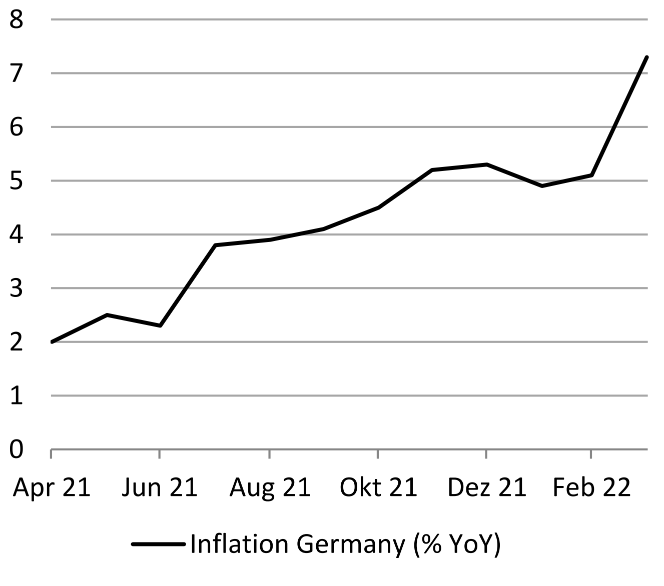
PRINCIPAL

Review of the first quarter 2022

Increasing risk of recession in Europe

The substantial price increases, which renowned economists and high-ranking representatives of central banks had considered to be a temporary phenomenon, intensified during the first quarter. The war in the Ukraine further exacerbated the trend. In Germany, the inflation rate rose continuously to a high of 7.3%. The Council of Economic Experts lowered its economic forecast for Germany from 4.6% to just 1.8% as a result of the serious economic consequences stemming from the sanctions imposed on Russia. The council warned of an imminent recession caused by Germany's high dependence on Russian energy and increasing uncertainty of future supply.



Following an announcement that Russia would invoice "unfriendly western states" only in rubles, Germany activated their emergency gas plan as a precaution, should the gas supply be halted. Representatives of the energy-intensive chemicals industry envisage a dramatic scenario in the event of a complete embargo of Russian energy, which would cause production to come to a complete standstill after a couple of days. The construction, automotive and packaging industries would also be unable to produce. The sanctions imposed on Russia and the calls for an embargo have already led to substantial price increases for oil and gas. Disrupted supply chains, increasing deglobalization and climate policy are also contributing to rising prices. In spite of inflation soaring to 7.5%, the ECB left the key interest and the deposit rates unchanged at 0% and -0.5% respectively. The ECB cites increased uncertainties for keeping rates on hold. In stark contrast to consensus the ECB President does not foresee the Eurozone slipping into a period of stagflation (weak economic growth and high inflation).

Interest rate hike cycle in the USA

In March, the U.S. Federal Reserve commenced a new cycle of monetary tightening with a hike of 25 basis points. Analysts have floated the prospect of six further rate increases in 2022. With inflation approaching 8%, some are even expecting rates to increase by 50bps at the next Fed meetings to bring prices back under control. In addition, President Powell has indicated that the Federal Reserve will go ahead with "quantitative tightening" and start reducing the FED's USD 9 trillion balance sheet. On average half a million new jobs were created per month in the first quarter. The unemployment rate dropped to 3.6% by the end of the quarter, while hourly wages rose sharply by 5.6% year-on-year. In response to Russia's attack on Ukraine, U.S. President Biden imposed an embargo on Russian oil and announced the release of 180 million barrels of crude oil from the U.S. Strategic Petroleum Reserve. The administration is attempting to lower crude prices by increasing supply.

Renewed Lockdowns in China

The Chinese government continues to pursue a zero-covid strategy and recently imposed a lockdown on Shanghai, its economic metropolis. Ports in other economic centres have been closed for the same reason. These measures could well lead to a renewed disruption of global supply chains. The structural problems in the real estate sector caused by the high indebtedness of many real estate companies remain unresolved. Due to an energy shortage the Chinese leadership is sticking to its strategic partnership with Russia despite the war in Ukraine. China is seeking to increase its share of Russian energy imports.

Investment Policy and Outlook
Richly valued growth stocks mainly from the tech-sector already faced stiff selling pressure in the first days of the new year. The expectation of rapidly rising US interest rates led to a revaluation of technology stocks and resulted in the Nasdaq 100 ending January down 8.5%. As part of our risk management, we had reduced the equity allocation in the discretionary portfolios by approximately 5% in January. We had anticipated rising prices and an increasingly restrictive US monetary policy. A labour shortage and rising wages in the USA, coupled with a global shortage of raw materials and supply chain issues are key components of rising prices.

Russia's attack on Ukraine caused a severe sell-off in markets and a sharp spike in volatility at the end of February. Gold and commodities rose together with increasing uncertainty. We increased the (already over-weight) gold position in the managed portfolios and shifted European equity investments into a broadly diversified US equity fund. Uncertainty surrounding supplies of energy and raw materials increased the prospect of a recession and higher inflation in Europe. The massive price increase in energy and raw materials are already impacting consumer purchasing power and eroding corporate profit margins. Higher inflation could prove to be a permanent phenomenon via the implementation of price increases by companies and second-round effects such as wage increases.

U.S. inflation rose to 7.9% (last seen in the early 1980's) and lifted the yield-curve across all maturities as higher than expected rates were priced-in. The ten-year rate rose by only 83 basis points to 2.34%, while the five-year rate rose by 120 basis points to 2.46%. The yield curve between the five and the ten-year notes has inverted, often regarded by analysts as an indicator of an impending recession. The prospect of rapidly rising rates caused the US bond market to decline sharply during the quarter. The JP Morgan Global Bond Index declined by -6% in the first quarter while the MSCI World Equity Index lost a similar amount of -5.7%. Both government and corporate bonds with longer maturities remain fundamentally unattractive as negative real-interest rates prevail. In our view, the US dollar can continue to appreciate due to the significant interest rate differential against the Euro.

Investments in commodities and gold are suitable as adequate protection in the current environment of high inflation. In the managed portfolios a commodity investment fund returned a very pleasing performance of +26% in the first quarter. Gold investments had a stabilizing effect in our portfolios and increased by +6.6%. The gold mining equity fund we have deployed in the managed portfolios also contributed positively to performance with a 10% increase.

In terms of equity investments, sector selection will continue to be crucial. We prefer defensive sectors as well as stocks from the commodity sector. In the turbulent current investment environment, our diversified portfolio approach and deliberate use of stabilizers has proven its worth. With the war in the Ukraine, high inflation and a weakening economy we are anticipating high volatility and large fluctuations in the markets and therefore the necessity for our strict risk management.

Schaan, April 2022

Principal Asset Management AG