Market Commentary on the FY2021 Results Season:

Pricing in the Impact of Inflation and Geopolitical Risk?

Amid hopes that the latest coronavirus variant has less of an impact in 2022 and enables a return to a more "normalised environment",[i] the **rally in global equity markets was suddenly over** when the US Federal Reserve announced in December the end of its accommodative monetary stimulus policy by late March 2022 and indicated its willingness to raise interest rates as early as March. For more than a decade, professional fund managers have been navigating through choppy economic waters with the help of massive liquidity injections from central banks. They will now have to **take a view – and price in – the durability and impact of the latest inflationary surge**,[ii] which has led to a significant market correction in January 2022, notably among technology and growth stocks.[iii]

With investors weighing up rising rates and slowing growth following the pandemic-induced pent-up demand in 2021, new geopolitical risks – notably a potential Russian invasion into the Ukraine but also a growing Chinese military threat of Taiwan – have led to a **change in institutional behaviour from focusing on rate-sensitive areas to more panic-driven sell offs** in the second half of January. In the wake of global equity markets switching gear to a renewed "risk-off" mode, we look first at the **implications of the recent shift in the trading regime** as investors increasingly depart from the "meme mania" of 2021, best evidenced in the retail stock speculation driven by social media networks,[iv] and pour billions into inflation-backed assets. Then we turn our attention to **emerging markets as the combination of higher inflation and new geopolitical risks** have brought back to investor attention markets such as Turkey, Pakistan, Kazakhstan and Russia.

Against this backdrop, the first three weeks of the **FY2021 reporting season have shown continuing investor interest in three key themes:** i) supply chains and logistics; ii) labour shortage and wage inflation as well as iii) measuring companies' net zero pledges – with a **strong focus on earnings quality, operational leverage and the cost base affected by inflation, as well as IT investments for greater productivity gains**. Not only have the continuing problems with global supply chains led to a strategic review of the previously prevailing "just-in-time" business model, but also companies were increasingly asked about the **fungibility of their capacity planning, implying a potential "rejig of supply chains",[v] possible inventory corrections** following the "just-in-case" build-up in recent months, whether they are designing their own components and spare parts as well as about evolving customer relationships and pricing policy.

Finally, as we had also followed a number of ESG webinars and strategy updates in late 2021, there was not only more talk about the post-pandemic **"resilience"[vi] of companies** but – given labour shortages and pressure for higher wages – a much **greater focus on the social element within ESG**, notably on employee engagement, education and higher qualification, diversification with first companies openly addressing the gender pay gap,[vii] and increasing references to "agile work" and "high-performance culture".[viii] Given the **growing importance of the new EU green taxonomy** and all the pledges companies have made in recent months to cut their emission to net zero, in our final section we briefly outline the **current investor debate about the need to track**

and measure those pledges consistently in future years.

TRADING REGIME SHIFT

As we had already witnessed a rotation into small cap, value stocks almost exactly a year ago, there is again much talk about a "long overdue" market regime change,[ix] as high inflation, strong employment and the US Federal Reserves' indication to raise interest rates have resulted in investors moving out of growth companies to more price-sensitive value stocks. However, this time around it is seen as an "inflection point" in stock market trends, with first signs of a less binary investing world (tech stocks and growth against everything else) as investors switched into oil and gas, mining, retail, transport, consumer plays and financials hoping for these sectors to benefit strongly from a sharp earnings recovery.[x]

The other key theme in the current discussion is the fragility of markets, as the suddenness and severity of market turbulence has shown in recent weeks, with a growing focus on the lack of liquidity even in such large markets as the US, compounded by factors such as algorithmic trading, passive investment and high-frequency trading.[xi] Best evidence for liquidity drying up was during the first week of February when major US technology companies reported their FY2021 results and some of them hugely disappointed the market (Meta, PayPal, Netflix).[xii] Others go as far as saying that exuberant investor confidence in abstract future investment – ranging from specs to cryptocurrencies, metaverse, electric vehicles and space travel, i.e. essentially "buying dreams at the highest price" - will be hurt as "valuations return to earth".[xiii]

EMERGING MARKETS

Whether this change in the market regime will end in shatters remains to be seen, but emerging markets have clearly taken a battering in recent months. With first signs of slowing growth and rising inflation in the second half of 2021, emerging market indices started to underperform those of developed markets, as rising energy and commodity costs hit trade balances while, at the same time, severe delays in vaccination undermined economic recovery.[xiv] From our perspective, with growing geopolitical risks, higher inflation, currency devaluation and structural problems due to specific commodity exposure,[xv] the market will increasingly look at Western companies' exposure to risky markets such as Russia, Turkey, Kazakhstan and others.[xvi]

In turn, both the strengthening of the US-dollar and expectations of higher US interest rates have resulted in a sharp drop in foreign investments in emerging markets, further destabilising the economies of countries such as Turkey, which is an isolated case for its erratic and politically influenced central bank policy, but also Brazil, South Africa and India, which heavily depend on foreign inflows.[xvii] However, in stark contrast to previous periods of emerging market vulnerabilities, there is much evidence for more financial stability due to less foreign debt, higher foreign exchange reserves, stronger currencies and current account balances being in surplus, notably China but also some of the new "manufacturing powers" such as the Czech Republic, Vietnam and Mexico. In the wake of current geopolitical risks, it remains to be seen whether there will be a "quiet comeback" of emerging markets driven by rising prices for commodities, manufacturing strength, rapid growth in the digital economy and financial conservatism.[xviii]

SUPPLY CHAINS AND LOGISTICS

Having followed closely the FY2021 reporting season over the last three weeks, we observe a clear dichotomy in the view US and European companies about ongoing supply chain disruptions, with the former describing Q4'2021 as being the worst quarter so far and the latter feeling more confident in being able to navigate through the worst.[xix] However, US management seems to take more of a long-term, demand-driven view, as secular trends such as electrification and digitalisation have, from their perspective, extended the economic cycle by another five to seven years[xx] and they are working intensively on "rebuilding resilient, globally balanced supply chains".[xxi] They seem to see less "restocking in the channel", with orders and sales in their view converging,[xxii] and sense even the need for an inventory replenishment cycle.[xxiii]

As most executives agree that supply chain constraints will continue throughout 2022 and into 2023, currently being aggravated by the Beijing Winter Olympics as China imposed new restrictions to support its zero-Covid policy,[xxiv] there was great interest among analysts and investors about what companies are actually doing at their end in terms of risk mitigation and even innovation.[xxv] In international logistics, there are first signs of consolidation with Maersk buying Hong Kong's LF Logistics in December 2021 aiming to expand its land-based operations,[xxvi] and Lufthansa and MSC expressing interest in buying the majority stake in ITA Airways.[xxvii] While there are still widespread practices of double ordering, customer prepayments and supplier diversification,[xxviii] from a long-term perspective, there is also clear evidence of companies investing in supply-chain capacity.[xxix]

LABOUR SHORTAGE AND WAGE INFLATION

While the outbreak of the pandemic has sparked a huge discussion about the future of hybrid work,[xxx] the FY2021 reporting season has for the first time seen a very intensive debate about labour shortages, notably in the US market, and to what extent this has fueled wage inflation.[xxxi] Interestingly, among some of the banks almost every second question in the Q&A was on labour shortages,[xxxii] with a special focus on the "war for talent" in this industry, with all the implications for cost pressure, digitisation and building up of internal talent. Other industrial companies were pressed hard to quantify the current wage inflation, which was typically quoted in the range of 3.5 to 4% for European businesses.[xxxiii] Some went even as far as saying that "talent scarcity is the key issue for 2022".[xxxiv]

While this is not the place to discuss all the reasons of US companies facing so much more of an acute labour shortage[xxxv] – suffice to point to much higher Covid infection rates in the US but also the lack of state sponsored short-labour support schemes in Europe – the interesting debate, from an investor's perspective, is what companies are actually doing in terms of deploying pay, perks and training to counter labour shortages and, ultimately, what cost implications this would have.[xxxvi] And, as we had mentioned in the introduction, it is probably no coincidence that companies started talking much more frequently about their employee engagement scores and how respective efforts resonate with their workforce. Following years of emphasising "customer centricity" and net promotion scores, any outline of sustainable value creation ambition will now include a strong focus on employee recruitment, development and retention.[xxxvii] This is certainly a space to watch in coming quarters as we are just at the start of the broader investor debate.[xxxviii]

MEASURING NET ZERO PLEDGES

While we are still at a very early stage in terms of the new EU green taxonomy, first questions have already been raised during the FY2021 reporting season by analysts, notably those covering energy companies,[xxxix] though most businesses are still struggling to get to terms with the new reporting requirements (eligible in 2022 and applicable in 2023). The EU green reporting rules require every listed company with more than 500 employees to disclose the percentage of revenue, capital expenditure and operating costs from environmentally sustainable activities covered by the green taxonomy.[xl] This applies not only to individual companies, but also to asset managers, as the latter must show how their portfolio complies with the rules.[xli]

In the wake of the COP26 summit in Glasgow in November 2021, however, the more pressing issue for investors has become how to measure companies' pledges for net zero emission. Following an earlier period of betting on renewables and being underweight, or even excluding, fossil fuels in portfolios, the investment community has entered a second phase as companies increasingly started to make net zero commitments.[xlii] Investors will now require more data, metrics and, above all, reliable benchmarks, which is currently considered to be the Science-Based Targets Initiative (SBTi), an independent regulatory body that approves companies' net-zero targets. Currently 1,155 companies are SBTi-aligned,[xliii] although only about 20% of the world's largest companies with broader net-zero pledges are included in this number.[xliv]

In this context, there is no doubt that investors will shift their focus more towards a bottom-up view on how individual companies can reduce their carbon footprint, which needs to be mirrored by auditors, regulators, customers and even NOGs. The one professional group, which had been largely absent at the COP26 in Glasgow, was that of auditors, despite being put under heightened investor scrutiny, potentially facing reputational and liability risks if they ignore or misjudge climate risks.[xlv]

FINAL COMMENTARY

Given the intensity of inflationary pressure and the scope of market correction in recent weeks, one final comment for companies still preparing their FY2021 results release, notably when thinking about guidance for 2022 and the dividend policy. Over the last 3-4 weeks, investors have reacted highly sensitive about vague guidance, especially when leaving out inflationary adjustments and - for companies with large operations in emerging markets - foreign exchange sensitivities. The year-to-date poor performance of major stock indices has also heightened the relevance of shareholder return, in terms of both dividends and share buy-backs. Guidance and capital deployment will need to be thought through carefully and explained in detail, as the share price reaction on the date of FY2021 results publication can go massively in both directions, with UBS being up by 6% on 1 February 2022 and Julius Baer down by almost 6% the next day.

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7 February 2022

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ENDNOTES

[i] This is how the CEO of the largest listed container shipping company A.P. Moeller – Maersk A/S, Soren Skou, had raised hopes already at the company's capital markets day in May 2021, though at the Q3'2021 results call in early November the main focus was much more on the high level of congestion and to what extent this has further pushed up contract rates and tied up capacity. Interestingly, the head of diagnostics at Roche, Thomas Schineker, spoke at their FY2021 results call on 3 February 2022 about his expectation that "the virus will stay for a decade" in one way or the other, and how the Roche team assumes the issue of respiratory diseases to spread more widely going forward.
[ii] Mohamed El-Erian, *"The key to 2022 will be how inflation is brought down"*, Financial Times, 4 January 2022
[iii] The S&P 500 index was reportedly down by 5.3% in January 2022, whereas the tech-heavy Nasdaq Composite index fell by 9%, its worst one-month decline since November 2008. Similarly, the FTSE All-World index fell by 5.6%, while European markets fared marginally better, down by 3.8% (Nicholas Megaw and George Steer, *"US stock markets endure worst January since global financial crisis"*, Financial Times, 1 February 2022).
[iv] For a good overview to what extent academic research has tried to make sense out of the phenomena of "lottery stocks" through both the power of social networks and the "attention factor", see: Gillian Tett, *"Meme mania is reshaping US markets"*, Financial Times, 10 December 2021.
[v] Credit Suisse analyst at AMD FY2021 results call, 1 February 2022. Given the structural demand explosion most of the semiconductor companies we had followed in recent weeks were talking about, it is perhaps no coincidence that sell-side analysts focused particularly on supply constraints, with most CEOs conceding that "capacity will remain tight throughout 2022" (TSMC FY2021 results call, 13 January 2022) and "ecosystem constraints" (shortages in substrates, components and foundry silicon) "continuing even into 2023" (Intel FY2021 results call, 26 January 2022). When asked about supply-chain disruptions, the CEO of ASML, Peter Wennink, spoke about a "daily battle with sourcing" though he claimed, at the same time, that they are "getting better in managing the situation" (ASML FY2021 results call, 19 January 2021). Swiss-based VAT Group even conceded that their volumes will moderate in the first half of 2022 "due to supply chains" (VAT Group Preliminary FY2021 results call, 12 January 2022).
[vi] A huge library of literature on the "resilience" of society exists by now, with an increasing number of companies preferring this terminology instead of "robust" and trying to differentiate their strategic approach, see for example German insurance company Allianz at their CMD 2021 on 3 December 2021, with the relevant slide provided in our Appendix. In the current academic debate, a good example is Markus Brunnermeier, *The Resilient Society*, Endeavor Library Press, Colorado Springs, 2021 and, for a more socio-technical analysis of future sustainability, see: Raphael Kaplinsky, *Sustainable Futures. An Agenda for Action*, Polity Press, Cambridge, 2021.
[vii] See for example, UniCredit putting EUR 100mn aside to address the gender pay gap within the organisation for the period 2021-24 (UniCredit 2021 Strategy Day, 9 December 2021, slide 36).
[viii] Relevant examples here were UBS in terms of „agile working" and Straumann for its "high-performance culture" at their CMD 2021 on 16 December 2021 (see Appendix). Interestingly, at their Q&A, Straumann was hardly asked about their "evolving culture journey", whereas UBS received at least one specific question on how to incentivise staff for more agility (RBC analyst at the UBS FY2021 results call, 1 February 2022). In response, the CEO of UBS, Ralph Hamers, outlined "behavioural components" such as collaboration, accountability, innovation and focus on teamwork, which apparently are now part of the remuneration process across the entire organisation.
[ix] Maike Currie, *"US stocks and the market regime change"*, Financial Times, 26 January 2022.
[x] For an interesting analysis to what extent has the sudden increase of bond yields been a trigger point for a major financial crash, as some market observers fear might now be just around the corner, see: Philip Coggan, *"Trigger points loom over equity markets"*, Financial Times, 6 February 2022.
[xi] Robin Wigglesworth, *"Markets are more fragile than investors think"*, Financial Times, 29 November 2021.
[xii] Eric Platt and Joe Rennison, *"Traders struggle to transact shares in volatile US stock market"*, Financial Times, 4 February 2022.
[xiii] Peter Atwater, *"After years of abstraction, things are getting real for markets"*, Financial Times, 11 January 2022.
[xiv] Jonathan Wheatley, *"Emerging markets miss out on 2021 stock rally in developed economies"*, Financial Times, 5 November 2021.

[xv] For a good analysis of the situation in Kazakhstan, which suffered from a "double-edged impact" of a commodity boom for cobalt, copper and uranium – key resources for electric vehicles – and high inflation, see: Charlie Robertson, *"Kazakhstan turmoil shows double-edged impact of commodity surge"*, Financial Times, 13 January 2022.

[xvi] Interestingly, in the wake of Russia's military threat of invading the Ukraine, UniCredit decided to withdraw from its due diligence of Russian Bank Otrkrytie, despite its CEO, Andrea Orcel, being part of the joined call between President Putin and leading Italian business executives just a day before reporting FY2021 results on 28 January 2022. When being asked about this U-turn at the Q&A, Andrea Orcel estimated Russia to account for only about 3-4% of UniCredit Group's revenues and profits, with about 4,000 FTEs on the ground. For any neutral observer, one could not have missed the change in tonality, with a suddenly much stronger focus on its partnership with Allianz in Germany.

[xvii] Kate Duguid and Jonathan Wheatley, *"Emerging markets hit by abrupt slowdown in new foreign investment"*, Financial Times, 9 December 2021.

[xviii] Ruchir Sharma, *"A quiet comeback is starting in emerging markets"*, Financial Times, 17 January 2021.

[xix] This line of argument was taken by various European companies including ABB, Infineon and Trelleborg. However, all three of them spoke at length about the still growing backlog, with ABB aiming to convert 75% of backlogs into revenues in 2022 (ABB FY2021 results call, 3 February 2022) and Infineon even targeting 80% (Infineon Q1'2022 results call, 3 February 2022). Trelleborg indicated that the length of the backlog has now stretched to six months and more (Trelleborg FY2021 results call, 3 February 2022).

[xx] Tom Williams, CEO of ParkerHannifin, at the Q2'2022 results call, 3 February 2022.

[xxi] Pat Gelsinger, CEO of Intel, at the FY2021 results call, 26 January 2022, providing the example of the new plant in Ohio, which is arguably a result of the US-China trade conflict.

[xxii] Craig Arnold, CEO of Eaton, at the FY2021 results call on 4 February 2022.

[xxiii] Tom Williams, CEO of ParkerHannifin, at the Q2'2022 results call on 3 February 2022.

[xxiv] Kathrin Hille, Eri Sugiura, Leo Lewis, Primrose Riordan, *"China's zero-Covid policy poses challenge for manufacturers and supply chains"*, Financial Times, 16 January 2022.

[xxv] In this context, the CEO of ParkerHannifin, Tom Williams, highlighted not only the need for adding new modular services but also for reviewing functions within the organisation, which was partly aggravated by the severe labour shortage in the US (ParkerHannifin Q2'2022 results call, 3 February 2022).

[xxvi] Richard Milne, *"Maersk to buy Hong Kong's LF Logistics in $3.6bn deal"*, Financial Times, 22 December 2021.

[xxvii] Harry Dempsey, Philip Georgiadis, Silvia Sciorilli Borelli, *"Lufthansa and MSC consider taking majority stake in Alitalia successor"*, Financial Times, 24 January 2022.

[xxviii] AT&S Q3'2021/22 results call, 3 February 2022.

[xxix] AMD cited the amount of $1bn specifically invested in "supply chain capacity", notably substrates and wafers, see: Dr. Lisa Su, CEO of AMD, at the FY2021 results call on 1 February 2022.

[xxx] For some very different views, see: Pilita Clark, *"We will pay for our hybrid work freedoms with more hot-desking"*, Financial Times, 31 January 2022; Delphine Strauss in a special FT Collections series: *"Nick Bloom: 'It is becoming pretty clear now that hybrid is here to stay'"*, Financial Times, 22 December 2021; and Megan Greene, *"Why US workers will return to the labour market"*, Financial Times, 3 February 2022.

[xxxi] While demographic developments and even refugees moving in big numbers to different continents have been defined increasingly as a new megatrend, only in isolated cases we came across companies considering recent labour shortages as a megatrend, see for example: Wienerberger at its 2021 capital markets day on 26 November 2021, with the relevant slide provided in the Appendix. For a very sombering view on the current situation in the US, notably the impact of absenteeism on daily workload planning, see: Craig Arnold, CEO of Eaton, at the FY2021 results call on 4 February 2022.

[xxxii] This type of question was particularly frequent at the ING FY2021 results call on 3 February 2022, but other banks were hardly spared either, notably UBS FY2021 results call and strategy update on 1 February 2022 and Julius Baer FY2021 results call on 2 February 2022.

[xxxiii] KPN FY 2021 results call on 31 January 2022, which also informed the market about its plans to cut 700 FTEs in 2022 in addition to natural attrition. Wienerberger reported a similar number for wage inflation across its European markets during the 2021 capital markets day on 26 November 2021, while SGS Group estimated this to be 2% in 2021 (SGS Group FY2021 results call, 27 January 2022).

[xxxiv] Frankie Ng, CEO of SGS Group, at their FY2021 results call, 27 January 2022.

[xxxv] There is an extensive coverage on what has been dubbed "the great resignation" in the US, with most post-pandemic era quitters saying that they have left for search of better pay, a better work-life balance and/or better

benefits in the workplace, see: Taylor Nicole Rogers, *"The switching generation: US workers quit jobs in record numbers"*, Financial Times, 9 December 2021.

[xxxvi] For an extensive review across different markets and companies, see: Janina Conboye, Eri Sugiura, Eir Nolsoe and Taylor Nicole Rogers, *"What does it take to recruit and keep staff in a tight market?"*, Financial Times, 31 January 2022.

[xxxvii] For a representative example, see: Lonza FY 2021 results presentation, 26 January 2022, slide 9 (see Appendix).

[xxxviii] Employees have now a much stronger hand, witness the backlash Amazon faced after revelations of its work practices in: Patrick McGee, "*Amazon settlement with labour board paves way for workers' union"*, Financial Times, 26 January 2022, and for the fast pace of unionisation in recent months, see: Taylor Nicole Rogers, *"Starbucks workers await results from first US union vote"*, Financial Times, 9 December 2021.

[xxxix] The Goldman Sachs analyst, Michele DellaVigna, was asking the same question on the likely score in terms of revenues and investments at both the OMV FY2021 results call on 3 February 2022 and Shell FY2021 results call the same day. OMV estimated about 40% of their investments to be in sustainable energy in 2022.

[xl] Andy Bounds, *"Only a handful of companies show they are ready for EU green rules"*, Financial Times, 26 January 2022.

[xli] Chris Flood and Simon Mundi, *"Influential asset owners group lifts its climate change game"*, Financial Times, 25 January 2022.

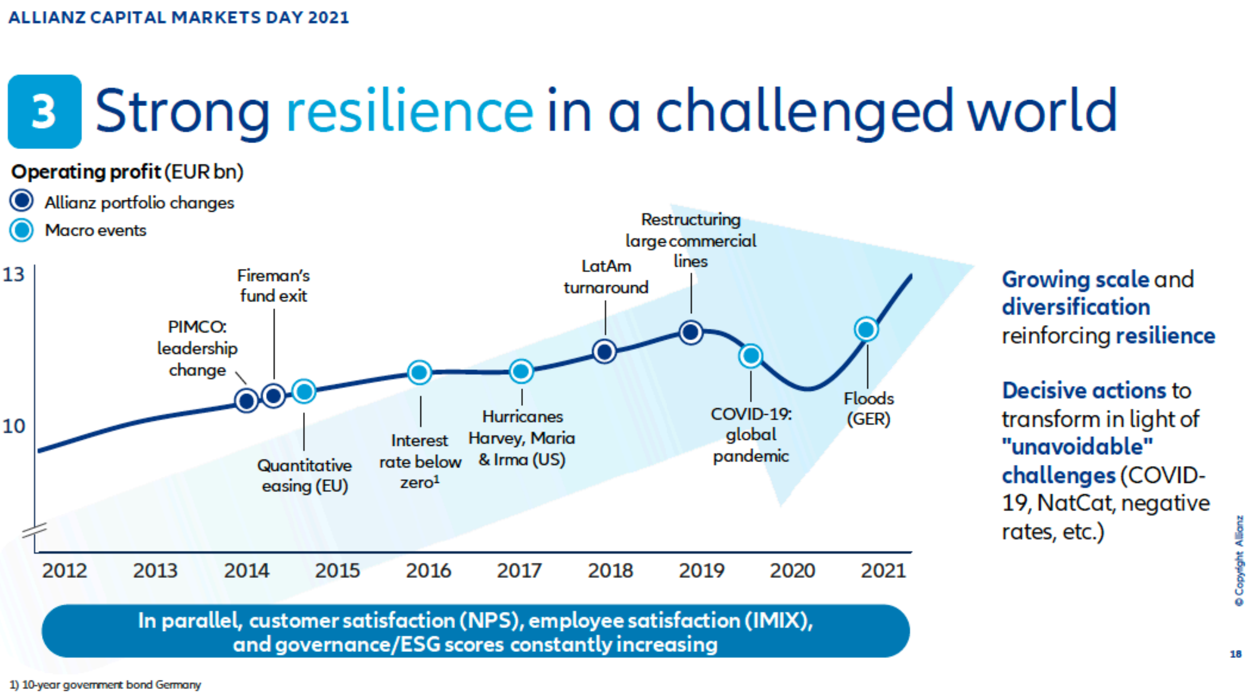
[xlii] Huw van Steenis, *"A new phase for green investing"*, Financial Times, 17 November 2021.

[xliii] https://sciencebasedtargets.org/companies-taking-action

[xliv] Polly Bindman, *"Why Science-Based Targets are no substitution for coal policies"*, Capital Monitor, 21 September 2021.

[xlv] Gillian Tett, *"The green transition may depend on auditors"*, Financial Times, 5 November 2021.

APPENDIX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PIMCO: leadership change
Fireman's fund exit
Quantitative easing (EU)
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LatAm turnaround
Restructuring large commercial lines
COVID-19: global pandemic
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Growing scale and diversification reinforcing resilience
Decisive actions to transform in light of "unavoidable" challenges (COVID-19, NatCat, negative rates, etc.)
In parallel, customer satisfaction (NPS), employee satisfaction (IMIX), and governance/ESG scores constantly increasing
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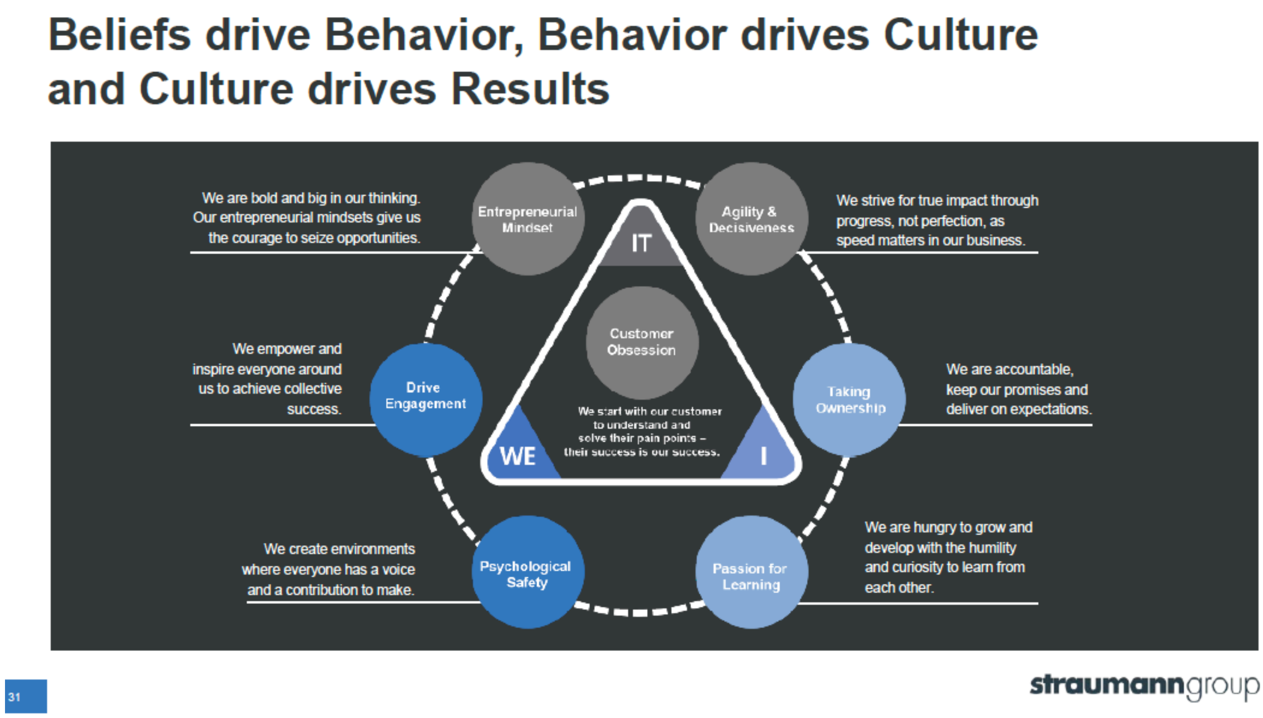
1) 10-year government bond Germany


Beliefs drive Behavior, Behavior drives Culture and Culture drives Results
We are bold and big in our thinking. Our entrepreneurial mindsets give us the courage to seize opportunities.
Entrepreneurial Mindset
Agility & Decisiveness
We strive for true impact through progress, not perfection, as speed matters in our business.
IT
Customer Obsession
We empower and inspire everyone around us to achieve collective success.
Drive Engagement
Taking Ownership
We are accountable, keep our promises and deliver on expectations.
We start with our customer to understand and solve their pain points – their success is our success.
WE
I
We create environments where everyone has a voice and a contribution to make.
Psychological Safety
Passion for Learning
We are hungry to grow and develop with the humility and curiosity to learn from each other.
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straumanngroup

Megatrends

We base our development on underlying key megatrends

wienerberger

Lack of skilled labor

The construction industry faces **skill shortages** and the need for **"on time in full" construction delivery**

Climate Change

Unpredictable weather conditions lead to water scarcity while increasing demand for energy conservation and an emission free lifestyle

System solutions

Robotization and prefabricated solutions

Creating more convenience via digitalization of processes

Training (Digital & Onsite)

Infrastructure solutions

Water management

Prevention of flooding

Irrigation

Transportation of Renewables

Sustainable living solutions

Reduce energy consumption

Improve CO_2 footprint

Implement circular economy

Water management

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Refocusing our Business to Deliver Sustainable Value Creation

Our Sustainability status today

Lonza

- CO_2 footprint is 35% smaller following the divestment of the Specialty Ingredients business
- Nitrous oxide: catalytic converter in Visp (CH) successfully commissioned in early October 2021, ahead of schedule[1]
- Significant investment in sustainable remediation of legacy environmental issues
- 11% relative greenhouse gas (GHG) intensity reduction compared to 2020, corresponding to a 2.3% absolute reduction[2]
- Lonza recognized by Ethisphere® as one of the world's most ethical companies

Our Focus: Material Topics[3]

Environment

- Carbon Emissions
- Energy
- Water and Effluents
- Waste

Responsibility

- Anti-Bribery / Anti-Corruption
- Supply Chain Responsibility

Society

- Occupational Health and Safety
- Diversity and Equal Opportunity
- Employee Recruitment, Development and Retention
- Employee Engagement

[1] The business was transferred to the purchaser of the Specialty Ingredients business in July 2021
[2] Calculations based on Q1-3 2021 vs Q1-Q3 2020. Full-Year results to be published in Lonza's Sustainability Report, March 2022
[3] Topics identified as the most relevant for Lonza to best support sustainable development

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