Blackshield Capital

MARKET OVERVIEW Q4 2022

Projections and outlook for 2023

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December 2022

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Executive Summary

Year 2022 turned out to be one of the most challenging for all types of investors in the past 30-40 years. The high and persistent inflation prompted central banks to change their previous monetary and fiscal strategies. As a result, we observe a significant revaluation of both the equity and debt markets, and a lot of questions arise about what to expect in 2023 from both retail and institutional investors.

We are convinced that panic selling in the market and falling prices do not objectively reduce the true value of assets but rather create opportunities and it is important to understand when and under what conditions will the time to turn to a strong bullish attitude arrive, and it is equally important not to do it prematurely.
In the coming year of 2023, we forecast more market certainty, a relatively mild cyclical recession, lower inflation and, at the same time, lower corporate profits. Meanwhile, commodity markets, non-cyclical sectors and corporate debt instruments will show more consistent return trends than the major stock indexes and cash.

In terms of historical data analysis, it is quite rare for a deep bear market and asset sell-off to occur before the active phase of a recession, so regardless of its dynamics going forward, it is important to note that markets have largely discounted the expected downturn in economic activity.

To ensure sustainable returns in times of the turbulent economic conditions, we recommend broad market diversification of assets that, under the base case scenario, are able to continue generating returns both in absolute terms and relative to the market:

Stocks
- non-cyclical sectors of the economy
- companies with a low debt burden and stable cash flow

Fixed Income
- corporate bonds with high credit ratings
- U.S. government bonds with a short duration

Global Markets
- Europe: non-cyclical economic sectors, energy sector
- China: recovery in the IT sector

Commodities
- gold, midstream companies

Key factors with a significant impact on markets in 2022:

- U.S. inflation, that peaked amid a decline in commodities
- A strong labor market, that enables the Fed to raise interest rates in response to rising inflation
- The end of the era of low interest rates and soft monetary policy in 2022 in the U.S. and Europe
- Gradual reduction of the inflationary pressures that will not be fast enough to avoid recession

Outlook:

- A reduction in the pace of the interest rate hikes under the conditions of solid macroeconomic data on the labor market and inflation, as a reason for future stable optimism in the markets.
- Shrinking dollar strength if no further escalation of geopolitical tension happens
- Emerging markets are among the few that have maintained soft monetary policy with the potential for cyclical growth

We expect a consolidating market in the first half of the year and a more optimistic sentiment in the second half. At the same time, the main risks for 2023 are:

- Deeper recession development, which will put a pressure on the economy and GDP growth rate
- Continuing geopolitical tensions, rising prices of agricultural assets, energy and freight prices
- China's strict policy on COVID-19 and increasing deglobalization

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STRATEGY

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__The protracted stock market decline, negative sentiment and global risks have created an environment in which many investors are choosing cash over an active market positioning. We believe there are a number of reasons why cash is not the optimal choice:__

- *Simultaneous decline in the stock market and the debt market, which is a rare phenomenon*
- *Negative market sentiment is no reason to completely avoid markets*
- *Low-risk bonds give higher yields than cash*
- *In long-term investing, consistency, not market timing, is crucial*
- *Higher interest rates will lead to upcoming periods of higher low-risk returns than before*
- *Active portfolio management and diversification does not exclude risk, but determines the profitability*
- *The major risk lies in the lack of investment strategy scenarios*

Strategy

Based on the situation at the end of 2022, we consider the following as the base economic scenario in 2023:

- Contraction of economic growth to about zero percent
- Decrease in inflation to 2.5-3.0%
- Moderate increase in unemployment to 5%
- Reduction in corporate profits by 10-12%

According to the expectations, the U.S. economy is likely to enter a relatively mild recession closer to the 2nd half of 2023, which will put negative pressure on the stock market.
In such a scenario, we recommend increasing exposure to equities by buying non-cyclical sectors of the economy, companies with low debt burden and stable cash flow.
Regarding the debt instruments, long position in corporate bonds with high credit ratings and increasing duration are to be considered closer to the 2nd half of 2023.

As for the alternative scenarios, we consider the following:

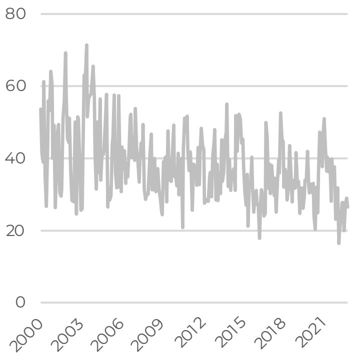
- In the "soft landing" scenario the best option is buying riskier assets, namely, the depressed cyclical sectors, the technology sector, as well as commodities. Positioning in debt instruments will include an increase of the share of high-yield bonds and higher duration in the portfolio
- With a deeper and prolonged recession in the U.S., the most optimal solution is buying more government bonds with shorter duration in combination with shares of dividend companies from defensive sectors with a high proportion of cash for the possibility of active management. It is worthwhile to gradually pick positions over the course of the year.

The following table represents a more detailed discussion of asset purchase strategies according to these scenarios:

Scenarios	Bull	Base	Bear
Economic growth	Growth slows, but the economy avoids recession, resulting in a smaller drop in corporate profits (up to 5%)	The economy falls into a mild recession, GDP growth slows to ~0%, corporate profits fall by 10-12%	Economic contraction is more prolonged, corporate profits fall by 15-20%
Fed policy	Fed's inflation target is reached ahead of schedule with stable labor market, resulting in interest rate policy easing	Inflation reaches 2.5-3.0% target by the end of 2023, with the Fed not cutting key interest rates	Fed cuts key rate too soon, inflation rises again, leading to stagflation
Inflation	Inflation declines rapidly to the target level	Inflation reaches the level of 2.5-3.0% gradually	Repeated growth in inflation in the absence of economic growth
Labor market	Unemployment is up less than 1%	Unemployment rises to 5%	Unemployment is above 5%
Recommended assets	Technology sector, cyclical sectors, commodities, bonds with medium duration	Shares in non-cyclical sectors, companies with low leverage and stable cash flow, government bonds with short duration, corporate bonds with high credit rating	Government bonds with ultra-short duration and money market, shares of dividend companies from protective sectors, high share of cash for active management

Although the share of investors with bullish sentiment is at historically low levels for 2022, this trend could change in 2023 if the future directions of the economy becomes clearer.

Share of investors with bullish sentiment, %



Summary

According to our view, 2023 could become a turning point in global macroeconomic processes. Many markets and investors are potentially drawn to the upcoming resolution of the current circumstances, including a decrease in inflationary pressures, a final understanding of the terminal interest rate, and the potential for economic growth from the resources available in the economy. This will make it possible to determine the balance of forces in the market and form the right medium-term positioning.

As the market tendency is determined by the expectations, we believe that some economic clarity, which is a major driver for the year ahead, will allow investors to be more confident in buying assets. In addition to that, a significant revaluation of assets happened in 2022, which already discounted the negative effects of the Fed's tapering policy, inflation shock, and lower consumption and can become an important decisive factor in 2023.

However, the current pressure on the market remains high, which does not give a reason for the market reversal. The subsequent turn could happen under several scenarios:

- The Fed changes its policy or soften rhetoric (less likely scenario, given the current level of inflation)
- An economic recession is avoided (less likely scenario)
- External factors are improving (not fundamental, but rather an additive factor that can soften the market)

The cumulative clarity on these three factors will be perceived in the 2nd half of 2023, which will provide enough information for the market revaluation. Considering the current events, the risk-off stage is still ongoing, and investors are getting rid of risky assets, which is likely to continue until the end of H1 2023. In this environment, the best option would be a conservative strategy that provides partially regular returns, lower volatility, and has a historically high probability of positive momentum relative to the market. This strategy includes stocks of less volatile companies with above-average dividend yields and stable financial conditions, U.S. government bonds, and investment grade corporate bonds.

At the same time, monitoring the macroeconomic context will allow for timely realignment of the strategy to accept a higher level of risk/return at a time when the economic growth potential will allow for the implementation of a long-term growth strategy.

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