# BEYOND COVID

## QUARTERLY ECONOMIC OUTLOOK Q4 2020

MAZARS

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# Foreword

Global stock markets built on the astonishing rebound from the Spring to post further, albeit more modest, gains during the third quarter of the year. Global stocks rose by nearly 5% in sterling terms. That said, again the rises were far from uniform geographically, with US and Japanese equities posting strong returns whilst Europe struggled to a marginal positive return. UK equities continued to struggle, losing 2.5% over the period, as sectoral differences (the UK has very little in the way of large Technology companies) and Brexit uncertainties which dissuade foreign investors left the UK market at a significant discount to other developed markets. Aside from equities, Gold, started the quarter strongly, but then sold off in early August as safe haven assets including the US Dollar retracted in less volatile markets.

There has been a noticeable change in market behaviour when it comes to news of a vaccine or therapy for Covid-19, with reports of successes and setbacks not causing bouts of exuberance and panic in the way they did during the Spring. Partly this reflects a more grown up understanding of the medical situation – we no longer hope for an overnight cure – and relatedly, an acceptance that the virus will be with us for some time at least, requiring governments to find ways of keeping economies open to the fullest extent possible given the risks to life.

Thus we find ourselves living not only in an age of ultra-low interest rates with little prospect of this changing in the medium term, but also in a time where direct fiscal support has become a necessity to keep the show on the road. In the US a bill to release a $2.2 trillion fiscal support package is making its way through congress. Its progress will be hindered by the split legislature (for now at least) and complicated by the November elections, but in all probability, sooner or later a massive deal will be agreed funded as always from future tax receipts. Similar packages can be seen across Europe, and in the UK we have seen further measures so that the state can for all intents and purposes pay the wages of private sector employees. This is not insignificant stuff, and whilst the case for doing it is sound the repeated question of its cost, the accumulated debt, and when the 'chickens will come home to roost' is persistent.

Aside from the struggles of fighting the coronavirus, the UK and Europe face the more manmade issue of Brexit. Last month saw the UK Government move to step away from the agreed withdrawal bill leading to an admission of the violation of international law, and the EU announcing a legal challenge. To what extent such manoeuvring is part of a plan to drive through a deal before the UK's exit is open to speculation, but most investment commentators seem to believe that some sort of agreement will be found, and if so, it will probably be found at the eleventh hour. Such assumptions are often weighted to one's own preference, and with visibility of the final outcome almost completely obscured we see no reason why not to prepare our portfolios for the possibilities of either a basic deal or no deal at all.

At our September meeting the Investment Committee voted to retain our close to neutral position in equities and our overweight to gold. We continue to hold underweight positions in low yielding sovereign debt and the commercial property sector. We reinstated a degree of currency hedging within our overseas equity exposure, mindful that Sterling is the primary transmitter for Brexit developments.

DAVID BAKER

Chief Investment Officer
Mazars Wealth Management

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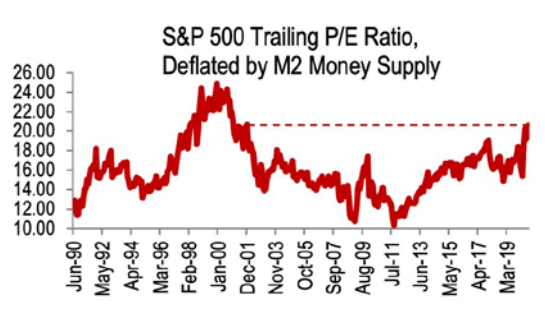
## Preface

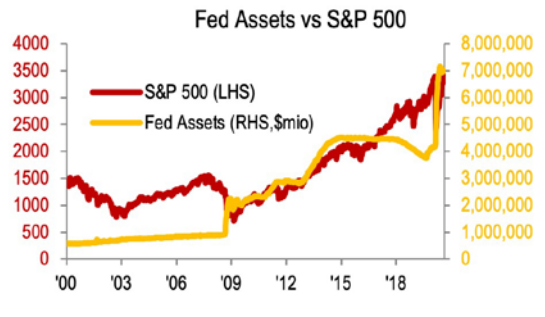
Quarterly outlooks such as this often offer a wealth of numbers and information about what is going on in the world. By their nature, however, they are also tactical. After all, how much does strategy change over 90 days? Returns are not about valuations at this point. Even accounting for monetary expansion, stock valuations are the highest they have been in nearly 20 years. And it is not about economic data or Covid-19, as the economic rebound is petering out and Europe is seeing a full second wave of the coronavirus. All these issues against a backdrop of nearly record-high stocks propelled by Federal Reserve printing. But a lot of investors are wondering whether prices are sustainable against that backdrop. The issue is not whether fundamentals are deteriorating but whether they are irrevocably changing. This particular quarterly focuses on these big themes, as we believe they are now driving portfolios.

The theme of this publication is "Beyond Covid". We try to look at the larger themes in play and how Covid-19 affects trends that have been key to investment returns for years. This doesn't mean we ascribe to every possible outcome and try to accommodate them within our portfolios. Some are more appropriate than others for our discretionary portfolios, and some would fit more bespoke models for particular investors. Nevertheless, we will try to analyse as much as we can.

Stock valuations highest in 20 years




Record high printing supports prices




GEORGE LAGARIAS
Chief Economist



Chart Source: Mazars Calculations, Refinitiv

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# Beyond Covid (continued)

## Economic performance

In the second quarter of 2020 the global economy saw its worst contraction since Gross Domestic Product began to be recorded in the modern way. The US lost more than 10% of its output, Europe 13% on aggregate, and the UK a whopping 20%. At the time of writing more than 32 million cases of Covid-19 since the beginning of the year have resulted in just over 1 million deaths worldwide. Cities with busy airports, such as London and New York, took the hardest hit rendering the so called "first world", some of the world's biggest economies such the US, Europe and Japan, the most vulnerable. As a result, stock and bond market volatility increased substantially, with global equities losing a third of their total value before the US Federal Reserve, the world's de facto central bank, stepped in, once again flooding the market with liquidity and driving an unprecedentedly speedy recovery of risk assets back to peak prices within the space of 45 days. The move was followed by other central banks, most notably the European Central Bank (ECB), which added $1.5tn to the Fed's $3tn into the financial system.

## The investor conundrum

This persistent dichotomy between stock market performance and economic performance has been a particularly hard puzzle for investors. While it is very clear that the previous 12-year economic cycle has undoubtedly come at an end, the financial cycle, thanks to central banks, has survived a five standard-deviation event (1 in 3.5 million probability), and continues unabated. With the global economy in turmoil, can stock and bonds be trusted to create or even maintain wealth?

Despite euphoria about another convincing display of the "Fed Put", investors are understandably worried and reticent as corporate earnings, which depend on real demand for goods and services as opposed to artificial demand for stocks, did not rebound along with stock prices, rendering risk asset valuations extremely expensive by any conceivable metric. Analysts are estimating a 30%-40% drop in earnings due to the pandemic, without expecting a full rebound until well past 2025. And, of course, when one looks at the actual damage to the global economy and the potential for high unemployment, one wonders when a modicum of healthy and self-sustaining demand will come back online. Investors have spent 12 years convincing themselves that economies and stock markets can remain medium-to-long-term disconnected longer than they could possibly hope to bet against that outcome. During that period, the US economy rose by an average of 2.4% per annum, as opposed to the S&P 500 which averaged

Record output loss in Q2


...but the financial cycle is intact

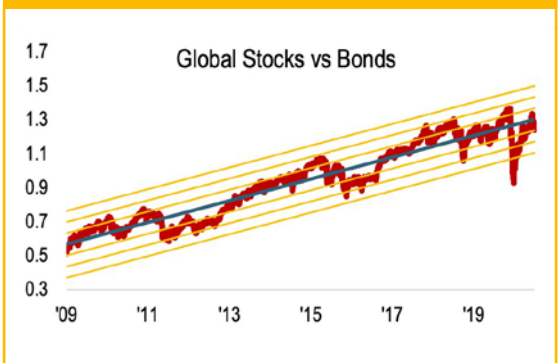




Chart Source: Mazars Calculations, Refinitiv

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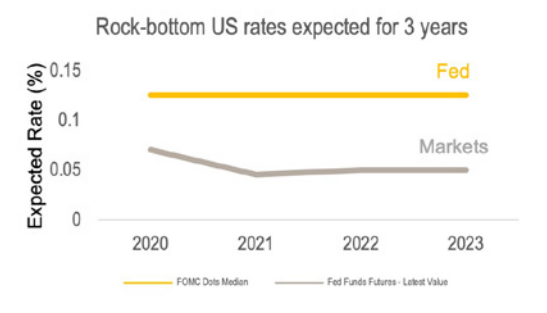
# Beyond Covid (continued)

9%. And capital investments, which had risen 58% in the three years preceding the global financial crisis, have fallen 8% cumulatively in the 12 years since. But it is very difficult to accept that fiat currency can be ad infinitum printed to support risk assets, in a manner completely disconnected from the real economy, without any repercussions.

Enter, once more, the Fed, which in mid-September all but promised not to raise interest rates until 2023 and will accept higher than target inflation in a bid to allow the economy room to perform a rebound. But, also importantly, Mr. Powell ignored market expectations and didn't further increase Quantitative Easing (QE). Which begs the question: when the Fed's balance sheet has increased six-fold over the past twelve years, it is a bit curious why it would choose this particular moment to let markets down. Whether this was an isolated incident or a new policy of less reliance on QE is still up for debate. That QE is by and large ineffective in times when credit is not frozen it is well documented. Market operations can also be used proactively, to make sure credit doesn't freeze. But for years, observers have been criticising the practice as an incentive for massive capital misallocation, something the global economy can ill-afford during times of unprecedented economic contraction and rising unemployment pressures. Case in point, Covid-19. In China, huge resources were devoted to quickly and exponentially increase healthcare capacity. In the QE-driven west, resources during the crisis were diverted into stock markets rather than hospitals.

Economies and markets disconnected


Rates to remain low




Source: Fed, Mazars Calculations

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# Beyond Covid (continued)

**So the major question investors now have to answer is: Is Covid-19 the proverbial straw that broke the camel's back - the camel being an already ailing and malfunctioning liberal capitalistic system? And if so, while QE may have been beneficial for risk assets in the previous economic backdrop where the economy was at least somewhat functioning, can it continue to drive risk assets to defy all other fundamentals, even if the underlying economic system is identified as broken?**

Human brains are hardwired to pay maximum attention to the problem at hand, what psychologists call "availability bias" and downplay other issues already known and analysed. Thus it may be easy to focus on the damage the "Great Lockdown" of March-April has done to the global economy, trade and supply chains, and not to the backdrop of "secular stagnation", upon which this crisis unfolded. Secular stagnation refers to the 12 years that passed after the global financial crisis of 2008 which saw sluggish growth, low job quality and wage growth and as a result higher savings and lower investment rates. Importantly, the period saw governments and central banks focusing more on stabilising the financial system and suppressing financial risk but not managing risks in the real economy, thus driving flows into global stock and bond markets and, unavoidably in a low growth environment, away from real businesses.

Outlooks are deemed necessary by markets and investors especially in unprecedented times such as this, when uncertainty reigns supreme. And frankly it is easier to produce one, as the capacity for analysis is low, since a key variable, the course of Covid-19, is completely unknown, leaving significant room for speculation. In other words, the balls are up in the air and the future is so open-ended that any forecast about it becomes legitimate.

How the Covid-19 Crisis will play out may just not be predictable. Or rather, the only certainty in a situation like this is unpredictability. If we can't forecast with a degree of certainty that will result in high-confidence investment decisions, there are three things investment committees must do:

1) They must remain diversified and able to benefit from varying outcomes.
2) They must refrain from taking significant low-confidence bets "just because they feel they have to".
3) They must make sure they are asking the right questions.

## Our investment committee approach

To the first and the second points, our investment committee has taken the approach that our portfolios are sufficiently diversified to navigate investors through these tumultuous times. Our overweight and underweight positions, more prominently an overweight in Gold and an underweight in Fixed Income, reflect longer term concerns about the effect of so much fiat currency flooding the economy and very low yields on most bonds. Our gradual move away from our UK home bias reflects the idea that we need to focus on finding growth in a world that doesn't grow and that currency fluctuations are a risk which can be mitigated and can provide diversification benefits.

On the third point, we are focusing on the Five Debates we think all investors should be considering:

1) The New Economy: Is the current economic system indeed dysfunctional and if so what would a new economy look like and how will demand be affected?
2) The New Asset Allocation: Given low bond yields and dampened demand, is traditional asset allocation still effective?
3) The New Geopolitics. Economic growth is often a function of power. As the West loses its step, the East rises. Traditional alliances shift and the world turns from multilateralism into bilateralism, as globalisation falters. How will seismic geopolitical shifts affect risk assets?
4) The New Consumer: Consumers are frustrated, conservative, savings-prone, faced with higher unemployment, lower salaries and - if the Fed succeeds - higher inflation. Additionally they face working from home as a permanent reality. How will Covid-19 affect consumer behaviour over the longer term.
5) The New Business: Businesses struggle with low income and face the prospects of trimming personnel. Supply chains have been disrupted, some permanently. On top of everything, Brexit is rearing its head again. What might the new business landscape look like?

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# Beyond Covid (continued)

## Debate 1: The New Economy

It should be evident from the above that we believe that global liberal capitalism has reached a critical point, where it just may not be functioning to allocate assets efficiently enough to foster positive growth conditions over the longer term. The long term trends we are seeing are worrying:

- Low investment levels (capital expenditure down 8% for the last 12 years)
- Perennially sluggish growth (2% average for developed markets after the Global Financial Crisis)
- Slowing trade (averaging 3%, down from 10% in the decade preceding the global financial crisis)
- Slowing productivity
- Unsustainably debt (OECD countries' Debt to GDP expected to reach 140%)
- Higher savings rates (US savings rate rising to 7% from 2% in 2005),
- Rising and more pronounced income inequality and the concomitant political turmoil

This is an economic reality that would usually be associated with short-term recessions, rather than featuring prominently throughout a decade of "recovery". A stock market bounce of 540% from the depths of the financial crisis to early September 2020 should be a "cause celebre", not featured as the so-called "most hated bull market in history". The truth is that asset reflation (or rather asset inflation) covered for all manner of economic and political sin during that period. Put another way, as long as stock markets soared, newspaper articles didn't ring the "danger" button on the underlying economic issues.

Liberal Capitalism, most successfully championed by Ronald Reagan and Margaret Thatcher in the 1980s, has enjoyed an unusually long "grace" period afforded to it by the Cold War. Unlike previous economic theories, Liberal Capitalism was not a mere tool employed by the government to be replaced by the next iteration of the system. Instead, in the context of the Cold War, it mutated into political dogma. Questioning its efficacy was tantamount to treason for most of the 20th Century when the West was "fighting communism" across the globe.

A cycle of negative investments


Trade volumes down


Chart Source: S&P Global Capex Survey, OECD, Refinitiv

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# Beyond Covid (continued)

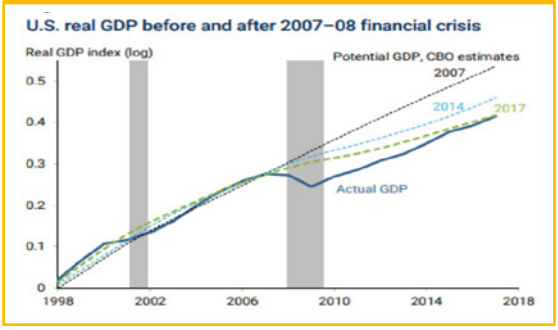
This dogma not only allowed for the theory to become stale, but also to develop into its extremes, like neo-liberalism, Milton Friedman's idea of eradicating state presence in everything but the bare essentials.

Until 2008, investors often felt that politics was just noise, and markets were efficient and self-regulating. The global financial crisis put an end to such theories. A 2018 study by the Federal Reserve Board found that the crisis cost every single American approximately $70,000, on an average household income of about $56,000. This means a bit less than three years' worth of work for the average household. The magnitude and repercussions of the crisis were not a simple and short-term invitation for the state to step in. It was the admission that tough regulations like Basel III and Insolvency II, burdensome compliance costs coupled with significant monetary and fiscal stimulus, were necessary to restore confidence and repair sagging demand to an acceptable minimum. Confidence in banks, which for almost a decade have made "compliance" their key deliverable, has been restored. However demand has been sluggish, with savings rates going up and capital expenditure down. The "bare minimum" hadn't been enough to resuscitate growth and progress in rates that had previously been the western world norm.

Covid-19 may have arguably become the death-knell for the previous economic paradigm. Prior to 2008, developed economies' GDP growth was an average 2.8%. After 2010 the world grew by a mere 2% per annum, with increasing inequality (Gini Coefficient in the US 0.48, up from 0.45 in 2008), which means that for most of the population there was little if any improvement over the decade. If growth acceleration proved a difficult proposition for a decade before February 2020, with both left-wing and populist mercantilist approaches having virtually no positive effect on local or global growth, the pandemic further puts the goal of 5% sustainable growth for developed economies out of reach, making it indeed a very low probability event.

We believe that governments and central banks have stopgap measures to fight the repercussions of Covid-19, and may try some new ways to stimulate growth. These will probably focus around two axes: empowering consumers and stimulating direct investments. The methods that may be used: helicopter money, central bank targeted actions and state-sponsored targeted investment vehicles. We are already seeing central banks pull away all the backstops, namely inflation crossing the 2% threshold to facilitate the success of possible future strategies.

Global Financial Crisis changed everything




Developed markets barely growing

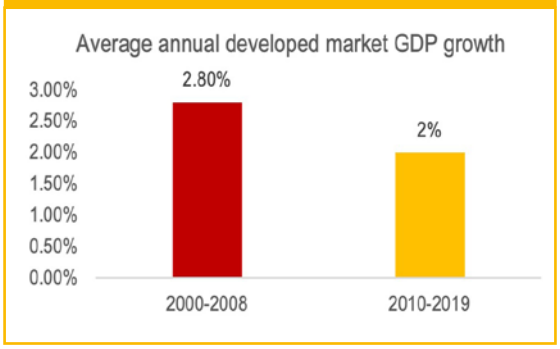



Chart Source: San Francisco Fed, Mazars Calculations

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# Beyond Covid (continued)

### A) "Helicopter Money"

The idea of this stimulus is to get a pay-check directly into the hands of consumers, as has happened in response to Covid-19, but in a more sustainable fashion, and even under better employment conditions. The Treasury issues 50-year zero coupon debt, say £1tn, which the central bank then buys at nominal prices. To do so, it prints money. Then it pays the Treasury £1tn, which it can then release to the public. Studies show that income windfalls tend to be spent, so that £1tn would become demand and jobs.

### B) Central bank targeted actions

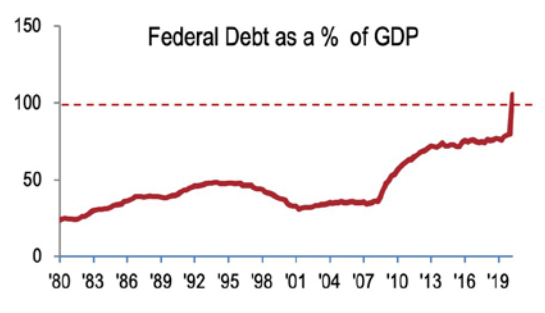
European Central Bank President Christine Lagarde has already alluded to a plan whereby the ECB would not buy debt indiscriminately across the board, inadvertently financing zombie companies along with creditworthy investments. Instead it would target companies and projects focused on "Green" investments.

### C) National Investment Vehicles

Central Banks, like the Federal Reserve or the Bank of England, started life out as normal banks lending money to all sorts of businesses. As, over time, finance began to develop and new private banks sprang up, authorities realised that these banks were restrained by competing with a "National Bank", which could afford better rates and easier loans sure to cover its losses from the budget. So National Banks gave way to the private banks of today. In the past few years, it became evident that the state also needed to cover the balance sheets of private banks. Only lending is now more restricted, due to strict regulation and a perennial fear that a 2008-like breakdown in global finance might re-manifest itself due to excessive lending.

In the past few months it has become apparent that the conservative nature of banks blunts the effectiveness of fiscal and monetary policies, rendering them a poor policy transmission channel. For all the Fed's extra $3tn, the US has seen significant tightening in credit standards and rising delinquencies. A study by the BoE has suggested that of the first £200bn of Quantitative Easing, only £30bn was translated into actual market demand, leaving £170bn to fix bank balance sheets and spruce up returns for risk assets. Many have argued for either the return of National Banks or government investment vehicles to directly target sectors and companies which would create the higher overall demand for goods and services.

US debt ballooning ...




...so is global debt

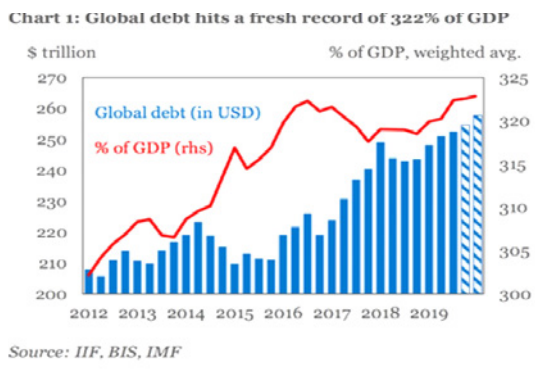



Chart Source: Federal Reserve (FRED), Capital Economics

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# Beyond Covid (continued)

All of these solutions come with strings attached. First, at the heart of all solutions lies an increase in national debts, which is already at very high levels. The OECD calculates that post-Covid, OECD average debt levels could rise to 140% of GDP. Debt service levels of even 1%, when assuming 140% debt to GDP, would mean that to pay it off, a country would need at least 1.4% growth per annum. With global developed market growth of 1.5% to 2.5%, before this latest crisis, this doesn't leave much growth for societies.

Additionally, "helicopter money" is a public liability. Thus the central bank doesn't "create" wealth out of thin air, it creates a liability forcing people to spend instead of saving.

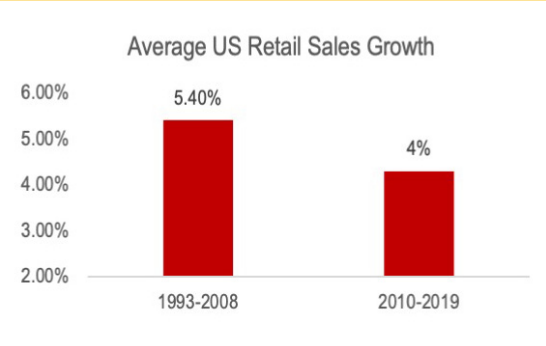
It becomes apparent that there's no "silver bullet". So what kind of solutions should investors look out for? For one, they should accept that "more government" is not a threat to the economic system, but that it will become the norm for some time going forward. Second, they should brace for possibly higher taxation of corporate earnings, capital gains and income and inheritance taxes, as a way to redistribute wealth under an increasingly unequal system. Inflation is a key risk in this scenario, especially supply-side inflation, as it can quickly eradicate wealth, much like it did in the 1970s.

Ultimately, however, we should all look to science and economic theory for new solutions. A common narrative is that the "Dark Ages" ended when painters in Italy picked up their brush. In reality it was the confluence of the Bubonic Plague (1347-1351) which ended feudalism and allowed for a more centralised government with less overall taxes that gave the economy a boost, coupled with the discovery of a new and very wealthy continent across the Atlantic. In the next few centuries, growth came from increasing populations, either naturally or by annexation, the real reason why Europe was in a permanent state of war for 500 years. Growth again exploded when science began to affect our lives. The industrial revolution, followed by steam and electricity. Following WWII the world became smaller, as the US sought to increase its reach. International air travel, the internal combustion engine, modern communications, the TV, the internet all contributed to making the world smaller, more globalised and at the same time richer.

## What does this mean for asset allocation?

We have reached that breakpoint when breakthrough innovation is warranted. In the near future, academia should produce an economic revolution similar to that of the 15th century. But it's going to be technologies like the quantum computer or fusion power which might again bring real growth in the world.

Consumption dented long term




Debt levels rising dangerously

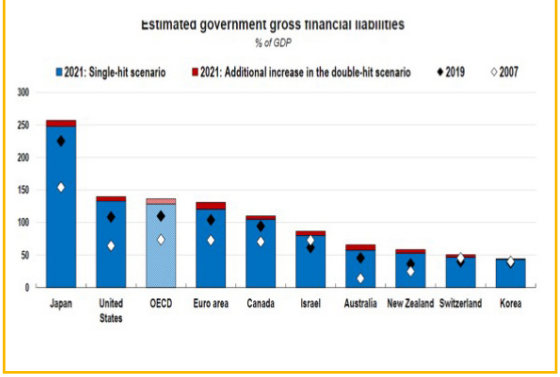





Chart Source: US Census Bureau, OECD

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# Beyond Covid (continued)

Until such time as they succeed and become commercial, asset allocators should expect slow growth, sluggish demand and all the political consequences that come when low growth confronts inexorable western consumer appetite to be the normal economic paradigm, especially in the West. As for the East? China and India are playing a game of "catch up", but ultimately they will have to settle for lower growth rates as their economies mature.

Financial volatility may well continue to be artificially suppressed by central banks, and that is not a given, but the Fed has shown little potency outside the realm of financial markets. Along with a resumption of long-forgotten macroeconomic volatility, we would not be too surprised if increasingly sluggish western world growth would continue

To make the political environment more dynamc. Since 2008, we haven't had a financial crisis, mostly because we spent the decade fighting the previous war, stabilising the financial and banking ecosystem. But we have had a series of political breakpoints (referendums, rise of autocracy, breakdown of multilateralism) as well a black swan event, exacerbated in many western countries by a profound lack and diversion of resources away from healthcare. Portfolio managers should anticipate such "crises" in high frequency. Thus, investors should be prepared that there might be larger windows when they can position portfolios to take advantage of the volatility, but proportionally shorter windows within which to meaningfully reap the benefits as the situation normalises and their bets play out.

In terms of security selection, investment managers will have to plan, knowing that the situation is going to work reversely for their underlying investments: companies will find shorter windows where they can confidently grow organically and longer windows where they will be in defensive mode.

The situation also means a constant advantage for larger capitalisation companies which have access to market financing and can "buy" growth buy either cornering their smaller competitors or outright buying them out. Facebook's, Amazon's and Google's acquisitions of many smaller companies is a good guide of things to come. Investing in smaller caps will still be a viable strategy, but careful selection will be required, with preference to companies that have a sustainably higher Return on Capital (ROIC) than their large cap rivals. Investors will continue to pay for growth where they can find it, so higher growth companies will rightly trade at higher multiples. As for bonds, sluggish growth means low interest rates and flat yield curves for many years to come. In a slow growth world where access to capital will be easy, high yield bonds will continue to be a good solution for income, but will invariably carry higher risk than the debt instruments which income seeking investors are used to.

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# Beyond Covid (continued)

## Debate 2: The New Asset Allocation

In 1928 Walter Morgan, a US manager alarmed with the speculation in the stock market, started the Wellington Fund, the world's first "60/40" or "balanced" fund, consisting of 60% stocks and 40% bonds. Amazingly, the Wellington Fund survives to this day, almost 100 years later. In the 1950s, Harry Markowitz set out the mathematical rules by which modern asset allocation would work, eventually earning him the Nobel Prize. The idea that investors should look at risks and returns as an analogy, (with more returns come higher risks) rather than focus just on potential returns put the 60/40 portfolio at the heart of every long-term investment strategy. Most wealth management firms build a "balanced portfolio" and then offer variations of it consisting of higher or lower bond/equity mixes, with the "bond" part considered the "safer" part and the "equity" part the higher risk one.

Ten years of Quantitative Easing have forcibly changed the assumptions behind the 60/40 portfolio. Massive buying of government bonds has flattened yield curves and floored long yields, anchoring even the 10-to-30-year part of the government yield curve to near zero or in some cases, like Germany, in negative territory. The effect of QE on efficient frontiers has been detrimental. Equity risks have been lowered, whereas bond risks have remained the same. Adding high bond returns into the mix have effectively flattened the curve, to the point where defensive (high bond) portfolios have similar rewards to high equity portfolios.

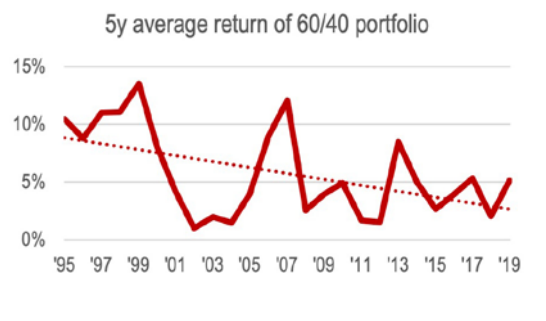
With central banks now aiming for the return of some inflation, and at the same time purchasing bonds and keeping yields near zero, investors are troubled. At the time of writing, someone investing in a 10Y US Treasury, the bedrock of all portfolios, would get a mere 0.7% per annum. With current inflation (US Core Personal Expenditure) at 1.6%, they would already lose 0.9% in real terms each year. If the Fed pushes inflation north of 2%, even to 3%, this would mean an assured loss of 2.3% per annum. In the case of Germany, where the 30-year bond yields less than zero, losses both in nominal and real terms are assured.

To put it simply, traditional portfolios and asset allocation funds have a serious bond problem.

**Why would investors keep investments assured to lose money?**

Some would by mandate. Many pension funds require holdings in government bonds. Others may just want the coupon income, regardless of the actual yield. For many private investors, research indicates that bond holdings continue to improve the risk profile of their portfolios. In other words, holding equities and bonds improves the so-called Sharpe Ratio, the ratio of risk versus rewards.

60/40 portfolio underperforming




Longest flattening period

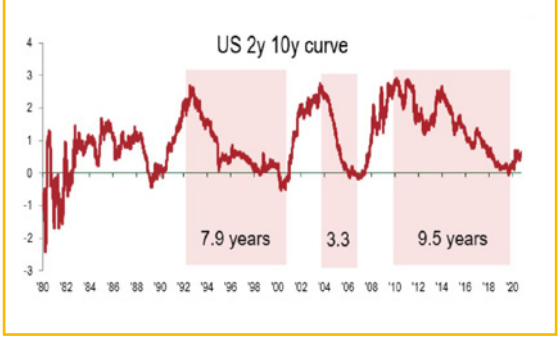





Chart Source: Mazars Calculations

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Realistically, however, for most investors the principle in recent years has been "buy what the central bank buys". Bonds were not purchased as a long-term holding, but rather for the capital gains, sure that the state would push prices higher.

However, this goes against industry standards. Bonds, are supposed to be the "Fixed Income" part of the portfolio, ideally to be held until maturity. QE has fundamentally changed the nature of the asset class. Wealth managers create long term portfolios with a view to hold assets for at least 3-5 years. But if one is just looking for capital returns, then holding periods drop dramatically.

QE renders 20-year returns and risk numbers irrelevant, as past bond returns will probably not be repeated. Looking into the future, with bond yields near or below zero already, is there a price ceiling beyond which returns will be minimal for future investments? What can investors with high exposure to bonds do?

The problem is compounded when one thinks of the third effective asset class, cash. Financial planners and fund managers often use cash as a buffer, to draw from when times are bad without having to resort to fire-sales of assets, or to keep some dry powder for purchases. For depositors, real rates (interest rate less inflation) have been negative for over a decade, which means a simple cash deposit is losing purchasing power over the longer term. The ECB has been using negative rates for two years, essentially punishing depositors, in a bid to convince banks to increase their lending rates. The BoE is having similar thoughts at the time of writing, although nothing is definite. According to economist Kenneth Rogoff, for the strategy to work, negative deposit rates should go to near -3%. Add the potential for 3% inflation, that would mean a whopping 6% loss every year for a simple bank deposit.

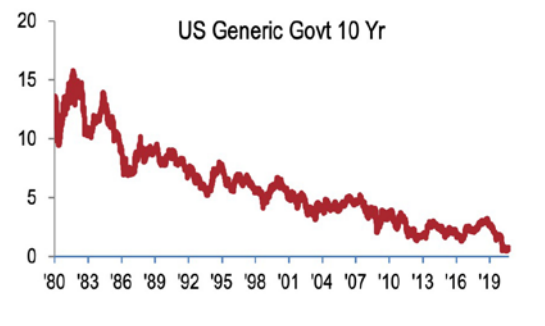
Do all these spell the end of 60/40 portfolios, the lynchpin of modern wealth management? According to JPM strategist Jan Loeys, a typical 60/40 portfolio returned 10% per annum (before charges) over the past 40 years. He expects this to fall to 3.5% in the next decade.

**What does this mean for long term asset allocation?**

## Managing costs

For one, lower returns over the longer term mean that costs need to be managed effectively and "to a T". Investment firms have no option than to maintain at least a portion of their less mobile assets in passive strategies, and seek "Alpha" (returns over benchmark) with carefully selected strategies, where possible returns outweigh costs involved.

US 10 year at record lows




Inflation above 10y bond

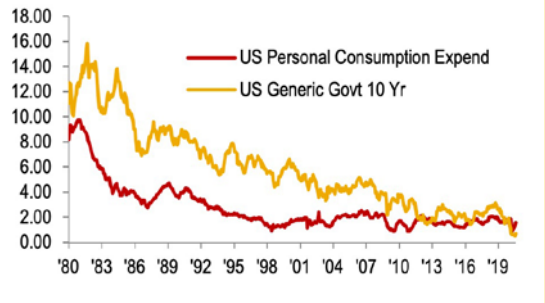





Chart Source: Mazars Calculations

# 02

# Beyond Covid (continued)

## Retain diversification

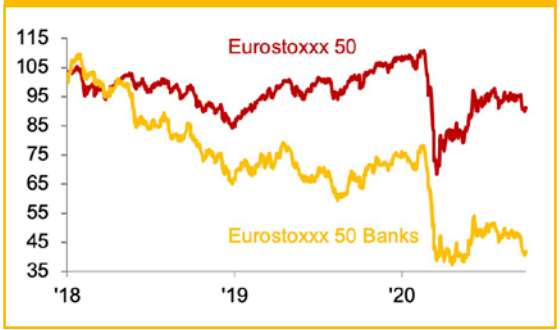
Diversification is down, but not out. Even if we assume long term Equity risk at 11% and Bond risk at 5%, with Equity returns at 4.9% (world average historically) and future bond returns a mere 0.5%, as well as positive 25% correlations between the two asset classes, efficient frontiers maintain their shape, which means that asset allocation works. So it makes sense, from a risk management perspective, to maintain an allocation in Equities and an allocation in Bonds.

## Creative diversification

The fact remains that whatever the risk profile, investors will still need returns for the bulk of their assets, which will be especially difficult for bond-heavy portfolios. Investors have already forgotten past returns for Bonds. To achieve returns there are two options: move higher in the risk spectrum in terms of profiling, or move the bond part of the portfolio higher into the risk spectrum itself. For a large part of the industry this already means substituting Government Bonds with Investment Grade Corporate Bonds. The Barclays Global Aggregate Investment Grade Corporate index, with a 7-year duration, yields about 0.9%, which is still much better than most Government 10Y Bonds (UK 0.2%, US 0.7%, Germany -0.5%). Higher risk portfolios could move into the High Yield space altogether. Global High Yield Bonds currently yield around 6%. Nevertheless this strategy, given the general state of the global economy and the pressures on companies with not-so-healthy balance sheets, needs careful consideration and navigation. Past default rates are not a guide to future default rates, no matter the amount of quantitative easing. Another solution offered is increasing exposure to hybrids, either convertible bonds, preferred stocks, or collateralized bonds, which after a decade of misery are back in vogue. If the central banks achieve their inflation goal, inflation-linked bonds might also be a good tactical solution, not so much to protect against actual inflation, but rather against rising inflation expectations.

Income: Income is set to remain low, but outlined above are a number of alternative strategies investors might use to gain alternative exposure to income. Until 2020, high income equities, especially in the utility sector, were also a potential source. However, yet another crisis reminded investors that companies pay dividends when they have earnings, and probably not when they have been receiving government aid. "Equity income" is and will remain the more speculative part of the income portfolio.

Negative rates have hurt European banks




Diversification still works

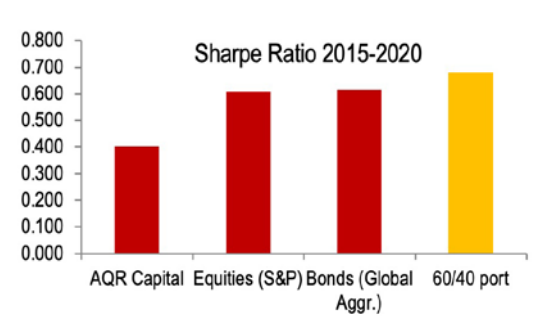





Chart Source: Mazars Calculations

# 02

# Beyond Covid (continued)

## Real Assets

Massive quantitative easing after five decades post the introduction of fiat currencies has been driving up demand for real assets. Before 1971 Gold traded around $35/oz. Currently, it trades around $1,900, 54x times higher. As central banks continue to print money in their quest for a modicum of inflation, investor demand for real assets is bound to remain solid. However, as this demand is institutional, only a few asset classes have deep enough liquidity to be in portfolios. These would include Gold and possibly Silver, as well as REITs, which also provide a viable alternative to income seekers (see above). Gold has been a consistently expanding part of our portfolios for the past 2 years, during which time its value has risen 58%.

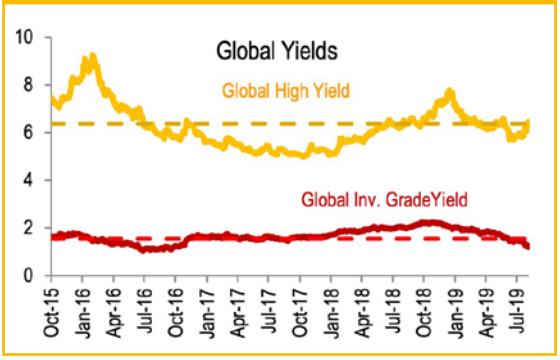
## Bank stocks/debt

Although we don't generally refer to sectors, we would be amiss not to mention that new economic and asset allocation paradigms may be detrimental for traditional banking models. Banks, already facing tough regulatory frameworks which may take decades to ease, as well as lower profitability due to flattened yield curves and in some areas negative interest rates, may soon come upon a wall of non-performing loans as the global economy falters. Additionally, they could very well face stiff competition from national investment vehicles, or new banks coming up without old liability burdens. As a sub-asset class, the sector is bound to face problems for many years to come.

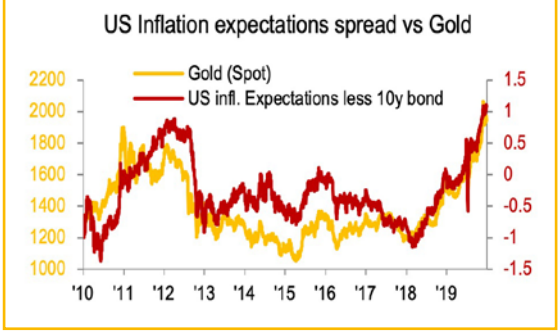
## Wealth management – financial planning

As investment income becomes more precarious, investors should make it a point to seek out the best financial planners and make sure they take advantage of the tax reliefs and allowances afforded to them. Lower investment returns means that a higher onus will be placed on planning in the next few years. The wealth management industry has already recognised this and it is turning towards trained financial planners, instead of regular relationship managers, to make sure wealth is managed in a holistic way. In this environment, established financial planners have an advantage.

Global yields low




High inflation expectations help gold




Banks face a tough time after 2008

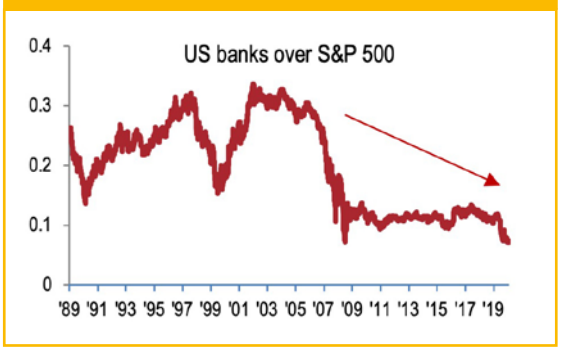





Chart Source: Refinitiv, Mazars Calculations

# 02

# Beyond Covid (continued)

**The future**

When Harry Markowitz introduced his theory in the 1950s it was quickly picked up by investment firms, desperate to return to a more reputable state after the misery of the Great Depression and the ensuing global conflict. Simply put, the heavily regulated industry continues to operate within established norms, but investors can ill-afford financial assumptions which may have worked in the past but not necessarily the future. We believe that conditions are again ripe for a breakthrough in financial theory. With one half of risk assets performing at levels significantly below what historical norms suggest, the "normal distribution" absent (markets have "fat tails"), as well as the gradual establishment of quant investing and algorithmic trading, which change volatility conditions by making dips shorter but more pronounced, markets should once again turn to academia for solutions. These may include behavioural overlays to portfolios or quant diversification theories. Investors should also heed the fundamental differences between long and short term investing (Cambell & Viceira) in an era where high frequency trading and low bond holding periods push them towards shorter term solutions.

# 02
# Beyond Covid (continued)

## Debate 3: The New Geopolitics

Sluggish to non existent growth in the western world, the speed of globalisation, the rebalancing between the East and West and more pronounced income inequality have created the perfect storm for the post WWII world order. In previous editions we have thoroughly discussed how this is challenged by the rise of populist leaders and autocrats across the world, as well as centrifugal forces in global and regional institutions.

First and most challenged is the EU. For one Brexit means a 10% reduction in the budget and the departure of a founding country which provided the bulk of the legal framework upon which the Union was set up. The second challenge within the EU is the rise of autocrat leaderships across the board, which directly criticize the so called four freedoms (goods, services, capital and movement of people), especially the latter. The third and most important challenge to the block is the inherent instability of the Euro itself, as the monetary union between 19 EU members remains incomplete and leaves members open to bankruptcy, the only developed countries which may not be able to print money to service their debts. Despite recent moves to mutualise some debt, mostly symbolic stepping stones rather than a radical overhaul, the possible implosion of the EU remains the single biggest geopolitical risk.

The other risk is of course the retrenchment of the US from global affairs over the past four years. The upcoming general election will determine whether the move will be a solidified trend, or whether it can be reversed. Having said that, global forums like NATO, the WTO, the IMF, the World Bank, the WHO and the IEA have already suffered enough damage in the past four years, partly because of criticisms from the US President and partly due to the chronic failings themselves.

The third risk is the rise of China. Before 2008 global growth was 3.7% and 2.8% for developed markets, after 2008 it was 3.4% for the world and 2% for the world's largest western economies. This suggests that the slack has been picked up by China. The threat doesn't come from economics, but rather from the creation of a credible pole against liberal capitalism, which unavoidably leads to collision. The economic success of a system of one-party, state-guided capitalism has directly challenged western paradigms.

And whereas the West may adapt post-Cold War dogma for the modern economy and accept a much higher level of state intervention, it would not compromise democratic principles or the ability of individuals to pursue wealth. The assertion of western principles can be backed up by the strength of western countries in financial markets, as well as US military power which still dwarfs the rest of the planet, including Russia. Chinese observers also note the risk of implosion. Given the poor quality of data out of China, investors often complain they don't always feel they have the same amount of clarity of the environment surrounding their investments as in the West. Whether the assertion is true or not, unknowns are the biggest risks.

Where the collective recedes, the individual advances. Citizens, worrying that globalisation is making them irrelevant, retrench to their core principles, which mainly consist of the power of their individual state, as opposed to multilateral solutions to their problems. Thus in the last few years we have seen the rise of autocrat leaders across the world, even within the bosom of the liberal EU establishments. These leaders govern with an iron grip and often ignore the repercussions of their moves, not only on their surrounding environment but often on the long term benefit of their own state. The biggest threat to the multilateral "Pax Americana" is unilateral actions meant to destabilise regional balances.

# 02

# Beyond Covid (continued)

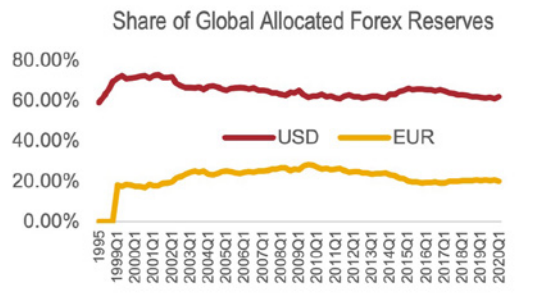
### The awesome power of the US Dollar

While we have established the numerous threats to the global status quo, we should also look at the other end of the scale. There we would see the biggest purveyors of globalisation, the Dollar and technology, reigning supreme. At the time of writing, 62% of the world's currency reserves are in US Dollars. When turmoil occurs in Emerging Markets, consumers have been conditioned to quickly exchange local currencies to the US Dollar, with a lot of state and corporate debt also in US Dollars. Globally, if governments want their currency to appear strong they peg it to the US Dollar. This means the US can control the interest payments of many countries around the world and it can freely impose sanctions on any dollar account anywhere inthe globe. All of this is underpinned by communications technology (the internet) which allows for that sort of control. The US government, additionally, can assume direct control over any server in its domain (and indirectly on the soil of its allies), essentially shutting down any operation it deems a threat to its national defence. No non-domestic entity is beyond the reach of the American government, as Deutsche Bank, Volkswagen and Macau have learned in recent years. Attempts to dethrone the US Dollar, like the 2014 currency swap between China and Russia, haven't even dented its power. The only serious threat, the Euro, which after its inception saw a rise from 20% to 30% as a global reserve currency, quickly receded back to 20% levels after the 2011 crisis and has remained there since. Debt has historically made countries vulnerable and US debt to GDP has surpassed 100%. Yet China dumping US debt in 2010 and 2015 has barely dented the strength of the US Dollar. In fact the US Dollar and the Renminbi are near the exact same levels (6.17) today as at the beginning of 2010. Foreign investors own less than 30% of US debt, with government institutions and the central bank owning the remaining 70%.

The combination of the Dollar as the global reserve currency and the internet tilt the scale towards globalisation over the longer term. The real threat that may unravel it is not politics, but a breakdown of global communications due to, for example a pandemic like Covid-19. De-globalisation efforts are to be expected, but overall the longer term trend remains intact.

The threats described above are long term ones. Empires don't crumble overnight. It took exactly 300 years, from the death of Marcus Aurelius in 176 AD to 476 AD, the sack of Rome by Odoacer, for the Roman Empire to decline and fall. And it took 38 years for the British Empire to finally give up its position as a global leader, from the end of WWI to 1956, when it was threatened with sanctions from its American allies if it attempted to take Suez back from Gamal Nasser.

The Dollar is still the only global reserve currency




Mercantilism doesn't work




Chart Source:

# 02

# Beyond Covid (continued)

**What does this mean for asset allocation?**

First and foremost it means that US Dollar-based risk assets will continue to form a better efficient frontier (better returns for the same risk) than non-US assets. Most investment committees around the world already start with "should we be investing more or less in US Dollar assets?". This practice should continue over the next few years as well. The US Dollar will remain the potent force and global reserve currency, as alternatives have failed.

This means that US debt is safer than that of the rest of the world. It also means that US companies will continue to enjoy better market access than the rest of the world and that the US amongst all countries will have an easier time issuing more debt, as demand for US Dollar assets is bound to remain strong across the globe. A richer market also means more access to talent and resources, which means US assets should continue to enjoy better Returns on Capital than their counterparts in the developed and the emerging world.

The risk to this position is the prospect of so-called currency wars. This would mean competitive devaluations and trade sanctions in a bid to acquire more growth, but, if proliferated, it can leave all parties significantly poorer. There are times when it looks as though we are heading in that direction, due to higher debt levels and erratic leadership. The world is still looking for multilateral solutions to the biggest problems, however. If the US re-assumes its traditional position at the head of global institutions, the ride will be smoother. If not, then we would expect volatility in our US Dollar-Primacy thesis.

The last part of this quarterly, what will the New Consumer and the New Business look like, is more open to interpretation. The reason is that Covid-19, which has already had a profound impact on all societies, could directly alter consumer behaviours and thus demand in ways we can't yet predict.

US assets still reign supreme

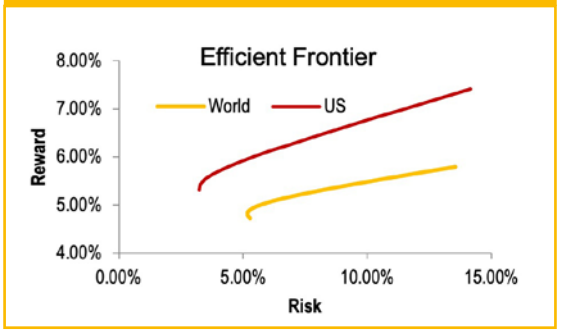





Chart Source:

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# Beyond Covid (continued)

## Debate 4: The New Consumers

About 70% to 80% of western economies is based on consumption. This renders GDP mathematical models less useful, as consumer psychology is notoriously fickle.

In 2015 Oil prices collapsed from $110 to $28, or from $4 to $2.5 per gallon. Investment analysts had assumed that the move would automatically translate into extra retail purchases by consumers as in the past. In fact, it took 18 months before the savings rate came down from 8.2% to 6.7%, while actual retail sales growth dropped from 4.9% in December 2014 to 1.9% by December 2015. This was a big lesson for the industry, that consumers had changed subsequent to the GFC. They had become more conservative, less eager to spend. Crises, especially if they last, can leave a lasting scar in consumption. In 2005, the US savings rate was 2.2% of disposable income. By 2011 it was trending around 7%-8%, where it stayed until the Covid-19 crisis. Consumers were less eager to spend on their credit cards or buy discretionary goods and services. Part of the reason was an inherent and instilled fear that 2008 might repeat itself and part is the stagnation of real incomes in the West for the last 15 years.

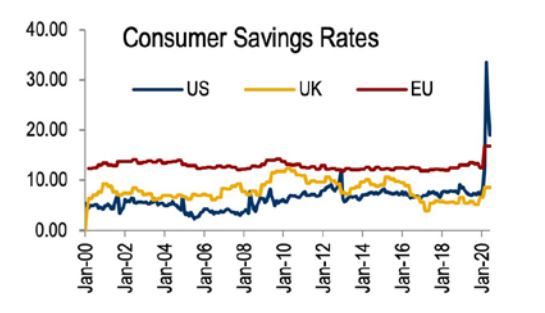
Covid-19 only exacerbated the situation. By April 2020 the savings rate had reached 33% and has now fallen 14%. At the time of writing, consumer surveys suggested a rebound in forward expectations, but still optimism levels were far below pre-February norms.

According to a survey by McKinsey (A global view of how consumer behaviour is changing amid Covid-19, July 7 2020) suggested that incomes had decreased across the board in all major developed and developing countries. The OECD is expecting 14%-15% unemployment across developed countries, delinquencies are already higher and credit standards tighter, so we can assume that these trends are only getting worse.

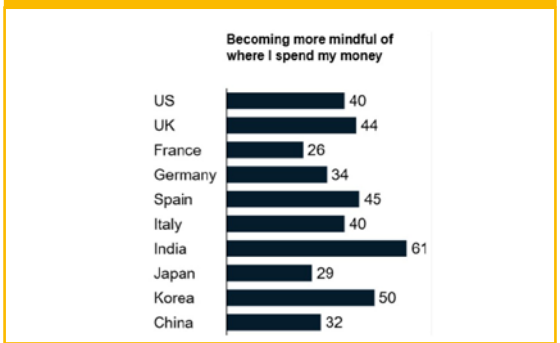
The survey also found that:

- Most consumers outside China expect a long rather than a short-term recovery
- Large parts of the consumer base were becoming more mindful about spending, looking for less expensive products and performing increased research before making purchases
- More than 60% of global consumers had tried new consumer behaviours (mostly online shopping). Most categories have seen more than 10% growth in their online customer base during the pandemic

Savings rates have gone up




More mindful shoppers




Consumer confidence still low

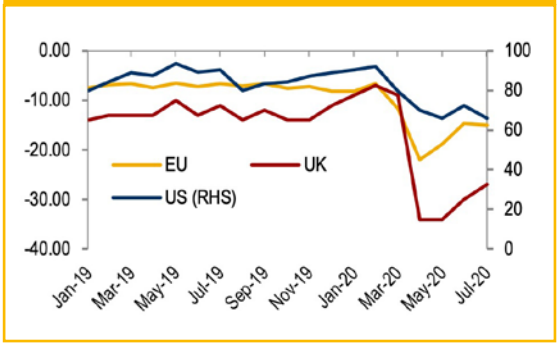





Chart Source: Refinitiv, OECD

# 02

# Beyond Covid (continued)

- Brands were disrupted: Where Covid-19 caused supply-chain disruptions, it "led consumers who couldn't find their preferred product at their preferred retailer to change their shopping behaviour, including trying different brands and stores"
- "Value" for money was becoming the norm in shopping for new brands
- Consumers wanted to see visible signs of "cleanliness" before entering shops
- Many were not yet ready to engage in out-of-home activities.

If the GFC taught us anything is that a return to "normality" might take a long time, or even never come, as we could be in a "new normal" paradigm. Millennial consumers, already a quarter of the total consumer cohort, already started life $30-$50K in debt. Real wage growth in the past few years has been minimal (in the UK real wages have stagnated from 2005 to 2019) and house prices have been soaring as investors poor money into real assets. Which means that it was already difficult to spend, let alone pay debts.

We would thus expect to see more reticent, online, and carefully investigative consumers in the next few years.

### What does this mean for asset allocation?

In terms of security selection the implications are clear: along with the high street, brands will be challenged. Easier access to finance might suggest that those companies will survive, but top-line growth will not be organic, but rather come from acquisition. This will place higher multiples on "acquirees" and lower on "acquirers". Investors in Corporate Bonds should be careful to avoid "Zombie-Brands", where a big household name might not necessarily be supported by a strong balance sheet.

In terms of asset allocation, previous sluggish economic growth and high savings trends should be expected to continue for some time, probably at an even higher level than before 2011. Companies will probably mind their margins, which could result in upward unemployment pressures. This could mean that "real" and "healthy" growth be assigned an even bigger premium than before. It also means that real "value" might not go out of style, but investors will be slow to recognise value plays at a high enough volume for investors to profit significantly. High growth and quality Small Caps, targets for acquisition now more than ever, could continue to trade at higher multiples.

Unemployment to remain high

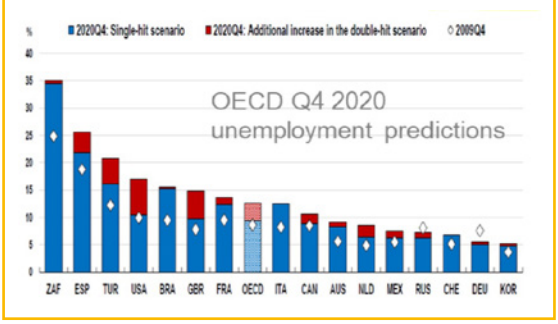





Chart Source: Refinitiv, OECD

# 02

# Beyond Covid (continued)

## Debate 5: The New Business

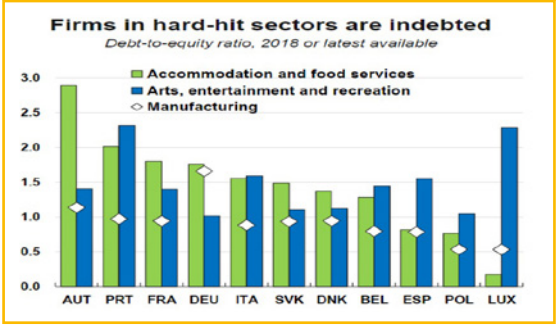
The disruption of city centres has empowered employees like never before, especially in white-collar industries, such as finance or professional services. Covid-19 is not only accelerating consumers moving online, but workers too.

According to several studies,

- 2/3 of Britons don't plan to work full time from the office
- Finance (57%) and Professional Services (53%) are more likely to work from home
- Queries for housing in London have been significantly reduced, whereas queries to move outside the M25, especially East Anglia, have increased dramatically
- The average office is expected to host 25%-60% of its staff while maintaining social distancing
- A 2017 American review found that people would be willing to take an 8% pay cut to avoid commutes
- Productivity improved: During the Covid Lockdown, meetings increased by 13% and participants increased by 13%, but average meeting time went down 20%. Working from home has increased the average work day by 48 minutes
- Millennials prefer to work from home, Generation Z (1995-2010), Generation X and Baby Boomers are keen to return to more sociable activities.

The "office" is to become a "hub" more than a workplace, losing its social function. This will create a challenging environment for employers, who will have to adjust to new ways of working altogether. On the plus side, we expect to see a wider and accelerating adoption of productivity enhancing technologies, including cloud computing, collaboration tools, automation and data analytics. More durable work-from-home arrangements could increase productivity by opening the door for individuals who were previously out of the labour market to re-enter and find productive employment. Also, companies are expected to alleviate pressures on their margins by cutting down on rents and travel expenditure.

Firms indebted




Consumer Company earnings down




Chart Source:

# 02

# Beyond Covid (continued)

There are significant drawbacks, however. Leadership models will be challenged and a new focus on individual priorities will be needed. Leaders have only a short period of time to map out the necessary skills and competencies to develop in this environment. New generations of workers will have to adapt to corporate life without the subtle clues one picks up in the office. The "skill shortage" gap might become more difficult to address in an insulated environment. New safeguards for mental well-being will be needed. And of course, those "White Collar" privileges, creating two-tier workers, might be addressed by government legislation seeking to even the playing field.

Conversely, for non-home operations, like stores or construction, companies could see a rise in costs to make sure sites are visibly clean and adhere to all regulations. We believe that this could become the "new normal" as consumers will be more sensitive to "cleanliness" even after the pandemic has been addressed.

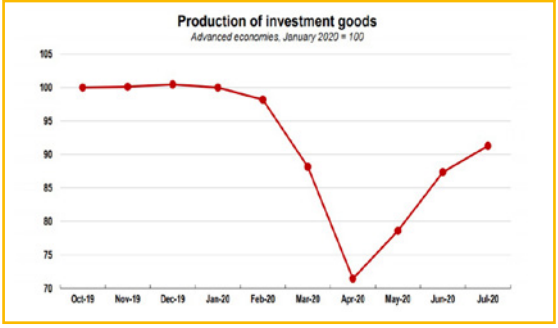
Employees and employers should be prepared that in a crisis-laden world, windows of growth and mobility might be fewer and further apart.

### What does this mean for asset allocation?

In terms of security selection, services companies which did not see a significant disruption in operations might come out ahead of the pack and command higher multiples. Manufacturing, construction and high street will be further burdened with "clean" costs for some time. For asset allocators this could mean a hard look at margins, leadership and how adaptive business models are. Fund selectors should make sure that fund managers are now asking these questions to company management.

In terms of wider asset allocation, it means that sector selection will be an even more significant source of alpha, as will geography, were different countries with different regulations deal with the pandemic differently.

Production rebound sluggish




We won't be back until 2023

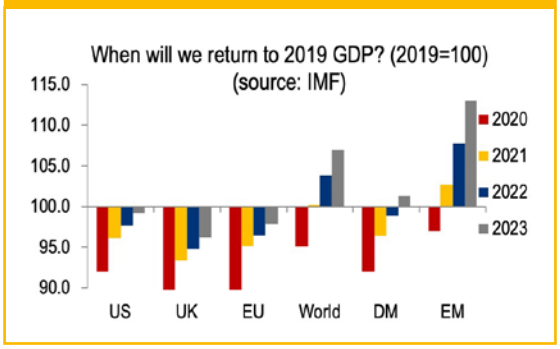





Chart Source: OECD

# 02

# Beyond Covid (continued)

## Conclusion

As a general conclusion we see a world where broadly previous norms have not changed, but accelerated or decelerated depending on the case. "Beyond Covid" does not lie a new world, but rather an even slower one, where consumers will be more reticent to make capital decisions. Central banks and governments are quickly recognising that and adapting their policies, but ultimately it is only a technological breakthrough that might restore growth to levels that consumers are happy with, especially in the West. Asset allocators should be mindful of such an environment, spend time and resources finding growth and be prepared to pay when they do. They should think long and hard about the position and composition of Bonds in their portfolios. Most importantly, they should be attuned to new technologies and new theories as a system which does not efficiently function to allocate assets will sooner or later have to go through transformational changes. Staying abreast of these developments, in conjunction with utmost efficiency in financial planning, will ultimately make the difference between portfolios which achieve their goals and those that do not.

# More reading...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Quarterly outlook


Investment blog

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