ESSEX

The Essex Exchange

Autumn 2022

ESSEX INVESTMENT MANAGEMENT COMPANY, LLC

Inside this issue:

How High is the Wall of Worry — 1-3

By: Nancy B. Prial

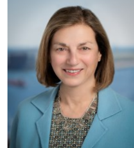
Essex Strategies — 4

Investment Team

- Joseph C. McNay
- Nancy B. Prial
- Robert J. Uek
- William H. Page
- Saralyn Sacks
- Marcy R. Carlin
- Anne Marie McMichael
- Elizabeth Giroux
- Martin P. Cournan
- Jack Lloyd

125 High Street
Suite 1803
Boston, MA 02110
617-342-3200

Please see our website www.essexinvest.com for updated insights from our portfolio management and research team.



How High is the Wall of Worry?

By: Nancy B. Prial - Co-CEO & Senior Portfolio Manager

The market rebound of July and August came to an abrupt halt following Jay Powell's remarks at the Jackson Hole conference as it became clear to market participants that the excitement over a moderation of the Fed's tightening posture was premature. Chair Powell, and other Fed speakers, have reiterated their stance that they do not want to repeat the mistakes of the 1970's by prematurely relaxing their hawkish stance and will risk a sharper economic downturn as they work to break the current inflationary cycle.

Since the date of the Jackson Hole speech (August 26, 2022), the SP500 declined 11.6% as markets grappled with the rate of interest rate increases and the pace of economic decline. In fact, as the market reacted to the litany of bad news and worries, there were no places to hide with losses for all market cap sizes and styles, losses both domestically and internationally, losses in short- and long-term fixed income, and losses in commodities.

This past quarter is the first time since 2008/2009 where the SP500 has had 3 consecutive declines, driven by a seemingly unending series of worries:

- Inflation
- Interest Rates
- Ukraine
- Energy Prices
- China
- UK Financial Issues
- Interest Rates
- Earnings
- Midterm Elections

As the market has struggled with this myriad of concerns, as well as new ones that keep appearing, we have started to see extremes in many areas:

- The percent of investors who are bearish rose above 60%
- US 30-yr average fixed mortgage rates spiked above 7%
- US Dollar surged over 6%
- Over 90 central bank rate hikes in the quarter

How High is the Wall of Worry?

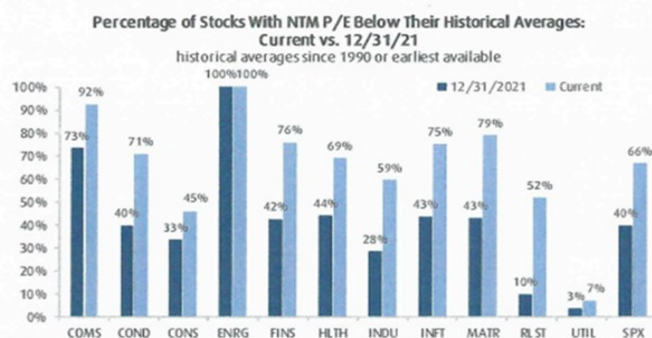
By: Nancy B. Prial - Co-CEO & Senior Portfolio Manager

The question on investors' minds now is what has the market discounted in terms of both rate increases and a potential recession. Although it is too soon to know for certain, the likeliest outcome is continued market volatility in the near term as the market digests the reality of slower growth and possible recession. We expect very slow growth led by the industrial sector and capital spending with muted consumer spending that will lead to easing of inflationary pressures as next year progresses (demand destruction). However, within the current gloom we also see some green shoots emerging:

- *Inflation was understated last year, overstated now?*
    - Rent equivalency is lagging indicator
        - Did not show rate of increase as fast
        - Will not come down until last year's rent increases anniversary
    - Long term inflation expectations still muted (expected to come down to 2.5-3%)
- *Is the 1970's the correct analogy?*
    - Is it more like the late 1940's?
        - Demand surge post WW2
        - Supply still constrained from war shortages, retooling of manufacturing, labor shortages
        - Inflation ran very hot, but ended up being "transitory" over 3 years
        - Inflation expectations did not get embedded; long term rates stayed under control
- *Is a recession inevitable or likely to be deep?*
    - Earnings have been stronger than expected
        - Wage pressures have been manageable
        - Companies using price to offset some cost increases
        - Proactive expense management emerging
    - Industrial/Energy economy strong
        - Reshoring mentions accelerating in earnings calls
        - CHIPS bill was signed –strong spending cycle to rebuild US semiconductor manufacturing capacity
        - IRA passed
            - ◊ Content requirements for EV's will drive auto manufacturers to open more facilities in US
        - Energy industry ramping up capital spending
            - ◊ Rig counts are up
            - ◊ Looking to add refining and distribution capacity
            - ◊ Retooling energy infrastructure for energy transition
        - Sustainable energy spending is strong
            - ◊ Solar installations growing
            - ◊ Wind installation growing
            - ◊ Inflation Reduction Act will add incentive for clean energy

What has the market already discounted?

- The market multiple is around 17x CY22 (neither cheap nor expensive)
    - But stocks are much cheaper if you take out the largest SP500 decile and much cheaper down market cap
        - For example, the Russell 2000 sells at 11.5x CY22
    - 66% of the SP500 have P/Es below their historical average vs 40% in 12/31/21



Source: BMO Investment Strategy Group, FactSet, IBES.

How High is the Wall of Worry?

By: Nancy B. Prial - Co-CEO & Senior Portfolio Manager

- Markets have bottomed with rates and multiples near current levels
    - The average since 1942 is 11.7x with inflation running at 4.65%
        - That includes the extreme years of 1942 and 1974 with inflation solidly in double digits and p/e's less than 10x
    - Many stocks/sectors are already selling at or below these historic levels

Source: Strategas, September 2022

- The average stock is already outperforming the largest names in the SP500 and NASDAQ100. This improved breadth is a positive sign for active management as more stocks can add value in such an environment.

Source: Strategas, September 2022

Which leaves us with the question,

<u>Can markets start to climb the wall of worry?</u>

We believe that they can and that we are in a process of making a bottom in the market. Given the crosscurrents in the economy, higher interest rates, higher inflation, and the geo-political concerns, we do not believe that the future market will look exactly like the market of the past 15 years. Rather, it will be a market where fundamentals matter, where valuations matter, and where diversification is a benefit rather than a cost. This market should be led by those sectors that can continue to benefit from the secular growth trends that we have discussed in past commentaries:

- Capital spending boom (reshoring of manufacturing, 7-10 semiconductor plants, automation/robotics)
- Productivity boom (technology spend reaching all aspects of the economy coupled)
- Technological boom (AI, Robotics, Personalized Medicine with genomic analysis, EV's, battery technology, Space, etc.)

In this environment, we are optimistic that our focus on undiscovered names and under-exploited areas can add value as these companies benefit from the process of discovery.

ESSEX

ESSEX INVESTMENT MANAGEMENT COMPANY, LLC

Client Service and Support:
Essex is fortunate to have great clients whom we are more than happy to assist. Please feel free to contact any of the following Essex personnel below should you need assistance or have questions:

Michael S. McCarthy
Chief Operating Officer
Phone: 617-342-3245 or mmccarthy@essexinvest.com

Carly Semerjian
Senior Executive Administrator
Phone: 617-342-3202 or csemerjian@essexinvest.com

Sue Bathalon
Operations Manager
Phone: 617-342-3204 or sbathalon@essexinvest.com

Client Service & Support Fax Machine: 617-342-3280

DISCLOSURE

The opinions and analyses expressed in this newsletter are based on Essex Investment Management Company, LLC's research and professional experience, and are expressed as of the date of our mailing of this newsletter. Certain information expressed represents an assessment at a specific point in time and is not intended to be a forecast or guarantee of future results, nor is it intended to speak to any future periods. Essex makes no warranty or representation, express or implied, nor does Essex accept any liability, with respect to the information and data set forth herein, and Essex specifically disclaims any duty to update any of the information and data contained in this newsletter. The information and data in this newsletter does not constitute legal, tax, accounting, investment or other professional advice. Certain information contained herein has been obtained from third party sources and such information has not been independently verified by Essex. No representation, warranty, or undertaking, expressed or implied, is given to the accuracy or completeness of such third party information

Essex Strategies

LONG EQUITY STRATEGIES

Micro Cap, Small Cap and SMID Cap Equity Growth Strategies are managed by our all-women investment team based in Evanston, Illinois, which is focused exclusively on long-only growth equity strategies and has worked together for more than 15 years. The team manages three equity strategies that each share a common investment philosophy and process:

Micro Cap Growth Strategy: We look for under-followed, under-owned, under-appreciated companies & industries in early stages of acceleration.

Small Cap Growth Strategy: The strategy focuses on identifying companies in an inefficient sector of the market at an inflection point where their growth rate is improving.

Small/Mid (SMID) Cap Growth Strategy: Our approach is to execute a systematic, fundamental process to find companies whose future growth prospects are not fully reflected in the price of the stock.

Essex Research Strategy is managed by a team of investment professionals seeking growth equity opportunities across an all-cap universe. By employing fundamental top down economic and sector analysis with bottom-up stock picking skills, the strategy provides the investment team a wide framework in which to identify growth candidates regardless of market capitalization restraint. Individual client portfolios are offered in two risk profiles: aggressive growth or growth and income.

Essex Global Environmental Opportunities Strategy (GEOS) is a thematic, all-cap global stock strategy that invests in clean technology and clean energy companies that help solve the world's environmental problems. The Strategy is focused on nine environmental technology themes and invests with a long investment horizon, typically holding about 40 companies. GEOS is clean technology and energy infrastructure-focused, with companies that exhibit generally high growth rates. ***This strategy is available as both a separate account and mutual fund.***

LIMITED PARTNERSHIP HEDGE FUNDS

Essex Performance Fund is an ultra-aggressive equity strategy which primarily aims to uncover small and mid-sized companies that exhibit the potential for meaningful growth over time. Seeks to maximize returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. The strategy will use leverage to enhance returns.

Essex Evolution Long/Short strategy is a hedged equity strategy that aims to provide competitive risk-adjusted returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. Specifically, we aim to understand key themes within dynamic sectors to capture the growth in those trends and utilize short positions to both hedge portfolio risk and exploit specific mispriced stock opportunities. The fund generally has an equity exposure less than that of the overall market.

Please refer to our firm's website at www.essexinvest.com for more information about Essex, the strategies we manage and important disclosures.