Q2 2024 Outlook

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Megatrends for the Decade Ahead

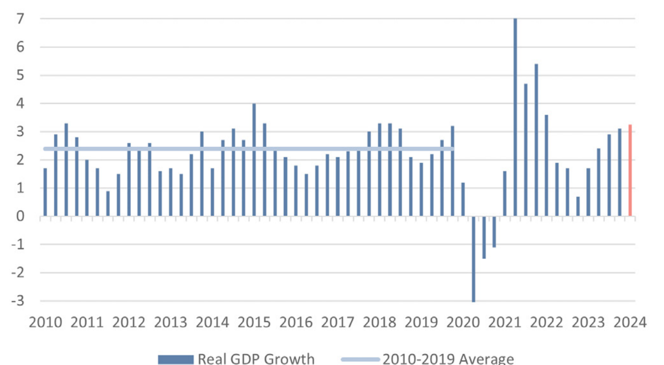
By Michael Crook, Chief Investment Officer

Last month's commentary hypothesized that we might be on the cusp of a sustained period of elevated US economic growth and discussed many of the investment implications of a higher-growth economic environment. This quarterly publication takes a step back and focuses on four potential catalysts that could drive higher real economic growth:

1) baby boomer consumption,
2) millennials hitting middle age,
3) immigration, and
4) artificial intelligence.

Real GDP growth averaged just under 2.5% between 2010 and 2019 (Fig. 1). However, due to factors like an aging population, low birth rates, anemic productivity growth, and high federal deficits, the Federal Reserve and many mainstream economists believe the US can only sustain 1.8% trend real gross domestic product (GDP) growth on a going-forward basis. While such a view is very reasonable based on the 2010–2019 economic climate, in our opinion, it ignores significant changes in the US economy that will sustain higher economic growth through the balance of the decade.

Fig. 1: US GDP growth, year-over-year (%)



Source: Bloomberg, Mill Creek. Red column represents Atlanta FedNow forecast for Q1 2024.

Calculating GDP

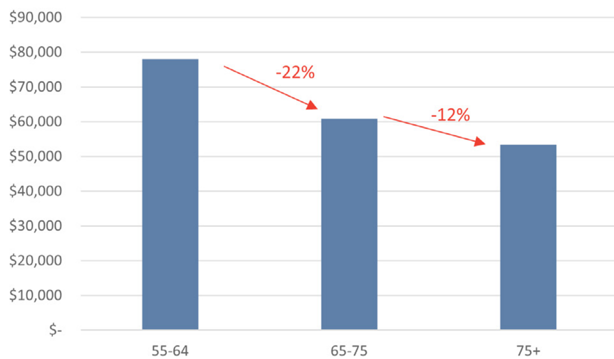
One way to calculate GDP is called the expenditures approach: GDP = consumption + investment + government purchases + net exports. This approach measures the total market value of all final goods and services that are produced in the economy in one year.

Another way to calculate GDP is to add up all income (i.e. labor income, land income, capital income, and entrepreneurial profit) that is earned in the country each year. With some nuance, both measures should provide the same basic result.

Baby Boomers Will Drive Consumption Growth

As more and more baby boomers retire, traditional economic models point to lower consumption growth and lower income growth as reasons that overall economic growth should slow. After all, retirees (by definition) don't earn labor income and generally cut their spending by 1–3% per year through retirement (Fig. 2).

Fig. 2: Consumer expenditures by age, 2022

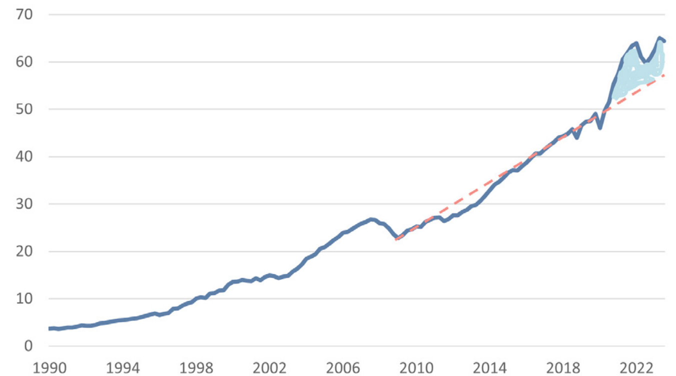


Source: Bureau of Labor Statistics, Mill Creek.

However, the post-COVID financial market boom resulted in at least an extra $4.5 trillion of assets on baby boomers' balance sheets versus what they could have reasonably expected at the end of 2019. Baby boomers increased their net worth by 7.8% annualized between 2012–2019. Since Q1 2020, their net worth has increased 10% per year driven by substantial gains in real estate corporate equities and the value of private businesses (Fig. 3).

To put the $4.5 trillion of excess savings in perspective, total US GDP is around $28 trillion per year and 70% of the economy is consumption. Spending just the income (assuming 4% yield per year) on $4.5 trillion amounts to a 0.6% boost to annual GDP. If baby boomers decide to spend down

Fig. 3: Baby boomer net worth (trillions)



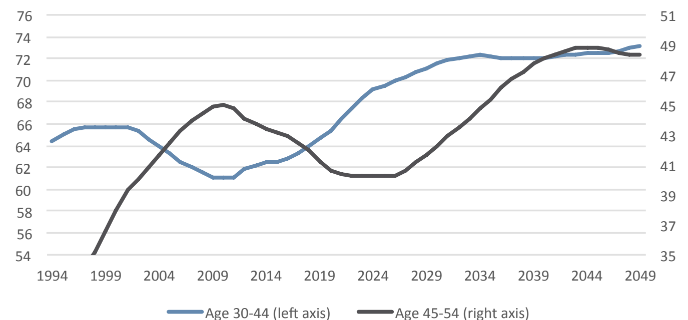
Source: Federal Reserve Board, Mill Creek. Salmon line represents 2009-2019 trend.

some of their excess assets, the boost to GDP could reach 1% per year for the balance of the decade.

Millennials Hit Middle Age

Millennials were born between 1981–1996 and are now age 28–43. This is a generation that is hitting their prime child-rearing, spending, and residential investment years. Starting with the demographic trend, the number of adults between 30–54 years of age will increase by about 7 million over the next decade (Fig. 4).

Fig. 4: The "middle-aged" US population will grow rapidly (millions)



Source: US Census Bureau, Mill Creek.

This will drive significant residential investment, as the average age of a new mom in the US is now 30 years old. The US currently has a housing shortage of about 3 million single family homes and the units created during the multifamily building spree that occurred between 2014 and 2023, which consisted mainly of one- and two-bedroom apartments designed for 20- to 30-year-old millennials, are poorly matched to the needs of growing families. New home starts are an excellent leading indicator for the economy and we believe

millennial demand, coupled with current high prices, provides a multiyear tailwind for new home starts.

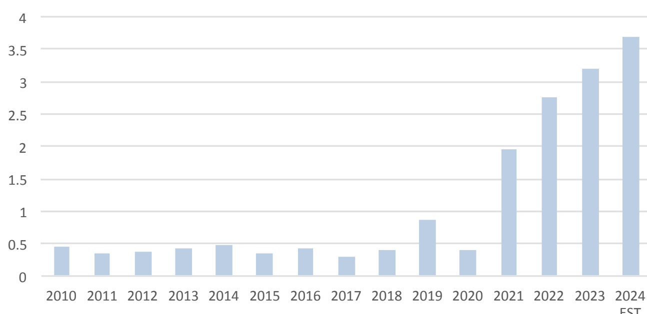
Millennials are also moving into a high-consumption growth period of their lives. While the age segmentation isn't exactly the same as the generational breakpoints, 2022 annual expenditures were about 30% higher for individuals age 35–54 than 25–34, with much of the increase coming in the earlier years.

Immigrants Will Drive Population Growth

We're grabbing the third rail by both hands by including a highly political subject, immigration, but it is also one that will have significant implications for the US economy. Our interest is not *what should be*, or to pass judgment on any specific policy. Our focus is simply *what is* — analyzing the impact of immigration from an economic standpoint.

Immigration into the US — specifically undocumented immigration — has been much higher than projections would have indicated five years ago. While we don't know exactly how many undocumented immigrants have recently crossed into the US, estimates vary from 4–12 million people since January 2021 (Fig. 5).

Fig. 5: US Border Control encounters (millions)



Source: US Border Control, Mill Creek.

Putting these numbers in context, the US population is likely 1.5–3% larger than it would have been without this influx. It is the equivalent of two years of natural births in the US — except the births have been mainly young working-age adults and families. It's a number that is larger than the population of over 30 US states, and equivalent to 4.5 new Philadelphias or one new New York City.

While many migrants are poorly educated with low-income prospects, not all are. Migrating from Central and South America can be accomplished cheaply, but immigrating from other parts of the world tends to be quite expensive, and US Border Patrol has encountered a surge in migrants from China, Turkey, and India, among other countries of origin.

For example, the Washington Post recently reported that there are likely 750,000 undocumented Indian immigrants in the US — many of whom they believe immigrated over the last three years. They also found that these immigrants tend to be from prosperous families in India but see better future opportunities for their families in the US. They typically pay $40,000 to $100,000 per person for the journey, which "bounces them" (the trip is called *dunki*, a Punjabi term for *donkey process*) through several countries with easy visa requirements before they attempt to cross undetected through one of the US borders.[1]

At low-wage rates, just $20,000 per year per immigrant, a 4–12 million population increase is equal to a 0.3–1% annual boost to GDP. This might not sound like much, but the Congressional Budget Office has already updated their 10-year projections to account for this higher-than-expected net immigration. The surge in immigration (whether or not it continues) will be one of the most important economic factors impacting US labor markets, housing policy, and consumption growth over the next decade.

Artificial Intelligence Boosts Productivity

We left perhaps the most important trend, but also the most speculative trend, for last. We believe artificial intelligence could drive a resurgence of productivity growth in the US.

Productivity is a measure of the amount of goods and services created versus the inputs used to create the goods and services. At a high level, productivity growth plus population growth equals economic growth. US productivity growth averaged about 2% from 1960 through 2023, but with significant variation over time (Fig. 6).

Fig. 6: US productivity growth has lagged since the mid-2010s (%)

Source: Bloomberg, Mill Creek. 5-year rolling average.

[1] The 9th highest-grossing Indian film of 2023 was a comedy/drama called *Dunki* that used this immigration process as the backdrop for the film.

We didn't get flying cars, but we might get better and cheaper education and health care.

US productivity growth declined during the 1970s due to factors like high energy prices, a shift toward a service-based economy from a manufacturing-based economy, low levels of technological innovation, and increased regulation across industries. Advances in computational power and advancements in information technology led to an acceleration of productivity growth in the late 1990s and 2000s, but another productivity slowdown occurred after the financial crisis of 2008. To quote venture capitalist Peter Thiel: "We wanted flying cars, instead we got 140 characters."

Sectors that exhibit low productivity growth tend to become expensive. If you find yourself asking "why does *this* cost so much?" it's probably a low-productivity growth sector. Education is a low-productivity growth sector (the model of one teacher standing in front of 25 students has been consistent for the last 100 years), Broadway shows (the theaters fit the same number of people as they did 125 years ago) are a low-productivity growth sector, and health care (one doctor meeting with one patient has been the delivery method for generations) is a low-productivity growth sector. Service sectors, in general, tend to be low-productivity growth sectors.

A few years ago, the mantra to nearly every problem was "crypto solves this," but crypto didn't solve anything unless the void in your life came from not owning a digital picture of a monkey smoking a cigarette. Artificial intelligence *does* solve the cost disease eating away at many low-productivity sectors.[2]

While one teacher might struggle to maintain quality while expanding from a classroom of 25 elementary school students to a classroom of 250 students using traditional methods, artificial intelligence can support that teacher in ways that are difficult to understand for those who have not engaged with it. You can already take a picture of a paragraph in a textbook or of a problem that you find difficult, load it into ChatGPT, and have it tutor you until you have a full understanding and are ready to move to the next level. Teachers can use AI to evaluate students on the fly, pick out areas that need reinforcement in real time, and create (plus grade) new problem sets that are tailor-made for specific students. Students can use AI at home to prep for tests or simply pursue their own areas of inquiry. The possibilities for productivity enhancement in education are nearly endless, particularly once the student interacts directly with AI.

The prospects for health care are similar. Not only can AI handle "normal" disease diagnostics (the difference in AI and the human interaction I had during my last telehealth visit would be de minimis), but it can also be used for analyzing CT scans, X-rays, MRIs, personalized disease treatment, and in drug development. AI can increase productivity in the easy cases (e.g., diagnosing a cold) and the more challenging ones (e.g., putting together a rare disease fact pattern that only impacts one in a million people) as well.

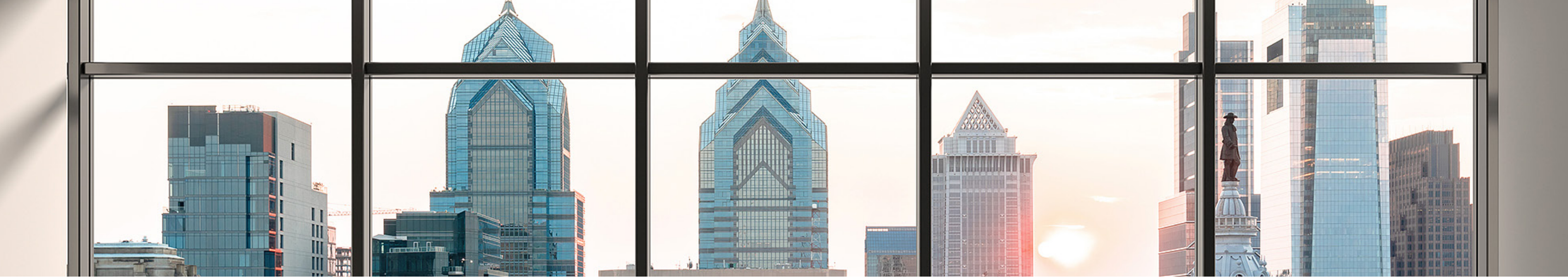
Even if AI doesn't have the same productivity impact that we experienced from telecommunications and the internet, moving back to 2% productivity growth would result in a noticeable boost to GDP over the next decade. We didn't get flying cars, but we might get better and cheaper education and health care.

Mega Trends vs Immediate Risks

While we believe the mega trends driven by baby boomers, millennials, immigration, and AI will provide strong tailwinds for the US economy, investors should expect bumps along the road. Many developed markets, like Germany, Japan, and the UK, have succumbed to higher rates and fallen into recession over the last two years.

US economic data indicates we are not in a recession today nor are we at immediate risk to fall into a recession, but the Fed remains restrictive, geopolitical risks abound, and there are clear problems on the balance sheets of regional and community banks. We don't try to forecast recessions (economists are notoriously bad at doing so) and recognize that — based on historical experience — any given calendar year comes with a 20% probability of recession. Our investment positioning (p. 5) reflects how markets are pricing these future opportunities and risks.

[2] Education and health care are ripe for huge productivity gains, but we don't see much hope for increased productivity in Taylor Swift concerts. She's already performing at the largest venues on the planet.



House View Summary

Our Tactical Preferences

	Underweight	Neutral	Overweight
Cash		=	
Municipal Fixed Income	–		
State/Local GO	–		
Lease			+
Transportation	–		
Higher Education		=	
Health Care			+
Duration		=	
Taxable Fixed Income	–		
Corporate			+
Government	–		
Securitized			+
Duration		=	
Public Equity		=	
US Large-Cap			+
US Mid- and Small-Cap			+
US Growth		=	
US Value		=	
International Developed	–		
Emerging Markets	–		
Private Assets			+
Private Debt			+
Private Equity			+

Our Perspective

1. The US economy is experiencing a soft landing. Inflation has declined significantly without a corresponding recession.
2. The Fed will likely reduce the Fed Funds target (cash rates) sometime in 2024, but the cuts won't be significant unless the economy falls into recession.
3. However, sticky inflation and continued above-trend growth are risk factors that could push bond yields higher and end the current goldilocks period for US risk assets.
4. Interest rate–sensitive countries, including Australia, Canada, Norway, Sweden, and the UK, remain weak links in global growth.
5. Commercial real estate values will likely fall further, continuing to put pressure on regional and community bank balance sheets.
6. We are underweight fixed income and expect headwinds for bonds as Fed rate cut expectations for 2025 and beyond prove to be excessive.
7. We are neutral duration within fixed income and believe it is prudent to maintain high credit quality. In municipals, we prefer revenue bonds to general obligation bonds.
8. US equity valuations, particularly in the mega-cap growth space, remain elevated. Small-cap US equities are trading at the largest discount to large-cap in 30 years.
9. We are overweight US equities, overweight US small cap equities, and underweight the rest of the world.
10. We are overweight private credit and private equity.

First Quarter 2024: Market Review

- US economic growth appears to have remained intact during the first three months of 2024. The Atlanta Fed's GDPNow real-time estimate of real GDP growth remains above 2%.
- US inflation has firmed above the Fed's 2% target in the 2.5-3.5% range.
- The Fed continues to signal a preference for modest Fed Funds rate cuts in 2024, but timing remains uncertain.
- Restrictive central bank policy has taken its toll globally. The UK, Japan, Ireland, and Finland recently fell into recession. The eurozone has essentially been at 0% GDP growth since late 2022.
- Interest rates rose during Q1, leading to headwinds for bond returns.
- Equity markets performed well in Q1. US equities led, followed by international developed market equities.

Index Returns	Q1 2024	2024 YTD	2023	2022	2021	2020	1 Year	3 Years	5 Years	10 Years
Global Equities	8.2%	8.2%	22.2%	-18.4%	18.5%	16.3%	23.2%	7.0%	10.9%	8.7%
US Equities	10.0%	10.0%	26.0%	-19.2%	25.7%	20.9%	29.3%	9.8%	14.3%	12.3%
Large Cap US	10.3%	10.3%	26.5%	-19.1%	26.5%	21.0%	29.9%	10.5%	14.8%	12.7%
Mid Cap US	8.6%	8.6%	17.2%	-17.3%	22.6%	17.1%	22.3%	6.1%	11.1%	9.9%
Small Cap US	5.2%	5.2%	16.9%	-20.4%	14.8%	20.0%	19.7%	-0.1%	8.1%	7.6%
US Growth	11.2%	11.2%	41.2%	-29.0%	25.8%	38.3%	38.0%	11.5%	17.8%	15.4%
US Value	8.6%	8.6%	11.7%	-8.0%	25.4%	2.9%	20.2%	7.7%	10.2%	8.9%
Int'l Developed Equities	5.8%	5.8%	18.2%	-14.5%	11.3%	7.8%	15.3%	4.8%	7.3%	4.8%
Emerging Market Equities	2.4%	2.4%	9.8%	-20.1%	-2.5%	18.3%	8.2%	-5.1%	2.2%	2.9%
US Taxable Bond Market	-0.8%	-0.8%	5.5%	-13.0%	-1.5%	7.5%	1.7%	-2.5%	0.4%	1.5%
US Municipal Bond Market	-0.4%	-0.4%	4.6%	-4.8%	0.5%	4.2%	2.2%	0.0%	1.4%	2.0%
Diversified Commodities	2.2%	2.2%	-7.9%	16.1%	27.1%	-3.1%	-0.6%	9.1%	6.4%	-1.6%
Hedge Funds	2.7%	2.7%	7.8%	-6.9%	9.7%	9.5%	8.6%	2.6%	5.2%	4.0%

Index Returns (as of Q3 2023)	2023 Q1-Q3	2022	2021	2020	1 Year	3 Years	5 Years	10 Years
Global Equities	10.1%	-18.4%	18.5%	16.3%	20.8%	6.9%	6.5%	7.6%
Private Equity	10.9%	-0.3%	36.1%	20.3%	14.2%	19.2%	15.5%	14.6%
US Taxable Bond Market	-1.2%	-13.0%	-1.5%	7.5%	0.6%	-5.2%	0.1%	1.1%
Private Credit	5.6%	6.3%	12.8%	5.5%	7.7%	9.5%	8.0%	8.5%

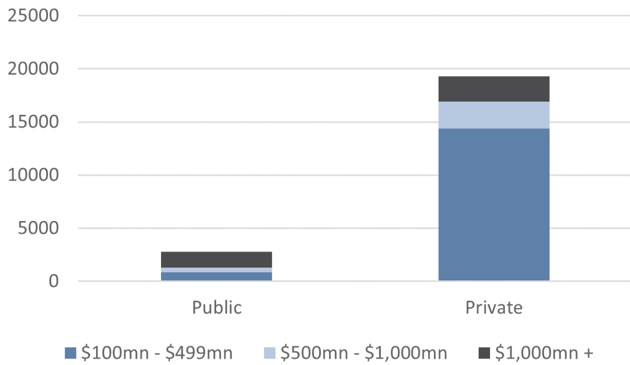
Key Rates (as of stated date)	Mar-2024	Dec-2023	Dec-2022	Dec-2021	Dec-2020	Dec-2019	Dec-2018	Dec-2017	Dec-2016	Dec-2015
US 10-Year Treasury	4.2%	3.9%	3.9%	1.5%	0.9%	1.9%	2.7%	2.4%	2.4%	2.3%
Barclays Aggregate Bond Index	4.9%	4.5%	4.7%	1.8%	1.1%	2.3%	3.3%	2.7%	2.6%	2.6%
BBarc Muni 1-10 Yr Blend (1-12) Index	3.1%	2.8%	3.0%	0.7%	0.6%	1.4%	2.2%	2.0%	2.1%	1.6%

Source: Bloomberg, Mill Creek. Returns for periods greater than one year are annualized. Index rates are yield to worst. As of March 31, 2024 unless otherwise stated. Indices used to represent periodic capital markets returns include: MSCI ACWI (Global equities), Russell 3000 (US equities), Russell 1000 (Large Cap US), Russell Mid Cap US (Mid Cap US), Russell 2000 (Small Cap US), Russell 3000 Growth (US Growth), Russell 3000 Value (US Value), MSCI EAFE (International Developed), MSCI Emerging Markets Index (Emerging Markets Equities), Bloomberg Aggregate Bond Index (US Taxable Bonds), Bloomberg 1–10 Year Municipal Bond Index (US Municipal Bonds), HFRX Global Hedge Fund Index (Hedge Funds), Bloomberg Commodity Index TR (Diversified Commodities), Bloomberg Buyout PE Index (Private Equity), and Bloomberg Private Debt Index (Private Credit).

The historical index performance results are provided exclusively for comparison purposes over various time periods only. It is not possible to invest directly in an index. Index performance does not reflect any management fees, transaction costs, or other expenses that would be incurred by a portfolio or fund, or transactions in fund shares. Such fees, expenses, and commissions would reduce returns. It should not be assumed that any account holdings will correspond directly to any comparative index reflected herein. Data as of March 31, 2024.

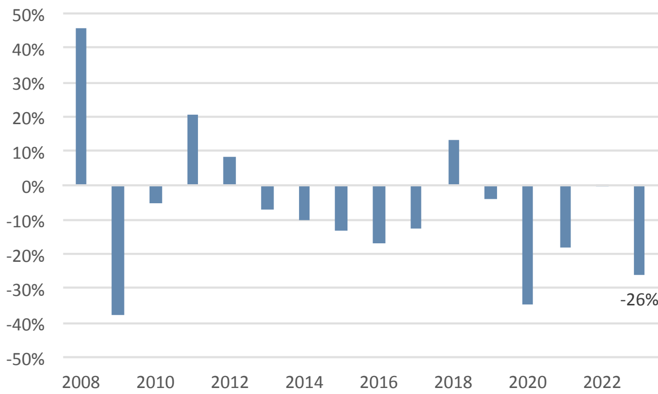
Why We Like Private Equity in 2024

Fig. 1: Number of public and private US companies by revenue



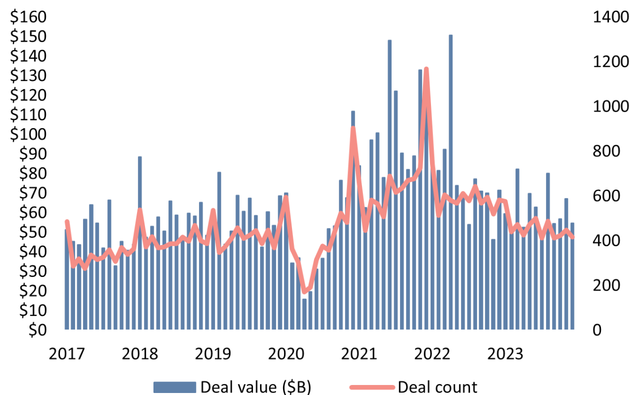
Source: Bloomberg, Hamilton Lane, Mill Creek.

Fig. 2: Premium/discount to public equities



Source: PitchBook, Bloomberg, Mill Creek.

Fig. 3: US buyout deal activity



Source: PitchBook, Mill Creek.

1) Market Breadth

- The number of publicly traded companies in the US has declined by half since the mid-1990s.
- 87% of US companies with revenue in excess of $100mn per year are privately owned.
- The market cap of private equity-backed companies is only 6% of the US stock market.

2) Valuation

- Valuation is a metric used to measure how expensive or cheap a company is to purchase.
- The US stock market is modestly expensive on a valuation basis.
- Private equity managers are buying companies at a 26% discount to the valuation of the stock market.
- Lower valuations (buying at a discount) has historically been a good indicator of higher future returns.

3) Normalization

- Private equity deals collapsed in 2020 and then exploded in 2021.
- Higher interest rates and a more challenging fundraising environment has led to a normalization of deal activity.
- “Normal” has been good for private equity investors. Between 2007 and Q3 2023, private equity produced twice the return of global equities with half the volatility.

PUBLICATION DETAILS

Investment Strategy Group

Michael Crook, Chief Investment Officer
Sam McFall, Managing Director
Andrew Murray, Managing Director
Nora Pickens, Managing Director
Daniel Bradley, Manager of Private Investments

Project management and editing

Rachel Hassett, Communications Director

Report design

George Stilabower (www.gsdesign.work)

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