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The Past is Prologue

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We are facing a confounding investment landscape.

Going into 2024, we have a potential storm looming over markets and portfolios: a fiscal deficit ballooning to unreasonable levels, the stronghold of a few technology companies over U.S. equities, an election year unlike any other with over half of the world's population heading to the polls, and an escalation in geo-political conflicts that have resulted in two ongoing wars. To add to these tempestuous conditions, we have the emerging influence of artificial intelligence in homes, markets, and industries. Furthermore, many market participants have yet to acknowledge the potential likelihood of long-term interest rates staying above 4%, steadfast in their belief that markets will return to the low inflation levels and easy money of the last decade.

We believe higher rates and tighter monetary policy are here to stay.

At NEPC, we believe higher rates and tighter monetary policy are here to stay. We also believe that businesses and consumers are yet to feel the full impact of the higher cost of capital as they struggle to shed their biases left over from a previous era. As markets continue to adjust to the new investment regime, we look to the past for guidance and context, so we may frame our outlook for the present. Shakespeare said it best: The past is prologue. Market moves and economic cycles, shifts in capital and labor markets, corporate and household spending, fiscal and monetary policy, and business and consumer sentiment of one period form the underpinnings of the next. While studying the past is not predictive of the future, it does offer lessons on dealing with the present.

After all, the low rates at the beginning of the century—as the world braced for Y2K and braced for economic challenges—fueled newfangled financial structures that spawned excessive credit growth that ultimately brought on the Great Financial Crisis. In response, and to kickstart the global economy, central banks slashed rates, marking an era of unprecedented quantitative easing and easy liquidity, allowing the U.S. economy to muddle through a decade of low growth while capital markets surged. A global pandemic brought that to an end with lockdowns and fiscal support which, in turn, sparked supply chain challenges and outsized spending, ratcheting up inflation to levels not seen since the 1980s. As a result, we have been bearing witness since 2022 to the most aggressive monetary tightening in over four decades that set the stage for the new investment regime.

Still, despite the higher rates and the new regime, markets have pushed back. In 2023, we saw a resurgence in stocks and bonds with a 60/40 portfolio generating a top 10-year relative to the last 50 years. We saw the incredible economic resilience of U.S. consumers, buoyed by a strong labor market with the unemployment rate holding steady below 4%. Rising short-term rates failed to deter economic

activity amid the seemingly extended lag of monetary policy. Businesses and consumers basked in the security of long-term fixed-rate debt. This bullishness has propelled market sentiment higher with expectations of 150 basis points in rate cuts from the Federal Reserve in 2024, taking us back to the time of easy money and plentiful liquidity. Furthermore, equity risk premiums hover around multi-decade lows due to higher interest rates and elevated price-to-earnings multiples.

Amid this optimism and a seeming disregard for the reality of the new investment landscape, we feel the urge to recommend prudence. We remain comfortable holding greater levels of cash to support safe-haven fixed-income exposure. The key guideposts we outlined in 2023 still hold: opting for defensive beta exposures, implementing value positions, exploring the potential for active management, holding an appropriate level of liquidity through Treasuries or safe-haven fixed income, and maintaining commitments to private markets.

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To be sure, when we refer to the power of the past, Shakespeare says in The Tempest that it is not the role of the past to predict and write the future, but rather to explain and demystify. To that end, it is hard to spot a catalyst that will end this cycle of economic growth, meaning this pace of global growth will likely continue with the United States leading the way, potentially rewarding risk assets like equities and credit in the near term.

We encourage reducing exposure to U.S. mega-cap stocks and opting for value in U.S. large-cap equity. Speaking of the so-called the Magnificent Seven, concentration in large-cap equities is not new even though these companies may be relatively young; looking back, there was the Nifty Fifty in the 1970s or the dominance of Japanese equities in the 1990s. The past also informs us that these conditions do not last forever, and we expect mean reversion to kick in even if we cannot predict exactly when that will occur. Investors looking to benefit should consider adjusting exposure to equities to embrace smaller companies and those with value characteristics. We also suggest tilting equity implementation to global equity strategies and recommend greater use of active equity approaches.

In addition, the premiums offered to take on illiquidity risk remain attractive, and we are focused on identifying opportunities within private markets for clients. Similar to public equities, we think the opportunity for value investing in buyouts has resurfaced. Within private credit, we are starting to see cracks in the capital structure for borrowers with higher leverage. Consequently, we favor higher-quality opportunities and also see emerging potential for regulatory capital relief through banks. Meanwhile, in real assets, we find appealing the new age of infrastructure supporting digital needs and the global-energy transition.

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We believe the market forces of the past decade, characterized by lower interest rates and easy monetary policy will not be revisited, and investors have yet to feel the impact of this paradigm shift. To counter the potential disruption from this impact to portfolios, we place a greater emphasis on liquidity. We

advise clients to explore the portfolio benefit of diversifying asset classes. We encourage stakeholders to review strategic policy targets, while emphasizing the importance of real portfolio returns and, for some, assessing the improved risk-return benefits of fixed income.

Overall, we encourage investors to lay the groundwork necessary to adapt to the present investment landscape, while leaving behind the behavioral biases that we have been conditioned to over the last 15 years. At NEPC, we stand ready to partner with you as we face the future head-on.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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