BANQUE HAVILLAND

Q1 2022 OUTLOOK

JANUARY 2022

Banque Havilland, a well-established banking group offers services to both ***private*** *and* ***institutional*** *clients, who can benefit from the advantages of a robust banking platform located across seven financial centres. The bank was founded in 2009 in Luxembourg, where it has its head office, and today also has presences in Monaco, Liechtenstein, London, Dubai, Geneva and Zurich.*

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MARKET ENVIRONMENT

Forecasting market returns over a certain period has always been something of a folly – more a ritual exercise for marketing purposes or for the entertainment of those who don't follow the markets closely, than an accurate means of determining the correct asset allocation over the same period – and trying to do so during the fog of Covid and the associated government restrictions makes it an almost meaningless task. Many investment outlooks for 2022 will have been written in late November/early December, before the outbreak of the Omicron Coronavirus variant, while others will have been in mid-December as many regions were re-entering yet another set of social restrictions for an unknown length of time, with the seriousness of the latest variant as yet confirmed.

"A focus on economic growth and corporate profits over the medium to long terms remains the best guide to asset returns, and therefore remains our focus, however interesting the prevalent news-flow may be. Furthermore, we are not in the business of making return predictions, but rather identifying a sensible mix of financial assets that have a good chance of providing positive returns over a multi-year period without betting too heavily on a few assets or outcomes."

As human beings have become more resilient in coping with the restricted version of life, so has economic growth and (by proxy) risk assets, and we have maintained our optimism since mid-2020 that the recovery will continue, even if it is basically delayed at times as Covid variants or other negative events dominate the headlines. A focus on economic growth and corporate profits over the medium to long terms remains the best guide to asset returns, and therefore remains our focus, however interesting the prevalent news-flow may be. Furthermore, we are not in the business of making return predictions, but rather identifying a sensible mix of financial assets that have a good chance of providing positive returns over a multi-year period without betting too heavily on a few assets or outcomes. Most analysts have published expected high single-digit returns for the S&P 500 in 2022, which seems intuitively sensible, but is almost certainly influenced by a desire not to be too bullish but also to avoid predicting a loss, though in reality is likely to be some distance out. The average return of the main US Index is indeed around 8% since 2000, though in the past 10 years it is double that and it is rare to have a return around 8% in a single year – actually a gain of 10-30% is more common, and indeed a loss of -20% has occurred more than a high single-digit gain! Thus, stock-market predictions should be taken with a pinch of salt, with a focus on the underlying health of the economy and monetary backdrop being more useful.

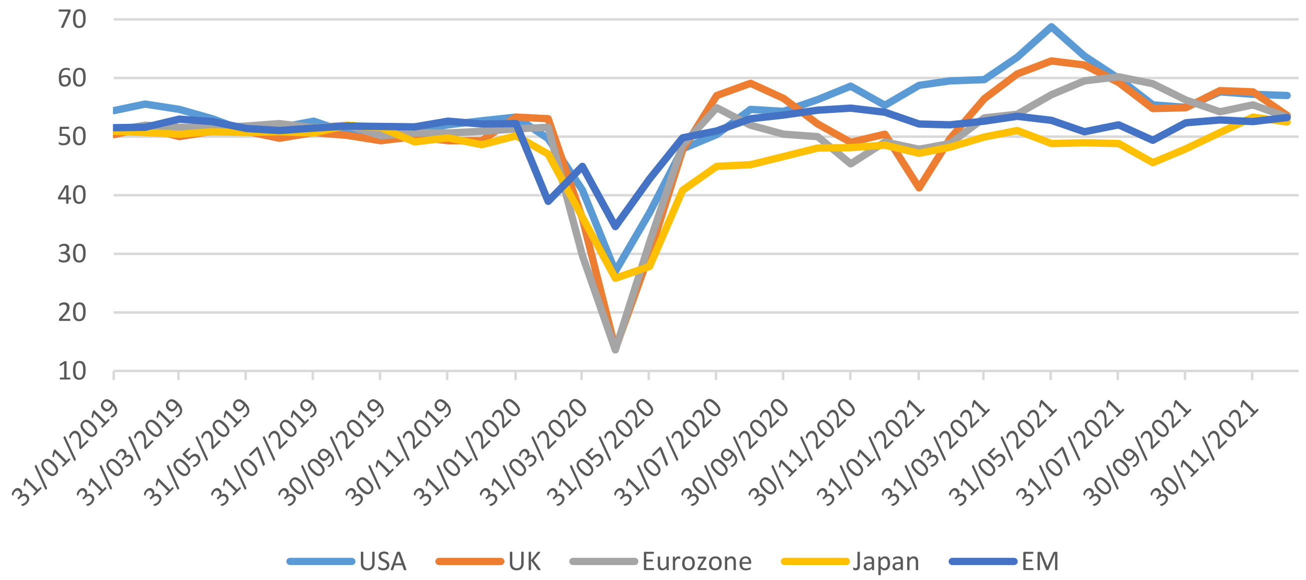
This is perhaps demonstrated by the performance of the global equity index last year, that returned around 20% despite on the face of it, 2021 not being a vintage year in terms of what markets had to contend with: While vaccine rollouts were by and large quick and successful, they did not prevent many of us being in de facto lockdowns (thus suppressing activity) for large parts of the year; geopolitical risk resurfaced (China/Taiwan, Russia/Ukraine) public debt levels rose sharply; equity and bond valuations continued to defy gravity; and inflation really took off along with energy prices as central banks did their best to assure us rate rises were coming as a supply crunch occurred – abetted by a large ship blocking the Suez canal! None of these factors would suggest a favourable environment for risk assets so we are left with rebounding GDP, rebounding earnings and a continued easy monetary environment to explain the strong performance of most stock markets, with a flourish in the final few days of the year (as markets absorbed improving Omicron-variant optimism) providing the icing on the cake.

Overview of the IMF World Economic Outlook Projections (Percent change)

	YEAR OVER YEAR		
		PROJECTIONS	
	2020	2021	2022
World Output	**–3.1**	**5.9**	**4.9**
Advanced Economies	**–4.5**	**5.2**	**4.5**
United States	–3.4	6.0	5.2
Euro Area	–6.3	5.0	4.3
Japan	–4.6	2.4	3.2
United Kingdom	–9.8	6.8	5.0
Other Advanced Economies	–1.9	4.6	3.7
Emerging Market and Developing Economies	**–2.1**	**6.4**	**5.1**
Emerging and Developing Asia	–0.8	7.2	6.3
China	2.3	8.0	5.6
India	–7.3	9.5	8.5
Emerging and Developing Europe	–2.0	6.0	3.6
Russia	–3.0	4.7	2.9
Latin America and the Caribbean	–7.0	6.3	3.0
Brazil	–4.1	5.2	1.5
Mexico	–8.3	6.2	4.0
Middle East and Central Asia	–2.8	4.1	4.1
Saudi Arabia	–4.1	2.8	4.8
Sub-Saharan Africa	–1.7	3.7	3.8
Nigeria	–1.8	2.6	2.7
South Africa	–6.4	5.0	2.2

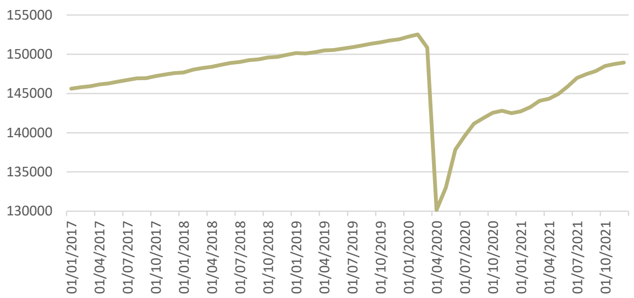
Growth is set to modestly continue in most developed nations. Among emerging markets there is significant divergence, with many experiencing sluggish recoveries that do not justify an equity allocation.

Composite PMI's



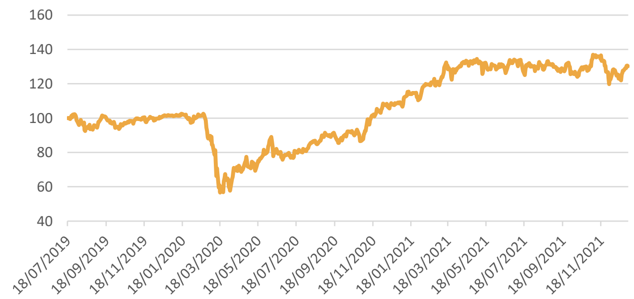
PMI's completed their rebound mid 2021 and while they mostly indicate growth, the momentum has peaked poiting to more modest economic actvity this year.

US Non Farm Payroll



The jobs market continues to recover towards pre-pandemic levels, with many job-seekers leaving the market altogether.

Wage inflation



Wage inflation seems to be lagging the tight jobs market - when this converges it will further fuel higher inflation.

Baltic Dry Index

Shipping costs have fallen from their peak in late 2021 - this should ease some of the inflationary pressures that have mounted.

The outlook for the global economy is once again positive as we move into the new year, with the IMF expecting growth of 4.9, new Covid outbreaks/restrictions notwithstanding, but we must temper this optimism for markets with the reality that central banks are set to act in 2022, which may be the biggest factor in preventing a fourth consecutive year of double-digit equity returns. In December, the Bank of England belatedly fired the starting pistol among major central banks for the new rate hike cycle while the Federal Reserve is reducing its monthly asset purchases twice as fast as previously planned making it on course to finish its Quantative Easing programme by the Spring, with three rate hikes planned for 2022. The importance of the effective ending of 'free money' cannot be underestimated, and while markets are currently taking the development in their stride, the longer term impact has surely yet to be felt – a decade of stimulus means equities have become used to an artificially suppressed risk free rate of return. The Fed is not the only central bank in town, however, and though the ECB has hinted at a slightly less Dovish approach it has become further entrenched in its 0% rate policy following the re-imposition of social restrictions across several member states, and has doubled its existing Asset Purchase Programme in the short term as it attempts to wind down its Pandemic Emergency response by March. In Japan the BOJ has committed to its ultra-loose policy, actually extending its pandemic relief loan scheme for a further six months, while China cut its reserve requirements ratio by 50bps in December, so it clear that we are far from any sort of meaningful global tightening where stimulus comes to a sudden halt. In terms of rate rises too, while the reversal in the direction of travel is of course important, it should be remembered that after even three Fed hikes in 2022 the Reserve rate is not expected to be higher than 1%, i.e. still incredibly low by historic standards and hardly a cost of borrowing high enough to stunt growth. Threatening this cosy backdrop of a glacial monetary tightening environment, however, is inflation, which remains rampant and consistently higher than monthly expectations indicate. Central banks and governments alike are praying that price pressures will return to pre-pandemic levels, but it has become increasingly apparent that this is unlikely – energy prices are still rising fast and the labour market remains very tight. Undoubtedly some aspects to the inflation we've seen have been pumped up by the rapid nature of the global recovery, where supply has essentially suddenly outstripped demand such as oil and the price of petrol (up 58% for the year by the end of November), however, other aspects will be less transitory: ports and shipping lines may have started to unclog but the main Chinese ports have been putting up their rates by 10-20%, and this has yet to feed through. Likewise wage inflation has yet to properly register in the inflation statistics. With hiking expectations priced in to markets, should more virus-shocks require it, then Central bank inaction should be enough to soothe any financial worries (i.e. policy makers have created room for Dovish surprises) so we think the Fed and its' counterparts falling behind the curve with respect to inflation is the most probable risk to market sentiment in the coming year. Even after stripping out Covid-sensitive items and base effects, inflation is still running way above the central bank's official target at 3.6% and it seems increasingly apparent that the dilemma of raising rates too quickly and precipitating a market crash or holding firm and letting inflation rip will be the theme of the year. We can only hope that inflation starts to plateau, thus giving policy-makers and markets some breathing space. Inflation aside, there other reasons for investors to be cheerful – along with anticipated economic growth, consumer sentiment is buoyant, there are excess US household savings of USD 2.2 trillion and global gross savings are at an all-time high of 28% (IMF) while comfort can be taken from the increasing resilience of developed economies to Covid restrictions (fears of drastic changes to consumer habits have so far proved unfounded). The shape of the Federal Funds curve suggests an interest rate of less than 2pc by the end of 2026. Thirteen years on from the financial crisis, with rates still on the floor, lower for longer continues to look like the most probable scenario. As ever, a range of outcomes is possible and we advocate a fully invested approach but with a cautious, selective allocation with a view over the longer term – thus negating the need to make meaningless predictions.

EQUITIES

The relative appeal of stocks over bonds probably remains the most compelling reason to own them, aside from them being the best way to participate in an improving corporate profit environment, though as bond yields look to continue rising it is important to recognise that not all equities will benefit from this trend. As bond prices fall and their income yields improve, growth stocks (defined as those with greater future return potential) become less appealing and we have seen recently that when central banks become more hawkish, bonds have sold off along with the more speculative parts of the equity market. The well-documented 'stay at home' theme that dominated the 2020 equity rebound was led by stocks that supposedly represented the 'future', e.g. e-commerce, video-calling, online gaming, electric cars etc, and investors were seemingly able to stomach the high valuations of these areas as the pandemic rolled on indefinitely and bond yields remain suppressed. At the time of writing the bubble seems to be bursting, and there is no better epitome of this than the ARK Innovation ETF that having tripled in price in 2020 is now over 45% lower than its peak in early 2021- perhaps it will recover just as quickly but in the meantime it is a reminder how violently prices can correct when valuations have lost touch with reality. Value stocks, however, did not shoot the lights out in 2021 as many expected, having threatened to do so during the first half of the year as vaccine/reopening optimism gave way once more to a protracted and bumpy recovery outlook. We have seen enough evidence that value and cyclical stocks do outperform when the pandemic clouds lift, but unfortunately, this has too often been short-lived with policy seemingly defaulting to social restrictions with the obvious connotations for travel/leisure/retail/energy companies. It is notable in the equity market how closely the relationship between value and growth stocks is mirrored by that between sectors that stand to benefit from post-Covid normalisation and those that were winners during the pandemic. In other words, post-Covid recovery sectors share characteristics with value stocks, while those that performed well through lockdown look a lot like growth stocks.

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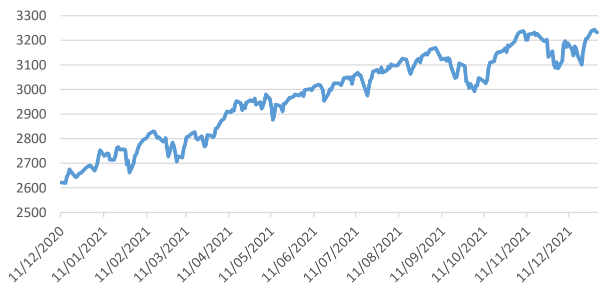
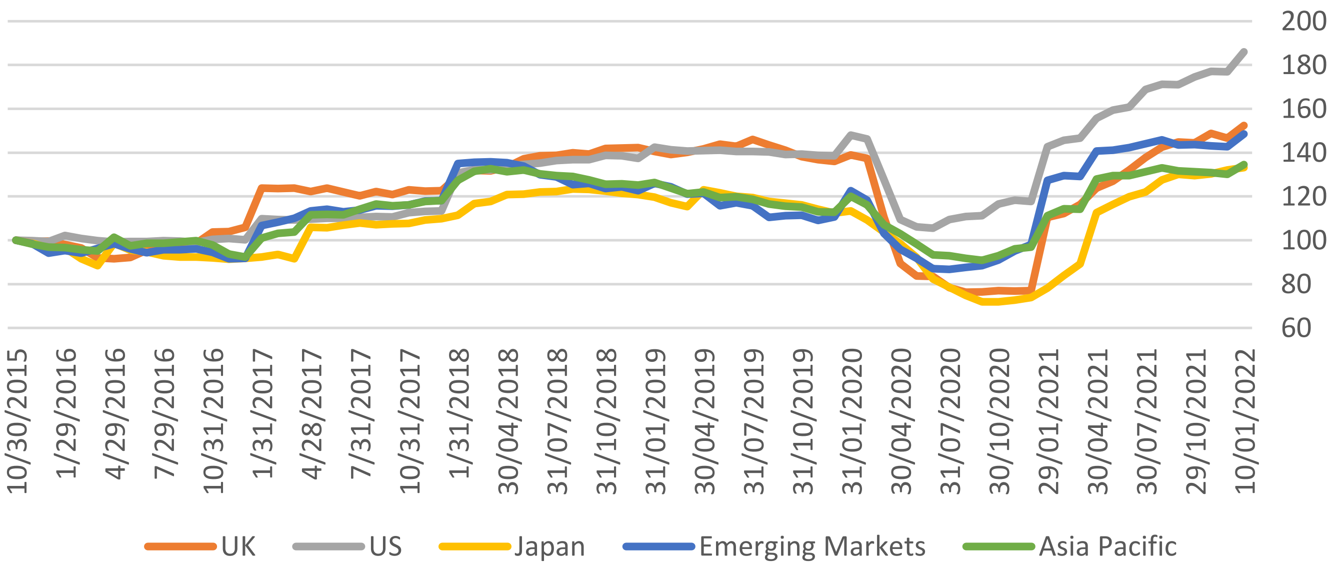
Broadly speaking, the market remains unconvinced that the pandemic is over, and we feel that this points to further outperformance potential for value/cyclicals, particularly as the apparently more virulent but less lethal Omicron becomes the dominant virus strain meaning major economies should take a 'learn to live with virus' approach. The bull-market remains intact for now, supported by a decent growth outlook and an earnings outlook that points to a year of over 20% EPS growth for the global stock index, though we note this is not carried forward into years beyond 2022. Though stocks are relatively preferable to fixed income assets, we are cognizant they would be vulnerable to genuine inflation such as wage growth that could hit already elevated profit margins and hence damage corporate earnings per share.

World Equities in 2021



The global stock index has recovered to all-time highs - while we expect equities to outperform, a pull-back from these levels would be no surprise.

Earnings



Earnings expectations are still optimistic, though this could wear off as growth momentum stalls. There is scope for other regions to catch up with the US.

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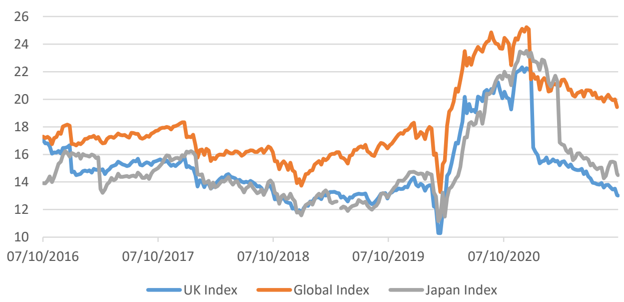
EQUITIES								Large swathes of the global economy have further to recover from the growth shock of the pandemic, pointing to more returns for equities. Markets are at record highs, however, so caution is needed.
US								Remains a very expensive market, supported by Federal Reserve liquidity and high investor participation. Growth stocks look set to be punished by higher rates.
UK								British stocks are at their cheapest versus global stocks for many years, and should benefit from the catch-up/ value rotation.
Eurozone								Cyclicals (financial and energy stocks) will benefit from a resumption of the reopening trade, providing nations don't default to lockdowns
Switzerland								Quality, defensive nature of the market continues to see Swiss stocks in demand, though valuations rich now.
EM								Though we retain an allocation to emerging Asia for the long-term growth story, most developing markets look challenged by Covid. Buying opportunity in China soon?
Japan								Attractive valuation for a developed market and we like the safe-haven qualities of the currency. Domestic growth is improving with supportive monetary policy.

The US economy looks robust, and providing there is no major Fed misstep, North American equities look well set for more returns though should other regions catch up with their vaccine programmes and reopening momentum there is a good chance the US will give up its market leadership as it did briefly in the first half of 2021 with some deceleration from the double-digit returns of the past three years likely. We therefore have a neutral view from a passive perspective on the US, but see opportunity for outsized gains in the small-cap market given the valuation re-rating at the end of 2021 and their close alignment with the US economy. We prefer a valuation-conscious approach to the large caps with a particular care to avoid the aforementioned froth of some of the overpriced technology/online stocks until they come back down to earth. Our preference for a reasonable valuation continues to draw us to British stocks and it's a source of frustration but also opportunity that the UK valuation discount did not close in 2021. The UK remains on a material valuation discount to the rest of the world even when sector adjusted. This is despite the most dramatic downside risks of a new relationship with the EU failing to materialize and an advanced vaccine program. We also like Japan, where COVID-19 case numbers have fallen back to very low levels and the positive economic impact from its initial reopening is starting to emerge. Looking forward to 2022, we believe a combination of the pent-up demand linked to reopening and the government's large fiscal stimulus plan all but guarantee a period of significantly above trend growth which should be a tailwind to corporate profit growth at a time when the yen is trading at a favourable level for the manufacturing sector. As for the Eurozone, much will depend on the various nation's willingness to 'live with the virus' and there are swathes of companies that are perfectly healthy and profitable but whose price potential is being illogically suppressed by the threat of further lockdowns. There is great scope for a recovery for these companies, once the fog of Covid has lifted, while the loose monetary background provided by the ECB in contrast with the Fed could provide an extra boost. We expect to once again add to our Chinese equity exposure at some point, once the current cycle of regulation, policy tightening and financial de-risking has matured. The Evergrande situation has yet to fully play out, but appears to be fading in terms of systemic importance and it is likely that following the 20% fall in the Chinese market, there will be a return of the administration's growth focus with a loosening of credit policy and regulation. The valuation is once again attractive at around 18X PE, but the optimism is tempered by the zero-covid policy which may scar economic growth is it continues indefinitely.

British and Japanese stocks: 12M Fwd P/E ratios



British and Japanese stocks are cheap compared with the Global index and also against their own recent valuations.

FIXED INCOME

While bonds remain an important part of a diversified portfolio for capital preservation reasons, we continue with a minimum allocation to the asset class, bearing in mind the largely unfavourable (rising rate) environment that is looming. We expected a greater move in yields last year, (but in an inverse move to value stocks) bond prices were given some respite in the middle of the year as the prospect of a more sustained period of restricted economic activity became apparent. However, this respite has now passed and with the lethality of the Omicron variant seeming to have been overestimated, persistent inflation, and an increasingly Hawkish Fed – yields have resumed their inevitable climb and headline US treasuries are now here they were in March last year. While still historically low, front end yields are leading the sell-off, and look certain to approach pre-pandemic levels soon (around 1.5% for US 2 year Treasuries). Having said this, and despite the recent hawkish rhetoric, it is clear that central bank action will be very cautious and therefore we do not foresee a taper tantrum in the vein of 2013, but rather a more orderly decline in Treasuries. Of course, the divergence in monetary policy suggests that European and Japanese Sovereigns may well fare better than US and UK, but with the majority of the formers' curves being in negative territory there is little incentive to hold these bonds for either income or capital preservation over any serious length of time, while such valuations look hard to justify when the region is experiencing above-average growth and its central banks are reducing stimulus. In credit markets, investment grade bonds are currently less attractive on a total return basis. Spreads are tight and total returns are low, and we see little sign they will improve any time soon. Fundamentals are also weak compared to history. Even if they do improve, this would be offset by a deterioration of credit quality, in our view. In high yield, defaults should remain fairly low with the cost of rolling over debt to stay manageable.

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US 2yr Treasury Yield

As the global recovery picks up again, and monetary policy tightens, Treasury yields look set to rise, with 1.5% being the next line in the sand.

2 Year Bond Yields Global

REGION	SECURITY	YLD
Switzerland	SWISS 4 02/11/23	-0.77
Belgium	BGB 2 1/4 06/22/23	-0.675
Austria	RAGB 0 07/15/23	-0.674
Netherlands	NETHER 1 3/4 07/15/23	-0.673
France	FRTR 0 02/25/23	-0.665
Finland	RFGB 0 09/15/23	-0.638
Denmark	DGB 1 1/2 11/15/23	-0.633
Ireland	IRISH 3.9 03/20/23	-0.616
Germany	BKO 0 12/15/23	-0.6
Portugal	PGB 4.95 10/25/23	-0.576
Spain	SPGB 0 04/30/23	-0.562
Greece	GGB 3 1/2 01/30/23	-0.442
Sweden	SGB 1 1/2 11/13/23	-0.172

REGION	SECURITY	YLD
Italy	BTPS 0 01/30/24	-0.081
Japan	JGB 0.005 01/01/24	-0.08
Israel	ILGOV 1 1/2 11/30/23	0.13
Hong Kong	HKGB 0.31 11/22/23	0.527
Australia	ACGB 2 3/4 04/21/24	0.663
United Kingdom	UKT 0 1/8 01/31/24	0.819
Singapore	SIGB 2 02/01/24	0.9
United States	T 0 3/4 12/31/23	0.911
Canada	CAN 0 1/2 11/01/23	1.072
Norway	NGB 3 03/14/24	1.403
New Zealand	NZGB 0 1/2 05/15/24	1.992
Iceland	ICEGB 2 1/2 04/15/24	3.58

	-			=	+			
FIXED INCOME								An unattractive asset class as a standalone investment, with tightening policy and stubborn inflation to push yields higher
Sovereign Bonds								Sovereigns offer safe harbour in time of market stress, but have limited upside remaining and negative real yields long-term. TIPS a bright spot.
Corporate I.Grade Bonds								Central bank asset purchasing is supporting corprates for now, but tapering is on the horizon and spreads are very compressed.
High Yield Bonds								Yield pick-up is still relatively attractive, but low historically. Default risks are a concern, but low nevertheless.
E.M. Bonds								Local currency appreciation in an economic recovery, together with meaningful yield pickup make certain EM bonds relatively attractive. Short duration.

Liquidity is still plentiful and the demand for yield is strong - supportive factors that we expect to continue, and we have observed that buyers return to the market when even some yield is on offer. Some specific sectors offer value, such as energy, and spreads may compress further from here. The asset class's lower interest rate sensitivity is also appealing in an environment where government bond yields may rise. Overall we still think a lower duration stance for a fixed income basket is prudent when rates are essentially rock-bottom and can only meaningfully move in one direction, and we expect volatility especially around Fed meetings.

With respect to Emerging Markets, we believe a selective approach to quality, low duration bonds is very much worthwhile despite the challenges faced by the various developing regions. As we mentioned earlier, sentiment may depend very much on China (the biggest driver of EM activity for 20 years) which is currently deprioritising growth in favour of improving social cohesion, de-levering the property market and reforming many parts of the private sector – if and when this ends, EMD could be well-placed to benefit. We prefer countries that are further advanced with their vaccine programmes, and also those that are further along their rate tightening cycles – pointing to Russia, Brazil and Mexico. Turkey needs to be avoided as the experiment of cutting rates against an extremely high inflation backdrop may prove to be very painful for debtors in the country. It is also possible that Dollar strength has peaked, which suggests that in time a transition to more local currency exposure could be a good strategy, particularly in regions where growth is returning, but for now, while uncertainties are rife, a hard currency basket is the best tactic. Rather than chasing yield at the expense of questionable credit quality, we prefer to seek diversification and we feel that high-quality structured credit and asset backed securities fit the bill in this respect. Therefore we retain an allocation to this sub-asset class as it tends to perform relatively better in period of rising rates given to the inherently average lower duration.

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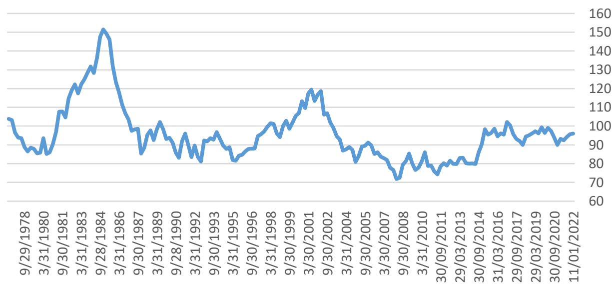
CURRENCIES AND COMMODITIES

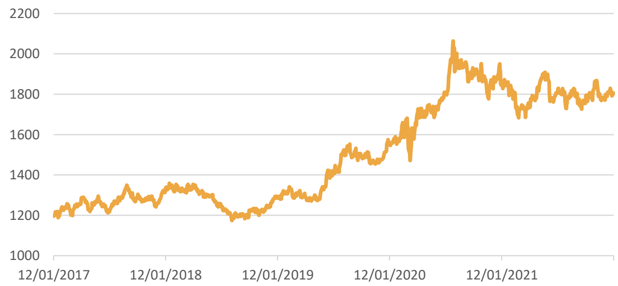
The US Dollar index that measures the greenbacks value against a basket of major trading partner's currencies climbed over 7% last year, tracking America's rapid post-pandemic bounce back and the widening rift in rhetoric between the Federal Reserve and other central banks, the Bank of England excepted. Undoubtedly the residual virus fears also kept many market participants in cash, and by proxy in US Dollars. The US recovery looks to have largely completed however, and if the reopening trade resumes in earnest then the Dollar strength may to start to fade as other economies play catch-up. Should central banks stick to their current narratives then the divergence should continue with daylight between the majors, but much will depend on the relative nations Covid policies and the speed at which growth returns. GBP for example should benefit from a fairly relaxed social restriction policy and a rate-rising central bank compared with the EURO, where the ECB remains cautious and where several member states are wed to strict lockdown imposition. This of course can turn on its head if the hawkish BOE agenda ends up stunting the economic recovery in Britain, while the Eurozone economy splutters into life with the accompanying inflationary pressures forcing the ECB's hand earlier than anticipated. Essentially a weaker dollar will probably signify a good thing as far as global economic heath is concerned – as it will indicate the rest of the world is recovering, US rates are normalizing and commodities that the world relies on will be cheaper for non-US economies. Commodities enjoyed a bumper year in 2021 with the wider index up over 25%, even as reopening sentiment softened, helped by supply bottlenecks and demand for raw materials. So called 'green' metals (i.e. those needed in the shift to renewable energy and electric vehicles) are doing especially well, with copper catching the eye climbing 23%, and lithium (for rechargeable batteries) more so at 240%. It is difficult to see this trend reversing while governments push on with their green agendas while the required resources appear finite. More traditional, cyclical materials such as oil and iron-ore largely followed other assets exposed to the virus/economic sentiment (i.e. a strong first half of the year and weaker second half) and this a pattern we expect to continue as virus sentiment battles economic activity in the coming year.

US Dollar (DXY) 30 years



The Dollar has been strong over the duration of the pandemic, but the longer term trend is down.

Gold Spot Price



Gold failed to shine in 2021 despite the extraordinary negative yield backdrop - nevertheless the 5 year trend is positive.

Such commodities can be a useful exposure for portfolios where investors are concerned about runaway inflation. Precious metals, namely Gold, had a perplexingly disappointing year during a time that real yields (income adjusted for inflation) stooped to deeply negative levels which is when it is supposed to be especially appealing. On the face of it the outlook for Gold does not look good with rates set to increase and inflation thought by many to have peaked, however, any turns in risk sentiment such as further Covid 19 shocks will see the safe-haven appeal return, while as we posited earlier - tightening policies are not globally universal and are set to set to be very gradual in any case. The yellow metal remains as good a hedge as any against general risk-off market situations. We remain on the lookout for genuine alternative assets to diversify away from equities and bonds, but as yet this does not extend to the world of cryptocurrencies which have so far been shown to predominantly correlate with 'risk-on' sentiment albeit with substantial volatility. 2022, however, is set to be a milestone year for crypto now that the long sought approval of the first US-based ETF has been given, meaning there is now institutional access to the asset class which could usher in a more mature era, rather than essentially being a retail betting market.

Commodity Index

Commodities, led by industrial metals and crude have rallied sharply since March 2020 and reflect the reflating global economy.

		-		=		+		
CURRENCIES								While the US economic growth story is losing a little momentum, the Dollar remains relatively in demand due to central bank divergence versus other major currencies (GBP excepted)
U.S. Dollar (DXY)								Rate rises are largely priced in. While a huge stimulus bill will boost the economy, the debt pile grows.
Sterling (GBP)								The UK recovery has peaked, and despite short-term energy tribulations the pound should continue to claw back post Brexit underperformance, supported by BOE (eventually).
Euro (EUR)								Variant over-reaction a risk to economic growth, and ECB not intending to move any time soon will see EUR under pressure.
Japanese Yen (JPY)								JPY has fell around 10% in 2021, but only back to pre-Covid levels and broadly in line with its 5yr average. A nice currency for diversification in risk-off times.
Swiss Franc (CHF)								CHF remains a genuine safe haven. Nice diversifier, though global recovery could dampen demand, with SNB curbing upside.
EM								Many EM nations remain mired with Covid and Political setbacks and inflation. Mixed rates directions in other EM. PBC cutting rates.

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