THE BYCOFF GROUP

2023 Outlook

Key Takeaways:

- **2022 was a historically volatile year – more daily moves of 2%+ in the market than in 2008, the start of the Global Financial Crisis.**
- **There were many headwinds in 2022, as valuations across speculative and profitable companies were reset.**
    - The valuation reset in 2022 is ultimately good for new capital to be invested.
- **Investors may need to look at a multi-year period of returns to properly judge 2022 in context.**
    - 2023 is already showing a major reversal – the 5 best performing sectors to start 2023 were the 5 bottom performers last year, while 4 of the 5 top finishers in 2022 have started 2023 among the bottom this year.
    - Public growth equities have still been the best performing asset class over the last 3 years despite the drop last year.
- **A recession in 2023 is not currently being projected by a poll of the country's biggest macroeconomists (in fact the average calls for slight GDP growth) though a recession is a possibility.**
- **We believe 2023 will be a better year for the growth-oriented equity investor, though perhaps not for the overall market.**
    - Growth companies are starting 2023 with both lower estimates and lower valuations, a better investment set up for them in 2023 along with a more stable cost of capital environment.
    - The valuation gap between growth and value companies is closer this year and presents a compelling opportunity.
    - The "micro" should matter more – small caps were the best performing asset class in the inflationary period of 1970s once the Federal Reserve paused interest rate hikes.
    - The themes have not changed – consumer habits, secular shifts like electric vehicles are still intact and breakthroughs in artificial intelligence and fusion made at the end of 2022 reinforced this view.
    - Foreign exchange rates are much more favorable to US investors and China is reopening after covid lockdowns.
- **Our strategy contemplates:**
    - Investors should prepare for a range of outcomes from modest growth to a potential recession induced by the Federal Reserve.
    - Valuations matter again as long as cash rates remain this high and we must be patient on entry points.
    - Investors may need to accept a more stable return construct where equities appreciate about 7-10% on average and to generate higher returns we need to find companies that are executing extremely well and can defend and argue for a higher share price.
    - Exposure to smaller companies is attractive and must be done through direct investment in each company – 25% of the S&P 500 is still just 10 companies, index investors could be surprised by slower returns.
    - At a position level, we want to buy companies that are exhibiting the following:
        - Accelerating growth
        - Stronger growth for longer
        - Special situations

Asset Class Matrix:

EQUITIES

- Our preferred long term return option
- Despite sell-off last year, Growth Equities were the best performing asset class over the last 3-years
- Investing into uncertainty has typically been a good strategy
- Valuations are more compelling this year than they were at the start of 2022

OTHER ASSET CLASSES

- Short term treasury rates are more attractive now
- Investors should keep in mind their tax rates - the after tax rate of US Treasury Bills is 3% at a 37% tax bracket vs. 2.5%+ on a dividend stock with long term equity upside
- The Federal Reserve Funds Rate is about 5%, 2 Year US Treasuries yield about 4% and Investment Grade ETFs are currently yielding less income than cash rates

POSITIONING

- Patient on entry points as valuation matters again
- Favoring smaller-sized companies, the best performing asset class in the period of inflation, the 1970s
- Investors will need to look for alpha in companies that can grow even in a mild recession
- The 10 largest companies still make up over 25% of the S&P 500 index - single stock exposure is important

HEDGE

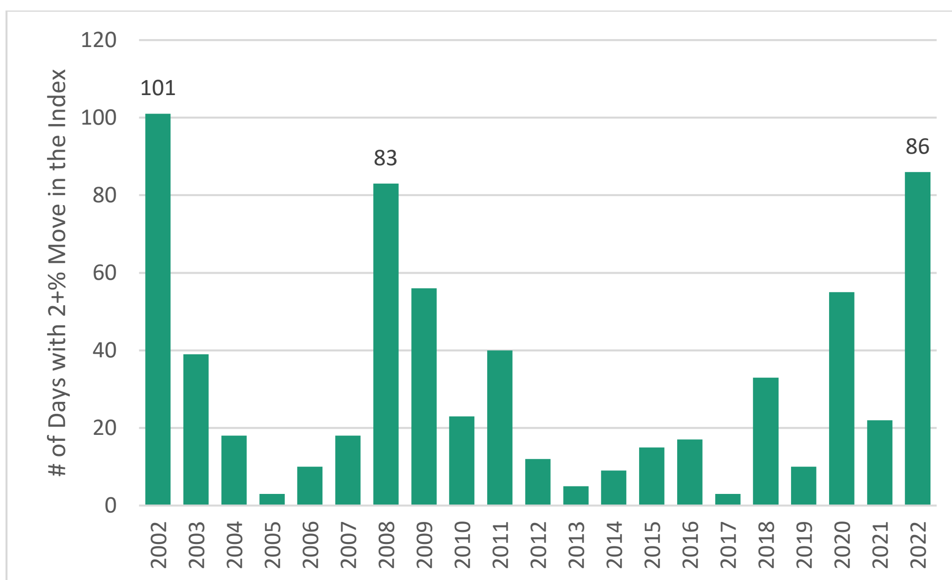
- Last year's hedge was Oil & Gas Companies and Cash
- We devoted a meaningful % of the portfolios to Energy companies for the purposes of protecting against inflation
- This year we do not think oil will serve as a hedge - the price of natural gas is down 50% over the last 6 months
- We anticipate using cash and trading more to book profits on successful trades

2022 Recap:

2022 Was Historically Volatile

If 2022 felt especially volatile, your instincts are correct! There were more daily moves of 2% or greater, 86 to be exact, than even 2008, the start of the Global Financial Crisis (see Figure 1 below). The headline reasons for the volatility we're all quite aware of – one of the biggest wars in Europe since WWII, steep and rising inflation in the US for most of the year before peaking in July at 9.1% (inflation has not been over 6% since 1990), the Federal Reserve's significant interest rate increase with the goal of slowing the economy, and severe covid lockdowns in China (the world's biggest economy).

Fig. 1: Daily Moves of 2% or Greater in the Nasdaq Composite Index



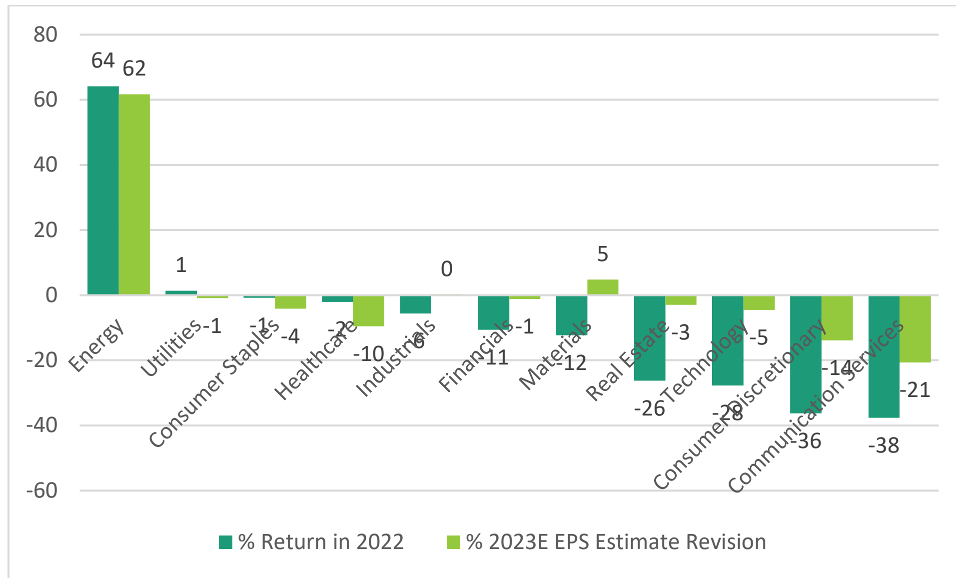
Source: WSJ, "Nasdaq's Big Swings Are Most in Year since 2002", Miao, Hannah. Dec. 15, 2022.

Fundamentals Still Mattered But Valuations on Growth Companies Were Hit Especially Hard

In 2022, the Energy, or Oil & Gas Sector, was the only sector to generate positive returns. Last year Energy outperformed the Technology sector by 92%. Estimates for 2023 profits for the Energy sector rose 62% over the course of last year driven by the rise in oil and gasoline prices. As a result, the sector finished with a total return of 64% (see Fig. 2 below). Compare that to the Communication Services sector where estimates for 2023 profit came down by -21% over the year while stock prices in the sector fell by over -38% as their valuation multiple compressed as well.

Growth sectors that are valued on a combination of future growth prospects and current estimates rather than commodity prices saw a valuation reset as investors went from paying many multiples of a company's growth to just 1 or 2x their growth rate. These changes are positive for new investment dollars as company valuations are more attractive today than 12 months ago, especially across what has historically been some of the most attractive parts of the market to invest in.

Fig. 2: Stock Price Returns and Estimate Changes Organized by Sector



Source: Bloomberg and TBG analysis.

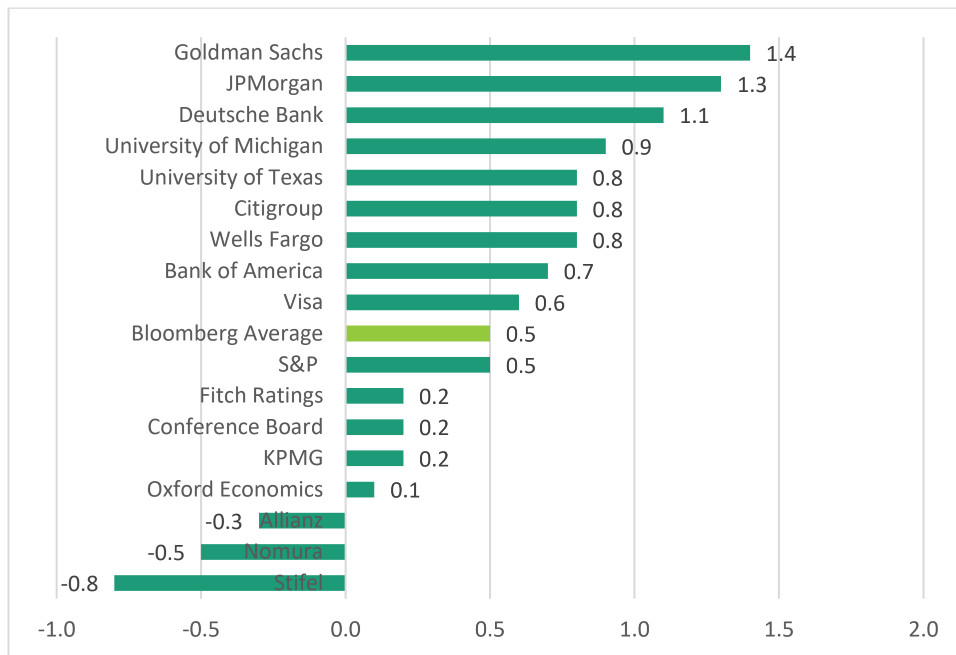
2023 Macroeconomic Outlook:

What are macroeconomists predicting? Is a recession in the cards?

Currently, US economists are not on average predicting a recession this year. Economists are expecting US GDP to be flat to up slightly with an average growth rate of 0.5% per Bloomberg (see Figure 3 below). The S&P 500 index is expected to have flat profit growth of about $225 per share in earnings as revenue growth will not be able to offset higher costs driven higher by inflation.

We can debate these economists. There is potential for a recession as the Federal Reserve continues to seek to slow the economy. However, there is also potential for a modest growth year where deflation slowly plays out.

Fig. 3: Forecasts for US GDP Growth in 2023 (%)



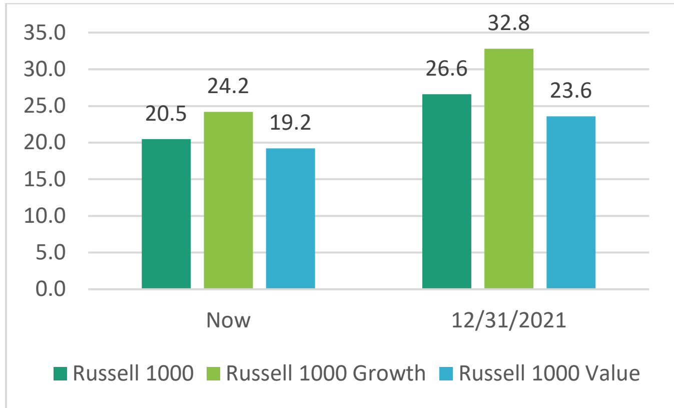
Source: Bloomberg and TBG analysis.

Our Outlook for the Stock Market in 2023:

We expect 2023 to be a fair investment year. By fair, we mean strong individual company performance should drive positive returns while economic headwinds are expected to impact all companies, not just technology stocks.

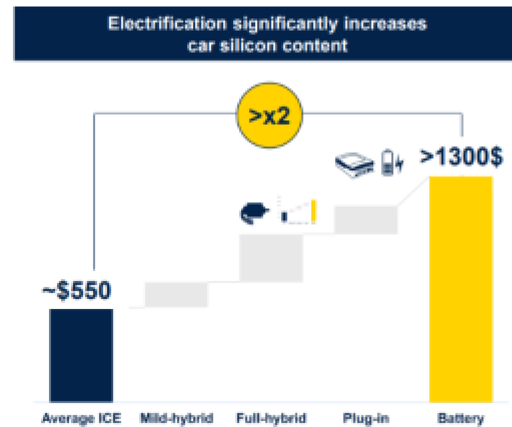
1. **The valuation gap between growth and value companies has closed and growth companies are more attractive now.** Value indices have seen their valuation multiple decrease from 23x to 19x over the course of 2022, a 4x decrease, while growth companies have seen multiples fall from 33x to 24x, a 9x decrease. Valuation alone does not typically drive positive outcomes in stocks – you need estimates to go higher as we mentioned above. However, on a growth adjusted basis, growth companies are now cheaper than value companies and we expect a more level playing field in stock performance across all sectors. (See Figure 4)
2. **The "micro" should matter more. Small Caps stocks were the best performing asset class in the 1970s by a factor of 2x.** Once the Fed pivoted to reduce interest rates in 1973, small caps materially outperformed other asset classes. We think this could happen in 2023 as the cost of capital should be more stable this year (Fig. 6).
3. **The Themes have not changed!** While 2022 was not a favorable year for most growth areas, we do not think the factors that are shaping our world for years to come have changed. Electric vehicles, the desire to live longer lives through medical advancements and healthier lifestyles, and consumer interests such as shopping (both online and in store), dining and traveling are all intact (see Figure 5 for instance regarding electric vehicles). We exited 2022 with one of the most profound advancements we've seen in artificial intelligence via ChatGPT as well as critical progress in clean energy technology, with the advancement of nuclear fusion. An ironic way to end 2022 given oil companies dominated the markets most of the year.

Figure 4: P/E Valuation for Growth vs. Value at the End of 2021 to Now



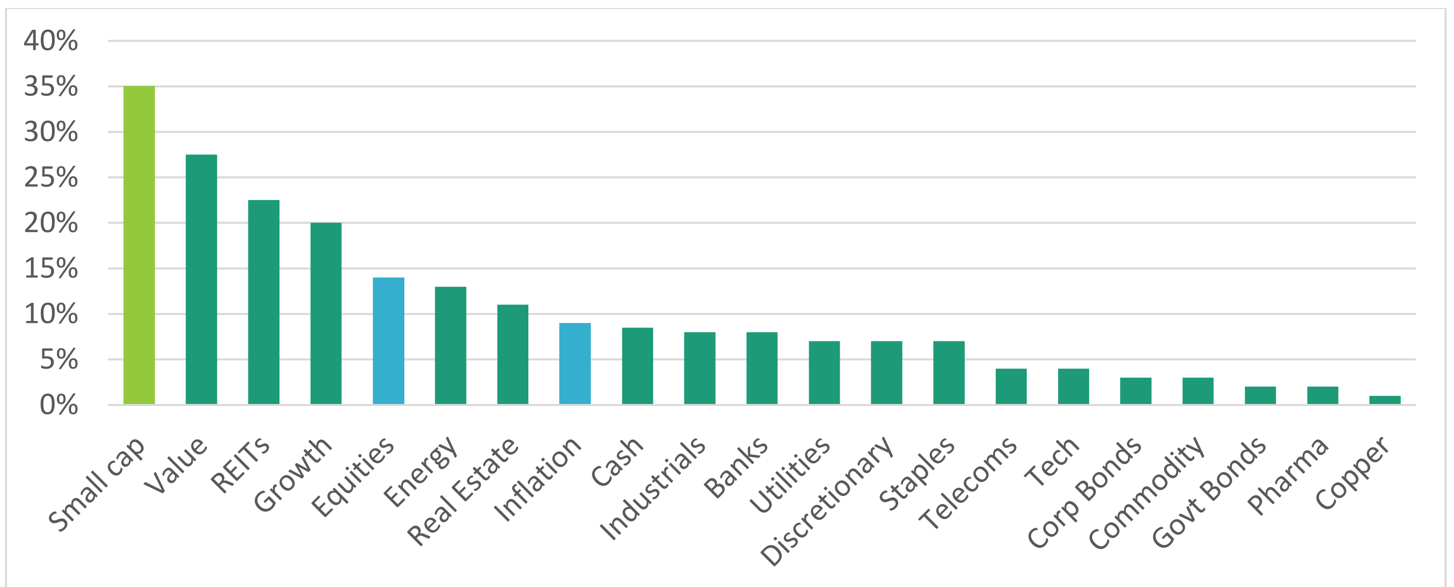
Source: Bloomberg and TBG analysis.

Figure 5: Many Industries that Experienced Weakness in 2022 are Still Poised for Substantial Growth



Source: BofA Global Research

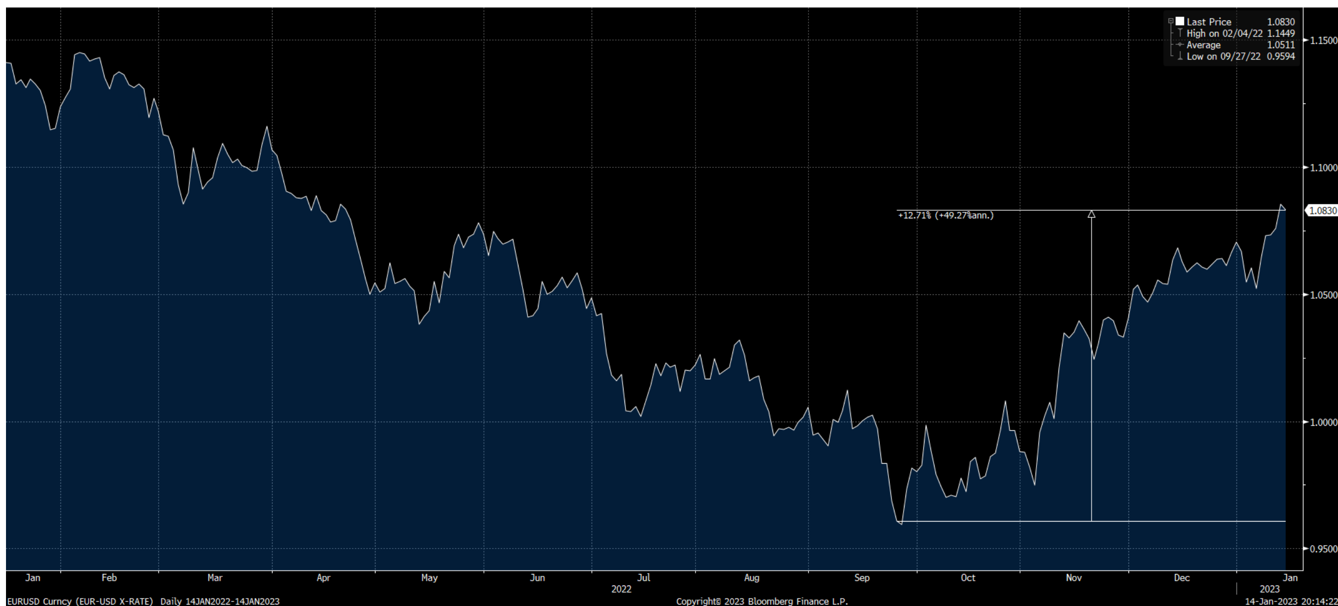
Fig. 6: In the 1970s, Small Cap Stocks Crushed Other Asset Classes



Source: BofA Research, "The Flow Show", Nov. 3, 2022.

4. **Foreign exchange rates are more beneficial for US stocks and China is reopening from covid lockdowns.** Foreign exchange rates have materially improved for US investors over the last 3 months with the US dollar weakening and other currencies stabilizing. This is a very good dynamic for US companies that sell internationally as their foreign profits are worth more in dollars this year than they were last year. China has removed covid lockdowns and while this resulted in spread of covid initially, this spread has subsided, and relations seem somewhat better with the US as well based on recent news. Unlocking the world's biggest economy could be a material driver.

Fig. 7: The Euro Has Strengthened by 12% since Companies Last Reported Earnings in Q3



Source: Bloomberg.

Our Investment Strategy for 2023:

We are excited about the factors that we think can lead to more favorable markets for public growth equity investors. There are still potential headwinds that we must acknowledge.

Our Tactical Positioning Contemplates the Following:

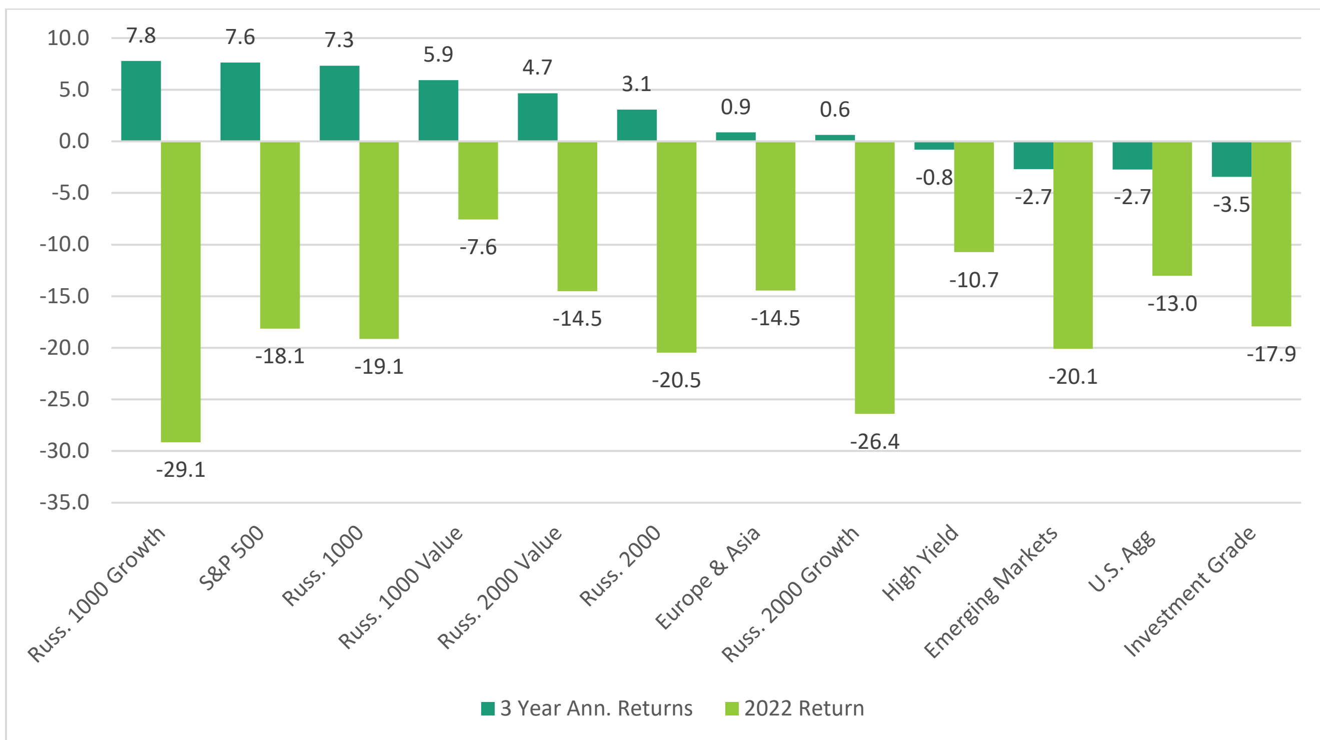
- Prepare for multiple outcomes.
  - There is a potential for a steady recovery in asset prices through the year as a major recession is avoided and strong tailwinds of growth in the emerging markets bolster the global economy.
  - There is also the possibility that the Federal Reserve causes unemployment and a recession.
  - As we noted major macroeconomists are not projecting contraction, but we must be cognizant.
- Our preference for long term, growth-oriented investors remains public equities:
  - Public growth equities have still been the best performing asset class over the last 3 years despite the drop last year generating about 8% annual returns versus fixed income which lost -3% (see Figure 8).
  - More than 75% of S&P 500 companies have fixed long-term debt and hence should not be as impacted by rising interest rates as other asset classes like private companies or real estate.
  - Statistically over the last 95 years of market history per Bloomberg, the S&P 500 has generated a positive return 75% of the time after a down year.
  - There are exciting themes to invest in, including robotics and artificial intelligence that will need to be further developed as our population ages.
- Cash and fixed income are more attractive now but equities still edge them out.
  - Treasury bills and high yield tax accounts yield an attractive 4-5%. After taxes, an investor will earn about 3% assuming a 37% tax bracket. This compares to an after-tax yield of about 2-3% on a dividend stock plus an investor has potential for long term upside.
  - Investment grade ETFs are yielding 3.5% which makes Treasury Bills superior income producers.
- Positioning and hedging:
  - Valuations matter again! We will be patient on entry points and sizing up new investments.

- Smaller companies will generate alpha – we believe there are companies that will show sustainable growth even in a slower growth or moderate recession climate.
- 25% of the S&P 500 is still just the 10 largest companies in the US by market cap. To get exposure you must invest directly at the company level.
- We found valuable Hedges last year in oil & gas companies and cash, dedicating 10+% of the portfolio to these hedges. Natural gas prices are off 50% over the last 6 months, however.
- We will look for new areas to add hedge exposure as markets stabilize.

<u>Our Investment Criteria:</u>

- We want to buy companies that are exhibiting the following:
  - <u>Accelerating Growth</u> – Companies that are inflecting for faster revenue growth or faster profit growth even in a slower economic period.
  - <u>Stronger for Longer</u> – Companies that offer more attractive valuations post the 2022 sell-off and are likely to see profits grow above market rates over the next 3-5 years, bonus points for dividend payers.
  - <u>Special Situations</u> – There are a number of founder-led companies with real business models that have much lower stock prices this year. We think they could look to sell the business or take action to drive stock prices higher.
  - To the extent companies check all three boxes at once, returns could be especially strong.

Fig. 8: 3 Year Annualized Returns by Asset Class



Source: Bloomberg.