ISSUE 23

FROM THE DESK OF ERIK OROS

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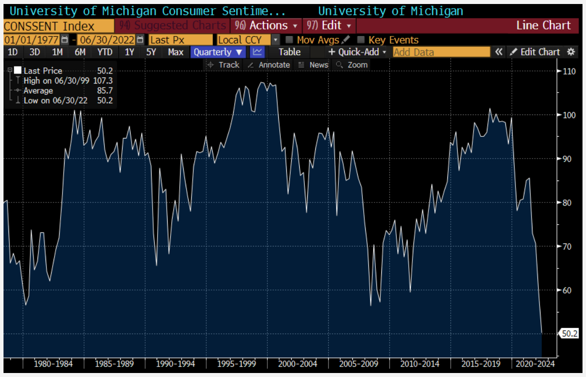
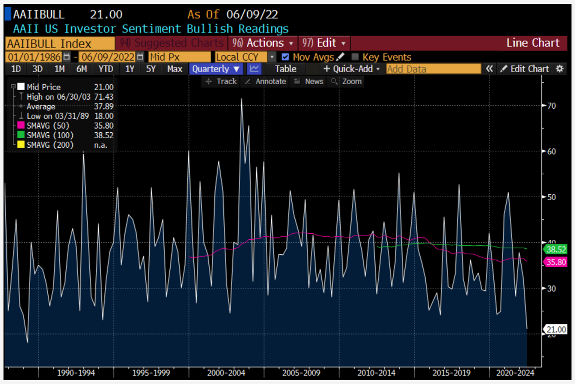
In 1971, Hunter S. Thompson released the cult classic *Fear and Loathing in Las Vegas: A Savage Journey to the Heart of the American Dream*, lamenting the disappointment of the 1960's counter-culture movement and foretelling the upheaval in the decade ahead. Investors lately have been feeling much fear and loathing themselves, harkening back to the 1970s with the specter of stagflation and policy mistakes looming precipitously over financial markets.

Soaring prices at the pump, geo-political upheaval, and a Fed scrambling to amend its missteps certainly evoke the 1970s. This year, in a dramatic reversal, both the Fed and investors have jettisoned the "temporary" inflation narrative that characterized the bulk of 2021. Today, in fact, the Fed has struck a tone much like that of Paul Volcker who famously promised to "break the back of inflation" by raising interest rates aggressively. Soaring rates have brought the death of the TINA (there- is-no-alternative) narrative that provided a seemingly endless tailwind to multiple expansion, wreaking havoc on growth assets. Consumer confidence levels have plummeted to all-time lows and fund manager positioning has shifted as bearishly as we've seen in past decade.

University of Michigan Consumer Confidence



AAII Bullish Sentiment Readings



Ultimately, these worries have compounded to push equities officially into bear market territory. To make matters worse, there has seemingly been nowhere to hide, with the bond market on track for its worst performance (by a longshot) since the seventies. Mortgage rates have exploded higher, as have corporate spreads, fueling fears of a looming recession.

Barclays Aggregate Bond Index Yearly Total Return

Yr	Ttl Rtn	Yr	Ttl Rtn	Yr	Ttl Rtn	Yr	Ttl Rtn	Yr	Ttl Rtn
2022	-12.65%	2012	4.21%	2002	10.26%	1992	7.40%	1982	32.64%
2021	-1.54%	2011	7.84%	2001	8.44%	1991	16.00%	1981	6.26%
2020	7.51%	2010	6.54%	2000	11.63%	1990	8.95%	1980	2.71%
2019	8.72%	2009	5.93%	1999	-0.82%	1989	14.53%	1979	1.92%
2018	0.01%	2008	5.24%	1998	8.69%	1988	7.88%	1978	1.40%
2017	3.54%	2007	6.97%	1997	9.65%	1987	2.76%	1977	3.03%
2016	2.65%	2006	4.33%	1996	3.63%	1986	15.25%	1976	15.60%
2015	0.55%	2005	2.43%	1995	18.47%	1985	22.13%		
2014	5.97%	2004	4.34%	1994	-2.92%	1984	15.15%		
2013	-2.02%	2003	4.10%	1993	9.75%	1983	8.37%		

30yr Mortgages & Junk Bond Spreads

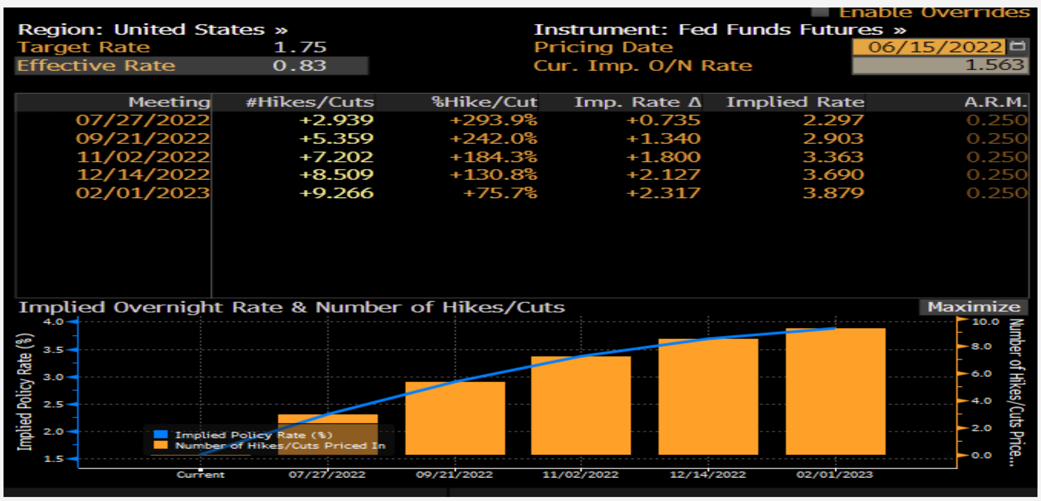
Credibility Check

The question therefore looms as to whether the dramatic "Fear and Loathing" we've witnessed thus far is warranted. The ultimate persistence of inflation and the likelihood of a US recession will without question remain the key drivers of both fixed income and equity prices. However, daunting a recession may be for markets, these sorts of pressures are well understood. An inflationary spiral however takes on a life of its own and there is nothing the market hates more than uncertainty.

While similarities abound to the 1970s, the inflationary spiral and its extended duration at that time were largely due to the compounded policy mistakes of the Federal Reserve. Inflation began in 1966 but it was not until 1979 when Paul Volker was appointed that the Fed made a concerted effort to bring inflation under control. While the current Fed undoubtedly misdiagnosed the persistence of supply chain issues and should have begun to normalize policy last summer, 12 months stands in large contrast to 12 years. However, as former Fed Chair Ben Bernanke penned this week, “Inflation will not become self-perpetuating, with price increases leading to wage increases leading to price increases, if people are confident that the Fed will take the necessary measures to bring inflation down over time.”

The Fed made clear today that they recognize the importance of regaining their credibility, and while this certainly equates to aggressive tightening, these steps and the market’s confidence in their ability to control inflation are critical to avoiding a prolonged inflationary spiral. In fact, the tools at the Fed’s disposal are inevitably aimed squarely at reducing aggregate demand and perhaps even engineering the very recession that the market fears. While the market woefully mispriced the necessity for drastic monetary tightening, Eurodollar futures suggest that aggressive tightening is now well telegraphed with 150bps worth of hikes expected to follow today’s 75bps.

Eurodollar Implied Fed Funds Rates



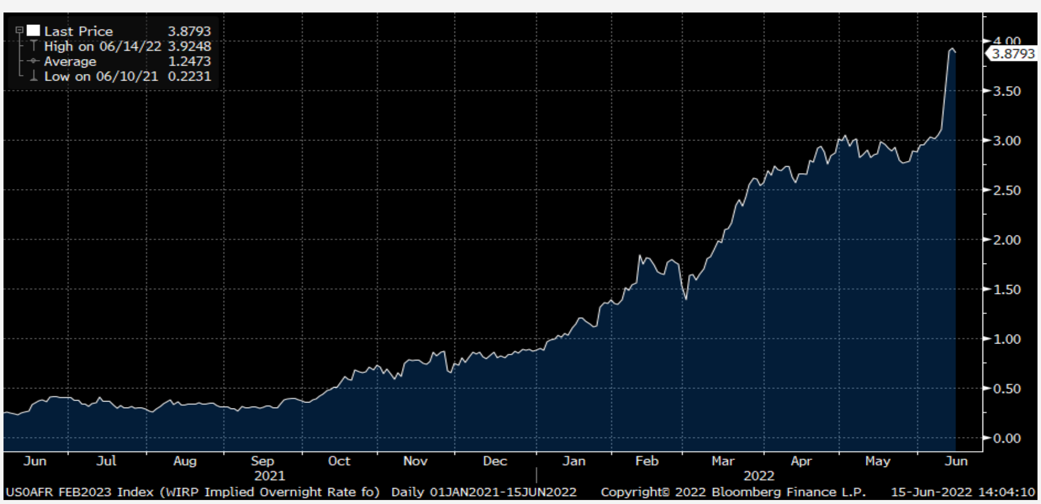
Enable Overrides

Region: United States »
Target Rate 1.75
Effective Rate 0.83

Instrument: Fed Funds Futures »
Pricing Date 06/15/2022
Cur. Imp. O/N Rate 1.563

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
07/27/2022	+2.939	+293.9%	+0.735	2.297	0.250
09/21/2022	+5.359	+242.0%	+1.340	2.903	0.250
11/02/2022	+7.202	+184.3%	+1.800	3.363	0.250
12/14/2022	+8.509	+130.8%	+2.127	3.690	0.250
02/01/2023	+9.266	+75.7%	+2.317	3.879	0.250

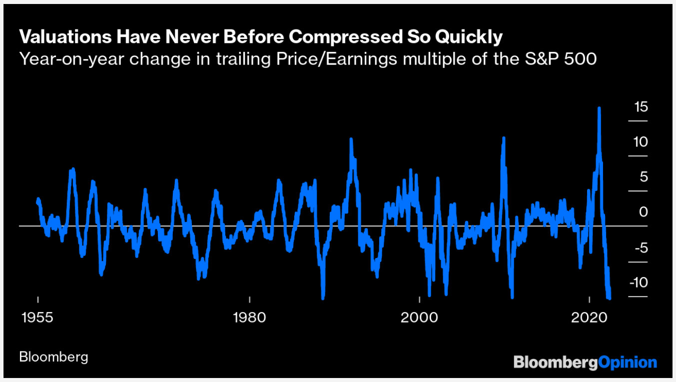
Expected Fed Funds Target Feb 2023



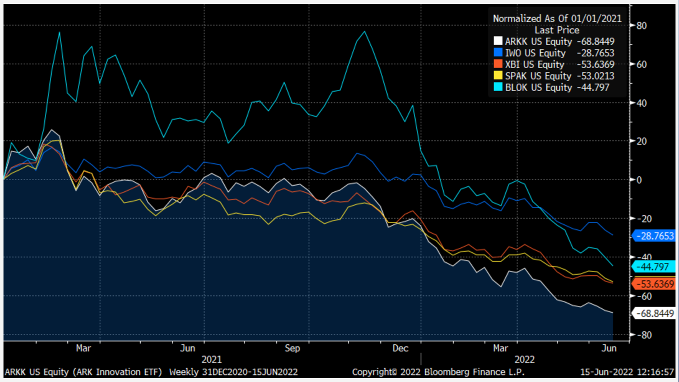
If the Fed indeed engineers a recession, what is priced in as it relates to equity and bond markets remains much more difficult to access. The yield curve has remained inverted signaling that the market remains confident not only in the Fed's ability to regain control over inflation but the likelihood that ultimately the Fed will be forced to back-track. Certainly, following today's announcement, short duration yields seem to present value. Unless there is an additional acceleration in inflation that requires more aggressive tightening from the Fed, yields of north of 3.25% on 2-year treasuries, and higher yields on high quality corporates/municipals are beginning to look more attractive. With little to no additional yield to be gained beyond the 24-month paper, it continues to be difficult to underwrite longer duration fixed income. Should the market lose confidence in the Fed's control around inflation, the duration risk of these securities remains substantial with no compensation for this additional risk.

In equity markets we have seen a historically rapid compression of valuation multiples, particularly in high growth sectors. For the past 12 years, equities have largely been driven higher through multiple expansion that reached a fever pitch in January of 2021. This unimpeded expansion was driven purely by the march of interest rates to historically low levels, negative in real terms across the developed world. Multiples particularly in high growth sectors such as Biotech, Web3, and enterprise software extended to levels not seen since the dot-com era and their fall has been perhaps even more dramatic. Multiples have contracted across the S&P 500 by over 15% year to date at a speed as rapid as the liquidity crisis induced by COVID, and even more quickly than during the GFC. Nowhere has this revaluation occurred more dramatically than in high multiple equities, to the magnitude of 60-80%..

Y/Y Change in P/E Ratios



Performance of High Multiple Sectors



Select Software Multiples

$ in millions	12/31/20			6/15/22			
Ticker	EV	TTM Sales	EV/S	EV	TTM Sales	EV/S	% Change
SNOW*	$ 73,427.10	$ 592.00	124.03	$ 34,886.30	$ 1,412.80	24.69	-80.09%
TWLO	$ 45,045.80	$ 1,761.80	25.57	$ 11,343.20	$ 3,127.20	3.63	-85.81%
PLTR	$ 40,650.40	$ 1,092.70	37.20	$ 14,200.30	$ 1,647.00	8.62	-76.82%
U	$ 40,351.60	$ 772.40	52.24	$ 10,584.00	$ 1,195.90	8.85	-83.06%
TTD	$ 37,587.70	$ 836.00	44.96	$ 22,029.40	$ 1,292.00	17.05	-62.08%
NET	$ 22,849.80	$ 431.10	53.00	$ 13,918.40	$ 730.50	19.05	-64.05%
DDOG	$ 21,972.00	$ 603.50	36.41	$ 26,861.40	$ 1,193.30	22.51	-38.17%
ZM	$ 20,484.50	$ 622.70	32.90	$ 27,142.80	$ 4,217.40	6.44	-80.44%
HUBS	$ 17,819.30	$ 883.00	20.18	$ 14,033.10	$ 1,414.90	9.92	-50.85%
ZS	$ 16,781.00	$ 431.30	38.91	$ 20,107.90	$ 970.00	20.73	-46.72%
ZEN	$ 16,593.70	$ 1,029.60	16.12	$ 7,084.60	$ 1,428.90	4.96	-69.24%
OKTA	$ 15,405.10	$ 586.10	26.28	$ 13,352.30	$ 1,464.10	9.12	-65.30%
DOCU	$ 14,222.60	$ 974.00	14.60	$ 11,795.00	$ 2,226.80	5.30	-63.73%
CRWD	$ 12,097.40	$ 481.40	25.13	$ 36,486.40	$ 1,636.60	22.29	-11.28%
FSLY	$ 9,823.60	$ 290.90	33.77	$ 1,443.60	$ 371.90	3.88	-88.51%
BILL	$ 6,488.60	$ 157.60	41.17	$ 10,661.30	$ 518.10	20.58	-50.02%
ASAN*	$ 6,162.10	$ 227.00	27.15	$ 3,558.30	$ 422.40	8.42	-68.97%
AI**	$ 5,688.00	$ 183.20	31.05	$ 893.50	$ 252.80	3.53	-88.62%
SMAR	$ 5,341.90	$ 270.90	19.72	$ 3,534.70	$ 602.10	5.87	-70.23%
DCT***	$ 4,732.00	$ 211.70	22.35	$ 1,946.00	$ 288.60	6.74	-69.83%
		Avg.	36.14		Avg.	11.61	-65.69%

*as of 1/31/2021

** as of 4/30/2021

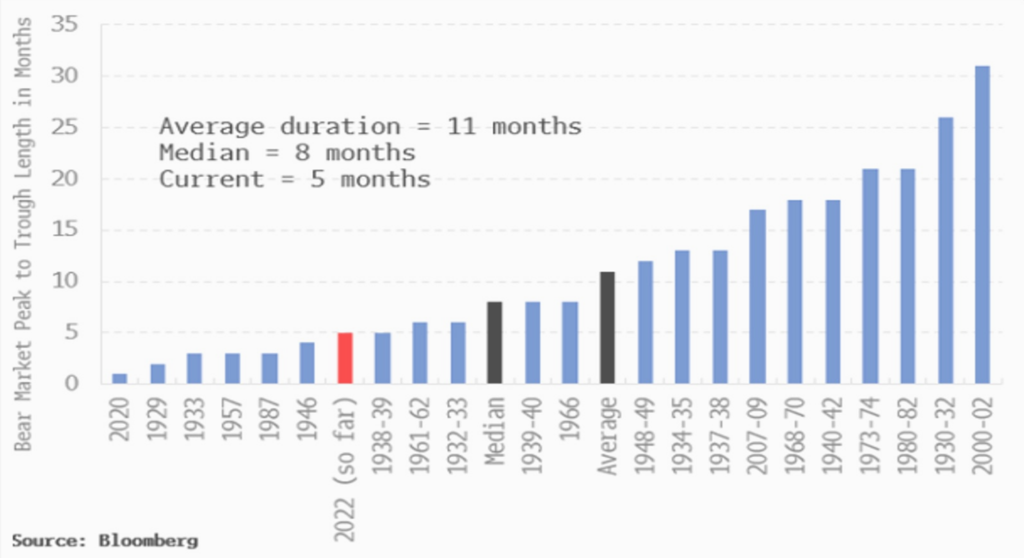
***as of 8/31/2020

Historic P/E on S&P 500

The Place Where the Wave Breaks and Rolls Back

The undiscriminating carnage across equities, and growth sectors in particular; opens the door to compelling risk/reward in companies at reasonable valuations, with an important caveat. The level of uncertainty remains elevated as it relates to the path of inflation and the economy over the coming months. Markets always overshoot to the downside and fresh capital in this environment requires an extended time horizon. Indiscriminate selling creates opportunities in quality companies at great prices, however there is no shortage of very poor companies that remain richly valued. In such an environment, the ability to act opportunistically and selectively is critical. While the bear market appears to be nascent, increasingly compelling valuations and a Fed with improving credibility allow for a more constructive framework and undoubtedly opportunity for long-term investors.

S&P Bear Market Durations



The valuation compression across public equities has extended to private markets as well, where arguably multiples had reached levels that were equally egregious. While a much-needed reset is welcome, it also creates tremendous opportunity particularly for private credit providers who can provide (less) dilutive growth capital. In addition, equity strategies able to deploy fresh capital suggest upcoming vintages and direct investments will come at deeper discounts.

Select Private Market Valuations

Private Company Prices Plunge
Stakes in many tech startups are fetching less on the secondary market

	October 2021		June 2022	
Company	Share Price	Valuation	Share Price	Valuation
Instacart	$150	$39B	$65	$22B
Epic Games	$1,450	$46.7B	$885	$31.5B
Chime	$69	$25B	$50	$15B
GoPuff	$450	$17B	$200	$8.33B
Klarna	$1,750	$45B	$1,100	$30B
FTX	$46	$32B	$37	$26B
Canva	$1,750	$40B	$1,150	$27B

Source: Next Round Capital
Bloomberg

Investors cannot be blamed for feeling like today's markets resemble the Bazooko Circus casino visited by Thompson's protagonists. Volatility is unlikely to resolve in the near-term. The Fed remains under pressure to produce a so-called soft-landing, essentially getting inflation under control without causing a recession. While that outcome looks increasingly unlikely, surely a recession is an event the market can be much more comfortable absorbing versus the chaos of an inflationary spiral. Investors can no longer expect multiple expansion given the expected interest rate trajectory, and thus must look to opportunities and businesses whose results are driven by execution and idiosyncratic factors within management's control. While amidst the volatility investors may find it easy to slip under the panicked guise of uncertainty as if gonzo journalists, a flexible and clear-headed framework for long-term deployment of capital remain as paramount as ever.

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