Trail Guide to 2023 Asset Class Performance

QUARTERLY LETTER FROM THE DIRECTOR OF RESEARCH

JAN 2023

As winter takes hold in the northern hemisphere, there are those that choose to escape to warmer climates and those that embrace the season and choose the mountains. Anyone familiar with downhill skiing knows that every ski trail is marked with a shape and color to designate its difficulty. For those unfamiliar with these ratings, the North American system looks like this:

EASY MORE DIFFICULT MOST DIFFICULT

Of course, weather and trail conditions can also impact a trail's difficulty and must be accounted for when turning down the mountain: Environment and terrain matter. Similarly, investment prognostications must recognize the current setting. By now, the environment is all too well known: High inflation, aggressive Fed policy, Russia–Ukraine war, labor supply shortages, and a potential recession. These topics have been covered extensively in recent letters and continue to loom over markets as we start 2023. At a high level, general consensus is that the majority of rate hikes from the Fed are behind us (two are expected for 2023 at time of writing), and inflation will continue to normalize in 2023, thus further supporting the thesis of fewer rates hikes from the Fed over the next year. If a recession comes to fruition, expectations are for it to be short-lived and shallow which reduces the long-term threat to markets.

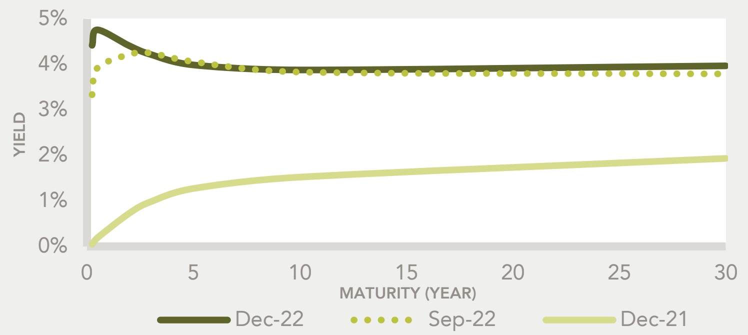
With this backdrop in mind, we turn our attention to an asset class by asset class outlook for the coming year, assessing the degree of difficulty for each to deliver positive returns in 2023. In some cases, the difficulty will change as the year goes on — similar to trails that are "Most Difficult" for the first half and become more palatable as the journey goes on…which brings to mind a certain trail in Utah that the author found himself on last year that literally had him over his skis…but I digress. Tighten your boots and click into those skis!

THE WARM-UP RUN:

If only every trail was this easy!

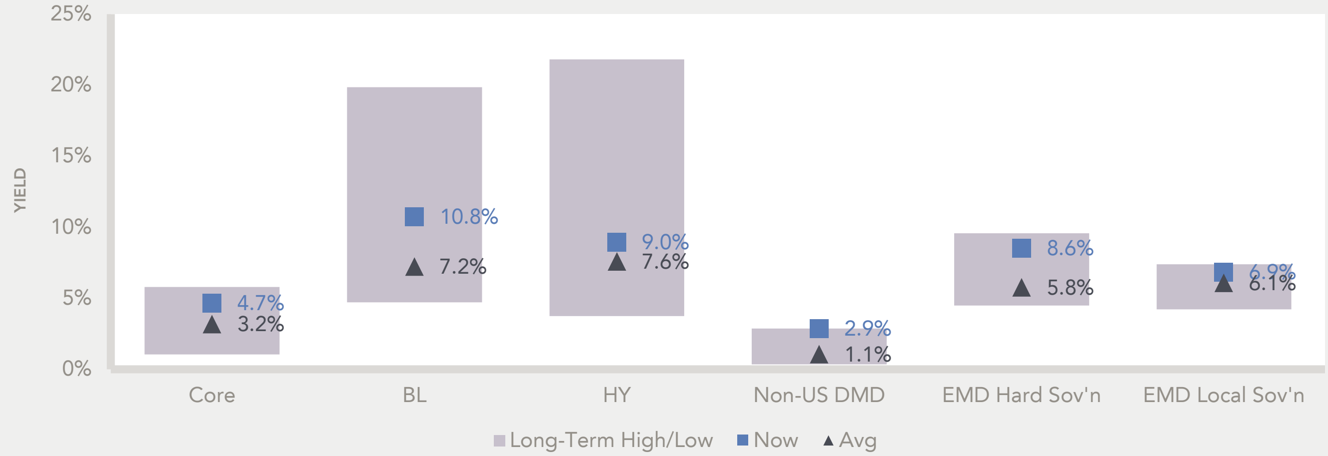
Following the massive movement in rates during 2022, fixed income has finally gotten its last name back…Income. Yields for almost all sectors of the asset class currently sit above their long-term averages *(see chart on next page)* and should more than offset any further rate increases that can drive price depreciation (the dynamic that pushed returns so negative in 2022 because starting yields were so low). Furthermore, rate hikes are expected to slow this year so there will be less price pressure from rising yields. We expect the majority of fixed income sectors to resemble "groomers" — smoothed trails that offer the least resistance and difficulty — when it comes to portfolios in 2023.

YIELDS ROSE SIGNIFICANTLY IN 2022



Source: Federal Reserve as of December 31, 2022

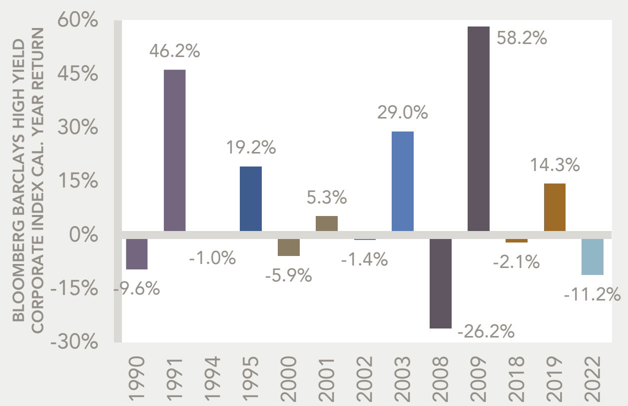
FIXED INCOME YIELDS ARE ABOVE LONG-TERM AVERAGES TO START THE YEAR



Source: Bloomberg, Credit Suisse, Deutsche, JPMorgan as of December 31, 2022. Long-term high, low, and average based on longest available data for each index.

That said, even the smoothest slopes are not without their bumps ("moguls") and when it comes to fixed income, the most likely source of imbalance is usually the below-investment grade market. Indeed, there was an uptick in defaults last year and expectations are for the trend to continue over the next two years. However, it is worth noting how low defaults have been over the last decade (2020 notwithstanding) and that future projections are not expected to meaningfully exceed long-term averages. Finally, it is also worth noting that the high yield index has never delivered consecutive years of negative returns and it would come as a great surprise if 2023 bucked this trend.

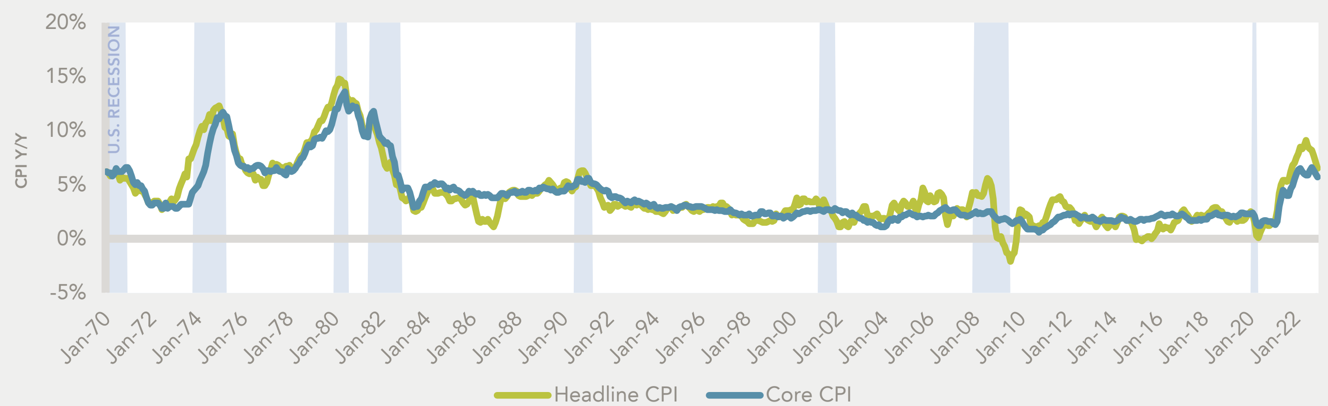
HIGH YIELD PERFORMANCE AFTER A NEGATIVE YEAR



Source: Bloomberg as of December 31, 2022

Assuming there is not a(nother) flurry of unexpectedly high inflation — which given recent readings should continue to fade — the run through fixed income this year is expected to be relatively smooth and predictable for investors.

INFLATION CONTINUING TO EASE



Source: Bloomberg, Bureau of Labor Statistics, Federal Reserve Bank of St. Louis as of January 12, 2023

THE PULSE QUICKENS:
Hopefully not a repeat of 2022's yard sale

Image via Reid Neureiter, Flickr

For those unfamiliar with the term, "yard sale" is used to describe one of those head-turning falls when a skier's skis, poles, helmet, goggles, and other gear are scattered across the trail — not unlike items strewn on the lawn at a yard sale. The image at right offers a pretty good summary of what equity returns looked like in 2022. Can we avoid another tumble in 2023?

To be clear, equity markets by their very nature are inherently risky and will always present greater realized volatility; even the most supportive economic backdrops will feature negative months and material corrections within a calendar year. Looking over the ledge before dropping down any diamond ("black") trail will quicken the pulse and heighten the senses; assessing the relative volatility and wide range of outcomes for equity returns in any year is a comparative exercise for investors and why equities will always be characterized as the most difficult, regardless of overall market environment. That said, here is how we see the terrain for equities.

U.S. EQUITIES

From a "top of the mountain" view, the prevailing valuations for equities suggest they are fairly priced, with the exception of small-caps, which appear notably attractive versus long-term history.

U.S. EQUITY VALUATIONS

	S&P 500		Russell 1000		Russell Mid Cap		Russell 2000	
VALUATION METRICS	CURRENT	HISTORICAL PERCENTILE (%)	CURRENT	HISTORICAL PERCENTILE (%)	CURRENT	HISTORICAL PERCENTILE (%)	CURRENT	HISTORICAL PERCENTILE (%)
P/E	18.1	47	17.7	43	15.8	11	11.7	2
Forward P/E	16.4	68	16.5	66	15.7	58	12.0	6
P/B	3.9	81	3.7	84	2.9	89	2.2	56
P/S	2.3	89	2.1	85	1.5	77	1.1	58
P/CF	12.9	60	13.0	62	12.6	79	11.4	24
EV/EBITDA	12.9	76	13.1	78	12.8	71	12.6	57
Average		70		70		64		34

Source: Bloomberg. TTM P/E is adjusted for negative earnings. Small-cap forward P/E is adjusted for negative earnings. Percentiles are based on data Jan. 1995 – Dec. 2022

While this could support outsized returns for small-caps, the other capitalization figures do not offer tremendous insight, particularly over shorter time periods. However, we can point to more focused shorter-term data that provides some meaningful optimism for U.S. equities in 2023. More specifically, if we consider the absolute performance in 2022 coupled with one of the biggest drivers of it — historically high inflation — past data suggests that the next year might look a lot different.

RETURNS FOLLOWING PEAK INFLATION

INFLATION PEAK	CPI (%)	NEXT 12 MO RETURN (%)		NEXT 36 MO RETURN (%)	
		S&P 500	RUSSELL 2000	S&P 500	RUSSELL 2000
Jan-70	6.2	17.0		14.6	
Dec-74	12.3	37.2		16.4	
Mar-80	14.8	40.1	72.1	20.7	33.5
Nov-90	6.3	20.3	40.6	16.2	27.4
Jun-22*	9.1	2.3	3.9		

Source: Bloomberg, Bureau of Labor Statistics as of December 31, 2022.
*Returns July 1, 2022 through December 31, 2022.

However, equities would not be characterized as the most difficult if they didn't present their fair share of moguls, and although inflation and by extension interest rate hikes are poised to fade — particularly in the second half of the year — earnings estimates are still under pressure. At the end of the day, meaningful growth in equity prices is best supported by earnings growth that at least meets — if not exceeds — expectations, and reductions to earnings estimates threaten to upend returns. Similarly, a reversal of the downward inflation data or supply chain improvements will assuredly exacerbate market volatility and exert downward pressure on prices.

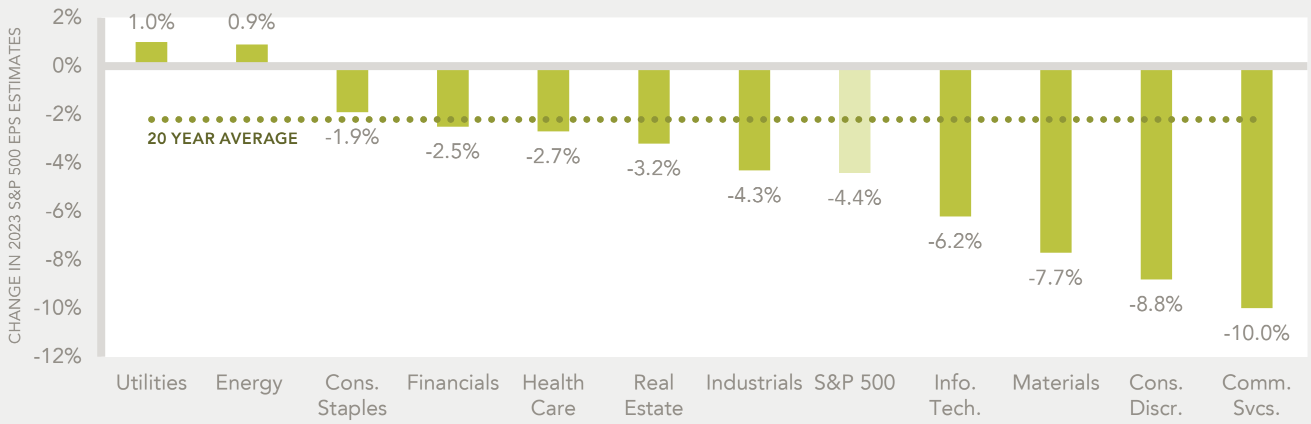
RECOVERY AFTER A NEGATIVE YEAR

S&P 500		
	CALENDAR YEAR RETURN (%)	NEXT YEAR RETURN (%)
1981	-4.9	21.5
1990	-3.1	30.5
2000	-9.1	-11.9
2001	-11.9	-22.1
2002	-22.1	28.7
2008	-37.0	26.5
2018	-4.4	31.5
2022	-18.1	
	Average	15.0

RUSSELL 2000		
	CALENDAR YEAR RETURN (%)	NEXT YEAR RETURN (%)
1984	-7.3	31.0
1987	-8.8	25.0
1990	-19.5	46.0
2000	-3.0	2.5
2002	-20.5	47.3
2008	-33.8	27.2
2011	-4.2	16.3
2015	-4.4	21.3
2018	-11.0	25.5
2022	-20.4	
	Average	26.9

Source: Bloomberg as of December 31, 2022. Includes years with returns less than -3%.

EARNINGS ESTIMATES UNDER PRESSURE



Source: FactSet as of January 6, 2023

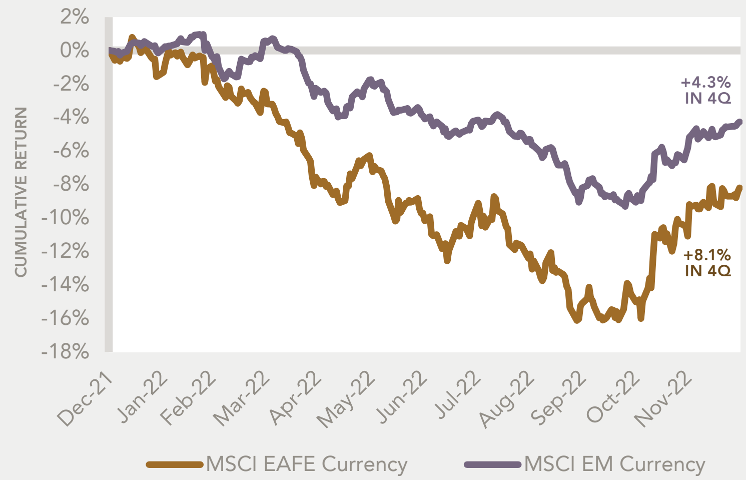
◆ NON-U.S. EQUITIES

Beyond the dynamics discussed for U.S. equities — which are equally relevant for non-U.S. equities — it is worth pointing out some additional forecast items that could impact non-U.S. performance.

One of the additional challenges faced by non-U.S. equity investors is the impact of currency on returns. As the Fed implemented aggressive rate hikes in 2022 — especially compared to most other central banks across the world — the dollar soared, with a bit of a give-back in the fourth quarter *(see chart on next page)*. Nonetheless, the overall strength of the dollar last year compounded the losses for dollar-based investors. Looking forward, though, non-U.S. central banks are catching up as the Fed starts to reduce both the frequency and magnitude of rate hikes; ultimately, this should further slow the rise of the dollar and simultaneously remove one of the primary obstacles for non-U.S. equity returns from 2022.

With further rate increases expected across the globe, it is not surprising that GDP forecasts continue to fall. Similar to what has happened in the U.S., higher interest rates are a detriment to growth simply because it is more expensive to borrow money to finance growth. It will be worth monitoring recession outcomes across the world in terms of duration and magnitude, with the "less is more" preference for any recession. Any rebound to growth projections should have an accretive impact on equity returns.

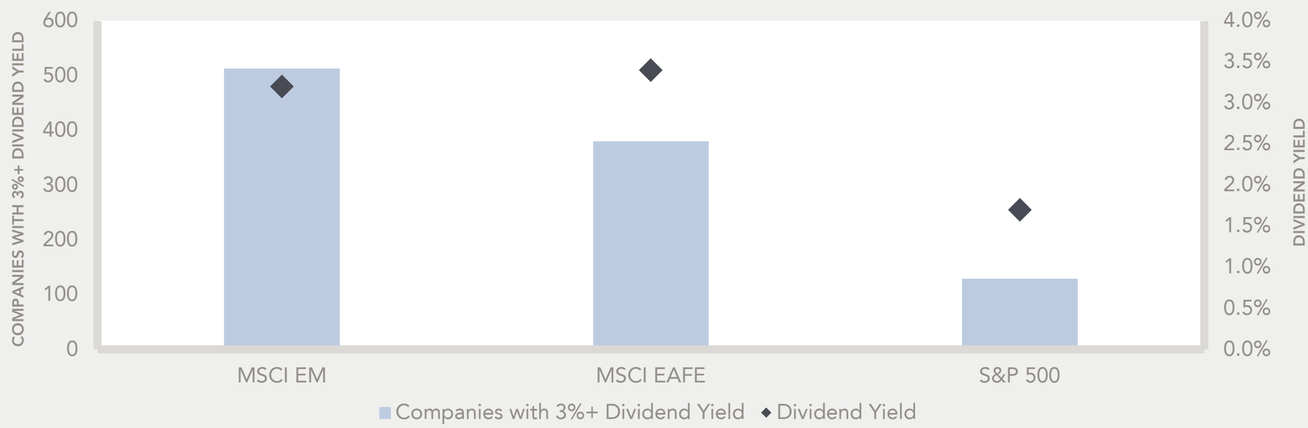
CURRENCY PERFORMANCE



Source: Bloomberg as of December 31, 2022

Finally, dividend payers could provide a lift to performance in 2023. Ultimately, dividends may become a more significant and stable contributor to returns going forward, which could serve as a tailwind for non-U.S. equities. While price appreciation will typically drive the majority of returns, dividends offer steady income, particularly if we see further squalls of pronounced volatility.

DIVIDEND PAYERS MORE PROMINENT IN NON-U.S. MARKETS



Source: Bloomberg as of December 31, 2022

In conclusion, we think equities as a whole will resemble the type of trail that is very steep and challenging at the top but gradually eases on the way down the mountain. Although the majority of macroeconomic challenges that thwarted markets in 2022 still exist, they are not as pronounced and should continue to soften as the year goes on. Consensus is for market indicators to become more supportive during the second half of the year and the probability of a positive year — absent an unforeseen seismic source of market volatility — will be more dictated by how quickly economic conditions normalize and earnings growth stabilizes during the first half of 2023. All of that said, it seems quite unlikely we will see another 2022-esque magnitude of declines this year across equity markets, but a massive snapback similar to previous recoveries is equally unlikely. At this point, we foresee modest positive returns across U.S. and non-U.S. stocks in 2023.

CHALLENGING BUT REWARDING

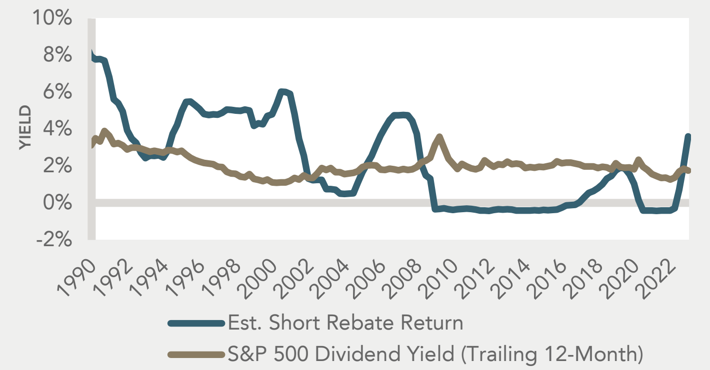
At times, visibility can be limited

For most skiers, blue trails fall right in the middle of difficulty. There is less likelihood of the "yard sale" outcome discussed previously, but these runs are not without challenges, especially if visibility is impacted by snow or wind. We see the following asset classes adhering to such an outlook for 2023.

HEDGE FUNDS

Perhaps more than any of the other asset classes in this section, hedge funds are most prone to the "limited visibility" caveat, due to their wide-ranging mandates and limited transparency. That said, market volatility and dispersion along with an evolving capital market landscape improves the opportunity set for long/short managers across both equity and credit. Additionally, the higher rate environment today should increase return expectations for equity hedge portfolios as short rebates exceed dividend yields for the first time in 15 years.[1]

POSITIVE SHORT REBATES



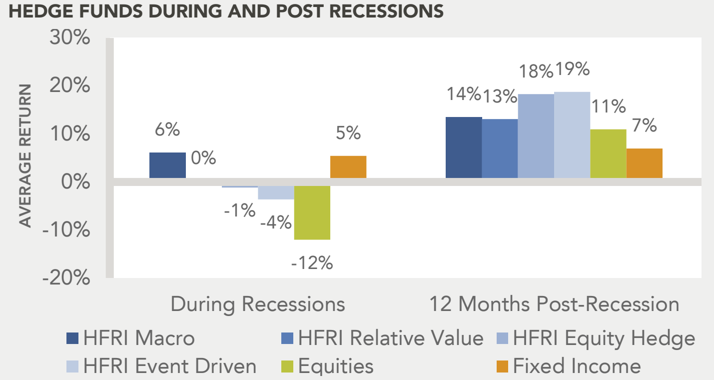
Source: Federal Reserve, Bloomberg; data from January 1,1990 to December 31, 2022. The estimated short rebate represents the effective federal funds rate less a 50bp spread.

Keep those goggles on: What we're watching for

For the better part of the last decade, markets have been driven more by macro factors than security-specific dynamics, which has generally been dilutive to hedge fund performance. While the general expectation is that 2023 will see a reversal of this trend, elevated market volatility and macro concerns may pose continued challenges for funds that focus on bottoms-up fundamentals. Furthermore, hedge funds have drifted towards more conservatism with their overall exposures and while reduced gross and net exposures have helped protect against the downside they may limit upside participation in a swift equity market rally.

One of the more sizable mogul trails out there is the prospect of a recession, albeit expectations indicate any such recession will be mild. Regardless, hedge funds have historically protected principal during recessions and provided portfolio upside after recessions, which is not surprising given their ability to vary gross and net exposures, sell stocks short, and utilize idiosyncratic investments. Hedge funds protected capital relatively well in 2022 and the current market environment of higher rates and greater stock dispersion should provide them further alpha opportunities in 2023.

HEDGE FUNDS DURING AND POST RECESSIONS



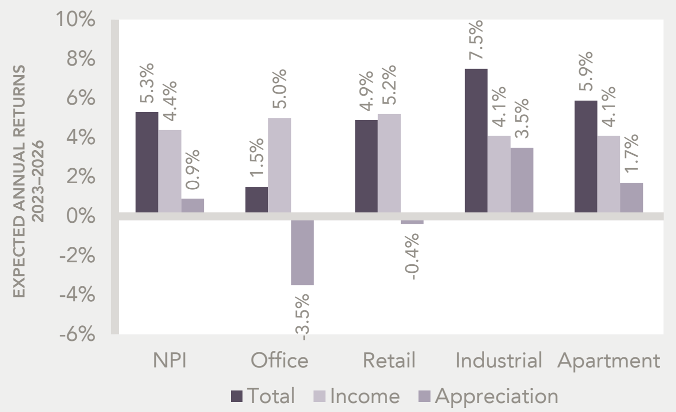
Source: HFRI, eVestment as of December 31, 2022. Recessions determined by National Bureau of Economic Research's defined recession indicator: July 1990 to March 1991, March 2001 to November 2001, December 2007 to June 2009, February 2020 to April 2020. Equities are represented by MSCI ACWI (Gross Total Return) from January 1990 to January 1999 and MSCI ACWI (Net Total Return) from January 1999 to December 2022. Fixed income is represented by the Bloomberg US Aggregate Total Return Index.

[1] A short rebate represents the interest earned on collateral (minus a fee) required to borrow stocks in order to sell short, a staple of equity hedge strategies.

REAL ESTATE

Until 2022, real estate would have been included in the "green" category for market outlook. However, the rapid rate rise in 2022 has pushed the asset class up a peg on our difficulty rating scale. Prices across most property types appear to be flatlining, largely as a result of higher cap rates. Cap rates work in the same manner as yields for fixed income prices; as cap rates rise, prices fall. Higher interest rates have also pushed financing costs higher for new commercial development and the overhang of potential inflation has slowed rent growth and thus net operating income across most property types.

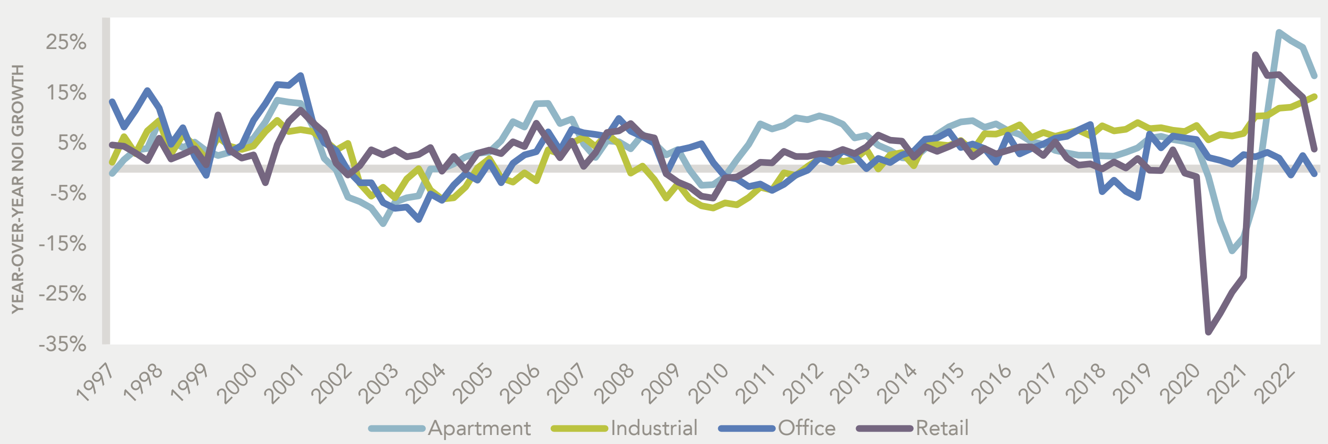
PROJECTED ANNUAL RETURNS BY PROPERTY TYPE, 2023–2026



Source: PREA Consensus Survey, AEW as of December 31, 2022

In spite of these challenges, private real estate should continue to be accretive over longer time periods, but the components of return will likely shift. Rent growth (income), rather than price appreciation, is expected to drive returns across core sectors through 2026, as shown in the chart above.

NET OPERATING INCOME HAS STARTED TO FALL



Source: NCREIF, AEW as of December 31, 2022

We think the real estate trail in 2023 looks very similar to equities: A choppy first half with potentially more downside than upside, but a more favorable finish to the year once the market has digested the final rate hikes from the Fed.

PRIVATE MARKETS

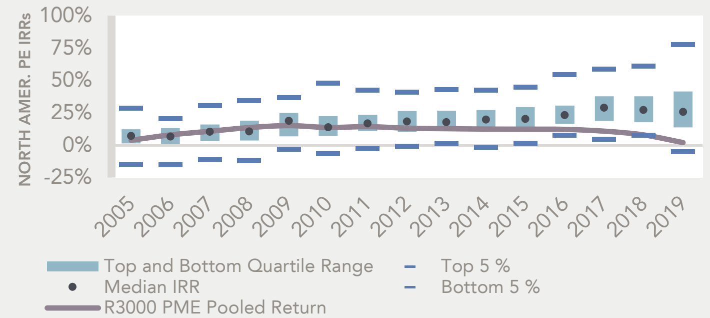
Private markets are illiquid asset classes that do not typically show the same sensitivity to the macroeconomic environments as their public market counterparts. That said, the rate hikes of 2022 coupled with the equity market drop have started to manifest themselves in 2023 returns for the asset classes.[2] That said, the case for private equity and private credit continues to be compelling for long-term investors.

For private equity, funds are diversified across vintage years which helps smooth out the impact of an especially damaging vintage year of returns, and over the long term, median performance exceeds

[2] As private market returns are lagged, one-year numbers for 2022 are not yet available; however, the expectation is they will follow the same pattern as seen in the first three quarters of the year.

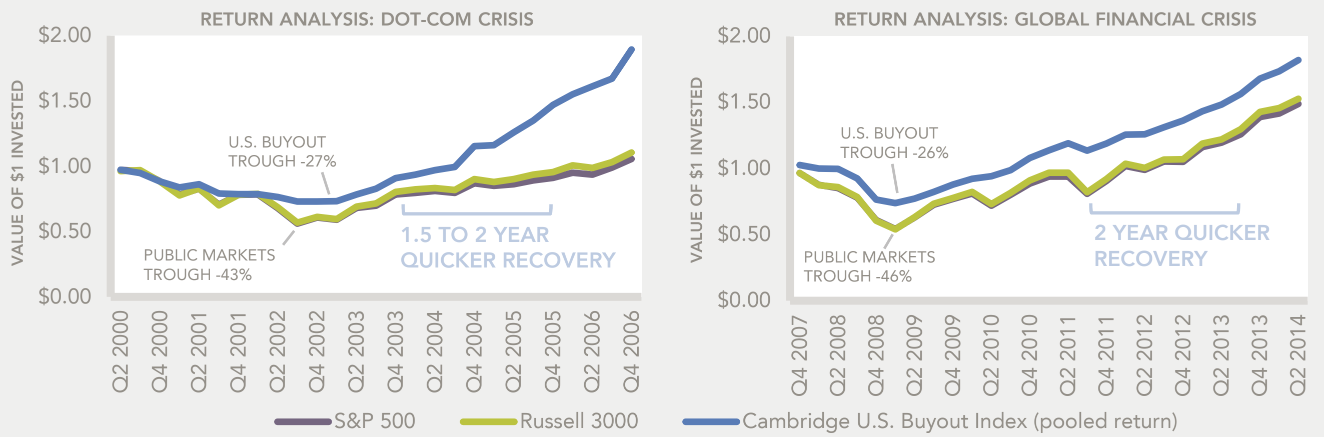
public market equivalents. And in past years of public market distress — similar to 2022 — private equity has shown less significant pullbacks with quicker recoveries versus public markets; it would be surprising if this trend does not hold in 2023. Although the higher rate environment will inevitably slow the pace of deals this year and the gap between private and public valuations has narrowed, private equity should continue to buoy portfolio returns within the context of a well-designed program.

U.S. PRIVATE EQUITY VINTAGE PERFORMANCE



Source: Burgiss North American All Private Equity Public Market Equivalent, Pooled Returns as of September 30, 2022

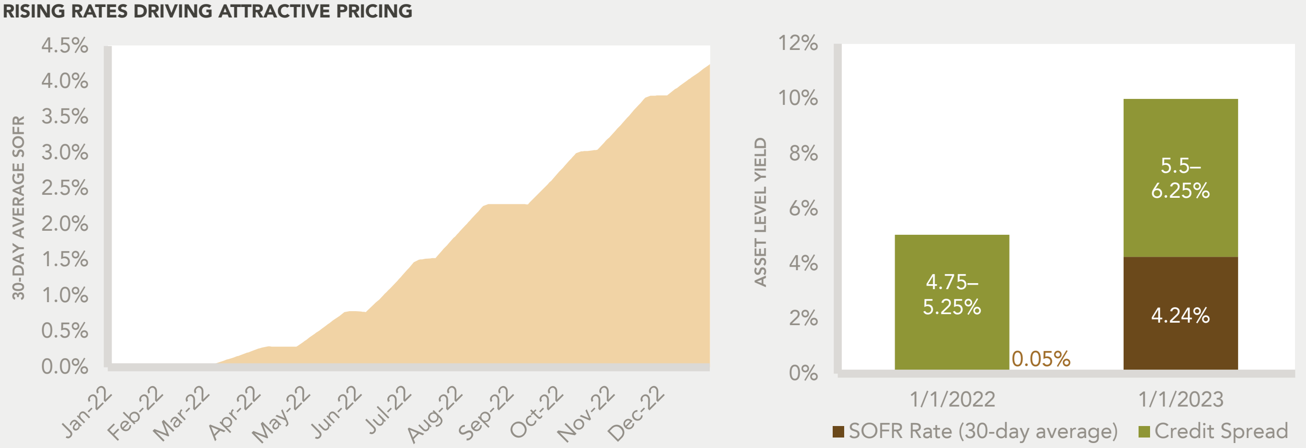
PRIVATE EQUITY IS RESILIENT DURING DOWNTURNS



Source: Bloomberg, Cambridge Associates, Neuberger Berman

For private credit, the higher rate environment presents a more attractive opportunity set for investors. As seen in the charts below, yields have effectively doubled over the last year as a result of higher base rates coupled with widening credit spreads. Additionally, the historic amount of fundraising by middle market private equity is fueling private credit deal flow which should provide sustained momentum for the asset class, regardless of any short-term obstacles in the year ahead.

RISING RATES DRIVING ATTRACTIVE PRICING



Source: Federal Reserve Bank of New York, credit spreads based on sample of representative deals closed

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Given the long-term nature of private markets, it's more difficult to assign an explicit trail rating. Over the long term, assuming an effective program featuring managers with an established track record of success, we would rate private markets in the green rating; however, in the interest of focusing on the coming year, we moved it to blue as the lagged nature of returns has not yet shown the full impact of the macroeconomic dynamics that fueled the drops across equity and fixed income indices last year. Over a long-term investment horizon, private markets have proven beneficial to portfolios and the current environment is not expected to change that outlook, but sometimes even the most favorable trails can be impacted by the elements.

THE APRÈS-SKI

2022 was a run to forget for investors. However, the "yard sale" of 2022 has created opportunities across asset classes for the coming year, most notably in fixed income, hence its green rating. The equity story is more nuanced in that the 2022 losses have moved the asset class to more favorable valuations but lingering macroeconomic headwinds and earnings reductions could make for a bumpy ride down the mountain, particularly during the first half of the year. Alternative asset classes — hedge funds, real estate, and private markets — offer a variety of income, diversification, and upside potential based on the underlying asset classes and strategies. These options are not without risks but have a more limited downside than publicly-traded equities. Overall, we are cautiously optimistic about returns across asset classes for the coming year and feel confident that the evolving market environment will generally move markets higher. Collectively, we hope the après-ski lookback next year tastes better than this year's version and we can toast to positive returns for our client portfolios!

Until next time,

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