M|A|M

MONACO ASSET MANAGEMENT

Investment Outlook

1Q 2023

Executive Summary

- **Recession risk superseding inflation risk.** Recession risks should top the headlines over the coming months. The Fed is haunted by the specter of the 1970s and afraid of history repeating itself. Here is why the pivot narrative should fail to gain traction for at least a couple quarters. Wage inflation remains elevated while median inflation and sticky factors have yet to roll over. In other words, expect policy to remain unchanged until both sentiment and payrolls capitulate thus further exacerbating deep recession risks (e.g., hard landing). Unless inflation stays high, labor markets remain imbalanced, and wage growth fails to slow down, central banks will be forced to act eventually. This is when the investment landscape turns more attractive for investors, notably in the back end of the year. A US Yield Curve steepening (i.e., 30-2 Year) is a key trade for 2023.

- **Wider credit spreads ahead.** Consensus remains constructive on credit on the back of resilient (backward looking) fundamentals, citing robust EBITDA against flat debt levels. Compressing margins will be a key driver in widening credit spreads later this year. Whether in the US or Europe, spreads continue to fail to reflect recession risk - making credit still relatively expensive. Staying cautious for the quarter ahead but turning more constructive and ready to build an allocation to credit should spreads widen closer to 400bps on investment grade. Remaining long of Emerging Markets Local Currency bonds.

- **A progressive dollar weakness.** After peaking in 2022, the dollar should continue to progressively weaken this year. Moderation in global inflation measures against bearish consensus expectations support risk-sensitive currencies for the back end of the year. Any weakness in the dollar until then should however be moderated given relatively high interest rates, falling breakeven rates, and limited growth outside of the US (ex-China). Peak inflation and Fed terminal rate expectations marked the dollar top. Bottoming global growth expectations and a decline in real yields in the coming quarters will accelerate the dollar decline.

- **Negative earnings growth risk for equities.** Rates and inflation peaking is a warning sign for profitability, an underappreciated reality that can no longer be ignored. Developed market monetary policies are at/heading into restrictive territories and should remain there most of the year. Leading macroeconomic indicators continue to weaken. Bottom-up consensus is anchored near all-time highs on forward earnings estimates. Elevated and rising inventories with healthier supply chains reflect a deteriorating demand backdrop, particularly for goods. In our base case, earnings should decline 5-10% YoY for the S&P 500. Applying a 16.0x multiple (long-term mean), we see a market trough around 3,000 (-21%) over the coming quarters but risks remain skewed to the downside (e.g., not being bearish enough). Precious metal (i.e., gold) miners will be a key allocation. In the back end of the year, when the macro environment warrants it, we will look to tactically deploy capital into distressed high growth equities.

- **Commodities supported by broad-based supply-demand tightness.** Under-investments are amplifying supply constrains over the long-run, inventories are running low, and capacity remains tight while producers remain generally unresponsive. New tailwinds are emerging: the dollar should progressively weaken, and China’s economy is reopening. The transition to a greener economy and reshoring of supply chains provides long-term price support in a supply-constrained environment. We maintain our bullish stance on commodities, but see precious metals (e.g., gold, silver, platinum) outperforming.

Investment Stance Overview

The investment landscape is moving away from inflation to focus on recession, but continues to underestimate a credit event risk. Central banks are extremely slow to react in this rapidly evolving environment and paying the price in the form of a loss in credibility. In 3Q22, the Bank of England was forced to intervene to save the UK pension system from collapsing. In 4Q22, FTX was uncovered as nothing more than a Ponzi scheme while Blackstone exercised its right to limit redemptions in its $69bn BREIT ETF after redemption requests exceeded 5% of the fund's NAV (just 4% of demand to cash-out was met in December). Cracks are emerging in the system.

It is extremely complex to pinpoint where facture lines are lying, but the "end game" is fast approaching with odds of it unravelling in coming quarters rising. Real earnings growth has been negative for twenty months, consumers are stretched, savings are eroding (so is the propensity to consume), employment remains robust but layoffs are making headlines as hyper-cyclical components of labor are showing some cracks. Business and consumer confidence is plummeting, inventories are rising, and cost of capital is at its highest level in years. All represent major headwinds to the global economy. China is a rare outlier, but geopolitical risks prevail.

Financial assets are slow to adjust in these environments. Risk happens slowly, then all at once. Credit and equity valuations remain rich and not appealing enough to warrant any cash deployment especially when factoring in a deeper and longer recession risk. We maintain our S&P 500 base case trough target at 3,000 (-21%). Credit spreads should near levels last seen in the GFC. A default cycle is fast approaching. In this environment, we find value in US Treasuries. As disinflation persists and the economy falters, sovereign bonds should attract flows. Falling real rates will push the dollar lower and be favorable to precious metals (upgrade to very bullish).

Bear markets typically last between 1.5-2 years. It is our belief the bear market in risk assets will end sometime this year. Despite our negative 1Q23 outlook, we want to keep a "glass half full" perspective. Investment opportunities will emerge as we move through the cycle, and we want to be ready to play the 2H23 recovery. Most of our work in coming months will be geared towards identifying these opportunities such as valuation-distressed high growth and FCF generative companies (*see Key Themes section*).

	Investment Stance						Quarterly
	Very Bearish	Bearish	Neutral	Bullish	Very Bullish		Change*
SOVEREIGN BONDS						BULLISH US/EM	-
US				■			-
Europe (Core)			■				-
Europe (Periphery)		■					-
Emerging Markets				■			-
CORPORATE BONDS						BEARISH DM	-
US High Yield		■					-
US Investment Grade		■					-
EUR High Yield		■					-
EUR Investment Grade		■					-
Emerging Markets				■			-
CURRENCY						BEARISH USD	-
USD		■					-
EUR			■				-
EM				■			-
CNH		■					-
EQUITIES						BEARISH DM	-
US		■					-
Europe		■					-
UK		■					-
Japan		■					↘
Emerging Markets				■			-
COMMODITIES						BULLISH	-
Energy				■			-
Precious Metals					■		↗
Metals & Agriculture				■			-
ALTERNATIVES						BULLISH	-
Hedge Funds				■			-
Real Estate		■					↘↘
Private Equity			■				-

** Change compared with previous quarter. One arrow means the stance has moved one place to the left or the right, two arrows means a move of two places, etc.*

Model Portfolios

The following model portfolios are based on current positioning at the start of 1Q 2023. Considering the volatile nature of financials markets and our outlook, their compositions is likely to change throughout the quarter.

USD Based Portfolios

Asset Class	Last Price	Perf. 5D	Perf. MTD	Perf. YTD	MAM Outlook	Asset Allocation
Currencies						
Portfolio Bases						**100.0%**
EUR	1.05	-2.0%	-2.0%	-2.0%	Neutral	10.0%
USD	105.59	1.7%	2.0%	2.0%	Bearish	90.0%
Equities						**30.0%**
Developped Markets	**56.51**	**1.6%**	**0.9%**	**0.9%**	Bearish	**22.5%**
Europe	440.25	3.6%	3.6%	3.6%	Bearish	3.4%
North America	3,808.10	0.7%	-0.8%	-0.8%	Bearish	13.5%
Great Britain	7,658.18	1.9%	2.8%	2.8%	Bearish	2.3%
Asia Pacific	25,973.85	-1.4%	-0.5%	-0.5%	Bearish	3.4%
Emerging Markets	**984.00**	**2.8%**	**2.9%**	**2.9%**	Bullish	**4.5%**
Asia Pacific	606.56	3.1%	3.0%	3.0%	Bullish	3.0%
EMEA	193.22	0.0%	0.6%	0.6%	Bullish	1.1%
South America	2,107.75	-2.0%	-1.0%	-1.0%	Bullish	0.5%
Thematic						**3.0%**
Asset Allocation	29.16	1.2%	0.7%	0.7%	Bullish	3.0%
Fixed Income						**20.0%**
Europe						**0.0%**
Sovereign	196.43	1.0%	1.0%	1.0%	Neutral	0.0%
Investment Grade	205.77	0.9%	1.4%	1.4%	Bearish	0.0%
High Yield	392.49	0.8%	0.9%	0.9%	Bearish	0.0%
North America						**10.0%**
Sovereign	2,390.75	0.6%	0.8%	0.8%	Bullish	10.0%
Investment Grade	2,993.29	0.6%	0.8%	0.8%	Bearish	0.0%
High Yield	2,210.55	1.2%	1.1%	1.1%	Bearish	0.0%
Emerging Markets						**8.0%**
Local Currency	342.16	0.1%	0.2%	0.2%	Bullish	8.0%
Hard Currency	1,077.96	0.4%	0.4%	0.4%	Neutral	0.0%
Others						**2.0%**
Convertible	878.84	0.8%	0.8%	0.8%	Bearish	0.0%
Trade Finance	102.41	-0.2%	-0.1%	-0.1%	Neutral	0.0%
Broad Funds	447.19	0.2%	0.3%	0.3%	Bullish	2.0%
Commodities		**-4.6%**	**-5.0%**	**-5.0%**		**10.0%**
Agriculture	100.68	-2.9%	-3.0%	-3.0%	Bullish	1.3%
Energy	36.58	-9.9%	-11.3%	-11.3%	Bullish	1.3%
Industrials	160.14	-3.8%	-3.1%	-3.1%	Bullish	1.3%
Precious Metals	215.15	-0.1%	0.1%	0.1%	Bullish	6.0%
Alternatives						**25.0%**
Hedge Funds	1,373.05	0.4%	0.4%	0.4%	Bullish	15.0%
PE/Real Assets	1,856.05	-0.6%	0.0%	0.0%	Neutral	5.0%
Pre-IPOs	605.70	-0.3%	0.1%	0.1%	Bullish	5.0%
Cash						**15.0%**

Source. MAM Research, Bloomberg

EUR Based Portfolios

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Cash						**20.0%**

Source. MAM Research, Bloomberg

Asset Class Returns

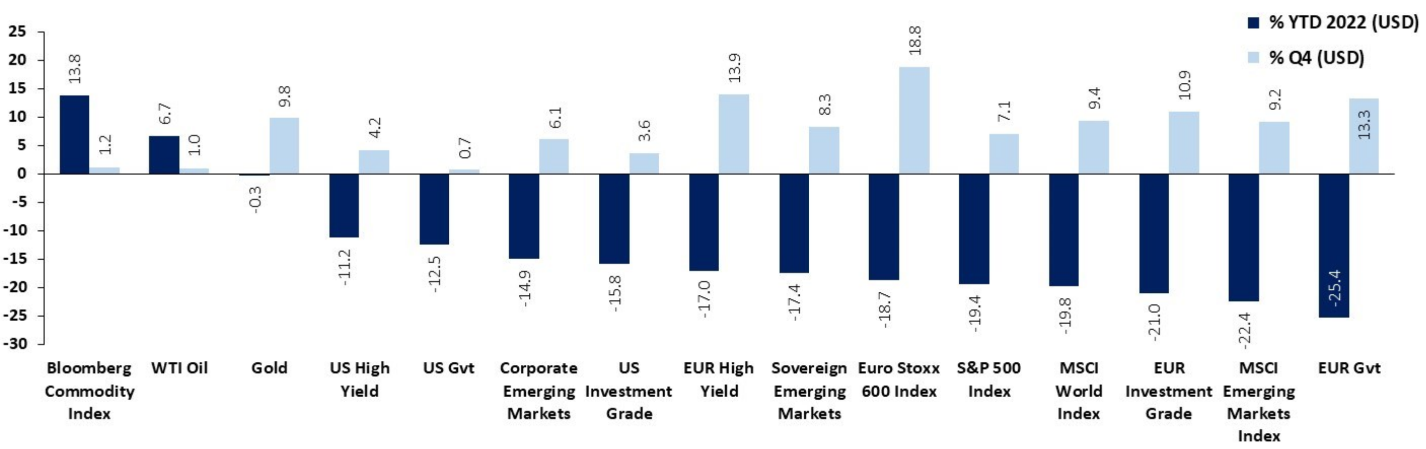
Last year was a difficult and historic year by many measures. Although risk assets paired some of their losses in 4Q22, they remained largely negative for the year. The S&P 500 rallied +7.1%, fuelled by a softer than expected CPI and hints of a downshift in the pace of rate hikes, but closed the year down -19.4%. It was its worst year since the Global Financial Crisis. The picture was similar in Europe. The EuroStoxx 600 had its best quarter in two years (+9.6%) amid renewed optimism around China, milder-than-expected weather, and looser global financial conditions. Nevertheless, the index ended the year down -12.9%. Emerging markets trailed global equities for the 7th time in the last 8 quarters, closing 4Q22 up +9.2% in USD terms.

Despite a protracted global monetary policy normalization and higher interest rates, fixed income rallied in 4Q22 amid expectations of a slower pace of tightening. Despite the ECB lifting rates 125bps this quarter, European Sovereigns rallied +4.1%. EU HY corporate bonds were up +4.7%, while Investment Grade continued to underperform (+1.7%) to close down in its worst year ever. In the US, Fed Chair Powell's rhetoric remained hawkish and pessimistic with regards to the economy. Yet, US fixed income assets also soared. US Sovereigns were marginally positive (+0.7%) while US HY and IG bonds were up +4.1% and +3.6%, respectively.

After reaching 20-year highs over the summer, the dollar abruptly depreciated amid peaking inflationary pressures and smaller rate hike expectations. The greenback had its worst quarter in over a decade, down -7.7%. After dropping sub-parity in the summer, the Euro strengthened against the dollar following its best quarterly performance since 3Q10, up +9.4%. The JPY/USD appreciated +9.4% amid expectations for a new BoJ chair who would bring an end to the current accommodative monetary policy.

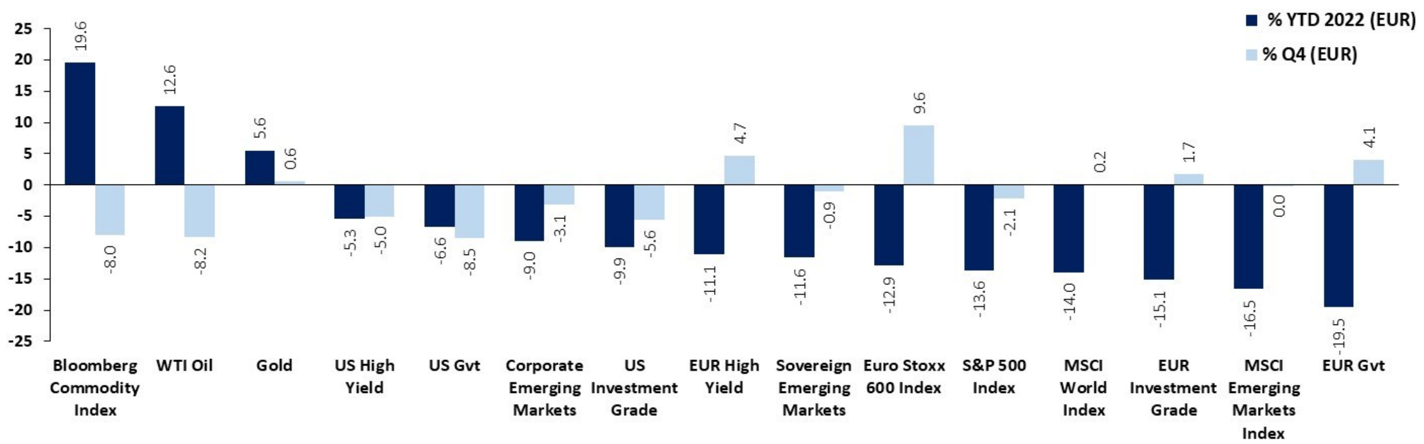
Although commodities were the sole positive asset class in 2022, they were interestingly the only negative performers in 4Q22. Broad commodities were flat with gains in precious and industrial metals offsetting declines in both energy and agriculture prices. Dollar weakness, declining inflation rates, and expectations of slower rate hikes helped gold (+9.6%) and silver (+25.8%) conclude their best quarter in over two years to finish the year flat. On the other hand, energy suffered from a rise in recession fears, outweighing benefits from a China re-opening. After hitting multi-decades highs in March, crude oil ends the year up a mere +0.9%.

Chart 1. Asset Class Returns 4Q 2022 vs. Full Year 2022 (USD Base)



Source. MAM Research, Bloomberg.

Chart 2. Asset Class Returns 4Q 2022 vs. Full Year 2022 (EUR Base)



Source. MAM Research, Bloomberg.

MAM Actions

Equities

What have we done?

After markets approached the short leg of S&P 500 put spread initiated back in 3Q22 (lower limit of downside protection), we used the subsequent bear market bounce to initiate a put spread with 360-325 strikes (SPY ETF) to hedge declines past beyond short leg. In November, we used the drop in volatility (and rally) to close the short leg of our 399-359 put spread to take profit and un-cap the downside protection. At the same time, using an improvement in sentiment around Chinese stocks, we exited part of our exposure to China by selling a China Internet ETF (KWEB). In December, using another bear market rally and given our medium-term outlook, we bought an at-the-money option of the SPDR S&P 500 ETF with a strike at $396 and a maturity of 02/17/23.

Our strategy going forward?

The hedging strategy in 3Q22 paid off. While the hedging implemented in November 2022 did not, the puts bought in December did successfully protect portfolios against declines into year-end. We will remain active in our allocation and hedging in 1Q23, driven in large part by ongoing market developments. Should markets were to drop materially, we would look to add incrementally.

Fixed Income

What have we done?

As our US High Yield put spread approached maturity in late 4Q22, we chose to take profit and roll our position to a February 2023 maturity as our view on this segment of credit remains bearish in the medium-term. Then, we bought a 2-Year digital option on the 30-2 Year spread with a strike at 135bps for a potential net payoff of 3.0x. The trade aims to benefit from a steepening of the yield curve when the Fed is forced to cut rates in the next two years given the degrading (or then degraded) economic conditions. To reduce our risk exposure to China real estate, we fully exited the Manulife Asian High Yield fund.

Our strategy going forward?

We are likely to boost exposure to US Treasuries across the curve in dollar portfolios and initiate Eurozone sovereign bond buying as the narrative moves away from inflation/rates risks to recession and financial stability risks. On the Europe, inflation has some room to go before the ECB can be inclined to pause.

Commodities

What have we done?

We increased our exposure to broad commodity by 3% to take advantage of the pullback in asset prices given the supportive supply and demand dynamics despite recessionary risks. We kept the precious metals (e.g., Gold and Silver) exposure constant.

Our strategy going forward?

We are unlikely to meaningfully change our exposure to commodities over the course of 1Q23.

Currencies

What have we done?

We have kept our FX exposure constant in 4Q22.

Our strategy going forward?

Disinflation, peak rate expectations, and prospects of a deeper and longer recession will force the Fed to pause in coming quarters. As it creates favorable dynamics for non-USD currencies, we will look to reduce dollar exposure in mid-to-late 1Q23.

Hedge Funds

What have we done?

We made no changes to our allocation to alternatives in 4Q22.

Our strategy going forward?

Our hedge fund exposure is unlikely to change meaningfully over the course of 1Q23.

Events

Figure 1. 2023 Major Event Calendar

JANUARY	FEBRUARY	MARCH	APRIL	MAY	JUNE	JULY	AUGUST	SEPTEMBER	OCTOBER	NOVEMBER	DECEMBER
12^{th} US CPI Report	1^{st} FOMC Meeting	9^{th} BoJ Monetary Policy Meeting	8^{th} BoJ Change of Guard	3^{rd} FOMC Meeting	13^{th} US CPI Report	12^{th} US CPI Report	3^{rd} BoE Monetary Policy Committee	13^{th} US CPI Report	12^{th} US CPI Report	20^{th} FOMC Meeting	10^{th} Spanish General Elections
17^{th} BoJ Monetary Policy Meeting	2^{nd} BoE Monetary Policy Committee	14^{th} US CPI Report	12^{th} US CPI Report	4^{th} ECB Monetary Policy Committee	14^{th} FOMC Meeting	26^{th} FOMC Meeting	10^{th} US CPI Report	14^{th} ECB Monetary Policy Committee	$13\text{-}15^{th}$ 2023 World Bank & IMF Annual Meeting	2^{nd} BoE Monetary Policy Committee	12^{th} US CPI Report
$16\text{-}20^{th}$ World Economic Forum Annual Meeting	2^{nd} ECB Monetary Policy Committee	16^{th} ECB Monetary Policy Committee	27^{th} BoJ Monetary Policy Meeting	10^{th} US CPI Report	15^{th} BoJ Monetary Policy Meeting	27^{th} BoJ Monetary Policy Meeting		20^{th} FOMC Meeting	26^{th} ECB Monetary Policy Committee	12^{th} US CPI Report	13^{th} FOMC Meeting
	14^{th} US CPI Report	22^{nd} FOMC Meeting		11^{th} BoE Monetary Policy Committee	15^{th} ECB Monetary Policy Committee	27^{th} ECB Monetary Policy Committee		21^{st} BoJ Monetary Policy Meeting	29^{th} Argentinian General Elections		14^{th} BoE Monetary Policy Committee
		23^{rd} BoE Monetary Policy Committee			18^{th} Turkish General Elections			21^{st} BoE Monetary Policy Committee	30^{th} BoJ Monetary Policy Meeting		14^{th} ECB Monetary Policy Committee
					22^{nd} BoE Monetary Policy Committee						18^{th} BoJ Monetary Policy Meeting

Political Events | Central Banks Meetings | Inflation Reports

Source. MAM Research.

Central Bank Action

Central bank meetings should keep capturing a lot of attention. Each major central banks (e.g., Fed, ECB, BoE, BoJ) will have two meetings. The Fed will meet on Feb. 1^{st} and Mar. 22^{nd}. It should bring to a close the rate hiking cycle, bringing the terminal rate to 5.0%. Although Powell explicitly called for a 5.25% terminal rate, markets seem to discount this outcome. The ECB will meet twice on Feb. 2^{nd} and Mar. 16^{th}. Markets price a 50bps hike in February, but are uncertain with regards to the March meeting. Estimates point to an ECB peak rate of 3.5% in July, from 2.0% today. The BoE is meeting Feb. 2^{nd} and Mar. 23^{rd}. It is expected to raise rates by 50bps before slowing down the pace to 25bps. Estimates show a peak rate of 4.75%, from 3.5% today. Markets do note expect the BoJ to raise rates this quarter. Governor Kuroda's YCC policy tweaks will be closely watched.

US Congress Division

Midterms did not yield the "Red Wave" Republicans hoped for. While the GOP has taken control of the house, the absence of a governing majority means the administration faces a legislative gridlock. Under a divided government, the Biden administration will have to decide on either moving to more centrist policy and finding compromises with GOP leadership or try and impose its policies via executive orders. The Farm bill, omnibus multi-year bill governing a broad range of agricultural and food programs, will be a priority in the 118^{th} Congress. Republicans should push back on policymaking and move forward with their own political agenda ahead of the presidential election by hitting Democrats on high inflation, high government spending, and the recession. However, both parties are likely to presenting a relatively united line against Big Tech, focusing on reining in dominant platforms through a revisions of antitrust laws.

China Re-Opening

With the 20^{th} Party Congress over and zero-Covid abandoned, China is focusing on economic growth and re-opening in 2023. Domestic travel restrictions, mass testing retirement, and other zero-Covid policies were scrapped in December. On January 8, China opened its border. International travellers no longer have to quarantine. Though industrial production remained strong thanks to a "closed loop management" approach under which factories arranged for staff to live and work on-prem, Chinese consumers remain fearful of getting the virus. It is a lingering headwind to the recovery of high contact service sectors. While health authorities stopped publishing daily infections, estimates show 250m people (c.18% of the population) may have been infected since December. The surge in cases has been putting pressure on Xi Jinping, who remained largely quiet, making only oblique references to the recent outbreaks.

Bank of Japan Change of Guard

After a 10-Year tenure at the helm of the BoJ, Governor Kuroda should step down in April. Prime Minister Kishida will announce the nomination of a new Governor in January or February and seek approval from both houses of parliament. Former Deputy Governor Nakaso is the leading candidate followed by Deputy Governor Amamiya and former Deputy Governor Yamaguchi. The latter consistently called for maintaining ultra-low interest rates while Nakaso and Yamaguchi have both been advocating moving away from easy monetary policies.

The BoJ's first change of guard in a nearly decade could have wide-reaching implications for global financial markets should investors sense a potential change in Japan's monetary policy.

Economics & Rates

Conclusion. Recession > Inflation. Inflation has peaked. Recession risk will supersede inflation risk as we progress through the cycle. However, the Fed is haunted by the specter of the 1970s and afraid of history repeating itself. Here is why the pivot narrative should fail to gain traction for at least a couple quarters. Wage inflation remains high while median inflation and sticky factors have yet to roll over. In other words, expect policy to remain unchanged until both sentiment and payrolls capitulate thus further exacerbating deep recession risks (e.g., hard landing). What is their alternative? A labor market imbalance feeding into a negative feedback loop whereby elevated wage growth drives inflation and so on. Something has to give and the Fed knows it. With liquidity being squeezed out of the system, consumption declines, the economy slows, and asset prices drop. Unless the inflation stays high, labor markets remain imbalanced, and wage growth fails to slow down, central banks will be forced to act eventually. A US Yield Curve steepening (i.e., 30-2 Year) is a key trade for 2023. Favoring long-term over short-end bonds for the time being.

On Wall Street, financial conditions remain too easy for the Fed. Policymakers want to err on the side of caution and favor being more restrictive than not. As long as financial conditions remain misaligned with the Fed's goal, we expect additional tightening. Based on the most recent summary of economic projections, the Fed needs to see its policy rate at 5% or 75bps above to consider it in a zone that may be sufficiently restrictive.

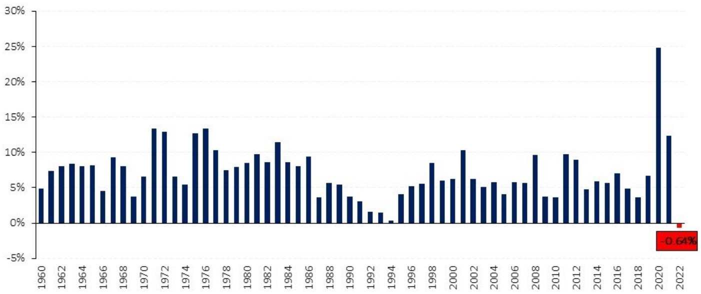
To the risk of repeating ourselves, "Do Not Fight the Fed" is key. Liquidity is being pulled out of the system. Is a financialized and levered global economy more than a 1- factor model anchored on liquidity when said liquidity is experiencing outsized moves? We saw a surge in asset prices when liquidity was afloat, so why would the opposite not hold when it is being pulled out. Money supply is contracting for the first time in decades (**Chart 3**) and the repercussions are broad based, spreading from asset prices to the consumer, businesses, and employment.

On main street, consumers are feeling the pain as the squeeze continues to intensify. Over 40% of people regularly run out of money and have to rely on credit cards or family as the monthly streak of negative real earnings growth attains 20 (**Chart 4, LHS**). Credit card balances grew at the fastest pace in at least 20 years in 3Q22 to the high level since 4Q19 (**Chart 5, LHS**). Meanwhile, the cost of debt continues to step higher to multi-decade highs (**Chart 5, RHS**). Excess savings were revised away by the Bureau of Economic Analysis with the regular savings rate sinking to lower multi-decade lows at 2.4% (**Chart 4, RHS**) and the record $370bn decline in total bank deposits in 2Q22 was followed by a further $206bn decline in 3Q22.

In housing, builder confidence has declined at the fastest pace ever and for a record twelve consecutive months (**Chart 6, LHS**) while signed contract activity fell at the fastest pace ever in the latest November data (**Chart 6, RHS**).

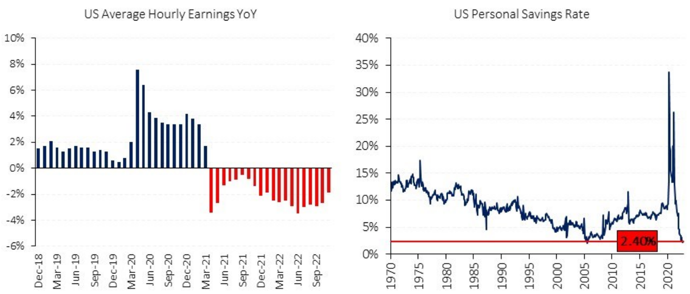
Activity is slowing, cracks are emerging, and CBs' indicators lag. Fragility is manifesting in more sensitive parts of the economy. Small business employment MoM turned contractionary for the first time in over a year, layoffs at unprofitable tech companies have been rising. Temporary help and staffing employment, the hyper cyclical components of labor and the harbinger for the broader cycle, have been negative for four consecutive months while overtime hours are now approaching recessionary levels. The front end of the yield curve may remain anchored for a couple more months as the Fed stay put and long end may continue to drop, but the key trade here remains a curve steepening within two years (see *Key Trades in 2023* for details).

Chart 3. US M2 Money Supply YoY



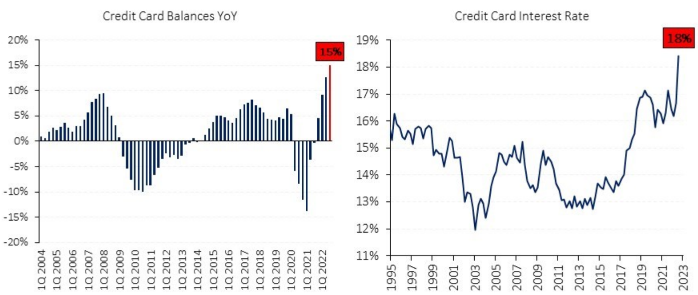
Source. MAM Research, Bloomberg

Chart 4. Real Earnings Growth YoY and Personal Savings Rate



Source. MAM Research, Bloomberg

Chart 5. Consumer Credit Card (CC) Balance YoY and CC Interest



Source. MAM Research, NY FED, FDIC

Chart 6. HMI Buyer Traffic 1-Yr Δ vs. Pending Home Sales YoY

Source. MAM Research, Bloomberg

Credit

Conclusion. Wider Spreads Ahead. Drawdowns in credit were deeper or comparable to the worst 12-months during the GFC, but much of the damage was attributable to aggressive Fed hikes and the ensuing rates volatility. Spread and excess return performance was quite strong despite earnings headwinds later in 2022 and fund outflows throughout. Healthy balance sheets, ample liquidity, and termed-out maturity walls all kept market functioning from being impaired (unlike 2020 or 2018). The big yield reset provides better income opportunities for the year ahead, but the recession will force spreads to widen. Consensus remains constructive on credit on the back of resilient (backward looking) fundamentals, citing robust EBITDA against flat debt levels. Margins compressions will be one of the key drivers in sending spreads wider over the coming quarters. Whether in the US or Europe, spreads fail to reflect recession risks - making credit still fairly expensive. Staying cautious for the quarter ahead, but turning more constructive and ready to build allocation to credit should spreads widen closer to 400bps on investment grade. Staying long EM Local Currency bonds.

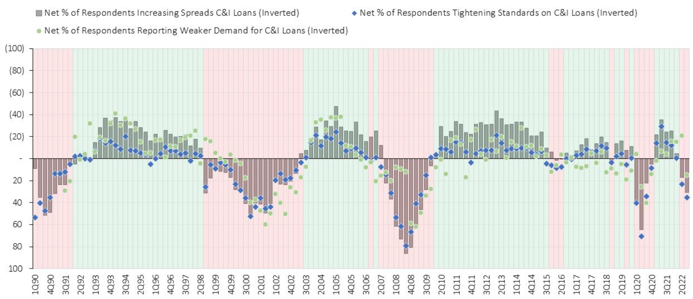
Data from the Senior Loan Officer Survey can be a good leading indicator for predicting a recession. When two of the three C&I (Commercial and Industrial) questions (using mid-point of large and medium, and small firms survey) turn negative, it precedes a recession (**Chart 7**). It is not coincidental, but causal. As banks tighten standards therefore increasing cost of capital, economic activity slows. However, the problem is cyclical activity tends to auto-correlate or self-reinforce. In other words, the tightening of credit leads to rising layoffs and delinquencies which forces banks to further tighten credit and so on and so forth.

Why is it relevant to credit? As credit tightens and liquidity falls, spreads typically widen. The surge in net percent of respondent highlighting tighter lending standards in the C&I Loan Survey suggest high yield spreads are (very) probably heading higher (**Chart 8, LHS**). Surveys from S&P Global show liquidity concerns and pressure from higher rates increased over recent months. Although nothing is acute yet, early stress is building and we are seeing it in a rise of distressed supply since last year. Ultimately, with spreads set to push higher, charge offs will chase spreads on a lag (**Chart 8, RHS**); self-reinforcing the negative credit cycle.

The growth payback associated with cumulative Fed hikes from last year is becoming clearer by the month. Economic activity is slowing. Manufacturing activity is rapidly declining and should feed into credit fundamentals via wider spreads (**Chart 9, LHS**). The activity pipeline is depicting a similar picture. ISM Activity (**Chart 9, RHS**) and PMI both foreshadow credit fundamentals. While credit tends to hold up after the last rate hike, loans and to some extent high yield underperform high grade credit, thus suggesting a prolonged period of elevated policy and muted earnings growth would be a source of concerns for issuers.

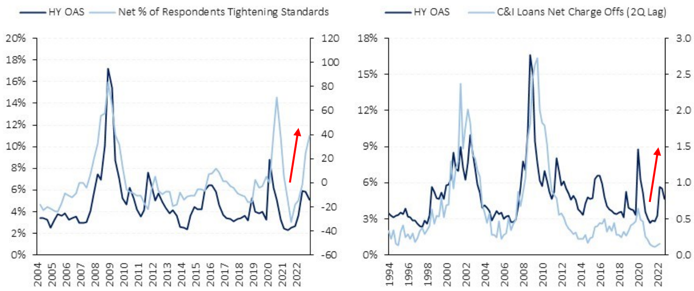
Credit ratings continue to deteriorate. The ratio of upgrades to downgrades fell to some of its lowest level since the pandemic, falling below 1.0x meaning downgrades now exceed upgrades (**Chart 10**). Rising downgrades coincide with wider spreads and deteriorating credit quality. Given the higher cost of capital, companies will have to rethink leverage. If all of the outstanding index-eligible debt of IG and HY issuers were marked-to-market, companies would have to cut debt by 30-50% to keep interest expenses constant (*Source: MS Research*). If better affordability and WACC optimization were economic justification for highly leveraged balance sheets, maths should work in reverse when issuers and investors solve for a higher yield regime. Limited market access for weaker names should start to matter as 2024 and 2025 maturities come into focus in 2H23.

Chart 7. C&I Lending: Spreads, Standards, & Demand



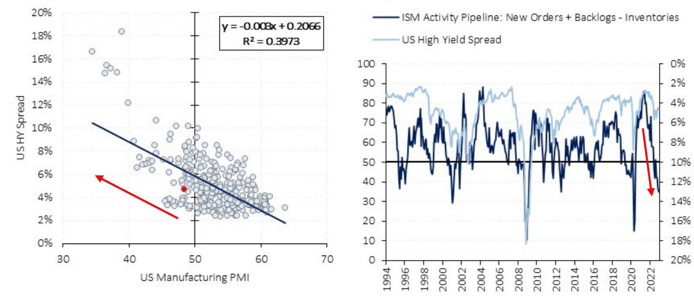
Source. MAM Research, Bloomberg, Hedgeye

Chart 8. HY Spreads vs. C&I Tightening and vs. Loan Charge Offs



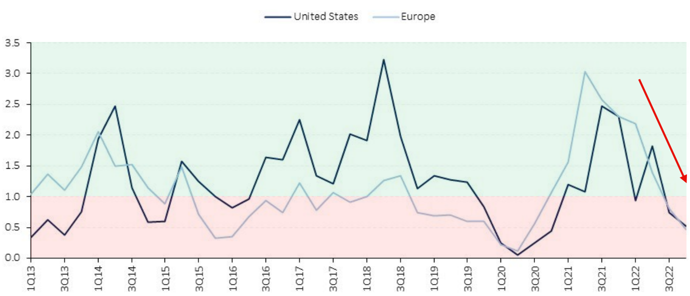
Source. MAM Research, Bloomberg

Chart 9. US HY Spreads vs. Manufacturing PMI and ISM Activity



Source. MAM Research, Bloomberg

Chart 10. Credit Up/Downgrades Ratio (Mid-Point S&P/Moody's)



Source. MAM Research, Bloomberg

Currencies

Conclusion. Dollar Weakness. After peaking in 2022, the dollar will continue to progressively weaken in 2023. Moderation in global inflation measures against bearish consensus expectations support risk-sensitive currencies in the back end of 2023. Any weakness in the dollar until then should however be moderated given relatively high interest rates, falling breakeven rates, and limited growth outside of the US (ex-China). Peak inflation and Fed terminal rate expectations marked the dollar top. Bottoming global growth expectations and a decline in real yields in the coming quarters will accelerate the dollar decline. Some of the key catalyst will be rising breakevens and risk appetite. Europe moving from a current surplus to a deficit should prove supportive to the Euro as the ECB continues to raise rates farther into the year relative to the Fed. Excess capital demand, a lower rates differential, and recovery in China (Eurozone economy strongly exposed to China) provide a strong backstop for the Euro in 2023. We see it rising to 1.08 with risk to the upside at 1.14. The Yen should continue to underperform despite the potential shift in the BoJ's monetary policy.

In 2022, the dollar strength has been the result of risk aversion, softening growth, and monetary policy tightening amidst strong policy divergence vs. other major central banks (e.g., ECB, BoJ). A shift away from an inflation to a recession narrative would be supportive of a weaker dollar through the year. The magnitude of the decline should be a three factor function of how (1) fast inflation falls, (2) much global growth rebounds, and (3) quickly central banks and interest rates normalize. The challenge is that in many ways the dollar remains somewhat attractive despite its elevated valuation (**Chart 11**). The Fed's policy rate is unlikely to fall much, even if the central bank kicks off its rate cutting cycle. Fed fund rates are expected to remain above neutral until 2024, keeping rates relatively high among G10 currencies. FX markets traded with higher real yields and tighter breakevens for most of 2022. Fed expectations are close to peaking (if not already) as disinflationary pressures build and risks of a recession build. It should keep the dollar in a range. When/if breakevens pick up in the back half of the year, the weakness against risk-sensitive currencies should begin to accelerate.

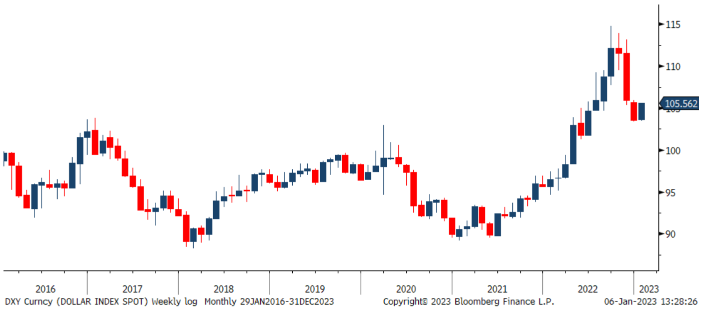
We expect the Euro to rise towards 1.10 with risk skewed to the upside at 1.14 (**Chart 13**). European investors deployed a large amount of capital into foreign fixed income (notably the US) as US yields materially trumped domestic yields (even FX-hedged). However, the trend is likely to evolve as European rates rise and a persistent yield curve inversion generates negative FX-hedged returns. While returns suggest capital flowing back to Europe, so does demand for capital. European energy prices are likely to be structurally higher in the near-to-medium term, shifting the region from a net saver (current account surplus) to net debtor (current account deficit). This raises incentives for private and public borrowers to attract back capital to support the euro.

JPY was the second worst performing G10 currency last year. The weakness against the dollar is attributable to the monetary policy divergence against the Fed. However, in December, the BoJ announced a decisive change to its policy by widening the Yield Curve Control ("YCC") target range for 10-Year JGBs from 0%±25bps to 0%±50bps. The unexpectedly early tweak to the YCC framework drove a large carry unwind. A deceleration in global growth is coming, but risk sentiment may nevertheless remain sufficiently high to support a renewed focus on carry trades, whereby JPY would be the funding currency of choice within the G10 currency space thanks to Japan's lower interest rates and relatively strong liquidity. JPY is likely to underperform more risk-sensitive currencies.

Chart 11. US Dollar Index - Real Effective Exchange Rate

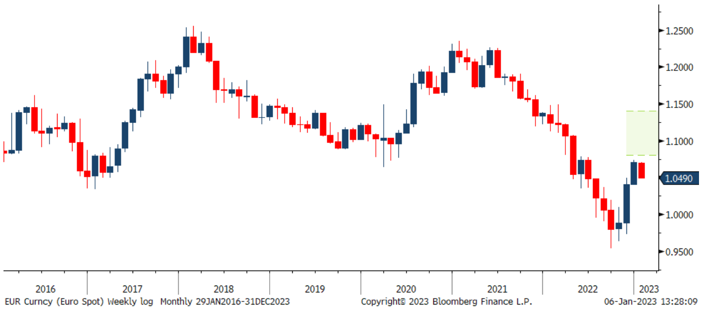
Source. MAM Research, Bloomberg

Chart 12. Dollar Index (Monthly)



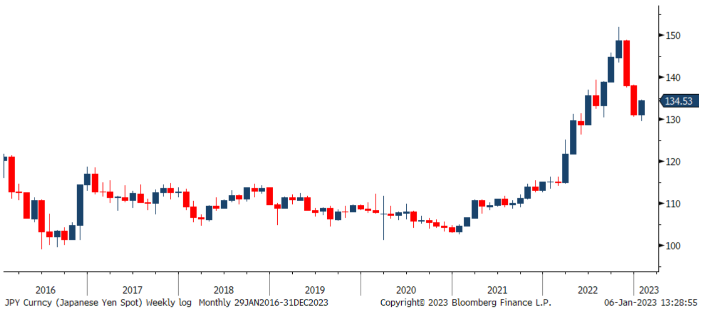
Source. MAM Research, Bloomberg

Chart 13. Euro Spot (Monthly)



Source. MAM Research, Bloomberg

Chart 14. Japanese Yen Spot (Monthly)



Source. MAM Research, Bloomberg

Equities

Conclusion. Negative Earnings Growth Ahead. The fixation on inflation and the Fed continues, but markets are slowly moving past it and focusing onto real concerns: recession risk and earnings growth. Rates and inflation may have peaked but we see it as a warning sign for profitability, a reality that is still underappreciated but can no longer be ignored. Developed market monetary policies are at or heading into restrictive territory and should remain there through 2023. Leading macroeconomic indicators continue to weaken. Bottom-up consensus is anchored near all-time highs on forward earnings estimates. Elevated and rising inventory with healthier supply chains reflect a deteriorating demand backdrop, particularly for goods. In our base case, earnings should decline 5-10% YoY for the S&P 500. Applying a 16.0x multiple (long-term mean), we see a market trough around 3,000 (-21%) over the coming quarters but risks remain skewed to the downside (e.g., not being bearish enough). Precious metals (i.e., gold) miners will be a key allocation. Lower real rates, capex underinvestment, higher prices, and strong balance sheets and cash flows create a supportive environment.

Under normal market conditions, as liquidity declines volatility picks up. However, vol has been subdued for the better part of a year now. Despite broad declines and swings in asset prices, vol has been understated. The spread between rates (MOVE) and equity (VIX) volatility remains near the wides (**Chart 15, LHS**) while the percentage of days with both the S&P 500 down and the VIX down has seen anomalous dislocation (**Chart 15, RHS**). Recession conditions have not been supportive to complacency. Equity vol step functions higher as a recession kicks offs or turns "official" (**Chart 16**), which is (very) negative for risk assets.

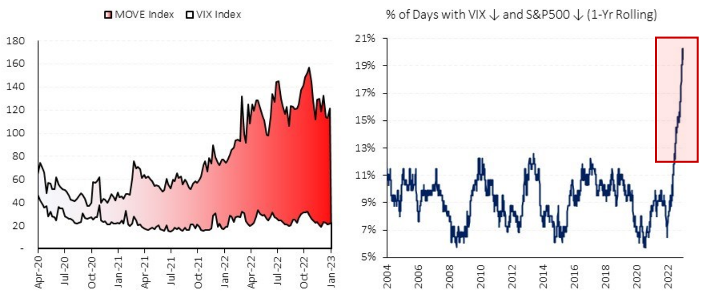
EPS bottom-up consensus is too high due to straight-lined and too optimistic margin expectations. We remain confident in our negative operating leverage thesis. Corporate confidence is at depressed levels. Business activity is falling, implying significant downside risk to growth. Supply chains and backlog data eased dramatically. Demand (notably goods) is eroding while elevated and rising inventories start to pressure end-market pricing.

ISM Backlog and Supplier Deliver composite (market tightness) tends to lead PPI Trades Services (markups or margins proxy) by three quarters (**Chart 17, LHS**). The pricing power, which helped margins through and out of the pandemic, looks at risk as slack returns. Corporate margins should follow lower with a lag. NTM EPS estimates are only down 3% from their high (**Chart 17, RHS**). It is the same dynamic across Europe and Global benchmarks. Valuation fail to capture the recession risk. We see the S&P 500 troughing near 3,000 (-21%), a level where we would turn more constructive. However, mean-reversion implies overshooting to the downside is a low-to-mid probability outcome. In the back end of the year, when the macro warrants it, we will look to deploy capital into distressed high growth equities.

With the BoJ adjusting its monetary policy stance and the global economy slowing down, we are turning more bearish on Japan.

Precious metal miners, notably gold miners, will be a key trade for 2023. The set-up is very supportive. Capex is expected to fall by $11bn in 2023, led by Iron Ore and Gold projects. Spending on large mining projects has slowed down meanwhile no new developments of similar size were announced. Gold production (YoY) in producing regions continues to decline. Precious metals miners stayed disciplined and shareholder friendly through the cycle, transitioning to buybacks since 2018 (**Chart 18, LHS**). The backdrop from underinvestment is two-fold supportive for gold miners as investors get paid on the dividend (**Charts 18, RHS**) (higher than the market) and the absence of capex supports the price outlook for the underlying commodity.

Chart 15. Rates vs. Equity Vol. and % of Days w/ VIX + SPX Down

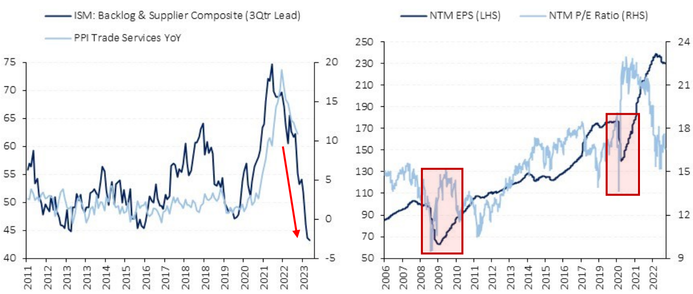


Source. MAM Research, Bloomberg, h/t Hedgeye and Tier1Alpha

Chart 16. Equity Volatility Step Functions Higher in Recessions

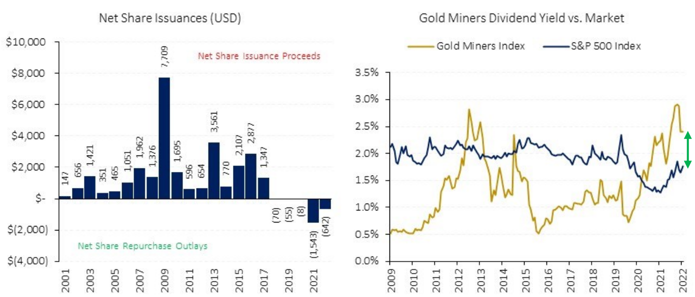
Source. MAM Research, Bloomberg

Chart 17. Margins Proxy vs. S&P 500 NTM Multiple and EPS Est.



Source. MAM Research, Bloomberg

Chart 18. Gold Miners Net Share Issuance and Dividend Yields



Source. MAM Research, Bloomberg, Hedgeye

Commodities

Conclusion. Supportive Supply-Demand Imbalances. Under-investments are amplifying supply constrains in the long-run, inventories are running low, and capacity remains tight while producers remain generally unresponsive. New tailwinds are also emerging: the dollar should progressively weaken, and China's economy is reopening. The transition to a greener economy and reshoring of supply chains provides long-term price support in a supply-constrained environment. A slowdown in economic activity may not necessarily translate into lower prices for these reasons. We maintain our bullish stance on commodities, but expect precious metals (e.g., gold, silver, platinum) to outperform. Peak rates and inflation provide a highly supportive backdrop for gold. The negative carry and dollar strength was a source of headwinds for the better part of 2022, but should fade and reverse through the year, allowing the precious metal to outperform. Historically, gold (safe haven asset) performs strongly (in both absolute and relative terms) in a decelerating growth and inflation environment.

Despite our negative macro outlook in coming quarters, cyclical headwinds should be increasingly offset by structural factors.

Although global GDP growth and oil demand have been slowing down materially in recent quarters, SPR has been drawing at its fastest pace in 2022 (**Chart 19, LHS**) as the Biden administration tried to fight inflation. Rising rates may negatively impact the oil demand but OPEC+ guidance and SPR refills should support it. We believe $80/bbl. is the new $60 for crude as spare capacity dwindles and investment lags (**Chart 19, RHS**). Crucially, most of Asia has just begun to reopen post-Covid at a time when oil inventories remain relatively low and spare production capacity is at a minimum. Some oil-to-gas switching remains yet another factor that could prove further supportive of higher prices.

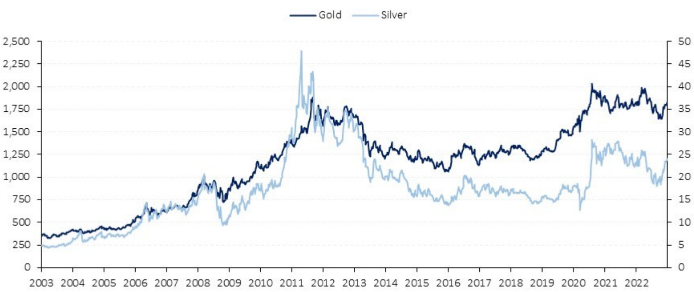
After a lacklustre second and third quarter, China's reopening is going to prove supportive to industrial metals. Iron Ore should be one of the key beneficiary in the first half of the year. With sequentially improving Chinese steel production, from a decent Spring construction season/backlog in infrastructure projects, and a seasonally softer supply, the market should remain tight. With the recent pullback in energy prices, aluminium corrected lower. Although further European smelter curtailments may not materialize, restarts remain unlikely and power shortage-driven shutdowns continue in China. 1Q23 will be bumpy and headline driven but the above creates a positive backdrop for aluminium. Most importantly, we expect the energy transition push to turn into the most pertinent driver for metals important to future technologies. Renewables have become more important in the electricity mix. The low renewable capacity factors means more capacity needs building, providing a backstop to many metals.

Gold's safe haven status is prominent in a decelerating growth and inflation environment, generating positive absolute returns (**Chart 21, LHS**) and alpha against risk assets (**Chart 21, RHS**) as the precious metal moves inversely to real rates **(Chart 22, LHS)**. Physical gold demand from central banks and India/China has been quite strong. A slowdown in the pace of tighter monetary policy will bring investors back in the market. Historically, a yield curve inversion is a strong leading indicator for a recession. The prospects of a recessionary environment drives a flight to safety from investors, typically associated with a decline in real yields. A steepening of the yield curve driven by a Fed pivot would be the ultimate driver for gold outperformance as it would drive lower real yields (**Chart 22, RHS**). Meanwhile, risk-off dynamics and dollar headwinds should remain the key drivers behind gold returns over the coming quarter.

Chart 19. SPR Strategic Petroleum Reserve and WTI Crude Oil

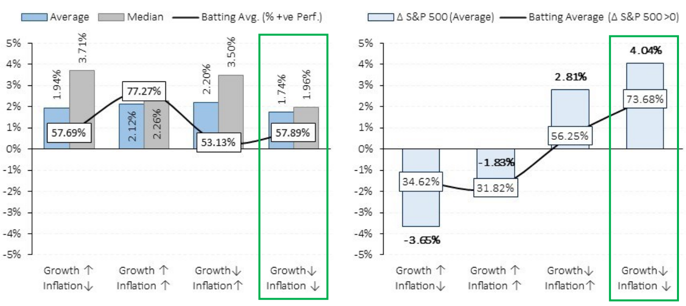
Source. MAM Research, Bloomberg

Chart 20. Gold and Silver Spot Prices



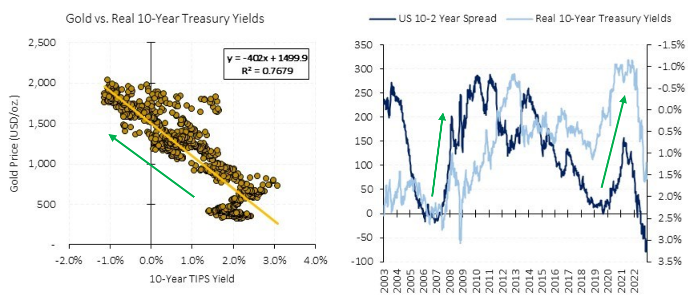
Source. MAM Research, Bloomberg

Chart 21. Gold Returns by Growth/Inflation Regime (Quarterly)



Source. MAM Research, Hedgeye

Chart 22. Gold vs. Real Yields and US 10-2 vs. Real Yields



Source. MAM Research, Bloomberg

Key Trades For 2023

US 30-2 Year Treasury Yield Curve Steepening

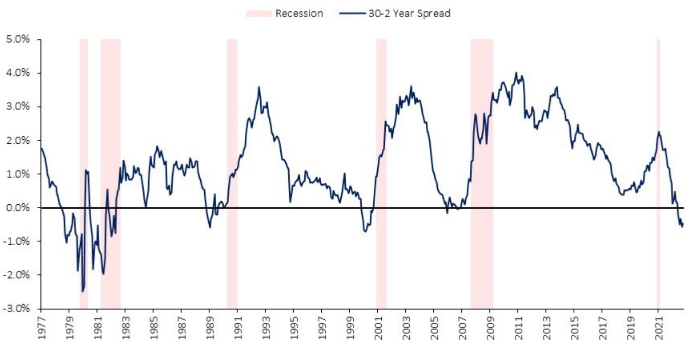
The monetary policy tightening cycle has considerably increased the probability of a deep recession over the coming year. Since the 1970s, every single recession has been preceded by a yield curve inversion in the prior 12-months (**Chart 23**). On average, the curve bottoms eleven weeks prior to the final hike. With the final one expected to occur at the FOMC's March 2023 meeting, we expect the 30-2 Year spot spread to bottom in early January.

Interestingly, there is a clear relationship between how negative the spread gets and the pace at which the curve steepens thereafter. Given where the US 30-2 Year spread was this year, our backtest suggests it would take 1-1.5 years to top 135bps.

We recently initiated a trade using a 2-Yearr digital call warrant to profit from a potential curve steepening. The investment will pay investors 4.0x (gross) their premium spent if the underlying spread closes above the 135bps strike at maturity.

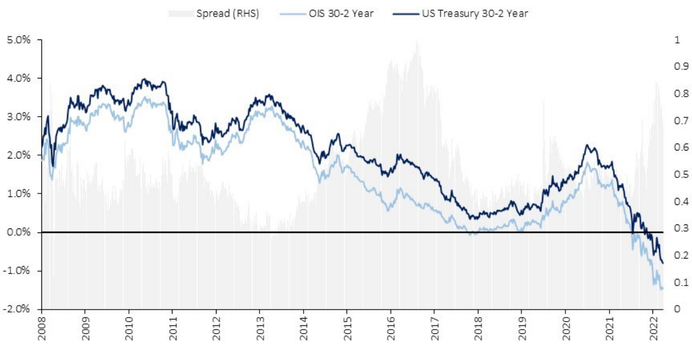
Due to limitations on derivatives markets for treasury yields, we used the 30-2 Year OIS (Overnight Indexed Swaps) as underlying and proxy although they slightly diverge from Treasury yields by approximately 50bps (**Chart 24**). As the current spread (76bps) is nearly two standard deviations wide, we expect it to narrow and revert to its long-term mean. In turn, recapturing it would accelerate the "curve steepening" on our digital call warrant.

Chart 23. 30-2 Year Yield Curve Inversion and US Recessions



Source. MAM Research, Bloomberg

Chart 24. Treasury 30-2 vs. OIS 30-2 Year Spread



Source. MAM Research, Bloomberg

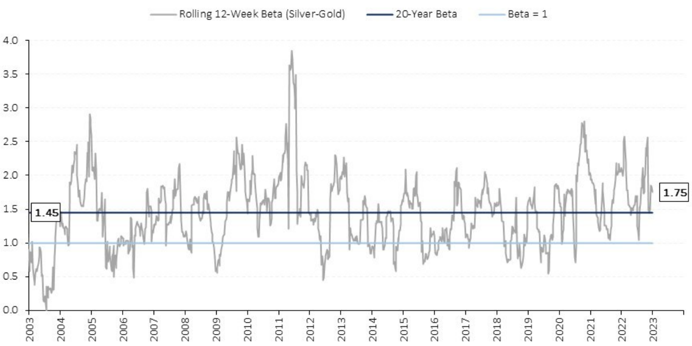
Precious Metals & Precious Miners

Gold's safe haven status is prominent in a decelerating growth and inflation environment, generating positive absolute returns. Physical gold demand from central banks and India/China has been quite strong. A slowdown in the pace of tighter monetary policy will bring investors back in the market. As unemployment rises and the recession becomes a known fact, central banks will be forced to reopen the liquidity taps, driving real yields lower and precious metal prices higher. With a bullish backdrop for gold, the move in silver should be amplified (**Chart 25**).

Although the rates and macro set-up is very supportive, so is the fundamental. Capex is expected to fall by $11bn in 2023, led by Iron Ore and Gold projects. Spending on large mining projects has slowed down meanwhile no new developments of similar size have been announced. Gold production in producing regions continues to decline. Precious metals miners stayed disciplined and shareholder friendly in the cycle, transitioning to buybacks since 2018. The backdrop from underinvestment is two-fold supportive for gold miners as investors get paid on the dividend (higher than the market) and the absence of capex.

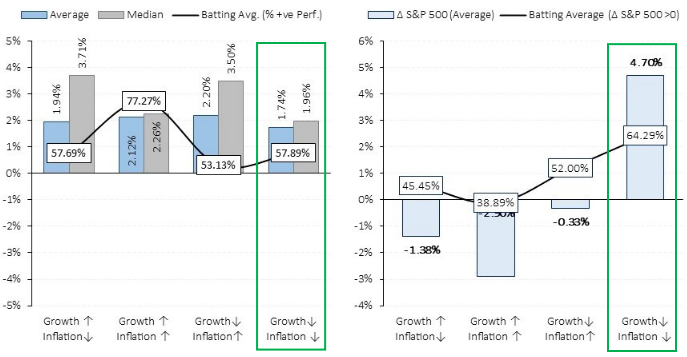
Equity tend to fare the worse in the current environment, but gold miners' absolute returns have been solid in both absolute (**Chart 26, LHS**) and relative terms (**Chart 26, RHS**). Silver miners produce similar returns. However, in both gold and silver, junior miners (typically weaker balance sheets) fail to generate alpha.

Chart 25. Silver-Gold Beta



Source. MAM Research, Bloomberg

Chart 26. Gold Miners by Growth/Inflation Regime (Quarterly)



Source. MAM Research, Hedgeye

Key Trades For 2023

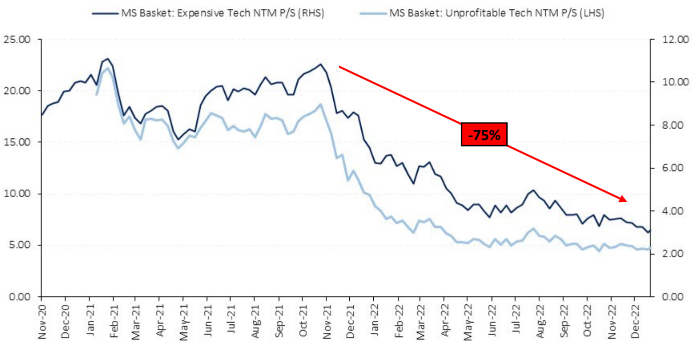
Distressed High Growth Equities

Tighter financial conditions and higher interest rates prompted a large reset in valuation across the high growth equity segment of the market. NTM P/S and P/E multiples are down more than 70% from their early 2021 peak (**Chart 27**). We are not calling for a bottom nor are we recommending on buying high growth (profitable) stocks today. Instead, we want to show where we want to be in six to nine months.

As the macro economic conditions continues to deteriorate, the odds of a credit event occurring rises in a non-linear fashion and so does unemployment. When economic hardship approaches a point where central banks are either forced to pause or pivot, we will look to buy companies with positive cash flows, strong balance sheets, high revenues growth, and depressed multiples. We would look for data inflection points (steeper yield curve) to start implementing such trade. Based on our current outlook, we do not foresee a window of opportunity to initiate a position until the second half of the year or when the aforementioned credit and employment events occur.

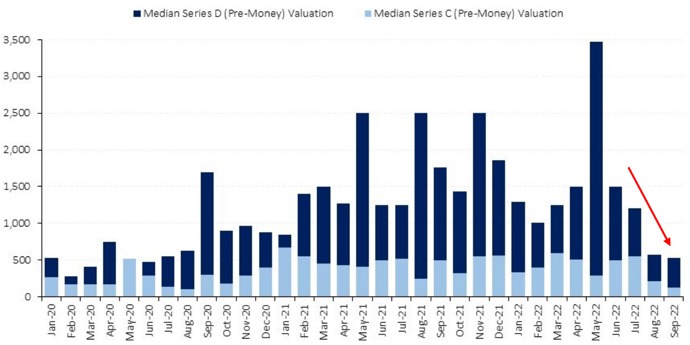
Though primarily geared towards publicly listed companies, our strategy also applies to private markets and pre-IPO companies where valuations have meaningfully been revised lower in some recent transactions (**Chart 28**). Private equity has yet to mark its investments to market (potential credit event catalyst?) but we already see steep discounts in primaries and secondaries.

Chart 27. Distressed Valuations Are Emerging in High Growth



Source. MAM Research, Bloomberg

Chart 28. Median Series C &D Pre-Money Valuation



Source. MAM Research, Cooley Ventures

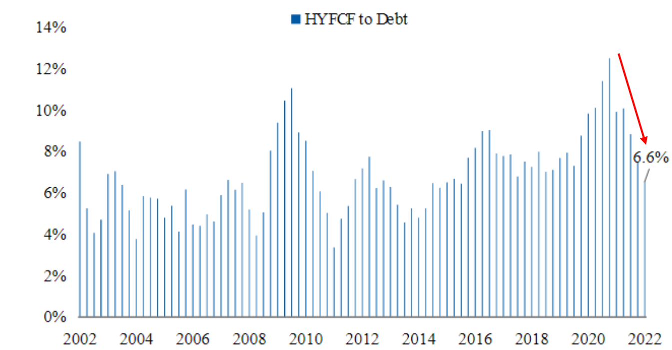
Distressed Credit

Most key credit metrics held up at healthy levels in 3Q22, but sequential trends suggest some weakness ahead with the ability of high yield issuers to preserve cash flows and margins likely to be tested in coming quarters. Continued strength in operating metrics allowed leverage to settle at a decade low and lifted coverage ratios to new peaks for the median high yield issuer. As earnings growth flips negative and interest expenses rise, the operating outlook for this year and next turns more uncertain.

Cash burn rates have increased and free-cash-flow generation has softened. Despite the optical relieve from healthy cash/debt ratios, the broad-based erosion of cash balances persisted along deteriorating FCF profiles. For the median high yield borrower, balance sheet cash was -3.6% lower in 3Q22, down -22% YoY. Meanwhile, weaker FCF figure pushed FCF/Debt to a multi-year low of 6.5% after another 100bps decline (**Chart 29**). High capex and inventory overhang are hindering FCF conversion rates. Fundamental cracks remain confined to select sectors, for now. Although nothing is acute yet, early stress is building in the distressed space with supply starting to percolate (**Chart 30**).

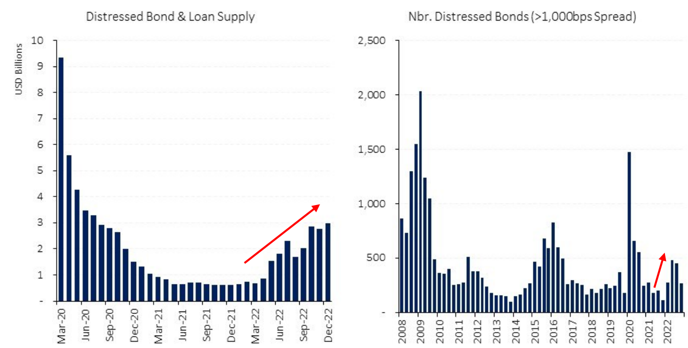
Although not an imminent risk, the current economic slowdown is laying down the pieces for credit event to materialize. In turn, it will create the breadth of opportunities across the investment landscape but we believe distressed credit and will offer strong returns to those ready to take the opportunity later in the cycle.

Chart 29. High Yield Free-Cash-Flow/Debt Ratio (Quarterly)



Source. S&P Capital IQ, MS Research

Chart 30. Distressed Bond & Loan Supply Building Up



Source. MAM Research, Bloomberg

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