

2023 ANNUAL REVIEW AND 2024 OUTLOOK

SUMMARY

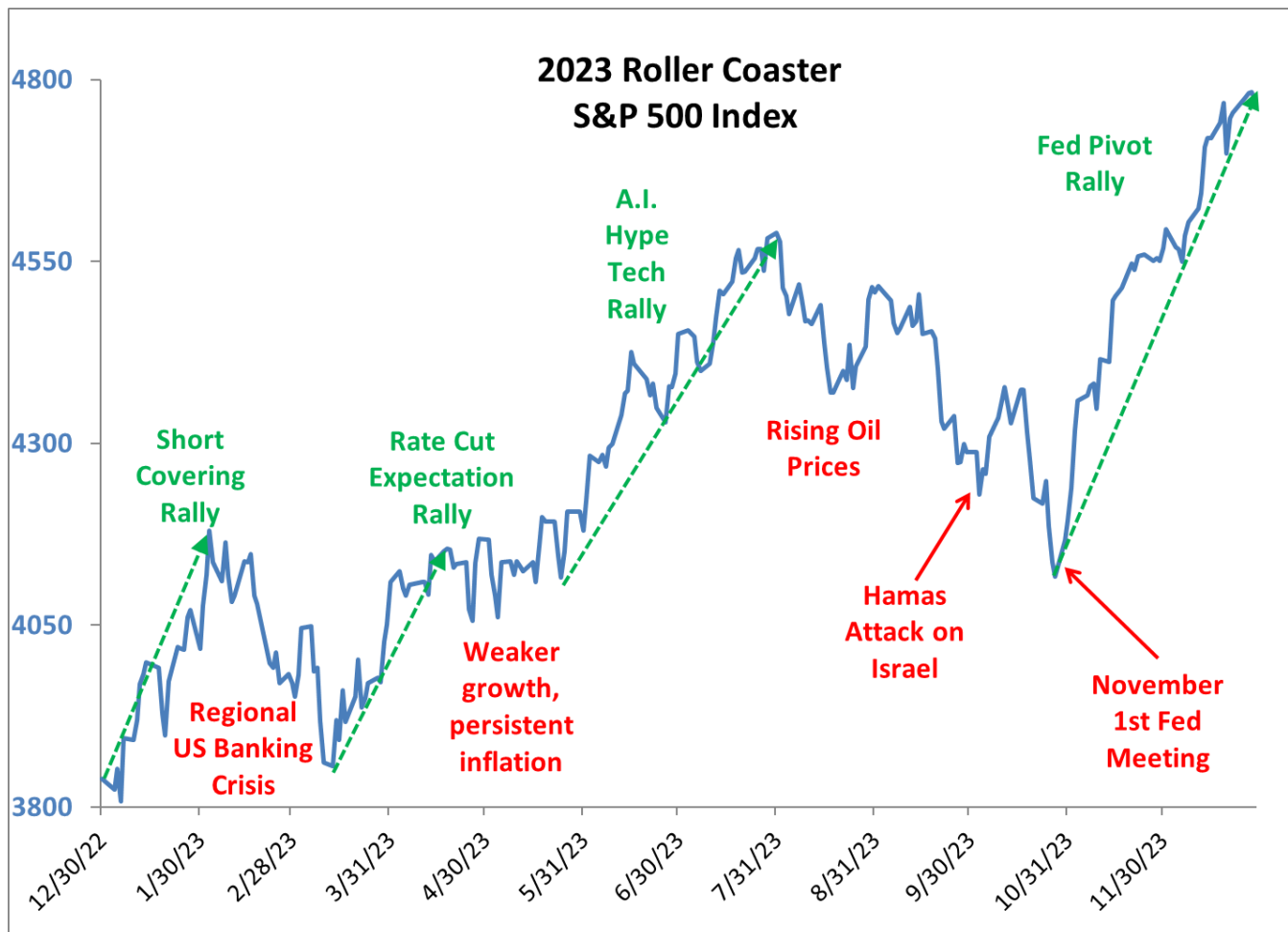
Global equities defied consensus, rising sharply for the year despite a U.S. banking crisis, geopolitical tensions and recession fears. Declining inflation readings fanned expectations of lower interest rates, while developments in machine learning prompted hopes for renewed earnings gains and rising productivity. U.S. rates ended the year marginally higher after a year-end rally triggered by dovish Fed comments.

For the year, global equities gained 22.2% while U.S. fixed income rose by 5.5% and broad commodities fell by 7.9%, the mirror image of 2022. Market volatility declined markedly through year-end.

A CHRISTMAS STORY



The Fed gave the market an early Christmas present at its November 1st meeting, offering the strongest indication yet that it may have concluded its hiking cycle. From that point through year end, the yield of the 10-year treasury declined by 1.05% to 3.88%, pulling the Bloomberg US Aggregate bond index from a loss of -2.8% to a gain of 5.5% for the year!



Source: Windrose Advisors

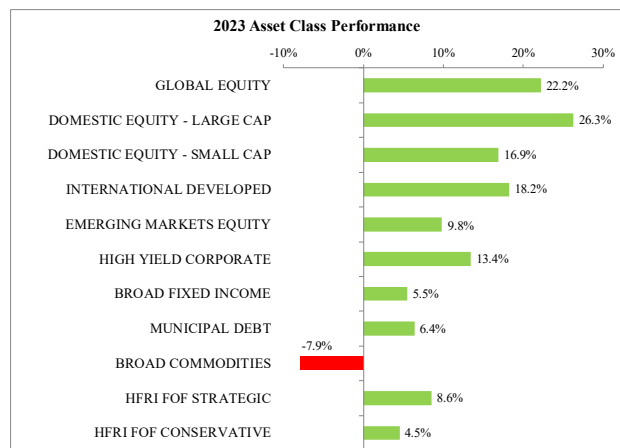
(Figure 4)

Equity markets rallied alongside bonds, with the S&P 500 index notching gains of 14% for the last two months of the year (figure 1).

Along with rising rate cut optimism, equity volatility (VIX index) fell from 21.7 at the beginning of the year to 12.5 by year-end. Declining interest rate differentials between the U.S. and foreign economies led the U.S. currency lower by 5.2% in the last two months of the year (DXY U.S. Dollar index). Among major trading partners, the Euro appreciated 6.8% for the year and the Japanese Yen fell by 7.2% vs. the U.S. Dollar.

For the year, all major indices across equities, credit and fixed income markets posted gains. Commodities were the exception, led by declines in energy. U.S. large cap equities outperformed foreign markets thanks to a higher exposure to the Technology sector. High yield credit outperformed investment grade fixed income assets. Hedge fund strategies (proxied by the HFRI indices) delivered muted returns, in line with their hedged exposures (figure 2).

(Figure 2)



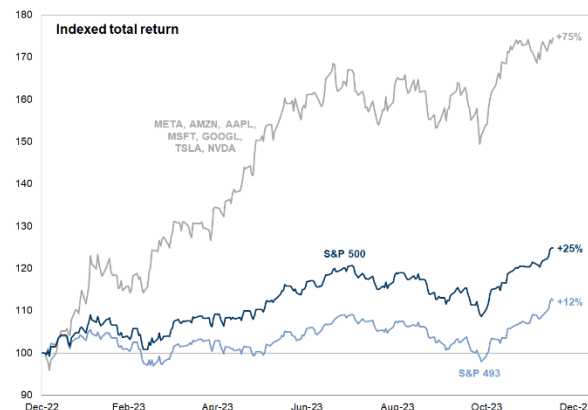
Source: Bloomberg

In the end, 2023 was most notable for how much market developments differed from consensus expectations. Investors started 2023 anticipating a recession (earnings compression) in a higher for longer rates environment (flat equity valuations). Instead, a resilient labor market sustained consumer spending while supply chain inflation pressures abated, raising hopes for rate cuts and allowing a rebound in risky assets.

This rosy macro-economic narrative omits the other major narrative for 2023, which is the Technology rally induced by excitement surrounding developments in artificial intelligence and applications across industries.

The “Magnificent Seven” stocks¹ appreciated by 75% for the year thanks to AI hype, while the remaining 493 stocks in the S&P500 index only gained 12% (and were in the red through October, see figure 3). Thus, a better description for the year would be a flat (macro-economically resilient) equity market, rescued by a late drop in interest rates and boosted by what could be a bubble in a handful of stocks.

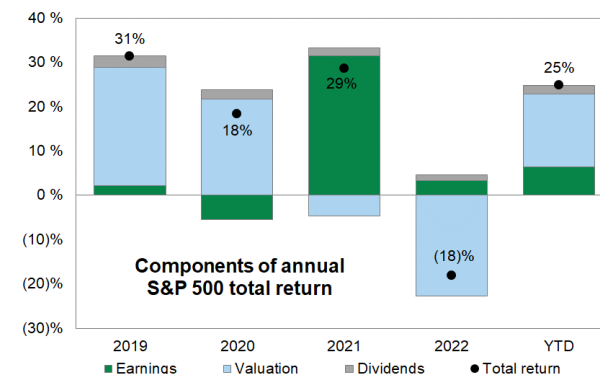
(Figure 3)



Source: Goldman Sachs

In fact, most of the returns for 2023 consisted of valuation expansion (the mirror image of 2022), with a more modest contribution from earnings and dividends (figure 4).

(Figure 4)



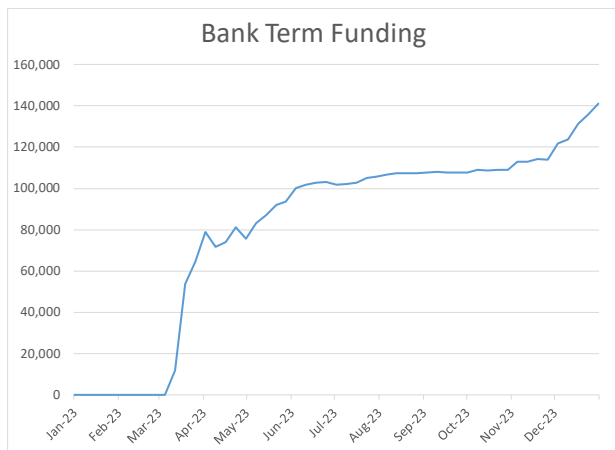
Source: Goldman Sachs

¹ Meta, Amazon, Apple, Microsoft, Google, Tesla, and Nvidia

Risky assets also benefitted from a significant assist from the Fed and U.S. government during the year.

As most investors expected, something did break in the economy when interest rates rose, and it was the banking sector, which experienced several failures in March 2023. Thankfully, the Fed provided emergency funding to banks, preventing broader economic contagion at a relatively modest cost of \$140 billion (figure 5).

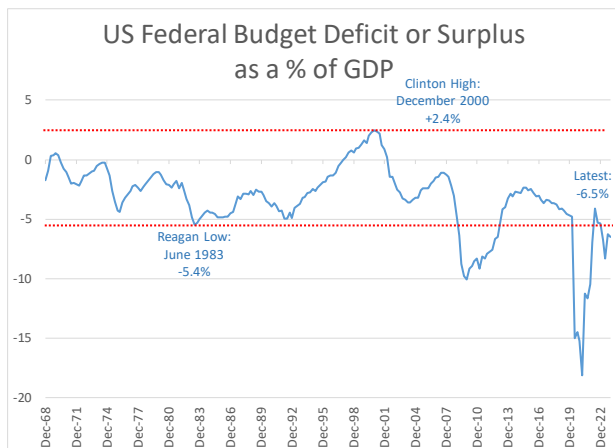
(Figure 5)



Source: Bloomberg

And for all the talks of economic resiliency, the U.S. government continued to pump fiscal stimulus (e.g. CHIPS Act, Inflation Reduction Act), leaving the Federal deficit at -6.5% through year end, an unthinkable figure given we are not even in a recession. Consider that in the 1982 recession, following the Volker rate hikes and Reagan-era tax cuts, the Federal deficit “only” dropped to -5.4% (figure 6).

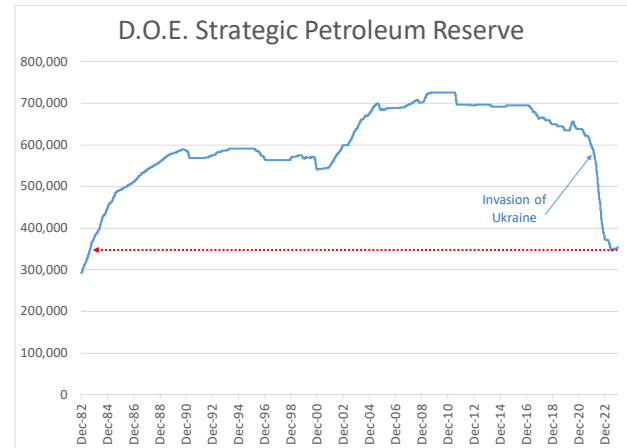
(Figure 6)



Source: Bloomberg

Finally, the less talked about form of stimulus was the incredible release of oil from the Strategic Petroleum Reserve (SPR) following the Russian invasion of Ukraine, which continued through June 2023. This cut the SPR in half, bringing reserves back to 1982 levels. This action prevented an oil supply shock, avoiding a recession, but now leaves the U.S. exposed to another potential energy shock in the future (figure 7).

(Figure 7)

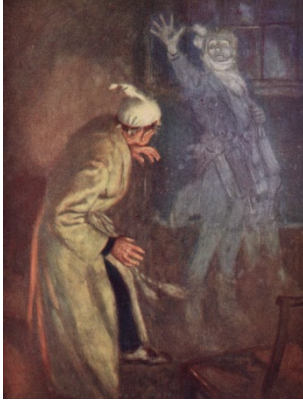


Source: Bloomberg

It is apparent that the era of permanent intervention has not ended yet. While markets proved everyone wrong, the right course of action in 2023 was to be cautious. Would it be sound investment policy to assume authorities will always find a way to prop up markets? Maybe if you believe in Santa Claus.



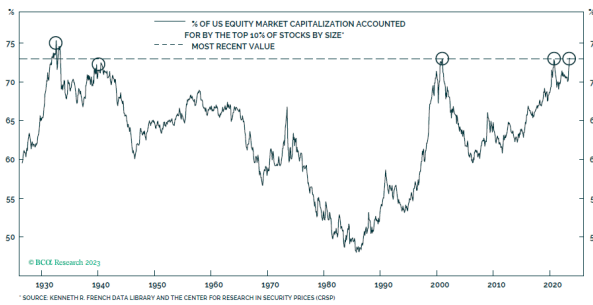
GHOSTS OF CHRISTMAS PAST



Much like in the Charles Dickens novel, we feel like markets are being visited by the Ghost of Christmas Past as the concentration of returns in a handful of stocks once again reaches levels last seen during the Tech bubble.

As shown in figure 8, the top 10% of stocks by market capitalization represent close to 75% of the entire stock market.

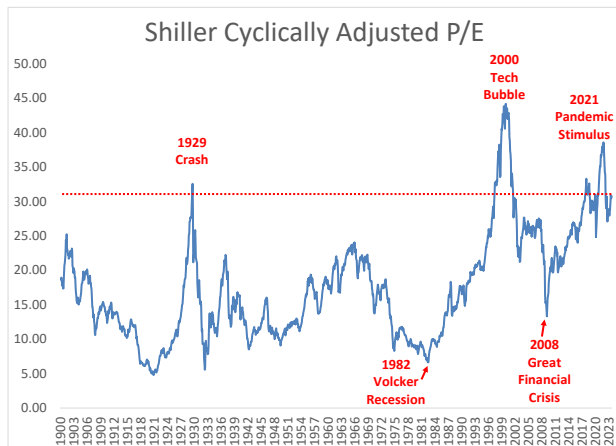
(Figure 8)



Source: BCA Research

High equity valuations as experienced today have historically reached these levels at precarious times. While valuations are a poor short-term signal as to the direction of markets, they portend poor inflation-adjusted returns over the coming decade, at least at an index level (figure 9).

(Figure 9)



Source: Prof. Shiller's database (Yale University)

GHOSTS OF CHRISTMAS PRESENT

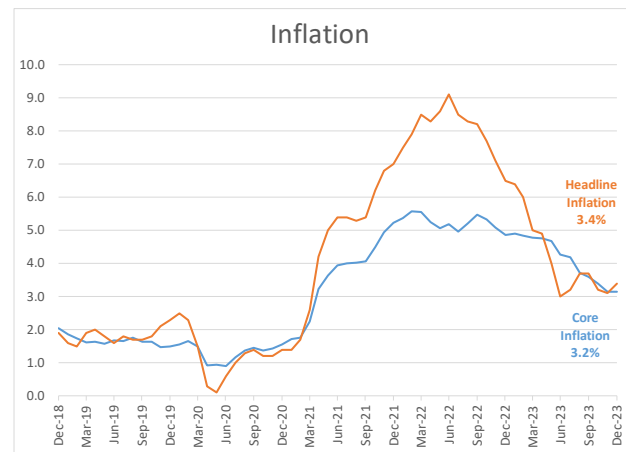


Despite these worrisome memories of the past, all eyes are now on the Fed and pondering the speed of coming rate cuts. The soft-landing scenario (stable growth with no inflation) has become consensus, and recession fears are receding.

Did the Fed really succeed in bringing down inflation without a recession?

As shown in figure 10, substantial supply-driven inflation pressures that drove headline inflation to a peak of 9.1% have abated and headline inflation is now in line with core inflation.

(Figure 10)



Source: Bloomberg

This was more a result of substantial declines in energy and food prices and the resolution of post-pandemic supply chain disruptions, which had little to do with Fed actions. Inflation from wage gains and higher demand have been slower to correct.

For households, tight labor conditions supported wage gains post-pandemic while low interest rates allowed them to refinance mortgages, lowering debt burdens. As a result, consumers were relatively insulated from the initial effects of interest rate increases and could cope with inflation. However, wage gains are now fading and returning to trend (figure 11).

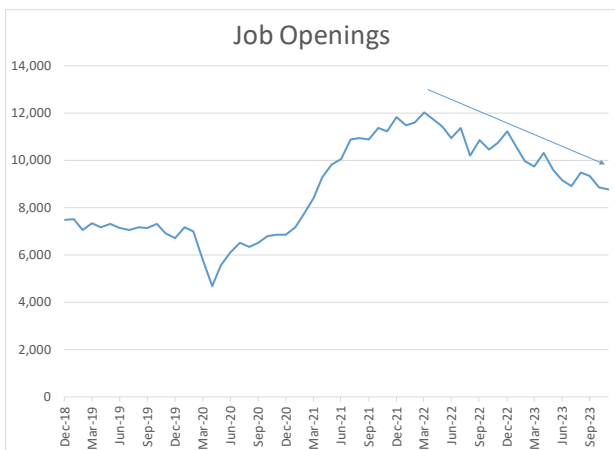
(Figure 11)



Source: BCA Research

In fact, the lagged effects of higher rates have yet to be felt in the economy. As higher rates impact the ability of corporations to secure attractive debt financing, projects are being scaled back, reducing the number of job openings (see figure 12).

(Figure 12)



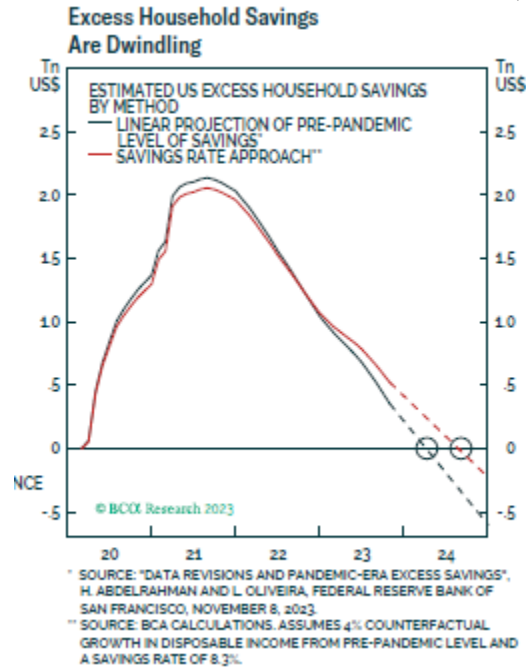
Source: Bloomberg, Bureau of Labor Statistics

Eventually the declining number of job openings will reach equilibrium with the number of job seekers, ending tightness in labor markets. At that

point, it will look like a soft landing has been achieved. But further declines in employment will then likely tip the economy into outright recession, we think later in 2024.

Excess savings accumulated during the pandemic have supported consumption but will also likely run their course this year (figure 13),

(Figure 13)

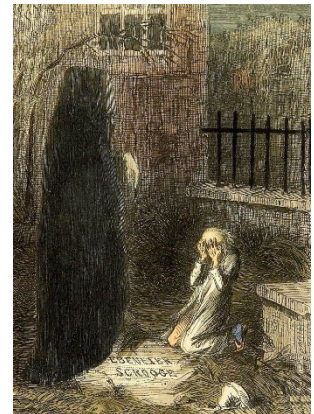


Source: BCA Research

GHOSTS OF CHRISTMAS FUTURE

Beyond near term worries of cyclical weakness, markets will eventually have to deal with a number of issues.

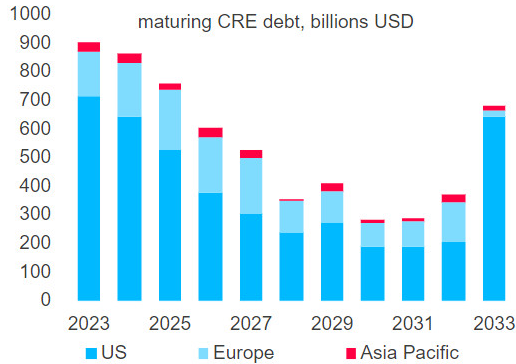
First, we believe that credit problems in leveraged loans and commercial real estate have been delayed but not resolved.



As shown in figure 14, commercial real estate debt faces a maturity wall in 2024, with nearly \$700 billion coming due in the U.S. alone. It is unlikely that interest rates will fall low enough

to allow refinancing without at least some equity losses to investors.

(Figure 14)

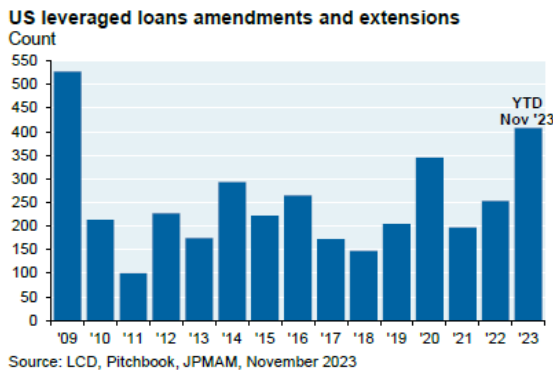


Source: IMF, TS Lombard

Source: Financial Times

Stress is also evident in the corporate credit market, particularly for issuers of floating rate loans (a.k.a. leveraged loans), which saw their coupons reset higher with each Fed rate hike. Creditors have been willing to “amend and extend,” or temporarily suspend the original terms to avoid defaults. As shown in figure 15, amend and extend activity increases in periods of stress (2009, 2020). With a likely economic slowdown or outright recession in our future, we think the default rate is bound to rise.

(Figure 15)



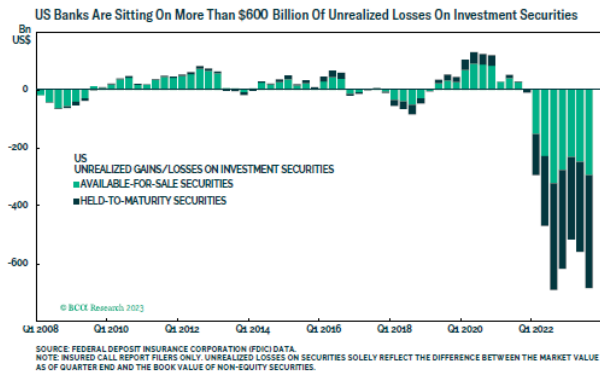
Source: LCD, Pitchbook, JPMAM, November 2023

Source: JP Morgan

Could new debt cure these woes? Despite Fed support, the banking sector is still reeling from the impact of higher interest rates and U.S. banks are currently sitting on \$800 billion in unrealized losses on investment securities (figure 16). Declining rates will help, but in the meantime, this has forced

banks to curtail new lending activity. With declining credit availability from banks, corporate borrowers will need to turn to private credit lenders for new financing, although this form of credit is typically more expensive and will come with more stringent covenants.

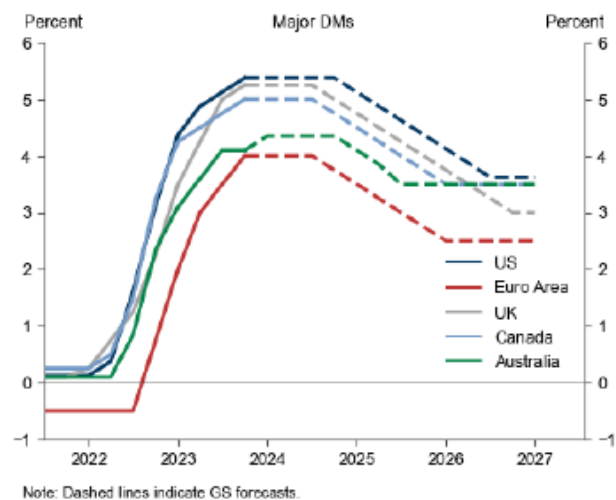
(Figure 16)



Source: BCA Research

Could lower interest rates save the day? It will help but no economist is forecasting a return to the days of zero interest rates (figure 17) across Developed Markets central banks. Thus, loans issued at extremely low interest rates post-covid will still struggle to refinance.

(Figure 17)

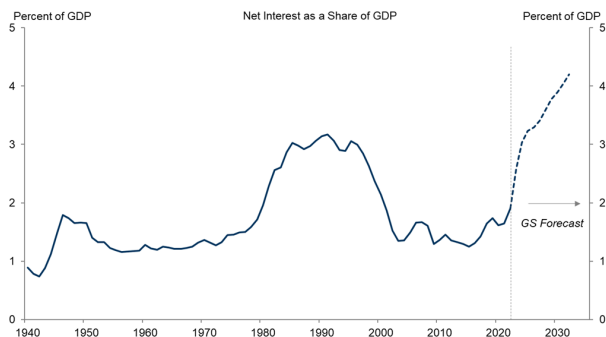


Source: Goldman Sachs

And it is not just the private sector that will welcome lower interest rates. Higher fiscal deficits have ballooned U.S. government debt levels. Current projections show that interest payments on

the national debt could double from 2% of GDP to 4% in the coming decade (figure 18).

(Figure 18)



Source: Goldman Sachs

Rising debt and political dysfunction already cost the U.S. its AAA sovereign credit rating. It is likely that “bond vigilantes” will curtail the ability of the U.S. government to provide fiscal stimulus during recessionary times at some point in the future.

The following quote from Scrooge in A Christmas Carol seems oddly appropriate in this context: *Merry Christmas! Out upon merry Christmas! What’s Christmas time to you but a time for paying bills without money; a time for finding yourself a year older, but not an hour richer; a time for balancing your books and having every item in ‘em through a dozen of months presented dead against you?*

FINAL STAVE

It is clear that the coming period will not be without its challenges. What is an investor to do in this environment? The most pressing advice is to stay the course and maintain a well-diversified portfolio to hedge against multiple market outcomes.

Our base case scenario would be lower inflation and lower growth, with a mild to severe recession. If we are correct, then 2024 would (at last) be the year of the bond, with investment grade fixed income benefiting from declining rates and relatively strong credit quality. And while low-quality credit would face significant challenges, it would open up a vast opportunity set for discerning distressed managers.

The market consensus is currently embracing a lower inflation, higher growth scenario of soft landing. Bonds could still do well as lower inflation allows for lower rates, but equities would outperform. However, given current valuations of capitalization-weighted market indices, investors would be well-advised to seek better value in smaller capitalization stocks or foreign equities. We think this scenario would be short-lived.

We are more worried about a higher growth but higher inflation scenario as the Fed may cut rates too soon in an attempt to prop up employment. Resurgent inflation could then shake markets, negatively affecting stocks and bonds. Commodities could surprise on the upside in that scenario, especially precious metals. We think that active managers would reward investors with a focus on select quality businesses trading at reasonable valuations.

Finally, geopolitical risks, particularly if an energy supply shock materializes, could usher in a scenario of lower growth but higher inflation. Energy commodities would be the natural hedge, as well as TIPS and macro strategies.

We aim to protect our clients against market volatility by investing in a mix of assets that will provide resilience regardless of market outcomes. Expectations of volatility mean that there will be opportunities stemming from portfolio rebalancing, and liquidity will become a valuable parameter in portfolio performance.

It is normal for investors to feel regret at missing out on last year’s equity rally by being cautious. However, heeding sound advice of diversification will help deliver more stable returns, and a more satisfying ending to this Christmas story.



INDEX KEY

Indexes are unmanaged, statistical composites and their returns do not reflect payment of any brokerage commissions or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. It is not possible to invest directly in an index. The indexes include a different number of securities and have different risk characteristics than the model. Past performance of the indexes and benchmark is no indication of future returns.

Global Equity (MSCI All Country World-USD), Domestic Equity Large Cap (S&P500), Domestic Equity Small Cap (Russell 2000), International Developed Equity (MSCI EAFE), Emerging Market Equity (MSCI EM), Energy Equity (MSCI ACWI Energy) Broad Fixed Income (Barclays Aggregate), U.S. Government Debt (Barclays U.S. Treasury), U.S. Inflation-linked (Barclays U.S. Treasury Inflation Notes), U.S. Corporate Debt (Barclays U.S. Corporate), U.S. Securitized Debt (Barclays U.S. Securitized), Emerging Debt U.S. Dollar (JP Morgan Emerging Market Bond Index Global), Emerging Debt local currency (JP Morgan Global Bond Index Emerging Markets), High Yield Debt (Barclays U.S. High Yield), Municipal High Yield (Barclays U.S. Municipal High Yield), Municipal Debt (Barclays U.S. Municipal), Commodities (Bloomberg Commodity Index), Public Real Estate (MSCI U.S. REIT), Global Hedge Funds (HFRI Fund Weighted Composite), Directional Hedge Funds (HFRI Fund of Funds Strategic), Absolute Return Hedge Funds (HFRI Fund of Funds Conservative), Venture Capital (Cambridge Associates Venture Capital Index), Private Equity (Cambridge Associates Private Equity Index), Private Real Estate (Cambridge Associates Private Real Estate).

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