VERMEER NEWSLETTER

January 2021

2021 OUTLOOK
Cloudy with a Chance of Meatballs

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As I tried to gather my thoughts for 2021 over Christmas and wrestled with the prospects of sounding like a broken record with regard to short term uncertainties, my daughter reminded me of this 2009 animated classic. It has the dual attractions of a snappy and unusual title and a plot which nicely sums up our views from the very top down. Putting the pandemic to one side for just one moment, the great dilemma the world faces is how to pay for the huge costs of Covid-19 and the lingering legacy of the 2008 financial crisis. In the film, Flint Lockwood develops a machine which can convert water into food. All is fine until it starts to produce food storms and it must be destroyed. The parallels to how the global economy goes about unwinding Quantitative Easing (“QE”) are quite clear – everyone agrees it was a good idea in the first place, but nobody has a clue as to the implications and unintended consequences of unwinding it. At some point these need to be addressed, the only question is when.

That said, it is unlikely that governments and monetary authorities around the world will actually do much if anything about it in 2021. Covid-19 will continue to dominate, and the only major decision will be whether anyone is brave enough to even broach the subject of austerity and starting to repair the balance sheet damage which has been inflicted on virtually every nation. In the meantime, with the QE taps still turned on asset prices will be underpinned, as investors eagerly seek out any form of available return.

We remain broadly positive on the outlook for global equities. The first half may be difficult with a lot of poor and negative medical and economic data to deal with, but there is a realistic chance of meaningful economic recovery in the second half. The main caveat to this, is the fact that many stock markets, particularly the US, already discount much of this recovery as we enter the year with much higher market multiples. The bulls believe governments will stay in inflationary mood, providing a sound macro environment and that at the corporate level, cost savings made during the pandemic will be permanent and earnings will rebound past previous levels. Although we can find companies that we do believe can achieve this, we struggle to believe that this will be achievable at the aggregate level, and large parts of the economy will be permanently scarred.

Perversely the most positive aspect of the outlook for 2021 is the rude health of consumers around the world. Broadly speaking high income earners cannot find enough things to spend their money on and middle incomes are broadly in equilibrium. Lower income parts of the population have suffered disproportionately from unemployment but have received much of the government support on offer, which has enabled them to maintain spending. Although this broad description should not obscure the economic and human misery 2020 inflicted on many, it does mean there is potentially a large pot of demand to be unlocked. Hence recent commentary on a return to the post WW1 “roaring twenties”. Without wishing to dampen the enthusiasm of all the aspiring Great Gatsbys, we would point out that this is likely to be a one-off, and things may not look quite as rosy once government support programmes inevitably come to an end.

In terms of our geographical preferences we continue to focus on finding great companies regardless of where they operate. However the end markets we prefer include: China, which still has the ability to create domestic growth on its own; Japan, where we are convinced that various strands of corporate reform will result in large parts of the country’s corporate balance sheet being unlocked for the benefit of equity investors; and India where the government is starting to harness the country’s attractive demographic profile and, like China, to control its own destiny.

Much as though we would like to champion the prospects of the UK, it is difficult to get excited by it as an end market given the challenges of Covid-19 recovery twinned with finding our way through the complexities of a poorly structured Brexit treaty. That does not mean we will not find UK companies to invest in. Many trade extensively in other parts of the world and even in the most difficult times, there are opportunities for skilful operators. In addition, we expect there to be a marked upturn in the level of corporate takeovers globally in 2021. Corporates, and in particular private equity, are flush with cash and virtually any deal is earnings enhancing given the cost of debt and highly rated equity. Unless the pound were to strengthen substantially from current levels, then the UK will be a fertile hunting ground. We can also expect a step up in shareholder activism.

Corporate debt issuance is likely to decline simply because virtually everyone raised money in 2020 and there is very little to spend it on, except buying other companies. It would be nice to believe that an increasing proportion of newly raised debt may find its way into actual investment, but there is scant evidence of this at the corporate level. Governments meanwhile will continue to issue debt in vast quantities. Much of it will be consumed by the various QE schemes operated by the world’s various monetary authorities, but large amounts must also be sold to institutional and private investors. This could result in an interesting quandary in the US, where the Treasury has mapped out its plan to issue a lot more long dated Treasuries than previously. The Federal Reserve will take much of these, but it will be interesting to see if the market will continue to buy everything else at the prevailing super low yields. If not, then we may witness a rise in interest rates at the long end of the yield curve, driven purely by supply and demand and not necessarily by economic necessity.

The UK lockdown, announced as we compose this piece, will certainly have a further economic impact on the UK, and will further delay a recovery to previous levels of activity. Around the globe there are many hurdles that will have to be overcome. However, it does appear that we are closer to the end than the beginning. If we can

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avoid the Meatballs, markets and investors are desperate to look through the current malaise, and although we do not share the unbridled optimism of some of the higher profile market commentators, who are forecasting strong equity performance in 2021, we do believe markets can make progress. We expect individual stock picking to have more of an impact this year, which we believe plays to our strengths and the external fund managers we entrust your money to.