Julius Bär

INVESTMENT GUIDE

Market Outlook Mid-Year 2022

MARKETING MATERIAL
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Julius Bär

EDITORIAL

Dear reader,

First, the world was hit by a global pandemic. This was then followed by inflation rates not seen in decades and news of a major war breaking out in Europe. One would wish to live in more tranquil times. However, this is the (investment) world we live in.

But even in the face of many uncertainties, we remain constructive on the merits of holding a diversified portfolio of equities. History shows that they have stood the test of time as a store of value. In fixed income, where we take a more tactical approach, there is income again thanks to the rise in bond yields.

Many of our conversations with clients centre around the current high levels of inflation. While those in emerging markets have had experience with inflation, for many in the developed markets it is a first. Thus, we use this opportunity to take a closer look at what type of investments can thrive in a more inflationary environment.

Last, but by no means least, sustainable investing means understanding that investing is about capturing future opportunities – an important point to remember after the rout we have seen on financial markets so far this year.

We thank you for your continued trust in Julius Baer in these times of change and wish you peace and success for the months to come.

Yours faithfully,

Yves Bonzon
Group Chief Investment Officer
Member of the Executive Board

Christian Gattiker
Head of Research

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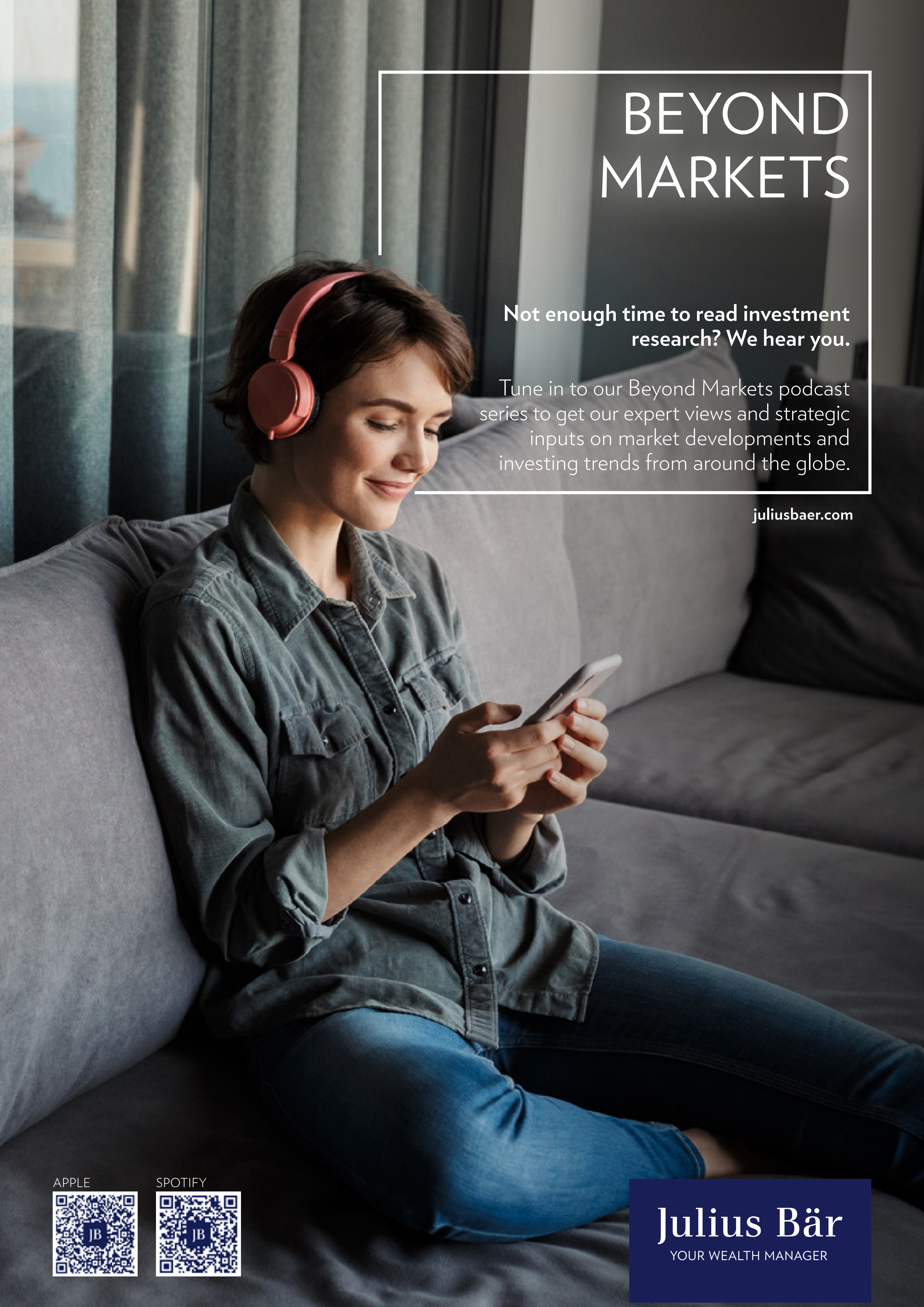
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A BRIEF REVIEW

During the first few months of the year, both the ongoing Covid-19 pandemic and the war in Ukraine caused global supply chains to clog further and inflation expectations to spike ever higher. Markets started pricing in an aggressive tightening of financing conditions around the world, which gave investors hardly anywhere to hide – except in commodity- or defence-related investments. Natural gas stands out in this respect, having more than doubled in price since the beginning of the year. Traditional safe havens, like US Treasuries and gold, did not shield investors from the market rout. Holding US dollars at least mitigated the pain to a certain extent, as the world's number one reserve currency rallied given the global risk-off mood.

MARKET REVIEW

The US Federal Reserve's strategy of letting inflation overshoot in 2021 spectacularly backfired in the first five months of 2022. For the first time in years, global equity and bond markets sold off in unison. The question now is whether aggressive policy tightening will derail the global economy – we believe it will not.

EQUITY REGIONS

	2018	2019	2020	2021	YTD	5-year annualised
Switzerland	-8.03%	29.98%	1.07%	19.51%	-8.98%	7.45%
Eurozone	-10.57%	26.05%	-3.32%	21.54%	-6.44%	5.24%
USA	-5.04%	30.88%	19.70%	25.75%	-14.06%	12.84%
Japan	-15.15%	18.48%	10.23%	12.93%	-4.90%	6.87%
UK	-8.82%	16.37%	-13.93%	15.13%	5.17%	4.13%
China	-19.45%	24.34%	29.49%	-19.30%	-18.29%	0.65%
Emerging markets ex. China	-12.43%	16.23%	12.55%	7.87%	-10.39%	5.09%

The best
While major equity markets around the world plunged on inflation concerns and the war in Ukraine, the UK stood out, posting a positive return. Year-to-date, the British market has benefited from its above-average exposure to commodity-related stocks.

The worst
In an already difficult environment for stocks, Chinese markets underperformed significantly, driven by local Covid-19 flare-ups, which triggered numerous lockdowns and clouded the outlook for the economy. The Chinese government's growth target of 5.5% for 2022 seems to be at risk.

EQUITY STYLES

	2018	2019	2020	2021	YTD	5-year annualised
Quality	-5.50%	36.08%	22.20%	23.24%	-16.66%	12.80%
Value	-10.78%	21.75%	-1.16%	18.42%	-2.83%	7.11%
Growth	-6.74%	33.68%	33.83%	19.33%	-22.04%	12.06%
Large cap	-7.75%	27.73%	15.94%	20.04%	-12.49%	10.34%
Small cap	-13.86%	26.18%	15.96%	12.09%	-13.29%	7.61%
Cyclicals	-9.83%	31.54%	19.30%	25.80%	-15.30%	11.40%
Defensives	-4.94%	21.69%	1.60%	21.70%	3.60%	9.50%
High dividend	-7.56%	23.15%	-0.03%	12.07%	-1.46%	7.06%

The best

Defensive stocks tend to do well when leading indicators roll over and policy uncertainty is high – as has been the case so far this year. We expect defensive stocks to keep on outperforming as the economic slowdown continues.

The worst

The outperformance of growth stocks in the wake of the recovery was closely linked to the strong performance of selected large-cap information technology stocks – exactly those that have led the downturn over the last five months. We see catch-up potential.

EQUITY SECTORS

	2018	2019	2020	2021	YTD	5-year annualised
Information technology	-2.60%	47.55%	43.77%	28.21%	-21.77%	19.33%
Materials	-16.92%	23.35%	19.93%	12.19%	-0.24%	10.99%
Oil & gas	-15.84%	11.45%	-31.46%	37.71%	45.53%	8.70%
Industrials	-14.54%	27.77%	11.68%	14.10%	-13.13%	6.65%
Communications	-10.02%	27.39%	22.98%	13.02%	-22.25%	5.30%
Healthcare	2.52%	23.24%	13.52%	15.52%	-5.20%	11.49%
Financials	-16.97%	25.51%	-2.84%	24.80%	-7.73%	6.90%
Consumer cyclical	-5.51%	26.57%	36.62%	15.67%	-25.78%	10.01%
Consumer defensive	-10.10%	22.80%	7.79%	9.85%	-6.23%	5.43%
Real estate	-6.36%	22.96%	-4.99%	24.11%	-11.26%	5.83%
Utilities	1.97%	22.53%	4.76%	6.09%	2.56%	8.07%

The best

The star performer in terms of sectors over the last five months, just like towards the end of 2021, has been oil & gas. Russia's invasion of Ukraine further amplified uncertainties about Europe's supply of oil and natural gas, driving up the prices of commodity-related stocks.

The worst

As communicated at the beginning of the year, consumer cyclicals were ripe for a period of consolidation, though the magnitude of the correction up to the end of May was surprising: -26%. Nevertheless, valuations still look demanding, and the sector continues to be challenged by structural headwinds.

FIXED INCOME

Developed markets	2018	2019	2020	2021	YTD	5-year annualised
Government bonds	-0.38%	5.59%	9.32%	-6.04%	-10.38%	-0.35%
TIPS	-4.11%	8.04%	12.03%	3.54%	-10.78%	2.06%
High quality IG	-3.54%	6.33%	11.89%	-7.17%	-13.30%	-0.77%
Low quality IG	-3.90%	12.52%	11.56%	-4.42%	-12.97%	1.11%
High yield	-4.06%	12.56%	6.91%	0.36%	-9.77%	1.80%

Emerging markets	2018	2019	2020	2021	YTD	5-year annualised
EM hard currency	-3.02%	12.13%	7.02%	-2.48%	-13.65%	0.23%
EM local currency	-3.40%	9.47%	5.29%	-2.53%	-5.78%	1.66%

The best

Basically, there was no place to hide. Emerging market local-currency bonds turned out to be the relative haven in the fixed income space in early 2022, as currency appreciation in large parts of Latin America in the wake of the commodity rally provided performance tailwinds.

The worst

Emerging market hard-currency bonds were the worst-performing segment, although its performance was not significantly worse than that of other segments. European emerging markets were the most affected, given the sell-off in Russian bonds, while commodity-exporting nations in Latin America and the Middle East registered the smallest losses.

COMMODITIES

	2018	2019	2020	2021	YTD	5-year annualised
Brent crude oil	-19.55%	22.68%	-21.52%	43.61%	56.43%	18.59%
Natural gas	-0.44%	-25.54%	15.99%	49.43%	133.97%	22.63%
Gold	-2.14%	18.87%	24.42%	-5.74%	1.24%	7.96%
Silver	-9.36%	15.32%	47.38%	-15.61%	-5.38%	4.86%
Platinum	-14.80%	22.05%	10.71%	-14.02%	-2.22%	0.04%
Aluminium	-19.28%	-1.84%	10.61%	34.93%	2.31%	8.37%
Copper	-20.28%	6.31%	25.81%	21.63%	-3.52%	10.92%
Iron ore	10.76%	28.58%	55.25%	-39.48%	40.57%	16.34%

The best

As previously mentioned, natural gas and oil stand out in terms of performance year-to-date. Only marginally related to Europe's Russia-focused fears, North American natural gas prices have surged due to supply concerns and low storage levels.

The worst

The worst-performing commodity in 2022 so far has been silver. Also referred to as 'poor man's gold', the metal is, in fact, primarily used for industrial applications, making it more cyclical than gold and not well positioned for higher prices in times of a cyclical downturn.

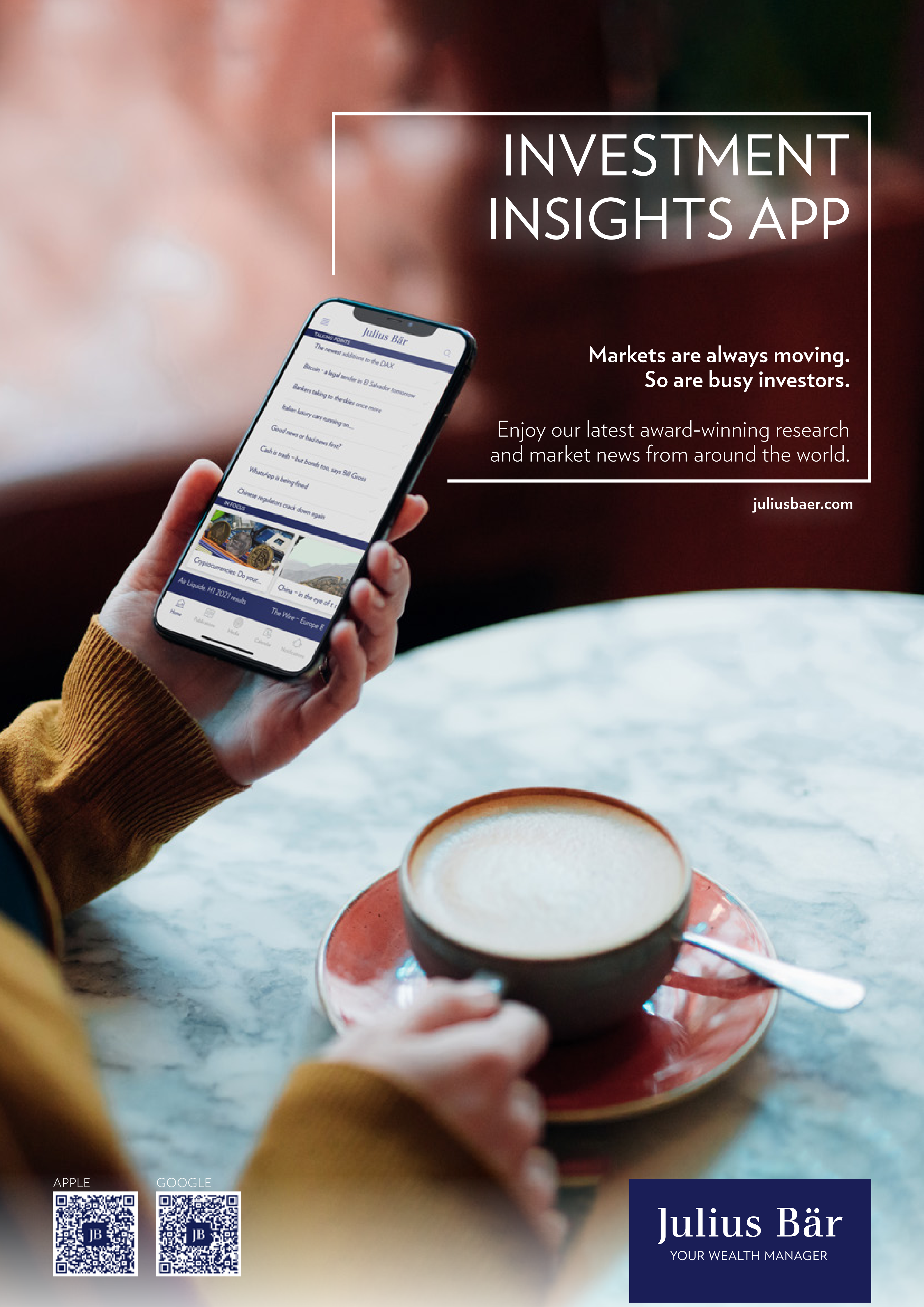
Source: Bloomberg Finance L.P., Julius Baer Investment Writing
Please see the 'Further Information' section of this Investment Guide for more details on the indices used. Annual performance numbers are in USD, except for equity regions that are calculated in local currency. Year-to-date (YTD) numbers are as at the close of business on 30 May 2022. IG = investment grade; EM = emerging markets; TIPS = Treasury Inflation-Protected Securities. Past performance is not a reliable indicator of future results. Returns reflect all ongoing charges excluding transaction fees. All investments have inherent risks, and investors may not recover their initial investment.

SCORING OUR CALLS

In this section, we show how our key investment ideas for the year played out until 30 May 2022.

TOPIC	INVESTMENT IDEA	RETURN*
The big picture	Healthcare stocks	-5.95%
	Information technology stocks	-21.57%
	Financials	-12.55%
	US equities	-13.42%
	Swiss equities	-15.91%
	Italian equities	-8.35%
	Indian equities	-10.02%
Fixed income	Flexible fixed income	-9.84%
	Alternative fixed income	-6.93%
	Hard-currency EM bonds – Asia	-11.09%
The post-pandemic normal	Stocks to prosper post pandemic	-21.42%
	Energy transition stocks	-12.55%
Next Generation	Cloud Computing and Artificial Intelligence	-28.27%

Source: Julius Baer Investment Writing
* Return numbers are for the period between 1 January 2022 and 30 May 2022. The performance of our calls was evaluated on the basis of the performance of a representative benchmark index, which we consider the best fit to our call. Certain calls may not be reflected due to the lack of an appropriate benchmark. More information on these benchmark indices is shown in the 'Further Information' section of this Investment Guide. Past performance is not a reliable indicator of future results. Returns reflect all ongoing charges excluding transaction fees. All investments have inherent risks, and investors may not recover their initial investment.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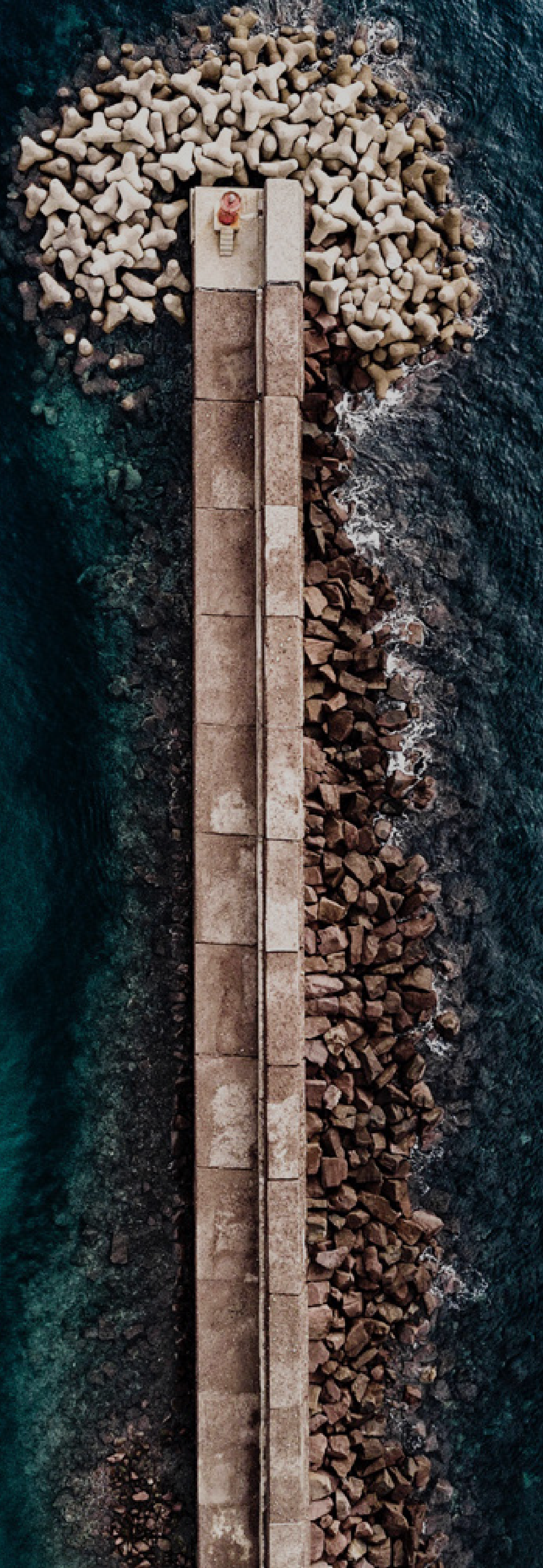
THOUGHTS FROM OUR CIO

The market environment continues to be challenging and leaves investors with little place to hide. Our Group CIO Yves Bonzon explains that portfolios positioned for a disinflationary environment and political stability will have to shift gears to survive the new market paradigm. Thus, prudent portfolio construction matters more than ever, and investors are well advised to favour real over nominal assets.



FOCUS ON REAL ASSETS

So far, 2022 has not been what investors would qualify as an easy ride: a rapidly shrinking liquidity environment on the one hand, and record-breaking inflation on the other, turned out to be a toxic mix for markets.

A NEW MARKET PARADIGM

"The current market environment is one of the most challenging I have ever faced in my career," says our Group CIO Yves Bonzon. As the red-flashing numbers on our preferred finance applications tell us, aside from cash, energy companies, and commodities, there is hardly any place to hide (and even the last two have been a poor hedge in recent weeks). And while we still believe that we are most likely in the midst of a cyclical bear market driven by liquidity reduction rather than a US recession, the hard truth is that the world will probably not return to its status quo once the dust settles.

Going forward, geopolitics, rather than economics, is in charge. De-globalisation will accelerate as governments work to onshore those complex and efficient supply chains whose dependence on unreliable partners has been laid bare in the wake of the war in Ukraine. The push for domestic investment, in turn, will reignite the flame of private sector borrowing in developed economies. For investors, this means bracing for higher average inflation (i.e. somewhat above central bank targets but lower than the current red-hot readings), as well as higher volatilities. Portfolios that have been positioned for 30 years of disinflation and relative political stability will have to shift gear to survive the new market paradigm.

THE IMPACT ON PORTFOLIOS

There are two major changes investors need to consider when it comes to portfolio construction.

First, the increased geopolitical turmoil and the now clear willingness of governments to instrumentalise the financial system to punish non-compliant countries means that the geographical scope of portfolios needs to be carefully defined. Investors should be willing to accept the risk of capital confiscation in case investments in a particular country

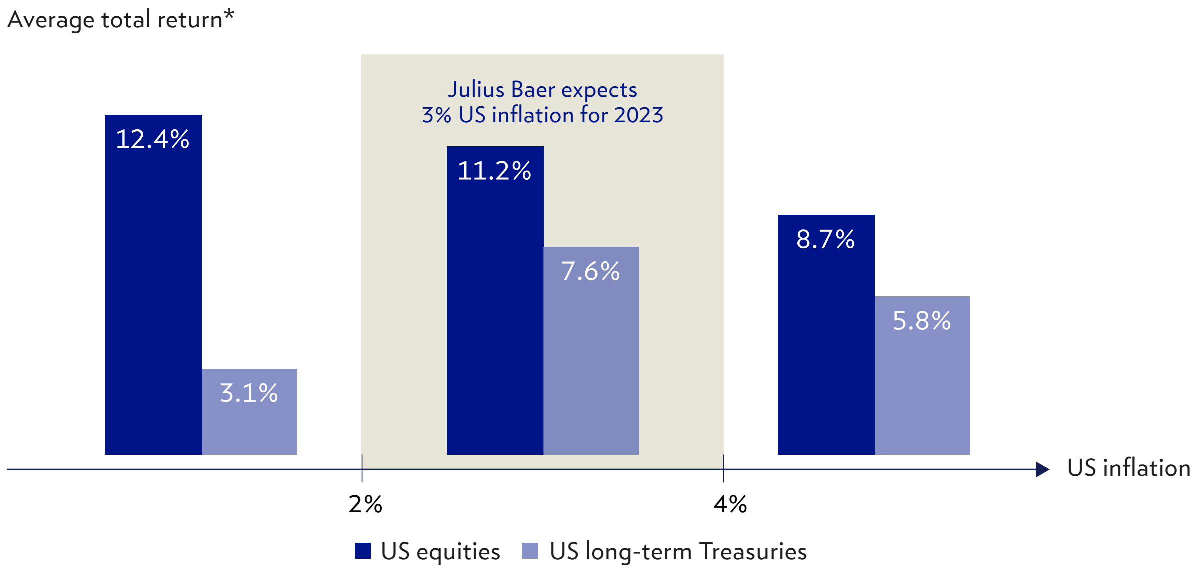
are sanctioned. On our part, we have decided to tactically and strategically decrease to zero our standalone allocation to Chinese equities, as they are exposed to a heightened risk of both domestic regulation due to the country's 'common prosperity' goal and to external punitive measures in the context of China's tensions with the US. We remain exposed to China through the broad Asia index (excluding Japan).

> The key to surviving inflation is to favour real over nominal assets.

Second, with inflation becoming a more persistent feature, fighting against capital erosion is more important than ever. The key to surviving an inflationary investment environment is to favour real over nominal assets in a portfolio. What is the difference between the two? Nominal assets represent a claim to a numerical value (e.g. cash, the principal amount and coupon payments of a bond denominated in a particular currency), while real assets are a claim on something with an intrinsic value. Examples of real assets that immediately come to mind are commodities, gold, and real estate, which are linked to the physical world. But many forget that equities, both public and private, which give investors ownership of a company whose value is linked to its future profitability, are also real assets.

In the case of bonds, investors demand higher yields, which in turn decreases valuations. For real assets, that is not necessarily the case. The value of a company can either increase or decrease, depending on how high the price pressure on its costs and products is and how well positioned the company is to protect its profitability. Historically, real assets have indeed outperformed cash and bonds during elevated, but contained, periods of inflation.

EQUITIES: THE FIRST LINE OF DEFENCE AGAINST INFLATION



Source: Bloomberg Finance L.P., Ned Davis, Robert Shiller, Julius Baer Research
Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations. *5-year average annualised in USD (1953 to April 2022).

HOW TO PRESERVE WEALTH

While favouring real to nominal assets will be crucial to preserve capital in a sustained inflationary environment, overall portfolio construction and diversification remain the keys to success.

Piling into public equities might be more than the average investor would ask for in terms of volatility and may not lead to a sustainable risk-adjusted allocation.

When it comes to commodities, the management of the asset class in a portfolio context over the medium to long term may be tricky, and we prefer to see it as a tactical, rather than a strategic, opportunity. In the same vein, gold is a hedge primarily against financial instability risks, which we do not expect to materialise in the US or in Europe. Moreover, there are other asset classes that exhibit the same volatility over long periods of time as gold does but that offer higher returns.

One real asset class that should be considered in the context of a well-diversified portfolio, particularly in the current economic and geopolitical landscape, is private equity. The relentless hunt for returns in an ultra-low-yield environment has made the rise of private equity markets one of the biggest trends in finance over the last decade. This, however, is the past. Going forward, the economic playing field is changing, and we are looking at the end of the ultra-low-yield environment. Nevertheless, the merits of private equity are not undone; far from it, they can be very useful to investors in times of increased uncertainty.

A CLOSER LOOK AT PRIVATE EQUITY

While it may be entertaining to watch the real-time performance figures of our investments on our smartphone, especially when most of the screen is shining green, doing so is also a critical source of error, especially when all we see is red. This constant flow of information increases the likelihood of taking the wrong decision at the worst possible moment. We know that the average investor tends to underperform a long-term buy-and-hold strategy because they trade too frequently, rebalance their portfolio too often, and fail to time the market successfully.

This is one of the reasons why we see private equity as an interesting asset class, especially in these uncertain times. Additionally, with public markets currently offering little place to hide, private equity investments provide important access to a growing opportunity set. For some time now, public markets have experienced a trend of de-equitisation: the number of traditional initial public offerings has been trending down and the time companies take to go public has increased, effectively shrinking the total number of companies publicly traded. By contrast, the number of privately owned companies has been increasing steadily, opening up new opportunities for long-term investors while improving their risk/return profiles and further diversifying their portfolios.

> The illiquid nature of private equity funds protects investors from themselves, helping them to stay invested and, in the end, reap the gains of their long-term investments.

In the end, of course, what really matters is the enhanced performance that an allocation to private equity can offer. But this is exactly where the challenge for this asset class lies. For while past performance has been attractive, the outperformance generated has been concentrated in the top quartile, while average returns have been roughly in line with public markets.

What does this mean for interested investors? It means that while including private equity in a portfolio is important, it is crucial to have access to the top fund managers, which in turn means relying on experienced advisors and a broad network of experts and professionals in the field.

THE BIG PICTURE

Central banks are tightening their monetary policy to fight inflation. The full impact on the economy and financial markets is not yet known, but we believe that overall, the economies in many places seem to be well supported going into the summer. Equities are therefore still our preferred asset class, but we now favour having a more defensive tilt in a portfolio.

INVESTING WITH A DEFENSIVE TILT

Policy normalisation in response to record-high inflation has begun, and the full consequences of the war in Ukraine are still unknown. What should investors focus on in this environment? We asked five questions on the outlook for investors to Julius Baer's Head of Research, Christian Gattiker.

1 Are we heading for a recession?

There are many opposing effects at work currently, but overall, no, we do not believe that we are heading for a recession. Monetary policy normalisation has begun, and this is the sharpest and fastest phase of monetary policy tightening on record. But tightening monetary policy in order to fight inflation is also a headwind for growth, and it remains to be seen what impact it will have on the economy and financial markets.

It is also important to mention China here. The Chinese officials' zero-Covid-19 policy is the single biggest constraint on China's economy, but it is not just the local economy that is impacted – a slowdown of Chinese growth is the biggest risk to global demand.

There is no doubt that the war in Ukraine and the commodity price spikes due to economic sanctions are also weighing on the global economic outlook, and the long-term geopolitical and economic consequences are still unknown. Moreover, no one can tell when the war will stop, which adds to the huge level of uncertainty.

Overall though, we believe that the global economy will not be derailed. A number of factors support our view: 1) inflation has not destroyed demand so far, evidenced by consumers who are still spending even though prices have risen; 2) job creation is still solid; and 3) companies are continuing to invest across the board. A major reversal in these drivers would be needed for the economy to suffer over the coming months.

We therefore believe that the near-term risk of a recession is currently low, as long as the demand destruction is moderate, employment keeps rising, and capacity expansion continues.

BEYOND MARKETS PODCAST

Listen to the podcast on our market outlook mid-year 2022.

2 What is your outlook on inflation?

Inflation readings have been at highs not seen for decades in many countries. The war in Ukraine and the resulting issuance of sanctions have caused supply-chain disruptions, slowing globalisation, and more fiscal spending in response to the energy price shocks, and these have all increased inflationary pressures further. As already mentioned, central banks have started to raise interest rates in response to the high inflation levels.

We observe a change in the structural inflation drivers, and the balance of structural inflation and deflation drivers has shifted. Structural deflationary forces like technology and productivity gains stand out, and these were both amplified during the pandemic. But the impact of such forces is more gradual by nature, when compared with shock factors like the war. On the other side, slowing globalisation, supply-chain issues, and more and more fiscal transfers are among the inflationary forces that were already prevalent and the war in Ukraine is now reinforcing them.

Yet we believe that inflation should ease in the second half of 2022. Despite the short-term pain for the economy due to the war-related burdens, we expect the self-healing forces to get going in the coming months.

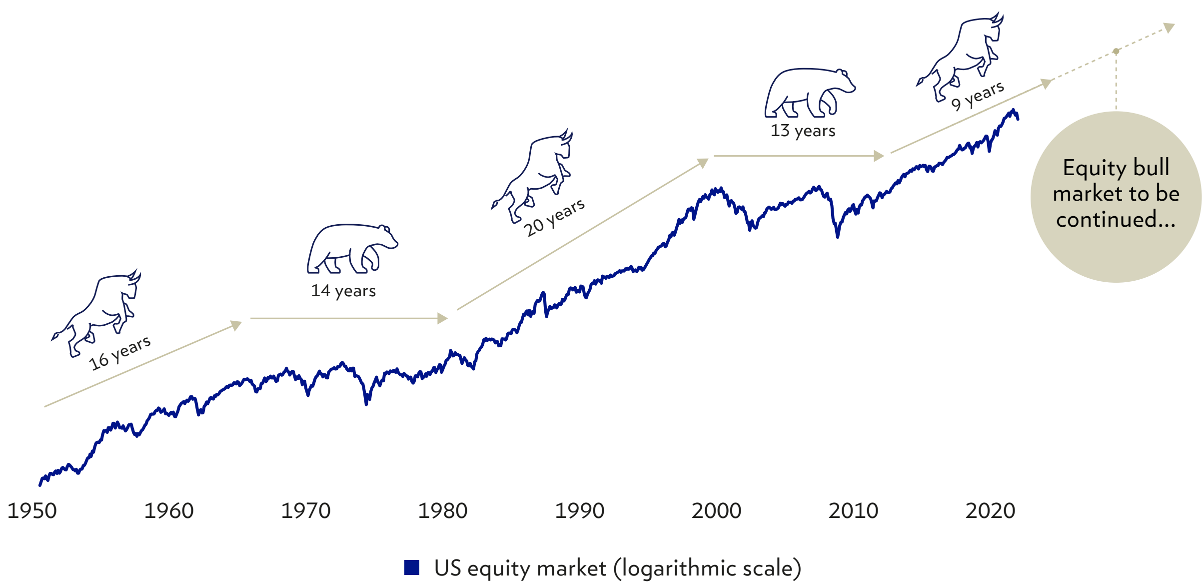
We forecast global inflation of 7.9% for 2022, but we attribute most of this to the first half of the year. For 2023, we expect a notable decline in global inflation rates to 3.8%.

And what does this mean for bond yields? They have risen significantly, but we believe that the move in bond yields is now largely over, and we would expect some stabilisation ahead.

3 What is your view on oil?

Oil and gas prices have been the fear barometer in relation to the war in Ukraine, given that the supply of both is vulnerable to any interrupted supply chains and sanctions. Any further disruption to the flow of oil and gas would drastically worsen the already scarce supply, and the fear of such disruptions has led to several spikes in the prices of oil and gas since the war broke out, which has been a key driver of the soaring inflation.

STAY THE COURSE – WE ARE LIKELY STILL IN A BULL MARKET



Source: Bloomberg Finance L.P., Julius Baer Investment & Wealth Management Solutions
US equity market refers to S&P 500 on a logarithmic scale. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

In summary, the war in Ukraine is a geopolitical shock and the world is adjusting, but we believe that we may now be past the peak of the shock, and the oil price may follow familiar patterns seen when geopolitical events occurred in the past. We do not believe that the world is structurally running out of oil. High prices incentivise supply and curb demand, and much of Russia's commodity flows remain less clogged than initially feared. As a result, we have some confidence that the oil price bounce is temporary. Nevertheless, it is important to add that high volatility is likely to persist given the ongoing geopolitical uncertainties.

Lower global economic growth is one of the structural headwinds for the oil & gas sector. Decarbonisation is another – there has been a notable flow of funds into environmental and sustainable investment-based strategies. In our view, these headwinds remain and thus we do not expect a structural rerating of the sector.

Beyond the short-term uncertainties, we believe that factors including storage releases, supply boosts, demand destruction due to high prices, and the deflation of the always temporary risk premium are likely to lead to lower prices in the longer term.

4 In this environment, what should equity investors focus on then?

The short-term outlook is highly uncertain and there are more moving parts in the picture than usual. Yet we do not see a systemic breakdown looming like back in 2007/2008. Therefore, we deem it important for investors to stick to their investment plans. A broad-based mix of assets protects their wealth in the best possible manner.

As such, we suggest staying invested in equities in the current environment, albeit with a more defensive bias. In the defensive space, we like the healthcare sector, Swiss equities, and high-dividend stocks.

Stocks in the healthcare sector tend to have very strong balance sheets, mid- to high-single-digit sales growth, and relatively low sensitivity to inflation. In fact, healthcare has delivered on average an annual earnings growth rate of 11.5% since 1985, the second highest (information technology: 11.9%). In particular, we favour large-cap pharmaceutical and biotechnology companies due to their earnings stability and solid pipelines. As a long-term theme, we highlight digital health.

In an increasingly uncertain environment with high inflation and slower growth, we expect Swiss equities to continue to outperform. This is due to the market's heavy tilt towards the defensive sectors relative to the cyclical sectors. In fact, the Swiss equity market is one of the best-quality and most defensive equity markets in the world.

Also attractive are high-dividend stocks, due to their high balance-sheet quality and attractive valuations, and companies expected to offer share buy-backs. This type of capital return to investors is seen as a positive, as it shows that the company generates plenty of cash.

We also like the areas of food and drugs as well as personal and household goods, because the demand for these goods is relatively inelastic, i.e. consumers tend to buy these goods regardless of whether the economy is currently expanding or not. Products in these sectors are either a necessity in everyday life (e.g. food, medication, and cleaning products), or consumers feel that they are a necessity (e.g. beauty products and fragrances). Furthermore, looking back at previous periods of sharp inflation, we see that demand in these sectors tends to hold up well, in contrast to spending on consumer discretionary goods, for example.

Depressed investor sentiment means that there are also good opportunities to buy quality growth stocks.

VIDEO

Watch the video on Swiss stocks.

5 Is there still a case for investing in IT stocks?

Information technology (IT) stocks were the key drivers of equity markets for a long time, but performance has suffered as of late. We still like them though, mainly thanks to the market-leading growth rates the sector is generating in a world that continues to be characterised by below-average growth. We focus on profitable companies with strong cash flows instead of early-stage technology names. Relative to the market, IT stocks trade at a slight premium due to their attractive growth perspectives and above-average balance sheet quality. In our view, valuations are reasonable.

Higher interest-rate headwinds should be more than offset by market-leading earnings growth. Compared to the dot-com bubble in 2000, free-cash-flow generation is high for the large and profitable firms in the IT sector.

Overall, we feel that the IT sector remains in a secular bull market and offers investors the most promising growth perspectives. Within the sector, we have a preference for semiconductors and software over hardware companies.

IN FOCUS: GOING MORE DEFENSIVE

Why invest in defensive stocks?
Defensive stocks are shares in companies that tend to outperform the broader market in periods of economic downturn, but then in bull markets their gains can be smaller than those of cyclical stocks. They can thus reduce the performance variability of a portfolio and offer a degree of protection in a less favourable environment for equities. In times of higher volatility, lower growth, and higher uncertainty, our research analysts favour tilting exposure towards defensive equities.

What characterises defensive stocks?
Defensive companies benefit from more stable demand for their products and services where the demand does not tend to change as the state of the economy fluctuates. As a result, the companies tend to have stronger cash flows, more stable earnings, and they tend to pay more consistent and higher dividends. This also means that defensive stocks generally have a low volatility relative to the overall market, so-called beta; stocks with a beta of less than 1 are expected to move by less than the overall market (both up and down).

Our analysts do not expect a recession in the near future, so why do we prefer defensives now?
We like defensives in the current environment, but not exclusively. We advocate a barbell strategy with exposure to both defensive and beaten-down, but profitable growth stocks.

INTERESTED?

Please contact your Julius Baer representative for further information on products that best suit your needs.

SPOTLIGHT ON INFLATION

While many emerging markets have had times of high inflation, this has now become a developed-market phenomenon as well. This means many investors are investing in an inflationary period for the first time.

Although we believe that inflation will normalise in 2023, high inflation levels are likely to remain a top concern this year. In fact, the high-single-digit inflation figures that have been recorded show the true cost of holding cash in major currencies.

We take a closer look at what type of investments can thrive in a period of inflation.

INFLATION INVESTING

In this interview, our Head of Investment Advisory Diego Würgler shares his opinions on the current inflationary market environment by answering three major questions about inflation that many investors – and people in general – may have.

1 Why has inflation surged?

We can trace it back to the beginning of Covid-19 and the related lockdown measures, which led to a period of subdued spending. Once the governments started easing these measures, we saw a rapid increase in demand (so-called 'pent-up demand') for all types of products and services. Central banks' record-easy monetary policy and stimulus measures further supported spending and economic activity. On the other hand, the lockdowns also generated global supply-chain disruptions, which remain unresolved to this day. As such, the combination of higher demand and lower supply resulted in a surge in prices. More recently, to add fuel to the fire, the war in Ukraine has further compounded inflationary pressures through the rise in commodity prices.

2 Can holding cash be a good strategy?

The persistently high inflation that we are currently experiencing combined with the political pressure on the US Federal Reserve to contain it has increased uncertainties about the macroeconomic environment, which is reflected in the setback of developed markets in the first months of 2022. In periods of high volatility, investors tend to increase their cash allocation. This is a big mistake. Whilst the absolute amount of cash stays the same – which, granted, provides a sense of safety – its purchasing power is all but guaranteed to be steadily eroded by inflation. It is important to remember that investing is an exercise in relativity. As such, whilst financial assets can be risky, they can also have substantial reward potential. Cash, on the other hand, is guaranteed to lose its value in real terms once inflation is taken into account.

3 The portfolio context matters. What is your view on this?

First, investors should start by identifying their risk profile and return objectives, and from there they can define their level of cash needs. Second, in an environment of greater return uncertainty, it would certainly be wise for investors to ensure that their portfolio is well diversified. It is important to focus on the big picture, hold a long-term time horizon, and pin down secular trends. Finally, the old adage comes to mind: 'time in the market beats timing the market'. Investors often miss a great part of the market's longer-term ascent because they are waiting for lower price levels before investing. Unfortunately, this is an approach that hardly ever pays off. Of course, it does not mean that all the excess cash should be invested in one go, but rather that investors should have a deliberate strategy in which they put their excess cash to work with discipline and in full alignment with their return expectations and risk tolerance.

WEALTH INSIGHTS PODCAST

Listen to the podcast on how to deploy cash in uncertain times.

"Cash looks safe but, in reality, it is not. Financial history reveals that there is no better hedge against inflation than equities."

Diego Würgler
Head of Investment Advisory

WHICH ASSETS ARE REAL INFLATION HEDGES?

Here we take a closer look at the financial market investments that can preserve their real value or even thrive in a persistently high inflationary environment. It is not as straightforward as one may think.

1 COMPANIES THAT EXHIBIT STRONG PRICING POWER

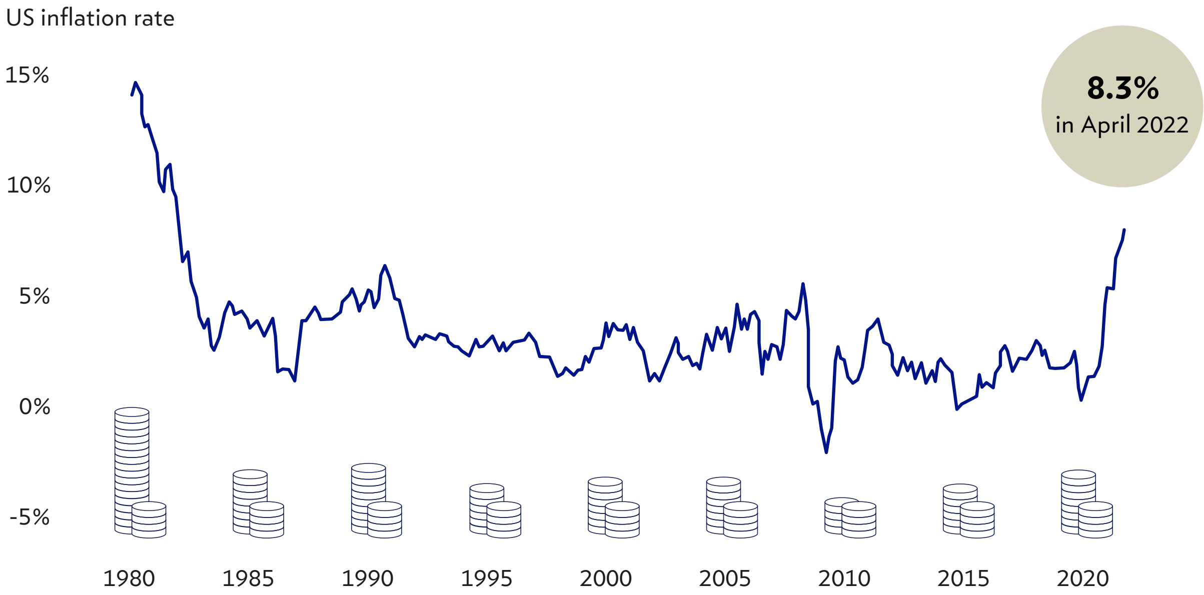
If the past is any guide, we can say that equities provide a long-term inflation hedge to a certain extent. The risk is primarily on the valuation side, which may move lower in times of high inflation and increasing interest rates. Yet, with inflation, revenues and earnings typically rise and many companies can keep up their profit margins by passing on their costs to buyers.

Typically, a company exhibiting purchasing power is one that provides a scarce or unique product/service with few competitors in that segment of the market. This can be an innovative product or an essential commodity that provides added value for which customers are willing to pay.

However, in periods of high inflation, it is also essential for companies to demonstrate strong supply-chain characteristics. These have always been imperative for smooth production processes, yet it is the ability to control production costs with respect to business processes and practices that allows for optimal financial flexibility. This forms the basis for cost leadership, which allows companies to adapt their pricing parallel to inflation.

Generally speaking, companies with an above-average scope for price increases benefit disproportionately in an environment of rising prices and thus are sought after by investors.

US INFLATION HAS SKYROCKETED TO A MULTI-YEAR HIGH



Source: Bloomberg Finance L.P., Julius Baer Investment & Wealth Management Solutions

2 FINANCIALS

Financials are set to benefit from policy tailwinds. In an effort to tame inflation, central banks globally have embarked on their tightening policy journey, with the US Federal Reserve announcing its biggest interest-rate increase since 2000 earlier this year. Historically, this has been a favourable environment for financials, as the sector benefits from higher interest rates and a steepening yield curve. This is especially the case for banks given the direct impact on net interest margins, but it also holds true for insurance companies, which can reinvest maturing investments at a higher rate.

We see opportunities across the major segments of the financial sector. Our preference is for high-quality companies with first-class balance sheets and strong profitability. Although we generally recommend tilting more towards defensives, financials hedge against high-inflation readings and steepening yields, which makes them our preferred cyclical sector. In addition, many financial-sector companies are classified as 'value' stocks as they trade attractively on valuation grounds.

3 VALUE STOCKS

Value stocks are companies that trade below their fundamentals – such as intrinsic value (price-to-book) or earnings (price-earnings) – and/or offer attractive dividend yields. After underperforming the market over the last five years, in the first few months of 2022, value stocks held up remarkably well and outperformed the overall equity market. This is because value stocks tend to do well in an environment of higher inflation and rising interest rates. Observing the last period of high inflation (1975–1985), the value segment was the best performer during that period, outperforming the market (based on the MSCI USA Index) by 2% annually and the inflation index (US CPI) by 9% annually. Therefore, value stocks are considered to be an essential part of our present barbell strategy approach (balancing growth and value stocks).

4 COMMODITY COMPANIES AND COMMODITY-EXPOSED MARKETS

Across the board, commodities have outperformed other asset classes since the start of 2022. This was sparked by the world economic recovery of the past two years, and, more recently, by the war in Ukraine, both of which have been a boon to commodities in general and an important driver of the current high inflation rates.

Commodity prices have partially corrected since their extreme highs, in part due to China's zero-Covid-19 strategy weighing heavily on metal prices, and we believe the overall set should consolidate further. Nevertheless, high commodity prices have been a positive for commodity companies – some of which have been among the best performers so far this year – and for commodity-exposed markets, such as Canada. These are markets heavily exposed to companies producing or trading hard assets, such as oil and industrial metals.

5 GOLD – ONLY AN INSURANCE

While gold has been a store of value for hundreds if not thousands of years, its reputation as an inflation hedge primarily dates back to the early 1980s. However, back then, the economic environment was different from today, not least due to the collapse of the Bretton Woods system, the severe economic impact of the 1979 oil crisis, and the change in monetary policies that saw policymakers caught on the wrong foot.

Today, the link between gold and inflation is not as simple anymore, especially as long as longer-term inflation expectations remain confined. Gold is a rather suitable hedge in times of severe recession or growing systemic risks in financial markets. In other words, safe-haven demand is ultimately the dominant driver of gold prices. Bearing this in mind, whilst the current inflationary environment creates tremendous market uncertainty, safe-haven demand should fade again as long as inflation does not get out of control and the US does not fall into a recession.

6 MACRO HEDGE FUND STRATEGIES

The combination of the current powerful market dynamics of monetary policy uncertainty and geopolitical risk is historically perceived as a good environment for macro hedge funds. These implement their investments on the back of macroeconomic top-down views. Using the broad set of financial instruments at their disposal (equities, fixed income, foreign exchange, commodities) and with their nimble investment approach, they can successfully navigate more volatile, macroeconomic-driven markets. Global macro hedge fund strategies came of age in the inflationary period of the late 1970s. We believe that global macro funds are uniquely positioned to navigate the current market gyrations, and could thus be considered as part of a diversified portfolio. That said, we would stress that fund selection is key, as the difference in return among individual hedge funds tends to be larger than is the case for more traditional strategies.

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BEYOND MARKETS PODCAST

Listen to the podcast on resilient companies.

FIXED INCOME

"The times they are a-changin", to quote Bob Dylan. This holds especially true for the fixed income world.

After a multi-year low tide in yields, interest-rate expectations and bond yields have moved up on the back of higher inflation. As a consequence, the starting point for fixed income investors has markedly improved.

Higher interest rates, as well as some spread widening and manageable corporate default rates, signify that attractive yields are available by taking on moderate credit risk. However, an active stance is still required.

THERE IS YIELD AGAIN

A surge in inflation has put central banks on the back foot with monetary policy tightening very fast. What do higher rates mean for fixed income markets and investor portfolios?

Global bond markets have corrected significantly this year in a perfect storm for fixed income. Since peaking last year, the broad Bloomberg Global Aggregate Bond Index lost more than 13% on a total-return basis. The Bloomberg Global Government Bond Index fared even worse, losing more than 15%, more than the Bloomberg Global High Yield Index, which has fallen 12%[1].

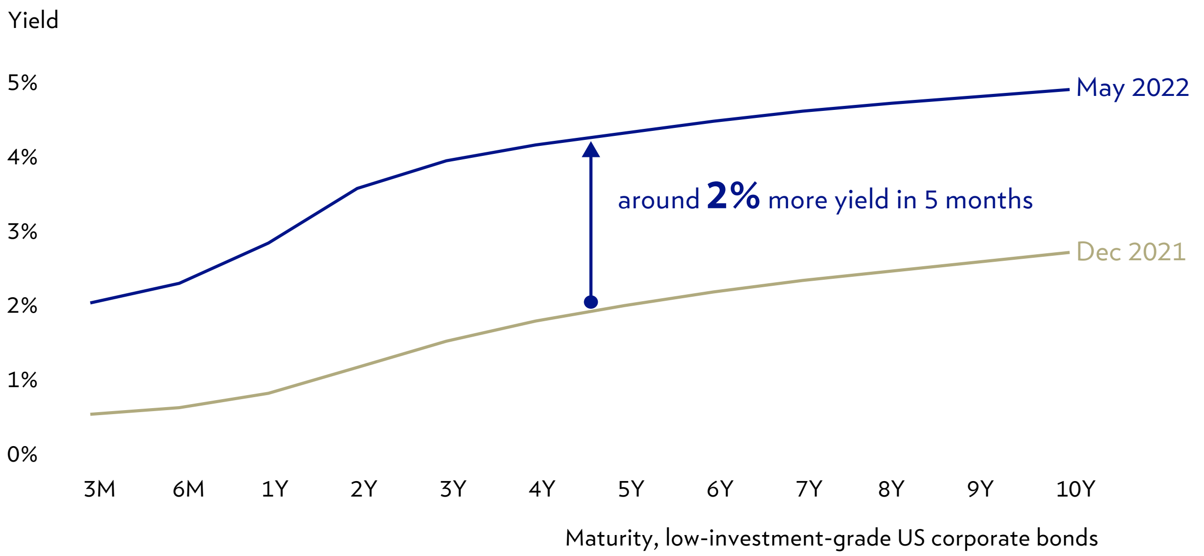
A surge in energy prices – and consequently consumer prices – exacerbated by the war in Ukraine, has pushed inflation to multi-year highs. In response, after a decade of ultra-low interest rates and quantitative easing, all major central banks (excluding the Bank of Japan) have moved to a tightening stance, at a faster pace than markets had anticipated.

This about-turn in policy led to a collapse in bond prices as financial markets transitioned from the end of the 'free money' era.

Fixed income markets offer more attractive opportunities again after the sharp increase in yields. While bond yields could still rise higher (and bond prices drop lower) over summer, we believe that we are past the worst, with rate normalisation well advanced. Valuations in riskier segments also appear attractive, with credit spreads now above long-term averages. Moreover, our research analysts believe that global inflation will correct lower over time (as supply bottlenecks ease and the old structural disinflationary forces kick in again, at least to a certain degree), with a material decline in 2023 back to long-term averages.

[1] All index data at the end of May 2022.

THERE IS YIELD AGAIN IN FIXED INCOME



Source: Bloomberg Finance L.P., Julius Baer Investment & Wealth Management Solutions
M = months; Y = years. Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

THREE KEY PRINCIPLES TO STICK TO IN THE CURRENT FIXED INCOME ENVIRONMENT

1. Short- to medium-duration bonds in the crossover corporate segment (i.e. issuers with BB or BBB rating) remain our preference, given that there is still some upward pressure on bond yields. A portfolio with a shorter average duration is less sensitive to rising interest rates than a portfolio with a longer duration.

2. Flexibility remains key in order to adjust quickly to an environment characterised by higher interest rates but also more volatility, which, in turn, helps to generate positive returns. Also, further weakness in the US Treasuries market may be used to add some duration and portfolio hedges.

3. Selectivity remains essential, and thus investors should avoid getting lulled by higher yields and carefully select investments to avoid a loss of capital. Needless to say, diversification remains important.

WHERE ARE THE OPPORTUNITIES?

Higher interest rates, as well as some spread widening and manageable corporate default rates, mean that attractive yields are back again by taking on moderate credit risk. We favour the USD low-investment-grade corporate bond segment. Specifically, with relatively short maturities (three to five years), investors can now get a nominal yield of close to 4% in USD investment-grade bonds. Furthermore, we also like the better-rated, more liquid part of the global high-yield segment.

In EUR, we favour the low-investment-grade space, given the current attractive yields against a riskier macroeconomic backdrop. Given that Europe's banks are well capitalised, we also focus on subordinated bank debt issued by European banks. This type of debt is further down the capital structure, i.e. later in line when it comes to being paid, and therefore offers additional yield. The yield of such debt has moved up significantly this year, in line with broad market trends, and is comparable to other credit-sensitive segments, such as high-yield and emerging market bonds.

Against a backdrop of rising rates and the fact that short-term rates have rallied sharply over the past months, investors may consider adding senior loan strategies to their fixed income portfolios too. Senior loans sit at the top of a company's capital structure

"We still expect inflation to slow and the US Federal Reserve to decelerate its tightening process towards the end of the year. This should provide some level of support to the fixed income market."

Markus Allenspach
Head of Fixed Income Research

and are secured by the company's assets, although they tend to be issued by companies with poor credit metrics. They pay interest based on floating rates with relatively low duration (which means low interest-rate risk). Senior loans can therefore be effective tools as part of an overall fixed income allocation, to satisfy both income generation and capital preservation objectives.

In addition, diversified hedge fund strategies, which aim to generate attractive returns with low overall correlation to traditional markets, can also be considered from a portfolio diversification perspective. However, investors should note that while hedge funds typically have low credit and duration risk, they come with their own set of risks, including tail risk, derived from the use of derivatives and leverage, and liquidity risk, due to less liquid fund terms.

BEYOND MARKETS PODCAST

Listen to the podcast on fixed income opportunities in a rising rate environment.

INTERESTED?

Please contact your Julius Baer representative for further information on products that best suit your needs.

"With the rise in bond yields, capital protection solutions can now be offered at attractive terms. This holds especially for USD product solutions, but increasingly also in other currencies as local central banks are raising interest rates."

Marc Blunier
Head of Investment Promotion & Solutions

SUSTAINABILITY MATTERS

Sustainable investing aims to create financial gains while also generating a positive social or environmental effect. As such, sustainable investing is all about capturing future opportunities – an important point to remember given the rout on financial markets so far this year. We highlight three accelerating structural trends and explain the opportunity set provided by impact investing through private markets.

TIME TO CAPTURE THE FUTURE

Sustainable investing is thematic investing, which in turn is a form of tactical investing. Slow-paced structural shifts are often overshadowed by the markets' restless temperament and short-term focus. 2022 is a case in point. But the old adage 'opportunity comes to those who are prepared' is especially true in periods when the markets are down. Here are some of the opportunities we believe are worth pursuing now for those wishing to invest in sustainability-related topics.

THREE TRENDS TO WATCH OUT FOR

Our Next Generation franchise has been screening companies through the lens of structural change for a long time already, and the trend towards a more sustainable economy – i.e. one that meets certain environmental, social, and governance (ESG) standards – is definitely structural in nature. Next Generation investing is not only about spotting the 'next Microsoft'. It is a thematic investment philosophy backed by thought-leading research and the courage to stick with long-term investment cases even if short-term market moves shake our confidence that we have made the right investment decisions.

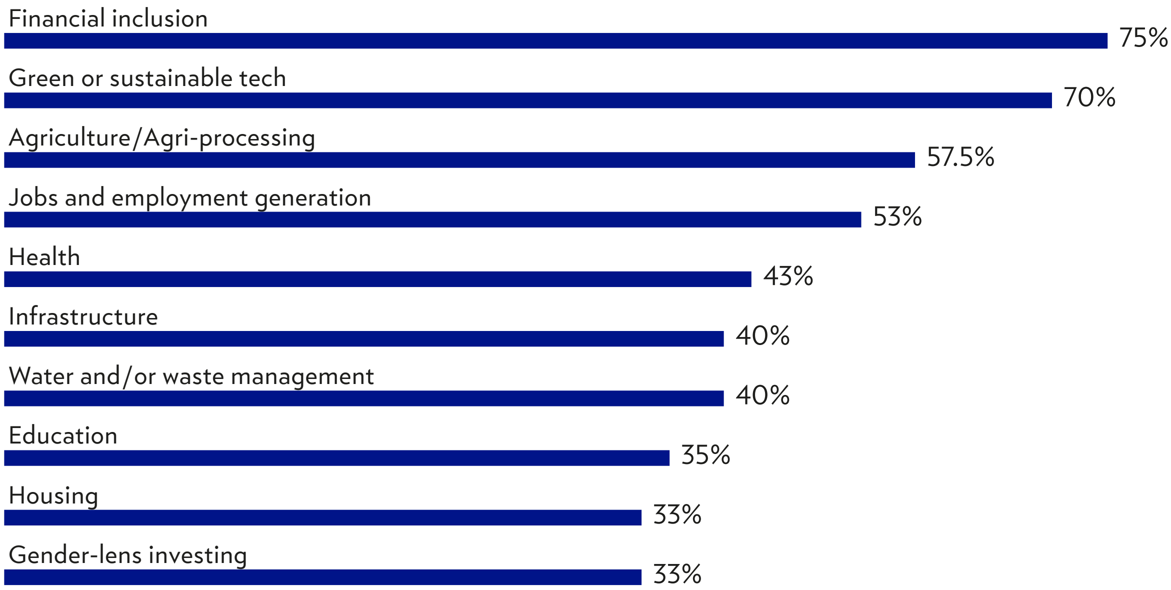
The push for more sustainable investing has, if anything, accelerated over the past years, thanks to regulatory adjustments, a growing public discussion, and the need of investors to have their sustainability-related investment preferences reflected in their portfolios. With financial markets under heavy pressure in the last few months, many of our Next Generation ESG-linked investment themes offer attractive entry points for long-term investors. In this chapter, we highlight three trends that we view positively and that are top of mind given the currently evolving investment environment.

- **Circular economy**: Considering the projection that global waste generation will increase by 75% by the middle of the century, there is an urgent need to tackle the worldwide problem of waste management. We consider the circular economy to be a special kind of structural growth story. While it does not exhibit the same staggering growth rates that we see in other themes, it is much more defensive – which is a plus in the current market environment – and enjoys strong regulatory support.
- **Clean energy**: The shift towards clean energy plays a key role in the fight against air pollution and climate change. Its competitive edge over coal and gas in terms of pricing, coupled with Europe's firm commitment to reducing its dependency on Russian oil and gas, all but accelerates the energy transition. A new round of innovation, investment, and political decision-making is under way.
- **Future mobility**: If you have any doubt that future mobility solutions will be electric, consider this – one in four new cars sold in Europe, and one in five in China, now comes with a plug. The transition away from petrol- and diesel-powered vehicles is here to stay. The beneficiaries are likely to be the early movers among the carmakers as well as the suppliers of the relevant technology, battery metals, and mobility services.

RENEWABLE CALIFORNIA DREAMIN'

With a gross domestic product of USD 3.4 trillion (2021), the US state of California is the fifth-largest economy worldwide, ahead of India and just behind Germany. For a few minutes on 30 April, more than 99% of California's electricity demand was satisfied by renewable electricity, a record in itself. Around two-thirds of the 18,000 megawatts demanded came from solar power. As a matter of fact, over one million rooftops in the state carry solar panels. The remaining third of the renewable electricity demanded on that day came primarily from wind and geothermal sources.

SECTORS IMPACT-FOCUSED INVESTORS PREFER



Source: International Finance Corporation, Julius Baer Investment & Wealth Management Solutions. Tech = technology

VENTURE AND GROWTH CAPITAL: WHERE RETURN AND IMPACT MEET

Those looking to dive deeper into sustainable investing can find opportunities in the promising field of impact investing through private markets. Impact investing, i.e. investing with the intention to generate a measurable social and/or environmental impact alongside market-rate financial return, is one of the fastest-growing trends in private market investing, with USD 500 billion in asset under management, according to market estimates.

The Julius Baer Private Markets team focuses on venture and growth capital to achieve return and impact at the same time. This is for two main reasons. First, it is by funding the technologies of the future, such as cellular meat, carbon-capture technologies, and precision agriculture, at the stage where the companies involved need it the most that we will be able to transition to a low-carbon economy. According to the United Nations, half of all emission reductions between now and 2050 will come from technologies that are not yet commercialised. Venture- and growth-capital funding provides the financial support that companies need to get there.

Second, venture-capital firms fund technology companies in finance, education, and agriculture ('fintech', 'edtech', and 'agtech', respectively) that disrupt old industries and provide innovative services to the 'bottom billion', helping them to escape from poverty. Fintech, in particular, has a vital role to play in emerging markets, as it provides new ways to evaluate credit quality and extend finance to companies and individuals who would otherwise have no access to it. Many of these venture capital firms back companies involved in 'digital leapfrogging', that is the deployment of technologies that skip an entire phase of the development that occurred in developed markets (e.g. implementing mobile telephony and skipping landlines completely). This is now happening with mobile banking and digital payments too, allowing for credit cards, cheques, and brick-and-mortar bank branches to be skipped altogether.

While there are impact opportunities across themes and investment approaches, our Private Markets team believes that venture and growth capital, in both developed and developing countries, is one of the most promising areas for risk-tolerant investors passionate about creating real impact while aiming for attractive commercial returns.

VENTURE & GROWTH CAPITAL

Both venture capital and growth capital are a form of private equity investment. In the context of impact investing, venture/growth capital typically refers to capital invested in technology-enabled companies that are providing social or environmental solutions.

Venture capital involves less mature companies, i.e. start-up companies or companies in early-stage development. Often, venture capital is provided for investments applied towards a new technology, or new products that do not yet have a proven record of accomplishment or steady revenue streams.

Growth capital is capital provided to relatively mature companies that require money to expand or restructure operations or explore and enter new markets. Companies that receive growth capital typically can generate revenue and operating profits but cannot earn enough cash to fund major expansions, acquisitions, or other investments.

INTERESTED?

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FURTHER INFORMATION

FURTHER INFORMATION

Please find below further information on benchmarks and indices used in the review section of this Investment Guide.

MARKET REVIEW

EQUITY REGIONS

REGION	INDEX	REGION	INDEX
Emerging markets ex. China	MSCI Emerging Markets ex. China Net TR USD	**USA**	MSCI USA Net TR USD
Switzerland	MSCI Switzerland NR CHF	**Japan**	MSCI Japan NR JPY
Eurozone	MSCI Europe Net TR EUR	**UK**	MSCI United Kingdom NR GBP
China	MSCI China Net TR USD		

Note: NR: net return, TR: total return

EQUITY STYLES

STYLE	INDEX	STYLE	INDEX
Quality	MSCI World Quality Net TR USD	**Cyclicals**	MSCI World Cyclical Sectors TR USD
Value	MSCI World Value Net TR USD	**Defensives**	MSCI World Defensive Sectors TR USD
Growth	MSCI World Growth Net TR USD	**Small caps**	MSCI World Small Cap Net TR USD
High dividends	MSCI World High Dividend Yield Net TR	**Large caps**	MSCI World Large Cap Net TR USD

Note: TR: total return

EQUITY SECTORS

SECTOR	INDEX	SECTOR	INDEX
Information technology	MSCI World Information Technology Net TR USD	**Financials**	MSCI World Financials Net TR USD
Materials	MSCI World Materials Net TR USD	**Consumer cyclical**	MSCI World Consumer Discretionary Net TR USD
Oil & gas	MSCI World Energy Net TR USD	**Consumer defensive**	MSCI World Consumer Staples Net TR USD
Industrials	MSCI World Industrials Net TR USD	**Real estate**	MSCI World Real Estate Net TR USD
Communications	MSCI World Communication Services Net TR USD	**Utilities**	MSCI World Utilities Net TR USD
Healthcare	MSCI World Health Care Net TR USD		

Note: TR: total return

FIXED INCOME

SEGMENT	INDEX	SEGMENT	INDEX
DM government bonds	Bloomberg Barclays Global Agg Treasuries TR Value Unhedged USD	**DM high yield**	Bloomberg Barclays Global High Yield TR Value Unhedged USD
Inflation-linked government debt	Bloomberg Barclays Global Inflation-Linked TR Value Unhedged USD	**EM hard currency**	Bloomberg Barclays EM Hard Currency Aggregate TR Value Unhedged USD
DM high quality IG	Bloomberg Barclays Global Agg Aa TR Value Unhedged USD	**EM local currency**	Bloomberg Barclays EM Local Currency Government TR Unhedged USD
DM low quality IG	Bloomberg Barclays Global Agg Baa TR Value Unhedged USD		

Note: DM: developed markets, EM: emerging markets, IG: investment grade, TR: total return

COMMODITIES

COMMODITY	FUTURE	COMMODITY	FUTURE
Brent crude oil	1st Crude Oil, Brent	**Platinum**	1st Platinum
Natural gas	1st Natural Gas	**Aluminium**	1st Primary Aluminium
Gold	1st Gold	**Copper**	1st Copper
Silver	1st Silver	**Iron ore**	1st Iron Ore

Note: 1st: front month futures contract

SCORING OUR CALLS

TOPIC	BENCHMARK INDEX USED	TOPIC	BENCHMARK INDEX USED
Healthcare stocks	MSCI ACWI/Health Care NR USD	**Flexible fixed income**	Bbg Multiverse TR Unhdgd USD
Information technology stocks	MSCI ACWI/Information Technology NR USD	**Alternative fixed income**	Bbg Multiverse TR Hdgd USD
Financials	MSCI ACWI NR USD	**Hard-currency EM bonds – Asia**	JPM CEMBI Broad Diversified TR USD
US equities	MSCI North America NR USD	**Stocks to prosper post pandemic**	MSCI ACWI Growth NR USD
Swiss equities	SPI Extra TR	**Energy transition stocks**	MSCI ACWI NR USD
Italian equities	MSCI Italy NR EUR	**Cloud Computing and Artificial Intelligence**	JB Next Generation Cloud Computing and AI Index
Indian equities	MSCI India NR USD		

Note: NR: net return, TR: total return, Unhdg = unhedged, Hdgd = hedged, ACWI = All Country World Index

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METHODOLOGIES AND GLOSSARY

Julius Baer: www.juliusbaer.com/en/legal/methodologies-and-glossary/

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