Quarterly Report
Q1 2022

Different Shades of Black Swan

APRIL 2022

STONE BRIDGE CAPITAL
HEDGE FUND

Q1 2022:

Different Shades of Black Swan

Dear Investors,

The profound changes in the global economy we are experiencing are likely to unleash a large number of secular trends. These are long-awaited and predicted early-stage structural shifts, driven by decades of “simple” money-making policies and record levels of debt-to-GDP ratios. The current global macro imbalance, which is unparalleled in recent history, has crucially distorted market perceptions of value and risk. This situation is only a prelude and will be a breeding ground for significant changes in the allocation of portfolios, from overvalued assets to disfavored and historically cheap alternatives. For investors who know how to read between the lines, this is – and will be – one of the best times ever.

The historical global debt-to-GDP ratio, the extreme valuation of financial assets and the global scarcity of resources represent an explosive mix of economic imbalances on a global scale, which are still in the early stages of major market movements. The escalation of geopolitical tensions, rising inflationary pressures and the collapse of stock and bond markets are the catalysts for the coming changes in our investment topics. The global stock, bond, commodity and foreign exchange markets currently offer enough opportunities for growth and wealth protection in a whirl of chaos in both top-down and bottom-up macro models.

We are pleased to inform you that, during the first quarter of 2022, we delivered a strong absolute return, as well as strong relative return, since the financial markets suffered losses on almost all fronts due to high volatility. Our strategies brought an increase of +5.21%, while the shares weakened by -4.91% over the same period.

Everything connects to everything else

As follows from our philosophy, predicting the course of events today is a matter of survival. A variety of scenarios revolve around our stories and investment themes, which we work with in detail in our proprietary research. On behalf of the entire STONEBRIDGE CAPITAL team, we invite you to gain insight into alternative thinking. We will provide you with a rough outline of how everything connects to everything else.

A rise in geopolitical tensions led to an increase in defence expenditures, which rose from historically low levels measured as a fraction of US GDP. This trend is of global character and will impact public debt levels, innovation and economic growth. The deglobalization process will trigger the long-awaited resumption of production in advanced economies, which will shift manufacturing back home or to nearby markets. At the same time, the countries of the West will continue with one of the largest fiscal programs in history, driven by the Green Revolution, especially in energy, social equality programs, infrastructure renewal and the aforementioned defense spending.

The forces mentioned above will place enormous pressure on government budgets and the struggle for resources, which means we are at the beginning of a commodity super-cycle. The thesis is further supported by the fact that the commodity sector has suffered for too long from a chronic lack of investment in infrastructure and new deposits. Government deficits and debt burdens will increase, due to a lack of political will to cut spending as well as the ambition of government elites to retain their power.

These factors will exacerbate persistent inflationary pressures, which will result in a worldwide rise in long-term interest rates. Business profitability will decline, due to rising cost of capital, labor and input prices. Commodities and alternative investments will once again show enormous importance in complementing traditional 60/40 portfolios as hedges against inflation and capital protection, confirming our thesis of high-value rotation and a multi-strategic approach.

Q1 2022: A quarter unprecendented in the past 40 years

Investors – especially passive investors whose portfolios consist only of equities and bonds – did not have the possibility of "the shelter". In Q1 2022, all major segments of these two asset classes ended the quarter in negative territory.

Among the four major US asset classes (equities, government bonds, investment-grade corporate bonds, and speculative-rated corporate bonds or so-called "junk bonds"), the "best" investment was equities, which lost "only" -4.91%. Other asset classes ended the quarter even more poorly. This kind of performance across the top four classes last occurred in 1980!

On the other hand, commodities, which have been on the sidelines for a long time, grew by +25.45% in Q1 2022. Nevertheless, commodities still do not enjoy major focus by institutional capital.

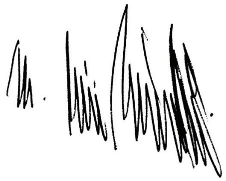
Different shades of black swan

Not long ago, we were evaluating Q4 2021 and 2021, the year we referred to as *The Year of Transformation*. As we have remarked, the transformation is only at its beginning and may last up to a decade. Today, unprecedented systemic risks are associated with the transformation process that will result in a new era in our history.

We can divide these risks into two groups: the ones we recognize and the ones we don't, including those that are highly probable and those that may be surprising. However, there will always be unknowns, and it is not daring to say that the flock of black swans will arrive during this decade. Risk management has always been an essential part of our process. It allows us not to look at events as black or white. After all, black is only a shade of an infinite spectrum of colors that can be constantly analyzed, combined, and customized.

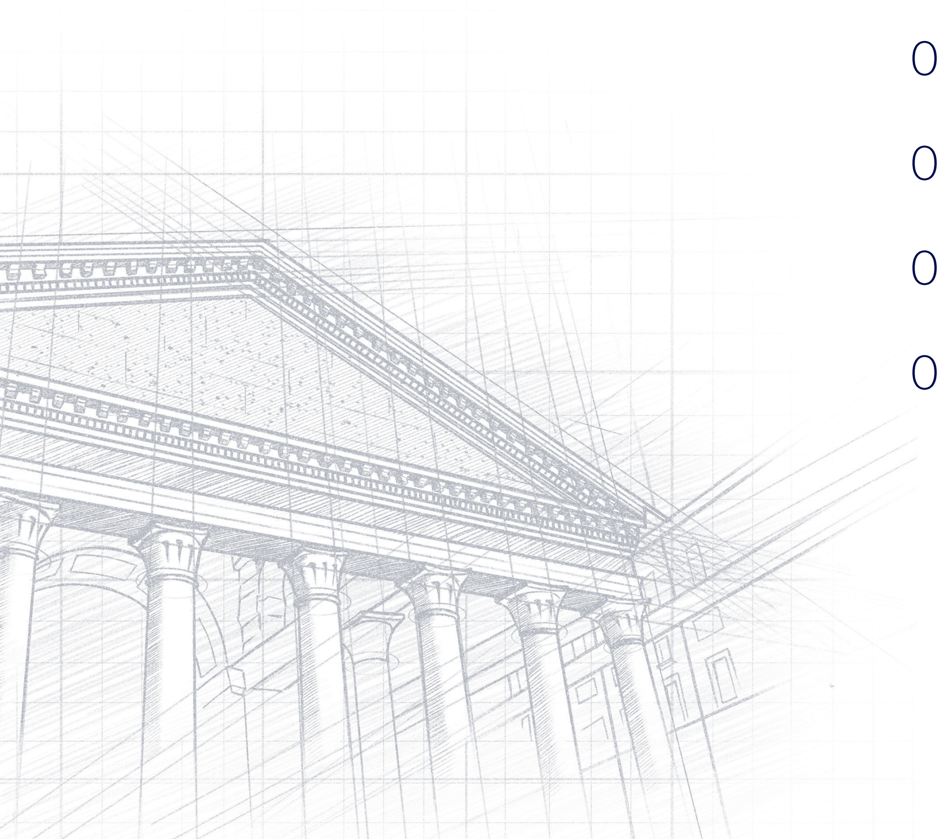
Knowing that black is only a controllable result of a broad-spectrum game, where the main player is our view of events, we can say with confidence that each black swan will have a number of different color shades. We thus perceive the events of black swans as a combination of multicolored scenarios, to which it is possible to react in time and correctly, even before they happen. That is for our non-transferable experience from the crisis years which we embrace with humility, determination and courage.

Adapting to turbulent situations is a fundamental feature in our decision making and creating investment strategies that ensure we are on the side of the winners, even through challenging periods. After all, the greatest works were always created in the most difficult and gloomy of times...



Martin Pitoňák,
Chief Execution Officer

Content



01

Highlights

Russia-Ukraine Conflict

The entry of Russian troops into the territory of Ukraine has caused a significant overestimation of risks on the financial markets.

Commodity Markets Experienced a Systemic Shock

The military conflict has caused a significant deviation from the price equilibrium of several commodities.

Inflation in US Highest Since 1982

Consumer prices increased by **+8.5%** year-on-year. Core CPI **+6.5%** is at a 40-year high. We can assume a more pronounced tightening of monetary policy.

QE Has Ended, Supporting Market Volatility

The Federal interest rate increase of 0.25 percentage points and the end of QE have created conditions for the market volatility growth.

Unemployment Rate of 3.6%

The low unemployment rate indicates the approaching peak of the economic cycle. Currently, the labor market still supports economic expansion.

Large Sectoral Rotation in Full Swing

The Dow Jones Industrial Average overtook the tech-heavy NASDAQ as investors move to value stocks.

02

Macroeconomic Overview

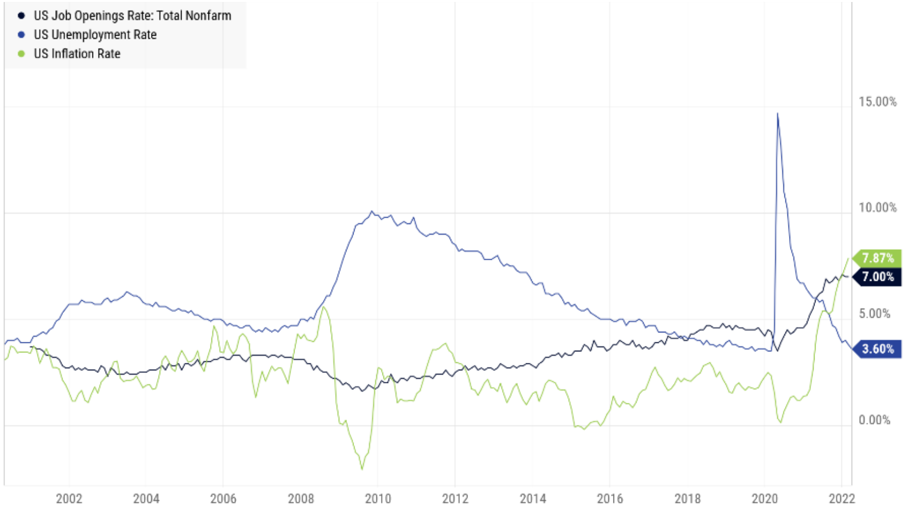
Unemployment, inflation, and GDP in the US point to fading growth in the US economy during Q1 2022

Price increases and a low unemployment rate indicate the approaching peak of the economic cycle. A similar signal is sent by the PMI, with a picture of economic expansion gradually weakening. The decline in the stock market during Q1 2022 points to a less favourable macroeconomic future, caused by the conflict in Ukraine and the tightening of liquidity.

Rising inflation rates and the conflict in Ukraine were the biggest scarecrows for the further economic growth in Q1 2022. The labour market, with an unemployment rate of 3.6% and an open positions rate of 7.87%, indicate economic expansion. There was a difference of 3.621% between the rate of wage growth and inflation at the end of Q1 2022 (*as compared to the long-term average of 1.659%*). The dollar index grew, too, indicating the strength of the US dollar and the US economy.

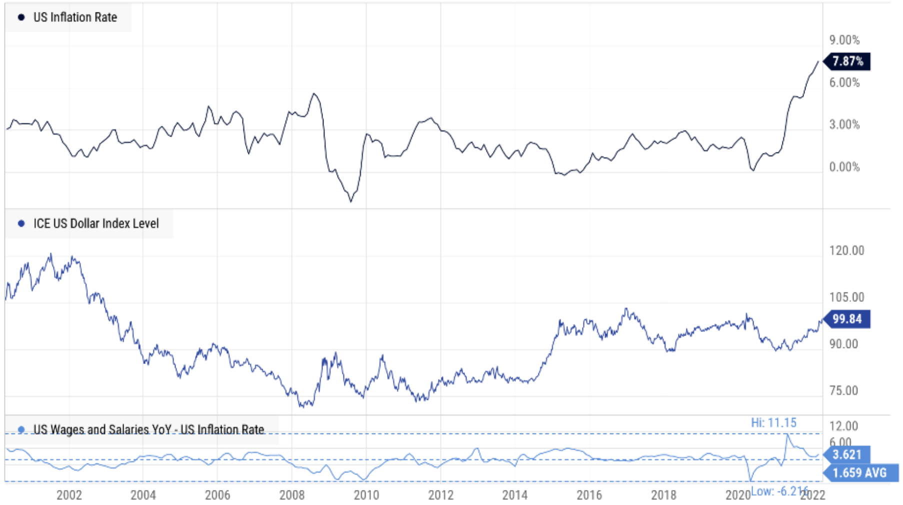
It is clear that the economy is starting to overheat, which is reflected in the growing – and record – inflation of 8.5% *(on a year-over-year basis at the end of Q1 2022)*. **High inflation is a typical sign of the late-stage of economic expansion, as well as the peak of the economic cycle.**

Chart No.1 New job vacancy growth rate, unemployment rate and inflation
Time range: *Since 2000*



Source: YCharts

Chart No.2 Inflation rate, dollar index and difference in wage and price growth
Time range: *Since 2000*



Source: YCharts

The Purchasing Managers' Index (PMI) in the manufacturing sector points to the continuing expansion of the economy ***(March 2022 was the 22nd consecutive month of growth, according to the PMI.)*** Economic activity continues to grow, but the pace of growth is slowing down by a gradual decline in the PMI throughout Q1, **which can be considered a warning sign.** The growth of the subcategory of prices seems problematic: The inter-quarter prices, according to the PMI, rose significantly (March reading 87.1), **but this price growth is not sustainable. In other words, inflation has a price, and that is lower demand.** According to the PMI in Q1 2022, new orders and production slowed significantly.

After a record year in 2021, in terms of the expansion of economic activity, we can see regression to the mean. The increased volatility in subcategories of PMI readings during 2021 decreased significantly by the end of Q1 2022, as did the PMI readings in manufacturing, **suggesting that economic expansion is slowing.**

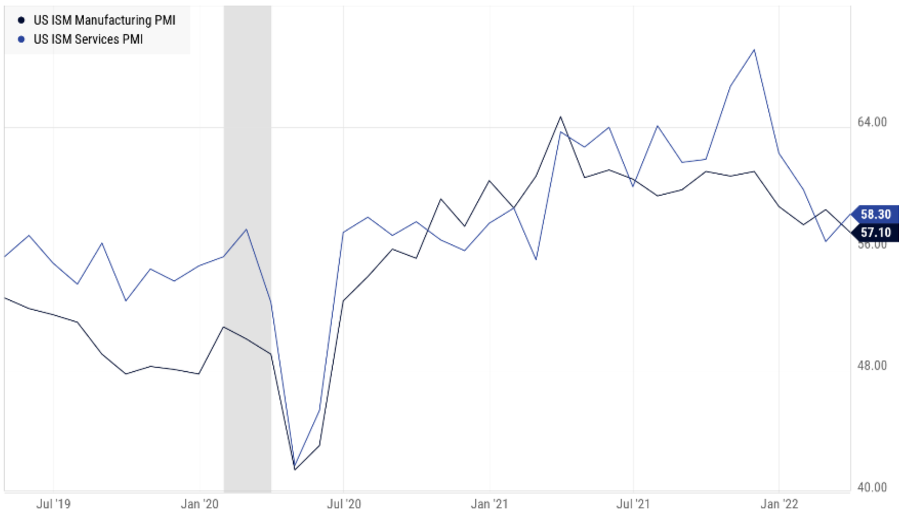
Table No.1 Growth rate of subcategories of the PMI in manufacturing
Time range: *Q4 2021 – Q1 2022*

Index	Q4 2021	Q1 2022	Growth pace
PMI Manufactory	58,7	57,1	Slows down
New orders	60,4	53,8	Slows down
Production	59,2	54,5	Slows down
Employment	54,2	56,3	Speeds up
Supplies	64,9	65,4	Speeds up
Stock	54,7	55,5	Speeds up
Customer inventory	31,7	34,1	Speeds up
Prices	68,2	87,1	Speeds up
Pending orders	62,8	60	Slows down
New export orders	53,6	53,2	Slows down
Import	53,8	51,8	Slows down

Source: ISM W.org

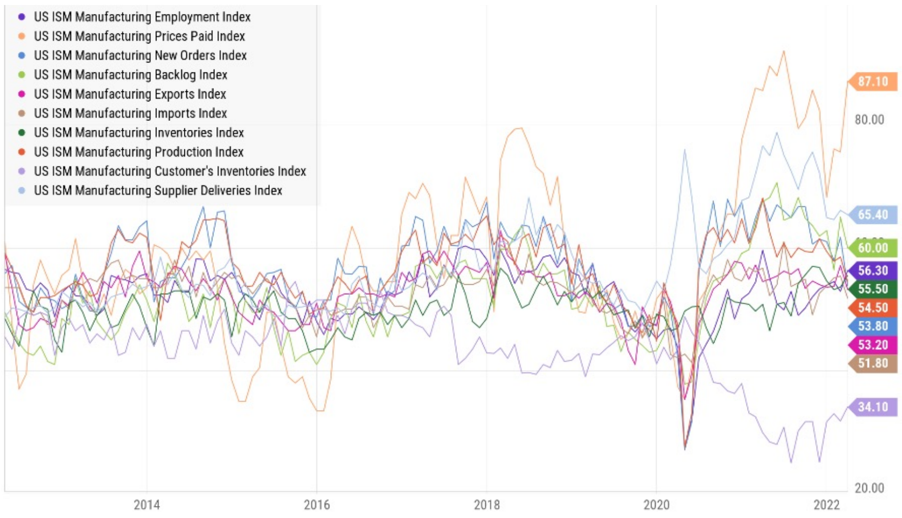
> The principle of regression to the mean has been confirmed by the reading of US real GDP that reached a quarter-over-quarter level of -1.40%.

Chart No.3 Development of the PMI focused on manufacturing and services
Time range: *Beginning of 2020*



Source: YCharts

Chart No.4 Comparison of Purchasing Managers' Index subcategories in manufacturing
Time range: *Beginning of 2020*

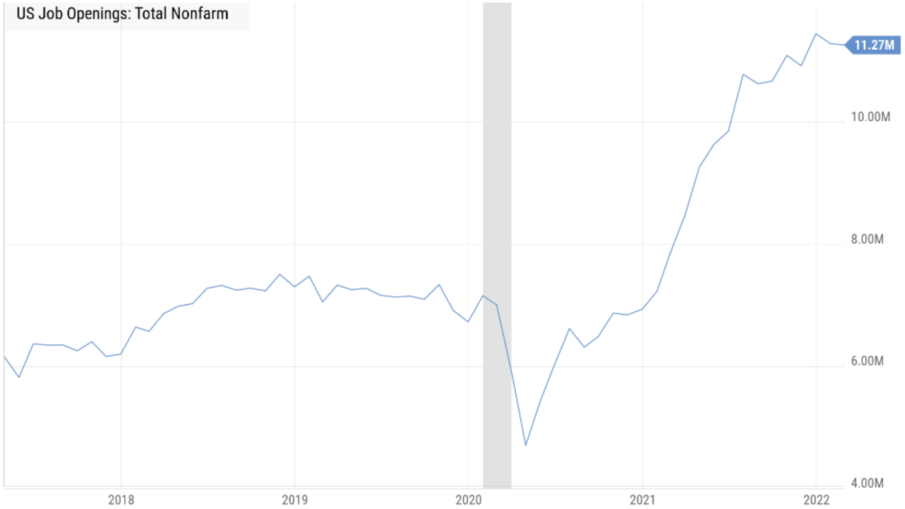


Source: YCharts

US unemployment stands at 3.6% (*pre-pandemic level was 3.5%, historical average from 1948 to 2022 is 5.75%*)

Low unemployment indicates economic growth. The record number of job vacancies combined with the low unemployment rate puts pressure on wage growth, which may be inflationary.

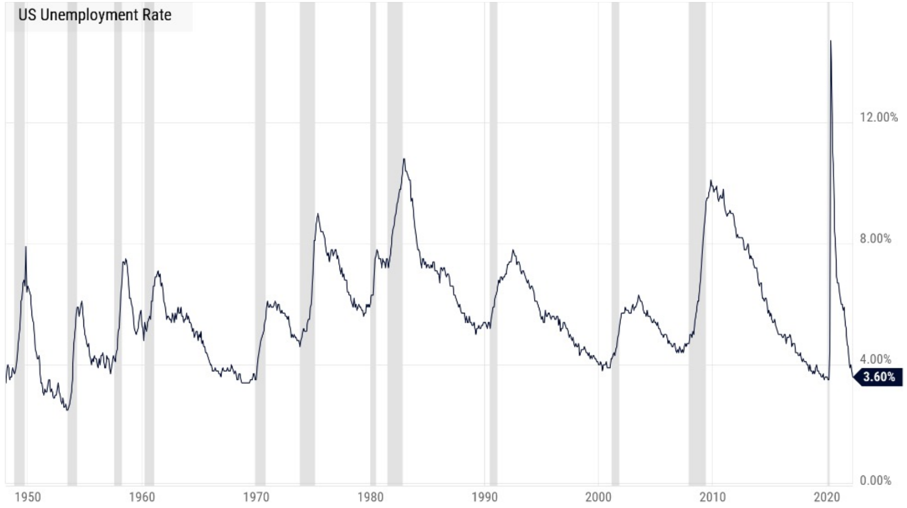
Chart No.5 Number of vacancies
Time range: *2017-2022*



Source: YCharts

The number of job vacancies in the US surpassed 11 million during Q1 2022, while the unemployment rate fell to 3.6% (*6 million*). **High demand for workers and simultaneous declining supply are pushing for wage growth.** The FOMC often points to the labour market development because the Fed's mandate is focused on inflation and unemployment. However, it is clear that the stabilization of the inflation will be the Fed's main objective in the near future.

Chart No.6 Evolution of the US unemployment rate
Time range: *2017-2022*



Source: YCharts

The low unemployment rate (3.6%) combined with inflation (8.5%) points to the overheating of the economy, which is a typical sign of the peak of the economic cycle. As history shows, recessions tend to follow periods of low unemployment rates.

Price growth in Q1 2022 accelerated and reached the level 8.5% on the year-over-year basis

The inflation rate is enormous, and a similar price growth last occurred in December 1981. Accelerating inflation increases the probability of a more aggressive interest rate hike.

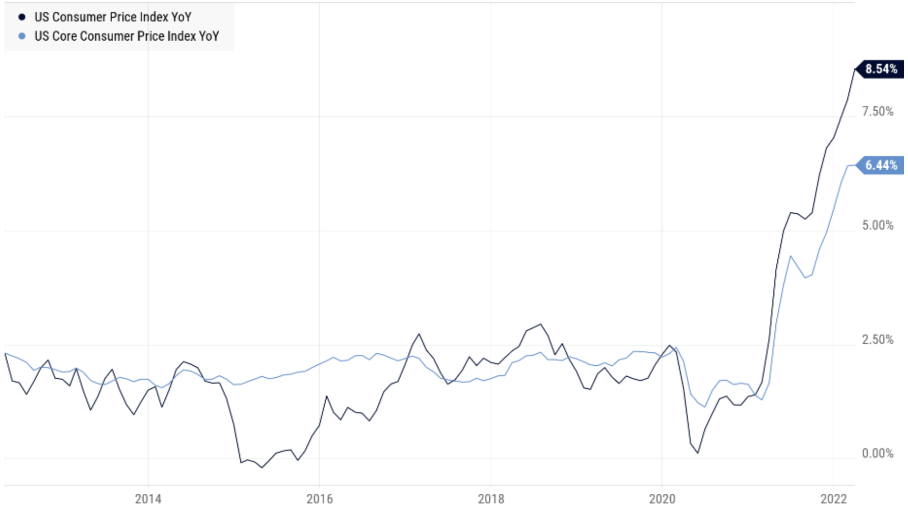
US price growth continued to grow significantly, ending Q1 2022 at 8.5%. The monthly inflation rate (CPI) was 0.6% in January, 0.8% in February and 1.2% in March. **The most significant growing component of the CPI was energy prices, with year-over-year growth of 32% in Q1 2022!**

The core inflation rate reached a year-over-year high of 6.5%, with monthly price increases of 0.6% in January, 0.5% in February and 0.3% in March. It is clear from the structure of the CPI that the growth of fuel prices (particularly gasoline) as well as housing and food were the most pronounced contributors to growth in the index.

Overall consumer price growth as of March 2022 increased +8.5% on a year-over-year basis, while the month-over-month increase in price growth was +1.2%.

Chart No.7 CPI inflation and core inflation in the US

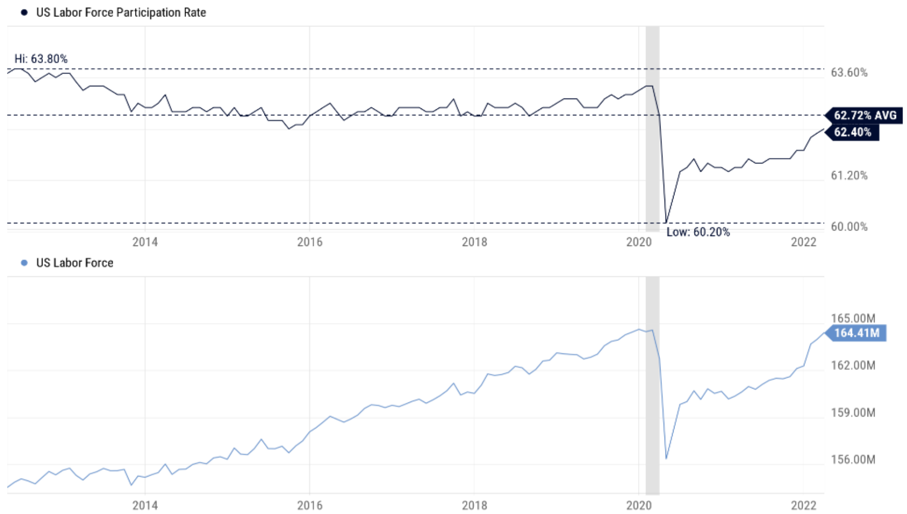
Time range: *2012-2022*



Source: YCharts

Chart No.8 CPI Labour participation rate and absolute number of workers

Time range: *2012-2022*



Source: YCharts

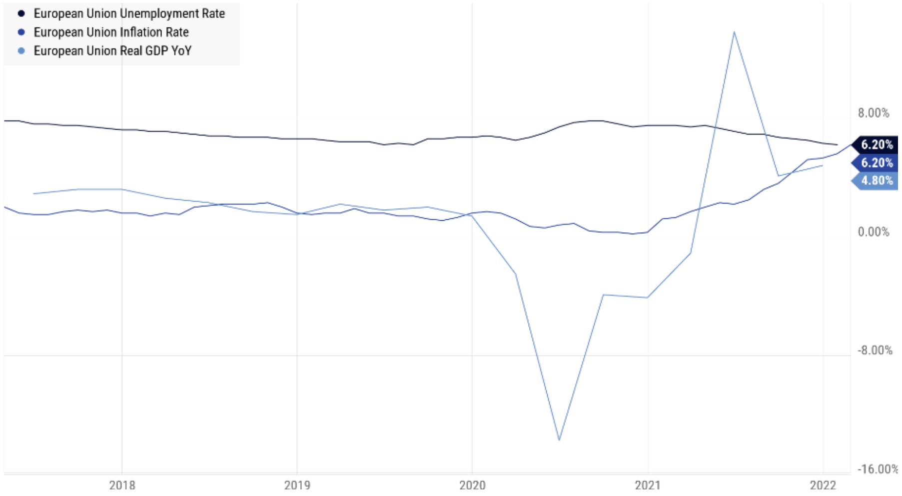
Macroeconomic data in EU a Eurozone

The unemployment rate in the EU followed a downward trend, reaching 6.2% at the end of the quarter. The last reading of GDP in Europe (*in Q4 2021*) achieved a year-on-year growth of +4.8% and the inflation rate accelerated to 6.2%.

Throughout 2021, inflation in Europe rose. Its acceleration in 2022 was caused predominantly by the rise in energy prices (*mainly oil and gas*) and by the ECB's policy (*as QE continues*). Europe's energy dependence – particularly its dependency on Russia – is well-known. This is why energy prices in the EU are responding strongly to the war conflict. At the same time, Europe's economy is more industrially-based ***(25% of GDP and 18% in the US)***; therefore, Europe is more vulnerable to rising commodity prices.

Chart No.9 Comparison of the unemployment rate, the inflation rate, and the real GDP growth in the EU

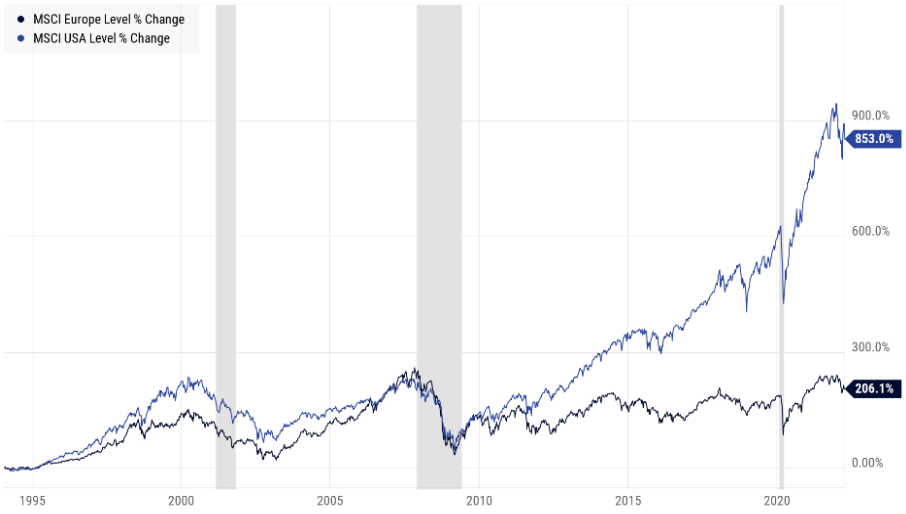
Time range: *2017-2022*



Source: YCharts

Chart No.10 Comparison of MSCI Index of Europe and USA

Time range: *2017-2022*



Source: YCharts

The MSCI of Europe has not recorded a strong increase, unlike the US. European capital markets developed similarly to US markets until 2010. **Since 2010, there has been a significant divergence.** In the long term, Europe is experiencing a similar situation to Japan's experience from the 1990s onward, coupling low inflation with low nominal interest rates (*potentially indicating the theory of Neo-Fisherism*). **The reason for this is the comparatively lower robustness, diversity and flexibility of economies on the European continent.**

> As of Q1 2022, the inflation rate in Slovakia reached 9% - the highest rate in the past 17 years.

03

Monetary Policy

In Q4 2021, the FOMC decided to end the QE programme of $120 billion

The end of QE was declared in November 2021 and was anticipated by the market. Finally, in March 2022, there was an increase of 0.25 percentage points in the Federal interest rate.

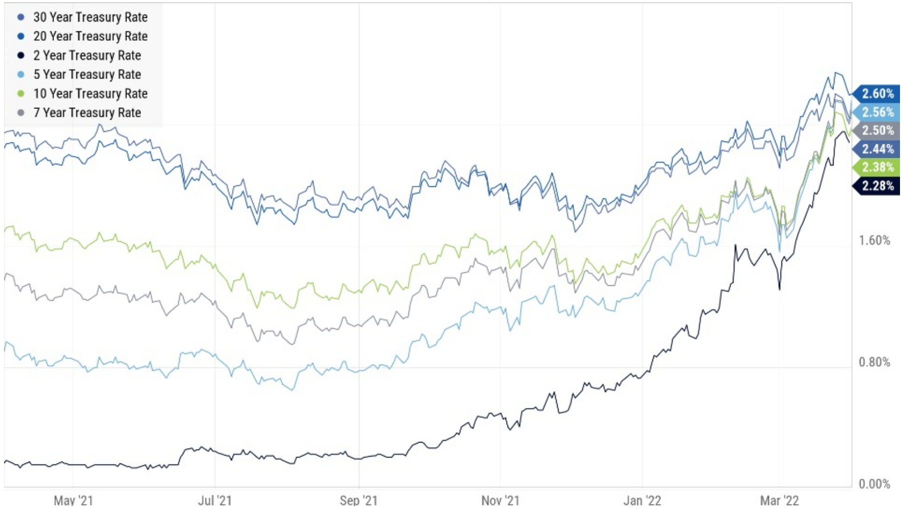
In the November meeting (Q4 2021), the FOMC announced a monthly slowdown of asset purchases (***$15bn***) under QE. The pace of QE's decline was recalibrated to **$30bn in December 2021, with the forecast of a complete halt of purchases in March 2022.**

Table No.2 Progress of the QE programme before its completion in March 2022
Time range: *November 2021 – March 2022*

Before QE's slowdown, ≥ $120bn	Level	Pace of decline
November	$105	$15
December	$90	$15
Recalibration QE (+$30)		
January	$60	$30
February	$30	$30
March	$0	$30

Source: FederalReserve.gov

Chart No.11 Yields on government bonds with different maturities (30, 20, 10, 7, 5, 2 years)
Time range: *Last year*



Source: YCharts

Chart No.11 illustrates the development of government bond yields with a maturity of 2 to 30 years. During Q4 2021, the yield on a 2-year government bond *(dark blue curve)* grew most rapidly. During Q1 2022, the bond yield growth accelerated, yields on individual maturities converged, and, by the end of Q1, there was **an inversion of 2Y and 10Y bond yields.** By aggregating all available information, the bond market **is gradually appreciating a further increase in interest rates by increasing bond yields.**

The level of yield on a 2Y bond, compared with the effective Federal Funds rate, indicates a mismatch between the monetary policy stance *(or its main instrument, which is the interest rate)* and the bond market's perception of the inflation rate, as well as the growth outlook. **This indicates a further increase in interest rates. In other words, the Fed is right behind the curve.**

Monetary policy normalisation began in Q4 with the QE programme slowing down and accelerated with the Federal Reserve raising its policy rate

Normalisation of monetary policy and the indicated reduction of the Fed's balance sheet may lead to a turbulent period in the next quarters of 2022.

An analysis of the Fed's balance sheet, as seen in ***Table No.3***, shows a quarterly increase of $247 billion, bringing the total level of balance sheet to about **$8.99 trillion.** The central bank's slowing demand for bonds may cause an increase in bond yields in the primary market. The growth of bond yields in the primary market is directly related to the inflation rate **(and inflation expectations)**.

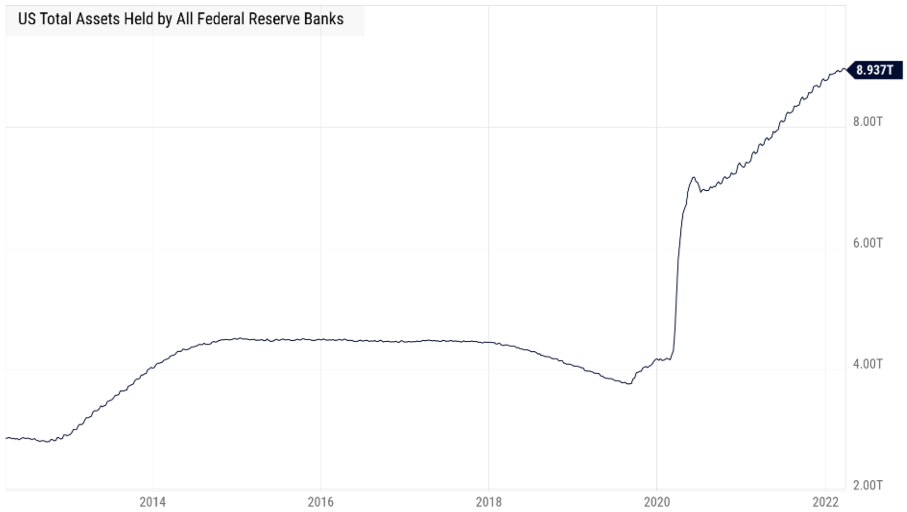
Table No.3 Basic structure of the Fed's balance sheet by the end of Q2 and Q3 2021 (*in millions*)

Assets	Q4 2021	Q1 2022	Annual Change
Securities	$8 289 331	$8 480 677	$191 346
U.S. Treasuries	$5 651 960	$5 759 706	$107 746
MBA	$2 635 024	$2 718 624	$83 600
SUM Assets	**$8 741 648**	**$8 989 632**	**$247 984**

Source: FederalReserve.gov

The increased inflation rate is pushing up inflation expectations and therefore may increase inflation over time. Despite the existence of a correlation between the interest rate and the rate of inflation, there is no absolute consensus on their mutual causality (*i.e.*, a clearly defined cause and an effect). **The causality of variables is crucial in modelling inflation because, in spite of conventional wisdom, raising interest rates may lead to an increase in inflation rates, as Neo-Fisherism assumes.**

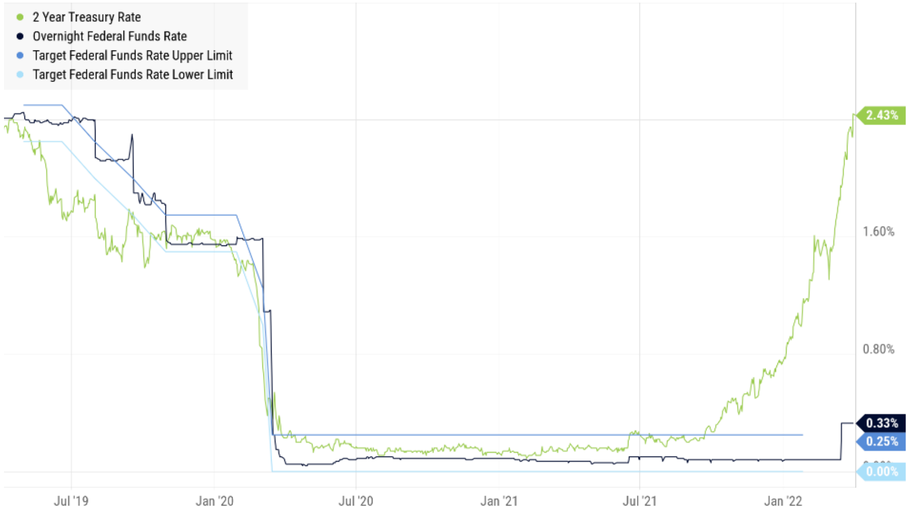
Chart No.12 Absolute amount of the Fed's balance sheet by the end of Q1 2022
Time range: *2003-2021*



Source: YCharts

Chart No.12 illustrates the long-term development of the Fed's balance sheet. During 2014, the QE programme slowed down, and the balance sheet level declined at a much slower pace vs. the increase. We assume that the normalisation of the Fed's balance sheet will be a gradual and long-term process, with a rather negative effect on the stock market. (See *more in our research analysis: Debt: The Vicious Circle, 2021*).

Chart No.13 2Y government bond yield rise indicates further rise in FFIR
Time range: *1992-2022*



Source: YCharts

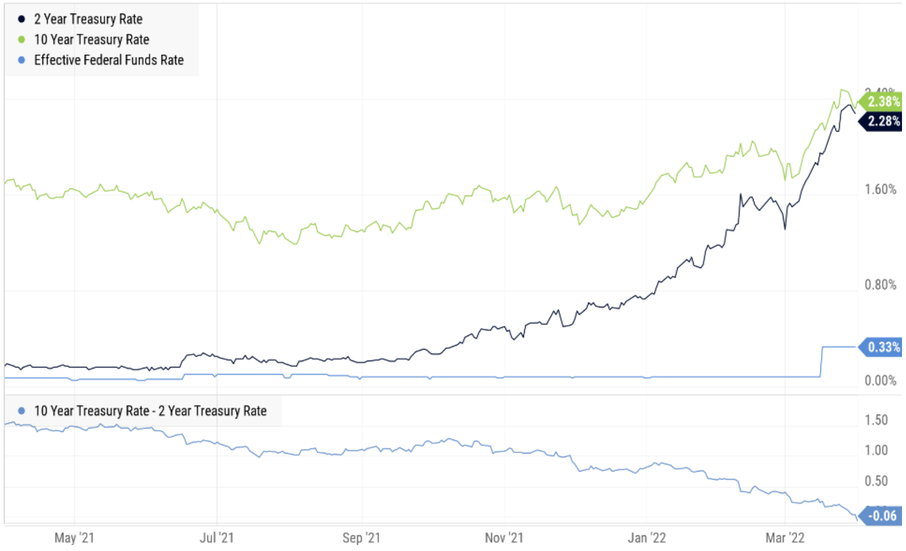
According to ***Chart No.13***, the evolution of the level of a **2-year government bond strongly correlates with the Federal interest rate development.** In Q1 2022, we observe a significant difference (of approximately 2 percentage points) between the bond market and the federal funds interest rate, implying that the Fed significantly lags behind the interest rate on the bond curve, which indicates a different view of the Fed vs. the market on inflation.

Given the Fed's changing rhetoric in terms of inflation, further and possibly stronger federal interest rate growth can be expected. (**Currently, the most likely increase of 0.5% will be in early May 2022**).

The March increase in the federal interest rate of 25 basis points has a more significant impact on 2Y bond yield compared to 10Y, so the gap between them is decreasing (***by 79 points, by Q4 2021***). By the end of Q1 2022, it reaches a negative value of -6 points.

In the US, interest rate rises will change inflation expectations and debt dynamics. Interest rate hikes encourage debt at the beginning of the monetary policy tightening cycle. We assume that US inflation will gain momentum in the short term.

Chart No.14 Interest rate hike signals rise in 2-year government bond yield
Time range: *2021*



Source: YCharts

The inversion of 10Y and 2Y yields is a risk signal. It indicates a slowdown in the economic growth and a possible recession.

In 2021, the debate about consequences of higher inflation rates was dominant, persisting throughout Q1 2022

The conflict in Ukraine and its impact on commodity prices reinforce the thesis of higher inflation rates during 2022. As historical events show, a lower equity risk premium is the fundamental implication of a positive inflation cycle and surprise inflation.

The cyclically-adjusted earnings yield (1/CAPE ratio, inverse P/E ratio) closed Q1 2022 at 2.65%, and a 10-year government bond at 2.38%. The difference in indicators (%), i.e. **(1/CAPE ratio) – 10Y Treasury, is a risk premium for shares.**

As seen in the ***Chart No.15***, there is a shrinking gap between the cyclically-adjusted stock yield market (**represented by the S&P 500 stock index**). The 10Y US government yield (***2.65% - 2.38% = 0.27%***), reached more than 1% level at the beginning of 2022. **The stock risk premium also decreased during Q1 2022. We assume that the decrease in the stock risk premium is a negative signal to the stock market.**

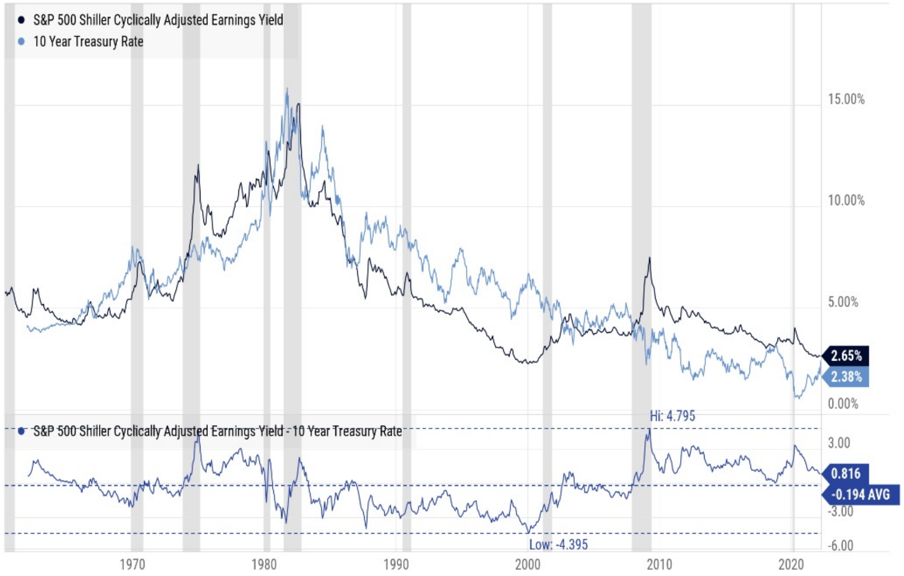
Historically speaking, the equity risk premium in 2000 was **the lowest in 60 years (-4,395%).** Investors were able to buy a 10-year government bond in 2000 with a yield of 6.5%, but the earnings yield was only 2.1% ***(2.1% - 6.5% = -4.4% equity risk premium)***. **The bonds were clearly a more profitable investment at the time, which is why shares subsequently slumped.**

In 2021, investing in shares was a more advantageous option compared to the bond market, since the stock market achieves a positive premium for stock risk. This given fact changes as the economic cycle develops.

We assume that the increased inflation rate (**8.5%**) and the related interest rate hikes (***by the end of Q1 of 2.4%***) increase the probability of a stock yield falling below the government bond yield level.

In the short term, the Fed lags behind the bond curve and the stock risk premium is positive. Given the anchoring of inflation expectations, a stronger tightening of monetary policy can be expected at the moment ***(25 b.p. an alternative, 50 b.p. is unlikely to be the most probable scenario)***.

Chart No.15 Stock premium (1/CAPE ratio) – 10Y Treasury yield
Time range: *1962 – Q4 2021*



Source: YCharts

04

Fiscal Policy

Quarterly growth (*Q4 2021 vs. Q1 2022*) of public US debt of $783 billion.

The quarterly increase in US public debt points to a slowdown in debt, compared to the previous quarterly change ($1190 billion). Total US government debt surpassed $30 trillion in Q1 2022, and the average interest expense was 1.482 percentage points.

Table No.4 Average interest expense of different government bonds (by the end of 2021 and Q1 2021)

Time range: *November 2021 – March 2022*

Treasuries	31.12.2021	31.03.2022
Treasury Bills	0,071	0,329
Treasury Notes	1,401	1,411
Treasury Bonds	3,028	2,999
TIPS	0,426	0,421
FRN	0,145	0,642
Total Interest-Bearing Debt	**1,432**	**1,482**

Source: TreasuryDirect.gov

Table No.5 Development and structure of US government debt (quarterly comparison)

Time range: *Q4 2021 - Q1 2022*

US government debt ($ trillion)	Intragovernmental holdings	Debt held by the public	Total government debt
4Q 2021	6,473	23,143	29,617
1Q 2022	6,521	23,879	30,400
Quarterly change	**0,048**	**0,736**	**0,783**

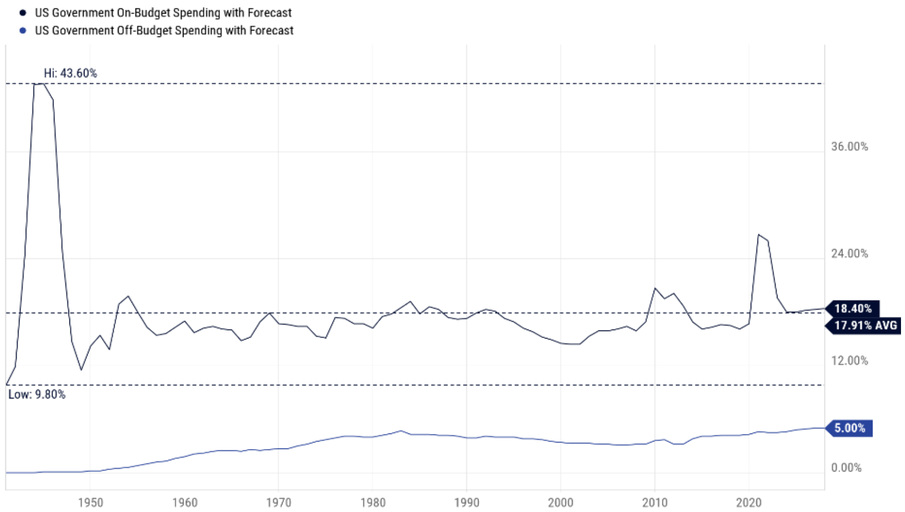
Source: TreasuryDirect.gov

The average interest on government debt as of Q1 2021, was **1.482%**, according to US Treasury Department data. The lowest average cost of negotiable government debt (**+0.329%**) is associated with the issuance of short-term bonds with a maturity of up to 1 year (***Treasury Bills***).

A reduction in the average cost of debt financing is a positive consequence of the QE programme for the US government. At the moment, the opposite process is taking place, and as a liquidity gradually tightens, interest costs ***(governments, households and corporations)*** **will increase. Despite the end of QE, interest rates remain at very low levels in the context of historical data.**

Chart No.16 Government spending as a share of GDP

Time range: *1940 – 2027*



Source: YCharts

Chart No.16 aptly describes the enormous US fiscal support following the Covid-19 outbreak. During the given period, US government spending accounted for more than 26% of GDP, of which the economy and stock markets benefited throughout 2021. Economic growth continues in 2022, but at a slower pace.

The conflict in Ukraine will accelerate the process of deglobalization

The conflict in Ukraine will accelerate the process of deglobalization and the widening ideological gap between the Western and Eastern powers.

Russia is turning its attention to the East and Europe to the West. The issue of US monetary domination and the gradual weakening of the status of the reserve currency is highly relevant. The conflict in Ukraine has clearly highlighted Europe's vulnerability and energy dependence on Russia.

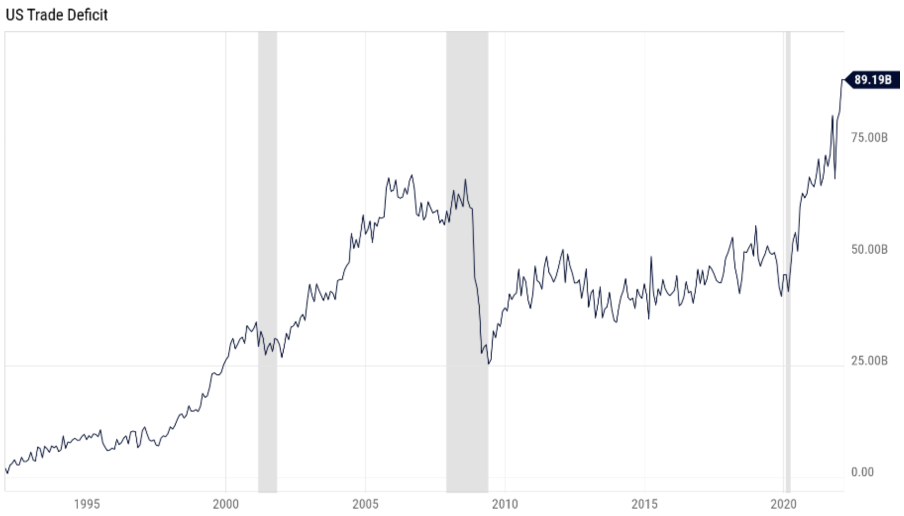
In an effort to de-dollarize the world, Russia is seeking to sell oil or gas to Europe in rubles, to India in rupees and to China in yuan. In Q1 2022, OPEC showed an unwillingness to produce more oil, so that rising supply ***and relatively stable demand*** led to a fall in the price. **With Biden in office, the US began (in Q1 2022) to release oil from its strategic reserves at 1 million barrels per day (equal to 1.25% of the world's daily production) for the next 6 months. This is due to efforts to lower inflation and fuel prices.** China continues to buy natural gas and commodities from Russia.

Economic cooperation between Russia and China is developing in the form of a pipeline construction (***Power of Siberia-2)***. During Q1 2022, Reuters reported the 30-year contract for gas supply in EUR through the Power of Siberia-2 pipeline. **The payment in euro is an essential geopolitical signal and may accelerate the weakening of the US reserve currency status.** That reserve status, and especially the dollarization of global commodities markets, has supported the US in multiple ways, such as making imports easier for US buyers and increasing demand for USD-denominated assets, including government debt.

Chart No.17 Daily world oil production (1973-2021) in millions of barrels
Time range: *1973 – 2021*

Source: YCharts

Chart No.18 US trade deficit (85.19 billion)
Time range: *1992 – 2022*



Source: YCharts

05

Problems With China’s Zero-Covid Policy

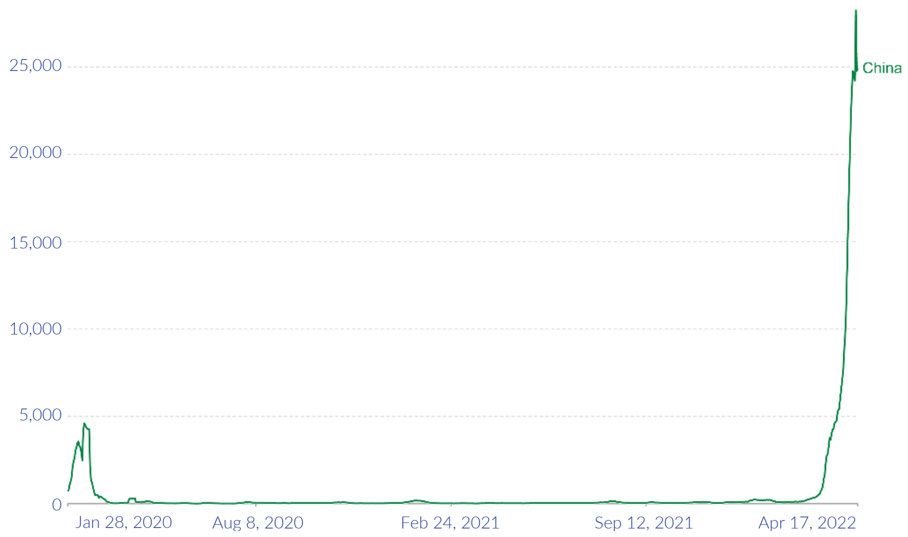
In March, the spread of the Omicron variant in China accelerated, and the Chinese government responded by enforcing lockdowns.

China’s financial hub (Shanghai), its technology corridor (Shenzhen) and its industrial center (Jilin) are all in strict curfew mode.

The Chinese government’s restrictive measures to prevent greater infection rates comes at the cost of social and economic damage. This provides drag in the driving force of the world economy and points to a further slowdown abroad.

The zero-covid policy that China had applied throughout 2021 began to show its shortcomings: **The population has not reached herd immunity is still susceptible to new variants.** Lower efficiency of local vaccines against the Omicron variant is one of China’s disadvantages.

Chart No.19 Daily number of new Covid cases
Time range: *Beginning of Pandemic*



Source: John Hopkins University CSSE COVID-19 Data

06

Market Overview

Global stock markets experienced the second worst start to the year in 123 years of history

The first quarter of 2022 began with a sharp decline in stock markets. In its first three weeks, the S&P 500 index lost -11.45%. The tech-heavy Nasdaq fell -16%, but the industrial Dow Jones fell only -8.77%, confirming our thesis of **value rotation.**

The quarter was driven by pessimistic investor sentiment that was associated mainly with the **appreciation of risks in the context of the Russia-Ukraine conflict and the appreciation of interest rate increases.**

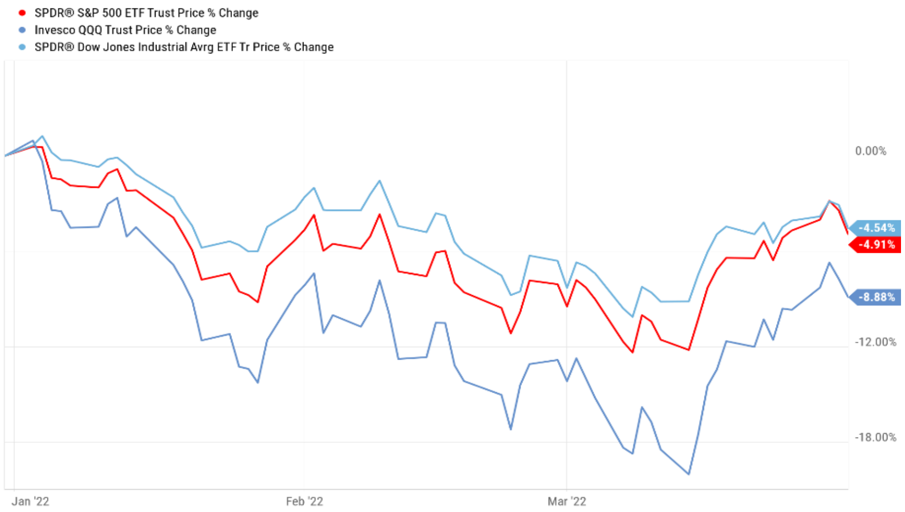
A positive sign appeared only on March 15, when the market appeared to correct against an earlier overreaction to monetary policy announcements, and the risk of the conflict moving beyond Ukraine's borders decreased.

Table No.6

	S&P500	Nasdaq	Dow Jones
Q1 2022	-4,91%	-8,88%	-4,54%
2021	27.04%	26.81%	18.81%

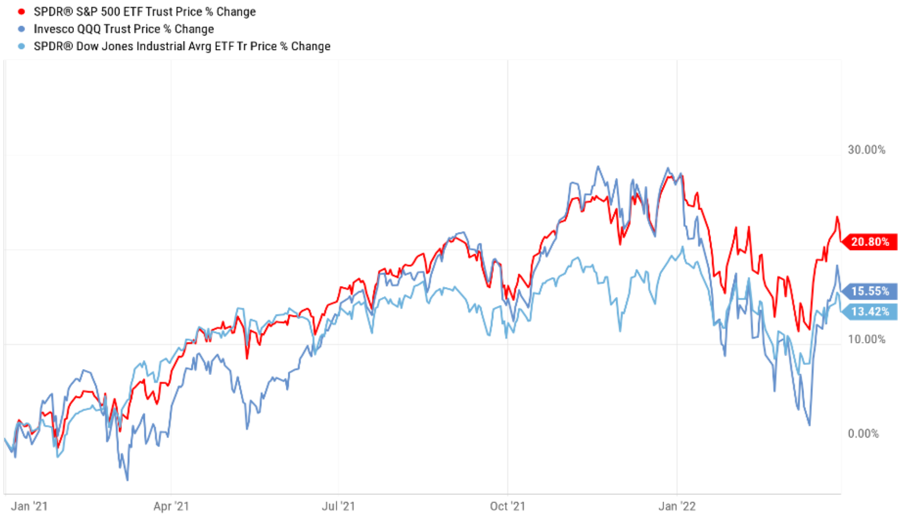
Source: HFSBC Research

Chart No.20 Comparison of NASDAQ, S&P 500 and Dow Jones
Time range: *Q122*



Source: YCharts

Chart No.21 Comparison of NASDAQ, S&P 500 and Dow Jones
Time range: *Beginning of 2021*



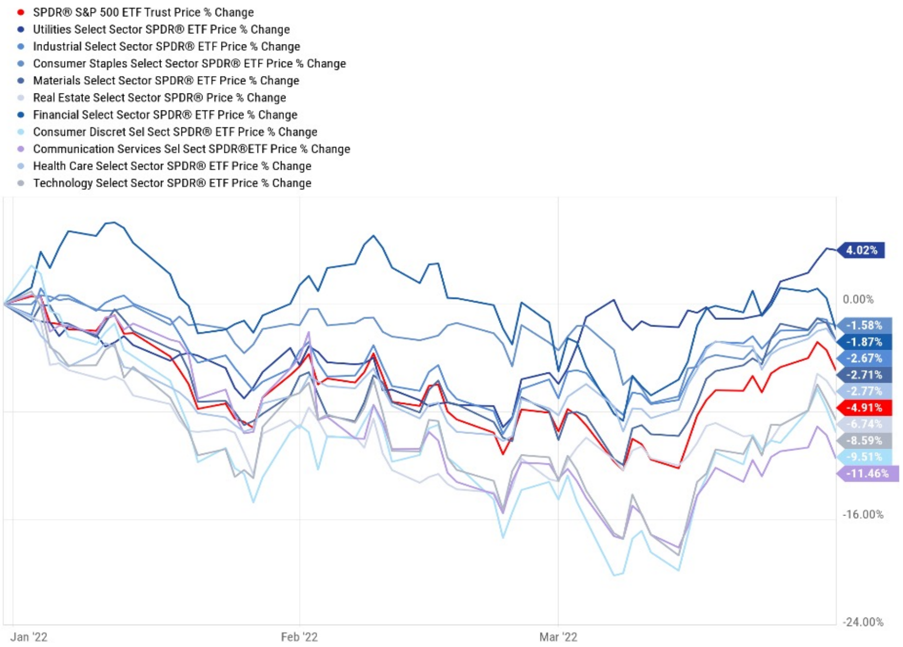
Source: YCharts

The great sector rotation in full swing

Looking at the volatility in oil prices, it probably comes as no surprise that the energy sector became the S&P 500's hottest sector for Q1 2022 (+37.73%).

We will discuss the surge in oil in the following pages of the report. From a sector perspective, the **rotation between growth and value companies** is more important, as we have pointed out on several occasions over the last half-year.

Chart No.22 Ex Energy's S&P 500 sector comparison
Time range: *Q12022*



Source: YCharts

Table No.7 Sector analysis based on the business cycle phase

ECONOMIC GROWTH	**EARLY:** Rebounds	**MID:** Peaks	**LATE:** Moderates	**RECESSION:** Contracts
OUTPERFORM THE U.S. EQUITY MARKET	• CONSUMER DISCRETIONARY • FINANCIALS • INDUSTRIALS • INFORMATION TECHNOLOGY • MATERIALS • REALESTATE	• COMMUNICATION SERVICES • INFORMATION TECHNOLOGY	• CONSUMER STAPLES • INFORMATION TECHNOLOGY	• CONSUMER STAPLES • HEALTHCARE • UTILITIES
UNDERPERFORM THE U.S. EQUITY MARKET	• ENERGY • HEALTHCARE • UTILITIES	• CONSUMER DISCRETIONARY • MATERIALS • UTILITIES	• CONSUMER DISCRETIONARY • INFORMATION TECHNOLOGY	• COMMUNICATION SERVICES • INDUSTRIALS • INFORMATION TECHNOLOGY • REALESTATE

Source: Fidelity

The quarterly results clearly point to a **shift in capital towards the defensive or value sectors.** Utilities (+4.02% in Q1), consumer goods (-1.58% in Q1), manufacturing sector (-2.67% in Q1). The results on the other side of the spectrum: communications (-11.46% in Q1), consumer discretionary (-9.51% in Q1) and technology (-8.59% in Q1).

As seen in the ***Chart No.22*** (***the red curve***), the S&P 500 composite index visually divides sectors to defensive (***overperformance to the composite***) and speculative (***underperformance to the composite***). The given rotation indicates a late phase of the business cycle (***Table No.7***).

Commodity prices in the first firing line

When we used the phrase 'problematic situation between Ukraine and Russia' in Q4 2021: Approaching the New Era, we considered an escalation of tensions to be less likely. The panic that swept through commodity markets at the beginning of March was justified, but, as is usually the case in stressful situations, it was overestimated.

The financial managers of raw material processing companies followed the notorious saying ***"better safe than sorry,"*** and were therefore willing to pay significant premiums for security of supply.

The biggest shock concerned mainly commodities exported from Ukraine and Russia:

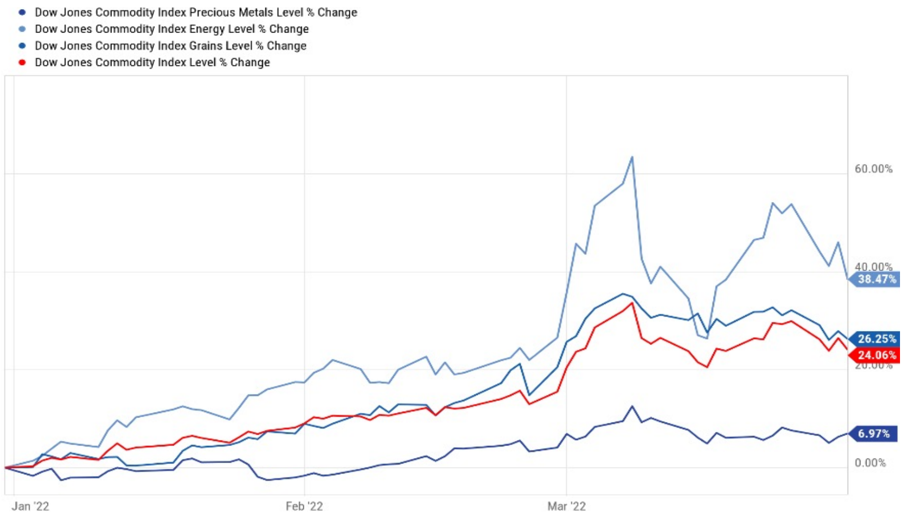
Table No.8

	Share of world exports	Price change for the first days of conflict
Sunflower oil	77,3%	+30,6%
Palladium	45,6%	+47,73%
Barley	29,6%	Non-standard contract
Wheat	25,6%	+58,96%
Natural gas	19,1%	147% (TFT contract)
Coal	17,8%	+76,84%
Corn	16,1%	+18,88%
Petroleum	11,60%	+45,32%

Source: OEC

Chart No.23 Comparison of Dow Jones commodity sub-index (% change)

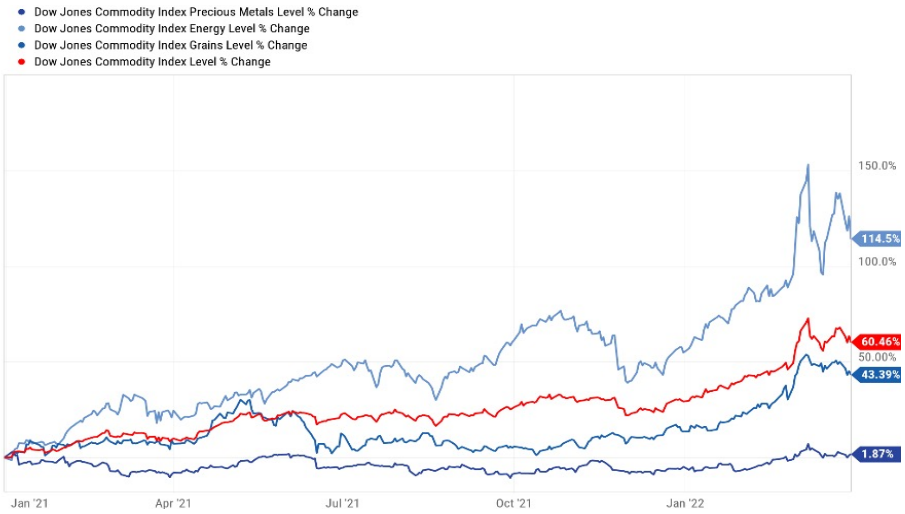
Time range: *Q122*



Source: YCharts

Chart No.24 Comparison of Dow Jones commodity sub-index (% change)

Time range: *Beginning of 2021*



Source: YCharts

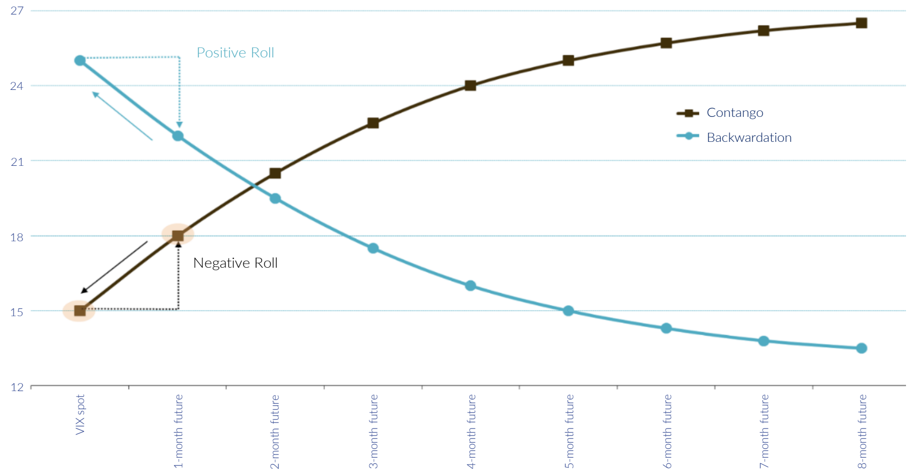
Nuances of futures contracts

The terms ‘Contango’ and ‘Backwardation’ specify the slope of the contract futures curve. Contango means that contracts with delivery further on the timeline are listed at a higher price than supply contracts closer on the timeline. Moderate contango is the natural state of physical commodity contracts.

Example:

*The company’s financial manager knows that every month his company consumes 100,000 barrels of oil. Instead of buying 1,200,000 barrels for a full year, he buys delivery contracts spread over specific months, eliminating the costs associated with storage and additional transport. For this reason, the buyer is willing to pay a moderate premium (*up to 0.5% per month*) = the contract further on the timeline is more expensive = Contango.*

Chart No.25



Source: HFSBC Research

Backwardation is exactly the opposite, meaning that contracts closer on the timeline are quoted at a premium.

The extreme level of Contango or Backwardation is nearly always associated with shocks in the balance of supply and demand of the commodities in question. Examples are surprisingly poor/good harvest of agricultural raw materials, **military conflict on the territory of the exporting country, or an unprecedented package of trade sanctions directed at the other country.**

“Better safe than sorry“

The military conflict in Ukraine has caused a significant divergence from the equilibrium of supply and demand. Futures traders were willing to pay an extra $4.28 per barrel of oil on March 7 to secure delivery by the end of the month.

The premium represented 3.42% of the value of the contract. It should be noted that the sharp increase in the price and the widening of the difference between the current and subsequent contracts were partly due to speculation on the price increase. Backwardation was also present in many other commodities.

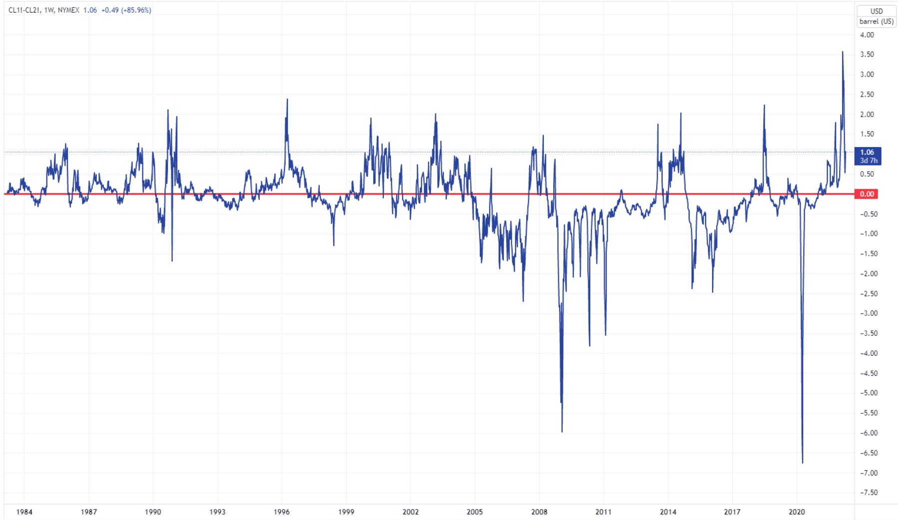
Table No.9

	The rate of backwardation at the beginning of the conflict	%	Backwardation rate as at 31.3.2022	%
Petroleum	4.28	3.42%	1.62	1.6%
Grain	0.994	7.58%	0.062	0.06%
Corn	0.472	6.27%	0.152	2.04%

Source: HFSBC Research

In modelling, we use, among other things, the methodology of reversal to mean values. We perceive extreme Contango and Backwardation values as one of the signs of **structural commodity shocks**, which are manifested by extreme deviations from the price average.

Chart No.26 Extent of the difference between the current and future oil futures
Time range: *Historical Chart*



Source: TradingView

The correction of the demand-supply relationship in the second half of March, which is visible on the slope of the futures curves, suggests that structural shock has disappeared from the commodity market for the time being.

However, it is important to point out that our thesis does not indicate a fall in commodity prices but merely a return to a trend that is growing; taking into account the macro environment, we assume that it will tend to grow more sharply in the future.

Safe heaven

In the latest report (Q4), we mentioned different perspectives on the valuation of US dollar or currencies in general. The world reserve currency proved in Q1 2022 that, despite doubts, it is not about to leave.

DXY – an index that compares the strength of the US dollar to a basket of foreign currencies – strengthened by +2.89%, surpassing even the quarterly CPI inflation, which stalled at 2.01%.

From a macroeconomic point of view, the most interesting monetary market event of Q1 was the opening of interest rate parity. We will skip the lecture in economic theory by a particular example.

USDJPY - the exchange rate between the US dollar and the Japanese yen - strengthened by +5.70% during the quarter. The dollar strengthened, and the yen weakened. This is due to an interest rate hike by the US Fed, while the Bank of Japan leaves (***and plans to keep***) interest rates at zero. The change in monetary policy affects the risk-free interest rate and thus **creates the possibility of arbitrage.**

Similar opportunities will continue in the market in the coming quarters, mainly due to the expected sharp increase in Fed interest rates and the lagging of the BoJ or ECB behind.

Chart No.27 US Dollar Index DXY

Time range: *Beginning of 2020*

Source: YCharts

Chart No.28 US Dollar Index DXY

Source: YCharts

The level of economic ties with Russia meant a rate of losses in Q1 2022

We will conclude our market overview by comparing global economies represented by local stock index. As seen in the previous pages, this section is marked by a noticeable aftertaste of the Russia - Ukraine war.

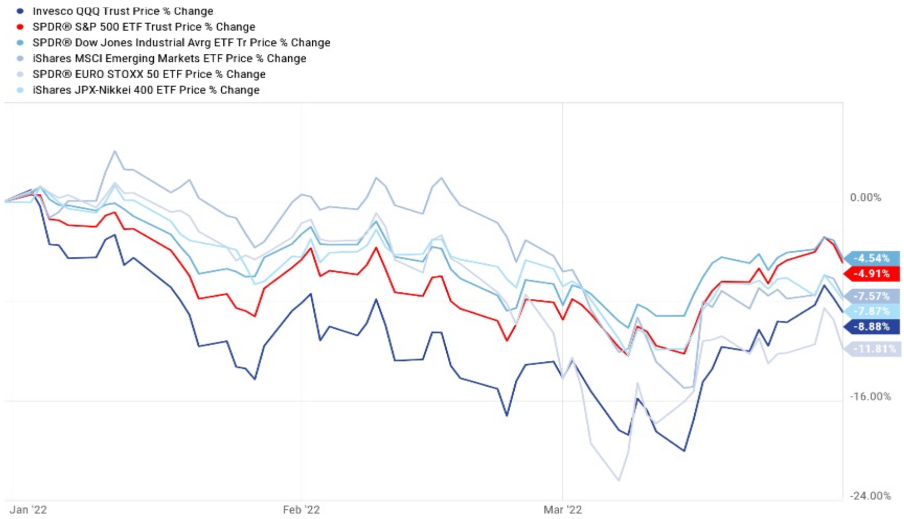
The degree of import-export connection to Russia dictated the degree of negative economic shock that was reflected in the values of stock indices.

Russia had (***before the introduction of global sanctions***) the strongest trade relations with the EU and China. This fact is confirmed by the quarterly performance of European and Chinese DAX stock index (-9.09%), CAC (-6.76%), STOXX 600 (-7.63%), China Composite (-10.65%).

It should be noted that in addition to its links to Russia, the Chinese economy has been hit by problems on the Covid front, as we mentioned in the chapter Problems With the Chinese Zero-Covid Politics, pg.16.

Japan's Nikkei 225, by contrast, fell at least-4.54 percentage points from the world's index, which is due to its different relationship to inflation. While inflation is a bête noire to many Western countries, the Japanese economy would benefit from a higher inflation rate.

Chart No.29 Comparison of global stock indices
Time range: *Q1 2022*



Source: YCharts

Chart No.30 Comparison of global stock indices
Time range: *Beginning of 2020*

Source: YCharts

07

What to Expect in Q2 2022?

This year's main topic of the financial markets is the change of course of American monetary policy.

During Q2 2022, two FOMC board meetings are scheduled, namely 3-4 May and 14-15 June. Traders appreciate the year-end interest rate price of 2.25-2.50%, representing a 2% increase over the course of 6 meetings.

We expect the Fed to respond more aggressively to rising inflation as early as the first half of this year, so **we anticipate at least one rate hike of 0.5% over Q2 2022.**

Historical correlations suggest the future **decline in volatility in the US bond market**, and futures curves point to commodity prices **returning to long-term moving averages**. The sector rotation in the US stock market will continue, and, while maintaining the current macroeconomic trajectory, the **US dollar will continue to grow.**

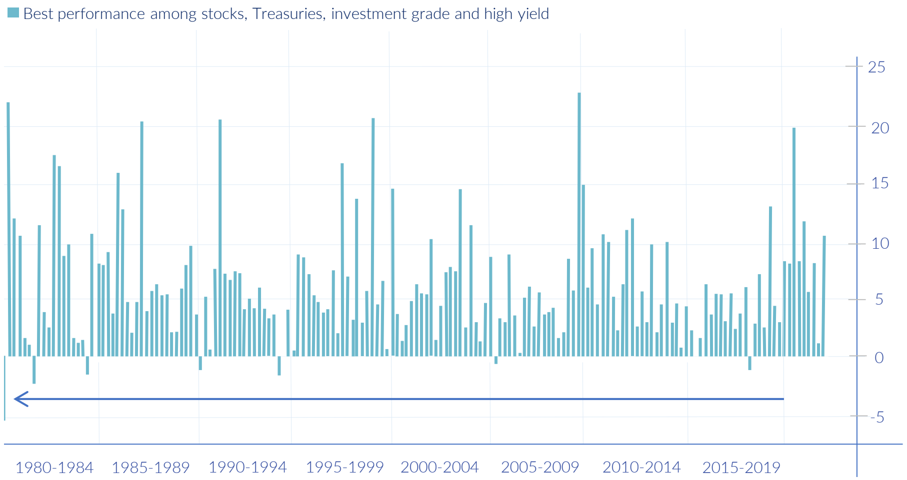
08

Q1 2022 Overview

Passive investments in stocks and bonds have had one of the worst quarters in 40 years. The traditional composition of the portfolio in Q1 2022 did not provide sufficient protection against the downturn at the time of culminating inflation and monetary policy tightening.

Chart No.31 Investors buying stocks and bonds have gone through one of the toughest quarters in 40 years

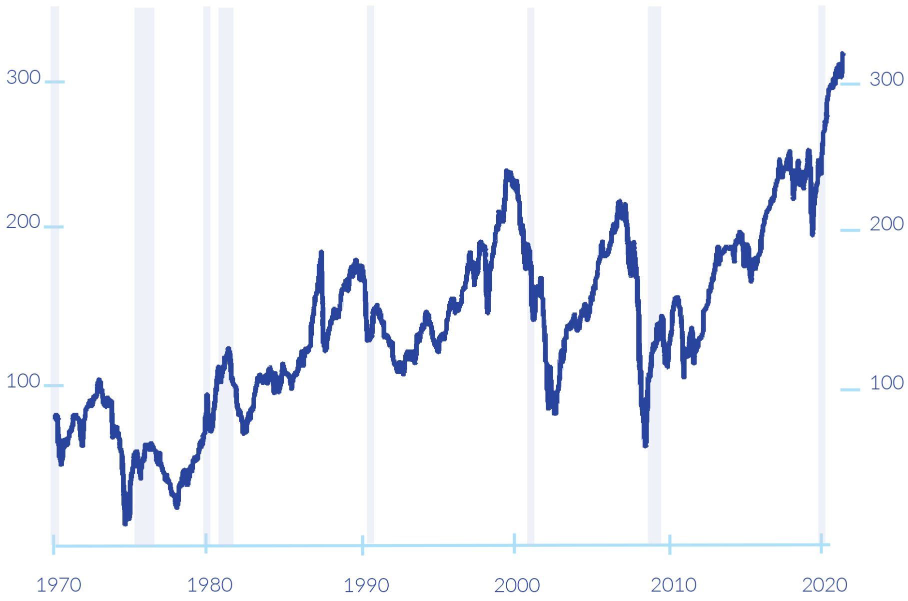
Time range: *1980-2022*



Source: Bloomberg

Chart No.32 Investors buying stocks and bonds had one of the toughest quarters in 40 years

Time range: *1980-2022*



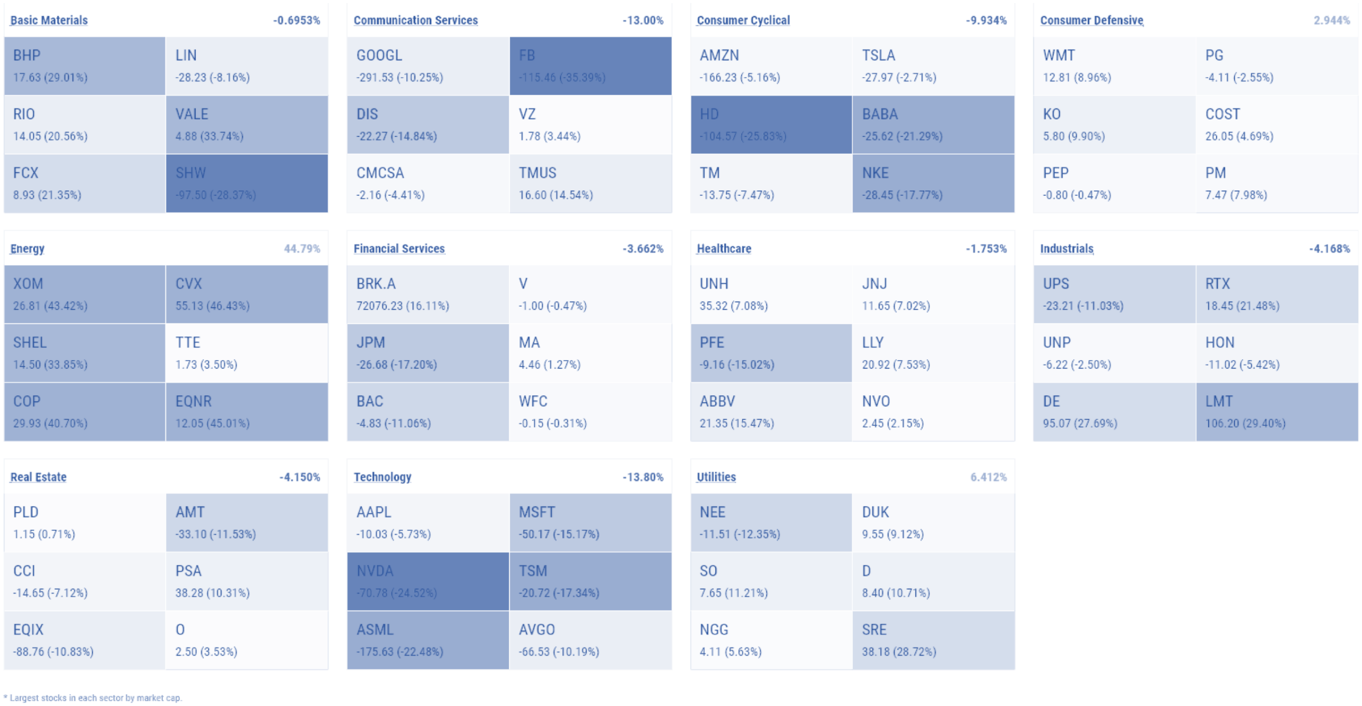
Source: MRB Partners Inc.

The ratio of global equities to bonds peaks near the end of the economic cycle. The high level of the global equity to bond price ratio is also due to the high inflation rate, which is typical of the late cycle.

The energy, utilities and defensive consumer segments achieved appreciation in 2022. The YTD profitability in the energy sector (+44.79), the decline in the technology sector (-13.8%) as well as the communication sector (-13%), point to the ongoing sector rotation

Chart No.33 Sector performance in Q1 2022 (for calendar year of 2022)

Time range: *YTD*

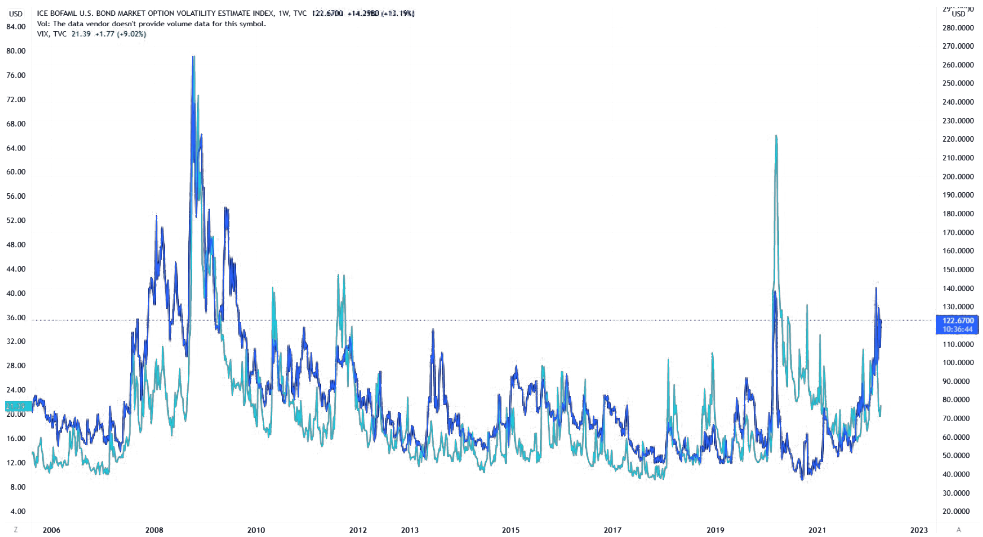


Source: YCharts

Divergence between bond volatility (MOVE) and equity volatility (VIX). Bond investors are appreciating the interest rates, while the defensive sector that benefits from a sector rotation is also present in S&P 500 composite. At the same time, the bond sell-off helps the stock market push upwards.

Chart No.34 MOVE vs. VIX

Time range: *2006-2022*

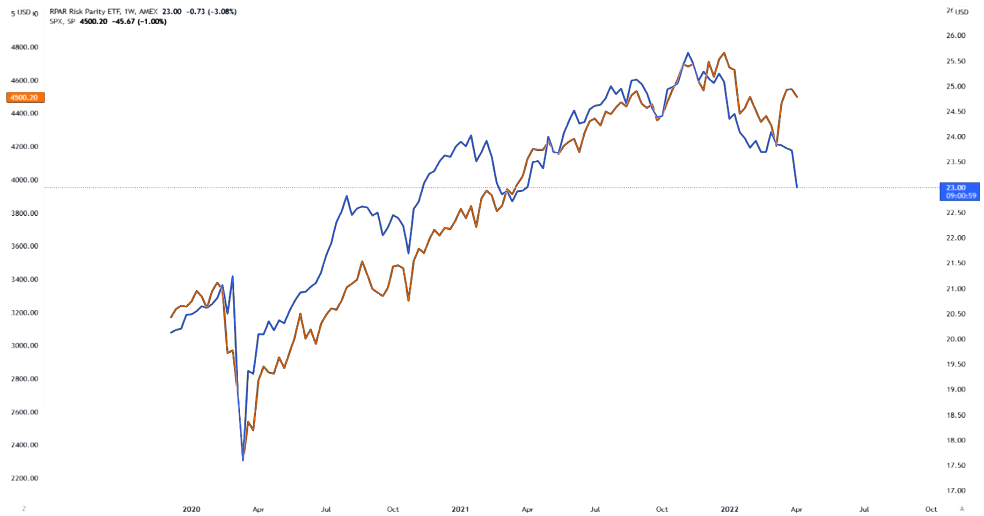


Source: TradingView

The divergence between MOVE and VIX has an impact on the divergence between the performance of the ETF risk parity vs. the S&P 500. We can expect an increase in stock volatility and a decrease in bond volatility.

Chart No.35 ETF strategies of risk parity vs. S&P 500

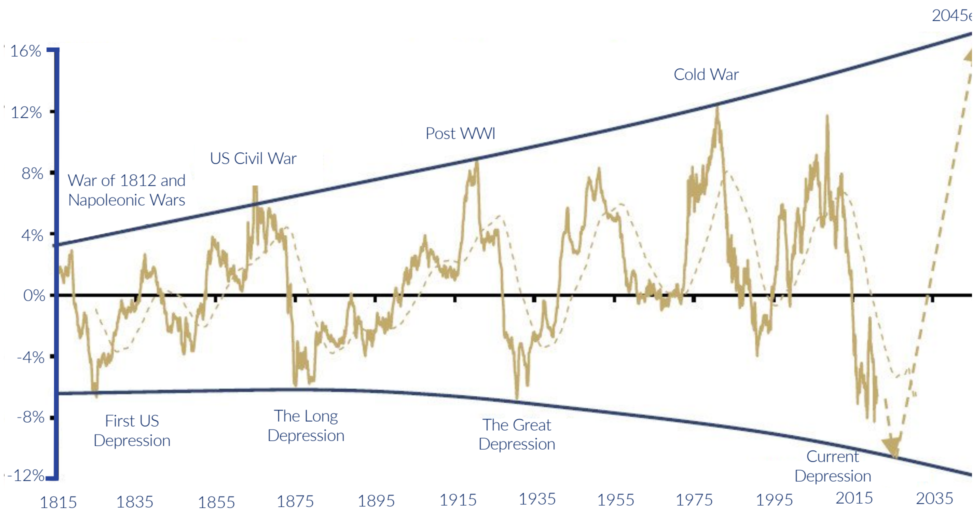
Time range: *2020-2022*



Source: YCharts

In the long term, the fluctuation of the 10-year continuous annual growth rate of commodity index prices is increasing and tends to follow commodity price hikes. The chart indicates that rising commodity prices in the coming period may lead to a compound annual growth rate above 6%.

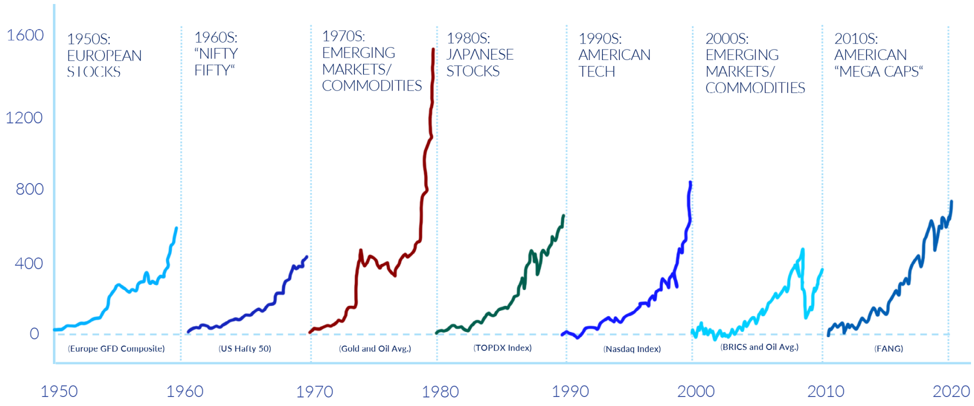
Chart No.36 US commodity price index and 10-year annual compound interest growth rate
Time range: *1815-2021*



Source: Stifel Report, Incrementum AG

American "Mega-Caps" (FANG) joint stock companies with a cumulated percentage yield above 500% (during 2010-2020) have been the leading investment theme over the last decade.

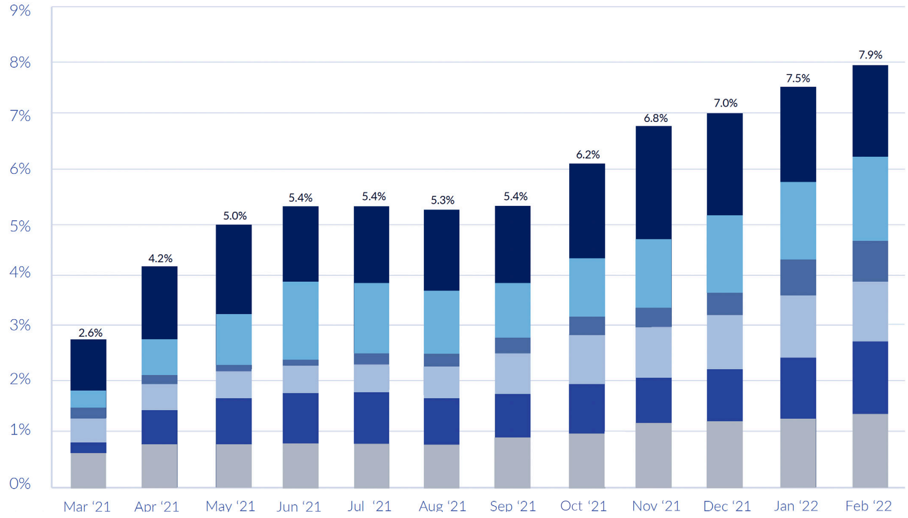
Chart No.37 Investment themes by decade and the cumulated % income (USD)
Time range: *1950-2020*



Source: Bloomberg

Chart No.38 CPI Structure Annual Basis)

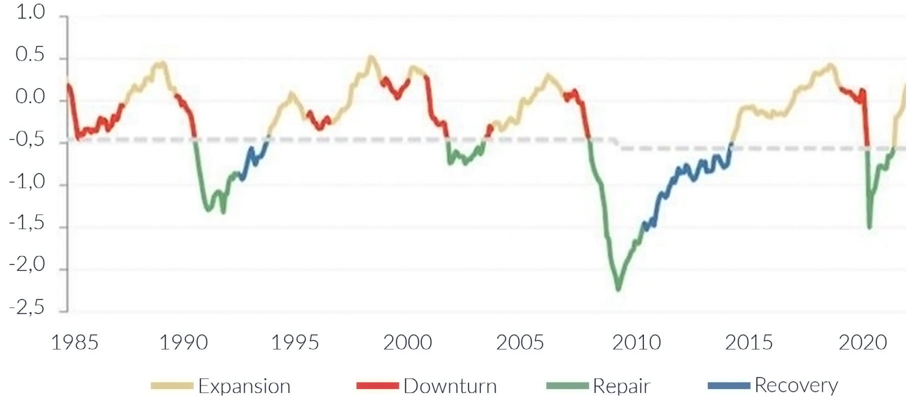
Time range: *2021-2022*



Source: bls.com

Chart No.40 Cycle indicator. A significant expansion leads to the peak faster

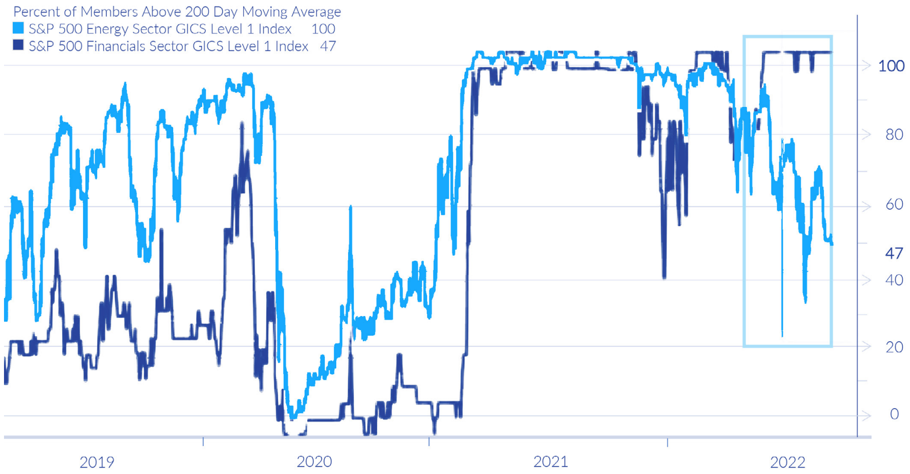
Time range: *1985-2021*



Source: Bloomberg, Datastream, Haver Analytics, Morgan Stanley Research

Chart No.39 Energy and financial sector performance

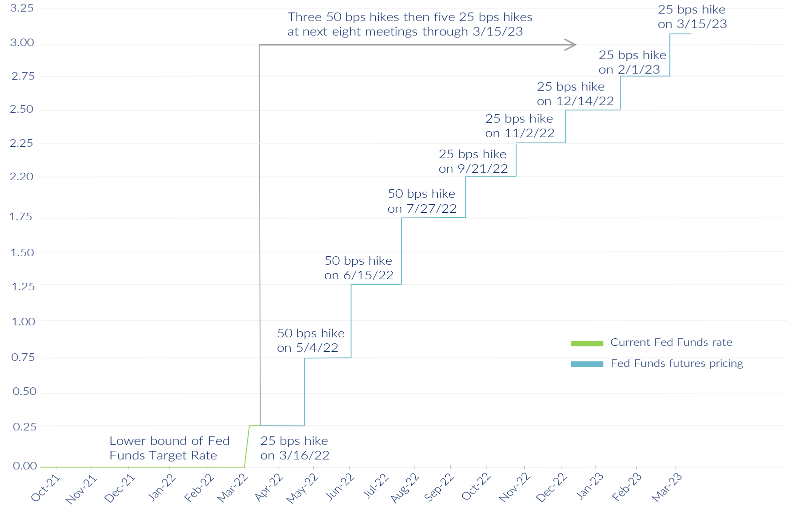
Time range: *2019-2022*



Source: Bloomberg

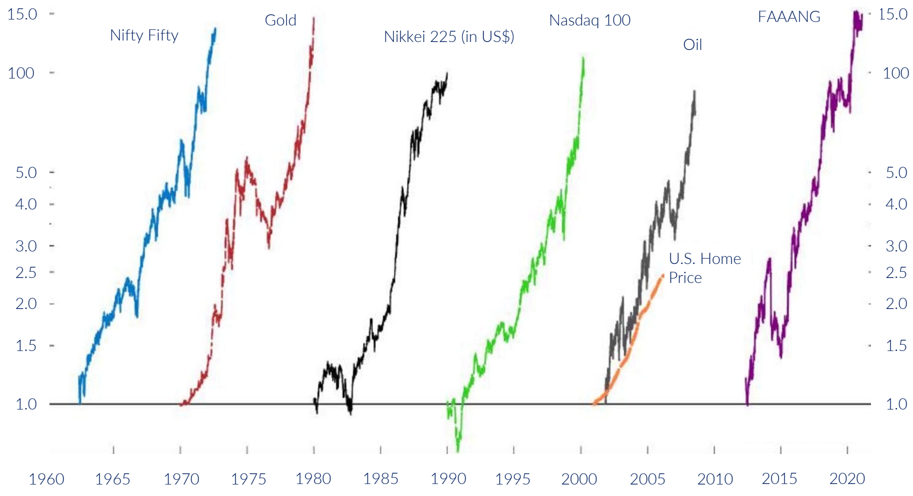
Chart No.41 Expected development of the Federal interest rate according to futures contracts

Time range: *2021-2023*



Source: CmeGroup

Chart No.42 Investment themes by decade
Time range: *21960-2020*



Source: Bloomberg

Chart No.44 The recession results in a high unemployment rate *(below-average unemployment rate prevents recessions)*

Time range: *1949-2021*

Source: TradingView

Chart No.43 The amount of debt with a negative yield is being significantly reduced
Time range: *2019-2022*

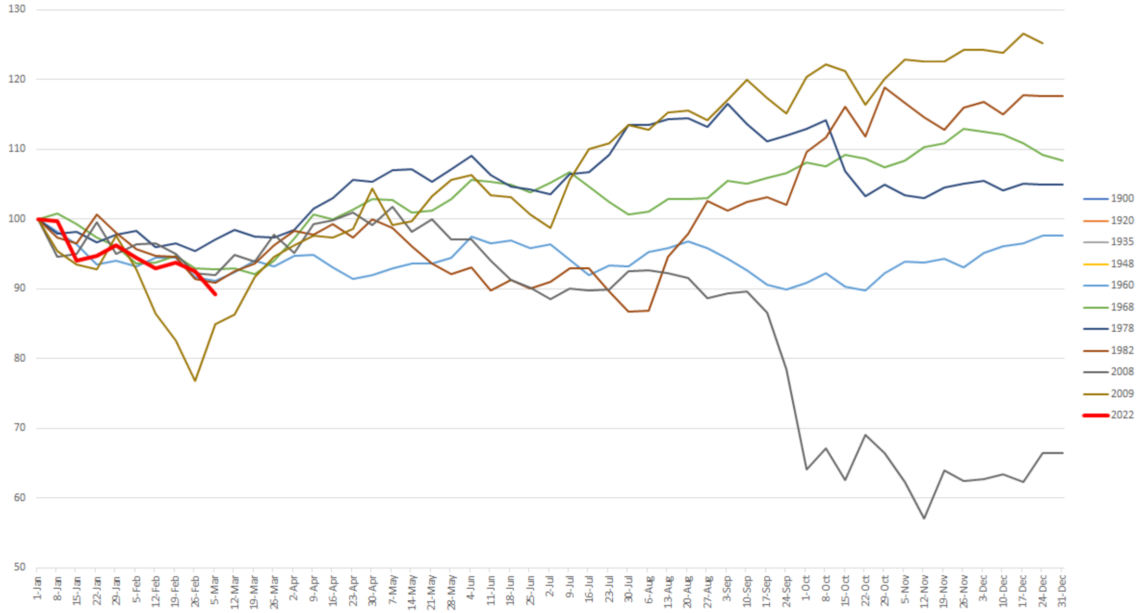
Source: Bloomberg

Chart No.45 123 years of stock performance history in the first 44 trading days
Time range: *1900-2022*

	THRU DAY 44	DAY 45-DAY 250
1/1/2009	-24.3%	49.0%
1/1/2022	-11.9%	
1/1/1920	-11.8%	-24.8%
1/1/1935	-11.1%	52.4%
1/1/1982	-10.8%	25.6%
1/1/1900	-9.9%	6.0%
1/1/2008	-9.2%	-31.4%
1/1/1968	-9.1%	8.2%
1/1/1960	-8.9%	5.4%
1/1/1978	-8.6%	10.3%
1/1/1948	-7.8%	7.6%

Source: Bloomberg

Chart No.46 Stock performance during the year (various periods 1900-2022)



Source: HFSBC Research

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HEDGE FUND

STONEBRIDGE CAPITAL HEDGE FUND

Hviezdoslavovo námestie 15 | 811 02 Bratislava
Slovak Republic
Tel. No.: +421 (2) 2079 2386
Fax: +421 (2) 7001 8491

E-mail: info@hfsbc.com

www.hfsbc.com | www.stonebridge.capital