OBSERVATION

1th QUARTER 2021

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AFTER THE RAIN…

…and it certainly rained last year. We all had to adapt to a new normal as life effectively came to an abrupt halt.

Last year we saw an unprecedented and historic caseation to economies as consumption stopped, investment was put on hold and trade died. It was the equivalent to the announcement of war where at a specific date and time expectations, habits and normality change.

As this team of authors and editor report our thoughts to you we are all still under a form of lockdown working from home. We are probably in the eye of the storm as we put this report together. Winter is here, levels of sunlight are low and populations are in a lockdown awaiting the vaccine rollout. Setbacks are to be expected but markets in 2020 began to clearly look through the headlines and do what they do best, look forward.

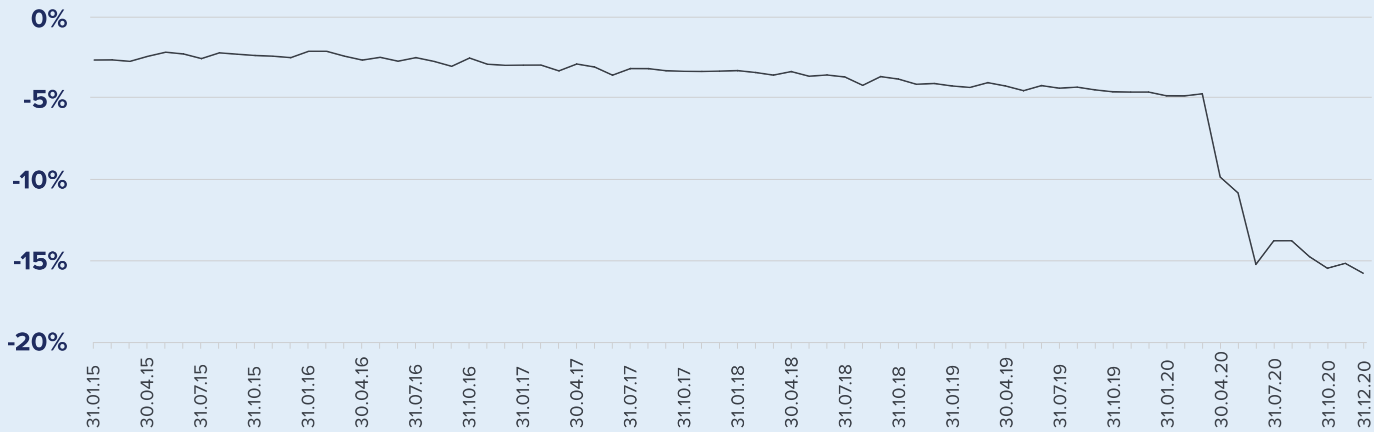
The key driver which we continue to discuss is the money supply and what that means for assets.

With the impact on markets last year, Central Banks unleashed a wave of stimulus under various guises designed to bring liquidity back to markets. It was successful with e.g. the Fed buying corporate bonds or the Bank of Japan buying ETFs. This liquidity has caused the asset inflation since the summer and is likely to continue to drive markets higher this year.

2021 will continue to see improvement. Political volatility will certainly fall albeit for Europe the German elections in September will be important. Brexit has been agreed upon which has benefitted our overweight in UK mid cap stocks. In the US the Democrats have control of the agenda in the Senate with several key Republican seats up for re-election in 2022 which will force those Senators to the negotiating table.

Biden inherits a divided nation, a pandemic, unemployment, income inequality and a squabbling and inefficient Congress. He has pledged to increase taxes, regulations and make green energy a key goal of his administration. California and Massachusetts have already enacted targets to ban sales of gasoline vehicles by 2035. China and Japan have

US budget deficit as % of GDP



Sources: Bloomberg

similar with the UK aiming for 2030. The EU will announce in June a package of climate bills towards its 2030 targets. Biden is likely to push the US further along this path, perhaps even into the vanguard. The price parity between internal combustion engines and EV lithium-ion batteries is forecasted by 2023. This is a trend that is very unlikely to be diverted. How he handles China will be key, although it's likely a lot less combative than President Trump, it's a bipartisan issue.

Economically we saw a large hit to growth which has, to date, seen a near V shape trajectory. The time lags are varied and it's likely that we continue in the coming quarters to see higher growth data before an element of mean reversion occurs and the data goes back to «normal».

When lockdowns end there will be a near tsunami of spending.

Savings rates for individuals and businesses are at elevated levels. Travel and holidays have been curtailed, new car purchases postponed, new investment in plant and equipment delayed. This will likely be a one off phenomenon as lockdowns cease and vaccination becomes more main stream. This combined with ample liquidity can see a growth spurt continue and a rebound in earnings albeit all from depressed levels.

Global trade will continue to pick up and excess liquidity pushed into more asset markets in more jurisdictions which should continue to benefit our overweight position in Japanese stocks.

In the near term however joblessness remains elevated which is a distinct headwind to consumption.

The threat of a US lockdown with the new administration is high which would be a detriment to US economic data going forward. Jobs will take years to recover, likewise air travel, restaurants and commerce etc. Many areas will be permanently lost and indeed many areas were slowly dying well before the virus. Time will tell. In the meantime, stimulus in the form of fiscal policy will need to remain and indeed Biden has spoken about this. Consumption is 70% of growth and with 25 million people unemployed, allowing them to pay their rent and medical bills whilst keeping them in the available workforce is important, especially for the Democrats.

However, increased spending combined with lower tax revenue is causing the budget deficit to explode to war time levels. This just means the US is issuing more and more bonds which are bought by pension funds, insurance funds, sovereign wealth funds and nation states. This should continue to weaken the US Dollar, something we have been positioned for since the end of last summer.

The pressure on the Dollar hasn't just been coming from excessive US spending. There has been a strategic move from many emerging market sovereigns away from dependence on the greenback. Russia, many middle Eastern states and, of course, China are slowly but surely making the transition. China has just signed a free trade deal with Japan, South Korea, Australia and 15 other ASIA Pac countries. All trade is in either local currencies or the Yuan.

2021 is likely to be a solid year in terms of growth which should push earnings higher.

The USD should continue to underperform and hence increasing equity allocations will flow into non US assets. Assets that are finite in supply will continue to perform against a backdrop of ongoing stimulus and loose financial conditions. Although political risks have diminished, economic risks remain and the path of main street will be a lot more sedentary than the path of wall street.

EQUITIES	LAST PRICE	YTD %
S&P500	3750.77	-0.14
Eurostoxx 600	395.00	-1.01
SMI Index	10723.39	0.19
Nikkei	28197.42	2.74
China A shares	3674.12	0.92
Brazil	115882.30	-2.63
India Nifty	13788.30	-1.38
Russia RTSI$	1370.95	-1.19
MSCI World Local	2018.04	0.40
MSCI EM Local	76589.4700	6.83

COMMODITIES	LAST PRICE	YTD %
Crude Oil	52.38	7.96
Natural Gas	2.64	3.94
Gold	1837.60	-3.03
Silver	25.25	-4.40
Copper	350.05	-0.53
RICI Global	2349.88	3.72
RICI Agriculture	918.60	3.70
RICI Energy	225.60	6.87
RICI Basic Metals	1335.07	0.14
RICI Prec. Metals	2367.49	-3.46

FIXED INCOME	LAST PRICE	YTD %
US Govt	445.61	-0.65
EU Govt	261.49	-0.38
US IG Corp	3526.07	-0.97
US HY Corp	2345.43	0.32
EU IG Corp	155.94	0.04
EU HY Corp	422.89	0.64

CURRENCIES	LAST PRICE	YTD %
Dollar Index	90.7240	0.88
Euro	1.2109	-0.88
GBP	1.3642	-0.20
Yen	104.3100	-1.02
AUD	0.7601	-1.21
CHF	0.8896	-0.49
Brazil Real (BRL)	5.4106	-3.92
Turkish Lira (TRY)	7.3739	0.90
India Rupee (INR)	73.0775	-0.02
China Yuan (CNY)	6.4750	0.81
JPM EM FX	57.1820	-1.32

As of January 28, 2021

BONDS TO UNDER-PERFORM STOCKS

The ten-year US Treasury yield halved with the onslaught of the epidemic last year as investors sold risk assets into safe havens. Ten months on the situation has changed.

Budget deficits in the US have literally exploded to war time levels of borrowing relative to growth. A mountain of debt across government, corporate and consumer balance sheets pre-virus remains and now potentially needs to be refinanced. What now for bond yields looking forward?

Growth continues to paint a V-shaped picture.

Many economies remain under strict lockdown and the data will be weak however global trade continues to recover. Inflation is the biggest enemy to bond investors receiving a fixed interest rate. The epidemic is curtailing global supply lines and we are seeing corresponding price increases across various commodities. This will likely last until economies open up. In the meantime, the picture for inflation will remain murky with time lags to the data.

Central banks have been seeking higher inflation for over a decade to help erode the mountains of debt that exist globally. To date they have been unsuccessful. Disinflationary forces exist given the amount of debt, demographics and technology. Add in the increased output gap from last year and heightened job losses then wages are unlikely to be forced higher.

Bonds are therefore likely to be very aware of either any demand or supply driven increases in inflation. In this environment combined with the deficit and a new President who is likely to keep spending, bonds will likely remain under pressure with the curve periodically steepening. It's possible for the market to price in a rate hike but very unlikely for central banks to enact.

However, in a world of few safe havens government bonds will periodically see demand as risk assets stutter. Increasingly, too, we may see the Fed step in to control yields given the refinancing needs of the US Government and the impact rapidly higher yields would do to risk markets.

Sources: Bloomberg

AT LONG LAST OK FOR THE UK

The UK equity market and, to a lesser extent, the overall European market have suffered from the last four and half years of uncertainty created by the Brexit referendum. This long and sometimes chaotic story came to a close at the end of last year.

2021 is Year One of the UK being out of the European Union. Despite the deal, Brexit will have a cost for the UK economy, as the Bank of England's governor recently warned. However, it will improve visibility for households, corporates and investors and thus support a return of inflows to UK equities chasing the current discount.

The new strain of the virus caused the UK to go back into lockdown, as the number of cases increased strongly. This will clearly delay the recovery and increase the cost to the UK economy in the short term. However, the good news, in our view, is that the vaccine seems to be effective against this new strain and the UK is one of the leaders in vaccine development in the Western world.

The relative valuation of the FTSE100 index compared to US equities is back at an all-time low (a 36 % discount, last reached during the Great Financial Crisis). Probably a consequence of different sector composition (more commodity-linked and banks stocks in the UK, more tech in the US). This discount pushed us to increase our exposure to UK stocks in December last year.

Sector wise, late last year we also decided to upgrade the energy sector to overweight. Even after the recent bounce, Energy has still underperformed by 30 % over the last year. In terms of relative valuation, the sector trades at levels last seen in the 1980s.

Another area we have favoured when implementing a reflation trade several months ago was into US financials. With markets looking through the Covid crisis and anticipating a reopening, the economic growth forecast is pushing long term rates higher, forming a steeper yield curve that typically benefits the sector. Add to that reserve releases given too cautious provision building last year, as well as a resumption of share buyback activity, and you get a recipe for a rebound. That trade may not last very long but is worth playing.

FTSE 250 Index (rebased to 100)

MSCI USA Financials Index (rebased to 100)

Sources: Bloomberg

THE TIP OF THE ICEBERG

2020 saw Bitcoin rally over 300 %. Comparing this to other assets, deemed by many to be also in a bubble, Tesla rose over 700 %.

Having a portfolio of 5 % Bitcoin and 95 % cash last year would have outperformed the S&P500. Debate rages often along demographic lines as to whether this 'new kid on the block' is the next revolution or a bubble waiting to find a pin. Currently one Bitcoin will cost you $38 210. One stock of Berkshire Hathaway «A» will cost you $350 000. Both have limited supply much like e. g. Zurich lake front properties.

Bitcoin has a limited supply of 21 million coins and given many have been lost over the years that number is likely closer to 18 million coins. These are 'mined' via a set schedule not set to expire till the middle of the next century.

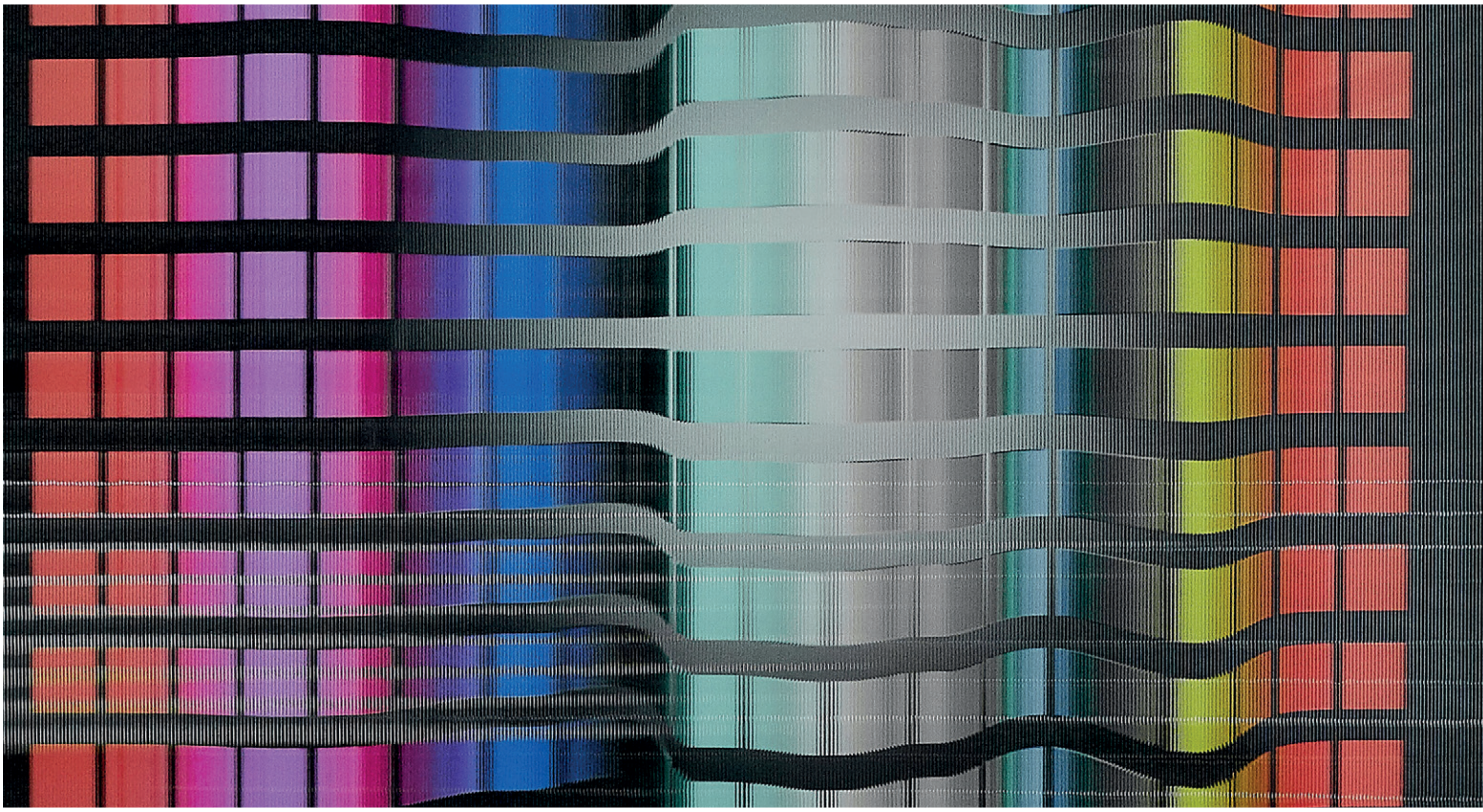
The writer first bought a Bitcoin back in 2014. A confessed Gold bug the same similarities were clear in the new digital asset. Since then demand has been driven by retail investors often trading outside the financial system. Financial products have found it hard to gain regulatory approval and extreme volatility, at times, hasn't helped. But it's a young asset and scepticism naturally abounds along as understanding lags.

However, we saw last year news flow that is turning a retail product into an asset accepted by institutions. This a game changer and should keep the price trajectory upwards.

Microstrategy is a NASDAQ listed software company who have added Bitcoin exposure as part of their treasury management. Indeed, they have issued debt to buy more exposure with stated concerns about the erosion of the company's balance sheet cash. Perhaps the most bullish piece of news was an insurance company (MassMutual) adding exposure. Insurance companies are some of the most regulated and hence cautious financial institutions. They will have, behind the scenes, asked for formal permission to add this exposure and how the regulator would want to account for it in terms of risk budgeting. Since MassMutual two other US insurance companies have followed. The regulators have said yes and more will do the same. The returns from money markets are

Bitcoin price in $

Source: Bloomberg



zero, fixed income is in the 1–3% range, stocks are deemed a risk asset and the US dollar is going down.

Other drivers included various hedge fund purchases, again regulated managers purchasing the asset. Guggenheim and JPM were both out with various guesstimates of where the price could go. The Guggenheim CIO believes a price target of $400k can be expected and JPM went into more detail estimating that a 1% allocation to portfolios would see $600bn of demand.

One American Football player has had half his $13m a year salary paid in Bitcoin. Standard Chartered have begun a crypto trading business and American Express have bought a crypto firm called FalconX. S&P announced they would begin specific crypto indices this year. CME announced the start of Ethereum futures next month. Ethererum is another crypto coin which acts more like the internet i.e. a platform.

All these examples are small steps away from the rejection of Bitcoin. However, regulators haven't accepted all coins.

Ripple has come under scrutiny from the SEC and indeed more stringent KYC regulations have also been announced. For true adoption regulations have to increase which allows more financial funds to open up Crypto to mass adoption. At this time most coins are still only accessible via exchanges and self-custody. This process is reasonably easy as your author is able to do it! However, the degree of trust and knowledge takes time and there is nobody to call if you make a mistake.

Bitcoin is the tip of the iceberg. This industry is new but the steps to mass adoption are being made. As I have highlighted we have turned a corner in the evolution of Bitcoin. Risks clearly remain. The regulatory environment is fragmented and various nations have banned their use. However, Bitcoin, especially, is a decentralized asset and if Europe comes out and bans its use, it will simply transfer to another region. Switzerland has embraced it. There are several financial products which allow exposure in Bitcoin or Ethereum or other coins.

The macro environment is very supportive for such assets.

Central bank liquidity as described in other articles is the dominant factor in markets and likely to cause continued asset inflation. What better as set than something that exhibits limited supply and can't be copied or printed. Equities are an example albeit clearly management can issue more. Gold is another as is fine wine or classic cars. The change and evolution that is coming via these coins and block chains is not fully understood, much like the change the internet brought. One new exciting US based company has introduced zero cost global instantaneous money transfers using the Bitcoin block chain. I can send CHF to Australia in AUD this very hour for zero cost. Clearly the world is changing.

PASSION

CONTRIBUTORS

Jean-Christophe Rochat, CIIA
Jack Loudoun
Michel Mazenauer, CAIA
Mikaël Safrana, CIIA
Stéphane Trezzini

EDITORIAL

Nik von Guérard

DESIGN

Now Werbeagentur AG
Basel, Switzerland

PHOTOGRAPHS

Patric Pop

HERITAGE.CH