

OLD CONTINENT, NEW CHALLENGES

Good news has been rather scarce in Europe of late. The continent has faced a deluge of challenges since Russia launched its attack against Ukraine in late February. Economists are nearly unanimously predicting a dire outcome and investor sentiment is deeply negative. These views may be warranted, but as always, when the consensus becomes overly one-sided, it pays to take a closer look.

Taking a step back, there was reason for optimism towards Europe coming out of COVID-19 lockdowns. The European Union (EU) recovery package was significant both in sheer size (reversing years of relative fiscal austerity) and form (jointly-issued debt); effectively bringing members one big step closer to fiscal unity. The combination of pent-up consumer demand, loose monetary conditions and the pivot to expansionary fiscal policy provided a potent growth impulse. This would simultaneously spur some “healthy” inflation, which had been muted since the European sovereign debt crisis in 2010-2012.

Russia’s incursion into Ukraine significantly changed these dynamics. While the implications of the war have been felt around the world, they have not been dispersed equally. In addition to surging consumer prices, Europe’s over-reliance on Russian oil and gas imports has created an energy crisis. EU countries have rushed to replenish natural gas inventories ahead of the winter months, but are up against storage capacity limitations, tight supply conditions and exorbitant prices. Energy rationing measures may need to be deployed, which would be a major hindrance for the industrial sector and beyond. Additionally, with a major conflict on its doorstep and an influx of refugees flowing into the eastern nations, geopolitical risks are running hot.

And if one war wasn’t already enough to contend with, it appears that Europe is also under environmental attack. A severe heat wave has caused fatalities, droughts and falling water levels in lakes and rivers. The latter point

is in focus presently, as the Rhine River (a major intra-continental shipping artery) has become too shallow in sections for cargo ships to traverse.

In financial markets, much of the pain has been felt through currency adjustments. The European Central Bank (ECB) has been hamstrung; with the impossible dual task of reining in inflation while cushioning the economic impact from the war. Per the chart below, the combination of ECB inaction (widening interest rate differentials) and deteriorating growth expectations have pushed the euro below parity with the US dollar; a low not touched since the inception of the currency 20 years ago.

But if one looks past the negative headlines, there are several silver linings emerging; necessitating a more balanced view on European assets. The war has served as a reminder of one of the EU’s key purposes: peace and security. The bloc’s unified response to Russia’s aggression bodes well for EU integration looking forward. Furthermore, investors are well aware of the challenges noted above, and significant pessimism has been priced into European assets. The aforementioned euro devaluation will exacerbate inflationary pressure in the near term, but will also serve to materially boost export competitiveness. Equity valuations have also cratered, as evidenced by forward P/E on MSCI Europe falling from approximately 17x to 12x since 2020. Lastly, European large cap indices are dominated by multinational firms, whose earnings are more exposed to global growth than domestic demand conditions.

GLOBAL STRATEGY OVERVIEW

CASH

Cash and equivalents' continue to offer a trade-off between acting as a buffer against volatility while simultaneously reducing purchasing power as inflation remains elevated. We have elected to maintain cash near neutral levels this quarter.

BONDS

As major global central banks begin or continue to tighten policy, bond market focus should pivot from inflation to growth; benefitting the long end of the curve. We believe it is too early to lengthen duration just yet, as inflation continues to be the dominant focal point for the time being and the US Federal Reserve begins shrinking its balance sheet. Short duration (overweight floating rate debt in particular) positioning has been maintained this quarter.

EQUITIES

We remain constructive on global equities which offer a decent inflation hedge and have had much of the froth drained out of their valuations amidst the challenging environment year-to-date. Conversely, we see risk emanating from tightening liquidity conditions and forward earnings expectations which have not fully adjusted to the shifting economic circumstances. Equity positioning remains overweight, but we have modestly decreased exposure this quarter.

OPPORTUNITIES

China's increasingly accommodative policy stance and dampening enthusiasm for aggressive internet regulation should provide a tailwind for offshore stocks. However, the stark difference in monetary policy versus the developed world has significantly eroded the yield advantage historically enjoyed by Chinese bonds. A position in Chinese aggregate bonds has been liquidated in income-oriented strategies, while offshore Chinese (H share) equity exposure has been increased in balanced and growth-oriented strategies.

FORSTRONG STRATEGIES	INCEPTION DATE	1 MONTH	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEARS	SINCE INCEPTION
GLOBAL SERIES								
Global Income	30/06/08	2.32%	-7.99%	-6.88%	1.09%	2.70%	5.86%	6.97%
Global Balanced	30/06/03	2.46%	-9.74%	-8.99%	3.89%	4.60%	7.33%	6.71%
Global Growth	30/06/03	2.83%	-10.79%	-8.70%	6.06%	6.27%	9.17%	7.87%
Core Income	30/06/08	2.48%	-6.40%	-5.51%	2.10%	3.14%	5.02%	6.02%
Core Balanced	30/06/03	2.25%	-6.75%	-6.04%	4.84%	5.09%	6.62%	6.85%
Core Growth	30/06/03	2.47%	-7.65%	-5.36%	6.94%	6.63%	8.20%	7.85%
GLOBAL EQUITY								
Emerging Markets Equity Focus	31/01/19	-3.98%	-11.06%	-13.20%	0.73%	-	-	0.46%
Global Ex-North America Equity Focus	31/12/19	1.73%	-13.01%	-14.21%	-	-	-	-0.31%

* Performance as of July 31st, 2022

Performance statistics for ETF Managed Portfolios are calculated from documented actual investment strategies as set by Forstrong's Investment Committee and applied to its portfolios mandates, and are intended to provide an approximation of composite results for separately managed accounts. Actual performance of individual separate accounts may vary with average gross "composite" performance statistics presented here due to client-specific portfolio differences with respect to size, inflow/outflow history, and inception dates, as well as intra-day market volatilities versus daily closing prices. Performance numbers are net of total ETF expense ratios and custody fees, but before withholding taxes, transaction costs and other investment management and advisor fees. Past investment results provide no indication of future performance. Future returns are dependent on the general investment environment, the nature of the investment mandate and specific portfolio risks. A rate of return for one year or less is not annualized.