Creating Value through Innovative Financial Solutions

2021 Investment Outlook

As 2020 is coming close to an end, time has come for us to share our house view for 2021 and on the back of this, how we think best to position one's portfolios into the new year. In this memo, we will delve deeper on the trends we are seeing, the outlook we gathered from the various research publications (both from global banks as well as independent research houses) and our house view across the main asset classes. However, before we move to those discussions, we would like to share the top consensuses shared by these research publications we have come across: The first one is that most banks anticipate the **economic situation to improve in 2021** and market to remain "reasonably" well oriented next year. The new motto *"Do not short the recovery"* is obviously echoing the more familiar motto of *"Do not fight the FED"* - a valuable lesson few investors have learnt at their own expense. It is commonly accepted that availability of vaccines, stronger growth in 2021, and continued loose monetary policies are likely to translate into higher equity and credit valuations, strength in cyclical stocks, a weaker US Dollar, and higher commodity prices. Secondly, **China** is a topic covered in all papers. What was once considered as part of an Emerging Markets play, China has now become a key, standalone component of any professionally managed portfolios. Last but not least, **ESG**, **digitalization** and **decarbonization** are the key themes commonly cited across the 2021 forecasts as being the growing trends and are likely to weigh more significantly when designing portfolios going forward.

A. Equities

a. 2021 Forecasts

As far as equities are concerned, we have witnessed several key trends across the 2021 outlooks by banks. **Barbell** – is probably the common buzz word that has appeared in 2020 publications which was not part of 2019's vocabulary. It basically implies that banks are recommending a dual approach whereby investors hold Technology and Healthcare stocks while **adding strong cyclicals stocks** to their portfolios, at the expense of sectors with a more limited upside like industrials, real estate, and utilities. For the sake of diversification within market cap and themes, we have seen few publications favoring **small caps over large caps** or **cyclical/value over growth** in 2021.

As mentioned earlier in the memo, **ESG** has also become essential in most research we have been through. As companies with the best ESG practices have shown significant outperformance against their peers this year, this has formed as a strong basis for most banks to keep their ESG recommendation as a pre-requisite investment filter for the years to come.

We noted a rather significant divergence in outlooks within the equities space among the banks and research houses. Those in **the uber bullish camp** justified their forecasts on the acceleration of the global economy and profits into 2021 and 2022 to be supportive of a reasonably strong year for equity markets overall; Expecting about 20% total return in global equities with the S&P 500 ending 2021 at 4,400 points. Those with a **more conservative outlook** cited that the upside is already priced in and hence expected returns has plateaued or even possibly shifted down. This group expects returns to be lower for longer and they forecast the gauge will reach 3,800 level which is a measly 3.7% rise.

Going long **Chinese** equities seems to be the common consensus across all houses, while a handful is of a view that the opposite applies as far as European, Emerging Markets and Growth stocks are concerned.

b. Our House View

The fast rally in market prices since March, combined with the difficult environment for fundamentals, has caused market-implied risk premia to drop significantly. While we understand that a low yield environment does not offer any other alternative than equities to traditional allocators, we remain cautious about valuations having noticed several flags this year:

- The proportion of **retail investors** in daily volume has increased significantly from 15% (2019) to 25% (July 2020) according to Bloomberg, which is a known feature of a "late stage" equity cycle.
- Recent **IPOs** of loss-making businesses such as Snowflake or DoorDash, whose prices doubled on their first day of trading, is another proof that equity markets are now more driven by a "**fear of missing out**" rather than fundamentals.
- Lastly, a **Put/Call ratio of 0.4x** (close to historical low levels) confirms that investors are more interested in short term gains (presented by call options) than hedging their downside risk (indicated by Put/Call ratio above 0.5x).

In a context where valuations look dear on average, we reiterate our view that the appropriate approach for equities is to stick only to good quality stocks while also reducing the overall delta of the portfolio. This can be done in two ways:

I. Stick to only "good quality stocks". By "good quality stocks" we mean stocks whose earnings are compounding (i.e. upward sloping curve of earnings per share) attributable to **growth** and **profitability** (defined as "return on capital" well above "cost of capital"). Since these stocks look expensive on average, we recommend selling listed Puts on the most volatile ones, with maturities up to 6-months and delta around 20%. The idea is to get remunerated to place a buy order on stocks we would be comfortable holding in the long term, with a 15-20% downside buffer.

II. Adding strategies that can be nimble on the long and short sides that could benefit from the natural **dispersion between the disruptors and the disrupted** over time.

B. <u>Fixed Income</u>

a. 2021 Forecasts

Unsurprisingly, all the banks agree that bonds look extremely expensive globally, with the short end likely to remain at rock bottom given central banks tight grip. Spreads on **Investment Grade** will continue to remain tight due to loose monetary environment. Consequently, most banks keep recommending **High Yield ("HY")** (ratings of BBs and lower), especially **Asia HY,** as the go-to strategies for income-oriented clients.

Most fixed income publications point to **meager average returns** across government bond markets next year - some even anticipate lower rates to remain for as long as the next 15 years! Even more concerning is that we have noticed a strong consensus across the banks research publications regarding **falling real interest rates**, whereby inflation is expected to settle well above nominal interest rates going forward. This is particularly bad for fixed income investors as it erodes purchasing power over time. In that context, most banks forecast the yield on **US 10Y government bond to move higher** (to compensate for higher inflation) from 0.90% today to between 1.25% and 1.50% at the end of next year. It is worth mentioning that one of the banks even boldly announced its expectation of US corporate defaults to peak in Q1 2021 while another is expecting a year-end 2020 default rate of 3.5% for Emerging Market Credit (roughly at the long-run average), to decline to 2.8% in 2021. Quite surprisingly, however, none of the banks mentioned the alarming defaults that is happening in supposedly safe Chinese State-Owned Enterprises ("SOEs").

b. Our House View

We are aligned with market consensus, reiterating that investors are **unlikely to be fairly compensated** for risk as far as bonds (both corporates and governments) are concerned. The **lack of liquidity** on the asset class (illustrated by the lack of bids or large bid-offer spreads) throughout the year even on good credit issuers, is another source of concern for us. While opportunities can still be found for investors with a buy & hold mindset, we keep recommending being extremely selective going forward, especially avoiding highly levered balance sheets. In that context, we recommend outsourcing both leverage and credit selection to experienced managers with a solid track record and proven ability to manage the downside risk in the credit space.

Finally, we have decided to take a very defensive stance and recommend being extremely selective towards **Chinese corporate bonds** on the basis that we have become increasingly uncomfortable with the level of leverage accumulated by both the private and the public sectors.

C. Currency

a. 2021 Forecasts

Interestingly, the consensus is a weaker US Dollar against most crosses next year. We also noticed a broad **bullish consensus on Emerging Markets currencies**, notably Mexican Peso and Indian Rupee as well as selected Asian currencies (Thai Baht, Taiwan Dollars, Korean Won and Singapore Dollar) which are all expected to rebound as they benefit from a better economic outlook. There were a handful of research houses which anticipate the Euro, Canadian Dollar and Australian Dollar to appreciate next year.

b. Our House View

Since most banks anticipate a weakening US dollar next year, we like the idea of carving out an allocation to high quality **local currency bonds** (e.g. government or strong corporate issuers) to benefit from the carry as well as the currency appreciation (Chinese Yuan, Mexican Peso, Korean Won).

D. Commodities

a. 2021 Forecasts

Most research think that **oil's price is likely to drift higher next year, supported by a weaker USD**, improving global economic situation as well as the lessons learned from the fiasco of negative oil prices. The lack of agreement between OPEC+ members will act as a long-term reminder that increasing supply when demand is in free-fall is never a good strategy.

Prospects of an imminent and effective vaccine could limit the room for extended gains in gold prices over the medium-term. That said, most research houses anticipate gold's recent softness to be short-lived pointing weaker USD and low real interest rates as two midterm supportive catalysts. On average, banks anticipate gold to revisit its recent high of $2,100/oz in 2021.

b. Our House View

We agree with the broad consensus on the **likelihood of oil price to remain well oriented** next year (lesson learnt by OPEC+) and that Gold is **likely to remain an interesting diversifier** considering valuations on bonds and equities.

E. Alternatives

a. 2021 Forecasts

A couple of the banks' research points out that **core bonds and Treasuries are likely to disappoint** investors on returns and their effectiveness as hedges. The reality is that investors would need to start looking elsewhere for new sources of portfolio diversification. A couple of the banks also interestingly argued that less liquid alternatives such as private equity and private debt could also act as true diversifiers for portfolios that mainly comprised of bonds and equities.

b. Our House View

We could not agree more with this approach. In fact, we have been reiterating this consistently over the course of this year that the **traditional approach of combining stocks and bonds has growingly become obsolete** and ineffective in achieving optimal risk-adjusted returns. Investors who are seeking a capital protected strategy are left with no choice but to reduce the overall beta of their portfolio by adding strategies lowly correlated to the traditional asset classes. We believe that this can be found in liquid alternatives such as commodities, trend-following, global macro or multi-strategy hedge funds.

Conclusion

Considering the record high valuations on both equities and bonds, we believe investors will have to be increasingly selective to achieve attractive risk-adjusted returns not only in 2021 but well into the next few years. With that in mind, we see value in active managers who should benefit from dispersion within each asset class, as opposed to ETFs that will most likely return the average performance of their members. Long/Short managers (bonds and equity alike) are, in our view, better positioned to deliver positive performance in a context of inflated valuations. Keeping in mind that 90% of a portfolio performance comes from its asset allocation (i.e. proportion of bonds, equities, others), we continue to recommend investors to shift away from the traditional "60/40" approach of combining equities and bonds. A well-diversified portfolio of low beta managers (0.2 or lower), should be favored in our opinion. Not only are they likely to keep performing well should 2021 be a positive year for risky assets, but they are also likely to largely outperform benchmarks otherwise. As usual, track records and discipline in risk management are paramount when calibrating the long-term allocation to these managers.

At Lighthouse Canton, discipline in investment and risk management remain as our core pillar. We pride ourselves in our commitment to provide our investors with strong risk-adjusted returns over multiple market cycle without compromising the downside risk. We thank you for your confidence and support in us and we look forward to be part of your journey in the new year and beyond.

We would like to wish all of you a very Happy Holidays and wonderful New Year and may the New Year bring you ample success!

Yours Faithfully,

The Lighthouse Canton Team

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