Climate Report

January 2022

Will the Goldrush continue?

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Climate Conclusions

- **Will inflation become a problem in 2022? Yes.** In our Base Scenario 'Profit Squeeze', we see a squeeze of profits and real household incomes that will dampen the global economy and weaken risk asset performance. As a result, we start the year with an underweight of our Risk Asset portfolio.

- **Will inflation get out of hand? No.** We see a moderation of crude/intermediate inflation during 2022 and only a mild catch-up in 2nd round inflation drivers (wages, rent, service prices).

- **Will inflation expectations stay anchored below 3%? Yes.** If not, the global inflation regime has changed – for real. Real rates will move higher in 2022 and underpin a rotation out of growth stocks if we are correct. If we are wrong fixed-income rates will move much higher, and we will have to adjust our investment scenarios in a negative direction.

- **Can Central banks start their tightening cycle without hurting risk assets too much? Yes.** We think they can, but the liquidity-credit-default mix scenario is a key risk for risk assets in 2022.

- **Will the USD continue higher? Yes.** Federal Reserve will hike interest rates in 2022, ECB will not. Therefore, we keep an overweight position in USD.

- **Will the economic transformation from Analog to Digital economy continue to dominate and secure +14-15% growth for global equities in 2022? No.** 2021 saw record-high global profit growth as profit margins did not fall. Profits in a few sectors/Big Tech companies surprised. In our Risk scenario: 'Goldrush Continued', we include a strong profit cycle that investors are willing to pay for. We were wrong on the topic in 2021. This could happen again.

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Scenarios
&
Forecasts

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Scenarios

Base Scenario "Profit Squeeze":

- Cost inflation continues to be high and squeezes in profits and real incomes slow the global economy.
- The Fed will tighten policy as anticipated and push inflation expectations down towards 2%. But ECB will stay put, why the USD will strengthen.
- China will continue its policy-driven slowdown.
- Tighter policy initiatives happen without hurting the Credit&Liquidity cycles critically.
- Weaker growth prospects turn investors' focus back on valuation and dampen risk asset performance.

Risk Scenario "Goldrush continued":

- Inflation will cool off when short/medium-term supply-chain disruptions are easing off.
- Fed will tighten policy more than anticipated as 2. round inflation effects (wages/rents etc.) will catch up. As a result, the credit and liquidity cycle will weaken but not critically as inflation expectations stay below 3%.
- Households will benefit from solid real income & wealth gains, while companies continue to benefit from the secular digital growth trends.
- Despite higher risk-free rates, solid growth prospects keep investors' risk appetite relatively high.

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Market scenarios – End 2022

Rates

	5 year avg.	Now	Risk Scenario: GoldRush Continued End-2022	Base scenario: Profit Squeeze End-2022
Fed Fund Target	1.25	0.25	1.00	0.75
2Y US T-Bill	1.40	0.80	1.50	1.25
10Y US T-Note	2.00	1.76	3.00	2.50
Yield curve US 2-10	0.60	0.96	1.50	1.25
ECB Overningt Deposit	-0.45	-0.50	0.00	-0.50
2Y EU Schatz	-0.65	-0.58	0.00	-0.50
10Y EU Bunds	0.05	-0.07	0.50	0.00
Yield Curve EU 2-10	0.70	0.51	0.50	0.50

EUR/USD	1.14	1.13	1.00	1.06

Equities

	5 year avg.	End-2021	Risk Scenario: GoldRush Continued End-2022	Base scenario: Profit Squeeze End-2022
MSCI World		643	730	665
EPS Trailing 12mth (*)		25.5	29.0	27.0
EPS growth	8.6%	50.9%	14%	6%
P/E Trailing 12 mth (*)	18.1	25.2	25.2	24.6
Return 12 mth pct.	11%	30%	14%	3%

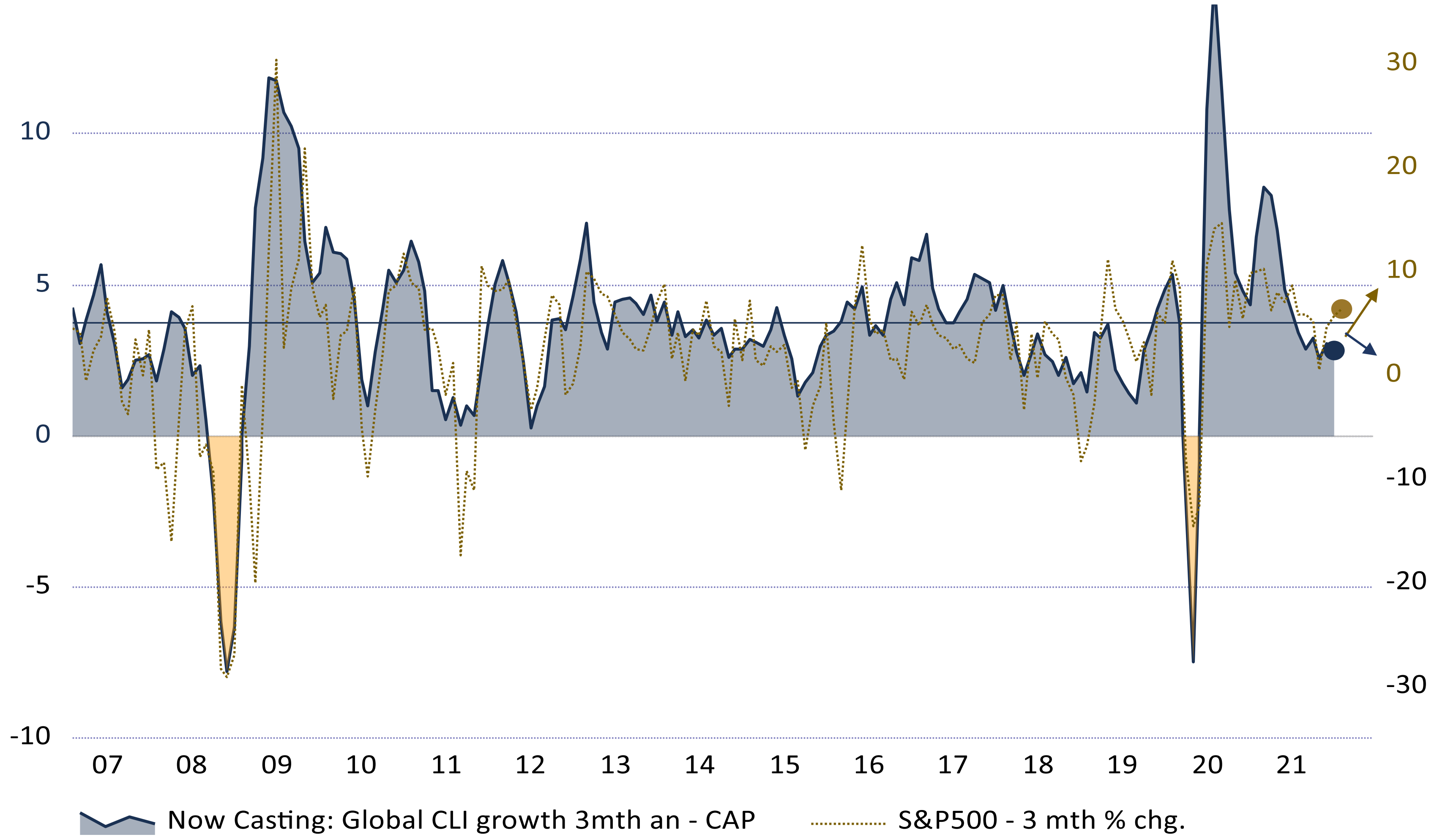
(*) Source: IBES

Macro Environment

Global economy is cooling off, Equities are reluctant to react
.....as GDP growth slows from a high level.

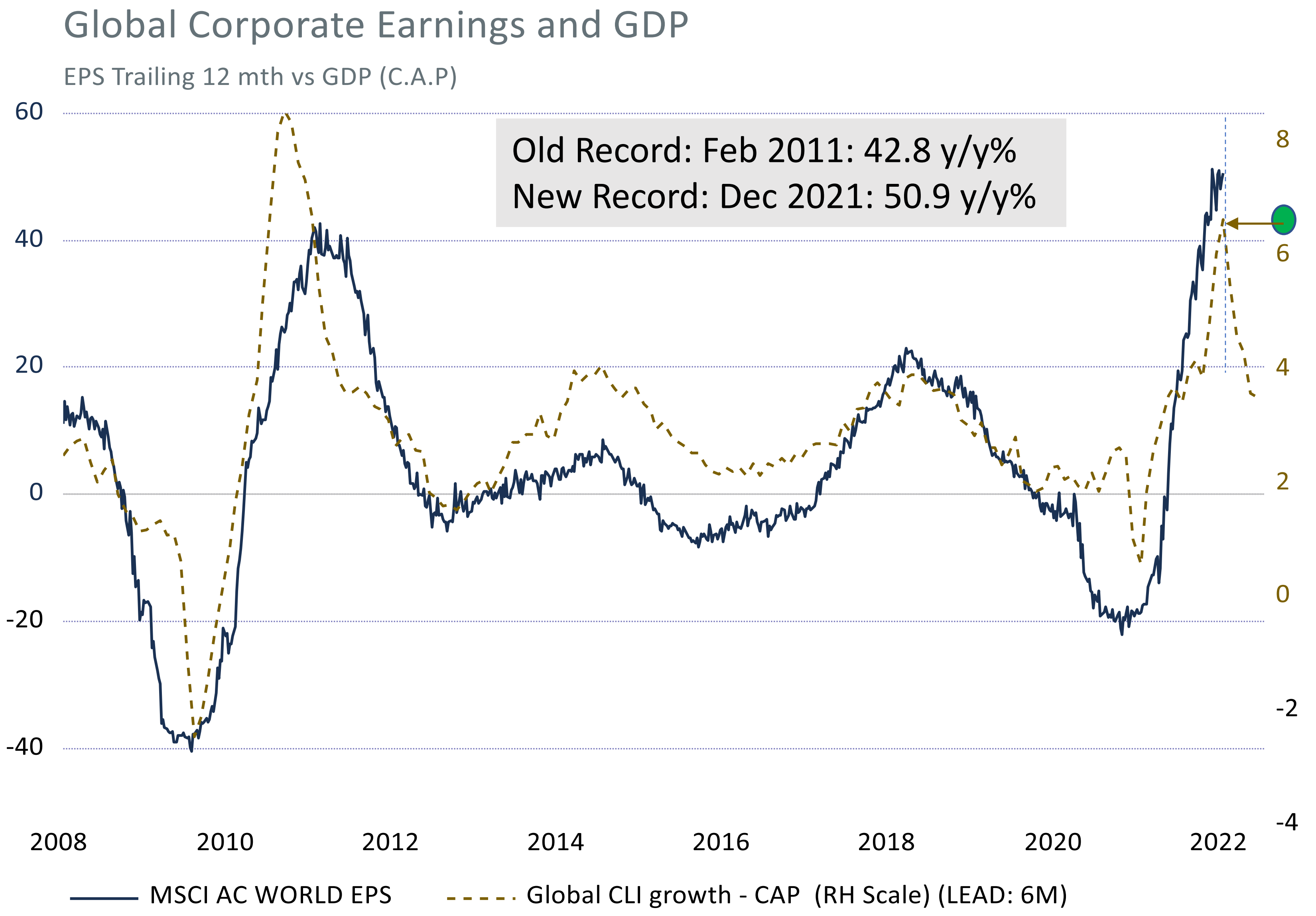
Now Casting

Global Growth & S&P500



Source: Refinitiv Datastream

The Global Profit Cycle: Stronger than ever!



CAP Forecast 2021 (June 2021)
Boom Scenario:
GDP +6.25% (+) / EPS ~~+28%~~ (-) +50%(!)

Jan 2022:
- Operational leverage has been higher than we thought.
- We see a GDP slow down to 3.5% y/y Mid-2022.

Source: Refinitiv Datastream

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The Global Profit Cycle: Stronger than ever!

Since start-2020

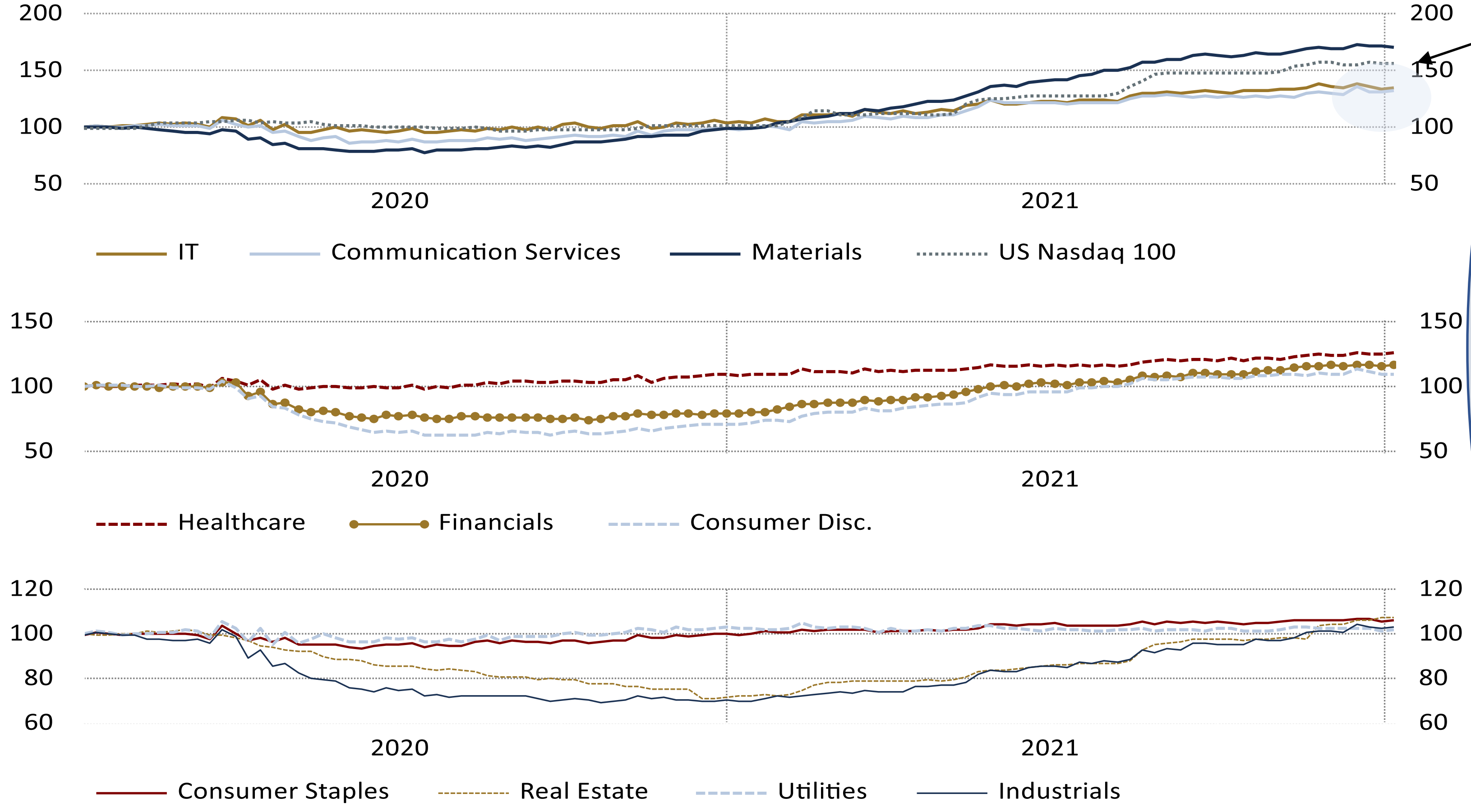
+30%

+10% to +30%

< +10%

Global Sector Earnings

2020&2021



Source: Refinitiv Datastream

From Analog to Digital Economy.

A secular transformation without the usual law of physics in place?
We have been wrong all along and continue to have our doubts!

eCommerce Healthcare
DeFi
Metaverse

……are all new growth drivers, but will they keep up +30% growth in a few sectors/Big Tech companies without a severe Corona crisis?

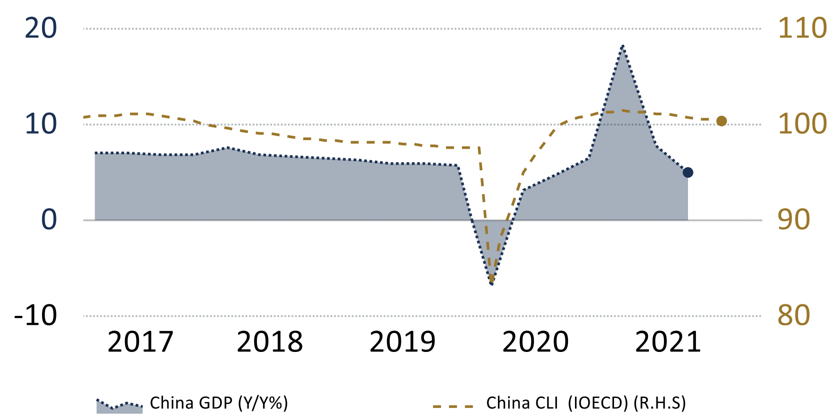
Our 'Goldrush Continued' scenario
It depends on it!

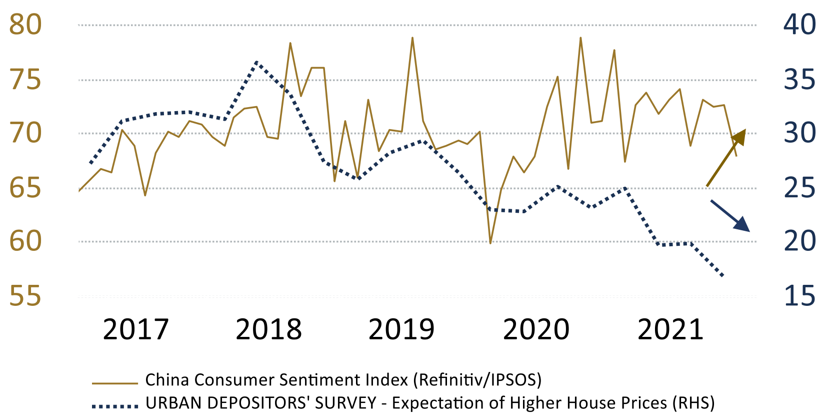
China’s growth is trending lower

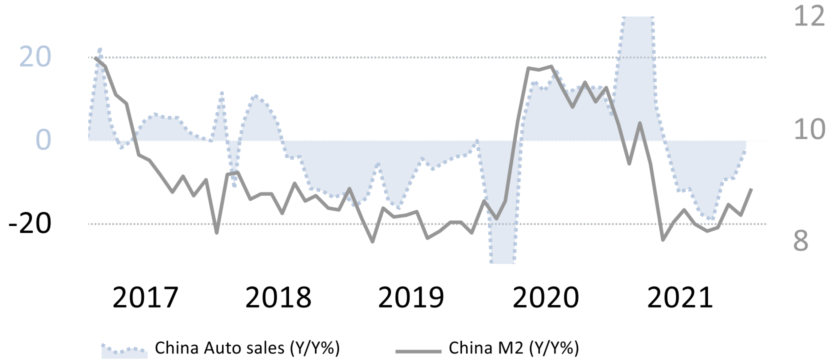
- China’s government is tightening its grip on the private sector, including tighter credits and stronger corporate regulation (e.g., on data ownership).
- With the 20th Communist Party within sight, the policy direction of 2020 is likely to continue in 2021.
- Neither the markets for housing, durable consumption, nor US exports are the growth engines they used to be.
- Will China continue along its sluggish growth path in 2022? We think it will!

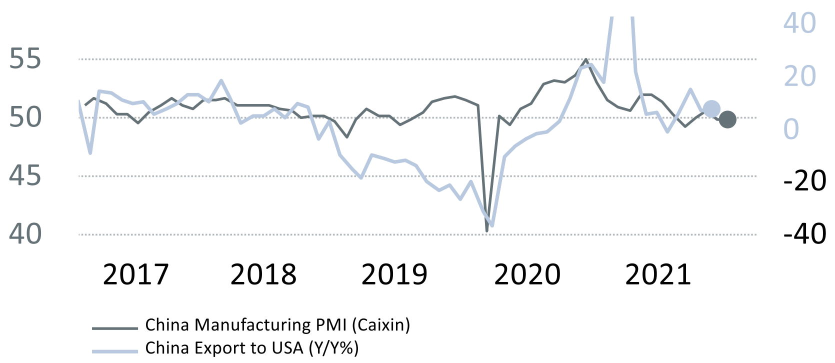
Cyclical Indicators

China









Source: Refinitiv Datastream, C.A.P

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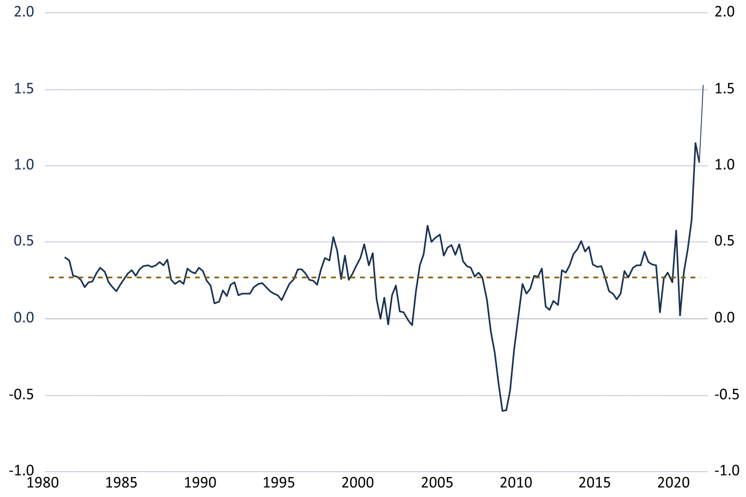
US Household income & wealth effects

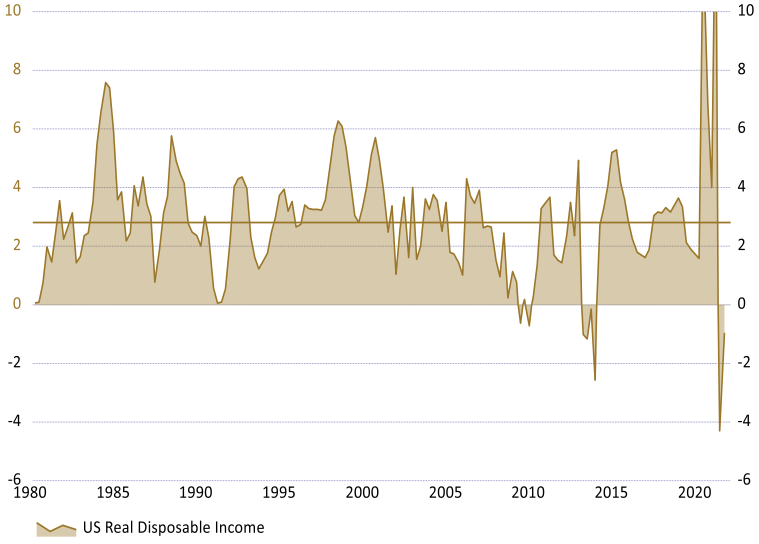
US Net Wealth change to GDP (AR)

12 mth change



US Real Disposable Income

Y/Y%



- Wealth Effects drove up consumption growth in 2021
- Monetarization of wealth is easy if credit conditions stay laxed
- Inflation has not yet squeezed household spending powers
- Convergence to income growth lays ahead, but it is likely to take some time before it happens. Wealth effects will – moving into 2022- continue to underpin US private consumption.

	Bn. USD	To GDP		Growth rate 12 mth %	
	21-Sep	Sep-21	LT Avg	Sep-21	LT Avg (*)
Personal Disposable Income	18168	78.3%	72.4%	5.80%	4.5%
Personal Consumption	16923	72.9%	66.7%	13.50%	4.3%
Household Wealth 12 mth chg.	34000	153%	27%	28.9%	7.1%
Personal Savings	1717	7.4%	6.9%	-39%	5.1%
GDP	23200	100%	100%	9.70%	3.5%

(*) Since 1990

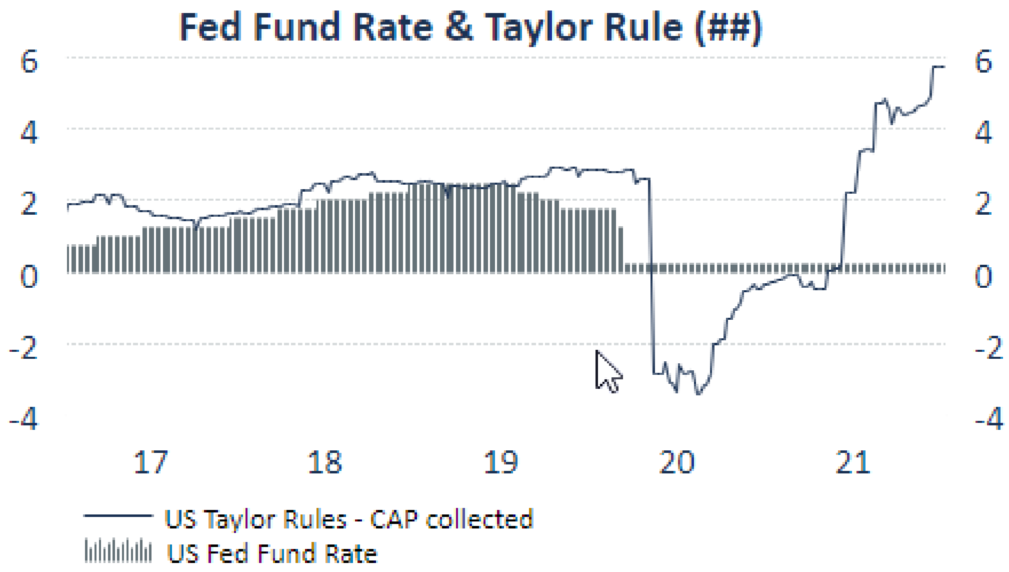
Source: Refinitiv, C.A.P

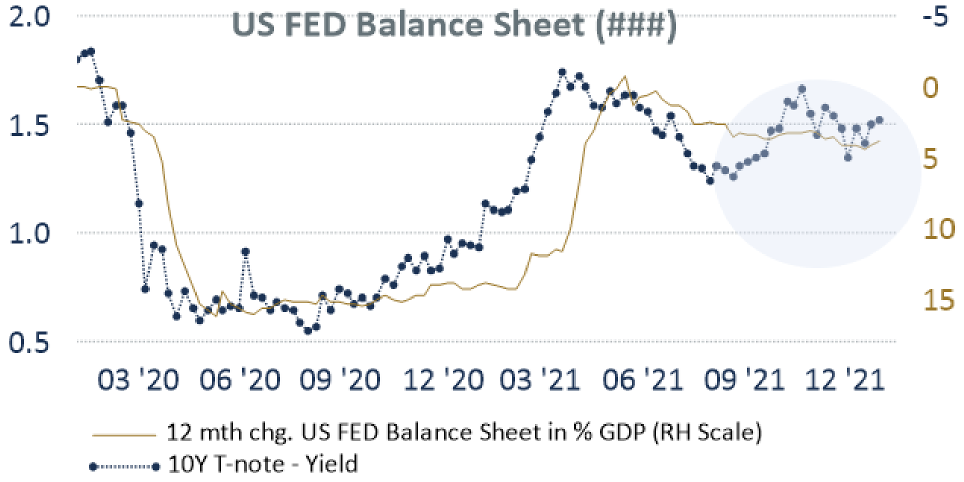
Yields on the rise

Following FOMC's decision to start QE tapering, 2-3 times 0.25% rate hikes are now discounted in the 2Y US T-bill.

Our Taylor Rule-based fair value rate has moved further up, now estimated at 5.75% (!) for the 2Y T-bill (!). The FED policy stance has become rather extreme!

Still….in 2021, QE continued to dominate the long Treasury market. This will not continue in 2022

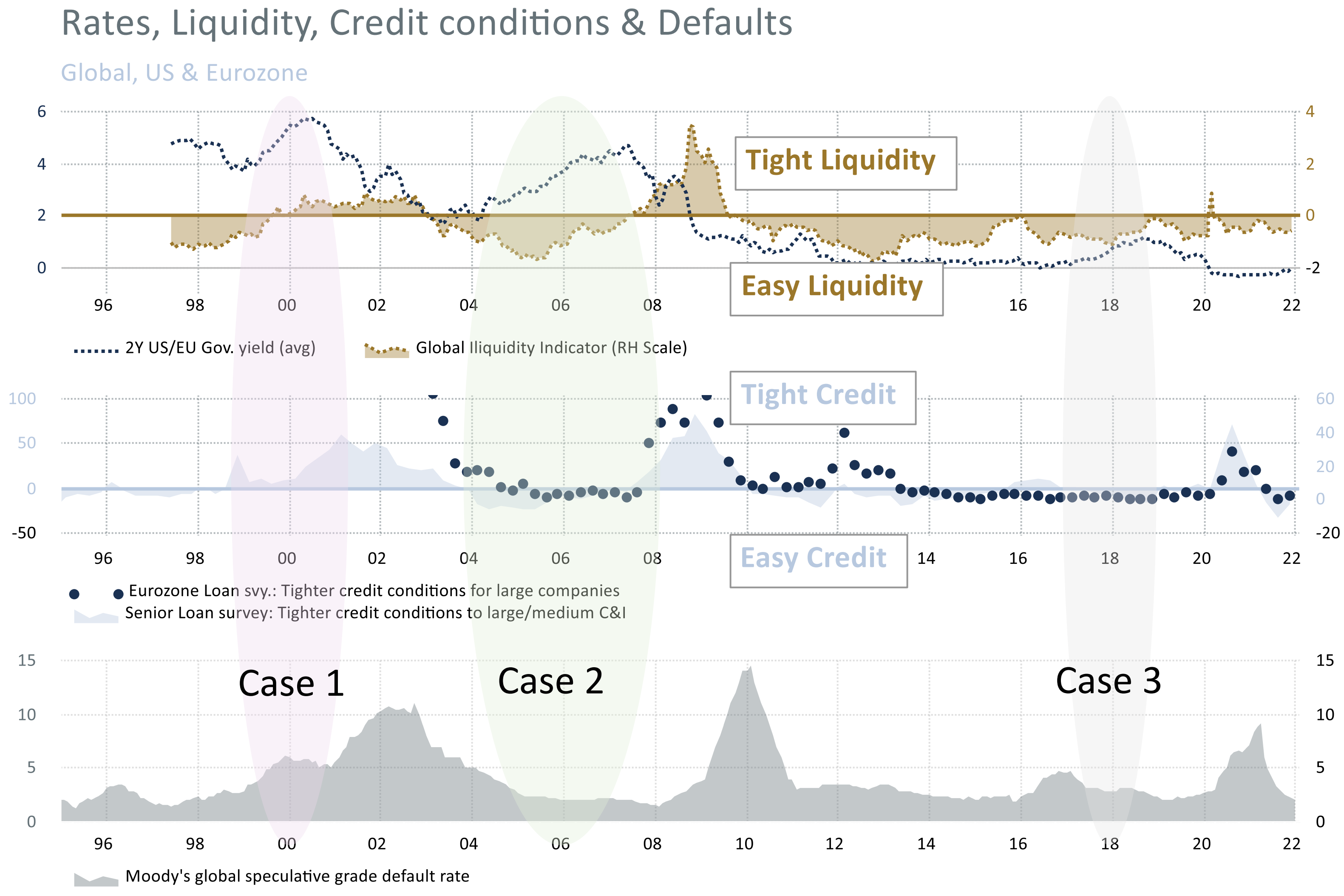




- FED QE tapering is starting this month (Jan-22), which will dampen the growth of the CBs balance sheet and ease the downward pressure on US LT interest rates.

Source: Refinitiv Datastream, C.A.P

What scenario plays out when CB rate cycle starts?



Source: Refinitiv Datastream, C.A.P

- Case 1 ”**1999”:** Short rates rise 200 bps, and liquidity, credit, and defaults react negatively within 12 mths.
- Case 2 **“2004-2007”:** Short rates rise 250 bps, but neither Liquidity nor Credits or Defaults react within 36 mths. time frame (GFC occurs +45 mths.)
- Case 3 **“2018”:** Short rates rise 125 bps, and liquidity almost turns tight before CBs manage to ease in time to prevent credit tightening and higher defaults.

Can CBs start a tightening cycle and prevent Case 1?

We think they can, but the liquidity-credit-default mix scenario is a key risk for risk assets in 2022/23.

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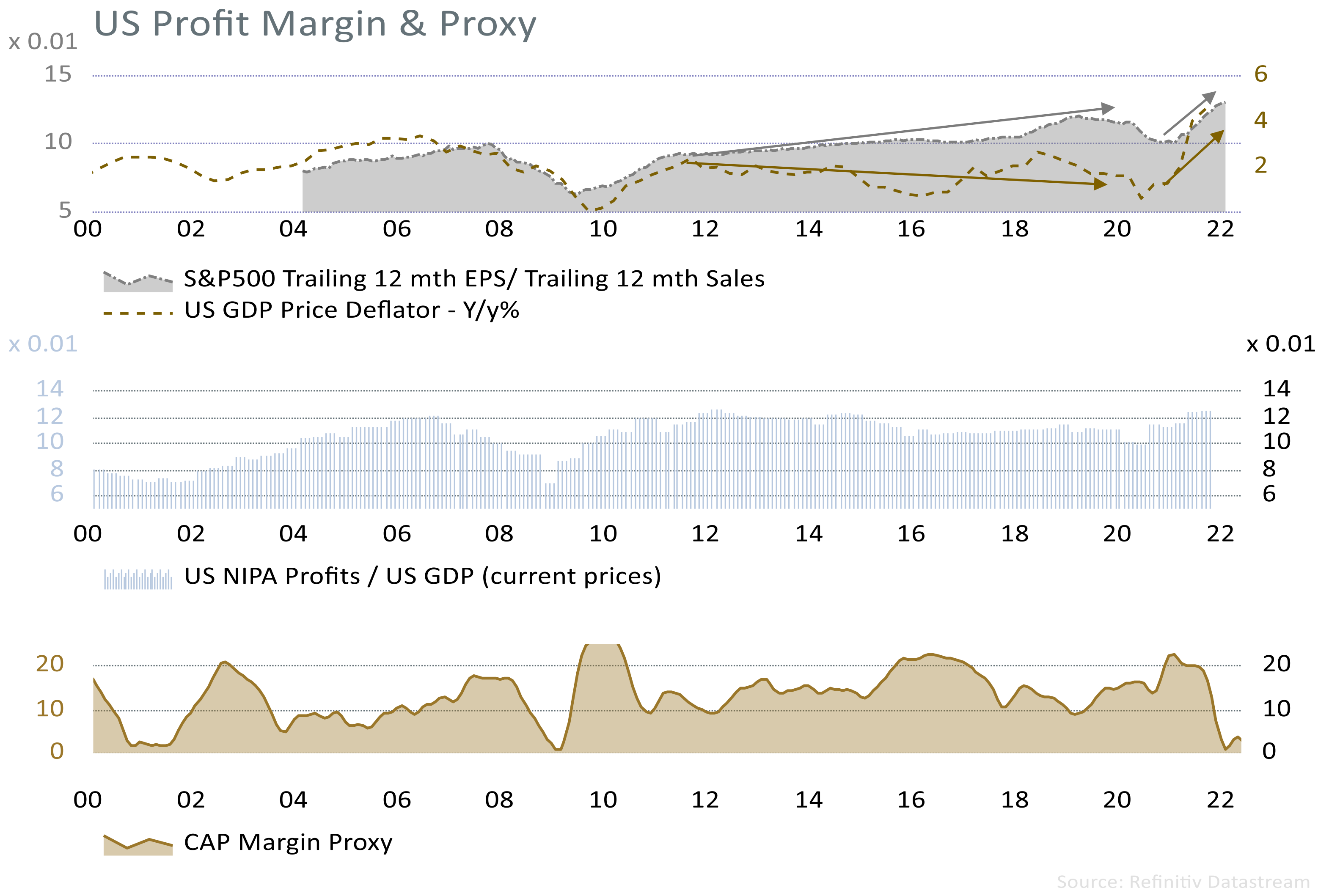
Inflation has not yet squeezed profits.



- **Record-high margins for SPX.** Inflation has been positive and not, as we had expected, a negative.

- **Peak margins for US Corporates** in general - but not at record as seen for listed SPX

- **Our margin proxy** is leading actual margins by nine mth. and indicates a 2022 squeeze. This is our Base case.

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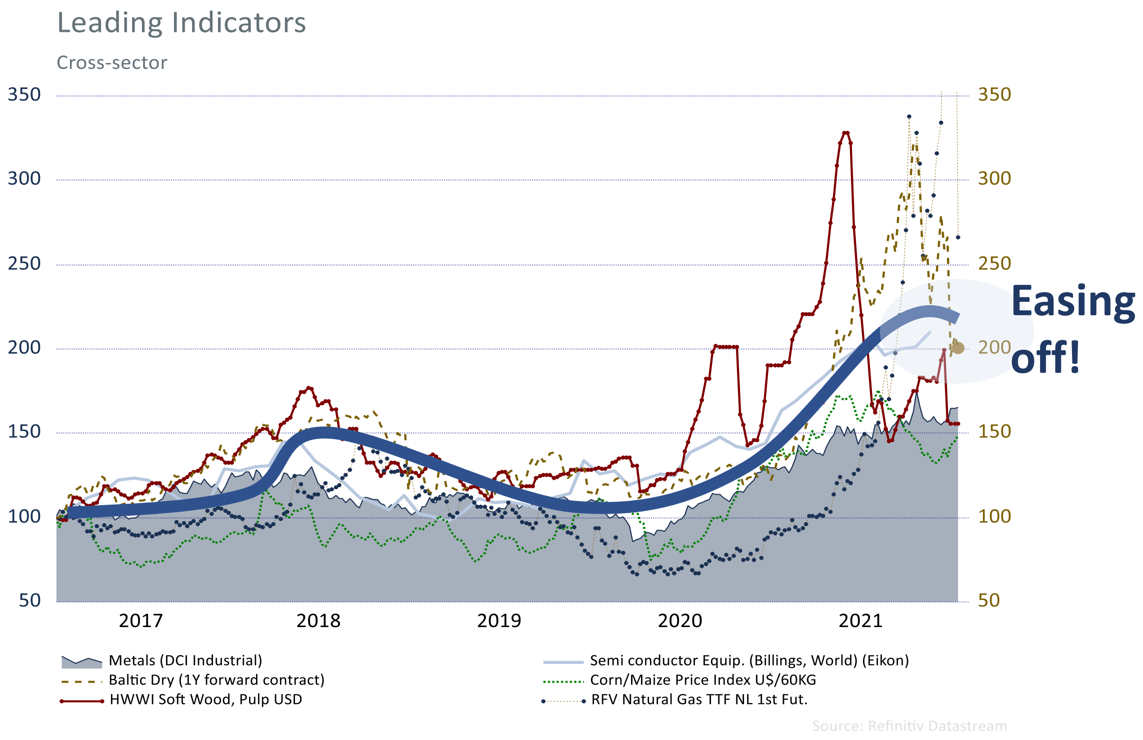
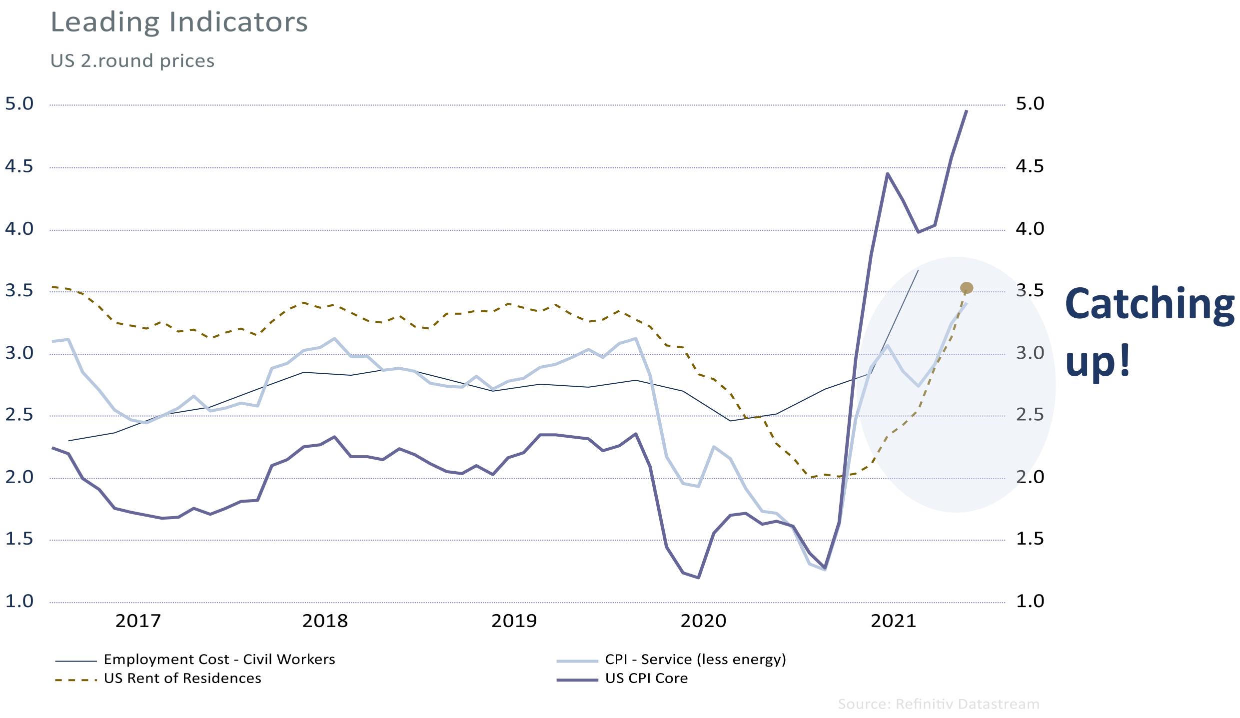
From Supply Chain disruption to Final prices ?

- The uptrend in Crude Prices is likely to ease off.
- Will Rental, Wages, and Service inflation take over? Not necessarily, but a risk to inflation & inflation expectations in 2022.





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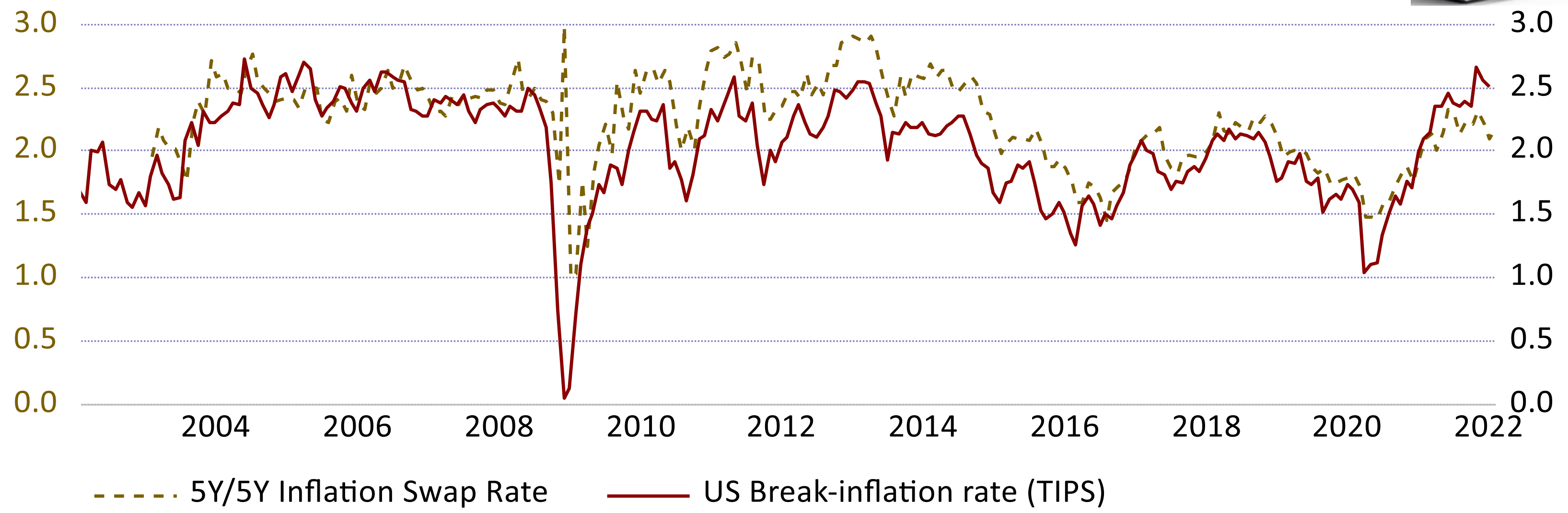
Inflation Expectations are still behaving rather well

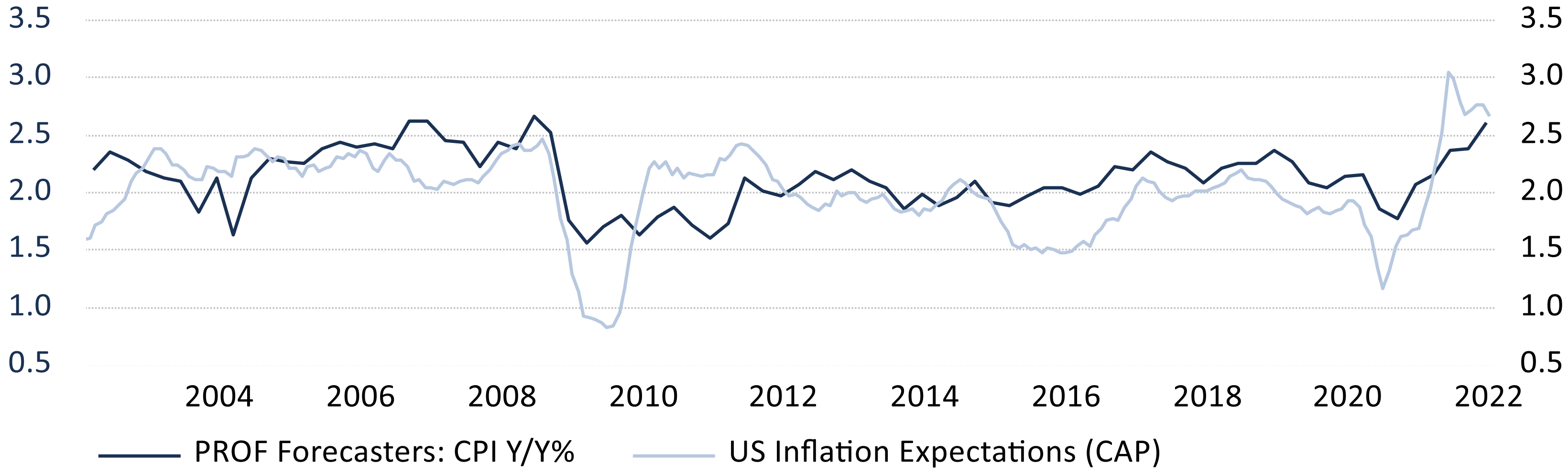
US Inflation Expectations are their highest in two decades

Are Inflation Expectations still well-anchored at around 2% in 2022?

It depends on 2nd round effects incl. employment compensation AND of course, FED policy

….but for now, it is included in our base case “Profit Squeeze” that inflation expectations stay below 3%

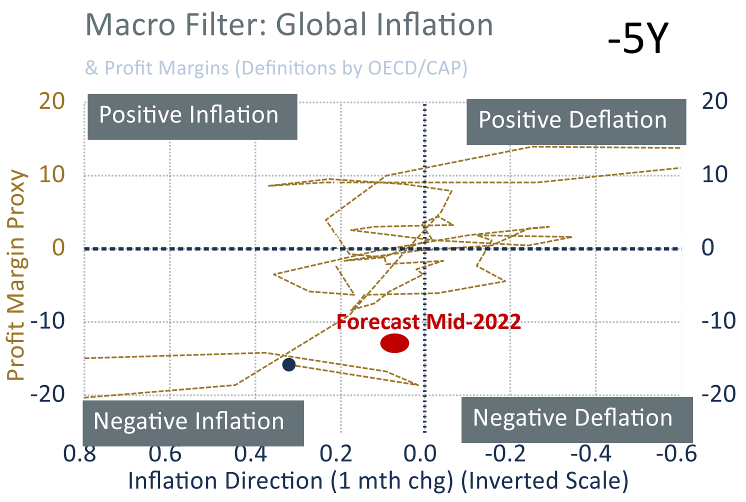




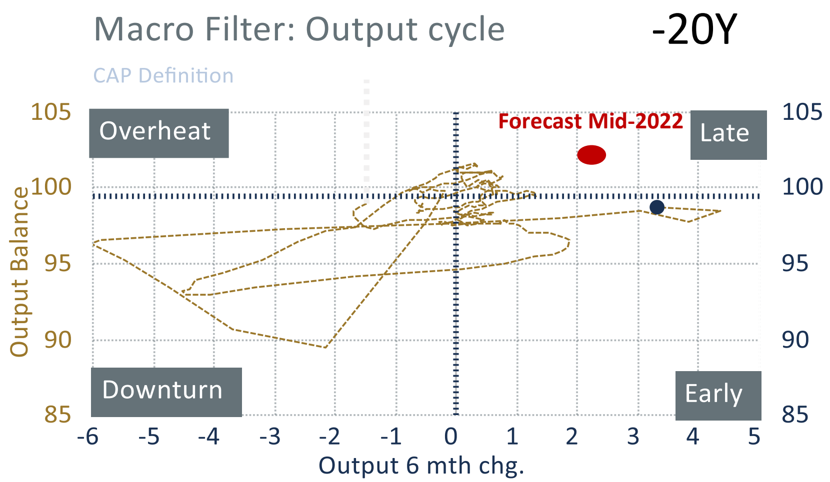
Source: Refinitiv Datastream

Risk Appetite
&
Cross Asset Allocation

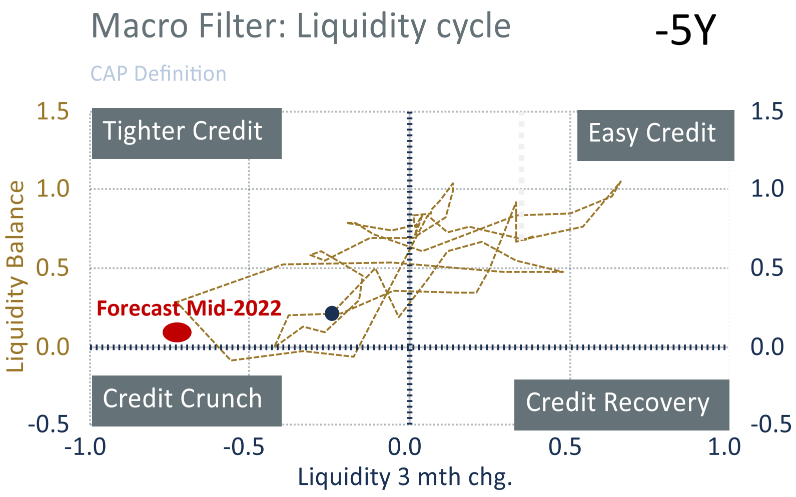
January 2022 – Our Climate readings!



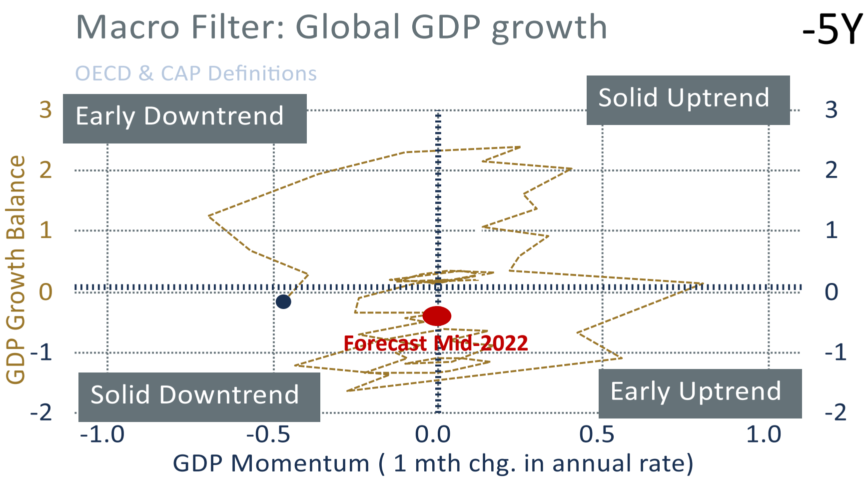
Risk Assets Return Score: Pos. Inflation (1), Pos. Deflation (2), Neg. Deflation (0), Neg. Inflation (-2)



Risk Assets Return Score: Early (2), Late (0.5), Overheat (-2), Downturn (0.5)



Risk Assets Return Score: Credit Recovery (1), Easy Credit (2), Tighter Credit (1), Credit Crunch (-2)



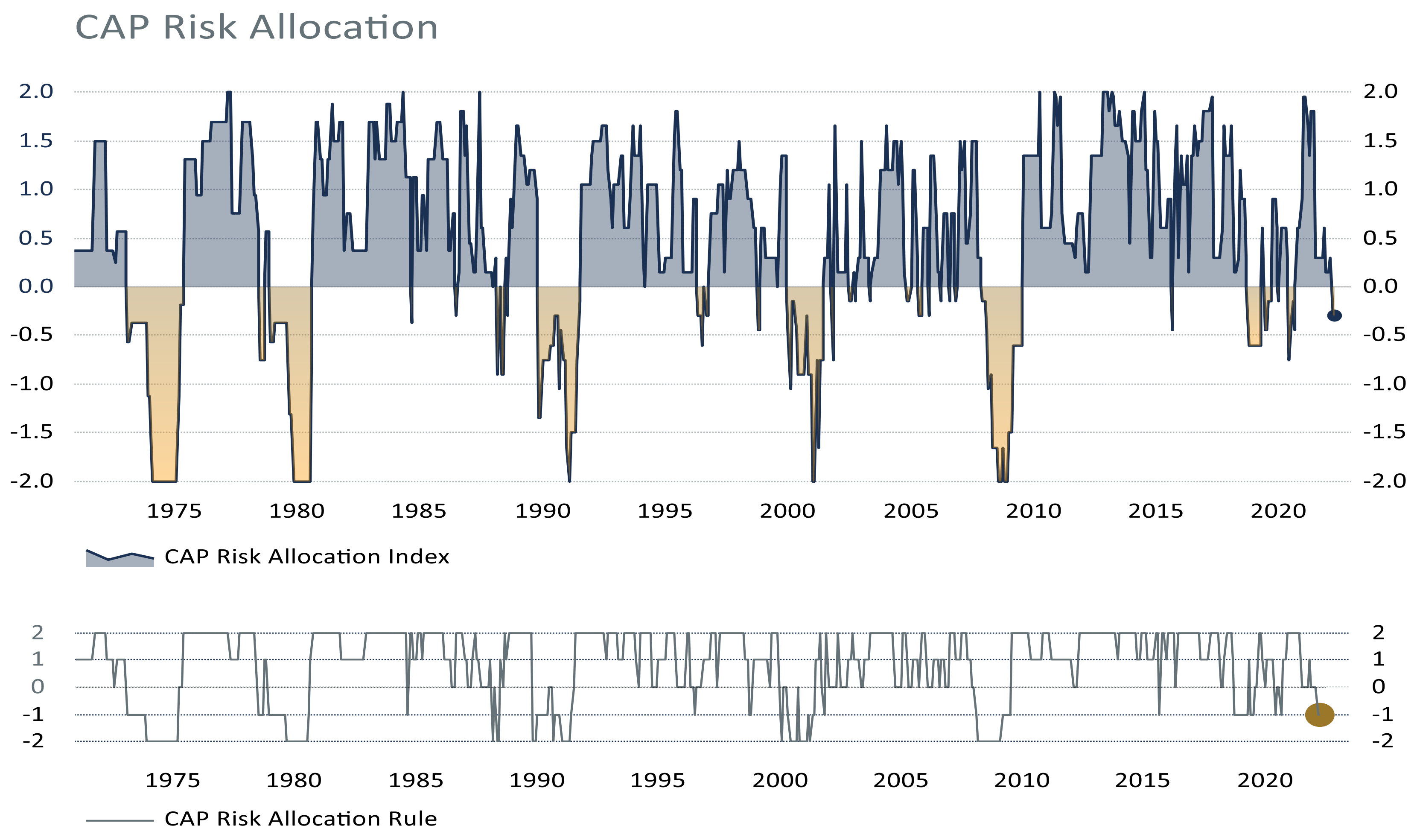
Risk Assets Return Score: Early Uptrend (2), Solid Uptr. (1), Early Downtr. (1), Solid Downtrend (-0.5)

'Global Inflation' and **'Global GDP'** keep our Risk appetite rather low from the start of 2022. However, both are likely to improve somewhat within a six mth. timeframe.

Both the **'Output cycle'** (if moving into 'Overheat') and the **'Liquidity cycle'** (if moving into 'Credit Crunch' could become additional headwinds for risk assets.
For now, however, we expect both these climate measures to behave well in H1 2022.

January 2022 – Our Climate reading aggregate – The Risk Allocation Index

- ❑ For now, we allocate with caution. That means that we follow the guidance of our Risk Allocation Index (see below) to reduce allocation to our Risk Portfolio.

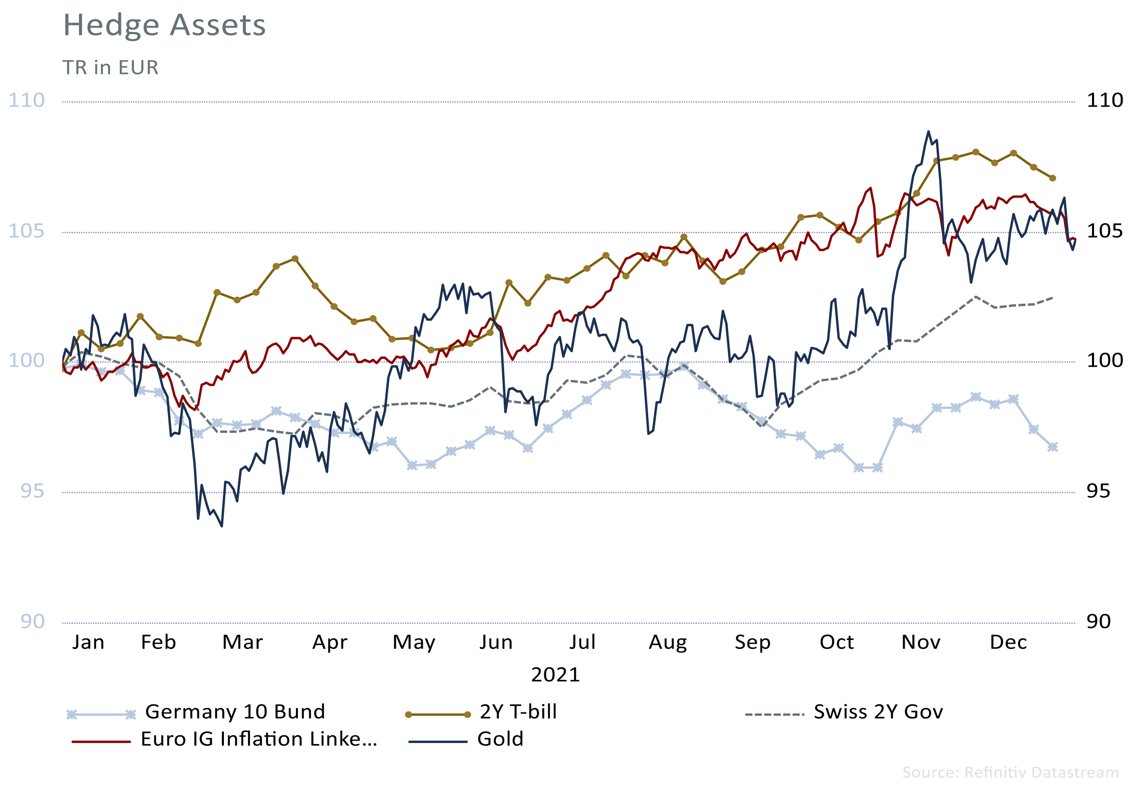


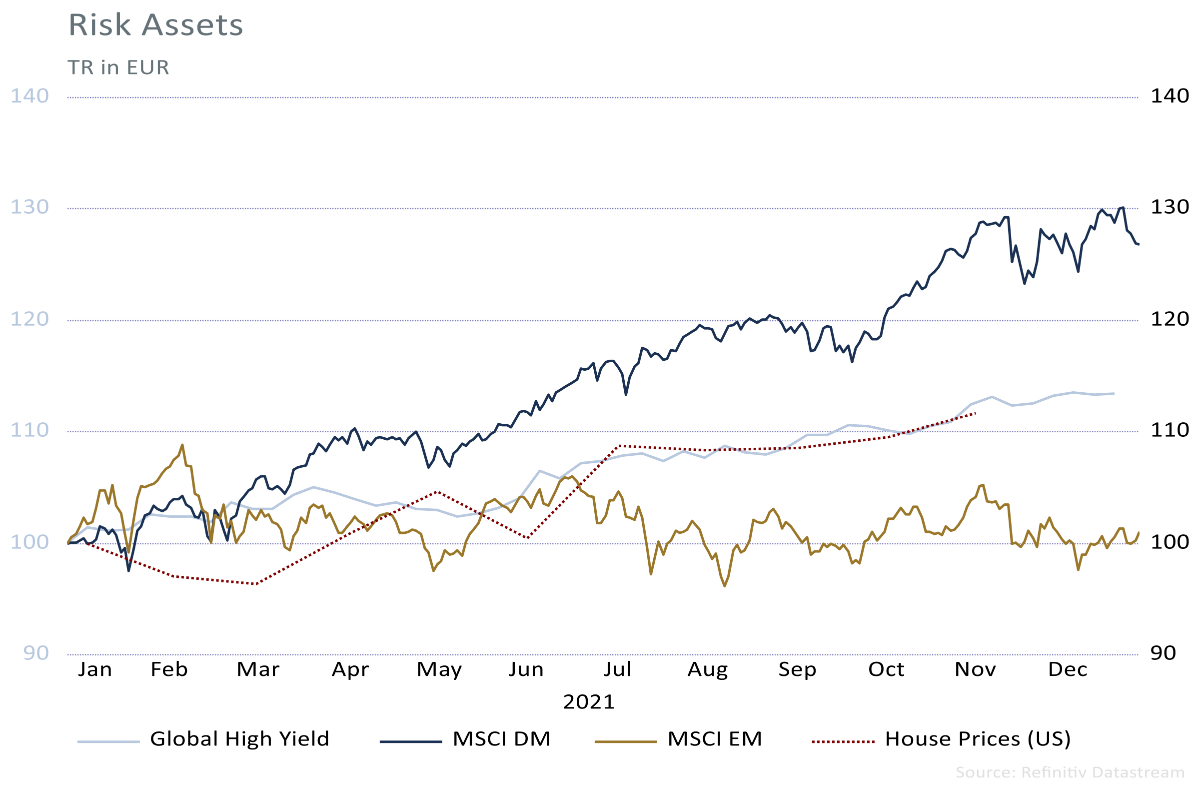
Source: Refinitiv Datastream, C.A.P

Asset Class Returns in 2021

- Hedge assets (EUR base) did – again - not offer real returns in 2021.

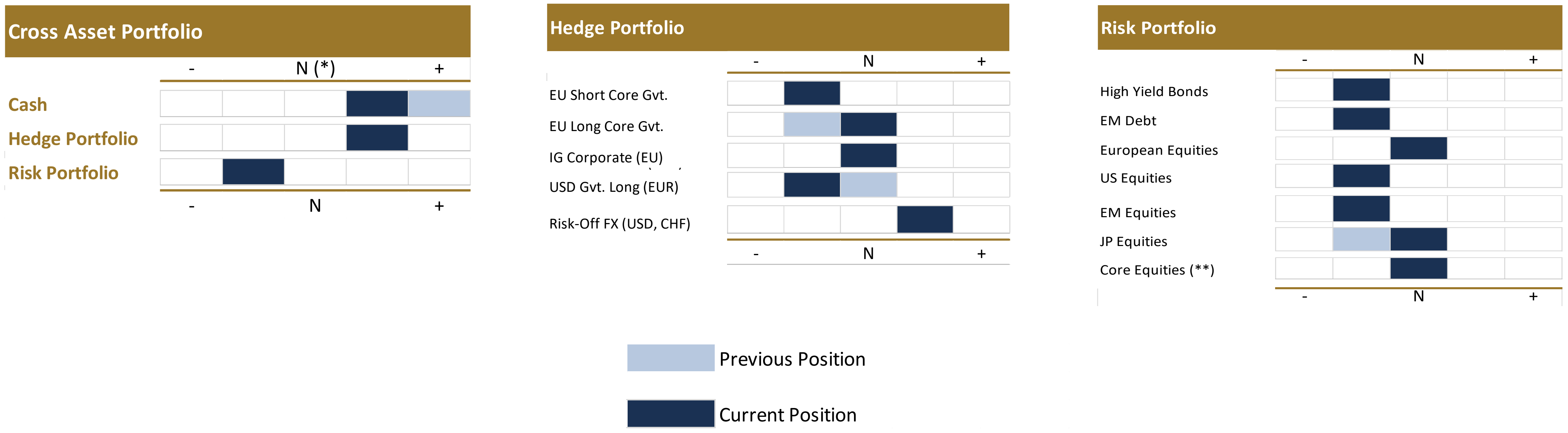
- The Goldrush in DM risk assets continued in 2021





Cross-Asset Allocation - Summary

- **Cross Asset Portfolio**: We keep our Hedge Portfolio & Cash in OW, and our Risk Portfolio in UW.
- In our **Risk Portfolio** EMD, High Yield, and EM equities are unchanged in UW. We keep exposure to US stocks in UW. We stay Neutral in Core Equities & European Equities and upgrade Japanese stocks to Neutral from UW.
- In our **Hedge & Cask portfolio**, we keep USD (& US 2Y rates) in OW together with Cash. We upgrade EU Long Core Gov.s from UW to Neutral. IG bonds are kept Neutral while the position in US Long bonds is reduced from Neutral to now UW.



Factor Allocation

Factor Allocation – Conclusions

- We have rotated into **Defensive** (OW) as we see signs that risk appetite will follow a weaker business cycle moving into 2022. At the same time, we rotate out of the **Cyclical** Factor (UW).

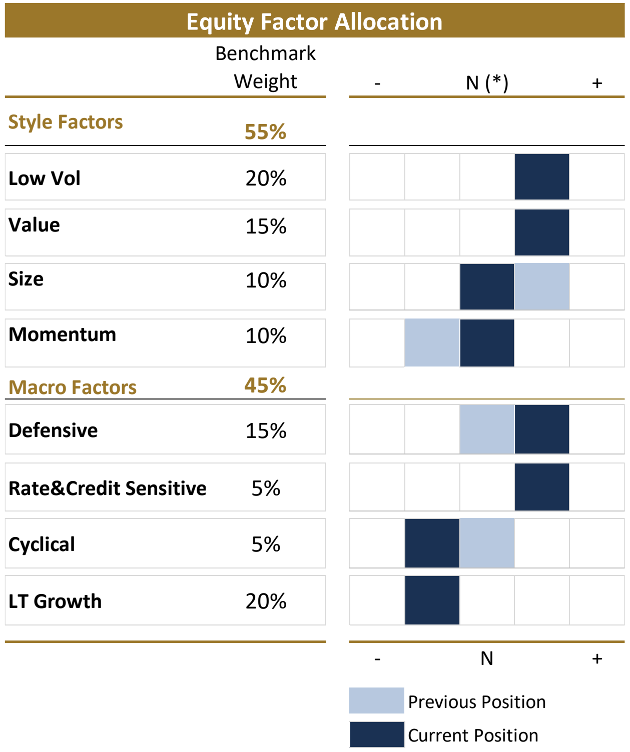
- **Momentum** has as an investment style weakened during 2021. The lack of a strong consensus about the winning strategy is weakening the factor's performance. For now, we keep the factor in UW

- Both **Value**, **Low Vol**, and the macro factor **Rate&Credit Sensitive** continue in OW. Value takes the lead with a rising probability score for harvesting, but higher real rates will underpin all three factors.

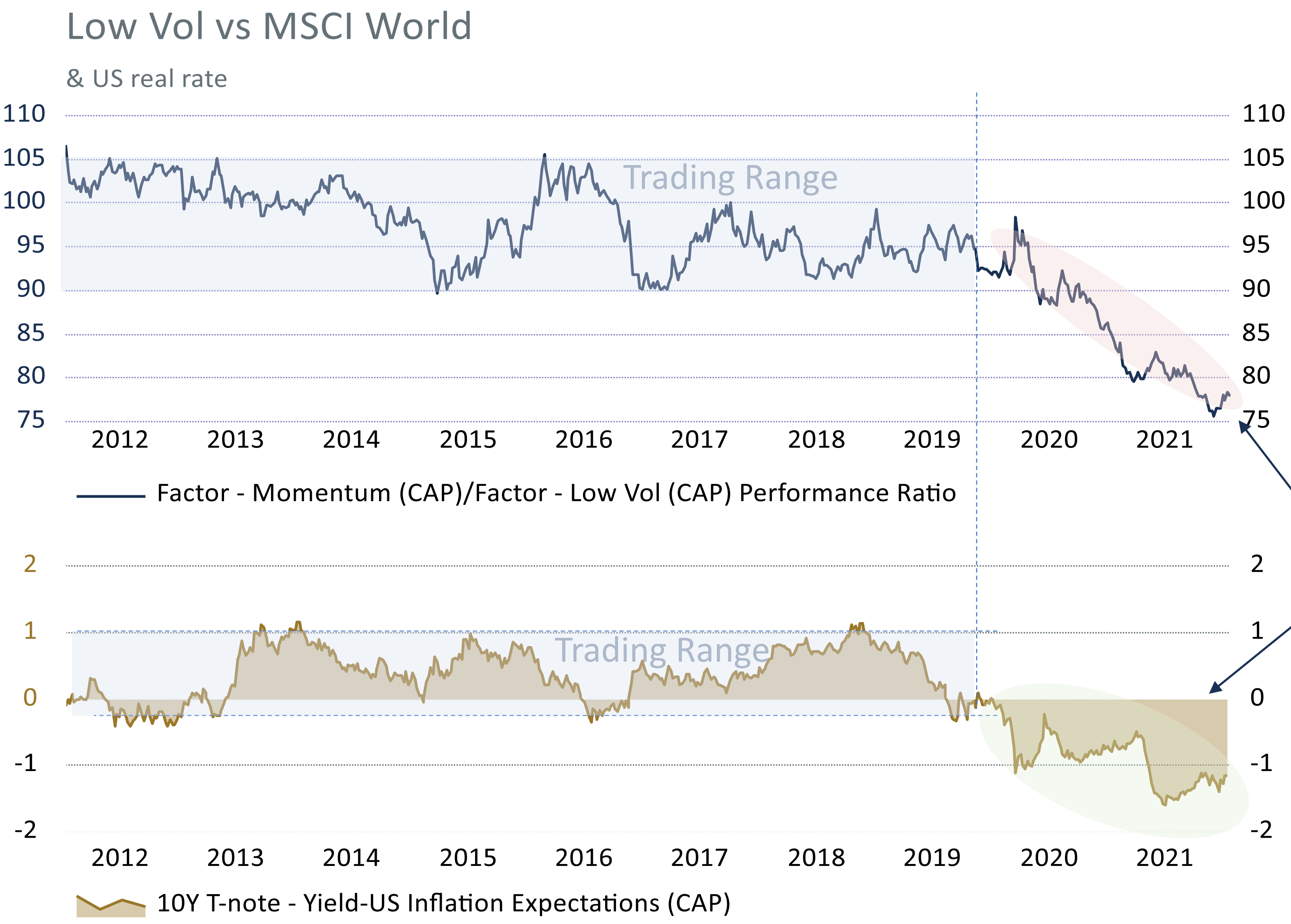
- **Size** is moved back into Neutral as business cycle headwinds are anticipated to challenge the factor.

- Lower real rates have contributed to the continued positive performance for **LT Growth** and with record high growth expectations (5y) and a pricing 'to perfection' (valuation), we stay UW. In our Risk Scenario 'Goldrush Continued' an UW position here well be unsustainable.

Performance	Update 7/1/2022		
Factor	Total return in pct. (EUR)		
	1 Mth	3 Mth	YTD
Cyclical	2.6%	9.2%	27.4%
Defensive	3.3%	10.2%	19.4%
LT Growth	-4.5%	5.7%	26.5%
Credit Sensitive	3.5%	6.0%	30.6%
Low Vol	1.1%	6.9%	19.0%
Momentum	-2.7%	1.6%	14.3%
Value	4.0%	7.8%	31.9%
Size	0.3%	2.5%	24.5%
World	-0.7%	6.7%	29.6%



Factor Case 1: Overweight Low Vol

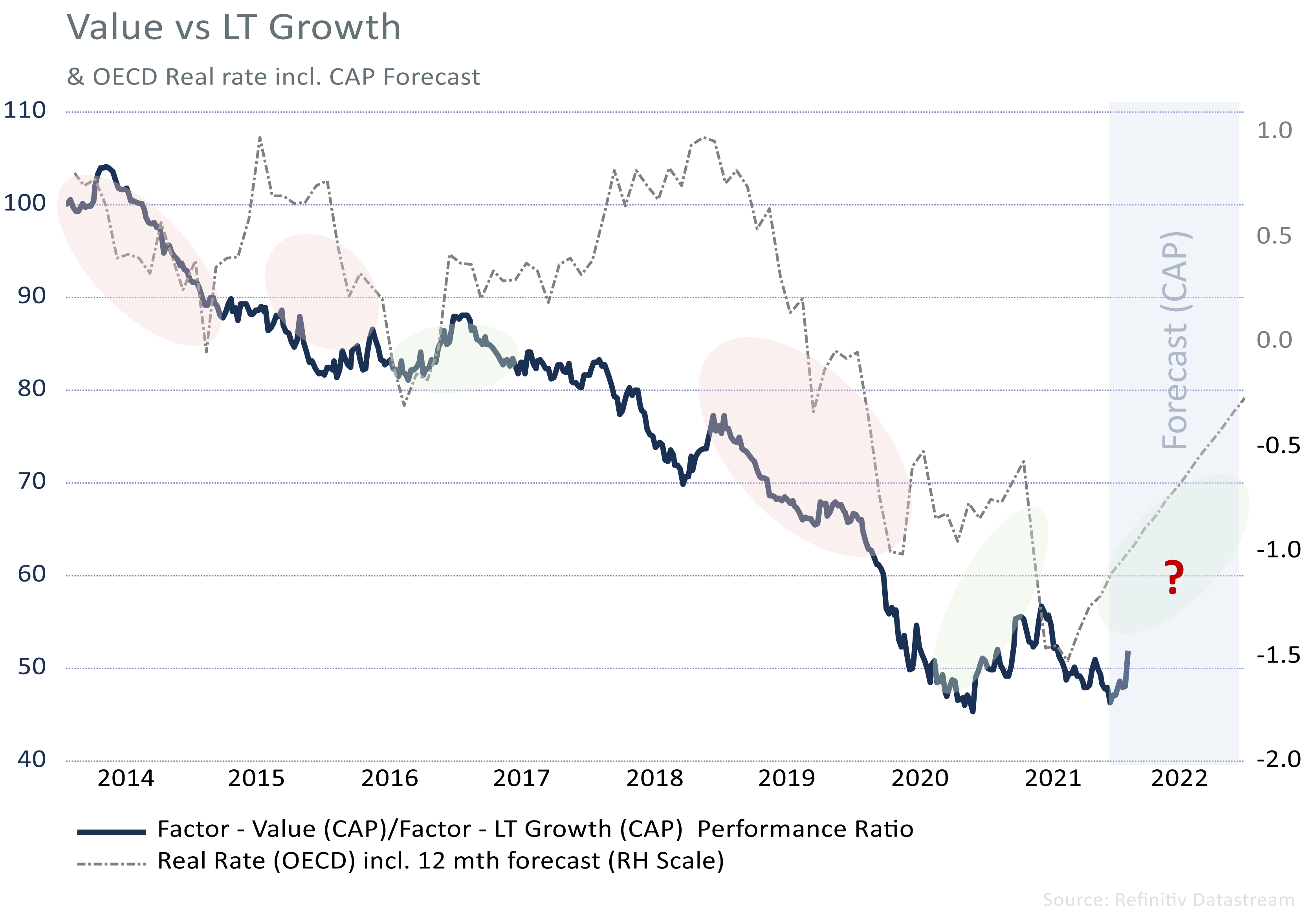


From 2012 to 2019 the real rate fluctuated between -0.25 to 1.10. After 2019 the US real rate has dropped below that range and triggered a regime shift in Factor performance.

Our Low Vol. Benchmark suffers as sharply lower real rates drive investors away from Stable Stocks to Growing Stocks.

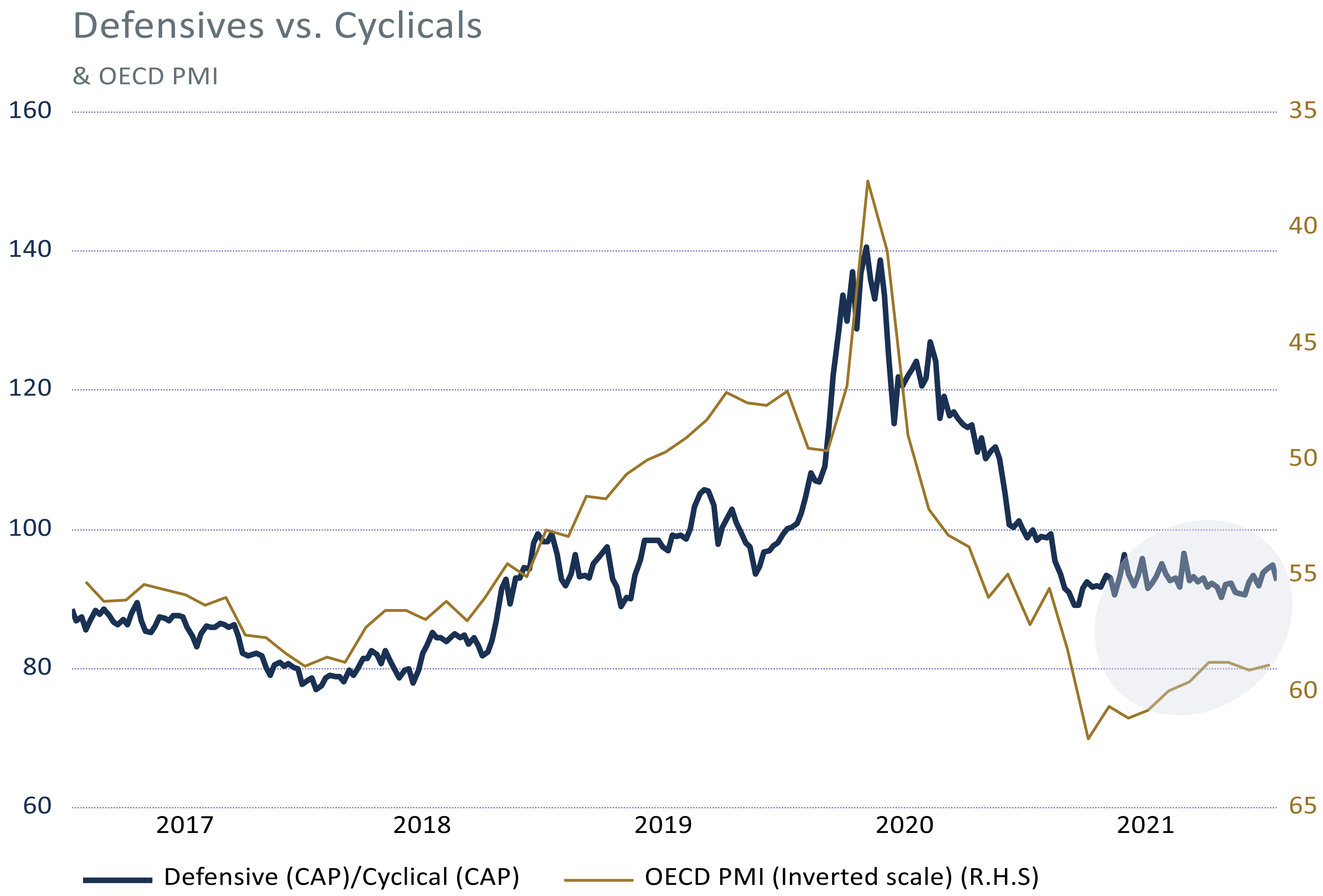
Source: Refinitiv Datastream

Factor Case 2: Overweight Value



- The lower real rates are essential to understand the long-term underperformance of Value to Growth.
- We anticipate a partial reversal of real rates, which should lift Value to Growth performance

Factor Case 3: Overweight Defensive



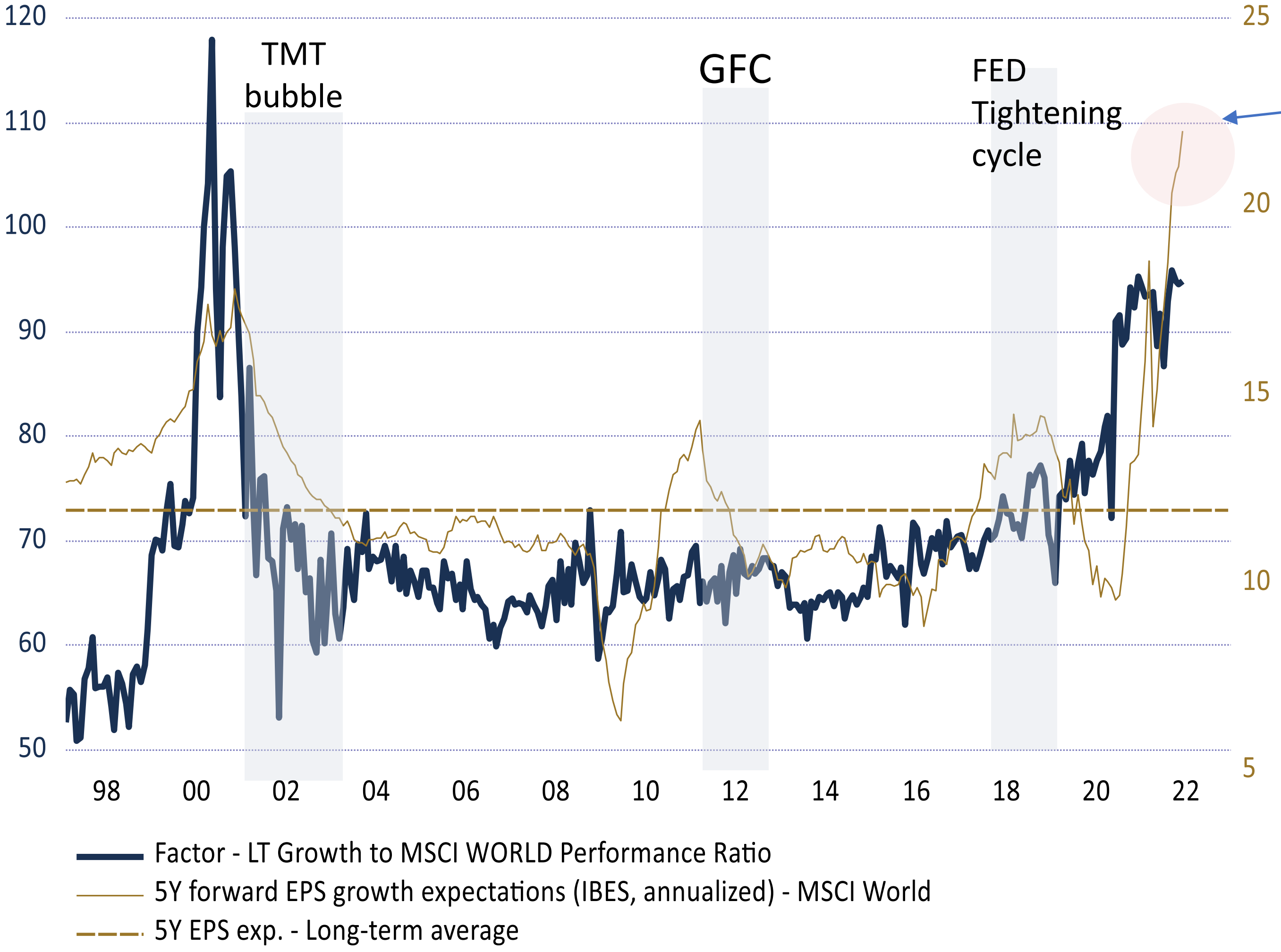
Source: Refinitiv Datastream

- If PMIs trend down, it is a sign that the Defensive factor can again be harvested.
- PMIs are, although only slowly, falling from a high level. We anticipate this to continue due to the broad-based business cycle slowing that we expect will continue to at least end-Q1 2022.
- Harvesting of the Cyclical premium now appears uncertain, while harvesting of a Defensive premium appears more certain.

Factor Case 4: Underweight LT Growth

LT Growth to Total Market

& Long term EPS expectations



Source: Refinitiv Datastream

- According to IBES, consensus analyst expectations for average LT EPS growth (5y) was in Late-November 2021 22% (annualized)! The LT average is 12%!

- Has growth outlook never been any brighter? Really!
- The issue is not IF growth expectations are come down but how and when!!

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