SINGALLIANCE

Letter n°24

Sketching the Year 2021

« No matter how hard they want to make the present, the future will be beautiful » Hugo in Hernani's preface.

At the dawn of 2021 and in order to assess the world economic situation, define a stock market strategy and draw up perspectives, let's think about the questions formulated by Emmanuel Kant: what can I know? What should I do? What can I hope for?

After having sensed the extent of the shock suffered by the world economy in 2020, with certain sectors in the throes of adaptation to a new world, it is difficult to be serene but, at first glance, the omens seem favorable. From macro-economic indicators to forecasts of company results, from politics to international geopolitics, the factors of confidence are multiple and encourage us to consider a continuation of financial market appreciation.

Thanks to more than $20 trillion injected by the States and Central Banks, almost the equivalent of one fourth of the world's GDP, the world's GDP should have returned to its 2019 level by the end of 2021.

1. What can I know?

- ***An atypical crisis:***

Let's not stop at the extent of the GDP decline. The figures are the worst since the Second World War but they are not comparable to those of previous recessions. The crises of 1974 and 1980 resulted from the quadrupling and then doubling of oil prices. The October 2007 crisis was the result of the stock market bubble burst while the crisis of the early 2000s was that of the technological bubble burst. The 2007/8 crisis was a financial crisis born of "subprimes".

Before the emergence of Covid, the world economy was pursuing its longest growth cycle since 1945, ten years in the United States, less in Europe. Excluding China, world growth was certainly not flamboyant compared to the 1980s much less compared to the 1960s, but if it was doped with debt, there was no premise for a crisis. At the beginning of 2020, banking systems were better capitalized than in 2008. Unemployment rates were at their lowest level in decades, budget deficits reduced, with the exception of the United States under Trump's administration.

The risks were more social than economic, more political than monetary. This was due to the rise in inequalities, the downgrading of the middle classes in the developed countries, the stagnation of their incomes, and the increase in their indebtedness gave rise to social movements (yellow jackets in France) and brought populists to power - Trump in the United States, Johnson in Great Britain and the Brexit, Salvini and Di Maio for a time in Italy...

The current crisis is the result of a temporary halt in activity and has a high budgetary cost, with budget deficits in 2020 at levels not seen since 1945: 18% of GDP in Brazil, 16% in the United States and Great Britain, 14% in Canada, nearly 13% in Japan, 8.5% in Europe and China.

To get out of this crisis, there are no banking systems to clean up, no real estate stocks to sell and no household over-indebtedness to absorb. Governments and central banks are injecting a lot of liquidity, but the debt issued is benefiting from rates below the medium-term potential growth rate and is being used, in part, to finance investments in the digital transition, energy conversion and infrastructure.

U.S. figures are topical with 16% of GDP, that is $3.4 trillion, spent or pledged as collateral in March-April 2020. This amount spent in two months, is more than double the stimulus spending deployed over two years between 2007 and 2009. When we look at these measures, we are reassured because, in the United States as elsewhere in Europe, China and the rest of Asia, we appreciate both the scale and the speed of these measures.

These support measures were rewarded by a rebound in growth in Q3 which ensued from the sharp decline in Q2. In the United States, for example, GDP grew by 33% in Q3 after a -31% decline in Q2 and 11 million jobs were created in the space of 7 months. Something never seen before.

Support measures that could raise tomorrow's growth potential and generate productivity gains. The issued debt also provides guarantees to companies in need of cash flow and to employees struggling with partial unemployment. Thanks to these measures, we can see, in the ***United States*** for example, that despite an unemployment rate of 6.7%, income over one year did not decrease. In the 2nd quarter, despite a fourfold increase in unemployment in 2 months, from 3.5% in February to 14.7% in April, the distribution of $600/week/person cheques allowed a 10% increase in household income. Thus, at the exit of the first and second confinement, consumption was able to record flattering figures. Businesses have not been forgotten with the default rate being limited to 6.2% in 2020.

In ***Europe***, despite the Cassandras' objections, bankruptcies are down compared to 2019 and there has been no increase in bad debts to date. In France, the contraction in purchasing power over one year is limited to 0.3%. In Germany, partial unemployment has limited the rise in unemployment by one point, now at 5.9%. Even in Spain, a country affected by the decline in tourism, the more than 20% year-on-year increase in unemployment is cushioned by 70% wage guarantees and exemption from corporate social security contributions. This has nothing to do with 2012, because in Italy, after a one-off pressure on the 10-year rate, they are at 0.55% from 3% in March, an exceptional level for a debt of nearly 160%.

In ***Japan***, between the end of 2019 and the second quarter of 2020, the savings rate rose from less than 5% of disposable income to 23%, representing 15% of GDP and a windfall for future consumption, even though the government is launching a third aid plan amounting to 2.8% of GDP.

In ***China***, growth should approach 8% this year after 1.8% in 2020. The confidence indexes, Caixin for medium companies or the activity index of the service sector have recovered, respectively to 53 and 56. The government aims to continue the development of consumption and to compensate for lower income growth through the dynamics of consumer credit: 130 million borrowers in 2019, or 50% more in one year, and a projected outstanding amount of nearly €400 billion in 2024. As a nod to Trump, we recall the ***Chinese proverb***: "***When the wind of change blows, there are those who build walls and those who build windmills***". Today's windmills are about technology and we think of the "China 2025" program.

In Asia, ***Vietnam, Taiwan and South Korea*** are the best performers, with the last two benefiting from the boom in new technologies, particularly in 5G.

In many countries, the industry, like construction, has returned to growth, but let's not allow a candid view and share an angelic perception of this exit from recession. Like all crises, it accelerates changes and causes downgrades. If there are winners in e-commerce, health..., there are obvious losers in the restaurant, leisure and hotel industries. The "zombie" companies cannot be supported forever, but the most affected sectors represent on average 4% of the GDP.

To sum up, World Bank figures suggest that the world economy is expected to rebound by 4% in 2021 after a contraction of 4.3% in 2020.

- ***A contrasted stock market:***

Brilliant in the United States, sparkling in some Asian countries, dull or negative in Europe, bad in many emerging countries, such was the market trend in 2020. The Nasdaq appreciated by 43% and the S&P500 rose by 18% in 2020, more than double the average observed over a century. The Chinese stock market has gained 60% since the low point in March as it is one of the few countries to show earnings growth in 2020, 2%, expecting +18% in 2021.

Admittedly, the results of S&P companies regressed by 17% but they should recover by about 20% in 2021 and the market has anticipated the brevity of this crisis. The MSCI World P/E ratio is 21x, the US market is valued at 23x expected earnings, Europe, lagging behind, at 17x, China at 15x and Japan, a third of the Topix 500 companies are valued at less than one times equity.

What should I do?

In the light of this summary of the macroeconomic situation, all the details and figures of which can be found in our monthly outlook, the performance of the stock markets in 2020 does not constitute a bubble but reflects confidence in the temporary nature of the decline in activity in many sectors.

- ***Regionally:***

Once again, preference will be given to developed countries, including China, Taiwan and South Korea, over emerging countries and, within this group, Europe will be favored over the United States. In the emerging world as a whole, we will avoid the big three in Latin America, Brazil, Mexico and Argentina. The crisis is less under control, public finances are or may be at risk and imported inflation, 4.3% in Brazil, due to currency depreciation, hinders monetary stimulus. In Asia, a privileged region, 30% of world GDP today, 50% by 2050, it is still necessary to overweight China, buoyed by the acceleration of the recovery, to invest in Taiwan and South Korea, favored by the dynamic demand for technology, to keep Japan, to stay away from the Philippines and India.

- ***Sectorally* :**

The technology and e-commerce sectors are benefiting from an acceleration in their pace of development. The stock market sometimes exaggerates, but the trend is undeniable. Technology still offers perspectives with the diffusion of 5G and the emulation born from the Sino-American competition. For example, Samsung, buoyed by the development of 5G, has thus recorded, in 2020, despite Covid, a growth of nearly 30% of its operating income to €27 billion.

Healthcare will continue to benefit fundamentally from the general ageing of the planet, excluding Africa, and, in the current economic climate, from the generalization of tests, prevention and telemedicine.

The energy transition will benefit a host of specialized companies, but also the oil majors because, rich in cash flow and with little debt, they are investing massively to catch up.

The more cyclical "value" sectors, which have been much tested, such as automobile sales at -15% in 2020 in the United States, have begun to recover and we are maintaining the exposure initiated in the fourth quarter in energy, materials and financial stocks.

- ***Take advantage of the dynamics of commodity prices* :**

Oil, copper, corn and soybeans, in a sector that is globally more oriented, are among the commodities to be selected.

The ***oil*** price, once again at $55/barrel for Brent, after having fallen to less than $10/barrel in the spring, is benefiting from both supply discipline and a recovery in demand. A supply regulated by OPEC+, OPEC, Russia and a few others, reduced by 9.7Mb/d in April, by another 7.2Mb/d at the end of the year and again, following the initiative of Saudi Arabia, by 8.2Mb/d, no doubt to please the new American administration. At the same time, after a drop from 100Mb/d in 2019 to 91.2Mb/d in 2020, demand is expected to recover to 96.9Mb/d in 2021.

The price of ***copper***, which was $4500/tonne in March, has risen to $8130, favoured by a drying-up of supply and an increase in demand. Supply was handicapped by the contraction of investments in recent years and penalized by strikes in some large mines in Chile. Demand, boosted by Chinese growth, which accounts for 50% of world consumption, stimulated by the need for renewable energy sources, be it electric batteries, wind turbines or solar energy, is anticipated by McKinsey at 30 MT in 2030 against 24Mt today.

Agriculture, and all that surrounds it, fertilizers, storage...will benefit from a sustained demand because, by 2050, the world population will increase from more than 7.5 billion to 9.5 billion.

Gold, +25% in 2020, is to be preserved. Tensions on long rates would be detrimental to the continuation of the rise, but a depreciation of the dollar would be favorable. This is the preferred scenario for this market, which has gained in liquidity because ETFs, "Exchanged traded funds", the main investment vector in the yellow metal, represent the equivalent of one year's production, i.e. 3300 tons.

What am I allowed to hope for or fear?

- ***In general :***

A new appreciation of the equity markets, a contrasting but often mediocre performance of bonds, a good performance of commodities, a depreciation of the dollar, moderate but against most currencies, an absence of a return of inflation and a continuation of monetary and budgetary injections.

At 22x, the P/E is high, but official short-term rates will remain at zero throughout the OECD. This situation is unprecedented.

The debt raised by many companies is more often a matter of opportunism (wanting to take advantage of low rates), than of necessity. Debt is increasing, but so is liquidity, and the ability to seize investment or financial opportunities is even greater.

- ***Prudence on bonds and the absence of fears about inflation :***

No risk of inflation because wage pressures will be low, available crude oil extraction capacity will remain substantial, relocations will be marginal and the digitalization of the economy will have a negative impact on prices.

Central banks are still intervening massively: the FED has already acquired $2 trillion in bonds, nearly 10% of GDP, and continues to do so at a rate of $120 billion each month. The Bank of Japan has increased its balance sheet by 25 points of GDP in 2020 to 140% of GDP. The ECB increased its buyback program in December.

As a consequence of this low inflation and the absence of monetary tightening, long-term rates have no reason to tighten but are not attractive to investors. It is difficult to be tempted by 10-year Greek bonds offering 0.56%, even if it is the highest rate in the Euro zone. At a rate of 0.3%, it is difficult to buy a 10-year English bond when you expect a depreciation of the currency and a rise in long-term rates. This is the same with $ bonds, 1.15% 10-year today, probably more in a few months. In this universe, only Asian bonds, especially Chinese bonds are attracting attention.

- ***The depreciation of the $ against all major currencies:***

Among all the major currencies, distrust will once again focus on the $. This is due to negative real rates, a large current payments deficit and a budget deficit, 16% in 2020, 11% in 2021, substantially higher than elsewhere. All of these factors are reinforcing the pressure. At the same time, the Chinese authorities, anxious to prepare an international status for the Yuan, are letting their currency revalue.

Conclusion: « ***The past is never but a sad memory, the present is dreadful, if it has no future. One day all will be well, that is our hope. All is well today, that is our illusion*** **», a poem by Voltaire about the Lisbon disaster.**

- ***An identifiable risk***: it would be a mutation of the virus that would invalidate the effectiveness of vaccines because the acceptance rates for vaccination would then become low and the crisis would be prolonged. But this is not, to date, the scientists' analysis.

- ***A serious crisis, particularly for emerging countries***: excluding China, GDP growth in 2021-2022 in emerging countries will be limited to 3.5% and, by the end of 2022, the crisis will have cost these countries six points of growth compared to expectations at the beginning of 2020. More than 120 million people worldwide will fall back into malnutrition and delays will occur in vaccination campaigns. Rising poverty is also affecting rich countries and, in the United States, according to Congress, 2.3 million people are slipping below the poverty level. Everywhere, young people are the most vulnerable.

- But there is no cause for alarm: analyses indicating a decline in the GDP in whichever country to the level of 2015 or worse, should be considered with circumspection. This is factually correct, concretely erroneous. A -11% drop, for example, in the GDP of the United Kingdom, will lead to a far from equivalent GDP in terms of value, but the wealth creation that has occurred in each of the last few years has not been erased. There has been no destruction as in a war.

- A lot of consumption has been postponed: consumption figures have been low but incomes have fallen little or not at all, savings rates have increased thanks to the cheques paid out twice in the United States and to the fact that the European states have taken over the financing of part of the partial unemployment.

- The new debt bears a non-prohibitive interest rate: the drift of the debt, at zero or negative interest rates, should be analyzed as an opportunity and not as a risk because the Central Banks will not decide on rate increases before 2023 or 2024. Nevertheless, one should not inject too much because savings are already abundant and because one must be careful to avoid a disproportionate increase in indebtedness that would break the contract of confidence with the States.

- ***A confirmed vitality of capitalism***: this is the essential point. The acceleration of digitization by companies, the rise of e-commerce led by household spending, the spread of telework in companies, the development of several vaccines, the rapid reaction of central banks, the budgetary involvement of governments, the rapid actions of the G20 and the IMF, first to suspend the debt service of the 73 poorest countries, and then to make $250 billion available. These demonstrate the capacity of economic agents to react and adapt. Criticism of governments is easy, sometimes justified, and frustration in the penalized sectors is understandable, but trial and error in the face of a new situation are inevitable and, overall, we can get out of this crisis.

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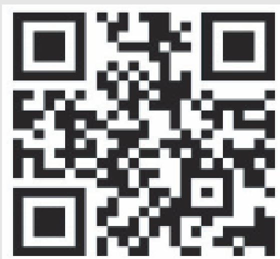

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