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Investment policy Q2/2022
English Version

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DEEP RUSSIA

Investment Policy

While the pandemic seems to be approaching its final phase, despite some resurgence of variants in limited areas, especially in the Far East, Russia's military operations in Ukraine burst onto the scene, with American and European sanctions (which Switzerland joined with an unprecedented political move), various retaliations and collateral initiatives that also influence the economic and financial sphere. The sharp increase in the price of most raw materials, from energy to metals and agro-food products, which had already been seen in previous months, had led to a significant inflationary trend, which reached the highest levels in the last 40 years, reinforced by bottlenecks in logistics chains, and now by geopolitical developments whose evolution is currently unpredictable. The energy crisis is heavily affecting Europe, including Switzerland, and other raw materials are destined to affect the lives of families and businesses in an equally significant manner.

The situation would require drastic choices in political terms and on the part of central banks, with significant increases in interest rates, which cannot be implemented, especially in Europe, so as not to compromise an economic recovery that was already proving to be weak if not ephemeral in certain areas. The situation in the United States, on the other hand, appears more favorable.

Of course now the evolution of the scenario depends largely on the development of the Russian-Ukrainian conflict: short-term agreement, with acceptance of the conditions desired by the parties, or continuation of the military conflict with potential extension. All of this would condition the process of greater or lesser normalization in central bank policy, energy prices, the revenues of companies, especially European ones, and the evolution of currencies. The spectre of stagflation, with rising inflation and a weak or declining economy, hovers over the current scenario.

Under these conditions, a prudent investment strategy is required, which in any case favors quality equities over bonds. A rise in the level of conflict would further reward safe haven assets.

Outlook

The Federal Reserve (FED) raised the reference rate by 0.25% at its March meeting, announcing at least six further restrictive measures during the year, in light of positive data on economic recovery and the labor market, and the desire to combat inflation, which has now reached the 8% threshold. Similar choices were made by the Bank of England and other countries, including those in the Gulf, which, however, benefit from much lower inflation, but better economic trends. In Europe, the choices of the European Central Bank (ECB) are more difficult, and fundamental reasons are combined with geopolitical ones. While there is talk of loosening or overcoming the so-called Stability Pact, special funds to support immigration, financing a common defense, and more, it makes sense for the ECB to be forced to operate cautiously on both the interest rate and the repurchase of securities on the market, while exposing itself to the risk of importing inflation. The Swiss National Bank (SNB) is also faced with the dilemma between interventions aimed at avoiding an excessive appreciation of the franc and potential inflation in the Swiss system. If the East-European picture is complex and uncertain, another critical pole that could weigh on the chessboard should not be overlooked, namely Beijing's already declared choice to annex Taiwan, capable of determining potential US reactions and destabilization on a regional level.

Macro

The American economy is progressing favorably in parallel with the labor market, although the impact of high energy costs, and inflation in general, on household consumption and business activity will need to be verified. More difficult, as mentioned, is the European situation, which is diversified in purely economic terms and with an industrial and banking system exposed to geopolitical risks.

However, apart from the Taiwan risk, the economy that is being looked at with greater interest is China, whose growth continues in parallel with the actions of the authorities aimed at regulating markets, calming excess speculation and real estate bubbles, excess credit and other distortions in the economic and financial field.

In general, with a solution to the Russian-Ukrainian crisis satisfactory for both parties involved and for the other chancelleries, the climate should improve. Perhaps it would be necessary to rethink certain excesses of globalization and the reformulation of supply chains that have had a negative impact on the development of certain key sectors, such as the automotive or technological sectors. In the light of what has happened in recent months, the energy transition also appears to be longer, more complex and more costly, both financially and socially, than was initially anticipated.

Fixed Income

If, in light of the current conditions, the ECB is likely to postpone the first interest rate hike until the end of 2022 and limit itself for the time being to a reduction in bond purchases, the outlook for euro bonds remains stable. US bonds are also under pressure, given the end of QE, the reduction in the FED's balance sheet and the rise in interest rates above 2% for maturities over 2 years. The yield curve is tending to flatten out in a worrying manner and, given the level of inflation, real yields remain largely negative.
The High Yield segment and some emerging markets are more interesting, with the exception of Russia if not in an ultra-speculative strategy. Chinese bonds are also suffering from the contagion of war operations even though performance remains very solid compared to the main markets.
Short durations and a preference for FRNs (floating rate notes), instruments with variable yields based on the evolution of inflation or other macro parameters, are recommended for euro securities.

Equities

In a scenario such as the current one, applying the evidence of historical-statistical analysis, we note how stock markets recover relatively quickly from corrections caused by geopolitical crises. Obviously, this depends on the depth and extent of the crisis itself. Even if valuations appear expensive (in any case lower than those of bonds) and volatility high, retracements due to Russian-Ukrainian events and the effects of sanctions may be an interesting moment to enter the markets.
Wall Street maintains its interest and the financial sectors stand out, which benefit from rising rates and have interesting valuations and dividends. The same applies to the Swiss market, in which the insurance sector is also attractive; equally interesting is now Japan, whose Nikkei index has fallen to levels of 27,000 points, making it attractive.
Amongst the emerging markets, investors are focused on China, where corrections have been strong. The central bank has again declared its willingness to support economic growth, but the Taiwan issue and Beijing's relationship with Moscow are hovering around. All in all, it may be time to marginally increase some positions, accepting a certain margin of risk and volatility, at least in the short-to-medium term.

Alternative Investments

This market also shows greater volatility but hedge funds that follow a Merger Arbitrage and Long/Short strategy with low net exposure are interesting.
In the commodities sector, regardless of the outcome of the Russian-Ukrainian conflict, energy prices (oil and gas) appear destined to remain relatively high, also because sanctions and counter-sanctions will not disappear in a hurry. Crude oil has reached its highest level in over 10 years and the position of OPEC+, and in particular of its leader Saudi Arabia, has remained stable in the face of political pressure coming mainly from Washington. On the contrary, for the first time Riyadh accepted crude oil transactions with India and China settled in yuan instead of US dollars. Moreover, India continues to purchase Russian oil despite sanctions and Iran's return to the market appears to be delayed by difficulties in negotiations over its nuclear program, while Washington is now even knocking on Venezuelan President Maduro's door.
Equally strong were the increases for industrial metals, including those essential for high technology, widely held by China and Russia, and for agro-alimentary products (wheat and corn), whose price explosion could prove particularly critical in poor areas such as Africa, leading to social destabilization, as has happened in the past.
Gold has resumed its full role as a safe haven asset, which could, however, be reduced by an easing of the crisis, an increase in interest rates and a further strengthening of the US dollar.

Currencies

The US dollar has appreciated significantly in light of the Russian-Ukrainian crisis, but its evolution will be determined by the combination of the monetary policies by the FED and ECB. The Swiss franc has also strengthened, with the SNB's interventions more limited in order not to import too much inflation. Investors looking for higher yields in the long term can look to currencies of countries linked to raw materials or with particularly favorable framework conditions, such as the Norwegian Krone, Australian Dollar or Chinese Yuan, the latter of which seems to have started on the path towards increasing internationalization.

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