



Butterfield





Global Strategy

How Much is Too Much?

Regular readers may have noticed that we have dedicated a lot of time over the past year to the array of policy support measures enacted to help get economies through the COVID-19 crisis. With vaccines now in the process of being rolled out at impressive speed in both the US and the UK, the focus has shifted to the outlook for these policy support programmes. The timing of the withdrawal of policy support should be dependent on the speed at which the virus and economic situation improves, but an important distinction needs to be made between the different measures and how directly and effectively they can influence either health or economic outcomes. The case for linking government support to the virus is compelling, as it directly impacts the measures taken to control the virus and helps support households and businesses most affected. However, President Biden's recently announced American Rescue Plan totals \$1.9

trillion, and has got many economists asking whether this is too much and risks causing inflation.

The package under consideration includes \$410 billion for fighting the coronavirus, \$1 trillion of income support for households (\$1,400 cheques and an expansion of unemployment insurance benefits) and \$440 billion in direct aid to state and local governments. If passed this would see the deficit peak at between 22% and 25% of GDP in fiscal year 2021. To put this number in context, the federal deficit peaked at just below 10% of GDP at the height of the Great Financial Crisis in 2009. The US economy is now on the cusp of receiving a much greater fiscal injection at a time when nominal GDP is only 2.7% off its prior peak, and this has significant implications for financial markets.

Spending money on measures to contain the virus and get economies open again is relatively uncontroversial. Indeed, this mindset has been a key element of the success of the UK's vaccine procurement and rollout strategy, as it focused on outcomes rather than financial cost. The new Treasury Secretary, Janet



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Yellen, recently explained the case for another large stimulus package this way: “the most important risk is that we leave workers and communities scarred by the pandemic and the economic toll that it’s taken, that we don’t do enough to address the pandemic and the public health issues, that we don’t get our kids back to school.” On the other hand, influential economist Larry Summers has taken a more cautious view, saying “there is a chance that macroeconomic stimulus on a scale closer to World War II levels than normal recession levels, will set off inflationary pressures of a kind we have not seen in a generation.”

Complicating this debate is the distinction between what is good economics and what is possible given political constraints. Early on in the pandemic, the need for quick action far outweighed the risk that the action was inequitable or not well targeted, but the trade off has narrowed as the economic situation has improved. The debate has unsurprisingly become very political, but what matters for us as investors is the potential impact on markets.

The market has already been pricing in this new stimulus for the last couple of months, as bond yields, inflation expectations, equities and commodity prices have all moved higher. The combination of the vaccine rollout and further stimulus will be a powerful driver of growth in the US this year, but does raise the prospect of material outperformance of the US economy versus the rest of the world. How the Federal Reserve reacts to the improving growth and inflation picture will be key to the performance of asset prices and particularly the US dollar. In the meantime, we have added to our commodity and US inflation protected bond exposure in appropriate mandates.



Fixed Income

Perfect Storm for Yields

The increasingly likelihood of further fiscal stimulus in the US has led to an increase in the 30-year US Treasury yield to 1.83% from 1.65% at the end of December. The US 10-year Treasury yield has also seen a smaller, but still significant, rise. With the Federal Reserve still an active purchaser of US Treasury bonds, yields would almost certainly sit much higher without the influence of the central bankers. We are not in the camp of a near-term interest rate increase, and we believe short-term rates will remain anchored for some time, but due to the substantial amount of US Treasuries that will need to be issued in 2021, risks are building that we witness an accidental bond taper as monthly purchases by the Federal Reserve fail to keep up with elevated issuance and a solid economic outlook; essentially a perfect storm for bond yields (higher yields and lower prices).

The global roll out of COVID-19 vaccinations remains very uneven with Israel, which benefits from special supply arrangements with

Pfizer, the UK and US vastly ahead of any other Western countries. The rate of vaccination in the UK is particularly impressive with around 15% of the entire population covered by at least one dose compared to 3% in the European Union, as the UK's success in rapidly signing multiple contracts early on in the pandemic now start to bear fruit. At their current pace, the UK looks set to gain herd immunity by May 2021 and the US in June 2021, allowing the reopening of large parts of the economy by the summer. Warmer weather should also keep cases at bay, whereas in Germany, for example, sometime in 2022 looks probable, which has implications for economic growth and bond yields.

Economic data in the US was broadly positive over the month, as continued strength in consumer confidence, manufacturing and housing offset a gradual slowdown in employment activity, as the economy awaits full reopening in order to push unemployment back to pre-COVID levels. Looking ahead, commodity prices are rallying with oil reaching US\$52 per barrel—a far cry from the negative pricing we witnessed in 2020—and precious metals weaker, as global growth is expected to bounce back strongly during the second half of 2021 when lockdown measures are reduced. Although, the European Union's slow vaccine rollout could mean



Fixed Income

Perfect Storm for Yields (continued)

much of Europe remains locked down in some form until the end of 2021, severely impacting growth forecasts and a potential tail risk for markets this year.

Risk assets remain almost invulnerable to negative headlines, as the central bank “backstop” and massive fiscal stimulus supports demand for financial assets. The pull back in the S&P 500 at the end of January triggered a small increase in credit spreads, as the CDX High Yield index rose 25 basis points, and also a decline of around 12 basis points in 10-year inflation expectations, but this was very muted relative to previous episodes of risk aversion, and was almost immediately reversed as equities found investors willing to buy the dip. As a result, it is clear the market will need to experience a much more significant event in order to break its current positive momentum; to this point a rapid rise in US bond yields and the US dollar are prime market disruption candidates for 2021.

The new composition of the US Senate, the appointment of Janet Yellen as US Treasury Secretary, slowing virus cases and a more favourable US vaccination outlook, means the path of least resistance for US yields is higher. However, we still remain cautious

due to the extreme level of positive risk sentiment, especially in equity markets, and we must also acknowledge our disappointment in January as government bonds failed to protect portfolios when global equities declined, increasing our desire to hold more liquid cash in portfolios. As a result of the more positive global growth outlook, portfolio positioning still has a risk on tilt and we remain buyers of corporate bonds, US inflation protection and Emerging Market bonds, which still have pockets of value relative to expensive government debt.

We also like the seven-year part of the US Treasury curve due to attractive carry and roll down characteristics, so choose to take duration exposure there if needed. Currency markets continue to show increased volatility, as one of the only liquid asset classes without any central bank manipulation and as a result, Fixed Income managers are starting to show signs of shunning bonds and embracing bond proxies such as the Japanese Yen and Swiss Franc. For accounts with multi-currency mandates, there is a growing probability of a rally in the USD as positioning is stretched, bond yields are rising, and growth differentials versus Europe will be large during 2021. We have, therefore, tactically added US dollars but expect to reduce positioning throughout 2021, as global growth catches up with the US.



Equities

Retail Induced Volatility

In what was a historic month on several fronts, equity markets marched higher until concerns around retail investor activity sent global equities lower over the last week of January. The MSCI World index finished the month down 1% in US dollar-terms, after a tremendous finish to 2020. Regionally, Emerging Markets, which is a portfolio overweight, returned over 3% during the month, outpacing North America, Europe, and Japan, which all finished negative. We were anticipating some market jitters due to the uncertain presidential transition of power in the US, which led to one of the most surreal scenes as rioters stormed the US Capitol building on 6 January. Equity markets took the riot in stride and actually increased in value over the following days. The bigger story for the month, from a markets perspective, was the price action of a handful of small and micro-cap US stocks driven by an army of retail traders urging others to buy via online social media platforms.

Shares of GameStop ended 2020 just under \$19 per share, giving the company a market capitalization of \$1.3B. After retail investors began to pile into shares of GameStop, due to what they were reading on platforms such as Reddit, shares spiked to \$347 at the close of trading on January 27th, valuing the equity of the company at over \$24B, and giving investors a year-to-date return over 1,700%! There is a confluence of factors that led to this sort of mania in stocks such as GameStop and a handful of others including AMC Theatres, none of which include the fundamental valuation of these companies.

Another common thread is that online traders have targeted companies with a high proportion of shares that have been shorted, or bet against. The number of traders on a specific “investing” forum on Reddit grew from 2 million active users to 8 million users over an 11-day period, showing the power of social media and momentum of ideas. We believe that these market events were driven by some combination of a lack of entertainment options due to COVID, inexpensive sources of leverage (including the use of equity options), and finally high



Equities

Retail Induced Volatility

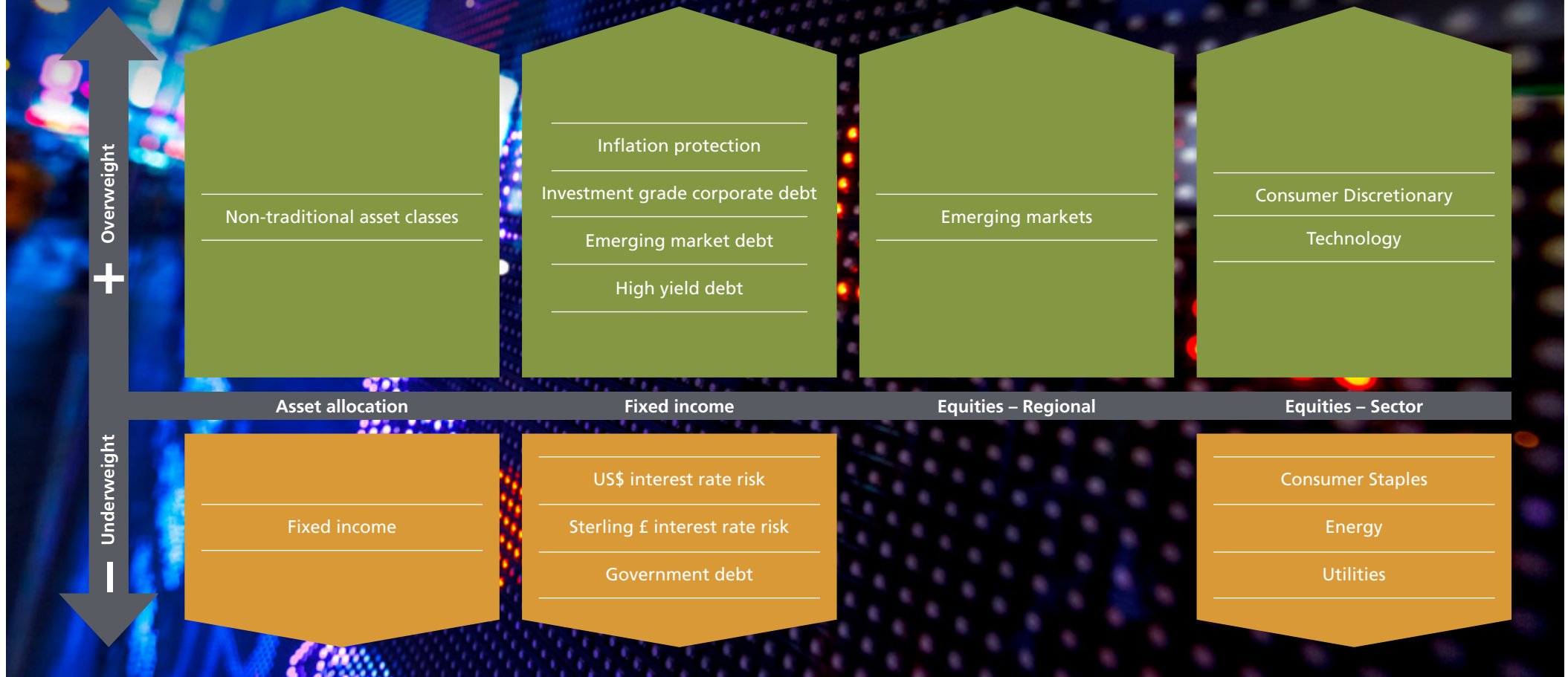
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levels of liquidity in the system through both monetary and fiscal sources (which may be the most important factor).

We are focusing on this episode of mania not because it was entertaining or that it had a large market impact, but because it is indicative of market-wide sentiment and an evolving and growing retail investor base. We have touched in the past on the growth of retail trading, and believe that retail investors will have a growing impact on flows into and out of the equity asset class. We have now seen the impact that a group of traders can have on small and mid-cap companies when banding together. We continue to believe that what we saw at the end of January was more akin to gambling or speculating, one of the potential unintended consequences of extremely loose fiscal and monetary policy. We also believe that these periods of mania will be more prevalent in the future and there is the potential that the outcome is much more detrimental to the financial system, however broader retail participation in equity markets can be a longer-term positive.

Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy





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