Psigma
Investment Management

View from Psigma

VALUATION COMMENTARY

'IF-'

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Notwithstanding the extraordinary events that we have already witnessed in 2021, it is hard to imagine that we will ever see a year such as we saw in 2020 again. Given the enveloping medical crisis and bruising economic shock that sadly still persists today, we certainly hope this is the case, even if most asset markets managed to brush off the negative situation and recover all of the losses from the market crash of the first quarter.

2020 can best be described as a "rollercoaster", both in terms of human emotions and market performance. From an investment perspective we had to employ a huge amount of flexible thinking as the year unfolded and tried to, as the famous Kipling quote goes, keep our head "when all about you are losing theirs". We wish that the experience of 2020 had prepared us for understanding the year ahead, but as we spent the "quiet period" over Christmas thinking about the outlook, we came up with fresh questions for every answer that we found. In this latest commentary, we outline how we believe the economic and market paths will progress over the next couple of years and detail further how we are currently investing our clients' money.

New year, no fear

The most interesting dynamic as we start this New Year is that financial markets appear so relaxed about everything, despite the myriad risks that currently stalk the global economy. On some of the measures we monitor, investor sentiment is just about as relaxed as it ever has been in history. I think we can all agree that this is a truly extraordinary situation to find ourselves in, given the perilous economic situation we are mired in. It is telling that those few remaining commentators with a negative view are pilloried and viewed as being as outdated as dinosaurs. Investors have been totally anaesthetised by the wonder drugs of central bankers and have taken the view that no matter what happens, markets will rise as central bankers will keep interest rates at zero and pump fresh money into asset markets to keep prices high. In all honesty, this could well be the take of 2021. So far this year we have seen plenty of evidence of the short-term medical challenge and a retightening of economic restrictions, as well as clear signs that the longer-term issues of political and geopolitical uncertainty are here to stay, but markets have continued to rise almost unchecked on the tidal wave of free money created by the monetary authorities around the world. Trying to call an end, or indeed even a slowing, of this powerful market trend is almost impossible.

The global economy should recover strongly

There is, of course, also a major element of markets presently looking through the deep uncertainty of the first six months of the year and focusing on a "brighter tomorrow". The future, the chorus of optimists tell us, is a world where everyone is vaccinated, "herd immunity" has been achieved, we are all going freely about our lives with no restrictions and a huge amount of "pent up demand" is fuelling consumer and corporate spending. A powerful economic recovery and rampant corporate profits growth are guaranteed. To a large degree this

Panglossian scenario is priced into asset valuations. As is traditionally the case, asset markets have moved before the new dawn to price in predicted economic activity. It is telling that on some measures, equity valuations are almost unrivalled through the entirety of financial market history, with some areas now showing classic signs of a major bubble, while other key markets like corporate bonds are, in basic terms such as available income, just about as expensive as they ever have been. This is not typical of the very start of a new economic and market cycle. Usually, market valuations would be very cheap at this stage in an economic recovery, even when they start to price in future economic improvement, to compensate investors at a time when normally investor confidence is scarred from the events that caused markets to sell off in the first place. So much about today's market environment is very unusual.

Are investors wrong to be optimistic?

The overriding question we must ask ourselves is whether the unbridled optimism in financial markets is misplaced. We would agree that the economic outlook for 2021 is significantly better than it was in 2020, particularly in the second half of the year when we expect the world to have moved far closer to "normality" than it has been since last spring. But, in truth, this isn't exactly a sweeping statement. Economic activity is so suppressed in many sectors across the developed world at this time that things can only get better.

The good news is that global economic activity is already starting to improve considerably. While we sadly have had notable and repeated setbacks in the UK and Europe, as well as the persisting weakness in global travel and leisure sectors, there is tangible evidence that the world economy is healing. In some of the "leading" economic indicators, such as Korean exports and American manufacturing confidence, there is clear and compelling evidence of a sharp economic rebound. Investors have fairly translated this economic upswing into rising asset prices and valuations, but it is right that we step back and question whether the unprecedently strong recovery seen in both over the last nine months is "too much of a good thing".

What could go wrong?

In our opinion, there are three factors that could destabilise the ongoing merriment in asset markets; risks around the vaccine, structural economic damage and a return of inflation. The governments of the West have made clear that the whole COVID management strategy now boils down to locking us up for as long as it takes to vaccinate those most vulnerable across society. Any issues with the vaccine roll-out, take-up and efficacy are undoubtedly the greatest short-term threats to asset markets. We must hope that the vaccination programme does not suffer major logistical issues, or a new mutation appears that current vaccines do not work against.

The structural economic damage assessment will have to wait until later this year, but surely there will be scarring in various sectors and for those who have sadly seen their financial situation deteriorate over the last year. As we have already stated, we expect a vigorous economic improvement by the end of 2021, and our own forecasts are for higher rates of short-term economic growth than the consensus expects, as further stimulus from the new US administration kicks in. But we must also constantly remind ourselves of the structurally low potential growth rates of an ageing society and debt-laden economies in the future. When will the structural growth obstacles start to reassert themselves?

Finally, the greatest threat to 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 this has had in elevating asset prices and valuations in the last decade, could this in turn be a major negative if central bankers feel pressured to stop their largesse, fearing that inflation could start to become a problem?

Our investment strategy

In truth, there remain plenty of "Ifs" for us to consider, and the main issues discussed today will only be answerable as we progress deeper in to 2021. For now, the greatest threat that we see is a major disconnect between asset prices and actual economic activity. We understand why that is the case and we are pleased that our portfolios have benefited from the recovery in markets, but we currently see a growing problem of insufficient reward for existing risks. 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.

There are three tenets to our current investment strategy that we would remind you of. Firstly, we continue to invest in a balanced and diversified manner. In addition, we re-stress the investments we hold every single day and make sure that we are comfortable that we want to own them through a period of uncertainty. The good news is that there remain several investments that we greatly admire for the years ahead. Finally, we will continue to be very active; 2020 was a year of great opportunity for nimble investors and we feel strongly that the year ahead will be similarly rewarding to active investors.

Conclusion

It is likely that in the year ahead we will have to keep the immortal words of Kipling already used in today's introduction in the forefront of our minds. The first few days of this nascent year have shown that there is going to be much "excitement" and a continuation of the emotionally draining and market-churning developments like the 2020 vintage. Our best solution to such a situation remains that which we have employed since we first founded our business nearly twenty years ago: remain balanced, remain diversified and remain focused on those investments in which we have high conviction. To continue with the Kipling quotes, the poem "If–" goes on to say that "If you can make one heap of all your winnings and risk it on one turn of pitch and toss, and lose, and start again at your beginnings". As you all know by now, that has never been our style, and our aim through 2021 is to continue to do what we have always done. This philosophy, when mixed with several exciting specific investment opportunities, gives us confidence that we can continue to achieve our clients' aims and aspirations, regardless of what the years ahead throw at us.

We continue to wish you and all your families well at this uncertain time and thank you all for your support last year.

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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