Research Review

May
2024

OVERVIEW

Following a bumpy April in which many key sectors across the financial markets faced performance headwinds amid a backup in interest rates, May brought a reversal of fortune in the form of interest rate declines and a rebound in risk and high-quality assets. In the global equity markets, domestic equities outperformed international—particularly emerging markets. From a capitalization perspective, smaller cap domestic equities participated in the monthly risk rally and essentially matched the performance of large cap. Bond markets regained their footing as recent upward pressure on many inflation surprise indices moderated, leading to a nearly 20 basis point (bp) decline in the 10-year U.S. Treasury Note yield, which ended the month at 4.50%. High-yield spreads widened slightly but remained near the lower end of their cyclical and historical range. Like the stock and bond markets, most major real asset sectors saw positive returns in May, with real estate investment trusts (REITs) and global listed infrastructure posting mid-single digit returns, while commodity futures—i.e., Bloomberg Commodity Index— witnessed a third consecutive month of gains.

ECONOMIC UPDATE
U.S. Job Gains Surge in May as Unemployment Rate Hits Highest Level Since Early 2022

> " *The gradual declines across the household survey since early 2023 have helped to stop the cyclical improvement in the headline unemployment rate in its tracks.* "
>
> **– MIKE O'CONNOR, CFA**

The U.S. economy has displayed significant global leadership in the post-pandemic era, with the historically tight labor market garnering considerable attention. Since January 2021, the U.S. economy has generated an average monthly gain of nearly 400,000 jobs, the strength of which helped send the headline unemployment rate, also known as the U-3, to a cycle low of 3.4% in both January and April 2023.

The rebounding labor market became so out of balance that at one point in spring 2022, there were approximately two job openings for every unemployed individual—a ratio that historically is reversed. Accompanying the highly unbalanced labor market were mid-single-digit annual employee wage gains. While these gains generally failed to outpace the rise in the cost of living, they helped serve as a tailwind behind the multi-decade high inflation rates that immediately followed the brief business cycle contraction in early 2020.

Fast-forwarding to May 2024, many headline measures of the health and well-being of the labor market have appeared sound, although they have exhibited a cooling in recent months. In May, for example, the Bloomberg median sell-side consensus estimate implied a monthly gain of 180,000 in nonfarm payrolls; however, the actual reading smashed expectations with a print of 272,000 jobs, sending odds of a 2024 Federal Reserve (Fed) rate cut decidedly lower. While financial media headlines quickly highlighted the upside surprise on the payrolls front, several worrisome developments continued to build during the month.

First and foremost is a historically wide divergence between the establishment survey of employment—from which the monthly nonfarm payrolls data is derived—and the less widely followed household survey of employment, which impacts data such as labor force participation and demographic trends. While the establishment survey has appeared on a nearly straight-line uptrend since the pandemic, the household survey has essentially flatlined over the trailing year.

The gradual declines across the household survey since early 2023 have helped stop the cyclical improvement in the headline unemployment rate in its tracks. In fact, despite the 272,000 gain in payrolls in May, the unemployment rate actually rose 0.1 percentage points to 4%, the highest level since January 2022 and 0.6 ppts above the cycle low. This is due in part to a 250,000 shrinkage in the labor force and a broader 408,000 increase in the count of unemployed persons. The gradual deterioration in the unemployment rate over the trailing year pushed the reported rate above its 3-year moving average in May for the first time in the current economic expansion, a cyclical dynamic that historically has placed market participants on "recession watch."

**SPREAD BETWEEN HEADLINE UNEMPLOYMENT RATE AND THREE-YEAR MOVING AVERAGE**
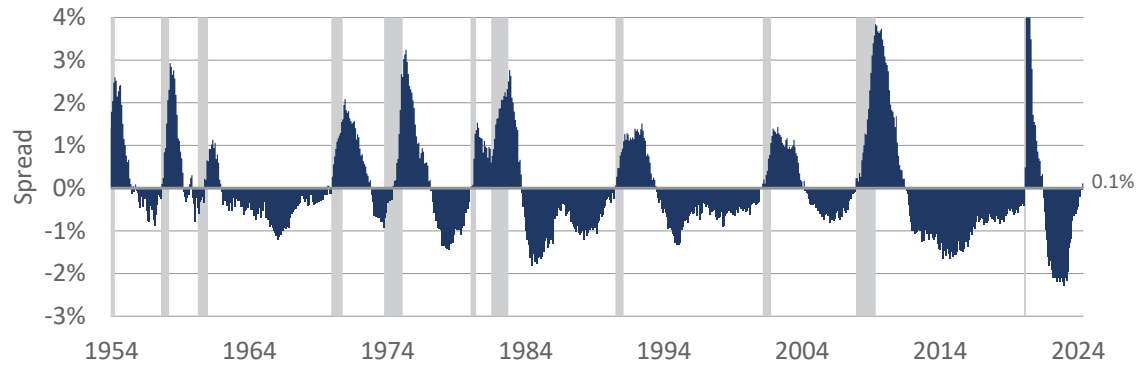
Data sources: BLS, NBER, Bloomberg, L.P.; Data as of May 2024

To conclude, financial markets rebounded in May as upside inflationary surprises moderated, interest rates declined, and the U.S. economy continued to display an expansionary bias. While labor market data for the month continues to appear sound, lurking underneath the surface is growing evidence of fundamental weakness that demands asset allocators' attention.

MARKET SUMMARY

MAY 2024
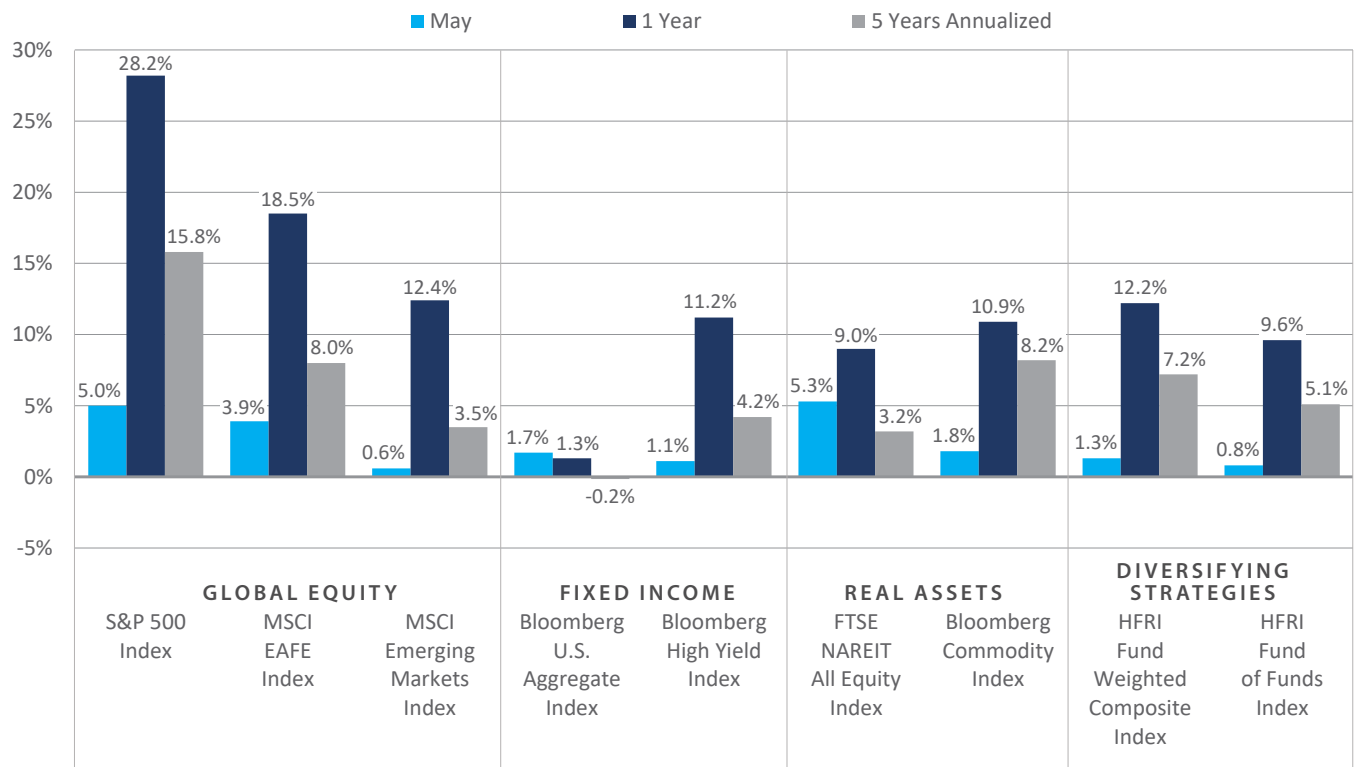
*Data source: Lipper, HedgeFund Research*

GLOBAL EQUITY

Equity markets rebounded in May after a brief decline in April. Continued demand for artificial intelligence (AI) drove returns as developed markets outperformed their emerging market counterparts. Slow but continuing disinflation in the U.S. and European Union gave investors confidence that the rate cuts expected later this year from major central banks may still happen, which did occur after the end of the month when the European Central Bank cut their rate 25 bps on June 6. This confidence provided a tailwind for small cap stocks, which had their best-performing month year-to-date.

U.S. large cap equities bounced back after experiencing negative absolute returns in April. Strong earnings results led the rally, specifically in the communication services and information technology sectors. Another contributor to performance was cooler inflation, as the April print marked the first time inflation did not exceed expectations this year. One of the biggest headlines during the month was the return of "meme stocks" GameStop (GME) and AMC Entertainment (AMC). The market presence of the Reddit user who led the short squeeze of these two names in 2021 caused prices and trading volumes to increase considerably during the month.

European equities ex-UK slightly underperformed their U.S. counterparts in May. Trends were similar to those in the U.S., apart from the underperformance of the consumer discretionary sector. Three of Europe's "Magnificent 7" stocks, Louis Vuitton, Hermes, and Ferrari, declined as the luxury goods sector corrected from recent expansion. The price corrections were mainly driven by a decline in consumer spending and a surplus of inventory.
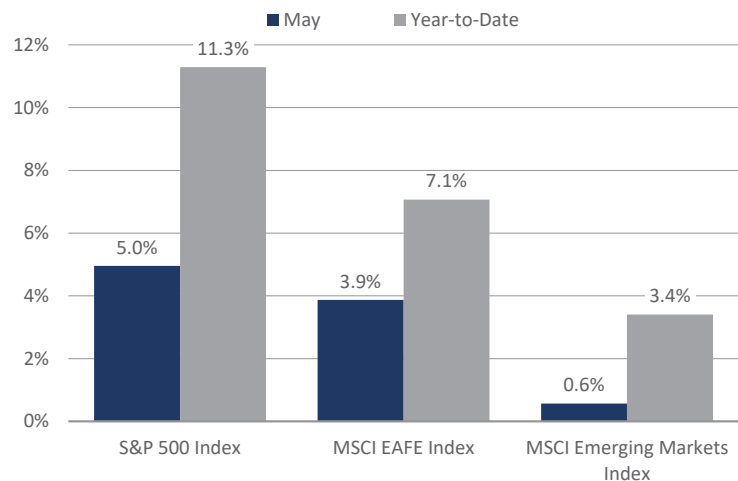
GROWTH CONTINUES TO OUTPACE VALUE
U.S. Style Returns
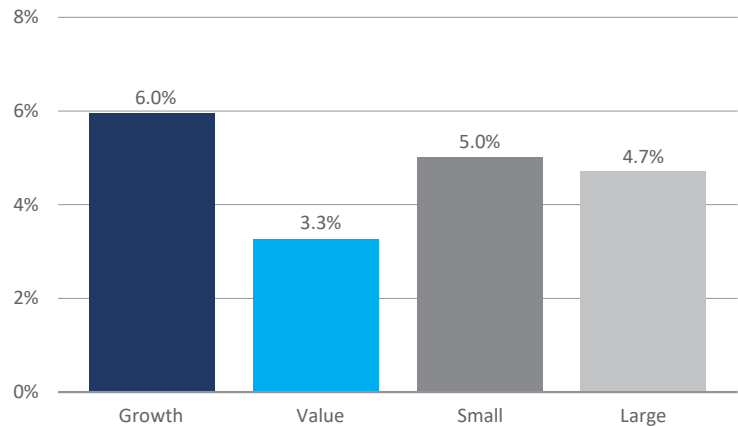
Data source: FTSE Russell

AI DEMAND CONTINUES TO DRIVE MARKET RETURNS
Equity Indices Performance Returns (U.S. Dollars)


Data sources: S&P, MSCI

Although they underperformed other developed markets, UK-based equities reached record highs after rebounding from a brief recession in the latter half of 2023. Defense stocks in the UK and broader Europe continue to outperform on the back of tensions in the Middle East and Eastern Europe. More holistically, UK equities are still trading at around a 50% discount when comparing UK valuation ratios to the U.S., even with the FTSE 100 Index establishing a new all-time high. These low valuations, combined with a recent recession breakout, have promoted increased deal flow in the UK, with bid activity for UK-listed companies reaching its highest level since 2018.

The Nikkei 225 Index remained relatively unchanged in May. A rise in long-term interest rates acted as a tailwind for the financials sector while the information technology sector underperformed. As net exporters, large cap Japanese companies are typically content with currency weakness; however, low yen levels have started to weigh on consumer sentiment. Consequently, Japanese companies have repurchased shares at a record pace, with 2024 share buybacks already totaling 67% of last year's total.

The MSCI Emerging Markets (EM) Index was also relatively unchanged, with mixed returns from different regions. The energy sector struggled amid weakened oil prices, negatively affecting countries such as the United Arab Emirates, Qatar, and Saudi Arabia. Eastern European countries contributed positively to overall performance due to idiosyncratic earnings results and currency strength. China outperformed despite real estate debt defaults and President Biden's tariff actions.

RELATIVE DISCOUNTS ACROSS THE POND
MSCI UK vs. MSCI USA Valuation Multipes
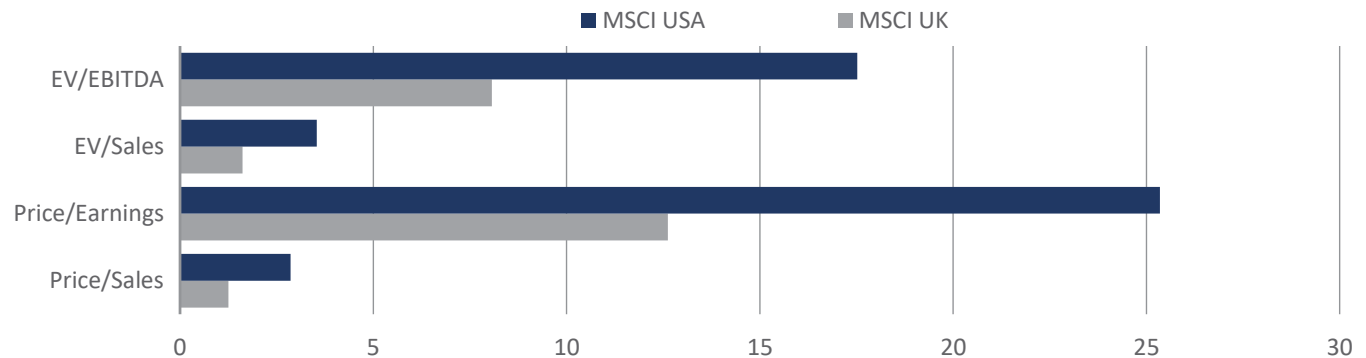
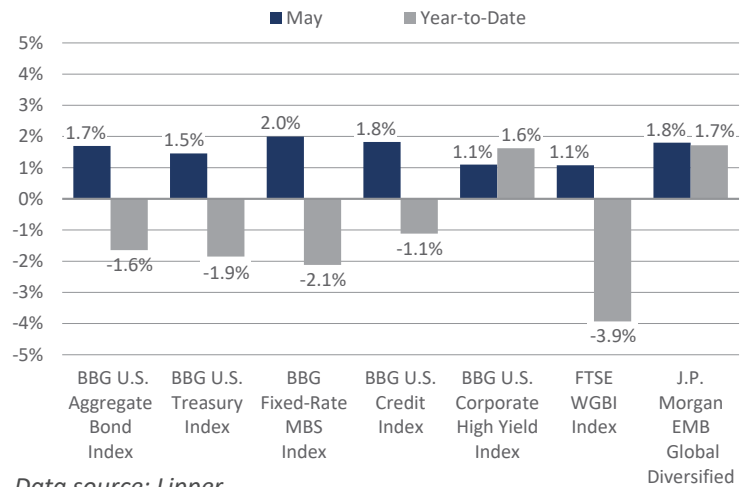

Data source: FactSet

FIXED INCOME

Rates fell in May, with the 10-year Treasury falling 18 bps to 4.51% and the 2-year Treasury falling 15 bps to 4.89%. The 10-year Treasury rallied to 4.36% mid-month, however, as the April Consumer Price Index (CPI) rose 0.3%, slightly below expectations of 0.4%. This eased inflation fears following multiple hotter prints earlier this year. Additionally, employment data pointed to a potential gradual softening of the labor market.

In Japan, the 10-year Japanese government bond rose nearly 20 bps in May to reach 1.06%, surpassing 1% for the first time since April 2012 as the Bank of Japan (BOJ) continued to roll back its easy monetary policy. Additionally, Japan's Ministry of Finance intervened in currency markets to protect the yen, which has continued to weaken and briefly touched ¥160 against the U.S. dollar—a level unseen since 1990—prior to the intervention. This move put pressure on the BOJ to continue raising interest rates.

Treasury auctions returned to the limelight in the last week of May following multiple auctions—2-year, 5-year, and 7-year—which "tailed," where the clearing yield, or the yield required to sell all the treasuries, was higher than the market yield before the auction. This caused a brief surge in Treasury yields. However, despite continued supply concerns, the bid-to-cover ratio, or the amount of Treasuries bid on divided by the amount brought to market, remained near historical averages at around 2.4. The Treasury's choice of funding, whether continuing to issue with a preference for short-term bills or shift back toward typical levels of longer-dated coupon bonds, will be closely monitored by market watchers.
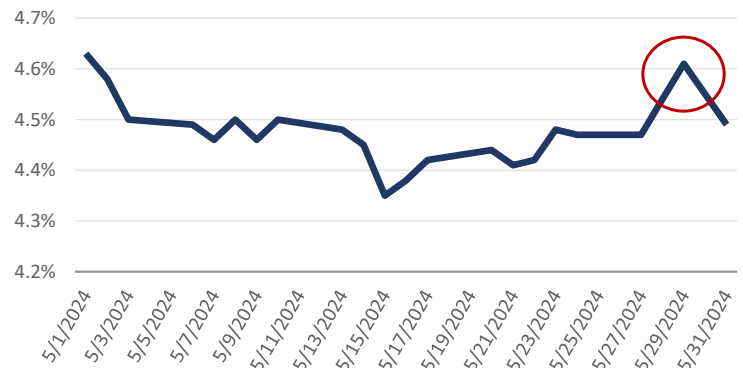
PERFORMANCE LED BY FIXED RATE MBS
Fixed Income Index Returns

Data source: Lipper

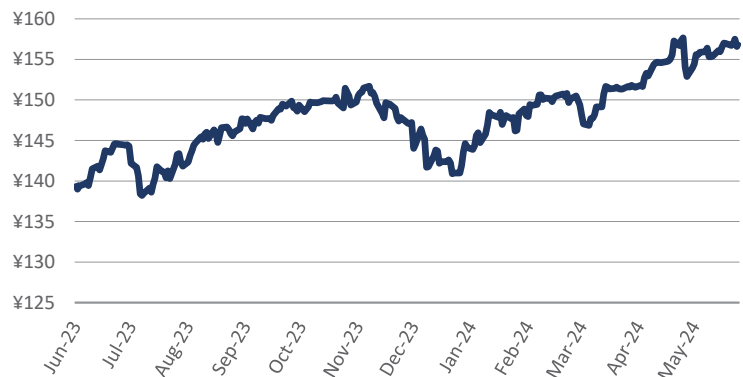**VOLATILITY SPIKED IN MAY FOLLOWING TAILED AUCTIONS**
U.S. 10-year Treasury Yield

Data source: FactSet

YEN REACHED HIGHEST LEVEL SINCE 1990
USD/JPY Exchange Rate

Data source: Federal Reserve Bank of St. Louis (FRED)

REAL ASSETS

REAL ESTATE

U.S. REITs rebounded in May but fell short of a full recovery from the sharp decline in April. Higher interest rates continue to pressure REITs, but fundamentals have remained strong across several sectors, particularly data centers, telecommunications, and shopping centers. In May, data center REITs led performance as they continued to benefit from the artificial intelligence theme due to increased demand for hyperscale facilities from large technology companies.
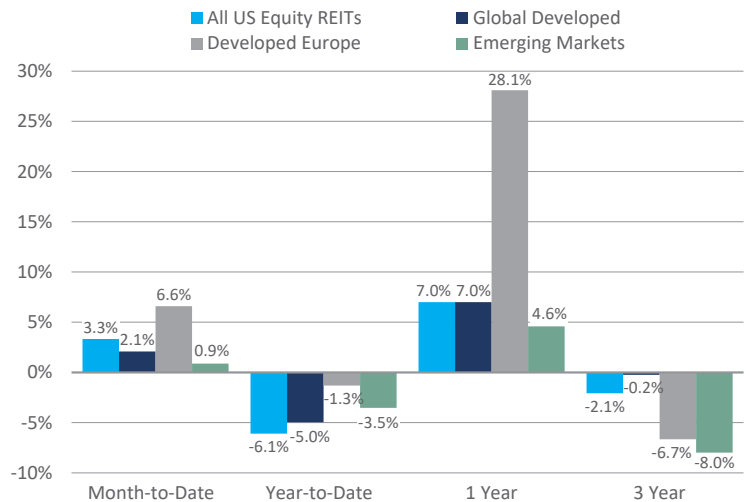
Developed Europe REITs outperformed the U.S. for a second month ahead of anticipated interest rate cuts by the European Central Bank (ECB). On June 6, the ECB cut rates from 4.00% to 3.75%, which many expect to provide a more supportive environment for European real estate.

EUROPEAN REITS OUTPACE U.S. AHEAD OF ECB RATE CUTS
Trailing REIT Performance by Geography

Data source: FactSet

NATURAL RESOURCES

As measured by the West Texas Intermediate (WTI) spot contract, crude oil prices declined 6% in May. Several factors contributed to the bearish sentiment, including a buildup in global inventories, economic growth concerns, and increased oil exports from Russia. Russia's export increase came as a surprise as OPEC+ announced on June 2 that production cuts would be extended into the second quarter of 2024, potentially phasing out of reductions in the fourth quarter of the year. Conversely, the Henry Hub natural gas spot contract rose nearly 30% during the same period. Anticipations of warmer summer weather drove this increase, although inventories remained above the long-term average.

NATURAL GAS FINDS THE BOTTOM
Price of West Texas Intermediate (WTI) Crude and U.S. Natural Gas
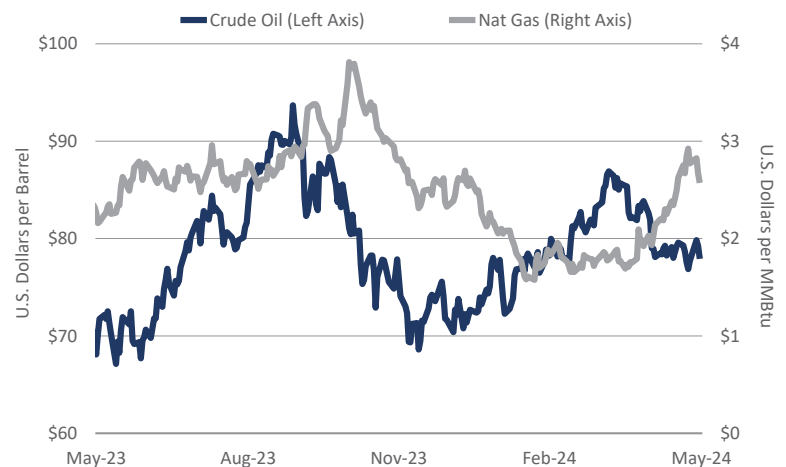
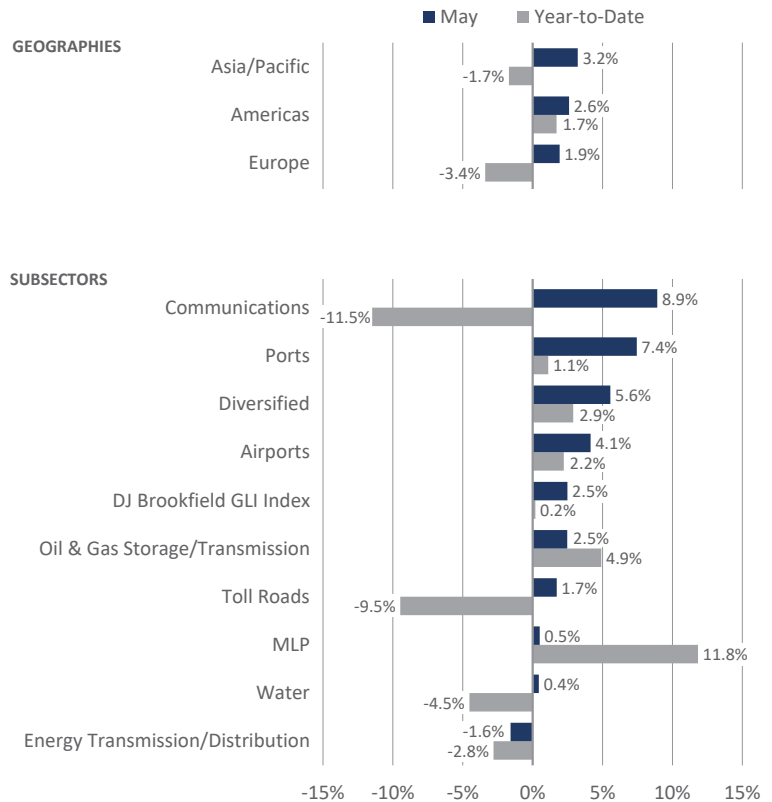*Data source: FactSet; Data as of March 4, 2024*

INFRASTRUCTURE

Global listed infrastructure stocks rose in May, as measured by the Dow Jones Brookfield Global Infrastructure Index. The communications subsector, composed of data centers and cell towers, was the top performer during the month. Data centers contributed to the strong performance, but cell towers rebounded significantly after continued pressure from higher interest rates.

Midstream energy infrastructure was relatively flat in May but has still posted double-digit gains in 2024, as measured by the DJ Brookfield Global Infrastructure MLP Index. Midstream energy continues to offer an attractive and competitive yield supported by improved industry fundamentals, and midstream master limited partnerships continue to grow dividends and execute share buybacks.

COMMUNICATION INFRASTRUCTURE LEADS IN MAY
Listed Infrastructure Trailing Returns

■ May ■ Year-to-Date

GEOGRAPHIES

Geography	May	Year-to-Date
Asia/Pacific	3.2%	-1.7%
Americas	2.6%	1.7%
Europe	1.9%	-3.4%

SUBSECTORS

Subsector	May	Year-to-Date
Communications	8.9%	-11.5%
Ports	7.4%	1.1%
Diversified	5.6%	2.9%
Airports	4.1%	2.2%
DJ Brookfield GLI Index	2.5%	0.2%
Oil & Gas Storage/Transmission	2.5%	4.9%
Toll Roads	1.7%	-9.5%
MLP	0.5%	11.8%
Water	0.4%	-4.5%
Energy Transmission/Distribution	-1.6%	-2.8%

Data source: FactSet
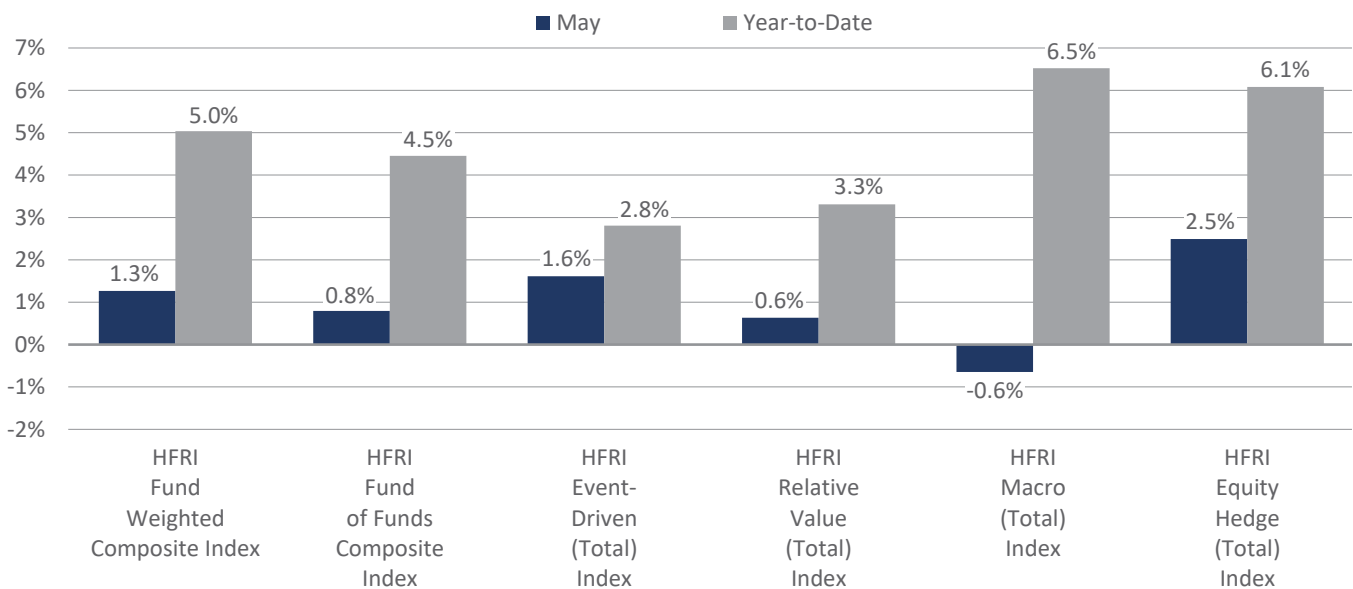
DIVERSIFYING STRATEGIES

Most hedge fund strategies performed well during the month, led by hedged equity and event-driven managers. It was a strong month for equity-oriented strategies, providing a solid tailwind to long/short equity and event-oriented allocations.

Hedged equity was strongest in the technology, healthcare, and quantitative directional sectors. Under the event-driven umbrella, gains were focused on distressed/restructuring, credit arbitrage, and merger arbitrage.

Systematic trend-following managers witnessed a reversal of fortunes in May. After four months of gains, the strategy experienced losses across currencies, energy, and bonds. In particular, currency losses were concentrated in long U.S. dollar allocations relative to the Euro and Australian dollar. Short exposure to U.S. Treasuries was another detractor for the strategy. Finally, losses stemmed from long crude oil and distillate positions in energy.

HEDGE FUNDS LED BY HEDGED EQUITY AND EVENT-DRIVEN

HFRI Indices Performance Returns (U.S. Dollars)

Legend: ■ May   ■ Year-to-Date

Index	May	Year-to-Date
HFRI Fund Weighted Composite Index	1.3%	5.0%
HFRI Fund of Funds Composite Index	0.8%	4.5%
HFRI Event-Driven (Total) Index	1.6%	2.8%
HFRI Relative Value (Total) Index	0.6%	3.3%
HFRI Macro (Total) Index	-0.6%	6.5%
HFRI Equity Hedge (Total) Index	2.5%	6.1%

Data source: HedgeFund Research

INDICES

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class.

Bloomberg Fixed Income Indices is an index family comprised of the Bloomberg US Aggregate Index, Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, Municipal Index, High-Yield Index, Commodity Index and others designed to represent the broad fixed income markets and sectors. On August 24, 2016, Bloomberg acquired these long-standing assets from Barclays Bank PLC. and on August 24, 2021, they were rebranded as the Bloomberg Fixed Income Indices. See https://www.bloomberg.com/markets/rates-bonds/bloomberg-fixed-income-indices for more information..

The CBOE Volatility Index (VIX) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time S&P 500 Index option bid/ask quotes. The Index uses nearby and second nearby options with at least eight days left to expiration and then weights them to yield a constant, 30-day measure of the expected volatility of the S&P 500 Index.

FTSE Real Estate Indices (NAREIT Index and EPRA/NAREIT Index) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded real estate securities. Relevant real estate activities are defined as the ownership, disposure, and development of income-producing real estate. See https://www.ftserussell.com/index/category/real-estate for more information.

HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc. (HFX), and are used by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2,000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund- of- funds which report to HFR. See https://www.hfr.com/ for more information on index construction.

J.P. Morgan's Global Index Research group produces proprietary index products that track emerging markets, government debt, and corporate debt asset classes. Some of these indices include the JPMorgan Emerging Market Bond Plus Index, JPMorgan Emerging Market Local Plus Index, JPMorgan Global Bond Non-U.S. Index and JPMorgan Global Bond Non-U.S. Index. See www.jpmorgan.com for more information.

Merrill Lynch high yield indices measure the performance of securities that pay interest in cash and have a credit rating of below investment grade. Merrill Lynch uses a composite of Fitch Ratings, Moody's and Standard and Poor's credit ratings in selecting bonds for these indices. These ratings measure the risk that the bond issuer will fail to pay interest or to repay principal in full. See www.ml.com for more information.

Morgan Stanley Capital International – MSCI is a series of indices constructed by Morgan Stanley to help institutional investors benchmark their returns. There are a wide range of indices created by Morgan Stanley covering a multitude of developed and emerging economies and economic sectors. See www.morganstanley.com for more information.

The FTSE Nareit All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs.

Russell Investments rank U.S. common stocks from largest to smallest market capitalization at each annual reconstitution period (May 31). The primary Russell Indices are defined as follows: 1) the top 3,000 stocks become the Russell 3000 Index, 2) the largest 1,000 stocks become the Russell 1000 Index, 3) the smallest 800 stocks in the Russell 1000 Index become the Russell Midcap index, 4) the next 2,000 stocks become the Russell 2000 Index, 5) the smallest 1,000 in the Russell 2000 Index plus the next smallest 1,000 comprise the Russell Microcap Index, and 6) U.S. Equity REITs comprise the FTSE Nareit All Equity REIT Index. See www.russell.com for more information.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation, among other factors by the S&P Index Committee, which is a team of analysts and economists at Standard and Poor's. The S&P 500 is a market-value weighted index, which means each stock's weight in the index is proportionate to its market value and is designed to be a leading indicator of U.S. equities, and meant to reflect the risk/return characteristics of the large cap universe. See https://www.spglobal.com/spdji/en/indices/equity/sp-500/ for more information.

Information on any indices mentioned can be obtained either through your advisor or by written request to information@feg.com.

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201 East Fifth Street
Suite 1600
Cincinnati, Ohio 45202

513.977.4400

information@feg.com

www.feg.com

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