M|A|M
MONACO ASSET MANAGEMENT

Global Research & Investment Strategy

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Flash Market Update

Dear Investors,

As a follow-up to the note shared last week, we wanted to provide an additional update. The situation remains extremely fluid. Above all, our thoughts remain with those truly impacted by the Russia/Ukraine conflict.

Permanent Geo-Political Shift

Our assessment of the situation has evolved since last week. We had previously thought that Russia's invasion of Ukraine would take a similar turn than the Crimea annexation of 2014. Yet, it is becoming increasingly clear that both sides will stand entrenched and that a swift resolution is unlikely. Of course, we hope to be wrong and that a solution comes to the fore promptly. Internal conversations, external research and participation in a discussion with Sir John Scarlett, Chief UK Secret Intelligence Service between 2004 and 2009 have supported our changing views. We now firmly believe that we are witnessing a permanent geo-political shift that increases the chance of another "cold war". The repercussions of the invasion are already too large to ignore. Sanctions imposed by the West are plunging the Russian economy in a depression. Sberbank, the largest Russian bank by asset, is trading at bankruptcy levels. A full-blown financial crisis is underway. The full extent of its ripple effects on the global financial system have yet to be determined. European banks exposed to Russia are down –30%+ from their highs. This will have consequences on future economic growth. In addition, we have yet to witness the full scale of sanctions. Some countries are rapidly adapting their foreign policies such as Finland discussing joining NATO. Others like China are in a difficult situation and will be forced into some hard decisions. Russia's invasion of Ukraine could mark the beginning of a turning point for the U.S. Dollar - wars tend to turn into major junctures for global currencies, and with Russia losing access to its foreign currency reserves, a message has been sent to all countries that they can't count on these money stashes to actually be theirs in the event of tension. As such, it may make less and less sense for global reserve managers to hold dollars for safety, given that they could be taken away right when they're most needed. A tectonic shift is underway.

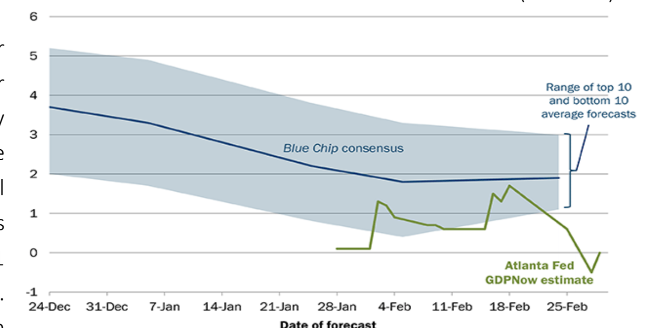
Chart 1. Sberbank (Monthly)

Source. Bloomberg

We Remain Confident About Our "Stagflation" Call

We have been talking about the risk of stagflation for the best part of 9 months. In hindsight we were early. However we remain extremely confident about our call. In fact, US economic data has already been pointing in this direction for a few weeks. The Atlanta Fed calculates a "live" US GDP growth estimate as economic data is being released. Currently, the Atlanta Fed estimates US GDP growth in Q1 2022 at 0% QoQ. I suspect this is not what investors expected as Covid fears receded. Yet, supply chain constraints, higher gasoline prices, tight employment conditions, are having a negative effect on economic growth. A new "cold war" could further exacerbate the situation and plunge G7 economies into a technical recession in H2 2022, quicker than expected. While lower aggregate demand from a slowing economy has a tendency to lower inflation, this may not be the case this time around. Indeed, commodity prices are unlikely to fall substantially. Hiring conditions either. While some base effect might push US inflation lower, our base case remains that it will stay around 5%, substantially above the Fed target of 2%. Inflation is eroding the purchasing power of the broad population. It is now the #1 concern amongst Americans, way before Covid and climate change. President Biden made it abundantly clear during the State of the Union address that combating inflation is a priority. The stagflation scenario is becoming increasingly more likely.

Chart 2. Evolution of Atlanta Fed Estimate GDP QoQ (Q1 2022)



Source. Atlanta Fed

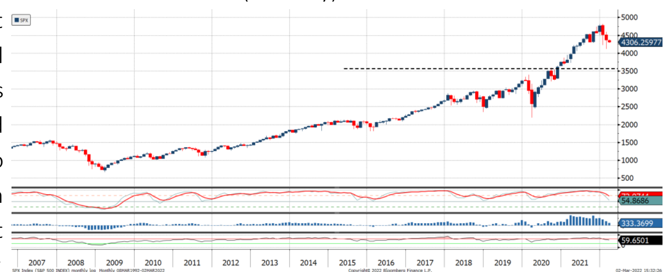
Central Banks Are Cornered

Central Banks have to perform one of the most complex balancing acts. The risk of a policy mistake is high. On the one hand, the Fed and the ECB need to control inflation before it becomes anchored in the economy. They also need to increase interest rates at a comfortable level above the 0% level to create accommodation room for the next crisis. On the other hand, they need to take in consideration the potential impact of a Russia/Ukraine conflict which has global ramifications. However, our assumption is that between inflation or growth, Central Banks and especially the Fed, will favour combating inflation. This is a big change from the past 10 years. Fed Chairman Jerome Powell recently mentioned that an interest rate hike in March is still at play. The Fed will remain nimble but the cycle of rising interest rates is still ongoing and only starting.

What this means for Financial Markets

Stagflation is negative for financial assets (stocks and bonds) and positive for real assets (commodities, precious metals, real estate). Looking back at history, we believe that the current environment has similarities to the oil shock of 1990. The Iraq invasion of Kuwait in August 1990 sent oil prices spiralling higher. Despite the potential for inflation, the U.S. Fed and central banks around the globe decided it would not be necessary to raise interest rates to counteract the rise in oil prices. Despite this, then S&P 500 Index fell –16% from the invasion until a bottom was found. It took 3 months for this bottom to happen and for markets to resume their uptrend. We believe this is a sensible template to use in today's markets.

Chart 3. S&P 500 Index (Monthly)



Source. Bloomberg

A sell-off of 16% from the date of the Russian invasion could push the S&P 500 Index towards 3,600 by June 2022. Assuming flat YoY EPS growth for the S&P 500 Index ($200/share), this would still lead to a valuation of 18x. This would be the average valuation in the 5-years preceding Covid and a reasonable level at which long-term investors would start to accumulate equities again. Wile credit spreads have widened, there is still scope for further widening, especially as liquidity conditions remain abysmal. It is extremely challenging to construct a portfolio when equities and bonds lose in tandem. This is when real assets (precious metals, commodities, real estate) and hedge funds have critical importance.

Actions Taken

We believe there is a time to invest and there is a time to risk manage a portfolio. While we may miss a relief rally on a positive headline, we firmly believe it is paramount to protect portfolios against the risk of greater capital erosion. So far, this is what we have done. We started the year with significant cash in portfolios. We protected equity exposures with option strategies. We also had outsized exposure to hedge funds which have negative correlation to financial markets. We believe that we need to continue in this direction. We reviewed all our investments and are happy to report that Russia/Ukraine exposure is minimal. Last week, we took advantage of elevated market volatility and oversold financial markets to sell put options on indices (Nasdaq Index and Euro Stoxx 50 Index) We intend to close these trades at a profit today. In addition, we intend to add portfolio protection via some of the below strategies to further protect against potential market weakness:

1. Buy S&P 500 Index 100%-90% Put Spreads with a June 2022 maturity
2. Buy US High Yield ETF 101%-92% Put Spreads with a June 2022 maturity

As always, please feel free to reach out to us if you have any questions.

Kind regards,

MAM Investment Team

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