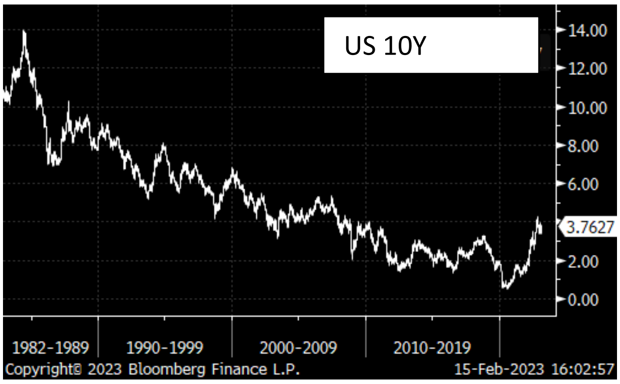
Annual Letter 2022

February 2023, Kuylenstierna & Skog S.A.

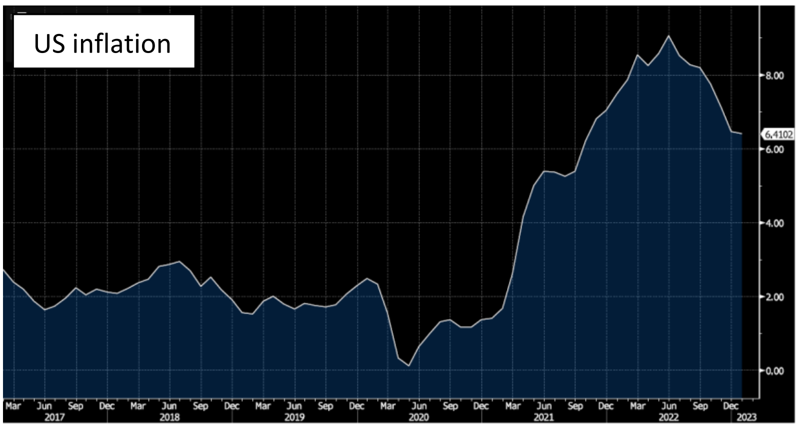
2022 was characterized by large movements in the financial markets with decreasing prices for both stocks and bonds. Easing pandemic effects with better functioning logistics chains and more normalized consumption patterns provided support, while the resurgence of inflation and its possible consequences created great uncertainty. Raised interest rates from central banks created concerns about a looming recession. However, a strong global demand and a hot labour market spoke against it, but rising prices for energy, mortgages and food put pressure on consumption.

Much focus has naturally also been directed at the war in Ukraine.

After the major stock markets around the world hit record highs a couple of days into the new year, the mood changed to the negative and markets fell. The rest of the year was characterized by big movements. The main explanation is that after 40 years of falling interest rates, due to, among other things, globalisation, digitalisation and access to cheap labour, inflation came back to life. The monetary and fiscal policy experiment, which began with the financial crisis of 2008, and which put many important market forces out of action, was extended during the pandemic with negative interest rates, purchases of various assets (QE) and helicopter money. This has meant that money has been free of cost and access to financing too easy.



A certain normalisation of monetary policy began before the pandemic hit but was abruptly interrupted as the world came to a standstill. The effects of the pandemic were difficult to predict, but in retrospect we can see that demand, on a general level, was maintained at relatively high levels and many employees were able to handle their tasks working remotely. Relatively high demand, high liquidity, supply shortages and logistical problems created a perfect cocktail for an inflationary shock.

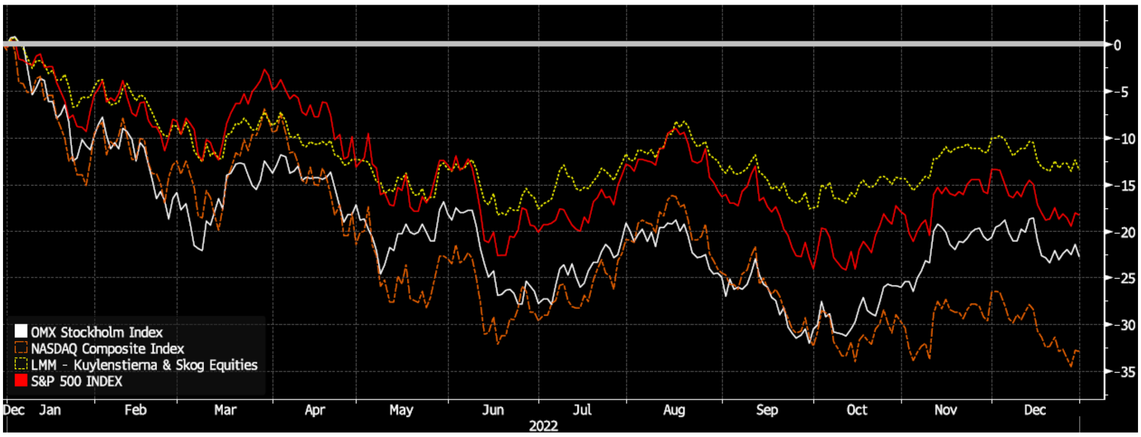


The conflict between Russia and Ukraine escalated into a Russian invasion on February 24th, and with that the conditions for both Europe and the world changed, both on an economic as well as on a human level. In addition to all the people affected by the horrors of the war, it also fuelled an already rising inflation as energy and dry goods shortages became increasingly apparent.

The central banks responded to the high inflation figures with their main weapon, the policy rate. The US central bank, the FED, led the rate hikes. The Riksbank followed and in April Sweden reached a key interest rate above zero for the first time since 2014.

Heavily raised interest rates are cooling the economic activity and worries increased that the world would be thrown into a recession. Rising energy, food and mortgage costs hit household finances hard, especially in Sweden where around 50% of the mortgages have a duration of less than 1 year. A weak SEK also led to imported inflation.

For the rest of the year, financial markets focused on whether inflation had topped or whether further interest rate hikes would be necessary – something that left markets torn between hope and despair. In Europe, there was more talk of supply-side inflation, while the US saw more of demand-side driven inflation.



In terms of company reports, many global industrial companies showed continued strong demand during the year. Reduced pandemic effects and better functioning logistics chains weighed on the positive side. The order books were filled, but profitability was affected by higher costs. However, some companies in the consumer sector saw demand fall rapidly and the real estate companies' access to future financing has been questioned when a big share of bonds mature in the coming years.

In China, the spread of Covid 19 increased again, with new closures as a result. The measures created great dissatisfaction and extensive demonstrations. The situation was sensitive for President Xi Jinping, who took pride in the country's successful fight against Covid, done with the country's own medicines. Increased contagion would mean a great loss of prestige for him personally, even so he was forced to ease the restrictions towards the end of the year to calm the situation down.

Our fund, Kuylenstierna & Skog Equities, summed up a challenging and, in many ways, tragic year with a decline of -13.5%. The broad index of the Stockholm Stock Exchange (SAX) fell by -24.6%, the S&P 500 (SPX) -19.7% and the broad index of Europe (SXXE) by -14.5%. At the beginning of 2022, the fund was invested 86% in shares, in December 92% distributed between roughly 30% in Sweden and the USA, 15% in Europe and 11% in emerging markets.

2023 – Inflation, recession, geopolitics and a transition to a more sustainable world

In 2023, we expect a continued focus on inflation and its effects on the underlying economy. Companies in the consumer sector will probably see major challenges when the purchasing power of households is eroded by higher costs. In 2022, however, figures emerged showing that inflation is on the way down in terms of raw materials and shipping costs.

Even so, it does not seem likely that interest rates will find their way back to the low levels we have become accustomed to in recent years. This means more expensive financing, both for households and companies. In Sweden, inflation continues to rise, partly due to a weak SEK and imported inflation, something that the Riksbank is beginning to see as negative. A strong labour market and strong global demand suggest that a possible recession could still be relatively mild. The reopening of China could also help.

Geopolitics will as well continue to be in focus. The war in Ukraine will naturally be followed closely, but also how the relationship between the US and China develops. The transition to renewable energy, electrification and investments in infrastructure are other themes for 2023.

Our ambition is to continue on the same path and invest in a well-diversified portfolio with both value and growth stocks spread globally but with a continued focus on Sweden. We stay cautious when it comes to investing in companies with large future financing needs.

ESG

Kuylenstierna & Skog S.A. (K&S) believes that is essential to hold environmental, social and governance (ESG) criteria to the highest standards. This is fundamental in reaching our collective ambition of creating a better everyday life for the future.

Companies and businesses that take responsibility and sustainability seriously also take climate-related risks seriously. K&S therefore pursues strategies that follow a clear path towards a more sustainable future. We believe that climate change poses a significant risk to the economy and financial markets, but it is not yet fully reflected in pricing. Although it is urgently needed, we do recognise that the transition to a lower-carbon economy could have significant long-term impacts on companies and assets in which we invest.

K&S sees a great opportunity in companies that recognise the need for this transition and a risk to companies that do not grasp the urgency. We are therefore proactive and this is reflected in our investment decisions.