Fourth Quarter 2020 Review: International Equities Strategy

Economic and Capital Markets Commentary

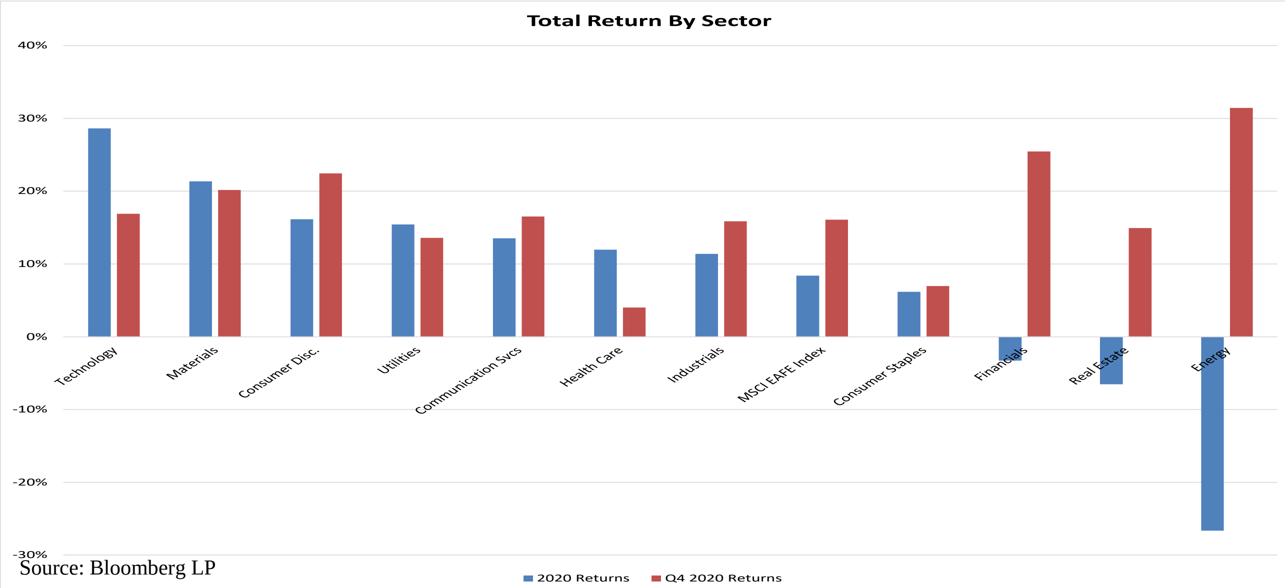
Market leadership maintained in the growth and momentum camp for the year, but cyclical and value names outperformed during the fourth quarter. The change in leadership for the quarter resulted principally from an outperformance during November. Despite the optimism brought by the successful development of vaccines, COVID infection rates in many countries continued to increase during the quarter. As economic activity indicators declined during the quarter, we expect to see sequentially weaker economic data from the fourth quarter. Our outlook continues to contemplate activity returning towards pre-COVID levels as the current year progresses with monetary and fiscal stimulus promoting further economic expansion into the latter part of 2021 and 2022.

During the historic year of 2020, the markets experienced their fastest fall into a bear market in history, as defined by prices falling over 20% from highs. Globally, countries elected for self-inflicted recessions through restrained activity in an attempt to contain a pandemic of the novel coronavirus. Timely action taken by leadership of major economies, through both fiscal and monetary policy, provided enough optimism to market participants to prompt a reversal of the bear market, with the MSCI EAFE Index rallying 38% from its March 24th low by mid-July. The appreciation in asset values was not evenly distributed across the markets, as low rates and uncertainty on the timing of a recovery promoted long duration growth assets over shorter-cycle, cyclical companies – particularly, those in industries directly impacted by the disruption in activity. This divergent market showed some signs of fading in late 2020 and early 2021, as prospects for an effective vaccine and continued stimulus encouraged forecasts for economic expansion in 2021 and 2022.

As we entered the year, the global economy had decelerated during the course of 2019 after registering record PMIs in 2018. Activity appeared to be resuming for the manufacturing cohorts in the series and outlooks abruptly shifted as the pandemic took hold. Interest rates, which in many markets had been moving higher during the fourth quarter of 2019, fell precipitously to new lows in early 2020. The yields on German 10-year sovereign bonds had fallen to -0.9% by March 9th. Globally, yield curves flattened, impairing profitability for many companies in the Financials sector, while the recession raised the specter of credit losses. These headwinds led to bank valuations compressing to levels not seen since the Great Financial Crisis. While yields on Japanese 10-year bonds resumed an upward trend during the course of the year, most of the European sovereign rates remained at depressed levels as this region struggled with containment of the virus – and restrictions on activity still persist into 2021.

The performance of the various market sectors reflected the moves by the rates during the course of the year. Growth and defensive sectors held up much better during the selloff of the first quarter, continuing to attract capital as uncertain outlook and low rates favored these sectors. Alternatively, the more cyclical and value sectors, industries, and companies saw underperformance through much of the year. The result was a strong market performance for the year that was narrow in its leadership and was more representative of multiple expansion for rate-sensitive, sustainable growth than an outlook for general economic recovery.

Technology outperformed all other market sectors, as the rate impact on future cash flows and terminal value, as well as some exogenous catalysts for some participants, overshadowed the drags of an economic recession. Energy was the worst performer, as a coalescence of expanded supply from prior years' capital investments with an acute drop in demand for transportation fuel undermined profitability. Energy commodities experienced such price dislocations that futures prices actually dropped to -$38/bbl in March, reflecting a strike on willingness to take delivery of crude upon expiration of the contracts. Outlook for operating cash flows in this sector cratered, dragging down enterprise values. The divergence in these two sectors exhibits a "tale of two markets" that persisted through much of the year.



Source: Bloomberg LP

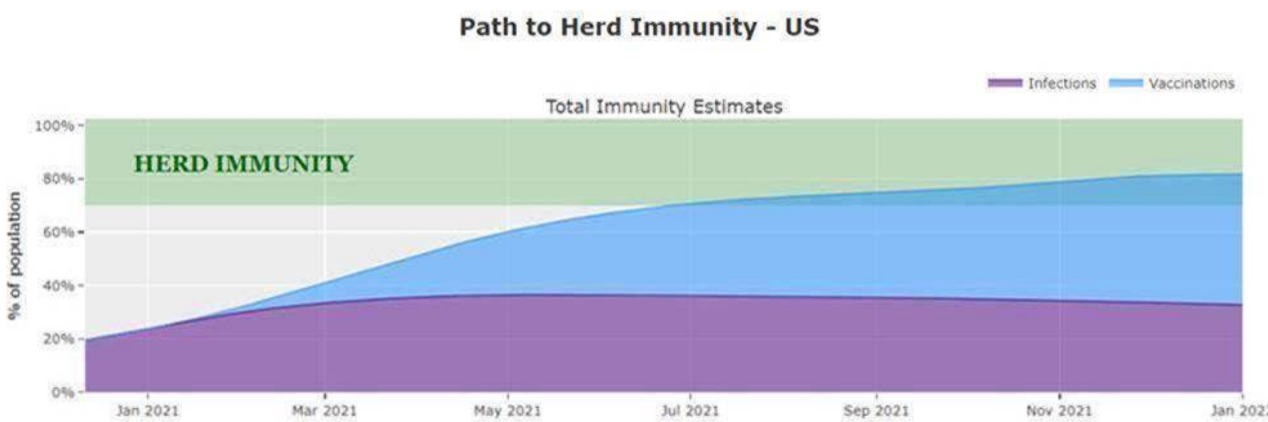
Economic surveys data series were consistent with the environment exhibited by the action of the capital markets. There was a proliferation of coincident activity monitors during the course of the year, all of which attempted to extrapolate levels of economic trends from libraries of web and mobility data. These series rolled over again during the fourth quarter for North America and Europe, as infection rates and restrictions increased. We expect that there will be a pause in the sequential improvements for GDP growth in the fourth quarter of the year but believe that subsequent activity and economic data will improve as we move through 2021. Unfortunately, there will be less enthusiastic data to digest during the first quarter despite better prospects ahead. The charts below exhibit the performance of certain data for the capital markets during 2020.

Though we will pass through a "Dark Winter," the outlook for major economies improves as we move through 2021. The coordination of stimulus – both fiscal and monetary – by policymakers across most nations will continue to flow through the markets providing expansionary kindling for a rebound after we contain the virus. Fiscal floodgates opened in 2020 with estimated deficit spending reaching levels of 12% in Eurozone, 11% Japan, 16% in U.S., and 18% in U.K., as percentage of respective GDP. We continue to expect additional fiscal stimulus to flow through both the U.S. and Europe. The European Union passed its first coordinate fiscal program last summer, and much of this stimulus package remains undelivered to member states due to delays in ratifying the EU's long-term budget, which occurred in December. While there could be some reversal of this fiscal impulse during 2021, the pent-up demand by consumers and their strong financial condition should lead to expansion in other parts of economic activity. Savings rates in Eurozone have improved from 13% in Q4 2019 to 25% in Q2 2020, while in the U.K. it quadrupled from 7% prior to pandemic to a 27% high in Q2 before falling to 17% in Q3. The transfers of income from public sector to private sector will present a runway for strong consumer activity, though it poses some longer-term risk, as sovereign debt-to-GDP for the United States may start to eclipse Italy.

The recent United States election will pave the way for more fiscal action through new prospects for an infrastructure bill, as well as greater unemployment checks and incentives for "green" investments, expanding on the stimulus bill passed in late December. The magnitude of this December bill was still a whopping 4.5% of annual U.S. GDP. The narrow majority won by the Democrats will mitigate the risk for immediate tax increases of magnitudes that would imperil an initial recovery. Therefore, restrictive regulatory and tax policy under the new administration won't likely pose material risks until 2022. China continues to show signs of economic expansion, as they were able to control the outbreak with their authoritarian zeal. This Asian strength, combined with U.S. outlook, should support external demand for Europe's reliance on trade. Europe's ~34%, United States' ~23%, and China's ~17% of the global GDP will be keys to global recovery, and the foundation appears to be laid for an economic resurgence during 2021.

As we have noted in our past reviews, the spread of COVID-19 during the last few months has led to a decrease in economic activity in many major developed economies. The announcement of the successful trials and subsequent approvals for vaccines boosted confidence for a rosier outlook as we move through 2021. Models for herd immunity currently predict populations reaching critical levels by mid-year, but as with all models, the inputs can have a wide range of variability, bringing into question the exact timing of such a panacea. Recent restrictions by European countries will lead to further downdrafts before economies return to more normal levels of activity.

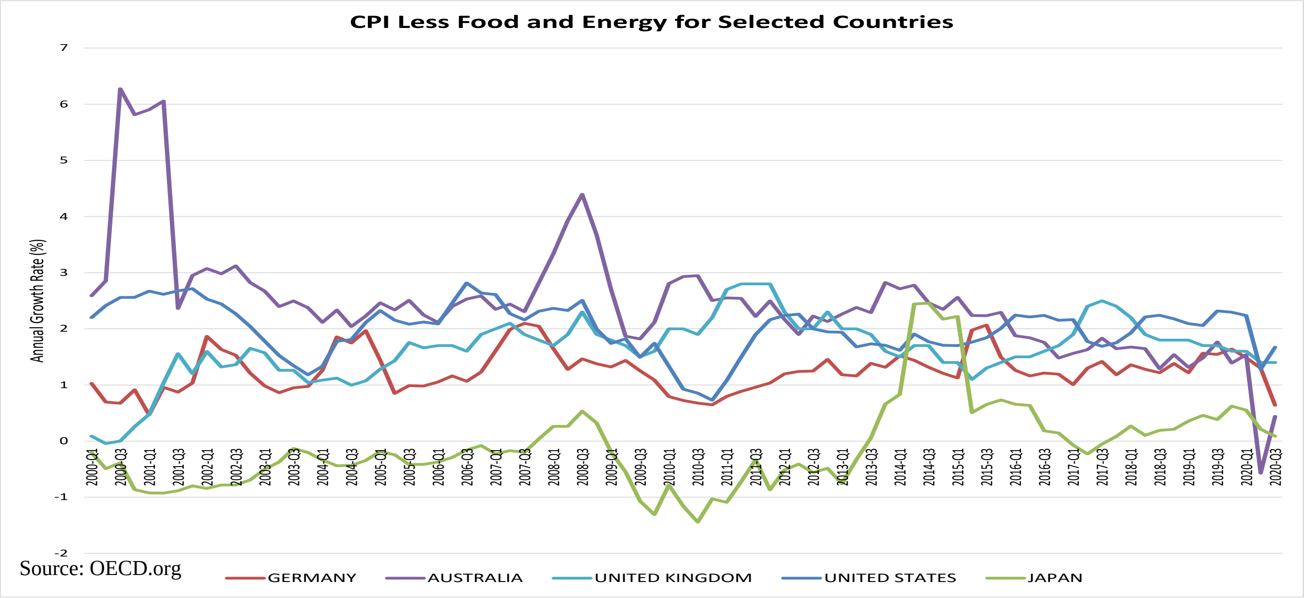
While we remain optimistic, it is important to recognize that the theory of herd immunity remains a relatively untested theory and an exact timing of such population immunity remains elusive. The models by Youyang Gu, creator of the YYG model that combines machine learning with Johns Hopkins University data, estimates that such immunity for the United States will be reached by around July/August 2021 at ~70% of population. If the prioritization of vaccines for high-risk individuals are effective, then the death and hospitalization rates could drop in advance, potentially prompting reduction of both state-mandated and self-imposed restrictions on activity by late first quarter. Complications in access to vaccine, persistency of antibodies, and virus mutations can potentially lead to material adjustments to these timelines. At this point, the markets appear to discount a sanguine outlook with regards to successful deployment of effective vaccines.



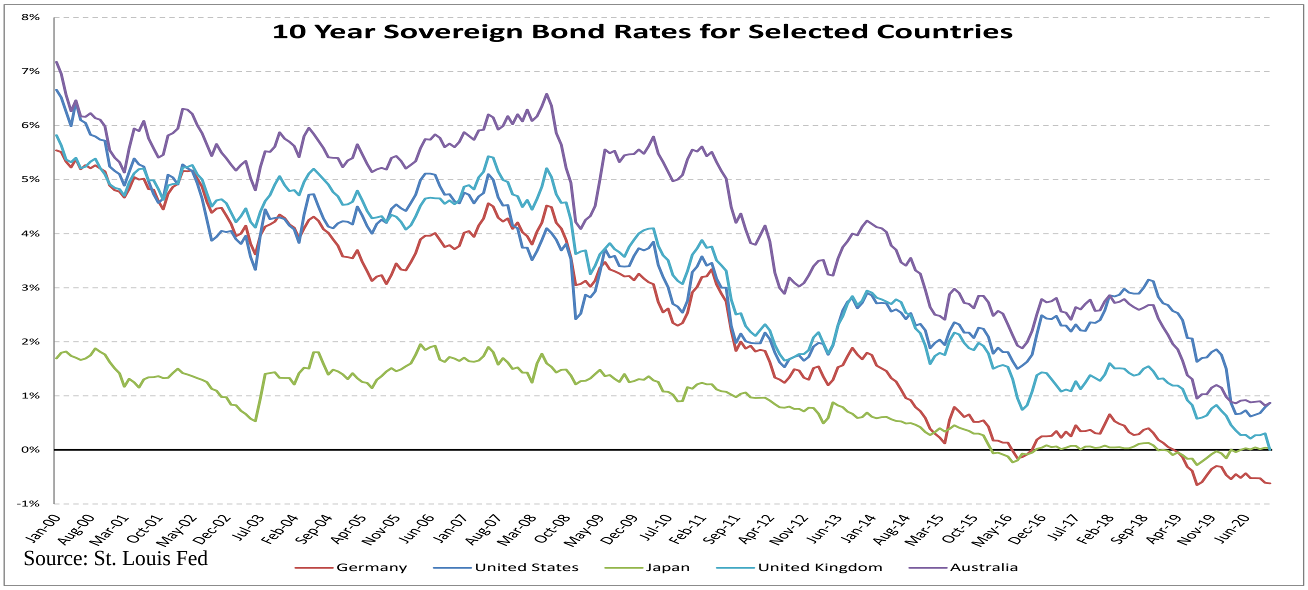
Source: Evercore ISI

Under the base case, the outlook for the economy should continue to improve as we move through the spring. Interest rates in the United States have already started to reflect this expectation, but we expect that rates in other nations will also start to increase as we move through the year. German, British, and Japanese 10-year yields have consolidated over the last two quarters but have not seen the same upward bias, which developed during the fourth quarter for U.S. Treasury yields. As the global outlook improves during 2021, we expect to see yield curves steepening, likely pressuring market values of long dated fixed income securities.

Longer duration interest rates should move higher on resumption of inflation rate expectations. Shutdowns and harsh social distancing measures crippled parts of the economy from spring 2020 onward, disrupting both supply and demand. As a result of the disruption in activity and resulting output gap, inflation will likely run below target during the initial stages of recovery. The large scope of fiscal action should bridge this output gap in magnitude but provides limited targeting to ease stress on parts of the market hardest hit – particularly, components of consumer services, travel, and retail. A resurgence in demand from consumer strength and inventory rebuild should more than offset the fading impulse from fiscal stimulus, aiding in the disappearance of an output gap. As part and parcel of a normal cyclical recovery, we expect core inflation to move higher as we progress through 2021, rising further into 2022. We expect annual core inflation, excluding energy and food, in Europe to exceed 1.2% by the end of the year from the most recent readings of 0.8%. The United Kingdom should also see core inflation rise towards 2.0% moving into 2022 from the current level of 1.4%. Increased fiscal activism, less productive industrial policy, and de-globalization of trade will shape rates of longer-term inflation as we move through 2022.

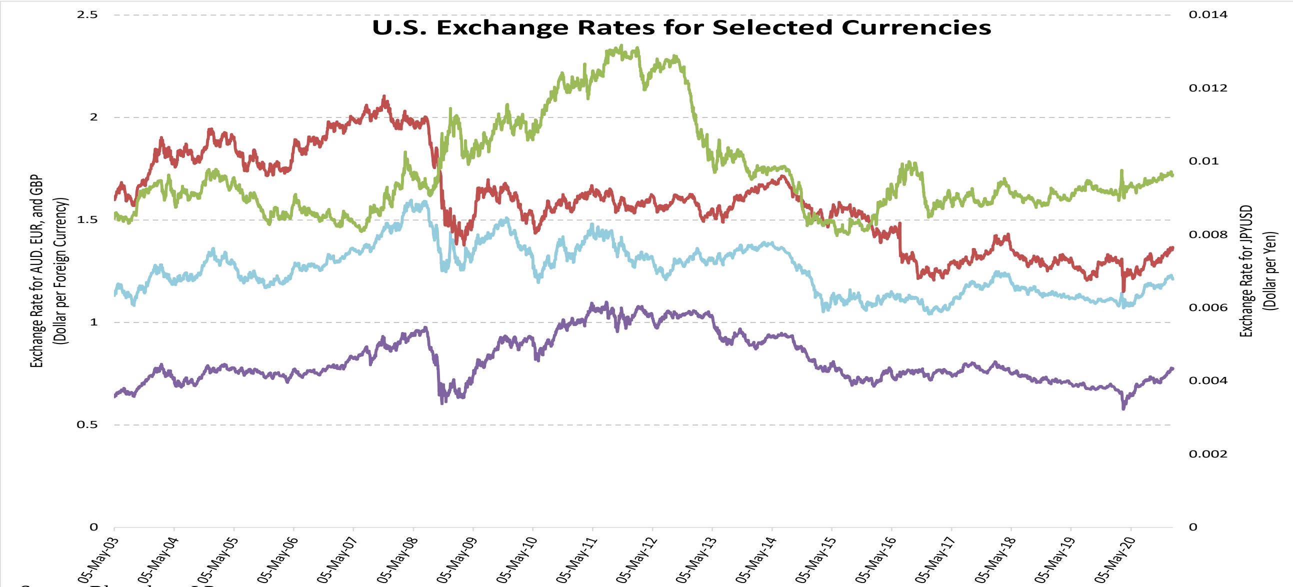


Source: OECD.org



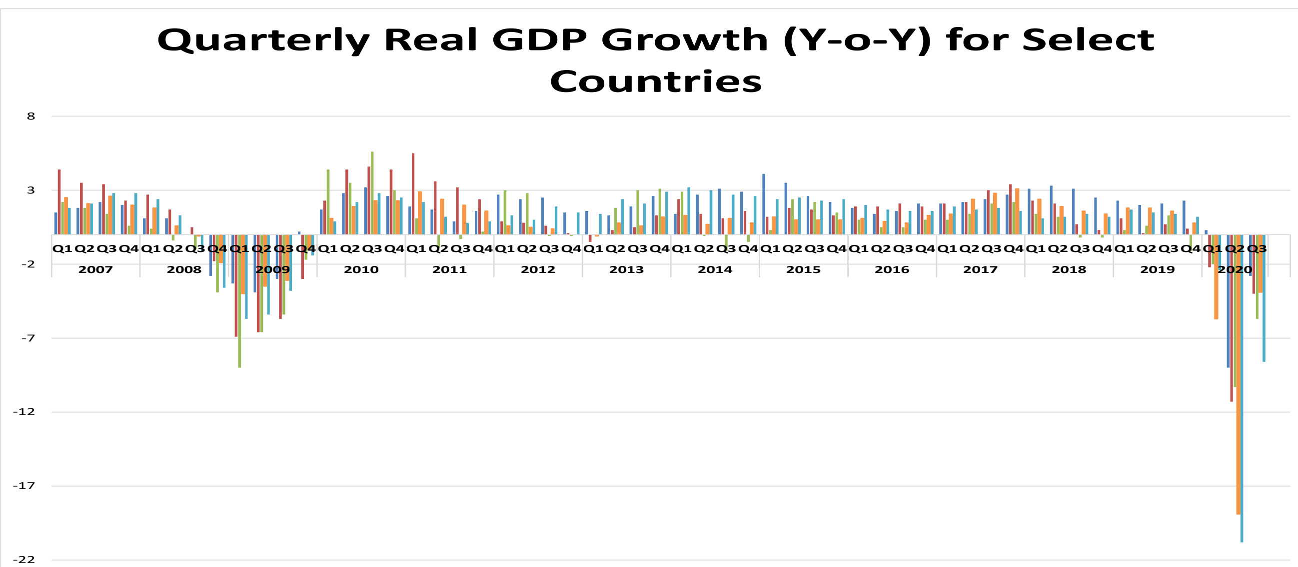
Source: St. Louis Fed

After initial strength in US Dollar, the market started to reverse this downward trend, which had been in place for a few prior years. As 2020 progressed, currency markets exhibited strength in more economically sensitive, developed markets. The weakening in the US Dollar reflected a narrower interest rate differential, combined with market value exceeding purchase price parity ("PPP"). While there appears to be more downside for the United States' dollar, the narrower PPP, oversold condition, and increasing interest rate spreads should temper weakness in the currency during recovery. Regardless, we see more upside for developed, non-US Dollar currencies during the next year.



Source: Bloomberg LP

Our outlook for interest rates and currency values reflects the expectation for economic recovery in 2021 and further expansion into 2022. Real GDP decreased dramatically as economic restrictions prompted a recession. Current estimates are for real GDP in 2020 to decline by 5.3%, 7.2%, and 11.5% for Japan, Eurozone, and United Kingdom, respectively. Conversely, those markets with the greatest losses will be expected to experience the most dramatic rebounds. Among developed economies, these growth rates should range from 3.5% to 7.5% with France, Spain, and the United Kingdom rebounding in the upper end of this range. Global real GDP will likely decrease by 3.4% in 2020, whereas the rate of growth should increase by approximately 4.2% and 3.5% for 2021 and 2022, respectively. As these markets regain footing, cyclical and consumer service exposure should benefit from the resumption of traditional economic and consumer activity. These market dynamics would be consistent with normal rotations, but certain industries that have been closer to the epicenter of the disruption should see some of the strongest rebound for the survivors, though could also represent industries with the greatest carnage. We will try to balance identifying new opportunities while sticking to our bias for quality and consistency.



Source: Bloomberg LP

Exogenous and systemic risks always exist in any market, and these risks could unsettle any nascent recovery. The virus introduced a major exogenous shock, which, combined with the health policy response, led to the current recession. Though the fiscal stimulus in this economic cycle is significantly greater than the prior financial crisis, any recovery hinges upon certain assumptions. The virus continues to mutate, introducing potential for delays in resolving the health crisis through effective vaccines or treatments – and thereby risking extended restrictions on activity. These restrictions would further delay economic recovery.

Credit quality could also undermine the influence of monetary policy, as non-performing assets derail the strength of new credit creation through the banking system. Andrea Enria, head of bank supervision the ECB, warned that bad loans in the Eurozone could reach €1.4trn, exceeding levels from the 2008 financial crisis. Fortunately, banks were much more strongly capitalized entering this crisis. Market participants will train eyes on credit quality in order to handicap risks of a systemic credit cycle undermining the strength of an economic recovery. Currently, we do not anticipate a systemic credit issue of magnitude to usher in another financial crisis.

Geopolitical landscape will also shift as the new administration works to shape their diplomatic agenda. China and Iran could push limits as they try to influence policy, but Biden could be more balanced in his response despite their emboldened actions. European leadership at some member states also presents some uncertainty, as Merkel will hit term limits this fall, Italy has shaky coalition leadership, and France's Marine Le Pen could gain momentum (vis-à-vis Macron) ahead of 2022 elections. Early success could also undermine longer term success, as economic expansion could lift inflation and interest rates to constrictive levels. Actions taken by leadership to cure economic malaise could make economies victims of such expansionary policy, as lingering, accommodative policy leads to economic overheating. The risks in markets are innumerable and, often, an exogenous shock that leads to a recession remains underappreciated until the economic impact is felt. We have just illustrated a few of these risks.

Mason D. King, CFA

January 28, 2021

IMPORTANT INFORMATION

The commentary set forth herein represents the views of Luther King Capital Management and its investment professionals at the time indicated and is subject to change without notice. The commentary set forth herein was prepared by Luther King Capital Management based upon information that it believes to be reliable. Luther King Capital Management expressly disclaims any responsibility to update the commentary set forth herein for any events occurring after the date indicated herein or otherwise.

The commentary and other information set forth herein do not constitute an offer to sell, a solicitation to buy, or a recommendation for any security, nor do they constitute investment advice or an offer to provide investment advisory or other services by Luther King Capital Management. The commentary and other information contained herein shall not be construed as financial or investment advice on any matter set forth herein, and Luther King Capital Management expressly disclaims all liability in respect of any actions taken based on the commentary and information set forth herein.