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"And bonds are not the place to be these days. Can you believe that the income recently available from a 10-year U.S. Treasury bond – the yield was 0.93% at yearend – had fallen 94% from the 15.8% yield available in September 1981? In certain large and important countries, such as Germany and Japan, investors earn a negative return on trillions of dollars of sovereign debt. Fixed-income investors worldwide – whether pension funds, insurance companies or retirees – face a bleak future."

Warren Buffett, Berkshire Hathaway Annual Report 1/3/2021

Stock markets were strong in the first six weeks of the first quarter of 2021 before falling back. More dramatically bond markets sold off sharply. For example the US 10-year bond yield rose from 0.91% to 1.74%, while the German 10-year bond rose from -0.57% to -0.29%. These are massive moves in what are enormous markets. In addition industrial commodities were strong, particularly those related to expanding renewable energy infrastructure. The investment debate was dominated by countries' efficiency in rolling out the various vaccines, and by concerns about inflation as economies start to reopen and respond to the tremendous stimulus that Governments and Central Banks have put in place. Bond markets will be closely watched for how they react to inflation. If the reopening of economies only leads to transitory inflation then the sectors that flourished prior to the pandemic should continue to thrive. However if inflation surges higher than expected and shows signs of being persistent then many asset classes will be reconsidered. Bond markets will continue to fall, as will those assets that are priced off bonds. On the other hand it could be a further boost for sectors that have languished in the past decade, such as commodities and financials.

It has been estimated that over $20 trillion dollars of debt was added to the global system in 2020 in response to the Covid crisis. Total global debt now stands at $281 trillion or 355% of global GDP. The scale of the intervention is extraordinary. Debt expenditure per capita in the US was $12,600 last year, which compares to an estimate of $5,200 spent over eight years in Roosevelt's New Deal in the 1930's. This is before the latest package by President Biden of $1.9 trillion, and a further recent announcement proposing one of $3 billion. The $1.9tn package includes sending a cheque for $1400 to almost everyone in the country. The proposed package focuses on huge infrastructure spending. Meanwhile the lockdown has driven the saving rate higher and it is reasonable to assume that this will decline when people are allowed out to spend again. If the savings rate returns to the pre-Covid level in the US that would free up one trillion dollars, or 4.7% of GDP. This level of stimulus raises the risk of inflation. The situation is different to the post 2008 crisis when banks were de-risking their balance sheets and being required to increase their weightings in Government issued paper. The enormous QE programs saw trillions of dollars issued by Central Banks, which were absorbed by the commercial banks which sterilised the inflationary impact. The money sat idly in excess reserves, trapping the inflation in asset markets. But today the excess money resides in household accounts and Government balance sheets and is earmarked for spending. This money is destined for the real economy and its impact is much more likely to be inflationary. In addition to this the events of the past year mean that companies have avoided unnecessary capital expenditure or running inventories at high levels, so the demand impact will be immediate. In addition to all this the trade tensions between the US and China have created extra pressure as supply chains are moved for reasons other than cost. Half the world's semi-conductor chips are made in Taiwan, and at the end of the quarter the accidental blocking of the Suez Canal by a container ship show how fragile supply lines can be. This has occurred when the market has squeezed all the defensive qualities out of fixed income by driving rates to extreme low levels. Buffett's quote at the

head of this report should be considered in light of the fact that most people's savings are linked to the bond market directly, or indirectly through equities or real estate, whose price is strongly influenced by the direction of interest rates. Despite these concerns companies have continued to enjoy benign conditions. At the beginning of March the European airline easyjet was able to raise €1.2 billion of debt at just 1.875%, at a time when it is operating at just 10% of normal capacity.

Such low interest rates have caused a number of distortions. Explosive amounts of liquidity and the abysmal returns from cash and bonds have driven the valuations of some assets to dangerous levels. At one point the software company Snowflake traded at 155 times its forecast revenues for 2021 (anything above ten times is extreme) to reach a market capitalisation of $92 billion. This is bizarre in the context that the company stated in its prospectus last September that their total addressable market was $81bn. Many companies have been selling at well above ten times their annual sales, meaning that they require many years of continuous success to justify their present valuations. History has shown that such stretched valuations are rarely sustainable, often growth rates reduce, or regulations or taxes spoil the profit outlook. This is particularly true of an area as disruptive as technology. In the last big stock market bubble in 2000 while the market correctly predicted that the internet would dominate the future it was less precise as to which companies would be the biggest winners. In 2000 Facebook didn't exist and Google barely existed, Amazon was selling books, and Netflix was a video rental company. Many leaders of that era no longer exist. It may be that Tesla, like the early computer leaders such as Atari, creates the market but ends up being overtaken. If global growth picks up accompanied by higher interest rates the conditions will change for the technology companies with few earnings or even sales. Investors will gravitate to companies with solid businesses that will benefit from the pick-up in activity. Since the successful vaccine announcements in November there has been increasing evidence of this.

Care needs to be taken when reallocating investments from growth to value on the assumption that economies will reopen. Many value stocks have heavy debt, and they may need to raise capital. The longer the Covid waves and variants continue the more these businesses will suffer, and a withdrawal of monetary support would be damaging. Most of all these businesses must prove themselves able to harness digital technologies. However investors have been conditioned to believe that low growth will continue forever, and if this proves wrong it presents an opportunity. If the current giant stimulus does generate stronger growth and inflation then the safety of bonds and bond proxy equities will be less attractive and investors will rotate into more cyclical industries with much cheaper valuations. These companies have made tough cost cuts to survive the Covid crisis, and are primed to benefit if revenues recover. Consumers have been suffering from lockdown for the past year, so when they are released pent up demand may go hog wild. A cyclical recovery would also disproportionally benefit markets outside the US. The valuation case for Asia looks as strong as for ten years. Japan is perhaps the market most geared to global recovery. It offers world leading companies which are plugged into the rapid growth of the Asia Pacific region. Its corporate sector has become far more disciplined, and companies are showing far better profitability. Japan's market has broken above levels not seen for three decades, yet it remains the cheapest major equity market in the world.

Commodities are performing strongly and a number of trends offer strong support. They are obvious beneficiaries of more growth. Till recently commodities had performed poorly over the last decade. Global growth has been weak following the 2008 crisis, and supply had built up previously that due to the China boom. More recently the environmental movement has made production harder. Capital expenditure is at twenty year lows while demand is rising. A large part of the new Biden package is aimed at renewing America's infrastructure. China has announced plans to double its railway system by 2035 and add 162 airports. All of this will require commodities, as will the drive towards renewable energy. Green does not mean commodity free. The new energy economy requires significant amounts of copper, lithium, cobalt and rare earths to function. Renewable energy stocks trade on high multiples of their sales, yet the resource companies that make them possible are lowly rated. Tesla's market capitalisation exceeded that of all quoted miners at one point, which seems absurd. The sector is cheap yet it offers the route to decarbonisation. Technology is also playing a role. There is increasing demand from the younger generation for companies to 'prove' that they abide by good ethical practices. Manufactured goods will need to show through digitised supply chains the provenance of their goods down to the mine that has produced the raw materials. Miners that are guilty of corruption, poisonous practices or pollution will be boycotted. This form of ESG will radically raise the cost of new capacity, and the time taken to bring it to market, at a time when it is increasingly challenging to find new reserves. Raw material producers will need to spend to keep things clean as much as expand volumes. This tightening of the market is also inflationary.

Uncertainty this year has moved from worry about how to contain the virus, towards concerns about inflation as the opening up releases the huge liquidity into an active economy. If the reopening doesn't reinvigorate the virus then it may well challenge the current policy of spectacular excess stimulus. Investors will look for companies that benefit from this burst of economic growth, and that may be accompanied by a de-rating of the more defensive areas like bonds. Equally if Covid surges back then investors will return to these defensive shelters, and the cyclical stocks will fall back. Selective stock picking is more important than ever, and investors face continued high levels of uncertainty.

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