FIRST QUARTER 2021 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

12 April 2021

PORTFOLIO THEMES

- We continue to favour larger, high-quality companies as our assessment is that we remain in a late bull market cycle despite the technical bear in 2020.
- The recent relative strength in smaller and more value-oriented companies is likely a typical countertrend in a longer growth-led cycle.
- Measures of economic growth and inflation likely moderate once last year's deeply depressed base levels are passed, supporting our preference for growth-oriented equities.

MARKET OUTLOOK

- **Expect an Above-Average Year for Global Equities:** We anticipate a strong year for global markets tied to equities' resilience, political clarity and continued vaccine development and distribution.
- **We Believe We are Late in the Market Cycle:** The 2020 downturn behaved more like an outsized correction than a traditional bear so the market cycle did not reset. The vast majority of our sentiment and market indicators point to this being a late cycle bull market, yet many forecasters expect early-cycle leadership.
- **Investor Sentiment is Elevated but not Euphoric and can Remain High for a Long Time:** Positive sentiment can reign for a while before equities reach a euphoric peak, with strong returns along the way. Monitoring sentiment will be key for investors in 2021.

Global markets extended their climb in Q1, rising 4.6%.[i] Value equities led growth with Tech and Tech-like equities lagging, however we believe this to be a temporary countertrend. We are monitoring this carefully with the understanding that style volatility is normal. Crucially, our outlook hasn't changed. We still think equities should have a good year, with growth regaining its leadership as markets climb alongside sentiment.

As detailed in past Reviews, 2020's bear market acted like an oversized correction. There was little to no excess before governments shut down the global economy to restrain Covid-19's spread, triggering a contraction unlike normal recessions. Markets priced this rapidly—too fast to reset the market cycle, in our view. As a result, equities are behaving like they are in the late stages of the bull market that began in 2009—a point when returns are usually strong with growth leading despite irregular value countertrend rallies. Overwhelmingly, most observers now envision a young bull market with years to run amid extended value leadership. Global markets efficiently price in broad expectations and we believe there are fundamental reasons for our current contrarian view. While we believe this bull market has room to run now, it is likely closer to its end than most expect.

Value's leadership dominated headlines globally in Q1—a big sign this is a temporary and fleeting leadership reversal, in our view. Long-term interest rates rose swiftly—which inflated expectations for inflation and fast economic growth to benefit the industries that suffered most during lockdowns—all value categories. The steeper yield curve also heightened expectations for bank earnings, another big value component.

i Source: FactSet, as of 01/04/2021. MSCI ACWI Index return with net dividends, 31/12/2020 – 31/03/2021.

Fund managers are now more optimistic on value than they have been in many years with retail investors following suit. After a brief bump tied to reopening, economic growth will likely be slower than headlines expect. Inflation probably won't spike, anchoring long-term interest rates—a backdrop favouring growth equities over value. Further, value equities, especially illiquid small ones, are generally lower quality and usually fare worst in bear markets. While we don't think a bear market is imminent, investors shifting heavily to value and not appreciating this bull market's late-cycle traits could be setting themselves up for disappointment.

Sentiment today is classically late-cycle. Optimism abounds. Pockets of euphoria exist in areas such as cryptocurrencies, digital assets called non-fungible tokens (NFTs) and so-called blank check companies (Special-Purpose Acquisition Companies, or SPACs). These fads wouldn't happen in a typical new bull market, when pessimism dominates.

Pockets of skepticism exist though, and politics underpins much of it. Many investors are concerned about spending and potential tax increases. This is understandable, and in the US more legislation may pass early in President Biden's term than we initially envisioned. But plenty of historical data show markets pre-price widely watched bills like taxes and spending, limiting their power over equities—positively or negatively. For example, major tax and spending hikes dominated last year's US presidential campaign and the vast majority of investors expected them in some form. Therefore, efficient markets dealt with all of this by the time President Biden was elected. Also, his "honeymoon" period with lawmakers and voters is nearly over. Gridlock— tied to the Democratic Party's narrow edge in the House and Senate as well as internal divisions—should result in any proposed legislation, such as a tax bill, getting watered down. Pushing bills through repeatedly would likely wear out fast, as many in Congress look ahead to 2022's midterms. As 2021 passes, gridlock's realities should grip tighter.

In European politics, Netherlands Prime Minister Mark Rutte's People's Party for Freedom and Democracy (VVD) won the most votes in mid-March's general election. Yet at the month's end, Prime Minister Rutte became entangled in a long-running childcare scandal, as allegations he tried to silence a whistleblower emerged. Italy has a new government, led by former ECB President Mario Draghi. Some observers think Prime Minister Draghi's popularity and reputation for competence bolster his ability to pass major changes, including overhauling Italy's bureaucracy and implementing sweeping tax reforms. However, we doubt Prime Minister Draghi's government will be much more active than its predecessors. Additionally, two widely watched German regional elections saw outgoing Chancellor Angela Merkel's Christian Democratic Union (CDU) suffer historic losses. Some observers see the results as a precursor for September's federal election, though that seems unlikely to us. No one party looks likely to run away with September's vote, and no politician currently has Chancellor Merkel's popularity. It appears another do-little German coalition government is likely, which should prevent extreme legislation—a positive for equities.

Emerging Markets (EM) also rose in Q1, rising in accordance with Covid-19 vaccine optimism and the value countertrend—helping EM heavy sectors such as Energy and Materials. However, Emerging Markets fell in March, with the biggest detractor a sharp fall in Chinese equities, which account for over 35% of the MSCI EM's market capitalisation.[ii] Chinese volatility, stemmed primarily from fears over the new enforcement of the Holding Foreign Companies Accountable Act—which raises the possibility of Chinese ADRs being delisted from US exchanges—and regulatory rumblings from Beijing. The People's Bank of China (PBOC) is reportedly planning to toughen oversight of digital commerce and payments—putting some large Tech and Tech-like names in its sights—and financial regulators are also considering measures that would further tighten private credit. While these issues are worth watching, we think the sentiment reaction to them is excessive.

ii Source: FactSet, as of 01/04/2021. MSCI Emerging Markets and constituent countries' market capitalisation on 31/03/2021

Once the sentiment reaction passes, we think the country's favourable economic fundaments should regain primacy, boosting Tech and e-commerce in particular. We think China's recent decline is a correction, not the start of something much worse, and we still think EM equities are likely to have a good to great year, with growth equities leading.

Markets' ability to pre-price major, widely discussed developments was one of last year's biggest lessons. It won't surprise us if the major economic data swings likely ahead push sentiment up and down. Economic data series are often calculated on a year-over-year basis. Last year's deeply depressed figures will be the base for forthcoming reporting, which will yield huge growth rates even if activity is static month to month. As we move through the second quarter, and last year's sharp rebound becomes the new base, we believe it could drive big slowdowns or even drops for the same reason. We expect to see plenty of headline volatility tied to this dynamic.

This "base effect" will also boost inflation briefly. This looks temporary to us, as inflation and interest rates move globally, not nationally. Global forces are relatively benign. On the economic front, many envision a big, stimulus-fueled boom in the coming months. Economic growth may spike temporarily, but we don't think a huge, lasting surge is ahead. We aren't pessimistic, but late in bull markets, high expectations and greed can drive some investors to make risky, overly optimistic decisions.

While we don't see a bear market as imminent, we are vigilant for what could cause one and we diligently monitor widespread signs which could affect equities broadly. But overall, this looks like a very good, late bull market year to us.

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