BPM | Berlin Portfolio Management

Review of the 1st quarter 2022 and outlook

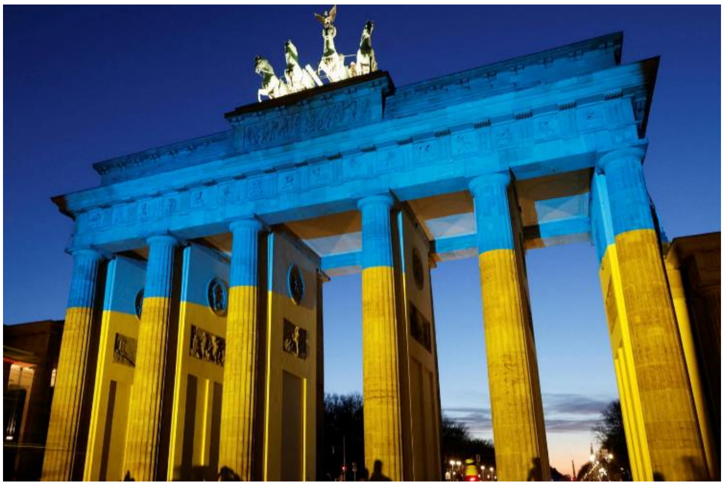
Change of times

„The Russian invasion of Ukraine marks a change of times.
It threatens our entire post-war order."

Federal Chancellor Olaf Scholz on 26 February 2022 on the German government's decision to supply Ukraine with weapons for national defence, two days after the Russian attack in violation of international law.

Despite the necessary restraint in using the term "change of times" to signal a historically important event, although one can only actually know in the future whether it has rightly been given this designation, it is nevertheless the case that on 24 February 2022, the beginning of the Russian attack on Ukraine, long-standing convictions and supposed certainties were destroyed overnight. The deliberate breach of diplomatic conventions, the simulation of a willingness to talk and even active deceit and brazen lies by the Russian president and his government were probably something that very few would have expected or suspected on this scale and at this point in time.

The strict German arms export guidelines adopted more than 20 years ago by a previous red-green government, as well as the coalition agreement signed by the governing parties only a few months earlier, did not withstand the force of this event for two days. Security, defence capability and a newly awakened commitment to NATO took on a higher political priority overnight than climate change or digital transformation. And this with a most rarely seen unity and approval in parliament.



The Russian attack on Ukraine led to solidarity in many countries with the Ukrainian population affected by the war and to a wave of support for those who fled the country, including in Berlin.

While it is our task to assess the economic consequences of the war and to understand the impact on our clients' portfolios, our deepest sympathy is for all the people who are suffering, losing their lives, health or property because of this war.

The political responses from many national governments, the EU and the USA also followed remarkably quickly and unanimously. In a very short time, sanctions against Russia and individual Russian citizens were imposed with a previously unknown severity. At the same time, economic dependencies of Western countries, especially Germany, on supplies of Russian energy sources such as oil, natural gas and coal, but also on industrial primary products from Ukraine, were painfully brought to the public's attention in many ways.

Even if an attempt to estimate the long-term effects of these dramatic changes today must be doomed to failure, it can be said with some probability that certain basic trends of recent years will be further reinforced and accelerated:

- Structurally higher inflation rates due to rising production costs as a result of a higher degree of in-house production, more warehousing and the relocation of production capacities back to the domestic market (efficiency losses due to de-globalisation vs. increasing security of supply).
- Efforts to become less dependent on Russian energy and raw material supplies lead to significantly higher costs in replacement procurement in the short term and require high investments in new plants and technologies in the longer term.
- Additional increase in public debt due to new debt-financed spending packages, e.g. for subsidies against the consequences of high energy costs or for security (defence against cyber-attacks up to military defence).

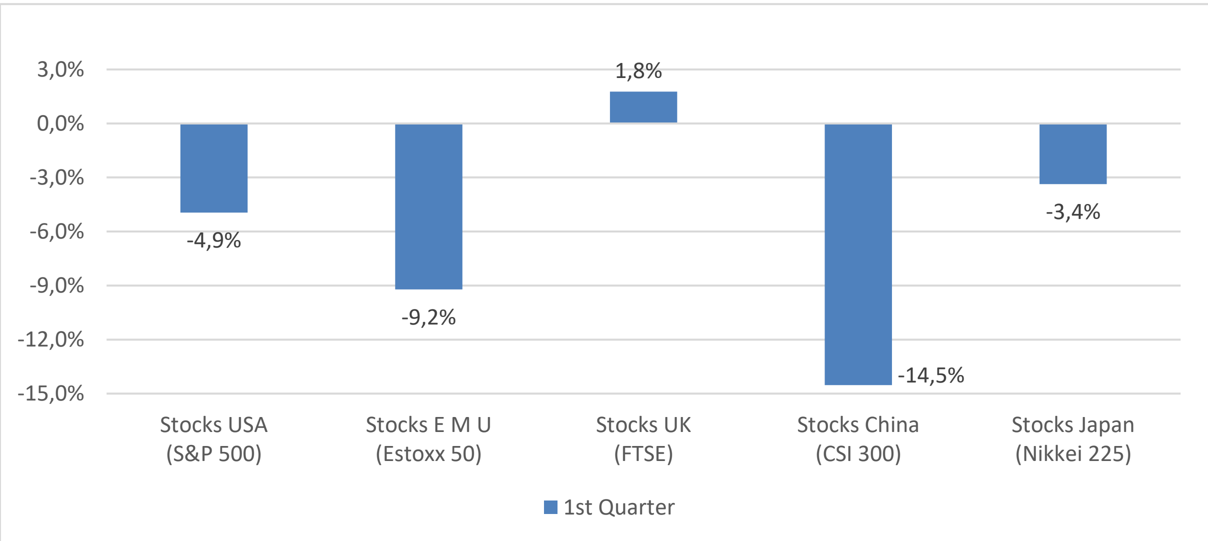
The economic recovery from the Covid-19 pandemic, which is not yet complete in many countries (including Germany), is thus being further postponed. In the last days of March, as a direct consequence of the war in Ukraine, economic researchers, banks and governments revised their economic and inflation forecasts for 2022 and the following years, in some cases significantly into the negative.

Review of the first quarter

Two issues, the war in Ukraine and concerns that the continuing strong inflation trend in many countries will force central banks to take an aggressive course of interest rate hikes, which could also lead to a recession, determined the development of the investment markets in the first quarter of the year. An unusually high degree of uncertainty, even about the outlook for only short periods of a few days, characterised the mood.

Most **stock markets** were able to recover significantly from their lows from the beginning of March after two negative months.

Development of selected stock markets in 2022



Source: Bloomberg

This was preceded by stock price declines that reached as much as minus 13 % in the case of the S&P 500 and as much as minus 19 % in the case of the Euro Stoxx 50 since the beginning of the year.

The significant catch-up movement is rather untypical for a phase of strongly rising interest rates. Stock prices should theoretically suffer from rising long-term interest rates due to the higher discount rates with which the expected future profits of companies are taken into account in current share prices. For companies, rising interest rates mean higher financing costs for their debt capital in the future.

We attribute this unusual reaction to a spreading mistrust in the current policy of the central banks. After hesitating for far too long to recognise the actual inflation trend, there are now justified doubts that they will be able to get the inflation wave under control at all, and moreover without a significant economic slump.

Chinese equities again ranked last among the major stock markets in the first quarter. The unexpected Russian invasion of Ukraine has led to a complete reassessment of geopolitical risks in the financial markets, as it did for us.

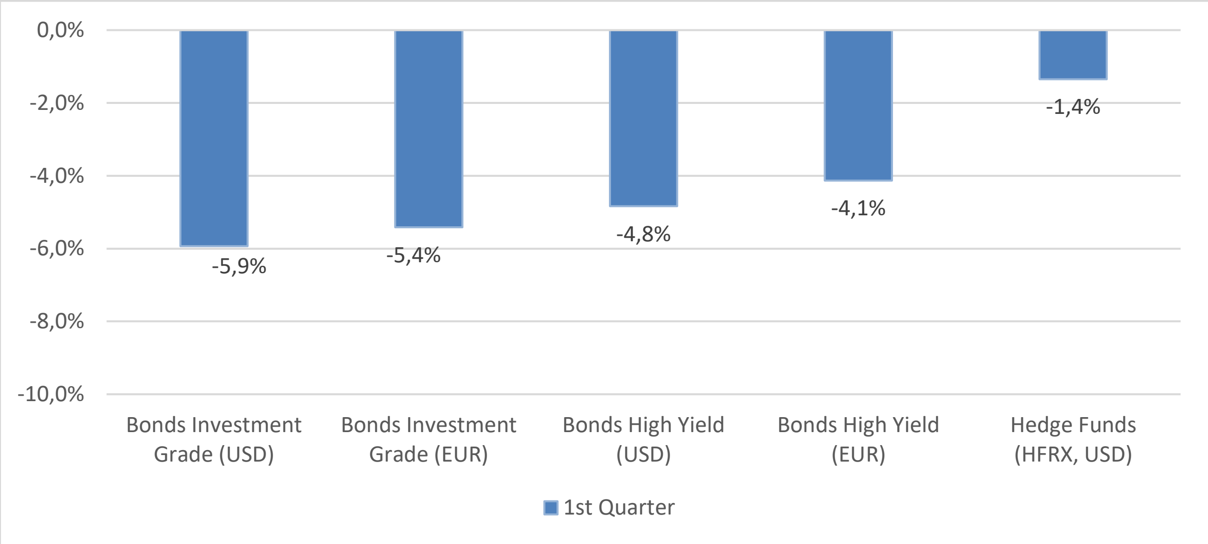
We therefore decided in mid-March to sell the equity investments directly related to China in our clients' portfolios. Despite the still very favourable fundamental valuation of the Chinese domestic stock market ("A-shares") and the positive growth prospects of 5 to 6 % for 2022, the flight of international investors from China, which has been continuing for some time, shows that the loss of confidence in complying with the rules of free markets has become too great in the meantime and that this will also be reflected in a very low market valuation for the foreseeable future.

We do not yet believe the government's latest promises to take greater account of the interests of foreign investors in China. The seemingly arbitrary and ideologically justified interventions in companies and markets in recent months have destroyed trust. In addition, the solidarity with Russia, which was also demonstrated after the Russian invasion of Ukraine, creates the danger that China itself could become the target of additional harsh international sanctions. The other known problem areas, existential difficulties in the real estate sector or the government's zero-covid strategy, which, with the recent Corona outbreaks in major economic centres such as Shenzhen or Shanghai, give rise to fears of further serious disruptions to international trade, further fuel our doubts.

In shares, many investors seem to see the "safe haven" sought in uncertain times. Perhaps equities, some of which undoubtedly have a certain property value character, will indeed prove to be the "lesser evil" in times of very high inflation rates. In our strategies we have currently weighted equities quite high, but we are also deliberately holding on to increased liquidity reserves, as we think that price setbacks are still to be expected in the coming weeks and months, which we would then like to use in a targeted manner.

Bonds were already among the investments we avoided last year due to negative real yields. In a classic portfolio mix, bonds should actually play the role of a guarantor of value stability in difficult times. In fact, however, we are currently experiencing the worst losses in value in the past three decades.

Development of selected bond markets and hedge funds in 2022



Source: Bloomberg

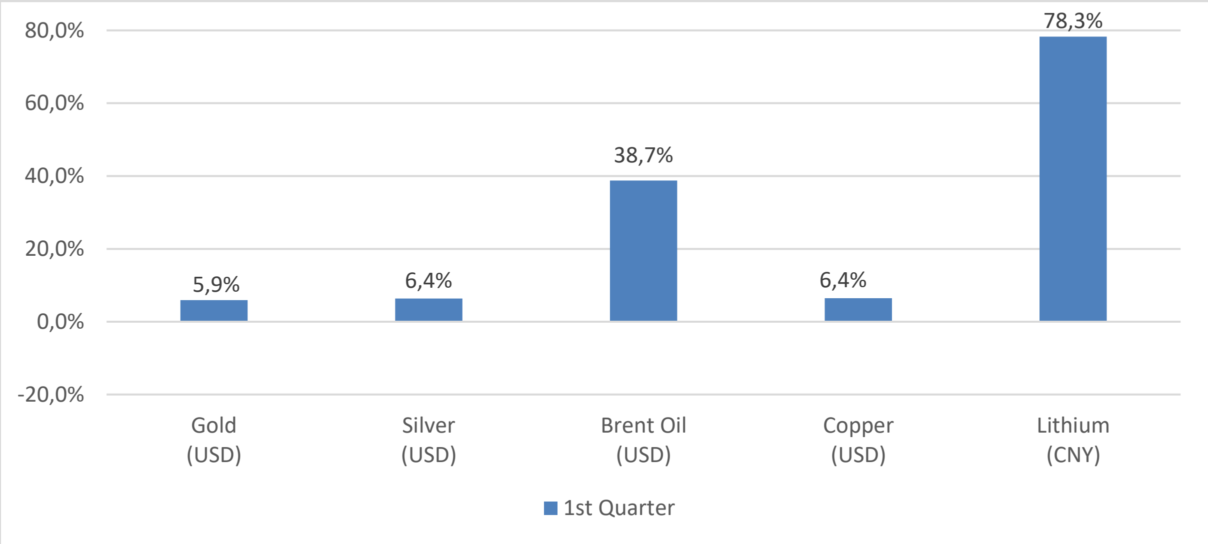
The main reason for the continuing unrest in the bond markets is above all the relentless rise in inflation in the USA and the Eurozone and the measures taken by the central banks against this upward pressure on prices, which have, at least so far, been regarded as completely inadequate.

For the first time in more than three years, the US Federal Reserve raised its key interest rate by 0.25 % on 16 March, thus taking the first concrete step towards fighting inflation after months of hesitation, which we expressly welcome. Further interest rate steps in the current year were held out in prospect to dampen the financial markets' skyrocketing inflation expectations. Besides the development of key interest rates, it is just as important for the bond markets to know how the Fed plans to reduce its balance sheet, which has been inflated by unprecedented money creation. There are no reliable findings on this yet. We assume that US monetary policy will continue to dominate the market for some time to come.

The European Central Bank, on the other hand, has not yet shown a clear stance on questions of fighting inflation. Representatives of countries like Germany, Austria or the Netherlands have been calling for an end to the ultra-expansive monetary policy for some time. This contrasts with the representatives of countries such as France, Italy or Spain, who show a much greater tolerance in terms of inflationary developments and want to continue with the zero and negative interest rate regime in favour of favourable financing conditions (low or even negative lending rates). The ECB Governing Council meeting in March at least brought indications that the extensive bond purchases could be reduced shortly and also discontinued altogether in the course of the third quarter. Only then would the way be clear for key interest rate hikes. In our view, the ECB's monetary policy still does not convincingly combat inflation risks in the face of inflation rates last seen in Germany in the early 1990s.

Commodities in general and energy sources such as crude oil, natural gas and coal in particular were the clear "winners" in the first quarter. Unchanged high demand and, in addition, the fear of additional supply bottlenecks due to the war in Ukraine and the selective sanctioning of Russian supplies triggered strong price increases. Industrial raw materials such as **copper** and, once again, **lithium** continued to be in high demand and also met with a supply that was far too tight.

Development of selected precious metal, energy and raw materials 2022



Source: Bloomberg

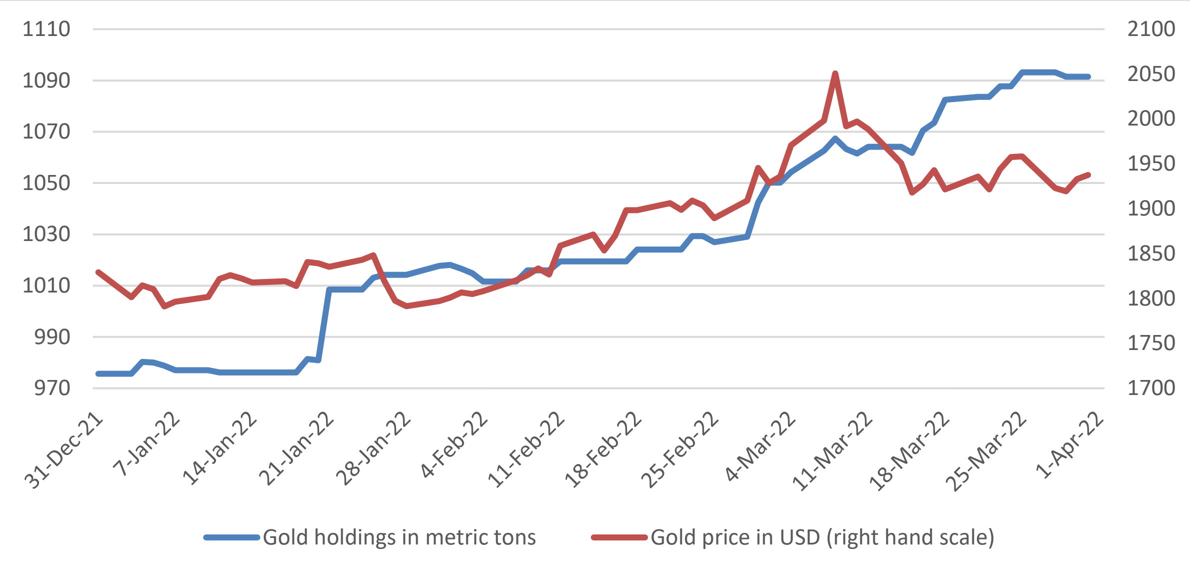
The performance of our clients' portfolios benefited particularly in the first quarter due to the continued high weightings of the commodities and mining sectors in our strategy. We think that given the ongoing and potentially worsening imbalances, this sector will remain a very important portfolio component in the coming quarters.

Gold showed its quality as a portfolio hedge in uncertain times in the first quarter after the restrained development last year.

Even the sharp rise in (real) interest rates, which should actually make gold less attractive as a non-yielding investment, could not distract from the rapidly rising inflation rates and the additional uncertainty caused by the Ukraine war. A high demand for gold shows it’s still high attractiveness as a "crisis investment".

In many portfolios, we used the increased weightings due to the price spike in March to partially sell at prices above USD 2,000 and realised profits in this way. However, gold remains highly weighted in our portfolios as we continue to see a high benefit as protection against extreme risks in precious metals.

Development of the gold price and gold holdings of the SPDR Gold Trust:



Source: Bloomberg

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

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

- **Will the US Federal Reserve be able to "deliver" the key interest rate hikes expected by the financial markets?**
  In the meantime, ten interest rate steps of 0.25 to 0.50 % are expected by March 2023 (measured by FED fund futures), which would raise the key interest rate from the current 0.5 % to over 3.0 %.

  The FED's stated goal of achieving a so-called "soft landing" (reducing inflation without sliding the economy into recession) is likely to be very difficult to achieve given the level of inflation that has now been reached, the numerous causes that lie outside the FED's sphere of influence (energy prices and supply chains) and the resulting stubbornly high inflation expectations. We see the danger that the FED will now abruptly stop the still ongoing post-Corona recovery with too rapid successive interest rate hikes.

  The Fed's last cycle of interest rate hikes, from 0.25 % to 2.5 %, lasted more than three years and was terminated in mid-2019 after nine rate hikes of 0.25 % each. Emerging recession fears accompanied by growth rates below 2 % had prompted the Fed to make a quick U-turn at the time. The inversity recently observed in the US yield curve (higher yields for short maturities than for long maturities) suggests that we are not the only ones facing this scenario.

- **The "investable world" is getting smaller**
  Where can capital still be invested in the future without running the risk of being surprised by extreme and incalculable political developments? The trade conflict between the USA and China that escalated during the Trump presidency or the sanctions against Russia introduced back in 2014 seem comparatively mild against the reactions of the Western-democratic bloc of countries that followed the war in Ukraine originating from Russia. The West's quick and, above all, unanimous reaction is unquestionably politically correct, but has very far-reaching economic consequences for both sides. An assessment of extreme political risks, such as Russia's departure from the global community, has played practically no role in investment decisions over the past two decades. The reassessment will mean that countries for which such risks can be assumed will no longer be able to attract foreign investment or they will have to offer investors very high risk premiums. At the same time, more investment capital will be concentrated in countries considered safe and reliable, which will tend to weigh on return prospects.

- **Once again a bipolar world order**
  Who could be the next countries to join the authoritarian-anti-liberal camp around China and Russia, out of conviction or opportunistic motives, and how far will they be willing to go in a confrontation? Of the countries relevant to the global economy, we look at India and Vietnam. It should also not be forgotten that in recent years China has tied many smaller, strategically important and often resource-rich countries to itself through direct investments and far-reaching contractual agreements.

What you can expect from us

A "change of times" means that we are confronted with drastically greater uncertainty about future developments. It also means, unfortunately, that we have to adjust to the fact that not every country or social order shares our ideas of economic cooperation for mutual benefit, of free world trade or of human rights and democracy. The danger of a division of the world into democracy-friendly countries and those that favour autocratic or dictatorial forms of government requires a very thorough rethinking of asset investments.

It is desirable, but by no means certain, that these blocs will at some point find their way back to a lowest common denominator, mutually beneficial economic cooperation. However, the most important basis for this, mutual trust, has probably reached a zero point after the war in Ukraine, China's unclear position and the escalations that may still follow.

Our task of protecting our clients' portfolios from well-known risks such as inflation, valuation bubbles, technological and social change will thus take on another facet in the future - achieving the greatest possible independence from the negative influences of potential opponents of the system.

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April 2022