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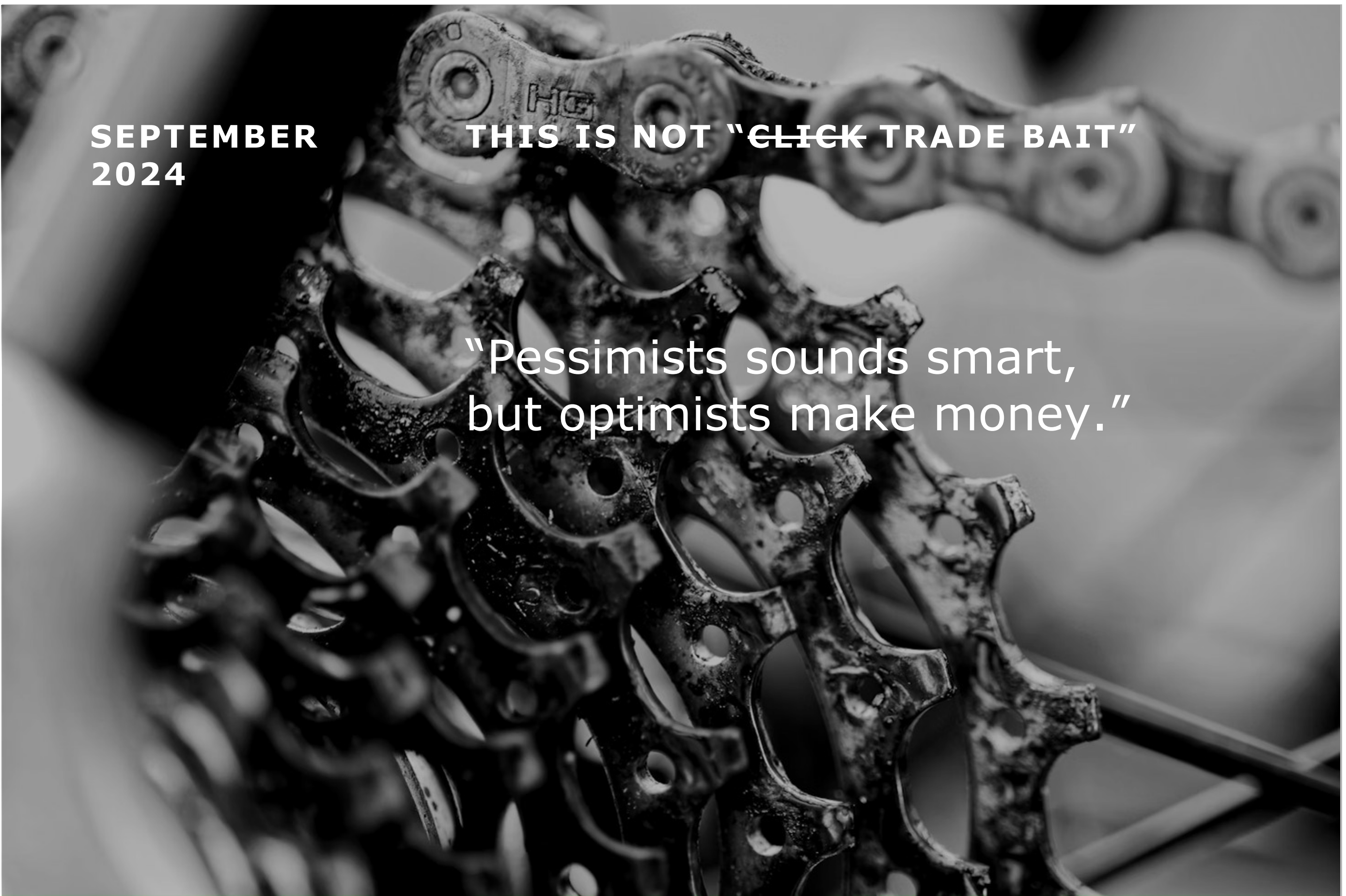
FROM THE CIO



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David brings over 37 years of experience and expertise in focused investment programs in both capital and private markets.

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While this report is normally a reflection on the latest quarter, the subsequent months, notably July (significantly down) and August (significantly up), and the forward view from here are much more interesting to comment on.

On the liquid side, we have been operating a series of proprietary objective market models/indicators to ensure that our asset allocation and or own sentiments are not trigger-driven by daily headlines or false positive/negative economic signals. As I have written before, headlines tend to be dramatic and are by design, intentionally click-bait which to me is synonymous with "trade bait".

Our models suggest we are leaning into the soft landing scenario with rates coming down persistently and the other Fed-watched indicator being unemployment which is bubbling a bit higher but not amplifying to alarm levels at the moment. This time around there is a higher level of noise because of the US election coming up but there is also a bit of the market projecting negative scenarios to perhaps goad the Fed into more accommodating monetary policy.

In this respect, the classic Goldilocks ("not too hot, not too cold") scenario is the central probability or the 'Market Regime' that we believe we are in at the moment: which is still a Growth/Recovery Regime, as opposed to the 'Overheating' and or 'Recession Regimes' which tend to deemphasize risk/longer duration assets such as equities. All of our signals at the moment support this Growth/Recovery regime which favors a risk on asset class overweight.

Of course, unknown risk factors can always be triggers to change sentiment materially at any time, and there are almost always alarmists out there selling some fear. Pessimistic or alarmist headlines get more clicks and therefore the media bias is predominantly a negative outlook. In this context, I recall a great quote from some time ago:

"Pessimists sound smart but optimists make money."
-Patrick Collison, Co-founder and CEO of Stripe

The above is also probably empirically supported by the notion that optimists are more likely to take action and run the experiment whereas pessimists might spend more time discussing why something won't work. Of course, with every maxim, there are exceptions such as the short sellers in 2000 and 2008, but these are notable exceptions to what otherwise more statistically favors risk-takers and or optimists.

The above "risk on" viewpoint/preference relative to safety assets is our view but it is noteworthy for me to briefly discuss what drove the July-August "snap and pop" because certainly that type of inter-month volatility can test your convictions!

So what happened to risk assets that in one-month perceptions and/or did sentiment change so dramatically to create such an enormous swing factor from one month to the next? There were several drivers for that sentiment change, but it was mostly attributed the unwinding of of the Yen carry trade which was essentially borrowing at low yen rates and using the proceeds to buy risk assets in both the fixed income arena as well as equities.

So, to summarize the catalysts to the July Drop:

Weak economic data: A disappointing jobs report released in early July showed only 114,000 jobs added, well below expectations. The unemployment rate also increased to 4.3%, its highest level since October 2021. This raised concerns about the health of the US economy and fears of a potential recession.

Unwinding of the yen carry trade: The Bank of Japan raised interest rates for the second time in 2024, strengthening the yen. This led to the unwinding of the popular yen carry trade, where investors had borrowed yen to invest in higher-yielding assets like US stocks.

Political uncertainty: President Joe Biden withdrew from the presidential race, endorsing Vice President Kamala Harris as the Democratic candidate. Additionally, Donald Trump survived an assassination attempt. These events added to market uncertainty.

Geopolitical tensions: Escalating conflicts in the Middle East and between Russia and Ukraine.

Concerns about artificial intelligence (AI) investments: Skepticism grew regarding the profitability of substantial investments in artificial intelligence amongst the LLM large mega Cap names pursing this angle on AI.

Then in August almost everything changed driven by:

Improved economic outlook: Retail sales data and other economic indicators suggested that recession fears may have been overblown. This provided evidence that concerns over a recession, which had triggered the worldwide sell-off, may have been exaggerated.

Expectations of Fed rate cuts: Optimism grew about the possibility of a soft landing for the economy, supporting anticipation that the Federal Reserve might start reducing interest rates in its upcoming policy meeting.

Strong earnings reports: Positive earnings reports from major companies, particularly in the technology sector, helped boost investor confidence.

Easing inflation concerns: Inflation data released in August showed continued progress in bringing down price pressures, supporting the case for potential Fed rate cuts.

Reduced political uncertainty: As the political landscape in the U.S. stabilized following the initial shock of Biden's withdrawal, markets began to adjust to the new reality.

Looking forward through the remainder of the year, I would venture to say that there is a higher probability of the bull market for risk assets continuing relative to the probability of a sharp sell-off despite what feels like higher valuations. I will explain below:

Stages of a Bull Market:	Comment on Stage indicators/timing
Bull Markets are born on Pessimism	After the 2022 inflation wash out 4Q 22
Grow on Skepticism	In process- Leadership in Rotation now 23—onward
Mature on Optimism	Perhaps for some stocks but hardly for all- think we are in a rotation of leadership phase
Die on Euphoria	We are not at a broad “mania” stage- An Everything Rally has not happened, and we are not at deal compressed timelines at the moment in the PE universe.

The price to earnings ratio for non-Magnificent Seven stocks (often referred to as the S&P 493) is significantly lower than that of the Magnificent Seven and while they naturally deserve a premium valuation because they are exceptionally strong high-margin sticky oligopolies, I believe that there is time for the rest of the market (The S&P 493/non-Magnificent Seven) to catch up. It will most likely never deserve the premium valuation of this strong set of great companies, but typically the bull markets top out (through exhaustion) when everything, including the lower-quality companies, goes up in leaps and bounds. At the moment the **non-Mag Seven** set has a PE ratio of approximately 19 whereas the **Magnificent Seven** stocks have a much higher PE ratio of about 45 and this is one of the widest gaps in the relative valuation of the leaders versus the laggards in history. I have learned not to “bet” merely on “gaps closing” because gaps often are justified and be sustained for long periods of time. What I am saying however, is that the euphoria stage, which often accompanies the final months of a topping bull market, is not reflected in the majority of stocks (497) at the moment.

Secondly, most often as has been the case in history, is that over the last 50 years (12 US presidential elections) the stock market appreciates post-election in 10 out of the 12 elections. The exception will not surprise you, the post-2008 election (Global Financial Crisis) and the period after the 2000 election of the internet bubble burst. All other periods saw post-election appreciation, and in some years, very significant 12-month post-election appreciation.

What could derail or be alternative risk factors that lead to a regime change?

1. Mag-7 concentration and valuation in investor portfolios: Leads to relative outperformance of small v large cap

2. The FED getting behind the curve and not easing quickly enough, thus driving economy down and away from soft-landing (most imminent risk to earnings) (positive for Growth versus Value stocks)

3. Risk of internal conflict escalating in the US post-election driven by either Trump or Harris not accepting outcome of election

4. Harris being elected and increasing corporate taxes or enacting a “unrealized gains” tax: Could be quite adverse to equities/wealth and consumer confidence

5. And as ever, the question around how much longer the US government can keep up loading on debt (i.e. how much demand for US debt is there outside of the FED), my view is that eventually this will become

unsustainable, but the regime change will continue to be very slow until it happens "all of a sudden"

So what does this mean for the private equity (PE) markets?

I think that the PE markets generally lag in terms of showing the performance of the public markets, but the psychological phases of a market cycle are similar to the above. Following the significant rise in interest rates in 2022 credit markets froze and M&A activity ground to a halt. Liquidity generation therefore all but stopped and because of this new commitments to the PE asset class paused general. Where we are now is that rates have stabilized and are coming down, credit markets are normalizing/liquifying and are showing up from new places in sources for loans (non-Bank Banks). Furthermore, the temperament of the FTC, which has been led by a super anti-business combination mentality under Lina Khan is starting to face increasing voices for her removal. Similarly, Gensler the SEC Chairman has faced bipartisan criticism though, particularly from the Republicans. Changes in leadership in both of these agencies would likely release the PE animal spirits and unfreeze the lack of capital mobility that has slowed down M&A and coincidental liquidity generation.

So, in a nutshell we believe that the aforementioned potential regulatory changes stabilized rates, a goldilocks economic scenario/soft landing, leads to increased M&A and IPO and Debt Refinancing activity that would be a warming set of conditions to stimulate more liquidity generation and more Private Equity activity. This has started already in the PE markets and just like in the public markets it first is driven by the highest quality assets which trade or refinance first and then later as these trailblazers open up the liquidity machinery of the capital markets again the queue for liquidity starts to process and moves more broadly across and into a wider spectrum of PE companies.

In terms of the AI headlines, we have stated that the large language models and the Nvidia's of the world are the hardware and software platforms for the potential of a lot of new app company formations. There are some that target and or highlight that Nvidia might be losing its dominance and or pricing power for its AI Chips. This might be the case eventually and analysts debate if this is a situation that is a weakness now or still on the horizon, but to us an increasing supply of LLMs and their increasing computing power (ChatGPT 5 is 10X more than ChatGPT 4 learned from our recent trip to the VC's in Silicon Valley) this is likely to create an even further wave of start-ups that would not have been viable or justifiable before this significant technological leap.

So, to conclude, we remain optimistic about risk assets whether they are liquid or illiquid and are guiding our client portfolios accordingly. We are still aimed at technology-driven growth themes in the private markets at a variety of stages, and because of the slowdown in volumes, we are capable of slower processes that enable careful and diligent underwriting processes on all prospective investments.

Respectfully,
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Chief Investment Officer

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