BALENTINE

Quarterly Market & Economic Report

Q3 | 2024

A Path to Normalcy

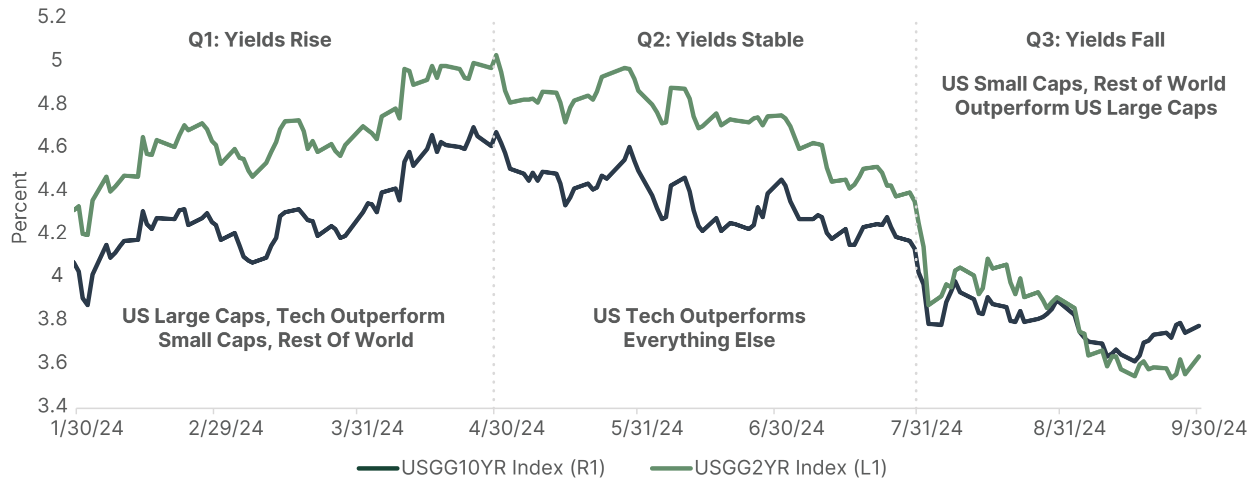
After keeping them on hold for over a year, The Federal Reserve pivoted to cutting interest rates by 50 bps, an unusually aggressive first step in easing monetary policy outside of recessionary periods by historical standards. Since July 2023, when they last raised interest rates, inflation has slowed meaningfully closer to The Federal Reserve (The Fed)'s target rate of 2%, while the unemployment rate has ticked up only slightly to just over 4%. With prospective inflation expectations remaining well anchored, The Fed has begun to communicate that it is now less concerned with achieving low and stable prices, and more worried about setting the stage to ensure a strong labor market and continued economic growth.

This is a welcome sign that the economy is on a path to normalcy after the very unusual years during and after the pandemic. For the first time in over two years, our Capital Markets Indicators[1] are sending consistent—not conflicting—positive messages about the future economic environment after two key changes. First, after an unprecedented 29-month inversion, the U.S. Treasury yield curve, as measured by the difference between 2-year and 10-year Treasury rates, un-inverted in early September and steepened to 13 basis points by the end of the quarter (FIGURE 1).

[1] *What Can Capital Markets Teach Entrepreneurs? (Balentine)*

FIGURE 1: Two-Year and Ten-Year U.S. Treasury Yields (09/30/2024)*

After an unprecedented 29-month inversion, the U.S. Treasury yield curve un-inverted in early September and steepened to 13 basis points by the end of the quarter.



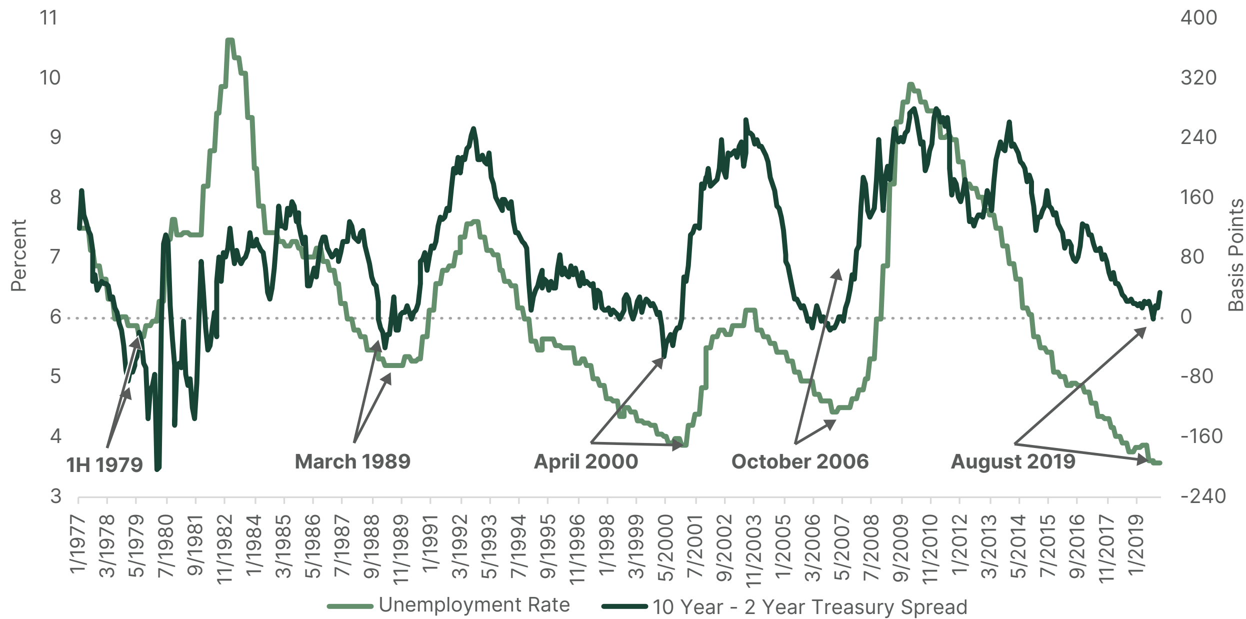
Source: Board of Governors of The Federal Reserve System (US)

Second, after China unveiled a plan to stimulate its economy, commodity prices bounced. Now, both the bond and commodity markets are confirming the positive outlook that the stock and credit markets have been signaling for a while.

As of early October, the Atlanta Fed's GDPNow indicator, which attempts to proxy growth in real-time, is signaling that the economy is currently expanding by over 3%. The September jobs report released in early October also confirmed the jobs market is still on solid footing. In the past, an un-inverting yield curve accompanied by significant interest rate cuts by The Fed was typically associated with rising unemployment and an imminent downturn, which is not the case today (FIGURE 2).

FIGURE 2: U.S. Unemployment Rates and 10-Year – 2-Year Treasury Spreads (1977–2019)

Even as The Fed eases monetary policy, the jobs market remains strong.



Sources: St. Louis Fed, Bureau of Labor Statistics

Perhaps, the thin silver lining of the pandemic, and subsequent inflation and interest rate shocks, is that after orchestrating a "soft-landing" for the economy, The Fed today has room to return short-term interest rates to where it would like them to be over the long run: a target "neutral rate" of inflation plus 1%. In the decade after the Great Financial Crisis and prior to the pandemic, the cost of capital was artificially cheap – negative after inflation. Today, the positive real cost of capital creates a far healthier environment because balance sheets are likely to be deployed and assets are likely to be allocated in a more disciplined and productive way.

However, those hoping for significant further interest rate cuts soon may be disappointed. On Wall Street, there's an old saying that interest rates "stair-step up" and then "take the elevator down" when The Fed decides to ease. This means rates are typically raised slowly and steadily, but when The Fed shifts focus, they often cut rates quickly and aggressively, as if they're falling down an elevator shaft, often because the economy has already tipped into a recession by the time they first begin easing. This time, instead of the usual pattern, we might see interest rates stair-step down as well, reflecting that The Fed does not need to take drastic action. Today, The Fed will continue to seek reassurance that inflation will not flare up again as it sets the stage for the economy to continue to grow during this mid-cycle adjustment to easier monetary policy.

If the near-term fundamental outlook appears benign, markets are wrestling with uncertainty around the implications of the upcoming U.S. Presidential elections[2] and escalating geopolitical risks, especially in the Middle East. As a result, precious metals like gold and silver, as well as the oil price, have remained in strong uptrends while the stock market has climbed to new highs.

Our best line of defense against such unforeseen shocks is to remain focused on ensuring that portfolios have ample cash to meet two years' worth of spending needs net of portfolio yield at all times. As always, we will lean on our unemotional model-driven process to navigate our well-diversified strategies as markets continue to climb the "Wall of Worry."[3] This may allow fully invested portfolios to continue to generate income and capital appreciation based on fundamentals like growing corporate earnings and gently declining interest rates.

[2] *For more on our views, see [Addressing Election Anxiety (Balentine)]*
[3] *[Reasons to Sell the S&P 500 (Balentine)]*

Public Markets

We made only one change to strategies during the quarter. Ahead of the Fed pivoting to cutting interest rates, we eliminated our tilt towards short-term bonds. We first established this position in the summer of 2022 to cushion the impact of rising interest rates on our fixed income portfolios. With the Fed clearly signaling that it was close to the end of its campaign to raise interest rates, the continued need for this risk management dissipated and we returned portfolios to benchmark duration.[4]

While continuing to enjoy the tailwinds of positive momentum, stock market valuations are still expensive compared to bonds and we remain at our long-run strategic targets between stocks and bonds. Within stocks we maintain our tactical emphasis towards U.S. Growth stocks and stocks that exhibit positive price momentum and low volatility characteristics around our long-run anchor of global quality stocks.[5]

While our strategies have generated strong absolute returns, they have slightly lagged their unmanaged stock:bond benchmarks over the last twelve months. On a rolling three-year basis, they generally continue to perform in line or ahead of our benchmarks, an unprecedented period during which the markets sent many mixed signals to navigate. Over the long-term our strategies have demonstrated the ability to outperform their benchmarks by sticking to our discipline and resisting the temptation to chase a “fat pitch” that may not be present.

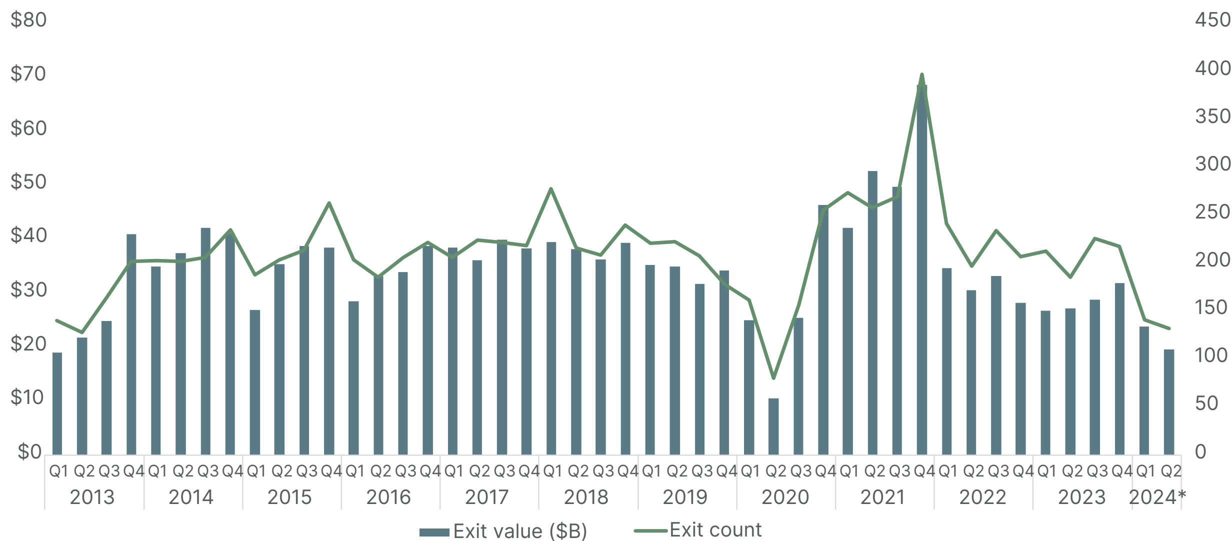
[4]Duration is a measure of how sensitive a fixed income portfolio is to interest rate changes.
[5]Quality stocks exhibit the characteristics of stable earnings growth, high profitability, and low levels of leverage.

Private Markets

During the third quarter, there were signs of private markets returning to pre-pandemic normalcy as well, although liquidity in the private equity market is still low (FIGURE 3).

FIGURE 3: Quarterly Volume of Private Equity Middle Market Exits (2013–2024)

Liquidity in the private equity market is still low, which you can see in the drop-off of private equity middle market exits in recent quarters.



Source: Pitchbook

Though these pressures have started to subside somewhat, fund managers are still feeling the impact as they begin to raise new funds. This has led to interesting innovations, such as General Partner-led secondaries or "continuation funds," where managers can sell one or more of the fund's assets to create much-needed liquidity for investors. Looking ahead, we expect 2025 to be a much busier year as pent-up transaction demand meets a more favorable environment for deals and investments.

As interest rates begin to decrease, we are expecting several knock-on effects across diversified private capital portfolios. For equity investments, lower debt costs make more transactions viable, creating opportunities for investors. In the real estate sector, decreasing rates provide relief to real estate lending and improving cap rates, which are crucial in determining property valuations. On the debt side, however, investments tied to floating rates will start to earn less as the Secured Overnight Financing Rate (SOFR) continues to lower.

We believe this dynamic reinforces the importance of a diversified private capital portfolio. While one segment of the portfolio may experience some drawbacks due to falling rates, other parts may benefit, adding tailwinds to the overall performance and helping to mitigate risk. We continue to underwrite our private capital strategies to give us confidence that they may generally outperform their public market equivalents by 300–500 bps to compensate for their unique risks. We are pleased with their progress across several vintage years so far.

Private Fund Updates

There has been some meaningful activity in Balentine's private capital funds over the last quarter.

Credit Opportunities 2023

The Investment Strategy Team approved the final fund allocation for Credit Opportunities 2023. This will be a commitment to J.F. Lehman Credit Fund II. This mandate is a complement to what J.F. Lehman does on the private equity side as it invests in the debt of aerospace and defense companies. Higher levels of interest rates over the last two years have created an opportunity to purchase existing debt at material discounts or originate debt at attractive yields. While rates have come down recently, they are still far above what they were in 2021. The J.F. Lehman credit team will look to leverage its long-standing experience in these sectors to originate and underwrite these credits.

Private Credit Opportunities II*

We held our first close for our next credit fund, PCO II. Early allocations in this fund will be a commitment to Monroe V, the successor fund of our last senior lending recommendation, as well as Pantheon Senior Debt III, a fund buying secondary interests in senior lending funds. We believe these allocations will give clients attractive starting yields in a diversified way.

Sunbelt Real Estate Plus*

In the fourth quarter, we will launch our next fund, Sunbelt Real Estate Plus. This fund's mandate will be to invest in the debt and equity of real estate and other real assets. We have approved our first manager for the fund, Benefit Street Partners (BSP). BSP is a debt manager that originates loans to real estate owners for purchase and development of mainly multi-family properties. We believe the high interest rate environment coupled with a wall of maturity coming for real estate loans offers clients an attractive return in a prioritized security.

**Clients, if you are interested in learning more, your relationship manager can provide further materials.*

In Closing

In the third quarter, several developments indicated a return to normalcy as markets sent consistently positive signals about the economic outlook for the first time in over two years. The U.S. Treasury yield curve un-inverted, and China's stimulus turned previously uncertain commodity signals positive. Both of these shifts finally confirmed that though several sectors suffered recessions after The Fed raised interest rates, the broader economy is set to continue to grow. The Fed has recalibrated its focus from inflation to employment and has begun implementing gradual rate cuts to support economic expansion without the need for further aggressive actions.

There are obvious causes for uncertainty, such as the upcoming contentious U.S. Presidential election and escalating geopolitical risks. While there are few obvious "fat pitches" to swing at, we will continue to lean on our unemotional, model-driven process that has stood the test of time over several market cycles. When it signals clear opportunities to capitalize on, we will implement with agility and conviction.

Thank you for the trust you have placed in our team and process. Please let us know if you have any questions.

Sincerely,

Adrian Cronje, Ph.D., CFA®
Chief Executive Officer

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