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BANCO CARREGOSA

Overview

Outlook - Winter

1st Quarter | 2022

Editorial

By the Chief Investment Officer

The change in the calendar year does not imply a change in the market cycle. An economic growth phase and inflationary pressure were apparent in 2021. Projections for 2022 anticipate this "inflationary boom" to continue, with economic growth and inflation rates above the average of recent years. The persistence and magnitude of the increase in price level, the response of monetary authorities and its consequences in the economic activity are the unknowns that will possibly determine the financial market developments in the coming months.

Central banks fear deflation scenarios. The mechanisms available to the monetary authorities have proved more effective in addressing inflationary rather than deflationary pressures, both of which are detrimental to economic sentiment, increase uncertainty among economic agents, and tend to feed themselves into vicious cycles. However, the failure of the Japanese economy to inflate over the past decades has created a fear that this situation will also spread to Europe and the United States. Recent months seem to indicate that in these economies it has possible to avoid falling into the vicious cycle of deflation.

As inflation represents the annual change in prices, changes over a period of a few months do not represent a typical inflation situation and often stem from a temporary phenomenon, scarcely more significant than a mere statistical disruption. Therefore, when discussing whether the current change in prices is transitory or permanent inflation, it is important to understand the time horizon of these references.

For the purposes of financial market investments it will be crucial to understand whether the expectations of economic agents remained anchored close to the target values defined by central banks. If these expectations remain stable, inflation gradually converge to that level and inflation will have been transitory, as it will not have materially influenced renegotiations of wages and other contracts. In this regard, the US economy has shown pressure on wages at a scale different from that seen in the Eurozone; as such, inflation in the US may turn out to be more lasting than in Europe. The Federal Reserve has been under more pressure to react to the rising prices, but it do so more gradually, keeping the real interest rate at low, possibly negative, levels over the coming months, thus maintaining the support to the economic activity and the process of gradual debt reduction. That flexibility was achieved when it admitted that it would purposely stay behind the curve, letting inflation exceed its average target in order to ward off deflation. It is hoped, however, that this deviation will not immediately lead to uncontrolled deflation and that over the coming months a smoother change in prices can be observed, with the fading of a large part of the global supply problems and the impacts of the base effects of the various phases of the pandemic. In the medium term, the risk of rising inflation is now more balanced compared to the previous trend of Japanisation seen in the developed world.

The economic environment should continue to create positive climate for equity markets. Higher volatility is expected, with more frequent and greater adjustments, with some sector rotation for the more cyclical activities, yet maintaining the upward trend. As regards bonds, the selective exposure to credit risk should continue to be favoured over interest rate risk.

Mário Carvalho Fernandes

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Position

Classes	Subclasses	— —	—	Neutral	+	+ +
Liquidity	Sight deposits, Term deposits				■	
Bonds	Investment Grade Europe		■	■		
	Investment Grade USA (EURHdg)		■	■		
	Global High Yield (EURHdg)		■	■		
	Global Emerging (EURHdg)			■		
Shares	Europe Except UK				■	
	USA (EURHdg)			■	■	
	United Kingdom (EUR)		■	■		
	Emerging (EUR)		■	■		
Other	Gold, REITS, Infrastructures, etc.				■	

1. Macroeconomic Analysis

Alongside the dynamic recovery from the 2020 economic crisis driven by the lockdown, last year was also marked by historically high inflation rates. In the USA, the Consumer Price Index (CPI) in 2021 reached an all-time high since 1982, mainly due to hitches in supply chains and higher wage costs determined by labour shortage. In Germany, the largest economy in the Eurozone, the CPI reached the highest level since 1993, driven mainly by the significant rise in the cost of energy, in particular natural gas and oil, largely pressured by the acceleration of the energy transition dictated by the decarbonisation policy.

There is general consensus that 2022 will continue to be a year of robust economic growth, but ar a more moderate pace, in line with the more mature phase of the cycle. As a result of the increasing number of vaccinated people, the availability of new medicines and gradually more effective pandemic prevention and response methods, the global economy is expected to be less and less affected by potential new outbreaks of Covid-19. However, other risks exist other than the pandemic, such as political risks, from the presidential elections in France to the US mid-term elections in November, problems in supply chains, which will tend to normalise over the year, to price hikes and wage pressures, turmoil in the Chinese real estate market, and energy costs. The economy is also expected to be leveraged by multi-year spending plans in the main developed economies, in particular the Recovery and Resilience Plan (PRR) in the Eurozone and President Joe Biden's infrastructure programmes in the US.

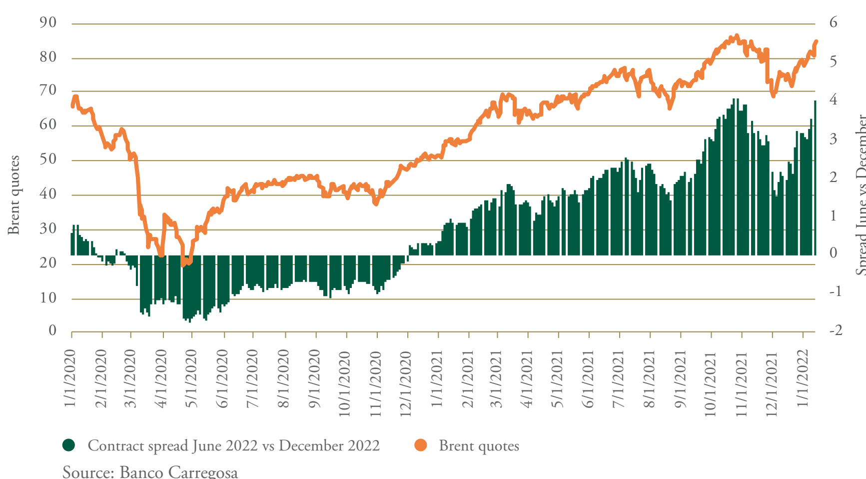
Described by the US authorities as the main priority in 2021, the recovery of the labour market was a reality and the US economy came close to full employment in December, with a 3.9% unemployment rate. However, the goal was partly achieved at a high price, i.e., a historic rise in inflation. The US Federal Reserve (Fed) is now seeking to quickly reverse the monetary policy and four interest rate hikes are currently expected in 2022, according to Fed Funds Rate futures traded on the Chicago derivatives exchange. Powell has stated that he could even start cutting the balance sheet in mid-2022 to curb inflation.

For 2022, the Fed estimates a PCE inflation rate of 2.6%, an economic growth of 4%, and full employment with an unemployment rate of 3.5%, identical to February 2020, before lockdown determined by the pandemic. In short, the US central bank is optimistic and, despite some slowdowns, still hopes for a robust economic growth characterised by full employment, and for inflation to be bottomed out. The development of the monetary policy throughout the year will try to realise the Fed's optimism, but there is the risk of an economic slowdown in the face of this more hawkish stance.

The growing decarbonisation policy is dictating the new economy in the post-pandemic phase, dubbed by some as decarbonomics, and as inflation fears continue, one of the main dilemmas is finding the best way to soften the increasing volatility of the energy transition. It is crucial to address the gaps between fossil fuels and clean energy, or else greenflation will be a reality. The global green policy agenda for 2022 (USA, EU, Asia, Latin America) is filled with major events defined to feed the ESG growth trends.

In Europe, inflation in 2022 will largely depend on energy costs. The intermittent nature of renewable energies, such as wind, solar and hydro power, does not fully meet the constant energy needs of the economy, driving up electricity costs and, consequently, the European consumer price inflation. The European Commission seeks to label new nuclear generation as 'green', but the results of this decision will only be seen in the long term. The European Central Bank estimates an increase of 4.5% in economic growth in 2022.

Changes in Brent quotes and spread



Source: Banco Carregosa

In the spring of 2020, the weak demand for oil determined by lockdown resulted in a surplus supply and, as a result, a significant drop in the Brent crude price, more noticeable in contracts for immediate delivery, a phenomenon known as contango, and which shows economic recession. The OPEP+ production cut, vaccines and the gradual economic recovery in 2021 have again boosted oil demand, but the still limited supply and growing decarbonisation policy have compounded oil shortages. The spread between June and December contracts, the most liquid ones, have turned positive again in early 2021, i.e., current prices are higher than futures, a situation known as backwardation. The emergence of the Omicron variant two months ago have caused fears of an economic slowdown to return and the price of oil dropped. However, there appears to be a gradually more undesirable than healthy backwardation, and one of the variables that has contributed the most to the rise in inflation, the price of oil, is stubbornly set to continue to do so in 2022.

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2. Bond Market

2021 proved to be one of transition in the debt market. Inflation, which early in the year seemed to be distant, turned out to be high and more persistent. Economic data have shown signs of recovery, although growth rates are expected to drop in 2022, particularly to average values close to those before the pandemic.

Central banks have been under pressure and announced the withdrawal of stimuli. However, the new Covid-19 variants have spread more uncertainties and lockdowns,
all of which represent an increase in volatility. In 2021,
the bunds rate rose from -0.569 % to -0.177 %, and that of treasury have increased 0.9132 % to 1.51%. Those who sought security, or Investment Grade debt ventures, ended up with a negative return. Our position for 2021 proved to be the most assertive, as we privileged investment in High Yield debt and Subordinates of the financial sector, which ended up with a positive return for the year.

As for 2022, we foresee major challenge, particularly in the second semestre, when the reduction in central banks' asset purchase programmes by central banks will be more evident. Reference rates are expected to rise in the major economies, which should reach a balance, resulting in a smaller variation than in previous economic cycles.

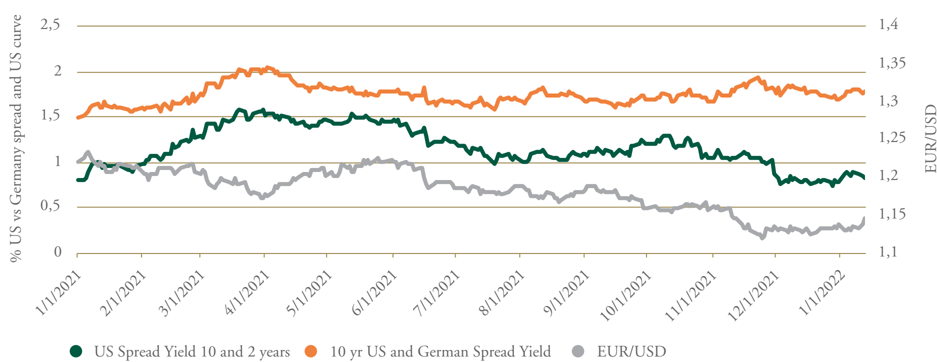
Inflation is expected to fall by the end of 2022, as the effects of energy prices and disruptions in supply chains fade. Central banks and governments will attempt the transition to sustainable and non-inflationary economic growth.

Despite the changes in interest rates setting higher risk premiums, companies were able to demonstrate resilience and an enormous ability to adapt. Accumulated liquidity levels are well above the average recorded for the 2017/2019 period, both in Europe and in the US, and default forecasts remain at minimum values.

The rise in interest rates should benefit the financial sector, improving their margins as banks are the one whose activity is indexed to them. As regards financial debt, we will maintain our position both in subordinated and in CoCo's, as their coupons are higher nd better able to absorb increased volatility.

Similarly, the position in High Yield will be maintained, as the companies that have survived have more resilient balance sheets and will continue to benefit from an accommodative policy and from continued support to SMEs. The rating agencies assess companies with the potential to move up the rating scale at 23 billion euros, resulting in an appreciation in price. We favour maturities up to 5 years and the selection of each issuer is also important.

US yield curve, US vs Germany spread, and EUR/USD



Source: Banco Carregosa

The steepness of the US yield curve, measured by the 10 to 2 year spread, accelerated in the first quarter of last year, driven by the robust economic recovery in the US. During this period, the dollar appreciated 5 % against the euro, reflecting the more mature phase of the economic cycle in the US compared to the Eurozone, reflected in the widening of the spread between the US and Germany. However, since the beginning of the second quarter of 2021 the slope of the US yield curve has gradually flattened and horizontality has accelerated over the past three months, more due to the 2-year rise, reflecting the closure of the Fed's pandemic buying programme and the expectation of several rate hikes throughout 2022. However, the slower rise in the 10-year yield and the lower slope of the curve foresee some investor fears that the Fed's interest rate hike will penalise economic growth.

3. Equity Outlook

2021 was rewarding for equity markets, with almost all indices ending with positive double digit returns. The exceptions were the emerging markets, namely China and Brazil.

The markets reacted immediately to the Fed's switch from defining inflation from temporary to persistent. Since the end of November, pure growth companies have underperformed in the market in the light of the market, and continue to do so, particularly against 'quality' companies. FAAMGs had a combined return of 37 % in 2021 and their performance was hardly affected in the last month, compared to other 'aggressive' technologies – many of them still having generated no profit.

The equity market remains expensive in absolute terms, but still attractive compared to other asset classes, especially Europe versus the US. The discount between Europe and the US is at the level of the Great Recession of 2009 and is the highest since the 1990s.

Historically, the monetary policy has been one of the drivers for financial market performance, particularly after the 2008/09 crisis. The recession brought on by the Covid-19 pandemic boosted the balance sheets of major central banks by more than 10 billion dollars, enabling the biggest equity market recover in 45 years. As the monetary policy reverses, equities will need a new driver: the trajectory of earnings will be the main catalyst determining behaviour in the markets.

2022 kicks off with some uncertainties: disruptions in supply chains, concerns of inflation, wage pressure, the adoption of a more contractionary monetary policy stance in the US, and policies to help prevent the spread of Covid-19.

Despite this 'overcast' environment, conditions now seem to be aligned for another year of global growth, supported by fiscal policies (green and infrastructure investments) and excess household savings that can be converted into more consumption.

On the corporate side, there is also excess cash and low inventories, so it seems realistic and necessary to have higher investments.

Although margins may be under pressure, especially for companies that are unable to pass on higher prices to the end consumer, it seems to us that high single digit profit growth may be possible in 2022.

The increased volatility caused by the change in monetary policy will serve as a buying opportunity, although selection is key: companies with sound balance sheets, generating cash flows, profitable and growing, low labour intensity and with pricing power, combined with some cyclical sectors.

We maintain the 'overrepresentation' of technology, adding industry and (green) materials, as well as tourism, now that the Omicron variant seems to be fading. We remain afield from the sectors with more value attached, such as energy, traditional banking and automotive trade, and add current consumption to this category (as it is considered a bond proxy and vulnerable to rate hikes).

We maintain our preference for the Euro Zone over the US. We take a more cautious approach to emerging markets and China, in particular, as well as the UK, where supply problems continue to exist and there has already been a first rate hike.

Developments in the last 3 months

	30-sept	31-oct	30-nov	31-dec	Last 3 months	Last month (dec)
Shares						
SP 500	4 307.54	4 605.38	4 567.00	4 766.18	10.65%	4.36%
Nasdaq 100	14 689.62	15 850.47	16 135.92	16 320.08	11.10%	1.14%
DAX 40	15 260.69	15 688.77	15 100.13	15 884.86	4.09%	5.20%
Stoxx 600	454.81	475.51	462.96	487.80	7.25%	5.37%
Nikkei 225	29 452.66	28 892.69	27 821.76	28 791.71	-2.24%	3.49%
Shanghai Composite	3 568.17	3 547.34	3 563.89	3 639.78	2.01%	2.13%
MSCI World	3 006.60	3 174.73	3 101.80	3 231.73	7.49%	4.19%
MSCI Emerging	1 253.10	1 264.75	1 212.42	1 232.01	-1.68%	1.62%
Long-term interest rates						
10 yr Treasury Yield	1.49%	1.55%	1.44%	1.51%	2.3 pb	6.6 pb
10 yr Bund Yield	-0.20%	-0.11%	-0.35%	-0.18%	2.2 pb	17.2 pb
Portugal 10 yr GT Yield	0.36%	0.52%	0.33%	0.47%	11.0 pb	13.5 pb
Short-term interest rates						
3-month Libor US	0.13%	0.13%	0.17%	0.21%	7.9 pb	3.6 pb
3-month Libor EUR	-0.56%	-0.56%	-0.60%	-0.58%	-1.7 pb	1.8 pb
3-month Libor JPY	0.08%	0.23%	0.09%	0.26%	18.0 pb	16.8 pb
Exchange						
EUR/USD	1.1580	1.1558	1.1338	1.1370	-1.81%	0.28%
EUR/GBP	0.8593	0.8446	0.8525	0.8413	-2.09%	-1.31%
Raw materials						
Brent	76.06	81.43	68.88	77.78	2.26%	12.92%
WTI	73.59	79.98	65.85	75.21	2.20%	14.21%
Gold	1 756.95	1 783.38	1 774.52	1 829.20	4.11%	3.08%

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4. Outlook for Alternatives

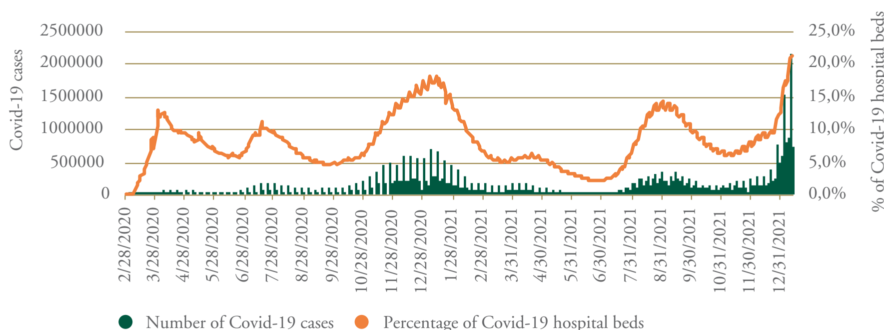
Our positive view on commodities for the previous quarter materialised and we continue to see that the same support conditions are in place for these assets.
As regards energy in particular, we believe that the imbalance between fewer supply than demand will persist. This is due to the absence of CAPEX from oil & gas companies in recent years, due to the energy transition, along with the destruction of capital with shale oil. Thus, there is the risk that the price of energy will continue to put pressure on inflation in a short to medium term.

Due to the current inflationary pressure, central banks (especially the Federal Reserve) have changed their speech to take a tighter policy stance. Precious metals have therefore had their opportunity reduced in the less distant future. However, in the long term, we believe that the need to depreciate currency as a means of reducing the real debt burden in developed countries will be beneficial for gold.

The current context is filled with currents and counter currents that may lead to mistakes in monetary and fiscal policy (both in developed and emerging economies), raising anxiety in the markets (i.e., volatility). It is a particularly interesting context for Absolute Return strategies (in particular macro, long/short, event driven ones). We believe that the inclusion/reinforcement of this type of strategy in portfolios could be useful to reduce volatility, correlations and, consequently, achieve a lower drawdown.

In conclusion, we remain interested in securities exposed to real assets: REITS (Real Estate Investment Trust Securities), infrastructures and shares of energy sector companies (oil & gas).

Covid-19 development in the US



Source: Banco Carregosa

Covid-19 infections are at an all-time high in the US and Europe and threaten economic recovery as restrictions increase. Currently, the daily cases of Covid-19 in the US are much higher than last winter, but about 62 % of the US population is inoculated, less than 5 % vaccinated a year ago, reducing the severity of the disease. Although 21.5 % of the number of US hospital beds are occupied by Covid-19 patients, an all-time high, these numbers are only 3 percentage points above the highs recorded a year ago, and allow for relative optimism and hope as regards the efficacy of vaccines, booster shots, new medicines and efficient practices in the current and future management of Covid-19.

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