ISGAM

Manager's Report

QUARTER TO 31 MARCH 2021

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The first quarter of this year saw quite some market consolidation and "rotation" of sectors and driving factors.

Areas that had held up well last year in the face of the pandemic, technology and other growth sectors, "stay at home" stocks, government and high-grade corporate bonds, experienced a correction, and more cyclical sectors, those previously most affected by the lockdowns and economic downturn, enjoyed a bounce back.

The start of vaccination campaigns, coupled with continued Central Bank support and government fiscal stimulus and support schemes, have boosted estimates for economic growth this year, and triggered an increase in inflation expectations.

While central bank policy is keeping short term interest rates at historic lows, 10-year bond yields rose significantly, especially in the US and UK where vaccination programs are progressing well. Continental Europe has incurred multiple setbacks to its vaccine supply, so euro bond yields rose relatively less, but rose all the same.

This increase in yields caused a sharp setback in high grade bond prices, especially for US Dollar and Sterling denominated bonds. High Yield bonds held up better; yield "spreads" between low grade and high-grade paper declined significantly, forming a cushion against rate increases.

As our bond portfolios were positioned to be underweight "duration" (ie length of term) and overweight corporate vs government bonds, they outperformed their benchmarks, but saw small corrections nonetheless.

Chart 1) Development of 10-year bond yields

Source: Bloomberg Finance L.P.

Estimates for global growth, and inflation, have increased markedly since the start of the year, albeit with some regional differences.

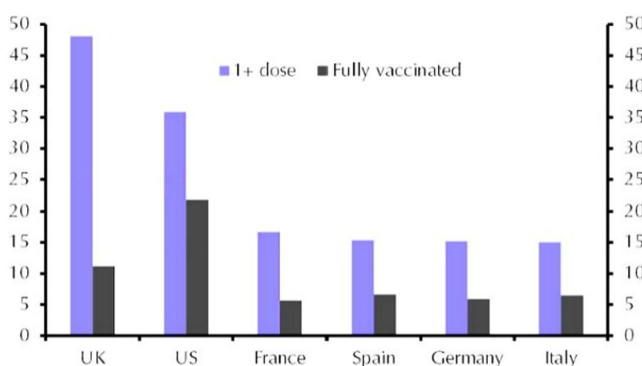
Capital Economics now expects real global GDP growth to amount to 6.7% this year, followed by 4.6% in 2022. Among developed economies, growth in the US is expected to be particularly robust at 6.5%, followed by the UK at 5.2%. Both countries have managed to roll out a successful vaccination program, and have started to reopen their economies, including some leisure and services sectors.

The EU is lagging in its vaccination effort, which has followed Murphy's law – everything that could go wrong, has gone wrong. It is currently expected that 50% of EU residents will have received their first shot (a level at which a gradual reopening process can begin) by July – quite a few months after the US and UK. EU GDP probably contracted slightly in Q1 and is stagnating in Q2.

It should catch up in the second half of the year though, and expected real GDP growth for the Eurozone is 3% this year and 4.5% in 2022, with some considerable differences between the export driven countries (such as Germany) and the Southern countries that depend more on tourism.

Growth in Developing Economies is estimated at 7.8% this year, led by a 9.6% growth rate in Emerging Asia. This is in spite of the fact that many developing economies are woefully undersupplied with vaccines – the UN estimates that so far, low-income countries have just received 0.2% of vaccines offered.

Chart 2) Share of Population Vaccinated, %



Source: Capital Economics, Bloomberg

The Biden administration managed to pass its USD 1.9 trillion stimulus bill with higher than expected bi-partisan support in the US senate. Coming on the heels of the previous administration's USD 900 bn December support package, it has provided a powerful shot in the arm for the US economy.

Millions of Americans (those earning $80,000 a person or less) received checks worth $1,400; the plan also includes increased weekly unemployment checks, healthcare funding, support for re-opening schools, and support for State and local governments. All in all, total fiscal support provided by the US government during the pandemic has amounted to USD 5.6 trillion; over 25% of GDP.

In the UK, the government has spent around GBP 250 billion so far to support businesses and households and expects to spend another GBP 90 billion this tax year (together around 17% of GDP).

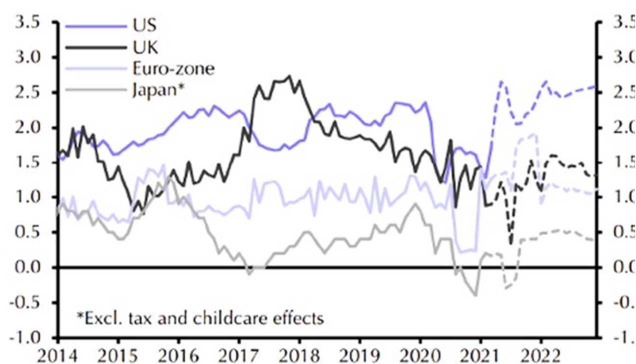
Fiscal support in the eurozone has been considerably smaller, ranging from over 10% of GDP in Germany to under 5% of GDP in Spain.

Will all this stimulus unleash a new wave of inflation, after the deflationary era that followed the 2008 financial crisis?

In our previous report we wrote that a temporary spike in inflation could well spook bond markets this quarter, and cause volatility in stock markets. This has indeed happened. However, many of the factors causing the current rise in inflation numbers are temporary in nature. CPI statistics are year on year comparisons and energy prices are currently much higher than a year ago, when they collapsed at the start of the pandemic. There are also some production bottlenecks and supply shortages in certain goods (such as semiconductors). As economies reopen increased demand for airline tickets, holidays and restaurant services coupled with a mismatch in initial supply will be inflationary.

Central Banks however have stressed their intention to look through higher inflation numbers as transitory and remain committed to keeping short term rates at rock bottom levels and their bond buying programs (QE) active both this year and next. Our economic forecast providers agree with this assessment and expect inflation numbers to settle down after a temporary spike, as per the chart below:

Chart 3) Core CPI Inflation in Major Developed Markets



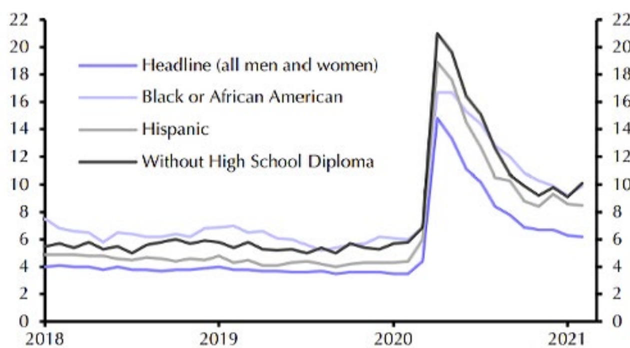
Source: Capital Economics

There are clear regional differences though, with more enduring inflationary pressures most prevalent in the US. This is partly because the fiscal stimulus offered in the US has been much larger than elsewhere. Also, in terms of demographics, the US remains in a better position than Europe or Japan, with a working age population that is still growing, thus avoiding a major and enduring deflationary drag (ageing population and declining workforce) that the latter two are subject to.

In terms of monetary policy, the US Fed has the dual mandate of supporting both price stability and full employment, whereas the European Central Bank has a single mandate – price stability.

It has been interesting to note the recent development in how the different Central Banks see their mission, which seems to be broadening in scope and emphasis. Jerome Powell, the current head of the US Federal Reserve, repeatedly states that interest rates will not be raised until the economy is back to full and inclusive employment, meaning across socioeconomic and racial groups and genders. The chart below shows there is still some way to go to achieve this goal:

Chart 4) US Unemployment Rates per Demographic



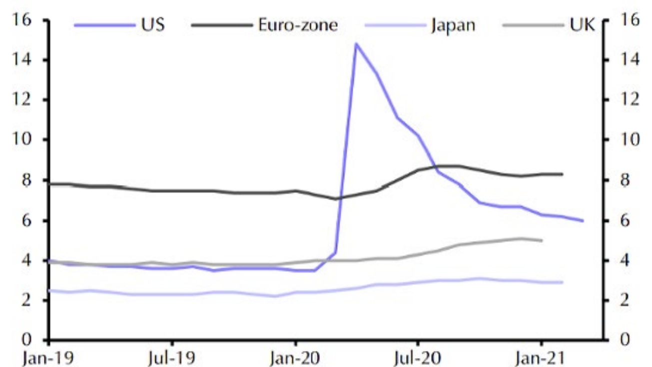
Source: Capital Economics, Refinitiv

The traditional mandate of the Bank of England is price stability and stability of the financial system; spearheaded by its previous governor, Mark Carney, the Bank is currently embedding climate change into financial decisions and macroeconomic analysis and has a mandate to buy Green Bonds in its QE program.

The European Central Bank has the singular mandate of price stability. Under previous leadership of Mario Draghi, and now Christine Lagarde, it has been very creative in broadening its role within this constraint, to ensure the effects of its policy are applied equally to all EU members, acting as a lender of last resort to Southern European nations when necessary. We expect the EU to maintain its current, negative policy rates until well into 2023 and perhaps beyond, as stubbornly high unemployment rates mean wage pressures, and risk of enduring inflation, are absent.

The ECB is highly unlikely to repeat the mistake made in 2011, under Claude Trichet, when it prematurely raised interest rates in response to a rise in inflation and nearly caused a breakup of the Eurozone. We expect the ECB to continue to support cohesion of the different Eurozone economies through its purchase programs and keep longer term bond yields low across the Bloc; nonetheless its scope of possible action is more limited than that of the US or UK central banks.

Chart 5) Developed Economies Unemployment



Source: Capital Economics

As Central Banks' missions seem to have evolved to include a broader social mandate, so has the role of many governments become more prominent as a result of the pandemic and ensuing economic crisis.

Even in the US, bastion of free market capitalism, and the UK, currently under a Tory (conservative) leadership, it is likely that the government will continue to play a larger role in the economy through supporting healthcare, help provide jobs through "build back better" and green infrastructure initiatives, set higher minimum wages (Biden has proposed setting a federal minimum wage of $15 an hour by 2025; the UK has extended its "living wage" to younger age groups). In Germany, the retirement of Angela Merkel, the country's popular and trusted leader since 2005, coincides with a decline in support for her party. At this juncture there is discontent both with the EU vaccine rollout and German lock downs. It looks likely that support for the left leaning Green party will be strong in the coming elections, making the "Greens" a likely partner in the next coalition.

This would turn Germany more pro-EU, less focussed on a balanced budget, austerity, and low inflation, and more supportive of EU wide job creation and green projects.

All in all, the days of the "Washington consensus", of responding to financial crises with austerity, market-determined interest rates, and free trade, which contributed to hardship and deep, painful recessions in developing economies in Latin America in the 1980's and Asia in the 1990's, seem to be well behind us.

Some of this stimulus will be paid for through higher taxes.

In the UK, the chancellor foresees that the corporate tax rate will be raised from 19% to 25% in 2023.

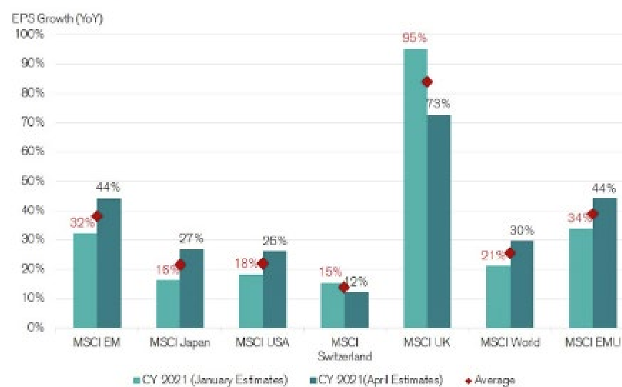
In the US, the Biden Administration's next big project, a $2.3 trillion infrastructure spending plan, is next on the table. It is less likely to pass as easily through the Senate as the Covid Relief plan and is likely to be scaled down. It will also be spread over a number of years. This "Build Back Better" plan has been compared to Franklin Roosevelt's "New Deal", which was smaller in absolute size ($41.7 bn) but represented 40% of the US economy back then; the Biden plan represents around 11% of today's US GDP, spread over 8 years.

It will partly be paid for by tax increases, the exact scope of which is not clear yet, but probably in line with what was presented in his election campaign. It would probably include an increase in income tax rate of households earning more than $400,000, pare back tax preferences for so-called pass-through businesses (such as limited partnerships), and increase the corporate tax rate, from 21% to 28% (this rate was cut from 35% to 21% under the Trump administration). In addition the Global Intangible Low Tax Income on US companies' foreign subsidiaries could be raised, from currently 10.5% to 21%.

So, where US company revenues are likely to see very strong growth in the next few years, from a recovering economy coupled with spending plans, it is likely that higher tax rates will somewhat crimp profit margins. Still, corporate profits are expected to see robust growth.

Chart 6) Company Earnings Estimates have risen sharply this year – estimates of 2021 EPS growth by Major Geographical Region

CY 2021 EPS growth estimates; beginning of the year vs. current month



Last data point: 13/04/2021. Historical performance indications and financial market scenarios are not reliable indicators of current or future performance.

Source: Credit Suisse, Factset

We have written in previous reports that the era of globalisation has been coming to an end, already well before the Trump administration's "America First" policies.

This has been driven by a number of factors. Firstly, by a growing recognition of the adjustment costs of globalisation on certain social groups. But also by the fact that complex supply chains had reached their limit, and more efficient manufacturing at home means labour costs are no longer the only driver as to where production is best located. Meanwhile, there has been a growing realisation politically, that China is not going to become the liberal democratic country that some in the West had hoped in the 1990's and early 2000's.

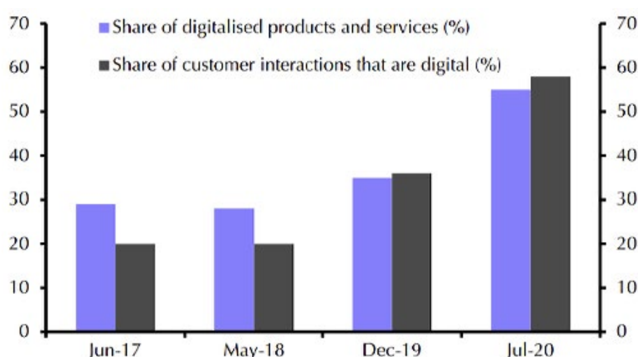
Expectations of some companies that the new US administration would offer a dramatically different approach to relations with China have been dashed. The Biden administration may give more room to diplomacy than the Trump administration appeared to do, but rivalry and potential for confrontation with China will clearly persist. Outright commercial rivalry may cede to rivalry of values and societal models, with commerce representing the means to an end for the USA. Climate action may become one of the few areas of cooperation between the USA, China and the rest of the world.

Thus any developments related to climate change, and indeed the specific role of US climate envoy John Kerry, will have highly strategic connotations. The rest of the world may find that the USA could be more demanding toward traditional allies, and this may complicate relations in the multipolar world that has emerged. In particular Europe may feel it when balancing it's interests with China and Russia. Europe had hastily concluded an investment treaty with China late last year that displeased the new US administration. Several other countries, including India, Australia, and much of South East Asia, will face even tougher political and economic trade-offs when negotiating their relationships with the US and China.

As globalisation will cease to be an impetus to global growth, new tailwinds may emerge, perhaps in the form of increased productivity.

Productivity growth has been nearly absent as a measurable component of GDP growth over the past decade, which puzzled many economists as it seemed that the incredible technological advancement of the past decade or so failed to "pay off".

Figure 7) Digitalisation of Businesses Globally



Source: Capital Economics, McKinsey & Co.

We may have reached an inflection point though where productivity growth is now accelerating, brought forward by a few years due to the pandemic and the increased digitalisation of many services. Whether it is working from home, shopping via the net, replacing some business travel with zoom conferences, paying digitally, or accessing medical services or higher education online, some practices that people and companies creatively turned to during the pandemic will persist after lock downs end. At least, they will be able to choose the most efficient, productive and enjoyable way to do things – probably boosting productivity in the process.

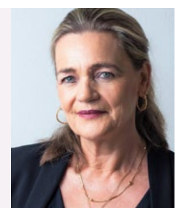
What does all of this mean for our investment strategy, and portfolio positioning?

- Global equities remain the most attractive asset class. Though 10 year bond yields may rise a bit further, especially in the US, they will be capped by Central Bank purchases for some time to come. Equity valuations are justified by low interest rates and strong earnings growth expectations.
- We are mindful to include some "value" stocks in portfolios but are careful to avoid value traps and maintain a focus on companies and sectors that enjoy secular growth momentum, many of which can be found in the technology, healthcare, communication, and industrial sectors. Companies that will profit from the coming boom in infrastructure investment, and the transition to clean energy, are also firmly on our radar.
- Alternative asset classes (private Equity, long/short equity strategies, event driven strategies, global real estate) offer appreciation potential and diversification/hedging benefits.
- In bond portfolios we retain an overweight to High Yield and Emerging market bonds, and underweight duration.

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

Marianne Rameau ASIP



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