OBSERVATION

3rd QUARTER 2020

HERITAGE.CH

IS IT DIFFERENT THIS TIME?

The famous American-born British investor, banker and fund manager Sir John Templeton, much like Warren Buffet, has left us many quotes regarding markets and investing. In one of them he identified "this time it's different" to be the four most dangerous words in the field. Here is our take on the situation.

The outlook for the rest of the year remains far from transparent. The uncertainty on the economic, political and social fronts heightened, near crippling and splintered. The impacts which are only just being felt have been historic, unprecedented and immediate. Economies and society have literally stopped dead in their tracks.

Job losses on a scale last seen during the depression of the 1930s has brought home the reality of the situation.

These job losses, shutdowns, social distancing and fear of an unseen threat to life meet an election in November where polarized voters and parties come together in a world of fake news and an undercurrent of social issues.

In response to the shutdown, central banks and Governments have moved to support markets with huge bouts of stimulus propping up consumption and confidence. The direct impact on the economic data is slow, lagged and given the size of the shock, makes economic predictions largely impossible and certainly pointless. However, global markets have reacted swiftly. The degree and reach of various national schemes and packages boosting and unlocking illiquid markets has seen markets move to price in a V shape recovery. The mantra of "don't fight the Fed" (or any other key central bank) has returned with a fanfare.

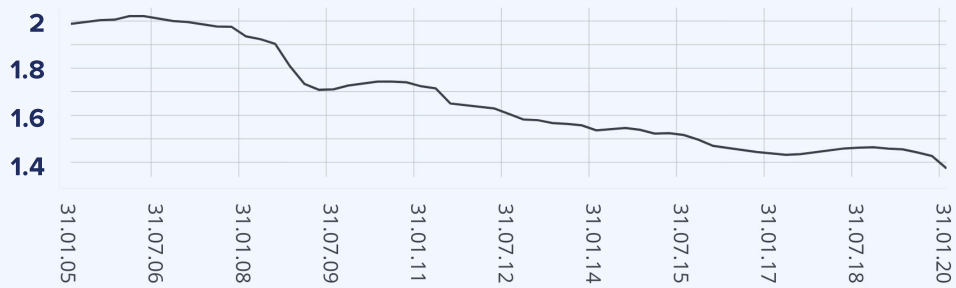
The alphabet soup of various permutations of the growth recovery are constantly changing. In this environment of uncertainties, we remain steadfast in our belief of running diversified portfolios to combine capital preservation and market rebound participation. There is no crystal ball in these uncertain times and hence as well as running portfolios in a prudent manner we like to look at what-ifs.

One what-if is whether we begin to witness the return of inflation, a variable that has been absent for decades.

Ultimately inflation could make redundant the whole notion of worrying about a W or U shape recovery.

Since the 1980s we, as investors, haven't had to worry about inflation – except maybe in some emerging or frontier market s. We worried after the global financial crisis (GFC) that QE was inflationary and that a new era was upon us. As mentioned, Sir John Templeton claimed the four most dangerous words in investing were "this time it's different".

Velocity of Money



The chart shows the ratio of the nominal GDP to a measure of the money supply M2 and it describes the rate of turnover or the number of times a dollar is used to purchase final goods or services included in the GDP itself.

Sources: Banque Heritage, Bloomberg

The Banque Heritage investment team respect that quote but don't want to be blinded by it. Systemic changes happen only once or twice in a career but they do happen.

The world and in particular the West is awash in debt and the epidemic has accelerated the accumulation of even more debt on government balance sheets to historic levels. Governments need inflation to erode their high debt to GDP ratio as clearly the last ten years have shown that they can't generate growth and nobody is ready and willing to have a debt jubilee.

To get inflation we need two things. Firstly, increasing money supply and secondly an increasing velocity of that money around the system. We are 50% of the way there. Money supply is increasing to unprecedented levels easily surpassing the increases post the GFC. However, the velocity of money has been going the other way. Cash has not been circulating, it's been sitting in commercial and central bank accounts doing nothing.

Ingrained within all this are inflation expectations or lack thereof. Market estimations of future inflation rates are at historically low levels in Europe, Japan and the US, but interestingly not in the UK.

If the velocity of money starts to turn around and inflation expectations increase, then we could be looking at a new investment environment.

However, there are hints that it may be truly different this time. We are starting to see central banks lend directly to main street, circumventing the traditional route i.e. via the commercial banks. We also have governments announce guarantee schemes on loans to main street. Both of these can turn around the velocity of money if there is demand for credit. These also won't be short term measures. No politician or government is going to relinquish these new toys.

Inflation expectations take a lot of time to get into the psyche of consumers, businesses and ultimately investors. At the moment individuals expect price falls whether it's in electronics or food at the supermarket. However, as we are already in a period of change, this too can occur on main street and Wall Street.

So what could this mean for investors? We could be witnessing a regime change to which the majority of investors are not set up for and, indeed, have never experienced. Inflation is an all-encompassing term and to a certain extent, how assets perform is determined by the extent and amount of the inflation and whether it's recorded efficiently via government statistics. The easiest asset to be confident in performing well in such an environment is Gold. Gold remains a cornerstone of our portfolios largely because it protects in multiple environments and is under-owned.

Government bonds will likely struggle in real terms with inflation linked bonds providing protection and if this premise is correct they are currently cheap. Commodities should do well with residential property too. Equities will see asset heavy firms outperform and, as was witnessed in the last equity bear market from 1966 to 1982, inflation proves a strong headwind to equity performance. However, it all depends on both the amount of inflation and its speed of arrival.

In conclusion we recognize that the future is particularly uncertain and, perhaps, increasingly binary. However, we believe in continuing to analyse the risks and setting up portfolios to firstly protect capital and to secondly gain from markets through a prudent risk managed investment process. We are aware of the narrative about a return of inflation and have examined areas that may perform. We, for example, go into some detail on CTAs in the below section. The change, if and when it comes, will not be instantaneous but gradual and it remains high on our watch list. Perhaps Sir John Templeton will be proven correct however - in the world we live in it is arguably prudent to assume he may well be wrong.

EQUITIES	LAST PRICE	YTD %
S&P500	3169.94	-1.88
Eurostoxx 600	368.13	-11.47
Nikkei	22529.29	-4.77
China A shares	3611.249	12.99
Brazil	99769.9	-13.73
India Nifty	10767	-11.52
Russia RTSI$	1245.71	-19.58
MSCI World Local	1721.622	-4.34
MSCI EM Local	61558.48	0.15

COMMODITIES	LAST PRICE	YTD %
Crude Oil	40.84	-33.11
Natural Gas	1.847	-15.62
Gold	1822.3	19.64
Silver	19.18	7.03
Copper	285	1.89
RICI Global	1895.56	-22.77
RICI Agriculture	694.38	-8.48
RICI Energy	188.29	-51.02
RICI Basic Metals	1120.63	-3.97
RICI Precious Metals	2082.33	10.14

FIXED INCOME	LAST PRICE	YTD %
US Govt	417.51	7.43
EU Govt	252.03	7.63
US IG Corp	3241.31	14.57
US HY Corp	2154.67	12.85
EU IG Corp	151.37	8.09
EU HY Corp	410.62	11.67

CURRENCIES	LAST PRICE	YTD %
Dollar Index	96.291	-0.10
Euro	1.1351	1.23
GBP	1.2639	-4.66
Yen	107.27	-1.23
AUD	0.6986	-0.50
CHF	0.9369	-3.07
Brazil Real (BRL)	5.3396	32.66
Turkish Lira (TRY)	6.8641	15.34
India Rupee (INR)	74.975	5.04
China Yuan (CNY)	6.9877	0.35
JPM EM FX	54.92	-10.70

As of July 9, 2020

BONDS VS INFLATION

It's been a bull run in fixed income for the last 40 years, aided by falling inflation and therefore also interest rates. Investors have jumped on board and now traditional pension funds will hold 40+% in fixed income securities.

As discussed in the main section, one what-if we are looking at is the impact of a return of inflation. This is more of a medium to long term driver and although market narratives can change with the wind such a 40-year trend is unlikely to change tomorrow.

At the present times the industry looks and analyses investment returns on a nominal basis i.e. we ignore what inflation has done to our money's value over this time. Perhaps going forward that will change. There is no point earning 2% on a corporate bond if inflation prints at 3%. For fixed income inflation is a risk and indeed the primary risk. In an environment where we do see inflation returning government bonds, in real terms, are going to struggle.

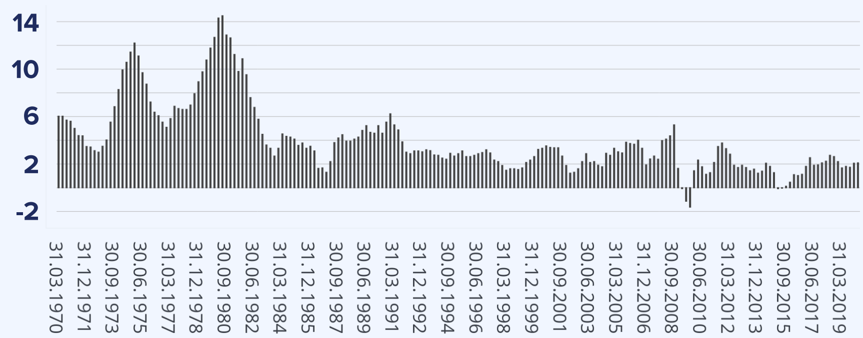
Corporate bonds however should do better given the higher spreads available to compensate for the risk of erosion caused by inflation.

What can even perform well are inflation linked bonds where the coupon and principal are linked to an inflation index. As mentioned in the main section these are also currently cheap because the narrative is more fearing for deflation i.e. no change in the trend of the last 40 years.

Governments face an issue. Budget deficits are exploding to levels last seen in war time i.e. post 1945. Governments however cannot afford for yields to rise with any return of inflation which would dramatically increase their cost of funding. It is therefore likely we see either central banks continue to purchase government bonds keeping yields near current levels or there will be some measures announced to cap yields and control the yield curve. These measures are currently being used in Japan and were last seen in the US until 1951. In this environment fixed income will do ok in nominal terms. In conclusion, inflation is the next risk for fixed income. However, within the asset class there are options to both diversify and hedge exposures. We continue to like corporate bonds particularly short dated and are looking at inflation linked bonds as a potential way to hedge a new risk.

US 5yr/5yr Forward Breakeven

US Consumer Price Index (YoY %)



Sources: Banque Heritage, Bloomberg

HIGH EXPECTATIONS FOR 2021

The first half of 2020 has been unprecedented in many ways. The fastest equity bear market in history, prompted by an economic halt resulting from lockdowns to prevent the spreading of the COVID-19 virus, proved to be the shortest as well.

The steep correction witnessed in the first quarter was quickly followed by the strongest quarter in decades for most indices. Equity markets are therefore pricing in a V-shaped recovery, despite a still worrying pandemic picture. At the dawn of the second quarter earnings season, expectations are in for rough results, down more than 40% year on year in the US for instance.

The consensus however thinks the worst is behind us with less negative outcomes in the third and fourth quarters, resulting in an overall decline of -25% earnings for the full year. All of the lost ground is however expected to be recouped by 2021 with a greater than +30% earnings growth foreseen for the S&P 500 stocks next year. Broadly speaking, the picture looks similar in Europe. So what drives the hope for such a sharp earnings recovery?

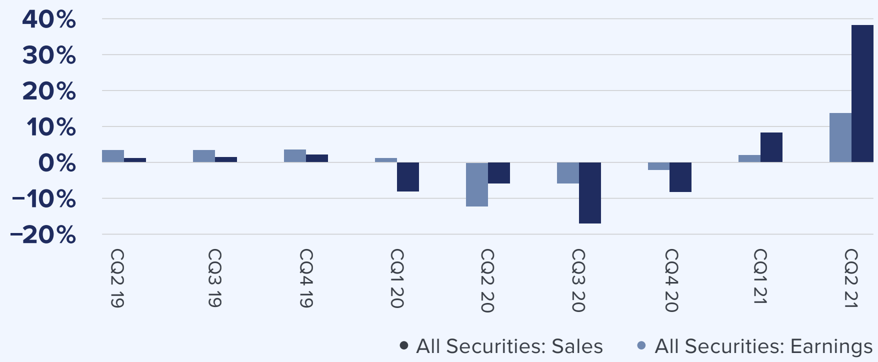
The answer is pretty straightforward: the unprecedented speed and magnitude of stimulus injected into the market by central banks.

The end result of such actions is yet unknown, but one of the consequences coming to mind is the return of inflation discussed in the macro section. Such an outcome usually acts as a headwind to equities and represents a risk to monitor carefully. Nevertheless, incoming data is tracking better than expected recovery in most regions, with the latest flash PMIs moving back into, or close to, expansion territory in Europe and the US.

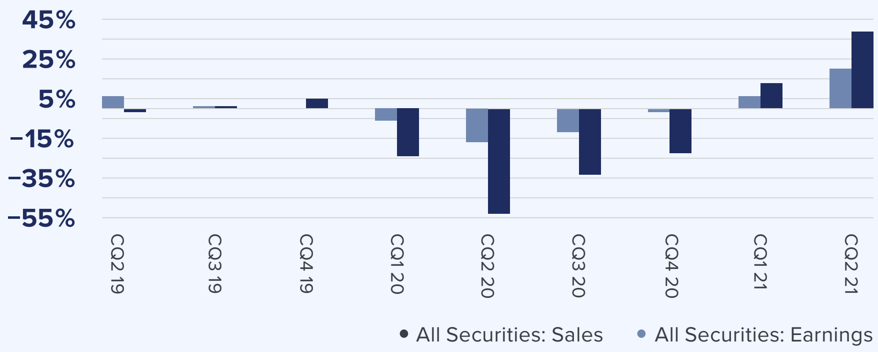
Another impact of massive QE is the loss of reliance of traditional equity valuation measures.

Optically, equities look very expensive having rebounded sharply from the lows despite a severe EPS recession. However, looking only through that lens would have resulted in meaningful opportunity cost already. A backdrop of high valuations, a greater-than-normal degree of uncertainty about the extent of a recovery, and scope for increased volatility into the November US elections suggest a degree of caution is warranted but we remain opportunistic, looking for upside in sectors and themes benefiting from structural trends.

S&P 500 Sales & Earnings Growth



Stoxx 600 Sales & Earnings Growth



Sources: Banque Heritage, Bloomberg

TRENDING? THEMES!

Themes are all the rage these days and from an investment standpoint following secular trends instead of cyclical recurrences can be a promising approach.

As detailed in the previous sections, the overhang from massive central bank interventionism is inflation and it remains nowhere to be seen. Or maybe one should look elsewhere... The one place where prices have gone unilaterally through the roof is the world of financial assets, and even more so equities. However, equities did not benefit unilaterally and while we all witnessed the ascension to dominance of the FAANG stocks, another phenomenon took place concomitantly.

Thematic funds' assets, both active and passive grew from less than $5bn in 2009 to more than $30bn at the end of 2019 and this momentum shows no sign of weakness.

What do Amazon, Facebook, and Paypal have in common? They benefit from structurally supportive societal, demographic and economic changes owing to the emergence of new relationship habits (social media) coupled with new generational supremacy (millennials) and new consumption habits (online retail and impulse buying). The same can be said of many other companies benefiting from secular trends.

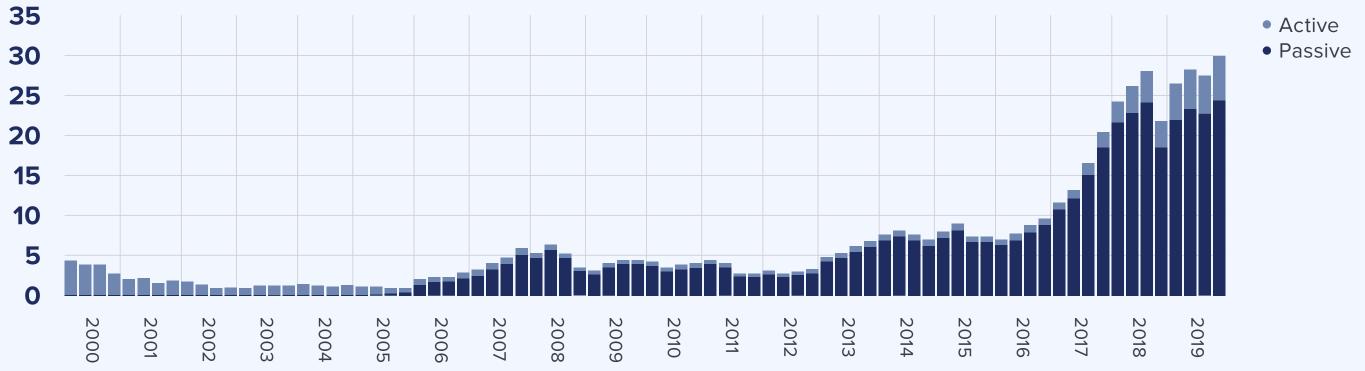
A secular trend is a trend associated with some characteristic or phenomenon that is not cyclical or seasonal but exists over a relatively long period. These trends are deeply rooted structural evolutions pertaining to demographics, ecology, wealth distribution, consumption habits and technology which shape and design the socioeconomic landscape over several decades. Identifying these trends is paramount to narrowing down opportunities and selecting those most likely to benefit from long term tail-winds while on the other hand, these trends require close monitoring as nothing lasts forever and disruption, unprecedented shocks, or even war can dramatically speed, slow or revert these fundamental evolutions, as exemplified by the ongoing COVID-19 pandemic.

It used to be that investors sliced and diced the market by sector, trying to time rotations (allocation) and selecting the companies they thought would outperform (picking). It is clear that for some time some sectors have been rather out of favor (financials, materials, utilities) while some others saw some important inflows (technology, communications, consumer discretionary) and we believe this phenomenon is linked to the thematic approach taken on by investors since the mid-2010s.

We have identified 5 secular trends and underlying themes which we believe will be structural for the years to come.

One Planet: Sustainability can be defined as "development that meets the needs of the present without compromising future generations' own needs". The main areas of focus are climate change and water/waste treatment with the necessity

Growth of Thematic Fund Assets under Management (USD Bil)



Sources: Morningstar Research. Data as of December 31, 2019

to increase the proportion of clean energy while preserving natural resources through rationalized use and recycling.

Silver Economy: Baby boomers have always had an outsized presence compared with other generations and while they peaked in 1999, they held that top podium position until 2019. Today they represent a large market with specific consumption, living and health needs. Furthermore, increased life expectancy will sustain these needs, creating challenges to redistributive social systems, healthcare infrastructure and tech appliances.

Internet 3.0: With internet penetration rates averaging 59.6% in 2020, there is still room for growth. Developed countries have close to 90% coverage but it took ages to get there. Developing countries will move directly to broadband, fiber optics and 5G, dramatically increasing the potential for Internet 3.0 applications. With better stability and faster speeds, internet technology and communications will become ubiquitous through streaming, social media, e-commerce, internet of things, blockchain, and cloud computing.

Millenials: Born between 1981 and 1996, often the children of baby boomers, and marked by their coming of age in the information age, they are today the largest generation in Western history. Millenials have been described as highly educated, entrepreneurial, idealist, progressive, civic-oriented and local. They have also been coined as Generation Me for some of their less enviable traits. Regardless, they are shaping the world through their politics and consumption habits, driving new industries and destroying old ones as a force to reckon with for the many years to come.

The Rise of EM: With three spots within the top 10 of global GDP (China, India and Brazil), emerging markets are not so emerging anymore. While many still suffer from lack of infrastructure, underdeveloped regions and are more volatile due to their less diverse economies, they are poised to bridge that gap and impose themselves as the only true regions for growth. They have long proven their ability to give birth to national champions in all sectors and to export their knowledge and goods. Yet, they are also swamped with western culture and have demonstrated their willingness to access iconic western goods as a showing of their catching-up. In this wealth creation process own taste and preferences are developed while local shortcomings of their economies need attention.

Themes have always existed, but only recently have investors started to apprehend them in such a structured and permanent way.

We believe that exposing ourselves to stocks benefitting from them will not only bring more growth to our portfolios but also reduce volatility, as themes, by definition, are here to stay.

INNOVATION

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