KFP
KEY FAMILY PARTNERS

Global Market View

September 2020

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🟡 Market expected to provide normal returns for that market

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🔴 Market expected to provide below normal returns, or negative returns

Ratings are not bound by a specific timeframe; they will change when fundamental conditions change

GLOBAL ECONOMY

It's different this time.. (part 2)

The US Federal Reserve launched a revolution at its annual Central Bankers' summit on Thursday. Hard inflation targeting of 2%, which was the bedrock of US (and global) monetary policy since the late 1990's, has been abandoned along with the Philips Curve on the relationship between employment and inflation. In its place is an innocuous sounding "average inflation of 2%" over a cycle...hardly revolutionary sounding, but the implications are profound.

The WSJ headline proclaimed **"Low rates forever!"**. In effect, the Fed has given itself license to ignore current inflation above the 2% level and maintain low real rates. As long as its self-defined average is not above 2%, the Fed will not raise rates, as opposed to the previous regime of almost automatic raising of interest rates as inflation approached 2%.

While paying lip service to inflation targeting of 2%, in practice the Fed could let inflation rise to significantly higher levels without taking action on interest rates. To add further to the uncertainty, the Fed has not spelt out how and over what period it will calculate the average – giving it, and its political masters, almost unlimited flexibility.

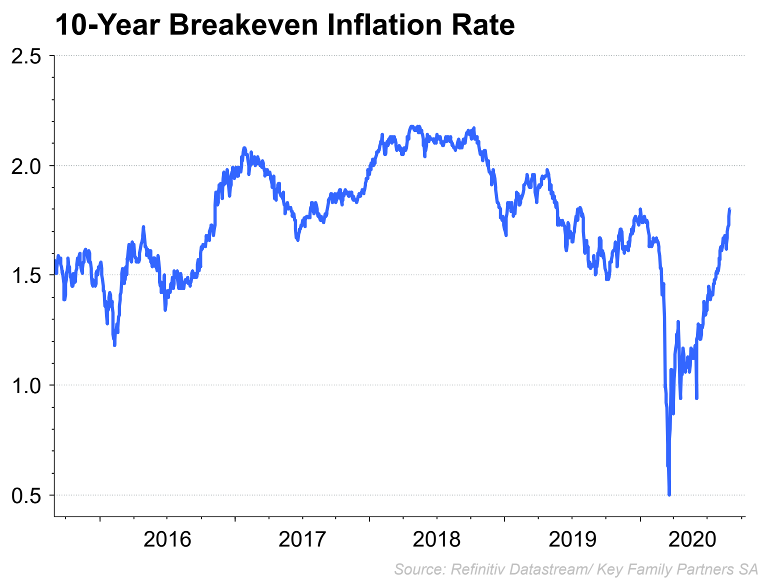
Why has the Fed made this 180degree change? It is an attempt to boost the growth recovery AND generate higher levels of inflation through negative real interest rates, all designed to erode the real debt burden of the US. Without inflation to do the heavy lifting, US (and other countries') debt levels will continue to rise in real terms and ultimately become unsustainable.

Paul Volcker will be turning in his grave.

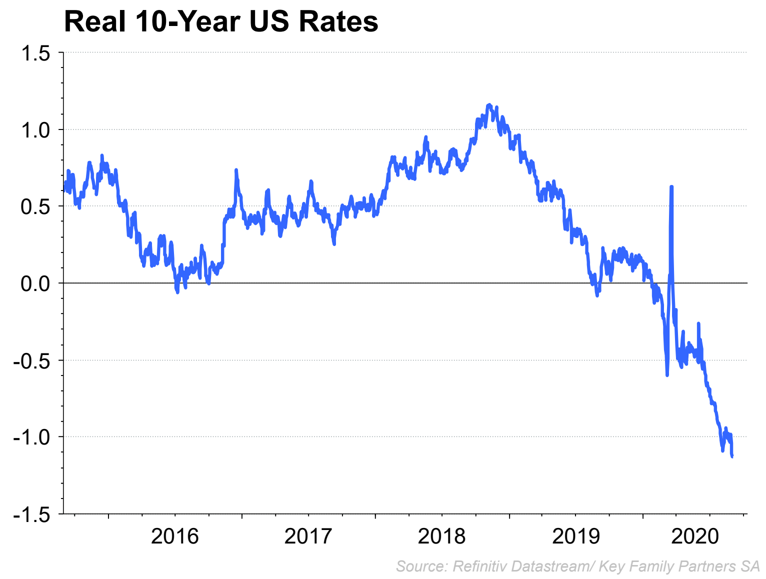
Inflation on the horizon

Meanwhile longer- term inflation expectations accelerated on the news, and real rates remained strongly negative.

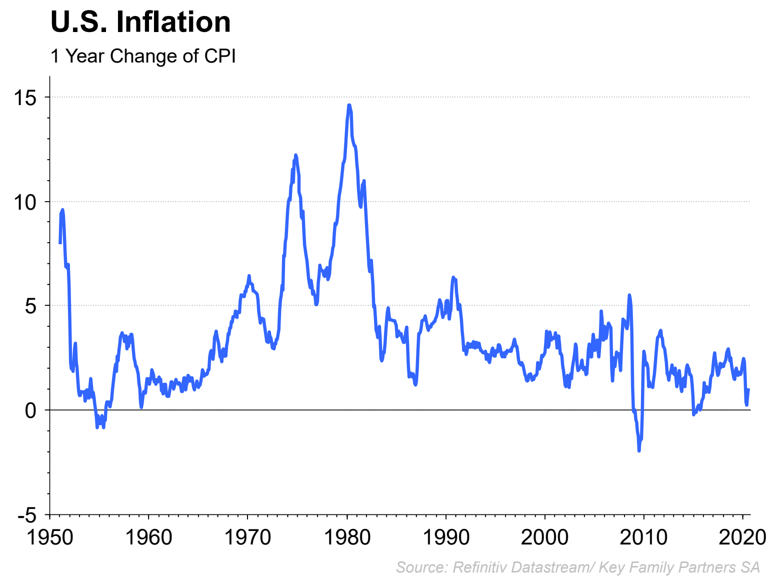
10 year inflation expectations rose to levels last seen in December 2019 before the pandemic struck, and now have entered a rising trend rather than falling trend as was the case last December. The rise in inflation expectations from the lows in March of 124bps is the largest since the GFC in 2009/10, when inflationary conditions were higher at the start of the crisis than this time around.



Real 10 year rates have therefore fallen to the lowest seen this century, at -1.03%, suggesting that real interest rates will remain negative for a significant period of time. The trend for real rates remains strongly negative, implying we could see even more negative rates as inflation expectations rise and treasury yields remain pegged for the time being by Fed QE activity.



After 40 years of benign and falling inflation, is the inflation trend ready to reverse, and if so why? The long-term chart below suggests that inflation is set to rise longer term.



Many reasons have been given for the past 40 years of low inflation the world has experience. My view is that a perfect combination of trade liberalisation (including China joining the WTO with low cost manufactured goods), technology driven productivity, demographics and positive real interest rates kept inflation under control on a global scale during that period.

Most of these factors are reversing:

- Trade liberalisation has come to a halt. On the contrary, new tariff and non-tariff restrictions by major trading blocks are likely to increase prices of traded goods
- Productivity growth has slowed as the early rate of productivity gains from technology have slowed
- Most importantly, real interest rates have collapsed to negative levels in all developed markets, and zero in China
- Fiscal stimulus at extreme levels following the recent recession

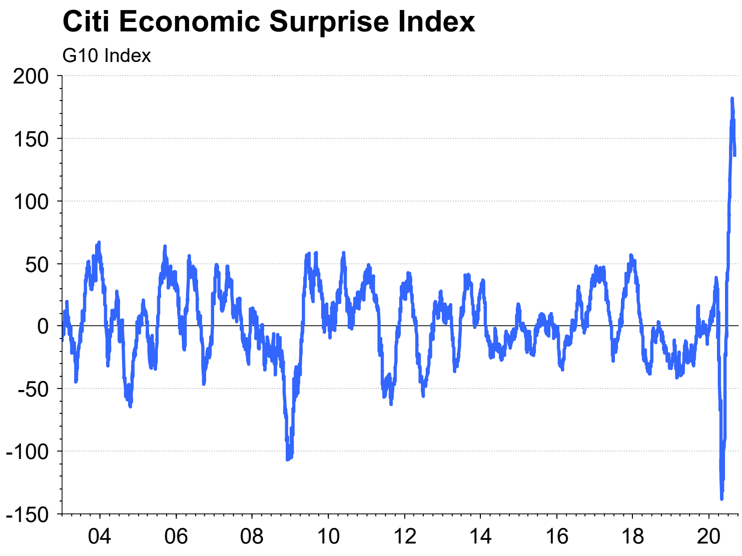
Recent data suggests inflation rates are picking up in most DM and EM countries following the recession. However, many commentators have cited the example of Japan, which in spite of many years of zero interest rate policy and fiscal stimulus, has not succeeded in generating their target inflation level. I would give two reasons for this experience: 1) the world as a whole was in a low inflation environment as described above, from which Japan on its own could not escape, and in addition 2) Japan has the most most acute demographic challenge of any advanced economy, with an aging and shrinking population which is deflationary on a domestic level. If the level of global inflation is seen to rise, Japan may have more chance of achieving its own target levels and inflating away its large mountain of debt but the demographic challenge will remain.

How is the economic recovery going?

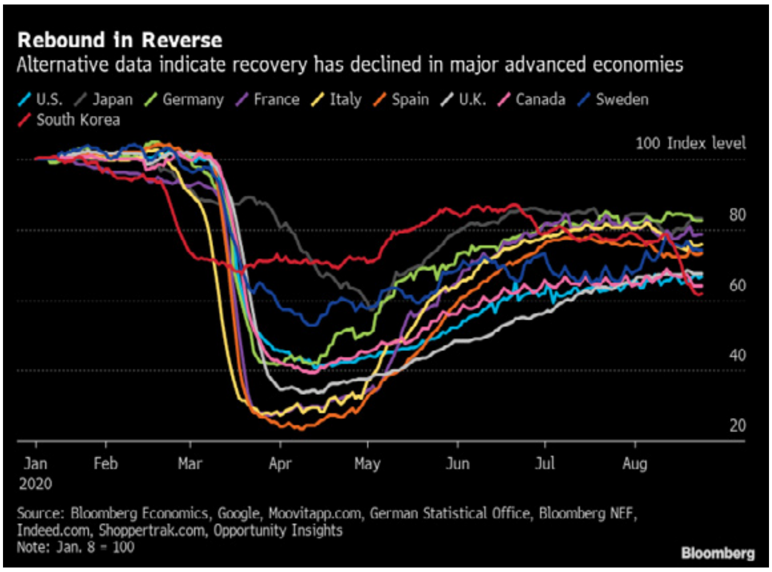
After the well documented recession in Q1&2, economic activity appears to be picking up across the world economy, but at very different rates. Differing monetary and fiscal policies, and approach to Covid lock downs, will explain most of the differences.

At a global level, using the Citi Economic Surprise index, the recovery is doing much better than expected in most countries. The question then becomes at what rate will economies recover from the record falls in GDP seen in the first half. For example, the UK saw a 21.7% fall in GDP in the first half of 2020, but is now showing some rebound as lock down is eased.

This chart shows the dispersion of recovery levels experienced by different countries using some alternative real time measures such as credit card usage, and their economic activity relative to where they were at the start of 2020. Clearly, economic activity remains well below the start of the year but in most cases is recovering – except where new Covid outbreaks force renewed lock down as in South Korea.



Source: Refinitiv Datastream/ Key Family Partners SA



China remains a standout post Covid performer, with manufacturing and non-manufacturing PMIs remaining in positive territory again in August – for the 6th consecutive month.

China's stated GDP growth year on year to June 30th stands at +3.2%, while every other major economy is in negative territory.

To summarise...

- The world economy continues to recover, albeit at uneven and disparate rates. However, aggregate economic activity remains well below the start of the year, except in China
- The Fed has implemented a radical new monetary regime to attempt to boost recovery and inflation, leading to negative real rates for the foreseeable future
- Current inflation has stated to edge up, and longer term expectations have risen strongly

Investment implications...

The implications of the Fed's actions are profound:

- With rising inflation risk, fixed income instruments, particularly DM Government bonds, no longer represent the risk free default holdings to diversify away equity market risk
- Equities with growth potential and pricing power will be discounted at lower rates for longer and could go higher, while companies with low growth and pricing power will remain "cheap" (zombies)
- Other assets (gold, real assets (eg base metals, lumber), some real estate) will provide diversification opportunities for investment portfolios

Portfolio rebalancing should be a priority for investors at this time.

EQUITIES

GLOBAL EQUITIES

	1 month	YTD	12 month
Global Equity	+6.3%	+3.7%	+14.7%
Global Eq. Ex US	+4.1%	-4.7%	+5.8%

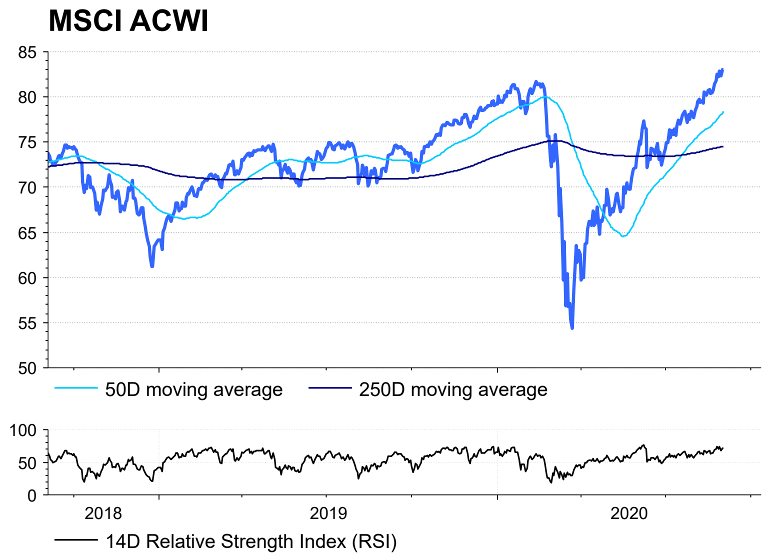
Equity markets gain globally, driven by tech stocks once again. Fed actions helped fuel the rise. Valuations reach extreme levels in the US.

Global equities rose again in August, once again driven by tech stocks globally. Global equities reached new record levels in the month at 586.44 on the index.

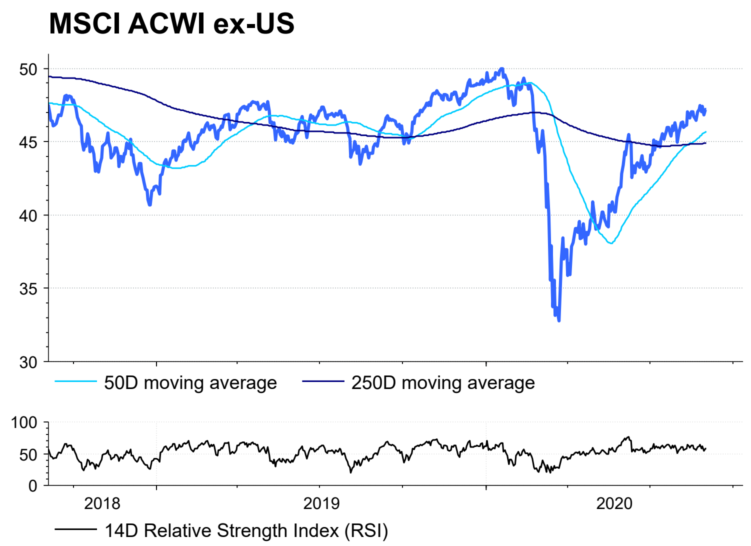
Sentiment remains positive although equities are once again very overbought.

Valuations on adjusted 2020 expected earnings have risen slightly to 23.7x from 22.6x as markets recover. These levels are the highest seen over the past 10 years.

The outlook remains NEUTRAL with downside risk due to extreme valuations in tech stocks.

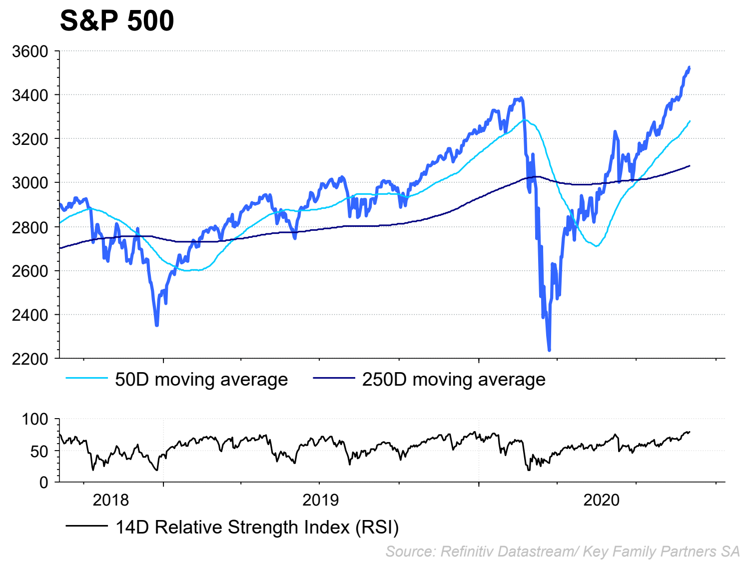


Source: Refinitiv Datastream/ Key Family Partners SA



Source: Refinitiv Datastream/ Key Family Partners SA

USA			
	1 month	YTD	12 month
US Equity	+7.0%%	+8.3%	+19.6%

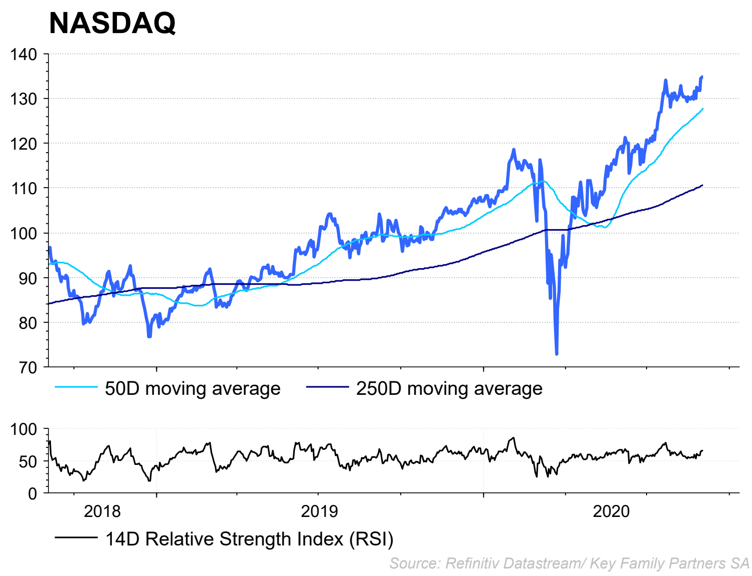


The S&P500 saw a further appreciation in August, reaching a new higher valuation on expected 2020 earnings, which has moved to 26.8x from 25.5x 2020 forward earnings.

The recent Fed actions have poured fuel on the fire of an already overheated market, setting it ablaze. The fire is concentrated in tech stocks which have an aura of invincibility in this "new" world, and their future earnings are discounted at near zero rates. Common sense (and history) suggests this cannot continue but when and how the bubble is burst remains no better than a guess.

The outlook remains NEUTRAL but with risk to the downside due to extreme valuations and political risks.

NASDAQ Comp			
	1 month	YTD	12 month
NASDAQ	+9.6%	+31.2%	+47.9%
FANG+ Index	+21.2%	+82.6%	+122.7%

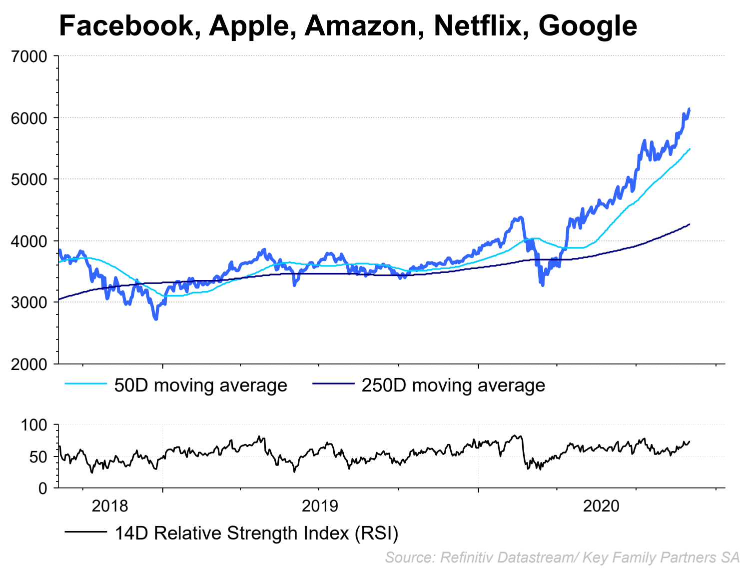


The NASDAQ and FANG+ indices both reached new peak levels in August, driven by the Fed fuel described above.

Valuation has now moved to an even more extreme level at 40.4x from 38.0x prospective 2020 earnings for NASDAQ and 51.7x from 44.9x for the FANG+ index. The Bubble continues to inflate.

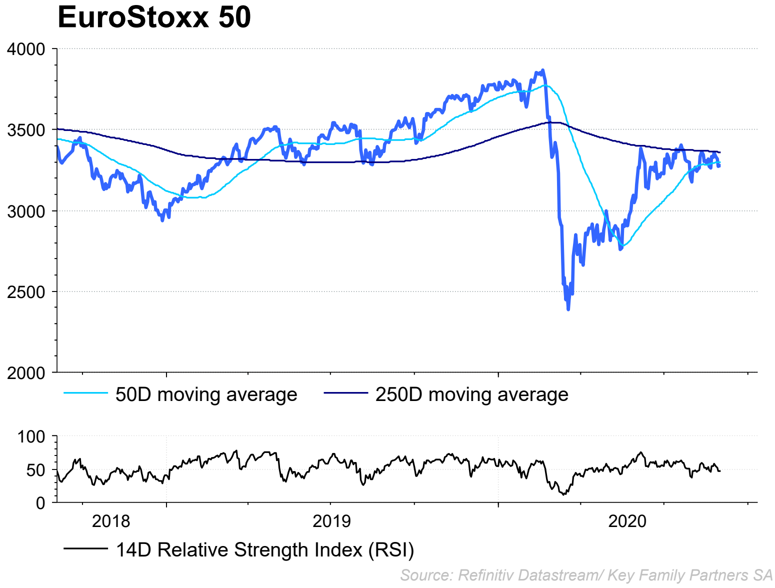
Both markets are in extreme overbought territory short term, but long-term sentiment remains positive.

The outlook is moved to NEUTRAL with downside risk due to extreme valuation levels and growing political risks.



EUROZONE

	1 month	YTD	12 month
EU Equity €	+3.1%	-12.6%	-4.5%
$	+4.5%	-6.9%	+3.9%



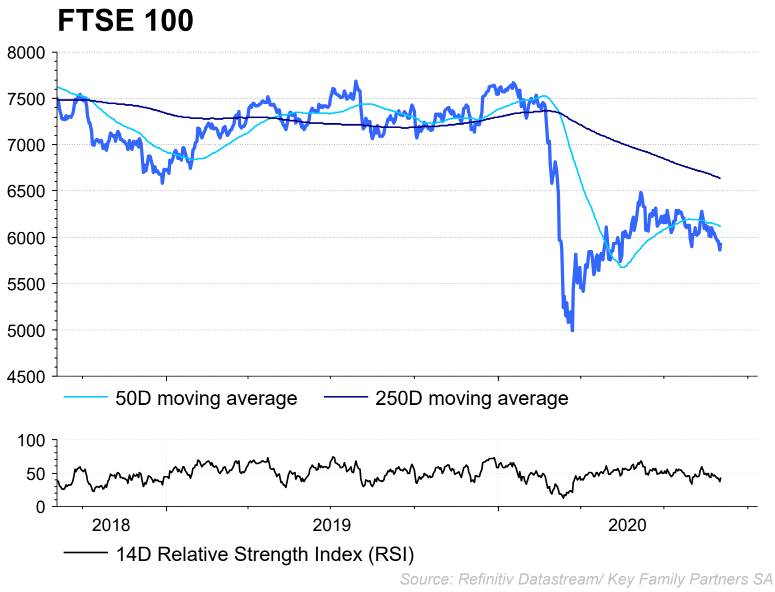
Euro equities recovered in August on better than expected economic news, even though the EZ economy remained in serious deficit for the year.

Valuations rose to 20.7x from 20.2x adjusted prospective 2020 earnings as expected earnings were adjusted downwards after Q2 results and the market rose.

Longer term sentiment remains neutral. The outlook remains NEUTRAL.

UK

	1 month	YTD	12 month
UK Equity £	+1.1%	-20.9%	-17.3%
$	+3.4%	-20.2%	-8.3%



The FTSE100 rose marginally on the month, but remains by far the worst performing global market year to date in sterling and USD – accurately reflecting the weakness of the underlying economy.

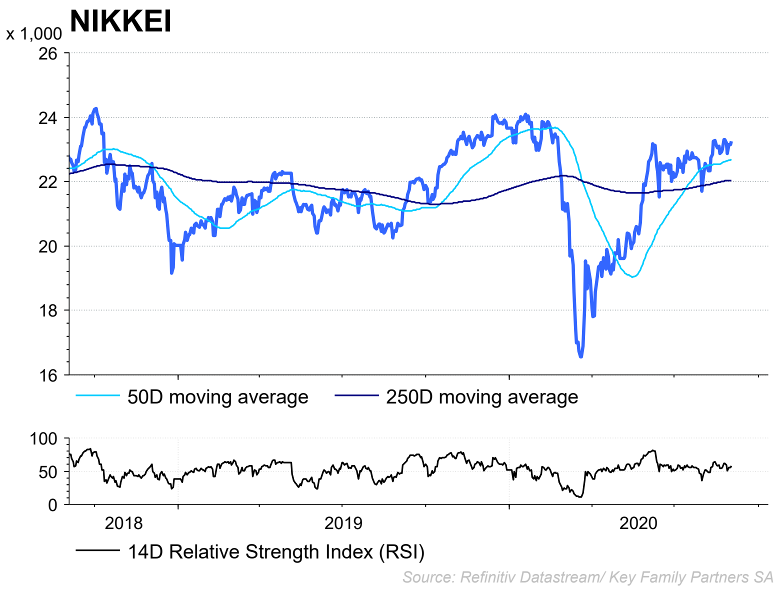
Market sentiment remains negative in the short and longer term.

Valuation rose to 19.5x adjusted prospective 2020 earnings, at the top of the 10 year range.

The outlook moves to NEGATIVE.

JAPAN

	1 month	YTD	12 month
Japan Equity ¥	+6.6%	-2.2%	+11.8%
$	+6.6%	+0.4%	+12.2%



The Nikkei rose as evidence emerged that the recession may be coming to an end and the global economy is beginning to recover.

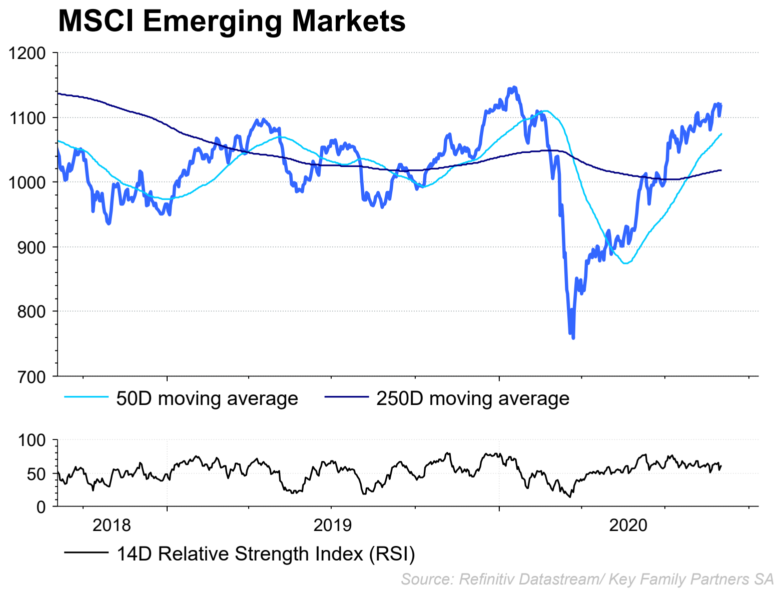
Sentiment turned more positive longer term.

Valuation rose to 23.2x adjusted 2020 earnings, making the market expensive.

Overall the outlook is moved to NEUTRAL.

EMERGING MARKETS

	1 month	YTD	12 month
EM Equity £	+4.0%	+0.6%	+13.9%



EM equities had a strong month in August, led by China once again, and tech stocks in particular.

Lower USD levels and USD interest rates should be positive for EM equities for the foreseeable future, but rising C-19 levels in many countries remain a brake on renewed growth for the time being (Taiwan).

Valuations have risen to 18.0x from 17.7x prospective earnings bringing EM equities into the top range of valuations over the past 10 years.

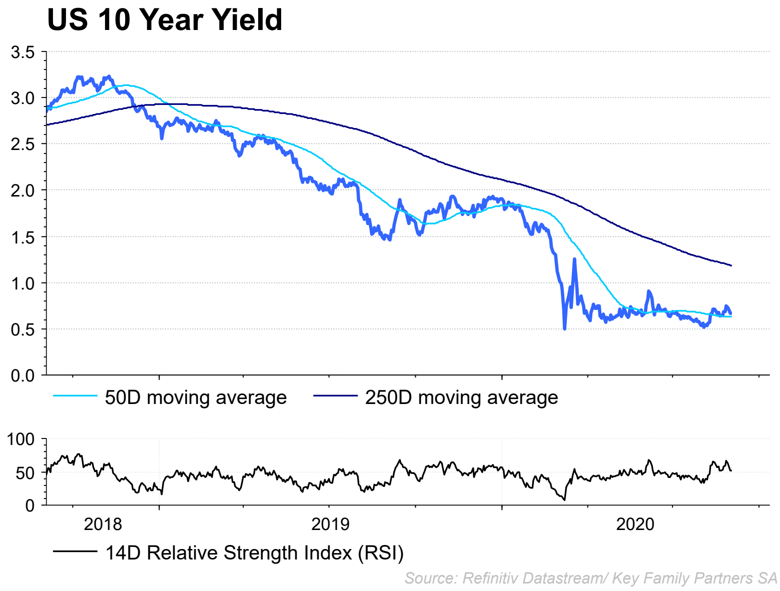
Sentiment has turned more positive.

The outlook remains NEUTRAL with a positive bias.

FIXED INCOME

Developed Government Bonds

	1 month	YTD	12 month
US Treasuries Total return	-1.38%	+8.44%	+6.67%



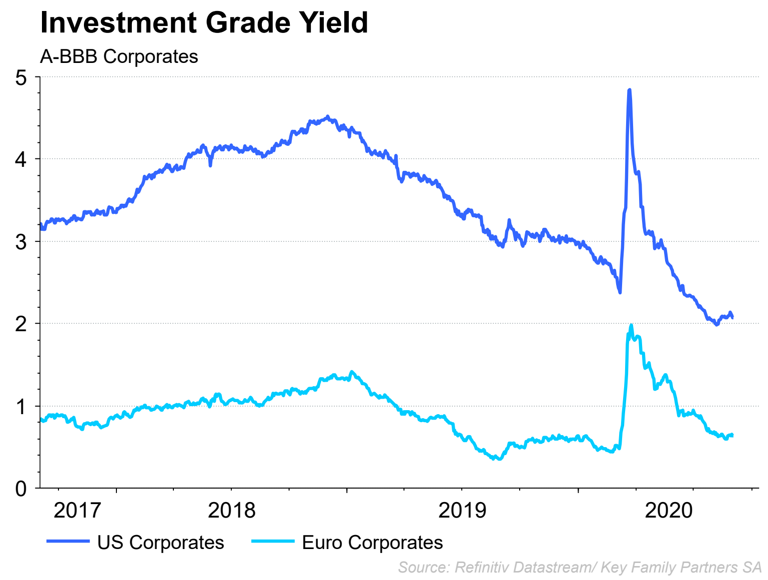
Yields on 10 year Treasuries increased in August to 0.71% from 0.53%, while 10 year inflation expectations rose to 1.79% from 1.55% - reversing the trend of the past 6 months.

The Fed's change to its inflation targeting policy, as described above, will likely lead to higher peaks in inflation than previously allowed – with the risk that inflation could rise beyond manageable levels. The market is beginning to price this in this risk of higher inflation.

The outlook is moved to NEGATIVE on a deteriorating inflation outlook.

Investment Grade

	1 month	YTD	12 month
US Inv Grade Total return	-1.79%	+6.50%	+7.06%



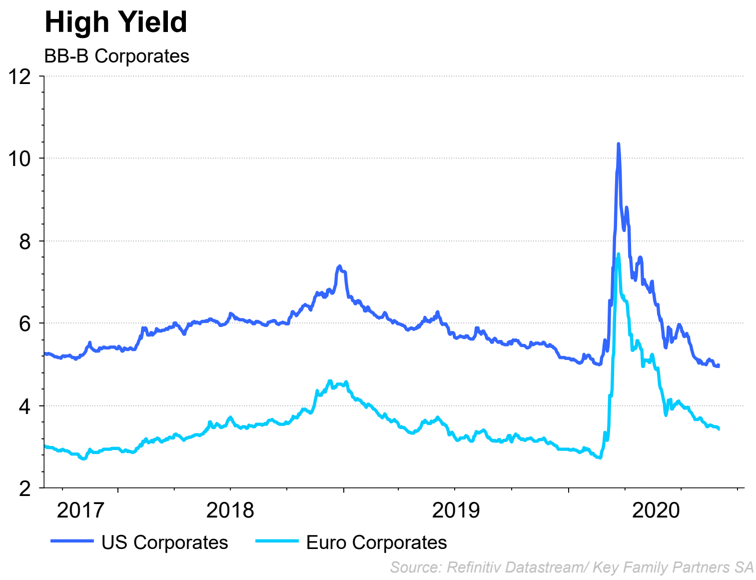
Yields on investment grade corporates increased to 1.99% from 1.86%, even while spreads fell to 130bps from 132bps.

Hope of economic recovery squeezed spreads further as credit risk fell, and the yield pick up remained attractive to investors. Spreads can fall further on continued recovery.

The outlook remains NEUTRAL given the Fed support measures for the sector and the still attractive spread over Treasuries.

High Yield

	1 month	YTD	12 month
US High Yield Total return	+0.89%	+1.61%	+4.65%



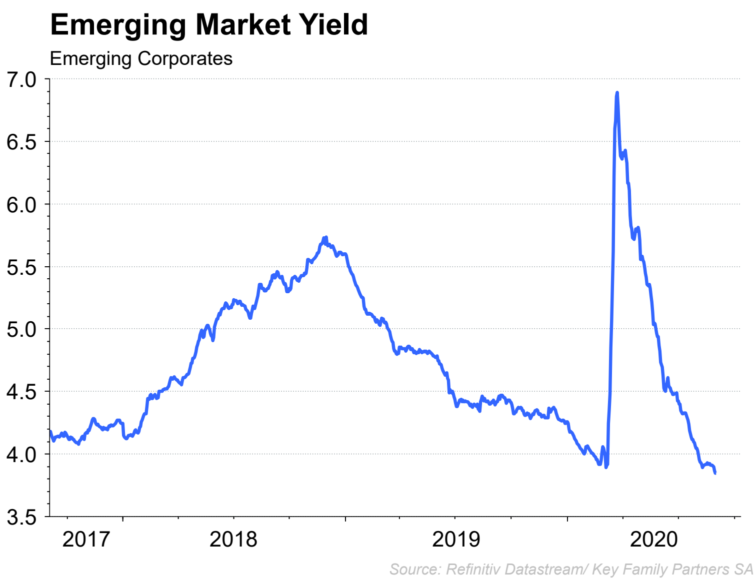
US HY bond yields fell marginally to 5.35 from 5.37% on recovery hopes in the US economy. Spreads fell to 475bps which is a neutral level over the past 10 years.

Fed actions continue to support the market so spreads are likely to remain tight for the time being and could fall further on continued recovery.

The outlook is moved to NEUTRAL on continuing recovery expectations.

EM Fixed Income

	1 month	YTD	12 month
EM USD Agg Total return	+0.35%	+3.04%	+5.23%



Yields on EM USD debt fell again to 4.17% from 4.23% and spreads narrowed further to 357bps from 376bps.

As economic growth recovers in EM, led by China, and US domestic rates stay lower for longer, EM USD debt should remain attractive to investors.

The outlook is moved to NEUTRAL with a positive outlook.

CURRENCY – USD vs DM, EM

USD vs DM currencies

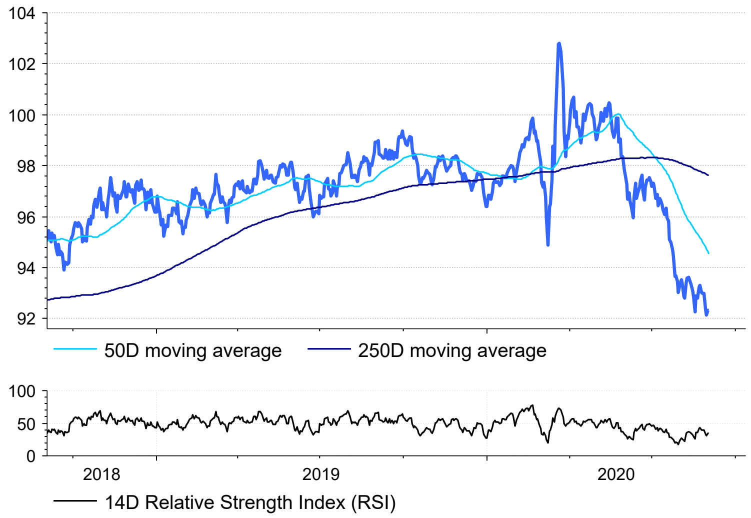
The USD continued to decline against DM, led by the Euro.

The Fed's "lower for longer" rates for the USD will encourage currency investors to diversify out of the USD as there will be no yield penalty for holding other currencies (including gold) for the foreseeable future.

Longer term sentiment remains strongly negative, but short term the currency is once again in oversold territory.

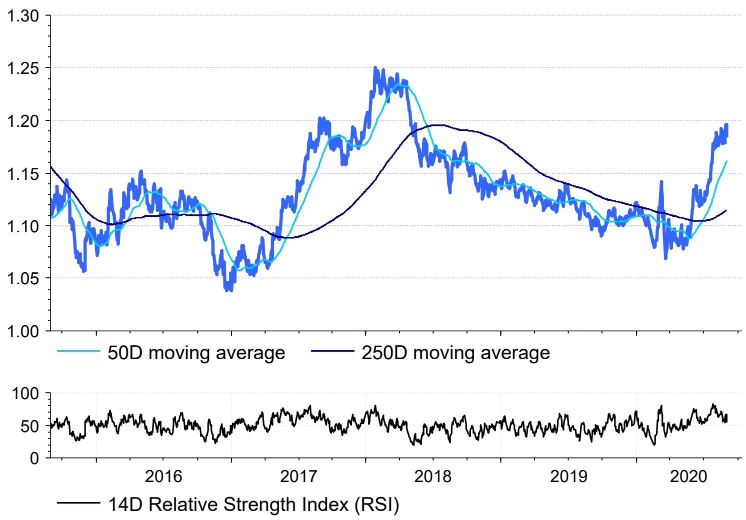
The outlook remains NEUTRAL short term, but with downside risk longer term.

Dollar Index



Source: Refinitiv Datastream/ Key Family Partners SA

EUR/USD



Source: Refinitiv Datastream/ Key Family Partners SA

CURRENCY – USD vs DM, EM

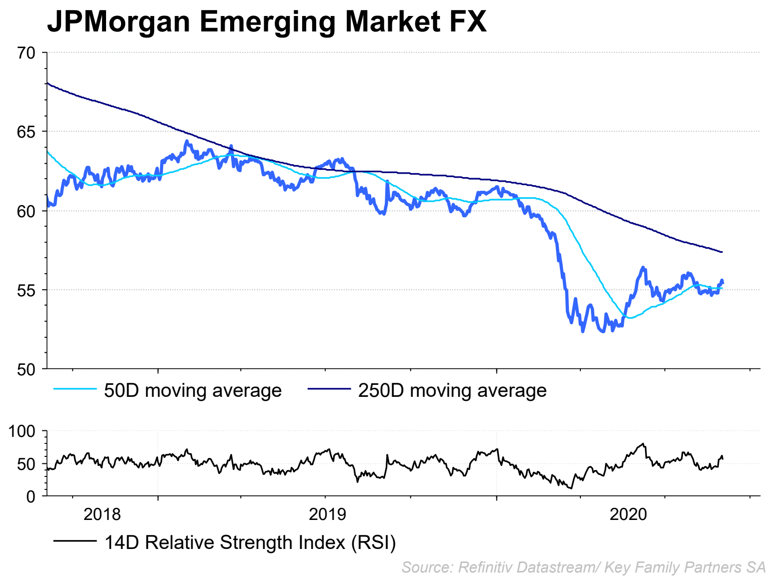
EM currencies vs USD

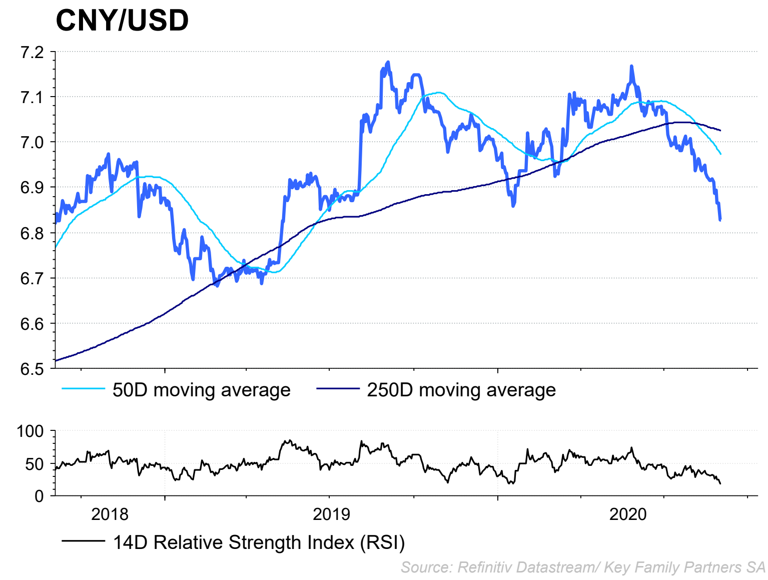
EM currencies were overall flat for the month, but with a wide dispersion of movements amongst different currencies.

The CNY continued its strong run against the USD as currency investors bought the positive yield on Chinese bonds (10 year Gov yield 3.02%). On the other hand, the Turkish Lira lost nearly 5% against the USD on concerns for the economy and currency.

Short term sentiment remains neutral.

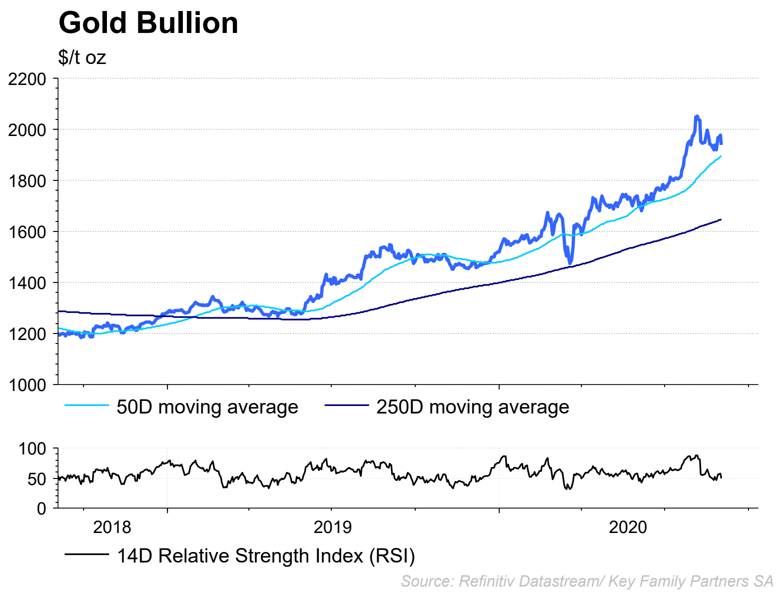
EM currencies outlook remains NEUTRAL with a positive longer term outlook.





GOLD

	1 month	YTD	12 month
Gold	-0.0%	+29.8%	+28.9%



Source: Refinitiv Datastream/ Key Family Partners SA

Gold continued its rally at the start of the month before pulling back from the extreme overbought position and finishing the month essentially flat.

The Fed's action reinforces the attractiveness of gold as negative real interest rates are like to persist for even longer than previously expected.

Rising inflation risk will also benefit gold as long as the Fed does not have a change of heart and start to raise rates unexpectedly – something they have effectively promised not to do.

The Fed PUT remains alive and well for the gold market.

The outlook remains POSITIVE.

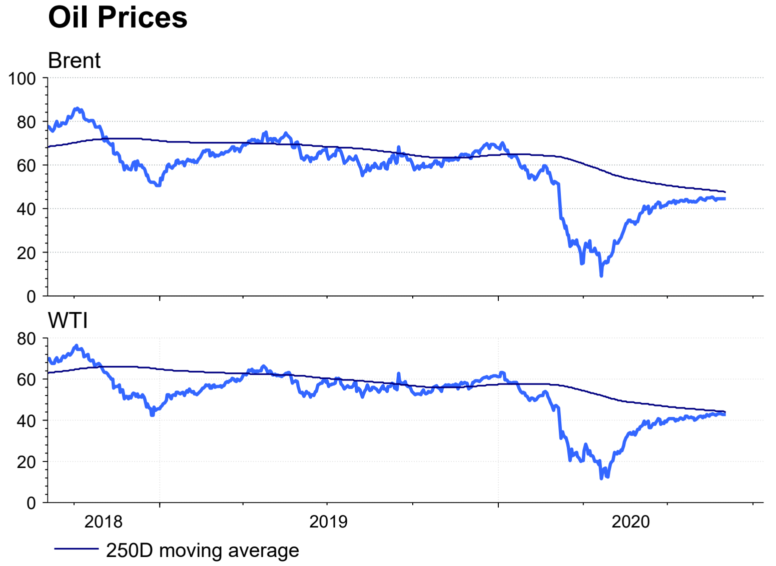
COMMODITIES

OIL

Oil prices continued their slow but steady recovery as economic growth recovers and demand improves. Having said that, the very low volatility levels seen in the past few months suggest a certain amount of price management (by producers?) to ensure prices stay on a rising trend. Producer country budgets have been hard hit by the fall in prices this year.

With Opec+ remaining steady on production cuts, prices are likely to remain steady at around these levels.

The outlook for oil remains NEUTRAL.



Source: Refinitiv Datastream/ Key Family Partners SA

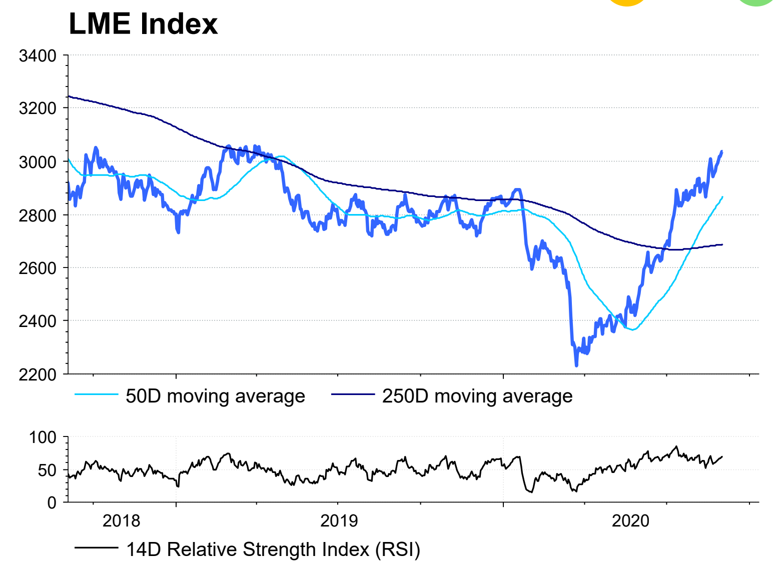
METALS

Metal prices continued their recovery on growing demand, principally from China.

While broadly based across base metals, Zinc was a particularly strong performer as demand for electrification and batteries continues to grow.

Long and short term sentiment remains positive, and with economic recovery in hand, prices should continue to rise.

The outlook remains POSITIVE.



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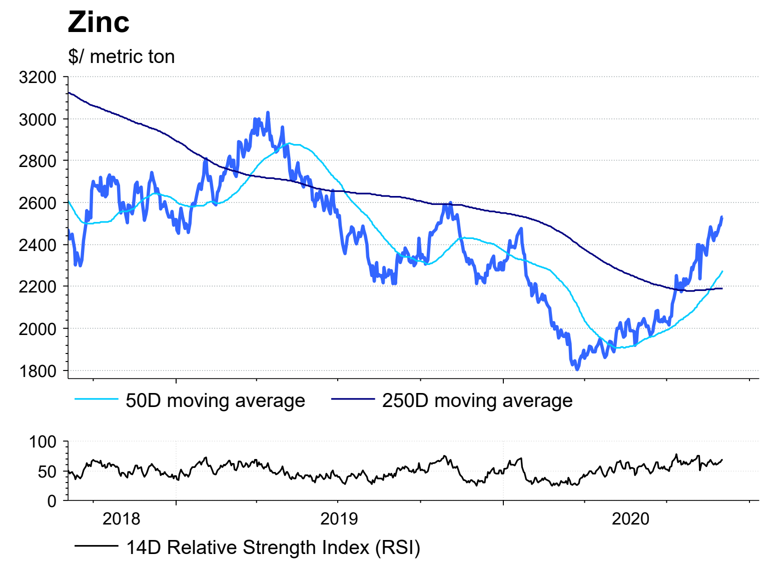

Source: Refinitiv Datastream/ Key Family Partners SA

ILLIQUID ASSETS

Real Estate	●	No change from previous month
Hedge Funds	●	No change from previous month
Private Equity	●	New opportunities for PE investors are likely as the economy slows and credit becomes scarcer. New investments going forward should attract better pricing than seen in the past 2 years.

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