NRP

NEW REPUBLIC PARTNERS

MARKET COMMENTARY

2Q 2023

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Market Commentary

Bifurcated Markets Persist

The first half of 2023 could be described as a tale of the “haves and the have-nots.” The U.S. equity market was up 16.9% in the first half of 2023 and yet firmly bifurcated, as the index gains were driven by a small handful of mega cap tech stocks. The tech sector continued its rebound with the Nasdaq 100 returning +15.3% in Q2 after its +20.7% Q1 return. The Nasdaq’s +39.1% return year to date is the strongest first half year return since 1983. Meanwhile, financial stocks remained depressed from the turmoil in regional banks that occurred in March.

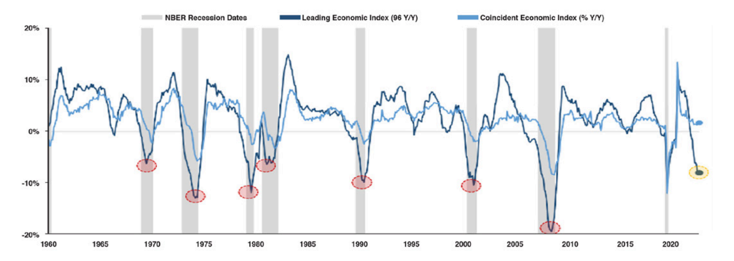
Conflicting Signals

Comparing an equal-weighted index to the market cap weighted S&P index displays the divergence that began in March with the first signs of regional bank turmoil. The S&P 500 traded higher in April and May, while the Equal Weight S&P 500 traded sideways. And, while the S&P 500 ended the first half of 2023 with a strong return, the average stock’s return was noticeably smaller and indicates the first half rally was top-heavy. The 9.9% spread between the market cap and equal-weight S&P indices is the 4th widest spread since 1990. Whether you believe this is a bullish or bearish phenomenon, you can find the data to fit your preferred narrative. We are closely watching to see if the first half S&P 500 rally broadens in the second half of this year. We will continue to monitor for a bottoming in corporate earnings revisions before adding long-only U.S. equity risk to portfolios.

While soft economic data (i.e., ISM & regional Fed surveys, sentiment, etc.) and other leading indicators point to an economic slowdown, the hard data (i.e., economic growth, employment, wage growth, airline passenger activity, etc.) continues to outperform expectations and indicates the economy is still expanding. Many economic forecasters continue to predict an imminent recession, but the hard data and, more importantly, the earnings of companies in the S&P 500 continue to hold up better than expectations and profit margins have steadied.

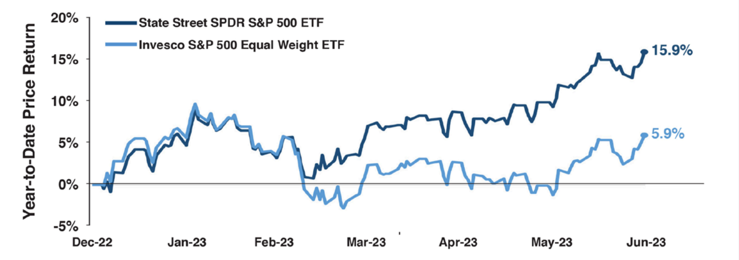
Market Monitor 2023	Q2	YTD
MSCI All-Country World Index	6.2%	13.9%
S&P 500 Index	8.7%	16.9%
Bloomberg U.S. Agg. Index	-0.8%	2.1%
Bloomberg Commodity Index	-2.6%	-7.8%

Leading vs. Coincident – Hard vs. Soft Economic Data



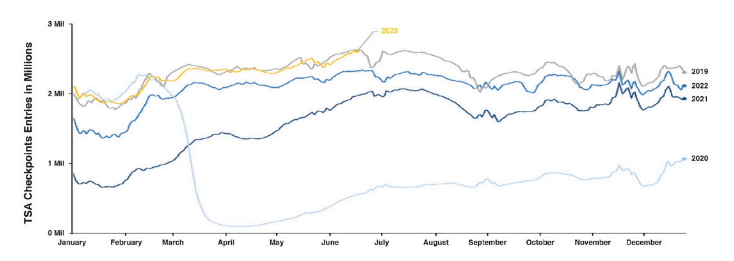
Source: MarketDesk.

S&P 500 YTD Return (Market Cap Weighted vs. Equal-Weighted)



Source: MarketDesk. Analysis uses State Street’s SPDR S&P 500 ETF as a proxy for the S&P 500 and Invesco’s S&P 500 Equal Weight ETF as a proxy for the S&P 500 Equal Weight Index. Past performance does not guarantee future results. Time period is from 12/31/22 to 6/30/23.

Economic Activity - TSA Checkpoint Travel Numbers Reach New Heights



Source: MarketDesk.

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Biding Time ‘til Earnings Begin to Bottom

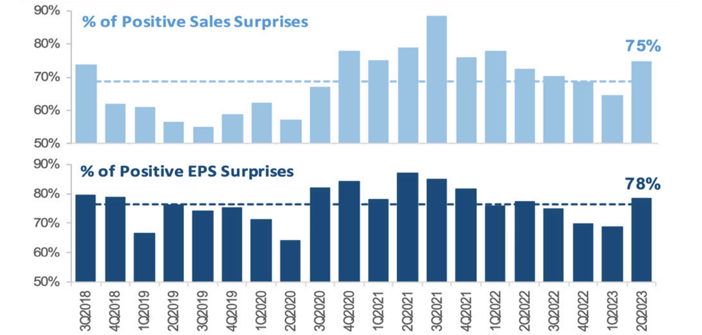
While S&P 500 earnings declined 2.0% year-over-year in the first quarter, an increasing number of companies reported results that exceeded analysts’ estimates. From an earnings perspective, 78% of companies beat their estimate, up from 69% the prior quarter and slightly above the 5-year average of 76%. However, S&P 500 earnings are forecasted to decline 7.1% year-over-year in Q2 2023. For reference, analysts forecasted a -4.7% earnings Q2 YOY decline only three months ago. It is not uncommon for analysts to revise earnings estimates during earnings season as they get more up-to-date information from companies, but the downward revision indicates analysts remain skeptical about companies’ ability to grow earnings in an environment with higher interest rates and the economy returning to trend after a period of strong growth over the past few years. Like the spread in hard/soft economic data, the question is whether the downbeat earnings forecast or Q1’s better-than-expected actual results is more indicative of the path forward.

Artificial Intelligence: a Netscape or iPhone moment?

The AI-led rally in technology stocks this year received a further boost (and validation) from chipmaker Nvidia’s impressive earnings guidance of $11B in expected Q2 revenues, 50% above estimates. As Nvidia’s release underscores, artificial intelligence is a huge trend and more than likely a Netscape-moment for the tech industry vs. an iPhone-moment in its significance and productivity lift. Said differently, we believe AI will have as great of an impact as the advent of the Internet back in the ‘90s. However, as one of our managers highlighted, the environment is exciting but treacherous given the significant disruption that will ensue. We are encouraged by how our long-only and hedge fund technology experts are navigating the unfolding opportunity set in AI adoption. These managers are investing heavily in the incumbents that lead in categories across several foundational layers of the AI stack and to a lesser degree in the consumer-facing SaaS/Internet/Social applications, where there is great upside but risk of disruption and commodititization is high.

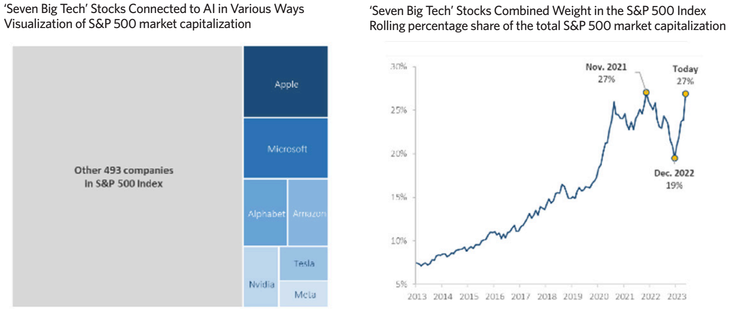
> *“Humans are hard-wired to dream, to create, to innovate. ... But today, we spend too much time consumed by the drudgery of work on tasks that zap our time, creativity and energy. To reconnect to the soul of our work, we don’t just need a better way of doing the same things. We need a whole new way to work. ”*
> *- Jared Spataro, Microsoft*

Percent of S&P 500 Companies Beating Quarterly Estimates



Source: MarketDesk. Data represents the percentage of S&P 500 companies with actual results greater than the market’s concensus estimate.

Market Themes - Investors Excited About AI Revolution



‘Seven Big Tech’ Stocks Connected to AI in Various Ways
Visualization of S&P 500 market capitalization

‘Seven Big Tech’ Stocks Combined Weight in the S&P 500 Index
Rolling percentage share of the total S&P 500 market capitalization

Source: MarketDesk.

NVIDIA YTD Stock Performance

Source: Yahoo Finance.

Market Commentary

Stall in International Equity Outperformance

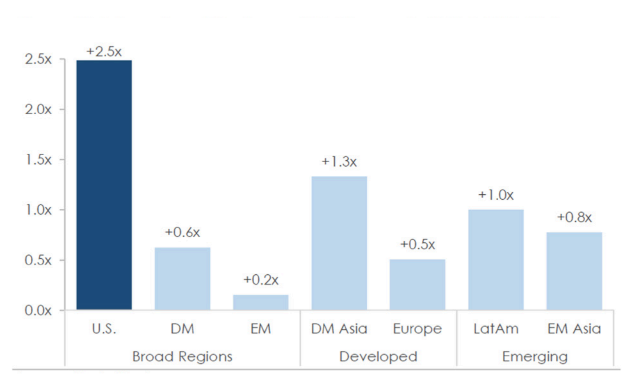
After outperforming in the first quarter and in Q4 2022, international stocks underperformed U.S. stocks in the second quarter of 2023. The MSCI EAFE Index of developed market stocks gained 3.2%, outperforming the MSCI Emerging Market Index's +1.0% return, but underperforming the S&P 500 by 5.5%. The International outperformance stalled as the U.S. dollar's weakening trend reversed and Growth stocks powered the S&P 500's P/E multiple higher. As shown below, the S&P's forward P/E expanded YTD (2.5x) while the forward P/E for International Developed Markets expanded by a smaller amount (0.6x) and for EM by even less (0.2x). We still favor International markets ("IE") vs. the U.S. due to valuations, as IE trades nearly two standard deviations cheap to the U.S. relative to its 20-year average P/E. Thus, we are shifting portfolios from a slight underweight to neutral for International Equities. However, we are still reticent to do the same with U.S. equity exposure until earnings revisions bottom and earnings grow into those stretched valuations.

Notable Convergence in Yields

We also believe that investors should take note of the convergence in market yields: the 3-month T-bill recently hit 5.3%, and the yield on T-bills, S&P 500 earnings, and global investment grade credit are all converging around the same level. That convergence flashes a signal to investors to not take big swings in the current environment but to hue closely to strategic allocation targets. There is a great deal of uncertainty around the path forward, and investors are not being compensated for the additional credit or equity risk they may be taking in traditional equity and fixed income. As yields converge, investors should increase focus on portfolio positioning. Positioning (e.g., long vs. short duration, growth vs. value, international vs. domestic, large cap vs. small, etc.) within an investor's strategic asset allocation will be key over the rest of the year as liquidity tightens.

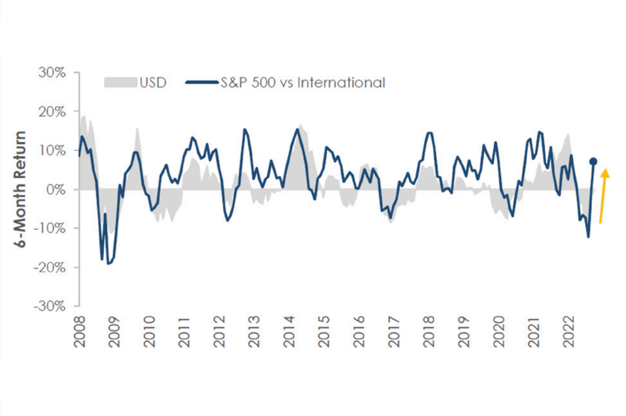
Take for instance the broad credit markets where another market disconnect is apparent. While rising interest rates caused bonds to trade lower, high yield corporate bonds traded higher in Q2 and produced a +0.7% total return. The below chart compares the return of CCC bonds, which are the lowest rated corporate bonds with a higher perceived risk of default, against a broad index of corporate investment grade bonds. CCC-rated bonds generated a ~10% total return through June 30th while investment grade bonds generated a ~3% total return over the same period.

International Regions - YTD Change in NTM P/E Multiple



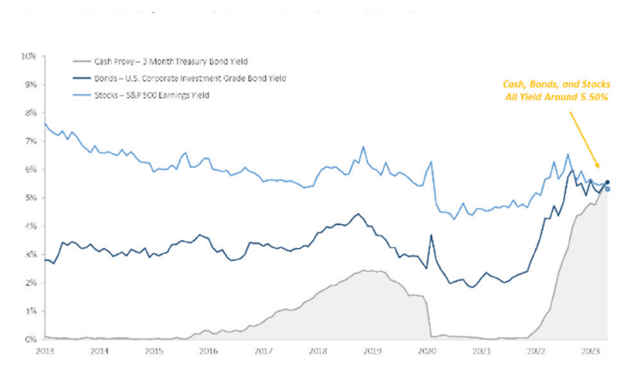
Source: MarketDesk.

S&P 500 vs. International Equity Return Gap Against USD



Source: MarketDesk.

Comparing Risk/Reward Across Stocks and Bonds



Source: MarketDesk.

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Notable Convergence in Yields continued

The return gap is striking considering another credit market theme this year: rising bankruptcy filings. The chart below shows the increasing number of monthly Chapter 11 bankruptcy filings since 2006. The number of bankruptcy filings in March 2023 crossed above the 20-year median for the first time since December 2020, coming back in-line with the pre-pandemic trend.

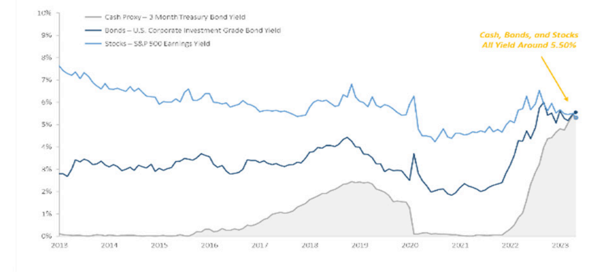
What's driving the increase? Several themes are contributing to the rise in bankruptcies, including higher interest rates, tighter bank lending standards, and easing inflation. Higher interest rates and tighter bank lending standards are increasing companies' financing costs at the same time inflation is easing and companies are starting to lose pricing power.

Adjusting to the Tighter Liquidity Environment

The screws continue to tighten on credit in the U.S. as the balance sheets of small/medium sized banks are increasingly constrained by the shift in deposits to money market funds. We still expect the ripple effect of tighter liquidity to propagate through the economy. For instance, small/medium sized banks account for 80% of total commercial real estate lending, and increased federal scrutiny of that segment will only exacerbate the tightening trend. As the chart highlights, as lending standards tighten, credit growth is pinched which then impacts overall economic growth.

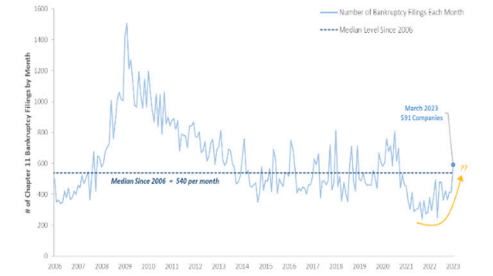
While banks may be in the "have-not" camp, the tighter lending standards are a net positive for private credit players that have the dry powder and underwriting expertise to take advantage of the current environment. With the increase in base rates and widening of spreads, direct lenders can currently collect all-in coupons of ~12% in unitranche loans. Further, average leverage levels for middle market buyouts have declined from 5.0x to 4.5x, and loan documents now feature tighter covenants further increasing the attractiveness of these loans. These combined elements lead us to recommend private credit exposure to our clients to barbell their fixed income exposure with short duration credit and treasuries yielding 5+% alongside private credit exposure that compensates investors for the added illiquidity and still delivers an attractive cash yield.

Credit Market - Riskiest Corporate Bonds are Outperforming in 2023



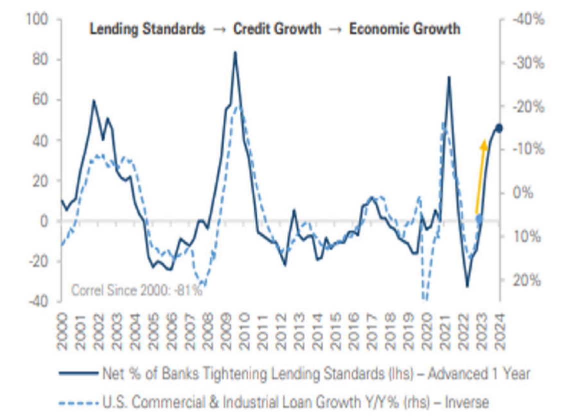
Source: MarketDesk.

US Bankruptcies Are On the Rise in 2023



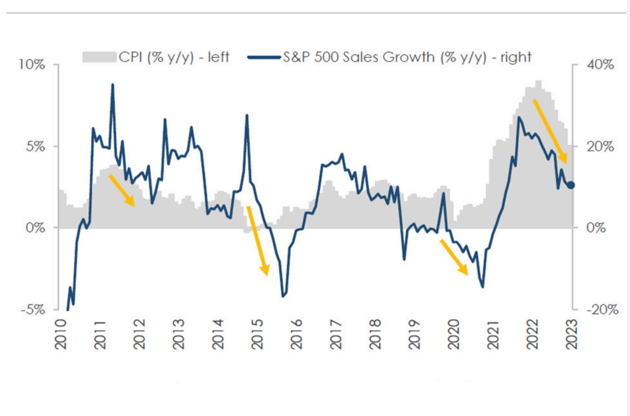
Source: MarketDesk.

Historical Lending Standards & US Loan Growth



Source: MarketDesk Quant Pack. Federal Reserve.

Consumer Price Inflation vs. S&P 500 Sales Growth



Source: MarketDesk. Department of Labor. Data is seasonally adjusted.

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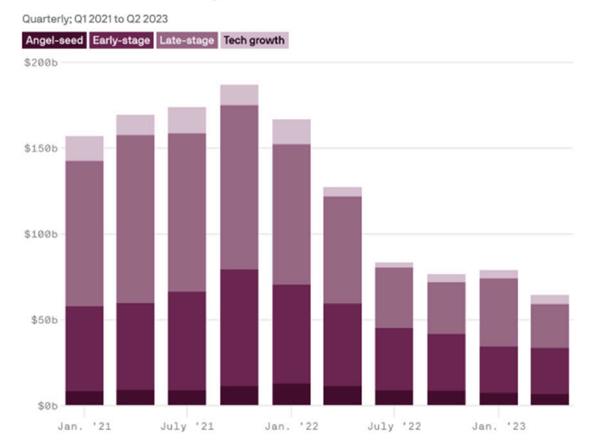
Portfolio Construction and Positioning Matter

In addition, within private equity as an asset class, portfolio construction and positioning matter. After a significant decline in valuations in ’22, the growth and venture segments of the asset class have seen an array of economic challenges in 2023 with rising interest rates, a frozen IPO market, slowing venture activity, and the collapse of two lenders, SVB and Signature Bank, which heavily underpinned the space. As a result, this challenging environment now makes growth and VC secondaries more attractive as you can purchase quality companies at huge discounts (e.g., 50-70% discounts).

Furthermore, New Republic Partner’s focus within private equity remains on middle market and lower middle market buyout funds, which are less exposed to swings in the public and large-cap private equity markets. One attribute of this segment of the market is that middle market funds invest in small companies and help them grow into larger, strategic platforms that large private equity firms want to own. Our managers are focused on executing organic and inorganic initiatives at the portfolio company level to create more scaled, resilient, and valuable companies. Much of the incredible sums of capital that the large private equity funds have raised over the past five years will be used to purchase these companies from the managers in the NRP portfolio. Despite macroeconomic noise, we have seen continued strength in the portfolio, measured by earnings growth and liquidity events. All of these elements underscore that diversification across segment and vintage year are paramount in building a private program that is self-funding and compounding over time.

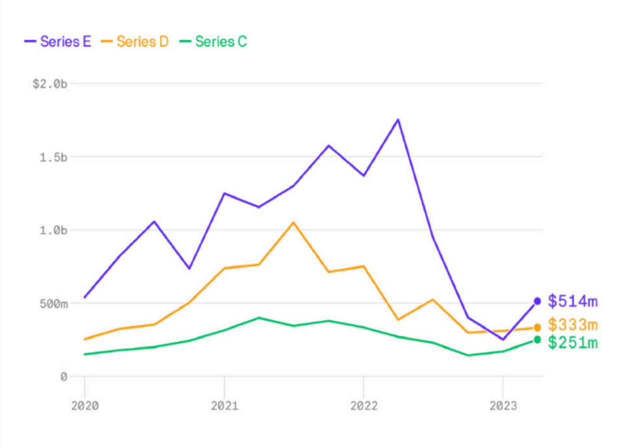
— NRP Investment Committee
July 31, 2023

Global Venture Capital Dollars Invested



Source: Data: Crunchbase. Chart: Tory Lysik/Axios Visuals.

Stabilizing Valuation Trends in VC



Source: Data: Carta. Chart: Axios Visuals.

Disclosure

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