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Weekly Market Flash
How high will the price be?

June 25, 2023

The last two weeks have seen the trends that were established in the second quarter of the year confirmed, with equity returns still positive, but now fully driven by technology names and (therefore) the US market. Europe, after the flare-up at the beginning of the year, and driven by institutional flows and the normalization of the energy crisis, came to a complete halt and started to correct in the last week (-2.5%).

Highlights

▪ While a clash seemed to be taking place in Russia between the Wagner army and the central government in Moscow earlier this week, the situation has now normalized.

▪ In terms of central bank actions, the Fed paused but announced that it expects two more hikes before the cycle ends. The Swiss National Bank raised rates as expected, and the Norges Bank surprised the market with a 50 bps rise. Meanwhile, the BoE exceeded expectations with a 50 bps rise.

▪ In the equities market, what looked like an unstoppable technology-led rally came to a halt —and there now seems to be a general sense of "reconciliation" rather than the continued belief in the doom-and-gloom scenario.

▪ In the VC market, the first quarter of this year has been marked by contrasting trends and significant pressures in both the European and US ecosystems. Startups and investors alike have been grappling with workforce reductions, challenging funding conditions, slower growth rates, a liquidity crunch, and a general shift toward investor favorability.

"It was unclear what Prigozhin's intentions were, whether the initiative will turn into a coup attempt or whether it will be limited to a negotiation..."

Markets & Macro | How high will the price be?

Will the Fed attack inflation or settle?

A clash seemed to be taking place in Russia earlier this week between the Wagner army, led by Prigozhin, and the central government in Moscow, which accuses the military leader of treason against the Russian state. While it was unclear what Prigozhin's intentions were, whether the initiative will turn into a coup attempt or whether it will be limited to a negotiation to gain more power in military operations, the situation has now normalized. As a result, this event is likely to have a limited impact on markets on Monday.

“If the hikes were not enough, Fed Chair Powell, expected to testify before the House and Senate, stepped up his game on several fronts...”

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

Equity Indices	Last Value	2 Weeks	Ytd
MSCI World	2,902.34	2.63%	12.90%
Nasdaq	13,492.52	3.98%	29.48%
S&P 500	4,348.33	3.40%	14.18%
S&P Equal Weighted	5,884.65	2.89%	3.50%
DJ Industrial	33,727.43	1.92%	2.86%
Nikkei	32,781.54	6.03%	26.94%
Eurostoxx	4,271.61	-1.52%	15.72%
Swiss SMI	11,221.22	-1.86%	7.72%
FTSE 100	7,461.87	-2.17%	2.14%
Canada	19,418.23	-2.52%	1.76%
Shenzen	3,864.03	0.34%	0.71%
Hong Kong	18,889.97	0.76%	-2.91%
MSCI EM	991.91	1.96%	5.10%

Equity Sectors	Last Value	2 Weeks	Ytd
S&P value	156.96	3.42%	9.10%
S&P Growth	69.03	3.56%	18.62%
S&P Defensives	1,545.72	1.32%	1.07%
ARK Fund	42.14	7.77%	34.89%
Fangs	7,656.03	7.43%	72.25%
S&P Banks	77.60	-0.32%	-21.68%
Euro Stoxx Banks	77.36	-0.87%	11.81%
S&P Energy	77.36	-0.93%	-9.85%
Gold Miners	29.79	-2.04%	3.94%

Commodities	Last Value	2 Weeks	Ytd
BBG Commodities	102.35	2.26%	-9.27%
BBG Agriculture	69.57	6.87%	1.08%
BBG Energy	31.78	0.42%	-22.92%
BBG Precious Metals	214.92	-2.30%	0.00%
BBG Industrial Metals	143.27	0.56%	-13.34%
Gold	1,921.21	-1.30%	5.33%
BBG Brent Crude TR	952.43	-3.18%	-10.31%
BBG WTI Crude Oil TR	168.76	-4.32%	-11.77%

FX	Last Value		Ytd
DXY Index	1,231.48	-1.16%	-1.21%
EUR/CHF	0.9775	0.70%	-1.22%
GBP Index	655.42	2.30%	5.23%
EM FX Index	1,684.55	0.34%	1.45%
USD/JPY	143.70	2.20%	9.59%
USD/CNY	7.18	1.63%	4.07%
Bitcoin	30,561.89	14.21%	84.78%

Bond Indices	Last Value		Ytd
US Inv Grade	107.70	1.48%	3.84%
US High Yield	74.19	0.71%	3.26%
Euro Corps	233.18	0.94%	2.42%
JPM Europe Govies	9,913.55	3.14%	7.41%
US Treasuries	2,231.48	0.71%	1.97%
China Aggregate	252.88	-1.53%	-0.93%
EMBI Global	796.45	2.63%	3.67%
EMBI Local	133.03	2.13%	7.55%

Source: Bloomberg, as at June 23, 2023. Performance figures in indices' local currencies.

Looking to markets, central banks' actions and interventions have dominated the scene, and have been decidedly hawkish. The Federal Reserve (Fed) paused, but announced that it expects two more hikes before the cycle ends (the Fed Funds should settle around 5.5%). Meanwhile, the Swiss National Bank raised rates by 25 basis points (bps) to 1.75% as expected, but made it clear that the tightening is not over. Norges Bank on the other hand surprised the market with a 50 bps rise to 3.75%. The statement anticipated further rises and placed the peak at 4.25%. The Bank of England (BoE) also exceeded expectations with a 50 bps rise, taking rates to 5%. The decision to raise by 50 bps was justified by the big negative surprises on CPI and wage inflation due to the strength of the labor market. Even the Turkish central bank raised rates by 650 bps to 15%. But in this case, the market even expected a 20% increase.

If the hikes were not enough, Fed Chair Jerome Powell, expected to testify before the House and Senate, stepped up his game on several fronts. He announced an increase in capital requirements for large banks, by 20%; he reiterated the need for greater oversight of regional banks and said he was concerned about the fallout from the commercial real estate crisis. Finally, he stated that fiscal spending in the US is at unsustainable levels, something he had also noted at the FOMC. Indeed, the 2023 deficit is expected to be around 8%, not far from 2008 levels, when unemployment was between 9% and 10%—whereas it is now 3.7%.

“The price, in terms of economic slowdown and labor market, could indeed be quite high.”

Our view: Therefore, the fact that fiscal policy is going in one direction, and monetary policy is pushing in the other, does not help the slowdown in inflation needed to calm the Fed's hand. It will therefore be interesting to see how the Fed will behave in the coming weeks, i.e. whether it will go the way of the BoE (and the Bank of Canada recently), of starting to attack inflation again by destroying demand, or whether it will have to settle for a normalized inflation regime, but above the old 2% target. The price, in terms of economic slowdown and labor market, could indeed be quite high.

In terms of asset allocation, we have recently neutralized our positioning by slightly reducing our underexposure to the equity market. Once we have taken note of the market's strength, driven by the Artificial Intelligence theme that has taken over from the macro aspect (which in any case, in the first half of the year, surprised positively), we believe it is right to maintain a pragmatic and cautious attitude. That said, the onset of weakness in Europe helps us, since we have not changed our structural under-exposure to the continent. The absence of a significant presence of the technology sector and weak economic data (confirmed by this week's soft PMIs, which are expected to lead to the second consecutive negative quarter) seem to us to be sufficient signs to say that the two quarters straddling the end of 2022 and the beginning of 2023 represent an exception of European outperformance compared to the dominance of overseas capital markets. Therefore, we would be happy at this point to see a summer correction in markets (driven by no longer favorable positioning, perhaps excessive tightening of central banks, now generous valuations, and perhaps a repricing of geopolitical risk, completely forgotten despite the war), to lengthen our positioning, but remaining predominantly in the US.

"The binary model of aggressive rallies and sharp pullbacks is simply a false extrapolation of the recent market history since the pandemic."

Equities | The elephant in the room

Does liquidity equal value?

It's amazing what two weeks of equity market developments can do. What looked like an unstoppable technology-led rally has come to a halt last week. And there was no shortage of bad news to sour investor sentiment, as soon as it hit extremely bullish levels (judging by several sentiment indicators): from hawkish central bank comments, to surprise rate hikes, to disappointing China stimulus, to poor European PMIs, to stretched positioning and valuations.

Our view: One would think that the pessimist voices would rise as a consequence, having been wrong on their bearish call so far. But strangely enough, there seems to be a general sense of capitulation or "reconciliation" rather than the continued belief in the doom-and-gloom scenario. In fact, this is how equity markets used to be; a very wide probability tree that is ever changing as a result of new macro and micro economic data. The binary model of aggressive rallies and sharp pullbacks is simply a false extrapolation of the recent market history since the pandemic. A model that works well when there is substantial (unprecedented) monetary policy easing.

"...the major indexes are not fair representations of the economy anymore."

There is only one question that is on each investor's mind today: are current market levels justified? And could this year-to-date rally continue, or was this just a bear market rally that should be faded? Pretending to have an answer to such question is only foolish and arrogant. Why? Because the major indexes are not fair representations of the economy anymore. We all have seen different versions of the graphs that point out the poor breadth of this year-to-date rally or the unbalanced weight of Big Tech within these major indexes. This is what makes the reliance on traditional metrics like index-level forward multiples or fund flows or hedge fund positions misleading. The S&P 500 index valuation might look stretched thanks to Big Tech, but strip out these names from the index and you'd struggle to defend the expensive argument. Signs of investor confusion are also abundant. Take for example the investors that were happy to own NVIDIA at 63x next-twelve-months earnings eight weeks ago, but now can't stomach the 49x multiple after a 60% rally.

So, where are we going with all this? We believe that equity markets are returning to normal. Returning to being driven by more than just the monetary policy. The game is back to being difficult. No more one tide lifting all boats. But rather the return of multiple option weighing, second- and third-order thinking, and stock picking. In such an environment, a strong balance sheet equals options. As the late Sam Zell used to say, "liquidity equals value". Could it be that this is the reason for Big Tech's resilience, staring us in the eye all along?

Venture Capital | Challenging landscape to remain

“A pivotal shift from a focus on growth to profitability has been observed on both continents…”

CVCs, angel investors look attractive.

The venture capital (VC) market in the first quarter of this year has been marked by contrasting trends and significant pressures in both the European and US ecosystems. Startups and investors alike have been grappling with workforce reductions, challenging funding conditions, slower growth rates, a liquidity crunch, and a general shift toward investor favorability.

In Europe, valuations expanded at the later financing stages and this might be linked to a strong drop in financing events, leading to only the most resilient/successful companies refinancing in the current market. However, valuations have now plateaued due to macroeconomic pressures including inflation, interest rate hikes, and lower growth, which have negatively impacted growth prospects. Meanwhile, the US venture ecosystem has seen a misleading growth in median seed pre-money valuations, reaching a high of USD12.9 million (+16.9% quarter-on-quarter). Late-stage venture markets in both regions continue to face challenges, with a noticeable decrease in deal sizes. A pivotal shift from a focus on growth to profitability has been observed on both continents, leading founders to seek measures for improved capital efficiency. In the US, this shift is further exacerbated by a closed IPO window, with investor focus moving toward profitability. The first quarter median venture-growth pre-money valuation in the US fell to USD90 million, a significant drop (-74.6%) from the 2021 full-year record of USD355 million.

Participation of non-traditional investors has decreased in both markets, with deal value involving these investors falling by 65.3% year-on-year in Europe and a decrease in activity in the US due to a lack of liquidity. However, corporate venture capitalists (CVCs) have remained active, reaching a record participation rate of 26.5% in the first quarter in the US. Incentivized more by strategic investments than financial returns, CVCs have primarily concentrated on seed and early-stage transactions. Up until now this year, these stages accounted for 60.2% of all completed financings. They, together with the remaining nontraditional investors, have allowed selected startups to raise larger amounts of capital at higher valuations than the broader market. But this support comes at a cost, as these investors demand larger equity positions in return.

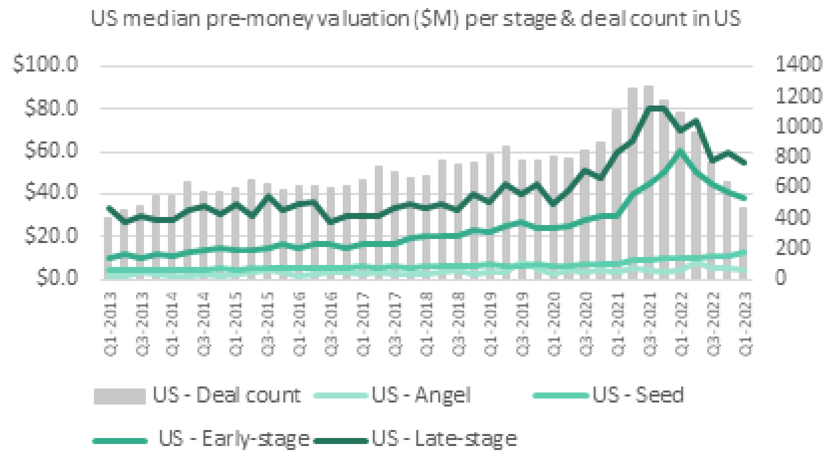
“In the US, angel and seed-stage companies have been relatively shielded from the macroeconomic challenges…”

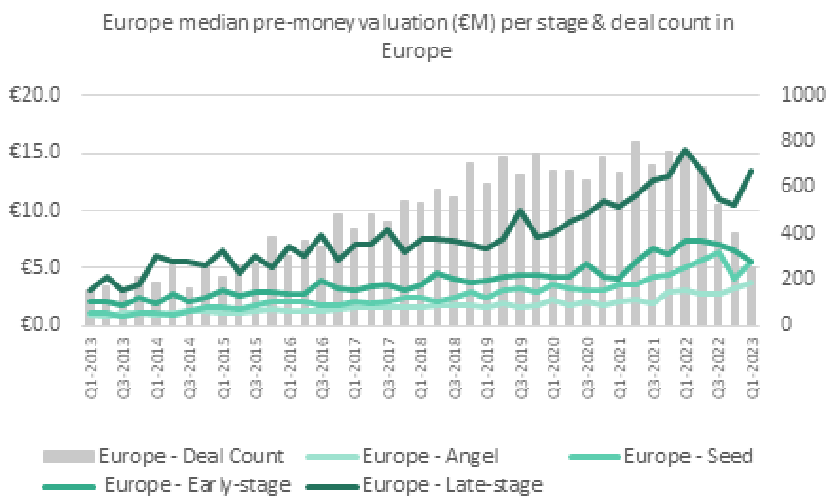
Our view: Angel investors have maintained robust valuations in Europe with a median of EUR3.7 million (EUR3 million in 2022), and seed-stage startups displayed resilience, with median valuations remaining flat at EUR5.5 million. In the US, angel and seed-stage companies have been relatively shielded from the macroeconomic challenges affecting their late-stage counterparts, with a consistent growth trend in the median seed pre-money valuation and deal size reaching a record of USD12.9 million and USD3.0 million respectively. This growth can be attributed to the fact that general partners (GPs) are now only investing in companies with strong fundamentals, healthy burn rates, and solid strategies to preserve runway. This is confirmed by the median time from inception to seed deals that has seen a substantial rise, moving from 2.4 years in 2022 to 3.0 years in 2023 to date. This suggests that startups that are more established, with discernible growth paths and other indicators like product-market fit, are succeeding in obtaining funding in the midst of intense competition.

Early-stage VC witnessed a significant decline in median valuations, reflecting the rigorous due diligence processes and scrutinized revenue models under current economic conditions. In Europe, median valuations drop 15.4% quarter-on-quarter at EUR5.5 million (the third consecutive quarter decline). In the US, the median early-stage valuations experienced a decrease of 5.7% from the last quarter, falling to USD38.2 million, with the median deal size also decreasing by 8.3% to USD6.0 million.

Late-stage VC in Europe was an exception to the downward valuation trend, with the median valuation increasing by 26.9% quarter-on-quarter to EUR13.4 million, driven in part by large deals such as the EUR215.0 million funding round by Enpal, a Germany-based solar panel supplier. In the US, the median late-stage VC deal size plummeted by 25% to USD6.0 million while median late-stage valuations saw a drop of 8.3% to USD55 million.

Figure 2: Pre-money Valuations in the US and Europe





Source: Pitchbook.

"The increase in corporate acquisition values can be attributed to the rise in buying activity amid depressed asset valuations."

The percentage of flat and down rounds has increased to 7.5%, (the highest point since 2018) in the US and has reached 39.66%, (the highest level since 2020) in Europe as startups run out of cash and are forced to raise capital at lower valuations. The median exit valuation in Europe also decreased 34.8% year-on-year but grew 48.5% quarter-on-quarter, with acquisition exit values increasing and public listing values decreasing. The increase in corporate acquisition values can be attributed to the rise in buying activity amid depressed asset valuations. Despite a quarter-on-quarter increase in the first quarter of this year, median acquisition sizes are still 14.1% below 2022 levels, indicating the continued depression in valuations.

"In conclusion, the VC landscape in both Europe and the US faced a challenging first quarter..."

In terms of exit, the first quarter recorded only 20 public exits in the US, including eight IPOs. The total exit count demonstrated modest growth from previous quarters, aligning with levels seen in early 2022, mainly powered by M&A activities. A lot of these cash-intensive, advanced startups find themselves caught in a capital accessibility squeeze and might have to consider options like raising a flat or down round, exploring debt alternatives, or ideally, achieving positive cash flow to weather the unfriendly financing environment. The median public listing venture capital exit valuation in the US saw a quarterly increase of 42.3%, yet it remained a fraction of what it was during the peak of market exuberance in mid-2021.

In conclusion, the VC landscape in both Europe and the US faced a challenging first quarter with less robust growth and stringent funding conditions. The market witnessed slower investment levels, tighter internal budgets, increased scrutiny on revenues, valuations, and runways. Despite these challenges, certain segments such as CVCs and angel investors continued to remain active, leading to potential long-term investment opportunities. However, expectations lean toward a more downward pressure on valuations that is expected as capital availability shrinks and businesses consider flat or down rounds. This suggests that the future of the VC landscape in 2023 will likely remain subdued and challenging, with startups needing to focus on running lean, maintaining efficient cost structures, and adopting more realistic growth strategies to succeed.

Week Ahead | Key events to watch for

- **The week will be dominated by inflation data**, with US PCE and Eurozone CPI.
- **Central bankers will also be in the spotlight**, especially in Europe. The ECB forum in Sintra will take place, and all the central bankers of the major countries, not only **Europe, will be there.**
- **In China, manufacturing and services PMIs** will be published, while further government measures to support the economy are expected.

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