CIO BLOG

Fahad Kamal | Chief Investment Officer
Investment Strategy | December 2020

TAILS OF THE UNEXPECTED VIII

Markets are exquisitely unpredictable, and each year events – financial, economic, geopolitical, or otherwise – occur which few see coming, but cause powerful ripples to the prices of securities. Instead of consensus-tinged forecasting, we continue an annual tradition of exploring which unlikely, but feasible, events are not priced by markets in the year ahead. These Black Swans, pushed to the overlooked "tails" of probability distributions, have the potential for outsized impact. If they occurred, how would our strategies perform? Do we have plans in place to protect portfolios against adverse market events? Are we positioned to prosper?

We hope you enjoy the eighth edition of our annual Tails of the Unexpected.

THE FUTURE IS YOU KLEINWORT HAMBROS

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1 Early to Rise

Life goes back to normal quickly, leading money velocity, employment, aggregate demand and consumer confidence to rise dramatically, which in turn generates inflation and forces central banks to increase interest rates.

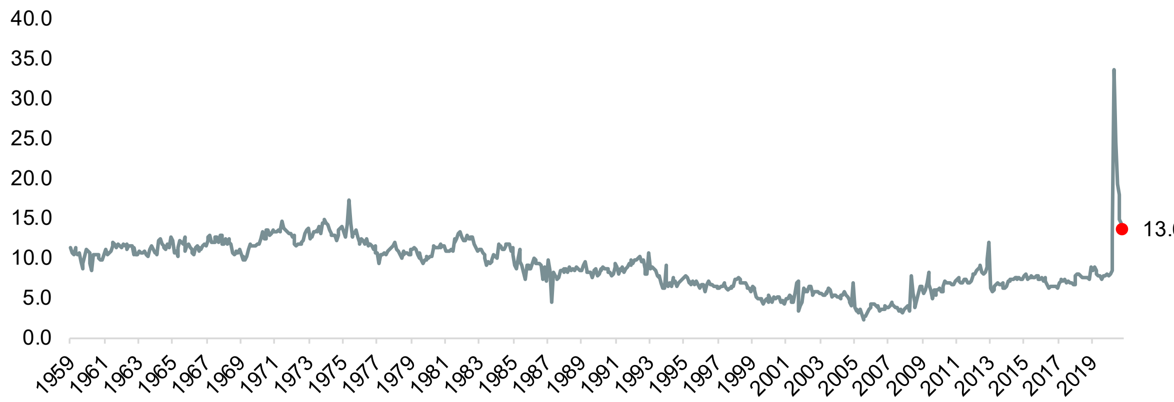
- **Consensus view:** Global inflation is expected to remain low given large output gaps (e.g. slack in the labour market, idle aircraft) resulting from the coronavirus. Moreover, with a long road to mass vaccination, savings rates still far above historical norms, money velocity at historical lows and even wider disparities in income than before the pandemic, there is plenty to hold back consumerism from returning to normal. Indeed, while the UK "reopened" in December 2020 after a month-long lockdown, retail footfall was down by 30% compared to the same December weekend in 2019[1]. With consumer spending being the engine of growth in mature economies, markets expect inflation to be soft and rates to remain low. In the US, for example, the inflation rate is expected to average 1.9% over the next 10 years[2]. This is below target, and remarkable when considering the trillions of dollars in quantitative easing and fiscal spending that are coursing through global economies today.

- **What the consensus view is not pricing in:** A huge upside economic surprise might occur, should vaccine administration go perfectly, leading to effective herd immunity in large swathes of the globe by the end of Q1. In this scenario, life – after all – goes back to normal…quickly. Hordes return to work in actual offices, city centres are brimming and travel for business and pleasure surges. It's not like videoconferencing did not exist in 2019, rather many people considered spending time with others on screen an inferior substitute to the real thing. As normalcy resumes, so does money velocity, employment, aggregate demand and consumer confidence.

- **Potential market reaction:** Pent-up demand from those that have been saving during 2020 is suddenly unleashed, leading to a sharp increase in demand. Brent crude rises back into the $60 to $80 range where it spent 2019, spurred on by OPEC keeping supply capped, which adds an important base effect to inflation calculations. Inflation rises to uncomfortable levels of 5% to 7%. Central Banks begin signalling a tapering of monetary stimulus and even an increase in interest rates: bonds and equities fall in value as risings base rates directly hit the former and indirectly hit the latter via a steeper discount on future cash flows. Zombie companies with unsustainable corporate debt levels default in record numbers and the high-yield debt market tanks.

- **Our positioning:** This will be negative for portfolios given equities and bonds make up a large majority of most strategies. We will not be shy to shift to cash quickly and aggressively. We exited the high-yield market in 2020 on the presumption that default rates were artificially low based on government stimulus. We may look to get back in should yields in the high-yields space rise into double-digits, which would more than compensate for the risk. Our outsized holding in Gold may well benefit as "real assets" are perceived to benefit in inflationary environments, particularly as bonds are dumped and alternative safe-havens are sought.

Chart 1: US Personal Savings Rate as a percent of Disposable Income
1959 - October 2020



Source: Federal Reserve Economic Data, US Bureau of Economic Analysis

[1]https://www.bbc.com/news/business-55209743
[2]https://fred.stlouisfed.org/series/T10YIE

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TAILS OF THE UNEXPECTED VIII

2 The strongest FTSE since Beckham

The UK equity market outperforms the US market for the first time in years; 2021 becomes an excellent time to have increased UK positions amidst a structural shift towards value and away from growth.

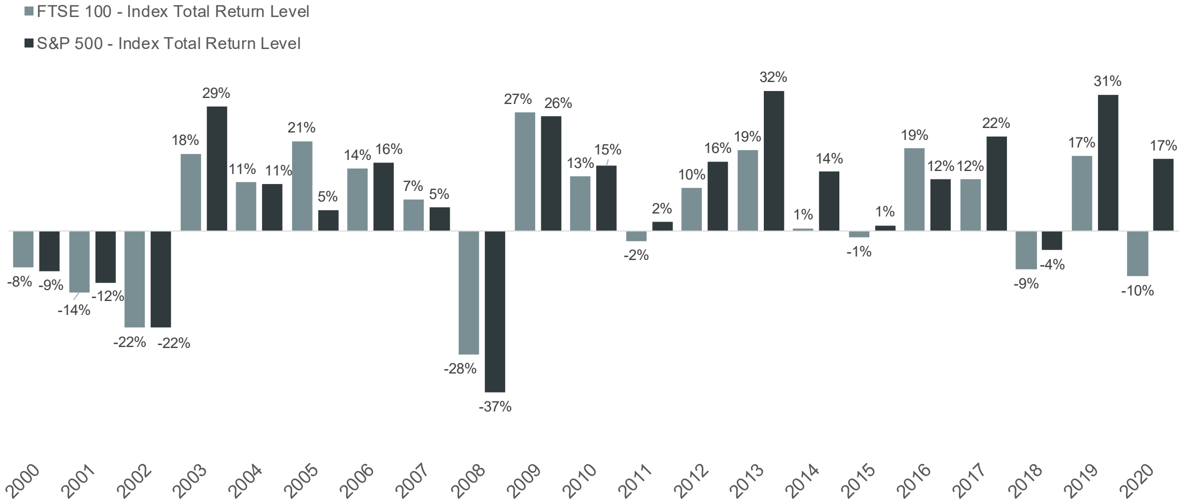
- **Consensus view:** While the FTSE 100 has had a spectacular November following the vaccine announcement, 2020 will still be considered an annus horribilis for the UK's flagship equity market. It ended the year down 13%*, amongst the worst performing anywhere in the world. Indeed, it has been a perennial underperformer, especially when compared with the US: in the ten years between 2010 and 2019 it only outperformed the US equity market once (in 2016). The reason for this is simple – with large banks and energy supermajors, the sectoral composition of the UK market has been deeply out of vogue with regions where technology companies form a greater concentration. The US is a prime counterexample. Indeed, even as "value" investing is getting a boost in the post-vaccine jet-stream, the view lingers that UK banks and energy companies are mature at best, and in secular decline at worst.

- **What the market is not pricing in:** Investors tend to be guilty of recency bias, where events that have occurred recently are weighed more heavily than those of the past. However, there was a time when the UK equity market not only held its own versus the US, but routinely outperformed. In the ten years between 2000 and 2010, for example, the FTSE 100 outperformed the US equity market six times. Ironically, those were years when technology was deeply out of vogue following the monumental dot-com crash at the turn of the century, and banks and energy companies were all the rage (prior to 2008, at least). In that decade, technology stocks – similar to the UK market today – were cheap, oversold and began trending upwards. In hindsight, it presented a fantastic opportunity.

- **Potential market reaction:** Given the consensus, most investors are underweight UK equities. However, a synergistic combination of a Brexit-deal and Covid-vaccine could see a stronger domestic economy againts a backdrop of robust global growth, which will play to the strengths of banks and energy companies, along with the general value-tilt of the index. This could lead to the FTSE 100 outperforming the S&P 500 for the first time in years. Indeed, this becomes a great time to have increased UK positions amidst a structural shift towards value and away from growth.

- **Our positioning:** We recognise these structural trends and have recently increased our equity weight to emerging markets and to Japan, both regions which should benefit from a renewed push towards value-oriented investing. However, we continue to also consider the UK closely. We are currently underweight in most strategies, but are closely following valuation, momentum and sentiments signals as well as the economic regime as it unfolds.

Chart 2: FTSE 100 vs. S&P 500 (Total Returns)
2000 - 2020



Source: Kleinwort Hambros, FactSet. Data as at 11th December 2020.

CIO BLOG

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TAILS OF THE UNEXPECTED VIII

3

This too shall Passive

The euphoria following vaccine announcements fades as the new normal looks a lot like the old one - except with even higher debt, slower growth, higher taxes and poorer productivity gains. A Darwinian corporate landscape favours active managers.

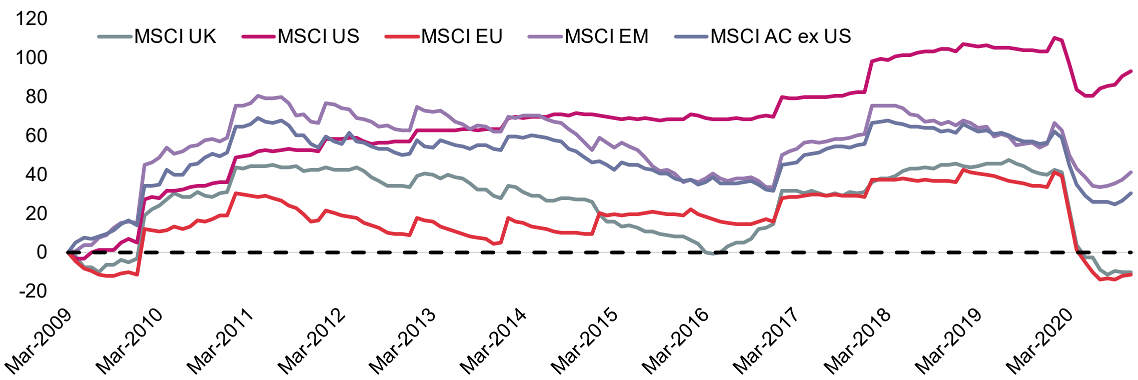
- **Consensus view:** Ever since the Great Financial Crisis, the greatest single force at work in global markets has been monetary policy in the form of slashed interest rates and a deluge of liquidity via quantitative easing. This has acted as a rising tide lifting all boats and has increased correlation between not just individual stocks but entire asset classes. Therefore, it has directly limited the ability to generate alpha for the selectors of individual securities. Over the last decade, research from S&P states that 89% of large-cap US funds, 84% of US midcap funds and 89% of US small-cap funds underperformed their respective passive benchmarks. This is not just a developed-market phenomenon; emerging market funds have produced similar results, destroying the myth that active management excels in so-called “inefficient” markets with information asymmetry. Similarly, 97% of high-yield and investment-grade long funds fell short of their benchmarks over the decade too. As a result, conventional wisdom is now for investors to consider passive implementation as a default starting point.

- **What the market is not pricing in:** While historically loose monetary policy regimes remain in place, the Coronavirus pandemic has been a gamechanger for the corporate landscape. *We enter 2021 with far more optimism than clarity*, and company earnings calls suggest caution on what lies ahead with wide latitude on actual earnings. Furthermore, with companies having rushed to raise precautionary cash by issuing more debt, there are now deeper vulnerabilities to interest rate changes. The picture becomes murkier still should any of the huge optimism prove misplaced: vaccine production or logistics may break down; huge debt in the face of tepid “return to normality” may become an albatross. A Darwinian corporate landscape may well emerge. This environment would be the perfect storm for active managers to rediscover their mojo.

- **Potential market reaction:** The euphoria following vaccine announcements fades as the new normal looks a lot like the old one except with even higher debt, slower growth, higher taxes and poorer productivity gains. Investors become more discerning in equity and debt allocations, not rewarding or punishing in wide arcs as has been the recent trend. Companies are increasingly viewed case-by-case, with a large weighting being given to individual balance sheet strength and strategic position.

- **Our positioning:** In typical funded portfolios across the core flagship strategies, KH portfolios tends to split equally between passive and active implementations. In the US equity market, our largest single position over the last few years was a passive one. This has been one driver of our top quartile performance. Nonetheless, we are well aware that nothing lasts forever. Our two most recent moves – an increase to Japanese equities and an increase in EM equities – have both been to active implementation with managers in whose process and style we have high conviction. We will always seek to implement our views through vehicles that are best suited to the purpose we wish to achieve. We are happy to pay for active management when it makes sense to do so; but are equally comfortable in the passive space given its low cost, liquidity and breadth.

Chart 3: Forward Earnings per Share rebased to 100 from March 2009
2009 - November 2020



Source: Kleinwort Hambros, Bloomberg, MSCI Data

CIO BLOG

Fahad Kamal | Chief Investment Officer

Investment Strategy | December 2020

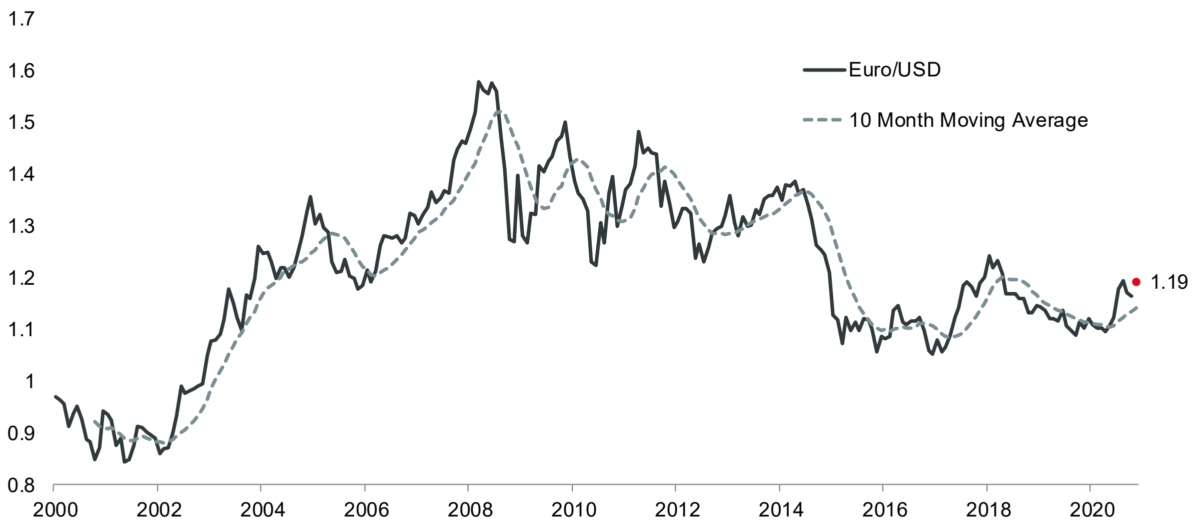
TAILS OF THE UNEXPECTED VIII

4 Kicking up a Fusilli

Eurozone breakup fears re-emerge, and this time it's not the UK .

- **Consensus view:** Despite the devastating effects of the Covid pandemic, the alliance of the European Union seems to be stronger than ever. It was bolstered immeasurably by the agreement between richer member states and former stimulus hawks such as Germany to issue collective debt in the throes of the first wave of the Coronavirus. Investors interpreted this as a clarion call for Continental unity and solidarity. As we enter 2021, the Eurozone no longer appears moribund, and the Euro is again gaining credibility as international payment currency. This single currency had a smashing 2020, up over 8% versus the US dollar.
- **What the market is not pricing in:** Good intentions tend to fizzle in the labyrinth of Eurozone bureaucracy. The impact of the pandemic on public health and economies diverges significantly, with the poorer South being hit much harder than the richer North. Despite a generous stimulus package being agreed, money remains to be slow to flow to the states – and the people – who need it most. This will add rocket fuel to restive right-wing populism in hard-hit countries like Italy. Moreover, far from deterring Eurosceptics, Brexit negotiations might provide a blueprint to navigating legal challenges when leaving the bloc for others.
- **Potential market reaction:** Uncertainty around the stability of the EU and its trade environment could prove to undermine Eurozone equity prices, and the EUR/USD pair drops to par as fears mount yet again about the future of the union. The euro loses credibility as payment and reserve currency, and large capital flows into USD-denominated bonds further depress yields in the US and prop up the dollar. US equities and bonds benefit from lower rates driving down discount rates.
- **Our positioning:** When it comes to our international holdings (i.e. ex-UK), our US equity exposure significantly outweighs Eurozone assets. Indeed, should US Dollar strength occur broadly, it has the net effect of raising the value of our non-Sterling denominated assets, providing tailwind in global strategies.

Chart 4: EURO/USD Mid Spot Exchange Rate
2000 - November 2020



Source: Kleinwort Hambros, Bloomberg

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TAILS OF THE UNEXPECTED VIII

5

Bit-by-bit

Bitcoin hits $100,000 in value as the market acknowledges it as a real currency that can no longer be ignored.

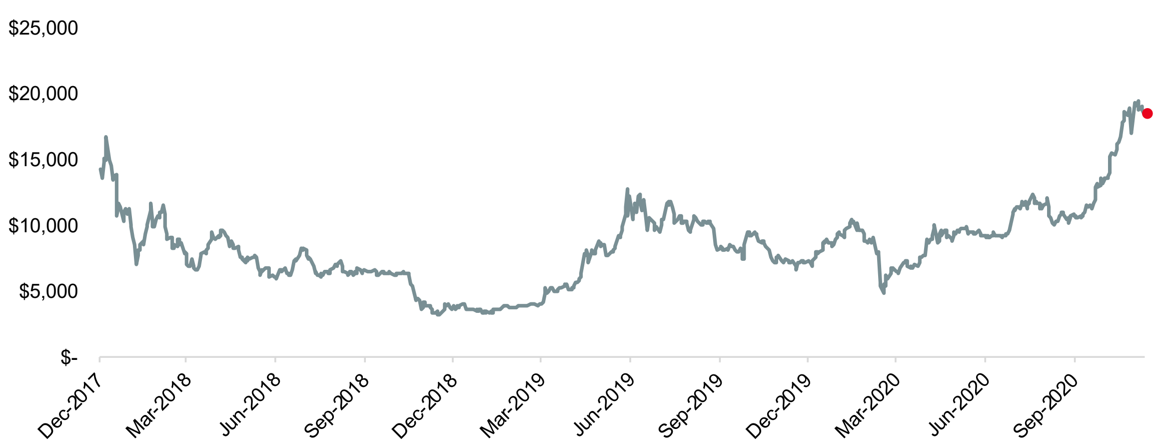
- **Consensus view:** Bitcoin has largely been shunned by the gatekeepers of financial orthodoxy. For one, it is still not widely understood. Perhaps most saliently, its main issue is that it does not meet the definitions of being a currency: Firstly, it is not a widely accepted medium of exchange (i.e. you can't use it on Amazon); secondly, it is not a stable store of value (i.e. what one bitcoin is worth fluctuates wildly day-by-day).

- **What the market is not pricing in:** PayPal has started to allow its customers to access Bitcoin, giving 26 million merchants in its network the ability to begin accepting it as a means of payment. *This gives it a critical impetus as a genuine medium of exchange.* Its acceptability achieved another milestone when analysts at JPMorgan suggested that a "doubling or tripling" is possible – only three years ago, CEO Jamie Dimon called Bitcoin a "fraud". Prestigious endowment funds at Harvard, MIT and Stanford have also been rumoured to have taken positions. Earlier this year, one of the largest asset managers in the world – Fidelity Investments with $3.3 trillion assets in assets – announced the creation of its first Bitcoin mutual fund. While widespread adoption is nowhere near close, clearly the gatekeepers of financial orthodoxy are no longer as dismissive as they once were. With institutional acceptance and holding will come increased stability as these owners are less interested in short-term speculation than long-term market-making. This should provide additional stability and predictability to Bitcoin, *allowing it to be a genuine store of value*. With these two conditions met, it is a real currency. The mainstream can finally believe too.

- **Potential market reaction:** While the adoption of Paypal was a quantum leap forward for the cryptocurrency, this year may well see another in the form of the total value of outstanding Bitcoins beginning to rival that of gold. Already, the value in Bitcoin ETFs is already roughly similar to that of Gold ETFs. However, a gulf still exists in the total value of gold at about $2.6 trillion (including bars and coins) versus $240 billion for Bitcoin. Should Bitcoin begin to be considered a substitute for gold – unlike fiat currencies they are both finite and decentralised - with research suggesting millennials preferring the former, the widespread adoption may turbocharge the price of Bitcoin to $100,000, a 500% increase from where it begins in 2021. Think it can't happen? Tesla jumped 700% in 2020 as it journeyed from being a heavily shorted and ridiculed security to being widely accepted and added to the S&P 500 – all in a few short months of a pandemic year!

- **Our positioning:** We have no direct positions in Bitcoin as we do not consider it a legitimate currency at present. Nonetheless, we are watching developments in the space with great interest. Moreover, we believe in the underlying Blockchain technology on which Bitcoin and similar cryptocurrencies are built. Indeed, one of our flagship strategies specifically holds investments in companies that are likely to benefit from the ongoing blockchain revolution.

Chart 5: Price per Bitcoin per $
December 2017 - December 2020



Source: Kleinwort Hambros, Bloomberg

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