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Q4 2024 Outlook

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Economy: Economic growth has remained resilient as the rate of inflation has come back down near long-term averages, leaving markets with a positive macro backdrop.

- Q3 GDP growth is currently expected to come in at 2.5% per Atlanta Fed projections. This follows 1.6% growth in Q1 and 3.0% growth in Q2 as announced and revised by the BEA. Personal consumption has continued to drive economic growth despite high prices, high interest rates and concerns that savings built up during the pandemic have evaporated. There are very few clear warning signals that the US consumer is set to slow down. For the time being, it appears the Fed has successfully navigated the economy to a soft landing, or no landing, as it has fought off what now appears to have been transitory inflation after all. We see potential for certain industries and sub-sectors to see slowdowns as volatility and high prices from the past few years are digested, but we don't see this stalling the entire economy.

- The labor market has softened, but not enough to indicate a potential slowing of the economy. Bearish economists have been regularly pointing to myriad rules, indicators and signals that have historically been infallible in predicting recessions. These rules have not proven themselves to be accurate this cycle. Most recently, employment reports for July and August triggered fairly violent market reactions as some of those indicators and rules were triggered, however employment had previously been so tight that those rules do not appear particularly relevant this time around.

- We believe inflation is more controlled than the data indicates. Shelter is a big contributor to inflation, and we observe rental rates for housing being mostly flat to negative over the past year. It appears shelter's contribution to inflation may be overly influenced by the concept of owner's equivalent rent, or what a homeowner would have to pay to rent their own home. This part of inflation is running at a persistently high level due to ever-increasing home prices in many markets. However, owner's rent is not an expense actually incurred by anyone, so we question if it is a relevant enough data point to include in the calculation of CPI. The reality of low shelter inflation creates the risk that actual price changes drift lower than what the data reflects, possibly towards deflation. Nonetheless, prices for all things are significantly higher than they were a few years ago and are not going back down to those levels. These higher prices are a pain felt most by those who can least afford them, creating

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an ever-widening wealth gap in the United States that could lead to changes in political outcomes and increasing unrest that may increase market volatility.

- Private markets have shown clear signs of thawing after a very challenging couple of years. M&A activity is picking up in the world of private equity and VC. We also have seen a significant uptick in activity within commercial real estate, with cap rates gravitating towards sellers' expectations as interest rates have stabilized and moved lower. As a next positive step forward, we are looking for an uptick in IPOs to create even more healthy liquidity in private markets.

Stocks: The S&P 500 gained over 5.5% in the third quarter to close at a record high of 5,763, pushing its total price gain for the year to approximately 20.8%.

- The quarter was marked by a significant increase in volatility. Uncertainty over the economy and the Fed's plans early in the quarter combined with market mechanics to cause a series of violent sell-offs that were followed by near immediate rallies. With a macro backdrop that we see as positive overall, this kind of volatility can create trading opportunities if the market becomes adequately oversold and shows clear signs of reversal.

- It is important to understand the mechanics behind the short-term volatility we have experienced recently. Although covered widely in financial media, the impact of the Yen "carry trade" needs to be underscored. This is in reference to a trade, often used by hedge funds over the past decade-plus, whereby Japanese assets denominated in the Yen are effectively sold short. These assets have a low cost of capital due to Japan's monetary policies. Proceeds can then be used to buy higher-yielding assets such as US Dollar denominated bonds, or risk assets like US growth stocks. This trade had proliferated and become large and crowded as US interest rates and stocks rose over recent years. During Q3, the expected path of monetary policy in both Japan and the US changed as Japan raised rates and the US signaled interest rate cuts. This caused the Yen and Yen denominated assets to rally, creating a short squeeze on that side of the trade. The riskier US assets experienced forced selling to create liquidity to buy back the Yen denominated assets, quickly driving the US stock market lower. The widespread use of programmatic and algorithm-based trading in the US can magnify these selloffs. With these programs now controlling significant trading volume, we observe that the stock market, which is presumed to be incredibly liquid, becomes very illiquid when that liquidity is most needed. Selling must be exhausted before a tradable bounce can be bought, but the bounce back can be extremely fast and powerful.

- Early in the quarter we started to see a broadening of the market and sector rotation. Interest rate and monetary policy expectations caused interest rate sensitive sectors to catch a bid, driving up financials in general, regional banks, home builders, and others. It can be hard to tell how much of the benefit from the changing interest rate environment is already "priced in," but we do expect a continuing tailwind for the businesses in these sectors and are monitoring for allocation opportunities.

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- The indicators we watch closely are all still very positive as we enter Q4. We increased exposure in Q3 and have reduced slightly to lock in some gains as we exit the quarter with a few signs that the market is slightly overbought in the short-term. We expect to continue to manage this exposure around the edges as volatility persists in the first half of the quarter.

Bonds and Rates: Treasury yields drifted lower across the curve throughout the quarter with the 10-Year Treasury yield falling from 4.34% to 3.80% as clarity over monetary policy and inflation combined with a few macro scares to anchor rates.

- The Fed's path forward with monetary policy is now clearer than it has been at just about any point in recent years. They have all but declared victory over inflation and are now monitoring employment closely to make sure economic growth is sustainable. They are also providing specificity on the pace and scale of rate cuts, with a series of 25 basis point cuts expected at upcoming meetings and a future expected equilibrium between 2.75% to 3%, or about a 75-100 basis point premium to expected inflation. This is what most economists would suggest as a healthy real interest rate, so it is hard to suggest a different result unless inflation or the economy take a very unexpected turn.

- We don't see much room for rates to rise on the long end of the yield curve. We see the most likely path forward as being modestly lower with the 10-year likely settling in a range between 3% and 3.50% as inflation and Fed Funds get to their long-term targets.

- We do not see much as attractive in credit with spreads still relatively tight, thus moving more of our focus to yield curve positioning. We do see potential opportunities to take advantage of illiquidity premiums in certain sections of tradable markets and are monitoring credit managers that can demonstrate consistent alpha over long time periods as potential allocations as we look to eventually increase credit risk.

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