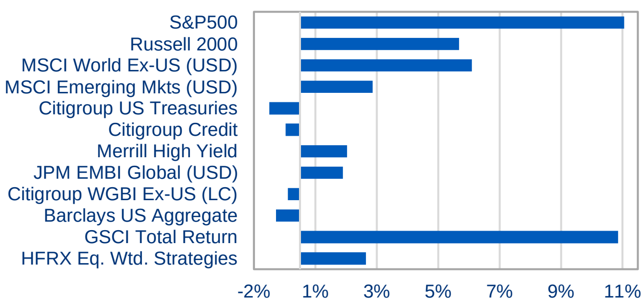
Global Market Review

Summary

A surprisingly resilient U.S. economy and hopes for an AI-induced productivity surge sent the U.S. equity market steeply higher in the first quarter. U.S. and Japanese equities, Bitcoin, and gold all hit record highs. U.S. Treasuries and investment grade credit lost ground, however, especially at the long end of the maturity spectrum, as investors became more realistic about the likely timing and pace of Fed easing. High-yield bonds, in contrast, rose as credit spreads narrowed in sympathy with the strong equity rally. The Fed, unfazed by two months of higher-than-expected inflation, kept rates on hold in March. The Bank of Japan raised its policy rate from just negative to barely positive, signaling victory in its long fight against deflation (see this quarter's Special Topic). Oil prices spiked and the U.S. dollar appreciated against most major currencies. The Japanese yen fell to 30-year lows.

Exhibit 1
Performance of Major Market Indices
Source: Bloomberg. Quarter ending March 30, 2024.

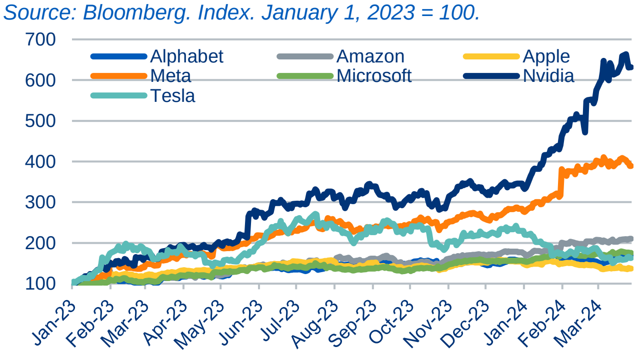


Global equity markets enjoy a stellar first quarter.

Artificial Intelligence Fuels Genuine Rally

The U.S. equity market rose 10.6% in the first quarter of the year and 34.4% in the 12 months through March. The gains were widespread across the growth, value, large- and small-cap segments of the market and all economic sectors. However, the most spectacular gains were generated by NVIDIA, which is up 82.5% so far this year, and a handful of other firms caught up in the AI frenzy. The Magnificent 7 (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla) have enjoyed strong gains over an extended period. Their market capitalization has increased from about 8% of the S&P 500 index in 2012 to over 27% at the end of the first quarter this year. Members of the Magnificent 7 parted company in the first quarter, with firms having the strongest connection to AI, like NVIDIA and Meta, extending their gains, while others, like Tesla, falling behind (Exhibit 2).

Exhibit 2
Magnificent Seven Diverge
Source: Bloomberg. Index. January 1, 2023 = 100.



In addition to fervent hopes that AI will trigger a wave of productivity gains and corporate profits, the resilience of the U.S. economy and expectations that the Fed will ultimately bring inflation down while piloting the economy to a feather-light landing have been the primary catalysts of the market's gains. The strong stock market rally combined with tight credit spreads on corporate bonds have contributed to an easing of financial conditions that has blunted the impact of the 525-basis point increase in the Fed funds rate (Exhibit 3). In addition, overall consumer spending has been sustained by wealth effects from rising equity and house prices, fiscal largesse, and the impact of savings accumulated during the

1001 Nineteenth Street North
17th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

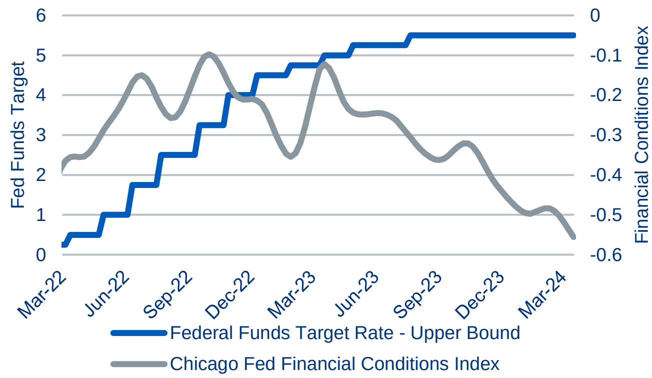
strategicgroup.com

pandemic. As a result, economic growth has been stronger than expected and inflation, although down from a peak of 9% to about 3% currently, remains stubbornly above the Fed's target. Looking forward, some of the factors that have been supporting consumer spending are dissipating. The Fed estimates that the $2.1 trillion in excess savings accumulated by households during the pandemic had been largely consumed by February. Moreover, the size of the fiscal deficit, although still large especially given the strength of the economy, is declining. Finally, real rates have risen with the decline in inflation, increasing the likelihood that the Fed's rate hikes will start to bite.

Exhibit 3

Easy Financial Conditions Counter Rate Hikes

Source: Bloomberg. Fed Funds rate in percent. Financial Conditions Index (below 0 = easy).



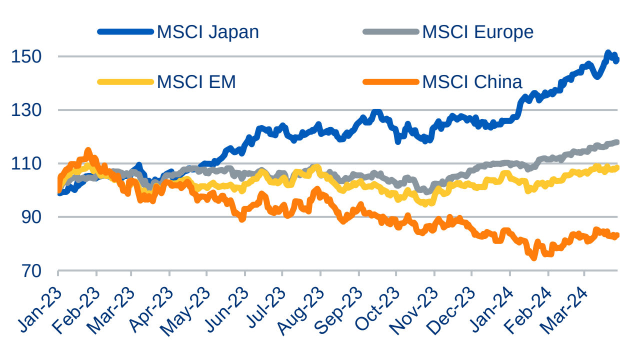
Japan Recovers, China Continues to Lag

Advanced and emerging equity markets also rose in the first quarter, although not so strongly as the U.S. The MSCI World ex-U.S. index of advanced equity markets rose 5.5%. Japanese equities had a particularly strong quarter, gaining 10.5%, extending gains that have finally brought the market back to its bubble peak of more than three decades ago (See Special Topic). Chinese equities, in contrast, continue to be weighed down by high levels of leverage, turmoil in the property market, a faltering economic recovery, deflationary forces, and medium-term challenges in the form of an aging population and declining labor force (Exhibit 4).

Exhibit 4

Japan Leads Non-U.S. Equity Markets Higher, China Lags

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



Credit Spreads Narrow to Low Levels

The U.S. Treasury yield curve steepened in the first quarter as short-term yields were little changed, while yields on securities with maturities of two or more years increased. The increase in longer dated yields reflected mainly higher real yields, although inflation expectations also rose. Credit spreads narrowed further to low levels across the credit spectrum. Despite this spread compression, the investment grade sector lost 0.9%. The lower duration high yield sector, in contrast, benefited from narrowing spreads to gain 1.5%. The sovereign bonds of other advanced economies also declined in the first quarter, losing 3.4%. The EMBI index of emerging market sovereign bonds, in contrast, rose 1.4%.

Alpha and Growth Drive Hedge Fund Gains

The HFRX equal-weighted hedge fund index rose 2.1% in the first quarter. Alpha accounted for a large share of these gains as the industry took advantage of wide valuation dispersions to add value through security selection. Performance was also helped by the industry's bias toward growth stocks. Macro strategies performed exceptionally well in the quarter, while merger arbitrage strategies lagged due to the lack of corporate actions.

Commercial Real Estate Slides Further

Real estate, as measured by the NCREIF Open-End Funds Core Index (reported with a delay), lost 12.7% in 2023 as rising yields and shifting patterns of work and consumption weighed on the market. The office sector was particularly hard hit, losing 17.6%. Only the hotel sector, benefiting from a spurt in post-COVID travel, managed gains, rising 10.3%.

Private Equity Lags Public Markets

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) rose 2.9% in the 12 months through September 2023, lagging public markets. Venture capital strategies lost 10.4%, compared to a gain of 9.3% for buyout strategies and a modest 1.6% return for growth equity. Mark downs in late-stage venture capital portfolios contributed to the sharp decline. Across all strategies, transaction activity has slowed significantly. Fund raising is also down, although firms remain flush with record levels of dry powder. Tighter credit and a weak exit market are likely to continue to weigh on private equity valuations.

Bitcoin and Gold Hit All-Time Highs

Bitcoin and gold both reached all-time highs in the first quarter, although Bitcoin has fallen back since. Bitcoin's boost was courtesy of the SEC, whose approval of crypto-ETFs made speculation in Bitcoin easier and attracted significant inflows. Gold's rise of 11.6% in the year through March appears to reflect geopolitical concerns, uncertainty surrounding the persistence of inflation, and official purchases by China. The surge in purchases of one ounce gold bars at Costco, although far from enough to move the market, is a sign of the times.

Outlook & Strategy

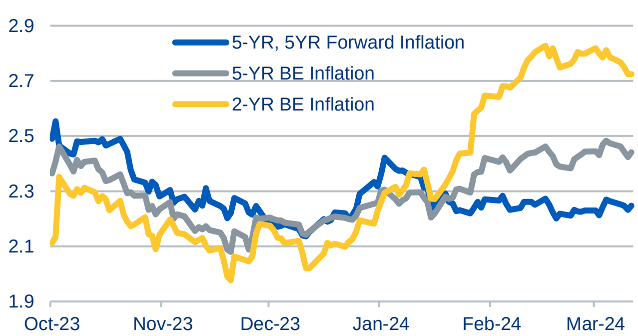
Changing Outlook for Inflation and Rates

Vacillating views on the future direction of inflation and interest rates have dominated the macro backdrop. Markets have swung from believing that inflation had been tamed by the Fed's largest and fastest tightening in over 40 years to worrying about the implications of persistent price pressures. Since the beginning of the year, the number of Fed rate cuts expected in 2024 plummeted from 6-7 to 2-3. Many analysts do not expect any cuts this year (Exhibit 1).

Exhibit 1
Markets Reassess Inflation's and the Fed's Persistence
Source: Bloomberg. Number of Fed rate cuts expected in 2024.

A succession of stubbornly high inflation readings was the catalyst for the market's (and the Fed's) reassessment. While down from a June 2022 peak of 9%, the year-over-year change in U.S. CPI has not yet fallen below 3% and price pressures have increased in recent months. Moreover, U.S. economic growth has proven to be remarkably resilient, thanks largely to consumers whose spending has been fueled by pandemic savings, fiscal stimulus, and the wealth effect of higher house and stock market prices.

Exhibit 2
Longer Term Inflation Expectations Remain Anchored
Source: Bloomberg. Average inflation rate expected over each period.

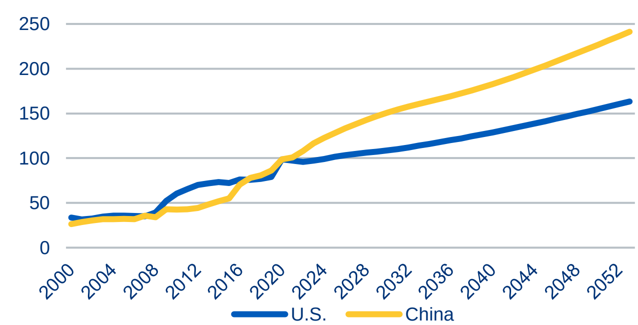


Fortunately, although short-term inflation expectations have risen, medium- and long-term expectations remain well anchored, suggesting that although inflation will take longer to contain, it is unlikely to spiral out of control (Exhibit 2). Expectations for average inflation over the next two years have increased significantly since the beginning of the year. The average inflation expected over the next five years and the five years after that, however, remains little changed.

Near term risks are focused on the interplay of inflation, the Fed's reaction function, and the impact of each on economic growth and market stability. So far, risks arising from high debt levels, high asset valuations, and high levels of market concentration have been contained. However, some of the factors that have hitherto supported economic growth, notably accumulated pandemic savings and the impact of fiscal stimulus, are dissipating. Moreover, with inflation falling, real rates are up, increasing their contractionary force.

Over the medium-term, prospects appear more problematic. Both the U.S. and China are on an unsustainable debt trajectory with interest payments on public debt taking up a growing share of fiscal revenue (Exhibit 3). Without a major boost to productivity, demographic changes and a contracting labor force are destined to slow potential output growth and increase the debt burden. Hope that AI will reinvigorate productivity growth has increased and been a dominant factor in the U.S. equity market, notwithstanding a long history suggesting that the impact of new technologies takes a considerable amount of time to be felt.

Exhibit 3
U.S. and China on Unsustainable Debt Trajectories
Source: IMF. General government debt as a share of GDP.



This year's wide swings in expectations on such fundamental issues as the rate of inflation and the direction of monetary policy were extreme, but not unique. They remind us of the essential need to structure portfolios in a way that sidesteps the risk of getting one key, but essentially unknowable, forecast wrong. Over the long run, markets have rewarded our focus on fundamental valuations and on constructing portfolios that are highly diversified across risk exposures. We see continued favorable prospects for a strategy based on diversification and fundamental valuations.

Despite Imbalances, Fundamentals Prevail

We maintain an underweight to U.S. equities and continue to favor equity strategies that use active security selection to take advantage of valuation anomalies. We believe that current market conditions remain favorable for this approach.

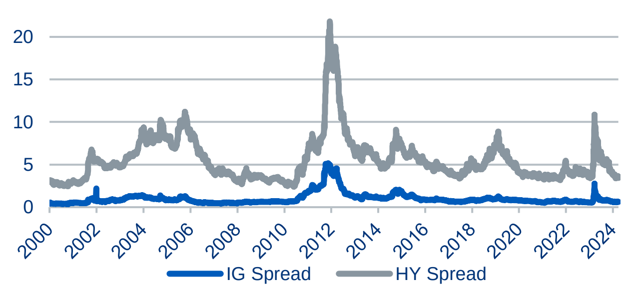
The U.S. equity market is quite overvalued, with the equity risk premium near 20-year lows. The market is also highly concentrated. The Magnificent 7 comprising mega-cap stocks in the tech sector has dominated market gains and contributed to the market's concentration and overvaluation. Up a cumulative 142.5% since the beginning of 2023, the Magnificent 7 have a trailing P/E ratio of 39.9 and represent 27% of the market capitalization of the S&P 500. Reflecting this dynamic, the dispersion of the most and least highly valued stocks, although down from its peak, remains at historically high levels, leaving open continued opportunities for active management.

We remain overweight advanced and emerging non-U.S. equity markets which are much more favorably valued than the U.S. The Japanese market is especially attractively valued and has the added benefit of a highly depreciated currency whose eventual recovery would compound the gains to foreign investors. To benefit from the opportunities we see in the Japanese market, we have recently added a new specialist active equity manager. European and Emerging equity markets also remain attractively valued relative to the U.S. Emerging markets have on the whole become more resilient. Their ability to withstand without incident the recent rapid tightening by the Fed and other major central banks stands in stark contrast to a history of emerging market crises precipitated by past tightening events.

Credit Spreads Are Too Tight

Within our fixed income portfolio, we are holding a neutral duration position and an underweight position in credit. We believe that the probability distribution of future Treasury returns remains balanced, and that the valuation of U.S. Treasuries is about fair given the current environment. Investment grade and high yield credit spreads, however, are at the lowest levels since the 2008 Great Financial Crisis (Exhibit 4).

Exhibit 4
Tight Investment Grade and High Yield Spreads
Source: FRED. Spreads in percent.



Our barbell approach remains an effective tool for active fixed income management. By combining U.S. Treasuries at one end of the barbell as a source of quality and duration positioning with BB-CCC credits on the other end, we aim to take advantage of the segmentation between the investment grade and high yield sectors within the fixed income market. We see continued opportunities to add value within credit.

There are still attractively priced securities within the credit markets, notwithstanding the overall low spread levels. In addition, mortgage asset-backed securities have a particularly attractive yield and risk profile. We are also continuing to expand our allocation to direct lending to take advantage of opportunities opened up by the retrenchment of bank lending.

Hedge Funds Remain a Key Diversifier

Hedge funds retain two features that make them especially attractive. First, they epitomize our goal of focusing our added value on security selection, rather than timing broad market movements. Second, our approach to hedge fund portfolio construction seeks to minimize market beta while relying on multiple idiosyncratic sources of value added as the main source of return. Because of this portfolio construction, our hedge funds provide important diversification benefits that are central to constructing robust multi-asset class portfolios. Balancing these alpha opportunities and diversification benefits with the desirability of maintaining adequate liquidity, we retain a neutral allocation to hedge funds.

Selective Opportunities in Real Estate

We are beginning to see opportunities in real estate despite falling demand for office space and reduced credit availability. Pricing in selective transactions has become more attractive. Accordingly, we are gradually moving to a neutral allocation to real estate. However, we are avoiding new investments in the office sector, which remains particularly challenged and difficult to price. In contrast, select industrial, retail, residential, and alternatives such as storage and data centers are benefiting from high demand and rental income growth, providing an inflation hedge. We are also retaining a neutral allocation to TIPS as a source of real yield and a further inflation hedge.

Private Equity Activity Remains Muted

Private equity and especially venture capital funds are still digesting the negative effects of outsized flows over many years. These flows contributed to high multiples and reduced discrimination across deals. Although inflows have since moderated, the dry powder held by private equity firms remains at record levels. Moreover, flows to L.P.s have declined as exit opportunities have slowed and many G.P.s are reluctant to recognize lower prices and prefer instead to prolong the partnership's life. We anticipate continued lackluster returns as economic headwinds, tighter credit, and a weak exit market gradually flow through to valuations. Despite these challenges, we are maintaining a disciplined approach to vintage year diversification as investments made coming out of a downturn typically generate superior returns over time. In particular, we believe that private equity strategies favoring investments in firms in the industrial, technology and consumer sectors with solid earnings growth will prove to be relatively resilient to more costly and less readily available funding.

Special Topic

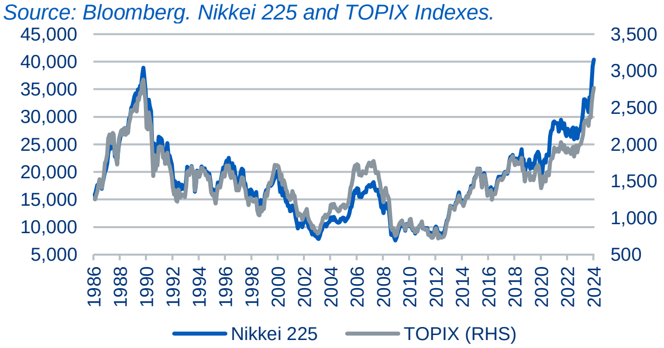
Japan's Long Recovery

The Japanese economy and financial markets experienced three major milestones in the first quarter. After more than three decades, the Japanese equity market finally recouped the peak level it attained in 1989, when a massive equity and real estate bubble burst. Second, the Bank of Japan (BoJ) signaled victory in its decades-long fight against deflation with an increase in its policy rate and other steps to tighten liquidity conditions. Finally, the yen reached a 34-year low against the U.S. dollar, notwithstanding the BoJ's policy shift. In this Special Topic, we discuss these milestones and assess the prospects for Japanese equities.

Japanese Equities Reattain Bubble Peaks

Japan's equity and real estate bubble reached epic proportions in the 1980s. When it finally burst, the bubble left a legacy of stock and property market losses, and deeply entrenched deflationary pressures. Between 1980 and 1989 when the equity and property market bubbles burst, Japanese equities rose by a factor of 5.7 times and property prices reached outlandish levels. At the bubble's peak, the 1.3 square miles occupied by the Imperial Palace was valued to be worth more than all of the real estate in California. When the bubble finally burst, there followed a prolonged period of economic stagnation and deflation, made worse by a series of monetary policy missteps. In a milestone that symbolizes Japan's long-overdue emergence from the bubble's shadow, Japan's equity market at long last reattained in February the peak prevailing in 1989 just prior to the bubble's bursting (Exhibit 1).

Exhibit 1
Japanese Equities Finally Recoup Bubble Losses
Source: Bloomberg. Nikkei 225 and TOPIX Indexes.



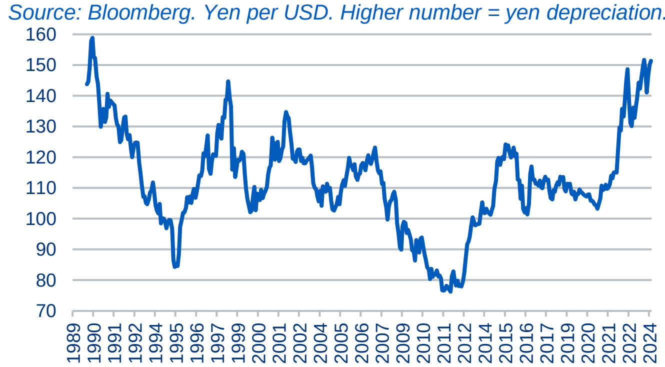
Japan Exits Post-Bubble Liquidity Trap

For many years following the bursting of the bubble, Japan's economy stagnated, and deflationary pressures persisted despite low policy interest rates, a massive increase in the BoJ's balance sheet, and large fiscal deficits. The Japanese economy faced a liquidity trap in which monetary policy was largely ineffective. In a further sign that the lingering deflationary aftershock of Japan's equity and property market bubble was finally dissipating, the BoJ announced in its March meeting that it would raise its policy rate to 0.1% from -0.1%, abandon its control of the yield curve, and curtail its asset purchases. This shift ended nine years of negative policy rates, lifted the target ceiling of 1% on 10-year Japanese Government Bonds (JGBs), and suspended purchases of equity and real estate ETFs, while continuing purchases of JGBs.

Yen Depreciates to Three Decade Lows

Over the past two years, the BoJ has been an outlier among central banks – maintaining low policy rates and extraordinary measures of monetary ease, even as the Fed and other major central banks aggressively raised their policy rates. Since March 2022, when the Fed started raising rates, the yen has fallen by about 24% versus the U.S. dollar. It reached a 34-year low versus the U.S. dollar in March (Exhibit 2). Expectations that the gap between the BoJ's policy rate and those of other major central banks will remain wide despite the BoJ's shift in policy is contributing to the weakness of the yen.

Exhibit 2
Japanese Yen Depreciates to 34-Year Low Versus Dollar
Source: Bloomberg. Yen per USD. Higher number = yen depreciation.



Japanese Equity Market Tailwinds

Japanese equities have enjoyed strong returns, gaining 10.5% in the first quarter and 26.8% in the year through March in U.S. dollar terms, notwithstanding the depreciation of the yen. Despite these gains, Japanese equities remain favorably valued. About half of Japanese equities trade at less than book value. Moreover, the market is likely to continue to benefit from favorable tail winds. Corporate governance reforms initiated in 2015 hold the promise of unlocking the significant value of Japanese equities that remains to be fully reflected in their share price. These reforms and more demanding reporting requirements have triggered a cultural shift in corporate management attitudes, resulting in renewed emphasis on increasing shareholder value. Moreover, with the yen at 34-year lows and the BoJ ending a long period of extraordinary monetary ease, a rebound in the yen has the potential to compound the local currency stock market gains to foreign investors. With these promising valuations and tailwinds, we see continued favorable prospects for Japanese equities.