PERSONAL WEALTH ADVISORY BY
Laird Norton Wetherby

Q1 2024 Commentary

> **"Every act of creation is first an act of destruction."**
> **– Pablo Picasso**

The Year of Momentous Elections

Many of us who have worked in finance for decades know that the global financial landscape is a highly dynamic tableau, a constant process of value creation and destruction. Certainly, the past two years serve as a reminder: The S&P's 19% drop in 2022 was in 2023 offset by a 24% surge, despite two ongoing wars, historic bank failures, federal debt theatrics and the highest U.S. inflation and interest rates in four decades. Remarkably, the stock market is back where it was two years ago.

Fundamentally, the key macroeconomic themes we have outlined over the past couple of years remain in play: (1) The ongoing tug-of-war between economic contraction vs. expansion, which could go either way in 2024; and (2) Inflation and interest rates at levels higher than the lows of the past decade, due to the evolution toward a multipolar world (economically and geopolitically) as well as other factors such as demographic trends.

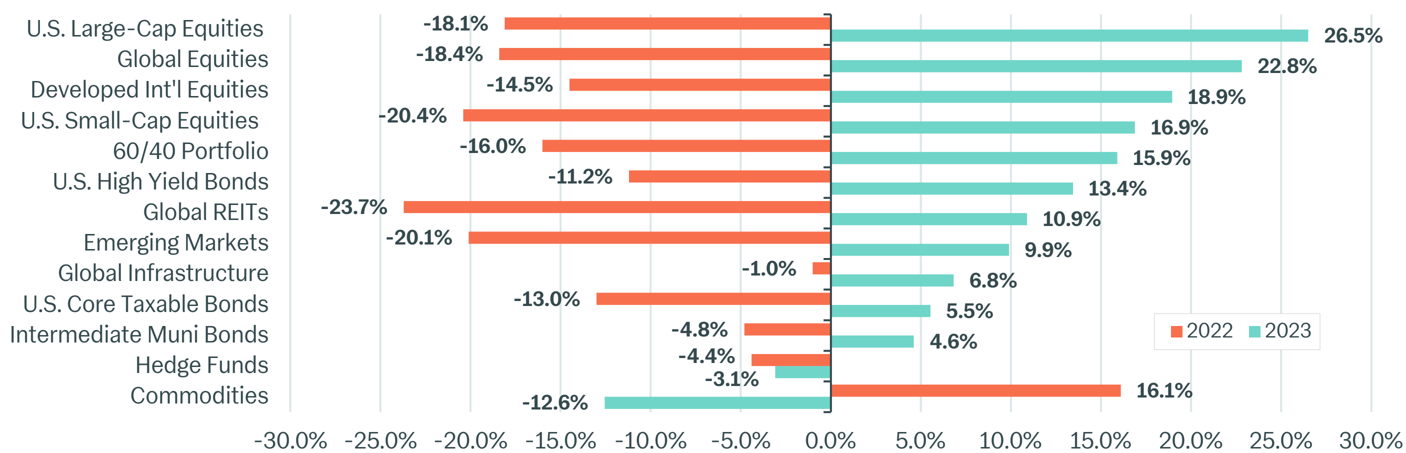
Geopolitics & Politics Take Center Stage

New in 2024 is the added risk and opportunity created by potential shifts in policy due to elections in key countries, including most importantly the United States. This year, nearly 4 billion people in nations representing over 50% of global GDP will be choosing new leaders.

The elections will take place against a backdrop of heightened bloc rivalry, driven by competition between China and the West, Russia's invasion of Ukraine, a war in the Middle East and increased posturing by countries trying to play all sides. While in the past we haven't devoted much print space to elections (since politics generally tend to have a transitory effect on markets), I will go out on a limb and say this time could be different.

The current lack of global leadership and escalating geopolitical conflict are becoming enduring factors with the potential to materially influence the capital markets and the global economy, thereby making the macroeconomic backdrop as complex as we have seen in decades. In this Commentary we explore the implications.

Mirror Image:
Asset Class Performance 2023 vs. 2022



Source: Bloomberg.

2024 Elections & Geopolitical Considerations

- **United States.** Either outcome in the U.S. Presidential election could lead to social and political upheaval. In a recent survey of U.S. investors[1], 32% believe a loss for their political party will lead to a recession within a year; 45% see the election as having more of an impact on their retirement plans than the markets. The fractured and dysfunctional political system in the world's most influential nation is prompting other countries to re-evaluate the potential opportunities and risks linked to the results.

- **China and Taiwan.** Taiwan's Presidential election on January 13 resulted in a win for Lai Ching-te of the ruling Democratic Progressive Party (DPP). While Ching-te has said he wants to assert Taiwan's separate identity from China, the one constant in Taiwan politics is voters' overwhelming desire to maintain the political status quo. China could divert attention from its high-debt/slow-growth economy by engaging with Taiwan and the Philippines more aggressively.

- **India.** Elections in April-May 2024 are likely to reaffirm support for Prime Minister Narendra Modi as India continues to strengthen its economic and geopolitical standing on the global stage. India's ability to maintain good diplomatic relations with major powers, including the U.S., and equally, with the developing world, could prove a stabilizing force in the international arena.

- **Mexico.** On June 2nd, Mexico will elect its first woman president, as the two contenders are both women. Front-runner Claudia Sheinbaum is an environmental engineer known for strong relations with the domestic and foreign business community. With a business-friendly technocrat at the helm, assuming she wins, Mexico could thrive as an economic and political connector of the Americas.

- **Russia.** In mid-March, Vladimir Putin is expected to hold on to power (likely his last term given his age), making him the longest Russian ruler since Catherine the Great. His last term could inspire him to move more aggressively to fulfill his vision of Soviet Union 2.0, including annexing another part of Ukraine.

- **Europe.** European parliamentary elections in June could further strengthen the European Union in response to Russia's aggression in the region. With that said, many signs point to some elections leaning right, which could put clean energy and ESG initiatives at risk.

- **Middle East.** The risk of potential escalation in the war between Israel and Hamas is high, especially in light of the U.S. response to recent Houthi attacks on commercial ships in the Red Sea.

When confronted with mostly negative fact patterns, we are mindful of the importance of mitigating behavioral risk. As a result, we are focused on what opportunities may develop as existing relationships morph and new influential players emerge. For example, India could be the surprise stabilizer globally as it continues to emerge as a crucial bridge between the Global South's developing and major developed economies. Additionally, Mexico's political stability combined with its dynamic economy position it as a key player in Western hemisphere integration.

We are not trying to make a call on geopolitics; that would be a fool's errand. But we do think it's important to prepare for the risks and also opportunities created by rising tensions in an increasingly multipolar world. Below is a closer look the implications for markets and portfolios.

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[1] Strategas. *Economics Report*. January 4, 2024.

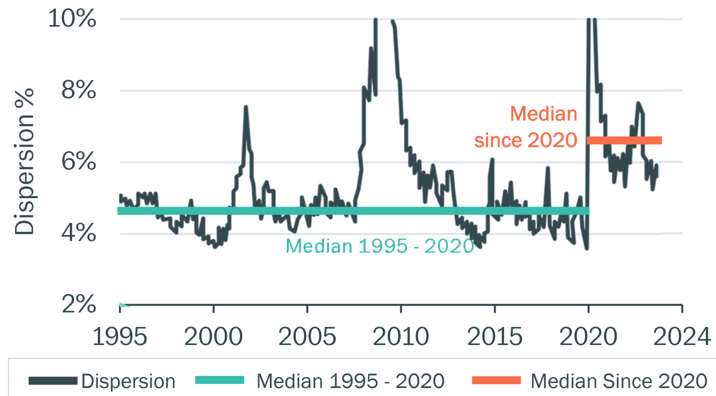
Macroeconomic Implications

- **Higher structural rate of inflation and interest rates.** A combination of forces are likely to keep inflation and interest rates at higher levels versus the past decade: Higher geopolitical risk, aging populations in the developed world resulting in labor shortages, costs associated with climate change and the transition to renewable energy, the rewiring of the global supply chain and trade wars. All these factors feed into keeping input costs high and constraining growth in advanced economies. *Potential beneficiaries: Real assets and also equities, if price increases are stable and not excessive. Higher-than-usual interest rates enable compelling yields for investors across the risk spectrum.*

- **Higher volatility.** While stock market volatility was somewhat subdued in 2023, bond market volatility has been historically high, hitting levels we haven't seen in many decades. *Potential beneficiaries: Hedge fund strategies, which offer idiosyncratic sources of risk and return as part of our Diversifiers category.*

- **Wider dispersion between market winners and losers.** New opportunities will arise from market dislocations and emerging themes such as artificial intelligence, the rewiring of globalization in a multipolar world and the clean energy transition, just to name a few. Navigating the evolving–and at times treacherous–geopolitical landscape will likely require access to deep wells of expertise by active managers, as geopolitical issues that could have been ignored in the past now stand to directly impact companies' supply chains and customer bases.

Adjusting to New Regime
Dispersion of U.S. Equity Analyst Estimates
1995-2023



Source: BlackRock.

For example, critical mineral supply chains are likely to grow in importance for the green energy transition, as well as their vulnerability to supply shocks. *Potential beneficiaries: Asset managers investing in management teams able to navigate geopolitical dynamics and hyper-focused on understanding and adapting their supply chains.*

- **Green energy transition.** At COP28 (the UN Climate Change Conference) in December, consensus was reached among 195 nations to move away from fossil fuels. Commitments included hastening the reduction of coal usage, tripling global renewable energy capacity by 2030, and advancing technologies like carbon capture and storage. In the United States, projections from Goldman Sachs suggest investments in restructuring the U.S. energy sector may soar to an estimated $3 trillion by 2032. Beyond the U.S., there is a notable potential for Latin American economies to benefit from the low-carbon transition, particularly those with substantial reserves of crucial resources such as copper and lithium. Additionally, Europe's drive to eliminate dependence on Russian energy will fuel investment. *These trends could yield a broad range of opportunities across geographies, asset classes and individual companies.*

- **Credit Market Diversification.** Banks facing capital constraints are creating opportunities for private credit and non-banking entities to step in and address the lending gap. *These same conditions are causing banks to offload assets to fortify their balance sheets, creating opportunities within the private credit markets.*

The U.S. Economy: Strong but Still Vulnerable

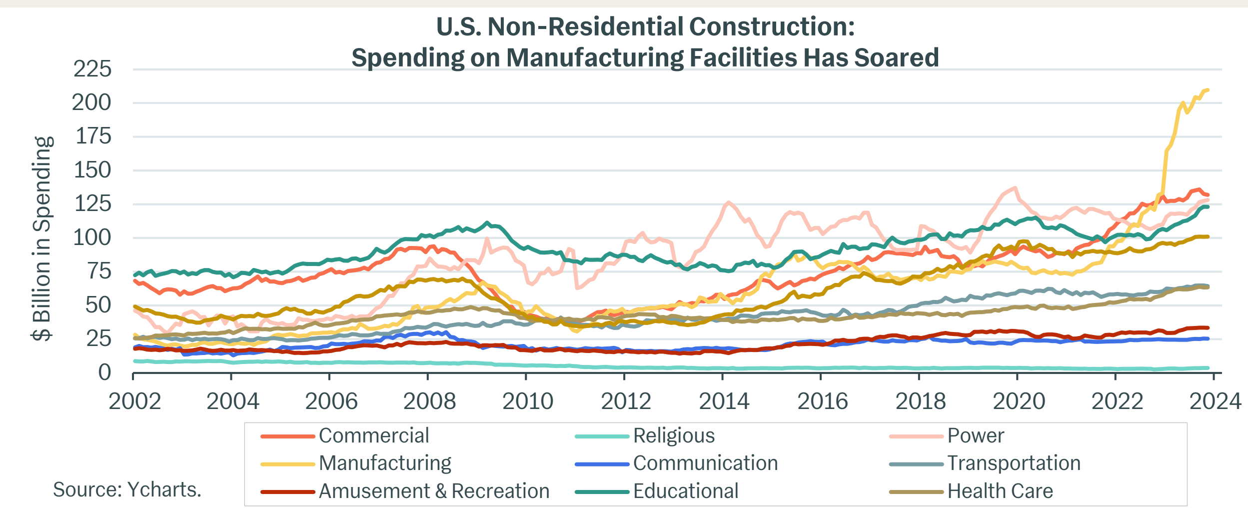
Markets appear to be jubilantly pricing in a "soft landing" for the U.S. economy. Pricing in the futures markets indicates expectations that the Fed will cut its key interest rate six times, or 1.5 percentage points in 2024, bringing it down to 3.75%-4% from 5.25%-5.50% currently. Additionally, Wall Street analysts have become optimistic yet again, expecting S&P 500 earnings to rise by close to 12% vs. being nearly flat in 2023.

These forecasts may be overly optimistic. Historically, interest rate increases take about 16 months to impact the economy. If this holds, only the first five of the 11 increases (March, May, June, July and September 2022) have been absorbed so far. The six hikes from November 2022 through July 2023 are likely to have most of their contractionary impact in the first half of 2024. If the economy drops off, the Fed would likely cut rates more aggressively and corporate earnings may not deliver versus expectations.

There are, however, factors that could make the U.S. economy and markets again surprise on the upside.

- **Election Year Stimulus.** Historically, the S&P 500 has risen in each of the 16 presidential re-election years since 1944. That's probably because both monetary and fiscal policies tend to shift ahead of a president seeking re-election. That seems to be the case in 2024. A $78 billion bi-partisan tax bill is now before Congress that would expand the child tax credit in exchange for reinstating corporate tax deductions. Additionally, the IRS could re-start processing claims for the Covid-era Employee Retention Tax Credit. And a Congressional deal to send more military aid to Ukraine and/or Israel (estimated at $100 billion) would go mostly to U.S. defense companies, a boost to the economy.

- **U.S. Manufacturing Resurgence[2].** Three U.S. legislative acts to fund infrastructure (2021), clean energy (2022) and domestic manufacturing (2022) are expected to continue stimulating private sector investment and job growth.



- **State-Level Diversification/Vibrancy.** Despite dysfunction at the national level, U.S. states are asserting their independent leadership economically, politically and socioeconomically. While areas such as California and New York excel in artificial intelligence development and global finance, other states such as Texas lead in fossil-fuel and post-carbon energy production, as well as attracting significant new investment in finance, banking and technology. *These "micro-economies" within the U.S. may be beneficial to small and medium-sized businesses in the public or private markets. This dynamic coupled with federal infrastructure investment suggests the U.S. may still have growth potential.*

[2] Strategas. *Economics Report*. Jauary 4, 2024.

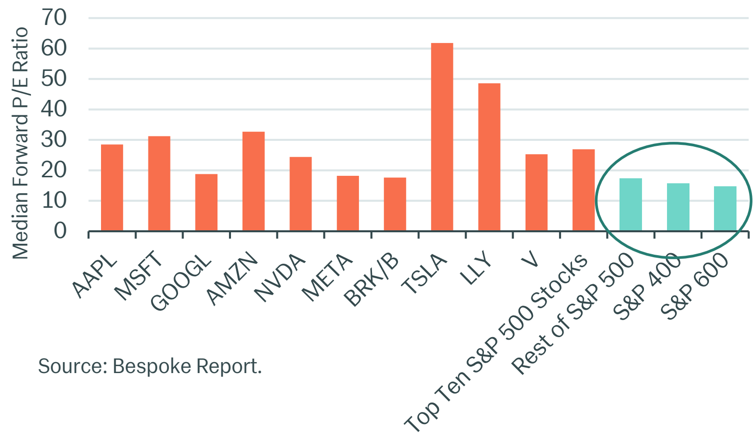
Portfolio Positioning

Our recent stress-testing and portfolio modeling using updated capital market assumptions indicates our long-term asset allocation targets remain generally appropriate. This comes with a few caveats: Portfolios that have benefited from the 2023 rebound may be due for rebalancing to lock in gains and bring the risk-reward characteristics back in line with long-term targets. Also, review of whether client portfolio risk is aligned with long-term objectives could be in order. And a portfolio that was more aggressive by necessity could in 2024 be repositioned more conservatively given higher interest rates. In both of the above cases, this likely means adding fixed income and diversifiers (hedge funds, private credit) while reducing equities to target levels.

U.S. Equities. Given the run-up in 2023, U.S. large-cap equity valuations may be pricing in a too rosy economic outcome, with price-earnings ratios and other valuation metrics now above historical averages. While the Magnificent 7 have an outsized impact on U.S. and even global market metrics, they represent a significantly smaller weight of index earnings. This indicates there are plenty of pockets of value within large-cap equities outside of these seven companies.

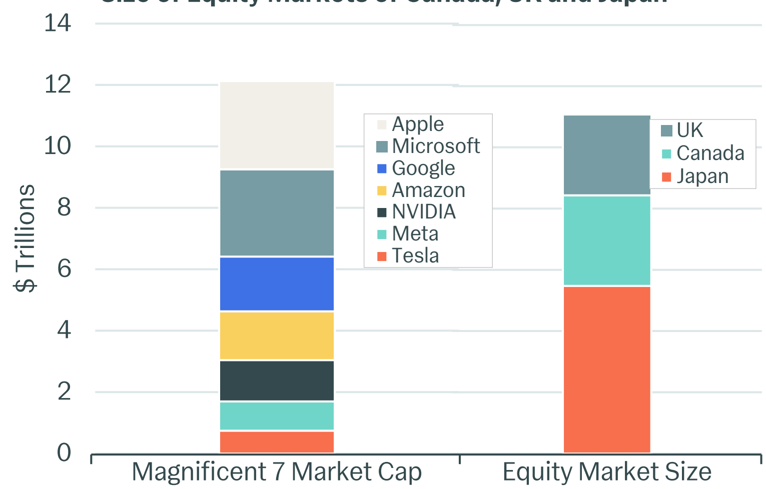
On a relative basis, U.S. small-cap stocks and international equities have not benefited as much from market enthusiasm and look more attractive by most valuation measures. This supports our strategic thinking regarding the need for geographical and market-cap diversification within equities.

Top-Heavy Valuations
Individual Price/Earnings Ratios vs. S&P 500



Source: Bespoke Report.

"Magnificent 7" Market Cap vs.
Size of Equity Markets of Canada, UK and Japan



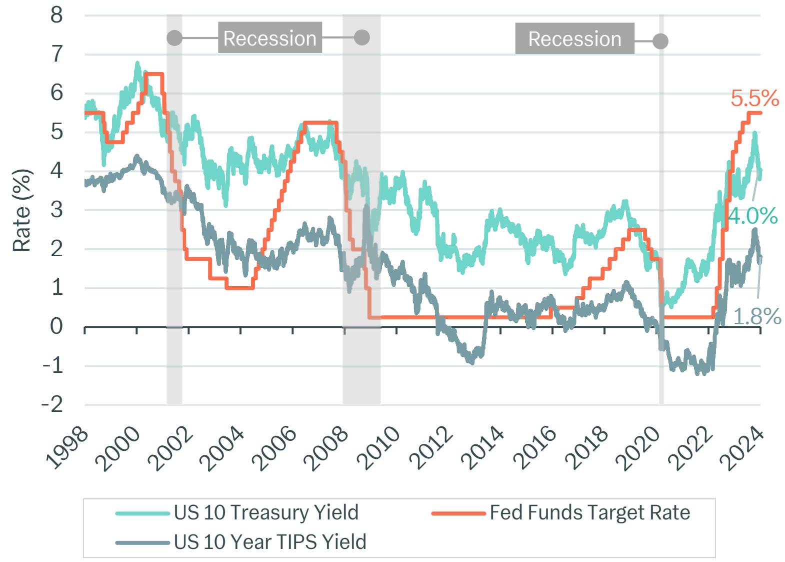
Source: CEIC Data & Bloomberg as of 1/10/2024.

International Equities. Country and currency diversification may become more important due to the bevy of elections worldwide that could change the direction of fiscal and monetary policies. Rising geopolitical tensions could also trigger more trade restrictions across the globe, resulting in further economic fragmentation. As such, the trend of developed markets reshoring/friend-shoring will likely continue to gain momentum benefiting countries such as India, South Korea, Vietnam, Mexico and a host of others.

Fixed income. Given the dramatic rebound in equities in 2023, making sure our fixed-income allocations are topped up is prudent. Yields remain soundly above where they have been over the last 15 years and historically speaking, a swift plunge like the one we saw in the fourth quarter has been followed by even lower rates.

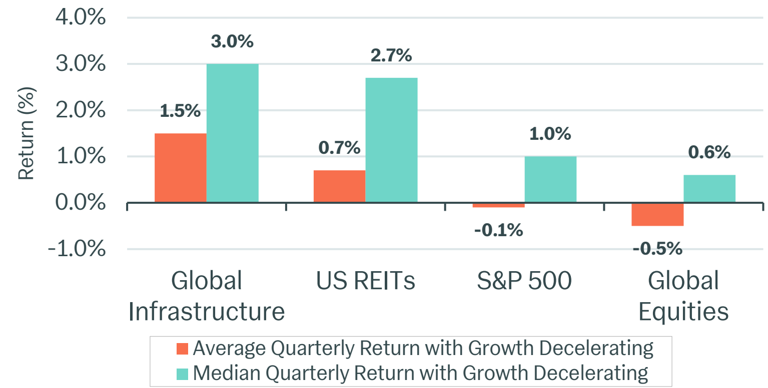
Whether it be an economic slowdown or recession that drives rates down, the potential for capital gains enhances the case for fixed income in the near term.

Real assets. While concerns over inflation seem to have diminished in the near term, we continue to believe that inflation is not likely to return to the ultra-low levels of the last 15 years, which makes real assets an important component of portfolios. Moreover, several areas, including infrastructure with its secular tailwinds, offer relatively attractive valuations following a lag during the 2023 runup.



Source: Bloomberg.

A unique opportunity we are evaluating is within the market for environmental commodities such as carbon credits. The structure of the market and its regulation-driven supply/demand could provide a source of non-correlated returns to enhance diversification.



Source: DWS.

Diversifiers and Private Markets. Markets with higher uncertainty and volatility (as well as higher interest rates) are more prone to dislocation and inefficiency, providing a backdrop in which hedge funds have typically thrived. Separately, with banks pulling back from the less-liquid corners of business lending, private credit strategies are stepping in to make loans to solid businesses at yields reaching into the double digits in exchange for less liquidity and patience. In this segment, we are looking at potential opportunities in commercial real estate credit, a space showing early signs of stress.

In Closing

While rising macroeconomic and geopolitical risks can create anxiety, they also create opportunities. To find these, we need to roll up our sleeves, dig deeper and think creatively. As we enter 2024, our focus will remain on pounding the virtual pavement of the asset management universe – checking in with our existing managers to see how they are navigating the shifting environment while searching for new strategies that could be accretive to LNW portfolios in terms of risk management and/or enhanced returns.

One last note: While this Commentary has highlighted the higher levels of political and geopolitical uncertainty in 2024, we hope this year will surprise by bringing more peace and harmony to the world.

ABOUT THE AUTHOR

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Ronald G. Albahary, CFA® is Chief Investment Officer at LNW. As head of the investment team (see below), Ron determines the firm's investment strategy, directs the investment selection process, and works in tandem with client advisory teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNW, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University of Pennsylvania.

The LNW investment team is comprised of 11 analysts and strategists working together to design and implement investment solutions for client portfolios. Six analysts at the firm hold the Chartered Financial Analyst® designation, with expertise spanning macroeconomics, public and private asset classes across the global capital markets, and impact investing. Collaborating with each other and with client advisors, the investment team's overarching goal is to help clients and their families preserve and grow their wealth over many generations.

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