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Capicura Partners – Outlook 2nd Quarter 2022

Russian invasion of Ukraine – tragedy with unknown outcome

- ***Despite the war in Ukraine, central banks are determined to fight inflation – risk of "policy mistake" has risen***
- ***Inflation a serious problem – transitory becomes medium-term***
- ***Central bank balance sheet contraction (QT) leads to headwind for financial markets***
- ***Markets indicate low recession risk***
- ***Despite various uncertainties, maintain a constructive asset allocation, review portfolio quality***

About three months ago, we highlighted the geopolitical risks, but assigned a low probability to a war in Ukraine. Today, we know that the "peace dividend", which has existed for more than 30 years, has vanished overnight and that the cold war is a new reality. The brutal invasion and the human suffering is distressing and demonstrates that freedom, democracy and property rights are values worth fighting for. The courage and resilience of the Ukrainian people are impressive. The quick and united reaction of the West has surprised positively. How long this war will last is impossible to estimate, but without a ceasefire and a solution in Ukraine, financial markets remain unsettled and volatile.

«Federal Reserve firmly committed to restoring price stability – elevated risk of a policy mistake»

Despite the war in Ukraine, both the US and the European central banks are trying to dampen inflation expectations with their clear announcements. As energy prices have continued to rise and supply chain issues remain, inflation has become a major problem. The pressure (also political) on FED Chairman Powell has increased markedly in recent months, which is why an initial rate hike was implemented last week. Further increases will follow suit. Whether the targeted six hikes this year and the additional three next year materialize remains to be seen. The FED will continue to focus on inflation but will not disregard economic development (dual mandate of the FED for price stability and maximum employment). At this point in time, central banks want to suggest that they are not "behind the curve" and are determined to fight inflation. In addition to the interest rate hikes, the reduction of the US central bank balance sheet is expected to be launched in May (better known as Quantitative Tightening or QT). This will become a balancing act, which is why the risks are rising for a "policy mistake" leading to a recession down the road. 10-year U.S. Treasury bond yields are in the process of breaking out of their more than 30 years downtrend (see Fig. 1). However, there is something positive about rising interest rates. It should give the ECB the opportunity to slowly exit the negative interest rate environment as of June this year (SNB likely to follow at a later stage).

Fig. 1) *Data Bloomberg / Chart Capicura Partners AG*

Financial markets will have to get used to this changing central bank regime (rising interest rates & QT). The strong monetary tailwinds that have persisted since the financial crisis have turned. This will lead to higher volatility on the financial markets and additionally challenge investors.

«Dramatic distortion in the energy sector is likely to be temporary»

It is no surprise that energy prices have risen sharply, and it seems fair to assume that these remain high for a bit longer. Still, based on past events, oil price increases due to external shocks are typically of temporary nature (see Fig.2).

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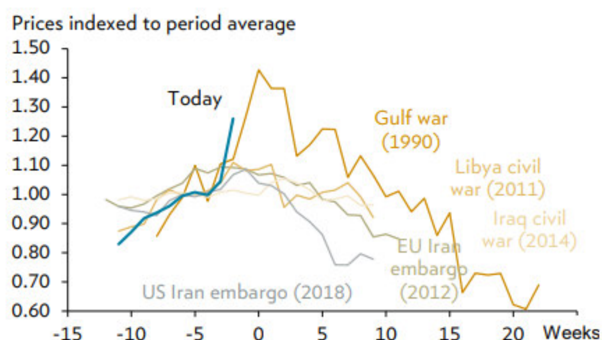

Fig. 2) *Oil price development around geopolitical events. Source Bank Julus Baer, House View 11.3.2022*

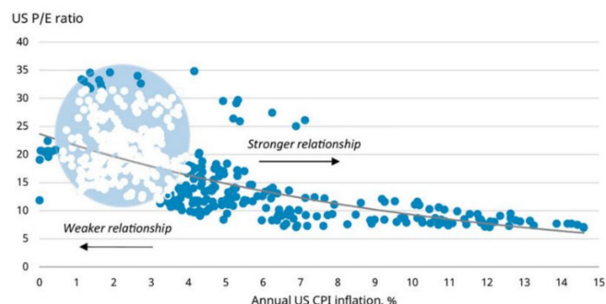

Fig. 3) *Source Hartfordfunds, / Refinitiv Datastream & Schroders. Data March 1973 – December 2021*

«Economic slowdown but no recession»

In our last update on February 24, we were undecided if global economic growth was weakening or whether we were potentially facing a recession. Various models and the yield curves indicate that the risk of a recession is currently benign. The war, high energy prices and sanctions against Russia will have an impact on economic growth, mainly in Europe which may lead to a slight slowdown in economic activity. However, there are no signs of a recession in Europe at the current stage. This assumption will only remain valid if a Russian oil and gas embargo can be avoided.

«High inflation – lower PEs»

In a high inflation environment, real assets should continue to be favoured. However, a valuation contraction may occur. Fig. 3) shows that for an expected US inflation in the region of 5-6%, a PE (price/earnings) ratio of approx. 15x applies. Currently, the expected 2023 PE ratio for the S&P500 reads about 18x. This implies that for the US stock market there is further correction potential in the region of 10-15%. Hence, a level between 3,800 - 4,000 points on the S&P500 should provide good support. European markets on the other hand, trade at much lower multiples (est. P/E 2023 EuroStoxx50 12.5x, SMI 16x). In times of elevated inflation, stocks from the following sectors should outperform: Energy, Food, Financials, Utilities, Gold & Mining, Industrials and Pharma. Since "value style" investing combines many of the above sectors, these strategies should continue to outperform the overall market.

«Central bank exit, new trends and increased volatility speak for alternative investments »

The gradual exit from ultra-loose monetary policy by various central banks opens opportunities for hedge fund strategies to generate added value (market influence by central banks decreases). In addition, we maintain our gold position and consider REITs (Real Estate Investment Trusts) as attractive investments due to their lower correlations to equities.

«Asset Allocation – hold on to constructive positioning»

Due to the stock market corrections, the equity exposure in our portfolio has been passively reduced from initially 55% to currently about 50%. We have refrained from any "rebalancing" of the quota and keep our positioning unchanged for the time being. Visibility remains poor, which is why we are not increasing the risks any further at the current stage. We are in the process of making the portfolios more defensive (see sectors above) and investing a bit closer to our home market (Switzerland). Also, in the fixed income space, the increased credit spreads offer some attractive opportunities.

Asset Allocation	
Cash	15%
Fixed Income	15%
Equities	50%
Alternative Investments	20%

Fig. 4) *Suggested asset allocation for a Balanced Portfolio in Q2 2022*

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