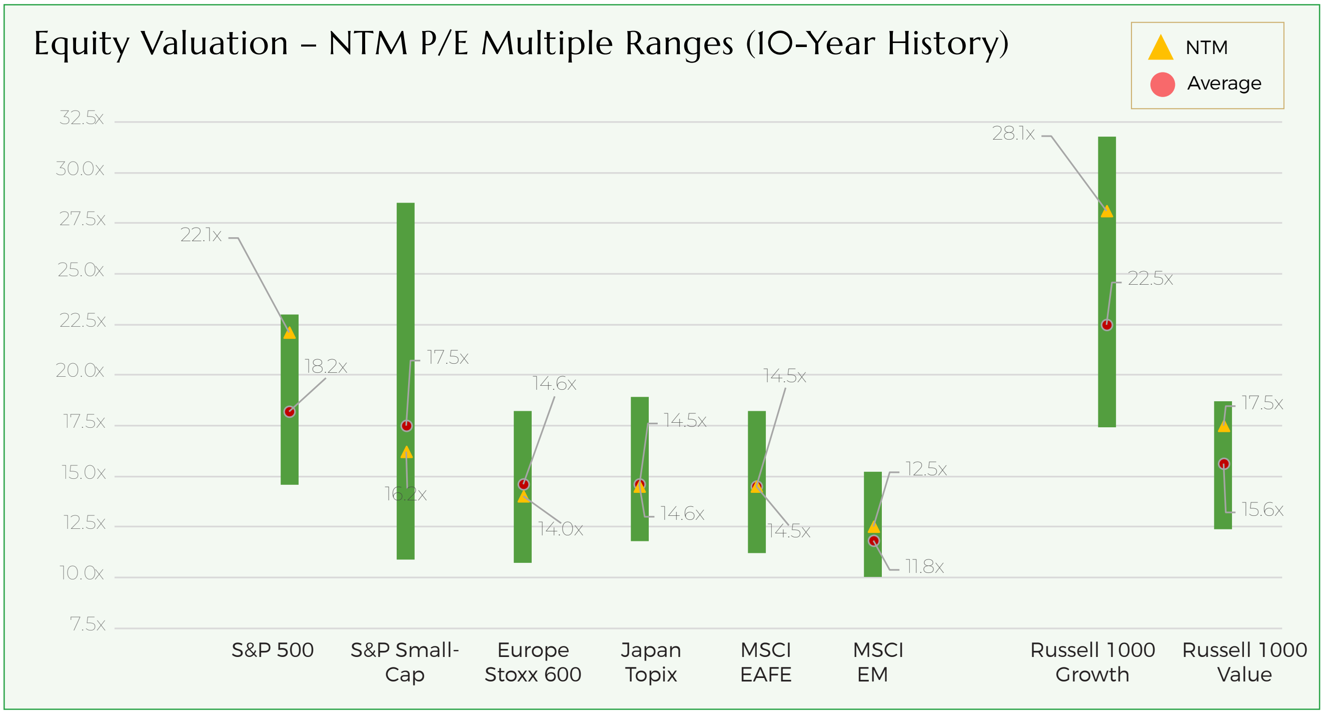
For mid-term investors, we continue to favor high-quality companies with strong business models, superior revenue growth, and attractive returns on capital. While these companies may face short-term underperformance following recent gains, particularly in technology and communication services, their long-term outlook remains compelling.

Over shorter time horizons, cyclical stocks such as value stocks and small caps could outperform as they benefit more directly from interest rate reductions and improving economic conditions.

CAPITAL MARKETS REVIEW

Equity Markets: Valuation

U.S. equity markets are trading at elevated valuations relative to historical norms and government bonds. However, there are important nuances in the S&P 500's valuation dynamics.



S&P 500 Valuation

The market-cap-weighted S&P 500 Index currently trades at 22.1x next-twelve-months (NTM) P/E, which appears expensive compared to historical averages. In contrast, the equal-weighted S&P 500 trades at 17.7x NTM P/E, a level closer to historical norms. This disparity highlights the concentration of market performance in a narrow group of large-cap stocks, particularly within the technology and communications sectors, which together account for 45% of the index.

While the S&P 500's valuation appears elevated, it is partly a reflection of the index's changing composition, which has shifted towards higher-quality companies with robust growth prospects, secular tailwinds, and a consistent record of attractive earnings growth.

Growth and Quality Stocks: U.S. growth and quality stocks, particularly in technology and communications, are valued at a premium relative to historical averages. Over the past 12 months, operating fundamentals in these sectors have been strong, with accelerating revenue growth and controlled costs driving outsized earnings gains.

EQUITY MARKETS: VALUATION (CONTINUED)

However, comparisons will become more challenging in 2025, as the growth rates achieved in the past year may be difficult to sustain.

Investors have largely overlooked rising AI-related spending in operating expenses and capital investments at many large-cap tech companies (Microsoft, Meta, Google). If AI revenue monetization does not meet expectations in 2025, these companies could face stock price pullbacks.

Value Stocks: In contrast, U.S. value stocks—including sectors such as healthcare, energy, financials, and consumer staples—are generally considered to be fairly valued to modestly expensive relative to historical norms.

Financials, especially banks, have reported better-than-expected fundamentals, while healthcare companies continue to grapple with cost challenges.

Energy prices remain subdued due to weaker-than-expected global demand and rising supply. However, energy demand could increase if economic growth accelerates in the West due to interest rate cuts, and if Chinese demand picks up following stimulus measures. On the other hand, rising U.S. energy supply and signs of weakening supply discipline within the OPEC+ alliance could limit the upside.

International Markets

International developed market valuations are more in line with historical averages.

If China's announced stimulus measures are fully implemented, European equities could see a boost in 2025, given their higher contribution of profits derived from China. Furthermore, if Chinese stimulus measures prove successful, Chinese equity markets will likely appreciate further which in turn would lead to strong EM equity market performance.

Equity Valuations Relative to Bonds

The valuation of U.S. large-cap equities appears especially high when compared to government bonds. The S&P 500 is trading at 22.1x consensus NTM earnings, whereas historically, the earnings yield (the inverse of the P/E ratio) has averaged 200-300 basis points (bps) above the yield on 10-year Treasuries.

With 10-year Treasuries currently yielding 4.1%, a 14.0x-16.5x forward P/E multiple would be considered "fair" based on historical relationships. However, many investors do not anticipate 10-year Treasury yields remaining at 4.1% for an extended period.

If the 10-year yield were to retreat to 3.5%, a more reasonable fair valuation would be in the range of 16.0x-18.0x forward EPS. It is important to note, however, that the traditional relationship between equity valuations and bond yields may not hold given the changing sector composition of the S&P 500, particularly with the prominence of technology stocks benefiting from sustainable secular growth trends.

CAPITAL MARKETS REVIEW

Fixed Income Markets: Performance

Safe fixed income assets, including government bonds and investment-grade corporate bonds, saw strong appreciation in Q3, driven primarily by declining interest rates.

Fixed Income Indices – Characteristics and Performance in USD (as of 10/9/2024)

			Annualized Returns				Duration
	YTD	Qtr	1Y	3Y	5Y	7Y	yrs
US Treasury	2.2%	4.8%	9.1%	-2.1%	-0.6%	0.9%	6.0
US Corp. IG	4.0%	5.8%	14.4%	-1.4%	0.9%	2.3%	7.1
US Corp HY	7.5%	5.3%	16.6%	3.0%	4.7%	4.6%	3.0
US Corp Lev. Loans	7.0%	2.1%	10.3%	6.6%	6.0%	5.3%	NA
Barclays US Aggregate	3.0%	5.2%	11.3%	-1.7%	0.0%	1.3%	6.2
Barclays Canada Agg. *	2.1%	4.5%	11.4%	-0.5%	0.3%	1.7%	7.4

** Barclays Canada Aggregate Index returns in CAD*

Drivers of Rate Declines

The decline in interest rates was fueled by better-than-expected inflation data, prompting the Federal Reserve to cut the Federal Funds rate by 50 basis points (bps) in September, marking the first rate cut of the current cycle. The Fed's median forecast anticipates an additional 50 bps of cuts by year-end and a further 100 bps in 2025.

- Short-term bond yields (2-year maturities) fell by 110 bps, while longer-term yields (10-year maturities) declined by 60 bps during Q3. However, since the end of September, yields for both short- and long-term bonds have risen by 30 bps due to stronger-than-expected employment data.

High-Yield Bonds & Leveraged Loans

Both high-yield bonds and leveraged loans delivered strong performance in Q3 and year-to-date (YTD).

- High-yield bonds benefited from high coupon rates and tightening credit spreads. Lower-quality, riskier high-yield bonds significantly outperformed higher-quality bonds as economic growth and corporate earnings proved more resilient than anticipated.
- CCC-rated bonds, the lowest-quality category, surged by 11.6% in Q3, vastly outperforming BB-rated (+4.6%) and B-rated bonds (+4.3%). YTD, CCC-rated bonds have appreciated by 15.6%, well ahead of the gains seen in BB-rated (+6.7%) and B-rated bonds (+6.1%).

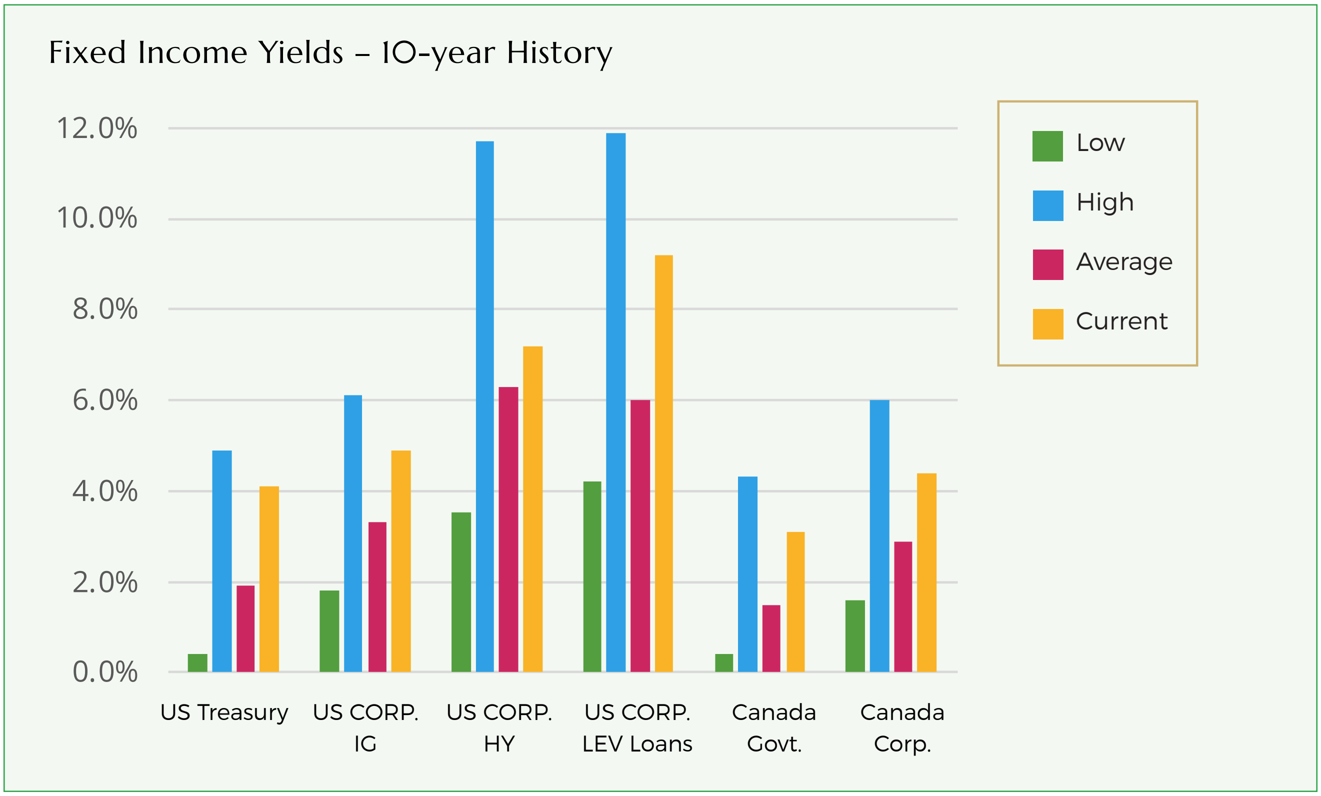
FIXED INCOME MARKETS: PERFORMANCE (CONTINUED)

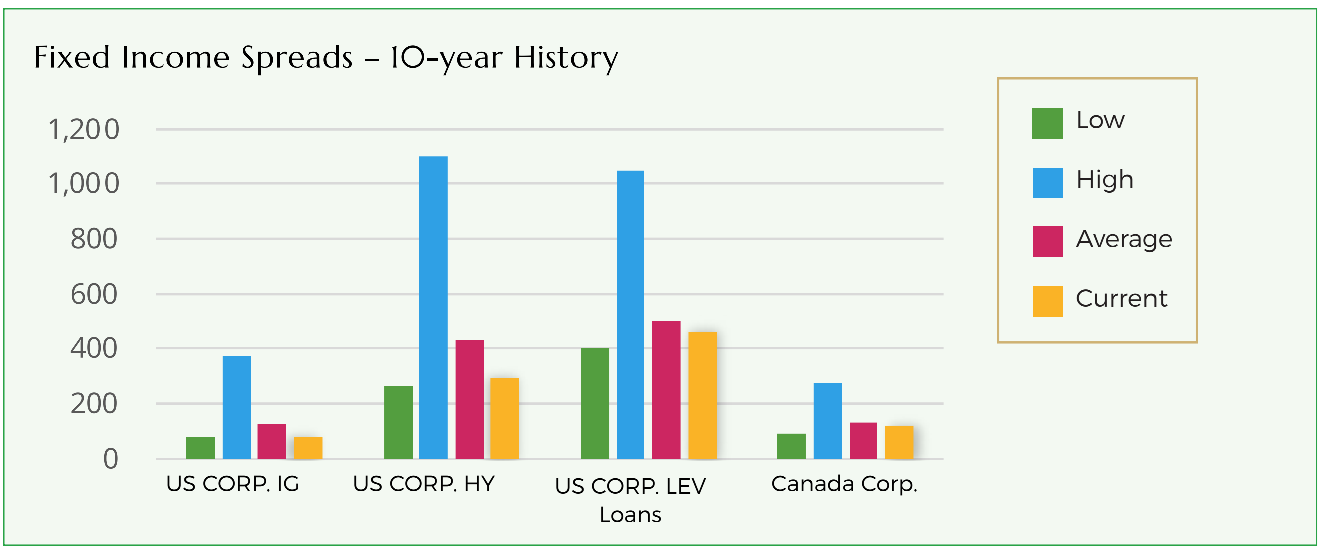
- Leveraged loans, which are floating-rate instruments, have benefited from high coupon rates driven by elevated SOFR base rates combined with stable credit spreads. However, the base rate has declined from 5.3% to 4.8% following the Fed's September rate cut, and further declines are expected over the next 12-18 months. As a result, leveraged loan returns are likely to decrease moving forward.

CAPITAL MARKETS REVIEW

Fixed Income Markets: Valuation

Safe fixed-income yields, including government and investment-grade corporate bonds, continue to offer attractive returns in the current environment.





FIXED INCOME MARKETS: VALUATION (CONTINUED)

Current Yield Landscape

U.S. Treasuries are yielding approximately 4.2% for 1-year maturities, 3.9% for 2-year maturities, and 4.1% for 10-year maturities. U.S. corporate investment-grade bonds are yielding around 4.9%, with the risk of default considered very low.

Tight Spread Premiums

Both investment-grade (IG) and high-yield (HY) bond spreads remain tight, supported by strong corporate earnings performance despite the elevated interest rate environment. Currently, IG spreads are at 81 basis points (bps), while HY spreads are at 283 bps, both well below their 10-year averages of 125 bps and 425 bps, respectively.

Historically, spreads have widened significantly during recessions, reaching approximately 200 bps for investment-grade bonds and 800 bps for high-yield bonds. However, the quality of the high-yield index is stronger today than in past downturns. Given the high base rates, it is unlikely that spreads will expand to previous recessionary levels, even if economic activity slows substantially.

Competitive Dynamics in Lending

The lending landscape is becoming more competitive, especially for large corporate borrowers, while conditions remain more favorable for middle-market lenders.

- **Large Corporate Borrowers:** These companies continue to enjoy ample credit availability from banks and large private lenders. After a period of reduced activity from late 2022 to mid-2023, large banks have returned to the leveraged loan market, leading to a 125-150 bps contraction in new issuance spreads. However, this increased activity has resulted in weaker covenant packages.

- **Middle-Market Borrowers:** Lower-middle-market and middle-market companies face more significant challenges in accessing capital. With regional banks pulling back from lending, spreads for these borrowers have narrowed less significantly (by only 75-100 bps) compared to larger corporate borrowers, reflecting the ongoing constraints in this segment.

CAPITAL MARKETS REVIEW

Alternatives and Private Investments

Hedge Funds

The HFRX Hedge Fund Index gained 2.1% in Q3 and is up 5.1% YTD. Year-to-date, the strongest performing strategies have been long-short equity hedge funds (+7.5%) and convertible arbitrage (+5.6%), while merger-arbitrage has lagged with a -0.9% return.

Commerical Real Estate

The NCREIF Index for commercial real estate declined by 0.3% in Q2 2024, marking the sixth consecutive quarter of negative performance. Low transaction volumes have resulted in variability in pricing data across different index providers. According to Green Street, a weighted index of commercial real estate values is down 19% from its 2022 peak and 3% over the past 12 months. However, prices showed signs of stabilizing toward the end of 2023, with higher-quality properties up 3% YTD. Cap rates have also leveled off and appear to be peaking for most property types.

Data from the RCA Commercial Property Index highlights variation across different property sectors:

- **Industrial**: Prices increased 0.4% month-over-month (MoM), up 4.3% YTD and 6.9% year-over-year (YoY).
- **Apartments**: Prices rose 0.1% MoM, but remain down 3.1% YTD and 5.7% YoY.
- **Office**: Prices edged up 0.2% MoM, but are still down 3.6% YTD and 9.6% YoY, with central business districts experiencing larger declines compared to suburban offices.

Operating fundamentals across property types show significant divergence:

- **Office:** Vacancy rates have climbed above 20% for the first time but appear to be bottoming.
- **Apartments**: Demand remains strong, with record absorption in Q3, but an increase in new supply is limiting rent growth.
- **Industrial**: Vacancy rates have risen to 6.5%, up from a low of 3.7%, but still below pre-pandemic averages. Despite strong demand, increased supply has resulted in flat market rents on a quarter-over-quarter basis.

Private Equity

Private equity deal and exit activity is rebounding from previously depressed levels. Cambridge Associates reports that U.S. private equity delivered a 1.8% return in Q1 2024, following a 9.3% return for FY 2023. Preliminary estimates indicate low single-digit returns for Q2 2024, reflecting private equity's lagging performance relative to public equity markets in 2023 and 2024 due to lower exposure to mega-cap technology stocks driving the broader market rally. Additionally, private equity managers remain cautious about marking up asset values amid low exit volumes.

ALTERNATIVES AND PRIVATE INVESTMENTS (CONTINUED)

Deal Activity:

- In Q3 2024, U.S. PE buyout deal activity reached $250 billion, up 23% YTD, and significantly higher than the $140-$160 billion per quarter seen in earlier periods. Platform LBO activity has also rebounded, up 28% YTD.
- Deal valuations have increased to 12.7x EV/EBITDA on a trailing twelve-month basis, compared to 11.2x in 2023 and 13.3x at the peak in 2021. Tier 1 assets continue to command high valuations, while prices for lower-quality assets have declined by 20%-30%, if they come to market at all.

Leverage and Exits:

- New deal Debt/EBITDA multiples remained stable at 5.1x in Q3 2024, down from 5.9x in 2022, with debt/total capital at 46%, below both 2022 levels (51%) and the 10-year average (55%).
- Exit activity has improved markedly in $ terms, up 50% YTD over 2023 levels, though the number of deals remains relatively flat. General partners are likely bringing their best assets to market for exits via sales or IPOs.
- Given still low exit values compared to 2020-2021, we anticipate increased secondary market activity as firms seek liquidity.

Venture Capital

Venture capital (VC) performance appears to have bottomed but remains uneven. According to Cambridge Associates, U.S. VC returned 2.2% in Q1 2024, while preliminary Q2 data indicates a -1.6% return. The number and value of deals for 2024 are projected to be similar to 2023 levels, which are in line with pre-pandemic activity but significantly lower than the 2021 peak (more than $350 billion versus $160 billion projected for 2024).

AI-related startups continue to attract substantial investment, with high valuations seen in seed and Series A funding rounds. Outside of the AI sector, investor terms for new deals have become more favorable compared to the 2021-2022 period.

Exit activity remains weak, with distribution rates at an annualized 5.2% of NAV, the lowest level since the Global Financial Crisis. However, recent VC IPOs have shown better performance in the public markets than those launched in 2022-2023, suggesting a potential turning point in 2025.

CAPITAL MARKETS REVIEW

Actionable Investment Opportunities

Private Equity

The secondary market for private equity remains robust, with strong activity in both LP-led transactions and GP-led deals. As buyer and seller expectations converge, the quality of LP portfolios and GP continuation vehicles offered via secondaries continues to improve, making this an appealing segment for discerning investors.

- **LP-Led Secondaries:** Volume has surged as exit activity remains low and several PE fund vintages from 2007-2011 approach maturity walls. This trend is expected to continue, creating attractive opportunities to acquire assets at discounted valuations.
- **GP-Led Continuation Vehicles:** The difficult exit environment is increasingly prompting GPs to utilize continuation vehicles to retain their best assets while providing liquidity for LPs wanting cash distributions from exits.

Private Credit

Private credit offers compelling potential returns, ranging from low double-digits to mid-teens, through a variety of specialty finance and structured credit solutions.

- **Specialty Finance:** There is increasing interest in niche opportunities such as consumer credit card portfolio purchases, forward flow agreements (i.e., "lending to lenders"), and bank credit risk transfers. These transactions are providing attractive yields as banks seek to reduce regulatory capital charges.
- **Flexible Junior Capital**: Demand is rising for flexible junior capital, which involves structuring payment terms with a mix of cash and PIK interest. These solutions offer mid-teens IRRs and can negotiate stronger financial and maintenance covenants, providing additional downside protection.
- **Asset-Backed Credit Solutions:** There is a growing appetite for asset-backed lending, where companies pledge high-quality collateral—such as receivables, inventory, and certain fixed assets—to secure liquidity. This trend reflects a shift towards collateralized lending in a more cautious credit environment.
- **NAV Financing and Liquidity Solutions for PE Firms:** There is increasing demand for NAV financing and other bespoke lending solutions tailored to private equity firms seeking to generate liquidity from their portfolios. These financing options can unlock capital without necessitating an asset sale.

Interestingly, while credit spreads for publicly traded corporate and high-yield debt remain tight, private credit funds report robust pipelines, suggesting significant divergence in borrower access to credit. This creates opportunities for private lenders to step in where traditional financing may be constrained.

Bitterroot
CAPITAL ADVISORS

118 East Main Street, Bozeman, MT 59715 USA +1 406-556-8200
BitterrootCapital.com