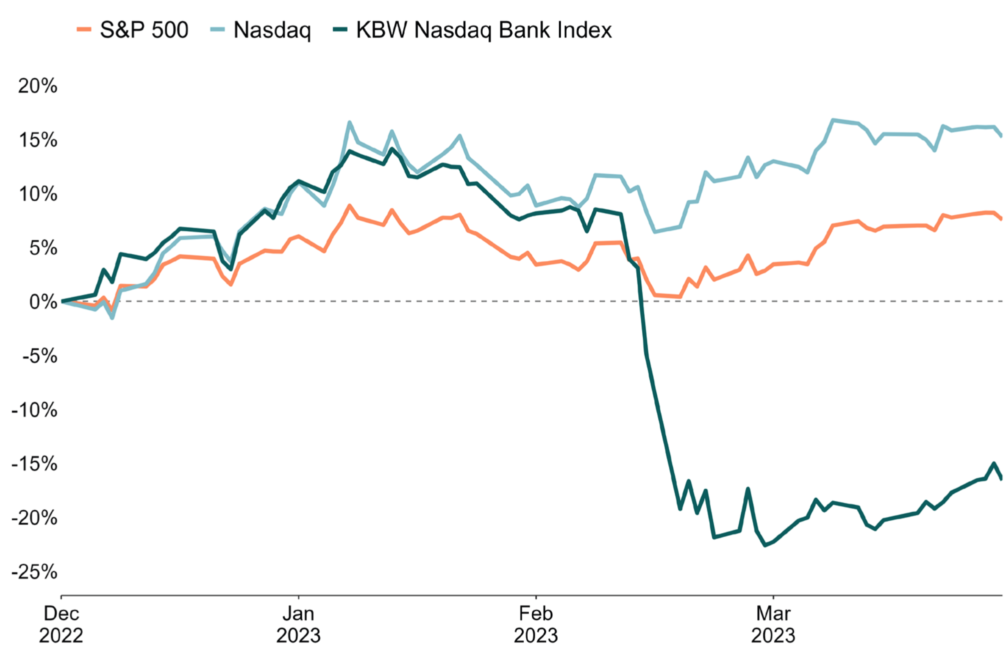
PUBLIC EQUITIES

Despite a volatile path, investors were treated to a winning quarter in equities. January saw a powerful rally across stocks that had been beaten down over the prior year, but the rally was cut short as a hot labor market and sticky inflation fanned concerns the Fed would keep rates higher for longer. March's surprise failure of SVB and the ensuing stress across the banking sector produced a spike in volatility. Ultimately, the market proved resilient as the cracks in the system fed optimism that the Fed would ease up, while at the same time the government's bailout of SVB depositors and other such measures eased pressures in the banking system. Chalk this up as another episode in what has become a range bound market since the end of April last year (Figure 4).

A clear trend emerging from investors coming into 2023 was a rotation into defensive mega-caps. The combination of strong factor performance from Growth, Large-cap, and Quality helped most actively managed

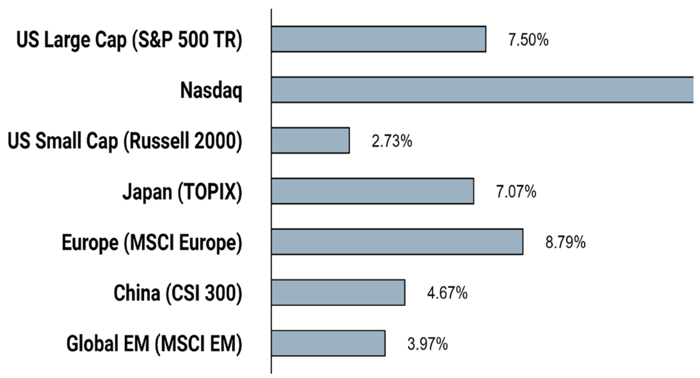
Figure 4. Equities performed well despite surprises in economic data and banking turmoil



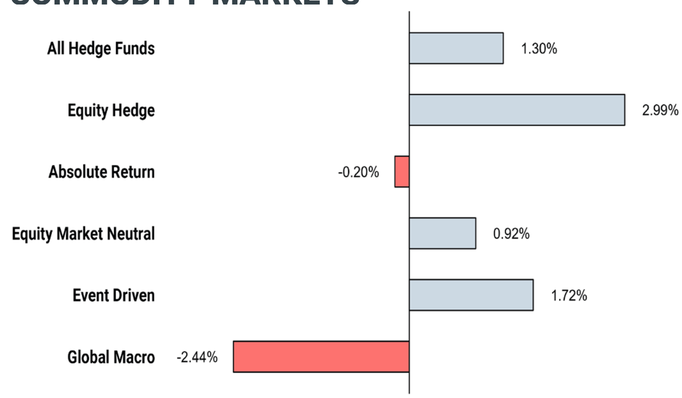
Source: RockCreek, Bloomberg.

ASSET RETURNS Q1 2023

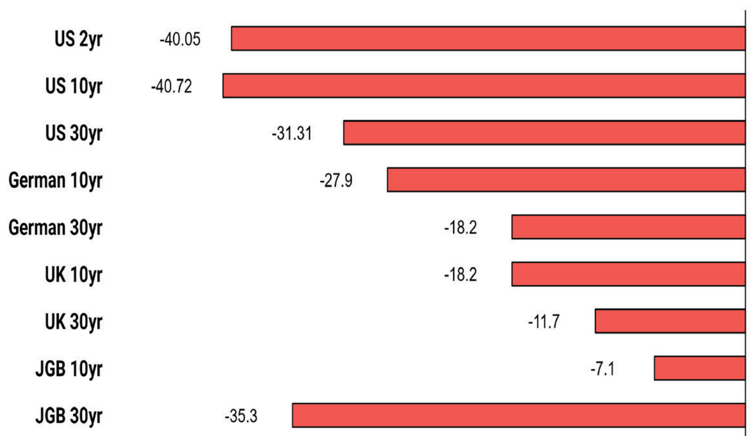
EQUITY MARKETS



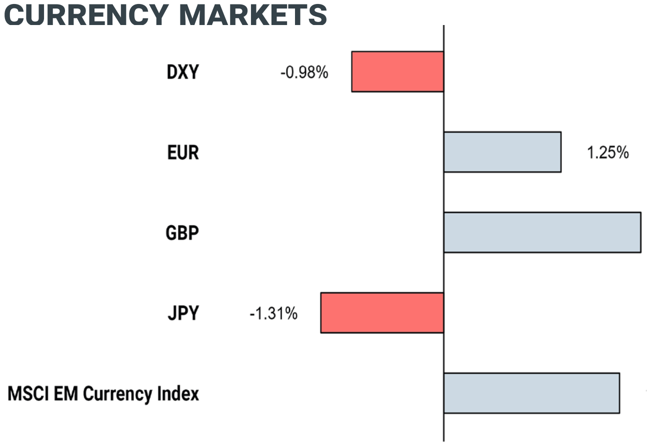
COMMODITY MARKETS



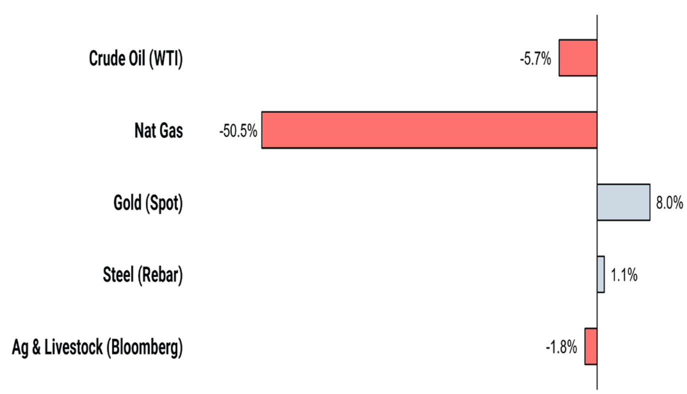
BOND MARKETS



CURRENCY MARKETS



RCG HF INDICES

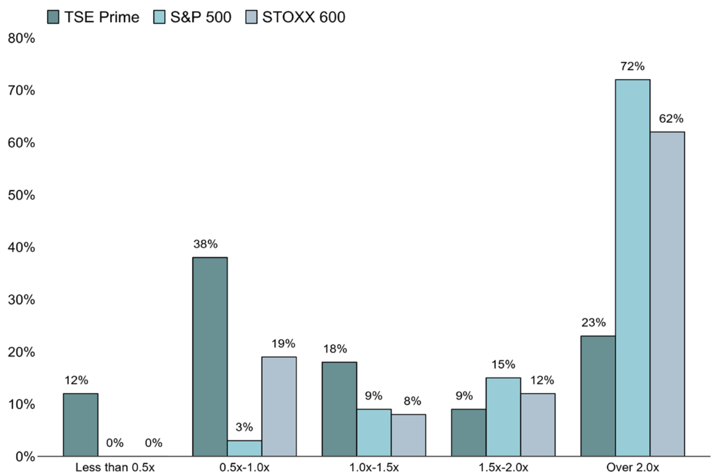


strategies get off to a good start this year. Over the quarter, technology stocks outpaced the market, followed by other growth-led sectors like consumer discretionary and communication services. Share prices for heavy weights like Alphabet and Amazon, which lost close to 40% or more of their value last year as revenues came under pressure, were rewarded for solid fundamentals and defensive characteristics, gaining 17.2% and 23.0%, respectively, in the first quarter. Other industries with defensive moats, such as advanced semiconductor manufacturers and equipment and enterprise cloud software, also posted strong returns. Meta Platforms, perhaps the poster child of a deep-pocketed growth company making an abrupt about-face from its big-spending habits, was rewarded with a 76.1% rise in its shares.

The story was different in the financial sector, where the KBW Nasdaq Bank Index dropped -18.7% for the quarter and -34.0% on a peak to trough basis. The market is ascribing an elevated risk premium in recognition of banks' losses on their bond holdings and rising concerns about deposit base funding and asset/liability mismatches. This may present opportunities for investors with deep knowledge of the sector. It is important to note that SVB is not emblematic of the overall banking sector, as it was uniquely positioned to service venture capital and other such investment management firms. The California-based bank was implementing business practices that other lenders generally do not do, such as issuing mortgages to investment professionals based on carried interest in private deals. It was also making loans to employees so they could invest alongside their firms' private equity deals. These risky practices helped SVB attract business from a very specific clientele and thus turbocharged its growth. The vast majority of regional banks are much better positioned to weather losses from their bond holdings thanks to a more granular deposit base and more diversified business model. In the aftermath of SVB's collapse, banks have also been further shoring up their balance sheets to absorb potential losses.

Outside the US, Japan's Nikkei 225 rose 7.5% for the quarter, led by cyclical sectors such as metals, machinery, and technology, which are well-exposed to China's economic rebound. Banks and insurers, on the other hand, underperformed during the quarter, mostly due to fears of contagion from SVB's collapse. Coming into the second quarter, investors are once again showing renewed interest in Japanese banks. With the BOJ now coming under the control of Kazuo Ueda, we could begin to see a shift away from former governor Haruhiko Kuroda's yield curve control policy. The resulting rise in yields would likely be a boost to bank shares. The key risk in such a scenario is that banks' losses from their long maturity domestic and US bonds would be too large a hit to their balance sheets. Japanese megabanks and regional lenders have about $1.1 trillion in US bonds as of end-2022 and are sitting on nearly $30 billion in unrealized losses. Despite this, many investors judge the risk-reward to be reasonably attractive given the significant discount at which Japanese banks' price-to-book ratios (PBR) are trading. Japan's own economy is also showing solid strength,

Figure 5. TSE Prime index has a lower concentration of 2.0x PBR compared to the US and Europe



Source: RockCreek, Goldman Sachs.

with positive industrial production, retail, and auto sales data in recent months.

The environment for Japanese activism also continues to be favorable as corporate management teams continue to face mounting pressure to improve profitability. According to Goldman Sachs, just 23% of the TSE Prime index trade over 2.0 PBR versus 72% of the S&P 500 (Figure 5). The TSE in January issued a notice requesting companies trading below book value provide a capital improvement plan beginning this spring. The Japanese government recognizes the country cannot move forward without growth and is firmly behind measures to improve the corporate governance culture.

In Europe, investors got an extra jolt in March with Credit Suisse's collapse following years of mismanagement. Shares of the Swiss giant ended 70.3% lower for the quarter on the heels of its forced combination with UBS. Most other major European banks also ended the quarter lower, including Deutsche Bank and Barclays, which fell 11.6% and 8.0%, respectively. Conversely, European defensive companies outperformed, as illustrated by the GRANOLAS, a collection of the largest European companies by market cap (GlaxoSmithKline, Roche, ASML, Nestle, Novartis, Novo Nordisk, L'Oreal, LVMH, AstraZeneca, SAP, and Sanofi). These stocks, offering a mix of sustainable growth and income, returned +11.1% on average for the quarter, led by LVMH, ASML, L'Oreal, and SAP, which were up more than 20% each.

Most institutional investors remain cautious on developed market equities going into the second quarter. Hedge funds' directional risk is historically very low despite increases in gross leverage levels, reflecting a healthy balance between long and short opportunities. Many investors were selling into the January rally and have since been reluctant to add much risk. Equity valuations still appear relatively expensive while pricing in a resilient economy. We have now seen the first real financial cracks from monetary tightening, and tighter credit conditions, inflation, and possible recession are key risks going forward.

EMERGING MARKETS

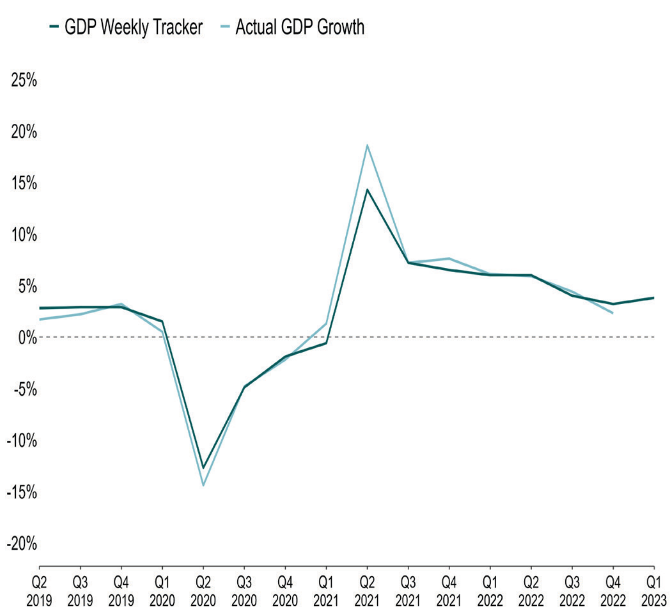
Investors generally felt there is strong value in Emerging Markets in Q1. Signs that a market recovery that was underway towards the end of 2022, led by China's re-opening, continued into the first quarter of 2023, though at a slower pace than the equity bump in developed markets. It was again a busy news cycle in emerging markets with local stories driving markets. Adani in India, the Lojas Americanas fraud story in Brazil, and China's errant balloon incident all contributed to EM volatility. Externally, Fed uncertainty and the banking crises in the US and Switzerland also impacted investor sentiment.

There was good macro news that came out during the quarter. EM manufacturing PMIs in the first months of 2023 showed signs that industry has fared better than it did in late 2022. The OECD weekly GDP tracker showed an uptick in growth for EMs (excluding China) in the first quarter to 3.8% YoY, up from 3.3% in the fourth quarter (Figure 6).

First quarter data revealed China's reopening is in progress, with trade, industrial production, and sales data showing picks in services and housing, driven by the post-re-opening recovery, near-term resilience in developed markets and China's macro support. However, the recovery is very uneven, and the majority of corporates and the population are still unwilling to invest in the longer term, since the fear from the recent three years is still so fresh. It is clear that the current on-the-ground confidence level is not as strong as macro data are suggesting.

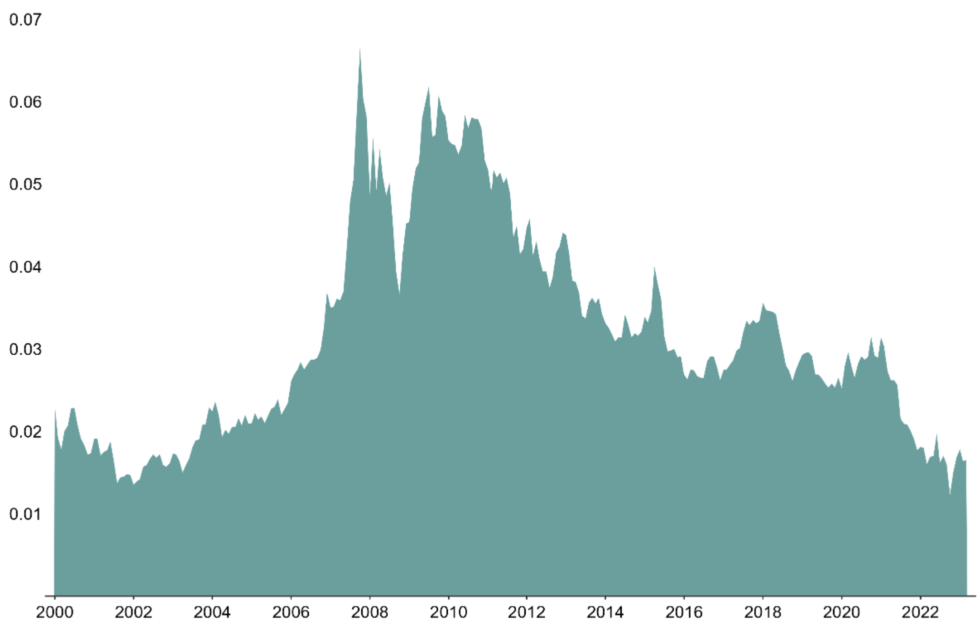
Inflation data in emerging markets proved more mixed in Q1. While inflation is on course for a significant drop in the first half of 2023, as the food and energy shocks of 2022 fade, it remains elevated on a year-over-year basis and above central bank targets in most emerging markets, with the exception of China. Headline inflation averaged 6.9% YoY in January and February, compared to 7.7% at its peak in mid-2022. This is, perhaps, why we have not seen broad-based monetary easing. Expectations going into 2023 called for some normalization of policy rates, particularly in countries – like

Figure 6. OECD Weekly Activity Tracker vs. Actual GDP Growth



Note: Data show percent change YoY. Quarterly GDP weekly tracker is aggregated by country across the period. Actual GDP values show median growth for EM countries in the sample. Emerging Markets (EM) includes Argentina, Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Poland, South Africa, and Turkey.
Source: RockCreek, OECD. As of March 31, 2023.

Figure 7. Chinese equities continue to trade at attractive valuations even with last year's late rally



Note: Shaded region represents relative performance of MSCI China to the S&P 500.
Source: RockCreek, Bloomberg. As of March 31, 2023.

Brazil – that had aggressively hiked in 2021, but elevated inflation levels and the Fed's forward guidance on rate policy has given EM central banks reason to pause. If the Fed, as is expected, does not begin cutting rates until at least 2024, EM central banks – in part to protect the value of their currency and to protect capital flows – are unlikely to loosen monetary policy any time soon, Turkey being the notable exception. Moreover, while EM is unlikely to see material spillovers to its domestic banking sectors from the collapse of SVB and other US regional banks, the shift in global risk appetite will intensify the tightening in domestic credit conditions already underway. As such, the prospect for EM fixed income remains mixed, with better prospects in local rates versus sovereigns.

Investors will also have to balance the positive effects of China's re-opening with the expected slowdowns in the US and Europe. With late-cycle dynamics intensifying and financial stability concerns surfacing, we may see weakness in EM currencies versus the Dollar in the coming months. This relative weakness can, in our estimation, be overcome by investing in the right companies with good prospects for margin expansion which are currently trading at attractive valuations. This is especially the case for Chinese equities, where – even after last year's late rally – are nowhere near historical highs versus US equities (Figure 7).