BERENBERG INVESTMENT REVIEW QUARTER 1 2022

Foreword

Much has changed over the last quarter, but it is not difficult to know where to start - our thoughts are very much with the people of Ukraine.

The period started with markets pricing in significant increases in interest rates, anticipating the inflation risk from the supply side induced price spikes of 2021. Against a background of strong economic growth, this caused a decisive move into economically sensitive sectors during January. The delicate balancing act in the monetary policy of central banks became more difficult with the outbreak of war in Europe driving commodity price rises higher.

Events in Ukraine have brought about unprecedented geopolitical collaboration ranging from humanitarian to energy policies. As a result, a move towards protectionism as countries reset post Covid may have slowed. In contrast, the climate-driven energy transition will hasten and this will bring both new challenges and opportunities for innovation. Companies that are adaptable, opportunistic and sustainable will benefit.

Now more than ever, it is important to retain the focus on due process and long term investing. We are in a period of great uncertainty, and that requires a nimble approach to investment and portfolio construction - qualities that we will discuss more fully in this review.

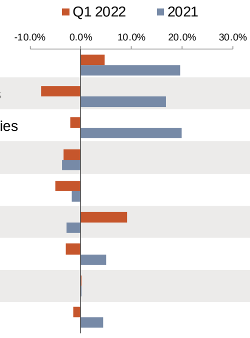
Yours sincerely,

Richard Brass
Head of Wealth & Asset Management, UK

SECTIONS

- Q1 asset performance
- Russia invades Ukraine
- US yield curve flashes inversion
- Disruption in global commodity supply
- Portfolio performance
- Outlook

Chart 1: Multi-asset performance (Q1 2022 and 2021)



	12 Month Performance Over Last 5 Years				
	31/12/21 - 31/12/20	31/12/20 - 31/12/19	31/12/19 - 31/12/18	31/12/18 - 31/12/17	31/12/17 - 31/12/16
UK Equities	19.6%	-13.2%	16.4%	-8.8%	11.7%
Europe Ex UK Equities	16.9%	7.6%	19.8%	-9.9%	15.9%
World ex Europe Equities	20.0%	15.3%	22.3%	-2.4%	12.8%
Gilts	-3.7%	3.6%	2.6%	1.0%	0.7%
Corporate Bonds	-1.8%	6.3%	8.8%	-1.2%	4.8%
Gold	-2.8%	21.6%	13.7%	4.4%	3.6%
Alternatives	5.1%	0.7%	6.3%	-5.8%	5.5%
Cash	0.1%	0.2%	0.7%	0.6%	0.3%
Sterling (T/W)	4.4%	-1.8%	5.0%	-1.5%	1.0%

Source: Bloomberg Finance L.P.
Total Return in Sterling to Close of Business 31/03/2022

Q1 asset performance

The majority of equity regions experienced a difficult quarter for returns, particularly Europe, through a combination of the outbreak of war in Ukraine in conjunction with increasing inflation and rate expectations. Commodity heavy markets, such as the UK with its exposure to large cap oil companies and Latin America which has exposure to both energy and agricultural based commodity firms bucked this trend as supply constraints buoyed these sectors. Chinese equities were weaker than its emerging market counterparts as it tackled a fresh wave of Covid-19 cases and implemented lockdowns in some notably large cities such as the port city of Shenzhen and the manufacturing hub Shanghai. Growth stocks were hampered more than their value counterparts due to rising rate expectations, although the majority of this performance discrepancy was confined to January.

Bonds across both the government and corporate sectors suffered as central banks shifted to a more hawkish approach to monetary policy. Inflation linked bonds initially fared better, however even these securities were not immune from rate movements in March. Although rate rises are typically a drag on the price of gold, its properties as an inflation hedge as well as a safe haven asset meant it experienced strong performance over the quarter. Almost all commodity markets in energy, metals and agriculture rose significantly given that both Russia and Ukraine are noteworthy suppliers.

Russia invades Ukraine

The first quarter of 2022 was characterised by Russia's invasion of Ukraine and the humanitarian crisis that has followed in its wake. The unprecedented attack has drawn condemnation at large from the majority of the free world and has potentially led to paradigm shifts in Europe and beyond with regards to defence spending, energy dependence and geopolitical relations.

Much of the developed world has now imposed strict financial sanctions on Russia, which have ranged from imposing restrictions of individuals closely tied to the Kremlin, removing Russian banks from the SWIFT payments system to freezing some 2/3 of the Central Bank of Russia's assets.

The importance of Russia as a provider of energy to the global economy can be seen starkly in financial markets. The price of Brent oil futures rose by over 30% in the wake of the invasion, however prices tempered somewhat as the month of March went by, with prices now sitting a hair over the $100 mark. What is more of a concern for European nations is its dependence on Russian natural gas. Currently Russian gas makes up c.30% of EU consumption. While neither side has withdrawn from trade of the commodity, it remains a significant overhang as the war continues.

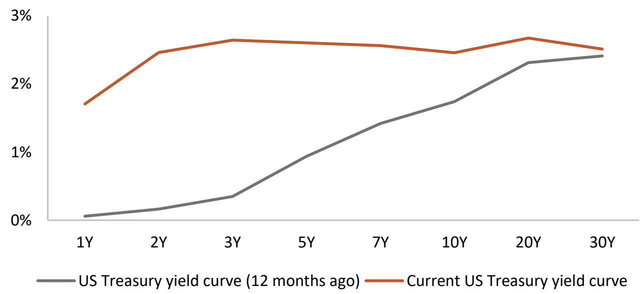
US yield curve flashes inversion

During the initial outbreak of the Russian invasion into Ukraine, investors sought safe haven assets, which saw government bond yields decline. However, investors began to digest the implications of the humanitarian crisis, particularly with regards to commodity prices rising rapidly as a significant portion of global supply was disrupted on the back of sanctions placed on Russia. Before the outbreak of the invasion, the world was already grappling with supply chain and inflationary pressures and this added impulse has only pushed shorter term inflation expectations higher.

Creeping inflation expectations accelerated the already emerging hawkishness of central banks across the global in the first quarter. The Bank of England raised rates twice to 0.75% while the Federal Reserve also notched its first hike of 0.25% and could not rule out 0.5% rate hikes in the future if the inflationary environment did not abate. The trend was similar across most of the developed world, besides Japan where even despite recent supply chain bottlenecks, inflation remains near the 1% level as well as the European Central Bank, which guided markets to rate rises once it has completed its asset purchasing programme.

This culminated in bond yields on government bonds rising across the board, most notably at the shorter end of the spectrum. This has meant the overall yield curve has flattened significantly, with the closely watched spread of US 2 year and 10 year treasuries briefly inverting during the month of March, which has often been associated with upcoming difficult economic conditions.

Chart 2: US yield curve flattening



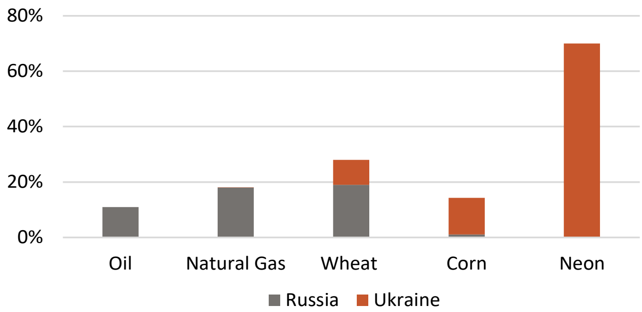
Source: Bloomberg Date: 31/03/2021, 31/03/2022

Disruption in global commodity supply

It is not energy commodities alone that have been impacted by the Russian invasion. Russia and Ukraine make up over a quarter of the global wheat supply which has raised concerns over significant inflation in the grain. Ukraine also houses two of the world's leading neon suppliers, which is a critical gas in the production of computer chips – an industry that was already facing notable disruption amid a global shortage and a backlog of orders. However, following the annexation of Crimea in 2014, which sent neon prices up c.600%, global chip manufacturers began implementing contingency plans to utilise other noble gases in the event of further disruption.

Nickel had a particularly volatile March. Prices initially spiked due to Russia making up some 7% of the global supply. This prompted a feed-back loop as it emerged that a large Chinese nickel producer was struggling to cover a large short position by buying up the commodity. At one point in March the price doubled, a move so sharp that the London Metal Exchange had to suspend trading in the asset.

Chart 3: Global share of commodity export market



Source: IEA, FAOSTAT, CIA, Techcet

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Portfolio Review

The 1st quarter of 2022 started with inflation and interest rate pressures, against a strong economic growth background which resulted in a rapid snap back in relative performance for the value equity style, relative to quality growth. The rotation lasted barely a month but was damaging to our relative performance. Following this, all eyes focused on Ukraine and the atrocities unfolding there. As markets became accustomed to the outbreak of war, attention began to revert to fundamentals once again meaning February and March performance for our strategies was better. For the quarter however, absolute returns were negative as were relative returns. The main detractors were in equity selection, but these effects have already started to reverse.

We remain marginally overweight in equities, but our optimism has flagged, resulting in us drawing in our horns a little. During the quarter we increased our value-cyclical exposure at the margin by increasing – and then taking a quick profit on – exposure to Latin American equities. We exited Nasdaq, a Multi Strategy hedge fund and Mortgage-Backed securities. Overall we reduced equities by a few percent.

Outlook

Whilst the underlying growth outlook is good and has many supports, there are significant risks building. The war in Ukraine has exacerbated a number of issues which were already of concern. Supply shortages are not getting much better and have indeed expanded to other sectors, pushing up inflation in areas like soft commodities. Likewise, continued sanctions are aggravating already significant inflation in energy prices. Markets are beginning to consider that the longer this goes on, the more damage it will inflict on economic growth. To be sure, we don't think this has reached a critical stage yet, but our economists have downgraded our global economic growth forecasts. The US is likely to grow 0.5% less than previously expected in 2022 whilst the cut to Europe is 1.1%. However, we still expect both regions to grow well in 2022 and recover in 2023.

Similarly our economists have increased our inflation forecasts – in the US by 1.2% and Europe by 2.8%. Many people have excess savings to cushion these price increases, but of course many – who would otherwise have a high propensity to consume – do not. These increases reflect the situation in Ukraine, but underlying them are special factors from 2021 which have yet to fully unwind.

Naturally the implication is that interest rates and yields will continue to rise. Central banks need to increase interest rates from the very low levels they are at, but if inflation is a supply side issue (labour and primary and intermediate goods) then rate hikes will only work so well before demand is curtailed. Bond markets appear to have already sussed this, which can be witnessed in the above comments on the yield curve flattening. Perhaps other interpretations are the pricing of success in curtailing inflation and the short end of the bond market reaching equilibrium on where the natural rate of interest is assumed to be.

Where this leaves asset allocation is difficult to call. Certainly the outlook for the bond market appears poor, but should inflation become demand destructive, this would presumably cause markets to reprice expected interest rate increases from the Federal Reserve. For equities, it is notable that earnings estimate revisions are flat to negative for all sectors except materials and energy. This likely reflects caution on the part of analysts.

Our expectation is that the current situation is temporary and that by the end of the year a more stable growth environment will have emerged. Naturally a lot depends on unknowns with regard to Russia / Ukraine, hence we are adopting a more cautious stance than previously.

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Data Sources

UK Equities	MSCI UK Net Total Return Local Index
Europe Ex UK Equities	MSCI Daily Net Total Return Europe Ex UK Euro
World ex Europe Equities	MSCI ACWI ex Europe Net Total Return USD Index
Gilts	IBOXX GBP GILT TR 5-7
Corporate Bonds	IBOXX GBP CRP TR 5-7
Gold	Gold USD Unhedged
Alternatives	Hedge Fund Research HFRU Hedge Fund Composite GBP Index

Cash	ICE LIBOR GBP 1 Month
Sterling (T/W)	UK GBP Broad Index 2005=100 Trade Weighted

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