

House View

21.04.2021

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Thriving investor sentiment

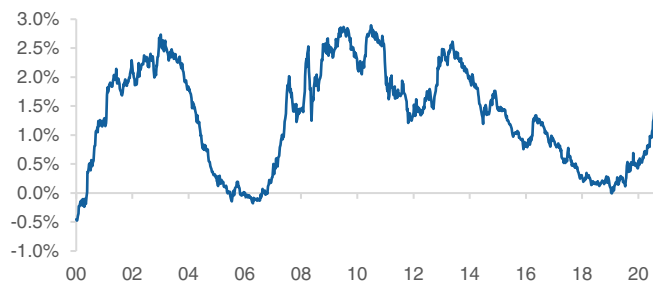
While the pandemic continues to cause much uncertainty, despite renewed lockdowns in some countries, retail investor sentiment is thriving. The sharp and painful plunge in equity prices of February/March 2020 is all but forgotten, as the recovery in economic activity should keep earnings healthily growing, according to market expectations. Since the beginning of the year, estimates for 2021 earnings have already moved up by 4%. With markets up more than twice this amount, the valuation expansion has continued.

Elevated equity valuations may well be justified with the low yield levels, so relative valuation models of equity earnings yields and bond yields continue to display a warm green light for stocks. Very strong economic growth – gdp growth estimates on Wall Street now center around 7% for 2021 – coupled with ultra-low interest rates should continue to support the stock market.

Bond yields started moving

Unfortunately, bond investors start to leave the party, leading to a surge in yields on the longer end of the curve: the difference between 10- and 2-year Treasury yields has risen by 100 basis points in the past 6 months alone, driven by a rise in inflation expectations for one part. For the other, the sheer amount of Treasury issuance volume that will hit the market is a matter of concern. Even with the Fed buying hundreds of billions of Treasuries this year, net Treasury issuance in 2021 will reach several trillion USD. Paired with a significant lift in inflation towards year-end, some dark clouds are brewing.

10Y-2Y TREASURIES YIELD SPREAD

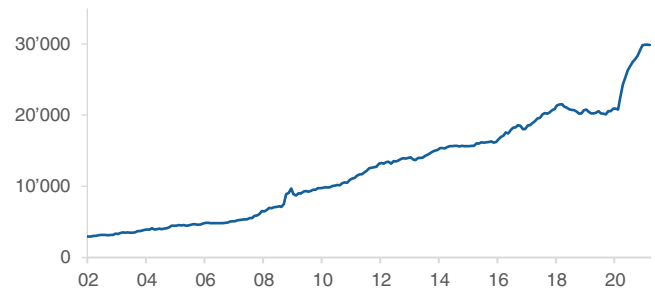


Source: Bloomberg

Continued monetary policy support

Optimists will say that this is only the market returning to more normal levels as one would expect after an economic shock. We fear that a combination of several factors will drive inflation up meaningfully not only in the short term, but also for a major part of this decade. Monetary stimulus has been with us for a long time and is one important condition for inflation to emerge. Certainly, the Fed's (and other central banks') emergency funding programs in the order of trillions could be considered a temporary bridge that has saved us from a great depression. Where we see the core of the problem is how or even whether this money will be taken out of the system in the future. According to official guidance by the major central banks of this world, say Fed, ECB, Bank of Japan, balance sheets will continue to grow for the foreseeable future – no trend reversal in sight, in other words. With the economy roaring ahead because of growing levels of vaccination, of the stimulus and of pent-up consumption, some demand-led price inflation could evolve.

MAJOR CENTRAL BANKS BALANCE SHEET SIZE (BLN USD)

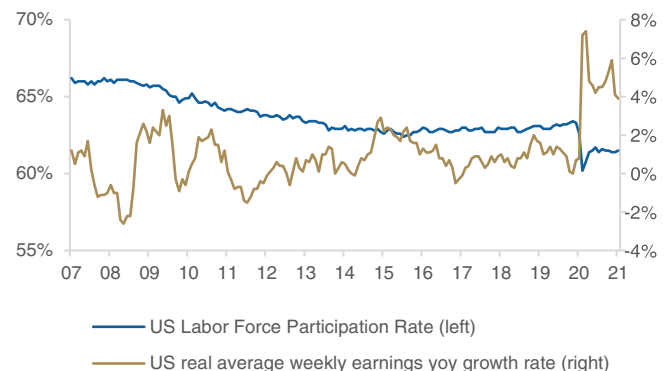


Source: Bloomberg

Wage-price spiral?

Add the potential of a wage-price spiral which is the highest in decades after a record plunge in labor participation rates. Although millions of people are out of work, it is notable that wages have risen considerably in the past quarters, which appears paradoxical. Already before the pandemic, anecdotal evidence hinted at a tight labor market. With the fall in the participation rate, job offers need to become more generous to lure jobseekers as the competition for workers has risen.

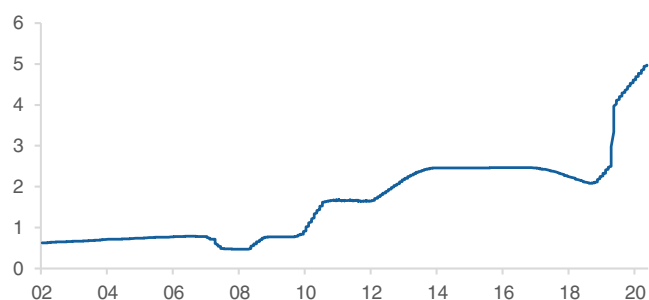
US LABOR PARTICIPATION AND WAGE GROWTH



Source: Bloomberg

Back in the golden days of central banking, after Paul Volcker's Fed successfully beat the beast of inflation of the 1970, reckless government spending was quickly reined in by the bond markets which disciplined governments by driving up interest rates and thus increasing the cost of growing indebtedness. In the past decade, however, central banks have started to interfere in government bond markets. Today, the US Fed holds some USD 5trn of Treasury debt, more than 20% of outstanding Treasury securities. Considering the vast amounts of new supply, we are convinced that the Fed will have to pick up the tab, most likely with an "innovation" such as "yield-curve control" (YCC) which is but a direct monetization of government deficits.

FED'S TREASURY HOLDINGS (TRN USD)



Source: Federal Reserve Bank of St. Louis

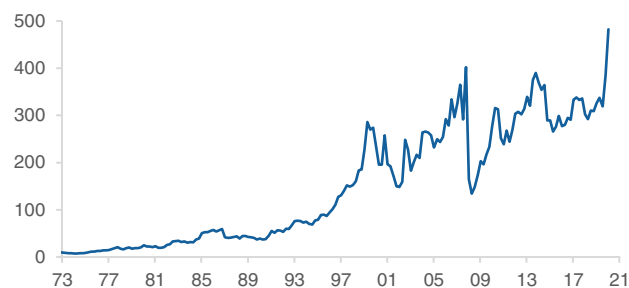
Unattractive Fixed Income

For such an extreme central bank measure to come, some observers see a need for a significant risk-off event on financial markets to take place, such as the short, but painful bear market in Q4 of 2018. The latter was triggered by an overly tightening Fed that raised Fed Fund rates to 2.5%. Thanks to Fed guidance, markets do not face this risk this time, however the longer end of the curve could start to pose an issue. Should we see a continued building up of the term premium, it could start to wreak havoc in the real economy via tightening financial conditions. Considering the elevated levels of debt as well as the low yields, a steep up-move in yields due to oversupply could very quickly turn into significant losses for bond investors, which probably would not increase the general appetite for the asset class "fixed income".

Non - transparent leverage in equities

The concerning news in the past weeks regarding an obscure family office named Archegos being able to gamble in concentrated stocks at unhealthy levels of leverage, leading to billions of dollars of losses at major banks globally, to us is purely a display of the extreme amounts of liquidity in markets, with investors chasing yield in extremely aggressive ways. With another incident at prime brokerage departments of several different banks, one is bound to re-assess the quality of the huge risk management departments that all of today's banking giants sport: how likely is it that similar practices were used by other players? How high is the likelihood that leverage in the system is coming down, due to a renewed focus on "risk" by management of major banks? The mere fact that by the implementation of total return swaps (a synthetic contract that gives exposure to your stock of choice), a given investor can hide his/her degree of ownership of a specific stock, speaks volumes about non - transparent pockets of risks in today's markets. Official leverage data, such as the total of Debit Balances in Customers' Securities Margin Accounts from FINRA (Financial Industry Regulatory Authority), a government agency, shows that in October 2020 (latest data), leverage has risen by almost 50% over 12 months. Total return swap-related exposure is not included in this data...

MARGIN ACCOUNTS AT BROKERS AND DEALERS (BLN USD)



Source: Bloomberg

Deflation fears unjustified

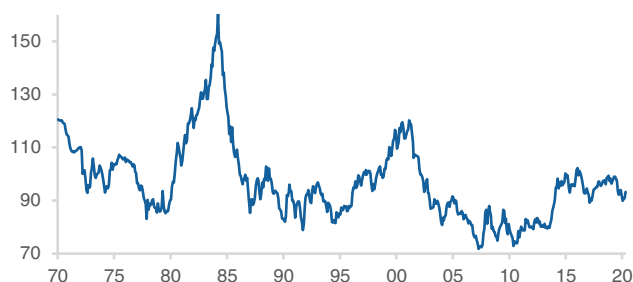
There are still many market participants convinced of the absence of any consumer price inflation for years to come. One reason for this notion can be attributed to the fact that for the past 10+ years, despite unprecedented levels of central bank accommodation, inflation never started to bite. The austerity in the public sector had its impact upon aggregated demand, and the additional central bank liquidity ended up in bank deposits on its own balance sheet. The transmission via the banking sector, in other words, did not function. Therefore, we put an important focus on bank lending data in the coming months, as it needs to pick up again during the post-covid recovery: after the surge at the beginning of the pandemic about a year ago, commercial and industrial (C&I) loans currently are shrinking. This can be attributed in parts by a booming bond issuance: in the twelve months to February 2021, corporate bond issuance volume in the US rose by more than 50% compared to the previous 12 months' total. However, some stabilization and pick-up is expected; the trend in consumer loans in this respect is encouraging.

King dollar

Looking at global financial markets, one needs to keep in mind the currency aspect: king dollar has an important impact on many different variables. In times of US-dollar strength, many emerging markets with negative current account balances are confronted with a growing external debt burden, and capital flight needs to be battled with interest rate increases in the local currency that has stifling effects on the domestic economy. This negative feedback loop can be observed in the performance of many EM currencies over the past decades. A weaker US-dollar however, is to be considered a net positive for many countries. The greenback's negative correlation with commodities also needs to be mentioned, i.e. commodity prices rise with a fall in the dollar.

Our medium-term view for the US-dollar is distinctly negative. Starting with a current account deficit that remains stubbornly high (and which may be less reduced by rising oil & gas exports due to the Biden administration's expected reining in of the fracking industry), moving over to a budget deficit situation that pales compared to every other since WWII and to the lack of a real yield advantage over other currencies, there are several fundamental reasons speaking for a weaker greenback.

TRADE-WEIGHTED US-DOLLAR INDEX (BLN USD)



Source: Bloomberg

Setback in the short term?

But after such a good start to the year and particularly into the start of the second quarter, with global equity markets up a strong 4% in the first half of April alone, the question remains how far this up-leg in risky assets goes. Considering the record optimistic retail sentiment in stocks, some setback must be viewed as a higher probability scenario in the short term. However, the outlook for company earnings in many sectors is bright, while in others, much hinges on the pandemic developments, because so many factors reduce earnings visibility.

Attractive commodity producers

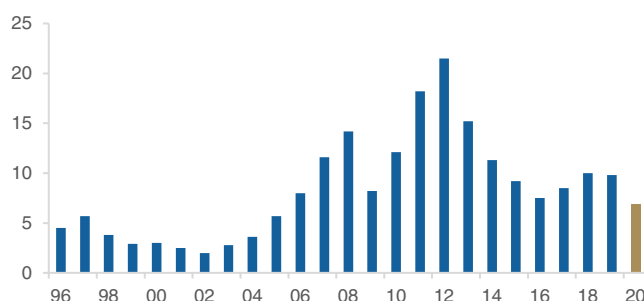
There is however one group that may see a strong revival in the years ahead: commodity producers. With the dedication to improve infrastructure not only in the US, but in many countries globally, while addressing the carbon footprint decisively, will drive demand in many commodities, be it metals, minerals, energy, cement and the like. After a decade of significant underperformance by commodity producers, we are convinced the time is right to increase exposure to the sector. The share in market capitalization of the materials sector in the S&P 500, for example, now has reached 2.5% of total market cap. In the mid-1990s, the figure stood at 7%. Also, the relative valuation vs. the market displays a discount of 30%, based on price-to-cashflow measures – the 32-year average lies at a 7% discount and the current 'rebate' is the biggest in 13 years.

Based on the expectation that cashflows could actually surge in the case of many producers, the case for holding commodity producers gets even stronger. In our latest Insight publication (link [here](#)), we gave an overview of the many bullish arguments that speak in favor of precious metals. However, for many industrial metals, a similar case may be made. There are even some segments that we consider overlooked by many market participants. One prominent example is coal. While ranking among the dirtiest fossil fuels, some 17% of global coal production is not used to produce electricity, but to produce steel, called metallurgical coal or coking coal. While many thermal coal producers are facing difficult times longer-term, we take the view that met coal producers will profit strongly from the transformation to a new, greener economy, as the amount of steel used globally will further grow, in our view.

Supply constraints

The most important price driver for commodities is the supply/demand dynamic. We have made the case for a clear increase in demand, but what about supply? Take copper, for instance. Demand will continue to rise, not last due to the growing transformation towards green energy. Since no major copper deposit has been discovered in the past 5 years, the production outlook for 2024 and later is bleak. So one may expect a lot of exploration to take place in the coming years – and further rising prices in order to incentivize new discoveries. Thanks to lower prices for longer after the end of the metals bull market in 2011, exploration budgets have been chronically low funded, leading to some supply shortfalls going forward. Prices will rise further, changing the incentives for new exploration ("high prices are the best cure against high prices"). For the coming 12 to 18 months, the fundamental outlook – barring a supply shock such as another pandemic or an international military conflict – therefore remains positive for the commodities producers (including energy).

NON-FERROUS MINING EXPLORATION BUDGETS DROPPED



Source: S & P

Financials profit from rising yields

Another sector that has suffered for years was the financial sector. It has started to recover from the relative lows at pretty much the same time we saw the begin of the rise in yields. This correlation makes also sense from an intuitive viewpoint: as yields are rising, so is the potential of increasing the interest rate difference between borrowing and lending, the banks' bread and butter; this leads to growing earnings estimates, supporting stock prices. Considering ourselves only at the beginning of a major and lengthy period of rising interest rates, financials' outperformance has only started.

Technology sector with headwinds

When it comes to Technology, rising yields act more as a headwind. This is due to the fact that profits lie far in the future and these need to be discounted to derive a net present value (the stock price) – with a rising discount rate, the net present value drops. We would therefore gradually reduce the exposure to Tech. The major players could also face renewed pressure on growing anti-trust sentiment in the US Congress. A global minimum corporate tax, the idea floated by the Biden administration, could have quite a heavy impact on the FAANG's bottom line, but much depends on the exact legislation and execution of new rules by the OECD, for instance.

The crypto age

Talking about financial markets nowadays includes the emerging asset class "digital assets" or "cryptocurrencies". Compared to the previous peak in early 2018, total market capitalization of cryptocurrencies has trebled to about USD 2.3trn. Readers of our previous publications can attest our continued bullishness on this asset class, based on our eroding confidence in fiat currencies' purchasing power. But digital assets are much more than simple stores of value as for instance bitcoin may be considered. We are still only at the beginning of a developing technology, and while there will be setbacks for sure, we remain bullish on the emerging asset class "digital assets".

Coinbase's IPO in mid-April drew even more attention of the investing public. At a market capitalization of more than twice that of Nasdaq (which was founded 50 years ago), there was high demand for the shares but, as is often the case with the digital asset prices themselves, volatility was very high: opening 50% above the IPO price, rallying 10% and subsequently dropping by 25%, and closing the day 15% below the opening price.

TOTAL CRYPTO MARKET CAP (BLN USD)



Source: Coin Dance

Bitcoin's share of total market capitalization, also known as "bitcoin dominance", has dropped significantly: At the beginning of 2021, bitcoin's share of total crypto market cap was close to 73%, currently it is below 52%. We are in altcoin season, in other words: digital assets other than bitcoin (=altcoins) are rising more than "the mother of cryptos". We expect this trend to continue as more and more projects based on Digital Ledger Technology (DLT) are alive and kicking, proving the new technology's worth in many different areas of application.

Considering the bubble-like price developments in many digital assets, some observers fear government interventions limiting the use of cryptocurrencies. That is a risk, of course, however we strongly doubt if e.g. the US administration is willing to stifle a new and very promising business area.

CONCLUSION

- Yields have started to rise, though not in proportion to the inflationary risks that are looming. We expect further upside pressure in yields (falls in bond prices) in the medium term.
- We take the view that in 2021, inflation could well surprise to the upside, due to several factors: pent-up demand will meet still constrained supply, commodity prices are rising again (including food prices), central banks have in effect given the green light on inflation overshooting thanks to FAIT (Flexible Average Inflation Targeting), and indebtedness has risen across the board, making the real economy less resilient against interest rate rises.
- The only way to reduce debt to gdp meaningfully is to employ a strategy of "financial repression", in which savers are losing purchasing power, because interest rates do not cover the loss of purchasing power stemming from inflation.
- Such an outlook speaks clearly in favor of real assets. This means stocks and commodities: supply in many metals is constrained due to under-exploration, while the coming infrastructure boom will drive demand for many commodities to new highs.
- Equity market valuations remain elevated in general, but some sectors are trading at steep discounts, due to the booming tech sector driving up average valuation levels.
- On the commodities side, we continue to like precious metals, but industrial metals will stay in high demand as well. Metallurgical or coking coal is often confused with thermal coal (that dirty fossil fuel to produce electricity). The former will remain essential for a very long time to come, as it is used to produce steel.

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CONTACT US

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