QUARTERLY COMMENTARY LETTER

U.S. STILL OUTPACING THE REST?

Q1 2024

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MACRO ENVIRONMENT

As 2024 got underway, the US continued to be the brightest spot for growth in the global economy. But that was coupled with a worrying pick up in underlying inflation. The path to monetary easing in America no longer looks so clear cut. Financial markets that boomed in Q1 are now less confident.

Adding to uncertainty, the government reported in late April that preliminary data for Q1 GDP showed an unexpected slowdown in the economy from the rapid pace of late 2023. The data likely exaggerated the downside. More importantly, disappointing inflation numbers for each of the first three months of the year may cast a shadow over Q2. The Fed’s preferred measure of core inflation rose at an annual rate of 4.4% in the latest three months to March, well above the 2% goal of price stability. Some cooling is likely in coming months, perhaps accompanied by slower growth and reduced wage pressure. But US central bankers will want a string of better numbers before they begin to relax today’s restrictive monetary policies.

Fears of a US recession receded into the rear-view mirror during Q1. Driven largely by consumer spending, the economy outpaced that of its peers. The GDP slowdown to an estimated annual growth rate of 1.6 % disappointed. But the headline number exaggerated the weakness in the domestic economy, reflecting strong import demand that automatically detracts from GDP, if not matched by rising exports, and by changes in volatile inventories. Private domestic demand was vigorous. Companies continued to add to payrolls, to the tune of 275,000 a month, well above the pre-Covid norm. And unemployment stayed below 4%, ending the quarter at 3.8%.

In Europe, Canada and other major economies, consumer price reports for March allowed central banks to reaffirm likely rate cuts in June. This makes sense. The European economy post-Covid has been much weaker than that of the US. Recent International Monetary Fund (IMF) forecasts saw euro area growth picking up this year, but only from 0.4% in 2023 to 0.8%. Contrast this with the IMF’s projection of 2.7% US growth for this year. The question for investors is whether stubborn inflation will delay interest rate cuts for long enough to dampen demand and slow US growth more sharply than seemed likely at the beginning of the year. Recent data, together with cautious words from Federal Reserve Chair Jerome Powell and a number of other Fed policymakers, have now pushed market expectations of rate cuts well into the fall. The May 1 Fed policy meeting will be watched for cues on how worried central bankers are.

During Q1 itself, markets remained sanguine, waking up only slowly to the shifting outlook for inflation and interest rates. US equities climbed by 9.5%, with the so-called Magnificent 7 (Mag 7) tech companies up by 17%. Only Japan among advanced economies did better than the US. The

Nikkei continued the 2023 run-up triggered by Japan's long-awaited return to "normal." Decades of deflation yielded to price increases and, in Q1 2024, the Bank of Japan (BOJ) finally shifted from negative to (just) positive interest rates.

Both January and February US inflation surprised on the upside. But an initial rate cut in June was still seen as the most likely. When consumer prices for March were released in mid-April, showing that consumer price inflation progress stalled in Q1, financial markets shifted dramatically. A further run-up in market interest rates came in late April, following the preliminary data for GDP and underlying inflation.

In Europe, easing already began in March, with a surprise rate cut from the Swiss National Bank. The European Central Bank (ECB) will likely cut its policy rate in June, reaffirmed ECB President Christine Lagarde. The Canadian central bank also saw its Q1 inflation progress as supportive of a Q2 cut in rates. The Federal Reserve is now almost certain to push its initial easing into Q3, or even later, unless there is a sharp reversal of the first quarter pattern, with an unexpected slowdown in jobs growth and spending and, most importantly, credible further progress towards price stability.

THREE THEMES TO WATCH IN THE COMING MONTHS

01

INFLATION - AGAIN

For a while at the end of 2023, investor and policymaker attention in the US turned from inflation, which was coming down nicely, to focus more on growth and jobs. That is still the case in Europe where growth is minimal and inflation continues to come down. But in the US, the string of disappointments on inflation data in Q1, coupled with looming concerns about the possible impact of mid-East tensions on energy prices and price pressures from supply issues, whether the Baltimore bridge collapse or attacks on shipping in the Red Sea, have put the focus squarely back on inflation.

02

GROWTH DIVERGENCE – WILL THE US CONTINUE TO GROW MOST RAPIDLY AS OTHER ECONOMIES BEGIN TO REVIVE?

After beating expectations and outperforming other countries in 2023, the US economy slowed in Q1. But the underpinnings of growth remain robust: a still tight labor market which is supporting consumer spending. Rising business investment, powered in part by hopes for AI. Can that continue, with interest rates still high? Will company earnings stay strong as wage pressures continue? Higher growth around the world would help US companies, as will the spending power of the American consumer. But much will depend on monetary policy.

03

HIGHER FOR LONGER RATES LOOK LIKELY IN THE US; WILL THE FEDERAL RESERVE BE THE MONETARY POLICY LAGGARD THIS YEAR INSTEAD OF THE LEADER?

Slower progress towards price stability in the US together with continued jobs growth have shifted the odds away from a rate reduction in Q2. Contrast this with Europe and Canada, whose central banks have signaled that easing is likely to begin in June. The Fed may end up lagging rather than leading rate cuts around the world. That in turn will support dollar strength – helpful for inflation, less so for profits and growth.

THE U.S. MOTOR – STRONG DEMAND MEETS FLEXIBLE SUPPLY

Europe, Canada and other advanced economies likely stagnated or barely expanded in Q1. In the US, businesses are still hiring. Indeed payroll growth picked up pace during the quarter. Early estimates suggest GDP growth continued to run comfortably above that in other advanced economies.

As for China, Q1 brought some signs of recovery in spending and output as Beijing took some steps to woo foreign companies and investors. Chinese GDP came in stronger than expected in Q1 alongside an improvement in PMI data. However, the signals were somewhat mixed. Industrial production was softer than expected, and the GDP increase was partially reliant on a revision lower to the prior year reading. A pickup in European growth will help to support China's economy, although threats of retaliation against subsidized Chinese goods are rising. Investor hopes for a more robust government stimulus were again largely disappointed in Q1.

Much credit for US outperformance goes to the flexibility of the economy. A strong supply response to post-pandemic price pressures and rising consumer and government demand has seen growth and jobs rising even as inflation cooled. The expanding labor force in part reflects a perhaps surprising openness to immigration. As Fed Chair Powell and others have noted, legal immigration rose substantially last year, with an estimated 3 million immigrants joining the labor force. This influx did not come at the expense of American workers, whose earnings and employment have risen in a tight labor market.

In contrast to the post traumatic shock after the Global Financial Crisis, when unemployment stayed high for almost a decade and household and company balance sheets took years to mend, the post-pandemic recovery was swift. The larger labor force, as demand pulled in workers from the sidelines as well as from overseas, in turn, has boosted consumption and demand, important in an economy where consumption accounts for 70% of GDP. Full employment has also brought benefits in terms of narrowing wage gaps between skilled and unskilled workers as the Administration's Council of Economic Advisers points out in the newly released Economic Report to the President.

One way in which the US treatment of low wage workers does lag that of other advanced economies is the lack of paid leave, whether for emergencies, family celebrations, or even a rest. As many as 60% of low wage workers do not get any paid time off for hours worked, economics professor Betsey Stevenson points out in a new study that focuses on paid time off in exchange for time worked, not the higher profile issues of sick leave or family leave. If these Americans cannot earn any leave, then missing work means not getting paid – and maybe risking losing their job.

For most other Americans, the picture has changed, although a quarter are still without paid time off. In other advanced countries, as workers have become more productive – and lived longer – governments and employers have agreed to more generous working conditions. The US Fair Labor Standards Act (FLSA) which regulates working hours and other conditions was passed in 1938. Time for an update, Stevenson argues, which would benefit employers as well as workers, in terms of keeping a more stable work force and raising productivity.

INFLATION: WHERE THE US FELL SHORT IN Q1

At its March meeting, Fed Chair Powell and colleagues recognized that inflation this year would likely be higher than predicted three months earlier. But the central bankers held in the main to the expected path for interest rates – with three cuts penciled in for 2024. Inflation in Q1 stopped improving. On some measures, it actually worsened.

Wage increases remained remarkably contained in the face of the 2021/2022 inflationary surge. But in Q1 they ran at a rate above that consistent with the Fed's 2% target. Average hourly earnings rose at an annual rate of 4.1% in the quarter. Unless productivity shifts upwards in a sustained way, or profits are squeezed, wage increases at this rate will leave inflation running at closer to 3% or higher, rather than 2%. Some economists argue that allowing the "price stability" goal to drift upwards would be better than squeezing the economy to get back to 2%. Polling would suggest that most Americans disagree: they hate inflation. So far, Federal Reserve chairman Jerome Powell and his colleagues have held firm to the line that inflation must be securely on its way to 2% before they cut rates.

KNOWN UNKNOWNS

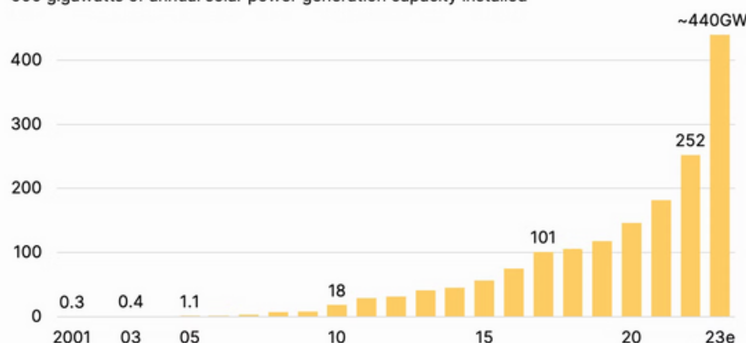
Since Covid – and perhaps even before – investors have had to grapple with a less predictable and more volatile global environment. This is not likely to end any time soon. Investors know that it's a risky world. The conflicts in Europe and the Middle East got worse, not better, in Q1. In April, the situation became more dangerous still. But pricing those risks remains near impossible.

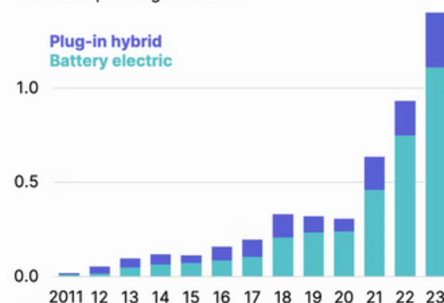
China and the US are at least talking – with a high level phone call between the two Presidents and April visits by Secretary of State Anthony Blinken and, before that,US Treasury Secretary Janet Yellen. But the two countries remain at odds over more than just the production of electric vehicles, particularly as China continues to support Russia. As RockCreek envisaged at the outbreak of war in Europe, Russia's bloody fight against Ukraine has dragged on, with terrible costs after two years. Israel's war against Hamas in the wake of the murderous terrorist attack of October 7, 2023 continues, despite increasing calls for a ceasefire. The path of these conflicts could become more dangerous, triggering global consequences. Uncertainty is heightened by the close US Presidential race and possible consequences of a win by former President Trump. These "known unknowns," to use the phrase of former Defense Secretary Donald Rumsfeld, do not signal clear actions for investors – other than vigilance, flexibility and careful diversification.

SUSTAINABLE INVESTING

The first quarter of 2024 brought with it a treasure trove of data on the state of sustainability throughout 2023, and there is much reason for optimism despite some newspaper headlines. Most notably, U.S. and E.U. emissions declined. Those declines are largely attributable to the energy transition, which continues to pick up steam as policy, corporate/consumer preferences, and, increasingly, economics favor energy transition solutions over incumbent technologies. Last year, energy transition spending was $1.8 trillion globally—far surpassing spending on traditional fossil fuel sources of energy.

This is causing record growth rates in many energy transition markets. For example, global solar installations in 2023 are estimated to have grown 75% over installations in 2022—translating to a ~1000x increase in just two decades. EV and hybrid sales grew 50% in 2023 to almost 1.5 million. While growth of pure battery electric vehicles seems to have slowed in Q1 2024 to a tepid 2.7% growth rate (almost entirely driven by weak Tesla sales in the quarter), plug-in hybrids grew 34% and non-plug in hybrids grew 45%. Other energy transition markets are similarly large and demonstrating tremendous growth. Corporates, consumers, and investors continue to spend on energy transition solutions.





Source: Nat Bullard (January 2024).

The growth of these markets also enables growth in complementary markets. For example, growth of EVs also drives growth of batteries (check out our blog post discussing RockCreek's recent investment in Renewance, a company that helps maintain, repair, and optimize these batteries), charging stations, financing solutions, and a variety of other related solutions. As cheap green power becomes more ubiquitous, other energy transition solutions become more economically attractive, including sustainable aviation fuel and green hydrogen.

2023 data also show that investing in sustainable solutions can outperform legacy solutions. Moody's data showed that green infrastructure projects have a 4% default rate ~10 years after the first financing; conventional infrastructure projects were nearly double that rate. Morgan Stanley also found that sustainability funds had a median return of 12.6% in 2023, compared to traditional funds' 8.6%. This general result was true across geographies and asset classes.

While money continues to flow into sustainability markets across asset classes, we believe that there are more attractive investment opportunities than ever before. However, finding alpha still requires a deep understanding of the nuances of these markets. For example, thanks to the Inflation Reduction Act, the financial status of the end customer, specific census track of the project, and system component sourcing are now as important for investors to consider as the availability of the sun. Those with insights and abilities to understand this complexity and nuance can find ways to benefit from growth and the dynamics described above.

Energy transition assets have become a key focus area for potential new investments. Transmission lines and capacity are the biggest bottleneck across industries—including data centers and renewable power—and we are seeing interesting investment trends addressing these issues. Solutions that allow power to be put on behind the meter can solve the demand issues while avoiding the transmission problems, as new transmission lines can take anywhere from three to eight years to come online in some markets. With the continued trend of electrification and huge power demand, this is a generational opportunity that can be addressed from an infrastructure investment standpoint for private investors. Finally, the lack of investment in the maintenance of aging infrastructure presents a potential opportunity. Where municipalities are willing to partner with private capital to address these needs, investors can efficiently capitalize and operate these projects.

While the energy transition news in 2023 was positive, the news about the state of the climate itself was unfortunately sobering. The year had the 12 warmest months on record. The heat brought with it a record number of $1+ billion weather-related disasters. As debates around potential climate solutions raged on, so did wildfires, including the Hawaii wildfire, which is the deadliest in modern U.S. history. These types of climate-related events are forcing businesses to re-evaluate risks across industries; for example, the CEO of insurer Aon recently called for the development of better climate models that can more accurately depict climate-related risks and losses after the insurance industry has become stressed as a result of extreme weather.

PUBLIC EQUITIES

The first quarter provided a constructive start to 2024 for equity strategies. With the economy remaining in good shape, earnings results from the prior quarter were above expectations and actively managed strategies generated solid alpha from stock selection. The large- and mega-cap segment of the market remained robust, highlighted by Nvidia's fantastic results pushing its shares 82.0% higher in the first quarter alone. Meta, Amazon, and Microsoft also beat expectations and gained 37.0%, 19.0%, and 12.0%, respectively. However, that was the extent of the Mag 7's double digit returns, leading to the new "Fab Four." While those four stocks accounted for nearly half the S&P 500's 10.1% first quarter return, it's worth noting that the equal-weighted S&P 500 still gained 7.4%. This indicates that the breadth of the market has been better than it was for most of 2023.

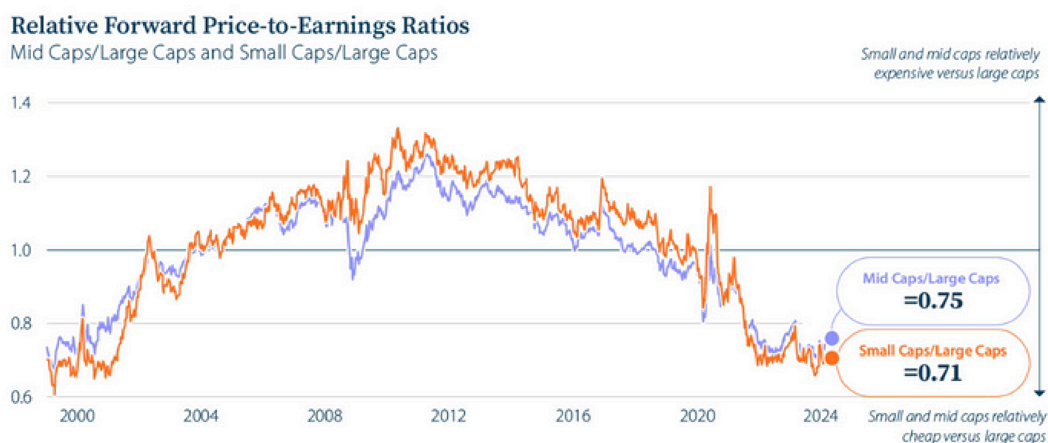
From a valuation perspective, as of March 31st the US equity market is looking somewhat elevated with a forward P/E of about 20.5 for the S&P 500 compared to a 35-year historical average of about 16.5. Its high over that same period was 25.3, in 1999. Not surprisingly, technology is the most expensive sector relative to its historic average (28.7 vs 20.1) while neither materials (22.0 vs 15.7) nor consumer discretionary (25.1 vs 19.8) are cheap either. The only sector trading below its average is energy (12.7 vs 17.4). That said, even when focusing on technology, it's unclear whether we are in bubble territory. As amazing a run as Nvidia has had with its share price up more than 5x since the beginning of last year, it still trades at a somewhat reasonable 35.0x forward P/E. Cisco was at nearly 100.0x at one point amid the dot-com bubble. What about the earnings growth expectations being priced into those corporate forward earnings? According to Zachs Research, analysts are expecting overall earnings to rise by 5.0% this year. That would seem an achievable goal in the current economy.

Small-cap universe valuations continue to be deeply discounted relative to large-cap. As shown in the chart below, the gap is the largest we've seen in more than 20 years. Such anomalies can persist for a long time, but there are factors at play that could help narrow the gap sooner than later.

For one, economic resilience in the wake of higher interest rates seems to indicate a future more similar to the soft-landing scenario. Second, market expectations for interest rate cuts have met reality after pricing in a Q1 rate cut last year. Now that the consensus is leaning towards rate cuts more in the back half of this year or early next year, some of that earlier exuberance in Q4 has gone away. Looking ahead, the path of interest rates will be a key determinant for when, and by what degree, the small/large gap changes.

ATTRACTIVE VALUATIONS

Small and mid-cap stocks are trading at their steepest discounts versus large caps since the early 2000s, presenting a compelling entry point.



Source: Yardeni Research, LSEG Datastream. March 3, 2024.

Coincidentally, we appear to be at the start of what could be a cyclical and structural rebound in M&A activity. From a cyclical perspective, deal pipelines are building up and corporate confidence is rising. Structurally, there is a lot of dry powder with global listed non-financials holding an estimated $5.6 trillion in cash and private market investors sitting on $2.5 trillion of capital ready to be deployed. Innovative trends across life sciences, AI, and clean energy will only help drive more activity.

Turning to outside the US, we believe Japan remains a favorable market for investors. The Nikkei's 28.0% gain last year will be difficult to replicate, but the macro-economic and macro-governance conditions remain highly favorable and valuations still relatively attractive. Major Japanese companies are expected to report record profits this year thanks in part to the weak yen, and while negative interest rate policy is no more, the BOJ's policy rate only sits at zero to 10 bps and the long end of rates has not moved up very significantly. At the same time, Japan's foreign rate holdings are now earning interest income, which was not the case when global rates were near zero. Lastly, a meaningful component of Japan's inflation has been wage growth, which is a healthy sign. This is helping pave the way for monetary conditions to remain highly stimulative.

From a macro-governance perspective, Japan is lightyears ahead of where it was 20 years ago and manifestly ahead of its condition even five years ago. Corporate cross-shareholdings, numbers of independent directors, and acceptance levels of takeover offers have all improved. Of Prime Minister Abe's "three arrows," the third—Structural Reform—was always going to be the hardest and take the longest time but finally appears to be bearing more fruit. Last year, outside directors occupied 44% of the board seats of companies listed on the TSE's Prime section, up from 28% five years ago. Last year's call from the Tokyo Stock Exchange to improve capital efficiency was also a major factor driving progress. Japanese companies expanded share buyback programs by 9.6 trillion yen ($65 billion) last year and are not yet showing signs of slowing down.

The Nikkei gained attention in February when it topped its all-time high last reached in late 1989, and it is fair to wonder whether the story has played out or if the market has gotten ahead of itself. However, about 40% of companies listed on the TSE's Prime section trade below the value of their assets, which is very unusual for a developed market. Japan's forward P/E of 16.7 still

compares very favorably to the world (18.2) and US (20.5). In addition, Japan's P/B ratio of 1.5 is nowhere near its 1989 high of 4.7.

Like the US and Japan, Europe saw strong performance from many of its largest companies. Its own version of the Mag 7, referred to as the GRANOLAS (GSK, Roche, ASML, Nestle, Novartis, Novo Nordisk, L'Oreal, LVMH, AstraZeneca, SAP, and Sanofi) are among the most valuable companies in the region and possess solid earnings growth, high and stable margins, solid balance sheets, and defensive compounding capabilities. However, they trade at roughly 31.0x forward earnings compared to 13.0 to 14.0x for the overall European market. We've found Europe to be a good source of alpha but with the region experiencing greater foreign flows the better opportunities are likely to be further down the market cap spectrum.

EMERGING MARKETS

The first quarter of 2024 proved largely positive for emerging markets. With the exception of Chinese and Brazilian equities, most major EM markets were up for the quarter, led by Taiwan and India among larger markets, and Turkey, Colombia, and Peru among smaller peers.

Taiwanese equities experienced a very strong first quarter, with the MSCI Taiwan Index up 11.3%, outperforming both the NASDAQ and S&P 500. The country's flagship semiconductor giant TSMC reported robust net revenue numbers during the quarter as the company continues to benefit from increased demand for chips catering to AI software applications. Investors see TSMC as the key proxy to play global AI growth and view the stock's 2025 valuations as attractive.

Korean equities faced a tougher quarter. While exports saw strong growth, benefiting some of the country's well-known manufacturers of finished goods, the domestic economy showed signs of sputtering. Domestic demand has been steadily weakening due to interest rates staying elevated for longer, raising concerns about the pace of the country's economic recovery.

Indian equity markets were a bright spot in EM in Q1. Investor demand has been a key driver, including a rapidly growing domestic retail investor base. These investors typically use Systematic Investment Plans, which allocate a fixed amount to a mutual fund scheme at fixed intervals, meaning investors are participating in the capital markets regularly. In addition, India has seen sustained inflows from foreign institutional investors. Of course, it helps that the country's record GDP growth rate, largely driven by significant gains in productivity, presents an attractive landscape for investors. Key economic indicators, such as the capital expenditure trend and the industrial production index, remain robust, primarily led by government capital expenditure. Expectations of rate cuts starting in the coming months are also underpinning market sentiment. Fueled by this relentless positive sentiment, the increase propelled India to become the fourth-largest equity market globally, just ahead of Hong Kong's US$4.29 trillion.

After a record-setting 2023, Brazilian equities had a tough start to the year as investors took profits and then wrestled with a shockingly low dividend payout from the country's oil giant, Petrobras. The smaller-than-expected dividend payout rekindled investor fears of increased government intervention in the nation's largest companies. As the state giant focuses on becoming a renewable energy giant, a key policy goal of Brazilian President Lula da Silva's administration, shareholder remuneration, may take a backseat. With US Ten-Year yields above 4.0%, Brazilian investors have opted to hedge their bets and increase exposure to US fixed income exposure as a hedge and at the expense of local equity holdings.

CHINESE STIMULUS—IS IT ENOUGH?

In China, equity markets had a volatile start, with the MSCI China Index down about 11.0% in January alone. The index managed to rebound, finishing the quarter down about 2.0%. Through a combination of government support for the stock market and encouraging economic data, equity markets managed to find a footing.

The Chinese government's role in shoring up equity markets was particularly significant, with state-owned entities effectively ordered to purchase 410 billion yuan (US$57 billion) worth of ETFs as part of efforts to stabilize markets. In addition, government authorities tightened curbs on short selling, removing another pressure point for markets. The appointment of a new CSRC Chairman, Wu Qing, at the beginning of February also suggests a stronger commitment from the government to stabilize the financial markets.

The beleaguered real estate sector in China continued to receive support from the central government during the quarter. Although these measures may not revive growth in the sector, they are aimed at halting the hemorrhaging and moving the sector from being a negative to a neutral contributor to the economy.

On the economic data front, tourism revenues and travel data during the Lunar New Year holiday shattered pre-COVID records, increasing 8.0% and 19.0% respectively. Data released during the quarter also showed a sharp uptick in trade activity.

While welcome, it is worth noting the increased reliance of the Chinese economy on government support, with the public share of total fixed investment reaching a 12-year high. This reliance raises concerns about the sustainability of the rebound, suggesting a need for further decisive policy support. Lukewarm growth in 2024 amid ongoing de-stocking in the property sector could limit the shelf life of any bullish China trades. Indeed, global investors are skeptical about the durability of China's recovery and remain largely underweight. Taking a sample of actively managed equity funds across three key buckets (Global, Asia ex. Japan, and EM equities), we find that managers are underweight China anywhere from 1.5% to 4.5%.

AN UPDATE ON FLOWS INTO EM

Year-to-date, flows into EM equities have been modestly positive while fixed income flows were negative despite record bond issuance.

Despite the modest inflows into EM, global investors remain significantly underweight the EM asset class. According to JPMorgan, the average allocation to EM among global investors is 5.7%. If one were to see a mean reversion to the 20-year average of 8.4%, that would translate into net-inflows of approximately US$673bn—nearly 48% of all current EM assets.

CROSS-ASSET EM FLOWS

	Asset	8w flows (8w ago → current)	This wk	YTD
Fund Flows	**EM Bonds and Equities**		-1.8	-7.4
Fund Flows	**EM Bonds**		-1.8	-10.1
Fund Flows	Hard Ccy		0.1	-5.7
Fund Flows	Local Ccy^		-1.8	-4.4
Fund Flows	o.w. EM ex-China		-1.7	-3.6
Fund Flows	o.w. China		-0.1	-0.8
Fund Flows	**EM Equities**		0.0	2.8
Fund Flows	US HG		5.2	106.9
Fund Flows	US HY		1.5	6.6
Fund Flows	Global Equities		15.4	55.2
	EM Bond and Equity ETFs		1.5	8.5
	EM Bond ETFs		-0.2	-4.0
	EM Equity ETFs		1.8	12.5
	Non-resident EM flows*		1.2	13.3

Source: JPMorgan Markets Publications, March 2024.

FIXED INCOME

The first quarter of 2024 was a busy, and in some instances historic, quarter for global central banks. All told, nine major central banks across emerging and developed markets cut rates in the first quarter while three more raised rates. And while the Fed stayed on hold, the Federal Open Market Committee (FOMC)'s updated summary of economic projections (SEP) certainly gave markets something to chew to end the quarter. Policy rates weren't the only parts of the yield curve with excitement. While the last quarter of 2023 was characterized by a significant fall in longer dated rates, this quarter saw a meaningful reversal of that trend although, as discussed elsewhere throughout this letter, the move was not enough to dampen risk appetite.

10YR GOVERNMENT BOND YIELD

Source: RockCreek.

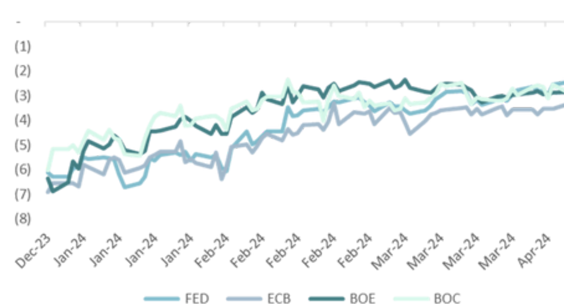
Arguably the most noteworthy, and the one event that could qualify as a historic, central bank decision so far this year has been the BOJ's decision to end negative interest rates and adjust its ultra-accommodative monetary policy. As RockCreek wrote on March 22nd, that increase in policy rates was the first of its kind in seventeen years by the BOJ. The other notable hiker of the quarter was Turkey, which raised its policy rate by a total of 7.5% in an attempt to combat ongoing inflationary issues. The Turkish central bank first hiked 2.5% in January, followed by a surprise 5% hike in March. Most of the central bank action was on the cutting side, however, with the largest portion coming from emerging market economies—particularly those in Latin America and Eastern Europe.

In developed markets the Swiss National Bank made headlines as the first major central bank to cut rates, doing so in March. The central bank cited inflation being at target and concerns over a stronger Franc in supporting its decision. The European Central Bank, Bank of England, Reserve Bank Australia, and Bank of Canada all met during the quarter and held their monetary policy steady. The Fed did the same. Although for the Fed, no policy action does not necessarily equate to a non-event. At the March FOMC meeting, the Fed released its latest SEP, which showed the same amount of cuts in 2024, despite a slight increase in the Fed's projections for inflation. This shift in outlook had a notable impact on interest rate markets that exacerbated the move higher in rates already in progress since the beginning of the quarter.

IMPLIED FED FUNDS TARGET

Source: Bloomberg.

EVOLUTION OF EXPECTED AGG. CUTS



Source: RockCreek.

One of the most notable moves in the days following the March FOMC was the fall in the MOVE index (think VIX, but for bonds), reflecting the market's perception of much less uncertainty about the path of rates going forward. Indeed, the median dot not moving despite higher expected inflation was read by many traders (rightly or wrongly) as the Fed's commitment to cutting rates in 2024 irrespective of the exact path of inflation. While the MOVE's 14 point drop from the day before the Fed meeting to the end of March was impressive, it had been on the decline throughout the quarter; it fell a similar amount from the end of 2023 leading up to the meeting. Given the inflation developments in April detailed in the opening section, much volatility has returned to fixed income markets, and the market's expectations of cuts continue to evolve alongside the economic data.

In addition, after a strong rally inQ 4 2023 yields rose across tenor, geography, and type as markets repriced their aggressive expectations of nearly seven cuts from the Fed this year to three. 10yr real yields in the US, Europe, and the UK rose approximately 10–20bps during the quarter while their nominal equivalents rose 40–70bps+. In the US, the entire nominal curve shifted higher by more than 30bps at most major points. It was not a completely even shift, however, leaving the 2s10s further inverted at the end of the curve than when they started. This is the longest inversion for both 2s10s and 3m10yr on record (454 days for 2s10s and 364 for 3m10y), and still no recession in the US. This helps spur hopes of a soft landing, with many references to a hiking cycle that occurred 30 years ago.

1994 REDUX?

The most commonly cited similarity is the expected three cuts in 2024 vs. the actual three cuts and pause in 1995. Three cuts seems more incidental than meaningful, so it may be worthwhile to look in slightly more detail at the ‘94/’95 cycle before jumping to any conclusions. The overall tightening in 1994 was a total of 300bps with the FOMC policy rate rising from 3.0% to 6.0%. In the latest tightening cycle the policy rate was raised 1.75x more than in 1994, with the upper bound policy rate rising from 0.25% to 5.25%. This was in response to a much stronger and stickier inflation impulse this time around of 2.5% to 6.0% vs. a spurt of 2.5–3.0% inflation. Despite a more entrenched inflation problem and tighter nominal monetary policy, the real amount of tightening, as measured by the Fed Funds minus Nominal GDP growth, has been significantly more accommodative this time around. This would suggest that the more pertinent question is whether or not policy was restrictive enough to curb inflation as opposed to loose enough to allow for a soft landing, justifying the Fed’s strict adherence to data dependency.

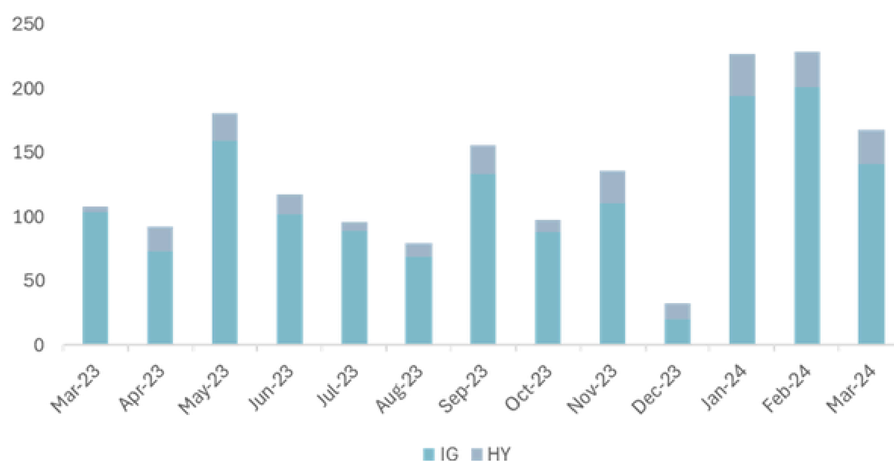
PUBLIC CREDIT

Following a robust and broad-based rally in Q4 2023, credit markets awaited a volatile first quarter of the year. This expectation was primarily driven by the uncertain outcomes in interest rates as well as the plethora of new issuance that was expected to arrive in the quarter. This tumult did not come to pass, and as a result public credit remained resilient due to the continued increase in demand from investors as well as better-than-expected economic data.

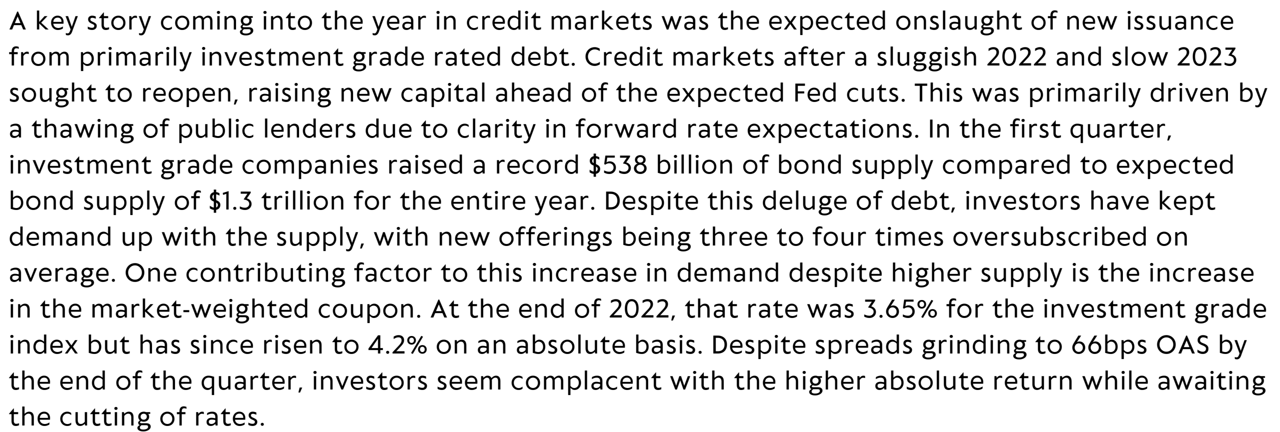
The largest division that occurred in Q1 was the divergence in performance in short- vs long-dated debt. Investors began the year positioning themselves in long-dated fixed instruments that sought to reap the tailwinds of easing monetary policy. When these predictions did not materialize, Investment Grade debt as well as other long-dated structured products, such as MBS, underperformed. Floating rate debt structures, such as Leveraged Loans and high yield, continued their resiliency in the quarter after a strong 2023, though for different reasons.

Coming into the year, Leveraged Loans were relatively expensive on a risk adjusted basis, with investors allocating to the sector for short term returns during interest rate uncertainty. With the seemingly inevitable Fed pivot, floating rate structures would then see their prices fall. However, now with fewer rate cuts on the horizon, Leveraged Loans returned a steady coupon for the quarter. High Yield bonds also saw a good quarter due to investor demand and improving economic conditions. Default rates increased somewhat during the quarter but nowhere near the level that could cause a major disruption in the market.

U.S. CORPORATE NEW ISSUANCE ($B)



Source: RockCreek.



A key story coming into the year in credit markets was the expected onslaught of new issuance from primarily investment grade rated debt. Credit markets after a sluggish 2022 and slow 2023 sought to reopen, raising new capital ahead of the expected Fed cuts. This was primarily driven by a thawing of public lenders due to clarity in forward rate expectations. In the first quarter, investment grade companies raised a record $538 billion of bond supply compared to expected bond supply of $1.3 trillion for the entire year. Despite this deluge of debt, investors have kept demand up with the supply, with new offerings being three to four times oversubscribed on average. One contributing factor to this increase in demand despite higher supply is the increase in the market-weighted coupon. At the end of 2022, that rate was 3.65% for the investment grade index but has since risen to 4.2% on an absolute basis. Despite spreads grinding to 66bps OAS by the end of the quarter, investors seem complacent with the higher absolute return while awaiting the cutting of rates.

PRIVATE CREDIT

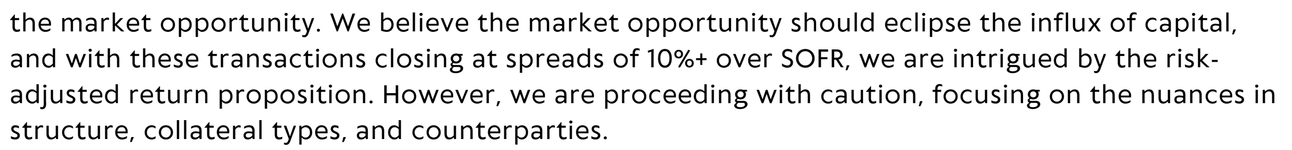
While economic indicators and Fed rhetoric have trended in a more sanguine direction, it is hard to ignore the harsh reality that many businesses are touting over-leveraged capital structures. Actual corporate defaults reached a post-pandemic high in February but failed to outpace 2023 volumes by quarter-end. And despite looming maturity walls and a dearth of debt financing available to many in-need borrowers, it seems increasingly unlikely that higher interest rates—even considering the waterfall of knock-on effects to inflation (of all flavors), asset and equity values—will culminate in a systemic credit event in the US.

For the time being, stressed and distressed credit opportunities will remain highly idiosyncratic in nature, requiring a multitude of skill sets to monetize value through refinancings, recapitalizations, bankruptcies, restructurings, and/or operationally intensive turnarounds. RockCreek continues to favor groups that are equipped to invest across public and private markets, through both the purchase of existing debt and the origination of new debt, with the ability to accrete value through financial engineering and asset management.

One expression of this theme is focused specifically on acquiring underperforming or distressed debt from banks, particularly those that are grappling with the need for increased provisions for future losses in their CRE loan books. Banks are intensifying their efforts to de-risk their balance sheets and maintain stability, often resulting in a need to discreetly divest assets at steep discounts. Such discounts can afford the leeway to cure an unsustainable capital structure and/or provide the necessary buffer to facilitate a profitable recovery.

An underperforming credit creates two issues for a bank: (i) the risk of economic loss associated with the loan (starting with the provisioning for potential losses) and (ii) the outsized risk weighting required by Basel regulation. While asset sales provide one mechanism to release pressure, larger US banks are starting to adopt the use of a second tool from their European and Asian counterparts: Synthetic Risk Transfer (“SRT”). SRT is a bespoke contract between a bank and a financial counterparty that provides first loss protection against a pool of loans held by the bank. While the structure of these transactions can vary, the effect is to reduce the capital requirements associated with a pool of assets held by the bank.

The SRT market is rapidly growing in the US to address a real capital deficiency being driven by bank regulation. Basel Endgame is on the horizon. Although RockCreek acknowledges the market opportunity supporting the trade, we are focused on understanding the barriers to entry that govern the market. Although the market is described as highly relationships driven, we have received nearly a half dozen solicitations for new SRT funds being launched by credit platforms in the past quarter alone. This excludes the existing players who are actively fundraising to exploit



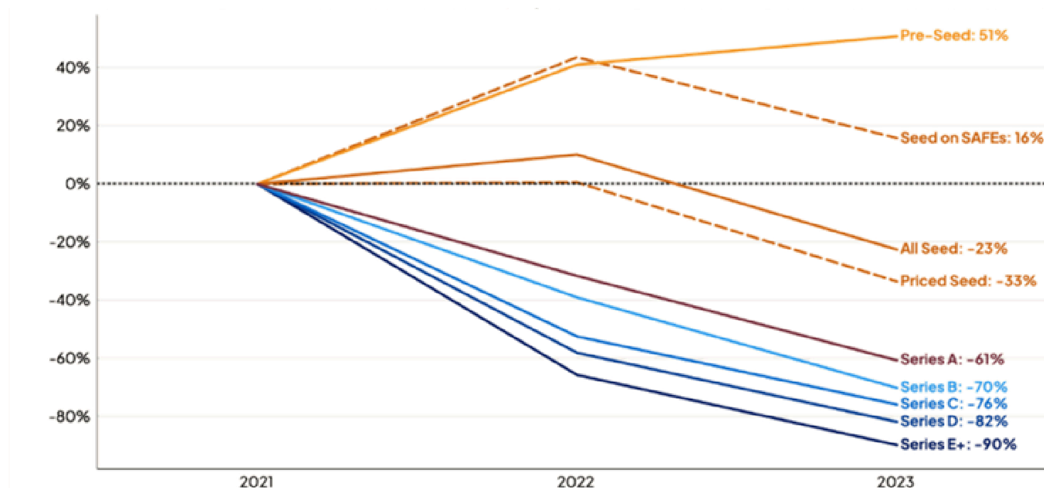
the market opportunity. We believe the market opportunity should eclipse the influx of capital, and with these transactions closing at spreads of 10%+ over SOFR, we are intrigued by the risk-adjusted return proposition. However, we are proceeding with caution, focusing on the nuances in structure, collateral types, and counterparties.

PRIVATE EQUITY AND VENTURE CAPITAL

The venture capital market appears to be thawing, with many VC firms and accelerators noting that this is the most activity they have seen at the early stage in years, if not ever. However, the drastic increase in number of deals has not filtered through to overall investment dollar volume. Concurrently, LPs are starting to see more frequent and more sizable capital calls. Cap table software company Carta released data showing capital flowing to the earliest stages is at a higher rate than 2021, while later stages are still depressed. Despite this, the tide seems to be turning as well for growth stage companies, and some optimism is beginning to creep back into the space as new bookings are accelerating and companies are preparing for stronger growth in 2024 after a tepid 2023. As companies begin to see their cash balances decline inside 12 months, we expect to see an uptick in later stage deal volume going into the later parts of 2024.

CAPITAL IS STILL FLOWING TO THE EARLIEST STARTUPS

Percent change in total invested capital by stage | All percentages relative to 2021 | U.S. startups only



Source: Carta. Pre-seed = round on SAFEs or Convertible Notes that raised under $1M | Seed on SAFEs = rounds on SAFEs or Convertible notes that raised over $1M

Similarly, the buyout market continues to be subdued, with $145 million of deal volume during the first quarter, the lowest quarter since Q3'20. Investors remain laser-focused on the ability of managers to generate liquidity in this market, and some reprieve was granted on the last day of the quarter in the form of the fourth-largest private equity exit of all time, the $18.3 billion sale of SRS Distribution to Home Depot.

In terms of areas of investment, AI continues to be “hot,” with large amounts of capital still flowing into the sector amidst varying degrees of skepticism amongst venture capitalists; many VCs are increasingly concerned that LLMs will become commoditized and are worried about high capex and purchasing power, as well as low switching costs. That said, the supply of GPUs is increasingly meeting and will likely outstrip demand, which could be a positive for the startup ecosystem as startup costs decrease and companies are able to pivot quicker. Not surprisingly, the most recent batch of Y Combinator (YC) companies (Winter 2024) was unveiled in early April, and 176 of the 247 companies (>70%) are AI-native companies. Many of these companies are pursuing the consumer end of the AI market, whereas capital flowing into the foundational layer (e.g. LLMs) is being driven by the tech majors that have very different cost of capital and time horizons.

The climate sector also continues to attract significant amounts of capital with several high profile financings announced during the first quarter, including Crux’s $18.2 million Series A and Antora’s $150 million Series B. Crux, which counts Andreessen Horowitz and Lowercarbon among its investors, is building a tax credit platform for companies to trade and monetize transferable clean energy tax credits created by the Inflation Reduction Act (IRA). The company already has over $8 billion of credits currently available for sale, and it provides instantaneous access to billions of dollars of active buy-side interest. Antora is a thermal battery manufacturer that is partnering with large industrial customers to leverage low-cost wind and solar to power the most energy-intensive industrial workloads. The company’s Series B was led by Decarbonization Partners with participation from existing investors Lowercarbon and Breakthrough Energy Ventures.

Crypto is also coming back into focus, with continued strong performance in 2024 after large gains in the fourth quarter of 2023. Through April 5, 2024, Bitcoin was up more than 50%, Ethereum was up more than 40%, and Solana was up more than 70%. Key stories during the quarter included the upcoming fourth halving of Bitcoin and the January SEC approval of Bitcoin ETFs in the U.S. In March, trading volumes for these ETFs reached $110 billion, three times higher than either January or February.

Additionally, amidst an uptick in geopolitical tension and a shifting economic environment, investments in traditionally specialist driven hard tech sub-sectors such as Logistics, Aerospace, and Defense have seemingly become more common. Within these areas, government customers increasingly are showing demand for technologies sourced by new entrants. Similar to the “PayPal Mafia,” a proliferation of engineering talent coming from companies like SpaceX, Anduril, and Palantir have led to successful ventures. Per BCG, Deep Tech startups now claim roughly 20% of venture capital investment, up two-fold in the past decade. Yet in many ways this new normal follows a similar trajectory, as Silicon Valley’s initial rise has long been linked government and military funding into research and development.

Lastly, Q1 marked the successful public market debuts of two venture backed companies: Reddit and Astera Labs. Though venture-backed IPO numbers are not expected to return to 2021 highs, the successful debuts have indicated that public market sentiment towards venture-backed companies may be becoming more favorable. As highlighted in the linked article from the Information, both public companies showed that sustainable growth and profitability or a clear line of sight towards near term profitability are essential.

The broader real estate market saw a continued decline in the first quarter, continuing the trend from prior quarters while industrial and alternative sectors did well. This was apparent in the public equity markets, as real estate was the laggard in Q1 2024. In terms of private markets, further decline in value is expected for the office sector, as Q4 appraisals primarily focused on industrial and multifamily assets. The primary appraiser for core real estate applied industrial and multifamily marks in Q4 without discrimination for quality or location, which may create a bifurcation in returns as relative quality can be discerned by investors. Another area that RockCreek has focused on is the internal valuation policies from GPs, and how these appraisals are reflected in portfolios. Additionally, as Q4 was primarily focused on two sectors, we expect the office sector to again come into focus in Q1 for further declines.

Retail is re-emerging as a possible area to watch, due to high entry capitalization rates and limited new supply that allow for landlord pricing power where there is tenant demand. Investors can now purchase retail assets at levels that allow returns to be driven by cash flow rather than appreciation, with further upside potential if capital does flow back into the sector and capitalization rates compress. Some areas that may be worth watching are specific sub sectors within retail that are still in demand from tenants after a structural shift in the way consumers spend their money. It has become apparent that retailers must adopt an omnichannel approach, and certain asset types such as grocery-anchored shopping centers have shown durability. The question for investors then becomes which types of retail assets will continue to show durability and the ability to attract tenants and consumers.

"Alternative" sectors in real estate have continued to spark interest. These include self-storage and alternative multifamily options like student housing. As investors need to deploy capital in real estate but industrial is relatively too expensive and offices do not show positive fundamentals, these sectors have emerged as strong options for durable cash flow. These sectors present unique investment opportunities and trends that could potentially reshape the real estate landscape, particularly given the ongoing shifts in living and working arrangements.

Given the current capital market trends and shifts in sector focus from investors, it is an interesting time in the industry for real estate and infrastructure. While the real assets market faces ongoing challenges and capital remains on the sideline, there are numerous opportunities for forward-thinking investors.