



Butterfield





Global Strategy

A Year to Forget and a Year to Remember

The fourth quarter of the year characterised many of the factors that dominated 2020: rising COVID-19 virus cases in the northern hemisphere; policy responses to limit the economic fallout; and rising stock markets. The various government responses to the pandemic will be analysed over many years, but one of the key themes of the year was how successful the economic policy responses around the world have been. The Global Financial Crisis, over a decade ago, reminded policymakers of the importance of responding rapidly in times of crisis. Fortunately, we did not repeat the mistakes of the past and central banks acted very quickly in March to provide liquidity and help ensure the smooth functioning of financial markets. However, the most important policy response came not from the central banks, but from governments.

The Global Financial Crisis started in financial markets and then spread to the real economy, whereas this crisis was fundamentally

a health crisis, which then became an economic crisis. It quickly became apparent that central banks' tools work well in financial markets, but could do very little to solve the underlying problems, so governments would need to go to extraordinary lengths to bridge the gap in economic activity. For context, the fiscal response to the Global Financial Crisis in the US (the American Recovery and Reinvestment Act) in 2009 was 5.4% of GDP and took five months to narrowly pass in the Senate. However, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was \$2.2 trillion (11% of GDP), passed the Senate with a 96-0 majority and came before the end of March. The support was conceived faster and was more substantial than anyone could have imagined was realistically possible.

Support programmes across the developed world varied in design. The US support was broad based across households and business, while furlough schemes and more targeted initiatives, such as Eat Out to Help Out, were used in the UK. Europe focused support on short-term work schemes and loan guarantees. The relative merits can be debated, but broadly speaking, the economic support



Global Strategy

A Year to Forget and a Year to Remember (continued)

programmes have been successful and are a key reason for the divergence between the weak economic performance and strong financial markets in 2020.

It is also fair to say that large parts of the economy have been more resilient to the COVID-19 crisis than most thought possible. For example, technology has made remote working easier, e-commerce and logistics platforms have been expanding for many years, and the housing and durable goods sectors performed well. People diverting their spending from experiences and social activities to goods benefitted a number of companies and sectors, many of which are well represented in stock market indices; Amazon being the most prominent example. Large companies have been more resilient to the economic shock than small businesses, as they have been able to borrow cheaply in the bond market, have stronger balance sheets and tend to be more diversified.

As we entered the fourth quarter, all eyes were on the US Presidential election. A relatively comprehensive, albeit still contested, outcome reduced uncertainty, but was not in itself a

market moving event. However, the news that effective vaccines were on the way was very much a market moving event, as investors began a rotation into stocks perceived as being most exposed to an economic recovery. It will take time to rollout the vaccines, but having some visibility to the end of the health crisis allowed markets to look beyond rising virus case numbers through November and December.

Looking ahead to 2021, the rollout of the vaccines is the most important factor, as this is our route out of this crisis. Early challenges with the rollout are to be expected, but as long as vaccines are effective and mutations do not limit the efficacy, then we can look forward to a much more positive backdrop by the summer. Household savings are elevated as many consumers were able to save money during the pandemic because of reduced opportunities for travel and leisure. Therefore, with pent-up demand to make up for missing out on social activities, and the associated rise in animal spirits, there is a plausible upside scenario in which growth later this year could surprise to the upside.





Fixed Income

The Rush for Herd Immunity

We ended the year largely on a high, with most Fixed Income asset classes registering a positive return in 2020. 1-10 year US Treasuries returned +5.7% and their Corporate equivalent +7.7%, which, given the ultra-low level of government bond yields at the start of the year, was unexpected to most market participants. Performance for the coming year is likely to be much more muted, but risk adjusted returns will be supported by central banks suppressing volatility across most asset classes. Financial markets across the world remain supported by low US Treasury yields, with the 10 year US Treasury still under 1%. This is below the New York Federal Reserve's estimate of fair value at 1.31%. Given the level of economic activity and unprecedented stimulus in the system, Federal Reserve policy will receive a lot of focus this year.

Economic activity in the US continues to gradually improve, but the pace of improvement is slowing and the level of positive

data "surprises" has fallen since August, with the economy unlikely to see any meaningful boost to activity until the Summer of 2021. In Europe, the improvement in confidence and growth resumed as movement restrictions were relaxed, with the Eurozone Composite PMI rising to 49.8. However, the new COVID strain in the UK is likely to spread rapidly, as we are already seeing in Ireland, and economic activity is likely to stall in the first quarter as restrictions on movement are once again rolled out. Asian data remains robust, especially in China, but the region is likely to feel an impact as activity slows again in the West.

Amidst all of this uncertainty, the EU and the UK finally signed a free trade agreement. While not perfect (with no provisions yet for the Services sector), it appears to deliver on the promises made to the UK electorate in the 2016 referendum. There will be zero tariffs on goods, zero annual contributions and it permits the UK to sign free trade agreements with the rest of the world, which represents a growing 85% of global economic output. Essentially political tail risks have been removed and the UK will now be able find its own way in the world with full control over its borders, laws and money.

As winter weather sets in, rising COVID cases in Europe and the US remain concerning and the new strains, which have appeared in South Africa and the



Fixed Income

The Rush for Herd Immunity (continued)

UK, are leading to rapid case growth rates and varying degrees of regional lockdowns. With international borders largely open, it is likely that the remainder of Europe and the US will see a substantial spike in cases soon, driven by the new strains and holiday mixing. Nevertheless, financial markets remain buoyant and look forward to the vaccine rollout. Although, supply constraints and logistics are already proving an issue, so a large dose of COVID-19 caution is still required. One country that is making good progress is Israel, which has already vaccinated 12% of its entire population, and will likely reach herd immunity by the end of January. This makes the country the test case for the effectiveness of the vaccine and its ability to defeat the virus.

The event most likely to move markets in the immediate term is the Georgia senate elections. Although traditionally a “red” state, betting markets had assigned a very small probability that the senate would flip to the Democrats. However, given the recent gridlock over the latest fiscal stimulus, in part driven by President Trump drawing attention to the subject, voters could well punish the Republicans, blaming them for the failure to pass a more substantial stimulus package. In the event the Democrats do take control of the

senate, the market will have to quickly decide if higher government stimulus will offset the increases in regulation and taxation. From a bond market perspective, it is very likely that this will lead to higher US Treasury yields, which central bankers are unlikely to try and minimise initially and could potentially put the Federal Reserve back into play during 2022 as they contemplate interest rate hikes.

Portfolio positioning as we enter 2021 continues to be defensive, and the risk of a resurgent mutated virus, coupled with a dysfunctional US federal government, leaves a lot of room for an unpleasant New Year’s surprise. This would increase the reliance on vaccines and therefore we are still not ready to completely abandon our caution by reducing duration. However, the future composition of the US senate may provide opportunities if control flips. In terms of risk assets, there is very little value in corporate credit markets at the short end of the curve, and the easy money in inflation-protected securities has already been made, although a Democrat blue wave could give this trade some longer legs. In addition, some pockets of value can be found in longer corporate maturities, or within currency markets, as we position for a weaker US dollar over the course of the next 12 months, although with the heavy speculative US dollar shorts currently in place the currency could be due a short-term reprieve.



Equities

Equities Power through Pandemic

The pandemic has altered almost every aspect of our lives, and has forced us to think about our needs versus desires, while it has also blurred the lines between work life and homes, as living and bedrooms have been transformed into temporary offices. There will surely be physical and emotional scars due to the impact of the pandemic, however the health impact aside, global equity markets are ending on a high note after enduring pain early in the year. Growing optimism on the vaccine front and the potential normalisation of life later in 2021 has sustained a rally that began with extreme levels of government and central bank support as markets bottomed in the first quarter.

After a strong 2019, in which the MSCI World rose over 27% in US dollar terms, the same index returned 15% in 2020. What makes the 2020 return so impressive, is the fact that global equities at one point had fallen -32%; this means that from March 23 through the end of the year, equities returned

approximately 70% in the face of increasing COVID-19 cases, deaths, and unemployment. As our readers know, not all sectors are created equal; one of the reasons we continue to believe in active management. Eight of the 11 global sectors produced positive returns in 2020, led by Technology and Consumer Discretionary, which returned 43% and 37%, respectively.

The three sectors that produced negative returns were unsurprisingly the most directly impacted by the pandemic: Energy (-30%), due to plummeting mobility; Real Estate (-5%), due to increasing delinquencies; and Financials (-3%), due to the near-zero interest rate environment. From a regional perspective, North American and Emerging Market equities outperformed their European peers, in part due to the difference in sector weights and a smaller exposure to technology-related companies in Europe.

Selloffs are not uncommon, as the S&P 500 has averaged intra-year declines of over 14% since 1980. Despite double-digit sell-offs, the S&P 500 has produced positive annual returns 75%



Equities

Equities Power through Pandemic (continued)

of the time between 1980 and 2020. What was unique in the 2020 episode was the velocity and duration of the selloff as the bear market only lasted for one month; the shortest bear market since 1929. What we can learn from this data is that we are in the midst of a health-crisis-induced selloff, which was viewed as a transitory event, rather than a longer lasting recession, and that we are closer to the end than the beginning. 2020 is also a prime example of capital markets not perfectly reflecting the strength, or weakness, of the broader economy.

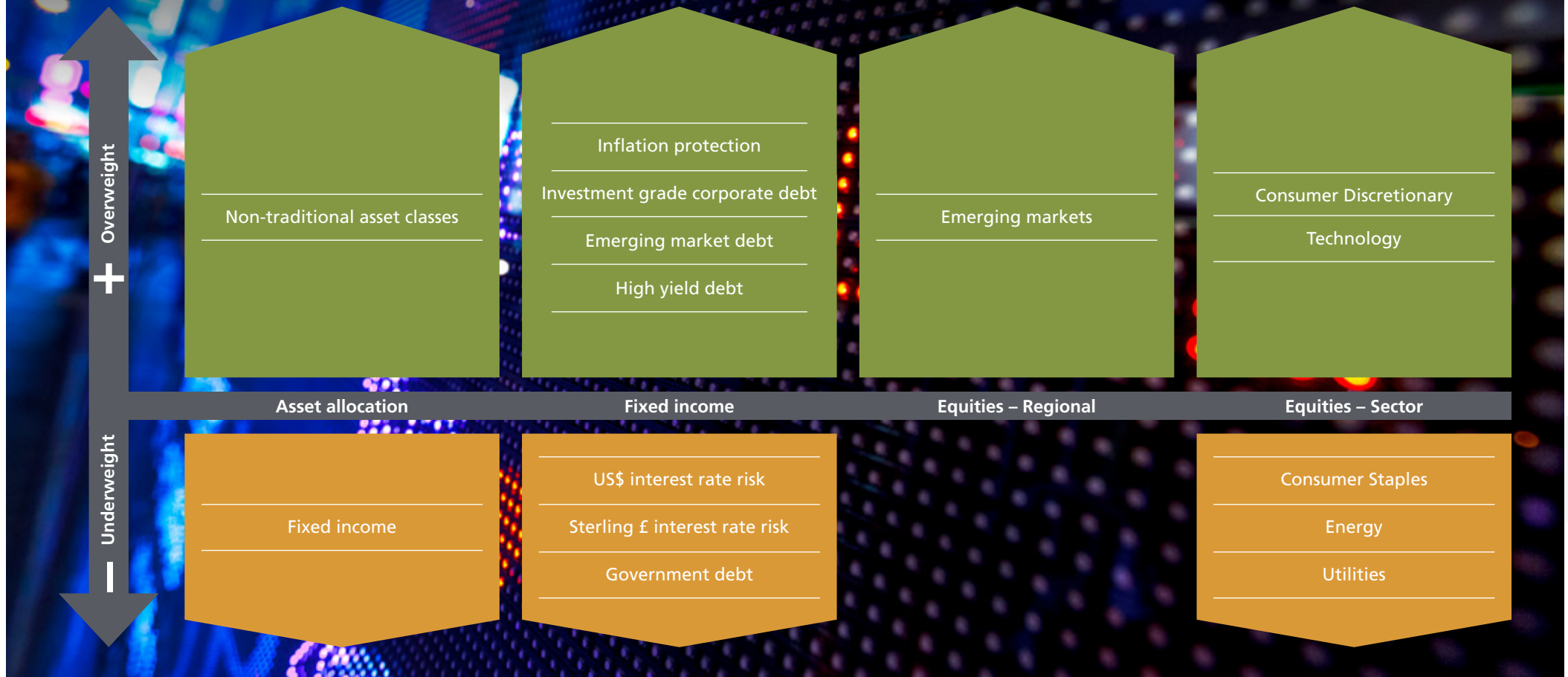
Looking ahead to 2021, one of the most important questions is whether technology can continue its outperformance, which has knock-on effects to regional allocations. Much has been written--both positive and negative--about the technology sector by the major investment banks and independent research firms of late. In client portfolios, we have been overweight the sector in 2020, but the size of the overweight has shrunk due to the recent sector rotations. The bullish case for technology is driven by fundamental strength, only accelerating during COVID, and

the defensive nature of the sector should governments struggle to roll out vaccines. We believe that the positives slightly outweigh concerns around earnings and potential bubbles forming due to the concentration at the top of the sector.

Our appetite for certain cyclical based allocations often included in the so-called "back to normal trade" has increased, and we will be looking to add exposure throughout the year to individual companies or pockets of the market that have been left behind in the rally. We have also grown slightly more positive on markets outside the US, as Europe and Asia tend to have higher betas to global trade and should perform well as the world normalises. Our equity portfolios performed well in 2020 and we have let allocations to the asset class run slightly over our long-term strategic allocations. While valuations are stretched, equities remain attractive relative to the low yields available in the bond market.

Global Asset Allocation

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





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