BALENTINE

Quarterly Market & Economic Report

Q2 | 2024

Steady Expansion Without Euphoria

In September 1929, economist Irving Fisher penned a now-notorious New York Times headline: "Stock prices have reached what looks like a permanently high plateau." Of course, that "permanently high plateau" was succeeded by an infamous crash the following October. After strong market performance this year, with U.S large-cap stock indices delivering over 15% total return, marking the twelfth best first-half return since 1950, some investors today wonder: is the stock market overheated? Does the market exhibit signs of the euphoria typically heralding a major market top?

Though on almost every metric relative to its history, the broad stock market's valuation is at a very high level, we don't believe the market is exhibiting signs of the euphoria we would expect to precede a crash. Though investors are willing to overlook valuations for certain thematic-driven stocks, such as those focusing on AI and weight loss, despite their underwhelming risk/reward profiles, this same risk-taking has yet to spread to the broader market. Other characteristics that normally put us on notice for the potential of an imminent bear market are not yet present. These characteristics include heavy fund inflows into equity markets, a major pickup in Mergers and Acquisitions and Initial Public Offerings, rising real interest rates, widening credit spreads, and weakening earnings expectations.

In fact, consensus earnings expectations are currently set to accelerate and broaden into 2025, according to Bloomberg, which, if realized, may allow the stock market to become less expensive over time and grow into its rich current valuations. Two factors allow the general economy to continue to meander forward and companies to generate growing profits, despite elevated interest rates:

1. Many consumers and firms locked in rock-bottom interest rates over the long term during the pandemic, making activity less sensitive to higher interest rates today;[1]

2. Many firms are reaping productivity gains from the adoption of technologies, such as Artificial Intelligence, allowing them to generate more revenue with fewer expenses.

Before we expand on just how much that second factor has propelled stock markets of late, let's quickly recap how the economic outlook has evolved during the last three months and check in on the potential wild card of the upcoming Presidential election.

Progress on Inflation Could Lead to a Rate Cut in the Fall

The Federal Reserve (the Fed) seeks to keep inflation at its target level of 2%. Lately, it has been working to reduce inflation after record highs of 9.1% in June 2022. In previous letters, we've written that the "last mile" of that journey was always likely to take longer than many expected at the beginning of 2024.[2] However, June inflation readings finally showed they were beginning to show signs of meaningful progress.

While the Fed seeks further evidence, such as wage growth and Personal Consumption Expenditures to increase its confidence that it can declare victory, markets have signaled a first interest rate cut of 0.25% may happen as soon as September, especially as medium-term inflation expectations have remained anchored near their target levels. The expectation of a September rate cut has been further fueled by two factors. First, there has been a slowdown in economic growth, with the economy measured by real GDP slowing to 1.4% in the first quarter due to still-elevated inflation and high interest rates continuing to weigh on consumer spending. Second, pressure on wage growth is easing due to loosening labor markets.

[1]The standout exception is in certain areas of the commercial real estate markets, where the need for refinancing is more imminent and where we see an opportunity to take advantage of repricing, as we discuss elsewhere.
[2]Q1 2024: Will the Momentum Continue? (Balentine) & Q2 2024: Mission Accomplished? (Balentine)

The Wild Card: 2024 Presidential Election

Against this relatively benign, “muddle through,” economic backdrop, the election cycle has become a bigger wild card. After he performed strongly at the first Presidential debate and survived an assassination attempt, betting markets named the Republican candidate, former President Donald Trump, as a clear favorite to return to the White House. Around the same time, the yield curve began to un-invert, causing some speculation that the market was adjusting to how it presumed the next administration would impact markets — weighing how lower taxes, higher tariffs on imports, and a lowering of labor supply could impact the trade-off of higher, more sustained economic growth against a widening fiscal deficit, and potentially higher inflation and longer-term interest rates.

Since then, the chaotic political developments have continued. A week after the attempted assassination, President Joe Biden withdrew as the Democratic candidate and Vice President Kamala Harris stepped up. Although Trump’s odds of winning remain strong, they have deteriorated since Harris became the Democratic nominee. Meanwhile, the yield curve has continued to un-invert, suggesting it is largely unaffected.

There is no statistically significant correlation between the yield curve and Trump’s relative winning odds against the Democratic nominee. Instead, the yield curve is primarily influenced by inflation expectations, Federal Reserve policy, and the overall state of the economy (Figure 1). We caution our readers that the “obvious” political trade is not always the right one, given the largely unknown and highly dynamic nature of the economy, markets, and politics. Instead, we believe that the business and economic cycle has a greater impact on the broader stock market and its sectors than who occupies the White House and what they say as presidential candidates.[3]

[3] Addressing Election Anxiety *(Balentine)*

FIGURE 1: U.S. 2-10 Yield Inversion vs. Trump's Relative Odds of Winning Election

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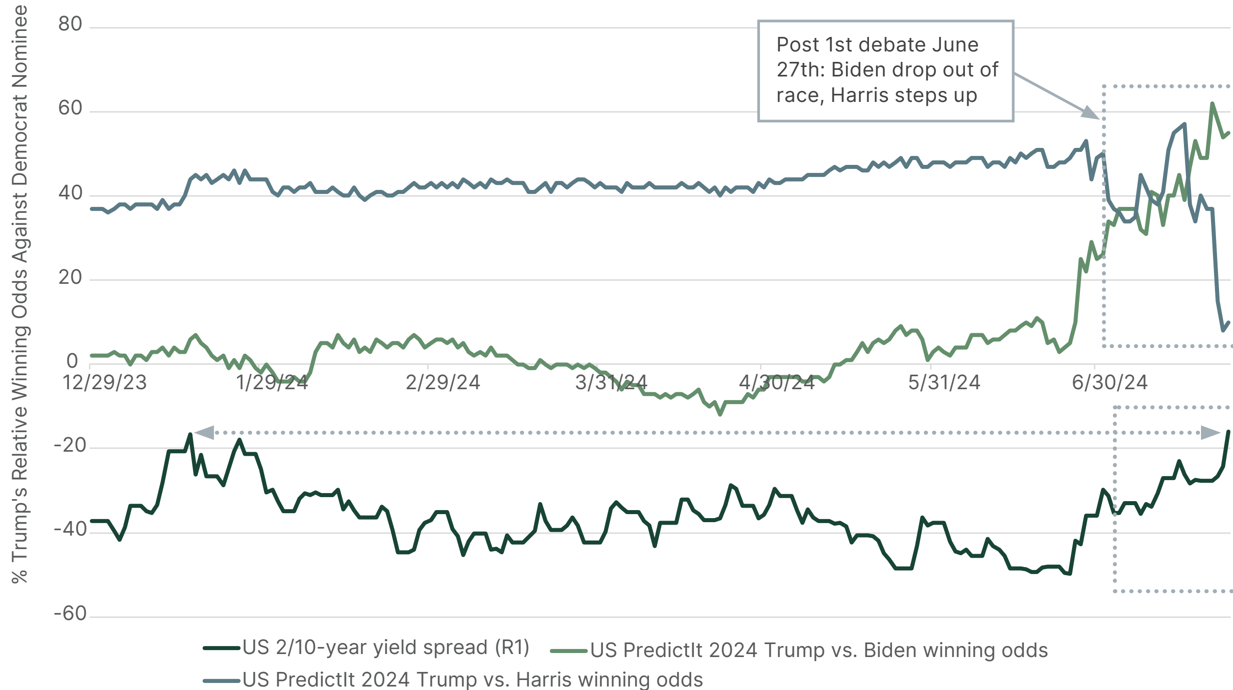


Source: Bloomberg, Balentine

For now, President Biden's administration appears determined to use all of its powers in the lead-up to November to stimulate the economy through consumer spending. So far, it has tapped the Strategic Petroleum Reserve to contain gas prices, forgiven student loan debt, restarted the Employee Retention Tax Credit, and granted statutory authority for Freddie Mac to buy home equity loans. It is also trying to keep a long-term interest rate cap by adjusting the Treasury's refunding schedule as it taps bond markets.

Running large budget deficits, which today amount to 7% of Gross Domestic Product, when the economy remains so close to full employment is unprecedented. The bond market may soon ask the next Presidential administration to provide a credible solution to the path of our debt trajectory to avoid long-term interest rates rising more quickly over the medium term. As we have discussed before, future policy toward our entitlement programs remains key.

The yield curve may eventually "uninvert" over time[4] due to the Fed easing monetary policy through lower short-term interest rates, while long-term rates remain elevated due to concerns over fiscal policy pressures.

[4]All else equal, and assuming that long-term rates remain relatively stable at elevated levels, that would make the stock market look less expensive using our criteria of relative valuation.

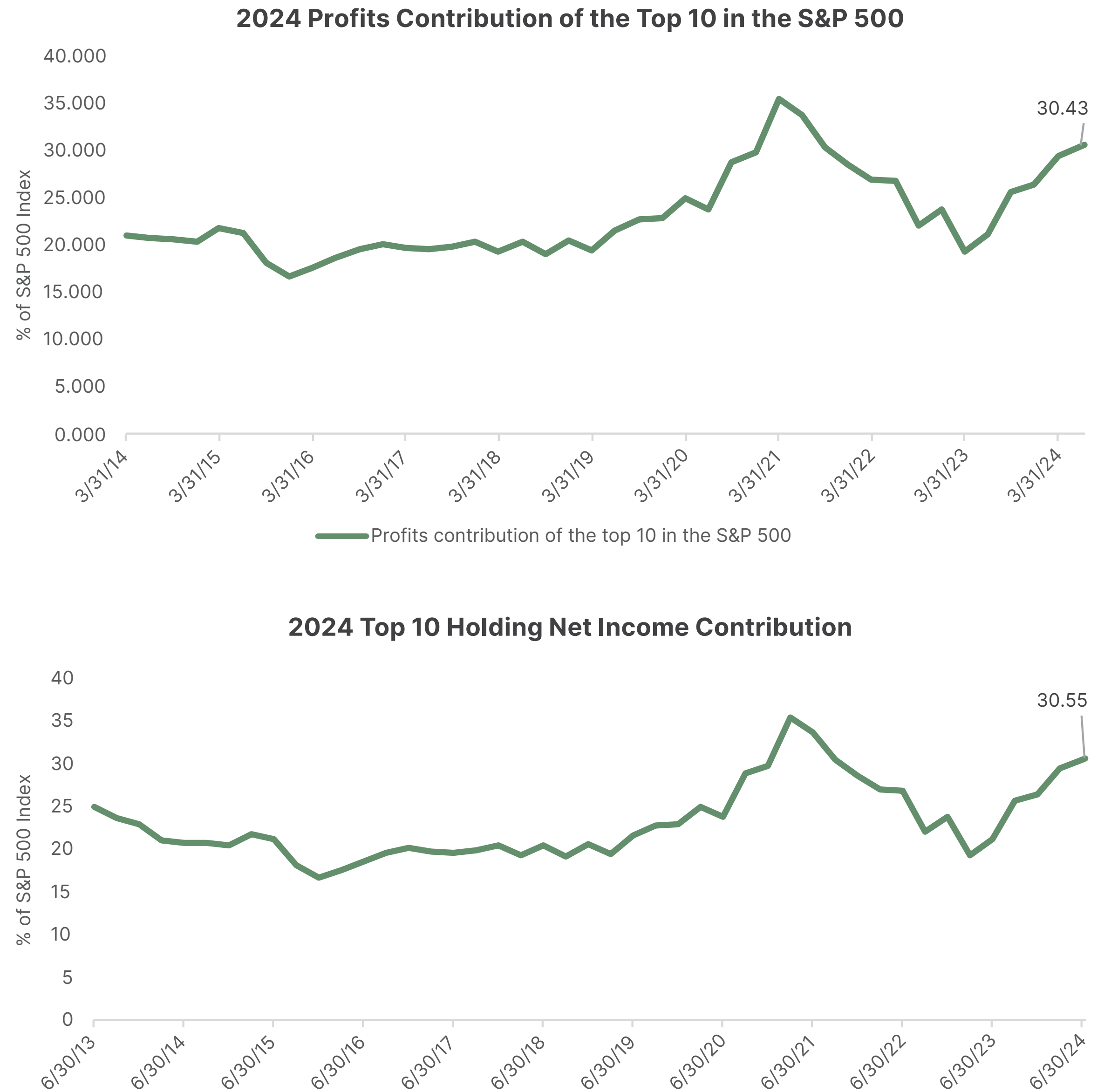
Market Returns and Strategy Performance

When we evaluate markets, one of the criteria we use is time horizon. In the near term, the headwinds of higher inflation and interest rates have dominated the outlook for several years. In the medium term, the additional headwind of our debt trajectory is likely to come into fuller focus. In the longer term, productivity gains and corporate profitability could be a tailwind to the economy and market returns.

Increasingly, stock market returns have become bifurcated between a small number of large stocks — especially those who stand to benefit from the boom in spending on Artificial Intelligence and its adjacencies — and the rest of the market. Though some are concerned by this stock market narrowness, the S&P 500 Index's ten largest stocks now account for 35% of its weighting, roughly justified by their 31% contribution to the index's net income, according to Bloomberg (Figure 2). Of those ten, seven in the technology sector are near-monopolies in their markets and generate significant cash flow to fund their growth despite higher general price levels.

FIGURE 2: The S&P 500's Top 10 Stocks: Weight vs. Net Income Contribution

The S&P 500 Index's ten largest stocks now account for 35% of its weighting (% of market capitalization), roughly justified by their 31% contribution to the index's net income.



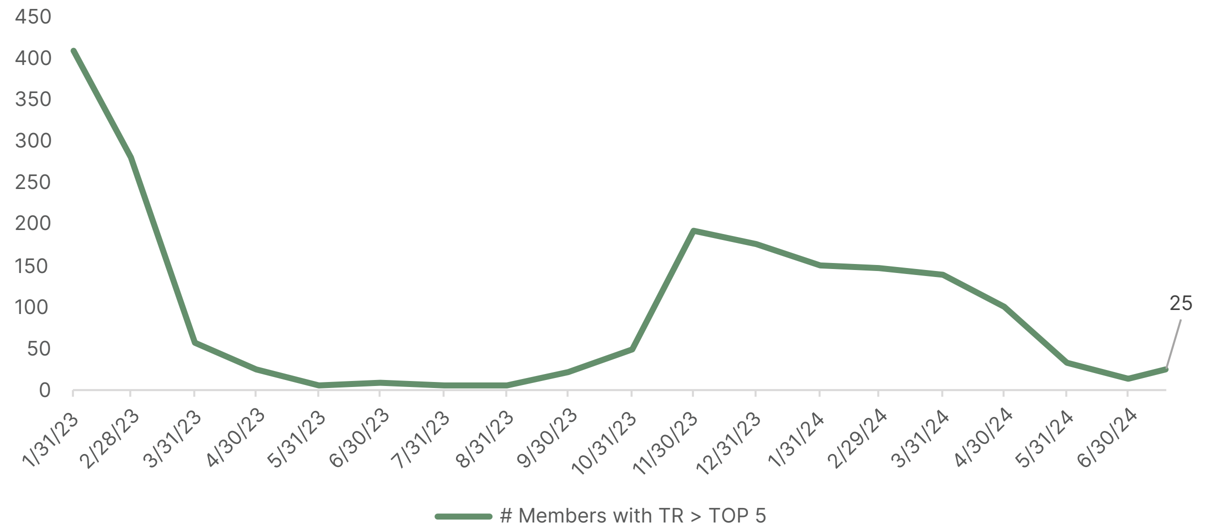
Source: Bloomberg, Balentine

In the meantime, higher long-term interest rates are steadily putting pressure on the earnings power and market performance of highly leveraged companies that depend on external capital. Investors are aware of this and are increasingly allocating capital to a few high-quality growth stocks at the expense of the rest, even within the S&P 500. During the first quarter, only one sector generated negative returns as the broad market rallied. In contrast, during the second quarter, seven sectors saw declines. This trend highlights both market concentration in terms of outsized weights and noticeable return dispersion.

The number of stocks outperforming the five largest stocks year-to-date dropped to only 25 out of hundreds in the S&P 500 Index (Figure 3). The new era of scarcer, more expensive capital has become entrenched, pushing a handful of stocks to trillion-dollar market caps at the expense of the broader market, creating headwinds for the average stock. Given the unprecedented level of concentration and return dispersion, we caution that near-term volatility is likely as the market becomes more susceptible to fluctuations.

FIGURE 3: This Year, The Number of Stocks Outperforming the Five Largest Stocks in the S&P 500 Dropped to 25

This has created headwinds for the average stock and makes the market more susceptible to fluctuations.



Source: Bloomberg, Balentine

Our emphasis on US Large Cap high-quality[5] growth stocks, which escape these headwinds, has been the primary driver of our strategies' outperformance of their benchmarks in 2024. Within fixed income, our continued emphasis on bonds with less sensitivity to higher interest rates has contributed as well. We remain at our long-run targets between stocks and bonds, given the conflicting cross-currents of elevated relative valuations in favor of bonds and strong relative momentum in favor of stocks. Our discipline and selectivity in picking and choosing our areas of emphasis within bonds and stocks will remain key.

[5]Here, we are referring to investments in stocks with a high quality factor. Read about quality factor investing in our 2023 Capital Markets Forecast Article "Quality As A Core."

Investment Policy: Private Markets

Our Private Capital team had another busy quarter with a number of fund closings and launches. The team held the final close on Industrial and Aerospace 2022, an internal partnership to access our leveraged buyout manager, JF Lehman, and their co-investments. This fund facilitates access for our clients to JF Lehman VI at a low minimum commitment and participates in co-investments with no additional paperwork or tax documents. We believe JF Lehman VI is off to a strong start due mainly to the success of Atlas Air, from which investors in Logistics 2022 have also benefited. We have held back enough capital to participate in one more co-investment, alongside the take private of Crystal Clean. We are pleased with the progress experienced by both Industrial and Aerospace 2022 and Logistics 2022.

We also completed fundraising for Adams Street Innovation IV, our access point for top-tier venture managers. As discussed before, we believe this venture capital vintage will be above average due to the compelling opportunity set and the lack of capital chasing it.

As we mentioned in the last letter, we launched Private Credit Opportunities II to take advantage of the high yields currently in the market. This is a successor fund to Credit Opportunities 2023 and will look to be more broadly diversified across senior lending, opportunistic lending, and thematic lending. Much has been said about the large amounts of fundraising in private credit. We believe it is important to stay disciplined in manager selection and allocate to secondaries at this time. Our Investment Strategy Team approved an allocation in the second quarter to Pantheon's secondaries debt fund, which will look to buy LP interests at a discount in diversified and aged funds from allocators who may have over-allocated to private credit.

We believe an allocation to secondaries allows our investors to achieve diversification quickly, as they are buying whole portfolios of loans. These purchases also come at a discount for providing liquidity, which should increase the expected overall return and buffer the portfolio from potential losses. By the nature of buying existing fund interests, secondary investments pay back quicker than primary investments, which helps to offset future capital calls and return money to investors at an accelerated timeline.

We believe pairing Pantheon with managers like Monroe, to whom we've allocated in the past and who has resisted the temptation to move up market with fewer loan covenants, is the right way to ensure we are providing our clients with diversified and disciplined exposure to private credit.

Lastly, we believe both Credit Opportunities 2023 and Decarbonization 2022 continue to find compelling investments in this market. Credit Opportunities 2023 recently returned capital from an early win by our manager 4612. 4612 invested in Mirador, a financial services company purchased by iCapital at a favorable valuation. This liquidated its debt and equity position, providing an early win for those invested.

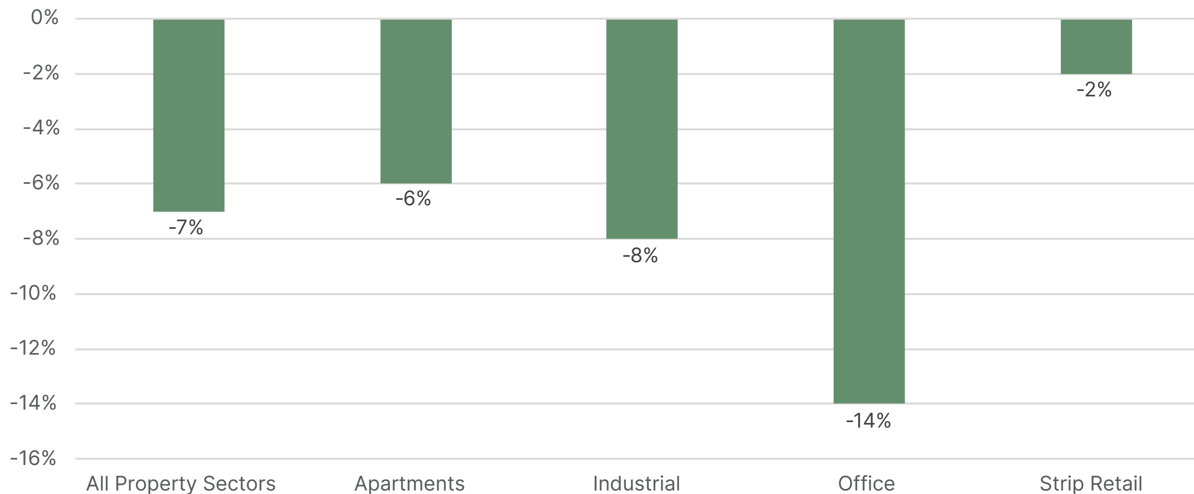
Decarbonization 2022 recently called an additional ~5% of capital. As the world moves to decarbonize its energy stack, Brookfield, Kendall Sustainable Infrastructure, and Energy Impact partners are finding investments.

Opportunities Ahead

The private real estate market continues to correct, as the trailing 12-month performance ending March 31, 2024, details (Figure 4).

FIGURE 4: 12-Month Performance of Private Real Estate Sectors

The private real estate market continues to correct.



SOURCE: Green Street Advisors

Couple these negative returns with the lack of fundraising in the real estate market, the gated redemptions, and the open-ended real estate funds, and we believe it is a very compelling time to put fresh dollars to work in real estate.

We see an opening to be opportunistic and thematic with our next internal partnership focused on real estate. The fund will allocate to real estate in the Sunbelt region, leveraging one of our intergenerational themes. We believe there are also opportunities in real estate to access the growth of AI, another one of our themes, with an allocation to data centers. According to CBRE, for the one year ending March 31, 2024, "North American data center vacancy rates hit new lows across major markets. Chicago led again with the biggest year-over-year decrease to 2.4% from 6.7%. Northern Virginia's vacancy rate decline closely followed, dropping to 0.9% from 1.8% the year prior despite an 18% increase in inventory over the same period." Low vacancy and high demand should provide a meaningful tailwind to investors able and willing to put capital to work to build and deliver data centers.

Leaning into our intergenerational themes is another way we look to stay disciplined as we recommend private capital investments for client portfolios. We believe our experience allows us to stand pat when investing fads fill the market, but also double down when trends that are here to stay present themselves. Decarbonization, AI, healthcare, and the persistent growth of the Sunbelt are all trends that we believe have staying power in the market, and will look to leverage in portfolios over the coming years.

Looking ahead, 2024 was focused on debt and real assets, and looking to 2025, we will seek to provide access across the private equity space for clients looking to put money to work in that area. We continue to see compelling opportunities in the early-stage market, given the innovation occurring in our economy. We also believe the reindustrialization of our country is providing interesting opportunities in the buyout market, as industrial and manufacturing in America could see a renaissance in the coming years. As always, we appreciate the trust you put in us in our process, and the private capital team stands by to answer any questions you may have.

In Closing

The economy and markets have continued to display surprising resiliency, despite interest rates remaining elevated for longer than most anticipated earlier this year. Recently, there has been meaningful progress in inflation falling back to the Fed's longer-run target. Despite historically rich valuations for the stock market in general by historical standards, there are no tell-tale signs yet that typically characterize a major market top.

The upcoming Presidential election remains a wild card to the outlook. We do not have unique insight into that outcome. Instead, we will stay true to our unemotional model discipline and continue to diversify portfolios intelligently to manage the risk of whatever outcome ensues by exposing them to different sources of return. Within public markets, we do not see any "fat pitches" to swing at, and we will continue to be patient and selective in our exposure. Ours is not a "buy and hold," hope for the best approach. We will continue to rebalance portfolios proactively as the near-term outlook changes.

We do see more compelling longer-term opportunities in Private Markets, and we are leaning into them. Thoughtful exposure to Private Markets is a "must have" and is no longer a "nice to have" in the current market environment.

Thank you for the trust you have placed in our team and process. Please let us know if you have any questions.

Sincerely,

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

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