QUARTERLY COMMENTARY LETTER

(STILL) WAITING FOR RECESSION

Q1 2023

RockCreek

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MACRO ENVIRONMENT

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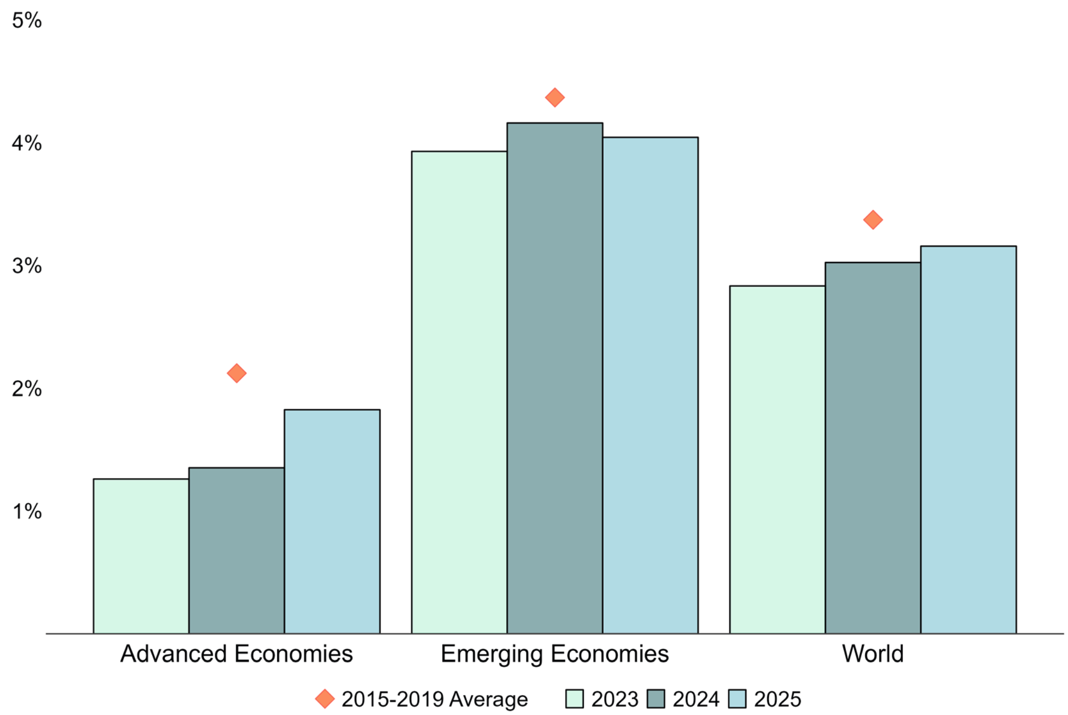
The long-awaited recession has not yet arrived. The first quarter of 2023 brought evidence that a global slowdown is indeed approaching. But it also showed that there is a way to go before central banks can declare victory in their fight against inflation and pivot to easier money. Despite these headwinds, investors in equity and bond markets had a good first quarter.

In the United States, the unexpected banking crisis in March – that spilled briefly into Europe – demonstrated that rising interest rates are biting. A credit crunch could result. Cooling labor markets both reflect and reinforce slowing demand. These signs of weakness in Q1 did not deter equity investors in public markets, although bond markets see-sawed violently during the quarter. Traders tried to make sense of confusing and changing economic information and predict its likely impact on central bank policymakers. Despite the turbulence, global equities finished the month on a high note, with gains across advanced economies and most emerging markets. The MSCI notched 7.7% in the first quarter, while the US S&P 500 and Stoxx Europe 600 gained 7.4% and 8.6%, respectively.

Investors saw two reasons for good cheer. First, hope persists that the Federal Reserve and the European Central Bank will soon ease monetary policy after one or perhaps two more notches higher in interest rates. At the same time, there is a scenario for a weakening US economy that could result in a pause in rate hikes and would make an early pivot towards lower rates more likely. At RockCreek, we continue to believe that such a pivot is unlikely to manifest anytime soon. Fed Chair Jay Powell and colleagues may pause monetary tightening by the end of Q2, as their counterparts north of the border did last quarter. But reversing rate hikes with inflation still so far above the 2% target would be a risky move for central banks that have seen inflation rise to forty-year highs. That is

Figure 1. The global economy has remained resilient in the face of higher interest rates

GDP growth estimates, 2023 - 2025



Source: RockCreek, IMF.

not to say that the Fed will wait for inflation to come all the way down to 2% before cutting rates. Indeed, a number of economists believe that achieving that target would be both costly, in terms of lost output and employment, and perhaps unrealistic given pressures on wages and labor shortages. One way to increase labor supply–immigration reform–seems out of reach in today's political climate. But even if the Fed quietly accepts inflation above 2%, it would not be comfortable with continued inflation at today's underlying rate of closer to 4-5%.

The second reason for markets to rally also helps to explain why rates are unlikely to come down quickly. Yes, the global economy is set to slow down. But the US and European economies have shown remarkable resilience in the face of the fastest monetary tightening in decades. Despite gloom from official forecasters at the World Bank and International Monetary Fund (IMF) this month about longer term prospects for the global economy, they believe that growth remained positive in Q1. The IMF's central forecast is for positive growth overall during 2023 (Figure 1).

FINANCIAL STABILITY VERSUS PRICE STABILITY: A NARROW ESCAPE?

Geopolitical tensions provided a somber backdrop to financial and economic issues last quarter. The one-year anniversary of Russia's invasion of Ukraine came and went with no progress toward ending the war. The US has mustered impressive support for Ukraine from many allies and partners. But much of the emerging world, including India, this year's G20 Chair, has stayed on the sidelines. China is the most important among them. Hopes of a return to regular exchanges between the world's two largest powers were undercut by sightings over American territory of a Chinese spy balloon. China's fumbled response – where quiet outreach by the US was met with official silence for more than 24 hours – demonstrated the dangerous absence of a functioning relationship.

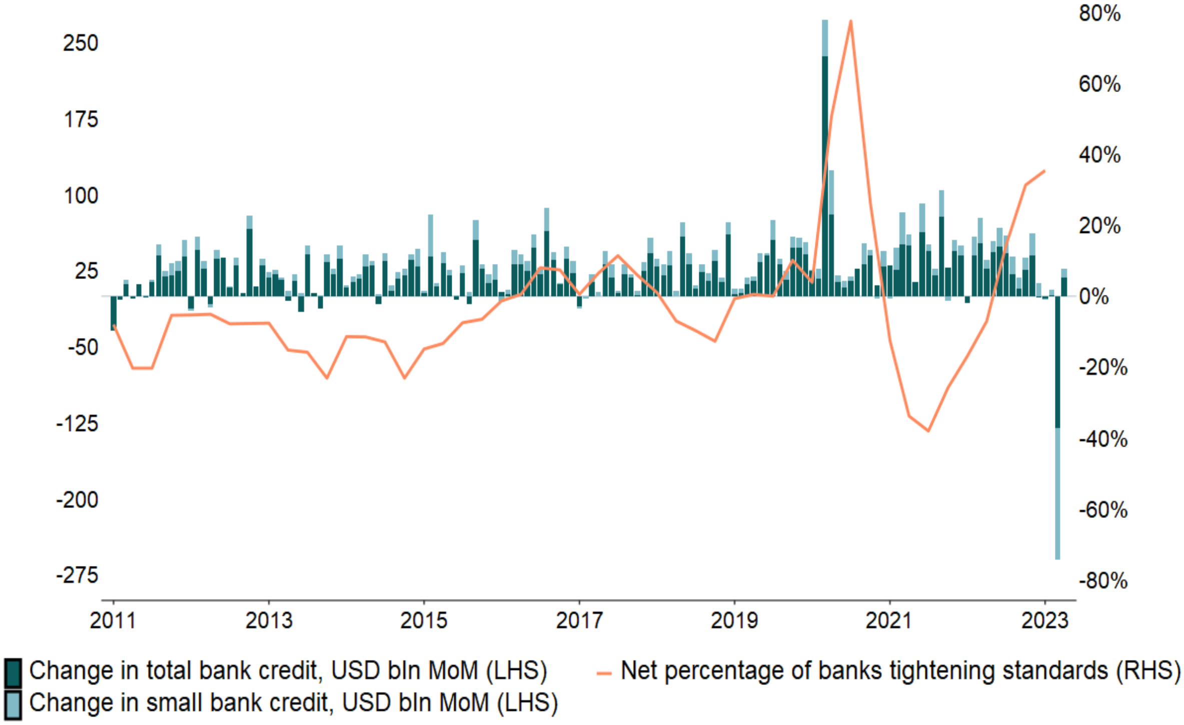
Despite growing mutual suspicion and US encouragement for companies and allies to rethink dependence on China, trade ties between the two economic giants deepened in Q1. China is – along with Canada and Mexico – among the country's top trading partners. With a smoother than expected exit from its stringent zero Covid policy in early 2023, growth in China is set to rebound substantially this year. Markets were further cheered by developments during the March "two sessions", where President Xi, with his third term secured and a new government in place, signaled an increased focus on economic growth and a roll back of the more stringent regulatory measures that crimped private tech companies and crippled the property sector in 2022. For US companies and investors, geopolitical risks need to be weighed against the advantages of doing business with the second largest economy in the world.

CREDIT CRUNCH COMING?

So far, so good for financial stability. Deposits in US regional and other smaller banks stabilized by the end of Q1, after substantial outflows in the wake of the bank failures, which included a smaller third bank, Silvergate, and sustained pressure on a fourth – First Republic Bank. But the ramifications of the bank crisis for the economy are not yet over. Longer-term, it is possible that regional and community banks – which are important sources of credit for local businesses, especially in commercial real estate – will gradually shrink, subject to a slow walk of deposits, if not a run. Consolidation in the US banking sector would open up opportunities. But it may also curb employment and growth as small businesses that rely entirely on these smaller local banks face tighter credit conditions as they search for new lenders.

In the near-term, the shock from the banking crisis, together with sustained higher interest rates, will increase the pressure on potentially vulnerable banks to improve their balance sheets, another curb on lending (Figure 2). Will a resulting credit crunch be sufficient to tip the US into recession? As Chair Powell and colleagues acknowledged in their March meeting, the economic impact of the banking turbulence is uncertain. But it adds to the downside risks. This is particularly clear in the real estate sector. The office sector – hurt by the pandemic and now by extensive remote work – is most vulnerable. Multifamily and warehouse are in a stronger position – and account for a larger share of the sector. But regional banks that have been put on notice by the March crisis

Figure 2. Bank lending contracted sharply at the end of the quarter amid on-going credit tightening



Source: RockCreek, FDIC, Federal Reserve.

will be wary of increasing lending as credit impairments threaten.

New forecasts from the World Bank, the International Monetary Fund (IMF) and others project the global economy to grow overall this year – but at a lower rate than in 2022, which in turn was weaker than in 2021, when a post-pandemic rebound took place across the world – except in China. As China has now left behind its zero Covid policy, it has become the lone bright spot where growth is accelerating, though we don't yet see significant new investments, including by Chinese companies.

For the US, there is still a chance that the longed-for "soft landing" from pandemic recovery can be achieved. Under this scenario, a gradually slowing economy would push inflation down further without triggering a sharp rise in unemployment. The key factor is what happens to inflation.

THE PROBLEM WITH INFLATION ...

As the period of high – and variable – inflation lengthens, the problems it causes abound. Families are faced with higher prices for essentials – food, housing, heating, and transport – and forced to make difficult choices. Those with fixed incomes suffer, especially if they are dependent on savings, which are losing their purchasing power. These are concrete difficulties. There is a more abstract problem that makes inflation so pernicious: we lose the measuring stick which guides economic decisions for workers and businesses, and investors and consumers.

THE LABOR MARKET PUZZLE

As the Fed has tightened monetary policy, it has watched for an impact on the labor market. The central bank has been fearful of a price-wage-price spiral, where rising prices lead to stronger wage demands, a tight jobs market leads employers to raise wages to attract and retain workers, and higher labor costs push up prices further. When the pandemic recovery began, labor shortages were widespread, especially in the service sector, where demand sprang back to life as Covid fears receded. Some of those who called the inflation risk early, such as former Treasury Secretary Lawrence Summers, cautioned that unemployment would have to rise significantly to hold wage increases in check and achieve a significant drop in inflation. The Fed's own projections are for unemployment to climb a percentage point to 4.5% by end-2023 as the economy reacts to its monetary squeeze.

Instead, the jobs market remained strong throughout 2022. Even as companies began to report sizable layoffs, it seemed that claims for unemployment insurance benefits remained low, vacancies were high, and an unusually high number of workers remained on the sidelines. Average earnings, however, were not matching price increases.

This labor market puzzle eased somewhat in Q1. Part of the reason was yet another set of data revisions, a reflection of the difficulties for government statisticians in catching up with pandemic-related shifts in seasonal patterns. Unemployment claims are now estimated to have climbed, as quits have reduced and the number of vacancies – though still high – slipped further during January to March. Labor market participation is also now creeping back up, as would be expected when the jobs market is strong. This is particularly true for prime age workers – those between 25 and 55 – and for women, as Professor Betsey Stevenson notes. But the labor market is still tight, especially for this time of the cycle. The puzzle remains, with a key question: does unemployment need to rise sharply to meet the Fed's inflation goals?

The tight labor market has led to some welcome trends that continued in Q1. Workers at the lower end of the scale have seen relatively larger wage increases, in percentage terms, during this cycle and the gap between white and Black unemployment has narrowed, to 1.8 percentage points in March, the smallest in over 50 years.

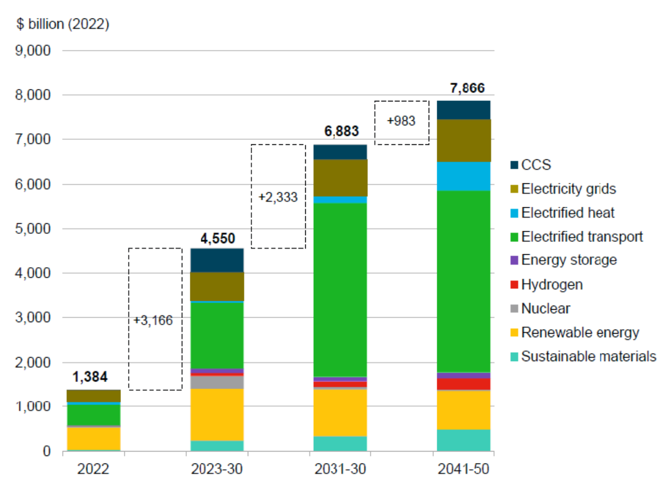
SUSTAINABLE INVESTING

The first quarter saw some encouraging statistics about the current state of investment in the energy transition. According to BloombergNEF, over $1.1 trillion was invested in the global energy transition in 2022—a whopping 31% increase over the prior year. Renewable energy and electrified transport accounted for the majority of this investment. The bulk of this spending emerged from China, which outspent the distant second place US by nearly three times.

An additional $472 billion was spent on key enablers of the energy transition, including investments in the power grid, clean energy factories and supply chains, and in equity financing of energy transition companies. Notably, spending on the energy transition in 2022 caught up to spending on traditional fossil fuels; it is forecasted to surpass fossil fuels spending in 2023 and thereafter.

Tripling spending on the energy transition is a massive undertaking. Investments will come from a growing set of incentives around the world. In the US, as details of the Inflation Reduction Act (IRA) are fleshed out, the expected size of the law is growing: Goldman Sachs' latest estimate is that this package is worth $1.2 trillion, more than three times the original $369 billion Congressional Budget Office estimate when the law was initially announced in 2022. This was complemented by a series of other announcements in Q1: the Department of Housing and Urban Development announced $3.3 billion for companies providing resiliency solutions, the National Park Service released $4.7 billion to states to plug orphan oil and gas wells, and details around $7.5 billion in incentives for EV charging were released. In the Euro area, the Net-Zero Industry Act was passed in March 2023, as a key part of the broader EU Green Deal. This initiative is focused on enabling the energy transition by reducing administrative burdens, simplifying the permitting process,

Figure 3. The investment needed to get on track for net zero must triple this decade



Source: BloombergNEF.

facilitating access to markets, and enhancing the EU's workforce focused on energy transition jobs.

At RockCreek, we see significant opportunity from the spike in demand for energy transition solutions that accompany the increased focus and spending on the energy transition. Companies with smart solutions that enable the energy transition, offer an attractive return-on-investment to customers, and have attractive unit economics will be the biggest winners in the transition. Growth-stage companies are positioned well: they have an opportunity to use their innovation. They also have the solutions that are ready to be deployed now to take advantage of customer preferences and government incentives.

Banking turmoil and volatility during the quarter weighed on markets in the sustainability space. After a strong start in 2023, sustainability-linked funds saw withdrawals in March but despite the turbulence, these funds managed to secure net inflows of $25.5 billion in one of the best performances in over a year. In public markets, the largest US IPO came from the solar world. Nextracker, a hardware and software provider to the solar industry, successfully raised $638 million in an otherwise challenging IPO market.

On the flip side, the climate venture market finally saw a slowdown in line with broader slowdowns in venture deal making. According to Pitchbook, $5.7 billion in transactions across 279 deals were completed during the quarter – a roughly 35% decline year over year, in line with overall trends in the venture space. While many in the industry are still attempting to discern whether this quarter is an anomaly or the sign of a new trajectory, it is worth noting that the downfall of SVB was particularly damaging to the climate tech ecosystem, but the longer-term impacts remain to be seen.

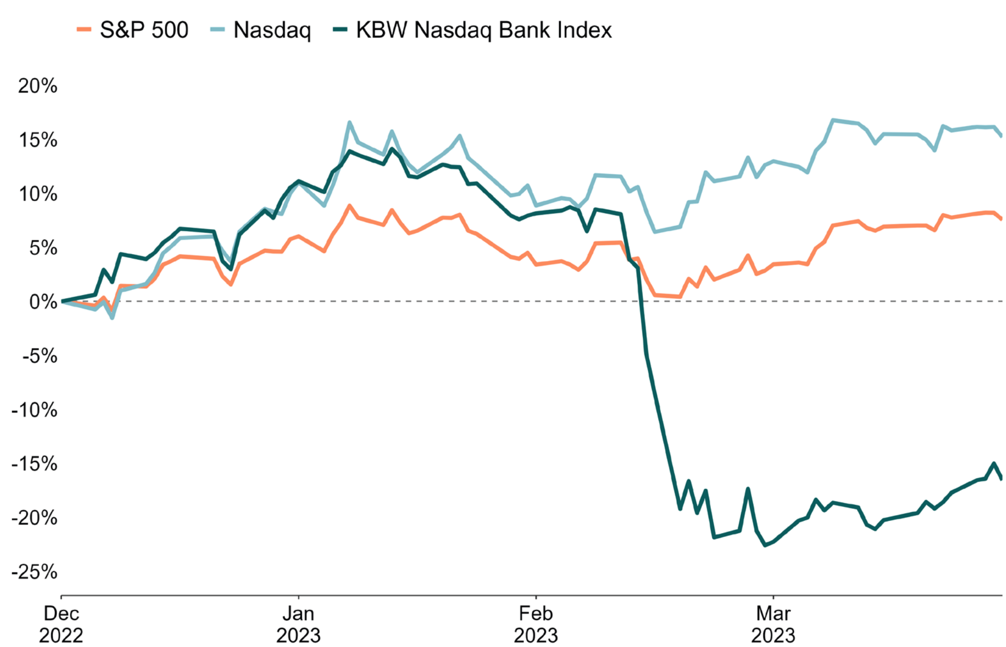
Looking forward, we expect the second quarter to be dominated by a series of announcements providing clarity about how the benefits of the IRA will be rolled out. We also think corporate buyers of commercial energy transition solutions will continue to ramp up spending as they continue to evaluate ways available to reduce their footprint. Therefore, we expect the compelling market opportunity for energy transition solutions to persist for the long-term.

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

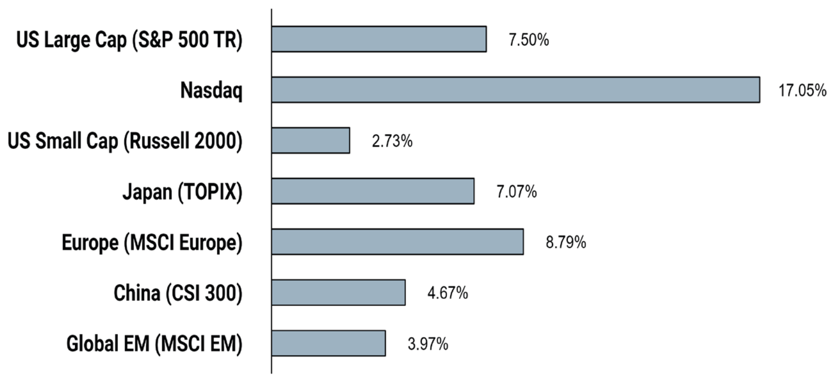
Figure 4. Equities performed well despite surprises in economic data and banking turmoil



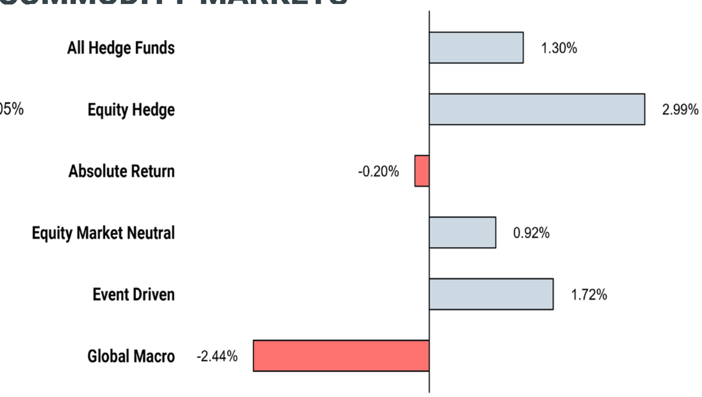
Source: RockCreek, Bloomberg.

Asset Returns Q1 2023

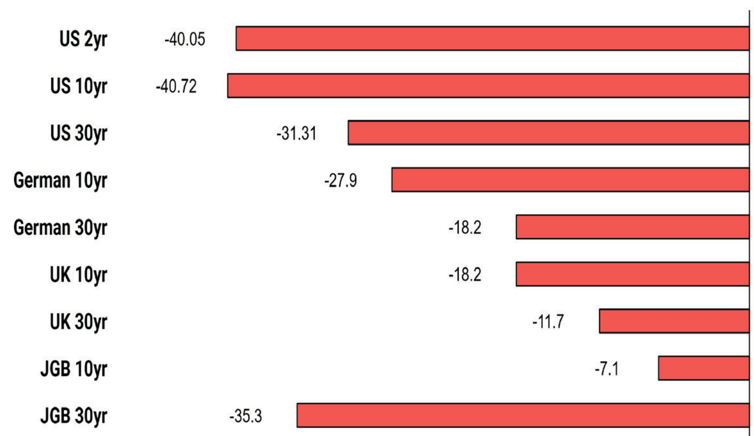
EQUITY MARKETS



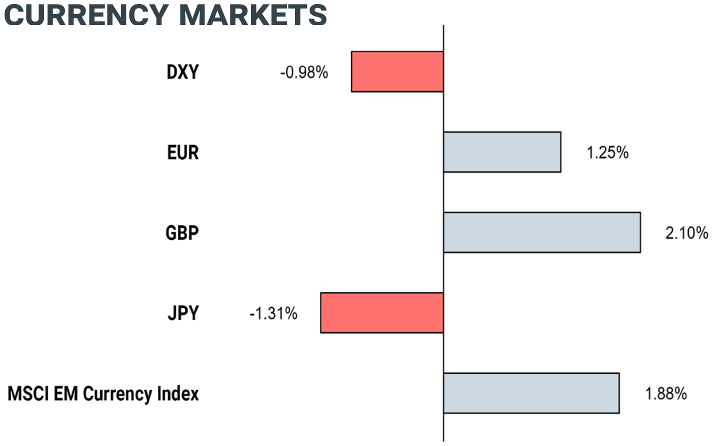
COMMODITY MARKETS



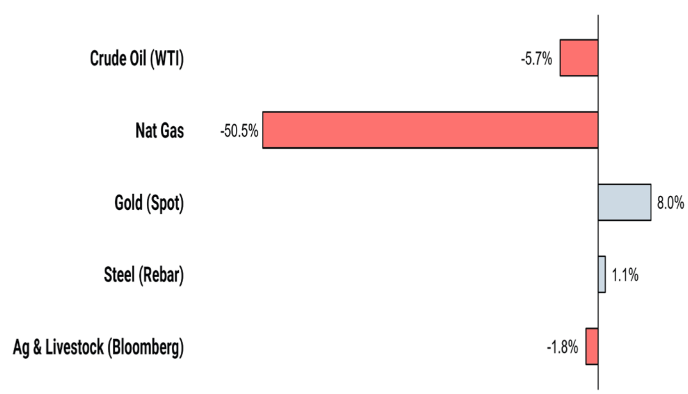
BOND MARKETS



CURRENCY MARKETS



RCG HF INDICES

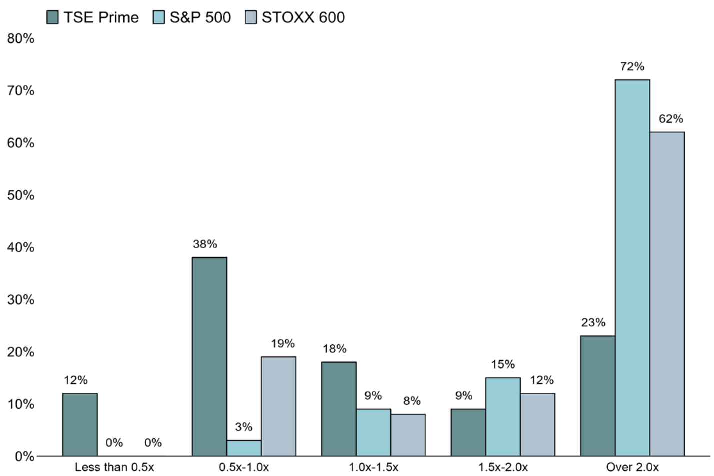


strategies get off to a good start this year. Over the quarter, technology stocks outpaced the market, followed by other growth-led sectors like consumer discretionary and communication services. Share prices for heavy weights like Alphabet and Amazon, which lost close to 40% or more of their value last 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.

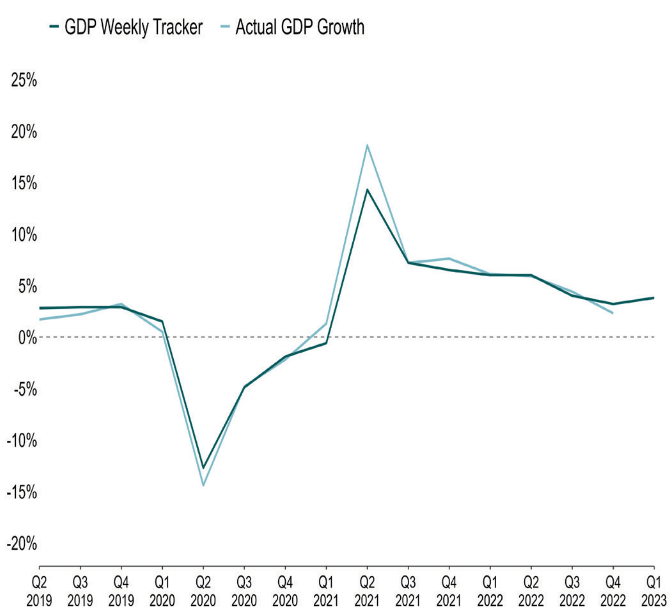
In Europe, investors got an extra jolt in March with Credit Suisse's collapse following years of mismanagement. Shares of the Swiss giant ended 70.3% lower for the quarter on the heels of its forced combination with UBS. Most other major European banks also ended the quarter lower, including Deutsche 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.

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



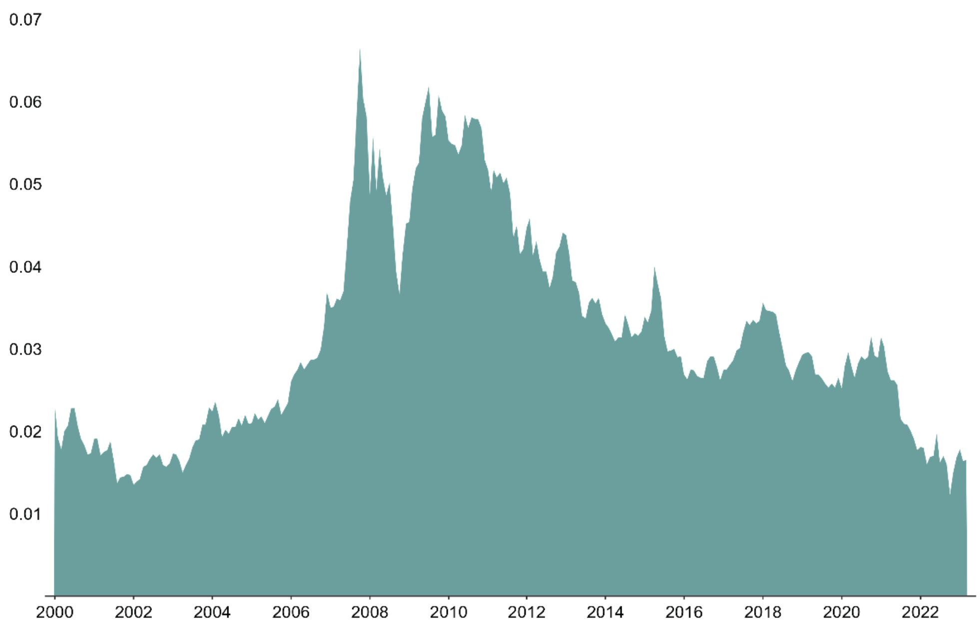
Note: Data show percent change YoY. Quarterly GDP weekly tracker is aggregated by country across the period. Actual GDP values show median growth for EM countries in the sample. Emerging Markets (EM) includes Argentina, Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Poland, South Africa,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

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 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.

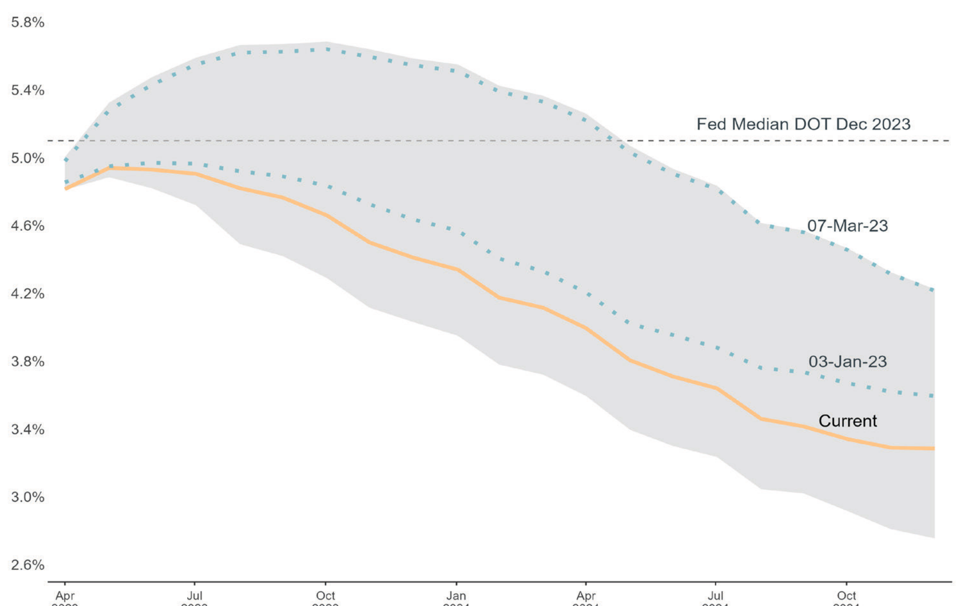
Investors will also have to balance the positive effects of China's re-opening with the expected slowdowns in the US and Europe. With late-cycle dynamics intensifying and financial stability concerns surfacing, we may see weakness in EM currencies versus the Dollar in the coming months. This relative 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).

FIXED INCOME

Bonds posted a second consecutive positive quarter, with the Bloomberg US Aggregate Bond Index up 3.0%. However, the ride was far from smooth, as the index whipsawed between positive and negative territory during the period. The three-consecutive months of moves represent a magnitude not seen since 1982 when the Fed funds rate was in the double digits. That description may not do the volatility justice as the MOVE Index - a measure of implied volatility in the Treasury market - surpassed its Covid-era highs to reach levels last seen during the global financial crisis in 2008.

The bond market's outlook shifted significantly over the quarter. After a strong start to the year on hopes of 'soft landing', a series of economic releases in early February showing a surprisingly resilient economy had the narrative reverting to a 'higher for longer' rates regime. Yields climbed steadily over the next month,

Figure 8. The Fed funds market implied rate path whipsawed as expectations rapidly shifted



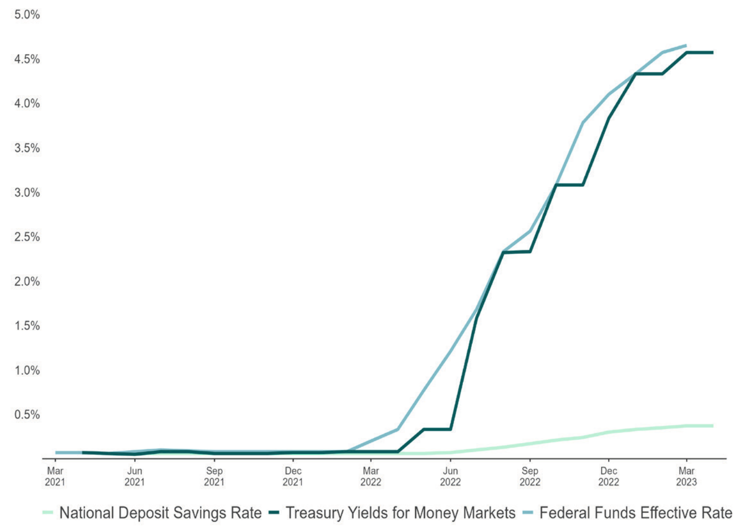
Note: Shaded region represents the upper and lower bounds of Fed funds futures pricing from January 3 to March 31. On March 8, SVB announced a capital raise plan before quickly collapsing by the end of the week.
Source: RockCreek, Federal Reserve, Bloomberg. As of March 31, 2023.

with the 10-year rising 68 basis points to a peak of 4.08% in the early days of March. The real action was in the front end though as the 2-year gained nearly a full percentage point, rising to 5.05%, as the market priced a terminal fed funds of 5.75%, up from 4.5% a month prior (Figure 8).

This was before 'AFS' and 'HTM' became widely known acronyms. As covered earlier in the letter, the failure of SVB put a spotlight on the liquidity challenges banks would have if forced to realize losses in their longer duration securities portfolios to meet deposit withdrawals. In a five-day span in mid-March, the 2-year Treasury yield dropped 112 basis points to 3.93% as the narrative again shifted to an impending credit crunch that would precipitate the Fed 'pivot.'

At the same time, depositors of all types became highly attuned to cash management. Yield and security, which have been overlooked in recent years, came back into the spotlight as investors moved out of low-yielding bank deposits and into money market securities (Figure 9). This only exacerbated the problem for banks, leading to a tap in Fed liquidity sources to a historic extent. It wasn't long ago that there was a cash glut and banks were turning away deposits due to an absence of productive uses. What is yet to be seen is the second order effects of this cash flight. While the immediate liquidity impulse has been accommodative, in the medium- to long-term, the money multiplier will be constrained as savings are not converted to loans. Consistent with the Fed's objectives, this should reflect in "real economy" data (e.g., employment) in time.

Figure 9. Deposit rates have lagged behind Fed funds rate and yields offered to money market funds



Source: RockCreek, FDIC.

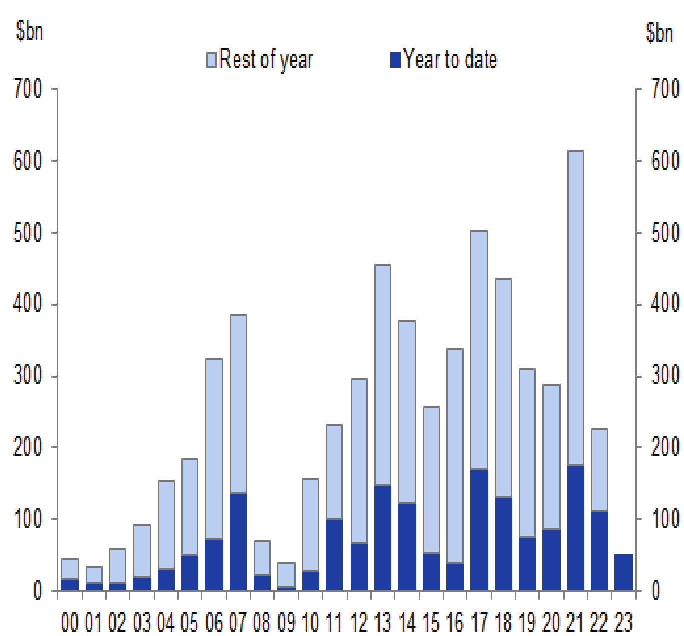
We wrote last quarter about the environments in which the yield curve normalizes. While the inversion only deepened during the first quarter, these cracks in the banking system look like the first stage of 'normalization' whereby the yield curve begins to bull steepen in response to financial conditions that are sufficiently tight to slow economic activity.

PUBLIC CREDIT

The high yield and leveraged loan market performed strongly in the first quarter on the back of positive investor sentiment towards risk assets. Specifically, the high yield and leveraged loan market was up 3.84% and 3.26% for the quarter. As we have discussed in prior letters, high yield has a much larger percentage of higher quality companies than the leveraged loan market as evidenced by the fact that BB issuers make up close to 50% of the market compared to just a little over a third before the 2008 global financial crisis. According to JP Morgan data, the 364 basis point outperformance of BBs versus CCCs for the month was the second largest outperformance gap since March 2020. However, both markets experienced significant volatility as a result of the turmoil in the US and European banking sectors. Spreads widened significantly post-SVB failure only to tighten modestly into month-end after the actions taken by governments and central banks to alleviate fears of broader contagion.

In fact, the primary reason that the high yield market was even able to generate a positive return for the month was the higher quality nature of the market. As we have discussed in prior letters, high yield has a much higher percentage of higher quality companies than the leveraged loan market as evidenced by the fact that BB issuers make up close to 50% of the market compared to close to just little over a third before the 2008 global financial crisis. In fact, the market was up 1.37% for the month as interest rate duration from BB issuers mitigated losses from the widening of spreads. According to JP Morgan data, the 364-bps outperformance of BBs versus CCCs for the month was the second largest outperformance

Figure 10. US leveraged loan issuances has ground to a halt after record issuances in 2021



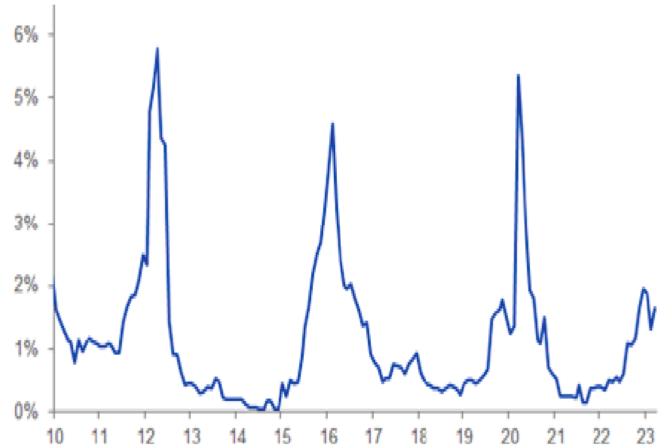
Source: S&P Capital IQ LCD, Goldman Sachs Research.

gap since March 2020. Leveraged loans, on the other hand, were close to flat as spreads widening offset income gains. Figure 10 shows leveraged loan issuance has almost come to a complete halt as CLOs, who are the largest marginal buyer, have seen their new issuance fall and investors remain cautious on the asset class.

MULTI-SECTOR APPROACH TO CREDIT INVESTING CONTINUES TO SHINE

Investors who have allocated to active public credit strategies that have the ability to pivot between leveraged loans and high yields have continued to benefit. These strategies were generally overweight leveraged loans in 2022 to limit duration as the Fed began increasing interest rates. Investors are now shifting their exposure from leveraged loans to high yield as the Fed nears the end of its rate hiking cycle and higher interest expenses as a result of the rise in short-term interest rates have put pressure on the fundamentals of leveraged loan borrowers. A large fraction of the leveraged loan borrower universe consists of private equity sponsored companies that were liberal in their utilization of the 'cheap debt' rationalizing that higher leverage was warranted, given that debt service costs were manageable when base rates were close to zero. Moreover, over 85% of leveraged loans are covenant lite which provides less protection for creditors and could exacerbate losses if there were to default. Figure 11 depicts the percentage of leveraged loans trading below $0.60 which has been creeping higher over the past several quarters as investors have become more discerning.

Figure 11. The percent of leverage loans trading below $0.60 has climbed but remains well below past peaks



Source: S&P Capital IQ LCD, Goldman Sachs Research.

A LOOMING DISTRESSED OPPORTUNITY?

The rapid rise in interest rates in the last year and the related drop in new issuance of high yield bonds and leveraged loans have dramatically expanded the opportunity set for distressed credit. At this same time in 2022, there were few names trading at distressed levels and today there are well over 100 issuers. Unlike past cycles which were restricted to secularly declining businesses or specific sectors such as energy that had more binary-like characteristics, current opportunities are incredibly diverse, as almost every type of company has been impacted by the combination of higher interest rates and reduced financing options.

The opportunity set has increased significantly with the number of issuers with debt trading at a yield above 15% that have substantial assets and whose creditors have much better prospects in a restructuring.

The last meaningful expansion of distressed liquid credit opportunities occurred during the early days of the pandemic, but it was short-lived, largely because of government intervention. We believe the opportunity building now will persist for much longer, because (a) the disruptions of the last three years have likely wrought economic damage that we're only beginning to see and (b) governments and central banks can no longer use unlimited stimulus to bail out economies, given the need to control inflation.

The business models, balance sheets, and valuation assessments of many companies were predicated on ultra-low interest rates continuing in perpetuity. We believe the failure of Silicon Valley Bank is likely to be a harbinger of opportunities to come in the credit markets.

Emerging Market Debt: Proceed with Caution

In 2022, based on widely used JP Morgan indices, the emerging market corporate high yield bond index and the emerging market hard currency sovereign bond index recorded losses of 10% and 16%, respectively – among the worst annual total returns for these indices since 1999. The causes were both internal – most notably the war in Ukraine – and external, primarily rising interest rates and elevated inflation in developed markets. While a few concerns have been resolved, such as those related to China's zero-Covid policy, the majority continue to remain.

However, the spreads of EM assets currently aren't reflective of bear market conditions. The current rally in EM sovereign bonds has seen valuations catch up with fundamentals and from here we see the rally facing headwinds from potentially higher US Treasury yields. Within corporates, credit fundamentals remain strong, but corporate buffers may be tested by the coming slowdown, with all sectors impacted by tighter liquidity. Aggregate leverage remains low, though we expect the number of issuers with extended balance sheets to increase going forward.

We believe that in order for these valuations to hold or even expand, a lot needs to go right. First, the economic recovery in China and greater Asia needs to continue unabated. Next, the war in Ukraine needs to be contained or, better yet, ended. And rising political risk in Latin America needs to be controlled. Moreover, EM assets could be subject to another bout of intense volatility if fears resurface about a potential global recession in the second half of the year or 2024. While we continue to monitor for pockets of opportunities, we remain cautious at best.

PRIVATE CREDIT

The issues associated with fractional-reserve banking – the system used by most countries globally to facilitate the extension of credit, creation of monies, and economic growth – have tested regulators for decades. Despite multiple and increasingly stringent iterations of Basel regulation governing liquidity and leverage, and supervisory oversight in the forms of inspection and stress tests, the modern banking system remains susceptible to "moral hazard" – i.e., no modern bank is equipped to absorb fleeting confidence by its depositors. Reinstalling confidence in the global banking system is a priority that far exceeds bank profit margins. And, while the long-term repercussions of recent events remain to be determined, it is likely that regulatory requirements will continue to increase, lending standards will continue to tighten, and access to bank credit will decline.

The combination of market uncertainty and further bank retrenchment is creating an outsized opportunity for alternative lenders to provide liquidity to take market share, drive pricing, and dictate terms. Although most private debt strategies are poised to benefit from higher risk-adjusted returns on a look-forward basis, several strategies look particularly interesting. One such area that is a direct beneficiary of bank regulation is synonymously known as Bank Risk Sharing, Regulatory Capital Relief, or Significant Risk Transfer. These strategies focus on bespoke transactions with banks that synthetically transfer the risk associated with certain assets held on the bank balance sheet to a third party in order to reduce the regulatory risk weighting of the asset and the capital held against it. As banks seek to optimize their balance sheets to preserve gross margins and equity value, these types of transactions provide a supportive solution.

One area of the banks' balance sheet that has become increasingly scrutinized as of late is their commercial real estate (CRE) portfolios. This is particularly true for commercial and regional banks given their ability to assume concentrated asset portfolios and avoid certain regulations governing the systemically important institutions. In addition to the uncertainty in the outlook of entire property types in the post-covid era (e.g., office, hospitality, retail), higher cap rates and lower valuations have caused banks to sell off assets that may often still be performing and to reduce their CRE lending activities. This has created the opportunity to acquire loans backing fundamentally healthy assets at a discount given that the banks have become non-economic, forced sellers. At the same time, higher interest rates have made existing debt more difficult to service. As there are few options to support a refinance, borrowers are being faced with the predicament of having to pay down an existing loan to accommodate an extension or hand the keys to the lender. The current supply-demand imbalance is creating significant opportunities to originate new CRE-backed loans and generate a better risk-adjusted return than has been achievable in the past.

PRIVATE EQUITY & VENTURE CAPITAL

Many investors continued to increase allocation to private investments in Q1. While knock-off effects of SVB's collapse are yet to be seen, the role and fate of the venture capital (VC) and private equity industry are closely intertwined. SVB serviced nearly 50% of the tech and life sciences startups in the United States, and the VC industry will feel a long-term impact as the cost of funding increases and capital becomes scarcer. Venture-backed fintech companies like Brex and Mercury have stepped in to fill some of the gaps left in the wake of SVB, but as highlighted by Brex CEO Henrique Dubugras, while the operational infrastructure – wires, automated clearing house, and payments – may go to fintechs, deposits will likely be concentrated with the large US systemically important banks.

Away from the SVB collapse, private markets were relatively quiet. Venture activity remains tepid amid a slowing fundraising environment. Following a record-breaking $154 billion of fundraising in 2022, preliminary data from Crunchbase shows that total venture funding fell 53% YoY to $76 billion in the first quarter of 2023. Unlike previous quarters where the funding slowdown was most acute at the later stage, every funding stage was down 44%-54% YoY. Further, the IPO window remains closed around the world, with funds raised from first quarter listings dropping over 60% YoY.

Despite the slowdown, there is cause for optimism as venture firms still hold record amounts of dry powder, which will likely be deployed at lower valuations across all stages. Although the primary market has slowed, the market for secondaries has picked up. Many funds marked down their valuations by 20-30% in 2022 and investors are becoming more comfortable with current marks. Recent buyouts, which often traded at a premium to net-asset-value over the last several years, are now trading at 5-10% discounts, and discounts for many VC funds are in the 50-70% range. Investors are becoming more strategic in how they manage their PE portfolios and have begun selling strips of their recent commitments in order to reinvest in newer vintages with higher expected returns.

Another emerging trend is the ongoing reshoring of US manufacturing, which has two key tailwinds. First, the semiconductor industry received a boost with the Chips Act driving an increase in government funding to solidify the US's supply chain. With labor shortages and increasing focus on productivity and safety, there has been significant investment in automation. This, coupled with the drive to the Internet of Things and the electrification of almost everything we do, means there is a considerable need for chips. Second, there is a trend more broadly in manufacturing on how the US can reinvest in its own supply chains across a variety of sectors from downstream oil & gas to cold chain to food & beverage.

Within the venture industry, many note periods of slowdown can be the best opportunity set for company creation. Historical data shows that tech downturns lead to some of the best VC vintages as funds enter at lower valuations, companies are forced to grow more capital-efficiently, and talent is more readily available. While late-stage valuations surged in 2021 and fell just as quickly in 2022, seed stage valuations and activity have been the least-impacted through the 2022 reset. Entering the second quarter, we expect early-stage venture will continue to attract investment dollars as LPs bet that 2023 and 2024 vintages will be some of the best performing in recent memory.

REAL ESTATE

The rising interest rate environment has narrowed the spread between real estate capitalization rates and investment grade bonds. Historically, the 10-year average spread has been 2% to 3.5%, depending on the property type, but the current range sits between -0.5% to 2%. Capitalization rates generally lag public markets, and continued rate increases suggest that cap rates will widen, putting further pressure on property valuations. As such, our focus in this environment has been to invest in strategies where growth in net operating income will continue to drive returns and offset any cap rate expansion.

In the property sector, office space continues to feel the most pain as financing costs increase. On several occasions in the first quarter, real estate owners had to give back the keys to the lender. The first to occur was in February, when Brookfield defaulted on two office properties worth a combined $784 million in downtown Los Angeles. After Brookfield, there was a domino effect of other respected and well-capitalized institutions like Blackstone, Columbia Property Trust, and RXR. Within the office sector, landlords have been generating less income to service debt as the work from home trend has led to declining vacancy and lower rents. This in turn has impacted loan-to-value ratios and the ability to refinance. Further, declining vacancies and higher rates have led to extraordinarily high carry costs for owners and have increased the risk of default.

As discussed in our private credit section of this letter, the distress in some property sectors and lack of traditional bank lending has led to opportunities for private lenders to generate equity-like returns against higher quality assets at lower attachment points. Office to residential conversions is another area where we are beginning to see opportunity. Until recently, the purchase price and renovation cost has been too high for the economics to make sense, but as value continues to decline, this area becomes more interesting. Since 2010, over 200 office buildings have been converted to residential, with Chicago, Philadelphia, and Los Angeles being among the most active markets for redevelopment. These conversions are not without physical challenges, but they have the potential to provide affordable housing in dense urban areas in need of solutions. In addition to affordable housing, we continue to remain focused on our high conviction investment themes across real assets, including communications, energy transition, and logistics to improve supply chains.

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