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# 2024 1st Quarter Outlook

# Outlook

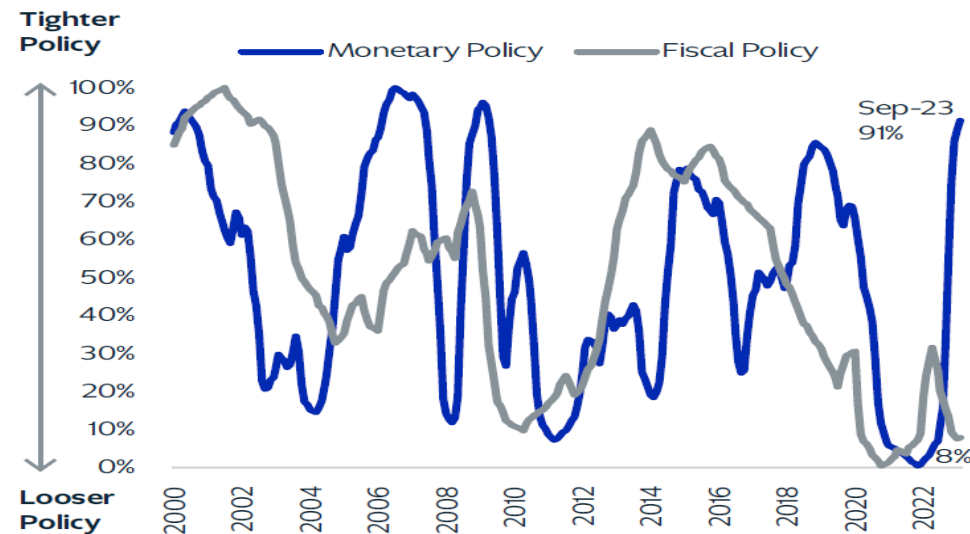
As 2023 wrapped up, we once again experienced how a dynamic economy with significant influence from monetary and fiscal policy can be difficult to model accurately. Most wall street strategists predicted a much weaker economy and muted stock market gains. We ended the year with GDP likely growing over 2.5% and the S&P 500 back near its all-time high. As we have written previously, the introduction of Quantitative Easing / Tightening along with near pandemic levels of fiscal deficits has made it more difficult to forecast based on traditional tools and measurements. While monetary policy has been tightened significantly, fiscal policy (Government spending) has been extremely loose. We continue to run deficits of 6%-7% of GDP, while the economy is growing at 2.5% and unemployment is below 4%. This level of deficit spending is not typical and is more in line with what we have seen during the pandemic and post-WWII. The increase in nominal GDP is in line with the deficit, both around 6%. While Government spending was higher, a significant amount flows through to consumer spending by way of transfer payments (unemployment, Covid-related tax credits, etc.). The case can be made that strong spending by the consumer has been held up by loose fiscal policy and increased consumer credit.

The consensus, which is currently priced into the market, is for the Fed to start cutting rates in March or May and for a soft landing. While we don't put a lot of faith in forecasts, we do want to understand what the market is pricing in. Whether the consensus plays out or we experience a normal recession, we are likely to see interest rates go down. For equities to go significantly higher we would need to see rates come down prior to an economic slowdown. If the Fed is behind the curve (they usually are) we could see the concentrated S&P 500 underperform other markets. We see private equity as a compelling space when compared to public market multiples, along with opportunities in private credit. We say it often, but this year seems to be setting up to likely be volatile. In a volatile and uncertain market, being more diversified can help mitigate risk.

# Monetary and Fiscal Policy

- While Monetary Policy is running historically tight, Fiscal Policy is running historically loose.
- Deficits continue to run over 6% of GDP and has contributed to short term gains in growth.
- If interest rates stay higher for longer, the cost of servicing the debt will start to limit potential growth.

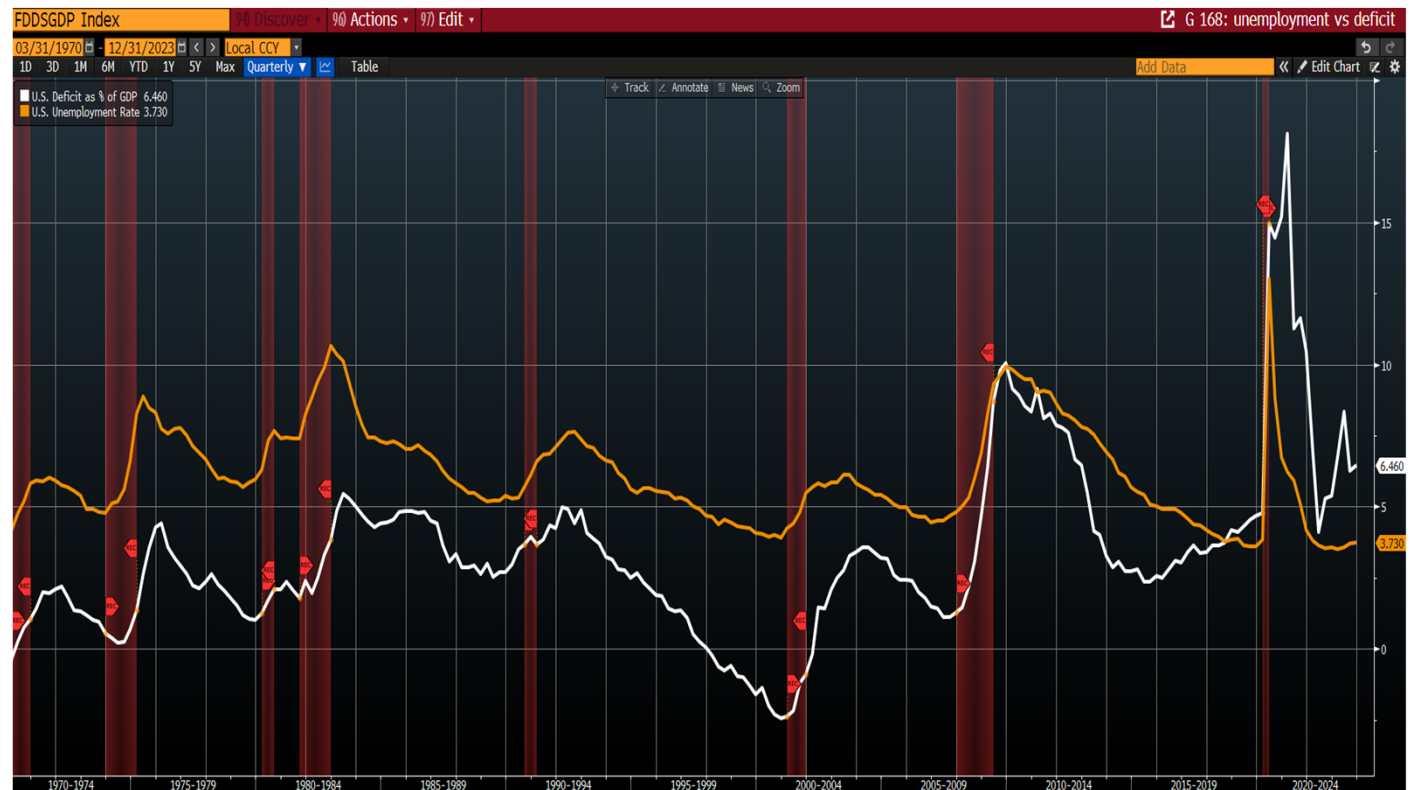
**Fiscal and Monetary Policy as %ile of Historical Range**



Monetary tightness measures the difference between real fed funds and potential GDP growth. Fiscal tightness measures the difference between the budget deficit and U.S. output gap as a % of GDP. Data as at September 30, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

# Fiscal Policy

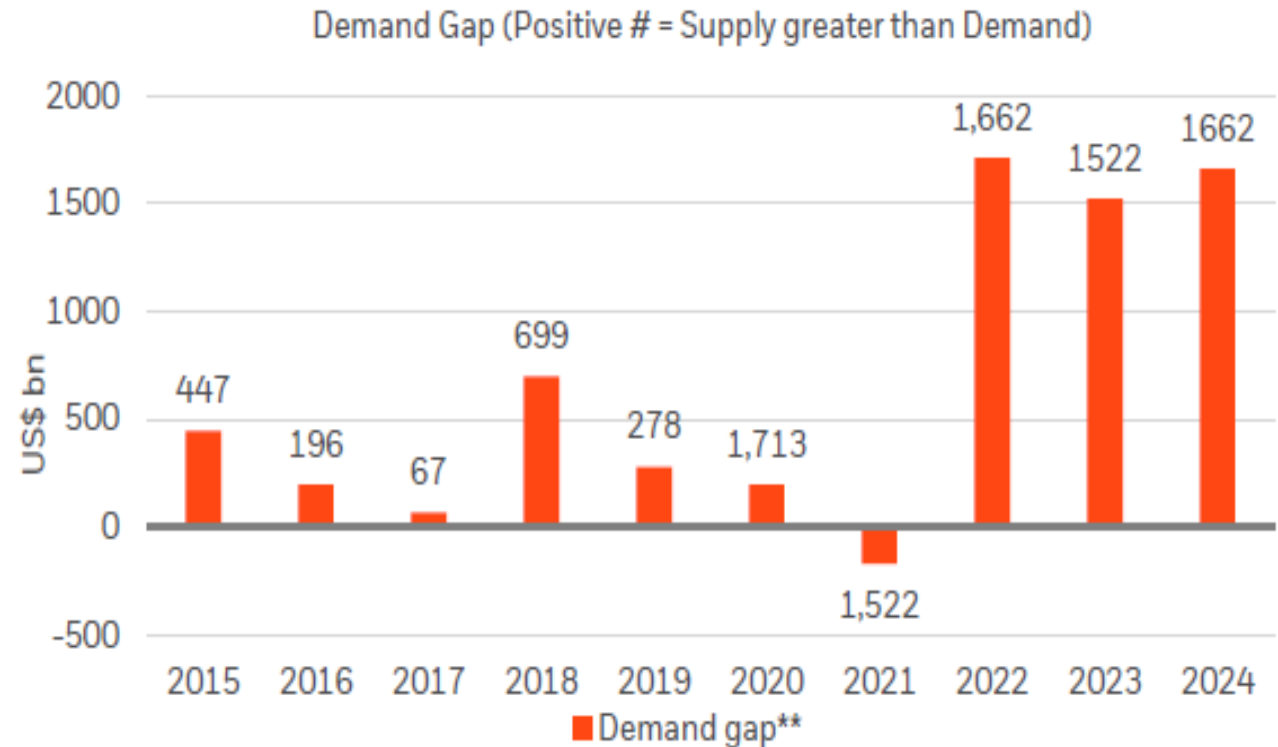
- Rarely have we seen the U.S. run this high of a deficit (white line) while unemployment (orange line) is so low.
- Running deficits usually line up with a recession and rising unemployment.
- A boost by fiscal policy helps to offset the decline in growth in the economy, providing a countercyclical hedge.
- We are currently seeing fiscal policy as pro-cyclical helping to fuel continued growth. In the next recession, we are likely to see fiscal policy underperform as a hedge.



Source: Bloomberg

# U.S. Treasury Demand

- The U.S. will continue to issue debt to fund large deficits.
- Recently most issues have been short term, but we will likely see more longer-term issuance (5-10 years).
- There is a supply-demand imbalance due to less demand from traditional buyers (China, Japan, Banks).
- Households would be likely buyers, but rates would need to be higher, or short-term rates need to come down to make them want to buy longer maturities.



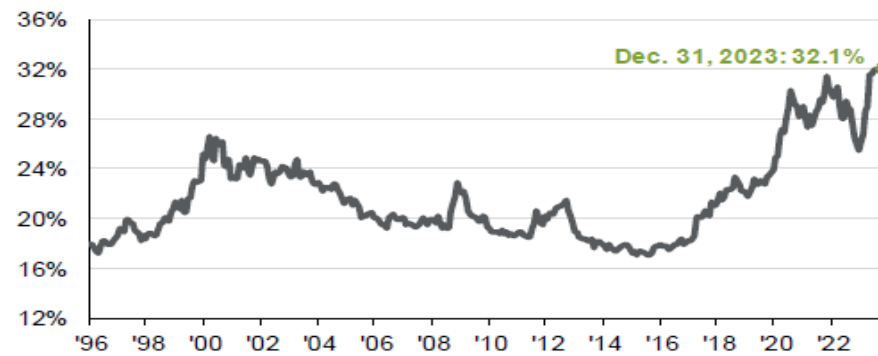
Source: Blackrock

# Equity

- The weighting of the top 10 stocks in the S&P 500 remains at a record high, surpassing the peak during the Tech Bubble.
- The earnings contribution of the top 10 is lower than the weighting, but not quite as a mismatch as 2000.
- We continue to be cautious around the concentration risk embedded in the S&P 500 by diversifying across market cap and geography.

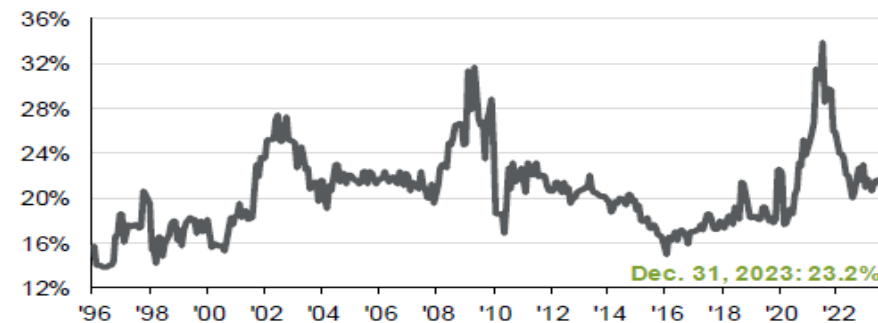
## Weight of the top 10 stocks in the S&P 500

% of market capitalization of the S&P 500



## Earnings contribution of the top 10 in the S&P 500

Based on last 12 months' earnings

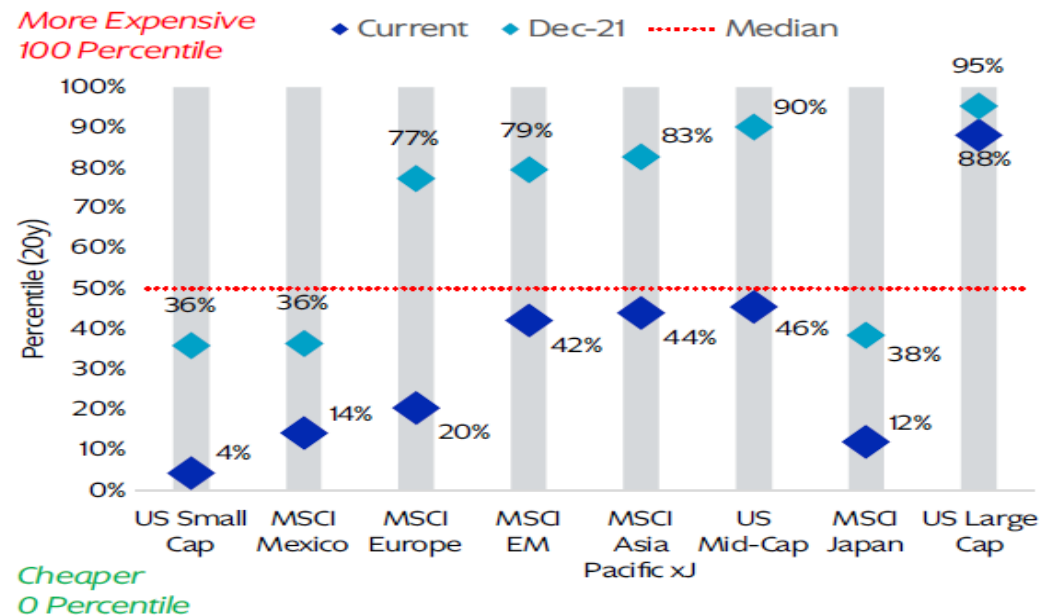


Source: JP Morgan

# Equity

- U.S. Large Cap stocks continue to trade rich compared to other markets.
- U.S. Small Cap stocks are currently as cheap as they have been during the last 20 years.
- While U.S. Large Cap stocks are rich, it continues to hold companies with the most innovation and growth compared to other global markets.
- We continue to see opportunities for active management within Small Cap and International markets.

## Cross-Asset Valuation Percentiles, Relative to 20-Years Average, %



Source: KKR

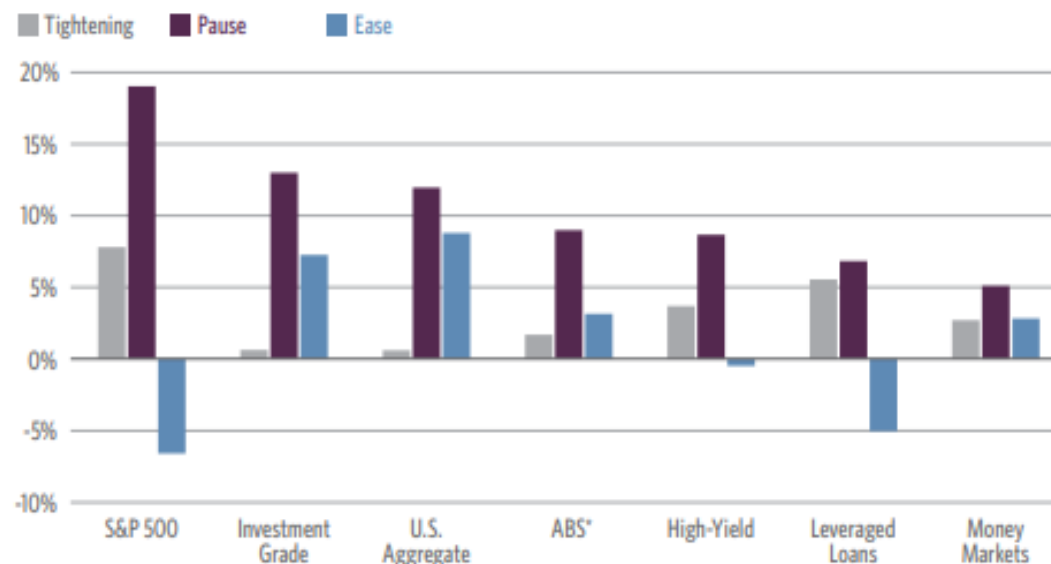


# Fixed Income

- With the Fed indicating that they are done raising rates, we see the best opportunity in fixed income being more quality oriented.
- Investment grade corporate bonds as well as U.S. Treasuries and Municipal bonds perform well during an easing cycle.
- While the likely scenario is for rates to come down, we see a scenario where the longer end of the curve (10 years +) may stay higher for longer.
- We seek to maintain a duration between 4.5-5.5 for most fixed income accounts.

## Higher-Quality Fixed Income Has Outperformed When the Fed Is Easing

Asset class performance over the past five Fed monetary policy cycles.

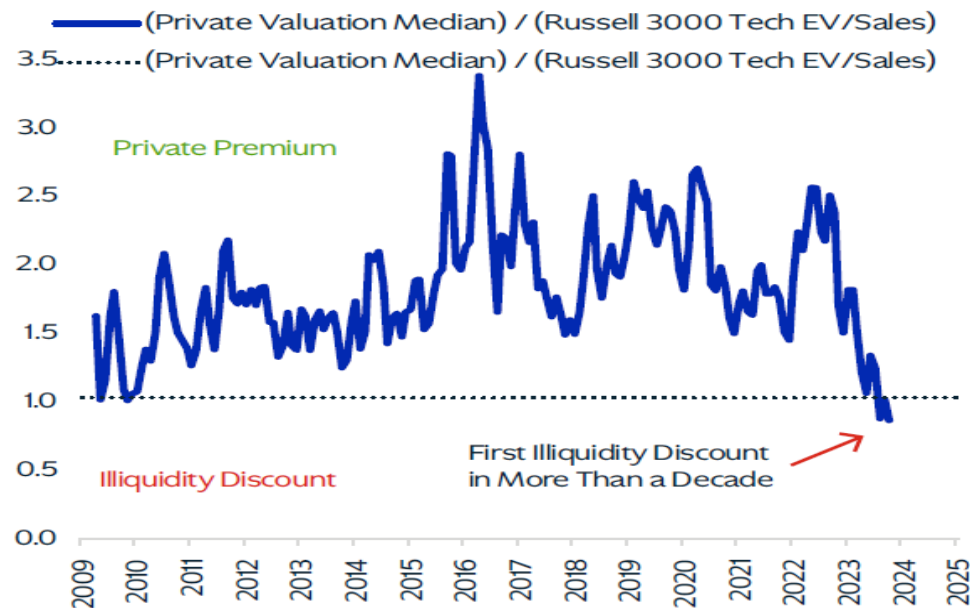


Source: Guggenheim Investments

# Private Equity

- Private equity has seen a decline in capital raised as well as difficulty raising new venture rounds for marginal companies.
- The improvement in private valuations, along with record highs in the S&P 500, has presented a compelling discount in private equity valuation.
- We seek to invest in small/mid buyout as well as growth and venture across multiple vintages and strategies.

**VC and PE Median Valuation/Sales of Completed Transactions vs Public EV/Sales (x)**



1.0 equals parity and differentiates between premium and discount. Data as at October 31, 2023. Source: Bloomberg, Pitchbook, Morgan Stanley.

# Market Positioning

- Our equity portfolio continues to tilt in favor of quality. We've added exposure to the S&P Equal Weight following a significant run up in the "Magnificent Seven."
- While we do foresee a re-steepening of the yield curve, we anticipate a less dovish Fed vs. market expectations (4-6 cuts).
- Within Alternatives, we plan to launch our 2024 Private Equity Vintage and a Private Credit Fund.
- **Equity:** Increasing active management within small/mid cap equities where markets are less efficient. Maintaining quality tilt within the portfolio as the market begins to price in multiple rate cuts in 2024.
- **Fixed Income:** Focusing on quality issues, extending duration at the margins where appropriate. Positioning the portfolio for a normalization of the yield curve following easing cycle.
- **Hedge Funds:** Increasing allocation to uncorrelated strategies within Absolute Return. Monitoring distressed-securities cycle taking shape in the current higher interest rate environment.
- **Private Equity:** Targeting lower middle-market buyout managers with a proven value creation process. Preference to funds with historically low loss ratios and top quartile performance.

# Disclosures

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