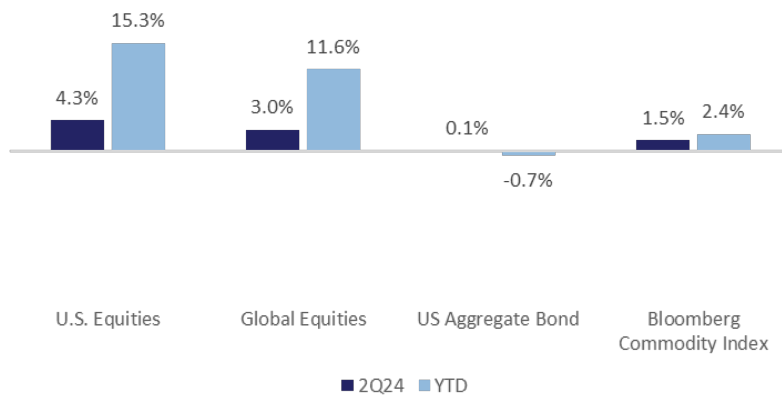
Second Quarter 2024 Market Commentary

July 25, 2024

Green Shoots & Troublesome Weeds: Looking Ahead at the Midpoint of 2024

Figure 1: Asset Class Returns
(2Q24 & 2024 YTD)



Source: Bloomberg, Nordwand Capital as of 6/30/2024.
Note: US equities = S&P 500 Index; Global equities = MSCI ACWI Index

At the turn in 2024, we've seen equity markets rise and bond yields rise while inflation remained above the Federal Reserve's 2% target and the U.S. economy continued its moderating trend as employment and manufacturing figures eased. In general, economic resilience has been a positive surprise.

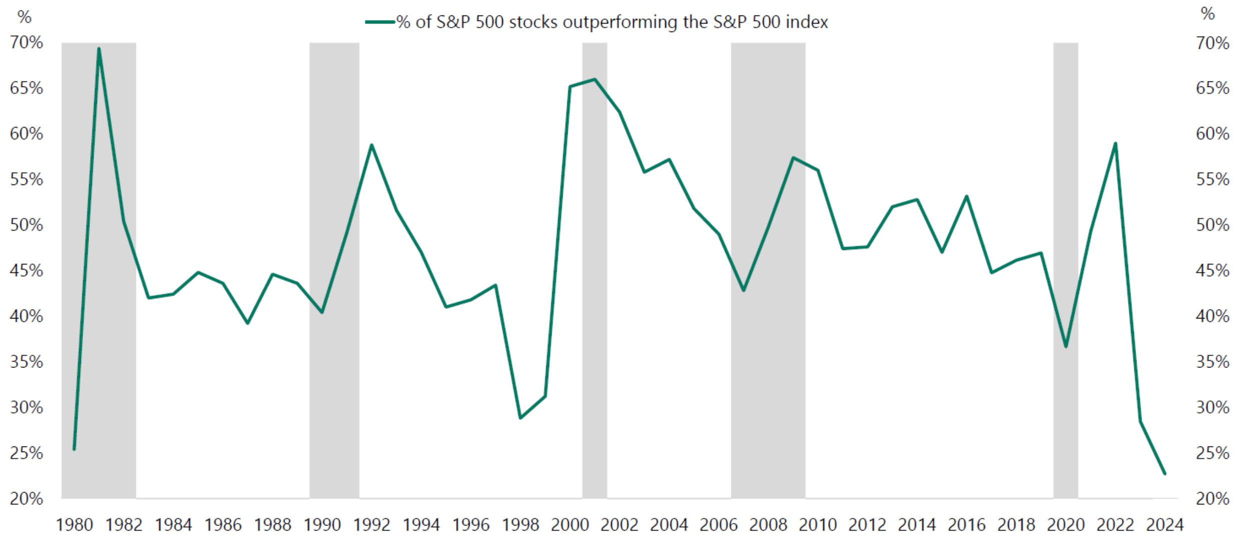
In the face of over two years of heightened interest rates, higher borrowing costs community bank weakness, and a stressed consumer we think it was reasonable to expect a recession by now. In the teeth of those conditions and sentiment, the Fed communicated a "pivot" in December 2023, expressing its desire to look for an opportunity to cut interest rates. Coupled with unparalleled fiscal stimulus, this change in tone eased financial conditions and helped to offset the effects of its rate-hiking regime and set the stage for a potential re-acceleration of growth. This scenario – the fabled and much-discussed "soft-landing" – has been the primary goal of monetary policy mandarins; and, to be sure, bringing headline inflation down from its 9.1% peak to its 2.0% policy target without triggering a recession would require a hat-tip.

Looking forward, inflation is moderating but still appears structurally stubborn, making the 2.0% target challenging. At the time of this writing, the political environment took a troubling turn, and we remain hopeful yet wary that "the temperature" will truly subside. Interest rates are poised to move quickly in response to an expected Fed cut, requiring more focus on reallocating outsized cash positions in both retail and institutional portfolios and a recognition that the destination of those cash assets is likely to factor meaningfully into the best trades or positions through year-end. In short: once again we are at the mercy of Fed-watching – which has driven far too much of the conversation, in our view – but now we add election-watching to the list and hope for the best.

A Recap of 2Q24

For equities, the strong start to the year continued into 2Q, albeit at a more moderate pace (Figure 1). For bonds, yields rose while credit spreads compressed, as fixed income investors continued to bet on an ordinary and unstressed credit default environment for the year. Gold strengthened by ~4% in 2Q and was up ~13% YTD through the end of 2Q, as investors bet on the stubbornness of the last 50-100bps of inflation and the continuing trend of eroding US dollar value as budget deficits and national debt reach peacetime/all-time highs.

Figure 2: Historic Narrowness of Equity Market Outperformance
(1980 - 2024 YTD)



Source: Bloomberg, Apollo Chief Economist.
Note: Annual data is from January 1 to December 31 for each year. The 2024 data is as of July 2, 2024.

As we noted above, **public equities** continued to rise in 2Q, but with ongoing warning signals around market breadth that we can see visually in Figure 2. Market winners within equities remain concentrated in a small band of large cap AI-oriented and thematic stocks that have been working despite concerns over valuation or pace and execution of growth strategies. The "narrowness" of this market is at its worst in half a century.

Figure 3: S&P 500 1-Yr Forward P/E
(2005-Present)

Figure 4: Equity Risk Premium
(1999-Present)

Source: Bloomberg, Nordwand Capital, as of June 30, 2024.

Additionally, valuations in large cap equities have kept ratcheting higher during this post-2022 rally (Figure 3), and equity risk premia (Figure 4) – a measure of the excess return an investor might expect to earn over a risk-free alternative – also sits at its lowest level in over 20 years. Clients will know that these combined concerns of 1) return concentration, 2) valuation, and 3) risk-reward balance have bothered us increasingly of late.

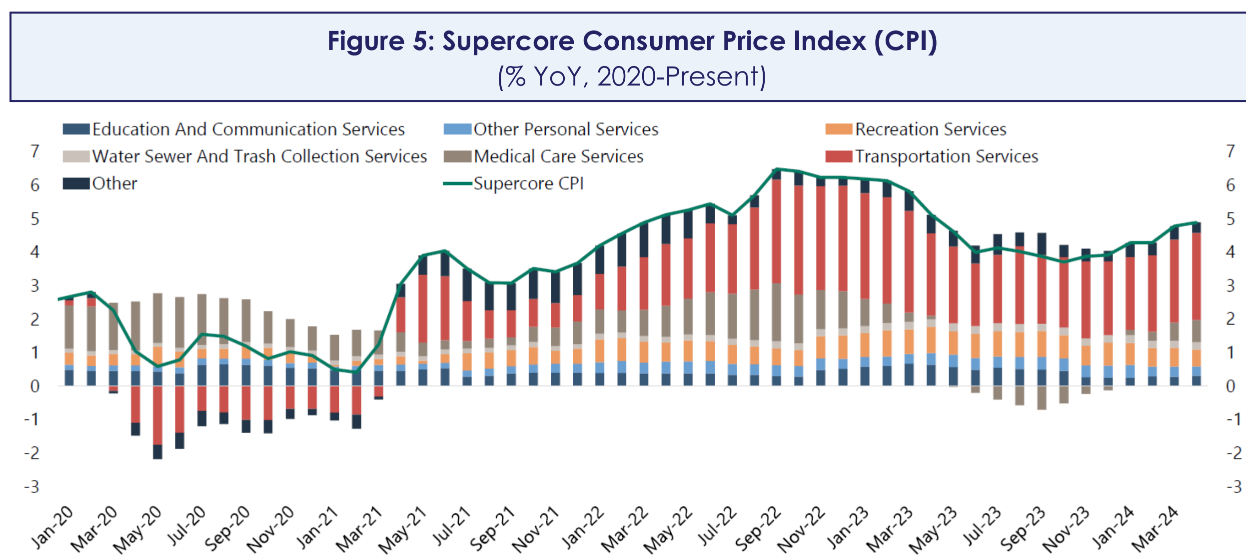
That said, we do see pockets of rationality popping up, presenting opportunities to find more appealing and diversified exposures. In other words, in addition to technology and semiconductor stocks continuing to post gains, we are seeing sectors like financials and utilities – sectors that could benefit from interest rate cuts and/or expansion of the AI trade – show notable strength in the first half of the year.

We have also very recently seen small cap stocks show signs of life. In the last 3 years, while the S&P 500 has been up 35% (~10.6% annualized), the Russell 2000 small cap index has been up only 7% (~2% annualized) – and, notably, all of that positive return for small caps occurred in the first 2-3 weeks of the third quarter! Unearthing solutions for clients in profitable sub-sets within the small cap universe may well produce outperformance for clients and may also serve as a productive diversifier as investors have concentrated into the largest and most liquid stocks in the U.S.

In **credit, or fixed income, markets** results have been flat YTD as measured by the Bloomberg Aggregate Bond index. For Nordwand's clients, cash yields have held steady at an annualized rate of ~5.35%. The drivers of credit market returns, such as the level of interest rates, the expected path of interest rates, and the yield spread demanded by investors to take additional credit or duration risk over the risk-free asset (i.e. U.S. Treasury) have been in flux, which has led to divergent credit returns this year.

We have held that cash positions yielding >5% can present attractive allocations, but as we approach a switch in monetary policy regime at the Fed, wherein we expect rate cuts to begin later this year, allocations to cash are likely to come under some pressure if alternative sources of yield – without taking undue credit or duration risk – are possible. We think there are attractive alternatives to consider here. But first, a brief detour to look at inflation is worthwhile.

Figure 5: Supercore Consumer Price Index (CPI)
(% YoY, 2020-Present)



Source: BLS, Bloomberg, Apollo Chief Economist.

The inflation picture has been generationally notable coming out of Covid. First, through a combination of supply chain constraints, surging demand, and unprecedented fiscal and monetary stimulus the U.S. has seen its highest levels of inflation in over 40 years. Many measures of inflation – including the Fed's preferred Core PCE (Personal Consumption Expenditures) reading – have ebbed significantly since peaking over mid-2022 to mid-2023. Headline CPI still sits at 3.3% through May, while Core PCE was at 2.6% for the same month, which suggests the Fed will likely be able to justify cutting rates this year.

Headline inflation measures the cost of a basket of goods over time, while "core" versions of the CPI and PCE strip out food and energy due to their higher short-term volatility to arrive at a more durable trend inflationary figure. Supercore inflation focuses on core services inflation (excluding housing) to arrive, hopefully, at what Fed Chair Jerome Powell has in the past deemed the most important category for understanding the future evolution of core inflation. In Figure 5, we see this level still lingering closer to 5%.

These divergent inflation levels help provide context for the ongoing food fight between those who think the Fed should cut rates to avoid an economic slowdown and those who think inflation may well come back if rates are cut and financial conditions ease. Adding to this issue, housing prices – which are excluded from some of these calculations – continue to make all-time highs, even with 30-year mortgage rates sitting around 7.25% in mid-July, making home ownership and affordability a daunting prospect for many. Finally, while energy prices have come down from recent highs, consumers and citizens are dealing with elevated (and still rising) underlying inflation in areas such as food and housing. It is for these combined reasons that we think the Fed will be measured and deliberate in any rate-cutting regime.

Turning to what this means for credit and fixed income allocations, we still find value in the short-to-intermediate parts of the yield curve (i.e. less than 5 years to maturity). We think these areas will feel the impacts of rate cutting most directly without investors having to take longer-term bets on the shape of the yield curve or the impact of continued and historically high Federal budget deficits on borrowing costs.

Figure 6: Moody's BBB Less UST 10-Yr Yield Spreads (2002-Present)

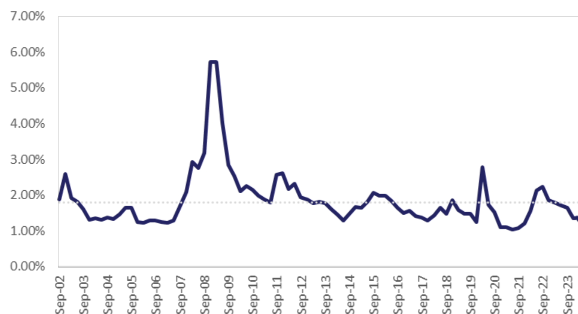
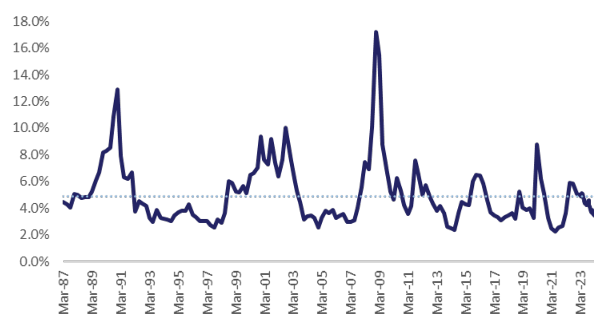


Figure 7: High Yield Less UST 10-Yr Yield Spreads (1987-Present)



Source: Bloomberg, Nordwand Capital. Data as of June 30, 2024.

Figures 6 & 7 illustrate yield spreads, which are the level of excess yield that investment grade (Figure 6) and high yield (Figure 7) investors are demanding to hold those instruments. We have been making the point for some time that these levels do not, in our view, compensate investors adequately for taking increased credit risk. In fact, as can be seen in Figures 6 & 7, yield spreads

across IG and HY liquid fixed income are below long-term averages, which we believe misprices credit risk and disincentivizes some core bond investing.

Looking at commodities and currencies in the second quarter, we witnessed the price of gold continue the sharp move higher that began in February, ending the quarter priced over $2,300/ounce. Crude prices faded during 2Q as prospects of weaker economic conditions and short-term supply-demand balance weighed on that part of the energy complex. Copper had a feverish run up and then right back down during 2Q, which said more about supply-demand conditions than it did macroeconomic prospects. Bitcoin – as our proxy for cryptocurrencies – was down ~13% to end 2Q at just under $62k. As a backdrop for these commodity moves, the US dollar was more or less flat for the quarter.

Holding the bitcoin price separate from the rest of this discussion – as its movements have to do more with technical factors and idiosyncratic factors affecting crypto markets like regulation and (in the case of bitcoin) the halving that occurred during the quarter – we think it is notable that safe haven commodities like gold were strong while more cyclical and industrial commodities like crude and copper were weak and it does tell us something about macro risk levels across the global economy that call for continued awareness and diversification across client portfolios in less-correlated areas like private markets and direct investing.

Figure 8: PE Exit Value & Share of AUM
(2014-Present)

Source: Pitchbook. Geography: US. Data as of June 30, 2024.

In **private markets**, holdings periods continued to push higher through year-end 2023, with Pitchbook noting that holding periods had reached an average of 7 years for managers. In 2024, financing costs have abated a little and GP-led continuation funds have reached more critical mass, providing a path forward to unlock liquidity for weary LPs (and GPs). Exit via continuation fund has risen ~50% YTD in 2024, suggesting this path is facing growing adoption.

Figure 8 highlights the aggregate reduced value of PE exits over the last 2+ years. We had noted in the past that the levels of exits in dollar terms were notable but not historic, in that recently elevated levels of activity in 2020-2021 were the deviation from long-term trends. That said, paying attention to the right axis in Figure 8 illustrates that as a percentage of AUM exit velocity is in fact rather historically low.

As Nordwand clients will appreciate, these reduced levels of exit relative to committed/invested capital can have impacts on ability to re-position as markets move and opportunities arise. Therefore, seeing modestly reduced financing costs and continuation funds providing some daylight for liquidity to enter these portfolios will be welcome if the trend continues and gathers momentum.

Looking Ahead: Navigating Electoral and Policy Shifts

The last 5-6 months of 2024 will almost certainly be dominated by 1) the presidential election cycle – particularly now that the landscape has shifted so dramatically with President Biden's exit and the presumptive entrance of VP Kamala Harris, and 2) the decision of the Federal Reserve with respect to rate cutting.

In **equity markets**, the recent (i.e. since July 9th) rally in small cap stocks relative to large caps has been making waves, and foots with what we've felt and have told clients: small cap stocks have lagged so much that finding a good entrance point and executing on stock picking among the profitable areas within small caps looks like it should provide room for outperformance versus large caps over the medium term.

This same trend is in evidence when looking at the S&P 500, which is market cap-weighted, versus the equal weighted S&P 500. The equal-weighted index, which relies less on the performance of the "Magnificent 7" for its performance, has gained ground since mid-July. Both trends are healthy for equity markets, as the lack of breadth and concentration of returns in a very few individual names was, and remains, reason for caution when investing fresh capital in this market. We'll continue to watch as this unfolds and hope for continued broadening in the months ahead.

In **fixed income markets**, the yield curve has been inverted for one and a half to two years depending on whether we are comparing the 3-month or the 2-year Treasury versus the 10-year UST. Curve inversions of these types and degree have always been historical harbingers of recession, and we are still watching this indicator to assess whether it will prove true this time as well. Generally, recessions occur after the curve re-normalizes and markets react accordingly.

With this backdrop, our preference for shorter-duration in our fixed income investments continues, as does our preference for lower-to-middle market private credit with stronger covenants and secured in some manner by the assets or operations of the business. Private deals often have less liquidity and have been issued by smaller companies, leading to higher levels of absolute yield and yield spreads versus more liquid alternatives. We expect to keep allocating here where possible, either in stand-alone direct deals or in commingled deals with the right manager. In liquid fixed income, we find pockets of value and more attractive risk-return in shorter-duration multi-sector bond strategies that have the flexibility to take advantage of pricing dislocations across the broad market, rather than more typical core bond exposures which leave us unenthused still given paltry yield spreads.

In **commodities and currencies**, we expect the dollar could be marginally weak with some increased political uncertainty and positioning for a rate cut from the Fed. Offsets to this would be more aggressive cutting in Europe or economic weakness on the Continent that makes the US a more attractive destination for capital flows. This uncertainty presents an opportunity for gold to continue working, which would not surprise us as a safety/hedge position, especially since the halving in bitcoin is behind us and therefore leaves the 'benchmark' cryptocurrency as lacking a near-term catalyst to drive flows.

In **private markets** we are watching closely whether exits and distributions pick up pace. IPO activity appears to be showing signs of life at the same time financing costs are rounding lower and investor appetite for liquidity and re-allocation of capital reach cycle highs. If these capital market trends continue, we would expect the next 12-18 months could see a lot of activity. This is doubly true going into next year if it appears possible that taxes are set to move higher. This last is

a political point to some degree, but there are obvious policy and capital market implications depending on who wins the race for the White House this fall.

Summary

In the second quarter, inflation continued to move lower while the economy softened modestly but overall remains in decent shape. In the markets, equities continued their hot streak while fixed income looked for its footing as yields moved around but a general direction was harder to find.

Finding value within equities leads us to favor small caps, value, and pockets of emerging markets, which is similar to our views throughout this year. Outside of those pockets, we think secured credit and shorter-duration exposures will prove a good way to get income generation and, in many ways, looks like a strong risk-adjusted return prospect for the next 12 months. Our long-held bias in favor of private markets is unchanged by these public market developments, and we look hopefully for increased liquidity in the months ahead as we position for a post-election 2025 and a future that has – we dearly hope – a bit less drama than the last 4-6 weeks have provided.

Here's to a less eventful 2H25. We'll talk to you all again in the fall!

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