Lotos Asset Management

Quarterly Investment Strategy

January 2021

2021: The Golden Twenties, Restored Normality or Volatility?

Happy New Year!

The tumultuous year 2020, full of extremes, uncertainties, deprivation, hope and positive surprises is finally behind us. The seemingly neck breaking fall in stock markets during the first quarter of last year was followed by a breathtaking catch up rally that never looked back. Unparalleled stimulus support by central banks and governments flooded markets with immense liquidity. With great confidence that the vicious virus can be overcome sometime this year - thanks to innovative vaccines researched in record time - market action accelerated and many laggards made up leeway briskly last year. Bond yields reached levels not seen in modern history but started quietly to rise thereby contradicting market consensus of an ever-lasting low-for-longer interest rate environment.

Dull normality has become desirable. Some like to flirt with the Golden Twenties, enjoying life extensively and excessively. What 2021 will reserve for us depends on the virus, its potential mutations, the success rate of vaccination and psychology. Consensus expectations currently anticipate some soft of normalization in the second half of this year. This will not be reached, however, should mutations of the virus invalidate currently available vaccines. Researchers emphasize that the new mRNA method can be quickly adapted. If so, this could merely lead to a delay. The willingness to get vaccinated might represent an even more substantial hurdle, particularly in Western democracies. According to an Ipsos survey, 80% of UK residents, but only 40% in France want to take a vaccine. One could assume that persons at risk would rather be inclined to get vaccinated, which would alleviate the situation in hospitals and death rates. Still, herd immunity is only reached at a level of around 70%. The change of vaccination strategy foreseen in the UK not to respect the time span between the first and second vaccination may undermine the most valuable factor: trust. As a broadly positive outcome is already anticipated by market participants, any of the above mentioned challenges represent downside risks.

The trajectory of interest rates will also be crucial as many valuation models are currently based on historically low bond yields. So far, rising yields at the longer end of the yield curve have been well tolerated as it is interpreted to reflect an improving economic environment. Inflation expectations have risen. Interestingly, inflation protected instruments showed a strong performance over several months already. Commodity prices have also risen sharply. How threatening will inflation become? Economists differentiate between prices of widely fluctuating prices, such as energy and food and prices that are sticky, such as labor. With unemployment still elevated and the slack in labor not likely to quickly disappear, labor costs may remain tame in the short term. Over the coming years, there are however some trends that could lead to continuous price pressure. The Corona crisis showed that just-in-time deliveries, dependency on a single vendor, long transportation routes, etc. can lead to shortages of critical, vital items. Surveys revealed that roughly 20% of US companies are planning to bring production back to the United States. In addition, some companies intend to diversify their suppliers. De-globalization has been a theme well ahead of the Corona crisis. In addition, many of the actual sanitary measures are here to stay. We currently observe an elevated Merger & Acquisition activity. Market concentration usually leads to pricing power. All these factors are inflationary. Digitalization on the other hand will have a cost-cutting effect.

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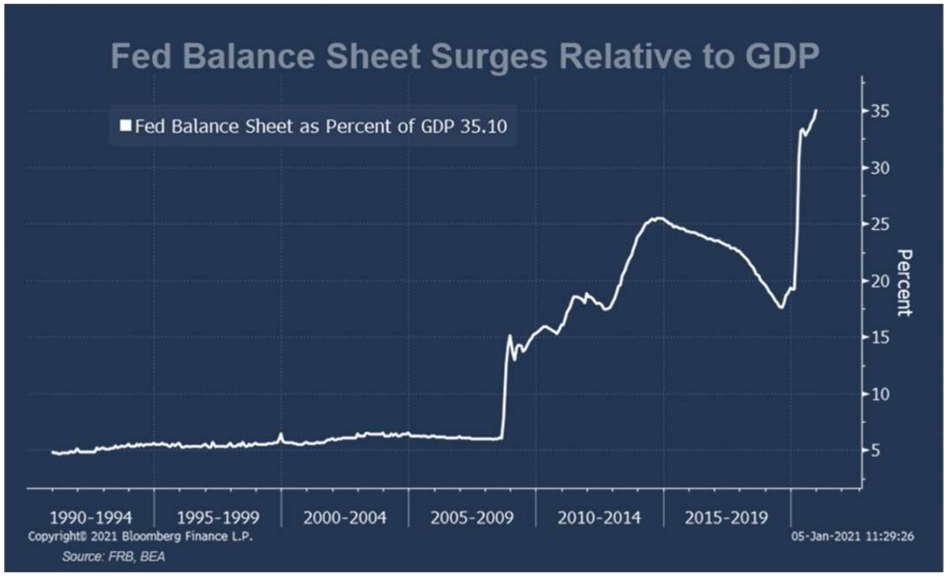
During the financial crisis, monetary bases have been extended massively and many feared price pressures as a consequence. But this has never materialized. Most participants therefore seem at present quite relaxed that the liquidity bomb unleashed on the markets will have a similar negligible effect. As banks substantially improved their balance sheets in the meantime, the transmission mechanism may work much better now and trigger some inflationary pressures.



Remember tapering efforts by Ben Bernanke end of 2018? Markets reacted furiously. How and when will the Federal Reserve try to exit this situation? Federal Reserve members Kaplan and Bostic just this week joined the chorus of members hoping to begin to discuss tapering later this year…

“Average inflation targeting” allows the central bank to run inflation above the 2% target in order to compensate for weaker periods. We expect the Treasury under Janet Yellen to intensely focus on the labor market. Her influence and curriculum will have an important impact on the Federal Reserve. We expect inflation to rise moderately this year. It could however surprise markets on the upside in coming years. Our multi-class portfolios contain inflation hedging instruments.

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Conclusions:

In our opinion, the Golden Twenties will not yet be celebrated in 2021. Some normality may be expected in the second half of the year but only if the vaccines will be potent enough to also fight mutations of the Corona-virus and herd immunity can be reached, which at the current stage represent big “ifs”.

What does this mean for markets? We are afraid to say, but heightened volatility seems the most feasible to us.

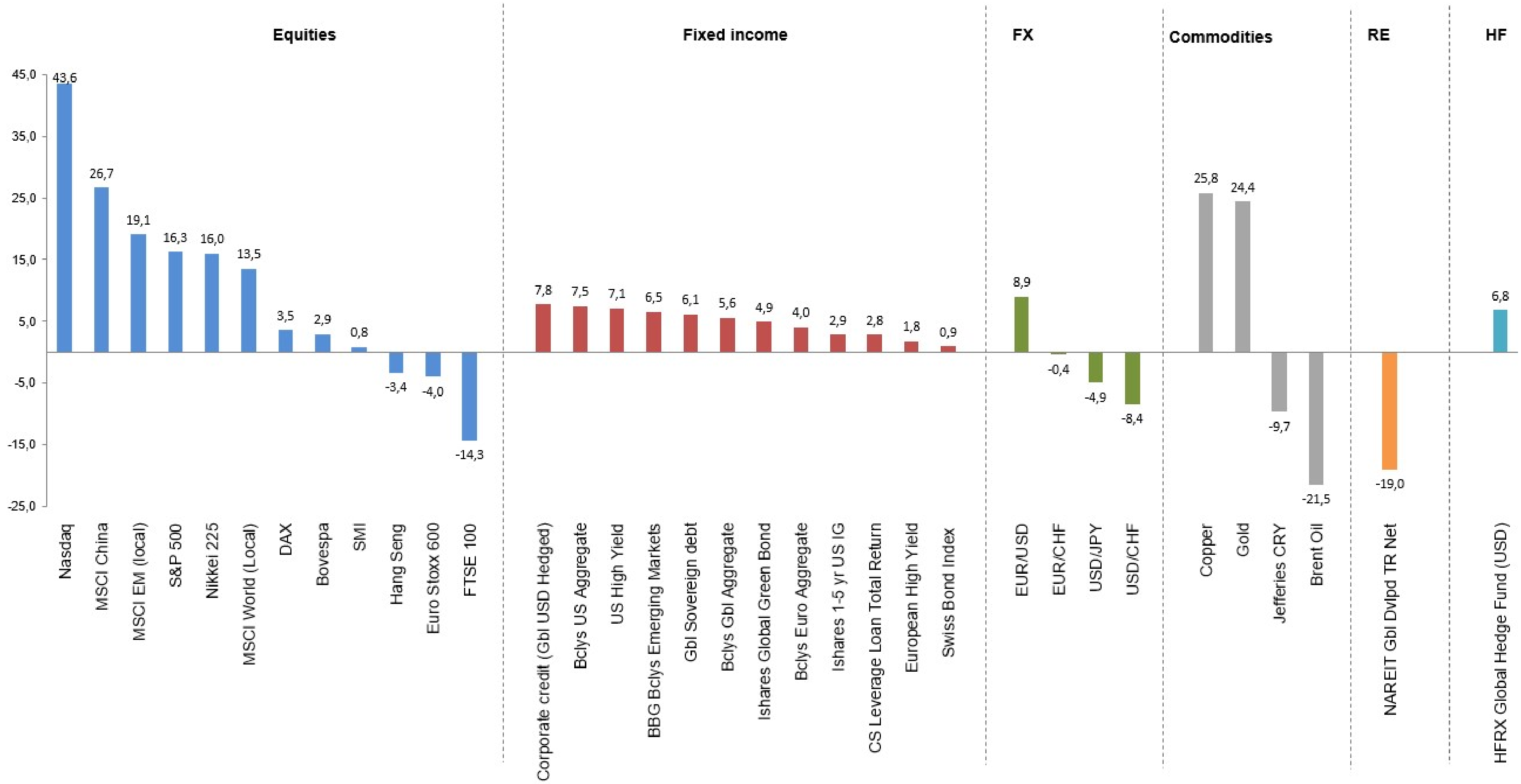
We observe a broad consensus of optimism among market strategists. There are admittedly many positive developments and liquidity is abundant. But we are now 73% above the market low in March in the S&P 500. It is hard to find notes of caution. At the March low, it was difficult to find any optimistic voices and most predicted still lower lows. Equity market are no longer cheap and many fixed income instruments are not worth the risk at ridiculously low yields. Some indicators, such as the ratio of the S&P 500 total market capitalization to US GDP, a rule of thumb made popular by Warren Buffett, have risen to levels last seen at the top in 2000. In some segments of the market, a bubble is developing judging by price action, retail call option volumes and median age of IPOs that join the market, to name a few. The most important factor, however, is the missing interest in fundamental valuation, which is probably explained by the flood of liquidity made available through stimulus measures. Of course, bubbles can last for some time.

As mentioned before, the trajectory of interest rates will play a crucial role this year: when looking at equity risk premium (gap between expected returns on stocks and risk-free bonds) equities still look very attractive. We have slightly reduced our allocation to equities but are still slightly overweight. This is mainly based on our assumption that bond yields, while grinding higher, will not experience a sudden rise given the still challenging environment, notably for the employment situation. We continue to underweight fixed income. The portfolios contain inflation-linked tools and instruments that protect the portfolio from rising yields. We have recently added a short-term emerging market fund.

In the FX market, a broad consensus prevails that the USD will weaken against major currencies. The anticipated even larger support for the US economy – this time through fiscal measures – may allow the US to exit the crisis perhaps earlier than many expect. We therefore rather expect a slight weakening or even a sideways trend.

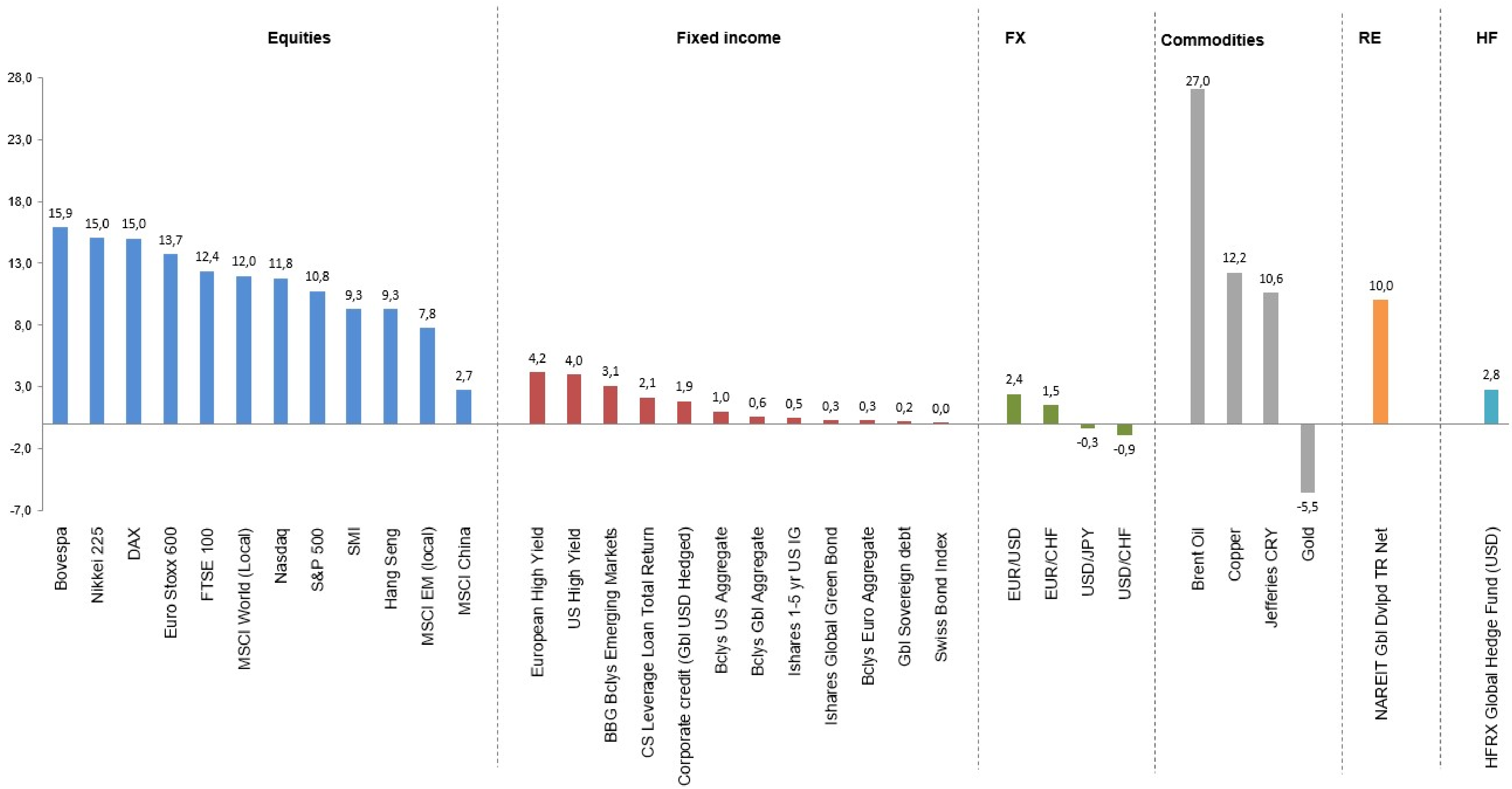
Please see details in the later section: How are we invested and why?

2020 Performance Major Asset Classes in Local Currencies



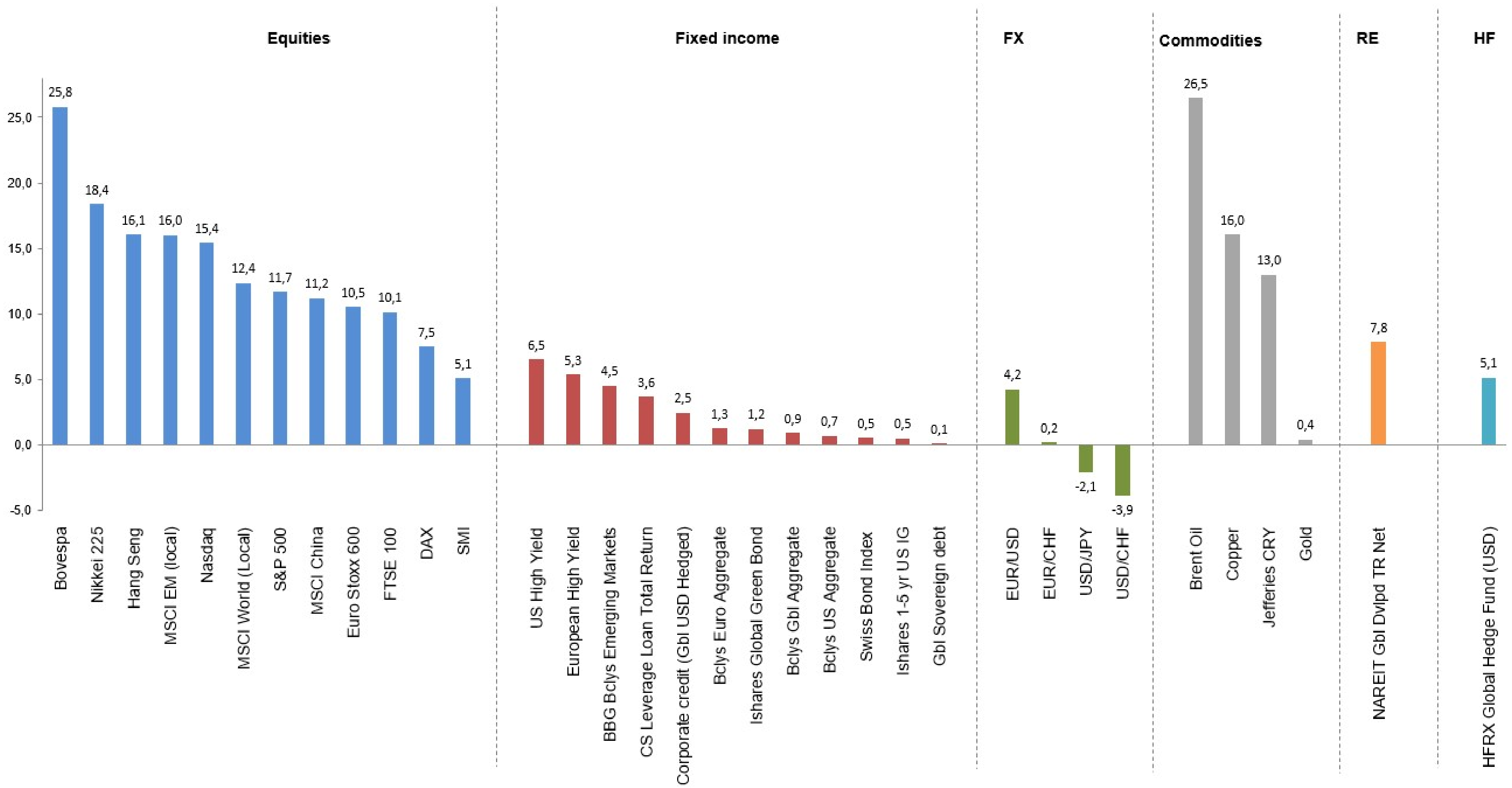
Source: Bloomberg

Performance November – the Month of the Vaccine Announcement



Source: Bloomberg

Performance Major Asset Classes in 4Q 2020 in Local Currencies



Source: Bloomberg

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