

Research Review

First Quarter 2024

Risk takers, particularly those with a domestic orientation, were handsomely rewarded in the first quarter of 2024 as U.S. large cap stocks—i.e., S&P 500 Index—advanced to a record high and credit risk premiums tightened to near record lows. These gains humbled stock market bears who raised alarm bells in recent months due to historically elevated valuations, stubbornly elevated inflation, an unsustainable U.S. fiscal trajectory, and an unsettling geopolitical stage.

For the quarter, the majority of large cap's gains came from the growth stocks, while small and microcap companies continued to lag, albeit still posting solid returns. International equities lagged domestic, as regional conflicts in Eastern Europe and the Middle East, paired with lackluster economic performance across Europe and China, helped weigh on investor sentiment. Performance in the bond market was mixed, with rate-sensitive sectors like investment-grade credit and Treasuries witnessing declines, while shorter-duration, below-investment-grade credit sectors such as high yield and bank loans eked out low single-digit returns. Real asset performance was also mixed, as real estate investment trusts (REITs) declined modestly amid the backup in interest rates, while commodity futures and global listed infrastructure generated positive total returns.

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Economic Update

U.S. Stocks Advance to Record Highs Despite Cooling Fed Rate Cut Sentiment

"Incoming inflationary data indicated that the Fed's multi-year campaign to restore price stability is unfinished."
 – Mike O'Conner, CFA, CAIA.

At their March policy meeting the Federal Reserve (Fed) affirmed their expectation for three 25 basis point rate cuts in 2024—an expectation first introduced at the December 2023 policy meeting—via updates to the Fed's Summary of Economic Projections "dot plot" table. While on the surface the Fed's unchanged view of the appropriate year-end level of the policy rate was unsurprising, it was notable that there was no material deviation in the Fed's desire to ease policy. This is despite U.S. equity prices and certain valuations having approached the upper-end of their historical range, inflation running well above its 2% target, gold and bitcoin spot prices having seen new record highs, and the labor market and broader economy continuing to demonstrate strength.

In recent quarters, the general trend of the equity market has ebbed and flowed in response to the implied path of Fed policy, with increasing expectations for Fed rate cuts serving as a tailwind behind risk assets and vice versa. This relationship seems to have decoupled, however, as incoming inflationary data indicated that the Fed's multi-year campaign to restore price stability is unfinished, driving Fed easing sentiment lower.

U.S. STOCKS HAVE MARCHED HIGHER DESPITE NARROWING OF FED RATE CUT EXPECTATIONS

Year-End 2024 Fed Rate Cut Expectations vs. Stocks



Data source: Bloomberg, L.P.

Early in the quarter, the fed funds futures market had discounted nearly seven 25 basis point cuts to occur throughout 2024. By quarter-end, however, this had narrowed to reflect just three 25 basis point cuts, in line with the Fed's expectations. Despite this convergence, U.S. large cap stocks (S&P 500) advanced to fresh record highs, humbling skeptics who called for a pullback.

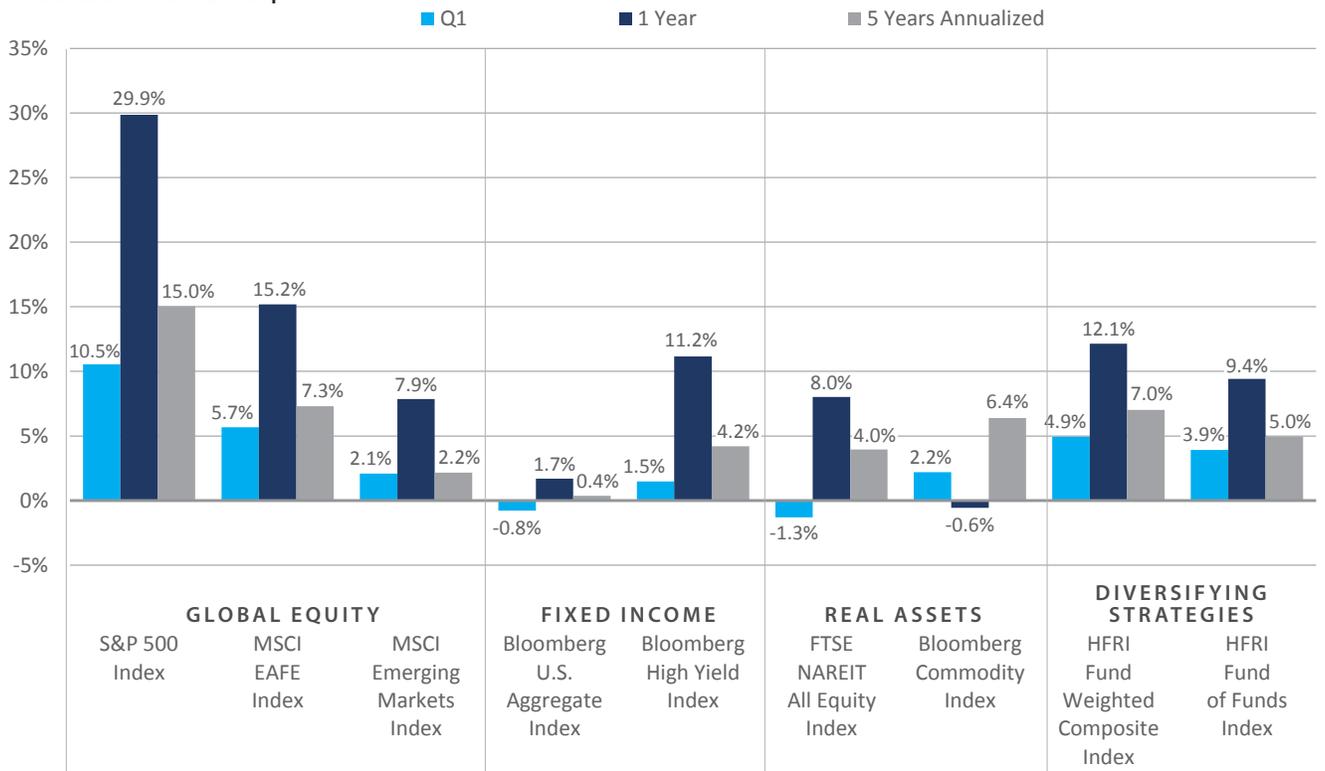
The strong bid for domestic risk exposure was not confined to the equity markets, as credit risk premiums narrowed to the lowest levels since early 2022, a time when the Fed was initiating the monetary tightening process. On a spread basis, U.S. high yield bond risk premiums tightened to a sub-300 basis point (bp) level during the quarter, placing this key financial condition variable in the fourth percentile of observations dating back to the late 1980s.

Often viewed as a leading cyclical indicator of the business cycle, the current subdued level of risk compensation demanded by high yield investors reflects supportive credit conditions, meaningful investor demand for credit risk, a lack of concern for a near-term economic downturn, and a backdrop seemingly priced for perfection.

To conclude, most major risky asset categories advanced in the first quarter, with notable positive momentum observed in domestic markets as U.S. large cap equities gained double digits on their way to a new record high. This strength contrasted with inflationary data suggesting the Fed's campaign to fully restore price stability is incomplete, which in turn helped drive a notable shift lower in the bond market's expectation for easing throughout the remainder of 2024.

Market Summary

First Quarter 2024



Data source: Lipper, HedgeFund Research

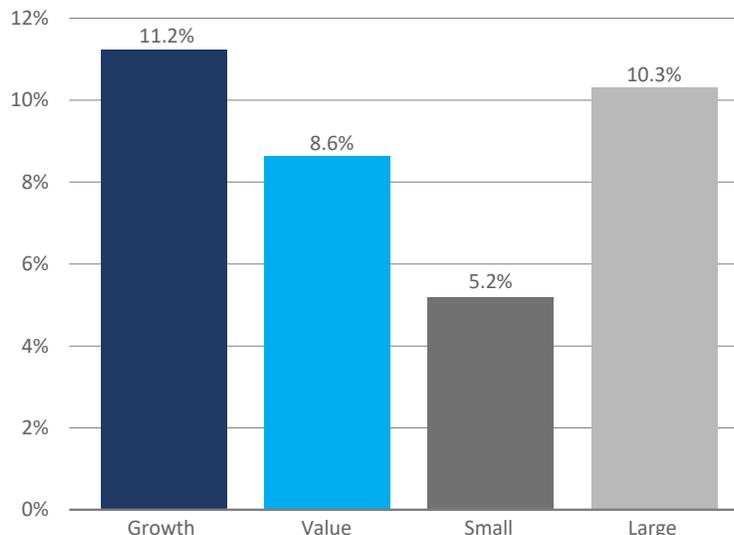
Global Equity

Equity markets continued the momentum of early 2024 in March providing the S&P 500 Index experiencing its best first quarter since 2019. U.S. markets outperformed both developed and emerging markets. Enthusiasm around artificial intelligence (AI) was especially pivotal in driving market returns across the globe.

The quarter experienced three consecutive months of positive performance for U.S. equities, driven primarily by what is now referred to as the “Fab Four”: NVIDIA, Microsoft, Meta, and Amazon. These four have outpaced their Magnificent 7 counterparts—Tesla, Apple, and Alphabet—thus far in 2024 and were consequently labeled as a unique group. Strong earnings releases from the information technology and communication services sectors drove returns. The energy sector also performed well due to increased oil prices.

TECH EARNINGS DRIVE CONTINUED GROWTH OUTPERFORMANCE

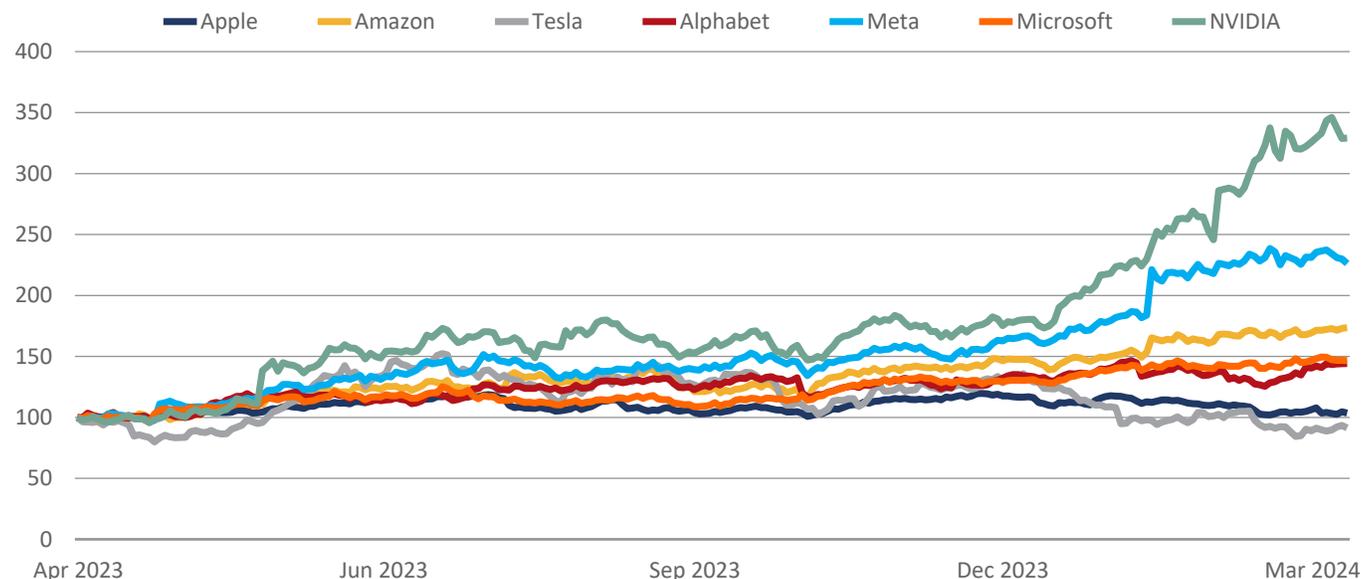
U.S. Style Returns - February



Data source: FTSE Russell

THE MADNESS OF MARCH – MAGNIFICENT SEVEN TO FAB FOUR

Growth Indexed to 100



Data source: FactSet

European equities ex-UK produced positive absolute returns, outperforming emerging markets but underperforming U.S. equities. Similar to other equity markets around the world, the information technology sector led returns due to AI demand. In addition, the Purchasing Managers' Index (PMI) increased in March from 49.2 to 49.9, signaling improvement in euro zone business activity.

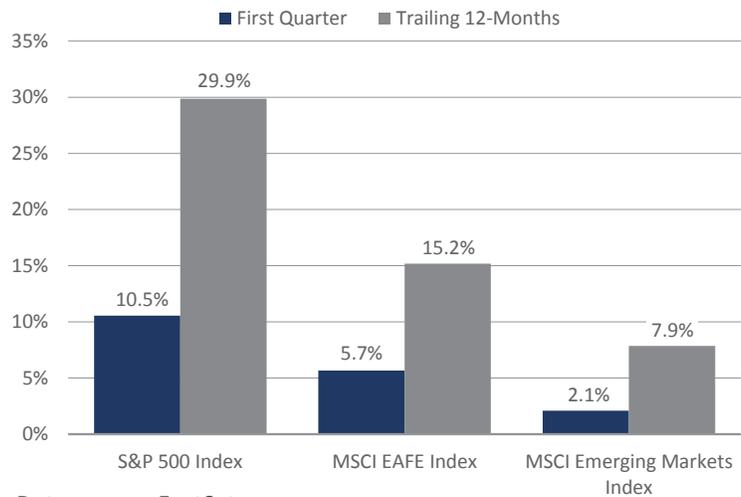
UK-based equities rebounded in March after remaining relatively flat in February. The financials, industrials, and energy sectors outperformed. Inflation has decreased faster than expected, helping to boost equity market sentiment. Even with the recent positive performance, UK equities are still trading at around a 30% median industry discount when comparing the UK forward price/earnings ratio to the U.S.

Japanese stocks continued to rally, with the Nikkei 225 Index topping 40,000 yen for the first time in history. Large cap automotive and semiconductor stocks led for the quarter. The weakening yen provided a short-term tailwind for recent corporate earnings announcements, given that many large cap companies in Japan are net exporters. The Bank of Japan (BOJ) hiked rates for the first time since 2007, ending the period of negative interest rates that followed the financial crisis.

Although emerging markets (EM) produced positive returns, EM equities still lagged U.S. and international equities. In Taiwan and Korea, enthusiasm for artificial intelligence drove market returns. China's equity markets rebounded in February and produced positive absolute returns in March, although the market still finished down over the first quarter. China has been gaining economic momentum on the back of significant expansions in factory activity.

CHINA HOLDING BACK EMERGING MARKET EQUITY PERFORMANCE

Equity Indices Performance Returns (U.S. Dollars)



Data source: FactSet

Fixed Income

Rates sold off in the first quarter, largely in February, returning gains from an impressive fourth-quarter rally. The 10-year Treasury yield rose 0.32% to 4.20%, while the 2-year Treasury yield rose 0.37% to 4.59%.

Expectations of interest rate cuts by the market fell from nearly seven late in the fourth quarter to around three by the end of the first quarter, in line with the Federal Open Market Committee's (FOMC's) dot plot and economic projections.

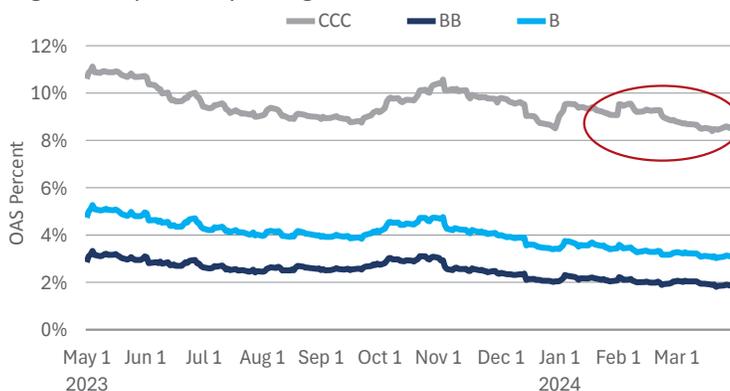
Inflation expectations reset during the first quarter following elevated CPI and PCE data, particularly in February following the hot January CPI reading. Additionally, strong economic and jobs data have reinforced the view that continued restrictive rates are needed to bring back price stability. Chair Powell has maintained that the Fed will need adequate evidence of cooling inflation before cutting rates.

Corporate spreads continued to tighten during the quarter. Investment-grade spreads fell 0.10% to 0.94%, while high yield spreads fell 0.24% to 3.15%. While tight spreads indicate limited upside for price appreciation, the high carry of these bonds, especially in the high yield space, can help insulate investors from losses even if spreads widen significantly.

The Fed's overnight reverse repo facility, commonly referred to as the RRP, has been steadily falling since May of 2023. The RRP is seen as a gauge of "excess" reserves in the system, and as it approaches zero—likely sometime in the middle of this year—the pace and timing of quantitative tightening (QT) will be reconsidered to ensure there is enough liquidity in the system. In September 2019, reserves fell to a level that left a liquidity gap in the financial system, causing repo rates to spike and prompting the Fed to halt QT and inject new liquidity.

CCC SPREADS HAVE TIGHTENED SIGNIFICANTLY IN ANTICIPATION OF LOWER DEFAULTS

High Yield Spreads by Rating



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

EXCESS RESERVES HAVE FALLEN STEADILY

Federal Reserve Overnight Reverse Repo Facility



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

Real Assets

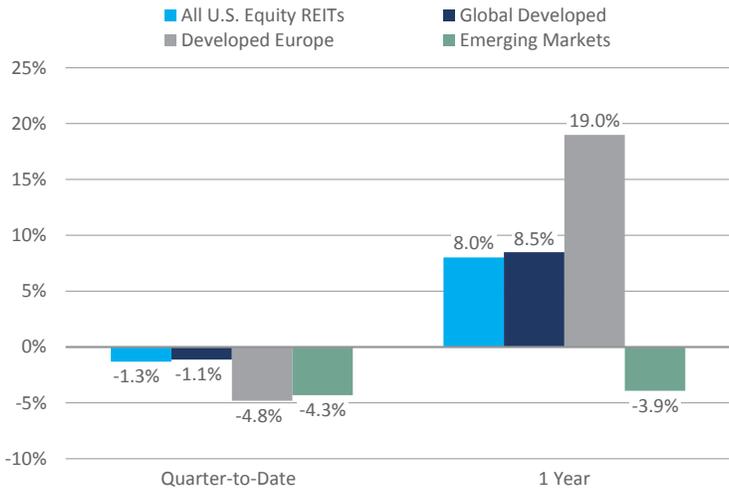
Real Estate

U.S. and global Real Estate Investment Trust (REIT) indexes modestly declined during the first quarter of 2024 following Fed Chairman Jerome Powell's announcement that the Fed may not cut rates to the extent the market had already priced in for 2024. Higher interest rates have been the most significant headwind for listed real estate due to increased borrowing costs and declining property valuations because of higher applied discount rates.

U.S. REITs outperformed their European brethren, although the Europe real estate sector faced similar challenges due to higher interest rates, declining property values, and subdued economic activity. Overall, the U.S. economy has been comparatively resilient for the first quarter, providing some cushion for the impact of higher rates.

INTEREST RATES CONTINUE TO PRESSURE REITS IN THE FIRST QUARTER

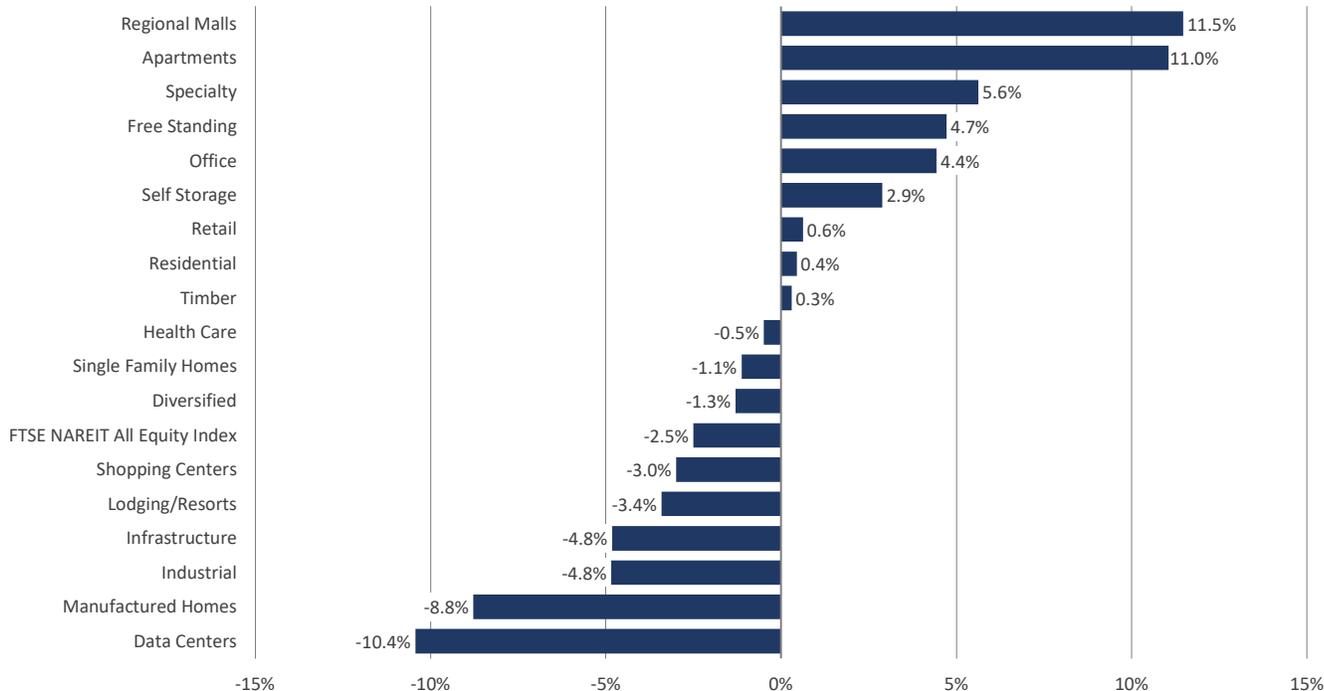
Trailing REIT Performance by Geography



Data source: FactSet

DIVERSE PROPERTY SECTORS BRING DIVERGENCE IN PERFORMANCE

U.S. REIT Trailing Performance by Property Type



Data source: FactSet

Natural Resources

Oil prices, as measured by West Texas Intermediate (WTI), rose over 15% in the first quarter. Geopolitical tensions in the Middle East continued to put upward pressure on oil prices, based on fears of potential adverse supply impact in the region, as Israeli strikes were carried out on an Iranian consulate in Syria. Furthermore, March Purchasing Managers' Index (PMI) data from China indicated a positive shift in the country's manufacturing activity. China's PMI is viewed as a significant economic indicator that can influence oil prices, with an increase in the PMI associated with higher demand for oil, which also contributes to higher prices.

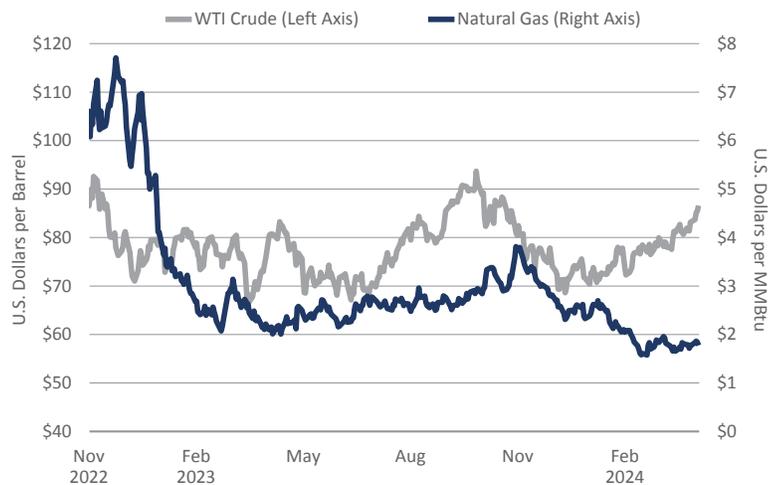
Infrastructure

The global diversified infrastructure index was flat during the first quarter, weighed down by the port, communications infrastructure, toll road, and water sectors.

Midstream energy infrastructure remains a standout performer, up more than 13% during the first quarter, as measured by the DJ Brookfield Global Infrastructure MLP Index. Many midstream companies have reduced debt, increased returns to investors, and maintained disciplined capital expenditures, resulting in strong earnings and distributions, with expectations for continued growth in free cash flows.

OIL PRICES ROSE FOLLOWING MIDDLE EAST CONFLICT AND POSITIVE CHINESE ECONOMIC DATA

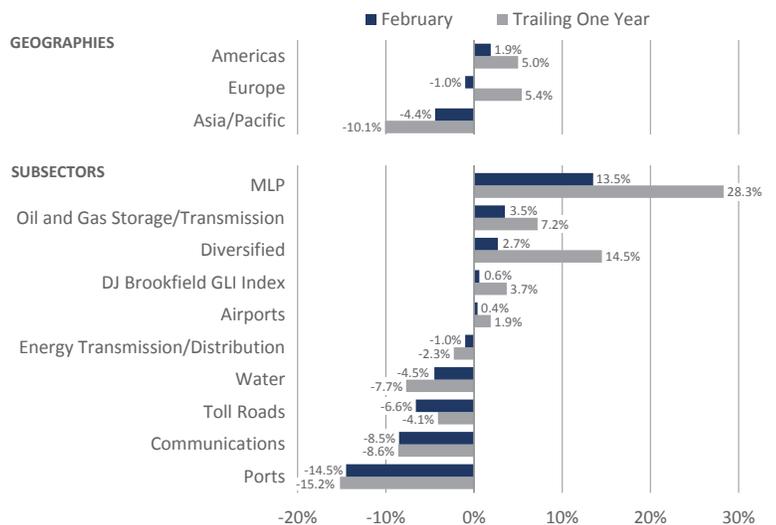
Price of West Texas Intermediate (WTI) Crude and U.S. Natural Gas



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

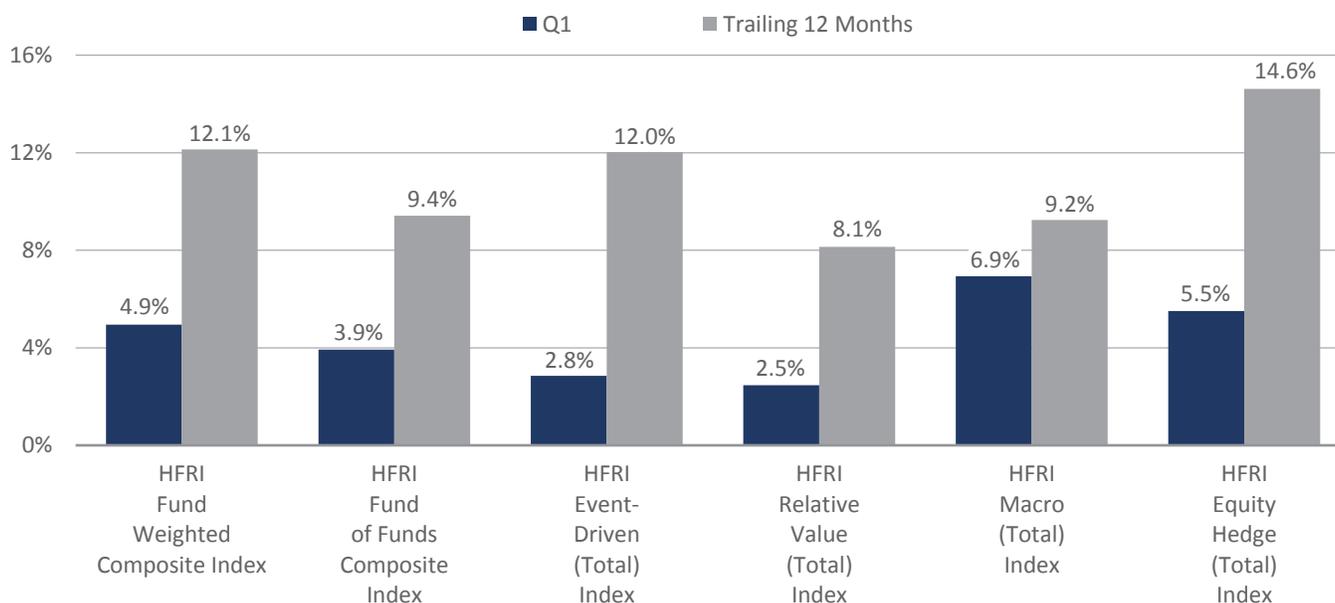
Hedge funds generated solid gains for the quarter, led by global macro and hedged equity strategies. Global macro strategies were particularly strong, witnessing the best quarterly return in over 20 years.

Performance dispersion declined during the quarter across the broad hedge fund industry. The hedge fund benchmark representing hedge funds generally built upon a strong run over the last five months. The elevated interest rate environment relative to recent historical averages has positively impacted most hedge fund strategies.

Trend followers, energy, and cryptocurrency exposures drove robust gains in macro-oriented strategies. The best performers within trend following were allocations to equities and agricultural commodities.

HEDGE FUNDS GENERATED SOLID FIRST QUARTER PERFORMANCE

HFRI Indices Performance Returns (U.S. Dollars)



Data source: HedgeFund Research

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All data is as of March 31, 2024 unless otherwise noted.

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