



S.P. HINDUJA

BANQUE PRIVÉE

# House View

APRIL 2022

# Thoughts of the CEO

“Global value chain challenges in a globalised world.”

The March edition of our House View looked into the continuous bottlenecks in the commodity markets and their impact on global inflation. This month I would like to turn my attention to the change in global trade that is beginning to emerge as a consequence of the pandemic-induced disruptions to global value chains and is being accelerated by the Ukrainian-Russian conflict.

Globalisation can be described as enhanced integration of economies via more liberal trade flows and has been a relentless process since the Industrial Revolution. After the collapse of the Soviet Union and its communist regime in the early 1990s, the World witnessed the expansion of globalisation, which brought with it a powerful trend that accelerated global trade, expanded global capital markets, increased economic growth and reduced inflation levels, which in turn helped alleviate poverty around the globe. Access to global capital markets is essential for countries to support economic development, companies to fund growth and more households to prosper.

There have been periods of temporary unravelling of globalisation before, notably during the Interwar Period in the early decades of the 20th century, which coincidentally witnessed in the beginning the most devastating global influenza pandemic on record, or after the Great Recession of the late 2000s. Nowadays, and with events such as Brexit, Sino-American trade disputes and greater self-sufficiency in essential items as a lesson from the pandemic, the notion of de-globalisation in which economic agents are increasingly severing their international economic ties and reshoring economic activity towards their domestic economies is again brought forward by an increasing number of analysts and media representatives.

Recent disruptions in the global supply chains have brought to light the degree of dependence on countries that are operating as outsourcing hubs for all kinds of products, ranging from semiconductors, semi-finished goods, food products and raw materials, and are spearheading calls for “economic self-reliance” and relocating of supply chains.

However, such a radical change in procurement processes would likely lead to a weakening of the benefits that globalised trade has brought to the world and slower economic growth in the long term. It can, therefore, be argued that instead of regionalisation of supply chains, corporates will try and resort to diversification with the aim of building resilience.

With my thoughts shared as above, I am happy to present to you the House View for April 2022.

Yours sincerely,

Karam Hinduja

# Small Cap stocks potentially benefitting from supply chain diversification

As companies rethink sourcing, new factors need to be taken into account, such as geography and geopolitics, logistics, decarbonisation and sustainability and suppliers' financial standing.

In order to achieve resilience and more flexibility, supply-chain managers will have to focus on developing production capacity and strategic capabilities in diverse locations. This will mean also including smaller companies in the value chain, which offer domestic infrastructure, capacity and know-how to respond quickly to shifting demand for production onshoring.

With the ongoing conflict in Ukraine, the economic outlook has started to deteriorate markedly across the globe. It is, however, safe to assume that economies more directly affected by the flow of refugees and those with a higher dependence on commodities being provided by the warring parties will be more strongly impacted. As a result, the likelihood of Europe facing the potential of a recession is substantially higher than for instance the US, where most economists expect merely slower economic activity, albeit

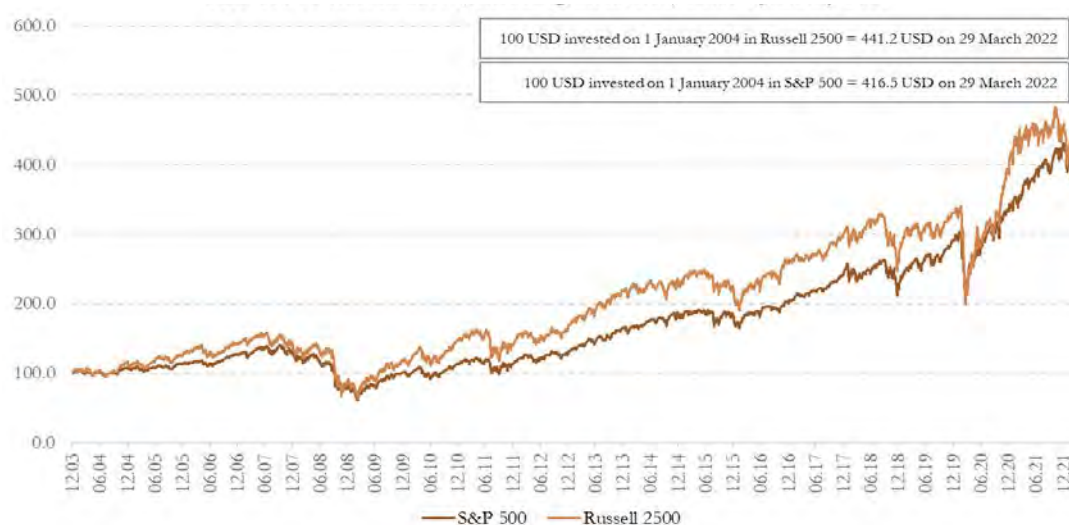
with persistently high inflation, during 2022.

In the context described above, the potential opportunities offered by investing in US small cap stocks need a closer look. The graph below shows a significant long-term outperformance by US small caps, as measured by the Russell 2500 Index, versus the large-cap tilted S&P500 Index (338.8% versus 314.8%, respectively) from 1st January 2004 to 29th March 2022. Only more recently, i.e. during the last two quarters of 2021, the former seems to have taken a pause, underperforming large caps by some 10%.

Whilst global equity markets are expected to face potential headwinds and higher volatility over the coming 12 months, US small cap may offer some distinct advantages.

According to the Small Business Administration, the US's 30 million smaller companies employ close to 50% of America's private workforce, which make them the real engine of the US economy. As a result, should there be a stronger recovery later this year, this would be a potentially significant tailwind for this segment of the market.

**Fig. 1: S&P 500 vs Russell 2500 (excluding dividends) since 1 Jan 2004**



SOURCE: S.P. HINDUJA BANQUE PRIVÉE, AS OF 29TH MARCH 2022

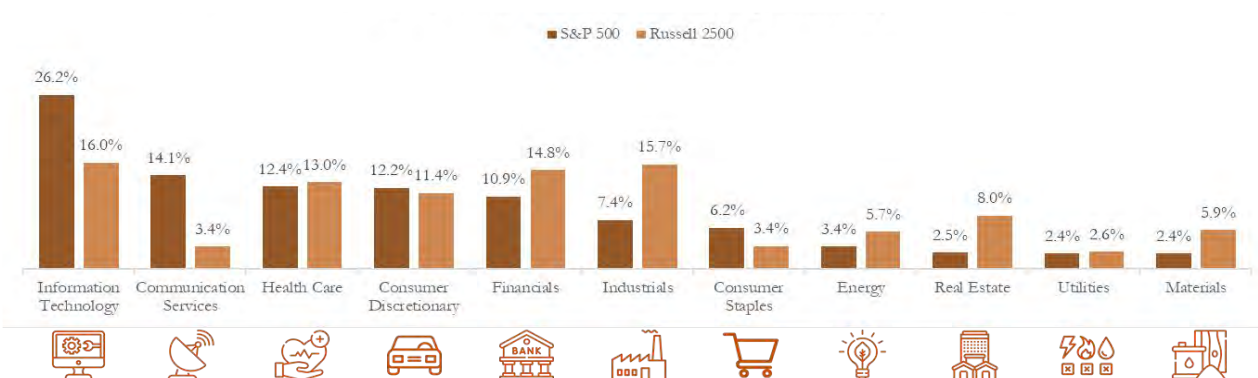
In periods of higher inflation trends and rising interest rates smaller companies have also fared well in relative terms, not least because of their slightly higher exposure to rate-sensitive financials.

This specific market universe offers a diverse, under-researched landscape. The constituents provide a broad mix of businesses from established industry leaders to younger and innovative smaller-sized corporations, whereas the larger

end of the market spectrum is heavily skewed towards a more limited number of industry sectors (see comparison below). Active, research-driven stock pickers focusing on companies with high quality business models, strong competitive positions, robust cashflows and low leverage thus have the opportunity to find hidden gems in a stock universe less well covered by mainstream analysts.

**Fig. 2: U.S. Small-Cap Sector Weightings for S&P 500 vs Russell 2500**

(% of Total Index by Market Capitalisation)



SOURCE: S.P. HINDUJA BANQUE PRIVÉE, AS OF 29TH MARCH 2022

### Asset allocation considerations

The current geopolitical and economic backdrop lead us to review portfolio positioning. In late January we wrote that despite heightened market volatility, we remained constructive for riskier assets, especially compared to fixed income, based on the observation that market pullbacks are part of investing in equities and are regularly followed by significant recoveries. We concluded that for long-term investors it paid to remain invested and to deploy cash in periods of drawdowns.

This appreciation remains generally unchanged. However, on the back of sharply rising probabilities for a substantial slowdown in economic growth in conjunction with persistently high inflationary pressures, we have revised down our corporate earnings expectations for the coming 12 to 18

months, which leads to lower return forecasts for equity investments in aggregate.

Over the past few weeks the US Treasury yield curve has shifted upwards by almost 90 basis points (bp) at the short end (2 years) end and some 30 bp at the long end (30 years), thus flattening it for most tenors and inverting it for some segments, such as 2-to-10 years and 20-to-30 years. Historically, for instance in 2006 and 2019, yield curve inversions indicated a pessimistic investor outlook for economic growth over the medium term. This time around, one might wish to be more cautious with such a conclusion because monetary conditions have been exceptionally loose over the past years as a result of the pandemic-induced economic contraction, and central banks need to hike interest rates more quickly and aggressively in order to fight inflationary pressure on one hand and generate some “dry powder” to react in case of a recession on the other.

Global Asset Allocation Preferences					April 2022
Asset Class	Opinion	Constituents	We favour	We avoid	Commentary
Cash	-				Temporarily increase cash for defensive profiles in times of heightened uncertainty
Fixed Income	=	<b>Segments</b>	Nominals over Inflation linkers	Emerging Markets, lower end of the credit spectrum	Central Banks normalisation effort potentially slowing as Russia-Ukraine crisis heightens uncertainty for growth and inflation
		<b>Duration</b>	medium term		Government bonds benefit from safe-haven flows - longer duration warranted
Equities	=	<b>Markets</b>	US	EM ex Asia	Rising uncertainty in wake of Russia-Ukraine conflict
		<b>Themes</b>	Value stocks, Smaller companies Carbon, REITS, listed infrastructure, industrial metals	Illiquid alternatives	Value stocks likely to benefit from sustained inflation environment
Alternatives	+				Commodity markets to benefit from supply/demand imbalance
Opinion	++	very attractive			
	+	attractive			
	=	neutral			
	-	unattractive			
	--	very unattractive			

## Figure of the Month

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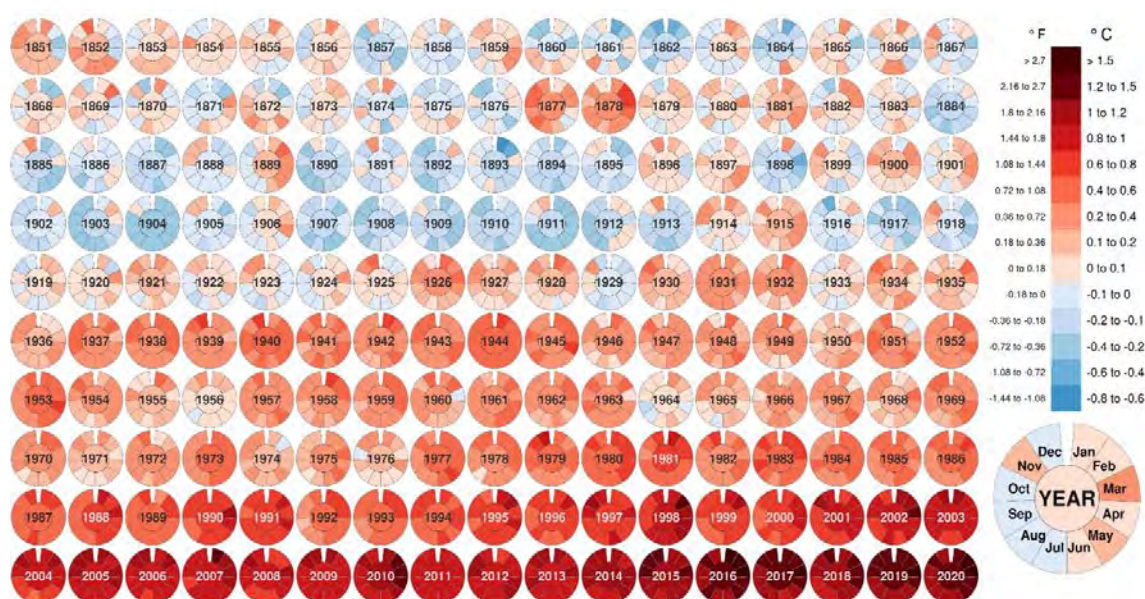
In mid-March 2022, researchers reported that temperatures of up to 40°C above normal levels were registered in both Antarctica and the Arctic. This was the highest temperature on record for this time of the year. The Concordia station, on the Antarctic Plateau, recorded an extreme temperature of -11.8°C, more than 40°C warmer than seasonal norms dating back to the late 1950s, when precise temperatures started to be recorded. At the same time, some stations near the north pole reached 30°C above normal, with unusually warm temperatures recorded in Norway, Greenland and the Russian archipelago of Franz Josef Land.

These unusual temperatures were related to a combination of strong weather systems over the Southern Ocean to the south of Australia that aligned to produce very strong polewards winds stretching from Australia to eastern Antarctica. To put this into perspective, a recent report issued by the Intergovernmental Panel on Climate Change found that a 3°C temperature rise in global temperatures could eliminate up to 39% of critically endangered species.

These extreme events alert us to the speed at which global warming is changing our planet. Furthermore, depending on what we do with our carbon emissions, we might see these types of temperatures much more regularly.

### Monthly Global Mean Temperature 1851 to 2020

(compared to 1850-1900 averages)



SOURCE: VISUAL CAPITALIST, AS OF 30TH MARCH 2022





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EDITORIAL DEADLINE: APRIL 4, 2022