commonfund

Fiscal Year-End and Mid-Year 2024 Market and Investment Review

Over the last 12 months, the global stock markets demonstrated remarkable resilience and growth despite several challenges, including persistently high interest rates, geopolitical instability, and contentious election cycles in the U.S. and abroad.

As we close out Commonfund's fiscal year-end and the mid-point of the calendar year, it's important to assess the current economic and market conditions before we embark on what could potentially be a volatile second half of 2024. There have been positive market surprises, certainly in equities, that investors are no doubt pleased with as the continuation of the strong performance of 2023 has led to new highs in the major domestic indices and strong returns globally. The S&P 500 advanced 24.6 percent in the past 12 months, led by big tech stocks, particularly those aligned with investor enthusiasm for artificial intelligence. The MSCI World Ex-US and Emerging Markets indices returned 11.2 percent and 12.6 percent, respectively. Fixed income markets were more mixed as duration exposure was volatile in response to rate uncertainty, while credit spreads have been contained. On the economic front, some data has been directionally disappointing. This shouldn't be surprising given the long lag that exists between the tightening of monetary policy and eventual impact on the real economy at the micro level. It is possible that the delayed economic impact from higher rates has been exaggerated in this tightening cycle by the huge fiscal outlays of the Federal government. Nonetheless, even with the "long fuse", the impact of rising rates is slowly feeding into the system.

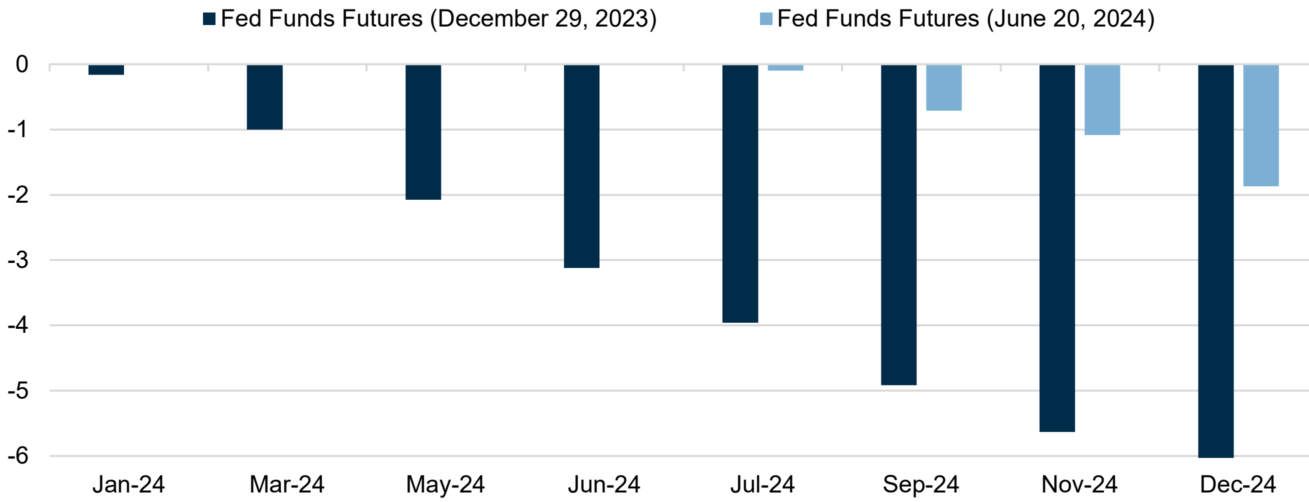
Since the beginning of the year, investors have had to embrace a less-accommodative-than-expected Fed. The market's "expectation" of six rate cuts has dwindled to the "hope" for just one rate cut. From the central bank's perspective, the June Federal Open Markets Committee (FOMC) meeting provided insight into the committee's views, with updates to the Summary of Economic Projections and Dot Plot. The outlook for inflation, growth and employment has been marginally adjusted but still reflects a stable economy with inflation taking longer than anticipated to return to target. As such, the committee's long-held view of three rate cuts in 2024 has now been reduced to just one rate cut later in the year, with additional reductions coming in 2025. Perhaps, one of the most revealing data points from the June FOMC communication was the move up in long-run interest rate expectations meaning, even after some accommodation, interest rates aren't returning to pre-COVID levels any time soon.

A theme for the second half of 2024 will be global central banks starting to ease with the hopes that still-elevated inflation starts to fade. The European Central Bank was the first major central bank to cut rates on June 6th along with Canada, Sweden and Switzerland also easing this year. History generally tells us the FOMC leads with others to follow, so this time around is different. The European Union is still dealing with inflation but taking the stance of getting ahead of any potential issues on the horizon even if data holds up in the short run. Ultimately, it is now safe to say the "higher for longer" narrative has shifted.

FIGURE I

FOMC RATE CUT EXPECTATIONS

Futures have adjusted significantly – higher for longer is the new consensus



Source: Bloomberg

Domestically, real GDP came in below expectations in the first quarter of 2024, but inflation remains range-bound between 3 and 4 percent with shelter and wages still elevated. There are various reasons for the slowdown in GDP growth, including a smaller fiscal impulse. The U.S. government continues to run huge fiscal deficits, but government spending has moderated since last year. In fact, the government's direct contribution to GDP in the first quarter was the smallest since the second quarter 2022. Also, domestic growth was supported by consumer spending, which slowed marginally in the beginning of the year after having been above trend for an extended period. Slowing consumer spending may also start to impact earnings as companies are less able to pass on higher costs and preserve margins. Now, savings have dwindled, and the costs and levels of revolving credit are building as consumers have taken on more debt to maintain a steady level of consumption. The reality is consumers are more focused on price levels in their everyday activities and this is the larger household challenge. Absent outright deflation, higher price levels will continue to put pressure on consumer budgets and impact marginal spending.

On the bright side, employment has remained relatively healthy according to the monthly Bureau of Labor Statistics data. However, secondary data (JOLTS, Challenger Job Cuts, ADP, Sentiment) may be showing growing weakness in the jobs market. The evolving narrative seems to be that people feel less secure in their current employment and finding a new job is becoming increasingly more difficult. Other than fiscal stimulus, the last source of comfort to the consumer is job security. If unemployment begins to rise, expect to see a significant downdraft in consumption and economic growth that should finally motivate the FOMC to reduce rates. However, with the unemployment rate at 4.0 percent, it remains to be seen whether that happens in 2024.

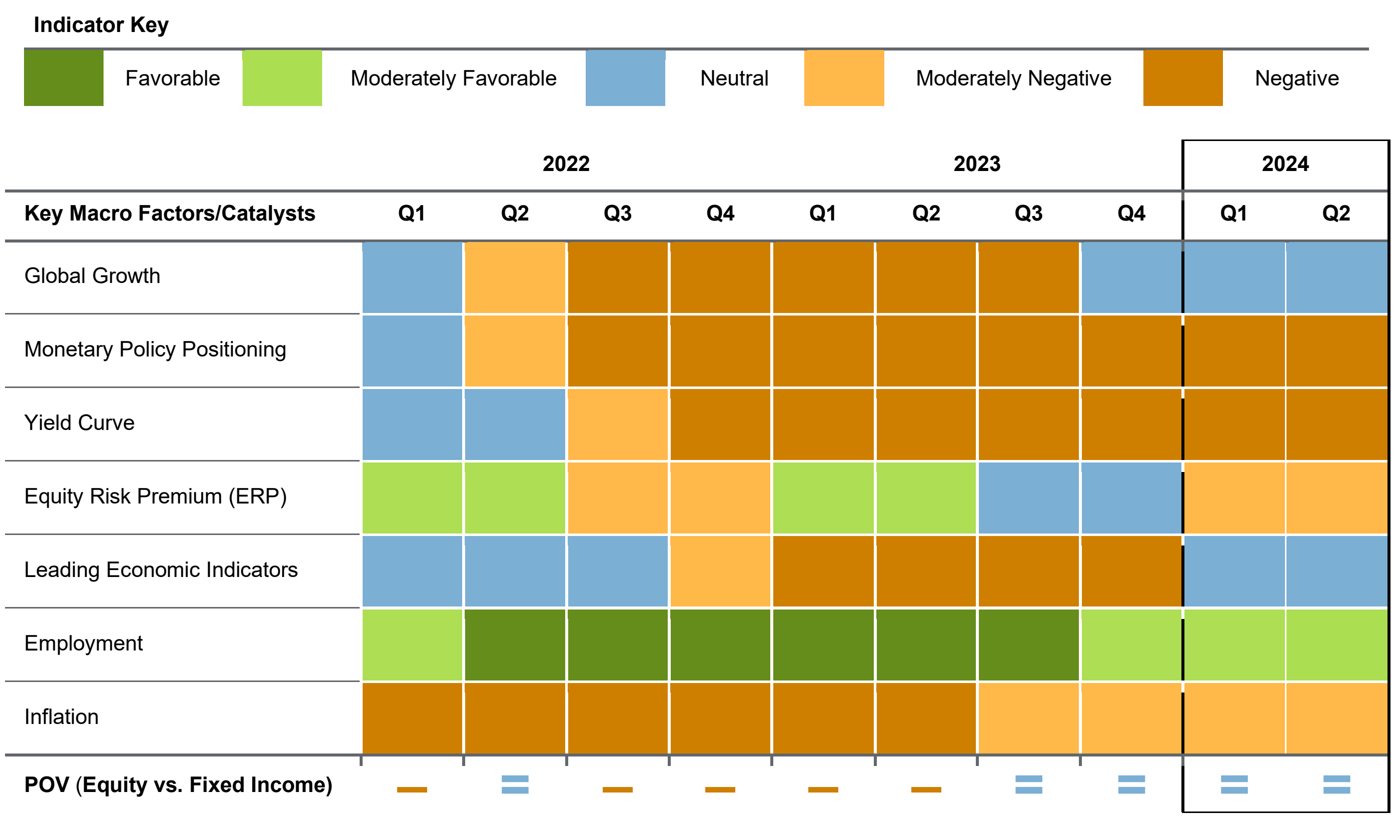
As we look at the remainder of the calendar year, we would be remiss not to acknowledge the upcoming U.S. elections. Taking an ideologically neutral approach, the biggest potential impacts from a market perspective will be heightened geopolitical risks, and uncertainties about the direction of taxes, trade, and the regulatory environment. In 2025, taxes will be a primary legislative issue as the Tax Cuts and Jobs Acts of 2017, a tax reform law that reduced tax rates across the income spectrum, is set to expire. On trade, both candidates support a rollback of decades of trade liberalization, but to different extents. Finally, if history is a guide, the regulatory environment that has put significant costs on the private sector will likely reverse if there is a change in the Executive Office. Lastly, at this point, neither party has a credible plan to deal with the unsustainable fiscal path of significant deficits the United States faces.

The environment facing the markets may seem daunting in the new fiscal year, but it is consistent with the long-term cycles that are accounted for when constructing a strategic investment policy. Economic strength ebbs and flows based on a variety of factors with central banks trying to use interest rates and balance sheet adjustments to avoid significant downside deviations from the normal outcomes. Globally, it appears to be close to the end of the cycle of restrictive monetary policy, which is a net positive for risk assets. However, there are non-market factors such as elections and geopolitical risks that can induce short-term volatility and create moments of distress in the coming months. Our Tactical Asset Allocation Dashboard helps us to tease out the important signals from the everyday noise in the markets. Based on current readings, portfolio positioning is neutral to policy for equity vs. fixed income exposure. While the dashboard provides a top-down input to our Asset Allocation Committee, it represents just one piece of the puzzle. Our investment teams are in constant contact with the hundreds of managers that we work with around the globe, synthesizing their insights into our investment process. Following, we share perspective from our teams.

FIGURE II

TACTICAL ASSET ALLOCATION DASHBOARD

Seven key factors that drive our tactical equity to fixed income allocations



Source: Commonfund June 2024

Public Equities Continue to Perform

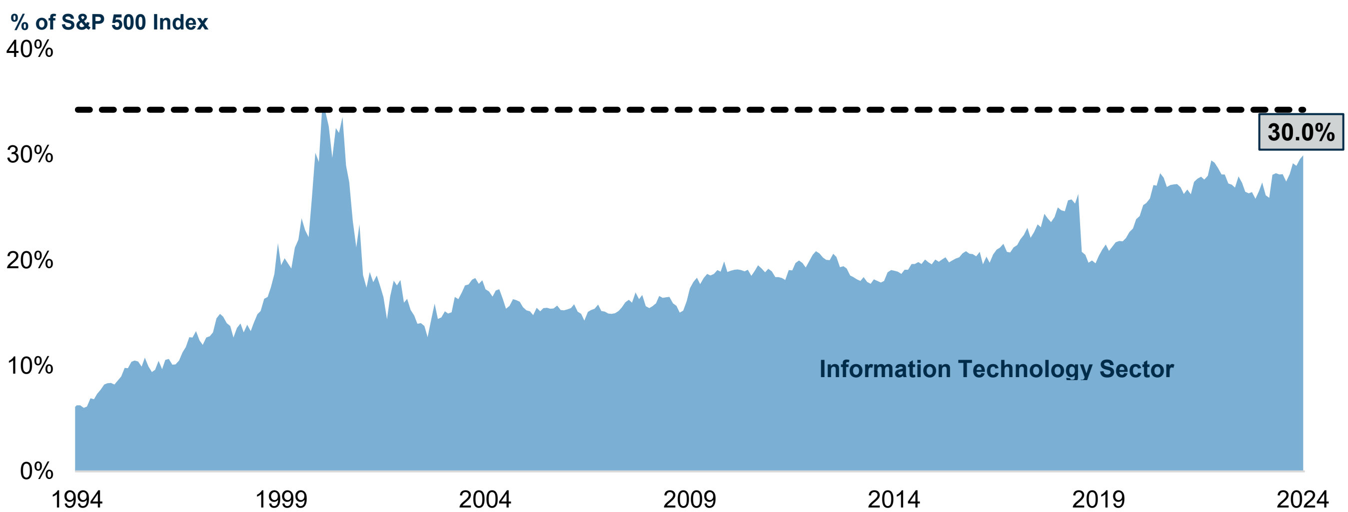
Fiscal 2024 turned in another strong year for public equities, with the MSCI All-Country World Index (ACWI) returning 19.4 percent and the S&P 500 Index advancing 24.6 percent. These strong returns follow on from fiscal 2023 gains of 16.5 percent and 19.6 percent, respectively, for the ACWI and S&P indices. This year's rally was led by technology and communication services shares (what else is new!) with suppliers and beneficiaries of the Artificial Intelligence (AI) investment cycle and buildout benefiting the most. No company embodies that theme more than NVIDIA, whose chips power much of the infrastructure buildout. NVIDIA stock returned 192 percent this fiscal year and was responsible for nearly 17 percent of the entire return of the ACWI index. For comparison purposes, all European and emerging markets stocks combined contributed approximately the same amount to the ACWI return as NVIDIA. Index concentration continued to create difficult conditions for actively managed portfolios, with over 50 percent of the S&P 500 Index return generated by just five stocks. Concentration has increased from 16 percent to 20 percent for the Magnificent 7 names (Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla) within the ACWI Index and a significantly higher percentage of the S&P 500.

While the earnings outlook for the U.S. tech sector continues to be supportive, the meteoric rise in share prices (and valuations) could cause investor exuberance to temper in the coming year. This would likely bode well for active management as some dispersion of valuations in the technology sector would allow for the application of economic fundamentals. Many sectors outside technology have equity valuations that are well within their historic ranges and are supported by steady earnings growth forecasts. Barring a surprise surge in inflation, or uncertainty surrounding the unprecedented number of key elections taking place across the globe, we could see increasing market breadth going forward, particularly if the Fed cuts interest rates.

FIGURE III

TECH SECTOR CONTINUES TO DRIVE MARKETS

Sector is approaching the all-time high index weight last seen amid the Dotcom mania



As of February 2024. Source: Bloomberg, Commonfund Research.

Green Shoots Appear in Private Equity Buyouts

Halfway through 2024, the industry has yet to see a pronounced “bounce-back” in dealmaking. However, the latest industry data suggests the trough in deal volumes is likely behind us. Further, our managers are starting to report improved dealmaking conditions, which they expect will translate to bolstered deal flow / exit opportunities heading into the back half of the year, likely leading to an increase in distributions from this recent trough.

2023 marked the private equity industry’s second consecutive year of lower deal volumes following 2021’s record-breaking activity, as dealmakers navigated dislocation in M&A markets catalyzed by higher interest rates and tighter debt markets. In contrast, portfolio company-level operating performance remained generally resilient in 2023. In our blog earlier this year, Private Equity in 2024: Where Do We Go from Here, we posited that private equity would rebound in 2024 driven by a confluence of interrelated macro-factors: (1) a stable monetary policy outlook, (2) more favorable debt markets, (3) a rally in public markets valuations, and (4) the mounting backlog of aging, unrealized private equity portfolio companies.

Given the current private equity environment outlook, we continue to believe lower-middle / middle market sector and geographic specialists are particularly poised to capitalize on the current opportunity set. Notably, ~80 percent of global aggregate private equity dry powder is held by funds greater than $1 billion in fund size; this pool of capital must be invested eventually, which should continue to support smaller private equity managers selling their portfolio companies up-market. As debt has become more expensive, we also believe smaller managers relying less on financial leverage and more on operational value creation will continue to be advantaged in the go-forward environment. Additionally, we continue to back managers targeting high growth, high recurring revenue, and profitable companies across several high-conviction sectors, including SaaS, tech-enabled business services, and healthcare services.

Gen AI Stands Out Amidst a Challenging Valuation Period for Venture Capital

Over the last year, valuations for new venture capital financing rounds have stabilized at a lower level than the late 2021/early 2022 market peak. Non-traditional investors such as mutual funds, hedge funds and sovereign wealth funds have remained on the sidelines, leading to a continued decline in growth and later stage fundraising activity. Given the more discerning investing environment, we see a “tale of three situations” unfolding for venture-backed companies dependent on underlying business performance. The best performing companies that have maintained strong revenue growth while operating efficiently have been growing into their valuations, and many have completed up-round financings in recent months. In contrast, companies that have not exhibited best-in-class metrics have been forced to raise down-round financings. Some of those companies will not be viable as independent entities and will need to either shut down or find a strategic buyer, although we haven’t seen many companies reach this category yet. The exit market will depend on a few factors: M&A, historically the largest source of exits by number, depends on the upcoming presidential election and its implication on regulatory support for M&A. IPOs may be bolstered by rate cuts, although any companies going public need to exhibit that they will benefit (or at least not be adversely impacted) by Artificial Intelligence. Although the IPO window has not fully opened, there have been recent successful IPOs including Rubrik, Astera Labs and Reddit, with several public-ready companies having filed or waiting to file when the window fully reopens.

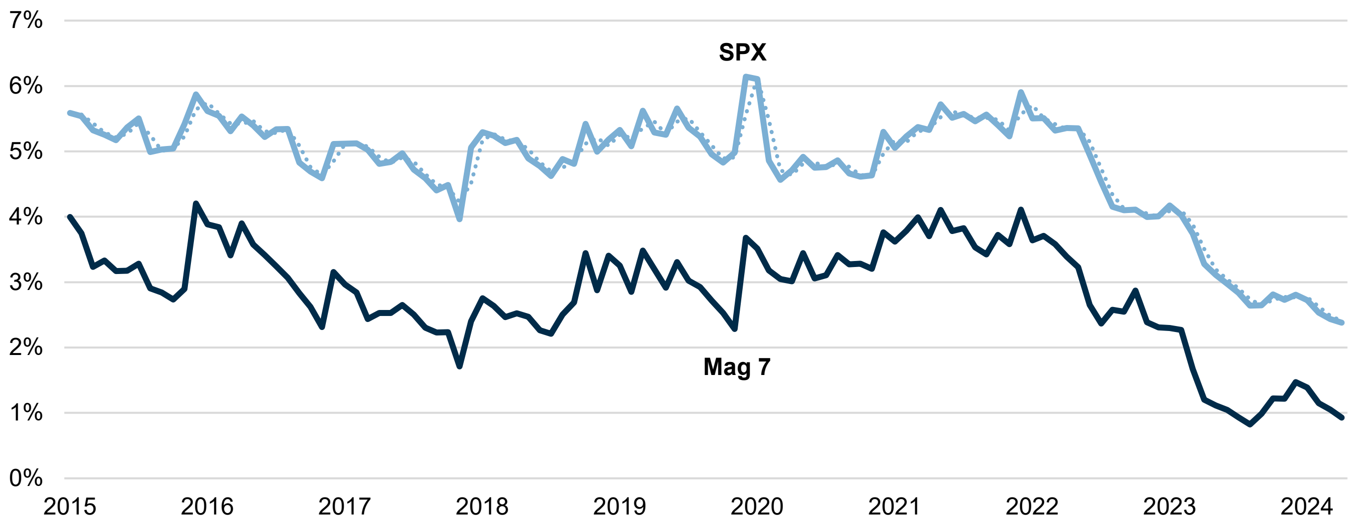
The venture market has historically been buoyed by technological shifts such as smartphones and the Internet, and we see a similar pattern emerging in the white-hot Generative Artificial Intelligence (Gen AI) sector.

Early foundational models and infrastructure companies have quickly monetized and scaled to multibillions in revenue over the last year (e.g., OpenAI, which owns ChatGPT, reached $2 billion in annual recurring revenue in just over a year after launching publicly), and the application layer is evolving rapidly with use cases being formed across industries. While the ecosystem around Gen AI will take years to develop, the potential economic impact could stretch into the trillions of dollars, and we believe the future category winners in this sector are being founded and backed by venture managers today. Because Gen AI will impact myriad industries, we continue to favor established, generalist venture managers that have experience leveraging their deep and broad knowledge base to capitalize on past large-scale platform shifts.

FIGURE IV

EQUITY RISK PREMIUM | S&P 500 VS. THE MAGNIFICENT 7

The Mag 7 Equity Risk Premium is below one percent



Source: Bloomberg

Secondaries Grow in Importance as a Portfolio Management Tool

Liquidity was at a premium this past year. 2023 marked a low point for M&A and IPO activity. Private equity investors desire to not miss vintage years and to re-up with managers led to a barbell of older and younger vintages years being sold into the secondary market to make room for new commitments. Younger vintages priced better than old tail-end secondaries. Investors also trimmed their commitments rather than selling their entire positions. Portfolio management was a main driver for sellers. This combined with the continued increase in supply from GP-led transactions led to a buyers' market. The LP-led market outpaced the GP-led market for the second year in a row. We are seeing more new entrants focused on the GP-led market as this new portion of the market continues to evolve. We believe that there are more barriers to entry in the LP-led market than the GP-led market. GPs are using continuation funds as an additional liquidity option to keep their best companies. LP transactions remain core to the secondary market because they allow investors to tailor their portfolio to their specific needs. According to Private Equity International, in 2024, there are over 3,800 funds in the market seeking $1.1 trillion in capital. Secondary fundraising is not keeping pace with the growth of the primary market. The secondary market remains undercapitalized and under-resourced despite an ever-increasing need for private equity investors to have liquidity options. 2024 may be another record year for secondary volume but still much lower than the secondary market's potential.

Under-Investment in Real Assets and Sustainability Continues

Commodities like energy, agricultural products and metals continued to be stubborn contributors to inflationary pressure, even in the face of tighter monetary policies in major markets. Geopolitical threats to resource supply chains grew and contributed to this trend highlighted by the war in Gaza, the ongoing Russia-Ukraine war, attacks on Red Sea shipping, and trade tensions between the West and China. Growing demand for electricity from data centers broadly (and generative Artificial Intelligence specifically) contributed to already significant strains on power grids in developed markets. Despite these dynamics, capital flowing into the resources markets continues to be relatively muted – particularly in upstream oil & gas, which has seen a growing wave of mergers and consolidation. Against this macroeconomic backdrop, we believe there will continue to be a need for investment across the spectrum into energy including both conventional resources and those associated with the energy transition. Beyond energy, the strain on supply chains continues to present significant opportunity in areas like food, agriculture & water as well as broader resource efficiency.

Real Estate Sectors Diverge

The real estate market over the past year continued to remain in flux as market participants sought to find equilibrium after the rapid interest rate increases in 2022. Transaction volume remained muted as bid/ask spreads remained wide, particularly for out of favor sectors or assets. Performance over the last two years was widely dispersed and dependent upon sector allocations and manager debt executions. Large exposure to office has generated significant losses, while exposure to data centers and related assets have been largely immune to market pressures. The multi-family sector, a long-favored segment of the market, has experienced meaningful writedowns as cap rates expanded. While fundamentals in the sector remain positive, debt structures will drive outcomes. Some investors took advantage of historically low interest rates, fixing agency debt for long periods while others utilized floating rate debt and, in some cases, did not hedge against rising rates. Depending upon future market dynamics, outcomes could be meaningfully different within the same sector.

However, green shoots have begun to appear with some transaction volume returning for small and midsized assets. The increase in interest rates has led to a silver lining for real estate owners as construction pipelines have declined due to high debt financing costs, current cap rates and construction costs. Supply and demand dynamics in 2025 and beyond should result in a positive backdrop for the asset class and these dynamics are already playing out in certain segments where construction has been muted for several years. This environment should prove positive for those with dry powder as capital is scarcer and investors that have it can take advantage of a lower priced market and stressed capital structures. Additionally, there remain areas of growth driven by supply chain reconfiguration and digitization of the global economy. We continue to believe digital infrastructure remains a significant opportunity for investors.

Core Fixed Income Faces Volatility, Fixed and Floating Rate Credit Provide a Tailwind

Like the prior fiscal year, investors experienced volatile yields, spreads, and currencies for the twelve-month period ending June 2024, as uncertainty around the economic and geopolitical backdrop kept investors guessing. From a sector perspective, investors were rewarded for taking corporate credit risk as investment grade bonds, high yield bonds and broadly syndicated loans all generated positive total and excess returns in an uncertain higher-rate environment. Generating the best outcome was floating rate debt, which benefited from the Fed's tightening cycle. Aside from these sectors, Treasuries and securitized debt also produced positive outcomes for investors, albeit it not to the extent corporate credit did, while the dollar appreciated relative to non-U.S. currencies, providing a headwind to non-dollar positioning. At this juncture, corporate credit defaults remain well-behaved, but the longer the Fed Funds rate remains higher, the more stress borrowers will be under due to elevated interest expense. Given this backdrop, we don't find credit spreads overly compelling, it's a bond pickers environment, and we remain watchful for both risk and opportunity.

Private Credit was a key part of the financial landscape during the fiscal year and given the effect of regulatory efforts impacting the banking system in North America and Europe, it will remain so for some time to come. While much of the capital entering the space in North America chose to focus on the larger borrower, driving spreads much tighter in that segment of the market, there remain many opportunities for investors to take advantage of wider spreads, tighter covenants, and lower leverage by lending to small to mid-size borrowers. Aside from corporate-focused private lending, some investors have also focused more attention on asset-based finance and other opportunistic strategies that can provide "all-weather" or "through the cycle" opportunities, while also securing a diversified approach to inflation protection aside from floating rate loans, or for those seeking more duration or fixed like characteristics out of their portfolio. Europe, where the development of the Private Credit ecosystem is estimated to be between four and five years behind the U.S., may also be a source of differentiated opportunities, as the various languages, legal systems and economies all combine to create a financial landscape that may be somewhat less efficient than what we see in the U.S., while also placing a premium on local knowledge. Whether the Fed stays higher for longer, or eases from here, there continues to be many levers to pull in Private Credit to achieve an attractive risk-adjusted outcome for investors.

Hedge Funds

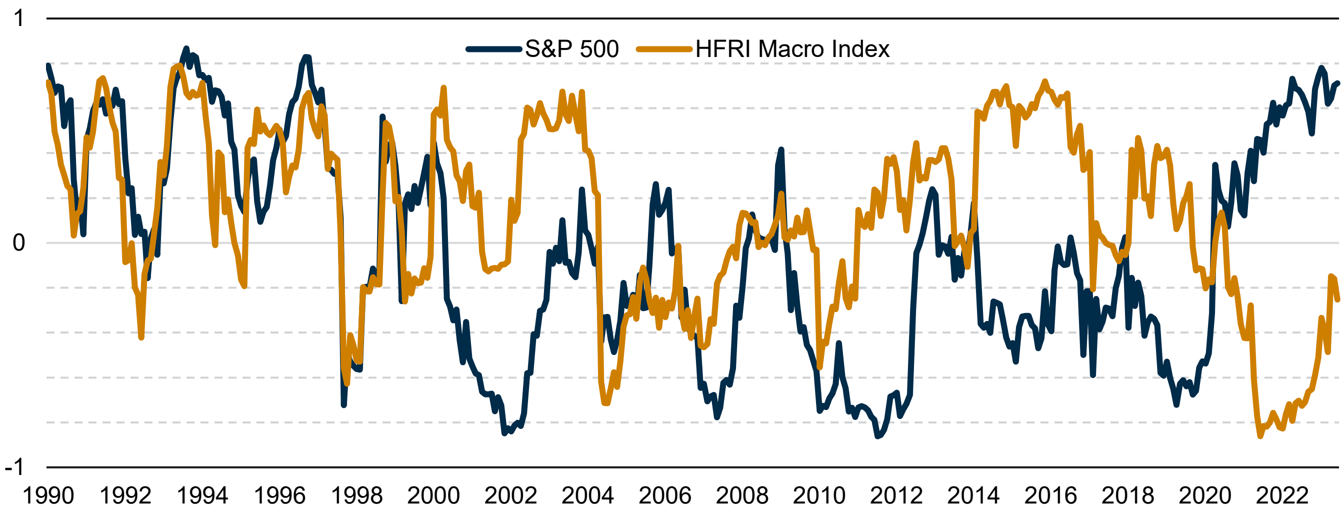
Hedge fund performance was broadly positive across most categories in fiscal 2024 and was led in absolute return terms by the more risk-on strategy categories such as (long-biased) Equity Hedge and Event-Driven. Within Long-Short, many of the familiar concentrated AI-exposed names were among key drivers for the year; in Event, while corporate activity did pick up off the lows of the prior year, and we saw a mix of notable mergers and spin-offs, it was (still) not quite the opportunity set that many continue to expect after 2+ years of subdued activity and presumed pent-up demand. In the meantime, credit including stressed-not-distressed provided powered the Event-Driven space to a risk-on positive year.

Finally, and perhaps most notably, Macro continued to stand out for its low-to-negative correlation to Fixed Income, particularly significant against the backdrop of elevated stock-bond correlation.

FIGURE V

MACRO HEDGE FUNDS PROVIDING DIVERSIFICATION TO CORE FIXED INCOME

Rolling 12-month rolling correlations of HFRI Macro vs. U.S. Treasuries Index



Source: Bloomberg, HFRI

Closing Thoughts and Developments at Commonfund

Over the past year, Commonfund has settled into a routine of three to four days in the office each week. We have found that the personal connection from in-person meetings simply cannot be re-created through the convenience of a video screen. Nonetheless, the Commonfund Staff have appreciated the flexibility that a balanced schedule provides between work and family life, and we continue to enhance that flexibility for our most critical asset: our Human Capital.

And, as we think about growing our human capital, here are the current statistics from our summer intern class: we have 22 interns in total, a very diverse group, 64 percent female and 45 percent of which are people of color.

Last, we would like to thank all our attendees who made the effort to join us for our annual Forum in Orlando. Steve Liesman did his typically stellar job as moderator and emcee to kick off Forum while the Commonfund staff worked hard to cook up perfect weather, great food, incredible speakers, and fun events. In all, we had over 400 clients representing approximately $850 billion in assets, from 7 countries and almost all 50 states. In addition, we had over 40 experts in economics, robotics, ESG, Generative AI, and more, providing introspective and thought-engaging ideas across 35 different panels, presentations, breakout sessions, and discussion groups. Next year we will again be at the JW Marriott Grande Lakes in Orlando, Florida, from March 9 – 11, 2025. Please mark the dates on your calendars and we hope to see all of you during the next year. Thank you for your partnership and trust in Commonfund.

Mark Anson, Deborah Spalding,
and the Commonfund Investment team

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