Quarterly Investment Strategy

January 2022

Monetary Policy and Divergency will likely determine 2022

Happy New Year!
A new year usually starts with good resolutions, hope and confidence. Rarely there is a worldwide consensus about what we wish for the upcoming year. This year it will definitely be: No more Corona. As we learned last year, issues that we seemed to have overcome sometimes hit back with a vengeance. But it wouldn't be New Year if we couldn't find something positive even on a topic like Corona: The now super rapidly spreading virus might soon have reached a phase similar to the final bouquet of a fire work.

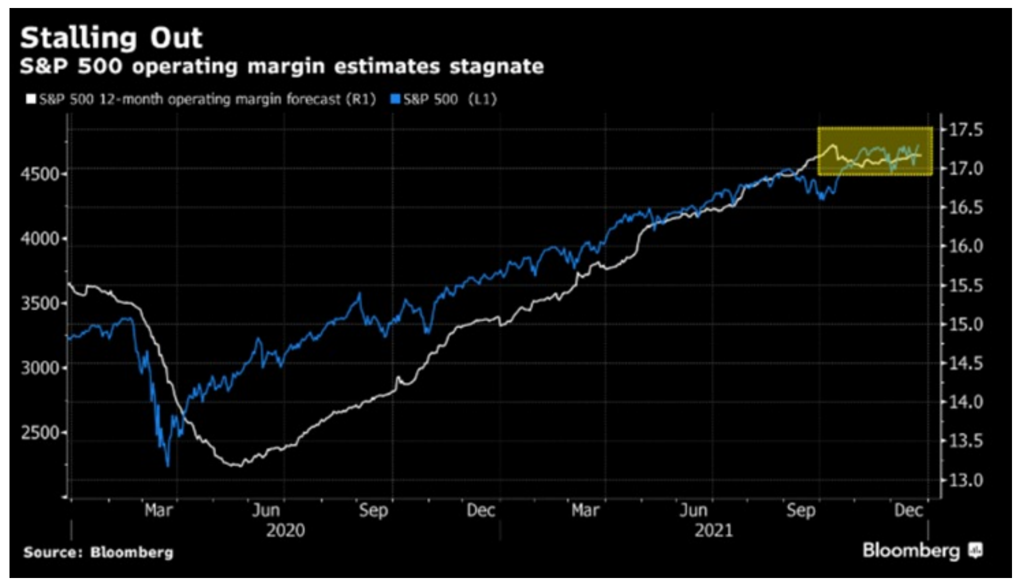
Also on the economic front, surprises were ample. Inflation proved to be more persistent than most thought and reached levels not seen in decades. This left negative prints on the bond performances. As many companies have been quite successful in rising prices and reducing costs, margins did not suffer from pricing pressures – but some stagnation may be on the horizon (see right chart below). Stocks showed a huge disparity: the US shined with a stellar plus of 26.9%, whereas China formed the tail light with a minus of 22.4%.

This year, monetary policy and exit strategies will likely determine the market outcome. We also consider the divergency in policies and politics as crucial.

Monetary Policy

A) Expected Increases	Current	end 2022	end 2023
US federal fund rates	0,25	1,00	2,00
Bank of England bank rate	0,25	0,75	1,00
Bank of Canada lending rate	0,25	1,00	2,00
Reserve Bank of India	4,00	4,25	5,00
B) Expected No Changes			
Europe deposit rates	-0,50	-0,50	-0,50
Bank of Japan policy rate	-0,10	-0,10	0,00
Swiss National Bank	-0,75	-0,75	-0,75
C) Expected Reductions			
People's Bank of China	2,95	2,75	2,65
Bank of Russia key rate	8,50	7,50	5,50

Source: Bloomberg Economics Forecast



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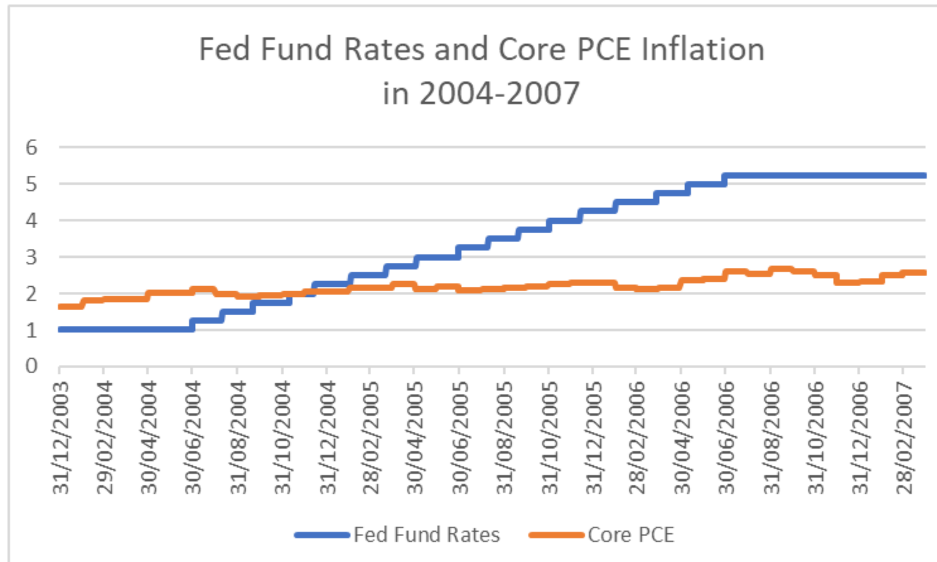
The Minutes of the Federal Reserve published on January 6, 2022 offered various very interesting insights and - very importantly - a judgement on how the current situation differs from the previous normalization periods. Some key observations include:

- The current economic outlook was much stronger, with higher inflation and tighter labor market than at the beginning of the previous normalization episode (see chart comparing a hiking cycle with today's level of PCE).
- Participants judged that several aspects of the previous approach remained applicable in the current environment. In particular, they noted that the principles and plans underlying policy normalization were communicated in advance of any decisions or actions, which enhanced the public's understanding and thus the effectiveness of monetary policy during that period.
- Changes in the target range for the federal funds rate should be the Committee's primary means for adjusting the stance of monetary policy.
- Almost all participants agreed that it would likely be appropriate to initiate balance sheet runoff at some point after the first increase in the target range for the federal funds rate. Many participants judged that the appropriate pace of balance sheet runoff would likely be faster than it was during the previous normalization episode.

The minutes had an immediate, severe impact on the bond markets. Many economists told markets for so long that inflation pressures were only a temporary phenomenon and would normalize once the base effect evaporated - and some are still of this opinion. But clear words from the central bank woke investors apparently up.

The Fed Chair Jerome Powell had previously sent unmistakable signals already at the start of December by retiring the word "transitory" to describe high inflation. He already then suggested that bond purchases could be wrapped up a few months sooner. So, market participants should have been prepared. But serious inflation occurred such a long time ago. Many market participants are totally new to this concept – apart from theoretical studies, of course. The rapidly spreading Omicron variant and its uncertain mechanism may explain the market hesitancy as well, as new lock-downs were feared. On the other hand, a rush among companies to sell new debt before yields rise further, might have been a reason for the sharp yield increase at the start of this year as well.



Source: Federal Reserve, Bloomberg Economics Forecast

The Core PCE in December 2021 was 4.7%

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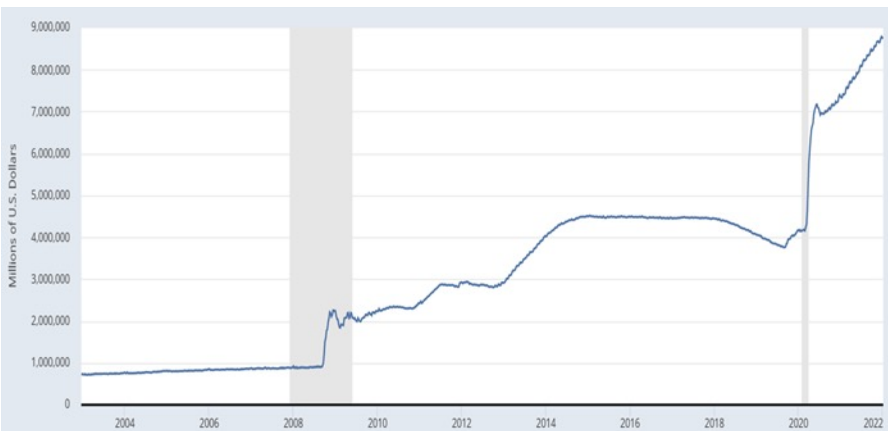
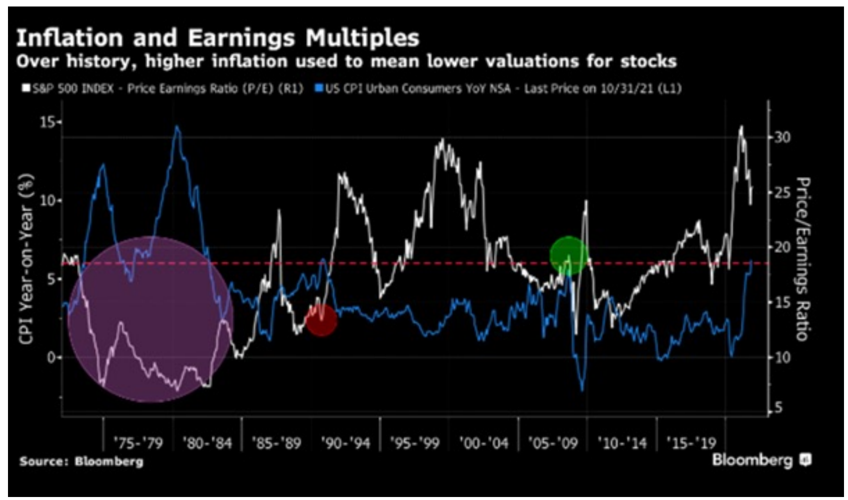
One surprising element in the minutes was the commitment to initiate a balance sheet runoff "at some point" after the first increase in the target rate. As can be seen in the chart below the Federal Reserve's balance sheet has blown up to a breathtaking USD 9 trillion. On the positive side, the weighted average maturity of the holdings is shorter than in the past. By simply allowing securities to mature it could therefore shrink faster. The central bank can of course also sell some of its assets, which would qualify as "Reverse Quantitative Easing". It will be very interesting to see how the Federal Reserve will proceed. Already in December, the Fed Governor Christopher Waller argued that shrinking the balance sheet might allow the central bank to hike rates even slower since the outright reduction of the balance sheet might be seen as a draining of liquidity. But for now, the minutes made clear that changes in the target range for the federal funds rate will be the primary mean with the argument that this mechanism is better understood by market participants.

How fast and how far will the federal fund rate rise? The market consensus has already switched to much more rate hikes. Some see four hikes (one model even suggest six hikes) in 2022 and further increases in 2023 to end somewhere above 2%. Goldman Sachs is expecting the terminal funds rate at 2.5-2.75%. But as mentioned before, the influence of a potential Reverse Quantitative Easing and the development of inflation will be key determinants. The fact that the most influential central bank is now going to tackle inflation in a serious way is recomforting. We stated for more than two years that inflation might be more persistent than what the market is pricing in. After the acknowledgement of the Federal Reserve, we started to reduce certain instruments that would have benefitted from negative real rates (such as gold) and have a less negative view on (inflation-sensitive) longer-term interest rates (though we consider it too early to buy).

Total Assets Federal Reserve



Source: Board of Governors of the Federal Reserve System



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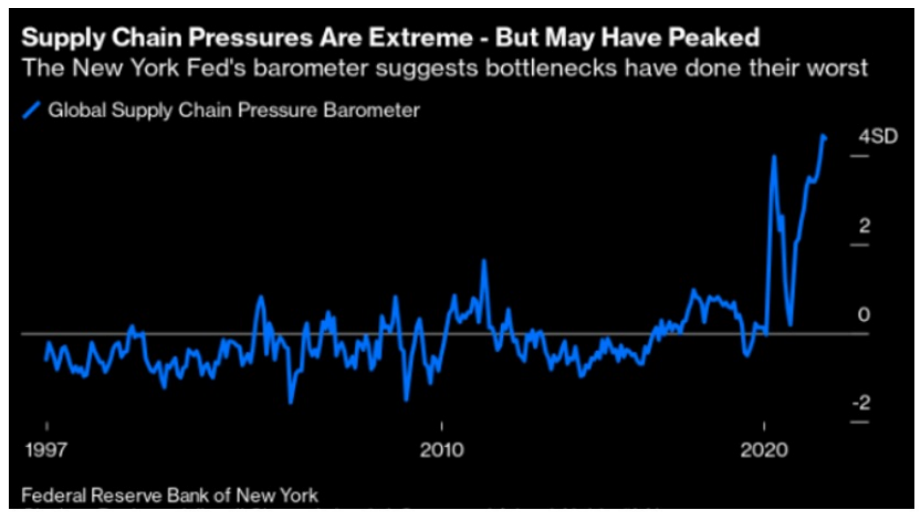
As we showed on page 2, some central banks are not expected to raise rates, notably the European Central Bank (ECB). The ECB will however start unwinding its pandemic policy measures in 2022, with net bond-buying under its emergency program to slow in January before ending in March. It is expected to take counter-measures, such as temporary regular asset purchases, should they consider financing conditions as too tight. In respect to inflation, the ECB still anticipates record CPI growth to ease without the need for interest rate increases. As many countries in the euro zone decided to fight the Corona virus with lockdowns, economic growth might slow down more than in other regions. If that is beneficial to inflation considering supply bottlenecks remains to be seen.

The measures to fight the Corona virus will indeed lead to a divergent economic development, the most extreme case being China. The "zero-tolerance" of the world's most important production site should slow down the domestic economy even further - and Omicron just started in China. Problems in the embattled property industry have increased and now seemingly reach bellwether companies. We expect reforms in the financing of real estates to remain a burden to the economy over coming years as will the fight to reduce inequality. We therefore see potential further economic stimulus as a way to stabilize the economic growth rather than accelerate it.

It might also mean that Supply Chain Pressures might last longer than some expect – though the Federal Reserve Bank of New York already suggest that the worst lies behind us.

Source: Markit



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Conclusion:

a) **We are comforted by the fact that the most important central bank is tackling inflation seriously. We started to reduce instruments that would have benefited from negative real rates. We are also less negative on longer-dated fixed instruments, as they are most sensitive to inflation but would not start buying them now.**

b) **In Fixed Income Portfolios we continue to apply a short-duration policy with average duration in the 2-3 year range.**

c) **In Equities, we are still slightly overweight with the US our favorate region.**

d) **We continue to include growth in our portfolios as some of these companies are world leaders in their respective field.**

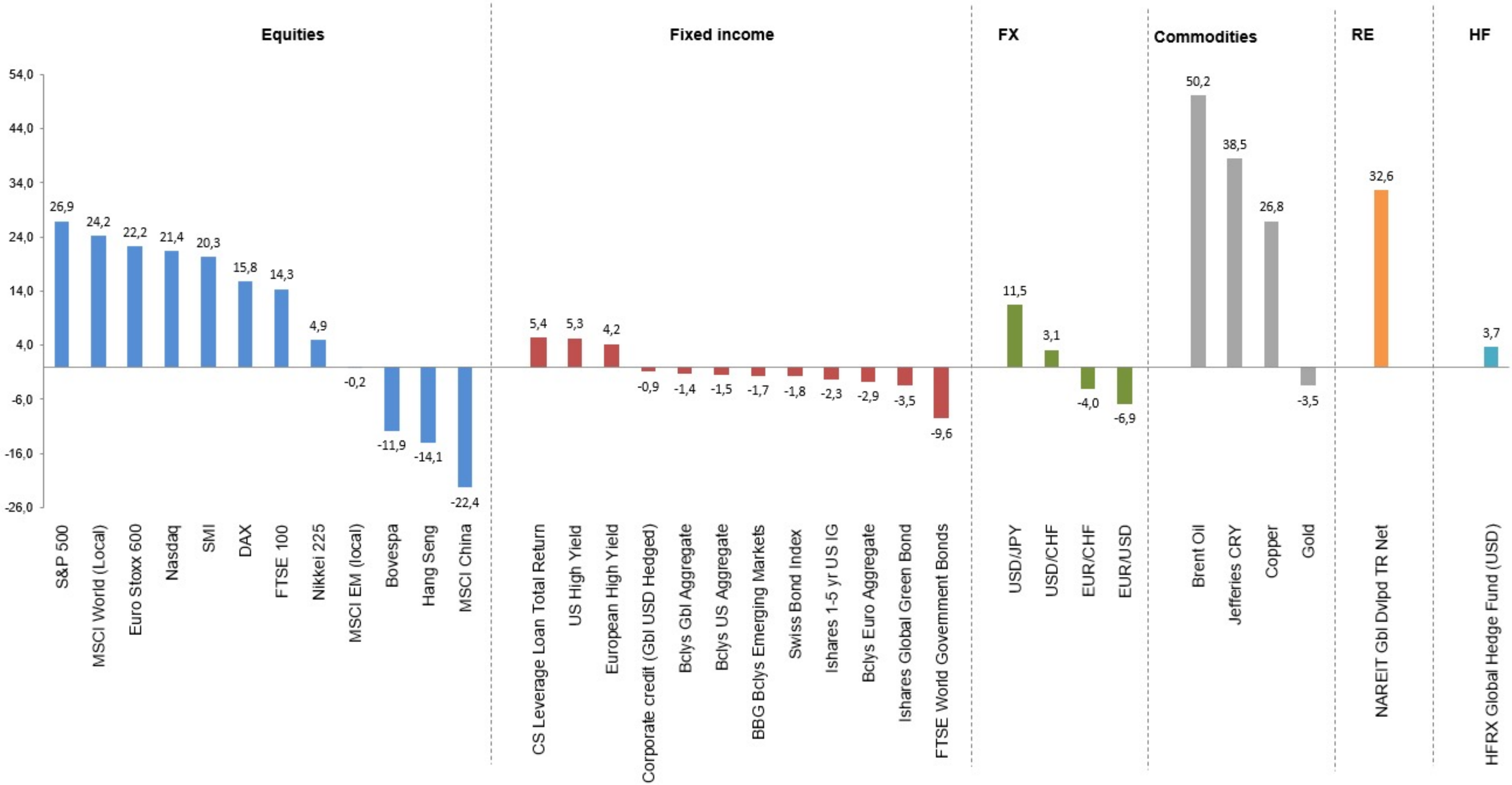
e) **Generally, we try to find companies that represent value in relation to their growth outlook. We consider this concept as a long-term valid investment approach that should also hold in more rough waters and during times when higher inflation weighs on multiples.**

f) **We expect less negative real yields going forward. Gold will be less appealing in this environment. We started to reduce our positions. We continue to hold some as gold is also one of the best portfolio hedges. We intend to reduce other inflation hedges going forward on the condition that the fight against inflation will be successful.**

g) **We remain positive versus the USD as we expect divergency to develop in favor of the US currency.**

Please see further information in the section: how are we invested and why

Performance Major Asset Classes 2021 in Local Currencies



Source: Bloomberg

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