

Review of the 4th quarter 2022 and outlook 2023

„Meep meep“

Phonetic call of the cartoon character of the "Road Runner" - a flightless but extremely fast-running bird from the US animated films of the Warner Brothers Film Studios (1949 to the present day).

No, don't worry! We do not take refuge in a childish fantasy world full of all kinds of impossibilities in the face of the crises and their effects on our everyday lives and the portfolios of our clients. But even classic cartoons can help to better understand financial markets and the mistakes sometimes caused by typical human behaviour and to better predict them in the future.



In the Warner Brothers cartoon classic, the coyote often plunges over the edge of a cliff into the abyss while chasing the fast and clever roadrunner. His fall often begins only after he has continued running in the air for a while and realises with a horrified look below him that he is about to plummet. The perseverance of the coyote is admirable, who has had such misfortunes several times and yet continues his hunt undeterred.

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The "Wile E. Coyote moment": Keep running despite no ground under your feet – can happen in financial markets!

What is physically only possible in cartoons, financial markets occasionally seem to manage in the real world. The time they spend hovering over an abyss can be surprisingly long. Investors believe they feel "solid ground" under their feet because of previous good experiences, although they are actually already hanging freely in the air above a (stock market) abyss. The careless continuation of previous developments and the overlooking or suppression of dangerous developments can have considerable negative effects, especially for long-term investors.

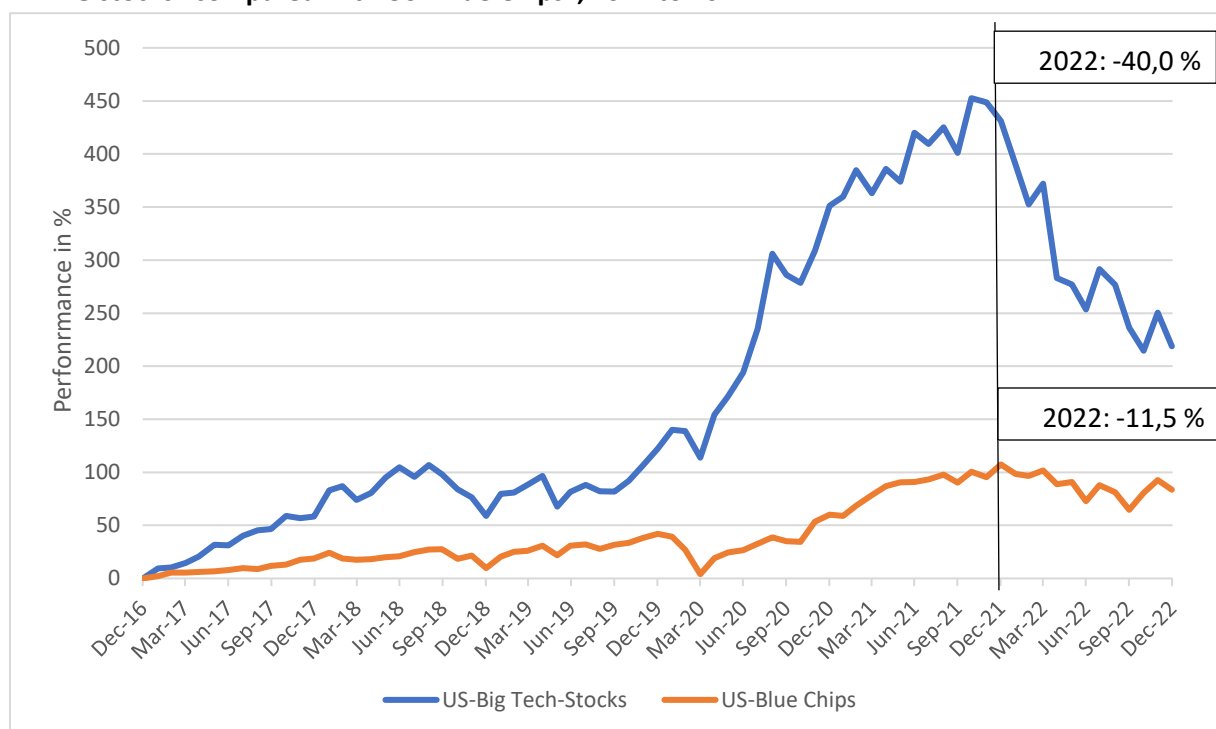
"Resurgence" of interest rate triggers collapse in highly valued equities

Rising interest rates mean price losses for shares - that is simply an old and still valid stock market rule. But not all sectors or shares are equally affected by rising interest rates (= rising cost of capital). It also always takes some time for shareholders and analysts to realise that future profits, even of very healthy, liquid and well-capitalised companies, are less valuable in the present (= stock market price) as soon as interest rates rise. The historically very low (USA) or even negative interest rates (EU) over a long period of time have perhaps made some people lose their sense of this mathematically compelling adjustment.

One equity market segment where this was very observable in 2022 is "Big Tech". This refers to the largest companies in the technology and consumer discretionary sectors, most of which have been very successful for years. Names like Apple, Amazon, Alphabet (Google), Meta (Facebook), Microsoft, Netflix or even Tesla are probably the best-known protagonists. These companies can be found in the portfolios of many investors because of their past successes or in many passive investment strategies, such as some exchange traded funds (ETF), because of their high weightings in stock indices. Their popularity went so far that the acronym "FANG" was created for them, for which official market indices were also created to make investing easier.

Let's imagine a strategically oriented investor who made the right decision at the beginning of 2017 to invest in all "Big Tech" stocks - represented here by the FANG index.

"FANG stocks" compared with US "Blue Chips", 2017 to 2022



Source: Bloomberg

At the end of 2021, after five years of investment, this investor would probably have been satisfied with a value increase of 431%. One year later, at the end of 2022, his result has been reduced to 219%. Still a good result, even compared to the "boring" blue chips with + 83%. In reality, however, this strategic investor is anything but ideal. Many of today's owners of "big tech" stocks are likely to have often joined later and at higher prices, directly or often indirectly via ETFs. Moreover, it is known from psychological research¹ that people feel anger about losses about twice as strongly as they feel joy about gains.

¹ First described by Daniel Kahneman and Amos Tversky (1979) in "Prospect Theory" - awarded the Nobel Prize in Economics in 2002.

That "FANG stocks fell off the cliff" at the beginning of 2022 is, however, not solely a consequence of the sharp rise in interest rates. The realisation that future growth rates will be significantly lower due to new and strengthening competition or even beginning market saturation was also possible for some time when soberly considering the exorbitant valuations reached by then.

The image of "running on in the air" (rising prices) until the moment when investors realise that they are over a abyss (rising capital costs weigh on them, sales stagnate or even fall, forecasts are missed) seems somehow fitting to us.

BPM clients benefited from our longstanding sceptical stance on "big tech" last year. The share in our portfolios is below 2% and results from unavoidable residual sizes in the funds selected by us due to other characteristics. By way of comparison, the six stocks mentioned at the beginning of this article alone are still included in the calculation of the American S&P 500 Index with a weighting of more than 20 %.

In the near future, it will be more important than ever to avoid shares and bonds of companies that can no longer earn the now significantly increased operating and capital costs. This does not rule out all, but many, long-standing growth stocks as investment objects for us.

Where is the recession?

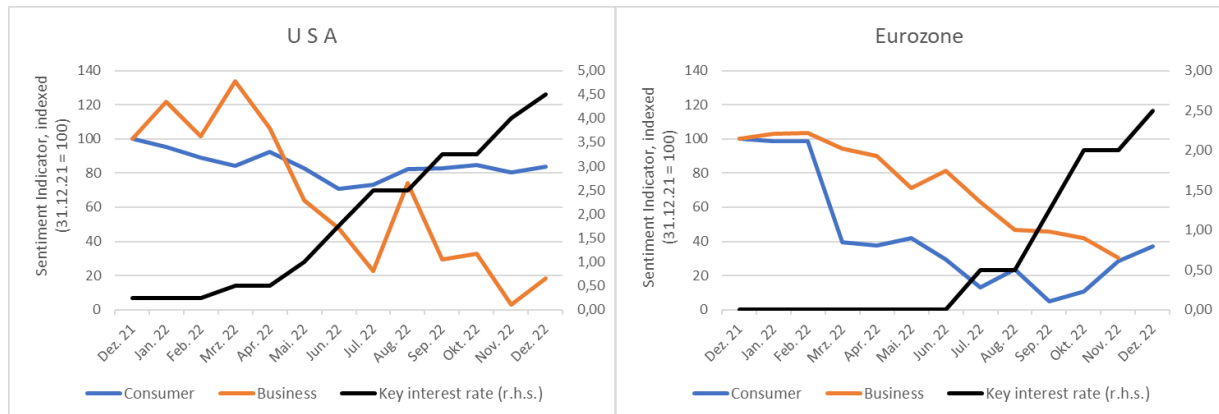
One of the most intensively discussed topics in the financial markets and among economists is the question of whether we will experience a relatively mild economic downturn in the near future or whether we will be confronted with a real recession. The possibility that the economy will continue to grow at a low but still positive rate plays almost no role in the outlooks of banks and fund managers for 2023. 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".

This may also be due to the fact that in the past the starting position was hardly ever as uncertain and unclear as it is at present.

We think that the first central banks will start to reduce the pace of interest rate hikes by mid-2023, without switching to interest rate cuts immediately afterwards. This also seems right to us, as the effective impact of interest rate hikes always sets in with some time lag and the central banks will have no interest in causing a severe economic collapse. Already today, there are clear drops in the sentiment indicators of companies and consumers, which signal lower demand. This is probably also intended by the central banks, as it acts as an "inflation brake".

Therefore, the most likely scenario for 2023 seems to us to consist of below-average growth rates and inflation rates significantly above the average of the last 20 years.

Consumer and business sentiment and development of key interest rates in 2022



Source: Bloomberg

The development of the financial markets will be less influenced by the absolute economic development but will depend more on the amount and price of available credit. The monetary policy of the central banks, especially their verbal statements, will set the pace in 2023.

Labour markets continue to be supported by high demand for workforce despite economic weakness. On the one hand, this leads to rising wage costs, but on the other hand it also supports consumer demand. Companies with healthy balance sheets will be in a good position to adapt to a changed environment and to finance the necessary investments for structural tasks, such as climate neutrality and digitalisation.

Even in the event of a recession by definition (two or more quarters of negative economic development), we would not necessarily fear further dramatic price declines under these conditions and after the strong price losses of the past year.

Much of the negative has already been priced in - the positive aspects are currently being given far too little weight in the general assessment!

2022 in review

2022 can be summarised as the year of deep disappointments, several parallel crises, war and the end of long-held convictions.

As recently as the beginning of January, the US stock index S&P 500 reached new historic highs. The German stock index DAX came within 10 points on its all-time high. European banks charged their customers negative interest rates for larger balances, central banks saw no reason to worry about rapidly rising inflation rates and there was no doubt about the quick recovery of the global economy after the end of all Corona-related restrictions.

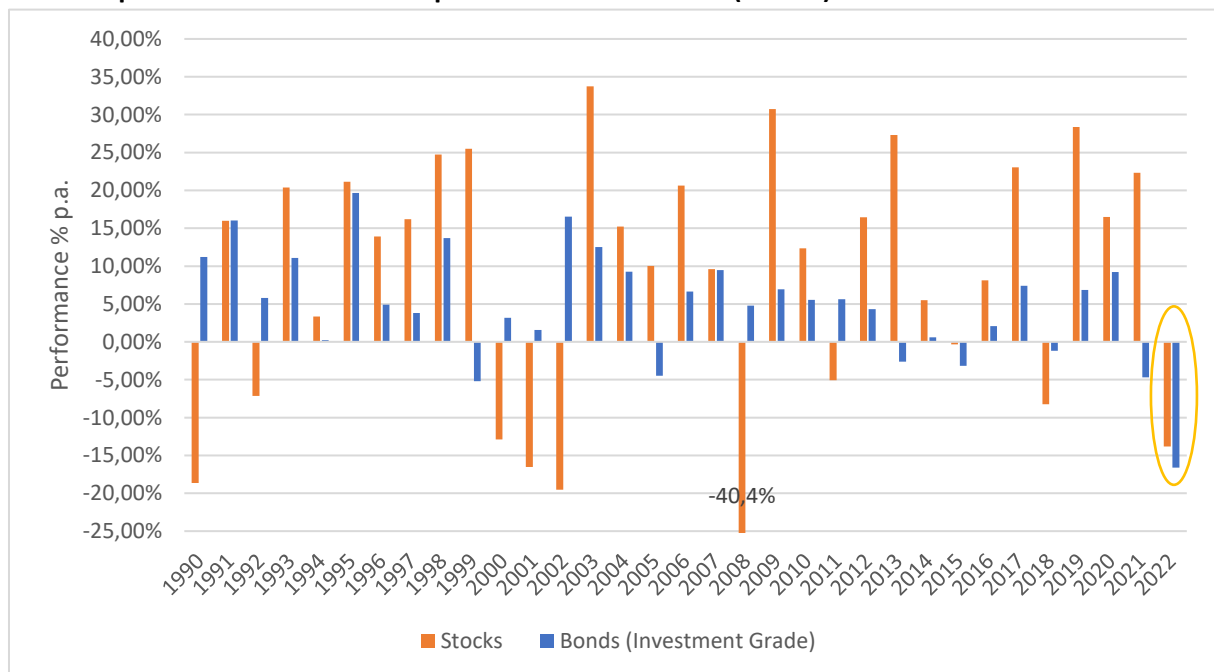
But even before that, some of the flashpoints emerged that made 2022 an investment year of extremes:

- Russia had already begun deploying troops in the border region with Ukraine in 2021. The invasion in February 2022, which violated international law, triggered the first war of aggression in Europe in decades and ultimately followed a pattern of Putin's foreign policy that had been familiar for years.

- The end of restrictions from the Corona pandemic had released the long pent-up demand from consumers and businesses. This met with largely empty inventories and idle production capacity, preparing the ground for higher prices.
- With the rising inflation rates, central banks reached the limits of their "cheap money policy", with which they had quickly suppressed any emerging sense of crisis in the economy and financial markets since 2008. The central bankers' complete misjudgement of the actual nature of the rapid rise in prices finally forced them to implement the most massive interest rate hikes in decades. The yield trend in the bond markets had already pointed in the right direction with a lead time of several months.
- China got bogged down in an ideologically motivated "zero-covid policy", which was supposed to demonstrate China's superiority to the Chinese population and to the whole world. Not only was the business activity of the world's second-largest economy paralysed, but the fragile system of international supply chains was also disrupted. As early as 2021, the Chinese leadership had begun to "prepare" for the Party Congress in November 2022, which is crucial for its survival, with massive interventions in certain companies and industries in order to demonstrate leadership and return to doctrine long thought to have been overcome.

All these events hit financial markets that were highly valued due to the preceding years-long phase of extremely low or, in the Eurozone, even negative interest rates. The result of the uncertainty that arose was a decline in the value of almost all forms of investment on a scale never experienced before.

Global equities and bonds: Annual performance since 1990 (in USD)

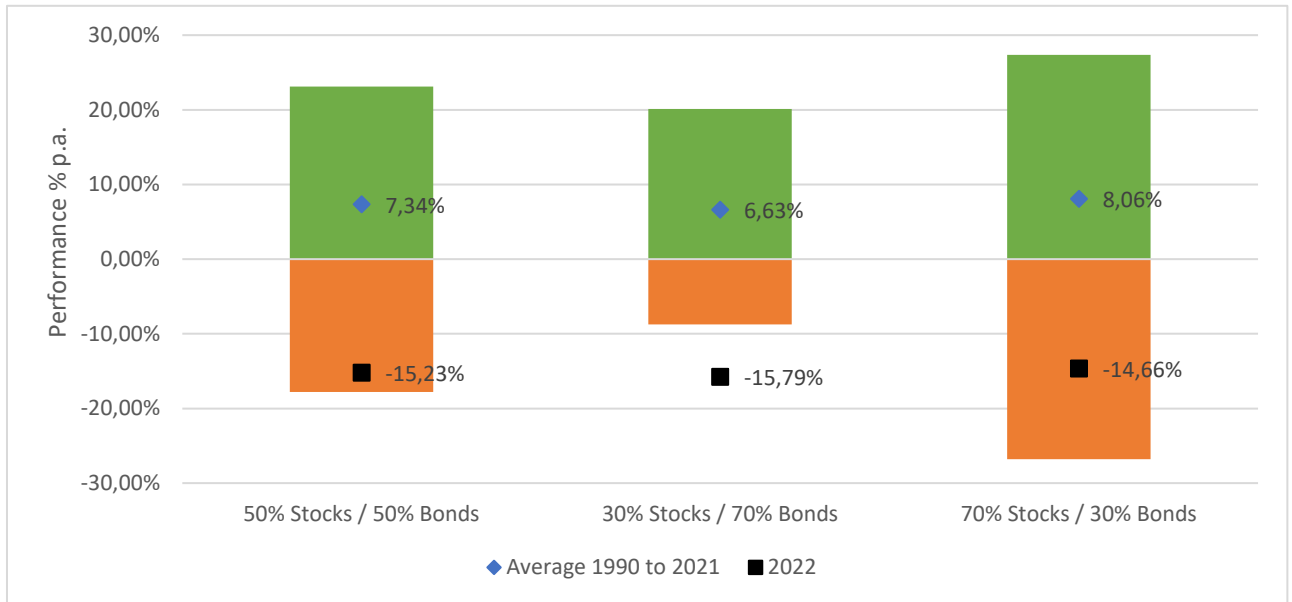


Source: Bloomberg (MSCI World Index incl. Nettodividenden und Bloomberg Global Aggregate Total Return Index)

2022 marked another historical novelty, as for the first time ever, equities and bonds ended a year with large losses in value at the same time. The historically quite reliable risk compensation by the other investment form in the portfolio context was thus missing.

This is also the reason for the unusual similarity of the results of strategies with very different risk profiles. In particular, the annual result of defensive strategies (30% equities / 70% bonds) is far outside the previous historical range.

Combined investment strategies 1990 to 2022: Annual performance (in USD)



Source: Bloomberg (MSCI World Index incl. net dividends and Bloomberg Global Aggregate Total Return Index), own calculations

The balance for 2022 as a whole is thus clearly negative, even if the last quarter at least brought a slight recovery from the lows at the beginning of October.

Cheerful financial markets, buoyed by the somewhat irrational expectation that the US Fed could soon reverse its interest rate hike policy ("Fed pivot"), were rudely brought back to reality after the December interest rate decisions by the Fed and the ECB and with the unusually clearly formulated interest rate hike intentions.

For the central banks, this attitude is logical since the strong price increases lead to an easing of the financial conditions from a monetary policy perspective. Thus, they fit neither the Fed nor other central banks into their plans, which are still geared towards fighting inflation.

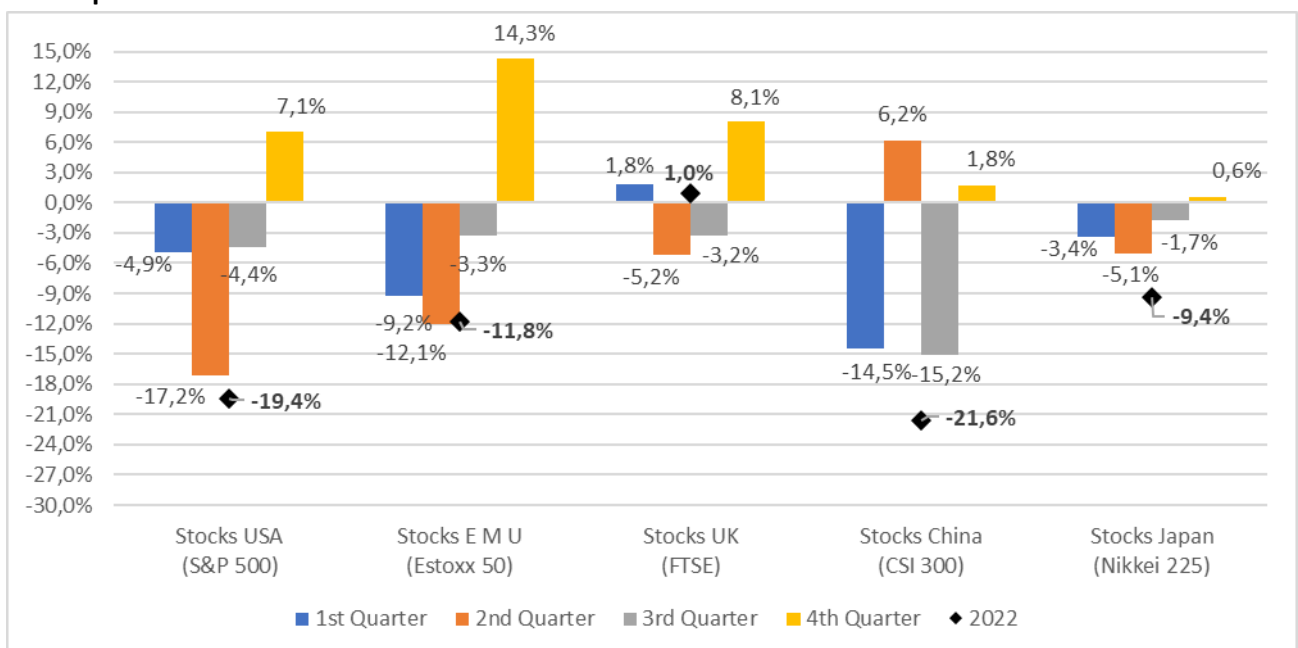
We can imagine that this sequence - financial markets betting on the imminent end of interest rate hikes, central banks holding out after limited market rises - will be the most likely "script" for the coming months.

The **stock markets** showed predominantly positive developments in the fourth quarter.

Price gains were more restrained in China, where the markets were under the spell of political announcements at the National Congress of the Chinese Communist Party, which meets only every five years, and were surprised shortly afterwards, at the beginning of December, by the sudden turnaround in the zero-covid policy. The economic damage, which could no longer be concealed, and the unrest among the population, which was unusually strong by Chinese standards, forced the government to act.

In Japan, an also completely unexpected tightening of the Bank of Japan's monetary policy in December led to sharp short-term declines in share prices.

Development of selected stock markets in 2022



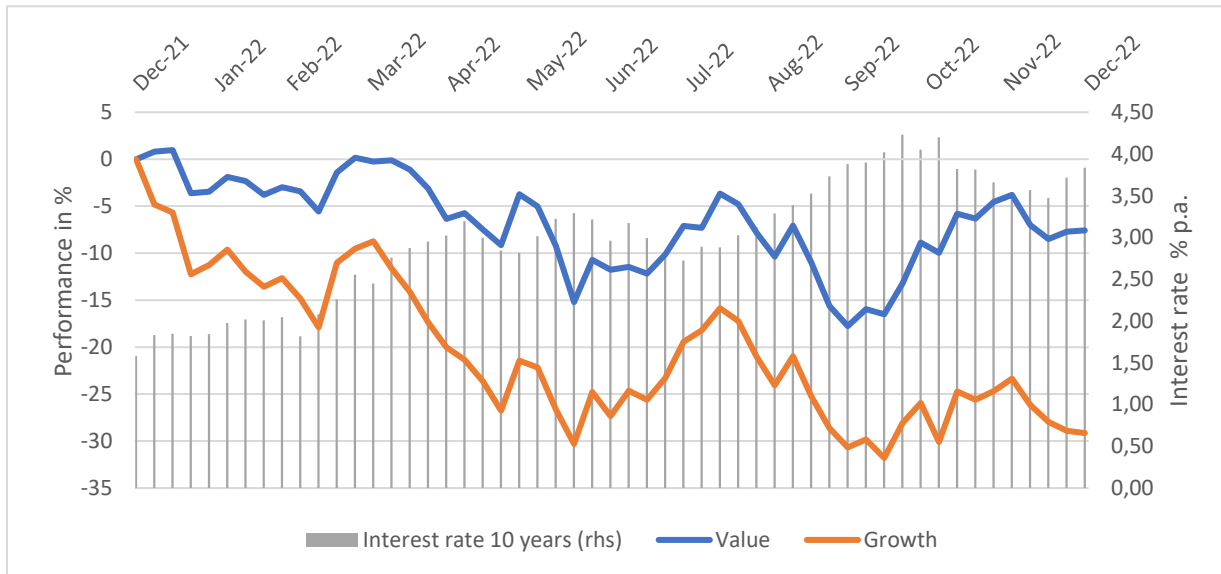
Source: Bloomberg

Overall, 2022 was one of the weakest years for equities in recent history. Only in 2008, in the course of the "Great Financial Market Crisis", did equities record worse results last time.

Interest rates, one of the decisive variables for the market valuation of stocks and for their comparison with other investments, triggered significant differences in performance due to the strong increase within the stock world. Companies and industries that are still making losses today or are only generating low profits and whose share prices are thus heavily dependent on the high profits expected in the future (so-called growth stocks) suffered more from the higher discount factors. Rising equity and debt capital costs will create additional headwinds in the near future. In contrast, value stocks, i.e. companies that already generate comparatively high and stable profits, were less vulnerable. The following chart shows the differences using the example of the Russell 1000, which as an index is representative of the full range of the US stock market.

The proportion of stocks in the "value" sector is overweighted in our clients' portfolios, also due to the subsequent acquisitions in 2022.

US equities, differentiated by "Value" and "Growth" and US interest rates 10 years



Source: Bloomberg

At this point in time, we do not see any reason for a change in strategy and expect the better fundamental underpinnings (rising sales, also thanks to higher prices, as well as only slightly shrinking profits) of these shares to provide more value stability and current income in the form of dividend payments in 2023. Regionally, North America and Europe will continue to be the focus.

Despite the temptingly favourable valuation, the Chinese government's excessive and ideologically motivated intervention in the economy still speaks against Chinese shares.

The UK, which also offers extremely favourable valuations, would in principle be an attractive equity market if the political situation were not so chaotic.

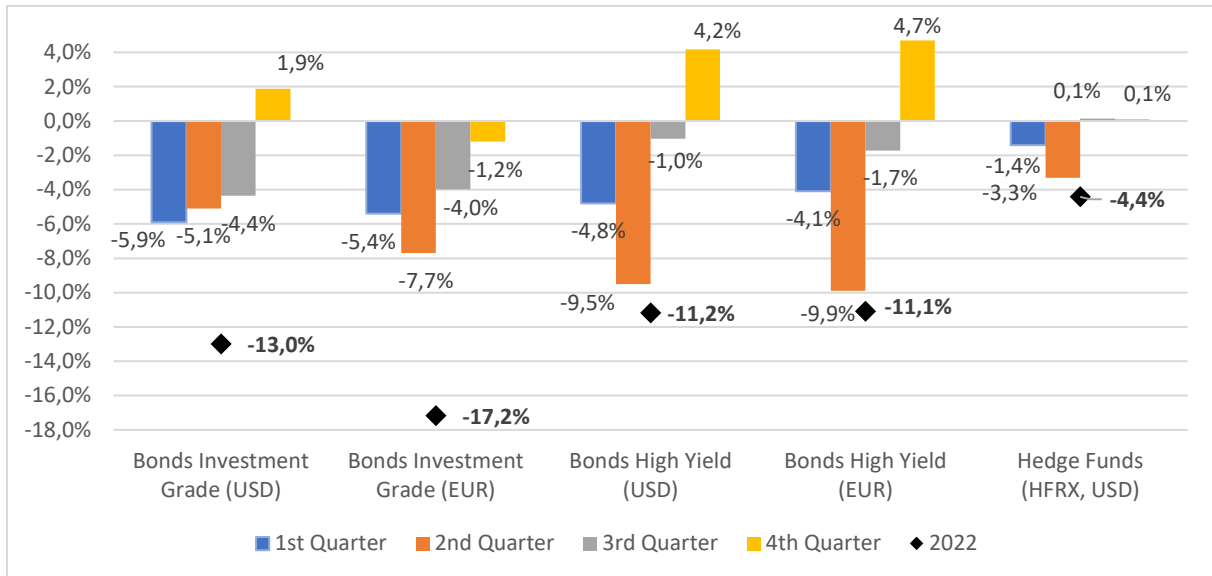
We are keeping a close eye on both countries with a view to a possible entry at a later date.

After more than two years of abstinence, we are now analysing the stock markets of some emerging markets with increasing interest. Geopolitical shifts, the world's unabated hunger for raw materials and the real chance of a weakening dollar should the Fed stop its interest rate hikes are increasingly generating price fantasy. First steps in this direction in the first half of 2023 seem reasonable to us.

Bond markets recovered somewhat in the fourth quarter from historically unprecedented losses.

The only negative exception, "investment grade Eurobonds", benefited on the one hand from the significant decline in risk premiums worldwide in the fourth quarter, but on the other hand suffered price losses due to the beginning inversion of the Euro yield curve.

Development of selected bond markets and hedge funds in 2022



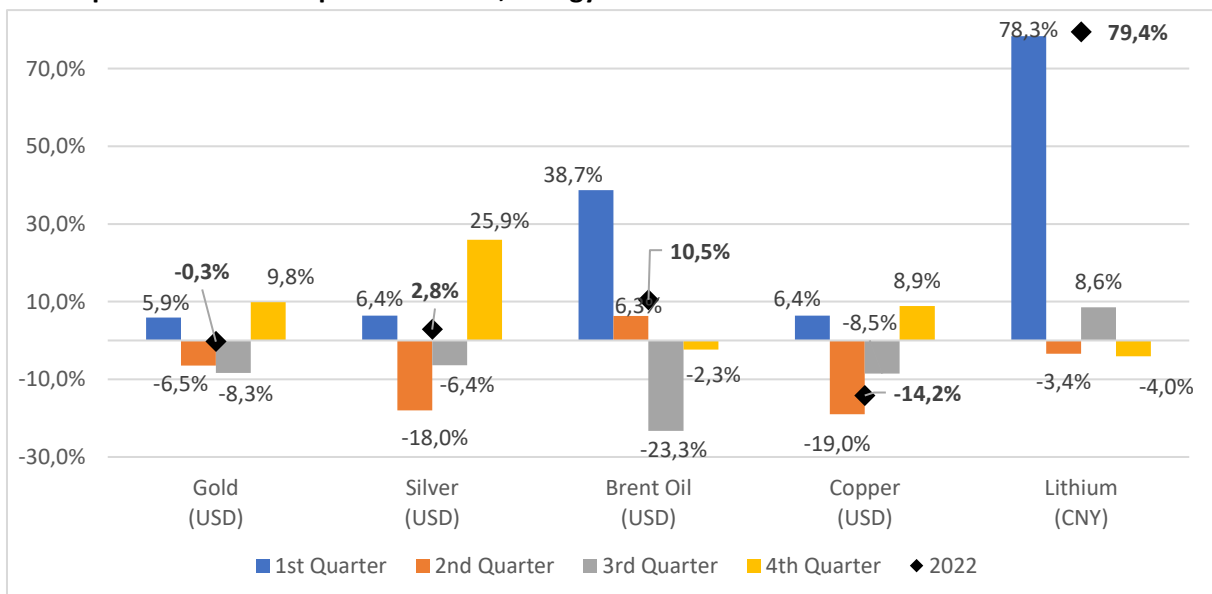
Source: Bloomberg

The inversion of yield curves - the unusual condition where shorter maturities have higher yields than longer ones - intensified further for US bonds. In the meantime, 2-year US government bonds have a yield about 0.8 percentage points higher than 10-year ones. In the past, this constellation reliably signalled upcoming economic weaknesses.

In contrast to stocks and bonds, **energy** and **precious metals** were able to benefit from the strong inflationary trend.

Many **raw materials** that are more closely related to the development of the economy were not able to profit. A special situation continues to arise for special raw materials that are related to topics such as future mobility or energy efficiency and that were able to maintain a high price level.

Development of selected precious metal, energy and raw materials 2022



Source: Bloomberg

Gold has recently recovered significantly and experienced its best quarter in two years. For investors calculating in euros, however, the price recovery was dampened by the somewhat stronger euro against the US dollar (+ 0.6 % in the fourth quarter and + 5.9 % for the year as a whole). Gold was also under the influence of the strong FED interest rate hikes throughout the year, which made gold investments less attractive due to the lack of current yield. Our expectations regarding real wealth protection could not be fully met in 2022. Nevertheless, with these results, gold is already one of the successful investments last year.

Even though bonds are gaining in importance with the resurgence of interest rates, gold remains one of the most strategically important positions for us in our clients' portfolios in the long term. Its potential value as a debt-free currency seems strategically given to us in view of unchecked growing debts of government households. Not least because of the ever-increasing fiscal packages launched in rapid succession against corona consequences, high energy prices or war and reconstruction.

Silver showed a strong price increase of around 25 % in the last quarter. This reflects the positive price development of other precious metals, but also the depreciation of the US dollar (e.g. by 9 % against the euro in the fourth quarter), which triggered additional demand. Silver is a precious metal also under cyclical influence. The high price fluctuations we experienced in 2022 are not least due to the long uncertain global economic outlook.

Cryptocurrencies and Digital Assets

The cryptocurrency and digital asset markets were dominated by the collapse of a major service provider in the "digital world" (FTX and Alameda) in the last quarter of 2022.

Clients of BPM are not directly involved in these developments, but there were various short-term spillover effects, e.g., on cryptocurrencies, which were also reflected in the performance of the investments we made.

As a result of these developments, governments and financial market regulators are now pushing the regulation of the crypto sector much more decisively. We see this as an important step in the process of "coming of age" of this still young investment sector. For us, the long-term prospects continue to be the best argument for investing early with limited exposure. After all, many of the developments we are currently witnessing in cryptocurrencies and digital assets remind us of the time of the commercialisation of the internet from the mid-1990s onwards. At that time, too, new business ideas emerged, some of which failed early on, but others are now among the most valuable companies in the world.

It is also clear that the broadly diversified approach we chose to enter this investment segment has distributed the undoubted risks in the best possible way. Even after the declines in 2022, our crypto investment has still achieved a positive performance of + 45 % since October 2020 in comparison to US technology stocks with - 4 %, an investment segment that is also highly susceptible to fluctuations.

What will keep us busy in the near future

The "resurrection of interest" - a curse and a blessing at the same time

Last year, the trend towards lower and lower interest rates, which dates back to the 1980s, came to an end. Like the sudden breakout of long-low inflation rates, this points to serious structural changes in the future.

Yield development of 5-year US government bonds (1962 to 2022)

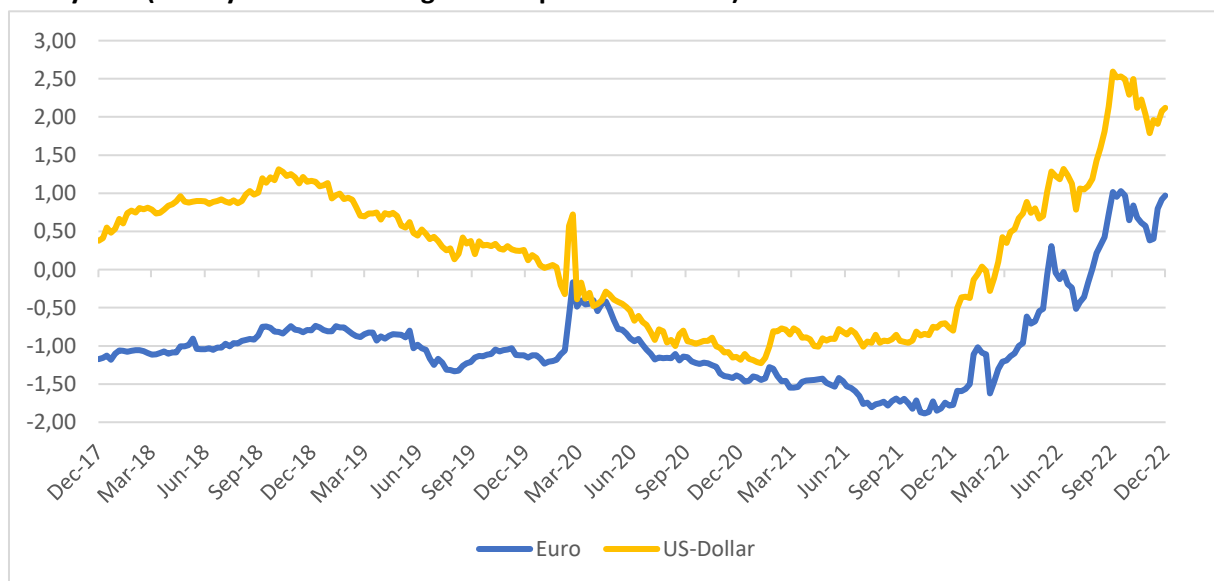


Source: Bloomberg

The consequence of the massive rise in interest rates, sharply falling prices of existing bonds with low nominal interest rates, characterised the development of bond portfolios in the last 18 months.

In the meantime, bonds with today's significantly higher yields have a benefit in portfolio design again - even if one includes the inflation rates to be expected in the long term:

Real yields (bond yields minus long-term expected inflation)



Source: Bloomberg (Bloomberg Euro and US Aggregate Total Return Index; 5-year-Forward Inflation USA and Eurozone)

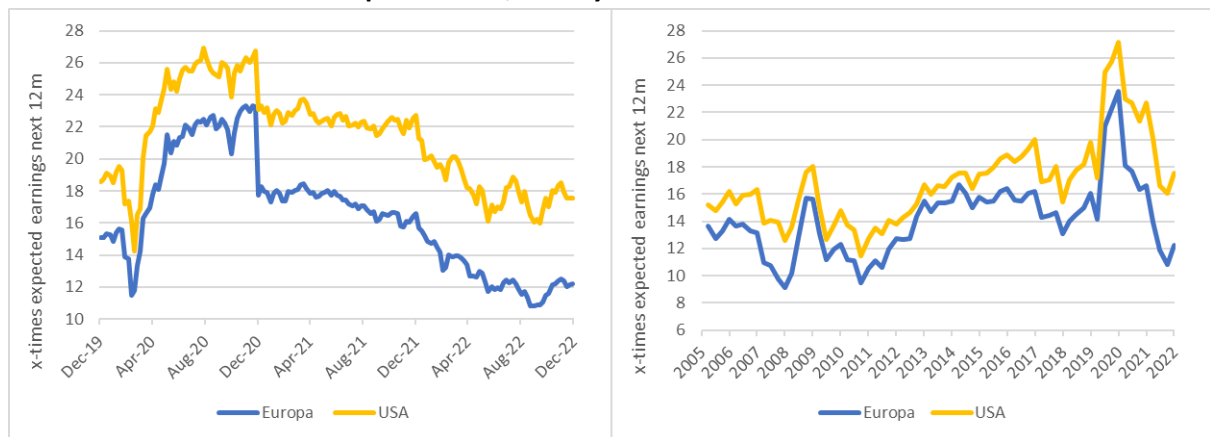
In the future, positive real yields will make bonds much more attractive again and enable asset protection. This was no longer the case in recent years despite low inflation rates, especially not in the Eurozone.

Bonds will once more play an active role in the portfolio structure in the future. However, risks from possible further increases in interest rates as well as a potential supply overhang on the bond market due to strongly increased issuing volumes of government bonds and the now really beginning significant balance sheet reduction of the central banks must be taken into account.

Stocks - significantly cheaper than a year ago

The strong price declines of the stock markets and the still strikingly stable profits of many companies led to a significantly more attractive valuation of stocks. This becomes clear, for example, in the multiple of the expected annual profit with which stocks are valued on the stock market (share price divided by expected annual profit per share). Here, the lower this factor is when entering the stock market, the more favourably an investor acquires shares in the company.

Stock market valuations Europe and USA, last 3 years and since 2006



Source: Bloomberg

Shares became about 25 % "cheaper" in the course of 2022 according to this valuation model.

Valuation factors of 12 to 14 (USA) and 9 to 11 (Europe) have been reached in recession phases so far. At these times, however, with a higher interest rate level.

We think that the residual risks for further price declines are thus already comparatively low, even if there should still be an economic downturn. For strategically oriented investors, experience shows that this market phase is the best starting point for future strong value growth.

What you can expect from us

2022 was one of the most difficult years of the last decades in almost every respect. Profound uncertainty can be found in almost all areas of life. This includes the unexpected end of peace and external security in Europe, but also the consequences of the frequently cited turn of the times for financial, energy and security policy. All this led to drastic losses in value on the financial markets worldwide. Only rarely before have there been years that brought comparable mental burdens for investors and asset managers.

We ourselves had to make the disquieting experience that careful analyses and consistent forecasts only work in "normal" times. Predicting short-term market developments, in which we never saw much sense anyway, proved to be an almost absurd undertaking in the upheavals of 2022. Rationality and logic could not help last year.

Wealth protection remains our top priority and we understand this to be "real" and long-term. Our goal is to ensure that inflation cannot harm the assets for which we are responsible. Inevitably, we will only be able to measure the success of our efforts in the future. But it is also clear that the results of the past year are far from satisfying us as an ambitious asset manager.

The history of the financial markets also shows, however, that it is precisely in phases of upheaval, such as the one we are currently experiencing, where the course is set for success in the future. We therefore ask for your patience and trust in our abilities to make the right long-term decisions for the assets entrusted to us.

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

BPM – Berlin Portfolio Management GmbH

January 2023

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