Review of the 3rd quarter 2022 and outlook

„Everything is connected to everything else“

Alexander von Humboldt (1769 - 1859), German polymath, naturalist and science pioneer

The realisation that "everything is connected to everything else" can be attributed to Humboldt's extensive research trips to several parts of the world and his intensive involvement with highly diverse scientific disciplines. This holistic view is still very helpful today when assessing the mutual influences of political, social and economic developments.

The multitude and simultaneity of the crises and events that currently determine our lives have connections to each other. Not necessarily in their causes, but in their effects. An example from the last quarter will illustrate this: During the summer months, the lack of rainfall in parts of Europe exacerbated the already prevailing scarcity of many raw materials and of energy.

Transport problems, e.g. with mineral oil, coal, grain or building materials, hit German industry with the low water on the Rhine and Elbe. France had to reduce the electricity production of some nuclear power plants, as the cooling water discharged would have further increased the already far too high water temperature of the rivers. Low water levels in reservoirs and lower river flow rates reduced electricity production from hydroelectric power plants.

Picture: OIl tanker navigating along the Rhine`s dry shoals during low water in August.

But it is not only in industry and energy supply where a lack of water is causing delivery problems and sales shortfalls. The effects on agriculture have been so severe in some cases that the expected crop failures will further drive up the price of some foodstuffs. Conflicts over the distribution of water are increasingly occurring and are being fought out between stakeholders in agriculture and tourism in Italy and Spain, for example.

Concern about inflation dominates headlines

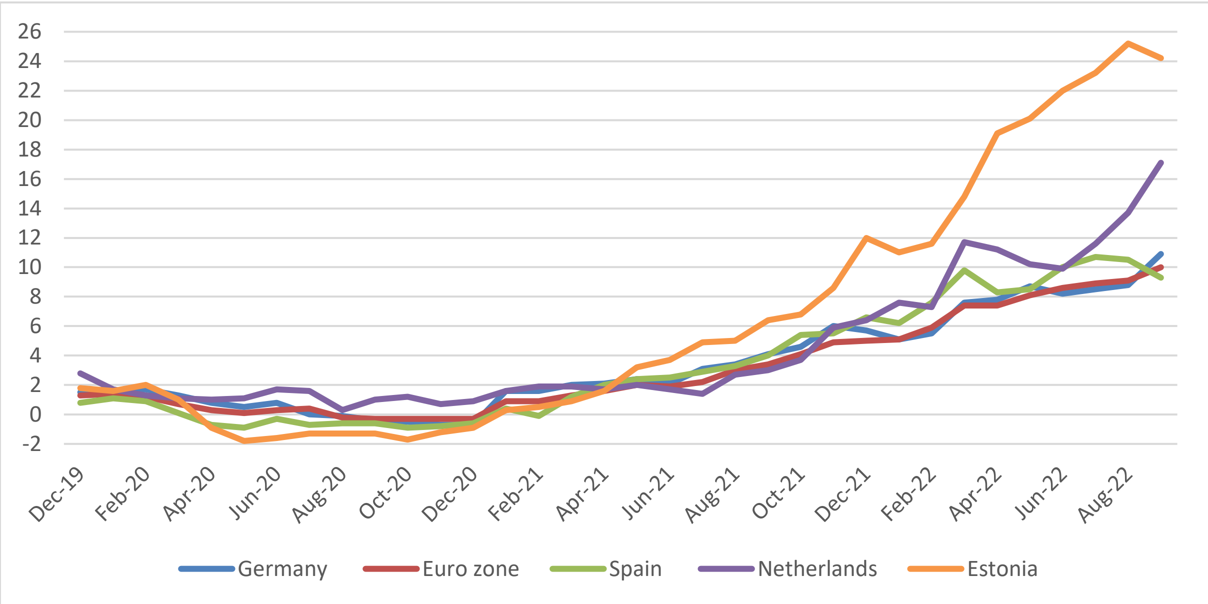
As if weather-related inflation drivers were not already burdensome enough, with a lot of luck ("hoping" for mild weather...) and savings efforts, cold homes and a temporary standstill of the economy due to energy shortages will be preventable in Europe in the autumn-winter half-year. The sharply increased prices for all forms of energy, at the latest since the outbreak of the Ukraine war, are increasingly leading to forced restraint in spending, not only among private households.

Many companies will also postpone investments in the face of massively rising energy prices and interest rates. On the one hand because future profitability is difficult to assess, on the other hand in order to preserve their solvency in the event of further setbacks and price spikes.

Price increases at producer level, most recently in August in Germany by 45.8% (compared to August 2021), show the danger that price shocks from the commodity and energy sectors will continue to move through the value chain to the consumer. Still high order backlogs in industry, which can often only be processed slowly due to a lack of materials or primary products, ensure that supply will remain scarce in many sectors for longer and that prices will therefore remain high. Largely stretched labour markets favour high wage settlements or individual agreements on higher wages and do not point to a rapid easing of inflationary pressures.

At the same time, consumer prices in the Eurozone are rising at different rates. This and the very different levels of debt in the EU states make it very difficult for the European Central Bank ECB to raise the key interest rates in a dosage that is acceptable for all countries.

Consumer prices in selected euro area countries (2020 to 2022)



Source: Bloomberg

Governments under pressure to act

The social and economic consequences of the dramatic energy supply situation and the significant price increase for many things in daily life are once again leading governments to provide relief through massive use of tax revenues only a short time after the expensive relief measures in the Corona pandemic. The bailout packages for consumers and businesses that have already been decided and those still to come, up to and including the nationalisations already underway to rescue energy utilities in Germany and France, not only increase the indebtedness of government budgets with long-term growth-dampening consequences, but also create "entrepreneurial risk" for taxpayers and tend to have an inflationary effect.

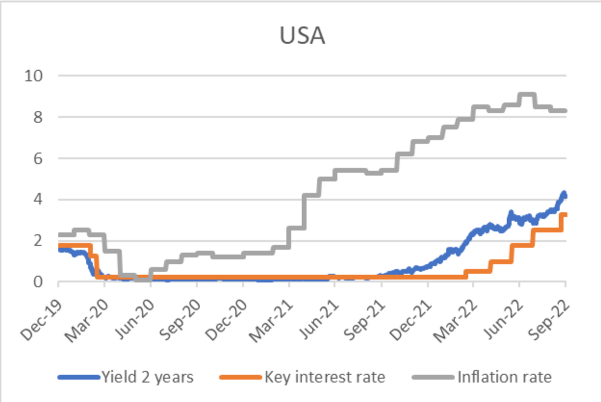
In the end, it is not certain whether these efforts can prevent a wave of insolvencies among consumers and companies. A recession in the Eurozone, as in many other countries, seems hardly avoidable.

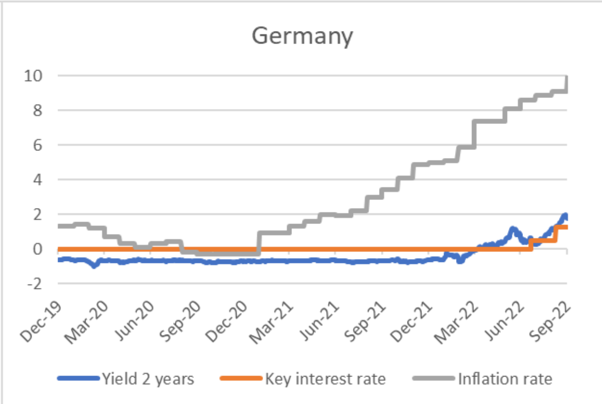
Suddenly the central banks are showing determination

The ECB's first interest rate hike in almost exactly 11 years can only be described as "finally, but too late"! Not only does the bizarre situation of having to pay interest on deposits in accounts come to an end, but the ECB is also one of the last major central banks to actively fight inflation. The US Federal Reserve, too, is showing its determination after its still timid start in March and has raised the key interest rate substantially several times. Nevertheless, we do not expect inflation to slow down quickly. As a rule, key interest rate hikes only have an impact on price developments with a delay of two to three quarters.

The following charts show that if central banks had reacted more quickly to the inflation trend, these 2 to 3 quarters could already be behind us. For too long, central bankers have clung to the false narrative of "temporary inflation".

Key interest rates, 2-year government bond yield and consumer prices USA and Eurozone





Source: Bloomberg

The sharp rise in inflation expectations, which have a significant influence on the economic decisions of private households and companies, would probably have been smaller. With the early rise in yields on short-dated government bonds, the bond markets correctly predicted later developments. For the central banks, this is a loss of confidence that they will probably be fighting for a long time to come.

Review of the third quarter

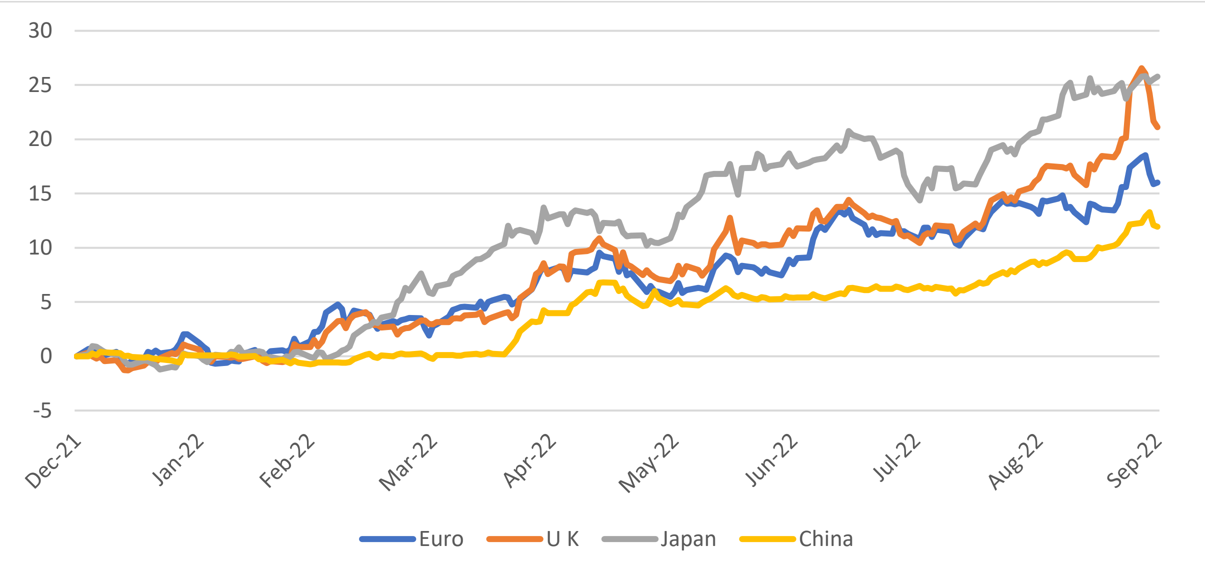
After the losses of the second quarter, July initially brought the "summer rally" on the financial markets that many had expected. The trigger for the positive change in sentiment was, of all things, "fear of recession", which only seems absurd at first glance. The related hope that the central banks would soon stop raising key interest rates and even lower them to stimulate the economy initially caused stock and bond prices to rise across the board.

Disillusionment set in from mid-August when clear statements from central bank circles abruptly destroyed the hopes of the financial markets that the interest rate trend would slow down or even reverse. By the end of September, the stock markets had completely given up the gains they had made since the lows in June. Yields on the bond markets reached new highs after the interim decline and thus caused new valuation losses in interest-bearing investments and also in many alternative investment strategies.

Key interest rate increases of 3 percentage points so far in 2022 and the status of the USA as a "safe haven" in the face of major geopolitical crises such as the Ukraine war, in which the use of nuclear weapons now also appears not to be ruled out, or the conflict with China over Taiwan provided the US dollar with additional appeal. This was not changed by the news that the USA entered a recession phase after the second quarter from a purely technical point of view.

At the end of the third quarter, the euro reached its lowest level since 2002, the Japanese yen even since 1998.

Appreciation of the US dollar in 2022 in % against the euro, pound, yen and yuan



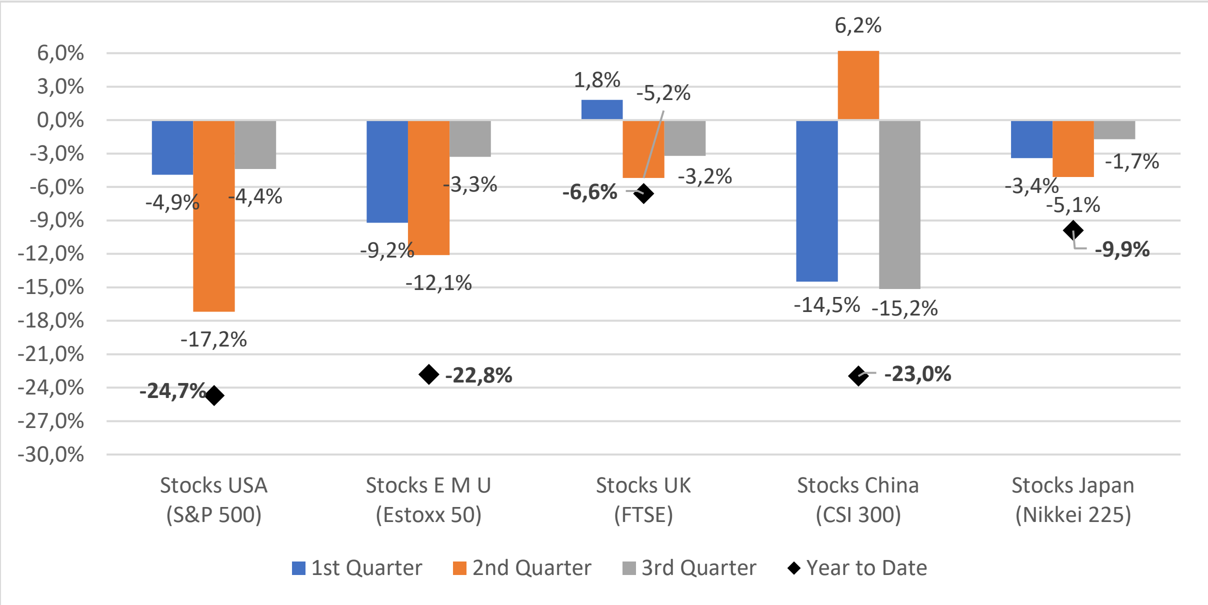
For countries and regions like the Eurozone, which rely heavily on imports of raw materials or oil and gas, the weakness of their own currency leads to rising import prices and thus to an additional strengthening of the inflation trend. The advantage of better competitiveness in exports, on the other hand, does not have a sufficiently positive effect during a global economic slowdown, or also because of the supply chain problems that are still holding back.

The consequences of inflation and a slowing economy have so far only become visible to a limited extent in the reported corporate results and outlooks. The question - only "balance sheet cosmetics" or real resilience - cannot yet be answered with certainty. In this respect, the company reports for the third quarter, which are due in mid-October, will be examined very closely by the financial markets and provide reasons for stronger price fluctuations.

The **stock markets** continued their negative trend. At the end of the third quarter, there was no relevant stock market that showed a positive performance. Performance in the current year now reaches minus 30 % in some cases.

Concerns about inflation, which from the point of view of the stock markets are pushing the central banks to raise interest rates further, have been supplemented by concerns about the economy, which emanate from the interest rate level, which has risen significantly in the meantime. The growing hope that the central banks would abandon the course of interest rate hikes prematurely due to a weaker economy has so far always been put to an end by the once again higher inflation rates. The financial markets have not yet succeeded in breaking this cycle of negative expectations.

Development of selected stock markets in 2022



Source: Bloomberg

The markets in Great Britain and Japan owe their less poor performance in each case to special circumstances.

The British FTSE 100 contains a particularly large number of shares of companies from the commodities, oil and gas sectors, which benefited from the significant price increases. Looking at the "broad" British stock market (e.g. FTSE 300 Eurofirst with - 18.7 % in 2022), the picture clearly evens out. Japanese equities also benefited from the fact that the central bank still shows no signs of moving away from its expansionary monetary policy. In addition, the very weak yen is helping Japanese companies with their export business, which is currently still supporting share prices.

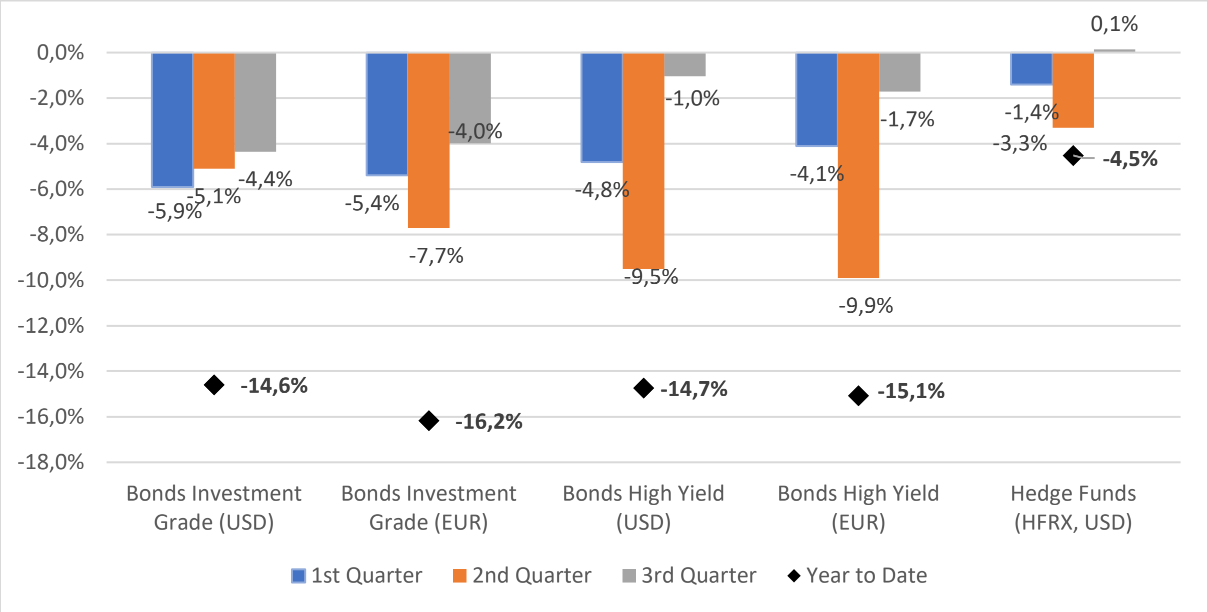
In addition to the effects of interest rate hikes and a possible economic downturn, an unusually high geopolitical risk premium continues to weigh on the stock markets. In view of the numerous global trouble spots, this risk premium is likely to remain in place for the foreseeable future.

Bonds continued their unprecedented decline by historical standards in the third quarter.

"Ice age on the bond market" was a recent commentary in the business press on the development of the bond markets. And indeed, at first glance there seems to be nothing speaking in favour of bond investments, which despite significantly increased interest rates with the current high inflation rates make a real loss of wealth mathematically probable.

The prospects of a continuation of key interest rate hikes are confirmed by the recently increased aggressive rhetoric of the representatives of the US Federal Reserve (FED). Bonds were thus unable to play their traditional role as value stabilisers in portfolios in the third quarter.

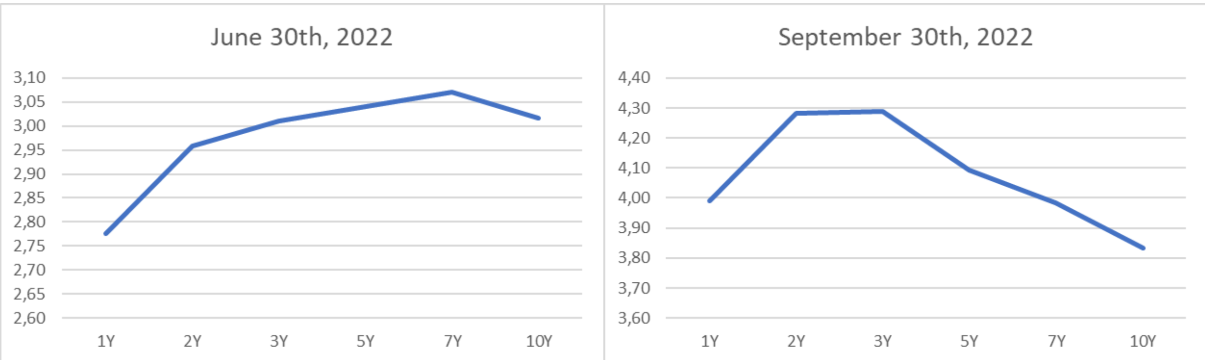
Development of selected bond markets and hedge funds in 2022



Source: Bloomberg

Nevertheless, we see initial opportunities in sub-sectors of the bond market.

For example, we have recently started our first investments in bonds with longer maturities. One important reason for this is the unusually strong inverse shape of the US yield curve:



Source: Bloomberg

The paradoxical situation that yields for longer maturities are lower than those for shorter maturities indicates with high probability that interest rates will fall again in the medium term. With appropriate positioning, this holds considerable yield potential that we want to exploit!

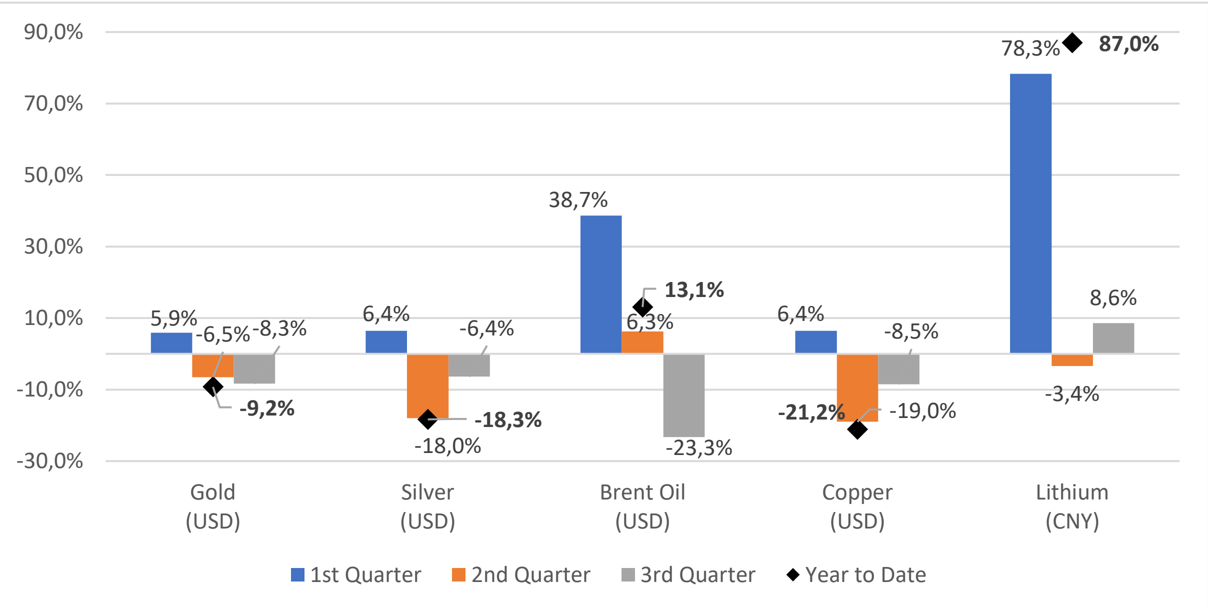
Because if the central banks must abandon their aggressive course of interest rate hikes due to sudden shock events or because of a severe economic slump, considerable price gains can be made here. Tactically, long-dated bonds in a portfolio context represent a sensible hedge against the consequences of recession by forming a counterweight to equities, which can come under pressure in the short term in such a scenario.

That a sudden U-turn in monetary policy "overnight" under the impact of external shocks is by no means abstract is shown by the example of the Bank of England at the end of September. After the new British government announced a politically sensitive supplementary budget with considerable new borrowing ("growth plan") and this led to a massive fall in the price of British bonds, the Bank of England suddenly felt compelled to prevent the impending collapse of British pension funds. The bond market was initially stabilised by the temporary purchase of British government bonds with long maturities and the postponement of the start of the balance sheet reduction announced for October. Here again, an example of "everything is connected to everything" can be seen. UK mortgage rates, which had already doubled earlier this year and are now beginning to affect the housing market, rose sharply again in the last week of September. Certain forms of mortgages were at times no longer offered at all due to refinancing problems.

It is not difficult for us to imagine occasions in the Eurozone that could force the ECB off its path of interest rate hikes. A look at Italy is sufficient for this.

Commodities and **energy** sources, such as oil and natural gas, recorded price declines in many cases in the third quarter. This effect will help to dampen the inflation trend with some delay. However, this price development also points to an overall slowdown in economic activity. Especially for commodities such as copper, the unexpectedly weak economic development in China plays a role.

Development of selected precious metal, energy and raw materials 2022



Source: Bloomberg

Irrespective of more short-term economic considerations, we see commodities such as copper or lithium, both of which play a prominent role in future topics such as electromobility or efficient energy generation and storage, as a core element for a robust and sustainable portfolio. Corresponding investments are already available, and we will weight them even more in the future due to the recognisable scarcity of supply and the future trend towards a strongly electrified world.

Gold has not yet been able to completely fulfil its function as a real store of value in the course of 2022. The gold price development is burdened above all by the higher interest rates and the strong appreciation of the US dollar, which has made the purchase of gold significantly more expensive this year, for example for euro investors. Measured against the negative performance of equities and bonds this year, gold's performance of - 9.2% in US dollars and around plus 2% for euro investors offers some consolation. We continue to have no doubt that in a long-term oriented investment strategy gold as a "debt-free currency" and as protection against escalating amounts of paper money should still not be missing.

Cryptocurrencies and Digital Assets

Our existing broadly diversified investment in cryptocurrencies was one of the few investments that made a positive contribution to portfolio performance in the third quarter, with a development of + 17% (in euros) and + 9.7% (in USD).

The public's attention is still focused on the oldest form of cryptocurrency, bitcoin. In the meantime, however, there is a whole range of cryptocurrencies that promise more success for long-term investors in view of their development potential for a wide variety of applications and beyond a pure means of payment.

In the Ethereum blockchain, a long-planned and prepared change to the authorisation procedure (proof-of-stake instead of proof-of-work) was implemented in September. This change is fundamental for the expansion of the basic technology blockchain into a platform on which new and decentralised business applications, for example in the financial sector, can arise. Faster, cheaper and many more transactions can be processed in this way. The new method saves considerable computing capacities and thus reduces electricity consumption, a previously critical aspect for climate protection reasons, by around 99 %. The future importance of Ether, the currency in the Ethereum blockchain, as a payment medium and alternative currency for global use is thus continuing to grow.

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

The bad news are piling up - once again just the right time to be brave

Recession, inflation, energy shortages - each one of these three factors is causing great anxiety in the financial markets. The good thing, however, is that these factors have been known for a long enough time and have already been incorporated into the price development of the stock and bond markets. Therefore, even though we are aware of the risk of a further deterioration of the situation, we may not ignore the opportunities that arise precisely from the currently very negative mood of the financial markets. Because we believe they are considerable.

The problem areas that are now open to scrutiny, when evaluated soberly and selectively, result in very special investment opportunities. For example, the scarcity of energy will massively accelerate future topics such as energy efficiency, from building insulation to more fuel-efficient systems. This is an investment theme in which we have already invested in our clients' portfolios in 2021.

Some of the stocks of companies with particularly valuable brands and high pricing power will also react very positively to rising consumer prices worldwide as soon as the undifferentiated and partly panic-driven sell-off on the stock markets gives way to clear strategic considerations.

Bonds lost massive in market value in the wake of rapidly rising interest rates. Since we already reduced the bond holdings in our clients' portfolios to a minimum almost two years ago, we can now start to take advantage of the opportunities that will present themselves in the near future.

What you can expect from us

The past quarter has once again taken its toll on you and us emotionally. The hope for a quick improvement, which was associated with the "summer rally" that started at the end of June, was followed by disillusionment after only a few weeks. As short as this period was, it nevertheless provided us with valuable indications with which we can assess the future a little better. We are thinking in particular of the clear positioning of the central banks or also of the fact that prices for oil or natural gas do not rise indefinitely despite scarcity but can even fall again.

In our last quarterly review, we promised that we would act decisively as soon as we felt the time is right. We have already taken the first steps in the last quarter - more will follow. Of course, we cannot rule out further price declines. However, we see that at the current price level much of a very negative future expectation has already been taken into account. With the experience and from the perspective of a long-term oriented investor, we have therefore taken advantage of the first opportunities to prepare our clients' portfolios for the subsequent upswing on the securities markets.

We are convinced that we must lay the foundation for future success now. Warren Buffet, the now 92-year-old US investment legend, once said: "be greedy when others are fearful and be fearful when others are greedy". He was and is known to be very successful with this anti-cyclical approach and we see no reason why it should be different this time.

BPM – Berlin Portfolio Management GmbH

October 2022