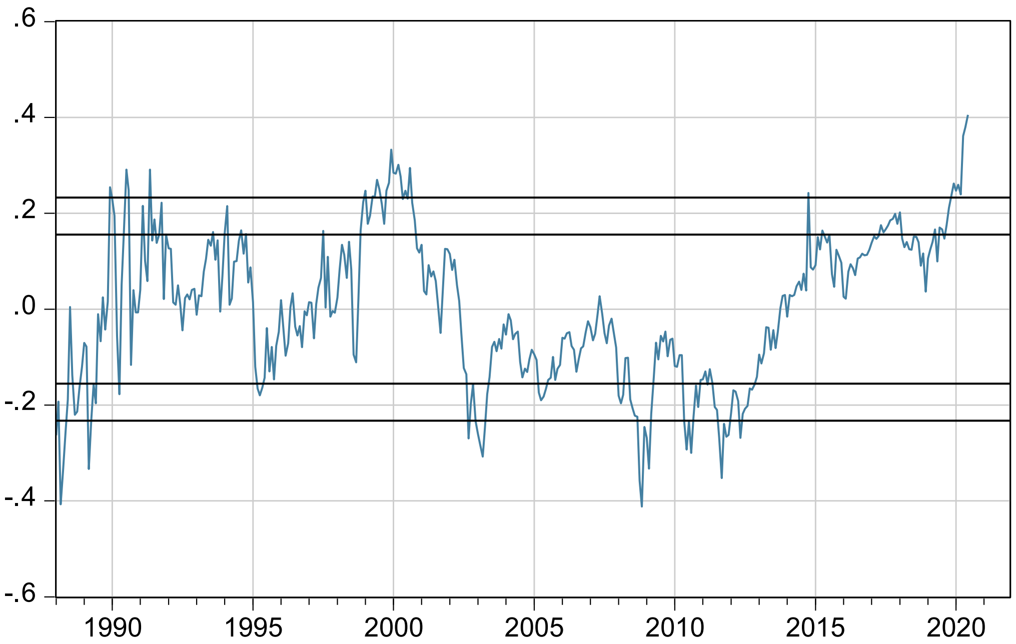
Perpetual Wealth Monitor

February 2021.

Executive Summary

- We expect global economic growth of around +4.5% in 2021.
- Lockdowns have been prolonged or even tightened in many regions. This will further delay the economic recovery.
- But it should be possible to get the pandemic under control by the start of the third quarter thanks to massive vaccination programs. (Current authorized vaccines are believed to be effective against the Covid 19 mutations that have emerged so far).
- As a result, a strong economic recovery is on the horizon for the second half of the year. In the meantime, further rescue packages will get implemented. These may prevent insolvencies but they will also further undermine public finances.
- Yields on government bonds in the most important regions have risen somewhat of late.
- A buying mania is underway in US small caps. We remain slightly overweight
- in our equity allocation.
- The US dollar is likely to remain under pressure. The Fed will maintain its very stimulative monetary policies.
- Precious metals prices are consolidating after their setback.

Valuation model for the world equity market



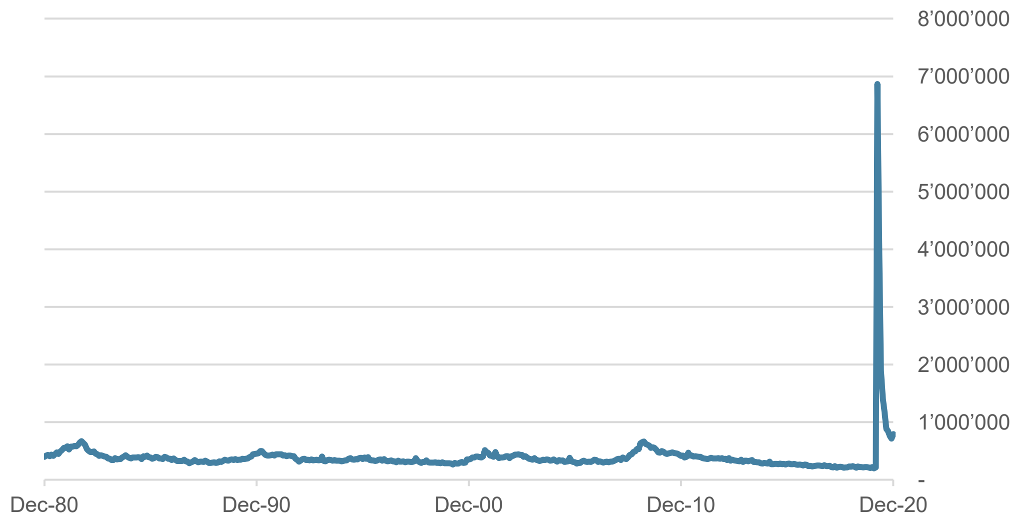
Source: Thomson Reuters / Datastram and own calculations

Relative to history the world's stock markets are highly valued

- The graph on the left shows estimates derived from a valuation model for global equities based on earnings forecasts and the interest rate on 10-year government bonds.
- If the average valuation since 1987 is viewed as "fair", then today's valuation, some 40% higher than this average, implies a 40% overvaluation. Since the main investment alternative to equities – namely bonds – is factored into these estimates, the argument that today's abnormally low interest rates mean one cannot compare the current situation with the past is false.
- The model, however, does not know the "new world" of central bank interventions and balance sheet expansions through the purchase of risky bonds et cetera.
- If central banks really aim for "asset price targeting", and permanently react to major stock market corrections by buying up risky bonds and possibly also equities, investors might permanently accept a lower risk premium for holding equities. This is because central bank equity ETF purchases would imply a mitigation of major stock market declines.
- A large part of today's high stock prices can also be explained by the fact that US equities, and within US equities technology stocks, are very highly valued and thus have high weightings in the global equity market.
- Elsewhere, there are much more favorably valued equity markets. These include the UK, emerging markets, small caps and Covid-19 problem sectors such as airlines, oil and tourism.

Business Cycle

USA: Initial Jobless Claims, since 1980



USA: ISM Purchasing Managers' Index for Manufacturing, last 5 years

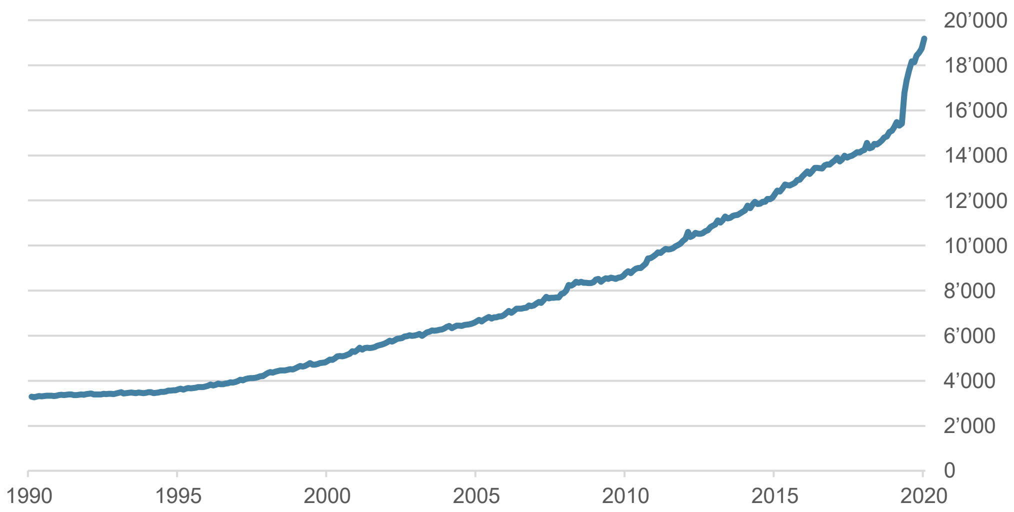
Fiscal policy at full throttle

- We estimate global economic growth at +4.5% in 2021. Other key growth forecasts for 2021 are as follows: USA: +4%, EU: +5.0%, Japan: +2.5%, China: 8%, UK: +5.5%, Switzerland +3%.
- Structural growth differences within the EU have been exacerbated by the Covid-19 virus: while the German economy shrank by less than 6% last year, the slump in Italy and France was probably around 9%, and in Spain more than 11%.
- Globally, Southeast Asian countries and China have coped best with the pandemic so far. China is likely to have been the only major economy to grow in 2020, an outturn supported by the strong export figures for December. These showed an 18.1% gain on 12-month previous levels! Overall, Chinese exports grew by around 3.6% in 2020 despite Chinese Covid-related shutdowns.
- In the US, as in Europe, the recovery has come to a temporary halt due to renewed lockdowns. Weekly initial jobless claims rose again to almost 1 million in the first half of January, the highest level since August 2020. With increasing immunity due to vaccinations, chances are good that a strong economic recovery will start in second half at the latest. But the next few months will be very tough, and the government will once again have to step in as lender to prevent insolvencies.
- The $1.9 trillion package sought by President Biden includes, among other things, an extra stimulus check of $1,400 to all households, an increase in the weekly bonus unemployment check from $300 to $400 to run until end-September and an immediate increase in the Federal minimum hourly wage from $7.25 to $15. Several proposals in the Biden agenda, such as aid to local governments and health care subsidies, are not expected to be approved by the Senate, whose rules for such proposals would require a 60% assent. Democrats only have 50% of votes in the Senate plus the vice-presidential vote.
- Although Joe Biden's speech included phrases like "paying their fair share" (i.e. tax increases) and "closing tax loopholes", the bulk of the bailout package will have to be financed by the Fed to prevent an excessive rise in interest rates.
- The following statement by the President of the Atlanta Fed, Raphael Bostic, shows how closely entwined fiscal and monetary policy have become: "The guaranteed basic income discussion is an important one. I think that conversation is one we should continue to have and think about" . Presumably, the Fed, along with many politicians, think that a higher minimum wage can be financed simply by the issuance of US Treasuries, to be bought by the Fed.

Source: Bloomberg Finance L.P.

Monetary Policy

USA: M2 money supply in billions of US dollars, since 1990



US inflation expectations , % pa. (based on 5-year swaps)

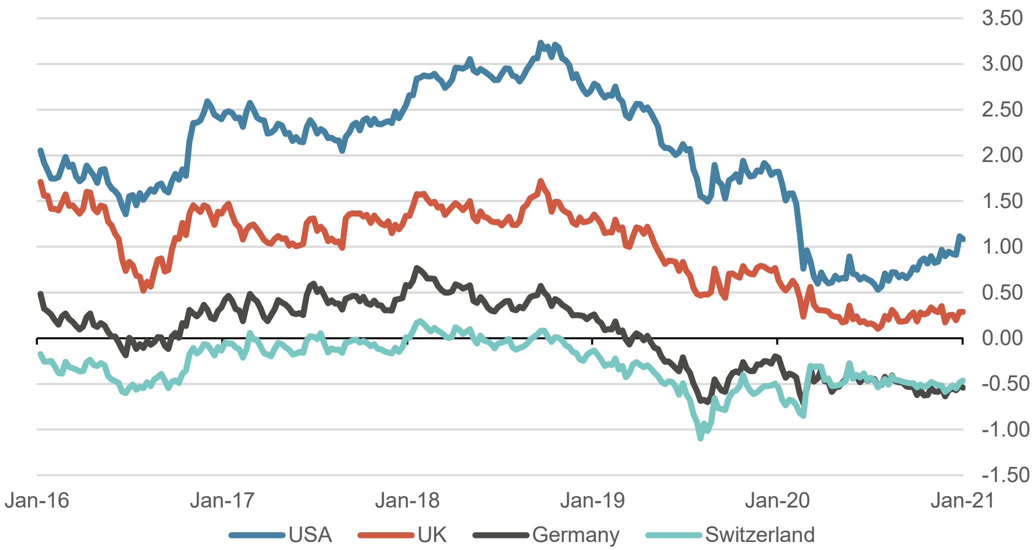
Source: Bloomberg Finance L.P.

Loosest monetary policy ever in the Western world

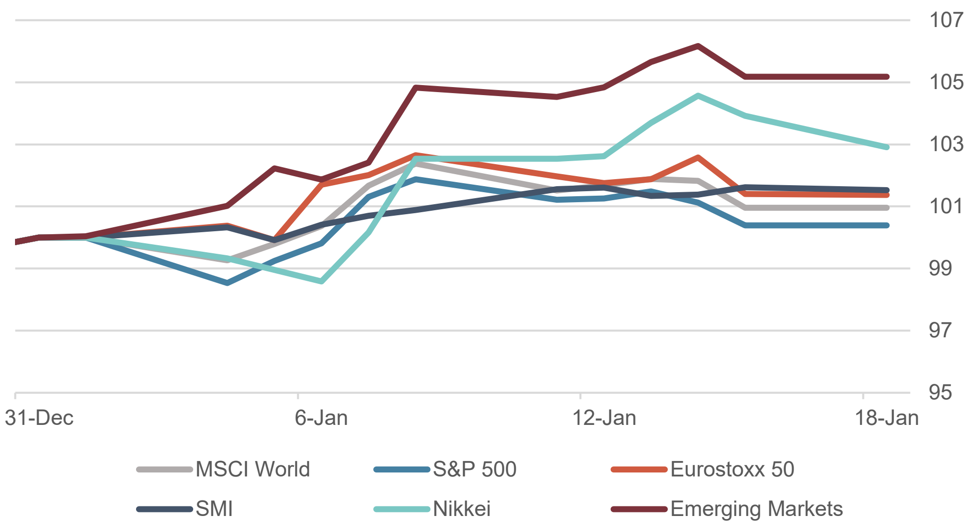
- The Fed's monetary policy can simply be described as "the loosest ever". The aim is to drive investors out of safe investments into riskier ones (shares). Money is, so to speak, "free" as the Fed fights hard against any "scarcity" of it.
- The more additional monetary units the central banks print, the lower the value of each monetary unit will be. In other words, the period of falling inflation rates has finally come to an end.
- Central banks, governments as well as politicians hope for unexpectedly higher inflation so they can finance their spending gifts via an inflation tax. If inflation were to rise as expected, ex-ante and ex-post real interest rates would rise by the increase in inflation expectations. Unexpectedly high inflation, on the other hand, is not built into interest rates from the outset and leads ex-post to low real interest rates and a devaluation of savings. Inflation taxation thus requires that inflation rises to an unexpected extent. Therefore, central banks will portray any rise in inflation over the next few quarters as "temporary", aiming thereby to suppress inflation expectations, meanwhile continuing their ultra-expansionary monetary policies.
- Covid shutdowns lead to consumer caution and a rise in precautionary, or "fear" savings. The newly created money flows into investments rather than the real economy, driving up the prices of stocks, bonds and real estate, but not the prices of consumer goods. If lockdowns come to an end, many consumers are likely to consume part of the savings they have built up. They may liquidate some investments in order to finally go on holiday, or to restaurants and gyms, or to visit distant family members, etc. In these circumstances the velocity of money in circulation will increase, a larger part of excess liquidity will flow into the real economy and thus inflation could rise.
- For the equity and real estate markets, the timing as to when discussions about tapering, and a return to more normal policies, gain momentum will be key. The shock of 2013, which went down in history as the "taper tantrum", is still engraved on the memory of many investors. At present, we think it likely that $120 bn. worth of bonds will continue to be bought by the Fed on a monthly basis until 2022. We also think more aggressive policies to shift the shape of the yield curve, targeting lower yields on long-term bonds, are likely. It will take tremendously positive economic data to persuade central banks to exit, even slowly, from their ultra-expansionary monetary policies

Asset classes – Bonds and equities

10 year government bond yields in %, last 5 years



Equity markets, indexed performance, year to date



Source: Bloomberg Finance L.P.

US Treasuries now on slightly higher yields

- Yields on government bonds in the most important markets have risen slightly, led by US Treasuries. Already, some want to see in this an anticipation of future inflationary tendencies. We rather believe that record high financing needs over the turn of the year and the prospect of even larger fiscal packages have put some pressure on the bond markets.
- However, we agree with the consensus that the debt situation of most countries does not allow for significantly higher interest rates.
- The interplay of government-controlled central banks and fiscal policymakers is becoming the dominant paradigm of the 2020s. In this environment, much stronger distortions in the markets are to be expected (e.g. yield curve control), as the problems of debt and anemic growth in developed countries become increasingly burdensome. With their liquidity created “out of thin air”, central banks are becoming even more influential participants in the bond markets.

“Mr. Smith” buys call options on US small caps

- A veritable buying mania is underway in the US equity markets. Retail investors are buying small and mid caps in particular. In many cases, the purchase commitments are being realized via call options. This can be easily seen in the statistics. (NYSE open call contracts are at a record high.) At the same time, the number of open puts is at an all-time low. In other words, “everyone is invested and no one wants to hedge“. At the same time, there is a certain reluctance on the part of institutional investors to chase the rally.
- A whole series of IPOs of companies that are far from generating profits have found their way into the market in its current euphoric mood. These include the “SPACs”, which have become very popular. In this form of IPO, a sponsor is paid money up-front in the hope that he will subsequently find a lucrative investment idea.
- Despite these warning signals, we remain slightly overweight in the equity quota. We would interpret setbacks on the stock markets as opportunities for additional purchases. In the medium term, the attractiveness of equities as real assets and as a source of income is likely to remain.

Asset classes – Currencies and other assets

USD/CHF, last 2 years

US dollar in a consolidation phase

- The US dollar has paused on its downward trend in recent days. This perhaps reflects market expectations that President Biden's proposed USD 1.9 trillion rescue package will end up being significantly smaller due to resistance in the Senate. Nevertheless, we remain of the opinion that the US dollar will continue to weaken in the medium term due to the US "twin deficits" and the massive acceleration in US money supply growth.
- But the fact remains that the other central banks are still under pressure to weaken their appreciating currencies. In the "race to the bottom", the US has the biggest freedom for maneuver. In the Eurozone for example, a further appreciation of the euro would put a dampener on any recovery of its export- led economy.
- The Chinese central bank is calmly and effectively counteracting the appreciation of the yuan behind the scenes through short-term liquidity injections into the system.

Gold price, US dollars per ounce, last 5 years

Precious metals in consolidation mode

- The narrative of a strong economic recovery in the second half taken up by the stock markets has triggered a strong correction in the precious metals markets. The gold price has lost about 12% since its peak last August. Mining stocks have also come under heavy pressure.
- Due to a slight increase in US nominal yields, real yields have moved slightly higher, as inflation expectations have remained unchanged. Naturally, this put precious metal prices under pressure.
- We view current prices as a buying opportunity, especially as we expect that sooner or later all central banks will be forced into yet further and stronger actions aimed at pushing down real interest rates.
- For investors who see the value of nominal assets being steadily undermined by a substantial trend rise in inflation, physical gold, as a real asset, is one of the "safe havens".

Source: Bloomberg Finance L.P.

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