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INNOVA
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THREE MAJOR RISKS TO MANAGE HEADING INTO 2022

The sudden rise of the COVID-19 pandemic left many investors shocked in early-2020, yet this year has also had more than its fair share of surprises.

It has been a year of contrasts with ongoing COVID-19 outbreaks and surging inflation barely slowing investment markets, which regularly broke new records.

If there are any lessons to take as we head into 2022, it's to expect the unexpected given things often don't go according to plan.

While no-one can predict the future precisely, we have pinpointed three areas of risk we think are worth considering for investors.

THE SPECTRE OF INFLATION IS REAL

We began 2021 worried about inflation – it then subsided but has since come back strong. While many market participants believe it is transitory in the wake of the COVID-19 pandemic, the weight of evidence is leaning towards something more permanent.

US inflation has surged to an annual rate of 6.2% (levels not seen in more than 30 years); UK inflation jumped to 4.2% in October (the highest in a decade); and eurozone inflation is now 4.1% (a 13-year high)[1].

Central banks such as the US Federal Reserve and the Reserve Bank of Australia are suggesting the rise is transitory as supply chains adjust in the wake of the pandemic. But we are also seeing solid wage growth inflation in the US and a tight labour force domestically, which should also lead to higher wages in the future.

Central banks are walking a tight rope as they have few ways to combat rising inflation except to raise rates. This risks slowing the economic recovery or tightening too fast given uncertainties such as the impact of potentially new COVID-19 variants. At worst, it could bring on another recession.

The RBA is sticking to its plans that it won't raise rates until 2024 but other central banks (potentially The Bank of England) are expected to move much sooner.

They may not have to as bond markets may effectively make the call for them, which will have implications for both bond and equity markets.

EXPECT MORE BOND AND EQUITY MARKET VOLATILITY

Inflation is partly driven by expectations – if the market believes it is going up, they will demand greater compensation for that risk. While most bonds are held by central banks, "bond vigilantes" can still force a big shift in the yield curve.

We think this is currently a high probability that will also disrupt equity markets.

In this scenario, investors won't be prepared to pay the same high valuation multiples as they were when inflation was low because a dollar of future earnings will be worth substantially less.

Growth stocks such as Amazon, Google, and Facebook, currently trading on enormous multiples, could be hit hard. Even small changes in inflation expectations would

[1] *Rushe, D., Inman, P., Rankin, J., Willsher, K., Hannam, P., McCurry, J., & Farrer, M. (2021). How world's major economies are dealing with spectre of inflation. the Guardian. Retrieved from https://www.theguardian.com/business/2021/nov/26/how-worlds-major-economies-are-dealing-with-spectre-of-inflation*

have huge implications given investors are buying their expected earnings in the decades ahead.

If inflation rises from 1% to 3%, the present value of companies like this and their future earnings could be cut quite severely.

Innova is tilted towards the more relative value end of the equities spectrum, which is far less interest rate sensitive (so have more inflation protection). We also have hedges in place if this scenario does not play out.

CRYPTO-CURRENCY CRACKDOWN?

Crypto-currencies have continued to be a great place to speculate (rather than invest).

Money has poured into speculative crypto-currencies with no useful function, including **meme coins** such as Dogecoin (the eighth largest cryptocurrency in the world with a market capitalisation of about US$31 billion) and the Shiba Inu token (the ninth largest cryptocurrency with a market capitalisation of around US$26 billion[2]).

We suspect it has become viewed as the new "digital gold" as these inflows would have once flowed to physical gold, given rates became even more negative as inflationary fears increased thanks to massive government and fiscal stimulus. It seems logical that in that environment, money would normally flood to gold bullion yet instead has seen cryptocurrencies surge.

This may change in 2022.

The U.S. **Securities and Exchange Commission (SEC)** has flagged the activities of Decentralized Finance (DeFi) participants, who don't need to rely on central financial intermediaries such as brokerages, exchanges, or banks, as an issue[3].

Their concerns are long-standing: transaction volumes can be faked, bots can collude to drive up values, insiders can leverage their information asymmetry without proper disclosure, and money launderers can reign freely.

It views DeFi participant activities as fundamentally about investing, yet none have registered with the SEC. Instead, they have attempted to manage their legal obligations by disclosing that these investments are risky and may result in losses.

Further, so-called 'stable coins' claim to be backed by real assets such U.S. Dollars or U.S. Treasury Bonds.

However, since they have not registered with the SEC, these accounts are not regulated – they simply register with a registration office – no audit on the assets backing these coins is required, and none has been given that we are aware of.

This has obvious moral implications – whilst we doubt there is nothing backing these stable coins at all (i.e. the money is essentially stolen), we doubt it is backed by zero-to-near-zero yielding bonds. It's more likely they are speculating in property and equity markets to generate excess returns.

This is clearly a moral hazard and could end very badly if investors find out the assets backing their assets are worth substantially less than previously thought.

The underlying DeFi technology itself continues to become mainstream (central banks are investigating the benefits of Central bank digital currency (CBDC) with China in advanced stages) but the future of crypto-currencies as an investable asset class remains totally unpredictable.

None of these three issues may crystalise, but they are the clearest ones to watch as we stand on the precipice of 2022. A sensible plan to mitigate risk while generating reasonable returns remains the surest path forward.

[2] The Future of Payments: Cryptocurrencies, Stablecoins or Central Bank Digital Currencies? | Speeches. (2021, November 18). Retrieved from https://www.rba.gov.au/speeches/2021/sp-so-2021-11-18.html [3] SEC.gov | Statement on DeFi Risks, Regulations, and Opportunities. (2021, November 09). Retrieved from https://www.sec.gov/news/statement/crenshaw-defi-20211109

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Dan Miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios since 2010. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.