

John Gambla, Senior Vice President, CFA, FRM, PRM

Rob Guttschow, Senior Vice President, CFA

In the third quarter of 2023, Alternative Investments ("Alternatives") were a haven of performance against a backdrop of negative returns for traditional assets, U.S. Treasuries, and global equities, in particular. Over the prior three quarters, there seemed to be hope of an economic "soft landing" or "no landing" as opposed to a significant recession. This sentiment was reflected in a consistent and strong bid for equities and other risk assets. Concurrently, there were also a growing number of voices expressing that despite a deeply inverted yield curve, declining Federal Reserve (the "Fed") balance sheet and other indicators of tightening credit, this was not the 1970s when the economy cycled between inflation blooms and recession busts; this inflation cycle would be different. While the end game has yet to be played, during the third quarter, the capital markets started to reflect a deeper concern that perhaps things are not that different than the inflationary decade of the 1970s, and a bit of risk aversion might be prudent.

Of note, it is now 18 months since the first rate hike and only 1 year since Fed Funds rate breached 3%. The Fed's balance sheet has shed nearly \$1 trillion in assets during this period and continues to shed roughly \$100 billion each month (Figure 1). After more than a decade of unprecedented financial liquidity here and abroad, the tsunami of money printed during that decade is being drained from the system and the monetary flood waters are receding. As Jerome Powell noted in June, it takes time for monetary policy to work its way fully through the economy. As tighter financial conditions start to impact the economy and late-stage inflationary forces (demands for higher wages to compensate for lost earning power) gather steam and feed into the economy, the capital markets could be looking at some very strong headwinds in the future, in our opinion. Compounding the situation is that macro trends of the past several decades (globalization, insatiable demand for U.S. Treasuries, cheap energy, and cheap commodities) that allowed central banks to keep the easy money machine going without significant consequence, are now reversing. We believe the combination of falling liquidity and structural inflationary trends has the potential to be a toxic mix for three of the most successful and most embraced investment exposures (beta, duration, and credit).

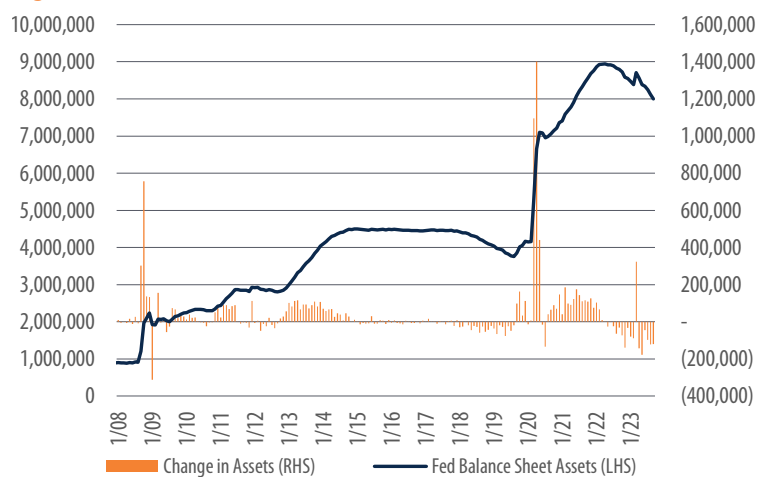
The Fed raised the Fed Funds rates only once during the quarter, a 25-bps hike in July and then paused in September. Fed Funds now sit at 5.25% - 5.50%. The Consumer Price Index Year-over-Year (CPI YoY) came in at 3.70%, monthly CPI registered 0.60% a significant uptick from the recent trend in month-over-month (MoM) data. CPI ex food and energy was 4.30% (YoY) and 0.30% (MoM), respectively. The year-over-year Producer Price Index Final Demand (PPI YoY) came in at 1.60% and the MoM PPI was +0.70%, both sharp reversals upwards in the recent downward trend. Though pausing hikes, the Fed continued to convey the theme of higher rates for longer, in our opinion. This hawkish tone coupled with rising energy costs, a disjointed and unaffordable housing market, upward wage pressure and concerns over fiscal spending and governmental dysfunction all served to shift U.S. Treasury rates up a stunning 0.73% and 0.84% on the 10 Yr. and 30 Yr. maturities. 10 Yr. rates are now at levels not seen in over 17 years. Short-term rates are well above 5% and if recent trends remain intact, longer maturities may breach that level. In sympathy, mortgage rates have skyrocketed and have hit levels not seen since late 2000.

It was against this very difficult backdrop for both equities and fixed income that Alternatives had a solid third quarter both on an absolute basis and a relative basis, once again highlighting the merits of the investment sector and the benefits of seeking out diversifying strategies, in our opinion. The average Alternatives outperformance versus the S&P 500 Index was 494 basis points. Seven out of 10 categories were positive, and 9 out of 10 outperformed the S&P 500 Index, for the quarter. The average Alternative outperformance vs the Bloomberg U.S. Aggregate Bond Index was +490 bps with 9 of 10 categories outperforming for the quarter. Multi-Strategy was the best performing Alternatives category (+8.66%). Other notable gainers were Global Macro (+5.75%), Commodities (+4.71%), Managed Futures (+3.15%) and Event Driven (+3.11%). Real Estate was by far and away the worst performing category (-8.56%) as the sector is contending with continued challenges in the commercial sector while the residential sector is facing 40-year highs in mortgage rates and levels of unaffordability not seen in decades (Figure 2 and Figure 3).

References to specific companies or securities should not be construed as a recommendation to buy or sell any such security, nor should they be assumed profitable.

All charts shown herein are for illustrative purposes only and not indicative of any investment. The performance illustrations exclude the effects of taxes and brokerage commissions or other expenses incurred when investing. **Past performance is not indicative of future results** and there can be no assurance past trends will continue in the future. An investor cannot invest directly in an index. See last page for definitions of asset class indexes and other terms discussed herein.

Figure 1 Federal Reserve Balance Sheet



Source: Bloomberg.

Figure 2 Alternatives Performance

	Q3 2023	YTD 2023
Equity Long/Short	-1.08%	4.27%
Event Driven	3.11%	4.78%
Equity Market Neutral	0.61%	3.28%
Real Estate	-8.56%	-4.86%
Commodities	4.71%	-3.44%
Convertible Arbitrage	-0.40%	2.39%
Multi-Strategy	8.66%	7.05%
Fixed Income Arbitrage	0.71%	4.63%
Global Macro	5.75%	4.66%
Managed Futures	3.15%	3.11%

Source: Bloomberg, data as of 9/30/23.

Figure 3 Alternatives Performance (Over/Under) vs S&P 500 Index

	Q3 2023
Equity Long/Short	2.20%
Event Driven	6.39%
Equity Market Neutral	3.88%
Real Estate	-5.28%
Commodities	7.98%
Convertible Arbitrage	2.88%
Multi-Strategy	11.93%
Fixed Income Arbitrage	3.98%
Global Macro	9.03%
Managed Futures	6.43%

Source: Bloomberg, data as of 9/30/23.

Traditionally, managed futures and macro strategies are viewed as having lower correlations to equities because they are diversified across a variety of markets and often employ shorting as part of their approach. Strategies that had lower 2-year correlations to U.S. equities (less than 0.60), on average, outperformed those strategies that had a higher correlation with U.S. equities. The spread was +811 basis points (Figure 4). Real asset returns were challenged as interest rates continued to rise while inflation moderated, thus pushing real rates higher. Broad commodities rallied primarily on rising energy prices. Real Estate tanked as the sector was no longer able to ignore rising mortgage rates, poor housing affordability and commercial real estate occupancy concerns. Gold fell as nominal/real rates moved up and this likely helped propel the dollar higher (Figure 5).

Figure 4 Correlations (2yr) & Returns

	S&P 500 Index	Q3 2023
Hedged Equity	0.00	0.00%
Event Driven	0.32	3.11%
Equity Market Neutral	0.02	0.61%
Real Estate	0.89	-8.56%
Commodities	0.41	4.71%
Distressed	0.00	0.00%
Volatility Arbitrage	0.00	0.00%
Credit Arbitrage	0.00	0.00%
Macro	0.00	0.00%
Managed Futures	-0.38	3.15%
Lower Correlation Avg TR (≤ 0.60)		3.29%
Higher Correlation Avg TR (> 0.60)		-4.82%

Source: Bloomberg, data as of 9/30/23. Correlation of monthly returns over 24 months.

Figure 5 Real Assets

	Q2 2023	YTD 2023
Real Estate	-8.56%	-4.86%
Commodities	4.71%	-3.44%
Gold	-3.68%	1.35%
Average	-2.51%	-2.32%

Source: Bloomberg, data as of 9/30/23.

Cryptocurrencies traded off sharply in the third quarter in sympathy with other risk markets. The Bloomberg Galaxy Crypto Index fell -12.74%, Bitcoin, Ethereum, and Litecoin all were down double digits -10.92%, -12.80%, and -38.09%, respectively. Bucking the negative return trend was Ripple (XRP), +8.70% (Figure 6). In July, a court ruled that Ripple was not a security when sold to the public on digital exchanges and thus not subject to SEC regulation. This was considered a milestone victory for cryptocurrency. The court also ruled that when sold to institutional investors, it was a security and therefore subject to SEC regulations. The decision is expected to be appealed by the SEC. Concurrently, several applications for exchange-traded funds (ETFs) where the underlying asset is actual bitcoin and not bitcoin futures, are pending at the SEC. Market sentiment seems to be solidly in the camp that the SEC will approve one if not several of the applications. Unfortunately, fraud and theft continue to be a feature of the sector with \$700MM in digital assets lost in the quarter, according to cybersecurity firm, CertiK with the total approaching nearly \$1 billion year to date.

Returns for major asset classes were negative in the third quarter of 2023. U.S. 20+ Treasuries had one of the worst quarters in recent memory (-13.00%) and erased all gains for the year as the yield curve moved sharply higher. The S&P 500 Index fell (-3.27%) as the message of higher rates for longer came back into investors' psyche. MSCI EAFE, Real Estate, and Emerging Markets were all negative (-4.11%, -8.56%, -2.93%, respectively) while High Yield Bonds managed to eke out a small gain (+0.33%). Commodities were a bright spot up (+4.71%) despite a significant rally in the U.S. Dollar (+3.17%). Prices, as measured by the Consumer Price Index (CPI), moved higher YoY and may signal a plateauing to the declining trend that has existed the past several months as inflation came off its highs. This would not be atypical in the later stages of an inflationary cycle in which lagging forces such as wages keep upward pressure on inflation and serve to counter the Fed's goals of a 2% rate. The yield curve while having flattened due to soaring long rates, remains deeply inverted. An inverted yield curve is financially restrictive and has often preceded a significant economic slowdown or recession. With inflation ticking down and Treasuries moving higher, real yields are now solidly positive across the entire yield curve (Figure 8). Negative real yields, which existed for much of the 2010s, are considered accommodative from a monetary perspective, while positive real yields are considered more restrictive.

Alternatives have historically provided significant diversification benefits when paired with a portfolio of traditional assets, in addition to both competitive absolute returns and attractive risk-adjusted returns. **Please Note: Alternative investments may employ complex strategies, have unique investment, and risk characteristics that may not be suitable for all investors.**

Figure 6 Cryptocurrency Returns

	Q3 2023	YTD 2023
BB Galaxy Crypto Index	-12.74%	36.44%
Bitcoin	-10.92%	63.68%
Ethereum	-12.80%	40.10%
XRP (Ripple Dig.Asst)	8.70%	51.32%
Litecoin	-38.09%	-5.34%

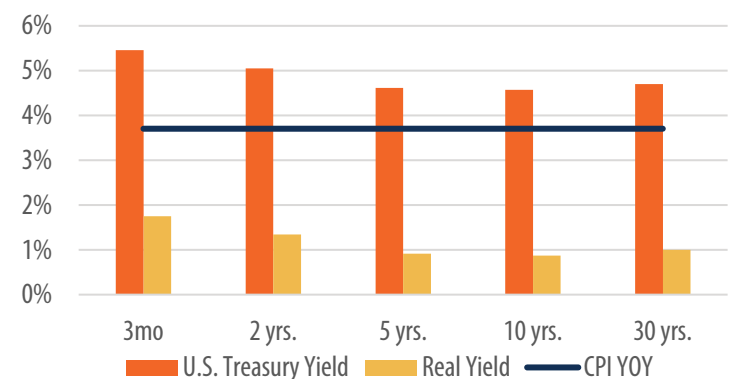
Source: Bloomberg, data as of 9/30/23.

Figure 7 Asset Class Returns

	Q3 2023	YTD 2023
U.S. Equities	-3.27%	13.07%
International Developed	-4.11%	7.08%
Emerging Markets	-2.93%	1.82%
U.S. Treasury	-13.00%	0.00%
Real Estate	-8.56%	-4.86%
Commodities	4.71%	-3.44%
High Yield Bonds	0.33%	5.81%
U.S. Aggregate Bonds	-3.23%	-1.21%
Bitcoin	-10.92%	63.68%
U.S. Dollar	3.17%	2.56%

Source: Bloomberg, data as of 9/30/23.

Figure 8 U.S. Treasury Yield Curve and CPI



Source: Bloomberg, data as of 9/30/23.

Definitions

10-Yr Treasury: Yield of U.S. Treasury securities maturing in approximately 10 years.

30-Yr Mortgage Rate: is a fixed interest rate home loan that will be paid off completely in 30 years if you make every payment as scheduled.

Aggregate Bonds: The Bloomberg US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

AllHedge Index: The Credit Suisse AllHedge Index is an asset-weighted hedge fund index derived from the market leading Credit Suisse Hedge Fund Index. The Credit Suisse AllHedge Index provides a rules-based measure of an investable portfolio. Index performance data is published monthly and constituents are rebalanced semi-annually according to the sector weights of the Credit Suisse Hedge Fund Index.

Bear Market: When a market experiences prolonged price declines typically 20% amid widespread pessimism and negative investor sentiment.

Beta: A measure of price variability relative to the market.

Binance: A cryptocurrency exchange, operating the world's biggest bitcoin exchange and altcoin crypto exchange in the world by volume.

Bitcoin: A digital currency using encryption techniques created for use in peer-to-peer online transactions introduced in 2008 by a person or group using the name Satoshi Nakamoto.

Bittrex: a cryptocurrency blockchain platform exchange founded in 2014. It provides the widest selection of cryptocurrencies in the United States along with fast trade execution and dependable digital wallets.

Bloomberg Galaxy Crypto Index (BGCI): The BGCI is designed to measure the performance of the largest cryptocurrencies traded in USD.

Coinbase: An online platform for buying, selling, transferring, and storing cryptocurrency.

Commodities: The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents 20 commodities, which are weighted to account for economic significance and market liquidity.

Consumer Price Index (CPI): A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living.

Correlation: A statistical measure that quantifies the extent to which two or more data series fluctuate together. Values run from -1.0 to +1.0.

Cryptocurrency: A digital or virtual currency that is secured by cryptography, which makes it nearly impossible to counterfeit or double-spend.

Emerging Markets: The MSCI Emerging Markets Index captures large and mid cap representation across Emerging Markets (EM) countries. The index covers 85% of the free float-adjusted market capitalization in each country.

Equity Market Neutral: The Credit Suisse AllHedge Equity Market Neutral Index is a subset of the Credit Suisse AllHedge Index that measures the aggregate performance of equity market neutral funds. Equity market neutral funds typically take both long and short positions in stocks while seeking to reduce exposure to the systematic risk of the market (i.e., a beta of zero is desired). Equity Market Neutral funds typically seek to exploit investment opportunities unique to a specific group of stocks, while maintaining a neutral exposure to broad groups of stocks defined for example by sector, industry, market capitalization, country, or region. The index has a number of subsectors including statistical arbitrage, quantitative long/short, fundamental long/short and index arbitrage. Managers often apply leverage to enhance returns.

Ethereum: Ethereum is a platform that offers programming code of any decentralized application. It has been linked to payment style transactions. Ether is the cryptocurrency issued through open-source code executed on thousands of nodes.

Event Driven: The Credit Suisse AllHedge Event Driven Index is a subset of the Credit Suisse AllHedge Index that measures the aggregate performance of event driven funds. Event driven funds typically invest in various asset classes and seek to profit from potential mispricing of securities related to a specific corporate or market event. Such events can include: mergers, bankruptcies, financial or operational stress, restructurings, asset sales, recapitalizations, spin-offs, litigation, regulatory and legislative changes as well as other types of corporate events. Event driven funds can invest in equities, fixed income instruments (investment grade, high yield, bank debt, convertible debt and distressed), options and various other derivatives. Many managers may use a combination of strategies and adjust exposures based on the opportunity sets in each subsector. Gold: The return of the gold spot price as quoted as U.S. dollars per Troy Ounce.

Fixed Income Arbitrage: The Credit Suisse AllHedge Fixed Income Arbitrage Index is a subset of the Credit Suisse AllHedge Index that measures the aggregate performance of fixed income arbitrage funds. Fixed income arbitrage funds typically attempt to generate profits by exploiting inefficiencies and price anomalies between related fixed income securities. Fixed income arbitrage funds seek to limit volatility by hedging out exposure to the market and interest rate risk. Strategies may include leveraging long and short positions in similar fixed income securities that are related either mathematically or economically. The sector includes credit yield curve relative value trading involving interest rate swaps, government securities and futures; volatility trading involving options; and mortgage-backed securities arbitrage (the mortgage-backed market is primarily U.S.-based and over-the-counter).

Global Macro: The Credit Suisse AllHedge Global Macro Index is a subset of the Credit Suisse AllHedge Index that measures the aggregate performance of global macro funds. Global macro funds typically focus on identifying extreme price valuations and leverage is often applied on the anticipated price movements in equity, currency, interest rate and commodity markets. Managers typically employ a top-down global approach to concentrate on forecasting how political trends and global macroeconomic events affect the valuation of financial instruments. Profits can be made by correctly anticipating price movements in global markets and having the flexibility to use a broad investment mandate, with the ability to hold positions in practically any market with any instrument. These approaches may be systematic trend following models, or discretionary.

Gross Domestic Product (GDP): Is the monetary value of all finished goods and services made within a country during a specific period.

Inflation is the decline of purchasing power of a given currency over time.

High-Yield Bonds: The Bloomberg US High Yield Very Liquid Index (VLI) is a component of the US Corporate High Yield Index that is designed to track a more liquid component of the USD-denominated, high yield, fixed-rate corporate bond market. The US High Yield VLI uses the same eligibility criteria as the US Corporate High Yield Index, but includes only the three largest bonds from each issuer that have a min amount outstanding of USD500mn and less than five years from issue date.

International Developed: The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. The index is a free-float weighted equity index.

Inverted Yield Curve: An unusual state in which longer-term bonds have a lower yield than short-term debt instruments.

JOLTS: The Job Openings and Labor Turnover Survey produces data on job openings, hires and separations.

Litecoin: A peer-to-peer cryptocurrency and open source software project similar to Bitcoin, Litecoin uses blockchain technology to process transactions. Litecoin, referred to as an altcoin can process blocks faster than Bitcoin, uses a different mining algorithm and has larger supply.

Long/Short Equity: The Credit Suisse AllHedge Long/Short Equity Index is a subset of the Credit Suisse AllHedge Index that measures the aggregate performance of long/short equity funds. Long/short equity funds typically invest in both long and short sides of equity markets, generally focusing on diversifying or hedging across particular sectors, regions or market capitalizations. Managers

typically have the flexibility to shift from value to growth; small to medium to large capitalization stocks; and net long to net short. Managers can also trade equity futures and options as well as equity related securities and debt or build portfolios that are more concentrated than traditional long-only equity funds.

Managed Futures: BarclayHedge US Managed Futures Industry Top 50 (BTop 50) Index. The Index seeks to replicate the overall composition of the managed futures industry with regard to trading style and overall market exposure.

Monetary Policy: Is the tool used by central banks to influence the money supply, and with it, the economy at large.

Money Supply: Is the entire stock of a nation's currency and other liquid instruments that is in circulation at a given time.

Month-over-Month (MoM): is a calculation that helps compare growth over the previous month and automatically negates the effect of seasonality.

Multi-Strategy: The Credit Suisse AllHedge Multi-Strategy Index is a subset of the Credit Suisse AllHedge Index that measures the aggregate performance of multi-strategy funds. Multi-strategy funds typically are characterized by their ability to allocate capital based on perceived opportunities among several hedge fund strategies. Through the diversification of capital, managers seek to deliver consistently positive returns regardless of the directional movement in equity, interest rate or currency markets. The added diversification benefits may reduce the risk profile and help to smooth returns, reduce volatility and decrease asset-class and single-strategy risks. Strategies adopted in a multi-strategy fund may include, but are not limited to, convertible bond arbitrage, equity long/short, statistical arbitrage and merger arbitrage.

Real Estate: The Dow Jones US Real Estate Index is designed to track the performance of real estate investment trusts (REITs) & other companies that invest directly or indirectly in real estate through development, management or ownership, including property agencies.

Real Yield: or Real Interest Rate has been adjusted to remove the effects of inflation to reflect the real cost of funds to the borrower and the real yield to the lender or to an investor.

Recession: Is a significant decline in economic activity that lasts longer than a few months.

Ripple: Known as XRP, Ripple is a cryptocurrency that can be used on open source distributed ledger created by the company Ripple. It is built upon the principles of blockchain as an on-demand option for faster cross border payments.

Securities and Exchange Commission (SEC): A government agency created by Congress to regulate the securities markets and protect investors.

U.S. Equities: The S&P 500 Index. An unmanaged index of 500 stocks (currently 505) used to measure large-cap U.S. stock market performance.

U.S. 30-Yr Treasury Yield: Yield of U.S. Treasury securities maturing in approximately 30 years.

U.S. Dollar: The U.S. Dollar Index (USDIX) indicates the general international value of the U.S. dollar. The USDIX does this by averaging the exchange rates between the USD and major world currencies. The ICE US computes this by using the rates supplied by some 500 banks.

U.S. Treasury: The ICE U.S. Treasury 20+ Years Bond Index is part of a series of indices intended to assess U.S. Treasury issued debt. Only U.S. dollar denominated, fixed-rate securities with minimum term to maturity greater than twenty years are included.

Year-over-Year (YoY): is a calculation that helps compare growth over the previous 12 months and automatically negates the effect of seasonality.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.