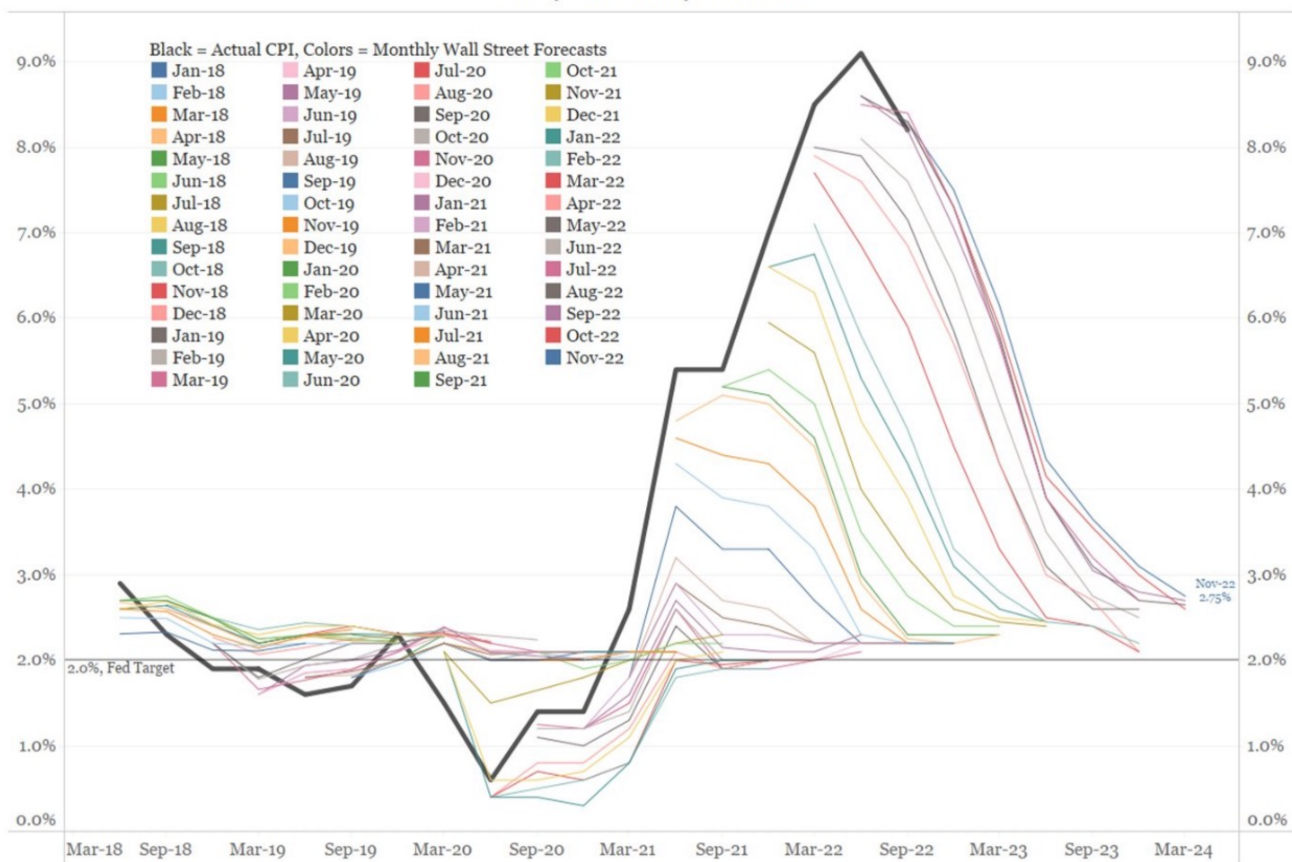
CLEARBROOK

2023

Clearbrook Investment Consulting: Research, Economic and Investment Outlook

Economists and strategists spend their careers referring to a period of history to make a prediction or give thoughts on the future. Anyone doing that today is potentially walking in dangerous territory. The more people try to boil down the soup to the lowest common denominator the more likely they will miss the key ingredient. This is clearly evident by the number of incorrect prognostications about inflation and or the direction of future Fed moves. If 2022 has solidified anything it's follow the old adage of "Don't fight the Fed".

We've seen a relentless belief by strategists and traders that the Fed would/should pause or ease. However, there is a difference between being right and losing money. It seems this had been a regular occurrence in the latter half of 2022. For context, here's the consensus predictions about the direction of inflation over the last two years.



Source: Bloomberg Bureau of Labor Statistics

Geopolitical events have dramatically affected how we view markets and how we live our lives. The rolling global impact of Covid leading to historic actions taken on monetary policy, which on a percentage basis, is unprecedented affecting both increasing and decreasing liquidity. There has also been military conflict (Ukraine) and potential conflict (Taiwan) and a stark recurrence of evaluating and valuing conceptual corporate growth without traditional bricks and mortar foundations. **These events that have not been experienced by most living generations** will affect all aspects of life from family to how a portfolio is invested.

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Investors no longer need to rely on equities to drive portfolio returns.

" I don't think camping out in the last decade's darlings, with rosaries in hand, hoping for a comeback, will be the winning strategy."

- Dan Loeb

2022 was the year where the inherent cost of liquidity was showcased. Not only has the Fed raised rates far beyond their initial parameters, they've limited the money supply and continue to do so through quantitative tightening. **The end of free money caused traditional core equities to be rocked.** This was compounded by the amount of fixed income assets which are now in ETF's to represent an allocation that moved markets to extremes as a forty-year bull market ended. Investors tried to recall actions taken in similar cycles with the Volcker era being most highlighted. However, the Volker era represented an almost unrecognizable economy compared to today.

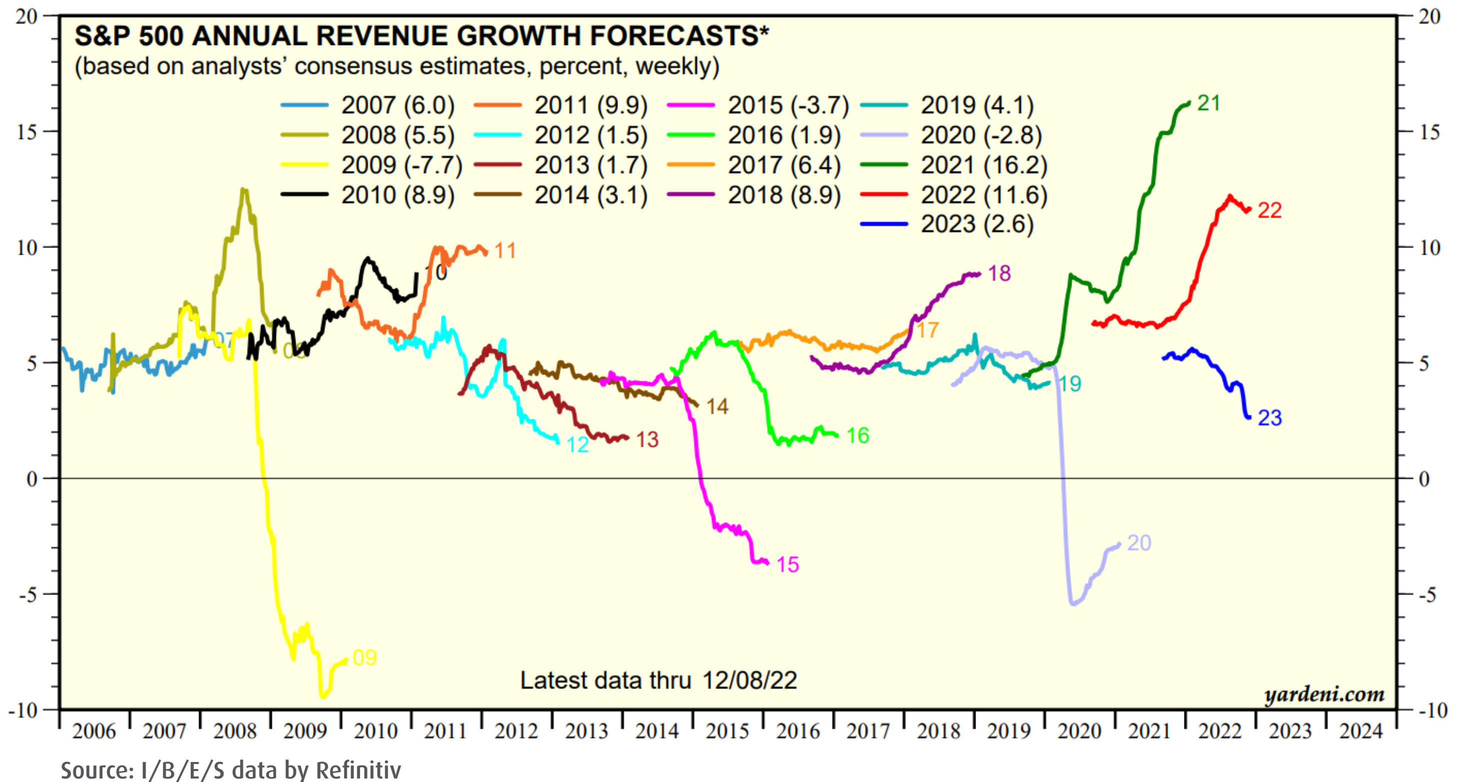
Most of Clearbrook's clients are responsible for investing permanent or near permanent capital and have the ability to remain patient in times of stress. As we move into a new return environment, that is no longer based on a zero interest rate environment resulting in equities increasing the value of the corpus, it is incumbent upon **investment committees to re-review their investment policy statements.**

We are NOT suggesting wholesale asset allocation shifts but do believe investors no longer need to rely only on equities to drive portfolio returns. Further, predictions of which asset classes will produce the highest returns rests on a variable(s) for which we cannot control – Fed Decisions, Geopolitical conflict, etc. Predictions give comfort albeit briefly to the reader. **2023 will likely be a transition year** and a Federal Reserve policy orchestrated slow-down will set the stage for equity growth in 2024, but the timing is still too hard to call given other geopolitical events. To that end, **we'll focus on what we know** and how they present opportunities in 2023 and beyond.

The three variables which we feel are the most significant to 2023 are liquidity, manager selection, and investment time horizon.

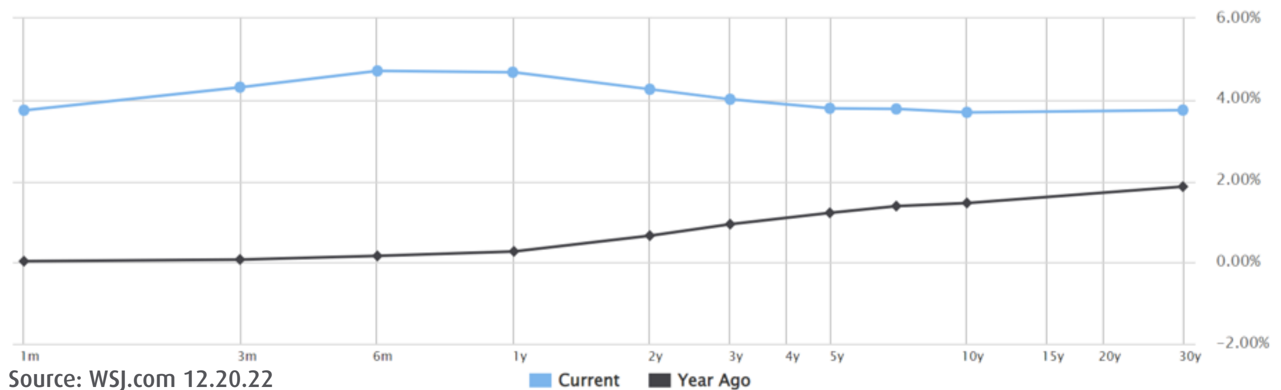
Liquidity: The inherent liquidity in public equities will persist in 2023 and be more of a tradable asset class similar to 2022. That being said just because liquidity still exists in equities, doesn't mean we think it is the appropriate time to significantly overweight equities. Along that line, we're not suggesting that investors make their asset allocations dramatically different. We are, however, suggesting that **active strategies should outperform passive strategies in 2023** and to adjust accordingly.

Manager Selection: Further, we believe that those active managers will outperform not by timing the market but by assessing value and future business prospects of each company. As the chart below from Yardeni.com indicates, **consensus estimates for revenue growth are much lower than previous years indicating a challenging environment.**



Source: I/B/E/S data by Refinitiv

Investment Time Horizon: We believe that interest rates will continue to rise modestly the first half of the year, with the yield curve staying inverted for at least the balance of this year. This should provide an excellent opportunity for those clients that need to keep cash on hand to fund their mission. An overall shortage of longer issued public debt should help keep longer rates lower than short rates.



Source: WSJ.com 12.20.22

Broadly speaking, in 2022 the markets whipsawed investor portfolios. **In 2023 many investors, if they are able, will take further steps away from traditional public debt and equity investing** to other areas where the return will be measured over a longer time frame which should moderate possible monthly market gyrations. In addition, with the increase in rates and growing interest in proper structuring, the outsized zeal for unrealistic returns will come down now that the "riskless rate of return" of US Treasury bonds are closer to historic averages. **GDP growth should return to a more normalized level of 2-2.5%** which is consistent with the structure and demand of the American consumer.

Private credit continues to present interesting opportunities for return.

We see many opportunities in the year ahead. Most notably, within the traditional asset classes, a more active approach is necessary as more volatility is expected due to continued Fed rate hikes and tightening with the most likely scenario of a recession in the US in the coming months.

Private Credit

- Private credit continues to present interesting opportunities for return. Clients can participate based on their liquidity needs in either business development companies (BDCs) or in limited partnership vehicles.
- **In private credit**, we feel it's in our clients' best interests to **choose more seasoned participants in this space.**
- **Private credit managers use leverage** to enhance the returns. Industry leverage averages approximately 1.2x. Generally, loans are floating rate but the borrowing costs of the manager are typically fixed. Again, this is where an experienced manager is necessary.

- **Loans are typically shorter-term loans** of three to five years.
- As business conditions have become tighter, loan terms have become more favorable for the lender. **Covenants are now tighter, and terms are stronger especially with the higher quality managers.** Should investors be more inclined to give up liquidity there are ample opportunities in the secondary market.

H.R.5376 - Inflation Reduction Act of 2022 Potential Areas Of Investment

- The Inflation Reduction Act of 2022 allocates $369 billion to address climate change by helping the US meet it's 50% emissions reduction target by 2030.
- Largely a domestic bill funds are allocated across multiple industries. **Roughly $70 billion has been allocated to manufacturing**. Multi-family housing, transportation, and farming are areas that could benefit.

In ESG, opportunity lies in active management and investors will benefit with those managers fully evaluating ESG risks, both liquid and illiquid.

ESG

- **ESG has become a politically divided issue** mostly played out in the main stream media and despite H.R. 5376 creating jobs in red and blue states ESG will continue be divisive in 2023.
- Despite it playing out on the political stage, the US investment community is past the event horizon and **ESG factors are already a standard part of most managers' processes to consider and evaluate risk.** Whether a fund is labeled as such will play out on the political stage.

Opportunity lies in active management and investors will benefit with those managers fully evaluating ESG risks, both liquid and illiquid.

Secondaries

- For those institutions that can allocate to less liquid investments, **secondaries offer exposure to private equity** with the ability to purchase those holdings from other L.P.s at a discount.
- We believe that deal volume will be elevated in 2023. Holders of private equity positions may need to take the opportunity to re-allocate a portion of their positions to secondary funds which grew rapidly in 2022. Investors in such funds will get to participate in those discounts.

- **Strategy selection is key** as different styles exist based on industry, fund strategies (i.e. tech, growth, VC) and maturity types. Some funds have longer duration while others invest in only LPs that are close to maturity which are similar to clipping a coupon. For clients with more liquid requirements, there are interval funds that invest in secondaries and co-invests.

International vs. US Equity

In 2022, Clearbrook shifted a portion of our equity exposure from International to US which benefited us throughout the year. Now in 2023, we believe it is the opportune time to shift some of that exposure back into international markets.

- In Europe, inflation should come down from higher levels.
- **Japanese companies have significant cash on their balance sheets** to weather any kind of economic downturn.

As stated earlier, we do not believe it is the right time to necessarily increase your equity allocation, but for our current US overweight, we believe it is prudent to shift some of those assets to other areas.

Despite the perceived challenges in front of us, there will always be opportunity in the financial markets. Finding those opportunities will likely be more challenging but our role always has been and will continue to be to seek out those investment professionals that evaluate and capitalize on those opportunities as they present themselves and direct capital to them for the benefit of our clients.

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