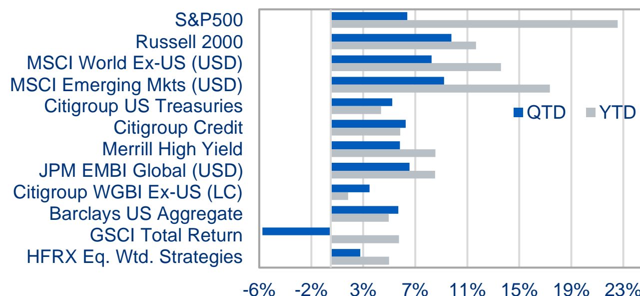
Global Market Review

Solid corporate earnings, resilient economic growth, moderating price pressures, and the Fed's initiation of rate cuts have combined to propel the U.S. equity market ever higher this year. Despite lofty valuations, the S&P 500 closed the quarter at a record on expectations for a continued favorable economic and earnings backdrop. Non-U.S. equities have also enjoyed strong gains, despite weakening growth. Following the announcement of a massive stimulus package, Chinese equities, which had been lagging other markets, spiked, making China the best performing equity market so far this year. Moderating inflation supported advances across sovereign bond markets in the third quarter. Credit markets also benefited from the falling yield environment. Oil prices plunged during the quarter, despite an increasingly volatile Middle East. Gold prices jumped to another record high, reflecting geopolitical concerns and central bank purchases.

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

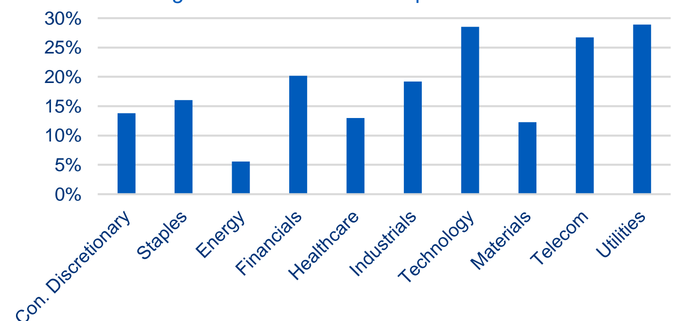


The favorable outlook for earnings, economic growth, and stimulative policies propelled global equities higher.

U.S. Bull Market Celebrates Second Year

The U.S. equity market is entering the second year of a bull run that began in October 2022.The S&P 500 index closed the quarter at another record high, rising 22.1% through the first nine months of the year. All style categories enjoyed solid gains in the third quarter and so far this year. Growth stocks are up 24% in the first nine months of 2024 compared to the 16.2% gain of value, while large- and small-cap stocks have gained 21.2% and 11.2%, respectively. Although still dominated by a few large-cap tech stocks, notably NVIDIA and other AI-related firms, the market's bull run has become broader in scope with all equity sectors participating in the rally so far this year (Exhibit 2).

Exhibit 2
Broad Advances Across Equity Market Sectors
Source: Bloomberg. Year-to-date returns in percent.



A number of factors have supported the U.S. equity market's stellar performance so far this year, notwithstanding the market's significant overvaluation. Corporate earnings growth and margins remain strong and balance sheets healthy. Real income growth and low rates of unemployment are sustaining household consumption, and contributing to continued overall economic growth. Inflation is fast approaching the Fed's 2% target, even as the economy powers on. This has put the Fed in the unusual and welcome position of easing monetary policy not so much to reverse a recession, but rather in recognition of easing price pressures. The favorable outlook for earnings, the economy, and monetary policy has been compounded by speculation on hopes that AI will become a transformative general-purpose technology with the potential to boost productivity, potential output, and living standards.

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Stimulus Sends Chinese Stocks Soaring

A litany of economic woes had been weighing on Chinese equity markets, resulting in subpar returns prior to September. High debt levels, excess capacity from years of poorly targeted investment, an over-built and over-levered property sector, and a fragile financial sector heavily exposed to the property market were undermining growth and consumer sentiment. Moreover, China's strategy of relying heavily on exports as a growth engine seems increasingly at risk from the threat of growing protectionism. The combination of excess capacity and slowing economic activity contributed to disinflation, compounding the difficulty of managing high levels of debt. Reflecting these economic concerns, Chinese equities had been lagging other emerging and advanced equity markets.

However, the announcement in September of a massive stimulus package transformed the performance of the Chinese equity market from lackluster to blockbuster. Encompassing a broad range of fiscal and monetary measures, the stimulus package includes support targeted at the property and stock markets. Following a 23.1% spike in September, the Chinese equity market is up 25.5% so far this year, eclipsing other advanced and emerging equity markets (Exhibit 3).

Exhibit 3

September Stimulus Sends Chinese Equities Soaring

Source: Bloomberg. Index January 1, 2024 = 100.

Buoyed by the Chinese equity market, the broad emerging equity market index gained 8.7% in third quarter, bringing its gain so far this year to 16.9%. Advanced economy bourses also posted gains. The MSCI World ex-U.S. index of advanced economy stocks rose 7.8% during the quarter. It is up 13.1% so far this year. Following the tumultuous unraveling of the yen carry trade in August, Japanese equity markets were considerably less volatile in September. So far this year, Japanese equities have retained gains of 12.4% in U.S. dollar terms. European equities rose 6.6% in the third quarter, despite signs of slowing output across the continent. With euro area growth slowing, most notably in Germany, and price pressures easing, the ECB is widely expected to cut rates further in its October meeting.

Fed Rate Cut Whets Appetite for More

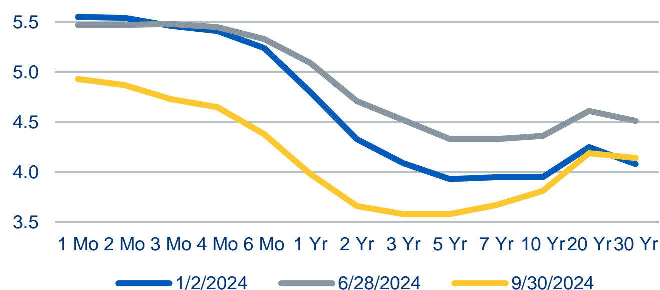
As telegraphed by FOMC members and widely anticipated by the market, the Fed lowered the federal funds rate by 50 basis points to a target range of 4.75% to 5%. The FOMC's projections point to more rate cuts to come, albeit in smaller increments.

U.S. Treasury yields declined across the maturity spectrum in the third quarter, with the largest declines focused on the short end of the curve. Although the yield curve remains inverted between three-month and 10-year maturities, it is positively sloped between two- and 10-years (Exhibit 4). The broad U.S. Treasury index rose 4.7% in the third quarter. In the credit markets, investment grade and high yield bonds were each up about 5¼%.

Exhibit 4

Treasury Yield Curve Reflects Shift to Easing

Source: Bloomberg. U.S. Treasury yields in percent at different maturities at specified dates.



Hedge Funds Find Continued Opportunities

So far this year, the HFRX equal-weighted hedge fund index is up 4.5%. Continued wide dispersion in stock valuations is opening up exploitable anomalies for equity-related hedge fund strategies, which are leading other strategies. Bond market dislocations are also creating opportunities in fixed income relative value strategies, boosting their performance as well. Merger arbitrage strategies, in contrast, have lagged reflecting the lack of significant corporate activity or defaults.

Hotel Sector Leads, Offices Lag

Real estate, as measured by the NCREIF Open-End Funds Core Index (reported with a delay), lost 10% in the 12 months through June 2024. The office and apartment sectors (down 14.4% and 5.1%, respectively) posed the largest drags on performance, although the industrial sector also lost ground. Retail, however, reversed previous losses to record a small gain of 0.3%. Shifting work and consumption patterns and tighter credit conditions drove the generalized decline. The hotel sector, continuing to benefit from a resurgence in travel, was the sole property sector to enjoy significant gains.

Venture Faces Continued Headwinds

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) rose 6.3% in the 12 months through March 2024. Venture capital strategies continued to lag, but its performance has improved from the prior quarter. Buyout and growth equity strategies rose 8.9% and 6.4%, respectively. Across all strategies, transaction activity remains limited. M&A exits and IPO activity remains low and well below the record set in 2021.

Outlook & Strategy

Strategic's Source of Sustainable Alpha

Central to our investment philosophy is the belief that active management pays off. Anomalies in the pricing of individual securities are the most rewarding, most persistent, and most reliable source of alpha. Adding value from the security selection of skilled investment managers has always been and remains our primary focus, the main source of our alpha, and the lion's share of our risk budget.

We analyze the macro backdrop to understand better the environment in which our active managers are operating. Our analysis focuses on how economic trends are influencing asset prices and whether the macroeconomic backdrop supports the strategies our managers are pursuing. This analysis influences broad asset allocation decisions and helps us identify managers and strategies most likely to be successful given where we are in the economic cycle.

While important, we typically limit the size and expected volatility of our top-down positioning. This cautious approach to calibrating such positions is based on two main considerations. First, unlike decisions on how best to be positioned across thousands of individual securities in multiple markets, macro decisions are typically few and binary in nature. They are also inherently riskier – decisions to adjust the relative allocation across assets will have a much greater impact on performance than decisions to be long or short individual securities. In addition to being few in number, binary in nature, and outsized in impact, getting the timing of macro decisions right is notoriously difficult.

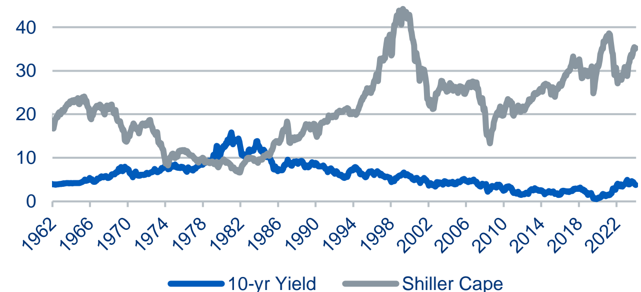
Accordingly, we take such positions only when there are very large valuation anomalies affecting a particular asset class and when we believe that these anomalies are exploitable. Even then, we are careful to calibrate such positions to avoid them having a disproportionate impact on portfolio performance.

Merits of Neutrality

The current macroeconomic backdrop presents starkly conflicting signals. On the one hand, the U.S. equity market is at a record high, and the valuation of U.S. equities is in the top percentile. The cyclically adjusted price earnings (CAPE) ratio developed by Robert Shiller is above 1929 levels and has only been exceeded twice before in its long history – the tech bubble of 2000, and post-COVID 2021 (Exhibit 1).

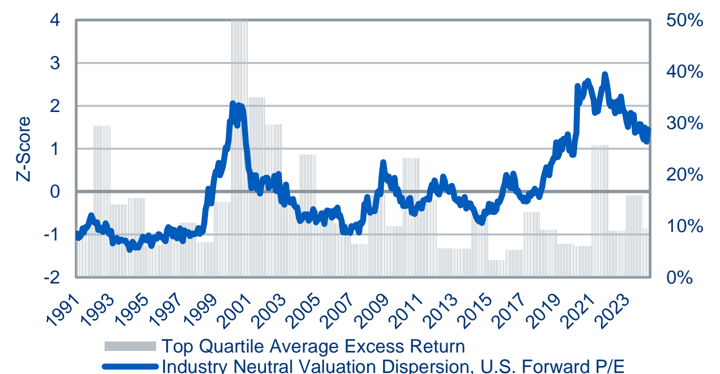
While the valuation of the U.S. equity market is quite high, the macroeconomic backdrop is remarkably favorable. Inflation is moderating, economic growth appears resilient, and the Fed and other major central banks are reducing their policy rates. U.S. corporate earnings growth is strong, profit margins wide, and corporate balance sheets sound. With real disposable incomes rising and unemployment low, U.S. households are in a similarly enviable position. More broadly, with inflation trending lower and further central bank rate cuts on the horizon, the outlook for sustained growth in economic output, corporate earnings, and household incomes appears favorable. These strong, favorable macroeconomic forces are now balancing our concerns over the high valuation levels of equity and credit markets. Given these crosscurrents, we have moved to a neutral allocation to public equities and credit.

Exhibit 1
High U.S. Equity Valuations
Source: Shiller Data. Cyclically Adjusted Price Earnings Ratio (CAPE) calculated using 10-year smoothed real earnings per share.



This change in positioning will reduce the level of top-down directional risk in client portfolios, increasing the relative proportion of active risk from bottom-up manager security selection. The environment for security selection remains robust (Exhibit 2). Valuation dispersion within industries continues to normalize, a sign that stock specific characteristics are increasing in importance. We have high conviction in the active strategies currently in place.

Exhibit 2
High Alpha Potential in U.S. Equity Market
Sources: eVestment, Bloomberg, and Strategic calculations. Top quartile average excess returns calculated using eVestment's U.S. equity manager universe.



Positioning in a Rich U.S. Equity Market

While moving to a neutral public equity allocation overall, we are retaining our relative underweight to the U.S. compared to non-U.S. as well as our overweight to value stocks. We continue to favor managers whose strategies gravitate toward the shares of firms with solid balance sheets and strong earnings.

We include a variety of investment strategies in the U.S. equity portfolio to enhance the robustness of its returns and the likelihood of generating added value. Accordingly, we have constructed the U.S. equity portfolio to comprise active long-only managers using a combination of quantitative and fundamental techniques as well as extension and portable alpha strategies. Extension strategies are an efficient way to capture alpha by allowing skilled active managers to express their outperform and underperform insights on particular securities through both long and short positions. Portable alpha strategies combine a rich source of diversified alpha streams with market beta. These strategies have the potential to generate higher risk-adjusted returns and more consistent value added than a single active manager.

We have further diversified the portfolio by adding industry-focused specialist managers, notably in the biotech sector. The sector's current valuation, large universe of small- and mid-cap companies, and the highly idiosyncratic risk factors driving each firm's earnings make the biotech sector especially fertile ground for specialist managers to add value.

We remain overweight advanced and emerging non-U.S. equity markets which are more favorably valued than the U.S. The Japanese market remains especially attractively valued. Shareholders in Japanese firms are also likely to benefit from corporate reform initiatives aimed at improving governance. European and Emerging equity markets also remain attractively valued relative to the U.S.

Emerging markets have, on the whole, become more stable and resilient to external shocks. We are concerned, however, by the stiff economic headwinds faced by the Chinese economy. Balancing these concerns are the very favorable valuations of the Chinese equity market and the large scope for economic stimulus available to the Chinese authorities. Given these offsetting forces, we are not currently planning a change in positioning relative to emerging markets.

Neutralizing Our Credit Underweight

U.S. Treasury securities appear to be fairly valued. The once steeply inverted yield curve is normalizing, real yields have risen, long-run inflation expectations are well anchored, short-term price pressures are moderating, and the stage is set for further Fed rate cuts ahead. Against this backdrop, the distribution of prospective U.S. Treasury returns appears to be symmetrical, warranting a continued neutral allocation to portfolio duration.

We are also moving to a neutral allocation to credit. Corporate borrowers easily weathered the large increase in the federal funds rate which began in 2022 and came to an end in September. Corporate balance sheets are likely to remain sound as borrowing costs decline. Although credit spreads remain tight, the credit markets are remarkably heterogenous and segmented offering attractive opportunities to specialist managers with the requisite experience to discriminate across issuers and securities in niche segments of the market. We see continued opportunities to add value through security selection in the credit markets.

Mortgage asset-backed securities (MBS), for example, currently have a particularly attractive yield and risk profile and offer fertile ground for adding value through security selection. We are actively pursuing opportunities in the MBS market. We are also continuing to expand our allocation to the rapidly growing direct lending market to take advantage of opportunities opened up by the retrenchment of bank lending. Although less liquid than other credit market opportunities, direct lending has the benefit of offering floating-rate coupons, short maturities, and strong covenants.

Alpha and Diversification with Hedge Funds

Manager selection is especially critical in the case of hedge funds. Our focus, as always, is on creating hedge fund portfolios with highly diversified streams of value added from security selection that minimize market beta. Constructed in this way, our hedge fund portfolios provide important diversification benefits that are central to constructing robust multi-asset class portfolios with strong value-added potential.

Selective Opportunities in Real Estate

We are gradually moving to a neutral allocation to real estate, although we are avoiding new investments in the office sector. 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. However, we are avoiding new investments in the office sector whose prospects remain especially uncertain. With real yields on TIPS at more normal levels, we are retaining a neutral allocation to TIPS as a source of real yield and a further inflation hedge.

The Secondary Market in Venture Capital

The private equity (PE) sector is still digesting the aftershocks of a rapid influx of funds which in some cases reduced investment discipline and bid up valuations for portfolio companies. Notwithstanding these challenges, private firms represent a large, growing, and dynamic segment of the U.S. economy that offers attractive opportunities for strong returns and added value. During the boom-induced period of reduced investor discrimination, we remained focused on investments in firms in the industrial, technology and consumer sectors with solid earnings growth. We believe that these prudent investments will continue to prosper as investor discrimination is restored.

We are pursuing select venture capital opportunities in the secondary markets which have grown significantly and improved in quality in recent years. Private equity investments in the secondary market provide access to portfolios of assets that are diversified across vintage years and trading at a discounted entry valuation. These secondary investments mitigate the J-curve effect, contain more mature and less speculative venture firms, and diversify and broaden our existing venture portfolio.

Special Topic

2024 Idea Lab Highlights

This year's Idea Lab explored strategies to enhance portfolio resiliency at a time that established paradigms across financial markets are being tested by the forces of disruption.

Although challenging to summarize the broad range of discussions that unfolded across the two-day forum, a few areas are worthy of note. First, the struggles of macro forecasters and market pundits to predict market moves in recent years were probed, as was the resulting impact on uncertainty, risk, and opportunity. Second, several external speakers specializing in public and private market investing highlighted the role that a focused, thematic investment approach can play in building a sustainable competitive investment edge. Finally, numerous investment opportunities were discussed, ranging from private markets opportunities in early-stage artificial intelligence companies, to ongoing opportunities in fixed income (which has shed its staid reputation in recent years given attractive yields and shifting market dynamics). Additionally, General David Petraeus, a 37-year veteran of the U.S. Army and the former Director of the CIA, shared his views on disruption and modern warfare, while Michael J. Mauboussin, a renowned investment strategist, author, and professor, led an interactive session on behavioral finance.

From Uncertainty Rises Opportunity

Strategic's Office of the CIO kicked off the forum with a review of the disruptions impacting the macroeconomic environment. A breakdown in the efficacy of economic forecasts following the onset of Covid-19 has contributed to an environment of uncertainty, as have a series of hot, cold, and trade wars, and shifts in immigration patterns. The crucial takeaway is that while uncertainty can contribute to elevated volatility, it also breeds opportunity. Consistent with the investment approach Strategic has honed over the past three plus decades, we are casting a wide net in rigorously assessing the risk/reward profiles of these opportunities. We see continued favorable prospects for a strategy based on diversification, an awareness of fundamental valuations, and a singular focus on adding multiple, varied sources of excess return, or alpha, to client portfolios.

Identifying Long-Term Winners in AI

Our first external speaker, a venture capitalist focused on early-stage opportunities in the artificial intelligence ("AI") sector, walked through the multiple eras of AI, highlighting key breakthroughs and providing a glimpse of what the future may hold. She emphasized the breadth of opportunities for early-stage investors, given the sheer number of AI companies being formed. She also highlighted the diligence approach used by her firm to try to identify AI's long-term winners, given the challenges of maintaining a competitive advantage in such a rapidly evolving field.

Lessons in Strategic Leadership

General David Petraeus, our dinner keynote speaker, shared his views on strategic leadership, with a particular focus on the leadership traits of those currently involved in the geopolitical conflicts roiling the globe. Consistent with our conference theme of disruption, General Petraeus also reviewed the evolving role of technology in the military theater. Highlighting the growing impact of electronic warfare and unmanned aircraft, the General leveraged his decades of "boots on the ground" experience to provide a unique perspective on modern warfare and its current and future impact.

Key Contributions from Private Markets

The importance of private market investments to generating absolute returns and increasing portfolio diversification came into focus on the second day of the forum. An external speaker focused on private equity investing in the entertainment, media, and communications sectors provided an overview of these quickly evolving areas. He also highlighted the merits of sector-specialization to developing and maintaining a competitive edge as a private markets investor.

Another speaker with experience investing in distressed real estate reviewed the current state of that market. While factors such as the level of interest rates and structural changes such as widespread "work from home" policies are depressing real estate values, he noted that there are a select number of properties in sectors like industrial that have the potential to add value to client portfolios over time. But he emphasized that there are few such opportunities today and provided insights on avoiding value "traps".

Behavioral Foundations of Investing

The forum closed with our general session keynote speaker, Michael J. Mauboussin, who shared his thoughts on a range of behavioral issues impacting investors. He reviewed the destructive impact of overconfidence and confirmation bias, which he characterized as a "brick wall" preventing investors from updating their views with new information. He also discussed the role of intangible assets in equity valuations and provided a historical perspective on today's equity market concentration.

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.