VUCA at the Gate

> **"Uncertainty is the only certainty there is, and knowing how to live with insecurity is the only security."**
> - John Allen Paulos, author and mathematician

As we enter the second half of 2024, the world seems increasingly complex, uncertainty is rising and change is happening at an accelerating pace. There is no clearer evidence than the horrific assassination attempt on July 13 that endangered former President Trump, killed one rally participant and injured two others. Welcome to what in the military world is known as VUCA – Volatility, Uncertainty, Complexity and Ambiguity.

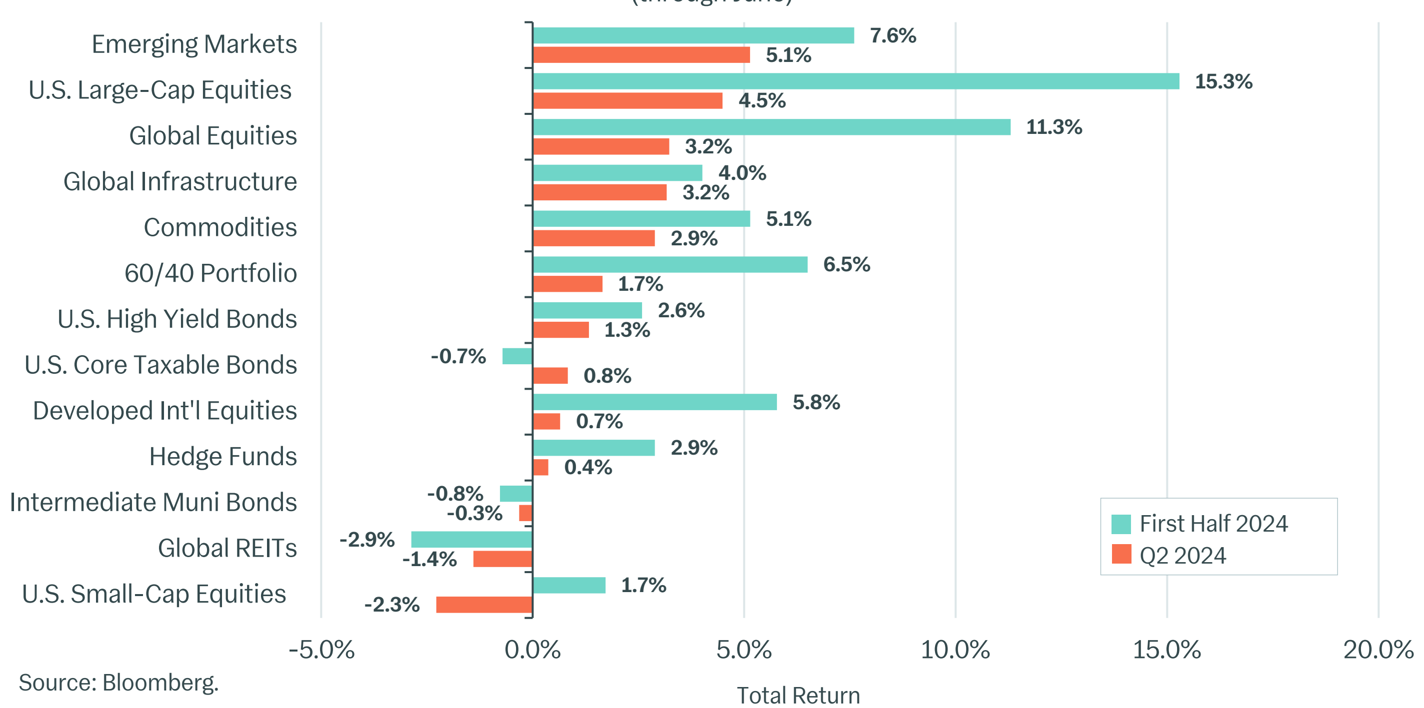
In fact, VUCA is a constant in the markets and the economy and something I have been navigating through my entire three-decade career. VUCA levels might be a bit higher today, but the same rules apply for capitalizing on VUCA's many facets: focus on what is known and relevant, keep personal biases in check, question the status quo, and seek out the opportunities that VUCA creates while minimizing the impact of threats.

In this Commentary, we evaluate the threats and opportunities created by potentially higher levels of volatility and uncertainty in the second half of 2024 and the implications for LNW portfolios.

Where We Are at Half Time

Having attended the NBA Finals in Boston last month, I cannot help but use a basketball metaphor: we have arrived at halftime in the markets. And the first half was quite impressive for global equities (see below and box on next page).

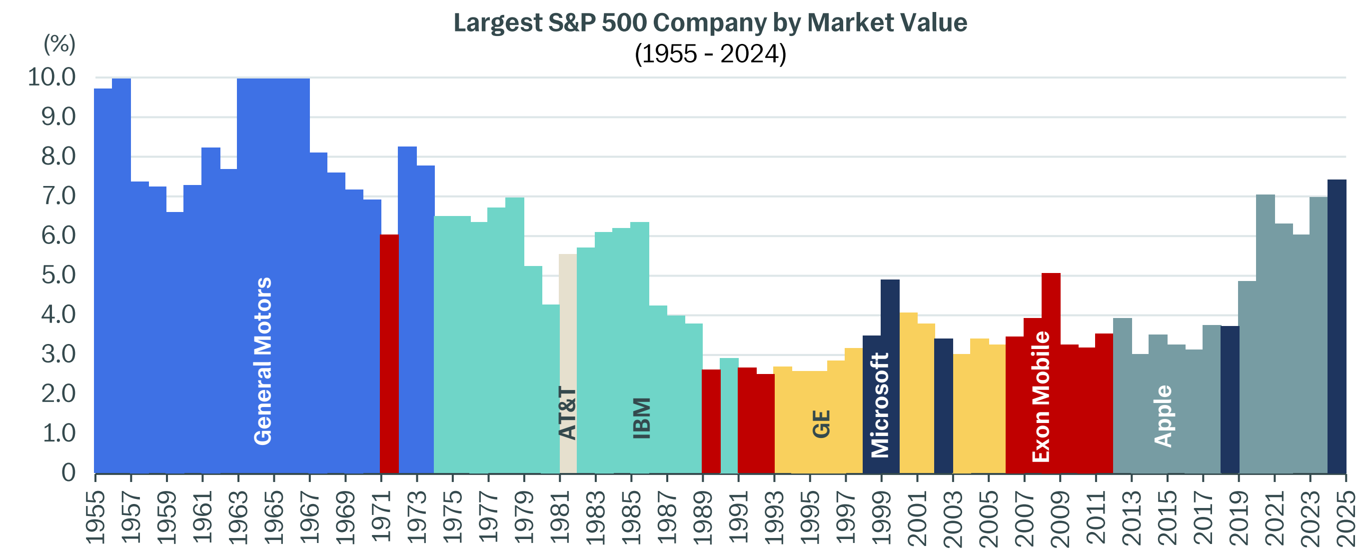
Asset Class Total Returns First Half of 2024 & 2nd Quarter
(through June)



Source: Bloomberg.

Taking Stock of the First Half

The S&P 500 was up an impressive 15% in the first half of 2024, with the Magnificent 7 tech stocks accounting for approximately 60% of that gain (Amazon, Apple, Alphabet/Google, Meta/Facebook, Microsoft, Nvidia and Tesla). AI chipmaker Nvidia rose an incredible 155% in the first half. Meanwhile, the average S&P 500 stock was up approximately 5% and small stocks badly lagged, ending the first half up just 1.7%.



Source: Goldman Sachs Global investment Research.

The U.S. economy appears to be slowing. Companies and sectors most impacted by an economic slowdown (materials, industrials, etc.) as well as small stocks saw share price declines in the second quarter. By contrast, defensive sectors such as consumer staples performed relatively well.

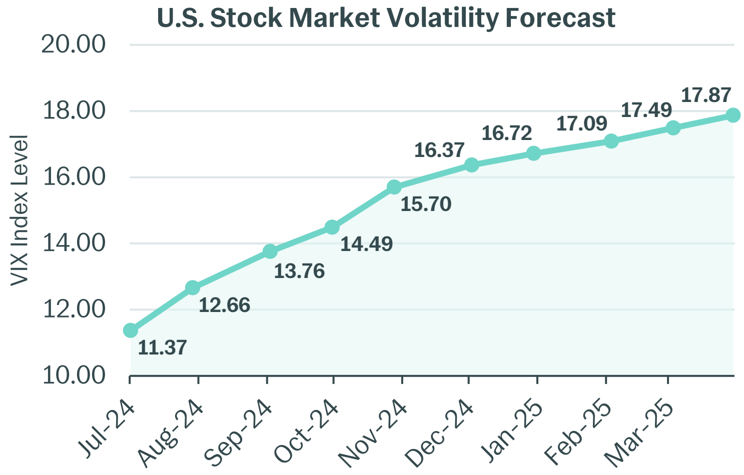
International equities also performed well, as many foreign economies showed signs of turning around as central banks outside the U.S. started easing monetary policy amid falling inflation.

Some of the tailwinds that have propelled U.S. equities appear to still be in place. One of the biggest positives: The continuous drop in inflation this year, making at least one interest rate cut by the Fed likely in 2024. Despite a couple of false starts in the first quarter, U.S. inflation continues to decline, with the Consumer Price Index down slightly in June vs. May and the rate of inflation slowing to 3% annualized. Already, the Federal Reserve has forecast one interest rate cut this year. Eight Fed officials have projected two cuts this year, suggesting the Fed is keen to start reducing rates and may do so if economic weakness becomes more pronounced.

Decelerating inflation and interest rate cuts do not change our long-term view, which is for both U.S. rates and inflation to remain higher for longer (relative to the pre-Covid era) for a variety of factors, including increasing regionalization, climate change, a large U.S. budget deficit and geopolitical tensions.

A sense of complacency seems to have set in, given the prospect of lower rates/inflation combined with ongoing excitement over Artificial Intelligence (AI), record-high corporate profits and U.S. household wealth. This is evidenced by the very low stock market volatility so far this year. But this relative calm could change during the second half.

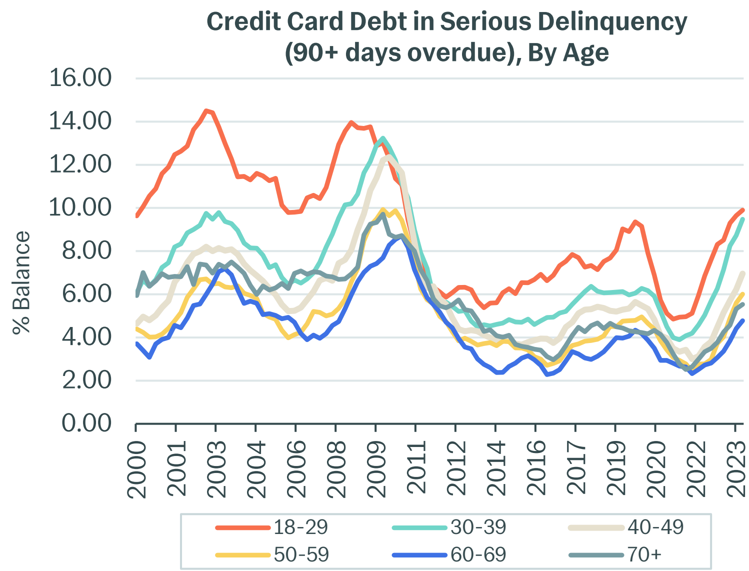
The CBOE Volatility Index (VIX), also known as the "fear gauge," is an indicator of the S&P 500's expected volatility. The VIX futures market (see top chart) predicts a nearly 40% rise from now through the U.S. Presidential election and until April 2025. Let's explore some of the potential reasons for these expectations of higher uncertainty and volatility.



Source: CBOE as of 7/10/24.

Risk Factors

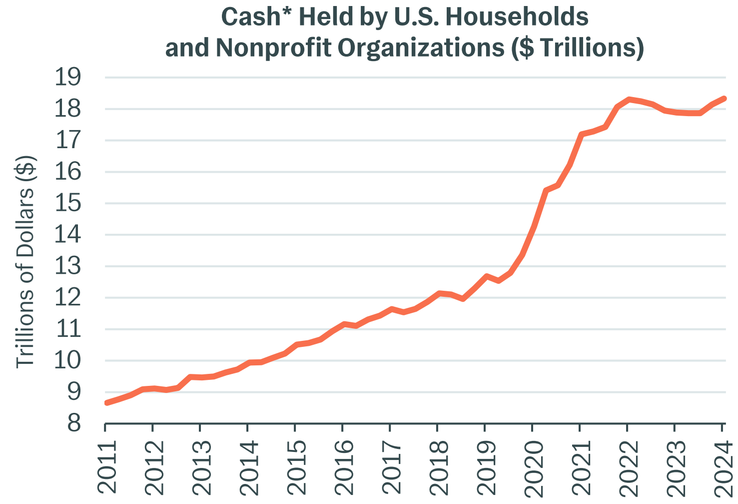
Slowing U.S. economy. The U.S. economy grew 1.4% in the first quarter (with 1.5% anticipated for the 2nd quarter). These are the lowest levels of growth since 2022, when the economy was shrinking due to Covid. There has been a noticeable increase in layoffs, and the unemployment rate has started to inch up (recently at 4.1%). The real estate market is relatively frozen due to high prices and high mortgage rates, with building permits and housing starts plummeting to the lowest levels since June 2020, when the economy was largely shut down due to the pandemic. Real income growth appears to be tapering off, and consumer sentiment has declined to levels typically seen during recessions.



Source: New York Fed Consumer Credit Panel, data through March 2024.

Most of the negative impact of higher U.S. inflation and interest rates has been borne by lower-income households, as evidenced by rising credit card and auto loan delinquencies. This segment is increasingly relying on discounts and cutting back on purchases. In response, retailers have started to reduce prices, which in turn has helped keep a lid on inflation.

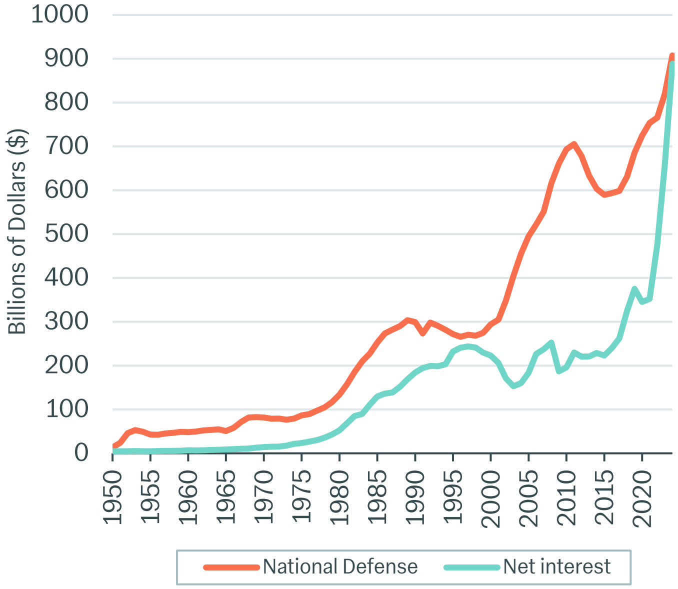
Meanwhile, the wealthier and generally older segments of the U.S. population continue to benefit from lower levels of debt and/or low borrowing costs, rising stock and real estate prices and higher rates of interest on the $18 trillion of cash on their balance sheets.



*Includes cash equivalents such as bank deposits and money market funds.
Source: Board of Governors of the Federal Reserve System (US), households and nonprofit organizations, as of March 31, 2024.

The U.S. Presidential election. The many foreign elections have occurred without incident this year, including the split outcome in France. And investors are now starting to focus on the prospect of further violence and the potential for a contested U.S. Presidential election and/or big shifts in policy that could potentially negatively impact the economy. Markets dislike uncertainty. For historical context, the 2000 U.S. Presidential election between Al Gore and George W. Bush took 36 days to resolve, during which the S&P 500 dropped 5%.

U.S. Government Interest Payments vs. National Defense Spending (1950-2024)



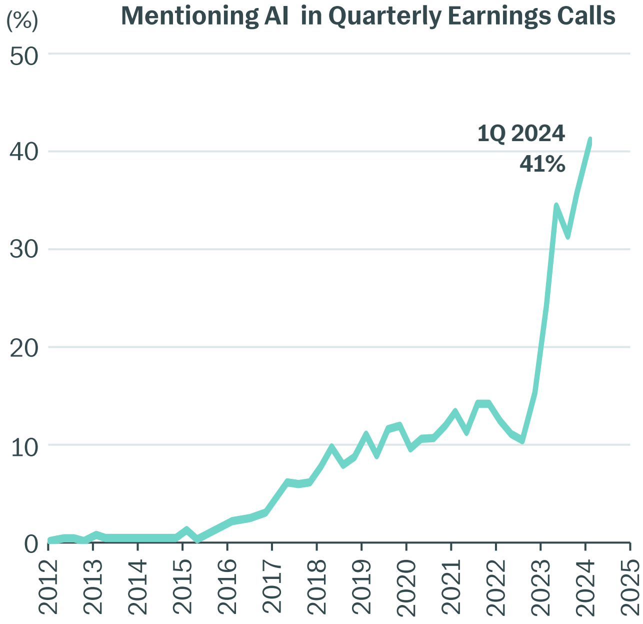
Source: Office of Management and Budget.

High U.S. government debt and interest payments. U.S. total debt was recently around $35 trillion (higher than U.S. GDP) and interest rates have risen steeply since the pandemic. The result is that the U.S. government is currently paying around $800 billion a year in interest on the federal debt, equaling the budget's biggest outlay: defense spending. Large deficits compel the Treasury to issue more debt, which can keep long-term rates elevated even if the Federal Reserve lowers short-term rates.

Federal Reserve policy risk. The Fed could miss the opportunity to begin easing rates at the right pace, potentially leading to a recession. As U.S. inflation falls, real interest rates rise if nominal rates remain unchanged. If the Fed delays lowering rates while inflation drops, it effectively tightens the economy further.

AI sector volatility. The expectation is that virtually all companies will be integrating AI into their business models, resulting in higher revenues, profits and productivity gains. Disappointing AI adoption rates or lower productivity than expected could negatively impact the high-flying AI stocks and by extension the broader market.

Percentage of S&P 500 Companies Mentioning AI in Quarterly Earnings Calls



Source: Goldman Sachs Global Investment Research.

Geopolitical tensions. In Eastern Europe, the U.S. recently allowed Ukraine to use American weapons to strike within Russia. In the Middle East, Hezbollah has been launching numerous rockets and drones toward Israel daily, firing over 5,000 since October 7, 2023. And we continue to see the Houthis attempting to destabilize the region.

The unknown unknowns. This risk for a negative unexpected event – a Black Swan – always exists but seems heightened in periods of rising uncertainty, where we find ourselves today. An exogenous shock can quickly change stability to instability.

Asset Class Drivers

While risks appear elevated, we cannot lose sight that the risks we outline above could also be resolved favorably. As such, portfolios need to be positioned for favorable and unfavorable outcomes with an ongoing focus on broad diversification, keeping emotions in check and maintaining discipline. Below is an update on the asset classes within LNW portfolios.

U.S. Equities. After strong price appreciation in the first half, rebalancing to target allocation may be advisable (depending on tax and other considerations). With that said, multiple factors could continue to benefit U.S. large-cap equities, including strong corporate earnings growth, interest rate cuts by the Fed, continued abatement of inflation, and income gains for lower-income households that could boost spending beyond the higher-income segments. All this has the potential to support U.S. stock prices not just in tech but across more sectors.

With that said, valuations currently look most attractive in both U.S. small cap and foreign equities as well as sectors less directly influenced by AI. U.S. small cap stocks have had good reason to be challenged with estimates that 600 to 800 companies within the Russell 2000 index are currently unprofitable, with the high cost of capital at least partially to blame. The anticipated drop in interest rates has recently awakened small-cap stocks from their torpor but may not be meaningful enough for a lasting rally.

Cash Hoards

The total cash on U.S. consumer and corporate balance sheets amounts to an astounding $23 trillion, generating over $1.2 trillion in annualized yield. This financial cushion supports both consumer and corporate spending on research and development, as well as capital expenditures. There is also support from current government spending through the Infrastructure & Jobs Act, the Inflation Reduction Act, and the CHIPs Act.

International Equities. While the U.S. economy has shown relative strength, most of the non-U.S. developed world has been experiencing low or no growth. This has largely been due to higher interest rates to combat inflation. More recently, however, developed economies overseas are starting to ease monetary policy or are on the verge of doing so, creating conditions for a potential turnaround in their growth trajectories.

Emerging markets, including India, Vietnam and Mexico, will play a critical role in the evolving global economy. Different regions of the world are taking up the growth mantle, and China's exporting of deflation is helping to keep global price pressures in check.

Fixed Income. U.S. yields have possibly stopped rising, recently falling to 4.2% on the 10-year Treasury, as investors see more signs of an economic slowdown. The likelihood is that U.S. interest rates have peaked, even if that doesn't mean they will fall dramatically. Given that yields are more likely to fall than rise from here, albeit not greatly, the risk reduction role that fixed income plays in portfolios is arguably even more attractive than it has been in over 15 years. Should the equity markets take a turn for the worse, it is likely that bonds will cushion that fall while compensating investors with meaningful yield in the meantime.

Municipal bond prices have struggled under a wave of new issuance as local governments rush to finance new infrastructure projects ahead of the Presidential election and uncertain fiscal policy in 2025. In general, the creditworthiness of municipal issuers remains healthy due to years of elevated tax revenue and pension reforms, supporting a core allocation for high-net-worth investors.

Real Assets (commodities, infrastructure, real estate). While rising macroeconomic, geopolitical and domestic political risks can create anxiety, they also create opportunities. For example, we recently approved a private real estate strategy that focuses on affordable housing to capitalize on the favorable supply/demand imbalance throughout the economic cycle and the manager's specialized expertise in this sector.

Infrastructure equities related to renewable energy saw a dramatic turnaround in the second quarter (+5.9%) and were among the strongest performing public assets due to attractive valuations, defensive characteristics, and the long-term secular demand for electrification and the development of AI. Traditional infrastructure (+3.9%) has also performed well, leading the real assets category with a 7.8% return over the last 12 months.

Additionally, many infrastructure managers have pivoted to investing in companies and sectors poised to benefit from AI development indirectly, such as publicly traded electric utilities, which because of their dividends and regulated operations offer marginally less downside risk while benefiting from the surge in demand for electricity.

Private Equity. Capital has resumed flowing but very selectively. Companies with strong backing from venture capital have shored up their balance sheets, so fewer total private equity transactions are likely for some time. Capital remains "stuck" given the rise in interest rates, economic uncertainty, inflationary pressures and geopolitical/political unrest driving a slowdown in activity. Bid-ask spreads remain wide as managers try to avoid selling assets into this lower-valuation environment. Attractive opportunities still exist for managers with access to capital, but fundraising markets are likely to remain slow until investors attain higher liquidity from prior funding rounds.

Diversifiers (hedge funds, private credit). Diversifying strategies such as hedge funds posted strong returns in 2023 and even stronger results in the first half of 2024. An environment of higher interest rates has been a plus, providing a higher base return for credit strategies and creating more dispersion and volatility, which is helpful for nearly every hedge fund strategy. The economic backdrop has remained more resilient than many expected, and avoidance of a U.S. recession has certainly helped.

Portfolio Considerations

The assassination attempt of former President Trump was shocking and will hopefully serve to unify both parties around a no-violence message. With that said, even prior to July 13, futures markets were forecasting a spike in stock market volatility from October into next year.

Our focus is on creating portfolios that can withstand higher levels of volatility and uncertainty, coupled with ongoing vigilance. Given the probability that market volatility will pick up, LNW advisory teams are reviewing client investment plans. Depending on the client's specific situation, the following may be advisable:

- Conducting sustainability analysis to ensure asset allocations remain aligned with client goals and risk tolerance, and possibly adjusting allocations to reduce risk, as client finances and goals allow.
- Topping off fixed-income exposures, if underweight.
- Adding (or introducing) Diversifiers to act as shock absorbers or take advantage of opportunities that surface during volatile markets.
- Rebalancing equity allocations if outside strategic targets and possibly rebalancing within U.S. equities (large-cap vs. small-cap) and between U.S. and non-U.S. equities, whose valuations appear more attractive.

ABOUT THE AUTHOR

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 12 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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