Investment Narrative

Quarter Ending September 30, 2024

In the U.S., inflation presented a mixed set of signals. Overall, inflation continued to show signs of softening, moving closer to the Federal Reserve's 2% target and ending the quarter at 2.4% year-over-year. However, concerns linger due to varied underlying inflation data.

Some consumer segments, such as new vehicles, used vehicles, and energy, experienced deflation, while key areas like shelter costs remained elevated, and food prices accelerated over the quarter. Increased labor strikes during the quarter raised concerns about potential production and trade disruptions, which could reignite inflationary pressures if such actions continue.

The Federal Reserve seemed pleased with the economy's direction, as indicated by a surprising 50 basis point rate cut. Investors responded positively, interpreting this as a potential start to a rate-cutting cycle. Third quarter GDP growth decreased slightly, reaching 2.8% quarter-over-quarter compared to 3.0% the previous quarter. Growth was supported by increased consumer spending and continued elevated government defense spending.

Personal spending remained within a 2 to 3% range, and the personal savings rate notably increased over the quarter. Despite resilient consumer spending habits, concerns persist regarding the sustainability of this resilience, especially as consumers express dissatisfaction with labor market trends such as reduced hours and job opportunities. Additionally, small business sentiment remained depressed as business owners face uncertainties related to inflation and higher financing costs.

The labor market showed signs of softening, though this appeared to result more from natural attrition and reduced hiring rather than widespread layoffs. Unemployment decreased to 4.1%. The Federal Reserve's rate cut in September, along with potential future cuts, was positively received by the real estate market, as lower rates could foster a more favorable environment for real estate transactions. However, if housing demand continues to outpace supply, the benefits of lower mortgage rates may be offset by rising home prices. The construction of new apartments has helped keep rent prices stable year-over-year, while home prices have continued to increase, widening the cost gap between buying and renting.

U.S. equities posted another quarter of positive performance, though they underperformed relative to international and emerging market equities. Continued gains have elevated valuations, reinforcing a "priced for perfection" theme in the market. Investors began rotating from large-cap growth stocks into other market cap segments, which positively impacted previously depressed stocks. The broad U.S. stock market, tracked by the S&P 500 index, returned 5.9% for the quarter. The U.S. Small Cap index, tracked by the Russell 2000, returned 9.3% for the quarter.

The U.S. yield curve un-inverted as shorter-term interest rates declined, in line with expectations of continued aggressive rate cuts by the Fed. Fixed income returns diversified across credit quality as spreads compressed, forcing investors to receive a lower reward for taking on additional credit risk. The fixed-income market remained stable, buoyed by a strong economy and low default rates, resulting in moderate returns over the quarter. The U.S. bond market, represented by the Bloomberg U.S. Aggregate Bond Index, posted a 5.2% return.

In international developed economies, such as the Eurozone, economic growth continues to decelerate, although inflation has declined to pre-pandemic levels. The combination of lower inflation and reduced growth has provided the European Central Bank with a foundation to initiate a rate-cutting cycle during the quarter. Emerging markets experienced notable year-over-year GDP growth, accompanied by some rate cuts. The U.S. dollar has remained strong throughout the year but is expected to weaken if the Fed maintains its rate-cutting trajectory.

A weakening dollar, coupled with strong growth in international economies, has made international equities more attractive and benefited investors in non-U.S. equities as funds rotated into these markets. International developed equities outperformed U.S. equities during the quarter, though much of this performance was driven by currency dynamics. Many developed countries face slowing or even contracting growth, which has caused concern from investors regarding the near-term outlook for these economies.

Emerging market equities outperformed both international developed and U.S. equity markets over the quarter. A late-quarter rally in Chinese stocks provided positive momentum, while Taiwan and India were also key contributors to the overall emerging markets equity index. International developed equities, represented by the MSCI EAFE Index, returned 7.3% for the quarter. Emerging Market equities, represented by the MSCI Emerging Markets Index, saw an 8.7% return over the same period.

Endowment Portfolio

The Endowment Portfolio delivered a 4.3% net return for the quarter, bringing the year-to-date performance to 10.4%. The portfolio outperformed its benchmark in those periods by 0.1% and 0.2% respectively. Stronger performance in international equities relative to prior quarters resulted in flat attribution whereas attribution was negative in the first half of the year. The portfolio's allocations in hedge funds, real estate and fixed income were the most additive to performance.

These contributions were driven by the outperformance of the underlying investment managers. The private markets allocation, specifically private equity, has been a drag on performance year-to-date. This is a result of depressed levels of deal activity in private equity, which have pinned valuations and prevented many managers from being able to exit their positions. Deal volumes started to slowly pick back up, which restored some investor confidence in the future potential of private equity.

Long-Term Portfolio

The Long-Term Portfolio had a 5.7% net return for the quarter, bringing the year-to-date performance to 12.5%. Performance for the quarter slightly lagged the benchmark by 0.3%, though performance is strong relative to peers. The performance lag can be partially attributed to underperformance in domestic large-cap equity, due to a broadening of equity performance outside of the mega cap technology stocks like the Magnificent 7. The other detractor to performance stemmed from holding a small cash position over the quarter. As of July 1, we started a multistage process to reduce the portfolio's hedge fund exposure, resulting in a temporary increase in cash. The process was completed at the end of the quarter, and going forward cash should return to its historical target of 0%.

Medium-Term Portfolio

The Medium-Term Portfolio posted a 5.4% net return for the quarter and 8.4% net return year-to-date, outpacing its benchmark by 0.3% across both periods. The outperformance was driven by a strong quarter for the portfolio's fixed income and emerging markets equity allocations. Fixed income accounts for 70% of the asset allocation. Of the four fixed income strategies, two strategies continued their trend of top decile ranked performance. Though the other two strategies did not rank as highly, they still offered returns in line or slightly higher than their respective benchmarks.

Intermediate-Term Portfolio

The Intermediate-Term Portfolio had a 4.6% net return for the quarter, which brought the year-to-date performance to 5.3%. The portfolio outperformed its benchmark over both periods by 0.3% and 0.7%, respectively. As the portfolio is 100% invested in fixed income, and 40% in short-term, low-duration bonds, performance is correlated to the Fed's decisions to cut rates. We would expect performance to move in tandem with the Fed's direction on rates.

Short-Term Portfolio

The Short-Term Portfolio concluded the quarter with a 1.2% net return and a 3.9% year-to-date net return, slightly lagging its benchmark by 0.2% and 0.1% respectively. Over the last year, the portfolio benefitted from an elevated interest rate environment in short-term bonds and resulted in uniquely strong performance. As short-term rates decrease in response to the Fed's rate cuts, performance is likely to normalize to its historical averages.

Sustainable Endowment and Non-Endowment Portfolios

The Sustainable Endowment and Non-Endowment Portfolios delivered a 7.2% net return for the quarter and a 14.4% net return year-to-date. Year-to-date, the portfolios lagged their benchmark by 2.1%. This detraction was largely caused by the underwhelming performance of a prior equity allocation that had difficulties delivering consistent returns. In the first quarter, we made the decision to transition the portfolios' equity allocation to a passive strategy to decrease performance volatility. Since then, the portfolios have been able to track more closely to their benchmark as evidenced in their third quarter results, which slightly lagged the benchmark by 0.3%. The most recent performance is in line with our expectations after the investment manager change.