Public Equities

Equity Markets	Q4 2022
US Large Cap (S&P 500 TR)	7.6%
Nasdaq	-1.0%
US Small Cap (Russell 2000)	5.8%
Japan (TOPIX)	3.0%
Europe (MSCI Europe)	9.2%
China (CSI 300)	1.8%
Global EM (MSCI EM)	9.2%

Bond Markets	Q4 2022
US 2yr	-14.7
US 10yr	-4.6
US 30yr	-18.7
German 10yr	-46.3
German 30yr	-45.3
UK 10yr	42.1
UK 30yr	-13.1
JGB 10yr	-17.8
JGB 30yr	-22.0

Currency Markets	Q4 2022
DXY	-7.7%
EUR	9.2%
GBP	8.2%
JPY	10.4%
MSCI EM Currency Index	4.3%

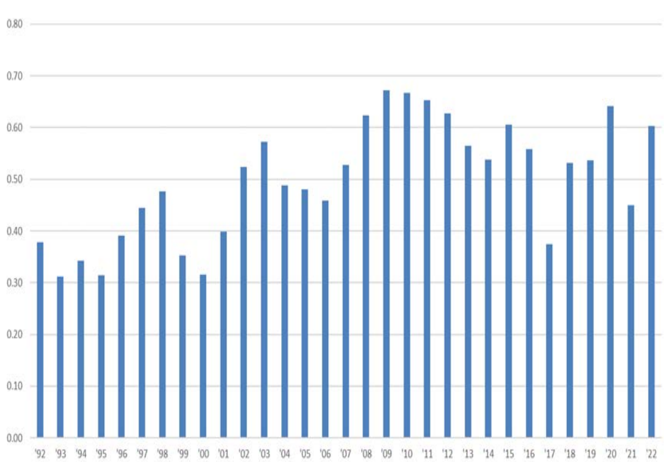
Commodity Markets	Q4 2022
Crude Oil (WTI)	1.0%
Nat Gas	-33.9%
Gold (Spot)	9.8%
Steel (Rebar)	4.0%
Ag & Livestock (Bloomberg)	2.3%

RCG HF Indices	Q4 2022
All Hedge Funds	2.2%
Equity Hedge	4.0%
Absolute Return	-0.3%
Equity Market Neutral	1.2%
Event Driven	2.9%
Global Macro	-1.0%

Although December was a thud, equity market performance for Q4 as a whole was more positive than it felt, driven largely by signs of cooling inflation and hopes that the Fed would moderate its pace of policy tightening. While better-than-expected corporate earnings in Q3 provided additional support, the lagging effect of higher interest rates remains a major concern looking forward. Many companies, particularly in the technology and financial sectors, warned of a worsening environment moving forward and are reducing capital expenditures and headcounts.

Despite the strong quarter finish, 2022 proved to be a historically bad year. The S&P 500's annual loss of -18% ranked at the bottom 5th percentile of all calendar year returns going back six decades. Energy and utilities, which were up approximately 66% and 2%, respectively, were the only GICS sectors to finish in positive territory. Meanwhile, communication services (-40%), consumer discretionary (-37%), and information technology (-28%) suffered the steepest losses. In fact, with a loss of -33%, the Nasdaq had its worst year of underperformance relative to the S&P since 2002. Owning low momentum and shorting high momentum stocks early on was the best trade of the year as speculative excesses were largely wiped out. With much of the market exhibiting high price correlations it was a challenging year for stock pickers. The 0.60 average monthly cross-sectional volatility of the S&P was one of the higher measures in recent years.

Figure 4. S&P 500 Cross Sectional Correlation by Year



Source: RockCreek

Going into 2023, most of the damage to equities has likely been done. The majority of stocks have come in line with historical average multiples even though there are still pockets of over-valuation with stubborn inflation and higher interest rates for longer continuing to act as headwinds for growth sectors. Despite lower risk of a severe recession, we expect to see continued rotation away from expensive growth, towards value. While 2023 S&P consensus revenue and earnings expectations may prove to be too high, a greater number of companies are starting to cut costs to preserve margins.

Assuming inflation continues to decline as the year progresses, investors will likely take more balanced views across sectors as opposed to the whiplash we saw around the evolving inflation and interest rate expectations of 2022. Equities are still priced much higher than they were at the onset of past secular bull markets and at the same time, sentiment is already near historic lows. This leads us to believe we are entering a more nuanced environment where stock selection skill will matter to a much greater degree than it has in the recent past.

History shows the small- and mid-cap segments of the market tend to be fertile ground for stock selection. Interestingly, smaller-cap equities are trading at a greater-than-normal discount to large- and mega-caps. Profitable companies in the Russell 2000 index have an average 12-month forward P/E multiple of approximately 12.5x compared to around 18x for the S&P. This further supports the fact that, at current levels, there are plenty of attractive opportunities for patient investors willing to go off the beaten path.

Europe

The MSCI Europe rallied 19% in Q4, bringing its annual loss to -15% in US dollar terms. Despite Russia's invasion of Ukraine and the resulting energy crisis throwing European markets into disarray, 2022 was a mixed bag for Europe. Defense and energy companies were natural winners and supported broad market indices in the last quarter. Rising interest rates also lifted banks' net interest margins, helping the sector to outperform. On the other hand, retail was clobbered by the rising cost of living.

Given the extreme volatility, the region's current valuation should be put into perspective. The 12-month forward P/E multiple for European equities has a long run average of around 14x. Coming into 2022, European equities traded at an elevated 16.2x according to Factset. Overall earnings estimates were revised higher thanks to the sharp rebound in energy and commodities, helping Europe's valuation fall all the way down to 10.9x by the end of Q3. Europe now trades at roughly 12.5x 2023's estimated earnings of the most recent rally – still a discount to the long run average, indicating the market is pricing in a moderate earnings recession. There is no doubt that there are plenty of opportunities for stock pickers at current levels; however, the market is likely to remain overshadowed by elevated inflation and high interest rates coupled with stagnant economic growth while the war in Ukraine drags on. The pieces needed for a positive market call on Europe versus other regions do not appear to be in place yet.

Japan

Japan's Nikkei 225 rose less than 1% in Q4 and ended the year with a -20% loss. Much of the weakness was rooted in the yen's 14% depreciation versus the US dollar. But Japan comes into 2023 with robust fiscal and monetary stimulus as the government remains in easing mode. Japan, as well as Asia more broadly, is also behind the US and Europe on the reopening curve. These factors could lead to a less severe economic slowdown than in other developed economies, though it is important to note that the dramatically weakened yen and rising inflation are fueling political pressure to change course. With Governor Kuroda stepping down as head of the BOJ, the April leadership change will be important to observe. Regardless of how the BOJ's policy evolves, we continue to see improvement in Japan's corporate governance. Measurable impacts include record share buybacks in the current March 31 fiscal year and improved returns on equity.

Emerging Markets

With all major global economies open for business for the first time in three years,and low valuations in emerging markets, many investors are entering 2023 more excited about these markets. However, many unknowns remain.

China is the most important variable that is likely to give investors plenty of head scratchers. From the stability of the country's public finances, its ongoing flirtation with a Taiwan takeover, and a re-opening that is putting the country's public health system under severe pressure, there is no shortage of worries. Nevertheless, as a lynchpin of global growth, China's reopening may indeed act as an economic tailwind, however subdued it may be compared to years past. If 2022 was about EM ex-China, 2023 may well play out differently. We expect a broad-based recovery in much of North Asia, led by consumer technology stocks in China, and tech/ hardware stocks in South Korea and Taiwan. Longer term, we remain concerned about China's prospects and have adopted a more tactical stance on exposures.

Outside of North Asia, it is worth noting that sector performance in markets such as India, Latin America, and the ASEAN region was not well distributed in 2022. Commodities and banks led the charge, while consumer, healthcare, and tech related stocks lagged significantly. At RockCreek, we expect the latter to outperform in 2023, backed by moderating inflation and lower interest rates, particularly in Latin America; however, don't count commodities out just yet. Recurrent labor unrest in Latin America and South Africa are contributing to a supply crunch in base metals, creating significant problems for the automotive and tech hardware sectors.

Emerging markets are critical to any technology driven societal transition, including electric vehicles, green energy, fintech, and consumer-facing tech hardware. For instance, Chile, Argentina, and Bolivia make up the famous 'lithium triangle', collectively accounting for close to 60% of globally identified lithium resources. South Africa produces close to one third of the world's manganese and has the largest manganese reserves, while Indonesia is the world's largest nickel producer. And of course, there is China, which tops the list with 80% of global refining capacity for raw materials needed for EV batteries and 60% of the world's graphite production.

On the currency front, emerging markets could see some weakness, particularly if the Fed oversteers in the coming months. But even if the Fed pauses and the focus shifts to addressing slowing growth, high-beta emerging market currencies may still be vulnerable. Sticking to domestic sector stocks with input costs in local currency should somewhat insulate investors from the vicissitudes of the currency markets. EM financials, on the other hand, could struggle, particularly if local rates go lower. Lastly, 2022 was a veritable annus horribilis for EM debt. Outflows were record breaking and yet there could be more pain, particularly in the corporate debt market. We do not expect issuances to recover until the second half of 2023.