NOVUM
CAPITAL PARTNERS

Weekly Market Flash

Perception vs. reality of the AI rally

July 23, 2023

Throughout 2023, the market has been on a constant search for evidence to validate its bearish sentiment, seeking a compelling narrative to justify its skepticism. There has been a hesitance to believe in the Federal Reserve's (Fed) capacity to orchestrate a soft landing. But the consumer was far more resilient than anticipated and corporate margins and earnings have also outperformed expectations. And the result was an impressive 19% year-to-date rally for the S&P 500 index that far exceeded anyone's expectations.

Highlights

▪ In the equities market, the Magnificent Seven companies contributed 66% of the index's total return. These are not small numbers: Apple +48% YTD, Microsoft +44%, Alphabet +36%, Amazon +55%, Meta +145%, Tesla 111% and NVIDIA +203%. This dichotomy in performance of the Magnificent Seven compared with the remaining 493 stocks explains the wide valuation gap of the S&P 500 index versus the equal-weighted S&P 500 index.

▪ In the private equity space, middle market funds have outperformed mega funds over the past three quarters. The performance difference has increased to 917 bps, which is the widest gap for the middle market since 2016. It also sharply contrasts Q4 2021, when mega funds were significantly outperforming all other funds by an even larger margin.

▪ In hedge funds, recent headlines on the development of several merger situations globally have highlighted the difficult environment for event driven strategies. In particular, the second quarter of 2023 has seen a notable pickup in regulatory intervention globally, which has created significant forced selling from hedge funds, resulting in a meaningful widening of spreads across the whole universe of deals and led to losses for the industry.

"The short bias in the market has proven detrimental to investors."

Markets & Macro | Perception vs. reality of the AI rally

What a difference a CPI print makes!

The short bias in the market has proven detrimental to investors. Bears went into full hibernation after the June CPI print vindicated the Fed and its ability to orchestrate a soft landing. Short sellers were crushed per a 14% June rally in the GS Liquid Most Short index, followed by another 14% rally July-to-date. Retail sentiment also saw no abating with the GS High Retail Sentiment being up around 11% in June and around 14% July-to-date. The contrast is dramatic when compared to the GS High Quality Stock index which was up 5% and 3%, respectively.

"Retail sentiment saw no abating with the GS High Retail Sentiment being up around 11% in June and around 14% July-to-date."

Figure 1: Year-to-Date Performance of Major Indices

Equity Indices	Last Value	Week	Ytd
MSCI World	3,028.71	0.36%	17.94%
Nasdaq	14,032.81	-0.57%	34.70%
S&P 500	4,536.34	0.70%	19.23%
S&P Equal Weighted	6,259.61	1.39%	10.21%
DJ Industrial	35,227.69	2.13%	7.54%
Nikkei	32,304.25	-0.27%	25.22%
Euro Stoxx 50	4,391.41	-0.20%	19.12%
Swiss SMI	11,207.38	0.87%	7.59%
FTSE 100	7,663.73	3.08%	5.00%
Canada	20,547.51	1.41%	7.95%
Shenzen	3,821.91	-1.67%	0.68%
Hong Kong	19,075.26	-1.74%	-1.01%
MSCI EM	1,014.58	-1.31%	8.14%

Equity Sectors	Last Value	Week	Ytd
S&P Value	165.52	1.06%	15.05%
S&P Growth	71.52	0.35%	22.90%
S&P Defensives	1,598.20	0.82%	4.50%
ARK Fund	47.93	-1.32%	53.43%
FANGS	7,753.60	-3.30%	74.45%
S&P Banks	87.67	6.55%	-11.29%
Euro Stoxx Banks	84.30	2.23%	22.58%
S&P Energy	84.30	3.50%	-1.76%
Gold Miners	31.49	-1.47%	9.87%

Commodities	Last Value	Week	Ytd
BBG Commodities	106.20	1.53%	-5.86%
BBG Agriculture	70.34	3.00%	2.20%
Gold	1,961.94	0.34%	7.56%
Silver	24.61	-1.35%	2.75%
BBG Brent Crude TR	1,050.23	1.78%	-1.10%
BBG WTI Crude Oil TR	188.40	2.43%	-1.51%

FX	Last Value	Week	Ytd
DXY Index	1,215.32	1.05%	-2.51%
EUR/CHF	0.9632	-0.47%	-2.66%
GBP Index	653.61	-1.28%	4.94%
EM FX Index	1,697.69	-0.43%	2.24%
USD/JPY	141.73	2.11%	8.09%
USD/CNY	7.19	0.64%	4.19%
Bitcoin	29,883.12	-1.07%	80.68%

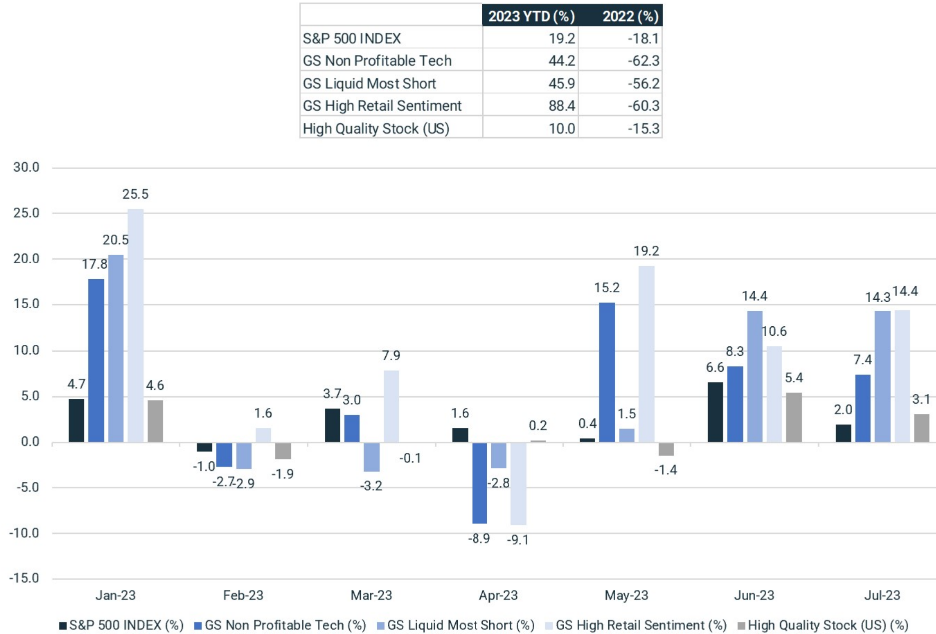
Bond Indices	Last Value	Week	Ytd
US Inv Grade	107.97	0.48%	4.44%
US High Yield	75.37	0.36%	5.47%
Euro Corps	234.46	0.32%	2.98%
JPM Europe Govies	9,975.51	0.39%	8.08%
US Treasuries	2,225.69	-0.02%	1.70%
China Aggregate	254.95	-0.44%	-0.13%
EMBI Global	806.59	0.10%	4.99%
EMBI Local	135.67	-0.30%	9.69%

Source: Bloomberg, as at July 21, 2023. Performance figures in indices' local currencies.

Our view: Seven stocks, the Magnificent Seven, contributed 66% of the index's total return. These are not small numbers: Apple +48% YTD, Microsoft +44%, Alphabet +36%, Amazon +55%, Meta +145%, Tesla 111% and NVIDIA +203%. This dichotomy in performance of the Magnificent Seven compared with the remaining 493 stocks explains the wide valuation gap of the S&P 500 index (19.6x next-twelve-months' earnings) versus the equal-weighted S&P 500 index (15.8x). In fact, one could argue that excluding these seven stocks the index is not expensive at all. Coincidently (or not), these seven stocks are the ones to gain the most from the Artificial Intelligence (AI) proliferation, capturing at least 40% to 50% of the value chain, in our opinion.

"Coincidently (or not), these seven stocks are the ones to gain the most from the AI proliferation, capturing at least 40% to 50% of the value chain..."

Figure 2: S&P 500: Retail Hype and Short Squeezes Dominate YTD



	2023 YTD (%)	2022 (%)
S&P 500 INDEX	19.2	-18.1
GS Non Profitable Tech	44.2	-62.3
GS Liquid Most Short	45.9	-56.2
GS High Retail Sentiment	88.4	-60.3
High Quality Stock (US)	10.0	-15.3

Source: Bloomberg, Novum Capital Partners, as at July 21, 2023.

“...value stocks have been left out of portfolios, completely hated and under-owned, especially after China’s economic recovery failed to materialize.”

The Most Hated Rally

What makes this a very difficult market to call is the lack of conviction among investors. Begrudgingly, long only investors had to chase the rally as CTA’s positioning had flipped from maximum short to long, despite concerns about the aftershocks of the US regional banking crisis. It is remarkable how little impact the liquidity drain has had on asset prices so far. Complicating the algo is the fact that micro data are starting to be at odds with the improving macro data. Several chemical companies have issued profit warnings ahead of their earnings reports, signs of softening in luxury goods demand is emerging based on Richemont’s report, Tesla’s recent price cuts are having a material impact on margins, and TSMC is pushing out its forecast of the semiconductor cycle trough.

Perception vs. Reality

With positioning in growth stocks at much higher levels than at the beginning of the year, there is a risk of earnings (primarily guidance) disappointing here as the expected path to monetization meets reality. Netflix and Tesla are two examples to mention. We also think that the news of Apple racing to develop its own generative AI tools to catch up with OpenAI brings up the subject of competition much sooner than investors had hoped. Conversely, value stocks have been left out of portfolios, completely hated and under-owned, especially after China’s economic recovery failed to materialize. The reaction of US bank stocks to second quarter results demonstrates what happens when an under-owned sector meets decent earnings. It is interesting to see oil up roughly 10% last week and copper up around 7% since mid-May. We believe that the soft-landing narrative gaining ground had something to do with that. A catch up move in cyclicals would widen market breadth and support the index.

A Quick Word on AI

Clients have been asking us how to play the AI theme. The simple answer is Big Tech. Microsoft, Alphabet, Amazon, Meta and NVIDIA dominate the infrastructure (cloud and data centers) and deep learning models verticals of the value chain. We are at this point in AI development because of these companies. And to them most of the benefit shall accrue until the infrastructure buildout phase is complete.

“Amid the drastic drop in private equity deal making activity from the late-2021 peak, middle market deals are still staying above pre-pandemic levels.”

Private Equity | Green shoots for middle market PE

Middle market activity remains above pre-pandemic levels.
Middle market funds, categorized as funds with assets between USD100 million and USD5 billion according to Pitchbook metrics, have outperformed mega funds (funds of USD5 billion or more) over the past three quarters. The performance difference has increased to 917 bps, as measured by median 1-year horizon returns. This is the widest gap for the middle market since 2016, which stands in sharp contrast to Q4 2021, when mega funds were significantly outperforming all other funds by an even larger margin.

Our view: Amid the drastic drop in private equity deal making activity from the late-2021 peak, middle market deals, targeting companies between USD100 million to USD500 million in enterprise value, are still staying above pre-pandemic levels. Year-over-year (for the period from March 2022 to March 2023), the declines in deal count and value accounted for 5.5% and 6.6%, respectively. These declines were not as steep as those in the buyout market overall, and, as a result, the middle market share of all buyout deals greatly expanded to 75.6%, being the highest reading in five years.

“...the growing complex of private credit lenders is providing additional and very valuable support to the middle segment.”

There are a few factors responsible for this trend. On the valuation front, prices paid on private equity buyouts of all sizes are in full correction mode. However, there are valuation divergences between the different size segments (taking into account the fact that there has always been a market premium for larger size / scale companies). Using enterprise value (EV) to EBITDA as a metric, the overall median private equity multiple at its peak has slid by 9%, while the middle market has fallen by 22.3%. If we go down the size scale, deals in the sub- USD100 million bucket have median EV/EBITDA and EV/ revenue multiples of 6.4x and 1.1x, respectively, what poses a 38.5% and 46.2% discount to the next size up. This indicates that the price gap between buyers and sellers may have finally closed at the lower end.

The other factor favoring smaller deals is the so-called limited access to debt packages for big leveraged deals. As per the feedback obtained, there seems to be a glass ceiling at the USD2 billion level for debt packages backing LBOs from bank syndications adding to tighter leverage terms, where non-tech companies with solid cash flows are taking the lead in accessing finance. Moreover, as we have commented in prior newsletters, the growing complex of private credit lenders is providing additional and very valuable support to the middle segment.

In this context and in view of our commitment plan schedule for the second half of the year into our private equity core allocation, we are searching among the strongest middle market GPs pursuing buy & build strategy—buying a high-quality platform company with the aim of making small subsequent acquisitions for it. In this sense, we would be taking advantage not only from the more advantageous dynamics in middle market, but also to tapping into the more fluid small market M&A segment through the bolt-on acquisition aimed at the underlying portfolio company level.

Hedge Funds | Regulatory roadblocks and slowing activity impact event-driven strategies

“This regulatory crackdown has created significant forced selling from hedge funds...”

But elevated merger spreads present opportunities for double-digit returns.
Over the past few weeks, headlines on the development of several merger situations globally have highlighted the difficult environment for event driven strategies, which are a type of investment strategy targeting opportunities created by significant corporate transactions or events. Indeed, the strategy has had a very challenging and volatile period since the beginning of the year.

As we often commented in our newsletters, the narrow concentration in a handful of sectors of the ongoing rally in traditional risk assets did not provide much of a tailwind. Rather, the second quarter of 2023 has seen a notable pickup in regulatory intervention globally, with several high-profile announced mergers getting blocked or materially delayed by antitrust bodies. This regulatory crackdown has created significant forced selling from hedge funds, resulting in a meaningful widening of spreads across the whole universe of deals and led to losses for the industry.

Our view: For event-driven investing broadly, and merger arbitrage specifically, this year saw the most significant regulatory challenges in years. The UK Competition and Markets Authority (CMA) initially blocked the largest deal in Microsoft's history, barring its USD69 billion purchase of gaming company Activision Blizzard in a sign of mounting global scrutiny of large technology companies' power. The US Federal Trade Commission (FTC) also sued Microsoft in federal court to block the acquisition. In a surprising threat to the pharmaceutical industry’s business model, the FTC also sued to block Amgen’s USD28 billion deal to buy Horizon Therapeutics, arguing the merger would reduce competition for the development of treatments for serious illnesses.

“In the absence of new deals, capital in the strategy is now forced to either chase a shrinking universe of “safer” deals, or a growing list of dislocated deals.”

This antitrust crackdown has also been evident on the legislative front: While the process has not changed since it started 45 years ago, US antitrust regulators have now released new guidelines for reviewing deals that have the potential to delay transactions by months. Consequently, merger arbitrage spreads have widened globally. According to data from UBS, the median annualized excess spread stood at 6.3% at the end of the second quarter— equivalent to 11% annualized rate of return—while the average excess spread is even larger, driven by a handful of speculative situations trading at elevated levels.

Adding to these challenges, merger deal volumes have remained muted despite a marginal pick up from the historical lows of the beginning of the year as dealmaking activity is still impacted by low levels of CEO confidence on the back of continued macro and geopolitical concerns. In the absence of new deals, capital in the strategy is now forced to either chase a shrinking universe of “safer” deals—leading to spread tightening—or a growing list of dislocated deals.

Our outlook for event driven strategies has been mixed for some time and we see little reasons to change our view for now. At the same time, merger spreads at current elevated levels present an attractive opportunity to generate double-digit returns—assuming all current deals successfully close and the significant pent-up demand in corporate activity could materially and quickly improve the opportunity set later in the year.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
Senior FX, Crypto & Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager

Carlos De Andres Perez
Senior Private Equity Funds Manager

Maxime Glasson
Senior Hedge Funds Manager

Julien Etaix
Senior Private & Direct Investments Manager

Giovanni Martinez
Senior Private & Direct Investments Manager

Please note that any views expressed herein are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions. We believe the information contained in this material to be reliable but do not warrant its accuracy or completeness. They may differ from other views expressed for other purposes or in other contexts, and this should not be regarded as a research report. Any projected results and risks are based solely on hypothetical examples cited, and actual results and risks will vary depending on specific circumstances. Investors may get back less than they invested, and past performance is not a reliable indicator of future results