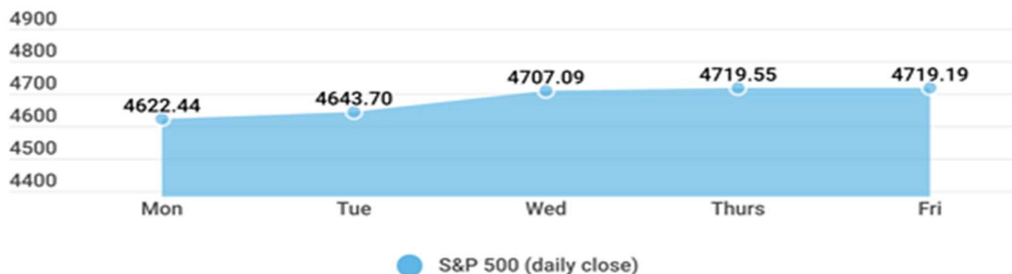
Amadeus Wealth Alternatives

WEEKLY ECONOMIC UPDATE DEC. 18, 2023

Markets reacted positively last week to cooler inflation and the idea of potential rate cuts next year, adding to the gains of the market's year-end rally.

The Dow Jones Industrial Average rose 2.92%, while the Standard & Poor's 500 gained 2.50%. The Nasdaq Composite index picked up 2.85% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, tacked on 2.75%.[1,2,3]

Market Index	Close	Week	Y-T-D
DJIA	37,305.16	+2.92%	+12.54%
NASDAQ	14,813.92	+2.85%	+41.54%
MSCI-EAFE	2,197.33	+2.75%	+13.04%
S&P 500	4,719.19	+2.50%	+22.91%



	Treasury	Close	Week	Y-T-D
	10-Year Note	3.91%	-0.32%	+0.03%

Sources: The Wall Street Journal, December 15, 2023; Treasury.gov, December 15, 2023
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, December 8, to Friday, December 15 close. Weekly performance for the MSCI-EAFE is measured from Friday, December 8 open to Thursday, December 14 close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

Rally Continues

Stocks gathered momentum last week after upbeat news from two key inflation reports. But the outcome of the Federal Open Market Committee (FOMC) meeting on Wednesday powered the week's advance. The combination of the FOMC signaling three rate cuts in 2024 and dovish comments by Fed Chair Powell led to a sharp drop in bond yields and a spike in stock prices, with the Dow Industrials closing above 37,000 and setting an all-time high.[4]

The rally continued the following day as beneficiaries of lower rates, such as smaller capitalization stocks and real estate, rallied. A solid retail sales number, which reflected a strong consumer and supported the soft landing thesis, also boosted enthusiasm.

Inflation Eases

The anxiously awaited read on November inflation came close to market expectations, with a 0.1% increase over October and a year-over-year increase of 3.1%. Core inflation, which excludes energy and food prices, came in a bit hotter, rising 0.3% month-over-month and 4.0% from a year ago. A 2.3% decline in energy costs helped offset a 2.9% jump in food prices. Shelter prices remained stubbornly high, rising 0.4% from October and 6.5% from last November.[5]

The inflation news was better on wholesale prices, tracked by the Producer Price Index (PPI). Producer prices were unchanged in November and higher by just 0.9% year-over-year. Excluding energy and food, the monthly increase was also unchanged.[6]

This Week: Key Economic Data

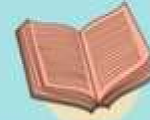
Tuesday: Housing Starts.

Wednesday: Consumer Confidence. Existing Home Sales.

Thursday: Gross Domestic Product (GDP). Jobless Claims. Index of Leading Economic Indicators.

Friday: Durable Goods Orders. Personal Income and Outlays. New Home Sales. Consumer Sentiment.

Quote of the Week



"The U.S. authorities in particular, and the American people more generally, benefited from the U.S. dollar's global reserve currency status just as a counterfeiter benefits from having a printing press."

– Robert P. Murphy

Of Note

As banks pull back from many types of lending, demand for capital is outpacing supply, providing the best potential opportunities in private credit since the GFC.

Fallout from the most rapid rise in interest rates in four decades may be creating the best environment for private credit investors since the global financial crisis (GFC).

Banks are retreating in the face of liquidity constraints, regulatory scrutiny, and higher cost structures. Sharply higher interest rates have raised borrowing costs, removing excess liquidity across the economy and prompting more depositors to move savings into higher-interest accounts. Additionally, the first major reform in bank regulation in over a decade – if passed – would take effect next year and increase capital requirements at a time when bank capital is already at a premium.

As bank retrenchment creates a void in lending markets, private capital has been able to step in, providing a stable and longer-term source of funding to banks while also aiding banks in reducing the overall size of their balance sheet.

Amid these shifting dynamics, it is crucial to make two important

distinctions when assessing the private market opportunity set.

First, we must distinguish between the existing stock of credit and future credit origination. The current interest rate environment will likely put pressure on much of the existing stock of credit – particularly corporate and commercial real estate-related credit that was originated in an environment of abundant supply and low interest rates. Yet bank retrenchment has reduced competition in many markets, creating new origination opportunities and a stronger position for the remaining lenders.

Second, we must differentiate between technical pressures on banks facing liquidity challenges, and fundamental pressures affecting the assets themselves. Consumer balance sheets have proven remarkably resilient, having locked in historically low fixed mortgage rates, and many companies have refinanced higher-interest-rate bonds by issuing low-coupon, long-term, fixed-rate bonds. Thus, while banks face liquidity pressure in a variety of asset-based finance areas backed by both consumer and non-consumer collateral, the fundamentals of the assets themselves are actually quite solid.

Real estate markets also face unique challenges: $3.6 trillion of commercial real estate (CRE) loans are maturing in the U.S. and Europe through 2025, many of which may not qualify for extensions. Compounding the issue of bank retrenchment has been similar declines by other lenders typically relied upon for financing, such as publicly listed mortgage REITs and CMBS issuers, which face their own fair share of challenges. As a result, the opportunity set in real estate-related credit will likely remain outsized relative to real estate equity over the investing cycle.

As demand for capital outpaces supply, investors stand to benefit from the combination of liquidity-driven opportunities in private credit, as well as more complex transactions that solve capital structure challenges for corporate and real estate borrowers. Critical to this is a broad definition of the opportunity set in private credit, which looks across specialty finance, real estate and corporate credit. Patience is also key, because many of these opportunities will arise over the coming months and years as asset owners face uncertain monetary policy, potential slowing growth, and elevated geopolitical tensions.

Specialty finance – collateral-based loans to consumers and small and midsize businesses – gained critical mass after the GFC, filling the liquidity gap left as banks retrenched across sectors, especially in residential mortgages. Many specialty lenders, however, rely on short-term, low-cost bank lines of credit (known as warehouses) to fund the loans they originate and on functioning securitization markets to sell into. Amid recent liquidity pressures, regional banks have cut warehouse lines of credit, while securitization markets have been muted – underscoring

specialty lenders' need for diversified sources of stable capital.

There are opportunities for private credit investors to provide capital in three ways: to banks – which are still originating loans, though on a far smaller scale; to non–bank lenders; and directly to borrowers. High conviction sectors are residential mortgage credit, short term construction, solar and home improvement lending, equipment finance, and aircraft leasing. Pricing has become more attractive as available bank capital shrinks and demand for specialty lending rises – the beginning of what we believe will be a secular trend.

The sector represents an exciting opportunity, with potentially higher risk-adjusted returns than other private asset classes, such as private corporate lending and equities. Amid today's uncertain inflation and interest rate trajectories, the shorter-duration of the assets may lessen volatility, with principal paying down over time rather than in a bullet payment at maturity. In addition, the wide variety of loans and borrower types offers potentially deep diversification, historically generating low investment return correlations to markets, the economy, and one another.

The commercial real estate market is the most severely dislocated it has been since the GFC, yet fundamentals outside of the office sector have largely held up thus far, particularly in multi-family. To be sure, the current dislocation derives from the capital markets. Rising interest rates have compressed valuations, induced ongoing financial market volatility, and curtailed liquidity in public and private debt and equity. Private credit opportunities are emerging, spanning performing to nonperforming credit in both public and private debt. Importantly, the current dynamics are providing lenders an opportunity to originate and acquire loans secured by higher-quality collateral, with stricter loan covenants, at lower loan-to-value ratios with a higher all-in return potential.

Within performing credit, there's been a surge in transitional lending, or loans on projects in lease-up, redevelopment, and construction. Transitional loans currently generate high single-digit to low-teens returns with modest and in some cases no leverage. Banks are also selling performing loans at attractive discounts to manage liquidity and capital ratios and get ahead of future potential problems.

There has also been a growing need for rescue capital both at the asset and holding company level. This is creating attractive opportunities to provide bridge capital in the form of preferred equity and mezzanine debt.

The next few years could be great vintages across the private opportunity set for a wide range of investor objectives. With demand for capital outstripping supply, investors may not need to take large risks to generate compelling returns.[7]

Footnotes and Sources

1. The Wall Street Journal, December 15, 2023
2. The Wall Street Journal, December 15, 2023
3. The Wall Street Journal, December 15, 2023
4. CNBC, December 13, 2023
5. CNBC, December 12, 2023
6. CNBC, December 13, 2023
7. advisorperspectives.com/commentaries/2023/11/28/opportunities-private-credit-stepping-banks-step-out?topic=alternative-investments

Investing involves risks, and investment decisions should be based on your own goals, time horizon, and tolerance for risk. The return and principal value of investments will fluctuate as market conditions change. When sold, investments may be worth more or less than their original cost.

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The market indexes discussed are unmanaged, and generally, considered representative of their respective markets. Index performance is not indicative of the past performance of a particular investment. Indexes do not incur management fees, costs, and expenses. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results.

The Dow Jones Industrial Average is an unmanaged index that is generally considered representative of large-capitalization companies on the U.S. stock market. Nasdaq Composite is an index of the common stocks and similar securities listed on the NASDAQ stock market and is considered a broad indicator of the performance of technology and growth companies. The MSCI EAFE Index was created by Morgan Stanley Capital International (MSCI) and serves as a benchmark of the performance of major international equity markets, as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia. The S&P 500 Composite Index is an unmanaged group of securities that are considered to be representative of the stock market in general.

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