BALENTINE

Quarterly Market & Economic Report

Q1 | 2024

Will the Momentum Continue?

An object in motion remains in motion unless an external force acts upon it. Newton's First Law of Motion, also known as the Law of Inertia, aptly describes the performance of the stock market during the first quarter of the year. Despite the opposite gravitational pull of rich valuations, stocks continued the momentum they exhibited during 2023, staging an impressive rally of over 10%.

Investors started 2024 optimistic that the Federal Reserve (Fed) would orchestrate a rare "soft landing" for the economy by lowering inflation to its long-run target of 2% without causing a general economic recession. As discussed in our Q4 2023 Market & Economic Report, investors expected the Fed to begin cutting interest rates by the close of the first quarter, declaring "mission accomplished" in its monetary tightening campaign. The view was that rates would be cut as much as six times during the year, over 1% total. However, inflation reports in January, February, and March have complicated things, with underlying price increases showing greater "stickiness" than expected, leading investors to ratchet down those expectations to three cuts totaling less than 1%, starting no earlier than June.

Though there have been pockets of weakness, such as a year-long recession in manufacturing, a steep correction in certain residential housing markets, and a downturn in international economies, such as China, Japan, and Germany, the U.S. economy has generally remained more resilient than many expected, thanks to a still-strong jobs market and strength in consumer spending. Fed officials ended the quarter trying to guide market expectations to the reality that interest rates may remain higher for longer to ensure that medium-term inflation expectations remain anchored. Each month the Fed holds interest rates steady and inflation comes down, monetary policy becomes more restrictive in real terms (i.e., the cost of borrowing after adjusting for inflation becomes more expensive). But for now, both short-term real rates and long-term real rates are at lower levels than those that preceded past recessions.

[1] The "real" rate refers to the rate adjusted for inflation.

Investment Policy: Public Markets

Performance

Despite diminished rate cut expectations and more restrictive monetary policy ahead, increased earnings expectations propelled stock markets higher. According to Bloomberg data[2], earnings for the S&P 500 are now expected to grow by 9% this year, 12% in 2025, and 9% in 2026. Gains over the first quarter were led by Quality and Growth in the U.S., especially in the Technology sector, where outperforming companies typically exhibit low levels of leverage, high profitability, and the expectation of high growth from Artificial Intelligence productivity gains. Our positions in Growth and Quality led all our strategies, excluding goal-based strategies, to outperform their benchmarks over the quarter, as did our position in a diversified basket of stocks geared towards smaller, cheaper stocks in cyclically sensitive sectors as the economy continued to grow.

Meanwhile, the bond market's performance was hindered as expectations of rate cuts were revised down. Our stance of slightly underweighting stocks and overweighting bonds, which we first adopted during the summer of 2022 as the Fed started raising interest rates in earnest, was detractive over the quarter. However, our continued emphasis on bonds less sensitive to interest rate increases meant our exposure in this area did not fall by as much as the broad fixed-income markets.

Policy Changes

Our models led us to make two changes to investment policy in public markets.

First, we eliminated our long-standing slight underweight of stocks and overweight of bonds while slightly increasing our portfolio's fixed-income exposure to interest rate changes. Due to conflicting market signals, we are not convicted in taking a stance one way or the other regarding overall risk levels in portfolios.

Conflicting Signals in Markets:

- **Expense of Stocks Compared to Bonds.** Since the summer of 2022, our forward-looking criteria showed that stocks have looked extremely expensive compared to bonds. While they still look relatively expensive by historical standards, they are less so now, driven by a slope of the yield curve that has become less inverted in recent months and increasing earnings yields relative to interest rates.
- **Relative Momentum.** On the other hand, the criteria we use to measure relative momentum are leaning decisively towards stocks over bonds.

Against the backdrop of these mixed messages, we believe the breadth in the stock market has improved, with the average stock participating in the rally to a much greater degree than last year when most of the gains were driven by seven large technology stocks known as the "Magnificent Seven."[3] When combining this evidence, we prefer to be at our neutral, long-run targets across strategies.

Within our stock market exposure, we eliminated our position in gold, as it experienced a loss in momentum relative to the stock market. While the price of gold has continued to rise to all-time highs as inflation remains elevated, it has not outperformed the gains in stocks.

[2]*Data is based on consensus estimates.*

[3]*The "Magnificent Seven" are Apple, Meta, Tesla, Amazon, Microsoft, Alphabet, and Nvidia.*

Investment Policy: Private Markets

The first quarter continued the active pace of our private capital program with a number of substantial updates. We are excited about the opportunities the private markets are offering across debt, equity, and real assets.

Fund Updates

We held the final close for Credit Opportunities 2023, a private access vehicle[4] we launched in an effort to take advantage of the increase in interest rates and the dislocation in the credit markets. We have allocated to four managers thus far and have called 27% of the committed capital. These underlying strategies have begun paying income, which we, in turn, distribute to investors. Over the coming months, we will be rounding out this fund with one or two more small allocations and are excited about the opportunities our managers are seeing across private credit markets.

As Credit Opportunities 2023 closes, we are launching its successor fund, Private Credit Opportunities II, to invest in high-yielding private debt. The fund will target senior secured loans, mezzanine debt, and other opportunistic lending strategies. This fund will be anchored by Monroe Capital Fund V. Monroe, our long-time senior lending partner, has invested in the lower middle market since 2006 and recently won 2023 Lender of the Year and Collateralized Loan Obligation (CLO) Manager of the Year by Private Debt Investor,[5] a media platform focused on private equity, private debt, private real estate, infrastructure, and agri investing. Private Credit Opportunities II will be open through 2024.

On the private equity side, Industrial & Aerospace 2022, our access vehicle for J.F. Lehman VI and associated co-investments, is wrapping up fundraising. This fund, along with Logistics 2022, our co-investment vehicle, has seen early success.[6] Our other current equity offering is Adams Street Innovation IV, which provides exposure to venture capital managers and emerging technologies. In previous letters, we have written about the dearth of fundraising in venture capital and how we believe this will lead to a favorable vintage. Adams Street Innovation IV will close in the second quarter, and we believe it to be one of the best ways to invest in the new waves of technology fueling the innovation economy, such as the disruptive technologies of Artificial Intelligence, Machine Learning, and Blockchain.

[4] *Balentine creates access vehicles as an accommodation for clients to allow them to access private capital market exposure in a diversified manner. Balentine receives no additional fees for doing so.*

[5] *Monroe Capital Selected as 2023 Lower Mid-Market Lender of the Year and CLO Manager of the Year by Private Debt Investor (Monroe Capital).*

[6] *Our coinvestment in Atlas Air is ahead of schedule due to operational improvements and the continued move by the company to using contracting revenue over spot rates. Q1 saw a 10% cash-on-cash distribution from the company, which was distributed to Logistics 2022 investors and used to offset capital calls in Industrial & Aerospace 2022. The Atlas position is currently marked at above a 59% return, which we anticipate will diminish as early cost savings and debt paydowns are amortized over the life of the investment.*

Opportunities Ahead

Similar to venture capital in 2022, the lack of fundraising in real estate has created a supply-demand imbalance, resulting in attractive pricing and terms for buyers. According to Pitchbook, an industry-leading data source, the fundraising for real estate funds in 2023 declined by 27% over 2022 and 47% since the peak in 2019.

We believe the pullback in fund commitments is the market signaling fear about the outlook for real estate, which is typically the very time investors should want to start investing in the asset class. Cap rates are higher than they have been in the recent past, and they are holding steady (Figure 1). This, combined with a lower capital supply, should mark an attractive entry point. This was last seen in the aftermath of the Global Financial Crisis, where the 2010 and 2011 real estate vintages were favorable.

FIGURE 1: Real Estate Cap Rates vs. U.S. 10-Year Treasury

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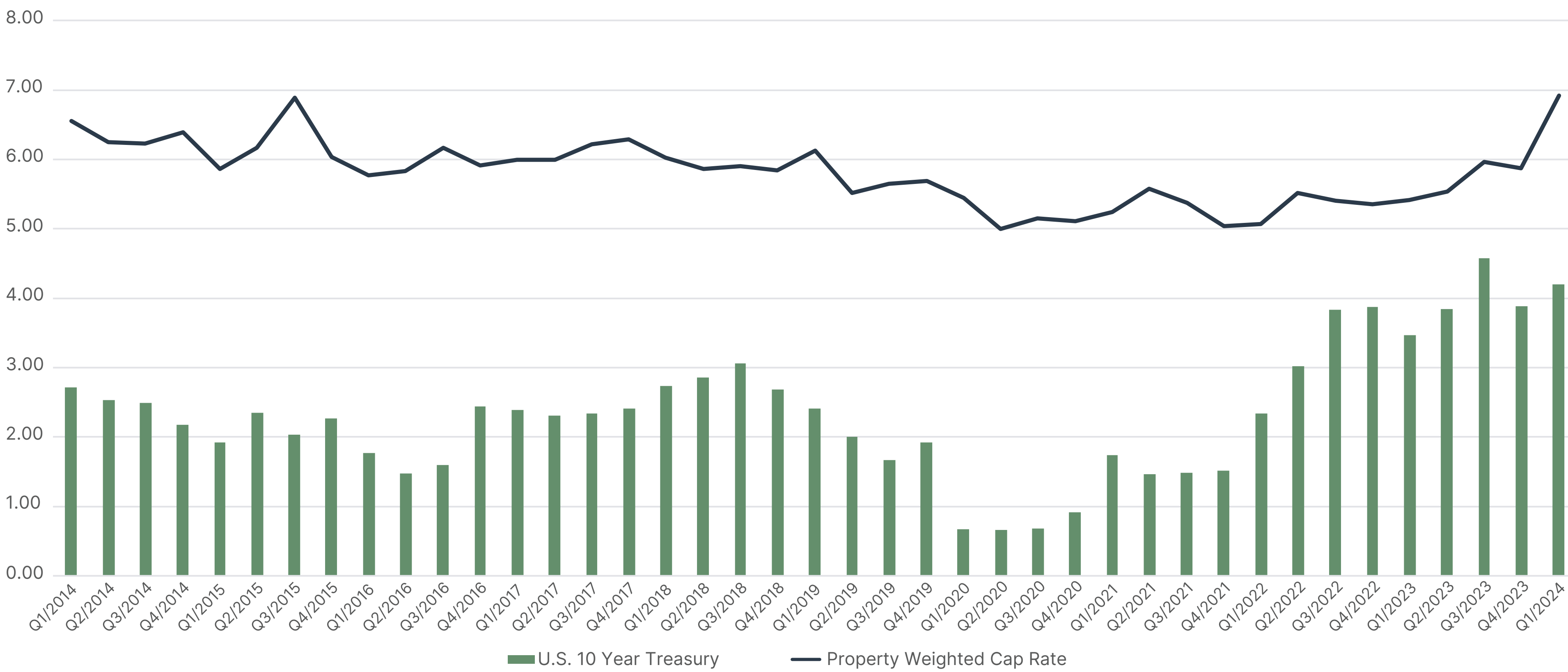


Source: Bloomberg

We are seeking opportunities in three areas of real estate: real estate debt, properties in the Sunbelt, and assets with strong tailwinds.

Real Estate Debt. The increase in interest rates will force the short-term debt that was issued to finance properties to be refinanced at higher rates. This "wall of maturity" is measured in the trillions, with roughly $500 billion of refinancing per year over the next three years. While a large portion of this maturity will be extended or restructured, we believe a significant portion will need to be refinanced at higher rates, allowing investors to receive real estate equity-like returns for debt-like risk.

Properties in the Sunbelt. In addition to debt, we see an opportunity in owning assets in the Sunbelt area of the country. This region has been consistently outperforming the rest of the country in population growth, job creation, income growth, and business formation. We believe these factors have created a robust demand for real estate across most sectors, which should lead to favorable accrual to asset owners and operators.

Assets with Strong Tailwinds. Lastly, we look for intergenerational themes[7], such as artificial intelligence and advancements in healthcare, to exert powerful tailwinds to real estate owners of specific properties. We believe these trends have created a strong demand for real estate assets such as data centers, chip production facilities, and medical offices.

We look to take advantage of these opportunities with our next access vehicle, Sunbelt Plus Real Estate Opportunities, which we anticipate will open near the end of the second quarter. This launch will coincide with the close of Harbert VIII, our value-added real estate manager, who focuses on acquiring and repositioning underperforming assets in the Sunbelt region, with an emphasis on multifamily and industrial properties. Harbert VIII has acquired two properties so far, with another three in the final stages of contracting.

[7]Intergenerational themes refer to four long-term trends we've identified that we believe will impact markets and livelihoods over a generation. Read more in this article from our 2022 Capital Markets Forecast.

Outlook

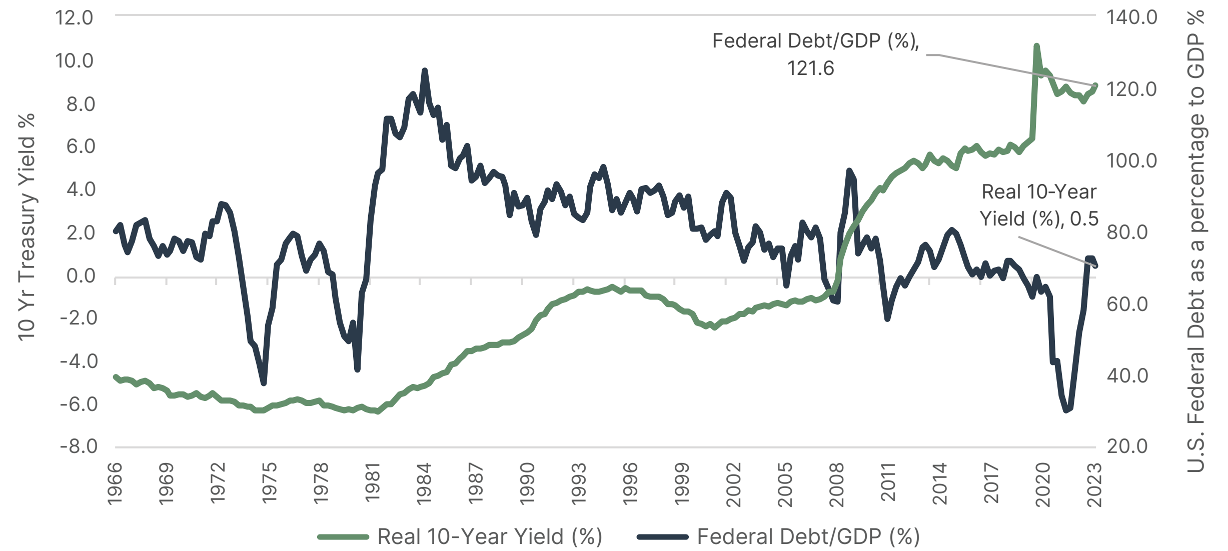
From Inflation and Interest Rates to Elections and Taxes?

Since the "Fed lift-off" of interest rates two years ago, the market and economic outlook has been dominated by questions over the path of future interest rates and inflation. Though substantial progress has been made in slowing the rate of inflation, the Atlanta Fed Inflation dashboard, which measures inflation in a variety of ways, shows that the rate of price increases is still far from where the Fed would like it to be.[8] While the Fed remains "on pause" for now regarding future interest rate increases, it remains to be seen how the economy will evolve as monetary policy becomes ever more restrictive over the bumpy last mile of the road to its 2% target.

As we first surfaced during our last update, greater attention is now likely to turn to the upcoming Presidential election and the policy implications on future taxes and government spending. Markets will be particularly attuned to the implications for our future deficits. The chart below shows that the last time real interest rates were at this level, the Federal debt-to-GDP ratio was below 60%; today, it is over 100% (Figure 2).

FIGURE 2: U.S. Federal Debt to GDP vs. Real 10-Year Treasury Yield

The last time real interest rates were at this level, the Federal debt-to-GDP ratio was below 60%; today, it is over 100%.



Source: Bloomberg & Balentine

[8]Underlying Inflation Dashboard *(The Federal Reserve Bank of Atlanta).*

The Federal government is now spending as much, if not more, on servicing its debt as it is on defense. The non-partisan Congressional Budget Office has already warned that markets may balk as they did in the U.K. in 2022 if there are no credible plans to bring the U.S.'s debt-to-GDP ratio onto a more sustainable course soon.[9] At the moment, neither former President Trump's plans to extend the temporary tax cuts of the 2017 Tax Cuts and Jobs Act nor President Biden's plans to tax the wealthy to fund a "middle-class tax cut" and greater government spending show a pathway to reducing the deficit meaningfully. Whoever wins the election will likely also have to tackle the long-term sustainability of the entitlement programs of Social Security, Medicare, and Medicaid.

Unless the economy is able to grow at a much higher nominal rate[10] of economic growth over the next decade, perhaps due to a productivity miracle driven by a number of disruptive technologies that businesses are now adopting, as we describe above, this fiscal calculus is likely to dominate the outlook. Though debates about the intractability of the national debt are often alarmist, it is helpful to remember that the challenge is not insurmountable. In the early 1990s, there was much concern about the twin fiscal and current account deficit the U.S. was running; by 1999, through a combination of a better balance of taxes and spending and a robust period of economic growth driven by productivity gains, the U.S. was on the verge of paying off its national debt in its entirety!

Nevertheless, the situation today has an important potential implication for families seeking to pass on their wealth to future generations. Whether eventual gridlock in Washington forces the temporary tax cuts of 2017 to expire or any future administration is forced to find more revenue, the generous estate plan exemptions that exist today enabling wealth to pass to the next generation estate tax-free may well be rolled back significantly at the end of 2025. Now is the time to revisit your estate tax plan to ensure that hidden liability is either funded or planned away in concert with the legacy you wish to leave with as much future flexibility as possible.

[9] *U.S. Faces Liz Truss-Style Market Shock as Debt Soars, Warns Watchdog (The Financial Times)*
[10] *The "nominal" rate refers to the rate without adjusting for inflation.*

In Closing

The markets and economy are currently enjoying the tailwinds of positive momentum. We have written before that we are no longer in an era of cheap and abundant capital, where a rising tide is lifting all boats. While we remain neutral at our long-run targets between bonds and stocks, we continue to be selective in our exposure in public markets and are taking advantage of the inefficiencies in private markets to drive returns. As we have always done over the last several decades, we will lean on our unemotional, forward-looking models to change our stance should the outlook call for greater capital preservation or opportunity to take more risk.

Thank you for the trust you place in our team and process.
As always, we welcome any questions you may have at any time.

Sincerely,

Adrian Cronje

Adrian Cronje, Ph.D., CFA
Chief Executive Officer

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