BANCO CARREGOSA
EST. 1833

Overview

Outlook - Spring

2nd Quarter | 2022

Editorial

By the Chief Investment Officer

Europe is once again facing armed conflit. The impacts thereof on the economy are felt firsthand in many areas and in different time horizons, such as in the supply of some products, with the consequent effect on prices and on the sentiment of economic operators. In the long term, we may see the reorganisation of the international geopolitical balance and a new argument in favour of reversing the globalisation trend of the last 30 years. As such, weaker growth and higher inflation are expected.

The outlook for economic growth in 2022 is decelerating and consumption is expected to shrink as disposable income and consumer confidence fall. Business sentiment and increased risks will penalise private investment. Public investment could come out stronger, both in military terms, energy supply infrastructures, and tax support to the population hardest hit by the drop in disposable income.

The economy was in a global economic expansion phase. The inertia of this expansion should prevent recession in 2022, even though risks are higher, in particular those related to the escalating conflict.

On the inflation front, the war has compounded an already worrying trend. The monetary authorities believed that it would be possible to ease the upward trend in prices to levels closer to their instructions in an orderly manner. However, the escalation of prices of energy and agricultural and mineral commodities was intensified by the outbreak of war. Central banks began to feel they were lagging behind in normalising the monetary policy. The likelihood of achieving a soft landing was considerably reduced. It is now more likely that the next recession could occur within a 1 to 3 year time horizon as a result of the attempt to control inflation.

The economic stimuli implemented in each economic bloc in response to the pandemic were quite different. Moreover, the seasonality of the virus has contributed to the regions being affected in different periods, depending on their latitude. Finally, the strong volatility in the price of commodities has created new winners and losers, depending on the production structure of each region. All these factors contribute to each economy being at a particular stage.

However, what goes on in the US economy will always influence global financial markets. As the US economy does not largely depend on or have interconnections with the Russian and Ukrainian economies, and is self-sufficient in terms of energy and has agriculture surplus, the direct impact of the conflict thereon will be reduced. Overheating in the economy, already prior to the conflict, was compounded, and this will be the greatest risk in the short term. The stock market, with a different composition from the economy, should be more immune to the real economy than to the rise in interest rates or the reduction of the central bank's balance sheet.

In Europe, however, the scenario is very different. The economy critically depends on energy and industrial metals, relevant for the automotive industry, which may delay recovery.

Among emerging economies, typically with lower income levels, those more dependent on imports will be affected by rising commodity prices, which may lead to increased social tensions (e.g. Turkey, Egypt, India). However, commodity-exporting economies may benefit from gains in their terms of trade (e.g. Brazil).

In the coming months, the economic environment is expected to continue to induce volatility and frequent corrections in financial markets, which may give rise to threats, but also to opportunities. This calls for a more disciplined investment strategy focused on risk management. We will continue to seek to identify assets with more attractive returns/risk ratios and suited to the profile and investment objectives of each investor.

Mário Carvalho Fernandes

Position

Asset classes	Asset subclasses	— —	—	Neutral	+	+ +
Liquidity	Demand Deposits, Term Deposits				■	
Bonds	Investment Grade Europe		■	■		
	Investment Grade USA (EURHdg)		■	■		
	High Yield Global (EURHdg)			■		
	Emerging Global (EURHdg)		■	■		
Equity	Europe excl. UK			■		
	USA (EURHdg)			■	■	
	United Kingdom (EUR)			■		
	Emerging (EUR)			■		
Other	Gold, REITS, Infrastructures, etc.				■	

1. Macroeconomic Analysis

The first quarter was marked by the before and after 24 February. The invasion of Ukraine by Russia and the consequent global economic repercussions accelerated inflation and slowed economic growth, raising fears about a stagflation.

Being closer to the conflict and depending more on Russian commodities, in particular natural gas, the European economies are among the most penalised globally.

The European economy had slowed down significantly at the end of last year, penalised by the restrictions imposed by the resurgence of Covid-19 and increased spending in energy as the coldest season of the year approached. But the expected recovery in the months following winter was frustrated by the looming implications of the Eastern Europe conflict. In recent weeks, the Ifo German economic outlook, GfK German consumer confidence, and euro area sentiment have fallen sharply and returned to levels of two years ago when the global pandemic lockdown was enforced in the spring of 2020.

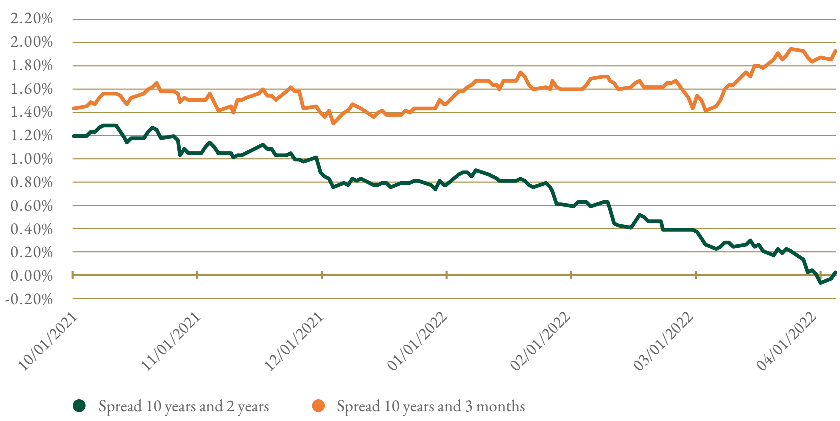
The European Central Bank (ECB) has in the meantime revised inflation in the euro area for 2020 upwards from 3.2% to 5.1% and economic growth downwards from 4.2% to 3.7%, and now seeks to take decisive action regarding high inflation by finalising the stimulus packages and increasing interest rates. However, we face a dilemma: hold down inflation without causing a recession. The attempt at a *soft landing* could result in economic contraction.

Inflation in Europe has been largely driven by soaring fossil fuel prices, a mostly exogenous variable which subtracts wealth from the GDP of the euro area, making contractionary monetary policies less effective.

The US Federal Reserve (Fed) also reduced US economic growth for 2022 from 4% to 2.8% and increased expectations for inflation, measured by the PCE, from 2.6% to 4.3%. The US may be better prepared than it was 50 years ago during the 1970s oil shock to mitigate or even avoid stagflation because its economy is now self-sufficient in oil and natural gas and less energy intensive. A robust North-American labour market shows a resilient economy, but puts pressure on wages. In March, the unemployment rate was down 3.6%, hourly wages went up 5.6%, and job offers currently exceed demand by 1.8, all of which puts pressure on North-American inflation. In the US, in addition to high energy prices, price indices are also driven by house rents, wages, and some, still resilient, mismatches in supply chains, which may return or worsen with the cascading repercussions of the war in Ukraine.

The Chinese economy is also weak at this stage. Industrial and service activities of the world's second largest economy have contracted simultaneously in March for the first time since the peak of the country's Covid-19 surge in early 2020, increasing the need for further policy interventions to stabilise the economy. The People's Bank of China (PBoC) is seeking to stimulate its economy through a monetary policy, reflecting a lag between the Chinese economy and other economic blocs, such as the US, the euro area, and the UK. Earlier this year, the PBoC lowered its key interest rates, for the first time since April 2020, also lowering the minimum legal reserves over the past year in order to stimulate its economy. Chinese inflation allows for this stance, with the year-on-year change in the Consumer Price Index was only 0.9% in March. Coal represents 57% of its energy mix and China is almost self-sufficient in this hydrocarbon. Meanwhile, the US and Europe are struggling with high inflation and their central banks are trying to counter it with interest rate hikes and a reduction of the balance sheet.

US long-term interest rates



Source: Banco Carregosa

In recent months, the spread between the 10-year and 2-year US treasury yields has been narrowing and has recently fell into negative territory. This phenomenon may indicate an economic recession in the US in the next 12 to 24 months. For the 12-month maturity, the Fed prefers to monitor the spread between the 10-year and 3-month, as it has proven to be a more accurate recession forecast. This spread has widened so a low probability of recession is expected within one year. The US economy remains resilient, underpinned by a robust labour market. Time will tell whether the reversal between 10 and 2 years is a leading indicator of a recession or a false alarm.

2. Bond Market

In the first quarter, the main risks we had flagged for the debt market materialised: rapidly rising rates, persistent and accelerating inflation, and central banks seeking to react to events.

The Fed announced the withdrawal of stimuli and began the upward cycle, with the market expecting it to raise another 50 base points at each of the meetings in the second quarter. The aim will be to raise rates to a neutral level, around 2.4%, by the end of the year. The Bank of Canada, Bank of England, and the Central Bank of Norway have also raised rates. The ECB has been giving inputs regarding the easing of accommodative policies and the market expects a hike this year.

This correction in risk premiums in sovereign debt has led to significant corrections. Early in the year, USD 10.7 trillion debt stock were trading at negative rates, but today it stands only at USD 2.9 trillion.

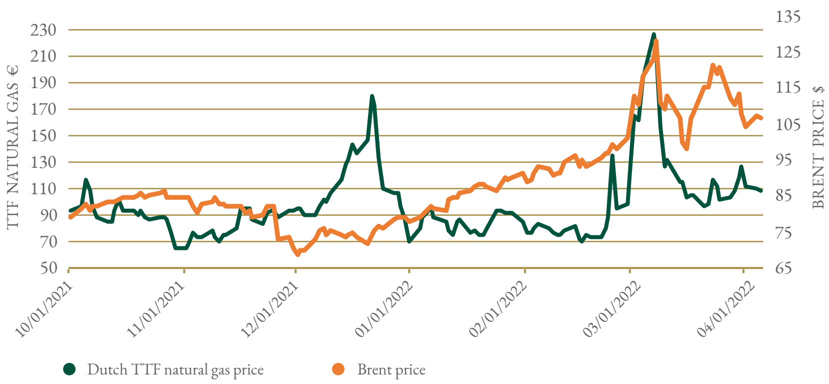
Despite the correction, the truth is that average interest rates in the G20 economies remained low by historical standards. Given current inflation, real interest rates remained negative, so central banks still have a long way to go in terms of monetary policy. The current consensus is that rates will continue to rise, albeit at different paces in the different countries.

Although the more speculative debt companies are usually more affected in these more critical market phases, default forecasted figures for the end of the year are low. The impact of the war in Ukraine was less than that following the pandemic. Greater market resilience can be justified by the following factors: the companies that overcame the pandemic strengthened their balance sheets, the current level of liquidity is the highest in recent years, the level of leverage is among the lowest, and there is no pressure to rollover debt until 2024.

The corrections created investment opportunities in investment grade debt, which already trades at positive rates. Subordinated financial debt became more attractive following the sharp correction in this class.

The robustness of the balance sheets of financial institutions associated with attractive risk premiums allows for investments with a good risk/return ratio, through the careful selection of issuers.

Oil and gas price developments



Source: Banco Carregosa

The war in Ukraine and the resulting sanctions on Russia have boosted the prices of the main fossil fuels and accelerated inflation, contributing to growing fears of a stagflation scenario. Russia is one of the world's largest producers and exporters of oil and natural gas, and these two fossil fuels, along with coal, account for about 84% of global primary energy. As such, the continuation of the war will keep putting pressure on the prices of hydrocarbon-based energies and on inflation, will accelerate contractionary monetary policies of central banks, and will increase the likelihood of a *soft landing* leading to an economic recession. Meanwhile, the increase in targetted containments in China, as part of the zero-Covid policy, has slowed China's economic growth rate and decelerated demand for oil, which may contribute to some easing of the price of this commodity.

3. Equity Outlook

Even before the war in Ukraine, the beginning of the year had already been marked by losses in equity markets, mainly due to fears of inflation and restrictive central bank policies. The most expensive companies suffered the most in this context, preferring to enhance value, where the banking sector and commodities stood out.

The conflict accentuated fears of stagflation, causing a sell-off in the markets, which was more pronounced in Europe.The financial sector and discretionary consumption were the most affected. Since then, indices have been recovering gradually, with commodities and defensive sectors outperforming in this scenario.

4Q21 earnings were strong for both US and European companies. Nevertheless, in terms of earnings per share the 'positive surprises' were lower than in previous quarters. Since the start of the year, several sectors have been upgraded by the consensus, in particular transport and commodities. Semiconductors and the luxury industry were also upgraded, which contrasts with their weak year-to-date performance (YTD) in the market.

However, this cycle of rising estimates has started to fade. Analysis are incorporating the new frictions in corporate growth and margins, mainly related to commodity prices being higher for longer periods, wages picking up, and continued disruptions in supply chains. This trend could be compounded by a prolonged conflict, a stagflation scenario, escalating US-China tensions, and the start of a 'deglobalisation' process.

Amid this high uncertainty, we prefer to take a more defensive and less cyclical stance. It is therefore crucial to continue to focus on growing, profitable, cash flow generating companies with strong balance sheets, low labour intensity and pricing power. The US and Switzerland are once again fitting choices, while the euro area, being more penalised by the conflict, moves to a neutral position.

Sector-wise, the preference lies in current consumption and healthcare, typically defensive, and in technology, in particular 'cybersecurity'. We have moved tourism and leisure to neutral due to their cyclicality, although we hold it in high regard due to the exposure of reopening in post-Covid times. In this context, the least preferred are discretionary consumption and industry, as these are the sectors most affected by inflation, due to reduction in disposable income and increased disruptions in supply chains.

Developments over the last 3 months

	31-dec	31-jan	28-feb	31-mar	Last 3 months	Last month (mar)
Equities						
S&P 500	4 766.18	4 515.55	4 373.94	4 530.41	-4.95%	3.58%
Nasdaq 100	16 320.08	14 930.05	14 237.81	14 838.49	-9.08%	4.22%
DAX 40	15 884.86	15 471.20	14 461.02	14 606.05	-8.05%	1.00%
Stoxx 600	487.80	468.88	453.11	455.86	-6.55%	0.61%
Nikkei 225	28 791.71	27 001.98	26 526.82	28 027.25	-2.66%	5.66%
Shanghai Composite	3 639.78	3 361.44	3 462.31	3 252.20	-10.65%	-6.07%
MSCI World	3 231.73	3 059.05	2 977.95	3 053.07	-5.53%	2.52%
MSCI Emerging	1 232.01	1 208.23	1 171.31	1 141.79	-7.32%	-2.52%
Long-term interest rates						
Yield Treasury 10 yr	1.51%	1.78%	1.83%	2.34%	82.79 pb	51.3 pb
Yield Bund 10 yr	-0.18%	0.01%	0.14%	0.55%	72.5 pb	41.3 pb
Yield OT Portugal 10 yr	0.47%	0.67%	1.00%	1.35%	88.7 pb	35.4 pb
Short-term interest rates						
3-month USD Libor	0.21%	0.31%	0.50%	0.96%	75.2 pb	45.7 pb
3-month Euribor	-0.57%	-0.55%	-0.53%	-0.46%	11.4 pb	7.5 pb
3-month GBP Libor	0.26%	0.64%	0.88%	1.04%	77.3 pb	15.7 pb
Exchange						
EUR/USD	1.1370	1.1235	1.1219	1.1067	-2.66%	-1.35%
EUR/GBP	0.8413	0.8353	0.8361	0.8424	0.13%	0.75%
Commodities						
Brent	76.39	86.64	95.10	104.71	37.07%	10.11%
WTI	73.94	85.11	93.50	100.28	35.62%	7.25%
Gold	1 829.20	1 797.17	1 908.99	1 937.44	5.92%	1.49%

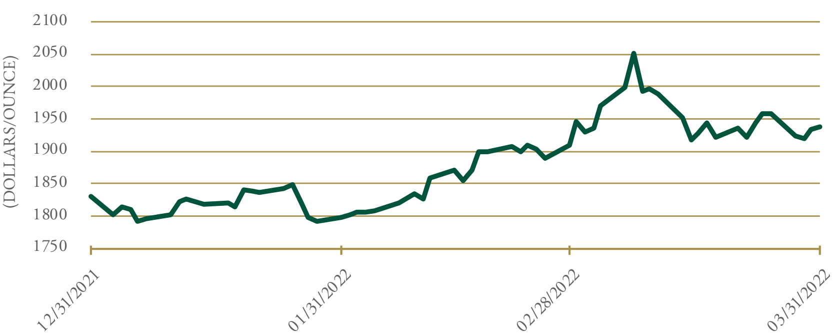
4. Outlook for Alternatives

In the first quarter of 2022, some themes we had been highlighting picked up after the pandemic: real assets such as REITS, infrastructures, gold and, more recently, energy and non-precious metals.

Early in the year, concerns with inflation were already relevant, as difficulties were still being felt in the recovery of supply chains. The conflict in Ukraine has reinforced the increased uncertainty that is reflected in the logistics of commodities, in the interconnections of sanctions, and in taking a stance on the moral aspect of the conflict. Thus, inflationary risks increased over a high base and not as transitory as initially expected.

Today, our tactical interest in gold is not as high as it was in 2021, having been replaced by interest in the US dollar (USD). The armed conflict is propitious for gold price, but we believe that the Fed is in a position where it has to take determined action to control inflation. This context is not favourable for this metal (*ceteris paribus*). However, exposure to USD has some of the defensive advantages of gold, without its disadvantages. A more hawkish Fed is propitious for the USD, while risk aversion is propitious for the appreciation of the reserve currency (USD). In a scenario where the greatest risk is a more aggressive Fed stance, the USD will tend to be more protective of a portfolio than gold, at least until a return of Quantitative Easing is envisaged.

Developments in gold price over the last 3 months



Source: Banco Carregosa

In the first weeks of February, the gold price was driven by the uncertainty attached to geopolitical tensions in Eastern Europe, a trend that would accelerate with the invasion of Ukraine by Russia on 24 February. On 8 March, the gold price reached an 18-month 'intraday' high of USD 2070 per ounce, the highest since the all-time high of 30 September 2020, at USD 2075. However, the slowdown in the intensity of the war, with the start of peace talks in Ukraine, and the significant rise in interest rates, reflecting a tightening of the Fed's monetary policy stance to respond to high inflation, have diminished the attractiveness of the gold metal in recent weeks. The price of gold in euros reached an all-time high in the quarter, reflecting the devaluation of the single currency against the US dollar.

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