Issue 12.2022

After a Year for the Financial History Books, the Outlook is Improving

Bayshore's Chief Investment Officer shares his thoughts on current events and topics.

In this issue of *Views From the Top*, we provide an overview of the market over the last year and what we expect to see in 2023.

2022 – Largest wealth correction in a century. As we are about to wrap a bruising year, it is prudent to take stock and formulate a plan for moving forward. The economic story of 2022 can be quickly summarized: inflation, unleashed during the pandemic as hyper-stimulated demand met clogged supply chains, surged to 7.5% before the Federal Reserve stepped on the brakes, losing confidence in its previous stance that inflation was "transitory." What has followed is the fastest rate-hike cycle in history, triggering the largest "wealth correction" in a century. One can see how many are more than ready to wave goodbye to 2022 when you add trillions of dollars in losses in adjacent markets like crypto, hedge funds, private equity, and venture capital.

Equities – Surprising resilience. On the other hand, broad equity markets have held up much better than one would have expected, given the 375-basis-points (bps) increase in the federal funds rate thus far this year. The S&P 500 fell 25%[1] before its recent rally took it to a tolerable -15% for the year. Furthermore, had I told you in December 2019 that a global pandemic would kill millions, shut down large parts of the global economy for months, and disrupt global trade and travel for years, you might have sold all your risk assets, bought some gold and bonds, and hid under a rock. Good thing I did not, given that the S&P 500 is up 10% since the eve of the pandemic, gold is largely unchanged, and bonds[2] are down 12%. In hindsight, the move in equities and bonds makes sense, given the massive inflationary stimulus deployed (equities love stimulus, bonds hate inflation). I am still puzzled, however, why gold is not trading much higher, especially given the sharp price decline in Bitcoin (often referred to as "digital gold"), which for a while was seen as a competitor to physical gold among potential inflation hedges.

Crypto – Maximum financial opportunity after annus horribilis. Speaking of Bitcoin, the crypto-sphere has not covered itself in glory recently, and 2022 is turning out to be an "annus horribilis" for the asset class with the high-profile failure chain triggered by the collapse of the Terra/Luna-coins and, more recently, with the Madoff-style alleged fraud around FTX. Within 12 months, sentiment around crypto went from euphoria to desperation. However, none of what happened this year changes our view that there is a future for the technology and its applications. Ironically, the case for sound use of blockchain technology is stronger today than 12 months ago. In simple terms, Terra/Luna was a terribly designed token pair that had evisceration programmed into its code. By design, it guaranteed an eventual inflationary supernova of coin issuance. This is exactly the opposite of what Bitcoin stands for, which is an asset that can't be inflated away, by design or discretion. Terra/Luna was so obviously flawed that I am not worried about its implications on the future of crypto. FTX, on the other hand, looks like classical fraud, which sadly often happens in bubble times. FTX was a centralized exchange, same as the New York Stock Exchange, but for crypto assets. The failure here was not crypto but fraudulent insiders. As damaging as the FTX saga currently is for the reputation of the crypto space, it without a doubt strengthens the case for blockchain-based decentralized finance (DeFi), a system where dependence

[1] All market references in this letter are through 12/10/2022 and rounded/approximated for legibility. Source: Refinitiv Datastream.
[2] Represented through the iShares Core US Aggregate Bond ETF (AGG).

on the trustworthiness of intermediaries like exchanges and banks is not needed for everyday financial transactions. We have yet to see true market capitulation, likely a necessary passage to finding a bottom, so this could get worse before it gets better. For anyone believing in the future of blockchain technology (like us), these are times of maximum financial opportunity.

2023 – Slowing inflation and slowing growth but decent setup for financial markets. Financial markets are currently enjoying a bit of a recovery. With the Fed's bucket of ice on the economy, inflation worries that were top of mind for investors for most of 2022 are receding, which is currently providing relief to equity and bond markets. The main topic of 2023 will be further economic cooling. Investors will be focused on consumer confidence, employment, and corporate earnings. Falling inflation and falling growth should be a good setup for investment-grade bonds (treasury and corporate) in public markets and for senior corporate and asset-based credit in private markets. As mentioned above, equity markets have held up surprisingly well so far, but the outlook for 2023 is complicated. The US market is still relatively expensive and therefore vulnerable to earnings downgrades and multiple contractions. A look at history also does not bode well. Of the last four rate-hike cycles (300 bps in 1994-1995, 175 bps in 1999-2000, 425 bps in 2004-2006, and 225 bps in 2015-2018), the last three were *followed* by equity-market selloffs. Since there is significantly more debt outstanding today than in any of the previous cycles, one should be worried about a repeat of this pattern. However, there are a few mitigating factors at play, and many of the bubbliest stocks of the previous bull market have already massively corrected (50-80%), taking air out of the speculative excess. Sentiment among institutional investors is extremely negative, and they are positioned accordingly (large amounts of market hedges and cash), capping the risk of contagion should markets grind lower. Finally, there is increasing evidence that central banks are moving back towards stimulus and provision of liquidity. In the US, the reverse repo market is a potential source of hidden easing (avoiding an official pivot that the Fed does not want to signal), and the UK has already had to inject liquidity into the bond market to bail out some of its over-leveraged pension funds. The Bank of Japan is buying almost every bond issued for its own books, and China has started to stimulate via credit impulses, historically a reliable lead indicator for the global economy. It feels like we have passed the period of tightest financial conditions and liquidity, and we could see improvement from here. After a difficult year, the outlook for many asset classes is improving, and most importantly, further downside seems relatively limited.

Opportunities for Bayshore's long-time investment theses. Should equity markets convincingly bottom out, this will be the green light to aggressively take advantage of opportunities around Bayshore's favorite structural themes—*technological acceleration and the socio-economic cycle*. We are entering a period of exponential innovation at a speed and dimension that is difficult to grasp today. The result will be a massive transfer of value towards the most innovative businesses. Much of this value creation will likely happen in the private markets, whereas mature, established public-market companies are at risk of being disrupted and becoming obsolete. The US retreat from controlling global affairs creates a power vacuum that increases the risk of conflict, and countries will have to invest in their security related to defense, cyberthreats, and supply of critical commodities. This has also given momentum to a return towards local sourcing and production. Technologies like 3D printing, robotics, and biomanufacturing will be key in cost-competitive reshoring. The world has also recognized the need to move to a low-carbon economy, and huge investments are necessary to reach such ambitious goals. These structural themes will move forward relentlessly, irrespective of whether inflation is at 2%, 4%, or 6%, and

irrespective of the fed funds rate. Rather than reading the macro crystal ball, we will be focused on investing in winning businesses at reasonable valuations, and the latter has just become much easier.

As we enter the holiday season, all of us at Bayshore are looking to 2023 with profound optimism. History has taught us that the current market environment is one for taking action, not sitting on the sidelines, and our investment team is busier than ever vetting opportunities created by the choppy markets.

We wish you a healthy and happy holidays, and we are grateful to serve each of you as a trusted advisor for your capital.

All the best,

Patrick

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