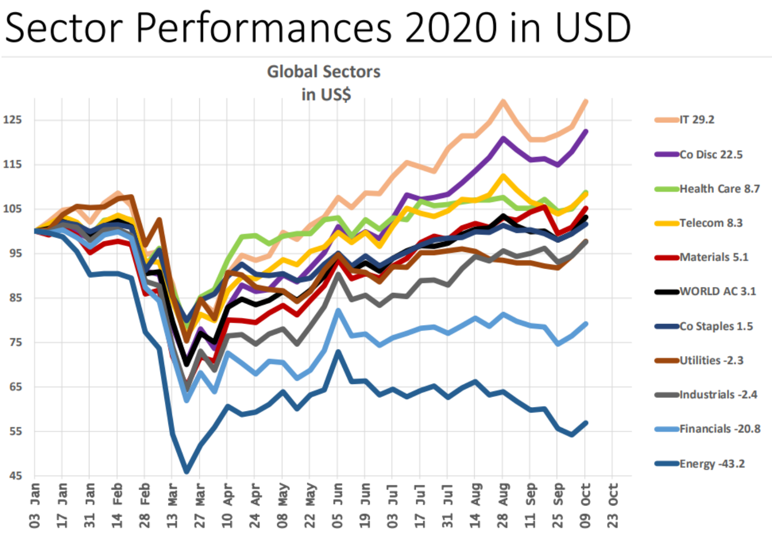
Equity Investment Strategy Q3

Iain Little, 20th October 2020

Biden & beyond: many a micro makes a macro

1. Growth sectors. Technology, healthcare, e-commerce to lead markets higher.
2. Energy. Old energy starting to be newly interesting.
3. Gold. Asset that is no one else's liability. Antidote to currency devaluation.
4. Banks. Continue to be dud investments in the developed world.
5. Beware. Bricks-and-mortar retail, real-estate and banks, all joined at the hip.
6. Two-horse race. China has emerged strong, but governance is all. Favour ASEAN.
7. Summary. Quality growth over lagging value.



Source: GTI

After such vastly different equity sector performances in 2020, how will a Biden Presidency affect sectoral trends?

A consensus is emerging that Biden – the bookies' favourite – will lead with higher taxes, far greater fiscal and infrastructural muscle, a greener economy and a bold frontal attack on the windmills of Big Tech. Micro-economic initiatives will hallmark a Biden administration. Expect higher corporate taxes, clean energy subsidies, disincentives to "fracking", stress tests on banks, handcuffs on Wall Street traders, price caps on generic drugs, less protection for Big Pharma drug sales. But, to coin a phrase, "many a micro makes a macro" … these are all inflationary policies.

The former governor of New York, Mario Cuomo, once said: "You campaign in poetry. You govern in prose." Investors shouldn't fall for poetic promises. Events, as Messrs Johnson and Trump are now learning to their cost, get in the way. Once elected, a new President is subject to the same limitations as the old one: haggles with dissident colleagues, bare knuckle fights on the floor of Congress, grimy side deals with opponents. Biden will have to bow to these pressures like any President.

We think political guesswork misses the larger point. Investors should focus on the seismic societal and technological changes that Covid has accelerated. These shifts are infinitely more reliable, stable and investable than the promises of fickle politicians. When human beings start to *behave* differently –iPhones, working from home, plugging in their cars at night, measuring their daily steps, washing their hands – that's when you get the most sustainable economic changes.

It looks like they're changing right now.

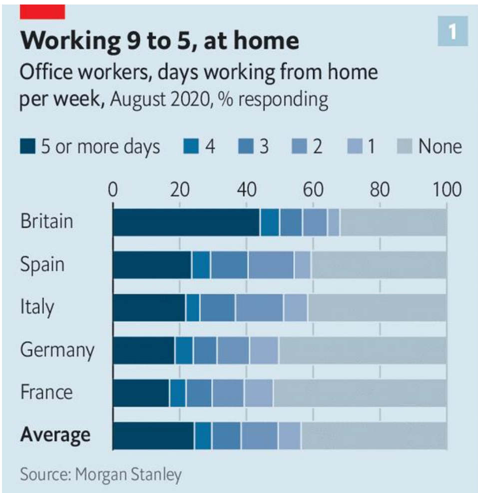
Source: Daily Mail

So here are our thoughts on investment strategy for "Biden and beyond":

1. Growth sectors – technology, healthcare, e-commerce – will continue to lead markets higher

In a zero-interest rate, depression-filled world, growth should be highly valued. Our technology adviser Charles Elliott, whose tech fund is up +45% in 2020, defines a growth stock as one with top line revenue growth exceeding +15% in a zero-interest rate world. People will continue to "overpay" for +15% growth because – assuming it leads to +20/25% earnings growth – it vaporises a 40x Price Earnings Ratio (PER) down to low double digits in under 5 years. So, the real question for an investor is not "is the company's PER too high to buy it?" but rather "will the competitive position of this growth company persist for 3-5 years?"

Distributed working, 5G, growing internet diffusion, Internet of Things, augmented reality, electric or hydrogen cell vehicles, ageing populations… these sectors and themes have saved portfolios this year. Such themes are more sustainable change-drivers than either a Biden or a Trump presidency. Since we wrote about the Covid effect of "acceleration" in March, most commentators are running the same tape. "Acceleration" is the watchword.

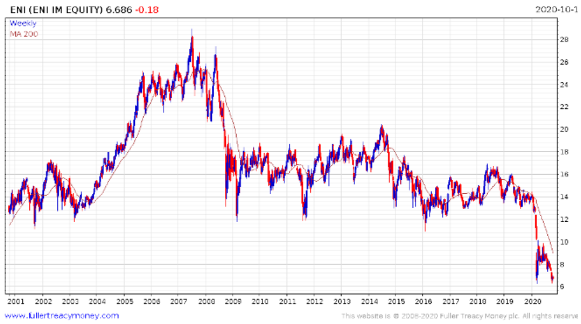


The Economist

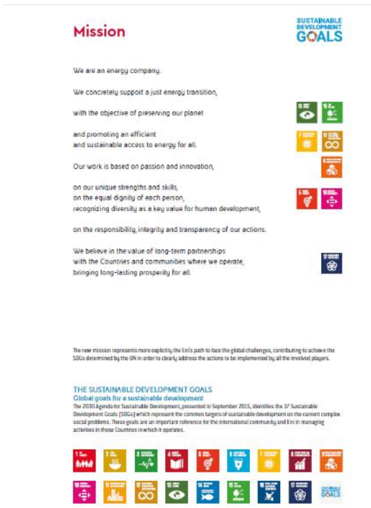
In our June report we advised against leaving these safer "growth" shores for more cyclical and beaten down "value" sectors like cyclicals, industrials, traditional energy and, the kiss of death, hospitality or airlines. This shift and emphasis won't last forever. But it's got longer to run, at least until central banks achieve their targets of 2% inflation by over-shooting it via a combination of fiscal reflation and Modern Monetary Theory.

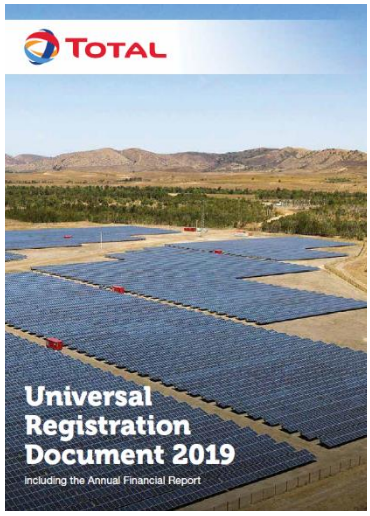
2. Old energy is starting to be newly interesting

Global clean energy ETFs are up +50% in 2020. Royal Dutch Shell, Total, Eni and BP are down -50/-80%. The charts of Big Oil look horrible.



But baseload-reliable electricity has to come from somewhere. It'll be years before fossil fuels as a resource are depleted or replaced. These days, everybody likes to throw rocks at Big Oil. But reality doesn't match appearance, and where this is so, investment antennae should be twitching. The annual reports of Big Oil read like paeans of praise for the Paris Accord. At some point, investors will notice this shift, maybe even violently.





Our best guess is that Biden will need a month or two's residency at the White House before investors will trust Big Oil as an investment area. Wildcat investors in Big Oil who don't mind being early while they chalk up 5-15% per annum in dividends, many of which have already been deferred or cut, might prefer to get in now. Finally, Big Oil – PER in mid-single digits – generally boasts better managers than miners. One to watch.

3. Gold is a major financial asset that is no one else's liability.

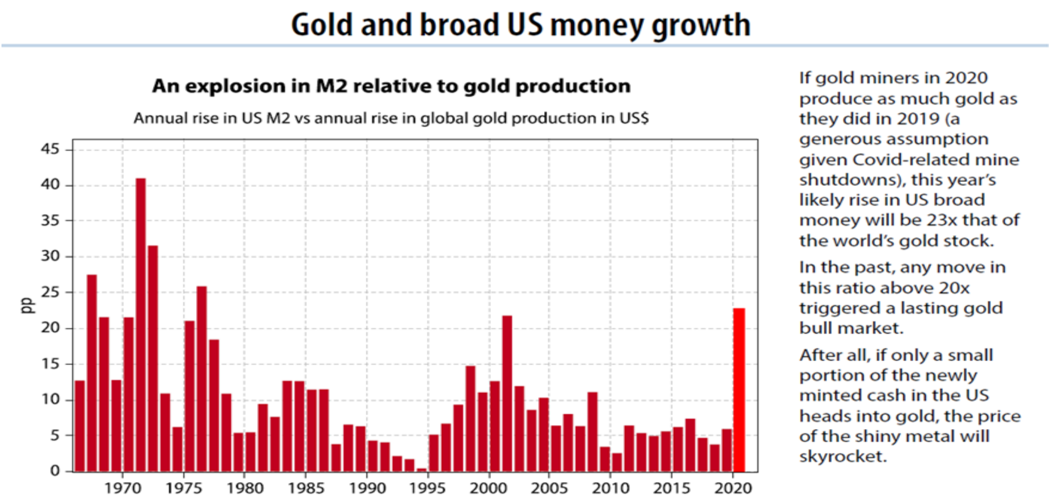
It's also the best antidote to the phenomenon of depreciating global currencies. Is it not remarkable that currency volatility amongst the major currency pairs (USD/ CHF, GBP/ EUR, USD/ JPY etc) is so small amid the greatest economic global crisis since the 1930s? That's because every major country is engaged in competitive devaluations in a race to the bottom. In the words of the late, great David Fuller, "no country <u>wants</u> a strong currency, but some countries <u>need</u> a weak currency more than others". Covid has enforced that need.

Gold, and its more volatile monetary cousin, silver, offer protection from fiat currency devaluation (central banks have added USD 20 trillion to their balance sheets in a year). That's one reason why gold must be in portfolios.

Warren Buffet –rarely a source of contradiction- once said that gold is useless. Gold pays no dividend and only costs money to hold. (He perhaps failed to remark that Berkshire Hathaway, his own company, is also a little shy in the dividend department). Buffett uttered the ultimate put-down: gold "gets dug out of the ground in Africa… Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head". Now he's bought a big stake in Barrick Gold, the world's largest gold miner.

"Don't do what I say, do what I do".

For those that follow them, crypto currencies – Bitcoin, Ethereum, Ripple and their like- offer an intriguing possibility. Governments everywhere are re-thinking monetary policy via "Modern Monetary Theory", an attempt to substitute the traditional levers of fiscal stimulus with the midnight grinding of the printing press. Crypto presents the ultimate *dirigiste* fantasy: place term-limited e-coin into consumers' bank accounts; "Use-It-Or-Lose-It" in other words. Imagine what happens to the gold price in this environment of enforced expenditure and dis-saving.

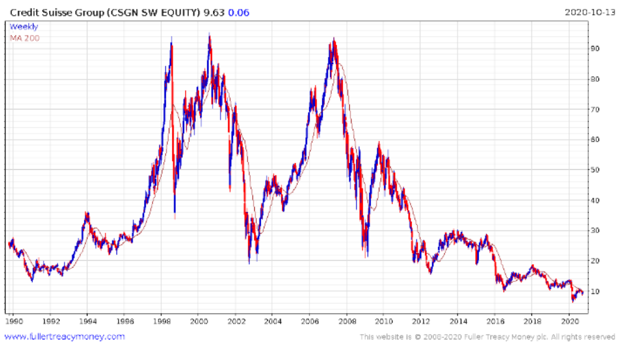


Source: Gavekal Research

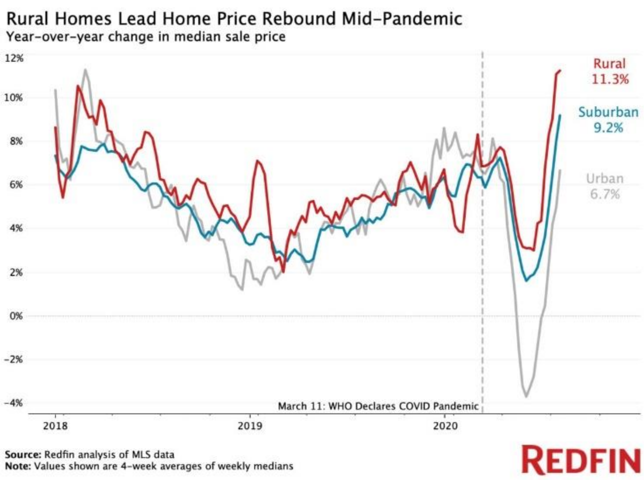
4. Banks in the developed world – *not, repeat not, in the emerging world* – will continue to be dud investments.

Banks – who really boasts about being a banker these days? – are caught in a vice of suffocating regulation, technological obsolescence, negative interest rates and moral constraint. How can CEOs of such complex and leveraged businesses really know what's going on? What about their investors? A bank's balance sheet – its protection and its profit driver – is a black box during a period of radical uncertainty. 3 years ago, Bank of America and Citibank had derivatives risk exposure equivalent to 100-200 times their market capitalisation. Imagine the impact of a "fat finger" trading error, or a series of them, or a meteor landing in NYC, or a global real estate crash. Covid has only made it worse.

Deutsche Bank and Barclays stand on a Price-to-Book Value ratio of only 0.3x, Credit Suisse is valued at 0.5x of its book value and UBS at 0.8x. Bargain basement valuations are illusory. No one knows the *real* "book value" of any major European bank. It is certain that bank book values are over-stated. Returns on equity (ROEs) are in the 8% pa region for industry leaders UBS and Credit Suisse, 5% for Lloyds and 3% for Barclays. Deutsche doesn't even have an ROE. It only squirts red ink, like a bloated vampire squid, to borrow the famous Goldman Sachs soubriquet. Over the last 30 years, dividends aside, UBS investors have made no capital returns at all. Loyal Credit Suisse investors have seen their capital halved.



A new threat to banks has emerged, one yet to be recognized. It is the effect of "distributed working" on those former strongholds of capitalism, the cities. The past model was simple. Tenants pay landlords, landlords borrow from the bank. But this time the city tenants have moved out to the leafy garden suburbs. *Who will now pay the piper?*



Source: Commuter @Waterloo Station 26.8.20 07h58

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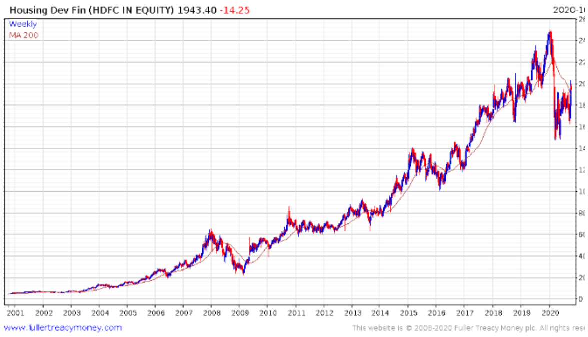
We have all seen pictures and videos of deserted city centres which should strike fear into property owners and their financial backers.

Finally, none of the above holds true for many private sector emerging market banks. They can be growth machines but beware the heavy hand of state ownership.



5. Bricks-and-mortar retail, over-priced city centre real estate and banks are joined at the hip: beware them all.

Source: HSBC

Economists used to preach the virtues of the Megalopolis. Economic vibrancy twinned with cultural pre-eminence bestowed huge advantages of scale on large conurbations. It was presumed that this would underpin lasting prosperity for a small but growing number of Mega Cities: London, Shanghai, Mumbai, NYC. That most reliable measure of Purchasing Power Parity, the humble hamburger, cooked up by The Economist, would always cost more in Tokyo, London or New York than in Tallahassee, Luanda or Newcastle. No more. Now, in the American Mid-West, we are treated to dystopian visions of dark, doughnut cities, their centres either empty or aflame, abandoned to the chaotic forces of revolution and racial victimhood, while their professional classes Covid-cower in the suburbs, isolated from the fires, disease and routine violence now stalking their streets.

The numbers in real estate are huge.

Banks will have to pick up the bill. But what number is on the ticket? Well, we asked the Bank for International Settlements in Basel (according to their web site, “The Bank For Central Banks”) how much international bank lending is property related? BIS told us that the figures were “not available”, not even after the 2008 Global Crisis. Oh dear.

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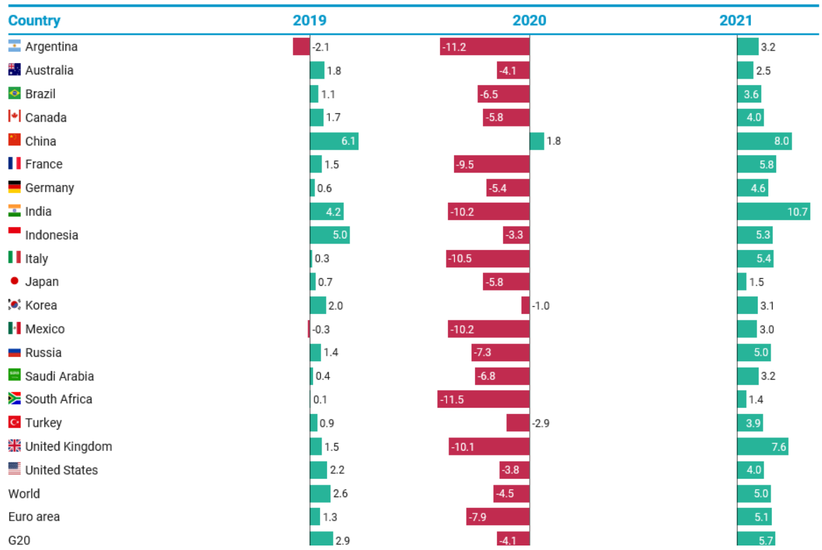
6. Governance is all

Real GDP Growth, %, year-on-year

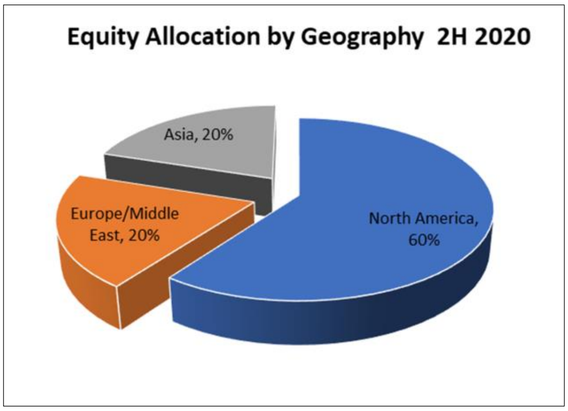


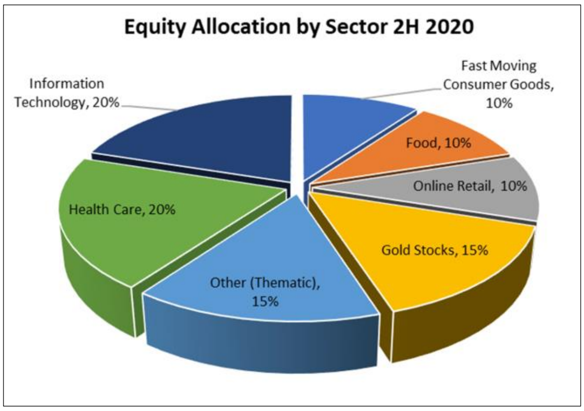
Source: OECD

In the gripping two-horse race with the USA, China has emerged stronger than ever; its success with Covid presents a problem for investors. Whatever credence one puts on China's published data – and only a fool would believe the public utterances of a one-party, dictator-for-life-led police state – China wins gold for its management of Covid. In 2021, it will take the silver after India in terms of Real GDP growth (the UK, perhaps suprisingly, takes the bronze).

But "governance is all"; how can asset allocation deal with the risks of invasive "social credit" and Beijing's Military Industrial Complex? The solution is to emphasise the dollarized economies of ASEAN, China's client penumbra. These economies – Indonesia, Malaysia, Singapore, Thailand, Taiwan – are direct beneficiaries of China's rising sun, but usually fare better when, like now, the USD is weak (their debt is more repayable, being dollarized, and mercantilist traditions benefit from the competitive advantage of a weaker USD).

7. Summary





"Quality growth" rather than "lagging value" has worked best in 2020.

As we have seen on page 1, a sectoral focus on 4 areas – technology, healthcare, (e-based) consumer and FMCG – has added value in combination. Adding gold shares in Q1 and further in Q2, has added further value. Our selected gold fund is up **+70%** in 2020. We have avoided developed country banks and, for the most part, Big Oil (the latter is up for review). Airlines, hotels and hospitality fill us with dismay, both as investors and as users. As always in investment, you don't have to dance with all the girls to enjoy a good party.

We are reviewing asset allocation in the days ahead. The USD 2-4 trillion of infrastructure spend telegraphed by both Biden and Trump will confer great benefits on infrastructure stocks; but which sub-sectors?

As always, we are happy to discuss our thoughts with any of our clients.

Good investing!

Iain