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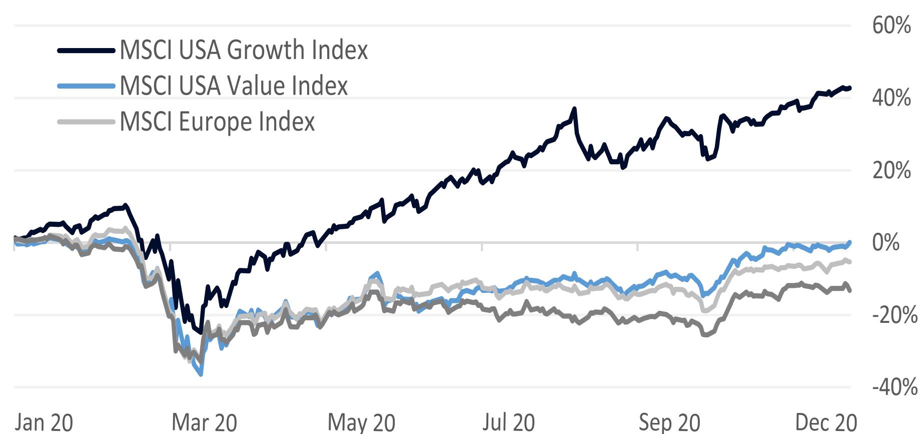
GLOBAL INSIGHT

Overview

- In our Macro View, we cover the support the global economy has received from the unprecedented fiscal response, with hope of a brighter future, and improved economic conditions, following major rollouts of vaccines all over the world.
- It will largely be up to policy makers to continue introducing investment-enhancing reforms to facilitate a re-investment cycle that could service sustainable growth from here that gradually relies less on government stimulus.
- In our Investment Outlook, we assess activity in the fourth quarter and the position that financial markets find themselves.
- Over the closing months of 2020, we adjusted our allocation toward positions that would benefit from the reopening of economies.
- Economists cannot yet conclude whether the world is at the beginning of a new economic cycle or the continuation of an old one. The pandemic has created unusual signals in this regard.
- In our **2021 Outlook**, Tim Sharp, Managing Director, Hottinger & Co. Limited, looks at some of the topics occupying the thoughts of investors going into the new year.
- We continue our search for potential bubbles and opportunities within financial markets.
- The 2020's could see Asia emerge as the central secular growth opportunity of the decade based on the growing strength of the region and solid structural foundations.

The value nature of European markets is clearly reflected in comparisons to US markets



Source: Bloomberg as at 31 December 2020

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Economic Highlights

- US GDP remains 3.5% below its peak in Q4 2019.
- UK Manufacturing PMI read at 57.5 in December 2020 pointing to the strongest expansion in factory activity in nearly three years.
- From -17.6 in November, the eurozone consumer confidence indicator was confirmed at -13.0 in December.
- China Manufacturing PMI read at 53 in December 2020, suggesting it has maintained its recovery momentum well alongside strong output and new orders.

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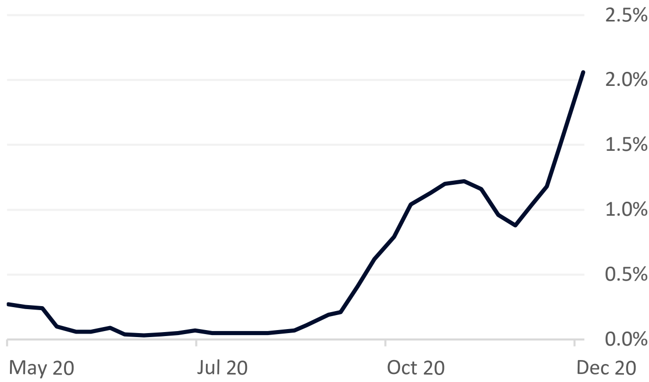
Key Issues in Charts

UK Covid infections



Source: Office for National Statistics

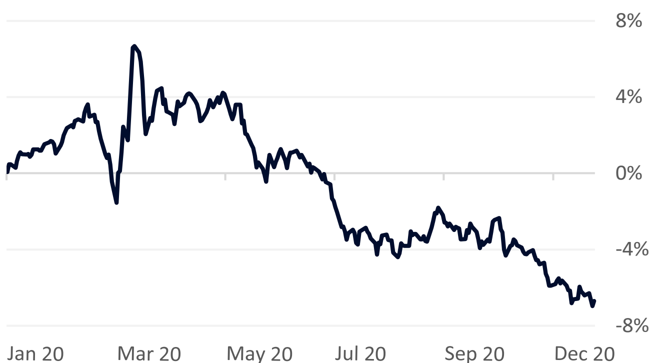
- The chart shows the ONS statistics of the percentage of the UK population believed to be infected with Covid-19.
- Renewed global lockdown measures will have suppressed the economic recovery that was triggered by the timeline of the vaccine roll-out. We are now in the grips of a third wave that has hastened the vaccine plans of most G7 countries as they look to head off significant pressure on health services, and serious risks to the general population.
- The optimism of investors towards a near term return to a semblance of normality is slipping causing the cyclical rotation to slow.

S&P Goldman Sachs Commodities Index—Full year 2020

- Commodity prices have benefitted from the prospect of increased demand as economies reopen and global growth recovers.
- The reflation trade also favours commodities as investment in real assets can be used as a protection against inflation.
- Inflation may not be a certainty in 2021, but investors will tend to react to the increased risk of the prospect of inflation.

Source: Bloomberg as at 31 Decemeber 2020

The Dollar Index—Full Year 2020



Source: Bloomberg as at 31 December 2020

- Betting against the world's reserve currency can be difficult but there are many arguments used to justify this stance currently.
- The graph shows that the US Dollar has weakened against a weighted basket of its major peers since the period of heightened anxiety in March when it was a safe haven.
- It can be argued that a resurgence of global growth requires a weaker dollar to support the green shoots of recovery.
- Prolonged dollar weakness could be justified to reflect the build up in government and personal debt through the pandemic and since the Global Financial Crisis.

Macro View

It has undoubtedly been a year full of surprises and drastic changes in focus, from the Eurozone's Japanification, trade wars, concerns around the global economy reaching the end of its cycle, to an unforeseen pandemic with its drastic impact on our daily habits, businesses, and world economies. Whilst the pandemic reached a new level of intensity in several major world economies during Q4 2020, we enter 2021 with hope of a brighter future, and improved economic conditions, following major rollouts of vaccines all over the world. Any recovery in 2021 is unlikely to be enough to offset the recessionary consequences experienced so far but is nonetheless a critical step in the right direction.

United States

Despite a rapid third quarter growth, GDP remains 3.5% below its peak in Q4 2019. To put that into perspective, this is not too far from the decline experienced during the financial crisis in 2007-09 that took at that point nearly two years to recover. As the pandemic yet again reached a new level of intensity, the economy has certainly been on a slowing trajectory, and could very possibly report a negative first quarter this year in our opinion. US Manufacturing PMI was little changed from 56.7 in November to 56.5 in December. Production growth remained steady following strong output and new orders growth, whilst vendors significantly deteriorated due to delayed deliveries and logistical constraints.

US Manufacturing PMI was little changed from 56.7 in November to 56.5 in December

The US labor market entered the year with a record low unemployment rate of 3.5%, a steady stream of new jobs coming to market and a healthy payroll inflation of 3.1%. Not unexpectedly, it ended the year in a higher territory. Whilst not as bad as 14.8% which was recorded in March, unemployment rates roughly remained unchanged over the quarter at 6.7%, reflecting the absence of proportionate fiscal stimulus to the health of not just the labor market but the wider economy.

Consumer spending remains strong and represents a higher portion of disposable income than before the pandemic.

Surprisingly, this has not coincided with a decline in consumer spending, which has been relatively strong over the past few months despite the rising cases of Covid-19, and the removal of the weekly $600 supplement to other unemployment benefits. Money spent on consumer goods today represents a higher proportion of disposable income than before the pandemic, reflecting an increase in savings across the country (even for those unemployed), and a clear change in consumer behavior. Subsequently, services have fallen significantly and is widely forecasted to experience a slow recovery as consumers may have exhausted their demand for durable goods *instead of* services spending. Qw feel US policy has been one of the most aggressive in the world in their response to mitigating the pandemic crisis throughout the year. Another significant relief package is currently being negotiated and expected to be released in the first quarter of this year. Whether this will focus more on relief measures as opposed to actual stimulus, is unclear at this stage. The government's deficit will remain very high over the course of this year regardless, which remarkably does not seem to have spooked investors, perhaps due to continued low interest rates and ongoing buying support from the Federal Reserve.

Another significant relief package expected during Q1 21

Fed's pledge to aim for an average inflation rate of 2, instead of a flat 2% target.

The Federal Reserve announced in August that its monetary policy framework would from that point onwards aim for an *average* inflation rate of 2, instead of simply a 2% inflation target. This means that the Federal Reserve have now promised to deliver an inflation above that of 2% to make up for the time it was running much below that. This represents a significant change as it will no longer respond to increasing unemployment rates with tighter monetary policies and inflation pressure, and as such, will not offset more expansionary fiscal policy to support the economy in the near-term. It also directly translates into tolerating an inflation higher than that of 2%, without tightening monetary policy. From an investors point of view, we believe this means that we can likely expect the Federal reserve to keep its adopted rate range between 0.00-0.25% and continue buying bonds until the economy recovers at a pace of at least $120bn per month.

Bank of England continues to extend its bond buying program (£875bn gilts, £20bn corporate bonds).

UK

Like other major economies around the world, further lockdown restrictions introduced over the quarter has slowed its recovery and will likely mean negative GDP growth in Q1 2021. To support businesses and employees, Bank of England has extended its bond buying program (£875bn gilts, £20bn corporate bonds) into this year, and the bank rate has been left in positive territory of 0.1%. With a surge in cases over the month of December in addition to the new variant of the virus, we do not foresee interest rates to increase anytime soon. Inflation is likely to remain below 2% and monetary policy is unlikely to tighten in the near-term.

UK Manufacturing PMI on the rise, but substantial delays at the boarder will likely slow recovery.

UK Manufacturing PMI read at 57.5 in December 2020 (minor uptick from 57.3 in November) pointing to the strongest expansion in factory activity in nearly three years. This expansion was supported by a boost in clients orders ahead of a potential disruption of a 'No Deal' Brexit. Quantities of purchases also rose at its third-fastest pace in recorded history.

We feel the UK's outlook looks less fragile with a Brexit deal in place. This has included a beneficial free trade agreement with no tariffs or limits on the amount that can be traded between the UK and the EU going forward. Significant changes have been introduced at borders though, which could potentially lead to delays and disruptions in goods transferred in the near-term, and result in a compounding Covid-19 hit that leaves the UK at risk of a slower pace in recovery relative to its peers.

Euro area manufacturing PMI recorded very strong Q4 readings - Netherlands and Ireland in the lead.

Eurozone

The euro area contracted 7% in 2020. Manufacturing PMI was recorded at 55.2 at the end of the quarter which is a significantly improved reading from that at the end of the first quarter at 44.5 and represents the strongest growth in factory activity since May 2018. That said, firms across the area have continued to aggressively cut their cost base in staff and continued its 20-month long trend in decline month-on-month. Except for the Netherlands and Ireland, all countries recorded a weakening in PMI. The lowest scoring countries included Greece, Italy, and Portugal. Consumer spending remains relatively modest alongside a mild increase in consumer confidence. From -17.6 in November, the consumer confidence indicator was confirmed at -13.0 in December repre-

senting a recovery in all components; household financial conditions (past and future), intensions to make major purchases and confidence about the general economic situation.

Like other places in the world, the euro area saw a sharp decline in services over the quarter following new lockdown restrictions whilst more cyclical sectors such as manufacturing have remained relatively resilient. Any recovery from here, is widely forecasted to be an asymmetric one with countries such as Italy and Spain with a weaker balance sheet and heavy reliance on tourism will take longer to reach previous output levels and countries like Germany are expected to benefit from the resilience demonstrated in global manufacturing.

ECB is devoted to take any measures required to protect the eurozone;

€1,850bn

QE package.

The European Central Bank has continued to expand its quantitative easing package and has in total devoted €1,850bn in a pandemic emergency purchase program to help provide liquidity and lower borrowing costs for governments, firms, and citizens. Whilst this has proved to soften the blow of the pandemic, it has also come at a direct opportunity cost and caused a setback in ECB's mission to raise inflation pressures. Core inflation (which excludes volatile items such as energy prices and hence represents a more accurate picture of prices) dropped to a new all-time low of 0.2% in September 2020, which will likely only serve to prolong a future recovery.

Japan

Japan's economy was challenged even before the pandemic hit. This has been led by a severe decrease in consumption following the consumption tax increase resulting in a deterioration in business confidence. Subsequently, this has led to severe declines in investments, most evident amongst manufacturers. While a recent rebound in global manufacturing does directly benefit the Japanese economy, trade remains a challenge for exporters due to the strong yen. Businesses have reported the most excess production capacity in over 10 years and machinery has seen a sharp decline in orders. This has put additional pressure on investments, which is already down -11% year-on-year.

Slowing consumption and decline in investments - manufacturing amongst the sectors most affected.

Japan Manufacturing PMI was recorded at 50.0 in December 2020 and represents the highest reading since April 2019. This could point towards a stabilization in operations amongst manufacturers, though has not been coupled with an increase in output and new orders. Household consumption remains almost 8% lower than that of a year ago and could proceed to decline further with Covid-19 cases recorded at new record levels throughout November.

2020 ended with a strong PMI reading despite a decline in output and new orders.

Fiscal and monetary support from the government has been key in softening the impact on Japan's economy. This has included fiscal easing to improve liquidity conditions, deferring tax bills and making credit lines widely available for business owners. That said and like other major economies, measures taken as of late represents somewhat of an exhaustion in future policy response with rates and inflation already being at reversal levels.

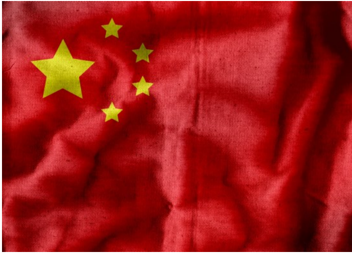
Emerging Markets

The pandemic has caused a deterioration of budget balances and rising debt-to-

GDP ratios in nearly all emerging countries. Due to the already challenged fiscal position of most of these countries, they have overall been more vulnerable to increases in debt as their borrowing costs have spiked. Fiscal support has helped some of the more advanced economies such as China, South Korea, and Taiwan whilst some of the smaller economies have not seen enough debt reliefs to fill their financing gaps in face of the virus.

Investors broadly continue to favour safe haven assets.

Across the region, spreads against the USD have continued to grow wider throughout the year, particularly seen in Brazil, Russia, South Africa, and India which we believe has had a dictating effect on how much room these economies will have for fiscal and monetary policy responses. The one outlier to this synchronized suffering has been China's cruising speed to recovery. Its industrial production has bounced back to pre-COVID-19 levels with underlying drivers including the speedy recouping of activity lost during the first half of 2020 supported by boosted demand following the government's economic stimulus and have also directly benefited from improving conditions in the US and Europe.

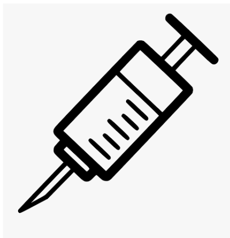


China Manufacturing PMI read at 53 in December 2020, suggesting it has maintained its recovery momentum well alongside strong output and new orders. We believe China is likely to continue its growth trajectory in 2021 and gradually start to tighten its monetary policy as key economic conditions and relationships improves. However, it is our opinion that even under Biden's presidency in the US, technology wars still represent a substantial risk to China's economy this year, and it is important to note that such pressures may not be confined to the US and China as we start to see several other major economies becoming more and more reluctant to use Chinese-made technology.

Technology war continues to be the number one risk to China's economy in 2021.

Conclusion

Assuming the Covid-19 vaccine rollout becomes widespread throughout the year, the economic outlook for 2021 could potentially be a positive one. In most economies, it has been the consumer driving the recovery thus far accompanied by investment growth beyond that of government spending. Bearing that in mind it will largely be up to policy makers to continue introducing investment-enhancing reforms to facilitate a re-investment cycle that could service sustainable growth from here that gradually relies less on government stimulus.



Investment Outlook

While the majority of the world is still living the nightmare, it is difficult to look back over the past year without disbelief. 2020 has proved bizarre and disastrous for many and the fourth quarter only continued that trend. A second wave of Covid-19 took hold across the northern hemisphere and has since been followed by a third. If that were not enough, new strains of the virus have been identified from South Africa and the United Kingdom that are estimated to be between 50-70% more infectious[i]. Yet, while the current state of affairs is dire, the global equity market rallied as it set it sights on promising lights at the end of the tunnel.

While the current state of affairs is dire, the global equity market rallied as it set it sights on promising lights at the end of the tunnel.

In October equities struggled to gain traction under election nerves, with the MSCI World index falling 3.1% over the period[ii], but quickly picked up steam in November following a Biden victory and strong vaccine trial results. Joe Biden eventually overcame a predictable surprise in a strong Trump turnout. Democrats won the house by 74 electoral college votes on margins that meant there was little uncertainty surrounding the President Trump's subsequent lawsuits. The President-elect is expected to raise tax levels but is also forecast to propose the largest stimulus package, and is viewed as a more global player when it comes to trade policies. Following the presidential news, Pfizer and Moderna both announced efficacy rates of over 90% and gave businesses and populations a more concrete timeline for the end of the pandemic. Equity markets rode on the back of a bullish charge for the final two months of the year and a value rotation finally took hold. The MSCI World Index finished the quarter up 12.0% with strong figures across geographies; S&P 500 (11.7%), EUROSTOXX 50 (11.2%), FTSE 100 (10.1%), Nikkei 225 (18.7%), Hang Seng (16.1%), Shanghai Composite (7.9%). The new strains of the coronavirus have become headwinds to the projected recovery, but so far are not believed to affect vaccine efficacy rates, leaving the carrot still ripe on the stick for investors.

Biden is expected to raise tax levels but is also forecast to propose the largest stimulus package and is viewed as a more global player when it comes to trade policies.

*MSCI World **12%** in Q4*

Aside from global vaccine news, the UK's focus of the quarter was Brexit. Rhetoric on both sides of the pond escalated in December as no ground was made on fishing rights and a level playing field. Ursula von der Leyen and Boris Johnson both warned that a 'no deal' had become the most likely outcome before salvaging a trade agreement from concessions on both sides. A no-deal was estimated to knock 2% off UK GDP in 2021 alone, and while the UK's access to the EU will not be as extensive as it was prior to Brexit, businesses and investors alike have recognised a lifting of uncertainty. By the 11th December, the pound had fallen 2.4% from its peak but recovered to reach its highest global value in over two years on New Year's Eve[iii].

While the UK's access to the EU will not be as extensive as it was prior to Brexit, businesses and investors alike have recognised a lifting of uncertainty.

Unfortunately, Covid-19 has continued to test the UK in particular and has dampened positivity. At the end of November it was found that the UK economy is expected to contract the most (-11.3%) and has experienced one of the highest death tolls out of the G7 countries despite allocating proportionally more of its budget to combating the virus than all but Canada[iv]. That situation has deteriorated further as both new Covid strains took hold in South East Eng-

land. Hospitals have filled and the Government has instigated a third lockdown. It is clear that the UK stock market is now relying on vaccine delivery to rescue a dire situation.

Value stocks outpaced growth by 2.6% in Q4 which meant that European stock markets were able to keep pace with the S&P 500 and its big tech constituents.

European countries have thus far avoided surges in new Covid cases of similar scale to the UK. Nonetheless, to suppress these numbers lockdowns have ensued across Europe, putting a stopper on the revenues of many businesses. At least in the short-term, economic contraction should be similar across the UK and Europe, and in the longer term, the UK's more successful vaccine rollout has offset its spiraling virus transmission rate in investor minds. As such, the FTSE and EUROSTOXX behaved similarly in the final months of 2020. Both indices are also typically more value-biased than the US market and benefitted from a value rotation that saw cyclical businesses return to favour in stock markets. Value stocks outpaced growth by 2.6% in Q4[v] and meant that European stock markets were able to keep pace with the S&P 500 and its big tech constituents.

The S&P 500's Price-Earnings ratio is not uncommon for the latter end of a recession, however, investors have set an ambitious recovery agenda for some sectors.

The United States has continued to be the centre for bullish behaviour. Aside from the likes of Tesla, the turnaround in the cyclical market was staggering. To name a few of the Q4 recoveries, General Electric returned 74%, Ralph Lauren 53% and Walt Disney 46%[vi]. The S&P 500's Price-Earnings ratio (PE) is not uncommon for the latter end of a recession, amounting to 37.7 at the turn of the year. However, investors have set an ambitious recovery agenda for some sectors. At year end, S&P Industrials sat at a PE of 40.3, Basic Material at 67.0 and Consumer Cyclicals at 71.8 and these figures have all climbed further since[vii]. Valuations have a substantial number of analysts concerned over a market bubble. An E*Trade survey of 904 investors found that 66% believed the stock market was at least somewhat in a bubble[viii], and Jeremy Grantham, a veteran investor, has added his voice to the rhetoric.

If the market did not convince analysts that there is an abundance of speculative positioning, the performance of particular assets might have. In 2020, Tesla gained 743% and Bitcoin reached a value of £29,988 on the 8th January last week, a gain of 528% from the start of 2020. Neither of these assets have much in the way of underlying value and pricing justification stems from expectations of extreme growth and success that would change the fundamentals of the asset. For Tesla that is to become a market leader in the production of vehicles, batteries, broadband and other technologies. For Bitcoin it is for the asset to finally be accepted as a valuable and less volatile store of capital and as an alternative to gold. News flow has been positive for both Tesla and Bitcoin in 2020 but there are many scratching their heads, wondering how the scale of the value surges is justified.

China's November export growth reached levels last achieved in February 2018.

As noted in our previous investment insights, China has maintained an impressive growth trajectory throughout the course of the global pandemic. Its economy is forecast to have grown 1.9 % in 2020[ix], bolstered by a resilient export industry and state aid. Lockdown demands have largely complemented China's largest exports, including phone and computer hardware, which resulted in China's November export growth reaching levels last achieved in February 2018[x]. However, all was not well for Chinese companies in the past quarter. Pressure

has been mounting for governments to lever more control over global tech giants. In October Jack Ma, Alibaba's CEO, catalysed that change in China by deriding the Chinese financial system. The result was a heavy backlash from authorities that blocked the Initial Public Offering of Mr Ma's new company, Ant Group, and unleashed investigations into Alibaba and other big tech companies. Alibaba's share price fell 25.6% in the two months from the end of October and Jack Ma is now keeping a low profile.

Emerging markets outside of China also had an impressive quarter.

Emerging markets outside of China also had an impressive quarter. East Asian economies largely continued to keep the Covid-19 spread suppressed by using strict crackdown measures and Southern hemisphere economies benefitted from seasonal warmth to stifle transmissions. The US Dollar has weakened further, shedding another 4.2% in Q4[xi], benefiting emerging market companies, which often trade and hold debt in USD. India and Brazil's equity indices rose 19.6% and 25.7% respectively in Q4[xii] as their economies were able to reopen without resulting in overly concerning case numbers.

$ has shed another 4.2% in Q4, benefiting emerging market companies, which often trade and hold debt in $.

The Japanese stock market, the Nikkei, ended the year spectacularly, reaching levels not seen since the Japanese equity bubble in 1990[xiii]. Japanese companies receive roughly 13% of their revenues from the US and 2.8% from South Korea, both countries that are instigating heavy fiscal stimulus packages for businesses. The Nikkei 225 also comprises of 18% consumer cyclical companies, a lot of which beat their earnings expectations, resulting in companies such as Sony Corp. (+28% in Q4) leading the bull market rally.

In Japan, the Nikkei ended the year spectacularly, reaching levels not seen since the Japanese equity bubble in 1990.

The historical performance of the Nikkei 225 index. Japanese stock prices have risen to a level not seen since the Japanese bubble in 1990

Source: Infront Analytics

The Nikkei 225 index comprises of 18% consumer cyclical companies, a lot of which have beaten their earnings expectations.

The Q4 market in government bonds bifurcated for the US and Europe. The US 10-yr Treasury yield rose, finishing the quarter 25 basis points higher while European yields fell further into negative territory. A brightening economic picture allowed US yields to loosen. However, in Europe, the European Central Bank announced further quantitative easing, reversing any potential rise in yields.

HY bonds
6.2%
vs.
IG bonds
2.6%

The German 10-yr yield fell five basis points but the Italian equivalent deteriorated sharply by 32 basis points. The UK 10-yr Gilt yield experienced little change, holding at around 0.2%[xiv]. Corporate bond returns were less mixed and posted handsome figures. High yield bonds returned 6.2% and investment grade bonds returned 2.6% as yields tightened and default rates remained low[xv].

Commodities performed well across the board in the fourth quarter, with even the price of gold remaining steady at $1,898. Other commodities fielded strong returns upon the prospects of stronger economic activity in 2021 and a weakening dollar. Production metals and fuel produced some of the largest gains, leaving commodities with a healthy return of 13% in Q4[xvi].

Over the closing months of 2020, we adjusted our allocation toward positions that would benefit from the reopening of economies. We invested in a commodities fund that would not only prosper from improvements in demand but also from a weaker dollar and a resurgence of inflation. As mentioned in previous insights, inflation is not a certainty but the monetarist argument for such is compelling, and inflation targeting of central banks has become dovish this year.

UK smaller companies have been dynamic in adapting their business structures to fit the Covid climate.

On the equity side we made an allocation to UK smaller companies and increased our exposure to European banks. Small companies have been surprisingly resilient in the wake of the crisis. Government support has helped to minimise defaults, but it should also be noted that these companies have been dynamic in adapting their business structures to fit the Covid climate. We expect small companies to continue to adapt to consumer preference and supply chain changes outside of the crisis. Furthermore, these companies are cyclical in nature and provide exposure to industries that are atypical in the FTSE 100, such as video gaming.

The banking sector in EU is the largest in the world, the deep level of integration means investors should not position for a recovery in Europe without also expecting a recovery in its banks.

As noted in previous Hottinger articles, there is a strong correlation between the performance of European and UK banks and the strength of their respective economies. The banking sector in EU is the largest in the world, with bank assets estimated to be triple the value of GDP at time of study in 2013. In contrast, Japan's banking sector amounted to roughly twice the size of its GDP and the US only 90%. This deep level of integration means investors should not position for a recovery in Europe without also expecting a recovery in its banks.

Beginning
or
The End
?

Economists cannot yet conclude whether the world is at the beginning of a new economic cycle or the continuation of an old one. The pandemic has created unusual signals in this regard. Regardless, a pertinent question remains; where can we expect growth in the next economic boom when economies will be suffering under unprecedented debt levels? It may be that productivity advances will finally be realised but otherwise economic growth may derive almost exclusively from emerging markets in the coming years. China will continue to be a bastion for growth, having set an aggressive agenda of doubling GDP by 2035 and is currently drawing up plans for economic restructuring towards consumerism, which it has termed its 'dual circulation' policy. While it is also important to monitor China's aggressive political stances as areas of potential

downside risk for its stock markets, China and other emerging markets will continue to be of significant interest for the majority of our mandates.

More generally, in the short term we expect markets to continue to be supported by positive expectations on economic revivals and further stimulus, particularly in the US under Joe Biden with the backing of the Senate. However, it is difficult to ignore that some areas of the market look stretched given the toll exacted on companies over the course of the pandemic. We would expect to see some pull-back in equity markets later this year as news flow cools and companies settle into more recognisable earnings patterns. While defensive assets such as government bonds and alternatives have not kept pace with the current equity race, they may play a greater part in portfolio returns once again should equities lose their steam.

It is difficult to ignore that some areas of the market look stretched given the toll exacted on companies over the course of the pandemic.

[i] https://www.forbes.com/sites/carlieporterfield/2020/12/24/new-coronavirus-strain-is-56-more-infectious- scientists-estimate/

[ii] Data from Infront Analytics

[iii] Data from the UK Pound Sterling index https://uk.investing.com/indices/uk-pound-sterling-index

[iv] https://www.ft.com/content/1f52fd2b-7daf-418e-be8b-acc38f819b8d

[v] Data from MSCI World Value index versus MSCI World Growth index

[vi] https://seekingalpha.com/article/4397391-50-best-performing-s-and-p-500-stocks-in-q4-and-2020

[vii] https://www.gurufocus.com/sector_shiller_pe.php

[viii] https://markets.businessinsider.com/news/stocks/stock-market-outlook-bubble-index-survey-recession-fears-risk-etrade-2021-1-1029945009

[ix] https://www.statista.com/statistics/263616/gross-domestic-product-gdp-growth-rate-in-china/

[x] https://www.bloomberg.com/news/articles/2020-12-07/china-s-exports-rise-most-since-2018-as-year-end-demand-surges

[xi] Data from the US Dollar index (DXY)

[xii] Data from the MSCI India and MSCI Brazil indices

[xiii] https://japantoday.com/category/business/urgent-nikkei-up-16-in-2020-at-highest-year-end-close-since-1989

[xiv] https://www.schroders.com/en/us/professional-investor/insights/multi-asset/quarterly-markets-review---q4-2020/

[xv] According to the S&P US High Yield Corporate Bond Index and the S&P 500 Investment Grade Corporate Bond index

[xvi] Data from the GSCI Commodity index

After the Rollercoaster of 2020, will 2021 prove any more predictable.

By Tim Sharp,** Managing Director at **Hottinger & Co. Limited

A rollercoaster year ended with many market headwinds dissipating. In December the Pfizer / BioNTech vaccine had received emergency approval in the UK, US and the EU with the first vaccinations underway. Furthermore, The Federal Drug Administration (FDA) had approved the Moderna vaccine for emergency use in the US, and the UK's MHRA had approved the Astra Zeneca / Oxford University vaccine[i]. Furthermore, the EU and the UK agreed a last-minute trade deal on Christmas Eve that was ratified by the EU council on December 29, and by the UK parliament on December 30 marking the end of four and a half years of "Brexit" negotiations at 11.00pm on New Year's Eve.

The ability of vaccine rollout to allow economies to reopen means that we can also view them in the same light as monetary and fiscal stimulus support.

The ability of vaccine rollout to allow economies to reopen means that we can also view them in the same light as the monetary and fiscal stimulus that is still supporting economies under ever tighter restrictions. While vaccinations may provide the light at the end of the tunnel, the journey may not be smooth with a potentially tough winter ahead before widespread vaccinations can be rolled out. Renewed lockdown measures in Europe, the UK and the US in the face of the new UK B.1.1.7 variant of the virus has seen new coronavirus cases hit new highs in many countries, with the probable effect of suppressing the economic recovery until the second quarter of 2021.

Morgan Stanley have held one of the most optimistic views throughout 2020, in our opinion, being strong proponents of a V-shaped recovery and continue to believe that 2021 will see a traditional post-recession, early cycle, strong growth pattern[ii]. The opposite view is that a new cycle cannot start until the undercapitalised, less productive elements of the economy are replaced by new, more dynamic companies. Without this economic cleansing this argument sees a wider period of corporate default ahead.

It is true to say that the fears over a rising default rate in 2020 as seen during the Global Financial Crisis (GFC) failed to materialise.

It is true to say that the fears over a rising default rate in 2020 as seen during the Global Financial Crisis (GFC) failed to materialise. In fact, pre-pandemic, non-financial corporate debt had risen to record levels relative to GDP in the US, and similar in the Eurozone, plus IMF and BIS research saw many firms globally were increasingly finding it difficult to service their debt, as well as seeing deteriorating profits[iii]. However, corporate bond defaults and insolvencies have not spiked following the pandemic lockdown, in fact, ASR report that bankruptcies have actually fallen in 2020 which undoubtedly reflects the unprecedented level of support provided to companies by governments in the face of a deteriorating environment that is not of their making[iv]. Many of the companies facing extreme trading conditions were strong, well-financed companies before the pandemic and find themselves in this situation through external shocks rather than poor management of trading conditions.

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The unprecedented buying of corporate debt by central banks and the fiscal support given to companies caught up in the social distancing protocols, dictated by government guidelines, will have supported all companies, including those

that were already in distress – Arcadia comes to mind, but many would otherwise have remained solvent, fundamentally strong businesses if it were not for the pandemic. In conclusion, we believe that there will undoubtedly be economic scarring as we emerge from the effects of the enforced recession, but policymakers will have provided an environment that will see many companies with the strength and flexibility to re-emerge as going concerns, therefore, this recession will quite possibly not see traditional default levels. In our opinion, the final test will be once support starts to be removed as the economy moves into a new cycle, and the traditional failings of unproductive companies can happen.

All asset classes are expensive on an historical basis.

All asset classes are expensive on an historical basis but despite the downside potential, we believe that the vaccination programme has the capacity to turn the K-shaped recovery that we have seen during the pandemic into a U-shaped recovery in the first half of 2021, as the valuation gap between the COVID-19 "haves" and "have nots" is given the opportunity to close. The likelihood, in our opinion, is that risk assets remain in favour during the first half of 2021, but eventually absolute valuations cannot be ignored, unless earnings expectations can justify higher levels.

The likelihood, in our opinion, is that risk assets remain in favour during the first half of 2021, but eventually absolute valuations cannot be ignored.

Again, profits have surprised to the upside in 2020 as third quarter results show, and this could be attributed to the fact that lockdown has not stopped consumers from spending on goods, only suppressed their ability to spend on services and hospitality. The savings rate in most developed economies has increased in both voluntary and precautionary savings, and this is likely to fall as economies start to re-open. It seems likely that the service economy will lead growth prospects in 2021 as the sectors most stymied by lockdown begin re-opening, with the support of effective vaccination programmes. Generally speaking, profit margins in service industries tend to be narrower than in manufacturing sectors, so ASR contend that the upswing may see a lower-than-expected profits recovery[iii].

One of the major takeaways from 2020 is probably the ease with which technology allowed many companies to move seamlessly to remote working.

One of the major takeaways from 2020 is probably the ease with which technology allowed many companies to move seamlessly to remote working and a generation of sceptics towards flexible working, were suddenly faced with the prospect of a workforce working-from-home. Surprisingly to many, this has been coupled with a productivity boom, as companies found new ways of operating, leading to greater efficiency, and probably permanently changed working practices. Market observers have considered for some time that productivity calculations may be being adversely affected by the advances in technology, and now we believe the continued deployment of technological change will probably provide productivity gains well into the future.

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The take up of technology has accelerated exponentially under the pandemic propelling the technology sector to all-time highs as a percentage of total equity market capitalisation. Cybersecurity; on-line medical services; medical technology, of which the COVID-19 vaccines are a product; and digital consumption have changed our behaviour enduringly and will lead to further improvements in logistics[iv]. This disruption is set to continue, in our opinion, with further strides being

Afterall, we know how the "dotcom bubble" ended!

made in Artificial Intelligence, Automation and the application of consumer and industrial software. This will inevitably require management and oversight at a national and international level, but we believe the acceleration of technological advancement is unlikely to reverse now that most of the population has been exposed to the opportunities.

Déjà vu?

At the risk of sounding like an equity broker from the year 2000, can we clearly value the prospects of the impact of technology, or as quality investors, should we just focus on the fundamentals? Afterall, we know how the "dotcom bubble" ended! Twenty years ago, forty five stocks in the S&P500 were trading at ten times revenues before the NASDAQ index memorably fell 83%. As blogger Jesse Felder points out in the latest Felder Report, currently nearly sixty stocks in the S&P500 are trading at more than ten times revenues so perhaps we can forgive more experienced investors a sense of déjà vu[v].

ESG exchange traded funds attracted record inflows of over $20bn in 2020.

In our search for potential bubbles in valuations, the level of investor interest, and the amount of funds that have flowed into ESG over the last two years cannot be ignored. In 2018 EU Energy Ministers agreed a renewable energy target of 32% by 2030, and China has recently set a target of zero emissions by 2060. With the increased media exposure of climate activists leading to mainstream acceptance, and the Trump administration pulling out of the Paris Climate Accord, we became aware of an increased use of the term "investing without leaving a footprint". ESG (Environmental, Social & Governance) exchange traded funds attracted record inflows of over $20bn in 2020, three times 2019, and this has led to the birth of the term "green washing," or the creation of an undeserved image for being environmentally responsible[vi].

The iShares Global Clean Energy (USD Distributing) ETF gained 137% in 2020.

iShares Global Clean Energy ETF

Source: Bloomberg as at 31 December 2020

While this approach to investment is to be applauded it is always worth assessing the fundamentals of the proposed investment as well as the attraction of the long-term investable theme.

While this approach to investment is to be applauded and may well help to hold companies and governments to account, fundamental evaluation must still apply. The iShares Global Clean Energy (USD Distributing) ETF gained 137% in 2020 leaving it on a Price-to-Earnings of 39.4 times and a Price-to-Book Value of 3.86 times. This may still prove to be an attractive entry point, as may Tesla's 780% price rise in 2020

to a Price-to-Earnings of 313.59 times, but it is always worth assessing the fundamentals of the proposed investment as well as the attraction of the long-term investable theme[vii]. Significant changes in policy and regulation by governments will be necessary in the medium term if they are to meet self-imposed emissions targets and this will have an impact on many industries and companies, providing investors with interesting growth opportunities.

Predicting the result can sometimes be clearer than foretelling the catalyst.

When we published "Big Picture for 2020" as part of Global Insights at the beginning of 2020 we were wary of the global economy being in late cycle and prone to medium term recession. Although we obviously had little clarity at that time of the impact on COVID-19 and the resulting pandemic, it probably stands as an example of how predicting the result can sometimes be clearer than foretelling the catalyst.

Fast forward to the beginning of 2021, we see that the disconnect between financial markets and the real economy remains in place.

Fast forward to the beginning of 2021, we see that the disconnect between financial markets and the real economy remains in place, with asset prices with already stretched valuations, in our opinion, supported by monetary, fiscal and medical stimulus when the restrictions on the ability of economies to reopen prevent a meaningful recovery from taking place. We asked the question in December whether investors should focus on the immediate, or the fact that we have a timeline to normality? However, the immediate is now having a very significant impact on the ability of investors to look too far ahead in an ever-changing environment.

In what can probably be considered as the first surprise of the year the Democrats now have control of the Presidency, the House of Representatives, and the Senate.

Most investment bank prophecies for 2021 were probably based on a divided US legislature and did not include the re-emergence of a Democratic sweep in the US election results. But in what can probably be considered as the first surprise of the year the Democrats now have control of the Presidency, the House of Representatives, and the Senate via the Vice-President casting vote, following the election run-off in Georgia for two contested Senate seats. The threat of this result during the main campaign in 2020 was enough to influence the second attempt at a sector rotation from growth into value, and its emergence in 2021 as a reality will probably cause a re-evaluation of the reflation trade.

Ten-year US Treasury yields have already moved above 1% for the first time since March 2020.

US 10 year Treasury Yield in 2020

***Source: Bloomberg* as at 31 December 2020**

Investors may be treating inflation as one of the main potential "Black Swans" of 2021.

There will be anxiety regarding changes to tax and regulation, as seen in December, but the prospect of increased stimulus means the risks of economies overheating in the medium term are to the upside. It is the threat that higher inflation uncertainty is skewed to the upside that can cause financial markets to react, and should bond yields also surprise to the upside, the path of risk assets may be upset. Ten-year US Treasury yields have already moved above 1% for the first time since March 2020 and pressure could grow on central bankers to qualify the extremely accommodative communications provided to markets thus far.

It may seem strange to see inflation as a risk when US Consumer Price Inflation was running at 1.4% in December, and the Eurozone continues to labour under deflation. Unemployment is still high, thanks to the pandemic, meaning wage growth is also weak. However, Gillian Tett reports in December 15 Financial Times that the fact that US inflation-linked bonds, or TIP's, have delivered a risk-adjusted return of 35% in 2020 suggests that investors may be treating inflation as one of the main potential "Black Swans" of 2021[viii]. The biggest risk for governments and central bankers is that any change in policy that feels like a tightening of conditions could trigger a "taper tantrum" similar to the surge in Treasury yields experienced in 2013. An aggressive rise in 10-year US Treasury yields to 1.5%, or even 2% in the medium term, could see investors become more nervous, while an orderly rise in yields due to a mild rise in inflation could still see risk assets thrive.

The 2020's could see Asia emerge as the central secular growth opportunity of the decade based on the growing strength of the region and solid structural foundations.

Finally, as highlighted during our December Strategy Meeting, President Xi has recently suggested that China could double its GDP by 2035 and, while we remain sceptical of this possibility, we do believe that China could be the engine for growth in 2021[ix]. The knock-on effect of the increased investor interest in the region especially as China's weighting in global indices increases, will likely have a positive effect on Asian economies and financial markets. In their Key Themes for Q1 2021, Karen Ward, JP Morgan's Chief Market Strategist, EMEA, highlights their belief that the 2020's could see Asia emerge as the central secular growth opportunity of the decade based on the growing strength of the region and solid structural foundations[x].

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[i] MHRA: The Medicines and Healthcare products Regulatory Agency, regulates medicines, medical devices, and blood components for transfusion in the UK

[ii] Morgan Stanley Research; Sunday Start – How You Get There Matters; December 6, 2020

[iii] Absolute Strategy Research; The 2021 Economic outlook; December 1, 2020

[iv] Edmond de Rothschild; EDR 2020 Outlook Convictions; December 7, 2020

[v] Jesse Felder; The Felder Report; January 6, 2021

[vi] https://www.bloomberg.com/news/articles/2020-10-25/record-flows-pour-into-esg-funds-as-their-wokeness-is-debated#:~:text=Inflows%20to%20ESG%20ETFs%20have%20surged%20to%20%2422,components%20--%20resulting%20in%20some%20surprising%20fund%20holdings

[vii] Statistics referred to have been extracted from Infront Professional Terminal reported data

[viii] Financial Times, US inflation pressure cooker builds up steam by Gillian Tett; January 15, 2021

[ix] https://www.bloomberg.com/news/articles/2020-11-03/china-s-xi-says-economy-can-double-in-size-by-2035

[x] JP Morgan Market Insights; Guide to the Markets As of December 2020; January 6, 2021

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