NOVUM
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Weekly Market Flash

A pivotal speech from Powell

December 4, 2022

It was another moderately positive week for equity indexes, with non-US markets leading gains. In particular, emerging markets equities performed well (the MSCI EM was up 4%), thanks to US dollar weakness after Federal Reserve (Fed) Chair Jay Powell finally sounded a little less hawkish—but not quite enough to be called dovish. Powell's speech was in fact pivotal during the week. Compared to the recent past, the tone changed, but not only that, so did the content. Indeed, he spoke clearly about the end of QT, without specifying when, adding that he expects a soft landing of the economy, rather than a hard one. At the same time, the labor market is beginning to show signs of weakening, and inflation in goods and the housing market is slowing conspicuously.

Highlights

▪ The spread between the S&P 500 index and Eurostox index has fallen significantly recently, and part of this underperformance can be attributed to the Fed’s stance.

▪ CleanTech, Supply Chain Infrastructure, Smart Manufacturing, Climate Tech and Health Tech are the new structural growth stories. The Inflation Reduction Act and other fiscal incentives that are likely to follow will only support this growth.

▪ Over the last five years in private equity, we have witnessed the rapid emergence of what is now the other main leg of the secondary market, the so-called GP-led transactions, that as of today comprise half of the total market share.

Markets & Macro | A pivotal speech from Powell

But we remain in a bear market.
There are two aspects that have calmed the market this week. First, Powell's alignment with what had already been exhibited by other Fed members. Namely, the awareness of the lag with which monetary policy acts, the need to assess outcomes, and the absence of statements with threatening overtones. In the past it had often happened that if by chance the market had ripped to the upside following the first statements prepared for reporters, the President had used the speech and responses to reporters to extinguish any enthusiasm. That did not happen this time, and the market took note, accelerating right at the end of the conference.

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Figure 1: Year-to-Date Performance of Major Indices

Equity	Last Value	Ytd
MSCI World	2,733.03	-13.69%
Nasdaq	11,461.50	-26.15%
S&P 500	4,071.70	-13.28%
DJ Industrial	34,429.88	-3.30%
SPX Value ETF	151.62	-1.68%
SPX Growth ETF	232.34	-23.52%
Nikkei	27,777.90	-1.54%
Eurostoxx	3,977.90	-4.32%
Swiss SMI	11,198.13	-10.55%
FTSE 100	7,556.23	5.93%
Canada	20,485.66	-0.71%
Shenzen	3,870.95	-19.97%
Hong Kong	18,675.35	-17.45%
MSCI EM	973.85	-18.58%

Bond Indices	Last Value	Ytd
US Inv Grade	109.42	-15.08%
US High Yield	75.56	-9.14%
Euro Corps	233.26	-11.52%
JPM Europe Govies	9,697.26	-8.82%
US Treasuries	2,226.28	-10.95%
China Aggregate	251.52	-6.59%
EMBI Global	776.72	-15.53%
EMBI Local	122.78	-10.84%

Commodities	Last Value	Ytd
BBG Commodities	114.47	15.43%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	65.88	8.37%
Gold	1,797.63	-1.73%
Silver	23.14	-0.72%
BBG Brent Crude TR	1,053.93	40.72%
BBG WTI Crude Oil TR	190.40	24.36%

FX	Last Value	Ytd
DXY Index	1,256.74	7.10%
Bbg JP ASIA	100.29	-7.19%
Bbg JP LATAM	40.04	-2.06%
EUR Index	119.68	-0.90%
EUR/CHF	0.99	-4.81%
GBP Index	638.50	-6.49%
EM FX Index	1,646.66	-5.06%
JPY/USD	134.31	-14.32%
CNY/USD	7.05	-9.89%
Bitcoin	17,029.80	-63.25%

Source: Bloomberg, as at December 2, 2022. Performance figures in indices' local currencies.

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Second, the market was prepared for the worst. Since all of Powell's recent speeches have been extremely hawkish—bordering on irritation at the easing of financial conditions—US indexes have underperformed international peers in recent weeks. The spread between the S&P 500 index and Eurostox index has fallen significantly recently, and part of this underperformance can be attributed to the central bank's stance (Figure 2). This relaxation then (aided by the remarkable weakness of the US dollar, with the DXY down 8.3% from its highs) should realign relative performance.

Figure 2: S&P 500 Index vs. Eurostoxx Index Spread

Source: Bloomberg, as at December 2, 2022.

"...the market focuses on one variable at a time, without linking the change in rhetoric to the worsening outlook."

Our view: The fact that the macro picture is worsening did not faze markets in the least, and they focused completely on Powell's words as justification for the rally. In practice, as we have seen now in recent months, the market focuses on one variable at a time, without linking, as in this circumstance, the change in rhetoric to the worsening outlook. It therefore comes naturally to think that once the Fed's less aggressive stance is fully incorporated (validated at last even by the Chairman, who had appeared to diverge from the other members of the board), the next phase may focus entirely on economic data—and for a while possibly forgetting the topics of inflation and geopolitics.

This week, our profit-taking order on the recent equity rise that we had rallied through futures on the S&P 500 index was triggered. Although we recognize that the market is sustained and that we will have to wait until next year for a new downside wave—which we believe will come due to the arrival of the recession and its impact on corporate earnings—we preferred to be disciplined, and stick to the 10% target we had set for this move. We have therefore gone defensive again in terms of asset allocation, consistent with the belief that we are still in a bear market, and that this will end with the alignment of two factors: the achievement of our fair value estimate (in the 3'400 area for the S&P 500 index), and a central bank that will reverse course in the face of a recessionary economy.

"...we recognize that the market is sustained and that we will have to wait until next year for a new downside wave..."

Equities | "Liquidity is there, but not really there"

Is the market complacent?

Last week we had a conversation with a business owner in the shipping industry who described the conditions within her sector as follows: "everyone is talking about the coming recession but nobody is taking action." We reflected upon this statement wondering if this is the same type of "complacency" we see in equity markets, and what the source of the complacency might be. Despite recent improvements in positioning and sentiment indicators, they are still well-anchored close to the low end of their historical ranges. Yet equity valuations continue to creep back up and credit spreads continue to tighten. And macro data remains inconclusive with inflation showing signs of peaking while employment conditions are still very strong. So, what gives?

"Despite recent improvements in positioning and sentiment indicators, they are still well-anchored close to the low end of their historical ranges."

Our view: There are two things to keep in mind when trying to answer this question. First, liquidity remains fairly tight in several parts of the market. As the shipping industry business owner described it, "liquidity is there, but not really there". Second, certain funds, especially macro hedge funds, capitalized successfully on the Fed's hawkishness, and now have every incentive to crystalize their gains before the end of the year. None of these funds will want to repeat the Bridgewater Pure Alpha fund fate, which lost most of its 2022 gains in the fourth quarter through November 25 (from 22% at the end of September to up around 6% now). The combination of suboptimal liquidity, maximum bearishness, and a high incentive to lock in gains in certain key trades for 2022 can lead to what appears to be market "complacency".

Widening the scope

We came across the following chart from Morgan Stanley, which highlights the size of venture deals by vertical. To us, it captured the essence of the parallel shift we are seeing in public equity markets (Figure 3). Note how FinTech, Gaming, Robotics, Esport and FoodTech (all hot themes of the past three years") slipped to the "Cost of Capital (/Narrative) Negative" quadrant. CleanTech, Supply Chain Infrastructure, Smart Manufacturing, Climate Tech and Health Tech are the new structural growth stories. The Inflation Reduction Act and other fiscal incentives that are likely to follow will only cement these narratives' lead. We suspect that these will be the same vertical that capital will flow to (multiple expansion) within public equities.

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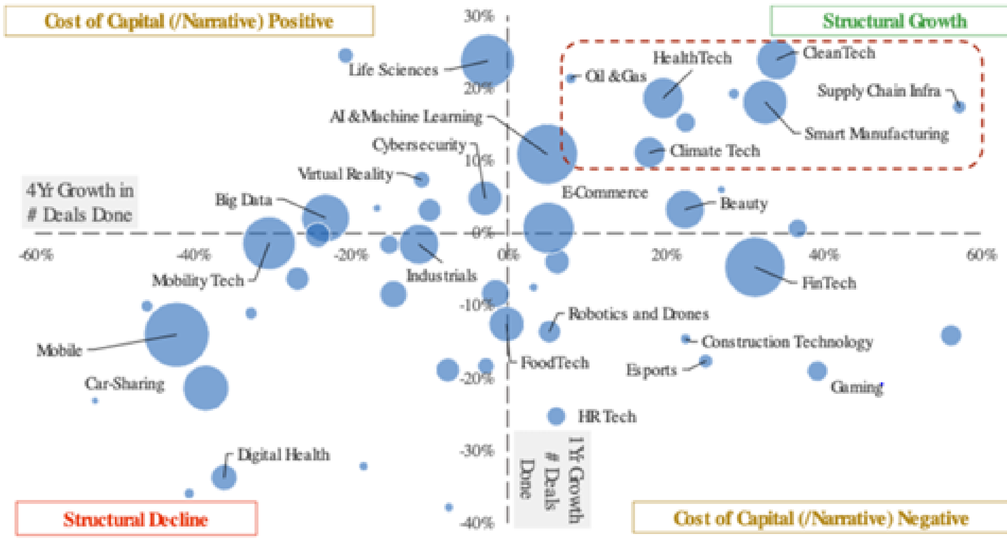
Figure 3: Venture Deals by Vertical (1-year x-axis versus prior four years y-axis)(bubble size = 5-year deals by vertical)



Source: Morgan Stanley.

Private Equity | Private equity secondaries dive

An attractive investment opportunity today.

“When managed well, this approach provides a source of liquidity to LPs wanting to cash out...”

In 2021, the global private equity (PE) secondaries market was worth around USD134 billion, according to data from investment bank Greenhill. If we go back to its origins, it is widely accepted that in 1979, it was the first time a limited partnership interest in a PE fund was purchased and transferred—the so-called traditional secondary LP-led transaction (by VCFA, or the Venture Capital Fund of America).

Over the following two decades, secondaries could hardly be called a market with a handful of firms engaging in buying secondary interests and very limited small sized dedicated funds. After the Global Financial Crisis, although initially volumes dropped as buyers and sellers were unable to agree on pricing, the new imposed regulatory restrictions to banks boosted secondaries deal flow and increased buy-side appetite. In the years that followed, the number of investment firms and asset management capitalizing on the sub-asset class grew in accordance with market size (by 2010, the secondaries market volume was USD25 billion).

Over the last five years, we have witnessed the rapid emergence of what is now the other main leg of the secondary market, the so-called GP-led transactions, that as of today comprise half of the total market share. In these deals, a sponsor arranges an optional liquidity process for LPs with the aim of moving one or more assets out of the fund and into a “continuation vehicle”. There are different motivations for a sponsor to pursue GP-led. When managed well, this approach provides a source of liquidity to LPs wanting to cash out, giving LPs the right to remain exposed while allowing for external capital to come in and an extended timeframe for the GP to create value. When poorly managed, such deals highlight an inherent conflict of interest between stakeholders.

Our view: In line with our positive stance in secondary PE funds under the current market backdrop, we wanted to write a few lines to contextualize our investment rationale. The sub-strategy benefits from a high level of diversification (over 1,000 underlying companies in top-line funds),

“...we believe the asset class is gaining relevance and making its way to become part of the allocation in PE portfolios.”

exposure to mature funds (bringing the distribution stream forward and softening the J curve), and inherent entry discounts to NAV (that historically have ranged from 10%-30% depending on the fund stage focus and market cycle).

2022 is poised to break all records by crossing the USD200 billion level in transaction volume if the activity in the fourth quarter keeps pace. As per our conversation with leading secondary GPs (including Ardian, Lexington, GS, and Hollyport) the increase in volume coming from institutional investors’ outsized exposure to private assets (due to the denominator effect) is being translated into all-time high discounts to fair value in new underwritings—and in some cases, reaching the 40% level.

Despite the attractive investment opportunity it presents today, we believe the asset class is gaining relevance and making its way to become part of the allocation in PE portfolios. Secondary funds, in our opinion, complement a diversified commitment into different PE / venture capital (VC) strategies. On the other hand, they pose an investment solution to portfolios that size-wise are unable to achieve sufficient diversification through primary fund commitments.

Among the different sponsors, secondaries are a scale segment where the most prominent and resourceful funds are able to perform look through asset-by-asset appraisals, getting a deeper insight of big institutional portfolios’ fair value on sale. Moreover, different funds focus on specific fund stages, strategies and transaction types in their investment process. At Novum, we are currently favoring LP-led tilted funds (where the higher discounts are present), with an average term of five years at entry and VC light funds. The bottom line is that—investment opportunity aside—we see the development of a secondary market for the PE industry as very positive in general, providing an opt-out for LPs and a portfolio management tool for GPs (when executed correctly). Greater efficiency will go hand in hand with greater depth.

Week Ahead | Key events to watch for

- After a busy week of economic data comes a week with little meaningful data and the Fed in blackout period. **In the US, we will see the PPI index and consumer sentiment** from the University of Michigan. In China, there will be CPI data and in Europe, German industrial production and the Eurozone trade balance will be published.
- Amid a softer oil price in recent weeks comes the **OPEC+ meeting and the start of European sanctions on Russian oil.**

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