NOVUM
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Weekly Market Flash

An all too quick recovery

September 11, 2022

This week, equity markets stabilized, following three weeks of losses which combined to a loss of over 9% for the S&P 500 and the Eurostoxx 50 indexes. Despite the paradox that strong US economic data continues to rattle markets (due to the hawkish effect that such data imposes on Fed-led central banks), following last Friday's labor market report—which seemed perfect for calming tensions as it was solid but with signs of slowing—it took a couple more days at the start of this week before we saw a stabilization. More than the news, it was likely once again excessive pessimism, reduced fears over rising rates, and the usual extremely short positioning of investors that set the stage for a recovery.

Highlights

- The ECB hiked rates by 75 bps, the highest hike in its history. Growth and inflation forecasts for the years ahead were also revised: inflation forecasts were raised to 8.1% for 2022, 5.5% in 2023 and 2.3% for 2024. Meanwhile for growth, a recession has not (yet) been factored in, but nevertheless the revisions have been markedly downward.

- China's CPI and PPI data fell to 2.5% and 2.3% (five-tenths below expectations), respectively. This can legitimately be seen as a sign of slowing global inflation, given China's role in the global supply chain.

- Following the rebound in the S&P 500 index from the June lows, the index is now trading at a 17x forward earnings multiple, compared with roughly 15x at this year's low.

- This year, venture capital pre-money valuations have proved to be resilient. Angel and seed rounds showed positivity in pre-revenue and nascent ventures on both sides of the Atlantic, with a pre-money median valuation reaching EUR5.8 million and USD12 million above 2021 in Europe and the US, respectively.

"Markets stabilized once rates reached key levels—after the US 2-year and 10-year reached 3.55% and 3.35%, respectively."

Markets & Macro | An all too quick recovery

Stabilization in rates supports equities.

As mentioned, excessive pessimism, declining concerns on rising rates, and extremely short positioning of investors likely drove a recovery across markets this week.

Our view: In our opinion, it was the stabilization of rates that allowed equities to recover. In particular, markets stabilized once rates reached key levels—after the US 2-year and 10-year reached 3.55% and 3.35%, respectively. Here, too, there was no big news, apart from a couple of slightly more dovish Federal Reserve (Fed) governor speeches, compared to Fed Chair Powell's hyper-aggressive speech a fortnight ago in Jackson Hole.

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

Equity	Last Value	Ytd
MSCI World	2,682.90	-15.67%
Nasdaq	12,112.31	-22.14%
S&P 500	4,067.36	-13.72%
Nikkei	28,214.75	-0.86%
Eurostoxx	3,570.04	-14.44%
Swiss SMI	10,900.24	-13.04%
FTSE UK	7,351.07	2.49%
Canada	19,773.34	-4.91%
Shenzen	4,093.79	-15.47%
Hong Kong	19,362.25	-14.63%
MSCI EM	970.29	-19.22%

Commodities	Last Value	Ytd
BBG Commodities	118.52	19.51%
BBG Base Metals	230.53	-17.36%
BBG Agriculture	69.07	13.63%
Gold	1,716.83	-6.14%
Silver	18.86	-19.09%
BBG Brent Crude TR	1,071.39	43.05%
BBG WTI Crude Oil TR	197.78	29.18%

Bond Indices	Last Value	Ytd
US Inv Grande	108.38	-16.68%
US High Yield	75.81	-10.01%
Euro Corps	232.28	-11.89%
JPM Europe Govies	9,482.85	-10.84%
US Treasuries	2,231.34	-10.74%
China Aggregate	257.31	-4.44%
EMBI Global	761.00	-17.24%
EMBI Local	120.60	-12.42%

FX	Last Value	Ytd
DXY	1,298.63	10.67%
Bloomberg JP ASIA	99.71	-7.73%
Bloomberg JP LATAM	40.66	-0.54%
EUR Index	117.84	-2.42%
EUR/CHF	0.96	-7.06%
GBP Index	619.23	-9.31%
EM fx	1,632.00	-5.90%
JPY	142.47	-19.23%
CNY	6.93	-8.24%
Bitcoin	21,683.71	-53.20%

Source: Bloomberg, as at September 9, 2022. Performance figures in indices' local currencies.

"It is now becoming a characteristic of this bear market... that at the slightest sign of normalization, the market quickly recovers..."

It is now becoming a characteristic of this bear market to reach extreme levels of pessimism, resignation, and defensive positioning, so that at the slightest sign of normalization, the market quickly recovers, providing a feeling of illusion that everything is over. In all this, as we have stated recently, it is that the Fed is continuing to fight a rearguard battle—and that the next course of action may be the opposite, that is, of shrinking nominal variables with an impact on consumers (affected at some point by rate rises), and companies (with shrinking margins and hence profits).

Here, too, little was evidently needed. After all, there are now plenty of early signs of inflation that hint at a decline, even a marked one, in the coming months (we refer to all the supply-side indicators, such as freight rates, the prices paid component of the PMIs, wage levels, online prices of goods, the housing market and house prices, and the collapse of oil and many other commodities due to the strength of the US dollar and lower growth). Interestingly, 1-year inflation swaps and 1-year breakeven rates have collapsed to around 2%, and well below the values prevailing the inflation scare that we are currently experiencing (Figure 2).

"...there are now plenty of early signs of inflation that hint at a decline, even a marked one, in the coming months..."

Figure 2: 1-year Inflation Swaps and Breakeven Rates Collapse

Source: Bloomberg, as at September 9, 2022.

In our view, the general sentiment was supported by the release of the CPI and PPI data in China, which fell to 2.5% and 2.3% (five-tenths below expectations), respectively. This can legitimately be seen as a sign of slowing global inflation, given China's role in the global supply chain. However, the situation in Europe looks very different. As widely expected, the European Central Bank (ECB) hiked rates by 75 basis points (bps), the highest hike in its history, while the bond reinvestment plan remained unchanged.

The aggressive decision was justified not only by the statement and Lagarde's words during the press conference, but also by the revision of growth and inflation forecasts for the years ahead. For inflation, which will remain well above the 2% target, the forecasts were raised to 8.1% for 2022, 5.5% in 2023 and 2.3% for 2024. Meanwhile for growth, a recession has not (yet) been factored in, but nevertheless the revisions have been markedly downward: 3.1% for 2022, 0.9% for 2023 and 2.3% for 2024.

As we have commented several times, looking at these numbers, and incorporating the energy crisis and the now chronic weakness of the Euro (we note that the "historic" 75 bps rise has generated a very small squeeze against the US dollar, but weakness against other European currencies led by the Swiss franc), the task for the ECB remains much more difficult than for the Fed in the coming months. On the one hand, the prevalence of the hawks (and the admission of guilt for having neglected inflation over the past few months) is justified, but on the other hand, the impending economic crisis should impose caution. In fact, after the ECB meeting, the usual anonymous rumors circulated (which the central bank often uses to spread messages), which spoke of a further 75 bps hike at the next meeting in addition to Quantitative Tightening measures on the way.

"The next downward leg in the equity market should be driven by earnings, and no longer by multiples..."

In terms of asset allocation, we started to include a dose of duration, through the purchase of US Treasuries, in our discretionary portfolios. The position is consistent with our earnings and multiples considerations made in our previous Market Flash publication. The next downward leg in the equity market (which we obviously do not hope for, but cannot rule out), should be driven by earnings, and no longer by multiples—which are largely a function of rates and other risk factors (such as geopolitics or the predictability of economic policies). If earnings fall in the coming quarters due to the recession, these should be a function of the inability of companies to pass onto consumers the cost pressures they are experiencing, as they have done so far.

Thus, in an environment of price disinflation, US Treasuries should, in our assessment, regain their safe haven status, and no longer be the driver of stock market losses. At current levels around 3.30%, the US 10-year is starting to offer value. To give some context, the 2-year yields 3.50%, Fed Funds are expected to touch 4% in the coming months, while real implied rates have almost reached 1%—a level touched in 2018 when Powell's sudden hawkishness caused the stock market to collapse in the last two months of the year. This time, the macro conditions are completely different, but the effect on the markets is just as heavy, and appears even more lasting. As for US Treasuries, our aim is to build the position gradually should yields continue to rise to the 3.75%-4% area, where we would see even more benefit from the position—as we believe the impact of even higher rates on the economy would be difficult to sustain.

Equities | Is guidance sufficiently reflecting the economic deterioration?

Margins normalize, but remain historically high.

"The rebound in the multiple was not only driven by the price rebound but also by the cut in forward earnings forecasts."

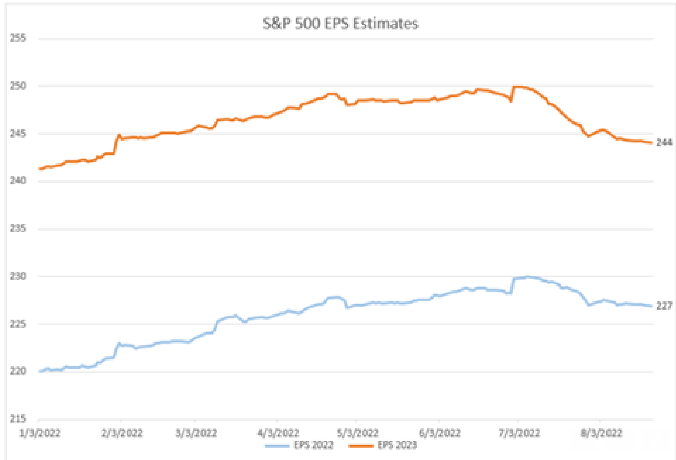
Since Powell's speech at Jackson Hole, major US and European equity indexes have gyrated wildly only to end slightly above or slightly below their US dollar levels from two weeks ago. What started as a negative reaction to the Fed's resolve to bring down inflation to its 2% target turned into excitement over signs of fading inflationary pressures: the Fed's Beige Book showed moderating price increases in nine of its 12 districts, a lower-than-expected Chinese PPI, and a surprise negative net change in Canadian employment. An extremely low investor sentiment, as judged by the latest very low AAII bull/bear ratio reading, and light volumes also contributed to the relief rally's intensity. Finally, Fed Vice Chair Brainard's comments were perceived as "dovish", lending hope to the possibility of a "soft landing".

Our view: Following the rebound in the S&P 500 index from the June lows, the index is now trading at a 17x forward earnings multiple, compared with roughly 15x at this year's low. The rebound in the multiple was not only driven by the price rebound (nominator) but also by the cut in forward earnings forecasts (the denominator).

At an index level, the earnings downgrades still appear moderate (Figure 3). A look under the hood, however, reveals that these forecasts are largely supported by the substantial upgrades in the energy sector. Almost all other sectors have seen forecasts earnings downgrades, led by consumer discretionary and communication services. The earnings downgrades are taking place despite a better-than-expected Q2 earnings season and better-than-feared overall corporate guidance.

“…analysts don’t see the guidance as sufficiently de-risked to reflect the deterioration in the macro environment.”

Figure 3: S&P 500 EPS Estimates



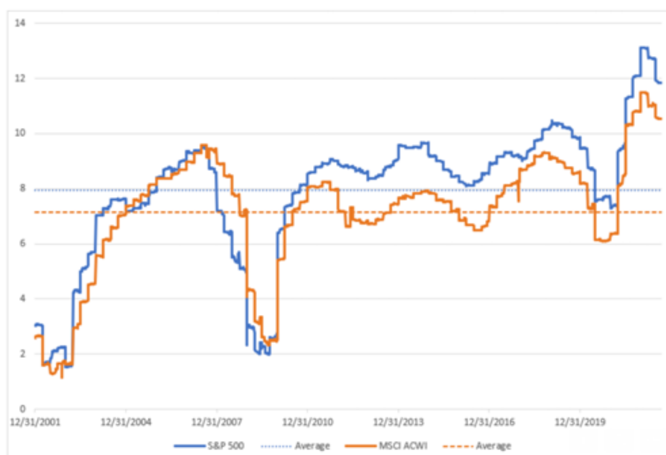
Source: Bloomberg, as at September 9, 2022.

Our explanation for this is that analysts don’t see the guidance as sufficiently de-risked to reflect the deterioration in the macro environment. Despite the cut in forecasted sales and earnings, we observed little change in forecasted margins. It is therefore our belief that the next leg of the earnings downgrade cycle (assuming no downside inflation surprises that would trigger a rapid Fed pivot) will address the margin normalization process.

We note that the profit margin levels, while compressing lately, are still at elevated levels compared to history (Figure 2). We expect the margin normalization process to have the least impact on companies within the quality style. Strong balance sheets, above average return on capital, substantial economies of scale, and highly defendable market positions should allow the quality style to outperform. On the contrary, stable dividend and highly leveraged companies are most vulnerable in such an environment.

“We expect the margin normalization process to have the least impact on companies within the quality style.”

Figure 4: S&P 500 & MSCI ACWI Trailing 12-month Profit Margin



Source: Bloomberg, as at September 9, 2022.

Private Equity | Will elevated prices continue?

Private venture capital remains resilient.

Amid a backdrop of broader financial market turmoil this year, venture capital pre-money valuations have proved to be resilient. However, different stages mirrored new market conditions in various ways following the trend observed in other private equity segments—where proximity to public markets and reliance on public equity multiples for valuation purposes have played an important role so far this year.

"The uncertainty on future funding weighed on markets, pushing founders to raise more capital in advance."

Angel and seed rounds showed positivity in pre-revenue and nascent ventures on both sides of the Atlantic, with a pre-money median valuation reaching EUR5.8 million and USD12 million above 2021 in Europe and the US, respectively, according to Prequin. Seed rounds are the furthest away from maturity and exit routes, thus valuations are more based on businesses' future potential and relatively insulated from short-term volatility swings.

Our view: In the US, early-stage saw diverging activity in regard to the evolution of median deal size and valuation in Q2 versus Q1. While deal size grew 19% to a median of USD11.9 million, pre-money valuation saw a 16.1% quarter-on-quarter decrease to a median of USD52 million. The uncertainty on future funding weighed on markets, pushing founders to raise more capital in advance. Moreover, GPs turned their "growth at whatever price" into a more conservative "cash aware" approach. The previous standard of 12 to 18 months of cash runway is no longer sufficient to weather macro uncertainties. In Europe, valuations held up amid a lower number of deals and less lofty valuations.

Meanwhile, late-stage start-ups faced mounting pressures to justify high valuation due to their proximity to public market activity. Deal size slightly dropped in the US to a median of USD14 million, a decrease of 7.1% from 2021, suggesting investors are more hesitant to commit to later stage rounds without better visibility on exit routes after a record low IPO activity in Q2. Valuations in general remained stagnant in the US (USD110 million median), however, the correction in lofty late-stage tech appears to be underway. Reports of major VC-backed companies, including US-based Stripe and Sweden-based Klarna, took valuation haircuts that could trigger further down rounds in the future.

Activity wise, VC fundraising during the first half of 2022 showed sustained strength despite the uncertainty of the macroeconomic climate. USD157.5 billion of new capital was closed on by 651 funds, maintaining the rolling 12-month fundraising pace. Capital continued to accumulate in large funds supporting fund size step-ups and shorter time frames between vintages. Fundraising strength has led to new highs for dry powder in VC funds, now sitting at USD562.4 billion, which contrasts with a reduction in the growth and buyout accumulated disposable capital. This could lead to an increase in competition for attractive deals—supporting elevated prices going forward.

" Deal size slightly dropped in the US, suggesting investors are more hesitant to commit to later stage rounds without better visibility on exit routes…"

Week Ahead | Key events to watch for

- **The US CPI report will be key**. The market expects a further decline in the headline to 8.0% from 8.5%, but for core inflation to rise from 5.9% to 6.1%. It will be important to see a positive surprise, especially on core, as this could cast doubt on the 75 bps hike expected by the Fed in the following week.
- **Inflation expectations from the University of Michigan** survey will also be released next week, as will be August retail sales data.
- **The Bank of England meet** on Thursday, with a hike of 'only' 50 bps expected.

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