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An IMA Company

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2024 Mid-Year Capital Markets Forecast

SYNTRINSIC INVESTMENT COMMITTEE

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Executive Summary

The more things change, the more they stay the same. In our last forecast, we discussed election uncertainty, sticky inflation, and geopolitical risk. Six months later, these issues are still with us. While we are not making across the board allocation changes or recommendations, the Syntrinsic Investment Committee has made a few modest changes in near-term sentiment.

- We are upgrading our near-term sentiment on non-U.S. developed market bonds to Neutral from Neutral/Negative, as central banks begin to shift toward more accommodative rate policy.
- We are upgrading our near-term sentiment on hedge fund strategies to Neutral from Neutral/Negative, based on continued higher risk-free rates and uncertainty and volatility. Hedge funds remain absent from our strategic Investment Committee portfolios that serve as a starting point in asset allocation discussions, for reasons including higher fees and dispersion across managers.

Across the other asset classes and market segments, our team maintains the same sentiment as we reported in January's 2024 Capital Markets Forecast. The economy continues to be reasonably robust, driven for now at least by consumer spending and supporting a moderately positive view on U.S. stocks. High yields and the prospect of some rate cuts support U.S. fixed income, with yield being the expected driver of returns for the remainder of 2024.

Geopolitical uncertainty continues outside the U.S., particularly in the Middle East, Ukraine and with China—and here in the U.S., we await a potentially fractious runup to the November elections. As our recent piece, The 2024 U.S. Elections in Perspective, discusses, while volatility tends to rise in the periods right around presidential elections, over the longer run basic economic factors prevail as drivers of return.

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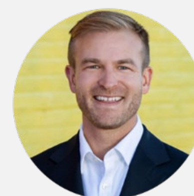

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Through uncertainty, we counsel continuing to manage risks through maintaining a longer-term mindset, sticking to the strategic asset allocation, remaining well diversified among asset classes, generally avoiding making short-term tactical bets, and being fully invested in the markets.

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Near-Term Sentiment Overview

Asset Class/Segment	3Q 2024 Near-Term Sentiment	1Q 2024 Near-Term Sentiment
Global Equities	**Neutral/Positive**	**Neutral/Positive**
US	Neutral/Positive	Neutral/Positive
Non-US Developed	Neutral	Neutral
Emerging Markets	Neutral	Neutral
Global Fixed Income	**Neutral/Positive**	**Neutral/Positive**
Short-Term U.S. Bond	Positive	Positive
Core U.S. Bond	Positive	Positive
Core Plus U.S. Bond	Positive	Positive
Non-US Developed Bond	Neutral	Neutral/Negative
Emerging Markets Bond	Neutral	Neutral
Real Estate	Neutral	Neutral
Commodities	Neutral/Negative	Neutral/Negative
Infrastructure	Neutral/Positive	Neutral/Positive
Hedge Fund Strategies	Neutral	Neutral/Negative
Private Equity	Neutral/Positive	Neutral/Positive
Private Debt	Neutral/Positive	Neutral/Positive

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Mid-Year Themes

In the pages ahead, Syntrinsic's research team has produced four related pieces to contextualize the issues we see materially impacting markets in the months ahead.

Senior Research Analyst Matt Kukla, in "**The Last Mile of Inflation May Prove Tricky**," reminds us that the Federal Reserve's tightening cycle has done a tremendous job in bringing inflation down since its peak in June of 2022. However, the last mile of inflation may prove challenging to bring down as quickly as many would hope, given tight supply and demand in both the labor and housing markets. This could result in rates being higher for longer than the market currently anticipates.

In his piece "**Rates Cuts Wait for Consistent Trend**" Senior Analyst Robin Meyer, CFA, finds that higher interest rates enduring for an extended period is not necessarily a negative development for financial markets. We've seen strong performance from broad risk assets this year and weaker performance from more obvious areas of the market, including those with more explicit interest rate risk. Our expectation for the remainder of 2024 is for the yield component of fixed income exposures to provide the primary source of total returns. And we do not anticipate meaningful changes to credit spreads absent an exogenous market event.

Regarding the U.S. economy as a whole, Research Analyst Eli Davidoff, in his piece "**Slowing Growth and Consumption, Signs of a Cooling Market**," notes that a main topic among market participants, economists, and investment professionals is the likelihood of a mild recession relative to that of a soft landing in the U.S. economy. In this piece we outline economic indicators for both sides that can support either argument, despite our conclusion that there are more indicators hinting at a soft landing.

Lastly, Senior Analyst Matt Kukla and Analyst Aaron Thammathi, in their piece "**Geopolitical Uncertainty Through November and Beyond**," observe that geopolitical risks, both globally and domestically in the U.S., are always present and wax and wane over time creating more or less uncertainty for economies and financial markets. We have been monitoring the geopolitical landscape for some time and although we did not make a mention of it in our 2024 Capital Markets Forecast in January, we believe geopolitical risks, both globally and domestically in the U.S., will increase over the next six months and beyond. The U.S. election in November only adds to the uncertainty on the future direction of U.S. domestic and foreign policy. Yet we counsel investors to maintain a long-term perspective, and stay invested and well-diversified.

We appreciate your confidence, welcome your questions, and look forward to our next conversation.

Sincerely,

Ben Valore-Caplan
Co-President
Syntrinsic

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Global Themes

Theme	Syntrinsic Perspective	Allocation Effects
The Last Mile of Inflation May Prove Tricky	Inflation continues to trend downward toward the Fed's 2% target, although the last mile of inflation may take longer to bring down given tight supply and demand dynamics in both the housing and labor markets.	• Equities are expected to continue to be a return driver, especially U.S. equities with high-quality (earnings, profitability, governance and management) characteristics
Rates Cuts Wait for Consistent Trend	Overall risk-adjusted prospects for the public fixed income asset class remain favorable, with attractive yields in excess of inflation available across most market segments.	• Maintain exposures to both short (good yield/risk tradeoff) and intermediate (broad market) maturities while market yields remain attractive • Timing interest rate changes with duration positioning is challenging
Slowing Growth and Consumption, Signs of a Cooling Market	Economic growth and inflation remain present but decelerating; conflicting signs point on the balance toward a higher likelihood of a soft landing	• Equities, especially U.S. firms with quality characteristics, expected to continue to be a return driver • Maintain modest overweight of U.S. vs. non-U.S. equities relative to world market portfolio
Geopolitical Uncertainty Through November and Beyond	Global and domestic geopolitical risks remain the same but are likely to become more heightened going forward which can lead to increased volatility in the financial markets and favors continuing to mitigate downside risks.	• Maintain long-term perspective; stay invested; avoid significant short-term tactical bets • Ensure broad diversification • Potential support for many hard infrastructure investment opportunities regardless of election outcome

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Theme: The Last Mile of Inflation May Prove Tricky

MATTHEW A. KUKLA

Heading into 2024, we were keenly aware that the key macro-economic factors impacting financial markets would continue to be the interplay between inflation, U.S. Federal Reserve (Fed) policy, and economic growth, along with investors' changing expectations for a "hard" or "soft" landing. Additionally, we were not of the mindset that inflation would dissipate quickly accompanied by six interest rate cuts by the Federal Reserve as the market was initially anticipating earlier in the year. Rather, we felt inflation was rather sticky and would come down over time followed by gradual cuts in interest rates which would allow the economy to achieve a "soft" landing with a "risk-on" sentiment.

Fast forward six months later and our views are largely unchanged, although the last mile of inflation towards the Federal Reserve's 2% target could prove challenging given tight supply and demand dynamics in both the labor and housing markets.

According to the Bureau of Labor Statistics, U.S. inflation as measured by the Consumer Price Index (CPI) continues to trend downward, falling to 3.0% year-over-year (YoY) in June 2024 from its 9.1% peak in June 2022. Still, inflation remains elevated above the Federal Reserve's 2% target, driven primarily by rising rents, or owners' equivalent rent, and strength in consumer spending stemming from real wage gains because of the tight labor market.

When the Federal Reserve tightens monetary policy, the goal is to cause a slowdown in economic growth, causing businesses to lay off workers to reduce costs, leading to an increase in unemployment, which in turn impacts consumer spending while easing inflationary pressures in both a virtuous and vicious cycle. However, this tightening cycle has proved atypical.

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The U.S. economy added 272,000 jobs in May, compared with economists' expectations of 190,000. The unemployment rate has ticked up to 4% due in part to young workers under 25 leaving school and returning to the workforce but remains in a historically low regime. Average hourly earnings increased by 4.1% in May from the year before according to the Bureau of Labor Statistics.

According to the U.S. Chamber of Commerce, there are about 8.5 million job openings in the U.S. but only 6.5 million unemployed workers. Even if every unemployed person in the country found a job, we would still have millions of open jobs and a labor shortage. The structural underpinnings of the labor shortage stem from early retirements and an aging workforce, low net international migration to the U.S despite recent increases, lack of access to childcare, an increase in new business starts, and an increase in savings. While not an exhaustive list, until the structural underpinnings in the labor market are resolved, the labor market is likely to remain tight which will continue to buoy household earnings and consumer spending into year-end absent a recessionary scenario.

Underpinning rising housing prices is a shortage of housing, as not enough homes were built since the 2008 financial crisis to meet demand coming from Millennials reaching their household formation years. Exacerbating this upward pressure in home prices is the Federal Reserve's tightening cycle which has caused 30-year fixed mortgage rates to increase above 7%. The increase in mortgage rates has created a chicken and egg problem. Many homebuyers locked in low interest rates during the Covid-19 pandemic. As a result, the combination of higher home prices and higher mortgage rates would increase a home seller's mortgage payment for their next home purchase in this market environment.

So, sellers are sitting on the sidelines until rates come down, leading to very thin inventories which is further increasing home prices and pricing prospective homebuyers out of the market although pent up demand remains. Additionally, construction of new homes is not enough to increase the supply of homes on the market to bring home prices down. With mortgage rates at these levels, inventories are likely to remain thin and the housing dynamics will likely persist into year-end as well.

The Federal Reserve's tightening cycle has done a tremendous job in bringing inflation down since its peak in June of 2022. However, the last mile of inflation may prove tricky to bring down quickly as many would hope given tight supply and demand in both the labor and housing markets. This could result in rates being higher for longer than the market currently anticipates.

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Theme: Rates Cuts Wait for Consistent Trend

ROBIN MEYER, CFA

Entering the second half of 2024, we reconcile the glaring difference between forward expectations for U.S. interest rates now vs. where expectations stood on January 1st. As mentioned earlier in this Update, to start the year market participants had priced in six cuts of 0.25% each to the federal funds rate to take place during 2024. The dovish tone coming out of the Fed's December 2023 Federal Open Markets Committee (FOMC) meeting buoyed optimism for swift policy normalization to take place this year.

In practice, what the U.S. economy has experienced since the start of the year has been more or less inconclusive data, most specifically non-trending data. Of particular note was March 2024's inflation data, which saw an uptick in inflationary pressures in excess of market expectations and a swift revision to forward interest rate projections.

As addressed above in our Inflation theme, the Fed has made strong progress toward its inflation policy goal, but Federal Reserve Chair Powell is far from declaring any sort of policy victory. FOMC members have reinforced through recent public comments that the Fed wants to see inflation data moving "sustainably"[1] toward its 2% policy goal. This and other abstract language FOMC members continue to employ, we believe, gives the Fed time to wait on policy rate action.

Also supporting the Fed's lack of urgency has been the performance of the U.S. economy from the gross domestic product (GDP), labor market and corporate earnings perspectives, among other data. As detailed elsewhere, several measures of economic data suggest a relatively healthy U.S. economy grinds forward. As we've noted since the onset of the current monetary tightening cycle, the Fed's interest rate hikes have been very well absorbed by market participants. As a reminder, the last action the Fed took on its policy rate was an increase in July of 2023, to reach the current level of 5.25-5.5%. Despite nearing a year with rates at current levels, no major cracks in the U.S. economy have yet visibly developed.

Our current opinion is that higher interest rates enduring for an extended period is not necessarily a negative development for financial markets. We've seen strong performance from broad risk assets this year and weaker performance from more obvious areas of the market, including those with more explicit interest rate risk.

As it stands in mid-June, markets are pricing in roughly two 0.25% interest rate cuts to occur during the remainder of 2024 while the Fed's updated June Summary of Economic Projections1 (often called the "dot plot" of interest rates) indicates median expectations for a single 0.25% interest rate cut to occur through the remainder of the year. We continue to take Federal Reserve Chair Jerome Powell at his word regarding the Fed's ongoing data-dependency when thinking about policy decisions over the remainder of the year.

[1] https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20240612.pdf

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Fed Balance Sheet Update

Detailed in May and implemented as of June 1, 2024, Fed Chair Powell provided an update to the Fed's balance sheet normalization, a process through which the Fed has begun reducing its holdings of U.S. government debt.

The mechanism here is mostly passive: as bonds mature monthly, the total amount of government debt held is reduced. $60 billion of US Treasuries and $35 billion of U.S. agency mortgage-backed securities (MBS) had been removed from the Fed's balance sheet every month, or more than $1 trillion per year in reductions.

The June 2024 update has been to reduce the U.S. Treasury component of the process, adjusting the monthly redemption cap from $60 billion to just $25 billion. The intention here is to lighten the footprint of ongoing policy tightening. Due to the relatively small tweak in policy pace, we don't believe these changes will hold meaningful implications for fixed income markets.

Bond Market Sentiment

The overall risk-adjusted prospects for the public fixed income asset class remain favorable and the ability to earn fixed-rate yields in excess of inflation reinforces the role bonds serve as an important component of diversified portfolios. Year-to-date, intermediate and longer-duration bond fund exposures have largely underwhelmed, primarily as interest rate risk resurfaced in the spring.

The logic still holds that extending portfolio duration in advance of rate reductions could lead to strong capital appreciation from bonds. However, the first half of 2024 has shown us that duration's sensitivity to interest rate risk can deliver unintended results if rates don't move the direction you predict.

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Our expectation for the remainder of 2024 is for the yield component of fixed income exposures to provide the primary source of total returns. And we do not anticipate meaningful changes to credit spreads absent an exogenous market event. With credit spreads currently near historic lows, however, we acknowledge a greater likelihood for spreads to widen rather than tighten from these levels.

We carry a similar disposition on the federal funds rate, as we believe in a much greater likelihood the Fed begins to ease policy than to further restrict at these levels. We continue to expect above-average bond market volatility as each passing economic data point is digested primarily in terms of whether it strengthens or weakens the case for a near-term interest rate cut. Ongoing geopolitical risks as well as a looming US election give further support to a potentially more volatile second half of 2024.

From a global perspective, we have seen important central banks embrace or begin steps toward monetary easing during recent weeks and months as evidenced by the June actions of each the Bank of Canada[2], Swiss National Bank[3] and ECB[4]. The prospect of easing policy is favorable from a bond investor perspective, and it is from this vantage point we are upgrading our sentiment on non-US developed bond markets to **Neutral**.

Opportunities exist in the differentiated timing of global monetary policies as they play out going forward. While US market participants wait patiently for local cuts from the Fed, bonds issued by non-US governments or corporations may benefit from the actions of central banks beyond our shores.

All the while, US government and corporate bond markets remain the strongest in terms of volume and breadth. Further, the higher absolute level of US treasury bond yields relative to most G-10 peers reinforces our favoring of US bond exposures. In current allocations we give discretion to certain active managers to pursue non-US opportunities within their mandates. We continue to prefer this means of implementing non-US bond exposures but will continue to be mindful of compelling dedicated non-US bond managers as we uncover them in our research.

Theme: Slowing Growth and Consumption, Signs of a Cooling Market

ELI DAVIDOFF

A main topic among market participants, economists, and investment professionals is the likelihood of a U.S. recession relative to that of a "soft landing"—in which the Fed successfully brings inflation down without a recession—in the U.S. economy. In this piece we outline economic indicators for both sides that can support either argument, despite our conclusion that there are more indicators hinting at a soft landing.

Consumer attitudes have been rising in the U.S., with the University of Michigan Consumer Sentiment Index at 77.2 in April, compared with its 50.0 low in June 2022. But sentiment remains well below its recent high reached in February 2020, which represented a post-2008 financial crisis peak.

The unemployment rate has ticked up to 3.9%, but remains in a low regime—a tight labor market by this measure, which can incentivize corporations to offer higher pay in hopes of catching the smaller pool of unemployed workers seeking opportunities. At the same time, job openings declined materially to 8.06 million in April, compared with 8.36 million in March.

[2] https://www.bankofcanada.ca/2024/06/fad-press-release-2024-06-05/
[3] https://www.snb.ch/en/publications/communication/press-releases-restricted/pre_20240620
[4] https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.mp240606~2148ecdb3c.en.html

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The number of job openings per unemployed person fell to 1.24 in April, which is the lowest since June 2021. For frame of reference, the index dropped significantly from its level pre-pandemic (1.24) all the way down to 0.20 in April of 2020, then climbed back up to a high of 2.03 in the beginning of 2022. In the JOLTS number hitting its pre-pandemic level, this is a sign that the labor market is cooling after its post-pandemic heat.

Job openings in most business sectors that were the most affected by the pandemic have seen steady declines, such as the health care sector (-193,000), accommodation and food services (-116,000). This paints a picture of normalization of the economy that would be supportive of interest rate cuts.

Corporate profits showed improvements in the financial sector in the first quarter of 2024. Profits of domestic financial corporations increased by $73.7 billion, compared with a much smaller $5.9 billion in the fourth quarter of last year. Corporate profits from non-financial domestic corporations, however, tell a different story, with their profits decreasing by $114.1 billion in the first quarter of 2024, compared with an increase of $136.5 billion in the fourth quarter of 2023.

This points to another indicator of a possible soft landing, as evidence suggests that firms tend to raise prices anticipating future inflation and higher input costs, seeing profitability rise, only to fall later in the face of rising costs and potentially weakening consumer demand.

Across the U.S, the percentage of debt in delinquency has increased, partly attributed to the return to more normal levels seen pre-pandemic, which were decreased due to temporary assistance programs that the government put in place to feed money into a struggling economy. However, current delinquency rates exceed those seen pre-pandemic, which may point to an indicator of a possible mild recession.

Taking in all of the sentiment of the fiscal and monetary policy enacted following the start of the pandemic, the rise in delinquency rates can be seen to represent a squeeze on consumers due to the higher interest rates that have been sustained to knock down inflation to its 2% target.

As discussed above, inflation is still well above its 2% target, trending at 3.3% with the Bureau of labor statistics report coming out for May. Although this is far from its 9.9% June 2022 high, the last mile of inflation, as mentioned in the above section, is still proving to be more challenging.

Lastly, there is evidence of yield curve inversions (short-term rates higher than longer-term, or a downward-sloping yield curve when it is normally upward-sloping) preceding recessions in the economy, having predicted nearly every recession since 1955. The current inversion of the yield curve began in July of 2022 and is the longest on record. Though the level of inversion (as measured by the 10-year Treasury yield minus the 3-month) has increased modestly in recent months, it is less than its greatest point in June 2023 and its recent local peak at the end of last year—a potentially good sign.

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Theme: Geopolitical Uncertainty Through November and Beyond

MATTHEW A. KUKLA AND AARON THAMMATHI

Geopolitical risks, both globally and domestically in the U.S., are always present and wax and wane over time creating more or less uncertainty for economies and financial markets. We have been monitoring the geopolitical landscape for some time and although we did not make a mention of it in our 2024 Capital Markets Forecast in January, we believe geopolitical risks, both globally and domestically in the U.S., will increase over the next six months and beyond. The U.S. election in November only adds to the uncertainty on the future direction of U.S. domestic and foreign policy.

Global tensions are on the rise between democratic and autocratic governments which have created fractures in the global order. Alliances between countries to reduce supply chain risks, or "friendshoring", have led to deglobalization efforts, including implementing policies that are more protectionist in nature such as sanctions, tariffs, and trade restrictions to protect national security interests.

On February 24, 2022, Russia invaded Ukraine. However, the antipathy between Russia and Ukraine goes further than the 2022 invasion. Going back to its incorporation into the Russian Empire, Ukraine has never truly been accepted as a distinct national identity by Russia. While the outcome of this war of attrition is uncertain, with Kyiv continuing to reject Russia's ultimatums to not join NATO in return for a cease-fire, the likely winner will be the country that has more resources to continue the war until its ultimate resolution.

The Middle East has been a volatile region of the world since the mid-20th century. Israel fought four major wars between 1948 and 1973 with its Arab neighbors. In the 21st century, the most consistent threat to Israel has been the Hezbollah, Hamas, and Houthi militias. The October 7, 2024, Hamas terrorist attacks on Israel and subsequent war in Gaza has created a complex security crisis that threatens to engulf the entire region with both sides facing international condemnation for civilian casualties.

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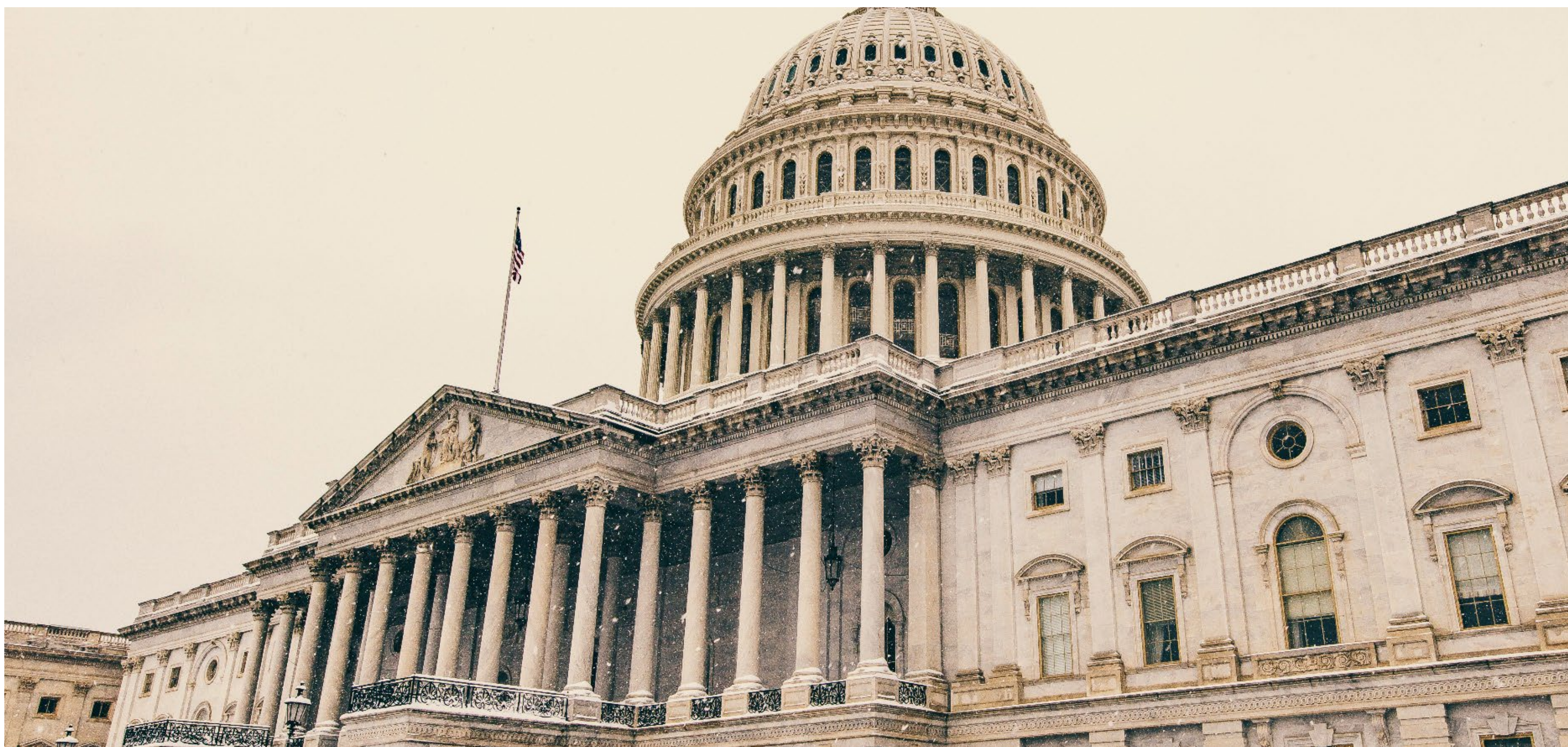
Tensions continue to ratchet up between the United States and China and are unlikely to abate anytime soon. China has emerged as one of the only global powers to challenge the international order created by the United States after World War II. Spats continue regarding differences in ideology, Taiwan's claim of independence, and territorial claims in the South China Sea. Additionally, the two countries have been in a prolonged trade war that has led to a Cold War mentality in the race for technological advancement particularly for advanced semiconductor chips. As both countries continue to vie for power and shape the global order, frictions are likely to persist.

While tension prevails internationally, there is uncertainty in the U.S. as well. There is concern regarding the United States debt levels which currently stand at $34 trillion and growing. And the potential impact of the 2024 U.S. elections on financial markets is on investors' mind. According to Gallup, the top concern among voters in 2024 is the economy, including inflation. Other top priorities include immigration policy and – somewhat concerningly – lack of trust in the government and accompanying institutions.

The uncertainty surrounding important issues and the impact on policies has led to increased volatility in the financial markets and has impacted investor sentiment, though in line with other market events. Despite the uncertainty—including that driven by Donald Trump's recent conviction on 34 counts of falsifying business records, and debate regarding Joe Biden's candidacy—historical data suggests that elections themselves have had muted impact on markets. What truly matters are fundamental factors such as growth, inflation, interest rates, and corporate earnings.

For those concerned about rising geopolitical risks and presidential elections, we counsel continuing to manage risks through maintaining a longer-term mindset, sticking to the strategic asset allocation, remaining well diversified among asset classes, generally avoiding making short-term tactical bets, and being fully invested in the markets. Our June 2024 write-up, The 2024 U.S. Elections in Perspective, provides more insight on the impact of elections on markets.



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