After a Year that Upended Most Expectations, More Surprises May Lie Ahead

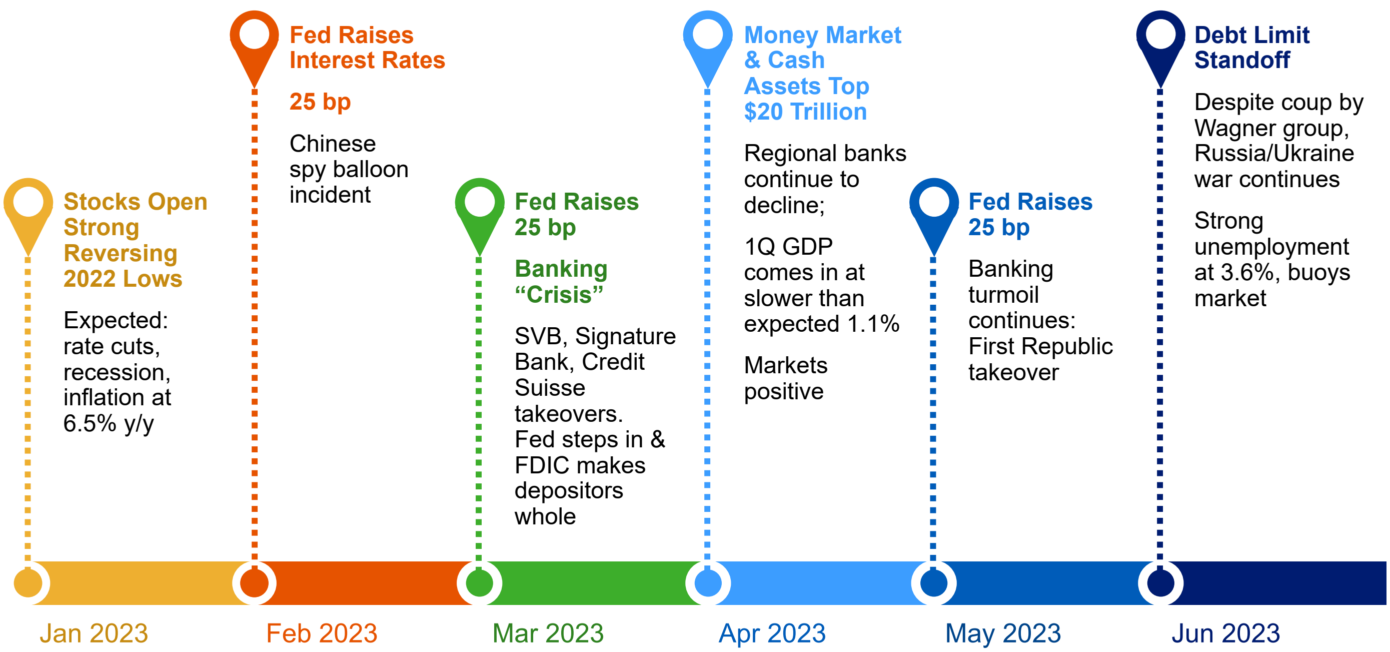
February 2024 Investment Outlook

Segal Marco Advisors

Overview

As 2023 began, the expectation for a recession was high; interest rates were expected to decline and the consumer was expected to slow spending. None of this came to pass. There was no recession; a soft landing came to fruition (so far); interest rates did not decline till late in year — due to the market, not actions taken by the U.S. Federal Reserve (the Fed) — and the consumer remained strong. This was despite three bank failures/takeovers in March, conflicts in the Middle East, the ongoing Russia/Ukraine war, budget standoffs and a downgrade of U.S. debt rating; but, on a positive note, inflation declined.

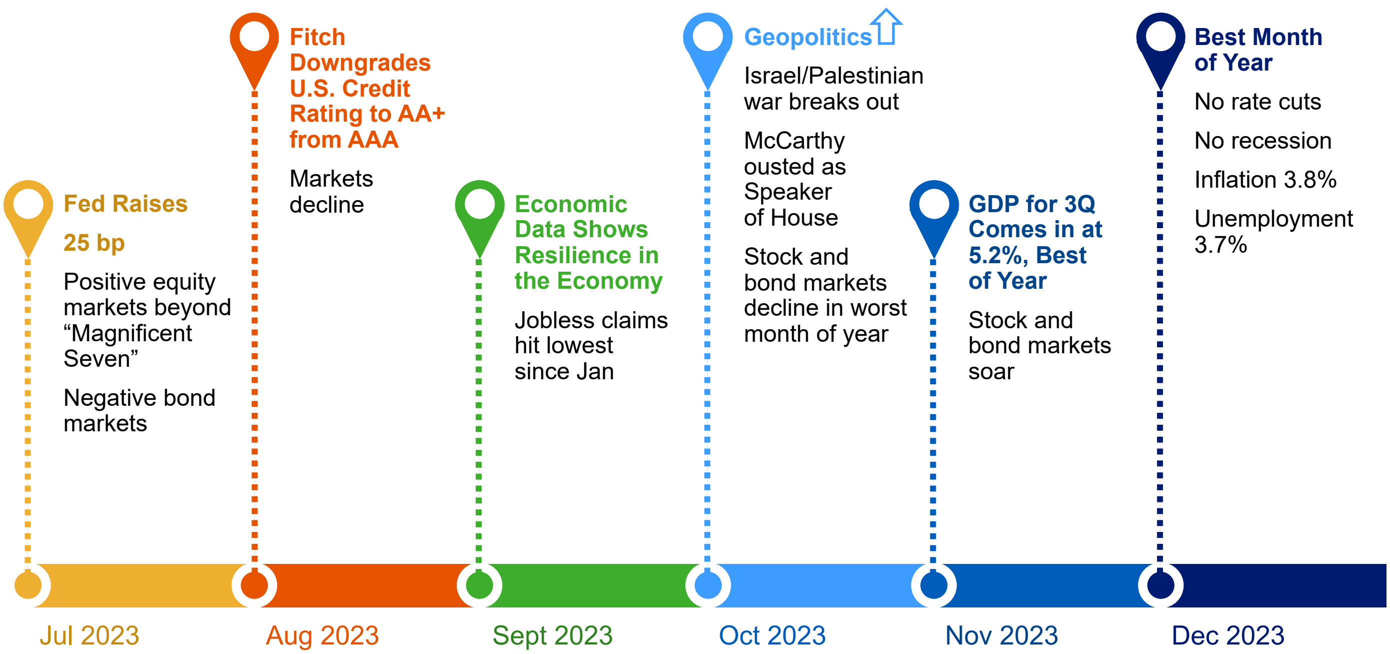
2023 in Review: The First Six Months



Source: Segal Marco Advisors

This *Investment Outlook* was written in January 2024.

2023 in Review: The Second Six Months



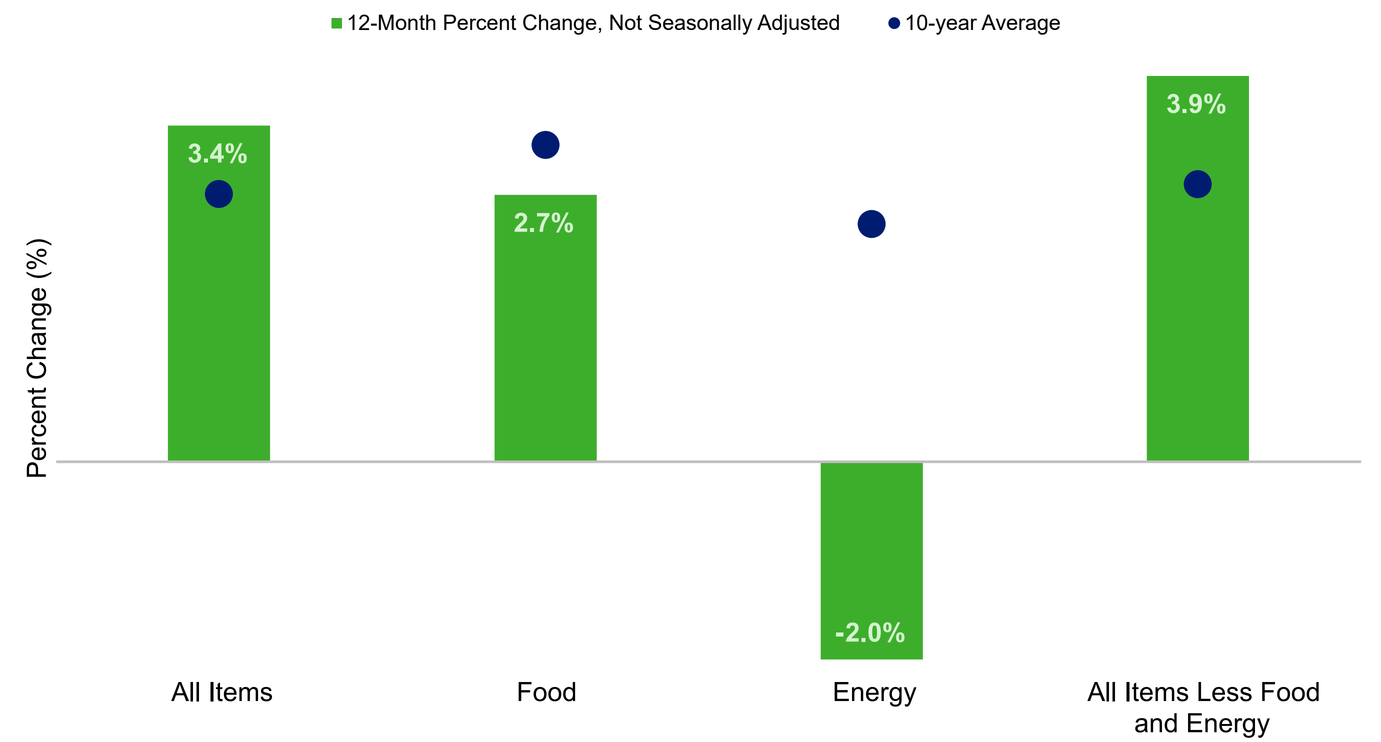
Source: Segal Marco Advisors

Economic backdrop

The U.S. ended the year at a 3.7 percent unemployment rate, up from 3.5 percent at the end of 2023. The low during the year was 3.4 percent. Importantly for consumer spending, wages increased 4.3 percent year over year for the period ended September (down from 5.1 percent in the equivalent 12 months one year earlier}. Benefit costs increased 4.1 percent over the same time frame (versus 4.9 percent in the 12 months that ended in September 2022). So, despite a slight softening, the labor backdrop is solid going into 2024.

One big 2023 surprise was the strength of the consumer. The advanced retail sales number for the 12 months ended December was up 3.2 percent, with the December 2022 to December 2023 one-month number up a strong 5.6 percent. This strength provided the support for the upside to GDP and the knock-on positive impacts for the economy. The wage increases helped support spending, as did an increasing wealth effect. Consequently, it is somewhat perplexing that we experienced the significant decline in inflation that occurred in 2023. But much of the decline in inflation was due to energy-related factors, as illustrated below, with the largest being gasoline. With the Fed target inflation rate of 2 percent in focus, we ended the year at 3.9 percent versus 5 percent, so a big improvement.

2023 CPI and Components Compared to 10-Year Average*



* Period ending December 2023

Source: U.S. Bureau of Labor Statistics

The global economy

Global economic growth in developed non-U.S. areas followed a similar trajectory to the U.S., in that inflation declines were seen, GDP slowed (and in some cases went slightly negative, like in Germany, with final EU figures to come), but employment remained strong and provided solid footing for growth and spending. Services continued to lead the growth momentum, while manufacturing showed a slowdown (hence the declines in Germany).

The International Monetary Fund's latest report shows expectations for 3 percent global growth, with the largest contributions coming from the U.S., India and China. (Despite all of the press on China's growth rate slowing, it still comes in at about 5 percent.) Inflation followed a similar pattern. With global inflation elevated coming into 2023, declines were seen throughout developed economies (albeit not as much as in the U.S.).

Not a bad environment given the higher interest rates globally, the increased inflation environment around the globe and energy issues due to the Russia/Ukraine war and Middle East conflicts.

In sum, at year end 2023 we are on solid footing with regards to the economy and labor.

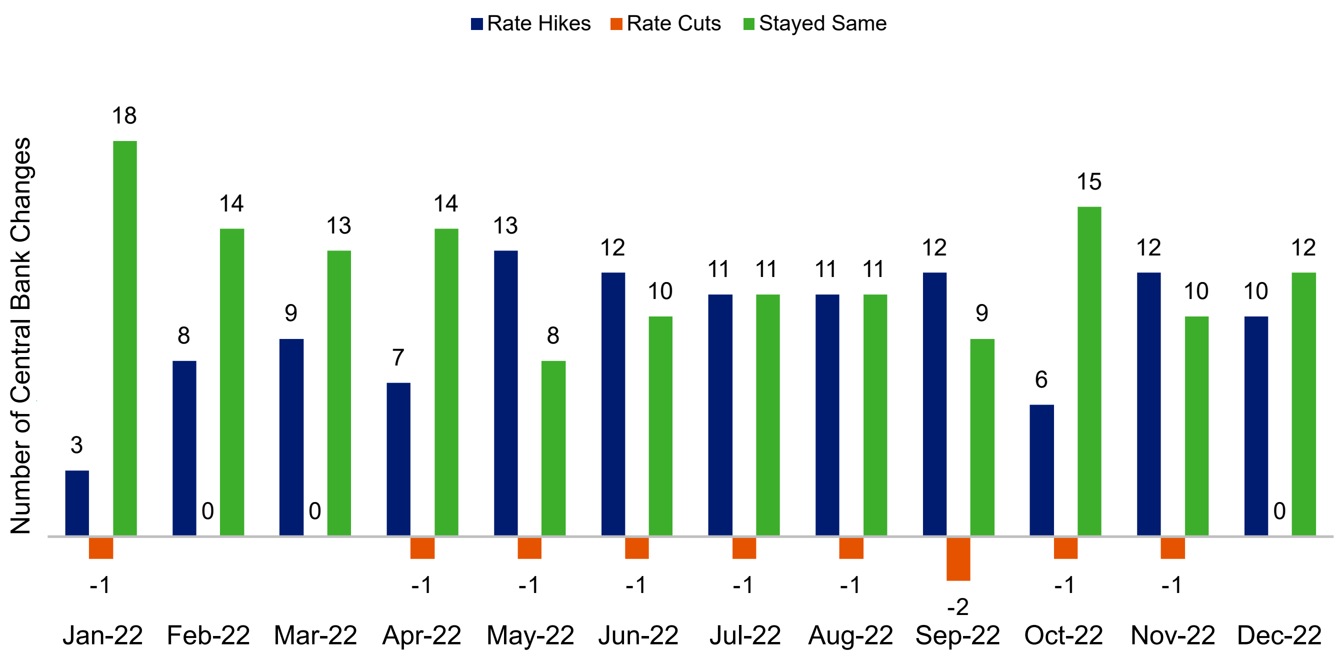
Economic outlook

The consumer feels a little tapped out, and while inflation is in check, there are yellow flashing lights around both factors that need to be monitored as we begin 2024. Inflation is an area to watch. Clear progress has been made, thanks to the COVID-19 goods mania behind us, as well as the post-pandemic price declines in services like airlines and hotels. However, given the geopolitical backdrop, energy is a wild card. While OPEC+ did its best to contain supply and keep prices elevated, U.S. shale producers provided ample additional supply and helped the backdrop remain stable. Food and shelter are two other areas where we feel progress needs to continue if inflation is to remain in check or decline.

Central bank policy backdrop

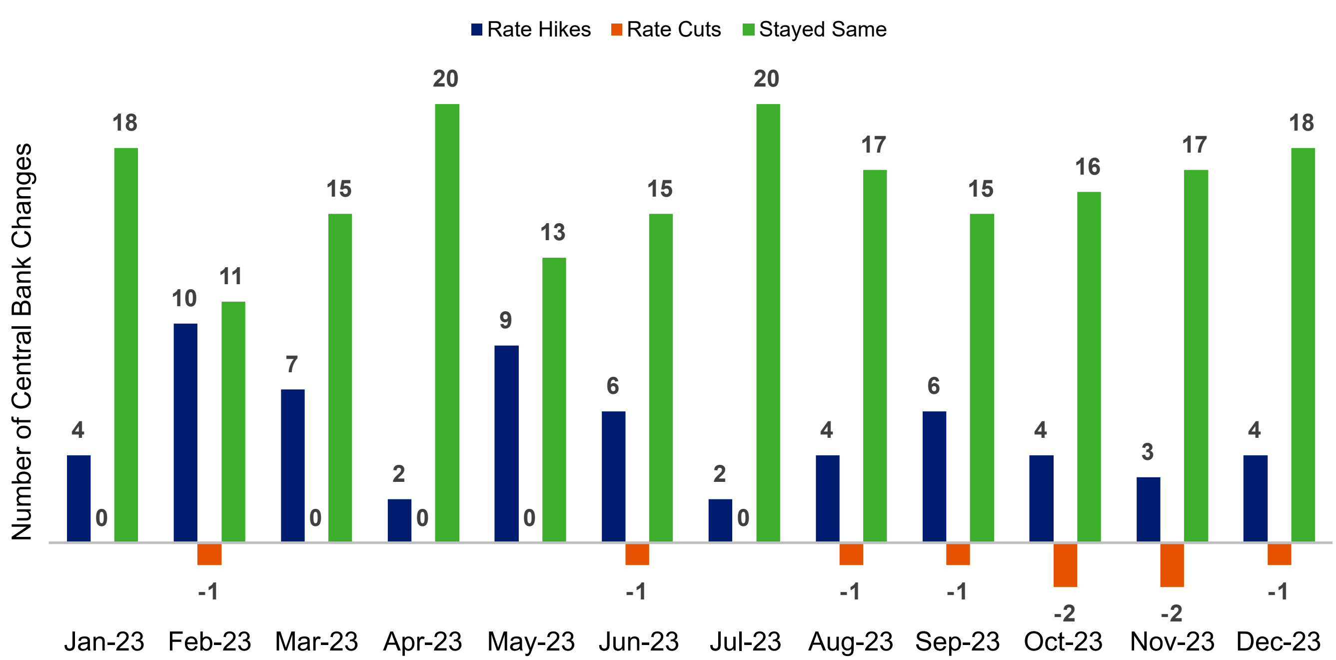
Given the dependence of central bank policy around the globe on inflation, growth and interest rate policy, let's review the current state. Year over year, a large dichotomy appeared in central bank policy around the globe. 2022 was essentially a consistently rising rate environment globally, with a synchronous environment to defeat inflation being the dominant theme. However, in 2023, we saw differing rate movements by central banks, with more central banks keeping policy the same as well as seeing far fewer rate increases.

Central Bank Rate Changes in 2022



Source: FactSet

Central Bank Rate Changes in 2023



Source: FactSet

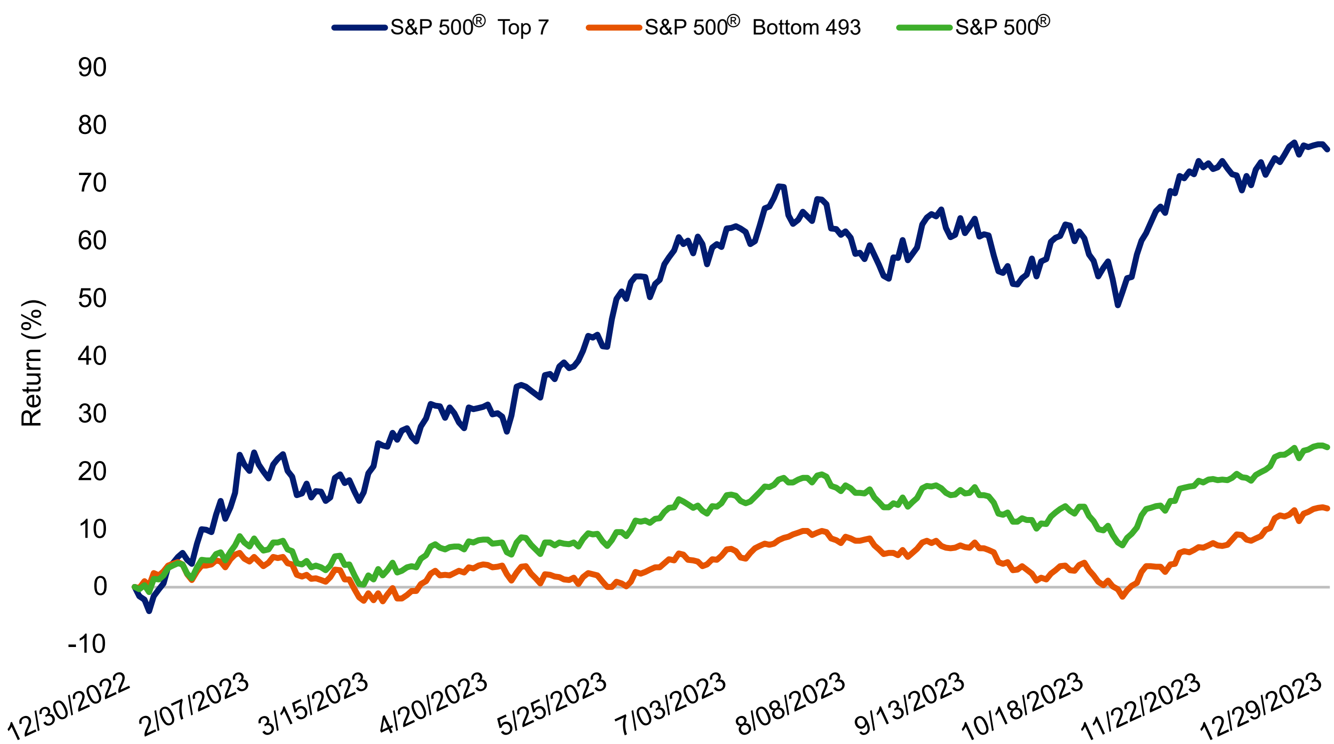
Central bank policy outlook

Like inflation, interest rates will continue to dominate the 2024 outlook. But, on average, it seems that interest rate volatility may have peaked; and while timing of rate cuts is debatable, especially versus current market expectations, 2024 could provide more downside than upside in rates than we have seen since the rate cycle began in 2022.

2023 equity market performance

While 2023 was a positive year for equity markets around the globe, it sure didn't feel great until late in the year because positive stocks indices were limited to large cap technology-oriented companies. This was, in part, thanks to the impacts of the artificial intelligence (AI) craze, which took companies that have direct positive AI stories, like Nividia, along with other less direct (Microsoft) and longer-term beneficiaries (Apple, Tesla) into the stratosphere. The equal weighted S&P 500® Index was up just 1.8 percent through September versus 13.1 percent for the overall index. By November, however, the market started to broaden its support for other stocks and even small-cap companies that had languished for most of 2023 came to life.

S&P 500® — 2023 Returns



Source: FactSet

In the U.S., the market price/earnings ratio (PE) closed the year at an above-average multiple of 19x. Although, if we remove the impact of the "Magnificent Seven," and use the equal weighted PE, the S&P 500® it is closer to fairly valued at 16x. Revenues and profit margins were positive in 2023, although down from the previous two years.

As noted, small-capitalization and mid -capitalization stocks were struggling throughout 2023 compared to large-capitalization stocks, until November and December market strength pulled them up to return about 17 percent each.

Non-U.S. equities

Once again, non-U.S. stocks underperformed their U.S. counterpoint. Despite a valuation that is remarkably discounted versus the U.S., since the Global Financial Crisis (GFC), the U.S. has outperformed in all but four years: 2022, 2017, 2012 and 2009. (In the years prior to the GFC, non-U.S. stocks outperformed 50 percent of the 34 years between 1975 and 2008). The dollar did not help the case for non-U.S. investments until late in the year.

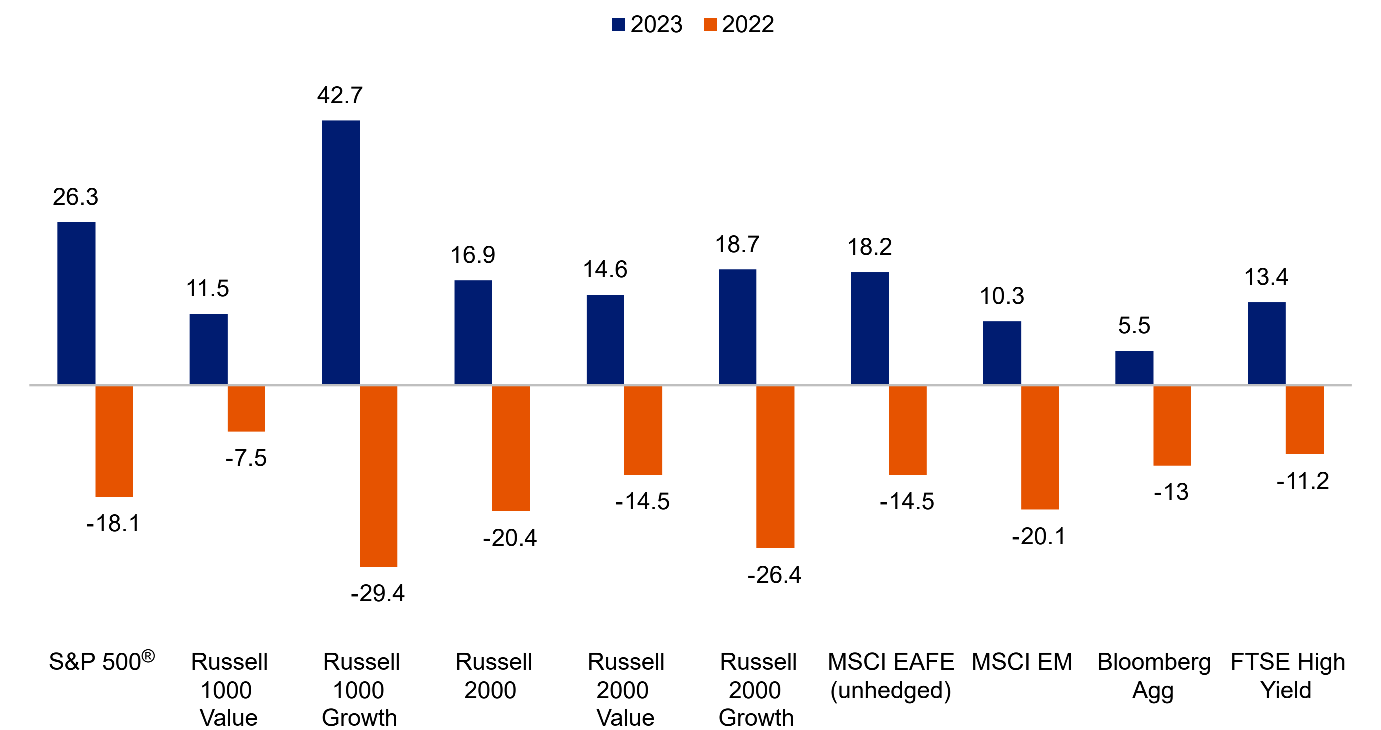
One interesting story amidst the continued underperformance has been the recent surge in Japanese stocks. Rather than being a drag on the EAFE, Japan returned 20.8 percent in 2023, surging behind the twin tailwinds of exiting the decades-long deflation era and a resurgence in the corporate governance movement. One simple statistic provides proof of change in the governance environment. By year-end 2023, 60 percent of Japanese boards had over 50 percent independent directors, versus just 30 percent at the end of 2022. In addition, the Tokyo Stock Exchange announced an intention to delist companies trading below book value unless they enacted corporate governance reforms. It sure looks like reforms could now, finally, be the real deal. There is certainly room for equities to be purchased, with only 11 percent of household holding stocks and tax incentives to boost ownership.

Other notable stories outside the U.S. included the strong growth environment for emerging countries, like Vietnam and India. Both benefited from diversification of supply chains away from China given the geopolitical, trade and economic headwinds. Latin America also had strong winners, like Argentina (65 percent), Brazil (33 percent) and Mexico (42 percent), as reshoring helped boost Mexico in particular in terms of prospects for growth. China was biggest drag on emerging markets indices, declining -11 percent over the year. Given China's weight in the MSCI Emerging Market Index at almost 30 percent, it was a large contributor to the index's muted return (10 percent).

One other interesting story in 2023 was growth- versus value-style returns. Recency bias would make you think growth has been running forever, while in fact, you may recall that since the pandemic, value had a resurgence only to be eclipsed again in 2023 behind the AI furor. For the two years that ended in December 2023, the Russell 1000 Value returned 1.52 percent versus Russell 1000 Growth at 0.55 percent. This data supports our often-cited advice to diversify and rebalance. Timing is very hard to manage.

It is sometimes hard to remember year-by-year market performance, but you may recall 2022 was a negative equity environment amidst the rising rates around the globe. 2023, as we have outlined, was much more positive. In fact, looking at the chart below, it forms an almost mirror image of the two years.

Markets in 2023 and 2022



Source: FactSet

Equity market outlook

We will need to see continued support from earnings in 2024 to keep the positive momentum for stocks.

Cash held in money market funds is a wild card for 2024. With a record $6 trillion in cash, will investors decide, either due to FOMO or a drop in short-term yields, that it is time to put money in the equity market? If so, this will provide a nice tailwind for stocks in the year.

2023 performance of fixed income markets

2023 was another volatile year in the bond markets. Despite ongoing elevated interest rate volatility, we ended the year almost where we started. Who would have thought? As we mentioned, at the beginning of the year the market expectation was that interest rates would stabilize, likely decline and that yield would provide most of the return. None of this materialized. We saw continued price volatility and returns and changing expectations for the Fed's long-awaited pivot.

The first two quarters of 2023 were marked by rising interest rates as the Fed increased rates four times in 2023 (on top of the seven in 2022). While we did finally get a pause in interest rate increases, continued market expectations for a decline in the Fed Funds rate led to ongoing volatility. The actual decline in rates, of course, never materialized, so, as we begin 2024, the Fed Funds started the year at 5.25 percent to 5.50 percent with three pauses to close last year.

It is notable that 2023 did, however, provide a less inverted yield curve than we have experienced over the last two years. The change in the long end of the interest rate curve late in 2023 followed Chair Powell's comments in November that although they were keeping rates steady (pausing) they expected to see rate declines of 75 basis points to 2024 as long as data (inflation and jobs) supported the cut. This change in language provided all the markets needed to bring down long-term rates and flatten the yield curve.

Despite all the noise, bonds as measured by the Bloomberg Aggregate Bond Index did finally provide a positive return in 2023. After the steep declines in 2022 as rates rose, this was a welcome relief. (Although for the two years ended 2023 the Aggregate return is still negative at -4.2 percent).

Double-digit returns came from both leveraged loans and high-yield bonds at about 13 percent. High yield, (given the maturity of the credit cycle and rising rates) was surprisingly healthy. Despite downgrades outpacing upgrades, the default rate ended the year at just 2.08 percent. With significant refinancing activity dominating the sector over new issuance, take up was positive as spreads also declined through year-end. Investment-grade credit was positive as we saw spread compression throughout most of the year. Throughout the credit space, including leveraged loans, collateralized loan obligations, high-yield debt and investment-grade debt, the worry among investors is about the ability to refinance given the increase in base rates for floating rate debt and for just higher rates on fixed-rate maturities. An increase in defaults would not be unexpected, and the need for managers with deep, high-quality, in-depth credit research is paramount in the face of trillions of dollars of maturities that need to be refinanced.

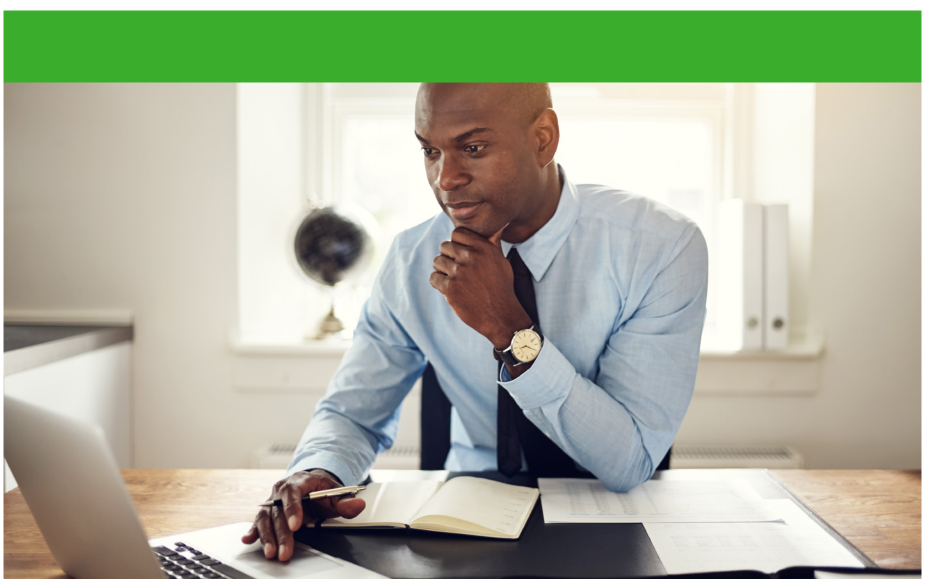
Despite the Fitch downgrade of U.S. debt this year, Treasuries remain a major anchor for the fixed income markets. Issuance due to the large budget deficits will continue to provide supply to the market, which so far has taken up all the debt in stride. That is a testament to the quality and reliability of our debt to date.

Non-U.S. markets fared pretty well in 2023. While there were isolated fiscal concerns and geopolitical factors impacting certain emerging-market economies that created volatility in government bond markets in 2023, they were not enough to derail the market. The FTSE Non-U.S. World Government Bond Index returned 5.8 percent and the JPM Emerging Market Bond Index returned 10.5 percent for the one year that ended in December 2023, as hard currency, local currency and corporates performed very well in 2023.

Similar to the U.S., other global developed economies experienced labor market durability and ongoing consumer demand in 2023. That said, excess post-pandemic savings and fiscal support are eroding, and the beginning of labor market weakness is already occurring in economies like the UK and New Zealand.

Emerging markets countries' central banks were generally raising rates before developed market countries heading into 2022. Thus, in 2023, as rates rose in the developed world, EM countries were largely better positioned from a policy perspective. Today, policy easing is in effect in areas of Latin America and central Europe. This is a break from history and evidence that select emerging markets are behaving somewhat independently of major developed markets. Some EM countries are actually in the inflation-target range (Brazil, for example, at 4.6 percent). Hungary saw inflation decline from over 25 percent to single digits by the end of 2023.

Many capital market participants anticipate declining inflation in emerging markets in 2024 and beyond. But given the unique country-specific issues, it is not likely to be uniform. China is also a big question given the slowing growth outlook due to real estate declines and financing issues continuing to weigh on the country. Deflation is now a concern for the China outlook.



The IMF forecasts debt in the U.S. to rise to around 137 percent of GDP by 2028. Projections for Italy, Germany, the UK and Japan are 140 percent, 58 percent, 108 percent and 253 percent, respectively. In contrast, emerging markets are in a very different position with IMF projections on debt/GDP in Indonesia, Mexico, Poland, Thailand, and India projected to be 37 percent, 56 percent, 59 percent, 61 percent, and 80 percent, respectively.

From a flow perspective, we expect net inflows into EM in 2024 given the tailwinds (high carry, attractive valuations and strong fundamentals) following two consecutive years of net outflows. 2024 will undoubtedly bring a varying outlook for U.S. and non-U.S. markets. This continues to underpin our advice on active management in the fixed income space. Indexing provides the investor exposure to the most indebted countries or companies and, by definition, the larger exposures will be to the most indebted. Given the maturity of this rate cycle, actively monitoring and researching should provide value-added exposures to a portfolio.

Outlook for fixed income markets

Monetary policy easing for the developed markets might not be as coordinated as the tightening seen in 2022/2023, but looser policy could very well be on the horizon broadly to prevent corporations and consumers from having to endure an overly burdensome refinancing environment. With that in mind, developed market yields are as compelling today as they've been in many years. The Prospective Real Yield on the FTSE World Government Bond Index (WGBI) sits around 1 percent, which is right in the middle of the range between the pre-GFC and post-GFC averages. 10-year developed market nominal yields hover in the 3.5-5 percent range.

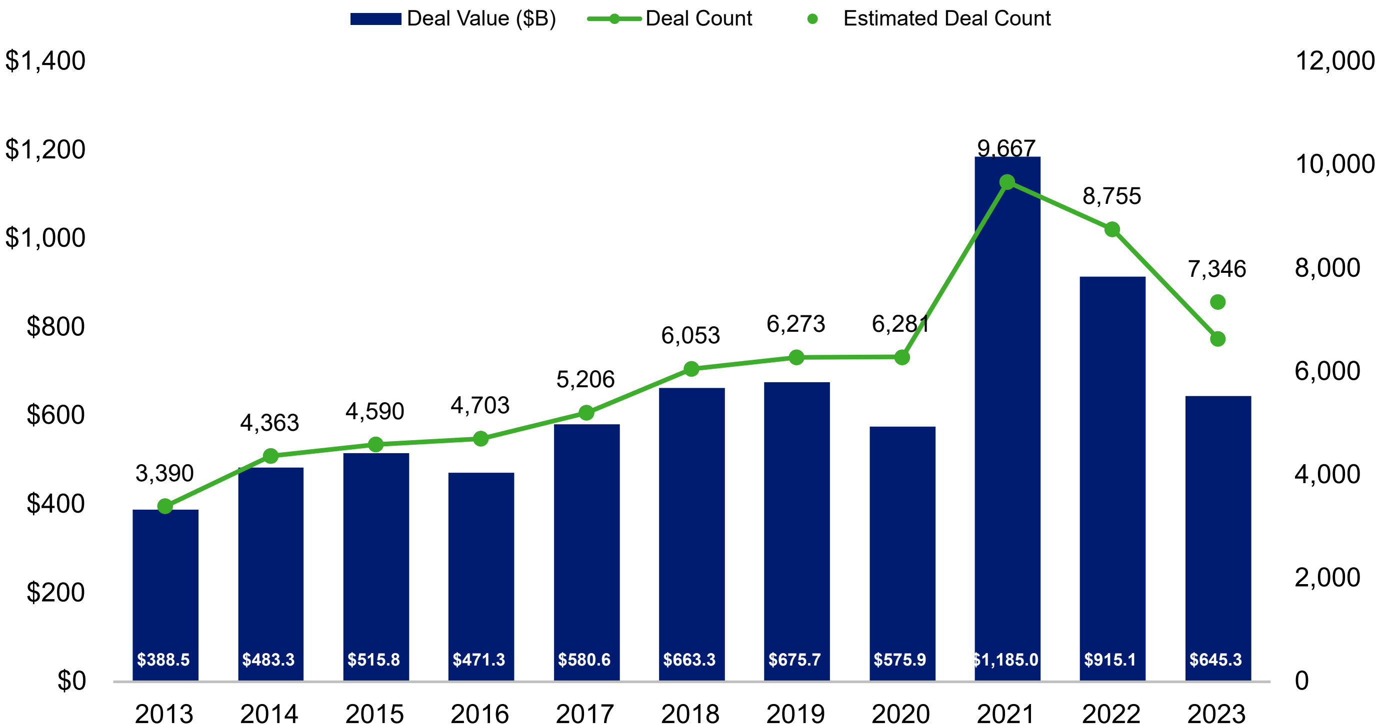
2023 performance of private markets

Private market assets also (real estate, private equity, private credit, infrastructure and other real assets) had a large dichotomy in the return profiles. While we won't see the fourth quarter prices for another couple of months, the returns through September were mixed, with real estate clearly the laggard and other markets positive yet more muted given the discounting of prices due to rising rates in particular. With the uptick in public markets in the fourth quarter of the year, the fourth-quarter pricing could provide a tailwind for areas like private equity.

Private equity

Within a backdrop of lower pricing, higher financing and a nonexistent IPO market, private equity has provided a reasonable return and lower volatility profile versus largely negative equity returns for a large part of 2023. As was true for the public markets, the fourth quarter provided tailwinds for private equity as well. Going into 2023, the denominator effect from lower asset returns in 2022 resulted in a decrease in private equity commitments. Coupled with lower distributions, flows were more muted in 2023 than in previous years. This was true not only for commitments but also for deal activity. For the second-year pricing was lower, and higher rates impacted deal financing. However, the IPO market did see a couple of large deals come to market during the year (Instacart, Birkenstock, ARM, to name a few), but overall activity remained lower than in four years. According to PitchBook, private equity exit activity in 2023 was last this low in 2013 and a sharp drop from the highs of 2021. That said, estimated exit activity at 1,121 was not too far from the range of calendar-year exit activity from the 2013–2020 period of 1,018–1434, (averaging 1,273) and on a trailing decade average of 1,319. In this framework, we would argue that by removing the exuberance that drove the market to the last peaks, we are now closer to private equity exit activity closer to historic norms.

U.S. Private Equity Deal Activity



Source: PitchBook

Venture capital distributions were still notable at $170.6 billion to (15,766 U.S. startups) compared to $242.2 billion for (17,592 companies in 2022), according to the annual Venture Monitor report from PitchBook and the National Venture Capital Association.

Leveraged buyouts were impacted in particular by the financing environment amidst higher rates. Private credit provided some relief for the markets but additional capital from private companies to refinance, as well as strategic and add-on opportunities were all notable in 2023.

While the fourth quarter uplift in public market pricing may provide a lift in valuations once year-end audits are available, the environment remains cautious. However, we are seeing better entry points than we have experienced in several years and selecting above-average managers remains key.

Real estate

Through September 2023, real estate returns were negative, with fourth quarter preliminary numbers reporting the most significant valuation declines for the year. (-5.01 percent net, -12.74 percent net year to date as per NFI-ODCE). Real estate open end funds through September of 2023 reported a loss of 12.88 percent for the trailing one-year period, as measured by the NFI-ODCE (Value Weighted) Index. The fourth quarter experienced additional valuation declines with preliminary results coming in at a negative 5.01 percent, resulting in a 12.74 percent loss for the year (on a net basis, NFI-ODCE). As such, open end real estate fund performance for 2024 is at the lowest level since the GFC (2008 -10.70 percent, 2009 -30.40 percent). Private real estate performance lags that of public real estate, due to the smoothing effects of quarterly appraisals, so the decline in appreciation across private assets has been slower than we saw in public real estate. While we have only received preliminary results for the NFI ODCE benchmark and funds, we expect to see write-downs across the board in Q4.

While fundamentals for most property sectors were generally strong going into 2023, the higher interest rate environment severely impacted real estate markets as the higher discount rate put downward pressure on valuations. Transaction activity stalled as bid-ask spreads widened significantly due to lack of clarity on valuations, with total deal volume for commercial real estate down over 50 percent year-over-year as of Q3. Sector performance has varied widely, with office faring the worst, followed by apartments, industrial and retail.

Change in Real Estate Sector Performance

Sector	Q4 2023 Change	2023 Change
Apartments	-4.0%	-7.33%
Industrial	-3.2%	-4.1%
Office	-6.7%	-17.63%
Retail	-2.5%	-0.90%

Source: National Council of Real Estate Investment Fiduciaries

The office sector remains the most challenged, due to headwinds from weak tenant demand arising from hybrid work trends, increased availability of sublease space and lower utilization rates. Tenants have become more selective with a marked preference for Class A and A+ properties with high-quality amenities, which continue to see most of the new absorption.

Apartments continue to benefit from the tailwinds of a significant housing undersupply, while increased interest rates have made single-family home ownership less affordable for new buyers. Industrial performance was relatively strong, as the sector continued to experience strong tenant demand with improving, albeit still negative, performance. Finally, retail was a surprising bright

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spot as the sector with the only slightly positive performance YTD. Following a significant re-pricing pre-pandemic, the sector has experienced limited new supply, resulting in declining vacancy rates and rent hikes in certain sub-sectors. The growth of nontraditional sectors continues to be a trend in real estate with areas like medical, self-storage, student housing and hotels becoming more commonplace in ODCE fund holdings and representing a larger component of the NFI-ODCE Index (6.8 percent as of Q3).

As with sector performance, results varied significantly across markets. High growth Southwest and Southeast markets that benefited from large in-migration and population growth experienced less valuation declines YTD compared to high-cost-of-living, mostly coastal, cities.

2023 Change in Real Estate Performance for Selected Geographic Markets

Geographic Market	Change Year to Date	High-Growth Market (^) or High-Cost-of-Living Market ($)?
Atlanta	-9.22%	^
Boston	-17.60%	$
Charleston	-5.88%	^
Chicago	-11.70%	$
Dallas	-6.67%	^
Durham	-7.63%	^
Houston	-4.86%	^
Jacksonville	-10.93%	^
Los Angeles	-13.03%	$
Memphis	-7.19%	^
Miami	-4.09%	^
Nashville	-10.66%	^
New York	-16.50%	$
Orlando	-10.10%	^
Portland	-14.61%	$
San Antonio	-7.72%	^
San Francisco	-23.75%	$
Seattle	-16.76%	$
Tampa	-6.66%	^
Washington, DC	-14.71%	$

Source: National Council of Real Estate Investment Fiduciaries

Income remained fairly strong (1.1 percent QTD, 4.3 percent YTD) throughout the year with appreciation accounting for the negative returns (-3.0 percent QTD, -7.9 percent YTD).

In terms of opportunity in 2024, newer funds not saddled with legacy assets would be a place to look, as current pricing offers value across many sectors of the market. In any dislocation, such as the current environment, opportunities will present themselves as prices decline and asset owners come under pressure to sell. In addition, real estate credit provides a high-income lower volatility option versus the equity side. The exodus of traditional lenders from the market has created an attractive opportunity for real estate debt funds to fill the gap. The retrenchment of banks coupled with the higher interest rate environment has presented an opportunity for real estate lenders to charge significantly higher rates while also availing of greater downside protection resulting in higher-than-normal returns for investors.

Private credit

Both headwinds and tailwinds will continue for the asset class. Tailwinds include the higher interest rate environment and the floating rate nature of the assets, until the Fed starts to cut rates, which the market "thinks" is by mid-year 2024. But, as rates decline, the fundamentals for repayment increase, hence the yin/yang. Further tailwinds include the private credit lending environment, as the withdrawal of banks coupled with lenders having the reins provide positive fundamentals for the structure of the debt. It is for this same reason, however, that tailwinds around the assets are also worth watching. Supply of debt and the number of funds raising debt continue to raise concerns as it likely will impact spreads. We continue to favor experienced investors with restructuring/workout experience and deep resources to identify the better credits for lending. With the higher rate environment providing increased costs to borrowers as well as later in the credit cycle, quality credit is paramount. As a result, the environment would favor direct lending and suggests distressed has more headwinds.

Evergreen fund structures are increasingly becoming a key focus (and certainly a viable alternative to the private equity-style structures) for institutional investors looking to access private credit. Other areas of opportunities within private credit may include private credit secondaries as well as the private real estate credit market, where higher rates, inability to lend by banks (who own some 45 percent of all CRE office debt and thus are limited in providing credit) and a wall of refinancing is coming in 2024 and 2025.

Infrastructure

A solid macro backdrop in secular trends (climate transition, global governmental support and financing, renewable adoption) as well as the essential nature of these assets and services continues to positively impact the long-term outlook for infrastructure. More recently, many of the same headwinds facing all private assets, (higher debt costs weighing on financing and valuations), have also impacted the infrastructure sector.

However, the higher and more predictable cash flows associated with many infrastructure sub-sectors as well as the asset classes' inflation protection characteristics (particularly for segments such as power generation, transmission or bulk storage) have helped mitigate the impact of higher interest rates. Both capital raising and deal activity slowed significantly in 2023. Following a record 2022 (primarily on the back of strong political support such as the Infrastructure Investment and Jobs Act and the Inflation Reduction Act), fundraising declined significantly in 2023 with only $20.9 billion raised by October, representing 12 percent of 2022 levels and 15 percent of average raised over last five years. Deal activity was also down, although not to the same extent as in real estate markets, with Preqin reporting $310 billion of deal activity across 2,000 transactions in 2023 versus $420 billion for the prior year. Despite the tumultuous year, the sector reported positive results for 2023.

Outlook for private markets

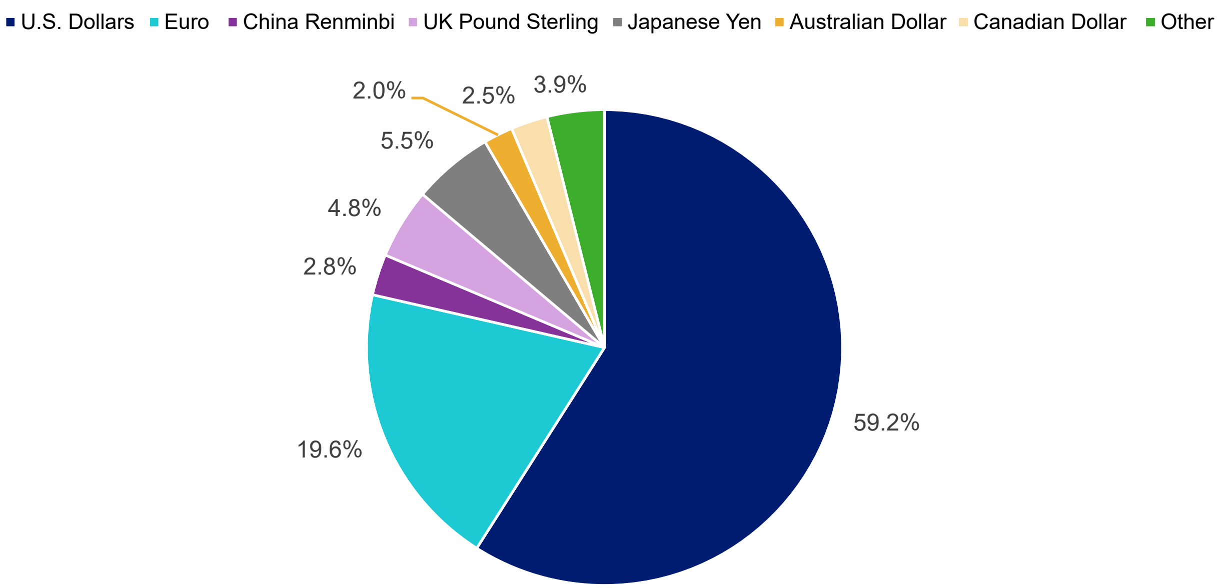
The energy transition remains one of the areas expected to provide substantial flow over the coming years, as well as ongoing activity in transmission, data, core services and transportation. With a substantial pipeline of activity, private financing for capex and add-on expansion should provide investors with ample opportunities on the value-add side. Dry powder is down from a peak of $310.7 billion as of the end of 2022 and is forecast to dip slightly at the end of 2023 to $286.1 billion and $278.9 billion in 2024, largely due to the slower fund-raising environment.

The outlook is for solid, stable income and return generation in core infrastructure and higher potential returns for value add and opportunistic infrastructure. Generally, infrastructure is a smaller allocation in institutional asset allocations, thus providing further opportunities for increased allocations to the sector.

Looking ahead: 2024 election-year expectations

Budget deficits will come into focus. Today, the U.S. debt-to-GDP ratio at about 125 percent is higher than any developed nation, with the exception of Japan (highest at 260 percent) and Italy. As the Fed seeks to unwind its balance sheet and, at the same time, continue to fund the deficit, the allocation of U.S. Treasury notes versus bonds will be a focus. So far, the U.S. status as the reserve currency of the world and the relatively attractive yields on U.S. debt have provided support for funding the deficit.

Allocated Foreign Reserves by Currency



Source: International Monetary Fund as of Q3 2023

Cash held in money market funds is a wild card for 2024. With a record $6 trillion in cash, will investors decide, either due to FOMO, or a drop in short-term yields, that it is time to put money in the equity market? If so, this will provide a nice tailwind for stocks in the year.

Much like 2023, we think this year will also be “data dependent.” Inflation, in particular will need to continue to decline for the Fed to actively lower interest rates. The same goes for global central banks, which are dealing with lower growth rates, on top of still-elevated inflation. Given it is an election year, the state of U.S. deficit spending will also take a front seat. Finally, as we noted, the elevated geopolitical backdrop, continues to be a wildcard for global markets, one that cannot be factored in, but does raise volatility.

Outlook for Canada

As we saw in most parts of the world, growth, inflation and interest rates dominated the narrative for 2023. Inflation declined faster (on a relative basis versus global inflation) early in the year, having peaked in late 2022. With the latest inflation numbers coming in at 3.4 percent it appears the Bank of Canada target for inflation of between 1 and 3 percent is within reach. However, both interest costs and the cost of rent remain as obstacles to reach desired ranges.

Growth expectations for Canada started the year leaning heavily toward recession, but as revisions to GDP were announced, the recession fears abated. However, unlike the U.S. strong growth, the Canadian economy stalled mid-year and by year end was fairly anemic, despite having an historic population growth throughout the year. Consumers pulled in spending on discretionary items in classic response to higher interest rates. Businesses also reigned in investment spending by the third quarter of the year, after starting with higher expectations early in the year. While fourth quarter GDP is expected to be positive and bring the full year to just 1.1 percent, this is down from 3.8% in 2022.

Interest rates rose throughout the year and policy rates closed the year at 5 percent. With overnight rates in the 5 percent range, and then 10-year Government bonds at 3 percent, the inverted yield curve remained in place through year end. However, more dovish tones from the Bank of Canada provided confidence to potential rate cuts and drove a strong fourth quarter return for the FTSE TMX Canada Bond Universe, bringing the year return to 6.69 percent.

Stocks also ended the year on a strong note, adding 8 percent in the final quarter to bring the S&P TSX return to 11.75 percent for the year. The late strength was driven by gold miners and financials. Energy continues to lag into year end.

The Canadian dollar started the year at 0.74 and ended at 0.76 to the U.S. dollar, so not much change. The only strengthening of note was the Canadian dollar to the Japanese yen, moving from 98.2 to 106.7 by year end.

Summary of Outlook Views

The tables on the following pages provide a snapshot of our forward-looking observations on the direction of specific asset classes.

Asset Class Signals and Outlook

There is a set of five signals for each asset class, represented by shaded circles ranging from an above-normal return outlook (dark green) to a below-normal return outlook (dark red), with the middle circle indicating a neutral outlook (gray). The views represented our 12–18 month perspective for each of the asset classes are *relative* to our longer-term expectations (10+-year capital market assumptions).

If our views on an asset class change from quarter to quarter, that change is represented by an arrow that stretches from the previous quarter's signal to that of the current quarter.

Return Outlook

Key: Below Normal — Neutral — Above Normal

Equities

Opportunity Set	Below Normal		Neutral		Above Normal
U.S. large cap	○	○	●	○	○
Large cap growth stocks dominated performance throughout 2023 and remain at elevated valuations. While other parts of the large cap universe are more fairly valued, we remain cautious on the growth parts of the market.					
U.S. small cap	○	○	●	○	○
Going into the fourth quarter of 2023, small cap valuations were compelling but the fourth quarter double-digit returns took the outlook back to neutral amidst growth and inflation expectations.					
Int'l dev. large cap (unhedged)	○	○	●	○	○
Neutral expectations are due to relative valuations and expectations for interest rate declines during 2024, with cautious outlooks due to geopolitical issues, especially energy-related and growth expectations. But, given the diversity of countries in developed markets, an active approach to investing is warranted as the have and have-nots will continue to dominate the return backdrop.					
Int'l dev. small cap (unhedged)	○	●	○	○	○
While positive valuations continue to provide a strong backdrop, inflation and higher interest rates could continue to weigh on earnings.					
Emerging markets (unhedged)	○	●	○	○	○
The MSCI EM index is dominated by the China weight, which continues to show a slow and declining growth outlook. Other emerging markets have a more positive outlook and active management could provide positive returns within the emerging-markets universe.					

Return Outlook

Key: ● Below Normal ● ○ Neutral ● ● Above Normal

Fixed income

Opportunity Set	Below Normal		Neutral		Above Normal
U.S. core	○	○	○	●	○
With the likelihood of less interest rate volatility in 2024, the yield environment is positive for fixed income instruments. In a portfolio context, having a less volatile, highly liquid bond allocation will provide strenght to portfolios.					
Non-U.S. core (hedged)	○	○	○	●	○
Higher yields and potential for dollar weakness offer a positive outlook for non-U.S debt. Diversification in a portfolio context also provides a tailwind for the asset class.					
Emerging market debt (hedged)	○	○	○	●	○
Recent outperformance of EM debt has brought the asset class to within normal valuation levels. But the attractive yields may continue to provide opportunity for higher yield and income, as well as diversification. If recent slight U.S. dollar strength continues it will also contribute to a more positive outlook.					
High yield	○	○	●	○	○
With double-digit returns in 2023, spreads are not as compelling, and are coupled with late-cycle credit dynamics.					
Bank loans	○	○	●	○	○
Similar dynamics to the high yield market here. Whatever the expectations are for changes in interest rates, the floating rate could provide diversification in a portfolio context.					
TIPS	○	○	●	○	○
With inflation coming down, the benefit of TIPS might be moderating. The year-end rally also provided a boost to TIPS, which seems unlikely to carry into this year. However, given exogenous factors that negatively impact inflation data, a neutral position may provide a hedge to portfolios.					
Private credit	○	○	●	○	○
While yields continue to provide a positive backdrop for private credit investments, the late-cycle and high-interest rate environment creates headwinds for borrowers. The floating-rate nature of the loans have been an insulator; however, as the interest-rate cycle nears the finish line, selection on lenders will be a key to success. Supply of new funds may also provide a headwind to pricing.					
Municipals	○	○	●	○	○
Increasing revenue shortfalls for state and local governments are starting to provide headwinds for the municipal market, as indicated by increased default. But most of the defaults have been in areas like continued care or assisted living, where costs, such as wages, have impacted the bottom line.					

Return Outlook

Key:

●	●	●	●	●
Below Normal		Neutral		Above Normal

Alternatives

Opportunity Set	Below Normal		Neutral		Above Normal
Hedge funds	○	○	●	○	○
Hedge funds have benefitted from their ability to be less directional than other types of strategies. Equity long/short, long/short credit and relative-value-driven mandates are well positioned to combat volatility across asset classes and capitalize on idiosyncratic situations and offer diversification in a portfolio context. If the market continues to broaden, this will provide a tailwind for equity-oriented strategies.					
Multi-asset class strategies (MACS)	○	●	○	○	○
These strategies' equity and commodity positions may struggle relative to bonds in the near term. We consider public fixed income allocation increases as preferable and would use this as a funding source, especially as distribution and exits in private markets have slowed.					
Private equity	○	○	○	●	○
Price declines were apparent last year, and the IPO market provided little in the way of exits, thus distributions declined and put pressure on new private equity fundrasising. But new vintage private equity could offer a compelling opportunity for those with capital to deploy. Venture capital is likely to remain challenged, with cost cutting and revenue generation as top priorities for additional funding. We continue to favor operationally-focused and early-stage strategies rather than large LBO where financing costs and availability are pressured.					
Real estate	○	●	○	○	○
Transaction volumes are anticipated to remain muted in the near term and well below historical levels given interest rate and financing uncertainties. Current property trades are exhibiting significant price corrections, which will factor into declining valuations over the near term. The office sector will continue to be a drag on the asset class, as record-high vacancies show no sign of abating. However, while near-term pricing (for year-end valuations) will exhibit negative characteristics, income levels have remained good in many areas, including multi-family, industrial and specialty areas. In addition to sector-related disparities, regional disparities in returns are also apparent and defy many of the factors outlined.					
Infrastructure	○	○	○	●	○
Demand for infrastructure is expected to remain strong, which will sustain valuations. Income remains robust, as both fundraising and fiscal stimulus will continue to provide a variety of spending and subsidies to private companies prepared to deploy capital across the asset class. Economically correlated infrastructure, such as airports, toll roads, rail and ports have more headwinds late in the cycle, but other strategies focused on energy transition, renewables and digital infrastructure continue to offer attractive growth opportunities.					
Commodities	○	○	●	○	○
The backdrop is neutral only due to some areas of the commodities complex offering value, namely those related to the energy transition, lithium, nickel, cobalt and rare earth minerals. Given the geopolitical backdrop, energy-related investments could be positive, although it is not in our expertise to bet on geopolitical outcomes. Agricultural outlooks continue to be volatile, due to supply issues related to cargo and war disruptions.					

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