Courtville Partners – Investment Outlook, January 2021

Summary of the key points in this quarter's Investment Outlook

- Both the scale and the speed of market gyrations in 2020 have defied all expectations – and in so doing have reminded us that it is nearly impossible to time entry and exit.
- Our model portfolio has performed well from 2Q20 onwards, helped by our decision to stay overweight equities, but to shift exposure away from the US and UK and towards Greater Asia.
- We remain dramatically underweight fixed income assets. Government bonds in particular have mostly been transformed from risk-free assets into return-free risks.
- There are no changes to our overall asset allocation this quarter.
- Investor sentiment is more bullish than ever. But plenty of risks lie ahead; and we expect investors to need steady nerves again this year.
- The biggest long-term risk remains a resurgence of inflation, which would present serious difficulties for bond markets (and government finances).

The New Year watershed naturally prompts both reflection and anticipation. But this year the transition seems an especially arbitrary waymark. If SARS-CoV-2 was the main event in 2020 – and who would seriously argue otherwise? – then it is far from over. The most we can sensibly do at this point is try to make sense of the recent convulsions in financial markets and then calmly survey the road ahead.

Taken in isolation, the start-to-finish performance data for 2020 suggest nothing more (or less) than a decent year for both equities and bonds, which returned 16% and 9% respectively in US dollars. But what turmoil those bare numbers conceal – for equities in particular. Pandemic panic caused global stock markets to subside 33% by March. Since then, however, equities have rallied a mind-bending 70%, shrugging off the deepest global recession in over a century. As counter-intuitive developments go, this was a whopper. In the final quarter alone the global index soared 15%, buoyed by the arrival of the first two vaccines. November's 12.3% rise made it the best month for global equity markets since 1975 and the second-best month of all time. If nothing else, the last year has been a forceful reminder that investors try to time their entry and exit from markets at their peril.

Although the scale of market gyrations has defied all – and we mean *all* – expectations, the immediate cause of the post-March resurrection is easy enough to identify: monetary and fiscal stimulus of a size never seen in peacetime. And when governments hose down their countries' economies with cash, not much of it needs to find its way into stock markets to push up the indices. Meanwhile, central banks have continued obediently to hoover up the couponless bonds that those same governments have issued in biblical quantities to pay for it all.

We considered Modern Monetary Theory ("MMT") in our April 2019 Investment Outlook and were happy to rubbish it as a serious approach to macroeconomic management: "MMT provides a veneer of intellectual respectability to the idea of the 'magic money tree' (shorthand for the idea that governments can create as much money as they like without incurring nasty consequences in due course)". Nevertheless, 2020 was the year in which Western governments embraced MMT suddenly and collectively. Think John McDonnell reborn as Rishi Sunak. And it seems clear that governments – on behalf of their taxpayers, present and future – are resolved to go on spending other people's money until it runs out ("other people" in this case being compliant central banks, now almost the only buyers of government bonds).

Was this ideological conversion born of a fear that the alternative – of *not* believing in MMT – was simply too frightening to contemplate? Economic historians of the future will answer that question. Here in early 2021 fiscal-irresponsibility-as-an-article-of-faith has inflated government debt to levels last seen in the aftermath of the Second World War. This in turn has rendered government bonds even less investible than before (if that was possible). Government bonds are traditionally described as risk-free assets; now they might better be described as return-free risks. If they haven't done so already, investors should learn to live without them.

The Courtville model portfolio has largely been doing without them for some time and employs a mixture of cash, gold and infrastructure investments as stabilising ballast. Our other big call is unchanged: overweight equities, still with a strong bias towards Greater Asia and away from the Anglosphere. The portfolio's +6.0% return in 2020 was 1% below its benchmark, but represented a strong recovery from an awful first quarter blighted by too much post-election exposure to UK equities. Having reduced that exposure decisively in the Spring, we are not tempted to backtrack in response to the Brexit trade deal. Whatever else the UK needs from here on, a relatively weak currency ought to be high up the list. Fortunately the country has 80+ years of experience to call upon in this regard.

Apart from taking an axe to UK equities, we made two other big calls last year – first, to underweight US equities (in part because of worries over the US dollar) and, second, to overweight China, both equities and bonds. Let's look at these two decisions in a bit more detail. First, US equities… In truth, we may have reduced the model portfolio's exposure a little too soon. Since the final quarter of 2020, however, our decision has at least been endorsed by significant shifts in global stock markets. For more than a decade global equity investors have had to run overweight positions in the largest US companies – above all, technology-related stocks – in order to perform better than the aggregates, but no longer. Positive clinical trial data for the Pfizer and Moderna vaccines seem to have been the trigger for three simultaneous rotations within equity markets – one from "growth" towards "value", another from "Covid winners" towards "Covid losers" and a third from US equities towards the rest of the world. In the fourth quarter of 2020 the Asia-Pacific region outperformed the S&P 500 by 10%. In fact, there has been a substantial overlap between all three rotations because stocks that performed well in response to the pandemic (most obviously technology) tend also to be classified as "growth" stocks (and *vice-versa*), while "value" stocks are often more heavily represented in non-US markets (than in the US).

Second, China… Who could deny that China was 2020's big winner from almost every angle? Exhibit A: the 38% surge in the Chinese stock market trounced the MSCI All World Index return of 14%. This relative performance was mirrored at macro-economic level: IMF data suggest that China's economy managed to eke out growth of 1.9% in 2020, while global GDP *shrank* 4.4%. The Middle Kingdom has exerted greater influence in other ways too: Western governments locked up entire populations, curtailed civil liberties, deployed smartphone surveillance, cajoled banks into lending on non-commercial terms – and so on. Who would have thought a year ago that the West would adopt so much of China's playbook? Those investors content to leave politics aside should continue to overweight Chinese assets – and, indeed, Greater Asian assets generally. In other words, follow the growth. We have no idea why our media paid so little attention to the Regional Comprehensive Economic Partnership when it was signed by 15 Asian countries in mid-November. It is one of the largest trade deals in history and is also a key plank in China's strategy to replace the US-led, but abortive, Trans-Pacific Trade Partnership.

It may be too early to tell whether these broad and deep shifts within markets will endure, though meanwhile they do help explain our model portfolio's strong performance of late, especially during last year's final quarter. Our hunch is that these rotations do have further to run. Our model portfolio is positioned accordingly; and we are not making any changes to our asset allocation this time.

What else can we see on the road ahead? Whether it owes to the vaccine effect or limitless government spending or huge rebounds in both GDP and corporate profits, all the survey evidence suggests that investors are expecting more of the same. They believe that the trend is their friend. Indeed, investor confidence has never been higher. That in itself constitutes a risk. Yet there are other important risks lurking.

Equity valuations are demanding on almost all metrics – and thus, *ceteris paribus*, vulnerable to shocks. What if robust economic recovery lifts oil demand above supply, sending the price sharply higher? What if that triggers more generalised inflation? How would central banks react, conscious of the impact any interest rate rise would have on governments' borrowing costs? Will US dollar weakness gain momentum to the point where it becomes a destabilising influence on the global economy? Will the several antitrust suits against Big Tech gain traction, turning the recent correction in US mega-cap stocks into a rout? Could the "green" energy bubble burst? How much more aggressive might China become towards Taiwan – and what would the rest of the world do about it? Could a Biden-led rapprochement with Iran unnerve the Sunni/Israeli proto-alliance?

Risks lie ahead at the beginning of every year, of course. But it does feel to us that investors will need strong nerves in 2021, just as they did in 2020. The risk that vexes us most is (still) a resurgence in inflation. Consensus holds that the gargantuan recession of 2020 has bequeathed enough idle capacity and labour to keep inflation subdued for at least a year or two, no matter how energetic the recovery may be. Perhaps this will prove to be the case. But capacity utilisation is not the only possible generator of inflation. We have already mentioned energy, where a collapse in capital investment has brought about a material reduction in supply. (Apple's market value exceeds that of the entire US energy sector. Go figure, as they say over there – or at least consider how utterly crushed expectations are for future hydrocarbon prices.)

We worry less about what the *source* of future inflation might be than about central banks' hugely restricted room for monetary manoeuvre as and when they identify the threat on their radar-screens. The US Federal Reserve (in the person of Randal Quarles, Vice-Chair of Supervision) has already wondered aloud whether the US treasury bond market is simply too big for the private sector "to support any stress". Does this mean that – in effect – the bond market has already been nationalised? At the risk of repeating ourselves, when big trouble comes, we expect it to come from the bond markets. So stick to real assets, not flimsy government IOUs. However vast the world's problems may seem at the moment, private capital deployed in market economies will once again provide a large part of the solution.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	14	16.0
International Equities	49	41.9
Fixed Income	11	24.8
Alternatives	13	9.4
Commercial Property	0	0.5
Cash	13	7.4
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**14**	**0**	
UK	VUKE LN	7	0	0.09
UK	VMID LN	7	0	0.10
International Equities		**49**	**0**	
US	VUSA LN	12	0	0.07
	XDPG LN	11	0	0.09
Euro	VERX LN	5	0	0.12
Japan	VJPN LN	6	0	0.19
Asia	VAPX LN	6	0	0.22
China	IASH LN	5	0	0.40
Emerging Markets	VFEM LN	4	0	0.25
Fixed Income		**11**	**0**	
Government Bonds				
Index Linked Gilts	INXG LN	4	0	0.25
China	CNYB NA	3	0	0.35
Corporate Bonds				
US	CORP LN	4	0	0.20
Alternatives		**13**	**2**	
Gold	PHAU LN	5	0	0.39
Infrastructure	INFR LN	4	0	0.65
Water	IH20 LN	4	0	0.65
Commercial Property		**0**	**0**	
Cash	GBP	**13**	**0**	
Total		**100**		**0.19%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2020	6.0%	6.9%	-0.9%
Since inception(1/1/2015)	64.3%	56.2%	8.1%
CAGR	8.6%	7.7%	0.9%

The value of your investments can fall as well as rise, and you may not get back all the money you invested.