

Global Market Review

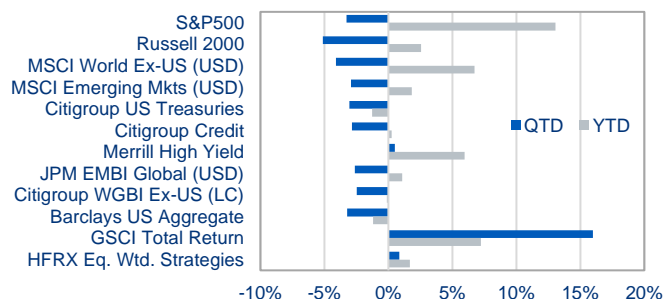
Summary

Global equity markets tumbled in the third quarter, eroding the large gains of the first half of the year. Nevertheless, with the exception of China, most equity markets remain solidly positive for the year. The Chinese market has been weighed down by a sluggish post-Covid rebound, depressed consumer demand, and continued distress in the property market and financial sector. Global bond markets also sold off in the third quarter, as long-term yields rose. U.S. Treasury securities with maturities of 10 or more years were among the worst performing assets of the third quarter. U.S. investment grade corporate bond prices also declined in the quarter, while high yield bonds managed a small gain. Oil prices jumped in the third quarter in the wake of OPEC+ production cuts and lower U.S. stockpiles, adding to already strong gains. The U.S. dollar rose against most major currencies.

Exhibit 1

Performance of Major Market Indices

Source: Bloomberg. Year to date through September 30, 2023.



Global stocks and bonds sold off in the third quarter.

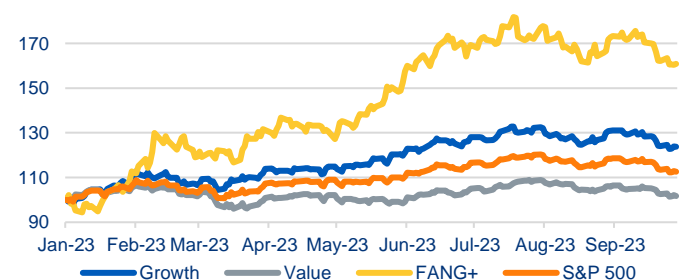
Large Tech Stocks Dominate U.S. Market

The S&P 500 fell 3.3% in the third quarter but remains up 13.1% in the first nine months of the year. The U.S. equity market's sell-off coincided with a spike in 10-year U.S. Treasury yields, leading to speculation that both markets were adjusting to the possibility that the U.S. would avoid a recession, inflation would stay stubbornly above the Fed's target, and yields would therefore remain higher for longer than previously thought. However, there are conflicting and contradictory crosscurrents in the U.S. economy casting doubt on this positive outlook for U.S. growth. The Conference Board's index of leading economic indicators, for example, continues to point to slowing output and possibly a mild contraction in the face of weak new orders, deteriorating business sentiment, and tight credit conditions. Housing, a sector that is especially sensitive to interest rate movements, is also pointing to an economic slowdown. With 30-year mortgage rates at 7.5%, the highest rate since 2000, existing home sales have plummeted, and the pace of new home sales is falling. Outside of the U.S., the Chinese and European economies, two key engines of global growth, are struggling.

Exhibit 2

U.S. Equity Market Moves Narrowly Based

Source: Bloomberg. Index. January 1, 2023 = 100.



Despite these crosscurrents, investors have pushed stock prices and earnings multiples higher in 2023. Moreover, market movements, both up and down, have been narrowly based and largely driven by a small set of mega-cap growth stocks in the tech sector. The FANG+ index comprising these market leaders fell 4.1% in the third quarter but remains up over 60% so far this year (Exhibit 2). At its peak in July, the index was up more than 80%. The concentration of the U.S. market on a

small set of overvalued stocks subject to large price swings driven by common factors has increased overall market vulnerability.

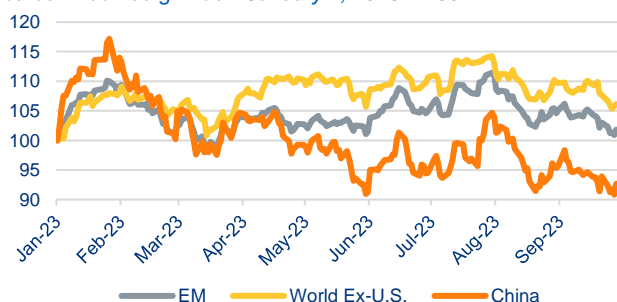
Chinese Equities Remain the Outlier

The MSCI World ex-U.S. index of advanced equity markets fell 4.1% in the third quarter but remains up 6.7% so far in 2023. The MSCI Emerging Markets index also gave up some earlier gains in the third quarter. It remains up 1.8% in the first nine months of the year. China has significantly underperformed other global markets and been a significant drag on the broader emerging market index (Exhibit 3).

Exhibit 3

China Lags Other Equity Markets

Source: Bloomberg. Index. January 1, 2023 = 100.



The Chinese economy, a critical engine of global growth, has been sputtering. Economic activity has slowed, consumer confidence is depressed, youth unemployment is rising, and sales and new construction in the property sector have fallen. Moreover, high debt levels, concerns over asset quality, falling bank profitability, and the exposure of the financial system to the property sector are contributing to financial market vulnerability. Faced with these headwinds, Chinese equities and its currency have declined, and disinflationary forces intensified, prompting China's central bank to ease policy.

Bond Markets React to "Higher for Longer"

The September FOMC meeting left the Fed funds rate target range unchanged at 5¼ - 5½%, a 22-year high. While this action appeared dovish, markets interpreted the FOMC's words as hawkish. In the wake of the decision, the yield on 10-year U.S. Treasuries jumped, bringing the increase in 10-year yields so far this year to 80 basis points. Virtually all of this increase has been driven by rising real yields on TIPS, with implied inflation expectations remaining little changed. With September's increase, the deep inversion of the yield curve moderated. Reflecting these yield movements, the broad U.S. Treasury index lost 3.0% in the third quarter, while bonds with maturities of 10+ years fell 11.4%. For the year as a whole, these indicators are down 1.3% and 8.3%, respectively.

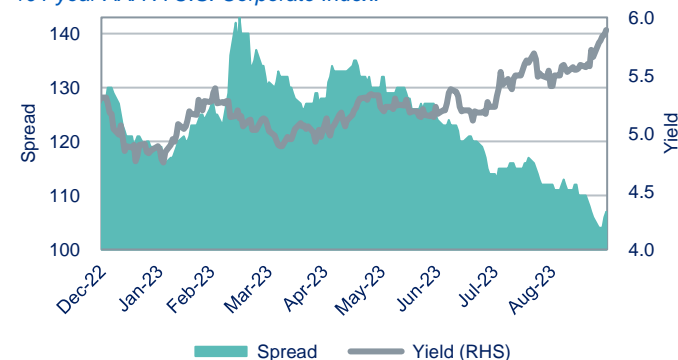
With the broader increase in yields, investment grade bonds lost ground in the third quarter. Narrowing credit spreads have dampened part of the impact of rising rates on corporate funding conditions and bond prices (Exhibit 4). The high yield sector, cushioned by its higher coupons and shorter duration, managed a small gain in the third quarter. So far in 2023, the

investment grade sector is down 1.1% while the high yield sector has gained 6.2%. Both have outperformed U.S. Treasuries because of the impact of spread tightening. The difference in performance between investment grade credit with maturities of 10+ years and their Treasury counterparts is particularly striking with the former down 2.3% so far this year versus the latter's 8.3% decline.

Exhibit 4

Spread Tightening Blunts Rising Yield Impact

Source: Bloomberg. Yield (in percent) and spread (in basis points) on 10+ year AAA-A U.S. Corporate Index.



Outside of the U.S., the WGBI ex-U.S. index of advanced sovereign bonds has declined 3.7% in the first three quarters of the year. The EMBI index of emerging market sovereign bonds has returned 1.1%, despite concerns over the debt servicing capacity of many emerging markets.

Hedge Funds Modestly Higher

The HFRX equal-weighted hedge fund index is up 1.7% so far this year. Strategies with a bias toward equity beta and growth have performed best, reflecting particularly strong market gains earlier in the year. High levels of economic uncertainty contributed to a wide dispersion across macro-oriented funds, which in aggregate are little changed so far this year.

Tighter Credit, Empty Offices, Falling Prices

Real estate as measured by the NCREIF Open-End Funds Core Index (reported with a delay) lost 3.9% in the 12 months through June 2023 as rising yields and shifting patterns of work and consumption weighed on the market. The office sector was particularly hard hit, losing 14.5%. Only the hotel sector, benefiting from a spurt in post-COVID travel, managed gains.

Private Equity Falls, VC Falls Harder

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) fell 5.2% in the 12 months through March 2023. Venture capital strategies lost 18.2%, compared to a 10.3% decline for growth equity strategies and a modest gain for buyout. Venture capital's lofty valuations contributed to its sharp decline. Across all strategies, transaction activity has slowed significantly. Fund raising is also down, although firms remain flush with dry powder. Tighter credit and a weak exit market are likely to continue to weigh on private equity valuations.

Outlook & Strategy

Resilience and adaptability are essential attributes of investment portfolios. This is especially true when, as now, asset markets appear unbalanced, risk premiums on equities, long-dated bonds, credit, and real estate are compressed, normally stable macro aggregates have been extraordinarily volatile, and geopolitical tensions are high.

The global economy and markets are still feeling the reverberations of the COVID shock. In its wake, we experienced the deepest fall in output since the Great Depression, followed by the most rapid economic rebound in history. Fueled by fiscal and monetary stimulus, supply chain bottlenecks, and pent-up consumer demand, inflation across major economies hit 40-year highs.

The Fed's response was commensurately aggressive, pushing the Fed Funds rate up 525 basis points in 19 months while also reducing the size of its balance sheet. Major global central banks acted with equal vigor. Whether inflation and the tightening cycle have now peaked, and a U.S. recession has been avoided despite the jump in rates remain open questions. Of more immediate concern from an investment perspective is the ultimate impact of steeply rising rates on asset prices. So far, with the exception of long-dated bonds, this impact has been limited, and most risk premiums are low. However, like the economic outlook, whether markets can avoid a downturn also remains an open question.

To build resilience, we incorporate multiple sources of diversification in portfolios and favor positions whose pricing is supported by strong fundamentals. We have also enhanced portfolio adaptability by raising liquidity. We have positioned client portfolios to exploit the wide dispersion of valuations across markets, calibrating these positions as a function of their expected contribution to risk while limiting exposure to any single risk factor. We believe that this approach is the best way to navigate portfolios through the current highly uncertain environment.

Unbalanced and Expensive

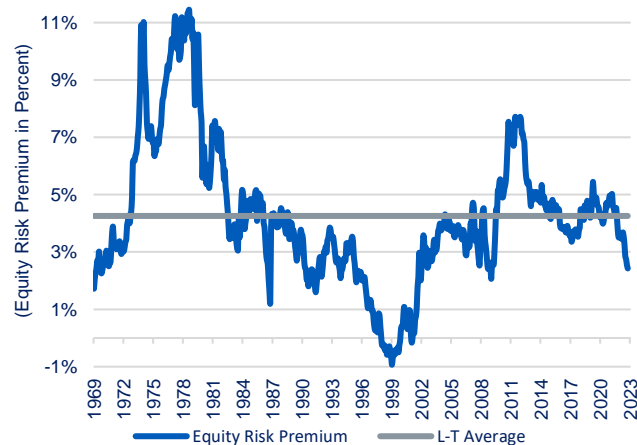
The U.S. equity market is unbalanced. Price movements have been dominated by a small number of mega-cap growth stocks in the tech sector. The top 10 stocks in the S&P 500 have outperformed the other stocks in the index by 33 percentage points this year. This dynamic has pushed the concentration of the S&P 500 to the highest level in over 40 years, well over that of the 2000-01 tech bubble. At end-September, the 10 largest firms represented 34% of the total capitalization of the index.

The market is also expensive, trading nearly 30% above our estimate of fair value. The market's gains this year reflect multiple expansion, rather than earnings growth, which has been lackluster. Moreover, with the sharp rise in real yields on TIPS, the compensation offered to investors for taking equity market risk over a more certain real yield on bonds, known as the equity risk premium, has plummeted (Exhibit 1).

Exhibit 1

Equity Risk Premium Plunges with Rising Real Yields

Source: FRED. ERP = normalized earnings yield less TIPS real yield.



The market's overvaluation and concentration on a small number of firms exposed to similar risk factors breed instability and risk. This dynamic also opens up opportunities for adding value through stock selection. The dispersion of the valuations of rich and cheap U.S. stocks is at levels not seen since the tech bubble and stands nearly two standard deviations above average. Given this environment, we are underweight equities overall structured as a significant underweight to U.S. equities partially offset by above benchmark allocations to developed and emerging non-U.S. equity markets that are more favorably priced. Within U.S. equities, we favor value over growth stocks whose relative valuations are at two decade highs.

Treasury Yields Rise Sharply

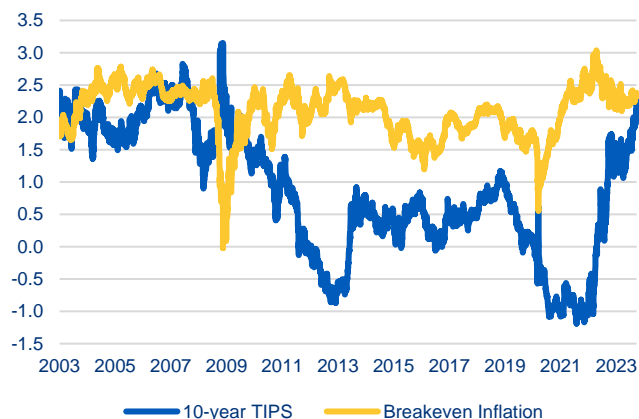
U.S. Treasury yields have jumped sharply higher, propelled by monetary policy tightening and stubbornly high inflation. Much of the increase in Treasury yields reflects rising long-term real yields. The real yield on 10-year TIPS is up over 350 basis points from its lows in 2021-22 (Exhibit 2). Long-run inflation

expectations, which rose in 2021-2022, have now fallen back to below 2.5%, in line with their usual historic range.

Exhibit 2

Real Rates Rise; Inflation Expectations Stabilize

Source: Bloomberg. Real yield and inflation expectations in percent.

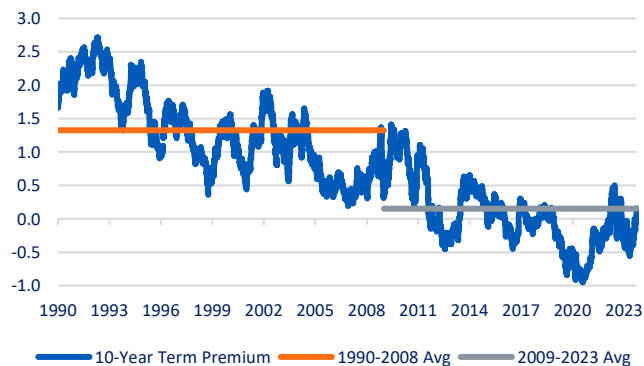


In contrast to the equity risk premium, which has compressed, the term premium measuring the compensation for investing in long-dated bonds versus a series of short-dated bills has risen recently (Exhibit 3). It now stands at about its average since the Great Financial Crisis, a period marked by historically low yields and for the most part low inflation. Seen from a longer perspective, the current term premium appears low, especially considering the uncertainty surrounding the future path of inflation and rates (see Exhibit 3). Which historical perspective is the right one to judge the adequacy of the term premium and thus the likely future path of yields is another open question.

Exhibit 3

Term Premium Remains Low Despite Rate Volatility

Source: Fred. Term premium = estimated compensation for holding a longer maturity bond versus a series of short-dated bills.



We believe that the probability distribution of future Treasury returns has become more symmetrical following the sharp increase in rates, and the valuation of U.S. Treasuries is about fair. We are therefore retaining our neutral duration position. The outlook for credit markets, in contrast, is mixed as firms face higher financing costs and the possibility of reduced credit availability. In view of these uncertainties, we are retaining a slight underweight to credit. Within credit, we see opportunities in mortgage asset-backed securities which have a particularly

attractive yield and risk profile. We are also expanding our allocation to direct lending to take advantage of opportunities opened up by the retrenchment of bank lending.

Conditions Right for Low Beta Hedge Funds

We are focusing on minimizing the beta of our hedge fund portfolio to maximize its diversification across multiple alpha sources. Hedge funds strategies seeking to exploit the wide valuation dispersion of stocks were particularly successful. We believe that the diversification benefit of our approach to hedge fund investing is an important source of portfolio resilience. Balancing these alpha opportunities and diversification benefits with the desirability of maintaining adequate liquidity, we retain a neutral allocation to hedge funds.

Real Estate Remains Challenged

The real estate sector faces challenges from rising interest rates, falling demand for certain property types such as office and retail, and reduced credit availability. Small regional banks, traditionally significant lenders to commercial real estate (CRE), have reduced lending to the sector following the failures of SVB and others. Their pullback comes at a difficult time for borrowers, given significant upcoming loan maturities and lower values requiring owners to contribute significant equity to obtain what little financing is available. Given these challenges, we have temporarily suspended new commitments to the sector. However, CRE is highly diversified. Some sectors – notably industrial, residential, and alternatives such as storage and data centers – are benefitting from high demand and rental income growth, providing an inflation hedge. TIPS also provide an inflation hedge, one that is even more direct than real estate. Following their recent spike, the real yields on TIPS appear to be at about fair value. We are therefore retaining a neutral allocation to TIPS.

Private Markets Adjust to Higher Rates

The excesses engendered by the wall of money flowing into private equity strategies over the past several years are gradually moderating. Although rising rates and less buoyant equity markets have slowed the inflowing tide of money, global dry powder held by private equity firms is at record levels. Private equity valuations are gradually adjusting to a wobbly public market that has become less open to IPOs. Venture capital and growth equity strategies have seen the largest reductions in valuation, while buyout funds have fared better. Private equity strategies favoring investments in firms in the industrial and consumer sectors with solid earnings growth have been relatively resilient to more costly and less readily available funding. Transaction activity has slowed significantly, and the exit market is weak. We anticipate continued lackluster returns as economic headwinds, tighter credit, a weak exit market, and pricing adjustments in public markets flow through to valuations. We are continuing a disciplined approach to vintage year diversification in the expectation that these investments will generate superior returns over time.

Special Topic

2023 Idea Lab Highlights

This year's Idea Lab examined the outlook for value-added investments, and the challenges of portfolio management in an environment beset by aggressive monetary policy tightening, high asset valuations, and shifting geopolitical tensions. While it is difficult to capture the breadth and depth of the discussions across the two-day forum, four areas were particularly noteworthy: the importance of diversification and a long time horizon to navigating today's turbulent markets, the opportunities arising from the commercialization of artificial intelligence, the value-added returns available today in the credit and mortgage markets, and the potential offered by disruptive businesses operating in the consumer sector. Additionally, Christopher Varelas, author of *How Money Became Dangerous: The Inside Story of Our Turbulent Relationship with Modern Finance* offered cogent observations on the world of finance. Finally, a special session reviewed Strategic's initiatives with Emerging Managers, and the intersection of these efforts with our work in the areas of diversity, equity, and inclusion.

Opportunities Amongst Regime Change

The Strategic team led the forum with a review of market dynamics and valuations, placing particular emphasis on the potential ramifications of rising real interest rates on the future returns of various asset classes. Uncertainty concerning the future returns of equities highlighted the importance of diversification in client portfolios, and the benefits of adding uncorrelated sources of excess returns like those provided by private markets and opportunistic investments. Additionally, dispersion in growth rates and market valuations across global economies were discussed as a potential source of return from tactical positioning.

Investing in Artificial Intelligence

Our first external speaker, a software engineer and venture capitalist with an insider's view of the artificial intelligence ("AI") sector, provided an overview of the current state of what has the potential to be an enormous opportunity set. He also reviewed the industries that could be first to be fundamentally disrupted by this technology (marketing and legal). He highlighted in particular the importance of investing with firms that have rigorous technical expertise in-house, given the priority that must be placed on assessing, at a granular level, the competitive advantages derived from proprietary intellectual property. This emphasis dovetails with Strategic's focus on investing with venture capital firms staffed appropriately for this type of forensic technical diligence.

Restoring Guardrails with Accountability

Our dinner keynote speaker, Christopher Varelas, shared insights gathered during his illustrious Wall Street career to highlight how, and why, the average individual has become disconnected from, and distrustful of, the world of finance. He discussed his belief that increased financial innovation has led to increased complexity and fragility as "guardrails" have been removed in the interests of speed, scale, and efficiency. Mr. Varelas concluded with his views on how increased accountability and sound leadership in finance can help restore the public's understanding of, and engagement with, the financial sector.

Compelling Returns from Credit

A common theme cutting across several speakers was the emergence of significant opportunities in pockets of the credit markets. This is partly a consequence of the retracement of traditional bank lenders due to regulatory and other issues. Two external credit specialists reviewed the alpha potential available to firms with the underwriting and structuring expertise required to be a capital provider to corporations today. Unable to secure financing from traditional banking channels, corporations are willing to pay a premium to borrow from private firms offering a certainty of closing on financing deals in a timely manner. This discussion was complemented by a discussion of the opportunities in mortgage-related credit. In this corner of the structured credit market, firms that have made the requisite investments in human capital and systems have a competitive advantage in extracting compelling, uncorrelated returns. Taken together, these discussions helped participants understand why Strategic includes direct lending private credit strategies and opportunistic credit investments, in client portfolios.

Brands Can No Longer Be Neutral

Our final speaker, a specialist in analyzing consumer behavior, made the case that the era of broad, universal consumer brands that are neutral on matters of values and ethics, is likely behind us. Instead, companies are having to navigate, and take positions on, a broad array of complex issues, whether they want to or not. This has already led to some well-documented instances of disruption, creating opportunities for investors with the experience and acumen to identify the new consumer leaders: those successful brands that have a well-defined sense of their target consumer and the values that matter to them.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.