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INVESTMENT REVIEW

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QUARTERLY INVESTMENT REVIEW

"Capitalism without bankruptcy is like Catholicism without hell. Markets work best when participants have a healthy fear of loss.

Howard Marks

"The US is now on a path whereby every sitting US president seems intent on adding as much debt into the national ledger as all of his predecessors combined."

Gavekal 18.12.2020

"People are always asking me where the outlook is good, but that is the wrong question. The right question is where is the outlook most miserable."

John Templeton

Markets in the fourth quarter of 2020 continued their strong recovery on the back of two developments. First the announcement of several effective vaccines to combat the Covid virus and the start of their implementation. These vaccine programs give strong grounds for hope that life can return to normal at some point in 2021. Second the US election results were cheered by markets, which welcomed the Biden Presidency alongside a Republican controlled Senate which will keep his policies in check. While the run off of the Georgia Senate race on 5th January could change this, as things stand President Biden will have less scope to expand fiscal deficits, introduce tough regulation for big tech, and raise taxes. As a result markets finished the year strongly, with the MSCI World Index up 14% in US dollars, which was a remarkable recovery from the point towards the end of March when it was down 32% at the height of the Covid panic.

The economic collapse in 2020 resulted in a highly unusual recession, one in which personal incomes held up, housing starts accelerated, IPO's on the stock market boomed, and companies were able to issue debt at very low rates despite their business conditions deteriorating. By the end of the year the quantity of negative yielding debt had reached a record $17.7 trillion and about 80% of the world's investment grade bonds are trading at 1% or less, as governments threw everything they could at the problem through support measures. Yet the pandemic has widened the social divide. The income gap has never been greater and governments are likely to continue subsidising the lower income brackets, even if that leads to the economy overheating from strong consumer growth. In contrast to 2009 the stimulus is not going into banks' collapsing balance sheets, but into financing government spending which ends up in the real economy. The US Government, for example, is estimated to have had a $4 trillion fiscal deficit this year, financed mostly by the Federal Reserve Bank. The mood in politics has changed, today there is no talk of austerity. The US election was relevant on this point. While Biden won, the contest was extremely close in blue collar votes, where Trump proved himself electorally competitive. One of his unsung achievements was he reversed the relative decline in income of the lowest segment of the population after forty years of deterioration. The Democrats will not want to risk losing this part of the vote again and will likely do all they can to consolidate the working class vote through labour friendly policies. Negative yielding bonds look inconsistent with this policy. Increasingly there are more signs of inflation starting to rise. Government stimulus, Central Bank printing, the disruption of supply chains due to the dispute with China, and a violent recovery as economies restock and rebuild inventories post-Covid all point to higher inflation. Moreover there must be a great temptation to inflate away the giant debt loads that have been built up over the past decade. For example, Gavekal estimate that US Government borrowing has added US$12,800 of debt per head of population in this year alone. Historically there is no example of a country choosing deflation over inflation to reduce a big debt load. However this is a message that the bond market is yet to acknowledge. In November Peru issued a $4bn 101-year bond for 2121. Peru has defaulted eight times in its 200 year history, yet the issue was oversubscribed by four times, and the coupon was just 3 ¼%. It seems strange that people's savings can be allocated like this. One can only speculate what bond prices would be if Central Banks were not so active in the markets preventing true price discovery. Nevertheless given current conditions bonds remain unattractive to the investor looking for real returns, or indeed seeking preservation of capital. In inflationary periods money dies, and bond yields offer scant protection against any rise in prices. In the end it will probably be inflation that brings an end to the long bond bull market which started in 1981. Already most private investors are unpersuaded to invest in bond markets, which are only being supported by Central Bank buying. If inflation does rise investors will sell their bond holdings to seek safer returns elsewhere. That will put upward pressure on interest rates to entice investors back to bonds. This could be a multi-decade process, similar to the long decline to negative interest rates.

With the natural refuge of bond markets left bare, active investors are forced to turn to equities. Given the economic catastrophe investors have sought companies that can demonstrate the ability to grow even in an economic shutdown. Most of these have been technology or internet related companies, as Covid gave an extra boost to shifting economic activity online. Indeed almost all of the S&P 500 gains this year have come from just six technology companies (Apple, Amazon, Microsoft, Google, Facebook and Nvidia). Technology's leadership of the indices goes back further, and the last decade has witnessed the rise of those companies that have exploited the stream of innovations created by the rapid advance in computer power. The tech behemoths are formidably impressive companies with immensely strong financial characteristics, and continued strong growth prospects. Nonetheless these companies have reached a scale where the law of large numbers may kick in. Wall Street projects that the five largest technology companies will grow their sales by 18% per year for the next five years. Should their share prices grow at the same rate then their combined market capitalisation will reach over $15 trillion. For context the S&P 500 has a market cap of $30 trillion today. Moreover these huge companies are starting to compete with each other in order to maintain their growth. Apple is entering search, and Amazon is growing in advertising. More substantial regulatory and anti-monopolistic action against them from lawmakers is likely. None of this is to say that these companies will not continue to produce excellent results and growth, but the numerous tailwinds their share prices have enjoyed in the last decade may lessen. If the vaccines spark a rotation from 'stay at home' winners to 'back to normal' recovery plays then other areas of the market will start to flourish. Recovering growth will mean rising bond yields which is bad for so-called growth equities because the discount rate by which they are valued will rise, but it will be good for value stocks because their revenues will recover. Investor weightings are dramatically tilted to growth stocks so there is the potential for a dramatic rebalancing.

November saw a violent rally in value stocks. Is this a flash in the pan or something more permanent? Many value stocks are severely compromised and appear structurally impaired as they battle large debt burdens and heavy pension liabilities, while their businesses have been made vulnerable by competitors making better use of technology. But other companies have a brighter outlook, while they are trading at a level consistent with a major economic collapse. If a recovery comes through they can recover. Demand will normalise, and pricing will be firm as capacity has shrunk, and inventories have been depleted. Unusually when moving out of a recession, balance sheets are strong at both the corporate level and for consumers, as household savings rates soared during the lockdown thanks to government support schemes. In the US alone it is estimated that household savings are well over US$1 trillion. That money is likely to be spent when people feel sufficiently safe and able to do so. Inventories in US retail and manufacturing are near all-time lows. Strong activity from fast rising demand for ball bearings and rocketing container rates from Shanghai all point to a recovery coming through. For the survivor companies 2021 and 2022 will see a surge in profits. As the vaccines stabilise consumer confidence the economy should surprise vigorously on the upside. This is in marked contrast to

2008 when the consumer was overleveraged and forced to save which led to years of subdued growth. This time the excess savings will be spent and assist the recovery.

The opportunities in this scenario will depend on the strengths of the individual companies, so stock selection will be critical. However some general areas appear to be fertile hunting grounds. Despite the trade disputes Asia remains the factory of the world so is a clear beneficiary. It is noticeable that since May Asian markets have started to outperform. Japan is a natural beneficiary of a global cyclical recovery. It is also a good market to play any return of inflation. Inflation would have a dramatic psychological impact on Japan's domestic institutions which are heavily overweight their bond market and underweight their equity market. Japan has seen an unravelling of its post-1945 industrial structure, and a significant pick-up in industrial restructuring and consolidation. The new Prime Minister is pushing a digital agenda, where Japan has lagged, so this offers an investment theme independent of economic growth. These policies together with the reforms of corporate governance are underwriting a quiet bull market in Japan, despite the low growth in its economy. The Nikkei is now at its highest level since 1991, and close to its all-time high measured in US dollars. As momentum builds on improving earnings, and the case for equities over bonds in Japan becomes increasingly compelling the market can break to new highs. The UK market also looks attractive as the long Brexit issue has finally reached as conclusion, though the small print continues to be scrutinised. International investors are as underweight the UK market as they have ever been, which is usually a good entry point for the patient investor. The FTSE Index is below where it started the millennium.

In term of sectors, commodities are an obvious beneficiary of reflation. Beyond their benefit from stronger economic growth commodities have two other supports from government policies. First a good part of the fiscal spending that governments have undertaken will be allocated to improving infrastructure which is commodity intensive. In both the US and Europe basic facilities like roads, bridges, and sewers are old and in need of renovation. Second, the energy transition occasioned by the fight against climate change will require an enormous quantity of metals. Electric vehicles, for example, require a lot of copper. This demand is coming at a time when the investment in new supply for these metals has not been strong. The greening of the global economy alongside dramatic money printing by central banks is a potent recipe for a commodity bull market. Despite the economic crash this year, several metals like copper are trading much higher than a year ago. Commodity companies do not have the outstanding financial characteristics of the big tech companies, but when the cycle swings their way these companies can produce dramatic returns. More controversially energy companies should also benefit. These companies' share prices have suffered from being perceived to be heavy polluters and for facing long term extinction as renewable energies supplant them. However the world still depends heavily on fossil fuels. The energy sector decline has been even more extreme than that for metals. Commodity equities has the smallest index weighting in decades but it's one of the few sectors that would benefit from rising bond yields, activity and inflation.

As the year turns the Covid virus is still having a dramatic impact on economies and societies, particularly those in the West, where the winter has seen an acceleration of cases. However markets are very good at looking through problems, and the three leading vaccines are allowing them to look through the current malaise. Any delay or problems in implementing the vaccines would be taken badly by markets. However assuming a reasonably smooth roll out of the vaccine programs and a continued political balance in the US, with the Republicans retaining the Senate, the world economy should start to heal in 2021 at an accelerating pace. Markets enjoy substantial support. There is no sign of Central Banks tightening while there remains the promise of significant fiscal packages. The savings accumulated during lockdown gives further fuel for markets. This can already be seen with the US investor returning to the stock market in size for the first time in twenty years. Many companies have also been able to take actions that would be hard in normal times, like reducing labour and closing marginal projects. It has left them lean and well leveraged to an eventual recovery. For many value companies this recovery would occur at a time that their stock prices are coming from an extreme low point. The bond market holds little interest, and if inflation revives should be actively avoided. The technology and bond-proxy stocks that have dominated returns in recent years would also face a more challenging environment. Investors should start to consider rotating their portfolios to include more value focused and commodity related ideas. Hedge funds also have an excellent opportunity given the wide dispersion of valuations. Currencies are harder to gauge but those ones associated with commodities should tend to be stronger, and it would not be a surprise if the US dollar gave up some of its recent strength given the size of the US deficits. In the event of stronger economic activity gold is likely to pause in its bull market, though it remains a good hedge against the continuing and expanding amount of global money printing.