CERTUITY

Research Review

October 2023

Similar to August and September, performance across the financial markets was challenged in October, with declines plaguing most of the primary asset classes and categories. Despite preliminary third quarter data indicating the U.S. economy is expanding at a remarkable inflation-adjusted quarterly pace. Hamas' attack on Israel on October 7 contributed to the volatility experienced during the month. Additionally, the revival of economic activity during the third quarter, paired with above-target inflationary pressures, supported sentiment for a tighter-for-longer Federal Reserve (Fed) posture, a key factor behind the surge in interest rates in October.

During the month, global equities were pressured lower by a confluence of forces: a notable spike in interest rates, a third consecutive monthly tightening in financial condition proxies, and heightened tensions in the Middle East. Bond returns were overwhelmingly negative in October, with rising rates and widening credit spreads serving as primary contributors to weak performance across both high-quality and credit-oriented sectors. The real assets space did little to cushion the blow of poor performance from the stock and bond markets in October, as real estate investment trusts (REITs), commodity futures, and global listed infrastructure each posted performance declines on the month.

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Economic Update

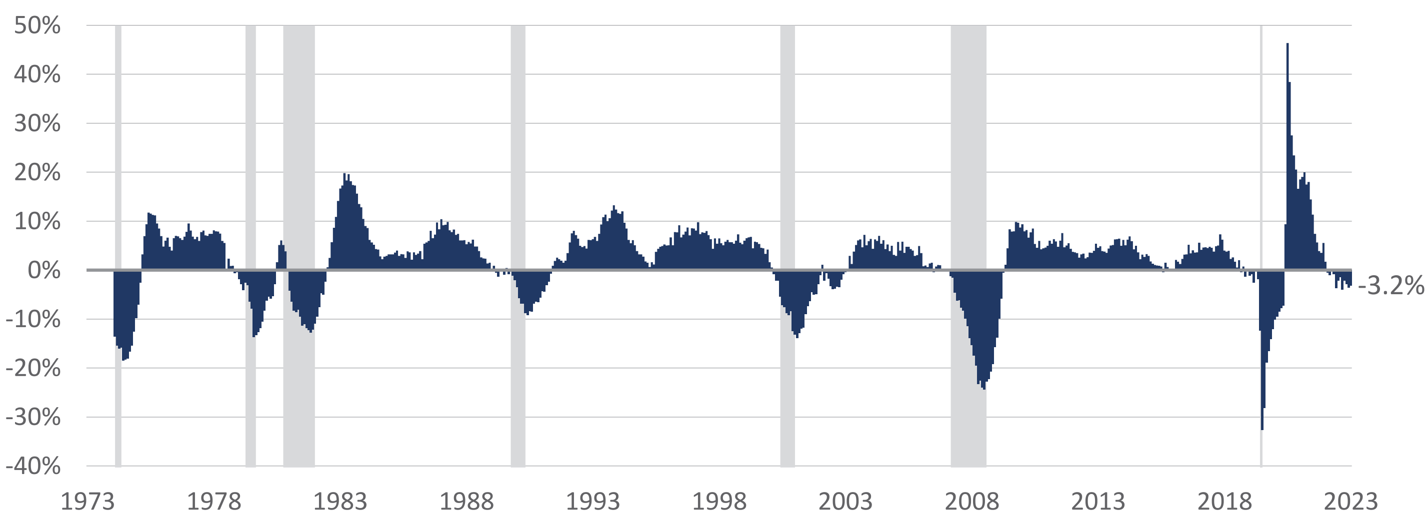
Surface Cracks Form Across Seemingly Resilient U.S. Labor Market Landscape

"While the U.S. economy enjoyed a spurt of positive economic momentum during the third quarter, the historically tight and presumed resilient labor market has begun to display signs of deceleration." - Greg Houser, Senior Vice President, Director of Research

The deep and widespread—albeit short-lived—downturn across the U.S. economy that accompanied the global pandemic inflicted much pain across supply chains and the broader labor market. The coordinated stimulative response set forth by fiscal and monetary policymakers helped plug the temporary demand void presented by the pandemic, in turn paving the way for a multi-year healing process across the labor market, the revival of which led to one of the tightest labor market backdrops in recent memory.

Despite the sharp monetary policy reversal over the past two and a half years—including a 500 basis point increase to the federal funds rate, a more than $1 trillion reduction in the Fed's security holdings, and a material tightening across broader financial condition gauges—the U.S. labor market exhibited meaningful strength over the approximate 3-year period between summer 2020 and summer 2023. Elevated labor demand —a pro-inflationary phenomenon, all else equal—provided the Fed with the necessary evidence to throttle back its monetary support of the broader economy. Data received in recent months, however, paints a starkly different picture of this key pillar of the U.S. economy.

EMPLOYMENT TRENDS INDEX GROWTH AND CYCLES



Data sources: Conference Board, NBER, Bloomberg, L.P.; Data as of April 2023.
Shaded areas represent periods of recession.

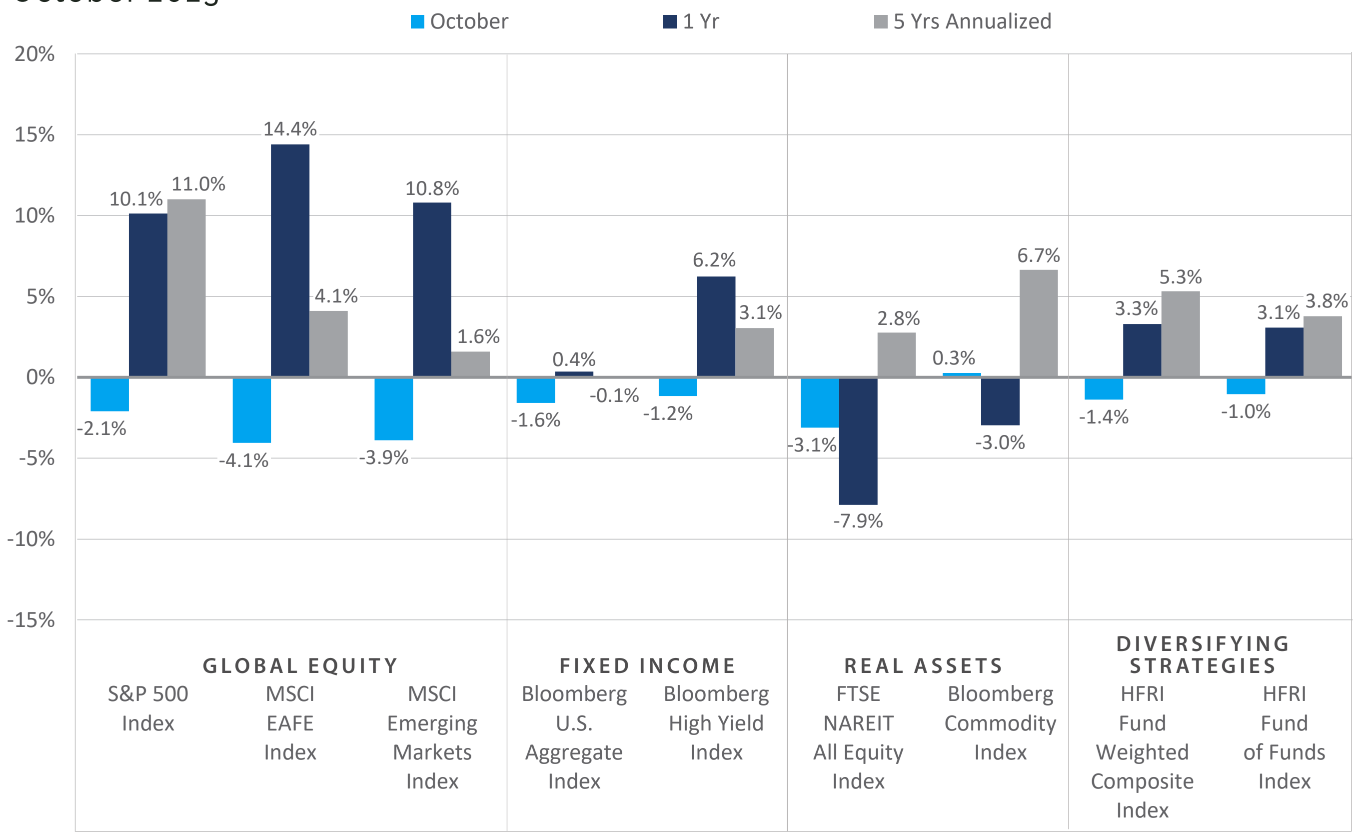
Compounding the widely reported issue of muted inflation-adjusted wage gains since the pandemic is the recent slowdown across payrolls growth, a related growth decline in the count of employed persons, and a recent increase in the headline unemployment rate to 3.9%, the highest level since January 2022. The Conference Board's Employment Trends Index (ETI), a composite of eight labor market variables that summarizes trends across the employment conditions, helps contextualize the state of the labor market. Through October, this composite has posted an annual growth rate decline in 11 of the past 12 months, the persistent deceleration of which has historically coincided with recessionary conditions, with no false signals in the past half-century.

Perhaps "this time is different" rings true for the current business cycle, given the myriad of complicating factors present today, front and center of which includes growth slowdowns across key economies such as China and the euro zone, as well as the ongoing Russian-Ukraine war and the more recent Israeli-Hamas war. A more prudent assessment, however, continues to necessitate an abundance of caution by global investors over the near-to intermediate-term horizons.

In summary, global investors endured a third consecutive painful month in October, with performance losses blanketing the financial markets. While the U.S. economy enjoyed a spurt of positive economic momentum during the third quarter, the historically tight and presumed resilient labor market has begun to display signs of deceleration.

Market Summary

October 2023



Data source: Lipper, HedgeFund Research.

Global Equity

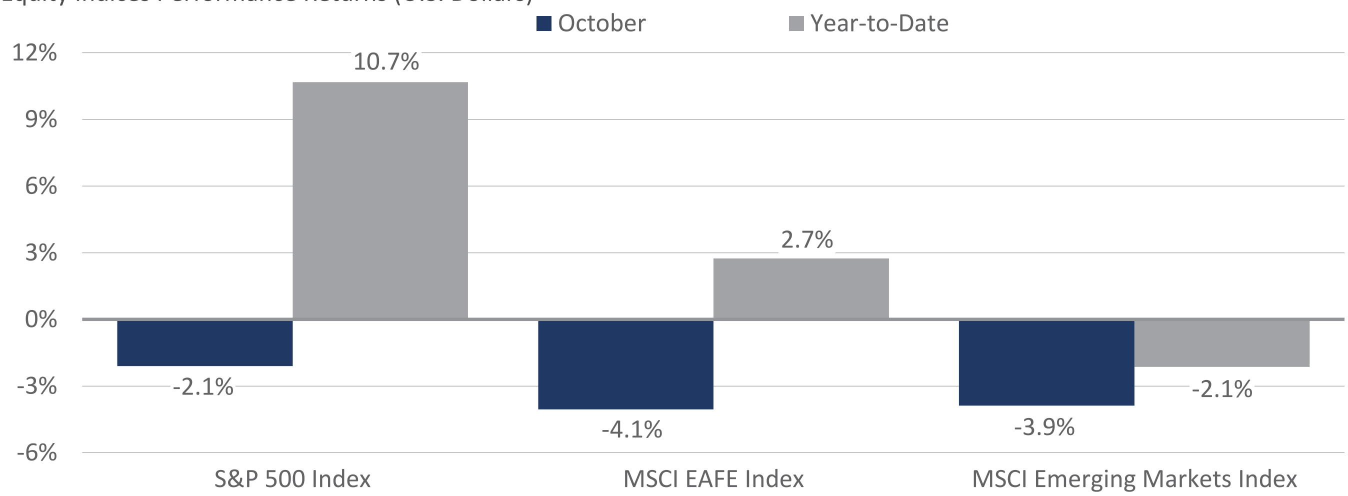
Global equity markets produced negative returns over the month of October. The fear of central banks maintaining interest rates higher for longer, coupled with geopolitical conflict in the Middle East, drove shares down. The Israel-Hamas conflict acted as a tailwind for the aerospace and defense industry as performance rebounded amid a shortage of munitions. RTX Corporation, Lockheed Martin, and General Dynamics finished up over 9% on the month, with the three stocks having produced negative returns for the year prior to the conflict.

Although it was the top-performing region, the U.S. market declined for the month. On October 26, the NASDAQ entered correction territory, defined as a 10% decline from its earlier high, which was made in July. Earnings reports and guidance from mega-cap companies within the index drove the decline. Meta, for example, sold off on reported slowdowns in advertising revenue despite strong top and bottom-line numbers.

European equities declined with the rest of the global equity market while recessionary fears rose in the euro zone. The preliminary PMI figure for October came in worse than expected at 46.5, down from September's 47.2. This marked the fifth consecutive month the data has signaled economic contraction—i.e., below 50.0—and is the weakest figure in almost three years. Easing inflation allowed the European Central Bank to pause its run of 10 consecutive rate hikes, which has weighed on growth within the region.

DOMESTIC EQUITY CONTINUES RUN OF OUTPERFORMANCE

Equity Indices Performance Returns (U.S. Dollars)



Data sources: S&P, MSCI

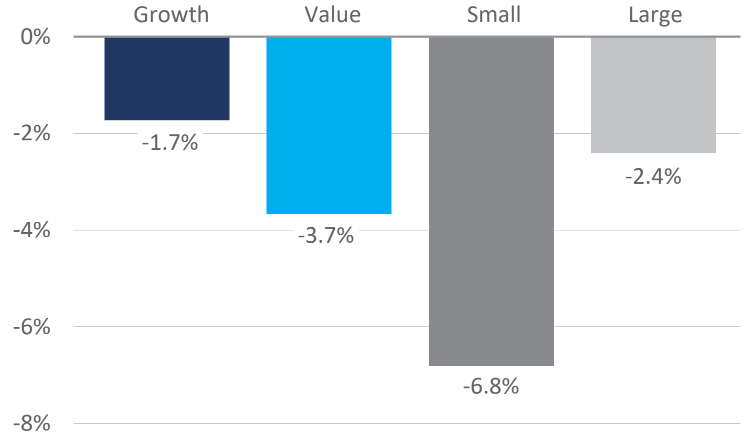
Within the UK, financials finished as the worst-performing sector. Poor performance was driven by uncertainty on how the higher interest rates would impact the lending and mortgage businesses of large banks.

Japanese stocks fell, with all sectors producing negative returns. Similar to the third quarter, regional banks and auto-related companies held up the best. Bank stocks were also resilient due to attractive valuations and a steady increase in long-term yields. Corporate earnings were mixed as the technology sector showed signs of weakness while the auto industries reported positive results.

Emerging markets equities underperformed developed markets. Chinese stocks declined as the real estate debt crisis and foreign relations have led to increased concerns. The U.S. restrictions on artificial intelligence chip exports to China could lead to further declines. Taiwan outperformed despite tech exports falling from September to October amid a belief that exports will turn positive in the fourth quarter.

LARGE GROWTH PLAYS DEFENSE

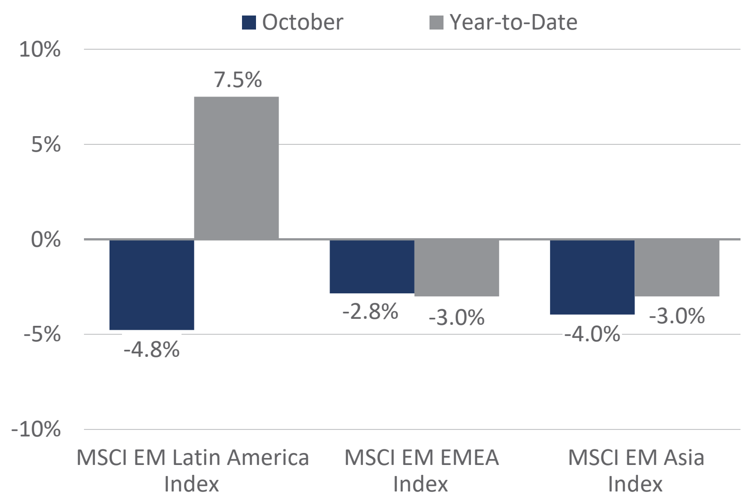
U.S. Style Returns



Data source: FTSE Russell

AS ENERGY GOES, SO DOES LATIN AMERICA

MSCI Indices Performance Returns (U.S. Dollars)



Data source: MSCI

Fixed Income

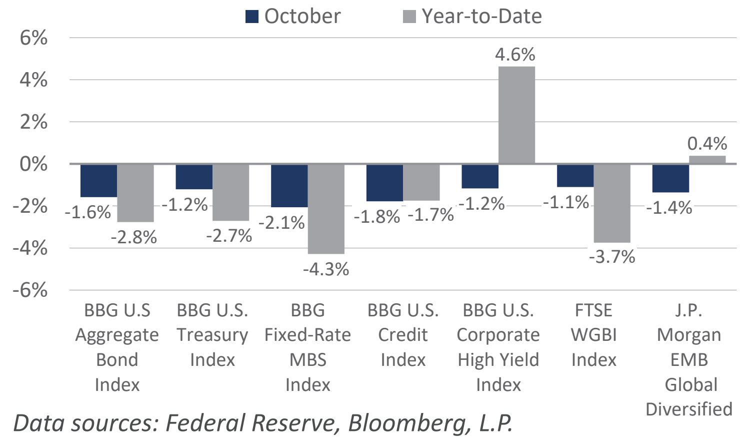
Long-term rates continued to rise during October while short-term rates remained fairly flat. The 10-year Treasury briefly touched 5% during the month on the heels of strong economic data–including hot third quarter GDP and non-farm payrolls and government debt concerns—indicating a possible supply-demand mismatch in the Treasury market. With this rise in long-term rates, the yield curve continued to de-invert. The 10-year/2-year Treasury spread steepened 0.25% to -0.19%, representing the lowest level of inversion since the curve initially inverted in July of 2022.

The Bank of Japan (BOJ) took another step toward dismantling its yield curve control (YCC), a monetary policy used over the last decade to lower the cost of borrowing, by announcing a plan to remove the hard cap of a 1.0% yield on the 10-year JGB. The bank still plans to use quantitative easing to prevent the 10-year yield from moving significantly past that level. Rising global yields and persistent inflation are making it increasingly difficult for the BOJ to maintain its YCC.

Investment grade (IG) spreads rose to 1.3%, while high-yield (HY) spreads rose to 4.5%, likely driven by a combination of concerns over the impact of higher-for-longer policy rates on earnings, some poor earnings results, and geopolitical issues. Corporate fundamentals are anticipated to deteriorate—albeit from strong starting points—as softer demand, higher financing, and sticky cost pressures are putting pressure on profit margins.

RISING RATES WEIGHT ON BONDS

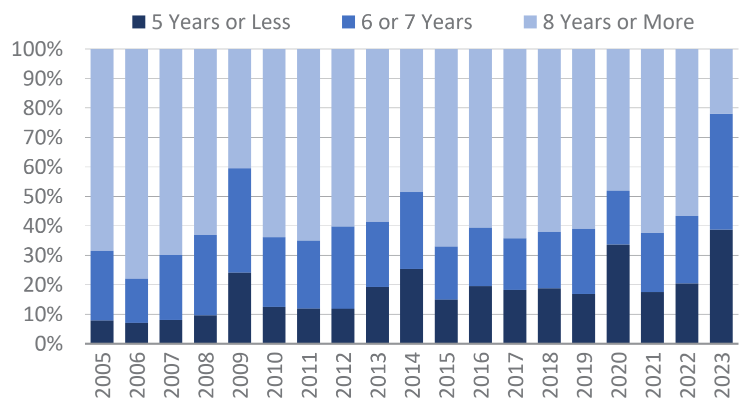
Fixed Income Returns



Data sources: Federal Reserve, Bloomberg, L.P.

HIGHER RATES LEADING TO SHORTER MATURITIES FOR HY NEW ISSUES

HY Bond New Issue Tenor Share by Count



Data source: FactSet

Real Assets

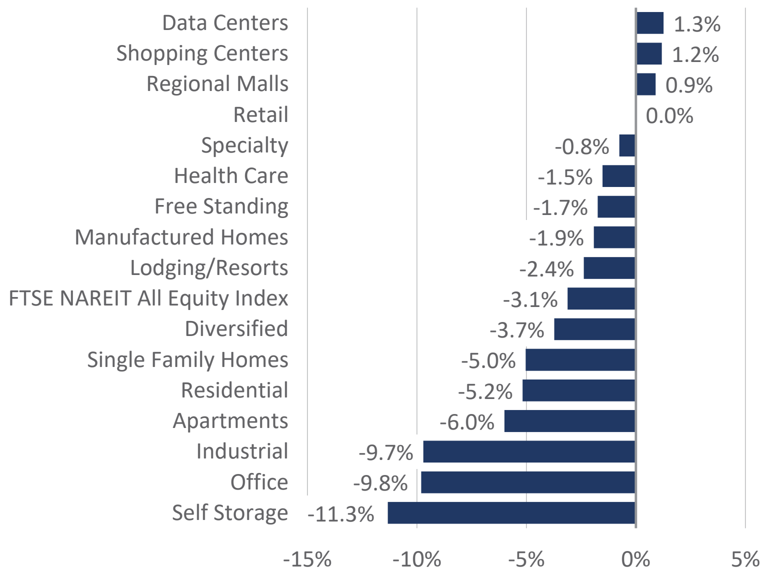
Real Estate

U.S. and global Real Estate Investment Trusts (REIT) declined several percentage points in October, as REITs have remained under pressure in 2023 with higher interest rates leading to declining property values and higher interest expenses.

At the end of October, two REIT merger and acquisition (M&A) deals were announced in the net lease and health care sectors. Within the net lease sector, Realty Income acquired Spirit Realty Capital in an all-stock deal valued at $9.3 billion. In the healthcare sector, Healthpeak Properties and Physicians Realty Trust agreed to combine in an all-stock merger valued at $21 billion.

DATA CENTERS CONTINUE TO OUTPERFORM

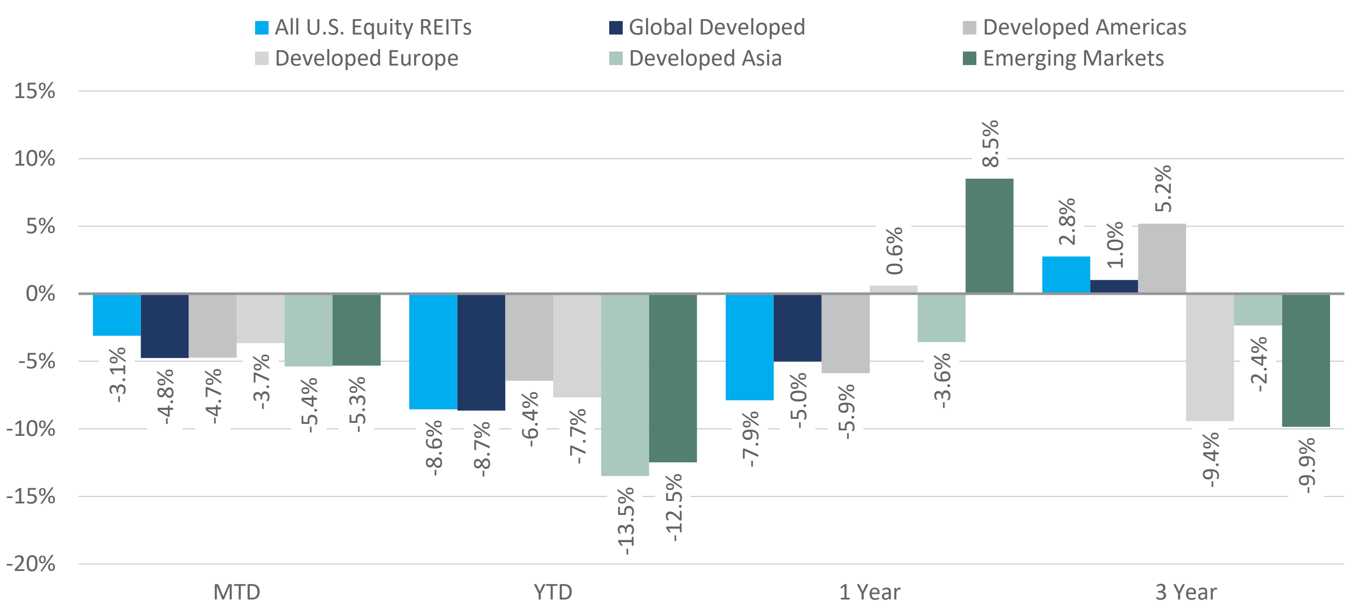
U.S. REIT Trailing Performance by Property Type



Data source: FactSet

GLOBAL REITs CONTINUE UNDERPERFORMANCE INTO YEAR-END

Trailing REIT Performance by Geography



Data source: FactSet

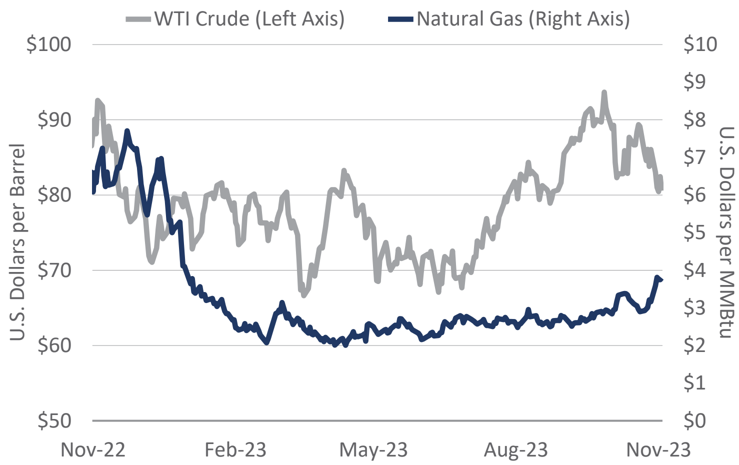
Natural Resources

Oil prices, as measured by West Texas Intermediate (WTI), declined in October despite the Israel-Hamas conflict. The event has yet to lead to a geopolitical premium in oil prices as investors expect the conflict will be contained. During the month, the U.S. Energy Information Administration (IEA) announced U.S. oil production hit an all-time high in August, surpassing pre-COVID levels. Natural gas prices, as measured by the Henry Hub Continuous Contract, rose nearly 30% during the month on cold weather forecasts, but remained negative year-to-date.

Oil producers have taken advantage of higher commodity prices to shore up their balance sheets through the reduction of debt and are now shifting excess cash to M&A. Chevron announced it would acquire Hess Corporation for $53 billion, and Exxon Mobil plans to acquire Pioneer Natural Resources for $59.5 billion.

NATURAL GAS PRICES RISE ON WINTER WEATHER FORECASTS

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



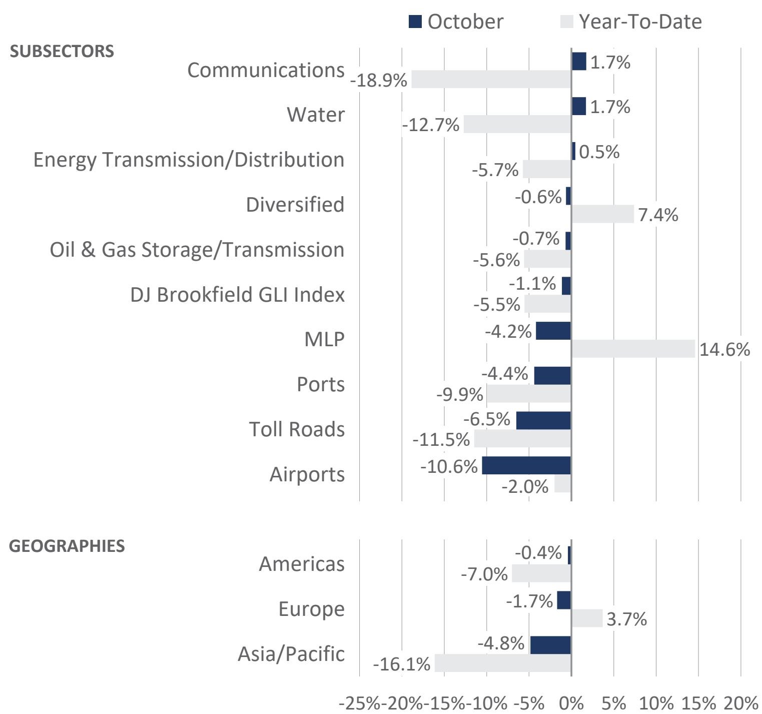
Data source: FactSet

Infrastructure

Global infrastructure broadly declined in October, as measured by the Dow Jones Brookfield Global Infrastructure Index. Midstream energy infrastructure declined during the month but has outperformed the broader equity markets year-to-date. Midstream energy infrastructure—particularly MLP companies—continues to benefit from higher commodity prices and strong balance sheets, making it well-positioned for the current higher interest rate environment.

MIDSTREAM INFRASTRUCTURE OUTPERFORMS YEAR-TO-DATE

Listed Infrastructure Trailing Returns



Data source: FactSet

Diversifying Strategies

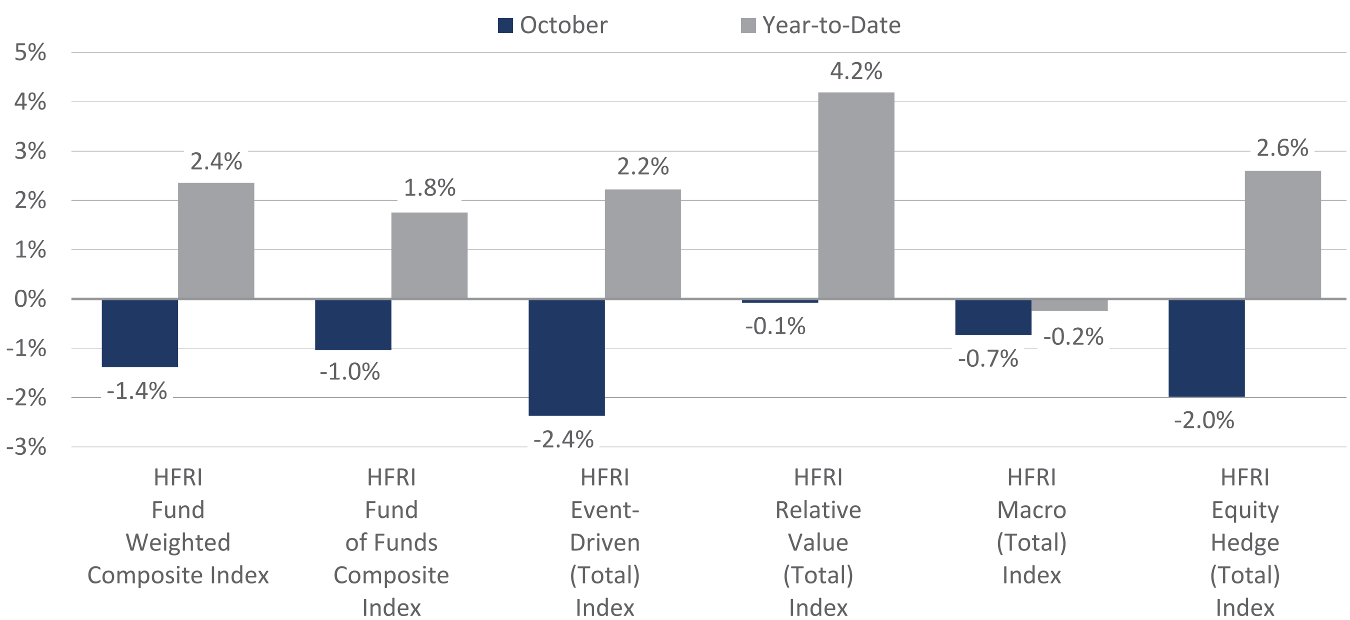
Hedge funds detracted in October across nearly all strategies. The broad hedge fund benchmark was down 1.4%, while the equity hedge and event-driven indices declined 2.0% and 2.4%, respectively. Markets faced an increase in volatility during the month, causing managers to struggle at the onset of the new quarter.

Event-driven managers focused on activism, which is typically accompanied by a higher equity beta, faced significant headwinds given market uncertainty. Within hedged equity strategies, sector specialists witnessed the largest losses, specifically in the energy, health care, and technology sectors.

Following a strong September, macro funds reversed course in October as long energy positions in particular moved against many macro-oriented managers. The move was most noticeable in the trend-following space and commodity-oriented strategies. The price decline in the oil complex was driven by higher inventories in the U.S. along with demand concerns. Short positions within precious metals were another negative contributor as gold and silver prices rallied in response to increased market risk aversion.

HEDGE FUNDS DECLINE BUT RETAIN YEAR-TO-DATE GAINS

HFRI Indices Performance Returns (U.S. Dollars)



Data source: HedgeFund Research

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All data is as of October 31, 2023 unless otherwise noted.

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