

Market & Strategy Update Q1 2021

Executive Summary

Following a roller coaster of a year, investors are eager to see an end to 2020 and look optimistically toward 2021. With central banks and governments reiterating their intention to focus on short term risks and keep the money printer going in spite of a widely expected recovery and rising inflation expectations, a very bullish consensus has been formed and markets have risen accordingly, forming a stark contrast with the state of the real economy.

Leading economic indicators suggest a continuation of the recovery but current valuations offer little margin of safety, should rosy expectations not be met or negative surprises emerge in 2021. Investors hope for a swift return to normality but seem to forget that normality has been a world of low growth and low inflation, thanks to an overwhelming amount of debt. This situation has not exactly improved in 2020, with governments going on a spending splurge to substitute incomes and support businesses, especially in the developed world.

Nonetheless, after holding back for most of the year, investors have started allocating their cash pile and rushed back into the equity market at a historic pace in the last quarter, reassured by the Biden victory and the expectation of a swift vaccine rollout. Although historically overvalued by most metrics, equities remain the only viable alternative for cash rich global investors given the level of fixed income yields. However, seasonality will become less supportive of the current rally in January and the abundant signs of exuberance suggest that caution into the new year is warranted.

The recent outperformance of value and cyclical stocks could have some way to go from a valuation standpoint, as COVID winners such as tech companies will have a higher hurdle to clear in 2021, but it may be too soon to bet on a reversal of this secular trend. Moreover, many of the COVID losers such as airlines and travel stocks have rallied too much for comfort. Europe will likely go through a very heterogeneous recovery, with peripheral countries taking longer to regain 2019 levels of activity. Moreover, the euro's rise and potential political disharmony around the Recovery Fund are headwinds into 2021.

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We favour getting exposure to the value/cyclical thematic by investing in Japanese and emerging markets. While foreign investors are yet to convincingly allocate capital to Japan, which we think is inevitable, they have returned to emerging markets aggressively in recent months.

Emerging markets' performance in 2021 will largely depend on the direction of the dollar, which is widely expected to continue depreciating given the combination of a record rise in supply and exploding budget and trade deficits. While it does seem that the dollar has entered a new bear market, positioning is extreme and a possible rally in the first quarter of 2021 cannot be excluded. Many emerging market indices are currently overbought and a minor correction would be welcome in order to add to existing positions.

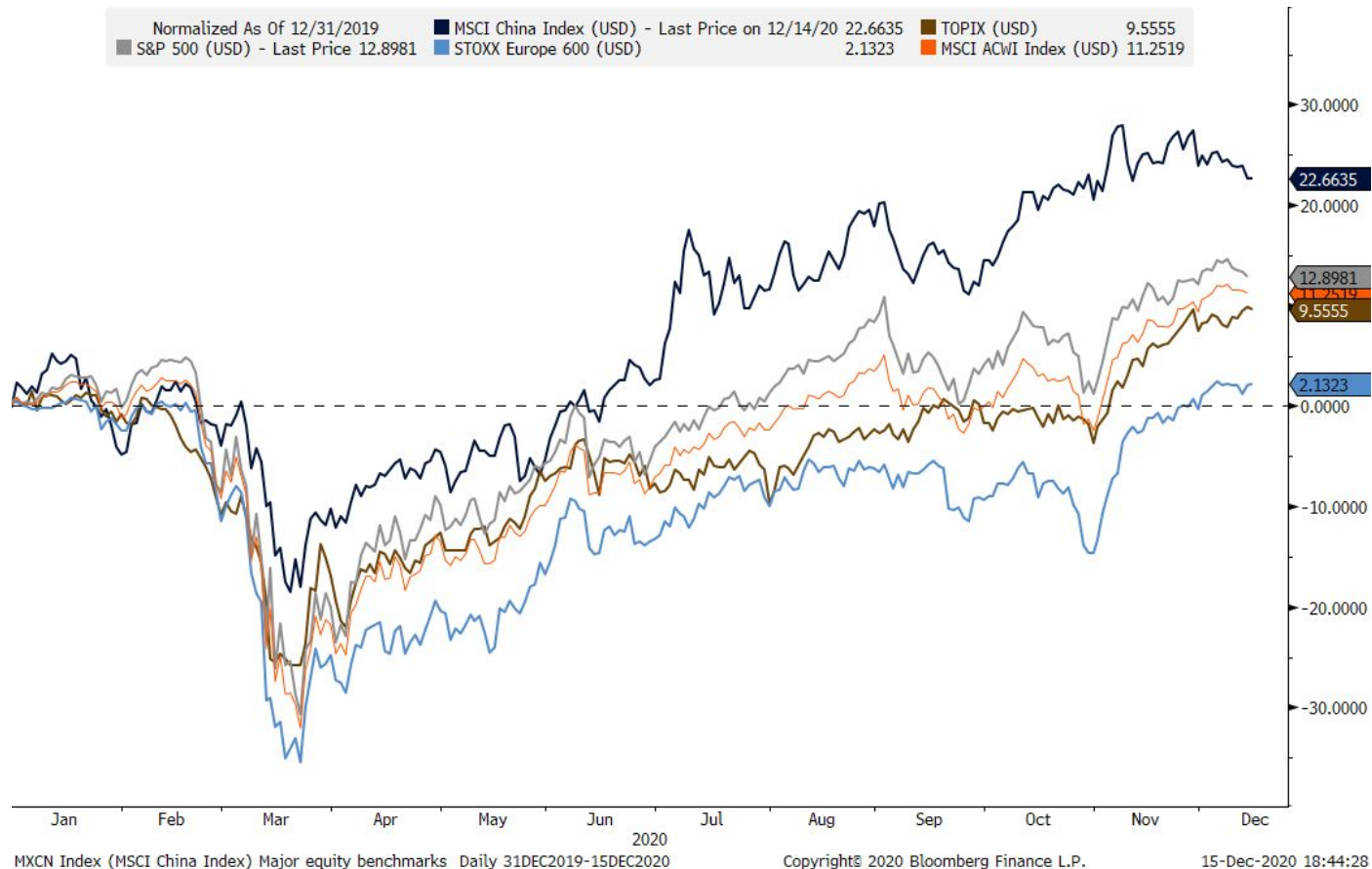
One of the largest beneficiaries of this year's government spending programs have been renewable energy stocks, which have rallied to extreme valuations while oil stocks remain very depressed, despite the recent recovery. It is likely too early to call for an end of oil, as demand will continue to grow in coming years while supply could become tight given the collapse of capex in recent years.

With monetary and fiscal stimulus likely to remain very loose despite a possible recovery, and the line between them increasingly blurring, the risk of inflation appears to be rising. The attractiveness of developed market fixed income remains as low as ever, while emerging market debt continue to offer specific opportunities both in local and hard currency terms. Monetary assets with inelastic supply such as gold and Bitcoin continue to remain attractive as fiat currencies are relentlessly debased. The latter particularly has a lot of room to rise, as it is becoming increasingly accepted as a financial and monetary asset.

Macroeconomic Context

Markets close the year in positive territory after a record-breaking slump

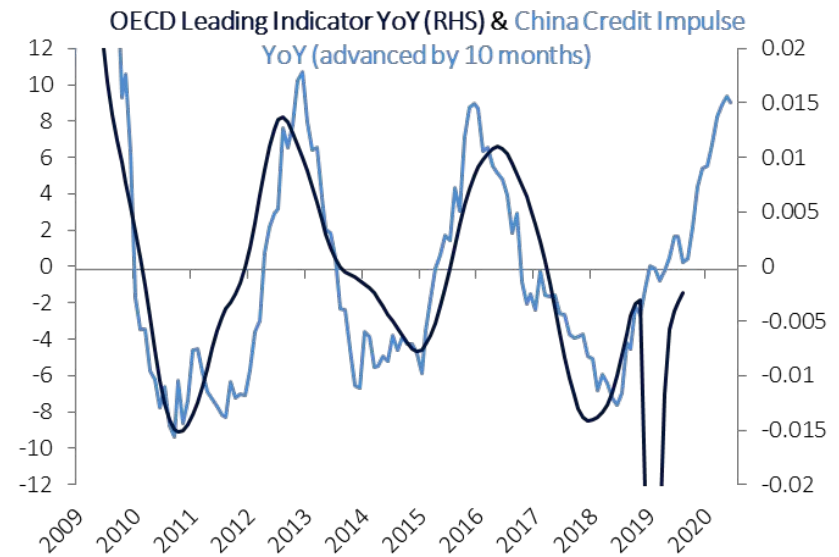
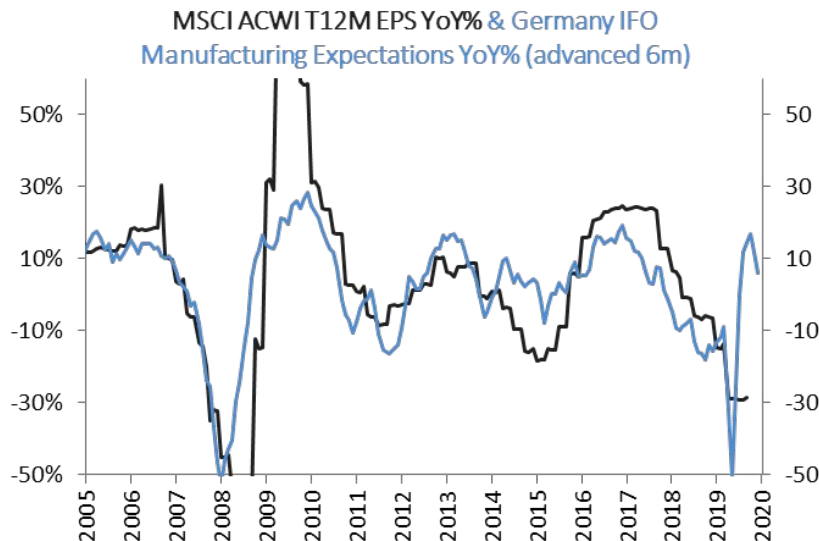
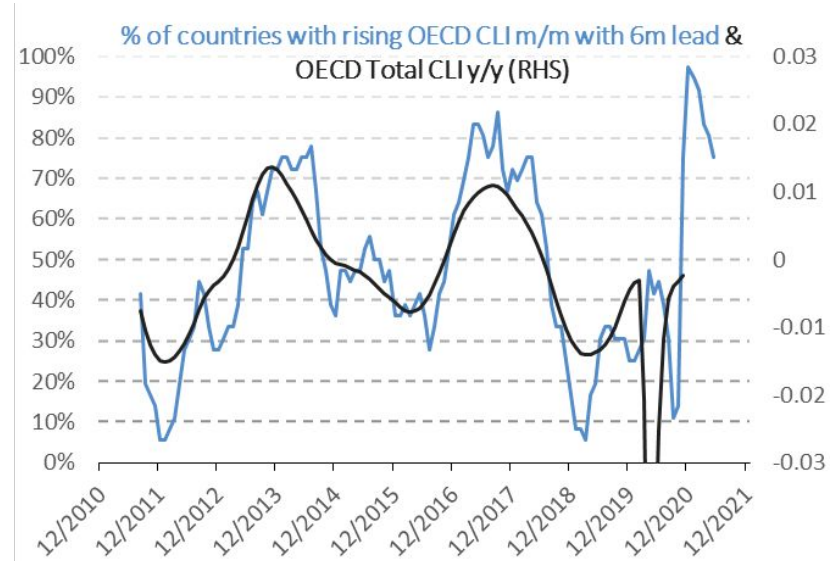
Equity markets have gone through a roller coaster this year. After falling between 20 and 30% in the span of a month, they have staged a relentless comeback. While China has managed to recover quickly for its economic slowdown and the US' tech overweight has lead the S&P500 higher during most of the year, the latest rally since the announcement of a vaccine has been quite broad in nature, pulling even Europe in positive territory. Markets are looking through the short term risks and appear to be already pricing in a significant recovery.



Leading indicators support continuation of the recovery

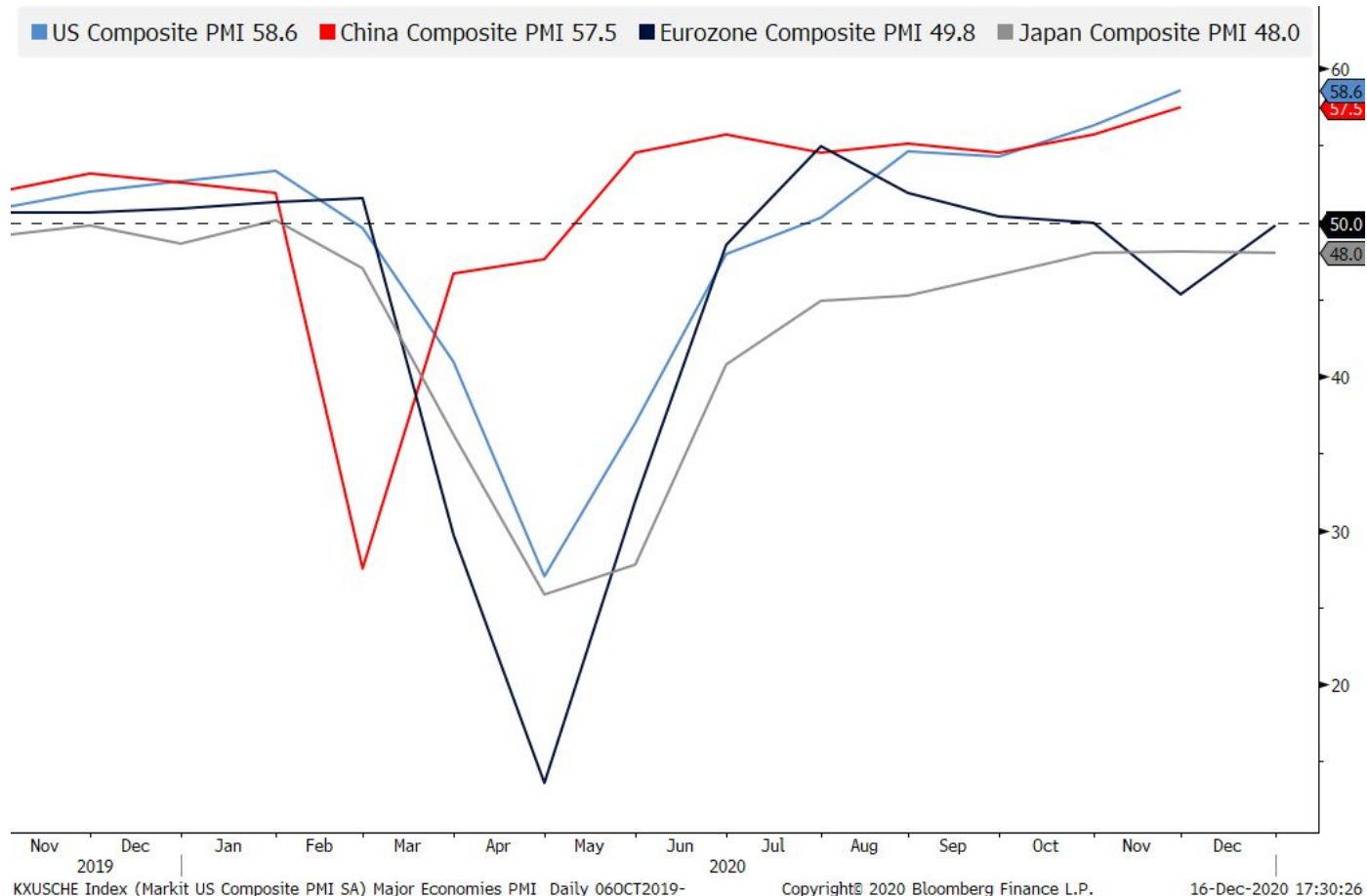
Some key leading economic indicators acted as powerful signals for this staggering market recovery and, encouragingly, they still suggest the economic rebound has further to run.

There are however early warning signs: the proportion of countries with rising OECD economic indicators (top right) or German IFO manufacturing expectations are rolling over. Chinese credit growth could also begin to fade given the recent comments by the government and measures to stem excesses.



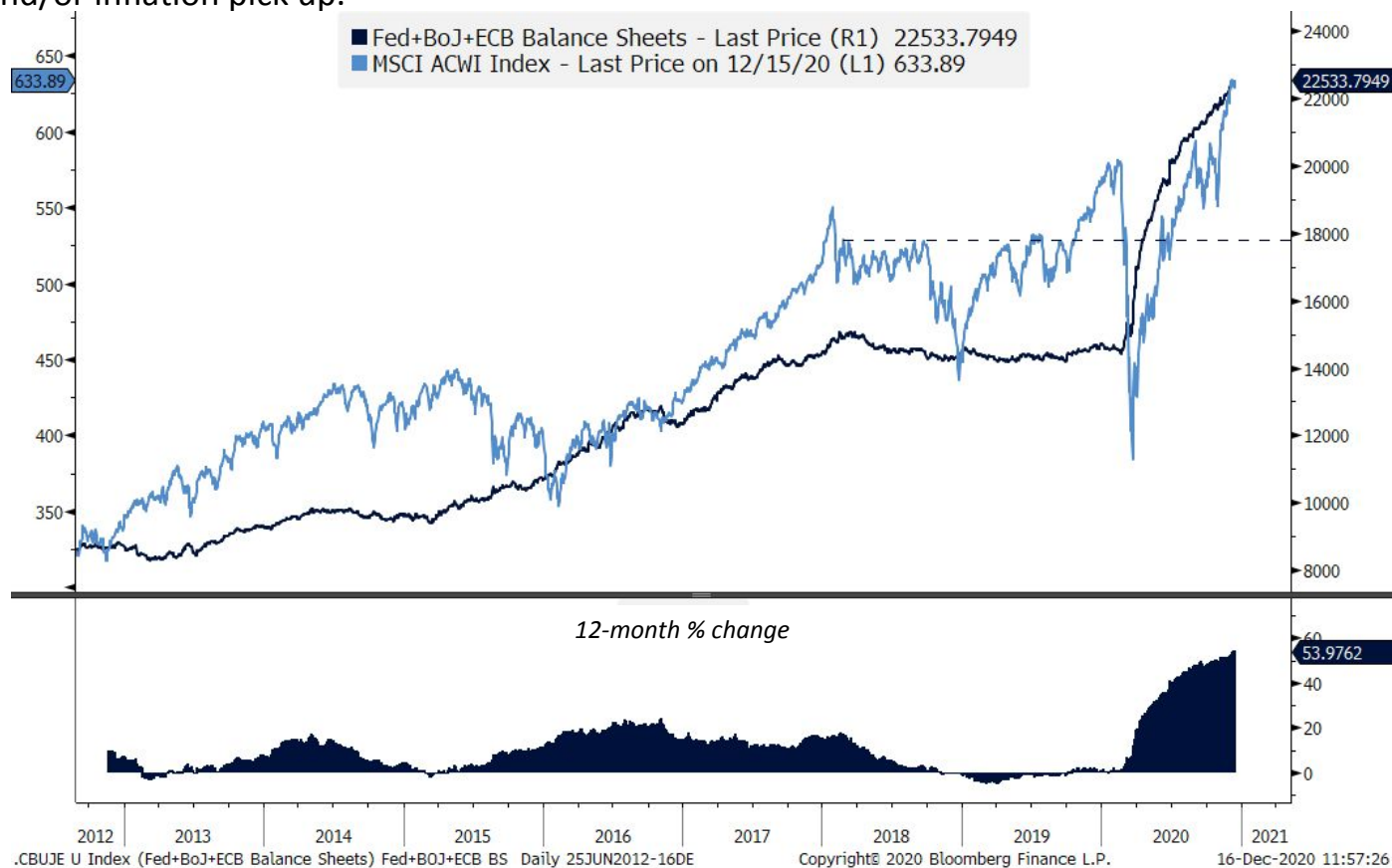
PMIs have remained very resilient during the second wave

PMIs have staged a significant rebound and have remained fairly resilient over the last couple of months despite the resurgence of the virus and worries about economic activity. US consumers and Chinese manufacturers have been the major pillars of the first phase of the global recovery. The December rebound in European PMI following a soft patch since August is encouraging, especially given the persisting restrictive measures.



Record increase of central bank balance sheets

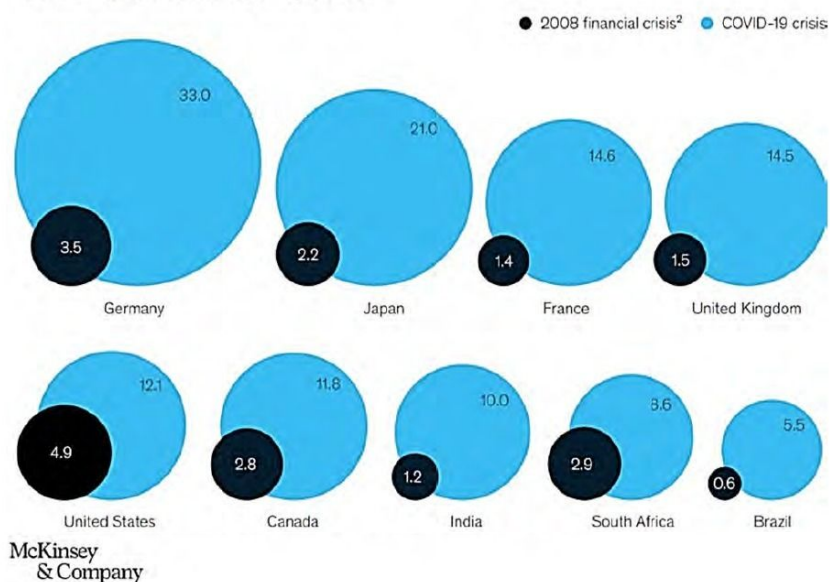
The Fed, ECB and BoJ have increased their balance sheets by north of USD 6 trillion in 2020, injecting liquidity in their respective economies and insuring that yields remain low to cushion the blow of the crisis and help governments finance rising deficits. While markets appear to ignore the short term economic risks linked to the virus' second wave fallout, central banks have shown no intention to reduce monetary policy accommodation, which is a big reason for the resilience of financial markets. The Fed has gone as far as adapting its mandate to an average inflation target, effectively removing the need to tighten policy when growth and/or inflation pick up.



Government stimulus comes at the expense of higher debt

Across countries, economic-stimulus responses to the COVID-19 crisis outsize those to the 2008 financial crisis.

Economic-stimulus crisis response, % of GDP¹



And the debt champion is...

Debt levels and increases in major economies

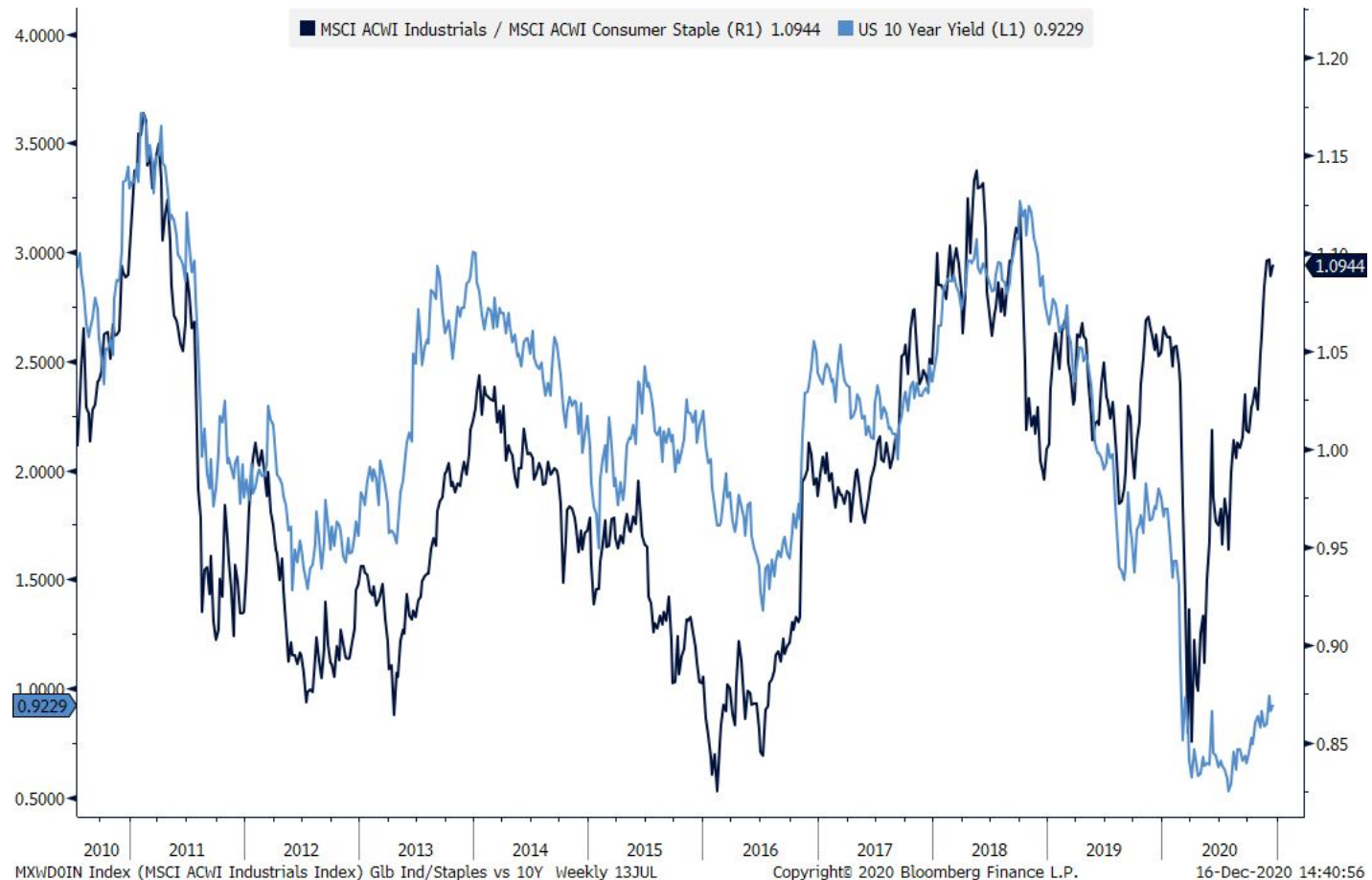
	2020 gov't debt (US\$ trn)	2020 rise in gov't debt (US\$trn)	Population (mn)	2020 gov't debt per capita (US\$)	2020 rise in gov't debt per capita (US\$)
USA	22.21	4.20	328.2	67,672	12,797
Canada	0.76	0.31	37.6	20,300	8,202
UK	2.68	0.46	66.6	40,176	6,961
Japan	9.01	0.72	126.5	71,192	5,690
Germany	2.12	0.44	83	25,571	5,286
France	2.92	0.34	66.9	43,552	5,063
Italy	2.85	0.24	60.3	47,157	4,048
China	9.65	1.66	1,393.00	6,931	1,191

Compared to the 2008 financial crisis, the magnitude of governments' fiscal responses to this virus crisis has been much more extreme; in this instance, governments have provided loans to businesses and substituted households' income, thereby supporting consumption and facilitated the build up of excess savings. With short term risks still high and excess savings being drawn down, government show no intention of closing the fiscal spigots.

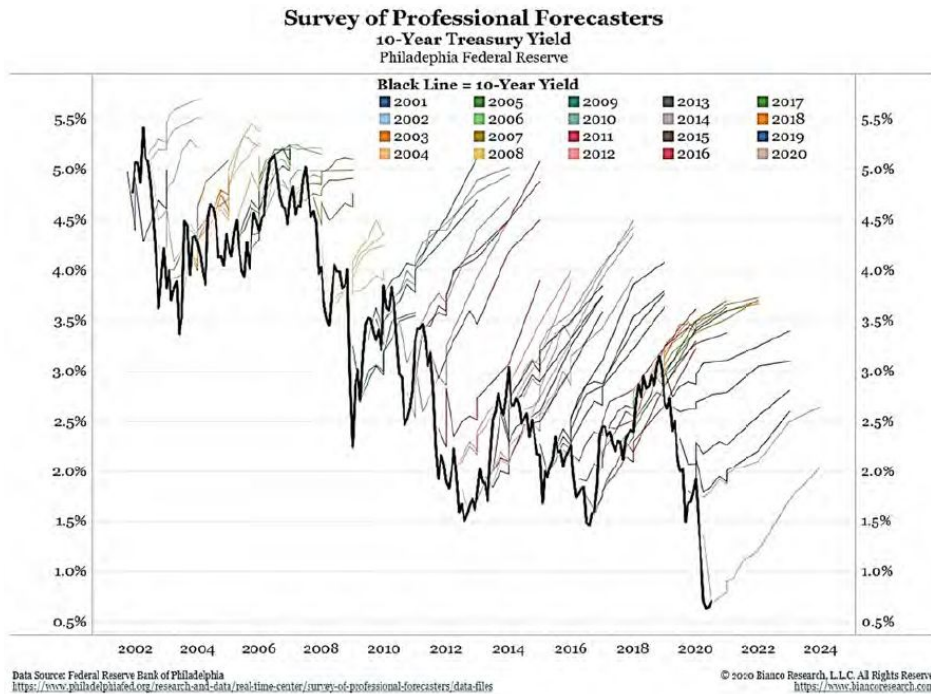
The knock-on effect of such a fiscal splurge is the accelerated build up of debt piles, particularly in developed economies, with the US taking the 1st place. Of course, the question of whether such a huge increase in (largely unproductive) debt can lead to a sustainable growth surge is quite reliably answered by economic history. Nonetheless, monetary and fiscal policy are becoming increasingly intertwined, as central banks purchase a large portion of newly issued debt and ensure that deficits can be financed at low levels of interest rates.

Long term yields are too low...but will the Fed let them go higher?

The economic recovery, fiscal spending and rising inflation expectations are combining to pushing US long term yields (light blue) higher. Given the large accumulation of debt and need for low yields to finance deficits, the question is how far yields will be allowed to rise; the Fed (and other central banks) are likely to step in and implement yield curve control measures at some point.



Optimistic consensus needs to be taken with caution



Year	Initial estimate for the year	Actual year-end EPS	Difference	Miss in %
2012	108.2	98.9	-9.3	-8.6%
2013	114.4	106.5	-7.9	-6.9%
2014	121.6	112.3	-9.3	-7.7%
2015	127.5	108.9	-18.6	-14.6%
2016	127.5	106.5	-21.0	-16.5%
2017	133.2	119.0	-14.3	-10.7%
2018	148.7	150.6	1.9	1.3%
2019	175.8	152.2	-23.6	-13.4%
2020*	179.9	141.2	-38.7	-21.5%
2021**	172.2	?	?	?
Average mis			-15.6	-11.0%

*2020 shows EPS estimates as of 31.12.2019 and 16.12.2020

**2021 expected EPS shown as of 16.12.2020

Source: Bloomberg, Probus

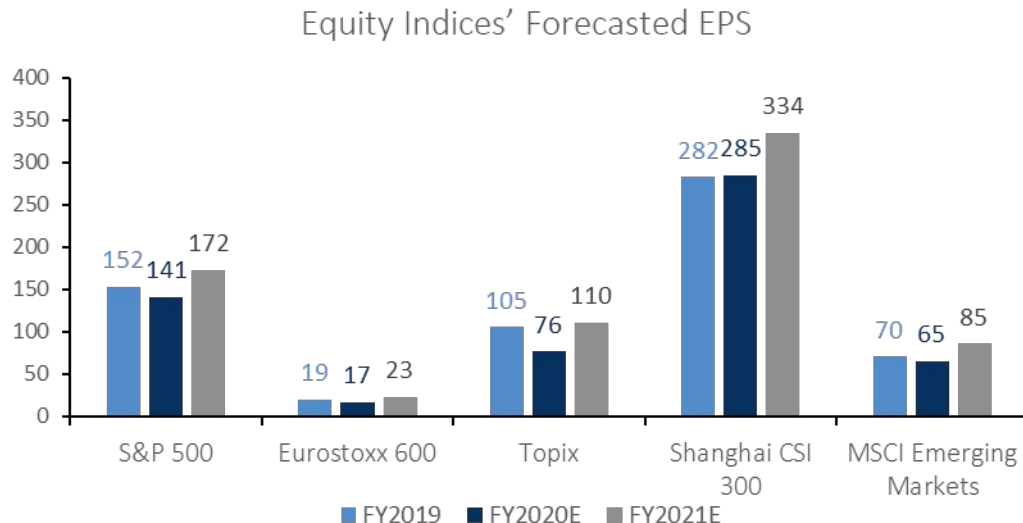
A very optimistic consensus of a global economic recovery has emerged among banks and investors. Dollar weakness, high equity returns and rising yields are now confidently forecasted for 2021.

Economic forecasts however have a long history of being wrong. The contrast between the actual level of yield (in black) and the yearly forecasted paths is quite stark. On the other hand, should forecasts of higher yields materialise, the case for purchasing equities at their high valuations will be weaker, impacting equity returns.

Equity analysts haven't been much better. Over the 8 years, they have overestimated earnings for the S&P500 by an average of 11%. Similar patterns exist on most indices. This is quite important to consider since earnings are expected to grow by roughly 22% in 2021, giving an already rich P/E of 21.4 for the S&P 500.

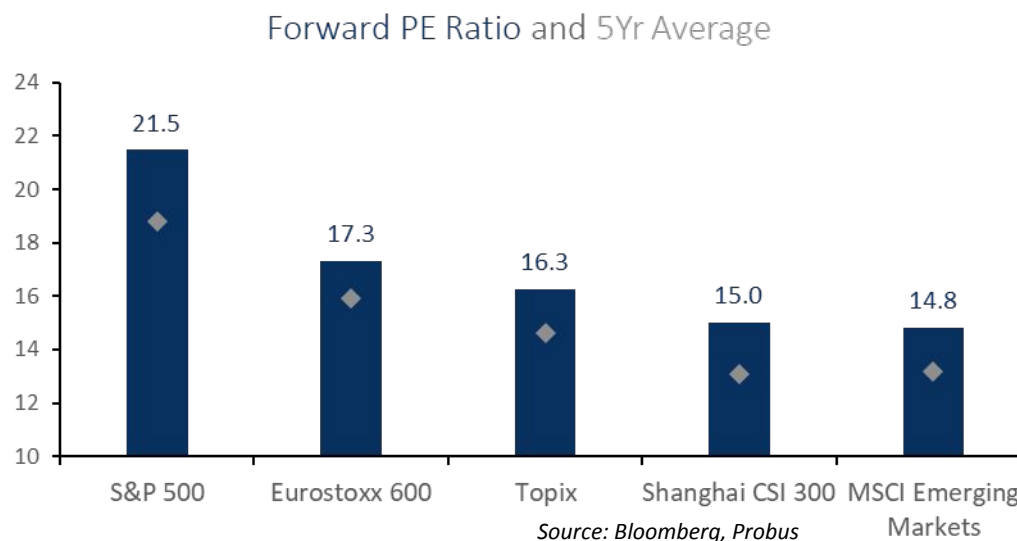
Markets are trading significantly above historical multiples

Earnings are expected to rebound significantly from the 2020 level, even exceeding the levels of 2019.



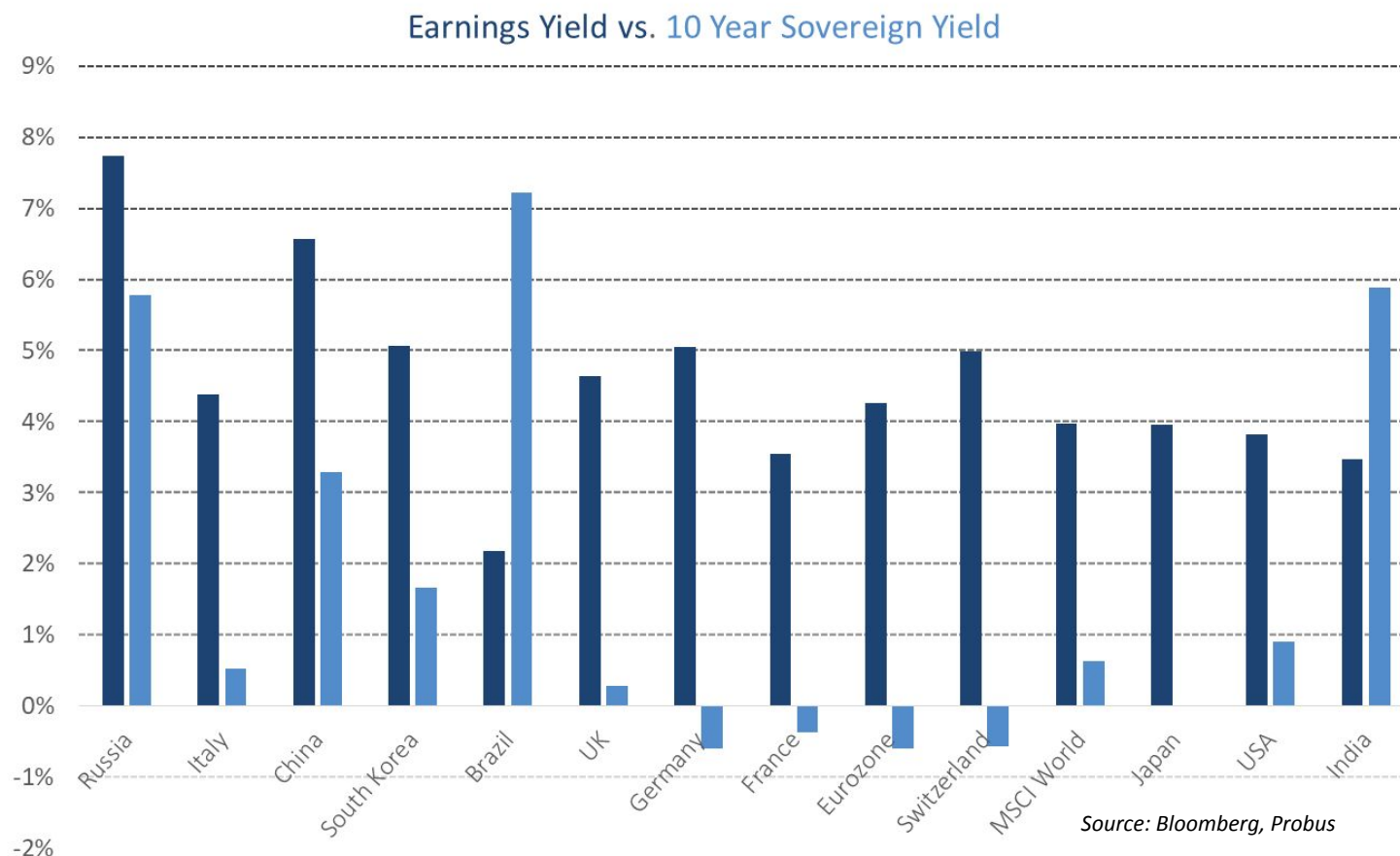
Source: Bloomberg, Probus

Even when factoring in those expectations, most indices are trading at a significant premium to the average of the last 5 years. At current valuations, it is hard to argue that most of the positive expectations for 2021 aren't priced in. This could make the market very sensitive to any negative surprise.



Equity bullishness is predicated on low yields

The main argument for maintaining a good exposure to richly valued equities is simply because the other asset class that competes for capital, fixed income, is even more overvalued. The chart below shows that when considering the yield that fixed income offers compared to equities (earnings yield), equities remain significantly more attractive.



2020 - a year with the Santa rally but what's next?

The tail end of the year has historically been a rewarding period for equity markets. Given the wealth of positive factors (including vaccine developments and extremely easy financial conditions), it seems we are seeing a repeat of events in 2020 as we close the year with a Santa rally. This being said, investors should tread the seasonally-weak month of January with caution, especially as sentiment has reached dangerously high levels.

MSCI All Country World Index Seasonality Chart 1991-2020



Sentiment is getting a bit frothy in the short term

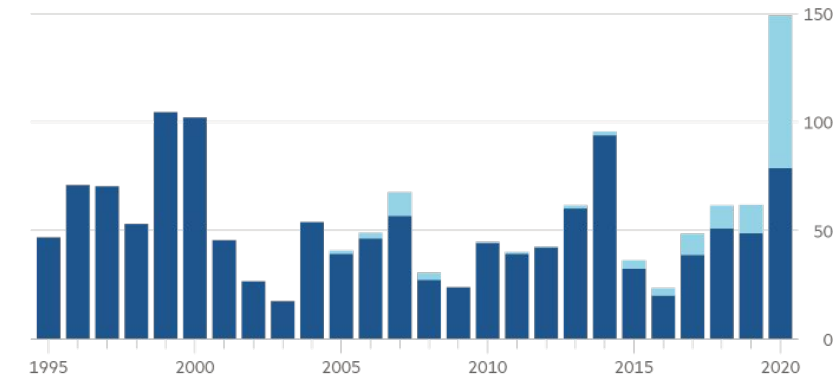
Signs of frothiness have emerged after months of excessive pessimism:

- The IPO market is in a boom that hasn't been seen since 2000 (bottom left)
- Flows to global equities reached a record high in early November (top right)
- The AAI Bull-Bear Investor Sentiment spread, capturing investor optimism, has returned to dangerously high levels.

US IPO boom reaches new heights

Proceeds raised (\$bn)

IPOs-ex Spacs Spacs



2020 figure is year-to-date.

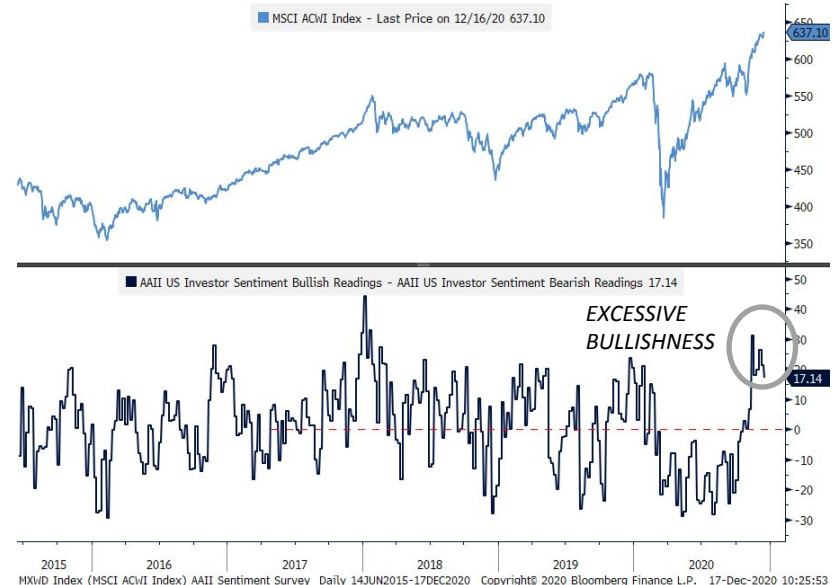
Source: Refinitiv

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Chart 7: Largest 2-week inflow to global stocks ever



Source: BofA Global Investment Strategy, EPFR Global

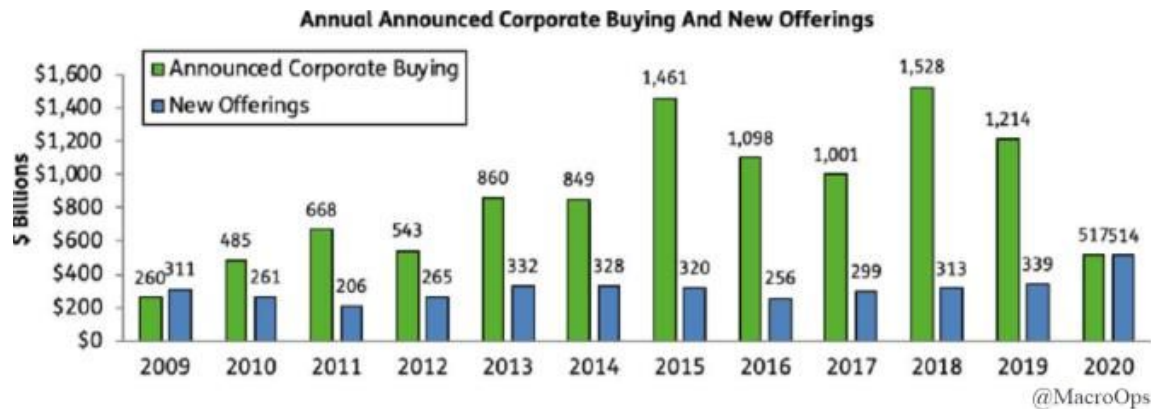
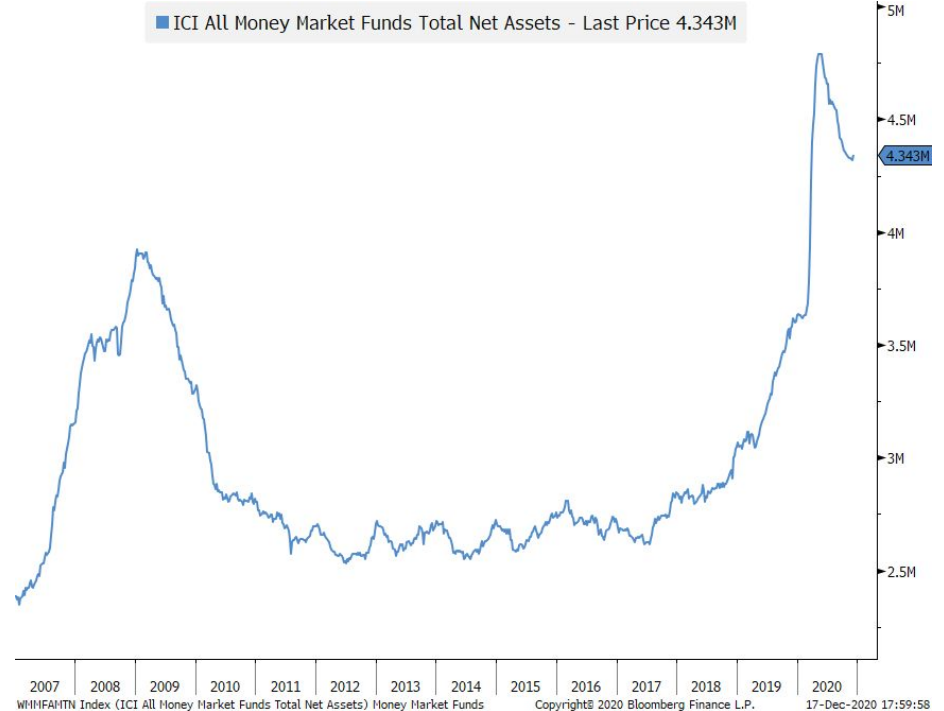


Cash piles remain the most compelling argument for the market

Although the current exuberance is likely to lead to some consolidation or pullback, there is an argument that large cash piles are yet to be allocated.

Assets in money market funds have indeed started to decline but remain very high.

On the corporate side, Barclays has reported that cash holdings have significantly increased in 2020. This raises the odds that buybacks will resume in 2021 after being cut this year (see chart below). This would create a large supply/demand imbalance and favour the equity market.

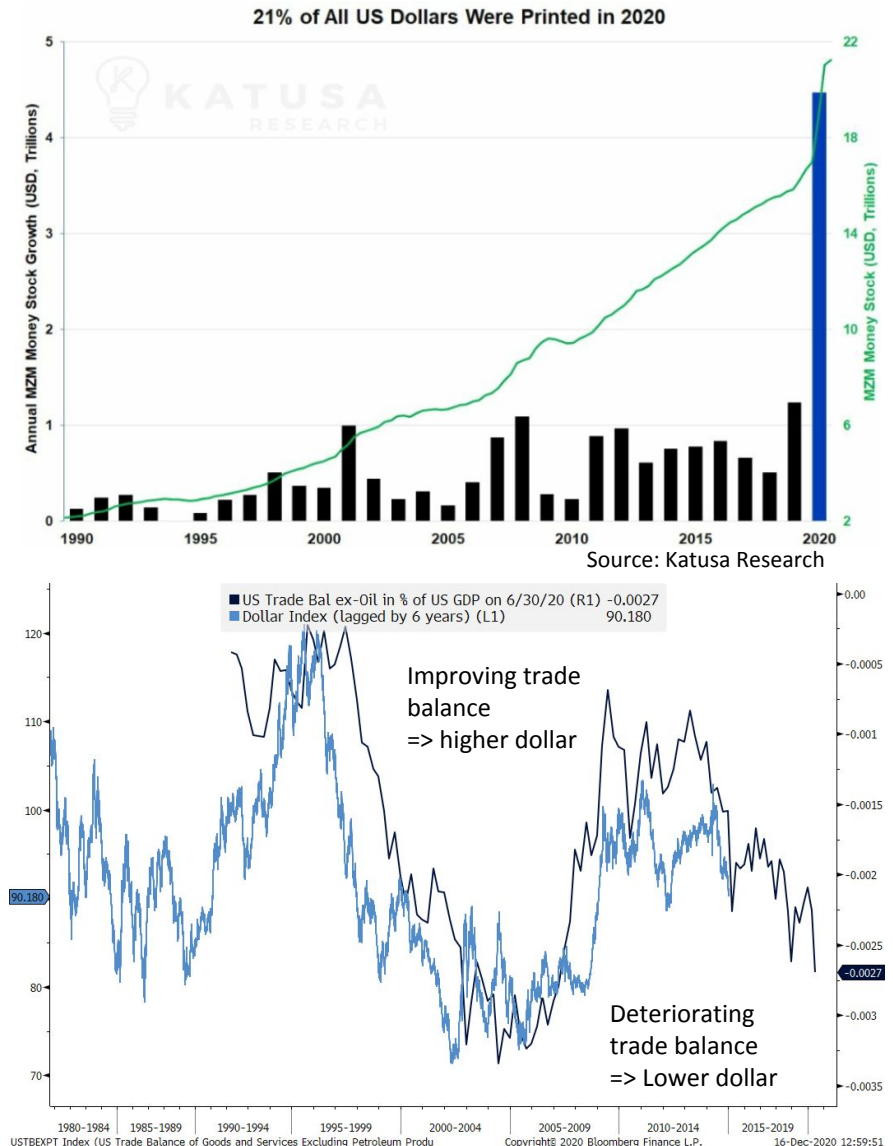


The consensus couldn't be more bearish the US dollar

This year saw 21% of all dollars in existence printed! While most fiat currencies are seeing large expansion of their supply, it is no wonder that assets with inelastic supplies (e.g gold or bitcoin) are outperforming.

The exploding budget deficit and deteriorating trade balance (bottom chart) are not exactly speaking in favour of the dollar.

Of course, it is hard not to agree with it, which is also why positioning is so heavily skewed in favour of a fall in the dollar (see next slide). A temporary but sharp dollar rally could be on the cards should market go through a pullback.



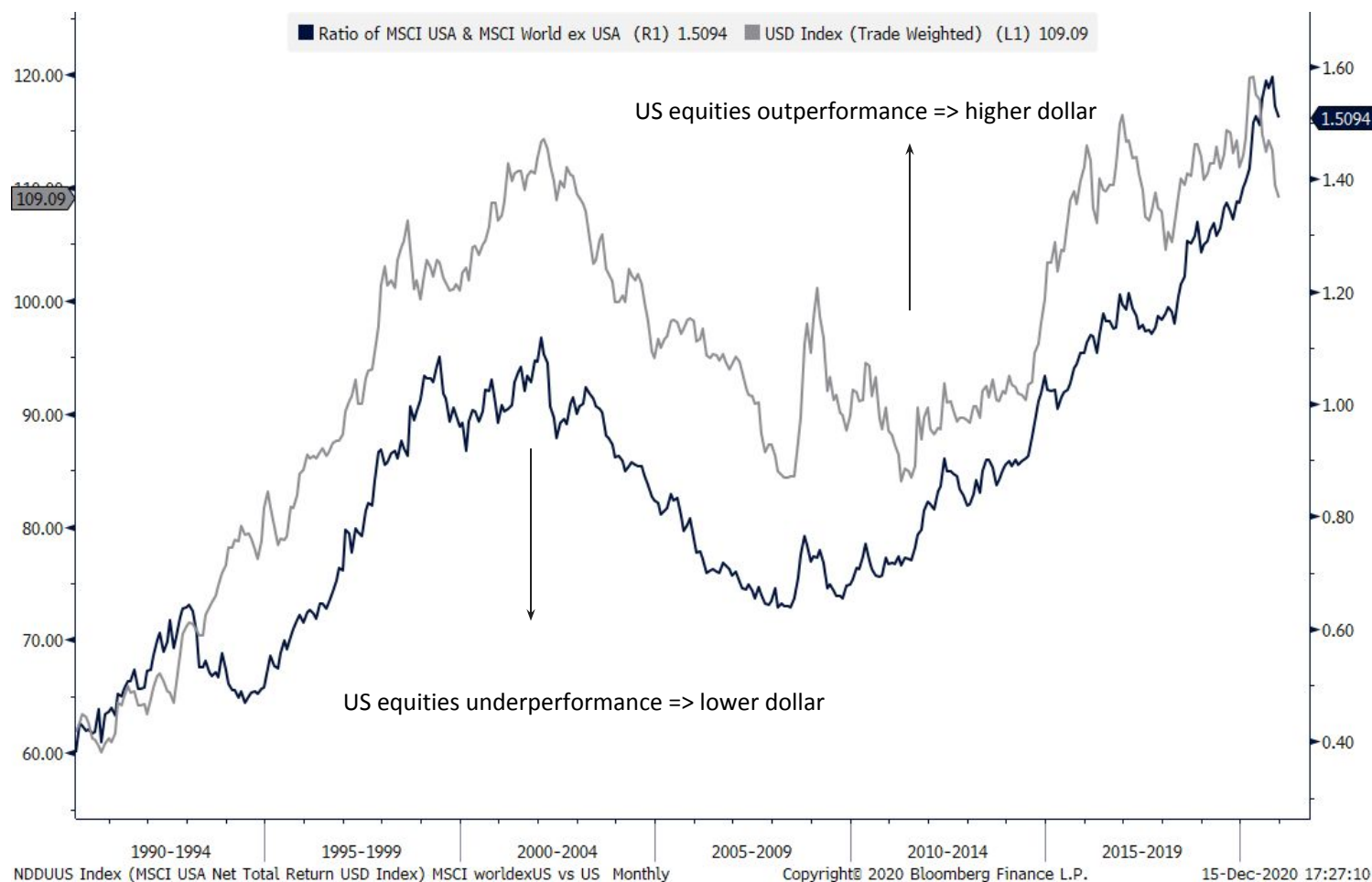
EUR breaking downtrend but positioning is too extreme for comfort

Despite recent additional measures announced by the ECB, the EUR continues to appreciate and confirms the breakout of its long term downtrend. While the path of least resistance is up for the EUR in 2021, positioning is very extreme (dark blue) and the dollar is very oversold; both elements suggest that a short term pullback could be on the cards to shake out weak hands.



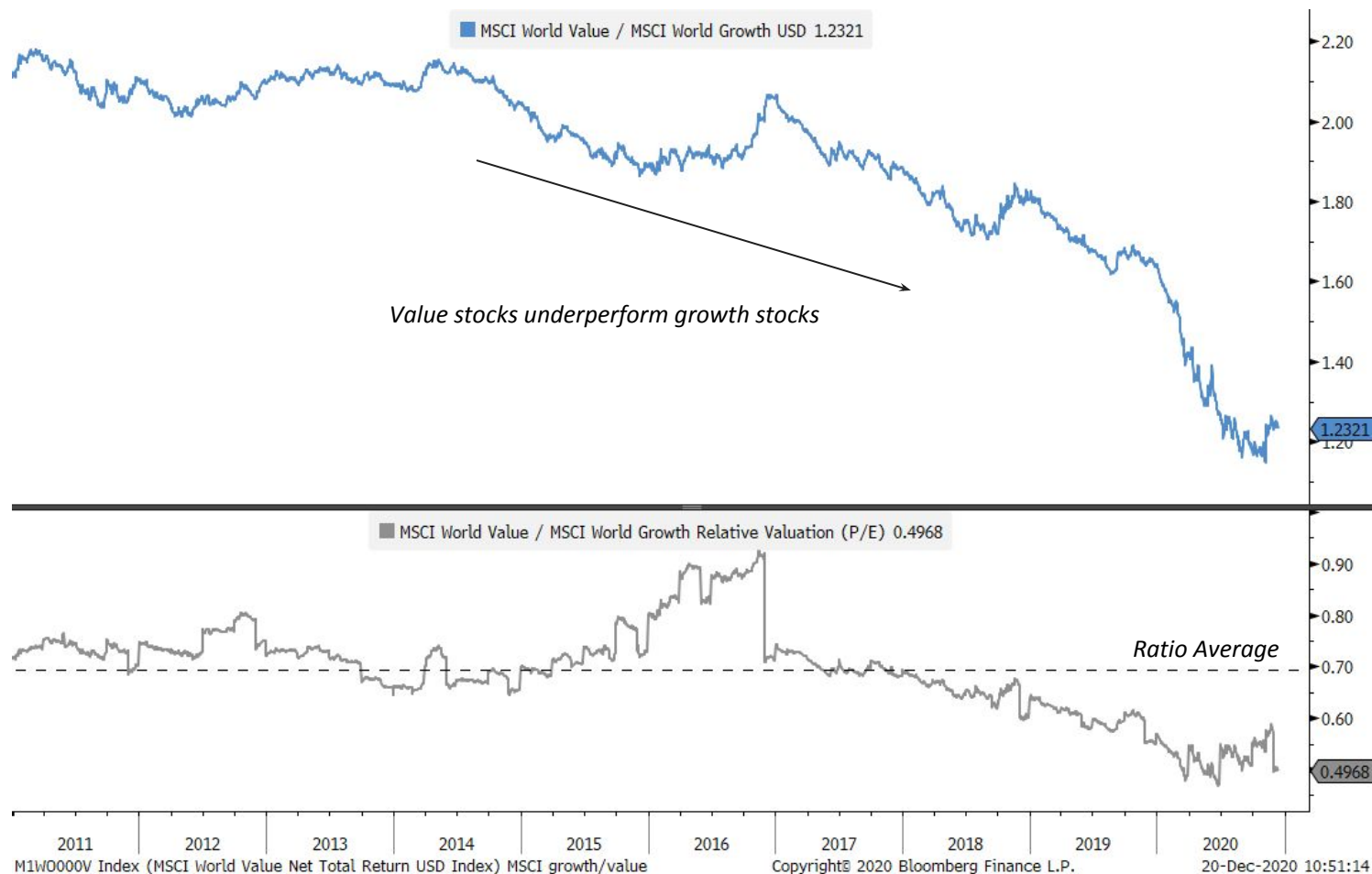
The end of US outperformance?

The most important implication of a change in trend in the dollar would be the end of US equity outperformance. Shifting capital outside of US markets toward Japan or Asian emerging markets appear to be the best way to bet on a continuation of the dollar's decline.



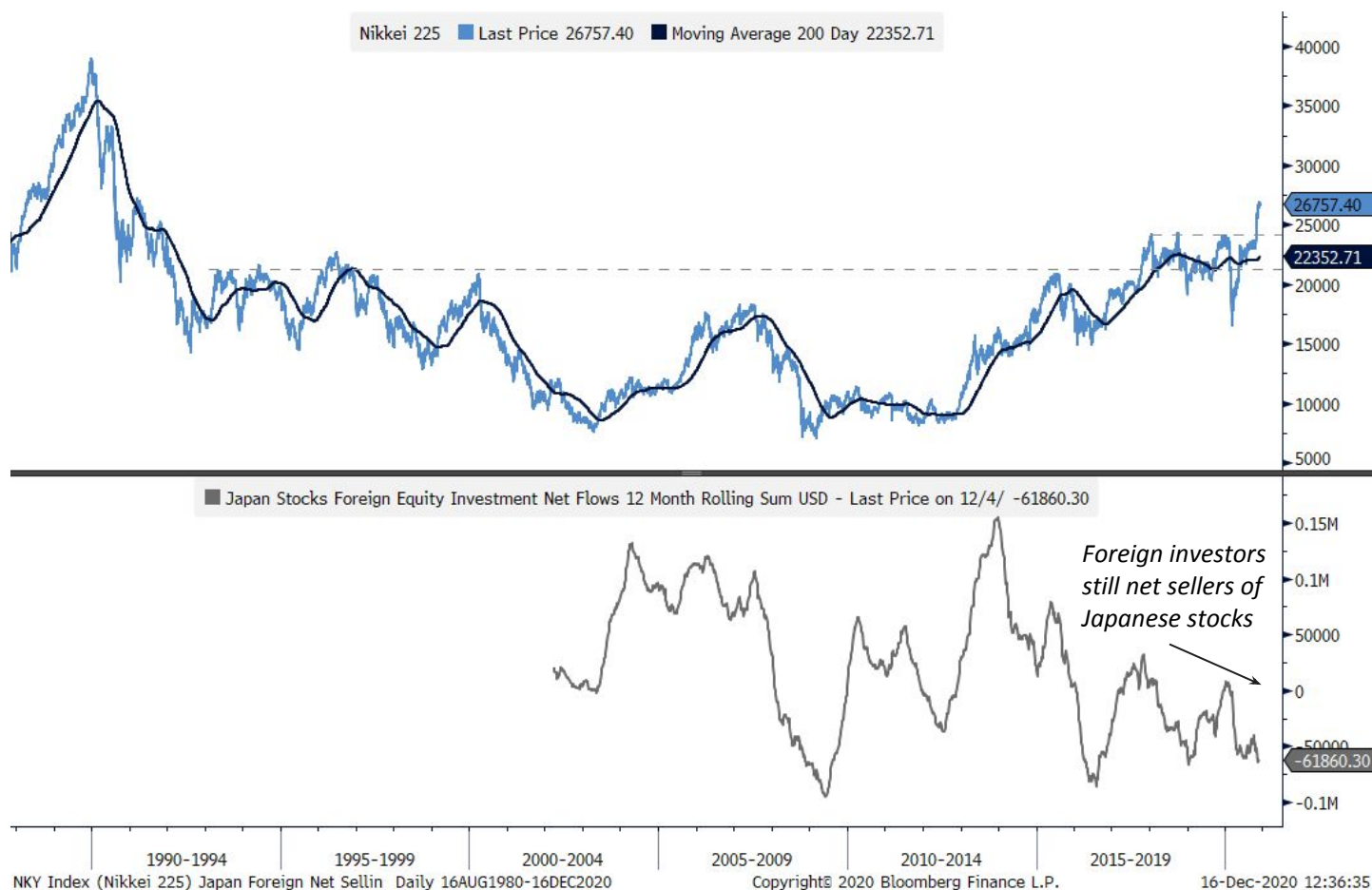
Value stocks remain egregiously cheap relative to growth

The recent optimism around the rollout of the vaccine has allowed value stocks to outperform growth stocks (light blue line rising), which have been the notorious drivers of this year's market rebound. It may be too early to bet on the end of the secular growth outperformance trend and it is not necessary; the valuation discount of value vs. growth has room to narrow (see bottom part).



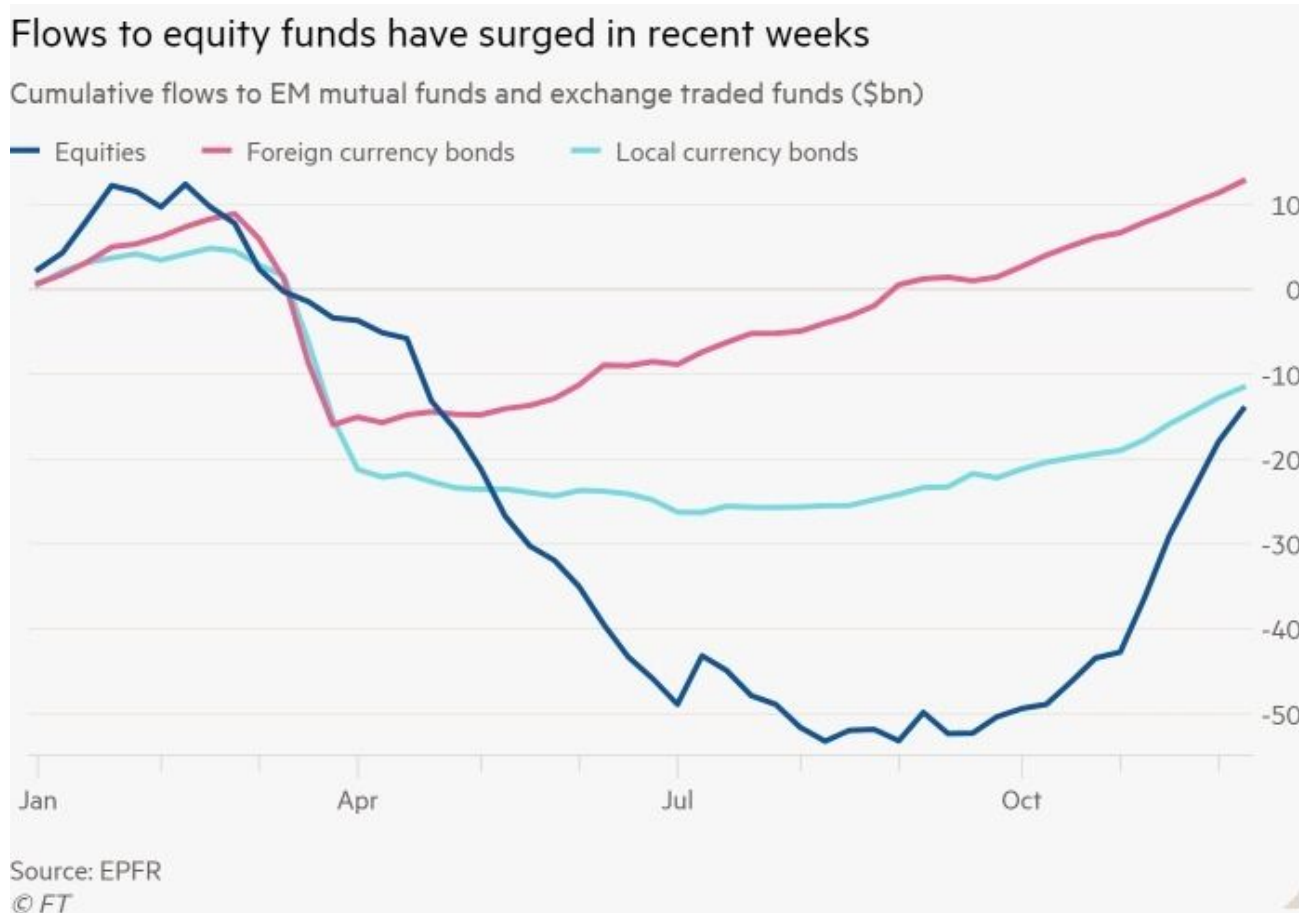
Japan is likely to be a major outperformer in the coming years

The Japanese market is an attractive way to play the cyclical/value catch up given it's sensitivity to global growth, very healthy corporate balance sheets, increased focus on shareholder value and attractive valuations. The remarkable breakout of a long term resistance still places the market far below its 1989 peak and is likely to attract lightly positioned foreign investors. Price action is slightly stretched in the short term and a consolidation would be welcome.



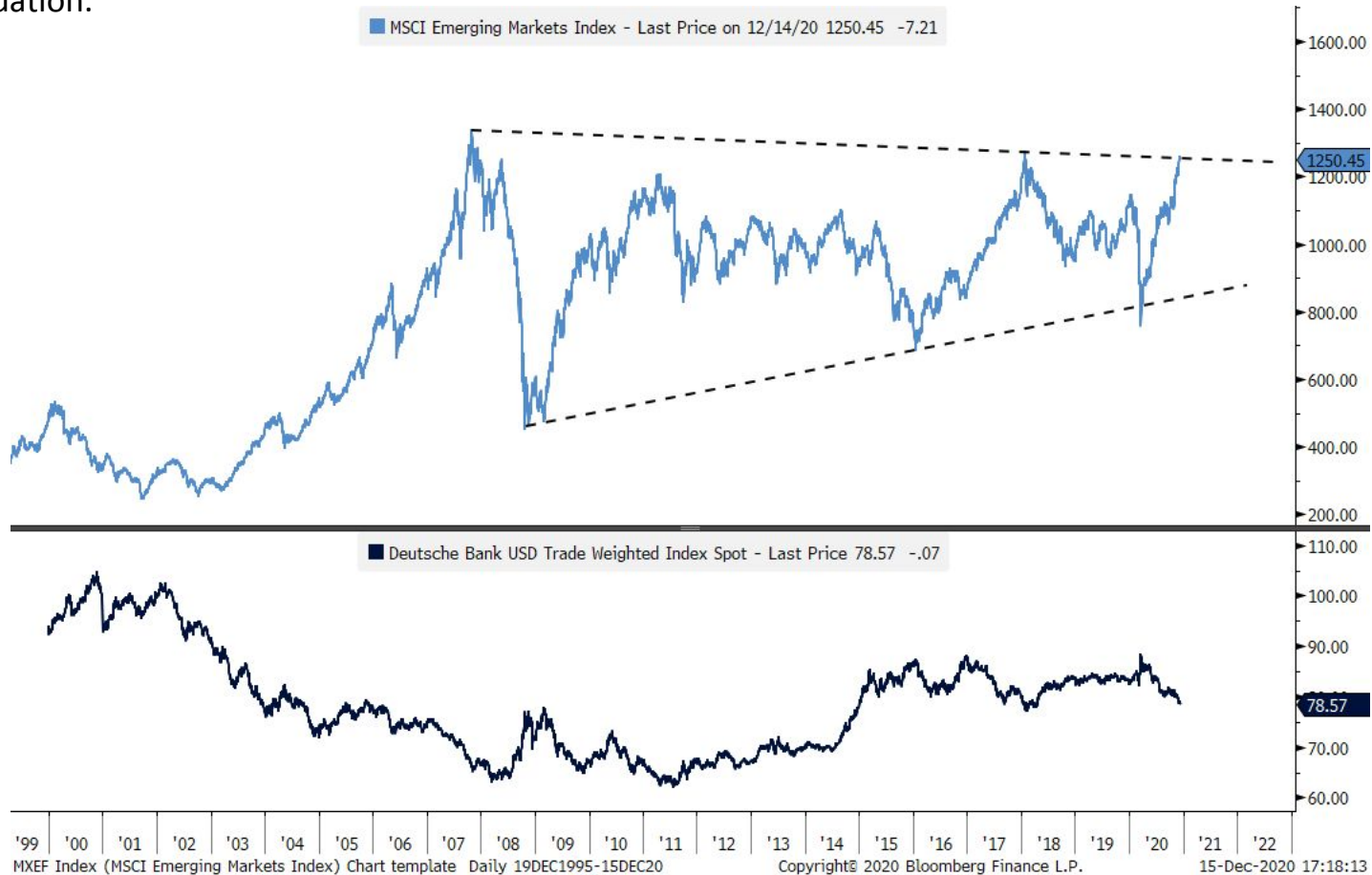
Investors are coming back to emerging markets

Investors are coming back in force to emerging markets, with large inflows over the last few months, as the consensus has turned very favorable for 2021. However, when looking at net flows YTD (see below), they remain negative, suggesting that there is further room for capital to flow to these market.



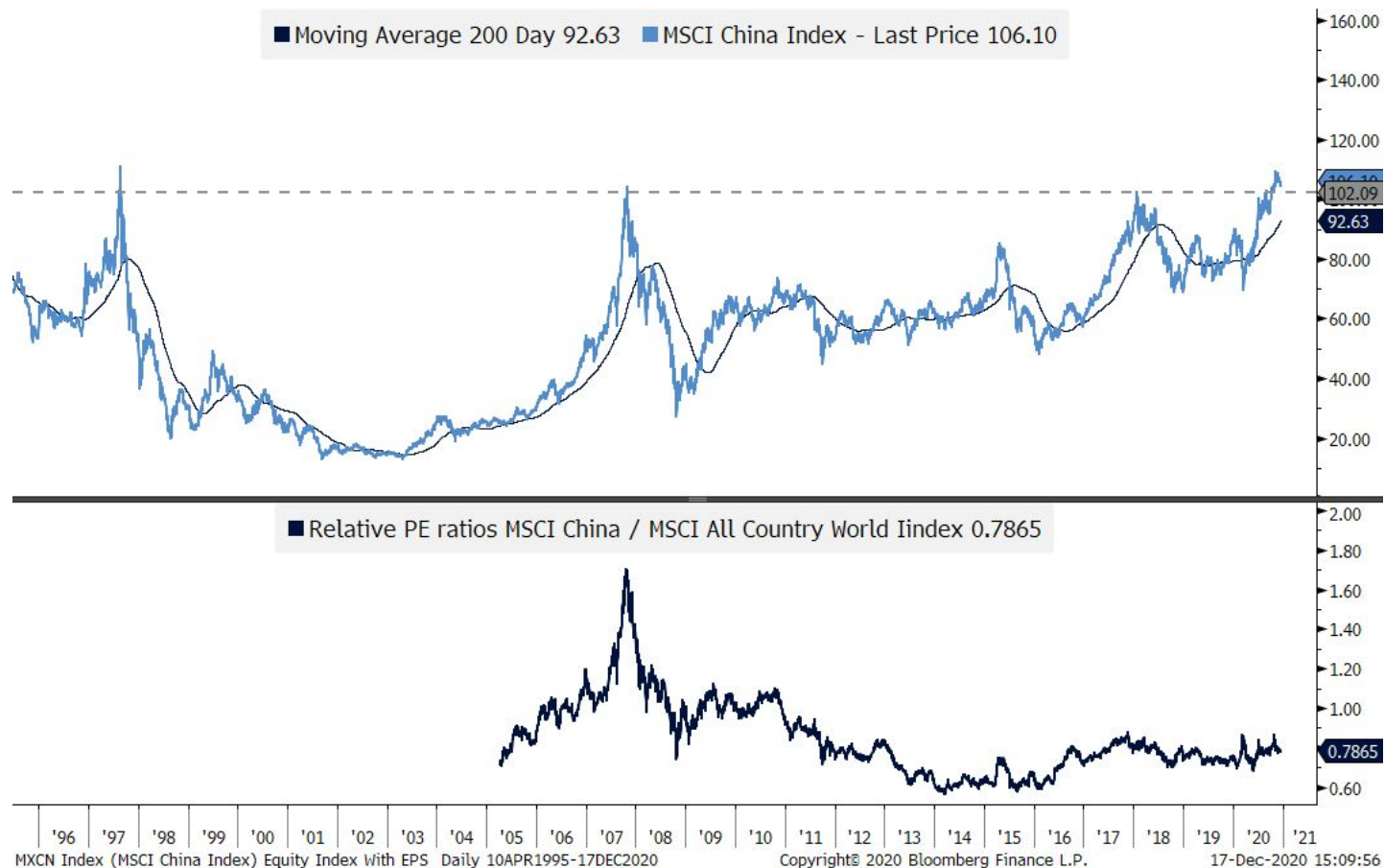
Emerging markets remain the best way to play a weaker dollar

The fall in the USD (dark blue) has been a major boon for emerging markets (EM). For most of 2020, emerging markets have been led higher by north-east Asian economies such as China, Taiwan and South Korea, which have been beneficiaries of the crisis. Lately, we have seen broader participation from other Asian and Latam markets, which still have catch up potential. The path for EMs in 2021 will largely depend on the direction of the dollar (dark blue). In the short term, the EM index is facing a key resistance which could see some consolidation.

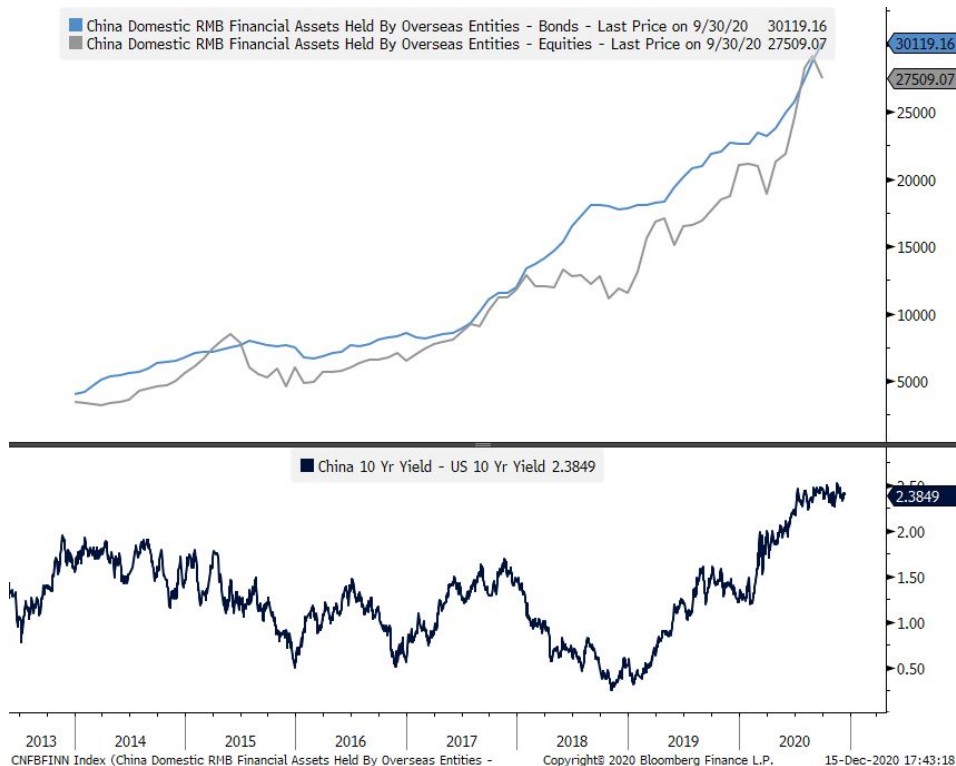


Chinese markets remain attractive but caution is rising

Chinese markets have performed very well in 2020, as the economy has been the first to recover from the virus, led by the industrial sector and rising exports. Encouragingly, the lagging consumer has recovered in recent months. The market still trades at a 22% discount to global equities, just as it attempts to break a key multi-decade resistance, which would signal further gains. We remain favorable to this market but are on the lookout for early signs of topping credit growth or additional measures on domestic tech leaders.

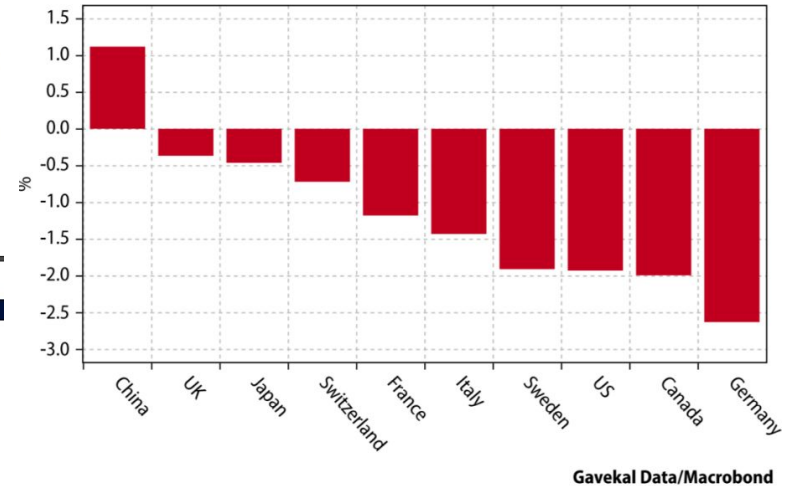


Capital continues to flow toward Chinese assets



China's real yield is higher than other global peers

1-year government note deflated by IMF GDP deflator estimates

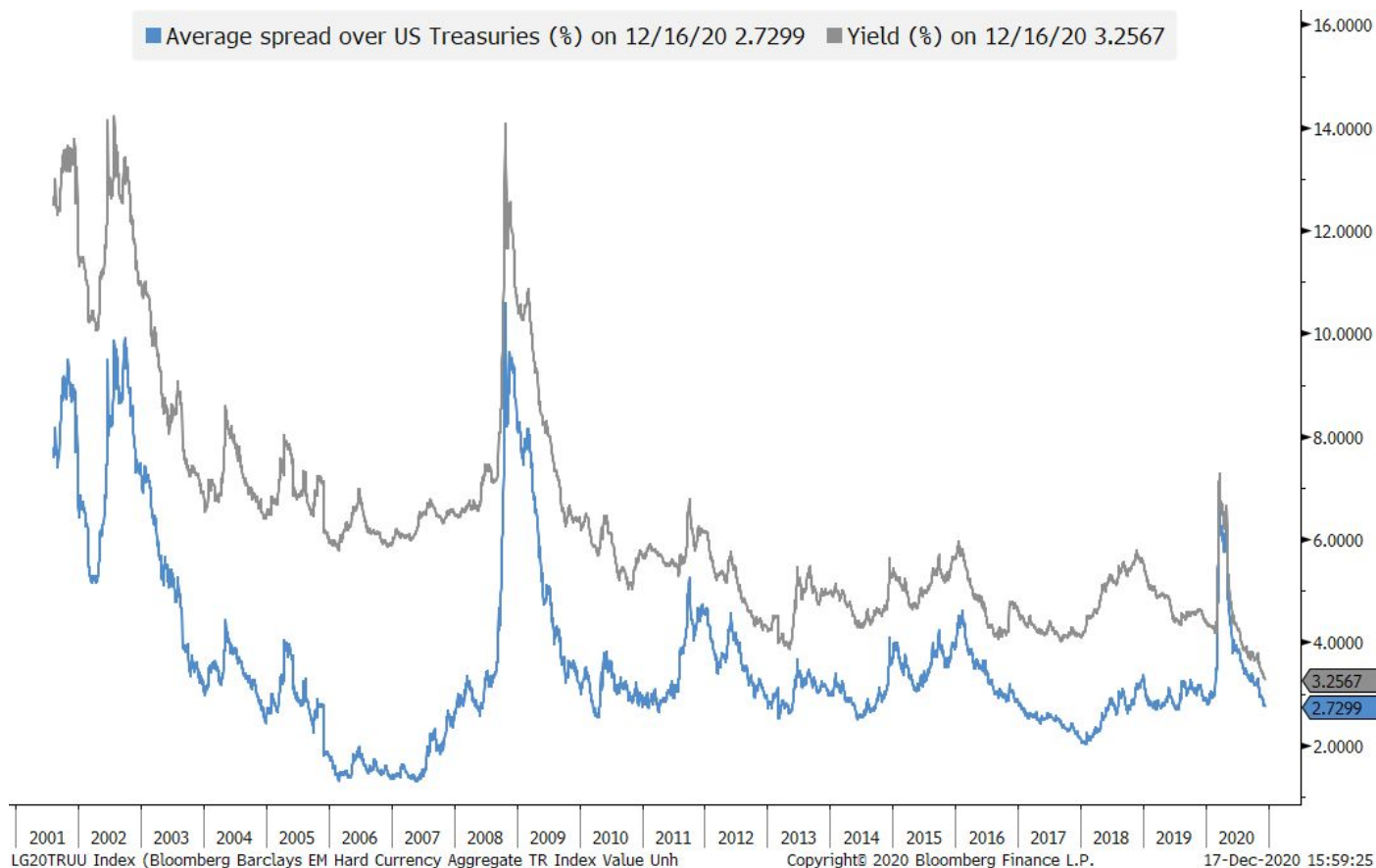


Foreign investors have piled into Chinese equities and bonds in recent years and 2020 has seen an acceleration of that trend. In addition to having the best performing economy in 2020 and an attractively priced equity market, the Chinese currency has proved very resilient and the bond market offers compelling yields.

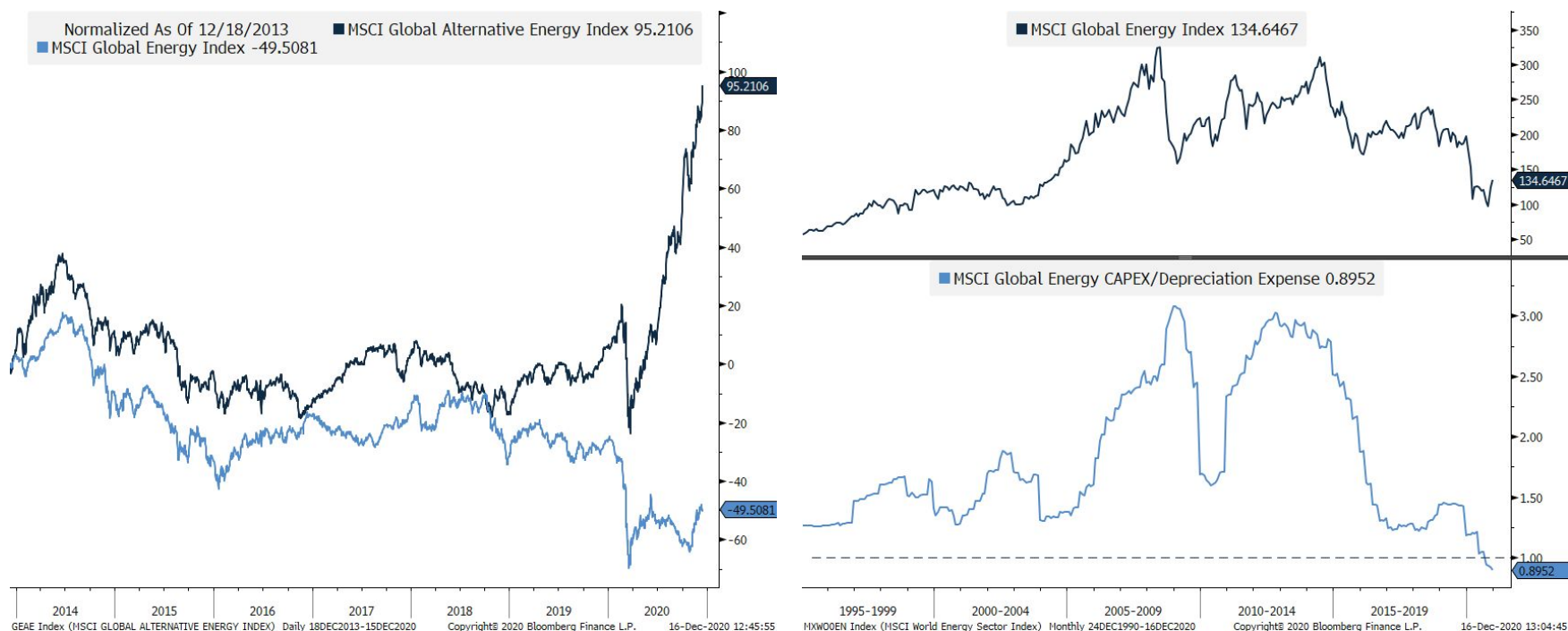
The Chinese 10Y yield stands at 3.3%, roughly 2.4% above US 10Y yields. Most importantly, Chinese bonds are the only ones (among large economies) offering positive real yields (chart on the right). In addition, the Chinese government has remained very reasonable in its policy response compared to other developed economies, committing to maintaining a reasonable cost of capital.

EM debt remains the only game in town in fixed income

As we have been pointing out for a while, with developed market debt yielding nothing, emerging market debt continues to offer relatively attractive yield both in local and hard currencies. While hard currency yields have plummeted to new lows (grey line), the 2.7% spread over treasuries (blue line) remains attractive. We are however keeping duration short. On the local currency fronts, there is still potential for further revaluation and lower yields; we currently favour Chinese and Indonesian bonds.



The 2020 energy disconnect



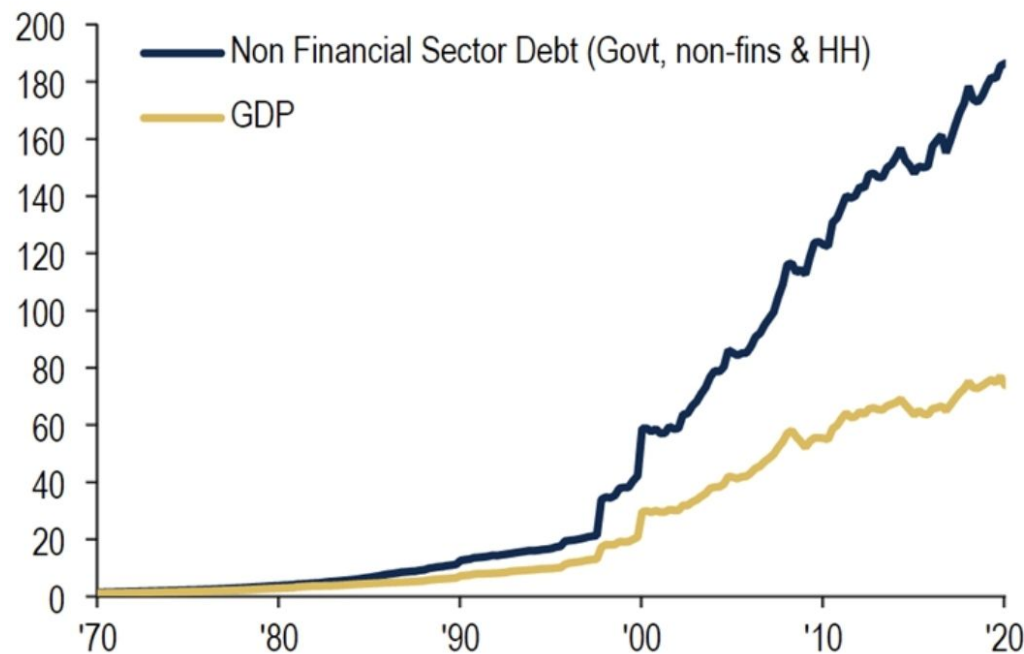
After a Democrat party victory and with the European fiscal stimulus being spun as a European Green Deal, renewable energy stocks have soared at the expense of “dirty” and “out of fashion” oil stocks. It will however take years until renewables can meet today’s global energy demand – even if oil is being phased out, it still presents opportunities for tactical contrarian plays.

Oil majors’ CAPEX has collapsed in recent years (lower panel right chart), suggesting that increasing supply in the coming years will be difficult, while demand is guaranteed to keep growing (especially in EM). The vaccine developments and the reopening of economies could lead to a robust demand environment and tight supply, which makes us comfortable holding high dividend paying and attractively priced oil stocks.

Debt keep weighing on the world

As we look towards 2021 with the hope of going back to “normal”, remembering what normality has been like for the developed economies may be in order. Yes, the activation of excess savings and the rebuilding of inventories will likely lead to a boost in economic activity in the short term but the odds of ushering into a new era of growth seem rather small. After all, we have only compounded the main issue with which the global economy has been struggling: debt. And, as the Bank of International Settlement points out below, the impact of the additional dollar (or trillion dollar) of debt contributes less and less to economic growth.

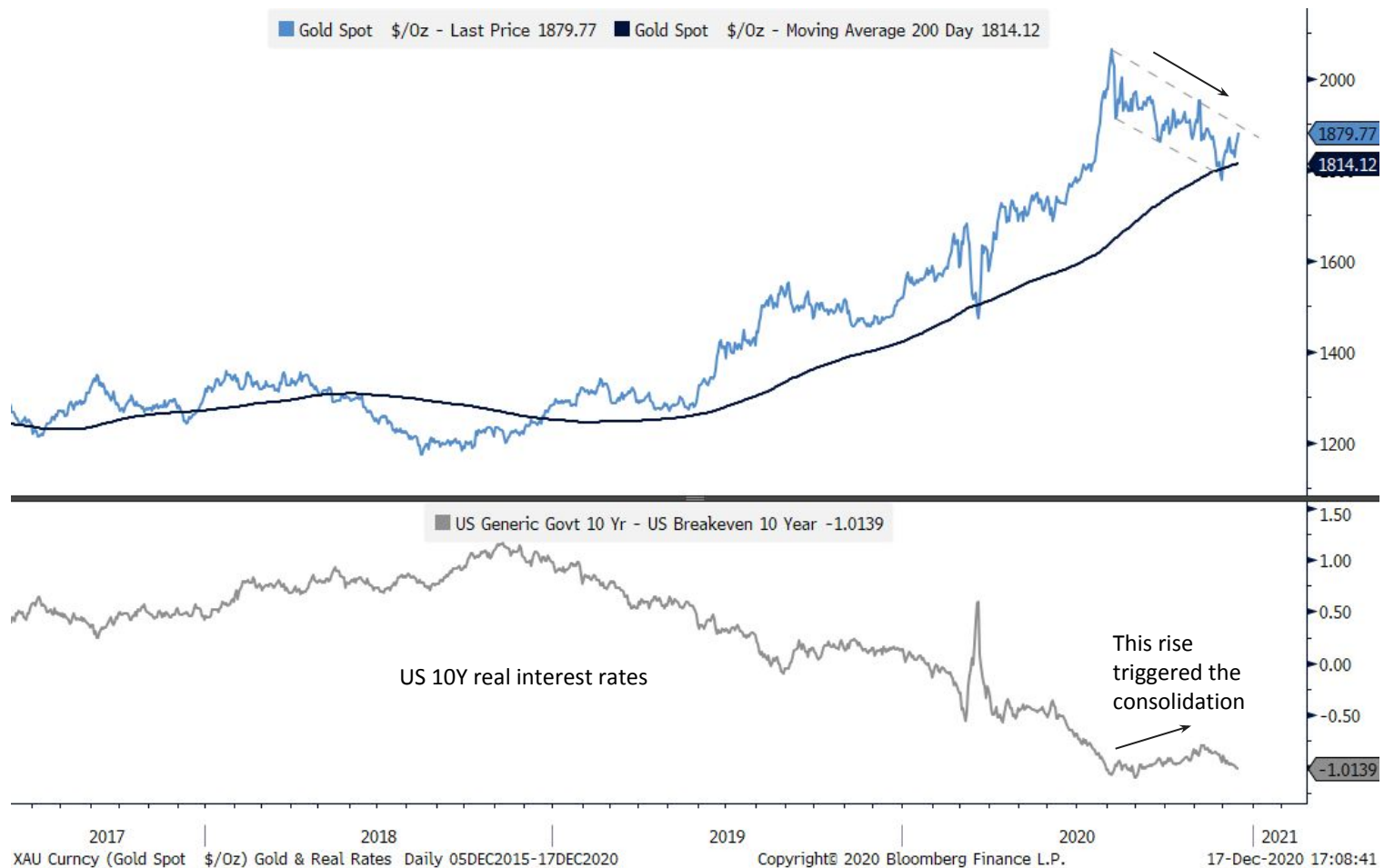
Global non-financial debt that is the aggregate of government, non-financial institutions and household debt (\$tr) vs. GDP



Source: BIS

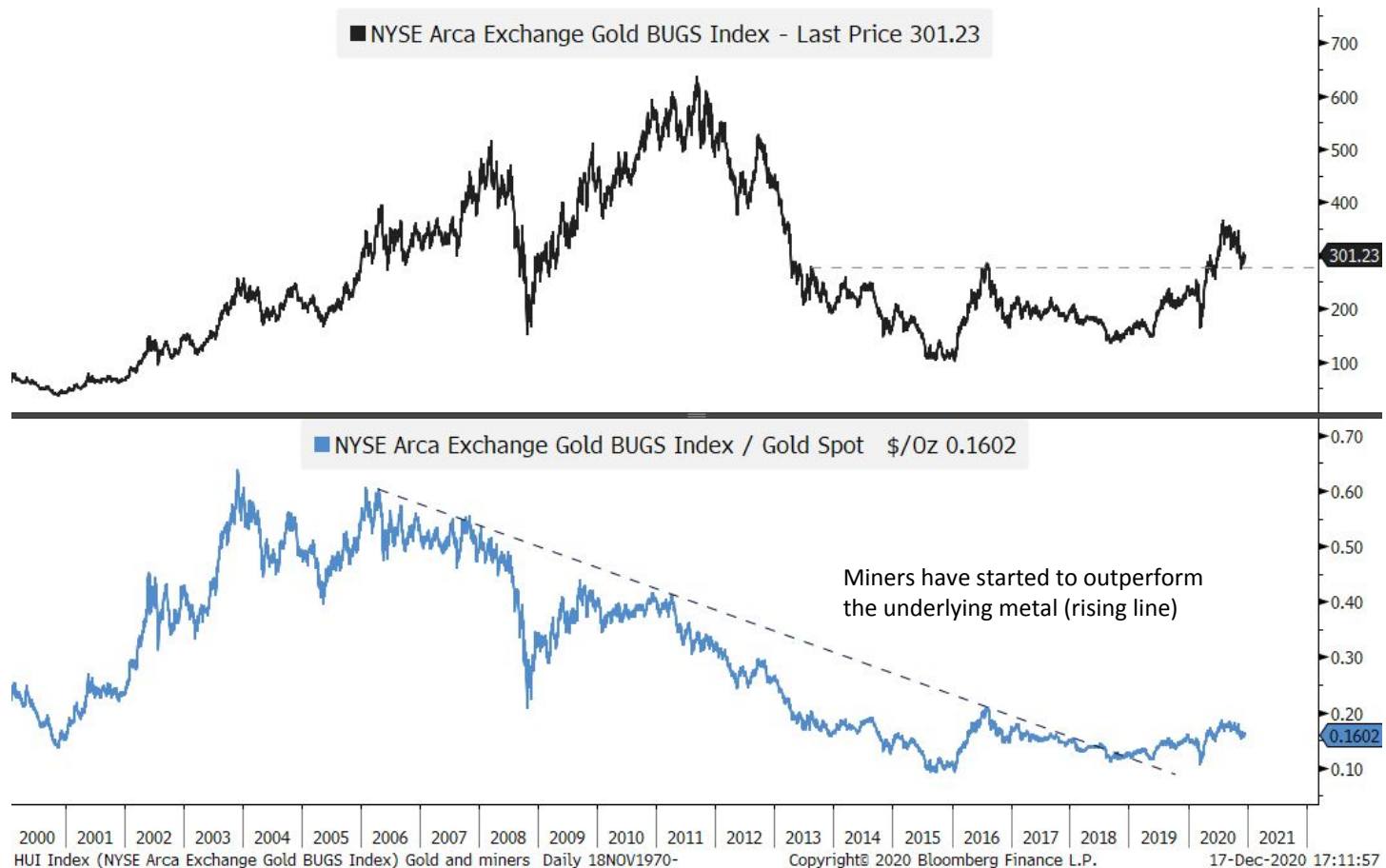
Gold is consolidating in its bull market

Gold has so far successfully tested its 200 day moving average, reinforcing the idea that the bullion is going through a consolidation within a bull market. This is also reinforced by declining real rates (grey line). The main risk for gold is that central banks decide to tighten policy in 2021 in the event of a major growth surge. We think this likelihood is low for the time being. Gold needs to close above 1900 to signal the next leg up.



Precious metals miners remain very attractive

We remain very favorable to gold and silver miners despite their stellar performance in 2020. Margins and cash flow have increased significantly and the recent correction has so far successfully retested a key level. Interestingly, miners remain quite cheap relative to gold (blue line). With gold production slowing down and no major discoveries in the last 10 years, production growth will have to come through acquisitions, which should favour junior companies.



Bitcoin's market cap remains extremely small at the scale of global assets

Bitcoin has rallied to new all-time highs as the follies of central banks and governments make its limited supply and high stock-to-flow ratio extremely compelling.

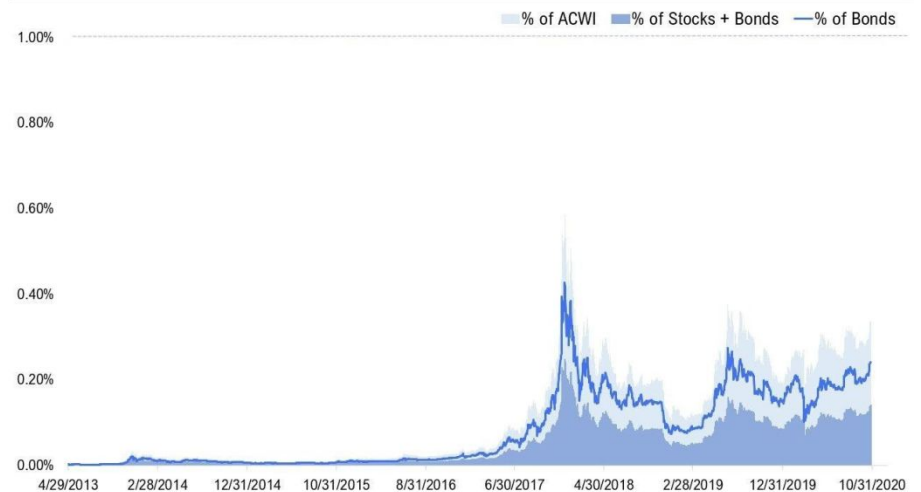
Crypto currencies' adoption continues to improve, with Paypal recently announcing that it will offer its 330m user the possibility to transact in and buy bitcoin and other large crypto currencies.

Institutional investors are increasingly giving their stamp of approval by gradually building an allocation to this asset class. For example, Massachusetts Mutual Life Insurance has invested USD 100m in Bitcoin, while prominent investors such as Stanley Druckenmiller, Paul Tudor Jones or Alan Howard have announced significant positions.

Interestingly, Bitcoin's share of global assets remains extremely small and is likely to keep growing.



Bitcoin's Share Of Global Liquid Markets



Source: Pervalle Global, Bloomberg

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