CROSSINVEST

Wealth & Asset Management
Private Equity & Venture Capital
Family Office Services
Since 1985

Quarterly Outlook Q2 2022

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Black Swans

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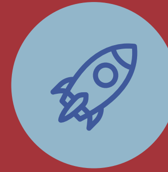
Where Risk-Free Assets Are The Risk

Three Key Market Drivers

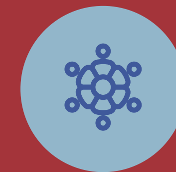
Correlation

Equities and fixed income fell in tandem as historically negative correlations converged this year. Diversification within traditional 60/40 portfolios evaporated as a result.



Inflation

Inflation has been far more persistent than expected this year. It was further exacerbated by Russia's invasion of Ukraine, which led to soaring energy prices.



Uncertainty

The fluidity of current events make the assumption of certainty in forecasts dangerous. Rather, we position our portfolios for maximum resilience and room to maneuver.

Overview

2022 has had an eventful start to the year, to say the least. Market volatility has been elevated, with the Federal Reserve and European Central Bank pivoting to hawkish rhetoric amidst soaring inflation. Markets were roiled as investors repriced interest rate expectations. The sharp and hawkish pivot resulted in the contraction of equity multiples, and surging yields in fixed income. Equities and fixed income fell in tandem, as historically negative correlation between the two converged instead. Inflation concerns were exacerbated by Russia's invasion of Ukraine on the 24th of February. While a potential invasion was deemed unlikely by us, we nevertheless protected our portfolios by increasing our overweight in energy equities before the event. As an investment house, our philosophy has always been to focus on downside protection before reaching for the upside. We base the resiliency of our forecasts on Karl Popper's Falsification Principle while pointing to the poor track record of humans and models in predicting low probability and high impact events – termed Black Swans by Nassim Nicholas Taleb.

Diversification – or Lack Thereof

Traditional safe havens such as investment grade corporate bonds and sovereign debt have become a key source of risk this year. Given interest rates are at the zero bound, the certainty of losses in fixed income this year is contrasted with the uncertainty of returns in equities. Rising rates and inflation also mean that fixed income is unable to perform their traditional role of portfolio diversifier and ballast in risk off environments. Indeed, the asset class is down more than equities year to date, with lower upside as well.

Diversification in traditional 60/40 portfolios evaporated this year as the correlation between fixed income and equities converged instead of being negative, which has been a mainstay of portfolio construction for decades. Rising rates and inflation contracted equity multiples while inflicting capital losses on fixed income securities.

We generated diversification and relative downside protection for portfolios by identifying the factors driving macroeconomic conditions to source for alternative hedges. Macro funds, energy equities, defense stocks and gold have performed the role of portfolio stabilizers this year that other traditional hedges have not. We continue to eschew assets and products which are dependent on assumptions of normal distributions, which tend to break during times of stress in capital markets.

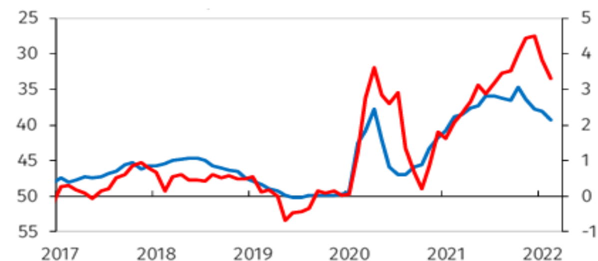
Few – if any – economic textbooks would classify commodity-linked assets as a safe haven due to high volatility. However, extraordinary times call for extraordinary measures. We note that one of the world's greatest investors – Warren Buffett – has poured scorn on volatility being an effective measure of risk in the past. In addition, we would also like to point out that the volatility of price movement is not the same as the direction of price movement. The relatively low volatility and negative returns of fixed income securities stand in stark contrast to the high volatility and positive returns of energy equities this year. At time of writing, the iShares Core Total USD Bond Market ETF is -10.84% year to date, while iShares Global Energy ETF has returned +36.68%.

In our previous publication, we pointed to inflation being a key source of risk this year. Inflation has consistently surprised to the upside. We shun notions that ascribe inflation to any one singular cause on grounds that such explanations are too simplistic, in our view. Elevated supply chain bottlenecks undoubtedly have contributed strongly to inflation. On the other hand, the vast amounts of money printing – with record amounts of direct transfers to consumers – remind one of Milton Friedman's dictum that "Inflation is anywhere and everywhere a monetary phenomenon". Hence, we remain overweight assets which are resilient against inflation.

Convergence of Correlations

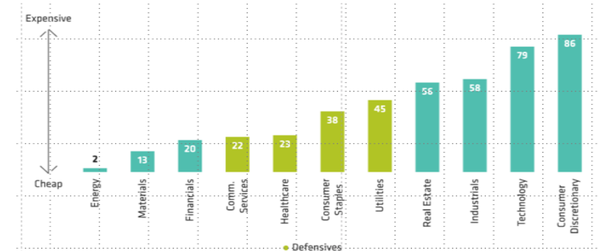
Source: Oxford Economics

Elevated supply chain bottlenecks



Source: EFG

Resilience to inflation



Source: Alliance Bernstein

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Geopolitics

Inflation concerns have been exacerbated by Russia's invasion of Ukraine on 24th February. While we did not anticipate the event as multiple indicators pointed to low odds of a Russian victory over a country the size of Afghanistan. The loss of the element of surprise, logistical challenges and the mounting costs of a war of occupation made the possibility of occurrence low in our view.

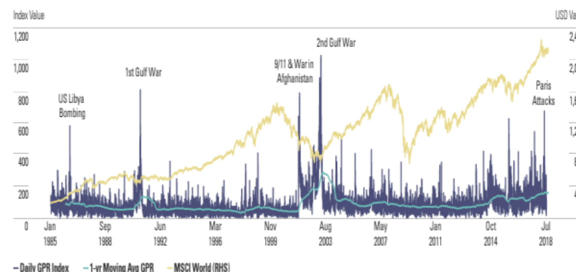
Nevertheless, we added to our overweight in energy equities, bringing it to a 300% overweight, scaled according to different portfolio mandates. We deemed it prudent risk management as low probability events can have outsized impact on assets. In addition, the world's transition to green energy does not remove it's needs for oil in the here and now. Activists have also curtailed capital investment in the energy sector, which would limit capacity to increase supply. Furthermore, with energy prices contributing strongly to higher prices, it was a very effective hedge against inflation. Lastly, energy equities would protect portfolios not only against a downturn in equities, but also a decline in fixed income.

In choices of hedges, we have a strong preference for assets which serve multiple purposes. This would help us avoid binary returns of assets which only serve to protect against a particular scenario. This exposes portfolios to being whipsawed by markets in capricious conditions. To that end, we have also opened a position in Defense stocks. Russia's invasion was a powerful reminder that national security is not to be taken for granted and breathed new life into NATO's raison d'être. Indeed, Germany announced a commitment of €100 billion to defense spending.

It is undoubtedly important to respond to market developments in a year of high volatility, but also necessary to look above and beyond the maelstrom. A perusal of equity returns during past geopolitical events show that while impact on capital markets can be sharp, they are often short lived. A key caveat is that a commodities crunch may lead to stagflationary risks. Hence, we have adjusted our portfolios to adopt a stance of cautious optimism towards equities, but within the quality factor.

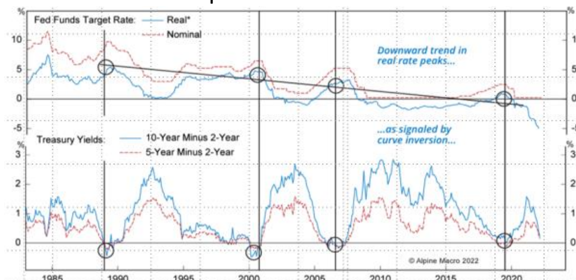
Duration has undoubtedly been hurt this year. While we eschew interest rate risk in fixed income and growth companies in equities, we remain overweight quality stocks. For critics who point to outperformance of value stocks this year, we offer 3 counterpoints. Firstly, the repricing of interest rates this year has contracted equity multiples irrespective of earnings power. Secondly, the structural downtrend of terminal interest rates since the Volcker years remains intact. Thirdly, the value rallies of the past decade have fizzled out.

Equity returns tend to rebound post global crises



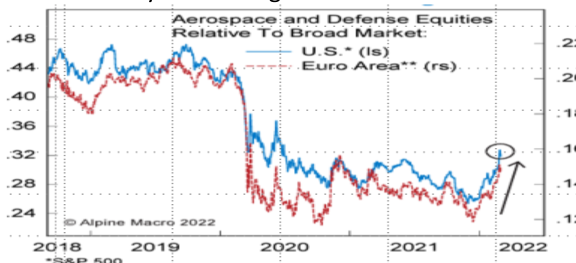
Source: State Street Global Advisors

Fed Funds 'choke point' in secular decline



Source: Alpine Macro

Defense rally still has legs



Source: Alpine Macro

Resilience

While past returns are not an indicator of future performance, many of these value stocks have poor fundamentals. While they may benefit from a boost in earnings when economic growth is robust, the lack of a moat in their business models often mean they cannot protect earnings in difficult times. These stocks are often cheap for good reason, giving rise to the term 'Value Trap'. We reduced beta in anticipation of a sector leadership rotation to late cycle assets. Indeed, research indicates that in terms of slowing economic growth and high inflation, quality stocks tend to outperform.

Within quality, our preference is for Consumer Staples and Healthcare. They remain at attractive valuations relative to history and peers. In addition, the pricing power and demand inelasticity offered by these companies position the portfolios well against high inflation and slowing economic growth The Fed's expectations of 2.8% GDP growth amidst rate hikes and balance sheet reduction look overly optimistic to us.

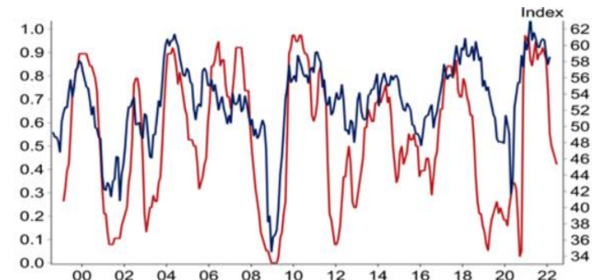
Our indicators are pointing to increasingly late cycle dynamics in the US, and inflation is only one of several culprits. The fact remains that the US was already past peak economic reopening – and peak economic growth – before Russia's invasion of Ukraine. Already historically high profit margins, a searing labor market yet with contracting real wage growth skew earnings to the downside, in our view. In addition, multiple segments of the yield curve have inverted or flirted with inversion.

But therein lies the rub. While the inversion of the 2s10s curve has proven an accurate signal of recession, it must be noted there tends to be a substantial time lag between inversion and recession. Average equity returns in that period from curve inversion to S&P 500's peak since 1973 were 14%. Even if a recession is imminent, it is far from immediate. Investors who bail at the first sign on yield curve inversion may be foregoing attractive returns.

In precarious circumstances, it is perfectly normal – comforting even – for humans to engage in a myriad of views on how events will eventually turn out. However, it is our contention that such environments are inherently unknowable, and it is dangerous for asset allocators to rely heavily on the accuracy of their forecasts. Rather than focusing on what happens if we are right, we directed our energies on the possible consequences if we are wrong.

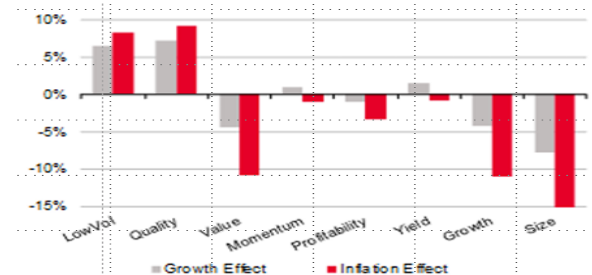
Therefore, while we hope for the best, we have prepared for the worst. We do so by emphasizing resilience, and express resilience across 3 key factors: 1) resilience to inflation 2) resilience to slowing economic growth 3) resilience on the downside against multiple outcomes.

Countries with rising OECD LEIs MOM vs ISM



Source: Oxford Economics

Equities during high inflation and slowing growth



Source: Société Générale

Equity returns from curve inversion

2- 10 curve inversion date	Inversion vs SPX peak in months	Inversion vs start of recession in months	SPX return from Inversion to SPX peak	S&P 500 Returns from Inversion to bottom in equities
Aug-19	6.3	6.1	15%	-24%
Dec-05	22.8	24.3	24%	-46%
Feb-00	1.2	13.1	13%	-28%
Jan-89	16.7	18.2	22%	-1%
Sep-80	2.5	10.1	12%	-18%
Aug-78	17.8	17.3	11%	-8%
Feb-73	0.9	9.1	3%	-44%
Average	9.7	14.0	14%	-24%

Source: Société Générale

Key Calls

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Looking Forward

Being overweight cash, energy equities, gold and defense shares means that the portfolio is relatively insulated from market drawdowns, while offering ammunition to take advantage of market mispricings of assets.

- We overweight quality assets as they offer pricing power, demand inelasticity and structural growth in a slowing economy and high inflation.
- We have raised our allocation to alternative assets which are resilient towards inflation and perform the role of portfolio diversifiers.
- We took partial profits on our tactical position in Europe to raise dry powder and capitalize on market dislocations.
- We are reducing our underweight to long dated Treasuries. 10-year Treasuries peaked at 3.25% in the last tightening cycle and are heavily oversold. We note that valuations of US Treasuries are increasingly attractive relative to equities.

Our current views are as follow

- United States: Underweight – US equities are the most expensive globally while the Fed is the most hawkish central bank globally.
- Japan: Slight Overweight – Attractive valuations and globally competitive franchises make for a small overweight.
- Developed Europe: Slight Overweight – Cautiously optimistic due to undemanding valuations and a less hawkish European Central Bank.
- Asia ex Japan: Overweight – Tactical trade contingent on policy support during COVID Zero and upcoming presidential elections.
- Emerging Markets: Underweight – Risk off sentiment can hurt emerging market assets disproportionately.
- USD Rates: Underweight – We are reducing our underweight as the risk of financial accidents increases.
- IG Credit, USD: Underweight – Flattening credit curves mean that we move up the credit curve for more attractive valuations.
- HY Credit, USD: Underweight – We are reducing HY credit exposure due to high valuations and room for more spread widening.
- Local currency Credit: Neutral – USD strength reduces the attractiveness of high yields in local currency EM bonds.

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About Us

We are a privately-owned financial institution, with over 35 years of Swiss heritage that exemplifies the finest wealth & asset management traditions.

Our key business areas are asset & wealth management, private equity & venture capital and family office services. We work exclusively with high & ultra-high-net-worth individuals, families and institutions.

As an award-winning independent asset manager, we are keenly aware of the importance of considering the cross generational impact of investment and wealth-management decisions.

We appreciate that every client is unique, and every need is different. This leads us to create tailored solutions to meet our clients' goals while maintaining institutionalized processes of asset management.

Our Mission

Our clients' wealth is the result of the time they sacrificed away from their families to ensure their financial security; it is our mission to protect and build on this sacrifice.

We achieve this through

- Establishing long-term relationships
- Our independence
- Operating as a dedicated fiduciary advisor
- Our commitment to provide the best investment solutions & services
- Crafting the best solutions for our clients' individual needs

CROSSINVEST AWARDS

2021

Rising Star for Asia-Pacific

Best Multi-Family Office Singapore 2021

Best Independent Wealth Manager Singapore 2021

2020

Best Asset Manager Serving Family Offices & Private Banks

Best Next – Generation Offering – Highly Commended 2020

2019

Outstanding Contribution to Wealth Management

Best Discretionary & Advisory Offering

Best Client Experience Overall

Outstanding Independent Wealth Manager & Client Experience

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