Q2 2022 OUTLOOK

APRIL 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.*

TABLE OF CONTENTS

MARKET ENVIRONMENT

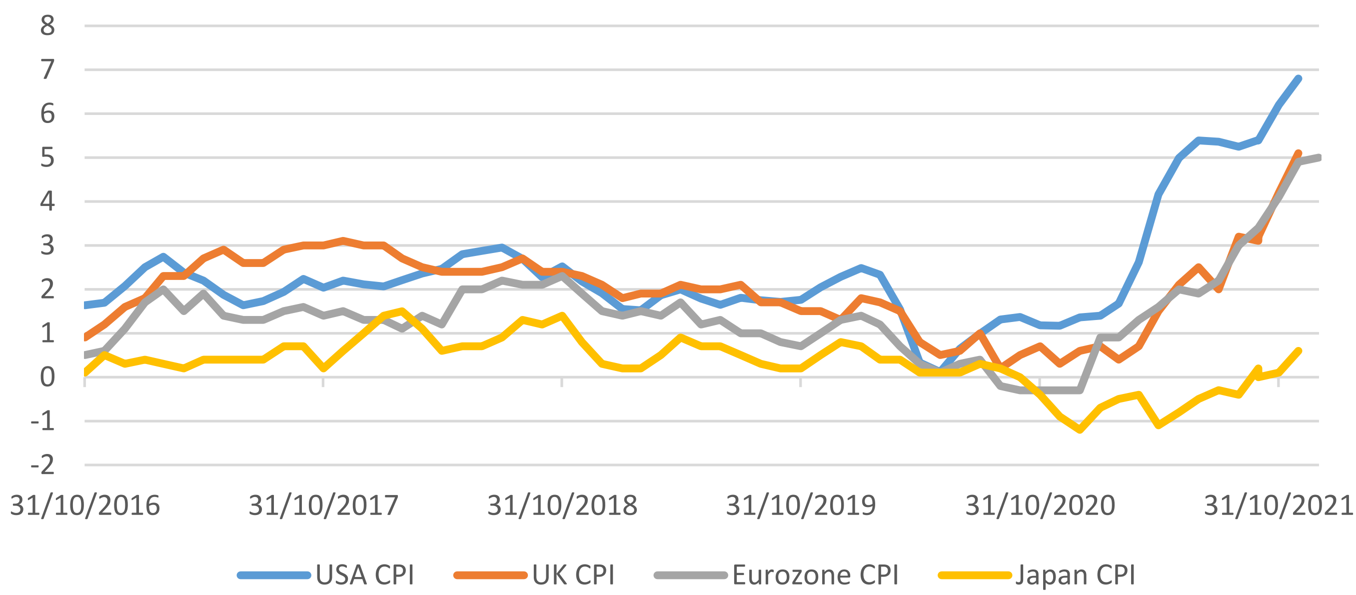
The Russian attack on Ukraine could hardly be classified as a 'black swan' event as far as markets are concerned with the disintegrating breakdown of diplomatic relations clearly apparent since the start of the year and the Putin regime making little secret of its views towards the former Soviet countries, but nevertheless financial assets have been rocked in the first quarter of the year and many of the globalist economic assumptions of recent decades require reconsideration.

> *"While the initial focus was on the impact of the world's energy supply, with Russia being a major exporter of oil and gas, attention is now starting to drift towards other commodities as disruptions in the flows of grains and oilseeds – staples for billions of people and livestock across the world – are sending prices soaring."*

Despite the obvious humanitarian cost and disruption the region is experiencing, following an initial burst of volatility and flight to safety the markets seem to have largely digested the outbreak of war and seem to be settled on the narrative of a drawn-out, stodgy Russian campaign, with most equity indices having recovered much of their 2022 losses and headline bond yields in apparent free-fall. Undoubtedly, runaway inflation and the anticipated reaction of the worlds' central banks is the dominant theme investors are contending with at the moment, but of course this is exacerbated by the Ukraine conflict due to the regions' significance in terms of exporting core global commodities. While the initial focus was on the impact of the world's energy supply, with Russia being a major exporter of oil and gas, attention is now starting to drift towards other commodities as disruptions in the flows of grains and oilseeds – staples for billions of people and livestock across the world – are sending prices soaring. Countries fearing potential food shortages are scrambling to find alternative suppliers and therefore new trades and opportunities are emerging. Western economies that have become increasingly 'service-led' over the years suddenly look vulnerable as the assumption of indefinite global peace and the resulting 'just in time' supply chains fall apart. If the pandemic was the first warning of this, then the outbreak of war and the realisation that the supply of still-essential commodities were concentrated in the hands of a few nations that do not necessarily have the best interests of the global economy as their primary concern was certainly the rude awakening. The readjustments required will not happen overnight, and in the meantime, the prospect of 'stagflation' is a concern for investors.

The conflict at the edge of Europe has merely supercharged an inflationary trend that was already in full swing due to the global response to the Covid pandemic - while supply chains were already stretched, 2021's price hikes were mostly demand-driven as people had more money to spend due to Covid-19 relief spending and pent up savings from 2020. The demand last year was accompanied by higher wages and booming employment, however, the current surge in inflation is more a result of a commodity supply shock that does not appear to be quickly resolved and central banks have largely given up on their attempts to reassure us that higher prices are 'transitory/transient/ temporary'. Furthermore, fears of a recession are growing with the aggressive re-pricing of the bond market seeing a flattening (and temporary inversion) of the yield curve, an occurrence that has historically been a leading indicator of an economic downturn. While most recessions are deflationary, the current environment where we are seeing higher energy prices is reminiscent of the 1970's Middle East oil embargo, i.e. the 'wrong sort' of inflation that is not a product of economic growth. This is why we continue to exercise a cautious approach to equities at the moment, as it may be that the traditional outperformance of stocks during bouts of inflation may not hold true this time around when growth is threatened by the reduction in disposable incomes, rather than being activity-generated. Overall, many economies are set for above-trend growth this year, but the optimistic projections from the start of the year must surely be tempered somewhat with the Russia-Ukraine war entering its third month, persistent volatility in energy prices and a deteriorating outlook in consumer sentiment in both the US and Europe. It may be that economic indicators start to tail off as inflation starts to bite later on in the year, but we note that many remain in robustly positive territory on a global level: PMI data is largely in growth territory while household balance sheets remain healthy with their debt service ratio 4 percentage points below 2008 levels and savings rates are largely decent with individuals yet to have spent all their lockdown excess. In truth, human error in the form of a central bank misstep looms as the most likely disruptor of market harmony, with the inflationary backdrop increasing the pressure on them to act notwithstanding the less rosy outlook for growth.

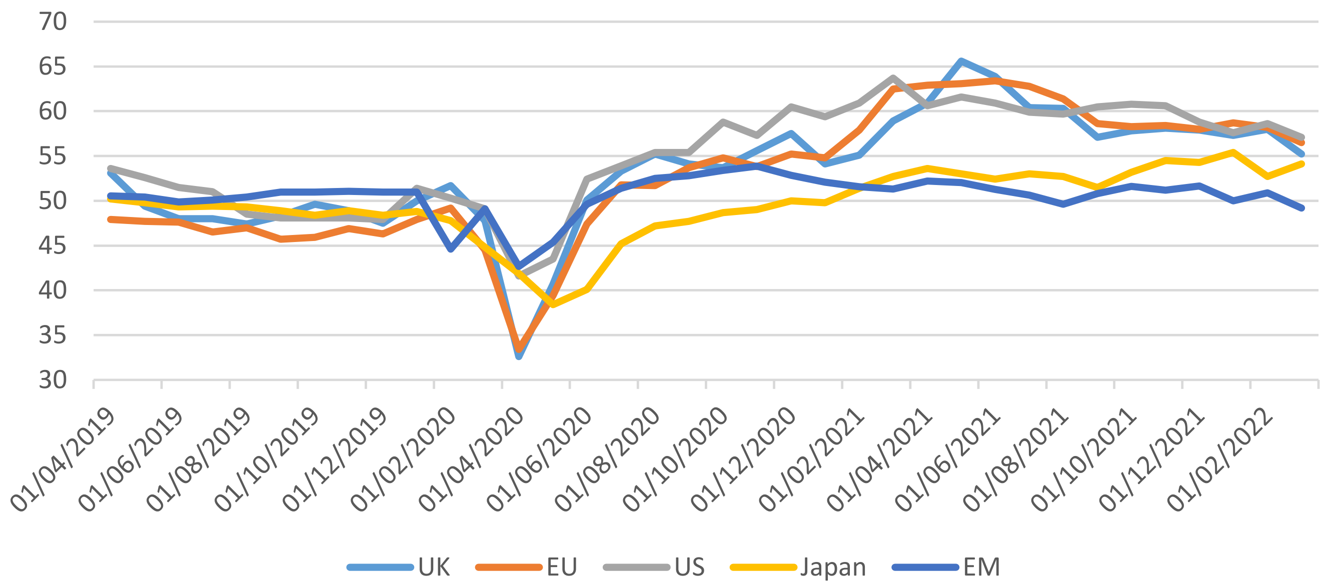
Inflation



Inflation continues to rise faster than expected, meaning negative real yields are deep and making fixed income assets unattractive.

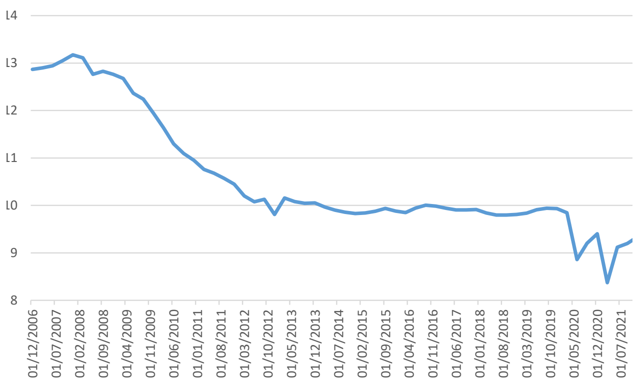
With CPI at around 8%, 6% and 6% respectively in the US, UK and Eurozone, inflation is already well ahead of central banks supposed target of around 2% and this before tightening has barely begun in earnest, so the risk of central banks quickly losing the initiative when it comes to controlling prices is clear to see. A key gauge to watch in terms of a further leg-up for inflation will be wages, which as of yet have not started to push higher but could become self-fulfilling should the publics' expectations of inflation harden – if wage inflation takes hold (on top of the commodity–led surge we are already experiencing), then spiralling inflation may be on the cards. Jerome Powell has suggested that the Fed could even serve up a half point increase rather than the usual 0.25% if inflation is seen higher than expected, so it may be time to prepare for an environment where the central banks are unable to effectively underwrite the equity markets as they have in most market participants lifetimes.

Composite PMI's



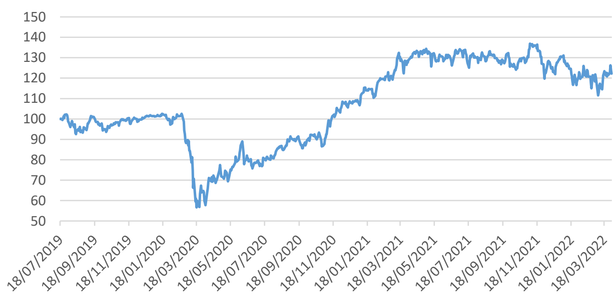
PMI's are in economic expansion territory (above 50), but appear to show a slower rate of growth

US Household Debt Service Ratio %



Household debt levels are not particularly stressed, suggesting consumers have a buffer against higher prices, which could support equities.

Wage inflation



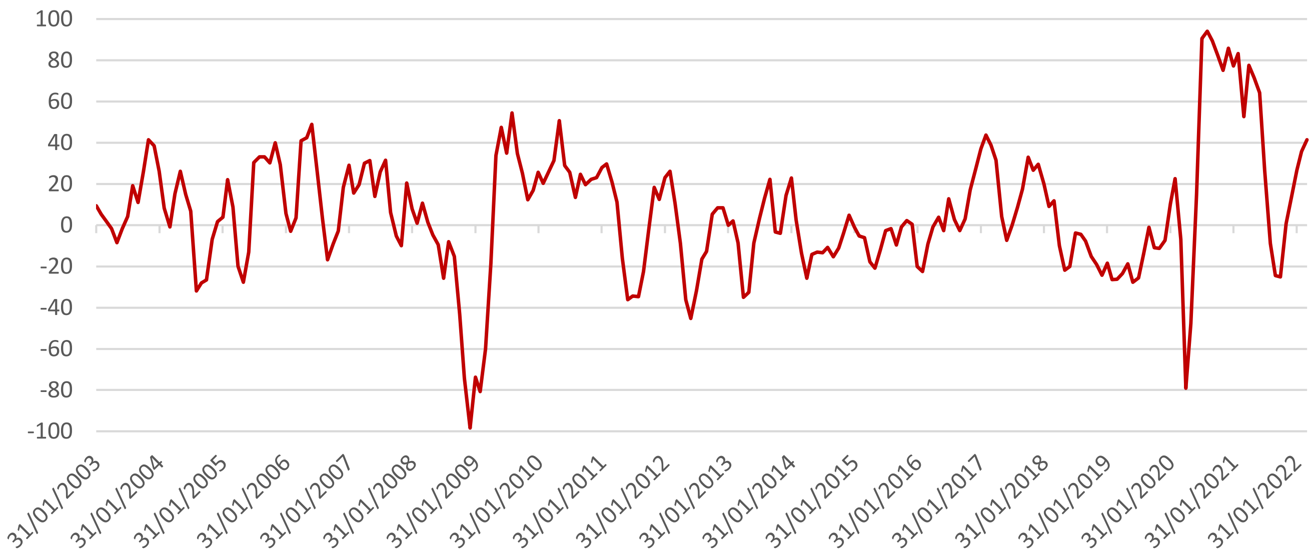
Wage inflation has still yet to meaningfully move considering the tight labour market and higher inflation.

Overview of the World Economic Outlook Projections (Percent change)

		PROJECTIONS	
	2021	2022	2023
World Output	**5.9**	**4.4**	**3.8**
United States	5.6	4.0	2.6
Euro Area	5.2	3.9	2.5
Germany	2.7	3.8	2.5
France	6.7	3.5	1.8
Italy	6.2	3.8	2.2
Spain	4.9	5.8	3.8
Japan	1.6	3.3	1.8
United Kingdom	7.2	4.7	2.3
Emerging Market and Developing Economies	**6.5**	**4.8**	**4.7**
Emerging and Developing Asia	7.2	5.9	5.8
China	8.1	4.8	5.2
India	9.0	9.0	7.1
Emerging and Developing Europe	6.5	3.5	2.9
Russia	4.5	2.8	2.1
Latin America and the Caribbean	6.8	2.4	2.6
Brazil	4.7	0.3	1.6
Mexico	5.3	2.8	2.7
Middle East and Central Asia	4.2	4.3	3.6
Saudi Arabia	2.9	4.8	2.8
Sub-Saharan Africa	4.0	3.7	4.0
Nigeria	3.0	2.7	2.7
South Africa	4.6	1.9	1.4

Future growth as been revised down in light of the Russia-Ukraine war. India stands out within emerging markets, while the UK and Spain are interesting in the developed world.

Global Citi Surprise Index



The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

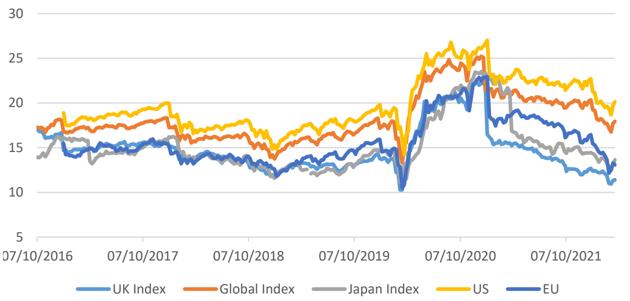
EQUITIES

The imminent direction of the equity market has seldom felt so unclear as it is now following the rebound that has occurred as investors have come to terms with the Ukraine situation, but now faced with the first bout of real monetary tightening in some years. This earnings season promises to be one of the most keenly-watched in some time, and it will be very interesting to see if companies are managing pressure on margins, and what that implies for the bottom line. Earnings per share expectations have shot up in recent weeks even as cost pressures could quickly become elevated: US unemployment has dropped below 4% and wage growth has just started to pick up, as indicated by the Atlanta Fed Wage Growth Tracker. Businesses will have to absorb rising labour costs without hitting margins while simultaneously dealing with the costs of other inputs such as commodities, materials and fuel. We also note with interest the successful unionization of an Amazon warehouse in New York, that represents an early warning sign that the wage suppression that corporates have become used to in the increasingly globalised economy may soon be a thing of the past. Bond markets are pointing to economic stress and record-high inflation has left central banks cornered, unable to resist hiking rates and taking liquidity out of the market that increases the probability of a downturn, and yet equities remain well supported. Part of this can be explained quite simply, by the fact that equities are relatively more attractive than fixed income not only in terms of capital growth potential but also real yield – while nominal bond yields have moved substantially, they have come from such a low base while inflation is quickly increasing that real sovereign bond yields are still negative. For investors looking to protect real returns certain equity markets are offering dividend yields of 3-4%, and of course, a targeted income approach could see this number higher still. Furthermore, valuations for many stock markets have fallen to below long-term averages – even a fairly crude look

“Businesses will have to absorb rising labour costs without hitting margins while simultaneously dealing with the costs of other inputs such as commodities, materials and fuel.”

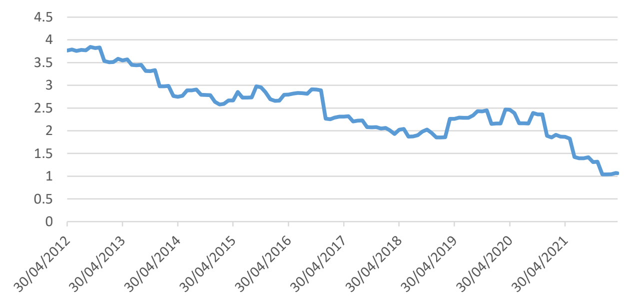
at the global index (that is dominated by US companies) shows the P/E Ratio has fallen below its average level of around 21 since 1995, and well below its’ 2021 peak of 33. Looking at regional indices on the same metric, and there are cheaper valuations still for the UK and Japanese markets in particular. Finally, the corporate sector is looking pretty healthy in general at this point, notwithstanding the price pressures that are likely to come: balance sheets in general are strong with the capacity to service debt post-pandemic fairly comfortable.

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



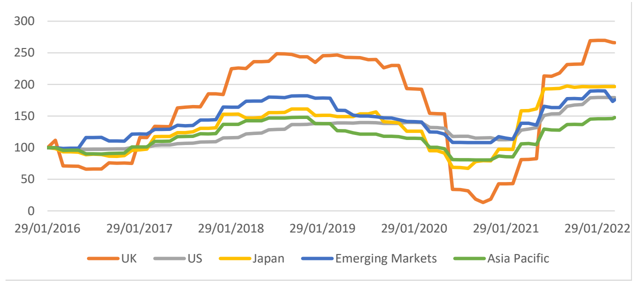
US equity valuations are considerably higher than elsewhere. Other developed markets are not especially stretched compared to recent history.

Net Debt/EBITDA: Global Stocks



Corporate balance sheets are strong in general.

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.

Rather typically, just as it looked that US stocks were finally handing over market leadership to European equities at the start of the year as the valuation gap and chronological lifting of Covid restrictions looked favourable for the old world economy, the outbreak of conflict on Europes' eastern border has proven a drag on performance due to the geographical proximity and the greater integration of trade and commerce. The German manufacturing economy in particular is especially dependent on Russian fuel, and it is surely of little coincidence that the DAX index is the worst performing continental equity market this year. Europe is exposed to a hit to growth and overall confidence caused by the rise in commodity prices and appears more vulnerable to a recession, that may require the ECB to delay any planned tightening. US stocks, on the other hand have proved remarkably resilient to the conflict raging in Ukraine and have recovered more quickly from the initial shock of Russia's invasion than most other developed equity markets, with their returns outpacing those of the Global Index by some 5 percentage points over the past few weeks. However, US valuations remain relatively hefty with the Fed poised to raise rates aggressively in the face of inflation, which could see the high weighting of growth stocks in the region disproportionately hold the market back, so while we retain a US exposure in our portfolios it is skewed towards the value end of the spectrum. Some Dollar exposure for European-based investors is also sensible while the uncertainty persists. As ever, while there are always selective opportunities from a bottom-up perspective, so there are at regional level – one continuing to be the UK market in our opinion, and so due to a mix of cheap defensive and commodity-oriented companies, decent dividends, all supported by decent (for now) economic data we remain overweight. We wrote last time that the picture for Chinese stocks was mixed, but that an entry point for equity buyers was likely to present itself as the credit cycle evolved and the administration cooled its regulatory crackdown on the education, technology and healthcare sectors, but unfortunately the outlook is now further clouded by new uncertainties, including the war in Ukraine and China's potential role in it and the strict 'zero Covid' policy that is hampering activity.

While some stimulus has been reintroduced, including rate cuts and credit growth, it seems the fiscal activity in China will be less super-charged than in previous cycles and there is little advantage to allocating risk here over and above other regions. In other emerging regions, valuations are looking increasingly attractive with many economies yet to fully recover from Covid, and with the unrest in Ukraine, the outlook for many is determined along commodity lines. The case for investing in EM is clear because according to the IMF (after adjusting for purchasing parity power) such countries will represent around 60% of the global economy within five years, but finding an entry point and a vehicle for harnessing this growth in terms of investment returns is not so easy.

		-		=		+		
EQUITIES								**Equities have steadied since the shock of the Russian invasion of Ukraine. It is unclear what will provide the catalyst for a further leg up, as growth is hindered by inflation and central banks tighten.**
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								Region is the most vulnerable to Russian exposure and energy restrictions, that may restrian growth. Selective opportunities, such as dividend stocks.
Switzerland								Quality, defensive nature of the market continues to see Swiss stocks in demand, though valuations rich now.
EM								We retain an allocation to emerging Asia for the long-term growth story, but other markets look less appealing. Sentiment has turned in China, with stimulus returning.
Japan								Attractive valuation for a developed market . Domestic growth is improving with supportive monetary policy. Weakening currency is a headwind.

FIXED INCOME

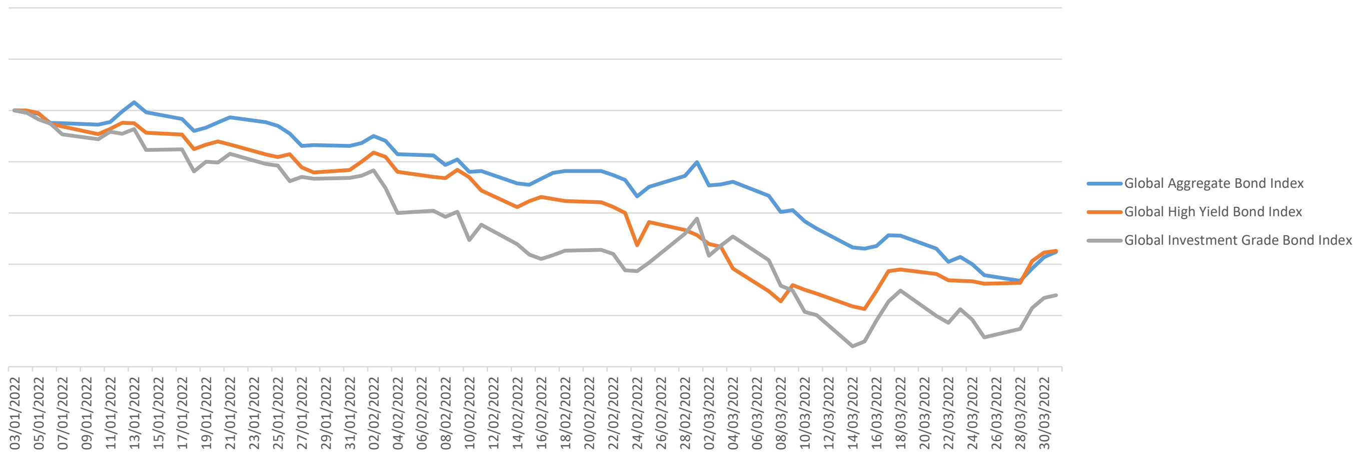
The decline in global bonds has been truly alarming, with moves year to date leaving the asset class more resembling equities or commodities than a supposed store of capital – fixed income securities are not supposed to fall in this way as usually the precipitating rise in yields would entice investors back to the asset class at the expense of more risky assets. The problem today is that yields are moving off such a low base that even a near 500% increase of the 10yr EUR yield translates to a 0.7% nominal yield, and with Eurozone CPI running at 6%, a real yield of -5.3%, i.e. to a level that is just not useful or attractive with inflation running so hot. Essentially most investors in the bond market are in new territory, and it is unclear at what level of yield buyers will return to the asset class. A sooner than expected drop in the rate of inflation could do the trick of course, as could a deceleration of 'quantative tightening' and rate hikes by central banks that become scared of killing off economic growth as they attempt to put the inflation genie back in the bottle. At the time of writing Global Investment Grade bonds are down a little under 10% year to date, and even the Global Aggregate index is down 7.5% - there has been nowhere to hide, and the usual safe harbour of short-dated Treasuries has been anything but a haven as the prospect of aggressive rate action has seen the near end of the curve being sold off more heavily than 10-year-plus maturities. Though perhaps we did not quite anticipate the velocity of the bond rout, we have been considerably bearish on the asset class for some time and have held as little weighting in it as possible, diversifying the holdings we do have away from traditional bonds where appropriate. Interestingly the extra yield on offer from High Yield bonds has given them a defensive advantage over Investment Grade this year, in fact outperforming on a global basis by a full percentage point – a further sign that the usual conventions of the fixed income market are currently broken. Certainly our focus on the quality end of the High Yield market has been relatively beneficial for our clients as well, and we believe this compromised approach to junk debt is the best policy in light of the potential for corporate default risk as base rates rise. A selective approach to emerging market bonds is also a useful diversifier for a bond portfolio with many EMs benefitting from higher commodity prices (2/3 of the index are exporters). EMD ex. Russia is attractively valued, however the conflict and risk of sanctions could hurt investor confidence. The time will come for adding duration to bonds, quite possibly later this year once the tightening cycle is further progressed, inflation has peaked and the economic outlook is clearer, but for now, we suspect that it is sensible to be underweight interest-rate risk as inflation shows little signs of relenting. One bright spot (albeit still producing slightly-negative returns for the year) has been structured credit, specifically mortgage-backed securities: property has often been a strong asset class in inflationary times and while remortgage rates will be increasing for homeowners, they are historically low indicating low default risk while possessing superior credit and income yields than normal bonds.

Developed markets 2 yr Sovereign bond

REGION	SECURITY	YLD
Japan	JGB 0.005 04/01/24	-0.09
Switzerland	SWISS 1 1/4 06/11/24	-0.035
Germany	BKO 0 03/15/24	0.123
Portugal	PGB 4.95 10/25/23	0.127
France	FRTR 0 02/25/24	0.171
Netherlands	NETHER 2 07/15/24	0.212
Greece	GGB 3.45 04/02/24	0.421
Spain	SPGB 0 05/31/24	0.431
Italy	BTPS 0 01/30/24	0.51

REGION	SECURITY	YLD
Sweden	SGB 1 1/2 11/13/23	0.849
United Kingdom	UKT 1 04/22/24	1.519
Brazil (USD)	BRAZIL 8 7/8 04/15/24	1.824
Australia	ACGB 2 3/4 04/21/24	2.11
China	CGB 2.56 10/21/23	2.2
Canada	CAN 0 3/4 02/01/24	2.448
United States	T 2 1/4 03/31/24	2.534
South Korea	KTB 1 7/8 03/10/24	2.991
New Zealand	NZGB 0 1/2 05/15/24	3.207

Bond benchmarks in 2022



Bonds have sold off heavily year to date, but interestingly High Yield has done so less than quality Investment Grade debt.

	-	=	+	
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.

CURRENCIES AND COMMODITIES

Commodities in general have been the standout performers in 2022, fulfilling their theoretical role as an inflation hedge following post-pandemic demand and further boosted by the partial isolation of one of the worlds' largest producers of energy and agricultural crops. As peace talks between Russia and Ukraine progress (at least superficially) the speculative mania seems to be dissipating and commodities have sold off from their peaks, though the markets are noticeably more volatile now: In the five years before Covid-19 struck markets, the Bloomberg Commodity Index saw daily moves larger than two-standard deviations on average about 14 times per year. Then, in the past year, we suddenly had 33. The index's absolute daily average move has increased by 38% over the past year. Its standard deviation rose to 1.2% from 0.8% during March 2015-2020. Such big swings make it harder to predict short-term direction, especially with so much geopolitical noise and current interruptions to global supply, but longer-term there appear to be structural forces that suggest an allocation to commodities is a good idea, not least while the inflation picture looks tended to the upside. The fundamental case for higher base metals prices remains because even without this war, many years of underinvestment were leading to supply shortages so the bull-market is likely to continue. We have noted before that in order to bring about carbon net-zero targets many metals are required to construct the battery technology in order to do so, while the war has forced many governments to reassess their immediate energy policies to prevent the lights going out. This probably means Western nations in the short-term relying more on fossil fuels than previously intended (good for the oil price), while simultaneously speeding up the transition to more renewable sources (good for rare earths, base metals and certain precious metals). Copper appears to be consolidating following its post-pandemic surge and while it is somewhat reflective of global economic health (is used just about everywhere: homebuilding, construction, manufacturing, power generation, electronics and transportation), it is also a crucial component of 'green energy' and electricity so it seems a good bet that the price will trend higher. One would also expect energy companies with operations in Western-friendly countries to enjoy something of a purple patch as they'll be faced with extra demand due to increasing sanctions on Russian oil and gas. Gold had a famously disappointing 2021 against a negative-real-return and inflationary backdrop, and it may be that the surge to $2000 was the market temporarily compensating for that as the war broke out, before consolidating around the $1930 mark – but it may also be signs of the precious metal jolting into life for a period of outperformance as it has done in the aftermath of other historical geopolitical events. While we aware that silver has provided many false-dawns in the past the gold/silver price ratio is currently around 78, which is towards the top of its 40-year range: a return to a ratio of 70 – assuming gold stays unchanged – would lift silver by around 10% and the usage of silver in green and traditional technologies provides fundamental support too. Precious metals remain an important diversifier for investors.

Commodities Index

Commodities have been the standout asset class this year and appear to be consoidating at current levels.

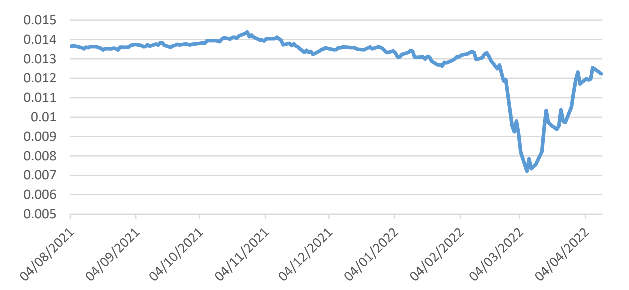
	-			=	+			
ALTERNATIVES								**An increasingly important allocation with equities expensive and bond yields so low. Ideally we like holdings that are genuinely uncorrelated to the main asset classes.**
Precious Metals								Gold and silver are moving in their own way as ever. Remains the most compelling long-term hedge against inflation and elevated geopolitical risk.
Hedge Funds								Genuine alternative funds that behave in a different manner to traditional assets are a vital source of wealth preservation and diversification.
Oil/Commods								Commodities mania has subsided, but shifting geopolitics and green policies will offer structural upside.

Prior to the Ukraine-Russia war currencies were largely following the paths outlined by their respective central banks. The US Dollar was meandering versus the Euro as despite the hawkish rhetoric of the Federal Reserve, the US economy was perceived to have been cooling a little having emerged from the pandemic first and therefore having largely already recovered, while the Eurozone(although later in the rate cycle) was to enjoy a bit of economic catch-up. Meanwhile the UK was somewhere between the two in terms of economic growth and the Bank of England had actually commenced raising rates so GBP was outperforming as a 'risk-on' currency, while the Japanese Yen with the BOJ in control of the yield curve was largely flat-lining. Fast forward three months and the Dollar has strengthened significantly at the expense of the others as the typical flight to the global reserve currency occurred and has yet to subside. Only the Aussie Dollar looks to continue its bounce due to the later economic reopening and of course its correlation with metals and mining prices due to its export economy. In emerging markets, those currencies that belong to energy exporting nations (e.g. BRL, MXN) have strengthened while those net importers (e.g. Indian Rupee) have struggled, and given our views on commodity prices this pattern is likely to persist. Remarkably the Russian Ruble has recouped nearly all of its 46% drop since the end of February in only a matter of weeks, though whether these levels are sustainable given the sanctions being imposed upon the Russian economy is dubious, notwithstanding its primary exports of oil and gas are still flowing into Eastern Europe. In all likelihood, the extremely thin volumes in RUB trading points to a currency being artificially propped up by its government, with bans on foreigners selling Russian assets as well as mandated hard-currency sales by exporters. With respect to the Euro, the immediate headwinds are numerous: threats to economic growth, spiralling inflation and a central bank that may find itself hemmed in by concerns about removing stimulus against such a backdrop, not to mention political risk from the French election that may not be quite the cakewalk for Macron as long assumed. In summary, for USD-based investors the risk-reward of holding other currencies is probably not justified, but for EUR, GBP and CHF a little Dollar exposure is sensible.

US Dollar (DXY) since 2006

The Dollar has received a boost due to the war and the hawkish rhetoric of the Fed, but is now heading towards the top of its 5 year range.

RUB/USD



The Russian Ruble has made a v-shaped recovery since the invasion of Ukraine. This may be due to it being traded on very thin volumes, and artificially supported by the Russian state.

	-			=	+			
CURRENCIES								**The dollar will remain supported while geopoloitical risk is elevated, while commodity currencies such as AUD will also do well. Policy divergence between nations, both EM and developed, in response to inflation and energy costs are opening up.**
U.S. Dollar (DXY)								Currently bid due to geopolitical risk, prior had shown signs of peaking, though ahead of EUR in tightening cycle.
Sterling (GBP)								GBP sits somewhere between USD and EUR in terms of policy. Inflation is high and the consumption based economy exposed to higher energy costs.
Euro (EUR)								Covid restrictions finally lifting, but bloc's exposure to Russian energy a headwind. May benefit from being a risk-on ccy.
Japanese Yen (JPY)								Lack of relative inflation in Japan means currency is under pressure due to rate differential. Growth returning though.
Swiss Franc (CHF)								CHF remains a genuine safe haven. Nice diversifier, though global recovery could dampen demand, with SNB curbing upside.
EM								Ruble the main story, as Russia faces exclusion from the financial system. Other EM's (espcially energy producers) holding up well with local rates increasing.

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