# Nordwand Capital LLC

## Third Quarter 2024 Market Commentary

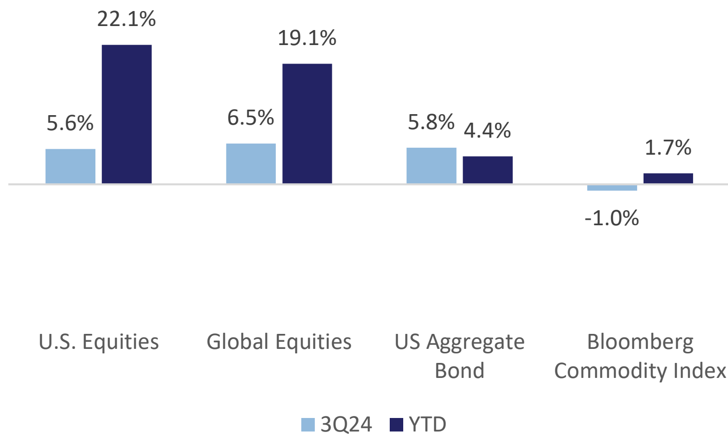
*Markets grind higher as rates cuts begin*

October 30, 2024

### 3Q 2024: Grinding Higher

In the third quarter market and investment conditions were largely positive. Interest rates began coming down, equity performance broadened, recessionary forces appeared to be held at bay, and geopolitical factors – while heightened – have not grown so dire they dominated risk-taking appetite and results. It is our base case that this continues for the remainder of the year, with the obvious caveats that geopolitics or US national politics could take center stage at any time. In the meantime, some quick thoughts about 3Q highlights are below with a fuller recounting and outlook on the following pages.

**Figure 1: Asset Class Returns**
(3Q24 & 2024 YTD)

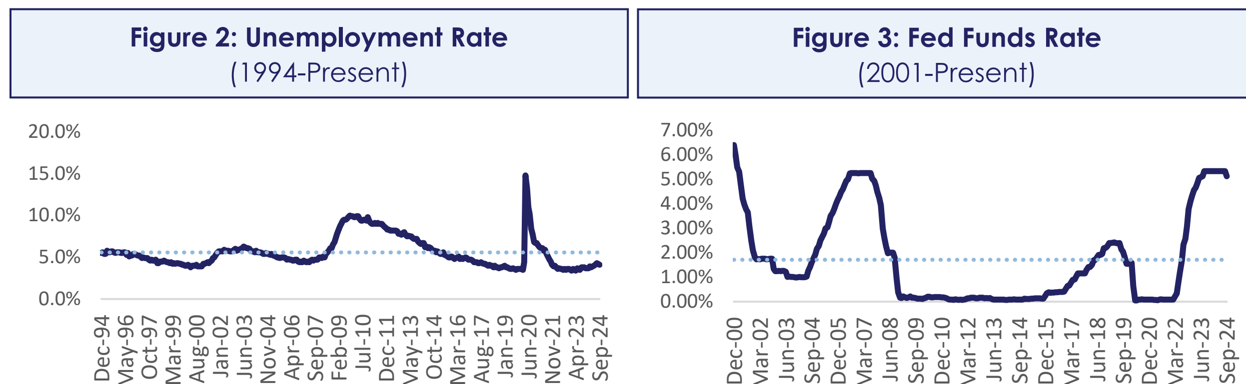



*Source: Bloomberg, Nordwand Capital as of 9/30/2024.*
*Note: US equities = S&P 500 Index; Global equities = MSCI ACWI Index*

- On Sept. 18 the **Federal Reserve cut the Federal Funds rate** by 0.50% (50 basis points), marking the beginning of a regime shift from rising to falling interest rates
- **Equity markets continued their rally** on confirmation of expectations for the Fed rate cut, with developed markets up ~1-3% in the closing two weeks of 3Q and emerging markets up 7-8% on the perception of reduced risk and an onslaught of China stimulus
- Showing strength in 3Q were equity sectors positively exposed to lower interest rates (e.g. utilities, financials) along with those exposed to positive cyclical economic growth (e.g. industrials, materials)
- Interest rates on the short-end of the curve dropped, allowing bond markets to produce positive returns as well (Figure 1), but issues still linger on the longer-end of the curve
- Notably, volatility (as measured by the VIX index) increased by ~50% during 3Q. While still below worrisome levels, in our view this rise reflects increased uncertainty with a change in monetary policy and an election looming in the US

## A Recap of 3Q24: Macro & Markets

We'll start by discussing the macro factors impacting investing markets. These are 1) economic growth, employment conditions, inflationary pressures, and monetary (i.e. interest rate) policy; 2) geopolitics; and 3) US national politics. Then we'll cover how markets reacted to these factors and of course what we think these imply for returns and risk going forward.




*Source: Bloomberg, Nordwand Capital as of 9/30/2024.*

Economically the US continues to plug along pretty nicely in spite of multiple external factors that could easily have tipped us into recession. The unemployment rate (Figure 2) sits at 4.1% at the September reading. While it's been on a modest upswing of late, which almost certainly influenced the pacing and timing of the Fed's rate cut decision in September, employment markets can best be characterized as very healthy by any historical standard.

The 50 basis point (bp) cut in interest rates last month (Figure 3) was in part a response to a rising unemployment rate that moved from 3.4% in April 2023 to 4.3% in July 2024. That level of rise in unemployment customarily precedes a recession, hence the Fed's action[1]

The cut in rates was also a reflection of a subsidence of inflationary pressures that left policymakers feeling that risks between reigniting inflation and rising unemployment were more balanced, allowing the Fed to shift its focus from inflation to employment for the first time in 3 years. Whether policymakers have chosen wisely we will all know in coming months.

Working off the supply constraints coming out of Covid, West coast port issues, ongoing global trade tensions (particularly with China) that span Democrat and Republican party policies, and labor unrest, have all been absorbed in workmanlike fashion. As everyone reading this will already know, we've worked past these issues in large part due to an extraordinary amount of monetary and fiscal stimulus that's been unlike any period, outside of war, in US history.

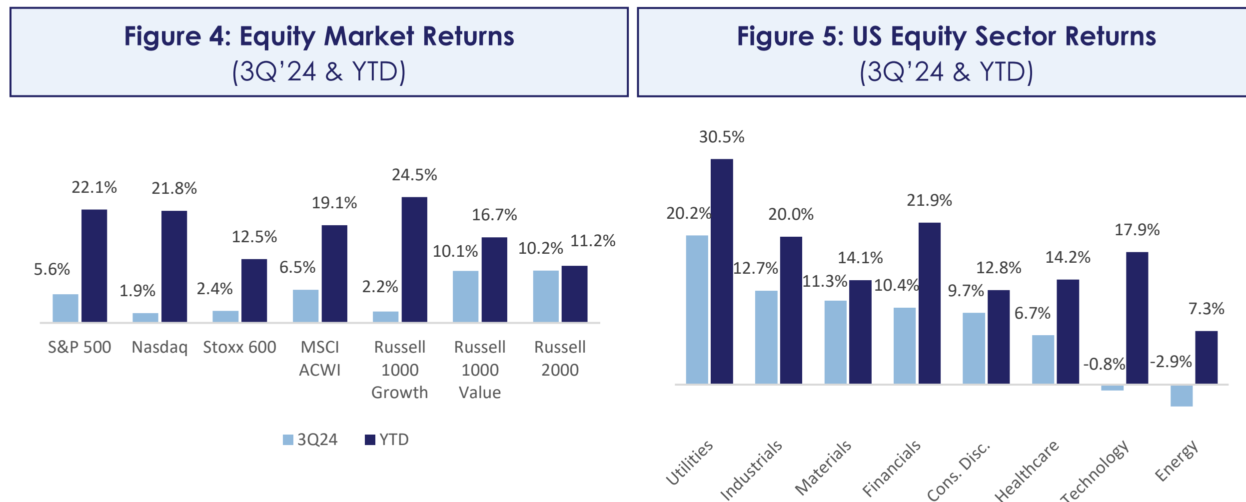
The federal government continues to run $1.5-2.0 trillion annual deficits and the Federal Reserve has been providing liquidity to serve as a backstop for asset prices in the market. Given this, it is difficult to imagine a near-term crisis of confidence impacting the economy in a manner sufficient to lead to a proper recession. Risking the most minor of political comments here, we feel comfortable saying that regardless of which party wins control of the White House in November we are likely to see a continuation of deficit spending lubricating the US economy.

[1] For those interested in more information on the topic of the Sahm Rule:
Real-time Sahm Rule Recession Indicator (SAHMREALTIME) | FRED | St. Louis Fed
What is up with the Sahm Rule, and what does it mean for the Fed? | J.P. Morgan Private Bank U.S.

Looking at the markets, 3Q continued a trend of positive returns with both equities and bonds posting positive returns (Figure 1). Looking under the hood during the quarter was slightly more revealing about where investors are positioning themselves going into the election and the end of the year.

**Figure 4: Equity Market Returns**
(3Q'24 & YTD)

**Figure 5: US Equity Sector Returns**
(3Q'24 & YTD)




*Source: Bloomberg, Nordwand Capital as of 9/30/2024.*

Value stocks and small cap stocks performed well during the quarter (Figure 4), although both still lag large cap equities on the year. Small cap stocks, in particular, have come in for disdain in this market as the percentage of unprofitable companies comprising some of the indices that measure the small cap universe make the space look less compelling in many respects. Our view has been, and remains, that stock picking and active management are designed to produce outperformance in precisely this kind of sub-market. Coupled with the fact that private equity and venture capital have been holding onto winners for longer and are running into problems with their investors as a result, and we are hopeful that we will see more profitable smaller-cap companies come to market and breathe fresh life into this important segment of the public equities market.

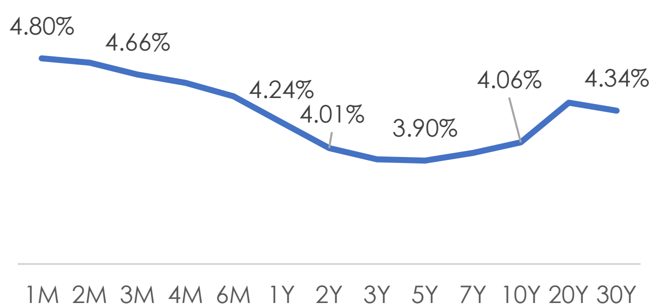
Looking at sectors in Figure 5 reveals a reasonable degree of bet-hedging within equities. On the one hand, that utilities and financials would perform well into an interest-rate-cutting environment is no surprise at all. At the same time, the soft-landing narrative we have discussed at length in prior updates would suggest that a continuation of the tech/growth story would persist, and yet technology and consumer discretionary companies have lagged the market in both the most recent quarter and YTD.

Overall, we think the market is unwinding some consensus positioning, with ignored defensive stocks that will benefit from declining interest rates (utilities, financials, consumer staples, real estate) gaining traction while recent winners begin to lag. Whether this trend continues depends on many factors – perhaps most importantly the path of interest rates and strength of the economy. That said, our overall view that adding to undervalued and under-loved areas in the market will produce better returns over time is entirely consistent with the market's recent performance trends. We believe that small cap and international stocks merit active positions in client portfolios in the time of rising uncertainty in which we find ourselves.

Emerging markets (EM) performed well in the quarter as well, with India up ~8% and China up 23% driving results higher. Late in the quarter China's leadership was engaging in a robust round of fiscal stimulus that it was thought might lead to better economic growth and therefore equity returns. While there is ample reason for either skepticism or optimism that these policies will lead to positive investor returns, we would point out to clients that catching these EM inflection points often leads to lagged results – and it is for this reason that we seek quality active strategies in EM who have demonstrated an ability to capitalize on these shifts for investors' benefit.

In fixed income markets, the promise – and ultimately the delivery – of an interest rate cut by the Fed buoyed bond prices as yields dropped into the September 18th meeting. The counter-reaction following the initial exuberance led to yields rising back above 4.0% at the long end of the curve, as investors digested the potential for continued deficit spending by both political parties and the need to finance that spending. Corporate yield spreads for both investment grade and high yield issuers remains tight and uninspiring – a refrain we suspect some of you may be tired of hearing us repeating at this point, but which nevertheless continues to be true.

**Figure 6: US Treasury Yield Curve**
(1Mo. thru 30 Yr. maturity)




*Source: Bloomberg, Nordwand Capital as of 10/09/2024.*

Commodities markets were mixed. In the energy complex, crude prices fell and natural gas prices rose, more reflecting short-term supply-demand dynamics and seasonality than a larger macro trend. Gold prices continued their torrid pace, rising 13% in the quarter and 28% YTD; gold prices have risen 50% since the start of 2023 and at current writing sit at all-time highs. As we often view energy and industrial commodities (e.g. copper) as proxies for global demand and gold as proxy for concern over financial conditions (i.e. health of the US dollar or inflationary expectations) it's fair to say that these markets are pricing in a slower-growth world with some currency risks. That sounds reasonable from our seat as well, and also influences our desire to broaden out some positions and search for value away from momentum where possible.

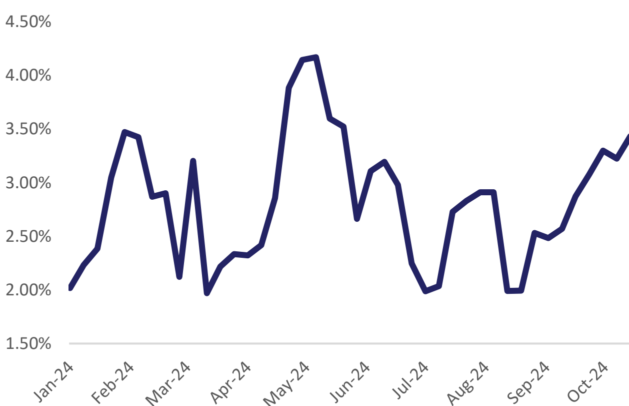
In private markets, exit activity remained constrained by lower valuations, higher interest rates/financing costs, and perhaps a bit by unrealistic expectations on the part of some sponsors. Long-time clients will know of Nordwand's preference for private markets given the exposure to distinct assets and uncorrelated cash flows that historically have delivered strong return streams. As dry powder sits at high levels we worry about the potential for trading assets between sponsors without providing liquidity to investors.

In private equity and venture capital we see these risks as much more pronounced, yet also see the increase in activity in private credit markets as an alternative to traditional syndicated loans or liquid debt markets as a secular shift that may produce options for sophisticated clients to capitalize on available higher spreads/yields as an antidote to some less-compelling public equity market return expectations. In fact, as we think about private credit or direct lending in client portfolios, it is quite reasonable, given return hurdles, to think of these allocations as equity alternatives rather than stand-ins for traditional fixed income allocations.

## Looking Ahead: Politics & Policy Influencing Near-Term Macro

The macroeconomic outlook into year-end is generally solid, barring the political outliers that loom on the margins. Data in the US continue to be strong, with stock prices at all-time highs, home prices supported by low available supply and declining interest rates, a dovish Fed cutting rates into a late cycle period, adequate liquidity for financing transactions, a generally healthy consumer, and strong secular trends like automation and AI supporting capital spending and the potential for productivity growth.

**Figure 7: Atlanta Fed GDPNow Forecast**
(Jan. 2024 - Present)




*Source: Bloomberg, Nordwand Capital as of 10/18/2024.*

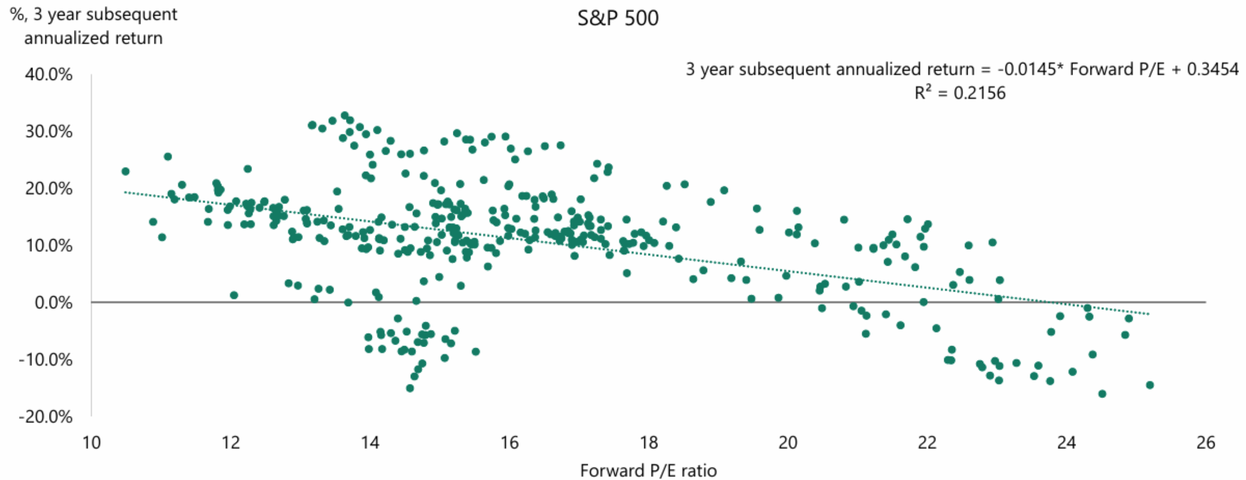
Shorter-term indicators like port traffic and upcoming layoff announcements[2] point to a hospitable economic environment as well. The Atlanta Fed's GDPNow series (Figure 7) forecasts a 3.4% GDP for 3Q 2024. Layoff announcements are at reasonable levels, and average hourly earnings (AHE) – a series we have shown from time to time – has seen an uptick in recent readings. Coupled with a likely rise in housing inflation based on the popular Case-Shiller Home Price Index that tends to lead broader inflation measures by several months, we think there remains slightly more pressure on the economy from a possible rebound of inflation than from imminent recession.

Expanding on that last point, it's worth reminding that as we stare at an election in the US that appears likely to lead to either participant favoring deficit spending, money printing, and some degree of trade protectionism that we have a higher propensity for inflation reigniting than most of us have become accustomed to in the prior 30-40 year period. As we shake off the lingering effects of a post-Covid global economy and return to the "new normal" we will keep that in mind as we build and update client portfolios.

With that said, our view of **equities** from here is influenced by an expensive US large-cap equity market that suggests lower future returns. In Figure 8 we highlight again that expensive markets (the current S&P 500 forward price-to-earnings multiple is 21.5x at the time of writing), produce lackluster returns in future periods. If the average stock in the S&P is trading at a 21.5x forward multiple history suggests a 3-year forward return of slightly less than 3% - effectively barely keeping track with inflation if it bore out. The critical caveat here is that much of this economy and this market have been different than ordinary periods and we have been more exposed to equities as a result. But it's hard not to look at returns in 2023-2024 as having borrowed excess return from future years as investors have piled in to support AI-fueled post-Covid rallies that have left the market with a smaller margin for error than we would prefer.

[2] The WARN (Worker Adjustment and Retraining Notification) Act requires most employers with 100 or more employees to provide 60 days' notice of planned closings or mass layoffs in an effort to prepare families accordingly.

**Figure 8: Correlation Between S&P 500 Forward P/E & Future Returns**
(Current forward P/E: 21.5x)




*Source: Apollo Chief Economist, Bloomberg, Nordwand Capital as of 10/18/2024.*

In **cash and credit markets** the driving factor is the Fed's policy shift toward rate cuts and what that implies for potential returns. In cash, it is clear that lower rates will make it more 'expensive' to remain in cash rather than taking some credit or duration risk among income-producing allocations. We favor reducing cash positions for those clients who do not need the extra buffer for near-term funding as we expect another 4-6 rate cuts by year-end 2025 leading to roughly 3.5-3.75% cash rates by that time. We are less enamored of yield spreads (as we noted above) for investment grade and high yield credit, and are also skeptical of taking duration risk (i.e. buying long-dated bonds that mature beyond 5-7 years out) as we don't feel investors are being adequately compensated for the risk in either situation.

The term premium of interest rates – which is the difference in yield from near-term or cash positions and long-term or 10+ year investments – has tended over time toward 100-110bps. Of course it currently is negative, and even were cash rates to come down 100-150bps (consistent with 4-6 25bp rate cuts by year-end 2025) the yields offered at the long-end of the curve don't offer much in terms of additional reward for taking a decade of duration risk. Hence our view that fixed income or credit investments – whether they be asset-based, private credit, syndicated loans, or traditional liquid corporate fixed income – should focus on the 1-5 year part of the curve.

In **private markets** we continue to watch the pace of distributions and transactions to see whether these improve. While signs of life are emerging, trade and fund-to-fund transactions are often not as promising for investors as cash sales to strategic players or public offerings. With this as a backdrop, fundraising has been challenging except for the biggest funds. In a report issued by Blue Owl using Pitchbook data we have seen that capital raises by funds over $1 billion in size have risen from ~44% of the market in 2009 to ~70% in 2023. These funds have a bias toward larger check sizes on the way in and deep and liquid markets to exit.

For this reason we tend to favor smaller emerging managers complemented by our own sourced deals as a way to deploy investment capital into smaller companies in need of growth support that is increasingly hard to come by in the institutional market. We have been pleased with this approach to date and expect to continue down this path going forward.

## Summary

Markets moved in some refreshing ways in 3Q, and economic data broadly supported the view that recession isn't the biggest near-term risk. For instance, if small cap equities can consolidate and build on these returns it can have the salutary effect of encouraging more exits from private equity holdings, in turn releasing liquidity into markets and giving investors a larger risk budget from which to allocate in 2025. While we think it's too early to suggest with confidence that this is playing out in markets, it is something to watch and hope for in the next few months.

Politics will play a role in how 4Q unfolds, and we will be watchful of risk-taking until we see the results. As yields move around we think investors should be mindful of further spread compression – if that's even possible – and find more appealing ways to deploy credit investment capital into structured credit, direct lending, and other areas where returns are more attractive if risk can be properly managed.

We'll see you on the other side of the New Year unless events warrant an interim note from us. In the meantime, here's to a prosperous autumn and holiday season for everyone!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