

House View

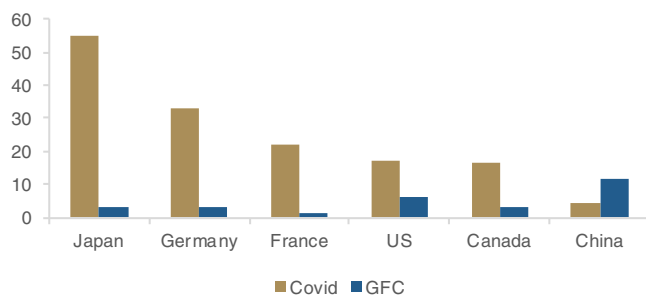
19.01.2021

This document is intended for marketing purposes.

A new calendar year has started, yet many uncertainties remain. Will Covid be fully defeated by year-end? Will governments continue to support their economies trying to recover from a raging pandemic with the help of taxpayers' money that, one day, should be paid back by - taxpayers? Will we witness an unprecedented spending binge by the US government, with the Fed financing via a new acronym such as YCC (yield curve control) or other imaginative ways? Will the foreseeable vaccination of the developed countries' population in 2021 be completed and will developing countries have to wait until 2022, with potential growth-limiting factors? How will a less combative US administration impact global trade?

While there is light at the end of the tunnel, in our view, in pandemic-related questions, the current rapid growth in infections especially in some European countries (UK, Germany) leads us to expect another form of gripping lockdowns, some of which are already enacted, while we may expect an extension of already harsh measures e.g. in Germany until Spring. The economic fallout from lockdowns is not to be underestimated, however governments will do the utmost to contain the damage. But how much will it cost? Comparing government's fiscal response to the Global Financial Crisis in 2008/09 with the fiscal stimulus in 2020 and beyond, today's reaction is an order of magnitude bigger, depending on the country analysed. The outlook for government finances will for certain be at the crosshairs of the political discussion in the years to come, possibly already in 2021.

FISCAL STIMULUS: COVID (2020) VS FINANCIAL CRISIS (2008)



Source: International Monetary Fund

There are numerous possible avenues for government debt to develop in this decade. They are ranging from debt fully getting out of hand in connection with MMT (modern monetary theory, where the central bank can seemingly endlessly finance government deficits), and the prospect of a combination of tax rises and reducing government expenditure. There is another way to reduce debt: simply inflate it away. While long-term in nature, it is the most "successful" approach when looking at history. UK government debt at the end of WW2 stood at 250% of GDP, but fell to below 70% 25 years later. Government budget surpluses after 1947 helped, of course, but the main driver was the high nominal growth rate of the denominator, GDP – with inflation contributing by more than 50% to the average nominal growth rate of 7% p.a.

Considering the effects of the past decade of austerity in Europe, with deflation posing a substantial threat, the austerity path to us appears unlikely. On the other hand, critics of inflating away the debt problem warn that the bond market could revolt and start to push yield levels to levels long unseen – the "bond vigilantes" argument. At present, we would argue against this, as central banks globally have signaled they will continue to suppress yields via market interventions. Therefore, we deem the risk of bond yields exploding higher as rather negligible in the medium term. With the prospect of steadily rising inflation, that means one thing: further falling real yields.

Therefore, with bond yields shackled to the ground, the relative attractiveness of asset classes other than Fixed Income rises strongly. Take equities: Looking back at the past 60 years, there has been a clear connection between bond yields and earnings yields (earnings per share divided by price). From an economic standpoint, it makes sense to ask for a yield premium for equities, due to their inherent higher riskiness compared to bonds. In the period between the early 1980s and the early 2000s, equities traded at a discount to bonds, so this "law" was violated. The reason for this inversion was the very high interest rate environment (both nominal and real, that is inflation-adjusted) – equities were still attractive, because they offered earnings growth in a time that saw very high productivity gains: this is why they were bought, although bonds offered higher yields.

10-YEAR TREASURY YIELD AND US EQUITY EARNINGS YIELD



Source: Bloomberg

Bond yields today are close to record lows, while earnings yields are very low as well, though not at record levels. As we are convinced of some form of price pressures developing over the coming years, possibly in a violent manner, equities profit from the rise in corporate pricing power and, as a result, in profit margins, that lead to over-proportional growth in earnings – at first. During the 1960s, bond yields started to slowly head north, adding 2 percentage points from 1962 to 1969. At the same time, equity earnings yields stayed virtually unchanged (although some swings can be observed) – earnings had grown some 50% over those 7 years (6% p.a.). The following 13 years, i.e. from mid-69 to mid-82, equity investors lost about 25% in real terms, including dividends. During the same period, the USD's purchasing power eroded by more than 60%.

BLOOMBERG INDUSTRIAL METAL COMMODITY INDEX

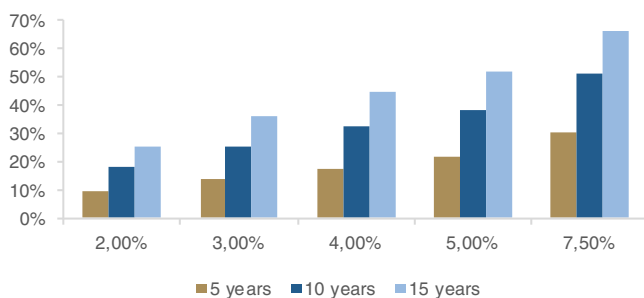


Source: Bloomberg

With the global economy starting to recover from the Covid pandemic, there is a high likelihood that pent-up demand will come back strongly. Lockdowns in connection with the pandemic had repercussions in many industries, particularly the commodity sector which was hit hard due to the standstill in many production chains, growing inventories and a corresponding fall in raw materials prices in the spring. The negative oil futures prices in April

were a prime example of the mayhem in the sector. The plunge in prices led many production sites to reduce output or temporarily shut down altogether. Prospecting for new deposits and in some cases even investing just to keep production rates going were abandoned. With the outlook for the global economy improving strongly thanks to the proliferation of vaccines, prices have recovered significantly. Copper consumption in China has already reached pre-pandemic levels, and Chinese oil imports are as strong as ever. With the underinvestment of the past quarters in many commodity sectors such as industrial metals, the prospects for prices to remain elevated (and in some cases to rise further) are good. This by itself will be a factor that stokes inflation rates, further bolstering our case that purchasing power will erode.

PURCHASING POWER EROSION BASED ON INFLATION LEVEL

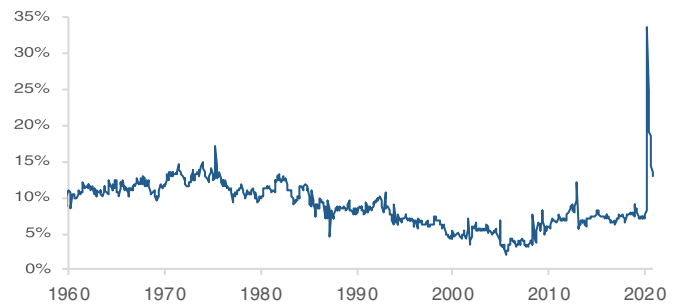


Source: Bloomberg

Therefore, all is well? Not perfectly, unfortunately. Equity valuations on an absolute level have become expensive, for one. Current retail investor sentiment, for the other, is excessively optimistic and has reached levels where “air pockets” (steep setbacks on markets) are common. Therefore, a buy-the-dips strategy appears wise, as the relative attractiveness argument vs. other asset classes will hold true until price pressures in the real economy manifest themselves, forcing central banks to act. Based on the market expectations, this point could be several years out. Some weakness in the weeks ahead is therefore possible.

There remains one powerful argument that the rally could resume in February: Future Senate Majority Leader Chuck Schumer (D) has stated that his first legislative project will be raising the unemployment benefits from 600 to 2'000 USD a month, while president-elect Biden's economic stimulus plan sees for unemployment benefits to extend into September 2021. Looking back to spring of 2020, when an amount of 1'200 USD was paid out as a one-time payment (with more for families with children), the US savings rate soared to 33.7%, double the previous record set in 1975. Coincidentally, the number of brokerage accounts surged as many, locked down at home, started trading stocks. This additional demand for stocks in some cases such as Tesla has resulted in strong price gains, while the cryptocurrency boom obviously was fueled as well by the surge in savings due to the lack of alternative opportunities to spend it. Any additional stimulus enacted by Congress in the first weeks of the Biden administration could therefore give another short-term boost to stock prices.

US SAVINGS RATE AS A PERCENTAGE OF DISPOSABLE INCOME



Source: Bloomberg

Considering the recent trajectory of cryptocurrency prices, with Bitcoin having reached levels that are more than double the previous all-time high in late 2017, this emerging asset class evidently displays signs of excessive speculation. However, based on our estimates, it is unlikely that we have reached the flagpole – by far. Therefore we would suggest to stick to positions, while some degree of diversifying out of the market leader Bitcoin in our view makes sense. The cryptocurrency eco system is growing by the day and institutional interest and investment is growing at a high rate. Due to the extreme volatility levels – vol spikes in the order of 150% for 10-day volatility are frequent – a relatively high degree of risk tolerance is necessary for any digital asset investor.

What could derail the current trend? We do not think that the earnings season that is starting will have much of an impact on the general direction of stock markets and risk assets in general. Rather, we could imagine a geopolitical crisis triggering a temporary sell-off (Middle East, South China Sea, ...), although at a low probability. Any surprise turn by a major central bank, e.g. starting to signal a much earlier tapering date than the market expects or categorically ruling out any form of yield curve control or quantitative easing in the broader sense, could knock the market down in the short term. However, the central bankers would need to pivot quickly, in our view, as in December 2018 when the Fed abandoned its plans to tighten the monetary screws after a violent sell-off.

BITCOIN PRICE IN USD



Source: Bloomberg

CONCLUSION

- ▶ With the global economy recovering from the pandemic in 2021, markets will test central banks' commitment to keep a cap on bond yields, as monetary authorities worldwide have most clearly stated not to raise rates anytime soon.
- ▶ Due to the very low yields, the risk-reward for many fixed income segments is negatively skewed. We still like Emerging Markets bonds, both in hard and local currency, and corporate hybrid bonds.
- ▶ There are interesting segments in the alternative income space, such as trade finance, but also insurance-linked bonds, that can generate a meaningful yield without adding too much risk to a given portfolio.
- ▶ Equities should remain well supported as any meaningful setback should prompt the monetary authorities to signal continued, seemingly never-ending support.
- ▶ We consider EM equities to outperform going forward, thanks to a valuation discount and an earnings recovery that should surprise positively. The US stock market could see some headwinds from the incoming administration in certain sectors and thus end its decade-long outperformance vs. international equities.
- ▶ The commodity sector looks very interesting in our view, thanks to pent-up demand meeting chronic underinvestment in certain segments.
- ▶ For the coming months, the outlook for the real economy is bleak; however, fiscal and monetary lifelines by governments will not lead to a collapse.
- ▶ The US dollar could bounce in the short term, due to a combination of stretched sentiment and positioning as well as the recent yield pickup making it more attractive relative to other major currencies. Medium-term, we remain negative on the greenback's outlook.
- ▶ We expect to see some gradual improvement by the spring. Vaccinations are starting to have a positive impact and by the third quarter, life could start to feel like it used to in pre-pandemic times.
- ▶ Asset classes offering a harbor against inflation, that is real assets such as equities, commodities (precious metals), but also cryptocurrencies, will gain in importance in many an investor's asset allocation.

Disclaimer

This document is for information and advertising purposes only provided by St. Gotthard Fund Management AG ("STGFM"). For further information, please consult the documents which are available at www.stgfm.com or contact STGFM. STGFM is domiciled and regulated in Switzerland. The above figures refer to a simulated past performance and simulated past performance is not a reliable indicator of future performance. A gain in value in the past provides no guarantee of positive performance in the future. The above figures are presented gross of fees. Before investing in a product please read the latest product documents (e.g. this teaser, factsheets and prospectus) carefully and thoroughly. The documentation is available free of charge in English and, where relevant, in one of the local language(s) where the product is registered. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. Members of STGFM may have a position in and may make a purchase and/or sale of any of the securities or other financial instruments mentioned in this document. The product mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States and other countries. Please contact your tax and legal advisor. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments.

The risk of price and foreign currency losses and of fluctuations in return as a result of unfavourable exchange rate movements cannot be ruled out. There is a possibility that investors will not recover the full amount they initially invested. The performance data do not take account of the commissions and costs incurred on the issue and redemption of the product. Commissions and costs have a negative impact on performance. The information in this publication is intended for information purposes only and does not represent an offer, solicitation of an offer, public advertisement or recommendation to buy or sell any investment or other specific product. It is recommended that advice be obtained from a qualified expert. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient. The details and opinions contained in this document are provided by STGFM without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of STGFM. Source for all data and charts (if not indicated otherwise): St. Gotthard Fund Management AG. The place of performance and jurisdiction is at the registered office of STGFM.

© St. Gotthard Fund Management AG, 2021.

CONTACT US

Gotthardstrasse 14
6300 Zug
Switzerland
+41 (0) 41 544 91 20
info@stgfm.com
www.stgfm.com