Nordwand Capital's Annual Outlook: Reflections on 2022 & Considerations for 2023

January 30, 2023

Executive Summary: Review & Outlook

After a year of increased volatility, uncomfortable stock and bond correlations in public markets, 40-year inflationary peaks, subsequent global monetary responses, and the probable onset of a mild recession that will impact earnings and revenue growth, the investment landscape in public and private markets has shifted for the first time in at least 15 years.

Below is an overview of Nordwand's views of the investment opportunities we find attractive in 2023, followed by a more detailed discussion of several markets and factors that are of interest. Opportunities exist within the shifting investment and macro landscape across equities, credit, and private markets owing to the changing geopolitical reality, the cost of money, and valuation dislocations experienced over the last 12-18 months.

In Brief: 2023 and Beyond

- **Limiting short-term cyclical exposure.** Nordwand takes a strategic view of asset and risk allocation, focusing on liquidity and client needs as a critical lens for determining and setting exposures. Investors should remember that asset prices in many markets – very notably equities – have never bottomed before the start of a recession. We find no reason this time should be different, and therefore propose more exposure to quality companies, dividend growth, and areas with more assured cash flows as good places to allocate. This includes areas like health care, listed infrastructure, and public REITs. The first two of these have stable cash flows and secular growth, and the last underperformed its private counterpart materially in 2022[1].

- **Increasing core bond positioning.** Nominal yields have risen across the credit spectrum, from sovereigns to high yield, but with yield spreads having moved less than in prior inflationary and pre-recessionary periods, we find investment grade and municipal credit offers attractive relative value. If the Fed and its peer central banks get the policy response to inflation right and do in fact drive it meaningfully lower in 2023 and beyond, then we expect the eventual loosening of rates policy may reveal the short-end of the curve to be well-priced at these levels. Given the difficulty forecasting whether central banks can maintain their current posture long enough to ensure no rebound to inflation in a world where globalism, international trade, and manufacturing policies have made shifts that all point to higher structural inflation, we also find prudent exposure across the duration

[1] *Private real estate performance is noted in Figure 16 of this report; public real estate – utilizing the MSCI US REIT Index – returned -24.5% in 2022, including dividend reinvestment assumption.*

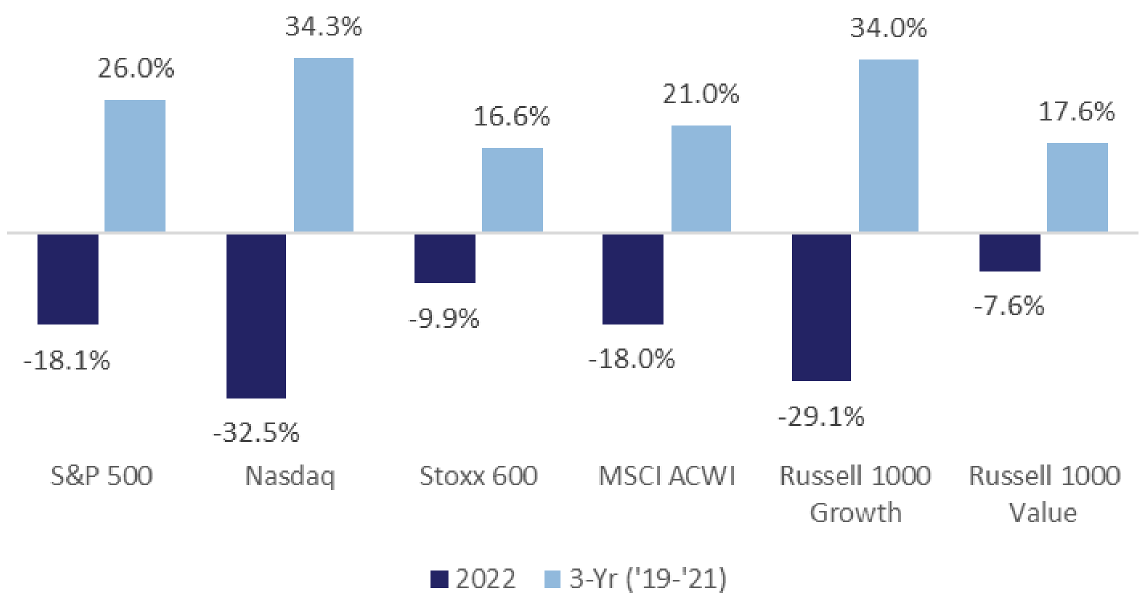
spectrum is warranted. In other words, we expect the inverted yield curve to resolve, but whether that will be due to inflation abating and the Fed changing its rates policy (i.e. the short-end of the curve comes down), or whether inflation returns, requiring more tightening and higher required yields to lend and hold credit (i.e. the long-end of the curve rises), we cannot say. This risk hedging is also consistent with our strategic, long-term view of asset allocation.

- **Selective increases to private markets.** With public markets de-rating so strongly in 2022, private markets provided a haven for many investors. The natural lag in reporting valuation changes may show that prices in many private markets are still too high, although with financing costs and required returns higher now than a year ago, that may correct in 2023. While we view private markets favorably for a variety of reasons – not the least of which is the lower implied volatility and required long-term view these investments require, and the fact that returns generated by private investments made right around the start of a recession have tended to be superior to other periods – we do find some areas more attractive than others. Two examples would be venture capital, which experienced more of a downturn in valuations in 2022 and may therefore see more appropriately priced assets; and private credit, whose nominal yield coupled with capital structure seniority present interesting options for obtaining both private and yield exposures.

The Year That Was & The Year That Might Be

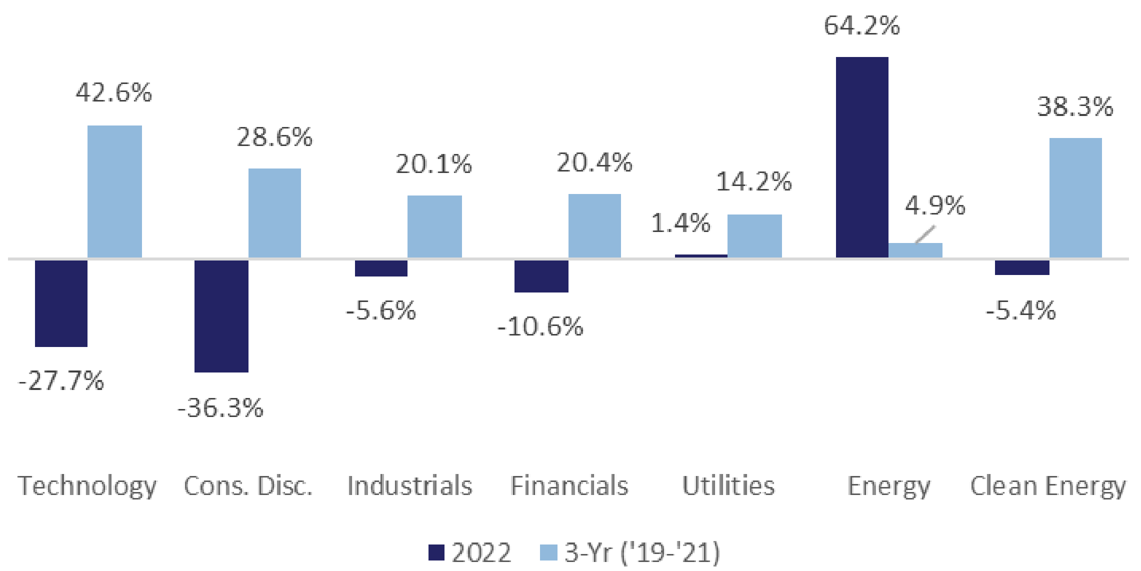
Looking back at market, macro, and policy developments in 2022 reveals a world vastly changed from the one in which investors have lived and invested over the last 10-15 years.

Figure 1: Global Equity Market Returns (2022 and 3-Year)



Source: Bloomberg, Nordwand Capital.

Figure 2: U.S. Equity Sector Returns (2022 and 3-Year)

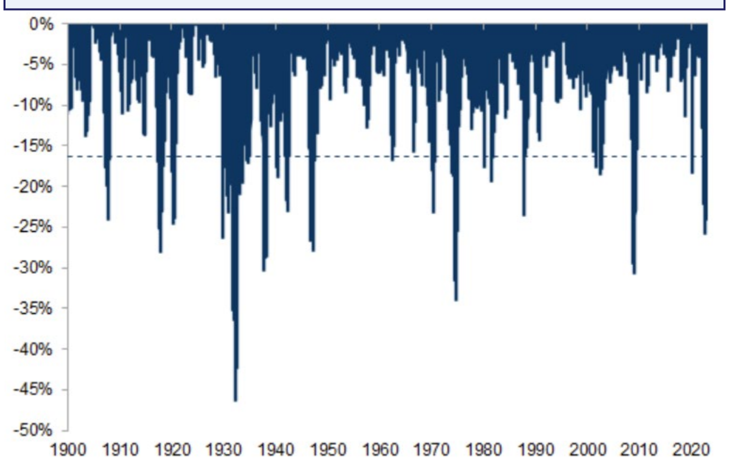


Source: Bloomberg, Nordwand Capital.

Global markets suffered a difficult 2022 (Figures 1 & 2), with selling concentrated in precisely those areas that had seen the strongest performance in the last few years. In 2022, technology underperformed its most recent 3-year annualized performance (2019-2021) by approximately 70 percentage points, while consumer discretionary and the broader Nasdaq lagged by ~65pp. Growth underperformed value by over 20pp for the year, as equities with long-tail growth risk was sharply sold in the face of steeply rising inflationary concerns and nominal interest rates.

Fixed income markets fared poorly as well, with the Bloomberg US Aggregate Bond index down 13% in 2022.

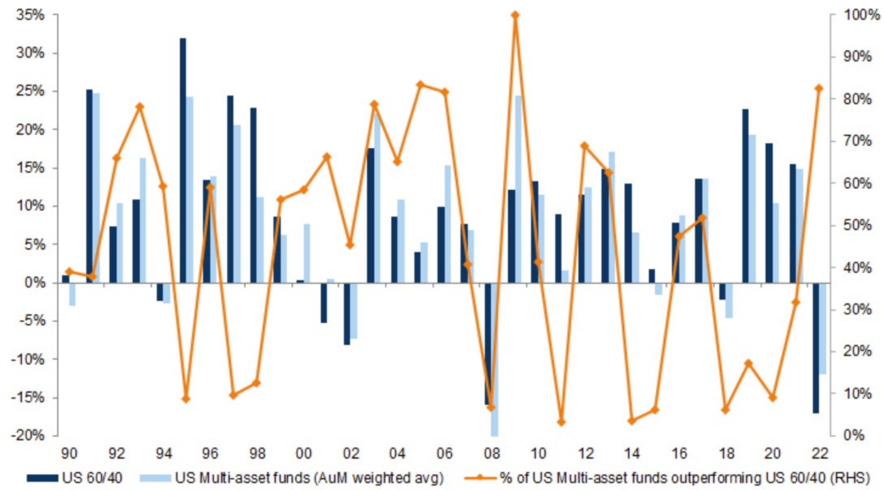
Figure 3: 12m Drawdown for 60/40 Portfolio
(monthly rebalancing)



Source: Datastream, Goldman Sachs Global Investment Research.

The net result of this strong positive correlation between asset classes meant the classic 60/40 portfolio had one of its worst drawdowns in the last 75 years (Figure 3), ending the year down 17% after clawing back some of its -26% intra-year low point.

Figure 4: Total Return Performance
(100 largest US multi-asset funds)



Source: Morningstar, Goldman Sachs Global Investment Research.

Importantly, with generic multi-asset class performance suffering from increased equity/bond correlations in 2022, the percentage of investment fund managers who outperformed in this environment rose to >80% (Figure 4). This augurs well for active performance during periods of heightened volatility, rising risk, and higher rates; and this informs our view of how multi-asset portfolios can be constructed and managed as we look into the future for Nordwand's clients.

As part of the preference cascade away from unprofitable – perhaps more charitably "pre-profitable" – growth and the pivot toward value, European equities, as exemplified by the Stoxx 600 Index, outperformed their US counterparts by a wide margin during 2022. In spite of evident

macroeconomic and geopolitical risk in Europe in the forms of 10%+ inflation across the EU and UK, the ongoing Russia-Ukraine imbroglio and the military and energy crises it represents, the fundamental valuations of European equities have been less stretched than those in the US and therefore provided somewhat of a haven.

In terms of outperformers among sectors, energy was the obvious winner. Energy equities were up close to 70% on the year, outpacing the strength in both natural gas and crude oil – the latter of which gave up the entirety of its spring and summer gains on the year as supply constraints and Russia-Ukraine worries gave way to 2023 demand outlooks and a mild start to the European winter. Strong cash flow, growing dividends, less lofty valuations, and a capital discipline from managements that was lacking during prior energy cycles gave investors reason to stay long the out-of-favor sector in 2022, a trend that may continue into 2023.

Looking at Policy: Defining "Transitory"

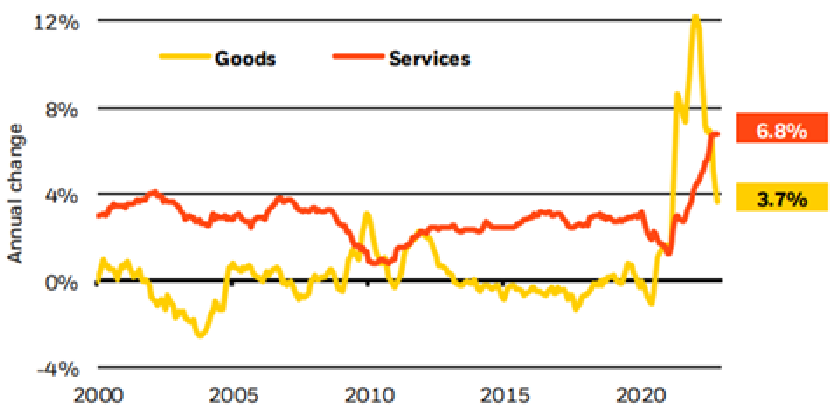
In the policy arena, developments during 2022 forced both political leaders and market participants – eventually – to reckon with the reality that inflation would be stickier than previously hoped and would in fact require a meaningful response.

As of mid-December, 33 of 37 central banks tracked by the Bank of International Settlements (BIS) had raised rates in 2022, and by a median 275bps. The Federal Reserve hiked rates at 8 consecutive meetings beginning in March 2022, ending the year at 4.25-4.50% target range. Not only is this notable because the speed of this hiking cycle exceeded any other, but it exposed a lackadaisical view in the market – and within the Fed itself – in late 2021 and early 2022 with respect to both inflation and the necessary response.

In December 2021, market participants expected the Federal Funds Rate to close 2022 at approximately 0.82% - which was 350bps below the actual outcome. Coupled with rate hikes, the Fed shifted to quantitative tightening (QT) in 2022, which is now running at a pace of close to $1 trillion per year and raising understandable questions about market depth and liquidity should selling pressures increase. Overall, global monetary supply is contracting, with the M2 money supply contracting the most since the 1940s.

Despite this monetary policy backdrop, the labor market in the US remains remarkably tight, with unemployment still at close to all-time lows at 3.5%. Household employment and the labor force both grew in the most recent readings, and wages continue to grow, albeit at a reduced annual rate.

Figure 5: U.S. Core Goods & Services Consumer Price Inflation
(2000-2022)

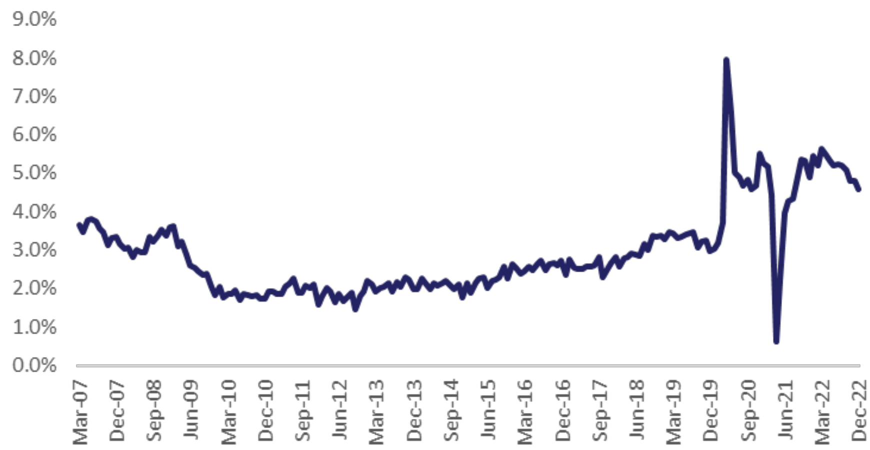


Source: BlackRock Investment Institute, with data from U.S. Bureau of Labor Statistics, January 2023.

Figure 5 highlights the sub-surface movements in the inflationary environment in the US. Goods inflation has cooled significantly, tracking a drop in demand that has filtered through to manufacturing activity (Figure 8). Some items that helped drive the goods inflation in 2022 have not only slowed but have reversed; used vehicle prices represent a good example of this trend, having risen sharply during last year but now are showing 14% declines as of December. The gradual re-opening of China's manufacturing capacity, and a mild start to winter in Europe have also contributed to this easing trend in goods and commodities.

As we noted, wage growth, and therefore services-based inflation, has been the sticky wicket in the inflationary outlook, and it remains more elevated than goods, but is also beginning to slow down (Figure 6). As wage growth and retail pricing power continue to normalize, services-based inflation will follow suit, allowing the Fed to consider less draconian measures. It is worth pointing out, however, that 1) 4.6% average hourly earnings (AHE) growth is hardly supportive of a low-inflation nominal wage environment, and 2) ~5% AHE growth still represents negative real earnings growth for workers in the US.

Figure 6: U.S. Average Hourly Earnings, Yoy (2007-Present)



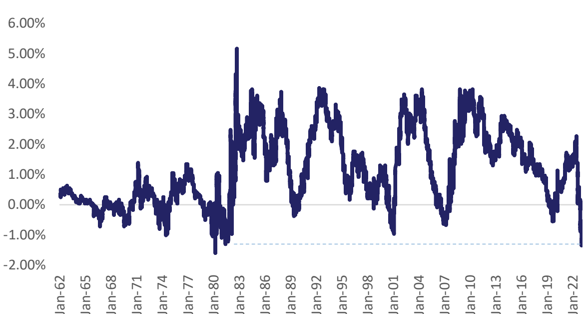
Source: Bureau of Labor Statistics, Nordwand Capital.

The Policy Shift: Will They Stick It Out… and Do They Have Any Choice?

Chair Powell has noted several times that he prefers to see meaningfully positive real interest rates – meaning nominal rates of inflation must recede below the Fed's target rate, and remain there, before he would consider cutting rates again[2]. Coupled with the strength in the labor market, we expect this will keep the Fed from being able to cut rates in 2023 unless Core PCE drops materially from its current 4.7% level.

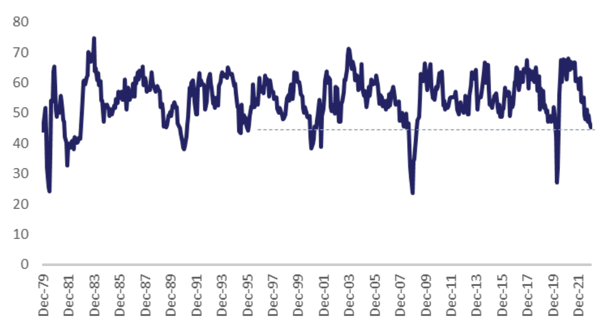
In light of these coordinated moves, the yield curve in the US is fully inverted from 3-month to 10-year US Treasury, with 3-month T-Bills offering approximately 124 basis points of higher yield than a 10-Year Treasury note (Figure 7). In addition, ISM Manufacturing New Orders (Figure 8) retreated to a level in December that it has hit just 3 times in the last 20+ years: 2020 (Covid), 2008/2009 (global financial crisis), and 2000/2001 (tech stock bubble).

Figure 7: 10-Yr Minus 3-Mo Treasury Yield Spread



Source: U.S. Department of Treasury, Bloomberg, Nordwand Capital.

Figure 6: ISM Manufacturing New Orders Index



Source: Institute for Supply Management, Nordwand Capital.

Three things about these two particular series are worth noting:

- Unlike the 2-year vs 10-year yield spread, which inverts with a bit more frequency and therefore "calls" more recessions than have actually materialized, the 3-month vs 10-year spread has shown itself a more reliable sign of economic weakness over time;
- An inversion of this degree has not materialized since the double-dip recessions of the early 1980s when nominal rates were approaching 20%;

[2] *Please see the minutes of Federal Reserve Chair Powell's November 2, 2022 press conference for an example of this language and posture.*

- The ISM New Orders series suggests manufacturing activity in the US is in a contraction at the moment, and we continue to watch this along with announced and expected layoffs to gauge labor market – and thus consumer – activity in the macroeconomy

These conditions are, of course, not dispositive of a recession, but they are strongly suggestive. For asset prices and markets, investors are currently deciding how to allocate capital in the absence of central banks propping up asset prices by continuing to grow balance sheets.

This has re-introduced some inherent volatility, curtailed risk-taking, placed a renewed emphasis on profitability rather than top-line growth, and reacquainted millions of investors with the concept of yield and income across asset classes from cash to equities. *We think this last shift in particular is salient for Nordwand's clients and supports our liquidity-oriented asset allocation approach.*

Asset Classes & Opportunities Ahead

2023 looks more uncertain to us than the last several years. In liquid markets the de-rating of valuations in nominal terms creates opportunities among those who recognize long-term pattens like mean reversion.

In private markets the combination of the naturally slower marking-to-market, along with high levels of dry powder to be invested, argue for care in choosing investments that may now look more compelling as well. Offset against this are potential value opportunities in venture capital and attractive income-producing options in private credit. Overall, choosing your investments well at these prices and at this time may turn out to be rewarding 3-5 years down the line in both listed and private markets.

Below we spend some time looking ahead at the opportunity set across equities, credit, and private markets in 2023 and beyond.

Global Equities

Figures 9-12 highlight long-term trends in forward market valuations among US, European, and global equities.

Figure 9: S&P 500 1-Year Forward P/E

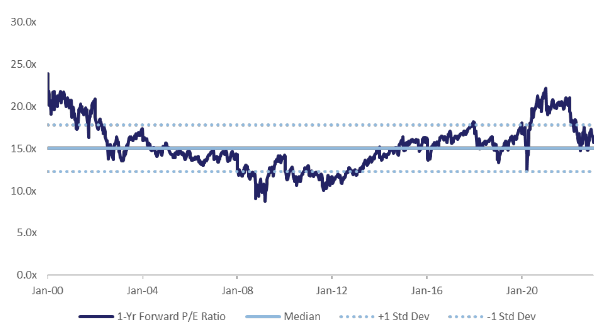
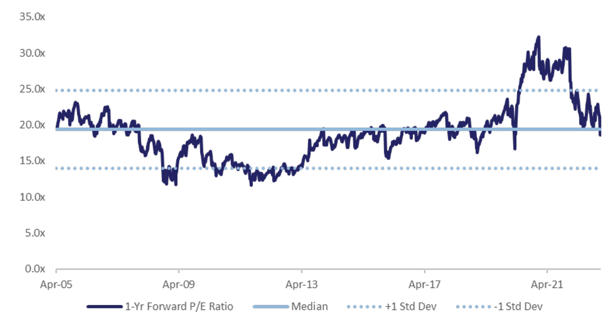


Figure 10: MSCI World 1-Year Forward P/E

Figure 11: Stoxx 600 1-Year Forward P/E

Figure 12: NASDAQ Comp 1-Year Forward



Source: Bloomberg, Nordwand Capital.

A down year for broad equity indices around the world often makes for an enviable entry point. In the case of 2022's results and their impact on 2023, we think the situation is more complicated than usual for a few reasons:

1. Valuations are not particularly cheap based on historical norms, trading only at or near long-term averages;
2. Forward earnings may have more negative revision risk, implying a more expensive market and negative short-term catalyst cycle;
3. Changing monetary policy regime – not just hiking rates, but removal of QE/central bank backstop – is a distinguishing feature of the current environment, suggesting more cautious stance on risk-taking is warranted
4. Typical recessionary patterns for markets and the economic cycle suggest the stock market bottoms ~12 months after the Fed cuts rates and the unemployment rate troughs. Further, no bear market has ever bottomed before the recession has begun.

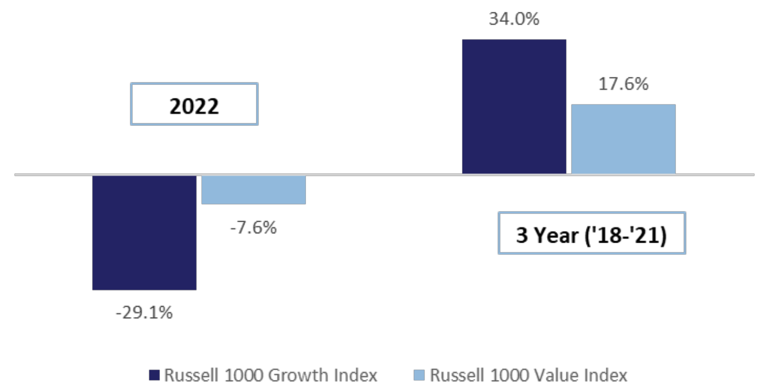
To be sure, these tactical considerations may be more applicable for traders than for investors. Counter-balancing these concerns is the long history of equity outperformance following market and economic downturns. We also take into account that this is perhaps the most-awaited recession in history. If a recession materializes and turns out to be short and mild, current positioning and expectations argue for a faster bounce in risk assets.

This is all presented with one important caveat: investors under age 40 have never contended with a market that did not benefit from central bankers' helpful hand in providing a liquidity backstop. The increase in realized risk and volatility in its absence will be worth monitoring, and could cause unexpected reactions in its wake. However, higher rates and a less active Fed/European Central Bank should also allow for a greater dispersion of returns, with investors pricing risk more appropriately and with active investors potentially entering a period where outperformance is more attainable.

The outperformance of value over growth in 2022 (Figure 13), which followed a slight outperformance in 2021 as well, was a welcome outlier in many respects. To be clear, growth is still outperforming value as an investment style over the 5- and 10-year periods by ~400bps per year.

If higher rates focus investors on the cost of growth and the cost of money, the landscape of attractive investment options may become more defined by profitable growth and cash flow generation than by top-line revenue growth.

Figure 13: Total Return: Growth vs. Value Equities



Source: Bloomberg, Nordwand Capital.

Whether this time will turn out to be different due to slower global growth prospects, more mature technology space, and more cautious investors remains to be seen. While the debate plays out, we think owning higher-quality companies, with stable cash flow generation, and managements who can deliver on their promises should a core risk-reward position for Nordwand, especially while we see whether "this time it's different."

Fixed Income & Credit

Credit markets suffered a systemic shock in 2022. While this last year offered much less acute existential threats to markets and global economies than it seemed in 2007/2008, the 10-year US Treasury nevertheless posted its first back-to-back years of negative returns in over 60 years. Even the global financial crisis presented safe harbors in terms of short-term debt and backstopped sovereigns because central banks were cutting rates and injecting liquidity to keep the system afloat in prior periods, but were unwinding those mechanisms this time.

A key risk for 2023, in our view, is complacence. Investors, many of whom haven't allocated capital without a central bank net to catch them, may be too eager to take near-term risk and therefore increase the risk of volatility spikes that carry with them margin, collateral, and liquidity risks to credit markets.

Policymakers have always struggled with how long to tighten conditions to obtain their desired outcomes, and after this prolonged period of easy money, the risks to pull back on tightening too soon and risk an inflationary return are all too keen. Add to that an investor base that genuinely does not believe the Fed will do what it says and you have the makings of rapid asset bubbles on the back of any perceived policy shift.

For example, the Fed's well-known "dot plots" – the central bankers' tool to help the market understand where they expect rates to be at certain points in time – indicate that by year-end 2023 the median Fed banker expects rates to be at ~5.1%, with an upward-bias to that figure as more Fed governors expect rates to be at or above that level than below it.

The market's expectations right now, however, are that Fed Funds rates will be at ~4.5% at year-end 2023. That ~60 basis point delta between the Fed and the market represents risk-taking willingness, lower implied cost of capital, and lack of belief that the Fed will choose to keep rates higher for longer. Unfortunately, that gap may help force the Fed's hand as it seeks to retain (or rebuild) its credibility.

Investors are therefore caught between three potential outcomes:

1. **Mild recession, inflation eases:** this is the "soft landing" outcome. The Fed hikes 2-3 more times this year and pauses; wage growth continues to slow; China re-opens and supply of

goods and labor increase across global markets; the US and EU experience a mild two-quarter recession; rates subside, with the short end of the curve coming down faster, putting the yield curve in its proper upward-sloping position; capital costs come down and lending increases… growth comes back;

2. **Mild recession (at first), inflation comes back:** this is near-term (i.e. 3-6 months) good news. Fed activity mirrors the bull case above, but inflation comes back faster as employment never fully came down, and the consumer was primed to start spending again once financial conditions (i.e. money and credit supply) returned; the Fed returns to hiking and hawkish messaging, and with renewed determination to crush inflation; wage-price spiral and simultaneous unemployment growth ensue; the consumer cuts back dramatically on spending activity; short-end of credit curve shoots up, inverts the curve, hurting short-term bond investors… deeper recession and economic pain follow;

3. **Deeper recession, inflation eases:** obvious impacts to employment and the consumer, along with negative earnings outcomes for corporates as everything de-rates; but a simpler path for fixed income investing in many ways: short-end of the curve comes down as the Fed moves to offset the recession, spreads widen as credit risk is more appropriately priced – hurting high yield relative to investment grade, and hurting duration/convexity risk

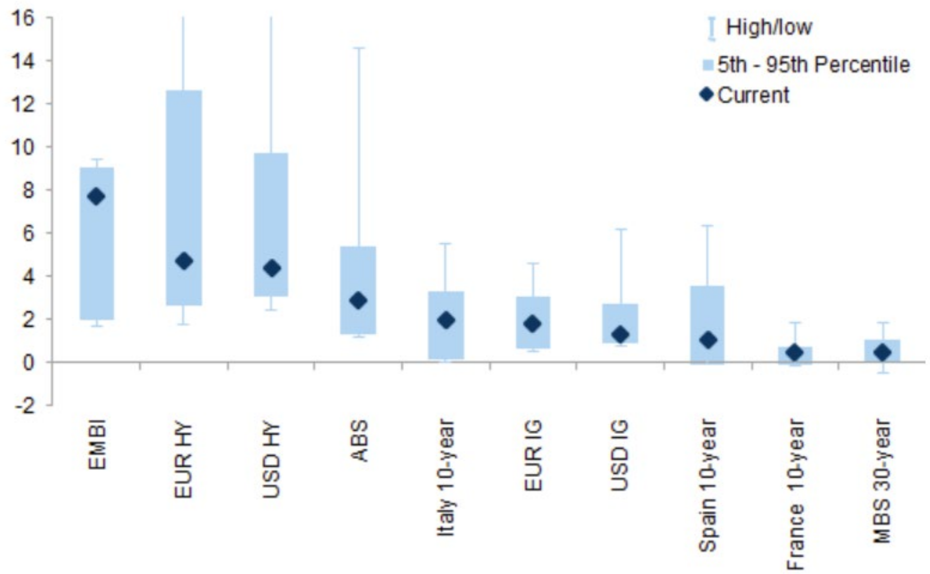
In two of these three potential outcomes, inflation eases and the short-end of the yield curve retraces and leaves solid return potential for investors without forcing much in terms of duration or credit risk. In the scenario where inflation comes back, the short-end of the curve whipsaws investors.

Nordwand's view is that higher inflation is likely going to be with us for some time. We remain skeptical that the march of globalism that brought productivity and labor cost improvements over the last 30+ years is permanently on the wane. That said, we expect that governments in the West are more aware of the strategic weaknesses of offshoring manufacturing for everything from semiconductors to pharmaceutical components and expect a rational response that includes more domestic production – or at least a more diversified supply chain.

We also tend to believe that the Fed's reaction to the market's lack of faith will provide cover to continue to with higher rates in 2023 than investors currently believe. Either way, probabilistically we therefore believe the short-end of the credit curve offers better risk-adjusted return prospects.

Looking further, yield spreads for European and U.S. high yield debt (Figure 14) have not increased much off their cycle lows, and we don't believe investors are being paid very well for the incremental risk. This is true for much investment grade debt as well, reflecting the reality that corporates generally are better equipped to handle credit and macro disruptions than they were in 2008, as most corporate leverage is lower than 2007/2008, counterparty risk is better, banks are better capitalized, and therefore not nearly as large a risk to trigger default/liquidity crises.

Figure 14: Various Credit Spreads vs. U.S. Treasury



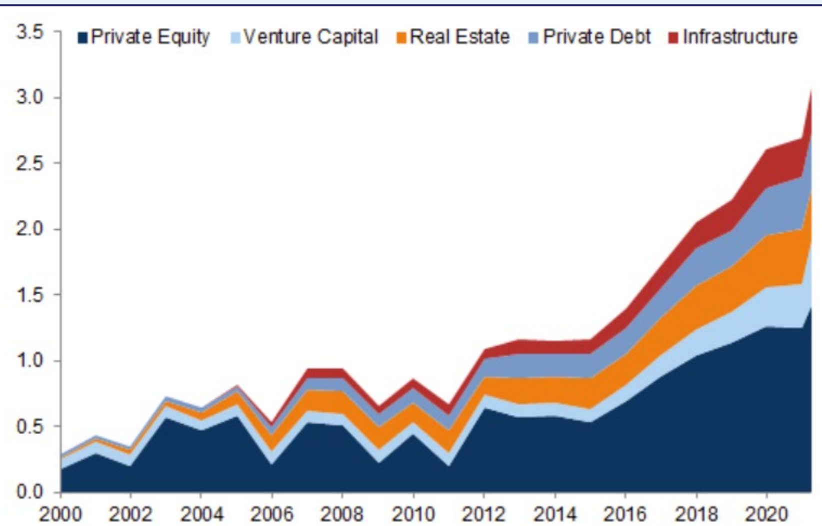
Source: Datastream, Haver Analytics, Bloomberg, Goldman Sachs Global Investment Research. Data since 1998.

Overall, our preference is for lower duration and higher credit quality as a relative value and return exercise, as adding duration to bond portfolios here requires a view that central banks will defeat inflation – a view we believe with ~65% confidence, but not necessarily enough to be overweight that particular exposure at this point in time. However, we recognize the higher absolute yields on offer across the high yield and private/direct credit landscapes at the moment and see those are opportunities to explore with Nordwand's families as we move into 2023.

Private Equity & Venture Capital

Allocations to private markets are at an interesting inflection point. Fundraising has remained brisk, while deal-making activity slowed in 2022, owing both to a disconnect in valuations between private buyers, sellers, and investors, as well as rising required returns and financing rates as nominal interest rates rose throughout the year.

Figure 15: 'Dry Powder' in Private Markets (US$ in trillions, global)

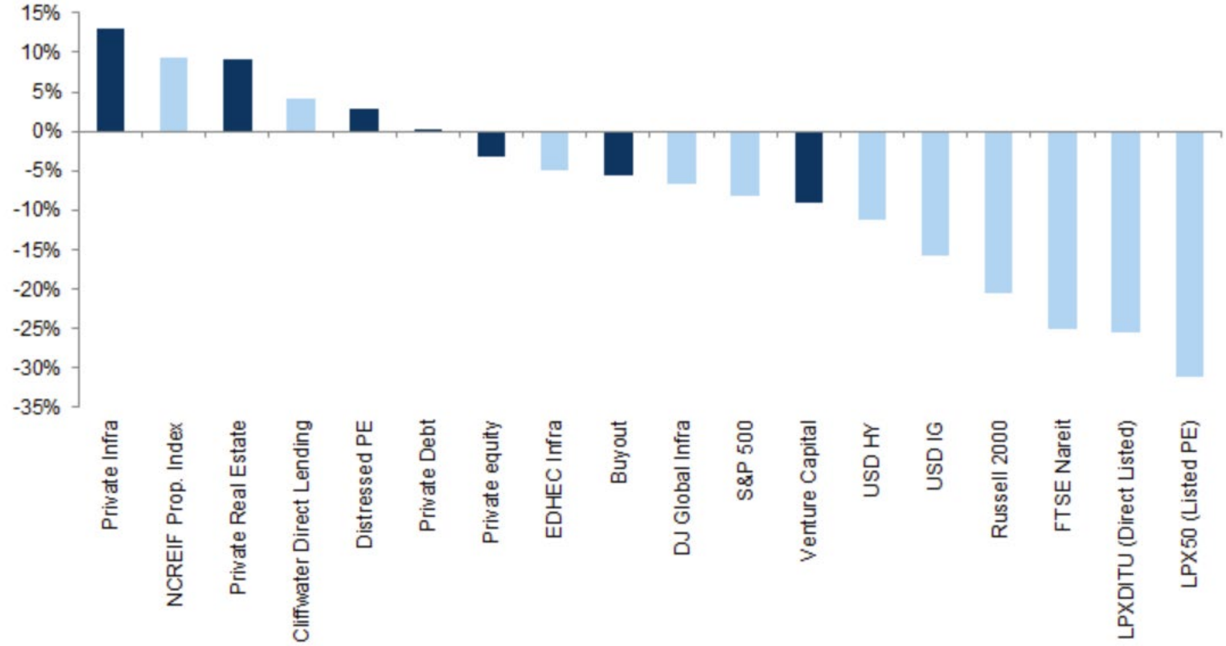


Source: Preqin, Goldman Sachs Global Investment Research.

This has led to a sizable amount of dry powder (Figure 15) waiting to be called and invested, providing important context with respect to the amount of capital sitting on the sidelines waiting to be deployed and its potential impact on prices paid.

Nevertheless, there are sizable pockets of opportunity, driven by 1) valuations, 2) cyclical history of returns, and 3) secular investing trends in capital markets.

Figure 16: 2022 Private Asset Performance (as of Sept. 2022)



Source: Haver Analytics, Preqin, Goldman Sachs Global Investment Research.

On the first of these pockets, Figure 16 reflects the wide range of private asset performance through 3Q22. We think the relative weakness of venture capital, which is more levered than most assets to the long-tail impact of inflation and interest rates, marked a much-needed breather for this asset class.

Private real estate, distressed private equity, and private infrastructure all performed well in 2022, but for different reasons. Private real estate's long-term leases provide cash flow protection during short drawdowns, although we remain wary of the post-Covid/post-Amazon trends in sizable components of the private real estate asset base and remain diligent when contemplating incremental investment in those specific real estate segments.

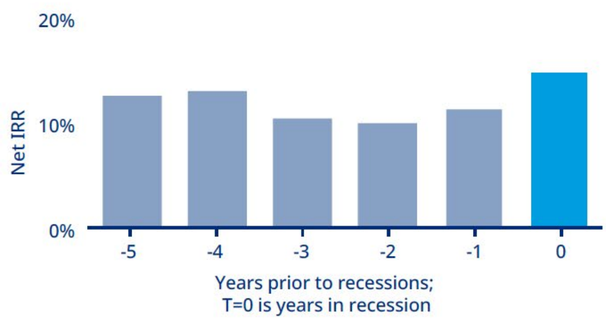
Distressed private equity had the distinct advantage of representing a value sector within private investing that mirrored the outperformance of value investing in public markets. As such we see this outperformance as reflective of its positioning and valuation fundamentals.

Private infrastructure outperformed for some of the same reasons as private real estate, albeit with stronger underlying fundamentals. Like real estate, its cash flow streams are driven by monopoly-like businesses either owned outright or granted operational authority under very long-term concessions (i.e. generally 30 years or longer). Unlike real estate, the utilization of the infrastructure assets is not seeing a decline in use – in fact, the reverse is generally true. Capital allocation into infrastructure provides a secular tailwind underpinned by the twin factors of increasing digital and clean energy investments.

That all said, when private and public assets tied to the same underlying asset diverge in performance as dramatically as they did with infrastructure and real estate in 2022, investors often look at that divergence as an opportunity to allocate capital to the laggard.

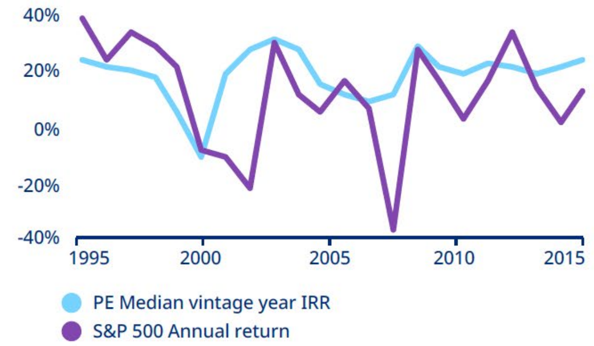
In spite of the tactical considerations raised above and their impact on our recommendations and our view of opportunities, the timing for broadly making allocations to private equity is fortuitous when viewed through a historical lens (Figures 17 & 18).

Figure 17: Private Equity Vintage Performance (average of median net IRRs)



Source: Schroders, based on data sourced from Preqin. Based on analysis of vintage years from 1980-2009. Recessions: 1980-1982, 1990-1991, 2001, 2007-2009

Figure 18: Private Equity IRR vs. S&P 500 (1995-2015)



Source: Hamilton Lane and Thomson Reuters Datastream,

If returns follow their historical trend through this cycle, then committing to 2023 and 2024-vintage private equity may benefit from a cyclical tailwind as we move through a moderate recession and into a period of growth – even if we think that eventual growth is likely to be subdued.

Summary

After almost two decades of free money providing decreasing financing costs and discount rates that disproportionately favored growth investments, the combination of market and geopolitical forces is shifting, with higher structural real and nominal interest rates and slowing global trade and growth an increasingly likely reality. Dividends, credit, and value all look more interesting from a return perspective than they have in years. Recognizing that trends emerge and fade constantly in asset markets, Nordwand nevertheless sees opportunity to increase allocations in some of these areas of the market with an aim of providing appropriate diversification and strong investment outperformance for its clients and their families.

IMPORTANT DISCLOSURES:

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Nordwand Advisors, LLC ("Nordwand"), or any non-investment related content, made reference to directly or indirectly in this market summary will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this market summary serves as the receipt of, or as a substitute for, personalized investment advice from Nordwand. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Nordwand is neither a law firm, nor a certified public accounting firm, and no portion of the market summary content should be construed as legal or accounting advice. A copy of Nordwand's current written disclosure Brochure discussing our advisory services and fees is available upon request or at www.nordwandcapital.com.

Please Note*: If you are a Nordwand client, please remember to contact Nordwand, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. Nordwand shall continue to rely on the accuracy of information that you have provided.* ***Please Note****: IF you are a Nordwand client,* ***Please advise us*** *if you have not been receiving account statements (at least quarterly) from the account custodian.*