A 40 Degree Day

2024 MARKET PREVIEW LETTER FROM THE DIRECTOR OF RESEARCH

JAN 2024

A former colleague once described his brother-in-law to me as a "40 degree day." The puzzled look on my face revealed my unfamiliarity with the term, so he went on to ask me: "When does anyone get upset about a 40 degree day?" I laughed and shook my head — it was genius, the perfect way to describe something more forgettable than memorable…not especially good or bad, just average.

Given what markets have been through over the last four years — COVID, outsized returns both good and bad, record inflation, sky-rocketing interest rates, geopolitical conflict, and elevated volatility — I know I'm not alone in hoping that 2024 market returns will resemble a 40 degree day. Indeed, an "average" year of returns across markets will equate to positive portfolio performance for most asset allocations and allow investors to satisfy their risk and return goals.

Of course, there are potential stumbling blocks to a "normal" year. In particular, we will closely watch the Fed pivot and the disparity between expected and actual rate cuts, geopolitical conflicts, and the U.S. presidential election.

With that as background, we offer our annual outlook across asset classes, highlighting trends and themes for the year ahead. Happy reading and here's to a year of normalcy!

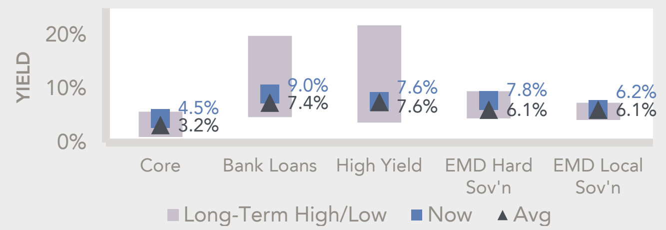
FIXED INCOME

Generally speaking, fixed income returns are driven by two factors: Interest rates and spreads (credit spreads incorporate default risk as well as liquidity and other risk measures).

Interest rates combined with credit spreads establish the yield of each bond, which determines the expected return for each instrument if it is held to maturity. However, bond prices vary and they can be sold prior to maturity. Movements in yields — driven by changes of rates and spreads, with rates the more influential of the two — propel price return. Higher yields cause temporary losses, but permanent losses only occur when a bond defaults. The opposite is also true: if yields drop, prices rise. The outlook for rates, spreads, and defaults should thus offer a relatively clear picture of what to expect out of bonds in 2024.

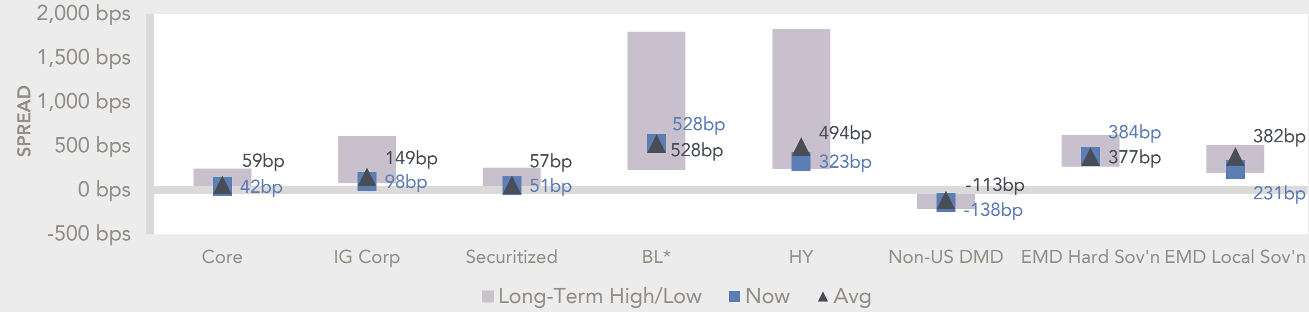
From a starting point, yields across most fixed income sectors are above their long-term averages, which should provide meaningful income return to bond portfolios. Credit fundamentals are healthy, and as a result, spreads are at or below long-term averages, which leaves limited room for further compression (and thus price appreciation from the same dynamic). Additionally, the market has already priced in five to six rate cuts for the year, so it is questionable how much the actual cuts will move the markets from this point forward. That said, previous rate cut regimes have benefitted credit markets and the absolute level of yields in today's market suggest that trend could continue.

FIXED INCOME YIELDS



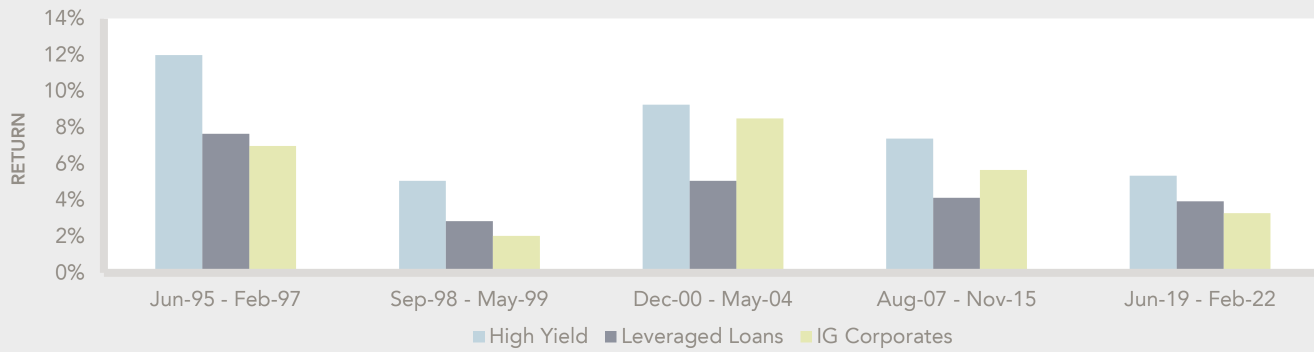
Source: Bloomberg, Credit Suisse, JPMorgan as of December 31, 2023. Long-term high, low, and average based on longest available data.

FIXED INCOME SPREADS



*BL spread over LIBOR, not over Treasuries.
Source: Bloomberg, Credit Suisse, JPMorgan as of December 31, 2023. Long-term high, low, and average based on longest available data for each index.

CREDIT PERFORMANCE DURING RATE CUT REGIMES

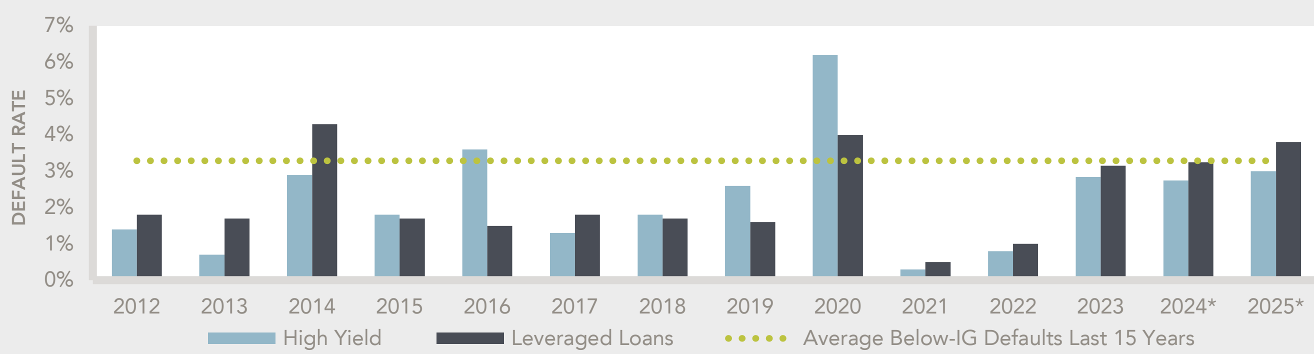


Source: Bloomberg, Credit Suisse as of December 31, 2023

Finally, default expectations have been revised lower due to the increasing likelihood of a soft landing for the U.S. economy, driven primarily by the resilient consumer. Financial stress tends to manifest itself first in the credit markets and given the relatively benign outlook for defaults combined with the overall level of yields, it is difficult to foresee a negative year for bonds across the three potential paths for rates:

- If yields remain steady over the year, returns closely resemble yield levels as of January 1;
- If we see an economic downtown and rates fall faster than expected, bond prices rise as suggested by their duration; returns will be somewhat offset by spread widening, but returns should be higher than starting yields;
- If rates stay higher for longer, prices can be expected to fall slightly, but a negative total return would be unlikely due to the overall level of yields and subsequent income.

DEFAULT RATES CAME IN BELOW EXPECTATIONS FOR 2023

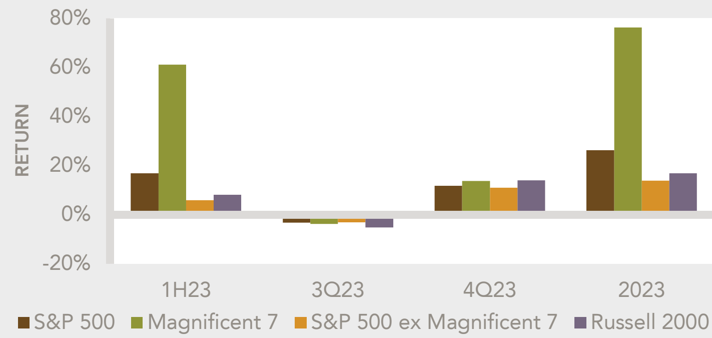


Source: J.P. Morgan as of December 31, 2023. *Projected.

U.S. EQUITIES

U.S. equities surged last year, most especially growth stocks. However, there is legitimate concern about how much influence the "Magnificent Seven" exerted on overall returns, though that effect faded in the second half of the year. While it is entirely unrealistic to expect a similar magnitude of returns this year, what factors will likely drive the market in 2024?

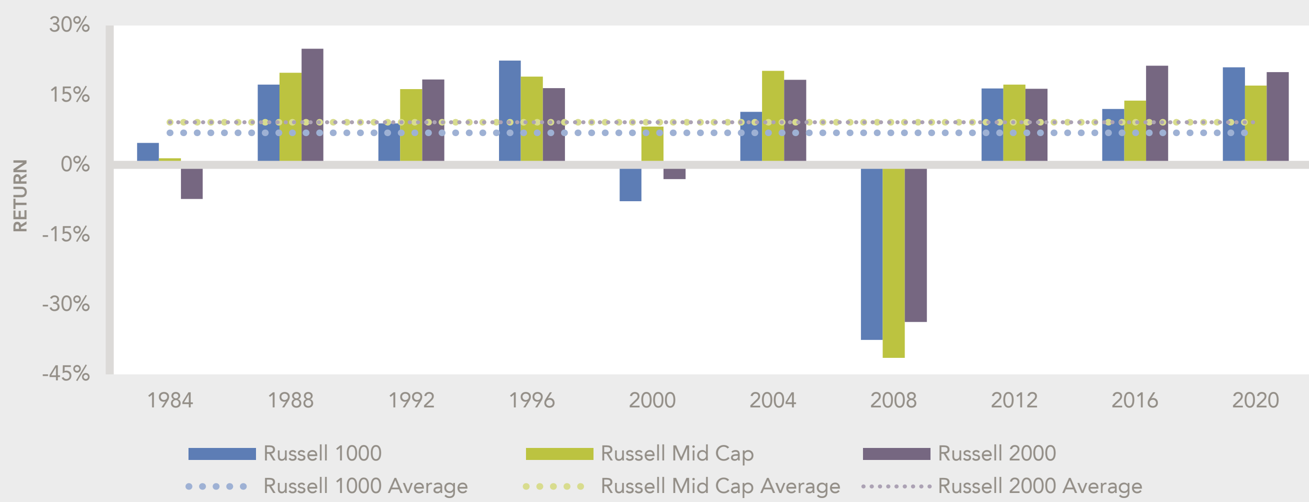
MAGNIFICENT SEVEN DOMINANCE WANED IN 2H23



Source: FactSet as of December 31, 2023. The "Magnificent Seven" includes Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla. SPY ETF used as a proxy for S&P 500. IWM ETF used as a proxy for Russell 2000.

As mentioned earlier, this is an election year (in case you haven't heard…). Predictably, the unknown outcome can fuel additional volatility as market pundits debate how corporate profitability and consumers will be impacted. However, volatility tends to fall once the outcome is known — regardless of the winner — simply because the uncertainty around policy is removed once the election is finished. And in spite of the additional volatility, equity markets tend to be positive during election years. Certainly, it's not a guarantee of a positive year, but equally important is that the presidential election has not been a material headwind for equity markets in the past, and 2024 should be no different.

PRESIDENTIAL ELECTION YEARS HISTORICALLY POSITIVE FOR U.S. EQUITIES

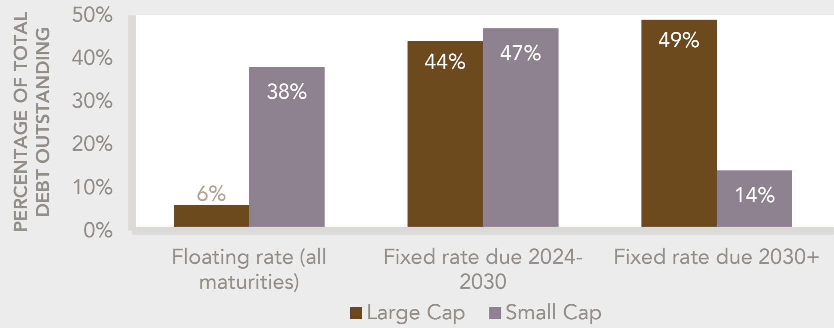


Source: Bloomberg as of December 31, 2023

From a valuation perspective, small caps continue to offer the most value and after a year of negative earnings, 2024 earnings are expected to grow by more than 20%. Nonetheless, the same was true last year and with the exception of value stocks, large caps materially outperformed. It is worth noting from the chart at top, however, that if the Magnificent Seven were removed from the S&P 500 Index, small caps actually outperformed in 2023. Furthermore, the Russell 2000 Index outperformed the S&P 500 Index by more than 8% in the final two months of the year, without controlling for the Magnificent Seven. However, the attractive valuations and positive momentum for small caps must be balanced with their debt profile, especially relative to large caps. With the Fed poised to cut rates in 2024, the frequency and magnitude will undoubtedly influence small caps more than large caps given their larger share of floating rate debt. By their very nature, small-cap stocks are more volatile and this dynamic bears watching as 2024 plays out. Based exclusively on valuations, small caps could be expected to lead the pack in

2024, but the higher percentage of floating rate and more immediately due debt could handicap any valuation advantage currently offered in the space.

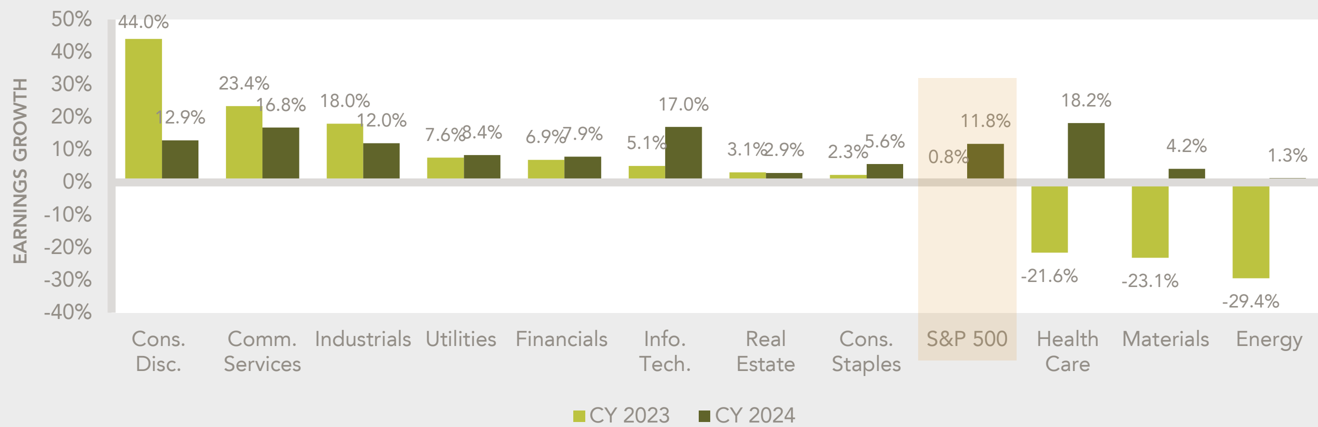
OUTSTANDING DEBT BY MATURITY YEAR



Source: J.P. Morgan as of December 31, 2023. S&P 500 used as a proxy for large cap and Russell 2000 used as a proxy for small cap. Excluding financials.

Ultimately, earnings drive sustainable equity market returns. Earnings for 2023 were largely mixed, and multiple expansion meaningfully contributed to last year's returns. The good news is that current 2024 earnings projections appear stronger than what 2023 delivered, albeit earnings projections are typically revised downwards during the year.

S&P 500 EARNINGS GROWTH



Source: FactSet as of December 31, 2023

Finally, the dynamic outlined in our Great Expectations newsletter last week could prove to be more forceful than any of the factors outlined above. Markets react to changes in expectations; as it currently stands, the market is expecting five to six rate cuts over the course of 2024, and the dramatic market rally — especially small caps — in November and December can be explained by the change in sentiment around future rates. The pullback in small caps to start 2024 suggests maybe there was too much exuberance and markets realized they got ahead of themselves. At the same time, however, large caps have reached all-time highs, so there is not a clear answer but the narrative around the timing and magnitude of cuts can be expected to go a long way towards determining what kind of year we see from U.S. equities.

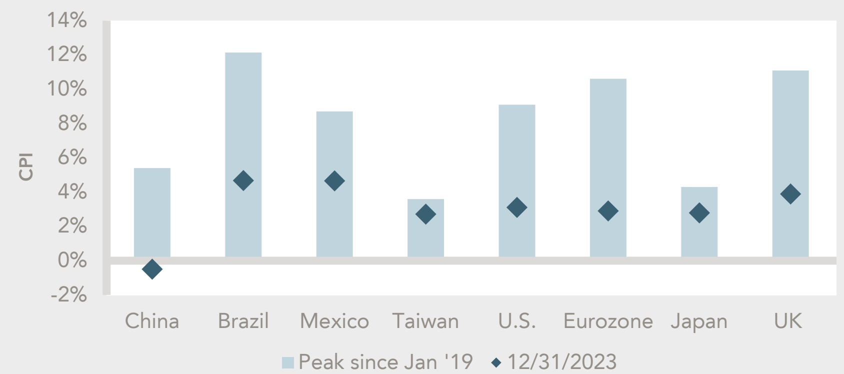
On the whole, market breadth returning in the second half of 2023 could bode well for the 2024 outlook because when markets reach historical highs in concentration similar to late last year, the equal-weighted index tends to outperform while the leaders going into peak concentration tend to be the laggards coming out. Though the exact timing of this reversal is unknown, it is a risk because any misstep could hit higher valuations disproportionately and weigh on the entire index, so earnings reports from the Magnificent Seven will remain in focus throughout the year. Overall, there appears to be sufficient support in place for a positive year, albeit a more moderate one than 2023, but the Fed pivot could have a significant impact on the market.

NON-U.S. EQUITIES

Similar to U.S. equities — though at a more modest level — non-U.S. equities also delivered positive returns in 2023, with developed large caps up 18.2%, while emerging markets and developed small caps were up 9.8% and 13.2%, respectively. Looking towards this year, we think the following factors will have the most impact on markets:

- Lower interest rates
- Japanese governance reforms
- China, as well as emerging markets beyond China
- Geopolitical uncertainty/widespread elections

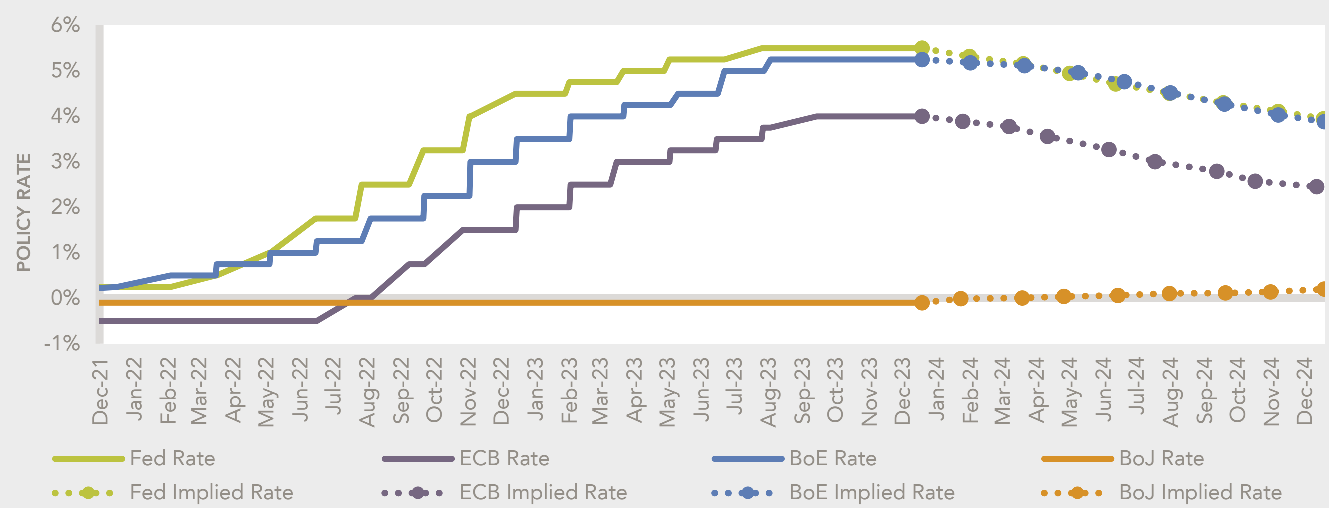
INFLATION ACROSS THE GLOBE



Source: Bloomberg as of December 31, 2024. Data pulled January 9, 2024.

As discussed in the U.S. equity section, lower interest rates should be a tailwind for global equity markets. Given that inflation is easing both domestically and abroad, it is reasonable to expect central banks to cut rates at some point this year, similar to how the Fed is poised to do so in the U.S. As shown below, most of the major central banks will ease later this year, at which point the main questions will center around market expectations vs. actual cuts and the divergence between the two. Under the presumption that cuts are mostly aligned with market expectations, lower rates should push non-U.S. equities higher.

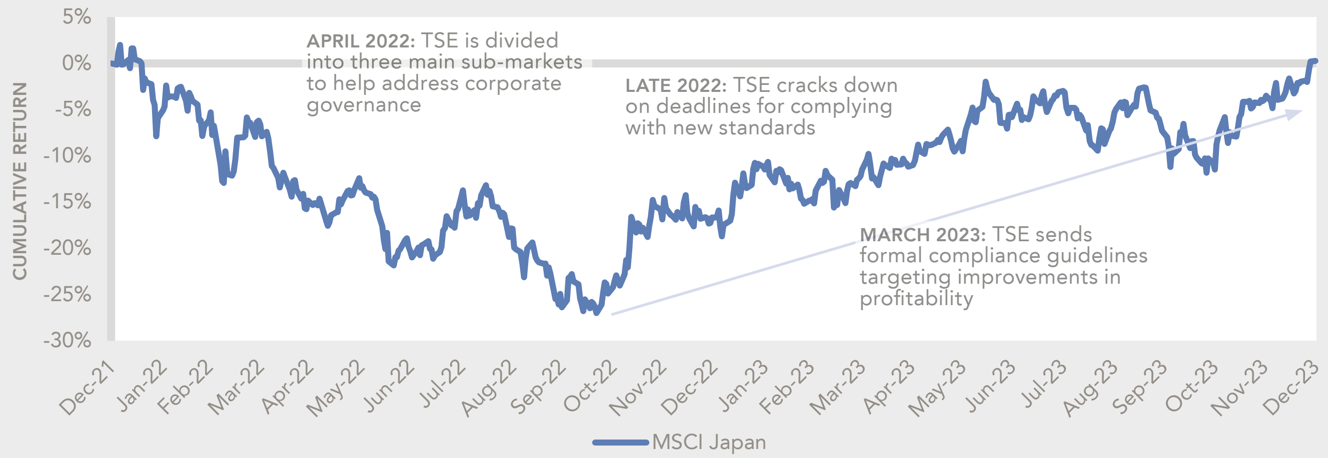
2024 INTEREST RATE TRAJECTORY PROJECTIONS



Source: Bloomberg as of December 31, 2023. Data pulled January 4, 2024.

An exception to this trend across the developed world can be found in Japan, as that nation's central bank is expected to increase interest rates in 2024. These higher rates will mark the end of Japan's ultra loose monetary policy and help to rein in inflation. Furthermore, recently enacted shareholder-friendly corporate governance reforms in Japan should also help fuel the stock market. More specifically, the Tokyo Stock Exchange (TSE) has incentivized listed companies to boost valuations and earnings, and companies could potentially be delisted if they do not show they are utilizing their capital efficiently. Since these initiatives were announced, the Japanese stock market has rallied significantly after bottoming in September 2022. The positive investment flows from 2023 are expected to continue their momentum, which in turn should help boost Japanese equities as well as the broad non-U.S. equity market, given Japan's 14% weight in the index.[1]

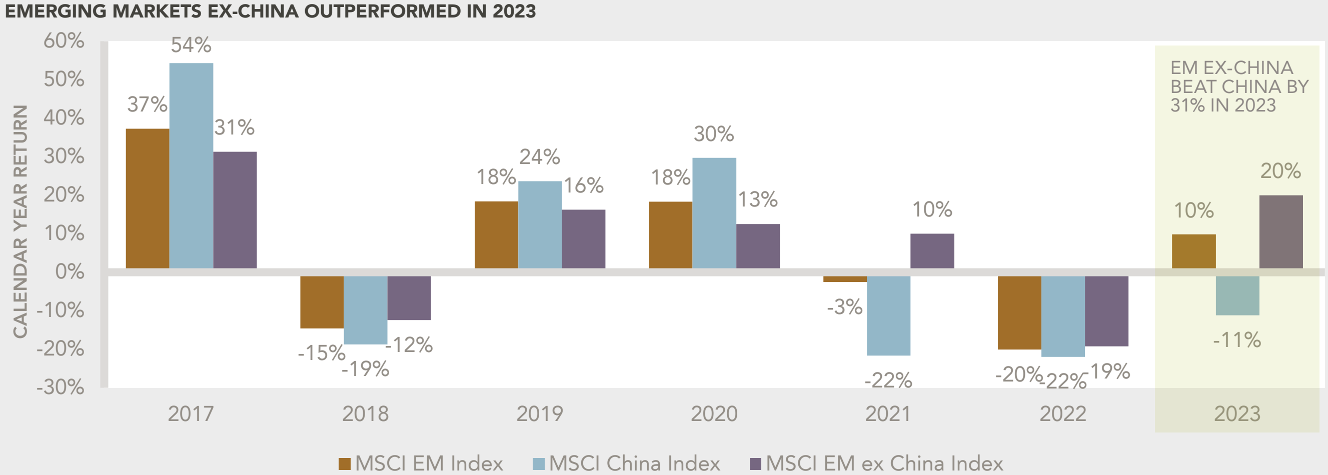
JAPANESE GOVERNANCE REFORMS PRESENT OPPORTUNITY



Source: Bloomberg, "Action to Implement Management that is Conscious of Cost of Capital and Stock Price," Tokyo Stock Exchange, Inc.

We noted above that the emerging markets benchmark lagged the developed large-cap index for the full calendar year. These more muted returns for emerging markets can be attributed to the poor performance of China in 2023, as challenges in its property sector persist and sentiment regarding the country's economy remains overwhelmingly negative. However, there are potential bright spots for the beleaguered nation in the year ahead if we see supportive fiscal stimulus from the Chinese government and a rebound in consumer confidence (though consumer spending in China remains well below historical averages). These are not guarantees though and we will need to see credible data to demonstrate reversals of these trends.

EMERGING MARKETS EX-CHINA OUTPERFORMED IN 2023



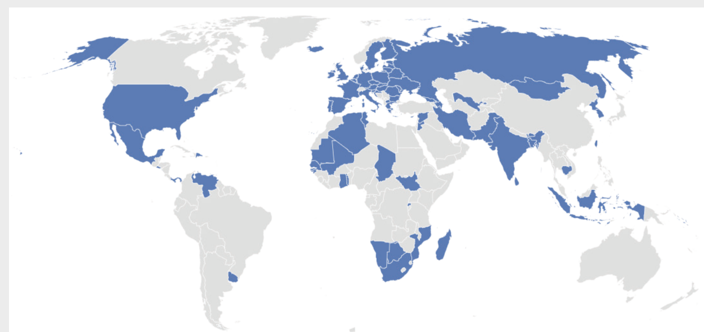
Source: Bloomberg

[1]MSCI ACWI ex USA index as of December 31, 2023

As it relates to emerging markets more broadly, countries like Mexico, India, and Vietnam stand to benefit from the continued theme of supply chain reconfiguration, as the U.S. and other major players on the world's stage diversify away from China. Additionally, Indian companies stand to benefit from constructive reforms championed by the Modi administration. These very trends led the rest of the emerging markets ex-China to significantly outperform the broad emerging markets index, and until we see a notable rebound from Chinese equities, a similar pattern could repeat itself in 2024.

Finally, it is impossible to assess non-U.S. equity markets without consideration of geopolitical factors. The Russia-Ukraine war will hit its two-year anniversary next month, while the Israel-Hamas conflict recently hit its 100-day mark. Any further escalation on these fronts can be expected to drive volatility higher, with more downside potential for markets should other major countries take a more active role. Additionally, the U.S. is not the only major country that will hold an election this year. Rather, 2024 has already been billed as the "year of the election" with national elections slated in more than 60 countries. Uncertainty surrounding results, or the election of leaders deemed a threat to global security and/or free markets could also slow markets.

60+ COUNTRIES HOLDING ELECTIONS IN 2024

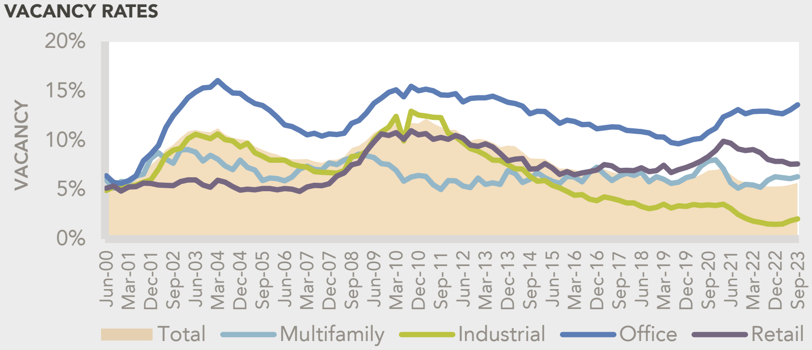


Collectively, non-U.S. equity markets are among the more difficult to predict because of the inherently divergent countries, economies, and policies. As we look at all of the factors for this year, we are carefully watching the geopolitical front and election results. Under the presumption that neither of the current conflicts worsen, election results are largely peaceful with stable administrations occupying office, and an absence of any further conflicts, the lower interest rate environment across developed markets combined with the favorable trends in emerging markets (excluding China) should broadly support non-U.S. equities in the year ahead.

REAL ESTATE

Despite the tone of "normalcy" across asset classes in 2024, real estate is the exception. Historically, core real estate allocations have provided meaningful income coupled with price appreciation. However, the brisk rise in interest rates along with the rapid descent of the office sector — driven largely by work from home trends brought forward by COVID-19 yet are here to stay — now cloud the outlook. The most recently available return data from the fourth quarter shows that all 25 funds included in NFI-ODCE index reported negative appreciation and downward pressure on pricing is expected to persist through the first half of 2024. Additionally, income levels for office are deteriorating. This trend reflects the rising cost of variable rate debt and lower in-place rents for many office portfolios, as well as climbing vacancy rates for the beleaguered office sector. It is worth noting, however, that net operating income growth remains positive

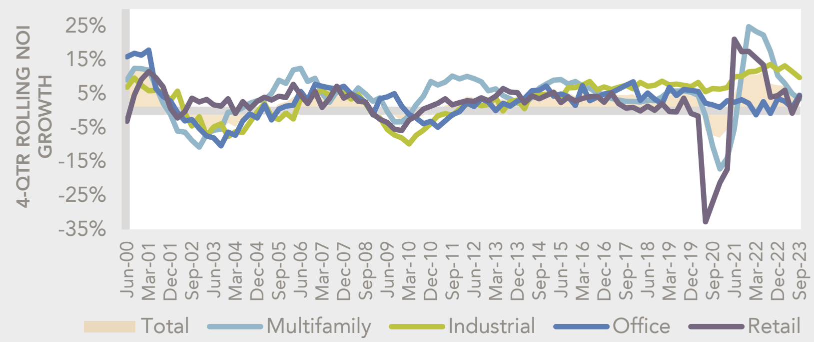
VACANCY RATES



Source: NCREIF (NPI Trends Report) as of September 30, 2023 within the industrial and residential spaces, as well as for a growing number of retail assets. That said, the pace of market rent growth has slowed materially.

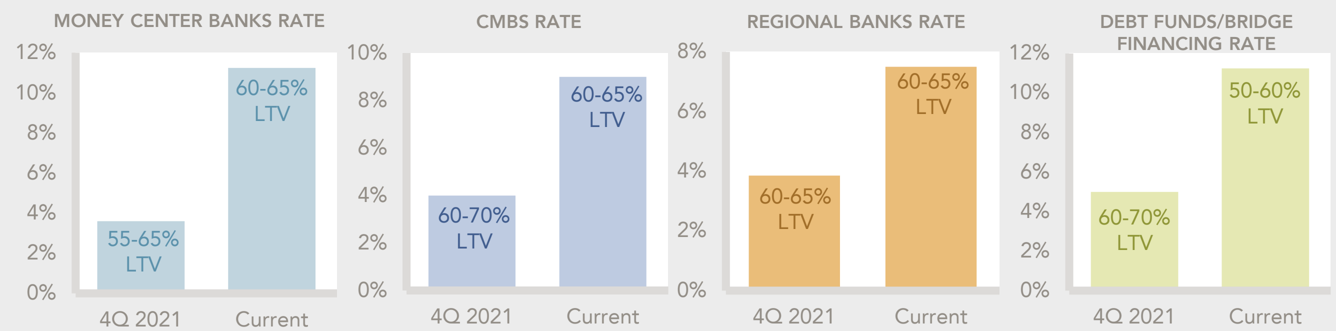
Furthermore, the availability of debt financing continues to be tight given last year's bank failures. Specifically, regional banks were a major source of commercial real estate financing, but over the past year have pulled back lending volume due to elevated bank balance sheet and capital requirements. Higher base rates and wider credit spreads have created an absolute cost of capital that is more expensive, creating further short-term headwinds for the asset class.

NOI GROWTH



Source: NCREIF (NPI Trends Report) as of September 30, 2023

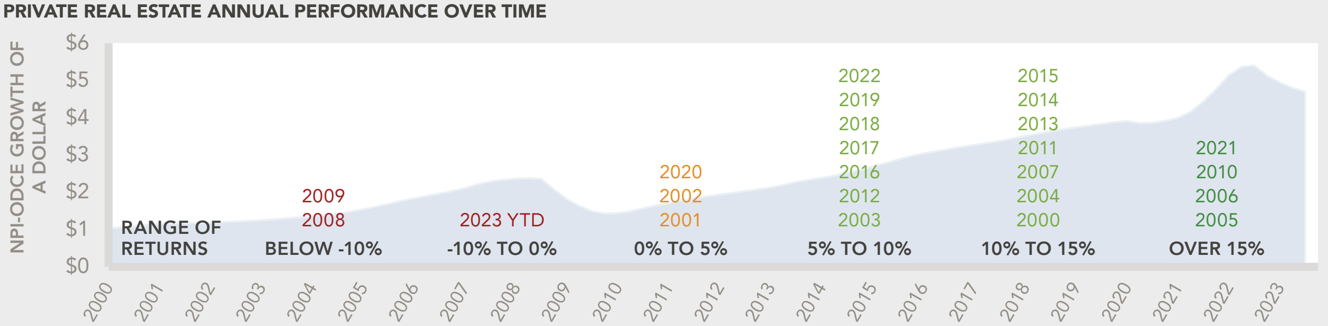
FINANCING HAS BECOME PROHIBITIVELY EXPENSIVE FOR OFFICE



Source: JLL Research as of June 30, 2023

All of that said, real estate is a long-term allocation in portfolios and long-term fundamentals across industrial, multifamily, and select niche sectors (particularly life sciences, affordable housing, and hospitality) in markets with dynamic job and population trends remain strong. As we wrote last year, there is significant bifurcation across sectors, geographies, and property classes and while office is currently the main culprit for the struggles of the asset class, the majority of other sectors should deliver positive returns in 2024. Real estate is not immune to temporary setbacks, but over time has proven its worth as an accretive constituent of investment portfolios, and that is our expectation as we move beyond 2024.

PRIVATE REAL ESTATE ANNUAL PERFORMANCE OVER TIME



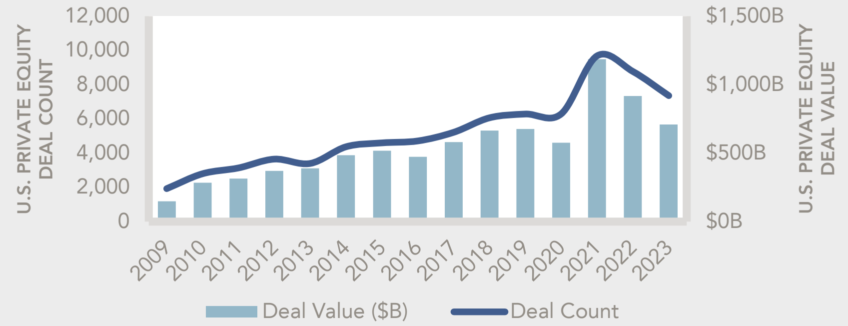
Source: NCREIF as of September 30, 2023

PRIVATE MARKETS

The higher rate environment has weighed on private equity, slowing both overall deal and exit activity. If there is any good news to the slowdown, it is that valuations fell in 2023, and this should help spark a rebound in deals for 2024 and beyond. With rates poised to drop and given the build-up in dry powder over the last few years, it is reasonable to expect a normalization for both deals and exits in 2024, which should benefit the asset class as a whole.

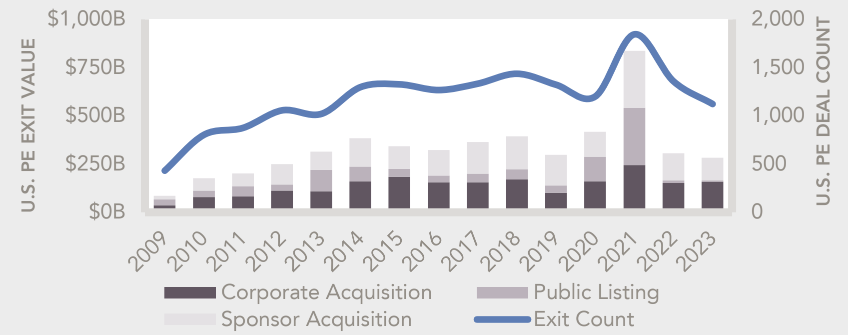
The private credit space returned roughly 1.2% during the third quarter of 2023 and is up 5.8% on a year-to-date basis through the end of September (most recently available data). Middle market direct lending posted returns of 3.2% and 8.9% over the same time periods, respectively. Direct lending has benefited from rising interest rates and given the expectation that rates will remain higher for longer, the space may continue to deliver attractive income going forward. Private equity transaction volume should pick up this year after a challenging 2023, with a majority of this financing likely supplied by non-traditional lenders within the private credit space. Defaults have remained low as the economy exhibited strength in 2023, though default rates may increase modestly in 2024 due to elevated debt servicing costs and the potential for economic weakness. That said, given the elevated yields offered by direct lending strategies, investors appear to be adequately compensated for this risk, and this should translate to another positive year for the asset class.

PRIVATE EQUITY DEPLOYMENT



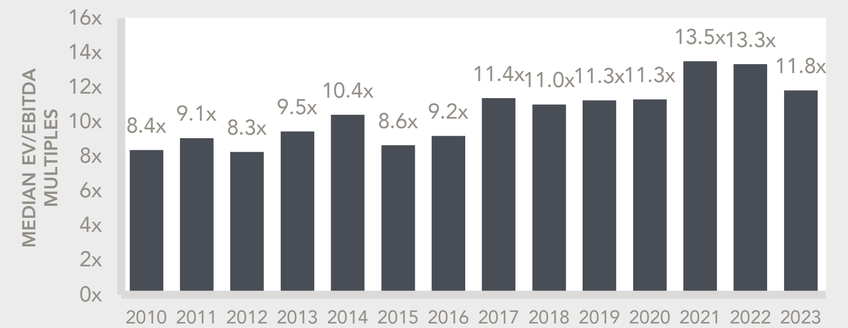
Source: Pitchbook, U.S. PE Breakdown Summary as of December 31, 2023

PRIVATE EQUITY EXIT ACTIVITY



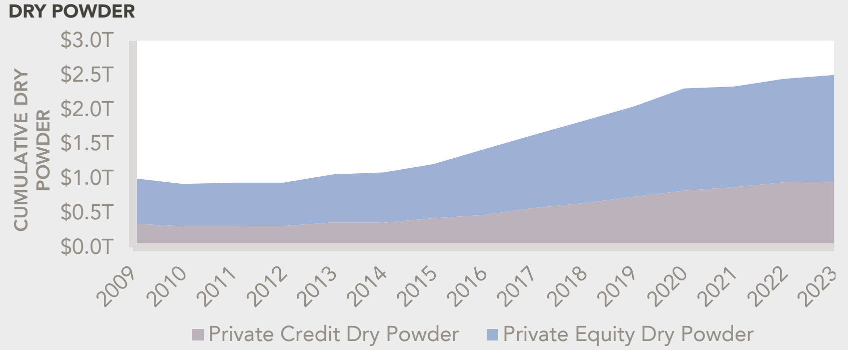
Source: Pitchbook as of December 31, 2023

MEDIAN NORTH AMERICA PE BUYOUT EV/EBITDA MULTIPLES



Source: Pitchbook as of December 31, 2023

DRY POWDER



Source: PitchBook as of March 31, 2023

MIDDLE OF THE ROAD

Given the roller coaster ride of the last four years, we would all welcome a year without any radical surprises. There will always be unexpected twists and turns each year, but at present, most global economies appear to be on solid ground, interest rates have stabilized, and markets are fairly valued. We are carefully watching the geopolitical front to see what the elections bring as well as a hope for more peace and less conflict between warring nations. More specifically in the U.S., the Fed pivot bears watching, not only for the pace and magnitude of cuts, but the rationale behind them. The U.S. election has shown to elevate volatility in the run-up to the actual election, and we expect the same pattern this year. Finally, the plight of China's economy will have ramifications at home and abroad, both for economic growth and capital markets. All that said, we see less dramatic threats to markets now than in years past; on the whole, most markets — real estate as the lone exception — appear poised to deliver returns roughly in line with their longer-term averages. Such a year will not go down as a remarkable year, nor will it be detrimental to meeting risk and return goals. In essence, the 40 degree day for capital markets — average in a good way!

Until next time,

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