QUARTERLY COMMENTARY LETTER

# ECONOMY ON TRACK. POLITICS?

Q2 2024

RockCreek

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# MACRO ENVIRONMENT

Markets were calm in Q2. The political scene was not.

Helped by lower inflation and evidence of a gentle cooling in the labor market, volatility in US financial markets stayed low throughout the quarter. Markets were buoyant as evidence mounted that the hoped-for soft landing is within reach. The US economy continued to outperform, with the latest GDP figures showing growth above potential in the US while Europe stayed in the doldrums and China's growth prospects dimmed during Q2.

Equities hit new peaks in Q2. This largely reflected continued outperformance by mega-cap tech companies. A long-awaited rally in small-cap began only after the end of the quarter when some of the shine also came off tech. Late in Q2, bond prices also rose on renewed hopes of monetary easing to come. Mortgage rates slipped back below 7% by the end of June.

Just-released GDP figures for Q2 reinforced hopes that tight monetary policy will not trigger a US recession, even as inflation has come within sight of the Federal Reserve's 2% price stability goal. Overall growth of 2.8% (annual rate) in Q2 surprised on the upside. There is evidence that consumer spending is gradually slowing, amid growing concerns about the cost of credit and a weaker jobs market. But underlying growth in overall domestic demand was strong, powered in part by rising business investment. Businesses continued to add jobs, albeit at a slower rate than in Q1.

Against this benign backdrop for the economy, the quarter ended with political upheaval in both the US and across the Atlantic. There were extraordinary calls for President Biden to step down as his party's candidate in the November election following his performance in the June 27 debate with former President Trump. It took just over three weeks for the President to heed those calls. He announced his departure from the race – but not the Presidency – on July 21. Within a few days, the market odds for Vice President Kamala Harris changed positively.

In Europe, far-right parties in Germany and France outperformed in EU-wide elections, leading French President Macron to call for snap national elections. Although these ended in July with a defeat for Marine Le Pen's National Rally party, the message of discontent was clear. Around the world, leaders were chastened in elections – including in two major emerging markets, India and South Africa. The market implications were different however. Investors hope that policies in both India and South Africa may become more market-friendly, while in many advanced economies, there is a backlash against globalization, immigration and foreign aid, including for Ukraine. It is too soon to say how much this will affect policy. The outcome of the US November election is the key determinant.

## THREE THEMES TO WATCH IN THE COMING MONTHS

01 **POLITICS**

In an era of disruptive and volatile global politics, the most important election is coming in November, in the US. Recent political and geopolitical upheavals may have had only a short-lived impact on markets. It is hard to price in long-term changes that may come from uncertain macro events. But big shifts in sentiment and policy, for example, the UK vote for Brexit, eventually affect economic outcomes, even if it takes time for the impacts to be felt.

02 **MONETARY EASING: FED TO FOLLOW NOW?**

In a break with the usual pattern, the Federal Reserve has been lagging the global monetary cycle this year rather than leading. After counterparts in Europe and Canada took the first steps to ease in Q2, the Fed is likely to cut rates in Q3 and again in its November meeting. Will this come soon enough to stick the soft landing?

03 **GLOBALIZATION UNDER PRESSURE**

The pandemic is over. Supply bottlenecks have unwound. But the move to highlight resilience rather than efficiency is still top of mind for policymakers. Industrial policy with subsidies and protected markets is being advanced in the US and other key economies. That opens opportunities in areas deemed to be high national priority, including the energy transition, advanced technology and manufacturing. But the open markets that America has championed in the past have supported US innovation and growth. American business has generally thrived on global competition. This competition has hurt some workers and communities, who have not been served well by inadequate policies to compensate. But ordinary Americans have also seen their living standards climb by more this century than those in other advanced economies. A move away from integration in the global economy is likely to disappoint those hoping for more growth and better jobs.

Taking the US first: the historic decision by President Biden to step down as the presumptive Democratic nominee will reverberate from now until November. His endorsement of running mate Vice President Kamala Harris led the way for many others in the party to rally around her, including enough delegates to win the Democratic nomination. By the end of the week, former President Obama and former First Lady Michelle Obama as well as three other key players – Speaker Emerita Pelosi, Senate Majority Leader Schumer and House Minority Leader Jeffries – endorsed the Vice President, demonstrating a united front as she visits key battleground states. Donations poured in after Sunday's announcement, from both small donors and large. Attention has now turned to the candidates for Vice President. Vetting is underway, with a digital vote planned to formalize the ticket ahead of the late August Convention. Investors and voters will be watching to see the policy proposals put forward by Vice President Harris.

At the Republican Convention in early July, the agenda adopted reflected the policies espoused by former President Trump. His choice of Senator JD Vance as his running mate doubled down on the agenda of "America First" and made some on Wall Street worry. The platform includes broad across-the-board increases in import tariffs and a drastic clampdown on immigration, perhaps involving deportation of migrants living and working in the US. These ideas are popular politically. But the economic impact is likely to be negative, adding to inflation and dampening growth according to recent analyses. But more traditional Republican measures usually favored on Wall Street, including deregulation and tax cuts, are also on the agenda.

Despite the broad consensus among experts – or maybe perhaps because of it – citizens and politicians in advanced economies are not inclined to agree that an open global economy is in the general interest. Disenchantment with globalization, open markets and, in particular, with immigration showed in elections in Europe and, in early July, in the UK. Far-right parties picked up votes in EU elections as well as in national elections called in Q2 in France and the UK. Electoral systems mean that the substantial move in voter sentiment has not translated into governing or legislative majorities across the Atlantic. But the trend is concerning for the longer term and could have unsettling implications for markets in the nearer term. In Canada, the pattern of voter rejection of today's leaders was repeated. Prime Minister Trudeau's party suffered defeat in a by-election in Toronto, a traditional stronghold for the governing Liberal party.

## THE US CONTINUES TO PULL AHEAD

The second quarter brought better news on the key issue – inflation – that has preoccupied US investors and policymakers since 2021. After an unexpected pickup in Q1, consumer price increases ex-food and energy slowed to an annual rate of 2.4% in the three months April to June. Average hourly earnings growth also eased, to 3.7% annualized in the quarter, from 4.1% in Q1. The Federal Reserve's 2% goal for price stability is not yet assured. Central bankers acknowledged this in the economic forecasts released at their mid-June policy meeting, raising projected inflation for end-2024 to 2.8% on their preferred core PCE measure and lowering the expected number of interest rate cuts for the rest of the year. But this came before a benign print for inflation. Hopes for monetary easing gradually lifted during the final weeks of Q2, reflecting improved May price data (reaffirmed in the report for June) and supportive comments from Fed Chair Powell.

The US labor market cooled in Q2, but gradually. The JOLTS report – showing job openings, hires and quits – returned to pre-pandemic territory, from the spike in the ratio of vacancies to job seekers which had earlier worried Chair Powell. Payroll growth slowed to a monthly average 180 thousand, from 270 thousand in Q1 and unemployment crept up to 4.1% in June. Any further increase in the jobless rate would raise concerns of recession, as predicted by the "Sahm rule," which suggests a tipping point for the economy after a rise of 0.5 % unemployment over a certain period. However, with economic relationships thrown out of kilter in the post-pandemic era, even Claudia Sahm – the former Fed economist who identified the indicator – has said that it may not work in today's economy. Company earnings have struggled to meet the high bar set for Q2. However, the hoped-for soft landing is still in reach.

Outside the US, the economic picture was less benign in Q2. Still sluggish growth spurred central banks in Europe, Canada and some emerging markets to begin cautiously cutting interest rates. Japan has moved even more cautiously in the opposite direction, with rates nudging up by 35 basis points in Q2. This was not enough to stave off further decline in the Yen, which fell to 161 against the dollar by June-end.

## CARTOON ECONOMICS?

As governments wrestle with voter concerns about the forces of globalization, the impact of the "China shock" particularly on manufacturing and the communities dependent on industries that were put out of business by foreign competition and the impact of immigration, pressures have mounted to restrict the movement of traded goods and people across national or, in the case of the EU, regional boundaries. Despite these pressures, the global economy continues to become more integrated. Trade flows are still rising, albeit more slowly in recent years than in previous decades. Attempts to limit immigration are mostly floundering. Failure to curtail globalization may exacerbate political problems if frustrated voters seek more drastic change. But success would also be damaging – to living standards and growth – according to recent research.

Arguments often used to support restrictions on trade and immigration – that such restrictions will boost jobs and incomes domestically – may be appealing but are flawed. On trade, the standard economic view is well documented. Trade is a positive sum game, with broad gains in growth and living standards from both importing and exporting. But while gains are widespread the pain from losing market share to an overseas competitor is concentrated on specific companies, workers and communities. Problems in these communities were ignored or underestimated for too long. But, as noted in G/S and PIIE research, middle class Americans would stand to lose if tariffs are raised.

Immigration has been less studied by economists. Interesting new work by migration expert and economist Michael Clemens suggests that this too is a positive sum game. Perhaps surprisingly, areas with higher immigration have had higher job creation for American-born workers as well. Clemons refers to the arguments against trade and that immigration takes jobs away from local workers as referring to a "cartoon economy". In reality, there is a dynamic impact of growing businesses, increased tax receipts and higher consumer spending that results from the bigger supply of labor.

# SUSTAINABLE INVESTING

## URGENCY MEETS UNCERTAINTY

The first half of 2024 has been a stark reminder of the escalating crisis and the urgent need for accelerated investment in the energy transition given the positive economics of renewable energy. Heatwaves have devastated regions worldwide, killing thousands in Saudi Arabia, hundreds in India, and shattering records across the United States. Ecosystems are facing tipping points – nearly 97% of corals in parts of the Great Barrier Reef have died. Hurricane Beryl's unprecedented early arrival emphasized the urgency of the crisis.

Meanwhile, the AI revolution, while promising on many fronts, is intensifying energy demand and threatening to reverse progress on emissions reduction. A recent BCG report projects U.S. annual power consumption in 2030 to be 800 terawatt-hours (TWh) higher than in 2024, with a staggering 60% of this increase stemming from data center energy consumption. The report also warns of a potential 80-gigawatt (GW) shortfall in firm power capacity. The impact is already evident in the technology sector, with Google recently reporting a nearly 50% increase in GHG emissions since 2019, citing AI as the key contributing factor.

## OPPORTUNITIES AMIDST THE URGENCY

This heightened urgency presents compelling opportunities for investors:

Firm and Clean Power Demand: The surging need for reliable, low-carbon energy is driving substantial investment. In Q2 alone, companies in the storage and geothermal sectors – both important for clean power – raised over $2B. US Energy Secretary Granholm called for tripling the US nuclear fleet, and the IEA released a new report urging a sevenfold increase in battery deployment by 2030 to meet global targets. The need for more renewables firming on the grid via batteries led to RockCreek’s investment in Renewance, a company focused on ensuring battery maintenance and optimization.

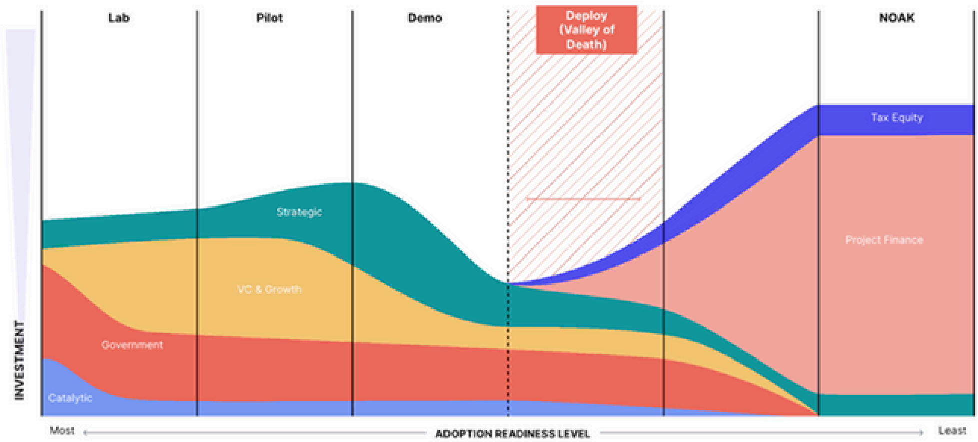
Policy Tailwinds: Significant policy developments in the US are shaping and solidifying sustainable markets. The Treasury Department's guidance on the Sustainable Aviation Fuel (SAF) credit, which ranges from $1.25 to $1.75 per gallon, is a major boost for the industry.

The EPA's $20 billion Greenhouse Gas Reduction Fund (GGRF) is poised to catalyze a significant wave of investment in clean energy projects within low-income and disadvantaged communities. With an anticipated 7:1 leverage ratio, each dollar of public funding is expected to unlock $7 of private capital. This presents a unique opportunity for companies like Gemini Energy Solutions, a RockCreek portfolio company that empowers underserved communities to participate in the clean energy transition, to scale their impact and drive meaningful change and brings EV charging to Black churches.

The US Federal Energy Regulatory Commission (FERC) has taken a significant step towards addressing the nation's growing energy demand by approving new rules to accelerate transmission deployment. However, the scale of the challenge is daunting, with interconnection queues currently at a staggering 2.6 terawatts (TW) of capacity – twice the size of the entire existing grid. This backlog highlights the critical need for distributed energy resources (DERs) like community solar. RockCreek's investment in Nexamp, the largest community solar provider in the US, reflects our conviction that DERs are essential for building a more resilient and responsive grid.

## NAVIGATING CHALLENGES AND MARKET DYNAMICS

The "hype" surrounding energy transition investing has led to some missteps, with several high-profile companies facing an inability to raise additional capital (Universal Hydrogen – hydrogen aircraft, Fisker – electric vehicles, Ambri – molten-salt batteries). This correction should encourage investors to refocus attention on solutions with sound unit economics and those that are currently scale-ready.




Source: Sightline Climate.

The overall investment landscape is also shifting. According to Sightline Climate, energy transition investment in the first half of 2024 totaled $11.3 billion, down 20% from H1 2023 and 41% from H2 2023. This decline is not necessarily due to a lack of capital – dry powder in VC and growth/PE funds has ballooned to over $40 across stages. Much of this dry powder is tied up in mega-funds ($1B+) that oftentimes look for the largest opportunities to invest in (>$100M), while the set of growth opportunities that exist are often in the long tail of sub- $100M investments. This disconnect between the size and scale of capital needed for the vast majority of scale-ready companies in the space poses a significant challenge for the energy transition, and financing solutions that fill this "missing middle" are essential to ensure promising technologies can reach their full potential.

Furthermore, uncertainty surrounding US and European elections, coupled with higher interest rates and persistent inflation, has created a cautious environment.

## LOOKING AHEAD: A RESILIENT OUTLOOK

Despite short-term challenges, the long-term outlook for sustainable investing remains strong. The world is on track to invest $2 trillion in clean energy technologies in 2024, a dramatic increase from the $750 billion spent just 3 years ago in 2021, but less than half of the IEA's estimate of $4.5 trillion needed annually, underscoring the vast opportunity ahead.

While some investors remain on the sidelines awaiting greater political certainty, we believe the current market presents a unique window of opportunity. The recent slowdown has led to more attractive valuations for high-quality companies with proven, cost-competitive technologies and compelling business models. These companies, poised to play a pivotal role in the global transition to a sustainable economy, offer the potential for both significant impact and outsized financial returns.

# PUBLIC EQUITIES

Developed market equities moved higher for the quarter with the MSCI World gaining 2.6%. However, most of the strength came from the US thanks in large part to the resilient US economy and elevated but slowly cooling inflationary pressures. With the S&P 500 notching another excellent quarter and the VIX remaining near its historical lows, it looked like a rather benign environment for US equity investors. In fact, the S&P 500 has not registered a 2% daily positive or negative move since February. Less chop does not mean less opportunities, however. There has been ample dispersion within the market. According to data from the CBOE, implied dispersion of S&P 500 stocks compared with the VIX reached the highest level since it began tracking the data in 2014.

Leading the market's smooth ascent has been Nvidia, along with other mega-cap tech stocks. Nvidia alone has been responsible for approximately a third of the S&P 500's gain this year in what has become an increasingly narrow market. Just 24% of S&P 500 stocks outperformed the index in the first half of the year, marking the third-narrowest six-month span since 1986. The S&P 500 gained 4.3% for the quarter. The top 10 contributors, most of them Magnificent 7 names, gained 5.6%, implying the other 490 stocks were negative in aggregate. The S&P 500 Equal Weight Index and the Russell 2000 small-cap Index lost -3.1% and -3.6%, respectively, for the quarter.

It was a challenging quarter for investors focused on small- and mid-cap stocks. Over time there tends to be an inverse correlation between interest rates and small-caps, so such weak performance ahead of an anticipated Fed interest rate cut may seem surprising. However, historically small-caps don't tend to outperform into the first rate cut but instead outperform in the following 6 to 12 months.

Europe's STOXX 600 slipped -0.2% for the quarter, but thanks to a strong Q1 the index remains up +6.8% year-to-date. France's snap election induced significant market volatility and a -6.4% fall in the French equity market weighed on broader European returns. Germany was also weak as its economy continued to sputter, although signs of economic improvement in the UK helped lift the FTSE.

Based on global equity flows, Europe has been the least-favored developed market with cumulative net inflows close to zero since 2020. This trend showed signs of reversing earlier this year with US investors returning and domestic investors appearing to gain slight confidence. There was a noticeable pick-up in asset flows in the weeks leading up to the ECB rate cut. Last quarter was one of the strongest earnings seasons for the region in several quarters. Other positive factors include rising corporate confidence, an M&A cycle recovery, and higher capital distributions through dividends and buybacks. So long as the political situation in Europe does not

## SMALL CAPS TYPICALLY OUTPERFORM IN THE 6-12M AFTER THE FIRST RATE CUT

Small vs. large-cap relative returns in the 1/3/6/12 months before and after the first Fed rate cut since 1974.


Source: Fama French data library. Haver Analytics. BofA US Equity & US Quant Strategy.

massively deteriorate, we may see a re-rating combined with earnings recovery into year-end. Investors in the region are targeting sectors including software, aerospace, pharmaceuticals, semiconductors, and banks.

Japan’s market took a breather last quarter after a tremendous rise in 2023 and the first quarter of this year. The country’s economy has continued to expand at a solid rate and corporate earnings growth remains strong. However, there is investor concern that the market may have gotten ahead of itself and that corporate governance improvements have already been fully priced into valuations. Potential for the Bank of Japan to tighten monetary policy and trigger an appreciation in the yen also poses risk. We will most likely not see a significant yen re-rating until the Fed cuts US interest rates. In the meantime, economic growth should hold steady while corporate improvements in capital efficiency improve earnings, making Japan an attractive active market.

Like 2023, Big Tech has been the driving force behind the market this year, even outside of developed markets. Considering the size and scope of investments being made into AI, the impact should be expected. The most advanced chip makers and the large hyper-scalers have been at the leading edge and seen their stock prices reflect that dominance. Going forward, investors are focused on what other segments of companies will benefit the most and how much of the productivity gains have already been priced into valuations.

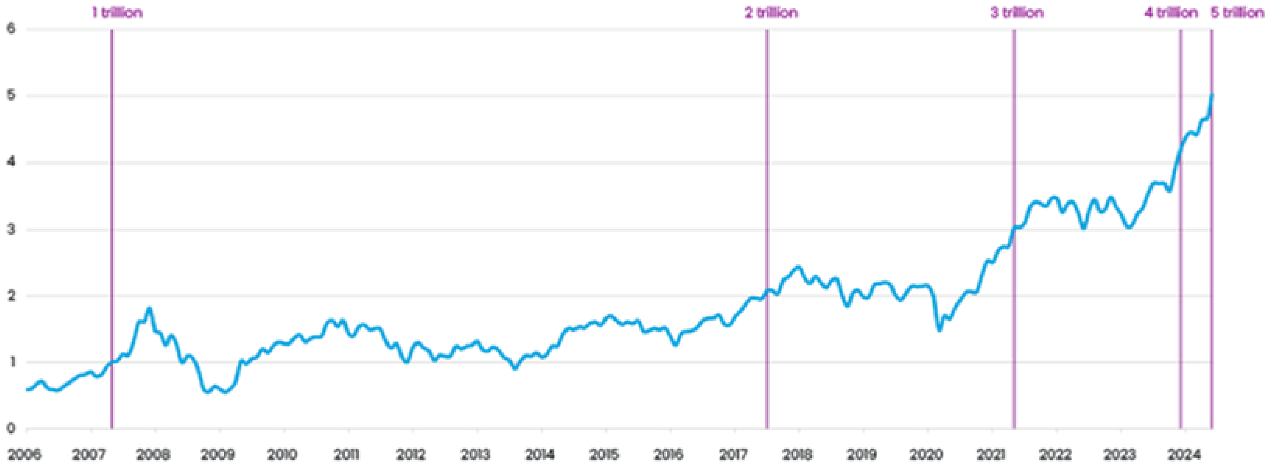
# EMERGING MARKETS

Emerging market (EM) equities rose 5% in Q2, outperforming global equities by two percentage points. Standout performers included Turkey, Taiwan, and India which rose 21%, 15%, and 10%, respectively. Latin American markets, detracted with the regional index falling 12% during the quarter.

AI has driven returns in EM as well. TSMC, the Taiwanese semiconductor manufacturer, rose 60% year-to-date through quarter end. Strong operating results, including price increases for advanced chips, drove performance. It is possible the market has not fully accounted for the impact of these price increases, which could continue to boost share performance going forward.

The failure of India's Prime Minister Narendra Modi to secure a simple parliamentary majority in the country's recent election came as a shock result. Consensus expectations were solidly aligned around Modi achieving an expanded majority position and, possibly even a bullet-proof supermajority. However, when the votes were counted Modi's BJP Party had lost over 20% of their previously held seats – largely to the advantage of the opposition Congress Party and its affiliates. While the outcome was sufficient to allow Modi to carry-on as PM, he has only been able to do so with the support of coalition partners. The immediate reaction from investors was negative as the market and the rupee sold off. However, those short-term losses were reversed and Indian equities continued to flourish, adding another USD 1 trillion of market cap in record time (see figure below).

## INDIA MARKET CAP IN USD TRILLIONS




Source: Refinitiv, East Capital, July, 2024.

In his first two terms, Modi made great strides in liberalizing India's economy and stabilizing public finances. The country's current account deficit has significantly narrowed in recent years and the RBI (India's central bank) has been successful in managing inflation; the rupee is no longer in secular decline. Economic growth, aided by taxation and labor reforms as well as transformative investment in the country's physical and digital infrastructure, is now running at 6 to 7% annually – a pace that can likely be sustained for the foreseeable future. The high expectations arising from India's economic transformation are reflected in equity prices - India's valuation is almost double the average for the broader EM Index. Justification of this premium is reliant on continued economic performance which, in turn, will require ongoing government support via pro-business legislation, sensible strategic public investments and prudent management of fiscal and monetary policies. While Modi and the BJP Party remain committed to delivering against these expectations, they now have to do so with the consent of coalition partners. At present, it seems likely that little will change – the ruling coalition appears aligned behind Modi.

The second quarter of 2024 also saw major election outcomes in Mexico and South Africa. In Mexico, the presidential election concluded with Claudia Sheinbaum securing a convincing victory. Her win should have signified a continuation of the economic policies of her predecessor, focusing on fiscal discipline and infrastructure development. The market reaction was less optimistic, the market fell 16% during the quarter.

In South Africa, the parliamentary elections resulted in the African National Congress (ANC) not securing a majority for the first time ever. Markets reacted positively to the prospect of an economic and market-friendly coalition.

# FIXED INCOME

Fixed income markets had another weak quarter with the Bloomberg Global Agg Index returning -1.1% for the quarter, bringing the year-to-date return to -3.2%. US performance was better than the broader market with the Bloomberg US Agg gaining 0.1%; this index is down 0.7% for the year. Treasuries and mortgages were the main positive contributors domestically. Investment grade corporate bonds were negative for the quarter, but high yield ended the period positive. Internationally, the notable drivers of underperformance were international sovereigns, which contributed -0.6% to performance, led by Japanese and French bonds.

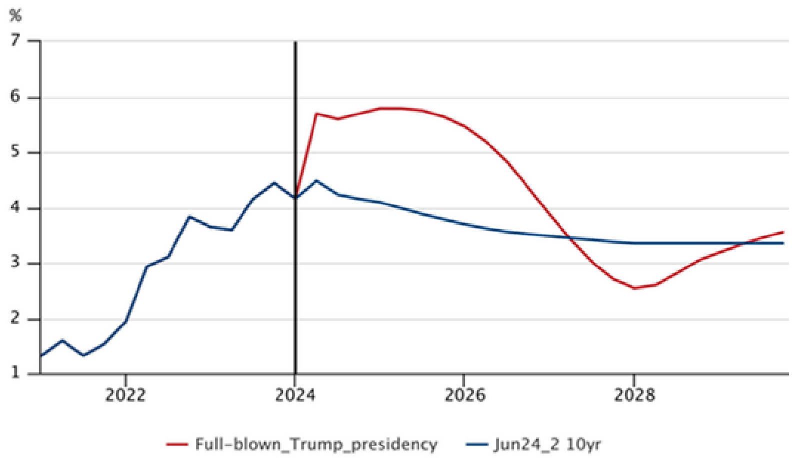
Moves higher in Japanese and French interest rates were pronounced in the second quarter. Japanese 10-year yields rose 37 basis points, trading above 1% for the first time since 2011 as inflation remained above 2% during the quarter. Persistent inflation of 2-3% coupled with a continued weakening of the Yen has led investors to start positioning for further policy action from the Bank of Japan – pushing rates higher. Markets are currently pricing a year-end policy rate in Japan of 0.275%, but various market participants think that policy rate could end the year as high as 0.75%. In France, government bonds, or OATs, sold off on Fiscal, not monetary, policy concerns. Yields on 10-year OATs rose 44 basis points during the month with their spread to the German equivalent widening 29 basis points during the quarter. In fact, France ended the quarter with a higher yield on its government debt than Portugal.

These moves higher in international rates, particularly in France, are important to highlight as higher for longer monetary policy as well as profligate fiscal policy are impacting US rates as well. Despite posting positive absolute returns for the quarter, yields on US Treasuries also rose in the April to June period. In fact, the US Treasury curve bear steepened during the quarter – a move that has been at least partially attributed to concerns over lax fiscal spending in the case of a “red-wave” in the coming US elections. Given the continued volatility in US interest rates, the rest of this section is devoted to exploring the current potential fair value of US 10yr rates and what a potential red-wave would do to that fair value over time.

Revisiting an analysis we detailed in our Q4 2023 letter, the “fair value” of the 2Q24 US 10-year yield, as calculated using the model put forth by Thomas Shelvin, fell very slightly from 3.95% at year-end 2023 to 3.92% at the end of this past quarter. Decelerating growth slightly offset stickier inflation dynamics, driving the yield ever so slightly lower. At the end of Q4, the model and observed yields were approximately seven basis points apart. The observed yield on the 10-year treasury at the end of Q2 in contrast was 4.40% – nearly 50 basis points higher than the modeled number. This break higher in yields despite counter-evolving fundamentals indicates a significant pricing of forward expectations.

Throughout the quarter there was meaningful volatility in inflation expectations, but by the end of the quarter inflation once again appeared on track and shorter-term interest rates did not back up as much during the quarter. This dynamic is what has led market observers and investors to suggest that markets are starting to price in this potential "red-wave" outcome. So how much is priced in? Using scenario analysis from Oxford Economics, we ran a stress test to determine the effect of a Republican sweep on US 10-year yields.

## BOND YIELDS - UNITED STATES




Source: Oxford Economics. RockCreek.

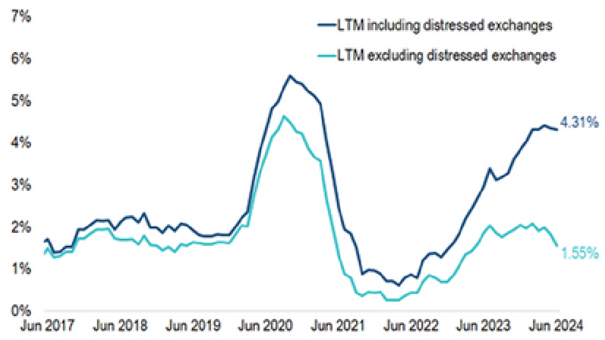
As you can see from the chart above, a sweep by the GOP is expected to result in a peak 10yr yield of approximately 5.7% vs. a baseline estimate of 4%. Assuming this estimate is correct (indeed a large assumption) that would translate into a further 130 basis points increase in the 10yr yield from the quarter end level. This move higher is driven by much more restrictive monetary policy as well as higher term premia for the 10yr bond. Over the next five years, the Fed is expected to first reduce rates in line with current expectations but must pause earlier and eventually even hike rates as tariff, immigration, and fiscal policies create a more inflationary environment. Higher and more variable inflation and monetary policy expectations add more than 100 basis points of term premia to the ten-year yield vs. the baseline forecast.

# PUBLIC CREDIT

Since the Fed began to raise interest rates in the second half of 2022, investors have shifted their fixed income exposure in order to minimize duration and maximize yield. This trade has benefited investors in products such as leveraged loans (LL), high yield bonds (HY), and collateralized loan obligations (CLOs). To make room for these allocations, investors moved away from credits more sensitive to rising rates including investment grade corporate bonds (IG) and mortgage-backed securities (MBS). Facing a higher-for (how much) longer rate environment, investors are beginning to debate whether it is time to reduce yield exposure in favor of more duration.

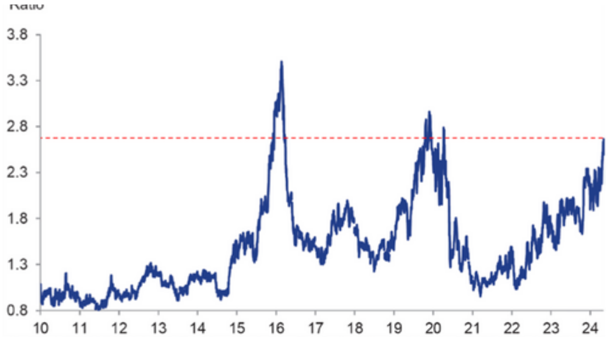
Current positioning continues to be supported by a strong performance. Q2 began with credit markets repricing for that higher for a longer environment. This led to investment grade corporate bonds losing -2.3% in April and mortgage-backed securities falling -3%. Strong earnings and moderating inflation data in May and June drove investors to allocate to high yield. Default rates in high yield bonds remained low, at 1.3% for US high yield bonds at the end of May. Similarly, leveraged loan volatility is currently just above its lowest level in 2021 and well off its May 2023 levels. This low level of volatility in leveraged loans appears to be driven primarily by collateralized loan obligations creation. Collateralized loan obligation creation stagnated in 2023 and rebounded strongly in the first half of 2024. May 2024, for instance, was the 2nd highest month on record for new collateralized loan obligations issuance. During this time, the trajectory of the default rate in leveraged loans has tracked downward, around 1.1% compared to 1.8% last year. But under the hood, stress levels for leveraged loans continue to rise. There is an increased amount of leveraged loans that continue to enter "distressed exchanges" as shown below. These are out-of-court bankruptcies that restructure their debt in exchange for equity upside and saving expenses from court proceedings. This has become a favored trade for credit managers, as they seek continued coupon payments in this high-rate environment.

## DUAL-TRACK US LOAN DEFAULT RATE: ISSUER COUNT




Source: PitchBook. LCD, Morningstar LSTA US Leveraged Loan Index. (June 30, 2024).

## DISPERSION RISING IN US HY MARKET




Source: Goldman Sachs Research. iBoxx. (May 20, 2024).

In high yield, volatility on the overall index remains low, but pockets of dispersion are at all-time highs, as shown by the graph below. There are different factors at play driving the market. The first is continued appreciation in price and size of the BB market. Historically, the BB tranche made up ~35% of the high yield market. In recent years it has grown to be ~50% of HY. BBB-BB spread has tightened to historically low levels as the BBs continue to tighten. From the beginning of COVID-19 to the end of 2023, the OAS spread of the BBB-BB tranches was 1.38 on average. As of June 2024, that spread had tightened to 0.63. Investors are thus weighing the risk-adjusted return between investment grade corporate bonds and high yield, as they can receive a similar absolute return for investment grade corporate bonds vs the upper ends of high yield. Also, within high yield, the excess return between the best and worst performing sectors (Pharma and Wireless, respectively), is a staggering 16% YTD. High yield bonds are thus a tale of two markets with high quality instruments in good sectors seeing record tights while the rest of the high yield market is experiencing some stress. This environment creates a strong case for active management where skillful investors can find mispriced credits amidst this dispersion.

As of now it would seem prudent to remain focused on yield. The US treasury curve is still inverted. At some point it will normalize, but it is unclear whether that will be driven by a bull or bear steepening. Either case would generally tend to favor shorter duration exposure. If, however, investors are worried about a recession it could be prudent to add some duration on the margin, perhaps through seasoned mortgage-backed securities which offer a higher yield than treasuries but can still perform well in a risk-off environment.

# PRIVATE CREDIT

Both opportunities and risks of the ballooning $1.7 trillion-dollar private credit industry continue to make headlines. Much of the scrutiny is well-founded. Certain segments of the private credit market present significant credit risk that investors are not being compensated for taking. These risks materialize in response to too much capital flowing into a certain opportunity. The combination of an explosion in the demand for debt capital and a lack of barriers to entry often results in a rapid influx of competition. As a rule of thumb, liquidity tends to erode illiquidity premium and competition tends to result in deteriorating underwriting standards, loosening loan documentation, and greater credit risk. Several strategies that demonstrate these characteristics include upper middle market sponsored lending and NAV lending, with Significant Risk Transfer (SRT) likely to follow suit.
Several recent headlines exemplify the risks that are present in private credit because of competitive market dynamics. Bloomberg recently reported on the actions of a large, blue-chip private equity firm that was able to raise cheaper debt financing by moving unencumbered assets away from private lenders. This “dropdown” strategy – known to be used within the Broadly Syndicated Loan (BSL) market – is only permissible in the context of loose loan documentation, which has become a hallmark of upper middle market corporate loans. The risk of having collateral stripped away from your loans or an early refinancing can be achieved by prioritizing lending into less competitive markets where protective covenants can be more aggressively negotiated.

Separately, the Financial Times and others, have reported on the risks associated with NAV lending, loans to GPs that are collateralized by fund residual value. In certain instances, these loans are being used as a tool by GPs to accelerate proceeds back to LPs during a drought of distributions – akin to a dividend recap of LP interests – resulting in a lack of alignment between a lender and borrower.

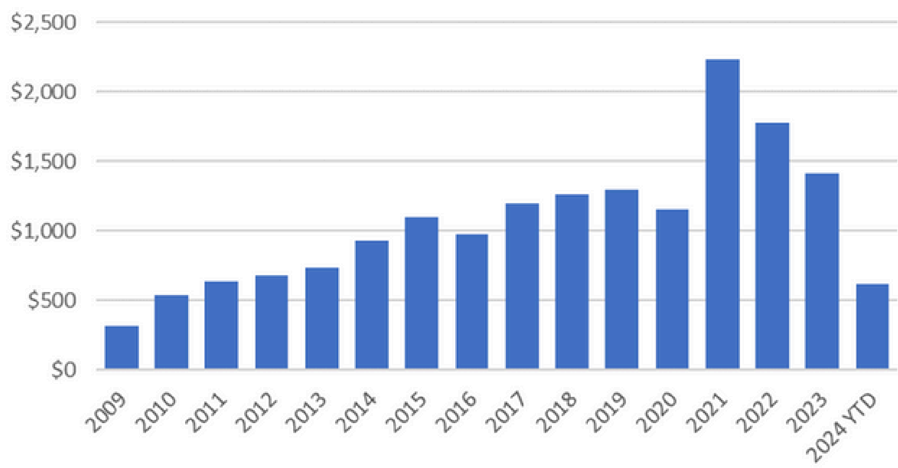
Other risks that have been reported provide captivating headlines but lack significant merit. Often these risks are being reinforced by the leaders of large financial institutions that are being disintermediated by private credit. These risks include a lack of regulation, systemic risk, and complexity. Although private credit funds definitionally are less regulated than banks and insurance companies, they are also not faced with the same liability structures. Private credit funds are invested via vehicles that are structured without redemption or withdrawal pressures, but other vehicle structures should be heavily scrutinized. While private credit has become an important component of corporate balance sheets, leverage in the system remains modest. Few corporate lending strategies utilize more than one turn of leverage and structure their borrowings to be non-recourse and non-mark-to-market. This is significantly more conservative than the lending done by bank proprietary trading desks prior to the Global Financial Crisis. Private credit is complex, particularly when you move beyond the scope of corporate lending. Private credit, like other alternative and private market asset classes, is designed for sophisticated institutional and qualified and accredited investors. Opportunities for non-qualified, non-accredited investors to participate are currently limited.

# PRIVATE EQUITY AND VENTURE CAPITAL

The private equity market remains in a logjam, with global deal volume down 8% relative to the first half of 2023 and down more than 40% as compared to the first half of 2022. The market is proceeding at a pace reminiscent of the 2016-2018 period, while exit value has totaled just $310 billion year-to-date through June. This is unlikely to persist, as dry powder remains at an all-time high while LPs are increasingly demanding liquidity from their private equity allocations. The reason for the muted activity is unclear, but one suggestion is that many in the industry are anticipating a decrease in interest rates, enabling them to sell assets into a stronger environment. Additionally, there is likely a general sense of caution and fear of making a mistake in the current market, as public equity premiums are at an all-time low and private equity firms' ability to pay has declined by 10-20% due to higher rates. For investors with sufficient liquidity in their portfolios, this environment is likely to create opportunities to step in as a liquidity provider, whether it be acquiring private stakes in funds and companies at a discount directly from limited partners, or providing creative financing solutions at attractive terms.

One area that has been active is M&A, as private equity firms look to bolster their existing portfolio companies. U.S. private equity M&A is up more than 40% year-to-date, while global M&A activity is up 30%. Strategic M&A also continues in the biotech sector, with Merck acquiring EyeBio for $1.3 billion and Biogen acquiring HI-Bio for $1.2 billion.

## GLOBAL PE DEAL VALUE ($BN)




Source: Pitchbook.

While the overall private equity market faces challenges, there are signs of increasing activity in the venture capital space. According to data from Crunchbase, global venture capital funding in May was up 40% month-over-month and 27% year-over-year, though this has been driven in part by large investment rounds in the artificial intelligence (AI) sector. AI companies raised $12.4 billion in May, representing 40% of the global total, highlighted by a $220 million seed round for French AI startup H. Not to be outdone, in June another France-based AI company, Mistral AI, raised a $640 million financing round. Despite headlines, the IPO window remains open, though few companies have decided to pursue a listing. That said, recent notable IPOs, including Arm, Birkenstock, Cava, Instacart, and Reddit, have traded at or above their offering prices, and the Renaissance Capital's IPO ETF has outperformed the S&P 500 over the past year.

As we have discussed in prior letters, the current environment has been particularly challenging for newer managers. To illustrate this, the share of capital going to emerging managers fell to an all-time low of 12.7% in 2023. Pitchbook estimates that more than a third of first-time venture capital funds will not be able to raise a second fund, and another report released by Pitchbook in June found that 13% of venture capital funds do not plan to raise another fund, double the rate over the same period in 2023.

# REAL ESTATE

The AI boom is driving significant capital towards data centers. This trend has spurred a dramatic surge in demand for data storage and computing power. However, this growth comes with an increase in energy use, primarily consumed by semiconductor chips and the specialized HVAC cooling systems for data centers. Current projections may overestimate the total energy consumption, however, as they do not factor in efficiency gains in either chips or cooling.

Electrification, another trend with ties to the AI boom, is key to meeting renewable energy demand. Earlier this year, we observed a net flow of energy to Canada due to their drier season and lower snowpack, as their abundant hydro power sources have been a significant factor in the ability to meet renewable energy goals with electrification, which highlights the need for a more interconnected grid. Furthermore, we have seen increased grid stress coming from increased load growth paired with limited capacity of existing transmission lines. As a result, we have prioritized investments in decentralized, point-of-use solutions and EV charging infrastructure as they provide attractive solutions.

Within real estate, the ongoing Work-From-Home (WFH) trend continues to disrupt the office real estate sector, resulting in lower transaction volumes that have impacted valuations. Stress is evident in capital stacks across all real estate sectors, and as year-end approaches, this trend is anticipated to become even more pronounced, particularly in the multifamily sector. However, caution is still warranted in office space. Despite the challenges, an uptick in multifamily transaction volume is expected, and investment opportunities remain focused on entities whose partners can operate or finalize construction in the event of a change in ownership.

The upcoming U.S. elections also have significant implications for investment infrastructure strategies. Uncertainty surrounding the results has led investors to adopt a cautious approach, delaying capital plans until policy outcomes become clearer. While there has generally been bipartisan support for the IRA, which is crucial for many jobs in red states, single party control over the presidency and Congress could lead to changes in specific sectors. We view clean energy deployment as the least at risk, grants to incentivize adoption as higher risk, and some risk to EVs and charging infrastructure. However, without single party control over both the presidency and Congress, any significant changes are unlikely. Continued support for renewables, clean fuels, and energy transition investments are expected regardless.

Finally, stringent water regulations, particularly those focused on PFAS/forever chemicals and specific types of plastics, are also a key theme. The EPA has implemented rules to reduce the use and contamination of these substances in water. Traditional water treatment methods are insufficient, necessitating more advanced solutions like incineration or reverse osmosis. These changes create investment opportunities in companies that recycle liquids and those involved in waste management.