



Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY

December 9, 2022

Weak IPO Market is a Bullish Sign

2022 has been a dismal year for initial public offerings (IPOs). And I think that's a good thing.

Generally speaking, the fall months are supposed to be the busiest time in the finance world, with a flurry of new offerings, mergers & acquisitions, and debt raises. But this year has been anything but. IPO volume fell to \$1.6 billion in October, marking a 95% year-over-over decline and the weakest showing since 2011. M&A performance was not much better, with total deals plummeting 43% to \$219 billion (for September and October).¹

This sizable decline in fundraising marks a dramatic shift from 2021 when IPOs (including SPACs) raised over \$300 billion, which was almost *double* the previous record set...the year before. Private equity also saw massive capital flows, with investors pouring \$93 billion into early-stage and 'seed-stage' startups.

We know now that many of these companies didn't do well or outright failed. In the traditional IPO world, of the 384 companies that went public in 2021, 255 ended the year trading below their offer price.² In the private markets,

we saw investors sometimes pouring millions of dollars into companies that didn't even have a product or a staff – just a big idea. Remember when investors were paying millions for highly speculative digital art, or NFTs? Also consider the state of the cryptocurrency markets today, when a bankruptcy headline is a daily occurrence.

The fact that froth is being drained from the markets is a good thing, in my view. Excess liquidity in the markets kept moving investors further onto the risk curve in hopes of bigger returns, and any time that happens, there is usually a reckoning waiting at the other end. We're seeing that now in the form of a capital drain for companies with negative cash flow, and at the riskiest end of the curve, in the form of bankruptcies, debt defaults, and an implosion of the crypto markets.

By some estimates, we could see some 2,000 credit-rating downgrades and hundreds of junk bond defaults in the 2023-2024 credit cycle. The highest that missed junk-debt payments have ever reached is \$200 billion in 2008 and 2009, and I believe that record will be broken since so

much new junk debt was issued in the heyday following the pandemic.

To understand why I think debt defaults and rising caution in the IPO markets are a good thing, an investor simply needs to think back to the 2000 – 2002 tech bubble and the 2008 Global Financial Crisis. Investors were overpaying for startups in 1999 and 2000 like they were in 2021, and the IPO market in the second half of 2008 and the first half of 2009 was among the worst in history. Proceeds from IPOs were less than \$1 billion from July 2008 to March 2009, a dismal figure just like we're seeing today. But remember what else happened in March 2009 – a big new bull market was entering its first year.

Bottom Line for Investors

When investors see a flood of IPOs and billions of dollars flowing to speculative asset classes and startups with negative cash flow, the response unfortunately is not to run for the hills. Instead, investors can't help feeling the 'fear of missing out,' which often lures even the most disciplined to get in on the action. Many end up making risky bets at just the wrong time, and as we're seeing in the headlines today, the result can be heavy losses in the riskiest corners of the capital markets.

But when we start to see the opposite happen— i.e., enthusiasm for risky companies and asset classes dries up alongside investor capital – I tend to view it as the market washing out excesses, which oftentimes means that great companies are trading at attractive prices relative to expected future cash flows. To me, that's bullish.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

¹ Wall Street Journal. November 6, 2022.
<https://www.wsj.com/articles/raising-money-on-wall-street-hasnt-been-this-hard-in-a-decade-11667730621>

² Nasdaq. 2022.
<https://www.nasdaq.com/articles/a-record-year-for-ipos-in-2021>

Weekly Market Update

Important Market News We Think Worth Considering

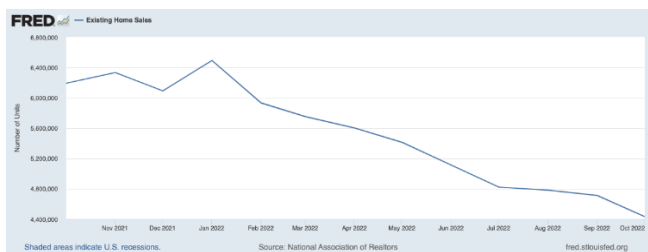
IN FOCUS THIS WEEK

- **U.S. Housing Market Update**
- **Today's Gas Prices**
- **China Eases Covid Restrictions**

Where is the U.S. Housing Market Headed Next? Depends on Who You Ask

There is little doubt the U.S. housing market is in a slump. The chart below of existing home sales in the U.S. shows that when we zoom out, the housing market has arguably been feeling pressure throughout 2022¹:

Existing Home Sales in the U.S. (Number of Units)



Source: Federal Reserve Bank of St. Louis²

Several factors are at play, but the most glaring has been that mortgage rates have been rising at their fastest pace in decades. Mortgage rates started the year hovering around 3% but more than doubled in the months that followed, at one point crossing 7%. The rapid shift in the mortgage market has whipsawed both buyers and sellers, both of whom have more incentive to wait versus entering the market. As for where the housing market is headed next, forecasters are all over the map. KPMG, a consulting and audit firm, believes U.S. housing prices could fall by -20% in 2023. Goldman Sachs thinks

housing prices could dip -7.5% next year, but the National Association of Realtors sees a 1.2% increase in existing-home prices. A variety of factors including the jobs market, interest rates, the possibility of an economic recession, and Fed policy decisions in the new year will impact the housing market. The wide dispersion of forecasts underscores how far apart industry watchers are from assessing these factors.

What's Behind Topsy-Turvy Natural Gas Prices?

Is heating a home this winter going to be more expensive, less expensive, or about the same as last year? For homes that heat with natural gas, the answer is unclear. That's because 2022 has been the most volatile year for natural gas prices in decades, with wild fluctuations sending prices into strong uptrends followed almost immediately by heavy downdrafts. Prices have also been moving counter to seasonal trends – since Thanksgiving, U.S. natural gas futures are down -25%, which is the opposite of what investors would expect heading into the winter season when demand rises. Last Monday, the price of U.S. natural gas futures declined -11%, which would normally raise eyebrows except for the fact that it marked the 39th instance that gas prices have moved more than 7% up or down in a single day. There are a few reasons behind natural gas price volatility. Among them, domestic drillers have hit new output records this year, mild winter temperatures in parts of the country have softened demand, and a fire at a key liquified natural gas terminal prevented a significant amount of liquefaction and export—which meant that gas was stored here in the U.S. and added to overall supply.³

Weekly Market Update

Important Market News We Think Worth Considering

China Finally Eases “Zero-Covid” Restrictions

China’s years-long “zero Covid” strategy has led to low death and infection rates, but has also stifled economic growth and led to rare protests across major cities. China’s exports have fallen for two consecutive months, with shipments plummeting -8.7% in November. Imports also fell by double digits in November, marking the weakest month since the onset of the pandemic. The very rare show of defiance by protestors sent a strong message, however, with the state now scrapping rules for mass testing, ending mandatory hospitalization for people who test positive, and reconfiguring how lockdowns are imposed, among other changes. The focus is shifting to vaccinating a larger percentage of the population, particularly the elderly who currently have low vaccination rates. Only about 40% of those over 80 have received the two-shot vaccine plus a booster. China is making concessions on Covid that global investors have long awaited, but their strategy pivot also comes as the winter months approach. In our view, there is ample reason to be cautious about how long and to what extent this easing of restrictions lasts.⁴

Weekly Market Update

Important Market News We Think Worth Considering

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¹ Wall Street Journal. December 7, 2022. https://www.wsj.com/articles/whats-going-on-with-the-housing-market-11670430769?mod=djemRTE_h

² Fred Economic Data. 2022.

³ Wall Street Journal. December 7, 2022. https://www.wsj.com/articles/natural-gas-prices-swing-again-in-unseasonal-slump-11670331531?mod=djemRTE_h

⁴ Wall Street Journal. December 7, 2022. https://www.wsj.com/articles/china-scrap-most-testing-quarantine-requirements-in-covid-19-policy-pivot-11670398522?mod=djemRTE_h

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