C8 USA Market Update March 2023

Don’t fight the Fed

Don’t believe them either

Powered by Boutique CIO, AK Global Asset Management

Arun Kaul, CFA, CIO C8 US and AK Global Investment Management

Executive Summary

- Inflation expectations and break-evens are converging towards Fed's long run target

- Futures indicate Fed funds rate to reach over 5% by mid-year, in sync with Fed forecasts
    - Post Powell's February 1 presser, Fed has finally convinced fixed income markets of its intentions to continue raising rates
    - Post February 1, 1-year and 2-year rates have moved higher by 35bps and 50bps respectively
    - Fed futures markets are now pricing in rate hikes that exceed the Fed's own forecasts

- Fed funds rate above Core PCE for first time since inflation surge began post covid

- Long bond yields priced at recessionary levels offering moderate to less than fair value
    - Strong recession indicator – inverted yield curve between 3s/10s - began signalling in October 2022

- Quarterly earnings are negative for Q4 2022 and forecast to contract again in Q1 2023 and Q2 2023

- Asset Class Valuations – TINA is no more with 5% Fed funds rate looming

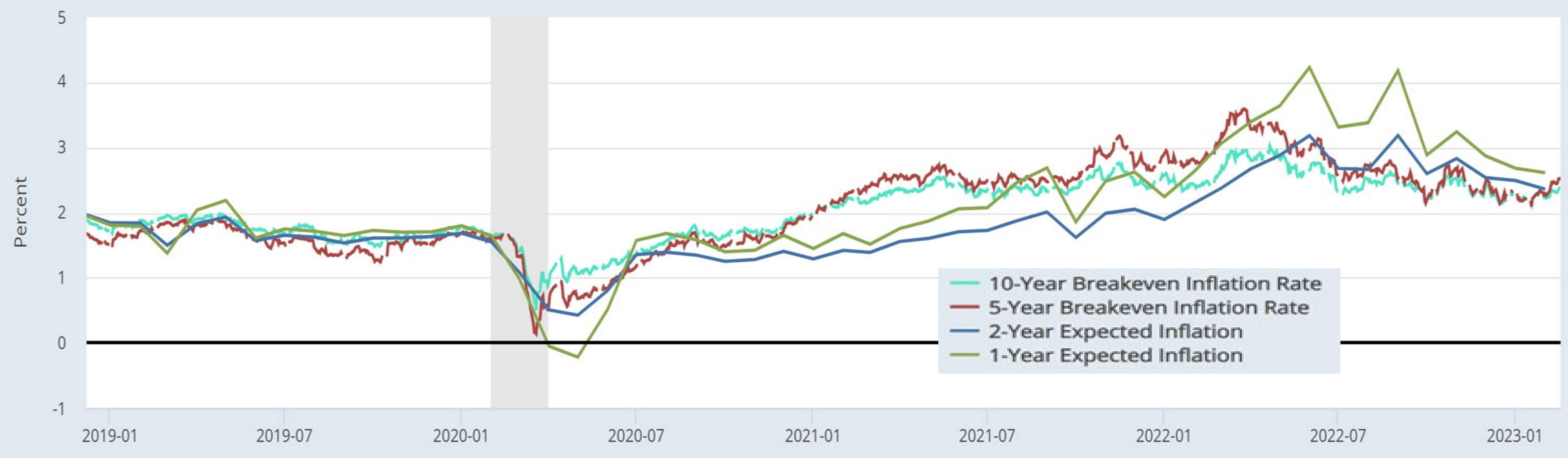
- S&P 500 likely over-priced for a soft landing, difficult risk reward versus both short and long rates

- Additional Portfolio Considerations: Gold, International, Growth Value, Small Cap, Volatility

Rates and Credit

Inflation expectations and breakevens converging towards Fed's long run target

- Inflation forecasters largely believe the Fed and expect inflation levels to return to target within 1 year.
- Inflation expectations 1Yr forward are at 2.6% and 2Yr forward at 2.4%.
- Breakeven inflation levels 5 and 10 years forward are at 2.5% and 2.4%, respectively, _*though have risen in the last few weeks.*_
- The Fed forecasts for core PCE are 3.5% for 2023, 2.5% for 2024 and returning to 2.1%, its long run target, by 2025.



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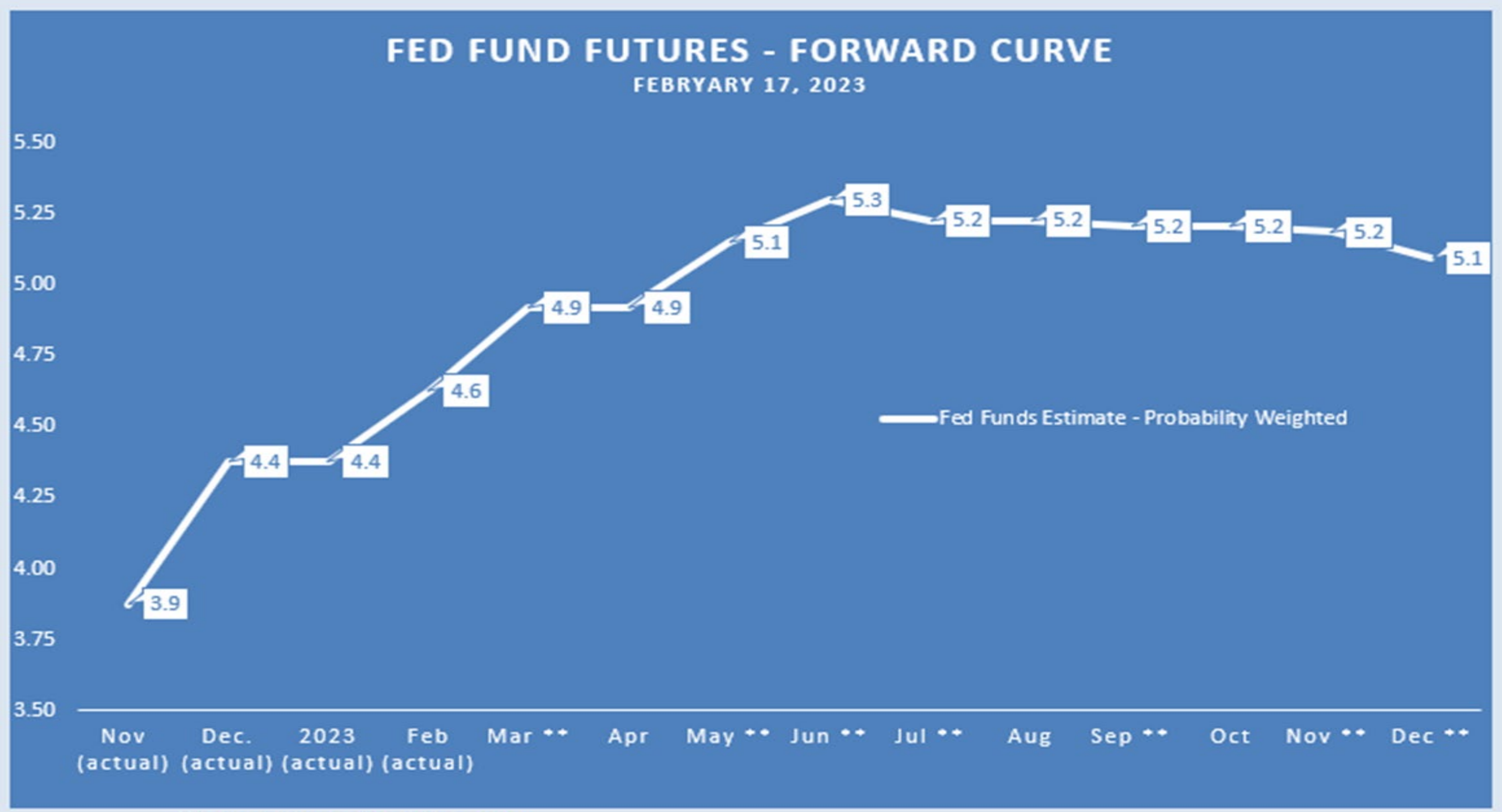
Futures indicate Fed funds rate to reach over 5% by mid-year, in sync with Fed forecasts

- Markets have spent the last several months not believing the Fed and its forecasts. The Fed, in Dec/22, in its most recent summary of economic projections, indicated a terminal level near 5% by year end 2023.

- Over the past two months, investors were pricing in rate reductions and a pivot by H2/23

- Today participants are forecasting rate hikes in tandem with Fed forecasts and Fed rhetoric - pricing in rates above 5% by June '23 and expecting those levels to persist towards year end.

- Be aware, Fed will likely pivot quickly away similar to Q4 2018 reversal from 'we are on autopilot autopilot'.



** indicate Fed meeting during month

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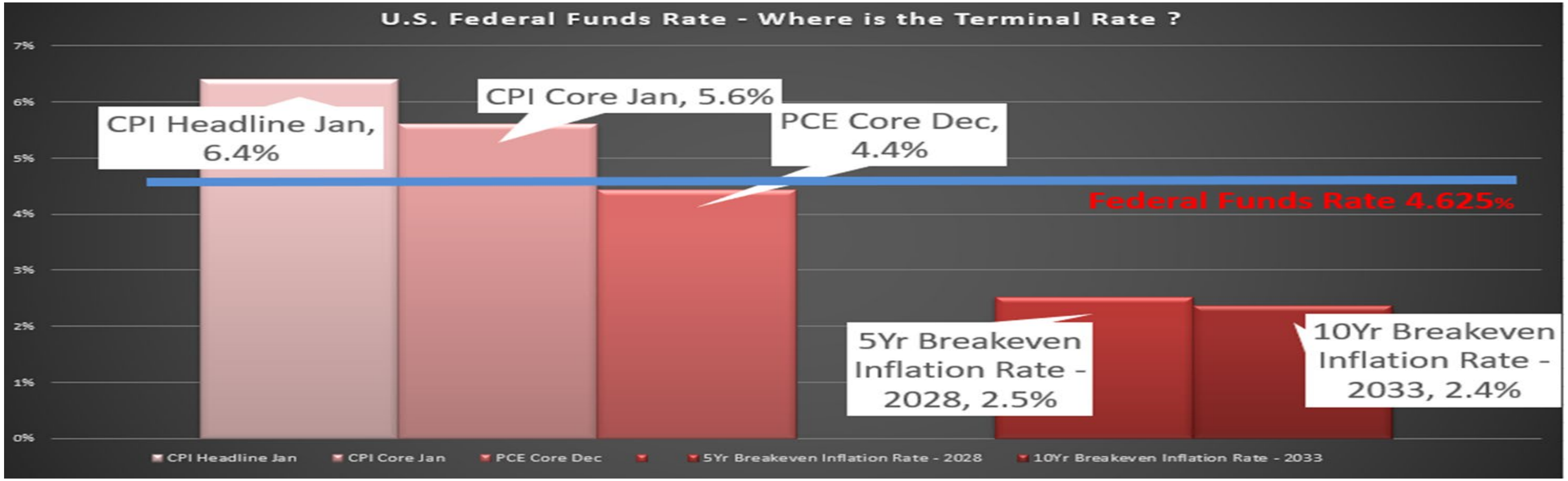
Fed funds rate above Core PCE for first time since inflation surge began post- COVID

- Fed funds rate now yielding 4.625% versus Core PCE, the Fed's preferred measure, at 4.4%.
- Fed funds rate is still lagging Core CPI which is running at 5.6% and Headline CPI at 6.4%, the real measure for U.S. households.
- Fed will need clear evidence of Headline CPI falling and remaining below the Fed funds rates prior to any rate reduction cycle.
- Long term break evens indicate rates above the Fed's long run target of 2% - but seem to indicate minimal risks of stagflation or stop and go economic growth.



Source: U.S. Bureau of Labor Statistics for inflation, Federal Reserve Bank of Atlanta, FRED and Factset for yields and breakevens. February 17, 2023

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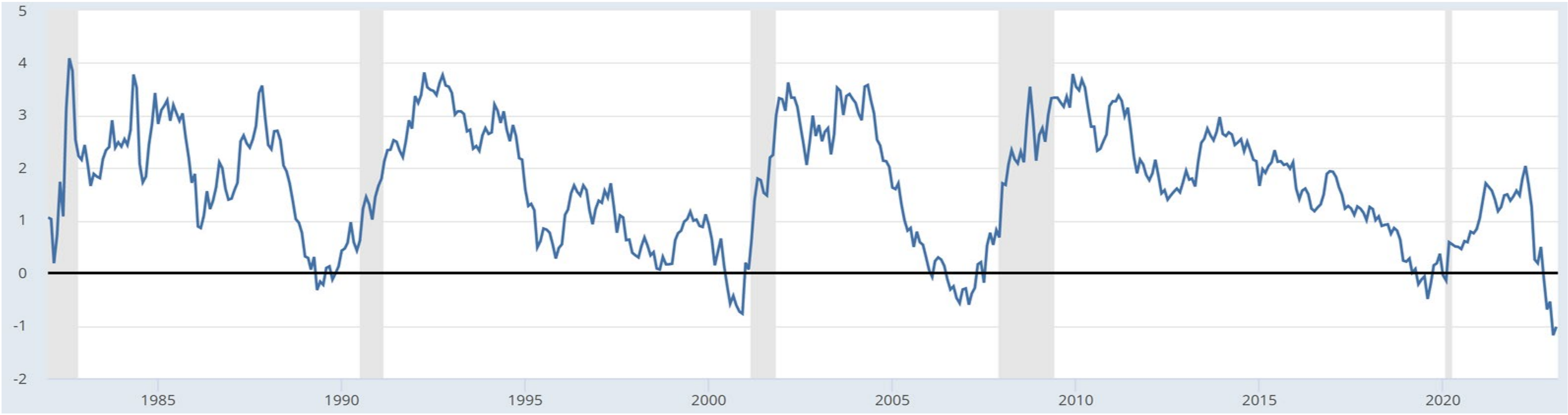
Long bond yields priced at recessionary levels offering moderate to less than fair value

- U.S. 10 Year Treasury yields have risen from 3.5% towards 3.8% in tandem with higher expectations for the Fed funds rate.
- The current yield curve inversion, (as measured by the U.S. 10 Year Treasury minus the U.S. 3 Month Treasury), is most inverted in more than 45 years. Strong recession indicator began signalling since October 2022.
- Long bond investors seem to be pricing in a fast victory over inflation commensurate with an economic recession.
- U.S. 10 Year Treasury *real yields*, based on 5 year breakeven inflation rate are near 120bps above inflation and based on 10 year breakeven inflation rates near 130bps above inflation. In a higher inflation environment, real yields above 150 bps and closer to 200bps provide better risk reward and are closer to long run averages, though last cycle real yields were rarely above 100bps.



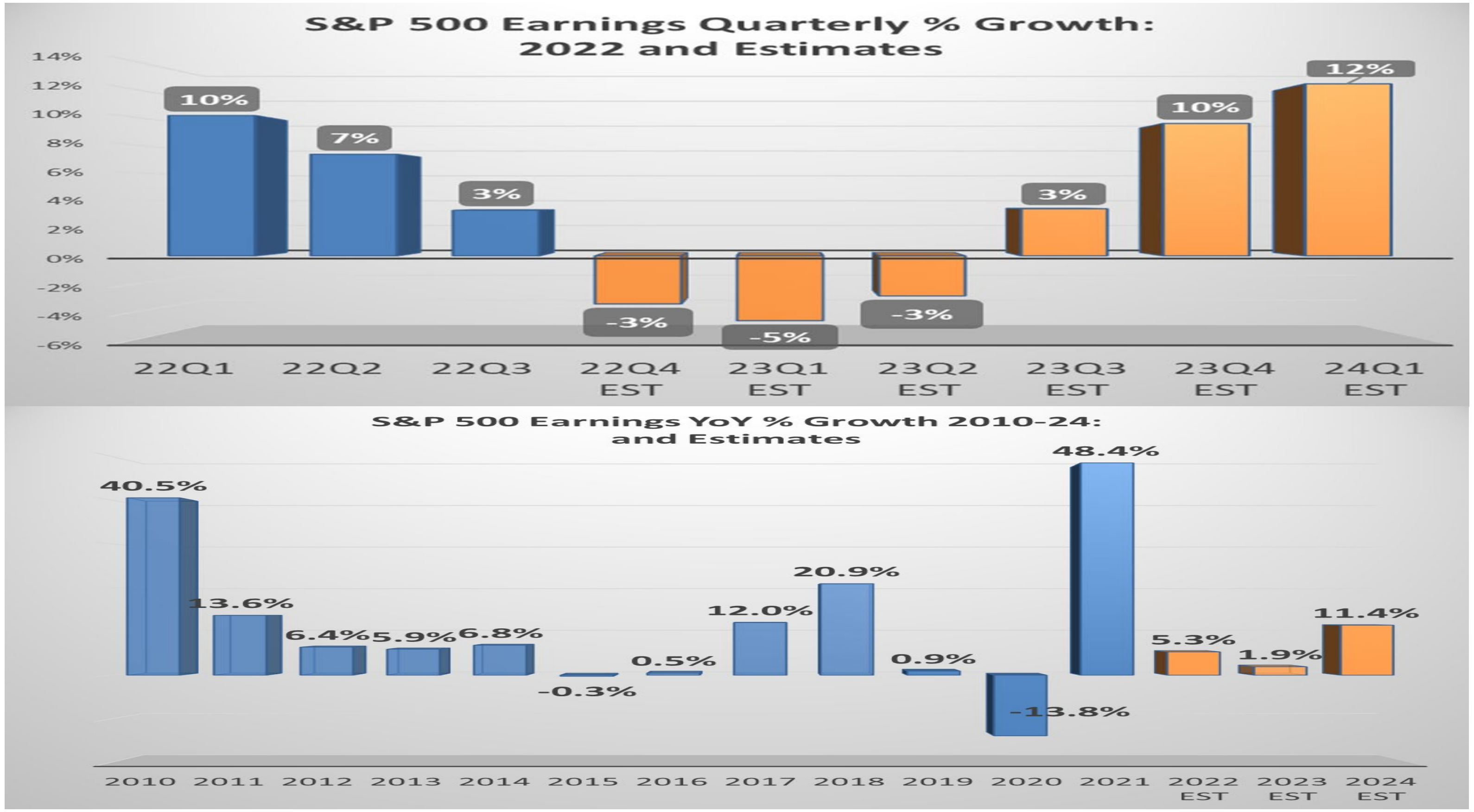
Curve Inversion: U.S. 10-Year Constant Treasury less U.S. 3-Month Constant Treasury

Source: Federal Reserve Bank of Atlanta, FRED, February 17, 2023

Corporate Earnings and Valuations

Quarterly earnings are negative for Q4 2022 and forecast to contract again in Q1 and Q2 2023

- For Q4 2022, SP500 earnings are seen contracting -3% and again by -5% in Q1 2023 and by -3% in Q2. Analyst forecast strong growth in Q4, expecting H2 to propel CY 23 earnings towards a 2% gain for the year.
- An earnings reacceleration in the face of rising rates and a slowing economy seems unlikely. Though a lower USD by Q4 23 will add currency gains (+5%) for multinationals
- *<u>For many firms, Fed policy of lowering inflation will transmit via weaker pricing power and falling margins, most likely leading to lower earnings. This remains a key concern for equity investors for the remainder of this year.</u>*



Source:AK Global Investment Management, consensus earnings data quarterly and CY23/24 Factset | February 17, 2023

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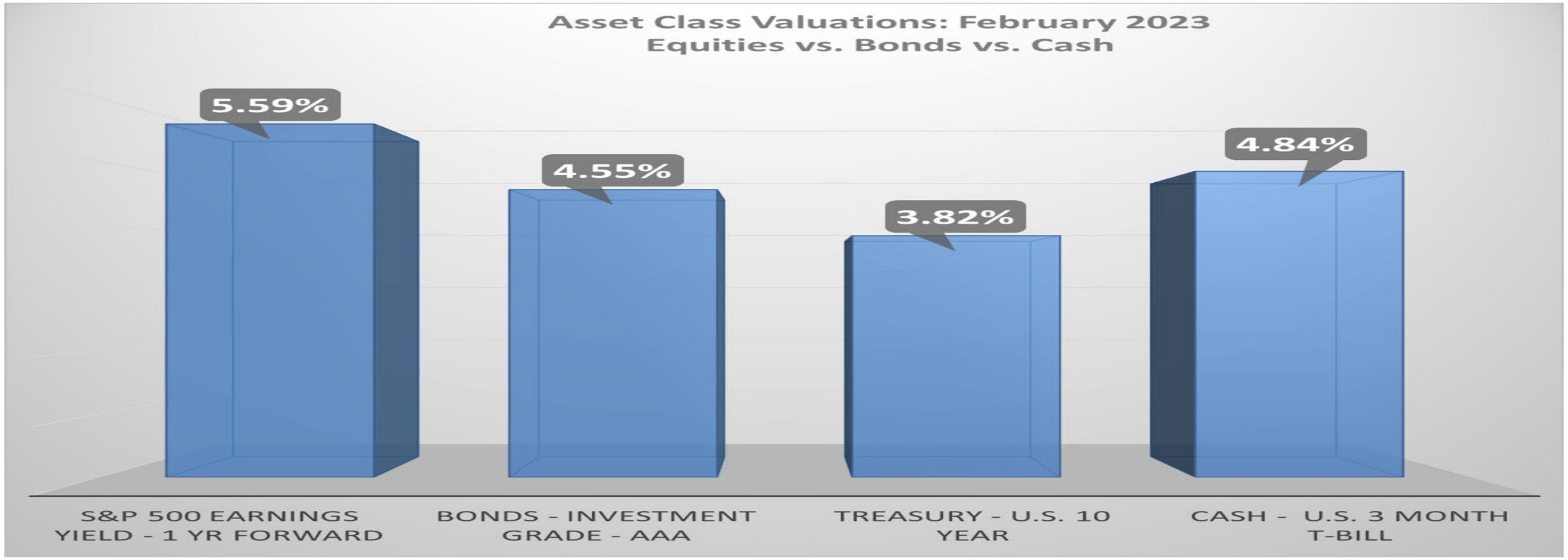
Asset Class Valuations – TINA is no more, with 5% Fed funds rate looming

- With U.S. 3 month to 12 month Treasury Bill yielding 4.8% to 5%, TINA is no more.
- PE multiples near 18x are priced for ‘no landing’ or immaculate disinflation which seems a low probability.
- Risk reward is against equities with S&P500 offering a historically low risk premium versus cash.
- Risk assets from equities to high yield bonds likely need to rerate lower given cash yields at 5%.



Source:AK Global Investment Management, rates Factset and Federal Reserve Economic Database, February 17, 2023

S&P 500 likely overpriced for a soft landing – difficult risk reward versus short and long rates

- Since the market low in October, the SP500 has risen 16%, while earnings have turned negative, earnings growth estimates for CY 23 have been reduced to low single digits and the Fed has raised 150bps with expectations for more.
- This is the largest disconnect between market valuations and earnings and discount rates since the Fed began its tightening cycle.
- Market was pressured as long rates rose towards 4% in October 2022, earned a reprieve when 10 Year Treasuries fell back to 3.4% and is now challenged by both short and long rates.

Source:AK Global Investment Management, based on consensus earnings data quarterly and CY23/24 Factset | February 17, 2023

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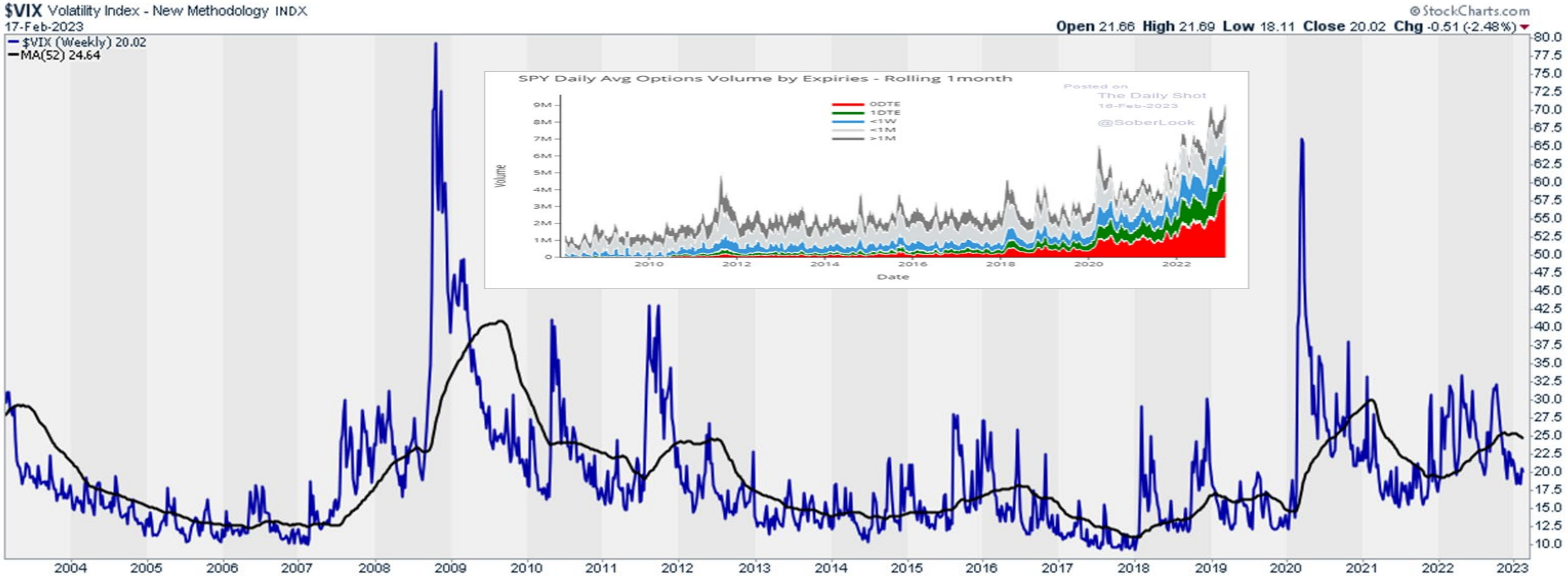
PORTFOLIO CONSIDERATIONS

Option markets see minimal concern with equity market valuations

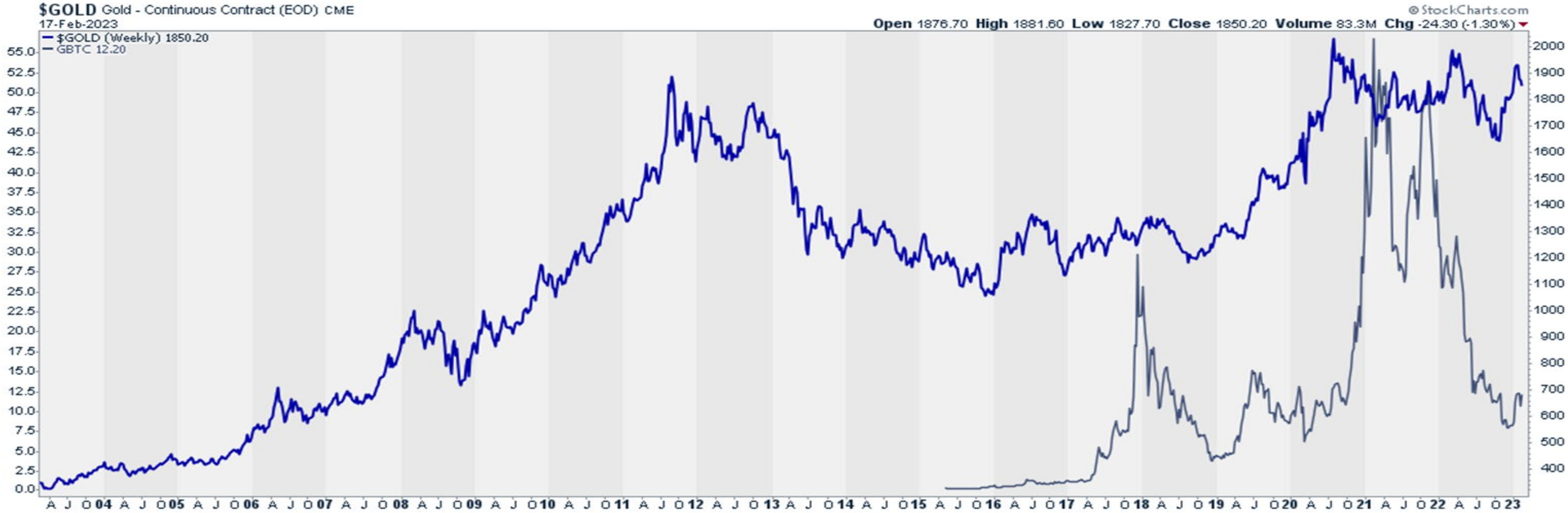
- Current VIX level is near 19, spot on the long-term average.
- While options markets may have changed their stripes with a significant increase in the creation and trading of short term volatility instruments, volatility may be under priced at this levels given the equity valuations or may be subject to more pronounced swings given the higher ratio of short dated instruments



Source: Chart courtesy of Stock Charts, options source Bloomberg, Bianco Research | February 17, 2023

Gold, near all time highs, seems priced for stagflation given rising cash rates

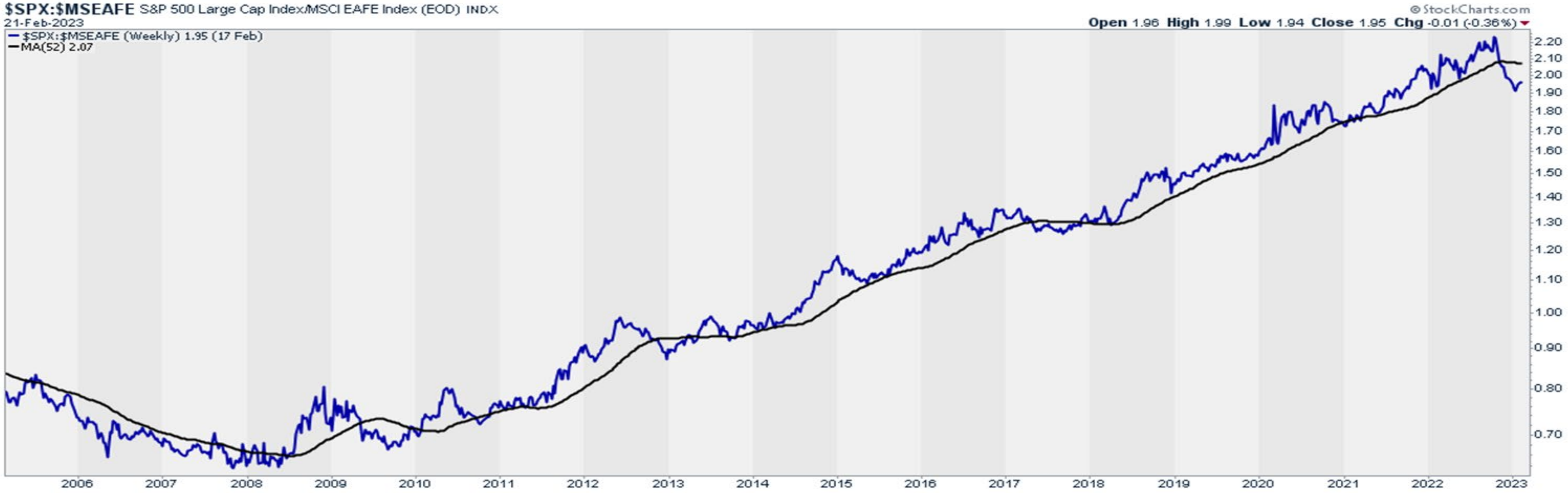
- Gold, left to play second fiddle to crypto over the past several years, may have regained its footing.
- Even with rising cash rates in the near term, Gold could act as a portfolio offset to Fed policy error or as an offset to stop and go inflation.
- Geopolitical backdrop provides further support.



Source: Chart courtesy of Stock Charts | February 17, 2023

Longest period of dominance by S&P 500 versus MSCI EAFE may be ending

- U.S. outperformance of 212% over last 15 years similar to 220% outperformance from 1995-2000
- MSCI EAFE trades at its largest PE discount to the SP500 in almost 20 years.
- MSCI EAFE dividend yield differential near highest in 20 years
- MSCI EAFE holdings skew towards Materials and Financials versus SP500 significant skew towards Technology.
- U.S. under performance going forward likely requires period of outperformance from global energy and commodities.



Source: Chart courtesy of Stock Charts JPMorgan data on PE, dividend yield

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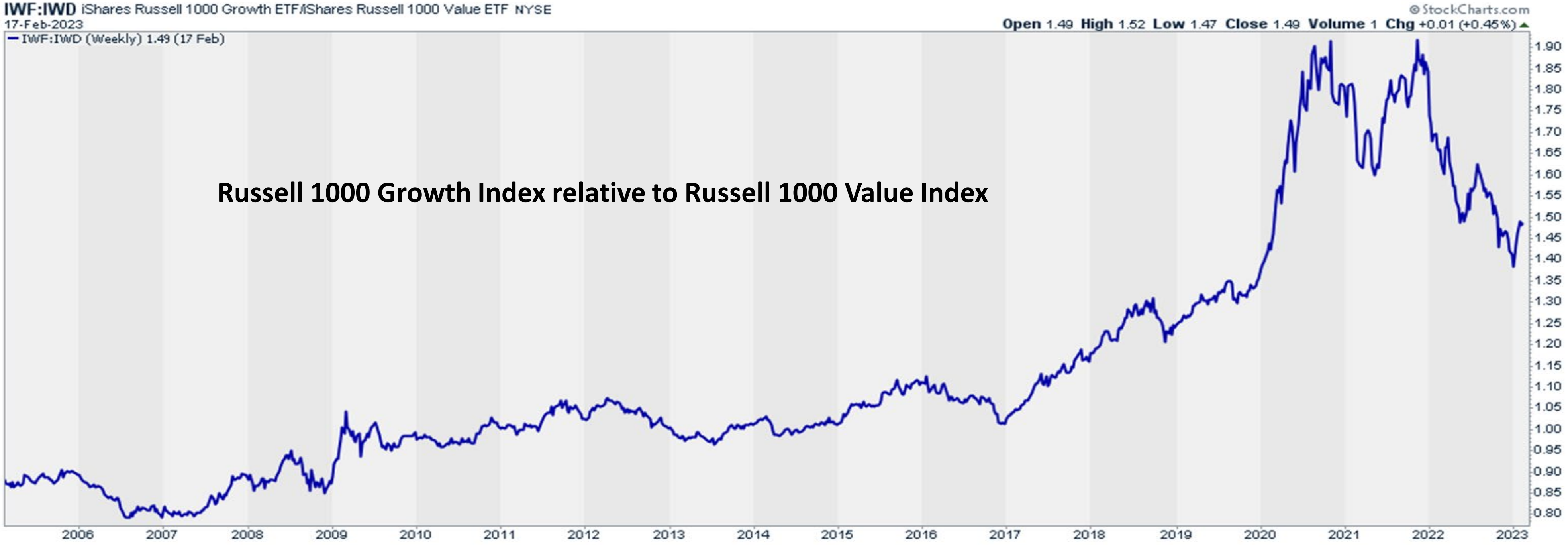
Long period of outperformance for Growth over Value may have ended

- Growth stocks (23x PE) are at a moderate premium to Value (15x PE) versus historic ratios
- Operating margins for growth and value stocks are in line with historic ratios.
- Skew in Growth Index towards top 6 names (AAPL, MSFT, AMZN, TSLA, NVDA, GOOGL) weighted at 33% makes relationship less stable.



Source: Chart courtesy of Stock Charts

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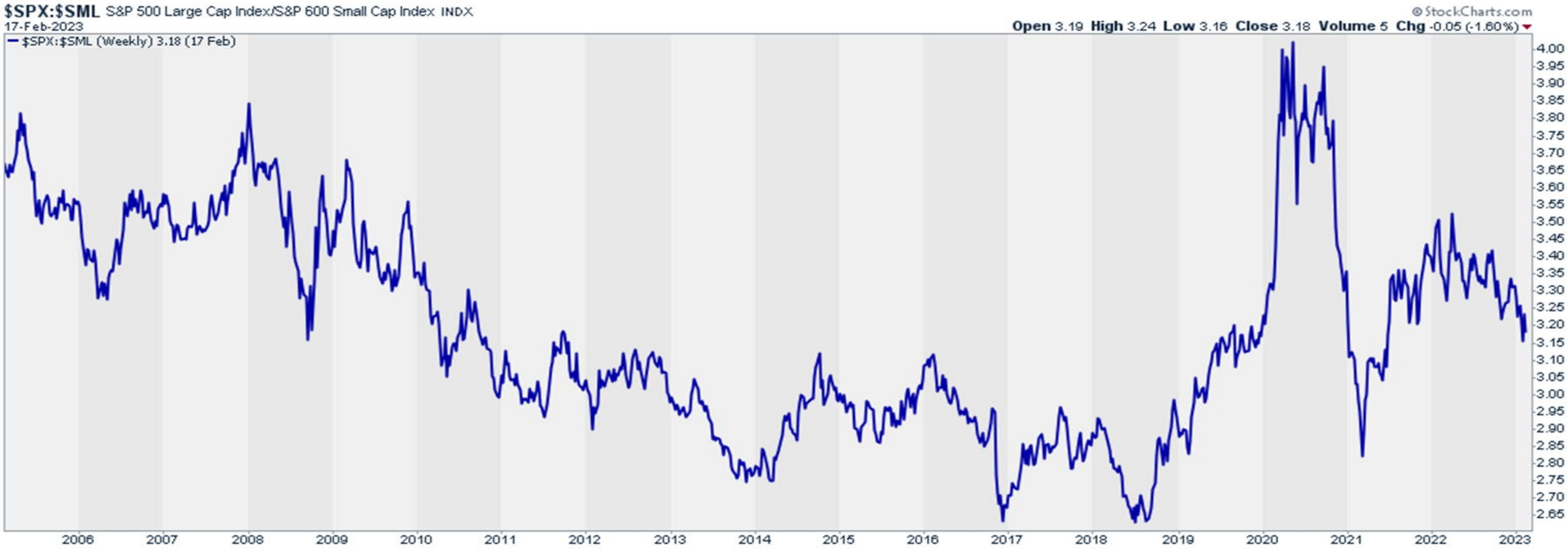
Large cap usually outperforms Small cap prior to economic slow downs

- Significant large cap outperformance versus Small cap in 2020, reversed heading into 2021.
- Operating margins are within historic ranges, however, small cap margins are much more sensitive to slowing economic conditions.



Source: Chart courtesy of Stock Charts

Arun Kaul, CFA

President and Chief Investment Officer, Boutique CIO
Chief Investment Officer, C8 USA

- Arun Kaul, CFA, President, and Chief Investment Officer. Mr. Kaul is responsible for managing the firm and leading the portfolio management team. Mr. Kaul brings almost 30 years of industry experience.
- Prior to founding Boutique CIO, Mr. Kaul was Chief Investment Strategist for a $4Bil bank-owned Chicago based advisory firm providing OCIO solutions for community banks and private clients, President and Chief Investment Officer for a $2Bil Boca Raton based advisory and consultancy firm providing customized investment solutions to high net worth individuals and Co-Chief Investment Officer for a half a billion-dollar investment management firm and hedge fund responsible for all aspects of portfolio management, research, and technology development.
- Mr. Kaul has extensive experience researching and managing equity, fixed income, long-short equity, high-frequency trading, hedging, and options strategy. He also has deep experience as a manager of managers and has directly interviewed, performed due diligence, and vetted hundreds of managers covering equity, fixed income, real estate, private equity, and hedge fund strategies.
- He has worked extensively with private clients, ultra-high net worth individuals, family offices, financial advisors, planners, and institutions delivering broad investment management expertise. A key focus has been on providing customized and bespoke solutions to all client segments. Mr. Kaul is a frequent speaker at industry conferences, universities, and corporate events has written for various trade magazines, taught finance within the California State University system, and mentored numerous graduates and interns through the firm's Internship Program.

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