Quarterly Market & Economic Report

Q4 | 2023

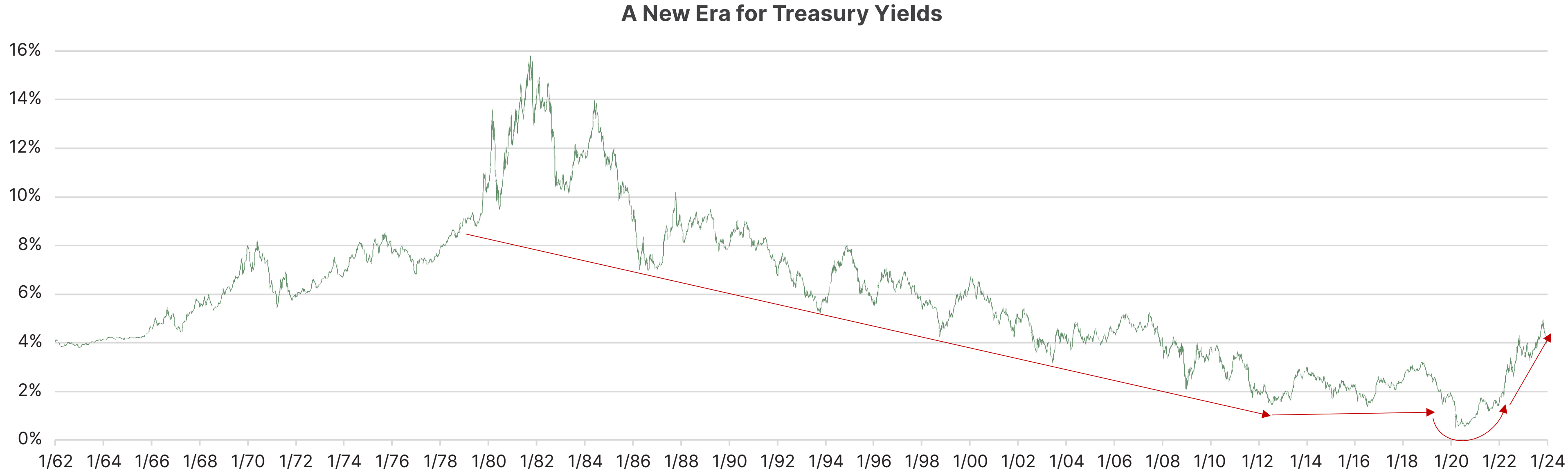
Mission Accomplished?

That is what the stock market seems to have concluded about the Federal Reserve's (Fed's) 18-month effort to contain inflation as 2023 ended. Not since the end of 1945 has inflation fallen from above 5% to below 3% without the economy experiencing a recession at the time of inflation falling to that level, or within the subsequent 18 months. The Fed has been raising interest rates aggressively since March 2022 to vanquish the post-pandemic inflation episode that has gripped the economy. Yet consensus forecasts are now for inflation to fall further to 2.5% without the economy sinking into even a short and shallow recession this year, a so-called, very rare, "soft-landing."[1]

At its December meeting, the Fed seemed anxious to declare "mission accomplished" by outlining that it had done enough to bring back inflation down to its target zone. It even signaled interest rates could be cut by 0.75% in 2024. Since then, long-term interest rates collapsed by over 0.80%, propelling the bond and stock markets to a strong year-end rally (Figure 1). The Fed clearly believes the natural long-run resting place for interest rates is lower than today's levels. If the Fed is wrong, prematurely taking its foot off the monetary brakes will act as an undue stimulus, and inflation may even re-accelerate, requiring interest rates to climb even further. It made this mistake in the 1970s, leading to a decade of stagflation, ultimately leading to double digit Treasury yields, as Figure 1 shows.[2]

[1]According to the Federal Reserve of Philadelphia's survey of professional forecasters.
[2]Stagflation describes a market characterized by low growth and high inflation, punctuated by frequent recessions.

Figure 1: A History of 10 Year U.S. Treasury Yields (1962 – Present)



Source: St. Louis Fed

Despite significant economic weakness abroad, especially in China and Europe, the U.S. economy has generally been resilient to the Fed's campaign of raising interest rates and draining excess cash from the system. Certain industries, like housing and manufacturing, have experienced significant slowdowns, but not enough to bring the general economy within sight of an officially-dated recession. The tight post-pandemic labor market and support it has driven to consumer spending has been the key difference between today's experience and past cycles. In the bond market, an inverted yield curve suggests it is too early to declare mission accomplished with certainty just yet. Another reason for caution is that talk of a "soft landing" often occurs just before recession strikes.

Though it fell by nearly 20% in 2022, the U.S. stock market clawed back nearly all of its losses in 2023 to return within touching distance of its all-time peak level, as measured by the performance of the S&P 500 Index. This is surprising because U.S. stocks started the year looking expensive relative to bonds and became even more expensive as they rallied. The U.S. stock market has not looked as expensive relative to bonds since the dot-com bubble of the late 1990s. This reflects that, despite higher interest rates, there is optimism that the widescale adoption of generative Artificial Intelligence will drive productivity gains and boost corporate earnings across the broader economy, not just for a concentrated handful of large technology stocks. Whether this optimism is justified remains to be seen, as history suggests that expected profits from new and yet-to-be-commercialized inventions are inherently uncertain.

[3]*An inverted yield occurs in the bond market when short-term rates exceed long-term rates. It typically decreases a banks' willingness to lend.*
[4]*See [Will America Manage a Soft Landing in 2024?](#) (The Economist) for Bloomberg data.*

Investment Policy: Public Markets

2023 delivered many surprises, as our team discussed in a recent Insight, Navigating the Uncharted Terrain of 2023. After delivering meaningful capital preservation during the difficult capital markets of 2022, our discipline did not lead us to capture much of the upside surprise that 2023 offered, despite generating decent absolute returns.

Generally, we were too defensive across and especially within asset classes. While stocks ended the year outperforming our emphasis on fixed income, our position in Low Volatility stocks (ticker: SPLV), concentrated in defensive sectors, such as Consumer Staples and Utilities, contributed to our relative underperformance as the economy continued to defy recession predictions.

One bright spot was our strategic, anchor position in global stocks tilted towards high Quality. Exposure to stocks exhibiting the characteristics of reliable growth, high profitability, and low leverage outperformed the broader stock market indices.

Despite relative underperformance in 2023, on a rolling three-year basis and over longer-term time frames, our strategies remain ahead of their benchmarks. Until our discipline signals stocks have become less expensive relative to interest rates, we remain cautious and selectively positioned in public markets.

We made one change to policy over the quarter. Our discipline called for a slight reduction in our exposure to international developed equity markets. We used the proceeds to broaden our U.S. stock exposure to baskets of stocks that exhibit Value, Momentum, Quality, and Size characteristics, depending on the economy's position in the business cycle. We discuss the opportunities offered by multi-factor investing in this year's Capital Markets Forecast.

Investment Policy: Private Markets

For several quarters, we have emphasized Private Markets as what we believe to be an area with abundant opportunities for our strategies to play offense. The fourth quarter saw a flurry of activity from our program, and we are pleased with the returns generated.

Credit Opportunities 2023, the access vehicle we created to take advantage of dislocations sparked by the interest rate shock we have experienced over the last two years, was especially active.

- Our partner, 4612, of the Cousins Family Office, called capital to fund its first three investments: high teens interest rate loans to fast-growing companies in the warranty, car wash, and fintech industries.

- Our partner MSD, Michael Dell's family office's credit arm, was also busy. Capital was called to fund three new investments: a telecommunications company, a fitness provider, and a specialty insurance distribution platform. We will likely close Credit Opportunities 2023 to new investments in the first quarter of 2024.

- Lastly for this vehicle, we approved and committed to our next fund, Pantheon Credit Opportunities III, an opportunistic credit secondaries fund. We expect it to begin calling capital in early 2024. We believe private credit has bloomed in recent years due to the attractive risk/return profile offered. This surge in popularity has led to a nascent secondary market, where managers like Pantheon can purchase mature portfolios at discounts, achieving diversification and return enhancement. Pantheon's secondary platform would be a natural complement to the primary funds to which we allocate for Credit Opportunities 2023. We will likely close Credit Opportunities 2023 to new investments in the first quarter of next year.

We also held another close and called capital for our **Industrial and Aerospace 2022** access vehicle. Recall this partnership was created to invest in J.F. Lehman VI and the co-investments the manager offers. J.F. Lehman is a buyout firm in New York investing in aerospace, defense, maritime, and environmental services companies. The fourth quarter saw us commit to and send capital for J.F. Lehman's second "take private" investment this year, Crystal Clean. Crystal Clean is an environmental services company that was delisted from the NASDAQ exchange and is now directly owned and managed by J.F. Lehman. Industrial and Aerospace 2022 will remain open into 2024 for additional investors looking for an allocation.

Elsewhere, several managers called capital as they saw opportunities. This included both Brookfield and Kendall in our **Decarbonization 2022** access vehicle, as well as **Harbert**, our core real estate manager.

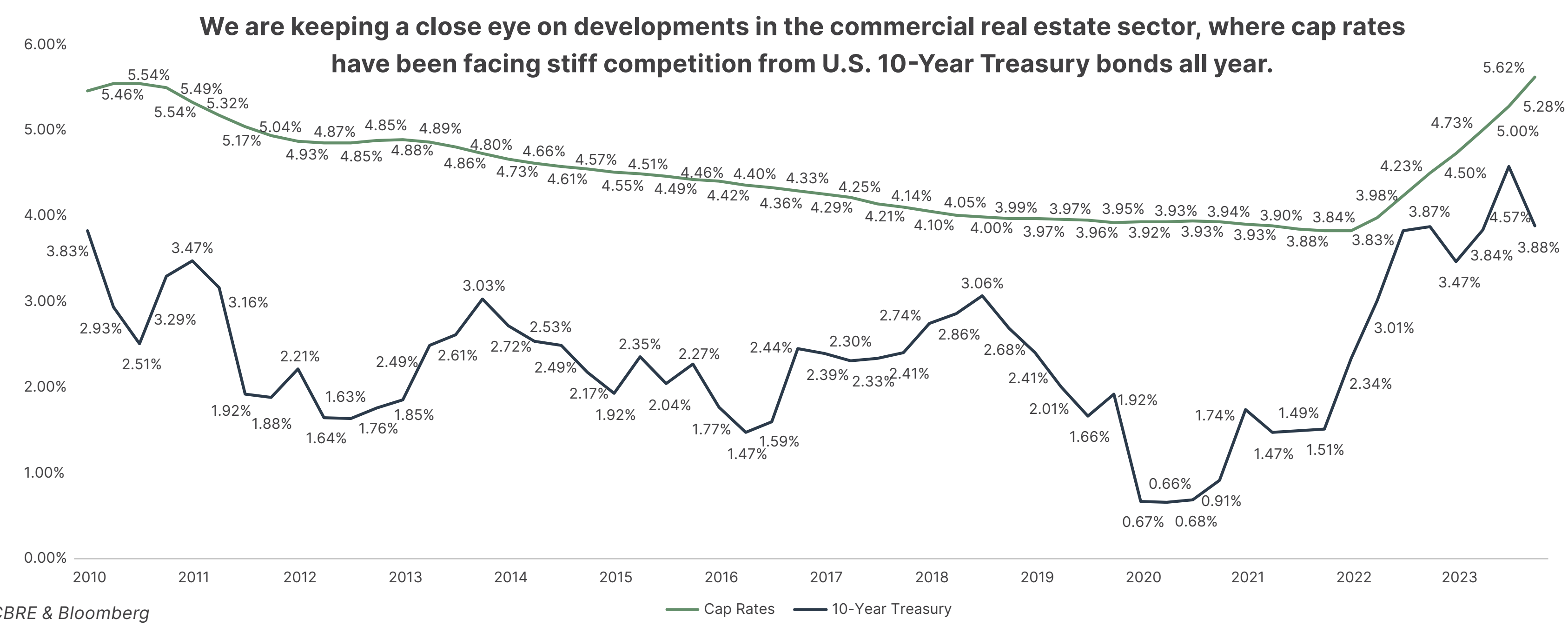
Our recommended implementation for growth equity, **Fulcrum V**, reached its final close. Fulcrum has been Balentine's partner since 2016, and this is the third fund we have recommended for portfolios. Fund V will look to continue the success of prior funds by investing in fast-growing healthcare and business-to-business software companies, predominately in the Southeast.

We re-underwrote and approved Adams Street's next fund, **Innovation IV**, as a core venture capital manager. As discussed in our [Capital Markets Forecast](), we believe the 2024/25 vintage for venture returns could be above average, given the dynamics in the early-stage investing arena.

Finally, early next year, we will form our next access vehicle to focus on senior lending. This will be anchored by **Monroe Capital V** and augmented by other managers seeking to take advantage of higher lending rates and banks who have backed away from lending. We are keeping a close eye on developments in the commercial real estate sector, where cap rates have been facing stiff competition from U.S. 10-Year Treasury bonds all year (Figure 2). We see potential distress surfacing for us to take advantage of, particularly as owners seek to refinance loans at higher interest rates while adjusting to lower demand for office space.

We believe private capital exposure is an essential ingredient to help many of our clients achieve their goals over time.

Figure 2: Commercial Real Estate Cap Rates* vs. 10-Year U.S. Treasury Bond



Source: BCBRE & Bloomberg
**Multifamily Specific Cap Rates*

Outlook

Soon the narrative driving public markets will shift from inflation and interest rates to the implications of the upcoming Presidential cycle. Strategas reports the last 16 Presidential election years have been positive for stocks as the incumbent administration seeks to create a strong economy to assist in its re-election. Historically, the Fed does not like to be seen as active in changing monetary policy during election years for fear of undermining its reputation for independence. That makes the number of interest rate cuts markets anticipate in 2024 all the more intriguing. The extent to which the current administration can use fiscal policy, such as greater spending or lowering taxes, to stimulate the economy is also severely limited.

The last time interest rates were at these levels, the federal debt-to-GDP ratio was around 30%; today, it is over 100%. The sustainability of the entitlement programs of Social Security, Medicare, and Medicaid are likely to loom large over the political policy debate. These programs will play a large role in the forecasted trajectory of our national debt as successive cohorts of the baby-boomer generation begin to retire this decade. On four occasions last year, monthly expenditures on servicing the national debt exceeded national defensive spending, which has not occurred in over 20 years.

Looking out further, we have just published our updated annual Capital Markets Forecast, "Balancing Act: Risk and Return in A New Regime." In it, our team has re-evaluated the market from today's starting point and the stage it sets for expected returns and risks over the next market cycle. In last year's edition, we discussed how the world was on the cusp of a bumpy transition to a new era of more expensive and less abundant capital. This year's edition outlines how strategic diversification plans should be skewed towards leaning on cash, fixed income, and private capital to maximize their probabilities of hitting their goals. Investors no longer have to over-rely on capturing the equity risk premium with excessive risk, as they used to in a yield-starved world. The Capital Markets Forecast also discusses how we have been preparing to take advantage of the multi-year disruption that broader adoption of Artificial Intelligence will cause. In a world where capital is no longer artificially cheap, the ability of companies to drive real, lasting value through productivity gains from such technological innovations will be a key differentiator.

In Closing

2023 turned out to be a banner year for the U.S. stock market, as the economy so far has escaped the much-anticipated recession that capital markets began discounting in 2022. Hopes that the Fed will begin lowering interest rates in 2024 fueled a strong year-end rally beyond the concentrated handful of stocks that led the market up for most of the year. Given how expensive the stock market remains, we remain slightly defensive and highly selective in our exposure to risky assets and prefer the certainty of higher-yielding cash and fixed income and the opportunity private markets offer to help our clients achieve their goals.

As we said last quarter, there is an unusually high level of uncertainty about the economy as we look ahead to another contentious election cycle. In this environment, it is easy to succumb to emotions or be paralyzed by fear when thinking about making investments. This is why we continue to lean on our unemotional, forward-looking, data-driven process, which we believe has helped our clients successfully navigate several market cycles with patience and discipline.

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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