Research

Review

Second Quarter 2024

The second quarter was dominated by a quickly shifting global macroeconomic picture with certain financial market themes remaining firmly in place. The most notable theme was the continued strong performance by U.S. large cap growth stocks, particularly versus value and smaller cap companies, which continued to lag. Internationally, emerging market equities modestly outperformed domestic, while international developed stocks posted essentially a flat return. Performance across the bond market appeared somewhat muted for the quarter, as total returns spanning investment grade credit and the broader core bond universe were essentially flat, while below investment-grade credit (e.g., high-yield bank loans) eked out low single-digit returns. Performance among the major real assets sectors appeared mixed for the second quarter, with modestly negative returns witnessed across the real estate investment trust (REIT) and global listed infrastructure sectors, while commodity futures and energy-related infrastructure assets saw solid gains.

INSIDE THIS ISSUE

Economic Update

Risk Assets Shrug Off Underwhelming Incoming U.S. Economic Data

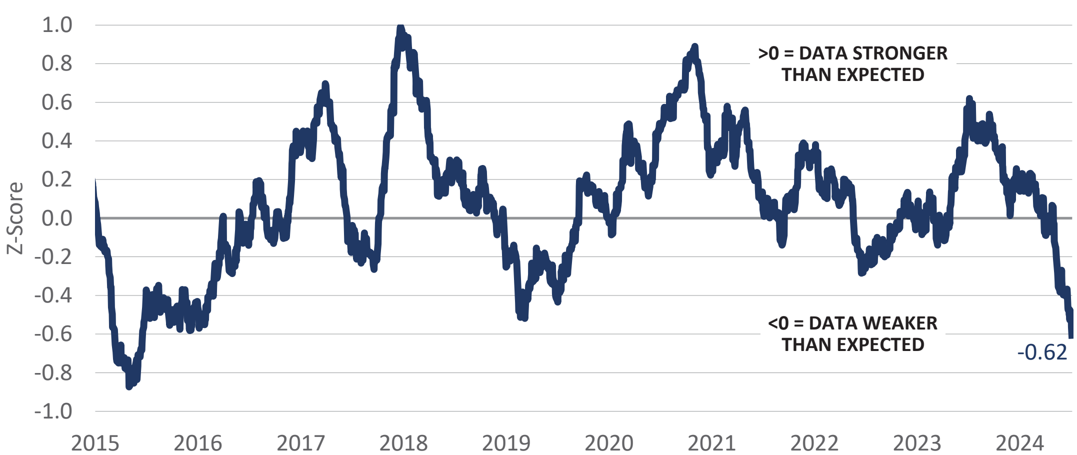
"While the recent cooling across the labor market has helped balance the employment situation, U.S. economic data in aggregate has significantly under-whelmed Wall Street consensus estimates." – Mike O'Conner, CFA

Continued solid performance by key sectors of the global investment universe, notably U.S. large cap and emerging market equities, below investment-grade credit, and energy-related infrastructure assets, was a welcomed, albeit surprising development during the second quarter. In addition to persistently elevated valuations versus historical norms and a tense geopolitical stage, the financial markets had to contend with another unsettling development in the way of disappointing economic data.

Since the post-pandemic period, the manufacturing base has experienced an ongoing downbeat sentiment. However, as of the second quarter, cracks have started to form within the U.S. labor market, a likely sign the Federal Reserve's (Fed) multi-year period of monetary restraint is taking hold. Through June, for example, the headline unemployment rate ticked 0.1 percentage points (ppts) higher to 4.1%, which was 0.7 ppts above the cyclical low established in January 2023.

Moreover, jobless claims activity has also risen from cyclical lows, with the count of individuals filing for unemployment benefits for at least two consecutive weeks (e.g., continuing jobless claims) at 1.9 million as of June 22, the highest count since November 2021. While the recent cooling across the labor market has helped balance the employment situation, U.S. economic data in aggregate following the tight conditions of the pandemic era has significantly underwhelmed Wall Street consensus estimates. Bloomberg's U.S. Economic Surprise Index, for example, has deteriorated to the lowest level in nearly a decade.

U.S. ECONOMIC DATA HAS MISSED SELL-SIDE ESTIMATES TO WIDEST DEGREEE SINCE 2015



Data source: Bloomberg, L.P.; Data as of July 5, 2024

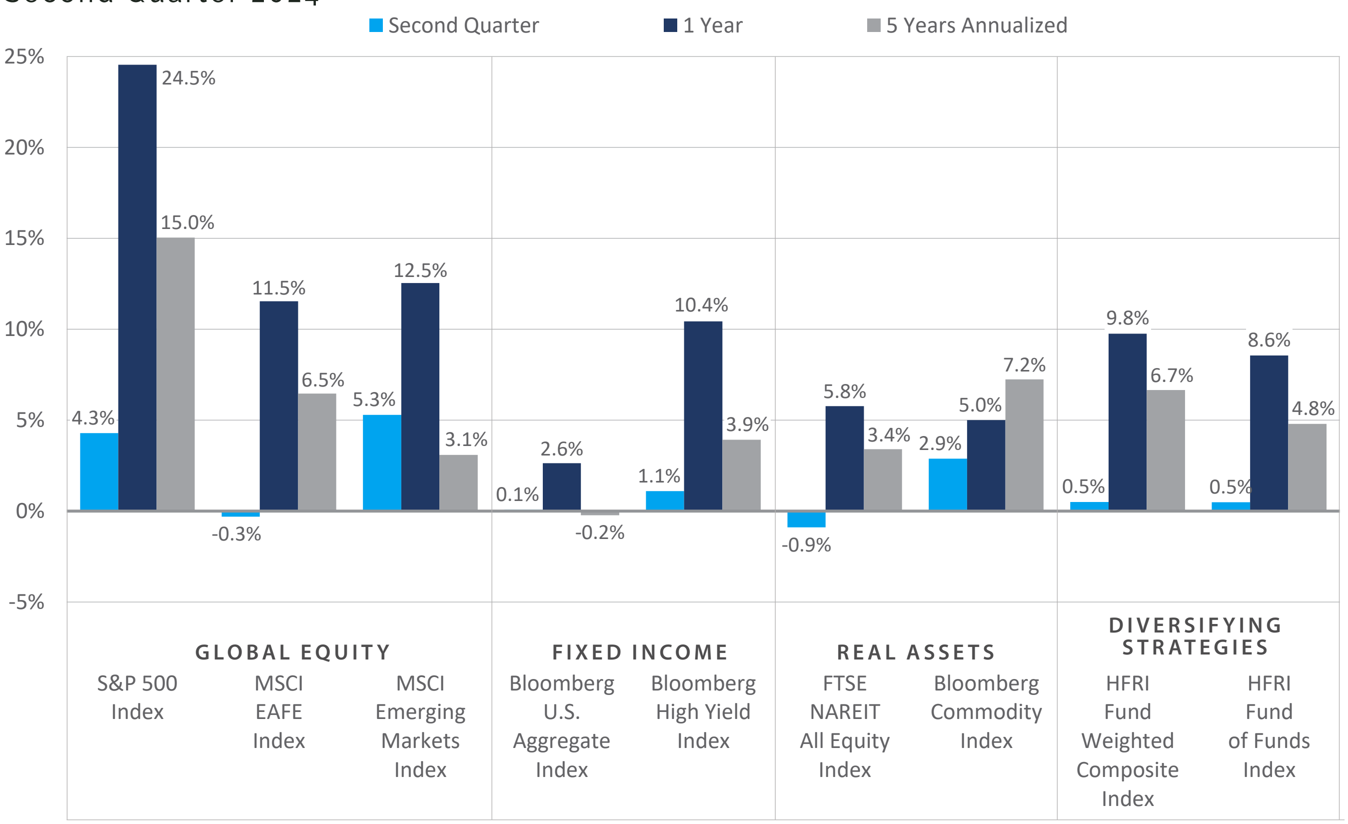
Of course, in the relative nature of the financial markets, the U.S. bears the characteristics of "the best house in a bad neighborhood," given the fundamental weakness plaguing many of the country's key trading partners, including the euro zone, in which the central bank cut interest rates for the first time 2019.

In the months ahead, market participants will seek to ascertain whether the recent disappointing labor market data and underwhelming broader economic data is sufficient evidence for the Fed to begin backing off its restrictive stance and how the looming U.S. presidential election might impact financial market volatility and investor risk appetites.

In summary, despite the appearance of a gradual cooling bias across the U.S. economy, many pockets of the risk markets provided investors with positive returns during the second quarter, including a new record high price level on the S&P 500 Index and continued solid performance from below investment-grade credit.

Market Summary

Second Quarter 2024



Data source: Lipper, HedgeFund Research

Global Equity

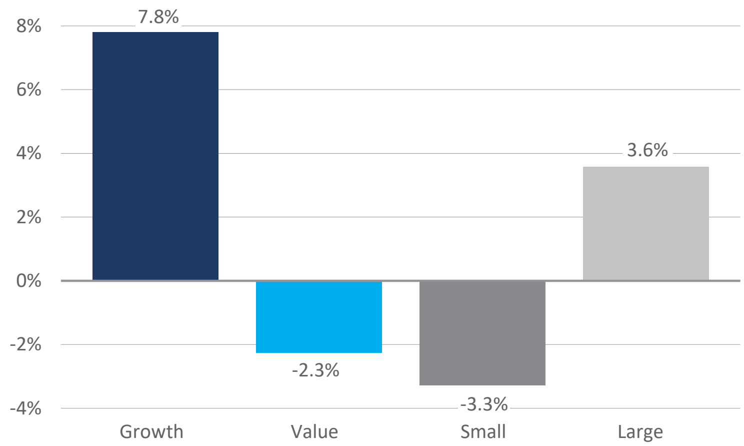
In the second quarter of 2024, equity markets were filled with volatility, new historic highs, and market oddities such as the return of "meme" stocks. Due to the strength of some Asian markets, emerging markets outperformed both the S&P 500 Index and MSCI EAFE Index over the quarter. Moreover, election results and announcements caused significant price movement in emerging and developed markets alike.

The artificial intelligence (AI) theme drove returns in the U.S. large cap equity markets. Strong earnings reports across different sectors contributed to relative outperformance, as the S&P 500 recorded its highest year-over-year earnings growth rate in over two years at 5%. Continued price appreciation of mega cap stocks has resulted in significant concentration in the S&P 500. Currently, the top 10 stocks in the S&P 500 comprise about 38% of the total market capitalization—a historical high. Nonetheless, the strong performance of these top stocks has led to the significant outperformance of large cap stocks over small cap.

European equities ex-UK underperformed their U.S. and UK counterparts over the second quarter. The consumer discretionary sector largely contributed to the relative underperformance. For example, three of Europe's "Magnificent 7" stocks, Louis Vuitton, Hermes, and Ferrari, declined from recent peaks due to a reduction in consumer spending and a surplus of inventory. French equity markets responded negatively to President Macron's snap election announcement, causing the CAC-40 to have its worst-performing quarter in nearly two years. More positively, the European Central Bank (ECB) became the first major central bank to begin reducing interest rates, slashing rates by 25 bps in June.

LARGE CAP GROWTH LED U.S. EQUITY MARKETS

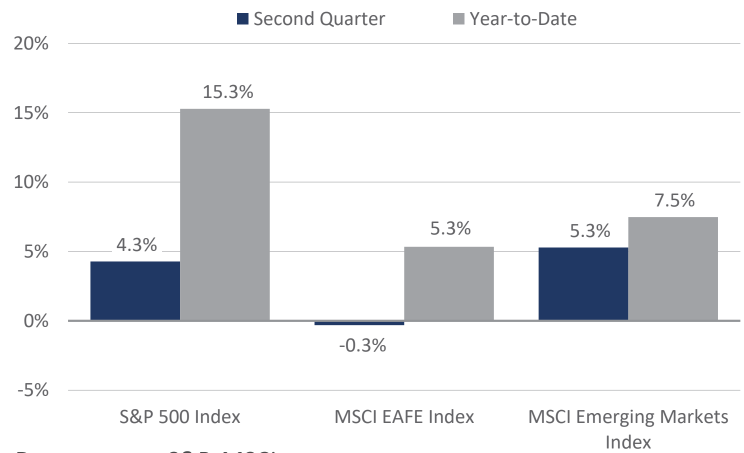
U.S. Style Returns



Data source: FTSE Russell

EMERGING MARKETS OUTPERFORMED U.S. AND INTERNATIONAL EQUITY MARKETS

Equity Indices Performance Returns (U.S. Dollars)



Data sources: S&P, MSCI

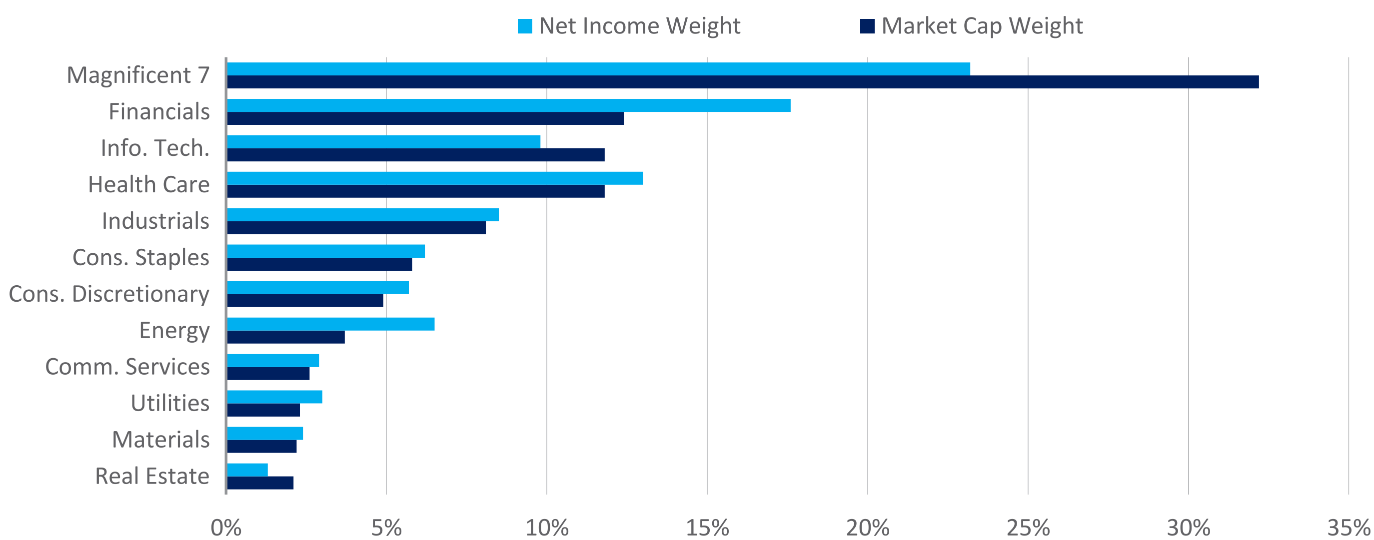
Despite underperforming U.S. equity markets, UK-based equities reached record highs in May after rebounding from a brief recession in the latter half of 2023. Defense stocks in the UK and broader Europe continue to outperform, given the tensions in the Middle East and Eastern Europe. Even with the FTSE 100 Index establishing a new all-time high, UK valuation ratios are signaling that UK equities are still trading at around a 50% discount to the U.S. These low valuations have promoted increased deal flow in the UK, as bid activity for UK-listed companies reached the highest level since 2018.

Although Japanese equities experienced positive returns at the local level, a weakening yen pressured USD returns and caused the Nikkei 225 Index to decline over the second quarter. As net exporters, large cap Japanese companies tend to benefit from a weakening yen, however, the yen's consistently depressed levels relative to the dollar are starting to weigh on domestic consumer sentiment. Consequently, Japanese companies have repurchased shares at a record pace, with 2024 share buybacks already totaling more than 70% of the prior year's total.

The MSCI Emerging Markets (EM) Index delivered returns over 4%, outperforming developed markets. Asian markets were key contributors to outperformance, particularly in Taiwan, where the demand for artificial intelligence has provided a significant tailwind. China's momentum from the first quarter fizzled out in May as real estate debt defaults increased and U.S. tariffs pressured Chinese manufacturers and retailers. Lastly, equity markets responded differently to election results throughout emerging markets. In India and South Africa, equity markets rallied behind the results, while there was a sharp sell-off in early June after the leftist Morena party swept Mexico's election.

THE MAGNIFICENT 7'S OUTSIZED IMPACT ON THE INDEX

S&P Net Income Weight vs. Sector Weight



Data sources: Strategas, FactSet

Fixed Income

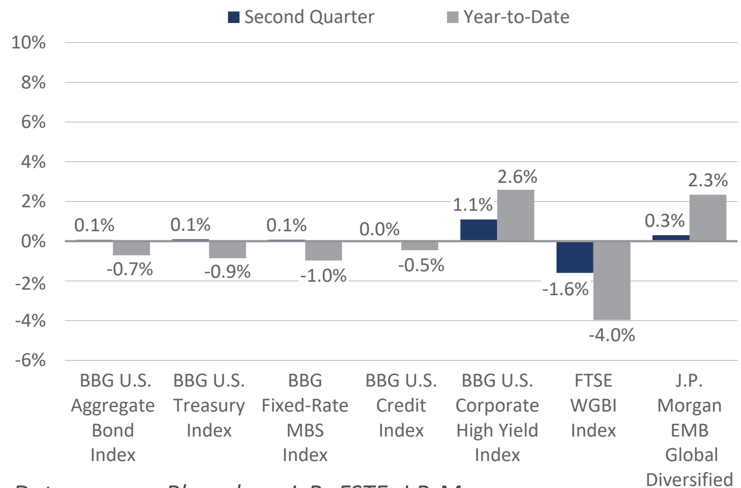
Market indicators experienced relatively mitigated movements during the second quarter compared to recent quarters. The 10-year Treasury yield peaked at 4.70%in April but gradually decreased and ended the quarter at 4.34%. Yield curve inversion persisted but showed slight flattening throughout the period. Credit spreads, which had reached a low in May, moderately widened during the quarter. Notably, the high yield spread narrowed to 3.03% but never crossed the 3% threshold. The 9-bps widening from the start of the quarter is seen as a minor adjustment, likely reflecting a reversion to the mean rather than an indication of heightened market risk.

Key events included weak treasury auctions due to slowing demand for U.S. debt. These auctions were affected by the treasury's strategic shift to issuing less long-term debt, specifically after the 10-year yield reached 5% last year. This transition led to an increased market share of short-term T-bills, dampening demand for U.S. debt and resulting in weak auctions. Consequently, the Fed had to offer T-bills at a greater discount, propelling yields higher.

The European Central Bank (ECB) cut rates for the first time since beginning its current hiking cycle, decreasing the key rate from 4.00% to 3.75%. The FED's decision to hold interest rates steady following their June meeting created increased divergence between policies, putting upward pressure on the dollar and further inflow to U.S. bonds, pushing yields down. The ECB's decision will likely create a more challenging path for Europe to meet its inflation target while putting further pressure on the Fed to cut rates before the year's end.

INVESTORS LOCK IN HIGH COUPON ANTICIPATING A RATE CUT

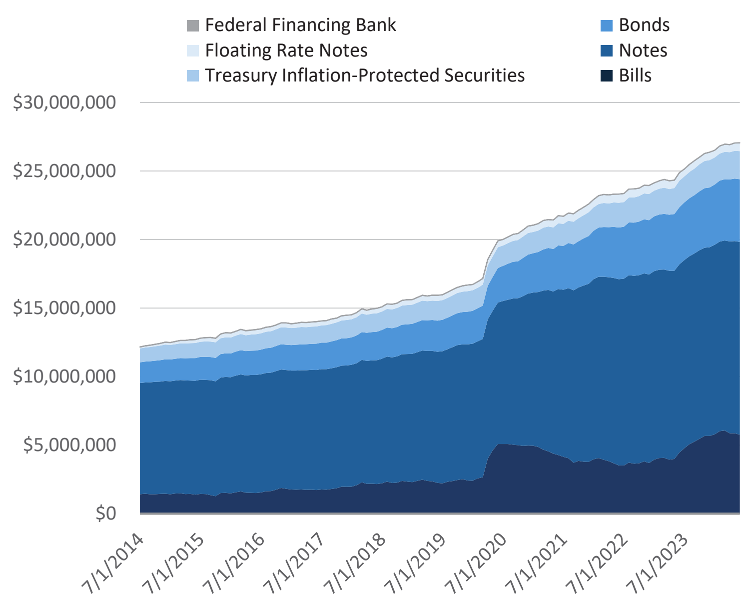
Fixed Income Index Returns



Data sources: Bloomberg L.P., FSTE, J.P. Morgan

DECREASE IN NOTE ISSUANCE LEADS TO DECREASED MARKET SHARE

Marketable Treasury Securities ($K)



Data source: Fiscaldata.treasury.gov

Real Assets

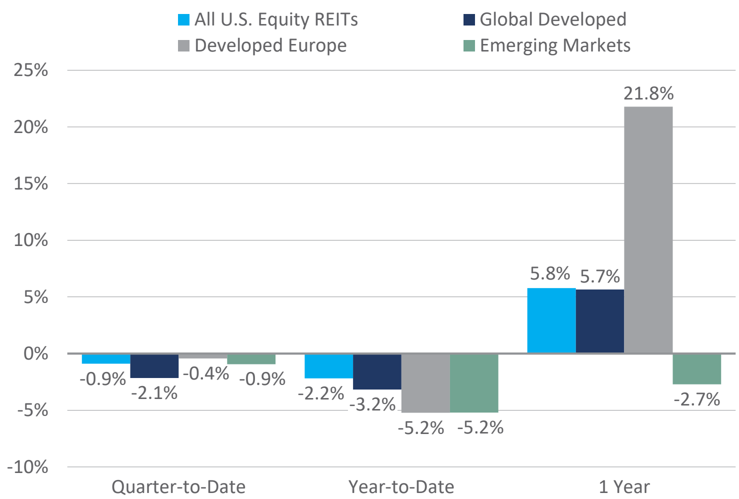
Real Estate

In June, U.S. Real Estate Investment Trusts (REITs) rose 2.2%, as measured by the performance of the FTSE Nareit All Equity REITs index. Higher interest rates continue to put downward pressure on REITs, with the U.S. REIT Index in the red year-to-date. Global Developed REITs were flat in June and have lagged the U.S. so far this year, as measured by the FTSE EPRA/Nareit Developed Index.

In the second quarter, U.S. apartment REITs emerged as the top-performing sector. Case Shiller reported record-high average home prices in June, leading to continued support for rental housing as consumers search for affordability. Rising home prices have been driven by higher mortgage rates, as homeowners with low rates are reluctant to sell their homes and forfeit their lower financing.

“HIGHER-FOR-LONGER” INTEREST RATES PRESSURE REAL ESTATE LOWER-FOR-LONGER

Trailing REIT Performance by Geography



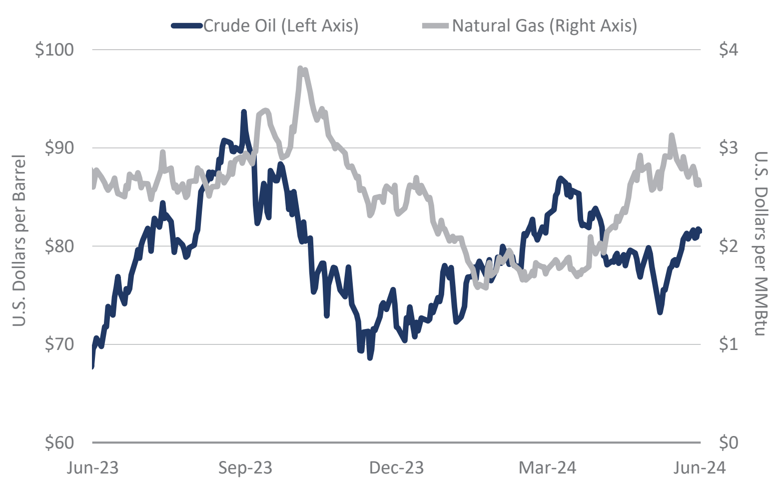
Data source: FactSet

Natural Resouces

In June, crude oil prices rose 6%, as measured by the West Texas Intermediate (WTI) spot contract. Oil prices remained volatile in the second quarter, staying above $80 a barrel as of the end of the quarter. Geopolitical instability and higher-than-expected demand thus far this summer has kept prices elevated. Natural gas prices were flat in June but rose 47.5% for the second quarter overall, as measured by the Henry Hub natural gas spot contract. This increase was driven by a lower-than-expected supply build and rising summer demand as households use more electricity for air conditioning.

NATURAL GAS RALLIES AHEAD OF SUMMER

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



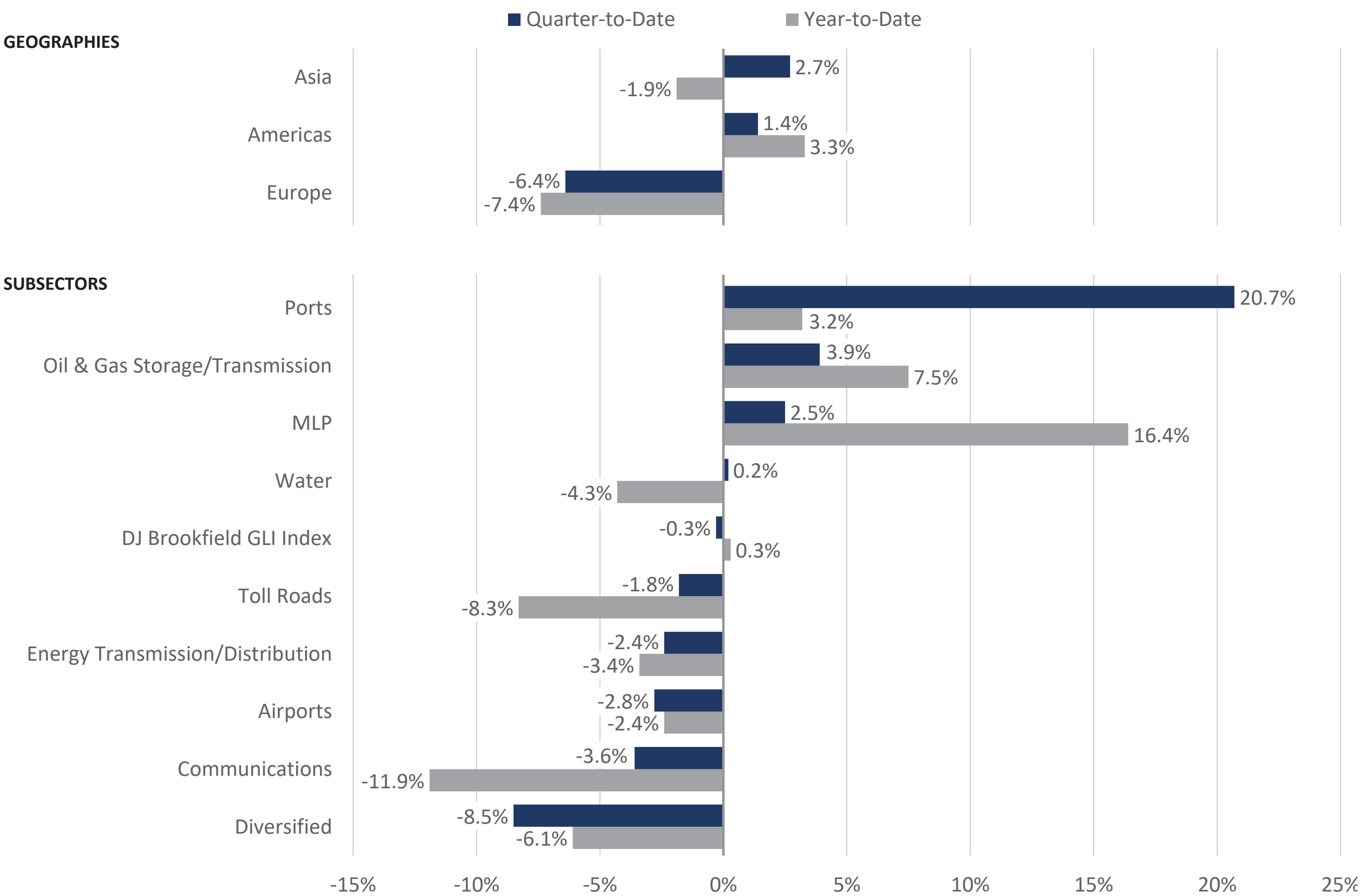
Data source: FactSet

Infrastructure

Global listed infrastructure stocks were flat in June, as measured by the Dow Jones Brookfield Global Infrastructure Index. The ports subsector was the top performer during the quarter, rising over 20%. Adani Ports, the largest port operator in the index, benefited from its inclusion in the Bombay Stock Exchange SENSEX Index. Midstream energy infrastructure also had another strong quarter, as strong free cash flow generation across the sector and an uplift in natural gas prices continued the sector's upward momentum.

RISING NATURAL GAS PRICES BENEFIT MIDSTREAM ENERGY INFRASTRUCTURE

Listed Infrastructure Trailing Returns



Data source: FactSet

Diversifying Strategies

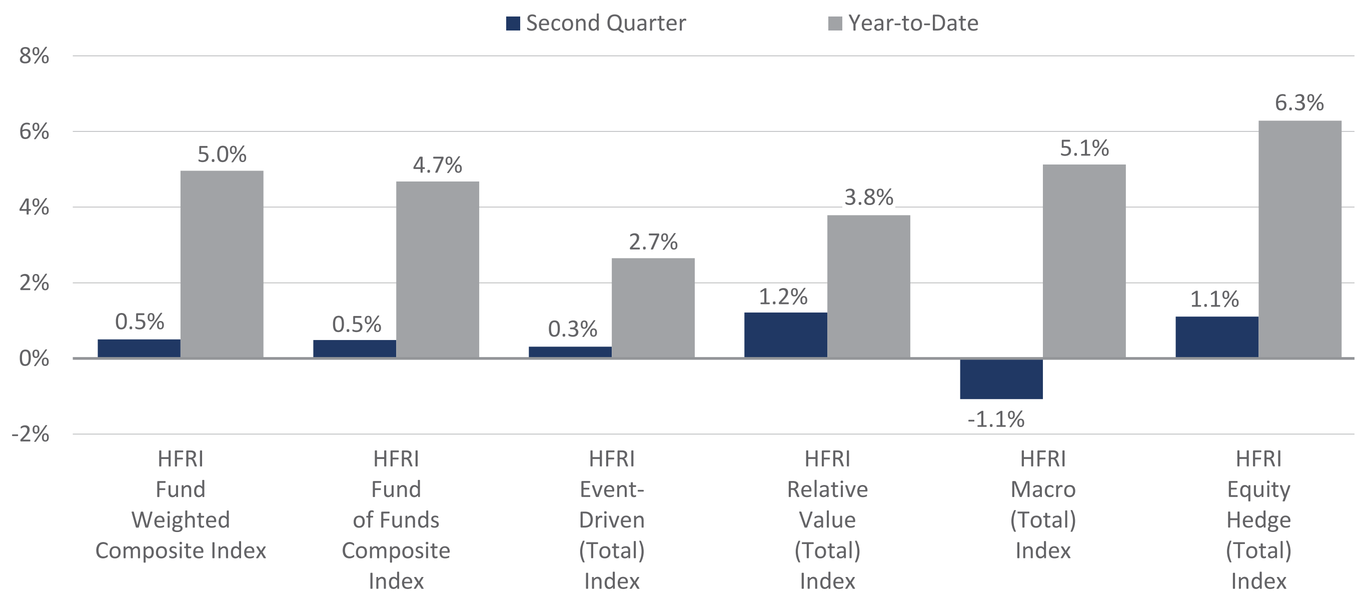
Hedge fund performance was relatively range-bound in the second quarter. Relative value and hedged equity strategies generally generated positive performance, while global macro faced headwinds.

Hedged equity continued to produce gains across the technology sector and quantitative directional strategies. The healthcare sector, which had previously been an outsized performer, was a detractor earlier in the quarter before rebounding in May and June.

Systematic trend-following managers started the quarter with solid gains across fixed income, currencies, metals, and soft commodities. The tides turned beginning in May, however, and continued into the end of the second quarter, with losses in short duration fixed income and long metals positioning. Performance in equities was also a detractor, especially in Europe.

HEDGE FUNDS WERE RANGEBOUND IN THE SECOND QUARTER

HFRI Indices Performance Returns (U.S. Dollars)



Data source: HedgeFund Research

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