Research Review

August 2024

Similar to the recent mixed messages from various key economic data sets, the financial markets displayed continued disparate signals in August, a dynamic likely driven by the looming shift in the Federal Reserve's (Fed's) money posture and asset allocators' varying approaches to best positioning portfolios against this change. Global equities generally posted solid gains during the month, particularly in the international developed space, with smaller cap equities continuing to lag their larger counterparts. Performance across the bond markets appeared broadly positive, with notably strong gains witnessed in the longer-duration sectors amid a fourth consecutive monthly decline in Treasury interest rates as measured by the 10-year U.S. Treasury Note. Like global equities, real asset performance was mixed on the month, with interest rate-sensitive sectors such as real estate investment trusts (REITs) and global listed infrastructure posting strong monthly gains while commodity futures declined amid pervasive global economic growth concerns.

INSIDE THIS ISSUE

Economic Update

Financial Markets Brace for Federal Reserve Pivot to Less-Restrictive Policy Stance

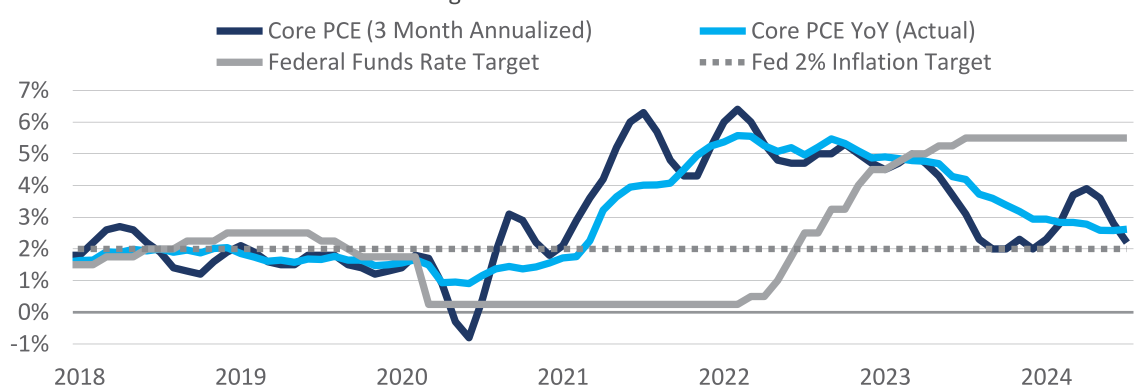
"Tollowing a year-plus pause in adjustments to the federal funds rate, the Fed finally seems to be on the cusp of altering its policy stance." – Mike O'Conner, CFA

Ultimately, the Fed elected to make a 50 bps cut in mid-September. Following a year-plus pause in adjustments to the federal funds rate, the Fed finally seems to be on the cusp of altering its policy stance, with a cut to the policy rate widely anticipated at the Fed's September 17-18 meeting. Debate among market participants have recently centered around the appropriate size of easing, with Fed funds futures reflecting a minimum reduction of 25 basis points (bps) and a 50 bp reduction also on the table.

Throughout the Fed's tightening campaign over the past two-plus years, Chairman Jerome Powell has consistently communicated the Fed's commitment to restoring price stability without a material decline in aggregate demand, outlining the conditions that would have to be met for the Fed to reverse its hawkish posture. On the inflation side of the Fed's dual mandate, there is no question the pace of inflation has cooled materially over the trailing quarters. The cyclical peak in the annual personal consumption expenditure (PCE) reading was 5.6% in early 2022 and has since eased to 2.6% through July. Moreover, this monthly inflationary data series has slowed to a 2.2% annualized pace over the trailing three months, essentially matching the Fed's 2% bogey.

THE FEDS INFLATION METRIC HAS BEEN COOLING SINCE THE PEAK IN 2022

Core PCS Inflation and Federal Funds Target Rate



Data sources: Federal Reserve, BEA, Bloomberg, L.P.; Data as of July 2024

On the labor side of the Fed's dual mandate, labor market distortions from the pandemic era appear to have normalized, albeit somewhat abruptly. Through August, the headline unemployment rate stood at 4.2%, 80 bps above the cyclical low of 3.4% from January 2023 and 20 bps above the Fed's year-end 2024 assumption as derived from the Federal Open Market Committee's (FOMC's) mid-June Summary of Economic Projections.

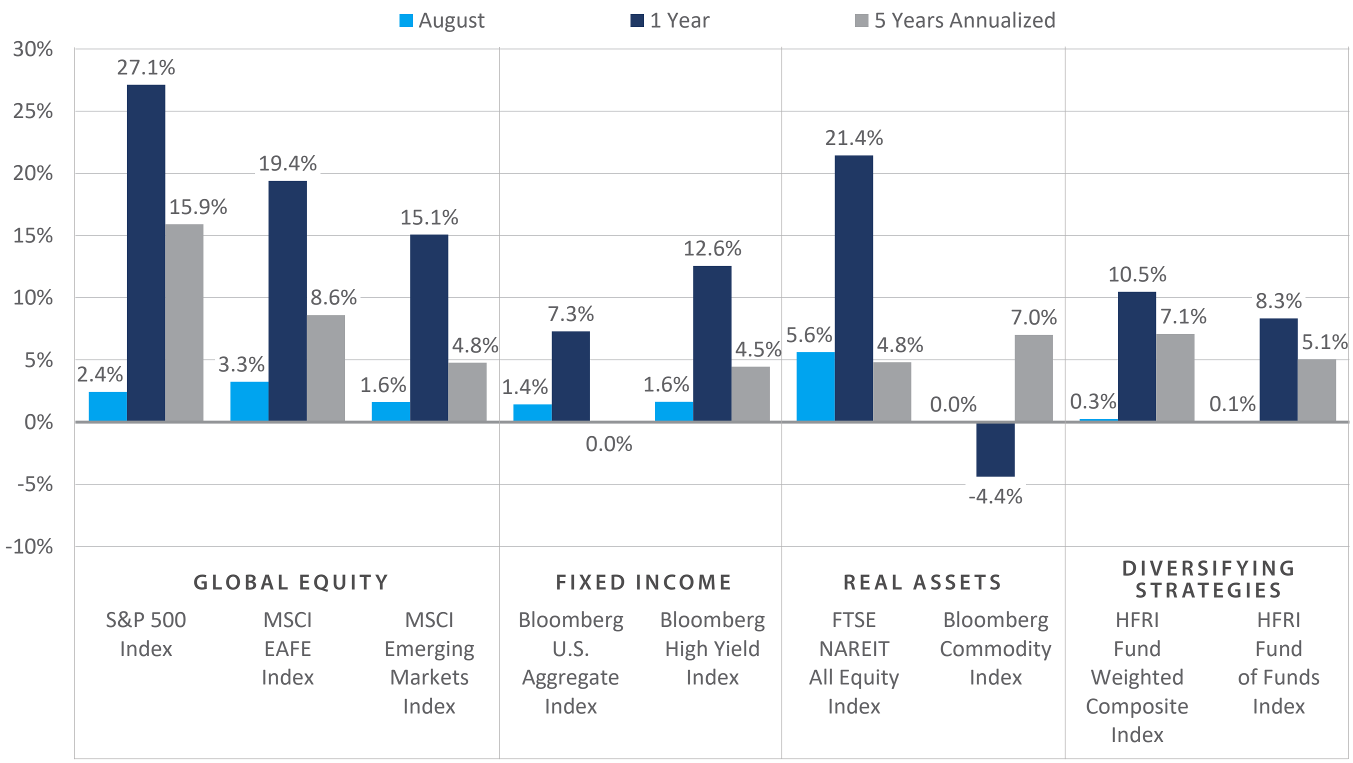
The marked downshift in the labor market in 2024—including a substantial downward revision by the Bureau of Labor Statistics' estimates of payroll gains over the trailing year, a sharp increase in the headline unemployment rate, and a gradual decline in the average workweek—remains a key driver behind the bond market's aggressive discounting of easing across the policy rate over the coming quarters. As of September 6, for example, the Fed funds futures curve had discounted nearly five 25 bp reductions to the policy rate by the end of the year, with a similar level of easing expected in 2025.

While current market conditions suggest the Fed may have successfully engineered the historically difficult task of tightening monetary policy to restore price stability without stoking a recession, the months ahead will be significant for establishing the confidence level of this assertion—particularly in the event that volatility significantly rises amid a changing of the guard in the White House or if inflation, which technically remains above the Fed's 2% target, and fails to progress on its downward trajectory.

In summary, similar to the continued mixed readings displayed by the U.S. economy, performance across the financial markets varied in August, albeit with gains across the majority of key asset classes and sectors. As market participants brace for a looming shift in the Fed's current restrictive stance, the confluence of shifting global central bank postures and a U.S. presidential election is likely to produce important thematic shifts that will demand allocators' attention.

Market Summary

July 2024



Data source: Lipper, HedgeFund Research

Global Equity

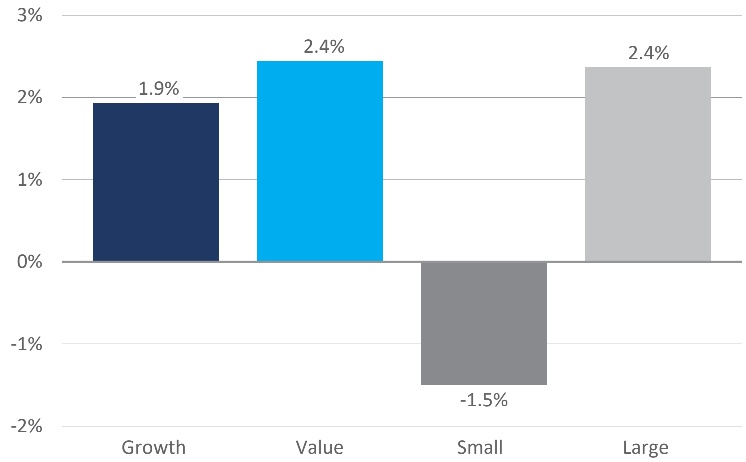
August was challenging for equity markets. On the third trading day of the month, the Cboe Volatility Index (VIX) recorded its largest intraday jump on record. The turbulent activity tapered off in the following weeks, however, and the month ended with modest gains. For the second straight month, value outperformed growth on the backdrop of weaker-than-expected economic prints. European markets outperformed in August as the U.S. dollar (USD) weakened and Japan navigated a choppy start to the month.

Large-cap stocks regained their relative outperformance in the U.S. equity markets following a brief resurgence of small-cap stocks in July. The U.S. equity market sold off as August began, triggered by unfavorable economic announcements and margin calls on carry traders that had borrowed Japanese yen. During periods of rising unemployment, it has historically been common that consumer discretionary stocks typically underperform the broader market and August was no exception as unemployment rose slightly in the U.S.

Japanese equities declined in August in local currency terms but remained relatively flat in USD terms due to the weakening of the U.S. dollar. Japanese markets experienced severe volatility in the early part of the month with the Nikkei 225 Index recording its second-largest decline in history on August 5th but quickly rebounding the following day. Market volatility was caused by the unwinding of a large carry trade, which is when traders borrow a currency at a low interest rate—in this case the yen—and purchase assets in another country.

U.S. VALUE OUTPERFORMS FOR SECOND CONSECUTIVE MONTH

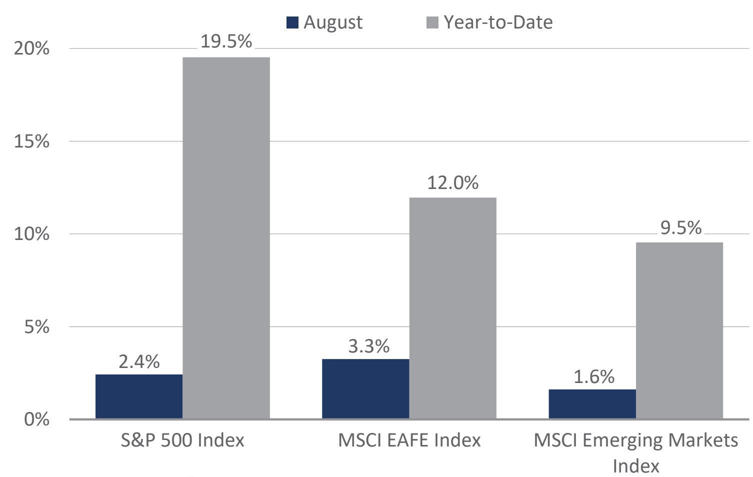
U.S. Style Returns



Data source: FTSE Russell

WEAKENING U.S. DOLLAR GIVES BOOST TO INTERNATIONAL EQUITY MARKETS

Equity Indices Performance Returns (U.S. Dollars)



Data sources: S&P, MSCI

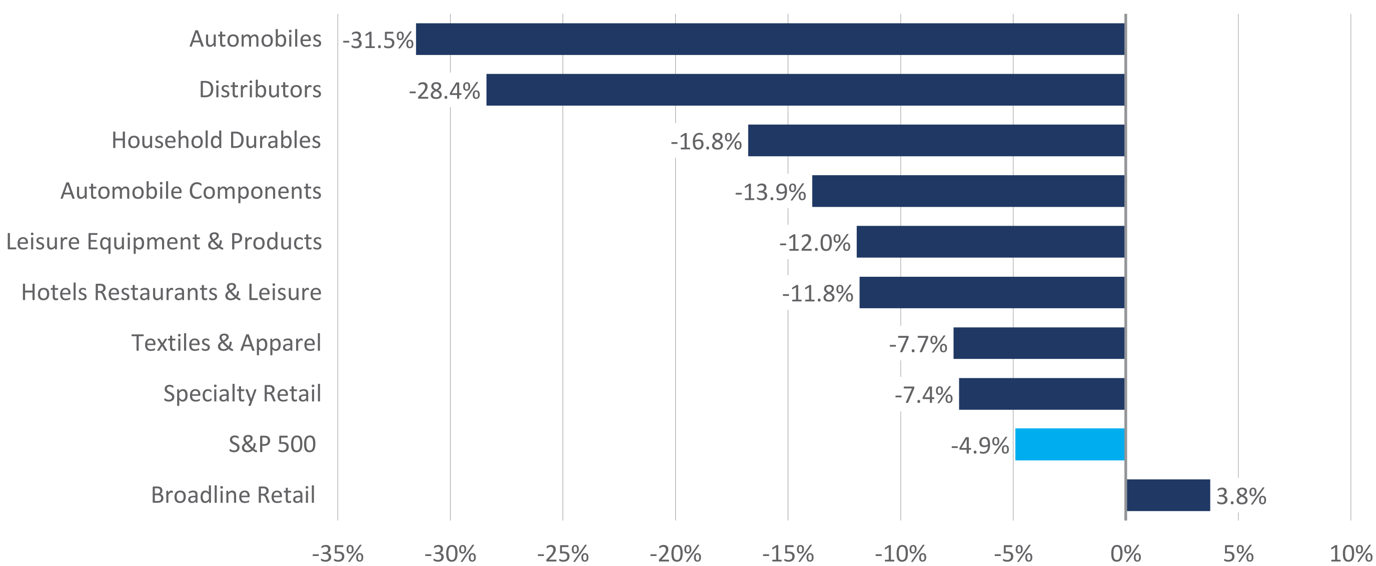
A weakening yen benefits this strategy due to the currency conversion, so as the yen began to strengthen, many traders were faced with margin calls or risk complications. Nevertheless, Japanese companies have been buying back shares at a record pace for the third consecutive year.

Europe ex-UK equities outperformed both U.S. and emerging markets. Real estate and communication services were among the strongest performing sectors, while energy and information technology lagged. In the face of continued decline in consumer demand in Europe and abroad, large market contributors like Burberry and Yves Saint Laurent have decided to slash prices indefinitely in an effort to win back upper-middle-class consumers. The consumer services industry did see a boost in August, however, due in part to Paris hosting the Olympic Games.

UK-based equities also outperformed the U.S. Like the U.S., expectations for a potential rate cut in September boosted market sentiment for interest rate-sensitive sectors. The recent surge in bid activity for UK-listed companies continued as investment firms took advantage of the relatively low valuations in the UK markets. Notably, Hargreaves Lansdown, as merger and acquisition activity increased, the largest investment platform in the UK and a FTSE 100-listed company, agreed to a takeover offer by a consortium of private equity firms.

Nvidia's underwhelming guidance caused a spillover effect on the information technology companies in the MSCI Emerging Markets (EM) Index. However, the index still finished the month with positive absolute returns. New export orders in China fell for the first time in eight months, further supporting the reshoring narrative. Conversely, in smaller Asian markets, increased exports and local currency appreciation allowed the Philippines, Indonesia, and Malaysia to outperform.

AVERAGE DISCRETIONAL INDUSTRY PERFORMANCE DURING PERIODS OF RISING UNEMPLOYMENT (ANNUALIZED)



Data sources: Strategas, FactSet

Fixed Income

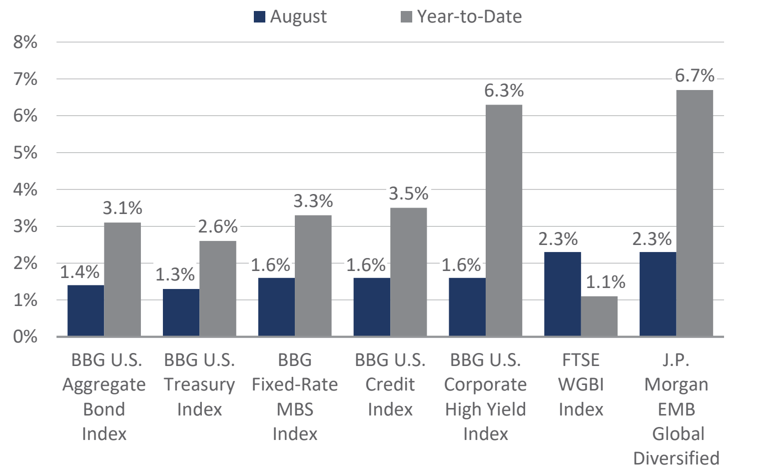
During August, the 10-year Treasury fell 20 bps to 3.91%, and the 2-year Treasury fell 36 bps to 3.93%. A rally in treasuries across the yield curve and ultimate normalization of the curve in August followed weaker economic data and renewed expectations of multiple rate cuts. The U.S. unemployment rate was reported at 4.3%, surpassing the forecasted amount by 0.2%, and non-farm payrolls missed expectations by 76,000 jobs. In a speech at Jackson Hole, Fed Chair Powell acknowledged the gradual weakening of labor data and reinforced the market's belief of a Fed rate cut in September.

The Bank of Japan raised its policy rate to 0.25% entering August and announced a gradual taper in its bond purchasing program. This policy change rippled through global markets and allowed the yen to rebound against the dollar, starting the month at ¥149, down 8.0% from its 2024 high. The strengthening yen triggered a partial unwind of the yen carry trade, contributing to the seemingly outsized reaction to recessionary fears in global markets. Although central bank rate movements contributed to increased volatility internationally, both U.S. investment-grade and high yield spreads ended the month flat.

The annual core CPI rate in the U.S., which excludes volatile items such as food and energy, eased further in August to a three-plus-year low of 3.2%, down from 3.3% the prior month. Even though the disinflationary trend persists, M2 money supply growth, a measure of the amount of currency in circulation, is no longer declining in August. Although quantitative tightening remains prevalent as approximately $50 billion in assets are leaving the Fed balance sheet per month, fiscal spending is still outpacing the Fed's efforts.

EMERGING MARKET BONDS CONTINUE STRONG PERFORMANCE

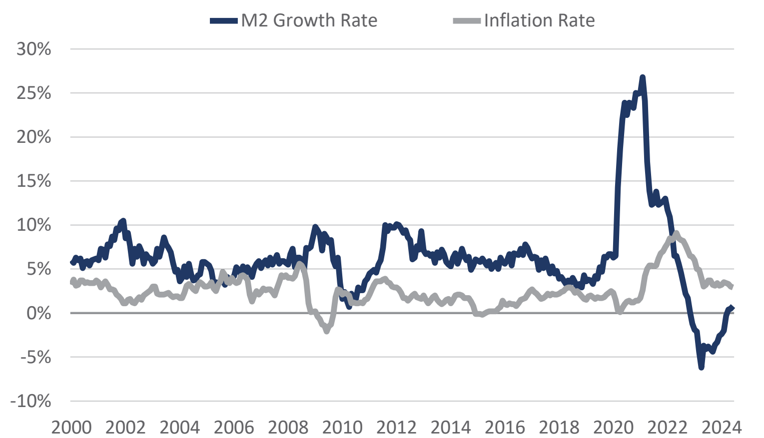
Fixed Income Index Returns



Data sources: Bloomberg L.P., FSTE, J.P. Morgan

MONEY SUPPLY GROWTH TURNED POSITIVE AS INFLATION SUBSIDED

M2 Money Supply Growth vs. Inflation



Data source: FRED

Real Assets

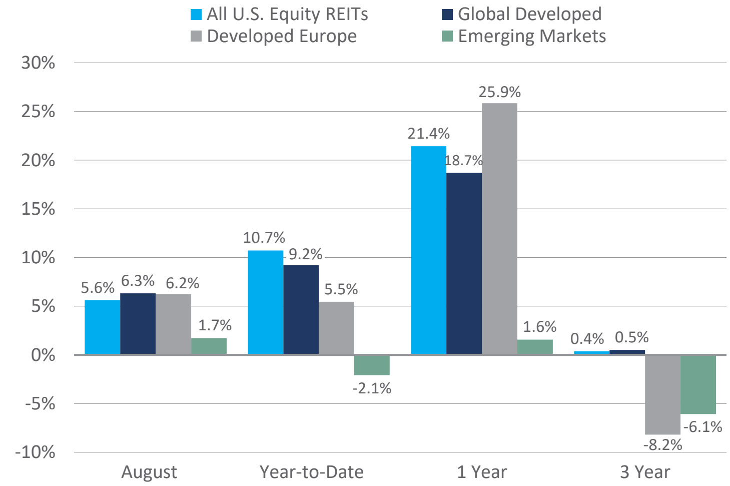
Real Estate

In August, U.S. REITs rose 5.6 %, as measured by the performance of the FTSE Nareit All Equity REITs Index. Market speculation of rate cuts persisted in August, pushing the year-to-date returns of U.S. REITs past double digits. Global Developed REITs were up 6.3%, driven by relatively stronger performance from developed Europe, as measured by the FTSE EPRA/Nareit Developed Index.

Self-storage was the top-performing sector in August, rebounding after being pressured by elevated interest rates. The sector's performance is closely tied to relocation trends, and it surged in August, likely driven by market expectations that interest rate cuts will lower mortgage rates, prompting more people to move and increasing demand for storage space.

REITs OUTPERFORM BROADER EQUITIES IN AUGUST

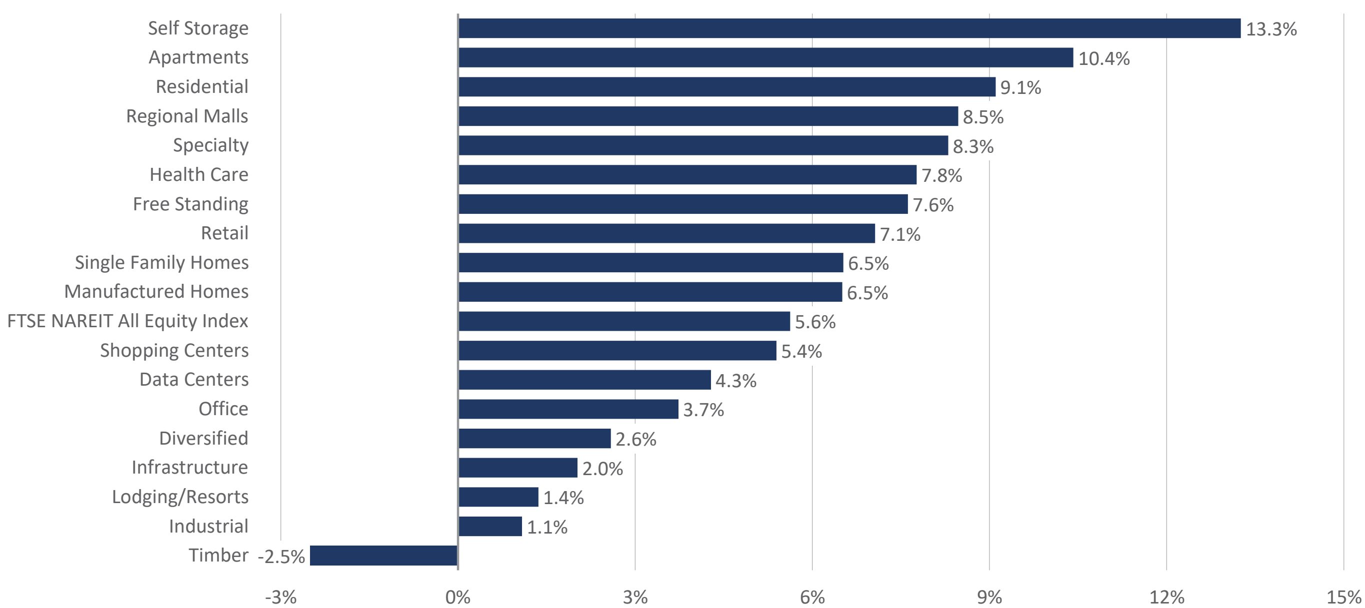
Trailing REIT Performance by Geography



Data source: FactSet

AUGUST GAINS FOR SELF-STORAGE DRIVEN BY EXPECTATIONS OF LOWER MORTGAGE RATES

REIT Trailing Performance by Property Type



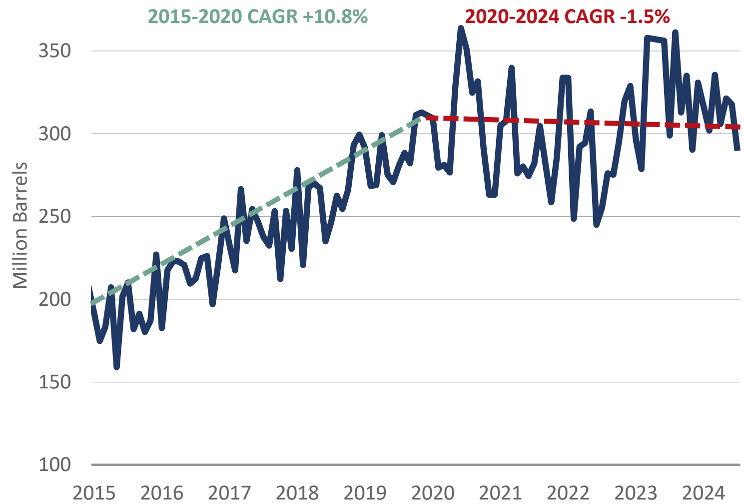
Data source: FactSet

Natural Resources

In August, crude oil prices declined 7.3% as measured by the West Texas Intermediate (WTI) spot contract. Oil prices fell through August and the first few trading days of September due to concerns of weakening consumer and global demand, primarily out of China. China's demand for crude has been a sticking point since the onset of the pandemic in 2020, with demand growth for oil still below the previous growth trend. Natural gas price volatility has continued, with pricing rising 4.5% as measured by the Henry Hub natural gas spot contract.

CHINA'S CRUDE OIL DEMAND GROWTH REVERSES

China Monthly Oil Imports



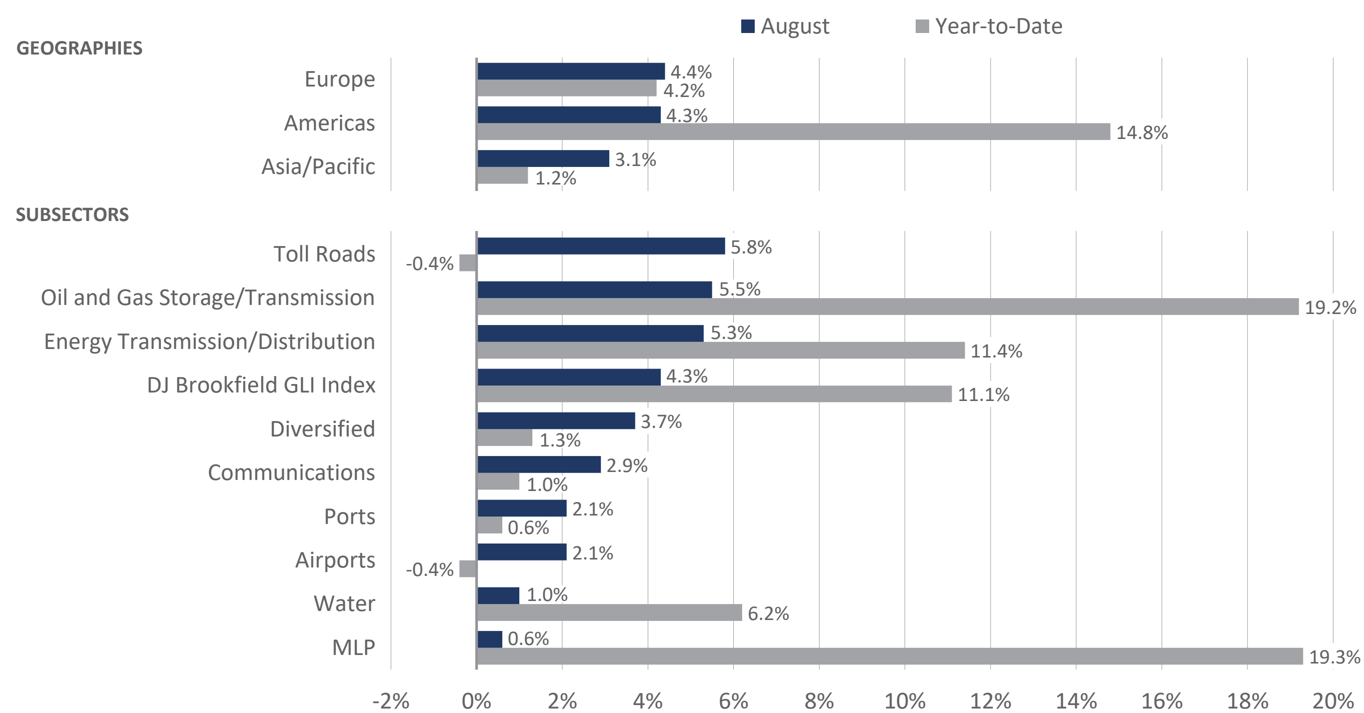
Data sources: FactSet, LSEG

Infrastructure

Global listed infrastructure stocks rose 4% in August as measured by the Dow Jones Brookfield Global Infrastructure Index. All sub-sectors were positive during the month, led by toll roads, oil and gas storage/transmission, and energy transmission/distribution. Midstream energy infrastructure lagged during the month due to falling oil prices, but with broad balance sheet improvements across the sector, stocks are better positioned to weather the impact of lower prices.

POSITIVE PERFORMANCE ACROSS ALL INFRASTRUCTURE SUB-SECTORS IN AUGUST

Listed Infrastructure Trailing Returns



Data source: FactSet

Diversifying Strategies

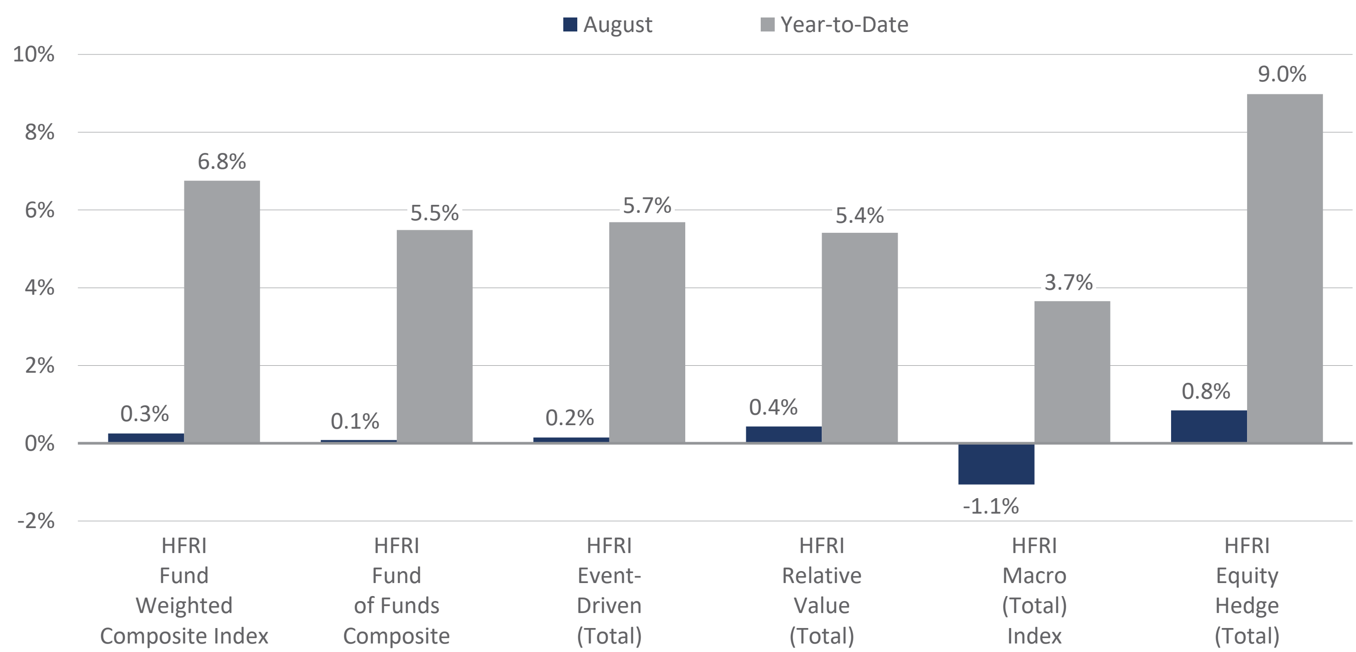
Hedge fund performance in August was positive across most underlying strategies, led by hedged equity. Within hedged equity, the healthcare and technology sectors were the largest outperformers, followed by quantitative directional strategies.

Relative value hedge fund strategies also generated solid gains, particularly fixed income-oriented strategies such as convertible arbitrage and asset-backed trading. Volatility trading was the one detracting underlying approach in relative value.

Systematic trend-following managers continued to struggle during the month as volatility in equity markets and reversals in currency market trends resulted in losses. In addition to detractions from equities and currencies, the energy complex was also a headwind to performance. Slightly offsetting those drawdowns were modest gains in agricultural commodities.

HEDGE FUNDS CONTINUE THEIR POSITIVE STREAK

HFRI Indices Performance Returns (U.S. Dollars)



Data source: HedgeFund Research

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