BTC CAPITAL MANAGEMENT™

INVESTMENT INSIGHT

Second Quarter | 2024

ECONOMIC & MARKET OVERVIEW

Contributed by | Jon Augustine, CFA, Chief Investment Officer

Mid-year Outlook

The United States economy has moved into a phase that can be described as "bending, but not breaking." With first quarter real Gross Domestic Product (GDP) registering a growth rate of 1.4%, the second quarter is forecast to accelerate to 2% before moderating to 1.6% for both the third and fourth quarters. Hence, the use of the "bending, but not breaking" descriptor. Another apt descriptor would be "weakening, but not weak." The resulting outlook described by this phraseology indicates a recession continues to be a relatively remote development which is not anticipated at this time. To highlight this viewpoint the survey of economists conducted regularly by Bloomberg shows a current probability of recession over the next 12 months of only 30%.

Our economic outlook continues to focus intently on two crucial variables: inflation and employment. Over the past year, we have consistently stated that a recession was not a high probability event due in large part to the ongoing strength in the labor market. When jobs are plentiful and wages are growing, it is difficult to see how a recession evolves in an economy where approximately 70% of its growth is attributed to consumer spending. While we have seen some weakening on the labor front, it still cannot be defined as weak. The unemployment rate has just recently risen above 4%, and job openings, as measured by the Job Openings and Labor Turnover Survey (JOLTS), have materially declined from the high point in March 2022 when JOLTS registered 12 million job openings versus its latest reading of just over eight million. The current level, while meaningfully below its recent high, is materially above its pre-pandemic level. Also, initial claims for unemployment have been trending higher but are in line with the levels seen a year ago at this time.

On the inflation front we have seen tremendous progress made as inflation has decelerated significantly as evidenced by the decline in the Consumer Price Index (CPI) from its year-over-year (YOY) high level of 9.1% in June 2022 to the most recent reading of 3.3%. As we have stated numerous times over the past several months, there will continue to be resistance to further declines, but we anticipate they will occur. The longer-term outlook for inflation via the Federal Reserve Bank of St. Louis' 5-Year, 5-Year Forward Inflation Expectation Rate measure points to modest future readings as it currently indicates a five-year average rate of inflation of 2.32% for the period starting five years from today.

> Our base case scenario at this time is that the employment picture will see moderation in its strength and that inflation will continue to recede.

Realization of this scenario would likely result in a Federal Reserve that could start the process of reducing the Fed Funds rate prior to year-end. Financial markets concur with this outlook as they are currently assigning a probability of 70% for an initial cut to occur in September. They also project a second cut that will occur in December.

There are several factors that could materially impact our current outlook. If the labor market begins to weaken more quickly than currently anticipated the probability of recession would meaningfully increase. If this scenario were to occur, a potential by-product could be a Fed that could decide to begin lowering rates more quickly than currently anticipated. Also, there are the ever-present geopolitical risks and in this presidential election year a heightened level of political risk.

Asset Allocation Overview

Equities continued their move higher in the second quarter as the Russell 1000 Index of domestic stocks returned 3.6% for the period. The Standard & Poor's 500 Index, a somewhat narrower barometer of United States equity market performance, returned an even higher 4.3%. International equities also moved higher with the MSCI ACWI ex USA Index offering a more modest result of 1.1%. On the fixed income front, quarterly returns were essentially flat with major indices registering results that were slightly above zero. Another asset class that deserves mention regarding performance is cash, or more specifically, cash equivalents. Money market funds that invest in cash equivalent vehicles, continue to have numerous offerings yielding 5% or more. Given the positive returns from equities, bonds and cash equivalents, all seven of our strategic asset allocation benchmarks also recorded positive results for the quarter.

For each of our seven investment objectives we maintained our neutral asset allocation positioning relative to their respective strategic benchmarks. Our Asset Allocation Committee continues to meet regularly and evaluate potential alterations to our various objective allocations, as well as alternative asset classes. To date, we have not developed sufficient conviction on either of these fronts to commit to a meaningful move away from our neutral stance.

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Returns generated by large cap domestic equities have provided continued support for the maintenance of our neutral positioning as it continues to be the dominant asset class in return generation in terms of both near-term and long-term time periods.

Our commitment to our current fixed income allocations has been reviewed thoroughly and given the potential for the Fed to cut short-term interest rates prior to year-end has led us to maintain our positioning. While international equities have appeal on a valuation basis, the growth anticipated from this market segment continues to lag that of the United States.

As stated earlier, we continue to monitor the economy and financial markets in our ongoing evaluation of our current positioning, as well as potential opportunities by changes to that positioning in the form of a change to our current asset class allocations or the introduction of alternative asset classes.

In closing, we encourage investors to conduct an evaluation of their own regarding their current investment objective to determine if it still reflects their goals, time horizon and level of risk tolerance.

FIXED INCOME COMMENTARY

Contributed by | Justin Carley, CFA, FLMI, Managing Director

Waiting for the Window to Cut Interest Rates

Core bonds ended the second quarter unchanged and are down 0.7% year-to-date. Corporate bonds barely outperformed Treasuries in the quarter but given a strong first quarter are up 116 basis points year-to-date. Mortgage-backed securities (MBS) slightly underperformed Treasuries in the quarter and have underperformed by 57 basis points in the first two quarters. However, things may be shifting as mortgage-backed securities outperformed corporate bonds by more than 65 basis points in June.

The 10-year Treasury ended the quarter at 4.40%, which is almost exactly in the middle of the one-year range of 3.75% to 4.99%. Potential Federal Open Market Committee (FOMC) rate cuts have been the headline story on many days over the last quarter, but so far, the market continues to push out the starting point. Bonds appear to be in a big trading range until we get more decisive action on a Fed policy path. This has become increasingly more difficult as the Fed becomes too focused on reacting to near-term economic data.

> Fed Chair Powell made it clear they are not thinking about raising interest rates, even if inflation data starts to pick up.

The FOMC believe they are restrictive and that inflation will come down over time. Members again increased their inflation forecasts for 2024 and 2025 in the June dot plot, while simultaneously forecasting a lower Fed Funds target. The FOMC now sees inflation returning to 2% in 2026, which would be a full five years since it became a problem. The CPI is now a cumulative 13% above where it would be if the 2009-2019 CPI trend were maintained. The Fed rhetoric has also sounded more dovish in the sense that their reaction function to weaker growth or rising unemployment is to cut quickly at any sign of weakness. We haven't had such weakness, so they are maintaining a hold posture.

Portfolio Positioning

It is becoming more likely that policy is not restrictive given that nominal GDP continues to come in the 6% range and yet the 10-year Treasury is only 4.5%. Neither the Fed Funds rate nor the key Treasury benchmark has been above nominal GDP for a sustained period. Historically, this is what has been needed to slow the economy unless the deficit was shrinking in a significant way. The wealth effect is also being under appreciated this cycle.

The Fed will likely get a chance to cut rates this year on a growth scare or equity market drawdown. The Citigroup Economic Surprise Index is at -30, its lowest level in two years. An interest rate cut is likely to ease financial conditions via bond and equity prices moving higher which has had direct feedback into economic growth two to three quarters forward over the last four years. If the Fed were to cut into only a modest growth slowdown, we could very well see some version of the 1970s repeat.

The portfolios are neutral on duration to slightly underweight. There is a potential that 10-year Treasury rates could fall 50-100 basis points as an interest rate cut becomes a green light.

> It would be at this point that a more pronounced duration underweight would offer a better risk/reward as easing financial conditions feedback into improving growth and inflation.

The portfolios are at near their minimum credit exposure, which is around the neutral level versus the benchmark. During the quarter, we have moved MBS in its largest overweight in at least five years. MBS spreads versus corporates remain attractive.

EQUITY COMMENTARY

Contributed by | Mark Mandziara, Senior Managing Director

Quarter In Review

Global equity markets continued to be led by the United States during the second quarter. Domestic equities, measured by the Russell 3000 Index, rose 3.2%. This was driven exclusively by Growth, which fully offset the downturn in Value (+7.8% versus -2.3%, respectively). Large cap continued its dominance over small cap, with the Russell 1000 Index advancing 3.6% versus a decline of 3.3% in the Russell 2000 Index.

Foreign equities rose as the MSCI All-Country World Index ex-USA (ACWI ex-USA) advanced 1% during the quarter. Somewhat different from the United States is that Value outperformed Growth, 1.3% versus 0.7% respectively. Foreign developed markets, measured by MSCI EAFE, exhibited a modest decline of 0.1% while the MSCI Emerging Markets Index surged 5%, fueled by China and India, and rose 7.1% and 10.21% respectively.

Year-to-date, the United States continues its lead as the Russell 3000 Index has advanced 13.6% which is double the return of 5.7% exhibited by ACWI ex-USA. The question remains; will the United States continue its leadership over the second half of 2024?

"Factoring" In Performance

Within the investment industry, a "factor" is a specific identifiable driver of return. According to MSCI Inc., during the second quarter the best performing factor within the United States was Quality (e.g., companies exhibiting high return on equity, stable year-over-year (YOY) earnings growth and low financial leverage) which returned 5.4%. Historically, Quality has been the best performing factor.

Our equity strategy parameters incorporate this factor, expressed as the ability of a company to sustain or enhance revenues, margins and earnings relative to peers.

> We believe that a company's future capacity for earnings influences its valuation, thus expected return.

According to the London Stock Exchange Group (LSEG), for the third quarter analysts estimate YOY growth in earnings per share (EPS) of 8.6% for the S&P 500 Index. Analysts currently project YOY EPS growth greater than the benchmark rate within four of 11 sectors (Health Care +17%, Information Technology +15.4%, Communication Services +11.8% and Industrials 10.4%). Recently, Growth in EPS has been clustered in technology oriented industries, specifically within Information Technology (the largest sector within the Index) and Communication Services.

For the Russell 2000 Index, analysts are more optimistic estimating EPS growth of 35.3%. Sectors exhibiting outsized estimated YOY EPS growth include Communication Services +130.6%, Health Care +33.7%, Industrials +26.4% (the largest sector), Information Technology +23.1% and Consumer Staples +20.7%.

Valuation is also a key "front of mind" concept for our firm. According to FactSet, the S&P 500 Index currently trades at a price-to-earnings (P/E) ratio of 26.4x trailing 12-month EPS (TTM) versus a 10-year historical average of 18x. When looking over the next 12 months (NTM), its projected P/E NTM is 21.1x versus a historical average of 16x. While the current valuation of United States large caps may seem inflated, estimated EPS growth appears sustainable within this asset class. Given the estimated EPS growth for this index, its price-to-earnings growth (PEG) ratio stands at 1.6.

United States small caps exhibit a differing mix of both EPS growth and valuation. Via FactSet, the P/E TTM for the Russell 2000 Index is 16.1x with a P/E NTM of 15.6x. Given its estimated EPS growth, this Index bears a PEG ratio of 1.2.

Outlook

Our fourth tenet is to "Practice Risk-Aware Portfolio Construction".

> While we remain cautiously optimistic concerning equities overall, the current market has priced in a "Goldilocks" scenario where inflation continues to cool, companies report growth in earnings accompanied by positive guidance and the economy continues its expansion.

With that being said, risks are on the horizon. In addition to the risks Jon highlights in our *Economic and Market Overview*, any disappointment in earnings reports, corporate guidance and/or a scenario where interest rates remain higher for longer may create potential headwinds.

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