BPM BERLIN PORTFOLIO MANAGEMENT

Review of the 2nd quarter 2022 and outlook

„Never put all eggs in one basket“

Harry M. Markowitz (*1927), US-american economist and Nobel laureate 1990

We can assume with a high degree of certainty that the advice with which the later Nobel Prize winner Markowitz summarised his scientific work was known long before, and not only to those dealing with agricultural products. Nevertheless, it was only through Markowitz's work that this basically trivial everyday wisdom became a common phrase in the financial world.

Source: https://pixabay.com/de/photos/eier-ostern-verkaufsstand-holland-1671574/

In 1952, Markowitz was the first to describe the mathematical principles for building efficient investment portfolios. His goal was to systematically create an optimal relationship between risk and return. His approach, which was revolutionary at the time, led away from "naïve" diversification, in which shares and bonds are combined quite randomly in a portfolio.

One of the central considerations of Markowitz is to align the typical profit and loss phases of different investments in such a way that, as far as possible, all investments never develop in the same direction. Ideally, extremely negative single developments should be balanced out by extremely positive ones. In this way, the entire portfolio should be less subject to extreme fluctuations in value and, in the long run, achieve a better result from the point of view of return and risk. In the world of asset management, this concept has been considered basic knowledge for years and usually achieves the expected goal.

However, the past quarter has painfully shown that all theory is sometimes grey, as Johann Wolfgang von Goethe, probably the most famous German poet of the 18th and 19th centuries, noted.[2]

Even though we did not "put all eggs in one basket", we experienced the rare case of an almost completely negative synchronisation of all investment forms in the portfolios. The balancing effect that is actually to be expected in a diversified portfolio seemed to be suspended.

This phenomenon, which does not call into question the fundamental correctness of Markowitz's theory, has already occurred in the past. Shock-like events cause the mood on the financial markets to "tip", investors get scared and initially take flight. In the process, rational considerations of value or long-term perspective suddenly no longer play a role.

[1] „Portfolio Selection“, Journal of Finance 7, No. 1

[2] “Grau, mein Freund, ist alle Theorie…“, from „Faust - der Tragödie erster Teil“

As the following graph shows, the year 2022 can probably already be considered a negative exceptional year in terms of "synchronisation" (mathematically correct "correlation"):

Performance of various investments on a quarterly basis (2016 to 2022)

	Stocks				Bonds				Hedge Funds	Precious metals		Negative
	USA	Europe	Japan	China	USD - I G	USD - H Y	EUR - I G	EUR - H Y	HFRX (USD)	Gold	Silver	
Q1/16	0,8	-7,7	-12,0	-13,8	3,0	3,4	2,9	0,5	-1,9	16,2	11,5	36%
Q2/16	1,9	-2,3	-7,1	-2,0	2,2	5,5	1,9	0,7	1,1	7,2	21,2	27%
Q3/16	3,3	4,0	5,6	3,2	0,5	5,6	1,0	3,0	2,2	-0,5	2,5	9%
Q4/16	3,3	5,4	16,2	1,8	-3,0	1,8	-2,4	2,2	1,2	-12,8	-16,9	36%
Q1/17	5,5	5,5	-1,1	4,4	0,8	2,7	-0,9	2,0	1,7	8,9	14,7	18%
Q2/17	2,6	-0,5	6,0	6,1	1,5	2,2	0,4	1,9	0,9	-0,6	-8,9	27%
Q3/17	4,0	2,3	1,6	4,6	0,9	2,0	0,7	1,6	1,8	3,1	0,1	0%
Q4/17	6,1	0,3	11,8	5,1	0,4	0,5	0,6	0,6	1,5	1,8	1,7	0%
Q1/18	-1,2	-4,7	-5,8	-3,3	-1,5	-0,9	0,7	-0,3	-1,0	1,7	-3,4	82%
Q2/18	2,9	2,4	4,0	-9,9	-0,2	1,0	-0,5	-1,2	0,2	-5,5	-1,5	55%
Q3/18	7,2	0,9	8,1	-2,1	0,0	2,4	-0,7	1,6	-0,4	-4,9	-9,1	45%
Q4/18	-14,0	-11,9	-17,0	-12,5	1,6	-4,5	0,9	-3,7	-5,6	7,7	5,7	64%
Q1/19	13,1	12,3	6,0	28,6	2,9	7,3	2,5	5,7	2,6	0,8	-2,4	9%
Q2/19	3,8	1,5	0,3	-1,2	3,1	2,5	2,8	2,0	1,6	9,1	1,3	9%
Q3/19	1,2	2,2	2,3	-0,3	2,3	1,3	2,9	1,7	1,6	4,5	11,0	9%
Q4/19	8,5	5,8	8,7	7,4	0,2	2,6	-2,2	2,5	2,6	3,0	5,0	9%
Q1/20	-20,0	-23,0	-20,0	-10,0	3,2	-12,7	-1,1	-15,1	-6,9	3,9	-21,7	82%
Q2/20	20,0	12,6	17,8	13,0	2,9	10,2	2,4	10,9	6,2	12,9	30,3	0%
Q3/20	8,5	0,2	4,0	10,2	0,6	4,6	1,5	2,6	2,7	5,9	27,6	0%
Q4/20	11,7	10,5	18,4	13,6	0,7	6,5	1,3	5,3	5,1	0,7	13,6	0%
Q1/21	5,8	7,7	6,3	-3,1	-3,4	0,9	-1,9	2,1	1,3	-10,0	-7,5	45%
Q2/21	8,2	5,4	-1,3	3,5	1,8	2,7	-0,4	1,4	2,4	3,7	7,0	18%
Q3/21	0,2	0,4	2,3	-6,9	0,1	0,9	0,0	0,6	-0,1	-0,7	-15,1	45%
Q4/21	10,7	7,3	-2,2	1,5	0,0	0,7	-0,6	0,0	0,1	4,1	5,1	27%
Q1/22	-5,0	-6,6	-3,4	-14,5	-5,9	-4,8	-5,4	-4,1	-1,4	5,9	6,4	82%
Q2/22	-16,5	-10,7	-5,1	6,2	-4,7	-9,8	-7,1	-10,7	-3,5	-6,7	-18,2	91%

Source: Bloomberg, own calculation

As can be seen from the colour distribution (red = negative quarters), it is not often that all investments develop positively in one quarter (most recently in 2020 after the previous sharp decline due to the outbreak of the Covid 19 pandemic) or negatively (such as in 2018 during the last attempt by the US Federal Reserve to raise interest rates).

Diversification will continue to be the best way to manage investment risks at the portfolio level. Nevertheless, we must note that no significant effects could be achieved from this in the second quarter.

Review of the second quarter

A number of serious events were responsible for investors losing heart in virtually all investment markets for the time being.

The continuation of the Russian war of aggression in Ukraine has led to widespread disruption of international trade, especially in the agricultural sector, in addition to shocking reports of destruction and human suffering. The feared supply shortfalls for grain products alone caused world market prices to rise rapidly. In addition, the supply of industrial primary products to European customers was temporarily interrupted, and even now can only be maintained at a reduced level and with some difficulties.

Tough sanctions against Russia and supply restrictions for Russian oil, gas and coal led to rising energy prices again strongly driving inflation in the second quarter. So far, Russia has already suspended deliveries of oil and gas to some EU states in isolated cases. A deliberately induced shortage of energy is used by the Russian government as a political weapon and in retaliation for the increasingly far-reaching sanctions imposed by the West.

The resulting supply insecurity has become a considerable uncertainty factor for the European economy and especially for German industry. In order to end the heavy dependence on Russia without risking major restrictions in energy supply in the short term, massive efforts and high expenditures are necessary to prepare for a complete supply freeze that is likely to follow. Whether this can actually succeed is not entirely clear at this point. For Germany, the scenario would very likely mean sliding into a severe recession.

The re-emergence of Covid 19 cases has led to massive restrictions for citizens and businesses in China's economically most important regions. The Chinese government's zero covid strategy, which imposes a complete lockdown in the affected regions as soon as the first infections appear, has once again led to weeks of massive production and supply bottlenecks. These immediately spilled over into the global economy and will continue to exacerbate the existing problems in supplier and logistic chains for some time to come.

The factor currently having the strongest negative impact on the financial markets is inflation data. This not only influences the spending behaviour of consumers and companies but is also an important point of reference for the monetary policy of the central banks. The unchecked upward trend in the prices of consumer and capital goods continued in the second quarter and led to a darkening of economic expectations.

Consumer price inflation rose to 8.6% in the US and 8.1% in the Eurozone in May. Values that have not been recorded for four decades and are not expected to fall again in the short term. This is indicated by the likewise strong increase in prices at producer level, which in Germany, for example, rose by 33.6 % in May compared to the previous year. Rising energy and food prices, but also the constantly high demand for goods and services from both private households and companies are keeping prices high for the time being. Upcoming wage negotiations will be influenced by the loss of purchasing power already suffered, but also by the still high demand for labour. The danger of a wage-price spiral remains unchanged.

In the meantime, perhaps with the exception of the Bank of Japan, there is also no central bank that questions the sustainability of the inflation trend. Too much time has passed before the US Fed and even more so the ECB have decided to take monetary policy measures such as raising key interest rates and reducing or ending bond-buying programmes.

The long hesitation and suppression has led to the fact that the transition phase towards rising interest rates, which is always very problematic for financial markets anyway, has been exacerbated by a considerable loss of confidence in the central banks' will and ability to fight inflation.

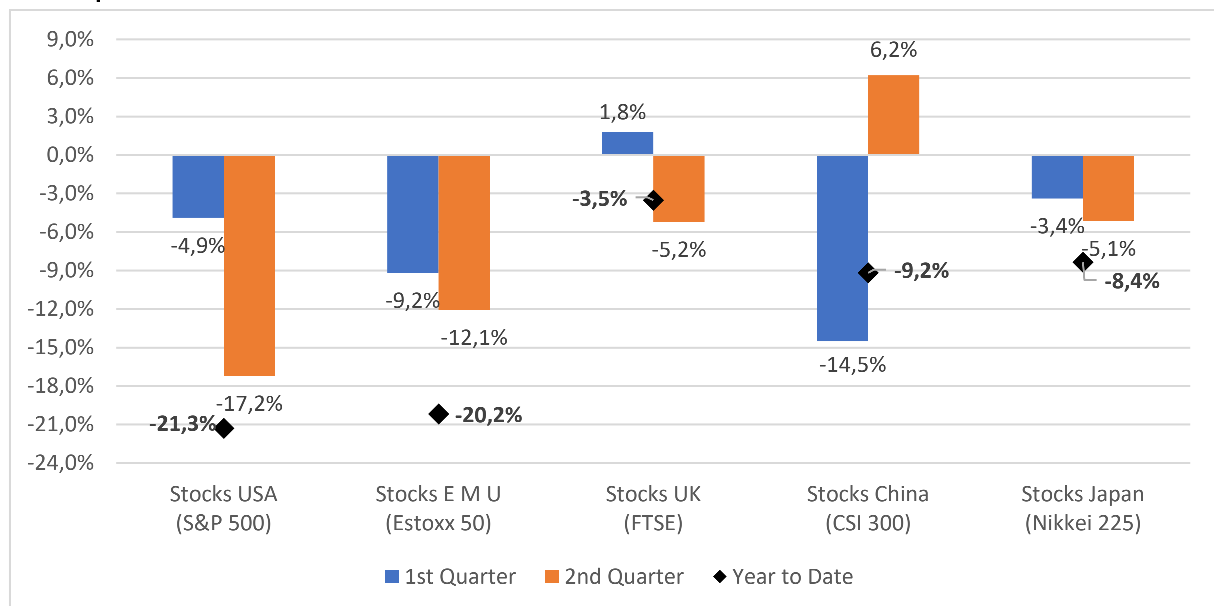
We attribute a large part of the market slump recorded in the second quarter to the negative impact on sentiment caused by the less than skilful actions of the central banks. Concerns about the suppression of inflation are now being followed by fears of an overdraft of the measures, which extend to expectations of a "hard landing" of the economy, i.e. a severe economic slump.

At least the US Federal Reserve has meanwhile taken concrete steps with significant interest rate hikes and a defined approach to balance sheet reduction and is trying to regain control in this way.

The European Central Bank, on the other hand, has not taken any active monetary policy steps against inflation until the end of the second quarter, apart from numerous speeches, internal discussions carried into the public domain and vague declarations of intent. This puts the ECB in sharp contrast not only to the US Federal Reserve, but also to the Bank of England, the Swiss National Bank or the central banks of Scandinavian and Eastern European countries, all of which have already run ahead with significant interest rate hikes.

Equity markets suffered price declines in the second quarter, in many cases among the steepest ever recorded.

Development of selected stock markets in 2022



Source: Bloomberg

At the end of the second half of 2022, almost all major stock markets were in a so-called "bear market", which according to the usual definition requires price losses of more than 20 % since the last high. Certain stock indices, such as the traditionally very technology-heavy American NASDAQ Composite Index, were in some cases even deeper in the loss zone (- 29.5 % in the current year).

The sharp rise in interest rates acted as a negative amplifier of the factors that were already burdening companies, such as supply chain problems, sanctions or rising labour costs. These trigger a decline in the current share value, as the companies' expected future profits have to be discounted with a higher interest rate. In addition, bonds appear more attractive again due to increased yields in direct comparison to shares and despite the currently still very good order and earnings situation in most companies. This puts additional pressure on stock prices.

Finally, the very real danger of the economy sliding into recession due to increased financing costs (interest rate hikes) is also part of the current lower market valuation of equities.

Mining stocks, which are represented in our portfolios in various forms, performed better than the market average, but were not able to completely decouple themselves from the negative overall stock market development despite massively increased commodity prices and thus rising earnings prospects. From our point of view, mining stocks remain very attractive investments in terms of substance valuation and excess demand for commodities.

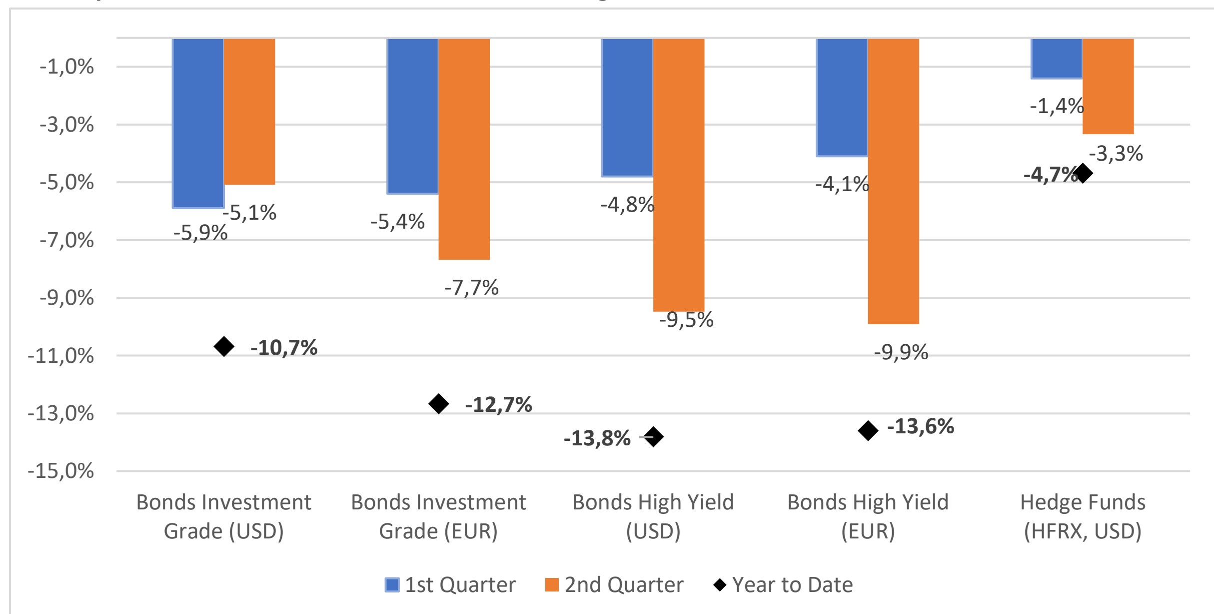
Also outperforming the overall market, although not free of declining prices in the first half of the year, was the development of shares from the biotechnology and health sectors, which we hold in the portfolios as part of our thematic equity investments.

On the one hand, **Chinese equities** suffered from the slump in the domestic economy caused by the zero-covid policy. On the other hand, there has been some hope that the Chinese government might reduce the draconian market interventions and regulatory campaigns that have been weighing on the Chinese market for more than a year. This prospect led to an initial recovery of the prices in June that had previously fallen sharply.

China's geopolitical positioning, unresolved problems in the real estate sector as well as the government's still unclear stance on basic market economy principles make us continue to refrain from investing in the Chinese equity market despite interesting valuation levels and long-term growth prospects.

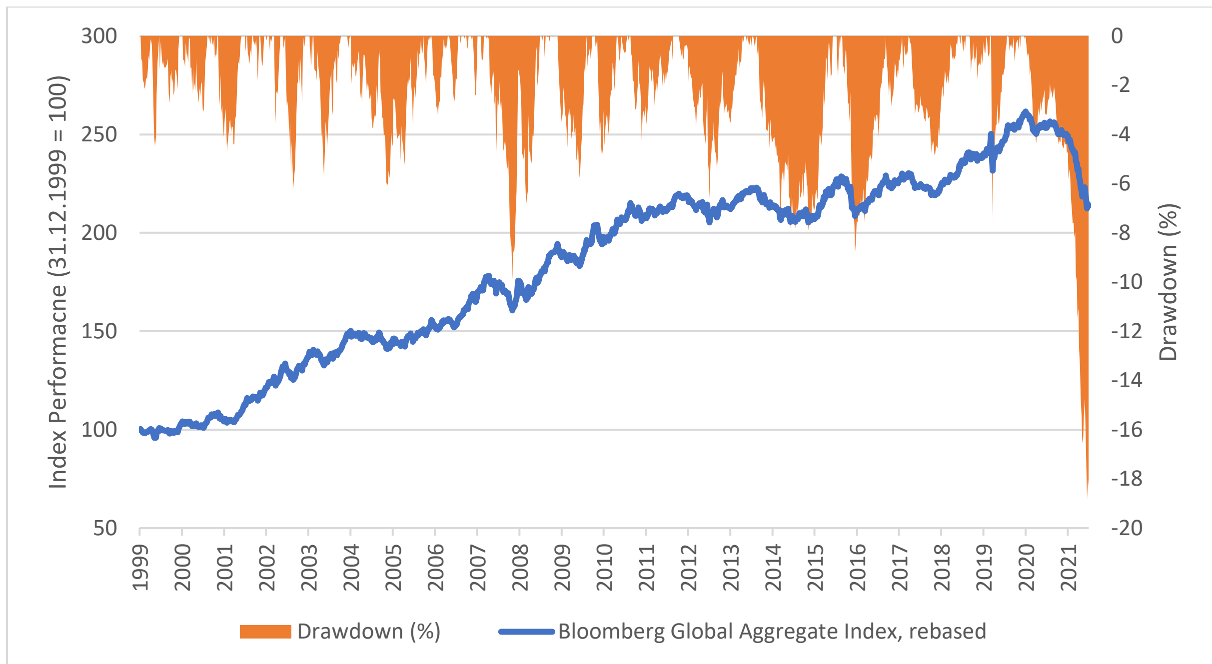
Bonds are not part of the core of our portfolios due to the negative real yields that have existed for a long time. Only in some marginal segments do we still hold an exposure. So far, neither the rising yields on the bond market have changed anything, as inflation rates rose even more strongly at the same time. Despite our extensive abstinence from interest rate investments, the development of the bond markets indirectly influences some components of our portfolios, up to and including alternative investments**.**

Development of selected bond markets and hedge funds in 2022



Source: Bloomberg

Bonds are currently suffering by far the worst period of losses in recent decades. The bond market index (Bloomberg Global Aggregate Total Return Index) shown in the following chart exemplifies the performance of a large part of the investment grade bonds issued worldwide in the US dollar currency.

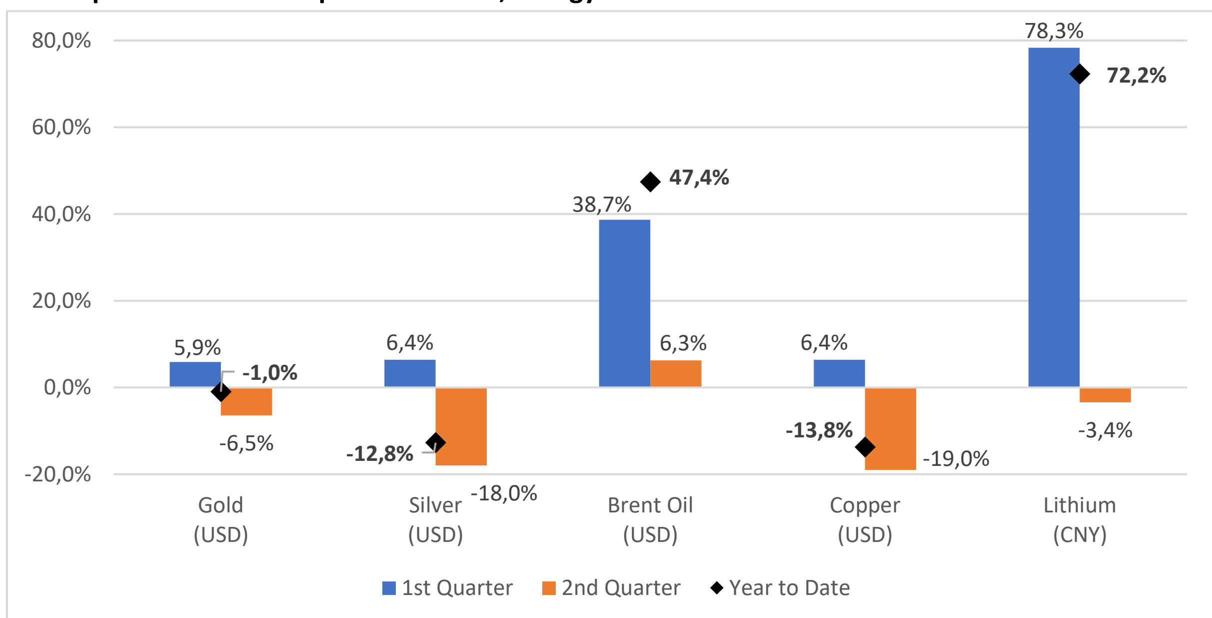


Source: Bloomberg

In the current cycle, this index, measured from the last high at the end of 2020, is now down more than 18% - interest payments included (red areas in the chart). In other words, the gains of the last 5 years have been eroded by the current market slump. Our early reduction of bonds in the portfolios has thus turned out to be a very fortunate decision so far.

Investments in commodities, energy and precious metals also did not show positive performance in the second quarter. Even in the case of industrial raw materials that are still in demand, such as copper or lithium, the price increase did not continue. The expectation of a decline in demand in view of increased risks of recession are already playing a role here.

Development of selected precious metal, energy and raw materials 2022



Source: Bloomberg

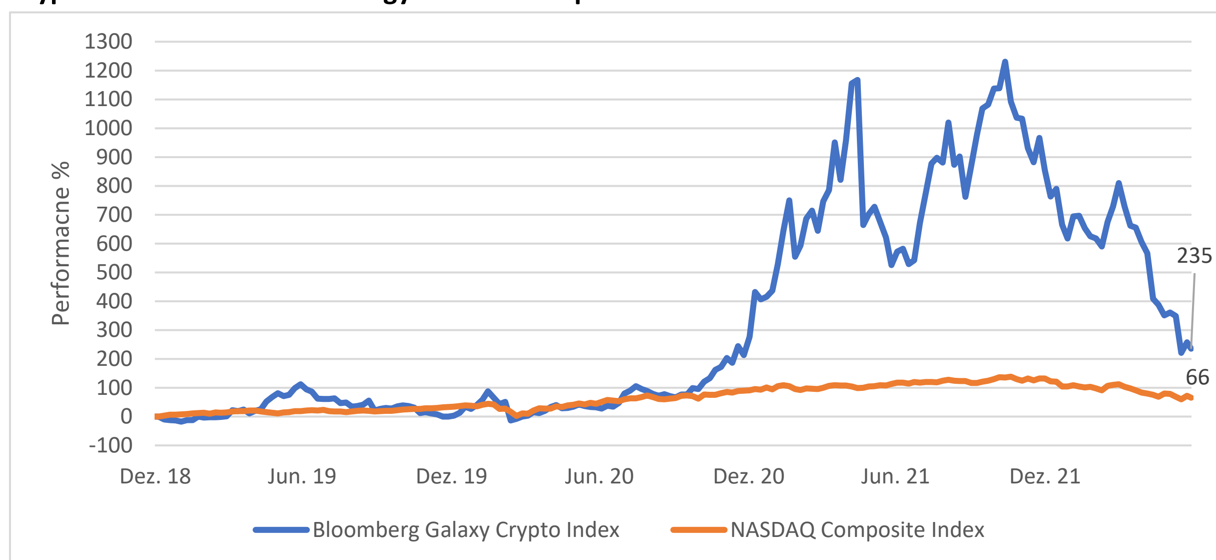
During the second quarter, **gold** was only able to partially fulfil its role as a “store of value” in the portfolio. The sharp rise in interest rates in most countries of the world led to declining demand for gold due to its lack of current income. At least during the sharp price declines in June, it became apparent that gold continues to function as a liquid store of value even in phases of greatest uncertainty. The liquidity needs of speculative investors triggered by the violent market fluctuations (so-called “margin calls”) could be covered by the gold market without causing further price declines. A small consolation for euro investors is that due to the pronounced weakness of the euro against the US dollar, gold has shown a positive performance of + 7.1 % (in euros) since the beginning of the year.

Cryptocurrencies and Digital Assets

Cryptocurrencies and digital assets experienced strong setbacks in the first half of 2022. Regardless of the future-oriented characteristics of the technology, digital assets and the shares associated with them came under strong pressure. However, we see this more as a consequence of the sometimes observable "sell-off sentiment" in the technology segment than as a reason for us to doubt its long-term significance.

A comparative look at the development of the last 3 years shows that cryptocurrencies (+ 235 % in the Bloomberg Galaxy Crypto Index) represented a very high-yielding investment compared to technology stocks (+ 66 % in the NASDAQ Composite Index) despite the most severe price fluctuations.

Cryptocurrencies and technology stocks – comparison since 2019



Source: Bloomberg

On the news side, cryptocurrencies were weighed down by negative reports on a failed algorithmic stablecoin (TerraUSD), among other things, which are not the subject of our investments but had strong repercussions on the overall market. Regulation of cryptocurrencies, which is now becoming increasingly apparent and is in our interest in terms of investability, also initially put an end to the rampant price rises and drove away many of the investors who were only interested in speculation.

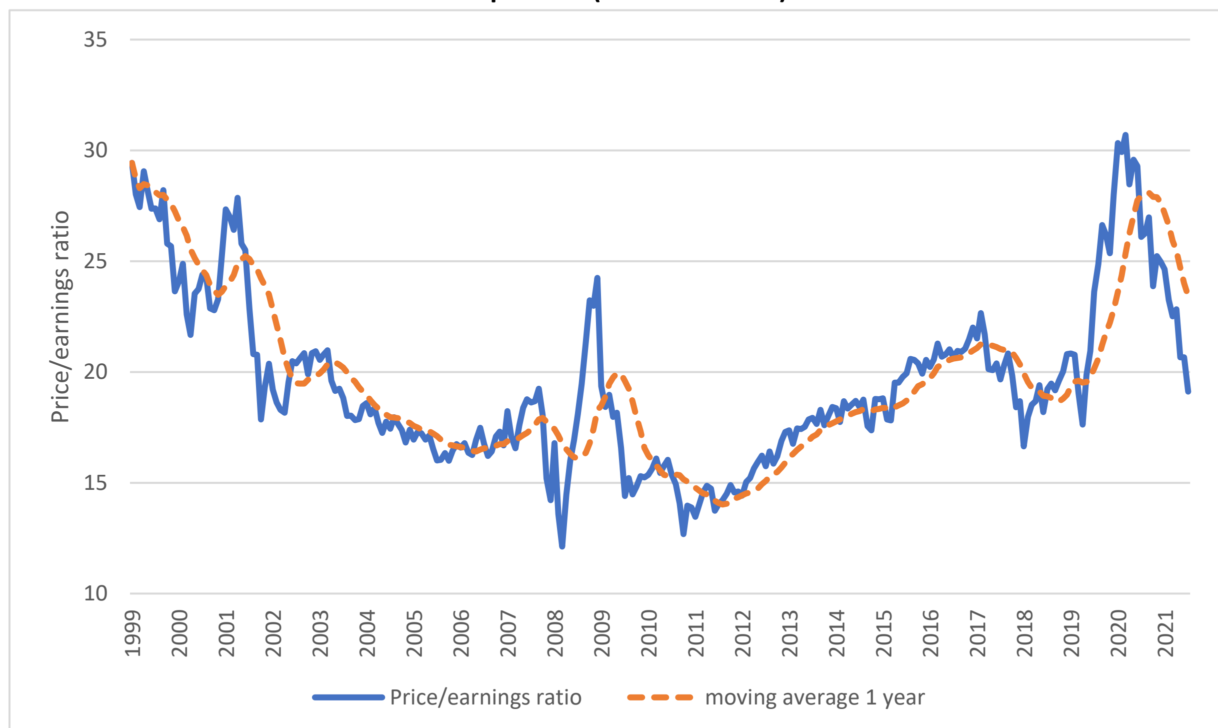
Our cautious approach over the past 1 ½ years of repeatedly reducing the investment to a weighting that is compatible with the portfolio by realising profits proved to be correct once again.

What is likely to be keeping us busy in the coming months

The following selection is again only a small sample of the topics that we have to constantly monitor and evaluate in our investment process. For us, they are some of the current key questions for a successful and sustainable portfolio design.

- **Will stocks soon be so cheap that value-oriented investors can buy them again?**
  Price declines in major market indices of more than 20 % in the middle of the year raise the question of whether these declines are already sufficient to make a longer-term attractive investment. In fact, the price declines of the last few months have already made the stock market more appealing, while at the same time the turnover and profit development of the companies has been largely stable. This can be illustrated on the basis of the price-earnings ratio (share price divided by the share of company profits attributable to a share) and the deviation from a mean value:

Valuation level of stock markets - example USA (S&P 500-Index)



Source: Bloomberg

With a current price-earnings ratio of 19.1, this value is slightly below the average of the past 22 years (19.6). Compared to the beginning of 2022 (with a price-earnings ratio of 24.6), shares are thus already significantly cheaper today, although they cannot yet be considered real "bargains". In particular, the question of whether companies will succeed in passing on rising costs to their customers in the form of higher prices will be decisive for the level and development of corporate profits in the coming months. This will also be an essential point of consideration in the company reports at the beginning of the 3rd quarter and for the profit estimates that will follow. Reductions would initially worsen the valuation ratios again.

There is no doubt that the lower valuation level has already reduced the danger of even further setbacks, also in connection with the interest rate expectations, which have also risen sharply.

We are prepared for purchases in order to benefit from a rapid market recovery, even without a long-term holding intention.

- **How far will the central banks be able to go with their aggressive interest rate hikes?**

  The bond markets have already reacted massively to the necessary interest rate hikes with the heavy price losses of the last 12 months and have "priced them in". This automatically leads to expectations about the next steps of the central banks.

  The following table shows the market expectations for the development of key interest rates in the USA and the Eurozone derived from the interest rate futures market prices:

Markterwartungen Leitzinsen Ende Juni 2022		
	USA	**Eurozone**
im...	von 1,59% auf...	von - 0,58% auf...
Jul. '22	2,26%	-0,29%
Sep. '22	2,81%	0,20%
Nov. '22	3,19%	0,59%
Dec. '22	3,38%	0,91%

Source: Bloomberg, as of June 30, 2022

For the end of 2022, further key interest rate increases of 1.8% in the USA and 1.5% in the Eurozone are already anchored as expectations in the current prices and thus already anticipated in their effect.

Should the central banks be forced to react with an end to interest rate hikes or a significant slowdown, for example because of the threat of a massive economic slump or because the high interest rate level is no longer bearable for some states, this should lead to a quick turnaround in market sentiment. Strong price gains in a short time for almost all forms of investment would then be expected. Not least because the currency areas of the USA and the Eurozone are still supplied with a great degree of liquidity.

In our view, there is now a high probability of such an imminent "turnaround", so that we have already planned concrete investments for this development.

- **EURO CRISIS 2.0 in sight?**

  It was with some surprise that we took note of the special meeting of the ECB Governing Council on 15 June. An already noticeable price decline (= interest rate increase) for Italian government bonds on the bond markets seems to have been the reason for the meeting. The yield gap between 10-year German Bunds and Italian government bonds had jumped to as much as 2.4% p.a. shortly before. Memories of the euro crisis of 2012 came to mind, which was brought under control by the then ECB head (and now Italian Prime Minister...) Mario Draghi with the famous words "whatever it takes", in which he unceremoniously made the ECB's balance sheet available to buy up bonds of highly indebted euro states.

  Today, the ECB is concerned with preventing a "fragmentation of the Eurozone" (or more precisely: of its debtors with very different credit ratings). To this end, it wants to create a new "anti-fragmentation instrument", which is intended to keep financing costs as low as possible via direct capital market interventions (extensive bond purchases, but this time specifically in favour of countries with the highest financing needs, such as Italy), thus keeping the debts serviceable and the Euro as a currency alive.

Parts of the capital market could see this as an invitation to once again speculate massively against the continued existence of the Euro, if the ECB's defensive reflexes kick in at an interest rate of just over 4%.

What you can expect from us

The current situation on the financial markets demands a great deal of nerve from both investors and asset managers like BPM. Price losses, even if they initially only appear on paper, always trigger doubts or even self-reproach in the observer, up to and including fear.

As individually difficult as it may be for everyone - overcoming these emotions is imperative in order not to lose sight of the truly relevant and effective long-term developments.

In the last few weeks, we have seen all too clearly that the "turn of the times", which we discussed in our review of the first quarter of 2022, also applies to the capital markets. It is necessary to adjust to an environment with higher inflation, higher interest rates, but probably still negative real interest rates, scarce resources and structurally lower market valuations. We are convinced that even under these circumstances, only wise and forward-looking action is the key to long-term investment success.

For us as asset designers, the starting point of every decision is a realistic assessment of the situation, the risks and the most probable development scenarios. We consider it one of our most important strengths to remain disciplined and as unaffected as possible by the daily excitement and hectic pace of the financial markets.

Because only in this way is it possible to set up our clients' portfolios in such a way that they can follow the long-term trends that are really decisive for success.

In this sense, we can promise our clients that we will act decisively as soon as we feel the time is right.

BPM – Berlin Portfolio Management GmbH

July 2022

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