2nd Quarter 2024

Highlights

- **Interest rates rose, and credit spreads widened slightly during the quarter. Despite this, credit markets performed relatively well. Our portfolios benefited as higher risk sectors outperformed.**
- **The economy showed signs of slowing, although inflation stayed elevated leading to a delay in rate cuts. We believe the economy has achieved the desired "soft landing."**
- **Emerging markets asset classes experienced withdrawals over the last three years. Events raised concerns about the risk and return relationship. It may be time to invest again.**

Markets

		Returns (%)			
GIA	Average Quality	2Q24 Gross	2Q24 Net	12 Months Gross	12 Months Net
Core Plus Composite	**(A+)**	**0.52**	**0.43**	**5.25**	**4.88**
Global Investment Grade Composite	**(A-)**	**0.51**	**0.41**	**5.92**	**5.50**
Global Credit Plus Composite	**(BBB+)**	**0.84**	**0.72**	**7.95**	**7.42**
Global High Yield Composite	**(BB-)**	**0.92**	**0.77**	**11.99**	**11.32**
Emerging Market Corporate Debt Composite	**(BB+)**	**1.62**	**1.47**	**12.16**	**11.49**
Benchmark Bonds					
Bloomberg U.S. Agg. Index	(AA)	0.07		2.63	
Treasury	(AA+)	0.10		1.55	
Corporate	(A-)	-0.09		4.63	
Mortgage	(AA+)	0.07		2.12	
Government/Credit	(AA)	0.05		2.74	
ICE BofA U.S. Corporate & Yankees	(A-)	0.17		4.83	
ICE BofA U.S. Corporate	(A-)	0.12		5.04	
ICE BofA U.S. High Yield	(B+)	1.09		10.45	
ICE BofA Global High Yield Constrained Index (USD)	(B+)	1.21		10.62	
ICE BofA EM Corporate Plus	(BBB)	1.35		7.57	
ICE BofA Global Gov't ex-US	(AA-)	-1.65		-0.24	
JPM Emerging Markets EMBI GD	(BB+)	0.30		9.23	
JPM CEMBI Broad Diversified	(BBB-)	1.49		9.30	
JPM GBI-EM Global Diversified	(BBB+)	-1.63		0.67	
Benchmark Equities					
S&P 500	NA	3.92		22.70	
Nasdaq Composite	NA	8.26		28.61	
Russell 2000	NA	-3.62		8.42	
MSCI EAFE	NA	-1.48		8.58	
MSCI Europe	NA	-0.76		8.57	
MSCI Japan	NA	-4.44		10.90	
MSCI Emerging Markets Equity	NA	4.13		9.78	

* Please refer to the respective factsheets for the long-term composite and benchmark returns for each strategy.

Markets

A word that might aptly describe the second quarter is complacency, and likely justifiably. The economy showed signs of gradual moderation, geopolitical hot spots did not worsen or expand, monetary authorities continued their transition toward easing, even if at a slower pace than anticipated, and electoral surprises around the world were not disruptive. In the U.S., financial markets remained intently focused on artificial intelligence (AI), the Federal Reserve's policy intensions, and the coming presidential election. Away from AI and its boundless promise, little else delivered market moving direction. U.S. equity markets had a stellar quarter, although performance was concentrated in a few, mostly technology related, stocks. The S&P 500 returned 3.92% for the quarter while the Nasdaq delivered an eyepopping 8.26%. Year-to-date both indexes ended near record levels with returns of 14.48% and 19.73% respectively. Bonds remained pressured by high rates after disappointing inflation readings in April and May. The Bloomberg Aggregate Index returned a paltry +0.07% for the quarter and -0.71% year-to-date. As occurred during 2023, credit sectors outperformed with securitized lagging, although the divergence narrowed. High yield was the performance champion, returning 0.97% for the quarter and 2.62% for the six months. Investment grade corporates and securitized products outperformed marginally over the quarter, although securitized still lagged year-to-date. These sectors returned +0.12% and +0.23% during the second quarter respectively, and +0.04% and -0.84% year-to-date.

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Investment grade credit continued to outperform, although more modestly as spreads were already tight and investor demand slowed. For the quarter, the investment grade corporate bond index, the ICE BofA U.S. Corporate Index (C0A0), was up 0.12%, which tipped the year-to-date return to a negligible positive 0.04%. After declining steadily since October 2023, spreads widened marginally during the quarter, leading to – 4 b.p. of excess return. Over the first half, excess return remained at a healthy 85 b.p. Corporate option adjusted spreads (OAS) widened by 3 b.p. to 96 b.p., while the yield to worst of the index rose 16 b.p. from 5.34% to 5.50%. Investment grade credit issuance moderated from a frothy first quarter to $406.3 billion. Together with Q1, issuance totaled $1.06 trillion, a level that puts this year within reach of the record $2.1 trillion borrowed in 2020.

The high yield market outperformed again as higher yields and moderate rate volatility delivered the sector's carry advantage. Yields rose about evenly along the curve during the quarter, giving the high yield market an advantage due to the sector's shorter duration. The ICE BofA U.S High Yield Index (H0A0) was up 1.09% for the quarter and 2.62% for the first half, ahead of other fixed income sectors. At quarter-end, the spread to worst for the sector was wider by 8 b.p. from 331 b.p. to 339 b.p. The yield to worst remained attractive at 7.84% compared to 7.66% in March. After a sizeable withdrawal of funds in April, investors added funds in both May and June. A positive net for the quarter pushed year-to-date inflows above $5.4 billion. The default rate including distressed exchanges decreased to 1.79% from 2.59% at the end of March (1.17% not including distressed exchanges). Confounding expectations, bond defaults declined during the first six months of 2024, although distressed exchanges became a more prevalent form of restructuring. The new issue market slowed to $77.9 billion for the quarter and totaled $165.5 billion over six months. Even though the pace of issuance slowed for high yield bonds, borrowing in the leveraged loan market was the heaviest since 2022.

Emerging markets hard currency bonds continued to outperform along with other credit sectors. Unlike EM equities, hard currency bonds held their own even as rates rose in April. In this sector, performance was driven by ongoing improvement in fundamental factors and a favorable shift in fund flows. Investments affected by currency continued to experience outflows. While hard currency bonds had a strong quarter and half year, investors remained apprehensive about the sector given geopolitical risks in major countries like China, Russia, and Israel. Nevertheless, growth prospects for most countries improved. The JPM Emerging Market Bond Index – Global Diversified (EMBIGD), a dollar denominated sovereign index, was up 0.30% for the quarter and 2.34% year-to-date. Similarly, the JPM Corporate Emerging Markets Broad Diversified Index (CEMBI BD) rose 1.49% and 3.85% for the quarter and six months respectively. Meanwhile, the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, had negative performance of -1.63% for the quarter and -3.71% for the six months due primarily to the appreciation of the U.S. dollar.

Economy

Economic data released during the quarter largely reinforced the gradual slowing narrative that gained traction after the first quarter. However, higher than expected inflation disappointed in April and May leading to an increase in interest rates and expectations for delays in rate cuts by the Fed. June data was more benign and messaging from Fed officials suggested the central bank's policy path tilted toward easing with timing still uncertain. The Fed's next meeting is the last week of July.

After more than a year of transition driven by the inflation spike in 2022 and the Fed's unprecedented rate hikes, the economy appears to be settling into a more predictable path. Economists surveyed by the Wall Street Journal forecasted a steady glide to about 1.5% growth for both the third and fourth quarters of 2024. Surprisingly, after 61% of surveyed participants predicted a recession in their April 2023 response, only 28% did so on July 1, 2024. Also, the range of outcomes narrowed considerably compared to prior quarters.

Our review of industries confirmed the messages from the data and economists. In particular, consumer products companies are experiencing softening demand with consumers becoming more value conscious by trading down. While service providers like airlines and hotels continue to report solid bookings, forward-looking demand is softening and price sensitivity increasing. While pandemic engendered labor and capacity constraints have not fully abated, competitive pressure for labor and equipment has eased. Equally, pricing flexibility has lessened, which augers well for the inflation outlook.

Away from the U.S., the Chinese economy appears to be enjoying a resurgence which should offset the U.S.'s moderation in maintaining moderate global growth. Europe also showed signs of life which may be further boosted by the central bank's rate cut in June. Other emerging economies are seeing the benefits of more stimulative policies and a strong U.S. dollar. Geopolitical friction remains an ongoing concern given the apparent intransigence of involved parties and the absence of realistic compromises. For now, financial markets are largely dismissing this risk, although the subject is often mentioned by strategists and policy makers.

Scenarios

We propose three scenarios for the U.S. economy over the next 6 months:

1. Our most likely case has the U.S. economy growing at a steady clip of about 1.5% to 2.0% in 3Q and 4Q. Despite restrictive policy from the Fed, the economy has demonstrated remarkable staying power and a gratifying glide into "soft landing." Momentum from a better-than-expected start in 2024, steady labor markets, and an improving outlook abroad should keep the trajectory going into the second half of the year. Recent and expected inflation readings are giving the Fed clearance to commence rate cuts. With services activity easing and unemployment creeping higher, the Fed will likely reduce rates in September to signal comfort with the economy's state and to avoid tipping it into recession. While consumers and businesses have slowed their outlays, neither is showing signs of stress or excessive leverage. Indicators suggest the economy can sustain the slower, yet positive, rate of growth while inflation declines to the Fed's desired target. PROBABILITY 60%

2. A second scenario has the economy slowing suddenly to a rate of 0.0% to 1.0% at an annual rate during the next six months. In this scenario, the Fed's chooses to delay rates cuts on fears of an inflationary resurgence. The extension of restrictive policy has a more debilitating effect than experienced so far, thrusting the economy into a slower pace of growth. In this scenario, longer-term rates remain elevated, lending becomes more restrictive, and consumers downshift their expenditures further. In addition, businesses curtail investments, and the unemployment rate creeps higher. PROBABILITY 25%

3. A third scenario has the economy expanding at a stronger pace of 2.5% to 3.0% at an annual rate during the next six months. In this scenario, the economy's momentum is boosted by productivity enhancing investments and a resurgence in personal consumption. In this scenario, companies invest further keeping the unemployment rate low and wages elevated. Inflation steadies at a higher rate than desired by the central bank, leading the Fed to delay cuts until December or even 2025. Furthermore, China and Europe achieve better growth which powers the global economy to better performance. PROBABILITY 15%

Market Outlook

The economic outlook remains volatile as better-than-expected economic performance generates investor enthusiasm yet entails higher rates and tighter financial conditions. We believe a lower, although positive, growth rate is a welcome development that can be sustained provided financial conditions do not get too restrictive. The move higher in rates makes fixed income more compelling and an attractive alternative to equities given current valuations. While credit spreads are tight relative to history, creditworthiness remains robust and absolute yields are compelling for diversified, high quality fixed income portfolios. With this in mind, we continue to hold a modest overweight position in credit, including in high yield and emerging markets. However, we are trimming riskier positions and favoring higher quality names that still offer some spread.

July 15, 2024

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Index Definitions

Bloomberg U.S. Aggregate Index
The Bloomberg U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Bloomberg U.S. Treasury Index
This index is the U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg U.S. Government/Credit Index
The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries and agencies. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Bloomberg U.S. Corporate Index
This index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers. (Future Ticker: I02765US)

Bloomberg U.S. Mortgage-Backed Securities Index
This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

ICE BofA U.S. Corporate & Yankees Index
The ICE BofA U.S. Corporate & Yankees Index tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market by US and non-US corporations and non-US quasi-governments.

ICE BofA U.S. Corporate Index
The ICE BofA U.S. Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch) and 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).

ICE BofA U.S. High Yield Index
The ICE BofA U.S. High Yield Index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

ICE BofA Global High Yield Constrained Index
ICE BofA Global High Yield Index tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets and issuer exposure is capped at 2%..

ICE BofA US Emerging Markets Corporate Plus Index (EMUB)
The ICE BofA US Emerging Markets Corporate Plus Index is a subset of The ICE BofA Emerging Markets Corporate Plus Index including all securities denominated in US dollars.

ICE BofA Global Government Excluding the U.S. Index (N0G1)
The ICE BofA Global Government Excluding the U.S. Index tracks the performance of publicly issued investment grade sovereign debt denominated in the issuer's own domestic currency. N0G1 excludes U.S. government bonds.

Emerging Markets Bond Index Global Diversified (EMBI® Global Diversified):
The EMBI Global Diversified is a uniquely-weighted version of the EMBI Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.

JP Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI Broad Diversified)
The CEMBI tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. Two variations are available: CEMBI Broad and CEMBI. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds. The CEMBI Broad Diversified limits the weights of those index countries with larger corporate debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding.

JP Morgan Government Bond Index-Emerging Markets (GBI-EM)
The GBI-EM is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.

S&P 500 Index
An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Nasdaq Composite Index
An index that tracks the change in the total market value of all companies listed on the Nasdaq Stock Market.

Russell 2000 Index
An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small cap stocks in the United States.

MSCI EAFE Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe, Australasia and the Far East.

MSCI Europe Index
The index is a free-float weighted equity index measuring the performance of Europe Developed Markets.

MSCI Japan Index
The index is a free-float weighted equity JPY index.

MSCI Emerging Markets Equity

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.