January 2022

INSIGHTS

Looking Into 2022

This paper shares my views on markets and the ensuing opportunities for our strategies, as well as an update on the Firm.

Sir Michael Hintze, Co-CEO
and Senior Investment Officer

We live in exciting and challenging times.

Massive political and economic realignment is underway. The world is more complicated and nuanced. There are many crosswinds.

We are seeing divergent geopolitical aspirations, major societal change and economic dislocations.

With this comes conflicting policy challenges. The push toward resilience and self-sufficiency at a state level, which started with the Global Financial Crisis, continues. A major consequence is the challenge of inflation. Money supply growth, fiscal and economic stimulus, supply chain disruption, labour market shortages and the transition to green energy are key additional factors not only driving inflation but also investment opportunities.

It is an interesting world, with many moving parts. There are dislocations and opportunities to exploit and manage. I am both excited and cautious about the investment landscape. Given the significant number of conflicting uncertainties, the optimal solution can be hard to ascertain. Even when it is, one needs to be able to pivot and be nimble. Today's stability could be tomorrow's instability.

CQS

An Update on CQS

Let me begin by thanking you, our clients, for giving us the trust to manage your assets through 2021 which proved to be a successful year for CQS. We worked hard to rebuild and strengthen post 2020 by focusing on our core strengths across credit markets. As ever, our primary focus has been our clients, and our teams have worked relentlessly to deliver long-term, risk-adjusted performance on the portfolios we manage for you. In fact, clients have entrusted us with more assets. We started 2020 with USD18.6 billion and today we stand at USD21.6 billion. My colleagues and I feel a great deal of responsibility for the trust given to us by allocators striving hard to deliver for their ultimate pensioners and investors. Our Directional Opportunities, Asset Backed Securities and Credit Multi Asset Funds ended 2021 with gains of 21.5%, 13.1% and 6.3% respectively. Our Convertible Bond and New City Investment Trusts also performed well, with our Global Sustainable Convertible Fund up 8.2%, Convertible Arbitrage up 4.7% and New City High Yield, Natural Resources and Geiger Counter up 18.1%, 43.4% and 83.4% respectively[1]. We also launched our first US CLO at USD410m, achieving excellent pricing and seamless execution.

As we plan for the next phase of our development, it is important for me to make that journey with colleagues I trust. I wanted to create a sense of ownership and succession through individuals who have had a long history within our business, understand our core markets and how to meet client needs. To that end, in early 2021 we established a Senior Partner's Group. As Partners, Soraya Chabarek (my Co-CEO and Global Head of Distribution), Craig Scordellis (Head of Multi Asset Credit) and Jason Walker (CIO of ABS) represent the key pillars of our Firm. They have consistently worked with me and together to deliver for our clients and to drive our business forward. In her 10 years working with me, Soraya has been instrumental in representing our clients' views and championing their needs. She has helped me manage the Firm over the past few years, enabling me to focus on performing for our clients, which is my primary motivation. In 2021 we made Soraya's role official, promoting her to Co-CEO.

I am most proud of the strides and successes we have achieved in Responsible Credit investing. Today we manage 60% of our AUM in Article 8 mandates as part of CQS' Firm-wide initiative to drive sustainability across our platform. We are signatories to the PRI, the UK Stewardship Code and the Net Zero Asset Managers Initiative. We are currently investigating the launch of one of the first Responsible Investment-aligned CLOs in Europe on our existing European CLO platform. We also manage Responsible Investment Regulatory Capital strategies through our ABS platform. With Soraya at the helm, we are focused on our initiatives around diversity & inclusion, again building on our significant progress to date. We pride ourselves on a demonstrable track record of nurturing our home-grown talent and a key area for us has been our flourishing graduate programme. This scheme has brought fresh, diverse talent into our organisation, and helped us participate in important city-wide initiatives such as 10,000 Black Interns and RedStart.

Our charitable work is important to me. This year, for example, I was pleased to be able to support the evacuation of more than 100 female jurists and their families from Afghanistan. These women and their families' lives were at immediate risk, and we had to move quickly by supporting the initiative spearheaded by Baroness Helena Kennedy.

In the pages that follow I will share my views on geopolitics, economics and markets. The investment opportunity set for our strategies is strong and there is more to do.

Thank you for your continued support. I would like to wish you and your families a happy New Year and all the best for 2022.

[1]Source: CQS as at 31 December 2021. Past performance is not a guide to future returns. Please refer to the disclaimers at the end of this document.

My views in brief:

- The world is complex. There is a significant amount of change
- There are notable shifts in both monetary and fiscal policies which will in turn influence asset markets
- Inflation is a major driver of fiscal and monetary policy, and of sentiment, profits and returns
- Geopolitical events are more likely to be felt in markets this year
- Potential dislocations and dispersion should lead to exciting investment opportunities to exploit across long and short strategies
- Doing the bottom-up work across asset classes is essential to capture alpha-driven returns
- Floating rate asset classes are especially attractive

Geopolitics

2022 will see the next steps on the road to Globalisation 2.0 which started with the Global Financial Crisis (see the below graphic). But while China's rise initially dampened global inflationary pressure, this year's increased wages, a workforce that has plateaued, and its geopolitical ambitions will add to it. States will have little room for error as they attempt to promote growth, and reduce both public debt and inequality. And Great Power politics is back. Systemic rivalry is framing economic and political competition and I sense, despite huge complexity and much talk of multi-polarity, a discernible drift to a bipolar world.

While the West looks to weaponise the existing international system (sanctions, tariffs, non-tariff barriers), opponents (and Western entities seeking more autonomy from Washington) are looking to protect themselves by reshaping it and undermining the pre-eminence of the USD, including through the digitalisation of currencies. All are prioritising resilience and sovereignty in supply chains. Autocrats see malign foreign interference and existential risk in every popular movement and deploy a full-spectrum response. The probability of trouble in Ukraine, Taiwan and Iran is too great to view as tail risks; the embroilment of the US is the tail risk in each, and leaders in the Democratic People's Republic of Korea and a resurgent Al Qaeda are anxious for international attention. Any one of these could prove hard to contain.

In 2022, geopolitical risk will matter more. Monetary and fiscal responses to inflation and record public debt will tighten the transmission mechanism between geopolitical events and markets. There are a number of geopolitical factors that I expect to be in play in 2022, which will provide the context for our investments and the pricing of risk. Please see page 16 for our assessment of these.

End of Globalisation: Road to Globalisation 2.0[2]

2001-07

9/11 Interrupted the New World Order but not the rise of China

The US led a Global War on Terror.

China joined the WTO and worked toward becoming the manufacturing engine of the world, and this lowered inflation.

2008-09

Peak Globalisation, Global Financial Crisis

Global markets, supply chains optimised.

2009 Hu targeted increasing China's influence on global governance.

2010-16

Continuing rise of China with transfer of wealth and jobs

QE did 'whatever it took' but led to real asset inflation and exacerbated inequality.

China's strategic move to dominate certain core materials, supply chains and manufacturing.

Expansion of BRI, further building influence.

2016-19

Peak Populism and Great Powers

Populism rose in the West.

Brexit and Trump.

Nationalism and Protectionism and Great Power competition.

2020-21

Global Pandemic and Great Powers

Resilience, autonomy, and sovereignty.

Recovery, inflation, and inequality.

Great Power competition for the International Order.

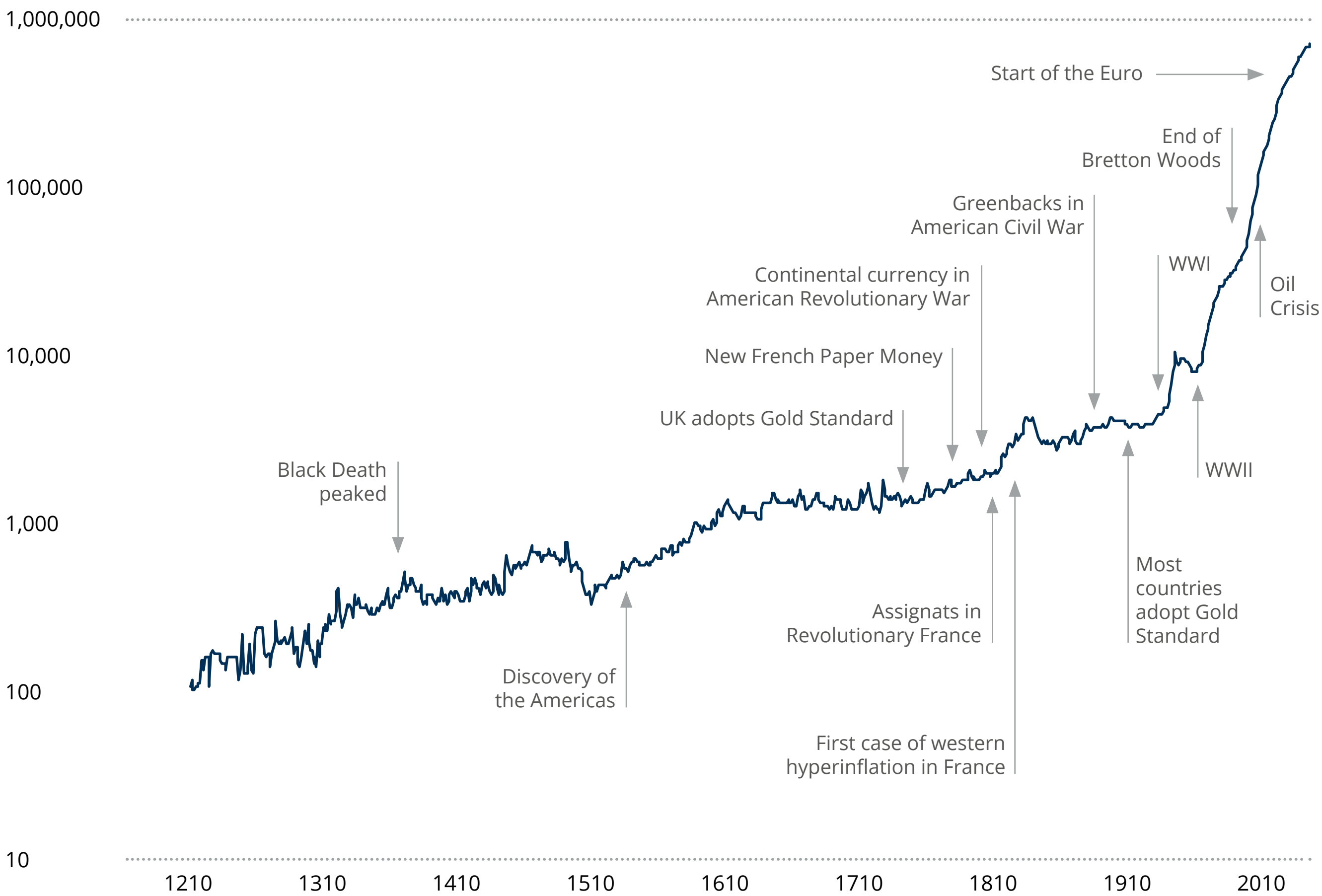
[2]Source: CQS as at 14 January 2022.

Economics & Markets

We are living through a shift in the economic landscape. We have seen transitions before. The demise of the Gold Standard, the shift to Keynesian fiscal policy and then to the Volcker monetarism of the 1980s all represented similar shifts. The 1980s witnessed the start of growth of the swaps and derivatives markets. In my view, the scale of the interest rate swap market in particular is now blunting the transmission mechanism of monetary policy from the Federal Open Market Committee. The 'Dynamic Stochastic General Equilibrium' model has been increasingly replaced by a model more driven by narrative feedback. As can be seen from Figure 1, the scale of monetary base to GDP is unprecedented leaving inflation as a key challenge to corporates, consumers and central bankers alike.

Figure 1

Global Median
Inflation Data

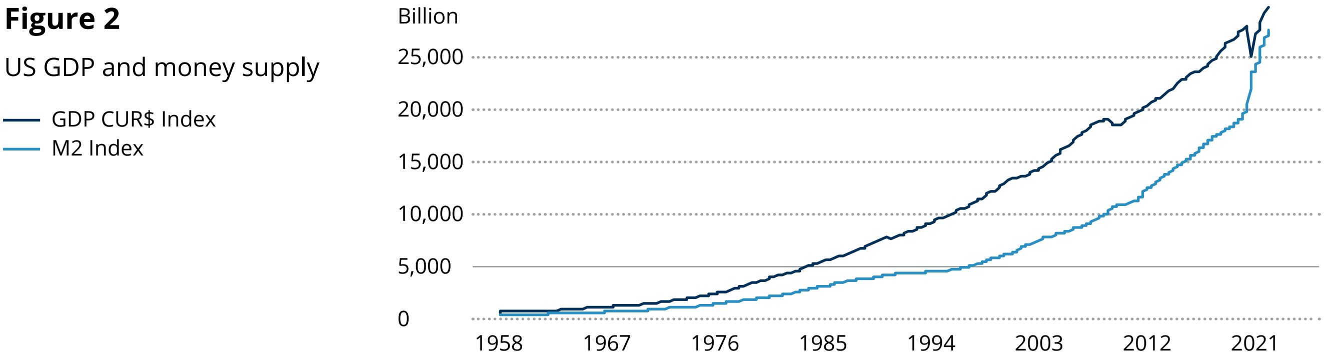


Source: Deutsche Bank as at December 2020.

It is hard not to have inflation when the money supply base, both absolute money supply and relative to the size of the economy, is so large. It rapidly expanded following the Global Financial Crisis and more so in the face of Covid-19 (see Figure 2). The effect of increased money supply has been considerable across markets. It has been good for credit spreads, default rates, equities, and other assets keeping real yields low (as we can see from Figure 3).

Figure 2

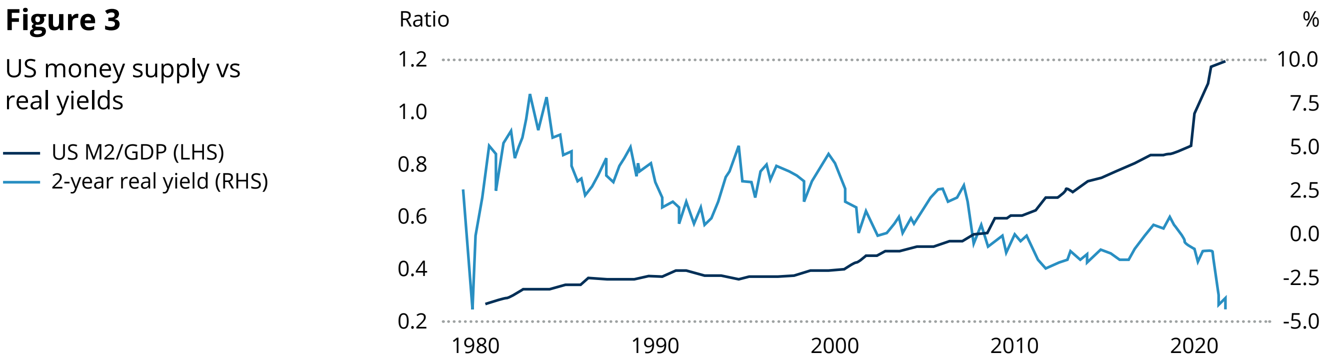
US GDP and money supply



Source: Bloomberg and CQS Research as at 30 November 2021.

Figure 3

US money supply vs real yields

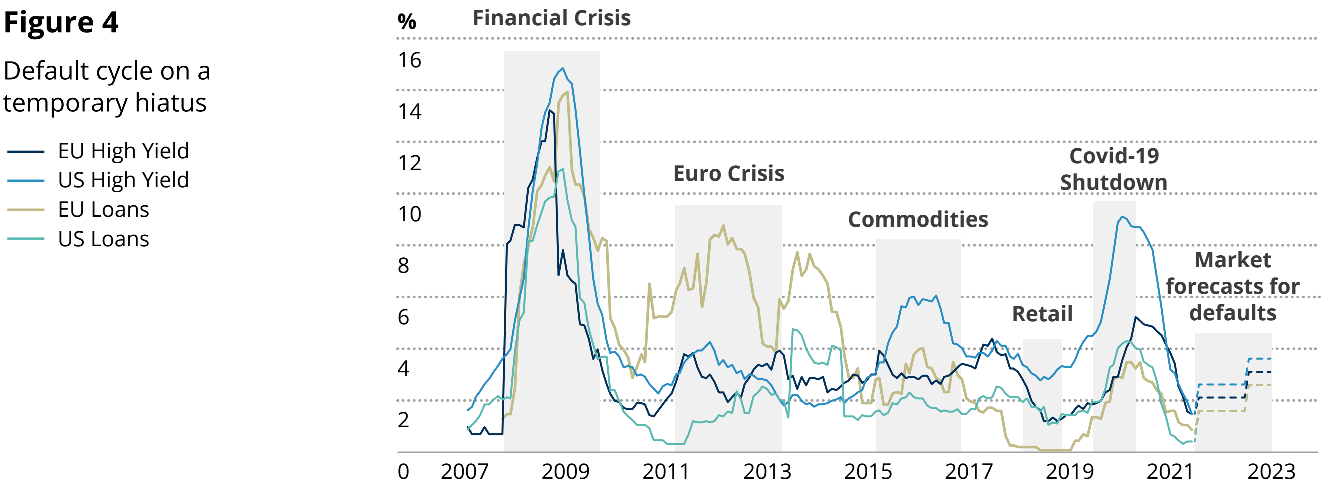


Source: Federal Reserve and Citi Research as at 4 January 2022.

Low levels of interest rates and the impact of QE have both lowered market interest rates and compressed corporate credit spreads. Corporates have been able to refinance at ever lower rates. Even those more marginal borrowers have been able to maintain access to credit and have done so at attractive rates of interest. As Figure 4 illustrates, we have seen corporate defaults at a much lower level than we might have expected, especially through this Covid-related economic upheaval.

Figure 4

Default cycle on a temporary hiatus



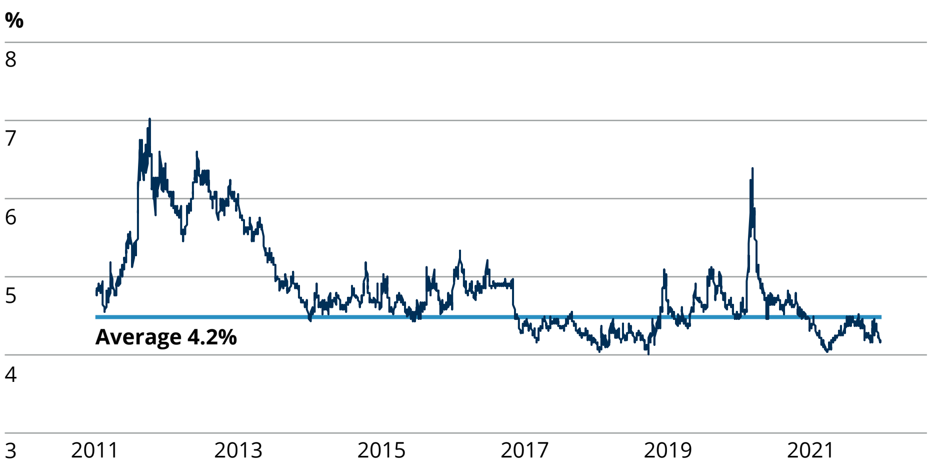
Source: Moody's Default Report and LCD as at 31 December 2021.

Another consequence of the interest rate and spread compression is the increased relative attractiveness of equities versus fixed income. As the Covid economic collapse proved to be much shorter than expected, corporates quickly returned to generating profits and paying dividends. The earnings yield attraction of equity relative to fixed income has lifted the Equity Risk Premium (see Figure 5) and in doing so amplified the TINA ('There Is No Alternative') effect. Equity markets have therefore benefited from low absolute levels of rates and spreads, and also the portfolio flows that followed.

As discount rates have fallen, the long duration, growth, unprofitable areas of the market have, until recently, been the largest beneficiaries of these trends.

Figure 5

US Equity Risk Premium over the last 10 years



Source: Bloomberg and CQS Research as at 12 January 2022.

On rates, given the Fed's recent hawkish pivot, market consensus expects an acceleration of QE tapering, rate hikes in at least the first half of 2022, and currently elevated inflation levels to recede over the course of the year. With the money supply base so large, inflation will likely remain high in the shorter term, underlining the pressure on the Fed to be seen to act. Separately, China looks to be leaning the other way and, especially following recent re-initiations of lockdowns, offering more monetary and fiscal support to their economy.

After the beta run from the last 18 months, there is now more scope for generating alpha amid dispersion and divergence.

This all presents nuance for risk markets. Most major structural equity bull markets start with depressed profits and margins, low absolute valuations and moves toward more accommodative policy. However, 2022 starts with high absolute valuations, record profit margins, very low/soon-to-be-rising interest rates and lower fiscal support year-on-year. So after a period of elevated macro drivers to asset returns, overall market returns may well be lower than in the recent past.

Central Banks moving to a less benign policy stance means markets will have to navigate those factors that had been beneficial. Within credit markets, the so-called 'Zombie' corporates, only kept alive by the 'access for all' refinancing, will have to withstand more expensive financing and tighter lending standards. Within equity, while headline indices are clearly of interest, powerful rotational trends are likely as rising discount rates favour a different set of corporates.

Doing the bottom-up work, company by company, is key. Which companies can pass on higher costs? After the beta run from the last 18 months, there is now more scope for generating alpha amid dispersion and divergence.

Investment Themes

Responsible Investing

ESG has been a key theme in financial markets for a number of years. This has driven fund flows, fund launches and the bifurcation of asset valuations across winners and losers. As we can see in Figure 6, as ESG-driven assets have risen, the relative valuation of companies with stronger ESG scores has also increased.

We have also seen newly-labelled European sustainability funds adding USD1.7 trillion to ESG assets under management (Figure 7). The overall ESG market is now USD35 trillion.[3]

From an investment perspective, the team and I have been focused recently on the opportunities that have fallen through the gaps.

I talked earlier about what we have done, and continue to do, as a business. From an investment perspective, the team and I have been focused recently on the opportunities that have fallen through the gaps. That is to say, those corporates that are neither 'fish nor fowl' given exposures to both the good and bad of ESG metrics and also those embarking on an ESG transition. There is opportunity here.

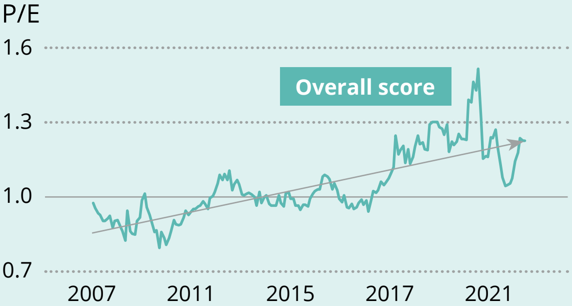
By way of example, our research has identified a global leader for subsea solutions for the Oil & Gas industry. As a high tech engineering business, this company faces material environmental challenges and continued drop in profitability from its traditional Oil & Gas-related business, affecting both its valuation and cost of capital. Its response has been to deploy intellectual capital in energy transition. By adapting to the new world, areas of this company's growth could be lucrative and the provision of ESG targets should aid its path to recovery.

There are ESG overlaps across our areas of thematic work. For example, de-carbonisation of the global economy breaks down into a wide range of themes including, the commercialisation of hydrogen, energy storage (e.g. batteries) and renewables such as solar and wind. Themes that combine top-down ESG compliance with new technological developments and a new set of tradeable corporates present ongoing opportunities. Battery technology is of particular interest given both the looming technological progress and the reset in corporate valuations of recent months.

[3]Source: Credit Suisse as at 6 December 2021.

Figure 6

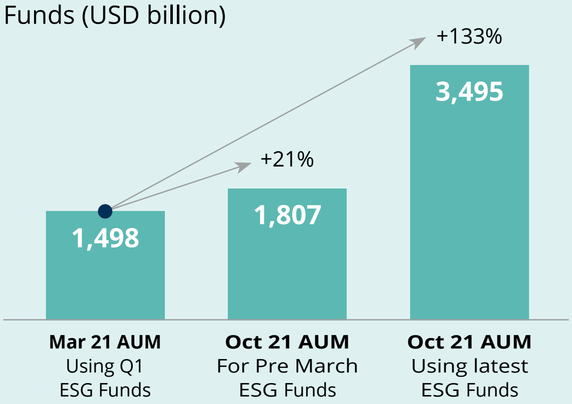
Rising relative valuations of companies with stronger ESG scores



Source: MSCI, Factset, BofA US Equity & Quant Strategy as at 19 November 2021.

Figure 7

AUM of European Sustainability Funds (USD billion)



Source: Morningstar, Morgan Stanley Research as at 22 November 2021.

2021 Returns[4]

European Gas
+300%

Oil
+56%

Copper
+24%

Uranium
+76%

Gold
-4%

[4]Source: CQS and Bloomberg as at 31 December 2021.

Energy Transition and Commodities

2021 was an extraordinary year for energy. European Gas gained 300%, despite a 50% correction from the mid-December 2021 high. Oil gained 56%, Copper 24% and Uranium 76%. Gold fell 4%.[4] There are some additional specific issues for Gas, such as reduced flows from Russia, but ultimately this was caused by the ongoing energy transition. This matters as energy has risen as a percentage of GDP given the recent rise in energy prices and the increasing role of alternative energy. As such, the extended nature of these price rises acts as an inflationary impulse through the global economy and has implications for growth and monetary policy alike.

Investment into the so-called ‘old economy’ industries has already been reduced over the past few years, especially in fossil fuel supply and storage. More specifically, new gas and oil supply is being restricted by both government policies and a need to adhere to ESG principles. So the economic rebound of 2021 became a key pinch point. Aggregate economic demand reset far quicker than impaired supply chains could facilitate and this dynamic became particularly apparent in global power markets.

Clearly the global economy is fully behind the broader shift to electrification. Copper is the key base metal in this regard. However, underinvestment in copper mine production and other key elements required in the electrification of the global economy has hindered the growth in supply required in the short term to facilitate the energy transition. Supply remains constrained given the long lead time for new mines and political uncertainty in Chile and Peru (the largest two producers). Meanwhile, the accelerating desire to de-emphasise fossil fuel sources has led to a disorderly unwind in parts of the base power capacity and as such has put pressure on power grids.

The energy transition requires buy-in from policy makers, corporates and consumers alike and there is a requirement to mobilise and reallocate enormous amounts of capital across developed markets and importantly also emerging markets to meet mid-century targets. Accordingly, volatility in energy markets is likely to continue.

Ultimately higher prices will have the same desired effect in reducing demand. However, this also has an impact on the broader economy, with implications for inflation and therefore interest rates. Energy has already added inflationary pressures directly to global CPI calculations. This may be felt more so in 2023 as one-year fixed price contracts, which somewhat protect industrial and retail users, expire into next year. We note that forward curves for gas have seen increases of up to 300% (UK Gas is up 370% for November 2022 year-on-year). There are also many indirect price pressures.

The energy transition will ultimately show up in other bottlenecks, especially around the supply of key inputs and materials to enable this shift to occur. Lithium will likely remain tight due to strong demand growth, but ultimately isn’t rare, so will always be at risk of excess capacity at some stage. Rare earths, used in powerful magnets for wind turbines and electric vehicles, aren’t rare, but processing capacity for them is, given complex chemistry. Their production is dominated by China so it is heavily affected by geopolitics, leaving a particular Australian producer, as the largest non-Chinese producer, well placed to benefit. Nuclear power seems critical to governments meeting their COP26 carbon emissions targets and will likely see a further positive shift in support for the continuation of the existing reactor fleet. The German anti-nuclear position is not likely to affect the EU decision that nuclear is green (and the potential development of small modular reactors), but China remains the primary driver of new reactor construction.

Thematic investing remains a key focus. Identifying durable trends that accelerate growth and drive asset re-ratings provides a powerful combination for investment returns.

Technology and the New Economy

A persistent feature of the 'Great Moderation'[5] of the last few decades has been the deflationary impact of new technologies. Whether through the automation of business processes via robotics or the migration of services into the cloud, new technologies have both stimulated growth, through the creation of new markets, and exerted a disinflationary impulse via the substitution of capital for labour.

Since the Covid pandemic struck, the disruption of global supply chains, the reach for 'Just in Case' rather than 'Just in Time' inventory management and geopolitical sensitivities around reshoring key industries have injected shortages into the global economy, resulting in pricing power across various product channels. As the 'bullwhip' of inventory fluctuations works its way through supply chains, the disinflationary impulse from technology is likely to return.

Thematic investing remains a key focus. Identifying durable trends that accelerate growth and drive asset re-ratings provides a powerful combination for investment returns. Recent areas of focus have included macro themes such as decarbonisation which in turn covers a wide range of narrower themes such as nuclear, hydrogen, energy storage and renewables. Demographic trends also drive a number of thematic subsets, such as payments, food, social care and gaming.

Occasionally, multiple themes may overlap and amplify the persistence and strength of the investment drivers. A recent example has been the conflation of the desire of certain geographies to re-shore key technologies and the electrification of global economies which have combined to underpin secular trends in the semiconductor space and throughout their own supply chains.

Another theme that has seen a significant pick-up through the pandemic is Cybersecurity. Lockdowns and subsequent Work-From-Home requirements have increased the 'attack surface' for every corporate. As such, from a very low relative level of the technology budget, corporates have been and will continue to accelerate spending in this area. This combines with technological progress within the sector as the business model migrates to the cloud, lifting margins and returns accordingly.

The relationship between monetary and fiscal policy and the role of Central Banks has been especially important since the Global Financial Crisis and will remain so.

Central Bank Digital Currency

The relationship between monetary and fiscal policy and the role of Central Banks has been especially important since the Global Financial Crisis and will remain so. The question of Central Bank independence is back along with the question of the development of digital currencies, whether as vehicles for the modernisation of financial services, political control, or geopolitical rivalry – or all three.

Almost every Central Bank is exploring digital currency. Many see the benefit of incredible control of who has what, where, and who is doing what, and having the ability to extinguish holdings. Many governments also see digitalisation as a way to reduce dependence on the US dollar and US-centred banking and payment systems, and therefore vulnerability to Washington which periodically weaponises them (e.g. through sanctions). This clearly includes the PRC and Russia who are assessing alternatives to Swift, but includes some in the EU who see it as essential for their strategic autonomy.

[5]The Great Moderation is the name given to the period of decreased macroeconomic volatility experienced in the United States starting in the 1980s. During this period, the standard deviation of quarterly real GDP declined by half and the standard deviation of inflation declined by two thirds. The Great Moderation can be summed up as a multi-decade period of low inflation and positive economic growth.

Cryptocurrency

Given accelerating economic growth and considerable liquidity provision, retail investors have been very constructive on risk assets, largely fully invested and prone to buying any dip. With its attendant volatility, the crypto universe including cryptocurrencies, non-fungible tokens and the wider metaverse have been recipients of considerable interest from the retail trading community.

Despite the apparent growth in the total value locked in Decentralised Finance (DeFi), the number of active addresses has stagnated, and some of the growth is due to double counting. The shortage of USD available to crypto players remains acute given high yields available on staked stablecoins, and this combination points to increased concentration of risk amongst players.

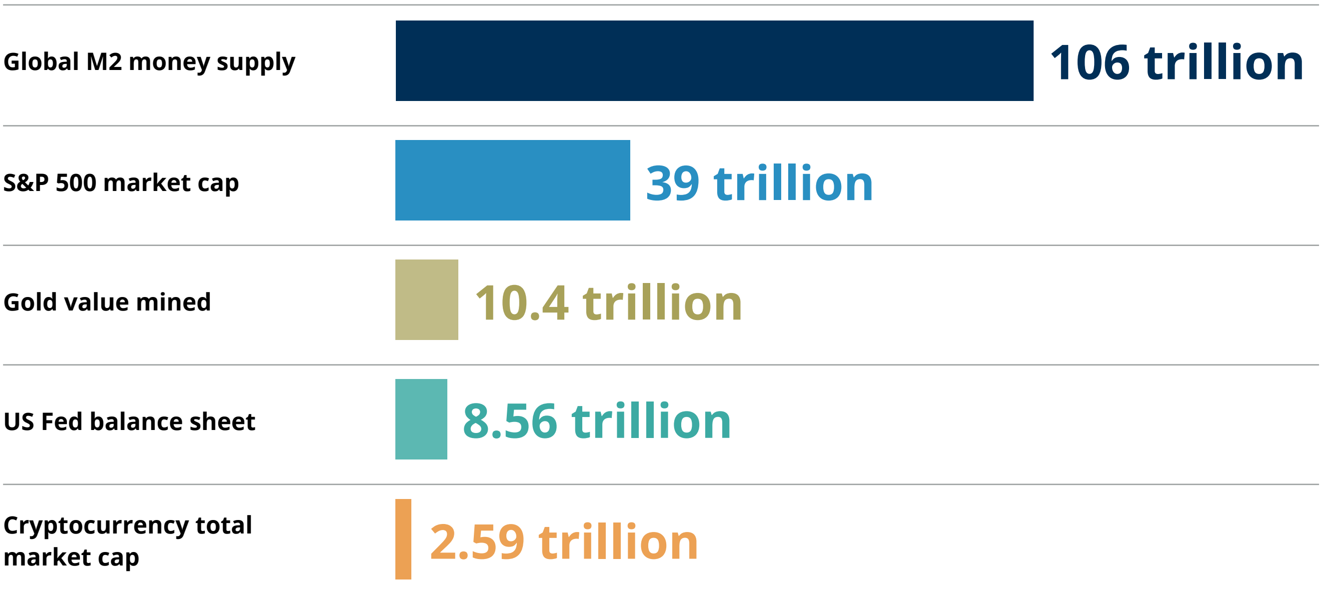
Despite talk of Bitcoin being 'digital gold' it, and the rest of the crypto space, while being inversely related to real yields and hence correlated to gold, have exhibited a greater linkage to non-profitable technology stocks. This is due to retail investors, who in aggregate have been one of the key features of this investment landscape over the last year.

Commensurately, there are now notable positive correlations across significant 'growth' parts of the equity market and the crypto universe. Retail investors' risk appetite is therefore likely to influence both asset classes accordingly, and we are closely monitoring its cross-asset impact.

Going forward, increased regulation is clearly a risk (notwithstanding regulators' seeming inability to keep pace with developments). Anecdotally timelines for institutional involvement, bar Cayman-regulated hedge funds, are consistently delayed.

> *There are now notable positive correlations across significant 'growth' parts of the equity market and the crypto universe. Retail investors' risk appetite is therefore likely to influence both asset classes accordingly, and we are closely monitoring its cross-asset impact.*

Cryptocurrency vs Major Asset Classes (USD)



Source: Morgan Stanley Research as at 30 November 2021.

Risks and Tail Risks

Risk is ever-present, and in this volatile and interconnected world the likelihood and impact of events is constantly changing. National prioritisation of resilience and sovereignty in response to lessons exposed by Covid has added to short-term supply chain risk. International prioritisation of climate action, leading to the abandoning of fossil fuels, has added to short-term energy supply risk. The market impact of political volatility in recent years has largely been masked by low interest rates, cheap money, cheap energy, and low inflation. That all appears about to change.

Imagination as well as technical know-how will be vital in identifying direct and indirect threats and opportunities, and understanding how to trade them. The conduct of top-down and thematic research, and engaging with global specialists in academia and think tanks, will continue to provide us with context to complement our fundamental bottom-up research, and will increasingly offer insights.

Events of recent years have reminded us that tail risks, however improbable, carry impact (including second-order impact) that demands our attention. Political tail risks abound (page 4) and pricing them will be assisted by prior assessment of scenarios. Covid has reminded us that tail risks extend well beyond the world of politics but that probabilities and impacts of outcomes are susceptible to political and geopolitical factors. The hedging of tail risks, when, in what size and how, will represent an increasingly important challenge. Notable tail risks include:

Economic

- Inflation duration and stagflation
- Monetary policy error
- Supply chain disruption
- Energy supply disruption
- The ‘Big Quit’ and labour pricing

Natural Disasters

- Tsunamis, earthquakes, volcanoes, forest fires affecting major cities
- Pandemics
- Covid variants
- Acute water crisis

Security

- US conflict with PRC, Iran or Russia
- Nuclear war risk
- Biological attack
- Cyber attack
- Critical national infrastructure vulnerability
- Massive migration

Investment Opportunities

As markets and economies develop, we see a range of interesting alpha-driven opportunities likely to present on both the long and short sides across asset classes.

Directional Long Short

Single Name Credit

We are actively trading a selection of our analysts' best ideas, both fundamental and technical, with attractive yield, event catalyst or both. Current positions include European financials names, high yield and hybrid bond exposure in select European corporate issuers, and certain deeply-researched stressed names (such as a European gaming company and a recent position in a German real estate company). This book also contains various idiosyncratic shorts, the most active of which is our short Italian Sovereign position which we believe has great convexity. We run this position outright not only as a rates view but also as a credit view given the impending end to the Pandemic Emergency Purchase Programme and also potential disruption to the political stability we have seen under Draghi as the European presidential elections draw closer.

Structured Corporate Credit

This strategy gives us a strong backbone of expected forward carry. Our focus is on tranches in liquid credit indices, having allowed less liquid bespoke risk to roll off. Index tranches provide a similar exposure and return profile to bespoke tranches but with much greater liquidity, lower position entry cost and more efficient margining. The team adjusts exposures using single name hedges as and when considered appropriate. We have been selectively rotating from junior mezzanine to equity risk as we seek to tilt toward taking default risk in preference to spread risk given the spread tightening we have seen. We are currently selectively adding short-dated risk in equity tranches in Crossover and High Yield liquid credit indices. We prefer shorter dated tranches where we have more fundamental visibility and shorter duration market beta.

Equities

As the market cycle matures, we would expect to see less directionality (beta driven) in markets and more alpha-driven opportunities. As Central Bank policy starts to normalise, the associated higher financing rates and lower asset flows will likely inject a greater degree of dispersion and volatility into risk asset markets and in particular equity markets. While I'm mindful of elevated valuations more generally, combining our top-down thematic work with bottom-up specific research presents rich opportunity across areas of investment such as battery technologies, 5G, rare earths, hydrogen and uranium/nuclear amongst others. Also, previously unloved areas of the market come back to the fore such as the banks, where features such as rate sensitivity, the provision for write-backs from early in the pandemic and overcapitalised balance sheets allows for considerable capital returns to shareholders. This combined with cheap valuations present an investment opportunity.

Macro

Our macro positioning covers a range of long and short positions across asset classes. Given the current inflationary backdrop, we remain long US CPI through options along with oil, gold mining equities and copper, the latter also playing into the electrification thematic. My central scenario sees yields higher and thus we are long European financials. In light of the rich macro tapestry, we envisage trading opportunities in foreign exchange.

Asset Backed Securities (ABS)

We are seeing excellent opportunities in ABS. In this period of rising inflation, an attractive feature of a large number of ABS instruments is their floating rate nature. Our portfolios have significant investments in floating rate ABS assets, some of which are specifically positioned to benefit from rising rates. We have some key conviction trades in the space. These include long CMBX series 6, with some offsetting relative value short exposure to CMBX series 11 and 12, conviction positions in a major monoline insurer, and opportunities across aircraft securitisations, both in our existing positions and in attractive new opportunities we are seeing created by the prolonging of travel disruption due to the ongoing spread of Omicron.

Multi Asset Credit

With rates, yields and spreads so compressed on credit indices more creative solutions are required by asset owners and allocators to access income. Our actively managed Multi Asset Credit (MAC) strategy is focused on accessing yields and income levels that are substantially higher than credit indices, importantly in a sustainable and responsible manner.

Our MAC approach mitigates the risks of volatility, inflation, rates, long-term defaults and transition risks by moving between asset classes and geographies. Given below-average default rates, in our view taking risk is more attractive than in an average year. This combined with a bottom-up approach will allow us, as a flexible manager, to provide good risk-adjusted income in alternative credit over the coming years.

Currently our MAC positioning is weighted to low duration, floating rate securities (Loans and ABS). We have a fundamental and sectorial bias towards corporates which can deal with inflation and are transitioning for 2050. Given our size as a manager, we are able to engage with a large number of these corporates to help drive sustainability and long-term ESG improvement.

Loans

Loans are particularly attractive from the perspective of mitigating the impact of interest rate rises through their floating rate nature. They are senior in a company's capital structure, secured against its assets. They also have higher recovery rates in the event of default. As active managers who do the bottom-up credit work, we have an opportunity to enhance returns by selecting the best businesses to whom to lend. With the headwinds affecting corporate issuers more broadly that I've discussed (not limited to supply chain disruption, raw material, labour and semiconductor availability etc.), we like technology, health care and business services sectors. We think they will be better insulated from these headwinds. In terms of geographic positioning, we have a slight bias toward Europe over the US due to the more favourable risk/reward characteristics currently available in the European market.

Private Markets

CLO Debt and Equity

Ongoing refinancing activity will also serve to enhance returns in our conviction European CLO single B portfolios, with an adjacent developing attractive opportunity set in CLO equity, with expected mid-teens return profiles. Some of the highest, most attractive yields in the alternative credit universe are in CLOs. The asset class accesses the income from portfolios of senior secured loans and high yield bonds that are managed by deeply researched, best-in-class CLO managers. We like the low interest rate duration (floating rate nature) afforded by CLOs and the compelling relative value compared to income available from both traditional and other alternative credit asset classes.

Significant Risk Transfer

The evolution of private market opportunities such as Significant Risk Transfer (SRT or Regulatory Capital Relief) offer compelling income-driven returns. With asset-level yields now between 8% and 12% on an unlevered basis, and growing issuance driven by the stricter regulatory requirements that banks face, there is a compelling opportunity for investors to capture stable risk-adjusted returns from private markets, and do so sustainably. In these strategies, investors are compensated for investing over a longer time horizon, (an 'illiquidity premium') and these assets both exhibit less correlation to wider markets and insulate against rising rate risk due to their floating rate nature.

Convertibles

We think now is an excellent time to add convertible exposure to balanced portfolios. With interest rates low, credit spreads tight and equity valuations extended we think that exposure to balanced, high quality convertibles helps to add attractive upside/downside asymmetry to portfolios in uncertain market conditions. Convertible issuance is strong, which is further enhancing the excellent opportunity set in the asset class. The convertible arbitrage outlook is further enhanced by the prospect for greater market volatility, alongside greater dispersion of security returns, which is also additive to the strategy.

Geopolitical Crosscurrents

Great Powers

US and PRC leaders will be positioning for domestic political tests. Washington's 'durable co-existence' with Beijing will mean simultaneous competition, co-operation and containment. Continued prioritising of sovereignty and resilience will produce more decoupling, reshoring, and 'friend-shoring' in more strategic sectors and more countries. This will produce supply chain chokepoints, increase costs and add inflationary pressure. The primacy of the USD will be a target not just for the PRC, Russia and Iran, but also those in the EU seeking strategic autonomy. The PRC and Russia will continue to develop proposals to evade the US-created financial system (e.g. Swift). Trade blocks (CPTPP, EU, RCEP, BRI) and strategic alignments (AUKUS, Quad, 16+1) will have a role in the growing global competition to write the international rules.

United States

Democrats will focus on saving the Senate. The sense that 'something is better than nothing' will keep alive the prospects of some Build Back Better stimulus in Q1, with emphasis on technology and clean energy. This will be a White House trying to treat the causes of Trumpism and hopeful that the 1/6 Commission and potential prosecutions and litigation will weaken the prospects of Trump 2024. The fortunes of 'Trump' candidates this year will be telling. Abroad Biden will seek allies for a 'full spectrum response' to the challenges to democracies and will not want to be outflanked by Republican hawks, but international rivals will sense weakness.

PRC

The chance for Xi to seal the leadership for life at the 20th National Party Congress will see his efforts to increase control of the Party, and Party control of the country, intensify; and this from a regime with a world view very different from that of the West. This means more efforts to: use data, which the CCP sees as a 'national asset', as an engine of control; promote a dual circulation economy less dependent on the US; control entrepreneurs; eradicate dissent in Hong Kong; and pressure (not invade) Taiwan adding to the risk of miscalculation between PLA and US forces. The PRC's part in reducing post-Global Financial Crisis inflation looks set to be reversed.

Russia

Putin, 'prepared to be persuaded' to stand for election again, is also positioning. A Biden administration may offer less scope for mischief, but Putin will leverage US-EU tension (e.g. on Nordstream2), along with any EU-NATO or intra-EU27 tension he detects. The centrality of the 'Holy Rus' to his thinking means the threat to Ukraine will remain, so will risk in Eastern Europe, MENA and Africa where Moscow's 'private' security presence is growing. The question will be what the West can do to stop a state with deep pockets and most of the gas Europe needs? At the Arctic Council, Russia will seek to manage increasing international interest which will look less economic and more strategic.

MENA

Tehran will seek to leverage Trump's abandonment of the 2015 JCPOA and make demands (e.g. unlocking of USD80 billion, compensation for US sanctions, Biden binding his successors) that are politically and/or constitutionally untenable. Iranian diplomatic engagement with the rest of the P5+1 and its neighbours will be tactical; it will not stop Tehran's malign use of proxies across the region.

But US efforts to leverage Iran's oil exports will be limited by energy price considerations. And JCPOA failure will increase the prospects of Israeli intervention, cyber, kinetic or both. Lebanon and Libya will continue to suffer from regional and global meddling. Also significant will be 'Abraham Accord' relationships and GCC reform. Talk of US withdrawal (after Afghanistan), will be misplaced.

European Union

The EU's French Presidency in H1 may turn the Covid crisis into an opportunity for integration. The Council for the Future of Europe will not lead the debate, but tackling important questions of foreign policy, migration, green taxonomy, emissions trading could. Re-interpretation of the Stability and Growth Pact and progress on fiscal and banking union and capital markets are overdue, and along with China, Russia and MENA, will add to tensions between the EU27 and in Berlin. The EU needs strong leadership, but the roles of Macron and Draghi may be thrown into doubt by presidential elections, and German coalition weakness may surprise. Brexit will remain a lower priority and an issue on which EU unity is deliverable. That spells trouble for London which is keen to put UK-EU relations on a more stable footing, and for Brussels which would be better able to deal with regional and global challenges if they were.

United Kingdom

Brexit delivery will be the primary policy test for the Johnson government. Success will depend on addressing the Northern Ireland Protocol and this will require an admission that London enabled opportunists in Dublin and Brussels. Avoiding civil unrest and a UK-EU trade war will require new clarity of thinking and resolve. If it can be achieved there will be opportunity for continued post-Covid growth harnessing the technology-focus of the flagship Levelling Up and Integrated Review agendas.

Key, if the PM is to position himself for an early election, will be tangible results from new trade deals, managing inflationary pressures, and addressing current questions of competence and credibility. Newly robust UK foreign policy action on Russia and China (e.g. Ukraine, AUKUS) will have strategic impact, especially if better communicated.

Emerging Markets

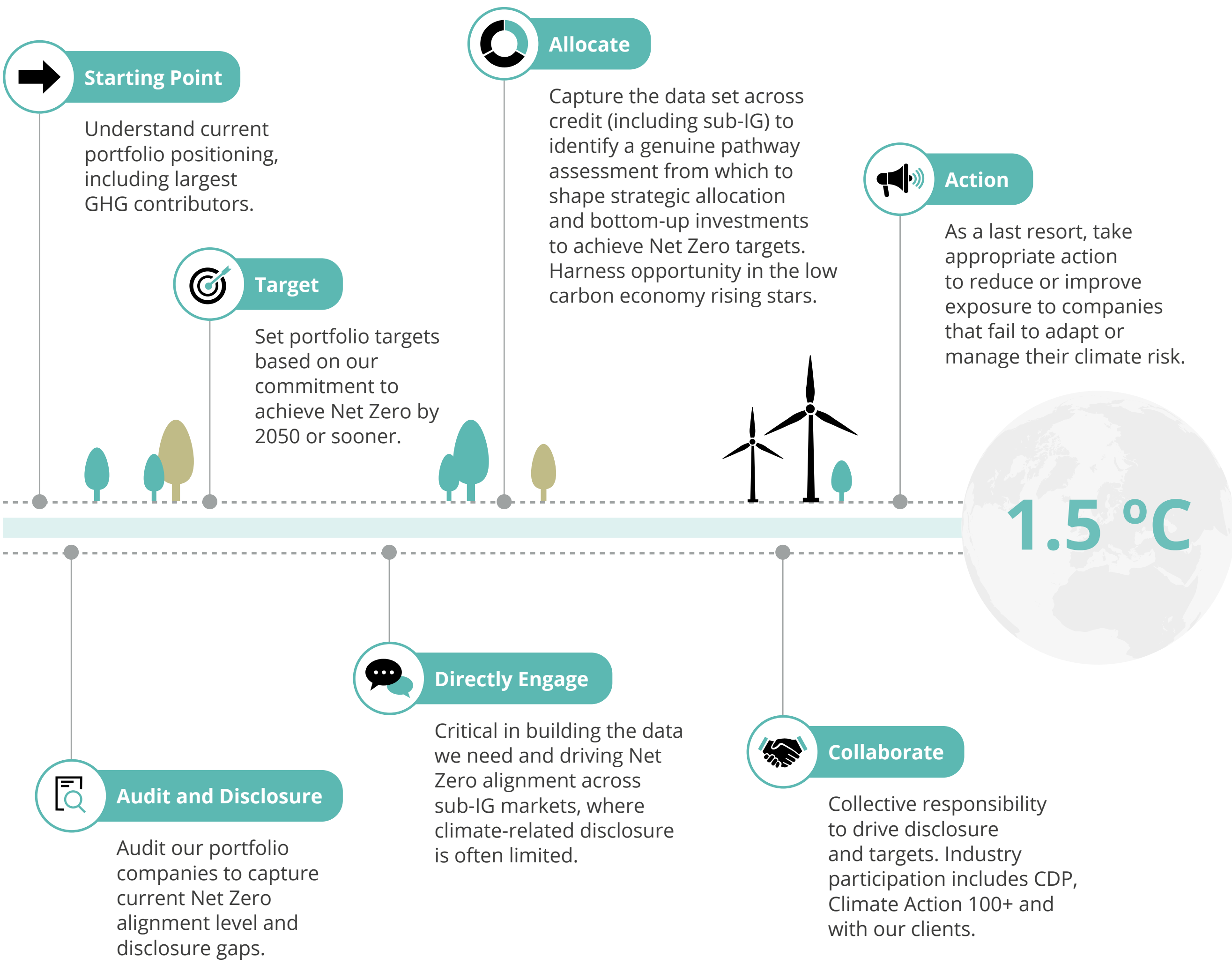
Political risk will remain elevated, notably in Turkey and Brazil where leaders will continue to try to defy economic and political convention with elections looming and rivals circling. Argentina will continue to wrestle with the IMF. Venezuela will struggle on. In South Africa, overdue delivery of undoubted potential will depend on PM Ramaphosa marginalising Zuma loyalists to reform the ANC without losing its electoral base. Generic threats in Africa will include water stress (increasingly a global issue), Jihadists and the activities of Russian security 'contractors'. The PRC will continue to offer investment the West cannot match. Even at reduced levels, BRI projects will look more attractive relative to alternatives proposed by the West (e.g. Build Back Better World) which this year will be constrained by climate policy in addition to restrictions focused on democratic values and the rule of law. National oil companies (notably from MENA and Russia) will enjoy opportunities which Western international oil companies (increasingly mindful of ESG) find univestable.

Our Pathway to Net Zero

As part of CQS' Firm-wide process to drive sustainability, we focus on companies which demonstrate strong ESG characteristics as well as adaptability and resilience in the transition to a low carbon economy.

CQS has become a signatory to the Net Zero Asset Managers Initiative. In doing so, we are part of the collective goal to engage and, through investment, achieve net zero greenhouse gas emissions by 2050 or sooner.

Managing the impact of the transition to a low-carbon economy is essential to deliver the returns and outcomes sought by our investors, as well as playing our part to deliver the goals of the Paris Agreement. Indeed, addressing decarbonisation is now critical to ensure we mitigate risk and deliver opportunities for our clients.



Source: CQS as at December 2021.

CSR Initiatives

Our Corporate Social Responsibility is focused on working with organisations who share our goals and values. Below are a few examples of the organisations we support.

RedSTART

We have partnered with RedSTART, a charity which aims to educate primary school children on how to control of their finances. Their aim is to make financial literacy a statutory part of the primary school curriculum to ensure that children of all backgrounds are provided with opportunities to acquire the basic knowledge, skills and attitudes to manage their money. Our graduate cohort held a workshop for Year 6 children from a school in Enfield to help them learn the principles of saving and earning money, and raise awareness of our industry.

10,000 Black Interns

We partner with the 10,000 Black Interns programme, which is an initiative that works to offer opportunities to increase the number of Black professionals in the workplace. We have pledged to offer a minimum of two internships to candidates from this programme annually. We hosted two interns in 2021, one of whom then joined us as a graduate trainee.

Greenhouse Sports

Greenhouse Sports is a charity which aims to bring sport to young people living in the inner city to realise their full potential. It delivers 50 programmes across the capital by engaging coaches, to teach full time in secondary schools, special needs schools and in their performance clubs. The charity operates in schools where at least two-thirds of pupils live in areas of high deprivation according to the Income Deprivation Affecting Children Index (IDACI). CQS competes in the annual dodgeball tournament where banks, hedge funds and asset managers play to raise awareness and funds.

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PRI Note: PRI is an investor initiative in partnership with UNEP Finance and the UN Global Compact. GMv9.

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Signatory of:

PRI Principles for Responsible Investment

In our first year of reporting for the Principles for Responsible Investment, we are pleased to confirm CQS scored an A for the Strategy & Governance of our overall process, and across each of the three direct fixed income modules, we scored a B.

NET ZERO ASSET MANAGERS INITIATIVE

CQS is a signatory of the Net Zero Asset Managers Initiative, committing to achieve Net Zero greenhouse gas emissions by 2050 or sooner.

Signatory of: UK STEWARDSHIP CODE | 2021

CQS is a signatory to the UK Stewardship Code 2020 (the "Code"). Our Stewardship and Shareholders' Rights Report sets out how we have complied with the Code and have applied its principles in the context of our global credit investing.

TCFD TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

CQS is a public supporter of TCFD (Task Force on Climate-related Financial Disclosures), with climate disclosures a core component of our ESG Engagement Framework.

CDP DISCLOSURE INSIGHT ACTION

CDP (formerly the Carbon Disclosure Project) is a key collaboration amongst asset owners and asset managers in the drive for greater transparency on Climate Change, Forestry & Water Stress.

A proud participant of Climate Action 100+ Global Investors Driving Business Transition

As a participant of Climate Action 100+, CQS actively supports engagement with some of the largest carbon emitters globally, as we collectively seek strong accountability & oversight for climate risk, action on GHG emissions and proper company disclosure.

CQS (UK) LLP
4th Floor, One Strand, London WC2N 5HR, United Kingdom
T: +44 (0) 20 7201 6900 | F: +44 (0) 20 7201 1200

CQS (US), LLC
152 West 57th Street, 40th Floor, New York, NY 10019, US
T: +1 212 259 2900 | F: +1 212 259 2699

CQS (Hong Kong) Limited
1308 One Exchange Square, 8 Connaught Place, Central, Hong Kong, China
T: +852 3920 8600 | F: +852 2521 3189

CQSClientService@cqsm.com | www.cqs.com