First Quarter 2024
Market Commentary

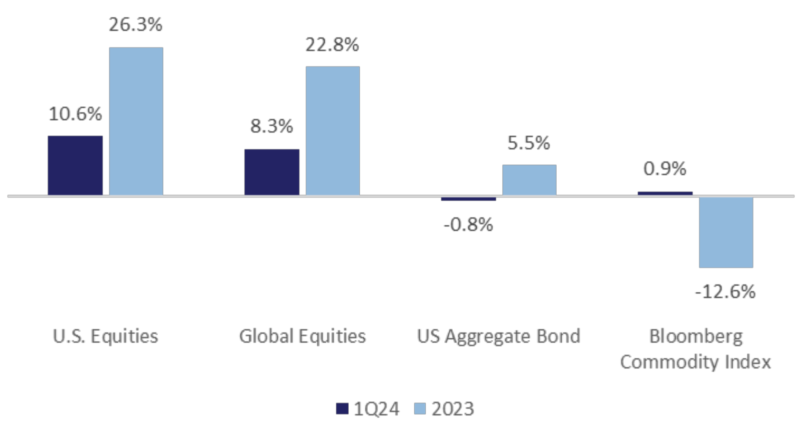
April 26, 2024

Problems Emerging in the Last Mile?

Like many others, we've been focused on and have spoken to clients about the nature of the ongoing post-Covid economic re-normalization. Will "the last mile" of inflation reduction see us return to 2% inflation? Will the Fed be able to deftly manage the consequences of the abrupt policy shifts of moving from zero interest rates and quantitative easing ("QE") to 5.35% rates and quantitative tightening ("QT") without driving the economy into a ditch? Will there be a decrease in liquidity that drives an increase in volatility and a re-pricing of assets? In short: will we have a recession and what will that do to markets? Although this is a letter about the first quarter, we will incorporate some April headlines into our discussion because they help punctuate some of our thoughts as we move deeper into 2024.

Looking ahead in 2024, we continue to think it will be a hard road to get inflation back to 2% and indeed think the Fed is comfortable with a figure higher than that as well. In the meantime, we think the pace of rate cuts will be slower and start later and that a "higher for longer" rate environment will persist. If, in fact, we skirt an actual recession or significant negative credit event then short- to medium-duration credit can continue to be a productive allocation for investors and clients. In addition, in public equities we find better value among smaller capitalization companies and emerging markets ("EM") and believe allocations here can be productive for portfolios as well. Finally, we will continue to focus on lower-middle-market and growth stage private equity investments as we believe these segments are more fragmented and capital-starved and can provide opportunities for strong performance over time.

Figure 1: Asset Class Returns
(1Q24 & 2023)



Source: Bloomberg, Nordwand Capital as of 3/31/2024.
Note: US equities = S&P 500 Index; Global equities = MSCI ACWI Index

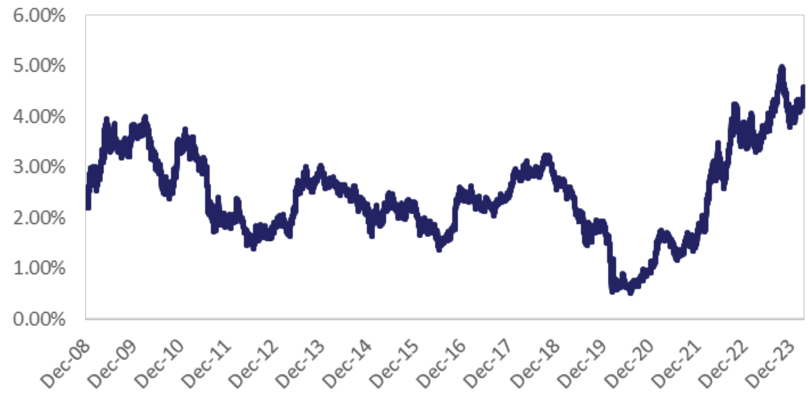
A Recap of 1Q24

The torrid 1Q performance in US and global equities (Figure 1), partly fueled by comfort that interest rates would begin moving lower in the US by mid-year, was met with accelerating headline inflation data at the end of March that cast doubt on that outcome. This led to a sell-off in equities that saw US and global large cap equities give up roughly half their YTD gains in the first 2+ weeks of April and saw small cap equities slide into negative territory for the year.

In public equities, performance was once again concentrated in a few mega-cap names in 1Q24. In 2023, the top performers were tagged with the "Magnificent 7" moniker, highlighting how overall market performance was dragged higher by a very small number of stocks. In early 2024, it would be more accurate to refer to the successor group as the "Fantastic 4", as the "cool kids" lunch table has seemingly become even more selective as stocks like Tesla (Nasdaq: TSLA) and Apple (Nasdaq: AAPL) have fallen off the pace. Understandably, we believe this to be symptomatic of a challenging market environment and one that merits close evaluation and diversified exposures to navigate effectively.

In fixed income and rates markets, bond yields moved higher through 1Q24 and into April (Figure 2), with yields on the 2-year and 10-year US Treasury higher by ~0.60-0.65 basis points (i.e. ~0.60-0.65%). This move higher in yields is a consequence of sticky inflation dampening prospects for interest rate cuts. At the end of 2023, markets expected the Fed to execute six 25-bp rate cuts in 2024, ending the year around 3.82% versus the current 5.35% we referenced earlier. At the end of 1Q, this expectation had dropped to ~2-3 25-bp cuts, and as of this writing has dropped further to 1-2 cuts. If this plays out, it would translate to ~1.00-1.25% of higher interest rate expectations this year, and higher financing costs for the US Treasury, corporate borrowers, mortgage-seekers, and so on down the line. This whipsawing of expectations and yields led to negative performance for bonds to start the year, as the US Aggregate Bond Index returned -0.8% (Figure 1) and long-duration Treasuries in the form of the popular iShares 20+ Year Treasury Bond ETF (Nasdaq: TLT) returned -4.3% in the quarter. We were concerned about excess duration exposure coming into the year, and continue to feel comfortable with this stance – although with rates having risen so dramatically to start the year we do find this part of the market more balanced than it was at year end.

Figure 2: 10-Year US Treasury Yield
(2009-Present)



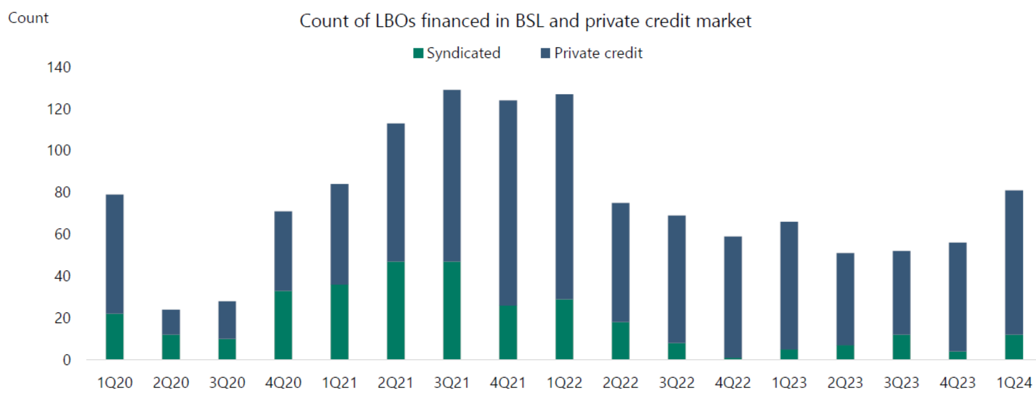
Source: Bloomberg, Nordwand Capital as of 4/12/2024.

Commodities were broadly higher as well, with West Texas Intermediate crude oil up ~20% YTD, reflecting both supply dynamics and confidence in global economic prospects in the short-term. Copper, often considered a prescient industrial metal given its broad applications in the economy (and therefore colloquially referred to as "Dr. Copper" by old-time market denizens), is up almost 10% YTD, again indicating decent confidence in economic prospects. Gold is up approximately

15% YTD as well, which includes setting multiple all-time highs for a commodity often thought of as an inflation hedge and store of value. It is not lost on us that inflation indicators have trended higher in 1Q at the same time that gold is setting all-time highs; it appears consumers and market-watchers both are seeing persistent inflation as something to contend with longer-term. In short, signals from commodities markets are sending mixed messages about global economic health.

In private markets, leveraged buyout ("LBO") activity picked up in 1Q for both the private credit and leveraged loan markets (Figure 3). These developments are worth watching as indicators that capital markets activity could be picking up – leading to the potential for assets changing hands, distributions from private equity vehicles, and capital recycling of the sort that's necessary for investors and companies. It's early to call this a durable trend, but a notable shift nevertheless.

Figure 3: LBO Financings (# of deals)
(1Q20-1Q24)



Source: Apollo, Pitchbook LCD, Nordwand Capital.

On the broader economic front, conditions continue to show conflicting but generally comfortable signals. The main unemployment rate in the US reads 3.8%, historically among the lowest readings ever recorded, while labor force participation continues to rise. Within these readings, though, job growth seems concentrated among part-time workers, new arrivals to the workforce, and immigrants. In addition, although average hourly earnings continue growing at >4% year-over-year, headline inflation and housing affordability has left much of the workforce justifiably uneasy about its prospects.

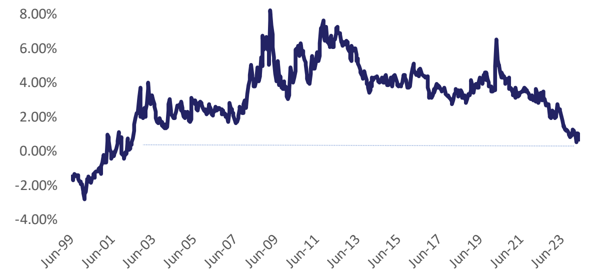
Although we don't think our clients misunderstand this point, it is worth remembering that when politicians talk about "inflation heading lower," they often mean that the rate of increase has *slowed*, not *reversed*; most regular people just see prices going continually higher and have to contend with that reality. In all, prices have risen faster than wages in the post-Covid period, and prices continue to rise.

With all that said, manufacturing figures in the economy ticked into expansion territory for the first time since late 2022, which should bode well for job hunters and overall GDP growth if it bears out in the coming months. As we noted, a confusing brew of sometimes-conflicting signals suggests overall growth will continue, albeit impacting citizens and consumers in a more nuanced manner. Overall, it remains our case that we experience a mild recession or none at all over the short-term. The longer-term, with aggregating impacts of budget deficits, debt-to-GDP ratios, and non-discretionary spending, is another matter for another piece.

Looking Ahead: Peering Through the Crystal Ball

Markets have had a complicated start to the year: a small fraction of public equities once again began the year on a tear while the rest of the universe stared on in wonder; yields began the year considerably lower than they are now, leading to flat-to-down performance for broad fixed income markets and instruments year to date as well.

Figure 4: Equity Risk Premium
(1999-Present)

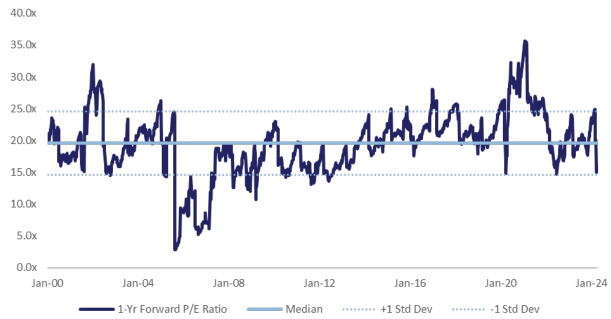


Source: Bloomberg, Nordwand Capital as of 4/10/24.

Figure 4 illustrates the equity risk premium – which is basically a way of looking at the return premium equity investors can expect over the "risk-free rate" of US Treasuries. This measure of expected risk-adjusted return for large cap stocks in the US is rather unattractively at its lowest point since the tail end of the tech bubble in 2002.

Not all equity markets are similarly situated, with small cap stocks, represented in Figure 5 by the Russell 2000 index, looking attractive relative to their historical valuation. This is an artifact of how passive investing has rewarded bigger companies at the expense of fundamentals at certain times. As we've communicated in the past, we feel this dislocation in small cap stocks represents an attractive entry point for the right investors to buy smaller companies – that traditionally grow at a faster rate than their larger peers – at a discount.

Figure 5: Russell 2000 Forward P/E Ratio
(2000-Present)



Source: Bloomberg, Nordwand Capital as of 4/6/24.

In fixed income markets, we remain believers in a "higher for longer" framework as we stated earlier in this piece. As a result, fixed income and credit may be more attractive in portfolios than in the years leading up to 2022. At the beginning of the year, we thought rates had perhaps come down too-far too-fast, but with recent retracements higher, the landscape is more balanced. We are also still less convinced that taking on a lot of duration is necessary to generate adequate returns in credit markets, but also acknowledge that cash allocations should start to come down following a very pleasant 5%+ rate for much of the last 1-2 years. Shorter-duration instruments with higher yields and prudent deployment of measured credit risk are plentiful in the current environment and should fare well when the front end of the rate curve comes down. Diversified exposure to these still looks to be a wise portfolio component for most of Nordwand's clients.

Across private markets, we continue to find constructive pockets in which to deploy capital. Direct and co-investing are our preferred options where possible, and 2023 proved a conducive environment for locating, underwriting, and investing in several deals. We are seeing some of the same backdrop in early 2024 and expect this to be productive for clients as the year wears on. Our willingness to explore private credit exposures in key market segments is related to this same search for improved risk-adjusted returns in private vs. public markets and continues to be attractive to us as well.

Summary

A tidy summary for the start to 2024 is no easy task, but we're up for the challenge: Inflation stayed sticky, causing the Fed to falter ever-so-slightly on its path to lower interest rates. The resulting uncertainty caused bond yields to rise and early equity winners to retrench.

As we think about asset allocations across longer periods of time generally, these short-term gyrations have a minor impact on our strategic view of portfolio construction. On the margin, however, higher rates and yields in credit along with large swathes of the equities markets like small caps and emerging markets look opportunistic and worth exploring further.

Moving into the middle of the year, the election will begin to loom larger and constrain monetary policy options employed by the Fed, so we will watch closely whether we approach the June Fed meeting with any momentum toward cutting interest rates. Election years can often see macro drive outcomes more than fundamentals; this year may see that as well.

Thanks, as always, for reading and for being our partners at Nordwand. We look forward to speaking or meeting with many of you in the near future.

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