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May 2022

Market Commentary

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The Ukraine-Russia conflict is weighing on the economy and driving inflationary pressures. The continuation of the war keeps volatility high in the equity markets, with uncertainty most pronounced in the euro area, as a potential gas embargo by Russia would undoubtedly have a substantial impact on the EU. The US is less affected by the immediate effects of the Ukraine-Russia conflict due to its geographical location. Nevertheless, the Ukraine war is increasing global inflationary pressures. The high inflation rates in the US are causing the Fed to act more restrictively and are weighing on the stock markets.

Another factor that could cause continued volatility in the equity markets is China. Regional lockdowns in China impact global supply chains and cost economic growth. Although the Chinese government is supporting its economy and rising temperatures make it seem realistic that the COVID wave in China will subside, one can expect the impact to persist.

Concerning the respective central banks of the EU and the USA, the picture is still slightly different. The Fed will continue to tighten monetary policy in the coming months, and Fed Chairman Jerome Powell signaled a rate hike of 50 bp for the FOMC meeting in May. Although the Treasury market is already largely pricing in the hawkish Fed expectations, further movements remain realistic. In the case of the ECB, no rate hike has been made yet. In its monetary policy decision in April, the ECB stuck to the course of a gradual, data-based normalization of monetary policy and an end to the APP purchase program in Q3 2022. However, in the course of last month, voices were raised from the ECB's Executive Board that an end to the purchase program could be conceivable earlier. The risk of an earlier interest rate hike has thus increased. Nevertheless, new policy decisions by the ECB are not likely until June, as soon as the ECB's new projections are available. Against the background of the broad dispersion of inflation estimates for the euro area, which according to Bloomberg ranged between 6.8% and 7.9% before their announcement, continued interest rate volatility on the bond markets nevertheless seems likely.

Uncertainty caused by the ongoing war in Ukraine, the COVID wave in China and the ongoing inflation risks, which are drawing increased comments from members of the ECB Governing Council on tightening monetary policy, continue and markets are thus expected to remain volatile.

In focus in May: Interest rate risk

- Tightening of the Fed's monetary policy is expected
- Sounds of an imminent ECB rate hike grow louder
- Short-term interest rates will rise
- Increased uncertainty for medium and long rates

Our Solution

The current interest rate risk shows that the central banks' upcoming interest rate decisions will directly influence short-term interest rates. On the other hand, long-term interest rates tend to be more strongly influenced by expectations for economic growth and are, therefore, currently subject to more significant fluctuation uncertainty. This impacts longer-dated government bonds, among others, so that investors must deal with increased interest rate risk.

With our Fixed Income Protect Alpha Add-On, we offer an innovative approach that enables investors to optimise their position in bonds in an alpha-driven manner.

Traditional hedging approaches face significant challenges, particularly due to the high cost of hedging. Continuous short positions (or put options) entail a high cost (negative cost of carry), which mostly eats up expected returns in times of low volatility. Interest rate swaps offered by banks are expensive hedging instruments due to high fees.

Using advanced and highly proprietary technologies such as artificial intelligence and machine learning, we have developed systematic strategies that attempt to predict the market and take short positions in the 10-year US Treasury future situationally rather than continuously.

Through market timing, rather than continuously holding positions, we achieve an alpha-driven optimisation of client portfolios even in times of rising interest rates and elevated interest rate risk, while at the same time being able to significantly reduce costs compared to traditional hedging methods such as interest rate swaps.

The *Fixed Income Protect* Alpha Add-On is available as a stand-alone solution or as part of our Volatility Special Opportunities Program (VSOP) for investors.

VSOP is a multi asset investment product consisting of several Alpha Add-Ons addressing major client requirements in one product.

VSOP's investment approach leverages a set of absolute return strategies, agnostic to markets or market regimes.

Individual strategies are targeting one asset class and market (e.g., S&P 500) and are being implemented through derivatives. Collectively, those strategies may be combined into multi-asset strategies. Special emphasis is being put on the inclusion of strategies generating 'Crisis Alpha' in crisis situations.

VSOP's multi asset investment approach focuses on long-term capital preservation but requires risk tolerance towards short-term drawdowns. It is being managed according to volatility und Sharpe ratio metrics.

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