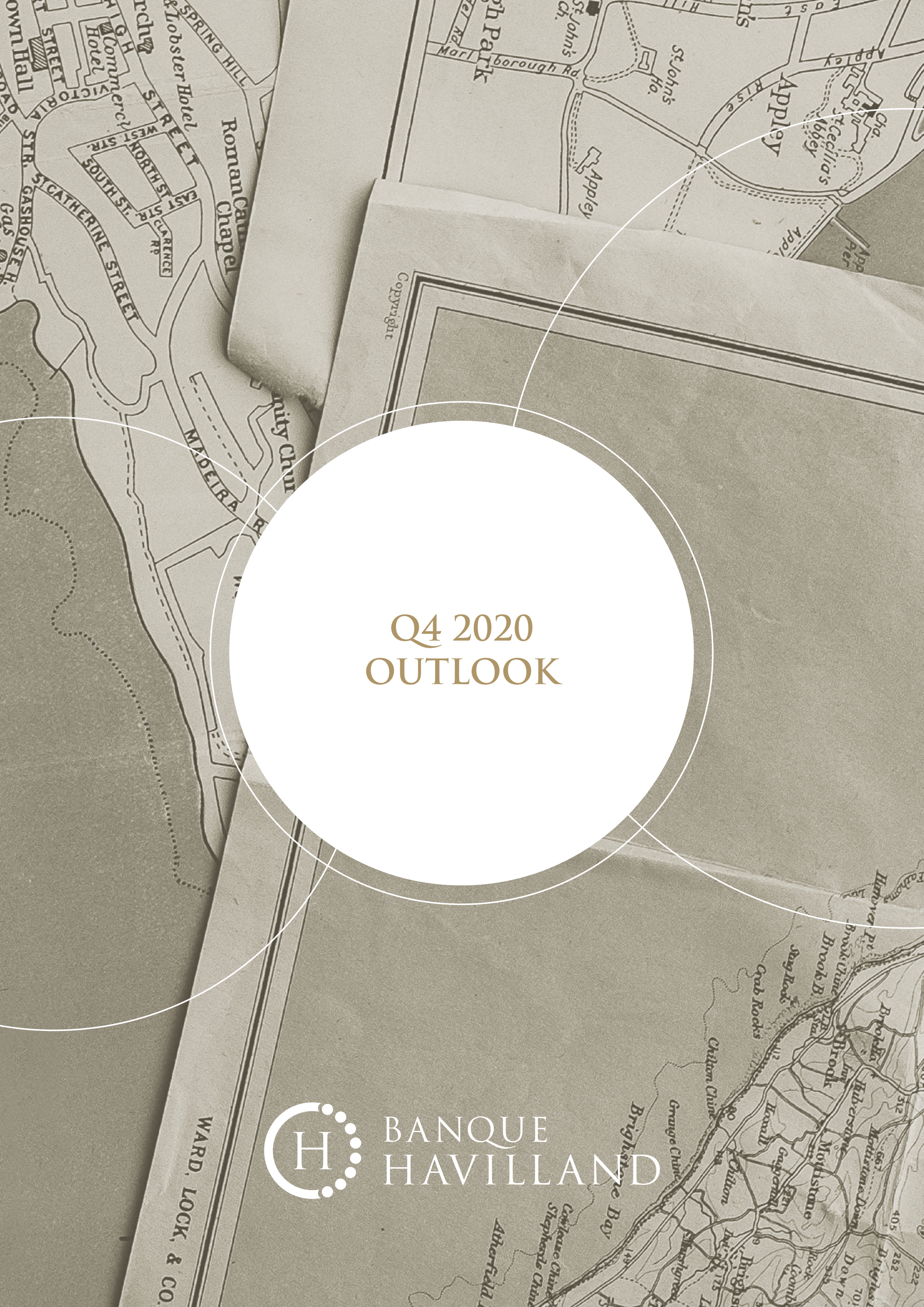

Q4 2020 OUTLOOK

BANQUE HAVILLAND

Banque Havilland is a Private Banking Group established in 2009. The Bank is headquartered in Luxembourg with offices in London, Monaco, Liechtenstein, Dubai and Switzerland. The Group provides private banking, asset and wealth management services and institutional banking services to High Net Worth families and individuals from all over the world.

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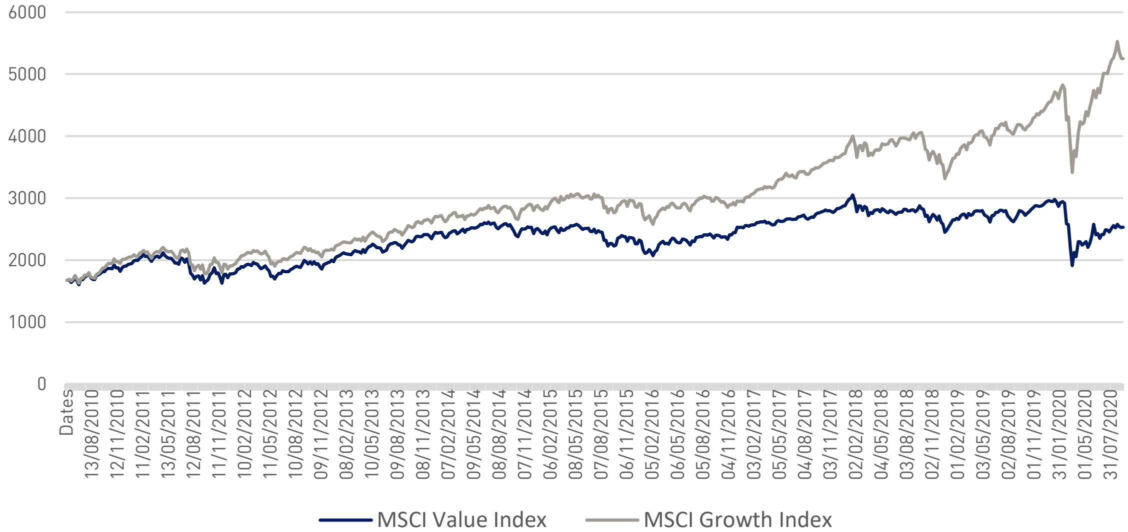
MARKET ENVIRONMENT

As we move into the final three months of what has been a quite extraordinary year, investors are faced with both imminent and long-term challenges that on the surface will require perhaps more intricate and thoughtful planning than has been necessary for some time.

At global level, the rebound of risk assets since the Covid-inspired nadir of March 23rd has been so furious that we have reached an inflection point far earlier than could have been anticipated, as unprecedented central bank and government stimulus has seen many financial assets recover or surpass their pre-virus peaks within a few months.

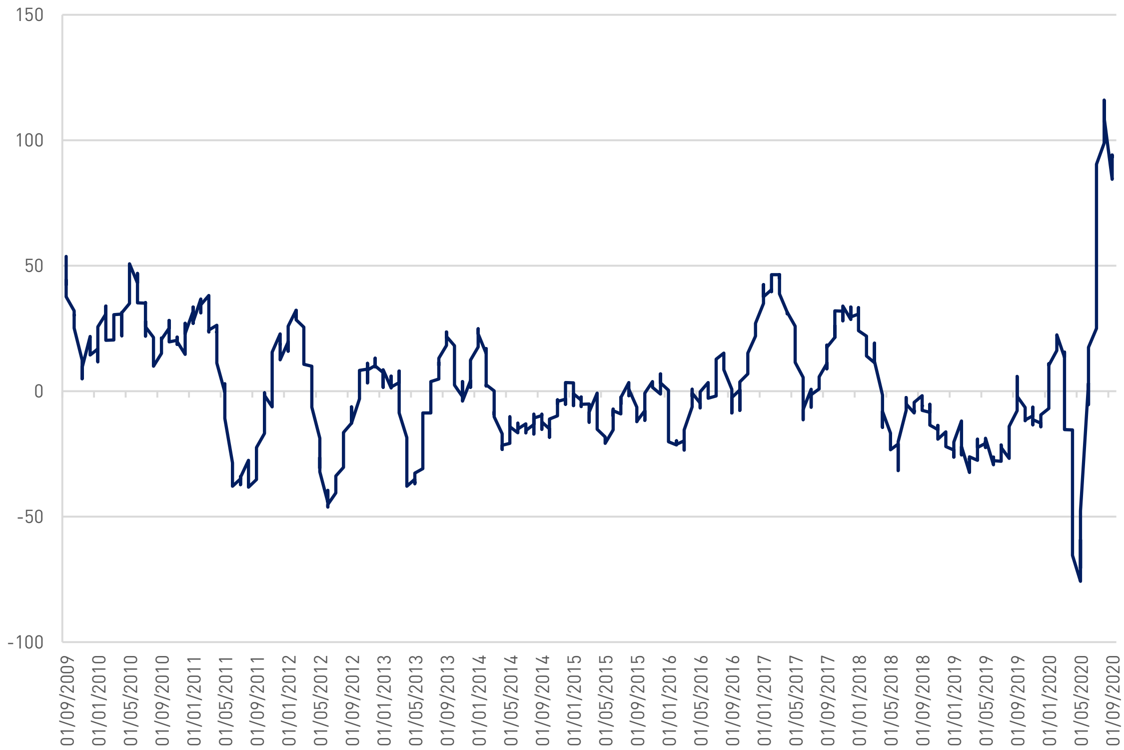
Where we may have expected in Q4 to be tentatively seeing recovering equity markets, we are instead once again concerned about unrealistic valuations and asset bubbles! The rebound, of course, has not been universal by any means (except perhaps in the bond markets) and nowhere is the disparity better demonstrated than how much the US equity market rebound has depended on the technology giants. In fact if you exclude Facebook, Apple, Amazon, Google, Netflix and Microsoft the S&P 500's market cap has barely changed from where it was in January 2018. While the Nasdaq has been as high as 30% year to date even after March lows, the Dow Jones remains in negative territory - we wrote in last quarters Outlook how much of this was rational to a certain extent as many businesses would benefit from the 'stay at home' theme and certain technological trends were brought forward by the Covid outbreak, but even since then the Nasdaq has rallied a further 30% before the recent pull-back. The performance of growth and momentum stocks versus so-called value stocks has also widened to extreme levels, more so than any point in history, with earnings per share in the value category having declined by 50% year-on-year by aggregate compared with a 15% decline for growth. Conversely, many other global indices are still very much in the red and even then with big gaps between the indices of neighbouring economies (eg. A difference of about 15% between the French CAC and the German DAX), while in the commodities markets Gold is up around 30% in 2020 but Crude Oil remains down well over 30%. With such significant divergences even between similar asset classes, it is clear to see that a modest degree of mean reversion could result in opportunity for investors even if the headline valuations look unappealing at this point.

Growth v Value Styles over past 10 years



The divergence between Growth stocks and value stocks is at a record high, to the extent that the correlation has broken down altogether. (source: Bloomberg)

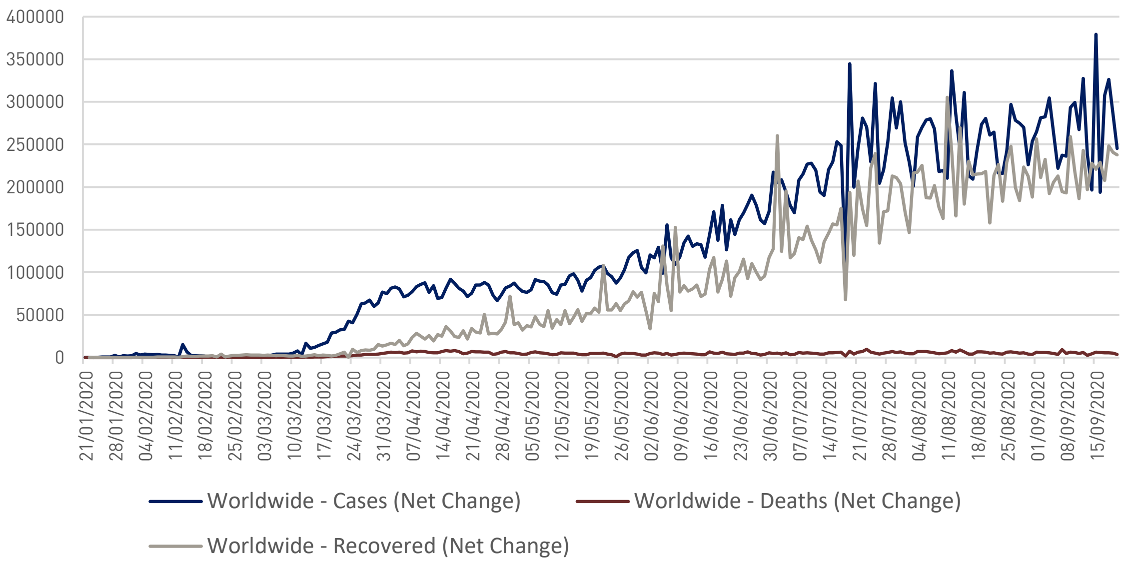
Citi Economic Surprise Index - Global



The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected. Sentiment is strong but may have peaked.. (source: Bloomberg)

Away from the US tech giants and Asia, stock markets have in reality been treading water now for a few months and one could argue the case that these are more reflective of the 'real' economy, with optimism over the economic rebound being tempered by fears of further government restrictions in response to any resurgence of the virus. As such, markets remain highly sensitive to changes in sentiment either way. Encouragingly the race for a successful vaccine against Covid 19 is well underway and positive news-flow surrounding this has surely been a large factor in why equities have remained buoyant, but we would suggest that much of this hope is already priced in, and that the anticipated timescale of a good vaccine being rolled out to the general public is potentially too optimistic meaning any hiccups (such as the Oxford/Astrazenica test-patient having side-effects) could skew risk to the downside. Nevertheless, should a vaccine arrive this year it will draw a line under the economic recovery and therefore asset prices – representing something of a silver bullet as far as markets are concerned and essentially as a consumer confidence placebo. As for the economic recovery itself, much was made of what 'shape' it would take, and quite simply to date it has been of the 'V-shaped' variety as signalled by the data from the US, China and Europe. Forward-looking PMI's in particular have rebounded swiftly into expansion territory, while employment and industrial production has started to recover in most regions as governments ease their lockdown policies, but it has to be said that all this is subject to reversal should further draconian anti-virus measures come in. Presently, it seems that most governments are loathe to re-establish nationwide shutdowns and would prefer localised approaches which points to a more lumpy recovery than a straight line to previous economic activity levels, whereas a return to full lockdown would suggest another large dip before resuming any recovery. The IMF forecasts GDP Growth will return to pre-Covid levels in 2021, but perhaps most reassuringly of all is that the death rate of the virus is now statistically very low and steady, and has not picked up even though the new cases being confirmed has increased (most likely due to far greater levels of improved testing, of a wider, less vulnerable populace). One would hope this clear pattern continues and deters politicians from the most economically damaging course of action.

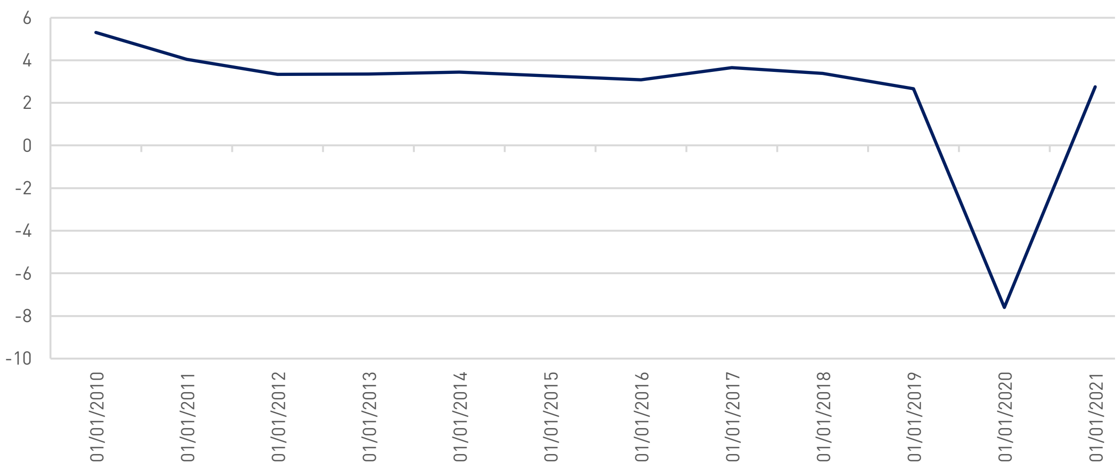
Covid 19: net changes in Cases, Recoveries and Deaths



The death rate of the virus does not appear to be proportional to the number of cases. (source: Bloomberg)

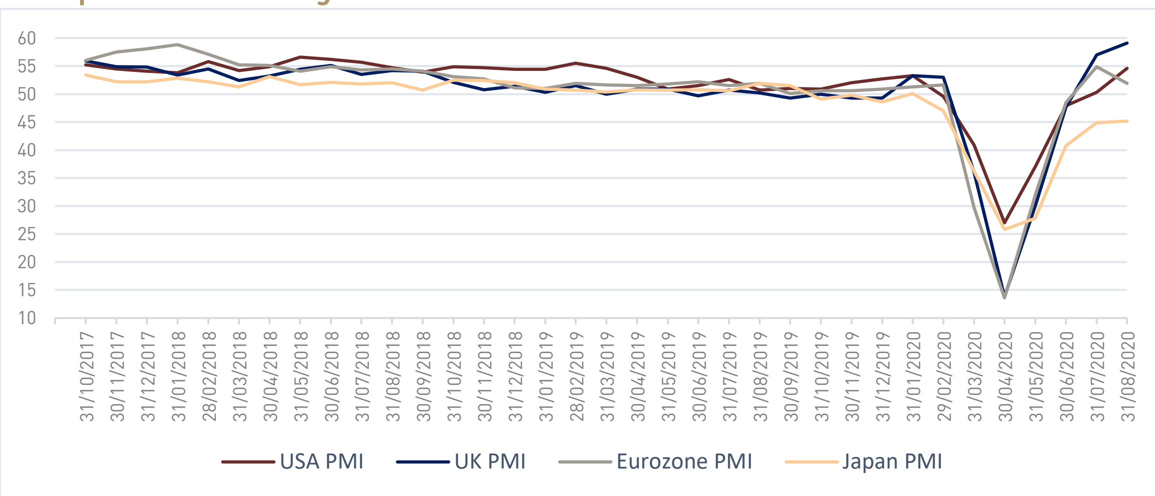
Away from the economy and Covid a number of familiar geopolitical risks are set to reach some sort of finality in the final quarter of the year, namely the US election in November and confirmation of the exact terms of Britain's departure from the European Union, while the US and China have moved their trade dispute into the technology sphere. All are known events and investors should take comfort in this while expecting increased volatility as matters come to a head. With respect to the US election, a Trump victory is largely seen as a market friendly outcome in terms of being the continuity candidate who will maintain a lower tax environment for corporate America, with a Democrat sweep of both Congress and Senate being the least favourable scenario as this could lead to higher taxes, a greater deficit and the possible break-up of the mega-tech companies. As it stands markets seem complacent about a Biden victory, though this could be a measured expectation of additional stimulus that would counter the more socialist aspects of such a regime, or a belief that Trump will close the polling gap as the election draws near.

OECD World GDP Growth Outlook



After troughing in Q2, GDP growth expectations for 2021 are back at 2019 levels. (source: Bloomberg)

Composite PMI Readings



PMI's have recovered to pre-Covid expansionary levels, reflecting the pent-up demand that built over the summer months and the likelihood of a fast recovery. (source: Bloomberg)

Markets may witness further volatility should the President's campaigning efforts overlap with the US's approach towards China – there will surely be a temptation to break the trade deal, or at least threaten to, as the race heats up and a further polarisation between the mega tech businesses of the US and China is another threat to the highly valued sector. Interestingly, this could speed up China's drive to move more supply chains onshore and not only with respect to technology or just China - in the wake of Covid and ongoing trade tensions many governments have shown a desire to have speed of security and supply within domestic borders. From an investment perspective we have long attempted to gain exposure to the domestic economies of countries when choosing to invest overseas, rather than simply buying into the leading index which may in reality be a replication of global returns, and this theme looks set to intensify in the future. Brexit is something that has been hogging headlines on and off for over four years now, and we would expect that as a 'no deal' or bare-bones trade deal has been our assumption for some time, so it would be both for businesses affected by changing UK/EU trade practices and by market participants – resulting in muted price reaction to whatever sort of deal transpires - though that is not to say there will be no volatility as news-flow emerges. The pound has tended to take most of the strain in this respect and with UK equites having been lagging their global counterparts for four years the scope for further downside is surely limited in any case.

We also suggest that European investors keep an eye on Turkey's brewing credit crisis which has already seen the Lira hit new lows and the countries' foreign reserves dwindle substantially.

The Turkish economy is closely entwined with that of Europes' banks having invested billions of Euros there and Spanish banks are especially on the hook with over $62 billion of Turkish loans on their balance sheets. The Spanish banking sector is already showing signs of strain and the risk of further contagion may well explain the EU's gentle diplomatic response to Turkey's aggression towards member states Greece and Cyprus so far.

The above risks should be seen through the prism of monetary policy, and with the Federal Reserve and numerous other central banks sending the message that it will do whatever is needed to support the promising economic recovery, we believe investors can remain sanguine providing their portfolios are well diversified and the most expensive sectors are held in moderation. In our portfolios this means underweight positions in mega-tech equities as extreme valuation dispersion means more palatable risk is available elsewhere, and a progressively sceptical view on bonds as an effective store of wealth.

EQUITIES

We continue to prefer equities to the fixed income market, and while very mindful of the extreme valuation of certain sectors (i.e. US Technology) expect global equities to be near or slightly higher than current levels at the end of the year, as the liquidity provided by central banks remains a stabiliser, with the obvious caveat of a Covid-19 resurgence.

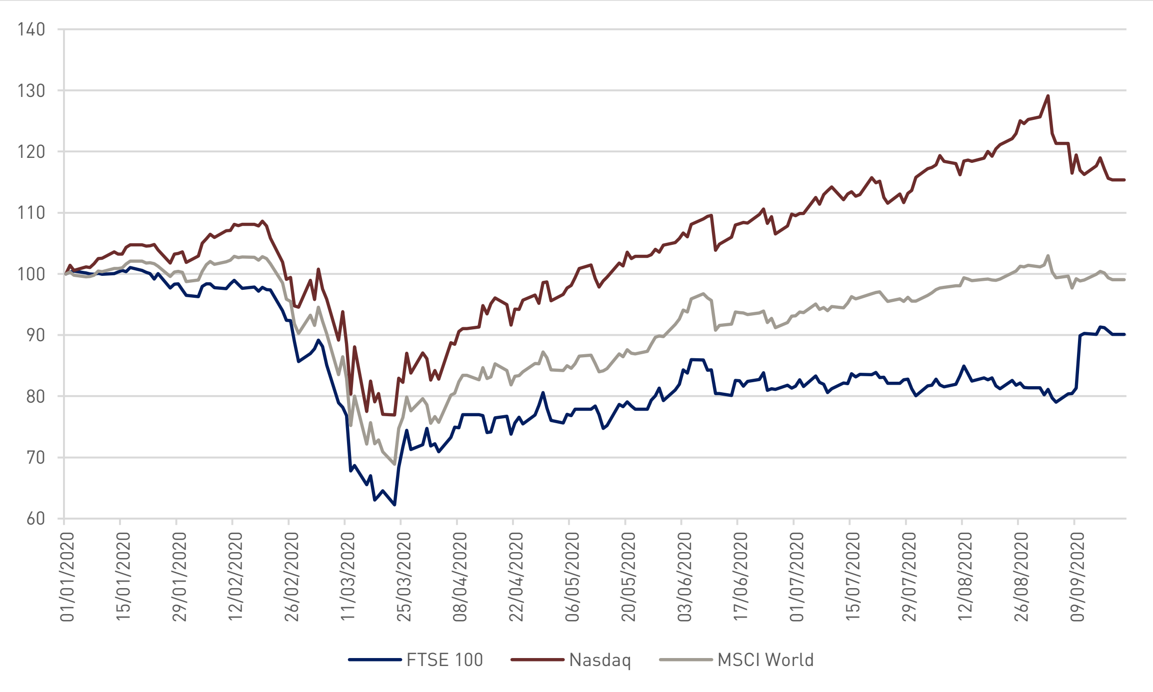
The recent 10% correction in the Tech sector hardly came as a big surprise – a reality check was much needed – with many companies seemingly in bubble territory on a number of metrics.

Over 6% of all US stocks currently trade on a price/sales ratio of more than ten (for every $1 in sales investors are willing to pay $10) which has only been higher at the peak of the dotcom bubble in March 2000 while the 'Buffet Indicator' (market cap: GDP) is now around 200% compared with the dotcom era high of 140%. Furthermore, there has been a noticeable rise in M&A activity recently and a concerning resurgence of blank-cheque Special Purpose Acquisition Companys (SPACs), where shell companies with no business operations go public on the promise of a future corporate takeover or merger. Typically such activity can be a sign of late cycle euphoria.

The market trend however, is powerful, as is the appeal of these tech stories as major players in the future of our society and we would not wish to bet against them (many a short-seller has lost his shirt where Tesla is concerned) – we simply see better risk/reward opportunities elsewhere.

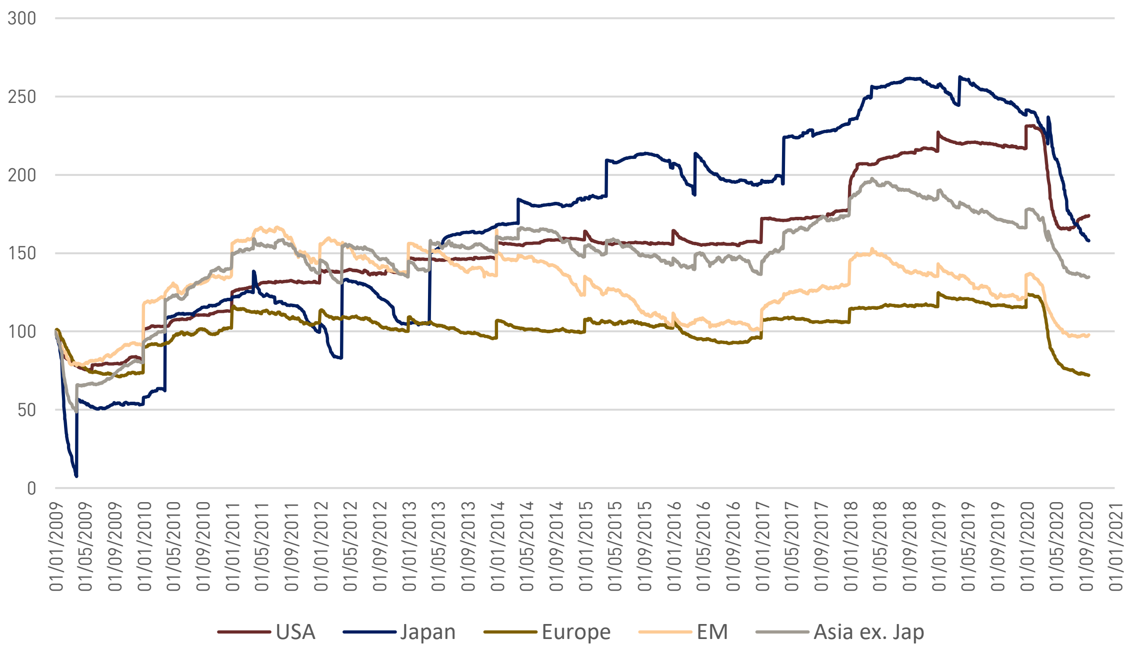
In the US this leads us to small-caps for access to growth and a careful eye on valuation when it comes to large-caps, looking for stocks with the potential for high returns and balance sheet/secular advantages. In Europe, the establishment of the EU recovery fund and various national 'green' spending pledges suggests the economic prospects are improving though some of the data has started to slow. Germany's industrial export economy is aligned to the global recovery though so could continue to benefit from the strong Chinese recovery even if domestic European activity stays muted – the DAX has surged ahead of its local peers since March. We believe the valuation of the UK market (i.e. the domestic index so not including the international energy and pharma stocks) is now so discounted following the lockdown hit to the consumer/services led economy and the upcoming Brexit uncertainty, that it justifies a buy though we are braced for the coming job losses as the employment-support scheme comes to an end before other European nations.

Long Term Price Earnings Ratio (rebased to start of 2021)



The valuation dispersion between underperforming markets such as the FTSE 100 and the tech-heavy Nasdaq Index is stark and is surely unsustainable in the longer term. (source: Bloomberg)

Earnings Estimates (rebased to 100, 2009)



Analysts have drastically amended estimates downwards in the wake of the global lockdown to more realistic levels. (source: Bloomberg)

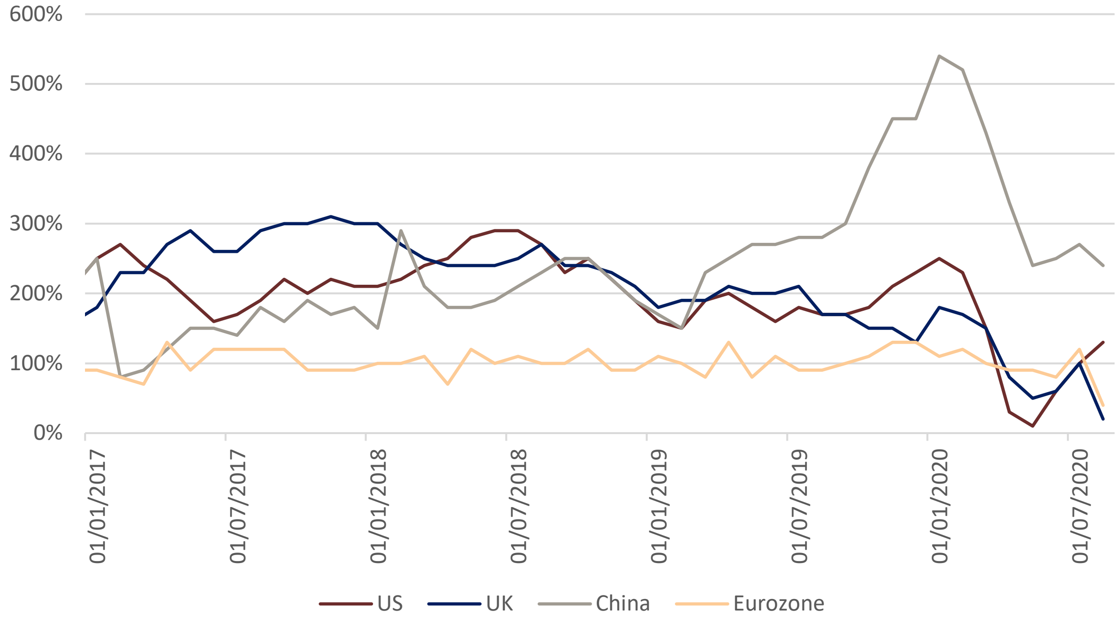
		–		=		+		
EQUITIES								**The stock market recovery is distorted at the top line by a handful of companies that had a 'good virus'. As the recovery continues investors should focus more on regions and sectors that have fallen behind.**
US								The S&P 500 has touched new highs, largely propelled by a handful of familiar tech names, whose appeal has been further boosted by the virus lockdowns.
UK								British stocks are at their cheapest versus global stocks for many years. Economic data points to a fast recovery, but future unemployment and Brexit risks exist.
Eurozone								Earnings and growth were already slowing pre-virus, but the prospect of increased fiscal harmonisation have boosted assets in recent weeks. Selective approach is crucial.
Switzerland								Quality, defensive nature of the market remains in demand, and the weighting to healthcare is attractive as is the diversification haven of the Franc.
EM								We favour emerging Asia for the long term growth story with too much political risk elsewhere. Likely to emerge from virus earlier than developed markets.
Japan								Attractive valuation for a developed market, and we like the safe-haven qualities of the currency. Anaemic growth is countered by vast BOJ asset-buying which is underpinning market.

We kept our overweight exposure to Emerging Asia and China throughout the crisis earlier in the year on the basis that the region was the first affected by the virus and would likely be the first to emerge too, and this has been vindicated thus far by the Chinese economic data and the performance of the region's equities. The resilience of China's big tech names such as Alibaba and Tencent throughout the recent US clampdown (Tiktok, WeChat etc) perhaps shows how much growth potential there remains internally and is an encouraging sign that the region is moving away from dependence on exporting to the West, though exports themselves have been helped by the weaker dollar. This will be tested in the coming months, no doubt, as the US election campaigning gets underway and the US's foreign policy towards China becomes a political football. Japanese stocks have held up relatively well compared with many indices – a reflection of the limited Covid outbreak there and the relatively 'low' drop in GDP growth of 7.9% in Q2 compared with 32% in the US, 20% in the UK and 12% in the Eurozone and the country remains a part of our global allocation for both growth and valuation reasons. Shinzo Abe's replacement, Yoshihide Suga appears to be the continuity candidate meaning the market-friendly asset-purchasing and stimulus will not slow down in the foreseeable future and the corporate picture looks good. Japan's earnings-per-share-growth has actually beaten most global markets in USD terms since Abe took office and profit margins haven't dipped below 5% in the past 5 years, and while the export economy looks to strengthen in line with the global recovery we are attracted to the domestic growth story and the defensive properties of the currencies.

BONDS

In August US 10-year Treasury yields set a new record low, while simultaneously US equities hit record highs, meaning we are compelled once again to question the purpose of bonds for investors other than those drawing on a pension. As noted in the introduction, all major bond benchmarks have now returned to February's levels indicating that the 'easy' money has been made as Emerging market bonds (which a few weeks ago still offered some relative value) have now caught up as well. In the short term it can be expected that core fixed income (treasuries and high quality Investment Grade) will stay supported at current levels, as fears exist over the prospect of further Covid-19 outbreaks and the trajectory of the economic recovery remain uncertain, while worldwide asset purchasing programmes remain in force. Furthermore, interest rates are low and will stay low for the near future, with central banks probably desiring negative real returns to combat the vast debt piles that have accumulated (and recently accelerated) in response to the virus. Countering these powerful pro-fixed income forces however, is the spectre of inflation over the longer term which was brought sharply back into investors radar at the recent Jackson Hole summit. In a nutshell, the Fed stressed their commitment to maximum employment while changing their inflation target to an average of 2% inflation 'over time', effectively casting aside the traditional Phillips Curve orthodoxy (lower employment will eventually lift inflation) and stating their ambivalence to prices running higher. The problem with this, while reassuring for bonds in the short/medium term, is that the Fed is hyper sensitive to the effect of raising rates or even raising the prospect of this due to the 'taper tantrum' of 2013 and to the similar reaction in late 2018. Historically (and admittedly we have to go back 40 years plus) when meaningful inflation returns it does so in violent fashion leaving the central bank policy makers scrambling to get it under control, and with current market sentiment built on the foundations of record stimulus and corporate debt it is unclear how this could be handled. Of course, the outlook in the post-Covid world is undoubtedly deflationary and set to become more so as surely unemployment starts to rise when government Covid-support schemes start unwinding, but nevertheless the fixed income market is uniquely prone to inflation and this, combined with the lack of yield on offer leads us to a generally unfavourable view of the asset class.

Year-on-Year CPI Inflation Rates



Inflation has dropped to multi-year lows, which explains the low-yielding bond market. However, should reflation appear bonds would be very vulnerable. (source: Bloomberg)

2 Year Bond Yields

COUNTRY	MATURITY	YIELD + / -
SWITZERLAND	25/05/2022	-0.87
GERMANY	16/09/2022	-0.74
AUSTRIA	20/09/2022	-0.73
FINLAND	15/09/2022	-0.69
BELGIUM	28/09/2022	-0.69
NETHERLANDS	15/07/2022	-0.69
FRANCE	25/02/2022	-0.67
DENMARK	15/11/2022	-0.67
PORTUGAL	17/10/2022	-0.62
IRELAND	18/10/2022	-0.61
SPAIN	30/04/2022	-0.53
SWEDEN	01/06/2022	-0.40
ITALY	15/07/2022	-0.21
JAPAN	01/09/2022	-0.16
BRITAIN	07/09/2022	-0.13
NEW ZEALAND	15/04/2023	-0.08
ISRAEL	31/01/2022	0.04
UNITED STATES	31/08/2022	0.13
GREECE	30/01/2023	0.15
HONG KONG	22/08/2022	0.15
AUSTRALIA	15/07/2022	0.16
SINGAPORE	01/04/2022	0.18
CANADA	01/08/2022	0.25

(source: Bloomberg)

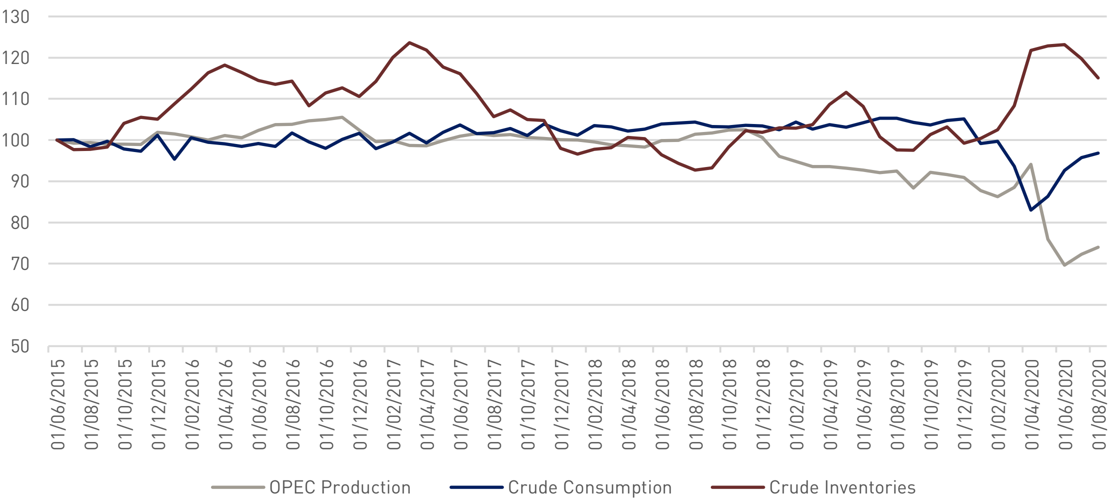
An active approach to fixed income can generate some income, and of course idiosyncratic selective opportunities can be found though are increasingly hard to come by. The role of bonds in a multi-asset portfolio has morphed from one of providing capital protection plus regular income to that of volatility suppression and possibly some yield and only this can be achieved by holding a wider range of fixed income instruments than was traditionally necessary. A core holding in Treasuries, albeit a smaller allocation than historically, still serves a purpose in terms of immediate downside protection as was seen in March where short-dated Sovereigns were the only asset class not to free-fall, and with the US 10 yr currently at 0.7% there is some room for capital protection before hitting 0% yields. For any chance of meaningful spread compression and real yield it is necessary to position more of the bond portfolio in High Yield and Emerging markets than one usually would at a time of economic uncertainty, but we are afforded this by a) being underweight equities and b) being highly selective. We have been concerned about default rates in the wake of the virus, and indeed still are, though Moody's has reduced its' peak default forecast due in Q1 2021 from around 11% to 9.3% while it is striking how forecast defaults are very much a sector specific rather than market-wide. We note that that lending standards are tightening rapidly with 70% of US banks doing so, and with 25% of European banks following suit – threatening the ability of companies to roll over their debt in the future. Once sectors such as energy and leisure are taken out, however, there remain sensible opportunities with attractive yields with no worse than average default risk. The weakening dollar potentially offers an interesting income stream for local currency Emerging market debt, but we would hesitate to bet too much on this trend with idiosyncratic EM currencies prone to instability (BRL, SAR, MXN etc), and as mentioned previously the EMD market has largely returned to pre-virus yields. A selective approach to both region and credit quality, however, with a focus on short duration can still offer an approximate 6% yield to maturity which we think is an attractive return that alongside a core holding of investment grade credit can provide some much needed income.

		–		=		+		
FIXED INCOME								**Low yields and low return profile make bonds a relatively unnattractive asset class, though Treasuries remain a short term safe haven.**
Sovereign Bonds								Sovereigns offer safe harbour in time of market stress, but have limited upside remaining and negative real yields long-term.
Corporate I.Grade Bonds								Central bank asset-buying should be supportive for EUR and USD debt, yields not that attractive historically though. Should remain supported and total return potential.
High Yield Bonds								Rebound has been fast and the easy money has been made. Yields remain compelling, but default risks are a worry, especially later as government support dries up.
EM Bonds								Market has further to go before it reaches pre-virus highs - many EM countries are struggling with virus. USD weakness favours local currency.

COMMODITIES AND CURRENCIES

Commodity prices, led by Crude oil have largely been following the trajectory of stocks in rebounding quite rapidly but have seemingly stalled in September as the outlook for increased demand reaches an inflection point. Crude remains in the range of $40 a barrel as we suspected it would and looks set for modest gains at best during the rest of 2020 assuming no significant virus second-wave. As the accumulation of oil reserves was so substantial earlier in the year, even if supply outstrips demand as the recovery continues - prices are unlikely to shift too much. Moving into next year as these reserves start to dwindle alongside the planned OPEC supply restraint then the outlook looks a little more positive for oil in the medium term. Industrial metals, led by copper have outstripped the returns of Oil largely due to the reinvigorated appetite of China in line with its impressive recovery and focus on metals intensive infrastructure spending, and while there is scope for further upside, the large move has probably already happened leading to less vigorous gains in 2021. Lower US real yields, the economic rebound and loose policy have led to Dollar softening (the DXY Dollar index is down 10% since its peak in March) and this could well go further which would be a continued natural boost for commodities, as it is for precious metals that saw a spectacular rally over the summer. Having long been proponents of the usefulness of Gold in an investment portfolio, we were still surprised by the ferocity of the move in June and July and were prompted to take some profits in August – that is not to say the conditions for Gold and Silver have changed, far from it, so we retain a healthy exposure viewing the current period as a consolidation.

Oil: Demand v Supply v Inventory Levels

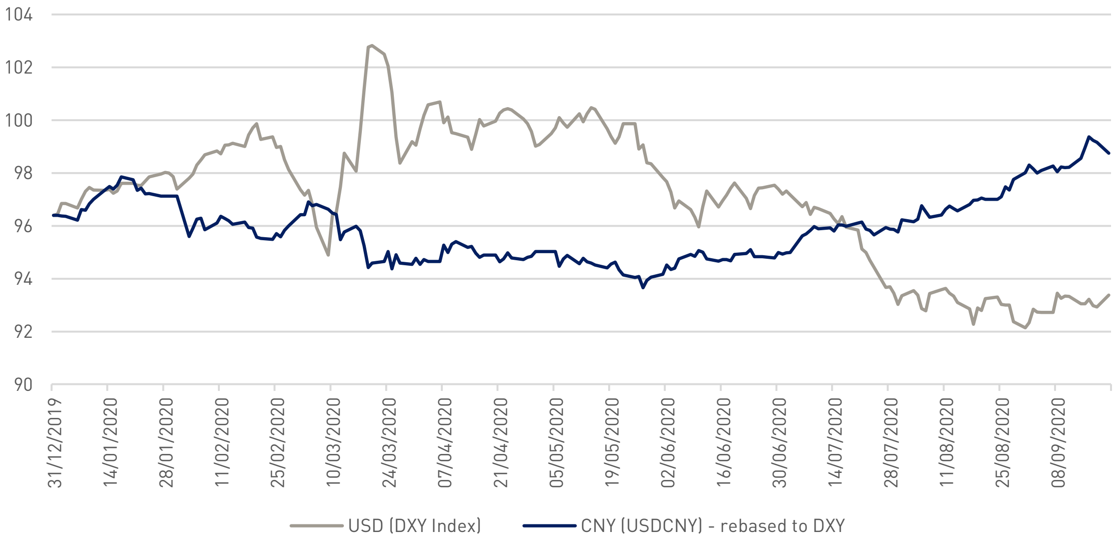


Consumption of crude oil and liquid fuels has recovered in recent months, but the inventories that built up earlier in the year mean that the price is unlikely to be driven higher during the rest of 2020. (source: Bloomberg)

		–		=		+		
ALTERNATIVES								**Uncorrelated assets will play an increasingly important part of a portfolios' asset allocation.**
Precious Metal								Gold has reached record highs, and may take a breather, but the environment remains perfect for an extended run, and silver should follow.
Hedge Funds								Genuine alternative funds that behave in a different manner to traditional assets are a vital source of wealth preservation and diversification.
Oil/Commods								Global production cuts have put a floor under the price for now. Virus recovery could lead to a demand-led move up, but not to pre-virus levels soon.

All else being equal we see the Dollar continuing to slowly weaken with neither Presidential candidate likely to pursue policies conducive to a stronger currency and with the Federal Reserve all but confirming rates will not rise until 2023 at the earliest. The emergency swap lines established by the Federal Reserve have been effective in ensuring there is no USD liquidity shortage and this may well curtail any near-term flight to the Dollar in case of another Covid-related economic shock. Weighing up a currency is always a relative consideration of course, and our only real conviction expressed in portfolios has been to hold some exposure to the Japanese Yen and Swiss Franc for safe-have reasons. The Yen, in particular, has been strong reflecting the relative calm of the Japanese economy though as JPY approaches 105 versus the Dollar it is likely the BOJ will consider action to prevent further strengthening – conscious of the drag on their export-heavy corporations. EURUSD is the biggest currency pair and much of the Euro's strength has derived from the closing rate differential with the USD, further consolidated by closer monetary amalgamation within the EU. It is hard to see increased fiscal union move any closer in the near term however, with tensions already growing in Italy about how much autonomy the nation has in choosing to spend its portion of the rescue fund while the threat of a continental virus resurgence together with data disappointments suggests the single currency is due a pause. The Pound will continue to be buffeted around until the Brexit transitional period is concluded but is unlikely to test its post-referendum low, and could be set for a period of extended stability from the end of the year. So, the outlook for the Dollar is generally weaker which for most assets is a good thing, but as with the forecasts concerning all markets the cloud of further social and economic restrictions in response to the Covid 19 virus continues to linger.

The Dollar and the Chinese Yuan in 2020



The Dollar has been weakening since May, but the Yuan has been strengthening in line with the recovery of the Chinese economy. (source: Bloomberg)

		–		=		+		
CURRENCIES								**The dollar remains under pressure, in the absence of any shock as we saw earlier in the year. JPY and CHF are useful hedges in light of abundant risks.**
US Dollar (DXY)								Election risk, little relative rate differential, deficit concerns and virus fears points to a lower Dollar.
Sterling (GBP)								GBP has bounced off recent lows, but is unlikely to find its post-election momentum again as economy staggers out of virus response. Brexit risk largely priced in.
Euro (EUR)								Strong rally recently - possibly overdone. Following passing of rescue deal, a major downside risk has passed but recent data was weak.
Japanese Yen (JPY)								A big move in July, more as a result of USD weakness. No strong view, but a natural hedge against JPY stocks and portfolio diversifier.
Swiss Franc (CHF)								Virus fears and US monetary policy have seen CHF strength continue though has weakened v EUR. Nice diversifier.

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