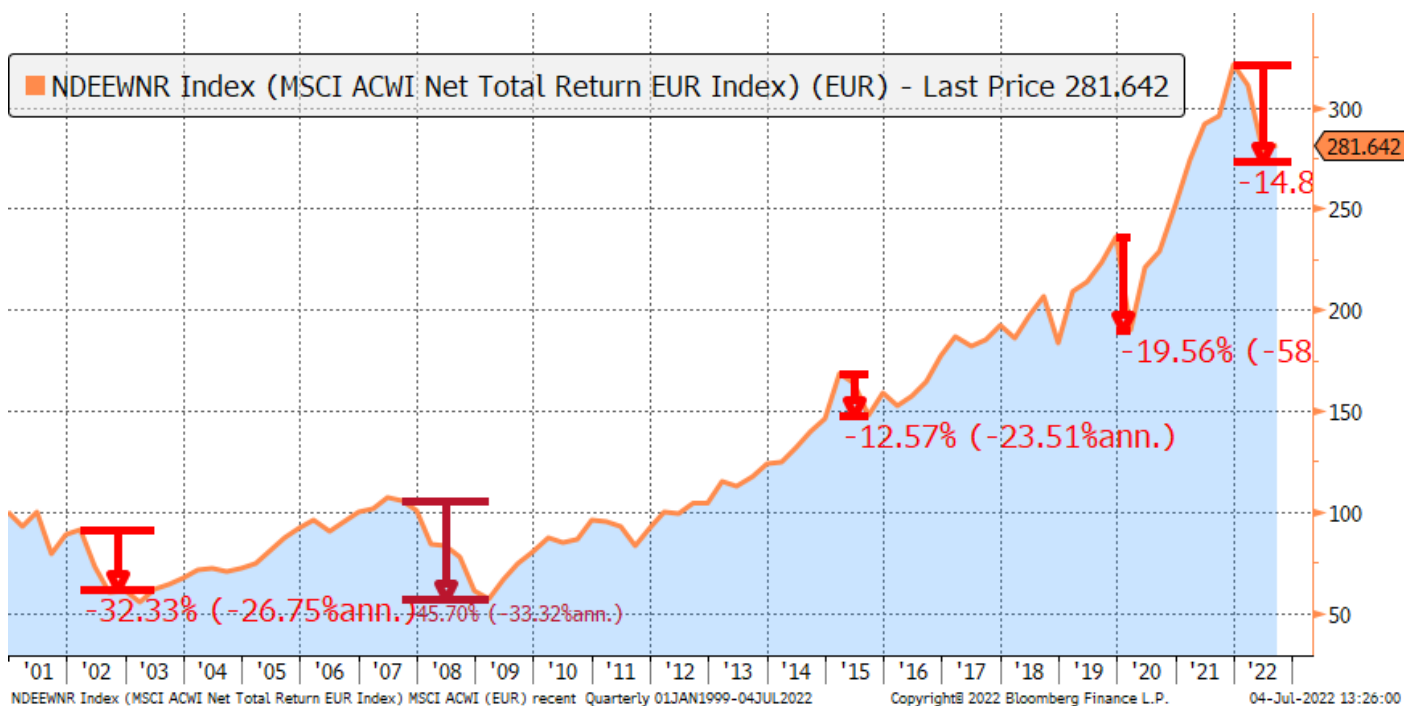


Jacques Berghmans

1. Economic and Market Environment

The poor performance of global equity markets so far this year reminds every investor that investing, while generally rewarding in the long term, can sometimes be challenging. The recent sell-off in global equity markets mostly resulted from an acceleration in inflation in Europe and the United States and its potential impact on economic growth and long-term interest rates. Exacerbating the crisis, the war in Ukraine resulted in an energy crisis in Europe and increasing food prices across the world.

It is important to keep in mind that **short term market corrections** like the one we had over the last six months are not unusual. Since the global financial crisis in 2008, we have had three similar corrections, one in 2015 due to the euro crisis, one due to COVID and the current crisis.



The key issue affecting major economies across the world is inflation and the potential need to raise interest rates to fight it. In Europe and the United States, citizens are now facing double digit price increases, affecting consumer confidence and purchasing power. The reasons behind higher inflation are manifold, the most important ones being a strong rebound in energy prices, supply chain bottlenecks and fiscal/monetary expansion in the Western World during the COVID pandemic.

High inflation, especially if combined with growth stagnation, is a problem for the economy and households as it destroys savings and makes it difficult for economic actors (households, companies and the government) to manage their finances. Budgeting becomes difficult as prices are not certain anymore and inflation also creates social tensions, as workers try to preserve purchasing power by demanding higher wages. A major risk is that inflation spirals: as higher

prices lead to higher wage demand, which increases costs for companies and further increases prices, which leads to further wage demand. The cost of borrowing also tends to quickly increase as lenders demand higher interest rates to compensate for increasing prices. For all these reasons, world governments and central banks are very nervous about inflation and try to stop it before it gets completely out of hand.

For investors, there are no miracle solutions for inflation, but there are mistakes to avoid. Some investments, while decent in a normal environment, tend to perform horribly in a high inflation environment. As we have often repeated over the years, investors should avoid most fixed income instruments like government & corporate bonds, especially in recent years, as investors took more and more risk to compensate for lower yields. One of the most egregious example was the issuance of 100 year debt in Austria in 2020.¹ While the investment initially worked fine, this AA rated bond is now down 55%.² It is important to notice that bonds are generally considered 'safe' and can end up in supposedly 'conservative' funds, so one should pay extra attention in this difficult environment. Another important measure to take is to keep a cash buffer large enough to face daily expenditures, especially as they are becoming bigger with inflation. This does not mean that investors should keep everything in cash, as cash held over the years will inevitably lose value. The amount of cash needed should be discussed with a professional as it depends on several factors (expenditures, income, age, risk profile...).

	Euro Area	United States	China	Japan
2022 inflation	8.1%	8.6%	2.1%	2.4%
1 year currency change VS USD	-10.6%	-	-3.7%	-18.5%
10 year government bond yield	1.6%	3.2%	2.6%	-
Government debt to GDP	95.6%	123%	20.3%	225%
Stock index YTD	-19%	-21%	-10%	-9%

Figure 1 – Source: The Economist

As we can see on the table above, inflation is really high in the US and Europe and has stayed low in the two other major world economies, Japan and China. The major difference between Asia and the Western World is that Asian governments gave much less financial support to its citizen and companies during the COVID pandemic. China is also currently under a partial COVID lockdown limiting local consumption & inflation, and this is creating supply bottlenecks which limit exports and boost inflation in the US and Europe. Japan is a case on its own and there is a risk of accelerating inflation going forward.

It is also important to note the difference between the European and American economies, which currently face similar inflation numbers but have very different prospects we believe. The major difference is energy as the US is mostly energy independent³, while Europe imports around 60% of its energy needs, mostly from Russia⁴. Energy, especially oil and natural gas have been key drivers of higher inflation over the last 12 months. This has affected most regions in the world, but an important shift has started in recent weeks. As of today, and despite the significant growth of renewables, fossil fuels (coal, natural gas and oil) still account for ~80% of the world's primary energy needs. Oil and coal are for the vast majority globally traded commodities, with not much difference between prices in Europe, the US and Asia as it can be transported relatively easily. Natural gas on the other hand is much more expensive and difficult to transport as it needs to be liquefied into LNG and transported into expensive and complicated vessels which take years to build. As a result, gas prices can be very different depending on where you live and the Ukraine war has widened this difference further. European natural gas prices have been higher than US natural gas prices since the shale gas revolution of the last decade, and the recent crisis has exacerbated the difference. EU-gas prices, which are still climbing, are now 7.3x higher than American gas prices, which have fallen in recent weeks due to the slowdown in economic activity. This difference in energy costs will have a major impact on European industries, electricity prices, consumers and ultimately the European stock market. Unfortunately, we don't really see how the situation can improve quickly in Europe, bar a regime change in Russia.

¹ <https://moneyweek.com/investments/bonds/government-bonds/602086/why-would-anyone-ever-buy-a-100-year-bond>

² <https://www.bloomberg.com/news/articles/2022-03-30/an-aa-rated-government-bond-down-55-shows-the-pain-of-higher-rates>

³ <https://www.eia.gov/energyexplained/us-energy-facts/imports-and-exports.php>

⁴ [https://www.cleaneenergywire.org/factsheets/germanys-dependence-imported-fossil-fuels#:~:text=European%20Union's%20import%20dependence,%25\)%20are%20met%20with%20imports](https://www.cleaneenergywire.org/factsheets/germanys-dependence-imported-fossil-fuels#:~:text=European%20Union's%20import%20dependence,%25)%20are%20met%20with%20imports)

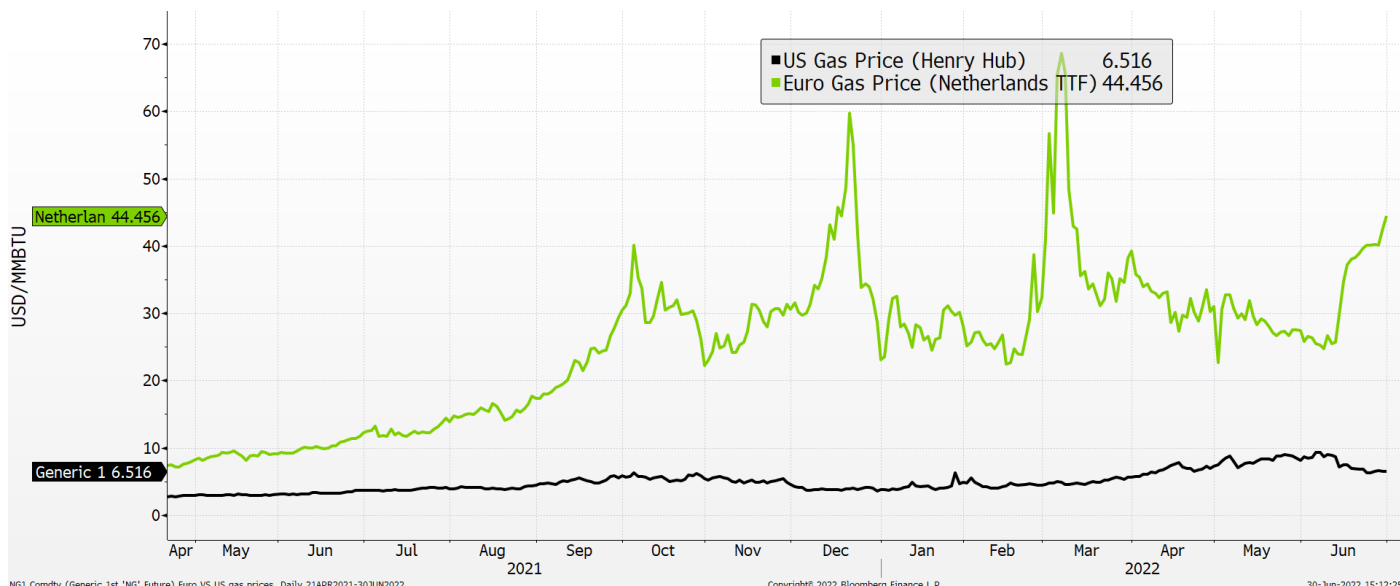
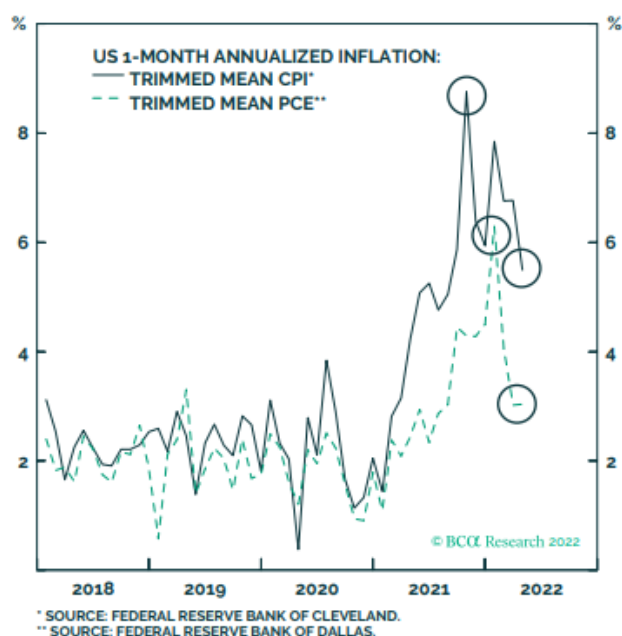


Figure 1 – Source: Bloomberg



The difference in energy prices has also started to impact the real economy. As we can see on the graph to the left, it looks like US inflation has already reached its peak a few months ago and has started to decline while inflation in Europe continues to increase and it is not clear what is going to stop it. A year ago, the White House posted an article on inflation crises since World War II⁵ and observed that the current crisis bore more resemblance to the high inflation episode following the World War than the long and protracted inflation period of the seventies. The article argued that the recent inflation surge was only temporary. While this conclusion for the US economy has been proven wrong so far, it might just mean that the writers made the call too early.

Another consequence of rising inflation is the increasing of rates by central banks as well as increasing spreads, i.e. the difference between the best rated financial entities (the US government for example) and the lower rated ones. In the US for example, the average 30 year fixed mortgage rate has gone from around 3% at the end of last year to close to 6% right now⁶. Such a drastic move will likely have a significant impact on the housing market in the US and we have already started seeing transactions drying up. In Europe, increasing inflation and rates hasn't had an important impact on mortgages yet, but this could eventually happen affecting housing prices especially given their elevated levels following the post COVID boom. We are already seeing stress in government bonds with Italian yields increasing to levels seen during the last sovereign bond crisis in 2014⁷. Increasing financing spreads will also have consequences on certain companies, mostly highly levered businesses, which will need to pay more for finance and/or might not be able to find adequate funding.

⁵ <https://www.whitehouse.gov/cea/written-materials/2021/07/06/historical-parallels-to-todays-inflationary-episode/>

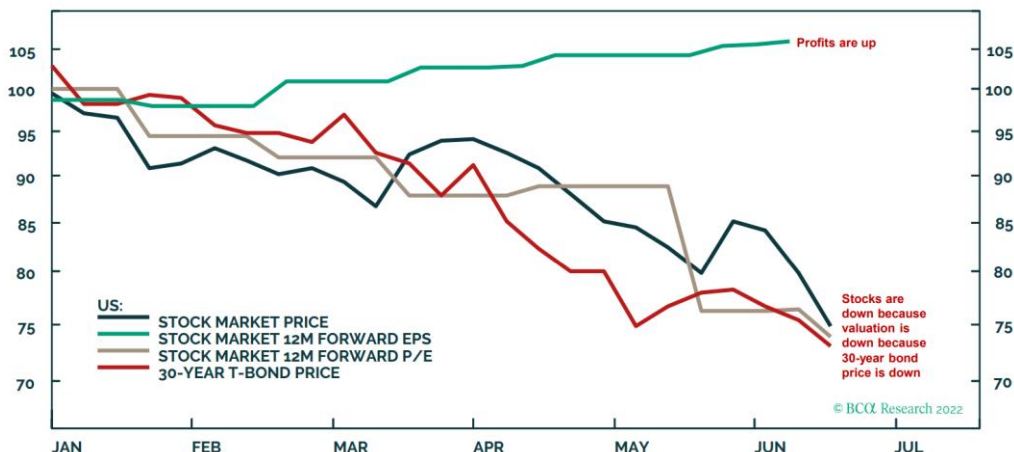
⁶ <https://themortgagereports.com/61853/30-year-mortgage-rates-chart>

⁷ <https://www.cnbc.com/2022/06/13/europes-fear-gauge-just-hit-its-highest-level-since-may-2020.html>

As a result, it is more important than ever for European investors to look beyond their borders and be selective when investing. Not all the companies in Europe are going to suffer and this crisis could serve as a catalyst for positive change, like more investment in housing insulation and renewable energy, but this is likely to be more the exception than the rule.

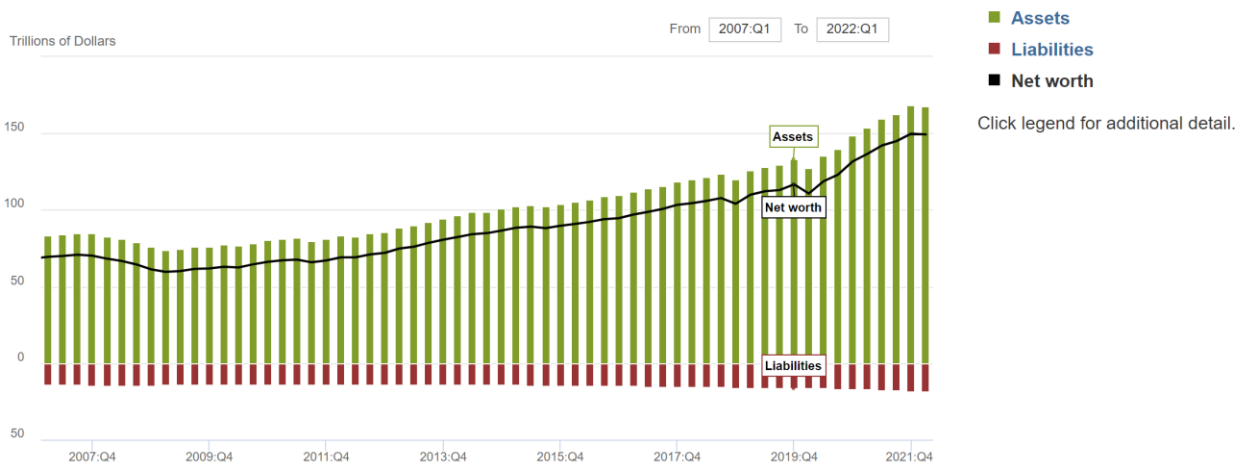
We continue to believe that a global indexed investment approach with a small selection of active funds is interesting for the long-term investor. As large American businesses make up over 60% of global indexes, global stock market performance will mostly depend on the performance of American companies. Fortunately, as we can see on the graph below:

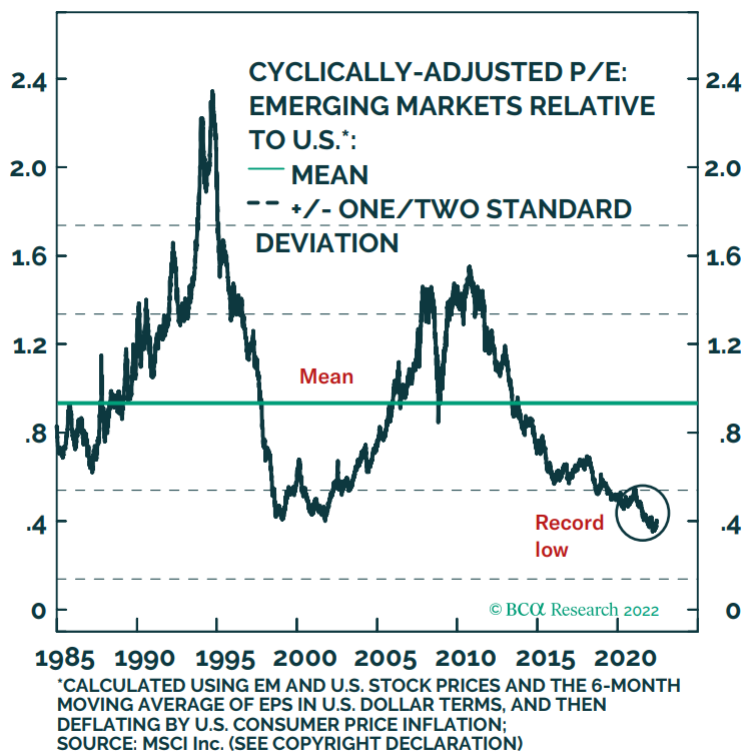
- (1) Earnings expectations for US companies are still good
- (2) The market is much cheaper than six months ago



- (3) We could have a short and sharp earnings recession but there are few structural concerns about the US economy given healthy corporate & household balance sheets, an entrepreneurial culture and good demographics

Assets, Liabilities, and Net Worth





At TreeTop, we think that given the high concentration of large American businesses in global indexes, a selection of active funds with more exposure to emerging markets and sectors is also interesting. As we can see on the left, emerging markets have rarely been as cheap relative to the US market as they are today. China and India are on very different paths, India is roaring following a bad COVID crisis, China is facing several challenges, mostly related to real estate but continues to be entrepreneurial and has some interesting companies.

A higher US dollar rate will continue to test the resilience of emerging markets. Frontier economies (Pakistan, Sri Lanka, Egypt) will be challenged, but we don't have any investments there. Major emerging market economies (South Korea, Taiwan, South-East Asia, Brazil) are much more solid and stock markets are cheap. A lot of emerging market economies are in much better shape than Europe with world class companies

(Samsung, TSMC, Infosys), benefits from higher commodity prices (Indonesia, South America) and good macro-economic indicators.

In conclusion, volatility is the unfortunate by-product of investing in the global stock market and it's important to always have a three to five year time horizon, with enough cash buffer to face uncertainty. However, being invested purely in cash is a sure way to lose purchasing power over the long term. It is also important to remember that the global stock market, due to its liquid nature, is a leading indicator for a lot of other asset classes (private equity, real estate...). It tends to plunge first but should also be the first to rebound. Our Financial Advisors continue to be available for any eventual questions you might have.

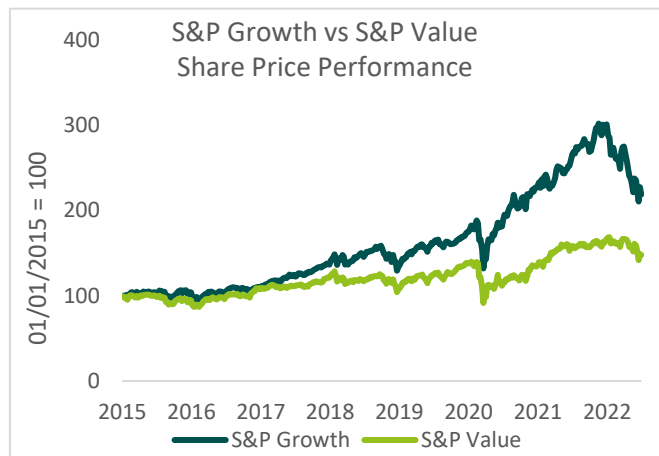
2. Our convictions

Our strategy, while unable to deliver positive results this year⁸, still generated better results than the overall market, due to some successful investments in China and in American value stocks. Our most successful investment so far this year has been the Chinese company **FUFENG**, the world leader in MSG and amino acids. We have held the position for a long time and for a while it significantly underperformed the market, but it finally took off in recent months nearly doubling year to date. This kind of stock behavior is unfortunately common in the stock market and it shows that the right investment thesis is not enough, but one needs to show the perseverance and patience as the market can work against you for a long time. Our investment thesis was simple and assumed that **FUFENG**, after building a cost leadership in its markets, with modern factories in the right locations, would progressively build more sustainable cashflows. The latter part of the thesis took more time to play out than expected, as small competitors continued to launch price wars. The situation appears to have finally stabilized, as the volatility in commodity prices and financing in recent years in China forced these small competitors out enabling **FUFENG** and its large competitor MEIHUA to better control prices and margins. Despite the good performance of the stock⁸, we continue to keep a large position in the Company as the stock is still cheap in relative and absolute terms. The Company has also started building a

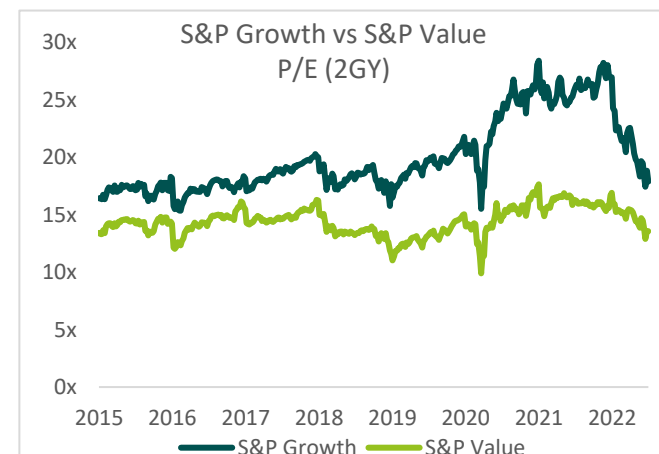
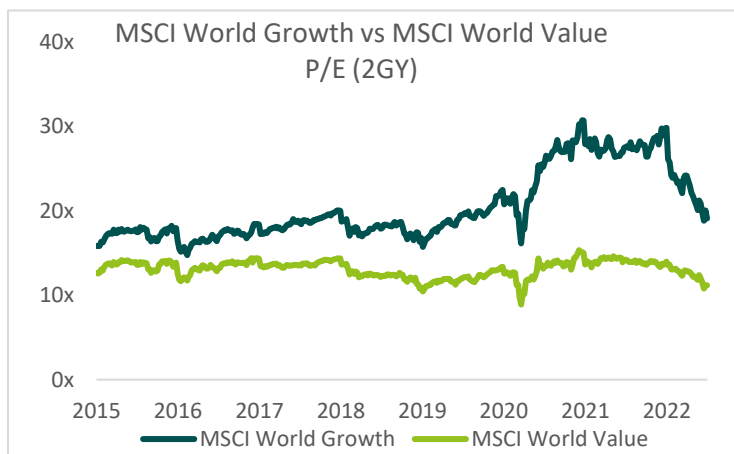
⁸ Past market behaviours do not prejudice future behaviours

factory in North Dakota, USA, to better serve the local amino acid market. We think it is an interesting move as **FUFENG** can combine its excellent know-how of fermentation processes with the low-cost corn and energy prices of the US to have a best-in-class factory.

Twelve months ago, we decided at TreeTop to launch several new value products as well as allocate part of our strategy to value stocks in the U.S. through the Dogs of the Dow' strategy. This proved to be a prescient move, as value stocks across the world significantly outperformed their growth counterparts.



The growth versus value underperformance can be observed in both global equity markets and in the US market and follows a very similar pattern. As we can see on the two graphs below, growth stocks had become very expensive compared to value during the pandemic and the recent reversal in performance is a return to the normal trend.



We think that allocating a portion of investments to 'value stocks' will continue to make sense as these companies tend to outperform in a higher inflation environment⁹. Growth companies' valuation are heavily dependent on cashflows far in the future, which are discounted more heavily in a higher rate environment, while value stocks generate much more cash right now, albeit with less growth.

In our strategy, we used the 'Dogs of the Dow' methodology to systematically allocate a portion of our portfolio to American value stocks. The methodology is simple and consists of buying the highest dividend yield companies of the Dow Jones Industrial Average, which has the advantage of including the largest American businesses which generally always pay their dividend. The technique has worked well in recent months with several stocks generating positive returns for the year⁸. Major contributors to performance were **CHEVRON**, a large American oil & gas company, **MERCK & Co**, a large pharmaceutical business and **AMGEN**, one of the world's largest biotechnology companies.

⁹ No guarantee of results or performance

A number of positions had small losses and a few stocks faced significant draw-downs, which dragged our strategy's performance into negative territory. The most disappointing performance came from **IWG**, **ASSTEAD** and **INDIABULLS HOUSING FINANCE**. **IWG** is the world leader in serviced offices and working from home has unfortunately heavily affected its business. Nonetheless, it is by far the strongest company in its sector, has an interesting franchise strategy to expand its network into suburban areas and the move to more work flexibility post pandemic could eventually benefit its business model as the company can offer a wide variety of locations close to its clients' employees. Both **ASSTEAD** and **INDIABULLS HOUSING FINANCE**, despite being widely different businesses suffered from increasing interest rates and a slowing world economy. In the case of **ASSTEAD**, a leading equipment rental company, a slowing economy will mostly affect its clients potentially leading to a slowdown of equipment demand. Higher interest rates are affecting **INDIABULLS HOUSING FINANCE**, a mortgage provider in India more directly as it increases its cost of funds which could pressure margins and slow down growth. Taking a more long-term view though, we think that none of these three investments are structurally broken. **IWG** will help its clients to transition to a world with more flexible workspace. Companies will continue to invest and infrastructure will continue to be built, which will benefit **ASSTEAD**. Finally, Indians will need more mortgages to buy houses which should benefit **INDIABULLS HOUSING FINANCE**.

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