FIVE CHANGE VECTORS THAT WILL IMPACT YOUR PORTFOLIO IN 2021

Op Ed by Dr Rory Knight

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JOONGANG GLOBAL MONEY

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2020 was one of the most violently volatile years in living memory. 2021 in turn focuses a range of factors that will transform the world and potentially disrupt financial markets. Investors will need to take a hard and wide look at their portfolios. *This time it might actually be different.* When - if - we emerge from the pandemic, what will be the new normal? Will we inhabit a world not only of shattered economies and hollowed out city centres but new values and behaviour? Have we bid a last hurrah to the globalization of the Twentieth Century based around the shrine of liberal free markets? Will long-established Western values of freedom and democracy be superseded by more authoritarian Asian models? Alternatively, will the old models reassert themselves? With new vaccines coming on line, will economies and equities soar as never before? Unfortunately there are no easy answers to these questions. On the dark side, the world economy has undoubtedly been dealt a severe blow. A recent IMF report identified a global recession in 2020, and world GDP last year will certainly be significantly lower than 2019. This will be accompanied by substantial unemployment virtually everywhere. Yet to be revealed is the damage done to small- and medium-sized enterprises around the world, many of which may never recover. These developments have been attended by a significant expansion of debt, both private and public. When will the price be paid? Inevitably, the bill will one day need to be settled and could bring in its wake a very serious risk of inflation-driven recession. So what could go wrong and what should we do about it?

Green shoots of recovery? On the bright side, the vaccination programmes mounted in many countries offer hope that the world economy will emerge from lockdown by mid-year. Most stock markets actually performed positively in 2020 as shown in Figure 1. While 2020's Q1 was the worst quarter in most markets, Q2 bounced back as the best quarter in decades. However, given the dire state of most real economies around the world, nearly all of which except China contracted in 2020, many claim that equities are a bubble about to burst. A more optimistic interpretation is that market judgements correctly predict a rebound in real economies as countries emerge from lockdown. Encouragingly, Korean stocks surged on the back of its technology mix and positioning in the global chip manufacturing value chain. Although the Korean equity market has been undervalued for years, the swing to value from growth investing has certainly added momentum. Foreign interest has increased from a relatively low base, and the strengthening won has helped dollar-based returns. However, the overall market picture masks worrying underlying trends. Performance has been exclusively driven by a small proportion of stocks, chiefly large-cap technology companies, which compensated for the huge losses in airlines, travel, retail and banking. The truth is that buoyant prices may reflect neither bubble nor rational pricing. The answer lies not at the aggregate but the individual stock level. Generalisations about stock-markets are no longer valid in the post-Covid world. The old order is over, and grasping that will be crucial for all investors even passive index huggers. Five powerful, mutually reinforcing change vectors will shape this new order. Understanding their impact on portfolios is crucial.

1. Geopolitical change

Formerly, investors could ride out macroeconomic factors. In future they will ignore them at their peril. Even before the pandemic serious fissures had opened in the geopolitical landscape and these have widened significantly since. Prominent among these were the US-China tensions escalating from trade frictions to more ominous levels, and a rise in nationalism, exemplified in Trumpian republicanism in the US, Brexit and Italy's Five-Star movement - the last two of which suggest problems ahead for the EU. The Biden administration may change the tone of US foreign policy but not its direction which will revolve around continuing rivalry with China. China for its part is signalling a more insular approach with its so-called 'dual circulation' economy, privileging domestic consumption and technological autonomy whilst weaning itself off the dollar, which will continue to decline in significance as the world's reserve currency. It is inevitable that China, the second-best performing stock market after Korea in 2020 and the only country to enjoy a positive GDP growth, will soon overtake the US far sooner than once expected. International capital will increasingly shift to China. While more than 90% of Chinese equity is still owned by local investors, foreign capital will inevitably take up a larger ownership share in Chinese companies. Fortunately Korea is well placed to benefit from these changes with its strong technological capability and close proximity to China.

2. The spectre of inflation

Financial risk has been dangerously heightened by the pandemic. The world financial system was already fragile in the wake of the 2007 financial crisis. Government and private debt were high, central bank balance sheets bloated as a result of years of quantitative easing and interest rates very low. The financial system is now significantly more fragile. Central bank balance sheets have doubled in size, the US Federal Reserve's now stretching over $7 trillion from $3.5 trillion in December 2019. Government debt has spiralled as a result of the recent additional stimulus packages needed to sustain the lockdown - around a trillion dollars in the UK and over two trillion in the US. Interest rates world-wide are more or less zero, with many long-term sovereign bond issues offering negative yields. Compensation for taking risk is at an historic low. Government expenditure as a proportion of GDP is at an all-time high for the world economy which is driving up nominally cheap government debt. Any increase in interest rates will be a considerable inhibitor of economic recovery. Household and corporate debt has expanded, also increasing the exposure to interest rate risk. Any jump in interest rates could result in stagflation plunging the world economy into severe recession. A Catch 22 looms. If vaccination offers a path out of lockdown, winding down government debt and central bank balances will require higher taxes and interest rates – which in turn will dampen economic growth. Conversely, if recovery requires a further year of lockdown and round of stimulus, this will simply push a bigger problem into the future. Oil may do well under either scenario, and it is also unsurprising that the safe haven of gold and bitcoin are both at an all-time high. Meanwhile the global banking sector is under considerable pressure. The low interest rate regime makes most banks unprofitable, which reduces the supply of money and increases pressure on central banks to further expand their quantitative easing programmes. The investment prospects in this sector are extremely limited except for universal banks which may benefit as smaller regional banks suffer. All future equity investments will call for caution and close attention to balance sheets, as higher debt levels threaten equity holders with increased risks of bankruptcy. With a Keynsian now in the White House it will be 'spend, spend, spend' and with a monetarist in the Federal Reserve it will be 'print, print, print'. Biden's $2 trillion stimulus package takes the cumulative spend to $5.5 trillion – 25% of GDP. The policy is likely therefore to be spend, print, repeat – a perfect formula for inflation. So there is a risk of inflation rearing its ugly head again. High inflation causes serious damage to society, eviscerating earnings and savings and a consequent risk *in extremis* of serious social unrest.

3. Social changes

Globalization has helped lift billions out of poverty in the last thirty years but at a cost of income and wealth inequalities within and between countries. Governments' responses to the 2007 crisis involving bank bailouts and massive monetary expansion exacerbated these gaps, with the rise in asset prices benefiting the wealthy while the poor suffered from austerity policies. The situation was already at a tipping point before the pandemic, and the future will see it come to the fore far more stridently with demands not just for greater diversity and social justice and stronger environmental protection. We are already seeing this in movements like BLM and the direct actions of climate activists. Environmental damage and climate are now core corporate concerns. Investors are becoming more demanding with respect to responsible investing. Sectors such as fossil fuels, tobacco and alcohol producers especially find themselves in the firing line. The pandemic has accelerated this process by at least a decade. Corporations which ignore their social purpose risk decline and obsolescence. This factor will have a major impact on corporate returns, and investors should consider the exposure to stocks subject to such tectonic change. Politicians will of course see opportunities to build political capital in this changed climate.

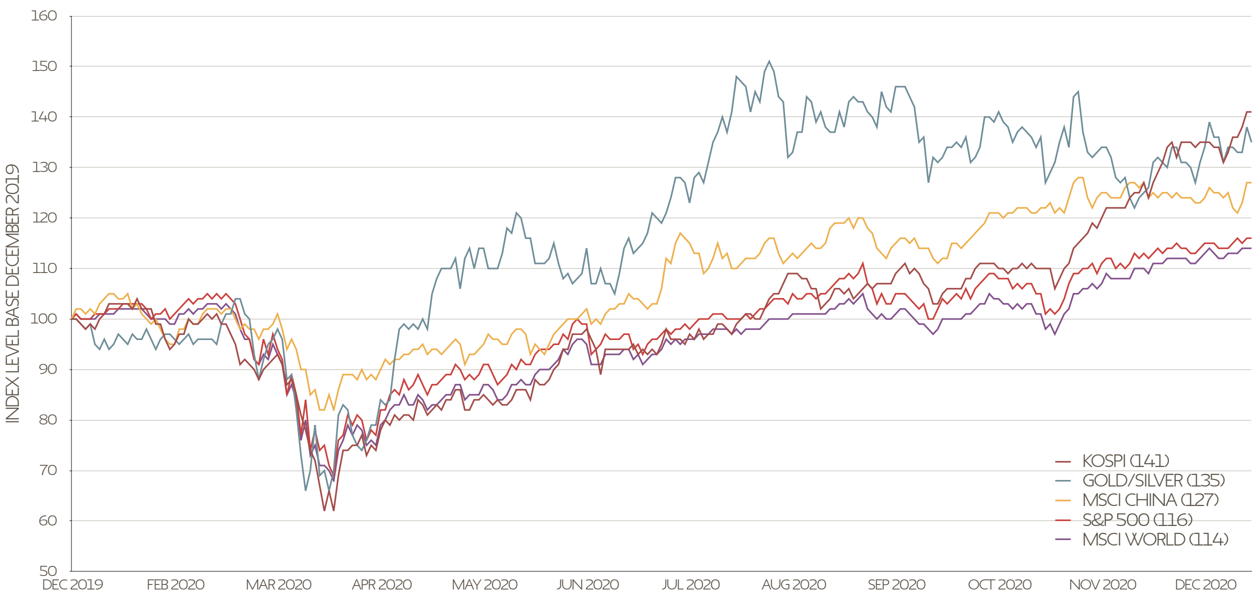
4. Regulatory changes

The pandemic has seen government interventions in economies reach unprecedented levels. These may take a decade to reduce if ever. Politicians have enjoyed a windfall of power which they will be reluctant to relinquish, providing the perfect conditions for regulation to flourish. Under Trump regulation was slashed, although not as much as he promised. Biden will undo most of Trump's deregulation and introduce more in part as a result of rejoining the Paris Climate Accord. Another area attracting regulatory attention will be social media. Regulating these behemoths which control global social media platforms has been on the agenda for some time. A regulatory crackdown in the US and EU will likely impact on the valuations of these companies - which ironically have been major contributors to the 2020 equity market rally. Portfolios overweight in these companies are therefore likely to be at risk. The financial services sector is also likely to be subject to more stringent regulation in the US, Europe and China, with a knock-on effect on internationally listed banks and companies. In the US there is talk of non-US companies being delisted, although the costs for US investors may prove prohibitive. In Europe, the Brexit agreement completely left out financial services leaving worrying uncertainty over the final shape of regulation that emerges. Other international financial centres such as Hong Kong may also have to adapt their regulatory regimes to maintain competitiveness. Overall, the deadweight of increased regulation could well dampen growth. Fortunately technology may be a counterweight.

5. Innovation to the rescue?

Increasingly the world is driven by intellectual capital rather than financial capital or physical resources. As often remarked, data is the new oil. Technological innovation hand-in-hand with favourable demographic trends helped keep inflation at bay over the millennium. However the changes unleashed by the pandemic could well prove inflationary. Equally though, innovation could continue to keep costs down through gains in productivity. Schumpeterian creative destruction is an inevitable by-product of innovation. High street retailers are being wiped out by online innovation and other stocks in financial portfolios may well await the same fate. Understanding how investments could benefit from innovation in a digital world is key. Three overlapping areas of innovation will be critical to an inflation-free recovery: healthcare, artificial intelligence (AI) and cryptocurrencies. Innovation in the healthcare sector to create new vaccines has been remarkable and continuing efforts will be vital to future protection. AI will have a critical role to play in managing Covid clearance and reinvigorating the world economy by reopening international travel. Cryptocurrencies will play a crucial role by shoring up fiat currencies otherwise exposed to inflationary dilution. Many believe that technology stocks valuations represent a price bubble. The evidence suggests this is not the case. True, technology stocks have greatly benefitted from the lockdown: Shopify, Zoom and Tesla have all doubled in value. The key question is whether these companies will continue to enjoy sustainable free cash flows in the future. Generally, their values reflect markets' rational expectation of future free cash flows. Of course there are risks. A general downturn may cause tech stocks to tumble, regulation may rein in some of the large tech companies or there may be a swing away from growth to value investing placing such high growth stocks under pressure. But this is likely to have only a transitory impact. Some are high beta stocks but those with little debt and strong brands will continue to deliver value. Looking ahead to 2021 and beyond, I believe pessimism is misplaced. Markets like humans are remarkably resilient and will inevitably bounce back. Just look at Korea. As figure 1 shows, it was the strongest performer in 2020 with a staggering 41% return, outperforming gold by 600 basis points and the S&P by 2,500 basis points. In the face of the five vectors of change I described Korea looks very well placed to benefit from their impact. Let us hope other economies follow its example.

FIGURE 1: Market performance 2020 (US$)
SOURCE: Refinitiv



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