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Winter 2021

IT IS ALWAYS DARKEST BEFORE THE DAWN. NEVERTHELESS, ... NOW IS THE TIME TO BELIEVE IN BETTER.

I WORRY ABOUT INSANITY

No, not my own (although you can't be too careful these days!).
Rather, my concern revolves around what is going to happen when things return to some kind of normality and lockdowns are lifted. Make no mistake, they will be lifted gradually at first and then cascade like a waterfall.

How will people react once they have to deal with this new-found freedom? Will they emerge from their houses/caves like bears coming out of hibernation?

While I have been wrong about the timeline and the severity of lockdowns – especially in Europe, where we have moved from lockdown light to lockdown medium, with only essential services open alongside manufacturing – spring will surely come, followed by summer. We in Switzerland are even allowed to go skiing, as everyone learns at an early age and so it shouldn`t be a problem to outrun the virus!

In my opinion, earnings are the most important drivers of equity indices, and I believe this will remain the case for the foreseeable future. However, psychology has been acquiring a more important role, especially in recent times. Given the current situation, our behaviours and thought processes will perhaps have a greater impact on markets in the near term.

Figure 2: Increasing business activity is generally a positive sign for corporate profit growth

Source: MSCI, FactSet estimates, Bloomberg and PIMCO calculations as at 31 October 2020

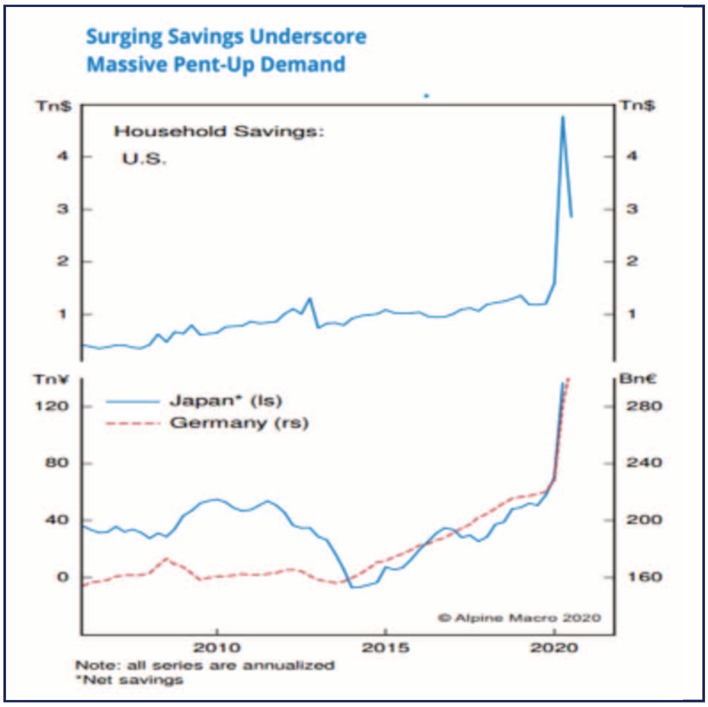
Of course I realise that while psychologically we are all tired, fed up, frustrated and bored, some of us have fared better than others. When we finally awake to a post-Covid world, will we view everything with wonder, amazement and joy as if through the eyes of a toddler as we rediscover simple things like shared meals with friends, birthday parties and holidays to exotic destinations?

I would like to believe so.

Will we know how to interact with people again or will it be more like going on a first date as a teenager?

Will we know how to behave in a restaurant or on a plane or train?

The post-Covid party is likely to dwarf anything we have seen before in history. Forget the millennium, which was just a walk in the park, or the roaring 20s, which will seem rather staid in comparison. You are likely to see lunacy and a zest for life never witnessed before, and this will no doubt translate into markets. The longer we are locked down, the crazier things are likely to be!



Source: Alpine Macro, household savings rate in the US, Japan and Germany, 2005-2020

My guess is that as human beings we can perhaps tolerate the current situation of having our privileges severely curtailed until around Easter at the latest. After that, if freedoms are not restored, be prepared for a very nasty push-back from populations as they take matters into their own hands. After all, not everyone can be locked up, and you can be certain that politicians everywhere will focus on votes and will have no desire to pursue vote-losing policies for too long.

DON'T BE A PARTY POOPER

Of course, I do realise that as individuals it is hard – indeed very hard – to see the endgame, but we are now in the final push and a rather amazing world will be waiting to be rediscovered.

As always, some commentators are saying that we are in an equity market bubble. In fact, some of them are so good that they have called 20 of the last three pullbacks! From my simple way of thinking (and markets confirm this), it is very hard to have a bust without a boom first. We are in the early stages of a cyclical bull market (read that as around five to seven years) within a longer-term (secular) bull market.

Source: Bloomberg, extreme valuation point of S&P 500 between 15 October 1997 and 14 January 2021

While there can be no doubt that risk assets have priced in some good news, this is from the starting point of extremely pessimistic levels in March last year. Economies have still not recovered anywhere near their lost output, but once the party starts expect ground to be made up very quickly indeed and the rally to continue for longer than anyone anticipates.

Within the next 12 months, I now expect a global GDP growth rate of at least 5%, with the US pushing north of 6% and Europe perhaps matching this number.

The continued rotation since September towards more economically sensitive stocks and the broadening out of the market rally can only be seen as a positive development going forward.

The continued pronounced rotation on any given day between pandemic winners and losers can again be taken as a rather positive sign that investors harbour doubts over if and when we will ever get to the other side.

If I had told you in March last year (and we did) that markets would recover their pandemic losses in record time, or that we would already have vaccines available, you would have thought I was completely insane.

The key takeaway is that the current situation has clouded our thinking and made us somewhat despondent, with the result that we are underestimating humanity and our resilience.

Global Vaccination Campaign

Country	No. of doses administered ▼	Per 100 people	Last updated
Global total	56,740,891	–	*Jan. 21*

Source: Bloomberg, global vaccinations to date (https://www.bloomberg.com/graphics/covid-vaccine-tracker-global-distribution)

I fully expect animal spirits to return to markets not just in 2021 but also in subsequent years as we finally break out from the last decade of tepid growth.

Help from governments has been generous, but as always in life there is room for improvement. Governments that act generously now will, I believe, be rewarded with quicker and superior growth on the other side of this crisis and avoid what is now referred to as economic scarring (long-term impediments to economic growth).

Now is not the time to have arguments about debt levels, which could easily be paid off on the back of superior growth. Those who take a different view should look at how long it has taken the Japanese economy to recover.

BUT WHAT ABOUT INFLATION, INTEREST RATES AND TAPERING?

Of course, these are valid worries. In fact, we do see longer-dated bond yields climbing – especially in the US – as a result of rising inflation expectations. That said, these are merely expectations.

I have no doubt we will see some rather wild short-term inflation numbers globally, but I expect these to be parried by words such as “temporary” or “transitory” from central bankers who, of course, know by now that it is much easier to fight inflation than deflation. Governments and central banks are likely to err on the side of magnanimity for the foreseeable future and let economies run hot.

I find it very hard to believe that any central bank is likely to take away the punchbowl anytime soon (although some market participants will worry about this), as it will probably take us years to recover the lost economic output and – perhaps even more importantly – to get jobless numbers (the canary in the coalmine) back to pre-pandemic levels.

Even when we get to these levels, a very compelling argument could be made that just returning to where we were pre-pandemic after a number of years is hardly cause for celebration.

As I have maintained before, investment strategy does not have to be complicated. The future areas of outperformance are likely to be those that have been pandemic losers. There will of course be some heart-stopping moments depending on daily and weekly Covid headlines, but you should stay the course.

Figure 3: Cyclical sectors tend to outperform in the early stages of a recovery

Source: MSCI, FactSet estimates and PIMCO calculations as at 31 October 2020
Cyclicals: autos, banks, capital goods, consumer durables, diversified financials, energy, materials, media, semiconductors, transportation
Defensives: utilities, telecom services, food and staples retailing, food/beverage/tobacco, household products, pharma and biotech and healthcare equipment and services.

Figure 4: Industry composition by region: Japan and EM have the highest cyclicality

	Region					
Industry group	U.S.	Europe	U.K.	Japan	EM	China
Cyclicals	36%	48%	42%	**55%**	**53%**	28%
Defensive	28%	38%	40%	30%	17%	17%
Other	36%	14%	18%	15%	30%	55%

Source: MSCI ACWI world index as at 30 November 2020

IT REALLY IS TIME TO BELIEVE IN BETTER.
SEE YOU ON THE OTHER SIDE!

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