LOOK AHEAD

Slowing Down to Speed Up
Slower Growth, Lower Rates, and the Next Cycle

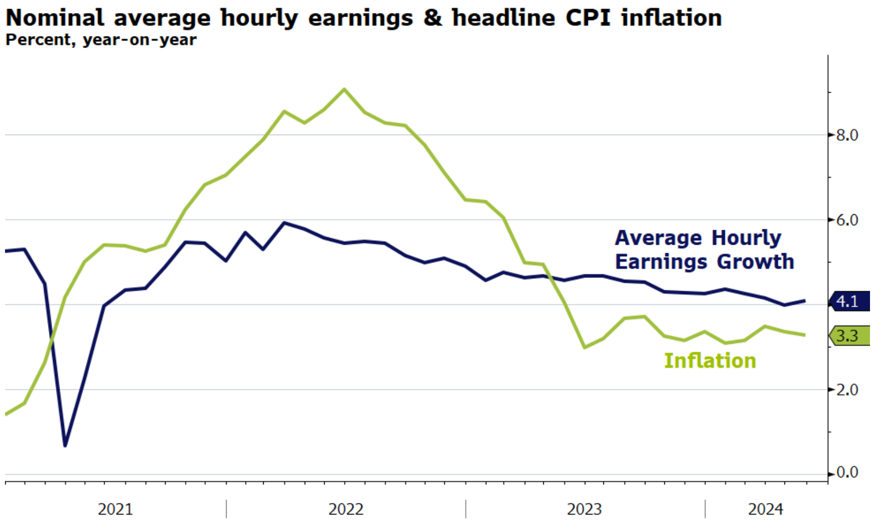
Q3 2024

DISCLAIMER

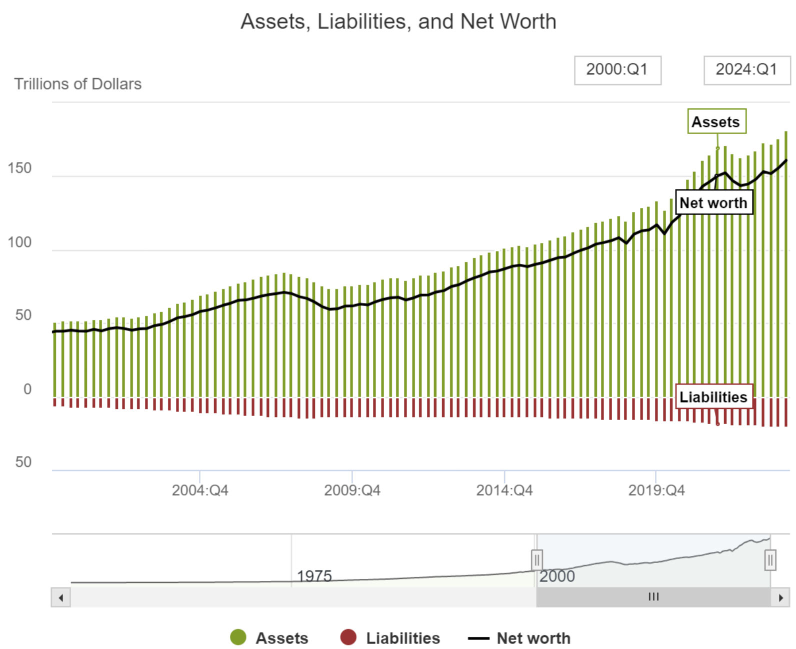
Certain information in this presentation constitutes forward-looking statements. Due to various risks, uncertainties, and assumptions made in our analysis, actual events or results or actual performance of the markets covered by this presentation may differ materially from those described. The information herein reflects our current views only, is subject to change, and is not intended to be promissory or relied upon by the reader. There can be no certainty that events will turn out as presented. Data are from sources deemed to be reliable. No representation or warranties either expressed or implied are made as to the accuracy of the information presented. Past performance is not a guarantee of future results.

Consumer Strength – Work, Wages, & Wealth

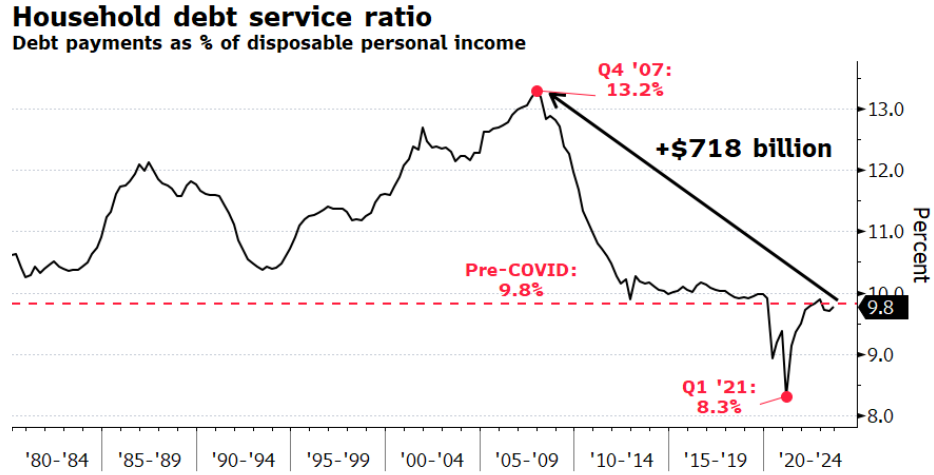
Wage growth continues to outstrip inflation, but is moderating, giving a win to U.S. consumer's purchasing power while also placating the Federal Reserve's ongoing fight against inflation.



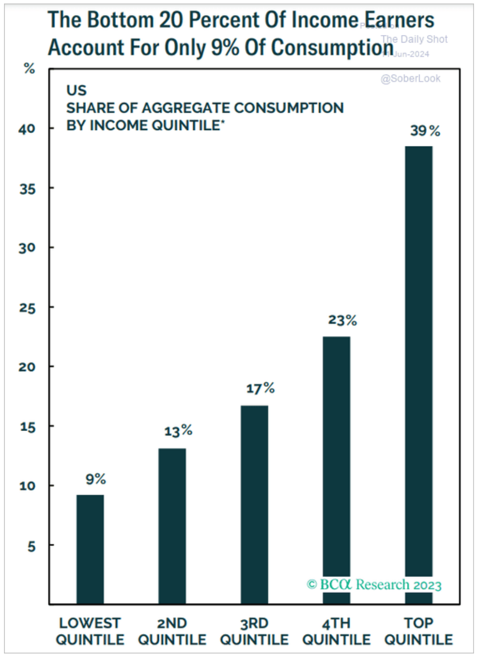
Household wealth in the U.S. has increased to record levels as U.S. consumers – primarily higher quintile earners – reaped the benefits of a surging stock market and higher home values.



Beyond work, wages, and wealth, the borrowing capacity of consumers has plenty of fire power (in case of emergency).



Additionally, and perhaps most important, is the bulk of U.S. consumption is composed of higher quintile earners. The U.S. economy might slow, but the top 60% of income earners represent 79% of consumption. We view this as a strong moat against higher rates and a slowing U.S. economy.



Data Sources: U.S. Bureau of Labor Statistics, Board of Governors of the Federal Reserve System, BCA Research

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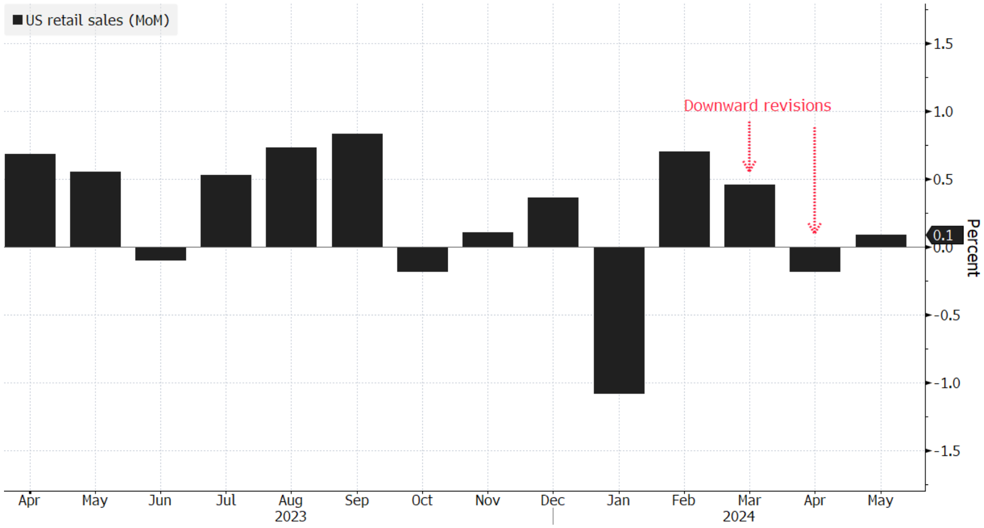
Economic Air Pockets

Initial applications for U.S. unemployment benefits continue to rise, with the four-week moving average reaching the highest level since September, pointing to a labor market that continues to cool.

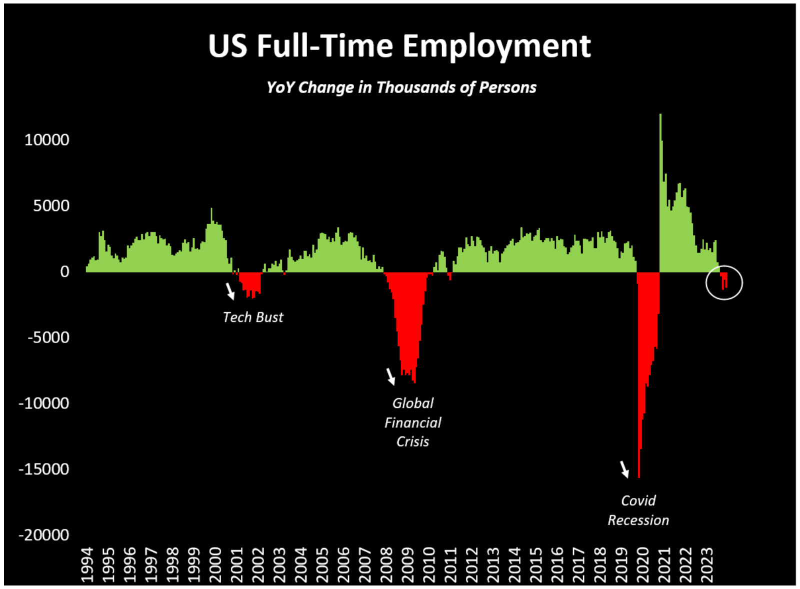
US Initial Jobless Claims Jump to 9-Month High
The 4-week moving average rose to the highest since September

U.S. retail sales barely rose in May and prior months were revised lower, underscoring a notable downshift in consumer spending.

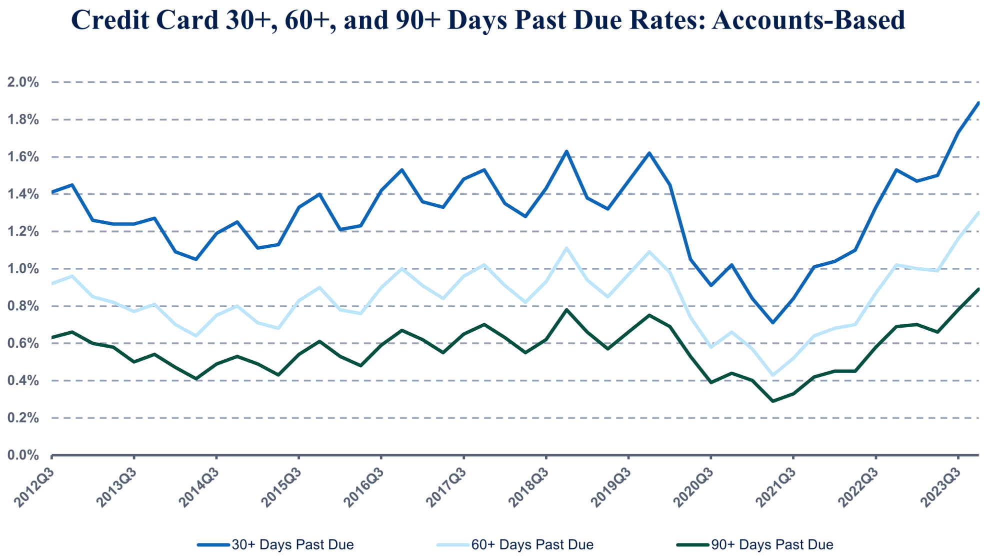
Retail Sales Continue to Dip



While headline employment might seem robust, most of the job gains are coming from part-time workers. That's a clear sign of distress in the labor market.



U.S. credit card delinquency rates were the highest on record in the first quarter, according to a Federal Reserve Bank of Philadelphia report, signaling added pressure on U.S. household finances driven by higher costs of living.



Data Sources: U.S. Employment & Training Administration, U.S. Bureau of Labor Statistics, U.S. Census Bureau, Federal Reserve Bank of Philadelphia

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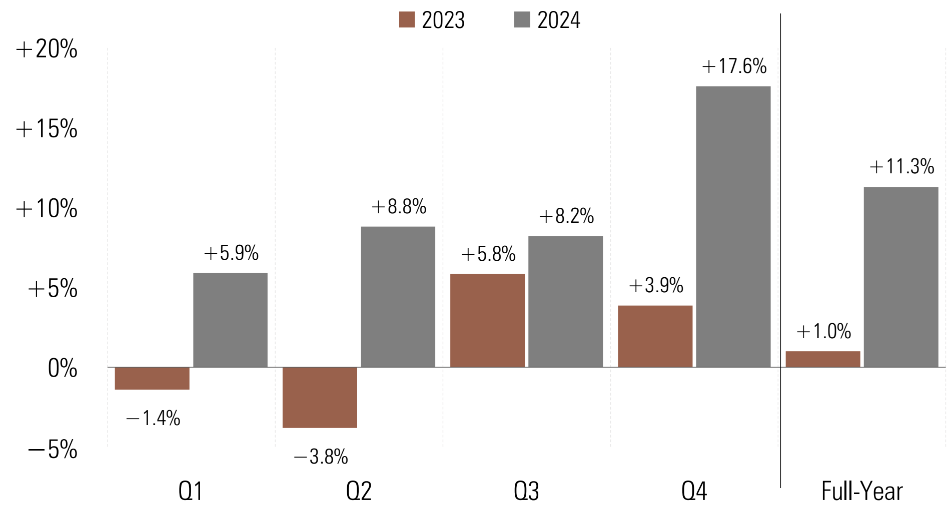
Earnings, Productivity, Margins, & the AI Boom

Corporate earnings results for the first and second quarters of 2024 signaled continued corporate strength. The trend is shaping up to continue in the second half of the year, with expectations for full-year 2024 earnings growth topping 11%.

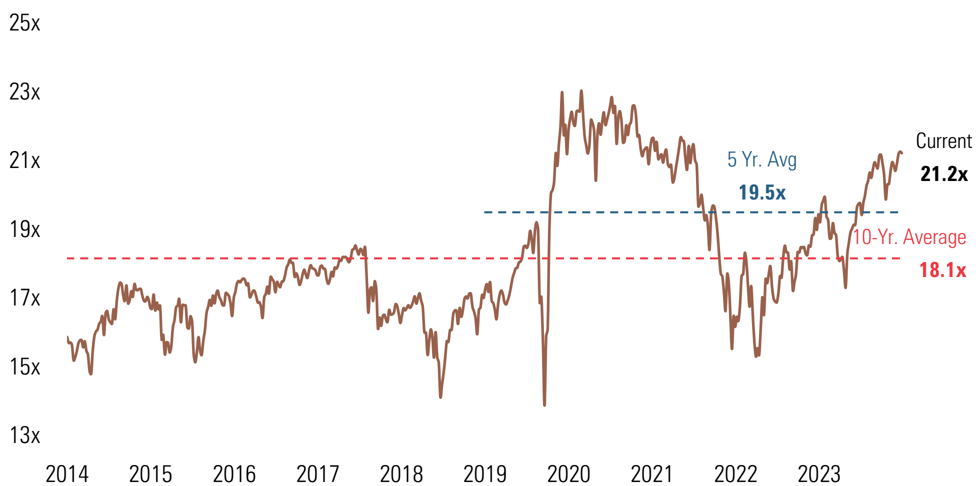
S&P 500 Earnings Growth: 2023—2024



Earnings growth is fueling P/E expansion as more investors chase equities.

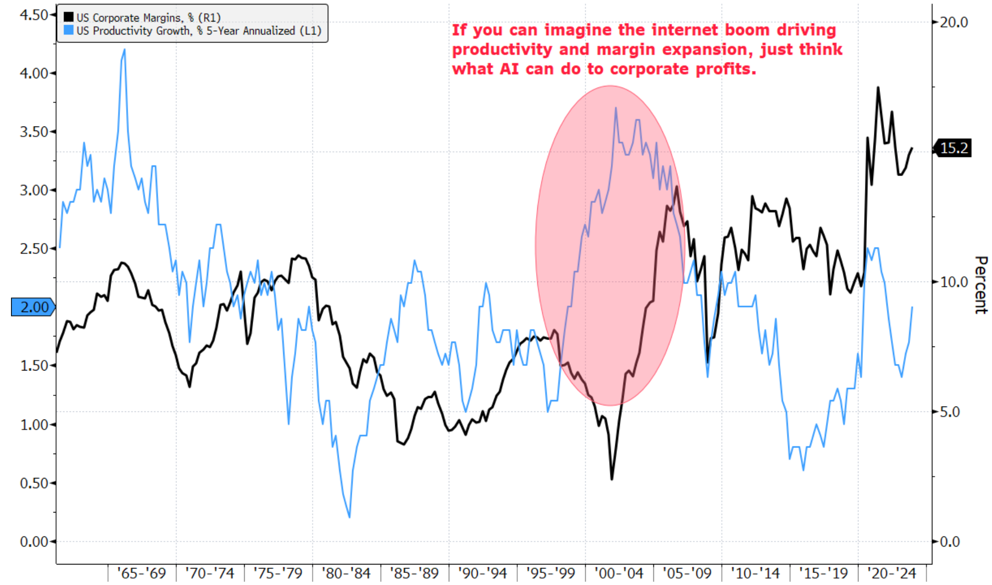
Looking forward, P/E multiples typically expand following the first Fed cut, but economic growth is a key determinant of the trajectory for equity prices.

S&P 500 Forward Price-to-Earnings



While margins lag productivity, they correlate.

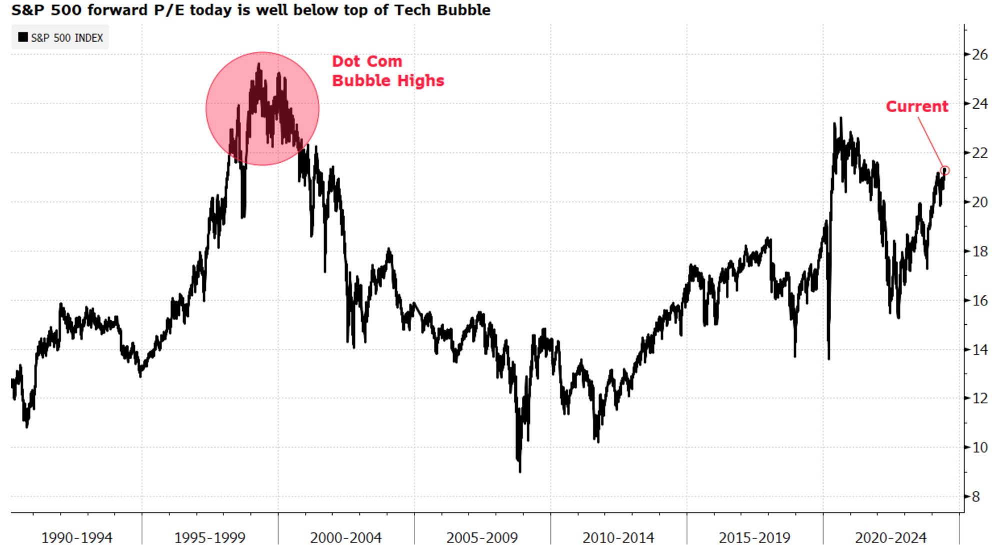
US Corporate Margins & Labor Productivity



The current rally in Tech stocks has shifted the optics on valuation. But a comparison between the dot-com bubble and current valuations shows that companies were far more overvalued in 2000 than they are in 2024.

Not Near Peak

S&P 500 forward P/E today is well below top of Tech Bubble



Data Sources: FactSet, Bloomberg, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics

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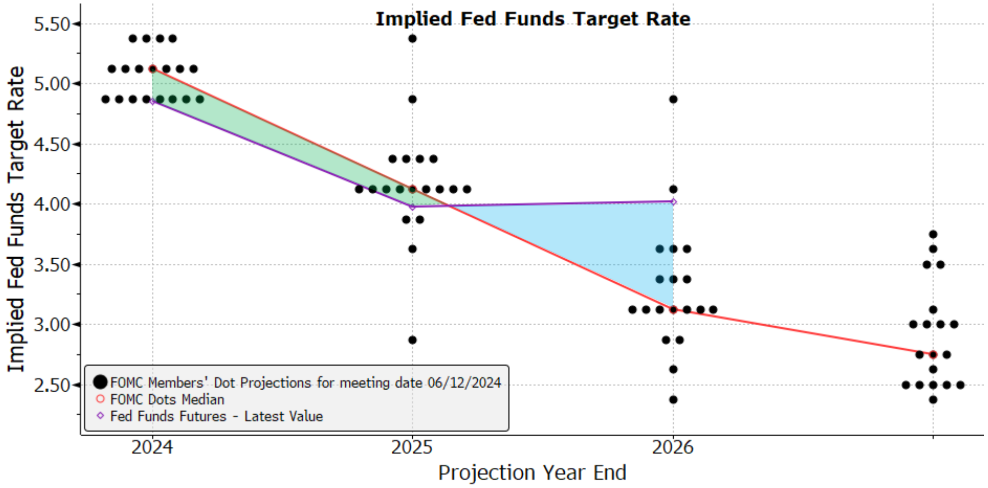
Supercore = Super Tight

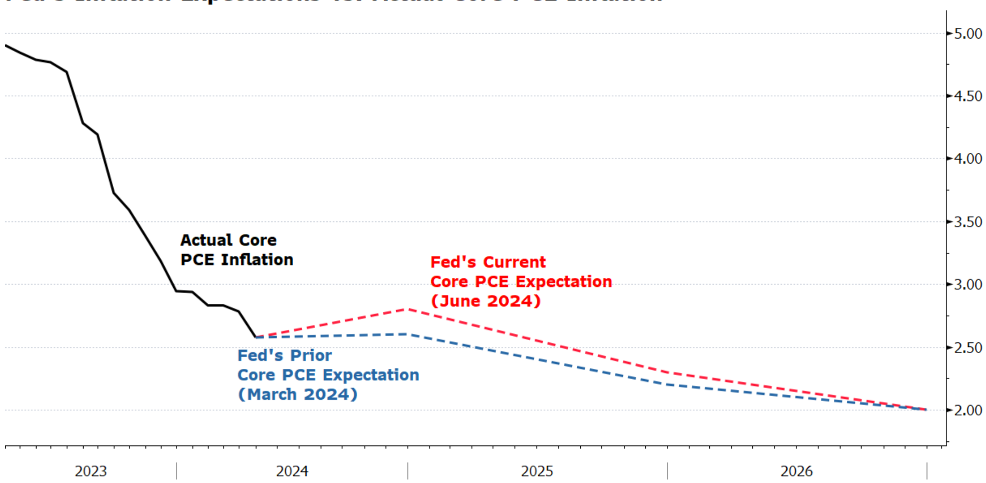
Coming into the year we knew of the large discrepancy between what the Fed was forecasting for rate cuts and what Wall Street believed was the making of market risk.

Today that picture looks entirely different. Wall Street is trending much closer to the Fed's forecast than their prior forecast (green shading), However, beyond 2025 futures suggest a higher-for-longer approach compared to the Fed. We concur that the Fed Funds rate will likely normalize around the 4% level.

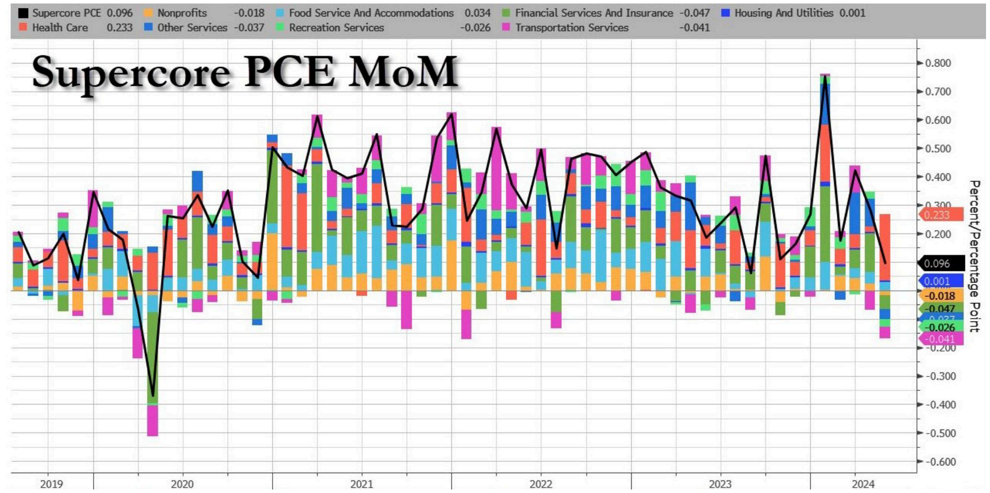


The Fed's preferred gauge of inflation, core PCE, has been trending down on a year-over-year basis while the Fed's 2024 core PCE inflation projection rose 0.2% to 2.8%. This higher inflation forecast lowers the bar slightly for incoming inflation data to meet the FOMC's expectations and keep rate cuts on track.

Fed's Inflation Expectations vs. Actual Core PCE Inflation

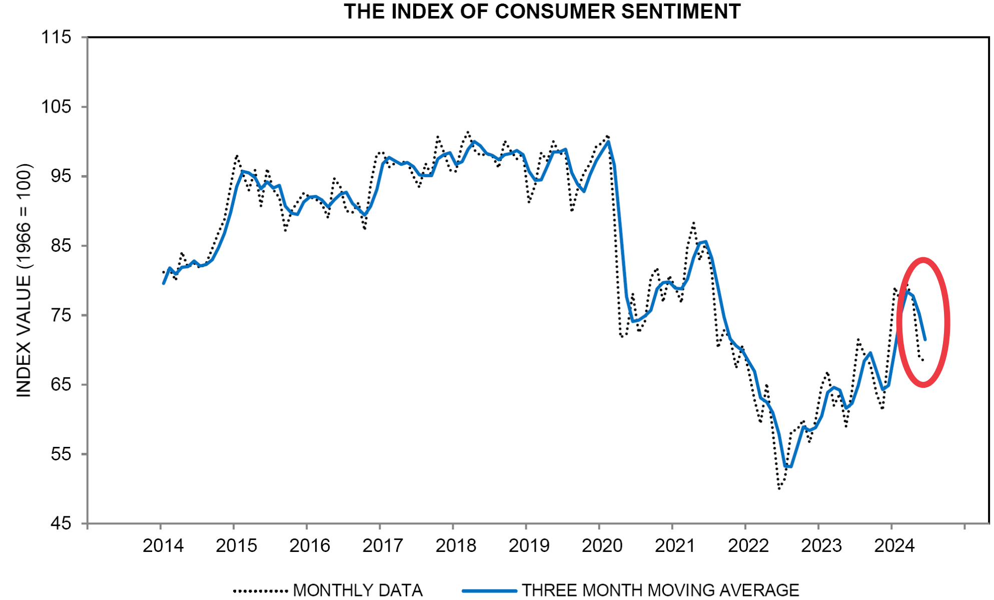


And when you take out the flawed housing measurements ("Supercore"), the economy is actually deflating. In May, prices for these core non-housing services rose just 0.1% on the month, the least since last August.



With inflation moderating and the Fed stuck on a higher for longer path, monetary policy is getting super tight. It will careen into a reluctant consumer unless the Fed cuts sooner.

THE INDEX OF CONSUMER SENTIMENT



The point being, the Fed should cut sooner not later with Supercore and median inflation below 2%.

Data Sources: Board of Governors of the Federal Reserve System, Bureau of Economic Analysis, University of Michigan

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Rate Cuts Into a Growing Economy

Is this time different?

The interest rate setting committee of the Federal Reserve expects:

- Real GDP growth to be in line with what they anticipated in March.
- Unemployment rate to be in line with what they anticipated in March.
- Core inflation to be higher than anticipated in March.

All the while they expect to lower the Fed Funds rate to 5.10%.

U.S. Federal Reserve 2024 Economic Projections

March 2024 vs. June 2024

Variable	March 2024		June 2024
Change in Real GDP	2.10%	→	2.10%
Unemployment rate	4.00%	→	4.00%
PCE inflation	2.40%	↑	2.60%
Core PCE inflation	2.60%	↑	2.80%
Federal funds rate	4.60%	↑	5.10%

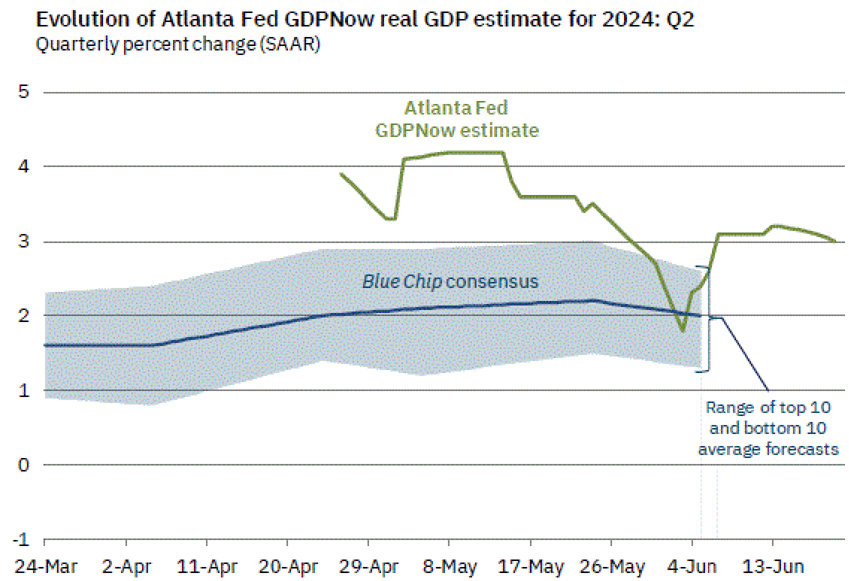
It appears the Fed is now actually verbalizing the fact that rates can be cut when unemployment is at record lows. From Fed Chairman Powell's Q&A session after the March FOMC meeting:

Q- New York Times: *"would continued strength in the labor market be a reason to hold off on rate cuts…?"*

A- Jerome Powell: *"No, not all by itself no…You can have (rate cuts) if you have a continued supply side activity …"*

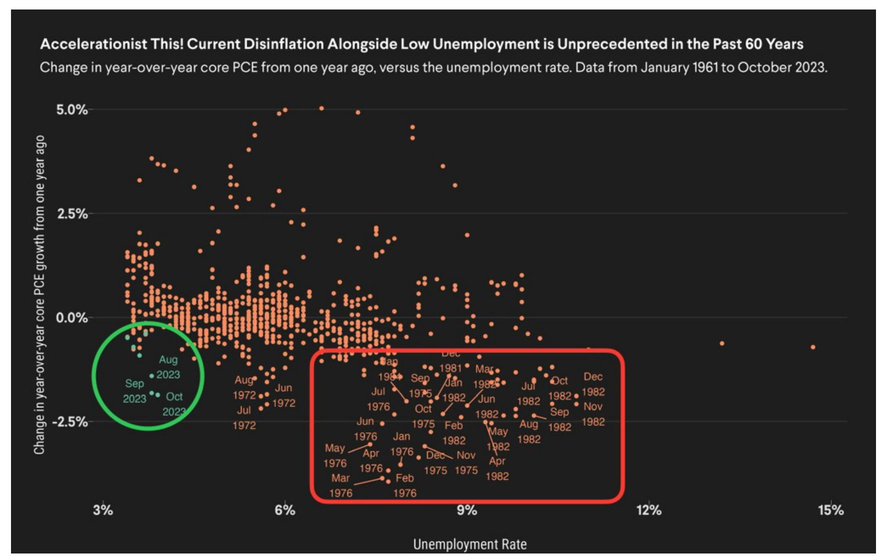
While I doubt this time will be different, the Fed Chairman might just be signaling he understands the flaws in his inflation data and the impact higher rates have on middle America.

According to the Atlanta Fed, Q2 GDP growth is expected to come in at 3.0%. That's not bad if you are considering growing supply in the economy.



History suggests rates get cut when there is a rapid rise in unemployment (red box below).

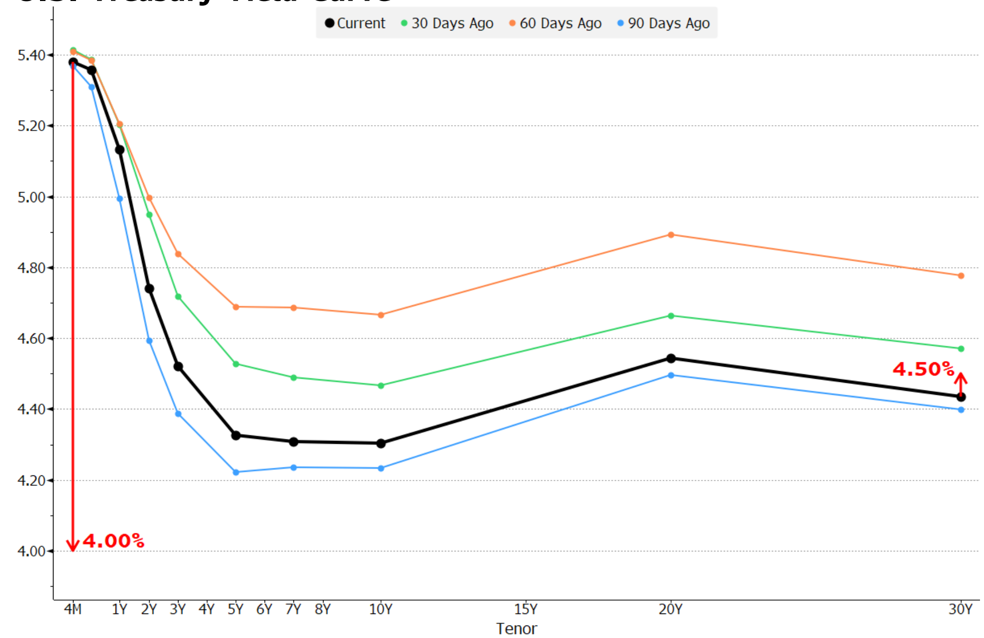
However, we are in a time when the Fed might be considering cutting rates when unemployment is at historic lows (green circle).



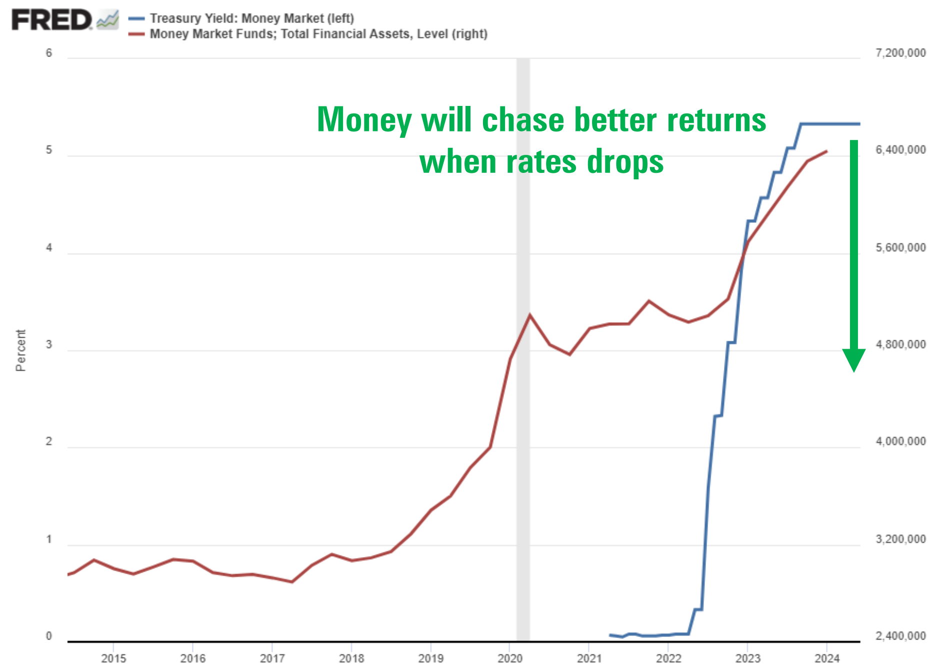
Fixed Income – A Return to Higher

Our expectation is for a flatter yield curve as the economy normalizes to lower rates, but certainly higher for longer.

U.S. Treasury Yield Curve



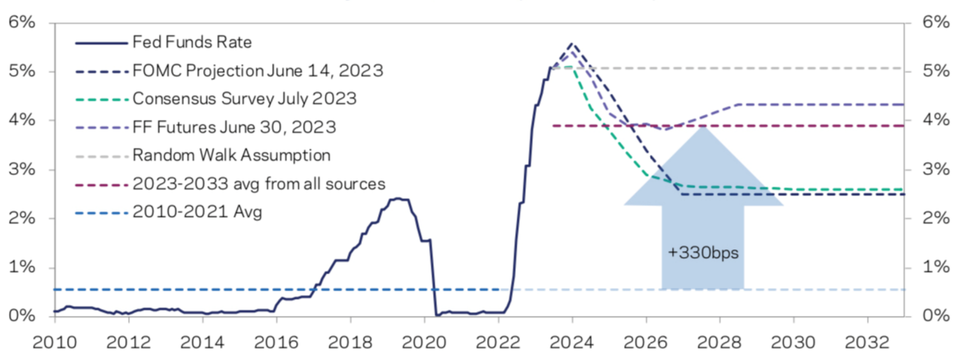
The money in money markets will flow towards equities and fixed income as the yield curve normalizes.



Fed Funds policy rates have spent a long period of time near the 4.5% range rather than the 0.5% range from 2010-2021.

Productivity is up for American workers, offsetting higher wage growth, which could mean we return to our past with a more normalized Fed Funds rate around 4% -- much higher than the fed's longer run forecast of 2.5%.

Fed Funds Rate and Various Projections, January 2010 – July 2023



Source: Federal Reserve, Consensus Economics, Bloomberg, AQR. Furthest available projections are extended to end of period where necessary.

Rate cuts can be great for bond returns, with the Bloomberg U.S. Aggregate Bond Index posting positive returns during each of the last nine major rate-cutting cycles.

With the Fed nearing the end of its current hiking cycle, investors may benefit from extending duration in their bond portfolios.

US Bond Market Performance During Major US Rate-Cutting Cycles (Since 1980)

Fed Rate-Cutting Cycle	# Months	Starting Fed Funds Rate	Ending Fed Funds Rate	Change in Fed Funds Rate	Bloomberg US Agg Total Return	Bloomberg US Agg Ann. Return
Apr 1980 - June 1980	3	20.00%	9.00%	-11.00%	18.80%	99.10%
Jun 1981 - Dec 1981	7	20.00%	12.00%	-8.00%	5.80%	10.20%
Apr 1982 - Dec 1982	9	15.00%	8.50%	-6.50%	27.60%	38.50%
Aug 1984 - May 1985	10	11.56%	7.75%	-3.81%	23.00%	28.30%
Dec 1985 - Aug 1986	9	8.00%	5.88%	-2.13%	16.20%	22.20%
Jun 1989 - Sep 1992	40	9.56%	3.00%	-6.56%	46.30%	12.10%
Jan 2001 - Jun 2003	30	6.50%	1.00%	-5.50%	24.30%	9.10%
Sep 2007 - Dec 2008	16	5.25%	0.13%	-5.13%	9.20%	6.80%
Aug 2019 - Mar 2020	8	2.38%	0.13%	-2.25%	5.40%	8.30%
Average	**15**	**10.92%**	**5.27%**	**-5.65%**	**19.62%**	**26.07%**

Data Sources: Bloomberg, AQR, Federal Reserve Bank of Atlanta

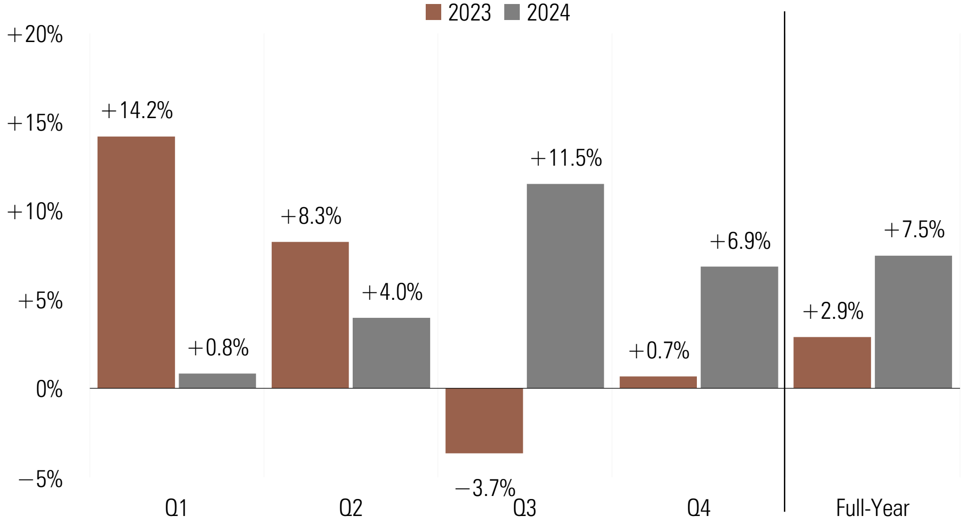
Developed Markets

Over the past 12 months, Developed Markets equities have risen 15%, with most of the rally driven by P/E expansion rather than earnings. If economic growth modestly accelerates and central banks embark on a rate cutting cycle, valuations could rise further.

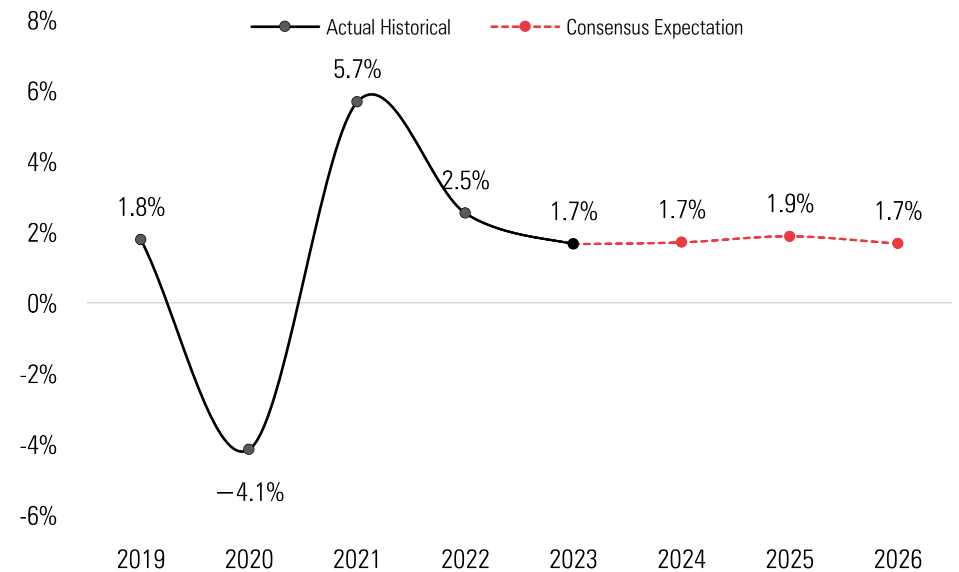
Developed Markets valuation discount to the United States remains wide at 32%, reflecting weaker relative economic growth and a higher risk premium for Developed Markets equities.

While growth expectations remains weak, increasing manufacturing activity and clearer signs that the credit drag is starting to diminish could improve the outlook for Developed Markets GDP growth in 2024.

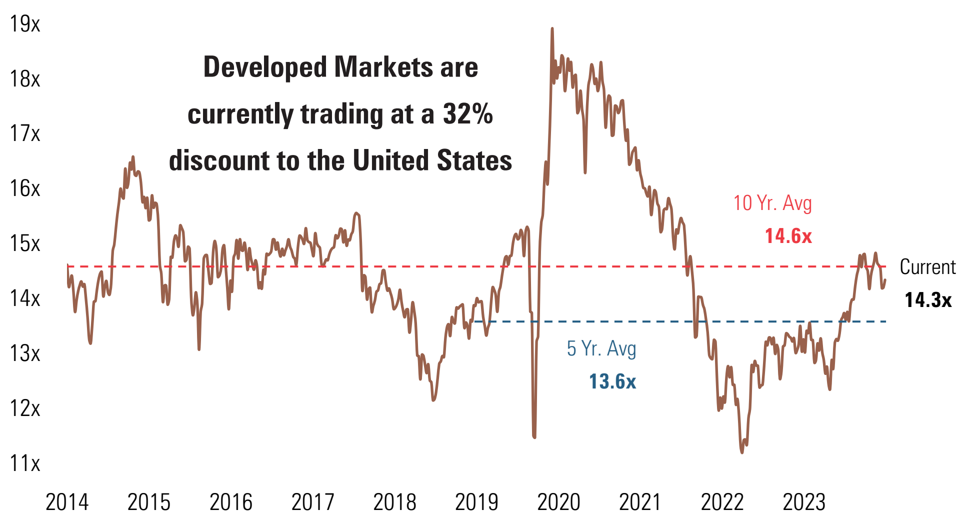
MSCI EAFE Earnings Growth 2023–2024



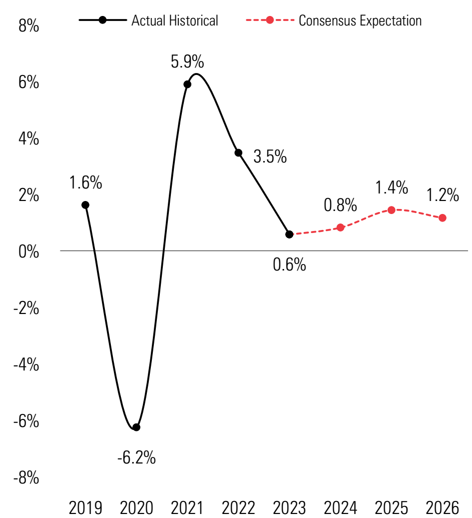
Developed Markets GDP Growth



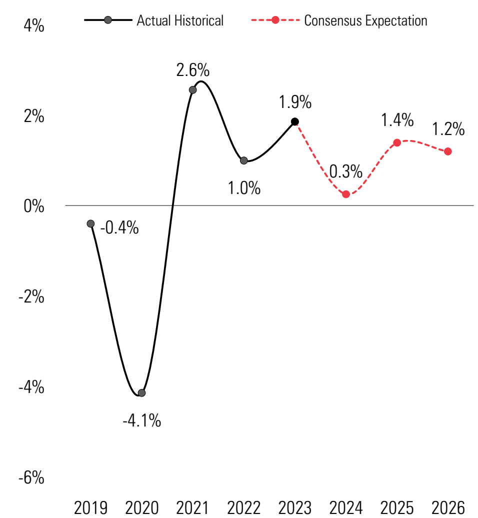
MSCI EAFE Forward Price-to-Earnings



Euro Area GDP Growth



Japan GDP Growth



Data Sources: Bloomberg

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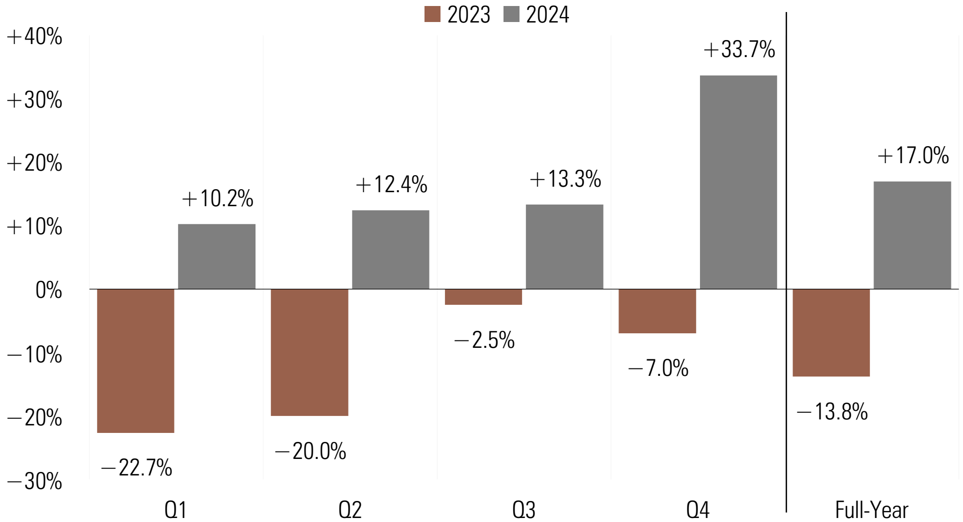
Emerging Markets

Earnings growth expectations are for a very strong year in Emerging Markets. While the easy comps to 2023 are a factor, a weak foreign currency should help export growth in Emerging Markets.

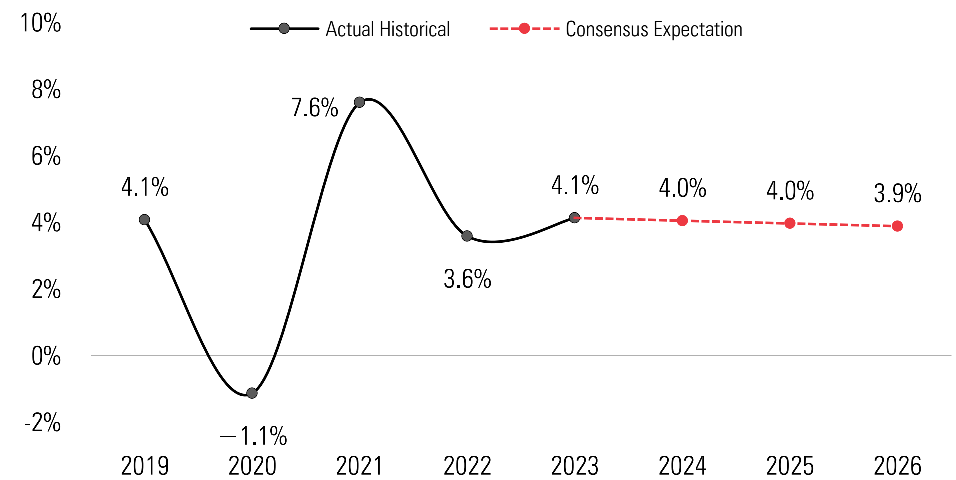
Emerging Markets valuations were largely flat during 2023, while the valuation discount to the United States remains wide at 42%.

Emerging Markets economies grew by 4.2% in 2023, significantly faster than DM growth. This strength appears to have carried over into 2024, reflecting strong momentum, the fading headwinds from tight financial conditions, and declining inflation.

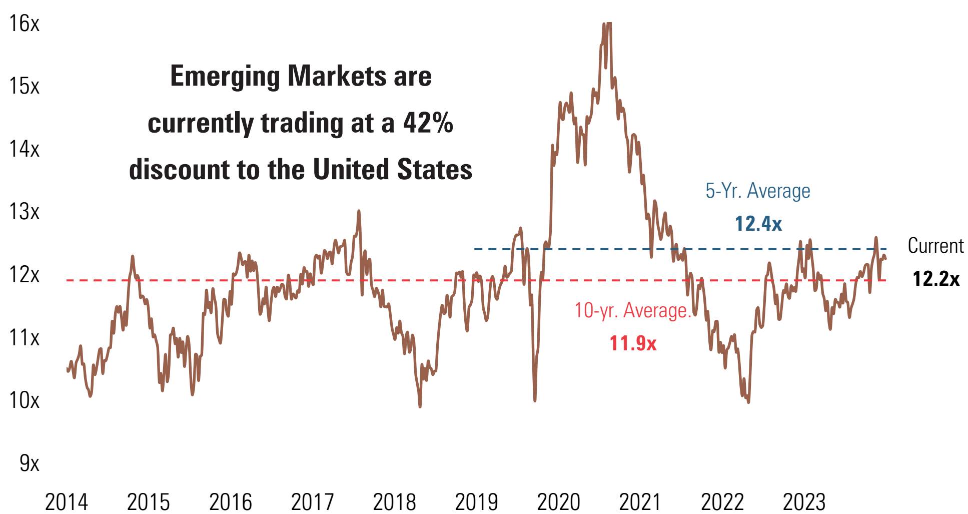
MSCI Emerging Markets Earnings Growth 2023–2024



Emerging Markets GDP Growth

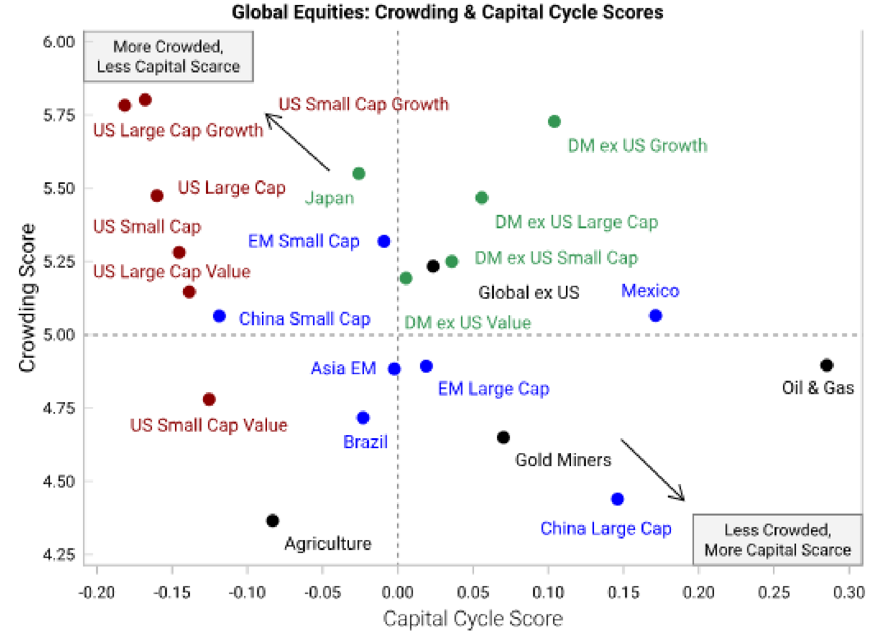


MSCI Emerging Markets Forward Price-to-Earnings



China Large Cap is the least crowded trade, offering some of the best risk adjusted return opportunities.

Global Equities: Crowding & Capital Cycle Scores



Data Sources: Bloomberg, Variant Perception

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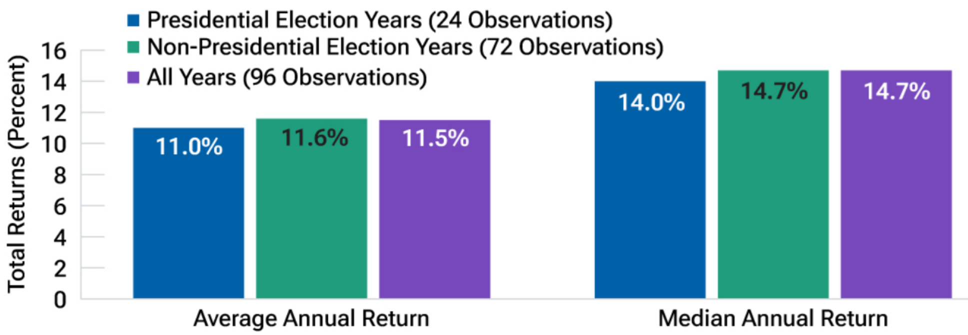
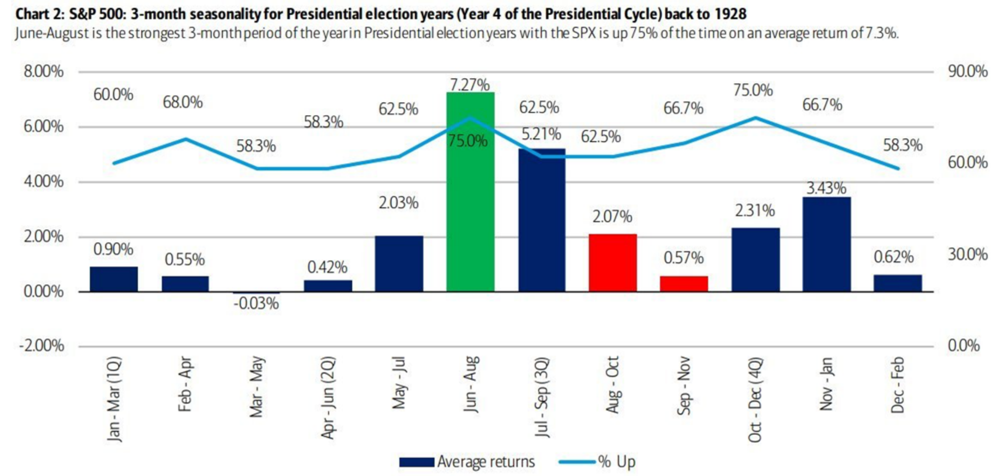
Elections – Policies, Personalities, Perceptions, & Earnings

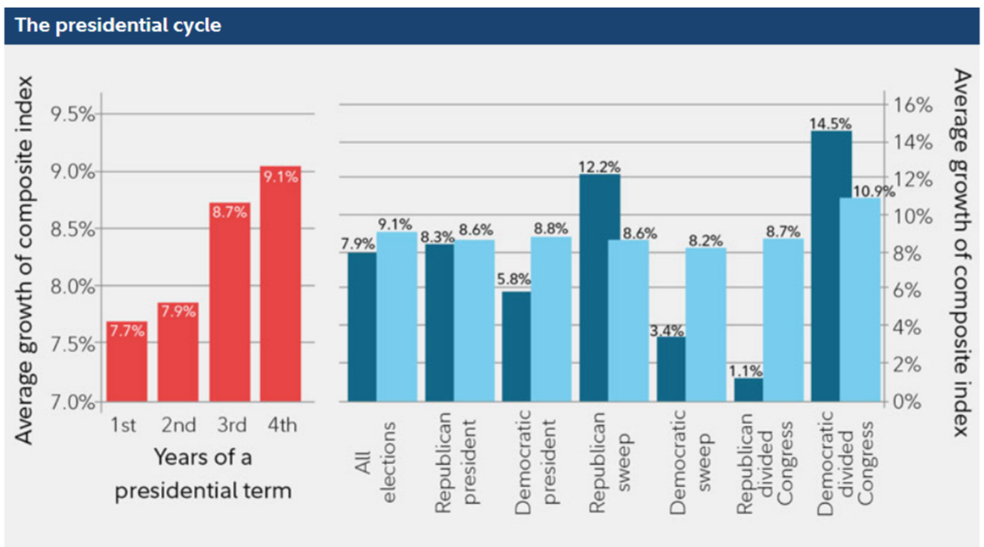
However anxious Americans are, the investment thesis still suggests strong market returns during Presidential election years. While the risk (volatility)/reward is not as beneficial, the historic returns are still solid.



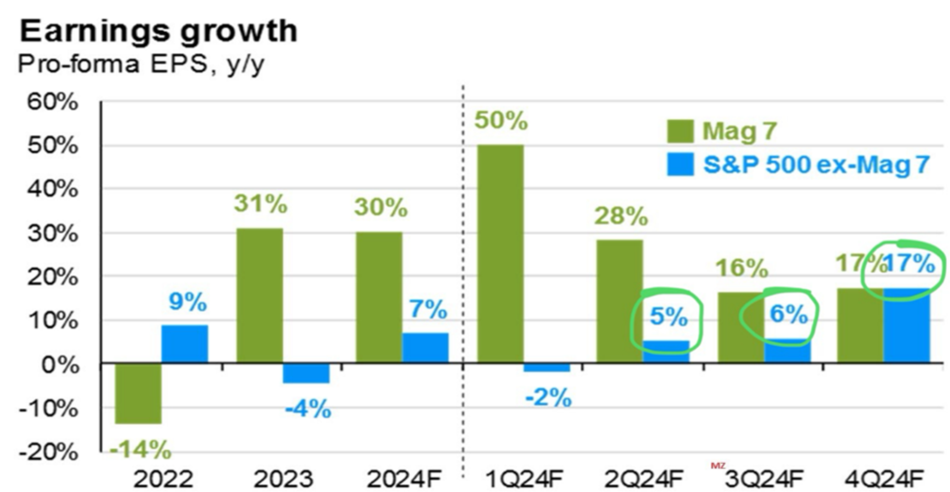
On a 3-month average, we are entering the best period of time for equities during a Presidential cycle.



Based upon a study completed by Fidelity, the first two years of a Presidential cycle have modest returns while the last two years show much better returns. Division in congress is also very supportive of equity investing – especially in the last two years (light blue in the chart below).



U.S. elections have consequences for taxes, spending, and geopolitics. So do earnings. The second half of 2024 looks to be very strong for corporate earnings growth rates (ex-Magnificent 7) and that's likely driving the current equity rally.



Mean Reversion Dashboard

Style Forward P/E as a % of 20-Year Average

Size	Value	Blend	Growth
Large	111.4%	129.5%	146.8%
Mid	100.7%	103.2%	123.5%
Small	107.2%	105.6%	96.7%

Regions & Countries Forward P/E as a % of 20-Year Average

Regions

World	Developed Markets	Emerging Markets	Frontier Markets
121.7%	104.6%	105.6%	86.4%

Countries

United States	Germany	United Kingdom	China	Brazil	India
133.0%	98.6%	96.2%	83.4%	66.4%	140.9%

Sector Forward P/E as a % of 20-Year Average

Sectors

Energy	Materials	Industrials	Consumer Discretionary	Consumer Staples	Health Care	Financials	Technology	Telecom	Utilities	Real Estate
44.1%	124.2%	124.0%	117.6%	113.5%	126.4%	119.8%	169.0%	125.8%	104.2%	84.3%

Data Source: Bloomberg

Our Views & Recommendations

Our View

- The Fed will tolerate small policy errors but will be forced to cut rates by end of Q3.
- The U.S. consumer at the lower-end will show more strain but the bulk of the consumer economy will remain intact, with higher income earners driving the results.
- Developed and Emerging Markets will continue to benefit from a modestly weaker U.S. economy and rate cuts in Q3.

Recommendations

- Reaffirm your investment strategy and maintain strategic liquidity to cover spending needs and provide opportunities for cost averaging. Utilize higher yielding money markets while short-term rates are high.
- Rebalance from Large Cap Growth to Core and continue to overweight U.S. Small Cap.
- Maintain an overweight to Emerging Markets to take advantage of reasonable earnings growth to valuation prospects.
- Look to add exposure to intermediate Municipal bonds to take advantage of attractive tax-equivalent yields.
- Move duration to benchmark.

What's On Our Mind?

ARE WE IN THE MIDST OF A SECULAR REGIME CHANGE FROM:	POSSIBLE ALLOCATION RESPONSES
Moderating Inflation → Possible Disinflation Cut in Rates	Benchmark duration and opportunistic longer duration fixed income
Globalization & Importing Deflation → Deglobalization & Higher Costs Carbon Driven Energy → Carbonless Economies	Commodity exposure – Infrastructure
Correlated Stock & Bond Movements → More Decoupling of Stock & Bond Movements	Non-correlated equity alternatives – illiquid, event-driven, hedge, Emerging Markets
AI as the driver of secular productivity improvements → Up and downstream including MLPs and Utilities will benefit beyond just Tech stocks	Energy, Utilities, Technology

THANK YOU

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