Research Review

Third Quarter 2024

Despite an intra-quarter spike in volatility, investors embraced an "everything rally" by the end of September. Gains were supported by a reversal in the restrictive postures of many of the world's key central banks, declining inflation, falling interest rates, and continued resilience in the U.S. economy. Global equity returns were robust nearly across the board in the third quarter as signs of a shifting leadership regime began to develop. International developed and emerging market equities outperformed U.S. large cap, and small cap outperformed their larger cap counterparts. The fixed income markets similarly churned out mid-single-digit gains, as a steep decline in interest rates and a decline in credit spreads supported markets during the quarter. In real assets, real estate investment trust securities (REITs) were the standout performer, with the quarter's double-digit total return buoyed by the decline in interest rates and a continued supportive economic backdrop.

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Economic Update

Federal Reserve (Fed) Reverses Restrictive Stance as Global Central Bank Postures Diverge

"The long- awaited Federal Reserve (Fed) pivot—following a two-year-plus tightening campaign—finally materialized in the third quarter." – Mike O'Conner, CFA

The long-awaited Federal Reserve (Fed) pivot—following a two-year-plus tightening campaign—finally materialized in the third quarter, with the Fed slashing the federal funds rate 50 basis points (bps) at their mid-September policy meeting to an updated range of 4.75–5.00%. In line with the Fed, several key central bank cohorts, including the European Central Bank (ECB), Bank of England (BOE), and the People's Bank of China (PBOC), enacted stimulative measures of their own.

Despite an overwhelmingly accommodative shift in most monetary policymakers' postures in the third quarter, the move away from the inflation fight in favor of fending off potential growth headwinds did not occur in Japan, where inflation has proven more challenging to contain. The Bank of Japan (BOJ) hiked its primary policy rate 15 bps in July. This followed a 20 bp hike in March when the BOJ lifted the policy rate from its eight-year negative level. Looking ahead, the discounted path implied by the bond market foreshadows a similar disparate picture, with meaningful reductions anticipated in policy rates across the Fed, ECB, BOE, and PBOC over the next two years and a further tightening bias in Japan.

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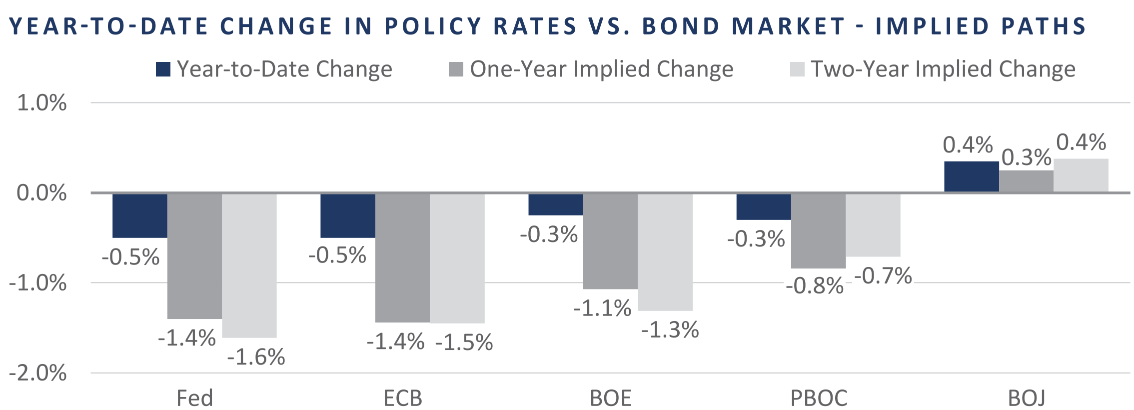


Data source: Bloomberg, L.P.; Data as of October 4, 2024

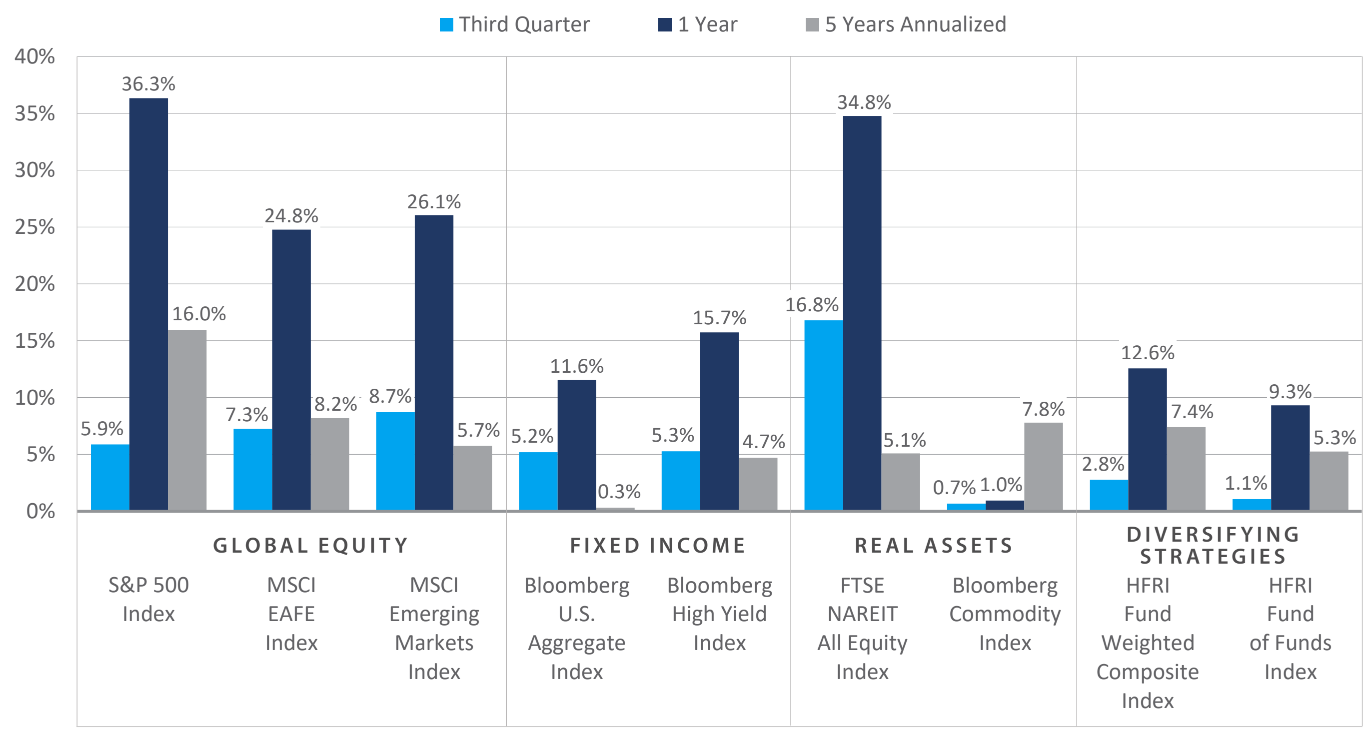
The divergence between the Fed's and the BOJ's policy stances was a key macro contributor behind the disorderly unwind of the longstanding yen carry trade, with the Japanese currency appreciating double-digits versus the U.S. dollar (USD) on the quarter, the strongest gain versus the greenback since fourth quarter 2008. With an approximately 200 bp anticipated divergence between Japan's key policy rate versus the federal funds rate discounted by the bond market in the coming two years, further volatility between these two important global currencies is expected.

As the end of the year draws closer, investors are set to navigate several significant geopolitical events, most notably the November U.S. presidential election, growing turmoil in the Middle East, and shifting global central bank policy initiatives. Despite this backdrop and seemingly steep near-term "wall-of-worry," the financial markets and U.S. economy continue to surprise to the upside.

To conclude, financial markets enjoyed broad-based gains across most major asset classes and sub-asset categories in the third quarter, as easing inflation pressures, a material decline in interest rates, and a general shift towards less-restrictive central bank postures were sufficient to overwhelm an increasingly unsettling geopolitical environment. With the U.S. presidential election looming, the final quarter of 2024 may prove to be a bumpy conclusion to what has been a strong year across the financial markets.

Market Summary

Third Quarter 2024



Data source: Lipper, HedgeFund Research

Global Equity

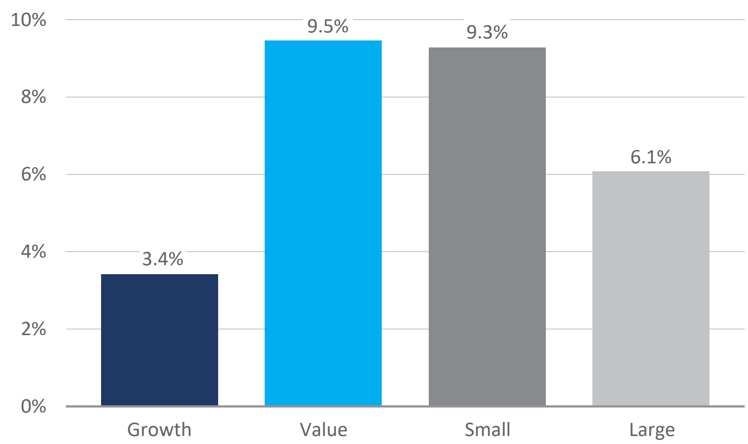
The third quarter of 2024 was marked by significant volatility across global equity markets, with investor demand favoring small cap over large cap and value stocks over growth. Despite a sharp sell-off in early August, equity markets generally recovered by the end of the quarter. The BOJ's unexpected rate hike added to the market turbulence, while the Fed and ECB shifted to more dovish policies, stabilizing investor sentiment. Emerging markets, particularly China, experienced substantial gains due to aggressive stimulus measures.

In U.S. equity markets, more interest rate-sensitive investments, such as small cap stocks and real estate investment trusts (REITs), provided the most substantial returns. After the market sold off at the beginning of August, investors took comfort in the expectation of lower interest rates in the back half of the year, which materialized in September. Sectors such as utilities and industrials outperformed over the quarter due to the strong demand for AI infrastructure and higher dividend yields that compete with fixed income investments. Valuations continue to rise in the U.S., with 10 out of 11 sectors trading above their 20-year average forward price-to-earnings ratio by quarter-end. Energy was the only sector that lagged its 20-year average and was the only underperformer over the third quarter.

Japanese equity markets faced a challenging quarter, primarily due to the BOJ's surprise rate hike in August. On August 5, the Nikkei 225 Index recorded its second-largest decline in history but quickly rebounded the following day. Market volatility was caused by the unwinding of a large carry trade, when traders borrow a currency at a low interest rate—in this case, the yen—and purchase assets in another country.

INVESTOR SENTIMENT SHIFTS DEFENSIVE IN THE THIRD QUARTER

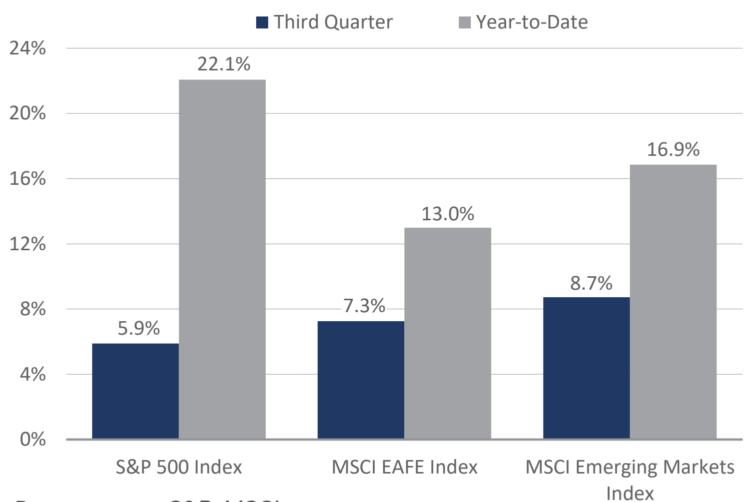
U.S. Equity Markets Style Returns



Data source: FTSE Russell

CHINA'S STIMULUS PACKAGE GIVES LARGE BOOST TO EMERGING MARKETS EQUITIES

Equity Indices Performance Returns (U.S. Dollars)



Data sources: S&P, MSCI

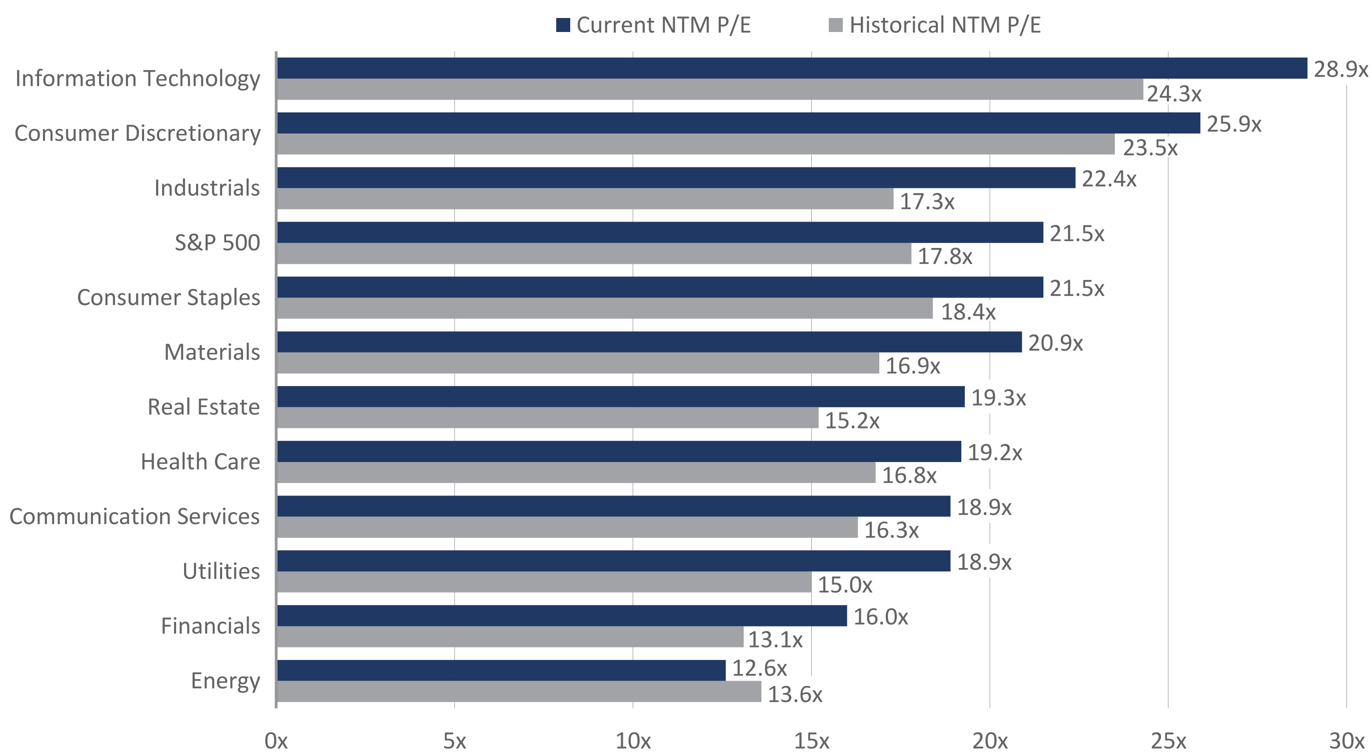
A weakening yen benefits this strategy due to the currency conversion, so as the yen began to strengthen, many traders faced margin calls or risk complications. The market showed signs of stabilization towards the end of September, with the BOJ signaling a more cautious approach to future rate hikes.

Euro zone equity markets were under pressure throughout the third quarter due to concerns over economic growth, as highlighted by earnings guidance drawdowns in the manufacturing sector. The ECB's decision to cut rates provided some relief but was not enough to offset the broader economic concerns. Inflation in the euro zone slowed to a two-year low, which may allow for further easing measures in the future. The UK equity market mirrored the trend in broader Europe of significant volatility and mixed performance across sectors. Real estate and utilities stocks were among the top performers, benefiting from the defensive shift in investor sentiment. However, sectors like consumer discretionary and technology faced headwinds due to weaker earnings and an uncertain economic outlook.

Emerging markets outperformed their developed counterparts, primarily led by Chinese equity markets after the PBOC unveiled one of the largest stimulus packages since the financial crisis. As a result of the boost in investor sentiment, Chinese markets logged their best quarterly performance since 2009. Although information technology outperformed once again in emerging markets, Korea underperformed amid increased competition in the technology hardware industry in recent periods. Mexico and Brazil also underperformed due to fiscal and monetary policy concerns, respectively.

U.S. EQUITY VALUATIONS CONTINUE TO BE STRETCHED

Current NTM P/E Ratios vs. 20-Year Historical Average



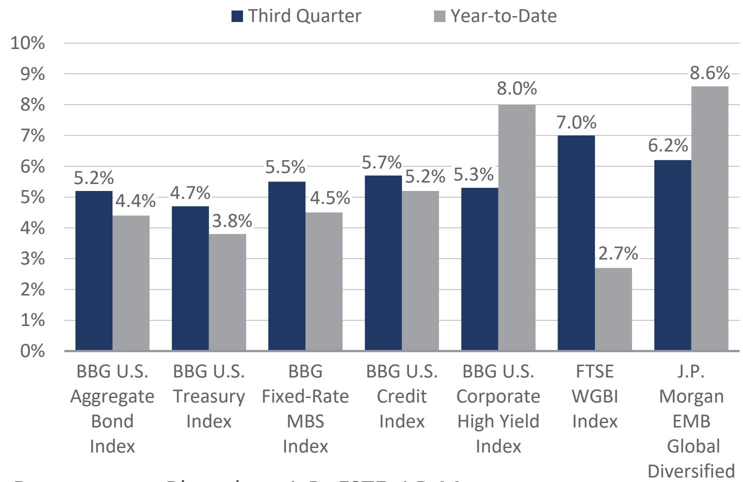
Data sources: Strategas, FactSet

Fixed Income

Interest-rate-sensitive bonds rallied signifi-cantly during the third quarter as the Fed began its cutting cycle. The 2-year Treasury yield fell 106 bps to 3.66%, while the 10-year Treasury yield fell 55 bps to 3.81%. These moves ended the 26-month inversion of the yield curve, and the 10s/2s spread ended the quarter positive 15 bps. This rally led to a strong quarter for fixed income, with the Bloomberg Aggregate Index returning 5.2%.

WORLD GOVERNMENT BOND INDEX SAW A STRONG REVERSAL DURING THE MONTH

Fixed Income Index Returns

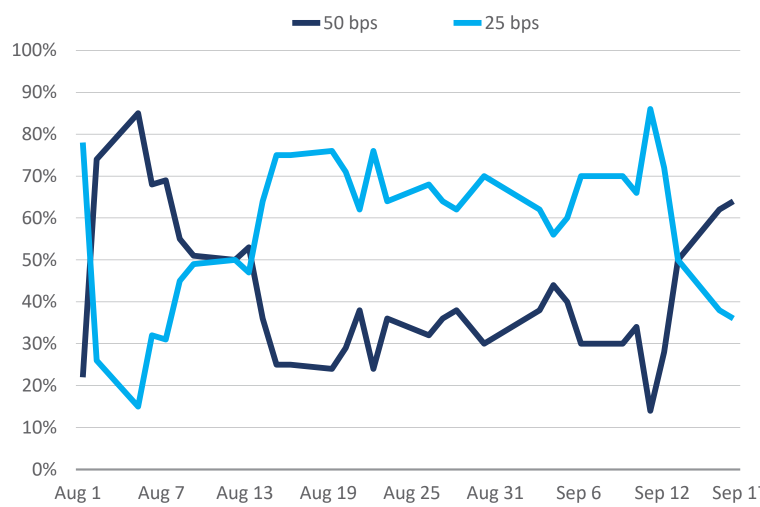


Data sources: Bloomberg L.P., FSTE, J.P. Morgan

The Fed elected to cut its key interest rate 50 bps at the September FOMC meeting, the first rate cut in more than four years. While investors anticipated the direction of the move, the magnitude was surprising. The modern Fed generally prefers to avoid surprising the market, and there is usually little variability in expectations going into FOMC meetings. However, prior to the September meeting, markets were pricing close to a 60/40 chance that the Fed would cut 50 or 25 bps. This uncertainty, and the release of the updated dot plot and economic projections, made the September FOMC meeting one of the most closely followed in recent history.

FED KEPT MARKET UNCERTAIN HEADING INTO RATE DECISION

September Fed Meeting Rate Cut Probabilities



Data source: CME Group; Data as of September 17, 2024

Spread sectors performed strongly in the quarter, and the credit environment was largely risk-on. High yield (HY) and invest-ment-grade (IG) credit spreads continued to tighten, with HY spreads near historical lows at 3.0%. Additionally, mortgage-backed securities (MBS)—a widespread overweight amongst money managers this year—performed well. Interest rate volatility, which widens MBS spreads, has fallen following increased clarity surrounding the Fed cuts. Additionally, banks are beginning to return to the MBS market, which could be an additional source of spread tightening.

Real Assets

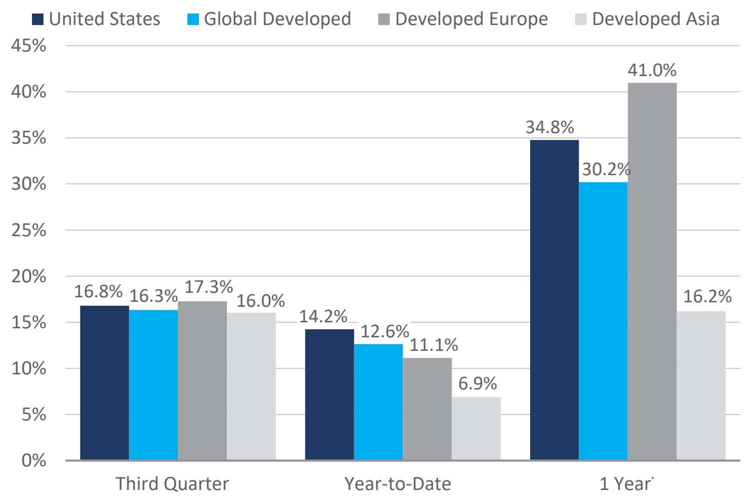
Real Estate

REITs performed exceptionally well in the third quarter, driven by the market's anticipation of Fed rate cuts. Optimism stemmed from the expectation that REITs would benefit from lower rates through reduced borrowing costs for property acquisitions and developments, improved profitability, and more attractive dividends relative to other income-generating assets.

Specialty property has led performance year-to-date with a staggering 50.6% return, largely driven by Iron Mountain, which has gained momentum from increased pricing across its traditional physical storage business unit and hype on the firm's expansion into data centers. However, data centers only account for 9% of the firm's revenue.

REITs REBOUND IN THIRD QUARTER ON EXPECTATIONS OF FED RATE CUTS

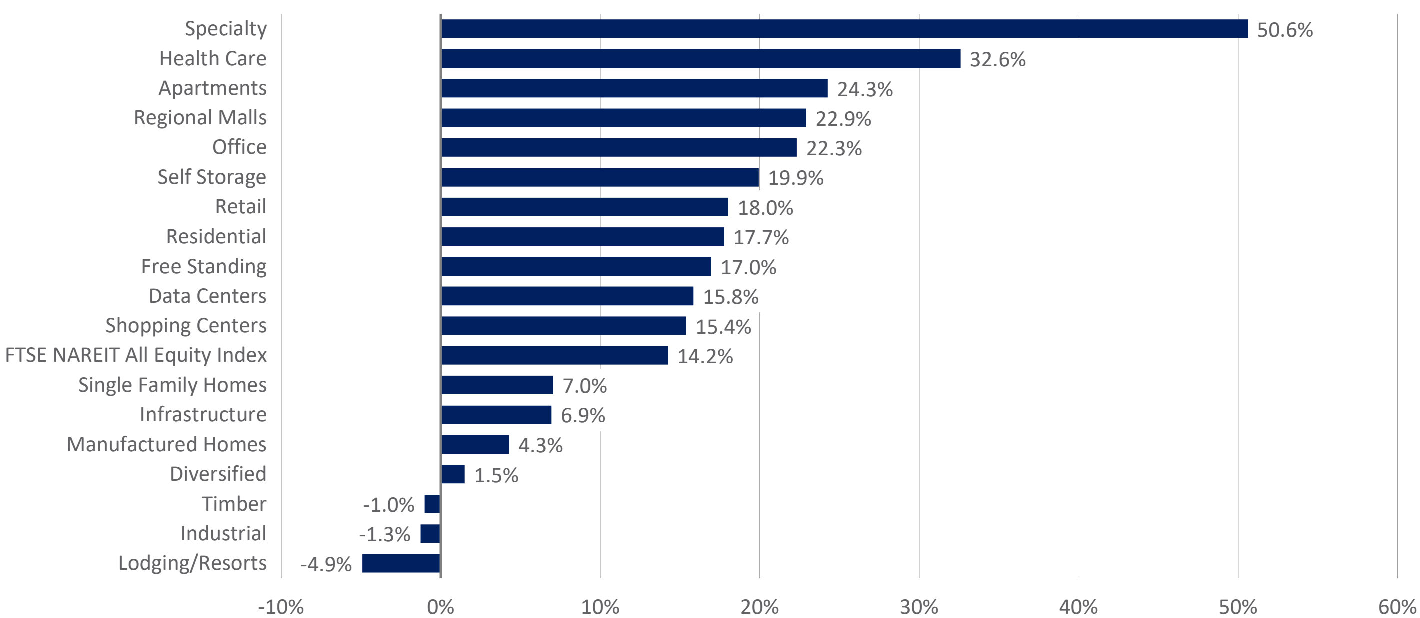
Trailing REIT Performance by Geography



Data source: FactSet

DATA CENTER BOOM LIFTS SPECIALTY PROPERTY SECTOR

REIT Trailing Performance by Property Type



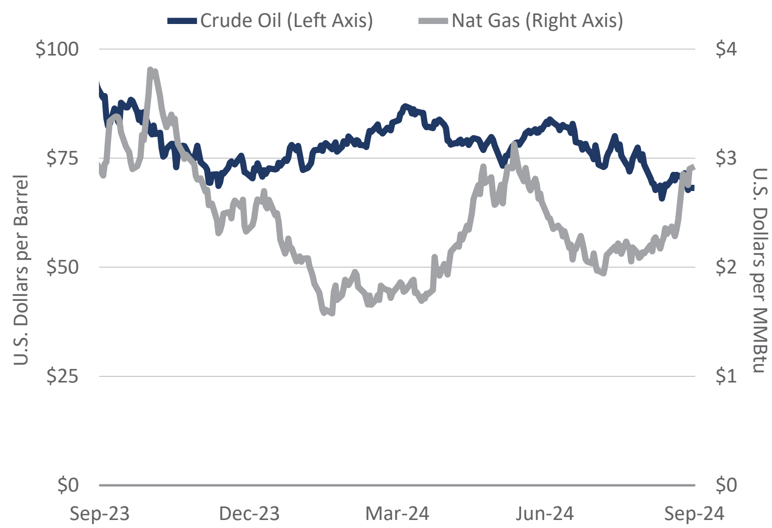
Data source: FactSet

Natural Resources

Crude oil prices drifted below $70 per barrel, as measured by the West Texas Intermediate (WTI) spot contract. Oil prices fell with continued concerns of weakening global demand, particularly out of China, one of the world's largest consumers. Oil opened higher in the first three days of October following missile attacks between Iran and Israel that fueled concerns about potential supply disruptions in the Middle East. Natural gas price volatility resumed, with pricing surging nearly 40% in September, according to the Henry Hub natural gas spot contract, amid concerns about hurricane impacts on infrastructure.

CRUDE OIL AND NATURAL GAS MOVE IN OPPOSITE PATHS IN SEPTEMBER

Price of WTI Crude and U.S. Natural Gas



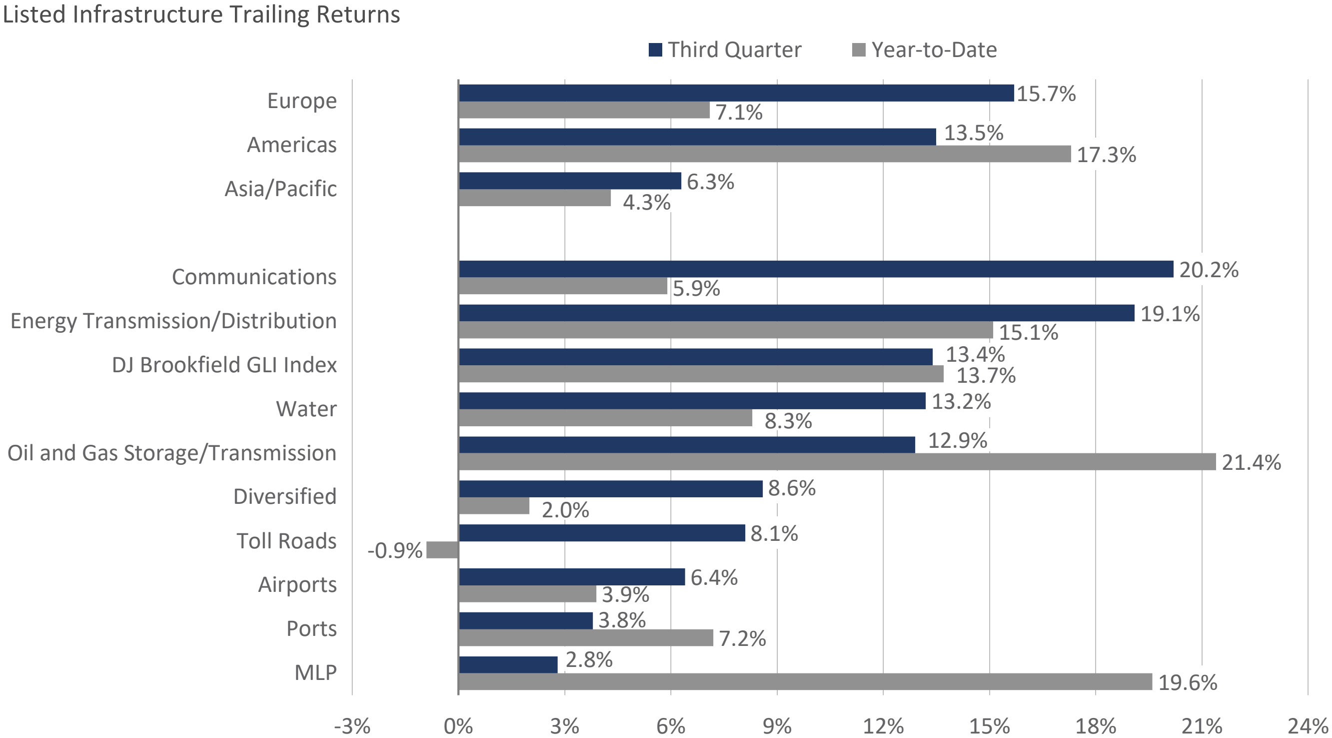
Data source: FactSet

Infrastructure

Global listed infrastructure stocks, as measured by the Dow Jones Brookfield Global Infrastructure Index, rose 12.7% for the third quarter. The communications sector led with the strongest performance, driven by the outperformance of cell tower stocks, which had been under pressure from higher discounting rates and borrowing costs. The marine ports sector experienced a surge in September into the first trading days of October amidst the East and Gulf Coast dockworkers' strike.

BOOSTED BY FALLING RATES, CELL TOWER STOCKS OUTPERFORM

Listed Infrastructure Trailing Returns



Data source: FactSet

Diversifying Strategies

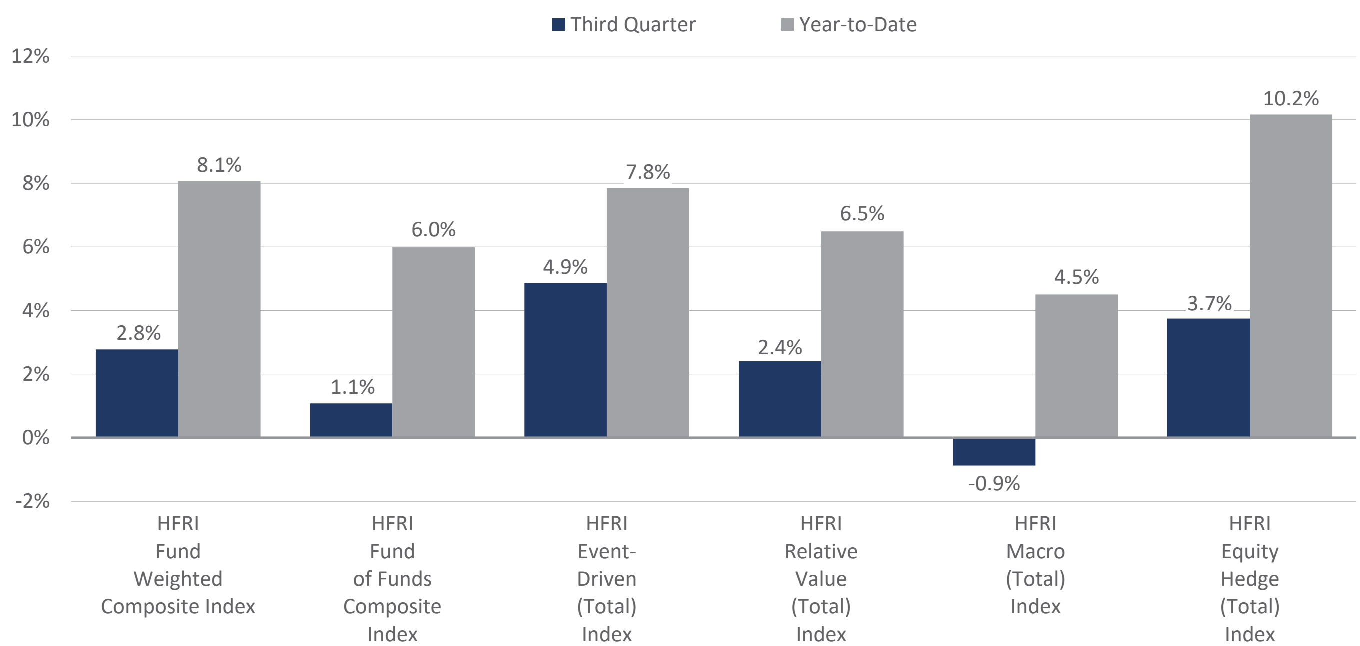
Hedge funds produced gains during the third quarter, as the broad hedge fund benchmark were positive each month. Event-driven and hedged equity were the leading sub-strategies, with rising equity markets serving as a tailwind.

Event-driven strategies continued to perform strongly within the stressed/distressed credit space. Credit managers have been actively purchasing significant amounts of paper as companies approach a relatively large maturity wall.

Global macro strategies performed the weakest of the main hedge fund approaches, with the broad macro index detracting approximately 90 bps during the third quarter. However, macro funds still provided positive returns year-to-date.

HEDGE FUNDS BOASTED STRONG GAINS LED BY EQUITY-ORIENTED STRATEGIES

HFRI Indices Performance Returns (U.S. Dollars)



Data source: HedgeFund Research

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

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