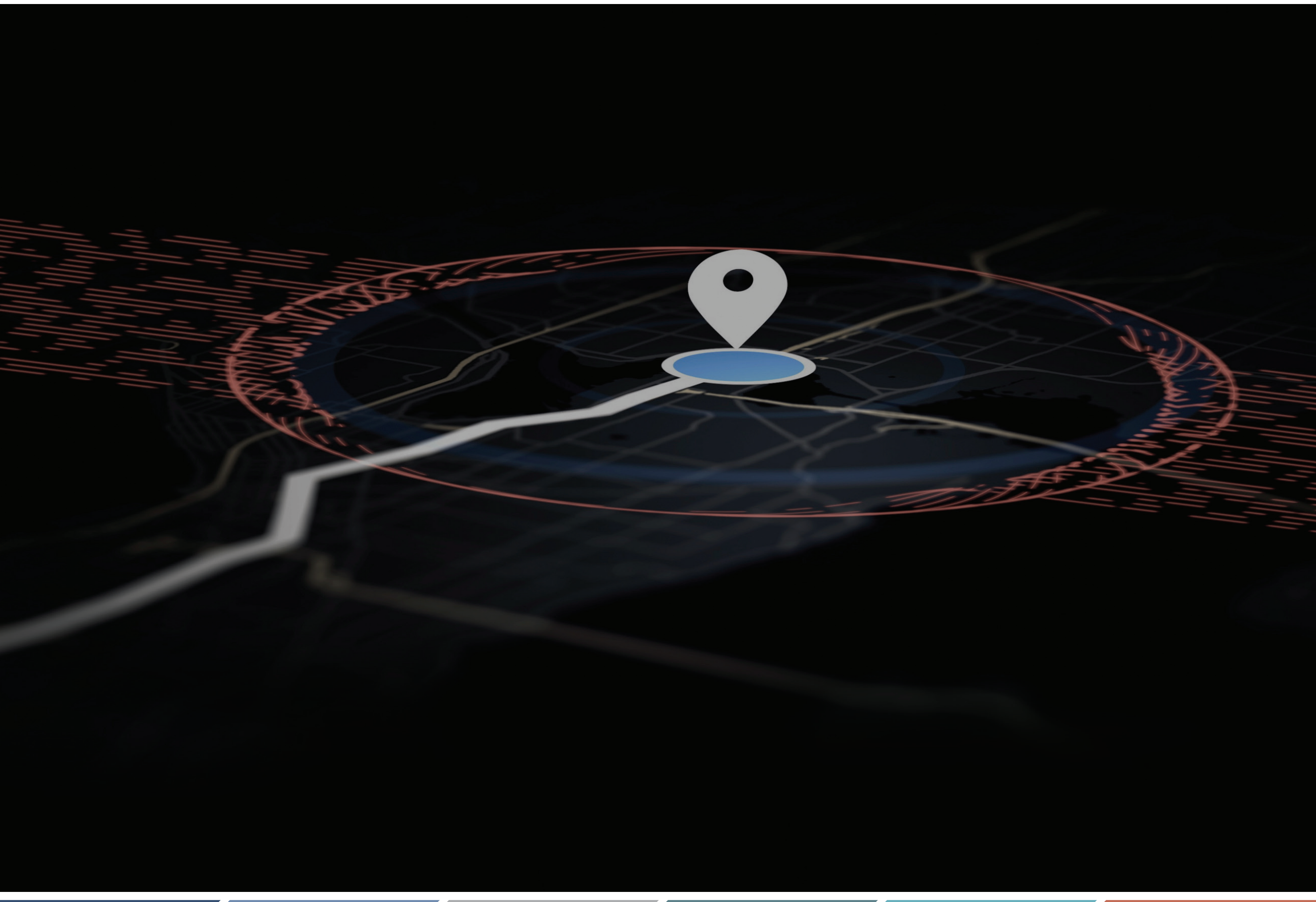

Ten for 2023

Midyear Update

Last November, the heads of our four investment platforms identified the key themes they expected to be prominent in the markets during 2023. With the year now half over, we revisited these concepts to see how they've played out so far. We give ourselves an interim grade for each one and assess our outlook for the second half of 2023.

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MACRO: BACK TO THE "OLD NORMAL"

1

A YEAR OF PEAKS AND TROUGHS WITH A RETURN TO THE "OLD NORMAL"

GRADE:

While largely correct about the peaks and troughs, our miss on equity markets suggests we may have been wrong about the severity of the downturn.

What we said: We think the next 12 months are likely to see this cycle's peaks in global inflation, central bank policy tightening, core government bond yields and market volatility, as well as troughs in GDP growth, corporate earnings growth and global equity market valuations. But we do not believe this will mark a reversion to the post-2008 "new normal". We see structural forces behind persistently higher inflation—and therefore a persistently higher neutral interest rate, a higher cost of capital and lower asset valuations.

What we've seen: Headline and core inflation rates in the U.S., Europe, China and Japan appear to have peaked between June 2022 and March 2023, but rising prices have been more persistent than many anticipated, supporting our structural view that we are returning to the "old normal." After a series of large hikes, the U.S. Federal Reserve and European Central Bank reverted to 25 basis points in February and May, respectively. So far, the U.S. 10-year Treasury yield has not breached the level hit in October 2022, but the two-year yield hit a peak above 5% in March this year. Bond market implied volatility has been very high, but equity market implied volatility has been low and declining. U.S. GDP growth has been positive so far this year, after a brief recession in the first half of 2022, but some leading indicators have been weakening. The Euro zone entered recession in the first half of 2023. Consensus estimates now suggest that U.S. and European large-cap earnings will trough during the second or third quarter—we think there is a further decline to come this year, albeit not as big as the most bearish estimates. Finally, on market valuations, due to a highly concentrated rally in U.S. mega-cap technology stocks and surprisingly resilient corporate earnings, the picture has improved for many equity indices. So far, we appear to have been largely correct about the timing of the peaks and troughs, but our miss on market valuations suggests we may have been wrong about the severity of the downturn. The path of consumer prices, GDP and jobs markets through the rest of the year may give us more information, however, and there is still time for those markets to reconverge with weak leading economic indicators.

2

ADJUSTING TO HIGHER RATES CONTINUES TO DISRUPT

GRADE:

The mini banking crisis confirmed our fears.

What we said: As rates rise and investors demand higher risk premia, the cost of capital goes up. This happens at some point in most cycles, but we believe the current adjustment is structural, and it is proving unusually large and rapid—raising the risk that it is disruptive. Many mortgage borrowers could be shocked when they refinance at 2023 rates. Many corporate capital structures built for a low-rate environment are in for a similar sharp adjustment. And with government debt exploding during the pandemic and "bond vigilantes" back on watch, some sovereigns may be forced into the kind of uncomfortable re-think recently forced upon the U.K. We think investors should be watchful for weak points that could cause broader disruption.

What we've seen: Unusually sticky inflation in the U.K. is pushing up rate expectations and beginning to generate stress in the mortgage and housing markets: we think it is important to monitor that situation. So far, however, the highest-profile examples of vulnerable businesses getting into difficulty because they were built for a low-rate environment have been Credit Suisse, Silicon Valley Bank and First Republic Bank. They failed after suffering deposit flight, compounded by having to crystalize steep losses in large holdings of Treasury bonds. Authorities appear to have acted swiftly to contain the fallout. While high yield issuers have so far been relatively resilient due to limited current refinancing pressures, defaults have been rising, and we are seeing considerable pressure in U.S. commercial real estate loans and floating-rate structures, in general—at a time when overall U.S. financial conditions have actually been easing, not tightening.

3 MORE DE-GLOBALIZATION

What we said: Manufacturing supply chains, commodity markets, financial systems, regulatory regimes, fiscal and monetary policy frameworks—we have seen them all become more integrated between 1980 and 2008, and more fragmented since. We see many and varied reasons, including the political backlash against the unequal outcomes of globalization; the shocks of the Great Financial Crisis and the pandemic; the waning internationalism of the U.S.; and increasing tensions as geopolitical blocs realign. We anticipate more landmarks on this journey in 2023, as it is driven by strong political, security and risk management imperatives.

GRADE:

While Covid constraints continue to ease, geopolitical and protectionist stresses continue to accumulate.

What we've seen: Relations between the U.S. and China, in particular, have been strained, and those strains appear increasingly to coalesce around the supply of semiconductors. Even the heightened tensions around Taiwan, alongside tit-for-tat bans on certain companies having access to one another's markets, can be seen as part of this emerging "Semiconductor Cold War." The ongoing war in Ukraine continues to complicate that relationship, as well as re-align relations between the U.S., Western Europe and the "Global South." Moreover, these are not issues solely between geopolitical competitors, but also between allies: witness the controversy in Europe over the U.S.'s Inflation Reduction Act, for example; and the beginnings of divergence within Europe, but also between Europe and the U.S., on the question of how to balance political and commercial relations with China. As U.S. trade representative Katherine Tai put it recently, "I want to put the U.S. back in USTR." While the supply-chain shocks of the pandemic and the war in Ukraine have waned significantly, pushing the New York Federal Reserve's Global Supply Chain Pressure Index to very low levels, the underlying geopolitics continue to deteriorate.

4 REDOUBLED EFFORTS TO CLARIFY "ESG"

What we said: Environmental, social and governance (ESG) investing became increasingly politicized in 2022 as the crisis in Ukraine triggered strong outperformance from fossil fuel assets, and stoked fears that ESG investors were starving domestic energy providers of capital. To counter this politicization, we believe more clarity is needed on the distinction between investing processes and investing outcomes. ESG integration is a process designed to ensure that financially material ESG factors are considered, alongside others, in traditional investment analysis. Exclusions, sustainable investing, and impact investing pursue a specific non-financial outcome, in a portfolio or in the real world, alongside managing financial return. We anticipate focus on this clarification from the industry and its regulators in 2023.

GRADE:

The debate remains noisy and not much clearer, although corporations and investors continue to press forwards.

What we've seen: Continued noise, but not much more clarity. In the U.S., hearings in the House of Representatives in May and June confirmed that some remain determined to conflate terminology and muddy the debate for political ends. We do not expect the Security and Exchange Commission's forthcoming rules on ESG fund disclosures to fix that. Those rules will be part of a busy second half of the year for ESG regulation worldwide, but as the rules proliferate, we also see growing divergence in regulation, enforcement and guidance across different jurisdictions. We continue to hope that the International Sustainability Standards Board can introduce some consistency, and that local regulators consider interoperability. While corporations and investors are now more likely to keep one eye on the noisy politics, however, we see a general convergence in their attitudes and aims. Despite regulatory divergence, corporates are adopting either mandatory or voluntary disclosures in growing numbers, improving our ability to price for financially material ESG considerations. And the reason Neuberger Berman continues to invest in resources and capabilities to improve our ESG integration and sustainable investing is that our clients increasingly seek these capabilities and prioritize them in their manager selection criteria.

FIXED INCOME: THE RETURN OF MARKET DISCIPLINE

5 PERSISTENT INFLATION SUGGESTS PERSISTENT BOND MARKET VIGILANCE

What we said: We enter 2023 with high inflation and extreme levels of government debt. Against this background, we see bond investors standing up more strongly for their interests against policymakers. Markets are punishing policy inconsistencies between fiscal and monetary authorities within sovereigns; and excessive fiscal or monetary policy divergences between sovereigns. We think core government bond yields may be range-bound where policies are consistent, but potentially higher and more volatile where policies are inconsistent. Despite the pace of policy adjustment and attendant market rate moves, outside the U.K. central banks have so far not had to intervene to maintain market liquidity—but an emergent policy conflict remains a tail risk for bond markets in 2023.

GRADE:

While no tail risk has materialized so far in 2023, pressures have been evident in the areas we suggested.

What we've seen: In most developed countries' sovereign bond markets, yields have been range-bound through 2023, with some heightened volatility around the collapse of Silicon Valley Bank in March. The major exception has been the U.K., where yields are now as high as they were following the catastrophic "mini budget" of September 2022, as the market is beset by especially persistent inflation, concerns about fiscal sustainability and projected bond issuance, hesitant central bank messaging as mortgage borrowers begin to struggle with higher rates, and ongoing political uncertainty at the heart of government. We would also observe that the ultra-short part of the U.S. curve was exceptionally volatile in the run up to the Federal debt ceiling. Among corporates, we have seen credit-spreads diverge from the broader market where issuers are struggling with costs rising faster than revenues, a dynamic that is putting pressure on entire industries such as healthcare and telecommunications. While no tail risk has materialized so far in 2023, pressures have therefore been evident in the areas we suggested.

6 ABILITY TO ABSORB HIGHER RATES LIKELY TO DOMINATE CREDIT

What we said: Over the course of a decade, many financial structures have been built around falling and ultimately near-zero rates, including a lot of debt structures. Floating-rate borrowers will need to adjust right away, but because we see structurally higher rates ahead, we think fixed-rate borrowers will eventually need to adjust, too. We do not anticipate a major uptick in defaults: the economy has historically been able to generate healthy growth with rates at these levels, balance sheets are generally strong and maturities are generally several years away, supporting a range of fixed income credit markets. That said, in our view, the sooner investors work higher-rates-for-longer into their credit analyses, the sooner they are likely to make what we regard as the necessary portfolio adjustments.

GRADE:

We see the beginnings of dispersion based on creditworthiness, and anticipate more to come over the rest of the year.

What we've seen: The relationship between index-level credit spreads and the rates outlook has been loose during the first half of the year. But that disguises substantial dispersion at the industry and issuer levels. Floating-rate structures are generally under pressure. Some sectors, such as U.S. regional banks and commercial mortgage-backed securities (CMBS), have struggled very publicly with higher rates, but trouble in industries like telecommunications suggest the challenges are more widespread. In high yield, the majority of industries are now experiencing depressed and deteriorating cash flow. Coming into 2023, our U.S. high yield default-rate estimate for the year was less bearish than many other firms', at 3%, and so far that appears to be on track—but there are stresses in the market, and revenues lagging costs, including interest-rate costs, is one of the major causes of that stress.

EQUITIES: WINNERS AND LOSERS

7 EARNINGS ESTIMATES RECALIBRATE AND FAVOR THE FITTEST

What we said: Much of the equity bear market of the first half of 2022 appeared to be due to the application of higher discount rates to largely unchanged future earnings estimates. Consensus earnings growth estimates for 2023 did not fall in the same way as real GDP growth estimates, perhaps because high inflation has supported nominal GDP growth. As inflation turns downward but remains relatively high as the economy slows, we think earnings estimates are likely to be revised down. We also think dispersion will increase, favoring companies that are less exposed to labor and commodity costs and have more pricing power to maintain margins, and use less aggressive earnings accounting. We believe this will translate into greater dispersion of stock performance.

GRADE:

A more gradual than expected economic slowdown has so far supported earnings estimates.

What we've seen: We have seen earnings estimates recalibrate. Consensus estimates for 2023 S&P 500 Index earnings have declined this year, but more modestly than we anticipated or believe is justified, from $229 per share in December to $220 in June. That would represent 1.7% growth over 2022 earnings. For the STOXX 600 Europe Index, the consensus estimate for 2023 earnings has declined even more modestly, from €35.33 to €34.95, which would represent a 0.7% drop on 2022 earnings. There has been no clear increase in the dispersion of estimates, but we have seen it in reported earnings. There was a full 80-point range between the top and bottom S&P 500 sector for first-quarter earnings growth, for example. Excluding the volatile energy sector, that range is typically 30 points. The highest growers were consumer discretionary, industrials and energy, the laggards were communication services, healthcare, utilities and materials, largely bearing out our view on the types of business that would find favor this year. What we and many other investors missed was the explosion of interest in artificial intelligence that would drive extraordinary outperformance by U.S. mega-cap technology stocks, and particularly the "Magnificent Seven" largest stocks in the U.S. market. Excluding those stocks, the U.S. large-cap market finished the first half of the year essentially flat, and was outperformed by the emerging markets and other developed markets, especially Japan. This points to underlying regional dispersion alongside sectoral dispersion, after a long period of markets being led by U.S. large caps; but it also reflects that we have seen a more gradual global economic slowdown than we had anticipated.

8 MANAGEMENT TEAMS RE-FOCUS ON SHAREHOLDER VALUE

What we said: When equity investors demand higher risk premia and bond yields present a meaningfully higher return hurdle, one way to keep the cost of capital down is to re-focus on delivering tangible, near-term shareholder value. When the economic going gets tough, effective management teams typically start improving capital structures and balance sheets, spinning out lower-return divisions, acquiring strategic targets finding efficiencies, and engaging creatively with shareholders. In these conditions we tend to see the true potential of alignment between active shareholders and company management: 2023 could be a lively year in the boardroom.

GRADE:

We see the beginnings of this focus on shareholder value, but may have to wait to see it translate into broader corporate strategy.

What we've seen: As we note below, private equity managers are currently forecasting lower earnings multiples on exit for new deals, on average, indicating that they think all their net return will come from growing earnings via acquisitions and business improvements. In the public markets, perhaps the most prominent example of this theme has been the outperformance of the "Magnificent Seven". Much of that appears to be due to liquidity, technical flows and artificial intelligence, but part of it is also due to management teams "getting religion" on shareholder value: these mega-cap enterprises have a lot of levers to pull, including redirecting capital from some ambitious investment plans and the occasional vanity project—and in 2023 the market has rewarded them for doing so. U.S. regional banks, for example, face much tougher decisions, such as how much of their loan book to liquidate. In addition, it is notable that, while the Event Driven family has been a mixed bag in the HFRI Hedge Fund Indices, the Event Driven Activist Index has been one of the best performers. It is not surprising that merger transactions are often failing due to an inability to agree a price under the current uncertainty, but a pick-up in approaches and discussions suggests green shoots to us, and we think it underlines the urgency that management teams feel to make strategic changes when they lack confidence in simple multiple expansion.

ALTERNATIVES: CHALLENGES AHEAD, BUT OPPORTUNITIES FOR THE NIMBLE

9

MORE DISPERSION IN PRIVATE MARKETS PERFORMANCE

What we said: Private markets won't be impervious to the ongoing slowdown. Exits are more difficult in volatile public markets, and while private company valuations tend not to fall as far as public market valuations, we do think they are likely to decline. Such a challenging environment is likely to result in performance dispersion that tends to favor higher quality companies, especially where management has well-defined growth plans as opposed to relying on leverage and multiple expansion. It's also important to remember that private equity funds generally invest over multi-year periods, typically enabling new and recent-vintage funds with "dry powder" to seek opportunities as valuations decline through the slowdown.

GRADE:

At this stage in the cycle, the highest-quality companies are almost the only ones being transacted.

What we've seen: Exits, which were already down more than 50% in the second half of 2022, have continued to decline in the first half of 2023. We see data for more than 400 active private equity funds, and that suggests the valuations of existing deals, outside of venture capital, has been notably resilient: existing buyout valuations were up, on average in the first quarter of the year. As we intimated, however, the more important question concerns deals being made with today's dry powder during 2023. Here, we see the valuations of completed transactions down 15 – 20% on comparable deals of recent years—and it is worth noting that, with private equity managers increasingly willing to walk away from deals that are not attractively priced, only higher-quality companies are currently being bought and sold. We attribute much of the resilience in existing buyout valuations to the broad ability of private companies' management teams to respond to the challenging environment. As we move through the current cycle, we believe we will see the relative quality of the companies, company management and of private equity managers involved in current transactions reflected in greater valuation dispersion. On average, we see private equity managers forecasting lower earnings multiples on exit for new deals, indicating that they think all their net return will come from growing earnings via acquisitions and business improvements.

10

A GROWING OPPORTUNITY SET FOR OPPORTUNISTIC INVESTORS

What we said: In a market downturn, liquidity providers can be selective across liquid and illiquid alternatives and niche opportunistic strategies as valuations decline—or even dislocate. Among liquid alternatives, we think global macro and other trading-oriented hedged strategies can continue to find opportunity amid volatility. We anticipate increasing opportunities to provide niche capital solutions at attractive or even stressed yields as debt structures are reworked. And on the illiquid side, we think private equity secondaries has become a buyers' market. Economic strains could also open up long-term value opportunities in inflation-sensitive real assets, in markets both liquid (e.g., certain commodities) and illiquid (e.g., real estate).

GRADE:

Trading-oriented strategies in liquid markets have disappointed, but providers of capital have been well-rewarded in illiquid and semi-liquid markets.

What we've seen: Returns data to the end of May suggest that 2023 has so far been a lackluster year for hedge funds. Among the major strategy families, according to HFR, Macro has struggled in an environment with range-bound bond markets and generally declining volatility—with currency-focused and short-term trading strategies bucking the trend. Equity Hedge has delivered positive returns, in general, but lagged the market as outperformance came from the mega-cap growth stocks that these strategies tend not to favor. Event Driven has been a mixed bag, with Activist and Credit Arbitrage doing well but Merger Arbitrage struggling. Relative Value strategies have generally been positive, while generating lower than recent average returns in the rising rate environment. Insurance Linked Strategies have been a bright spot within liquid alternatives, as premiums have been rising. We have been seeing a more opportunistic landscape in illiquid and semi-liquid markets, however. Yields on niche capital solutions have generally risen from low teens to high teens. As private equity and especially private real estate investors seek liquidity in the secondary market, bids of 30% or more below par have become common. Overall, however, the story of 2023 has been about liquid-market "beta," whether that be the currency carry trade or equity indices driven by high quality, mega-cap technology stocks.

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