Review of the 4th quarter 2020 and outlook for 2021

Finale furioso! After a number of setbacks in October, the last few weeks of the year did bring some clarity, at least on two issues weighing on the financial markets. The results of the US election with their outcome that cannot be seriously contested and the release for general use of the first vaccines against COVID-19 triggered a true buying frenzy.

Then, just before the end of the year and after a long and bitter dispute, representatives of the outgoing US government agreed with the newly elected representatives on the long-awaited continuation of the state pandemic aid for businesses and consumers. At the same time, a last-minute agreement in Brussels headed off the danger of a hard Brexit. And, at Christmas, the first injections of what has come to be regarded as a magic bullet in our collective longing for a return to a normal life, the COVID-19 vaccine, were administered to great media acclaim.

The financial markets in turn were infected by these hopes of early normalisation and, with significant gains, provided an upbeat end for an otherwise devastating year. And yet, the disturbing contrast with the well over one million lives that have so far been lost to the pandemic and the ongoing wreckage of livelihoods on a massive scale by the countermeasures cannot be ignored.

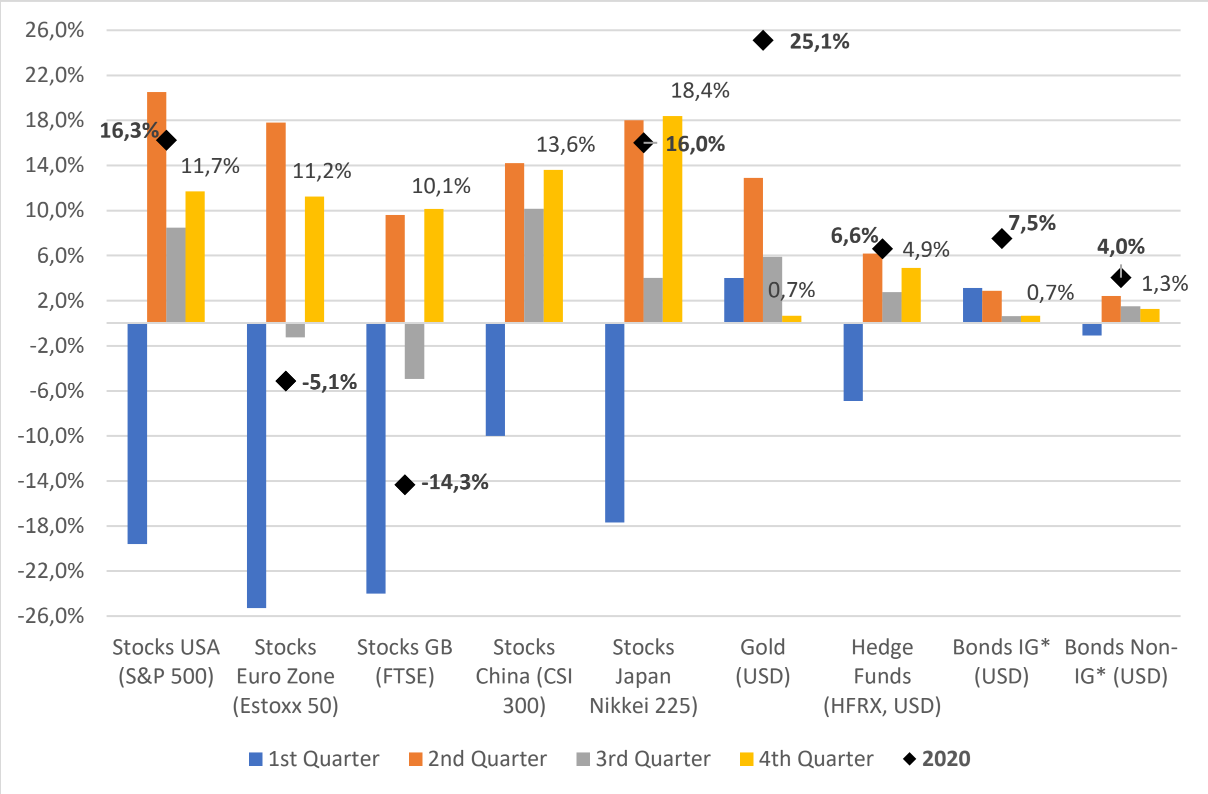
In any case, the sheer number of unprecedented events will ensure that the year 2020 will long abide in our collective memory. From our point of view as asset managers, a few things are particularly striking:

- Back in 2019, the US Federal Reserve had initiated a global "competition for the lowest interest rate" due to the expiring economic cycle and the disruptive ripples spreading out from the US-China trade dispute. This conflict intensified in 2020 and began to divert global capital flows – as a prelude to a prolonged devaluation of the US dollar and even lower, now in many cases negative, interest rates.
- Having until then been confined to regional outbreaks, in February, COVID-19 grabbed the attention of the financial markets. A rapid flight of investors from all risk-bearing investments triggered dramatic price losses as well as temporarily putting well-positioned and diversified portfolios under considerable pressure.
- It was only the willingness of central banks to jettison even more rules and create huge sums of money through various unconventional measures that enabled governments to enact the most comprehensive aid programmes of all time. This close cooperation, which would under other circumstances have been well-nigh inconceivable, was interpreted by the financial markets as absolute determination to prevent a complete collapse of the financial system. The new flood of liquidity triggered the fastest and strongest recovery movement in the history of capital markets. This was despite the fact that the real economic data were more indicative of a slump than a sustained recovery.
- The second wave of COVID-19 infection, which set in as early as October, and the necessary but restrictive protective measures quashed all hopes of a rapid restoration of the global economy in the form of a "V-shaped recovery". Consumers and businesses are still holding back on spending in the face of weak labour markets and generally uncertain prospects. Meanwhile, sovereign debt ratios continue to rise at a record pace.

2020 – first a deep crash, then a long recovery

The following chart shows the performance of various investment markets in the four quarters of 2020 and the results of the year as a whole.

Development of key investment markets in 2020



Source: Bloomberg *IG = Investment Grade

After a somewhat bumpy start in October, the fourth quarter saw a very positive development, especially for equity investments. Notwithstanding the precipitate losses of March, some **stock markets** managed to end the year 2020 as a whole on high or nearing record levels.

There were outstanding developments in Chinese equities (+ 27.2% in 2020) and Japanese equities (+ 16% in 2020). China is benefiting from being the first economy to leave the recession behind and return to a growth trajectory. In Japan, at the end of February, the central bank doubled its annual limit for buying ETFs (exchange traded funds) on the Nikkei and the TOPIX to the equivalent of approx. EUR 95 billion. By the end of the year, some EUR 50 billion had been used for this purpose.

European stock markets, on the other hand, have not yet been able to recover to the previous year's levels. The absence of highly capitalised "stock market darlings" in the consumer and technology sectors ("FAANGM") and exceptional events such as Brexit, with its unforeseeable negative economic consequences, are proving to be detrimental.

The performance of **bond markets** largely followed the monetary policy guidelines of the central banks. Falling interest rates led to a hike in bond prices. Risk premiums on government and corporate bonds, which should actually have increased in response to negative fiscal and cyclical developments, were severely distorted by central bank bond-buying programmes and caused unexpected price gains.

A comparison of the performance of bonds with an investment grade rating with that of non-IG bonds, i.e. those with weaker credit standing, which were not acquired by central banks gives an impression of the effect of the buying programmes.

Precious metals

Even though gold's proven qualities in troubled times did not come to its aid in the last quarter, it nonetheless ended the year as one of the most profitable forms of investment (+ 25.1% in USD) around. After the price of gold had helped support the performance of our clients' portfolios in the uncertainty-ridden month of October, reports of the imminent availability of a COVID-19 vaccine led to redeployments to more risk-oriented investments. Like us, it is above all those investors who value gold because of its status as an inflation-proof asset and are not guided by short-term price gains who remain committed to this precious metal. As early as December, this patience was rewarded by a significant recovery in the gold price.

Another precious metal that we have used since the second quarter in many of the portfolios we look after is silver or silver mining funds. Due to the fact that it is more useful as an industrial commodity than gold, silver is more closely aligned with the real economy. Its performance so far has been very pleasing, with the result that silver was one of our best investment decisions in 2020.

Cryptocurrencies – suddenly a serious investment?

A change in the attitude of many investors towards cryptocurrencies was observed in the last quarter. The best-known representative of this new form of investment for many is Bitcoin, created in 2009 as the first digital currency. Bitcoin currently represents around 70% of the market capitalisation of the more than 7,000 existing cryptocurrencies.

A significant breakthrough came with the October announcement by payment service provider PayPal that it would in the future offer its more than 340 million users the opportunity to trade in and use Bitcoin. Many institutional investors, such as companies, pension funds and hedge funds, also reported investing some of their liquid assets in digital currencies. Speculative investors joined in with this procession of money, lured by the ever-increasing prices for the various cryptocurrencies. Many are still motivated by hopes of turning a quick profit. However, we are also seeing an increasing number of investors turn to cryptocurrencies as a serious alternative to conventional currencies, which are burdened by negative real returns. This is certainly not an unreal concern; after all, the recent splurges of governments and central banks have further eroded the "intrinsic value" (i.e., the volume of money in circulation in relation to its economic output) of the well-known currencies. The ever more obvious preparations of the world's major central banks to create digital versions of their currencies also suggest that "digital money" is emerging into the everyday life of consumers and businesses from what used to be the occasionally murky world of just a few insiders.

For BPM, broadly diversified exposure to various cryptocurrencies has an important role to play in our efforts to protect portfolios against future inflationary risks. Since this investment segment is at an early stage of development and in view of what have on occasion been extreme price fluctuations in the past, we do not make direct investments here, preferring instead to use a diversified instrument.

The value fluctuations to be expected due to the relatively low market volume of cryptocurrencies (approximately USD 700 billion at the end of 2020 – compared to Apple with approximately USD 2,300 billion) should not distract from the fact that this is primarily a strategic investment in which we have been investing for many mandates since October 2020.

Economic crash, recovery and crash again?

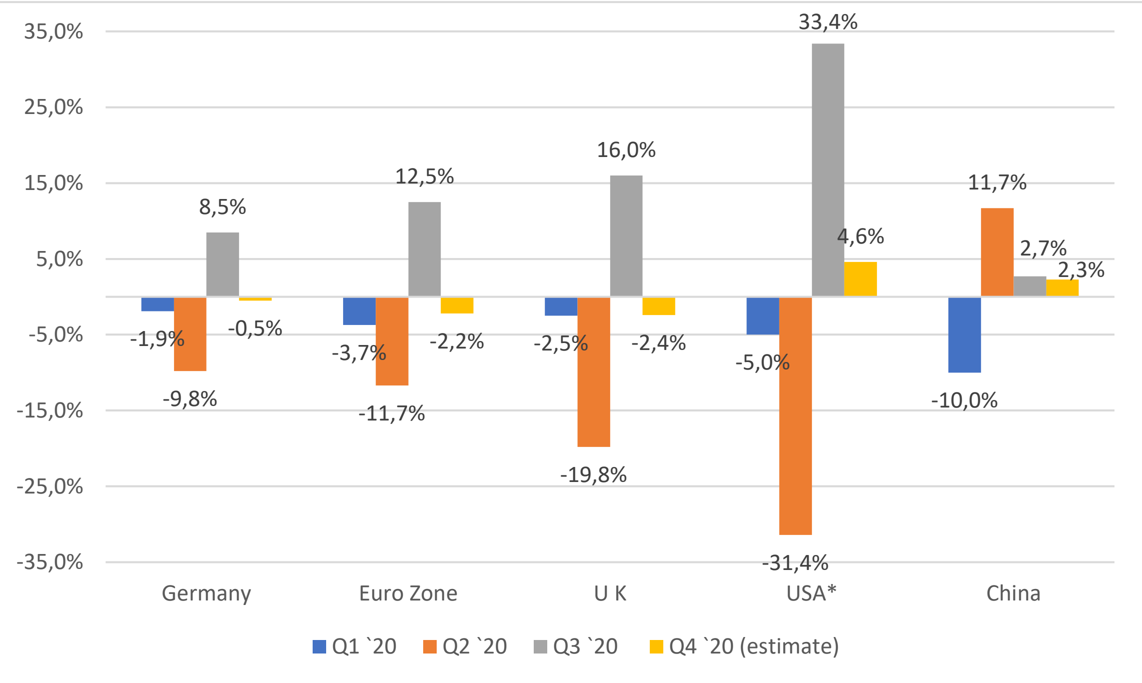
In our review of the third quarter of 2020, we commented on the economic recovery:

"The strong recovery in the third quarter should not be over-interpreted. To us, the trend seems, in particular, to be shaped by catch-up effects, which are further accompanied by the ongoing massive use of fiscal and monetary support measures. We cannot, therefore, identify any signals for a rapid return to a pre-pandemic level".

As we saw in the fourth quarter, our scepticism was not misplaced. The predicted second wave of COVID-19 infections and the associated new restrictions on daily life are likely to lead many countries back into recession.

The following chart shows the economic development of selected countries over the past year. In each case, the rates of change in real gross domestic product in the previous quarter are shown.

Change in the real gross domestic product



Source: Bloomberg, data and estimates as of 05.01.2021, *US data are seasonally adjusted and annualised

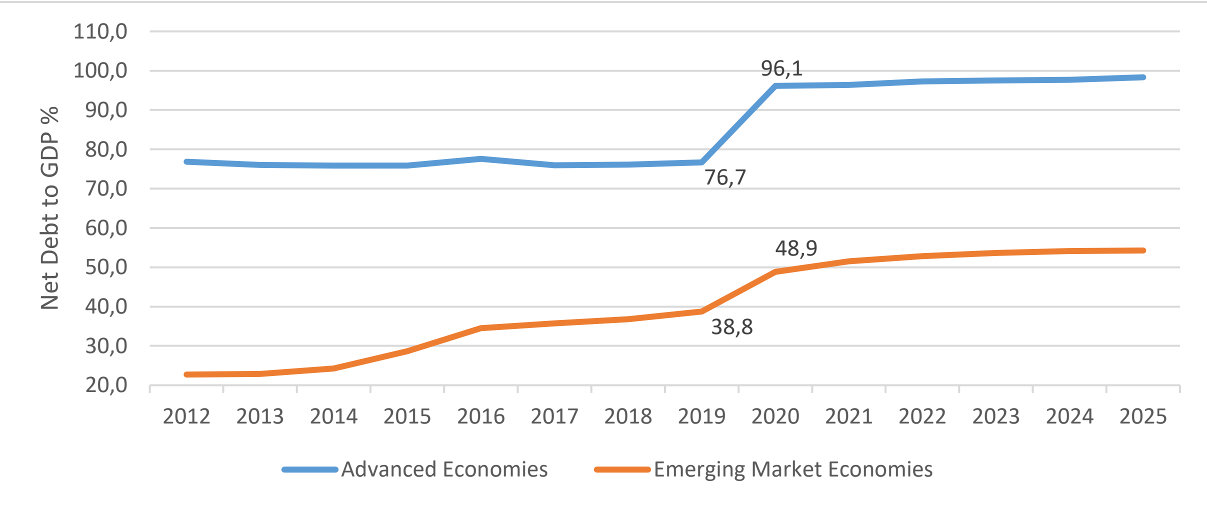
A positive turnaround may be caused by a rapid and successful vaccination campaign, although this is not guaranteed. Other factors, such as the need for further massive fiscal and monetary support, will continue to be decisive.

Why the world will still need low interest rates in the future

An existing trend which has greatly intensified the fallout of the global pandemic is the increasing indebtedness, not only of governments, but also of companies and households. The aid programmes launched to mitigate the economic consequences of the pandemic are in many cases historically unparalleled in scope. All major central banks, with their extremely expansionary monetary policy, have facilitated these fiscal measures, figuratively speaking, by vigorously shaking the "magic money tree".

The International Monetary Fund (IMF) estimated in its "Fiscal Monitor" published in October 2020 that the net debt of the largest developed economies would rise from 76% of gross domestic product (GDP = total economic output of a year) to 96% of GDP in 2020. By contrast, the emerging markets appear almost solid, with "only" half the level of debt.

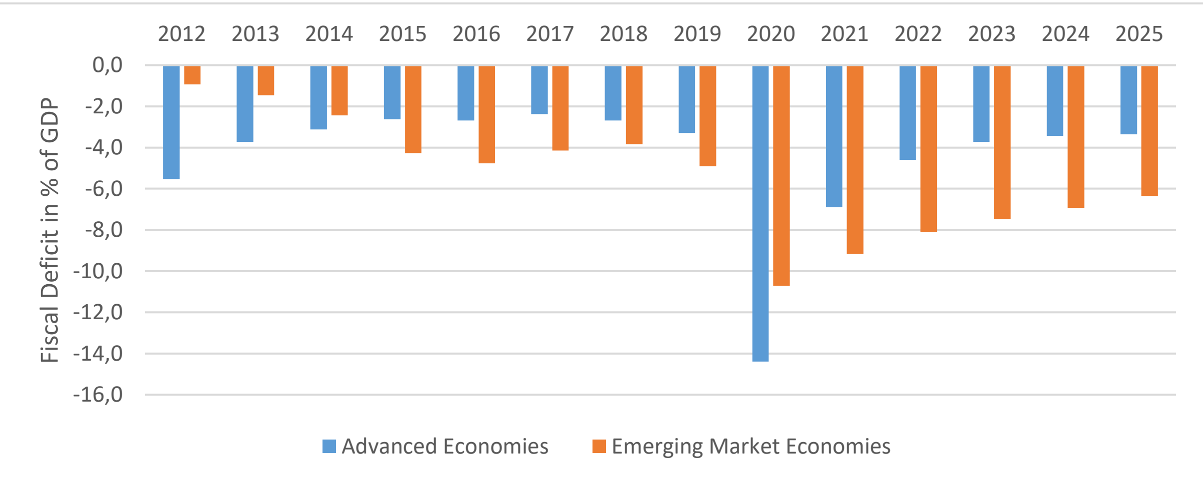
Changes in net government debt in relation to annual economic output



Source: IMF, Fiscal Monitor October 2020, own calculation

If we look at the forecasts for the development of government budget deficits over the next few years, it is clear that states will continue to spend considerably more than they earn.

Development of government budget deficits



Source: IMF, Fiscal Monitor October 2020, own calculation

Even a rapid recovery of the global economy (which is not visible in the current forecasts) would only dampen this development without leading to significantly more solidly financed government budgets.

This fairly clear development perspective leads us to the following conclusions:

- A rise in interest rates, as already ruled out by the US Federal Reserve until at least 2023, is not to be feared in the coming years. Higher interest burdens would quickly prove unsustainable for governments, businesses, and even households.
- Forms of investment based on mere promises of debt (bonds, bank deposits, but also currencies) offer no prospect of yield, simply due to the economic constraints forcing banks to keep interest rates at zero or even below — but they do come encumbered with increasing credit risks.
- The structure of the portfolios we manage will adapt to this and continue to change. Classic bond investments (=securitised debt), which have been a stable foundation for decades courtesy of current interest payments, will be gradually replaced by alternative sources of return.
- Simply switching to investment forms with supposedly higher returns but also higher risks is not a solution. Popular advice such as “dividends are the new interest” has been heard in many places. But this last year, with its numerous cuts to and, in some cases, suspension of dividend payments, has surely finally exposed the inadequacy of this all-too-simple strategy once and for all.

Risk factors in 2021

There are a number of issues that will require our special attention in the coming year. For example:

Delayed insolvencies of companies and consumers:
Until now, extensive government protection measures for debtors, which are mostly temporary, have ensured that insolvency does not necessarily trigger the liquidation processes that it normally would. The question arises as to how creditors can protect themselves against loss of assets resulting from the deferred insolvency thus prescribed. A “snowball effect” of defaults, liquidity shortages and reduced equity represents a real and present danger to companies with their customers and supply chains and banks and their borrowers. This would result in strongly negative economic effects and a renewed "flight to safety" of the financial markets.

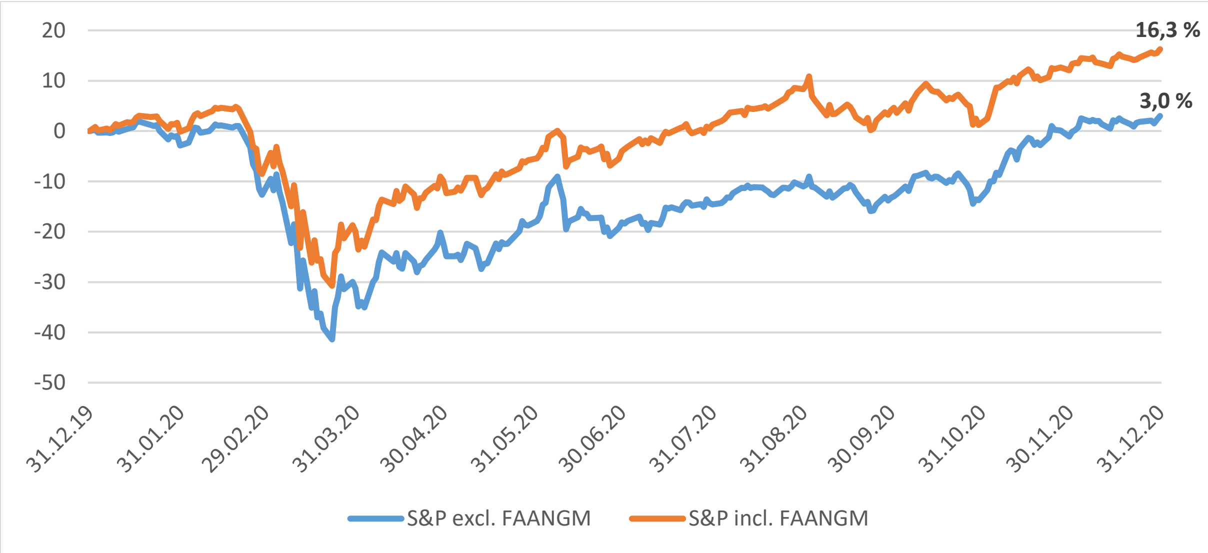
Devaluation race with the world's leading currency, the US dollar:
After the short “escape to the safe harbour” phase, with a gain in value of approx. 8% in the first quarter (currency basket / DXY index), we saw a devaluation of around 13% in the US dollar by the end of the year. The rapidly diminishing interest rate advantage of US dollar assets (e.g. the interest rate advantage of 2-year US Treasury bonds over German bonds shrank from more than 2% to well below 1% p.a.), combined with the sharp rise in US government debt, put pressure on the USD exchange rate. As a result, exporters from other currency areas are losing their competitiveness on world markets. At the same time, import prices are falling for these countries, which is proving detrimental to the necessary revival of growth-enhancing inflation, for instance, in the Eurozone.

Thus far, the central banks concerned have remained tight-lipped on the issue. However, we expect this issue to be addressed shortly, with the aim of limiting or even reversing the pressure to revalue the currencies concerned.

Headwinds for "FAANGM" stocks:

The stock market darlings to date, e.g. Facebook (+ 32% in 2020) and Amazon (+ 77% in 2020), which are both directly (thanks to their high level of weighting in stock indices) and indirectly (as a mood setter) important drivers of stock markets, are under rapidly growing international political pressure. Their sheer size means that they are becoming victims of their own success. Antitrust lawsuits, allegations of misuses of data and market power, poor treatment of their employees and overly aggressive tax avoidance models are likely to become significant burdens for these stocks in the future. The following chart shows the potential impact this may have on the overall market:

2020 performance of the S&P 500 index including (orange) and excluding (blue) FAANGM shares



Source: Bloomberg

Other developments which started earlier will also continue to have an impact on the readiness of the financial markets to take risks:

- The fight against the COVID-19 virus, in particular, the effectiveness of the new vaccines and the speed of their roll-out, as well as further measures to mitigate the fiscal, economic and social consequences of the pandemic
- The first actions of the new US administration under President Biden, which will hopefully be shaped once again by the spirit of cooperation rather than that of confrontation
- The practical test of the new political and economic relationship with the United Kingdom enshrined in the last-minute Brexit agreement.

Our ideas for 2021

In general we expect that in 2021 financial markets will continue to be flooded with liquidity and a large amount of excess capital in search of yield. It is also our observation that the financial world has entered a significant period of change, which will require changes in thinking in many places. Some examples include:

- The transition of the world's economy and energy base to a sustainable model (climate change and social justice), which is being driven by intense political pressure
- the stress test of international supply chains (de-globalisation and insourcing) triggered by the coronavirus pandemic, and
- profound changes in processes in economic and social life, starting with completely new technologies and as yet unknown applications (digitalisation)

We have already initiated targeted investments in some of these long-term developments in the past year – not just because the issues are important in themselves, but also because of the resulting investment opportunities. We want to expand these issue-based equity investments (which have, until now, included, for example, special Internet and environmental technology plus biotechnology), away from the very highly valued "standard markets". For example, new communication technologies, innovative forms of mobility and ways of tackling resource scarcity will all play a role.

If there should be strong signs of normalisation and sustainable economic recovery as early as 2021, we may also be able to add a more strongly cyclical focus on equity and commodity investments.

What you can expect from us

In our outlook, we have described some of the risks that we see in the future to the yield on and capital preservation of the assets you have entrusted to us.

However, wherever there are risks, there are also exceptional opportunities for returns – especially in a world that is changing so drastically.

Past experiences will be of limited help here. Rather, despite all the uncertainty and, in many cases, bewildering complexity, it will be incumbent on us to make the right decisions to set the right course for future returns on your portfolio.

We feel well equipped for this task and are determined to carry it out.

Thank you for all the trust you have placed in us in the past year.

Your

BPM - Berlin Portfolio Management GmbH

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