Mt Fort Advisers - Investment Strategy Update -

December 2020

Dear Sirs,

We are delighted to present you our latest investment strategy paper with the contribution of our independent macro strategist, Prof. Michel Girardin. As usual, we will be reviewing the performance of the financial markets during H2 2020, marked by a strong recovery post the burst of the SARS-CoV-2 pandemic, and elaborating on our perspectives for the first half of 2021 under the reins of a new President of the United States and a split congress. You can access our research by directly clicking here and request a password.

The second part of 2020 was a continuation of the sharp recovery on the financial markets, which started on March 23rd (post the FED announcement of its unlimited monetary support). At the time of writing, the S&P 500 is climbing to new records and has appreciated almost 20% in H2 2020 after having rebounded 35% already in H1 2020 from its lows on March 23rd. That is an extraordinary total appreciation of 68% from March lows and a 15% gain for the whole year 2020. Quite remarkable after the 35% drop from its February highs and the damage created by the pandemic on the economy world-wide. Markets have been quick reacting to about $20 trillion of monetary and fiscal support globally. As we know, the **recovery has been uneven** among the various sectors, geographic zones, styles and sizes. The so-called FANGS+, growth and large cap stocks, as well as US, Japanese and Chinese shares taking the lion share of the market performance to the detriment of the cyclical, value, small and European stocks. That trend resumed in H2 2020, although we have seen over the past couple of months a **rotation** taking shape with cyclicals, value, small and European stocks taking the lead and outperforming the former winners. That is a major theme, which we will discuss in more detail in our investment outlook. We reckon that this rotation has more breath for longer looking at a similar pattern following the TMT bubble between 2002 and 2007, assuming the COVID-19 remains under reasonable control through the forthcoming vaccination campaigns.

We cannot obviously elude the **pandemic** topic, which will remain centre-staged and critical in any scenarios unfolding in 2021. It is illusory to expect a full restart of the economy without controlling the progression of the pandemic and the battle there is not over. All hopes are on the various **vaccines**, which have been developed at an incredible pace thanks to vast sums injected by governments and private foundations. The estimated cost of the ACT (Access to COVID-19 Tools) Accelerator for instance amount to about USD 40bn. Markets have priced a lot of good news in anticipation of successful vaccines. We should be hopeful the vaccines are as effective as anticipated, while adoption level will be high and inoculation efficient across the population. But there will be surely no easy and straight path. In the US, still 42% of adults would not agree to be vaccinated due to concerns about the rushed timeline and its safety level. There are also significant logistical challenges to inoculate vaccines across such a wide population within a short time frame, in particular in the much-affected emerging countries such as India or Indonesia. Global equitable access to COVID-19 vaccines estimated to generate economic benefits of at least US$ 153 billion in 2020–21, and US$ 466 billion by 2025, in 10 major economies, according to a new report by the Eurasia Group. It seems clear that **coordinated efforts** would be much more beneficial to the world economy, but it has to overcome strong nationalistic sentiments.

We would expect the economic growth to keep recovering overall, albeit at a slower pace post the sharp rebound, thanks to extremely **accommodative monetary conditions** coupled with **strong stimulus packages** and of course successful vaccines. Even if central bank injections might be reduced, there are significant liquidities in the system and there is little risk for short term interest rates to increase anytime soon. The US gridlock situation with a split congress might prevent the expected full Biden stimulus programs, but a fair compromise should be found, enough to support the US economy. Political gridlocks turned to be positive for the financial markets. Over the last century, the S&P500 rose the most by 60% when the US enjoyed a divided government. Globally, fiscal policies remain critical to a solid and sustainable recovery, further expanding **public debt** levels which are reaching all-time highs. This should not be a prime source of concern for now: as long interest rates remain low; debt servicing is manageable. But, longer term, a debt should be repaid at some stage and there are a lot of debts (in the US nonfinancial debt surged to all-time highs to almost 300% of GDP, while US private debt amounts to about 260% of GDP). **China** exemplary, although authoritarian, resolution of the pandemic allowed for a strong recovery with its economy back to its pre-COVID-19 level. This has been a significant catalyst to the current **reflationary** environment with a re-rating of base metal and energy prices including copper, iron ore and the oil price. We should expect China to keep on with a strong economic growth at least in H1 2021 until the 100th Anniversary of the Chinese Communist Party (starting on July 1st, 2021). The CCP had set up to doubling its 2010 per capita income figures by 2020. The Chinese locomotive at full steam should rainfall over the world economy further supporting the cyclical and value recovery on the financial markets.

With the FED formally committing to "average **inflation** targeting", i.e. allowing inflation to run above 2% for some period of time, we should expect interest rates to remain v low. Real interest rates should keep moving south, while inflation start to show up. There are structural inflationary forces in action, such as an aging population and a low productivity despite the digitalization movements. Although this is not our central scenario, there is a medium-term risk for inflation to overshoot if the economy does restart fully thanks to very successful vaccine campaigns. This is particularly true in light of the significant liquidities in the system, whose velocity could accelerate if credit kicks back in. In that context, there is a strong (too strong?) consensus for a w**eakening US dollar** due to the expanding twin deficit, a huge monetary base and yield gap shrinking. We have long advocated USD based investors to start diversifying their currency exposure in particular to the renminbi. We would expect the Euro and the British pound to strengthen over the next few years under the current environment.

With interest rates still very low but in a most likely reflationary environment, **TINA** (there is no alternative) is back in town. Despite **rich equity valuations** at around 22x forward PE on the S&P 500 (that is almost as high as the top of the TMT bubble), bonds are even more expensive, particularly government bonds of which German and Swiss sovereign bonds are trading at negative yield. The risk/reward is simply not attractive, and we prefer keeping additional cash on the sidelines for future equity purchases on periods of weakness. **Chinese local bonds** are the only pockets together with **TIPS** that we would favour currently on the sovereign space. The former to benefit from higher yield at an acceptable level of risk and the latter as an inflation hedge. Corporate bonds can still offer some opportunities but often to the detriment of higher risks with spreads having recovered all their losses on the investment grade space, but not fully in some high yield pockets, in particular with corporate emerging market bonds and lower grade bonds in which we would not venture.
Earning growth should be strong in 2021, recovering from its abyssal levels in 2020, with a market consensus in the range of 15% to 25%. Our equity allocation would focus on the reflationary theme and the cyclical plays with **materials, industrials and financials** predominantly in the **EU and UK** thanks to more attractive valuations, stimulus support and an expected weakening USD. The UK is slightly speculative with the current Brexit drama which should reach a final point soon, but it is extremely attractive in terms of valuations, while we cannot underestimate Britts' capacity to adapt in any circumstances. It also has a number of cyclical plays which could be perform well. EM equities with **China and HK** should keep their existing trend northward. We have built a core exposure onto the **environmental** investment thematic and would keep exposure to the **tech** space and **disrupting** companies (avoiding preferably the expensive FANGS), as well as the **health care** sector. We would take some exposure into **small caps**, which would benefit from the reflationary environment and the overall rotation.

It is hard to project ourselves into 2021 after such an incredible year 2020. We have to accept that financial markets are evolving fast and we can only adapt to the changes. It seems clear that the **retail demand** channelled through providers such as Robinhood and cheap (or free) on-line platforms is taking greater importance and in certain cases can "make" the market sometimes based on thin rationales and pure "buzz". It is not clear yet if such a herd movement can be reminiscent of what happened in the late nineties during the TMT euphoria. But there are certainly some analogies with the same retail demand driving share price, exuberant demand, mind-boggling valuations, boiling hot IPO market, many of which are not making any profits, and any new trendy company share price surging to the sky. **Algo-based systematic** programs, **high-frequency trading** platforms and **passive investing** are also influencing the market patterns. All those factors partly explain the more erratic and frequent brutal movements in some stocks and the financial markets generally with investors having increasingly a **shorter time frame**. We remain **disciplined** with our approach and portfolios, while not ignoring those changes and adapting to the current conditions. We are combining three different pockets of exposures: 1) a core thematic allocation, 2) a "quantamental" driven basket and 3) a selective disrupter stock picking pocket. We have also increased our exposure to **non-traditional** assets, accepting a lower liquidity to enhance returns and reduce portfolio volatility, which include distressed private debt and infrastructure private debt, tech venture capital and private equity opportunities in the form of club deals, such as farmland or cleantech investments. Diversification and a solid risk monitoring system, while setting up clear investment objectives remain essential. You can read more in our paper by clicking here.

We would be delighted to discuss it in more detail and exchange on your valuable thoughts.

Wishing you an enjoyable reading and more importantly our warmest wishes for a more relaxing holiday season and a healthy and more prosperous New Year 2021.

Keep all safe and healthy.

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