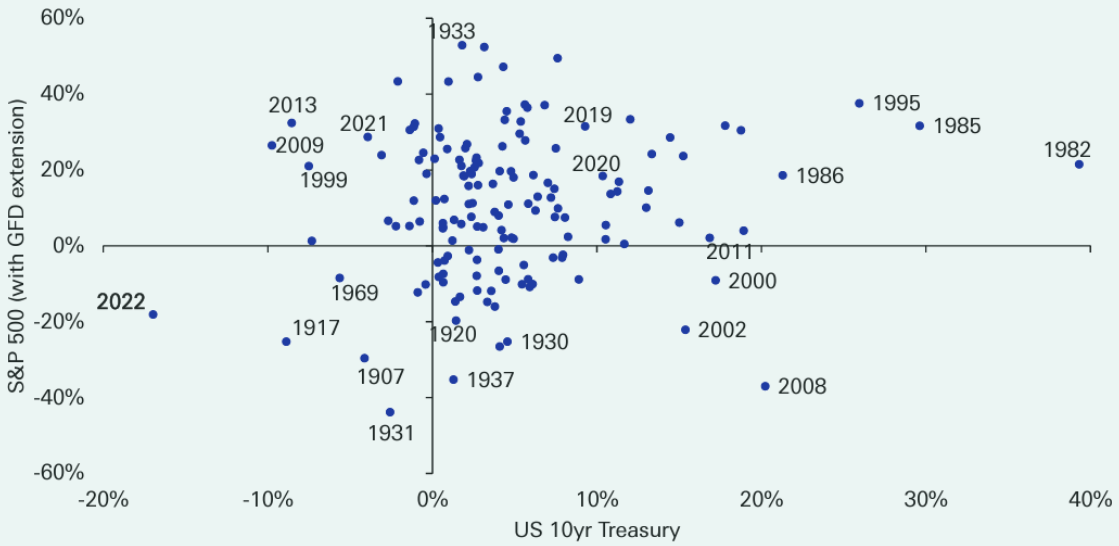
2023 Investment Outlook

REVIEW OF 2022

By now most of those reading this letter will know that 2022 was the worst year for most asset classes since 2008 so we will not cover it in too much detail. It was, remarkably, only the seventh year since 1871 that both stocks and (the usual safe haven of) government bonds were down in unison, highlighted by the dot chart from DB below.

Fig 1: Annual performance of the SP 500 and US 10-year Treasury since 1872

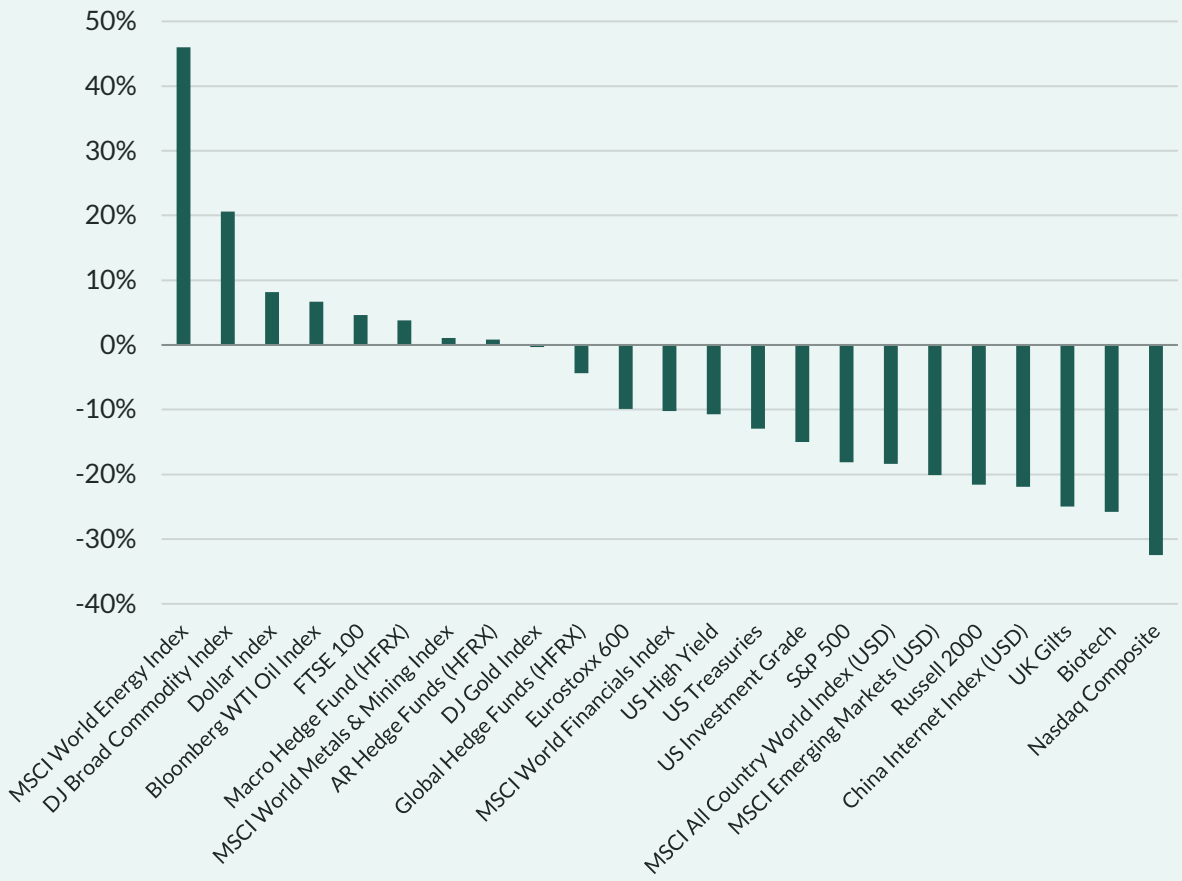


Source: DB Research

Looking across asset class returns (Fig 2) shows there was limited opportunity for investors to generate positive returns outside of energy related investments. Most stock and bond markets were negative, but some alternative investment strategies held up better such as macro hedge funds, highlighting that in practice it was very difficult to achieve diversification for most global investors. Why was this the case? The last 10-year period of very low rates had in our view two key impacts:

1. It drove all asset prices to rise together, as the discount rate fell – resulting in higher asset class correlations
2. It caused investors to "chase" returns, by allocating more to speculative assets or illiquid assets in an attempt to secure higher returns

Fig 2: 2023 asset class performance – only energy assets and the USD delivered a material positive return



Source: DB, Refinitiv

We had warned about this risk in previous letters and in late 2021 we began to implement tail risk protection in most portfolios as we started to see risks increasing amid higher inflation and tightening monetary conditions. The core principle of our approach is not to time the markets, and we did not know whether markets would react negatively or not to the changing environment, but we wanted to be sure we had some portfolio diversification if things turned out worse than expected. This decision was the primary driver for our portfolios to have one of their best years relative to their risk equivalent benchmarks with outperformance around 5% for the year. In addition, positive contributions came from our private debt allocations and absolute return strategies. Through the course of 2022 we increased portfolio liquidity and deliberately held higher than average cash balances. We recently began reducing these cash balances in favour of short-duration high quality fixed income opportunities, including floating rate bonds as the public fixed income asset classes finally began to offer some attractive yields.

On the negative side of the ledger equities were the principal detractor. A modest skew to growth and technology stocks further detracted from performance, with the majority of client equity allocations down around -21% for the year which compares to down -18.4% for the MSCI World AC Index in USD terms. Portfolios did benefit from an allocation to energy stocks off the back of reopening demand and a squeeze in energy supply (more on this in the portfolio update section).

Our private equity performance was largely flat and venture capital saw marginal mark-downs. We would anticipate further convergence to public market pricing in 2023. The net result was most portfolios were modestly down in the negative mid-single digit range (-4 to 6%) which compares to portfolio benchmarks being down -10-12%.

Whilst never pleased to report a down year, we take some comfort that despite very adverse conditions we have kept losses manageable. Protecting capital in these more difficult environments is absolutely crucial to building long-term wealth because it allows the portfolios to compound off a higher base usually when opportunities are at their most attractive.

As per our usual format we will spend the next few pages discussing the path ahead as we see it and what changes we will be making to our portfolios going forward.

OUTLOOK FOR 2023

Last year we didn't find too many experts predicting that by the end of 2022 we would have:

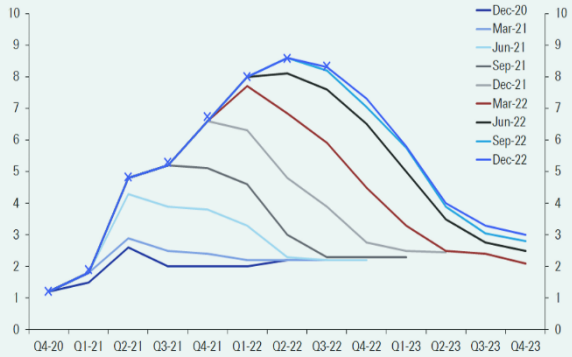
1. The US Federal Reserve embarking on the fastest tightening cycle in 40 years raising rates to 4.25%
2. Inflation hitting 40-year highs of 9% in the US and low double digits in the UK/EU
3. A -19% decline in the S&P 500
4. A new record low in the GBP/USD exchange rate, and
5. 3 different prime ministers in the UK!

The above points are just a reminder that extreme and unpredictable things happen more frequently than we anticipate. Since founding Capricorn Private Investments in 2017/18 we have had a global pandemic, followed by an unprecedented amount of stimulus, followed by a large-scale conflict on European soil between two major trading nations and then multi-decade high global inflation. Whilst we lay out some of our thinking on the path ahead, it is important to remember than any number of unpredictable events can cause a forecast to become irrelevant. That is why we will always strive to build resilient portfolios that can withstand different environments giving us the opportunity to reposition accordingly.

What is the outlook for inflation?

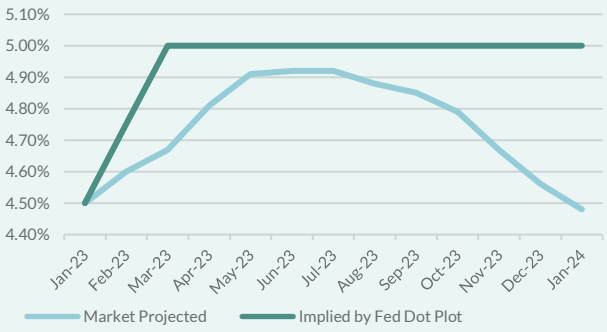
This is probably the key question entering 2023, much as it was a year ago. Interestingly the market consensus was consistently wrong about inflation – suggesting an anchoring to the recent past era of low inflation. We also see this continuing today with the market pricing in a drop in interest rates from the middle of next year in anticipation of lower inflation, though this is in complete contrast to the FOMC's communications.

Fig 3: Consensus expectations for inflation consistently over-estimated how quickly inflation would come down



Source: DB, 2022 Review, Jan 2023

Fig 4: Interest rates are expected to decline from mid-2023



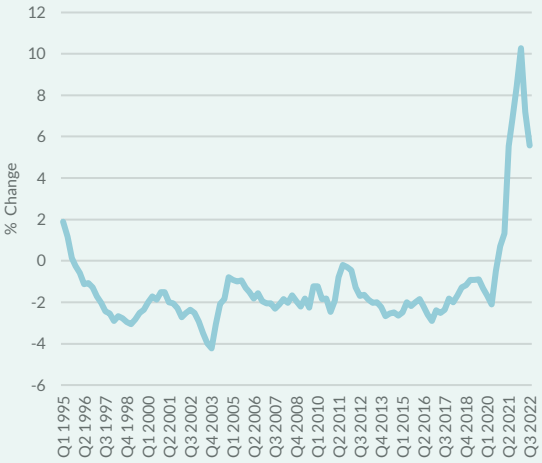
Source: Refinitiv, Internal

Ultimately the driver of inflation has been simply "too much money chasing too few assets" mainly off the back of Covid stimulus. However, we view there being some key regional differences and some short and long-term factors in play.

Starting in the US, Covid fiscal stimulus amounted to ~30% of GDP (Source: IMF). This compared to 2009 when post GFC fiscal stimulus amounted to 5.5% of GDP. This unprecedented delivery of cash to households, at a time when supply chains were disrupted and many people were unemployed, naturally led to a huge demand spike and a subsequent price squeeze on goods.

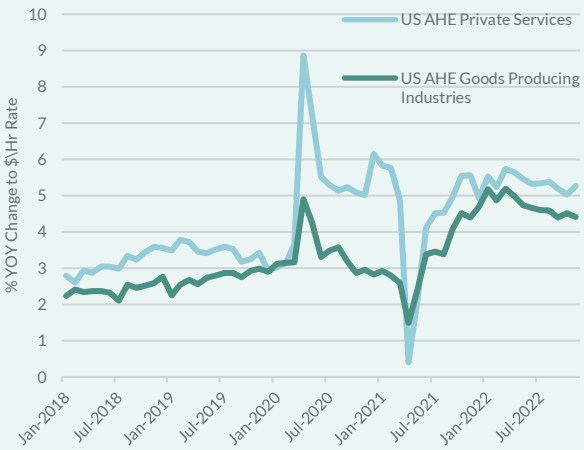
Goods price inflation (which had been negative for most of the last 20 years) has since moderated as supply chain disruption has come down, as evidenced in Fig 5. However, from this initial squeeze on goods we have now seen a migration of inflation into the service sector, which is much bigger than the goods sector (80% of the US economy vs 20% in goods). This will be much harder to dislodge, as the primary driver of service inflation is wages.

Fig 5: US Durable Goods Price Inflation, 1995 – 2022



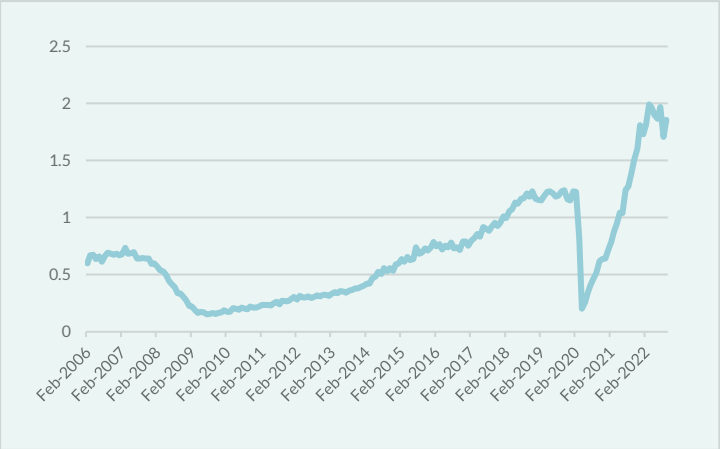
Source : Refinitiv

Fig 6: US wage inflation – services versus goods sectors



Given that US unemployment remains very tight on almost any measure, labour market shortages are the main obstacle facing the Federal Reserve to achieve its goal of 2% inflation. Our sense is that these interest rate hikes take substantial time to play out. It is well documented that interest rate sensitive sectors are slowing down rapidly, such as housing and cars. We are now starting to see lay-offs pick in large cap tech and banking, though these are small unwinds relative to the significant hiring that recently took place in these sectors. Eventually unemployment will start to creep up, but it could quickly accelerate as we have seen in the past if the economy meaningfully decelerates.

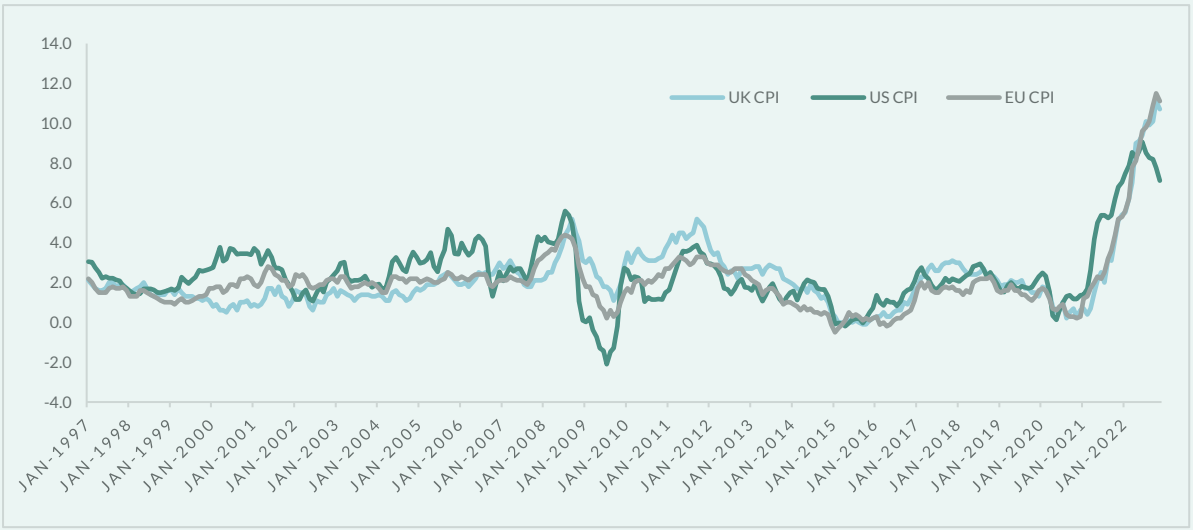
Fig 7: US labour market tightness expressed in vacancies per unemployed person



Source: Refinitiv

US inflation has peaked and is now clearly on the way down. The signs are that demand is now cooling and the rate hikes have had the desired impact. We still, however, see a very tight labour market and this will make it challenging to achieve the desired "soft landing" of a decline in inflation to 2% and no material increase in unemployment.

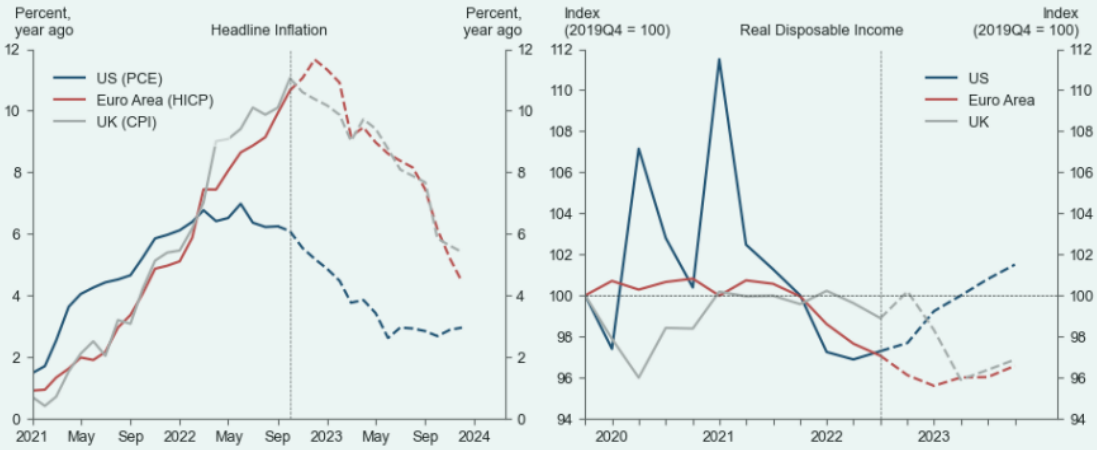
Fig 8: CPI Inflation (%) in US, EU and UK



Source: Refinitiv

In Europe we see a more difficult picture. The recent CPI inflation prints are of a larger and longer magnitude to the US and the drivers are more problematic. The dependence on Russian energy has uncovered government thinking as woefully short-term. This has left the European economy in a very difficult position where the cost of energy increases has resulted in a material decline in real living standards as shown by the GS research below.

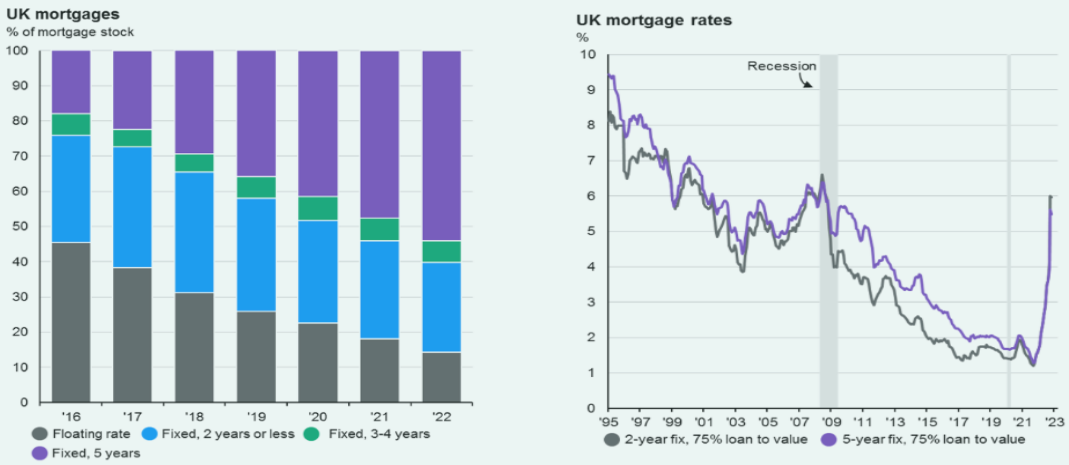
Fig 9: The energy price shock in the UK/EU is much worse than in the US.



Source: GS, Q1 2022, dashed lined indicate GS forecast

There is also great sensitivity in the UK (and Europe) to higher mortgage rates because most borrowers only borrow for 2 to 5 years. While mortgage arrears do not yet appear to be showing any signs of rising (under 1% of outstanding[1] loans), the data is lagged and around one third of UK homeowners have fixed rate mortgages expiring within the next two years which will need to be refinanced at materially higher rates.

Fig 10: UK mortgage stock and change in UK mortgage rates



Source: JPMAM, Dec 2022

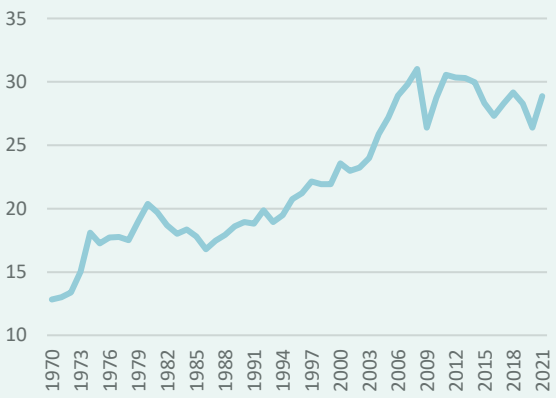
[1] Mortgage Lenders and Administrators Statistics - 2022 Q2 | Bank of England

UK mortgage rates hit 6% in November though they have since moderated to 5%. The BoE is constrained in how far it can go without risking a banking crisis. Therefore, our view is that rates will not be able to rise much higher than markets anticipate in the UK, and likely the "pain" will be taken via ongoing higher inflation and a weaker currency unless difficult-to-implement structural reforms which promote higher growth are made (and these would take some time to have an impact).

Putting some of these short-term issues to one side, there are some global structural issues which could keep inflation higher for longer, and is probably where reality differs most to the market's expectation of a return to the 2-3% "low-flation" era. These would include:

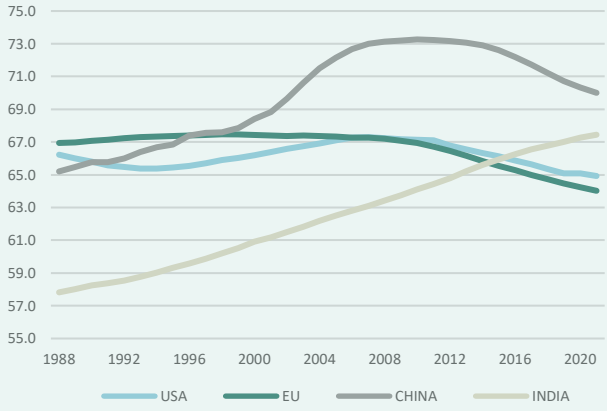
1. A switch to onshoring and re-building of supply chains
2. Less global trade
3. Ageing populations reducing the pool of workers
4. The sheer amount of capex required to decarbonize economies (more on this later)

Fig 11: Exports as a % of GDP have been flat-lining



Source: Refinitiv

Fig 12: Share of working age population (percent)



Source: OECD

Onshoring and more supply chain autonomy will also put upward pressure on prices. This has already begun with the introduction of the US CHIPS and Science Act which aims to specifically increase investment into semi-conductor production – currently close to 75% of global semiconductor production occurs in East Asia. Relocation is likely to come at higher costs, and while some of the impact might be mitigated by moving production from China to India or Mexico ("friendshoring") whatever action is taken will generate frictional costs and put upward pressure on prices.

Our overarching concern is that unless some of these more structural issues are addressed, inflation is at risk of climbing again after an initial fall. It may not need much to light the blue touch paper again to set off another inflation spiral as we have seen before in the 1970s where inflation took off in repeated waves.

How deep will the coming recession be?

The Conference Board indicator for a US recession within the next 12 months hit 96% in August[2]. From what we can tell most commentators are not expecting a severe recession, and market pricing indicates a soft landing. Valuations in most risk asset markets are close to long-term averages rather than a discount to reflect recession risks.

What we can see from the past is when things crack it happens quickly and unexpectedly. Fast interest rate rises also increase the risk of something severe occurring that no one expects, and contagion can happen really quickly (moving fast and break things?). We saw a small glimpse of this in the UK with pension funds running out of liquidity and unable to fund losses on derivatives due to lower gilt prices (which were the collateral). The negative spiral was only arrested via yet another central bank liquidity intervention.

It is entirely possible that a soft landing of some kind does occur, but it would take quite a bit of luck to get there. We would expect that the European/UK recession to be worse than the one in the US. Various emerging economies will also suffer, so our view is the risks are not yet fully discounted in most investment asset classes.

Fig 13: Economists have been downgrading GDP consistently all year but earnings forecasts have lagged

Source: Apollo Weekly Watch, Dec 2022

What about the impact on markets?

Going into a recession one would expect corporate earnings to suffer in 2023. The average decline in earnings during a recession is -18% for the S&P 500 since 1900. If we exclude 1929 and 2008 this moderates to -8.4%[3]. Given current multiples are around the long-term average it would be unusual not to see some downward pricing adjustment to reflect this risk – our thinking is captured in the sensitivity table below which indicates that a -10% decline in earnings while maintaining a 17x multiple sees the S&P fall to 3400 from 3800 at the end of 2022.

[2] Source: https://www.conference-board.org/
[3] Source: www.schroders.com Dec 2022

Fig 14: S&P 500 price estimates based on earnings changes for 2023

EPS Scenarios	P/E Scenarios					Current PE: 17
2022 EPS (USD 224)	20	19	18	17	16	Average
+5%	4704	4469	4234	3998	3763	4234
0%	4480	4256	4032	3808	3584	4032
-5%	4256	4043	3830	3618	3405	3830
-10%	4032	3830	3629	3427	3226	3629
-15%	3808	3618	3427	3237	3046	3427
Average	4256	4043.2	3830.4	3617.6	3404.8	3830
Current S&P 500: 3808						

Source: Refinitiv, Internal

Conversely a recession could end up being good for bonds, but we won't know unless inflation falls too and gives central banks the scope to reverse course. The danger here is that we end up with a kind of stagflation which means risk assets perform poorly, but also bonds struggle too in a repeat of 2022.

INVESTMENT THEMES

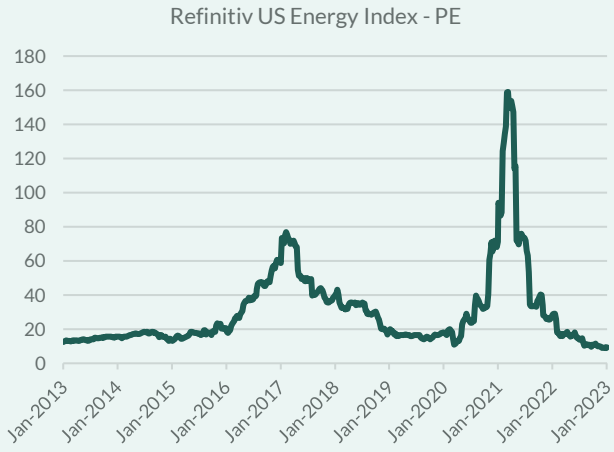
Energy and commodity equities

We remain bullish on energy stocks. Whilst oil and gas stock prices have risen, sector multiples remain at historically low levels. Low multiples do not incentivise future investment, and our expectations are that the companies will potentially buy back debt and equity as cash flows improve.

Fig 15: Energy shares were up more than 50% in 2022 but the multiples remain in single digit territory

Source: JPMAM, Dec 2022

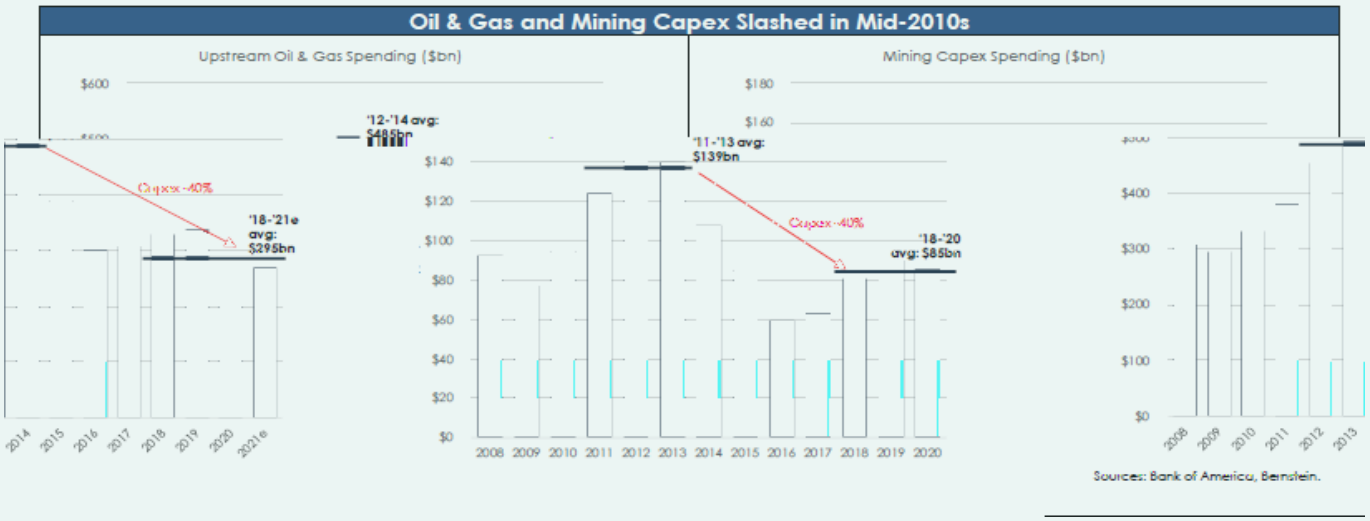
Fig 16: Multiples for energy stocks remain depressed as earnings grew with share prices



Source: Refinitiv

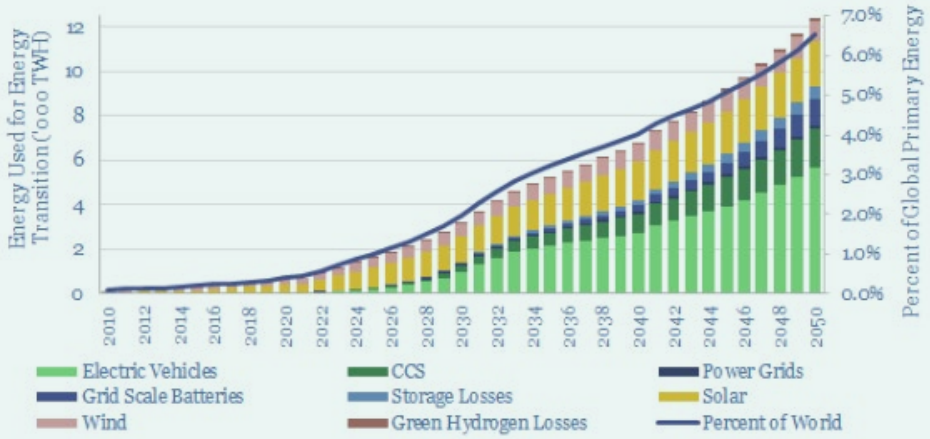
We also observe there has been a significant drop in investment in both new energy and materials production over the last decade despite the expectations of a higher demand. Our thesis is that there will be continued upward pressure on commodity/metals prices because of this supply tightness. Although extraction will require capex, this should result in greater profits for companies operating in this sector.

Fig 17: Oil & Gas and Mining capex was heavily slashed in the last 10 years



Source: Soroban Capital Partners, Q1 2022

Fig 18: Significant energy is required to produce the renewable infrastructure needed



Source: Thunder Said Energy

In addition, should China's re-opening be successful we would expect that this could provide further upward price pressure across the energy and metals complex.

Growth equities

Growth related equities have borne the brunt of the market correction in 2022, and we believe it would take at the very least a pause in the interest rate cycle for growth equities to start to recoup some of their lost ground. Clearly the excess was extreme in some parts of this space (SPACs and so forth), and as predicted most of this has been unwound.

As mentioned in our summary section, we have some exposure to growth equity via biotech and emerging tech specifically. Both positions were moderately sized, and we remain optimistic of turnaround for those companies performing on track.

Within the biotech sector valuations remain very cheap on a historic basis. The M&A cycle has started to turn with recent activity and the major pharma companies are flush with cash from the Covid vaccine profits bonanza. Given some of these positive catalysts we continue to hold our position in this sector where we have exposure in the venture capital area as well.

Fig 19: Percent of Biotech companies trading below net cash

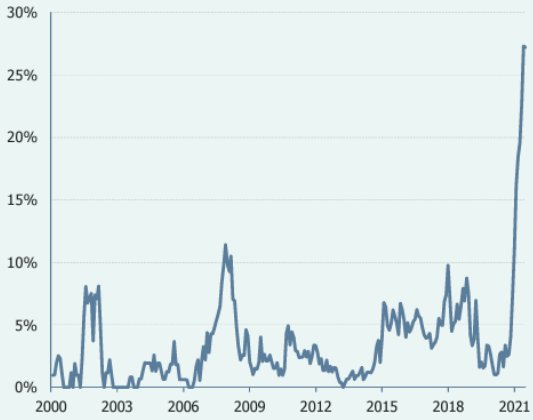
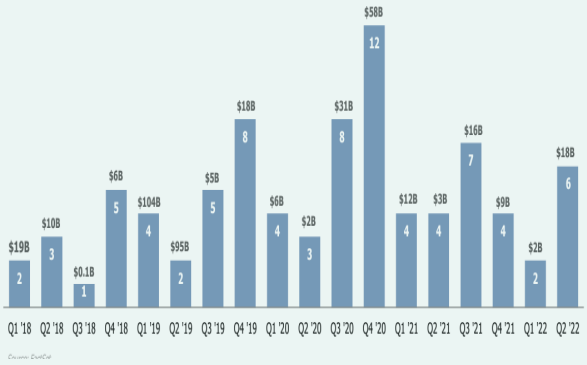


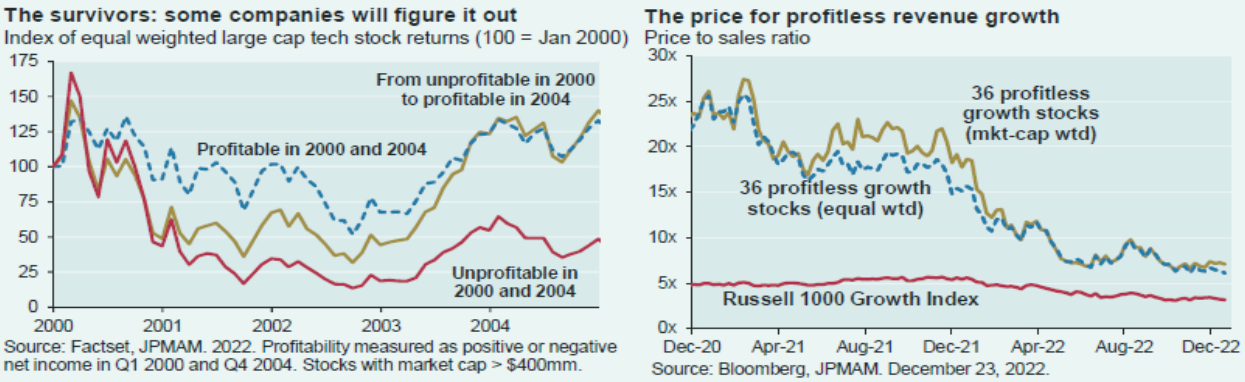
Fig 20: Announced Public BioTech M&A



Source: Biotech Growth Trust, June 2022

Within emerging technology there will undoubtedly be some strong winners coming out of this episode of consolidation. Companies who are market leaders, who do not require further funding and have achieved a degree of scale where incremental margins have the potential to be very high should do well from this point onwards. Michael Cembalest of JPM references this phenomenon from 2000-2003 as depicted in Fig 21 below which shows that those companies which managed to convert losses into profits in the aftermath of the tech bubble saw their share prices catch up with those stocks that were already profitable. Therefore, there should be some good opportunities for skilled managers to benefit from picking the potential winners that emerge from the inevitable consolidation.

Fig 21: In the aftermath of the tech bust in 2000 share prices of companies which turned a profit eventually caught up with the share price performance of profitable companies



Source: JPM, Eye On The Market, Jan 2023

Blockchain Enterprise

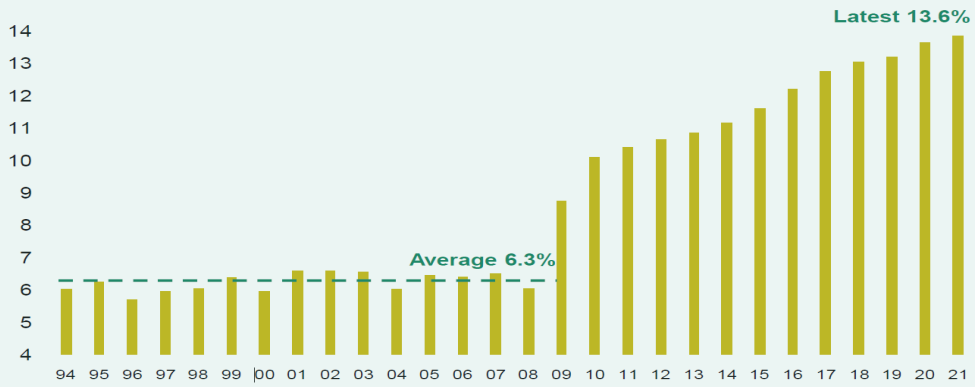
Last year we made an initial investment into a blockchain enterprise fund. Our thesis was focussed on the likely use cases to emerge from distributed ledger technology which we see being applied in fintech, compliance, logistics and various themes within the gaming industry. We had deliberately avoided coins, tokens and investment in the trading of them, believing these to be purely speculative trading instruments with no intrinsic value. We partnered with a fund which has compliance and regulatory alignment at the heart of their investments. Our view is that post FTX crypto will not go away, but there will be greater motivation for the sector to fall under the scope of regulation much like other financial businesses. Once this happens it will be much easier to disseminate the benefits of blockchain tech to broader society and we expect to hear more about stablecoins, central bank digital currencies and settlements of traditional securities etc on blockchain in the coming months among other use cases.

Fixed income has some income again

The one area we have added to in recent weeks has been fixed income as yields have finally become more attractive. Most of our exposure has been in high grade short duration investments and floating rate securities given our "higher rates for longer" point of view. The inversion of the curve means that longer-dated fixed income offers very limited margin of safety albeit there has been some improvement versus recent years. For example, a 10-year Treasury yielding under 4% is still well short of inflation and would only require an increase of 0.5% in yields to result in a negative annual return.

Within fixed income we have allocated to European bank AT1s. We have tracked this sub-asset class for years and never allocated given the high duration and low yields on offer and potential (albeit it very low risk) for sub-ordination and write-offs. As a reminder AT1s, or Additional Tier One capital, are junior bonds that behave like equity if a bank experiences a large erosion of its capital base. Since the GFC banks have been made to be much more resilient and can weather very significant losses before their capital is eroded. The nature of the businesses has changed as well with much less focus on speculative balance sheet investments and more on wealth management revenues and transaction fees and other more stable income sources. Yields were ~4% at the end of 2021 and we invested in the 11-12% area in Q4.

Fig 22: European Banks Tier 1 common equity ratio has significantly risen since 2008



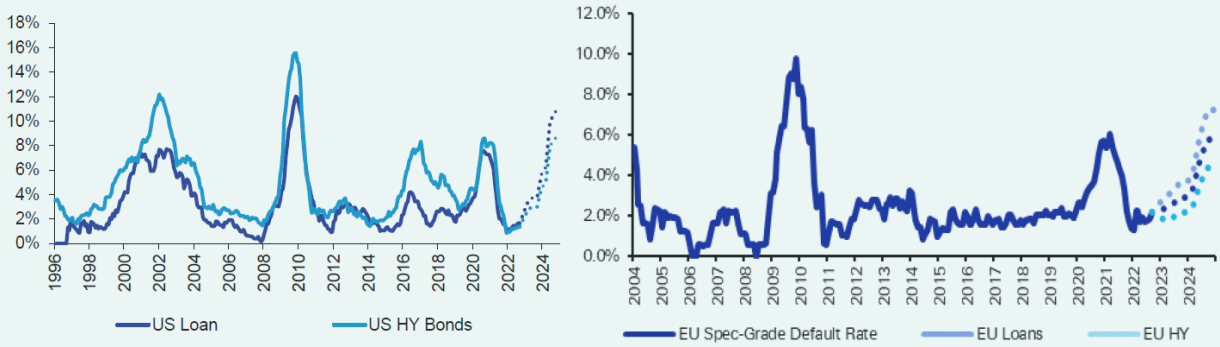
Source: UBAM, July 2022

Distressed opportunities in private / illiquid markets

While we have seen a return to yield in public fixed income, we have also seen a return to better conditions in the private credit markets. Private loans have grown quite significantly in recent years and from what we can tell they are holding up quite well. This new environment creates opportunities to lend at attractive rates of return and with better / stronger covenants than previously. Private credit strategies now form a very useful anchor allocation in our client portfolios going forward as we expect interest rates to remain high. Most of our managers can secure interest rates in the 8-12% range with good covenant packages, floating rate linked at modest loan to values (50-60%).

There will also be some opportunities in the distressed and turnaround areas as well, as defaults emerge, however, we think this may take some time given that many companies extended their financing in better times and are still likely to have some runway yet.

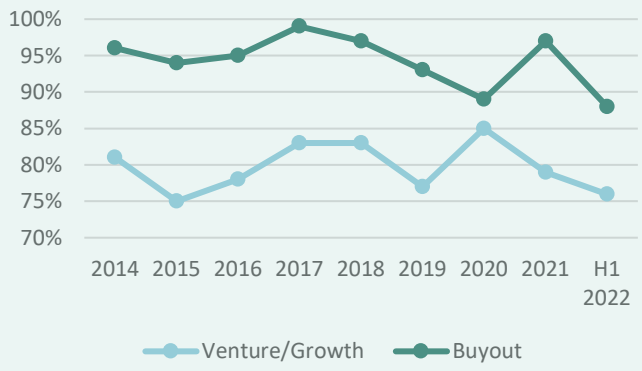
Fig 23: DB forecast defaults to rise in 2024 as more debt maturities come up for refinancing



Source: DB, 2023 Outlook

We also see good opportunities in private market secondaries. Private markets AUM has increased significantly in recent years as investors sought out higher returns, but it is also likely to have led to a few missteps along the way. Usually in times such as these some investors need to de-risk and increase liquidity leading to opportunities to buy high quality portfolios at increasing discounts to NAV.

Fig 24: Secondary pricing as a % of NAV



Source: Prequin

Deal flow has dropped precipitously in 2022 which is likely to drive these discounts deeper. Data is not available for H2 2022, but comparing H1 2021 to H2 2022 global VC funding fell by -27% and European VC suffered a greater decline of -38%[4]. Without doubt these numbers deteriorated further in H2. Buyout funding also dropped significantly from $284B in H1 2021 to $138B in 2022 - a fall of 52%[5].

So, the outlook is challenging for recent private vintages, however, this does look like a good entry point for investors who are able to maintain private programmes and also increase exposure to high quality opportunities via the secondary market. This will be one of our areas of priorities in 2023.

PORTFOLIO POSITIONING

Given our outlook we had avoided rebalancing into equities in 2022. We still think valuations need to come down to reflect higher bond yields and lower earnings, implying approximately 3000-3250 on the S&P 500 per the above table. We are likely to remain underweight until this point is reached unless the economy surprises to the upside.

In the last quarter of 2021, we exited most of our high yield exposure (except short duration) and in January 2022 we exited gold. We have continued to build up our private credit allocations and this has worked well as they are largely short duration or floating rate in nature so have benefitted or will benefit soon from the market repricing of interest rates, albeit higher defaults may also be a risk.

We continue with clients' private market programmes as discussed, with a focus on secondaries given the excellent risk adjusted returns available.

[4] Source: www.altfi.com
[5] Source: Preqin

Fig 25: Model allocation for a USD, non-taxable client

Asset Class	Beginning 2022 Asset Allocation	Beginning 2023 Asset Allocation	Change
Cash	3%	2%	-1%
Government Bonds	0%	0%	-
Credit (Liquid)	3%	6%	+3%
Credit (Private)	8%	10%	+2%
Absolute Return	20%	18%	-2%
Long-Short Equity	5%	5%	-
Equities	37%	34%	-3%
PE/VC	15%	15%	-
Real Estate	5%	5%	-
Tail Risk	4%	5%	+1%
Gold	0%	0%	-
Total	**100%**	**100%**	

KEY TAKEAWAYS

1. A recession is almost a given based on market indicators but most risk assets are pricing in a relatively soft landing, with strong expectations of a pivot from central banks as inflation declines. We think the risk is skewed to inflation being stickier than the market is discounting. Therefore, our portfolios will favour shorter duration and higher quality assets. If we are wrong and soft landing materializes our equity allocations will recover quite strongly.

2. There remains longer-term upward pressure on both energy and commodity prices, due to a lack of investment and increased demand post Covid reopening. China re-opening could add further upward price pressure in 2023. We continue to hold this particular skew in portfolios.

3. We are seeing pockets of stress in private markets, opening good opportunities in private debt to lend to or against quality assets with superior terms, private equity secondary interests and what we expect to be an emerging distressed debt opportunity later in the cycle, most likely in Europe given the weaker economic backdrop.

READING AND PODCAST LIST

Given the positive feedback on our reading and podcast list from last year we have decided to continue with this. So below we share some of the team's favourites from 2022:

Books

1. **How the World Works by Vaclav Simil.** This really is a must read for those who want to have an appreciation of the sheer scale of resources that are used by society to carry on its everyday business and in particular the huge challenges we face we in reducing our use of fossil fuels. The book is not intended as fatalistic, but to convey to those of us who are less connected with the physical world due to our work (i.e. desk jobs) what the above requires.

2. **Empire of Pain by Patrick Keefe.** This is the story of the Sackler family, the family behind Purdue Pharma which is widely known to have propagated Opioid epidemic in the United States. It starts right at the beginning and how humble beginnings and intentions were quickly abandoned in the pursuit of profit. The story is also serialized in the excellent Dopesick, starring Michael Keaton on Disney +.

3. **Power of Geography by Tim Marshall.** Last year we mentioned Tim's first book Prisoner of Geography. This sequel delves into how specifically nine countries, via their geographical position in the world yielded specific political advantages.

4. **Talking to Strangers by Malcom Gladwell.** The author needs no introduction. Drawing on the psychological trait that humans are generally over-trusting, Gladwell aims to explain a variety of events including why Hitler was underestimated before it was too late, the Madoff Ponzi scandal, the trial of Amanda Knox, among others

5. **The Cult of We by Eliot Brown and Maureen Farrell**. Building somewhat on the above book, just how did Adam Neuman manage to persuade a number of experienced investors that a real estate leasing company was something else?

Podcasts

1. **Capital Allocators: The power of quitting by Annie Duke, Sept 2022.** Duke discusses her recently released book under the same title. The premiss is that while sticking to a task/endeavour is most often considered a virtue, we need to be better at knowing when to quit in all parts of our lives – e.g. when should an allocator redeem their investment in an underperforming manager, when should climbers turn back from climbing Everest when they are behind schedule.

2. **Invest like the best with Aswath Damodaran – Making sense of the market, May 2022.** Aswath is a guru of valuation and his two and half hours distilling his thoughts on current investment landscape were grounded in pure common sense. He covered topics such as how the majority of investors have only known one environment, how to invest in an inflationary period, some of the problems with active management and other insightful topics.

3. **Invest like the best with Eric Mandelblatt, - Investing in the industrial economy, March 2022.** Eric is the founder of Soroban Capital Partners, a $10B private investment firm. He highlights some of the issues raised around the importance of materials and energy to the economy as we move to an era of decarbonization.

4. **Diary of a CEO with Tim Spector – Shocking new truth about weight loss, January 2023 –** always relevant in a January Tim's podcast busts various dieting myths and conventional wisdoms based on solid academic research and what healthier changes can people make on a sustainable basis.

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