OBSERVATION

2nd QUARTER 2022

HERITAGE.CH

THE END OF FINANCIAL REPRESSION?

The first quarter 2022 painfully reminded investors how a combination of geo-political escalations and tighter monetary policies ask for skilful navigation through a stormy ocean.

Market attention quickly turned from the omicron variant to other factors. Merely looking at the quarterly performance of the MSCI world local index (-4.31%) only represents the preface of the story. Putting that number in relation to other figures & facts we have observed during this turbulent first quarter of 2022 gives outside spectators important indices of the market volatility experienced so far:

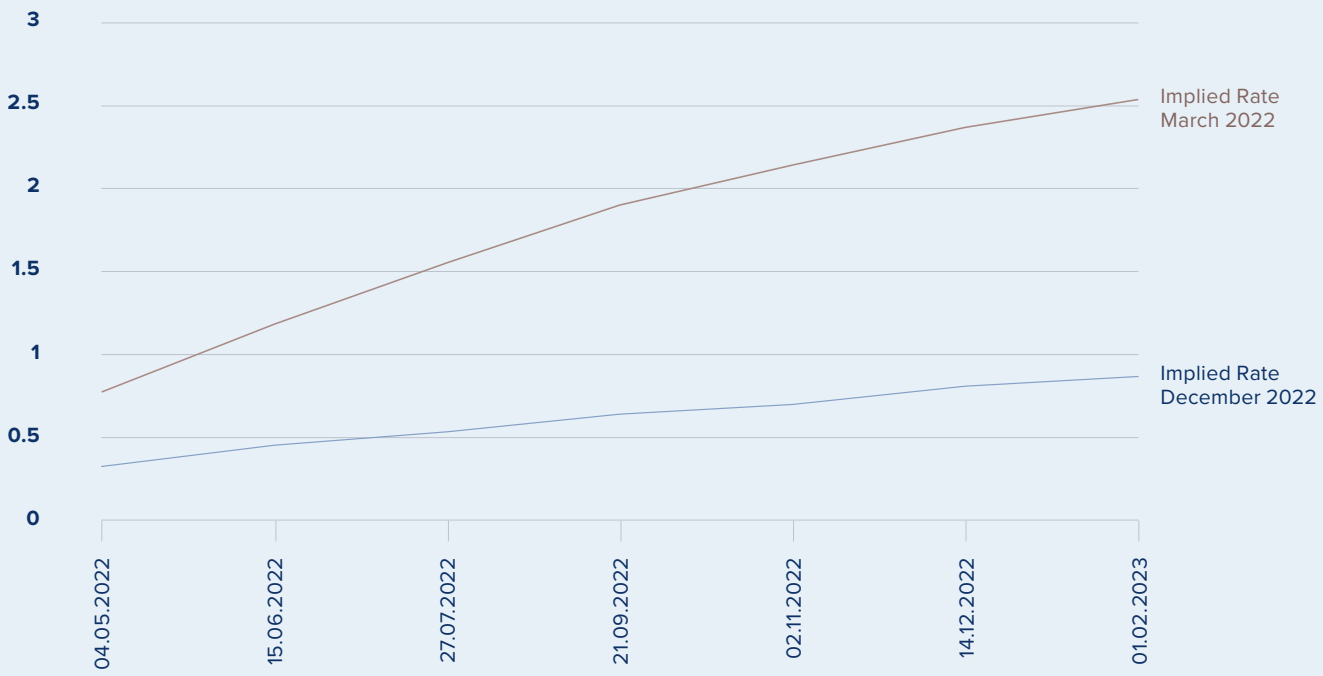
US inflation through the CPI hit a 40-year-old high touching 8.5% in March 2022!

The US 10Y-treasury finished the quarter at 2.34% yield, almost at the same level as the US 2Y-treasury which tripled from 0.73% beginning of January, indicating well the pressure on the FED to frontload its interest rate hike trajectory. Credit default swaps on Russian government bonds had hit just above 600bps when Crimea was annexed by Russia in 2014. The disbelief in western nations was high when Putin's forces invaded Ukraine just after the end of the winter Olympic games in Beijing resulting in 5Y Russian credit default swaps to spike to almost three times the level seen back in 2014.

With the additional inflationary pressures due to the raging war in Ukraine and its consequences on higher oil and gas prices, the economic backdrop looks challenging for the remainder of the year.

Two questions emerge from the recent developments we have observed: First, are we finally at the turning point of the financial repression and what will the long-term consequences be for global trade and globalisation in general on the back of the menace of a renewed cold war? The latter had already been put into jeopardy when Trump's ambitious plans for "America first" resulted in the US- Chinese trade war through tariffs on imported goods. The rapid liberalisation and integration were the main story of the global economy for the last couple of decades which had accelerated enormously since the end of the cold war through the collapse of the Soviet Union and the fall of the berlin wall in 1989. Institutions like the European Union and its objective for free trade within its boundaries and member states, developments and innovation in technology, trade deals and improvement in shipping all contributed to the ongoing importance of international trade and globalisation. Over decades globalisation has helped nations drive their economic growth, focusing on manufacturing where it is cheapest and allowing access to new markets. However, following Trump's protectionism policies and his goal to bring manufacturing jobs back to the US, the Covid-

Implied Rates FED Fund Futures



Source: Bloomberg

crisis also made its contribution to depressed global trade. From one angle, disruptions in global supply chains weighed heavily on the global trade while some countries carefully decided on how much sanitary products they were exporting, often only doing so after their own needs were covered. The importance for self-sufficiency reignited and put further pressure on global trade and its growing share of GDP contribution. Ironically, and in contrast to 1989, it is again Russia who is casting a shadow on global trade by invading its neighbouring country Ukraine. The unprecedented responses by Europe and the US through financial and economic sanctions on Russian companies, individuals and the Russian government will further lead to cutting Russia from any international ties. As a major exporter of many commodity goods, this will result in further structural shifts in the global supply chain for many years. In addition to ongoing deglobalisation trends, the first quarter was marked by hopes for an end of financial repression. Unprecedented amounts of liquidity have been pumped into the financial system to support global economies from falling into a global recession during the Covid-crisis. The FED is focussing on two goals: Price stability and a healthy job market.

The massive stimulus by the FED (besides fiscal policy) has achieved its objective when looking at the sharp recovery of the US job market.

Out of the 20 million people who have lost their jobs during the Covid-crisis, only about 5 million remain without jobs. Currently, there are even more jobs open than unemployed people actively looking for jobs, which we expect to normalise further. Looking at both, the total number of unemployed as well as the unemployment rate, we can now consider the US job market to be at a pre-crisis level. When the minutes of the December 2021 FED meeting were published in mid-January 2022, it was clear that the FED would focus on its second objective: Inflation! Incoming data has been showing persistently higher inflation, both on flash as well as core CPI compositions. The FED's hiking cycle was drastically revised upwards as the graphic on page 3 suggests. As per March 31st, 2022, the market currently prices in an implied effective rate of 2.37% by December 2022 vs 0.80% it was expecting three months ago. This corresponds to an additional 6.5 rate hikes for 2022 the market was discounting not much longer ago. As a result of this more aggressive

US job market: Unemployed workers (back to pre-covid level) vs Job Openings (USD)

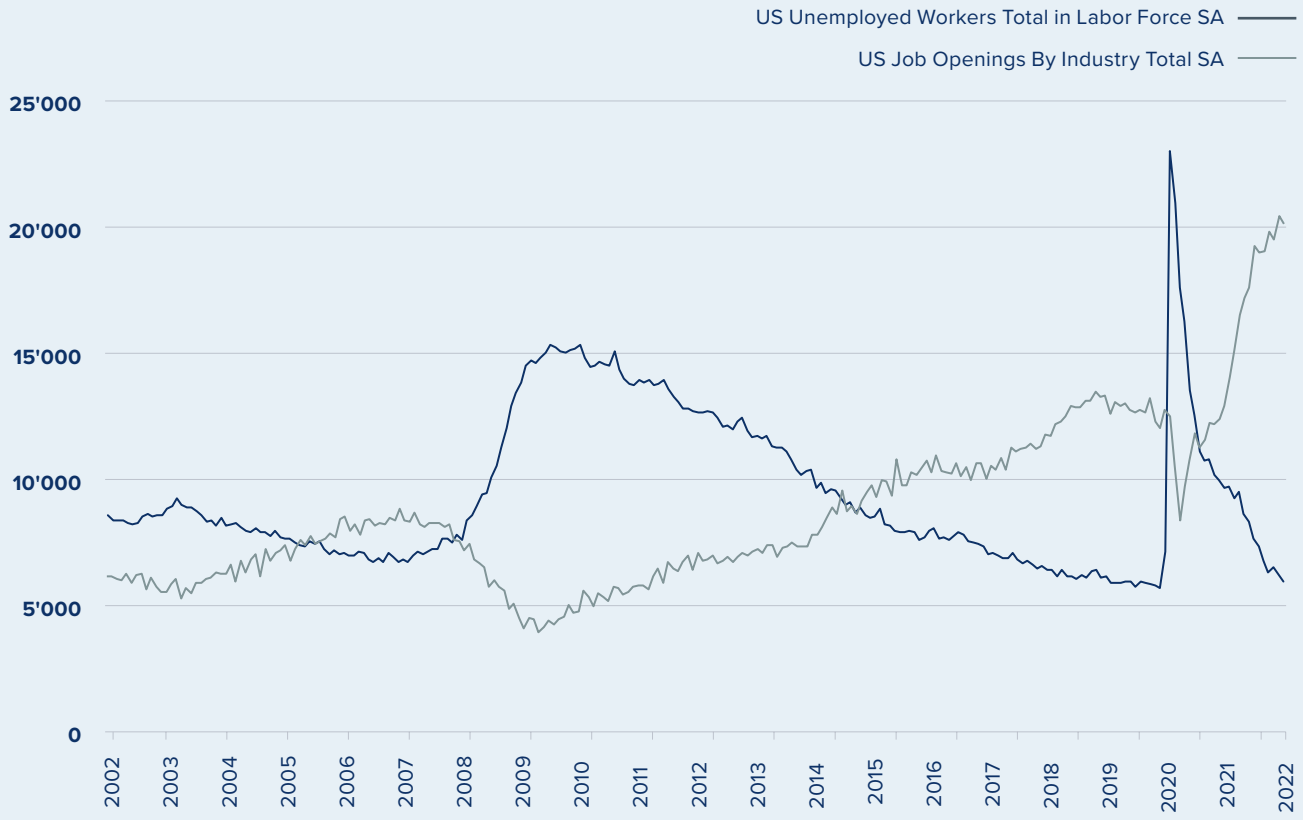
Source: Bloomberg

tightening, the fixed income market went through an important shift as well, ending the quarter with mark-to-market losses making Q1-2022 one of the worst since 1980 for bond investors. The magnitude of this shift is well represented with the amount of negative yielding debt outstanding (see graph below). By the end of 2021, over USD 11 trillion of debt was trading in negative yield territory. Within 3 months of FED rhetorics, this number is down to below USD 3 trillion. Years of close friendship between central banks and bond investors have been put into a stress-test following the important front-loading and aggressive monetary tightening policies. And yet this happened without the start of the balance sheet reduction of the FED, which is expected to start in May 2022, and which could further trigger higher yields for new issues raised by the US treasury once the FED does not step in anymore as the most important buyer. One would say that the global economy is already in stagflation as inflation has taken the upper hand over downwardly revised growth expectations for 2022. However, the third ingredient for a stagflation by means of high unemployment is not yet the case and hopes for a growth-flation or ongoing mid-cycle expansion are still intact, albeit at lower probabilities.

The risk that we enter a late or aging business cycle a lot faster than initially thought have increased considerably.

The duration of the Russian/Ukraine conflict, the involvement of other countries and further sanctions on energy exports will dictate the mid-cycle journey in 2022. Throughout the first quarter 2022, we have kept an important underweight in fixed coupon instruments and focused on products that would benefit through floating rate characteristics. In addition, our exposure in gold and other commodities has acted well as a hedge against inflationary pressures. Corporate earnings for Q1-2022 will be a guide on how companies can maintain their earnings margins amidst a quarter that was again highlighted by sticky inflation. Inflation will continue to play a major role for the remainder and how inverse base effects will roll out for the second quarter of 2022. With the fragmented commodity market due to imposed sanctions on Russia, pressure will stay on. Renewed military spending and the additional boost for greener energies will also be closely watched themes for the remainder of the year.

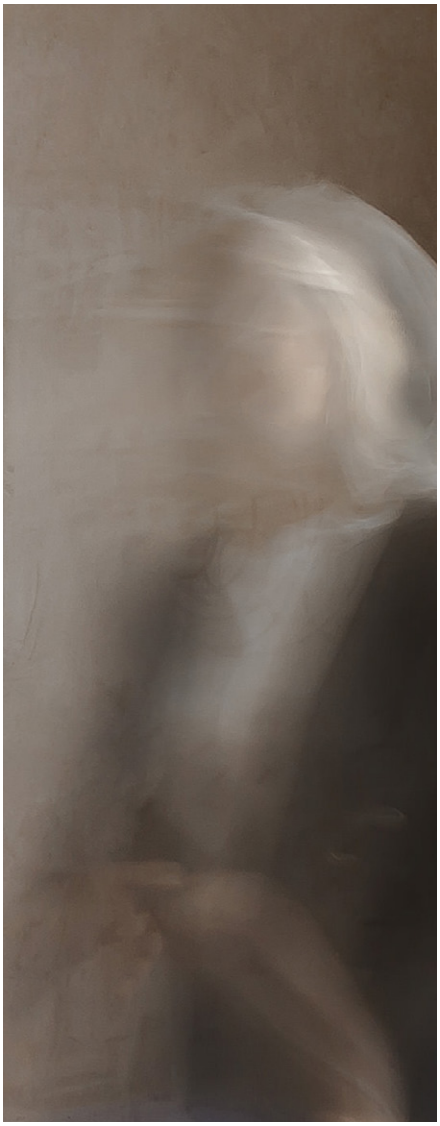
Bloomberg Aggregate Negative yielding debt in USD



Source: Bloomberg

THROUGH THE FIRE

European markets fell sharply, and volatility jumped when the Russian troops suddenly invaded Ukraine. The war had a huge impact on already rampant inflation, not seen in decades, as commodity prices skyrocketed.



Against all odds, European markets recovered all their losses, and the VIX index came down quickly to the low twenties.

Amidst this repricing of tighter financial conditions for the remainder of the year 2022, equity markets have undergone an important derating process. By the end of 2021, the S&P 500 was trading about 21 times its next 12 months earnings, while Europe was trading 15.5 times and the Swiss SPI at 19.5 times its future earnings. The bigger the growth sensitivity in the indices' compositions, the higher future earnings were penalized. As such, the more growth-oriented US index S&P 500, with its bigger share in the technology and communication sector derated much more than its counterparts in Europe and Switzerland. As per today (22nd of April), the S&P 500 is trading at 18 times its futures earnings, down over 15% from its December 2021 highs while Europe trades at 13 times its future earnings undergoing lesser derating. With its well represented big three, Nestle, Roche and Novartis, the SPI barely underwent a derating, trading just below 19 times its next year earnings. It does not come as a surprise that growth stocks have underperformed value equities as distant earnings seem much less attractive today being discounted at higher rates.

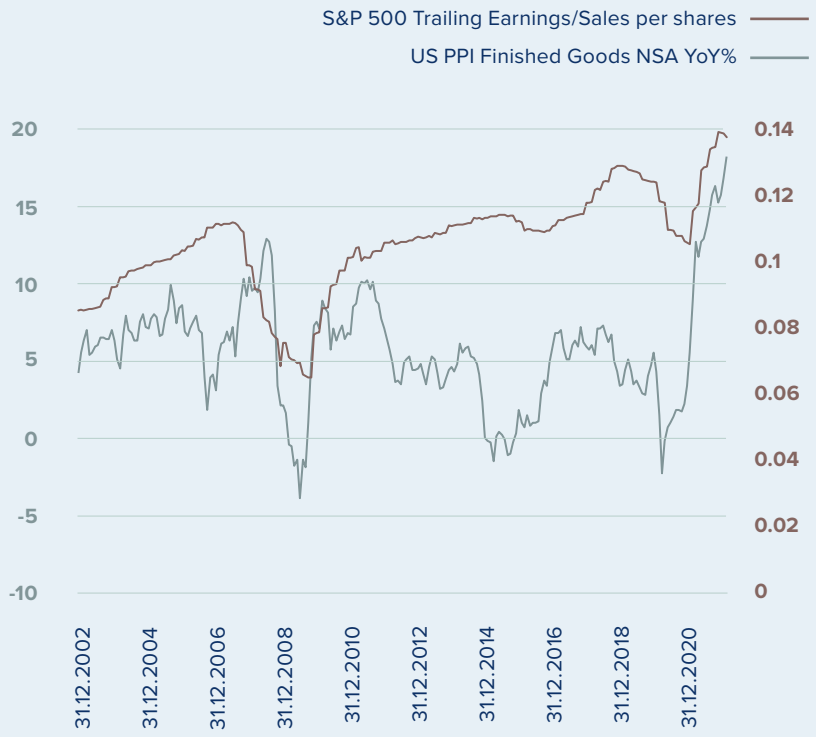
It seems that the fate of equities will again need to depend on earnings.

Prior periods of equity market drawdowns in the last 5 years were mostly offset thereafter by strong earnings. Q1-2022 earnings will give a clear picture how companies manage margin resilience amidst a full quarter packed with very high inflation starting 2022 at 7% and ending Q1 at 8.5%. Obviously, whenever possible, higher input costs but also rising wages could be a perfect scapegoat for earnings misses. The latest Netflix crash being a good example, “Blame it on inflation” will be a key slogan. Q4-21 was already a good first stress test, albeit inflation was not as high as in the first quarter of 2022 and companies showed a rather high degree of resilience across their margins. As observed in the graph on the next page, trailing 12 months margins have reacted rather suprisingly well with higher input costs reflecting well US companies’ ability to adjust pricing. It probably depends

on more than just pricing, including their ability to further cut costs and improve efficiencies by finding ways to sustain growth and profitability. While the yield curve is seen as a good indicator, given its history of inversion prior to bear markets, we would point out that it is a poor timing indicator. Indeed, there is usually a long lead time before market weakness materialises. In the last six 10-yr vs. 2-yr inversions, economic contraction occurred only 16 months later on average. Moreover, on average markets peaked 12 months after the inversion, the S&P 500 index adding gains of +18% in the meantime. Maybe a somewhat more reliable indicator is the spread between the 10-year and 3-month yields. Currently this spread remains positive and indicates that calls for a recession seem premature. However, recession risk in Europe is higher given the ongoing uncertainty with regard to direct and indirect effects of the war in Ukraine.

In Europe, recent sector performance trends have been characterised by a rotation from Cyclicals into Defensives with Pharma being the biggest beneficiary. Pharma is the most overbought sector in Europe and valuations are starting to look extended and are now above the long run median, earnings revisions are however supportive for the sector at this time meaning the sector represents a defensive play with strong fundamentals; we therefore stay overweight. Otherwise, we maintain a barbell strategy with cyclical picks like Energy and Financials. Energy is a good hedge against both inflation and increases in commodity prices, plus the sector has strong cash flow and an attractive dividend yield. In financials, the Ukrainian crisis has undoubtedly set back the European banks trade but, in our view, has not derailed it. Rising rates, dividend pay-out and more buybacks are tailwinds for the sector. Within Consumer Discretionary, Autos is amongst the cheapest sub-sector in the old continent with relative valuations back down near their Covid lows. We have recently added a German car manufacturer to our Fundamental List but stay neutral on Consumer Discretionary.

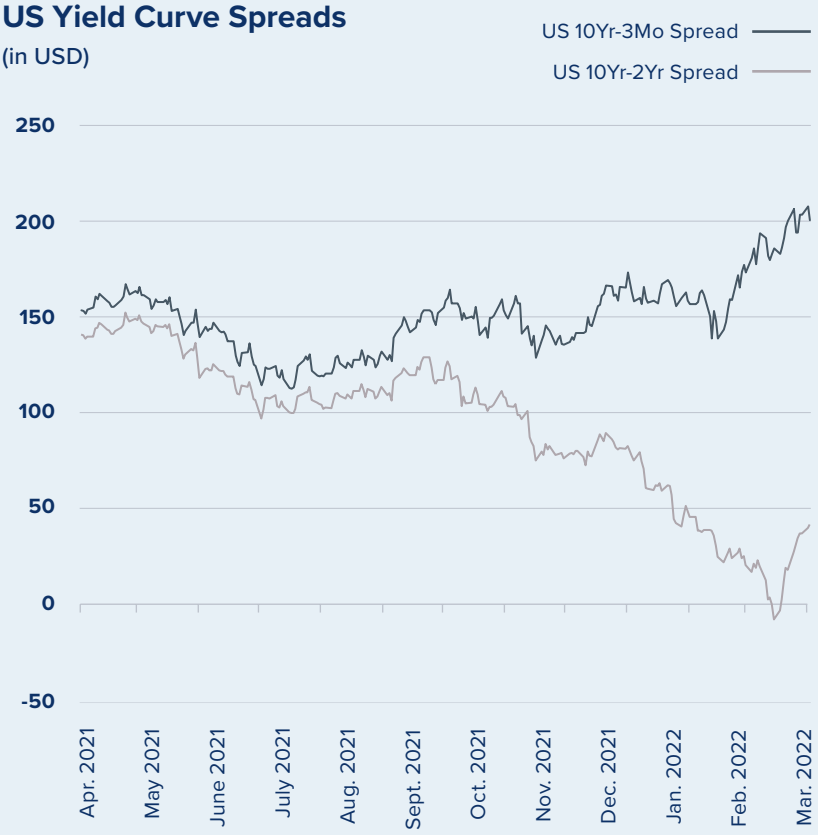
Margins vs producing prices US



Source: Bloomberg

US Yield Curve Spreads

(in USD)



Source: Bloomberg

MOST PEOPLE DON'T LIVE ON LOVE AND FRESH AIR

The supply chain stress caused by the pandemic laid the ground for the inflation expectations firming up at the end of last year.

They were mostly confined to certain raw materials and manufactured goods, due to the supply chain failing to adapt to the relative swiftness with which the Covid-19-led restrictions were lifted in developed markets. But the war in Ukraine not only increased these existing constraints, it added uncertainty for commodity producers and consumers around the world and has done so across the board, contrarily to previous commodity crises which tended to be focused on either energy or agriculture products. Russia has a leviathan role in global commodities. By way of example, Russia and Ukraine account for 30% of annual global wheat exports. Within the first seven days of the invasion, European wheat prices rallied over 60%. In addition to lower expected production, exports have been further affected by both the logistics of the war and sanctions imposed on Belarus and Russia, including bans from the world's three largest shippers. The effects are bound to be felt everywhere and efforts to relocate production will take time. The entire value chain is affected, as the two allies account for 16% of fertilizers exports. Higher food prices in all steps of the ladder are therefore to be expected and have already exceeded the levels of the 2008 food crisis. Even if the war ended tomorrow, Ukraine will have missed sowing season, the effects of which would be felt for months.

This has vast implications for both developed market economies but also global stability. It can be expected that consumers from rich countries will be able to adapt their regimen to account for this increased cost base, switching out expensive animal-based foods for cheaper plant-based diets. However, poorer countries already relying heavily on grains for sustenance may experience turmoil similar to that of close to fifteen years ago. These led to a number of civil unrests and sometimes revolutions with very heterogeneous outcomes. The same can be said about energy, and especially so in Europe. Half the region's coal, 45% of its imported gas and approximately one third of its oil can be attributed to Russian exports. While the desire to punish Putin for the invasion is shared and strong, current sanctions exempt energy commodities. With its German industrial core member facing the most challenges in this regard, Europe faces an unsolvable dilemma between economic sacrifice and the ongoing funding of a war that could undo 80 years of continental peace.

Oil prices have already catapulted over their highest level since 2008 and its rally pales in comparison with European natural gas which reached the equivalent of more than $600 per barrel of oil.

Rising input costs (many on track to reach their 1970s sharpest rise) have therefore become a significant risk for a wide variety of European companies because of the war. Doing what is morally right will be expensive and not all these companies will be able to pass these costs to their customers. Furthermore, the volatility we are bound to experience exacerbates this stress as companies need visibility to plan, market, manufacture, and invest.

In financial markets, traders are experiencing a liquidity crisis due to a reduced ability to finance margin calls in both the physical and derivative markets.

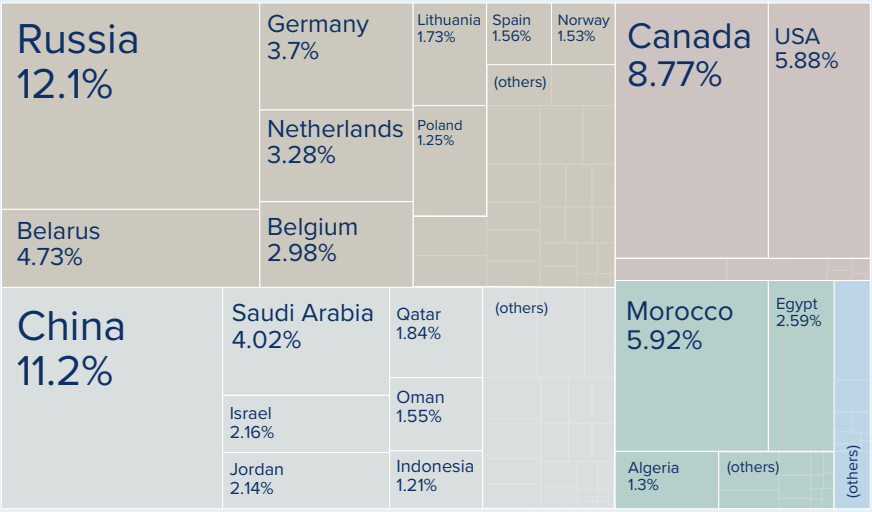
With rising prices, the funding requirement for shipments are rising sharply, as have the costs of hedging (sometimes reaching 75% of the total trade value). This poses a danger to the foundation of global exchanges. One can easily see that in a late cycle environment, with only one way for interest rates to go, this cocktail could quickly send the global economy into a recession.

We thus remain long on gold for its safe haven characteristics and have been invested in diversified commodities alongside this exposure since January. The current context has prompted us to prolong our stay, as both a driver of performance but also a hedge against the tail risk of a clear worsening of the global geopolitical situation.

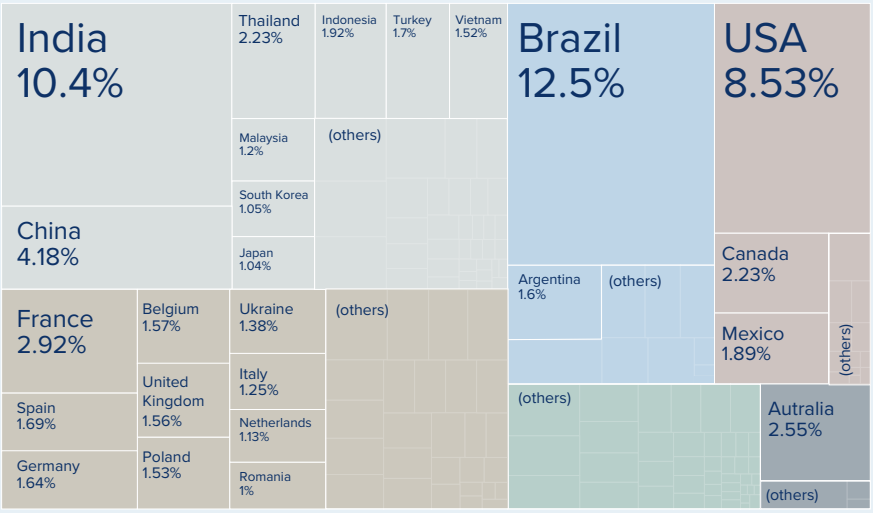
Clearly, the globalisation "pendulum" is swinging back to a position of surety over profit maximisation as the recognition of certain trade-offs becomes clear. Some even go as far as calling for an end of globalisation as we've experienced it over the past 30 years, supported by technological advances, the likes of which helped us get through another phenomenon which put a sudden halt to global travel and exchanges: the Pandemic. It further goes hand in hand with environmental concerns and a bid to lower energy consumption, agriculturally intensive products and increase recycling. A lower demand is, for now, the only fool proof utensil in our toolbox to rapidly curb commodity price increases. As mentioned, the issue is where we stand in the economic cycle. To that point we remain bullish on everything green, which saw a retail and regulatory driven bubble in 2020 deflate in 2021. The fundamentals are here, and it is clearly part of the solution.

Fertilizers Balances

Exporters of Fertillizers (2020)



Importers of Fertilizers (2020)



Source: The Observatory of Economic Complexity (OEC) as of 2020

EQUITIES	LAST PRICE	YTD%
S&P500	4357.56	-8.57
Eurotoxx 600	454.31	-6.87
Nikkei	27105.26	-5.86
China A shares	3235.27	-15.18
Brazil	112412.47	7.24
India Nifty	17171.95	-1.05
Russia RTSI$	946.47	-40.69
MSCI World Local	2285.77	-7.13
MSCI EM Local	62989.6400	-10.08
SMI Index	12273.95	-4.67

CURRENCIES	LAST PRICE	YTD%
Dollar Index	100.9320	5.50
Euro	1.0810	-4.93
GBP	1.2873	-4.87
Yen	128.3300	-10.32
AUD	0.7271	0.11
CHF	0.9565	-4.56
Brazil Real (BRL)	4.7257	17.90
Turkish Lira (TRY)	14.7532	-9.82
India Rupee (INR)	76.4837	-2.81
China Yuan (CNY)	6.5030	-2.26
JPM EM FX	53.2370	1.15

FIXED INCOME	LAST PRICE	YTD%
US Govt	417.51	-8.40
EU Govt	252.03	-8.25
US IG Corp	3241.31	-12.00
US HY Corp	2154.67	-6.98
EU IG Corp	151.37	-6.81
EU HY Corp	410.62	-5.47

COMMODITIES	LAST PRICE	YTD%
Crude Oil	102.48	36.26
Natural Gas	6.85	83.65
Gold	1931.10	5.61
Silver	24.38	4.40
Copper	466.45	4.50
RICI Global	4228.68	32.28
RICI Agriculture	1470.42	23.24
RICI Energy	537.90	56.09
RICI Basic Metals	2096.28	15.62
RICI Precious Metals	2345.47	4.36

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OPINION

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