GADD
WEALTH MANAGEMENT

Market Insight

WINTER 2021

2021 : The year of reflation

Unlike the crisis of 2008, the crisis we experienced in 2020 was intentional, as health issues came as a priority. The unprecedented reflationary policies of central banks and governments and, above all, coronavirus vaccines, give hope that the global economy will recover in 2021, starting in the second quarter. It will even be strong enough to raise fears of some inflationary pressures, mainly in the United States, but on the whole the macroeconomic framework should remain favorable this year. This positive scenario has been largely discounted by financial markets for the last 12 months or so, and the search for undervalued assets will be more a challenge in 2021.

Money after life ?

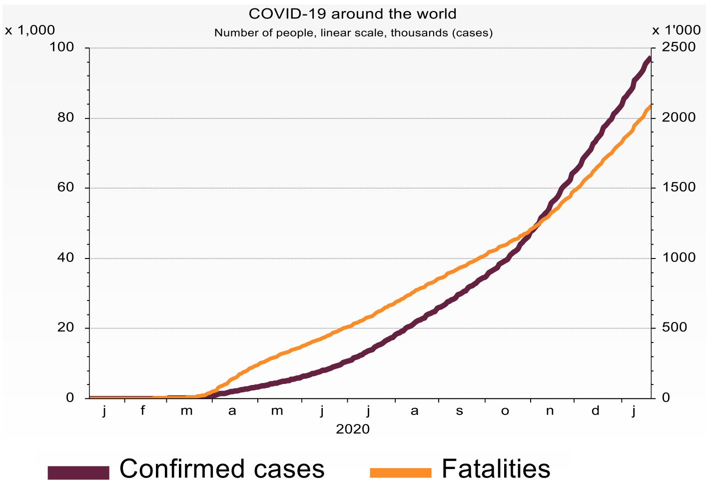
In the Middle Ages, highwaymen were not devoid of a form of courtesy: they gave their victims a choice between money and ... life: a Cornelian choice that our political leaders had to face in 2020. It was a year in which, for the first time in history, "life prevailed over the economy", to use the words of Luc Ferry, former French Minister of Youth. We will not go as far as decreeing that 2021 will mark the primacy of the economy and the stock market over our existence, but, more simply, that this new year will be one of a fair return to normality.

In this case, this gradual return to the status quo ante will undeniably require a broad vaccination of all segments of the population. This first graph shows that both the curve of the number of cases and the curve of deaths related to Covid19 in the world have not yet reached their inflection point. The former will soon reach the 100 million mark (left scale), while the latter has just crossed the 2 million mark.

The year 2020 was the year of the crisis, and it was both wanted and assumed by our authorities to save lives.

The year 2021 will be the year of recovery, against a backdrop of vaccines and reflationary economic policies. The financial markets have already echoed this last year. This year, they will have to navigate between the pitfalls of debt and inflation. And, of course, the new strains of Covid19.

1. Coronavirus : the inflection point has not yet been reached

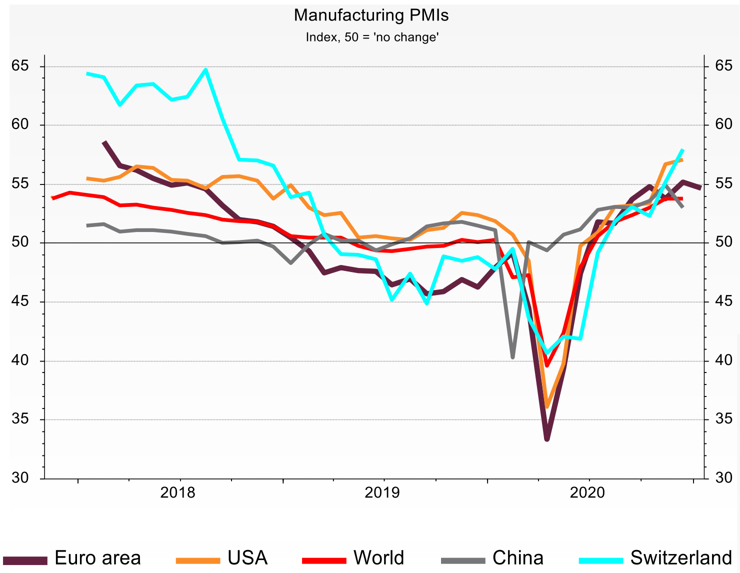


Health is priceless, but .... It has a cost

The cost of health care is not limited to medical and health insurance costs. They also include the considerable expenses related to lockdowns. For example, each month of full confinement in France costs about 4% of the gross domestic product of the country, or 97 billion euros. The new strains of the virus increase the risk of new confinements, but these drastic measures should be gradually eased as of this spring, thanks to vaccination extended to all segments of the population. With the exception of the United Kingdom, doubly penalized by the appearance of a new strain of Covid19 and Brexit, the economic outlook shows a solid rebound in activity from the second quarter.

The latest published figures of the PMI (Purchasing Manager Index) are rather encouraging. The rebound in activity is evident in industry, helped by the need for companies to rebuild their inventories. Services are lagging behind, but will make a big comeback as early as the 2nd quarter. After a drop of 3.3% in 2020, the United States should see a strong rebound in GDP to some 6% this year, followed by 3% in 2022. For the world economic leader, the second quarter of this year will mark the return of activity to the pre-pandemic level. China was the only country in the world to experience positive growth in 2020. It is expected to reach 8% this year, more than double global growth.

2. Recovery of industrial activity



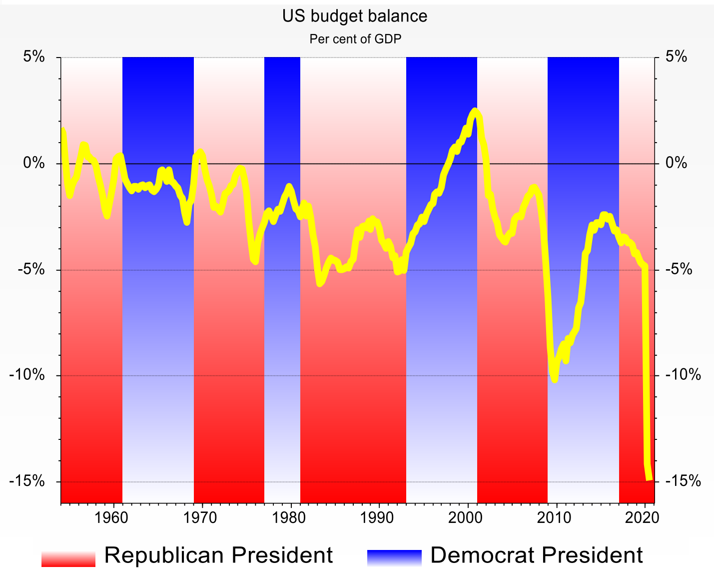
In most OECD countries, consumption is the engine of growth. As such, we consider consumer confidence to be the best leading indicator of the economy. We have constructed a series of such indicators for the main OECD countries: with a few exceptions, such as Italy, which lags behind the global business cycle, they all show a gradual return to normal by 2021. After declining by nearly 7% in 2020, Eurozone GDP is expected to rebound by at least 4% this year and next. Japan and emerging countries should follow the general trend.

Will reflation lead to inflation ?

The marked resumption of growth raises the question of the possible return of inflation. Largely absent from the recovery phases of activity over the last 30 years, we would not be surprised to see it increasing to 3% or so in the United States. There are two reasons for this: on the one hand, the extent of the easing of monetary and fiscal policies is unprecedented. On the other hand, the U.S. Central Bank has already indicated that it will not tighten its policy if inflation were to reach and then exceeds its 2% target. This target remains an average, and it will not hesitate to let inflation overshoot it somewhat. This is all the more so since a little inflation would not be to the displeasure of the new Washington administration, given that it would alleviate the real burden of the public deficit, and therefore the debt, which are likely to increase this year. Counter-intuitively, it is interesting to note that in the United States, the public deficit tends to decrease under Democratic presidencies.

Thus, a little inflation would not hurt the public finances, and not only in the United States. It is galloping inflation that would be a problem, but we believe that the central banks will be able to control this danger.

3. Will the US public deficit decrease with the Democratic presidency ?



Financial markets : growth or value ?

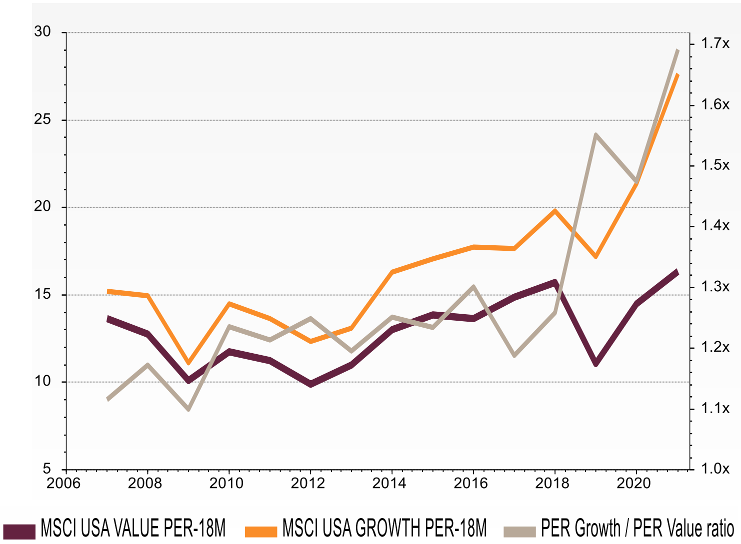
The return of economic growth is good news. The question that arises is to what extent this pleasing prospect is not already integrated into stock market prices.

Let's be frank: as far as stock market indices are concerned, their valuations in terms of earnings multiples bear witness to their high price. If there is one comparison that is favorable to them, it is with the bond markets, which are overpriced.

To be true, the high valuation of government bonds is not our only motivation to favor equities in 2021. Equities should enjoy a favorable environment as the economy returns to growth. Among our investment themes, we favor industrial and cyclical stocks, value stocks, emerging countries and commodities.

The question of the attractiveness of value stocks compared to growth stocks deserves to be addressed. In this case, the high price of equities is largely due to their phenomenal performance since 2010. In the growth bucket, we find first and foremost the companies of the famous FAANGM (Facebook, Apple, Amazon, Netflix, Google and Microsoft). At nearly 30 times expected earnings over the next 18 months, the valuation of growth stocks has never been so rich compared to value stocks, which are trading at 16 times expected earnings (graph 4).

4. U.S. equities : growth stocks are overpriced

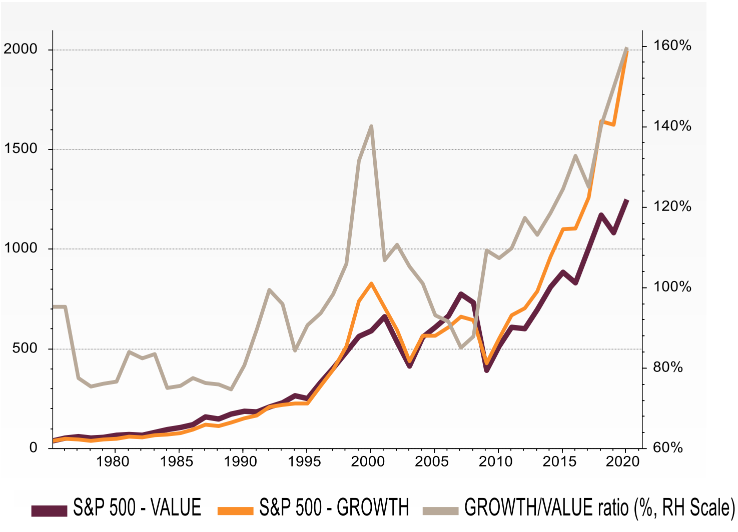


The last graph clearly indicates that, just before the bursting of the tech stock bubble in 2000, the outperformance of growth over value had reached 140% (light grey curve on the right-hand scale). We have now largely exceeded this figure to reach 160%.

When the technology stock bubble burst in 2000, the value style began a cycle of outperformance that lasted until the subprime bubble burst in 2007.

We believe that value stocks should experience a comparable outperformance in the coming years.

5. US stock : the outperformance of growth stocks is at a peak



As regards the other asset classes, government bonds remain attractive mainly from the point of view of risk diversification. There is already more upside potential for corporate bonds and emerging market debt. But spreads with government bond yields are becoming narrower. On the currency side, the dollar is expected to continue to suffer from a narrower interest rate differential and a still large current account deficit.

In a nutshell, the scenario for 2021 is positive but ... with one condition, which we must mention: the risk of new strains of coronavirus that are resistant to the action of vaccines. We can only hope that we don't have to put life on the line again and risk killing the economy.

Michel Girardin, *Senior Economic Advisor*

Money-market and fixed-income

The major Western economies have not been able to return to a normal growth rate as the "deconfinement then reconfinement" plans have proved unable to stop the circulation of the Covid 19 virus. Hope now rests on the rapid vaccination of a large part of the world's population in order to achieve sufficient herd immunity. In the meantime, fiscal support measures by governments and monetary stimulus measures by central banks continue to support global activity, even if these decisions highlight strong political differences within the main developed countries, particularly in the USA which is now majority controlled by the Democrats. In the absence of inflationary pressures, key rates are being kept at their lowest level while sovereign bond yields are struggling to recover to around 1% for the 10-year US and -0.55% for the 10-year German bond. Credit spreads have returned close to their pre-crisis levels. We continue to increase the dynamically managed euro sovereign share and to diversify exposure to local currency debt. Expectations of an inflationary recovery are prompting us to maintain a short duration of the bond portfolio by means of protections while shifting some of the fixed-rate bonds to inflation-indexed floating rates.

Equities

Despite the persistence of a worrisome epidemic situation, good news has been accumulating since Joe Biden's victory and the announcement of the vaccine last November. The Democratic wave has spread all the way to Capitol Hill and with it the hope for a normalization of international relations and a major fiscal stimulus. The global economy contracted by 4.3% in 2020 but Chinese growth rebounded by 2%. Markets ended the year up 16% for the USA and Japan, 27% for China, while the Euro zone fell by 4.7% and Brazil by 20%. Investors are focusing on growth sectors linked to the digital economy, renewable energies or certain segments of the pharmaceutical industry. Conversely, services, transport, energy and consumer defensive are more affected by the pandemic and remain for the moment in the background. We are once again favoring Europe for 2021 as well as Asia-Pacific to the detriment of the United States. Our favorite sectors are technology, healthcare, financial services, consumer cyclicals and industry. The tactical hedge was closed at the end of the year and we are now slightly overweight the equity portion of our balanced portfolio.

Currencies

The widening of deficits linked to stimulus plans continues to weigh on the US dollar, which is no longer supported by attractive remuneration. The U.S. currency has lost about 13% against the Euro since the first support announcements in March. We are again reducing the exposure to the US dollar through hedging while maintaining a significant allocation in local currencies as well as in metals, gold and silver.

Alternative

The contribution of the alternative share has been positive over the last few months and its decorrelation to traditional investments encourages us to maintain this asset class in our portfolio. Equity Long Short represents 40% of the allocation, mainly complemented by Global Macro, Multi Strategy and Event Driven.

Outlook

The International Monetary Fund has revised upwards its global growth outlook for 2021 to +5.5%, with China in the lead (+8.1%), followed by the United States (+5.1%) and finally the Euro zone (+4.2%). The planets seem to be particularly aligned for this recovery to be unique and inversely proportional to the contraction of the first half of last year. Vaccination and the scheduled end of Covid19 , monetary and fiscal stimulus, but also the exuberance with which the population will welcome the lifting of health constraints should be the main drivers. Of course the road will seem long before collective immunity is achieved and the markets are likely to be shaken in the meantime. But we do not anticipate a major correction and will not hesitate to increase the proportion of risky assets in the downturn .

Armand du Pontavice, *CIO*

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