Newsletter

December 2020

INDEX House View

The US elections' result might have surprised the divided American society, but polls were already telling a clear story in the previous five months. Markets reacted positively since November 3rd, which is not a surprise given the return to normalcy that mr. Biden brings to domestic and international US politics. All American and major Asian indexes are now in the black for 2020, while the Europeans are lightly negative. At the same time, bitcoin has breached $20,000 after matching this level three years ago, while gold has indeed reached a very high valuation in a long-term perspective, but lost 10% since its summer peak. In aggregate, these market reactions suggest investors have little worry on the future of the global economy. Instead, the argument is in favor of a risk-on attitude, where preference goes to assets with a higher growth promise and less current fundamental strength, as opposed to more stable, high return businesses. This is typical of a world in economic expansion, where earnings forecasts are overall positive. Only that we are simply not in this situation, excluding isolated pockets of economic growth in China and Brazil.

Meanwhile, many countries are fast approving various vaccines for the current strain of Coronavirus. This factor indeed contributes to the year 2020 concluding with anticipations of a swift global economic recovery. In this optimistic environment, it is no wonder that tech names have powerfully outperformed the rest of the market, with 2020 IPOs in tech posting +90% (Snowflake, NetEase, Zoom, Airbnb), about double the global 2020 IPO average performance (+46%) and the Western best performing index S&P500 (+15%).

As conservative and long-term investors, this year we bet exclusively on fundamentally solid companies both in business model and balance sheet strength terms. Interestingly, the maximum discount we saw was around 40% (Rational AG), with many others down only 20%, a sign that quality companies almost never come comfortably cheap. We participated in the lockdown-generated spike of earnings of US tech companies, prepared ourselves for a disruption in global fisheries, bet on the Brazilian domestic market and on the return to normal domestic flights in the US. One important takeaway from this year is that the Covid-19 emergency accelerated dramatically the digitalization of many industries. Opportunities exist today thanks to this trend, while other opportunities seem to have run their course and entered puzzling expensive valuations – Tesla above all, a company that inspires so much hope in humans and therefore trades at about 333 times the little cash it generated in the last 12 months.

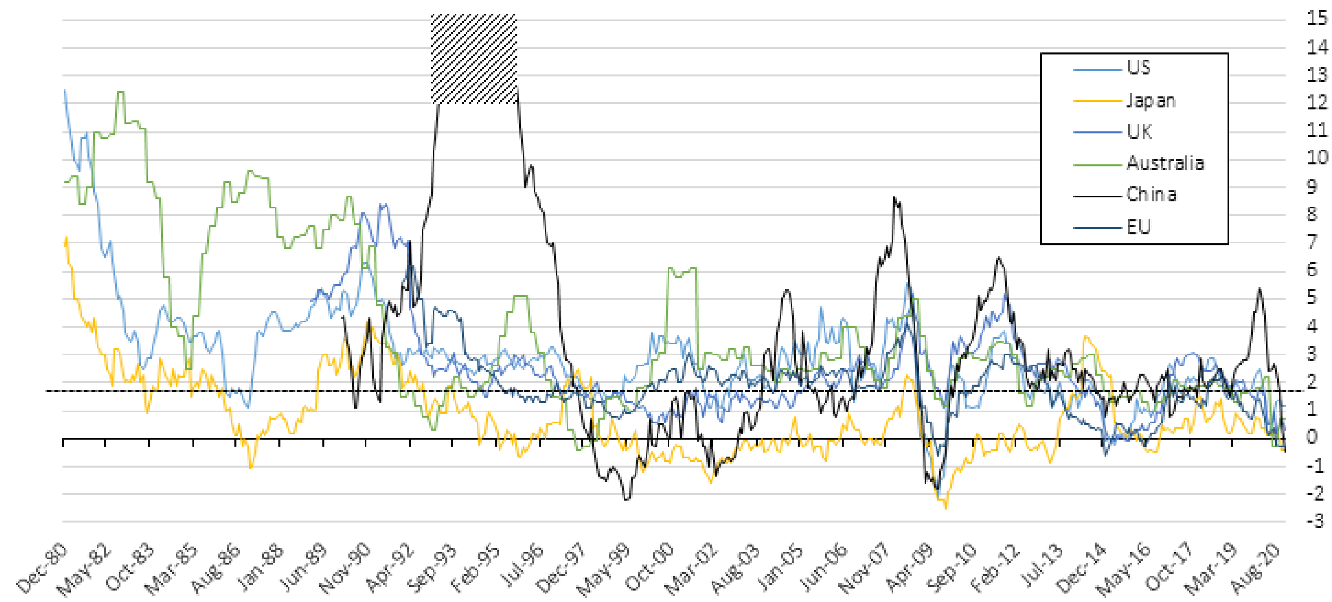
Our view of 2021

Looking on to 2021, the direction of equity valuations depends almost exclusively on three elements: continued government financial support, low interest rates and contained inflation.

The first two are intended to reign on an out-of-control debt burden, both at government and corporate levels – AAA companies are at their thinnest numbers since 2008. Currently, the US Congress is deliberating on the 3rd economic stimulus of 2020, which markets have already decided will happen. At the same time, interest rates are not forecasted to increase any time soon. Interestingly, some traders this year bet on a further US rates' decline from close to zero to practically zero, and actually made money – US 3M Libor was almost 2% in January, now 0.22%. Inflation is key for central banks to avoid both economic depression and economic overheating. Should inflation stay around the 2% threshold, interest rates will not increase. The nightmare for both regulators and investors begins if consumer demand spikes after businesses go back to normal.

A glance at the graph below reveals that inflation tends to floor as economies reach a developed state. This is only logical. Economic expansion has plateaued in Western countries and Japan, together with a stabilization in social evolution and consumption – with the exception of China, which is still in full expansion mode. In simple words, there is only a moderate chance of inflation spiking, and even in that case it will only be a spike, rather than developing into a sustained high inflation phase into 2021.

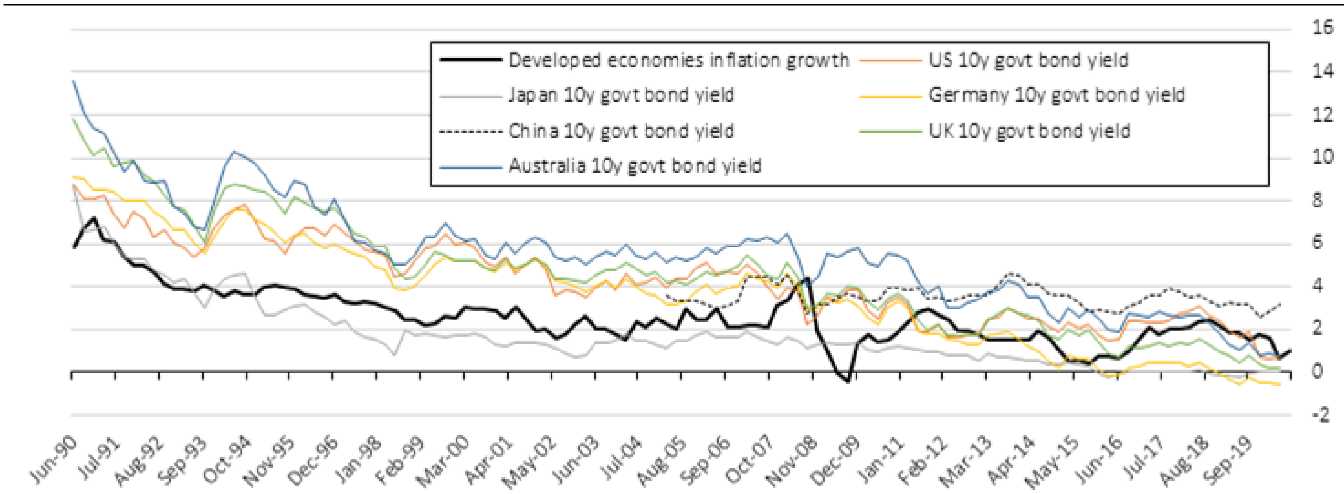
Global consumer prices' growth in developed economies plus China (%)



Source: Bloomberg

A further glance at Western inflation versus bond yields also reveals there is very little remuneration coming from fixed income – China is the highest paying entity at 3.15%.

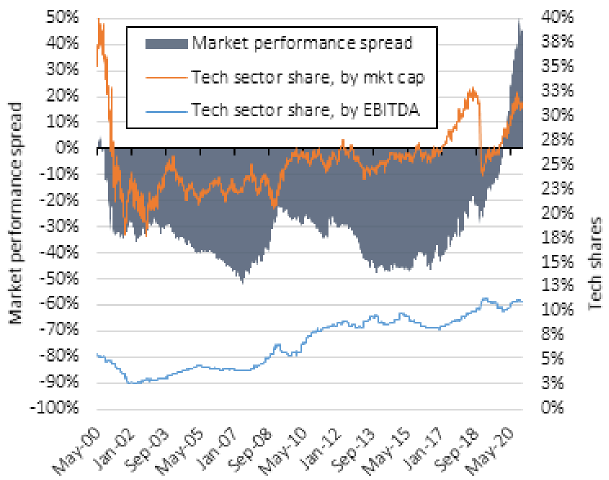
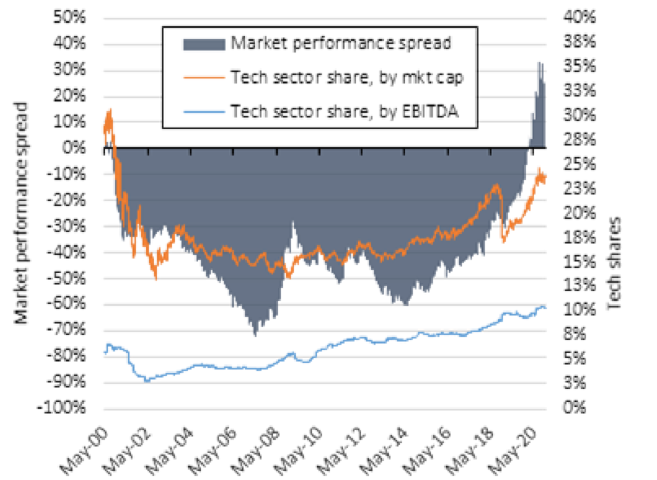
Developed economies bond yields and inflation growth (%)



Source: Bloomberg

With an outlook of stability in these three variables, the argument for continued growth in equity valuations is inevitably strong. In addition, zero returns in bond yields further amplify the attraction of high-growth equities. As a result, we shall continue to witness a rise in tech valuations in 2021. It is simply the most attractive option for investors looking for remuneration.

We have updated our relative view of the tech industry versus the rest of world. While this is only a partial view of it, it is clear this sector is slowly contributing more in fundamental (EBITDA) terms to the global economy. At the same time, market valuations have spiked considerably. Is this wrong? No, but there is a non-negligible chance investors have got ahead of themselves in 2020.

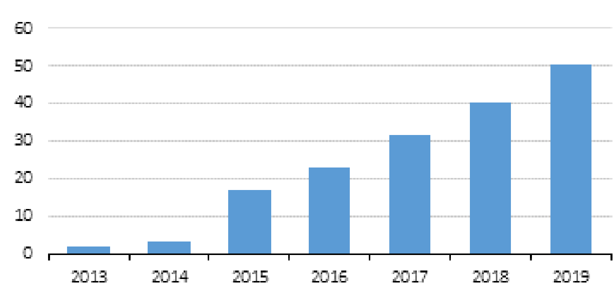
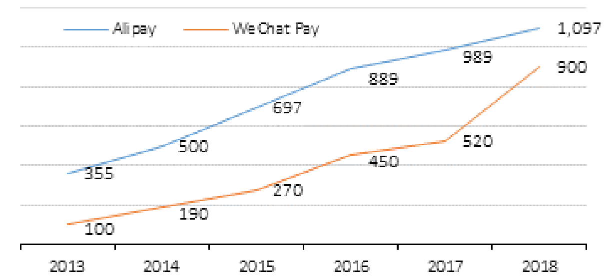
Tech share of the world	Tech share of the US
	

Source: Bloomberg

New trends

Despite some worrying unbalances in the global economy, we see various opportunities worthy of investigation and perhaps investment. Of course the global economic migration from physical to web-based takes center stage. The Economist Intelligence Unit estimated that online retail sales in the 60 biggest economies grew by over 30% in 2020. By 2025 online sales will probably account for nearly 20% of total retail sales, up from 10% in 2019. We expect more industries to undergo this substitution trend, specifically basic materials, automotive, education and healthcare (Medicare in the US went from reimbursing 11,000 virtual visits a week before the lockdowns to 1.3m visits a week during March-May 2020).

Perhaps more immediately accessible are the solar, payment and cybersecurity industries. A quick look at what is going on in China shows that the future of payments, in particular, is online. No more corresponding banks charging $60 for transfers that take four days through the Swift system. Transferwise and Revolut already offer such services, saving money and time for all clients globally. Intelligently, this change from traditional to online payments only takes a phone, without having to pass through a credit card or a bank account. Therefore, frontier and emerging markets that have seen low numbers in banking and cards are the perfect breeding ground for online payments (India's Unified Payments Interface, Brazil's PIX, and Chinese Ant Group).

Mobile payment transaction volume (USD trillions)	Numbers of active users (millions)
	
Source: People's Bank of China, Caixin Data, CEIC	Source: Statista, Xinhua, China Plus, Tech in Asia

Lastly, the physical-to-online transfer will naturally happen as newer and more digitally savvy generations will play more controlling roles in the global economy. The earliest age of smartphone users today is around 5 years old among Western countries. So, by the time this individual becomes financial independent in his/her twenties, he/she will be largely accustomed to a life online.

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