Research
Review

May 2024

Following a bumpy April in which many key sectors across the financial markets faced performance headwinds amid a backup in interest rates, May brought a reversal of fortune in the form of interest rate declines and a rebound in risk and high-quality assets. In the global equity markets, domestic equities outperformed international—particularly emerging markets. From a capitalization perspective, smaller cap domestic equities participated in the monthly risk rally and essentially matched the performance of large cap. Bond markets regained their footing as recent upward pressure on many inflation surprise indices moderated, leading to a nearly 20 basis point (bp) decline in the 10-year U.S. Treasury Note yield, which ended the month at 4.50%. High-yield spreads widened slightly but remained near the lower end of their cyclical and historical range. Like the stock and bond markets, most major real asset sectors saw positive returns in May, with real estate investment trusts (REITs) and global listed infrastructure posting mid-single digit returns, while commodity futures—i.e., Bloomberg Commodity Index—witnessed a third consecutive month of gains.

INSIDE THIS ISSUE

CERTAINTY + INGENUITY

Economic Update

Stagflation Worries Return as Inflation Proves Sticky and Growth Has Cooled

"The gradual declines across the household survey since early 2023 have helped to stop the cyclical improvement in the headline unemployment rate in its tracks." – Mike O'Conner, CFA

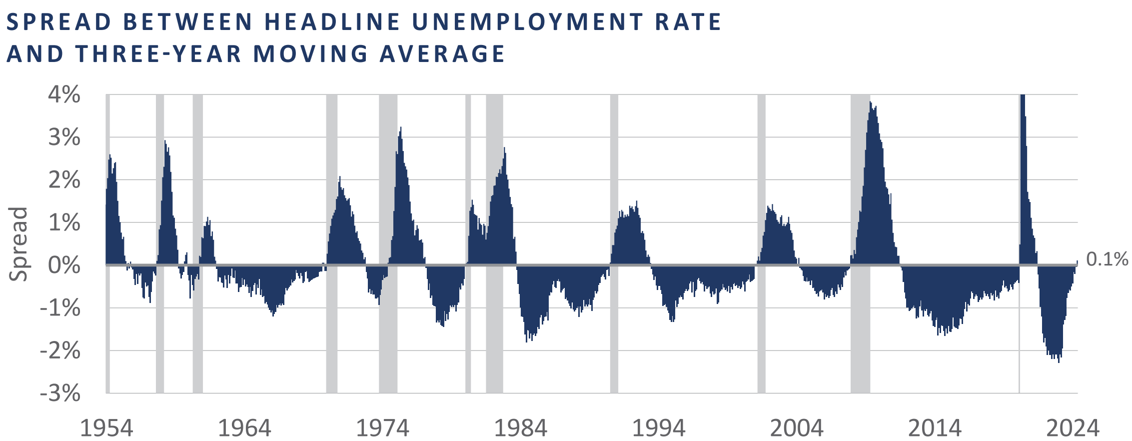
The U.S. economy has displayed significant global leadership in the post-pandemic era, with the historically tight labor market garnering considerable attention. Since January 2021, the U.S. economy has generated an average monthly gain of nearly 400,000 jobs, the strength of which helped send the headline unemployment rate, also known as the U-3, to a cycle low of 3.4% in both January and April 2023.

The rebounding labor market became so out of balance that at one point in spring 2022, there were approximately two job openings for every unemployed individual—a ratio that historically is reversed. Accompanying the highly unbalanced labor market were mid-single-digit annual employee wage gains. While these gains generally failed to outpace the rise in the cost of living, they helped serve as a tailwind behind the multi-decade high inflation rates that immediately followed the brief business cycle contraction in early 2020.

Fast-forwarding to May 2024, many headline measures of the health and well-being of the labor market have appeared sound, although they have exhibited a cooling in recent months. In May, for example, the Bloomberg median sell-side consensus estimate implied a monthly gain of 180,000 in nonfarm payrolls; however, the actual reading smashed expectations with a print of 272,000 jobs, sending odds of a 2024 Federal Reserve (Fed) rate cut decidedly lower. While financial media headlines quickly highlighted the upside surprise on the payrolls front, several worrisome developments continued to build during the month.

First and foremost is a historically wide divergence between the establishment survey of employment—from which the monthly nonfarm payrolls data is derived—and the less widely followed household survey of employment, which impacts data such as labor force participation and demographic trends. While the establishment survey has appeared on a nearly straight-line uptrend since the pandemic, the household survey has essentially flatlined over the trailing year.

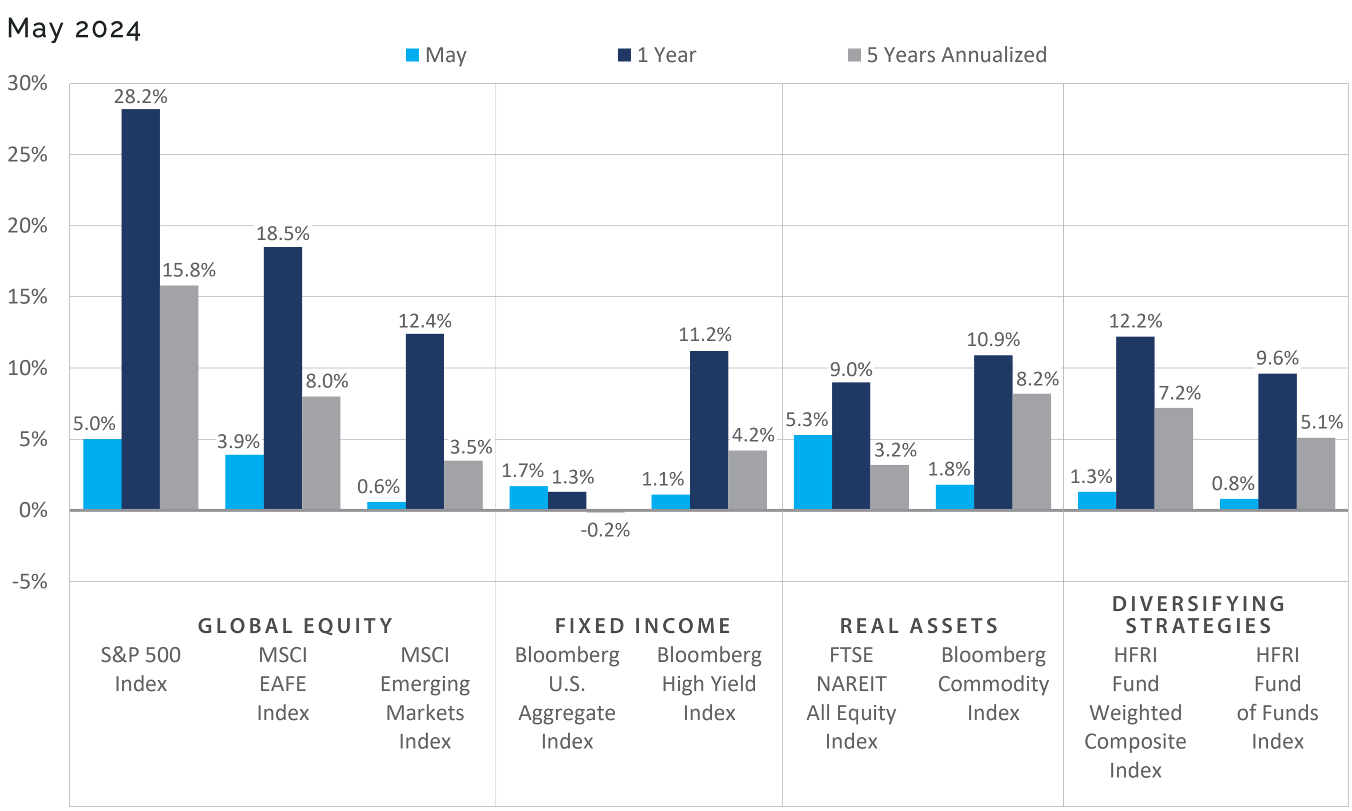
The gradual declines across the household survey since early 2023 have helped stop the cyclical improvement in the headline unemployment rate in its tracks. In fact, despite the 272,000 gain in payrolls in May, the unemployment rate actually rose 0.1 percentage points to 4%, the highest level since January 2022 and 0.6 ppts above the cycle low. This is due in part to a 250,000 shrinkage in the labor force and a broader 408,000 increase in the count of unemployed persons. The gradual deterioration in the unemployment rate over the trailing year pushed the reported rate above its 3-year moving average in May for the first time in the current economic expansion, a cyclical dynamic that historically has placed market participants on "recession watch."



Data sources: BLS, NBER, Bloomberg, L.P.; Data as of May 2024

To conclude, financial markets rebounded in May as upside inflationary surprises moderated, interest rates declined, and the U.S. economy continued to display an expansionary bias. While labor market data for the month continues to appear sound, lurking underneath the surface is growing evidence of fundamental weakness that demands asset allocators' attention.

Market Summary



Data source: Lipper, HedgeFund Research

Global Equity

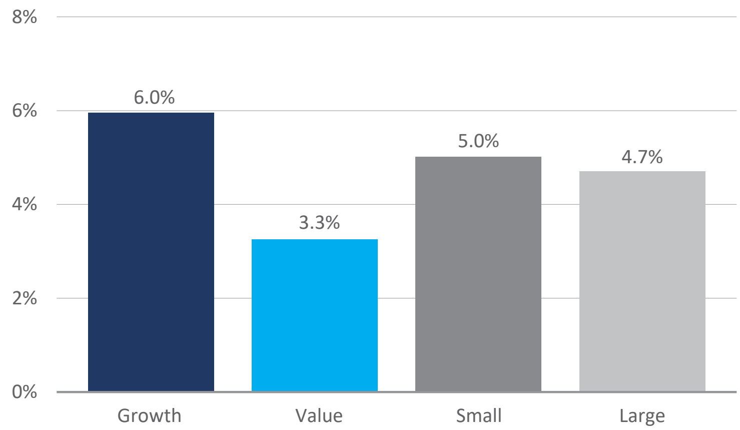
Equity markets rebounded in May after a brief decline in April. Continued demand for artificial intelligence (AI) drove returns as developed markets outperformed their emerging market counterparts. Slow but continuing disinflation in the U.S. and European Union gave investors confidence that the rate cuts expected later this year from major central banks may still happen, which did occur after the end of the month when the European Central Bank cut their rate 25 bps on June 6. This confidence provided a tailwind for small cap stocks, which had their best-performing month year-to-date.

U.S. large cap equities bounced back after experiencing negative absolute returns in April. Strong earnings results led the rally, specifically in the communication services and information technology sectors. Another contributor to performance was cooler inflation, as the April print marked the first time inflation did not exceed expectations this year. One of the biggest headlines during the month was the return of "meme stocks" GameStop (GME) and AMC Entertainment (AMC). The market presence of the Reddit user who led the short squeeze of these two names in 2021 caused prices and trading volumes to increase considerably during the month.

European equities ex-UK slightly underperformed their U.S. counterparts in May. Trends were similar to those in the U.S., apart from the underperformance of the consumer discretionary sector. Three of Europe's "Magnificent 7" stocks, Louis Vuitton, Hermes, and Ferrari, declined as the luxury goods sector corrected from recent expansion. The price corrections were mainly driven by a decline in consumer spending and a surplus of inventory.

GROWTH CONTINUES TO OUTPACE VALUE

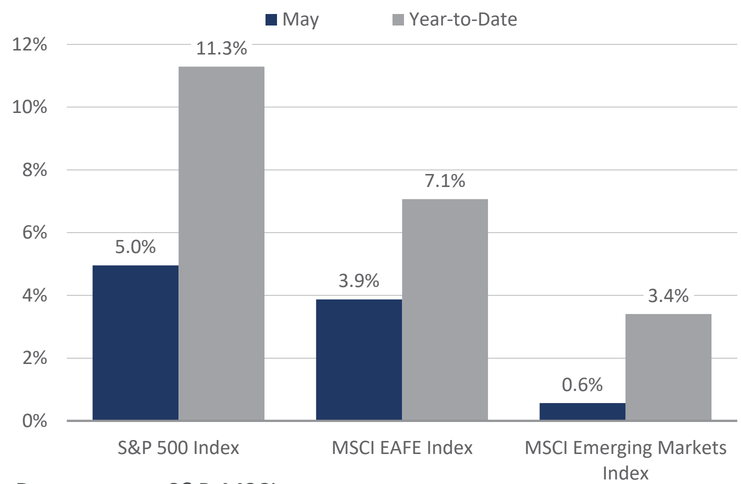
U.S. Style Returns



Data source: FTSE Russell

AI DEMAND CONTINUES TO DRIVE MARKET RETURNS

Equity Indices Performance Returns (U.S. Dollars)



Data sources: S&P, MSCI

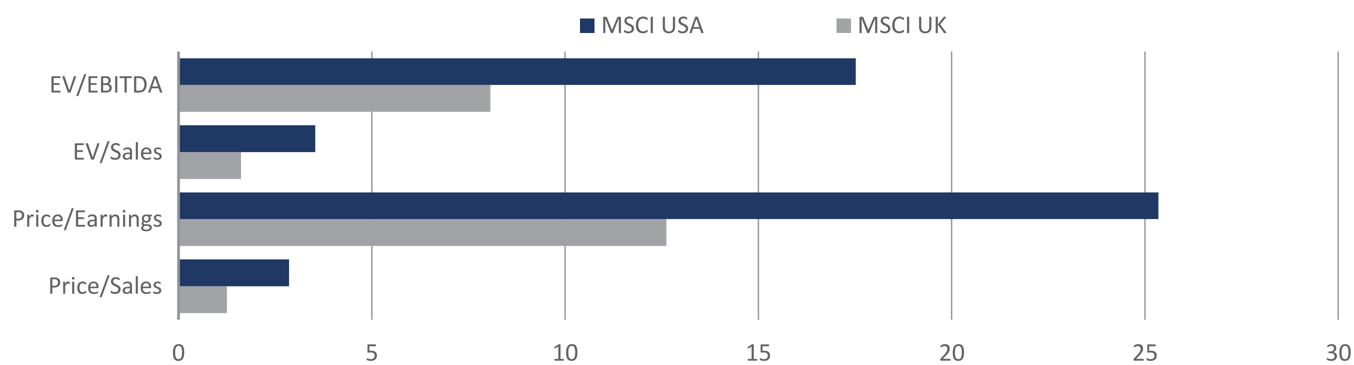
Although they underperformed other developed markets, UK-based equities reached record highs after rebounding from a brief recession in the latter half of 2023. Defense stocks in the UK and broader Europe continue to outperform on the back of tensions in the Middle East and Eastern Europe. More holistically, UK equities are still trading at around a 50% discount when comparing UK valuation ratios to the U.S., even with the FTSE 100 Index establishing a new all-time high. These low valuations, combined with a recent recession breakout, have promoted increased deal flow in the UK, with bid activity for UK-listed companies reaching its highest level since 2018.

The Nikkei 225 Index remained relatively unchanged in May. A rise in long-term interest rates acted as a tailwind for the financials sector while the information technology sector underperformed. As net exporters, large cap Japanese companies are typically content with currency weakness; however, low yen levels have started to weigh on consumer sentiment. Consequently, Japanese companies have repurchased shares at a record pace, with 2024 share buybacks already totaling 67% of last year's total.

The MSCI Emerging Markets (EM) Index was also relatively unchanged, with mixed returns from different regions. The energy sector struggled amid weakened oil prices, negatively affecting countries such as the United Arab Emirates, Qatar, and Saudi Arabia. Eastern European countries contributed positively to overall performance due to idiosyncratic earnings results and currency strength. China outperformed despite real estate debt defaults and President Biden's tariff actions.

RELATIVE DISCOUNTS ACROSS THE POND

MSCI UK vs. MSCI USA Valuation Multipes



Data source: FactSet

Fixed Income

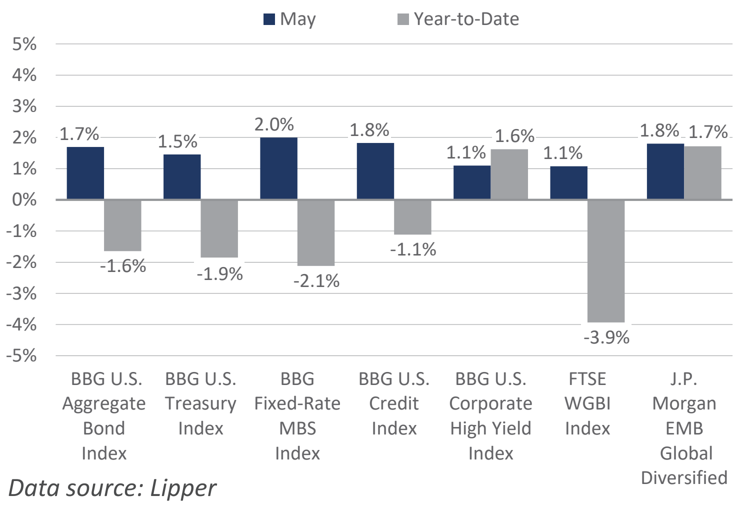
Rates fell in May, with the 10-year Treasury falling 18 bps to 4.51% and the 2-year Treasury falling 15 bps to 4.89%. The 10-year Treasury rallied to 4.36% mid-month, however, as the April Consumer Price Index (CPI) rose 0.3%, slightly below expectations of 0.4%. This eased inflation fears following multiple hotter prints earlier this year. Additionally, employment data pointed to a potential gradual softening of the labor market.

In Japan, the 10-year Japanese government bond rose nearly 20 bps in May to reach 1.06%, surpassing 1% for the first time since April 2012 as the Bank of Japan (BOJ) continued to roll back its easy monetary policy. Additionally, Japan's Ministry of Finance intervened in currency markets to protect the yen, which has continued to weaken and briefly touched ¥160 against the U.S. dollar—a level unseen since 1990—prior to the intervention. This move put pressure on the BOJ to continue raising interest rates.

Treasury auctions returned to the limelight in the last week of May following multiple auctions—2-year, 5-year, and 7-year—which "tailed," where the clearing yield, or the yield required to sell all the treasuries, was higher than the market yield before the auction. This caused a brief surge in Treasury yields. However, despite continued supply concerns, the bid-to-cover ratio, or the amount of Treasuries bid on divided by the amount brought to market, remained near historical averages at around 2.4. The Treasury's choice of funding, whether continuing to issue with a preference for short-term bills or shift back toward typical levels of longer-dated coupon bonds, will be closely monitored by market watchers.

PERFORMANCE LED BY FIXED RATE MBS

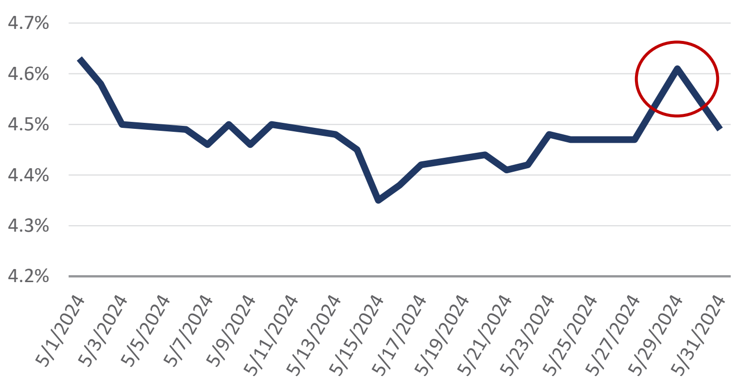
Fixed Income Index Returns



Data source: Lipper

VOLATILITY SPIKED IN MAY FOLLOWING TAILED AUCTIONS

U.S. 10-year Treasury Yield



Data source: FactSet

YEN REACHED HIGHEST LEVEL SINCE 1990

USD/JPY Exchange Rate

Data source: Federal Reserve Bank of St. Louis (FRED)

Real Assets

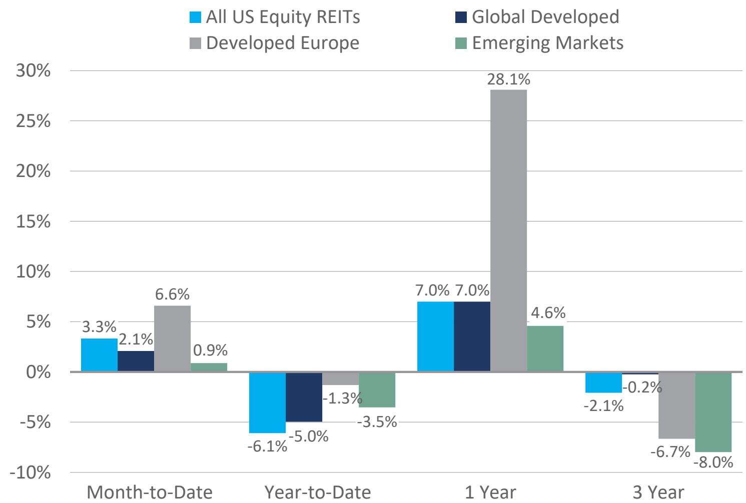
Real Estate

U.S. REITs rebounded in May but fell short of a full recovery from the sharp decline in April. Higher interest rates continue to pressure REITs, but fundamentals have remained strong across several sectors, particularly data centers, tele-communications, and shopping centers. In May, data center REITs led performance as they continued to benefit from the artificial intelligence theme due to increased demand for hyperscale facilities from large technology companies.

Developed Europe REITs outperformed the U.S. for a second month ahead of anticipated interest rate cuts by the European Central Bank (ECB). On June 6, the ECB cut rates from 4.00% to 3.75%, which many expect to provide a more supportive environment for European real estate.

EUROPEAN REITS OUTPACE U.S. AHEAD OF ECB RATE CUTS

Trailing REIT Performance by Geography



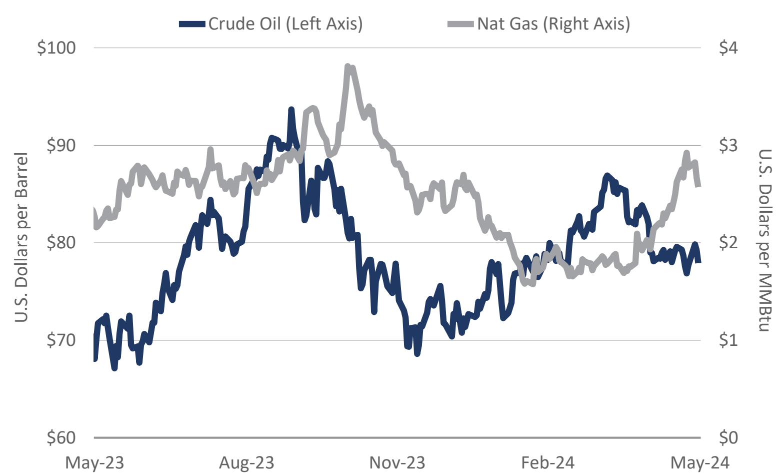
Data source: FactSet

Natural Resources

As measured by the West Texas Inter-mediate (WTI) spot contract, crude oil prices declined 6% in May. Several factors contributed to the bearish sentiment, including a buildup in global inventories, economic growth concerns, and increased oil exports from Russia. Russia's export increase came as a surprise as OPEC+ announced on June 2 that production cuts would be extended into the second quarter of 2024, potentially phasing out of reductions in the fourth quarter of the year. Conversely, the Henry Hub natural gas spot contract rose nearly 30% during the same period. Anticipations of warmer summer weather drove this increase, although inventories remained above the long-term average.

NATURAL GAS FINDS THE BOTTOM

Price of West Texas Intermediate (WTI) Crude and U.S. Natural Gas



Data source: FactSet; Data as of March 4, 2024

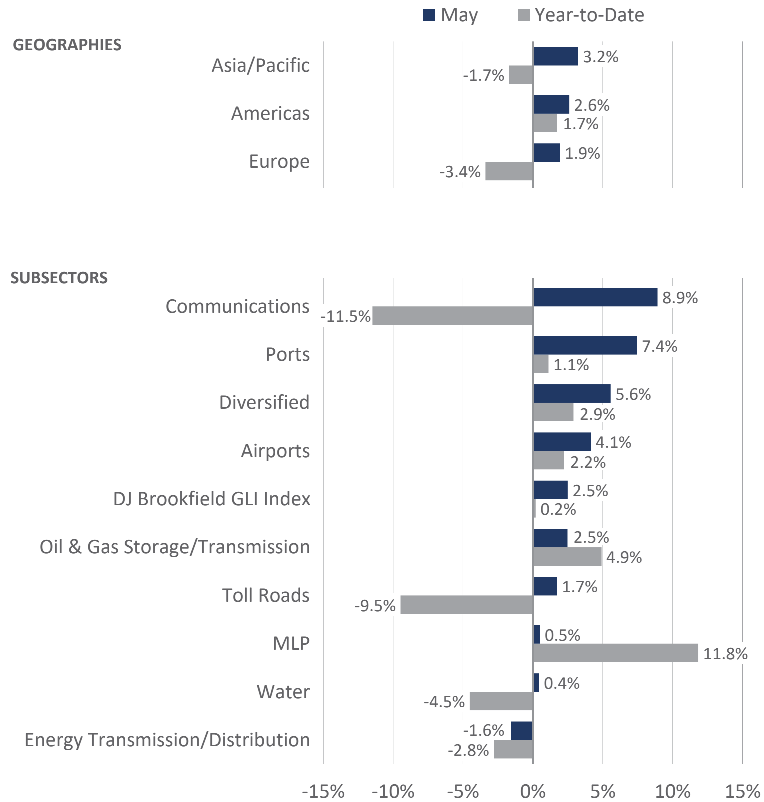
Infrastructure

Global listed infrastructure stocks rose in May, as measured by the Dow Jones Brookfield Global Infrastructure Index. The communications subsector, composed of data centers and cell towers, was the top performer during the month. Data centers contributed to the strong performance, but cell towers rebounded significantly after continued pressure from higher interest rates.

Midstream energy infrastructure was relatively flat in May but has still posted double-digit gains in 2024, as measured by the DJ Brookfield Global Infrastructure MLP Index. Midstream energy continues to offer an attractive and competitive yield supported by improved industry fundamentals, and midstream master limited partnerships continue to grow dividends and execute share buybacks.

COMMUNICATION INFRASTRUCTURE LEADS IN MAY

Listed Infrastructure Trailing Returns



Data source: FactSet

Diversifying Strategies

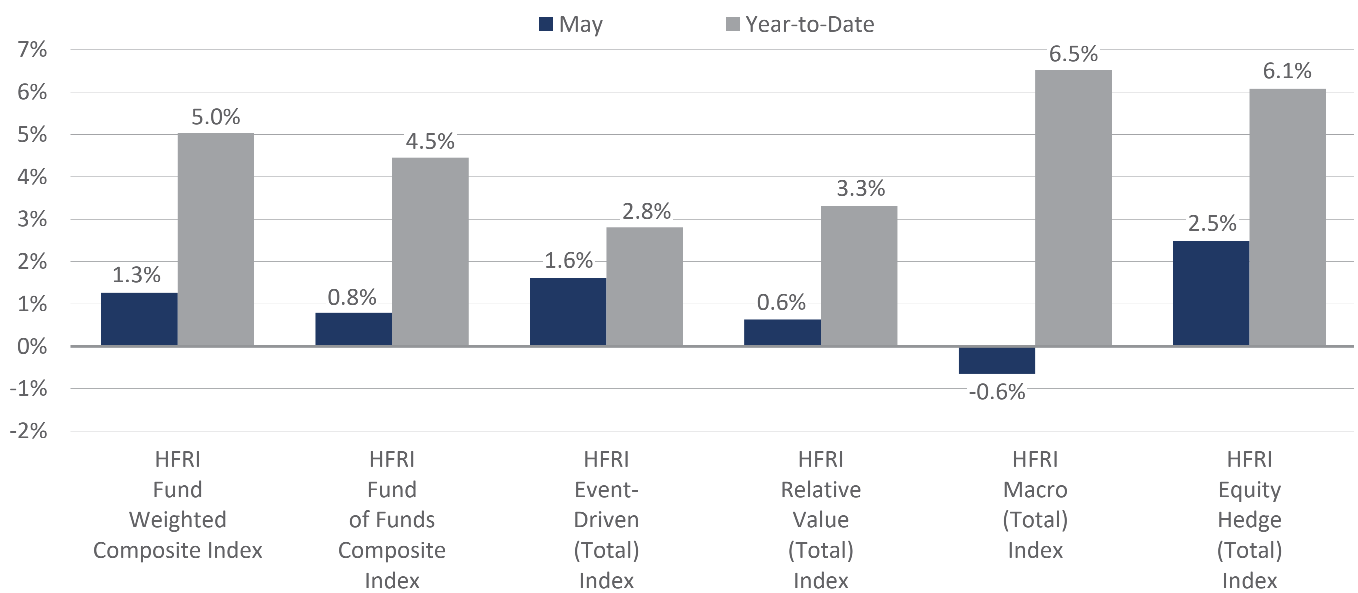
Most hedge fund strategies performed well during the month, led by hedged equity and event-driven managers. It was a strong month for equity-oriented strategies, providing a solid tailwind to long/short equity and event-oriented allocations.

Hedged equity was strongest in the technology, healthcare, and quantitative directional sectors. Under the event-driven umbrella, gains were focused on distressed/restructuring, credit arbitrage, and merger arbitrage.

Systematic trend-following managers witnessed a reversal of fortunes in May. After four months of gains, the strategy experienced losses across currencies, energy, and bonds. In particular, currency losses were concentrated in long U.S. dollar allocations relative to the Euro and Australian dollar. Short exposure to U.S. Treasuries was another detractor for the strategy. Finally, losses stemmed from long crude oil and distillate positions in energy.

HEDGE FUNDS LED BY HEDGED EQUITY AND EVENT-DRIVEN

HFRI Indices Performance Returns (U.S. Dollars)



Data source: HedgeFund Research

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All data is as of May 31, 2024 unless otherwise noted.

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