NRP

NEW REPUBLIC PARTNERS

MARKET COMMENTARY

4Q 2022

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Market Monitor 2022	Q4	YTD
MSCI All-Country World Index	9.8%	-18.4%
S&P 500 Index	7.6%	-18.1%
Bloomberg U.S. Agg. Index	1.9%	-13.0%
Bloomberg Commodity Index	2.2%	16.1%

A Brutal 2022 Gives Way to Opportunities in 2023

Despite the lack of a Santa Claus market rally, equity and fixed income markets found some relief during the 4th quarter. U.S. equities were up 7.6% and fixed income increased 1.9% to cap an otherwise horrid year for investors in public equity and fixed income markets.

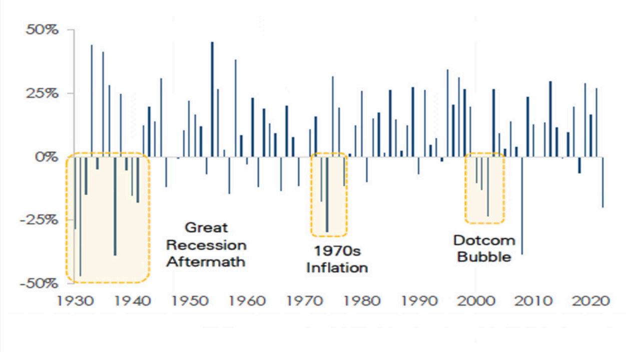
Inflation and Fed Policy Ruled the Day for much of 2022

There were few places to hide as central banks rapidly tightened monetary policy throughout the year. Commodities (+16.1%) and energy stocks (+65.4%) were the lone bright spots for 2022, though they too faded toward the end of the year. The S&P 500 returned -18.1% in 2022, its worst annual return since 2008, while the Bloomberg U.S. Bond Aggregate produced its worst total return since 1976 (-13.0%). For a 60/40 stock/bond investor, 2022 resembled 2008 with a return of -16% compared to -20% in 2008.

Inflation and Fed policy ruled the day for much of 2022 as the U.S. headline Consumer Price Index reached a 40-year high of 9.1% in June. The high inflation prompted the Federal Reserve and its global central bank peers to aggressively raise interest rates. Including the Fed's balance sheet tightening, the pace of tightening was one of the strongest on record, catching many market forecasters and investors off guard. In 2023, we expect inflation to continue to moderate as the Fed's policies take effect. The futures markets currently predict that the Fed will begin reducing rates in the second half of 2023. While this is possible, we believe the Fed will keep financial conditions tight until wage inflation weakens, as the Fed is loath to repeat the past mistakes of the 1970s.

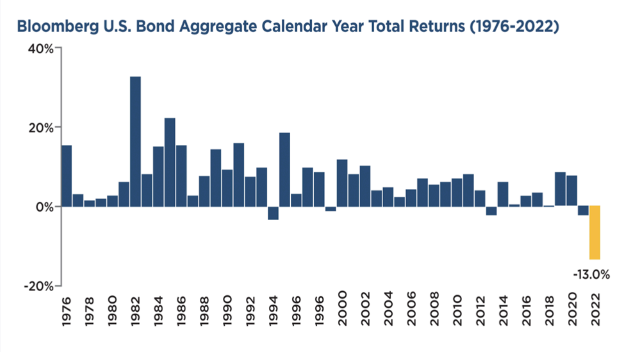
With a growth slowdown entrenched and financial conditions tight, the prospect of a recession in the U.S. is elevated as many indicators and prognosticators now show. This may be one of the most widely anticipated recessions, but we believe it will be a shallow one given that consumer and bank balance sheets are in relatively good shape and unemployment remains at historic lows. The consumer strength is also underpinned by $1.1T in excess savings[1] remaining from the Covid stimulus; however, this excess is due to run out mid-year, and we are mindful of the cracks forming in this picture as shown in recent retail sales and manufacturing data.

Back-to-Back Negative S&P 500 Return Years Are Rare



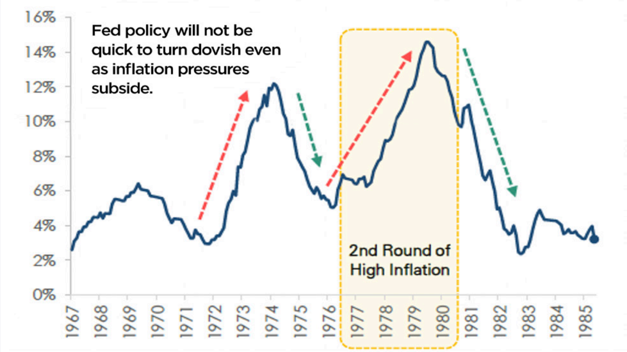
Source: MarketDesk.

State of the U.S. Credit Market Entering 2023



Source: MarketDesk.

Fed's Most Feared Chart = 1970s Inflation Roller Coaster



Source: MarketDesk, Federal Reserve.

[1] J.P. Morgan Asset Management.

Market Commentary

Corporate Earnings: an Open Question for 2023

While current valuations are at a more attractive starting point at year-end (17x forward P/E) than at the beginning of 2022 (21x forward), corporate earnings are an open question entering 2023. Despite expectations for an economic slowdown, Wall Street analysts still forecast single-digit earnings growth for the S&P 500 in 2023; however, Leading Economic Indicators point to a decline in earnings for 2023. The median EPS decline in the 12 recessions since WWII is 13%. Margins have fallen on average by 132 basis points in the 8 recessions since 1970; however, consensus on Wall Street has margins falling a mere 26 bps in 2023.[2] The disconnect is apparent. Thus, we are looking for earnings to reset in early 2023. Investors should use this reset in earnings and corresponding change in market values to add incremental equity exposure as equity markets typically turn 6-9 months before the economy bottoms.

A Long Time Coming: Value vs. Growth

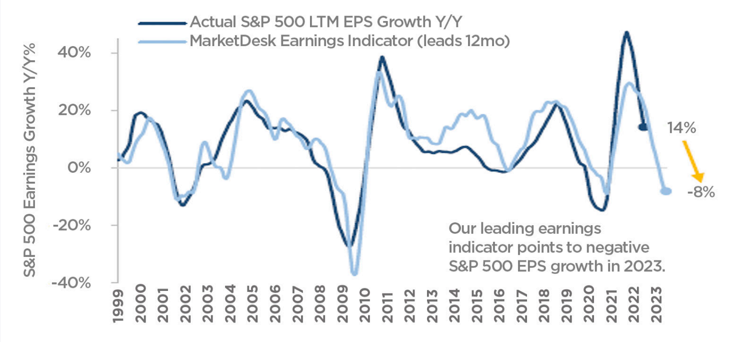
Value stocks also notably outperformed growth stocks in the fourth quarter with large value stocks exceeding their growth counterparts by 1000 basis points and small value outpacing by 400 basis points. As we look to the eventual exit from this bear market, there is typically a sector/factor leadership change that leads markets out of the trough. Historically, value stocks tend to outperform growth stocks in a monetary tightening environment where inflation is greater than 3%. Data has also shown that value stocks tend to outperform growth stocks around the start of a recession.[3] In a higher rate regime with lower relative valuations for value-oriented sectors, the value run seems likely to continue after a decade of underperformance relative to growth. Thus, we believe incremental adds to equity exposure should lean towards value stocks and sectors as we emerge from this bear market.

Continuing to Move Where the Puck is Headed

A lesser-noticed headline is that international stocks outperformed U.S. stocks during the fourth quarter and for the year. The MSCI EAFE Index of Developed Market stocks returned +17.7% during the fourth quarter, while the MSCI Emerging Market Index returned +9.7%. A weaker U.S. dollar boosted the returns of international stocks. The weakness in the dollar was driven by a shrinking monetary policy gap between the U.S. Federal Reserve and other central banks, which began to catch up with the Fed's aggressive policy later in the year.

[2] Goldman Sachs Investment Research.
[3] UBS Investment Research.

Earnings Will be the #1 Focus for Investors in 2023



Source: MarketDesk.

U.S. Style Returns (4Q 2022 in %)

	Value	Blend	Growth
Large	12.2	7.6	2.1
Mid	10.3	9.1	6.9
Small	8.3	6.2	4.1

Source: MarketDesk. Data Reflects Most Recently Available As of 12/31/2022.

Trailing 10-Year Annualized Return — Growth vs Value

Source: MarketDesk. Analysis is based on 10-year annualized price return of Russell 1000 Growth minus Russell 1000 Value.

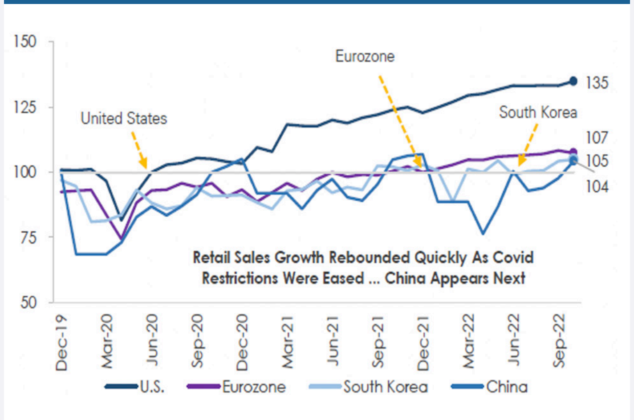
Market Commentary

Continuing to Move Where the Puck is Headed continued

Further afield in Asia, the investment narrative has quickly changed around China in a span of a few months. The proceedings of China's National Party Congress in October and the re-appointment of Xi Jinping to his third term as president led many investors to call China un-investable last year. However, the Chinese government's positioning materially pivoted in November and December as it abandoned its Covid-zero policy and shifted policy to support the economy. One could argue whether this change was voluntary or out of necessity given poor economic and demographic data of late, but it is clear that for the first time in three years regulatory, political, and Covid management policy are now aligned in a pro-growth stance. This stance supports the re-opening story for the country and the broader Asian region which will be driven by the pent-up demand of Chinese consumers who are also flush with excess cash.

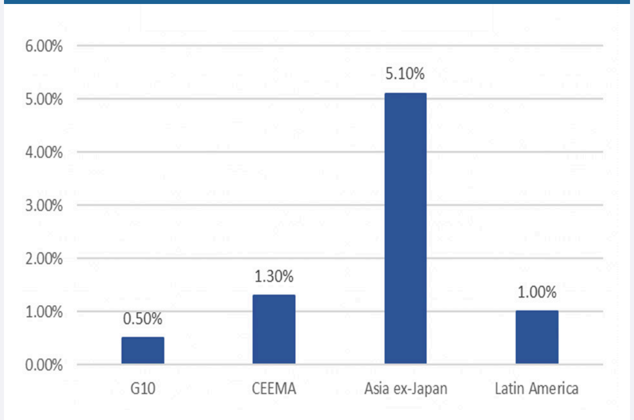
The re-opening may be uneven as Covid rips through the country, but traffic and subway congestion data are already showing a rebound from the first wave of infections post the relaxation of policy. After underweighting EM assets within client portfolios in 2022, we believe equity portfolios should lean in to where the growth is headed for 2023 (i.e. EM Asia) as highlighted by the below chart. Given this encouraging growth picture, EM equity valuations look attractive relative to Developed Markets at 11x forward P/E. China's reopening is also supportive to the commodity complex over the medium term, and we are maintaining our exposure to this asset class while keeping an eye on longer-term supply/demand imbalances in certain sectors.

Retail Sales Indexed to Easing of Covid Restrictions



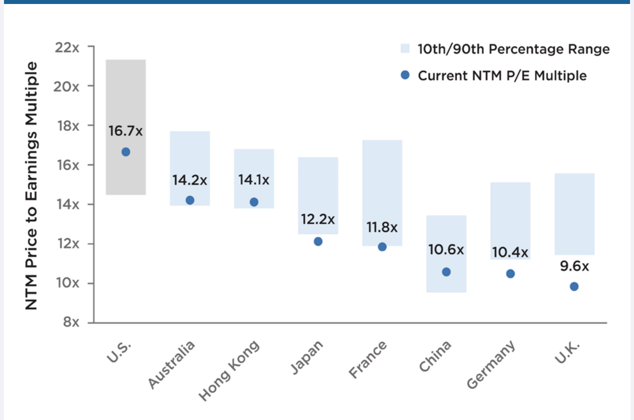
Source: MarketDesk, U.S. Census Bureau, Eurostat, Korean National Statistical Office, National Bureau of Statistics of China. Data is seasonally adjusted.

2023 Projected Regional Growth



Source: IMF, Morgan Stanley Forecasts.

Current & Historial Next 12-Month Price to Earnings



Source: MarketDesk. The 10th/90th percentile range is calculated using month-end data from 12/31/2012 to 12/31/2022.

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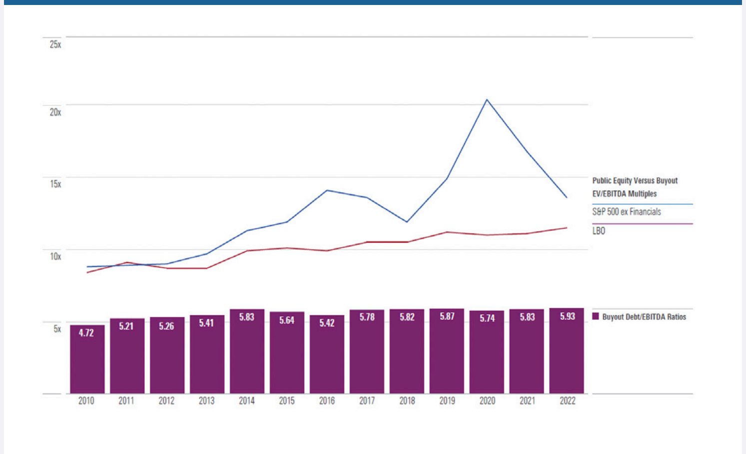
Closing Thoughts On Private Markets

Much ink has been spilled by public market managers pointing to the lack of true marks for private investments as the reason that privates outperformed public markets in 2022 (-8% Cambridge PE vs. -24% for S&P 500 thru Q3). While it is true that private markets lag the public markets by one to two quarters and we are likely to see more deterioration in private equity fund valuations as fourth quarter numbers come in, it is also true that in the past three recessions (i.e., Dot-com, GFC and Covid), private equity fund valuations did not decline as much as those of public markets and they subsequently recovered faster.[4] What is less advertised is that PE entry multiples are more conservative than their public market equivalents, dampening the severity of drawdowns on a relative basis. In addition, skilled PE managers are not forced sellers and can use market downturns to grow market share for their portfolio companies, putting them in an advantaged position when a broader market recovery takes hold. One benefit of the decline in public market valuations is that private equity firms with dry powder can purchase companies at reduced prices. This is one of the reasons private equity funds that began investing during or right after a recession generated outsized returns. We believe the current environment sets up well for the types of private equity managers in our portfolio and recommend adding capital to new vintages.

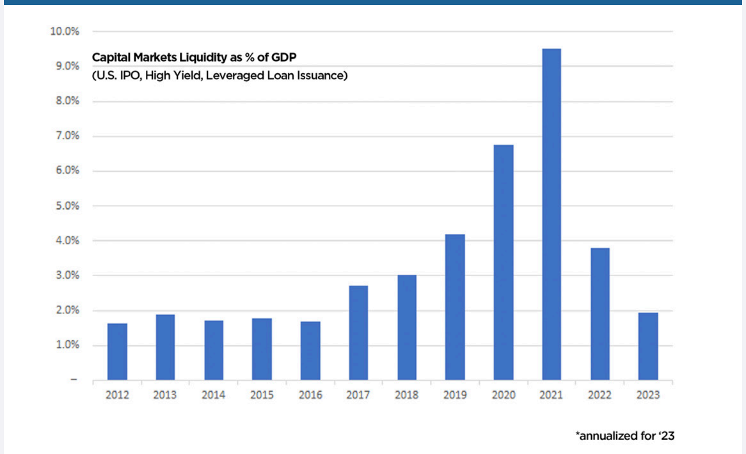
Finally, the tight financing environment also elevates the attractiveness of private credit. Over the past four years, this asset class has quickly established itself as an important, stable financing source as growth in U.S. private credit assets has exceeded growth in the U.S. broadly syndicated loans market by 4.0x.[5] Since the second quarter of 2022, banks and public credit markets have been effectively closed to companies, forcing management teams and private equity firms to look to the private credit markets for financing. Private credit lenders have taken advantage of this opportunity to provide capital to strong companies on more attractive terms than those that existed only six months ago. As capital has become more expensive and scarce, private credit managers with dry powder have driven better terms and covenants in their new debt deals. Importantly, loans from private credit funds typically have floating rates which insulate those loans from changes in underlying base rates. Over the past five years, uncalled capital at private equity funds has increased by 2.5x and exceeds $1.0 trillion today.[6] Private equity funds will put this capital to work over the next 4-5 years which will create increased demand and compelling opportunities for private credit.

Public vs. Private EV/EBITDA Multiples



Source: Morningstar.

Supply/Demand Power Shifting Back to Lenders



Source: Bloomberg.

[4] UBS, Cambridge Associates, FactSet.
[5, 6] GoldenTree Asset Management.

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Closing Thoughts On Private Markets continued

Private credit also includes funds that invest in the debt securities of stressed and distressed companies. As the economy enters recession, these managers are more excited about the opportunity set available to them than they have been in a decade. The combination of better terms for direct lenders and the opportunities for distressed managers will make private credit an important part of all diversified portfolios for the next several years.

With each passing day, markets get noisier and it is incumbent on investment managers and advisors to look beneath the headlines to better discern where one should allocate the incremental dollar. Fundamental investors can take heart though: whereas inflation and central bank policy were the primary drivers of markets in 2022, economic data and corporate fundamentals will play a larger role in determining the market's direction in 2023.

—NRP Investment Committee
January 31, 2023

Disclosure

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