IHT Market Update

March, 2021

The World Opens For Business

It's been a year since we saw markets react to the spread of Covid-19. The world was afraid, not knowing what we'd be facing or how we'd recover. Stock markets fell, sections of the bond market panicked, and companies across the country all of a sudden had to contend with a business disruption worse than any normal worst-case forecast.

Since then, we've seen our scientists excel in putting together a vaccine in record time. We've seen a wash of stimulus money. We've seen contentious political turnover. We've seen new market highs and interest rates pegged to zero. Janet Yellen is back, and Fed Chairman Powell has shown steady hands through the turmoil.

Put another way, the last twelve months have been unprecedented. And now, as we emerge from a Covid winter and look at a world about to reopen, we have to reassess where we are and what we expect to happen next.

Where Are We Now

Equity markets are at or near all-time highs. Tech led the way higher off Covid-19 lows in the spring of last year, and then since late summer we've seen value, small caps, and international markets make up ground as the reopening trade started to accelerate. Ongoing stimulus measures and expanding earnings are underpinning the global recovery in equity markets.

Fixed income markets have been similarly volatile. Everything from investment grade corporate bonds to illiquid collateralized loans saw spreads blow out at the beginning of the pandemic. The Federal Reserve intervened and over the course of the year, most credit instruments stabilized. Now, as the markets reopen, the yield curve is steepening, and fixed income volatility is once again a focus as we assess where markets will go.

Positioning For The Future

There are three big themes right now in terms of equity positioning. First, and perhaps most obvious is the reopening trade.

Covid-19 decimated business plans for companies across a variety of industries. Travel names, airlines, hotels, shopping malls, and mom and pop shops in neighborhoods across the country were all impacted in a highly visible way. Perhaps less obvious were the impacts of Covid-19 on manufacturing, supply chains for retail sectors, financers for discretionary sectors, and utility companies providing power to all the factories and hotels across the country.

Now, as we look to reopen economies across the globe, all of these sectors are coming back into play and share prices need to move from reflecting their odds of bankruptcy in 2020 and early 2021 to what kind of revenue growth and margin expansion these companies can achieve in 2022 and beyond. Some of these companies will be hampered for years by debt taken on to survive the crash, but a lot of the companies are poised for real organic growth. In fact, for many firms the downturn was an opportunity to streamline operations. A reduction in cash flows forced firms to refocus on their internal costs, reduce redundant personnel, and start using more technology to boost productivity. In short, a lot of firms used 2020 as an opportunity to tighten up their operations and focus on margins. Now, as the world reopens, they can begin to focus on revenue growth with better profit margin spreads.

The second big trade theme is Innovation and Technology, both as a growth play and as a way to make your portfolio more resilient to downturns. Technology and growth companies leading the way isn't exactly a new trend – growth has outpaced value for a few years – but the way tech companies held resilient in 2020 is worth expanding upon.

For many, big technology is still something from the dot-com era. Lofty valuations, revenue that's unstable, not something you can depend on. But over the past few years we've seen the way technology is viewed change. Yes, the valuation in the space can be lofty, but the cash flow generation of today's big tech companies is unmatched and makes some of today's big tech companies look like the bellwether consumer staple names of old. They have light asset footprints, healthy balance sheets, and lower employee headcounts. Their products are also becoming more and more essential – no business can operate without its tech stack anymore. From accounting to marketing to operational efficiency, technology is everywhere. This shift was on full display during Spring of 2020 as technology companies actually benefited from quarantines, lockdowns, and a shift to remote work.

Positioning For The Future, Cont.

The other part of the technology narrative worth paying attention to is the incredible shift towards innovation across industries. Under the hood in every sector, technology and innovation is taking hold. In financials, the payment companies and exchanges are leading the way. In industrials the manufacturing process is increasingly automated and the companies with the best code have an advantage. The oil companies use technology to enhance their yields from every well and utilities shifting from coal and gas to renewable power are realizing wider profit margins. Automotive companies are shifting to electrification, and consumers are shifting their shopping online. Putting it simply; innovation is where you want to be invested, regardless of the industry or traditional style box you're looking at.

The third big trade theme we're looking at is the way the global economy will reshape in the wake of Covid-19. Developed international markets that are less technology focused are naturally more levered towards the reopening of the economy. Furthermore, many developed international markets are more heavily levered towards trade than the United States is. International trade as a share of GDP is higher in most developed markets than in the United States and reopening trade flows will be big economic boosts. A shifting political landscape should also help boost international markets as the United States shifts back to more inclusive foreign trade policy under the Biden administration.

Furthermore, the globe is awash in stimulus. Just as the United States has passed several rounds of financing, so too has the rest of the globe. With trade reopening and stimulus dollars everywhere, we expect the global recovery to be strong, especially in emerging markets with younger demographics and stronger pre-covid growth rates.

It's also worth noting that there may be some isolated instances wherein trade continues to constrict and we see supply chain on-shoring. Semiconductors in particular look like a space that may see geopolitical pressures to shift from globalized supply chains to domestic subsidized manufacturing. While frictions like this to trade can often be a negative for markets, in this particular instance it may actually lead to an investment opportunity as the build out of substantial onshore semiconductor manufacturing will require large capital outlays and significant investment.

What Are The Risks?

Reopening economies, stimulus, an accommodative Fed, low interest rates, the stage is set for a strong economic rebound and similar strength in equity markets. The big picture looks good – but as always, there are risks.

The chief risk and the one that's the hardest to prepare for is that there's a new mutated Covid strain. A new highly contagious or especially lethal strain could force new quarantines and disrupt trade once more. For businesses that are already financially stretched, another round of closures could be far more damaging than this first round, even if stimulus efforts were to come to the fore.

Fortunately, the vaccines appear to be quite effective against the currently known strains and the platforms upon which many of the vaccines were designed are adaptable. New booster shots to provide wider immunity should only take a few months to develop if necessary.

Another primary risk is inflation. With trillions of dollars of stimulus being pumped into economies across the globe, there are concerns that average price levels will increase, starting with commodities and producer prices, and flowing through into the average basket of American consumers. We believe that while there may be isolated pockets of inflation, such as constrained reopening goods like air travel or short-term lodging, broad inflation should be contained. Most American spending is on bigger ticket items like healthcare or long-term lodging that should see minimal inflationary pressure. Furthermore, long-term demographic and technological headwinds make it unlikely we'll see any sort of sustained inflationary pressure.

The final serious risk to consider may be that of a policy mistake. For now the Fed has signaled they'll be holding interest rates at zero; they're willing to accept slightly hotter than expected inflation over the short term if it helps bring employment numbers back up. Should the Fed rapidly start to raise interest rates, misgauge inflation, or otherwise mix up their signaling to the market, that could cause confusion and be a negative for equity markets. Similarly, fiscal policy errors in Washington DC preemptively curtailing stimulus or running unsustainable budget deficits could also be a cause for concern.

However, as with the other risks we've listed above, a policy error seems unlikely. Fed Chairman Powell has shown a steady hand at the helm thus far, and Janet Yellen has extensive experience qualifying her to be the Secretary of the Treasury.