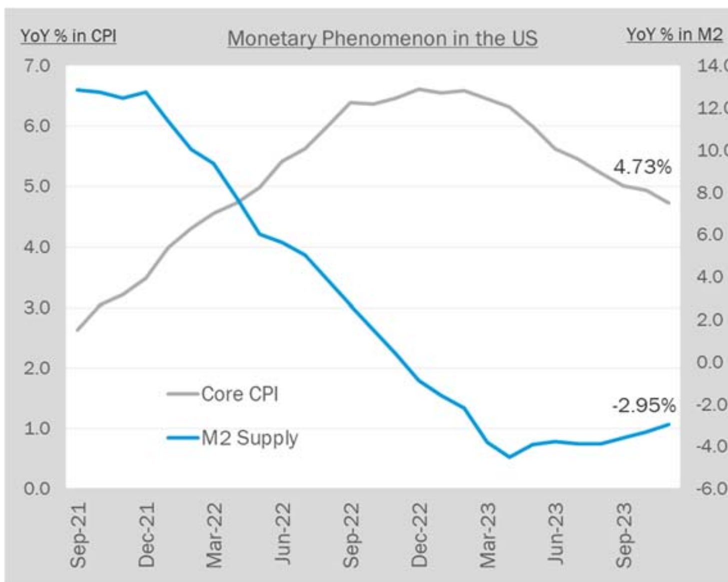
Canterbury Outsourced CIO

Fourth Quarter 2023 Commentary

Overview

The consistent decline in inflation reading and Jerome Powell's recent indication that the Federal Reserve may consider cutting rates in 2024 have led to an increased sentiment that the economic slowdown anticipated in the U.S. in 2024 may be a "soft landing" rather than a true economic recession.

The restrictive monetary policies of the Federal Reserve over the last two years have helped taper the year-over-year growth in the supply of money (M2) in the economy. With a lag, we have seen year-over-year inflation come down to 4.7% at the end of November 2023. While not at the target 2% inflation rate, Powell indicated that the Central bank was aware of the risk of keeping rates at restrictive levels for too long. Given the dynamics of rising rates over the last two years, we have noticed a convergence in yield across equity and fixed-income instruments. Income-generating instruments, from REITs to corporate bonds, compete with cash equivalent yields. When clients meet near-term liquidity needs, it is easier to raise the cash in anticipation of the cash need even a few months out, as they are paid to hold cash and not take market risks.



Convergence of Yields

	Dec-23
S&P 500 Forward Earnings Yield (E/P)	5.13%
FTSE NAREIT All-Equity REITs	3.92%
3-month Treasury	5.40%
10-year Treasury Yield	3.88%
Investment Grade Corporate Bond Yield	5.06%
HY Bond Yield	7.59%

Figure 1 & 2. Source: Federal Reserve of St. Louis, Bloomberg, Standard & Poor's. CPI and M2 Data through Nov 30, 2023

Despite concerns over higher borrowing costs, higher input costs, and restrictive U.S. fiscal policies, the U.S. economy grew at an impressive rate of 4.9% in the third quarter of 2023 while inflation continued to trend lower. Consumers have remained resilient, supported by a tight labor market, but delinquencies have picked up for credit card and auto loans. Corporations that secured long-term fixed-rate borrowing before 2022 fared well, but areas such as commercial real estate, which rely on floating-rate borrowing costs, have seen their net operating income decline as short rates increase.

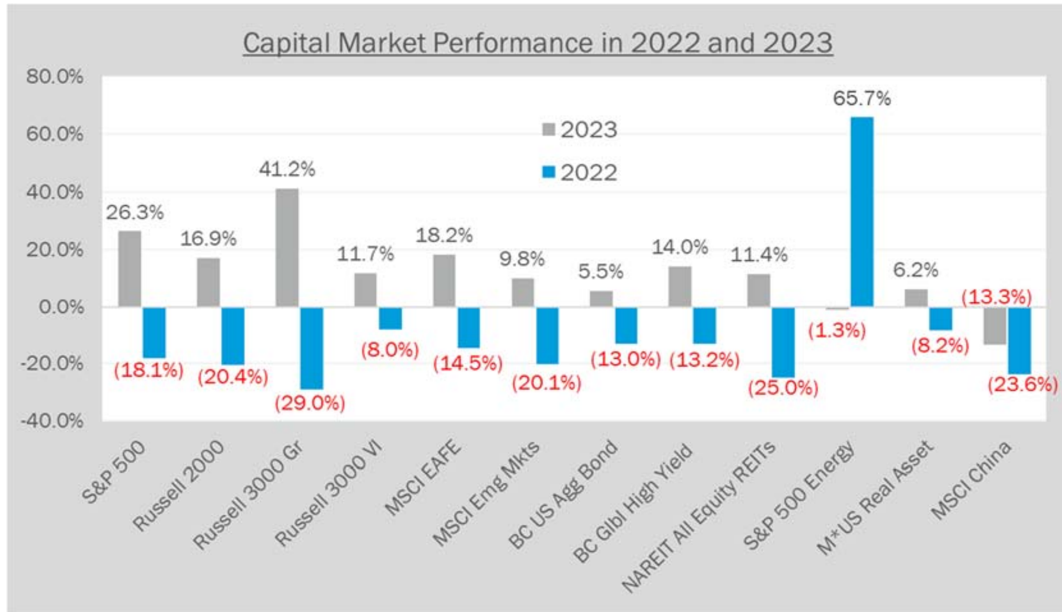


Figure 3. Source: MSCI, Standard & Poor's, Barclays Capital, Morningstar, FTSE Russell & Co.

The major Global equity and fixed-income markets recouped much of the losses they incurred in 2022, with some exceptions, notably China. Much of the gains came through in the second half of 2023. This may be in anticipation of falling rates in 2024, which will likely happen in tandem with an economic slowdown. As we explain further in this letter, there is considerable dispersion in performance across the underlying constituents within each market.

While near-term performance is always hard to predict, the volatility will likely remain high in both equity and fixed-income markets.

Equities

U.S. equity markets outperformed their non-U.S. counterparts for the year with the broad market indices led by a narrow group of stocks. The impressive gain of 26.3% for the S&P 500 was largely attributable to the "Magnificent Seven" stocks that comprise over 21% of the index weight. Over 72% of the index's constituents underperformed the overall return of the market-cap-weighted S&P 500 index.

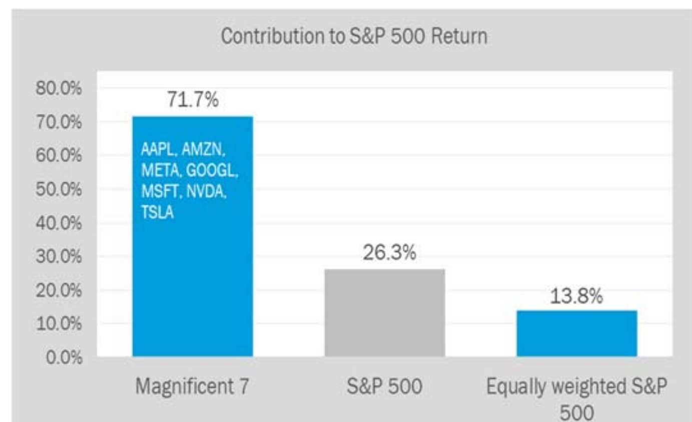


Figure 4. Source: Standard & Poors

Much of the one-year return for 2023 was attributable to the fourth quarter. During the quarter, the equity market performance broadened, with the small-cap Russell 2000 index outperforming the Russell 1000 with a return of 14.0% vs 12%. A steady decline in the U.S. Dollar relative to other currencies during the fourth quarter also helped boost non-US equity returns. The MSCI ACWI ex-U.S. index was up 5.4% in local currency but up 9.8% in U.S. Dollars. A strong quarter for MSCI Emerging Markets equities, up 7.9%, helped bring the one-year return to 9.8%.

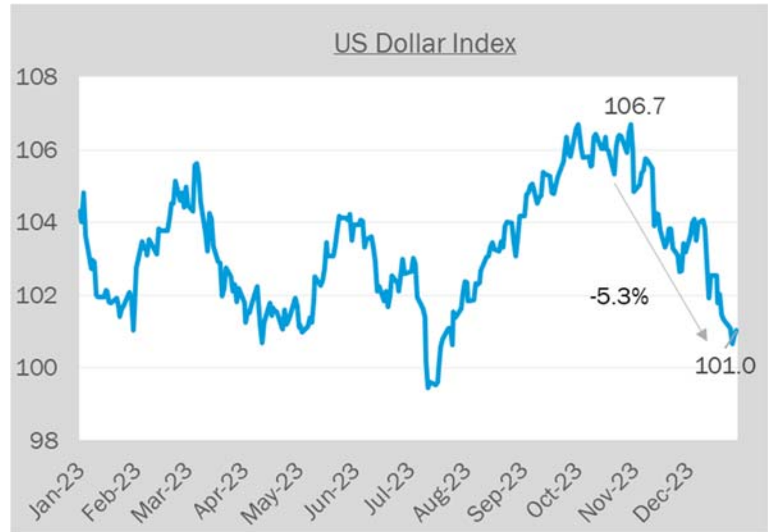


Figure 5. Source: investing.com

We have dedicated Emerging Markets exposure in the portfolio but have taken out the exposure to dedicated Asian developing economies. While we do not look to be tactical with regional or style exposures, we have been vigilant about capital flows in various segments of the market. Where a large outflow of capital begins to create business risk for the asset management firm, we have been prompt to get out before there are organizational or liquidity issues at the manager or fund.

Fixed Income

Where we often associate higher volatility with equity-oriented strategies, the last two years have demonstrated the possibility of interest rate volatility to far exceed that of equity markets. In 2023, the VIX index, representing the volatility of the global equity markets, was fairly low relative to the Merrill Lynch Option Volatility Estimate (MOVE) index, which reflects the swings in the bond markets.

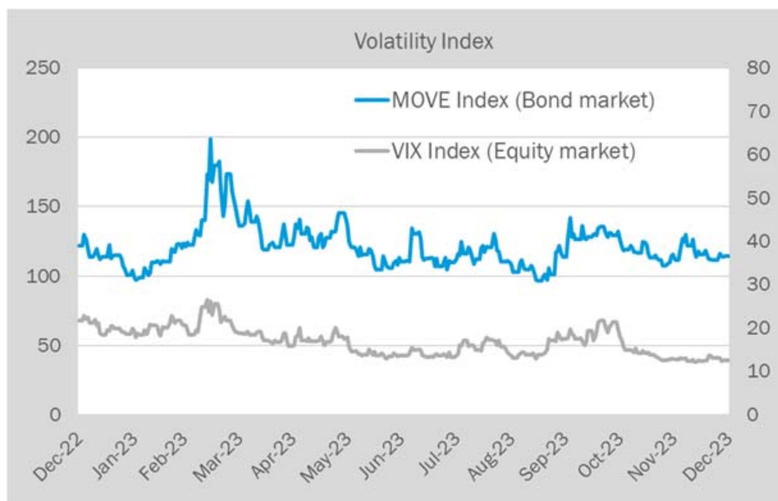


Figure 6. Source: Bloomberg

U.S. 10-year Treasury bonds began 2023 with a yield of 3.88% and ended the year at the same place, but went as low as 3.4% in February and as high as 5% in October before rallying to 3.88% at the end of the year. This translated to a 12.2% gain for the quarter for long-duration bonds. The BC U.S. Aggregate index was up 6.7% for the fourth quarter and ended the year with a gain of 5.5%. The end-of-year bond market rally was partly in anticipation of lower rates next year, but should the size of the drop and frequency be less than anticipated and given tight spreads, caution is still warranted even in the fixed income space.

We shifted the constitution of our fixed income segment during the second quarter, allocating 70% of the segment to core fixed income. Duration was lengthened, and we could benefit from the increased yield from intermediate investment-grade bonds. Where clients are not able to allocate to private credit, we continue to hold public high-yield bonds to take advantage of the higher yields.

Real Assets

Lower energy prices contributed to the falling rate of inflation in 2023, which was a negative for Real Assets. Despite geopolitical risks, supply chains opened up further, bringing down transportation costs. Where Treasury rates were a headwind for most of 2022 and early 2023, they became a strong tailwind during the fourth quarter. The Morningstar U.S. Real Asset index, which includes a weighting of 40% to U.S. Treasuries, was up 6% during the fourth quarter, largely because Treasury rates came down, causing the bonds to price at higher levels.

This segment of the portfolio consists of a diversified basket of securities backed by hard assets or an inflation-protected stream of income, such as TIPs.

The rapid change in inflation caused primarily by pandemic-related supply shock and the follow-on rapid rise in rates created an interesting dynamic across equity and fixed-income securities. If interest rates and inflation stabilize at levels that are higher than what we experienced in the quantitative easing era, there will likely be a different, longer-term, positive inflation trend, which would benefit real asset-related investments.

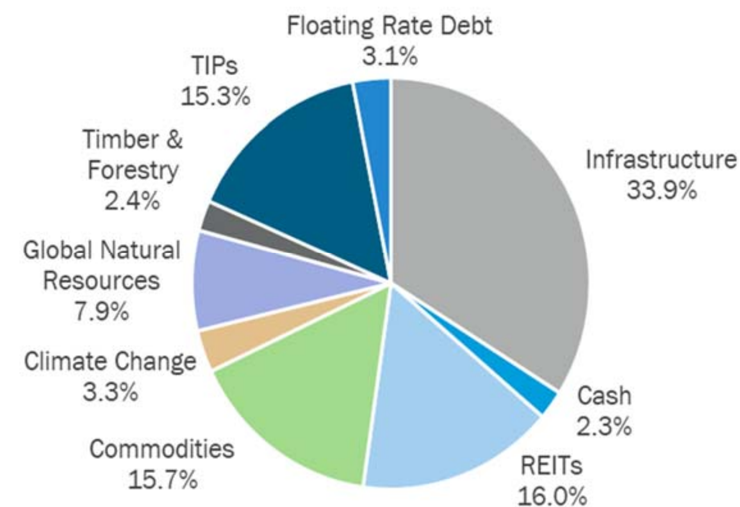


Figure 7. Source: Principal

Marketable Alternatives/ Opportunistic Strategies

Hedge funds have had tremendous challenges attracting capital as trending equity markets and low-interest rates reduced investment opportunities and made hedging expensive. Cash yield and broader market performance will be helpful for both credit and equity-oriented strategies. The markets have shifted significantly in the area of private lending.

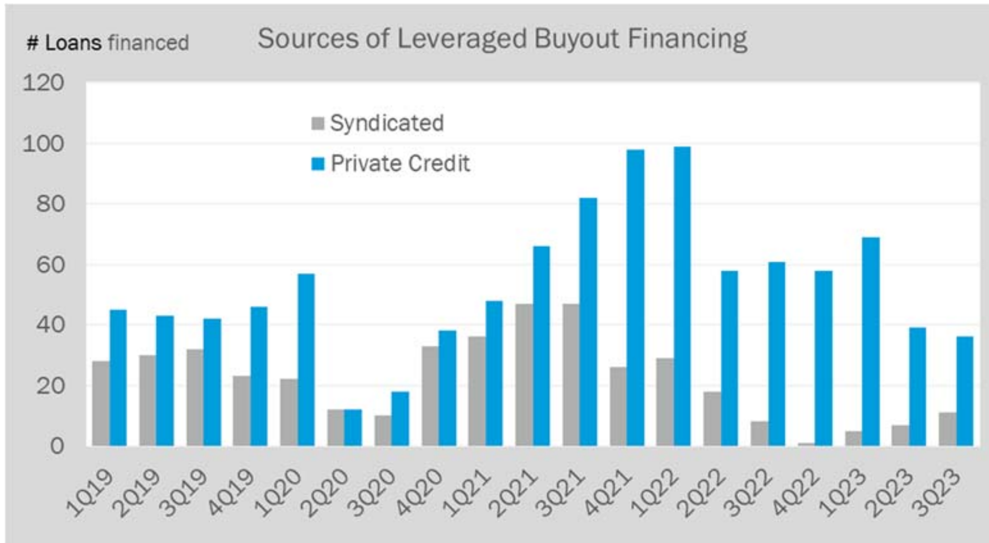


Figure 8. Source: Prequin, Data thru Sept 30, 2023

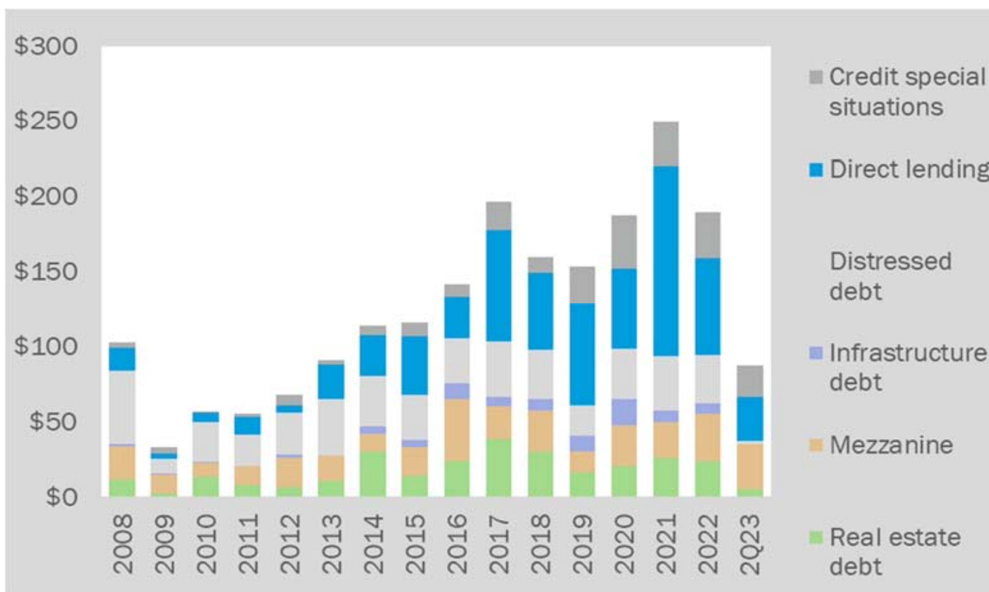


Figure 9. Source: Prequin, Data thru June 30, 2023

More and more private equity deals are being financed through private credit instead of syndicated public high-yield bonds or leveraged loans. Private Equity sponsors can complete the debt financing efficiently when completed in the private market, and they can negotiate terms that provide flexibility as the deal progresses. Among private debt funds raised, we have seen a larger portion of the capital being raised for direct lending. Our focus has been on direct lending funds that target financially healthy middle-market companies backed by experienced private equity firms. These funds target low double-digit returns, use moderate leverage, and have a growing market opportunity to deploy capital. As the debt is not traded publicly, it does not have the mark-to-market volatility of publicly syndicated fixed income. We have been cautious about the amount of leverage used in these funds as well as the debt multiples in the underlying companies. As most loans are floating-rate loans, we have also closely monitored the managers' assessment of the underlying companies' ability to service higher interest payments.

Private Equity

As public equity markets went through a correction in 2022, we anticipated that there would be a similar effect on private equity markets. The underlying investments are not marked on a regular basis, but should there be stress with the underlying company or delinquencies in meeting their debt obligations, there is a repricing of the investment.

Over the last three years, the most pronounced repricing has been in early-stage investments, primarily in venture capital. Some of this was due to elevated peak valuations for companies financed with low-cost debt as well as an active IPO market.

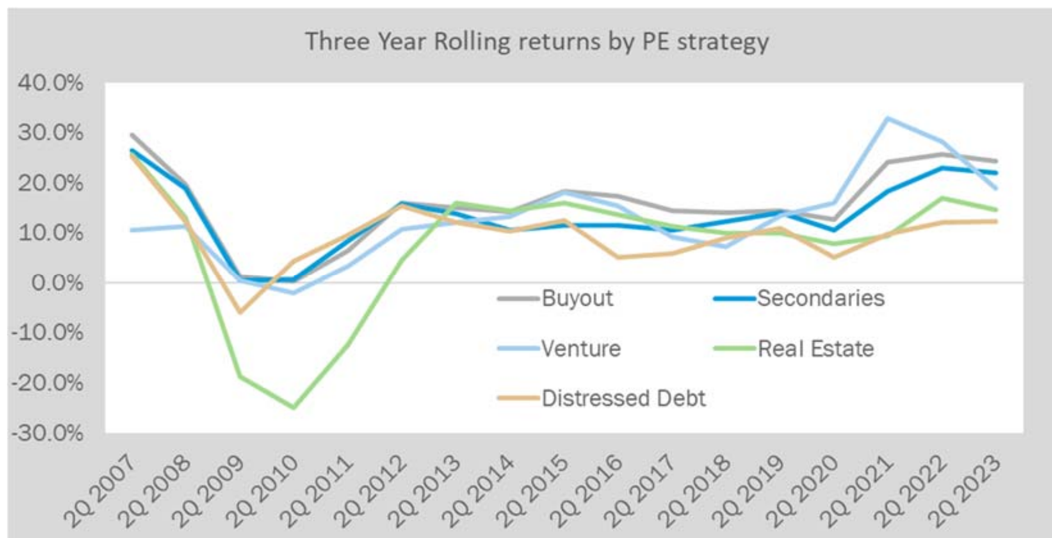


Figure 10. Source: Prequin, Data thru June 30, 2023

Since the Pandemic, as rates have gone up, buyers and sellers have stepped back to reassess pricing, and deal volume has declined. Private equity funds are taking longer to raise capital. We have seen large plans reassess their private equity commitment amounts, particularly where the sponsors

rely on distributions from older funds to provide the capital to deploy into new funds. Overall, the impact on private equity returns has not been as stark as it was in prior periods of market downturn. We continue to believe that staying disciplined to invest across market cycles is important, as it is to remain diversified across the various segments of private equity.

Overall Summary

We are only one to make drastic changes to the portfolio if there is a compelling dislocation in the market. Yet, looking back at 2023, we made meaningful changes to the fixed income segment and made manager changes in equities where we felt there were business risks at the manager level.

We also stay cognizant of the individual client's preferences and circumstances, particularly if a change requires a reassessment of their portfolio construction. We seek to be responsive where needed and proactive where warranted.

We hope the coming year brings peace and success to you. We are always appreciative of your trust in us.

Sincerely,

Poorvi, R. Parekh, CFA
Director of Outsourced Investments

Ms. Parekh is a member of the Board of Directors, a shareholder of Canterbury, and directs the Canterbury Outsourced CIO platform, which caters to institutions and private clients seeking to outsource the day-to-day management of their portfolios. In this role, Ms. Parekh is the chair of the Canterbury Outsourced CIO Committee and a member of each of the firm's five Manager Research Committees. Joining Canterbury in 1996 as the manager of analytics, she directed the firm's account analysts and client services group, securing many of the asset allocation modeling and research software tools we use today. In 2001, she became the director of manager research — overseeing all manager, fund, and product research; maintaining Canterbury's proprietary research database; and chairing the Investment Manager Research Committee. Ms. Parekh graduated from the University of Hong Kong with a Bachelor of Arts in economics and completed her Master of Business Administration at Shenandoah University.

About Canterbury

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