Manager's Report

QUARTER TO 31 DECEMBER 2020

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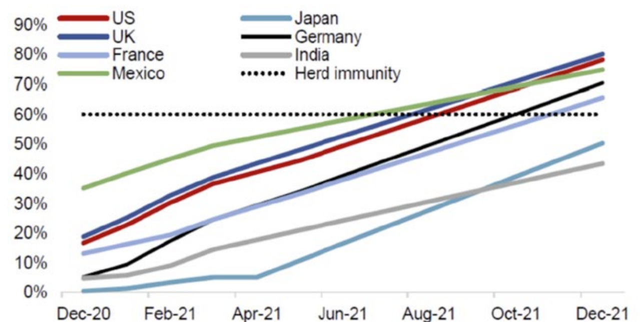
A most turbulent year has delivered decent returns for investors.

In spite of an accelerating "third wave" of Covid infections in recent weeks, and renewed lockdowns, asset markets reacted positively to good news on the efficacy of vaccines published at the start of November.

This sparked a rotation of money flows into economically sensitive, cyclical sectors and thus a broadening out of the stock market rally beyond those stocks benefitting from the "stay home" theme. The roll out of vaccines has been slower than expected in most countries so far, but markets are looking past that for now, expecting "herd immunity" to be achieved by the summer or autumn in most developed economies, once approximately 60% of the population has received a vaccine.

Figure 1) Estimates for the Path to Herd Immunity in Major Economies

IHME estimates used for infection acquired immunity to April 2021. Assumptions: R0 of 2.5, 85% vaccine efficacy, immunity acquired 1 month after first shot, and vaccines administered evenly across seropositive and seronegative population. Projections for vaccination pace extrapolated from statements from health officials, politicians and experts in each country.



Sources: Credit Suisse estimates, IHME

The apparent success rate of vaccines has caused most economists to increase their projections of global GDP growth. The table below shows the boost to growth estimates made by Capital Economics for the current year and next year – the boost is strongest for countries most negatively affected by the virus.

Figure 2) Boost to Growth Projections

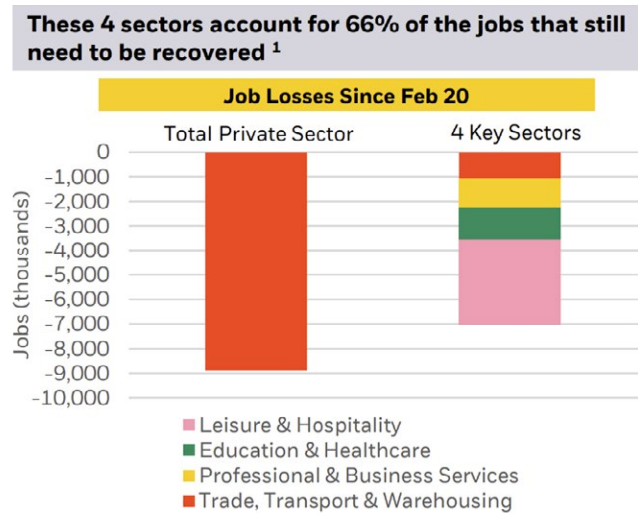
	2021		2022	
	Pre-vaccine	Latest	Pre-vaccine	Latest
US	4.5	5.0	3.8	4.5
Euro-zone	3.0	5.0	3.5	4.0
UK	4.0	7.5	5.0	7.5
Japan	3.5	3.7	2.0	2.3
China	10.0	10.0	4.0	3.5
India	10.5	12.0	7.0	9.5
Latin America	4.8	5.6	2.6	3.7
Emerging Europe	4.1	4.8	3.4	4.4

Sources: Refinitiv, CEIC, Capital Economics

One of the unusual aspects of this pandemic-induced economic slowdown is that fact that it has supressed the in-person services sector, which has not experienced a contraction in growth for decades, much more than the goods or manufacturing sector – contrary to previous recessions.

The services sector provides a lot of jobs – albeit a large share of relatively low paid jobs. The chart below shows the extent to which a return to full employment in the US depends on a normalisation of the services sector -especially leisure and hospitality.

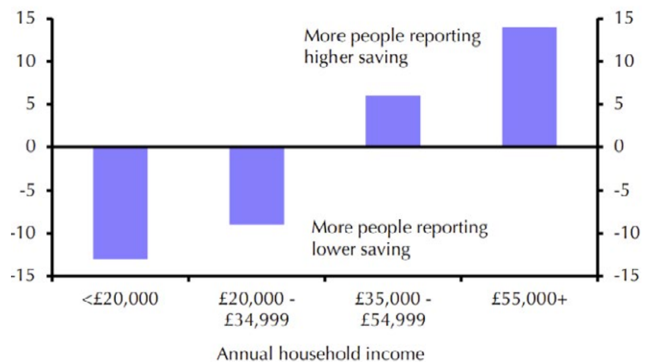
Figure 3) Normalisation of Employment Dependent on Services Sector



Source: Blackrock

US statistics show that employment for the top quartile of workers (those earning above USD 60,000 a year) has already recovered above levels from a year ago, whereas employment for the bottom quartile of American workers (those making less than USD 27,000 a year) remains 20% below January 2020 levels. This pattern is evident in all economies and has exacerbated wealth inequality. Figure 4 shows the increase or decrease in savings for different income cohorts in the UK economy:

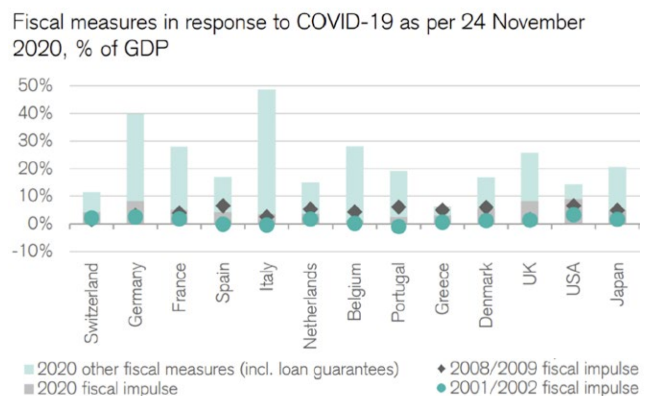
Figure 4) Net % of UK Households Reporting a Rise/ Fall in Saving because of the Pandemic



Source: Capital Economics

Some economists therefore call this a "K shaped" recovery – a positive V shape for white collar workers who can continue to exercise their professions remotely, but a renewed dip for those working for in-person services. Governments maintaining support through extended benefits schemes, and the job support and furlough schemes offered in Europe, will remain vital for much of this year. The good news is that governments appear willing to extend support, and Central Banks appear committed to unlimited extension of liquidity and suppression of interest rates, enabling governments to sustain large fiscal deficits.

Figure 5) Fiscal Support Provided by Governments Exceeds Previous Recessions



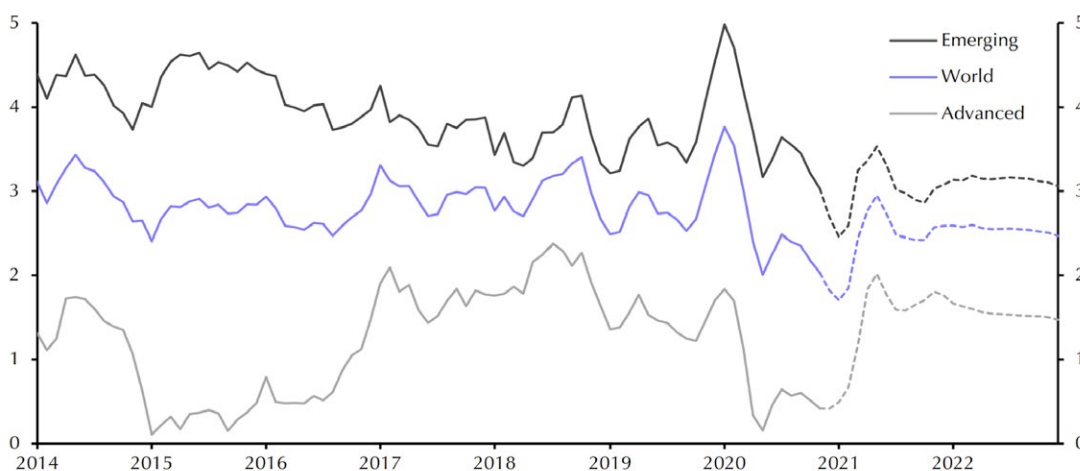
Source: IMF, Bruegel, Federal Council, Credit Suisse

There are those who worry that this stimulus will cause a resurgence in inflation. The positive vaccine news, that triggered "reflation" expectations at the start of November, also marked a turning point for 10 year government bond yields, which have increased somewhat.

The 10 year US Treasury yield currently stands at 1.08%, up from a low of 0.5% in August. The yield on 10 year UK Gilts is now 0.28%, after reaching a low of close to 0%. The German 10 year Bund yield remains negative (at -0.53%) but slightly less so than last summer. In truth, some temporary factors will cause official CPI inflation statistics to temporarily spike higher in coming months – such as the recovery in the oil price, some resumption of VAT levies, and a possible initial supply and demand mismatch in certain services.

But Central Banks will largely look through these factors and be more concerned with the actual level of nominal GDP (which will remain below its previous level until 2022), than with the rate of change. The US Federal reserve has clearly stated it will pursue an "average" inflation target of 2%, meaning that after a period of undershooting this target they will allow some "overshoot". Beyond the expected temporary increase in the CPI, inflation in developed economies is expected to remain below the 2% target for the next 2 years. Interest rate expectations of members of the US Federal Reserve, expressed in dot plot graph form, show no foreseeable increase before 2023 at the earliest. Despite the steady hand of Central Banks, bond markets could be spooked by perceived inflation risks in coming months and cause temporary market setbacks – we would view these as buying opportunities.

Figure 6) Estimates of CPI Inflation



Source: Refinitiv, Capital Economics

Markets' reflation expectations were mainly kindled by the efficacy of COVID vaccines, but other supporting factors were 1) the Brexit trade deal agreed by the UK and the EU at the very last moment, and 2) the (narrow) "Blue Wave" in US Congress due to the results of the Georgia Senate elections earlier this month.

The Brexit trade deal only covers goods, not services, so still leaves many details of future UK/EU cross border business undecided. But at least it provides a positive basis for future agreements to be worked out in a spirit of cooperation, rather than a deeply disruptive shift to WTO trade terms.

In spite of this, there is plenty of anecdotal evidence of confusing new bureaucratic complications and unresolved details hitting UK exporting companies, as the deal was made in haste. But a worst-case scenario (an uncooperative, no deal Brexit) has been averted. Sterling recovered to the top of its recent trading range as a result – around 1.12 to the euro and 1.35 to the US Dollar.

Most forex analysts expect the Pound to be able to recover a bit more (to roughly 1.16 Euros and 1.42 dollars) but not reach its pre-2016 levels.

Recent events in the US, such as the storming of the Capitol in Washington DC and subsequent impeachment proceedings against Donald Trump, were dramatic but had no discernible effect on markets or on economic projections. The election result in the Georgia runoffs did however have a significant effect, as it tilts the balance of power in the Senate and therefore increases the scope of policies the new Biden administration can expect to enact.

Biden hopes to pass a new fiscal package worth USD 1.9 trillion, including vaccine funding, aid for cash strapped State and local governments, and increasing the USD 600 cheques included in December's fiscal package to USD 2,000 a person. The current Democratic majority in the House however is very thin – the Senate is now split 50/50 between Democrats and Republicans with a deciding vote for Kamela Harris, the Vice President. This makes the approval of a dramatically increased fiscal package unlikely and the final stimulus bill could amount to only half of the above figure, and perhaps only be achieved through a lengthy process of budget reconciliation. Notwithstanding, a package would represent an upside potential to the current growth projections for the US economy quoted in Figure 2 above.

Given the fine balance of power in both the House and the Senate, any substantial change in legislation is unlikely to be achieved. But some shift in focus can be expected in foreign policy, as well as in environmental regulation (the US will re-join the Paris Climate Accord), increased scrutiny on the monopolistic power of large Tech companies (which at this point could well have bipartisan support), and some changes in taxation. Biden's plan to partially un-do Trump's corporate tax cuts (from 35% to 21%), by bringing them back up to 28%, might be postponed due to the still fragile economic climate. Some future increase in corporate tax on overseas profits is also possible.

Financial companies are likely to see a strong push for enhanced rules of conduct.

In terms of healthcare, the ball is very much in Congress' court; it is likely that healthcare coverage will be expanded at the margins with little structural change.

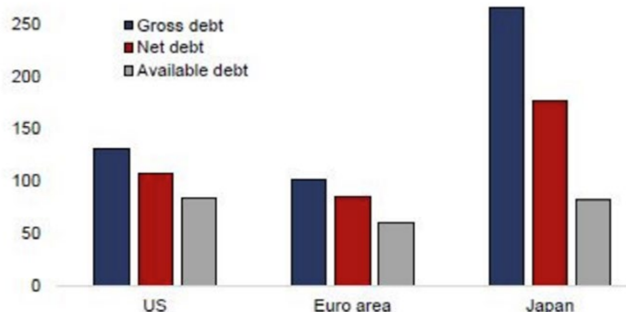
Meanwhile, some bipartisan support may exist for an infrastructure spending plan, which would include renewable energy projects.

How sustainable is the increase in government debt, taken on to support economies buffeted by the pandemic?

After the 2008 Financial Crisis it was commonly argued that countries with high debt would suffer slow growth. That thesis has been discredited and given way to its antithesis: that debt levels do not matter. Both views are extreme, and the truth lies in the middle. The sustainability of a country's debt has to do with many factors, including interest expense, tax revenues, and the ability to cut spending – in other words: political flexibility. At the current low level of interest rates, interest expense is very low, and provided the economic growth rate is above the interest rate, debt to GDP ratios will naturally stabilize and reduce over time without the need to resort to austerity for most developed countries. In addition, gross debt to GDP levels overstate a country's actual indebtedness as it does not take the country's assets into consideration. And with Central banks willing to hold much of a country's outstanding debt stock, net debt available in the open bond market is lower still.

Figure 7) Government Debt in Developed Economies Not Unsustainable

Projections for 2020 figures taken from the IMF World Economic Outlook. Consolidated debt of general government. Net debt is equal to gross debt minus government financial assets. Available debt is equal to net debt minus central bank holdings. % GDP



Source: Credit Suisse, Haver Analytics, IMF

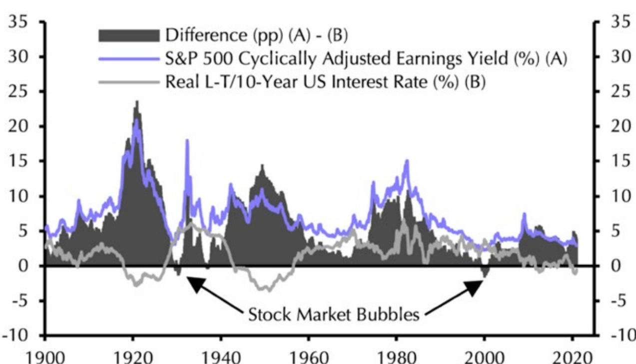
What does all of this mean for investment strategy?

Whereas traditionally Government Bonds have always formed a natural hedge against stock market volatility and thus the backbone of a balanced investment portfolio, at current suppressed interest rates they are not an attractive asset class and are exposed to downside risk once growth expectations pick up and interest rates rise.

High yield corporate bonds, and Emerging Markets bonds still offer an attractive yield differential. Spreads in both asset classes have tightened considerably in recent months – not quite to previous lows but getting close.

Stocks of resilient companies are the most attractive asset class in our view. We would characterize the current market mood as "rational exuberance". Compared to today's ultra-low risk-free rates, a balanced basket of stocks that contains both "disruptor" type innovative growth companies, and undervalued stocks in more cyclical sectors that have recovery potential, currently offers the most attractive potential return. It is the only asset class that offers decent cash flows (dividend yields on many stocks are currently higher than bond yields) plus some inflation protection.

Figure 8) The Equity "Risk Premium" (the differential between company's earnings yields and the risk-free rate) remains attractive, unlike during previous market bubbles (1929 and 2000)



Source: Capital Economics

Most portfolios are currently slightly overweight equities after the recent outperformance of this asset class, but we see no need to reduce equity exposure back to "neutral" levels at this point.

Within equity portfolios we retain a broadly neutral global allocation with a slight overweight to emerging markets and to smaller companies. The former can be expected to outperform due to the weakened US dollar, increased risk appetite, and firmer commodity prices.

The latter tend to outperform when real interest rates turn negative, which is currently the case in all developed markets. The smaller companies' universe is also a fertile hunting ground for active stock pickers, looking for disruptive and innovative new businesses.

For clients that have access to Alternative asset classes we like "Event Driven" strategies that profit from merger and acquisition activity (which is booming), Private Equity (a hot bed of innovation), global managed real estate, and long/short equity strategies that can monetize the differential between "winning" and "losing" business models.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general.

We hope you are safe, and well, and keeping in good spirits in these most unusual and turbulent times.

Portfolio Management Team ISGAM AG

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