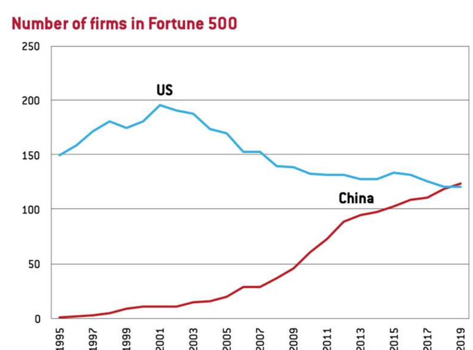
Monthly Commentary 5th May 2021

April was another strong month for equity markets as there are high expectations of a strong economic recovery following the start-stop pattern due to Covid 19. World stocks were up more than 3.5% in April, with the US markets the clear winners as growth stocks had a strong month (up almost 7%) after many months of underperforming value stocks. Bonds recouped some of their losses and were up modestly, but rising inflation fears are keeping them on the back foot year-to-date. The US dollar suffered is first setback in 2021 and fell about 2% while commodities were very strong on the back of energy, precious and base metals. Bitcoin finally had a losing month, falling modestly by less than 4%.

China vs the US

There is not a day that goes by without news of the strained relationship between the world's superpowers. The graphic below by Bruegel shows that for the first time there are more Chinese firms in the Global Fortune 500 of the world's biggest companies than there are American ones.



Of course, one chart does not tell the whole picture. In a thoughtful piece in the Financial Times lately, Martin Wolf, the paper's excellent chief economics commentator argues that "*China is wrong to think that the US faces inevitable decline*". Wolf's main arguments are:

1. While stock markets are imperfect, the value that investors put on companies is a relatively impartial assessment of their prospects. To that end, 14 of the world's 20 most valuable companies are in the USA. See chart on the next page.

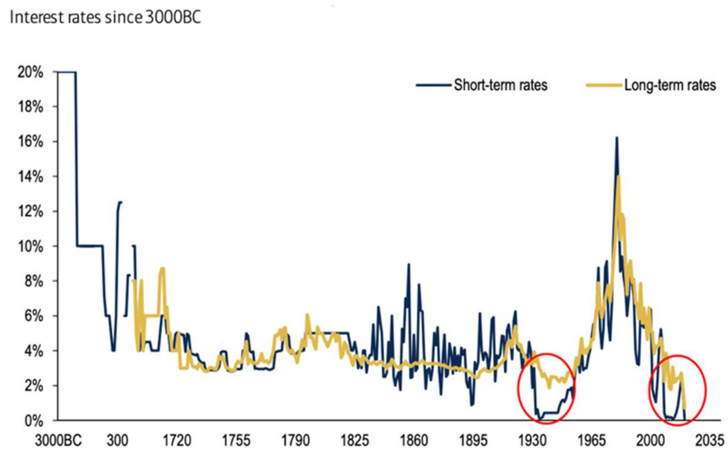
2. In life sciences, another crucial sector for future prosperity, 7 of the top 10 most valuable companies are American.
3. The US continues to lead in venture capital (VC), another harbinger of the future. In the last three years, the US has invested $487B in VC vs $379B spent in total by China, Germany, France, UK, India, Canada, Singapore and Israel.
4. The US continues to be the home of 10 of the world's top 20 universities (as per QS rankings), whereas China only has one on this prestigious list. As is well accepted, top universities are centers of innovation that affect everyone's future.

Wolf goes on to argue that the biggest threat to the US role in the world lies in itself and not China. We quote: "*If it elects leaders who despise democracy, ethnic diversity, global alliances, science and reason, it will surely decline. Republicans' failure to repudiate the former president (Trump) makes that more likely. Yet, that would be the self inflicted result of a failure to create a shared vision of a better future*".

On risk profiles and balanced portfolios

For the longest time, a typical balanced portfolio was a mix of equities and bonds (typically 60%-40%). While equities have had the highest historic returns (about 6-10% annually), they are also more volatile, and thus riskier. Bonds have had lower historic returns (circa 2-6% annually) but are generally considered "safer". At the same time, equities and bonds were not too correlated, so when one of them did well the other might not have performed. This made the balanced portfolio an attractive proposition.

Then something happened. Bond "yields" i.e. the percentage expected return from a bond, reached levels that have been the lowest in 5000 years! See the following graphic. Bond yields are long term rates (yellow):



Source: Bank of England, Global Financial Data, Homer and Sylla 'A History of Interest Rates' (2005), BofA Global Investment Strategy
BofA GLOBAL RESEARCH

Because yields are now so low (and even negative in some countries like Germany and Switzerland), there is much debate about the 60-40 model in wealth management. Many, like Merrill Lynch (Bank of America) have strongly questioned it lately as bond yields had "run out of runway". Do investors really want to shoot themselves on the foot by investing more money in an asset that is in all likelihood not going to make any returns? i.e., not only are bond yields still historically very low (so the income is negligible), but if yields move up even a bit, they can result in losses to the investor. That is why the likes of the Norwegian Sovereign Wealth Fund (the world's biggest fund) has obtained permission from the government to significantly move out of bonds and into equities over a number of years.

As managers we face the same dilemma. It seems to us almost safer to have the bond part of a balanced portfolio sitting in cash rather than risk putting it in bond funds that have a good chance of producing meagre returns or even negative ones.

As such, it is our opinion that while equities might also be considered historically overvalued, they are expected to do better than bonds, especially over the medium/long term.

Please contact your advisor if you would like to reconsider your expectation and a change in risk profile.

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