Review of the 4th quarter 2021 and outlook 2022

Digital assets – just a new hype or real change after all?

"The internet is a gimmick for computer freaks, we don't see a future in it"
Ron Sommer in 1990, later Chief Executive Officer of Deutsche Telekom AG (1995 to 2002)

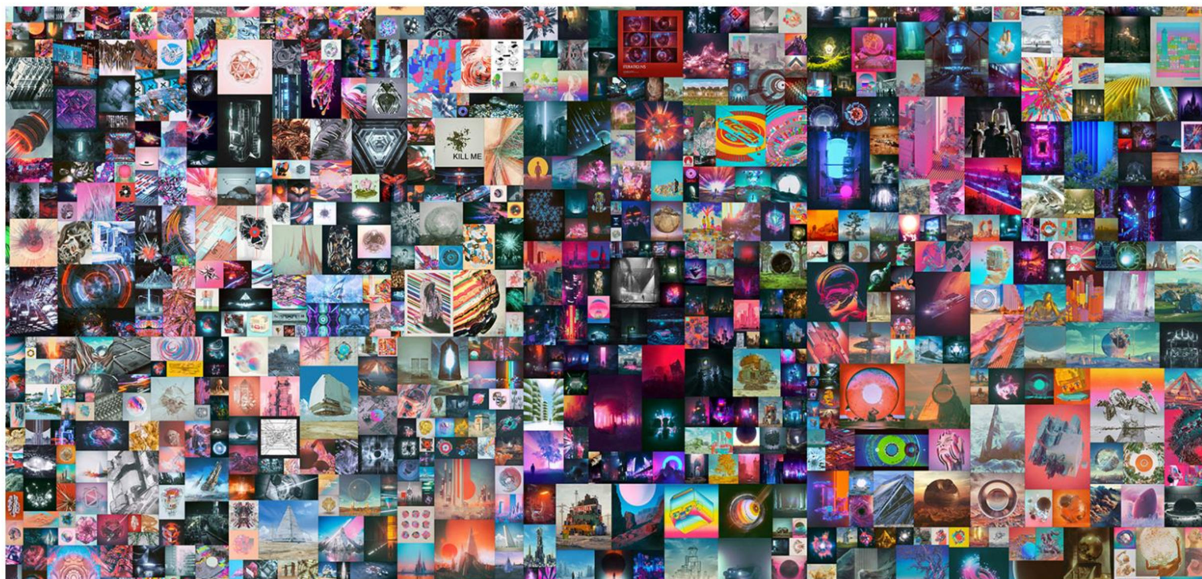
Of course, it is always easy, with the distance of a few decades, to describe a statement that referred to the then still unknown future as a great error. However, it also shows how easy it can be for truly groundbreaking developments not to be recognised as such, or only at a late stage. To Ron Sommer's defence, it should also be mentioned that during his time at Deutsche Telekom he recognised the importance of the internet and made it a central line of business for the company.

1990 the internet – 2022 the blockchain?

Today, the significance of blockchain technology is as important as the development potential of the internet was in 1990. With the help of a decentrally managed and securely encrypted database, it makes it possible to guarantee contracts and their exact and automated execution directly between all parties involved without intermediaries and without being based on a state legal act. Consistently elaborated and implemented, this technology enables an enormous simplification of processes in the economy with considerable advantages in terms of security, transparency as well as time requirements and costs.

It is already foreseeable today that blockchain technology will significantly change the way we will be making payments (cryptocurrencies, stablecoins and digital central bank currencies), owning (security tokens and non-fungible tokens) and using (smart contracts) real and virtual objects and assets in the near future.

Digital art – a still very young example of assets in the blockchain



Excerpt from „EVERYDAYS: THE FIRST 5000 DAYS" Mike Winkelmann (aka as „Beeple")
Source: www.christies.com

The collage, consisting of 5,000 images each created on one day with often very bizarre motifs, is considered the most expensive purely digital work of art to date and was sold in March 2021 as an NFT (Non-fungible token, a transparent and tamper-proof system for securing rights of use or ownership based on blockchain technology) in a spectacular auction at Christie's for 42,329.45 Ether (the cryptocurrency of the Ethereum blockchain). At the time, this corresponded to around 69.3 million USD. Today it is already over 180 million USD, thanks to the rise of Ether alone and regardless of any potential increase in the value of the digital artwork itself. Anyone who now thinks "speculative bubble!" is certainly not entirely wrong. But examples of seemingly absurdly high purchase prices can also be found in the classic art market for real works of art. Ultimately, value is always what a buyer is willing to pay.

In the future, this NFT is intended to be accessible in a museum that can only be visited virtually, giving the viewer completely new impressions, regardless of which part of the world one is in reality during the "museum visit". The entrance ticket is then bought with a blockchain-based application and paid (of course) with digital money.

What may still seem a little crazy also shows the direction in which the internet is currently developing - towards a virtual world ("metaverse"). This virtual world will go far beyond what users of video games, for example, are already familiar with today and has economic potential that should not be underestimated. Virtual museum or concert visits are still rather to be seen as modest beginnings. The ambitious plans of technology companies such as Meta Platforms (until recently known as "Facebook") or Microsoft, but even those of luxury brands such as LVMH or Gucci, indicate the future prospects that lie behind this development.

Although there are still many unanswered questions and little certainty, we are convinced that it already makes sense today for investors to take the first cautious steps into this "new world".

Realistically, we have to assume that we will still experience various twists and turns. A too early and too one-sided commitment to certain forms of application is not yet reasonable. It is also important that we do not let ourselves be blinded by enthusiasm alone. For as is so often the case with new technologies, "Amara's Law" applies (named after the US futurologist Roy Amara, who described that people tend to overestimate the effect of new technologies in the short term and underestimate it in the long term).

Theme investments - targeted use of future trends and special opportunities

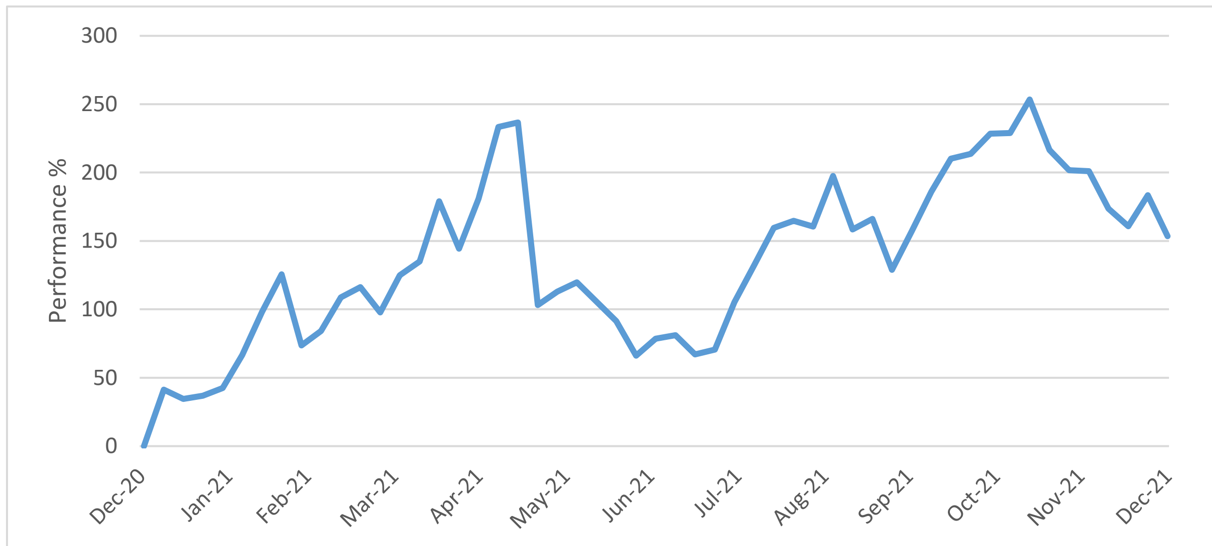
We see digital assets and their basis, blockchain technology, at the beginning of a development that will continue for many years to come. From technical aspects to economic forms of use to questions of social consequences, the next few years will bring changes and a strong transformation in all areas of life. We want to tap into the related investment opportunities for our clients at an early stage.

We therefore established a position at the beginning of december, weighted by up to 3% of the portfolio, in an ETF investing in stocks of companies whose businesses are directly related to the development of digital assets for all mandates whose investment guidelines allow this.

Prior to this, we reduced the investment in a basket of cryptocurrencies, which has already existed in most of our mandates since 2020, once again with respectable price gains. We are thus following our hedging strategy, in which we restore the original weightings in the portfolio through partial sales in a disciplined manner after a stronger price increase.

Cryptocurrencies were among the investments with the best performance in 2021, but also with the highest fluctuation in value:

Indexed performance of the largest cryptocurrencies 2021 (in USD)



Source: Bloomberg

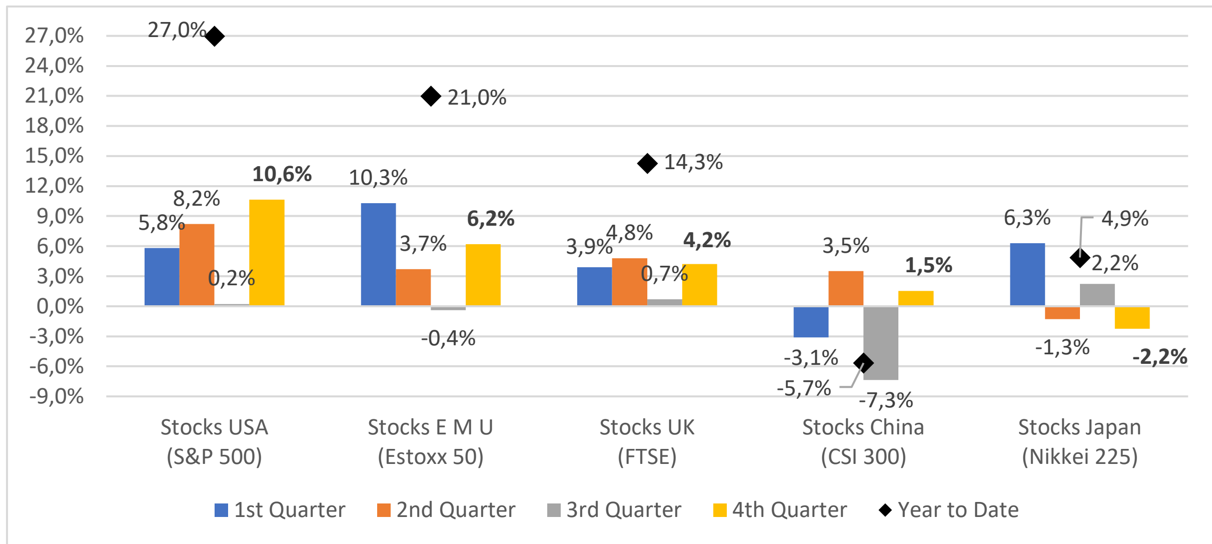
We continue to consider this investment to be of high strategic value. In addition to the high growth potential, cryptocurrencies are also important for us in the portfolio context both as diversification within the risk-bearing investments and as an alternative store of value in times of strong monetary and geopolitical risks.

Review of the fourth quarter

The fourth quarter provided a positive end to a challenging but nevertheless successful investment year in all of our strategies. A drop of bitterness is that the extraordinarily good development until the end of October did not continue in all investment forms and regions until the end of the year.

Most stock markets reached their previous highs by mid-November, only to enter a correction or sideways movement. This was mainly triggered by an even stronger rise in inflation and the prevailing expectation of a rise in key interest rates in the near future, as well as by the emergence of the new Omicron virus variant. The latter was also responsible for the strongest short-term stock market slump this year, which was in most but not all cases offset in the last two weeks of December. Further headwinds were delivered by significant price increases for energy (above all crude oil and natural gas) and the increasing number of warnings of an economic setback, which was also justified by the tightening of supply chains in almost all sectors.

Development of selected stock markets in 2021



Source: Bloomberg

In contrast to the above-average performance of the stock markets in the USA (+ 27 %) and the Eurozone (+ 21 %), Japan (+ 4.9 %) and China (- 5.7 %, or - 15 % for Chinese stocks listed in Hong Kong) stand out.

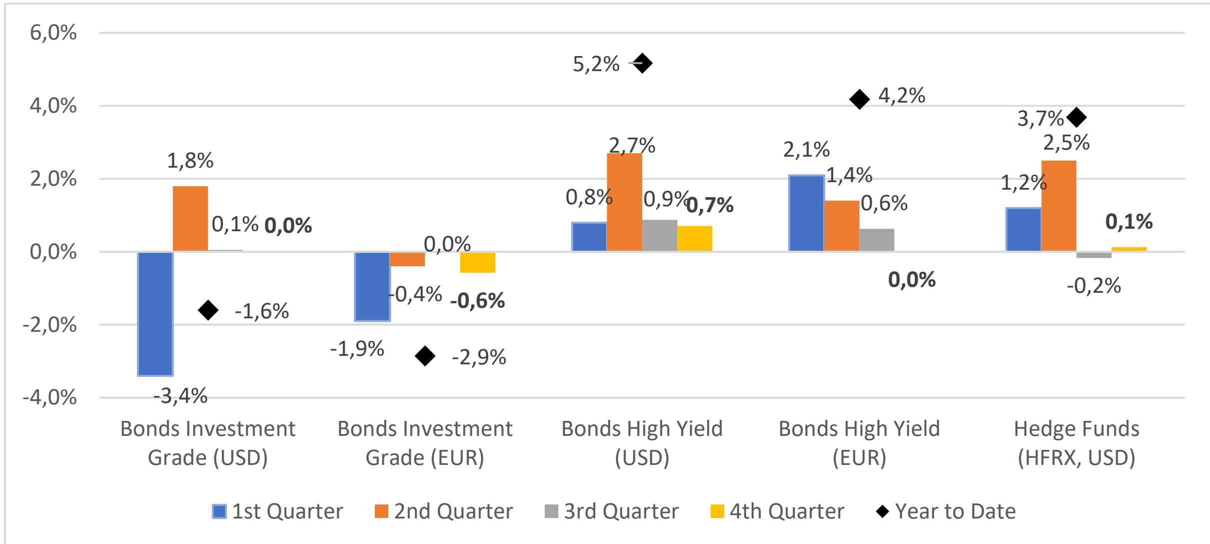
Japan's main index, the Nikkei 225, with its comparatively small increase is returning to its 1990 level only now. This must be compared to an increase of more than 1,300 % for the American S&P 500 index or more than 800 % for the German stock index in the same period. This shows the consequences of decades of below-average real economic growth in Japan (+ 32 % in the past 30 years compared to + 98 % in the USA) due to a multitude of structural problems that have not yet been overcome.

Chinese equities, which suffered from an unprecedented government campaign to clamp down on individual companies and industries in 2021, managed to stabilise in the last quarter. Despite a weakening Chinese economy, very cautious consumers and the Chinese real estate sector struggling with some major bankruptcies. Most recently, the Ministry of Finance and the central bank had resumed a more expansionary fiscal and monetary policy stance, and these signals alone prevented further dislocations and laid the foundation for a market recovery. We see a good chance that Chinese equities (A-shares, the so-called mainland equities) can make positive contributions in terms of performance and diversification in the portfolios we design in the coming year. Accordingly, an initial position has been in our strategy since November.

The performance of **bonds** 2021 confirms our unusually strong restraint towards this asset class for some time. Negative real yields on investment grade bonds, in some cases even in the European high-yield segment, represent a conceivably poor starting point for our claim to value preservation. The situation is aggravated by the still largely unclear position of the central banks in the conflict of objectives between monetary stability and debtor-friendly financing conditions. This has repeatedly caused a high level of nervousness in the past year and will probably continue to do so in the coming year.

We see very little value in the bond segment in the portfolio context in the near future, especially for long term maturities, and are staying away from it as much as possible.

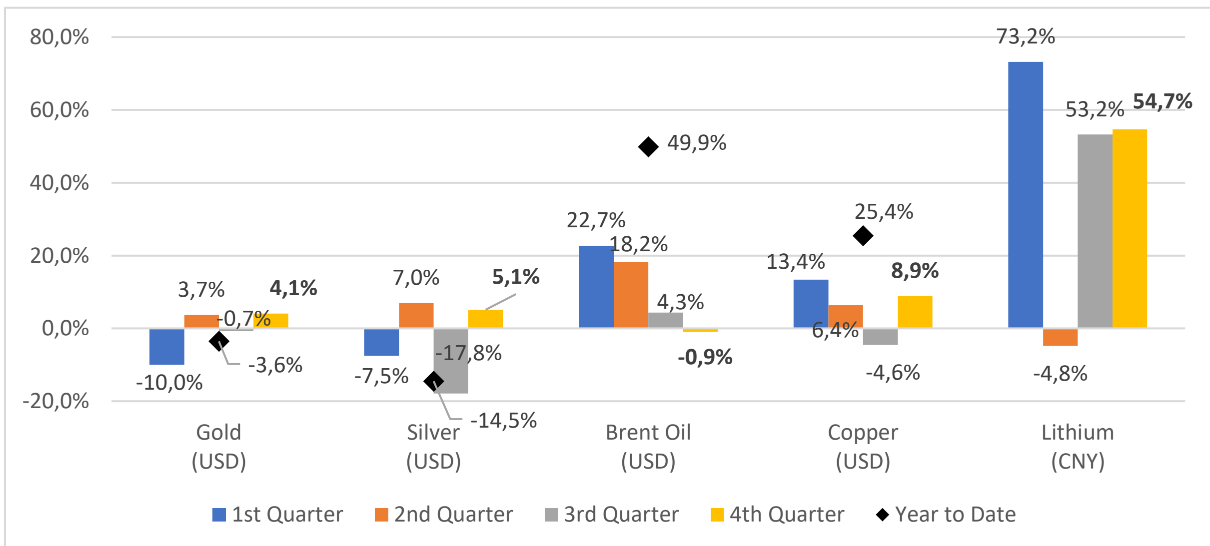
Development of selected bond markets 2021



Source: Bloomberg

Energy sources such as **crude oil** or natural gas were in high demand in 2021 and met with very limited supply. Raw materials that play an important role in electrification, such as **coppe**r or **lithium** (+ 290 % in 2021), recorded extremely strong price increases.

Development of selected precious metals, energy and raw materials 2021

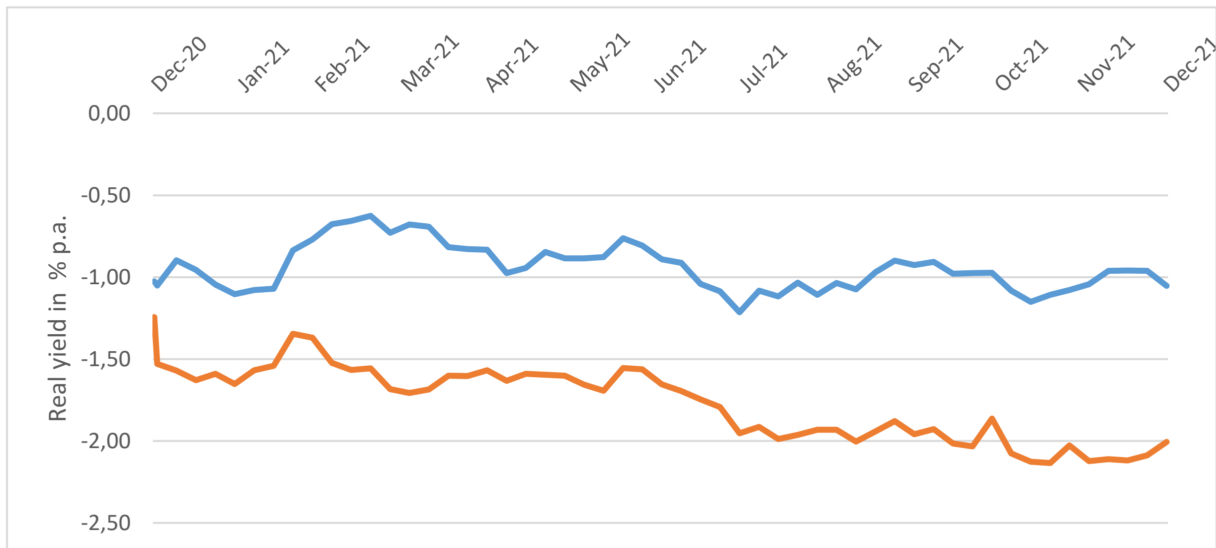


Source: Bloomberg

We found the price development of **gold** somewhat disappointing in view of the sentiment dominated by fear of inflation. Although important fundamental drivers for gold, such as government debt or money supply, again rose very strongly in 2021, gold was not really able to show itself in a positive light over the course of the year. The discussion about rising interest rates and the stronger US dollar gained the upper hand for the time being. Investors with the euro as their home currency were at least able to achieve a slightly positive annual return of 3.5% via the stronger US dollar.

Even the jump in inflation rates from the second quarter onwards did not bring the gold price close to its historical highs. The noticeable rise in nominal interest rates over the course of the year provides only an insufficient explanation, especially since the persistently negative level of real yields (interest rate minus the expected future inflation rate) actually speaks for a stronger demand for gold.

Real yields on 10-year inflation-linked bonds USA and Germany



Source: Bloomberg

The question why, for example, a euro investor who cannot or does not want to take any risk is willing to accept a guaranteed loss of purchasing power of more than 2 % per year over an investment period of 10 years can hardly be answered intuitively. One possible interpretation is that these investors do not assume that the central banks have too strong a will to fight inflation and expect future real yields to be even lower.

We think that in the face of further growing money supply and mountains of debt, a more than unclear course of the central banks and structurally higher inflation, investing part of our clients' assets in physically backed gold will prove to be a good strategic decision in the future.

Another precious metal that plays a role in our strategy is **silver**. We had to experience a very volatile development here in 2021, which also became more detached from the gold price development in the second half of the year. Here, as with other precious metals with industrial use such as platinum or palladium, there was a stronger dependence on economic expectations.

As part of an investment strategy focused on long-term trends and future themes, we continue to consider silver an important commodity that plays a central role in electro mobility and the expansion of renewable energies, among other things. Irrespective of the growing industrial demand, silver also seems to have great appeal for investors who want to counteract a loss of purchasing power due to negative interest rates and inflation. Try to buy euro-nominated silver coins in Germany in specialist shops. They have been sold out for weeks!

In our view, the long-term outlook for silver will be particularly beneficial for the shares of silver miners, which are still very favourably valued from a fundamental point of view. These are also included in our strategy.

Inflation remains - but the period of strong increases will soon be over

Inflation, with its dynamic development probably the surprise of the year for most, is presumably the event that is now keeping consumers, companies and financial markets most busy. As already mentioned in our review of the third quarter, we assumed and still assume that inflation will continue to accompany us for some time. The inflation target of 2% per year set by most central banks will probably be exceeded many times.

Base and special effects will at least ensure that price increase rates are somewhat lower in the course of the first half of 2022. Other price-driving effects, such as the disruptions in the supply chains, will continue for the time being, but should be moderately reduced in the course of the year and thus slow down the partly double-digit percentage increases in transport and producer prices. Increasing production expansions will ease the supply situation in the medium term, empty warehouses will be replenished, the high order backlog will be worked off bit by bit and demand will begin to return to normal.

Structural price drivers such as investments in digitalisation, the climate-neutral transformation of the economy, the replacement and new construction of infrastructure and rising wage costs due to the ongoing shortage of labour (especially with suitable qualifications) are keeping inflation at a significantly higher level compared to the last 20 years. The real risk of a wage-price spiral, along with an unusually large number of factors of uncertainty, is probably the biggest risk for the capital markets in the coming quarters.

Monetary policy 2022 - the central banks' lurching course continues to keep the financial markets on tenterhooks

The current task for central banks is extremely complex and leads them straight into a dilemma. Consumers are demanding that the price increase must be combated and savers are protesting against the real devaluation of their deposits. Many companies need cheap loans to survive, to invest or to justify their high stock market valuation by low interest rates. Governments also finance new debts through the balance sheets of their central banks. To whom should monetary policy do justice and whose interests have to wait?

We suspect that, at least at the ECB, we are about to experience the next "sin" after the undermining of the ban on monetary state financing (through indirect purchases of government bonds), that the ECB's primary objective of ensuring price level stability (i.e. fighting inflation by tightening liquidity = raising interest rates) will no longer be vigorously pursued. This would mean that priority is given to the needs of governments (favourable financing of their debt), the economy and financial markets (higher company valuations thanks to lower discount rates).

How otherwise a monetary policy could look like that manages the balancing act between avoiding an economic and debt crisis due to rising financing costs, effectively fighting inflation and moderately stimulating the economy is beyond our imagination at the moment.

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

As always, we would like to present a small selection of considerations to which we are paying particular attention at the moment. We expect that they will provide us with important clues for our investment strategy and future portfolio design:

- In the first half of the year, the upcoming presidential election in France (at that time also holder of the EU Council presidency) and the not yet certain, but quite probable change of office of Mario Draghi in Italy are likely to provide indications of the future direction and stability of the EU as the second largest currency area. Draghi could change from the head of government of an effective multi-party coalition, which is finally introducing some overdue reforms and which is currently also recording astonishing economic growth, to the primarily representative office of president. New elections and a relapse into political chaos would be a possible consequence. Both countries have for a long time been pursuing an EU policy that can be characterised by the heading "communitisation" (budget funds, national debt, bank and deposit guarantee systems). Italy, which is very highly indebted by EU standards, benefits most from the active support of the ECB in financing the national budget and from the EU funds of the reconstruction programme. In the majority perception and in their respective traditions, both countries also stand for a less stability-oriented monetary and fiscal policy.

- The central banks will try hard to keep the nominal interest rate level under their control. Interest rate hikes will not be their first choice, because of the expected destabilising effect on government budgets and the valuation level of stock and real estate markets. It is possible that other instruments will be used, to which the financial markets would still have to adjust. It is conceivable, for instance, that the FED or perhaps also the ECB will follow the example of the Bank of Japan and move not only to setting the key interest rate (valid for very short maturities) but also to limiting the yields on government bonds in certain longer maturity ranges to previously announced target values through continuous and, above all, unlimited buying and selling. The price formation mechanisms of a free capital market would be even more undermined than they already are.

- It seems that companies, consumers and governments will have to learn to live with the corona virus for a long time. However, this "learning process" will be much less supported by fiscal measures in 2022 than it has been in the past two years. The US government's $1.75 trillion spending programme ("Build Back Better"), which failed in December shortly before the Senate vote and was also supposed to serve as an "economic booster", is an example of how high the political hurdles are now for an unlimited continuation of such spending programmes. The signal effect on the US economy and thus on all other regions should not be underestimated.

What you can expect from us

We are entering the new year with optimism, but we are also under no illusion - 2022 will hardly be less challenging than last year.

All those who live and do business in the euro area are faced with the unpleasant prospect that their cash assets, if they are "stored" in accounts with negative interest rates, will probably suffer a real devaluation in the order of 4 to 5 % by the end of 2022.

As an asset manager, BPM feels particularly spurred on by this initial situation and in a positive sense. We see it as our task to develop effective strategies for our clients' investments in this environment. We are happy to accept this.

To be honest, we are already looking forward to it!

In this spirit, we wish all clients, partners and interested parties of BPM a successful new year.

BPM – Berlin Portfolio Management GmbH

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