SARANAC
PARTNERS

Investment Committee Update

February 2021

AT A GLANCE

- The three key issues articulated in January continue to dominate the market narrative: economic growth versus elevated valuations; rotation from growth to value; and the search for diversification.
- We continue to be aligned with the consensus view of a strong rebound in growth in H2 but also believe that on balance valuations are likely to compress this year. Our portfolios are therefore cautiously, albeit not bearishly, positioned.
- Most of our activity is concentrated within asset classes to align with the rotation from growth to value within equities, and we are on an ongoing search for return and diversification within fixed income.
- Over the past several months we have increased our exposure within fixed income to sub-investment grade credit and emerging market debt.
- This month we have looked to increase yield and return by moving some of our investment grade credit exposure into asset-backed securities and structured products.
- Our equity allocation has already increased exposure to value and cyclical factors through the rotation of direct holdings in the portfolio.
- This month we have added a new fund with a strong value bias and a tilt towards UK and European markets.

As we move into February, our investment narrative and analysis continues to be focused on three key themes:

1. Economic growth versus elevated valuations
2. Rotation from growth to value
3. Search for diversification

1. ECONOMIC GROWTH VERSUS ELEVATED VALUATIONS

Vaccines versus variants

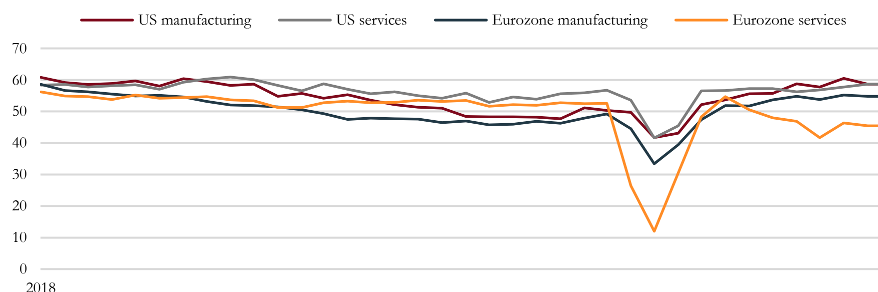
In recent weeks, news flow around the virus has concentrated on the tussle between vaccine rollouts and the emergence of new variants. While vaccination programmes are starting to hit their stride in the US, UK and elsewhere, the emergence of new variants, issues of vaccine efficacy and the potential requirement for 'booster' doses has dampened some of the optimism around the revolutionary impact of vaccine programmes.

Our view is that some of this caution is overplayed. We believe that vaccines will work, lockdowns will ease in late Q1 or early Q2, economies will see significant reopening over the summer and growth will be very strong indeed in H2 2021 and into next year. We are therefore very much aligned with the consensus view that we are going through a period of weakness that will be followed by a very strong rebound.

It should be noted that the current weakness is specific to both the service sector and Europe. There is broad-based strength in manufacturing globally and PMI numbers remain high (figure 1). The service sector has also held up far better in the US than Europe, where US authorities have taken a noticeably different approach to the second wave of coronavirus infection and resisted a full national lockdown response.

Figure 1: US and European PMIs

US and European PMI survey data show manufacturing remains on a strong growth path. Services, however, are mixed as the impact of lockdowns in Europe are evident, while US activity is surprisingly resilient.



Source: Saranac Partners.

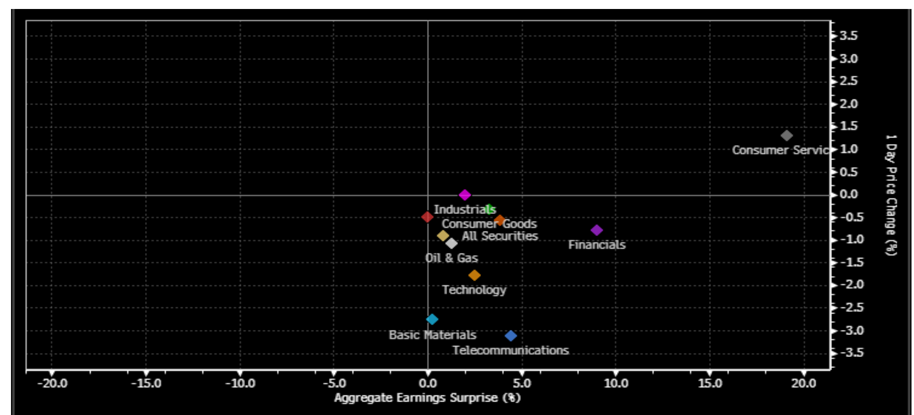
Stronger growth and positive earnings surprises could deliver further upside to equity markets, but on balance valuations are likely to compress this year.

Valuations

Despite the optimistic consensus on economic growth, valuations remain problematic and much of the good news on growth is already priced in. Stronger growth and positive earnings surprises could deliver further upside to equity markets, but on balance valuations are likely to compress this year (figure 2). Q4 2020 earnings have so far beaten analyst expectations by record levels, yet the market response has been generally negative. This muted response implies most of the good news was already in the price, although a lack of positive guidance with regard to 2021 also plays a part.

Figure 2: Q4 2020 earnings reaction

The vast majority of stocks in the S&P 500 have fallen in the immediate aftermath of their results, despite Q4 earnings season being the best on record for positive surprises. Much of the good news around better profitability and a generally stronger corporate environment is already in the price.



Source: Bloomberg, Saranac Partners.

Short-term sentiment remains overly optimistic – investor surveys are bullish and positioning in the derivatives market suggests investors are fully invested and reinforces the bullish view. The Reddit/Robinhood drama over attacks on highly shorted companies highlights both growing retail participation in this market, as well as heightened focus on social and wealth inequality within the market system. While the GameStop episode raises lots of questions for market participants, from a valuation perspective it relates to a very small pocket of companies and is not something that should be extrapolated across the market more broadly.

In contextualising current valuation levels, comparisons with the tech bubble of 2000 highlight some similarities such as retail participation, IPO activity and loss-making companies on high valuations. However, the differences are notable and substantive – monetary and fiscal policy is much more accommodative, expected earnings growth in the near term is higher, fund flows are normal and historic performance is still some way below the returns seen in the run up to 2000. On balance, therefore, our risk appetite is not bearish, but does remain cautious and unchanged.

Inflation

As noted in our previous communications, inflation is a critical driver of market dynamics and something we are monitoring closely. Inflation expectations have continued to move higher in the US and Europe, but they remain at relatively low levels, reaching 2.2% in the US and just 1% in Europe. UK inflation expectations have been stable at 3%.

We would note, however, that expectations for inflation over the next two years have risen more sharply and are now higher (2.5%) than expectations for the next 10 years (2.2%). We would agree with this view that there are temporary, cyclical factors that could drive up

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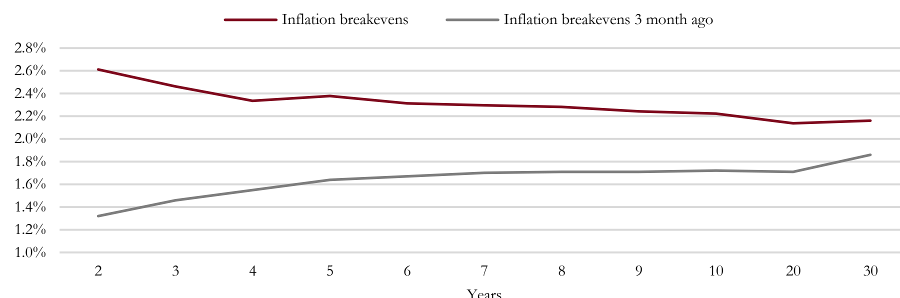
inflation in the short term but which are unlikely to be sustained – commodities and shipping being two key contributors. Our scenario analysis now gives greater credence to a pick-up in inflation, but only to levels slightly higher than seen pre-Covid-19 (figure 3). We firmly believe that a return to 'high inflation' above 3% or 4% is highly unlikely.

Figure 3: Inflation expectations
Inflation expectations have shifted higher over the past three months and are back to levels seen prior to the pandemic. Unusually, near-term inflation is expected to be higher than long-term inflation, a result of the run up in commodity prices and shipping costs as the global economy bounces back from the disruptions of 2020.



Source: Bloomberg, Saranac Partners.

Furthermore, despite the potential for higher inflation in the near term, we do not expect central banks to change their policy stance. Given fears of tightening too soon and a target of 'average inflation', a loose policy stance is likely to persist, even if inflation were to run above target for a while.

This is crucially important as markets are particularly sensitive to monetary policy now, given high valuations and the expectation of low interest rates for a very long time. We don't think the Fed or other central banks are likely to change their narrative this year, even if growth and inflation are stronger than expected, due to the extent of the damage from Covid-19 and the lack of growth and inflation in recent years. Furthermore, central bank policy is pushing real yields negative in developed markets – a situation governments are happy to maintain as it allows them to deflate their debt burden away, albeit very slowly.

2. ROTATION FROM GROWTH TO VALUE

As we noted in our last investment update, we believe there will continue to be a rotation into cyclical and value stocks as the growth environment strengthens in the second half of the year. We believe the shift to a period of accelerating and high economic growth will be more powerful and longer lasting than similar macro improvements in recent years. As a result, we think the outperformance of value relative to growth is going to last longer than the brief periods it did so in 2013 and 2016. Our investment approach is long term and so a brief flurry of performance from value-oriented stocks would not normally interest us. But this rotation in the overarching equity regime is significant enough to make meaningful changes to the style of our portfolio.

Nevertheless, it should be noted that our scenario analysis highlights our view that the underlying long-term macro environment is still one of low growth and low inflation. As this environment reasserts itself and the rebound from the supply and demand disruptions of 2020 and 2021 fades, so should a growth style of investing once more perform best.

Within our equity portfolio, we continue to look for ways to gain exposure to cyclical and value factors and align the portfolio to the rotation we see in the market. Analysis of our equity holdings shows that we have indeed moved our overall exposure to a more balanced portfolio, with the preponderance of growth characteristics falling sharply.

3. SEARCH FOR DIVERSIFICATION

There is little value left in higher quality fixed income markets. Government bond yields have risen from their lows but remain well below pre-Covid levels. Nearly $16 trillion of investment grade debt still offers a negative yield. Credit spreads have tightened back to levels seen in 2019 and 2018.

With such low returns on offer we are looking for ways to generate better performance without compromising the risk management of the portfolio. Volatility remains high in many parts of the market and so we are actively looking for ways in which we can sell volatility and lock in relatively attractive returns with little downside risk. Structured products are going to play a more important part in portfolios going forward.

PORTFOLIOS

Asset allocation

We are not making any significant changes to the asset allocation in portfolios this month as the macro environment is relatively stable. However, we continue to look for ways to improve returns within asset classes themselves. We retain our current risk appetite at around 5 out of 10 and continue to hold around 37% of the portfolio in equities.

Fixed income

Given the market environment, generating returns in fixed income continues to be challenging. We already have moved a significant proportion of our fixed income exposure into sub-investment grade debt, notably high yield, subordinated financial paper and senior loans. Positions have also been increased in emerging market debt, specifically local currency debt where the weaker US dollar has been a helpful tailwind. We have therefore extended the credit risk of our overall fixed income exposure as far as we want to at this time.

Asset-backed securities is a sector we have identified which offers a pick-up in yield within investment grade. To this end, we have rotated some of our investment grade credit exposure into asset-backed securities, which enhances yield for relatively little duration risk.

We are also looking to switch some of our investment grade fixed income into highly defensive structured products that can take advantage of elevated volatility and generate superior fixed rate returns with very little downside risk.

Equities

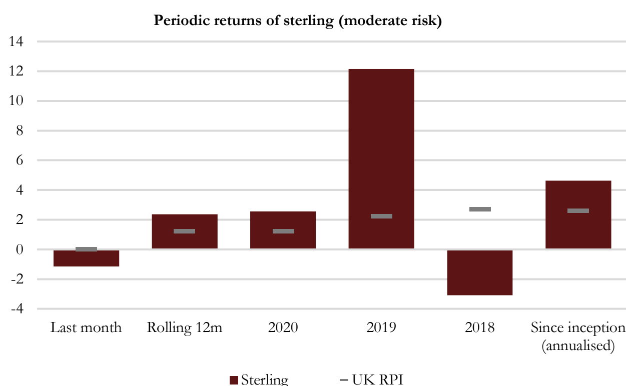
Within our equity portfolio, we continue to look for ways to gain exposure to cyclical and value factors and align the portfolio to the rotation we see in the market. Analysis of our equity holdings shows that we have indeed moved our overall exposure to a more balanced portfolio, with the preponderance of growth characteristics falling sharply.

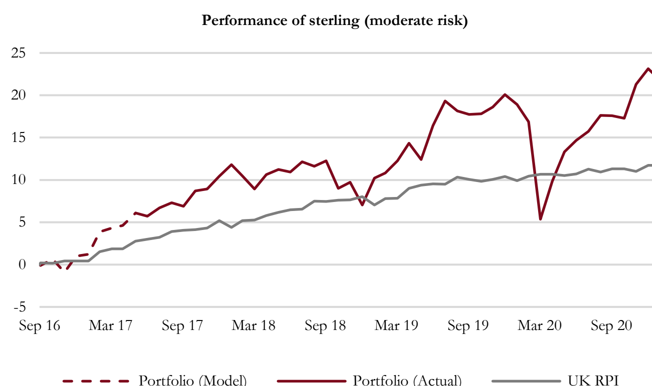
In addition, we have added a new equity fund to the portfolio which brings a strong value bias and a tilt towards the UK and European markets, further moving our overall equity exposure toward cyclicals and cheaper areas of the market.

Multi-asset strategies

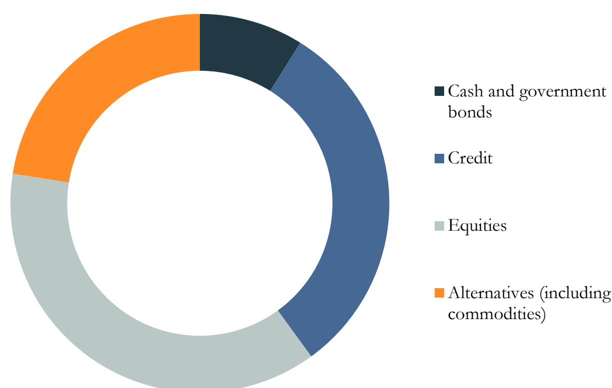
Performance as of 1 February 2021

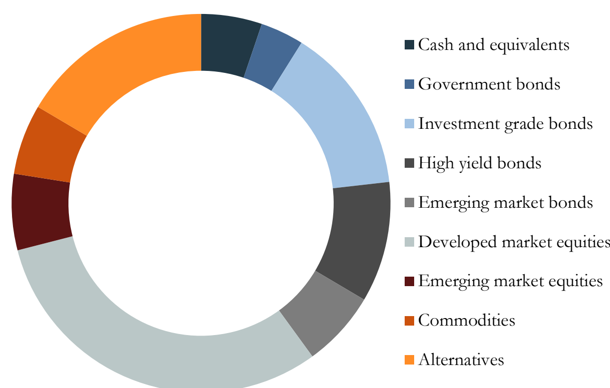
Returns (%)





Asset allocation (average across all portfolios, %)

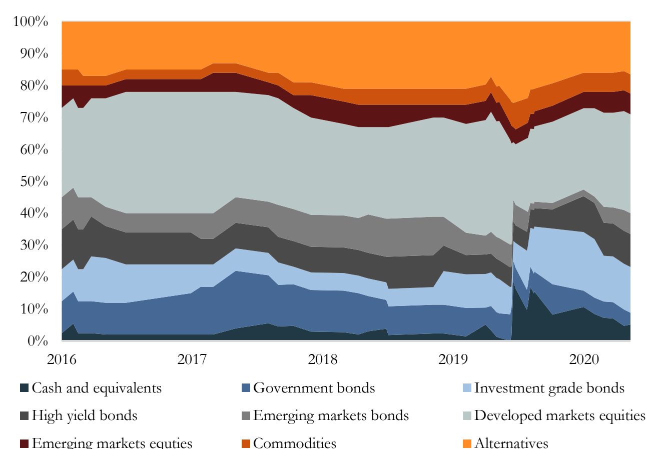




Changes over the past month (%)

	Sterling	Change
Cash and government bonds	**8.9**	**-1.0**
Cash and equivalents	5.2	0.4
Government bonds	3.7	-1.4
Credit	**31.1**	**0.0**
Investment grade bonds	14.3	0.0
High yield bonds	10.3	0.0
Emerging market bonds	6.5	0.0
Equities	**37.5**	**0.0**
Developed market equities	31.0	0.0
Emerging market equities	6.5	0.0
Alternatives	**22.5**	**1.0**
Commodities	6.0	0.0
Alternatives	16.5	1.0

Changes over time (%)

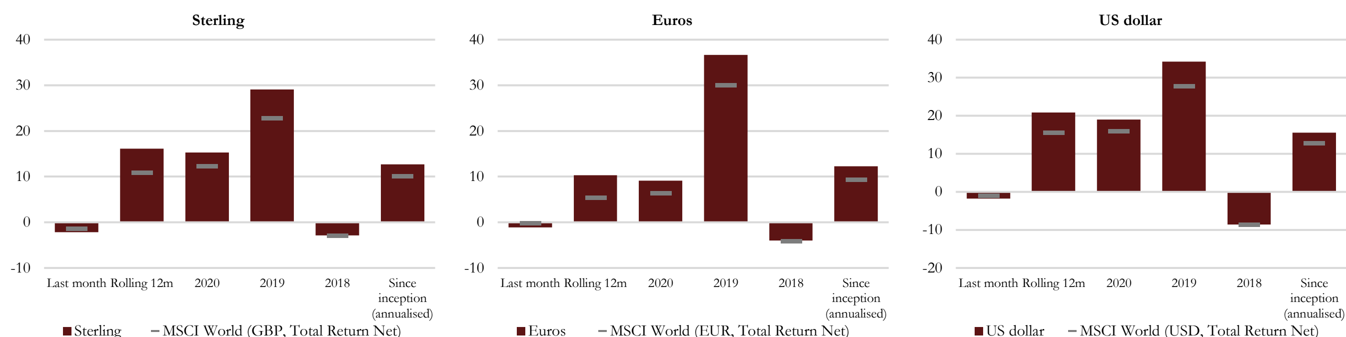


Performance figures from inception (28 September 2016) to end May 2017 are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Performance figures from June 2017 onwards are based on an aggregation of actual client portfolios whose mandate most closely follow the Moderate Risk model. Dividends have been included on an accruals basis in both cases. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance.

Equity strategies

Performance as of 1 February 2021

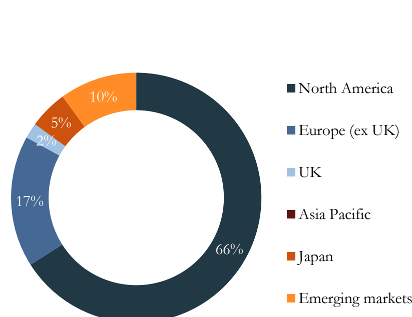
Returns (%)



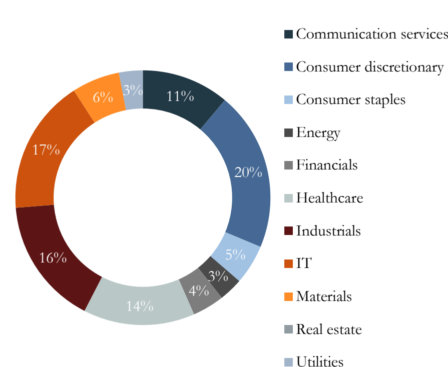
Top 10 holdings (%)

Holding	Weight (%)
FANUC	4.7
Alphabet	4.3
Discover Financial Services	4.3
Taiwan Semiconductor	4.2
Facebook	4.2
United Rentals	4.1
Microsoft	3.9
Home Depot	3.9
LVMH	3.3
Visa	3.2

Regional exposure



Sector exposure

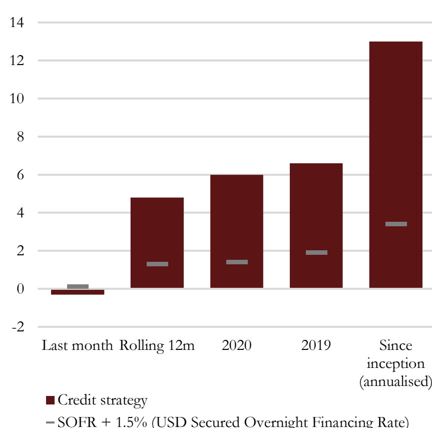


Performance figures from inception (1 January 2017) are based on a model portfolio, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance. Actual fees paid by the client portfolios excluded. Fees may vary.

Credit strategy

Performance as of 1 February 2021

Returns (%)



Asset allocation and performance measures

Issuer type	Weight (%)	Yield to maturity (bps)	Modified duration	Composite rating
Core IG allocation	**73.0**	**185.6**	**4.5**	**BBB+**
Developed markets	51.0	164.9	4.5	BBB+
Emerging markets	19.0	216.0	4.8	A-
Asset backed securities	3.0	345.0	2.2	A-
High yield satellite	**27.0**	**458.1**	**3.1**	**BB**
Developed markets high yield	13.0	399.5	1.8	BB-
Emerging markets high yield	2.0	816.0	7.7	BB
Corporate hybrids	4.0	445.9	2.9	BBB-
Financial subordinated	8.0	469.9	4.3	BB+
Total portfolio	**100.0**	**259.2**	**4.1**	**BBB**

Performance figures from inception 31/12/18 are based on an actual client portfolio whose mandate most closely follows the Diversified Credit Strategy. All performance is shown inclusive of fees. Since inception, the portfolio has experienced zero defaults. Your capital is at risk and past performance is not a reliable indicator of future performance.

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