

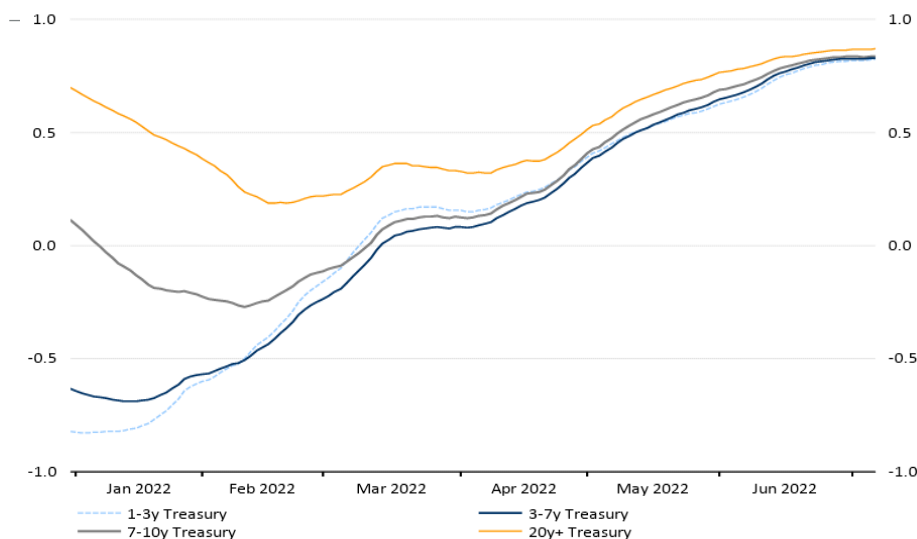
GLOBAL INSIGHT



Overview

- In our Macro View, we wonder whether the uniqueness of this cycle could lead to outcomes that differ from those currently expected.
- We find ourselves struck by just how consistently the same themes and conclusions emerge.
- In seeking to deliver uncommon value to our clients we often find ourselves in the position of having to challenge conventional wisdom.
- In our Investment Outlook, monetary policy tightening has continued aggressively over the course of the second quarter leading many investors to actively price in the chances of recession during the second half of this year.
- The success story so far this year has been the elevated level of commodity prices proving to be one of few safe havens against rising inflation.
- Equities are in bear market territory, but what are the bond markets telling us when the dollar is so strong?
- In our feature piece, Richard Beggs assesses the impact of cryptocurrencies on investors.
- As a store of value, it is clear that Bitcoin falls short of this quality and substantial loss of value this year are far too dramatic to label Bitcoin as a consistent store of value.

Equities & Bonds—Rolling 6m Correlation across tenure. Nowhere to hide.



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Economic Highlights

- US Investment Grade and High Yield Bond Indices down by some -17% & -15% respectively in the past 6 months
- US, futures markets anticipate more than 200bps of additional hikes between now and the end of Q1'23.
- Q1 2022, nominal GDP growth is running at more than 11%.
- The Indian stock market saw over \$6.3bn of outflows in the month of June.
- 10-year yields rally to close out June back under 3%.

Contact Details

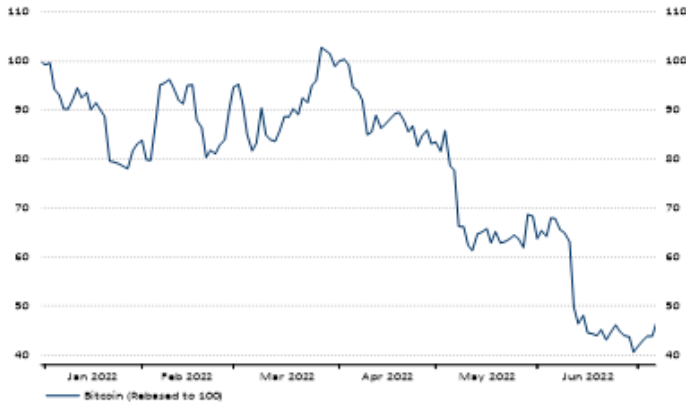
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Based upon information available up to and including 12th July 2022

Key Issues in Charts

Bitcoin vs USD (YTD)



- Bitcoin has suffered along with other major currencies and gold vs. USD.
- Bitcoin has shown itself to be a particularly inefficient inflation hedge over this recent period of high inflation.
- Bitcoin has struggled to grow a reputation as a store of value.
- Although Gold seems correlated to real interest rates Bitcoin, a theoretically similar investment, seems completely uncorrelated and subject to more fragile supply and demand volatility.

Eurodollar Dec 22 vs Dec 23—60bps of easing priced

- Despite the short term forecast for the tightening of rates, futures markets are already suggesting this may be overdone.
- The spread between expected short rates in December 2022 and those expected in December 2023 currently imply a 60bp *easing* in policy rates through 2023.
- Does an easing in short rates forecast recession?
- Perhaps inflation is expected to fall sharply when short term uncertainties are overcome?



USD investment grade & high yield faring poorly YTD



- This chart shows the performance of credit indexes in the US which have been pricing a sharp slowdown alongside higher rates.
- Although default rates remain low perhaps further tightening of borrowing will create stress amongst the highly indebted.
- Investors favouring quality stocks with robust balance sheets and low debt ratios are impacting credit markets.
- Despite the significant widening of credit spreads, a recession is likely to see spreads widen further as lower earnings bring debt sustainability into question.
- Time will tell if central banks can engineer a soft landing, in other words, considerably reduce inflation without causing a recession.

Expecting the Unexpected

By Adam Jones, Senior Investment Manager

- **Market participants appear to be leaning in one direction. While deteriorating market and economic data clearly support this view, we wonder whether the uniqueness of this cycle could lead to outcomes that differ from those currently expected.**
- **Government bonds appear more attractive to us in the context of recent price declines, although we remain wary of corporate credit.**
- **Cooling inflation, peak policy expectations, poor market sentiment and the resilience of the US consumer could prove to be a surprisingly positive mix for equity markets. We see more opportunities in individual equities than we believe have existed for several years.**
- **Alternative strategies, especially those in the discretionary and systematic macro space, have proven themselves able to capture positive returns from elevated volatility across asset classes. We believe these conditions will likely persist.**

This quarter's outlook piece was partly inspired by one of the late Bob Farrell's 'Market Rules'. Having initially studied under famed value investors Benjamin Graham and David Dodd, Bob went on to serve for more than 50 years as a highly respected equity market strategist on Wall St, the majority of which he spent with Merrill Lynch as Chief Market Analyst. Bob later became more widely known for having distilled these decades of wisdom into a timeless and concise list of rules which he labelled 'The 10 Market Rules to Remember'¹.

Specifically, it is Bob's 'Rule Number 9' upon which we have recently been ruminating:

“When all the experts and forecasts agree—Something else is going to happen”

Reading through recent financial media commentary, and indeed a variety of investment strategy notes with similar intentions to this one, we find ourselves struck by just how consistently the same themes and conclusions emerge.

Without wishing to oversimplify, these fall largely into the following categories:

- Interest rates are moving higher (stay underweight bonds)
- Economic growth is slowing, recession is fast approaching (position defensively within equities, remain underweight)

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Of course, there exists a huge amount of historical market data which support these defensive changes in positioning, particularly with respect to a deteriorating economic environment. This, however, is where we can't help but pause for thought.

As inflation looks set to cool and broad indicators of economic growth decelerate, we find ourselves wondering whether markets might already be pricing too aggressive a path for interest rates.

In seeking to deliver uncommon value to our clients we often find ourselves in the position of having to challenge conventional wisdom, so in many respects this feels like business as usual. The difference on this occasion, however, is the consistency with which our own indicators point toward the very same outcomes that are currently most feared by market participants. This is an important point for us to emphasise.

In our Q3 2021 Outlook noteⁱⁱ (published back in October) we discussed both the instability of bond-equity correlations and the idea that a forthcoming period of higher than anticipated inflation could have negative consequences for returns in both equity **and** bond markets. Having seen these ideas play out (somewhat convincingly) we now find ourselves wondering whether it is right to align more closely with our peers, many of whom have since decided that portfolio risk should be reduced.

Of course, there exists a huge amount of historical market data which support these defensive changes in positioning, particularly with respect to a deteriorating economic environment. This, however, is where we can't help but pause for thought.

At Hottinger we consider the current cycle to be anything but typical, so the seemingly innate human tendency to draw parallels with prior periods of slower growth or higher inflation feel less than useful to us. Whilst we are not necessarily comfortable moving in a direction which good old-fashioned data might contradict, we do believe the current economic cycle to be sufficiently unique as to warrant the exploration of new thinking and ideas. As such we have spent some time attempting to identify factors that might mean the economic future looks a little less bleak than currently feared. **Perhaps most importantly, we remain highly alert to the idea that the distribution of potential future outcomes is far wider than history might suggest.**

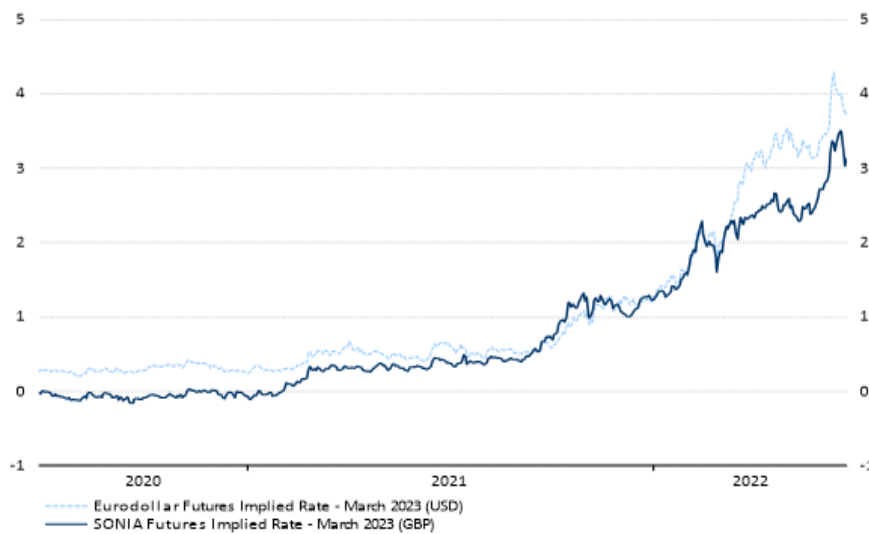
So, taking our earlier generalisations in turn;

- **Interest rates are moving higher (stay underweight bonds)**

In thinking about interest rates it is crucial to distinguish between *actual* increases in rates and those expected future changes that have *already* been incorporated into market pricing. In the US, futures markets anticipate more than 200bps of additional hikes between now and the end of Q1'23, which would leave overnight rates just below the 4% level. Here in the UK the story is similar, with base rates expected to reach >3% by the end of March.

As inflation looks set to cool and broad indicators of economic growth decelerate, we find ourselves wondering whether markets might already be pricing too aggressive a path for interest rates. In this context **we recently took the opportunity to invest a portion of client cash balances into short-dated government bonds, which offered us yields comfortably greater than those available at any prior point in more than a decade.**

Future Markets Already Pricing Much Higher Rates by March 2023



Source: Hottinger Investment Management & Refinitiv Datastream

While perhaps not overly exciting in terms of absolute returns we feel the absence of default risk and the optionality the position affords us to be especially helpful, particularly with market volatility realising at high levels.

In fixed income more broadly we maintain our view that it remains **too early to be re-entering corporate debt**, an asset class to which our portfolios have had negligible exposure over the past year. With US Investment Grade and High Yield Bond Indices down by some -17% & -15% respectively in the past 6 months alone, however, we are beginning to see some value emerge.

Whilst this might appear to be an attractive point at which to invest we feel that, particularly given the speed with which interest rates have risen, we are yet to fully understand the impact on corporate balance sheets and the ongoing ability of companies to service debt.

- **Economic growth is slowing and recession is fast approaching (position defensively within equities, remain underweight)**

Economic growth *is* slowing. There is no getting around that, although in many ways it had to given the extent to which economies rebounded in 2021. The suppression of output in 2020 as vast swathes of the global economy entered lockdown meant that growth in 2021 appeared very robust on a year-over-year basis. GDP growth is now running at far lower levels, with the widely followed GDPNow indicator (published by the Atlanta Federal Reserve) estimating growth to be tracking at just 0.3% per annum^{iv}.

An important point for us here, however, is that GDP data is most often published in real (i.e after inflation) terms. A closer look at nominal (i.e. before inflation) growth reveals a somewhat different picture, and one that we think

US and UK futures suggest much higher rates by March 2023.

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When we consider this alongside the level of accumulated savings, which remains highly elevated in the wake of fiscal support packages ushered in post-pandemic, we find cause for optimism.

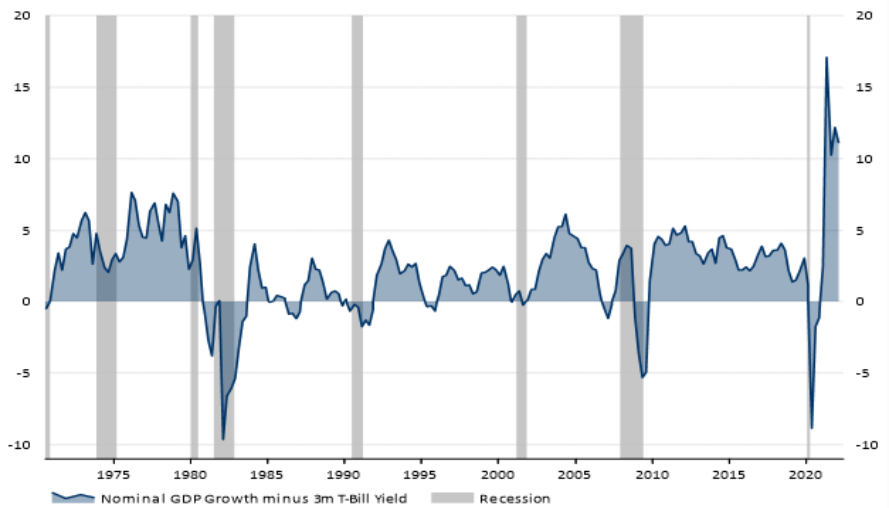
could be important. Nominal GDP growth matters; it is the actual price and level at which the purchases of goods and services in an economy are taking place. The ‘real’ element matters more so when consumers can no longer afford to pay these prices, a situation we believe could be further away than is generally expected. The key takeaway is that **corporate earnings, and their corresponding equity prices, are also priced in nominal terms.** To some extent we believe this at least partly explains the apparent disconnect between lower economic growth and relatively robust earnings expectations.

According to the most recent estimate for Q1 2022, nominal GDP growth is running at more than 11%. When placed in the context of overnight interest rates (which, at least for now, remain low) it becomes clear that the macro environment remains highly stimulative and economic activity is robust.

Not that 70s Show...

The broad structural and macroeconomic differences between now and the 1970’s are beyond the scope of this note, however one issue we feel can be viewed with slightly more optimism is the proportion of consumer expenditure that relates to energy. While it would be naïve of us to suggest that recent energy price increases have had no impact on consumption (they clearly have) it is also true to say that, at least until very recently, **spending on gasoline and energy has formed a lower percentage of total consumer expenditure than it has for many decades prior** (and remains well below levels witnessed during the 70’s & early 80’s).

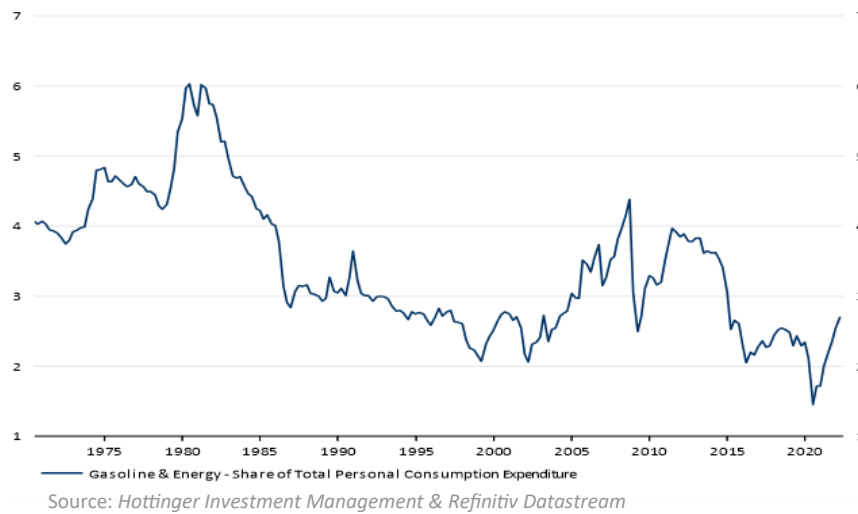
The Gap Between Nominal GDP and Short-Term Interest Rates



Source: Hottinger Investment Management & Refinitiv Datastream

The important point here is that while higher energy prices are never pleasant, US consumers currently find themselves in a relatively robust position. This should allow them to absorb these costs more comfortably (whether they should have to is an entirely separate discussion). When we consider this alongside the level of accumulated savings, which remains highly elevated in the wake of fiscal support packages ushered in post-pandemic, we find cause for optimism.

Gasoline & Energy Spend as % of Total Consumption



One of the issues with deposit data (as in the above chart) is that it is difficult to get a clear sense of exactly how these assets are distributed.

For example, are the majority of these deposits held by the wealthiest individuals who are far less likely to spend them? It's certainly possible. On the other side of the coin (and as is all too often the case) the very lowest income households are suffering disproportionately as the rising cost of necessities places an increasing strain on disposable income.

Significant Household Savings Provide Support for Future Consumption



Without delving into the complex issue of income inequality the simple (albeit unfortunate) economic truth is that **the top two income quintiles (i.e. the highest 40% of earners) together account for an estimated 70% of total consumption, while the lowest income quintile accounts for less than 5%**. So, while those in lower income cohorts are unquestionably suffering most, the

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The top two income quintiles (i.e. the highest 40% of earners) together account for an estimated 70% of total consumption, while the lowest income quintile accounts for less than 5%.

While those in lower income cohorts are unquestionably suffering most, the resulting impact on economic growth is actually likely to be far less than feared.

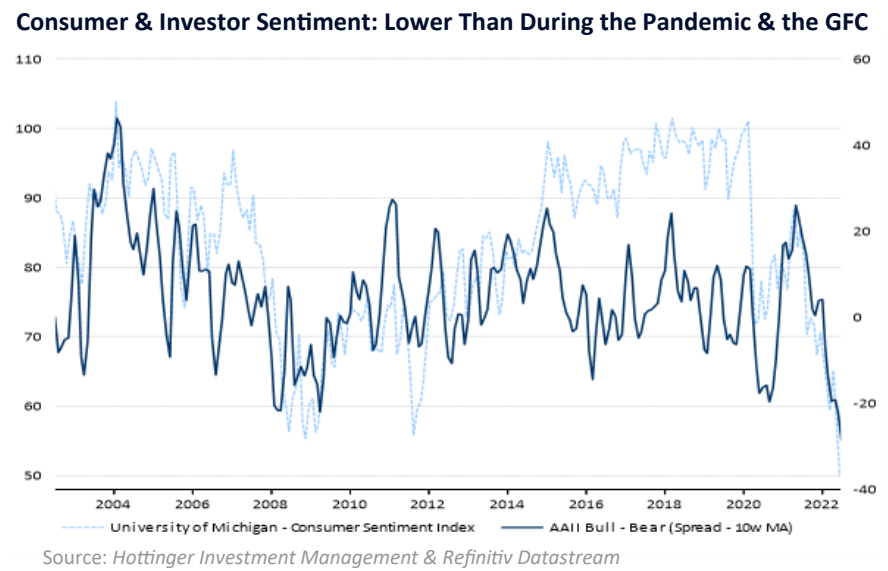
The chart highlights two popular measures of sentiment and here we see that current levels reflect a lower degree of confidence in future outcomes than those witnessed during both the Pandemic of March 2020 and the Great Financial Crisis of 2008. Are things really that bad? We are not entirely convinced.

Having made these observations we think it sensible to at least entertain, and to some extent position for, the idea that the US economy (alongside its equity markets) may well prove to be more resilient than is widely expected.

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In terms of how these concerns around US interest rates, growth and inflation have affected markets we would highlight that the S&P500 is currently down -20% YTD, and the technology focused NASDAQ100 is down by nearer -30%. These are significant moves and arguably reflect pessimistic investor sentiment. That is not to say that prices cannot fall further, but merely that a good proportion of future economic pain may already be reflected in valuations.

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Having made these observations we think it sensible to at least entertain, and to some extent position for, the idea that the US economy (alongside its equity markets) may well prove to be more resilient than is widely expected.

i [Wall Street Legend Bob Farrell's 10 rules for investing \(cnbc.com\)](https://www.cnbc.com/2021/10/07/wall-street-legend-bob-farrells-10-rules-for-investing.html)
 ii <https://hottinger.co.uk/wp-content/uploads/2021/10/Global-Insight-Q4-2021.pdf>
 iii [US LL, HY Default Rates to Rise Slightly in 2023, Exceed 2% by 2024 \(fitchratings.com\)](https://www.fitchratings.com/web-content/2022/01/US-LL-HY-Default-Rates-to-Rise-Slightly-in-2023-Exceed-2%by-2024)
 iv [GDPNow - Federal Reserve Bank of Atlanta \(atlantafed.org\)](https://www.federalreserve.org/economic-and-bank-information/data-reports/gdp-now-report)
 v [Income shares by quintile, United States, 1979 to 2013 \(ourworldindata.org\)](https://ourworldindata.org/income-shares-by-quintile)

Investment Outlook

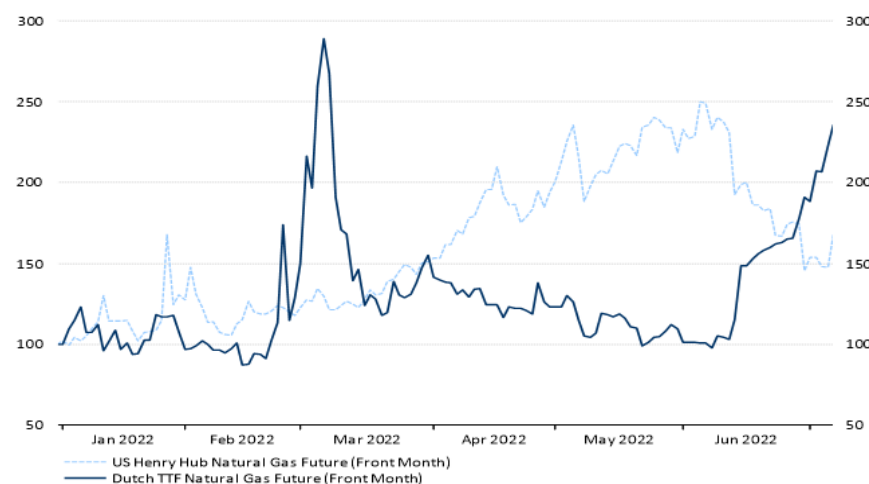
At the end of the first quarter, we suggested that it would be challenging for central banks to engineer a soft landing now that taming inflation was their main priority. Monetary policy tightening has continued aggressively over the course of the second quarter leading many investors to actively price in the chances of recession during the second half of this year in the major economies.

The Federal Reserve seems to have dominated global financial markets over the quarter as it comes to terms with headline inflation at 40 years high and a consistently tight labour market. Much of the elevated price action arose during the pandemic as the demand for goods replaced service sector consumption. The much-anticipated re-opening of the economy would see a leveling up in demand for goods and services back to pre-covid levels, however, this path back to normality has been de-railed by significant global energy and food inflation exacerbated by the Russia-Ukraine war and growing wage inflation. **This leaves us unsure as to how much proposed tightening will be necessary to regain control of inflation but does make us question whether peak inflation has already been seen.** Even if this proves to be true, it is still likely in our view that headline inflation will remain elevated over the second half of the year and require central bank vigilance, but with so many unknowns, avoiding any recession will be difficult.

Commodities Safe Haven

As with many periods when the global economy is in transition, the resulting inflection point for financial markets leaves few safe havens for the multi-asset investor as correlations between traditional asset classes break down. The success story so far this year has been the elevated level of commodity prices proving to be one of few safe havens against rising inflation.

US vs EUR Natural Gas



Source: Hottinger Investment Management & Refinitiv Datastream

Monetary policy tightening has continued aggressively over the course of the second quarter leading many investors to actively price in the chances of recession during the second half of this year.

It is still likely in our view that headline inflation will remain elevated over the second half of the year and require central bank vigilance, but with so many unknowns, avoiding any recession will be difficult.

The success story so far this year has been the elevated level of commodity prices proving to be one of few safe havens against rising inflation.

The flow of gas supply and demand is very much a European issue, in our opinion, created by decades of over reliance on Russia.

The threat to global food supply also remains tied to the conflict as Russia continues to blockade Ukrainian supply routes.

An investor who has had exposure to general commodities will have returned approximately 18% this year.

Perhaps significantly, the copper price has fallen 23% over the quarter.

Over the course of the quarter, equities and bonds have fallen in tandem as the market comes to terms with the idea that central banks will be tightening into weakening growth and many major equity indices are now in bear market territory.

We have always maintained that a global recession, or at least a US recession, is unlikely while earnings growth is positive.

However, the disruption to global oil supply caused by the Russia sanctions has seen the price peak during this quarter with the Brent crude spot price falling from approximately \$135 to trade in the mid-twenties by quarter-end. **The flow of gas supply and demand is very much a European issue, in our opinion, created by decades of over reliance on Russia.** Although many European countries are trying to find new supply chains and looking at new LNG projects the political fragility of Russian supply will likely dominate European government and central bank policy decisions while uncertainty over the conflict continues. The threat to global food supply also remains tied to the conflict as Russia continues to blockade Ukrainian supply routes and the soaring cost of fertilizer reportedly makes it increasingly difficult for other major supply countries to increase yields in the medium term to fill the void. As is often the case the pending shortage will likely be a much more significant human tragedy than financial consequence although **it is worth remembering that the Arab Spring riots of 2010/11 started with crises over food and economic hardship.**

An investor who has had exposure to general commodities will have returned approximately 18% this year and 25% over the last twelve months in USD terms so **it would seem prudent to us to take some profits as most supply shocks seem to be priced in, and as investors increasingly look towards recession then some supply pressure will be expected to dissipate.** Perhaps significantly, the copper price has fallen 23% over the quarter, not least because its largest market – China – has spent much of the quarter in zero-tolerance lockdown, but “Doctor Copper” is so-called in the commodity markets for its ability to predict overall economic well-being due to its varied applications across multiple industries.

Equities in Bear Market Territory

Over the course of the quarter, equities and bonds have fallen in tandem as the market comes to terms with the idea that central banks will be tightening into weakening growth and many major equity indices are now in bear market territory. European equities are collectively down over 20% having fallen more than 12% over the quarter while in the US the S&P500 has fallen 16.4% and the NASDAQ 21.75% leaving them down 22.9% and 29.5% year-to-date respectively. **The question for investors now is whether all the bad news is now priced in?** UK investors have enjoyed the benefits of a defensively minded index of energy, healthcare and financials with a high percentage of dollar-based earnings leaving the FTSE 100 down only 4.6% during the quarter and -2.9% year-to-date and the wider All-Share Index -5.9% and -6.3% respectively.

We have always maintained that a global recession, or at least a US recession, is unlikely while earnings growth is positive, so we continue to monitor earnings estimates and revisions for growing price pressures. We believe the recent pressure on long duration growth stocks was due to the unwillingness of investors to price the cash flow of future earnings. **Consensus estimates are for 9% earnings growth for 2022 and 2023 for the S&P500¹** which when looked at in the context of analyst forecasts at the beginning of the year seems optimistic to us.

Absolute Strategy Research (ASR) chart that US Earnings-per-Share (EPS) is almost 25% above its 25-year trend when in each of the last three major cycles EPS ended between 25-30% below trend. As we move into third quarter earnings season, ASR expect global EPS to fall 10-15% year-on-year from current levels of a rise of 9% as the earnings reality gap starts to closeⁱⁱ. Sectors most at risk of a reversal are energy, basic materials, technology, and banks where forecasts vs. trend are most stretched.

Furthermore, we have started to see some of the pressures in the market begin to unwind after a long spell favouring inflation protection in equity sectors. **The energy sector has undergone a major change of fortune losing 17.8% in June** although remains the only significantly positive sector year-to-date up 31.4%. No sector can say that the second quarter was kind but the defensive sectors of healthcare, consumer staples and utilities had single digit falls while consumer discretionary and communication services, which includes Meta, Alphabet and Netflix among others, fell over 20%. Flat yield curves despite the back up in rates still makes life difficult for banks and should we start to see stress within the credit markets then financials will remain under pressure.

In summary, despite the weakness seen thus far in equity markets, we are yet to see investor capitulation creating overly cheap valuations or a change in the economic environment to suggest a reversal in falling earnings. We continue to favour quality stocks across sectors which show strong cash flow generation, an ability to set pricing and margins within their markets, and robust balance sheets with low levels of debt. **Quality stocks should show more consistency in earnings growth in changing environments giving investors more comfort in their decision-making.**

What are Bond Markets telling us?

As already stated, the second quarter was brutal for both equities and bonds as forecasted central bank hiking cycles and rising inflation expectations were priced into yield curves. US Treasuries began the second quarter as they finished the first, pricing aggressive fed action that saw 10-year yields continue to back up from 2.32% to hit a high of 3.48% halfway through June. If we were to add the widening credit spreads to approximately 175 basis points, this points to a rough cost of debt of approximately 5% challenging the current earnings yield (the inverse of price-to-earnings ratio) of the S&P500 of 5.4%. However, recession fears started to eat away at investors which should also bring current earnings into question but also questions the need for the forecasted trajectory of interest rates. Therefore, as the quarter came to a close, bond markets started to price in recession and that meant lower long yields as inflation fears recede seeing 10-year yields rally to close out June back under 3%. The 10-year Gilt yield was a similar story moving from 1.6% at the start of the quarter to 2.65% at its peak mid-June. If the signaling from the bond market ends up being correct, then long yields have potentially peaked, and this may well prove to be further bad news for equities. **But then there is the dollar.**

As we move into third quarter earnings season, ASR expect global EPS to fall 10-15% year-on-year from current levels of a rise of 9% as the earnings reality gap starts to close.

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Despite the weakness seen thus far in equity markets, we are yet to see investor capitulation creating overly cheap valuations or a change in the economic environment to suggest a reversal in falling earnings.

If the signalling from the bond market ends up being correct, then long yields have potentially peaked, and this may well prove to be further bad news for equities.

The US Dollar has strengthened substantially over the quarter with the dollar index up 6.48% by the close.

The Bank of Japan remains out of step with other central bank policy and so the Yen has come under ferocious pressure rising to over ¥135 to the dollar, rates not seen for twenty years.

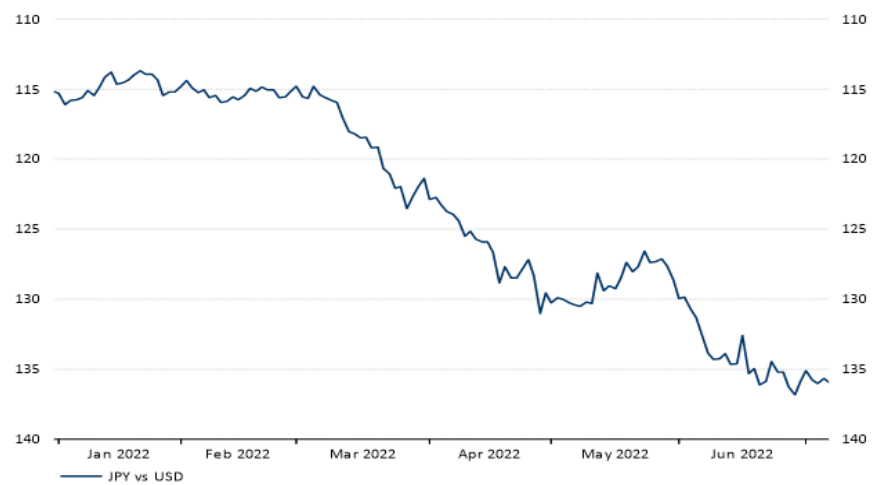
Such currency strength could suggest that the fed tightening cycle remains necessary to control inflation and the domestic economy remains too strong to stoke recession fears.

A strong dollar is a continual headwind to global growth and despite emerging market central banks embarking on rate hikes of their own, they have been unable to reverse the dollar's dominance.

Dollar Strength belies the Bond Market

The US Dollar has strengthened substantially over the quarter with the dollar index up 6.48% by the close having passed some major milestones against other major currencies. The Bank of Japan remains out of step with other central bank policy as it continues to try and generate inflation of 2% by anchoring bond yields, and so the Yen has come under ferocious pressure rising to over ¥135 to the dollar, rates not seen for twenty years. Despite similar performance at an equity level the Euro has suffered a similar fate falling to 1.0480 from 1.1065 to the dollar with little sign of deceleration by quarter-end while the pound fell 7.29% from 1.3133 to 1.2175.

USD vs YEN



Source: Hottinger Investment Management & Refinitiv Datastream

Such currency strength could suggest that the fed tightening cycle remains necessary to control inflation and the domestic economy remains too strong to stoke recession fears. **However, there are other factors to consider:** The zero Covid tolerance policies of China continue to disrupt global trade and create domestic demand weakness that by comparison favours dollar assets; and the Russia-Ukraine war continues to favour countries with energy security which again favours the US. Furthermore, due to the fact that global commodities markets are priced in dollars there exists a traditional inverse correlation between rising commodity prices and a falling dollar which until very recently had broken down. Perhaps the reason for this relationship to return after twelve months absence is the rapid contraction in dollar liquidity outside of the US or perhaps it is indicating that inflation is yet to peakⁱⁱⁱ. **A strong dollar is a continual headwind to global growth** and despite emerging market central banks embarking on rate hikes of their own, they have been unable to reverse the dollar's dominance. This will also pressure credit markets where dollar debt is prevalent and witness foreign direct investment move back to dollar assets creating further headwinds in the developing world. As an example, India has seen a significant reversal in foreign investment with \$33bn having left the Indian stock market since October 2021 with over \$6.3bn of outflows in June alone^{iv}.

Cross Asset Round-up

In summary, the second quarter left few asset classes unscathed and major equity and bond indices fell significantly with yield curves flattening once again. With very few places to hide the traditional balance portfolio of bonds and equities offered little security while traditional safe havens such as gold (-6.7%), general commodities (-3.3%), the Yen (-11.5%), the Swiss Franc (-3.5%) vs. the dollar all failed to support portfolios, and global listed real estate also lost 17.2% over the quarter. The inclusion of alternative funds in portfolios creating uncorrelated returns probably added protection producing a positive return over the quarter of 3.9% as represented here by the HFRX Global Hedge Fund Index in sterling terms, 5.5% year-to-date. **We remain wary of risk assets and continue to favour quality companies in the developed world until the remaining known unknowns become more certain.**

With very few places to hide the traditional balance portfolio of bonds and equities offered little security while traditional safe havens all failed to support portfolios.

The inclusion of alternative funds in portfolios creating uncorrelated returns probably added protection producing a positive return over the quarter.

ⁱ Barclays_Investment Outlook:Looking for Places to Hide_2022.06.23

ⁱⁱ Absolute Strategy Research_Investment Strategy_2022.06.24

ⁱⁱⁱ John Authers_Bloomberg Opinion_Points of Return_2022.07.06

^{iv} [Foreign investors dump record \\$33bn of Indian stocks since October | Financial Times \(ft.com\)](#)

Speculative Asset Bubble or Alternative Currency?

**By Richard Beggs, Investment Committee Member, at Hottinger & Co. Limited
11 July 2022**

Is the cryptocurrency roller-coaster of the past 24 months just déjà-vu, or are their reasons to adopt a more optimistic assessment of its future?

Since its birth there have been many claims about Bitcoin's attributes and uses.

Can Bitcoin be considered a currency or even a 'money substitute'?

Currency itself is not money, it simply represents the system of credit accounts and their clearing.

While today national money has next to no physical existence, in the time between the first minting of physical metal coins, metal coins and paper equivalents were by far the dominant form of 'money' around the world.

Recent extreme volatility in Bitcoin and other so-called cryptos has severely damaged its investment credibility and legitimacy as an alternative currency. Was the roller-coaster ride just another 'Tulip Mania' or is there still a future for Bitcoin and its cohorts?

According to Wikipedia, the tulip mania refers to a period during the Dutch golden age when contract prices for bulbs of the recently introduced and fashionable tulip reached extraordinarily high levels. The major acceleration started in 1634 and then dramatically collapsed in February 1637 and it is generally considered to have been the first recorded speculative asset bubble in history. Is the cryptocurrency rollercoaster of the past 24 months just déjà-vu, or are their reasons to adopt a more optimistic assessment of its future?

Since its birth there have been many claims about Bitcoin's attributes and uses. Aside from its role as a speculative digital investment, commentators and supporters have heralded it a medium of exchange, even a currency, as well as an inflation hedge. At this stage we can comfortably dismiss the latter claim as its value has collapsed over the past several months, a period over which inflation has delivered one of the largest upside shocks in history. Interestingly, the same can also be said of gold.

To the question of whether Bitcoin can be considered a currency or even a 'money substitute', the Oxford dictionary defines money as 'a generally accepted medium of exchange which enables a society to trade goods without the need for barter; any objects or tokens regarded as a store of value and used as a medium of exchange.'

Bear in mind that currency itself is not money, it simply represents the system of credit accounts and their clearing.

The history of money would indeed suggest that it most likely evolved from a primitive system of barter that relied upon a 'dual-coincidence of wants' to facilitate moneyless market transactions. In fact the actual concept of money as we know it dates back centuries to the island of Yap, where giant limestone discs called Fei were originally used as a medium of exchange. Importantly, the Fei wasn't Yap's money, it was the underlying principle on which crediting and clearing accounts were based, Fei are simply tangible tokens by which accounts were kept by their users.

While today national money has next to no physical existence, in the time between the first minting of physical metal coins in Lydia around 600BC, both met-

al coins and paper equivalents were by far the dominant form of 'money' around the world. Today, at least for many in mature economies, the only tangible aspect to monetary transactions is a plastic card and a keypad or a phone using biometric data. The 'relatively' recent introduction of credit cards has allowed consumers to engage in borrowing activities which have contributed to the high aggregate levels of debt seen in today's society.

In the timeline of money it is only in the last few seconds that cryptocurrencies have entered the picture. Introduced in 2009 by Satoshi Nakamoto, the creation of Bitcoin has engaged the attention of investors, advisors, and market regulators. However, the recognition of Bitcoin as a form of money remains a widely debated subject.

In order to be considered money a currency must adhere to three functions;

The first, and perhaps most important, feature is a common medium of exchange.

Austrian economist Karl Menger believed that communities have a propensity to gravitate towards using one single good as money. Once the people within a community begin to accept this good, not for consumption or production of goods, but for its expected use in indirect exchange, it gains weight as a form of money. In the past Fei, coins and paper money have all been widely accepted in exchange for goods and services within their regions of use. Nowadays, every national currency is, by law, the means of exchange inside the territory of the sovereign state which issues it.

Credit cards also perform this function, working in an 'I owe you' format. Bitcoin, however, fails to meet this criterion. As far as Bitcoin is concerned, it lacks backing. Research conducted by Coinbase reveals that in 2018 only 25 million bitcoin addresses worldwide are believed to be economically active wallets belonging to private individuals on the network. As things stand very few goods and service providers accept Bitcoin as a payment method. Today, Bitcoin might possibly be considered a minority currency, if at all. Nevertheless, its reach has increased exponentially. With this in mind Bitcoin has the capacity to become a dominant form of money, contingent on wider adoption by significantly more users.

The second is a store of value

Investors and institutions in the public and private sector need to own assets whose value is considered to be safe. Previously, both coins and the gold standard have been a very effective at providing a store of value as they hold value within themselves and are finite. Today, this is achieved in some but not all currencies. Since the end of WW11, the US dollar has been the world's main currency reserve, all countries accepting the US dollar due to its stable attributes. However, looking at countries for example Venezuela, where inflation of the Bolívar reached 1,000,000% demonstrates how a currency can be rendered

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The chart shows the dramatic loss of value this year in Bitcoin.

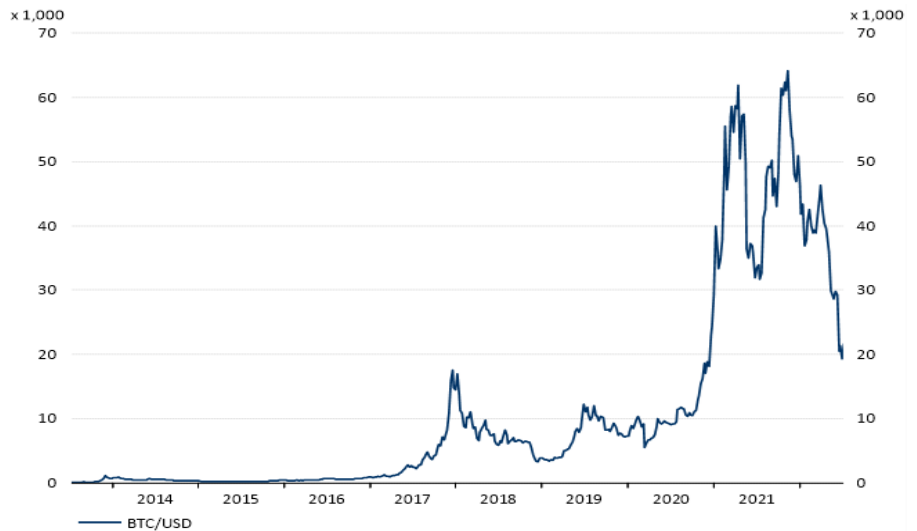
To be considered a unit of account, the good being used as money must be divisible, fungible and impossible to forge.

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Some similarities do prevail between gold and Bitcoin, both goods act as alternatives to fiat currencies both operating without government.

‘worthless’. Judging Bitcoin against this criterion, it is clear that it falls short of this quality, indeed its recent volatility and substantial loss of value (see chart) this year are far too dramatic to label bitcoin a consistent store of value.

As an alleged ‘store-of-value’ Bitcoin has proven to be anything but consistent



Source: Hottinger Investment Management & Refinitiv Datastream

The final quality is a unit of account

To be considered a unit of account, the good being used as money must be divisible, fungible and impossible to forge. Bitcoin does adhere to these conditions, each bitcoin can be divided up into a Satoshi (one hundred millionth of a bitcoin) each bitcoin is equivocal, and although not impossible, it is infeasible to forge a bitcoin.

Standard currencies and Bitcoin differ in a variety of manners. The main difference is that Bitcoin lacks sovereign government backing. Both currencies operate independently to the state. However, some similarities do prevail, especially between gold and Bitcoin, both goods act as alternatives to fiat currencies both operating without government. They are both ‘mined’ although in very different manners. They both have a finite quantity; 21 million bitcoins will have entered existence by 2140 and an estimated 250 tonnes of gold are currently in existence (25% of which remains un-mined).

Bitcoin does, therefore, appear to have some of the attributes required to be termed money: it is divisible, fungible, recognisable, portable, and can potentially be stored securely with relative ease. This aside, Bitcoin still faces two significant hurdles which hinder its monetary status. The first is the lack of a committed user, the support of a government appears to be an important feature for a curren-

cy's success and this is a support that currently does not exist for Bitcoin. The second is volatility, giving reason to believe that Bitcoin will retain a certain unpredictability compared to fiat currency. Currently, governments may intervene to stabilise a fiat currency, manipulating the supply of their chosen currency to keep in line with demand. Due to its decentralised feature, Bitcoin lacks this attribute.

At this point the odds seem firmly stacked against cryptocurrencies as making it further than being an investment fad. However, the evolution of money and currencies has never been rapid and there still remains a chance that we could yet all be buying our goods and services with them in the years to come. In the meantime, investors should tread carefully.

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