NOVUM
CAPITAL PARTNERS

2022 Outlook
Embracing the unknown (as we head to herd immunity)

December 31, 2021

Our investment team recently carried out a brainstorming session with Sharon, the highly appreciated "ghost editor" of our weekly Market Flash newsletter. We discussed the main economic and financial topics heading into 2022, along with some comments and lessons from the closing year. It was a long and thorough discussion with different opinions articulated by our investment team.

An important note about our team: Novum's first employee, Margot (currently an equity analyst), will be leaving us in the first month of 2022. We will take the opportunity to ask her about her experience at Novum. Carlos, a third-party fund analyst, and Liz, in charge of execution and alignment of our portfolios, have also joined us. Valentine, on the other hand, will take Margot's place immediately and we will be asking her a few questions as well. In spite of this change, which we were able to achieve quickly and harmoniously, we can say that our strength lies in a spirit of sharing and a strategic desire to provide continuity for the client. We consider this to be fundamental: our idea is that the intelligence of the group is greater than that of its individual members, so we intend to continue to sustain an atmosphere of dialogue, cooperation and even cheerfulness to encourage the generation of ideas and solutions for the benefit of our clients!

As per tradition, we decided to share the results of the discussion in a Q&A format, which we believe will hopefully help our clients and our network to shape up their investment decisions and focus on the relevant drivers to navigate the year ahead. Before we begin, we need to make a painful premise. Since Novum's launch in 2018, our CIO has expressed a strategically bullish view on the stock market, especially for the US. While the belief in the superiority of the US market is absolutely intact (at least for Vittorio), there is less certainty in the direction than in the past. There is a major new unknown variable that is being presented to global investors for the first time today: ***inflation****. Much of our thinking and investment decisions will have to take this variable into account. If we want to be more sophisticated, the real variable to interpret will not be inflation* ***per se****, but the reaction function of the Federal Reserve (Fed) to (possibly) stickier than expected inflation.*

"If we want to be more sophisticated, the real variable to interpret will not be inflation per se, but the reaction function of the Fed to (possibly) stickier than expected inflation."

The central point is that, unlike in the previous two decades, we may find ourselves in a situation where, if economies are hit by an unexpected shock, central banks, led by the Fed, may not have the option of easing to offset the slowdown. Not so much for the argument that rates are already extremely low (there is no limit to monetary creativity and quantitative easing, which as demonstrated during the pandemic shock, works!), but for a political issue, of protection of consumers and workers of the weaker groups, who suffer heavily from price increases in consumer goods and energy. Therefore, before giving the "all clear" signal with respect to the classic guarantee of a "Fed put" always ready to support equity markets, we will have to see some sign of inflation returning (and rapidly) toward the 2% threshold. Unlike in the past, inflation prints (and Fed officials' comments) will therefore drive markets in the first few months of the year. With the economy decelerating back to its 2-3% trend, the Fed has understandably decided to normalize monetary policy.

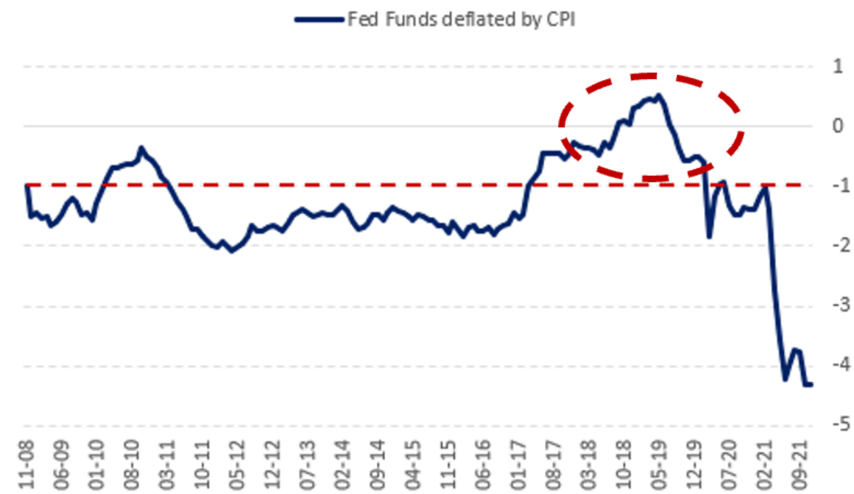
The Fed, under fire from politicians of both camps, has bowed to the expectations of tightening that had already been built into the money market. As of today, the market expects the Fed's balance sheet assets to be tapered in a matter of three to four months, with a cycle of three 25 basis points (bps) hikes in 2022 and four more between 2023 and 2024, giving a terminal level for Fed Funds close to 2%. A lot of questions come to mind at this point, but let's go in order and try to help our readers by clarifying.

"We have to consider the possibility that it is normal for our economies to travel with negative real rates, without this being a warning sign of coming catastrophes, or a distortion in capital allocation..."

How do these expectations look in the post-Covid macroeconomic context? Is it a lot or a little?

Strange as it may seem, it may be a lot, or even too much! This is for two reasons that are easy enough to explain: a) it is useless to show graphs with debt levels in the system, especially those of governments. With Covid, debt versus GDP increased by 20-30 points, and we were already starting from levels considered high, and b) we have to look at real rates, not nominal ones. I mean that inflation will do most of the adjustment. If inflation falls naturally (as the Fed and the market expect), real rates will rise without Fed intervention. If the Fed raises too much, with inflation falling, we could end up in a situation similar to 2018 (Figure 1), with real rates well above zero, and we all remember what happened to asset prices in the last quarter of 2018. We have to consider the possibility that it is normal for our economies to travel with negative real rates, without this being a warning sign of coming catastrophes, or a distortion in capital allocation, as some argue. Negative real rates are a sign of an old society with savings in excess of invested capital.

Figure 1: Fed Funds and Inflation



Source: Bloomberg.

"We have seen that between Covid and liquidity reduction, we are always "at risk"."

How will financial assets react to the upward rate cycle? Can we say that this cycle is already fully incorporated into prices, as we saw in the mid-December correction, so that we have a clear path for a smooth start to the year?

As I said before, a lot depends on the evolution of inflation, and the implicit impact on real rates. The issue is neither tapering nor planned rate hikes. The point is that there is little room for negative contingencies in our system, which on the one hand sees very strong and recovering economies, but on the other hand we are dragging a number of problems because of debt and the age-old issue of income inequalities. And we have seen that between Covid and liquidity reduction, we are always "at risk".

What could lead the Fed to reverse its tightening policy?

The feeling is that this time the bar is set rather high. A year ago it was rightly said that with Yellen at the Treasury, the economic policy objective was to "run a hot economy" in order to absorb the 25 million unemployed created in just three months from March 2020. The point is that in just a year and a half, 20 of those 25 million have been recovered. And in a way, it is not true that five million jobs are still missing to return to pre-Covid levels of employment: if we add the increase of the infamous "job openings", i.e. jobs that companies cannot fill due to the lack of available workers (four million), we end up with a very strong labor market, similar to the pre-Covid levels of employment. And indeed we have seen how the wind has turned, with Democratic politicians putting pressure on the Fed to remove monetary easing.

Inflation is becoming unpopular, because it is known to hurt the poorer classes. That is why I am seduced by the argument that we may be facing a policy error. Basically investors (as expressed by all the forward measures of rates or inflation swaps, or the slope of the curve) have embraced the transitory inflation theory proposed by the Fed and other central banks. It's the media, social networks and politicians who don't believe in it, so they've forced the Fed to comply... and looking at it with a bit of detachment, I think it's fair to say that these sectors don't have a great track record of macroeconomic forecasting. So we will see. I don't claim to have better inflation forecasting ability, but I find it right to be very cautious in this context.

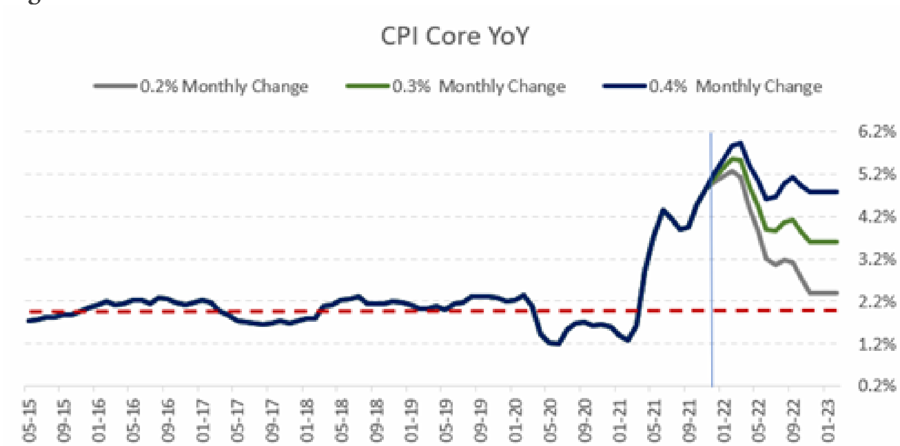
"...as much as I don't believe the hyperinflationary rhetoric, it will take a few months for us to relax in the face of monthly data prints..."

Vittorio, since you claim that inflation will be the key variable in 2022, what is your view on inflation? How long will it take to get back toward the Fed's target?

Vittorio: To answer this question, I help myself with a very simple graph which I've reproduced (Figure 2). Unfortunately, the arithmetic is not favorable. In 2021, core CPI has averaged 0.4%. The average since April, not coincidentally 12 months after the March 2020 Covid-shock, is 0.5%. What I am saying is that to get back to acceptable levels, with year-on-year growth just above 2%, the monthly average over the next few months would have to be 0.2%. Every tick above that implies a conspicuous departure from the expected target. And the worst months will be the next four, as the base year-on-year effect will be very unfavorable (the year-on-year comparison is against months with no inflation), then it will improve. In addition, the price of housing rent, which accounts for more than 30% of CPI, could remain high and disturb the slowdown in inflation after the explosion in house prices. Finally, at Novum, we remain bullish (and long) on the price of oil and energy in general, following restrictions on exploration for new wells imposed by environmental protection rules.

So, unfortunately I can only be a realist here: as much as I don't believe the hyperinflationary rhetoric (I don't see the structural rationale of it, barring more lockdowns with supply effects, or a further decline in the savings rate to support private consumption), it will take a few months for us to relax in the face of monthly data prints...

Figure 2: CPI Core



Source: Bloomberg.

"We entered the Christmas period with the fear of new lockdowns and full hospitals, we could come out of it with a new reopening boom."

The Fed tightening was announced in the middle of the emergence of the new Omicron variant, and in the middle of winter. Then came the news that Democratic but (very) moderate Senator Joe Manchin has no intention of voting for the "Build Back Better" fiscal plan, which included USD3 trillion in infrastructure spending and European-style social welfare. How do you interpret these recent developments in relation to the economy, the Fed and the markets?

On the Omicron variant, we have been constructive from the outset, and now more than ever I feel able to support an optimistic outlook on the matter: while maintaining the usual caution, perhaps this is the right time for us to emerge from the pandemic and be able to live with the virus. Between less severe consequences for the body, vaccinations and healing antibodies, perhaps we can hope for a normalization of life and the economy. In fact, we believe we might reach herd immunity relatively soon, enough to support markets early into 2022. We entered the Christmas period with the fear of new lockdowns and full hospitals, and we could come out of it with a new reopening boom. As a result, I would bet on a positive start to 2022 for the economy and markets, with the real economy, and reopening sectors such as hospitality, travel and energy and materials leading the way.

“Looking ahead to 2022, earnings growth is expected to moderate to 9.0% year-on-year, still well-above the historical average.”

Vittorio and Karim, you always mention earnings as a key variable to position on the equity market, both at an aggregate and at a single corporate level. What happened to earnings during the pandemic, and what about the earnings outlook for 2022?

Karim: The biggest surprise of 2021 has been the earnings strength relative to 2020. We focus on the S&P 500 index, given the significant size of the US equity market capitalization and its material weight in all the major global indices. According to FactSet data, the current estimated S&P 500 earnings growth rate for CY 2021 is 45.1% year-on-year, which increased materially from the projected figure at the beginning of 2021 and is well above the 10-year average earnings growth rate of 5%. The combination of a low base from 2020 but also very robust sales fueled the earnings boom of this year.

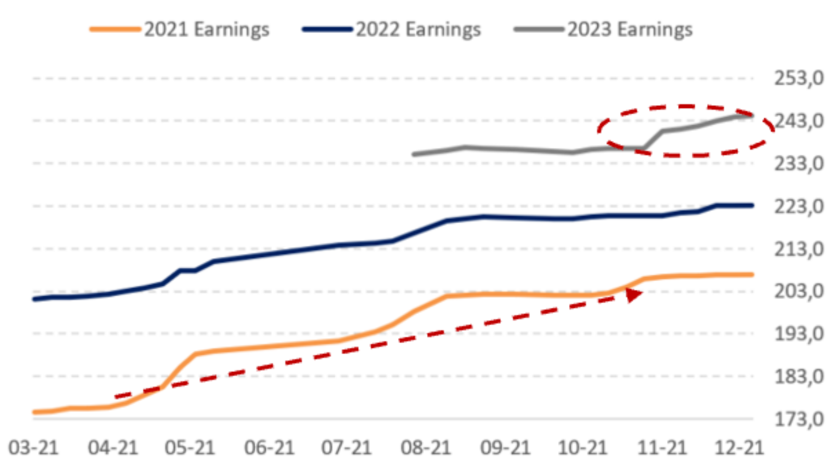
Looking ahead to 2022, earnings growth is expected to moderate to 9.0% year-on-year, still well-above the historical average mentioned above. FactSet data points out that 10 of the 11 S&P 500 sectors are expected to report year-on-year earnings growth, led by industrials (36%), consumer discretionary (32%) and energy (28.4%). Information technology is expected to post inferior earnings growth of 9.8%, and financials are the only sector expected to post negative earnings growth (-8.9%). The strong earnings growth expected for the industrials, consumer discretionary and energy sectors is the result of analysts forecasting the reopening trade to come to fruition after more than 20 months of Covid-driven lockdowns. At the industry level, airlines, aerospace & defense, hotels & restaurants, auto components, oil & gas refining & marketing, and oil & gas equipment and services are all expected to lead their respective sectors.

Analysts forecast a 7.3% revenue growth to be the driver of the 2022 earnings growth of 9.0%. This would imply a net profit margin of 12.8%, above the 12.6% for 2021 and above the 10-year historical average of 10%. The abnormal market returns we’ve witnessed over the past three years (average annual gain of the S&P 500 index since 1957 is 8.4%) have been supported by stellar earnings growth and recovery and by rock-bottom interest rates. While the sustainability of an above-average trend in earnings is the subject of debate, there is no question that the Fed tightening cycle has begun. Supply chain disruptions, labor shortages and higher input costs also pose a risk to the above-average net profit margin expectation for 2022. Recall that the market always looks ahead. So, the question is, where and how could earnings surprise to the upside?

“In 2021, not only did profits grow by over 40%, but month after month, it was a triumphant march with analysts' expectations rising steadily, only to be beaten when the results were actually published.”

Vittorio: This year (unfortunately) I share Karim's caution, not to say skepticism. I add a graph to confirm what Karim expressed, from which two aspects emerge, one relating to the past year, and one relating to the next two years.

Figure 3: Earnings Forecasts



Source: Bloomberg.

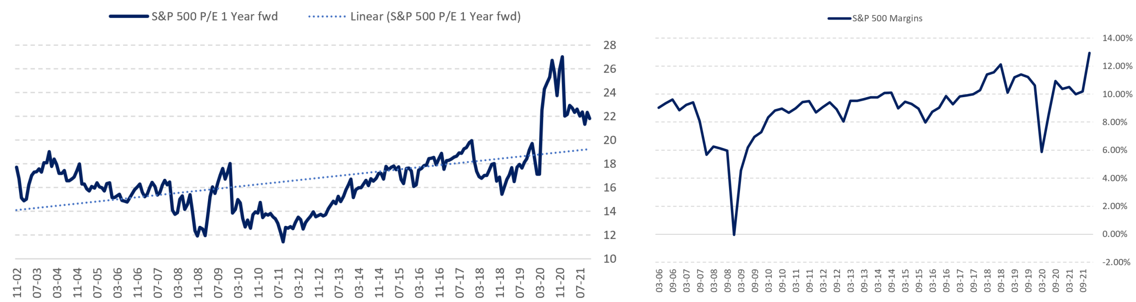
In 2021, not only did profits grow by over 40% (the final numbers are not yet known, and could grow further given that expectations for Q4 2021 are not particularly high), but month after month, it was a triumphant march with analysts' expectations rising steadily, only to be beaten when the results were actually published. Expectations therefore started at +20% year-on-year and ended up at over 40%, as mentioned (orange line). The grey line (2022) and the blue line (2023 – incomplete as forecasts for 2023 are only made as the year progresses) show expectations for the future. As can be seen, expectations for 2022 rose rapidly during the first half of 2021, but have stabilized recently (albeit at high levels).

Conversely, projections for 2023 have risen sharply in recent weeks. As if to say: "we don't think 2022 will surprise us much in the positive, but 2023 will definitely be better!" In short, an act of faith. As a result, I admit that I am also a little skeptical about the sustainability of the well above historical average earnings expansion, which is why we monitor all consensus forecasts on a weekly basis to check for any inflection points that would expose the stock to disappointment in the medium term.

> “I admit that I am also a little skeptical about the sustainability of the well above historical average earnings expansion...”

I also agree on the margins, whose graph I attach to confirm what Karim expressed. I will try to explain my position in simple but scientific terms. In order to justify a stock market rise in excess of economic growth, one can use either earnings expansion or expansion of multiples. In 2021, both of these things happened. In addition to what I said about earnings and margins, multiples expanded thanks to two factors, in my view: 1) the liquidity provided by central banks globally, and 2) the surprising resilience of interest rates, which instead of rising as was reasonable to expect, have remained low, thus justifying low earnings yields for equities, and thus higher multiples (as you can see from the chart, forward P/Es have risen from 17/18 pre-Covid to 21/22 today). If we were only to fall toward a level around 20, there would thus be a compression of almost 10%, which would have to be offset by further earnings expansion to keep the Standard & Poor's from going down!

Figure 4: S&P 500 Margins

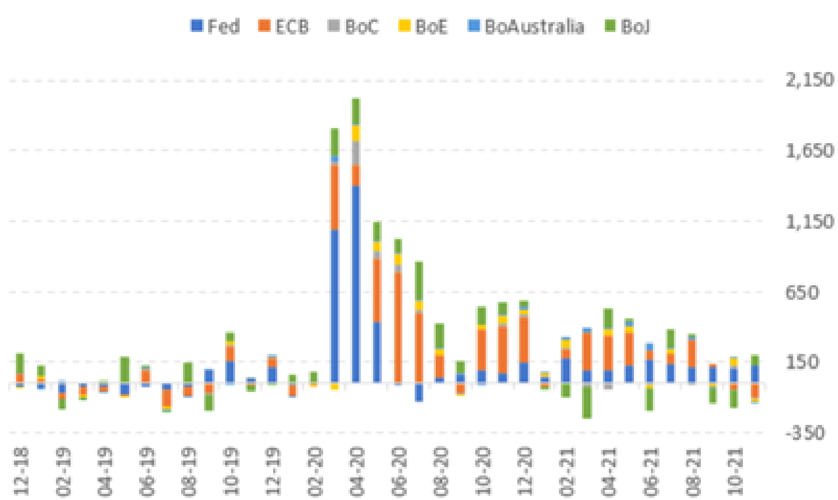


Source: Bloomberg.

A final consideration on the liquidity factor, which as mentioned has supported stock market multiples in 2021. If we look at the balance sheets of the world's top six central banks (excluding China), they have injected more than USD10 trillion of liquidity into the system since March 2020. Even in 2021, despite the economic recovery, liquidity has grown by USD2 trillion, or almost USD200 billion per month. And as you can see from Figure 5, the monthly amounts are decreasing, and will tend to zero in 2022. Some of this is of course natural, as the economy recovers and commercial banks begin to do their business again and lend money, but the fact remains that one element of support for the markets will diminish.

> “If we look at the balance sheets of the world's top six central banks (excluding China), they have injected more than USD10 trillion of liquidity into the system since March 2020.”

Figure 5: Central Banks' Balance Sheets - Monthly Change (USD billions)



Source: Bloomberg.

Many investors continue to call for easing by the authorities in the face of the economic slowdown and the collapse of many Chinese assets, from equities to credit, not to mention the property market. Karim, you follow China passionately. Will this easing be forthcoming, or will we only see a small opening, as we have seen in recent weeks? What do the Chinese authorities really want to achieve? And if they don't do any easing, does that mean that assets will continue to fall?

"While we don't disagree that we are at the beginning of an easing cycle, we can't help but feel that this easing cycle is different."

Karim: The confluence of slow economic growth (which translated to poor earnings growth), regulatory pressures over the internet and property sectors, an aggressive zero-Covid policy, and monetary tightening since the beginning of January 2021, has depressed equity market returns in China; both H- and A-shares. A couple of weeks ago, however, the People's Bank of China (PBOC) cut the banks' required reserve ratio (RRR) by 50 bps and the one-year Loan Prime Rate by 5 bps, in a sign that China's central bank is embarking on an easing cycle. This has led several major banks to upgrade their 2022 outlook for Chinese equities. And on December 25, the PBOC vowed to promote the healthy development of China's real estate market.

While we don't disagree that we are at the beginning of an easing cycle, we can't help but feel that this easing cycle is different. For example, the PBOC has been regularly emphasizing its bias toward supporting small businesses, especially those that have been absorbing significant cost pressures from commodity price inflation. Also, on several occasions, Party mouthpieces have called for balanced growth, in contrast to the short-term high economic growth targets of the past. In other words, we expect a less aggressive easing cycle that is more reactionary and targeted than previous ones. While we expect further RRR cuts in 2022, we sense that this won't be the kind of easing that lifts all boats. Valuations are supportive, but the earnings growth outlook is weak. We suggest focusing on direct liquidity beneficiaries that are supported by attractive valuations, rather than the traditional plays. The market has not yet made that distinction. Our preference would be for A-shares over H-shares and for small and mid-caps over large caps.

Karim, you like to invest on a thematic basis in equities. This year you have been very good at anticipating the metaverse theme. At this point, is it too late to ride it out? Alternatively, can you try to tell us what themes might be winning in 2022?

Karim: This year the metaverse theme was popularized in large part due to Mark Zuckerberg's vision and the renaming of Facebook to Meta. The November rally we observed in several metaverse theme proxies felt unsustainable as future cash flows were pulled forward aggressively. It's important to keep in mind that this is a multi-year theme that we expect to evolve as the technologies develop. Today's apparent winners are not necessarily tomorrow's market leaders. In October we pointed out that our favorite part of the metaverse value chain was the capex-exposed stocks, such as the semiconductor players. Since then, valuations have expanded dramatically. And while we remain constructive on this sub-theme, we would look for lower entry points.

"In 2022, we expect the sub-theme and the theme proxies to matter more than the overarching theme itself."

Our approach to thematic investing is unique in that we attempt to distinguish between themes that get hyped up without strong fundamental support and those where the theme proxies enjoy strong balance sheets, high degree of earnings visibility and a sustainable market position. Equally important is to assess the merit of each theme against the backdrop of the overarching macro environment. For example, without the support of rock-bottom interest rates and tame inflation, asset prices could see their returns converging to levels more in line with their long-term trend. Thus, popular long-duration themes would see their frothy valuations come under pressure, despite the favorable structural trend.

In 2022, we expect the sub-theme and the theme proxies to matter more than the overarching theme itself. For example, within the reopening theme, we are still more constructive on energy stocks given their high free cash flow yield and positive sensitivity to higher oil demand, compared with, say, the airlines industry which is adversely impacted by higher fuel costs and higher wages. While the expected payout of airlines is higher, we lean on the side of caution, looking to hedge against inflation until we see signs of inflation normalizing. Within the popular electric vehicles (EV) theme, we find that the level of competition among the various battery technologies very high to be able to declare a winner. Alternatively, we see more value in the raw material companies that are exposed to EV battery production.

Vittorio: In addition to what Karim said, another theme we are pushing, which offers our clients opportunities both through direct investments and private equity funds, is blockchain and cryptocurrencies. These are certainly not tactical, medium-term investments, but they are definitely strategic and long-term. We are also investing in training one of our resources, Daniele, to acquire more and more skills in this area so that we are always up to date and prepared on the issues that represent the new frontier in terms of technological innovation.

"The only segment that stands out on a yield side is Chinese credit (yields at around 20%, spreads of 1,800 bps)."

Flavio, you have bravely proposed a trade for 2022: go long Chinese credit, including the high yield sector! What is the rational of the trade? Despite the risks that I imagine you have considered, the reward is clearly higher?

Flavio: Due to very tight spreads, finding value in credit is a real struggle. The only segment that stands out on a yield side is Chinese credit (yields at around 20%, spreads of 1,800 bps). This is driven by the high yield part of China, which contains the real estate developers that were sold off aggressively as a result of a very painful increase in regulatory constraints, which led the property sector to a deep liquidity crisis. Almost 50% of the bonds in the property sector trade below 60c on the dollar. This suggests a too high expected default rate of over 30%.

Of course, valuation alone is not enough. What is needed is a trigger for change – and that trigger is "policy makers to the rescue". We believe that due to the systemic importance of the property sector, which makes up 25% of China's GDP, it is difficult to think that the government could allow half of the sector to go under. Indeed, the message from the December politburo meeting as well as from the December Central Economic Work Conference may suggest that we have reached a point where policy makers are changing course. If we suppose a still high default rate, but contained to 11-12%, potential returns should be in the region of 10-15% on a twelve month horizon.

To play this trade we have chosen two funds. The Angsana Asian High Yield Bond is focused in Asia, in particular on China, India and Indonesia. With a very active approach, the fund is fully aligned with our view and has strong exposure (beta) to China and especially the Chinese property sector. Despite our conviction on an active approach to invest in the asset class, this position could be combined with an allocation to the Fidelity China USD High Yield Bond Fund. The fund invests exclusively in China with a relevant weight in real estate, in line with the overall Chinese high yield market. It goes without saying that risks remain high: first, property developers will face a wall of US dollar maturities in the first quarter of 2022, and second, the lack of meaningful policy easing measures will not make the risk of idiosyncratic events disappear.

"In a world of negative real yields, the high yield segment should continue to benefit from interest from non-dedicated investors..."

Flavio, at Novum, you have practically eliminated the duration risk in your portfolios, thanks to the short on US Treasuries suggested by Vittorio. But what is your view on credit spreads? Is there still value in the investment grade or high yield segments? Will the Fed tightening cycle negatively impact the segment?

Flavio: Investment grade both in Europe and the US is expensive. Spreads are too tight to compensate for the expected rise in government bond yields. In truth, robust growth and still high levels of liquidity should translate into a good year for credit overall, but there will be regular episodes of inflationary/interest rate scares. This will likely induce more volatility with spread widening in the first part of 2022, and enough that the downside is much larger than any remaining upside. Overall, returns should be negative in the US and barely flat in Europe (the European Central Bank is less aggressive than the Fed).

In a world of negative real yields, the high yield segment should continue to benefit from interest from non-dedicated investors, which should help to underpin demand. Good economic growth and low default rates give high yield spreads some residual potential. With the segment's yields in Europe at 3.34% (and 3.84% in the US), rising rates are less of a concern than in investment grade. High yield breakevens are now above 100 bps, implying a 1% cushion in rising rates before any negative total returns. Good fundamentals (such as leverage, interest coverage and rating migration) and low default rates should underpin the asset class. Overall, returns should be positive at around 1.5-2%.

Finally the outlook for emerging markets (EM) spreads remains challenging. In 2021, EM sovereigns underperformed US high yield, leaving EM sovereign spreads wider. However, if the US dollar remains strong in the first part of 2022, rate volatility could continue to drift higher, real rates could start to increase – and external financial conditions will also tighten as developed market central banks move to more restrictive policies. Traditionally, this is not a good set of circumstances for EM sovereign spreads. With a carry return of around 5%, the expected downside in price return will produce a barely positive total return for the asset class.

"Now ,with companies flush with cash, less supply in 2022 should be positive for yields and spreads."

Flavio, regarding the primary market, which you closely follow to monitor market trends in terms of ratings, instruments offered and demand for bonds, have you noticed anything interesting this year that is worth sharing with our readers? Has the market remained healthy and strong even during the (weak) corrections that the equity market has experienced this year?

Flavio: In terms of issuance, 2021 has been a record-breaking year as companies borrowed billions of dollars in a rush to lock in low borrowing costs while they still can, and before central banks begin to rein in their loose policies. Investors were eager to oversubscribe to deals, allowing borrowers to get away with yields lower than the ones initially marketed. However, with the general levels of spread already very tight, there have been plenty of bonds taking a pummeling when investors got spooked by the greed of issuers/ lead managers. For example, Coinbase made its market debut on 14 September, attracting so much interest that it doubled the amount issued and reduced the initial yield offered – but the price fell almost immediately because Goldman's strategy of aggressively lowering the yield offered left little room to withstand any market turbulence.

Now ,with companies flush with cash, less supply in 2022 should be positive for yields and spreads. However, with the buyout boom of private equity spending like never before, JP Morgan is forecasting as much as EUR30 billion of non-investment grade debt for M&A deals to come to market in the first quarter of 2022. Clearly, the prospect of firms getting pumped up with more debt by their acquirers will not appeal to bondholders. Take for example the bid for Telecom Italia SpA led by KKR. Fitch could slash Telecom Italia's rating by four notches from its current BB+ to B, if the company's already significant leverage gets even bigger as a result of the buyout.

Another powerful trend leading to oversubscriptions and incorrect pricing is the race to buy debt tied to environmental, social and governance (ESG) goals. Sales rose to more than USD1 trillion for 2021, up from about USD480 billion issued in all of 2020. The green label gives issuers 2-3 bps pricing advantage (the so-called greenium) and excess demand will keep costs in borrowers' favor up, to even push companies to misrepresent or inflate sustainability claims. In short, with the prospect of another 50% increase in sustainable bond issuance, especially in the high yield segment, episodes of new issue mispricing could be plenty.

"I still think the dollar's trend is bearish, based on fragile fundamentals and an expensive valuation. I therefore believe that the last element of support for the dollar is the hawkish Fed."

Vittorio, I realize that managing currencies has become a nightmare in a world of financial repression and rates converging around zero. Most "Macro" managers, who use currencies to generate performance, have been betrayed by their convictions and lost money in 2021 (and beyond). Yet you are forced to take a view on the major parities. What do you plan to do in 2022?

Vittorio: Absolutely. I have to admit that as the years went by, and experience increased, I pretty much stopped taking bets on Forex. And I have to say it was a wise decision, looking at the performance of Macro funds and even more at the FX players in the market. So, I can only say two things: on the one hand, we try to use currency instruments almost exclusively to hedge currency risk. On the other hand, we have structural positions in currencies with very solid fundamentals, such as the Swiss Franc, which we hold almost as an asset allocation tool. Or, very rarely, we make tactical trades in currencies that we like (such as NOK, CAD and RUB) when they depreciate sharply as a result of risk aversion episodes – but always with caution and in small sizes.

To conclude, I would also like to express a view on the US dollar (even though I recognize that I was wrong in 2021). I still think the dollar's trend is bearish, based on fragile fundamentals and an expensive valuation. I therefore believe that the last element of support for the dollar is the hawkish Fed; so I respect the current strength of the Greenback, which in my view will be exhausted when the Fed has to change its stance, as it has in the past; at the moment the administration is using the dollar to contain inflationary pressures. But I don't think the US can afford a strong dollar for too long either.

Liz, as well as providing an exceptional execution service for our clients, interfacing with their custodian banks, you have been responsible for updating the team and our clients on market news and views from leading strategists. On the execution side, what critical issues do you see in the relationship between the External Asset Manager and custodian banks? Are banks efficient in their service? Are clients' interests protected in terms of costs and risks?

"For me, the most important factor is the timely fashion of best execution for the client while keeping costs low. A lot of this can be achieved by automation between ourselves and our custodian banks."

Liz: This is an interesting question. Some of the custodian banks are still very traditional in handling execution. This mean that trades need to be sent, then verified before making it to the trading desk, making it a slow process that can have a more expensive fee structure. For me, the most important factor is the timely fashion of best execution for the client while keeping costs low. A lot of this can be achieved by automation between ourselves and our custodian banks. In 2022, we will continue to onboard clients to direct market access via our custodians.

Our clients appreciate your "strategist digest". Which house has been more accurate in its analysis and forecasts this year? Which do you find more convincing in terms of analysis framework?

Liz: JP Morgan's Buy Dips approach has worked this year; they were always constructive on markets over the course of the year. Morgan Stanley, when it comes to the framework, held the view of an early transition from early to mid-cycle: that headwinds were approaching, including rising cost pressures/ supply shortages, which would lead to changes on economic data and earning revisions. They were early to take a defensive stance in the market.

Carlos, you joined Novum to look after the huge amount of money allocated to third-party funds. What was the funds' performance, divided by sub-funds, in 2021? Do you think the funds have, on average, repaid investors for the fees they have paid and the risks they have taken?

Carlos: It has been a tough year for active managers in terms of market factor rotation from growth to value, and cyclical to non-cyclical, which hindered managers' labor, where a blended approach proved to be the winner. On the other hand, and referring to the largest market, the US, there has been a huge stock dispersion in terms of performance between winners and losers. Those names that outperformed along 2021 coincided with the ones with a higher representation in the main indices. In that regard, this fact benefited passive over active last year.

"Despite active strategy investments not paying off last year, I deem it appropriate for the years to come given the higher dispersion observed and expected in the foreseeable future..."

However, in general, active funds' performance was in line or slightly underperformed their respective indices in 2021. Despite active strategy investments not paying off last year, I deem it appropriate for the years to come given the higher dispersion observed and expected in the foreseeable future, and the higher importance of stock picking.

Regarding Hedge Fund strategies, 2021 saw a challenging year with elevated levels of dispersion and volatility. The strategies that displayed the highest levels of dispersion across sub funds were Global Macro and Equity Long Short, while the lowest were Multi Strategy and Relative Value. The overall universe of funds performed in the high single digits on average in 2021. For the coming years, I consider it key to find uncorrelated strategies to traditional asset classes in order to build robust portfolios.

The main categories 2021 performance estimates (using HFRX indices per category and UBS global HF composites) are:

- *Equity long short:* directionality proved to be advantageous over market neutral and variable bias strategies given the positive evolution of markets. 2021 performance estimate was 9.6% for directional long short and 5.9% for low net funds.
- *Event Driven*: ended the year with positive performance overall due to the high M&A activity and the relatively attractive spreads in the arbitrage. Performance estimate for the year is 9.5%.
- *Global Macro:* discretionary managers displayed high levels of volatility over the year given the lack of a clear trend in markets and the erratic evolution of interest rates that decoupled from inflation expectations. According to UBS, Global Macro was the category with higher dispersion in performance across different managers. Performance estimate was 2.5% for the year.

- *CTA:* top performance category on average in 2021 due to positioning to protect against inflation. In general, the category benefited from long energy trades versus short bonds. Moreover, the CTA had less dispersion between managers than what we saw in the past. 2021 performance estimate was 12.5%.
- *Multi-strategy:* navigated different market environments well with diversification proving to be advantageous, with equity arbitrage and quantitative strategies among the top performers. Performance estimate for the end of the year was 9.2% with one of the lowest dispersions.

"For the 2022 outlook, I think it is difficult to have another year with stellar returns like 2021, with global cryptocurrency market capitalization growth from USD770 billion to USD2.3 trillion."

Dani, the focus of your work has shifted over the year from derivatives to crypto and blockchain, driven by strong client demand. You have also recently opened a dedicated section in Market Flash! What can you tell us about this world? Do you think the trend will continue in 2022? We are not asking so much about the currencies themselves, but about the technologies and their applications. Will we still be able to offer new opportunities to our clients in this space, without risking arriving late on expensive and crowded investments?

Dani: The highlight of this year was attending the Digital Asset Summit event in London. I was surprised to see so many guys turn from finance to crypto, and I think the trend is still there. For the 2022 outlook, I think it is difficult to have another year with stellar returns like 2021, with global cryptocurrency market capitalization growth from USD770 billion to USD2.3 trillion (and a peak of USD3 trillion in November). But the adoption from new users is steadily growing, and institutions are still waiting on the sidelines when it comes to moving into digital assets. We continue to recommend investing in technology and infrastructure as we think that what Ethereum does for crypto dollars and NFTs is here to stay. At the same time, we continue to avoid any speculation or hype, avoiding things like Shiba Inu and other meme coins.

My final recommendation relates to the volatility of digital assets. In my opinion, the key to success in investing in this asset class is to carefully choose the appropriate size of the investment based on your risk tolerance. Some of the projects are long term and will take time to get real adoption - for example, the metaverse. Some say that it could take another 10-15 years (or it could be much shorter), or the adoption of Web3 (the next stage of World Wide Web that incorporates decentralization based on blockchains) - which has the potential to disrupt the technology that today people are used to using and loving. Over the last year, we've seen that during selloffs investors tend to sell these long-term projects that are not generating revenue first, exposing investors to high short-term volatility and the risk of panic selling long-term success stories.

"…we come from sharing an open space between three to now being more than 20 employees with many steps along the way!"

Margot, you're leaving Novum after more than three years. In a few words, tell us how you have seen the company change during this time. What are you taking with for your new adventure?

Margot: What a great adventure! It is difficult to describe in a few words how Novum has changed… we come from sharing an open space between three to now being more than 20 employees with many steps along the way! In short, Novum is moving from the stage of startup to being an established company with a strong and established culture.

I have learned and applied so many things over the last three years but, above all, how to build a structured equity portfolio, with not only a clear focus on selecting quality stocks within their respective sectors, but also sizing each sector/position according to our convictions.

Vittorio Treichler	**Flavio Testi**	**Daniele Seca**	**Karim Khalil**	**Margot de Ziegler**	**Liz Kennedy**	**Carlos De Andres**
Chief Investment Officer	Senior Fixed Income Portfolio Manager	FX, Crypto and Derivatives Portfolio Manager	Senior Equity Portfolio Manager	Equity Portfolio Manager	Senior Equity Portfolio Manager	Mutual and Private Equity Funds Portfolio Manager