Like a Rock

Aprio®
Wealth Management

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Like a Rock

October 7, 2024

Executive Summary

In Q3 2024, financial markets faced heightened volatility, yet opportunities emerged for those with a steady, long-term focus. To navigate the choppiness, we drew on our disciplined investment approach that emphasizes fundamentals, secular cash flow growth, and valuations, even in turbulent times. With recent rate cuts by the Federal Reserve and early signs of recovery in key real estate sectors, there are promising avenues for growth, particularly in undervalued assets like multifamily housing. As the economy shows signs of slowing, we are carefully positioning portfolios to balance risk and opportunity, ensuring your financial goals stay on track despite uncertainties ahead.

Commentary

> ***"To be like the rock that the waves keep crashing over. It stands unmoved and the raging of the sea falls around it."***[1]
>
> – Marcus Aurelius, Meditations

As we reflect on the turbulence of the past quarter, I am reminded of the Marcus Aurelius quote about waves crashing over a rock. In moments of market volatility, like those we've seen recently, it's essential to maintain clarity of mind and perspective. Our objective, both as a firm and as your trusted wealth advisor, is to remain that rock — unshaken by the noise of the markets but attuned to its underlying currents.

The financial markets, influenced by the unwinding of the Japanese Yen Carry Trade[2] at the end of July, experienced a wave of uncertainty reminiscent of prior carry trade unwinds, such as the Asian Tiger currency crisis in 1997-1998. Our approach to understanding critical economic and financial market events, and their contextual history, provided the perspective of staying focused on what we can control. In navigating this volatility, we draw inspiration from another nugget of Marcus Aurelius' wisdom:

> *"You have power over your mind — not outside events. Realize this, and you will find strength."*
>
> – Marcus Aurelius, Meditations[3]

As a firm, Aprio Wealth Management holds itself to the fiduciary standard – above everything else, we are stewards of your financial well-being. To do this, we ensure that every decision is rooted in a consistent, disciplined, data-driven approach. In moments of volatility, such as the Yen Carry Trade unwind experienced this summer, our responsibility is to see through the noise, providing you with clear insight and assurance that your portfolio is being managed with calm, precision, and a long-term vision. We do this in several ways, including:

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1 Marcus Aurelius, *Meditations*, trans. Gregory Hays (New York: Modern Library, 2003), 57. Marcus Aurelius (121-180 AD) was a Roman Emperor and philosopher, best known for his contributions to Stoic philosophy. His personal writings during his military campaigns, *Meditations*, were not intended for publication but served as a series of reflections on how to live virtuously, govern wisely, and remain calm amid adversity.

2 A carry trade is a trading strategy where investors borrow in a currency of a country where there are lower interest rates and purchase securities with higher yields in other currencies. As the Japanese Central Bank kept interest rates low compared to other countries for years, investors often borrowed in yen to buy higher yielding assets such as US Treasury bonds and S&P 500 stocks.

3 Marcus Aurelius, *Meditations*, trans. Gregory Hays (New York: Modern Library, 2003), 104.

a) Communicating our perspective with you in real-time on the situation and

b) That our door is always open for conversations when you have questions.

We employ a consistent framework to evaluate opportunities which keeps our decision-making grounded when markets become highly reactive. This quarter, we continued to lean on the fundamental frameworks that have guided us through previous periods of market stress, notably, how we deconstruct prospective returns into three components:

1. **Cash flow yield** – the cash an investment should return over the next year
2. **Growth in cash flows** – how cash flows should grow over our hold period
3. **Changes in valuation multiples** – how markets are likely to value future profits, with the assumption that valuation multiples should return toward historical norms

By applying this model, we can systematically assess the relative attractiveness of various investments, across asset classes and relative to one another within asset classes, even in times of market stress. This structure incorporates value and growth into the total return for an asset class so that we can rank relative attractiveness. As prices of securities decline (faster than expected future cash flows), those securities become more appealing as the yield on those cash flows increase, while the path to a normalization of a future valuation multiple becomes more compelling.

We believe in this approach because historically financial markets are cyclical. They are cyclical because they are based on the vacillation of human emotions between greed and fear. Periods of volatility and instability are inevitable, but they often present opportunities for those who remain focused on fundamentals. The unwinding of the Japanese Yen Carry Trade at the end of July led to heightened volatility across global markets. While these developments may seem alarming, history has taught us that such dislocations are temporary. As we referenced in our note during the carry trade unwind, financial writer Morgan Housel tweeted,

"*This is the biggest market decline since the last decline you don't remember or care about anymore.*"

-Morgan Housel[4]

Our focus is not on reacting to every market ripple but on navigating these waters with a well-defined framework.

The Markets: What Happened in Q3 2024

The third quarter was marked by heightened volatility, with significant dislocations across global equity markets. The unwinding of the Japanese Yen Carry Trade caused ripple effects for a short period, though attention quickly turned to Federal Reserve (Fed) interest rate policies as the rate of inflation continued to decline while employment softened. The Fed's September decision to not only reduce interest rates, but to do so with a larger than expected half a percent (50 basis points) reduction, while economic growth remained stronger than anticipated (2nd quarter GDP growth was revised higher to 3.0%)[5] , drove equity markets higher.

4 Morgan Housel, X, August 2, 2024.

5 Source: Bloomberg Finance, LP.

Over the quarter, the markets broadened with more companies outperforming the S&P 500 benchmark than in the first half of the year, a phenomenon from which our approach to diversification benefits. The Dow Jones, Russell 2000 Small Cap, and Developed Market indices outperformed the S&P 500, which has been increasingly dominated by a small group of large, technology-driven companies. We believe the stronger performance by a larger group of companies reflects optimism that the U.S. economy will avoid a recession, as more economically sensitive companies performed well.

This market broadening underscores why a long-term perspective remains crucial. Historically, markets recover and reward patient investors who can see beyond short-term fluctuations and market concentrations.

In the bond markets, the Fed's policy shift was the dominant story. After a long period of rate hikes aimed at taming inflation, the Fed has begun to lower rates as inflationary pressures have moderated. Historically, periods of Fed rate reductions — such as during the 2008 financial crisis or the 2000 dot-com bust — have presented opportunities in fixed income as yields adjust.

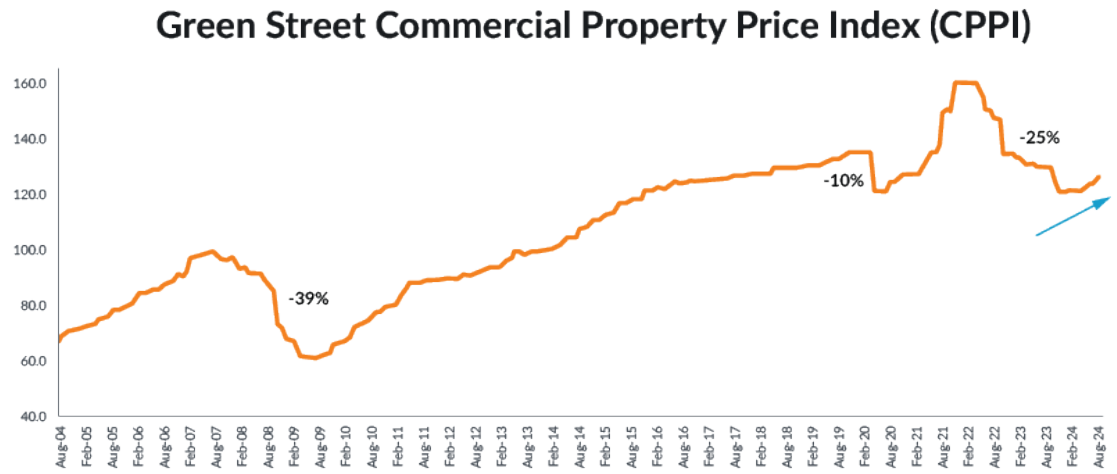
The policy shift resulted in the "de-inversion" or normalization of the yield curve inversion between the 2 Year U.S. Treasury and the 10 Year U.S. Treasury Notes. We have written previously that our portfolios were structured to anticipate this – we had built our fixed income exposure to benefit from declines in the short end (i.e. 2 Year Treasuries) with the sensitivity of longer maturity bonds through our position in the Simplify Short Term Treasury Futures Strategy (TUA). Further, as rates decline, the relative appeal of international bonds increases due to changes in the relative yield of bonds and the relative value of currencies, which benefitted our positioning in emerging market high yield debt.

From current economic data and recent Fed comments, we continue to expect the Fed to reduce interest rates toward more normalized levels. Over the next two years, we believe rates will normalize in the 3.25% and 4.25% range.

		Low	High	Notes / Reasons
	PCE	2.00%	3.00%	Assumption; Mean (3.2%), Median (2.7%) since 1960
+		0.50%	0.50%	PCE 50 bps below CPI historically (since 1960)
	CPI	**2.50%**	**3.50%**	Assumption; Mean (4.0%), Median (3.2%) since 1960
+		0.75%	0.75%	Assumed real interest rate; Mean (63 bps), Median (99 bps) since 1960 to CPI
=	**Fed Funds**	**3.25%**	**4.25%**	
+		0.25%	0.25%	Mean (18 bps), Median (31 bps) since 1976 to Fed Funds Rate
=	**2 Year**	3.50%	4.50%	
+		1.00%	1.00%	Mean (84 bps), Median (87 bps) since 1976
=	**10 Year**	**4.50%**	**5.50%**	

Source: Aprio Wealth Management estimates

Headlines surrounding the real estate market remain pessimistic, particularly in commercial real estate, where rising vacancies and fears of structural demand change in the office sector continue to dominate the narrative. However, as we've seen before, early signs of recovery are often overlooked in the noise of negative sentiment. This quarter, we've begun to observe green shoots in several commercial real estate sectors, including multifamily residential and industrial real estate sectors. According to Green Street Advisors, the real estate industry valuation specialists, commercial real estate prices may have already reached bottom. In many areas, demand fundamentals remain strong, excess supply will increasingly be absorbed, yet sentiment has not caught up.



Source: Versus Capital, Green Street Advisors

The parallels to 2009 are striking. In the wake of the global financial crisis, pessimism around real estate was widespread, yet those who recognized the signs of early recovery and acted decisively found themselves rewarded in the following years. While commercial real estate faces unique challenges, particularly in the office space segment, we are identifying regions and sectors within real estate that are beginning to stabilize. This recovery will likely be uneven, but the opportunities for selective, patient investors are growing. For example, several institutional real estate investors at a real estate conference we attended in September noted they can acquire properties at 30% below replacement value. Those valuations are more discounted than prior real estate declines, such as during the early 1990s, though not as significant as the Global Financial Crisis when banks were more negatively impacted.

In portfolios, we are overweight in the real estate sector after increasing our allocation over the summer.

THE ECONOMY

While growth in 2024 has exceeded expectations, we do anticipate a slowdown in the coming quarters. Inflation is cooling, and the labor market remains resilient, but the pace of growth is likely to decelerate as monetary policy, and global uncertainties take their toll. After second quarter GDP grew at a strong 3.0%, economists expect growth of 2.0% and 1.4% in the third and fourth quarters this year.[6] Concurrently, Core PCE (the Fed's preferred way to measure inflation) continues to march down, as the price of goods has declined four consecutive months.[7] However, barring any exogenous shocks, we believe it's more likely that the economy will avoid a recession over the next 6-to-12 months.

Historically, economic slowdowns do not always lead to recessions. The mid-1990s and 2016 are prime examples of how an economy can slow without tipping into contraction. We believe the current environment shares similar characteristics, and our expectation is that growth will slow, but not halt.

6 Bloomberg Finance, LP.

7 As measured through August 2024.

We believe the greatest risks to the economy lie in the consumer, which can be greatly impacted by the labor environment. The consumer experience is bifurcated – the lowest income segment is struggling after years of inflation compounding has stretched budgets; anecdotally we are hearing about more people holding down multiple jobs and looking to add hours. Middle- and upper-income consumers are still spending, though have become more value-oriented in their purchases. On Walmart's quarterly earnings call in August, Walmart's CFO noted that upper-income households accounted for most of the company's gains.[8]

Another risk we are monitoring is the 2024 U.S. presidential election. Historically markets have not favored one party; rather, markets have preferred that one party not end up in control of both the legislative and executive branches. In other words, markets prefer a split government, as any legislation that is passed into law will likely be more pragmatic and negotiated, as opposed to ideological. If it appears that the White House, Senate, and House will be led by the same party, we could experience volatility. Additionally, we believe there is a strong possibility that the election will not be determined on election night considering how tight the presidential race currently is and the growth of mail-in balloting and extended voting periods. Markets prefer certainty, and the longer the election is undecided, the less likely it will be that the market will rally. The positive is that markets often appreciate into year-end once elections have been decided, as clarity around policy priorities crystalizes.

The Markets – Where We Are Today

	STOCKS				BONDS		REAL ESTATE	
Return	Global Equities	US Market*	International Developed	Emerging Market	US Market	Global Market ex-US	US Real Estate	Global Real Estate
Q3 2024	6.7%	6.2%	7.4%	8.8%	5.2%	8.5%	17.4%	16.6%
2024	19.1%	20.6%	13.6%	17.1%	4.4%	2.8%	14.6%	13.1%
Last 5 Years	12.7%	15.3%	8.7%	6.1%	0.3%	(1.9)%	5.2%	3.5%
Last 10 Years	9.9%	12.7%	6.2%	4.2%	1.8%	(0.5)%		6.1%

Source: Bloomberg Finance, LP

**US Market reflects Russell 30000 Index*

The third quarter reflected the benefits of diversification. International stocks and bonds outperformed domestic, while publicly traded real estate outperformed equities and fixed income, reversing the performance of the first half of 2024. With the breadth of performance away from larger, tech-driven companies and toward smaller companies (Russell 2000), the equal-weighted version of the S&P 500 and the Dow Jones reflected the market's belief that the economy should lift more boats than the Magnificent 7 tech stocks. Year-to-date, the S&P 500 and Nasdaq have continued their strong performance, while domestic stocks, bonds, and real estate remain ahead.

8 Bloomberg Finance, LP.

SECTOR PERFORMANCE

Return	Q3 2024	2024
Information Technology	(1.1)%	26.8%
Healthcare	5.5%	13.8%
Consumer Discretionary	7.3%	13.3%
Communication Services	2.1%	29.3%
Financials	10.1%	21.2%
Industrials	11.5%	20.2%
Consumer Staples	8.7%	18.4%
Utilities	20.3%	31.7%
Real Estate	16.5%	13.6%
Energy	(0.1)%	10.8%
Materials	9.4%	13.8%

Source: Bloomberg Finance, LP

The underperformers from the first half of the year, notably utilities and real estate, outperformed in the third quarter. Both sectors are prime beneficiaries of lower interest rates. Further, utilities are considered a winner of AI infrastructure build-out due to the enormous power needs of AI data centers. Real estate's performance reflects what is seen as a potential trough in real estate valuation with assets available below replacement cost. The weakest performer, energy, was impacted by perceived weakness in GDP growth for China and Europe, two large markets for oil demand. In the quarter, the price of a barrel of West Texas Intermediate crude oil declined 16%.

BENCHMARK PERFORMANCE

Benchmark performance based upon risk tolerances for the quarter reflected the expected Fed rate cuts, as more conservative portfolios, which carry a higher weighting toward fixed income, slightly outperformed the higher equity-weighted portfolios. Year-to-date is a different story, where the more aggressive risk tolerances are significantly outperforming the more conservative options.

Benchmark Performance by Risk Tolerance

Return	Aggressive	Growth	Balanced	Conservative
Q3 2024	4.8%	4.9%	5.0%	5.1%
2024	15.8%	13.1%	10.6%	8.1%

Source: Bloomberg Finance, LP

See Disclosures section for benchmark details

Concerns that we are keeping our eye on include:

- Weakening consumer spending from the stresses of lower-income consumers growing to other consumer segments.
- The inflation rate decline stalls, resulting in central banks tempering interest rate reductions.
- Commercial real estate concerns spreading to the banking system.
- An unresolved presidential election which delays corporate and consumer spending.
- Geopolitical hotspots in the Middle East and Asia spreading.

CHANGES WE HAVE MADE TO THE PORTFOLIO

- With the pivot by the Fed, we increased the aggressiveness with healthcare by increasing exposure to Biotech (IBB) and reducing our position in the broader Healthcare ETF (VHT).
- We increased our exposure to U.S. real estate by purchasing the iShares Residential and Multisector Real Estate ETF (REZ) and sold the global Avantis Real Estate ETF (AVRE) to reflect the improvements that we are starting to see in U.S. real estate.

- For clients who want to increase exposure to emerging themes, we allocated to a portfolio of stocks focused on the theme of Riding the Post Pandemic Resurgence Wave. These are companies in two sectors – life sciences and real estate – where we saw a boom in the initial period during the pandemic, followed by a bust the last two years related to excess supply as companies over-extrapolated pandemic-related demand as stronger secular growth. We believe that these companies' financials have either troughed or are near a trough and will recover.

Investment Themes – Update

SUSTAINABILITY

Sustainability underperformed the broader market in the third quarter as the market broadened to reflect an economy expected to perform better due to declining inflation and a stronger job market. Year-to-date, the global and domestic sustainability indices are in-line with the broader market yet have outperformed the last two.

The Rise of Sustainability

	Quarter	2024	2 YR
S&P 500 Sustainability Index	5.4%	22.0%	30.0%
S&P 500	5.9%	22.1%	28.7%
Outperformance	*(0.5)%*	*(0.1)%*	*1.2%*
Global Sustainability Index	5.3%	19.2%	28.7%
MSCI All-Country World Index	6.7%	19.1%	26.7%
Outperformance	*(1.4)%*	*0.1%*	*2.0%*

Source: Bloomberg Finance, LP

FROM ANALOG TO DIGITAL

From Analog to Digital

	Quarter	2024	2 YR
Nasdaq	2.8%	21.8%	32.2%
Dow Jones Industrial Avg	8.7%	13.9%	23.9%
Outperformance	*(6.0)%*	*7.9%*	*8.3%*

Source: Bloomberg Finance, LP

The broadening of market performance created a large disparity in performance in our theme of ***From Analog to Digital*** as the Dow Jones Industrial Average outperformed the Nasdaq by nearly 600 basis points. However, year-to-date, the reverse is true – the Nasdaq is nearly 790 basis points higher, as large growth-oriented technology companies with global footprints, great cash flows, and strong balance sheets have led the market on the back of enthusiasm for AI.

EMERGING LIFE SCIENCES SUPERCYCLE AND HEALTHCARE TRANSFORMATION

Healthcare and Life Sciences slightly outperformed the S&P 500 in the quarter yet continues to trail for 2024. Unlike other sectors that had underperformed in the first half of the year, the defensive nature of many healthcare companies meant that they did not benefit from the perceived better-than-expected performance of the economy. While the last two years have been difficult for healthcare, we believe that the sector reflects the early boom and bust dynamics of the pandemic. As we look forward, we believe that the most challenging days are behind it, and that the sector reflects a good balance between greater than GDP growth rates that can be purchased at reasonable valuations.

Emerging Life Sciences & Healthcare Transformation

	Quarter	2024	2 YR
S&P 500 Healthcare Sector	6.1%	14.4%	14.7%
S&P 500	5.9%	22.1%	28.7%
Outperformance	*0.2%*	*(7.7)%*	*(14.0)%*

Source: Bloomberg Finance, LP

Fund Profile of the Quarter – iShares Residential and Multisector Real Estate (REZ)

For many portfolios, we added the iShares Residential and Multisector Real Estate ETF (REZ) in the quarter. We believe the multifamily real estate sector is primed for a strong rebound over the next two-to-four years. After the final supply of projects that were greenlit from 2021 to 2023 enters the market, we expect constrained future supply, a result of years of elevated

interest rates, alongside persistent demand from the severe shortage of affordable housing. As supply-demand imbalances widen, we anticipate growing rents and net operating income (NOI) to support robust long-term returns.

The iShares Residential and Multisector Real Estate ETF (REZ) offers targeted exposure to this thesis, with significant allocations to residential REITs, including multifamily, manufactured housing, and single-family rentals, which can be purchased 15% to 30% below replacement costs. This sector allocation is complemented by holdings in specialized segments like healthcare and self-storage REITs that offer additional defensive characteristics and growth potential. We see this as an opportunity for above-market returns compared to other sectors.

Summary

The third quarter's performance reflected:

- Staying steady during the period of volatility and the unwind of the Japanese Yen Carry Trade by using a disciplined approach to navigate short-term market swings.
- Remaining consistent with a structured investment strategy that deconstructs potential returns into cash flow, growth, and market value adjustments, allowing us to make sound decisions even in complex situations like recent market turbulence.
- The diversification of market performance in the quarter, as sectors beyond large tech companies performed strongly, highlighting the benefits of spreading investments across different industries and markets.
- Patience to realize the opportunities from interest rate changes as the Federal Reserve reduced interest rates, our positioning in bonds and real estate performed well.
- Real estate showing early signs of a potential recovery as we are seeing attractive opportunities in multifamily and industrial real estate with prices well below what it would cost to build new properties, offering potential for strong returns.
- Our structuring of portfolios to be prepared for slower economic growth and potential geopolitical risks, with a balanced approach that protects against downturns and takes advantage of emerging opportunities.

We continue to see great opportunities in our themes of ***The Rise of Sustainability, From Analog to Digital,*** and ***The Emerging Life Sciences and Healthcare Transformation.***

Please do not hesitate to contact us if you have specific questions.

Sincerely,

Simeon Wallis, CFA
Chief Investment Officer

Simeon Wallis, CFA, is the Chief Investment Officer of Aprio Wealth Management and the Director of Aprio Family Office. Each week, Simeon brings you insights from the financial markets in Aprio's Pulse on the Economy. To discuss these ideas and how they may affect your current investment strategy, schedule a consultation.

DISCLOSURES

The report includes assistance from generative artificial intelligence applications, including but not limited to ChatGPT, Google Gemini, Perplexity, Anthropic's Claude AI and Microsoft Co-Pilot.

For benchmarking purposes, Aprio uses allocation funds that we believe align with client levels of risk tolerance. These incorporate multiple asset classes, including occasional allocations to alternatives such as commodities, real estate and real assets. Specifically,

- For Aggressive risk profiles, we benchmark against BlackRock's Aggressive Target Allocation ETF – BIAPX
- For Growth risk profiles, we benchmark against BlackRock's Growth Target Allocation ETF – BIGPX
- For Balanced risk profiles, we benchmark against BlackRock's Balanced Target Allocation ETF – BIMPX
- For Conservative risk profiles, we benchmark against BlackRock's Conservative Target Allocation ETF – BICPX

Disclosures

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