

J O Hambro Capital Management

# 2021 OUTLOOK

## Better times ahead

Free from a house view on economies, markets or stocks, J O Hambro Capital Management's (JOHCM) fund managers invariably see the world in different ways. We asked a number of our managers for their thoughts on the outlook for their asset class next year, what they would like to see and the possible surprises that 2021 could bring.

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# FOREWORD

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**Aled Smith | Investment Director**

J O Hambro Capital Management

Reflecting on 2020, in aggregate, it is amazing how nimble our “Amazonified” economies have proved to be. However, if you were in the parts of the economy that saw health concerns and government policy switch off supply, then it has been a very painful year indeed.

We saw an unprecedented fiscal and monetary response to stave off depression and mass unemployment, and with it a surge in sovereign indebtedness. Debt levels in major economies have attained the same level as the end of WWII and governments are likely to play a bigger role in economies and markets after the pandemic is over.

Will this massive effort by governments and central banks to keep economies alive unleash long-dormant inflationary pressures as economic growth normalises and demand recovers? The powerful structural forces that have played out over 40 years to deliver the current inflation regime will not be undermined easily. We can argue about supply and demand but it is really politics that tips the balance in favour of inflation, and politics are changing. We must remain vigilant to major shifts in the interest rate and inflation regimes.

The outlook for returns from fixed interest is challenged from here. In equities, in only a matter of months, attitudes to risk have changed dramatically. The pandemic still leads the news coverage, but there has been an emotional shift from the need for safety to return-seeking.

What we witnessed this year was an environment where forming a view on what an asset is worth was very hard. Uncertainty was very high and, consequently, so was asset price volatility. Risk defines that more things can happen than will happen. In these circumstances, valuation cannot play its usual anchoring role.

With that in mind, was the vaccine news on the 9th November V-day for value investors? It certainly brought respite for the likes of our JOHCM UK Equity Income and JOHCM UK Dynamic strategies after a tough year to that point. The market needed confirmation that traditional business were investible again. Buying companies with solid balance sheets trading on sensible valuations is once again a viable approach, even if we accept that some traditional business models are challenged in the digital world.

2020 will likely go down as the year that responsible investment went mainstream. Having an investment approach that integrates ESG considerations is no longer a source of differentiation. In part driven by legislation, such as the EU Sustainable Finance Disclosure Regulation (SFDR), which will come into effect in March, responsible investment is here to stay. New innovative investment approaches that make positive change and help solve the environmental and societal problems facing us are taking off. Having launched our global equity impact fund this year under our new responsible investment brand, Regnan, we are at the forefront of this conversation.

As we head into 2021, we need to recognise that the investment world of the next decade and beyond will look very different. As Chris Lees, co-manager of the JOHCM Global and International Select strategies, has often noted, every decade has its investment bubble followed by the inevitable change in market leadership. Such a moment may be upon us, but I believe something even bigger maybe afoot.

Alongside the responsible investing trend, it is noteworthy that the best-performing asset of 2020 has been Bitcoin, starting the year around \$7,000 and currently trading at \$18,000. Reflect on that for a moment. Not just the performance, but the fact we are now accepting Bitcoin as an asset class. The nature of investing is undergoing changes.

Better times surely lie ahead but there will be much to navigate in the next 12 months and beyond. Our experienced investment teams can help you answer the questions of today and contribute towards the fulfilment of your investment goals.

I wish you and your families a peaceful holiday period and, most importantly, a healthy 2021.



## GLOBAL EQUITIES

### Christopher Lees | Senior Fund Manager

JOHCM Global Select

JOHCM International Select

Partly as a result of the positive vaccine news, November saw global equity markets rise to one of their biggest monthly rallies on record, and one of the biggest ever monthly rotations from growth/defensives to value/cyclicals. Many of the 2020 stock market themes and trends abruptly reversed. The key question is will this trend reversal be sustainable or prove to be another false dawn?

Our evidence-based, probability-adjusted process suggests a little bit of both. Both of our top-down sector/country monthly scorecard and our scenario analysis continue to get slightly more pro-cyclical at the margin, but not wholeheartedly so. Over the last few months there have been some small incremental changes in our indicators towards more cyclical companies and sectors, and we have made some small corresponding changes to the portfolio.

Since the positive vaccine news, our updated scenario analysis below has added 10% to Scenario 2 (cyclicals) and taken 5% out of Scenario 1 (growth/quality/momentum) and taken 5% out of Scenario 3 (bear market).

Our updated analysis is now:

Scenario 1 (45% probability- down from 50%): equity market rally with the same leadership i.e. growth, quality, momentum stocks (as fears of second and third waves prolong the current trends);

Scenario 2 (30% probability- up from 20%): equity market rally with new leadership i.e. cyclicals and small/mid cap stocks (this is starting to happen as we get positive vaccine data);

Scenario 3 (25% probability- down from 30%): equity markets fall until the Lehman-type bankruptcies.

So you can see that we are 75% bullish, 25% bearish, while keeping an open mind in a fast-changing world. The global economy is currently improving from depression to recession (i.e. positive rate of change), but nobody really knows if it will continue to improve to a sustainable recovery or stall again next year. If the economic recovery does manage to be durable, then stock market leadership will probably keep rotating to the more cyclical/distressed parts of the market. However, if the economic recovery proves unsuccessful, then markets have a long way to fall from their current high valuation and debt levels.

Equity markets are probably in for a choppy, volatile period ahead as markets digest their recent moves. Much of the vaccine related good news has probably been priced in after the significant equity market rally and rotation into cyclicals in November, while equity markets have not panicked as much on the renewed European lockdowns and coronavirus second/third waves globally. As the world evolves and adapts, we will continue to follow and improve our investment process (it works over time, but not every time), trying to avoid both the value traps and growth traps ahead, while focusing on the new opportunities and risks in the post-Trump, post-vaccine, and (maybe) post-Brexit world of 2021 and beyond.



## ASIAN EQUITIES

### Samir Mehta | Senior Fund Manager

JOHCM Asia ex Japan

From an Asian equities perspective, there is much to be potentially optimistic about in 2021: possible weakness in the US dollar; economic recovery in Asia and a gradual restart of travel thanks to the Asian economies' better handling of the Covid-19 crisis; the potential to rotate from growth to value (manifest in US equities vs. Asia); a mildly inflationary outlook; the West to start dealing with the pandemic better (which will otherwise dampen the global economic recovery); central banks remaining the backstop, leading to more money printing; and a divided US government that has ruled out the possibility of left leaning quasi-socialist policies that would otherwise dampen sentiment for equities.

What negative shocks should investors potentially be wary of? Negative interest rates in the US would signify deflation, not incipient inflation; shambolic EU governance could lead to an impasse in the region's stimulus efforts; adverse geopolitics, perhaps a skirmish leading to escalation around South China Sea as the new Biden administration tests China or China establishes offence in anticipation; and China clamping down on technology dominance and alongside that putting a throttle on credit growth.



## UK EQUITIES

**Clive Beagles** | Senior Fund Manager

JOHCM UK Equity Income

To use one of the words of the past 12 months, 2020 has undoubtedly been an unprecedented year. We saw Covid-19 significantly accelerate pre-existing and mostly technology-driven structural trends. Markets concluded that Covid winners must be long-term structural winners by definition, and any company which faced disruption must be a structural loser, driving the polarisation in the market between growth and momentum names on the one side and value stocks on the other, to its widest ever point. Although we have never sought to be deep value investors, our investment style has always had a value tilt, which meant for much of the year we were swimming against the tide.

Yet, as 2020 draws to a close, the tide seems to be beginning to turn. Positive vaccine news flow in mid-November led to one of the most powerful performance reversals from growth to value since records began.

Will the value rally be sustained? In our monthly bulletin, we have often talked about four catalysts that could change the market narrative in our favour: a Biden victory, a vaccine, a Brexit deal or increasing M&A activity. The first has happened, albeit a 'blue wave' would have been the ideal outcome. Vaccine news flow has been very positive. M&A activity has been building steadily over the last few months. Group 4 Security, McCarthy & Stone (held in the portfolio), William Hill, Asda, Urban & Civic, SDL and Arm are some recent UK examples. The final catalyst is Brexit. If the end result is a deal of some sorts, we will have a solid base from which to move forward. If it is not, there will likely be a knee-jerk downward move in UK equities before we move forward. But negative Brexit headlines won't change the fact that we are seeing increasingly positive news from the majority of our holdings. And this, combined with forecasts that are, in our view, too low, valuations that are even lower and the catalysts at the big picture level, mean we are confident for a continued recovery.



## JAPANESE EQUITIES

**Ruth Nash** | Senior Fund Manager

JOHCM Japan

The Japanese economy has outperformed many other developed economies during the Covid-19 pandemic, but many commentators suggest that we should therefore expect it to underperform in a recovery. However, corporate Japan is nothing if not used to dealing with crises, and many companies have responded to the pandemic by cutting costs aggressively. This means that any increase in revenues has a very significant impact on profits. Investors should focus on the micro, rather than the macro, in 2021.

The valuation gap between value and growth has never been wider than in 2020. This is because investors, concerned about the prolonged impact of Covid-19 on the global economy, have focused on a small number of companies which they believe could prosper in a pandemic and have been prepared to pay ever higher multiples for those stocks. As we start to see positive data on vaccines and a recovery in global economic activity, we would like to see a continued change in market leadership and a rotation from growth back into value.

We have seen some hostile activity in small caps in the past few months and activists are applying pressure to several companies. This could be the prelude to a move on a bigger company. If it were, it would draw global attention to the value on offer in Japan.



## EMERGING MARKETS EQUITIES

**James Syme** | Senior Fund Manager

JOHCM Global Emerging Markets Opportunities

2020 saw a very varied impact of Covid-19 on emerging economies and, relatedly, strength in the share prices of internet and technology companies. This accelerated a pattern in emerging market equities that has been seen since 2013 – outperformance by Asian export economies, led by China, Korea and Taiwan, with more domestic demand-led emerging markets lagging. The volatile second quarter of 2020 saw some large capital outflows from that second group of markets, especially from countries like Brazil, South Africa, India and Turkey, with associated currency and equity market weakness.

Whilst a recovery in global growth with continued stimulus and, hopefully, some further positive vaccine developments would be a big boost to the export economies, it is the more capital-flow dependent markets that should be the biggest winners in this environment. With ultra-low interest rates and bond yields across the developed world, some of the relatively higher bond yields in emerging markets should attract attention from investors at some point next year. If a demand recovery provides some support to commodity prices as well, then 2021 could be a strong year for the asset class, but with a possible rotation of leadership away from East Asia and internet/technology names.

As ever, there remain significant risks and unknowns in the emerging market space. Politics remains a key risk in some parts of the world. East Asia will see an increasingly aggressive Chinese foreign policy come up against a new US administration, which may be a flashpoint. Latin America has seen genuinely radical populist politics on the rise, with both Chile and Peru facing uncertain outlooks, particularly Chile as it seeks a new constitution.

One area that will be fascinating to see play out next year and beyond is how travel and mobility develops in emerging markets once Covid-19 is under control. This applies both to domestic commuting travel, where work-from-home has been a great alternative to braving some of the emerging world's legendary traffic congestion, and to tourism, where some countries took the opportunity to move from high volume mass-market tourism to low volume high-end tourism. Some of the shifts to lower levels of congestion, pollution, carbon generation and the social impact that Covid-19 brought on may prove enduring in a post-Covid-19 world.



## CONTINENTAL EUROPEAN EQUITIES

**Paul Wild | Senior Fund Manager**

JOHCM Continental European

After a torrid year many will be looking forward to 2021 and the recent news flow surrounding vaccines certainly gives some hope that optimism is justified. When looking back over the period since the global financial crisis there are few instances where Europe has emerged stronger, but there is a chance that things have changed this time around. Much hinges in the shorter term on the safe passage of the Recovery Fund, which is currently facing some opposition from Poland and Hungary under the guise of the "rule of law" stipulations. The momentum behind this package, not least from the likes of France and Germany, makes us think that, by hook or by crook, it will be passed, even if some small modifications are ultimately required. The Recovery Fund would undoubtedly boost GDP for the coming years and do so through helping the most severely affected sectors, regions and countries. When combined with the taboo-breaking joint financing via the European Commission's bond issuance, perhaps Europe may just start to look a little more cohesive and integrated than it has in the past. Might this just mean (if it goes through smoothly) that Europe may at long last have a year of outperformance?

We have been very impressed by the momentum behind the Green Deal in Europe and the fact that a third of the Recovery Fund and the 2021-27 budget will be focused on addressing climate change. Meanwhile the European climate law should come to fruition next year. When compared to the US and China, Europe is gaining some credible leadership here. With likely changes on EU taxonomy, carbon trading and cross-border carbon taxes, Europe could become the go-to region when it comes to the E in ESG. The flows into ESG have been unstoppable this year and will no doubt continue; no investors can afford to be remiss upon ESG integration. We have the Dutch general election in March and the German general election in the autumn, which will likely further cement Europe's green enlightenment.

The sooner a vaccine can be rolled out, assuming it is indeed efficacious, the sooner that normality can resume within all areas, particularly the service sector. For employees, the equilibrium between pent-up demand after a period of higher savings rates and the impact that the eventual end of the furlough schemes will have is a tricky one. Naturally, the sooner the world normalises the less the post-furlough unemployment effect will be and this will be a key point to monitor in 2021. Needless to say, this has ramifications for the GDP trajectory, bond yields and whether the decade-long outperformance of so-called growth and quality stocks can continue. It is likely that the sky-high delta of valuation spreads between value and growth will see some closure.



## UK EQUITIES

**Rachel Reutter | Senior Fund Manager**

JOHCM UK Opportunities

Whatever the outcome of the negotiations, 2021 should hopefully mark the end of Brexit negotiations and a period of forward-looking policies. The negotiations have hung over UK equities as an asset class for five years and have led to record outflows that have masked the fantastic long-term growth opportunities available in the UK market. The UK market is home to many global-leading companies. It's no secret that big companies are navigating the crisis better than small ones. With their market positions, diverse cash flows and balance sheet capacity, we expect these large-cap winners to accelerate their growth into 2021. Our hope is that Covid-19 has caused a fundamental reset in the capital allocation priorities of UK plc. With dividends now re-based at a more sustainable level, our hope is that management prioritise investment for longer-term growth and reconsider what appropriate levels of leverage are to better-cope with future shocks.

Rapid changes in the political backdrop and uneven global economic recoveries from the Covid-19 pandemic will bring to the fore the importance of portfolio construction. Given the uncertainty, we believe now is the time for checking portfolios have diversity of risk whether this be end market activity, geography or valuation. 2020 has been a year of very narrow market leadership and investors will need to be adequately diversified as the backdrop changes.



## EMERGING MARKETS EQUITIES

### Emery Brewer | Senior Fund Manager

JOHCM Emerging Markets

This time last year there was speculation of a possible market rotation out of large index, momentum/growth stocks into cyclical names, based on a recovery in global growth. Covid-19 and the resultant lockdowns worldwide meant this didn't happen. Instead, we had the opposite as the pandemic accelerated pre-existing trends in technology with stay-at-home winners (predominantly US tech names) continuing their upward trajectory and expanding the differential between secular and cyclical stocks.

Over the last few months we have been noting the first budding signs of a tentative market rotation, particularly in China. But now, with a Biden victory in the US presidential election, positive data surrounding Covid-19 vaccines and stronger-than-expected economic data, we are seeing a subtle rotation away from these mega-cap tech names. In Asia, for example, we are seeing countries like Indonesia, Thailand and the Philippines show signs of life. It's a similar story in Latin America and South Africa. With increasing antitrust regulations the market may begin to have a more dim view on the prospects for these large online service providers and technology companies. The recent cancellation of Ant Group's IPO in China is a clear sign that not only China will look to curb the market share and growth of Alibaba but developing markets look to be doing the same. This may provide a little sunshine for the forgotten weeds. We have been increasingly moving toward a more balanced portfolio between secular growth and recovery themes. Due to our barbell approach, which balances classic growth/momentum stocks with recovery names, we are gradually tilting the portfolio by taking profits selectively in our previous big winners and putting more money into pure recovery and more cyclical names on anticipation of a rebound in global growth.

Whilst we are not out of the woods yet, and we anticipate there may be a lull through the northern hemisphere winter months when we could see the worst of Covid-19, pent-up demand and further positive vaccine news flow could mean a global economic rebound come spring. Joe Biden should, relative to Trump, reduce volatility and uncertainty in emerging markets and although we may see a short-term rally in the US dollar as we go into the winter months and global growth contracts, we expect the long-term trend to continue.



## GLOBAL EQUITIES

### Ben Leyland | Senior Fund Manager

JOHCM Global Opportunities

JOHCM International Opportunities

It is probably wishful thinking, but we would like to see the global equity market become a bit less focused on short-term earnings momentum and a bit more focused on long-term intrinsic value. This could happen as vaccine-related news flow continues to take downside tail risk off the table and investors wake up to the value available outside the long-dominant US technology sector.

Given the weak comparators no doubt there will be plenty of very big year-on-year movements to catch the eye, but normalisation of real world activity sets will no doubt be a non-linear, stop-start process. The most important question is which, and to what extent, lockdown-enforced behavioural changes seen this year prove to be permanent. It is quite possible that 2021 won't provide a definitive answer. How the market reacts to all this will depend a lot on how extreme investors' positioning became over last summer, as well as on the evolution of bond yields, monetary policy and fiscal policy. Plus, there is plenty of added political interest, including the domestic and foreign policy agenda of the new US administration, a post-Brexit environment for both UK and EU, a new trading bloc in Asia and a relatively new prime minister in Japan.



## GLOBAL INCOME

### Giorgio Caputo | Senior Fund Manager

JOHCM Global Income Builder

Stocks are the new bonds! With interest rates low and central banks mopping up credit risk, income investors who don't like negative yields need to expand their playbook and think outside traditional fixed income investments. The news is good, as defensive equities such as consumer staples and utilities offer reasonable dividends and prospects for growth. Staples also have the ability to recover pricing pressure and offset inflation, as do well positioned industrials. Financial equities can appreciate when interest rates rise and thus offer a natural hedge against potential long-term bond losses due to interest rate risk.

Looking ahead, a number of secular trends could favour income generative equities: decarbonisation benefits utility shares and industrial gas producers, deglobalisation supports demand for factory automation equipment and digitisation benefits semiconductor makers. A modern income portfolio should be positioned to profit from these potential multi-decade trends.

The return of inflation toward the end of the year could shock bond investors. With vaccine success foretelling a recovering economy boosted by low rates and fiscal stimulus, it must be within the planning perimeter for resilient portfolios.

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