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Market Outlook:

Top Ten Investment Themes for 2023

January 2023

Please see page 34 for important disclosures.

January 2023

Top Ten Investment Themes for 2023

1. **Regime Change:** 2022 marked an important regime change for financial markets and investors. Gone are the days of ZIRP (zero interest rate policy), TINA (there is no alternative to investing in stocks), and the Fed Put (the idea that the Fed would come to the market's rescue during periods of market weakness).

2. **Inflation Outlook:** Although inflation has begun to decelerate over the past few months, price instability will continue to be a central theme in 2023, and stubbornly high inflation will force the Fed to keep interest rates at relatively high levels for the fore-seeable future.

3. **Monetary Policy:** Monetary policy will continue to be a headwind for risk assets, as the battle against inflation is still in its infancy.

4. **The US Economy:** The US economy was resilient in 2022, but key indicators point to a likely recession in the first half of 2023.

5. **Outlook for Equities:** Despite the S&P 500 having declined almost -20% in 2022 and the rarity of having back-to-back down years, we remain cautious on US equities.

6. **Outlook for Credit:** Rising interest rates have led bonds yields to approach attractive levels; however, deteriorating credit fundamentals in certain areas of the fixed income market warrant a measured approach towards investing in the asset class.

7. **Europe:** The outbreak of the Russia-Ukraine conflict led to a European energy crisis resulting in an economic slowdown in the region. Nonetheless, the resiliency of European risk assets during 2022, along with relatively attractive equity valuations and potential upside catalysts, are making us more constructive on Europe.

8. **China and Emerging Markets:** The rapid dissolution of China's stringent Covid restrictions catalyzed a strong rally in Chinese equities at the end of 2022, but many risk factors persist that we believe will challenge Chinese risk assets indefinitely.

9. **Real Estate:** As the Fed aggressively tightens financial conditions to curb inflation, we believe 2023 will be a challenging year for real estate assets, resulting in price declines, given high interest rates and the significant probability of a recession.

10. **Crypto:** The decline of crypto will continue in 2023, and most current cryptocurrencies and tokens, with few exceptions, will continue on a path towards ultimately being worthless.

TOP 10 INVESTMENT THEMES FOR 2023

1.Regime Change

As we spoke about on our third-quarter webcast, we believe 2022 marks an important regime change for financial markets and investors. Gone are the days of ZIRP (zero interest rate policy), TINA (there is no alternative to investing in stocks), and the Fed Put (the idea that the Fed would come to the market's rescue during periods of market weakness). Investors must now calibrate to a new market environment of normalized interest rates, where contractual payments in fixed income securities offer relatively attractive yields. Meanwhile, the Federal Reserve (Fed) is more intent on tightening monetary conditions to restore price stability than on supporting risk assets.

The thirteen years prior to 2022 were characterized by ultra-loose monetary policy that translated into extraordinary returns for US equity investors. The S&P 500 Index generated a compound return of 16.1% per year from March 2009 until the end of 2021.[1] During that time, the Fed Funds rate was pegged near zero for most of the period, the Fed expanded its balance sheet holdings from under $1 trillion to $9 trillion, economic inflation was subdued, and equity multiples consistently expanded. Unfortunately, the decade of cheap money gave rise to an explosion in global negative-yielding debt and culminated in the simultaneous emergence of several asset price bubbles, including crypto, special purpose acquisition companies (SPACs), meme stocks, and high-growth, unprofitable companies. That all came to an abrupt halt in 2022, with unpleasant consequences for risk assets and investors. Negative-yielding debt peaked two years ago at $18.4 trillion and now stands at zero. In 2022, the aforementioned bubbles popped, the traditional 60/40 portfolio had one of its worst years on record, and previous market leaders, such as large-cap tech, growth software, and semiconductor stocks, suffered outsized losses.

Exhibit 1: Global Aggregate Negative-Yielding Debt (Market Value, Trillions)

Source: Wall Street Journal, Bloomberg, as of 12/31/2022

1. Bloomberg, excluding dividend reinvestment.

The era of cheap money and growth-at-any-price investing has ended. The combination of accommodative monetary policy and the over-sized fiscal response to the pandemic unleashed economic inflation that the US has not experienced in forty years. In response, the Fed has had to embark on its most aggressive rate-hiking cycle in four decades, kicking off a new era of monetary policy and market conditions. While some of the inflationary pressures are indeed transitory, we believe that above-target inflation will persist longer than the consensus anticipates.

Inflation is generally sticky; the primary driver will be the tight labor market and elevated wage growth. There is no easy fix for our current shortage of workers, other than time and good government policy. Additionally, the ongoing energy transition, which was accelerated by the events in Ukraine, is resource-intensive, costly, and inflationary. The Ukraine invasion also catalyzed increased military spending around the world, creating further inflationary pressures. Finally, the pandemic and geopolitics have highlighted some of the shortcomings of globalization, resulting in an inflationary pivot towards de-globalization and onshoring.

Overall, we believe the battle against inflation will be long and frustrating. While some investors seem to think that interest rates will soon return to the lows of the last decade, we believe the Fed will have to remain in tightening mode by keeping real interest rates in positive territory for most of the next five years.[2]

The table below compares the prior period of cheap money to today's environment.[3]

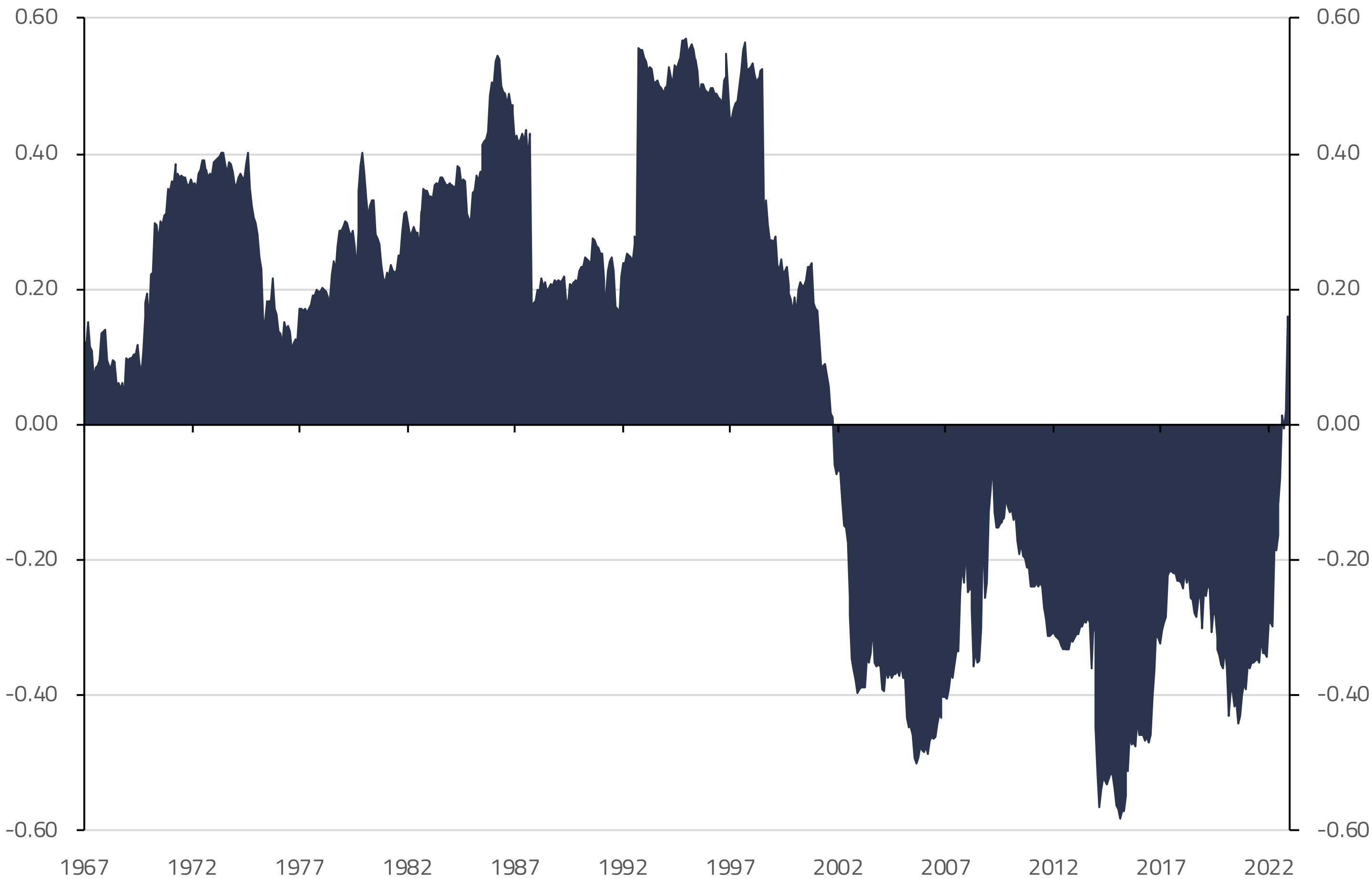
Exhibit 2: Regime Change

	2009 to 2021	Today
Fed behavior	Highly stimulative	Tightening
Inflation	Dormant	40-year high
Economic outlook	Positive	Recession likely
Likelihood of distress	Minimal	Rising
Mood	Optimistic	Guarded
Buyers	Eager	Hesitant
Holders	Complacent	Uncertain
Key worry	FOMO	Investment losses
Risk aversion	Absent	Rising
Credit window	Wide open	Constricted
Financing	Plentiful	Scarce
Interest rates	Lowest ever	More normal
Yield spreads	Modest	Normal

So what does this mean for investors and portfolio managers? Thankfully, we already got a glimpse of the playbook in 2022. First, we expect the stock/bond correlation to remain positive, much like last year and before the year 2000. When uncertainty around inflation is high, bond duration does not act as an effective hedge against equity volatility and losses. Higher interest rates and a less accommodative Fed result in shorter business cycles. On average, the economy may experience recessions every five years rather than the recent experience of every seven to ten years. The good news is that frequent recessions generally translate to shallower recessions, as imbalances and risk-taking are more subdued. Finally, higher interest rates and shorter business cycles can be a headwind for equity multiples. Multiple contraction has been the biggest driver of equity declines in 2022, but we suspect this could be an ongoing issue for equity prices over the coming years. For that reason, dividends will become a more important source of returns for stocks, and value stocks will likely outperform growth stocks.

2. In this context, positive real interest rates means the amount by which the fed funds rate exceeds inflation.
3. Marks Howard. "Sea Change." *Memo to Oaktree Clients,* 13 Dec. 2022, p. 7.

Exhibit 3: 5-Year Rolling Stock & Bond Correlation



Source: Strategas, as of 12/31/2022

Overall, we expect an extended period of below-average returns for US equities. However, it is expected to be a much better environment for active management and portfolio diversification. Regime changes usually come with a shift in market leadership. The dominance of big tech and the S&P 500 has defined the last decade. It was a difficult period for most active managers, and as a result, the industry has seen a massive shift towards passive investment vehicles. We believe that this vast shift has distorted valuations, so active managers now have a better chance of exploiting the limitations of passive management. Investors are likely to have an increased focus on fundamentals, particularly cash flow generation, expense discipline, and balance sheet quality. We also think the coming years will see outperformance by small and mid-cap stocks and select international markets. Finally, with inflation uncertainty high, we continue to believe that energy and commodities are prime leadership candidates for the next bull market.

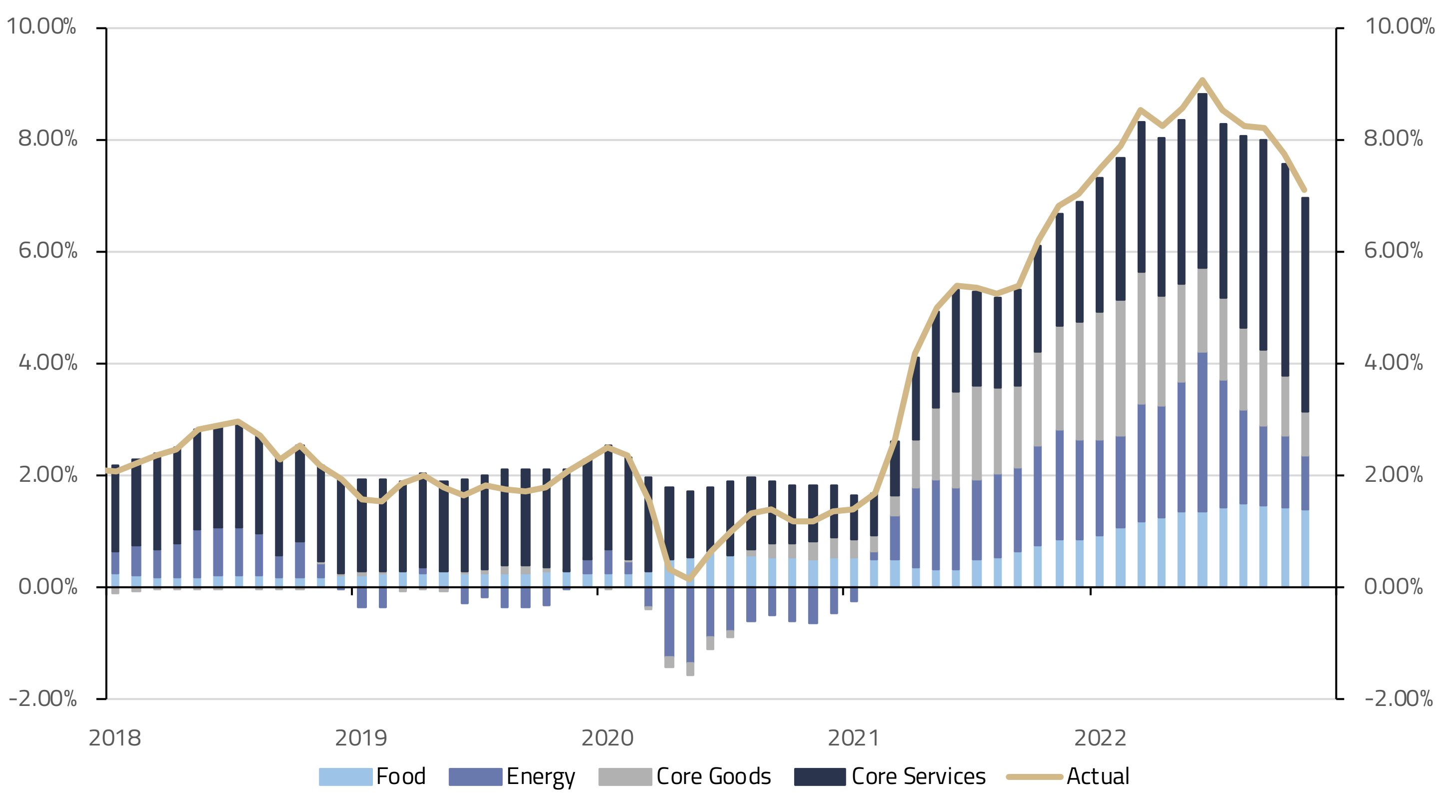
TOP 10 INVESTMENT THEMES FOR 2023

2. Inflation Outlook

The main drivers of market declines in 2022 were the sudden surge of inflation in the US economy following the rise in spending post-reopening, and the Fed's subsequent, aggressive rate-hiking campaign to combat this price instability. Although inflation has begun to decelerate over the past few months, price instability will continue to be a central theme in 2023, and stubbornly high inflation will force the Fed to keep interest rates at relatively high levels for the foreseeable future. As a result, restrictive interest rate policy will continue to be a significant headwind for risk assets, especially those whose cash flows are expected to be far out into the future.

Headline CPI rose 0.1% month over month in November, with a year-over-year increase of 7.1%. November core CPI rose 0.2%, the smallest increase since last August, with the year-on-year rate falling another three-tenths to 6.0%. Core goods prices fell -0.5%, led by a decline in used cars prices, which have fallen -2.9% over the past year.[4] Services inflation was mixed, with weakness in hospital and health insurance offset by healthy gains in personal care, car repair, and car insurance. Surprisingly, shelter inflation rebounded with Owner's Equivalent Rent (OER) and tenants' rents outpacing their October measurements. Overall, our view is that inflation peaked in June when headline CPI reached 9.1% on a year-over-year basis, and we anticipate that inflation will continue to trend downwards as we move further into 2023.

Exhibit 4: U.S. Consumer Price Index (Year-Over-Year Change)



Source: Strategas, U.S. Bureau of Labor Statistics, as of 11/30/2022

4. Hatsius, Jan. "USA: Core Inflation Slows Further Despite Shelter Rebound." Goldman Sachs Research, 13 Dec. 2022.

Core goods inflation soared during the pandemic due to a surge in demand for goods that was impeded by global supply chain disruptions. Global supply chain disruption can easily be observed by the rapid increase in freight cost, which rolled over in the last nine months. While still well ahead of pre-pandemic levels, freight costs are trending in the right direction, and the reduction of such expenses should continue to provide reprieve towards the prices of many core goods. On the contrary, while the decrease in freight costs provides evidence of supply-chain normalization, recent increases in geopolitical tensions make us skeptical that we will be able to return to pre-pandemic supply chain efficiency any time soon. Escalating tensions between the US and China have led to a reorganizing of the supply chains of many US companies, as they work towards bringing production onshore or relocating to ally countries. We believe the global supply chain's reorganization will be a source of long-term goods price inflation, as countries prioritize security of supply and redundancy over cost efficiencies when developing their supply chains. Thus, although we find the downward trend in core goods prices as a welcome reprieve, core goods inflation is likely to remain elevated compared to historical levels.

Exhibit 5: Cost of Freight (Dollar Cost per 40 Foot Container)

Source: Bloomberg, as of 12/31/2022

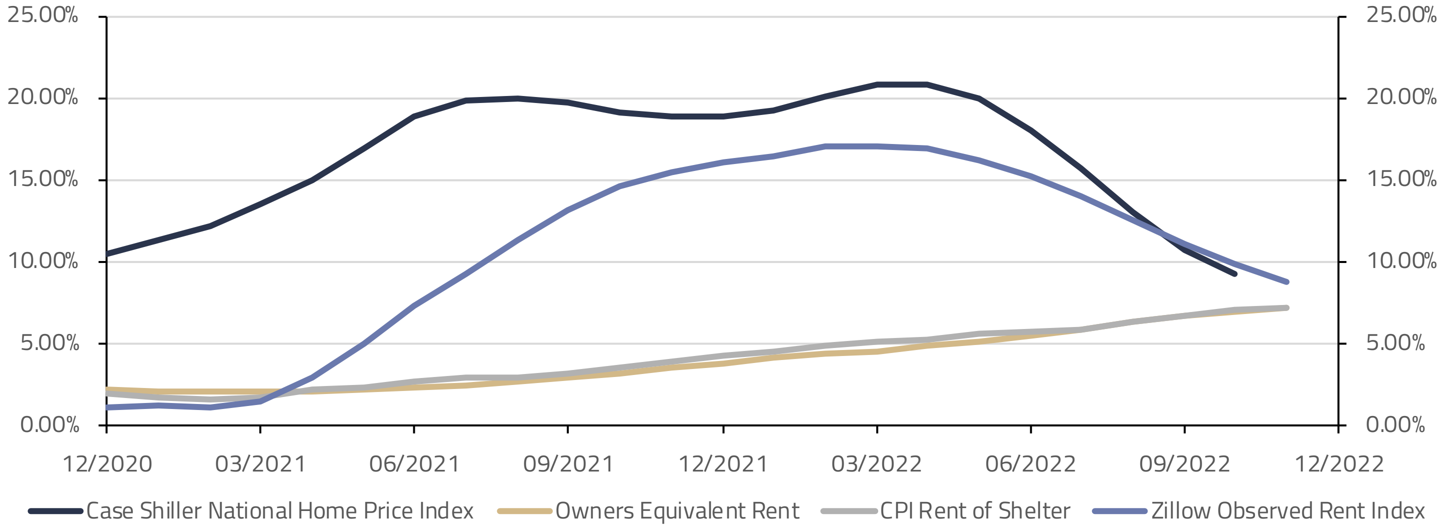
*China to U.S, represents the cost from Shanghai to Los Angeles, China to Europe represents the cost from Shanghai to Genoa,

Shelter inflation has been an area of constant upward pressure in the CPI report for the past year; historically low mortgage rates led to rapid increases in home prices, which in turn led to increases in rents and overall shelter inflation. Shelter inflation accounts for over 30% of the total weight of the CPI basket. Shelter inflation measurements move slowly and tend to lag the real-time data of the housing market by approximately 12 months. In 2021, 30-year fixed mortgage rates fell below 3%, increasing home affordability and contributing to a surge in demand for property. As a result, home prices appreciated at an unprecedented pace over the last two years. However, over the past year, mortgage rates increased rapidly, with the 30-year fixed rate exceeding 7% at some points in 2022, and finishing the year at around 6.5%.[5] Subsequently, home prices began declining in the latter half of the year, as home price affordability began to diminish. US housing data has been fragile in recent quarters, with measurements such as mortgage applications, single-unit permits, and refinance activity sharply declining throughout the year.

5. Bloomberg.

Despite this weakness, shelter inflation has remained robust, which we attribute to the slow-moving nature of this data. Shelter categories of the CPI report have historically lagged home prices due to the length of time it takes for leases to renew. Typically, residential landlords renew leases every 12 months, meaning that current price dynamics will not be reflected in new contracts for up to a year. While reported shelter inflation tends to be sticky, alternative measures, such as the Zillow Observed Rent Index, provide more timely information on shelter prices and are helpful for forecasting the trend of the CPI shelter components. As shown in Exhibit 6, the Zillow Observed Rent Index implies a rapid decline in rental price growth that we believe will be reflected in the CPI report over the coming year. Given the outsized nature of shelter on the overall CPI report, we anticipate that while shelter costs should trend lower over the year, the slow-moving nature of this measure will lengthen the time it will take the overall inflation data to reach the Fed's target.

Exhibit 6: US Housing Inflation Metrics (Year-Over-Year Change)

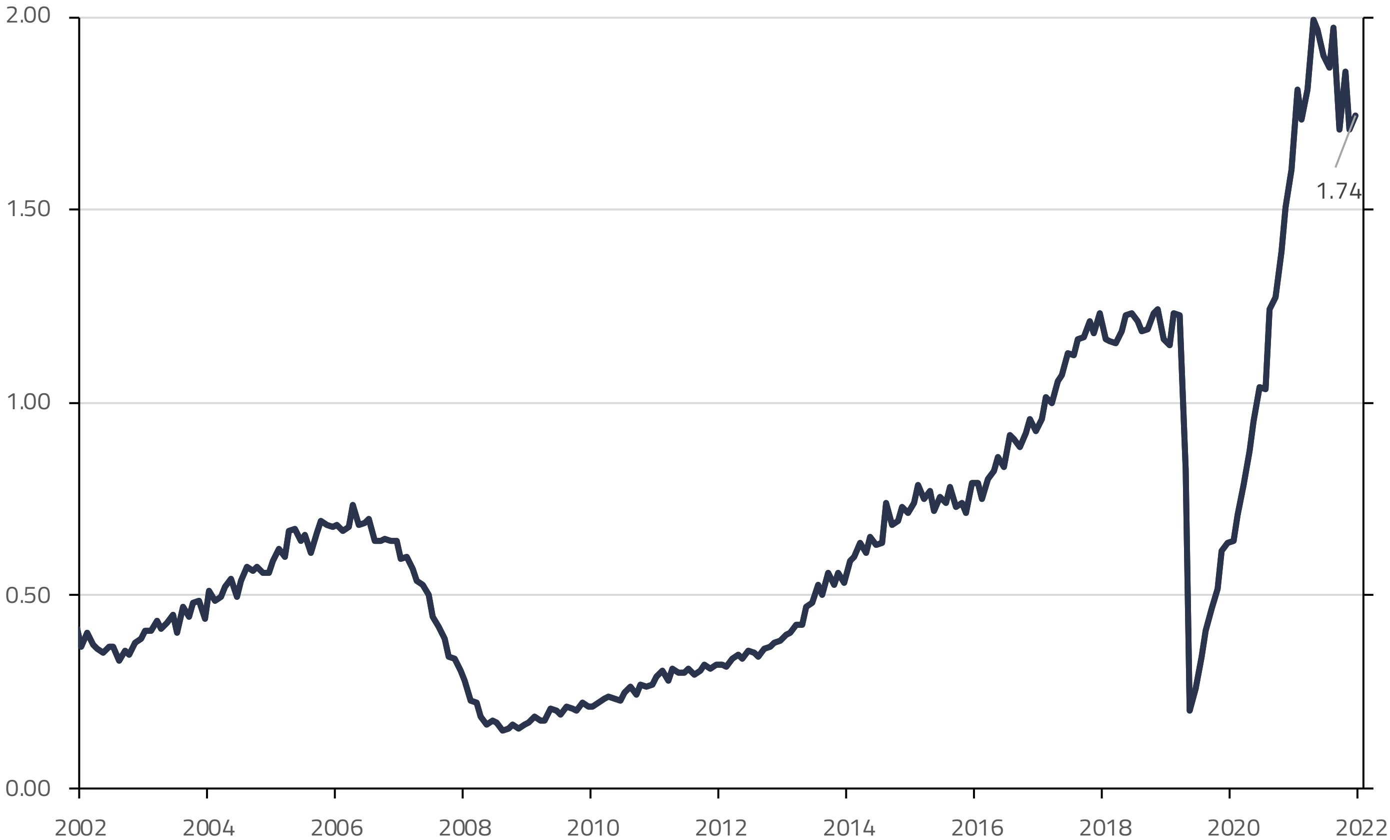


Source: Bloomberg, as of 11/30/2022

Turning to wages, average hourly earnings have risen rapidly over the past few quarters. Propelled by a historically tight labor market, we believe wage inflation will remain elevated throughout the year. As of December 2022, the US unemployment rate sat at 3.5%, below the Fed's long-term target, implying an economy in full employment.[6] US initial jobless claims remain low, and the Conference Board showed an increase in their "jobs plentiful" measurement. Notably, the amount of vacant job openings has been staggering during this cycle, with the job-openings-to-unemployed ratio at one point exceeding 2.00 before reverting down to 1.74, where it stands today. Since the reopening, business owners have had a challenging time hiring workers, forcing them to increase pay and provide attractive benefits to fill their hiring needs. A survey conducted as of October 2022 by Vistage found that 32% of small business owners find it more challenging to fill job openings than at the start of the year, showcasing the enduring struggles of hiring in this economy.[7] Since the beginning of the pandemic, the US economy has grown by nearly one trillion dollars in GDP, but the US labor force has shrunk. A significant factor in the decline in labor force participation has been an increase in retirements due to the pandemic – many of these retirees are unlikely to return to the workforce. This has drawn concern from the Fed, as seen in Fed Chair Powell's December 14th press conference, when he said, "despite very high wages and an incredibly tight labor market, we don't see participation moving up, which is contrary to what we thought."[8] With productivity declining, participation low, and job openings vastly exceeding the number of unemployed persons, it is safe to claim that the labor market is overheated. Thus, we expect wage inflation to remain elevated until slack begins to form in the labor market; in turn, we anticipate this will keep overall inflation elevated throughout the year.

6. U.S. Bureau of Labor Statistics.
7. "Wall Street Journal / Vistage Small Business Monthly CEO Survey Results." Vistage Research Center, 8 Mar. 2022, https://www.vistage.com/research-center/wallstreetjournal-confidence-index/results.
8. Transcript of Chair Powell's Press Conference - Federal Reserve. Federal Reserve, 14 Dec. 2022.

Exhibit 7: Job Openings to Unemployed Persons Ratio



Source: Strategas, Bloomberg, U.S. Bureau of Labor Statistics, as of: 11/30/2022

In summary, inflation has decelerated meaningfully in the latter half of 2022, and we believe this disinflation will continue throughout 2023, especially as the effects of interest rate hikes work their way through the economy. However, we believe the slow-moving nature of the shelter inflation data, combined with elevated service inflation readings spurred by a historically tight labor market, will lead to stubbornly high inflation over the year. As a result, our forecast is that inflation will fall precipitously into the range of 3.5% to 4%. At that point, we believe further inflation retracement will be difficult, and the Fed will have to maintain its hawkish stance to win the fight against inflation. We will keep a keen eye on inflation expectations, which ended the year at 3%. With an overheated labor market and inflation well above its 2% target, we anticipate that the Fed will maintain its hawkish stance until it can confidently claim victory in the inflation battle.

TOP 10 INVESTMENT THEMES FOR 2023

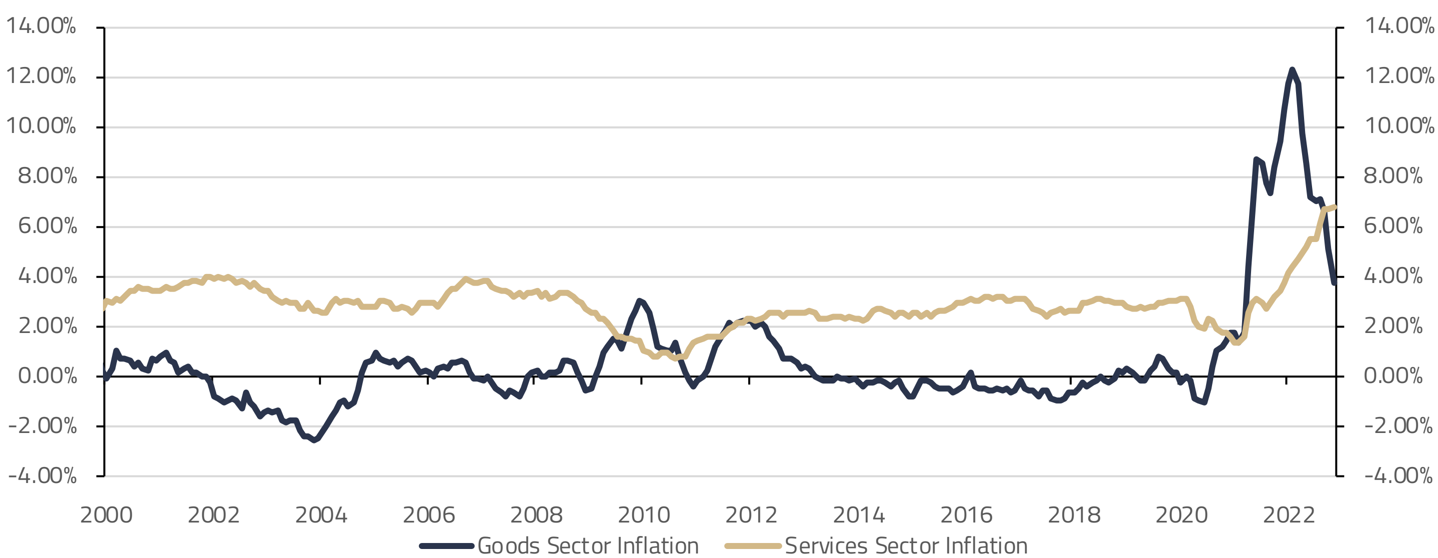
3. Monetary Policy

Monetary policy will continue to be a headwind for risk assets, as the battle against inflation is still in its infancy. The Federal Reserve embarked on a historic interest rate hiking campaign in 2022 to help combat the highest inflation the US economy has experienced since the early 1980s. In total, the Fed raised the Fed Funds rate 425 basis points to a range of 4.25% - 4.50%, and its most recent projections, released after December's committee meeting, reflect an intention to further hike rates by 75 basis points in 2023. This is the steepest rate-hiking cycle the Fed has orchestrated since 1980, demonstrating their determination to get inflation back down to their 2% target.

The market has continually underestimated inflation, and the Fed's fortitude, throughout this inflation battle. Remarkably, at the end of 2021, market expectations were for the Fed to raise rates 75 basis points in total for all of 2022. Instead, beginning in June the Fed delivered four consecutive 75-basis point rate hikes to go along with its other hikes, and Chairman Powell says the Fed still has "more work to do." On the positive side, we agree with both the Fed and the market that we are nearing the point at which the Fed pauses its rate hikes. We expect to see 50 to 75 basis points of additional hikes in early 2023, followed by a long pause from the Fed. Our view deviates from market expectations in that we do not equate a pause with a pivot, and we do not see the Fed cutting rates in 2023 unless the economy goes into a deep slump, which is not our base case scenario. In addition, we do not believe that the prices of risk assets appropriately reflect the likelihood of an extended period of elevated interest rates.

While US inflation has declined sharply from its peak, and there are compelling disinflationary trends in goods and housing, inflation remains well above the Fed's 2% target. There is little hope of getting inflation back down to 2% without a softening of the labor market, where wage inflation is running above 5%. Wage inflation is generally sticky and factors heavily in the price of services. It is also a significant driver of inflation expectations, which the Fed deems high-importance. Chairman Powell has repeatedly pointed to the strength of the labor market and the need to raise labor market slack in the battle against inflation. The jobs market is short an estimated four million workers, and job openings remain elevated. Despite extensive layoffs in the technology sector, jobless claims continue to point to a healthy labor market, and the unemployment rate is only 3.5%. Thus, we will need to see a significant softening in some of these labor market statistics and, likely a recession, before the Fed can gain any comfort that inflation is headed back to its 2% target. Given the slow-moving nature of the labor market and the fact that it enters 2023 in a position of strength, we do not think the Fed will cut interest rates in 2023.

Exhibit 8: Goods and Service Sector Inflation

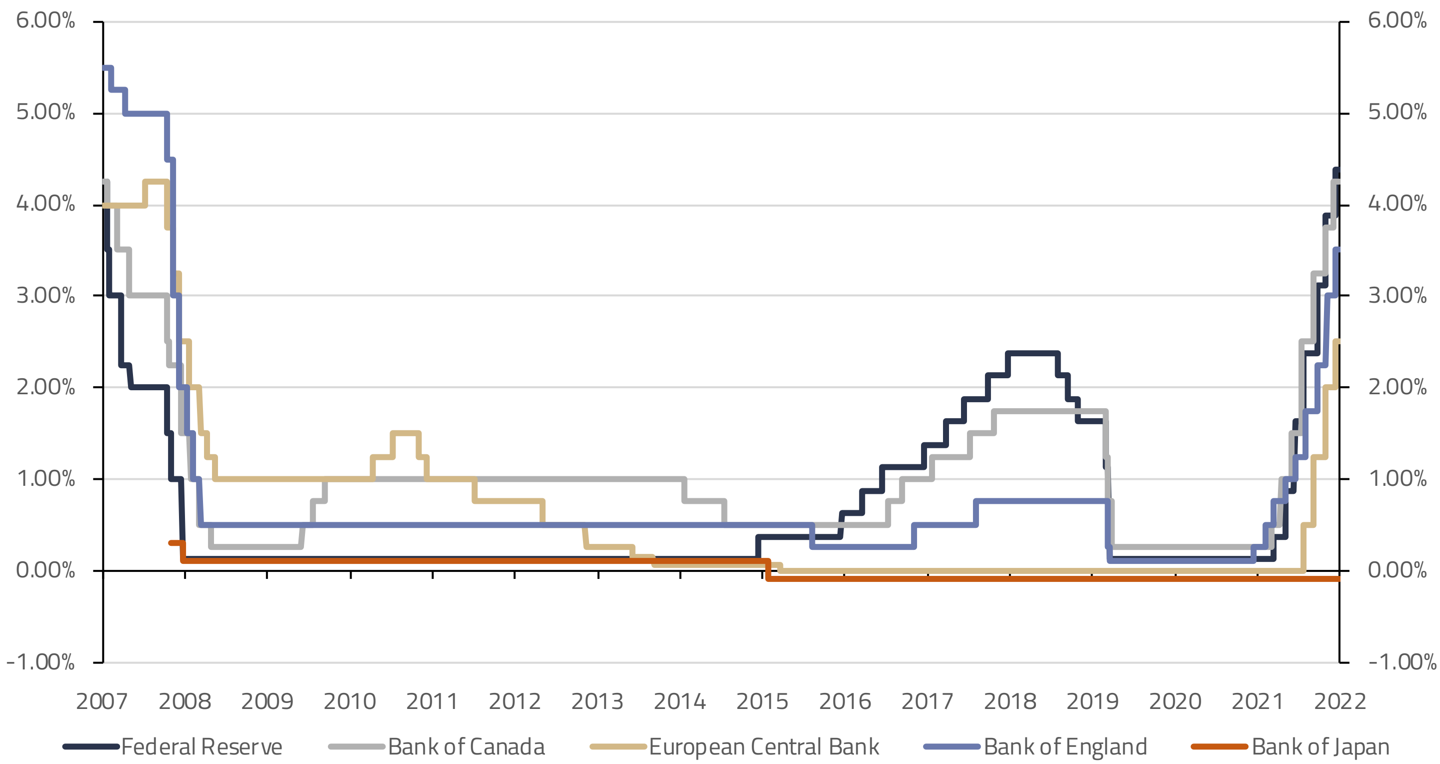


Source: Apollo, Bloomberg, as of 11/30/2022

The Fed and Chairman Powell are keenly aware that they bear significant responsibility for today's unusually high inflation. By misdiagnosing inflation in 2021 as transitory and keeping monetary policy extremely accommodative throughout 2021 and into the early part of 2022, they helped fuel the surge. The only time in the past 50 years that the US has experienced inflation this high is during the 1970s and early 1980s. That is the period that Chairman Powell referenced in his opening press conference remarks following the November 2nd Fed meeting, "The historical record cautions strongly against prematurely loosening policy. We will stay the course until the job is done."[9] Chairman Powell does not want his legacy to be like that of Arthur Burns, the Fed Chairman who cut rates prematurely on several occasions during the inflationary 1970s and is widely credited with prolonging that difficult period. Instead, Chairman Powell would like to be remembered as a modern-day Paul Volcker, the Fed Chair who is widely credited with extinguishing inflation and positioning the country for an extended period of low inflation and prosperity.

The Fed is not the only central bank battling high inflation. High inflation throughout Europe and most parts of the world has triggered a tightening of monetary policy across most leading economies, with two notable exceptions – Japan and China. In Europe, the European Central Bank (ECB) raised its key rate to 2% in December, and we believe there will be 150 basis points of additional hikes coming in 2023. In the UK, the Bank of England (BOE) recently raised its key rate to 3.5%, but also signaled concerns about further rate increases given weak economic conditions in the country.

Exhibit 9: Central Banks Benchmark Interest Rates



Source: Strategas, Bloomberg, as of 12/31/2022

9. Transcript of Chair Powell's Press Conference – November 2,2022. Board of Governors of the Federal Reserve System, 2 Nov. 2022.

Curiously, the Bank of Japan (BOJ) has resisted hiking short-term rates despite core inflation running at a four-decade high of 4.0%. As a result, the Japanese Yen has suffered from this misguided policy by declining over 14% versus the US dollar in 2022. In a bid to stabilize the yen and help markets function, the BOJ recently amended the terms of its yield curve control policy by allowing 10-year yields to rise a further 25 basis points to 50 basis points total. We believe this is the first of several tightening measures the BOJ will undertake in 2023 to avoid a sizable macroeconomic shock.

Finally, China is the only major economy not dealing with high inflation. Instead, its government is trying to revitalize an economy plagued by the unwinding of a real estate bubble and the side effects of its zero-Covid policy. As China's economy looks to re-open in 2023, its monetary policy may take a stimulative turn with potential implications for the price of oil and commodities. We believe China's re-opening will serve as a modest inflationary force on global prices, which is another reason why most central banks will be reluctant to cut rates in 2023.

Overall, 2023 will be a year of further global monetary tightening, but not at the pace experienced in 2022. However, a new easing cycle is still a ways off, as inflation appears to be entrenched in some areas, and it will take some time for global central banks to feel confident that inflation is under control. As a result, we believe the rate hikes we have seen in 2022 are sticky, and the world economy and markets will have to adjust to higher interest rates for some time. This process is likely to be frustrating and challenging for risk assets.

4. The US Economy

The US economy was resilient in 2022, but key indicators point to a likely recession in the first half of 2023. While we believe the economic contraction will be modest, we foresee an outsized impact to credit and lending markets, which will disproportionally affect risk assets. The environment we envision is much like the 2001 recession when the economic contraction was shallow, but risk assets performed poorly due to the bursting of the tech bubble and a contraction in credit.

The US economy is currently experiencing stagflation. After starting 2022 with two negative GDP quarters, the economy bounced back to GDP growth of 3.2% in the third quarter, and the fourth quarter data points towards above-average growth. However, for the full year, GDP growth is likely to be under 1%, and inflation, as measured by the CPI index, is likely to end the year well above 6%.

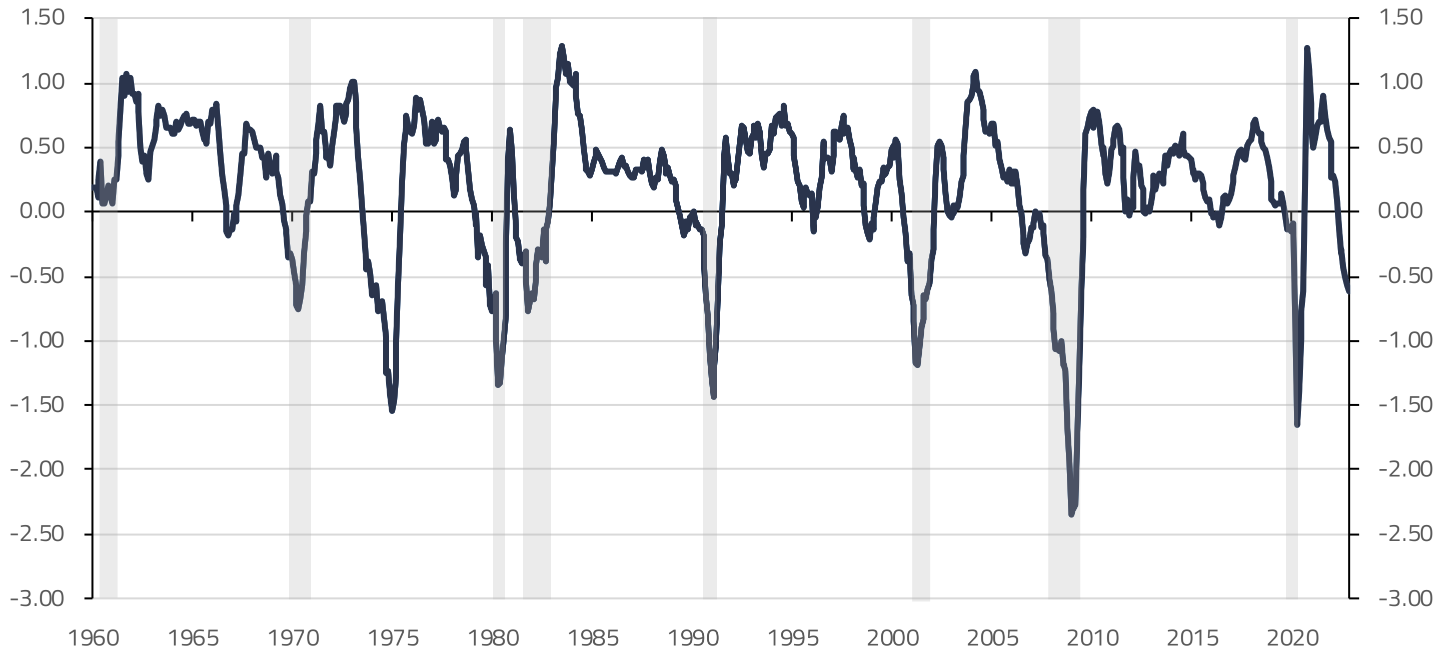
The economic environment has been uneven, with parts of the economy doing well, like the labor market and the service sector, while rate-sensitive areas, such as housing and autos, have suffered. Additionally, the end of cheap money and tightening liquidity disproportionally impacted venture-backed companies and the technology sector. These companies are responding by shrinking their workforces and cutting non-essential spending. Despite pockets of economic weakness, the labor market remains historically tight, and consumers continue to spend, especially on services that have benefitted from pent-up demand after two years of the pandemic, like travel and restaurants.

While excess consumer savings built up during the pandemic have been a tailwind for consumption, it is estimated that those savings have declined to nearly $1.1 trillion and are on pace to deplete around mid-year 2023.[10] Moreover, we now see clear signs that some consumers have already exhausted their savings. November's personal savings rate was 2.7%, well below the long-term average, and credit card balances are up 15% over the last year, the largest yearly increase in 20 years.[11] Another red flag is that hardship withdrawals from 401(k) plans are up 24% over the last year.[12] Finally, we have seen meaningful degradation in subprime and near-prime credit performance. Taken together, these are early-warning indicators that suggest a much more challenging backdrop for consumption in 2023.

Monetary policy works with long and variable lags, although the Fed's forward guidance policy intends to shorten those lags. With the economy already in stagflation and the bulk of 2022's interest rate hikes just now starting to have an impact, we believe the odds of a recession in the first half of 2023 are quite high. Several key indicators corroborate this view. As of November, industrial production growth has been negative for four of the past six months, and the manufacturing PMI report came in at 49, representing economic contraction. Key forward indicators of the report, like new orders and backlog of orders, were especially weak. Most importantly, the Conference Board Leading Economic Index (LEI), a composite index comprised of ten components highly correlated with real GDP which aims to anticipate turning points in the economy, has declined for nine straight months and is currently at a level that signals recession. As reflected in Exhibit 10, each time this index has reached current levels, as the shaded periods indicate, the economy has either been in a recession or nearing one.

10. Cembalest, Michael. "The End of the Affair." Eye on the Market Outlook 2023, 1 Jan. 2023, p. 11.
11. Schulz, Matt. "2022 Credit Card Debt Statistics." Lending Tree, 13 Dec. 2022, https//www.lendingtree.com/credit-cards/credit-card-debt-statistics/.
12. Lebovitz, David. What Is the Consumer Spending On? JP Morgan Asset Management, 21 Dec. 2022.

Exhibit 10: Conference Board US Leading Index (Month-Over-Month Change, 6-Month Average)



Source: Strategas, Bloomberg, as of 11/30/2022

Another key indicator that is flashing warning signs is the shape of the yield curve. The 2-year/10-year yield curve inverted in March and has reached a level of inversion that last existed in the early 1980s. While the 2/10 yield curve has a history of inverting up to 18 months before a recession, the 3-month/10-year yield curve is considered a more timely indicator. The 3-month/10-year yield curve first inverted in October and remains deeply inverted. Historically, an inverted yield curve has been a strong predictor of recessions, and it likely contributes to economic weakness by helping to restrict credit. The Fed Funds futures market agrees, as it forecasts several Fed rate cuts in the back half of 2023, presumably in response to a recession.

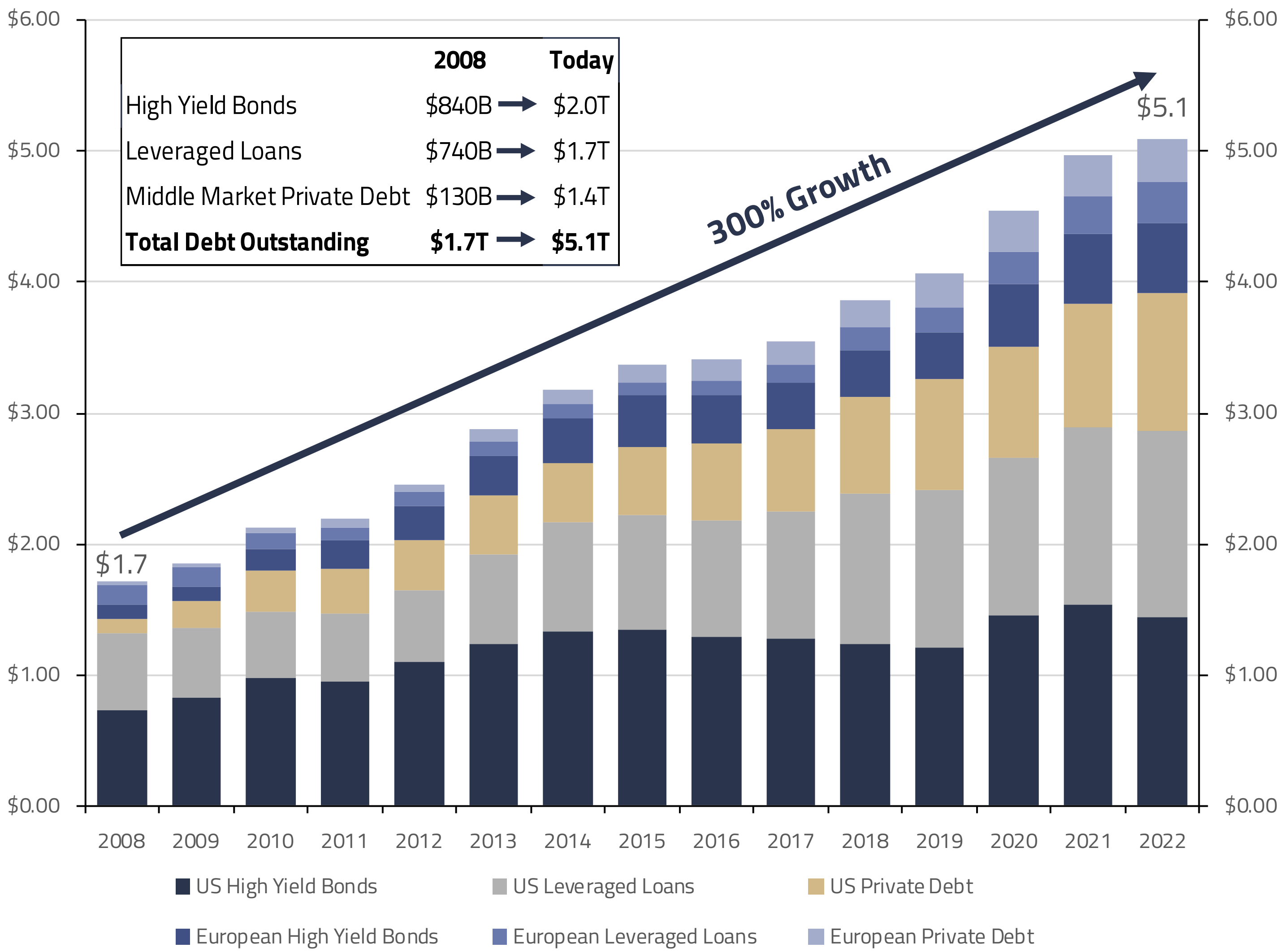
While our base case is for a modest recession, we believe investors and economists are not properly discounting the odds of a deep recession. Three key areas likely to determine the depth of the recession include the housing market, sovereign credit markets, and corporate credit markets.

Of the three, we are most sanguine about the housing market. We expect housing prices to decline 10%-20% nationwide over the next two years. Yet, we think that mortgage defaults will remain subdued, given built-up homeowner equity and low-interest financing that many homeowners were able to secure prior to the sharp increase in mortgage rates this year. We do, however, see the current slowdown in housing activity continuing, which will impede economic growth. Nonetheless, positive long-term housing fundamentals, led by a structural shortage in the supply of houses, should make this downturn modest and orderly.

Regarding sovereign credit – we are concerned that the sharp rise in global interest rates, combined with the growth in sovereign debt since the Great Financial Crisis (GFC), may give rise to economic instability over time. Post-GFC, many governments have been slow to cut outstanding debt levels, given low interest rates and debt-service costs. Recently, many countries have rolled out generous subsidy programs to help ease the burden of high food and energy costs. At some point, many governments are going to have to make the difficult choice between cutting expenses and raising taxes. If the market comes to view a country's debt level as unsustainable with no credible plan to address it, its currency and government bonds will likely come under pressure. We saw this happen to the UK in 2022; further episodes like this threaten to destabilize the banking system.

Our biggest area of concern is the corporate credit market – specifically the high yield, leveraged loan, and direct lending markets that have grown considerably since the last crisis. In the US and Europe, debt outstanding in these three markets has grown 300% since 2008 and today totals approximately $5.1 trillion.[13] Of these three, we believe high yield is the best positioned, given an improvement in credit quality over the last decade and fixed-rate financing that better shields its borrowers from 2022's sharp increase in rates. Leveraged loans and the private credit market, which have grown over ten times in size since 2008, are most vulnerable in our eyes. Leverage in these transactions has consistently grown over the last decade; many transactions include EBITDA-adjustments that add back certain expenses and assumed merger synergies or cost savings. These loans have also had a sharp deterioration in creditor protections at a time when the floating-rate nature of the debt translates to meaningfully higher interest costs for borrowers. Given our view that interest rates will remain elevated for several years, we anticipate a higher and more prolonged default cycle to emerge.

Exhibit 11: Outstanding Non-Investment Grade Corporate Debt (Trillions)



	2008	Today
High Yield Bonds	$840B →	$2.0T
Leveraged Loans	$740B →	$1.7T
Middle Market Private Debt	$130B →	$1.4T
Total Debt Outstanding	**$1.7T** →	**$5.1T**

Source: Marathon Asset Management, LP, J.P. Morgan, LCD, Acuity, as of 06/30/2022.

13. "State of the Markets." Marathon Asset Management, 1 Nov. 2022.

TOP 10 INVESTMENT THEMES FOR 2023

5. Outlook for Equities

Despite the S&P 500 having declined almost -20% in 2022 and the rarity of having back-to-back down years, we remain cautious on US equities. Our cautious stance is driven by what we see as overly optimistic consensus earnings expectations for 2023 and investor complacency with regard to the Fed and today's interest rate environment.

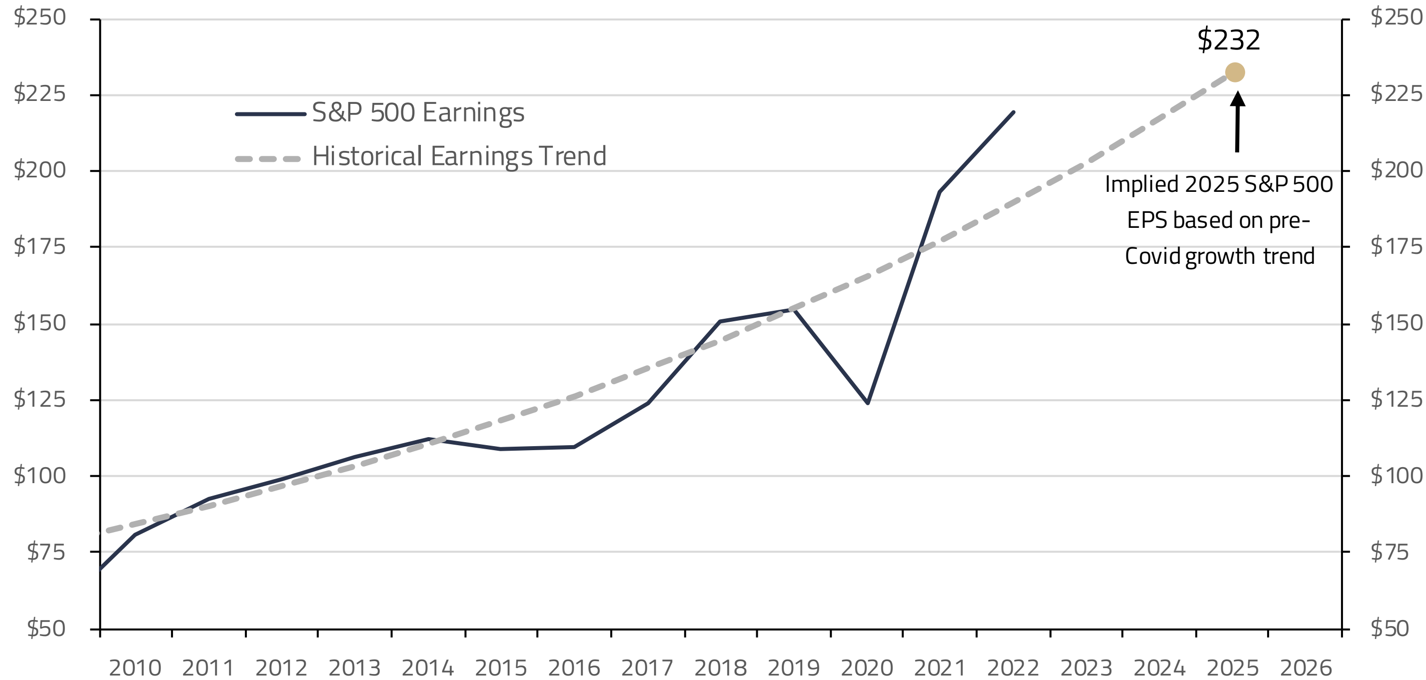
As we have communicated in the past, bear markets often share a similar pattern of having three phases. The first phase results from contraction of valuation multiples. In the second phase, earnings declines lead to lower stock prices. And in the third phase, investor indifference to equities leads to a lasting market bottom. We believe that we are currently in the middle part of the second phase. According to Factset, current 2023 S&P earnings expectations are approximately $230. While down from expectations of $252 six months ago, the current estimate still reflects 5% growth over expected 2022 S&P earnings of $220.[14]

Given that earnings growth in the second half of 2022 trended flat, and our view that a recession in 2023 is a near-certainty, we believe that current 2023 expectations are wildly optimistic. In mild recessions, S&P earnings usually decline 10% - 15%, consistent with a $190 - $200 forecast. Using these estimates and a generous multiple of 17x forward earnings gives us a fair value range for the S&P today of $3,230 – $3,400. This compares unfavorably to 2022's closing price of $3,840.

We recognize that the timing of recessions is always hard to predict, and we may be wrong about 2023. Thus, we look to a longer-term estimate for S&P earnings to establish a 2025 price target. For the last 35 years, S&P earnings have compounded at roughly a 7% annual rate.[15] Year-to-year variations exist; accommodative monetary policy usually pulls earnings forward, and restrictive policy decreases earnings to below trend. The extraordinary response to the pandemic pulled forward earnings considerably, but this will likely normalize by the end of 2025. Extrapolating the trend that was in place prior to 2020 results in a 2025 S&P earnings estimate of $232 (See Exhibit 12 & 13). Using a trailing twelve-month earnings multiple of 18x leads to an end-of-2025 S&P price target of $4,184. If our intermediate-term price target proves accurate, the table below highlights the expected internal rates of return for investing in the S&P 500 today at different levels. As you can see, this method also suggests the S&P 500 does not offer good value at 2022's closing price of $3,840, and the fair value range is similar to our prior estimate above.

14. Butters, John. Factset \ Earnings Insight. Factset, 06 Jan. 2023, p. 29.
15. Bloomberg.

Exhibit 12: S&P 500 Earnings vs Historical Trend



Source: Bloomberg, as of 12/31/2022

* Historical trend represents a CAGR of 7% observed from 1986-2019, 2022 Earnings are Bloombergs Estimate of EPS

Exhibit 13: Implied IRR Based On a 2025 S&P 500 Closing Price Target of $4184*

S&P 500 Starting Level	Implied IRR
$4,000	1.5%
$3,750	3.7%
$3,500	6.1%
$3,250	8.8%
$3,000	11.7%

*2025 S&P 500 target calculated with a price earnings multiple of 18, and an EPS of $232. Implied IRR calculations use a holding period of 12/31/2022 to 12/31/2025 & do not account for dividends.

Most sell-side economists are now calling for a 2023 recession. Even the Fed's economic projection for 2023 GDP growth is only 0.5%. Some strategists use this argument to suggest that stock prices are attractive because they already discount for the probability of recession. We disagree and continue to see the dissonance between economic projections and earnings forecasts. The table below contains forecast data from nineteen leading sell-side firms. Despite most of these firms predicting a recession in 2023, the average earnings decline estimate is only -2.5%. This is entirely inconsistent with historical observations during periods of economic weakness, especially since current earnings and profit margins are well above historical trends.

Exhibit 14: 2023 End-of-Year S&P 500 Targets by Leading Sell-Side Firms

Firm	Estimated 2023 Price Close	% Change From End of 2022 S&P Level	Estimated 2023 EPS	% Change From Current 2022 Estimate
Deutsche Bank	4,500	17.2%	$195.00	-11.5%
BMO	4,300	12.0%	$220.00	-0.2%
Scotiabank	4,225	10.0%	$225.00	2.1%
Jefferies	4,200	9.4%	$232.00	5.3%
J.P. Morgan	4,200	9.4%	$205.00	-7.0%
Cantor Fitzgerald	4,100	6.8%	$212.00	-3.8%
RBC Capital Markets	4,100	6.8%	$199.00	-9.7%
Credit Suisse	4,050	5.5%	$230.00	4.4%
Bank Of America	4,000	4.2%	$200.00	-9.3%
Goldman Sachs	4,000	4.2%	$224.00	1.6%
HSBC	4,000	4.2%	$225.00	2.1%
Citigrouo	3,900	1.6%	$215.00	-2.5%
Morgan Stanley	3,900	1.6%	-	-
UBS	3,900	1.6%	$198.00	-10.2%
Barclays	3,725	-3.0%	$207.00	-6.1%
Societe Generale	3,650	-4.9%	$220.00	-0.2%
BNP Paribas	3,400	-11.4%	$218.60	-0.8%
Evercore ISI	-	-	$221.50	0.5%
Stifel Nicolaus	-	-	$220.00	-0.2%
Average	**4,009**	**4.4%**	**$214.84**	**-2.5%**

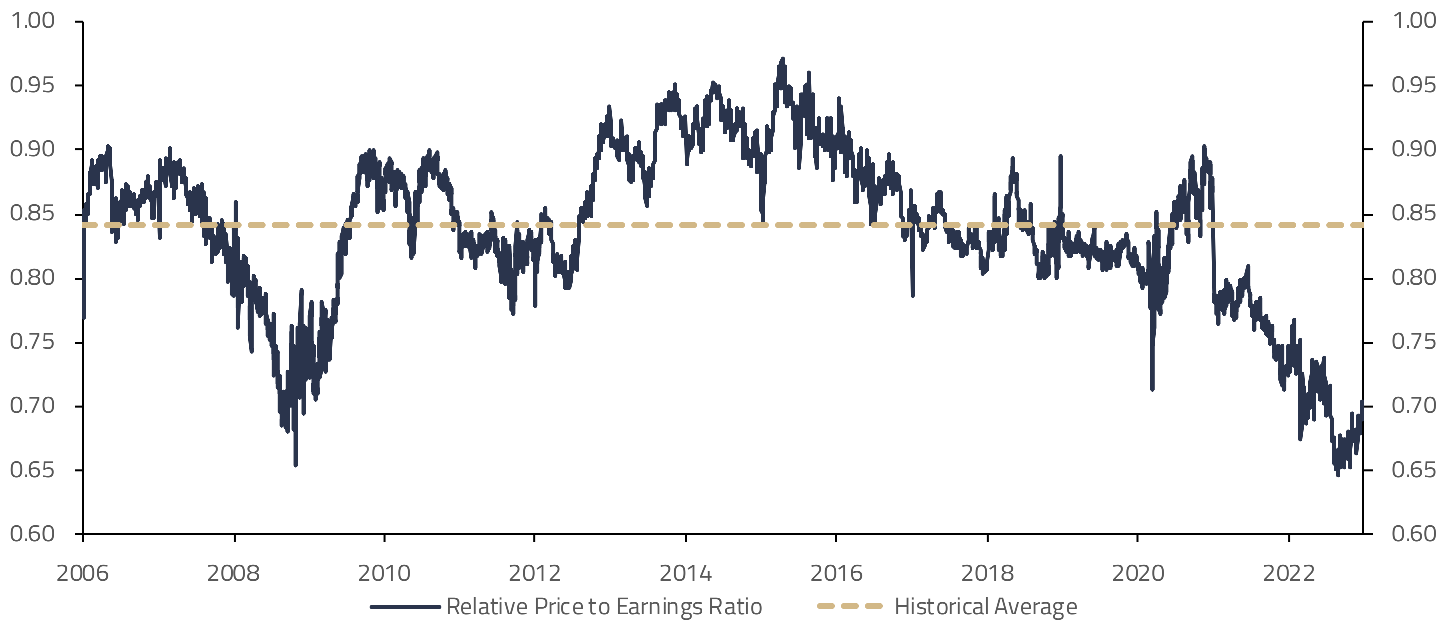
Source: Strategas, as of 12/31/2022

Despite what some say is widespread pessimism, investor behavior and market leadership suggest that the market has not bottomed. While hedge fund positioning is cautious, the buy-the-dip mentality among retail investors remains firm. Equity inflows recorded another banner year in 2022, and equity allocations in portfolios remain elevated. Market leadership is also inconsistent with the start of a new bull market. With the exception of energy, which benefitted from idiosyncratic events, the best-performing sectors in 2022 – utilities, consumer staples, and healthcare – are all defensive. We want to see improvement and leadership from more cyclical areas of the market before accepting the premise that the market has now priced in a recession.

Finally, we believe most investors underestimate the Fed's resolve to restore price stability by keeping interest rates at today's elevated levels. Consensus seems to think that with inflation already coming down, the Fed will pivot towards cutting rates at the first sign of economic weakness. We disagree and prefer to heed Chairman Powell's message that the Fed will not make the same mistakes it made in the 1970s. Thus, we believe today's multiples do not accurately reflect the likelihood of an extended period of the current interest rate environment and the possibility that it could lead to a credit crisis and deep recession.

Although we anticipate another difficult year for US equities, international developed markets, especially Europe, are looking better on a relative basis. European equities managed to outperform US equities modestly (in USD) in 2022 despite dollar strength and a much worse fundamental backdrop. Europe has proven resilient in the face of elevated energy costs and has proven adept at managing through a series of crises since the GFC. The composition of European equity indexes aligns favorably with sectors we believe will outperform, and relative valuations versus the US are the most favorable in many years. With signs that the US dollar will likely peak in 2023, and investors seemingly underweight Europe, we believe Europe will outperform over the next few years.

Exhibit 15: STOXX 600 vs S&P 500 Relative Price to Earnings Ratio



Source: Strategas, Bloomberg as of 12/31/2022
Price to Earnings Ratio calculated using twelve month forward-looking Bloomberg estimates

Within US equities, we maintain a preference for value over growth stocks, but we believe that many profitable growth companies now trade at attractive levels and are likely to outperform over a multi-year period. We also believe that small and mid-cap stocks have increasingly attractive relative valuations. Within sectors, we continue to prefer energy and healthcare. We expect oil and gas prices to stay elevated, and energy companies to remain disciplined with their spending and generous with their distributions. We like healthcare for its defensive and high-quality characteristics, along with reasonable valuations. Commodity producers and semiconductor companies are two areas to which that we are paying close attention. Commodity producers benefit from many similar dynamics to those that have helped energy companies this cycle, and the move to a low-carbon future is resource intensive, resulting in a strong demand environment. The semiconductor industry is currently going through a large inventory overhang that is pressuring earnings, but long-term secular demand drivers have rarely looked better.

Taken together, we see another challenging year ahead for the S&P 500, as earnings expectations and market multiples adjust to economic reality, but we also see an opportunity to consider increasing exposure into select international markets. Overall, we continue to be less optimistic towards equities and more constructive towards cash and cash equivalents. Periods of high market volatility tend to last several years, and we believe we will continue to see favorable opportunities as the year progresses.

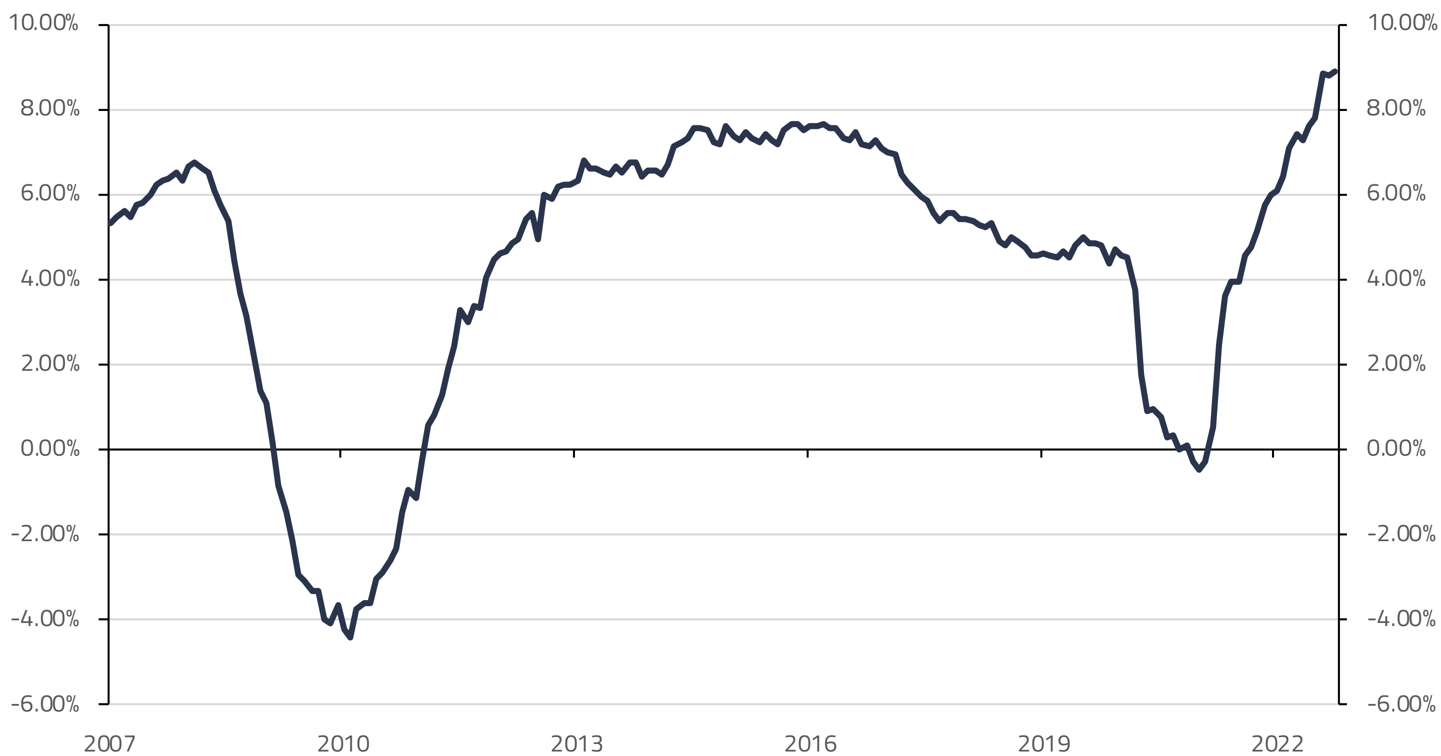
TOP 10 INVESTMENT THEMES FOR 2023

6. Outlook for Credit

The aggressive rise of interest rates in 2022 put significant downward pressure on fixed income securities over the course of the year. However, one of the benefits of the Fed's campaign to fight inflation has been the return of attractive yields. After over a decade of meager yields from fixed income products, the second half of 2022 saw yields across fixed income sectors soar; the yield on the Barclay's Aggregate Bond Index reached 4.68% and the Bloomberg Barclays Corporate Bond index reached a yield of 5.42% by the end of 2022.[16] The increase in yields has made fixed income products more attractive, and we have steadily grown more bullish towards the asset class throughout the latter part of 2022. However, the rise in debt-servicing costs and a slowing economy demands caution when allocating to specific areas of the fixed income markets.

Excess consumer savings increased rapidly during the Covid lockdown period, as a curb in spending combined with fiscal transfers from the government led to the creation of a large cash cushion for the US consumer. As fiscal transfers have abated and inflation has surged, the US consumer has begun to drain the excess savings generated during the lockdown period. Of concern, we have seen a rapid increase in the utilization of consumer credit facilities, as people have begun relying on debt to support their consumption. Credit card and auto loan delinquencies are still below levels seen during the global financial crisis but are trending upwards.

Exhibit 16: Break-Adjusted Total Consumer Credit (Year-Over-Year Change)



Source: Stategas, as of 10/31/2022

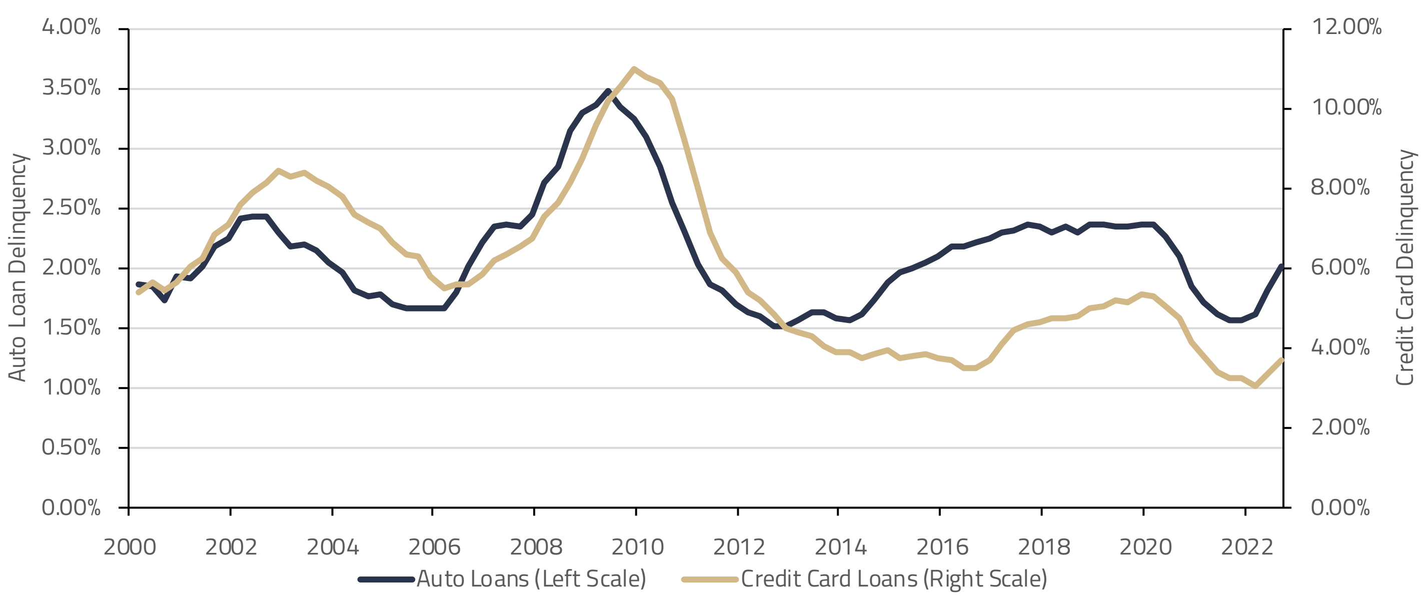
16. Bloomberg.

"Buy now, pay later" (BNPL) is a form of consumer credit that was first introduced 15 years ago with the founding of Klarna, and that has gained market share since it was introduced to the mass market in its current form. Initially intended as a more efficient way to pay for goods, BNPL has evolved into an affordability tool. Consumers are becoming increasingly uneasy about a potential economic downturn; many are turning to credit in order to preserve cash as a safety net. In the past, BNPL was used mainly to purchase big-ticket items. Lately, evidence shows consumers are utilizing the product for basic expenses, such as groceries. We view this behavior as evidence that consumers are becoming over-extended and could be vulnerable if the economy weakens.

Auto loans are another area of the consumer credit market that has us concerned. Transunion, which tracks more than 81 million auto loans in the US, reports that the percentage of loans at least 60 days delinquent hit 1.65% in the third quarter of 2022.[17] The rise in delinquencies also follows the end of pandemic-era loan-accommodation programs that were designed to prevent car repossessions among jobless Americans. As these programs have expired, Transunion notes that approximately 200,000 auto loans previously utilizing this program are now listed as 60 days delinquent. In addition, auto loan rates have soared during this time, with new-vehicle loan rates climbing to 5.2% and used vehicle loan rates reaching 9.7%, up significantly from the year-earlier period.[18]

Consumers are stretching loan terms in order to combat the effects of higher interest rates. For example, used car purchase loans have routinely extended beyond seven years (from traditionally five years) in order to keep monthly payments affordable. Further evidence of consumers tapping credit to pay for expenses can be seen in the 15% increase in credit card balances at the end of the third quarter of 2022, the most significant year-over-year increase in more than 20 years.[19] Although a tight labor market should continue to support consumer credit, many of these outstanding loans are particularly vulnerable to a sudden shift in the employment market. As shown in Exhibit 17, the percentage of auto and credit card loans that are 90 or more days delinquent began to inflect upwards in 2022. We anticipate that consumer delinquencies will continue to increase in 2023, and thus, we believe a cautious approach is warranted when investing in consumer credit instruments.

Exhibit 17: Auto & Credit Card Loan Delinquency Rates



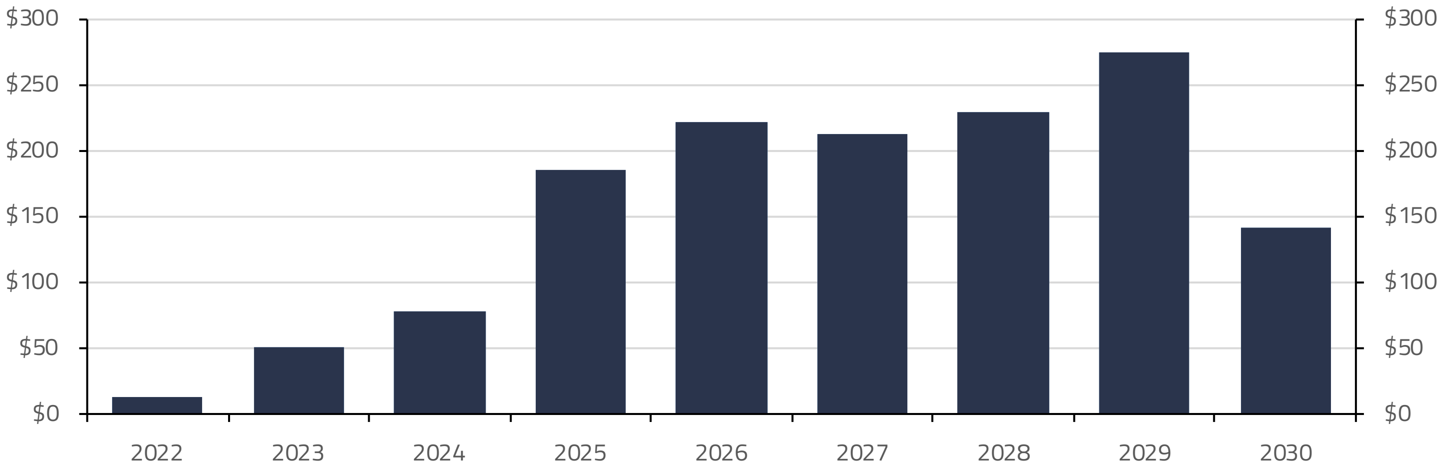
Source: Bloomberg, as of 09/30/2022

*Delinquency rate represents the percentage of loans reaching serious delinquency, as defined by a delinquency period of 90 days or more

17. LeBeau, Phil. "Auto Loan Delinquencies Rise as Loan-Accommodation Programs End." CNBC, CNBC, 8 Nov. 2022, https://www.cnbc.com/2022/11/08/auto-loan-delinquencies-rise-as-loan-accommodation-programs-end-.html.
18. Id.
19. Dickler, Jessica. "Credit Card Balances Jump 15%, Highest Annual Leap in over 20 Years, as Americans Fall Deeper in Debt." CNBC, CNBC, 16 Nov. 2022, https: www.cnbc.com/2022/11/16/credit-card-balances-jump-15percent-as-americans-fall-deeper-in-debt.html.

Corporate credit yields have reached a nominal level that has begun to look attractive from an income perspective. Nonetheless, it is important to consider the rapid growth in corporate debt levels over the past few decades and its potential effect on investment returns. It is no surprise that the zero-interest rate era of the past decade has spawned an explosion in the growth of corporate debt. With interest rates rising quickly, there is concern about whether companies can service their debt effectively. Management teams were opportunistic during the pandemic, utilizing the low interest rate and abundant liquidity environment to refinance a lot of their debt and extend bond maturities to the latter half of the decade. US high-yield bonds coming due by the end of 2024 represent only about 8% of outstanding notes, while the peak year for maturities is in 2029 (see Exhibit 18). The relatively few maturities over the next year give companies breathing room to navigate any future slowdown. While slowing growth can affect the underlying earnings of these debt issuers, companies usually tumble into bankruptcy when they cannot refinance borrowings that are coming due. For this reason, we have become more constructive towards the US high-yield market as a means of generating incremental yield.

Exhibit 18: High-Yield Corporate Bond Maturity Wall (Billions)



Source: Bloomberg, as of 12/31/2022

As noted in the US Economy section above, the leveraged loan market is an area of fixed income that we believe may face challenges over the next year. Issuers in this market have a similar credit profile to high yield issuers, but loans are issued with floating-rate coupon payments. Many of these loans are covenant-lite; lenders have fewer protections, and borrowers have wide latitude in regards to collateral, level of income, and loan payment terms. These loans performed relatively well in 2022, as their floating-rate nature protected the nominal value of the loans, as interest rates rose. However, this same attribute will likely lead to an increase in defaults, as companies have to service debt at much higher costs. In private markets, direct lending became popular over the last few years, as investors searched for yield in a low-interest-rate environment. Similar to their public-market counterpart, these private loans have a floating rate coupon structure that we believe will challenge borrowers to service their debt over the coming year. Increasing demand for yield, and bountiful exit opportunities due to a robust mergers and acquisitions (M&A) market, likely loosened the underwriting standards in the asset class. However, with M&A markets drying up, investors are becoming more skeptical about borrowers' ability to repay these loans. We share these concerns and anticipate lackluster returns in the direct lending market over the next year.

After the Fed's historic rate-hiking campaign in 2022, many parts of the traditional fixed income market now offer attractive yields for the first time since before the GFC. Accordingly, we have begun to form a favorable view towards some areas of the fixed income market, such as US Treasuries, investment grade municipal bonds, and high-yield corporate bonds. However, as stated earlier, we are cautious on many areas of the credit markets, and we therefore believe it prudent to take a measured approach when investing in fixed income, with a focus on capital preservation and the avoidance of sectors with potentially outsized risk factors.

TOP 10 INVESTMENT THEMES FOR 2023

7. Europe

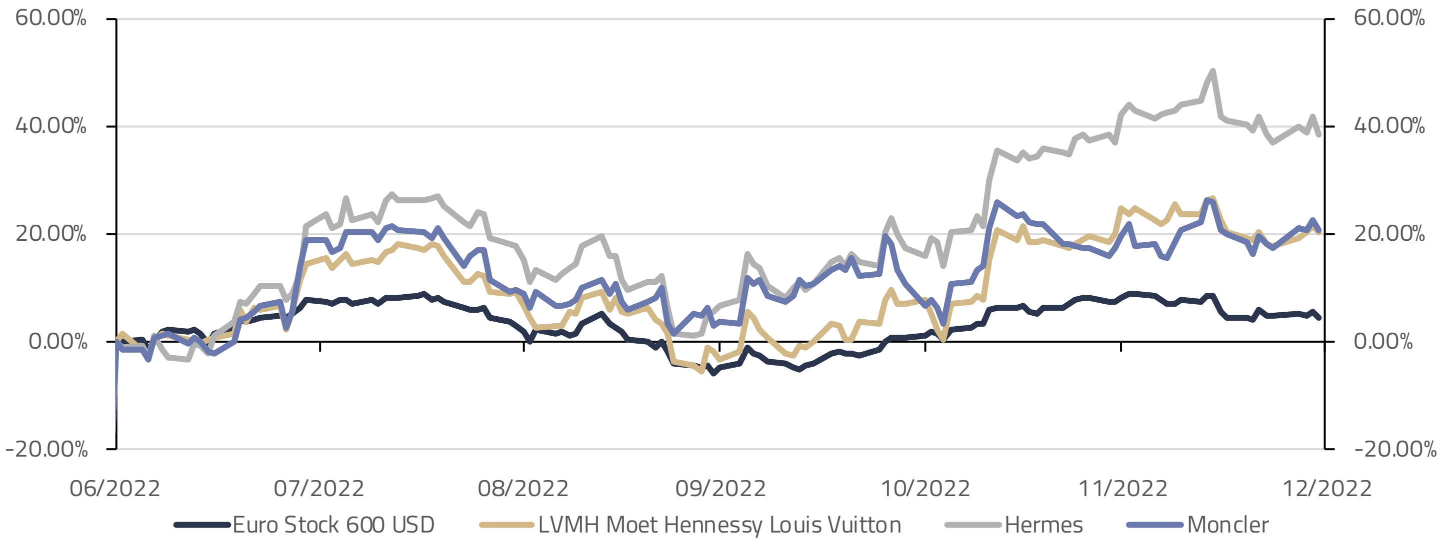
The ongoing Russia-Ukraine conflict has been a major geopolitical event that has influenced the European financial markets and economy since the beginning of 2022. The conflict led Russia to weaponize its natural gas industry in response to heavy sanctions imposed by Western nations. This has sparked an energy crisis throughout Europe, where countries have for years relied on Russian energy sources. The energy price spikes have been the main driver of European headline inflation and a significant headwind to real economic growth. Consensus expectations reflect the view that Europe entered a recession as of the fourth quarter of 2022, a view we share.[20]

The Russian invasion of Ukraine in early 2022 caused European equities to sell off sharply. As the conflict persisted, most investors surely thought that elevated energy prices in Europe would curtail economic activity enough to push Europe into a deep recession. Nonetheless, we have been surprised at Europe's ability to adjust to this unexpected adversity and reorganize its operations and energy consumption to adapt to this rapid price rise. This can easily be observed in Germany, which received 55% of its gas imports from Russia at the beginning of the war and was able to reduce that number to 25% by June 2022, through purchases of liquefied natural gas from the US and additional purchases of natural gas from Norway and the Netherlands.[21] Further, Germany has successfully reduced energy consumption in its manufacturing sector without significantly decreasing output. A survey conducted by Goldman Sachs Investment Research showed that German industry was able to reduce its gas consumption by almost 30%, relative to the average of the last four years, with only limited curtailment of production outside of highly energy-intensive industries.[22] However, while Germany has successfully reduced its energy consumption in the manufacturing industry, further energy rationing will likely lead to more extensive production disruptions, per the same Goldman survey.

Given the challenges Europe experienced in 2022, we have been impressed with the resiliency of European equities. As stated before, European equities outperformed US equities over the year, much of which can be attributed to the strong performance of the consumer discretionary sector. Within the consumer discretionary sector, stocks linked to the luxury goods market had a stellar year, as the strong US dollar led to a deluge of American tourists seeking to buy European luxury goods at a discount. This tailwind will persist into the first half of this year, given our anticipation that the relaxation of Covid policies in China will bring about a wave of Chinese tourism to Europe that will further support the revenues of these European businesses. The market seems to agree; European luxury stocks soared off the announcement of China's dissolution of stringent Covid policies that prevented many Chinese tourists from leaving the country. As with other re-openings, this surge in Chinese spending will be short-term in nature, and much of it has been priced in by the market; however, it should still prove beneficial for European companies reliant on tourism through the first half of the year.

20. Bloomberg.
21. Mahdawi, Arwa. "How Reliant Is Germany – and the Rest of Europe – on Russian Gas?" The Guardian, Guardian News and Media, 21 July 2022, https://www.theguardian.com/world/2022/jul/21/how-reliant-is-germany-and-europe-russian-gas-nord-stream.
22. Schnittker, Christian. "Germany — A Challenging Decade Ahead ." Goldman Sachs Research, 20 Dec. 2022.

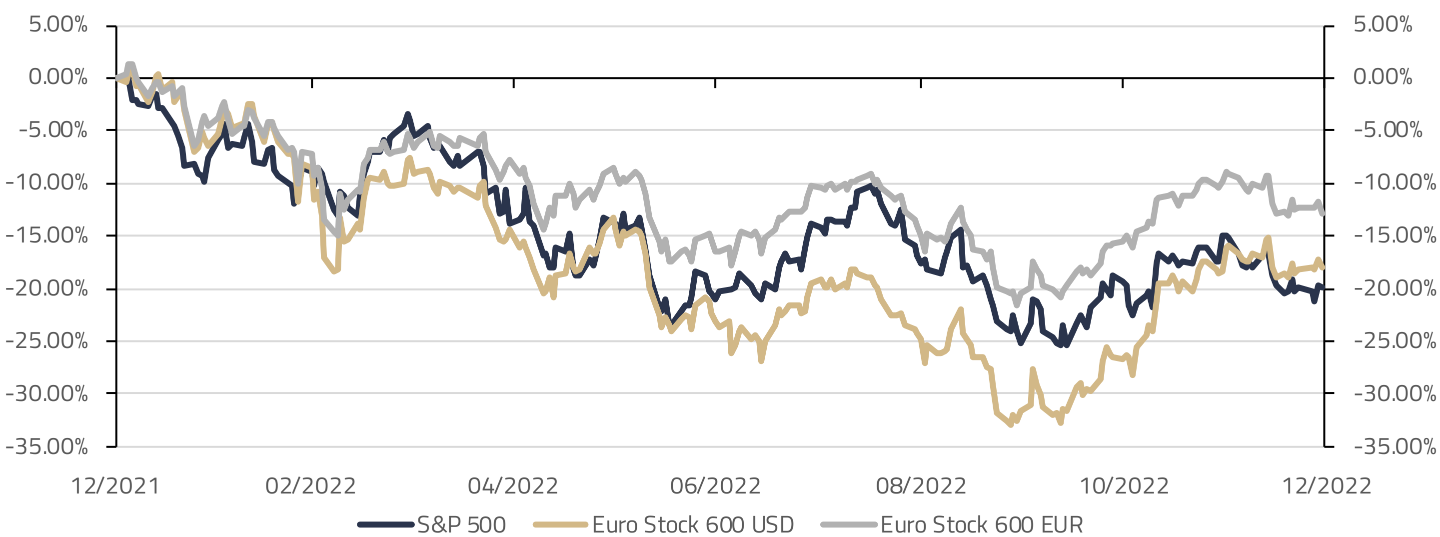
Exhibit 19: European Luxury Goods Stocks vs Broad European Equity Market Price Returns



Source: Bloomberg, as of 12/31/2022

We have been impressed, and surprised, by the performance of European risk assets over the past year. The Euro STOXX 600 finished the year down -9.88% on a local currency basis and down -15.22% in USD terms, both of which outperformed the S&P 500. Looking forward to 2023, the European economy and market will continue to be challenged by the ongoing energy crisis, the war in Ukraine, and rising interest rates. However, many of the downside risks to European markets have been priced in, and many of the potential downside risks for 2023 are shared by US markets as well. Upside surprises, such as a de-escalation of the Russia-Ukraine conflict or a weakening in the USD, could potentially be more beneficial for European risk assets than US risk assets. Therefore, we are becoming more constructive on Europe and believe it can be an appropriate means of providing geographic diversification within investment portfolios.

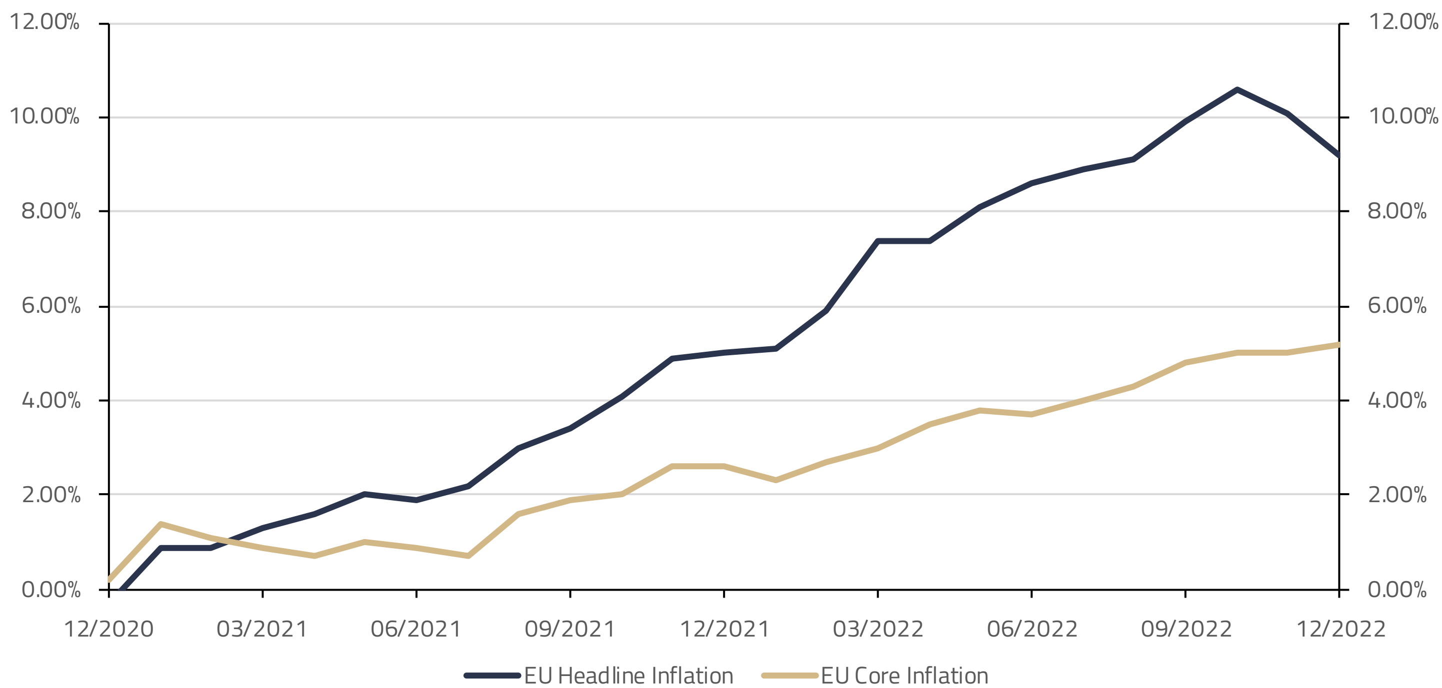
Exhibit 20: S&P 500 vs Euro Stock 600 Price Returns



Source: Bloomberg, as of 12/31/2022

Like in the US, inflation has been a significant issue for Europe in 2022. It has put pressure on the consumer and led to central bank policy tightening that has been detrimental to the valuation multiples of European equities. The latest inflation readings from Europe show a headline increase of 9.2% year-over-year and an increase of 5.2% in the core number.[23] Notably, energy is driving a larger share of European inflation, especially when compared to US inflation, with the headline number, which includes food and energy, outpacing the core number by 4.0%.[24] The difference in the US is only 0.8%.[25] We believe this is an essential consideration; inflation caused by the increase in energy costs will be harder to mitigate through traditional central bank intervention, leading to our forecast that the ECB will be less aggressive than the Fed in raising interest rates to fight inflation. The ECB has already raised its benchmark deposit rate by 250 basis points,[26] and we expect no more than 150 basis points of additional hikes in 2023.[27]

Exhibit 21: European Union Headline vs Core Inflation (Year-Over-Year Change)

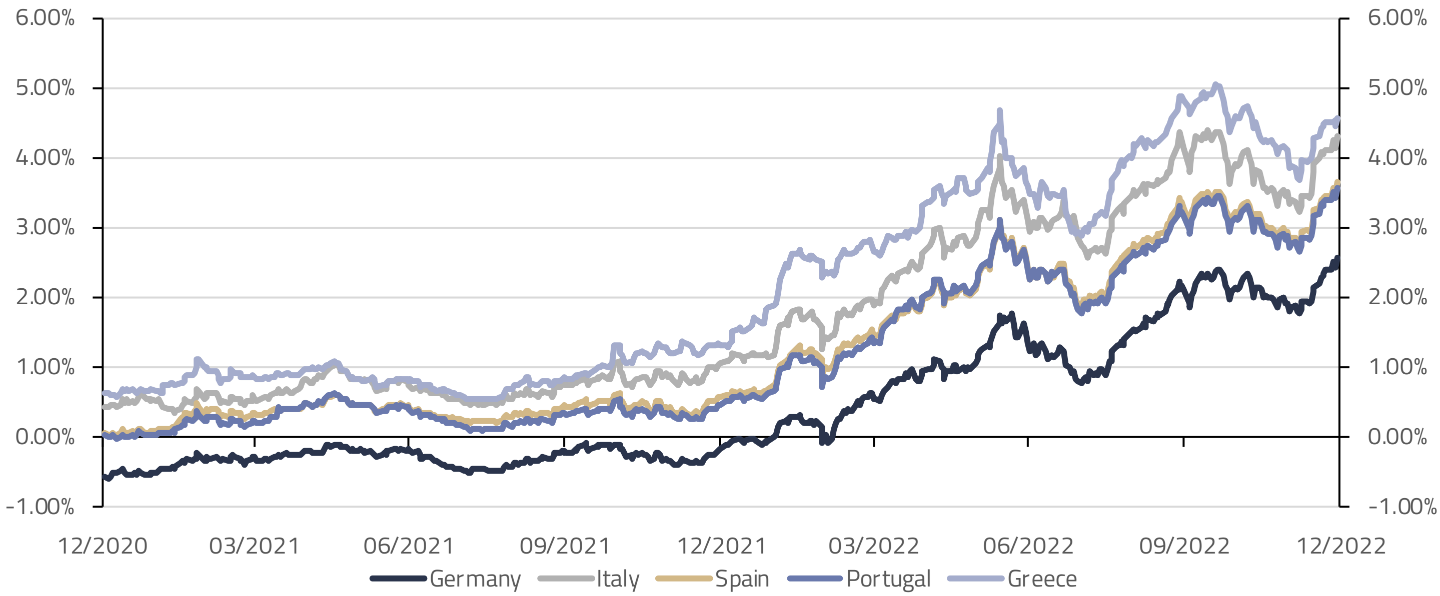


Source: Bloomberg, as of 12/31/2022

We also consider the ECB's unique initiative of anti-fragmentation, which is their objective not to allow sovereign bond yields to deviate by varying magnitudes in response to increases in the benchmark rate. Already, the sovereign bond yields of less fiscally sound nations, such as Italy, have increased in magnitudes greater than nations, such as Germany, that have stronger balance sheets. Furthermore, the ECB has stated its intent to mitigate future fragmentation through the Transmission Protection Instrument (TPI), which allows the ECB to make unlimited purchases of public debt in order to narrow bond spreads between core and peripheral Euro Area countries. In June and July, ECB data indicated that the Bank sold nearly 20 billion euros of French, Dutch, and German bonds, while buying over 17 billion euros of debt in Italy, Spain, Portugal, and Greece.[28] We believe that the utilization of TPI amid the ECB's tightening cycle could create attractive investment opportunities, as the region experiences the simultaneous effects of monetary easing and tightening.

23. Bloomberg.
24. Id.
25. Id.
26. Id.
27. Eglitis, Aaron, and Alexander Weber. ECB's Kazak's Sees 'Significant' Rate Hikes at Next Two Meetings. Bloomberg, 3 Jan. 2023.
28. Taylor, Hannah. Will Italy Be the First Target of the ECB's New Anti-Fragmentation Tool, the TPI?: Focuseconomics. FocusEconomics, 2 Sept. 2022, https://www.focus-economics.com/blog/posts/will-italy-be-the-first-target-of-the-ecbs-new-anti-fragmentation-tool-the-tpi.

Exhibit 22: Eurozone 10-Year Sovereign Bond Yields



Source: Bloomberg, as of 12/31/2022

*Yields are represented by each countries respective generic 10 year bond

The composition of the European equity market compared to that of the US should also lead to a difference in response to monetary tightening. In the past market cycle, US equity performance was dominated by high-growth companies with rich valuation multiples predicated on the expectations of growth and future earnings. In comparison, the European stock market appreciated far less over the past market cycle, as the composition of its market leans more towards shorter-duration equities. While this has led to significant outperformance by US equities in the ZIRP era, we believe that interest rate hikes will be less detrimental to European risk assets than to US risk assets. As of December 30, 2022, the STOXX 600 forward looking price-to-earnings ratio stands at 12.10 vs. the S&P 500 at 17.52, reflecting one of the largest spreads in valuations across the major bourses in their history.[29] We also note that multiple contraction is a more benign risk for European equities than it is for US equities.

A soaring US dollar, as measured by the DXY, has been a headwind for international equity returns measured in USD. Over 2022, the Euro crossed parity with the dollar for the first time in decades; however, a late-year rally reduced its yearly decline to -5.84% versus the USD.[30] Our base case is that the dollar will remain strong into the next year; however, we imagine that the magnitude of its strength will be more subdued than in 2022. Alternatively, many potential events could cause the US dollar to weaken versus the Euro, such as a pause in Fed interest rate hikes, aggressive ECB rate hikes, or even a de-escalation in the Russian-Ukrainian war. Any reversal in dollar strength over the year should bode well for European equities.

It is difficult for us to opine on the future of the conflict in Ukraine. Ukraine has shown remarkable resilience since the beginning of the conflict, and with further aid provided by Western allies, it will likely continue to defend effectively against the Russian invasion. On the other hand, reports have shown growing difficulties with the Russian campaign, with a loss of morale and support from home amidst a cratering Russian economy. Still, Putin is in a position where he must win, and our base case is that the conflict persists throughout the year. We believe European equities prices already reflect this sentiment, and further escalation of the battle should prove to be similarly detrimental to US equity prices and European equity prices. Yet, if a resolution or de-escalation of the conflict were to arise during the year, we believe that the potential upside for European equities is more significant than for US equities.

29. Bloomberg.
30. Id.

To be clear, we are far from bullish on European equities. A mild winter created lesser demand for heating oil across the continent, and rapid adjustment to the surging energy prices has allowed Europe to mitigate the effects of the price shock. However, with an economy most likely in recession, and energy prices anticipated to remain elevated, it is difficult to be overly optimistic about the region. Along with an evolving political landscape, rapidly increasing sovereign interest expenses, and a global slowdown in consumption, there is a litany of headwinds for European risk assets going into the New Year. However, after a challenging year for domestic equities, we believe European equities may offer good diversification benefits.

TOP 10 INVESTMENT THEMES FOR 2023

8. China and Emerging Markets

Chinese equities experienced a moment of reprieve at the end of 2022, following two years of historically weak equity returns. Equities in the world's second-largest economy dropped -21.77% in 2022 following a 2021 decline of -21.67%, as measured by the MSCI China Index in USD terms.[31] China's equity market has been weighed down by its government's stringent Covid restrictions, a real estate downturn, and regulatory crackdowns on the private sector. However, the Chinese National Health Commission recently announced that it would scrap all quarantine measures for Covid-19, after waves of protests in the Fall, in what appears to be an attempt to bolster its slowing economy.[32] Regulatory pressures for US-listed Chinese stocks have also abated, after US accounting regulators declared that China finally gave them full access to audit papers of such companies, reducing the risk of mass de-listings from American stock exchanges.

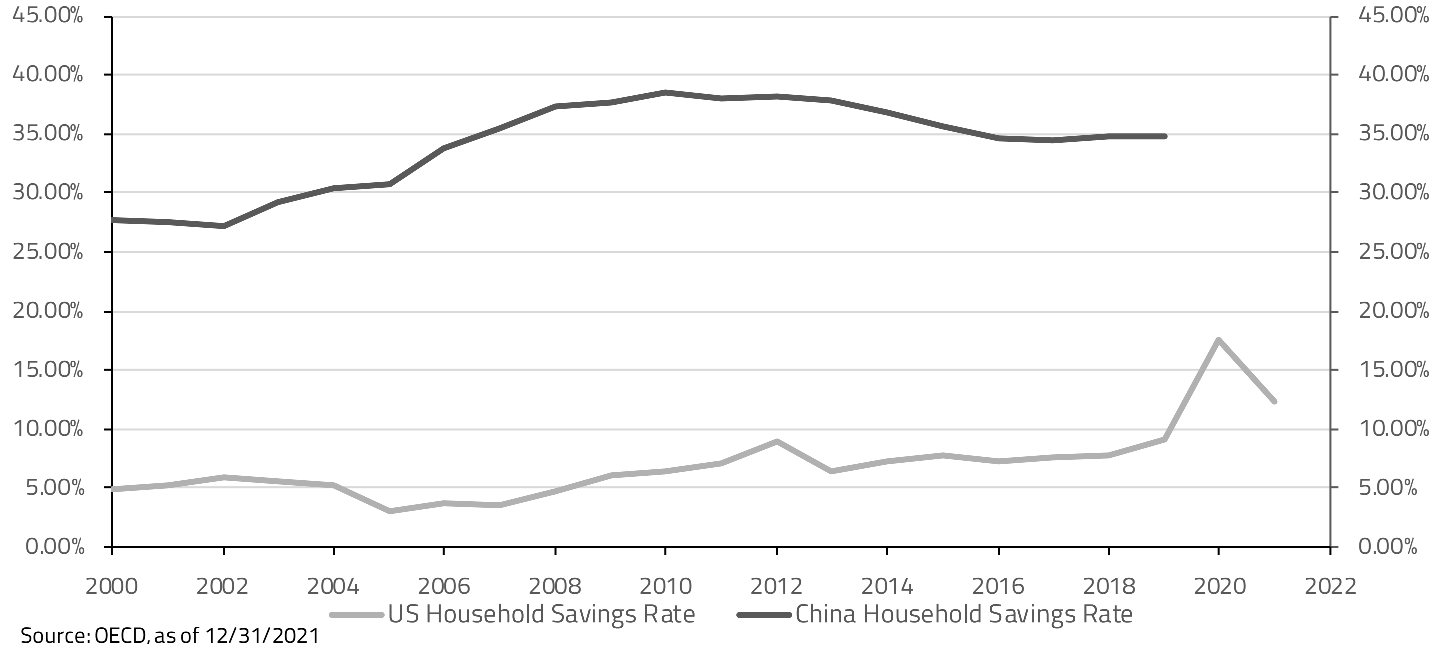
Domestically, Chinese authorities rolled out a slew of measures to aid property developers, whose financial troubles had spooked homebuyers, leading to a deep slump in new apartment sales. The recent changes have created a brighter outlook for China's economy in 2023, catalyzing a strong rally to end 2022 and leading many global investment banks and asset managers to be bullish towards Chinese equities. However, while we agree that recent developments should prove favorable for Chinese equities in the short term, we believe this rally will be short-lived. Potential regulatory pressures, heightened US-China tensions, and unexpected consequences from China's rapid reopening present a myriad of risks for US citizens investing in China.

In most western countries, economic activity accelerated almost immediately after reopening; however, we anticipate that China's growth may disappoint, as was the case in several other East Asian economies that previously implemented tight Covid controls. For example, South Korea and Taiwan experienced a surge in case numbers after their respective governments lifted Covid restrictions earlier this year. In response, mobility rates declined in both countries, as individuals cut down on social interactions for fear of catching the virus. This led to a growth slowdown post-reopening rather than the acceleration experienced in Western economies.

Economists expect a strong rebound in Chinese household consumption this year due to pent-up demand after a year of low nominal growth.[33] However, we believe the growth in consumption will disappoint, as compared to the US post-reopening, where the savings rate has fallen significantly below pre-Covid levels. Chinese households have allocated more savings towards less liquid time-deposits relative to cash over the past few quarters, limiting the amount of savings Chinese consumers can tap upon reopening. As a result, we expect the savings rate to revert towards historical trends rather than fall below trend, as happened in the US. The economic reopening in Shanghai earlier this year lends credence to this view. The savings rate there reverted towards the historical trend, rather than crossing below, and we anticipate this pattern will persist across the broader Chinese reopening. All things considered, the new reopening measures in China will provide a brief tailwind for risk assets, but realized growth is likely to disappoint consensus projections, causing the rally to be short-lived.

31. Bloomberg.
32. Cheng, Jonathan. "China to Open Borders as Covid-19 Cases Rise." The Wall Street Journal, Dow Jones & Company, 27 Dec. 2022, https://www.wsj.com/articles/china-to-open-borders-despite-surge-in-covid-19-cases-11672073476?mod=article_inline.
33. Shan, Hui. After Winter Comes Spring. Goldman Sachs Research, 17 Nov. 2022.

Exhibit 23: Household Savings Rate as a Percentage of Disposable Income



Source: OECD, as of 12/31/2021

Our longer-term outlook towards Chinese equities remains bearish due to regulatory concerns, despite recent efforts from Chinese authorities to comply with US regulators' requests for audits. The Public Company Accounting Oversight Board ("PCAOB") said it was able to secure complete access to inspect China-based audit firms for the first time in history. This comes after a decade of Chinese regulators refusing to allow the PCAOB to inspect China-based accounting firms or routinely access the audit records of Chinese companies. In the summer of 2022, the SEC flagged 160 Chinese companies as noncompliant with the new Holding Foreign Companies Accountable Act, which would force the delistings of companies whose auditors could not be inspected for three consecutive years. The companies the SEC flagged risked delisting from US-based exchanges beginning in 2024, causing their stock prices to decline significantly. China's compliance with the PCAOB's request led to a sharp rally in stock prices; however, PCAOB Chair Erica Williams reminded investors that the "announcement should not be misconstrued in any way as a clean bill of health for firms in mainland China and Hong Kong." [34]

The market's outlook on China turned bullish as a result of these developments; however, we remain skeptical that China will remain compliant with US regulators and anticipate that Chinese regulatory issues will persist into the future. Domestically, regulatory pressures that burdened the growth prospects of the Chinese property and technology industries have eased, providing some reprieve for stock prices. We view the easing of regulation as an attempt by the CCP to ignite some growth in its troubled economy, but we recognize that these industries remain in the crosshairs of the party, and future crackdowns are likely.

Geopolitical tensions continue to escalate between the US and China, lending further credence to our cautious outlook towards Chinese risk assets for US investors. On December 21st, the US military claimed a Chinese jet fighter conducted an unsafe maneuver while intercepting a US Air Force RC-135 in international airspace above the South China Sea.[35] The event is emblematic of the heightened tension between the two superpowers as it relates to the region where the US believes China is making overreaching sovereignty claims. At the same time, China condemns US military intervention in the area. Moreover, as war persists in Ukraine, the risk of a Taiwan invasion looms large, creating further tension.

34. Yang, Jing, et al. "U.S. Regulator Says It Has Access to Audit Papers of Chinese Companies." The Wall Street Journal, Dow Jones & Company, 16 Dec. 2022, https://www.wsj.com/articles/u-s-regulator-says-it-has-access-to-audit-papers-of-chinese-companies-11671115404?mod=article_inline.

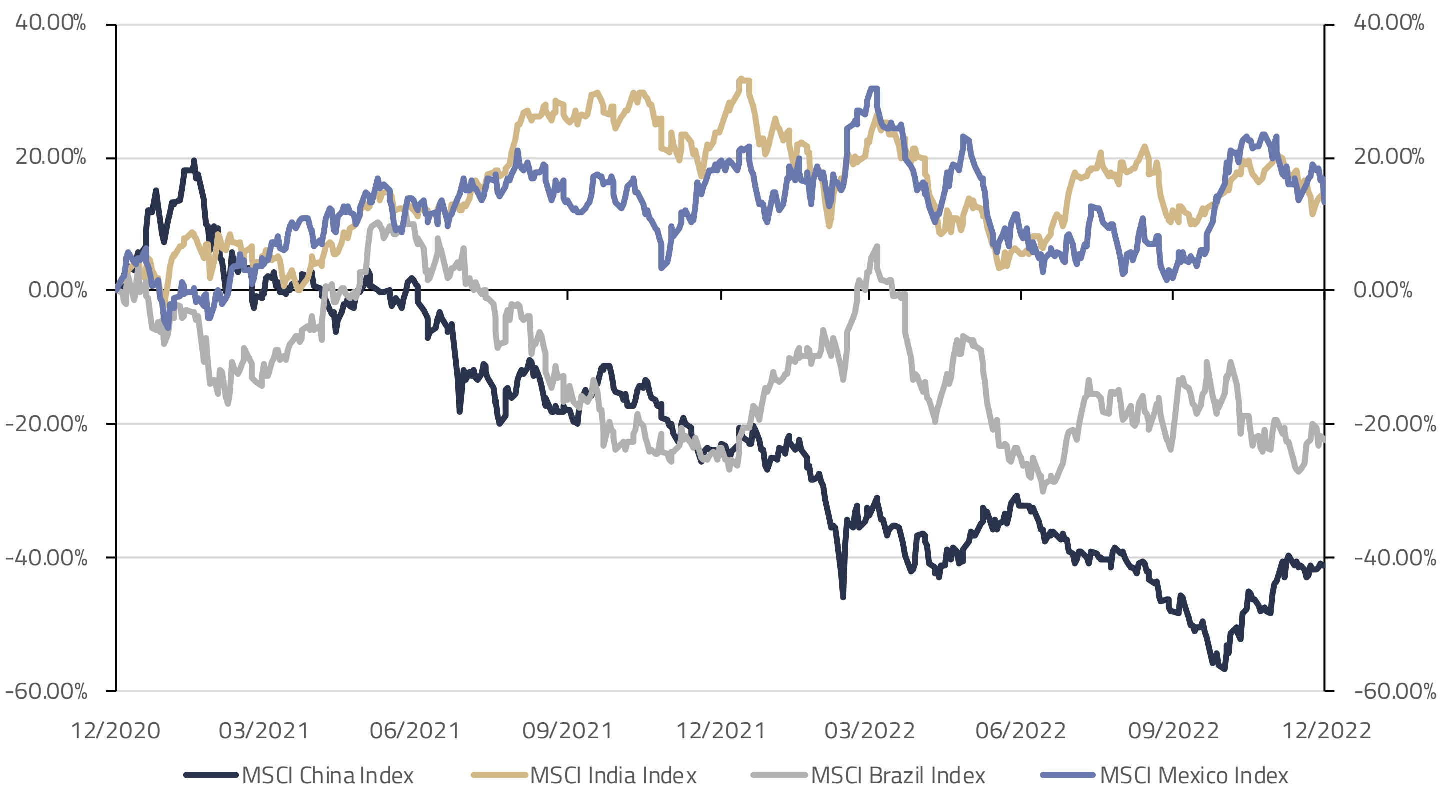
35. Wong, Chun Han. "China Asserts Military Power against U.S. with Naval Drills, Air Intercept." The Wall Street Journal, Dow Jones & Company, 30 Dec. 2022, https://www.wsj.com/articles/american-spy-plane-has-uncomfortably-close-encounter-with-chinese-jet-fighter-11672370402?mod=hp_lead_pos11.

In late December, the US Senate passed a $1.65 trillion spending package that includes $2 billion in financing for the sale of military equipment to Taiwan. We view this as a signal from the US government of its willingness to combat China on the global stage, and we anticipate tensions will increase over the coming years, presenting significant geopolitical risks to US investors' investments in China. Considering all the perceived risks for Chinese equities, it is difficult for us to be bullish on the region, even in light of recent events.

Despite our pessimism towards China, we believe there are interesting investment opportunities in emerging markets that could provide a diversification benefit to portfolios. Although headline emerging market equity returns were challenged last year, emerging market equities ex-China outperformed Chinese equities by a large margin. We have identified a few regions within emerging markets that present attractive investment opportunities for the year ahead.

Within Latin America, countries such as Brazil and Chile have shown evidence of peaking or declining inflation that will allow their central banks to provide rate relief. These countries are levered towards non-energy commodities, which provide potential upside given our favorable outlook on commodity prices. Escalating tensions between the US and China may spur a geopolitical realignment, where supply chains are reorganized to support political alliances at the expense of optimized cost and efficiency. As this unfolds, we anticipate increased investment into the economies of US allies, such as Mexico and India, which in turn should support the prices of their risk assets. Further, India shows the potential to be one of the fastest-growing emerging market economies, underpinned by strong demographic trends and a rise in innovation.

Exhibit 24: Emerging Market Equity Market Price Returns



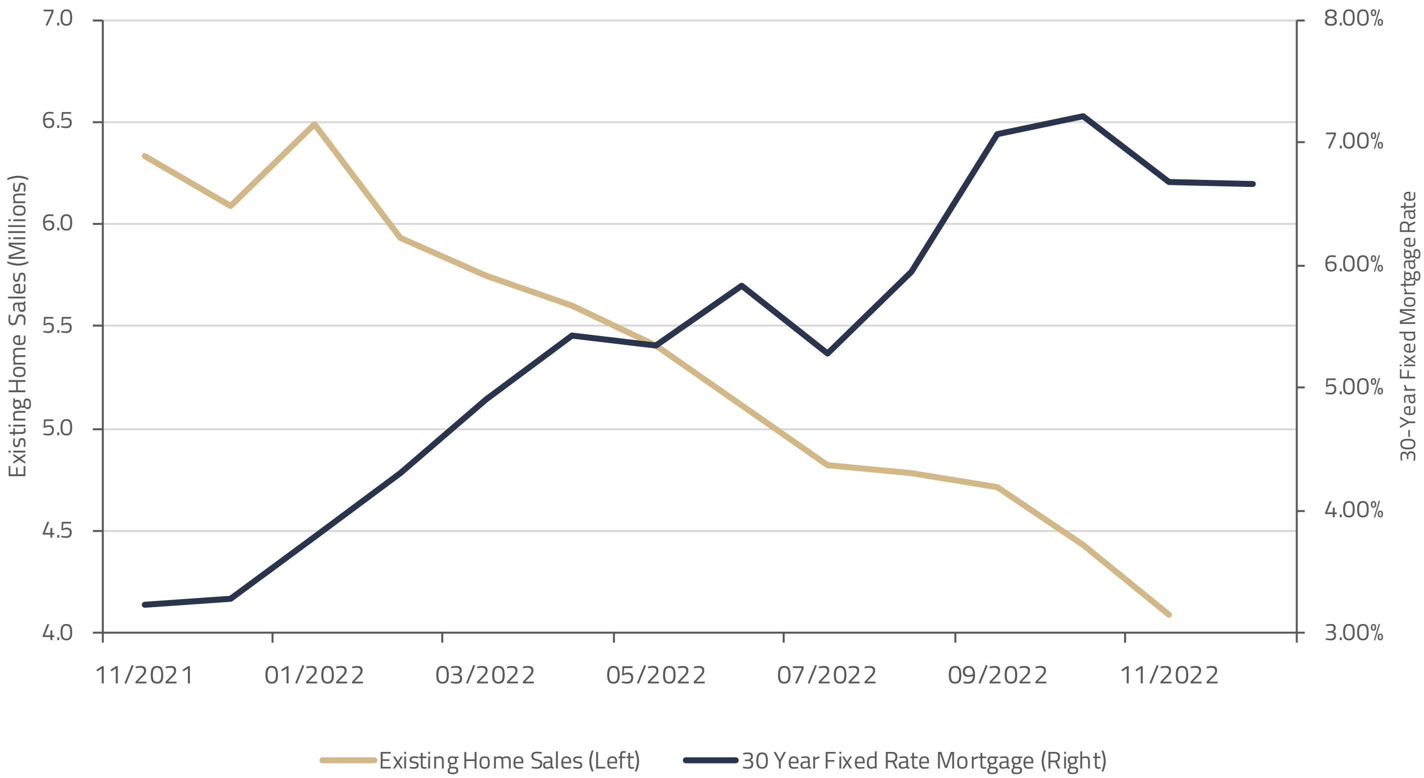
Source: Bloomberg, as of 12/31/2022

TOP 10 INVESTMENT THEMES FOR 2023

9. Real Estate

As the Fed aggressively tightens financial conditions to curb inflation, we believe 2023 will be a challenging year for real estate assets, resulting in price declines, given high interest rates and the significant probability of a recession. While we have a negative near-term outlook for real estate prices, we do not believe that price declines will compare to those seen in the GFC, as the economic backdrop today is fundamentally different. Corporate finances are in better shape as compared to the prior cycle and, although consumer confidence has softened, average household debt is low compared with the onset of previous recessions. Nonetheless, the housing sector, in particular, has already begun to show signs of increased weakness, with existing home sales data in decline since January 2022.[36] Exhibit 25 shows that existing home sales have had a strong inverse correlation to the path of 30-year mortgage rates over the last year.

Exhibit 25: US Existing Home Sales vs 30-Year Fixed Mortgage Rate



Source: Federal Reserve Bank of St. Louis, Bloomberg, as of 12/31/2022

For much of 2022, the ***commercial*** real estate sector was a tale of two markets – public vs. private. It was a terrible year for publicly traded real estate investment trusts (REITs), with the FTSE Nareit All REITs Index declining -24.9% on a total-return basis.[37] However, some of the largest non-traded, private REITs, including the Blackstone Real Estate Income Trust (BREIT) and Starwood Real Estate Income Trust (SREIT), reported positive returns and increases in net asset value in 2022. This juxtaposition, in our view, is cause for caution. The valuations differ because shareholders value public REITs at whatever price their shares are trading for on the stock market, and share prices tend to be forward-looking. On the contrary, sponsors work with independent appraisers to determine a private REIT's NAV on a monthly basis by analyz-

36. Federal Reserve of St. Louis.
37. Bloomberg.

ing how much the commercial property they own is worth. This monthly NAV is the valuation used for investors to buy or redeem shares. As noted by the Wall Street Journal in a November 2022 article,

> *"Some investors are asking why the value of nontraded REITs continue to rise. For one thing, values of apartment buildings have declined 14% in the past 12 months according to real-estate analytics firm Green Street, while industrial-property values are down 9%... Meanwhile, institutional investors have been selling interests in private real-estate funds, according to specialists who focus on secondary-market trading of these investments, and they have been willing to accept prices that sometimes are as much as 10% below net asset values from the third quarter, the most recent valuations."* [38]

In fairness to nontraded REITs, particularly the aforementioned Blackstone and Starwood vehicles, there are some distinctions between their real estate portfolios vis-a-vis the portfolios of many publicly traded REITs. For one thing, the Blackstone and Starwood funds focus on some of the stronger and (arguably) more resilient sectors of the real estate market, such as multifamily apartments and industrial properties. They have also been proactive in managing their exposure to rising interest rates; Blackstone, for example, reports that the "Value increases from BREIT's fixed rate liabilities and corporate and real estate interest rate hedges are $3.9 billion year-to-date as of November 30, 2022." [39]

Notwithstanding the prudent steps taken by the aforementioned financial sponsors, one of the primary concerns regarding nontraded REITs is that their valuations tend to weigh past events more heavily. For example, recent comparable sales is a metric widely used, but can be outdated in rapidly changing markets since many of those transactions were negotiated at least six months prior. Another metric is net operating income, which captures the property's profitability over the last twelve months. With expenses expected to outpace rent growth, it is likely this metric is overstated in today's environment. Taken together, this focus on backward-looking data means that valuations of nontraded REITs are generally slower to react to changing market conditions.

Given that we anticipate weakness in the real estate sector in 2023, we believe that market conditions will force nontraded REIT managers like Blackstone and Starwood to mark down the values of their real estate portfolios. Clearly, other investors shared this view, as both Blackstone and Starwood announced in November 2022 that they would be exercising their right to limit quarterly redemptions from their nontraded REITs. While this may sound like negative news, in reality it is a prudent decision on the part of Blackstone and Starwood. These REITs own massive, illiquid commercial real estate portfolios of core real estate holdings (i.e., rent-producing assets), and it would be imprudent for the managers to sell assets rapidly in order to meet investors' redemption requests.

Overall, our long-term view of the real estate market remains constructive; nonetheless, we believe that 2023 will be a year of real estate market declines, as the market readjusts to a new interest-rate paradigm and significantly tighter monetary conditions.

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38. Zuckerman, Gregory, and Peter Grant. "Public Reits Are Down, Nontraded Reits Are Up. Which Is Right?" The Wall Street Journal, Dow Jones & Company, 31 Oct. 2022, https://www.wsj.com/articles/public-reits-are-down-nontraded-reits-are-up-which-is-right-11667171717.
39. Why Has Breit Generated a Higher Return in 2022 than Publicly Traded Reits? Blackstone, Dec. 2022, https://www.breit.com/wp-content/uploads/sites/33/2022/12/BREIT-FAQ-Private-vs-Public-Real-Estate.pdf?v=1671146538.

TOP 10 INVESTMENT THEMES FOR 2023

10. Crypto

The decline of crypto will continue in 2023, and most current cryptocurrencies and tokens, with few exceptions, will continue on a path toward ultimately being worthless.

Since the inception of Element Pointe in 2016, we have avoided investing clients' money directly in cryptocurrencies. A key driver of this decision has been our perception of cryptocurrency as a tool for speculation rather than for ***investment***. Crypto-enthusiasts have argued for years that various crypto assets have utility as either inflation hedges, a means of payment or exchange, a solution for the "unbanked," or a store of value. However, as of yet, cryptocurrencies have arguably proven ineffective at each of these supposed utilities, and the trading of these assets remains principally based on what is known as the "greater fool" theory – the belief that one can make money through the purchase of overvalued assets if those assets can later be resold at an even higher price.

In 2022, a year in which cryptocurrencies as well as digital assets, such as non-fungible tokens (NFTs), had a terrible year; Bitcoin declined approximately -65% in 2022 and ended the year -74% below its all-time high reached in November 2021. Ether, another widely known cryptocurrency, has seen similar declines over the same period. In 2022, there were also several notable "blow-ups" in the digital asset ecosystem. In May 2022, TerraUSD, an "algorithmic stablecoin," and Luna, an associated coin, lost nearly all of their value within a 24-hour period, erasing $40 billion of value nearly overnight. Then in October 2022, crypto brokerage firm FTX, one of the largest intermediaries in the digital asset industry, collapsed in a matter of days amidst what appears to have been extensive fraudulent activity by its management team. At this time, US prosecutors have charged FTX founder, Sam Bankman-Fried, with fraud, and two key executives of FTX and Alameda (an affiliated crypto hedge fund) have plead guilty to fraud charges.

The crypto winter is likely to get colder and darker. As Bloomberg columnist Matt Levine noted in a recent article,

> *"One imperfect but useful way to think about crypto is that it allowed for the creation of a toy financial system. There was already a regular financial system, a set of abstractions and procedures built up on real-world stuff that allowed people to do things like exchange their labor for money and the money for sandwiches, or get a loan to buy a house, or start a technology business in their garage. That system grew up over time, in path-dependent ways; it was fragmented and complicated and embedded in society and history. Different bits of it had different cultures and practices and were regulated differently; the regulation had also accreted haphazardly over time, and it could feel arbitrary and constraining.*
>
> *And then crypto came along with a new set of stuff to do finance to. This stuff is so clean and new and shiny. It lives entirely on computers; you never have to worry about how to foreclose on a house or take delivery of 5,000 bushels of soybeans…Also, because it has so little history, crypto came with very little regulation. If you wanted to build a new system for trading US stocks, there were a lot of detailed technical rules that you'd have to work through, rules that might get in the way of your ideas, rules that you might think were arbitrary and outdated and bad. If you wanted to build a new system for trading crypto, you could kind of just code it up and see what happened…And it could all feel like a game; it could all feel unreal. It is unreal. You are trading tokens, they live on computers, many of them didn't exist a year ago, none of them existed 15 years ago…and what makes them valuable is just people's shared agreement to ascribe value to them."* [40]

40. Levine, Matt. "How Not to Play the Game." Bloomberg.com, Bloomberg, 30 Dec. 2022, https://www.bloomberg.com/features/2022-the-crypto-story-FTX-collapse-matt-levine/.

The absence of regulation has created a scenario wherein crypto markets are today replicating some of the same mistakes that traditional financial markets experienced over 100 years ago. Take, for example, the idea of stablecoins. Fiat-backed stablecoins (as opposed to algorithmic stablecoins) are cryptocurrencies whose value is pegged, or tied, to that of another currency – for example, the US dollar. In other words, the issuer of a stablecoin gives the buyer a coin in exchange for a US dollar and promises to keep that US dollar in reserve so that the coinholder can exchange it back to the US dollar on demand. The stablecoin market has grown to massive size, with Tether, the largest stablecoin in circulation, having a market cap of over $66 billion.[41] Alarmingly, Tether is a private company with shadowy ownership that issues coins in exchange for dollars and promises its customers that their dollars will be there when the customer wants them back. Yet, the company has no auditor, no regulatory oversight, and there is no way for its customers (i.e., the holders of the stablecoin) to be assured that the reserves actually exist. Does that not sound precarious? Even more precarious is that we have already seen this type of scenario before in the US with catastrophic results – over 150 years ago – during a period known as the "free banking era."

Many people are unaware that in the early days of our republic—until 1863— the dollar was primarily a mere unit of account rather than a currency.

> *"Yes, the US Mint minted coins, the Treasury issued some paper, and the First and Second Banks of the US issued some paper as well from the 1790s to 1836. But paper money—'notes'—were issued primarily by private banking institutions until late in the 19th century. Hence the term 'bank notes' for most paper currencies that circulated until late in the 19th century. America's paper money supply was primarily a plethora of privately issued bank notes. Bank notes were denominated in dollar increments, but were not sovereign-issued liabilities like today's dollar bills are…And different issuers, for their part, were differently reliable.."* [42]

Because bank regulation was more technologically difficult in the 19th century, regulators could not exercise quality control over paper currency issuers. This structure led to an economy wherein thousands of distinct bank notes all traded at various discounts to stated par value. As noted by Gerald Dwyer:

> *"There are fabulous stories of fraudulent activities…that appear frequently in histories of free banking and general histories of banking. For example, in an examination report for Jackson County Bank in Michigan in 1838, state bank commissioners report that they found the account books had accountholders' names written in pencil and their balances written in pen. In addition, when they examined the bank's specie."*
>
> *'Beneath the counter of the bank, nine boxes were pointed out by the teller, as containing one thousand dollars each. The teller selected one of the boxes and opened it; this was examined and appeared to be a full box of American half dollars. One of the commissioners then selected a box, which he opened, and found the same to contain a superficies only of silver, while the remaining portion consisted of lead and ten penny nails. The commissioner then proceeded to open the remaining seven boxes; they presented the same contents precisely, with a single exception, in which the substratum was window glass broken into small pieces. (U.S. Congress 1839-40, 1109).' "* [43]

This system of "free banking" failed catastrophically, ultimately culminating in the creation of a system of national bank notes, with regulation around reserve requirements wherein banks were required to hold U.S. government securities to back up their issuance of national banknotes, and regulators were required to verify bank holdings periodically. This monetary system later evolved further, leading to the creation of the Federal Reserve System and deposit insurance.

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41. CoinMarketCap, as of 01/10/2023
42. Hockett, Robert C. "Money's Past Is Fintech's Future: Wildcat Crypto, the Digital Dollar, and Citizen Central Banking." Cornell University Law School, June 2019, https://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=2756&context=facpub.
43. Dwyer, Gerald P. "What Do Wildcat Banks Tell Us about Stablecoins?" American Institute for Economic Research, 29 July 2021, https://www.aier.org/article/what-do-wildcat-banks-tell-us-about-stablecoins/.

One does not need to stretch logic too far to observe the parallels between the perils of the "free banking era" of centuries past, and the current cryptocurrency ecosystem. Indeed, much like the private bank notes of that era, many of today's cryptocurrencies will ultimately prove worthless, whether because of structural flaws, lack of utility, or outright fraud.

To be fair, not all cryptocurrencies are alike, and there will likely be some exceptions. Those, such as bitcoin, that are truly decentralized (i.e., have no central controller) have a better chance of surviving and retaining a role as a store of value. Proponents correctly highlight that, for bitcoin, there is no ***single point*** of failure, and no individual or company manages it. Nonetheless, the risks are extremely high, and "no ***single point*** of failure" is not the same thing as "cannot fail."

The events of 2022 have created a crisis of confidence in the cryptocurrency ecosystem that calls into question its long-term viability. We would most likely need to see sensible regulation of the industry and compelling use cases emerge before becoming more constructive on the asset class.

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