Market Overview

As America welcomes a new president committed to fundamental market change, investors around the world might do well to ponder a world radically different in the wake of COVID-19. Two issues of note for those wondering how events might play out are the twin issues of China's explosive entry into the 21st century, on the one hand, and the 'financialisation' of the World's economy, on the other.

On joining the WTO on 11th December 2001, China brought 1.4 billion people with an average wage below $1,000 p.a. into the G3 (US, Europe, Japan) trading system that had a population of 0.9 billion and a $30,000 p.a. average wage. It was thought trade might liberalise China's politics while Western consumers would benefit from cheaper goods as the invisible hand made any necessary adjustments. Things did not go exactly as planned. After 19 years, China gained 15 million manufacturing jobs whilst the US lost 5 million. Though the West's companies prospered mightily thanks to the torrent of low-cost labour, it was the Western system that came under pressure, as societies faced polarising inequality. Plunged into a deflationary productivity crisis, their central banks printed money and cut rates, but all they boosted was asset values.

With regulations and borders dissolving, asset and liability piles dwarf the World's US$80 trillion GDP, the system now evolved well beyond the standard macro textbook's fractional reserve banking model. Just two examples: listed assets total $250 trillion and the global liquidity (a sea of credit and collateral) sloshing round trade and finance lines is around $130 trillion. In 1986, the latter stood at a mere $10 trillion. Global liquidity (140% of GDP) is vastly bigger than net world savings (30% of GDP) with China's $36 trillion liquidity larger than either the Eurozone or USA's, each $29 trillion in 2019. Gross trade flows dwarf net trade surplus or deficit figures, so the work of the financial system is no longer providing new funding but rolling over existing finance. This means liquidity is vastly more important for keeping the

Photo by Joshua Sukoff on Unsplash

show on the road than interest rates.

Going into 2021 there is plenty of scope for uncertainty, but we can expect plenty more intervention including the addition of fiscal stimulus to the liquidity and interest rate barrages. While the numbers are large in relation to state budgets, they are drops in the overall liquidity and asset oceans. Labour supply has experienced a deep shock, which could be hard to reverse given lockdown incentives to stay home. Business is not missing the chance to replace labour with automation where possible, while high skill jobs will stay in demand. This means labour costs in a recovery could rise even while unemployment fails to shift (though against this argument is that one in eight Americans reported going hungry in December). Even if inflation exceeds 2.0%, we can expect the Fed and others to keep their foot on the gas if at last we do reflate. From 1933 to 1937, the US managed 3.5% p.a. inflation. How much more could it achieve today with its enhanced arsenal?

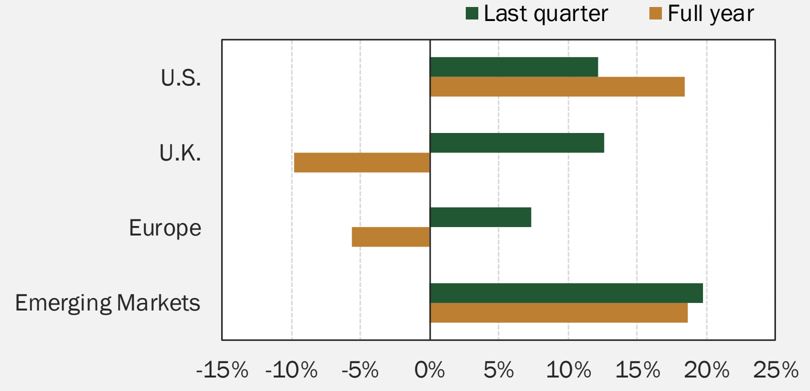
Which brings us to Mr. Biden's economic programme. 'America needs a new Economic Philosophy' by Jennifer Harris and Jake Sullivan (Biden's NSA adviser-to-be) in February's edition of Foreign Policy spelled out the priorities. Authoritarian capitalism is challenging market democracy as the prevailing model, and America needs to deal with a new era of great-power rivalry, inequality, technology and climate change. Experts failed to predict China's impact, and everything is up for a re-think: worker power, taxation of capital, monopolies, public investment. The days of neoliberal confidence in competitive markets as the best way to maximise individual liberty and economic growth, the argument goes, are history. Underinvestment is now a bigger threat to national security than national debt and a national industrial policy is a traditionally American way of doing things – from Henry Clay's American System to Johnson's Great Society. What better reason, goes the thinking, than the threat of climate change to justify 'a surge of directed public investment that underwrites a shift to a post-carbon US economy through R&D, deployment of new technologies and development of climate infrastructure'? Conjuring the ghost of the Moon race, it is also a better response to Xi Jinping's 'Made in China 2025' strategy than outright war. This time trade and economic policy will not prioritise tax havens and Goldman Sachs's access to overseas financial systems but have 'a laser focus of what improves wages and creates high-paying jobs in the United States'. Similar thinking is mirrored in EU and UK post-COVID exit plans. Rising wages, taxes and massive infrastructure spending, a lull in globalisation via onshoring all suggest inflationary pressure. On the other hand, the economic contest triggered by China's rise could well be a high payoff race for investors with a process capable of reconciling risk and opportunity in the face of complex global change.

Asset Classes

Equities

By December, most of us were happy to leave 2020 behind—although we wouldn't mind a continuation of last year's US stock market performance. Despite severe economic disruption caused by the worst pandemic in a century, US shares rallied 12.1% in Q4, putting them up 18.4% for the year (see Figure 1). November's resolution of election uncertainty and positive news on the vaccine front served to extend positive sentiment for US markets posting new highs throughout the second half. Emerging markets scored even greater gains in the final months of 2020, as US Dollar weakness and strength in commodities prices on the back of vaccine optimism pushed EM equities up 19.8% in Q4, resulting in an 18.7% gain for the year. European and UK stocks lagged in 2020, ending the year down by –5.7% and –8.9%, respectively. An overweight to cyclical industries which took a harder hit from COVID, along with the protracted drama of Brexit negotiations, contributed to the underperformance. On the bright side, an eleventh-hour trade deal between Britain and the EU in December, as well as hints of a rotation back to sectors that will benefit as inoculations progress and the pandemic eventually wanes, led UK stocks higher in Q4 by an impressive 12.6%, and European stocks to a 7.6% gain for the quarter.

Figure 1 | Equities Market Performance
Returns as of 31 December 2020



Source: S&P 500 (USD), FTSE All-Share (GBP), EURO STOXX 50 (EUR), and MSCI EM (USD) via Bloomberg.

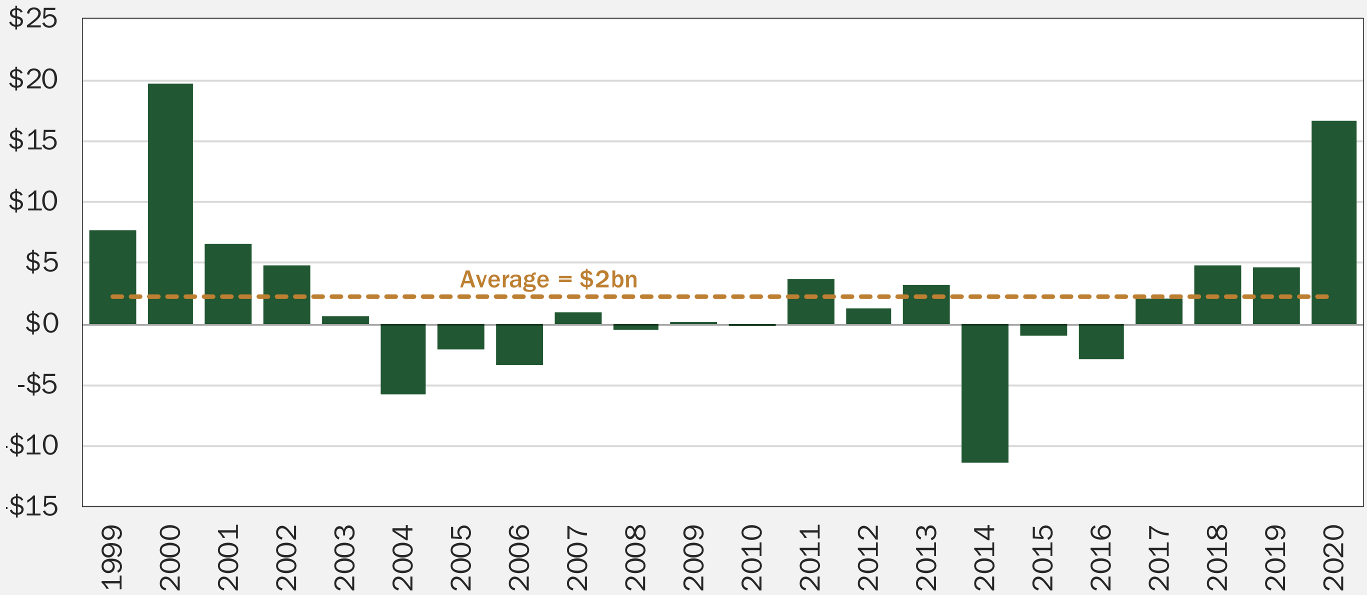
Quarterly Commentary WINTER 2020

The concept of "rotation" was on many equity investors' minds in the fourth quarter, as value stocks made a dramatic comeback on growth to close out the year. Motivated by November announcements of highly effective vaccines developed by Pfizer/BioNTech, Moderna and AstraZeneca/Oxford, markets began pricing in the implications of a post-pandemic economy almost immediately. Shares in sectors hit hardest by COVID, including energy, brick-and-mortar retail, and travel rallied, while stay-at-home stocks, including those in the online retail and home improvement segments, suffered a setback. This marked a departure from growth's strong outperformance versus value in prior quarters. Overall, 2020 witnessed massive flows into passive funds tracking the tech-heavy NASDAQ, reflected an exuberance for growth stocks not experienced since the dot-com bubble two decades ago (see Figure 2). By the end of the year, with so much of 2020's equity market gains concentrated in a small subset of new-economy stocks, market observers were beginning to question whether the theme was overbought, leading to a potentially promising situation for investors with an eye for quality growth firms capable of weathering a rotation, and an ability to sidestep value traps masquerading as bargains.

Figure 2 | Passive Flows to Tech Stocks Not Seen Since Dot-Com Era

In many respects, 2020 was a throwback to the stock market euphoria of the late-90s dot-com boom. As most brick-and-mortar business ground to a halt under COVID-19 restrictions, big tech flourished, with massive gains in the shares of new economy behemoths like Facebook, Amazon, Apple, Netflix, Alphabet, and Tesla—the latter worth a staggering $630 billion when it was added to the S&P 500 index in December, after starting the year at a mere $74 billion in market cap. Seeing opportunity in growth, investors piled into NASDAQ stocks, dropping nearly $17 billion into Invesco's popular passive tracker, the greatest inflow seen since two decades ago, when the internet bubble drove $20 billion into the ETF.

Annual net asset flows to Invesco QQQ Trust Series 1 ETF, billions of US Dollars, 1999—2020



Source: Bloomberg.

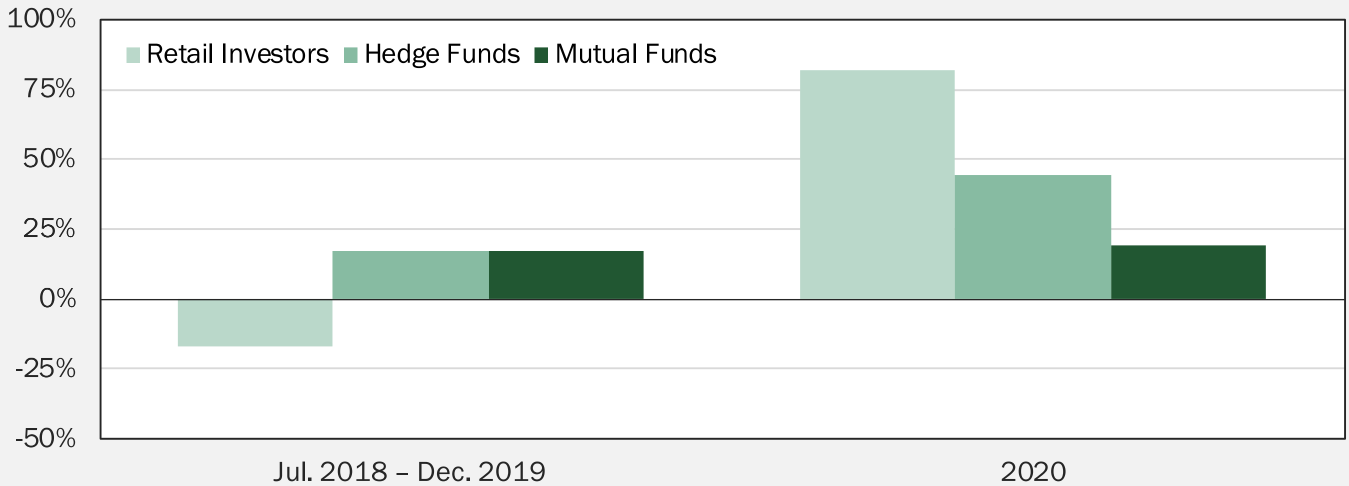
It remains anyone's guess when investors with such fundamental stock-picking skill will have their day. While professional money managers typically outperform amateur individual traders, the pros certainly didn't enjoy much success in 2020. Instead, inexperienced investors like those found on Robinhood—a popular online brokerage platform accused by Massachusetts securities regulators in December of "gamifying" stock trading—had no problem beating the market in 2020, racking up gains of 82%, according to data from Goldman Sachs (see Figure 3). Meanwhile, US stocks picked by some of the world's best hedge fund managers actually trailed the S&P 500 over this period, gaining 45%.

Ultimately, the greatest pain was felt by short sellers, including those expressing a view that seemingly ignored risks—ranging from skyrocketing infection rates and a poorly managed vaccine rollout to escalating tensions between the US and China—might expose a disconnect between prices and fundamentals and bring the rally to a halt. A portfolio of the most-shorted US stocks returned an astounding 156% since prices bottomed out at the end of March (see Figure 4). As frustrating as such conditions are for rational, evidence-based investors, patience and discipline have historically delivered better outcomes over longer horizons, when prices inevitably converge to economic reality, a lesson many individual investors learned the hard way when similar trends played out in the tech bubble and crash of 2000.

Figure 3 | Amateur Traders Finally Beat Pros in Epic Stay-at-Home Rally

In a decidedly strange year, the world of active asset management was also turned on its head, as amateur individual investors—usually the ones underwriting alpha for the "smart money" Wall Street professionals—strongly outperformed the world's best money managers. According to data from Goldman Sachs, who tracked stock picks by retail investors, hedge funds, and mutual funds since mid-2018, the typical amateur stock trader's gains totaled over 80% in 2020, nearly twice the return earned by sophisticated hedge funds over the same period, and over four times the gain they might have seen investing in a mutual fund. That winning record stands in stark contrast to a –17% loss suffered by retail investor portfolios over the prior 18 months, versus a 17% gain for the pros.

Cumulative returns over various periods to different groups of US equity investors

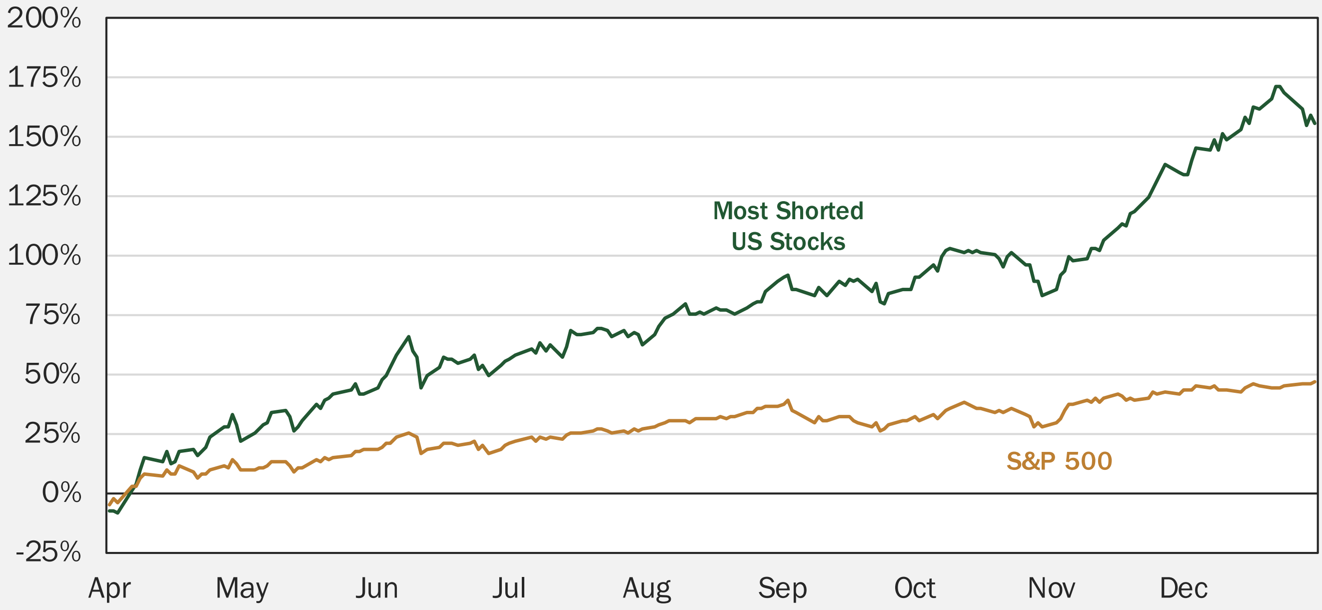


Source: Goldman Sachs, Bloomberg. Retail investors, hedge funds, and mutual funds represented by the Goldman Sachs Retail Favorites index, the Goldman Sachs Hedge Funds' VIP Stocks index, and Goldman Sachs Mutual Fund Overweight index, respectively.

Figure 4 | Bears Squeezed as Most-Shorted Stocks Crush S&P 500

Short sellers in the US betting equities had entered a bubble and that fundamentals would prevail in a difficult macro environment were sorely disappointed when stocks made a rapid bounce back from their March lows. Indeed, the most heavily bet-against shares were among the best performers in 2020. Data provided by S3 Partners suggest Tesla bears alone accounted for around $38 billion in short selling losses on the year, the most painful short squeeze by far. A "worst ideas" portfolio of US stocks with the highest short interest, tracked by Goldman Sachs, outpaced the S&P 500 index by over 100% in the last three quarters of 2020.

Cumulative percentage return, Apr. 2020—Dec. 2020



Source: Goldman Sachs, Bloomberg. Most shorted stocks represented by Goldman Sachs Most Short Rolling index.

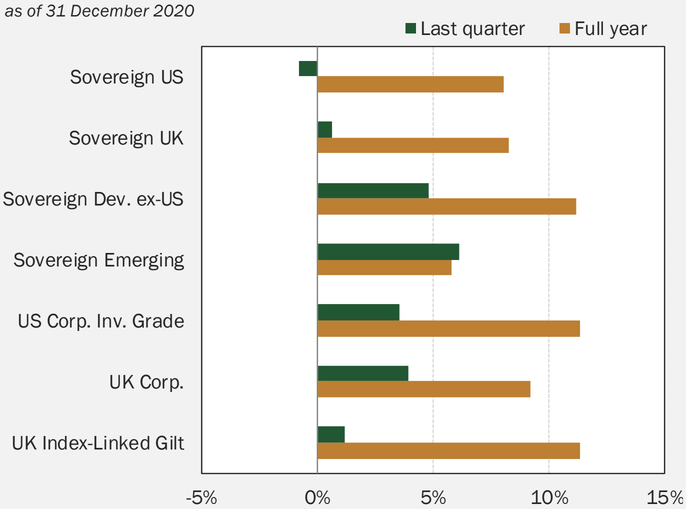
Fixed Income

Throughout 2020, the principal driver of bond market performance was policy stimulus to counteract the pandemic, leading to strong returns across the board for the year (see Figure 5). In Q4, hope that effective vaccines might speed a broad economic recovery led to a continuation of the prior quarter's "risk on" trend, favouring corporate credit over sovereign debt. In the US, Biden's victory led Treasury yields a bit higher in Q4, while across the pond, uncertainty surrounding Brexit weighed modestly on gilts. Overall, the upward pressure on rates from expectations for a faster recovery were tempered by continued central bank easing and signals that accommodative policy will be with us for some time to come. The US Fed met in December, committing to continue bond purchases of $120 billion per month, the Bank of England recently boosted its asset purchase facility by £150 billion, and the ECB expanded its budget for bond purchases by €500 billion.

One strange implication of massive and prolonged monetary stimulus has been a record accumulation of negative-yielding debt around the world, a sum that breached $17.5 trillion in market value at the end of December (see Figure 6). Over 40% of European investment grade bonds counted toward that total, including Portugal's debt—which, as recently as 2012, yielded in excess of 17% with CDS trading at an implied 70% fiveyear default probability. Even 30-year Treasury yields, although nominally positive, fell below zero in real terms in mid-June for the first time since at least 2004, leaving investors to look elsewhere for returns, usually higher up the risk spectrum. Unfortunately, even higher-risk junk bonds didn't offer much premium by the end of 2020, as central bank asset purchases, a surge of "fallen angels" with relatively good credit quality, and a thinning of the junk bond universe on the back of defaults triggered by the pandemic led to record-low yields among high yield bonds (see Figure 7).

Figure 5 | Fixed Income Market Performance

Returns as of 31 December 2020

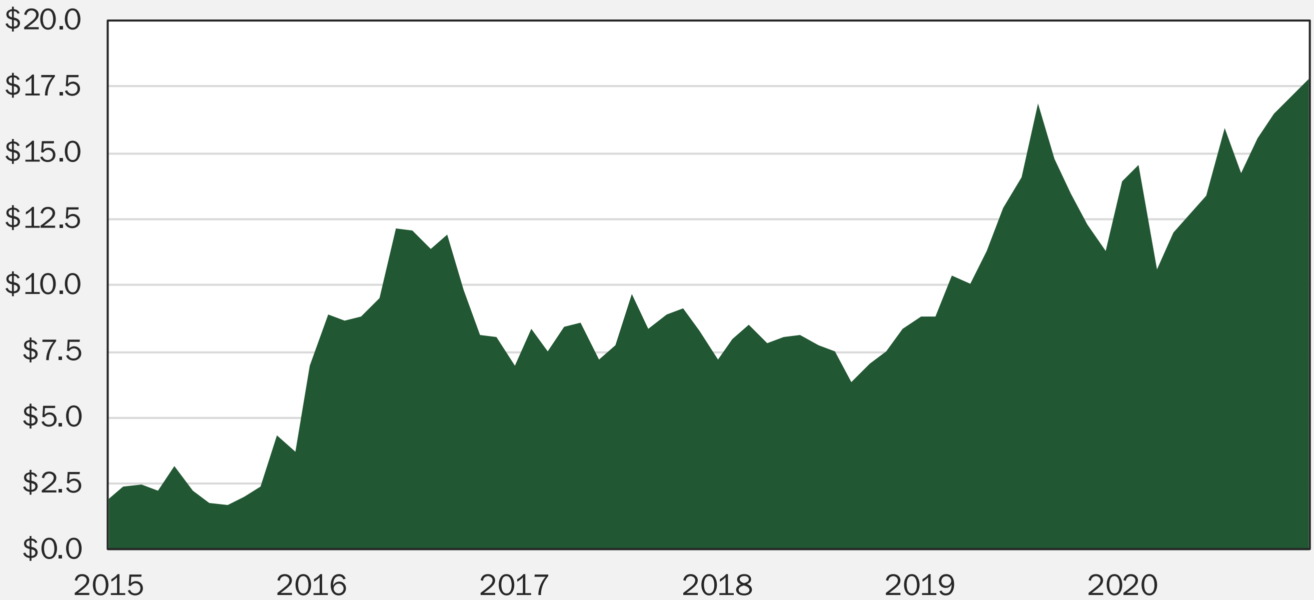


Source: Bloomberg, expressed in USD except for UK Gilts and UK Corporate in GBP.

Figure 6 | Stimulus Pushes Yield on Record Amount of Debt Below Zero

In response to a global economic slowdown, central banks around the world initiated massive monetary easing throughout 2020, pushing already-low rates down further. By the end of the year, global bonds with negative yield surpassed $17.5 trillion in market value. In European debt markets, over 40% of investment grade bonds offered yields below zero as of the end of December, while US 30-year Treasury real yields went negative in mid-June for the first time since at least 2004. Such conditions have weighed on bond investors struggling to hit target returns in an ultra-low-rate environment that many economists expect to persist for years to come.

Market value of debt with negative yield, trillions of US Dollars, Jan. 2015—Dec. 2020

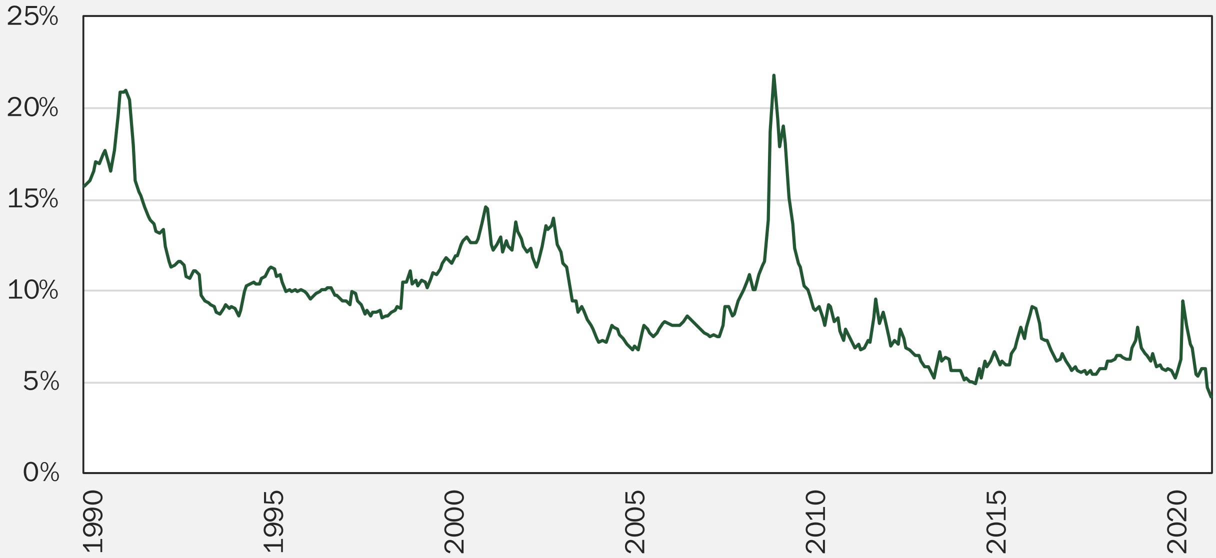


Source: Barclays Global Aggregate Negative Yield Debt Index via Bloomberg.

Figure 7 | Despite Distress Risk, Junk Bonds Offer Poor Premium in 2020

Bond investors willing to take a bit more risk for higher returns might be disappointed by speculative-grade bond yields, which dropped to record lows in the final quarter of 2020. Accommodative monetary policy, including central bank buying of corporate bonds, contributed to lower yields, as did a combination of some of the worst issues defaulting—thus exiting the pool—and a record volume of "fallen angels" entering the high yield category, both of which served to increase the average quality of speculative-grade bonds by year end.

Yield on speculative-grade US corporate bonds, Oct. 1989—Dec. 2020



Source: Bloomberg Barclays US Corporate High Yield Bond Index via Bloomberg, yield to worst.

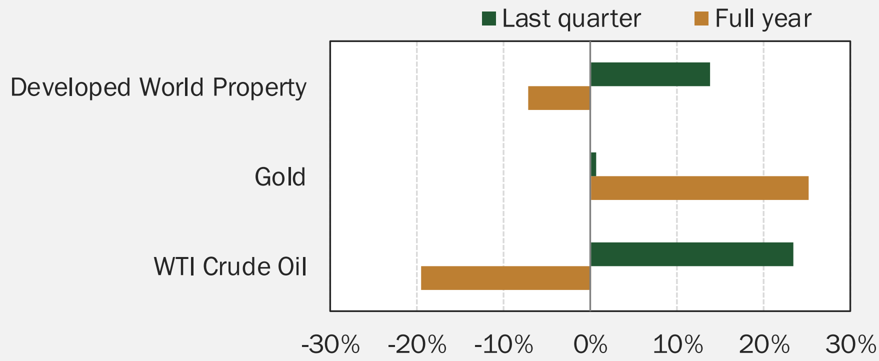
Alternatives

Commodities performed well overall in Q4, benefiting from the implications of vaccine progress for an economic recovery, a weak US Dollar, and robust demand from China. Industrial metals, agricultural commodities, and energy all posted good numbers to end the year. Oil was particularly strong over the last three months, with West Texas Intermediate crude climbing 23.4%, to finish the year down by only –19.7% (see Figure 8), after ending March with a –77.4% year-to-date loss. This comeback was a fitting conclusion to the wild ride energy investors took in 2020 (see Figure 9), kicking off in late March, when the global economic shutdown sent demand plunging and ill-timed conflict among OPEC+ countries kept output high. Agreement among producers in Q2, stronger demand from China in Q3, and promising vaccine developments in Q4 sustained gains in crude throughout the rest of the year. One commodity that didn't rally in Q4 was gold, essentially flat at the end of 2020, as vaccine optimism led investors away from safe haven assets and into riskier trades.

Like equities, property investments performed well in Q4, climbing 13.8% to finish –7.2% lower for the year, while some segments of the real estate market performed better than others. Indeed, similar to stocks, property investments experienced something of a rotation in the final months of 2020 (see Figure 10), with REITs hit hardest by COVID in Q1 (e.g., hotels and retail) posting the strongest numbers in Q4, while those supporting the stay-at-home economy (data centers and infrastructure) actually retreated on fears that a vaccine might interfere with prevailing themes benefiting properties associated with online retail. Although REITs gained back significant ground in 2020, many real estate investors ended the year with lingering doubts about the long-term effects the pandemic might have on certain parts of the market, including office and retail space. Data trickling out of companies' discussions with analysts have given credence to such concerns; Starbucks, for example, has observed a 25% decline in Manhattan's daytime population, while PayPal estimates two-thirds of the shift toward online retail will persist beyond the pandemic.

Figure 8: Alternatives Performance

Returns as of 31 December 2020

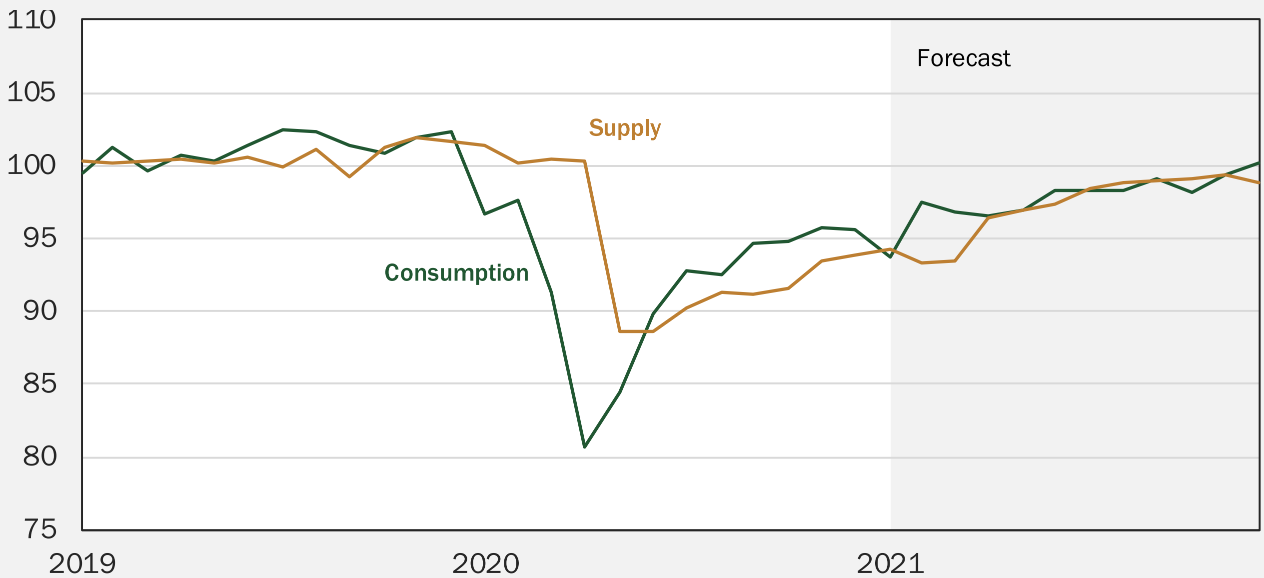


Source: iShares Int'l Dev. Real Estate ETF (USD), WTI Crude (USD), Gold Spot (USD) via Bloomberg.

Figure 9 | World Oil Demand Forecast to Fully Recover by End of 2021

Energy markets experienced historic disruption in 2020, as COVID's spread prompted a sharp drop in demand at the end of Q1 and supply-side frictions related to disagreement among OPEC+ countries kept output high despite plunging prices. The tide turned in April, with an OPEC+ agreement leading to record production cuts of nearly 12 million barrels per day in May, as well as stronger second-half demand from China and positive news on the vaccine front in Q4. At the end of 2020, economists expected worldwide oil consumption to reach pre-pandemic levels by December 2021, sending crude back above $50/barrel, a price not seen since early 2020.

Global demand/supply, oil and other liquid fuel, mil. barrels/day, Jan. 2019—Dec. 2021

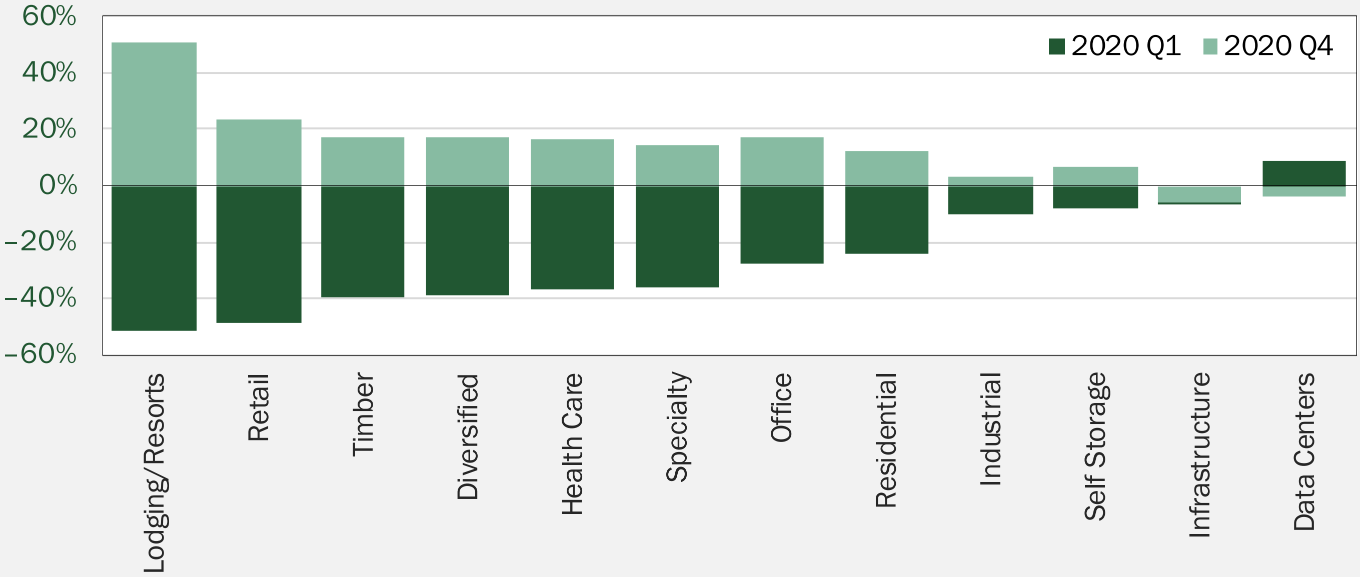


Source: EIA Short-Term Energy Outlook, published 12th January 2021.

Figure 10 | Vaccine Optimism Triggers Fourth Quarter Real Estate Rotation

Property bounced back to close out 2020, continuing a rally in REITs that began in Q2 and accelerated on successful vaccine trials announced in Q4. Despite that, REITs ended the year down, with investors concerned about the long-term ramifications of pandemic trends for real estate, including the hard-hit retail and office segments. Underscoring the broad rotation seen emerging as investors begin to factor a "COVID endgame" into prices, the worst-performing REITs at COVID's outset (e.g., lodging and resorts) saw the biggest gains in Q4, while segments that fared well as the economy moved to a stay-at-home footing (data centers and infrastructure) actually posted losses on news of a vaccine.

Cumulative returns over various periods to different segments of the US REIT market



Source: Nareit.

Looking Ahead

With the US election out of the way, there is some clarity on the path of US monetary and fiscal policy. With the Presidency and both Houses under their belt, Democrats can escalate stimulus measures with emergency jobless support extended beyond March and generous aid provided to states and local governments. Kamala Harris' tiebreaking vote in the Senate will make life easier for Democrat spending plans everywhere from infrastructure and clean energy to education, all assisted by higher taxes on corporations and the wealthy as well as ample printing. Expect double-digit budget deficits.

With world non-financial Debt-to-GDP now over 250% (China 280%, the US 286%, the UK 298%, France 363% and Japan 409%), inflation would be welcomed by high-spending governments everywhere—assuming they can achieve it. Equities tend to perform well when inflation is low, though profitability finds it hard to keep pace with rising input costs at high rates. When inflation expectations nudge up to around 3%, value stocks and cyclicals often benefit. But it is a dangerous road to go down. It takes time to get the inflation ball rolling, with employees, consumers, companies and investors all adjusting their expectations, and once in process it is not easy to stop. Trend changes are hard to detect early, much less predict ex ante, and although it may be we are not approaching a tipping point, there is a growing consensus that the days of deflation may be over.

Closing Comments

2020 has been a salutary lesson in the fallibility of forecasts, and making market calls on the basis of 'geopolitics'—fascinating though it is—generally turns out to be a good way for investors to lose money. But it is still worth noting what is going on with a view to looking for opportunities and dodging pitfalls. Despite evidence-based investors with a systematic, fundamental perspective lagging the Robinhood crowd in 2020, those with an eye toward the future will have been paying attention to disruptive trends in technology, emerging changes in investor appetite in sectors like resources, commodities, and infrastructure, as well as conditions that could eventually promote a higher rate of inflation. Building strategies with diversified exposure to factors and investment themes like these offers investors the best chance of capturing a rotation when it occurs, while avoiding the perils of trying to perfectly call a year like the one we've just had.

Key Economic Releases and Events for Q1 2021

UNITED KINGDOM

Bank of England Official Bank Rate Release:
4th February, 28th March

PMI Figures:
22nd January, 19th February, 24th March

EUROZONE

YoY GDP:
2nd February, 9th March

PMI Eurozone:
22nd January, 19th February, 24th March

Unemployment Report:
1st February, 4th March

ECB Monetary Policy Meeting:
21st January, 11th March

UNITED STATES

FOMC Rate Decision:
27th January, 17th March

GDP Figures:
28th January, 25th February, 25th March

PMI Figures:
3rd February, 3rd March

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