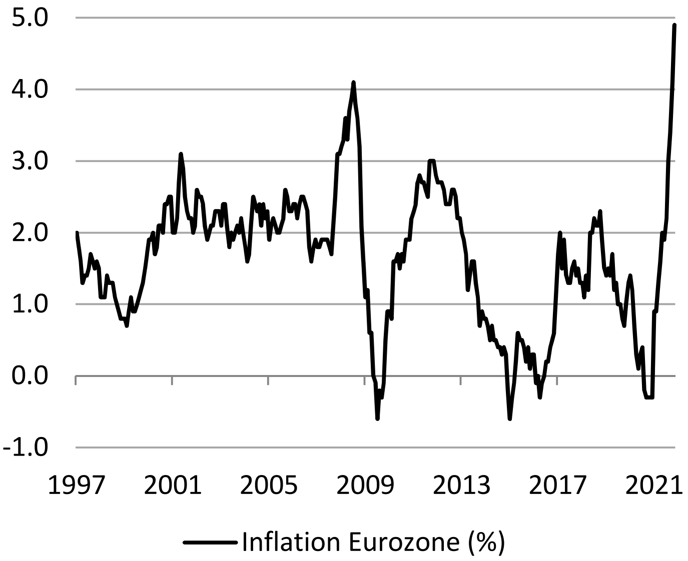
Review of the Year 2021

The return of inflation

2021 will go down in history books as the year in which inflation reached its highest level since the launch of the Euro. Currently Euro Area inflation is approaching 5%. How did this happen? Broken supply-chains, soaring energy prices and base-effects are cited as the main reasons for the jump in inflation. While ECB President Lagarde expects inflation to fall during 2022 and to drop below the medium-term two-percent target, renowned economists are pointing towards the risk of possible second-round inflationary effects such as wage increases and permanently rising prices attributed to climate policy.



It is for these reasons that the ECB left its key interest rate unchanged at 0% and its deposit rate at -0.50%. In spring the ECB will phase out the pandemic emergency purchase program (PEPP), but will increase the volume of the asset purchase program (APP). The ECB intends to continue to provide favourable financing conditions for member nations. The approach in the USA is different. Fed President Powell, who has been nominated for a second term, is expected to raise rates three-times by 0.25% in both 2022 and 2023. With an inflation rate reaching 6.8% and rapidly rising labour costs the potential for further rate hikes in 2024 remain. In the fourth quarter the yield curve of US Treasuries flattened significantly. The ten-year rate fell by 10 basis points to 1.50%, while the two-year rate rose by 40 basis points. The bond market is pricing the current level of inflation to be temporary.

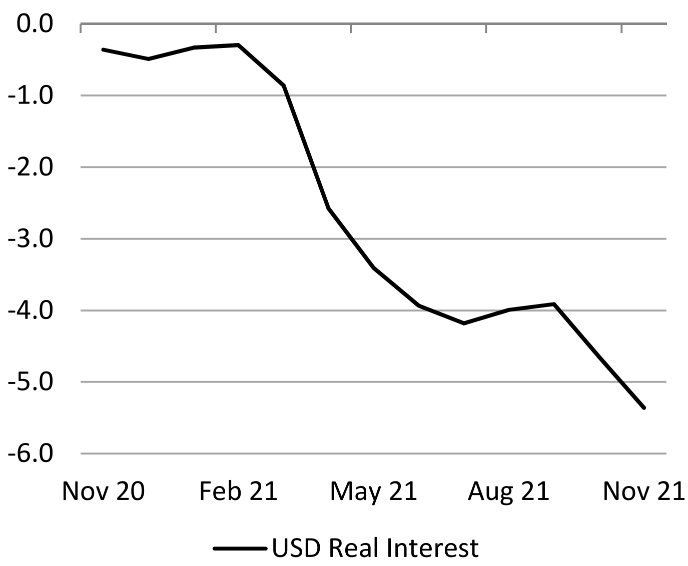
In the US the economic upswing of the first two quarters of +6.3% and +6.7% weakened significantly in the second half of the year due to supply bottlenecks, a shortage of labour and the expiry of government stimulus. While President Biden's USD 1.2 trillion infrastructure package was finally passed, his social security bill failed due to the lack of support from Democrat Senator Joe Manchin.

In China growth also slowed in Q3 to slightly below 5%. The real estate crisis, restrictive monetary and fiscal policies, declining credit growth and apparent energy shortages are cited as reasons for the deceleration. Apart from the Evergrande real estate group with debts of USD 300 billion many other companies in the sector faced a severe liquidity squeeze. The Chinese central bank finally reacted by lowering the minimum reserve ratio, thereby injecting additional liquidity into the banking system.

Hopes that the pandemic would disappear with the vaccination were dashed in the autumn. Volatility in the markets had been increasing with expectations of tightening monetary policy. During the second half of the year the breadth of the US stock market narrowed. It was the large-cap growth stocks, in spite of perceived more restrictive monetary conditions, that propelled the S&P 500 to new historic highs before the New Year (see also appendix of major indices).

If one compares the market value of US equities with US GDP or with corporate revenues, the valuation of the US equity market is at a historical high. However, considering the very low interest rate level, there remains a respectable risk premium for equity investments. Many companies are using their ample liquidity for dividend increases and share buybacks.

In our opinion, negative real interest rates of up to -5% were also responsible, among other things, that there were no significant price declines in euro zone and US stock markets during the year.



Strong demand from private investors allowed hundreds of empty shell companies (SPAC = Special Purpose Acquisition Company) to go public. The aims of a SPAC are to take over other companies and on occasion facilitate a reverse-merger. However, this type of investment is not part of our investment universe.

Investment Policy and Outlook

The equity outlook for 2022 remains positive with stable economic growth and negative real interest rates. Supply chain difficulties are expected to ease and many companies will be able to pass on inflation (or price increases) at least to some extent.

In the current investment environment, we continue to favour equity investments. We are focused on defensive sectors such as consumer goods and healthcare. This will remain the case as long as inflation is trending upwards and growth downwards. In addition, when selecting the equity funds for our discretionary portfolios, we ensure that the underlying holdings of the funds are companies with stable cashflows and solid balance sheets. However, as we believe the "headwinds" for equity investments have increased, we expect larger price fluctuations and more frequent corrections in equity markets. In the USA, the enormous fiscal policy support measures have come to an end. In addition, President Powell announced a more restrictive monetary policy with a series of interest rate hikes. The economic slowdown will be reflected in a lowering of earnings expectations over time. We are waiting for signs of easing supply constraints, labour shortages, rising energy and transportation costs. An easing of inflation during the year could provide a positive impulse for equity markets. Supportive monetary and fiscal policy measures by the Chinese leadership could provide the backdrop for a positive momentum in Chinese equities and global cyclicals.

We remain convinced that investments in bonds are fundamentally thoroughly unattractive in a clearly negative real-interest rate environment. Therefore, we maintain a significant underweight in bonds. In our portfolios we have focused on investments in first-class Chinese corporate bonds. We expect to benefit from higher interest rates and a strengthening Chinese currency. In addition, we are invested in a NOK-denominated Nordic high-yield bond fund. The investment provides an attractive yield and the potential for NOK appreciation. The euro lost value against the Swiss Franc and the USD due to the ECB's extremely expansive monetary policy. Gold gained 3% in euro terms. We maintain our core position in gold because of its role as a portfolio stabiliser.

Schaan, January 2022

Principal Asset Management AG