KOCAA Investment Roundtable: 2024 Mid-Year

THE INFLATION STORY –

As we enter the second half of the year, the Federal Reserve has been focused on inflation data in the context of the health of the economy. While it is true that inflation has materially declined from its high of 9.1% in June 2022, both CPI and PCE remain above the Fed's desired target of 2.0%; the latest headline and core CPI showed annual increases of 3.3% and 3.4% respectively. The current inflation environment is a combination of factors. Beyond the actual inflation statistics, one needs to focus on employment and spending data. Recently, the unemployment rate eclipsed 4% for the first time in several years. In general, there is a 12–18-month lag from the beginning of the Fed's monetary policy and the impact that policy has on the economy.

Job growth is slowing, and prior months' revisions have been consistently downward. Also, the nature of the job market is changing. The number of layoffs in the tech sector has been increasing over the last few months, while many of the newly created jobs are lower paying, service sector jobs. Given that the U.S. economy is 70% driven by consumer spending, a change in the composition of the labor force could have a material impact on aggregate spending and overall economic activity. Still, wages are growing faster than current inflation, which will likely keep upward pressure on prices. Anecdotally, consumers continue to spend as we had over 3 million people screened by the TSA on the Sunday of July 4th weekend.

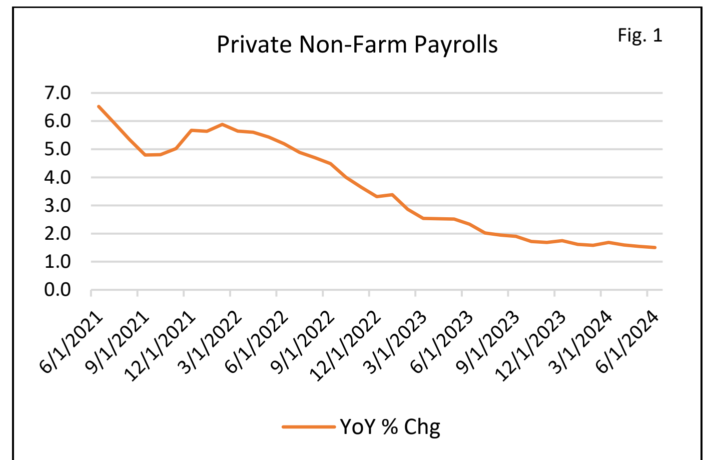
We are watching for a negative impact on spending and, in turn, economic growth, from the slowing job market. A slowing economy can itself have a negative effect on spending because if consumers perceive that we are in a difficult environment they may postpone consumption to boost savings, exacerbating a slowdown. The last reading of Industrial Production showed year-over-year growth of just 0.13%. Factory Utilization has eclipsed 78% but is still below near-term highs and Durable Goods Orders contracted 1.3% over the trailing month. So, there is evidence that the Fed's monetary actions are slowing the economy, and this may further reduce inflation. The primary issue at hand is whether this can be accomplished without plunging the economy into a deep recession.

POLITICS ABOUND –

President Biden's weak performance during the June 27 debate stoked several fires and ultimately resulted in Biden dropping out of the race. Democrats appear to have thrown their support behind Vice President Harris, but there could still be some fireworks at the party convention. Other alternate candidates mentioned include California Governor Gavin Newsom and even Michelle Obama, though both have disavowed interest. We shall see!

Theoretically, the Democrats have several alternatives, but all of them face substantial obstacles. The consequences of forcing out an incumbent president's primary winner may be too great a risk for the party to come to terms with and the path of least resistance may just be to stay the course. But Democrats are concerned that a weak Biden as their candidate may have significant negative implications for Senate, House, and local races.

The war in Ukraine continues to rage on and Putin appears determined to win. Peace talks have mostly been nonserious, so we remain in a stalemate between Putin demanding a win and Zelensky unwilling to cede territory. A weakened U.S. President may embolden China to attack Taiwan and North Korea remains a regional provocateur. A strong U.S. will help quell the war between Israel and Hamas because our divisiveness on this issue is fostering the fighting. The outcome of this election will not only dictate the path forward for the U.S. but, given the two leading candidates' divergent approaches to foreign policy may also help decipher the path for these various geopolitical issues.



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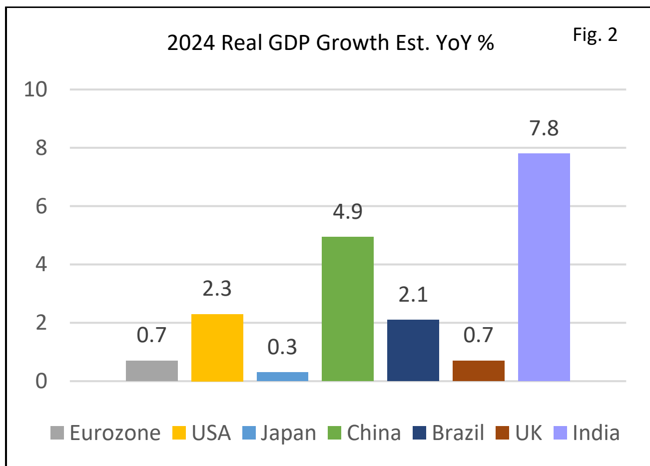
ECONOMY –

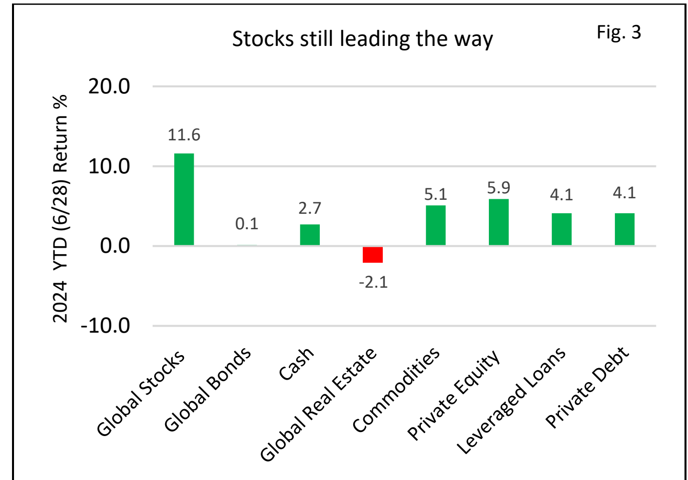
The consensus at the start of the year was that a global slowdown was in the offing. In the U.S., GDP growth was expected to cool off to less than 1.5% YoY from 2.5% in 2023. The "soft-landing" forecast buoyed hopes for multiple rate cuts (as many as seven at one point). But nobody told the data and the scenario through the first half of 2024 was "no landing." GDP growth in the U.S. is now forecast to nearly match the 2023 level and, internationally, estimates have increased for most economies with Japan a notable exception.

A combination of resilient employment and improving real wages, as inflation continued to ease, has kept U.S. consumer spending. Headline job growth has surprised positively for most of the year, a key factor that has kept the Fed on hold despite their preferred inflation measure, the Core PCE Index, falling below 3%. But under the surface, things look a little less rosy.

First, the gap between the two primary employment gauges (Establishment Survey: 2.6 million jobs, Household Survey: 195 thousand new hires) has reached a record 2.4 million. Secondly, the Establishment Survey data has been revised downward relative to the initial report in nine of the last 12 months for a cumulative reduction of 390 thousand jobs. Finally, the government has contributed 23% of total job growth while comprising less than 15% of the total employed. Notwithstanding known differences in the statistical methods used in the two data series, something's got to give.



MARKETS –



Rate cut expectations emboldened investors to push stocks higher around the globe in the first half, with domestic returns far outpacing broad foreign benchmarks. However, as discussed in the Equity section, U.S. market gains were narrowly driven, chiefly by the "AI" theme. In contrast to the steady grind higher for large cap equity indexes, bond volatility has been elevated with tight credit spreads as investors continue to weigh the inflation and employment data against the prospects of Fed rate cuts.

While it was difficult to keep up with the "Magnificent 7" stocks (+37%) in the first half, precious metals turned in a very respectable performance. Gold (+13%) and Silver (+22%) far outshined the broad commodity complex, and since the end of March spot Gold has beaten the S&P 500 Index (+9.6% vs +5.9%) while Silver (+19.5%) has nearly matched the Mag-7. Real Estate was the laggard as it failed to maintain the momentum from last year's rebound.

We continue to think that financial markets are underappreciating both the economic and global geopolitical risks as the U.S. presidential election inches closer. The Democrats find themselves in quite a pickle as the convention approaches. We know the Republican nominee and the market is certainly beginning to discount the significant implications of a Trump win. But, given everything that has already happened in this cycle, it is tough to make a big bet on that outcome knowing that there may still be a surprise or two between now and November.

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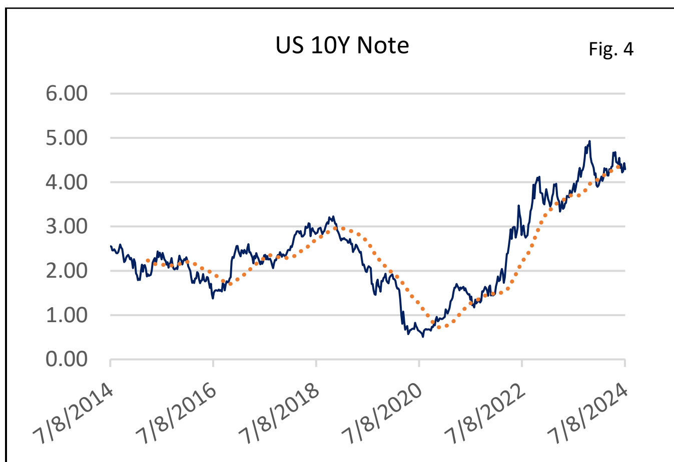
FIXED INCOME – GOV'T

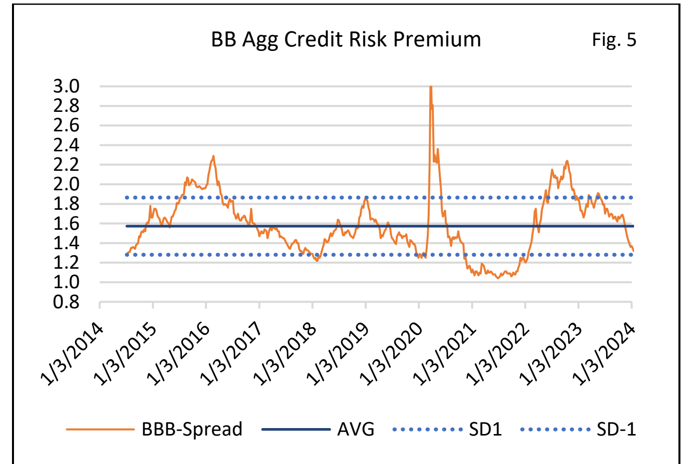
The first half of 2024 was a mirror image of the second half of 2023. At the end of last year, we saw a series of inflation figures that likely led market participants to overestimate the amount of easing that was to come in 2024. After starting the year expecting six to seven rate cuts, markets then rapidly recalculated as the early inflation reports led to an underestimating of the progress made on inflation. During this repricing, the 10-year U.S. Treasury increased by nearly 100 basis points as it attempted to re-test the 5% level. Once the year moved into Q2, market participants began to moderate their outlook toward the elusive Goldilocks' soft-landing narrative.

We believe that a Goldilocks scenario is not as assured as most people are expecting. Prices remain an issue and inflation reports have been aided by summer base effects. Both political parties, while different in ideology, will likely support various inflationary policies as the deficit continues to expand. Meanwhile, there are signs that the labor market is deteriorating, albeit ever so slightly. One thing to remember is that unemployment increases tend to display a degree of convexity as time goes on, which could turn small labor cracks into larger fissures.

With the Federal Reserve seemingly dead set on cutting rates this year, we believe expressing duration positioning via a bull steepening is appropriate in modest size. We remain cautious on the long end, especially for longer-term investors.



FIXED INCOME – CREDIT



The spread-tightening momentum seen at the end of 2023 carried through the first several months of 2024. Corporate credit tightened into the mid-80s which matched their post-crisis lows. Investor appetite for fixed income remains robust due to the all-in yields provided by the high base rates, despite tight spreads. It has been difficult to be underweight corporate credit risk in this environment as carry rules the day. We have endeavored to replicate that yield profile through alternative measures as we still believe the risk/reward in credit remains unappealing.

While the few basis points of spread widening during Q2 are not something that would prompt a second look, we have seen a degree of performance dispersion within the high-yield space. Spreads between CCC and B-rated corporate credits have started to widen as the effects of higher rates begin to take their toll on weaker borrowers. This dynamic is also playing out for the consumer as subprime delinquencies have steadily increased over the years.

We will continue to maintain our bias for higher quality carry-focused positions within our portfolios. While the American economy seems stable enough over the short and medium time horizons, we expect volatility to increase into the U.S. elections and various global geopolitical developments.

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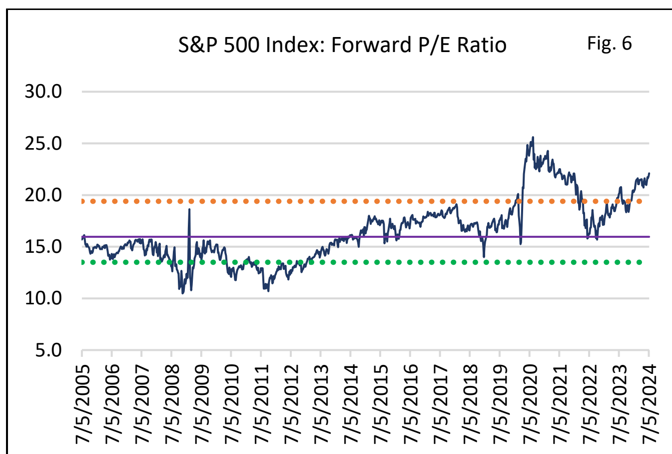
EQUITIES –US

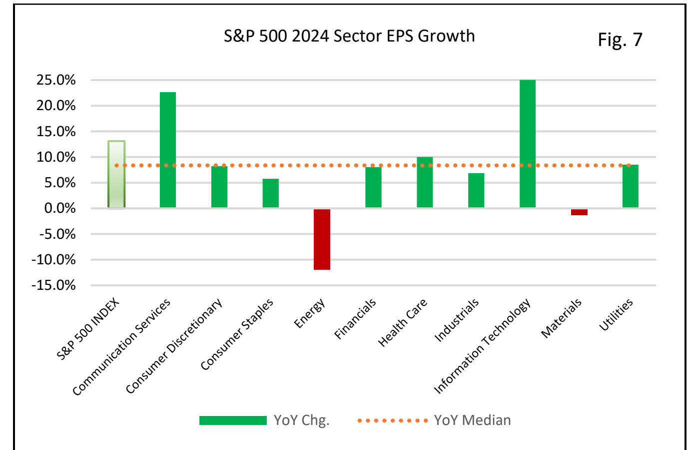
With a 14.5% price return through June, the S&P 500 Index posted its third-best first half in the past 20 years, surpassed only by last year (15.9%) and 2019 (17.4%). The first quarter offered encouraging signs that the market rally was broadening out, but price action soon reverted to the narrow, tech-focused leadership witnessed in 2024. In the second quarter, nearly 60% of index constituents registered an absolute decline and just *four* stocks produced the entire benchmark return of 4.29%.

For the first half of 2024, nearly 40% of the index posted a negative absolute return and 385 stocks (76% of the benchmark) underperformed. In contrast, the median return on the top 10 benchmark contributors was 30.4%, only two (Microsoft, and Apple) returned less than 20%, and their median forward P/E stood at 29x with only one less than 22x.

Once again it was mostly technology and media driving the market (with a bit of help from *GLP-1* drug leader Eli Lilly, up 55.8%) in the first half. Technology and Communications Services, which make up almost 40% of the S&P 500 by weight, were the only two sectors to outperform the index. Artificial Intelligence (AI) was the dominant theme, led by Nvidia's 149.5% surge. Underscoring Large Cap Technology's dominance, the Russell 2000 Smallcap Index gained less than 2% in the first half, while the S&P 500 Technology sector advanced 28%. The MSCI All Cap World Index, which lacks the US tech giants, returned just 6%



EQUITIES – US



Helping to drive the outperformance of Technology and Media stocks, not only do they have the highest expected growth rates, but they are two of only four sectors that have seen 2024 earnings estimates increased over the past 12 months. For the S&P 500 Index, the 2024 earnings estimate has increased by only 1% over the 52 weeks through the end of June compared to a price gain of 22%, pushing the benchmark index well into overvalued territory on a P/E basis for the first time since 2017 (excluding the anomalous Covid period). Further, estimates haven't budged over the past six weeks as the S&P 500 hit successive new highs.

Looking below the surface, two-thirds of S&P 500 constituents have a P/E below that of the overall index, which is constructive from a valuation perspective. However, the 2024 earnings estimate for seven of the 11 sectors is below where it was a year ago. Outside of the Technology and Media groups plus a few other very large companies (i.e. Amazon, Tesla, Lilly) most of the market isn't enjoying robust growth. What does that say about the economy?

This is the type of bifurcated market we've been dealing with for some time. Without some notable policy changes, impacting the economic landscape, perhaps resulting from the November election, we are likely to remain in a two-tiered market environment. We'll need to see better growth dynamics from the "rest" of the market to switch the narrative and bring valuation more in line with historical norms. But it might come at a cost.

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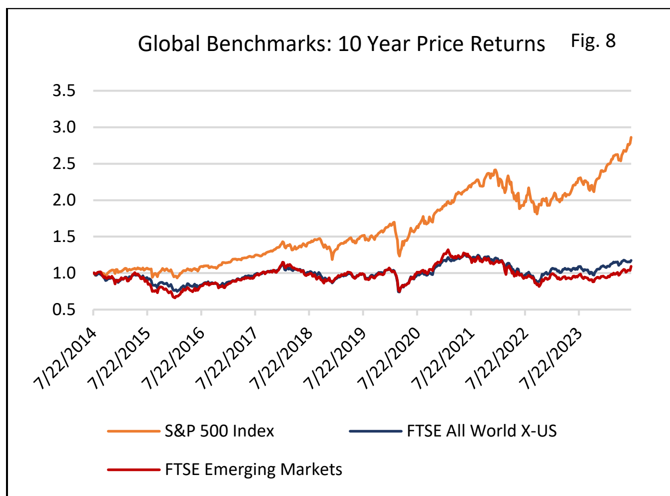
EQUITIES – INTERNATIONAL

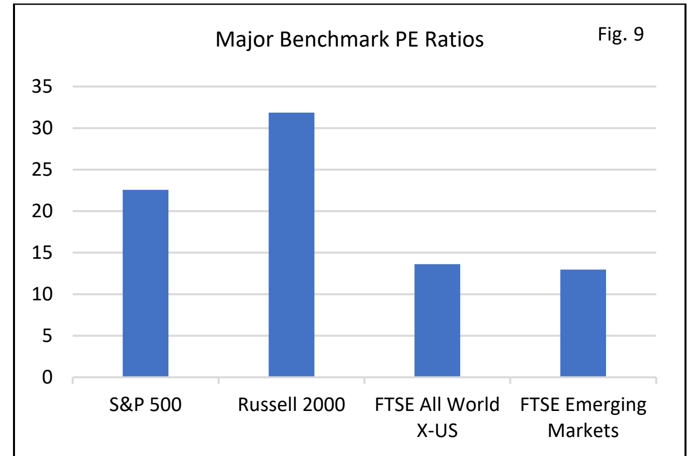
International equities have continued to rally, but at a slower pace than the second half of 2023, with the Bloomberg World Ex-US Index surpassing its 2022 highs in the first half of 2024. Markets have faced significant uncertainty due to geopolitical tensions and macroeconomic challenges. Looking forward to the remainder of 2024, international equities will continue to grapple with multiple macro uncertainties, including election risk, shifting central bank policies, and geopolitical tensions.

Market performance was supported by stronger-than-expected global economic growth throughout much of the world. The Bloomberg World ex-US Index rose +5.82% in the first half of 2024, which is slightly stronger than the second half of 2023 (+5.36%) but still trails the robust gains in the US. The benchmark was driven by Information Technology, Financials, and Health Care stocks, while Consumer Staples, Materials, and Real Estate were laggards.

Regionally, non-U.S. stocks turned in mixed results. European markets experienced a recovery from tough macroeconomic conditions due to an upturn in global manufacturing and lending growth. Japan's market also benefitted from improving manufacturing activity and a weak yen, despite a slow start to the year. Still, Emerging Markets outperformed Developed Markets (+6.43% vs +5.52%) in the first half.



EQUITIES – INTERNATIONAL



Emerging Asia was a standout in the first half of 2024, returning +9.63%, led by Taiwan (+29.60%) where Health Care (+52.60%) and Information Technology (+40.58%) were particularly strong. India also outperformed the benchmark (+15.86%) led by Communication Services (+40.17%). Latin America (-14.63%) underperformed the benchmark led by Brazil (-18.45%), where a decline in Consumer Discretionary (-23.28%) hurt. Weakness in Mexico (-12.91%) largely reflected a decline in Real Estate of -29.13%.

After a nice first quarter bounce helped by renewed government support of key economic sectors, Chinese equities reversed direction in the June quarter, as macro worries weighed on sentiment and investors remained wary of government policy. Though it finished positive, China underperformed the benchmark, returning +3.84% for the first half of 2024. China's weight in the Bloomberg benchmark is higher than the FTSE at 9.62% vs 6.64% but has fallen from 10.26% in the second half of 2023.

Non-U.S. equities have been underperforming domestic stocks for more than a decade. The earnings growth differential explains much of the spread, but relative valuations may be approaching levels that make international stocks look compelling enough to induce investors to consider an allocation shift.

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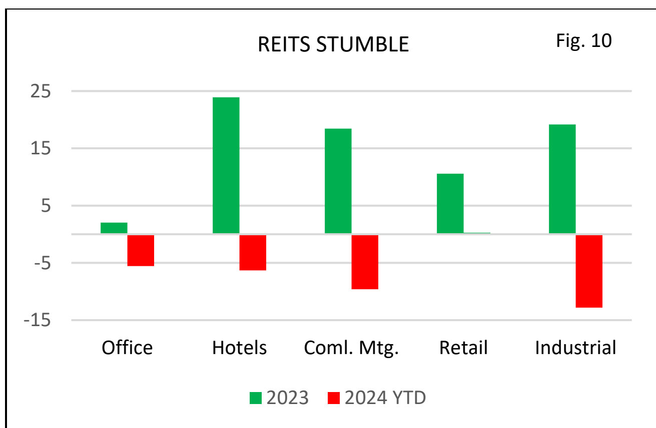
REAL ESTATE –

After a nice rebound last year following the "Covid crash", REITS retreated in the first half hurt by the Fed's higher-for-longer interest rate policy and ongoing stress in certain segments. Industrial REITs were the weakest segment in the first half, while the Office segment continues to face headwinds in the post-Covid environment. Hotels gave back a bit after leading the way last year, while Retail (flat YTD) has performed best.

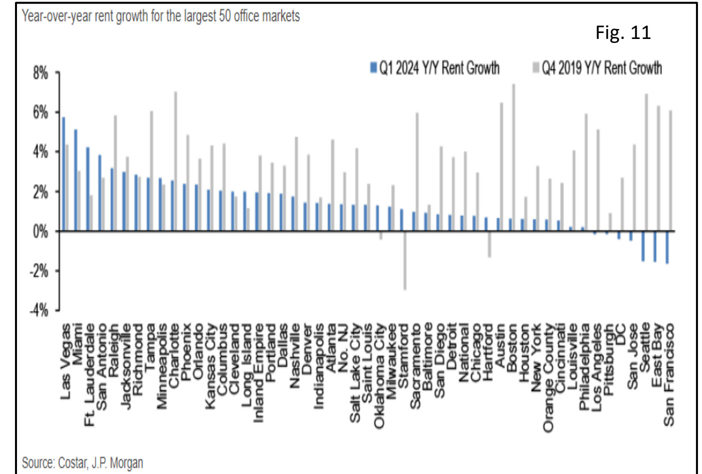
The first half of 2024 has revealed pockets of distress across asset types and geographies. In response, multiple cities have announced or launched plans to revive their downtown districts post-COVID, including NYC, San Francisco, Chicago, DC, LA, and Boston. Their incentive programs include re-zoning, tax abatements, tax credits, and supporting office-to-multifamily conversions. Notably, transactions in all property types have been well behind pre-COVID levels. Delaying distressed asset sales leaves room for average cap rates to widen and appraisal values to fall.

Office

Office occupancy continues to weaken. Availability rates (16.7%) and vacancy rates (13.7%) increased quarter over quarter and remain higher than the peak levels reached during the Great Financial Crisis (15.9% and 12.8% respectively). National office asking rent growth was flat year-over-year while the ratio of sublease rents to direct rents was reported at 84.8% in the quarter compared to 97.1% in Q4 2019. The deeper sublease discount implies that direct rents stand to see some weakening.



REAL ESTATE –



Office transaction volumes in Q1 2024 were 42% lower than a year ago and accounted for 23% of total CRE activity. Muted transaction volumes in the office space leave us waiting for full re-pricing in the office market to materialize. National office asking rent growth was flat year-over-year while the ratio of sublease rents to direct rents was reported at 84.8% in the quarter compared to 97.1% in Q4 2019. The deeper sublease discount implies that direct rents stand to see some weakening.

There are few major markets reporting rent growth above 3%. Seven out of 50 major markets have reported negative growth, including San Fransisco, Washington DC, Seattle, and San Jose. New York, the largest office market has seen significant growth in their availability rate since Q4 2019 (4.6%) but Year-over-year rent growth was flat in Q1 2024 (.6%).

Multifamily

Year- Over- Year, the national Average Daily Rate and Revenue Per Available Room both increased by 2% while occupancy rates were flat at 66.5%, (compared to the 2020 average occupancy of 38.2%). While sectors such as multifamily, industrial, and data centers have been most resistant to post-COVID behavioral shifts, we remain cautious and selective in the hotel space which is tethered to business and consumer discretionary spending. Hotels are also at risk of losing business traffic as a casualty in the flight to quality we are witnessing in the office sector.

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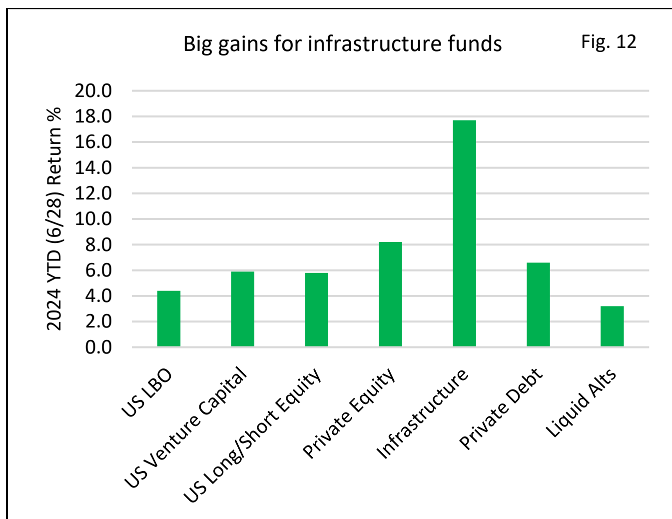
ALTERNATIVE ASSETS–

Alternative investments (Alts) and private market investments serve a unique purpose in portfolios as less volatile, diversifying positions in uncorrelated assets. Some of this benefit comes from the unique structure of these investments.

Minimum commitments to strategies are usually north of $1 million and have lock-up periods ranging from a few years to over 10 years. These lockup periods allow managers to execute business plans with a longer-term view aimed at generating more value than the public markets. Additionally, these funds only price quarterly which helps to reduce volatility experienced in other asset classes like public equities that get marked every second. Due to their lower liquidity and complex structure, investment in alts is limited to institutional investors and sophisticated investors (high net worth individuals, and qualified investors). Strategies range from private credit, private equity, hedge funds, and infrastructure to timberlands and farmlands.

Returns were positive in the first half across strategies. Infrastructure was particularly strong, likely benefitting from ongoing activities associated with the two infrastructure bills passed by Congress in 2021 and 2022. Despite ample system liquidity, investors have preferred to focus on larger, more liquid publicly traded securities, so deal flow has been below average compared to recent years



ALTERNATIVE ASSETS –

Private Equity

Private equity funds look to purchase companies at a discount, fix them up by changing management teams to grow the company, and then sell them for a profit. Sometimes they sell to a strategic buyer, other times to another private equity firm or they may take the company public. The first half of 2024 has been characterized as difficult to exit these illiquid investments.

While company multiples (how much a PE firm pays) have remained relatively stable, the initial public offering (IPO) market has been muted with no major IPO activity in H1 2024. This means investors in these vehicles are stuck holding investments for longer than originally intended. Private credit (debt) firms have been impacted by the slowdown in the private equity markets.

Private Credit

Private credit firms invest money from limited partners into a diverse pool of loans to private companies. If the company is owned by a private equity firm it is called a sponsor-backed company. With the PE firms (sponsors) not buying or selling as many companies it has been a tough environment to get deal flow as a private credit firm. However, when deals do get done, they are at higher rates with better covenants than in the recent past due to the tightening of credit standards. While both subsectors of alternatives have struggled in the first half of 2024, secondary funds have been raised to offer liquidity to private equity and private credit investors.

A secondary fund takes limited partners and purchases other limited partner stakes in existing funds at a discount. The existing limited partners are willing to sell to the secondary fund because private markets are extremely illiquid, and this approach provides an opportunity at a reasonable cost (usually a 5-15% discount) to exit whatever investment fund you are committed to. With private equity firms holding companies for longer and loans being held to maturity these types of funds offer great liquidity options for private market investors.

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SOURCE DATA

Exhibit	Source
Figure 1	Bloomberg
Figure 2	Bloomberg
Figure 3	Bloomberg
Figure 4	Bloomberg, KOCAA
Figure 5	Bloomberg, KOCAA
Figure 6	Bloomberg, KOCAA
Figure 7	Bloomberg, KOCAA
Figure 8	Bloomberg, KOCAA
Figure 9	Bloomberg
Figure 10	Bloomberg
Figure 11	Costar, J.P. Morgan
Figure 12	Research Affiliates (RA), Bloomberg, State Street

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Figure 1 Return Data

Asset Class	Index
Global Stocks	MSCI ACWI
Global Bonds	Barclays Global Agg USD
Cash	US 3M T-Bill
Global Real Estate	S&P Global REIT USD Index
Commodities	Bloomberg Commodity Index
Private Equity	Equally Weighted returns for NB Private Equity Partners, Harborvest Global Private Equity Ltd, Solactive Private Equity Select Index, FTSE Private Equity Buyout Index
Leveraged Loans	Markit iBOXX Liquid Leveraged loans
Private Debt	State Street Private Credit Index Annualized Qtrly

Figure 10 Return Data

Segment	Index
Office	FTSE NAREIT Office Sub Sector Total Return
Hotels	FTSE NAREIT Lodging/Resort Property Sub Sector Total Return
Commercial Mortgage	FTSE NAREIT Mortgage Commercial Financing Sub Sector Total Return
Retail	FTSE NAREIT Retail Property Sub Sector Total Return
Industrial	FTSE NAREIT Sub Sector Industrial Total Return

Figure 12 Return Data

Segment	Index
US LBO	RA: US LBO Simulation
US Venture Capital	RA: US VC Simulation
US Long/Short Equity	Bloomberg Equity Long/Short Hedge Fund Index
Infrastructure	Alerian MLP Index
Private Equity	Equally Weighted returns for NB Private Equity Partners, Harborvest Global Private Equity Ltd, Solactive Private Equity Select Index, FTSE Private Equity Buyout Index
Private Debt	State Street Private Credit Index Annualized Qtrly