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Ten for 2023: Midyear Update

Last November, our investment leaders identified the key themes they expected to be prominent in the markets during 2023. With the year now half over, we revisit these concepts to see how they've played out so far.

MACRO: BACK TO THE 'OLD NORMAL'

1. A YEAR OF PEAKS AND TROUGHS WITH A RETURN TO THE 'OLD NORMAL'

WHAT WORKED

Looking into 2023, we anticipated peaks in inflation, monetary tightening, government bond yields and market volatility, as well as troughs in GDP growth, earnings and equity valuations.

In many ways, the economic landscape has developed as we anticipated, with inflation proving persistent and economic growth showing signs of fading. Corporate earnings have also weakened, although not as much as expected. On equity valuations, our views were less prescient, with concentrated strength in U.S. mega-cap technology stocks and resilient earnings contributing to a strong rally for equity indices. As anticipated, however, bond prices generally reflected a more stable (albeit high) rate environment. We will look to U.S. leading economic indicators, as well as the pace of China growth, in assessing whether the U.S. can delay or even skirt recession, as these have meaningful implications for earnings growth and market performance.

2. ADJUSTING TO HIGHER RATES CONTINUES TO DISRUPT

WHAT WORKED

With tighter monetary policy, we expected higher interest rates to disrupt some businesses and consumers, potentially leading to breaks in the economic system.

The first half of the year saw the failure of some major banks, including Credit Suisse, Silicon Valley Bank, Signature and First Republic, which faltered after suffering deposit flight compounded by steep losses on longer-maturity bond holdings. The crisis appears over for now, with little contagion to other institutions or the broader economy. High yield issuers have so far been relatively resilient due to limited current refinancing pressures, but defaults have been rising, and the commercial real estate market remains under pressure. Given the lagging effects of central bank policy, we will continue to watch for economic fraying in the months ahead.

3. MORE DEGLOBALIZATION

WHAT WORKED

Economic systems and policies seemed likely to continue a trend of re-shoring that has been in motion since the Global Financial Crisis.

Economic relations between the U.S. and China have been strained, particularly around semiconductors and other security-related needs, and complicated by the Ukraine war and geopolitical realignment. Divergence is also happening among allies, as reflected in European objections to the U.S. Inflation Reduction Act. While the supply-chain shocks of the pandemic and the war in Ukraine have waned significantly, tensions remain elevated and could continue to affect trade patterns moving forward.

4. REDOUBLED EFFORTS TO CLARIFY 'ESG'

WORK IN PROGRESS

Given increased politicization around environmental, social and governance (ESG) investing, we anticipated heightened efforts by the industry and regulators to clarify its meaning.

We've heard continuing noise but seen little clarity on this issue. Hearings in the House of Representatives confirmed the continued politicization of this topic, with some officials conflating terminology and muddying the debate; we do not expect the Securities and Exchange Commission's forthcoming rules on ESG fund disclosures to clear the air. As rules proliferate on a global basis, we also see growing divergence across jurisdictions. That said, companies and investors are reflecting a general convergence in aims and attitudes, increasingly providing disclosures that enhance the ability to price securities in light of financially material ESG considerations.

ASSET ALLOCATION: REVISITING THE STATUS QUO

5. RISKIER HOLDINGS MAY NEED REASSESSING

WHAT CHALLENGED US

We expected higher rates to shift the relative appeal of growth-oriented securities and quality bonds, potentially laying the groundwork for reassessing long-term asset allocations.

The extended popularity of growth stocks appeared likely to recede in the rearview mirror as higher interest rates not only have reduced the present value of future earnings, but also have created new competition for investor capital from fixed income assets. However, this year's concentrated rally in some mega-cap companies has given growth stocks a second wind, with uneven economic reports creating uncertainty as to the extent and timing of economic softening. Still, higher interest rates have reintroduced "income" to the fixed income market, providing compelling risk-adjusted return opportunities. Meanwhile, for sophisticated investors, alternative assets could continue to provide a way to introduce differentiated returns in a changing environment.

FIXED INCOME ADAPTING TO PERSISTENT INFLATION AND HIGHER RATES

6. GOVERNMENT BOND PERFORMANCE MAY DEPEND ON POLICY SUCCESS

WORK IN PROGRESS

Bond investors appeared likely to stand up for their interests, generally keeping government bond yields in a range but punishing issuers that display policy inconsistencies.

Developed-market government bond yields have generally been range-bound in 2023, with some heightened volatility around banking stresses in March and weakness in the U.K. associated with elevated inflation and fiscal concerns; ultra-short U.S. government bonds saw turbulence during debt-ceiling negotiations. Among U.S. corporate bonds, yields have diverged where issuers are struggling with costs rising faster than revenues, a dynamic that is putting pressure on areas that we expected, including health care and telecommunications. More stresses could be possible as the lagging effects of monetary policy take hold.

7. ABILITY TO ABSORB HIGHER RATES LIKELY TO DOMINATE CREDIT

WORK IN PROGRESS

Amid higher rates, borrowers would gradually need to adjust, although we did not anticipate a major near-term increase in defaults.

Credit markets have largely proven resilient in the first half of the year, given strong balance sheets and maturities that are generally several years away. That said, we've seen substantial variation among industries and issuers. Floating-rate structures are broadly under pressure, while regional banks and commercial mortgage-backed securities have struggled with higher rates. In high yield, many industries are now experiencing deteriorating cash flows. Municipal bonds appear to be generally in healthy shape, as the impacts of economic slowing tend to be delayed in the sector.

EQUITIES: WINNERS AND LOSERS

8. EARNINGS ESTIMATES RECALIBRATE AND FAVOR THE FITTEST

WORK IN PROGRESS

Amid economic slowing and receding inflation, we thought earnings estimates would move downward while performance dispersion would increase based on corporate fundamentals.

Earnings estimates have declined this year but more modestly than expected, while their dispersion has been muted. However, a key difference has emerged in price performance, with just seven mega-cap technology companies—benefiting from enthusiasm for artificial intelligence—accounting for the bulk of the first half's strong equity index returns. Excluding those tech stocks, the U.S. large-cap market finished roughly flat, and was outpaced by emerging and other developed markets, especially Japan. This points to regional and sector differences, but also suggests an economic slowdown that is taking longer than anticipated to materialize.

9. MANAGEMENT TEAMS REFOCUS ON SHAREHOLDER VALUE

WORK IN PROGRESS

In a more pressured environment, in our view managements seemed likely to refocus on delivering tangible shareholder value.

Management teams appear to be "getting religion" on shareholder value. The rally in some mega-caps may partly be due to redirecting capital from ambitious, sometimes implausible investment plans; and banks, for example, face tougher decisions regarding their loan books. It's notable that, while the Event Driven category has been a mixed bag in the HFRI Hedge Fund Indices, the Event Driven Activist Index has been a strong performer. Moreover, the failure of some proposed merger transactions has been on price, but a pick-up in discussions around M&A reflects the urgency that managements may be open to strategic changes rather than relying on multiple expansion to satisfy investors.

ALTERNATIVES: CHALLENGES AHEAD, BUT OPPORTUNITIES FOR THE NIMBLE

10. MORE DISPERSION AND TACTICAL POTENTIAL

WHAT WORKED

A more challenging environment had the potential to widen differences in private company performance and enhance opportunities in private markets.

Based on our analysis, the valuation of many existing private equity deals has been notably resilient, but valuations of completed transactions have eased given managers' cognizance of pricing, while the focus has been on quality transactions and return potential via fundamental improvement. Secondary transactions, particularly led by general partners, remain particularly appealing. Meanwhile, private credit managers have capitalized on tighter banking conditions to step in as liquidity providers, offering potential for compelling total returns.

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1290 Avenue of the Americas
New York, NY 10104–0001
www.nbprivatewealth.com

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