Valvest

Investment View – 4th Quarter 2020

Review

Lockdowns, closed restaurants and shops, severely restricted travel, new all-time highs for stock markets - how is that possible?

The 2007/08 financial crisis taught the central banks how to deal with liquidity crises in the financial sector. This time, banks entered the crisis with a stronger capital base and politicians directed large relief measures directly to companies and private households. Since governments themselves are confronted with falling tax revenues, the supporting measures have led to massive fiscal deficits, which have increased the already considerable levels of debts for most countries. Record-low interest rates help make this burden of debt manageable and also keep the risk of default on consumer and corporate loans low. To maintain low interest rates despite the flood of new debt, the central banks have supported demand for bonds by expanding their balance sheets significantly. The balance sheets of the four largest central banks grew by around USD 8 trillion in 2020, a more than 50% increase. A significant part of the bond market is now owned by the central banks. This leads to extremely low liquidity in the markets, which, in addition to record-low interest rates, makes investing in bonds even more difficult.

The newly created money is seeking returns, which it is increasingly finding outside of the bond market. Bonds with a cumulative value of USD 18 trillion and around 41% of all investment-worthy bonds in EUR respectively, already yield a negative return. These represent potential capital flows shifting into other assets, especially when the economy is recovering. Opportunity costs for holding assets that do not generate income are therefore non-existent. It is thus not surprising that gold has also reached new highs. The low interest rates have valuation consequences for all other asset classes, which are valued relative to the interest rate level. Correspondingly, equities have set new highs despite falling earnings. Due to the versatile dependencies on low interest rates and the determination of the central banks to keep them low, no major interest rate jumps are to be expected in the next year either. In particular, central banks will keep short-term interest rates low for a long time to come.

So far, inflation has only been visible in assets, not in consumer prices. On one hand, much of this has structural reasons, such as technological advancements, which have strong deflationary effects, since raw materials, products and services can be manufactured more efficiently. On the other hand, scarce goods, especially productive goods with a yield component, like stocks and real estate, are exposed to strong inflationary tendencies due to the increasing money supply. It is therefore not surprising that the wealth gap continues to widen.

Outlook

Due to the different kind of relief measures applied today in comparison to the financial crisis back in 2007/08, unequal consequences for the economy are to be expected. This time, the money goes to companies and consumers. That has the potential for pent-up consumption and could lead to higher growth rates than was the case after the financial crisis. In addition, Biden's election has further put distribution and environmental policies on the political stage in the United States. If the vaccination efforts are successful and restrictions subsid, the economy should regain momentum or even boom due to a renewed desire to consume and travel.

However, depending on how long and intense the second lockdown phase turns out to be, an increased unemployment rate, bankruptcies of small businesses and other difficulties must be expected. So, there is a lot to compensate for on the part of governments and central banks and we expect large fiscal deficits and rapidly growing central banks' balance sheets for 2021 as well. Because of these uncertainties and the demanding valuation, we expect markets to be volatile with the potential of major shifts in the development of individual economic sectors and assets. In this environment it is important to be prepared for all scenarios and to be extremely vigilant with regard to the price, quality and sector of the companies we invest in. We continue to trust that assets such as stocks and gold will develop positively and consider an overweight to be appropriate. Those who do not invest their money are still exposed to high opportunity costs and risks.

Zurich, end of December 2020