NOVUM
CAPITAL PARTNERS

2023 Outlook

All is <u>not</u> quiet on the Western Front

January 8, 2023

Our investment team recently carried out a brainstorming session with Sharon, the highly appreciated "ghost editor" of our weekly Market Flash newsletter. We discussed the main economic and financial topics heading into 2023, along with some comments and lessons from the closing year. It was a long and thorough discussion with different opinions articulated by our investment team. As per tradition, we decided to share the results of the discussion in a Q&A format, which we believe will hopefully help our clients and our network to shape up their investment decisions and focus on the relevant drivers to navigate the year ahead.

An important introduction before we start. As we wrote in one of our recent newsletters, we think we are still in a bear market: "Our analysis is that we are actually entering the most problematic phase of this bear market. Specifically, one in which the economy starts to slow markedly, inflation is finally starting to normalize, but from levels too high for the Fed to reverse the tightening—and markets come into conflict with the central bank, resulting in equity losses and credit spread widening. The point is that unfortunately this phase could be a long one, as the core CPI is still at 6%, and the target level for the Fed is 2%."

We expressed this view in late December, and we don't foresee any relevant change to the picture in the short term. In fact, the opposite may be true—the Bank of Japan (BoJ) just decided to start tightening policy, changing the target band for the 10-year Japanese government bond from 25 basis points (bps) to 50 bps, thus further reducing global liquidity.

Vittorio, let's start from 2022. What have been the dominant investment themes? What messages can we draw from the performances of the main asset classes?

"The concept of duration, long undervalued, has returned to the fore as a risk factor and not just an opportunity factor, as it should be."

2022 was the year of wealth destruction. Rising yields impacted all asset classes, from equities to bonds to commodities to cryptocurrencies. The concept of duration, long undervalued, has returned to the fore as a risk factor and not just an opportunity factor, as it should be. The capitalization of global equity markets has contracted by around USD15 trillion, while around USD30 trillion has contracted in the bond markets, i.e. around twice the GDP of the US has evaporated.

As Figure 1 shows, there was nowhere to hide. Positive stock indices were rare and all among the emerging market countries; the only asset that did not betray was the US dollar, a safe haven asset legitimized by the Federal Reserve's (Fed) recovery of credibility after the mistake of having waited too long to raise rates in 2021 and early 2022. It must also be said that it was precisely the US dollar, toward the end of 2022, that began to creak, taking away the only certainty for global investors!

On the other hand, from an economic point of view, the most important fact is that the two major central banks, the Fed and the European Central Bank (ECB), have raised interest rates beyond all expectations to counter inflation, which has reached 8.2% in the US and 10.6% in Europe. 425 bps of hikes for the Fed (against only 75 bps expected at the end of 2021) and 250 bps for the ECB (against no tightening expected at the end of 2021) later, and the central banks are likely not finished: the market is still expecting 125-150 bps more hikes from the ECB, and 50-75 bps more from the Fed. The uptrend has indeed been global, and in the last week of 2022 even the BoJ threw in the towel by widening the band for the 10-year JGB from 25 bps to 50 bps.

In terms of economic growth, we note that the Fed and the ECB still expect real GDP growth in their respective areas of 0.5% for 2023, i.e. they still believe in the infamous 'soft landing'. A notable divergence, on the other hand, concerns inflation, where the central banks have become much more pessimistic than the market, which expects a rapid normalization as early as toward the end of 2023. Instead, the Fed and ECB estimate that inflation will only approach the 2% threshold in 2024, which is why forward rates (those discounted by the market) are lower than the rates forecast by the Fed and ECB in the range of 50-100 bps over the next 12 months.

“...the direction of inflation is certainly downward, but we consider a return to the 2% target unlikely—unless demand falls sharply.”

Figure 1: 2022 Performance of Major Indices

Equity	Last Value	Ytd
MSCI World	2,649.76	-17.71%
Nasdaq	10,569.29	-32.51%
S&P 500	3,895.08	-18.13%
DJ Industrial	33,630.61	-6.86%
SPX Value ETF	149.39	-5.40%
SPX Growth ETF	214.90	-29.31%
Nikkei	25,973.85	-7.38%
Eurostoxx	4,017.83	-8.55%
Swiss SMI	11,144.54	-14.29%
FTSE 100	7,699.49	4.57%
Canada	19,814.51	-5.75%
Shenzen	3,980.89	-19.83%
Hong Kong	20,991.64	-12.56%
MSCI EM	988.68	-19.94%

Bond Indices	Last Value	Ytd
US Inv Grade	108.60	-17.93%
US High Yield	75.53	-10.99%
Euro Corps	230.91	-13.65%
JPM Europe Govies	9,428.12	-13.22%
US Treasuries	2,224.97	-12.46%
China Aggregate	259.22	-5.20%
EMBI Global	775.02	-16.45%
EMBI Local	124.89	-10.18%

Commodities	Last Value	Ytd
BBG Commodities	108.11	13.75%
BBG Agriculture	66.84	13.22%
Gold	1,865.69	-0.28%
Silver	23.83	2.77%
BBG Brent Crude TR	972.04	41.78%
BBG WTI Crude Oil TR	176.20	24.94%

FX	Last Value	Ytd
DXY Index	1,245.12	6.23%
Bbg JP ASIA	101.91	-6.36%
Bbg JP LATAM	40.12	-2.76%
EUR Index	121.30	0.82%
EUR/CHF	0.988	-4.62%
GBP Index	624.62	-8.78%
EM FX Index	1,669.56	-4.26%
USD/JPY	132.08	13.94%
USD/CNY	6.83	8.54%
Bitcoin	16,950.30	-64.30%

Source: Bloomberg.

Let's talk about inflation. There is no point in trying to make a prediction, but at least we must have a structural idea. What are the key variables, and more importantly, what will be the reaction function of central banks?

“...if the world is changing, the 'rules of engagement' in investment decisions must also change.”

Let's start from the premise that we don't share the view, which we believe is superficial, that inflation in 2022 is the result of monetary policy being too loose for way too long, and that it is therefore bound to persist. Monetary excess is undoubtedly a contributory factor, but the tightening of supply resulting from the Covid-19 shocks, the war, and let's add the Suez Canal accident, are more relevant and structural. In my opinion, there are issues triggered by these events that will remain in the medium term: geopolitics have reversed the trend of globalization, with the issue of reshoring production capacity. Covid has impacted the labor market, with a structural reduction in the labor force and an increase in the demands of workers over the supply of labor. Then there is a final, far from minor aspect that will impact companies' inflation and margins in the future: the incorporation of environmental impact costs into the production process. A concrete example is the fresh approval of the 'carbon tax', or 'Fit for 55%', in Europe. An importing company will have to declare emissions directly linked to the production process in the country of origin of the goods and, if these exceed the European standard, they will have to purchase an 'emission certificate' at European prices.

All this is to say that on the one hand, the direction of inflation is certainly downward given the starting levels and the favorable base effects that have already taken hold in the last few months of 2022, but that we consider a return to the 2% target unlikely—unless demand falls sharply. And this may not even be sufficient if the change on the supply side is structural.

Let’s be clear, we’re not catastrophists, and we fully recognize that there are investment opportunities to make money out there. The point is that the world is changing, and not necessarily for the worse (see the previously neglected issue of environmental sustainability). The point is that if the world is changing, the 'rules of engagement' in investment decisions must also change. Another example concerns real interest rates; my impression is that, without exaggeration, central banks have realized that they will not be able to keep real rates artificially low structurally, but perhaps only for short emergency periods. When fully operational, I think we will have to get used to real rates between 1% and 2%. But again, this is not a negative, quite the contrary. It is clear, though, that the bar for profitability is slightly higher, since the cost of capital is higher and interest expenses higher. The same goes for corporate taxes. Large multinationals have benefited from a favorable tax trend over the last 20 years. Here too the trend has changed, with the minimum global corporate tax. And with interest expenditure for governments structurally climbing, where do you think governments will go to get more revenue? Certainly not from consumers already impoverished by rising prices.

On the other hand, inflation also has a very positive impact on the famous debt-to-GDP ratios. With nominal GDP exploding in the last two years (by around 20 percentage points in Europe and the US), all key ratios to GDP (equity market cap, government debts, household debts, corporate debts) have fallen sharply, in my view securing the soundness of the system, and in certain areas restoring value to assets.

"...the monetary and fiscal excesses of 2020/2021 that produced the inflation explosion have distorted the structure of the economy..."

As far as the business cycle is concerned, we said that central banks still believe in a soft landing, while the word 'recession' is on every investor's lips. What is the Novum view on this?

Vittorio: Let's assume that this is not a 'normal' business cycle. While the pandemic is almost a distant memory for Europe and the US, the monetary and fiscal excesses of 2020/2021 that produced the inflation explosion (amplified by the war) have distorted the structure of the economy, especially in the US. In China, on the other hand, a shocking attempt is underway to reopen the country from heavy lockdowns, with a still frightened population and the risk of severe health repercussions.

So the truth is that we cannot apply the classical interpretations. For example, the Chinese reopening could be smooth and offer an unexpected element of support to the Western Bloc. In the US, on the other hand, the excess savings accumulated during the pandemic (we are still talking about USD1.6 trillion, almost 6% of GDP), combined with a very strong and resilient labor market, could support consumers beyond expectations and avoid the most predicted recession ever. Having done some calculations on the savings rate, however, I feel I can make the following point. The US consumer has now taken savings, as the 'unspent' portion of disposable income, to the extreme, 2.1% in November (compared to an average of 6.5% over the last twenty years). This leaves these extra savings, which have been spent at a rate of over USD100 billion per month since this summer, which are used to keep consumption levels constant, mitigating the negative impact from price increases.

In short, this is to say that the economy could hold up for at least another six to nine months, prompting the Fed to raise rates further, before we see the unemployment rate rise and consumers begin to save to normalize their buffer. And this scenario, which would see Personal Consumption Expenditure (70% of GDP) contract by at least 2% according to our calculations, is not in the market's pricing right now. And finally, there is the wealth effect, which is impossible to measure because it actually enters the psychological sphere, but whose direction (negative alas) cannot be overlooked. For years we have said that we are not betting against the American consumer, and I think that part of its strength lies in the positive wealth effect resulting from the performance of the markets. But if we consider that the US markets alone have burned over USD10 trillion this year…

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The most important stock index for investors, the S&P 500, fluctuated between 4'770 points and 3'500 points in 2022. The forecasts of the investment banks were betrayed in 2022, when nobody had predicted a negative trend. What do the forecasts for 2023 say? And what is the Novum view?

Last year with Karim we developed a very simple forecasting model, linked to the main macro variables, and then translated them into an earnings forecast and, through a multiple (in our base case the current level of 18 on the trailing P/E is congruous) arrive at a fair value for the index (in the 3'400 area). This means that with the index at current levels, in the 3'850 area, we have to be defensive, as there is a 12% of downside before returning neutral. It is clear that circumstances could arise that would make our target even too optimistic:

1. A heavy recession could cause corporate sales to fall by more than the -2% (real) we assume.
2. Reshoring, increased global taxation, increased environmental impact costs and employee strength could increase the negative impact on margins (we assume a 3% reduction during the recession, in line with what has happened over the last 30 years).
3. Multiples might not stop at 18 x, but fall even below 15x, if geopolitical uncertainty rises, or especially if interest rates go above 5% in the US.

I have to say that of the three scenarios, the second is the most likely, and the others I believe little in. Of course we could also be wrong in the opposite direction, i.e. things could go much better than expected: if the Fed succeeds in its soft landing, and inflation falls rapidly, the certainly defensive positioning in the market today would push the index to new highs quickly, and we would suffer with our positioning. So, the positive scenario is possible, but unlikely to our judgement.

"A general theme that has emerged in 2022, and in my view should continue in 2023 if our macro scenario is correct, is the superiority of the value segment over the growth segment."

Since you are so defensive, what can you do to limit the damage if you are wrong? I mean, even in a bear market you can always find something going up, right?

You are absolutely right Sharon. There are some sectors that I like, some that we already have in our portfolio, some that I would like to buy at the first opportunity of weakness, that I think will do well in the core scenario we have outlined. For example, banks in Europe and Japan, the Japanese market more generally, and small caps in the US. For banks, the theme is consistent with rising rates and lending (which remains buoyant, thanks in part to the government guarantee programs following the pandemic that are due for renewal). In both countries then the sector is at a discount, in terms of P/E and Price-to-Book ratios.

A general theme that has emerged in 2022, and in my view should continue in 2023 if our macro scenario is correct, is the superiority of the value segment over the growth segment. In particular, value-oriented small caps could be the most attractive bet to outperform the market, as they start from better valuations, and should benefit from a normalization in absolute inflation levels.

Vittorio/Karim: It's been a while since we've heard about the 'Fed put'. What does it mean, and why is the concept no longer in vogue?

Vittorio: For the last two decades, ever since inflation basically disappeared in the Western world, investors traded knowing that if the S&P 500 index fell by 10-15% due to any shock, the Fed would intervene by cutting rates, or doing QE, to support the index. And this has always worked. In essence, the game worked because inflation never actually went up, regardless of monetary policy. My theory is that the supply curve, with globalization, had become so elastic that any increase in demand would be accommodated immediately by the increase in supply without incurring rising marginal costs. With the supply shocks we have been discussing, this no longer applies. Therefore, my view is that the Fed put is suspended for the time being, and its strike is much lower. To be fair, we have learned that there is a Fed (short) call, which is the opposite. The Fed includes the level of the S&P 500 index in the financial conditions, which it wants to keep tight at this time, so when the index rises too much (as it did this summer, when we bounced above 4'200), the Fed increases its hawkishness, even with some irritation.

"...my view is that the Fed put is suspended for the time being, and its strike is much lower."

Karim: The Fed put is a by-product of the Fed's dual mandate of 1) maximum employment and 2) price stability. In attempting to achieve its second mandate of price stability, the Fed has been targeting inflation at 2% since 2012. When inflation was within target, the Fed had every incentive to exercise the Fed put against exogenous shocks to ensure maximum employment. But when maximum employment is the cause of price instability and above-target inflation, the Fed is forced to abandon its 'put' tool.

Karim, let's talk about earnings, which are currently in the spotlight and are the reason for caution, even at Novum. What does the consensus say and where do you think they might converge? What are the reasons why they should fall (well beyond analysts' estimates)? At the same time, if everybody in the world expects earnings estimates to come down and they don't… Well, we don't need to guess what that might mean because we saw very recently FedEx and Nike both skyrocketing after their latest earnings announcements.

Two months ago when Vittorio and I did an exercise that aimed at determining the S&P 500 index's fair value, 2023 average consensus EPS forecast for the index stood at USD242, a 8% year-on-year growth. Today this estimate stand at USD210, already a 13% reduction in around 60 days. Clients who have seen our model know that there is further downside risk to this reduced estimate should margins contract like they do in a typical recession. It is true that many investors are now expecting lower earnings than before. We argue, however, that most still expect a mild recession coupled with a Fed pivot, resulting in flattish earnings growth for 2023. Should the deep recession scenario materialize, I think many investors will be caught wrongfooted. Q4 2022 earnings results are unlikely to be the straw that breaks the camel's back. The consumer remains healthy, with spending habits supported by very low unemployment rates. Pay close attention to capex and opex cuts.

"For 2023, our focus is on where governments are spending money."

Karim, you like to invest on a thematic basis in equities. In 2022 you kept a relevant underweight in Big Tech in your equity book, and this allowed portfolios to outperform international benchmarks. What will you play in 2023?

It is true that we favor long-term structural themes that are supported by reasonable valuations. For 2023, our focus is on where governments are spending money. One major event that occurred in 2022 was the passing of the Inflation Reduction Act (IRA) by Congress. The IRA bill underscores the government's resolve to fiscally fight climate change. Europe also shares the same resolve. As such, we believe this is likely to have legs for many years to come. This electrification push has the potential to trigger another commodity supercycle.

Another area where Western governments are likely to also spend money is on the reshoring of critical industries, as demonstrated by Taiwan Semiconductor's recent announcement to build a new chip plant in Arizona, taking advantage of the CHIPS and Science Act's allotted USD52.7 billion in loans and billions more in tax credits.

Vittorio, Flavio, what do you think about rates, or better, government bonds? 2022 scared investors with negative returns ranging between -10% to -15% for long duration bonds. Has value finally been restored? Can long-dated bonds be used again as a hedge to equity risk in portfolios (the 60/40 risk parity trade)?

Vittorio: Let me make a couple of fundamental assessments: eliminating the market distortion in the QE years, the golden rule for a 10-year yield is: *nominal rate = real growth + long-term inflation rate*; with a deviation of 100 bps depending on the phase of the cycle we are in, the monetary policy of the moment, the savings glut and other secondary factors. So in the US, around 4% on the 10-year you can buy, at least in terms of portfolio management, since bonds can offer a decent yield and a good hedge in the event of an equity crash. Let me add a little reasoning: if I buy the 10-year at a 4% yield, and hold it for a year, I accumulate a decent coupon. If yields fall by 100 bps, with a duration of about seven years, I add to the 4% coupon a 7% increase in the price of the bond. If I am wrong and yields rise by 100 bps, I will lose 7% on the price, but recover 4% coupon, so my return will be -3% in one year. In short, it is clear that the risk/reward is back to being asymmetrical, in favor of a long position!

"The uncertainty around inflation and monetary policy makes US Treasuries a volatile investment in the first quarter of 2023."

In Europe and Japan, with the Bund at 2.4% and the JGB at 0.5%, the golden rule is not respected at all. Moreover, inflation in Europe is well above that in the US, while the ECB is raising rates and will have to find a way to support the debts of peripheral countries to the detriment of the German one if it wants to hold Europe together, a desire of which I have no doubts and which is also well understood by populist governments (see how tame the Meloni government in Italy became once in government, after her party had opposed Draghi). In Japan there is no need to comment, with an artificially compressed rate well below the level of inflation, now above 3%. We implemented a short position on JGBs last summer, perhaps a little too early, but we are finally back in-the-money. I am confident it will give us satisfaction next year, as the risk/reward is opposite that of US Treasuries.

Flavio: In my opinion, the uncertainty around inflation and monetary policy makes US Treasuries a volatile investment in the first quarter of 2023. If macro data comes down on the side of sticky inflation, the Fed's dot plot will prevail (terminal rates at 5.25%). If instead they lean toward a weaker economy, the market will increasingly challenge the dots, hoping for a revision in March. That said, the prospects for a likely recession in the US and the EU by the second half of 2023 make the investment case for US Treasuries compelling on a six to 12 month horizon (US Treasury with a 5-year duration).

The question we always receive is "who will buy the bonds?", especially with a new obstacle on the horizon: quantitative tightening (QT). With regards to QT, we need to be honest and say that it is truly puzzling. At the same time, with little to no historical precedents, it is a challenge for anyone. The 2018-2019 episodes showed that bond yields fell despite QT, because growth and inflation dominated the minds of investors. Our gut feeling is that if QT has a bad influence on yields, this will be more felt in Europe, where the ECB will begin reducing its EUR5 trillion bond pile from March.

Returning to "who will buy bonds as central banks back away?", we can reasonably be more optimistic about demand dynamics. Households and asset allocators are underweight bonds and with investment grade (IG) bonds yielding 4-7% across maturities, it is reasonable to expect this underweight will be reduced, potentially inverted. Institutional investors such as corporates, pension funds, and insurance companies can now achieve the minimum target yield (4%, even in EUR), without having to accept lower quality or higher subordination, which will again support the market. Finally, there will be less of an overhang of IG bond issuance given that many companies have been able to front-load their funding over the past two years.

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Flavio, let's focus on corporate bonds. At current levels, can spread products represent a viable alternative to equities in the construction of a portfolio? Or does the recession threat pose too much of a risk for the asset class? It seems to me that little by little we are starting to get requests from clients who want to re-enter the asset class. What are you proposing? Does it seem to you, in short, that after years of financial repression, some intrinsic value has returned?

2023 will be a year where the recession risk is significant, while we are getting closer to the peak in global rates. This could put bond returns at a turning point. In credit (spread products), we need to distinguish investments in terms of quality. On one side, IG bond prices tend to be supported by falling government bond yields during periods of recession, which tend to outweigh the impact of rising credit spreads. On the other side, in a recession, as credit fundamentals deteriorate, high hield (HY) bonds tend to underperform because investors want compensation for the potentially negative rating actions, increasing defaults, and liquidity risks. Therefore, from a portfolio construction point of view, high grade bonds (IG) should be preferred. First, in terms of outright yields, we have seen a dramatic increase of 310 bps year-to-date to 5.44%.

Second, credit spreads as a proportion of the total yield are much smaller: 1.30% out of 5.44% versus 0.93% out of 2.33% at the beginning of the year—in other words, the spread is now only 24% of the total yield, when at the beginning of the year it was 40%. The recession poses much higher risks to the lower quality segment of the credit space, namely HY and leveraged loans (LL). Spreads for HY bonds typically head toward 800 bps over Treasury bonds in a typical recession, but at the current 452 bps, they're nowhere near discounting a genuine downturn.

To sum up, what I propose is to buy shorter-dated (1–5 year) bonds of select corporate issuers across IG to lock in attractive yields and to contain the price risk from rates and spread volatility. In USD, you can now achieve an average yield of 4.85% (coupon 4.3%) for maturities around 2.5 years and ratings of A/ BBB+.

With regard to requests from clients who want to re-enter the asset class, we are in fact starting to see some interest for the asset class. However, even if everyone acknowledges that what matters is the yield, the fact is that after many years of zero/negatives rates, coupons on display are very low (and bonds are now trading at a discount to par). This is perhaps psychologically and practically holding back the interest from those investors that are income oriented. But, next year in the primary market, finally, even for quality names, new bond issuance will start to display nominal coupons in line with yields, with both at interesting levels. The above analysis, however, only holds if the US economy enters recession in the second half of 2023. The timing of the recession plays an important role. If the recession is delayed to the end of 2023, because the US labor market remains resilient, meaning that inflation remains sticky, the market will need to reprice the probability that central banks will be obliged to remain restrictive for longer. This implies another relatively difficult year for bonds.

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Finally, regarding your question whether some intrinsic value has returned to the fixed income space, I would say yes. The BoJ's recent policy adjustment toward normalization triggered a jump in Japanese government bond yields, putting an end to the global era of negative yields, in which markets were relying on central banks to do everything. The worldwide stock of negative-yielding debt stood at about USD686 billion on Tuesday, down from a peak of USD18.4 trillion reached two years ago. For fixed income investors, this is positive if the inevitable adjustments, such as Japanese foreign investment repatriation, are made in an orderly manner. However, with cheap money becoming a thing of the past and after years of excess, several stress points have already emerged in credit markets, from banks stuck with piles of buyout debt, to a pension blow-up in the UK and real estate troubles in China. A deep recession could cause significant credit issues because in some corners of the global financial system, investments in illiquid products have grown. Offering liquidity in the form of redemptions from assets that do not have an active secondary market (private credit) or have poor quality (leveraged loans with weak covenants) can lead to potentially significant stress when sentiment weakens. Except for the ultra-powerful asset managers like Apollo or Blackstone, who have the know-how and financial muscle to cope with emergencies, who knows how many second-tier financial copycats have proliferated under the radar.

"Offering liquidity in the form of redemptions from assets that do not have an active secondary market or have poor quality can lead to potentially significant stress when sentiment weakens."

A big theme in 2022 was the volatility of fossil fuels. Do you think this will remain in the year ahead? Oil, after exploding following the invasion of Ukraine, plummeted, due to a confluence of factors: the release of reserves in the US, a smaller than feared production cut by Opec+ countries, the economic slowdown in the West, and lockdowns in China. At the end of the year, it was a big disappointment for energy bulls, with oil flat, but at least energy companies managed to perform strongly (58% year-to-date). What do you think lies ahead?

Vittorio: I think the risk/reward remains positive, both for oil and energy stocks. The strongest bet remains on the Chinese reopening—I see little reason why it should be much more problematic than in the West.

China's choice of easing seems to me irreversible: the zero-Covid policy is an experiment to be forgotten. Restrictions in place are now few and symbolic, while the most economically crippling measures such as quarantines, community lockdowns, and travel restrictions, have been quickly lifted. The financial and social cost of maintaining the zero-Covid policy had become too high. True, there are legitimate concerns about the reduced effectiveness of Chinese vaccines and the tightness of the hospital system, but I recall that similar worries marked the reopenings in the West, not to mention the terror in the face of the Omicron variable—which then turned out to be a panacea for the normalization of the virus, thanks to its high contagiousness and very low mortality rate. Then there is still the structural factor of the downsizing of supply due to environmental issues, so there remains a window of unbalance in the market, waiting for renewables to fill the energy gap.

Karim, let's assume that Vittorio is right about the Chinese reopening. But are we sure that playing the scenario again with oil or energy stocks is the right choice? It would be a shame to guess the scenario and not turn a good idea into gains, wouldn't it? What alternatives could one ride?

The most direct way to play the China reopening theme is via Chinese stocks. Since bottoming at the end of October 2022, the CSI 300 index and Hang Seng index are up 10.5% and up 34.9% (in local currency), respectively. Communication services and consumer stocks led the reopening rally as investors sought long duration and discretionary spending beneficiary stocks; positive news on the ADR delisting front also contributed to the outperformance of communication services stocks.

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However, investors remain skeptical of the China reopening theme, or at least expect a complicated reopening due to the rise in infection rates. As such, investors have also been bidding up other assets with large exposure to China, including European luxury names and Japanese exporters. But the returns of these proxies have lagged Chinese equities' returns and, in many cases, disappointed. Despite the rally in Chinese equities, many of these stocks continue to trade at a wide discount to their historical and global peer group average multiples, making them a far more attractive option than the indirect plays. Commodity stocks should also be theme beneficiaries, but are likely to be volatile, given the risk of recession in Europe and the US.

Carlos, has the repricing of the cost of capital in the public markets in 2022 also affected the private equity world? Is it true that exit opportunities have shrunk and that large funds are hoarding dry powder to deploy in better times?

For the last several months, private equity dealmakers have experienced a significant slowdown in activity and interest rates have certainly played a role in that. But it is important to keep in mind that the slowdown in 2022 feels especially dramatic as it comes after a blockbuster year in 2021, which set the records in pretty much every respect of the PE industry—the number of deals, value of deals, valuations, amount of debt, amount of fundraises, and amount of exits. There is no doubt that 2021 marked the peak of an unprecedented period of low rates that benefited high leveraged strategies, putting a question mark on the foreseeable expected return in the traditional PE LBO space.

“In terms of expected return, a healthier and a more reasonable valuations environment is going to be very positive for the industry going forward.”

Following the end of the zero-interest rate period, the number of transactions and the volume activity decreased during the second half of the year compared to the previous year's figures. On the one hand, a dislocation has occurred between the price multiples that buyers and sellers are willing to pay. Leveraged multiples are also coming down as lenders are no longer willing to lend M&A activity at a 7x or higher leverage (more in the 5-5-5x range) that is being translated into lower enterprise values. On the other, PE loans are much harder to get and more expensive. Bank financing activity was halted as they reassessed new deployments in their credit books in anticipation of the expected deterioration therein.

All of the above is leading into a repricing process that is taking place and it is expected to last until more certainty in the macro picture is reached. While dry powder provides undoubted support for valuations in the short term, we believe that we are in the early stage of a more traditional PE business cycle in which fund managers will become more disciplined in deploying capital spreading investment along investment years. In terms of expected return, a healthier and a more reasonable valuations environment is going to be very positive for the industry going forward. Entry multiples in long-term investments have been historically the most important variable in explaining outperformance—and therefore, we think attractive vintages are lying ahead. On the flip side, companies’ economics adjustments and fund mark downs will impact past vintages, especially those fully deployed at peak valuations from 2019 onwards. The latter outlines the importance of vintage diversification.

It seems to me that transactions on the secondary market have become increasingly common at the end of 2022, offering equity holders an avenue to sell stakes, the only way for investors to recover liquidity. But at what discounts do these transactions take place? And have you at Novum done anything in this suit?

That is completely right, as we commented in one of our recent weekly newsletters. Unlike all other PE metrics of 2021 versus 2022, secondary volumes are setting new all-time highs in terms of deal volume and deal count. We see the development of a secondary market in the PE industry as very positive in general, providing an opt-out for LPs and a portfolio management tool for GPs. With data for Q4 still to be confirmed, the secondary market is likely to exceed the USD200 billion threshold versus USD138 billion in 2021 due to institutional investors unloading private holdings. This additional supply is being reflected in record discounts in new deals originations, however, it is hard to generalize. Discount levels vary depending on the source of origination (LP / GP led), portfolio maturity (early stage / end of investment period / maturing) and strategy breakdown (PE / VC). Considering the above, deal discounts are ranging from 15% to 40% currently, posing an attractive investment opportunity into diversified portfolios with higher level of visibility. Following the investment rationale, during the last quarter of the year, we advised on committing to Ardian Secondary Fund IX for our client´s portfolios. The fund invests predominantly in LP-led type of transactions—where higher discounts and diversification are found—and it does not invest in VC / EM / distressed, in line with our positive view on the opportunity but still with a cautious stance on markets.

“The events of the last year represent a material blow during an extraordinary period of adoption.”

Daniele, 2022 saw a debacle in the crypto world. After the collapse of the major currencies came the FTX scandal. Is the SEC finally deciding to regulate this sector? Are there any signs in this direction? And at Novum, do you still have exposure to cryptos or blockchains?

The events of the last year represent a material blow during an extraordinary period of adoption. Although this represents another dark mark on the whole crypto industry's reputation, this is a remarkable failure of centralized entities (Luna foundation, FTX/Alameda Research). We assisted at a flight-to-quality among institutional investors, and users increasingly distinguish the difference between centralized and decentralized trading and custody protocols and realize that the latter eliminates counterparty risk by eliminating their dependence on intermediaries, or human judgment and trust. There are important characteristics that distinguish this market from the previous crypto winter. Institutional crypto adoption remains firmly entrenched. While veteran cryptocurrency investors are used to these cycles, many investors are starting to take a long-term perspective and recognize the cyclical nature of this market. The total market capitalization of cryptocurrencies is currently around USD800 billion, down 62% from USD2.3 trillion at the end of 2021, albeit still high relative to most of the asset class's history. From a Sharpe ratio perspective, crypto's risk-adjusted return performed negative, in line with US and global stock indices through 2022, and did much better than US bonds.

"Institutional adoption must obviously be accompanied by a greater demand for regulatory clarity, as institutional investors push for better governance and standards that help make the asset class more accessible, safe and easy to navigate for all."

Institutional adoption must obviously be accompanied by a greater demand for regulatory clarity, as institutional investors push for better governance and standards that help make the asset class more accessible, safe and easy to navigate for all. This necessity must take into consideration the idea of an alternative financial system not controlled by centralized actors but by laws that are codes, and the risk is that heavy regulation will push cryptocurrency participants offshore, putting customers even more at risk.

If the adoption is at an early stage, the regulation is at stone age. The conflict of interest showed for the FTX/Alameda story is something that US regulators started to deal with since 1933 with the Glass-Steagall act. After the 2008 banking collapse, there was another step with the Volcker Rule of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Eventually, after years, this restored confidence in the banking system that had lost steam. Likewise, trust in cryptocurrencies will have to be rebuilt over time, as regulatory scrutiny, already on the rise, is likely to intensify further.

In March 2022, US President Joe Biden issued an executive order focused on laying out organizational principles and regulatory objectives for the crypto space, asking government agencies to research various topics related to digital assets. Unfortunately, good hopes suffered a blow, as Sam Bankman-Fried was one of the leading voices in this process. In Switzerland, the home to Europe's Crypto Valley, the regulations governing cryptocurrencies are fairly accommodative. The country enacted the "Federal Act on the Adaptation of Federal Law to Developments in Distributed Ledger Technology" (the Blockchain Act) in August 2021. This provided a secure legal basis for the trading of cryptocurrency rights. The main regulatory body tasked with matters related to digital assets is the Swiss Financial Market Supervisory Authority (FINMA), which classifies crypto as a distinct asset class, most like property or hard metals, as opposed to securities.

Over the last year in our portfolios, we continued the transition from Layer-1 crypto to VC funds investments, selecting experienced team of crypto native with some financial background. On the upside, there's still a record amount of dry powder that ultimately needs to find a home, and many high-quality entrepreneurs continue to build in digital assets. The scale and visibility of this incident will undoubtedly lead to a loss of confidence on the part of consumers and institutions, lower VC interest and turbulent markets in the near term. However, we do believe the effects of the event will be a short-lived phenomenon that could last in the medium term. Ultimately, we continue to believe that blockchain is the most significant technological advancement of this generation—and we're still in the early stage of adoption.

"Hedge fund performance amid the market turmoil of last year highlighted that the asset class can be uncorrelated and play an important role in a portfolio by acting as a diversifier to a more traditional asset allocation..."

Maxime, one could really say that 2022 was the year of the great return of hedge funds. Your arrival at Novum could not have come at a better time then. What have you implemented in your clients' portfolios? And what are the prospects for the year ahead?

Undoubtedly, 2022 was a good year for hedge funds (the HFRX global index was down -4% in 2022 when both equity and fixed income reversed double digits) as performance was buoyed by strong macro manager returns in their largest comeback since the global financial crisis, as well as multi-billion multi-strategy platform funds that have efficiently moved capital across strategies to benefit from market dislocations.

Hedge fund performance amid the market turmoil of last year highlighted that the asset class can be uncorrelated and play an important role in a portfolio by acting as a diversifier to a more traditional asset allocation, and protect to the downside in a volatile market environment. That said, not everything worked in the hedge fund world and the well-publicized underperformance of long/short growth-focused managers have been a stark reminder that both due diligence and portfolio management are paramount when building a resilient allocation to hedge funds across market regimes given the wide dispersion in performance.

Specifically at Novum, we have always kept a bias toward alpha-driven strategies with the bulk of our allocation in the macro and relative value space, which certainly served us well last year, and we expect to maintain this overweight. Since joining the team, I have therefore dedicated my time to building further our manager line-up across strategies/sub-strategies and deepening our ties within the industry. This translated into new allocations and rebalancing being made for our client portfolios as we aim to offer expertise across the strategy spectrum, coupled with a strong portfolio and risk management framework.

Looking ahead, with the current market backdrop and our expectations for generally higher volatility / dispersion throughout 2023, we believe that many areas within both the relative value (RV) and macro strategies will remain attractive given their tactical trading abilities. That said, we also recognize that many parts of the industry could present near-term opportunities and should be watched closely—including credit, especially in the distressed space, specialist long/short managers or M&A focused strategies. Given the fast-paced nature of markets, these are all areas that we have already started researching as we want to be able to deploy capital rapidly and opportunistically should opportunities materialize.

"...we believe that many areas within both the relative value (RV) and macro strategies will remain attractive given their tactical trading abilities."

Vittorio Treichler	**Flavio Testi**	**Daniele Seca**	**Karim Khalil**	**Carlos De Andres Perez**	**Maxime Glasson**
Chief Investment Officer	Senior Fixed Income Portfolio Manager	Senior FX, Crypto & Derivatives Portfolio Manager	Senior Equity Portfolio Manager	Senior Private Equity Funds Manager	Senior Hedge Funds Manager

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