Quarterly Review and Strategy Update

March 31, 2024

Source: Dinesh Yalavarthy, Fortune

- **Strong economic growth and persistent inflation puts the Federal Reserve's interest rate cut plan in doubt**
- **Equity markets continue to generate impressive returns in the first quarter, increasing concerns about heated valuations**
- **Does the dislocation in venture capital provide opportunities for long term investors?**

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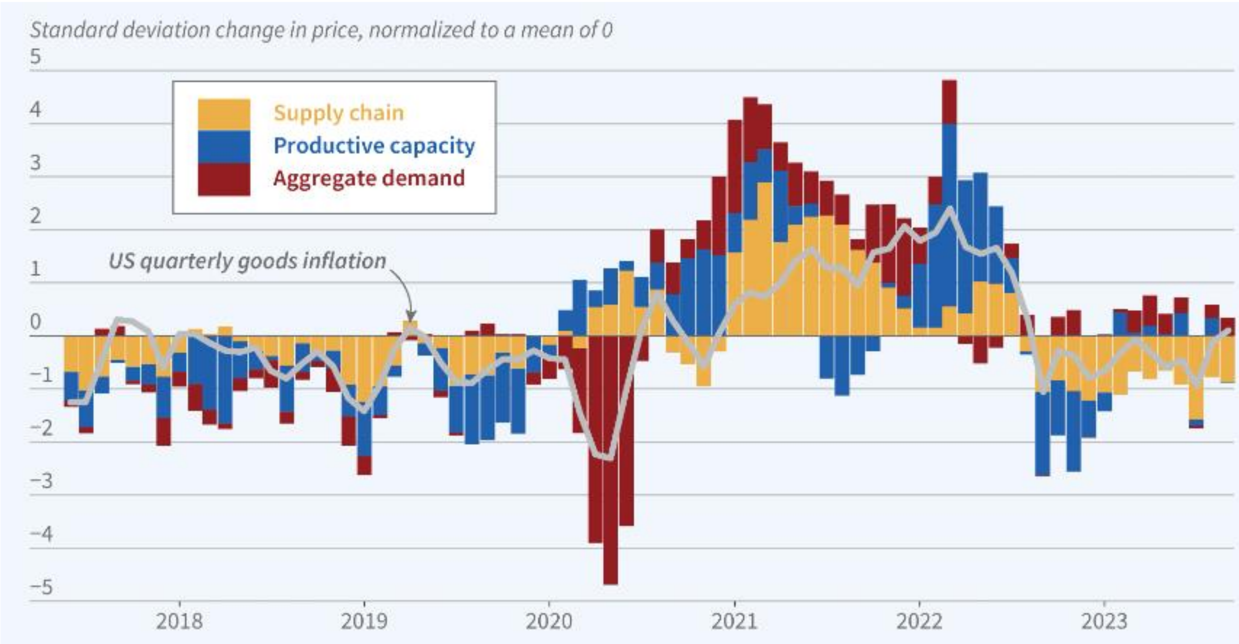
THE ECONOMIC ENVIRONMENT

Decomposition of U.S. Inflation, 2017 to 2023



Source: National Bureau of Economic Reserch

A strong economy, solid corporate earnings growth and continuing excitement over artificial intelligence propelled the equity markets to all-time highs in the first quarter of the year. U.S. GDP grew by 3.4% in the final quarter of 2023 and by 2.5% over the full year, defying the expectation of most economic forecasters who had predicted an almost certain recession. Almost all sectors of the economy – consumer spending; business investment; state, local and federal government spending, and exports – contributed to positive growth. Given high mortgage rates, construction and insurance costs, residential construction – particularly of single-family homes – was unsurprisingly one of the few sectors that slowed down during the year.

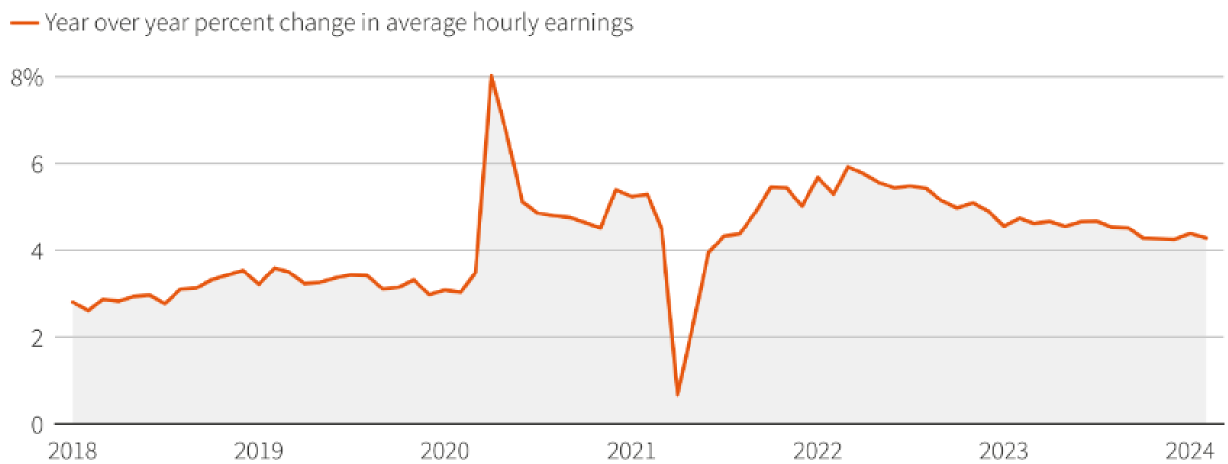
The optimism reflected in the stock market seems to be supported by consumer sentiment, which hit its highest level since 2021. The University of Michigan's consumer sentiment index was revised to 79.4 in March, up from an initial reading of 76.5, as Americans expect their personal finances to improve as inflation eases. Is this rate of economic growth and market bullishness sustainable? The consensus amongst economists is that it is not, but that while growth will slow, the likelihood of a recession is also fading. In Bank of America's monthly survey, two-thirds of global fund managers polled responded that a near-term recession is unlikely.

While the American consumer continues to spend – consumer spending in the U.S. rose by 0.8% month-over-month in February 2024, the biggest gain since January 2023 and significantly above expectations – the largest checks were written for necessities such as insurance, transportation, housing and utilities, as opposed to purely discretionary or luxury items. A lot of this spending is also being funded by debt, including from "buy now, pay later" platforms. Consumer credit card debt increased by 18% last winter, at a time when interest charges on credit card loans have been the highest in a decade. The personal savings rate continues to drop and now stands at 3.6% compared to the 7.7% level just before the arrival of the Covid pandemic in 2020. A McKinsey survey reported that 76% of consumers are "trading down" in search of cheaper alternatives.

So, the ability of consumers to sustain high growth might be fading. The employment picture, however, remains persistently strong. The U.S. added a total of 2.7 million jobs last year, and although the number of job openings has declined from the peak of 12 million vacancies in March 2022, it still stands at 9 million positions today – 1.4 available positions for every job seeker. 303,000 jobs were added in March, bringing the monthly average to 276,000 jobs so far this year, considerably above expectations. The unemployment rate dipped to 3.8% in March from 3.9% in February, but it has remained within a narrow range over the past 6 months as the labor force participation rate has fluctuated. One worrying trend has been the decline in the participation of "prime workers" – those aged 25 to 54 – who have left the workforce due to disability, opioid addiction, and dislocations as a result of the pandemic. In 1969, the labor force participation rate of men aged 25 to 54 was 96%. It is currently 89%.

Moreover, while wage growth has been running at 4%, above the rate of inflation, the trend is declining. From February 2023 to February 2024, real average hourly earnings, taking into purchasing power eroded by inflation, increased by only 1.1%.

Hourly Earnings:

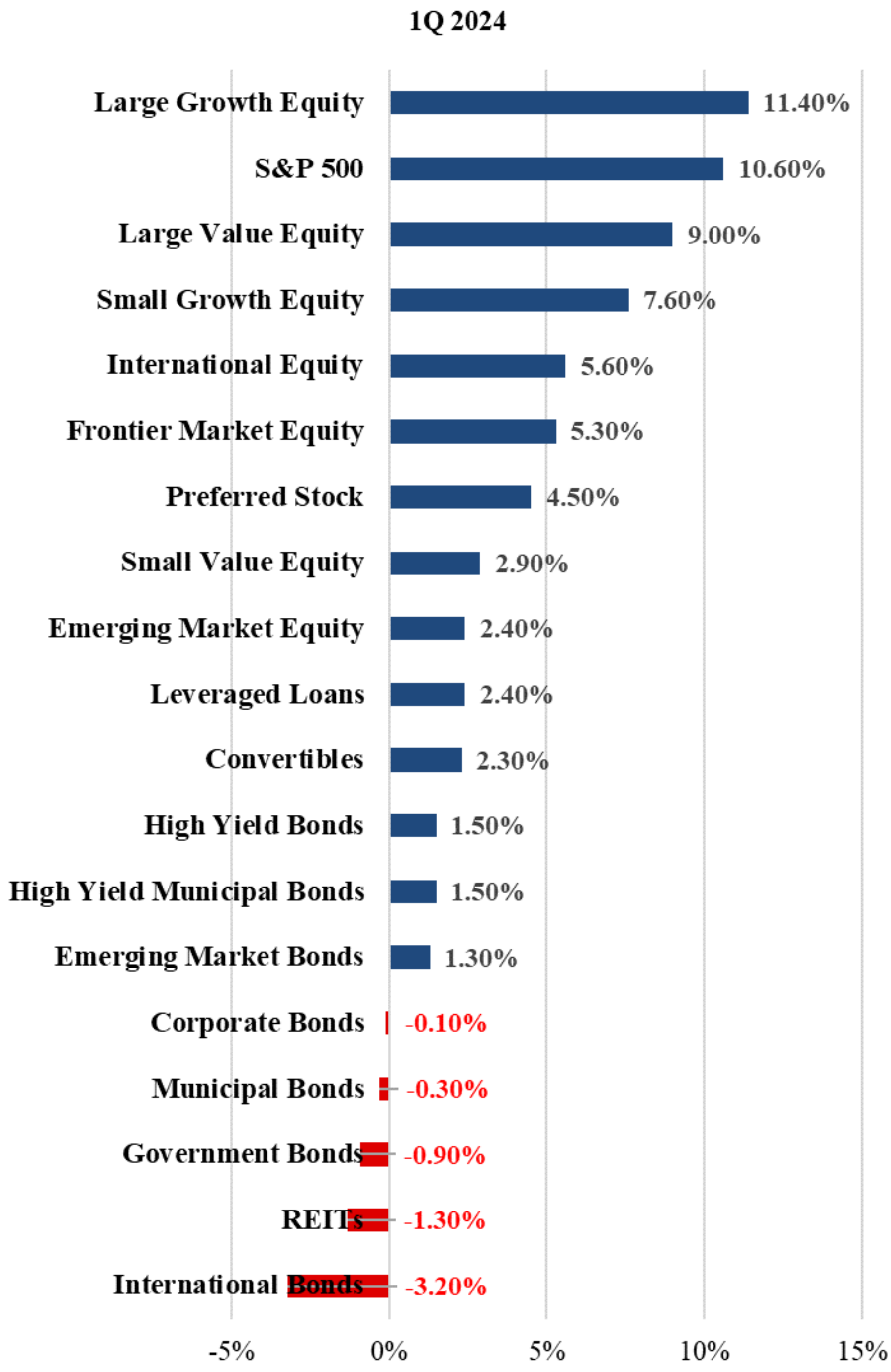


Source: Bureau of Labor Statistics, Reuters

Even as the evidence for a weaker economic outlook accumulates, The Federal Reserve may not cut interest rates as quickly or as deeply as the market seems to expect. While the central bank continued to guide the markets to 3 interest rate cuts this year, the inflation reports for February prompted many Fed governors to warn that cuts are not a done deal. "It's much too soon to think about cutting interest rates," Federal Reserve Bank of Dallas President Lorie Logan said after the report. The day before, Minneapolis President Neel Kashkari floated the possibility of no cuts at all this year. The February inflation data showed how difficult it might be to push inflation below 3%. The Consumer Price Index rose by 3.2% in February on a year-over-year basis, an uptick from the 3.1% pace in January, with core prices up by 3.8%. The index rose by 0.4% on a month-over-month basis, the second consecutive monthly increase this year. While food prices stabilized, energy, transportation and shelter costs rose. The Personal Consumer Expenditure Index, the Federal Reserve's preferred benchmark, also rose by 2.5% in the same month compared to 2.4% in January, with core PCE registering 2.8%.

One factor driving changes in inflation that may have been underestimated is the impact of supply chains on the economy. The chart at the top of this section illustrates an analysis published by a team of economists at the National Bureau of Economic Research that shows how central the disruptions in global supply chains following the Covid lockdowns, as well as its recovery, have been in both magnifying and then dampening inflation over the past 3 years. The ongoing tensions between the U.S. and China, the constrictions in both the Panama and Suez canals, and onshoring trends may all increase the direction and volatility of prices as much as consumer demand or worker productivity.

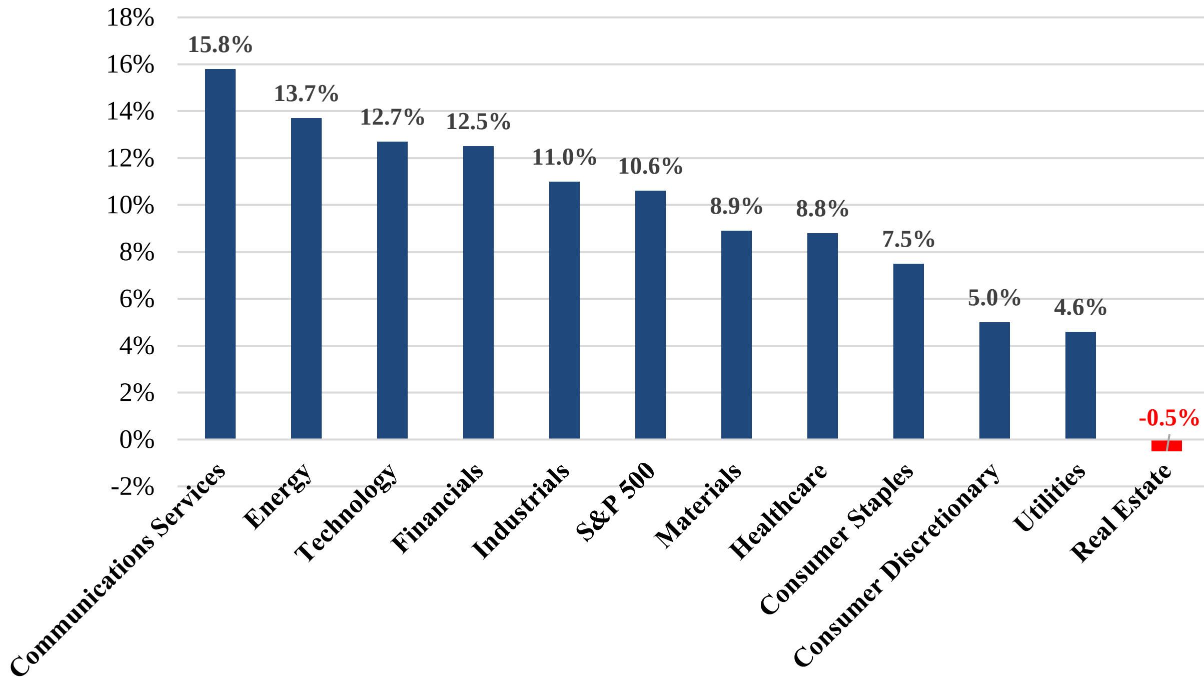
1st QUARTER PERFORMANCE OF MAJOR ASSET CLASSES



Source: Morningstar

EQUITIES

U.S. Equity Market Industrial Sector Performance, 1st Quarter 2024



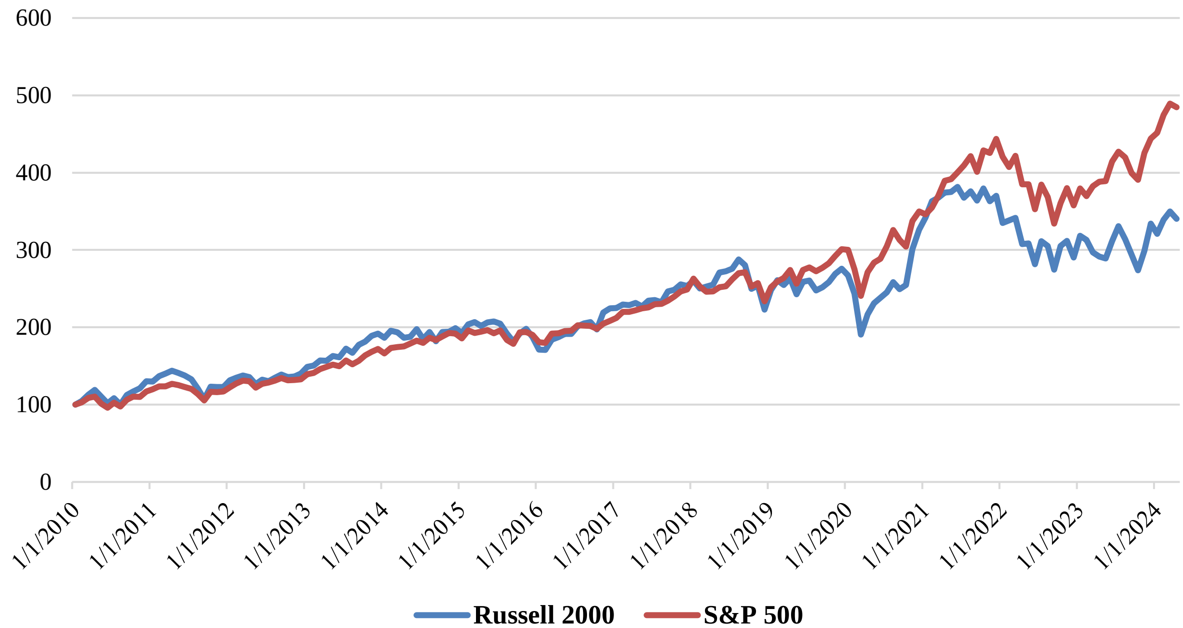
Source: Bloomberg, FactSet, MSCI, NAREIT, FTSE Russell, S&P, J.P. Morgan

Equity markets followed an impressive fourth quarter of 2023 with a very strong start to the year. The first quarter's performance came from all sectors of the market, with both growth and value styles up 11.4% and 9.0%, respectively. Several events in the quarter contributed to this positive performance. First, the continued trend from 2023 of strong economic data reinforced the prospect of a soft landing. Market expectations are still factoring in at least three rate cuts in 2024, despite recent inflation data. There were also no major geopolitical or financial disruptions to the global economy, such as Russia's invasion of Ukraine or the regional banking crisis we experienced in March of 2023. Finally, fourth quarter 2023 reported earnings were solid, with 73% of S&P 500 companies exceeding earnings estimates and overall year-over-year earnings growth increasing by 4%.

This quarter was also markedly different from 2023 because the gains were not led solely by the stocks dubbed the Magnificent Seven. Sure, Nvidia continued its astronomical rise, finishing the quarter up 82.5%, but the returns of Tesla (-28.6%), Apple (-11%), and Alphabet (7.9%) were all lower than the S&P 500's 10.6% return. Tesla in fact was the worst S&P performer overall, with a greater loss than even Boeing, despite its well-known struggles. According to Morningstar, the Magnificent Seven were responsible for around 67% of the S&P 500's gains last year, compared to only 37% for the first quarter of this year. The broader participation of other constituents of the index indicates a healthier equity market and economy.

Much has been made over the years about the merits of investing in large cap vs. small cap stocks. As you can see from the chart below, the Russell 2000 Index, the benchmark for smaller cap stocks, has noticeably underperformed the S&P 500. The Russell 2000 Index has risen 24% since January 2020, when compared to the S&P 500's more than 60% rise over the same time period.

Small Caps Have Lagged Large Caps

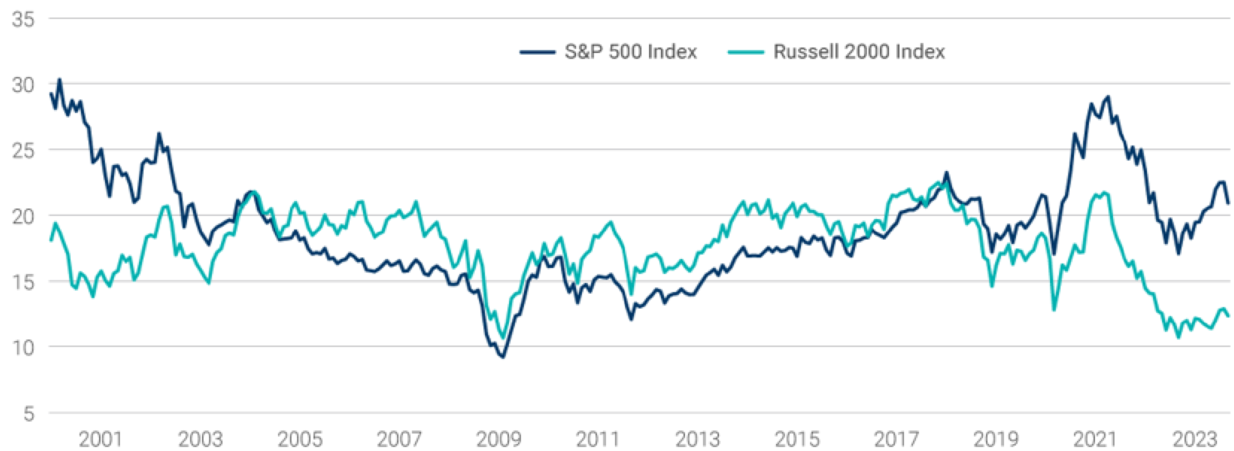


Source: Investing.com

There are a couple explanations for this gap. First, about 40% of companies in the Russell 2000 Index lost money over the last 12 months, compared with 9% for S&P companies. This makes sense, as the S&P constituents are larger, more stable corporations. Second, small cap stocks are more highly levered, making them more sensitive to increases in interest rates. In 2022, the Russell 2000 experienced a decline of 20.4%, compared to an 18.1% loss for the S&P 500. Furthermore, the subsequent recovery in 2023 in a higher rate environment also fell short of the S&P 500's return. Third, there has been a relative dearth of IPOs and mergers & acquisitions, of which small caps make up the majority of transactions.
So, why even consider small caps? When you take out the companies with negative earnings from the Russell 2000 Index and compare the rest with the S&P 500, you get a compelling difference in valuations of these indices.

As the chart below demonstrates, the valuation gap between positive earning Russell 2000 companies and the S&P is the largest it has been since 2001. Given the dispersion of returns in the index, active management can make a big difference in performance in this space. Despite the recent outperformance of large caps, small caps have historically produced higher returns. A smart investment manager may be able to materially outperform both the index and their small cap peers.

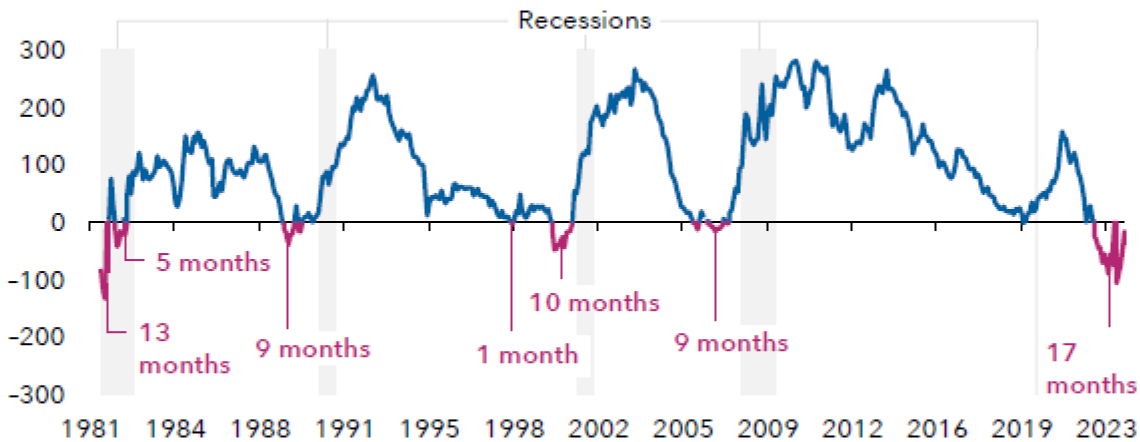
Relative Valuations of Small and Large Cap Stocks (P/E Ratios excluding Negative Earning Stocks)



Source: Lazard Asset Management

BONDS

Yield Curve Inversion – The Spread Between 2-Year and 10-Year Treasury Yields



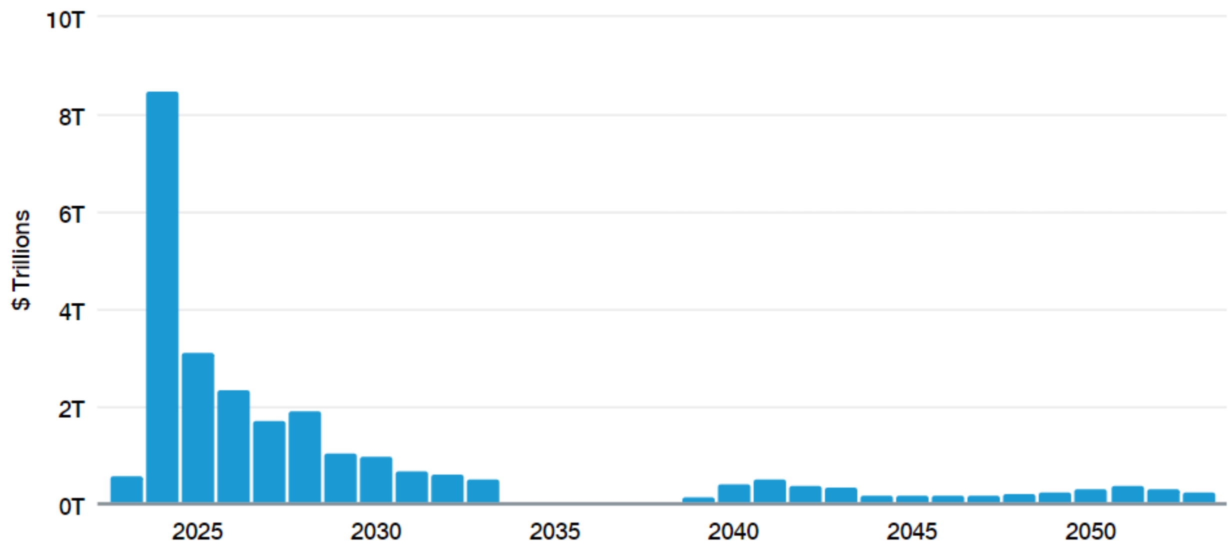
Source: The Capital Group

Reversing the gains generated in the final quarter of last year, bond prices declined in the first quarter. While short-term T-bill yields remained constant, Treasury Note yields rose by 30 basis points, with the 2-year Note yield increasing from 4.3% at the start of the year to 4.6% at the end of March and the 10-year Note yield increasing from 3.9% to 4.2%. Despite these changes, the U.S. Treasury yield curve still remains inverted. Indeed, March marked the longest continuous period of yield curve inversion ever, as the phenomenon that began on July 5, 2022, surpassed the 624-day cycle that began in August 1978. An inverted yield curve has historically been a reliable predictor of a recession, signaling the last 10 U.S. recessions, typically with a lag of 12 to 18 months. While a recession may be inevitable at some point, the extraordinary economic, fiscal and monetary developments of the post-pandemic era may have pushed it well into the future.

Although the markets still appear to be convinced that short-term interest rates have peaked and cuts are on their way, longer-term bond yields are shrieking with uncertainty. As the election approaches there will be more media attention on the federal deficit. The federal government missed a once-in-a generation opportunity to term out its debt when the Federal Reserve cuts rates to zero following the Covid pandemic. As the chart below shows, the largest chunk of federal debt is in T-bills maturing next year. With the inverted yield curve, the U.S. is paying a much higher cost than it would have if the Treasury had termed debt out into longer maturities. The federal government’s interest burden is now $1 trillion a year compared to less than $600 billion as recently as 2021. Even as the Federal Reserve cuts the Fed Funds rate, it is highly possible that longer-term yields will remain high as the Treasury’s refinancing program tests global investor demand.

Yet, even as Treasury yields have risen, investors have poured a record $185 billion globally into bond funds so far this year, according to financial data services firm EPFR. Although overall yields on credit assets rose alongside Treasuries – with investment grade, mortgage and below-investment grade bonds yields rising 20, 30 and 15 basis points, respectively – their credit spreads have tightened to their lowest level in two years. Credit spreads on average investment grade bonds are now at just 0.92 percentage points, according to ICE Bank of America, down from 1.04 percentage points in late December and are at the narrowest point since January 2022. Junk debt spreads are now at 26-month lows and just a whisker above levels last seen before the global financial crisis in 2007. Mirroring the equity markets, these tight spreads are indicating that investors have a high degree of confidence that American companies will continue to thrive.

U.S. Federal Debt Maturity Profile

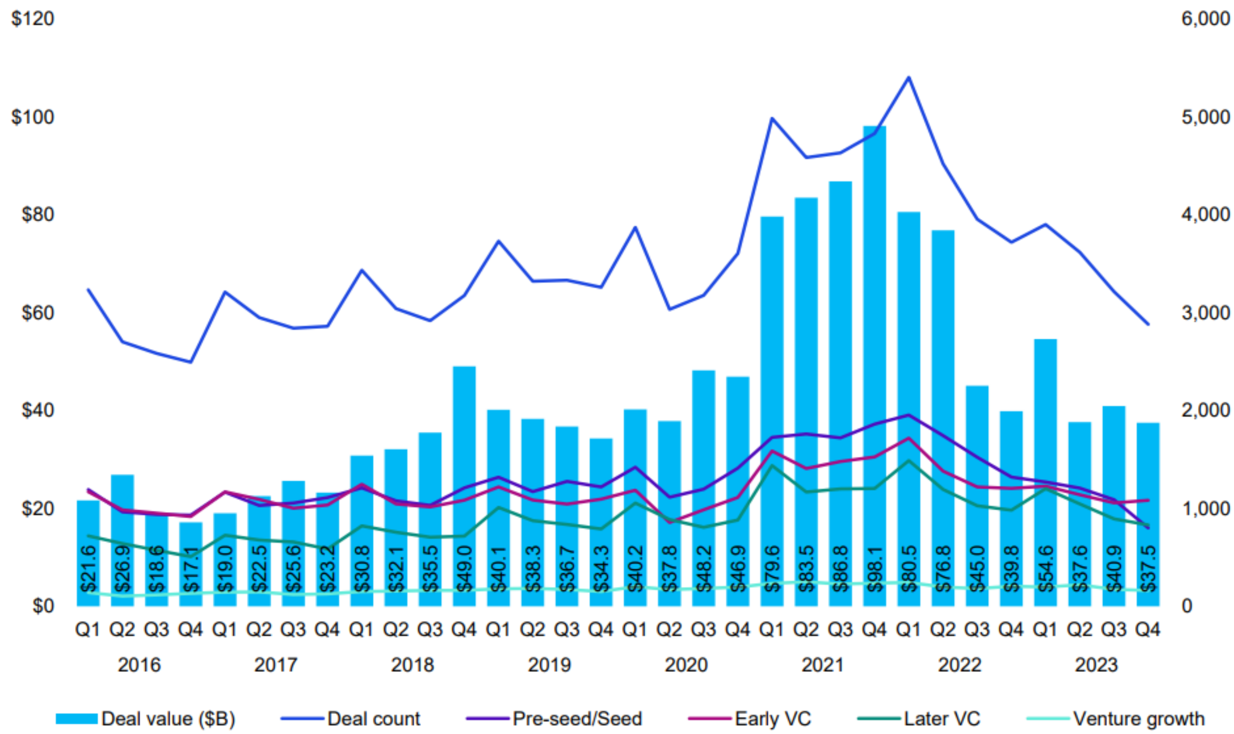


Source: Thornburg

It is true that in contrast to the federal government, many American companies may not be facing near-term refinancing pressures. Investment-grade issuers extended their debt maturity profile to an average of 11 years compared to 6 years for the Treasury. Although the absolute dollar amount of corporate debt has increased, the corporate debt to GDP ratio has actually declined from 84% to 78% today, compared to an increase in federal debt to GDP ratio from 100% to 122%. Nevertheless, the lagged impact of higher rates may manifest in a greater number of defaults. According to S&P Global, 153 issuers defaulted last year, up from 85 in 2022, an increase of 80%. The rating agency expects default to rise, particularly amongst lower-rated companies with negative cash flows, high debt burdens and weak liquidity.

So, the historically tight spreads in the current market may be pricing in a credit picture that is too optimistic. “There is a risk that this dynamic is overheating,” said Christian Hantel, portfolio manager at Vontobel complained to the Financial Times. “It is so strong that some investors might just want to get to the market no matter what the price is.” In response to strong investor demand, corporate borrowers have rushed to issue debt this year. Investment-grade companies alone have issued a record $561 billion, the largest volume seen since at least 1990. High-yield issuance has also accelerated, rising 64% year-on-year to $62 billion, the highest total in three years. While the higher yield available in the bond markets merits a greater allocation in portfolios than in the past, investors need to be aware of an over-heating market.

Venture Financing in the U.S.

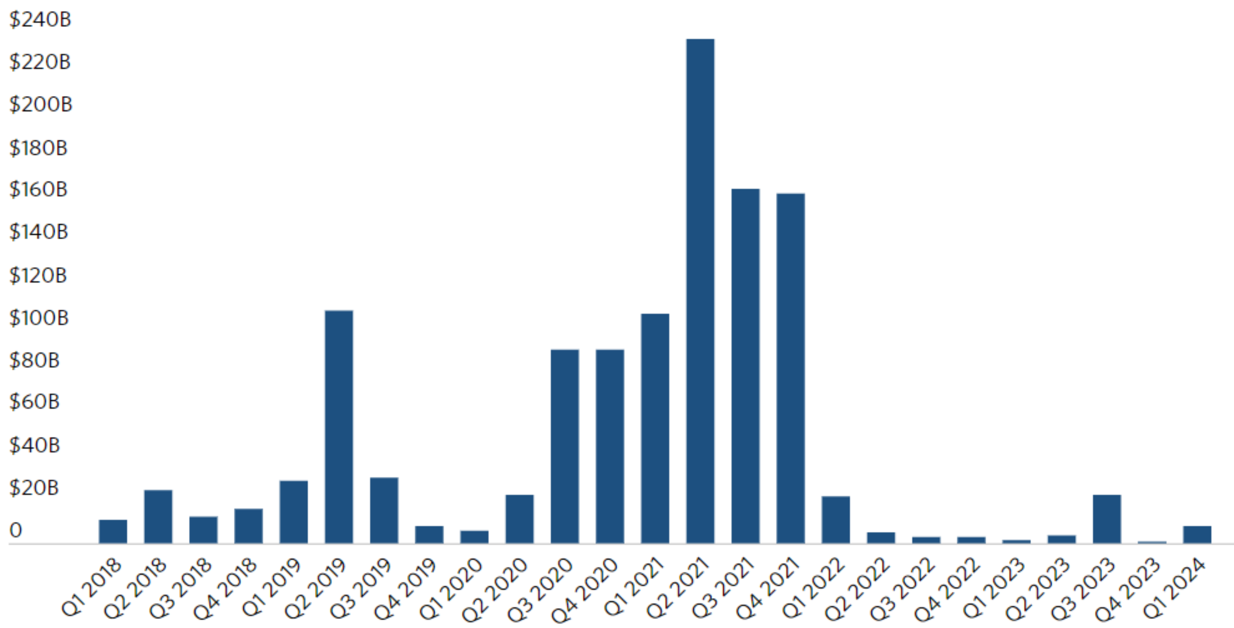


Source: KPMG, Venture Pulse

At the end of March, Tiger Global Management, a pioneer in late-stage venture growth equity investing, announced that it had raised $2.2 billion for its Tiger Global Private Investment Partners Fund XVI. To observers unfamiliar with venture capital, the amount raised might seem to be enormous, but for Tiger, which had hoped to gather $6 billion, the exercise was an embarrassing failure. For a private investment firm to be raising its 16th fund is an impressive achievement, a testament to its track record, pedigree and market reputation, and a feat unmatched by many peers. However, Fund XVI was the firm's smallest vehicle since its 8th fund, launched in 2014 with $1.5 billion. Subsequent vintages had raised successively larger amounts of capital with Fund XV having raised staggering $12.6 billion in 2022.

Tiger's story epitomizes the boom and bust in venture capital triggered by the Covid pandemic. The mania for tools that allowed people to function in lock-downs spread to technology in general, boosted by the sharp recovery and rise in stock markets and zero interest rates. The NASDAQ Index appreciated by more than 2.3 times from its trough in March 2020 to the fall of 2021. Companies like Palantir, DoorDash, and Airbnb all went public, as well as Snowflake, the largest software IPO of all time. The following year saw the highest number of companies going public, with 399 offerings, including Rivian, SoFi and Bumble, collectively raising $142.5 billion.

Global Venture Capital IPO values



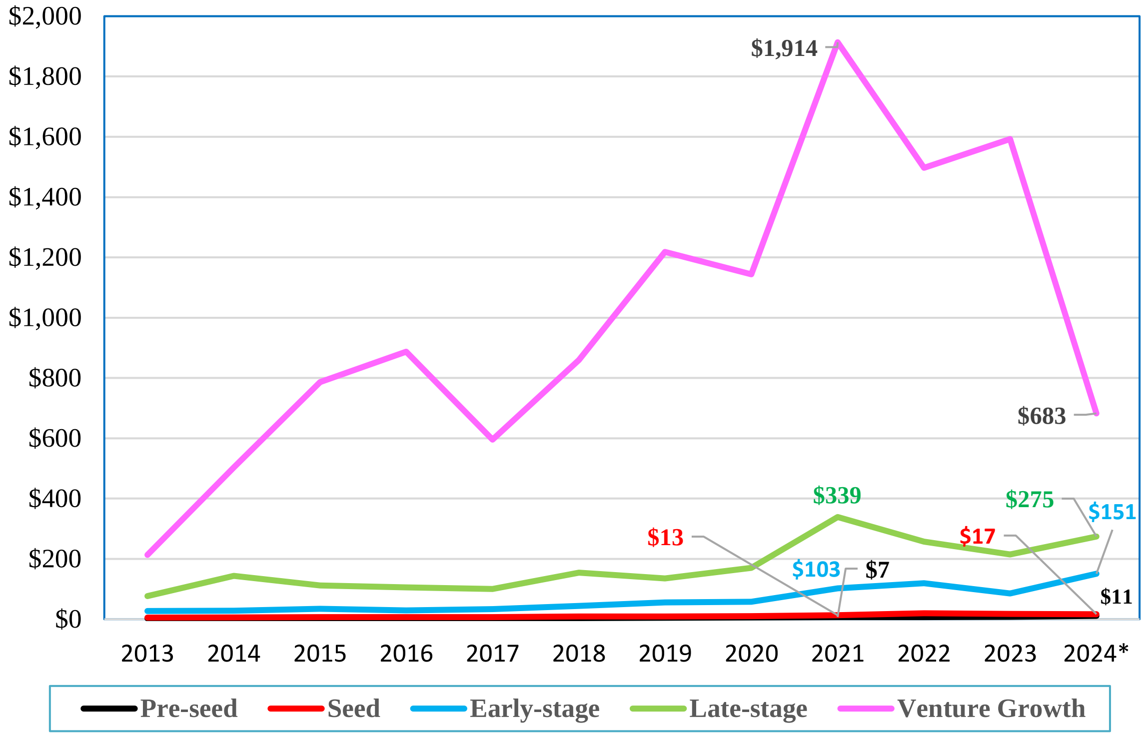
Source: Pitchbook

The stunning fortunes made by the venture capital firms that had seeded these companies led to an explosion of transactions and a flood of capital into the industry. In 2021, over $155 billion of new capital was raised by 1,600 venture funds in the U.S., and 19,078 startups were funded with $350 billion. During the previous decade only $47 billion had been raised on average every year by a third the number of funds, with 11,000 companies funded with $94 billion. Inevitably, the wave of capital led to excesses. "If there was one word to describe it, it was FOMO," said Eric Vishria, a partner at Benchmark Capital. "The fear of missing out brought a stampede at the peak of the market. It wasn't just the high prices investors were prepared to pay not to miss the boat: periods for conducting due diligence were drastically shortened and protections that investors usually build in to protect their investments fell by the wayside."

The boom ended abruptly as the Federal Reserve pushed interest rates up and the public equity markets collapsed in 2022. By the first quarter of 2024, all of the industry's metrics had reversed. Venture funds raised only $9.3 billion in the first quarter. At this pace, fundraising may end 2024 at just above $37 billion, the lowest amount of capital raised since 2013 and half the amount raised last year. A total of $36 billion funded 2,882 startups in the first quarter, a nearly 30% decrease compared with the same period in 2023.

What are the implications of this cycle for investors? Valuations, the supply and demand for capital, and negotiating leverage have all shifted dramatically in the investors' favor. Valuations increased across all stages of venture following the pandemic, but while the earlier stages experienced some subsequent declines, valuations have generally been stable or risen marginally. The highly speculative nature of early-stage venture investing means that entry prices will not have a meaningful impact on ultimate returns for investments that turn out to be winners. If the company ends up being the next Google it won't matter if its seed-stage valuation was at $5 million or $10 million. The most dramatic changes occurred in the late-stage and growth sectors of the market, since they are closer to a potential IPO exit and are more sensitive to public market volatility. The 64% decline in growth of stage companies – Tiger Global's focus – has taken valuations in that sector back to those that prevailed almost 7 years ago. Moreover, an increasing number of companies have been forced to raise capital in "down rounds" (financings at lower enterprise valuation than their previous rounds). Compared to 8% of venture truncations in 2022, down rounds accounted for 20% of deal in 2023, the highest ratio since the bursting of the internet bubble in 2000.

Venture Capital Valuations



Source: Pitchbook

More important has been the change in mindset for both portfolio companies and venture capital firms. The scarcity of capital means that they must both be laser focused on survival and deploy cash only for initiatives that lead to near-term revenue and profitability. Many startups are abandoning the "growth at all costs" model that prevailed in an era of plentiful capital. During the boom years, many venture firms were forced to make fast decisions without much diligence for fear of losing the deal to a competitor. They can now afford to be more discriminating and demand better financial terms, business plans and more experienced management teams.

It is fair to point out, however, that the enthusiasm over artificial intelligence may be accelerating the recovery of the industry. There is increasing amount of capital chasing AI deals, many of which seem fully priced. Brad Gerstner, a prominent technology investor and like many in Silicon Valley massively bullish on artificial intelligence, believes the power of the advanced technology could even trump the internet. “AI is going to be bigger than the internet, bigger than mobile and bigger than cloud software,” Gerstner said at a recent conference. While recent “unicorns” (venture-backed companies valued at over $1 billion) include AI companies like Anthropic, an model developer; Adept, a startup that trains AI to use enterprise software; and DeepL, a German AI language translator; AI is not the only field spawning venture winners. Other unicorns include companies in a diverse set of industries, such as SpaceX, Shein in retailing, Stripe in financial services, and Canva in graphic design.

These developments merit an assessment of the opportunities in venture capital. According to Cambridge Associates, an institutional consulting firm, venture capital has generated annualized returns 5% above the 15% annualized returns generated by private equity over the past 20 years. The vintages following both the internet bubble and the Global Financial Crisis produced some of the best returns in the venture industry. Will the recent turmoil in the industry result in funds raised over the next few years capturing above average returns?

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Glossary and Index Definition

•Alerian MLP Index (MLP) - The Alerian MLP Index is a composite of the 50 most prominent energy master limited partnerships calculated by Standard & Poor's using a float-adjusted market capitalization methodology. The index is disseminated by the New York Stock Exchange real-time on a price return basis (NYSE: AMZ). The corresponding total return index is calculated and disseminated daily through ticker AMZX.

•Barclays Capital U.S. Municipal Index – The U.S. Municipal Index covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligations, revenue bonds, insured bonds, and prefunded bonds. Many of the sub-indices of the Municipal Index have historical data to January 1980. In addition, several subindices based on maturity and revenue source have been created, some with inception dates after January 1980 but no later than July 1, 1993. In January 1996, Barclays Capital also began publishing a non-investment grade municipal bond index and "enhanced" state specific indices for Arizona, Connecticut, Maryland, Massachusetts, Minnesota, and Ohio. These indices are published separately from the Barclays Capital Municipal Bond Index.

•BofA Merrill Lynch Convertible Bond Index (Convertibles) - The BofA Merrill Lynch Convertible Bond Index tracks the performance of US dollar denominated convertible bonds issued in the US domestic market. In addition, qualifying securities must have at least one-year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $100 million.

•BofA Merrill Lynch Perpetual Preferred Securities Index (Preferred) - The BofA Merrill Lynch Fixed Rate Preferred Securities Index tracks the performance of US dollar denominated preferred securities issued in the US domestic market. Qualifying securities must be rated investment grade (based on an average of Moody's, S&P and Fitch) and must have an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings).

•BofA Merrill Lynch US High Yield Master II Index – This index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

•BofA Merrill Lynch EM External Debt Sovereign Index – This index tracks the performance of US dollar-denominated debt issued by sovereign issuers in countries belonging to emerging markets.

•BofA Merrill Lynch Mortgage Master Index – This index tracks the performance of US dollar-denominated mortgage securities.

•BofA Merrill Lynch Municipal Bond Index – This index tracks the performance of US dollar-denominated investment grade tax-exempt bonds.

•Credit Suisse Leveraged Loan Index – This index tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

•JP Morgan Emerging Market Bond Index (EMBI+) - The Emerging Markets Bond Index Plus tracks total returns for traded external debt instruments in the emerging markets. The instruments include external-currency-denominated Brady bonds, loans and Eurobonds, as well as U.S. dollar local markets instruments. The EMBI+ is concentrated in instruments from the three major Latin American countries (Argentina, Brazil, and Mexico), reflecting the size and liquidity of these external debt markets. The non-Latin countries are represented in the index by Bulgaria, Morocco, Nigeria, the Philippines, Poland, Russia, and South Africa.

•MSCI Emerging Market Index (Emerging Market Equities) - The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of March 2015, the MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

•MSCI Frontier Market Index – The MSCI Frontier Market Index is a free float-adjusted market capitalization index designed to measure equity market performance of the frontier markets. As of March 2015, the MSCI Frontier Markets Index consists of the following 24 frontier market country indices: Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Morocco, Nigeria, Oman, Pakistan, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine, and Vietnam.

•Russell 2000 Index (TR) - The best-known of a series of market-value weighted indices published by the Frank Russell Company. The index measures the performance of the smallest 2,000 companies in the Russell 3000 Index of the 3,000 largest U.S. companies in terms of market capitalization.

•Russell 1000 Index (TR) –A market-value weighted indices published by the Frank Russell Company. The index measures the performance of the largest 1,000 companies in the Russell 3000 Index of the 3,000 largest U.S. companies in terms of market capitalization.

•S&P 500 Index (TR) -Widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. S&P 500 is a core component of the U.S. indices that could be used as building blocks for portfolio construction. It is also the U.S. component of S&P Global 1200. Total return (TR) provides investors with a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend.

•FTSE NAREIT US Real Estate Index Series – The FTSE NAREIT US Real Estate Index Series is designed to present investors with a comprehensive family of REIT performance indexes that span the commercial real estate space across the US economy, offering exposure to all investment and property sectors. In addition, the more narrowly focused property sector and sub-sector indexes provide the facility to concentrate commercial real estate exposure in more selected markets.

Data Sources: Bloomberg, L.P., JPMorgan, BofA Merrill Lynch, Standard and Poors, Barclays Capital, Alerian, Morningstar Direct, MSCI, HFR, Goldman Sachs, Trading Economics, HIS Markit, Eurostat, Eaton Vance.