COMMENTARY ON FINANCIAL MARKETS 02/2022

Prague, 1 Jan. 2022

Equity Markets Corrected Previous Growth in January

In January 2022, the most closely watched S&P 500 Index dropped by 5.3 percent. The equity markets thus responded to high inflation and subsequent indications from the U.S. central bank (FED) that it was prepared to increase the base interest rate more than previously expected. Nowadays, the 'Wall Street' believe that the FED will boost the base interest rate more than four-times in the course of one single year; that would result in a rate in excess of 1.25 percent. Yet another reason supporting such correction in the equity markets was represented by the escalated international tension regarding the situation around Ukraine.

Among the sectors, the best performing last month were the Energy Sector (+18.8 percent), the Finance Sector (0 percent), and the Consumer Goods Sector (-1.5 percent). On the contrary, the worst performing were the Consumer Durables Sector (-9.5 percent), the Real Estate Sector (-8.6 percent), the Health Services Sector (-6.9 percent), and the Technology Sector (-6.8 percent). Shares that had been trading at a high or negative P/E ratio, such as Amazon or Tesla, were under selling pressure and caused the Consumer Durables Sector to decline sharply. The market rotated stocks from growth to value equities that had a lower P/E ratio, higher ROE, low debt, and paid higher dividends.

January 2022 saw the beginning of the corporate earnings season in respect of the past year. Approximately one third of the S&P 500 Index companies had already published their results; of them, 77 percent reported somewhat better profits than anticipated. On the other hand, a high percentage of companies issued negative outlooks for the fist quarter of 2022. As regards the entire year, it is expected that the aggregated growth of corporate profits of the S&P 500 Index companies would reach 9.5 percent, y/y, and of revenues 7.9 percent, y/y (*Source: FactSet*).

Higher inflation has already caused fluctuations in the yields of the ten-year sovereign bonds, not only in the United States but also in Europe. The yield of the ten-year U.S. sovereign bond increased from 1.5 percent in December 2021 to as much as 1.8 percent in January 2022. Germany's ten-year sovereign bond yield rose from negative values slightly above zero after a long time. The Czech National Bank will be in a session this coming Thursday and it is expected that the base interest rate will be increased from 3.75 percent up to 4.50 percent. In the Czech Republic, the yield of the sovereign bond with maturity of ten years increased from 2.8 percent up to approximately 3.2 percent in the course of one single month. Investors believe that inflation may slow down gradually, commencing in the first quarter of 2022.

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The first month of the new year was relatively demanding as regards investing. Prices of both bonds and equities were declining throughout regions, so it was impossible to identify a safe harbour. The funds managed by RIS experienced higher frequency of bond trading in January 2022; for example, sales and transfers of funds from Dollar-denominated obligations continued. This was due to the high inflation raging in the United States and the associated risks of higher rates hikes by the U.S. central bank. As the case was, Dollar-denominated bonds were exchanged: medium-term and longer-term maturities were sold and purchases made of short-term maturities, that is, bonds with fully hedged interest rate risks or, on the contrary, with yield linked to interest rates. A similar situation prevailed in Europe as regards EUR-denominated bonds because inflation had been unusually high here, too. The ECB – similarly as the FED in the United States – had long time refused to accept that the then current inflation was not to be a temporary phenomenon; now, voices have already been heard about the need to increase rates. That is why also the RIS funds have experienced reductions of the average terms to maturity in respect of the EUR-denominated bonds held in portfolios. Funds resulting from sales of Dollar- and EUR-denominated obligations have been exchanged back to Czech crowns; the aim is to purchase Czech bonds, mainly sovereign but also corporate ones. Purchases were made mainly of bonds maturing in or around the years 2026 and 2027. As regards equities, the traditional way was to mitigate declines through shorter-term trades while investing funds in both individual stocks and broad stock indices.

Analysts believe that both corporate profits and revenues will grow at a single-digit rate this year, so it can be hardly expected that the equity markets could repeat their 2021 growth. At the same time, as interest rates rise, the expected term of return on investments may shorten, which is likely to be reflected in a decline in P/E. Still, analysts anticipate the S&P500 Index to reach an approximately very decent 4,980 points at the end of the year (*Source: Bloomberg*), which represents roughly 10 percent above the current value.

On the other hand, attractiveness of Crown-denominated debt instruments has been growing in a significant manner; for example, the yield of the three-year Czech sovereign bond has currently reached the 3.6 percent mark. It needs to be mentioned here that higher rates, as well as a stronger Crown, will result in slower economic growth in the Czech Republic, possibly as soon as in the second half of this year. This development may result in a completely opposite approach to be taken by the central bank, namely, in the direction towards gradual lowering of the interest rates. Such situation will support investments into Crown-denominated debt instruments, and not only due to attractiveness of their current yields but also in view of their potential price increases caused by possible drops in the interest rates.

We adjust our investment strategy in this context: we are reducing the share weight in the model portfolio and increasing the share of Crown-denominated bonds. Still, though, we stick to slightly overweighting equities as against bonds. Also, we moderately extend the average maturity term in Crown-denominated bonds (so-called 'duration').

We wish you much success in the days to come!

For the Asset Management team,

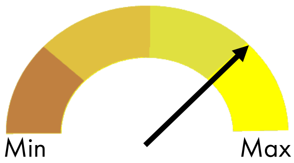
Mr Michal Ondruška

Summary of Investment Strategies:

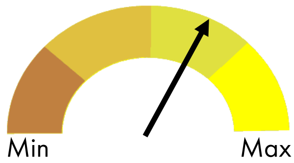
Tactical Allocation

Equity overweighted in portfolios

Current



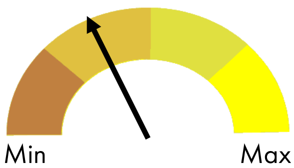
3M outlook



Interest Rate Risk

Average bond maturities (Duration)

Current



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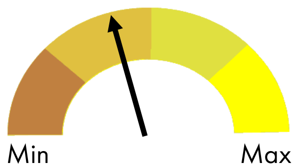
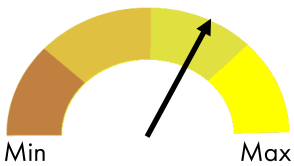


Credit Risk

Portions of, e.g., corporate bonds

Current



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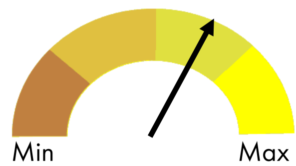
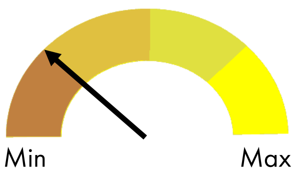


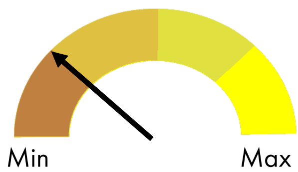
Currency Risk

Unsecured positions in foreign currencies

Current



3M outlook



Source: Raiffeisenbank, a.s., Asset Management, data valid as of 1 February 2022

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