NEW REPUBLIC PARTNERS

MARKET COMMENTARY

1Q 2023

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Market Monitor 2023	Q1
MSCI All-Country World Index	7.3%
S&P 500 Index	7.5%
Bloomberg U.S. Agg. Index	3.0%
Bloomberg Commodity Index	-5.4%

Q1 Conundrum

Despite turmoil in the banking industry in the early weeks of March, global equity markets rallied in Q1 with the S&P 500 and MSCI ACWI up 7.5% and 7.3%, respectively. The end point is a bit perplexing since markets had to digest the 2nd largest bank failure in U.S. history and the shotgun marriage of Credit Suisse and UBS.

Undercurrents Belie Calm Waters

In a span of eight trading days in March, the U.S Treasury yield curve saw unprecedented moves, as the 2-year Treasury yield dropped 1.2%. By the end of the month though, equity markets had extended their quarterly gains.

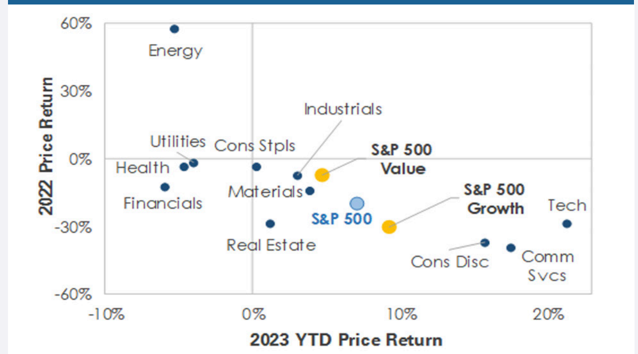
What was driving the equity market returns? It certainly was not earnings as expectations were reduced over the quarter (detracting -1.1% from the S&P 500 return). Rather, expanding multiples (+8.1% contribution) drove the bulk of the returns. In a reversal from an abysmal 2022, Bitcoin and Technology led the way while Healthcare, Energy, and Financials dragged on performance.

Notably, market breadth was rather poor in Q1, as the average stock was up a mere 1%, and large caps dominated: the top 20 largest companies in the S&P 500 added $2 trillion in market cap on a YTD basis while the remaining 480 stocks added $170B in market value.[1] While the Q1 narrow rally may look unhealthy and late cycle, bear market rallies are typically measured in weeks, not months … and therein lies the conundrum that the quarter presented. While tech valuations may be at more normal levels post the dreadful downturn in '22, our managers still see areas that are priced to perfection and have earnings expectations that are too high, such as companies in the cyclicals and industrials sectors. We are still keenly focused on earnings and company fundamentals as our signpost to add incremental exposure to equities (and/or rebalance target weight) across portfolios.

Value vs. Growth Reversal

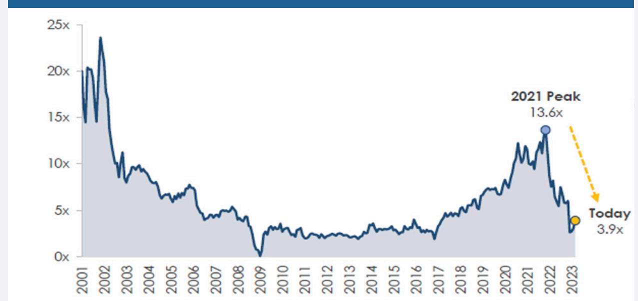
Since we highlighted the Value/Growth trend in Q4, there was a sizeable shift in factor performance during the first quarter. The Russell 1000 Growth Index gained +14.3%, outperforming Russell 1000 Value's +0.9% return. Like the outperformance of large caps over small caps, the Growth factor's relative outperformance occurred in March after the bank failures. The fast drop in Treasury yields with the banking stress favored Growth stocks over Value in the short run, but we still believe a value tilt has legs over the long run. According to the venerable value shop, GMO, "Value" is still cheap in the U.S. (in the 14th percentile of its relative valuation to growth since '81); furthermore, outside the U.S., they see Value as more broadly attractive. In a similar vein, New Republic Partners has removed the value tilt within U.S. equities and maintained the value tilt in international markets in light of the blurred prospects for financials and elevated valuations of industrials in the U.S. Above all, these shifting Value/Growth factors and uncertain prospects for corporate earnings make the case for active management in equities and we do not favor adding market exposure through an index.

Sector Price Returns – 2022 vs Year-to-Date 2023



Source: MarketDesk. 2023 returns are based on S&P 500 sectors through 3/31/2023. Performance is for illustrative purposes only and does not reflect any management fees, transaction costs or expenses. Past performance does not guarantee future results.

Next 12-Month P/E Valuation Gap – Growth vs Value



Source: MarketDesk. Analysis uses SPYG and SPYV as proxies for S&P 500 Growth and Value, respectively.

[1] Goldman Sachs.

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Knock-On Impact Of The Banking Turmoil

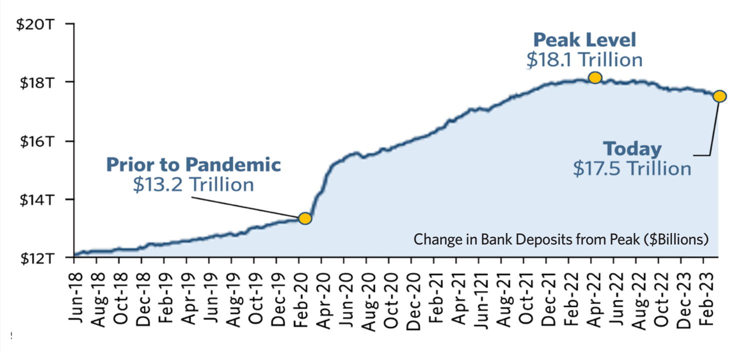
With the two largest bank failures since the 2008 financial crisis (i.e., SVB and Signature Bank), continued stress in the banking system is a new risk on the table that warrants monitoring. These recent bank failures have raised concerns about financial stability and drawn comparisons to 2008. However, there are important differences from 2008, including both regulatory changes and the causes of insolvency. Banking reforms after the 2008 crisis strengthened the overall financial system, and higher capital requirements now provide banks with a more robust financial cushion. In addition, regulators now possess greater authority to resolve issues in large, failed banks. In terms of cause, the 2008 crisis was primarily triggered by bad loans and complex securities. In contrast, recent bank failures resulted from the Federal Reserve's rapid interest rate increases, which created paper losses for banks that made loans or purchased bonds at lower interest rates. A crisis in confidence can beget more anxiety if left unchecked and the Fed and Treasury quickly moved to mitigate this risk with regulatory backstops. However, the knock-on impact of the turmoil will be a slowing of credit creation by lenders, large and small.

Not Letting A Good Crisis Go To Waste

Credit markets are already showing concern for the tighter bank lending standards. For perspective, banks aggressively tightened lending standards during the last 12 months in anticipation of the Federal Reserve's interest rate hikes slowing economic growth. With recent bank failures causing banks to question the stability of checking deposits, there is a risk that banks will adopt a more cautious approach to lending and reduce the total amount of credit they offer. In addition, as banking clients shift deposits to money market funds sporting 4+% yields, the lending capacity of banks shrinks. According to Federal Reserve data, $312 billion in deposits left the banking system in March.

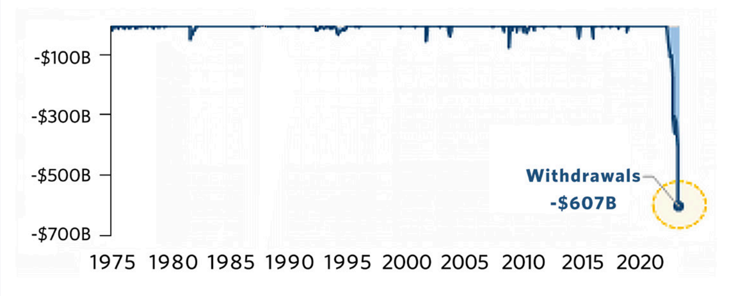
Credit access is a key driver of economic growth and promotes financial stability. The decreased credit supply and access to credit could have a domino effect, particularly for borrowers who are already in a stressed position. Credit issues may very well arise in the $20T commercial real estate market as occupancy has not fully rebounded to pre-Covid levels and regional banks control 80% of CRE bank lending in the U.S. We are keeping a close eye on developments in this market over the 2nd half of this year. Furthermore, as we highlighted last quarter, on the other side of the bank lending pullback, Private Credit managers with capital are primed to take advantage of the environment with a discerning eye to support borrowers with stressed balance sheets yet strong business fundamentals. We also support allocating capital to experienced Distressed Credit managers who see incredible opportunities that have not been available in a decade.

U.S. Commercial Bank Deposits in Trillions



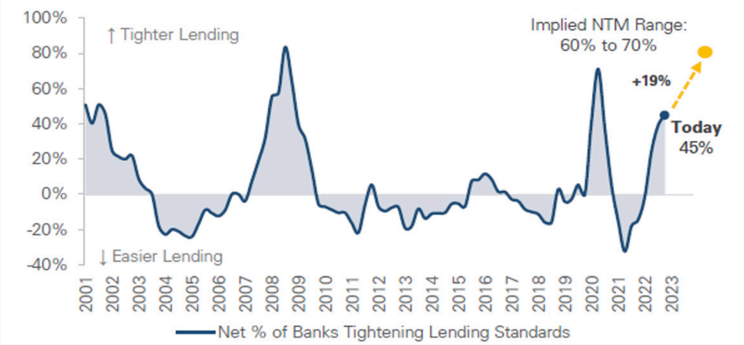
Source: MarketDesk.

Change in Bank Deposits from Peak ($Billions)



Source: Federal Reserve. Data from Jan. 1, 1973 through Mar. 15, 2023.

U.S. Lending Standards Indicator



Source: MarketDesk Quant Pack, Federal Reserve.

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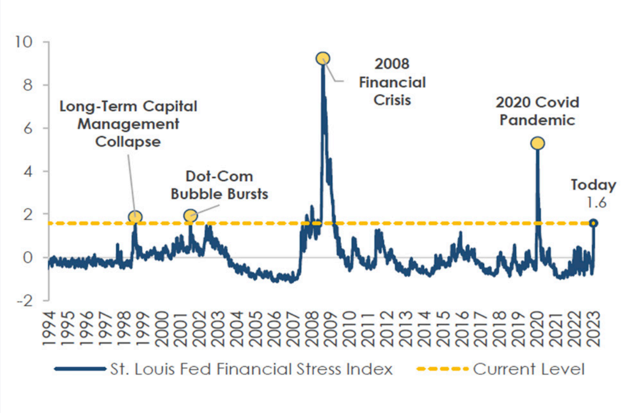
Don't Count On A 60/40 Revival

In Q1, the traditional 60/40 stock/bond portfolio was up 5.6% after posting its worst return since 2008 last year. However, we would caution against hopping back on the passive 60/40 train, as second-order thinking and active management are needed in this new rate regime. As Rick Reider, CIO of Fixed Income at BlackRock, recently highlighted: "At the end of 2020, when cash rates were close to 0%, there wasn't a huge degree of dispersion across fixed income in terms of risk-adjusted yield, but in March 2023 almost the opposite is true. A cash rate of 5% has left many fixed income assets below the incremental carry required to compensate investors for an additional unit of volatility. Investment Grade Commercial Paper, for example, offers near a 6% yield over 9-12 months, with almost no duration and little credit risk. Further, cash and cash equivalents are … hard to overlook as an uncorrelated asset that is delivering 30-40 bps of risk-free return a month." [2] Said differently, the bar has been raised on incremental investments in financial assets and asset selection matters a lot more than it did in the 2010-2020 decade, both in equity and fixed income markets. There is a role for cash and short-duration credit in portfolios at these yields today in addition to select EM Debt, Absolute Return strategies, and Private Credit. However, investors need to be compensated for any incremental credit or duration risk they take on. This new regime requires active management and alternative thinking to support an investor's income needs. Until then, we are content to hold more cash and short-term treasuries, getting paid 4.5%+ to wait until the peak of this rate cycle is in.

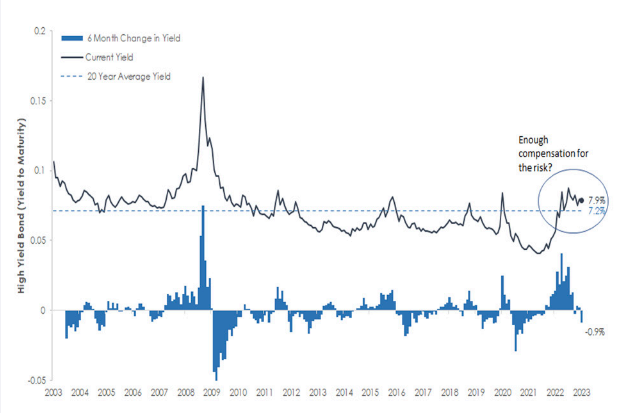
With financial conditions tightening, recession worries looming, and core inflation proving sticky in the U.S., International equities, particularly EM equities, look attractive on a relative basis. As the researchers at MarketDesk rightly point out, "When allocating to global markets, investors should be mindful of the divergences in monetary policy that exist among countries. EM central banks pursued a more conventional monetary policy approach during the last decade, while DM central banks spent the past decade experimenting with various unconventional policy approaches. The result could be noticeable in the coming years as DM countries dig out from a period of unconventional policy that distorted financial systems and economies. Investors only need to look at recent U.S. bank failures to see the risks of unconventional monetary policy." EM has also been ahead of DM in its tightening cycle, laying the groundwork for a spurt in economic growth.

Financial Stress Increases



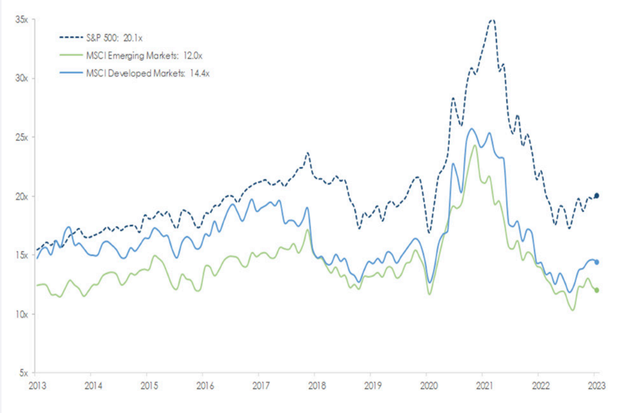
Source: MarketDesk, St. Louis Fed.

High Yield Bond Market



Source: MarketDesk.

Global Equity Valuations



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

[2] Rieder- 5 Reasons for an Investment Time-Out – Institutional | BlackRock.

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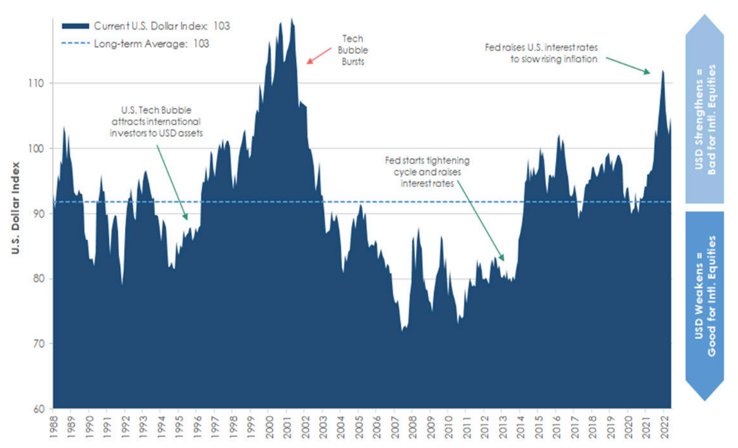
Asian Tiger Led Growth

Within EM, as we highlighted in our 4Q letter, we believe equity portfolios should lean into where the growth is headed for 2023, notably EM Asia. For the Asian economic tigers, India and China, financial conditions are not as tight and the growth picture is strong (in the case of India) or considerably improving (in the case of China). The economic backdrop for India is primed for a supportive capex cycle with bank balance sheets in good position and pent-up corporate expansion plans. Meanwhile, China's recovery is still on trend though it cooled somewhat in the first quarter. The National People's Congress meeting held in March highlighted the government's mandate to re-focus on economic growth after faltering in 2022 due to Covid lockdowns; similarly, property development is on the rebound as the government has loosened its grip on funding to property markets. We certainly recognize that these Asian tigers are still tethered to the global economy and bear some risk in a global growth slowdown scenario (e.g., exports comprise 20% of India's GDP). Their domestic growth tailwinds should help EM assets swim against the macro currents alongside a weakening U.S. Dollar. At New Republic Partners, we are voting with our feet in this trend with a relative overweight to EM vs. the benchmark and our EM-focused managers are overweight relative to both China and India in their portfolios. To be clear, our preference is to avoid an allocation to the EM index which includes exposure to high-risk regions. Rather, we favor using active managers who invest in leading companies in the most attractive geographies.

Peaking U.S. Dollar Bodes Well for EM



Source: MarketDesk.

Parting Thoughts

While headline inflation ticks down, it remains unclear whether the Fed's job is done; one should still look at investments through the lens of financial tightening and a slowdown in economic growth in the U.S. and in Europe. Equity markets may indeed take another leg down with the deteriorating earnings picture or markets may muddle through in a volatile trading range. Rather than guess at these trends, it is better to setup portfolios to play through in asset classes and strategies that exploit that volatility (e.g., Hedged Equity, Absolute Return) and market inefficiencies (e.g., Private Credit and Private Equity). Markets rarely give the "all clear" and in Pasteur's words, "chance favors the prepared mind."

— NRP Investment Committee
April 26, 2023

Disclosure

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704.626.1526

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