AXIOMA
Wealth Management AG

2022 Investment Strategy

1st of December 2021

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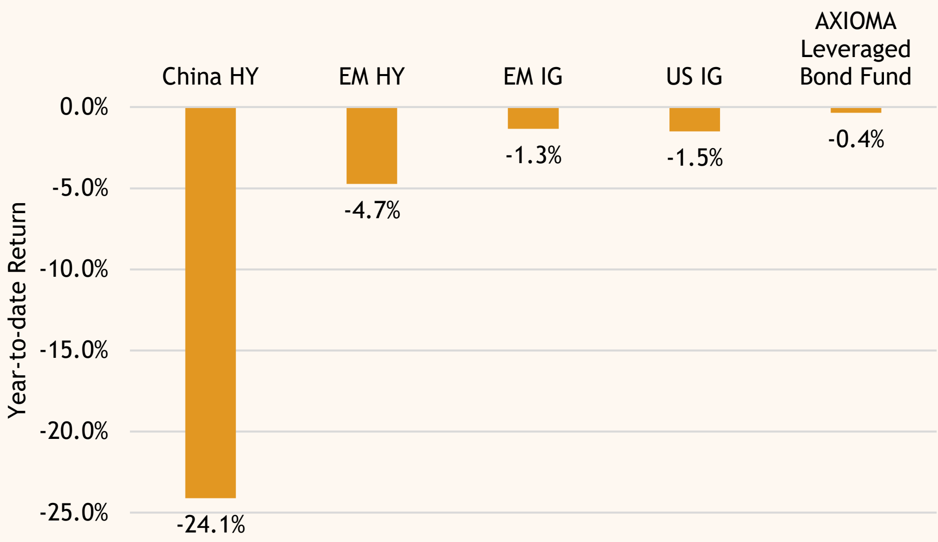
2021 in Retrospect: Too Much Money Chasing Too Few Assets

While the beginning of the year has seen a buoying mood on the markets, as the economies worldwide have started rebounding sharply from the pandemic lows, worries about the inflation in the US and elsewhere has started to resurface by spring and dominated the market narrative over the year. Inflation has proved stickier than initially projected, raising fears of a misstep by Fed and expectations of a sooner than previously-expected rate hike in the US have increased. US Treasuries have had a very volatile year so far, with many ups and down, but overall edged higher along the curve compared to the beginning of the year. Nevertheless, the risk appetite remained very strong throughout the year. Whereas the search for yield was partially rationalized by improving economic activity and corporate margins, it was significantly propelled by the abundant liquidity Fed flooded the market with.

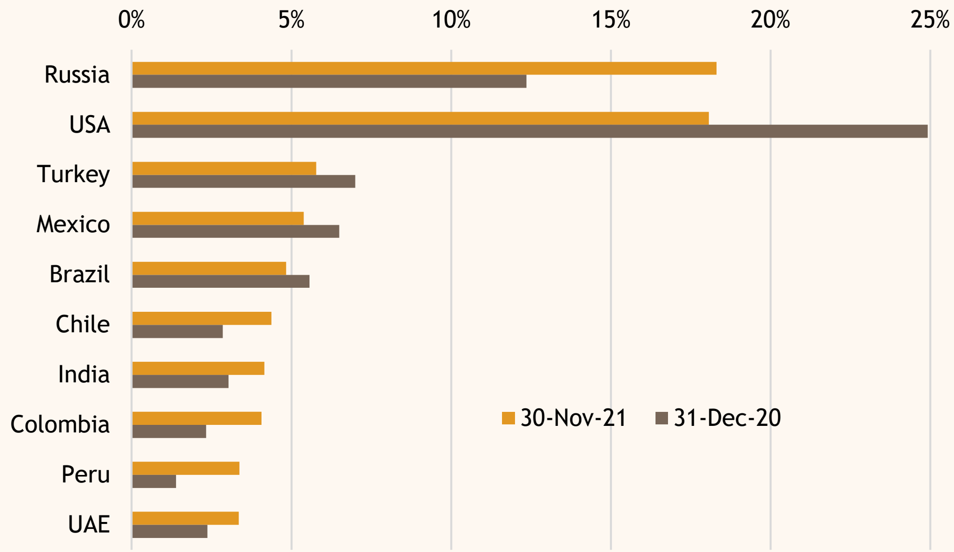
Axioma Leveraged Bond Fund has registered -0.4% YTD gross performance, as a result of the raise in benchmark US Treasury yields. Due to lower duration and security selection, our strategy has outperformed major bond indexes. In addition, we were able to shelter ourselves from the Chinese property sector debt crisis, which has hit hard many funds. This year, we have decreased our allocations to US bonds, which have reached historically low spread levels and have increased allocation to Latin American and Russian bonds. There were no defaults in our portfolio in 2021.

Fig. 1 AXIOMA Leveraged Bond Fund Has Outperformed Major Bond Indices



*Source: AXIOMA (*gross return), Bloomberg (Bloomberg Barclays Bond Indices), 30-Nov-21*

Fig. 2 AXIOMA Leveraged Bond Fund: Allocation by Country



Source: AXIOMA, 30-Nov-21

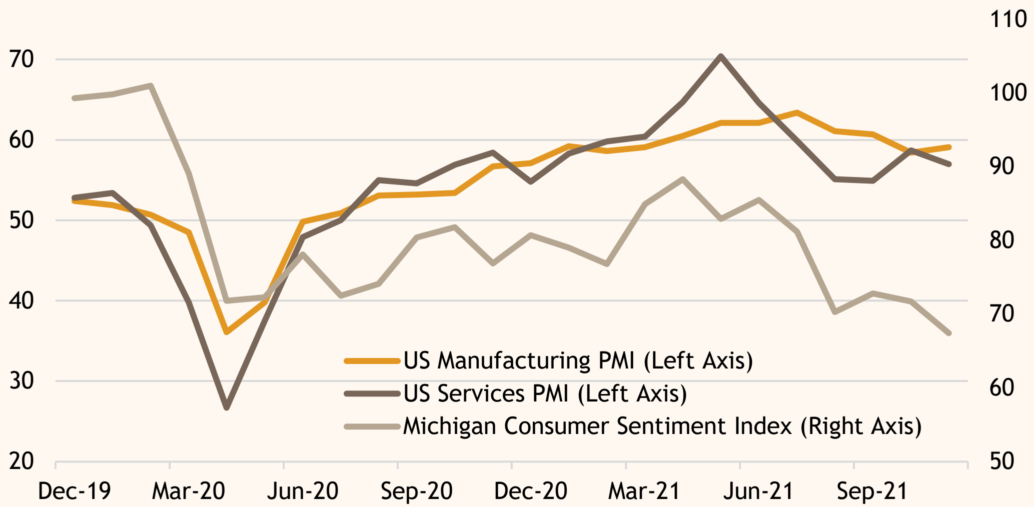
Economic Outlook: US

- The recovery is still under way, as the impact of the pandemic continues to ease, but growth momentum is softening.
- The supply and demand imbalance has sent inflation running very hot. Inflationary pressures from shipping costs and commodities are easing. However, the labor market is showing significant dislocations, as there a big number of open jobs, but fewer people taking those jobs and this may push wages and, subsequently, prices higher.
- The US Congress has postponed the decision on the debt ceiling until mid-December, which means markets will soon start worrying about it again. The basic scenario is that that the limit will be raised, but the magnitude of the impact of an alternative scenario, although unlikely, will keep markets in check.
- Fiscal deficit should narrow significantly in 2022. In the long term, the prospect of higher interest rates is a risk to debt affordability.

Fig. 4 US Labor Force Participation Remains Stubbornly Low

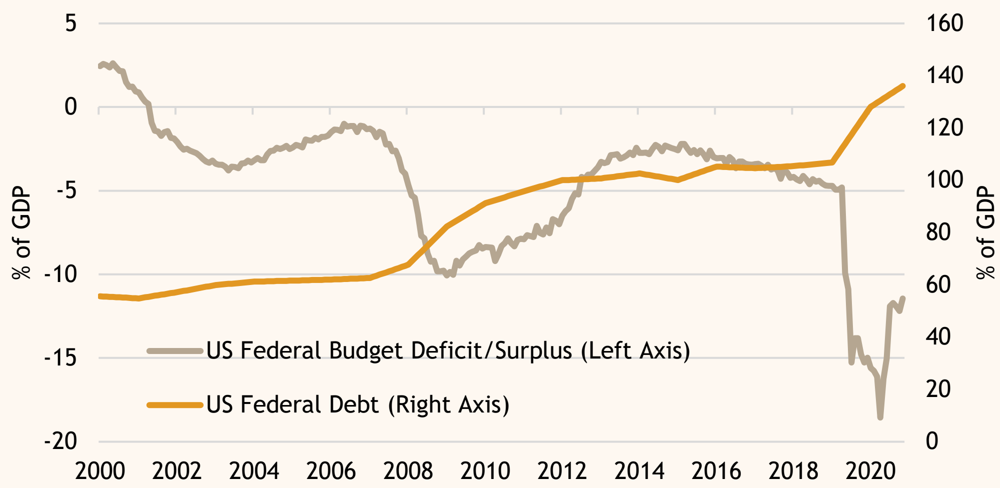
Source: Bloomberg, US Bureau of Labor Statistics, 30-Nov-21

Fig. 3 US growth peaked, while sentiment worsened



Source: Bloomberg, Markit 30-Nov-21

Fig. 5 US Debt to GDP Ratio Continues Rising



Source: Bloomberg, US Office of Management and Budget, 30-Nov-21

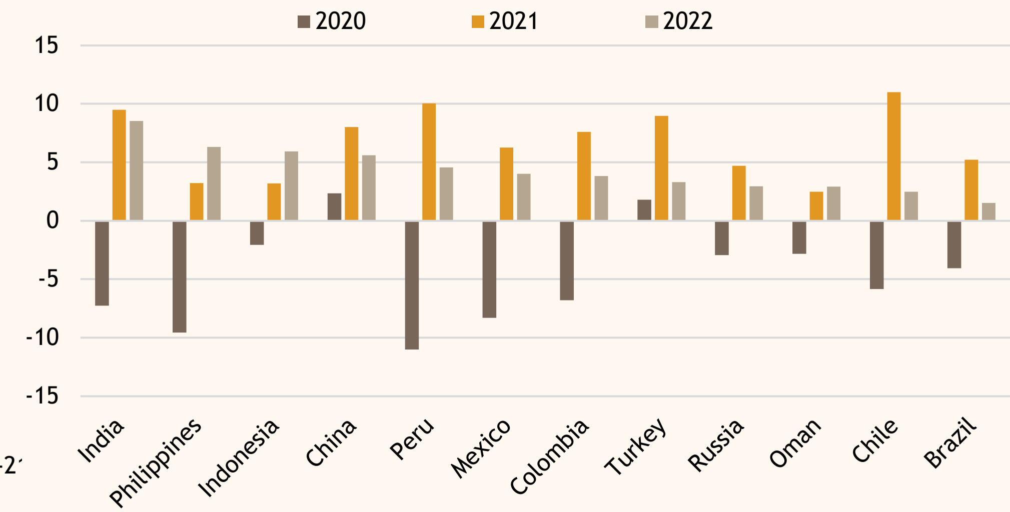
Economic Outlook: Emerging Markets

- Central banks in many EM countries are raising interest rates to contain inflation, even though macroeconomic conditions are still weak. Thus, financial conditions are tighter than pre-pandemic. An exception is Turkey, which cut rates by 400bps this year, despite rising inflation, which sent lira to historically low levels.
- China has made several negative headlines this year, due to its crackdown on regulations, as well as concerns over the debt restructuring of Evergrande, China's second-largest property developer. These issues will persist in 2022 and will continue to weigh on growth.
- Rising commodity prices have played well for Latin American and Middle Eastern countries, as well as Russia.
- The prospect of policy tightening in the US represents a risk for EM countries. However, even if US will raise rates, EM countries are now in a much better situation to weather the capital outflows compared to the 2013 taper tantrum. Many of them are now running current account surpluses and are less dependent on portfolio flows.
- Increased expectations from the governments in a post-pandemic world is going to put pressure on the fiscal situation of these countries. This is especially the case in Latin America.

Fig. 6 Yields on China's junk dollar bonds skyrocket (%)

Source: Bloomberg, Bloomberg Barclays Index, 30-Nov-21

Fig. 7 IMF GDP Growth Projections (%)

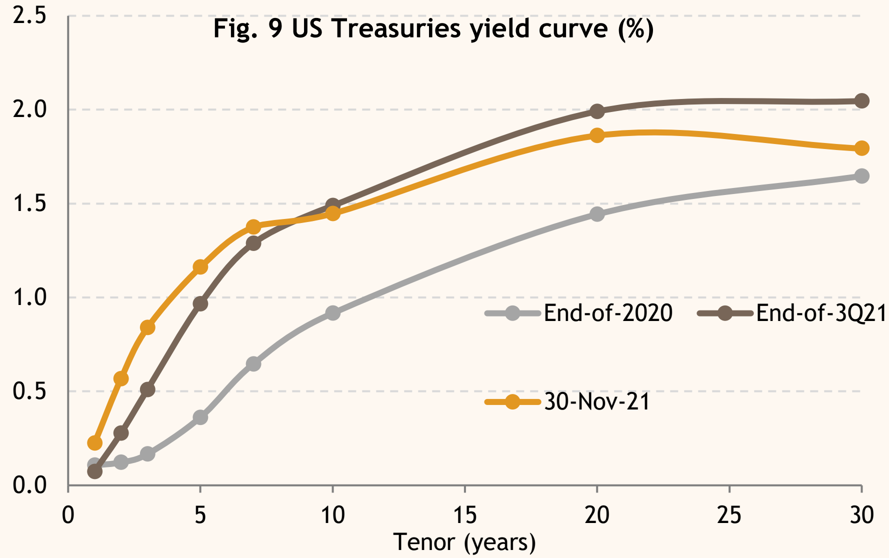


Source: IMF, World Economic Outlook, Oct-21

US Monetary Policy: Tapering Is Not Tightening

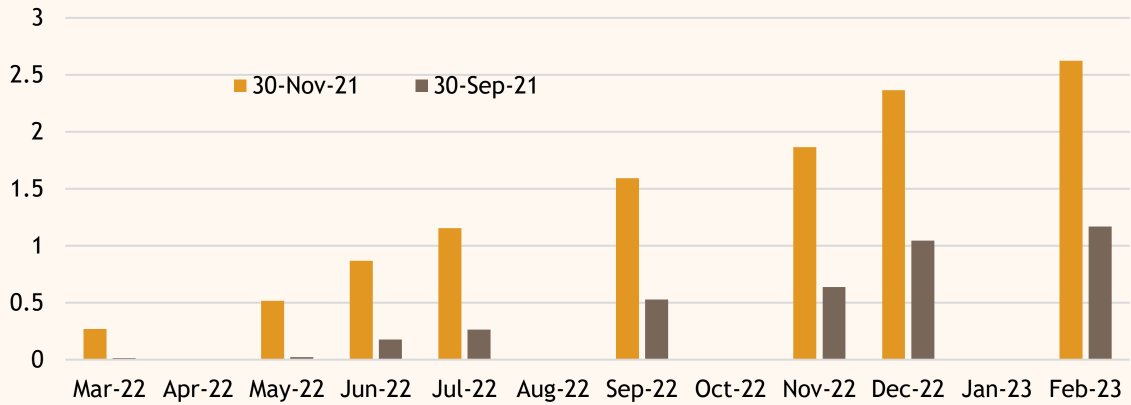
- Fed has announced it is starting scaling back its bond-purchasing program, as a first move towards policy normalization, with the program to be concluded by summer. The decline in purchases by Fed will be offset by a decline in issuance of new Treasuries.
- The maturing bonds which have been previously acquired by Fed will be reinvested, as the balance sheet is not being left to contract. Thus, this is not yet a policy tightening.
- However, at the latest meeting, Fed has recognized that inflationary risks have increased. Should data in the next few months prove inflation is broadening and stickier, Fed will probably increase the pace of reduction in the bond-buying program.
- The US yield curve has been flattening recently, as yield on 2-year Treasuries rose in expectation of rate hikes, while 10-year yields have fallen from the 1.74% maximum reached this year.
- US Fed has a double mandate. While inflation has reached levels high enough to prompt a withdrawal of accommodation, the labor market has not yet recovered. Thus, Fed will not rush to raise rates. The rate environment will most likely remain accommodative in 2022.

Fig. 9 US Treasuries yield curve (%)



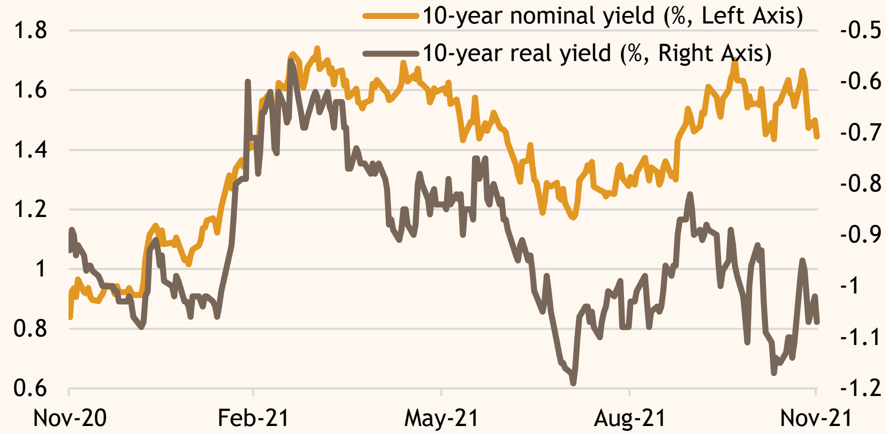
Source: Bloomberg, 30-Nov-21

Fig. 8 Number of 25 basis-point rate hikes priced in



Source: Bloomberg, 30-Nov-21

Fig. 10 US Treasuries real yields remain deeply negative

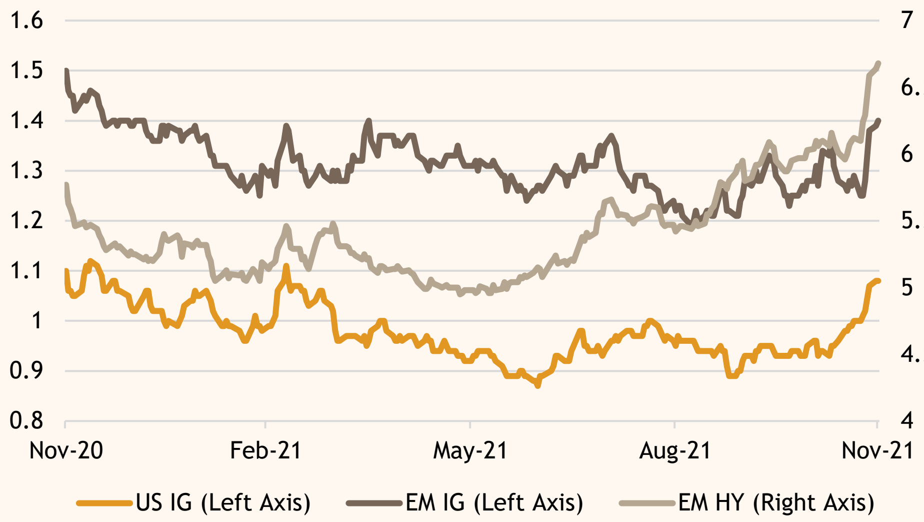


Source: Bloomberg, 30-Nov-21

Credit Spreads: Supported by Fundamentals

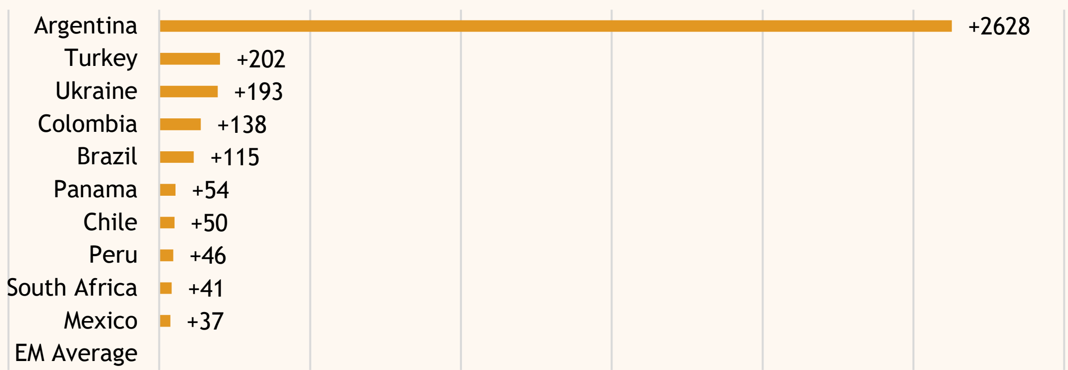
- Credit spreads have tightened significantly in the first two quarters, reaching historically low levels for US IG and EM IG. Fourth quarter saw credit spreads widening, due to increased uncertainty related to a new virus variant.
- In hard currency emerging market debt, spreads of HY bonds remain well above pre-Covid levels.
- Going forward, main risks for credit spreads, in our view, may come from a significant drop in economic growth worldwide, stickier and broader inflation in the US, which may induce a forceful policy tightening, geopolitical tensions and/or social instability in a post-covid world and rise of populism as sovereign risks.
- Overall, there were significant improvements in corporate balance sheets, as companies recovered from the pandemic lows. This was seen in the large number of upgrades in credit rating agencies. We believe the upgrade momentum will persist in 2022.
- Margins improved, reaching record highs for many companies. However, higher input costs could start pressuring margins over the coming quarters.

Fig. 12 Credit Spreads widened in the fourth quarter



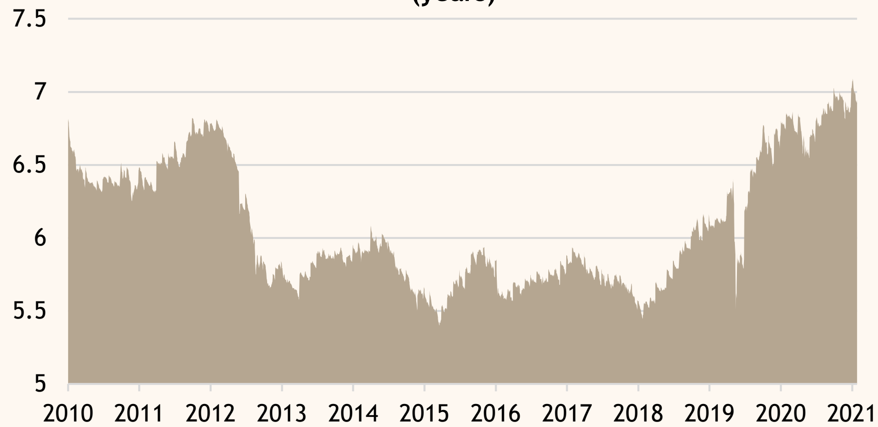
Source: Bloomberg, Bloomberg Barclays Indices, 30-Nov-21

Fig. 11 Worst-Performing EM Countries Year-to-Date (by largest positive change in 5-year CDS spread change (in basis points)



Source: Bloomberg, 30-Nov-21

Fig. 13 EM USD Bond Index Duration at a High Level (years)



Source: Bloomberg, Bloomberg Barclays Indices, 30-Nov-21

Our view & Scenario Forecasts

- We believe that overall, the market has focused too much on the inflation narrative and has underestimated the slowdown in growth which is imminent in our view.
- At this point, the inflation outlook is highly uncertain for the near term. While some pressures will last for a while, disinflationary factors that held back inflation before the pandemic will continue to keep inflation in check in the mid-term.
- We do not expect a significant increase in long-term yields in 2022.
- Considering the high current valuations, the margin for error is very low and the risk of a market correction is high. Should we see a big move in credit spreads due to an overreaction sell-off, we may add leverage at the opportune moment to buy high credit-quality bonds for which we have a high conviction.
- At current market conditions, we maintain a bias to credit quality (we aim to keep 60-70% of portfolios invested in investment-grade bonds). Currently, valuations on US bonds are overstretched. Meanwhile, emerging markets USD-denominated bonds continues to offer a premium to US bonds. We will continue to use idiosyncratic factors that cause volatility in prices, like elections and other events which may cause overreaction on the market, to increase exposure to issuers and segments we like.
- Our **3 market scenarios for 2022**:
  - **Optimistic Scenario**: economic growth continues at a high pace, which drives 5-year Treasuries higher, to 1.5%. Credit spreads tighten by 85bp, on average.
  - **Base-Case Scenario**: economic recovery continues, but at a slower pace. 5-year Treasuries edge higher, to 1.25%. Credit spreads tighten by 40bp, on average.
  - **Worst-case Scenario**: economic growth slowdowns significantly, which keeps 5-year US Treasury yield at 1.0% by year-end. Credit spreads widen by 110bp, on average. We also assumed -0.5% loss due to potential default rate for this scenario.

Fig. 14 Expected total return under the strategy for 2022 by scenario

Strategy return	Optimistic scenario	Base case scenario	Negative scenario
Coupon component	4.2%	4.2%	4.2%
Price change due to change in UST yields	*-1.8%*	-0.5%	*0.9%*
Price change due to spread narrowing or widening	*3.7%*	1.1%	*-6.7%*
Default	*0.0%*	0.0%	*-0.5%*
Total:	**6.0%**	**4.8%**	**-2.1%**
Return subject to 25% leverage	7.4%	5.9%	-2.8%
Return subject to 50% leverage	8.7%	6.9%	-3.5%

Fig. 15 P&L Scenarios

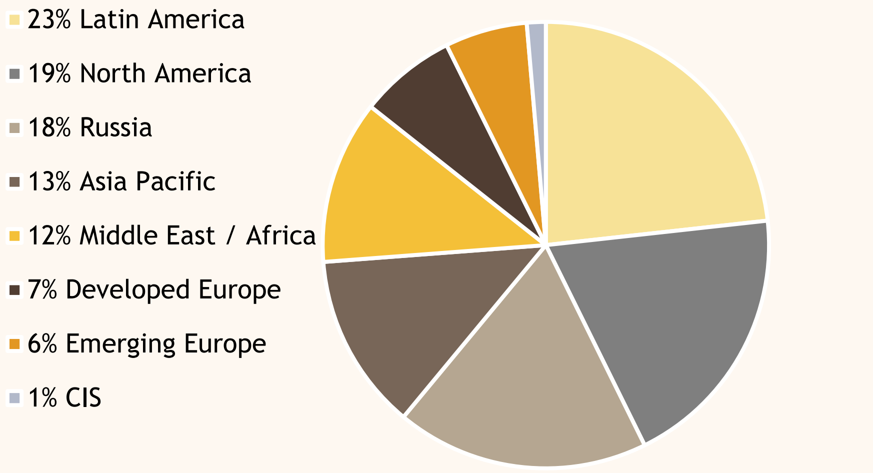
		5 years UST yield to maturity							
		0.25%	0.50%	1.00%	**1.25%**	1.50%	1.75%	2.00%	2.25%
spread (bp)	-46	12.8%	11.4%	8.7%	**7.4%**	6.0%	4.7%	3.3%	2.0%
	-31	12.0%	10.6%	7.9%	**6.5%**	5.2%	3.8%	2.5%	1.1%
	-15	11.1%	9.7%	7.0%	**5.7%**	4.3%	3.0%	1.6%	0.3%
	base	**10.2%**	**8.9%**	**6.2%**	**4.8%**	**3.5%**	**2.1%**	**0.8%**	**-0.6%**
	49	7.7%	6.3%	3.6%	**2.2%**	0.9%	-0.5%	-1.8%	-3.2%
	98	5.1%	3.7%	1.0%	**-0.4%**	-1.7%	-3.1%	-4.4%	-5.8%
	147	2.5%	1.1%	-1.6%	**-3.0%**	-4.3%	-5.7%	-7.0%	-8.4%
	196	-0.1%	-1.5%	-4.2%	**-5.6%**	-6.9%	-8.3%	-9.6%	-11.0%

Source: AXIOMA, 30-Nov-21

Investment Convictions

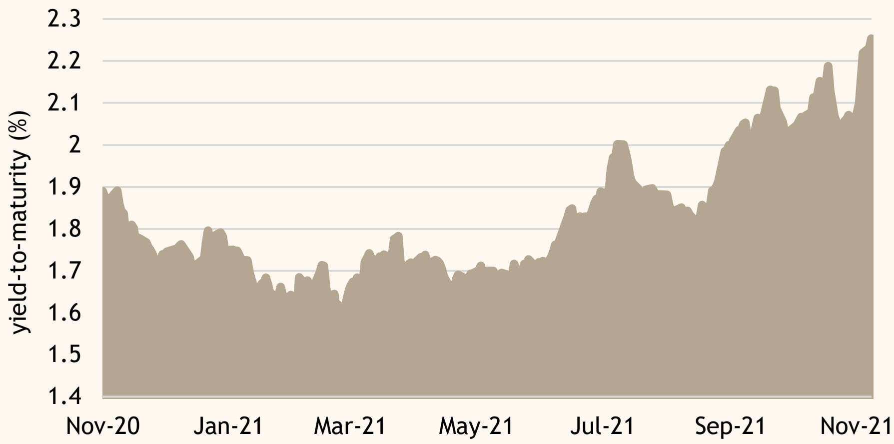
- Compared to the EM Aggregate index, we are overweight **Russia**, **Turkey**, **Chile** and **Colombia** and underweight China, Brazil and Mexico.
- **Russian** corporates have benefitted significantly from the commodity rally. We like **Lukoil**, **Gazprom, Metaloinvest,** but also **Polyus and PhosAgro**, for their credit quality. Credit spreads have widened marginally lately after US secret services have reported about an increase in Russian troops at the Ukrainian border. We continue to hold the bonds we own, as the geopolitical risks are overblown in our view.
- We hold almost 20% of the bond portfolio in **US** bonds. The weight should continue to drop due to upcoming redemptions. We do not intend to add US bonds at current valuations but will consider buying investment-grade US bonds should a broad market sell-off depress valuations.
- Despite balance-of-payments issue in **Turkey**, we continue to have a positive outlook on many Turkish corporates which benefit from natural currency hedging. Turkish USD-denominated corporate bond universe offers a selection of companies with solid corporate governance and strong balance sheets, which would have a higher credit rating should they be located in another jurisdiction. We like **Arcelik**, **Coca-Cola Icecek**, **Mersin**.
- In the **Asia-Pacific** region, **India** may replace China for many investors while uncertainty keeps clouding China's outlook. India is Asia's second largest bond market after China and its economy continues to grow at a very high rate, despite the setbacks this and last year due to the Covid-19. Among the bonds we like are **Adani Ports and Adani Transmission**.
- In **Latin America**, we prefer corporate credit to sovereign bonds. We may consider to increase exposure to such companies as **Petrobras, Ecopetrol, Braskem, Promigas, Meli** should valuations reach our desired levels.
- We believe there is value to be found in some BB+-rated bonds, as the credit-upgrade momentum will continue.

Fig. 16 AXIOMA Leveraged Bond Fund regional allocation



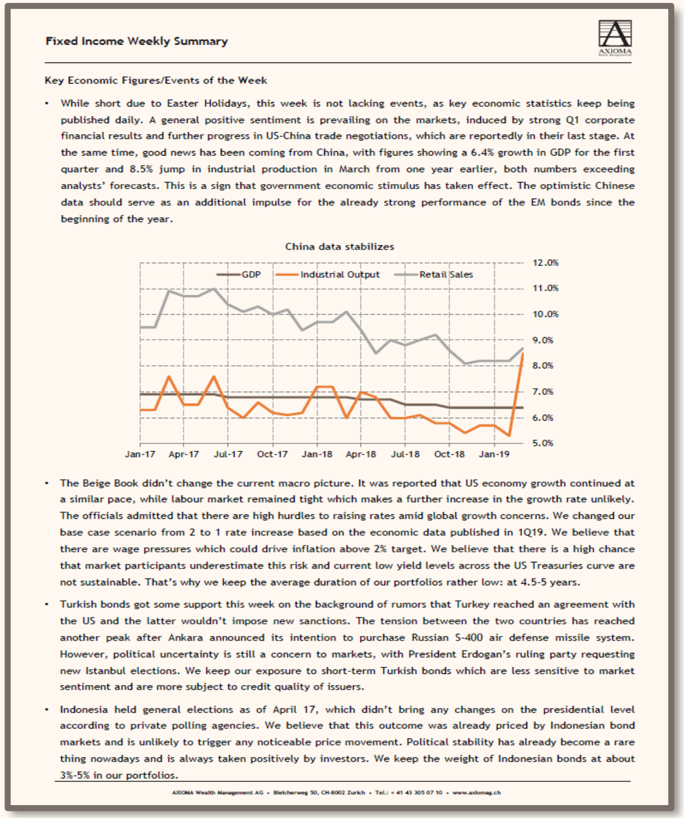
Source: AXIOMA, 30-Nov-21

Fig. 17 Emerging market USD bonds offer significant yield premium to US IG corporate bonds



Source: Bloomberg, Bloomberg Barclays Bond Indices, 30-Nov-21

Stay Informed about AXIOMA's Investment Strategy



Fixed Income Weekly Summary

Key Economic Figures/Events of the Week

- While short due to Easter Holidays, this week is not lacking events, as key economic statistics keep being published daily. A general positive sentiment is prevailing on the markets, induced by strong Q1 corporate financial results and further progress in US-China trade negotiations, which are reportedly in their last stage. At the same time, good news has been coming from China, with figures showing a 6.4% growth in GDP for the first quarter and 8.5% jump in industrial production in March from one year earlier, both numbers exceeding analysts' forecasts. This is a sign that government economic stimulus has taken effect. The optimistic Chinese data should serve as an additional impulse for the already strong performance of the EM bonds since the beginning of the year.

China data stabilizes

- The Beige Book didn't change the current macro picture. It was reported that US economy growth continued at a similar pace, while labour market remained tight which makes a further increase in the growth rate unlikely. The officials admitted that there are high hurdles to raising rates amid global growth concerns. We changed our base case scenario from 2 to 1 rate increase based on the economic data published in 1Q19. We believe that there are wage pressures which could drive inflation above 2% target. We believe that there is a high chance that market participants underestimate this risk and current low yield levels across the US Treasuries curve are not sustainable. That's why we keep the average duration of our portfolios rather low: at 4.5-5 years.
- Turkish bonds got some support this week on the background of rumors that Turkey reached an agreement with the US and the latter wouldn't impose new sanctions. The tension between the two countries has reached another peak after Ankara announced its intention to purchase Russian S-400 air defense missile system. However, political uncertainty is still a concern to markets, with President Erdogan's ruling party requesting new Istanbul elections. We keep our exposure to short-term Turkish bonds which are less sensitive to market sentiment and are more subject to credit quality of issuers.
- Indonesia held general elections as of April 17, which didn't bring any changes on the presidential level according to private polling agencies. We believe that this outcome was already priced by Indonesian bond markets and is unlikely to trigger any noticeable price movement. Political stability has already become a rare thing nowadays and is always taken positively by investors. We keep the weight of Indonesian bonds at about 3%-5% in our portfolios.

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- Every week, our in-house team of financial experts and analysts take an in-depth look at how global events are affecting the financial markets and present their forecasts

  Please visit axiomag.ch/insights

- Every month, AXIOMA's fund managers provide an update on AXIOMA Leveraged Bond Fund

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Your Team

AXIOMA's staff are always available to answer your questions and create a tailor-made solution for your specific requirements. Email or call us with any questions, or to make an appointment for a face-to-face meeting at our office in Zurich.

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