OPTIMUM®
Global Asset Management

Financial Outlook

First Quarter 2024

Summary

At a Glance

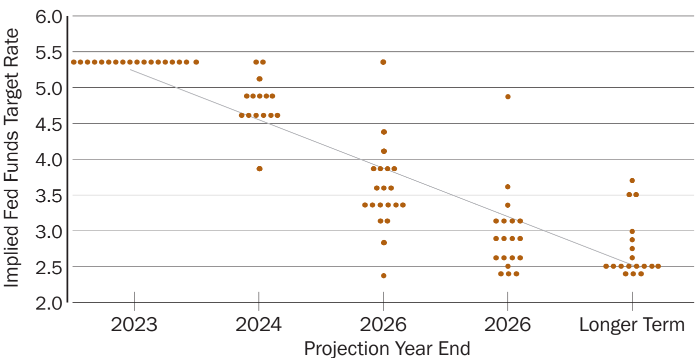
- The US economy continues to look strong going into 2024.
- Falling inflation will allow the Fed to start cutting rates, but not as quickly as the market thinks
- High real rates will act as a headwind for asset returns
- The US equity market looks the least attractive relative to bonds since 2002

Point of View

Jan Erik Warneryd, Chief Investment Officer

The fourth quarter of 2023 brought back the bullish trend in both stock and bond markets. After a significant rise in market yields in the second and third quarters of 2023, with the yield on 10-year Treasury notes rising from 3.3% in early April to 4.99% by October, in the fourth quarter investors again began to expect a pivot from the Federal Reserve's "higher for longer" policy. On December 13, the signal the market had been waiting for finally came: the "Dot Plot" where FOMC (Federal Reserve Open Market Committee), the rate-setting group of Fed Governors, members reveal their forecasts for Fed funds going forward, showed a **shift** in median expectations from **further tightening to 75 basis points of easing** in 2024 (see below).

The FOMC Dot Plot



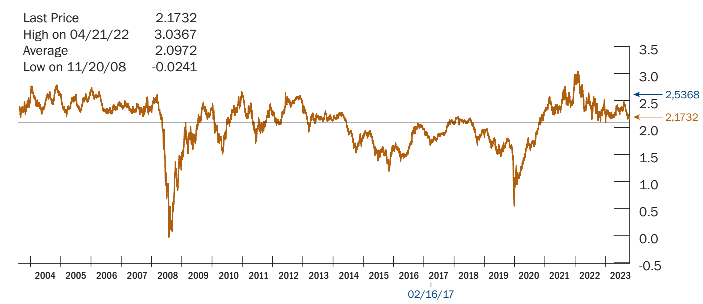
Source: Bloomberg

This shift provided further fuel to end 2023 on a strong note. Both equities and bonds performed strongly (yields fell) as the market priced in even more aggressive easing by the Fed than suggested by the "Dot Plot". At one point, 150 basis points of rate cuts in 2024 had been priced in with the first cut as soon as in March, causing widespread euphoria in asset markets. 10-year Treasury Note yields fell from a high of 4.99% in October to 3.88% by year end, exactly back to where they started in 2023.

The main thrust of Monetary Policy over the last two years has been to bring too-high inflation back down to the Fed's stated 2% target. In order to achieve this, Fed funds were raised from an upper bound of 0.25% to the current 5.5% in the period from March 2022 to July 2023. Higher rates were intended to cool the economy enough to bring inflation down, possibly causing a recession, but that was a price the Fed seemed willing to pay. Contrary to most observers' expectations, the economy has continued to expand, with real GDP growing by about 2% at an annual rate on average. Even as the economy has grown, the goal of bringing down inflation appears to have been met as well. Several key inflation indicators, including CPI and PCE, are now running at below 3% on an annualized basis. Investors, including ourselves, are beginning to think that the hoped-for "soft landing", where inflation approaches 2% without the economy in recession, has actually been achieved.

The December price action in financial markets shows the market expecting that the Fed will consider the inflation outlook benign enough to warrant policy normalization in 2024. After all, as chart 1 shows, the median FOMC member's expectation for the long-term neutral level of Fed Funds is 2.5%. This indicates that the current rate of 5.5% is fairly restrictive and should be lowered as soon as the inflation outlook allows. With the 10-year inflation rate implied by TIPS (Treasury Inflation Protected Securities) at 2.2%, the market is showing strong faith in the Fed's ability to reign in any future episodes of surging prices. The chart below shows changes in the TIPS market's expectations of 10-year inflation for the last 20 years. Note that the current level is just a few basis points above the 20-year average. This implies that the market sees the recent experience with high inflation as a passing event, unlikely to be repeated in the future.

10-year Inflation Expectations



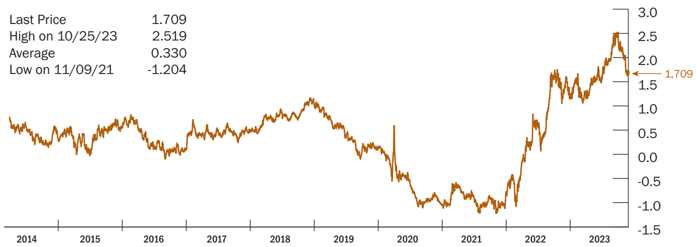
Source: Bloomberg

Before getting too excited about this somewhat benign outlook, investors should also look at what the market expects regarding real (inflation adjusted) rates. The chart below shows that, while off their highs, recently real rates on 10-year TIPS have reached their highest levels in 10 years. As our Financial Outlook article on equities shows, higher real rates are posing a potential valuation problem for assets such as stocks and real estate. Let us also remember that the Fed's implied forecast for real rates is much lower than the market's forecast. With an inflation target of 2% and the FOMC members' own estimate of the long-term neutral Fed funds rate at 2.5%, it follows that the Fed expect the level of long-term Fed funds to be about 0.5%.

Point of View (cont'd)

Jan Erik Warneryd, Chief Investment Officer

10-year Real Yields on TIPS



Source: Bloomberg

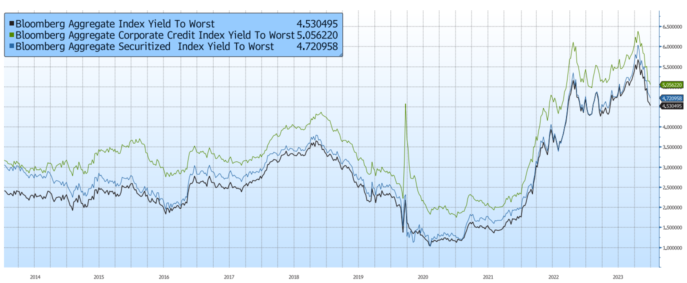
Maybe higher real rates is the "price" the economy will have to pay for inflation to stay at 2%. The market may be saying that it will require tighter monetary policy (higher real Fed funds) to reach the same inflation target in the future. De-globalization may reverse benign disinflationary pressures and large and persistent fiscal deficits could lead to a "crowding-out" effect through an ever-increasing supply of Treasury Notes and Bonds. The market is now expecting the long-term neutral Fed Funds rate to be around 3.5% rather than the Fed's own forecast of 2.5%. The challenge for investors going forward will be how to price assets in an environment of higher real interest rates.

Regarding the economic outlook, we are fairly optimistic that the end of monetary tightening will help sustain the current expansion, but we disagree with the market's optimism regarding the pace of easing. Current expectations of rate cuts starting as early as in March seem too optimistic for a Fed that only very recently abandoned their tightening bias. Higher real rates will also serve to keep bond yields higher than many market participants expect. The days of 10-year Treasury Note yields at 2% are most likely over for the foreseeable future. This new environment will challenge valuations in some segments of the market such as Growth stocks. Other asset classes such as Private Equity may also face headwinds as the combination of significant leverage and falling valuation multiples dent future returns.

Bond Markets

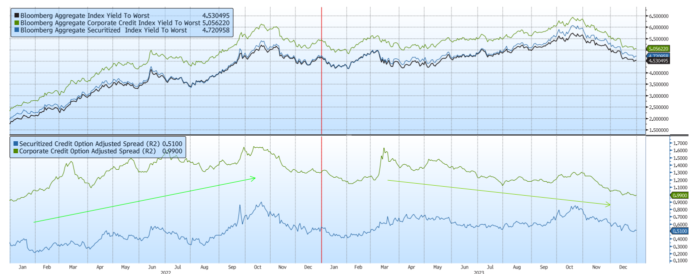
Mark McDonnell, Senior Portfolio Manager

We are macroeconomics driven investors with a solid tilt towards value. These last two years have been some of the most interesting and challenging times to be practitioners of this art. We open 2024 with yields on the Bloomberg Aggregate Index we haven't seen in over ten years. This is very good news for pension funds and insurance companies. To look for opportunities in the future one might look to how we got here with a focus on these last two years. Then we can accurately assess what is priced into risk assets with the hopes that we can capture changes in risk premia.
A review of these last two years will also illustrate that prudent risk management means getting the sector allocation right. We will divide the Bloomberg Index into three broad sectors; Treasuries, Corporate bonds, and Securitized debt which is mostly mortgage-backed securities.



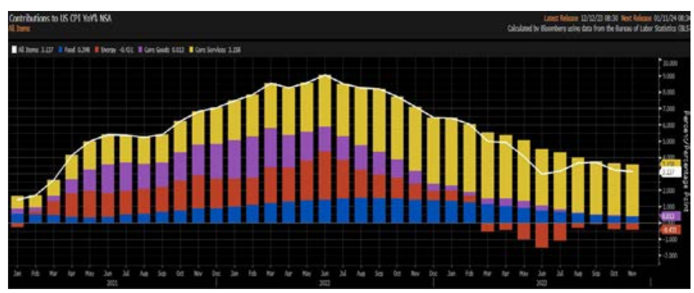
Source: Bloomberg

The last quarter of 2023 was a yield grab. Investors saw yields over 5% and bought more and more aggressively as rates dropped in a move known as Fear of Missing Out or FOMO. This contrasts with 2022, which saw the worst performance for both equities and bonds in 150 years. The Bloomberg Aggregate Index lost 13%. We entered the year with Federal Funds virtually at zero and market expectations for three small interest rate hikes over the course of the year. With all too persistent inflation by mid-year, the Federal Reserve hiked rates to over 1.5% and were going to increase not by 25 basis points per meeting but by 50 and 75 basis points at a time, ending 2022 at over 4.25%. This dramatic increase saw 2-year notes rise from three quarters of a percent yield to 4.43% or 369 basis points. The 30-year bond rose from 1.91% to 3.97%, a rise of 206 basis points in what is called a Bear Flattener. The longer the maturity, all else being equal, the more adverse the price change. The 2-year note lost 3.2%, while the 30-year bond lost 37.1%. This drove investor expectations towards the recession that never came in 2023. Coupled with Quantitative Easing turning to Quantitative Tightening, both corporate bond and mortgage spreads widened. Bond managers talk about the excess return of different sectors. Excess return is the additional total return one earned for investing in bonds other than U.S Treasuries. As spreads increased or widened the prices of those corporate bonds and mortgages fell more than the comparable Treasury. In 2022, the overall Bloomberg Aggregate Index returned -13.01% with .99% of that being negative excess return.



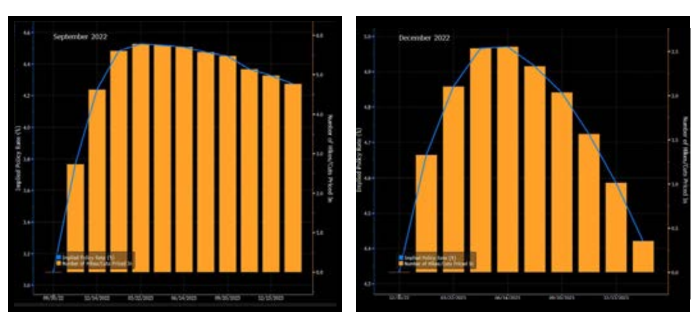
Source: Bloomberg

The chart above tracks both the yields of the Aggregate Index and two of its major components, credit and MBS, as well as the spreads for each of them. We can see credit and securitized spreads increasing for the majority of 2022, as the markets saw an increasing tempo of Fed rate increases only to slowly change the narrative from a recession in 2023 to a soft landing and finally by the end of 2023 the increased chances of a "no landing" scenario. Credit Spreads continued to tighten into 2023, only to be interrupted by the regional banking crisis in March of last year. Securitized spreads tightening into the close of 2022 only to widen modestly in the third quarter. This pivot coincided with inflation data peaking in May of 2022 and the markets seeing several months of falling Core Goods and Energy components clearly on the downtrend.



Source: Bloomberg

Indeed, we see this quite nicely when we compare the market's expectations of Federal Funds in September of 2022 versus the market's expectations just 3 months later when the downtrend in inflation was well established.



Source: Bloomberg

Bond Markets (cont'd)

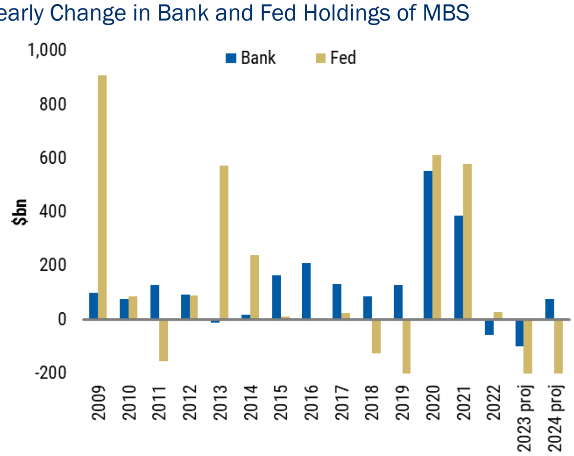
Mark McDonnell, Senior Portfolio Manager

As active investors, we look to get two major decisions right over the intermediate term; the rates decision and the sector allocation decision. The rates decision entails both the general direction of Treasury yields and to a lesser extent the shape of the yield curve. The sector allocation decision entails determining how the other two major sectors, credit and securitized will perform relative to their underlying treasuries.

We differed from the market's forecast regarding the stickiness of inflation in 2021. We thought it would come down more slowly than the market's forecast. Therefore, we believed the Fed would continue to tighten for much of 2022 and were underweight duration, buying back that underweight as rates rose and by the latter part of 2023 were positioned with a modest overweight in duration as we believed rates had risen too far too fast. Key to that understanding was the rise in real rates. Real rates are interest rates adjusted for inflation. Financial conditions become considerably more restrictive when real rates are positive.
The good news for bond investors is that the vast majority of the rise in rates appears to be behind us. However, we are focused on some upside risks. Key among the risks is the sizable Treasury issuance calendar. Market participants are keenly aware that 31% of all outstanding Treasuries will mature and need to be reissued. The Treasury meets frequently with a group called the Treasury Borrowing Advisory Committee (TBAC). This is a group of industry professionals from both investment banking and asset management. Based on a number of factors to include feedback from the TBAC as to what the markets can absorb in new issuance the Treasury makes a decision as to the composition of maturities. This is directly impactful on Treasury rates. For example, the Treasury decision announced at the end of October 2023 signaled an end to a massive rise in interest rates. We will primarily focus on the changes in economic conditions for our interest rate decisions and as discussed in our Point of View, we see the Fed slower to cut rates than is priced but will look to the quarterly announcements by the Treasury to assist us in understanding the future path of interest rates.

Turning to the Sector allocation decision and focusing on the Securitized Sector, we believe this chart explains much of the several years of MBS underperformance.

Yearly Change in Bank and Fed Holdings of MBS

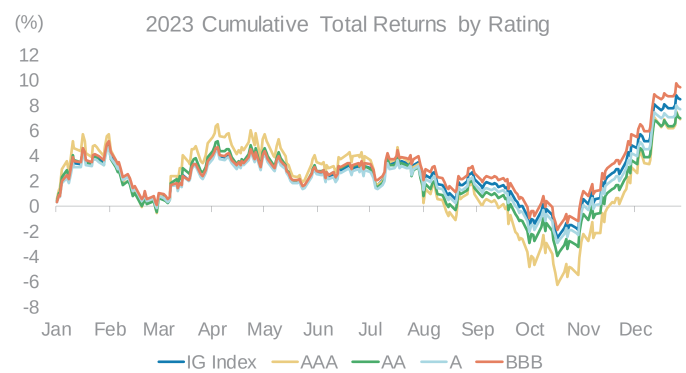


Source: Morgan Stanley

During 2020 and 2021, the Federal Reserve bought massive amounts of residential mortgages. They so distorted the market that by most analytical measures an investor should have expected to realize a lower return on their mortgage investments than had they invested in a comparable basket of treasuries. We were underweight MBS for the majority of that time. Quantitative Easing slowly turned to Quantitative Tightening. Coupled with the regional banking crisis in the first quarter of 2023 as well as portfolio managers having an overweight position in MBS in October of 2023, the marketplace found itself with $35 billion a month being offered from the Treasury and very few marginal buyers. Spreads widened to the widest they have been since the Great Financial Crisis in 2008. As spreads widened or normalized, we covered our underweight and currently hold an index weighting. MBS has a negative 2.23% excess return in 2022 and a positive .68% excess return in 2023. The combination of a macro-driven focus and value tilt allowed us to avoid some pf that relative underperformance.

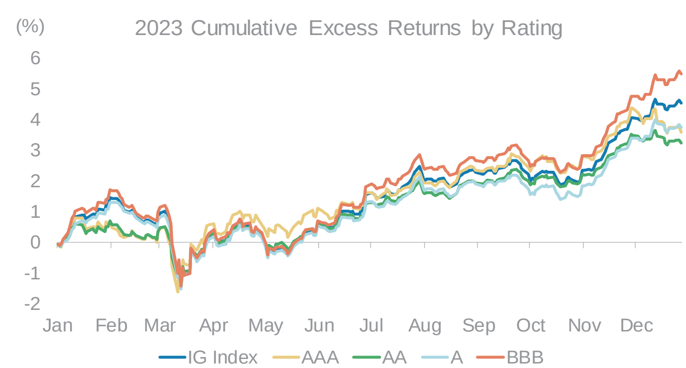
Credit performed well in 2023. To be more specific credit performed extremely well during November and December, salvaging what was looking to be another poor year. The following two charts serve to help explain the performance of this sector.

Total Returns Were Positive Across Rating Cohorts



Source: Bloomberg, Morgan Stanley Research

Excess Returns Rebounded From Negative Levels in March



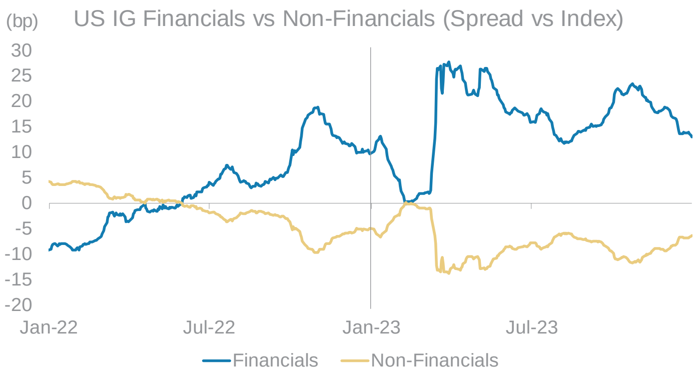
Source: Bloomberg, Morgan Stanley Research

Bond Markets (cont'd)

Mark McDonnell, Senior Portfolio Manager

The cumulative total return slid into negative territory as the underlying Treasury yields accelerated higher into October. As the selloff turned into a rally the Fear of Missing Out dragged investors into the market. Finally, the change in the Dot Plot released by the Federal Reserve in December served as one last final boost into the close for most asset classes. The cumulative excess return for credit started out strong in 2023 with BBB rated credit generating solid excess returns in the first few months only to see that rally derail in March as several regional banks came under duress. That pressure on Financial (Regional banks more specifically) continued for the remainder of 2023, ending the year with wider spreads than in December 2022. The market continues to monitor the health of the commercial real estate on their books and maintains an increased risk premium as expressed by the wider spreads for the regionals over the money center banks. We think that makes sense.

Financials Underperformed Heavily in 2023



Source: Bloomberg, Morgan Stanley Research

We continue to maintain a modest underweight in credit. This discussion started with the observation that investors now have yields that are both above inflation and can serve to give a reasonable return. The path we took warrants a discussion. As underlying Treasury rates rose credit spreads tightened. To some degree that makes sense. However, as rates continued to rise and spreads continued to tighten it became apparent that the aforementioned FOMO was at work. Investors that had not been able to invest in an A-rated industrial bond maturing in ten years at a 5% yield snapped them up. That's understandable, however, one also has to look at the spread or the additional yield one gets paid over a comparable Treasury to take that credit risk. One sees that as rates rose and 5.5% became available investors scooped up that bond *regardless of the yield on the underlying Treasury*. When rates started dropping investor bought credit more aggressively for fear of missing out.

The net result are spreads that are tight but not egregiously so. We had what is politely called an "earnings recession" over the course of the last two years and debt coverage ratios faired mildly worse for it though I hasten to add companies have built up cash and most took advantage of low rates to term out their borrowing. Corporate America is less susceptible to rollover risk than the U.S. Treasury. All else being equal, spreads should not be significantly through the 30-year long-term average. We try to invest by looking at a range of economic outcomes. Credit spreads at these levels appear to price only good economic news for the next several quarters. As Value Investors we would like a bit more compensation in the way of spreads before being fully index weight.

In summation, by approaching the markets with a value tilt after developing a solid understanding of the macroeconomic picture, we were able to underweight duration when yields on treasuries were 2 and 3%, and underweight mortgages when one wasn't getting paid to take on the variability of cashflows inherent in that asset class. We were able to offer reasonable downside protection while capturing most of the upside.

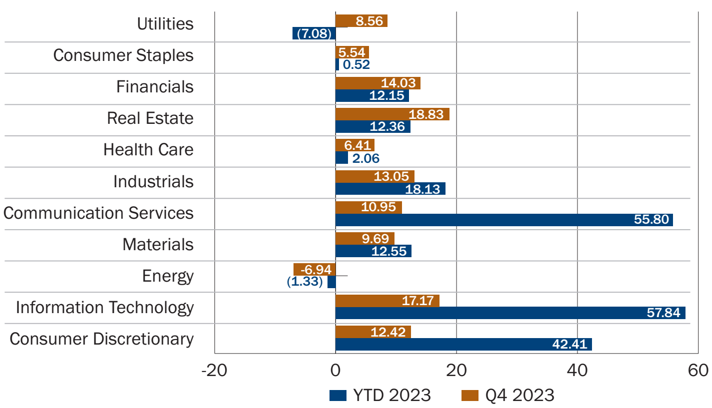
STRATEGY We are positioned essentially at index weight in duration and MBS exposure and hold a modest underweight in credit. We look to reduce that underweight should spreads reflect a broader range of outcomes than we see as priced today.

U.S. Equities

Jan Erik Warneryd, Chief Investment Officer

The fourth quarter of 2023 brought a return of the bull market in US equities: the S&P 500 Index was up 11.69% for the quarter and 26.29% for the year. The leading sectors, both for Q4 and all of 2023, were Information Technology, Communication Services and Consumer Discretionary. These sectors had been the worst performers in 2022 and have now, in the case of Information Technology, more than made up for the losses in 2022.
The other two sectors are still down from their levels at the end of 2021, by about 7% in the case of Communication Services and 13% for Consumer Discretionary. While the rally in 2023 was surprisingly strong, when seen together with 2022, the rise looks less spectacular. Out of the 11 GICS Sectors in the S&P 500, only 2 had negative returns: Energy and Utilities (see below).
The S&P 500 is up 3.4% for the 2022-23 period while the Nasdaq is down 2.3%.

S&P 500* Index
Total Return (%) by Sector / Quarter End December 2023



Source: Optimum Quantvest and S&P Global
* The S&P 500 is a stock market index is not managed, cannot be purchased and does not reflect the deduction of any fees. The volatility and performance of an index an investor will not be the same.

The market's strong performance in Q4 was, in large part, due to what appears to be the highly anticipated "Fed Pivot," where the Federal Reserve finally move away from their restrictive monetary policy back towards neutrality. The first sign of this change was the release of the "Dot Plot" (see "Our Point of View") on December 13, where FOMC (Federal Reserve Open Market Committee) members revealed their forecasts for Fed funds going forward. The previous "Dot Plot," released on September 20, had indicated that a majority of FOMC members still expected to hike rates by another 25 basis points in the near future, before embarking on modest rate cuts in 2024. In contrast, the December 13 forecast had removed the expected additional rate hike while also adding more easing in 2024, resulting in a net change in the year-end 2024 level of Fed funds of -50 basis points, from 5.125% to 4.625%. This change engendered significant further optimism in the market and served to push equities (and bonds) higher in the second half of December.

Falling market interest rates in anticipation of Fed easing came at a crucial time for the equity market after the rise in bond yields had caused significant headwinds in Q3. With the yield on 10-year Treasury Notes close to 5%, the equity market looked more vulnerable since any time after the financial crisis in 2008/9. If the era of low interest rates truly was over, as the bond market seemed to suggest, could the equity market's relatively high valuation be justified? In the chart below, you can see our preferred measure of the forward-looking equity risk premium. The chart shows the spread between the earnings yield on the S&P 500 defined as the inverse CAPE (Cyclically Adjusted Price/ Earnings, also known as Shiller PE) ratio and the real yield on a 10-year TIP (Treasury Inflation Protected Security).

Equity Risk Premium (S&P 500 vs. TIPS)

Source: Optimum Quantvest and Bloomberg

As can be seen above, earlier this fall the attractiveness of equities relative to TIPs reached its worst level in two decades, right before the push lower in market yields in Q4 relieved some of the valuation pressure. Since the beginning of 2008 until now, the average spread according to the measure above has been over 400 basis points in favor of equities, but we are now at 154 basis points, lower than at any point since 2002.

Going forward, an important question is whether the long-term relative valuation of equities vs. bonds will revert to levels seen before the Global Financial Crisis (GFC) in 2008-9, in which case equities still look fairly valued, or whether the market has become dependent on post-GFC levels of monetary and fiscal stimulus. In the latter case, equities are vulnerable if the market ends up disappointed by the pace of Fed easing. We are currently at an inflection point where we can say, with some certainty, that equities, in particular US equities after many years of outperformance versus the rest of the world, look more vulnerable than has been the case for many years.

U.S. Equities (cont'd)

Jan Erik Warneryd, Chief Investment Officer

STRATEGY

The US economy showed remarkable strength in 2023 and appears to be entering 2024 on a stable footing. With market rates and inflation declining, the case for tight monetary policy is weakening. This will be a net positive for both the economy and financial markets. Against this, investors must weigh not only a relatively rich equity market valuation, but also the impact of heightened geopolitical risk and the potential negative impact on firms' operating margins from lower nominal growth (due to lower inflation) and higher real wages (UAW and UPS are two examples) due to a still-tight labor market.

We think the best-performing sectors of late may be most vulnerable in the current environment. Growth has dominated Value as a return factor for a long time, contrary to the historical record which shows Value outperforming over the long term. While the timing is difficult to master, we believe there will soon come a time of significant outperformance by sectors such as Health Care and Financials and other sub-sectors with low valuations and stable cash flows. Equity market performance in 2023 was led by the "Magnificent Seven" (Meta, Envidia, Tesla, Alphabet, Microsoft, Apple and Amazon); stocks that were perceived to be not only resistant to a likely recession but also most likely to benefit from the coming boom in Artificial Intelligence. After a year of blistering performance (the Magnificent Seven were each individually up between 50% and 240% in 2023), expectations are very high that these stocks will continue to lead the market. We think investors will ultimately be better served by broadening their portfolio into cheaper names and sectors where expectations are lower. Our Equity Sector Strategy is overweight in Financials and Health Care as well as in Information Technology, while underweight in Communications Services and Consumer Discretionary.

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