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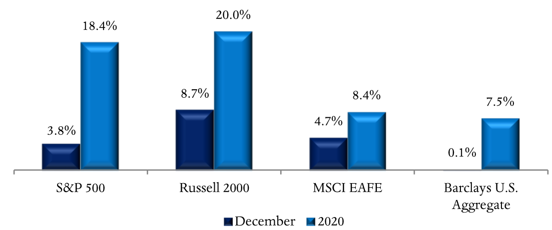
Markets

The year 2020 was weighed down by a global pandemic and associated recession, driving stocks into a bear market, thereby ending to the longest bull market in history, amid record volatility. Subsequently, equities rallied for three consecutive quarters, thanks to rapid and massive monetary and fiscal stimulus, the passage of US elections, and positive Covid-19 vaccine news, leading to positive overall returns for the year. The bellwether S&P 500 index rose +12.2% in Q4 (+18.4% in 2020). Positive news flow favored cyclical segments of the market, resulting in the best quarterly rise for value and small capitalization stocks since 2009. This was highlighted by the Russell 2000 index (+31.4% in Q4; +20.0% in 2020) which rapidly erased its underperformance for the year. Growth equities, as measured by the tech-heavy Nasdaq index, were the year's overall best performers, gaining +15.6% in Q4 and +44.9% in 2020.

Overseas equities produced mixed results in 2020. While the Euro Stoxx 600 index rallied +10.9% in Q4, it ended the year down -1.4%. To the upside, Asian and emerging markets rose in the high-teens percent for the full-year, benefiting from renewed hopes of a cyclical recovery, a falling dollar, and increasing global trade activity. Overall, the MSCI EAFE developed markets index returned +16.9% in Q4 (+8.4% in 2020).

Despite market expectations of an economic recovery, global government bond yields moved only modestly higher, guided by ongoing central bank interventions. US 10-year Treasuries ended the year with a yield of 0.9%, slightly higher for the quarter, but down significantly from 1.9% at the start of the year. The Bloomberg Barclays US Aggregate index rose +7.5% in 2020, while the ML High Yield index leaped +14.4%.

Commodity prices also rose, driven by strong demand



for industrial metals in Asia. Economically sensitive copper continued its ascent, rising +16.0% in Q4 (+25.8% ytd). Precious metals paused for breath during the quarter, but still performed admirably in 2020, on the back of abundant liquidity (gold: +0.7% in Q4; +25.2% ytd). During the fourth quarter, WTI crude oil prices rebounded +20.6% thanks to the prospect that economies will reopen sooner rather than later. However, the commodity ended the year -20.4% below where it started. Mal-investment and an extended period of low prices, have led the energy industry to reduce capital expenditures. As a result of a projected 5 million barrel per day decline in production, the US is expected to return to global oil markets to plug the deficit at a cost of approximately $100 billion per year.

Geopolitics

The coronavirus pandemic has taken a turn for the worse in many regions of the world. New infections have risen significantly in Europe and the US, exceeding previous highs. As a result, governments have implemented more austere lockdown measures in order to slow the spread of the virus. This has once again pressured a broad swath of industries, especially in the service sector. Thankfully, the gloom has been met by positive vaccine data from Pfizer/BioNTech, Moderna and AstraZeneca/Oxford. While an end to the Covid-19 crisis now appears to be in sight, the path to recovery is likely to be bumpy over the coming quarters. Questions regarding how quickly the various vaccines can be manufactured, distributed and administered on a mass scale still remain. It is important to note that the Pfizer/

BioNTech and Moderna vaccines both require costly cold storage. Success also depends on the willingness of the population to get vaccinated and the effectiveness of the vaccines against potential mutations in the virus.

As the year drew to a close, the UK and EU finally reached a Brexit agreement, including a free-trade regime. While regulatory red-tape and border controls will affect the more than $590 billion in annual trade, a worst case of WTO rules and tariffs was avoided.

December 2020 Economic Statistics

	Dec-20	Dec-19	Dec-18
Federal Funds Target Rate	*0 - 0.25%*	1.50-1.75%	2.25-2.50%
Consumer Confidence Index	*88.6*	126.5	128.1
Manufacturing PMI Index	*60.7%*	*47.2%*	*54.1%*
Unemployment Rate	*6.7% est.*	*3.5%*	*3.9%*
JPY/USD	*103.24*	*108.61*	*109.56*
USD/EUR	*1.2213*	*1.1210*	*1.1469*
Gold/oz.	*$1,896.49*	*$1,517.01*	*$1,282.73*
Oil (WTI)/bbl	*$48.52*	*$61.06*	*$45.41*

United States

The year-end period brought long-awaited economic relief for pandemic-stricken companies and households. Congress finally agreed to provide $900 billion in additional federal stimulus, bringing the annual total to $3.5 trillion. The plan will extend many of the CARES act support measures, including renewing direct payments to households and more generous unemployment benefits, reducing headwinds to US GDP growth over the coming quarters.

Manufacturing continues to show resilience to the pandemic, with data reaching a two-and-a-half year high, thanks to recovering demand for goods and record low inventory levels. Planning ahead for an improving economy in 2021, companies will have to restock. Unfortunately, this comes at a time of a weakening Dollar (DXY -4.2% in Q4; -6.7% ytd) making overseas purchases more costly and spurring inflation.

The US Federal Reserve (Fed) explicitly committed to purchase at least $80 billion per month of Treasuries and agency mortgage-backed securities (currently $120 billion) until the committee feels "substantial further progress" has been made towards its inflation and employment goals.

President-elect Joe Biden nominated former Fed Chair Janet Yellen to head up the Treasury Department, a sign the federal government may work more closely with the Fed to help battle economic inequalities through programs such as universal basic income, perhaps a sign of a sea-change. Overall, the Biden administration's economic team is highly experienced, widely respected, and proponents of activist fiscal, monetary and regulatory policy, with a clear focus on Main Street America. As we go to press, it appears that the Democratic party has achieved control of both houses of Congress after a sweep in the Georgia run-off elections.

Europe

EU governments finally reached a compromise to approve the union's €1.8 trillion financial support package, aimed at helping the economy recover from the pandemic-induced recession. Of note, it was agreed that a significant proportion of the budget and recovery fund has to be spent on sustainable and green projects. Members also agreed on tougher climate goals for 2030, increasing the targeted reduction in carbon emissions vs. 1990 levels from 40% to 55% by 2030. This will lead to significantly higher investments in renewable energy and increased associated regulation.

On the monetary policy front, the European Central Bank increased the size of its planned asset purchases by €500 billion to €1.85 billion. The central bank also extended the horizon over which it will make these purchases by nine months to the end of March 2022, while promising additional flexibility.

In the UK, house prices and retail spending were up year on year in November, despite severe restrictions on activity. Yet many other sectors are suffering, as seen by GDP levels that remain substantially lower than early-2020, leaving plenty of scope for recovery once the economy reopens. With regard to monetary policy, the Bank of England announced that it would expand its asset purchase facility by a further £150 billion.

Asia

When the Covid crisis started, the view in the West was that it may serve as a critical blow to the Chinese economy and potentially weaken the governing regime. However, thus far, China has emerged relatively unscathed economically, as has most of Asia. Strong demand for medical supplies and technology products lifted Chinese exports to their highest monthly level on record. South Korea, another beneficiary of increased technology demand, also showed accelerating momentum in its export industry, thanks to innovation stemming from research and development (R&D) investments.

In a clear change of Chinese government policy, during the recent recovery period, the Renminbi has witnessed the sharpest currency rally in history. Unlike prior episodes of currency appreciation, the central bank has allowed this inflationary and productivity reducing event to happen. With large positive real interest rates, capital has been flowing into the Chinese bond market. Perhaps this foretells that the deflationary forces that have emanated from China over the past several decades may be coming to an end, which would have significant repercussions for the global economy. Exacerbating the issue, the deterioration of US-China trade relations has led to a reorganization of supply chains across major Chinse (and global) industries, to ensure inventory, with less focus on price and more on security of delivery. Taken together, there are inflationary forces brewing in Asia, which are likely to affect the whole world.

Outlook

The global economy is likely to face some short-term headwinds until pandemic-related restrictions pass. The upshot is that, thereafter, a torrent of pent-up demand should reinvigorate global economies for an extended period of time, featuring shortages of various goods and services. Our analysis leads us to believe that we may be in the early stages of a reflationary environment given that global GDP output is already back to pre-pandemic levels, yet economies are not even close to fully reopened. If correct, ensuing inflation could be the biggest market surprise of 2021. Why? US Treasury yields are rising, commodities (including crude oil) are appreciating, and the US Dollar is in decline. These are meaningful forward looking indicators that have reversed course from a year ago.

We start this new economic cycle with equity valuations that are higher than normal. The fall in real rates has supported valuations but, with risk-free yields closer to the zero bound, there is a diminished potential for multiple expansion. Should the aforementioned trend (rising yields, coupled with a weak Dollar) continue, value stocks are likely outperform growth oriented ones. However, high quality companies and local technology champions should be held for the long term. Such an outcome would be attractive for investors, especially active ones that can identify the regions, sectors and companies that have the strongest prospects.

Government debt in the US has increased by more than $4 trillion this past year, to $27.5 trillion or 130% of GDP, mostly due to a massive spending spree to combat the pandemic. Most Western governments have followed suit. While necessary, such unproductive debt (on top of already large amounts of borrowings) poses the risk of rising interest rates, or a weaker currency, as we have seen over the past six months. These trends may eventually lead to consternation at the Federal Reserve, especially if growth and inflation become apparent, and in turn lead the central bank to cap interest rates (aka yield curve control). The US Dollar would, in turn, react negatively. Therefore, for the anti-fragile part of portfolios, we suggest avoiding long dated bonds, and instead focusing on short-term or floating rate credit. Further, as an alternative to fixed income, investors may consider select non-market correlated assets and gold.

As we try to best navigate what is sure to be a dynamic 2021 for investors, we have identified numerous opportunities in merger arbitrage, distressed real estate, hedged credit, European equities, water infrastructure, digital education, and healthcare.

Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal.

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