CERTUITY

Research
Review

April 2024

Upside inflationary surprises helped drive a pullback across the financial markets in April, as interest rates and the U.S. dollar (USD) climbed higher amid a further reduction in the bond market's expectations for Federal Reserve (Fed) easing in 2024. Global equities—particularly domestic and smaller cap indices—witnessed notable downward pressure over the month, while emerging market equities posted relatively solid performance. Bonds suffered in April after a nearly 50 basis point increase in yield on the 10-Year U.S. Treasury Note led to poor performance in interest rate-sensitive sectors. Despite weakness across the bond market and broader risk markets during the month, credit risk premiums remained well below historical averages and near the low end of their cyclical range. Real asset returns continued to appear mixed, as the rate-sensitive real estate investment trust (REIT) and global listed infrastructure sectors suffered amid the monthly backup in interest rates, while commodity futures posted a second consecutive solid monthly gain.

INSIDE THIS ISSUE

Economic Update

Stagflation Worries Return as Inflation Proves Sticky and Growth Has Cooled

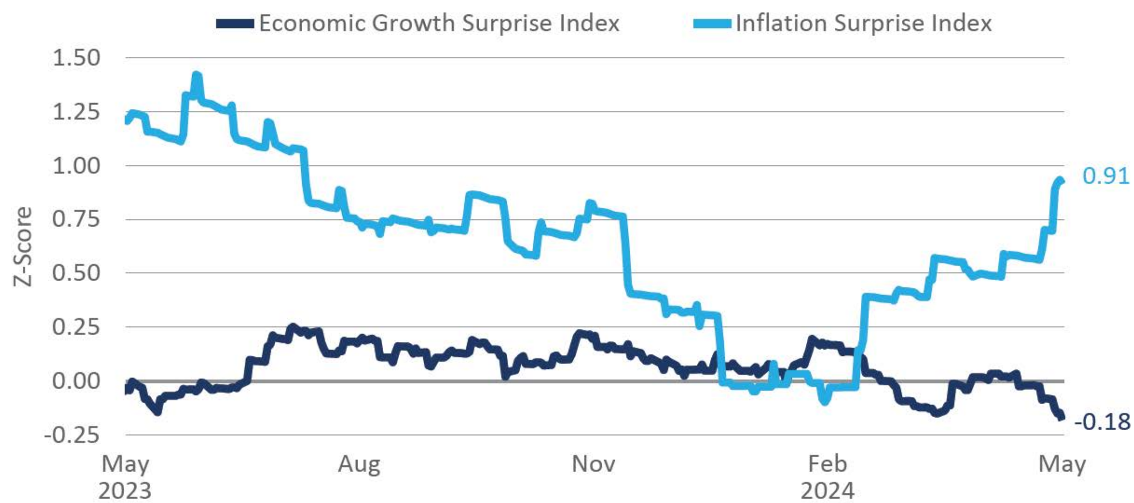
"Should the lag effects of monetary policy changes fail to return inflation to the Fed's 2% target, market participants may begin to sniff out the potential for an extension on the current "higher for longer" period." – Mike O'Conner, CFA

At the beginning of the year, inflation seemed to be on a declining trajectory, and the lagging effects of monetary policy still moving through the system were widely assumed to be working, which led market participants to pencil in Fed rate cuts throughout 2024. The Fed's updates to their "dot plot" policy rate projection table at their December 2023 and March 2024 meetings painted a similar picture, setting an expectation for three 25 basis point cuts throughout the year.

However, contrary to the past two years in which the U.S. economy grew at a healthy clip despite the most meaningful Fed tightening campaign in forty years, the advance estimate of first-quarter gross domestic product (GDP) showed a slowdown in business activity. For the first three months of 2024, the U.S. economy grew at an inflation-adjusted annualized pace of just 1.6%, the slowest quarterly growth rate since the second quarter of 2022.

Moreover, while growth moderated during the quarter, inflation reaccelerated. The Fed's preferred inflationary gauge, the core personal consumption expenditure (PCE), increased to a 3.7% annualized pace, the hottest quarterly print since the second quarter of 2023, and nearly double the Fed's 2% target. This combination of upside inflationary surprises and aggregate economic growth data surprising to the downside in recent months has driven a notable divergence between the Economic Growth Surprise and Inflation Surprise indices, renewing fears of stagflation.

U.S. STAGFLATION FEARS GROW AS INFLATION HAS SURPRISED TO THE UPSIDE WHILE GROWTH DATA HAS DISAPPOINTED



Data source: Bloomberg, L.P.; Data as of May 3, 2024

A longer-term view of this data shows that not only has incoming economic data missed sell-side estimates to the downside in recent months, but the degree of underwhelming data has appeared the most pronounced since May 2020, a period when the U.S. economy was clawing itself out of the depths of the global pandemic lockdowns.

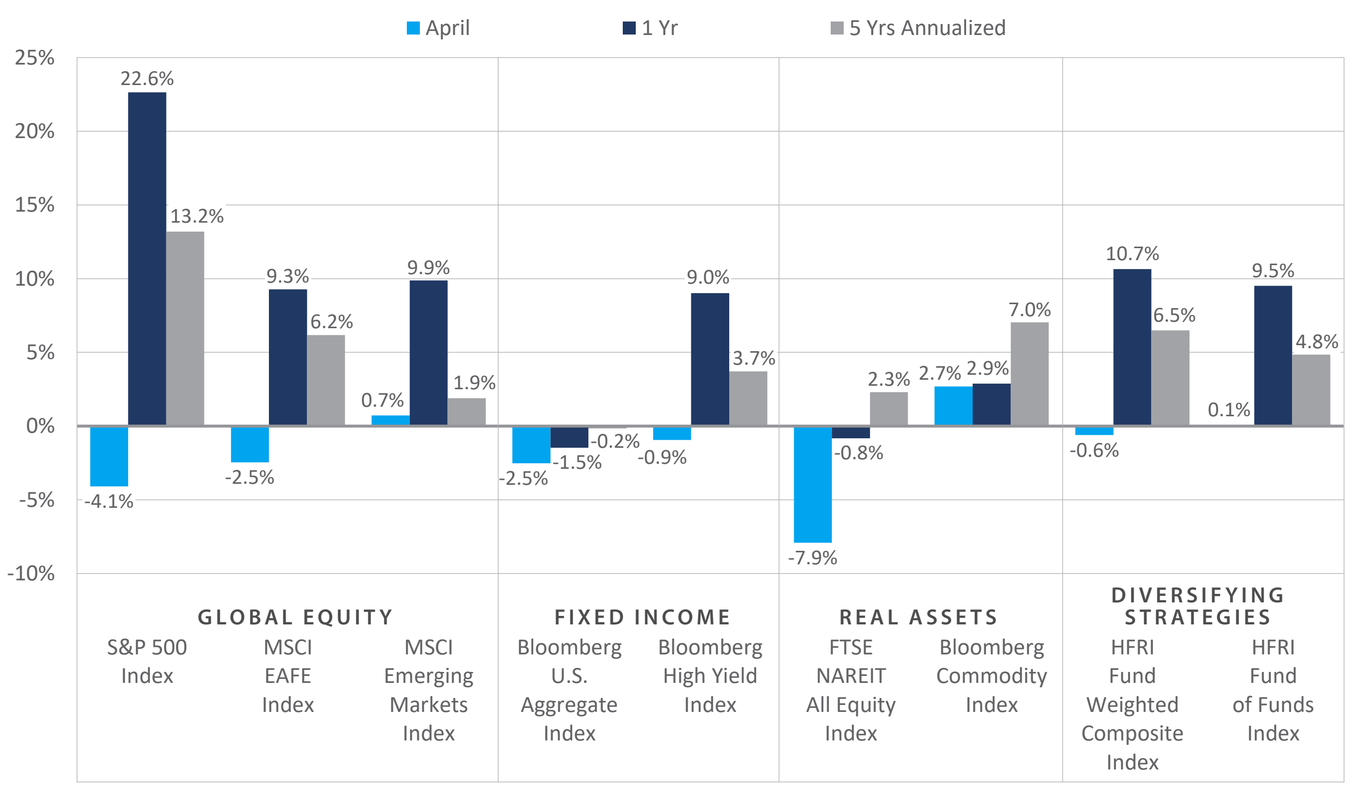
While it is likely premature to extrapolate the first three months of the year as the beginning of a trend, the Fed may find itself in a quandary if these pressures persist, the timing of which could prove problematic given the looming November presidential election. Should the lag effects of monetary policy changes fail to return inflation to the Fed's 2% target, market participants may begin to sniff out the potential for an extension on the current "higher for longer" period.

On the other hand, if the Fed begins slashing rates before inflation has returned to its 2% bogey, the risk of inflationary expectations becoming "unanchored" will come to the fore, in turn serving as a tailwind behind the recent rise in Treasury interest rates and the global exchange rate value of the dollar. The combination of these forces may likely contribute to economic volatility for many of the U.S.'s key trading partners.

In summary, after strong performance across most major asset classes and categories in the first quarter, volatility returned to the financial markets in April, as cooling economic data and stubborn cost pressures reminded global investors that despite being unlikely, the risk of a stagflationary regime cannot be altogether dismissed.

Market Summary

April 2024



Data source: Lipper, HedgeFund Research

Global Equity

Equity markets' momentum came to a halt in April as index returns retreated from previous highs set in March. After finishing with its best-performing quarter since 2019, the S&P 500 Index suffered negative absolute returns in April, alongside the other major world indices. This performance caused large cap U.S. equity year-to-date returns to fall back below double-digit levels. One trend that has continued throughout the year, however, has been the underperformance of small cap stocks due to the extension of rate-cut expectations.

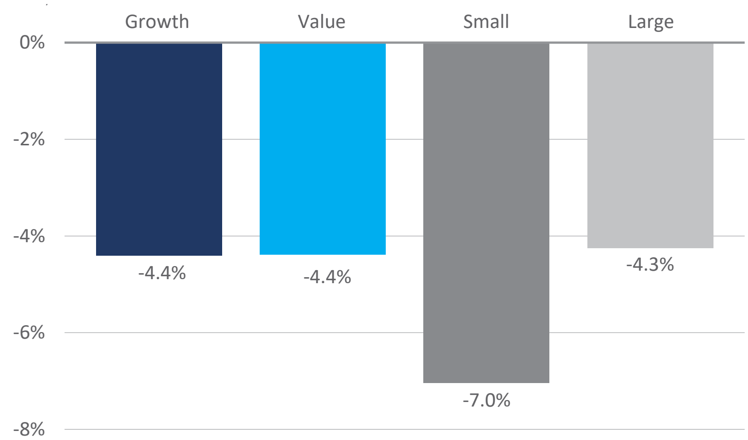
Rate cut expectations were delayed further as Jerome Powell and the Fed sought to navigate mixed economic signals. Even with the recent market decline, 10 out of 11 sectors posted gains on the year, with real estate being the only sector to produce a negative total return.

Mixed earnings results continue to significantly impact markets, specifically surrounding the "Magnificent 7" stocks. Notably, the market has punished earnings misses in recent quarters more severely than it has rewarded earnings beats.

European equities ex-UK outperformed their U.S. counterparts in April. Returns were led by Europe's "Magnificent 7" (Novo Nordisk, ASML, Schneider Electric, Safran, LVMH, Hermes, and Ferrari). As a composite, these stocks have outperformed the U.S. Magnificent 7 since 2020. Also, euro zone business activity has continued to rally since late last year, as evidenced by the Purchasing Managers' Index (PMI) surpassing 50 in April.

SMALL CAP UNDERPERFORMANCE CONTINUES

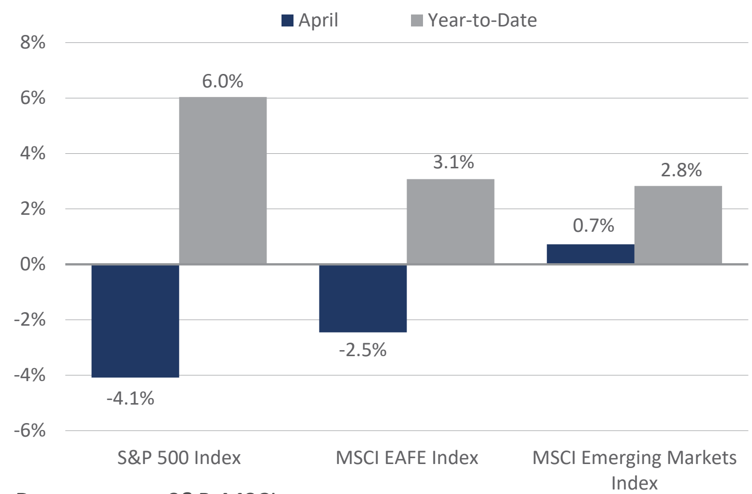
U.S. Style Returns



Data source: FTSE Russell

APRIL SHOWERS

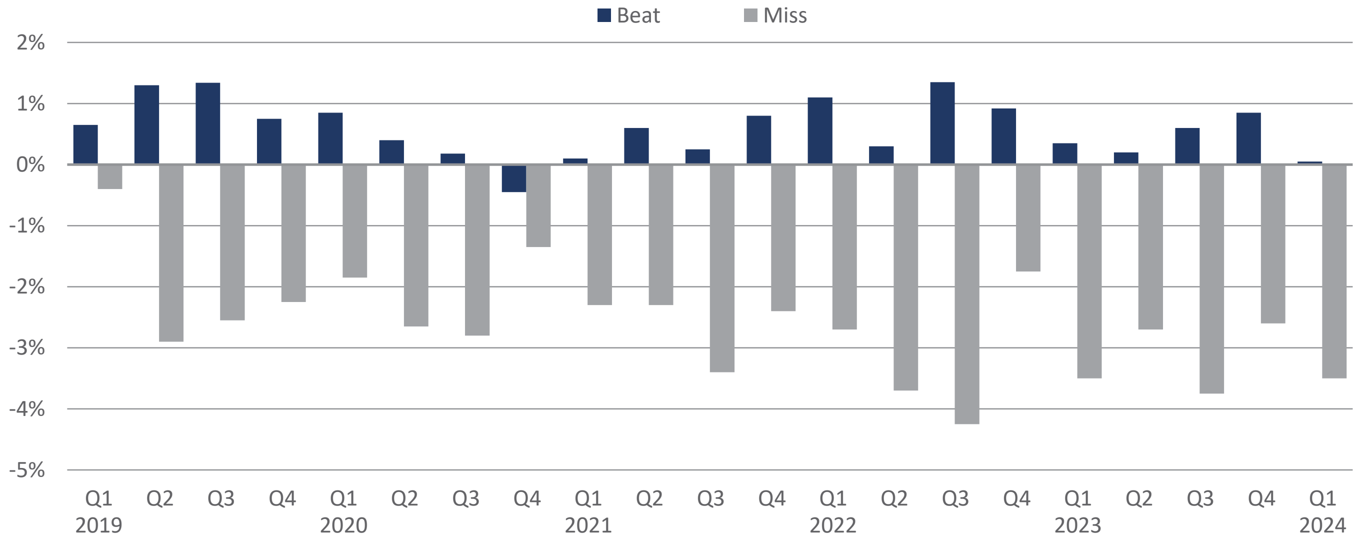
Equity Indices Performance Returns (U.S. Dollars)



Data sources: S&P, MSCI

THE MARKET IS PUNISHING EARNINGS MISSES MORE THAN REWARDING EARNINGS BEATS

Average S&P 500 Member Return in Excess of S&P 500 When EPS Beats/Misses



Data source: Schwab Asset Management, FactSet

Unlike most markets around the world, UK-based equities produced positive absolute returns in April, largely led by the health care, materials, and energy sectors. Meanwhile, UK equities are still trading at around a 30% median industry discount when comparing the UK forward price/earnings ratio to the U.S., even with the FTSE 100 index establishing a new all-time high. These low valuations, combined with a recent recession breakout, have promoted increased deal flow in the UK, specifically within the small cap space.

In Japan, the Nikkei 225 entered a correction phase in early April after topping 40,000 yen for the first time in history. However, the market began to recover in the latter half of the month due to the outperformance of earnings expectations. The weakening yen has provided a short-term tailwind for recent corporate earnings announcements, given that many large cap companies in Japan are net exporters.

Emerging Markets (EM) remained relatively flat over the month, underperforming European equities and outperforming U.S. equity markets. Recent momentum in China's equity markets continued through April on the back of the Chinese government's pledge to support the economy. In India, strong market performance from the first quarter flattened out as general election voting began during the month.

Fixed Income

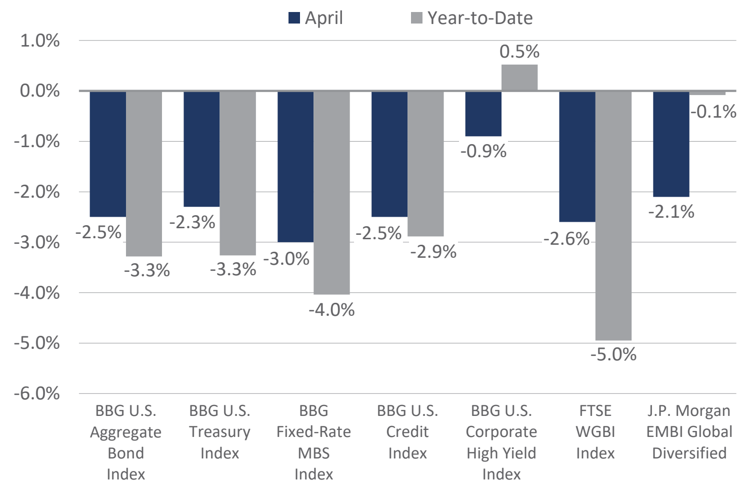
Rates rose in April, with the 10-year Treasury rising 0.49% to 4.69% and the 2-year Treasury rising 0.42% to 5.04%. The 10-year Treasury briefly breached 4.7%during the month—its highest level year-to-date—as the probability of a rate cut before July dwindled. The Personal Consumption Expenditures Price Index (PCE Index) March release came in at 2.7%, still well above the Fed's target of 2% and tempering rate cut expectations. The resulting rise in short-term rates caused the yield curve to further invert and the 10-year/2-year Treasury spread to widen 0.05%, dropping to -0.34%.

In April, fixed income markets saw tight spreads, with the high-yield option-adjusted spread (OAS) rising slightly by only three basis points to 3.18%, while the investment-grade OAS decreased by three basis points to 0.91%. The Bloomberg U.S. Aggregate Index (Agg) coupon rate finished the month at 3.2%, while the yield to maturity (YTM) reached 5.2%. Debt issuance ramped up in the first quarter of 2024—the highest level since the first quarter of 2021—further pushing out the impending debt maturity wall.

At the May 1, 2024 Federal Open Market Committee (FOMC) meeting, the Fed again opted to hold steady the federal funds target rate, further validating the "higher for longer" narrative that was prevalent for much of 2023. Most economists still expect the Fed to cut rates later this year, but the range of cuts declined from four to one. The CME FedWatch Tool estimates the probability of a cut in June or July as 8.9% and 29.6%, respectively. The Fed's total assets peaked at nine trillion in June 2022 and have since dropped to 7.3 trillion due to quantitative tightening. However, the Fed voted to slow the decline of its securities holdings by reducing the monthly redemption cap on treasury securities.

RISING RATES WEIGHED ON BONDS

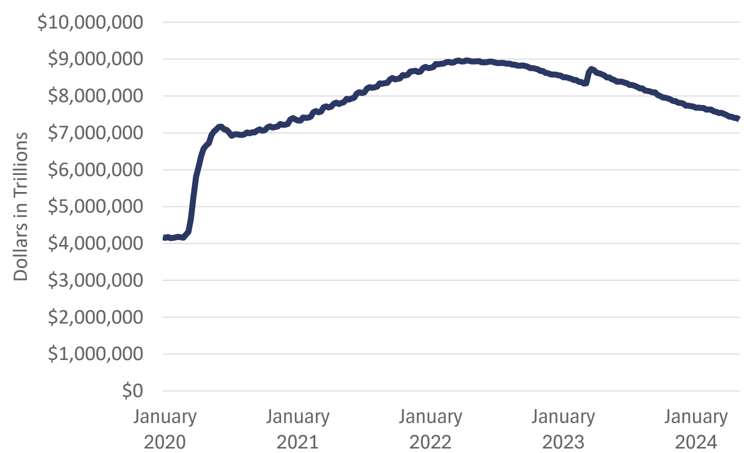
Fixed Income Index Returns



Data source: Lipper; Data as of October 2023

FED ANNOUNCES THEY WILL REDUCE THE PACE OF QUANITATIVE TIGHTENING

Federal Reserve Overnight RRP



Data source: Federal Reserve Bank of St. Louis (FRED)

Real Assets

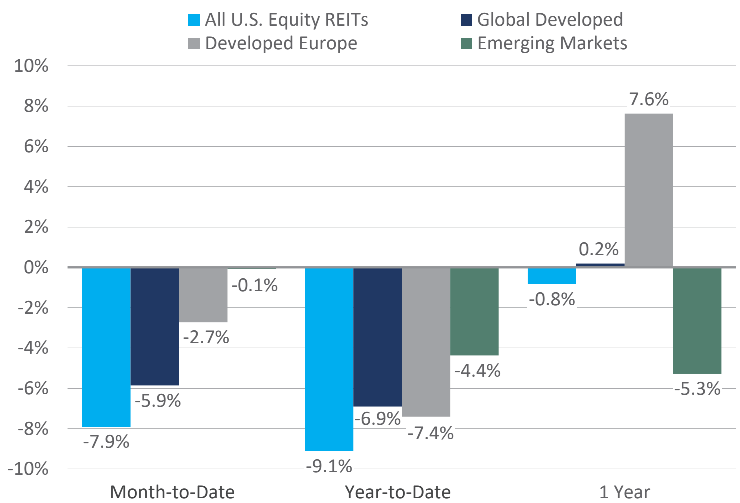
Real Estate

U.S. Real Estate Investment Trust (REIT) indexes declined sharply in April. In late March, the Fed issued its FOMC statement explaining that because economic activity and job gains had remained strong there would be no change in the federal funds rate and no indication of an interest rate hike in the near future. Higher interest rates have continued to put downward pressure on REITs, particularly in interest rate-sensitive sectors like cell towers, where long-dated contracts are discounted at elevated rates.

Developed Europe REITs have out-performed the U.S. recently, due in part to the European Central Bank having been more confident in cutting interest rates as inflation in the eurozone continued to ease. European REITs have higher leverage, on average, than U.S. REITs, which has led to more optimistic sentiment for the industry if rate cuts are implemented.

INTEREST RATES CONTINUE TO PRESSURE REITs IN THE FIRST QUARTER

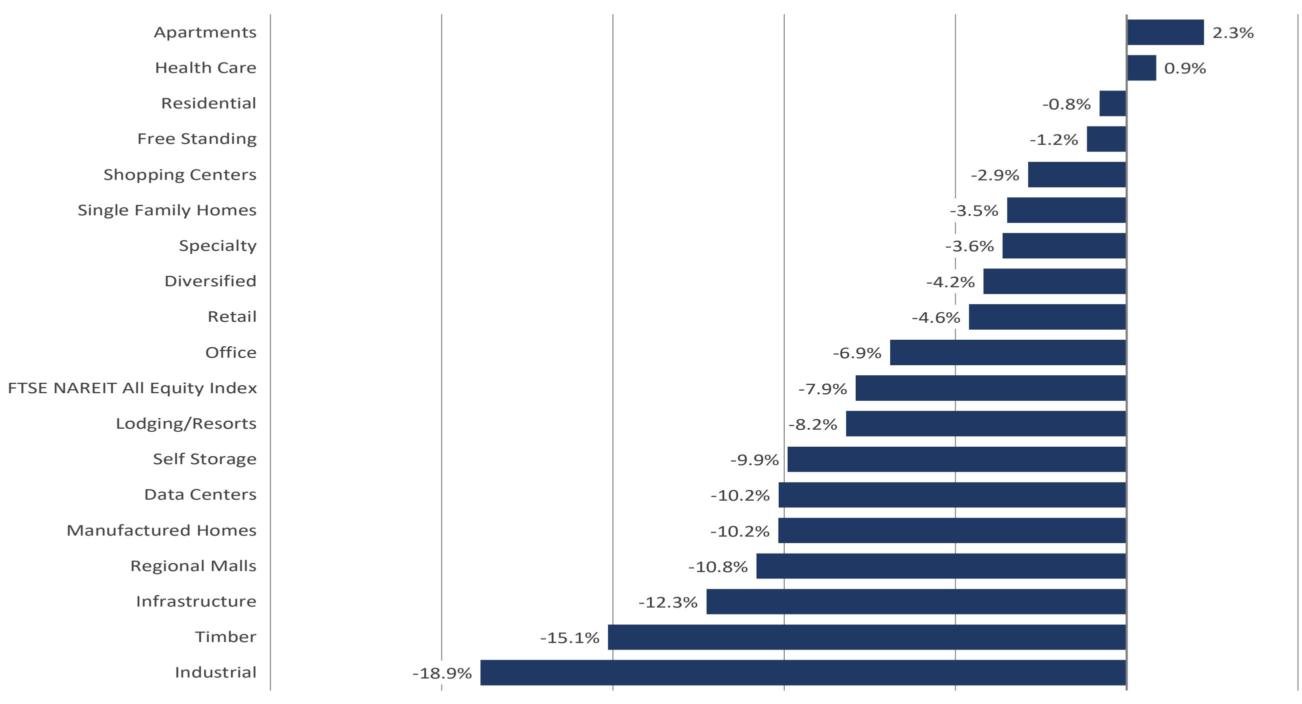
Trailing REIT Performance by Geography



Data source: FactSet

DIVERSE PROPERTY SECTORS BRING DIVERGENCE IN PERFORMANCE

U.S. REIT Trailing Performance by Property Type



Data source: FactSet

Natural Resources

April saw a moderate decline in oil prices as measured by the West Texas Intermediate (WTI) spot contract. This downward trend can be attributed to the alleviation of geopolitical risk premium as conflicts in the Middle East persist. Conversely, the Henry Hub natural gas spot contract rose over 12% during the same period, an increase which was driven by anticipations of warmer summer weather leading to heightened demand for natural gas as consumers increase energy consumption to run air conditioning.

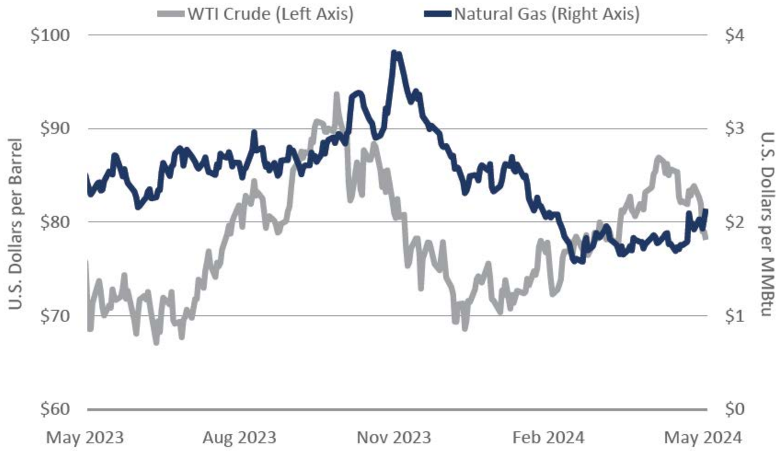
Infrastructure

As measured by the Dow Jones Brookfield Global Infrastructure Index, global listed infrastructure declined in April. Marine transportation was a standout sector, with global shipping rates and volumes rising during the first quarter. Shipment route diversions around Africa to avoid attacks in the Red Sea led to longer shipment times, which was compounded by strong trade flows from India and China.

Midstream energy infrastructure declined moderately in April but was still up double digits year-to-date, as measured by the DJ Brookfield Global Infrastructure MLP Index. Several midstream companies had strong first-quarter earnings, but stocks fell in line with the slight decline in WTI oil prices during the month.

OIL PRICES ROSE FOLLOWING MIDDLE EAST CONFLICT

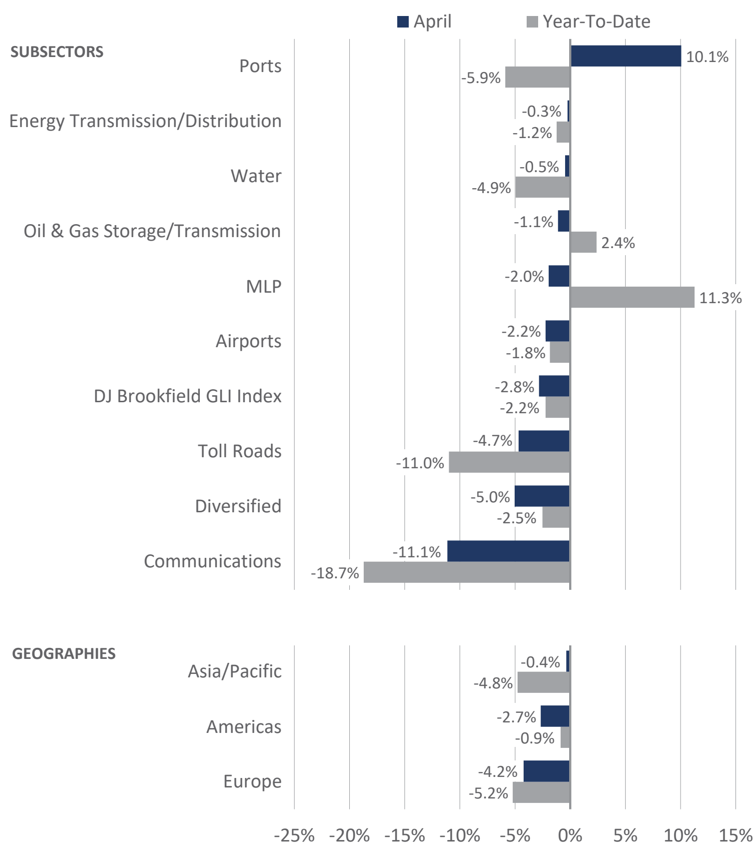
Price of West Texas Intermediate (WTI) Crude and U.S. Natural Gas



Data source: FactSet; Data as of March 4, 2024

ENERGY INFRASTRUCTURE BENEFITS FROM STRONG INDUSTRY FUNDAMENTALS

Listed Infrastructure Trailing Returns



Data source: FactSet

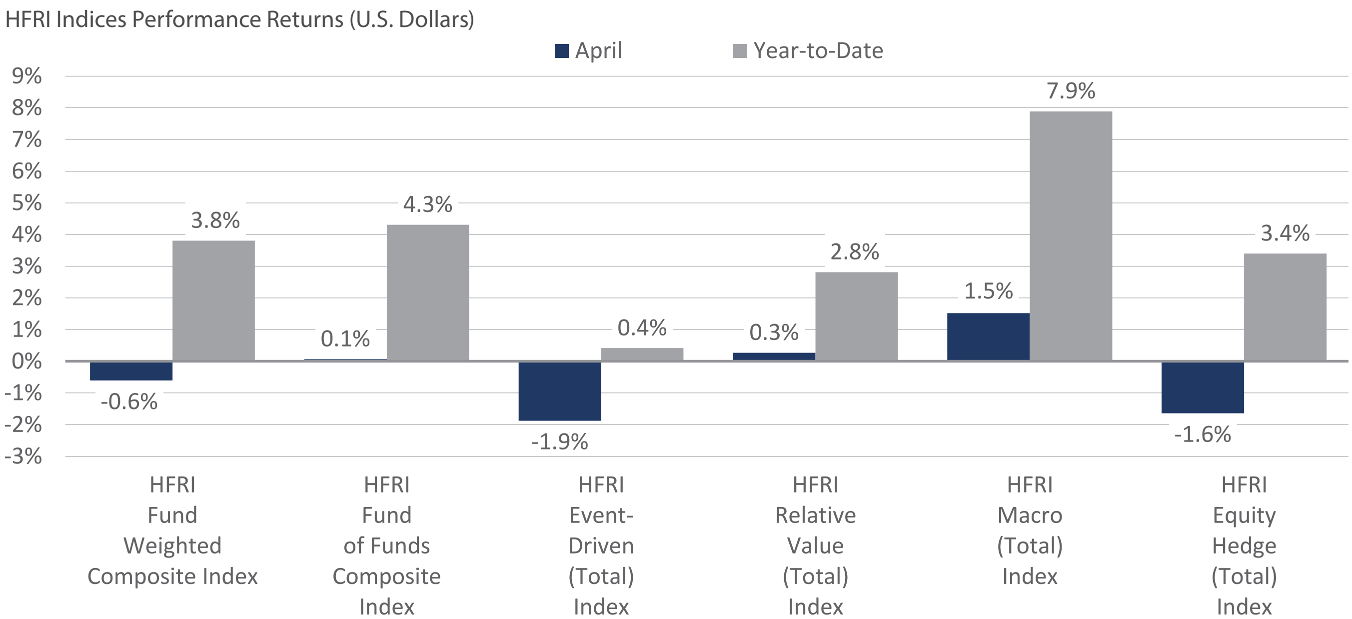
Diversifying Strategies

Hedge fund performance was mixed in April, with global macro strategies producing the strongest monthly return. Equity-oriented strategies, event-driven strategies, and long/short equity all faced headwinds as equities sold off.

Hedged equity generated losses in healthcare; technology; and quantitative, directional strategies. Equity markets experienced heightened volatility in April, resulting in a choppy trading environment.

April was another strong month for systematic macro strategies. Positive contributions came from fixed income, currencies, metals, and soft commodities. The largest winners were exposures long the U.S. dollar relative to other developed currencies, short fixed income, long coffee, and long copper and gold.

HEDGE FUNDS MIXED IN APRIL



Data source: HedgeFund Research

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All data is as of April 30, 2024 unless otherwise noted.

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