NEUBERGER BERMAN

MARKET REACTION COMMENTARY

The Bumpy Road to Normalcy

March 2022

Charles Kantor, Senior Portfolio Manager, Neuberger Berman Long Short Fund
Marc Regenbaum, Portfolio Manager, Neuberger Berman Long Short Fund

There is a famous quote, "The only constant in life is change." And until recently, the market had clearly been focused on inflation, supply chains, and interest rates – but the dynamic backdrop changed yet again with Russia's invasion of Ukraine, which brings forward a tragic human element and broader global unease. With this re-awakening of geopolitical concerns, new questions quickly emerged such as:

- Will Ukraine be Putin's only target?
- What is China's next step here?
- How will this impact European growth?
- How does this change, if at all, the Federal Reserve's (the "FED") actions?
- How will the sanctions impact economic activity and global commodity prices?
- Will we see a return to "nesting" ("The CNN effect") in certain regions?
- What is the potential for global cyber warfare?
- Why did the S&P 500 Index rally ~3.8% in the last 2 days (since the invasion); is it "sell the rumor" and "buy the event"?

And ironically – despite change being constant … and all the new questions above…most remarkably, the S&P 500 Index is down a mere -2.4% since the end of January.

Candidly, there are more questions (many more than the ones listed above) than answers – and some are more quantifiable (with ranges) than others. That said, we do believe that the depth and duration of any market weakness, as always, will ultimately be determined by the economic cycle. And although we are certainly not in a differentiated position to opine on the ultimate scope and end game of Putin, we would highlight a few points:

- The Fed's job is harder now – not easier. And globally, there are seemingly greater risks around inflation being higher and growth being lower. And while a 50-bps hike in March seemed like a near certainty just a few weeks ago, the probability of that action declined significantly post-invasion. One other chart we are watching closely is the spread between the 2-Year and 10-Year Treasuries (i.e., the shape of the yield curve), which has fallen from 80 bps at the start of 2022 to under 40 bps this week.
- The commodity environment is a key watch area – with implications differing by region; for instance, the Eurozone imports a disproportionate amount of its oil and gas from Russia.
- The largest growth concerns will likely be linked to "spillover" effects as opposed to Russia exposure itself; after all, Russia GDP is ~$1.7 trillion, which is smaller than that of individual states such as California, New York and Texas.
- The typical Russian citizen will feel significant pain from sanctions, currency, energy costs, and credit stress, to name just a few.
- China responses will be watched closely – as they relate to trade practices, Taiwan, or general Russian support.
- The Biden administration's response has seemingly been a scaled approach linked to events on the ground. It's clearly dynamic and Biden's state of the union speech needs to be updated from where it stood a few weeks ago.
- Cybersecurity is a secular theme – driven by both daily consumer and corporate activity as well as geopolitical concerns.

FOR INVESTMENT PROFESSIONAL, BROKER-DEALER AND INSTITUTIONAL USE ONLY. NOT FOR USE BY OR DISTRIBUTION TO THE GENERAL PUBLIC.

Ultimately, for now there is incremental uncertainty, and the market dislikes uncertainty. There will also undoubtedly be more headlines as this unfortunate conflict unfolds, which will lead to ongoing volatility. But medium and longer-term, we believe markets will anchor themselves on economic fundamentals and the prospects for growth.

And on that note, we believe the U.S. markets are primarily focused on what we are calling, "Normalization – working through the COVID-19 bump". Simply put, we are looking for monetary and fiscal policy normalization, corporate and consumer behavior normalization, and supply chain normalization – all of which will also contribute to higher equity market volatility (likely more in line with long-term averages as opposed to recent years). This path to normalcy is also leading to intense market debate over inflation and market valuations. Our quick thoughts on these two topics are as follows:

- We believe inflation is generally backward-looking and self-correcting over time. And while we believe it will moderate in the back half of the year as demand slows and supply arrives, we worry one "stickier" area could be wage inflation. That said, today's inflation is a manifestation of a demand boom that is likely only seen once in an investment lifetime – created by unprecedented amounts of fiscal and monetary policy stimulus…and exacerbated by COVID-19 and years of underinvestment in global supply chains. Like the Fed's debate over inflation, management teams had to determine if their demand bump was "secular" or "temporal." In fact, a "false positive" narrative began to emerge as corporate management teams started believing their total addressable market was larger than it was (we call it TAM creep)! Peloton became the poster child for mis-reading the COVID-19bump, but they were certainly not alone and others will be tested. Managements across industries - from autos to DTC companies to beverages to housing to name a few - are being forced to assess how long-lasting the existing demand patterns will persist...which will lead to capital allocation decisions and repercussions for years into the future.

- We believe adjustments to market valuations are well underway. After all, businesses characterized by high growth *and* low margins have seen their price to sales multiples fall from 12x to 6x (~50% decline). Meanwhile, high growth *and* high margin businesses have lost ~30% of their valuation multiples. We continue to be more cautious on the former (high growth with low margins) while believing the latter is ripe with investment opportunity. After all, we prefer business that can balance sales growth and margins while operating at reasonable free cash flow yields in a higher rate environment. In our opinion, "story stocks" with no earnings (and all the value resting in the terminal value) will be more sensitive to rate movements.

<u>So where does all of this leave us with regard to portfolio positioning?</u> Against a backdrop of more uncertainty and volatility we believe it is a market environment to do more with less. Less gross exposure and less net exposure at the margin while still taking advantage of overall market dispersion and volatility. After all, once all the dust settles, we find tremendous value on the long side while taking advantage of some of the aforementioned factors above short. At the risk of sounding like a "broken record," we want to be anchored in quality on our longs – whether it's due to Russia/Ukraine backdrop, inflation, or a slowing growth backdrop. We believe high-quality organizations characterized by true business moats, differentiated products or services, and strong balance sheets – all led by best-in-class management teams – have the potential to thrive in virtually any environment, or at a minimum, emerge even stronger. And in this type of uncertain backdrop – product/service differentiation matters, pricing power matters, scale matters, and management expertise and execution matters.

FOR INVESTMENT PROFESSIONAL, BROKER-DEALER AND INSTITUTIONAL USE ONLY. NOT FOR USE BY OR DISTRIBUTION TO THE GENERAL PUBLIC.

This material is provided for informational purposes only. This material is intended as a broad overview of the Portfolio Manager's style, philosophy and process and is subject to change without notice. The Portfolio Manager's views may differ from that of other Portfolio Managers as well as the views of the firm. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. The firm, its employees and advisory accounts may hold positions of any companies discussed. Any views or opinions expressed may not reflect those of the firm as a whole. The information in this material may contain projections, estimates, market outlooks or other "forward-looking statements" regarding future events, including economic, asset class and market estimates, outlooks or expectations, and is only current as of the date indicated. Due to a variety of factors, there is no assurance that such events, outlook, market behavior, and expectations will be achieved, and actual results may differ significantly from any views expressed. Information is based on current views and market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Certain products and services may not be available in all jurisdictions or to all client types. Investing entails risks, including possible loss of principal. Unless otherwise indicated, returns shown reflect reinvestment of dividends and distributions. **Past performance is no guarantee of future results.**

Neuberger Berman Investment Advisers LLC is a registered investment adviser. The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

© 2022 Neuberger Berman Group LLC. All rights reserved.