CEO Corner

Outlook 2022: A post pandemic world is emerging

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CEO BFI Infinity

First of all, we would like to wish you all a happy and prosperous New Year and hope that you had a good start to 2022. Since our last update in the fall, a lot has happened, even though the dominant story in the news continues to be the pandemic. While the situation was still pretty much under control before winter truly set in, new Covid cases have since been on the rise globally. Especially since the detection of the Omicron variant in November, which is now the dominant strain in most parts of the world, we have seen an explosive spread of the virus.

While we had expected a renewed surge in Covid cases as temperatures dropped, we were surprised, like most people, by how rapidly Omicron has spread. Luckily, current data suggests that this new variant mostly causes mild symptoms with fewer people ending up in hospitals. However, it still poses a major concern, because a lot more people are getting sick at the same time, which is creating serious operational challenges for companies around the world. Within a few weeks, the focus has shifted significantly, as it now becomes increasingly clear that Covid might not be primarily a health issue anymore, but another potential drag on the global economic outlook, a threat that is exacerbated by the various containment measures that governments have taken. However, we think that now a post-pandemic world is emerging and investors need to know what the consequences are for the coming months and possibly the coming years.

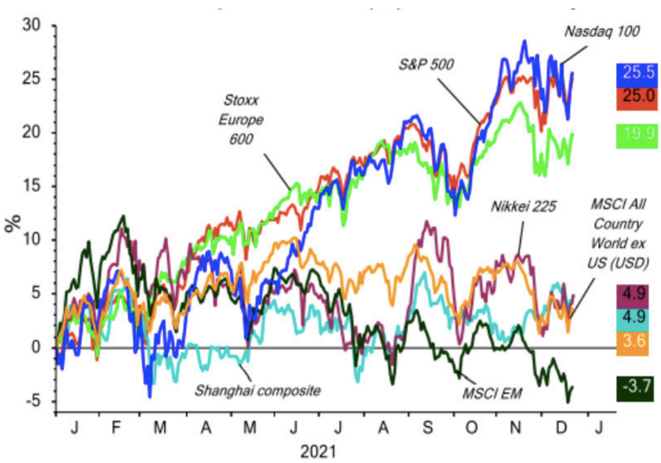
Meanwhile, the US and European equity markets had a great year, despite the covid-driven narrative that once again dominated the news cycle in 2021. Monetary and fiscal stimulus more than made up for the pandemic's impact and the negative real economic performance in many sectors. As can be seen in Figure 1, U.S. markets outperformed, and European stocks didn't lag too far behind, while Asia in general significantly underperformed.

Nevertheless, it is interesting to note that this stellar performance, particularly in the US, was very much driven by a just a handful of stocks. Around 65% of the Nasdaq's gains (comprising a total of 3,780 stocks) can be attributed to only five stocks - Microsoft, Google, Apple, Nvidia and Tesla. It remains to be seen whether this decoupling is sustainable. It also needs to be seen where the next push upwards can come from, especially taking into account that both the equity allocation of US households and the margin debt levels are at record highs.

While we have some concerns regarding U.S. markets, we remain bullish on European, including Swiss, stocks. Valuations are very attractive and, due to much less financial engineering, the balance sheets of European companies look in general much healthier than those of U.S. companies.

Shifting our focus to currencies, the USD also had a strong year, with the USD index gaining about 8% in 2021. This USD strength has naturally eaten into the relative performance of non-USD assets, but we expect the currency to

Figure 1: Global stock market indices, year-to-date performance in local currency



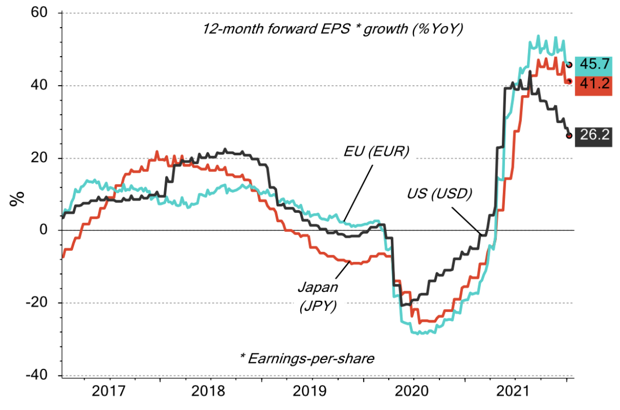
Source: Refinitiv

resume its long-term downtrend in 2023, which would then provide significant tailwinds for non-USD assets. We also expect the pandemic pressures to gradually lift during spring and into the summer and then we don't expect another major disruption caused by the virus going forward, despite a high probability of rising Covid cases in the fall again. This also means that we might be getting very close to a turning point and we believe we are now seeing the last spike of the pandemic before the virus becomes endemic.

Going forward, we anticipate growth momentum to pick up in areas that have been so far lagging behind, especially Europe and Asia. This also means that investors will probably focus again on stocks that will benefit from a normalization of the Covid crisis. Cyclical stocks, including commodity stocks, likely stand to benefit as well. However, with yet another rotation in the market, we see U.S. markets starting to underperform and we believe they might underperform significantly for a longer period of time. We think investing in European and Asian stocks could be the perfect move for U.S. investors for 2022 and beyond, especially in combination with non-USD currency exposures. Valuations and forward-looking earnings momentum speak a very clear language.

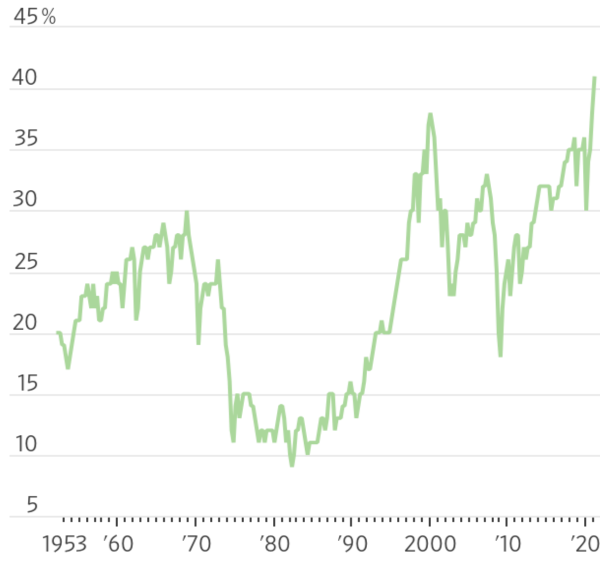
Why do we think that way? First of all, valuations for U.S. equities have gone up to such extremes that we don't believe this large premium is sustainable. Additionally, as mentioned above, U.S. markets have become increasingly driven by a few large growth stocks, while the broader market has actually underperformed European equities in recent months. Just to make our point clear,

Figure 3: Stock market forward earnings growth expectations



Source: Refinitiv Datastream, ECR Research

Figure 2: Equity allocation among US households at record highs



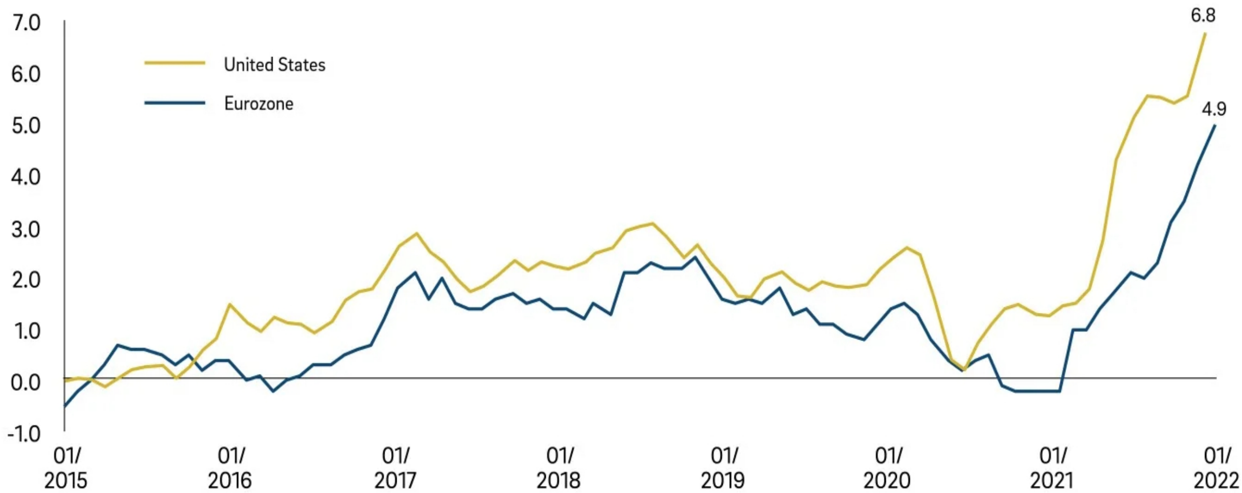
Source: JP Morgan, WSJ

we don't expect a large correction in U.S. markets, but we do think that the small number of tech stocks are very likely not going to sustain their extraordinary performance going forward. In the short-term, they might even move lower and consolidate to absorb the large price moves seen in 2021. The tech sector has by far the largest weighting within the S&P 500 index (29%) and together, the largest nine US stocks by market cap (Apple, Microsoft, the so-called 'FANG' stocks and Tesla, Nvidia and Netflix) account for 27% of the S&P 500 and 54% of the Nasdaq 100 index. Once they stop rising and start to roll over, the main pillar supporting the rally will be gone and these indices could drop fast within a short period of time, which would then create headwinds for the whole U.S. market.

Inflation is another important consideration that could cloud the outlook for 2022. Although it was dismissed as a "transitory" phenomenon just a few months ago, significantly higher consumer prices in the US, but also in Europe, now appear to be here to stay. Of course, this price rise can be in part attributed to supply chain disruptions that could be resolved in the coming months, but there are other inflationary forces at play too that are most likely going to be with us for longer.

Central banks will have to adjust monetary policy and currently the market expects the Federal Reserve to hike

Figure 4: Inflation rates in the US and the Eurozone, yoy %



Source: OECD, Roland Berger

rates by 0.25% three times this year. Of course, this does not look like a serious fight against inflation, but it is clear that policymakers have to perform a tightrope act: a more aggressive stance would probably cause a lot of market volatility and perhaps even jeopardize the economic recovery at large. Thus, solid economic growth with higher inflation and central banks that will stay behind the curve will very likely continue to create a constructive environment for stocks and for precious metals too. This inability of central banks to raise rates aggressively is bound to persist and this could be one of the most important big picture trends in the coming years.

Overall, our advice has not changed much from last year. Investors need to hold a globally diversified portfolio of high-quality stocks, commodities, precious metals, global real estate and even digital assets. The investment environment going forward will be more challenging and it will certainly not be enough to simply buy and hold the market. This is especially true for U.S. investors who still tend to have a very strong focus on U.S. markets. For the past few years, it was simple and effective to merely hold the U.S. market and enjoy the ride, however, this ride might soon be over. There are already indications that this shift is underway, with increasing divergencies and a growing number of stocks lagging or even correcting.

We also expect that inflation is going to impact the U.S. more negatively simply because rising prices will put a lot of pressure on U.S. households, 70% of which still live paycheck to paycheck. Climbing prices will dent consumer spending, which continues to be the main driver of GDP. This might also indicate that the relative momentum for the U.S. economy could turn more negative compared to other countries and regions around the world.

And what about other factors influencing financial markets in 2022? While inflation and interest rates seem to be the dominant drivers, other developments might have an impact as well, for example, fiscal spending, which seems to be high on the agenda of many governments. In the U.S., President Biden has had a hard time pushing through his BBB (Build Back Better) plan, but we still expect that at least some of it will eventually be implemented. Then there are also geopolitical concerns such as the growing tensions with China or the frictions between the U.S./Europe and Russia. In addition to the existing Ukraine conflict, another crisis could emerge in Kazakhstan, while there could also be further flare ups in the chronic tensions between Israel and Iran. However, unless there is a more serious escalation in any of these fronts, it is unlikely that financial markets are going to be impacted too much.

It may come as a surprise to many of our readers that we didn't count the pandemic among the key trends and factors to look out for in 2022. Indeed, at this point, we don't expect Covid to be a major issue anymore, especially from spring onwards. The world seems to be learning to live with the virus and a lot of people in the West are now immunized in one form or another. This might be a little different for places like Russia and China, where vaccination rates are either low or vaccines don't show as much of an effect. But in general, the world seems to be getting over this health crisis and this year, we look forward to our lives increasingly going back to normal. Well, to a "new normal" to be more accurate, as certain things have changed more permanently in our view, for example the way we work. This will again lead to some very interesting so-called "Super Trends" that we already see evolving, but we'll look into that more closely in our next update in the spring.

For now, we once again wish you all the best for 2022. We look forward to staying in touch during the year, and hopefully to meeting face to face again too. Also, please make sure to get a copy of our most recent Special Report on digital assets. You will find a brief overview in the second part of this update, but I strongly recommend you read the full report.

Feel free to contact us directly at info@bfiwealth.com, with any questions. We look forward to hearing from you.

Digital Assets and the future of investing

Dirk Steinhoff
Chief Investment Officer

Over the last year, we witnessed an unprecedented explosion of investor and mainstream interest in an entirely new asset class. A lot has been said and written about digital assets, decentralized finance (DeFi) and all kinds of blockchain-based applications that promise (or perhaps threaten) to forever change the face of finance and investing as we know it. And yet, there are still a lot of misconceptions and quite a bit of confusion in the minds of many investors, while the full potential of this tectonic technological shift that is already underway is still difficult to grasp.

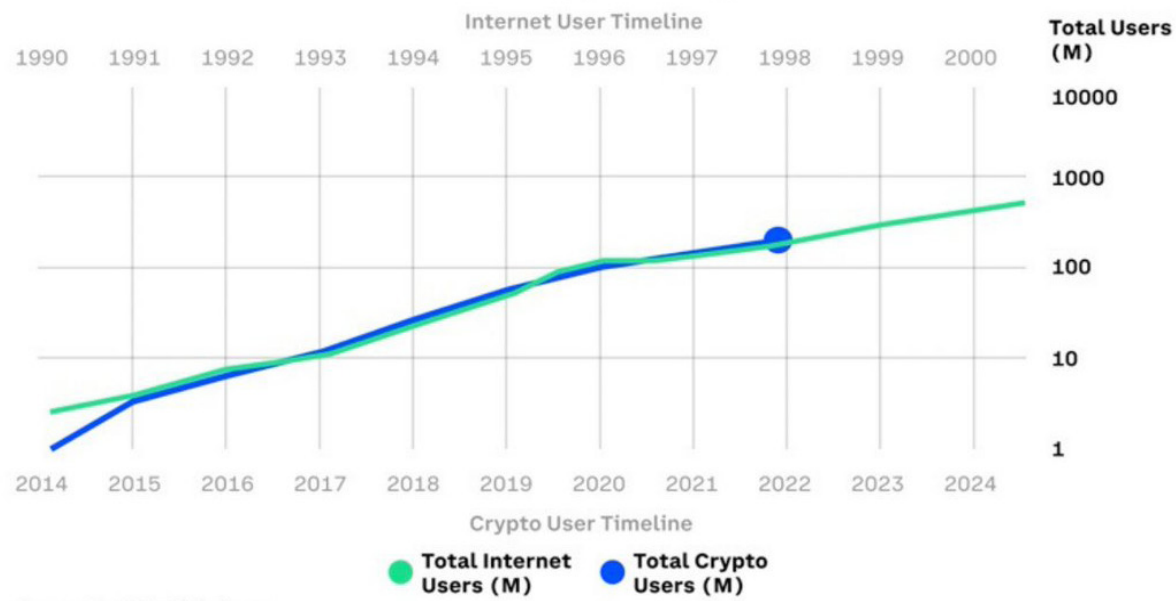
Beyond Bitcoin and crypto

For most mainstream investors, as well as for the wider public, the "poster child" of the blockchain revolution is undeniably Bitcoin, and to this day, the technology is most commonly associated with cryptocurrencies. Without a doubt, this one of the most prevalent and relevant applications so far, given the impressive growth of the crypto market and the mainstream and institutional adoption that Bitcoin, Ethereum and other important coins have been increasingly enjoying over the last few years. However, it is imperative for investors to understand that this is merely a single application of the technology.

Beyond currencies and transactions, blockchain has the potential to revolutionize entire industries, as well as the way we all do business and the way we think about investing. The efficiency, speed, security and convenience this technology brings with it is already finding very practical applications in multiple business areas and in different sectors: From "smart contracts" to supply chain operations tools and from data management to cybersecurity applications, blockchain's disruptive potential already appears formidable.

For many investors, the possibilities that this technology has unlocked and the opportunities it presents, especially beyond crypto, can seem overwhelming

Figure 1: Internet vs. Crypto adoption



Source: World Bank, Crypto.com

and often confusing. Without specialized expertise and a deep understanding of the underlying technical intricacies, it can be challenging to identify individual “winners and losers” in this nascent field, and the myriads of new projects and startups are somewhat reminiscent of the DotCom era and the rise of what we know today as the tech sector.

Much like the early days of the internet and all the mainstream hype and investor excitement that surrounded it during the 90s, blockchain-based solutions and innovations abound today, at least in theory, if not always in practice. And much like during the DotCom bubble, picking out the next Amazon at this early stage of the blockchain revolution is certainly much more challenging than investing in the underlying technology itself.

Digital Assets and DeFi

Although potential blockchain uses go well beyond finance and investing, this space has attracted a lot of interest not only because of the transformative impact that the technology can have there, but also because numerous use cases have already been successfully introduced. This is also why we decided to publish a detailed Special Report on this topic (you will also find a copy of this report as an attachment to the email in which you received this BFI InSights), to serve as an introductory guide for investors who are interested in the crypto sector and in the new world of digital assets at large.

While the term has been loosely used to describe all kinds of nonphysical alternative assets, cryptocurrencies or tokens, a digital asset can be literally any tangible, intangible, fungible or non-fungible asset that can be digitally represented, stored, bought, sold or used as a form of payment over a decentralized exchange or other digital platform, without the need for intermediaries, regulators, or any other third-party involvement.

This new ability to render an investable and tradeable digital representation of any real asset, or fractions thereof, has momentous implications, especially since the tokenization process, as well as the tools and platforms used to buy, sell and store those assets are increasingly reliable, accessible, secure and efficient. Virtually any illiquid asset can be made liquid, while removing many of the entry barriers that countless investors face today.

This opens the door to an entirely new investment universe, where all kinds of investors, large or small, professional or retail, can participate and access assets and investment vehicles that they previously could not, be it due to regulatory constraints or simply insufficient capital. From real estate to collectibles, we’re already seeing the first attempts to bring this concept from theory to practice. Companies like Finexity or Exporo in Germany are granting retail investors access to all kinds of tokenized and fractionalized alternative investments for as little as €500. Diamonds, art, classic cars and fine wines, all niche investments previously reserved for specialized funds or HNWIs, can now be owned by small individual investors too.

The rise of digital assets also has the potential to deeply and structurally affect traditional investments too, especially on an infrastructure level. There are immeasurable inefficiencies and waste that are associated with the way we invest and trade securities today, mostly having to do with the intermediaries and institutions that form the bedrock of traditional finance (“TradFi”). Due to the centralized nature of our current system, there are relatively high costs and delays in virtually every step of the lifecycle of most securities and assets, from issuance to cross-border trading and settlement. Most of this can be summarily eliminated by employing decentralized structures and blockchain-based solutions.

While still in its infancy, Decentralized Finance (“DeFi”), promises to usher in radical changes to the entire financial system. By allowing people and businesses to freely transact directly through peer-to-peer financial networks and by improving all kinds of security- and compliance-related processes though the use of consensus mechanisms, both the transaction costs and times are set to be cut dramatically, perhaps all the way down to zero in some cases. Other considerations such as a privacy and individual financial freedom are also important reasons behind the optimism and enthusiasm that surrounds the emergence of DeFi.

Practical considerations

The not-so-distant future certainly holds great promise of new ways and types of investing, as the underlying technology and its applications mature. As tokenization progresses and goes mainstream, we can expect to see greater investor interest in myriads of previously illiquid or inaccessible assets. However, at this stage, cryptocurrencies continue to be the easiest and more reliable way for investors to enter the digital asset class. And while the sector has matured significantly over the last few years, and while regulation and institutional investment have resolved a lot of early security concerns, it is essential for investors to understand that there is still a higher level of risk involved.

Apart from the notorious volatility levels, investing in cryptocurrencies also comes with a greater degree of complexity that surrounds custody questions, tax implications, safekeeping of private keys and account management in general. For the average investor who lacks the required technical knowledge and sophistication, achieving direct exposure can be particularly challenging. The emergence of passive investment options, as well as active trading strategies and specialized funds addressed most of these concerns, while it also allowed investors to participate in this nascent and rapidly evolving asset class, without the need for specific experience or a detailed understanding of the technological aspects that underpin it. In fact, the demand for access to top managers and strategies has given birth a new hedge fund boom, in many ways similar to the one we saw in the 80s.

By now it is clear that the most appropriate strategic approach to digital asset investing would be thoughtful active management and tactical agility. Focused professional expertise and direct experience in the sector are also essential to compete, as is meaningful diversification and diligent risk management strategies. These were among the chief considerations behind the recently launched crypto fund-of-funds solution by BFI Capital that allows investors to participate in a diversified basket of actively managed strategies, with a low minimum investment and a high level of service quality.

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