Psigma
Investment Management

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View from Psigma

Valuation Commentary

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The early days of the "COVID Crisis" now seem a very long time ago, despite the fact that we are only a solitary year on from the anniversary of the all-encompassing medical crisis, the start of the economic crash and the most extraordinary period of market behaviour in living memory. It is hard to use sufficiently strong superlatives to adequately describe the personal, economic and financial market experiences of the last year, and I'm sure all of us just want to consign this period to history and move on with our lives. Today we will update you on where we believe we are in the return to "normality", and how we are building our investment strategies with regard to the post-COVID environment.

The passport to freedom

The governments of the West made clear late last year that their whole COVID management strategy then boiled down to locking us up for as long as it took to vaccinate the elderly and those most vulnerable across society. Any issues with roll-out, take-up and efficacy of the vaccine were undoubtedly the greatest short-term threats to the economy, asset markets and, of course, our liberty. But the narrative has changed once again, particularly in the UK, even if some other countries, such as the US, are reopening more quickly. We should note that recent developments show that vaccines will not be the "freedom pass" we expected, due to concerns over virus mutations and the slower vaccine roll-out in the European Union. Any belief that we are finally and conclusively out of this mess must be delayed, and we will have to await the next government diktats to find out how fast normality will return. We are as much in the dark as any of you as to when this long-sought day will finally arrive.

An economic bust gives way to boom

Even if the limitations around personal freedom in the UK are still structurally impaired and uncertainty reigns, we believe it's highly likely that the global economy is about to go through a period of boom, inspired by government stimulus, supportive monetary policy and pent-up demand. We have held a more positive view on the economic potential for 2021 and 2022 than most other commentators, but notably many are now ratcheting up their expectations to the levels that we have been forecasting, as further stimuli from the new US administration are announced and other governments around the world continue to run their economies hot. The short-term outlook seems relatively certain (not least as things will struggle to be as bad as they were in 2020) but it is not a wholly positive story as we look further into the decade ahead. The structural economic damage assessment will have to wait until after the stimuli have been wound down. We remain watchful that there will be scarring in various sectors, and fear for the economic and human impact on those who have sadly seen their financial situation deteriorate through the COVID crisis. We must also constantly remind ourselves of the structurally low potential growth rates of an ageing society and debt-laden economies in the future.

The key side-effect could be inflation

We must stress that all the "free money" creation by governments and central banks is not without risk, despite asset prices rising and investors rejoicing at the ceaseless whirring of the printing presses. What we have been living through since the Great Financial

Crisis of 2008-9 has been and remains the greatest monetary and fiscal experiment in history. Indeed, the experiment has become even more extreme in the last year and the results are far from known. We absolutely expect the "Turbulent Twenties" ahead to be a period of political, social and economic upheaval, fuelled in no small part by the printing and pumping of money into the global economy and financial markets. Notably, in the last year we have seen over $10trn of fresh debt and money created by central banks and governments. The fact that we are yet to suffer any serious side-effects will encourage the authorities to go further in these exploits. Economic inequality and climate change are already being touted as the next target of central bankers' free money. As a result of all of this action, we expect inflation could rise in the future, following a sustained period of moderate inflation rates, as government spending and loose monetary policies clash with disrupted global supply chains, in an era where "reshoring" production of strategically important products is fashionable. A rise in inflation could also contribute towards further political and social uncertainty. We must remember that most revolutions of the past have been triggered by rising prices, particularly those of foodstuffs and energy sources. Inflation protection therefore remains a key element within our investment strategies and has served us well over the last six months.

Carry on printing

It is now frankly mathematically impossible to imagine a future without persistently aggressive monetary easing to both calm markets and to aid governments: to cover the cost of the governments' decisions around the COVID crisis, as well as the future bills and obligations caused by a "greying" society. What we have learned in the first few months of this year is that the predisposition of central banks is to do "far too much, not too little" in supporting governments and economies. This is the key factor behind the major disconnect between asset prices and actual economic activity of the last year, reflecting the fact that financial markets have become "overwhelmed by liquidity". Let's be honest and confirm that we are pleased that our clients' portfolios have benefitted from the liquidity-driven recovery in markets; but we must also admit that the outsized gains of the last year have contributed towards the growing problem of reduced reward for future investment risk. As we have said many times before, today's asset prices have borrowed some of the future's growth, and this will make our responsibilities harder in the coming years.

One year on

As we look back on the almost unbelievable period that started a year ago, we remember that at the end of Q1 2020 we stated that we thought that "the prospects for long-term returns from a range of investments are now as attractive as they have been for years and, in some cases, even as good as they were in the depths of the crisis of 2008". This positive stance was rewarded with good gains across our investment strategies as the recovery started, which continued through the last few months of 2020 and the early part of 2021. If you had claimed in the depths of the crisis last March that looking forward a year not only would nearly all financial markets have recovered their lost ground, but that many would be scaling to new highs, you would quite possibly have been laughed at. But that's where we are: the pendulum has swung so far from fear to greed that now very few appear willing to even consider what could possibly go wrong in the coming years.

Gazing into the crystal ball

Without doubt, the greatest threat in our view to extraordinarily elevated asset prices could well come from a cessation of the never-ending support of financial markets by the central banks. If we see a return of high economic growth and inflation, as we have written about extensively in the past, will this mean that the implicit and explicit stimulus of central bankers might have to end? Given the potency that monetary policy stimuli have had in elevating asset prices and valuations in the last decade, could this in turn signal the end of the period of elevated asset valuations, if central bankers feel pressured to stop their largesse, fearing that inflation could start to be a problem? Perversely, it could well be that economic success is translated into market troubles. There are also signs that bubbles are building in parts of financial markets, a situation created by rampant money creation by central banks and inefficient stimuli served up by governments. If any of these bubbles burst, the collateral damage across expensive and complacent asset markets could be painful.

Our investment strategy

Our current strategy is to avoid bubbles and to focus on specific assets that still offer reasonable growth potential at justifiable valuations, with industries like healthcare, elements of the technology sector and specific plays on infrastructure and "green" technology all favoured within our portfolios. These are the sectors where we see the highest potential for future growth in the post-COVID world and where the governments are likely to focus their attention (and money!). An obvious trend at the start of this year has been the relatively poor performance of some of the investments that performed so well in 2020; this has provided us with an attractive opportunity to increase exposure to favoured long-term themes.

Good value still on offer

We also continue to focus on the less popular parts of global equity markets, including the UK and Japan, where valuations are attractive and the opportunity for recovery returns is still possible. UK equities could continue their recent pattern of improved performance, as the UK equity market, due to the high sector weightings in resources and financial companies, is highly correlated to economic activity. As the global economy performs well in the coming months, UK equities should also perform well. Away from equity investment, we also continue to own a range of fixed interest investments in our strategies, including those that we own for "defensive" returns and others that are priced appropriately for the challenging economic situation that we are dealing with, and offer the potential for healthy gains in the coming years. It remains comforting that we continue to be able to source attractive fixed interest investments, where we feel that we are being suitably compensated for the risk that we are taking.

Preparing for uncertainty ahead

Whilst our short-term projections for the global economy are positive, we are not complacent and recognise that many challenges lie ahead. We cannot stress enough that we are in "uncharted territory" and the lack of historical precedence for today's economic environment makes any prediction about the future almost impossible. Our best solution to such a situation remains that which we have employed since we first founded the investment arm of our business nearly twenty years ago: remain balanced, remain diversified and remain solely focused on those investments in which we have high conviction. There are reasons to be positive and reasons to be negative, but our central philosophy is to continue to be pragmatic investors. As the American author William Arthur Ward once wrote, "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." This realistic approach is how we are managing our clients' portfolios.

Tom Becket
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For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providng you with a variety of investment and market commentary.

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