RockCreek

Q2 Commentary Letter

Switchback of Fear

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Macro Environment

The second quarter of 2022 was when reality sank in. The global investing regime has changed fundamentally, and for the foreseeable future. This regime shift had been underway for a year or more, since inflation began to become unmoored in the post-pandemic recovery. But it hit home to financial markets in Q2.

Geopolitical tensions – notably between the US, China, and Russia – together with the impact of the pandemic on supply chains have reduced support for the open, global trading system and added to inflationary concerns. China's zero covid policy has exacerbated production and supply disruptions. Russia's invasion of Ukraine in February led energy and food prices to soar. In Q2, the Federal Reserve – the world's most important central bank – finally moved decisively to tighten monetary policy and clarify that inflation fighting was paramount.

Markets plunged, leading to the biggest half-year decline since 1962. Investors were gripped by alternating fears – of inflation and recession. Data releases added to the confusion, first indicating higher and more persistent inflation than expected, then suggesting an economic slowdown that could tip into recession as consumer and business sentiment fell, and then showing continued labor market strength and jobs growth. The energy crisis triggered by Russia's invasion of Ukraine threatened a return to 1970s style stagflation, with a particularly devastating impact in Europe.

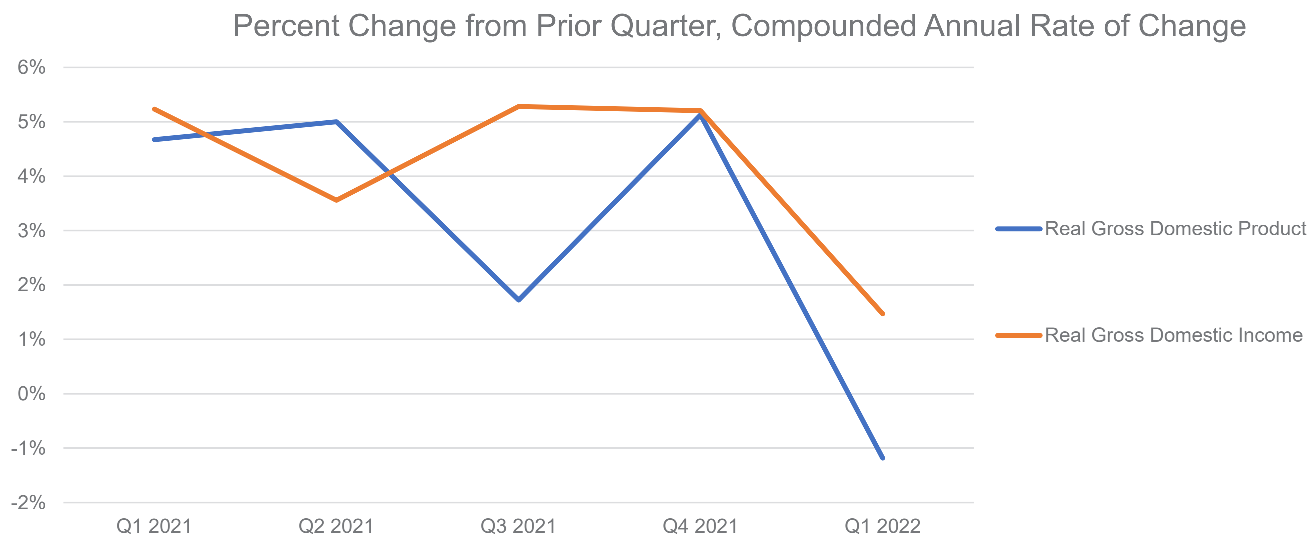
In the US, tightening monetary policy cast a shadow over equity markets, while reassuring those worried that the Federal Reserve and other major central banks had lost sight and control of inflation. The tech winners of the pandemic era of "low interest rates for longer" became the biggest losers. By the end of the second quarter, the outlook for fixed income investors had become brighter with interest rates having reset higher. However, we still expect volatility to remain elevated as central banks shift away from easy-money policies of the past.

It will take some time for the contours of the new economic, financial, and geopolitical world to become clear. Already in Q3, there have been political upheavals in the UK and Italy – with the resignation of Italian Prime Minister Mario Draghi particularly concerning for the European outlook. In the meantime, three key themes stand out: inflation, global slowdown, and a shift in trade patterns – notably of energy – that will have long-lasting impacts on growth, exchange rates, and geopolitical relationships.

Too Many Worries

For investors, Q2 began with inflation fears dominating. The inflationary impact of the war in Ukraine was becoming clear, as energy and food prices shot up in the wake of coordinated tough sanctions against Russia and the collapse of grain exports from Ukraine, one of the world's major wheat and fertilizer exporters. At the same time, monetary tightening was just beginning. How far and how fast it would proceed was unclear.

As spring turned to summer, the Federal Reserve and other major central banks stepped up their rhetoric – and then actions – against inflation. Fears shifted to the real economy. Would tightening overshoot and plunge the U.S and the rest of the world into recession? Data for Q2 growth will be telling, but interpreting these numbers may be a challenge. As Nobel-prize winning economist Paul Krugman has pointed out, different metrics for key indicators have been pointing in different directions, including for economic growth, which can be measured by output or incomes. Forecasting uncertainty – always particularly high at turning points – has been exacerbated by the unprecedented nature of this cycle.



Source: RockCreek, US Bureau Of Economic Analysis

In the US, we expect the summer months to see the peak in headline inflation, but not necessarily in the core wage-price dynamics that central banks are focused on when they set interest rates. Monetary tightening will therefore continue apace, with interest rates rising and the Fed balance sheet shrinking. The rest of the world is also tightening. The IMF calculates that 75 central banks globally are now also in a tightening cycle.

In the US, the labor market remained strong in Q2, with unemployment ending the quarter still close to its pre-pandemic low at just 3.6%. Employers added more than 1.1 million jobs during April-June. There are some tentative signs that the labor market is losing steam, with unemployment insurance claims creeping up from post-pandemic low levels, although employer reports of job vacancies remain at record levels in relation to the number of job-seekers. Labor market dynamics will be key to what happens to spending and growth – and inflation – in the coming months.

A slowdown is inevitably coming, in the US and elsewhere. The question is whether there will be a crash landing, or just a bumpy few months. Rising rates will curtail demand and growth, working most immediately through the traditional housing channel. Mortgage rates climbed 93 basis points in Q2, ending the quarter at 5.83%. Falling stock prices will also depress household wealth and spending.

More generally, consumers already seem to expect the worst, according to survey data. Expectation of recession could encourage a pullback in spending even as the jobs picture stays rosy.

Can the Fed, against the odds, succeed in cooling the economy sufficiently to bring down inflation without a sharp rise in unemployment? This remains a possibility, although success requires luck as well as skill. After all, today's economic challenges are the result of two non-financial events that have shaken the global economy since 2020: a global pandemic and a war in Europe.

Economic prospects are gloomier across the Atlantic, and around much of the world. In Europe, the energy shock is already weighing heavily on growth, prices, and trade. Germany – the economic powerhouse of the region – is suffering from long dependence on Russian energy, and on its export dominance to a now weakening China market.

Back to the Future?

In the 1970s (just like this year) inflation – and the fight to curb it – dominated the macro background. An energy price shock, at that time triggered by the jump in oil prices engineered by OPEC, was again responsible for a surge in consumer prices. And as central banks, notably the Federal Reserve, tightened policy sharply, recession warnings abounded. We know how that story ended. It took years – and Paul Volcker – for US policymakers to address inflation convincingly. And the resulting rise in interest rates led to deep recession. At the same time, President Ronald Reagan in the US and Prime Minister Margaret Thatcher of the UK began a regulatory shift that opened markets, notably in the financial sector, moved power away from unions, and ushered in big changes in their economies.

Might we be heading back to the future? The strong US labor market is an important difference between now and 45 years ago. Apart from today's still low unemployment rate, indicators of a tight market include job vacancies at record levels in relation to job seekers and staffing shortages evident all around, from chaotic air travel to forced closures of public swimming pools. Increased employment, together with savings built up from 2020/21 stimulus packages, may keep up consumption, at least in the US.

Another difference from the 1970s is that – despite this labor market strength – wages, and wage and price expectations, have remained relatively contained. Hourly earnings rose by 1% during April-June, well below headline price increases. The resulting drop in real incomes has hurt workers and families and compressed their spending power in recent months. But it could lead to a quicker return to price stability and less costly disinflation overall than following the wage price spiral of 50 years ago.

Central Banks Got Serious – Better Late than Never?

Why was it only in Q2 that central banks in the US and Europe acted to convince markets and economic actors that the battle against inflation was, in Fed Chair Jerome Powell's words, "unconditional"?

As we have written in our weekly newsletters, central banks in the US and Europe were slow to recognize, and therefore to react to, the inflationary surge now dominating economic concerns. Uncertainty in the wake of the pandemic recession was reasonable, as was the fear that new waves of Covid would hit the real economy – remember Delta in 2021?

But even after the problem was recognized, and the phrase "transitory" retired, action continued to be delayed. As outlined nicely by Sebastian Mallaby in the latest issue of Foreign Affairs, the Fed's commitment to forward guidance meant that it moved only slowly, once it decided to move. Officials were reluctant to accelerate the pace of tightening beyond what they had signaled through forward guidance, until the CPI release for May shocked them into a 75 basis point rate rise in June. Mallaby also noted that signaling from asset prices showed monetary policy was too loose.

The moment of apparently all-powerful central banks has gone. Confidence in the efficacy of monetary policy in delivering price stability at little or low cost in terms of jobs was perhaps always overdone.

Expensive Energy: Settle in for the Long-Term

The war in Europe goes on. By the end of Q2, the heady days of unexpected Ukraine wins against the much larger Russian army were over. As Russia was making slow, bloody, and uncertain progress in conquering Ukraine's East in June, the US and NATO allies promised more, and more sophisticated, weapons to bolster the Ukrainian army.

The war will go on for months, as we predicted from the outset. This will underpin high energy prices. As Germany prolongs coal use and the US Administration presses oil producers and refiners to increase output, what happens to climate concerns and the much-needed energy transition away from fossil fuels?

Sustainable Investing

Many of us at RockCreek have been investing sustainably for years. Even as sustainable investing saw a confluence of factors in the first half of the year, RockCreek clients are increasingly interested in raising the share of their portfolios invested sustainably in terms of environment, social justice, health, and affordable housing.

Final Q1 data showed that global sustainable funds attracted close to $96 billion of net new capital. The annual trend of inflows into the ESG space has been on a consistent upward trajectory since 2019, and while the second quarter of this year experienced a decline, positive investor sentiment continues to bring attention and new creative strategies to the space.

Regulators, including the SEC, expressed concerns around "green washing" in the market and signaled a desire for increased scrutiny over the accuracy of impact claims by ESG and sustainability investors. We believe this focus will only enhance and improve the sector with more analysis on how best to create both positive impact and financial return by investors.

With the rest of the year being difficult for equity and bond markets, public market sustainable investing flows continue to have long-term tailwinds that can counter the negative pressures in the broader market. According to Morningstar, US sustainable fund flows fell to $10.6 billion in Q1 2022, while assets in sustainable funds dipped for the first time in two years, to $343 billion. Despite flows into US sustainable funds dipping 26% compared to Q4 2021, the demand for sustainable flows showed higher resilience than the broader US funds market, which saw flows dip 65% to $85.7 billion.

Despite general market uncertainty, Q1-2022 saw 273 VC-backed climate tech rounds worth $9 billion and angel & seed dollars invested were strong at $283.3 million – 40% of the total dollars invested in angel and seed climate tech during all of 2021.

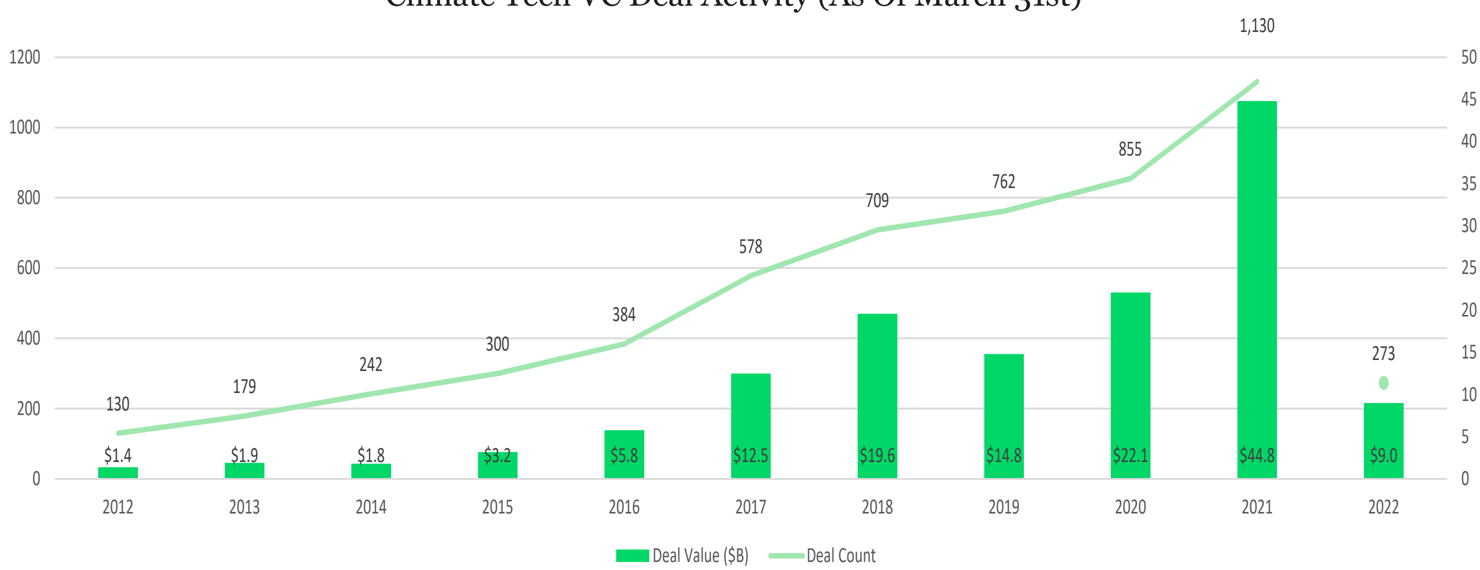
Taking a longer view on renewable energy specifically, over three years, renewables are up 84.8% – more than double the total energy market, which is up 34.5%. Over 5 years, renewables are up nearly 140%, while total energy is up only 41.1%. In the shorter term, renewables are down 15.2% over the past year and total energy is up 39.1%.

The Russian war against Ukraine could, ultimately, accelerate the energy transition. We have said before that the ongoing war has accelerated the renewable transition in Europe more than countless climate summits have. During Q2, the European Commission presented the RePowerEU plan, which aims to end the EU's dependence on Russian fossil fuels, while at the same time accelerating the transition to sustainable energy to tackle the climate crisis. We pointed out last quarter, Germany, especially, is wrestling with tough decisions such as extending the life of coal and nuclear power plants, while focusing on the transition. As German Chancellor Olaf Scholz said, the short-term needs for diversified energy can dovetail with the long-term transformation. "An LNG terminal that today receives gas can, tomorrow, be used to import green hydrogen," Chancellor Scholz said.

The push for European energy independence is likely to accelerate climate tech investment, namely hydrogen, solar, batteries, nuclear, and wind. Rising oil and gas prices are making renewable energy and electric vehicles more cost competitive and improving ROIs of energy efficiency solutions. Developments on the private side proved stable during a volatile first half of the year, despite much of the criticism from Elon Musk and others of the ESG space. Climate tech startup companies with focuses on everything from electric scooters to imitation meat products raised $53.7 billion in 2021. Amid an environment of general pullback in venture capital funding, sustainable companies saw an increasing need to be more conservative with their cash.

Sustainability-focused growth equity and private equity activity has remained strong amid a weak IPO market, which has caused companies to turn to private markets in lieu of public funding, and more dramatically improved pricing that has resulted from the broader market correction.

Climate Tech VC Deal Activity (As Of March 31st)



Source: RockCreek, PitchBook

Although dollars going to climate tech and other sustainable investment themes may be volatile in the second half of the year, long term prospects remain strong across several themes. Rising food and commodity pricing has spurred an increased interest in AgTech, while supply chain woes have been a catalyst for growth in a new wave of technology, logistics, and transportation companies.

At RockCreek, we are looking for opportunities in themes such as: AgTech, climate, clean energy, health, education, workforce, housing, and other sectors. Companies we invest in, along with partners, are operating electric vehicle infrastructure; bringing affordable healthcare to seniors; implementing agronomic and digital farming practices to improve sustainability and maximize crop yields; growing sustainable produce in urban greenhouses; helping millions of learners access education online; recycling food waste, organic waste, and water into renewable natural gas that can be used to power businesses, manufacturing plants, and schools; and building and operating the next generation of smart infrastructure.

In the US, specifically, investment may expand, pushed by the latest White House agenda. In June, the Biden Administration announced a handful of companies investing more than $700 million to expand the domestic electric vehicle charging infrastructure with the goal of building a national network of 500,000 public charging stations by 2030. Volkswagen-owned Electrify America announced an investment of $450 million; Siemens announced $250 million. In June, President Biden issued an executive order that eliminated concerns around near-term tariffs on solar panels from Asia and promoted long-term US panel manufacturing, which may brighten the outlook for domestic solar production in the years ahead, though it has created confusion and additional costs and delays to solar projects.

Public Equities

Global equities had a volatile Q2 as investors priced in further interest rate increases and higher odds of recession. Across the globe, Value largely outperformed Growth, though both segments suffered steep losses. All eyes are now on Q2 earnings to see whether the corporate sector can maintain historically high profit margins.

Evidence seems to be pointing towards 'No' with inflation eating into consumer spending power, companies facing greater wage pressures, and cost of goods still on the rise. China was one of the few bright spots as some major cities saw extended lockdowns get lifted. However, China also remains far from being out of the woods given risks of future lockdowns, geopolitical tensions, and a shaky housing market, just to name a few.

Equity Markets	Q2 2022
US Large Cap (S&P 500 TR)	-16.1%
Nasdaq	-22.3%
US Small Cap (Russell 2000)	-17.2%
Japan (TOPIX)	-3.7%
Europe (MSCI Europe)	-8.7%
China (CSI 300)	7.3%
Global EM (MSCI EM)	-11.4%

Bond Markets	Q2 2022
US 2yr	61.9
US 10yr	67.5
US 30yr	73.5
German 10yr	78.8
German 30yr	94.9
UK 10yr	61.9
UK 30yr	80.1
JGB 10yr	1.1
JGB 30yr	30.5

Currency Markets	Q2 2022
DXY	6.5%
EUR	-5.3%
GBP	-7.3%
JPY	-10.3%
MSCI EM Currency Index	-4.4%

Commodity Markets	Q2 2022
Crude Oil (WTI)	5.5%
Nat Gas	-3.9%
Gold (Spot)	-6.7%
Steel (Rebar)	-12.0%
Ag & Livestock (Bloomberg)	-6.4%

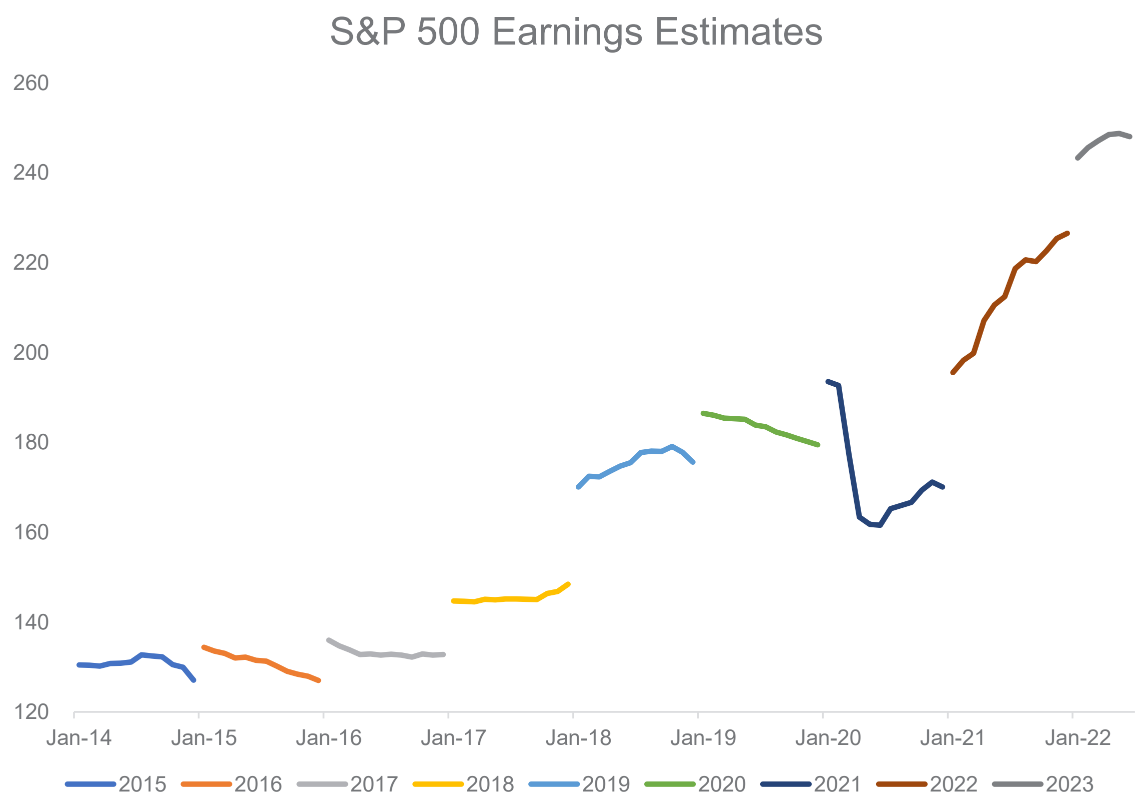
RCG HF Indices	Q2 2022
All Hedge Funds	-4.9%
Equity Hedge	-8.3%
Absolute Return	-1.1%
Equity Market Neutral	1.1%
Event Driven	-6.7%
Global Macro	2.1%

Source: RockCreek

The first half of 2022 was one of the worst starts for equity markets with the MSCI World down 20.5% year-to-date following a -16.2% return in Q2. US indices performed slightly worse in Q2 compared to Europe and Asia, but there was not much dispersion regionally as the strong US dollar served as a headwind for US investors' foreign equity holdings. The S&P 500 lost 16.1% in Q2 with each of its 11 underlying sectors in the red. Investors exhibited a clear preference for safety with defensive sectors down significantly less than consumer discretionary, technology, and other cyclical sectors. Even energy, which had been one of the few bright spots for investors in the first quarter, finally gave in to recessionary fears and began to fall out of favor in early June.

Despite all the carnage, there remain plenty of signs that things could get worse. Sentiment remains abysmal with little sign of improvement. There has been no shortage of negative news, capitulation is snowballing, and the market has yet to find a floor. And yet, sell side analysts are still reflecting a rosy earnings outlook. Despite the rising cost of goods, wage pressures, consumers eating into their savings, and the Fed's ongoing tightening cycle, the Street projects strong revenues and record-level profit margins into 2023.

EPS Trends Year-to-Year Have Been Sticky



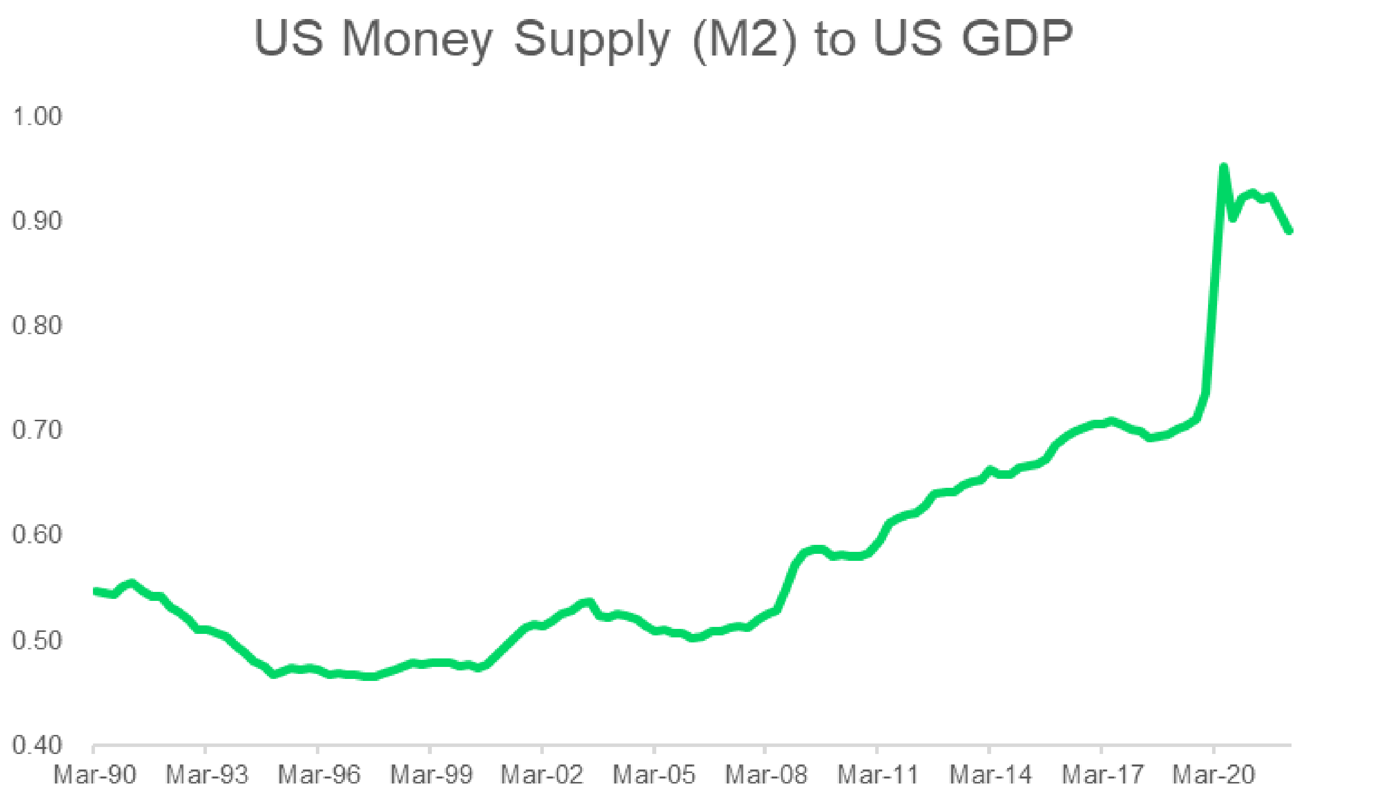
Source: RockCreek, Bloomberg

As seen above, consensus future EPS expectations compare strongly to past years. P/E multiples have re-rated, but this earnings season will be a crucial one for markets as expectations remain high. Even if economic activity is robust enough to support current earnings, forward guidance will almost assuredly come down for the second half of the year and 2023. Nike and Restoration Hardware are the most recent examples where supply chain pressures or softening demand trends led to more conservative guidance from management. In addition, United Airlines recently agreed to give pilots a 14.5% raise through the end of 2023, and some regional pilots under American Airlines received 50% pay increases through August 2024. Rising wages will increasingly eat into profit margins, which could lead to earnings misses and increased negative sentiment.

The ratio of total stock market valuation to GDP is known as the Buffett Indicator, after Warren Buffet called it "the best single measure of where valuations stand at any given moment." Every valuation metric has its advantages and shortcomings, but this one certainly provides an interesting perspective. The ratio doubled from 2012 to 2021 on the back of stimulus measures and record low interest rates, leading it to far exceed its historical average.

Source: RockCreek, Bloomberg

Assuming we have, in fact, entered a new regime of lasting inflation and tighter central bank policy, one can easily envision the Buffett Ratio correcting further, brought on by evaporating stock market valuation relative to GDP. This again points to the need for a reduction in earnings forecasts as P/E multiples have already collapsed to a large degree.



Source: RockCreek, Bloomberg

Source: RockCreek, Bloomberg

Earlier this year, Hartford Funds published an analysis showing the cyclicality of active versus passive management. In many ways, this dissipation of investor exuberance following a technology-led, decade-long bull market has strong echoes to the dot com bubble. Just as passive equity funds outperformed active funds for five straight years leading up to 1999, passive funds also outperform active funds in 10 of the last 11 years. It remains to be seen how well active strategies perform from here. But heading into 1999, nobody would have predicted that active strategies would outperform in 10 of the next 11 years.

This market environment will remain challenging until the current tightening cycle approaches its end and equity valuations better reflect a lower-growth environment. In the near-term, quality, durability, and margin of safety will be important investment criteria as the combination of inflation and higher interest rates impact companies' bottom lines in varying ways.

We also believe that concentrated, catalyst-driven strategies will play a valuable role, if they can differentiate themselves by identifying outsized earnings surprises, restructurings, and other corporate events in less crowded segments of the market. We have yet to see substantial buying into growth stocks, but in the coming quarters, investors who are willing to extend their time horizons will be rewarded. Some rotation toward beaten-down areas of technology is beginning, notably in software, where fast-growing companies can quickly mature into their price/sales multiples and soon become consistently profitable.

Emerging Markets

Index	QTD	YTD	1-Year	3-Year
MSCI Emerging Markets	-11.4%	-17.6%	-25.3%	0.6%
MSCI Emerging & Frontier Markets	-11.5%	-17.7%	-25.2%	0.5%
MSCI Emerging Markets ex-China	-17.9%	-20.8%	-21.5%	1.3%
MSCI EM Asia	-9.3%	-17.2%	-25.9%	3.1%
MSCI EM EMEA	-17.1%	-28.4%	-27.2%	-7.0%
MSCI EM Latin America	-21.9%	-0.6%	-16.1%	-6.3%
MSCI Frontier Markets	-13.8%	-20.6%	-17.3%	0.6%

Source: MSCI

Q1-2022 was characterized by the outperformance of EM ex-China, (specifically commodity related markets); Q2 saw China's equity market comeback.

Investors seem to be discounting the regulatory and geopolitical risks of investing in China, instead betting that the country's macro policy pivot will produce strong quarterly growth acceleration. The combination of renewed infrastructure spending (the highest since 2018), a relaxation of anti-speculative housing measures, tax incentives to spur domestic consumption, and softening regulatory pressures on China's tech platform companies are sending market participants an invitation to invest. It helps that current valuations are below the fifteen-year average, inflation is low, and the current account surplus is steadily growing.

Do these positive developments mean we are out of the woods on China risk? Not quite. The intrigue around President Xi's reconfirmation in October; ongoing tensions with the US, Taiwan, and its allies; and consumer confidence in the doldrums remain just a few of the reasons to be cautious.

EM Country Valuation Multiples

Index	FWD P/E	15 Year Avg. P/E
EM	10.8x	11.5x
China	11.6x	11.7x
South Korea	7.7x	9.8x
Taiwan	11.3x	14.4x
India	18.5x	17.0x
Indonesia	14.0x	14.1x
South Africa	8.2x	12.3x
Brazil	5.5x	10.8x
Mexico	11.9x	15.0x

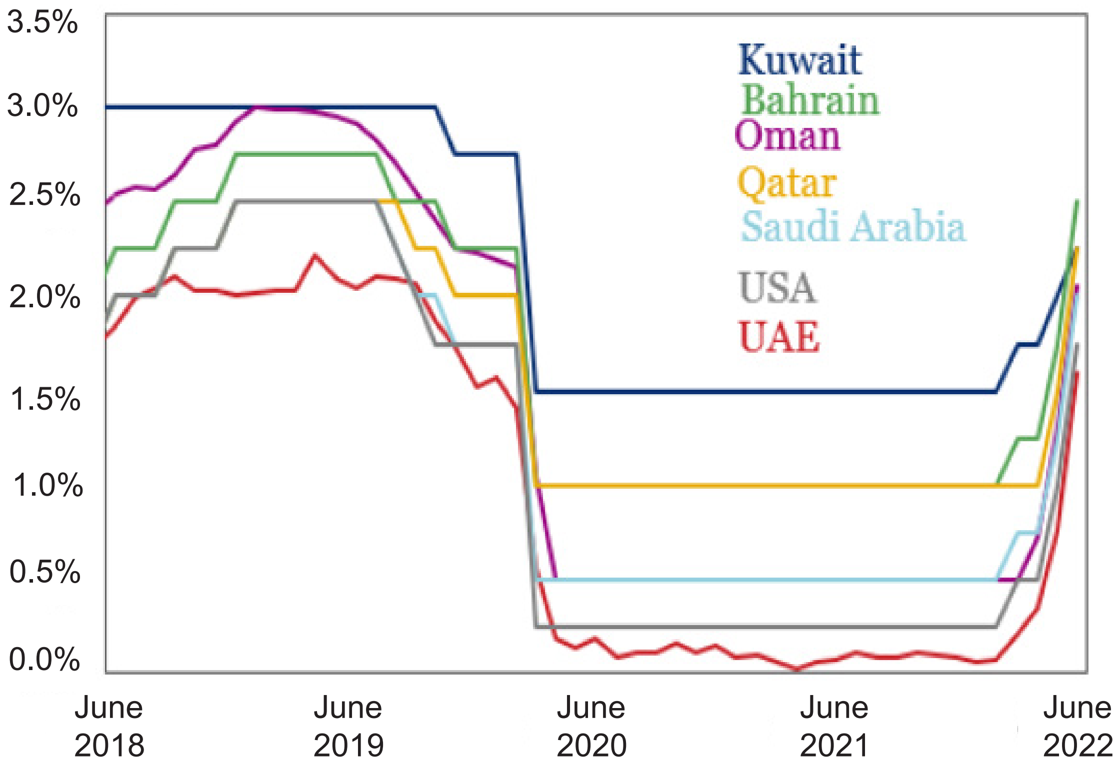
Source: RockCreek

Despite the macro uncertainty, China's recovery should be a tailwind to other emerging markets, including those with commodity links. Strong Chinese markets should help countries like Brazil, which in Q2 spectacularly lost all of the gains generated during Q1 and is currently trading at last year's low – one of the cheapest P/Es among major emerging markets.

Source: RockCreek

Indeed, most commodity exporters lost ground during the quarter, even though price action was mixed, and conditions of scarcity persist across all commodities. Of note – commodity exporters with a currency pegged or semi-pegged to the US Dollar fared significantly better than those with free floating currencies, a reminder that the higher 'beta' markets of Latin America and South Africa are more susceptible to eroding terms of trade once interest rate policy in the US begins to tighten. Gulf Cooperation Council (GCC) countries, on the other hand, maintain pegged currencies and are generally in lockstep with US policy moves.

US and GCC Policy Rates Move Together



Source: Haver, IIF

Recent election results in Colombia and upcoming elections and referendums in Brazil and Chile have added to a sense of lingering uncertainty over macroeconomic policy frameworks in the region. As the differential narrows between US and EM interest rates, we are paying special attention to countries' balance sheets and what they say about their ability to cope with the effects of a stronger greenback and higher financing costs. While many of the larger emerging market economies are in an arguably stronger position today than in past cycles of dollar strength, we are in the early innings; decisions made by policy makers now will influence outcomes later. Regional or country specific recessions may be the only real antidote to current inflation levels, but much will depend on developments in the US.

In other words, emerging markets cannot be buoyed by a resurgent China alone.

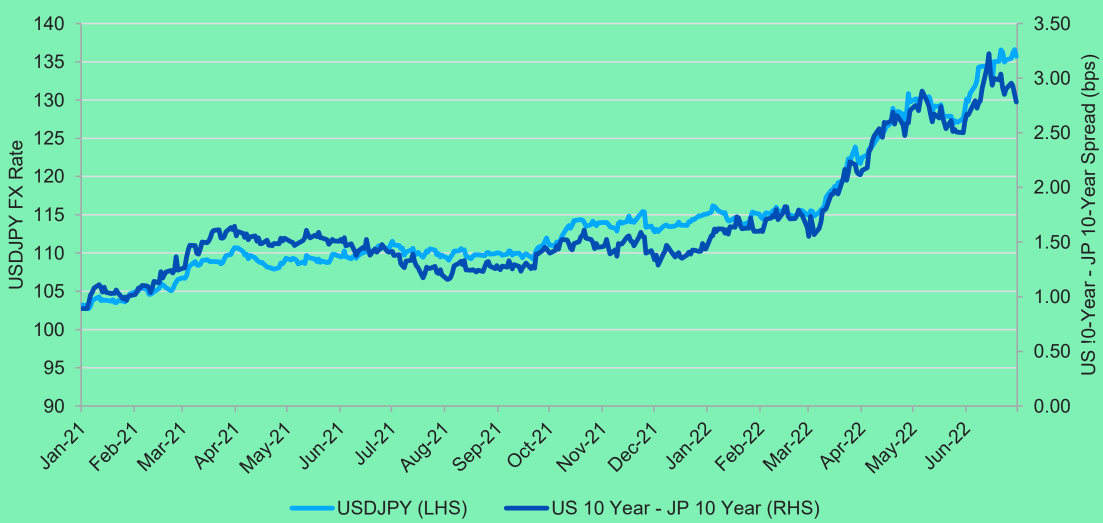
SPOTLIGHT: The Land of the Falling Yen

The first half of the year has not been kind to Japanese currency. This year, the yen has depreciated by roughly 15% against the US Dollar, owing – by and large – to the Bank of Japan's (BOJ) dovish monetary policy, which contrasts with other central banks' rate hikes to fight inflation. As global investors scour markets for attractive sources of yield, low nominal returns on Japanese government bonds (JGBs) and the yen have incentivized money managers to aggressively speculate against the currency. With the war in Ukraine and elevated commodity prices hampering economic growth, the value of the yen only adds to the country's economic woes.

Bank of Japan Governor Haruhiko Kuroda faces two equally unattractive prospects. If the BOJ tightens monetary policy to halt the yen's freefall, they likely risk economic contraction as the government and corporations face steeper borrowing costs. On the other hand, if the central bank keeps monetary policies loose to support the export sector, any economic recovery would occur at the cost of domestic consumer purchasing power and the threat of significant capital outflows from local investors. These challenges have caused institutional investors to ask: Where does Japan go from here? And what's the consequence of the yen's collapse on global markets?

Investors have progressively ratcheted up bets against the yen, leaving the currency at its lowest level against the US Dollar in several years. But this has not been matched with an increase in long-dated interest rates, as the BOJ still purchases JGBs to maintain its roughly 0% interest rate cap. With other developed market bond yields rising to incorporate higher inflation expectations, widening spreads between US Treasuries and JGBs have exacerbated the yen's decline. Investors looking for safe havens benefit from the higher carry of dollar-based assets compared to the yen and Japanese fixed income.

USDJPY vs. US 10-Year/JP 10-Year Spread



Source: RockCreek, Bloomberg

Read the [full report here]

Fixed Income

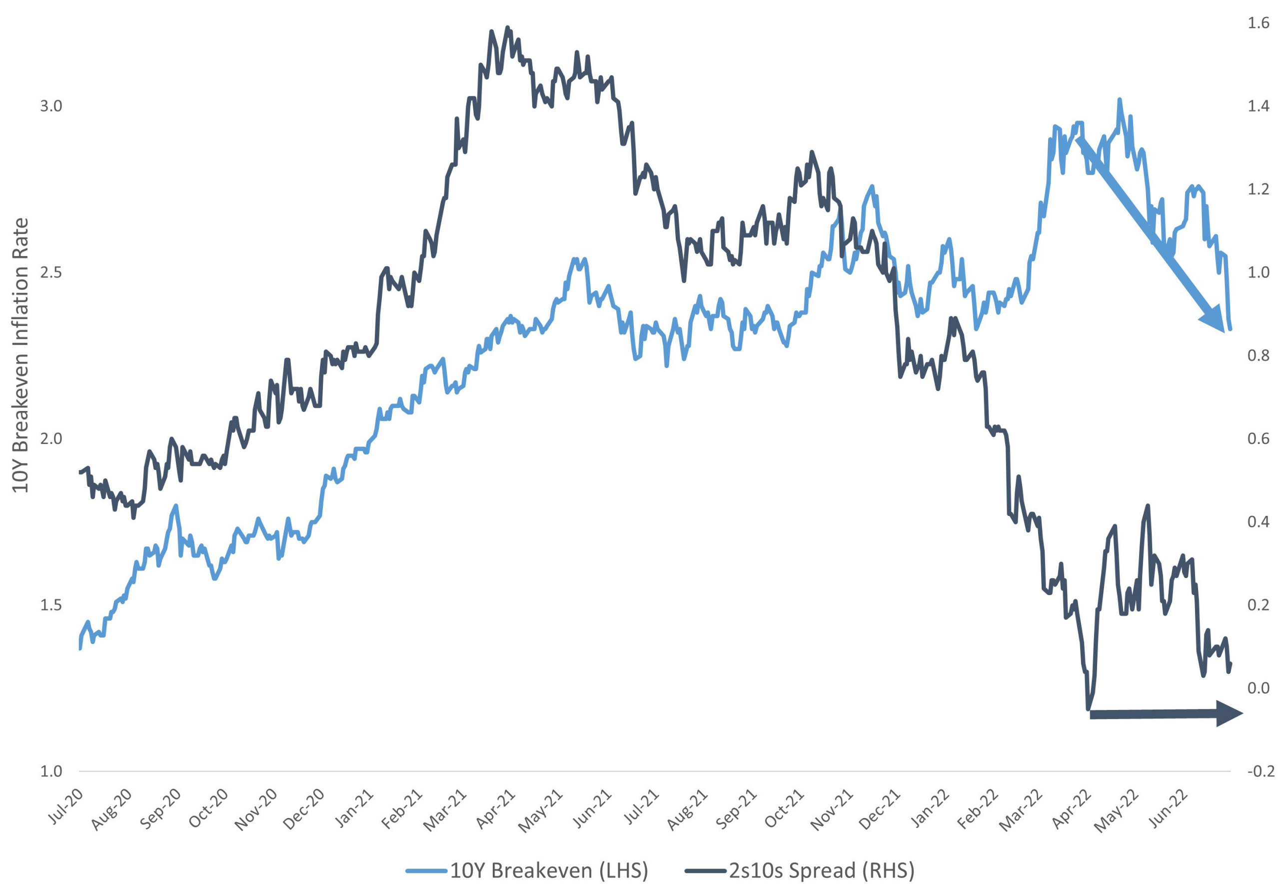
For most of the two years prior to 2022, we experienced a benign environment for nearly all financial assets. Real interest rates fell into negative territory and remained rangebound through the end of 2021.

This year has been far more eventful — only halfway through and we may be on the verge of entering the bond market's third regime change as real rates and inflation expectations, the two driving forces of bond prices, remain volatile.

The US bond market followed Q1 2022, its worst quarter in more than 40 years, with nearly an equal loss in Q2. The Bloomberg US Aggregate Bond Index declined -4.7% during the quarter to bring the year-to-date decline to -10.4%.

Despite the similarly poor performance of bonds over Q1 and Q2, there were notable differences in the composition of the move as breakeven inflation rates declined and the yield curve bear flattening came to a halt.

Inflation Expectations Rolled Over and Curve Flattening



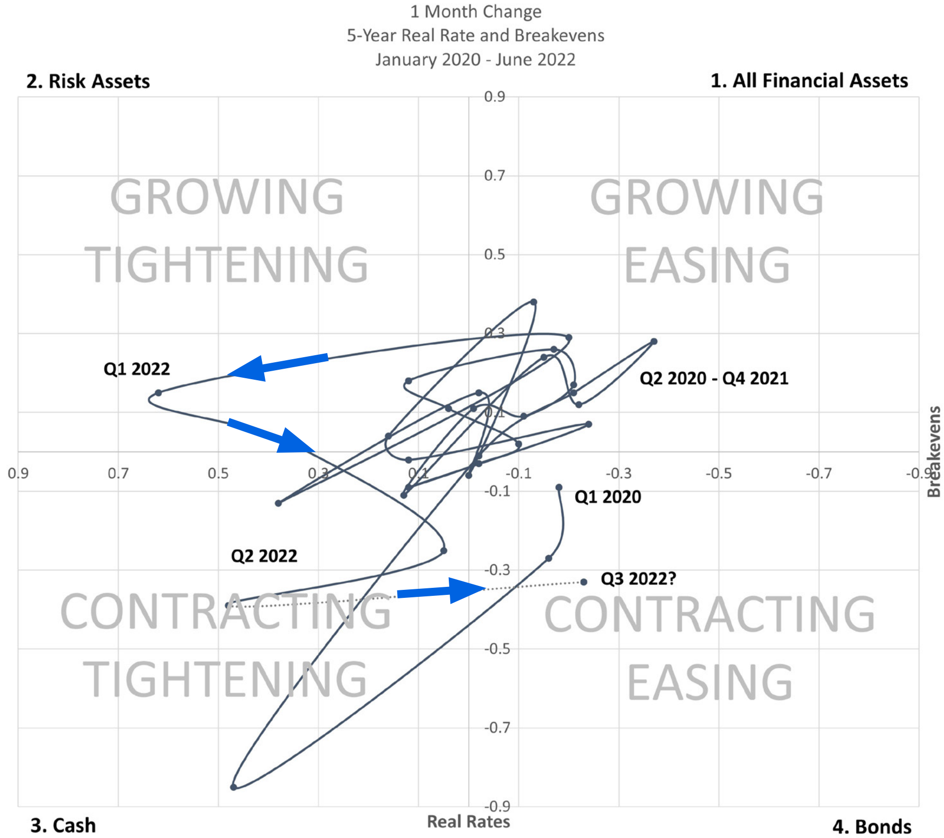
Source: RockCreek, US Treasury Department

10-year breakeven inflation rates came in by 51 basis points to 2.3%, returning long-run inflation expectations to levels previously seen in Q1 2021, when CPI was printing below 3%.

These changes in real rates and breakeven inflation rates can be used to define the economic regimes signaled by the bond market. The regimes not only have implications for the performance of bonds but asset allocation within a multi-asset portfolio.

As seen below, there are four regimes that can be presented as four quadrants representing the bond market's assessment of go forward economic and policy conditions:

The Four Regimes of the Bond Market



Source: RockCreek, US Treasury Department

Quadrant 1 (top-right) is defined by declining real rates and rising breakevens representing a positive economic growth trajectory – fueled by easier financial conditions – which tends to be supportive of all asset prices.

Quadrant 2 (top-left) is defined by rising real rates and rising breakevens representing a positive economic growth trajectory despite tighter financial conditions, which tends to favor risk assets (e.g., commodities, stocks, cyclicals).

Quadrant 3 (bottom-left) is defined by rising real rates and declining breakevens, representing slowing economic growth due to tighter financial conditions; this tends to be an environment where cash is king.

Quadrant 4 (bottom-right) is defined by declining real rates and declining breakevens representing slowing economic growth that is being combated by easier financial conditions, which tends to favor fixed income.

What we’ve seen so far in 2022 was a shift in expectations from Quadrant 1 to Quadrant 2 during Q1, as the economic tailwinds from the reopening were expected to offset central banker’s policy tightening. During Q2, we saw a shift from Quadrant 2 to Quadrant 3, as it became apparent that more persistent inflation would require significant tightening that would take a bite out of economic activity.

Based on the price action of the bond market since mid-June – falling real yields and breakeven rates – we may be transitioning to Quadrant 4, the disinflationary slowdown (i.e., recession). Consistent with this environment, bonds – and on a relative basis, other long duration assets – are the primary beneficiaries, while risk assets – notably commodities – are likely to underperform.

In this scenario, the bond market is telling us that the Fed won’t be able to follow through on its planned path of rate hikes through 2023 due to an economic slowdown. And as we’ve noted at prior inflection points, the bond market is often the “tail wagging the dog.”

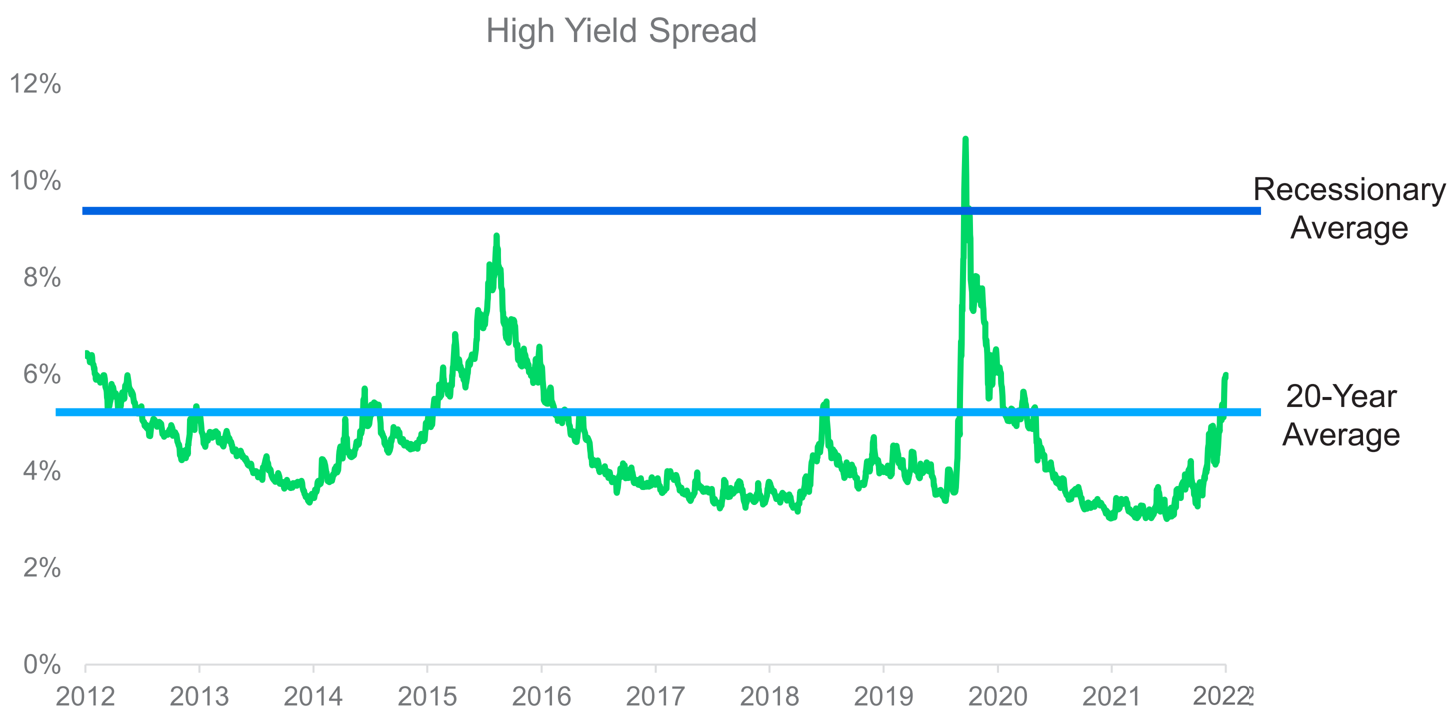
Public Credit

In a divergence from Q1, when duration largely drove returns, Q2 was marked by a sharp pickup in credit concerns, evidenced by widening spreads – finishing the quarter at 620 basis points, with June's widening of 150 basis points being the largest single month move since 2008.

Spreads are now above the long-run (20-year) average of 575 basis points and up sharply from the 420 basis point levels coming into the quarter.

High yield bonds finished Q2 with a loss of 10%, with June driving the weakness at -6.8%. This brings high yield year-to-date performance to -14%. Yield spreads in the high yield bond market widened by more than 260 basis points in the first half of the year reaching almost 600 basis points, reflecting investors' increasing pessimism about the economic outlook.

Significant downside risk remains. The recessionary spread average of 970 basis points still leaves potential widening of 350 basis points. Given heightened expectations of a recession, minimal capital market activity, and falling earnings (and margins), credit markets still seem, at best, fairly valued.



Source: Federal Reserve Bank of St. Louis

Leveraged loans have fared better than their bond counterparts when it comes to returns, with the market down only 5.8% year to date, but the rising debt servicing costs are likely to be felt much sooner for these borrowers compared to those with a bias more towards having more fixed rate debt outstanding. Much of the losses in the leveraged loan asset class have been since May, reflecting mounting concerns about how a slowing economy could affect junk-rated borrowers' finances. This sentiment has resulted in loan mutual funds and loan ETFs recording outflows in May and June, following 17 consecutive months of inflows. Outflows for Q2 totaled more than $3.1 billion.

The nearly $1 trillion in refinancing activity over the past 20 months has helped shore up balance sheets and push out maturities and therefore near-term defaults are expected to remain low. However, worsening financial conditions can have an impact, even if corporate borrowers don't default. The biggest buyers of leveraged loans are CLOs and if credit-rating firms downgrade a large number of leveraged loans, as was the case during the early stages of the pandemic, it would cut into CLOs' demand for such loans pushing prices lower. In fact, this sentiment is pushing through in the weakest segments of the debt market such as CCC bonds now trading at spreads well over 1,200 basis points.

Given that default rates are unlikely to materially rise, a full-blown distressed cycle is unlikely to be in the cards for the foreseeable future. However, the investment opportunity set has improved meaningfully as dispersion has increased both across and within sectors, debt is more attractively priced on a relative basis, and the abrupt exit of fair-weather 'tourist' investors in the space has led to significant mispricing opportunities.

Emerging Market Debt

Emerging market sovereign debt returned -10.55% in the second quarter, bringing year-to-date losses to 18.8%. The asset class is suffering one of its worst drawdowns since the 2008 Global Financial Crisis (GFC). Some of that of course stems from big losses in underlying rate markets, but credit deterioration has been a major driver for the most distressed countries. With the Russia-Ukraine war keeping pressure on commodity prices, global interest rates rising, and the continued strengthing of the US dollar, the financial burden for many emerging market nations is becoming strenuous at best. According to Bloomberg, there is $237 billion due to foreign bondholders in notes that are currently trading in distressed levels. That adds up to almost a fifth – or about 17% – of the $1.4 trillion emerging-market sovereigns that have outstanding external denominated debt.

This year, we have already seen Sri Lanka and Russia default on their debt and now all eyes turn to El Salvador, Ghana, Egypt, Tunisia, and Pakistan who could be next in line. Given increased political turmoil arising from soaring food and energy prices, an increasing concern to investors is whether these countries would begin to shift capital earmarked for external debt payments to providing access to food and energy for its citizens.

Private Credit

Private credit remained resilient over the second quarter and demonstrated its value to institutional portfolios, despite public credit coming under pressure because of increased market volatility. Investors' overweight income strategies generated steady returns as performance was driven by contractual payments, which generally offset any declines in mark to market valuation.

The performance of distressed and special situation strategies was more mixed, as gains through the monetization of seasoned private investments related to the COVID recovery trade were offset by the decline in value of recent securities purchases in secondary markets.

As of the end of Q2, the US private credit market has grown to more than $1.2 trillion, more than doubling since 2015 with institutional investors continuing to pour money into the asset class - especially with traditional fixed income no longer providing the same income and diversification benefits as it has in the past. This trend will likely continue and some forecasts have private credit assets reaching $2.69 trillion in AUM by 2026, overtaking real estate as the second-largest private capital asset class after private equity.

Inflows have been far from proportionate, however, with the larger established GPs receiving the bigger slice of the pie, tilting market concentration to a select group, and making it harder for newcomers to compete for capital. According to Preqin, nearly 40% of aggregate capital raised last year went to the 10 biggest funds, which is up from about 27% in 2017.

Fundraising is running at a rapid clip as well, with GPs returning to market every 15 to 18 months, an acceleration from the historical norm of three years, which has motivated established firms to launch even more new funds. Of the 2,800 individual funds launched over the last five years, 80% were from existing GPs. This has raised the barrier to entry, creating a problem for first-time fund managers, as both the number of funds closed by new managers and the aggregate capital raised fell to levels not seen since the GFC.

Despite certain industry headwinds, RockCreek continues to believe that backing experienced teams seeking to raise their maiden fund remains attractive. The increased presence of these mega sized direct lending funds has morphed the strategy from one that had historically focused on middle-market companies to a staple of multibillion-dollar buyout transactions. As a result, the market has seen an increase in both the number and size of large private credit transactions. Prior to the GFC, the biggest deals were a few hundred million dollars, but now multi-billion-dollar transactions are not uncommon.

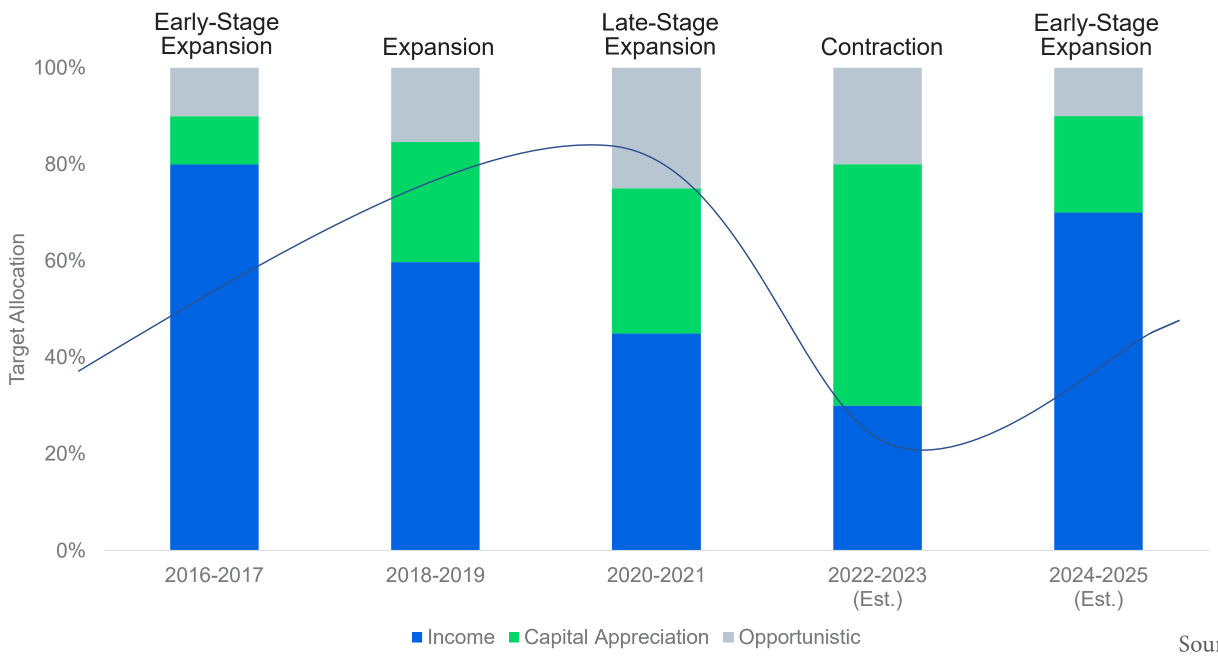
The first half of 2022 has seen this trend accelerate as banks have moved to the sidelines, given increased market volatility and these mega sized direct lending GPs have stepped into the spotlight. They are willing to provide capital, sometimes even at rates below what's available in the syndicate loan and high yield market, in order to build relationships and access deal flow from premier private equity firms.

Given these dynamics, RockCreek has avoided much of this space. Underwriting cash flows or a company's enterprise value has become especially challenging in the current environment. We have stayed away from all forms of corporate lending. We view specialty finance and asset-based lending strategies, where yields remain relatively healthy and there is hard collateral value supporting the loans, as being more economically favorable.

Recent areas of focus include loans backed by commercial real estate assets or working capital assets such as accounts receivables or inventory.

As the market environment continues to be challenging and the likelihood of a recession increases, we have focused our attention on commitments toward more distressed and opportunistic strategies. The combination of policymakers having to raise rates to tame inflation, against a backdrop of persistent supply chain disruptions and fallout from the war in Ukraine, is setting the stage for increased financial distress, especially for small and mid-sized companies.

How we think managers in the private credit space are likely to target their allocations to private credit strategies over a market cycle is as follows:



Source: RockCreek

One sub-strategy that is increasingly popular is a focus on venture debt. The strategy has gained increased traction with some investors over the past few years as a means to amp up their private credit portfolio returns through upside from warrants and equity participation that were typically structured into the transaction. We had generally avoided the strategy previously, as we believed that pricing had become tight, loan underwriting standards had weakened, and base case return expectations assumed that there would be some return from the equity participation.

Today this dynamic has shifted. Capital has now become a scarce resource and venture debt has become valuable as it can act as a liquidity bridge for cash-starved companies to avoid raising a new equity round at a potentially lower valuation. Some noteworthy growth equity investors, including Coatue and Viking, are seeking to raise multi-billion funds to provide structured liquidity solutions to such companies.

Private Equity and Venture Capital

Private markets have not been immune to the macro environment, with deal volumes declining across the board. During the first half of 2022, private equity deal volume was down 26%, while venture capital markets saw a similar pullback.

Investors have become more discriminating in the deals they pursue, resulting in a flight to quality, defined as companies that have an ability to grow (albeit maybe at a slower rate) while still generating significant free cash flow. Or as Jeff Bezos has said, "Stock prices are most closely correlated with cash flow. It's such a straightforward number. Cashflow is what will drive shareholder returns."

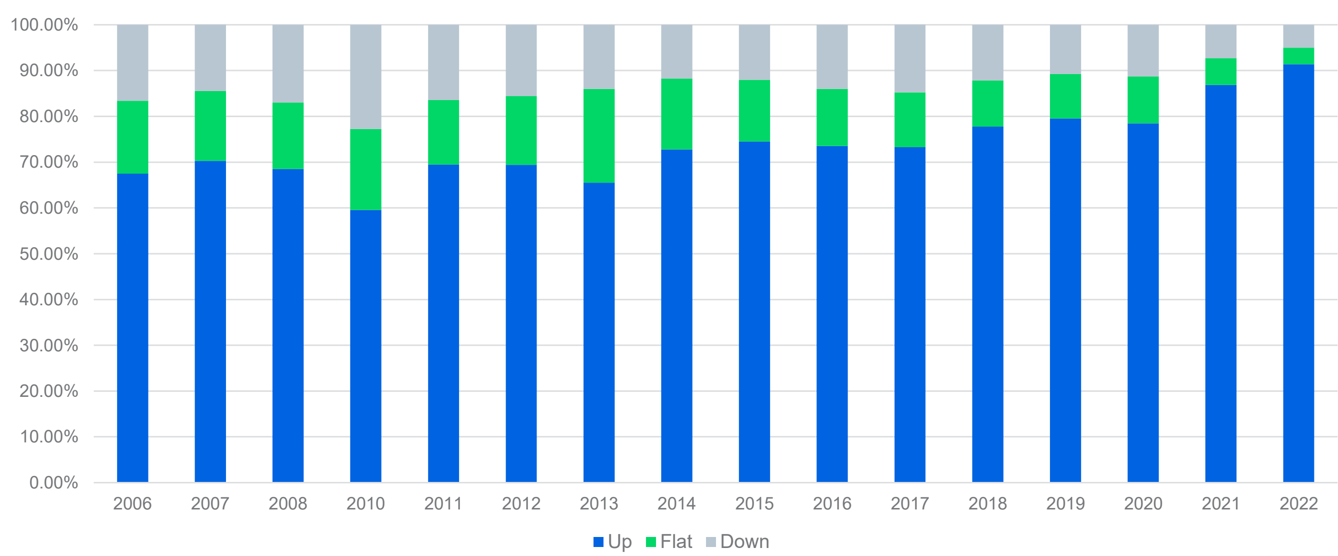
In public markets, valuation multiples are down across the board – falling 50% to 75% and reflecting the change in cost of capital and reduced risk appetite in the current environment. Nearly every venture capital firm has advised its portfolio companies to begin conserving cash to weather a potential recession, with several companies beginning the painful process of announcing cuts. Just in the last few months, Coinbase, Carvana, Compass, and Tesla have announced major layoffs, while Meta, Apple, and Uber have announced hiring freezes.

On the buyout side, several deals were re-negotiated at lower prices. This was highlighted by the take-private of Zendesk for $10.2 billion in a deal led by Hellman & Friedman, which was approved by the board in late June 2022, after a $17 billion offer was rejected in February 2022. Private equity firms are currently sitting on a record $1.8 trillion of dry powder, serving as an overhang for valuations becoming more rationalized.

Within the venture market, late-stage growth has seen the largest pullback, but there is some important context worth considering. These markets are effectively frozen and very few companies have announced new financing rounds. This is not just a reflection of the current market environment. Many companies aggressively raised capital in 2021 and came into this environment with significant cash balances, providing a cushion in the short to medium term. In surveying RockCreek's private portfolio, indications are that most companies have at least 24 months of cash runway, with very few companies having less than 12 months. As a result, it is unlikely that we will see many companies shut down in 2022.

With such little primary deal activity, private market valuations (at least in late-stage venture), are unlikely to be meaningfully revised downward over the ensuing quarters as companies leverage their strong balance sheets.

Valuations from Prior Rounds



Source: RockCreek, PitchBook

Setting aside valuations for a moment, fundamentals at many of these companies remain largely intact, particularly for software companies, but growth is slowing. Growth is still important, but growth at all costs only works when money is free. Money isn't free anymore and won't be for a long time to come. When capital becomes more expensive, a path to predictable, sustainable cashflow will drive shareholder value. In other words, profitability matters again.

It's important to note that this is the first time many venture investors have experienced a bear market on the heels of the longest bull market run in history. There is also valid concern that this correction will hit impact fund managers as well as emerging and diverse fund managers the hardest, as many LPs have communicated an intention to concentrate future commitments on re-ups with existing GP relationships. But it has been our experience that some of the better performing GP's have been with this group of traditionally passed over managers, which is why RockCreek remains committed to continuing to seek out these opportunities.

Overall, we think this correction will have some positive effects on the future valuation environment and go-forward opportunity in private equity, and we continue to be bullish on innovation, especially in areas such as life sciences and climate.

Selecting high-quality GPs and companies backed by strong, diverse teams has become more important than ever. Once the dust settles, there will likely be an incredible opportunity to deploy capital into companies with stronger business models at more attractive valuations than over the past market cycle.

Real Estate

As the Fed attempts to wrestle back control of runaway inflation through monetary policy, there are more implications for investors to consider across both commercial and residential property sectors. The primary impact of the Fed's recent rate hikes are the higher financing costs for investors and homeowners alike.

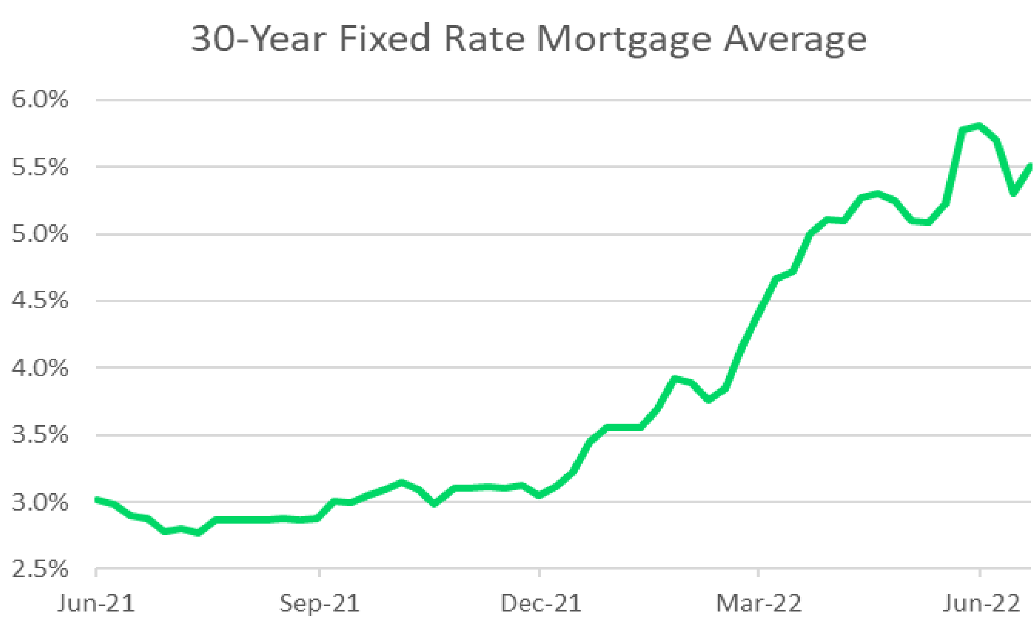
As a result, commercial real estate investors must reassess their business plans where the increased cost of leverage exceeds that of the going-in capitalization rate, creating a negative leverage effect that reduces short term profitability.

As we have discussed in prior research commentaries, real estate generally serves as a strong inflation hedge due to the supply constrained nature of the asset and ability to pass on price increases to tenants efficiently, depending on the lease term. Property types with shorter lease terms such as hotels (daily), self-storage (monthly), or multifamily (annually) will be able to reset their prices and efficiently pass inflation on to tenants in this environment. Office, industrial, and retail assets typically have lease terms of 5+ years and don't benefit from quicker re-pricing, but these leases usually have annual rent increases or CPI resets to absorb any inflationary pressure over the long term.

Certain property types, such as industrial and residential, have experienced strong value growth over recent years and now trade at 3-4% capitalization rates, exposing them to a greater impact from a leverage effect. Other sectors, such as office and retail, have 5-6% capitalization rates and provide more cushion for higher leverage costs.

In these situations, we have seen investors respond in two ways: (1) they can either pause new investment activity and wait for financing costs to ease, or (2) change their underwriting assumptions to justify new investments with the higher debt cost. The first scenario will create opportunities for investors with access to cheaper financing or unlevered investors as they will now face less competition. In the latter scenario, investors will likely need to increase rental growth assumptions, which can impact performance if assumptions are too aggressive.

Similarly to in the commercial sector, monetary policy has increased financing costs in the residential for-sale sector, as the average interest rate on a Fannie Mae 30-year fixed rate mortgage reached levels not seen since 2008 and has steadily grown over the last 6 months.



Source: RockCreek, Freddie Mac

As discussed last quarter, demand has outpaced the supply of single-family homes for sale, which has continued to push home values higher. Higher financing costs have impacted affordability, leading to the decrease of potential buyers for new homes - where there may have 10 buyers for a new home, now there maybe only half that today. Escalating the situation is the fact that roughly 80% of existing mortgages are below 4% fixed rates, which make it that much more expensive for existing homeowners to sell and get a new mortgage. As a result, we expect to see slowing new home sales velocity and potential value declines on a year over year basis in certain further out submarkets. While the headline numbers may look troubling, there is still massive demand for new homes, and a reset will be healthy in certain submarkets as the Fed looks to combat runaway inflation.

As we continue to assess the industry and opportunities in this uncertain financing environment, existing multi-family assets with leverage in place and particularly single-family rental assets should have more room for growth and value appreciation, as owning has gotten to get more expensive relative to renting a home for potential buyers. Another theme we are evaluating is the net lease market where corporates may look to monetize their real estate as an alternative source of financing given traditional public credit methods have shut down. We are also excited about opportunities in other asset classes, such as logistics and digital real assets, to ensure there is adequate cushion between our cost basis and the new leverage costs and our ability to increase value.

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