OPTIMUM®
Global Asset Management

Financial Outlook

Third Quarter 2024

Summary

At a Glance

- The US economy is starting to show signs of slowing down
- The market now expects about 35 basis points of rate cuts in 2024
- In spite of higher rates and a slowing economy, the US equity market is at a new all-time high
- The broader equity market offers better value than large-cap Tech and Media stocks
- The US equity market looks the least attractive relative to bonds since 2002

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Point of View

Jan Erik Warneryd, Chief Investment Officer

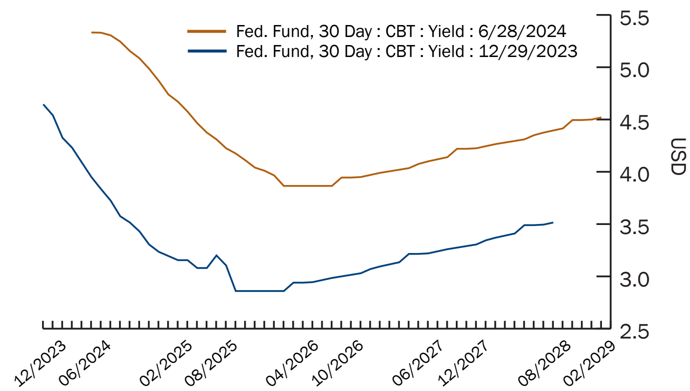
The story of 2024 to date has been one of a rising equity market, higher interest rates and a slowing economy. The S&P 500 was up 15.29% by the end of Q2 and the yield on 10-year Treasuries rose from 3.88% at the end of 2023 to 4.40% by late June while expectations for rate cuts diminished, yet the economy turned out to be weaker than expected. The chart below shows the Citi Economic Surprise Index (CESI) for the last year. It demonstrates that economic indicators have surprised by being weaker than expected since February of this year, yet surprisingly, the market now expects much less easing from the Federal Reserve (FED) than it did earlier in the year.

Citi Economic Surprise Index (CESI)

Source: Bloomberg

The chart below shows the change in expectations regarding Fed Funds from Q4 2023 to Q2 2024. The orange line is market (Fed Fund Futures) expectations as of June 29, 2024 and the green line shows expectations on December 29, 2023. As we can see, whereas the market expected FED Funds to end 2024 at about 3.75%, now the expectation is that rates will end the year at 5%. A significant change has also taken place regarding longer term rate expectations; by 2028 Fed Funds are now expected to be over 4.5% versus expectations of 3.5% just 6 months ago.

Expected Path of Fed Funds Q4 2023 versus Q2 2024



Source: Bloomberg

Since this change in rate expectations has coincided with a market rally, it would appear that investors aren't worried about interest rates staying "higher for longer" at this point as the stock market seems to have "decoupled" from the real economy.

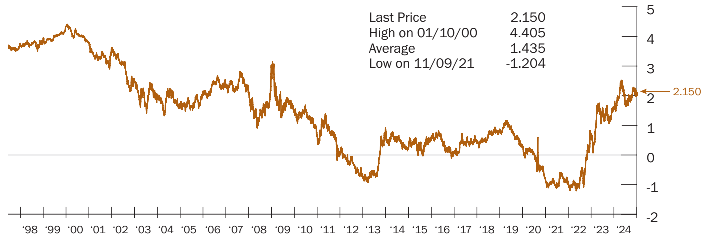
In most other circumstances, increasing signs of an economic slowdown with rates **rising** would be incompatible with the S&P 500 at a new all-time high.

Another interesting point to consider is the ability of the market to withstand fairly hawkish FED rhetoric; many FOMC (Federal Open Market Committee, the rate-setting group of FED governors) members have expressed a willingness to wait for inflation to come down further before considering rate cuts. As can be seen above, the market is currently only expecting about 35 basis points of easing by year-end 2024. An explanation as to why the FED is sounding more hawkish than the market has been expecting is that they can do so at no cost – the market is clearly able to shrug off current restrictive monetary policy. This allows the FED to run policy a bit tighter than absolutely necessary in order to build credibility for their ability to fight inflation and to build a "reserve" of easing to be used when needed.

Trying to fit a coherent consensus view that can explain recent market behavior is challenging but it would likely include investors demanding an increased risk premium for buying Treasury bonds due to increase in supply to finance the large US budget deficit. Investors appear to be expressing the view that assets other than Treasuries, such as Corporate Bonds (spreads are very tight) and Equities (especially anything related to Artificial Intelligence) will perform well in an environment of high fiscal spending. Investor behavior also suggests that liquidity from the Covid-related stimulus of 2020-22 is still in the financial system.

As mentioned in the Equities piece in this Financial Outlook, the higher real rates that investors are facing may serve as a significant headwind to the bullish market outlook. Below is a chart showing the real yield on 10-year TIPS (Treasury Inflation Protected Securities) since 1997. Note the significant rise since 2021.

Real Yield on 10-Year TIPS



Source: Bloomberg

It may well be the case that we have yet to see the full impact of higher real rates on the US economy. The effect of rate increases has been unevenly distributed across different income groups. For example, if you are a homeowner (home prices just hit an all-time high according to S&P/Case -Shiller) with a mortgage taken out before 2022 (more than 50% of US home mortgages carry a rate below 4%) and a diversified stock portfolio (the S&P 500 hit an all-time high on June 28), you are likely to feel quite good about your personal financial circumstances. If, on the other hand,

Point of View (cont'd)

Jan Erik Warneryd, Chief Investment Officer

you rent your home (the Zillow Rent Index is up 30% since the beginning of 2021) and have credit card debt (the average interest on Credit card debt has risen from 16% to 22.6% since 2021, according to the FED) you are likely to feel left out of the post-pandemic boom.

We perceive risks to the US economy and the performance of financial assets, in particular equities, to have increased in the last few months. The pattern of activity slowing in the US has become quite persistent and the FED have not yet changed their message to reflect a weaker outlook. When we add increasing international and domestic political uncertainty to the mix, we think investors would be well advised to start cutting back on risk going forward.

Bond Markets

Mark McDonnell, Senior Portfolio Manager

As the first half comes to a close and the Federal Reserve works towards the transition from tightening monetary policy to easing, we should pause and reflect on what that means for longer term investors. Higher starting yields today mean potentially less risk for investors. Carry is back. That helps reduce risk. Profligate spending is also the order of the day with deficits forecast well into the future. We will look to understand what that means for interest rates and the shape of the yield curve. We are constructive in the near to intermediate term but see a risk of a bullish steepening of the yield curve turning into a bear steepener if deficits are not brought under control. Sizable and continued issuance of longer maturity bonds by the treasury risks crowding out of corporate debt as well. Our job as professional investors is to navigate those risks.

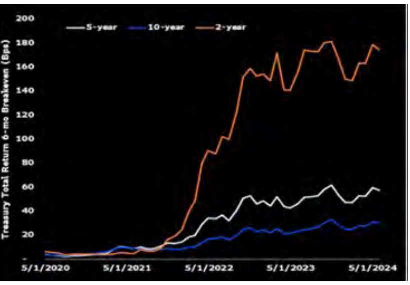
The bond market ended on a strong note in June, returning 0.95% for the Bloomberg Aggregate Index and cutting losses for the year down to -0.71%. The second quarter return was a very modest 0.07% as expectations for interest rate cuts were continually reduced, closing out with modestly over one cut priced in through year end. This is in marked contrast to the start of the year where over six full cuts were priced. We believe that skews the risks considerably in the bond market's favor. Real yields, or the yield adjusted for inflation, are over 2%. Coupled with a modestly rising unemployment rate and some signs of a consumer slowdown there is a reasonable chance that cuts in the Federal Funds rate will occur sooner and they will be deeper than is priced into the market. That should be positive for bond prices, especially in the shorter end of the Treasury curve.

The bond market has come a long way since May 2021. 2022 was the worst year in the history of both equities and fixed income in 150 years. We normalized rates and now the yield on the Bloomberg Aggregate is 5%. As rates rose, the risks of losses have become more balanced. The following chart illustrated this quite well.

Treasury Breakeven Analysis

As of 06/17/24	3m	6m	1y
2-year	71	168	518
3-year	42	94	236
5-year	24	51	116
7-year	17	36	78
10-year	13	28	58
20-year	9	18	36
30-year	6	13	27

As of 05/06/21	3m	6m	1y
2-year	2	5	16
3-year	3	6	16
5-year	4	9	21
7-year	5	10	22
10-year	4	9	19
20-year	3	7	14
30-year	3	5	11

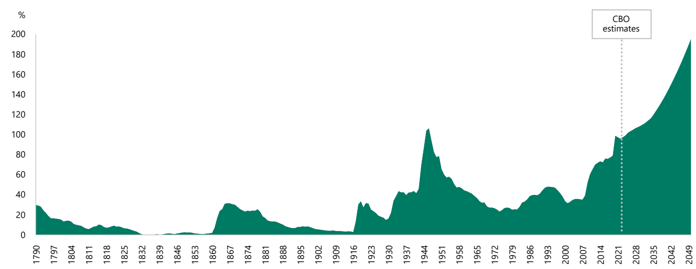


Source: Bloomberg Intelligence

It requires some explaining. The total return of a bond consists of the interest income plus or minus the change in the price of a bond. If rates are rising, the price of the bond falls and vice versa. This charts up what is called the breakeven spread or the rise in yield at which one neither made money or lost money holding over a period of time prior to a bond's maturity. For example: as of 06/17/24 had you purchased a 2-year note and rates rose 5.18% or 518 basis points in bond parlance over the course of a year the price decline would have been equally offset by a year's worth of interest income. That contrasts markedly with the breakeven yield for holding a 2-year note purchased in May of 2021 at a yield of 0.156%. Rates would only have to move against the holder by 0.16% for one to have broken even on the purchase a year later. If one focuses on the 7-year Treasury as a rough proxy for the interest rate risk of the Bloomberg Aggregate and one believes, as we do, that the next move by the Federal Reserve will be a cut rather than a hike, then the risk of investing in core fixed income is tilted in the investor's favor.

However, while in aggregate one should expect a friendly environment for bond investing, we believe one has to appreciate the potential changes in the yield curve that can occur. It's no secret we are engaged in massive deficit spending. Here is a forecast from the Congressional Budget office.

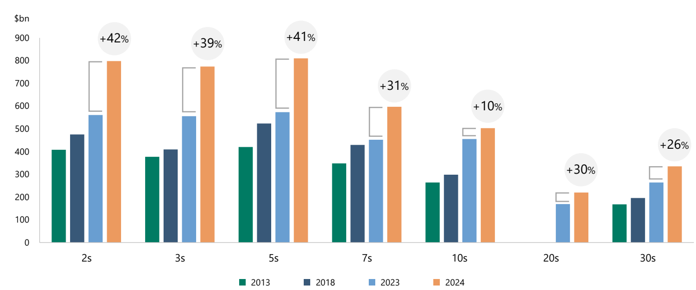
US Federal Debt Held by Public (% GDP)



Sources: CBO, Haver Analytics, Apollo Chief Economist

This deficit spending will be funded by significant increases in treasury issuance. The shorter issuances such as the 2-year and the 5-year has a multitude of buyers, including Central Banks and other foreign buyers. While nothing precludes overseas buying of longer treasuries that tends not to be the case.
In addition, ETFs benched against the Bloomberg Aggregate, Pension funds and Life Insurance companies tend to be the main buyers of treasuries in the 20–30-year maturities. While these three pools of investors are sizable, one should have concerns about how much of the longer dated new issuance they can absorb.

Treasury Issuance Across Tenors



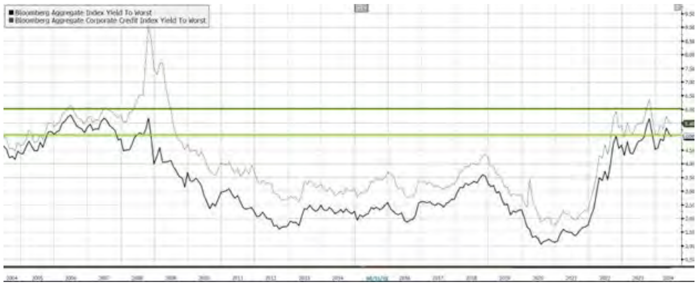
Note: Estimates from September 2023 to Dec 2024 from the TBAC neutral issuance scenario.
Sources: SIFMA, TBAC, Haver Analytics, Apollo Chief Economist

Bond Markets (cont'd)

Mark McDonnell, Senior Portfolio Manager

As we discussed earlier, the yield on the Bloomberg Aggregate Index closed the quarter at 5%. The following chart illustrates that the last time insurance companies had the opportunity to invest in the overall Investment grade bond market at 5% was in August of 2009 and the last time insurance companies could buy corporate bonds at a yield of 6% was in May of 2009. Insurance companies did buy corporate bonds as the rates backed up through those levels in 2023. Investors were buying yield, with less attention to the spread over risk matched treasuries. That spread, that compensation for credit risk, became significantly lower.

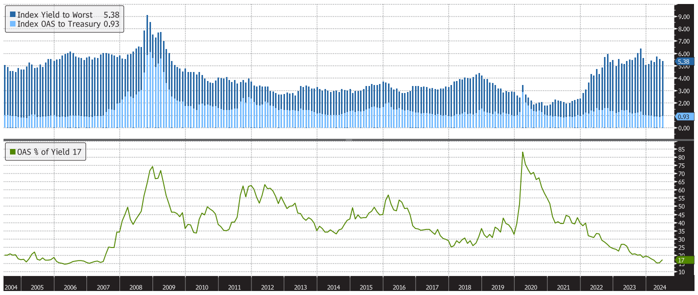
Bloomberg Aggregate Index Yield



Source: Bloomberg

We continue to look at the corporate bond segment of the investment grade with a modest amount of caution. The economic expansion is starting to show signs of weakening. If the history of spreads is any guide, the corporate bond segment is not pricing in much chance of a slowdown at all. We would further add that the additional spread mentioned earlier should also be viewed in conjunction with the overall yields. One way of expressing this is the Option Adjusted Spread as a percentage of the overall yield of the index. For example: if the yield of the index is 4% and the OAS of the corporate segment is 1%, the OAS % of yield would be 25%. Much like carry, one can think of it as a much simplified expression of the opportunity costs for being in treasuries as opposed to a basket of corporate bonds. Were I to incur the credit risk of an all corporate bond portfolio versus an all treasury portfolio, my increase in yield today would be about 17%. This is historically tight.

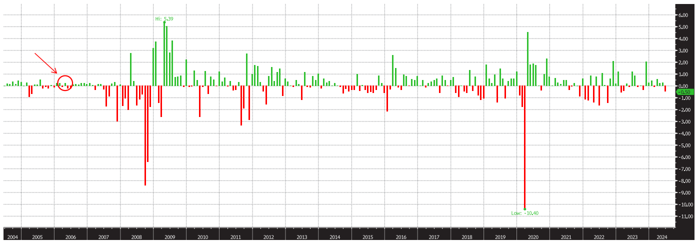
OAS % of Yield



Source: Bloomberg

When we review similar periods where the percentage was this low, we find the future excess returns of corporate bonds were not overly robust. The following chart shows this pattern. Therefore, when we see treasury issuance markedly picking up with that creates the risk of crowding out corporate debt, leading to wider spreads. Coupled with historically low spreads relative to treasury yields, we believe a very modest underweight in credit is called for.

Monthly Excess Return vs Treasuries



Source: Bloomberg

STRATEGY

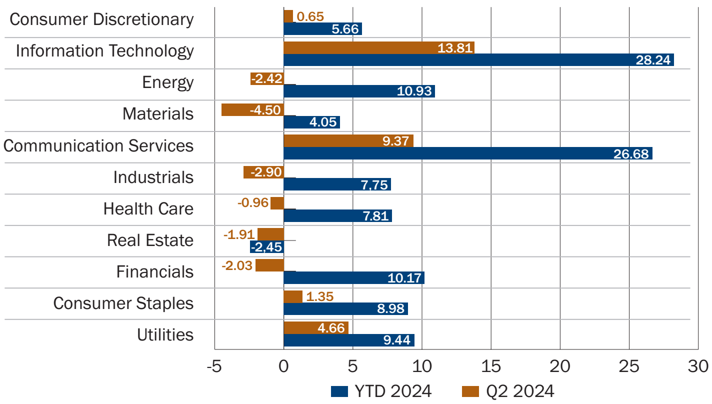
We are currently positioned for a general decline in interest rates, led by the shorter maturities but with an eye towards a steepening of the yield curve over longer periods of time. We find MBS be fairly priced and corporate credit valuations modestly rich.

U.S. Equities

Jan Erik Warneryd, Chief Investment Officer

The second quarter of 2024 saw continued strength in the US equity market, although the pace of the market's advance slowed down from Q1. The total return for the S&P 500 was 4.28% in Q2 and the rally was led by IT and Communication Services. Utilities, Consumer Staples and Consumer Discretionary were the only other sectors with positive returns for the quarter. See below for sector returns.

S&P 500 Index
Total Return (%) by Sector - Quarter End June 2024



Source: Optimum Quantvest and S&P Global

The rally in the US equity market continues to be led by relatively few stocks in the IT and Communications sectors. A measure of how narrow the advance has been is the relative performance of the overall S&P 500 and the equal-weighted version of the same index. The overall, cap-weighted S&P 500 is up 15.29% so far in 2024, while the equal-weighted index is up only 5.08%. Of the sub-sectors, the IT sector is up 28.24% and Communication Services is up 26.68%, again pointing to the dispersion between "growth" sectors and the rest of the equity market.

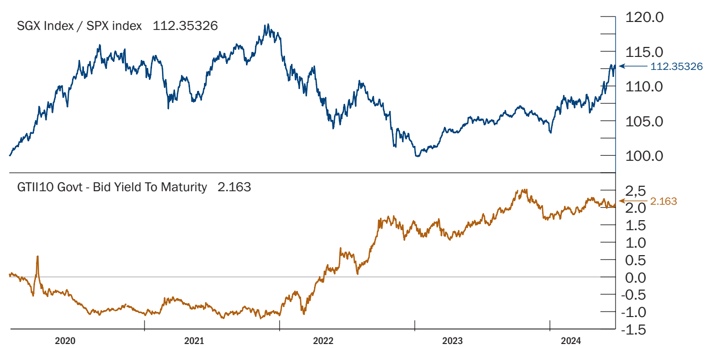
An interesting aspect to consider when looking at equity market leadership is to what extent interest rates have an impact. According to theory, when a company's future earnings are discounted to present value, the discount rate used has a significant impact on the value of that future earnings stream. A higher discount rate results in a lower net present value of future earnings and vice versa. The chart below shows the experience since January 2020. The upper panel shows the ratio between the S&P 500 Growth Index (SGX), which represents the 231 companies that are designated by S&P to belong in the growth category (current Price/Earnings ratio: 33.5) versus the broad S&P 500 Index (SPX), which has a current P/E of 24. A higher ratio means Growth is outperforming the broad index and vice versa. The lower panel shows the yield on 10-year Treasury Inflation Protected Securities (TIPS). We have chosen real TIPS yields rather than nominal Treasury yields to illustrate that the rate rise since 2022 wasn't just a result of higher inflation expectations but that the important real rate, which affects both nominal and real asset valuations, was also rising.

As we can see, the pandemic, starting in early 2020, first resulted in falling real interest rates. The real yield on 10-year TIPS fell from about 0% to -1% by the middle of the year. This coincided with a strong rally in the stock market, led by Growth. The relative performance of Growth made a new high for the period we are looking at towards the end of 2021, shortly before the Federal Reserve (FED) stated to raise interest rates to combat a surge in inflation. In 2022, the markets acted according to the textbook: higher rates caused Growth to underperform. By the end of 2022, Growth had given back all its relative outperformance versus the broad market. However, in 2023 and thus far in 2024, the market has abandoned the historical relationship between interest rates and market leadership. Since the end of 2022, SGX has outperformed SPX by over 12%. A potential answer to this conundrum is that factors other than interest rate drives market leadership, and that could well be true. Maybe the leading Tech and Media companies in the US will continue to have higher earnings growth than other companies and therefore still represent better investments notwithstanding their already-strong performance and high valuations. On the other hand, maybe momentum has driven this theme too far.

An alternative viewpoint is that one of the defining features of the post-2008 landscape has been extraordinarily low interest rates. Now that rates have normalized to roughly where they were in previous decades, before the Global Financial Crisis (GFC) of 2008, is it possible that the sectors that did extraordinarily well under the low rate regime could cede leadership to sectors that underperformed when rates were low?

If that is true, and we believe it probably is, then sectors such as Health Care, Financials and Utilities could outperform more expensive growth-focused sectors.

Ratio between S&P 500 Growth Index (SGX) vs. S&P 500 Index (SPX)
Yield on 10-year TIPS



Source: Bloomberg

As for the overall valuation of the S&P 500 versus real rates, the chart below shows the history of the spread between the CAPE (Cyclically Adjusted Price/Earnings ratio, also known as the Shiller P/E) yield of the S&P 500 and the real yield on 10-year TIPS (Treasury Inflation Protected Securities). The spread (currently

U.S. Equities (cont'd)

Jan Erik Warneryd, Chief Investment Officer

about 0.9%) can be seen as the incremental real yield over Treasuries an equity investor can expect over the next 10 years. The chart goes back to 1997, when TIPS were first issued. In the late 1990s, real yields were as high as 4%, but investors still preferred equities over treasuries, resulting in a negative equity risk premium. After the bursting of the "NASDAQ Bubble" in 2000, the spread turned positive and has stayed there ever since. The period after the GFC, in particular, offered very wide equity risk premia. Now, however, we are back to levels last seen in 2002.

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

Source: Bloomberg

The average yield advantage for equities over TIPS has been about 4% since 2008, so current levels represent a return to pre-GFC levels which could be a warning signal that the equity market is becoming stretched from a valuation perspective.

STRATEGY

The US economy appears to be slowing from the strong pace of 2023 which may lead the FED to ease later in 2024. Lower short rates could be a positive for equities, but the economic slowdown could impact corporate earnings negatively.

In addition, overall valuations in the US equity market are already stretched as a result of a rally led by large-cap tech stocks (The Magnificent 7). We believe better value can be found in the broader market and therefore prefer to have more exposure to the cheaper sectors in the S&P 500 such as Financials, Health Care, Utilities and the Telecom sub-sector. Overall, with a Price/Earnings ratio of about 21.5 times estimated 2024 earnings, the S&P 500 Index is expensive but not in a bubble.

We think the best-performing sectors of late may ultimately underperform the broader market. Contrary to the historical record, Growth has outperformed Value as a return factor for a long time. While the timing is difficult to master, we believe there will come a time of outperformance by sectors with low valuations and stable cash flows.

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