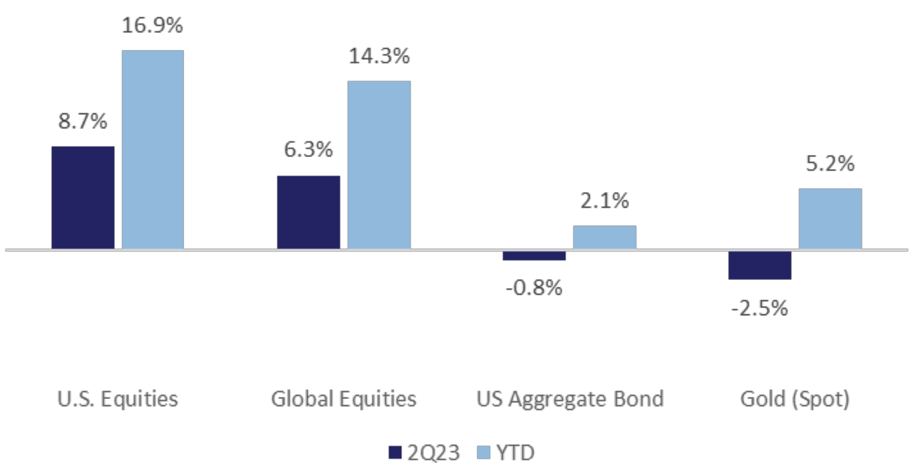
Second Quarter 2023
Market Commentary

July 19, 2023

Best. First Half. Ever?

At the halfway point in 2023 markets and the economy are sending a mixed message. Equities, in particular U.S. mega-cap growthy companies, are moving forward as if it were 1998-1999, the current Federal Reserve chair were Alan Greenspan and we were all talking about "irrational exuberance" and "Goldilocks." Credit markets, on the other hand, have been more circumspect. The Bloomberg U.S. Aggregate Bond Index is barely changed over the first half, while U.S. Treasury yields for the 2-year note are ~35 basis points (bps) higher and effectively unchanged for the 10-year. The yield curve remains inverted – suggesting a difficult environment for credit creation that historically has proved a harbinger of economic slowdowns and eventual recession.

Figure 1: Multi-Asset Returns
(2Q'23 vs YTD)



Source: Bloomberg, Nordwand Capital as of 6/30/2023.

Economically, the U.S. remains positioned at a cyclical and policy crossroads that ought to end in predictable fashion – with a cyclical recession; but as the year slides by the odds of a soft-landing become more firmly entrenched among market participants and commentators. In fact, the resilience of the economy – labor markets, corporate earnings, consumer confidence – has been the elephant in the room for the last six months.

Figure 2: Consumer Price Index (1962-Present)

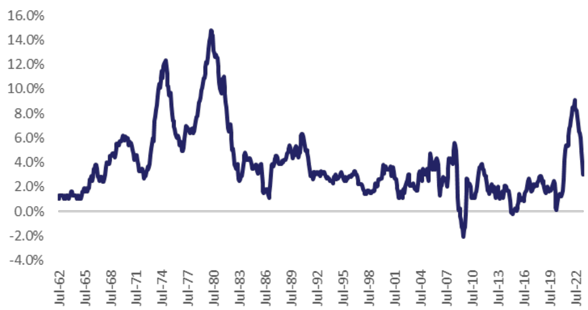


Figure 3: Core Personal Consumption Expenditures Index (1962-Present)

Source: Bloomberg, Nordwand Capital as of 6/30/2023.

The Fed began its current hiking cycle in March 2022, which has helped drive headline inflation, in the form of the Consumer Price Index (CPI), from 6.5% at the beginning of the year to 3.0% in June (Figure 2). At the same time, core inflation – using the Fed's preferred measure of Core Personal Consumption Expenditures Price Index (Core PCE) – has remained stubbornly elevated at 4.6% for its most recent measure (Figure 3). This is the same level Core PCE showed in December, as factors like food and, more critically, labor remain elevated. The visual of the Core PCE reading in Figure 3 may be illuminating here and help serve as a reminder that core inflation readings at this level have not been seen since the late 1970s.

Average hourly earnings (AHE), an important input for core inflation, remain stuck at 4.4% and have been coming in above 4% since July 2021. Notably, since April 2020 when the economy began digesting Covid, year-over-year AHE have increased >4% in 36 of 39 months. This has led to a 20% nominal growth in labor costs over the last three years for an average employer in the U.S. This is not an insignificant source of stress on job creation and small business profits.

A final note on headline inflation for our clients to bear in mind: Headline inflation in June 2022 was 9.1% - a reading we hope will prove to be the top reading during this cycle. Headline inflation began to retreat during 2H'22, and the highwater marks from 2022's spikey first half have laid the groundwork for the favorable year-over-year comparisons we have observed thus far in 2023. That said, the base effects of last year's ebbing should start to show up in 2H'23, implying that June's headline CPI of 3.0% may mark the low point for 2023 inflation readings. For this reason, and the fact that the Fed reacts more directly to Core PCE, we view the latter measure as more relevant in our analysis of price levels and the Fed's reaction function.

In the face of these somewhat divergent readings, it remains our expectation that the Fed will hike rates 25bps at its July 26th meeting, and then once again pause to observe labor market developments.

Overall, we think liquid risk assets have priced in a soft landing at this point. Leading indicators in the U.S. economy have been flagging even while lagging indicators like employment remain strong. Coupled with less liquidity stemming from fiscal policy, ongoing tightening in monetary policy, and limited breadth in equity market returns, we think risk management is critically important over the second half of the year. Trimming exposures and winners in pricey markets and sectors to diversify among lagging sectors, regions, and asset classes is, in our view, the prudent path forward.

Equities: When You're Hot, You're Hot. As we look at equity markets through 1H'23, the story is very similar to the one we related to clients after 1Q'23. In Figure 4, we note that large cap technology-levered companies with secular growth stories, along with stocks linked to the endurance of the U.S. consumer once again were the market's strength, providing most of the nominal returns for equities YTD. On the other end of the spectrum, energy and utilities have been negative YTD; near-term cyclical risks to commodity prices in a slowing global economy and elevated interest rates as alternative allocation options have hurt energy and utilities, respectively. Growth has once again outperformed value (Figure 5) as the optimism trade continued through the first half.

If markets grow less sanguine about the economic outlook, we would expect value to outperform growth and for market breadth to expand as we move out of an economic trough. In the meantime, we remain wary of pricey U.S. equities at this point in the cycle – and especially after such a strong bounce off 4Q'22 lows. We also continue to see value in some international markets and smaller cap stocks, both of which have lagged for some time versus their larger and U.S.-based peers.

Small caps, in particular, have underperformed large caps (Russell 2000 vs. Russell 1000 indices) every year since 2016 as the mega-cap narrative has taken hold. Over time, however, smaller more dynamic companies have been the source of greater earnings and cash flow growth. While we would expect more exposure to economic growth and interest rates from small caps to pose headwinds in the short-term, we also wonder if these risks aren't better priced into these companies than the near-perfection we see priced into their larger-cap and tech/consumer-oriented peers. As with everything, it's not just about absolute opportunities and risks, but what the market is discounting and therefore where the best risk-adjusted value lies.

Figure 4: U.S. Equity Sector Returns
(2Q'23 vs YTD)

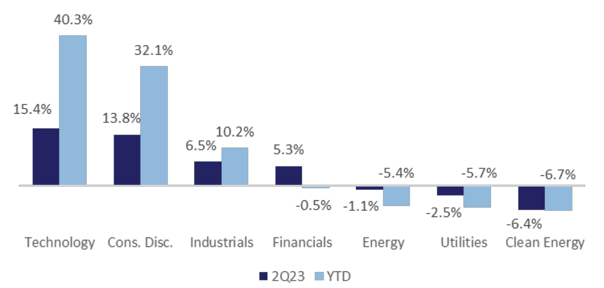
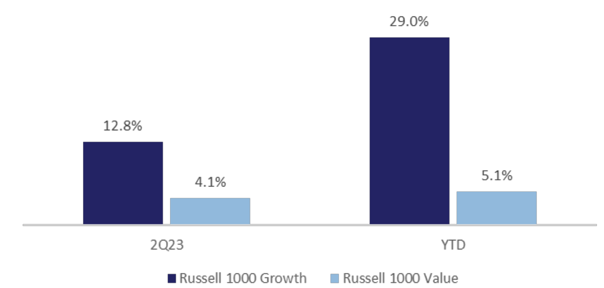


Figure 5: Growth vs. Value Equity Returns
(2Q'23 vs YTD)



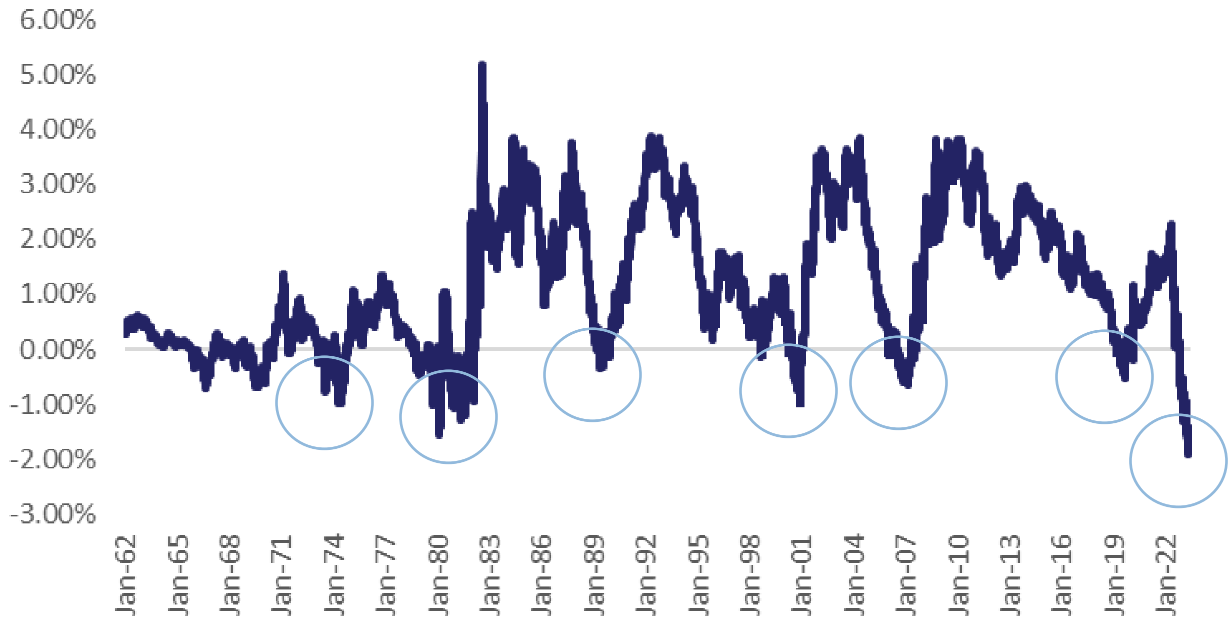
Source: Bloomberg, Nordwand Capital as of 6/30/2023.

Credit Markets Awaiting Cyclical Shift. Yields and credit spreads have vacillated wildly to start the year, and yet at the end of June yields, spreads, and returns across many credit sectors were largely unchanged from year-end 2022. The one divergent item is high yield credit spreads, which actually have come in over time, indicating less fear about widespread credit defaults among high yield issuers.

Monetary policy decisions have been the dominant factor in credit market performance over the last 12-18 months, with the Fed and European Central Bank both appearing to be close to the end of their respective tightening cycles. These moves have led to inverted yield curves (Figure 6) that have been the topic of much discussion. Going back more than 50 years, an inversion of the 3 Month-10 Year Treasury yield curve has always presaged a recession. We have discussed in the past the potential folly of believing 'this time it's different,' and we recognize that our expectations may lead us to being a bit overcautious in the short-term. Playing the odds, however, makes this feel like the appropriate position to take.

As we have noted before, we see value in short- to intermediate-term credit tenors in the event we reach an end to hiking activity while economic slowdowns ensue. The typical response pattern following these activities has been buying activity in the short end of the yield curve that drives bond prices higher and yields lower, bringing the curve back into its typical upward-sloping shape as investors reduce portfolio risk by shifting from longer-duration bonds and equities to account for the possibility of recession.

Figure 6: 10-Year Less 3-Month Treasury Yield
(1962-2Q'23)



Source: U.S. Treasury, Bloomberg, Nordwand Capital as of 6/30/2023.

After a brief unwind of the Fed's quantitative tightening (QT) regime to support markets in the wake of the March bank failures, the Fed is back on the QT path, and we expect this to continue. As a reminder, the Fed's balance sheet (i.e. the assets the Fed has purchased as a method of injecting direct liquidity into the economy in addition to its interest rate-setting practices), had ballooned to $9 trillion by the end of 2Q'22. This was up sharply from $7.4 trillion at the end of 2020, $4.2 trillion before Covid struck, and less than $1 trillion before the 2008 global financial crisis. So, while the unwind that is underway is a welcome maneuver, the Fed would need to remove another $4 trillion in liquidity from the market to return just to pre-Covid levels. To-date, it has only made reductions of about $700 billion from peak; there is a long way to go if the Fed is serious about reducing its influence on capital markets, valuations, and risk-taking. As this behavior has influenced an entire generation of investors, we remain skeptical the Fed will have the wherewithal to maintain this approach. We will continue to watch it closely as it has enormous potential to impact the pricing of risk in markets.

Figure 7: U.S. Private Equity Deal Activity

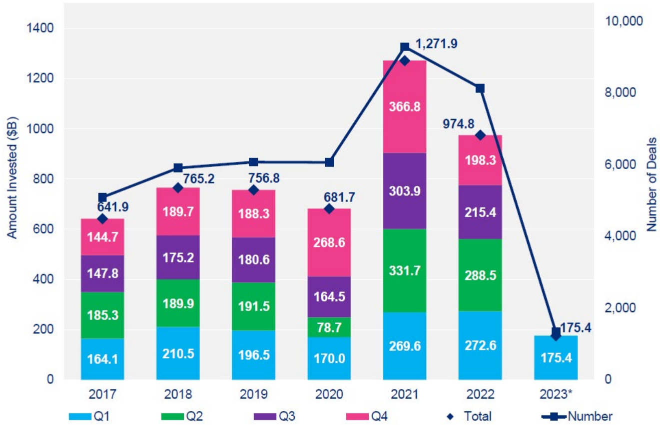


Figure 8: U.S. Private Equity Exit Activity

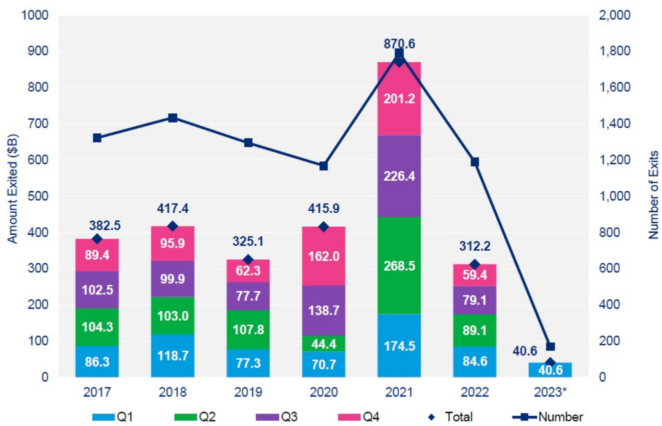
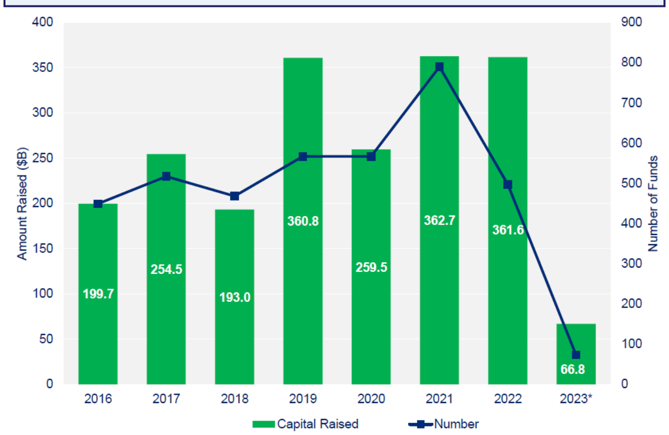


Figure 9: U.S. Private Equity Fundraising



Source: Mercer, PitchBook Nordwand Capital as of March 2023.

Private Markets: A Shifting Market Yielding Investment Opportunities. As we have noted for clients in the past, private equity and debt markets have seen impressive growth over the last 10-20 years, with an increasing number of companies opting to stay private longer or eschew going public altogether. Coupled with lower implied volatility owing to delayed marking-to-market for many investments in this space, investors have funded this capital market shift, first larger institutions and then endowments, foundations, and wealthy families.

The pace of deal-making activity spiked dramatically in 2021 and 2022, spurred on by extremely cheap debt financing and a deluge of investor capital. These conditions reversed abruptly in the second half of 2022 and have continued into 2023. Equity return requirements and cost of debt, coupled with lower valuations forcing a reappraisal of fundraising activity have changed the landscape.

As our clients will be aware, Nordwand has been a proponent of private allocations, and we find this current environment particularly fertile ground for finding attractive bargains for three reasons. *First,* while fundraising has been down, the number of funds has been down as well – implying that the diminished fundraising is concentrated among larger funds whose size forces them to make larger investments (Figure 9). *Second,* exit activity has dropped to the lowest level since 2013 (Figure 8), suggesting a rising need for private funding options while public capital markets remain more challenging to access. *Third,* ample anecdotal evidence has accumulated that private equity and venture capital funds find investing in smaller and pre-profitable companies too risky in the current fundraising and deployment environment. Taken together, these conditions are favorable for the kinds of investments Nordwand has already made and intends to seek in the future.

Summary

Public markets have been robust in the first half of the year. Risk appetite – whether measured as equity valuations, yield spreads, or consumer confidence – has remained strong. The market increasingly believes we will escape this cycle without a recession, or in any event an extremely mild and short recession of the type that could be termed a 'soft landing.' After 15 years of the Fed and U.S. Treasury providing unprecedented fiscal and monetary stimulus every time the economy encountered a rough patch, we think the confidence of market participants is entirely understandable.

That said, we also feel the market is not pricing in any meaningful downturn in the economy, and remains focused on reductions in headline inflationary measures and backward-looking indicators like employment to convince itself that the risks are small of an actual recession to catalyze a necessary re-pricing of risk. The consumer confidence arising from labor market strength and ebbing topline inflation we think will force the Fed to stay on its 2% inflation target long enough to slow the economy much more than is currently expected. It is from this dissonance that market corrections are created, and for this reason we remain hopeful, but cautious.