OBSERVATION

2nd QUARTER 2021

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BULLETPROOF BUT CHANGE IS AFOOT

Even when bad news should have startled the market, it just wouldn't care.

Since the first vaccine news back in November, markets have been bulletproof. A risk-on/reflation narrative has developed pushing stocks and commodities higher and leaving bonds weaker. The vaccine news has been mixed since then with several vaccines even being blacklisted. New strains have developed but the market just hasn't cared. The collapse of a hedge fund in late March and the subsequent significant losses at several globally systemically important banks did nothing to trouble this bull market either.

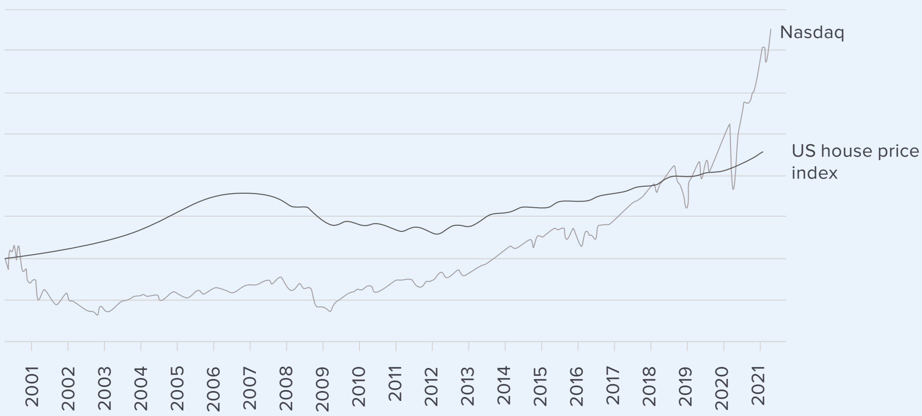
The underlying tailwind remains the ample provision of global liquidity by central banks and in particular the US Federal Reserve. Since the GFC in 2007/2008 monetary policy has been exhausted. Globally interest rates are either negative or zero with ongoing buying of government, corporate, mortgage and agency bonds.

Just as negative interest rates have been a failed experiment, the efficacy of monetary policy is now, too.

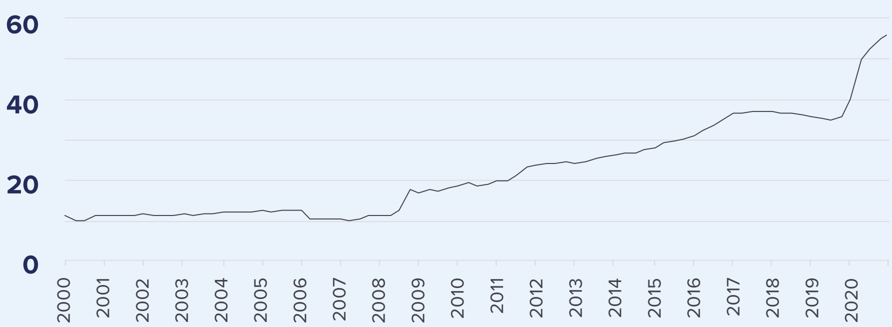
Japan is a prime example with decades of experimenting and nothing more to show for it than sub-par growth and inflation. Perhaps that is a positive result in itself.

A combination of Trump and Covid has brought on the last remaining «bullet» – fiscal policy. For years, successive ECB presidents have been calling for individual governments to do more and that monetary policy, which they were responsible for, was only one side of the equation. The advent of Covid has unleashed fiscal policy in terms of increased spending and/or lower taxation. The US have been sending out cheques to US citizens since April last year with another $1.9trn package just signed off last month. These are tremendous boosts to consumption which will be either saved or spent. With consumption being around 70% of GDP this stimulus is helping those who are jobless from the aftermath of the Covid lockdown survive. However fiscal policy is a blunt weapon and everyone is being sent these cheques irrespective of the effect Covid has or

Asset inflation – Nasdaq & US housing



G4 Balance sheet expansion as % of GDP



Sources: Bloomberg

hasn't had on their lives. Central bank digital currencies, when they arrive, will solve this bluntness albeit they also bring an unprecedented level of control. Infrastructure spending with a focus on clean energy is the next bullet coming from the Biden government in the US and a key focus already in Europe (we explore the topic of green energy in the last article in this publication). There has even been repeated rumours of cancelling student debt in the US.

The impact of all this is asset inflation, whether it is in classic car prices, bitcoin or the NASDAQ. The cost is a US budget deficit, as a percentage of GDP, that is at levels last seen after the Second World War. Budget deficits are expanding everywhere. This is one reason why we are seeing bond yields increase (prices fall) as the supply of available bonds expands dramatically. This has ramifications in that governments still need to be able to service this debt. Higher yields too are a potential problem to equity markets. The Fed are keenly aware of this and it is likely some kind of yield curve control would be introduced IF yields move too far, too quickly.

This experiment has been tested by the Japanese, currently by the Australians, and arguably since 2021 by the Europeans.

This dynamic is far from healthy for one's currency. The situation however is now common place and with rampant borrowing and spending it's a race to the bottom in currencies. Currencies are a zero sum game given they are quoted against each other. This is outright debasement in an attempt to reduce the debt burden. Taxation and inflation are the other routes of dealing with this excess level of debt. Taxation is coming after the Covid economic situation finally stabilises, and inflation has been on the central bank wish list for well over a decade. The USD will likely remain weak and fall over the medium term, given the spending dynamics in the US, with increased asset inflation being the most likely scenario. Indeed, the medium-term view for stocks remains positive as an escape valve for the liquidity being pumped into the system.

Inflation has been the dog that hasn't barked and we will go and discuss this more in our fixed income section.

More structural change is the only constant. We are experiencing a lot of change which will have an impact on our investments. Covid perhaps has accelerated some trends and/or re-focused our own beliefs in what is and is not important. But taking a step past this issue there are key drivers. Fiscal policy looks to be taking over from monetary policy and meets an increasingly polarised political situation and social turmoil with inequality concerns. Demographics continue to have a huge impact, which with a long-term view will benefit the US at the expense of China. Digitalization is a trend accelerating at an immense scale taken up by new generations as the new normal. Politics additionally looks to have turned around globalization. Jobs will return to e.g. the US from the Far East as well as technologies and raw inputs too.

Climate and green energy are becoming central pillars of government policy.

New Zealand has added this requirement to their central bank in adjusting interest rates. The share of electric vehicles is increasing, but so is the number of coal-fired power plants producing their electricity. How sustainable this all is is open to endless debate.

Looking into the rest of the year we believe asset inflation will continue. The robustness of the market will likely be tested but the fiscal policy path looks likely to be increasingly permanent. The USD is key and could see non-US markets outperform.

EQUITIES	LAST PRICE	YTD %
S&P500	4163.44	10.85
Eurotoxx 600	438.45	9.88
Nikkei	29020.63	5.74
China A shares	3641.47	0.03
Brazil	120364.50	1.13
India Nifty	14341.35	2.57
Russia RTSI$	1508.97	8.76
MSCI World Local	2196.96	9.31
MSCI EM Local	75253.6600	4.97
SMI Index	11172.98	4.39

COMMODITIES	LAST PRICE	YTD %
Crude Oil	62.27	28.34
Natural Gas	2.75	8.35
Gold	1772.00	-6.50
Silver	25.97	-1.67
Copper	432.60	22.93
RICI Global	2680.67	18.32
RICI Agriculture	1040.45	17.45
RICI Energy	265.27	25.66
RICI Basic Metals	1534.26	15.08
RICI Prec. Metals	2426.64	-1.05

FIXED INCOME	LAST PRICE	YTD %
US Govt	2474.93	-3.60
EU Govt	257.13	-2.82
US IG Corp	3442.75	-3.31
US HY Corp	2378.69	1.74
EU IG Corp	264.85	-0.51
EU HY Corp	355.02	1.87

CURRENCIES	LAST PRICE	YTD %
Dollar Index	91.0490	1.24
Euro	1.2052	-1.34
GBP	1.3844	1.27
Yen	108.1100	-4.50
AUD	0.7728	0.44
CHF	0.9163	-3.39
Brazil Real (BRL)	5.4873	-5.35
Turkish Lira (TRY)	8.3738	-11.15
India Rupee (INR)	75.0175	-2.60
China Yuan (CNY)	6.4961	0.48
JPM EM FX	56.8550	-1.89

As of April 23, 2021, Intraday

CAN EUROPE CATCH UP ?

Vaccination delays have slowed Europe’s recovery but it will not derail it.

The European pace of vaccination is set to significantly accelerate into the summer with an easing of lockdowns and positive contagion from the global recovery. The cash coming from the EU Recovery fund should provide an additional boost. This could push Eurozone investment excluding construction as a share of GDP, over the coming four to five years to a record high of 14%, around the levels seen in the US.

Eurozone competitiveness has been lagging for years. However, things are looking up.

European equities have underperformed global equities (total return) by more than 70% in local currency terms over the last decade, mainly because U.S. equities have had a stellar performance, up almost 300% in 10 years. The US Dollar will remain a key driver but cheaper valuations matter too. Europe is ahead of the curve in the «green revolution» but politics is changing with Merkel, and likely Macron exiting the stage.

The US is at a more advanced stage in the reopening process thanks to its more aggressive vaccination campaign and stimulus packages. Its equity market is at all-time-highs with a lot of good news priced in. To further boost the recovery President Biden recently unveiled an Infrastructure Plan, targeting transportation, domestic manufacturing, housing access, additional home care, and modernizing water, electric and broadband systems. To finance these investments an increase in corporate taxes to 28% is proposed, but this is likely to be the subject of significant negotiation, and a 25% level is already rumoured to have more chance. This package, and others to come, only add fuel to the reflation trade favouring the more cyclical and value areas of the market.

How much is already priced in remains the big question.

Therefore, we continue to favour our overweight in Energy, Financials and Healthcare. We have however upgraded Staples to Neutral as a first step to get ready for the next market phase where quality as a factor might be more prevalent.

MSCI Europe vs. MSCI USA

Sources: Bloomberg

INFLATION KILLS BOND RETURNS – WHAT NEXT?

The effect of the anticipated rebound in consumption is all about timing

Government bonds have struggled so far in 2021 as growth and inflationary expectations have increased and further fiscal policy expansions pushed budget deficits to keep rising. The ten year US treasury yield has doubled since the summer, currently around 1.6%, as stock markets keep hitting new highs. Non-US bonds have performed better but the path of US Treasuries remains one of the most important inputs to global market valuation.

For bond investors inflation remains the single most important potential headwind to bond returns, given the fixed rate nature of coupons. For the last thirty years, inflation has consistently fallen, and with it interest rates culminating in a tremendous bond market rally obviously helped too by central bank buying of government, corporate, agency and mortgage bonds. But what next?

There is a lively current debate as to where inflation is going next.

Over the next few months, inflation and price inflation will rise due to base effects.

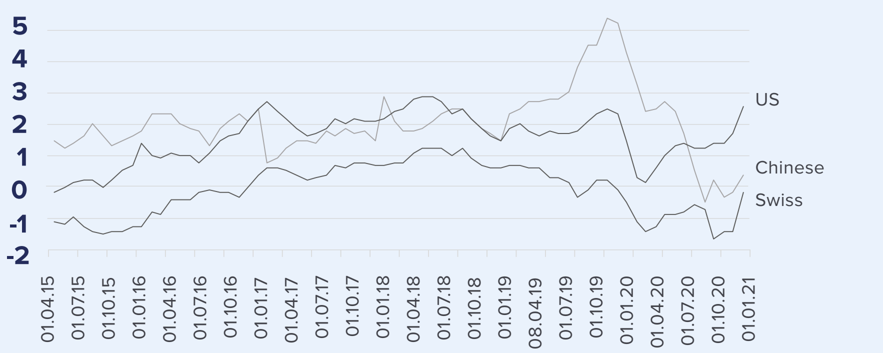
At the same time, it is hoped that lockdowns diminish and economies open up. This should ease price pressure on the supply side. Commodities have had a very strong 2021 and input prices have obviously increased.

However, economies are only starting to recover from the demand shock of last year when lockdowns first came into place. Indeed, much of Europe as we write remains in a lockdown. Employment and hence consumption have both been hit and it will take time for normality to return. Therefore, until wages can bounce back strongly and output gaps close it is unlikely for inflation to threaten going forward to any significant degree.

There are government changes which can stimulate the demand for credit but the time lags across economies still coming out of lockdowns are long.

So we see continued underperformance of bonds versus other assets, but we believe that rampant inflation is unlikely and hence bonds have seen most of their selloff for the time being.

US, Swiss and Chinese CPI yoy%



US 10yr Treasury yield

Sources: Bloomberg

THE REVOLUTION IS HERE

A revolution is here, and for once Europe is leading it.

A green revolution, to be precise, and things have come a long way since the 1992 Kyoto protocol. While most accords in the past focused on emissions and pollution targets without clearly stating the path to reach these goals, the European Union's Green Deal is the first policy-oriented effort and will be a strong engine of economic growth in Europe. It stems from the Paris agreement of 2015 and a zero net carbon emission target by 2050.

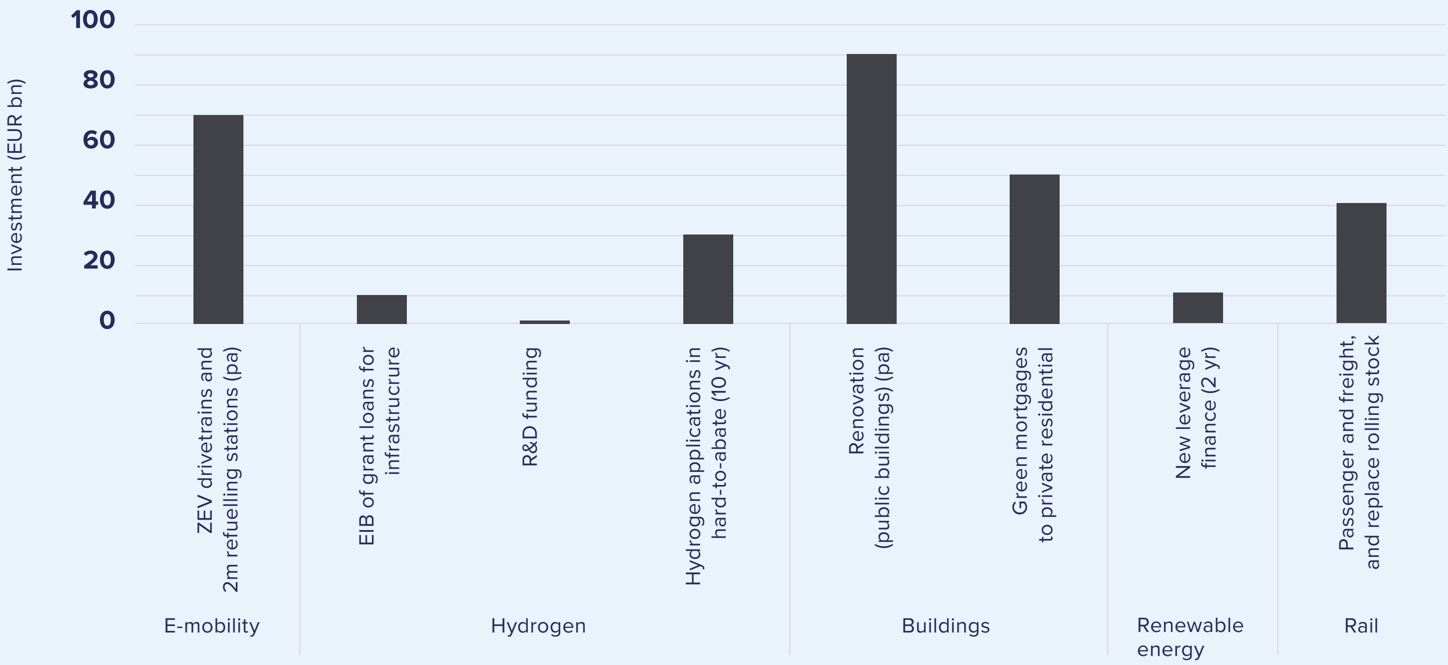
It further links real economy efforts with financings and investments, devising a taxonomy on sustainable finance. Its aim is to offer a classification system for both companies and investors for the disclosure of green initiatives, fostering transparency and readability. In practice, companies will be required to disclose their financial exposure to green business activities while investors will be required to disclose their taxonomy alignment for financial products or explain why this taxonomy was not utilized. Ultimately, this should help direct investments towards projects which will allow for the Paris agreement goals to be reached.

Interestingly, the health crisis has helped the Green Deal as 30% of the funds disbursed through the €750bn Recovery Fund and the €1.1trn Multiannual Framework Fund need to comply with the EU climate neutrality directive.

It is de facto the biggest green stimulus package in history.

Furthermore, big oil companies are also transitioning, understanding the unsustainable nature of their current business models. The rebranding of Total into «Total Energies» is a clear sign of the diversification into renewables to come. Notably, the Fuel Cell and Hydrogen Joint Undertaking

Planned investments per sector



Source: Kepler Chevreux

aims at launching mega-projects by bringing together stakeholders in a bid for efficiency.

It is important to note that both China and the U.S. are joining in on this action but their roadmap is much less clear, facing hurdles which have already been overcome on the old continent. China has indeed restated its plans to reach carbon neutrality by 2060 but one may wonder if generating the required electricity for its massive fleet of electric vehicles through coal plants isn't purpose defying in nature. Similarly, the Biden administration has made clear its renewed commitment to the Paris agreement and its intentions to roll back more than 100 environmental regulations weakened by President Trump, but will it get congressional support?

In searching for investment opportunities underpinned by the European Green New Deal, it is paramount to identify which economic sectors will benefit most for the roadmap laid ahead.

First, the Commission aims at doubling the renovation rate of EU's building stock to 2% per year. Buildings account for 36% of energy consumption, with an average consumption of 250kWh/m^2 which could be brought down five-fold for the most efficient units, some even being energy-positive. This represents a €90bn investment and should trickle down to the rest of the economy as renovations are very labour intensive (60% of costs).

Second, e-mobility will be encouraged through subsidies such as no VAT on clean vehicles or infrastructure spending looking to bring the number of charging stations to 2mio by 2025. This e-mobility initiative should deploy €60–80bn per year and be complemented by funds targeting specifically rail transportation, renewable energy production and other green infrastructure developments (smart grids, etc.). Further measures, more restrictive in nature, will also be put in place in order to motivate a switch to clean transportation means in the form of taxes on polluting vehicles, city-centre bans, etc.

Within this effort, hydrogen represents a very promising way ahead and its use could rise by a factor of 10 between now and 2050.

By then, it could represent a saving of 13% of emissions at today's levels. Its potential has been known for decades but production costs remained too high. New greener hydrogen production technology could bring them down to 25% of their current levels by 2030, making hydrogen a viable solution for hard-to-electrify usages, alongside other clean gases and fuels. A new industrial ecosystem will emerge, attracting a variety of companies and technologies.

It is seldom that Europe stands at the forefront of a major industrial or technological revolution. This has been the case for several decades. But the socio-economic inclination of most European countries that many argue has weighed on its competitiveness (social net, high wages, strong labour rights, focus on well-being), may prove the region's greatest strength in tackling this new phase of economic development.

EMOTION

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