Quarterly investment outlook

The undercurrents of the economy

Q1 2021

mazars

Contents

Foreword

Had you somehow been fortunate enough to have slept through 2020, you would have awoken to find that global equities had risen by nearly 16% during the year and could be forgiven for thinking that the world economy was in rude health. The reality is, as we are all too aware, altogether different with buoyant markets owing their gains mostly to the monetary and fiscal measures put in place to combat the effects of Covid-19, and partly to an optimism that that this year will be far better for businesses than last. A continuation of loose monetary policy also helped provide positive returns for bonds. Gold benefitted from its safe-haven status and a fear of rising inflation to post a 20% return for the year. Commercial property and Oil suffered steep losses as a direct result of lockdown measures.

Beyond the headline numbers there has been a huge dispersion between the returns in different sectors, with those which benefitted from enforced changes in working and social patterns, e.g. technology and online retail, massively outperforming sectors such as travel and energy. These sectoral differences were reflected in geographical returns, as the tech-heavy US market saw significant gains whilst the UK market, with its exposures to banking and energy stocks, was one of the few markets which lost money during the year.

The announcement of successful vaccine trials during November certainly played a large part in reviving stock market optimism, and though we, like most, hold an expectation that economic activity might be less encumbered by restrictions come springtime, we must acknowledge that our short term economic fate depends on the course of the virus. Beyond this, we must then consider what are the lasting socioeconomic effects of the pandemic and whether such an extraordinary episode in our history might be a catalyst for economic restructuring and refocusing, or might we simply return to something resembling the old norms. These questions are not just interesting, they are important for the medium term prospects of sectors and asset classes, and it would not be too surprising to see similar dispersion in investment returns in the years to come, though not necessarily in the same pattern as seen last year.

David Baker
Chief Investment Officer,UK

The undercurrents of 2021

The undercurrents of 2021
Overview

One ought to be very sceptical about the nature of forecasts. Outlooks, as every year, are the order of the day. Yet, looking back, 2020 should remind us exactly the futility of trying to peer into the future. An unpredictable once-in-50-years exogenous event has caused unprecedented global lockdowns and triggered the worst economic downturn since World War II. The Western Hemisphere, especially its large metropolitan areas and business travel hubs, was most affected. Economies that are heavily reliant on the services sector and consumption have been hit the hardest.

Hard as it was to have predicted the pandemic (even if it had always been a case of when, not if) it would be even harder to predict the world's collective reaction. In 1957-58, the influenza pandemic killed between 1-4m people worldwide. The same amount of people died in the 1968 Hong Kong Flu (H3N2) pandemic. At the time of writing Covid-19 is responsible for 1.6m deaths. Yet the world economy had never shut down before in such wholesale fashion. In the past, pandemics were dealt with in secret and governments ordered media blackouts. The 1918 "Spanish Flu" was so called, precisely because European countries were attempting to downplay its relevance. Spain was the only country where the press could report freely. Sad as it is, human lives mattered less in the past to decision makers. A century later, the level of democratisation, the importance of consumerism, social media and instant reporting meant that governments could ill-afford the backlash from inaction. As shutdowns began in China, Western governments had little option but to follow, lest they were accused by their electorates that they did nothing while watching their cash-strapped healthcare systems burdened by, an ageing population, collapse.

Even if we had somehow predicted the once-in-a-generation pandemic and the first "Great Lockdown" in history, it would sound absurd that, in the midst of this dystopia and the glaring absence of global leadership fighting the threat, stock markets would rebound from a 5-standard deviation event within a month. In doing so recovering all their 50%-60% losses and find themselves near all-time highs, even as corporate profits collapsed. Or that bonds would continue to act as safe havens despite soaring deficits and debt levels beyond 100% of GDP for many countries. Or that, despite all of the above, the UK government would still find time to focus on delivering Brexit by the end of the year.

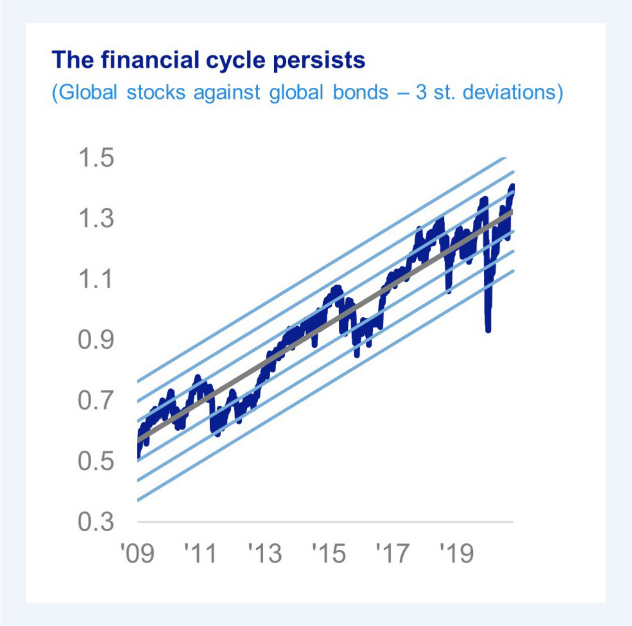


Chart Source: Mazars Calculations, Refinitiv

So how can we propose to "predict" anything in 2021? Yet, "forecasting" is at the heart of what we do. To invest, one needs a view and the more that view is unique, the better the chance of "alpha", outperforming a set benchmark.

The approach we need to take is two-fold. We need to acknowledge that tactical predictions are short-termish, and are more a response to current events. Strategic, long-term predictions, however, are relying on properly identifying the undercurrents in the global economy and financial markets and positioning portfolios around them. So, while Covid-19 was impossible to predict, the idea that central bank support would probably be an engine for rebound for global stocks over the longer term (we did not predict markets would take only a month to rebound) was well communicated throughout March and April.

George Lagarias
Chief Economist, UK

Tactical considerations for 2021

On the surface of things, 2021 will be as unpredictable as any other year in the calendar. While Covid-19 vaccines are now approved, the logistical challenges remain enormous, against a backdrop of mounting economic pressures.

2021 GDP remains, at this point, anyone's guess. After a 4.4% drop in global activity over 2020, the IMF expects a 5.2% rise in 2021, mainly due to resilient emerging markets. Persistent virus waves and failures in the supply of the vaccine could significantly affect headline GDP numbers. Worse, the rebound is set to be as unequal as the downturn, reflecting the local approach taken by many states to defend against the pandemic. Asia and the Emerging Markets seem to be in a better state than the US, which in turn seems to be better off than Europe, which seems slightly better off than the UK. Manufacturing is looking better than services. Some sectors, like retail, are set to rebound, albeit at a slow pace as consumer migration towards non-store (internet) sales continues. Other sectors, such as air travel and hospitality could suffer for a long time.

In the US, a $900b stimulus deal was signed, against a backdrop of record-Covid infections and delays in deploying vaccines. Businesses are shutting down and unemployment pressures are becoming more pronounced. Politics, and thus crucial decisions, are still at the mercy of hyper-partisanship, more than 6 weeks after the US presidential election. Meanwhile in Germany, the change of leadership by April, when Ms. Merkel's successor is expected to be chosen in her party's primary, could fundamentally shift the balance of power in Europe, for better or for worse. Japan could see another change in leadership after the resignation of one of its longer-serving prime ministers.

Overall, a lack of central coordination in dealing with this crisis has left global economies out of sync, a theme we believe will continue well into 2021. This cacophony may prevent companies from effectively managing stocks and cash flows, forcing output gaps to persist and perhaps delaying the repair of supply chains. This macroeconomic volatility has often been the driving force that puts a spotlight on corporate and government long-standing problems.

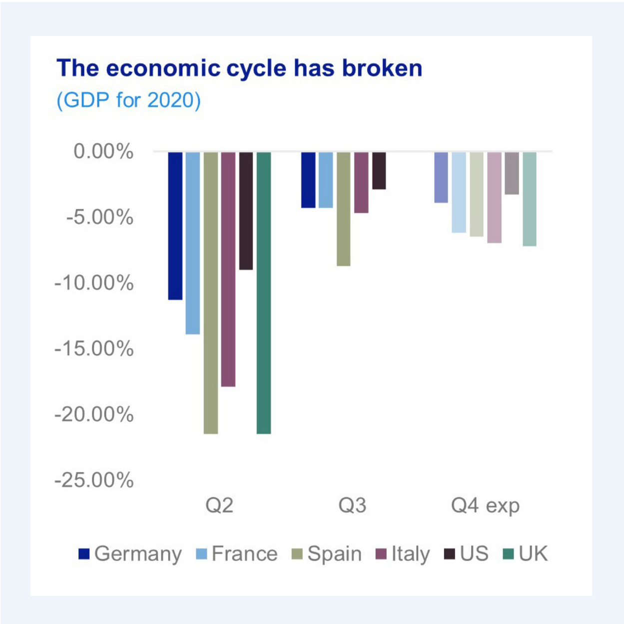


Chart Source: Mazars Calculations, Refinitiv

Strategic considerations for 2021

However, to better understand 2021, one needs to think of it, not in terms of a single calendar year, but rather in terms of one point in a long investment voyage.

The trip so far

It would be deeply offensive to call wars a process of "creative destruction". There's nothing creative about the loss of life. It is a sad fact, however, but a fact nonetheless, that strong spurts of growth and technology were more often than not the consequence of conflict or some other disaster, especially if the struggle involved the most developed economies.

The Black Death (1347-1351) which killed off half of Europe's population, broke feudalism, directly contributing to centralised government, which drew the world out of the Dark Ages and into the Renaissance. Following the South's capitulation in the US civil war in 1865, the US saw the proliferation of railroads, the use of steel, gasoline, oil and kerosene, the invention of electricity, the birth of modern finance and the internal combustion engine, all within a short space of 50 years.

The world's strongest middle class was born shortly after. Following the surrender of Germany in WWII, Europe saw the most expansive rebuild in its history, while advances in medicine and communication improved lives in the western world dramatically. Factory lines that were created to churn out bullets, fighters and destroyers, were subsequently converted to making refrigerators, TVs and plastic dolls for the benefit of the emerging consumer class.

Would the computer have been invented were it not for German U-Boats sinking allied convoys in the Atlantic? Possibly (Turing had published his original paper in 1936), but the technology may not have been available until many years later. Would Alexander Fleming have been focused on discovering bacteria were it not for his experience in St. Mary's Hospital during WWI? The Cold War (1947-1991) was mostly focused on communication technologies used for spying. No wonder then that in 2020 our world is defined by smartphones and the internet.

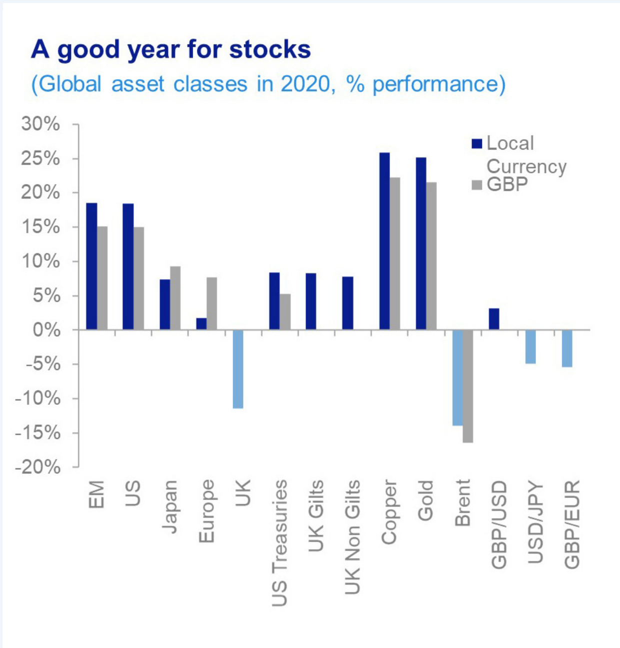


Chart Source: Mazars Calculations, Refinitiv

The undercurrents of 2021
Strategic considerations for 2021

However, the last major Western rebuild ended at the beginning of the 70's. Economic pressures forced Richard Nixon to withdraw the US from the Gold Standard, ushering an era of fiat currencies. From that point, debt substituted war as the driving engine for growth and development.

In the years that led to the 2008 financial crisis, growth was increasingly sluggish, especially in the Western Hemisphere, forcing low rates which eventually fueled house price bubbles which when combined with uncontrolled lending led to the Global Financial Crisis. The economic aftermath of that crisis is still very much with us. Growth remains slow by historical standards, hamstrung by an ageing population, lack of breakthrough technologies and less need for massive infrastructure and rebuilding programs than in the past. Developed economies, which have consistently borrowed to grow, now find themselves saddled with debt. Since 1985, a time when global banks were also unshackled from provisions which limited their lending activities, US government debt-to-GDP rose from a multi-year average of around 40% to 104% by 2010 and to 127% during the Covid-19 crisis. Another sad fact is that debt, even at low rates, is a prime reason for sluggish growth, especially when it is used to provide for an ageing population rather than used towards economic expansion activities. As a result, developed countries, make up more than 56% of Global GDP which were growing at an average pace of around 4% by the end of the 80's, were consistently growing at half that, around 2% per annum by 2019. Meanwhile, China, the world's marginal consumer, which grew at a breakneck pace of over 10% until 2008, saw its expansion rates dwindle to around 6%, as it turned its attention towards fostering its own consumer class.

The confluence of a huge debt overhang, chronically sluggish growth, income stagnation, and compounded consumer trauma following the Lehman Crisis marks the decade up to 2020 as one of the slowest (and longest) expansions in history. During that time, high levels for risk assets were sustained by consistent and often coordinated monetary stimulus from central banks. What was lacking in the equation, economists often noted, was large fiscal spending projects. Very high debt levels made expansive spending decisions politically – and practically – unpalatable.

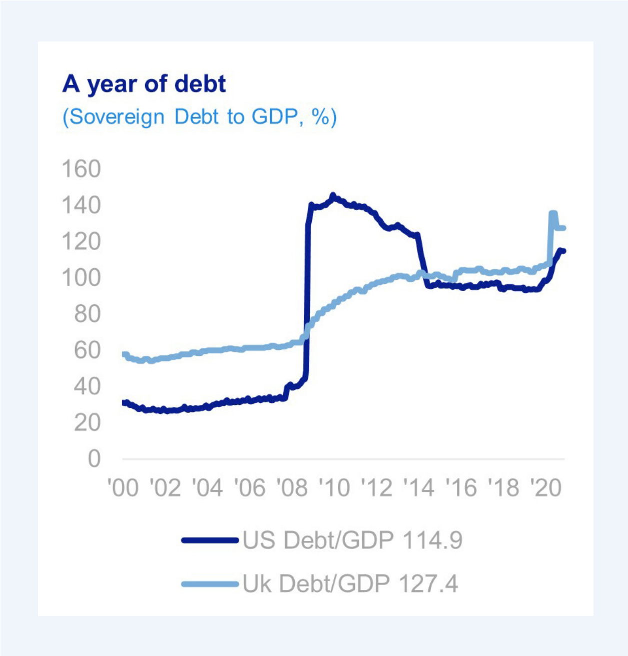


Chart Source: Mazars Calculations, Refinitiv

What lies ahead

As previously mentioned, we expect little change in the trajectory of aggregate economic growth, especially in the developed world.

The same surface

While 2021 aggregate output is expected to see a rebound of 4% (with risks to the downside, as the forecast assumes no further complications with Covid-19), growth after 2022 and 2023 should peter out, as output gaps close.

The exogenous nature of the threat to the global economy, means that once the dust has settled, there maybe be few changes to the way it operates. In other words, a banking crisis may fundamentally change financing and the way companies are run and make money. A virus may not fundamentally change the system. Thus, the same factors which hamstrung growth, ageing population, debt, lack of breakthrough technologies, lack of urgent and material infrastructure demand, will by and large determine output rates going forward.

In this environment, central banks which have underwritten growth and asset prices for a decade are expected to remain the dominant players.

Nevertheless, we also expect that some things will be different. Partly because of the expected demise of Covid-19 and partly because the US will once again feature a multilateralist in the Oval Office. The conflux of these two events was enough to trigger a rally for global stocks, with the MSCI World rising 16.5% (at the time of writing) since the beginning of November, trading at all-time highs.

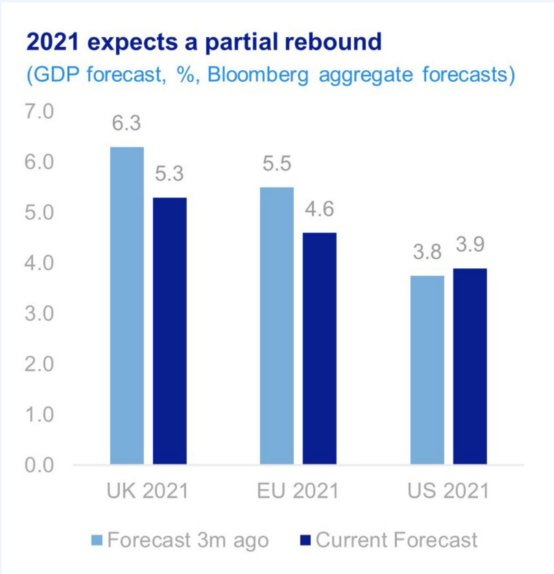


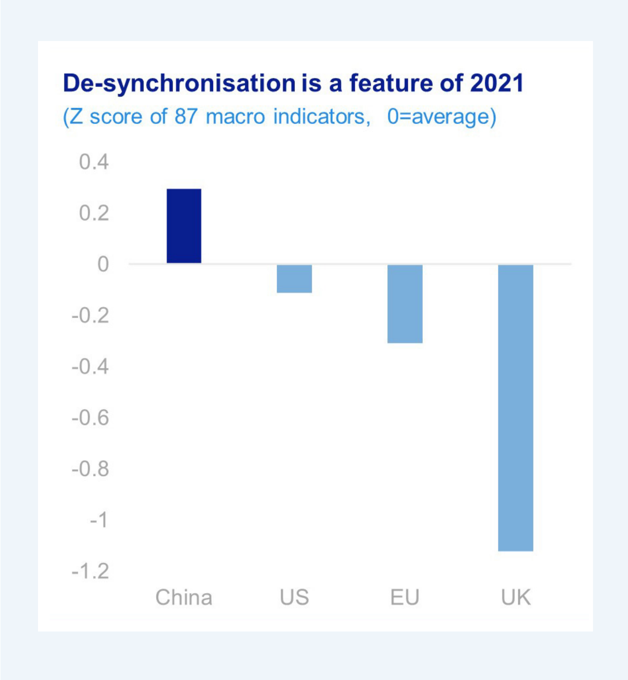
Chart Source: Mazars Calculations, Refinitiv

The undercurrents of 2021
What lies ahead

De-synchronisation

A keyword for 2021 will be "De-synchronisation". We expect the global economic rebound to be long, uneven and at times uncertain. This is partly due to the many disparate and local economic and practical approaches to fighting the virus, partly to the different manifestations of the virus across geographies and partly to long-time pressures against globalisation, especially by the outgoing US administration.

The US-China trade stand-off, which is not expected to just end abruptly with the election of a new president (80% of US voters back a stern approach towards China), will still determine trade flows and influence supply chains and economic balances across the globe. European imbalances and centrifugal forces were only augmented during this crisis and it will take some time before trade flows are normalised. For Britain, there's the added thorn of Brexit. A last-minute Canada-style deal still means a sizeable deviation from the current status quo in ways as yet unknown. We expect that all of these issues will contribute towards an unbalanced global economy and be a force against the swift narrowing of output gaps.



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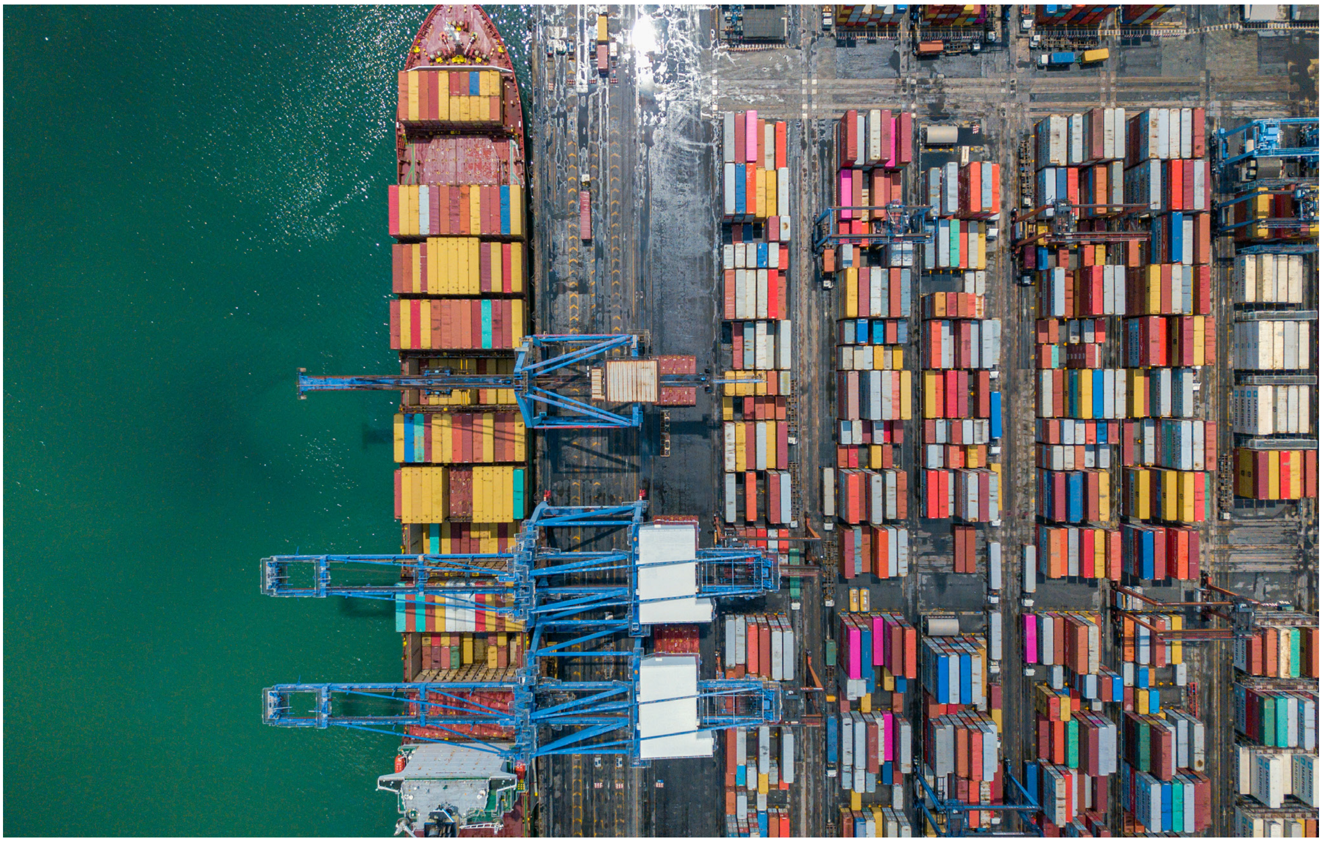


What lies ahead

Some new undercurrents

Fiscal support

In the previous economic cycle, monetary policy was what Mohamed El-Erian called "The Only Game in Town". The primary difference in the coming economic cycle is that fiscal support is very much on the table as another pillar for economic growth. Most countries undertook significant fiscal measures to combat the virus. As of September 2020, G20 Advanced economies were spending up to 9.1% and Emerging economies were spending up to 4.2% of GDP. Overall, measures average up to 6.6% of global GDP. We expect that the crisis response and fiscal recovery will be a marathon, not a sprint. This means that measures will probably be slowly retracted, especially if inflation remains tame and interest rates are kept low. A $900bn fiscal stimulus deal for the US economy is expected to help many companies keep afloat, while also providing a boost for risk assets.

Why is fiscal support important? After all it is still debt. Fiscal support is much more targeted than monetary support. The criticisms against QE, as a mechanism of allocating capital, were widely known before 2019, as a lot of the new capital printed cycled back into risk markets and away from the real economy. In fact, solely QE-driven growth led not only to capital misallocations but also prevented fiscal initiatives, as it was already driving debt up, mostly for the benefit of Wall Street rather than High Street.

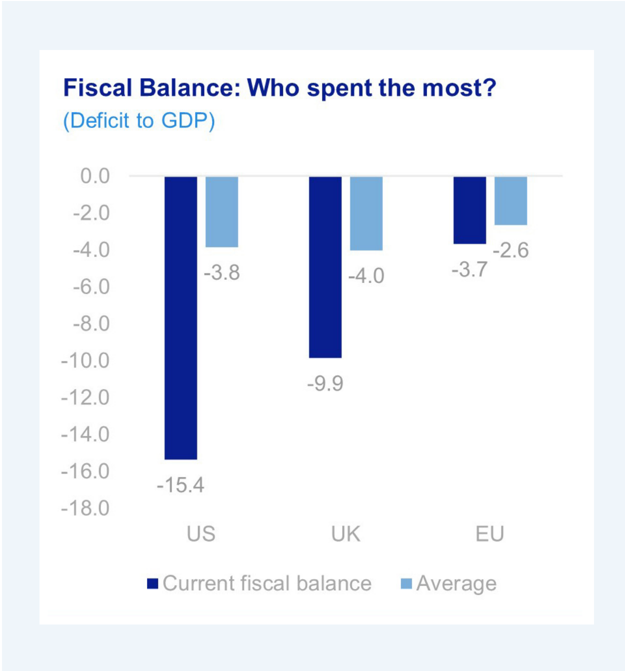


Chart Source: Mazars Calculations, Refinitiv

Some new undercurrents

Green spending

The change in administration for the US, along with more confident fiscal spending from governments, is expected to result in a renewed impetus towards a more "Green" future. The goals of the Paris Accord are still very far away, and governments will need to pick up the pace towards a more emission-free world. In this sense, the environment maybe the first beneficiary from Covid-19's "creative destruction". The OECD has encouraged governments to design recovery packages with decarbonisation objectives in mind.

Tax initiatives may also be a very helpful tool, especially if some areas see higher taxation as a result of widening deficits globally. The UK government for example, has put aside about £3bn in 2020 towards the "Green Industrial Revolution". It is our opinion that the "Green New Deal" can lead to massive infrastructure spending. However, the real change for the environment will probably come from the usual culprit, technology.

The same way the use of gasoline led to the invention of the internal combustion engine, the same way we would expect some new form of energy to become the ultimate driver towards a cleaner future. Along with fusion, investments in "Green" Hydrogen are also picking up pace. Currently the technology is prohibitively expensive. According to the Natural Resources Defence Council, "Green hydrogen is 4 to 6 times more expensive than fossil hydrogen and makes up less 1 percent of U.S. hydrogen production.". The incoming US administration has pledged $1.7tn towards a cleaner environment over the next 10 years, which it expects will leverage $5tn private sector and state and local investments.

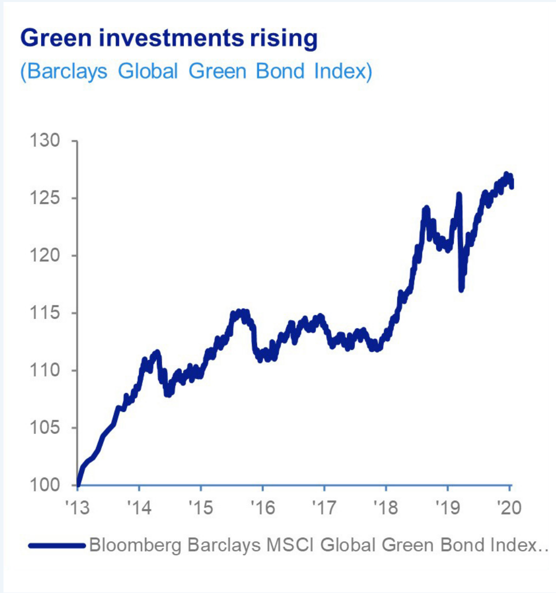


Chart Source: Mazars Calculations, Refinitiv

What lies ahead

Some new undercurrents

Emerging Markets

A key to the recovery will be Emerging Markets who may even turn the crisis to their own advantage. A few years ago, the share of Global GDP for Emerging Economies was less than 35%. Now it is edging closer to 45%, with the lion's share belonging to China (15%) and India following (3%). In terms of supply chains, consumption and aggregate growth, the Emerging Markets increasingly matter. One of the most remarkable features of this crisis was the Chinese economic resilience, a result of both very strict Covid-19 measures and targeted stimulus, the kind a command economy may be able to deliver better than a liberal one. For 2020, the IMF predicted that China's economy –whose data should really be taken with a pinch of salt- managed to grow 1.9% (a decent pace for any western economy on a normal year), and expects a rebound in the order of 8.2% next year. Conversely, India is expected to see a GDP drop of 10.3% in 2020 and an 8% recovery in each of the subsequent two years. Where recovery is faster, it could mean a larger footprint on the global supply chain and more opportunities seized.

Infrastructure spending

Working from home has become a staple for many employees in 2020. Companies, many of who had already instituted "hot desking" as a way of reducing rent expenditures, may seek to further reduce office space in the next few years. Surveys have suggested that more than half of employees would rather work at least part-time from home, when the option is available to them, and commute to the office only when it is necessary. As those who have tried it already found out, development of the internet is crucial for the experiment to work. According to the GSMA (Global System for Mobile communications Association), more than $1.1 trillion (the size of the current US stimulus package) will be spent worldwide between 2020 and 2025 to develop communications, with 80% being spent on 5G. As demand for de-urbanisation grows, we would expect that number to climb.

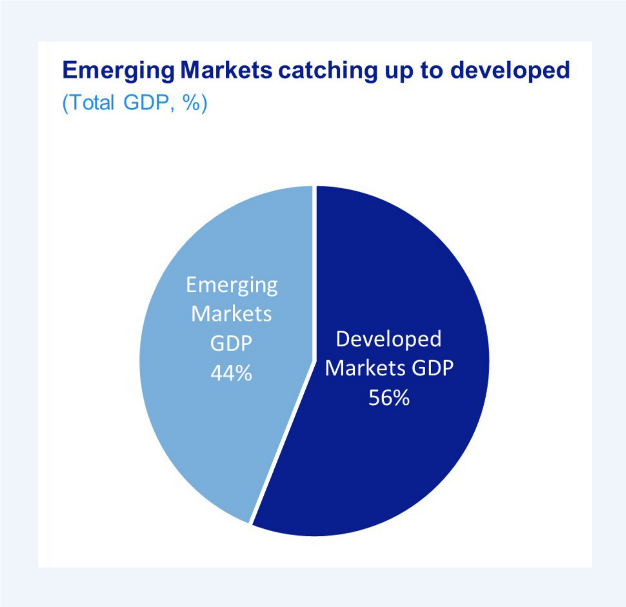


Chart Source: Mazars Calculations, Refinitiv

What lies ahead

Some new undercurrents

De-urbanisation

In theory working from home for certain key industries may mark a momentous shift towards de-urbanisation, challenging a process of moving towards cities which began in 7000BC in southern Anatolia. But we suspect it won't be all plain sailing. The reason people moved to cities was reduced transportation costs for goods, people and ideas. In an era of hyper-communication, people and ideas can be brought together regardless of physical location. If that happens, goods and services should certainly follow. Much as any urban dweller might relish the idea of returning to the country, reversing a 9,000-year-old process on a global scale is no small feat. Infrastructure would have to be rapidly built to accommodate the extra people, from roads and waterworks to elevated electricity consumption and communication towers. Healthcare systems would be pressured. Businesses will need to figure out how to effectively train new employees from a distance. Supply chains would have to be re-designed and may be stretched thin. Residential prices would rise significantly, to the point of eventually curbing the movement. Infrastructure (water, power, internet) may be abundant in larger urban centres, but it can be challenging if large amounts of people decide to settle in the country. The future for office buildings does indeed look bleak, at a time when the future for non-metropolitan area housing and warehousing space looks better. If done in proper doses, de-urbanisation, or rather a reallocation between urban centres, can improve the economy overall, reducing the differences between metropolitan areas across the world and allowing for a more even economic growth. This would still create some disturbances but with potential to create more capital in the future. The question here is, what if people rush to the exit? If they do so, en masse, we would expect to see disruption in services, cost-push inflation pressures and even more spare capacity if the tumult persists.

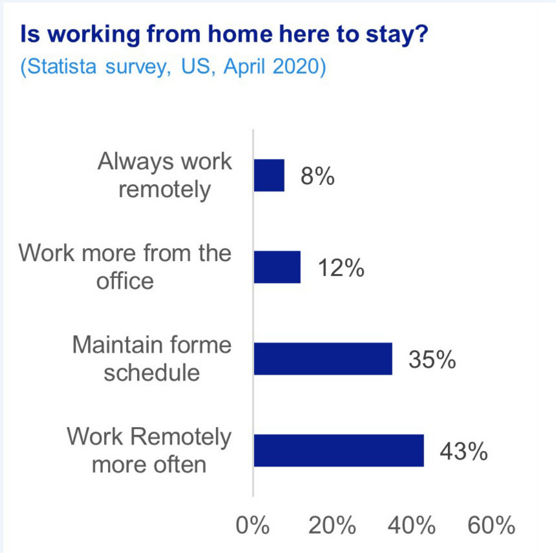


Chart Source: Mazars Calculations, Refinitiv

The risks – Covid-19 recovery

When looking at the major quantifiable and foreseeable risks with regards to the recovery post-Covid-19, we need to acknowledge that the economic and the financial risks are not exactly equivalent. This is because risk assets react immediately on announcement of the level of fiscal and monetary stimulus, whereas the real economy reacts after a considerable amount of time, depending of the success of those measures.

On the financial side of things, what markets really care about is not so much the damage, but the system's ability to pay for it. As long as the monetary and fiscal stimulus remain in place and liquidity is ample, there's always an incentive to buy risk assets even at higher valuations. The real risk is if stimulus, fiscal or monetary, is withdrawn too early.

This of course raises the question of monetarism itself: How much money can we print before the system collapses?

Historically, money printing is not a novel idea, and has always ended up the same way. The Chinese started printing money in the 9th century. Between 1190 and 1240 the supply of money in China increased six-fold, while inflation rose twenty-fold. A century later, they switched to silver until the 20th century. Europe saw its own bouts of money printing in the 18th century, which ended in mass bankruptcies and by the end of the 19th century the Gold Standard was considered so important that when William Jennings Bryan, a populist politician, threatened to reduce the amount of gold in coins, a practice known as bimetallism, his political opponents (which included JP Morgan, Andrew Carnegie and John D. Rockefeller) spent enormous sums of money to ensure his rival, William McKinley, would win the election.

What is different this time is that global GDP has risen so much in the last decades that gold –or indeed any other standard - is too scarce to be a reliable store of value for output. The system's survival is ensured by lack of an alternative.

On the economic side of things, however, the dangers are still many, mostly because of implementation risks.

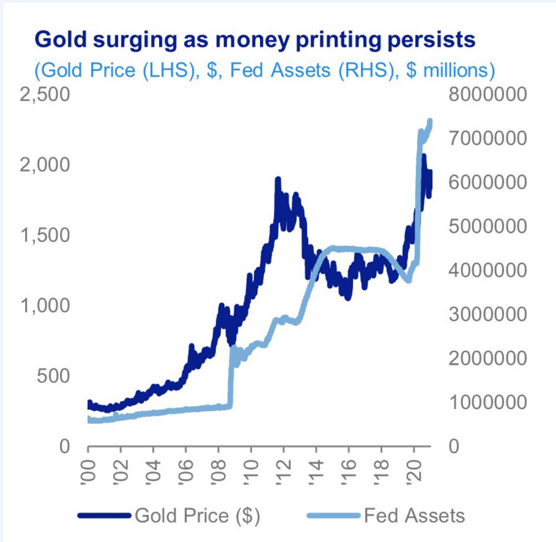


Chart Source: Mazars Calculations, Refinitiv

The risks – Covid-19 recovery

On the economic side of things, however, the dangers are still many, mostly because of implementation risks. To vaccinate at least 60% of the global population needed to eradicate the virus (assuming near 100% protection from the vaccine), it would require a logistical undertaking the size of which the world hasn't been seen before. To go smoothly it would require global coordination, which has not been a feature of this pandemic so far, and we cannot assume it will automatically begin again after January 20th. There are also significant risks from fiscal policy transmission failures. In the US, for example, the Main Street Lending Program (MSLP) has managed to push out only $6 Billion out of $75 Billion appropriated for mid-sized business. The reason being that banks are required to be 5% responsible for the loans they approved. i.e. if they lent $1m to a distressed company, they were liable for $50,000. Main street banks, after a decade of reform and hard oversight measures, maintained tight restrictions, refusing loans to businesses who needed it. This has anecdotally been the case for many smaller companies in Europe and the UK.

The question: Banks

This begs the next question. As central banks can very well still act as a lender of the last resort for banks, is it time to lighten the burden of the post-2008 regulatory restrictions? However criticized, debt remains the lifeblood of the economy, temporarily transferring wealth from idle savers to active entrepreneurs. However, when this debt becomes over extended, it puts the savers at risk. In recent history, liberal reform came along with allowing the banks more leeway into lending. Banks are the ultimate gatekeepers of stimulus. When restrictions are loose, they can create and multiply the stimulus available. This led to the post-1985 two-decade period of global economic expansion. When regulations are tight, they can equally destroy or nullify the effect of capital. The difficulties in transmitting stimulus during the Covid-19 Crisis are certain to be discussed in financial forums over the next few months.

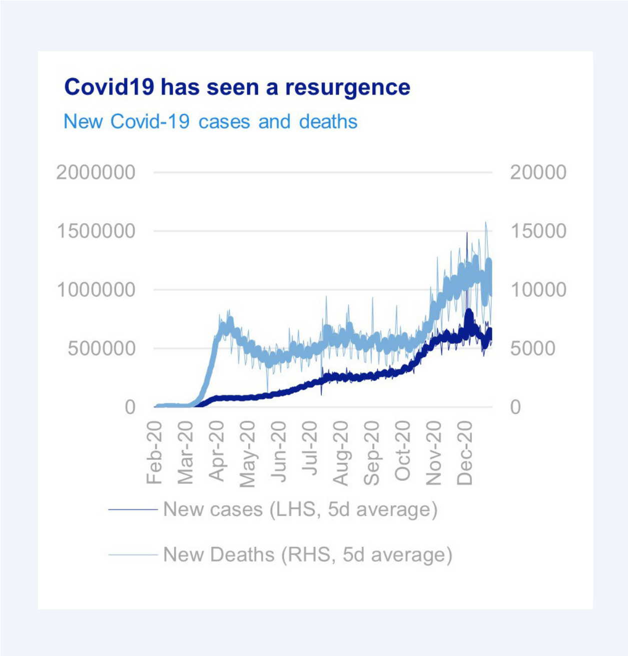


Chart Source: Mazars Calculations, Refinitiv

Conclusion

The conclusion is that the size of the crisis is important only to the extent that we can or cannot afford to pay for it. While the state hasn't been able to keep all companies operating, it has managed to mitigate a lot of the damage, maintaining employment levels (or unemployment benefits) and keeping consumption from falling off a cliff. The way forward will be for the state to slowly withdraw stimulus, as the economy comes back 'online'.
The big question to be answered is: now that fiscal stimulus has finally decided to come to the aid of monetary easing, will this stoke inflation and steepen yield curves? If this happens, capital might start to be allocated more efficiently, fostering growth. If, however, inflation undershoots, a sign that demand will not pick up, then "Japanisation" and "Secular Stagnation" will be the modus operandi for the next decade. If inflation overshoots, it risks an abrupt end to monetary stimulation, which could cause a massive rerating of assets. This has been the major concern of all market participants for more than a decade. As the status quo shifts, getting policy "just right" is of paramount importance for both the financial and the real economy.

The UK economy and Brexit

The UK's growth for 2021 and beyond will largely depend on the realities and shape of Brexit, as well as on the rate at which the economic consequences of Covid-19 are reduced. At the time of writing, and we suspect far beyond that, it is unclear what these consequences will be.

So far, the economic rebound has lagged that of other developed markets, mostly due to the longer initial lockdown and renewed Brexit worries, which might have delayed some post-lockdown reinvestment. The economic recovery lost momentum after summer, just as it happened with economies in the rest of the world. Subsequent lockdowns add to further to pressures and push recovery forecasts out of 2021 and into 2022. According to Markit: "uncertainty about the path to recovery, particularly amid new lockdown measures, meant many firms were fearful that the economy would remain weak". A survey of economists by Bloomberg suggests that the UK is worse positioned in the last few months of the year and for the following recovery. Britain was assumed to return to growth about a quarter later than the rest of the developed markets, the repercussions of a Hard Brexit, many of which are still unknown, are complicating projections.

The service sector is still expanding albeit losing momentum before the new lockdown was announced. The withdrawal of the UK government's Eat Out to Help Out scheme, plus an introduction of some tighter restrictions on activity in September, were the main culprits, as well as the fact that the previous uptick was mostly pent-up demand. Meanwhile, unemployment is meaningfully rising for the first time since 2011. Having said that, the pace of job losses is reducing and the Chancellor's initiative to extend the furlough scheme until the Spring helps keep unemployment pressures at bay. Currently, the OECD projects unemployment peaking around 7%, about half the original projection.

Having said that, unemployment will heavily depend upon the continuation of stimulus, with the Government indicating that it would prefer to err on the side of caution. Causing inflation, most of which is believed to be transitory is preferable to losing growth impetus. Inflation will depend mostly on the relationship of Sterling with other currencies post-Brexit. Our assumption, however, is that it will remain subdued, enough in fact to keep the Bank of England pondering the use of negative interest rates regardless of the fact that futures show 3% inflation in the next five years. Manufacturing is expected to be the steam engine of the economy as various components of the services sector rethink their business methods and objectives following a very tumultuous period. Growth itself will probably undershoot original expectations (which haven't factored in the second lockdown) and may further be temporarily hamstrung by various sectors restructuring as they try to deal with the post-Covid and post-Brexit realities. The housing market has been propped up by government stimulus and we would expect house price growth (currently rising at a 6% pace) to slow down after the stimulus is over. We would also expect to see a reduction in the price of office space as working from home becomes more of the norm (at least for part of the working week) and leases expire. There are positive trends, however, for warehousing and house prices outside the M25.

The UK economy and Brexit

The Brexit deal

In dramatic fashion and featuring a high-stakes political gambit, a Brexit deal was concluded over Christmas, averting some of the worst consequences of a no-deal scenario. According to the Bank of England's early projections, the difference between a rudimentary Canada-style deal, which was ultimately achieved, and a no-deal disruptive Brexit was about 4% in 2016 GDP, or £83b. To put the number in context, at the beginning of 2020 the UK government was expected to borrow £55b and ended up borrowing £394bn to combat the economic effects of Covid-19. Bank of England Governor Andrew Bailey warned that the loss in GDP would top £80billion, or 4% of GDP. Adding another £83b to that bill, a further 4% GDP drop, could be enough to break the economy for years to come.

The BBC summarises the key points of the deal as:

- There will be no taxes on goods (tariffs) or limits on the amount that can be traded (quotas) between the UK and the EU from 1 January
- Some new checks will be introduced at borders, such as safety checks and customs declarations.
- There are some new restrictions on certain UK animal food products.
- Businesses offering services, such as banking, architecture and accounting, will lose their automatic right of access to EU markets and will face some restrictions. A light "Equivalence" regime will replace "passporting" rights.
- There will no longer be automatic recognition of professional qualifications for people such as doctors, chefs and architects.
- UK nationals will need a visa for stays of longer than 90 days in the EU in a 180-day period.
- The UK is no longer subject to the ban on additional roaming charges, although both sides will encourage operators to have "transparent and reasonable rates" for roaming.
- Over the next five-and-a-half years, the UK will gradually gain a greater share of the fish from its own waters.
- The UK could choose to ban EU fishing boats from 2026, but the EU would be allowed to introduce taxes on British fish in response.
- There will be no role in the UK for the European Court of Justice (ECJ), which is the highest court in the EU.
- Disputes that cannot be resolved between the UK and the EU will be referred to an independent tribunal instead. (The ECJ could still have a role in Northern Ireland because it continues to follow some EU trade rules.)
- The UK will no longer have automatic access to key security databases, but should be able to gain access upon request.
- The UK will not be a member of the EU's law enforcement agency, Europol, but it will have a presence at its headquarters.
- The UK is no longer obliged to comply with EU standards of data protection, but data will continue to be exchanged in the same way for at least four months as long as the UK doesn't change its data protection rules.
- The UK will no longer participate in the Erasmus exchange programme, an EU scheme that helps students study in other countries.
- Students at universities in Northern Ireland will continue to participate in Erasmus, as part of an arrangement with the Irish government.

From a purely economic standpoint we would revert to Winston Churchill's famous Dunkirk quote: "we must be very careful not to assign this deliverance the attributes of a victory". This is still a "Hard Brexit", with many unknown variables as to how the complex divorce will work out.

For one, the blueprint of the EU – Canada deal is not necessarily pertinent. The EU accounts for 10% of Canada's exports, comprising mostly of raw materials, and Canada accounts for 2% of the EU's exports. Conversely, the numbers between the EU and the UK are 50% and 10% respectively, a lot of which involve services, signalling a much more complex and interdependent relationship.

The UK economy and Brexit

Secondly, "level playing field" clauses have the potential to disrupt the relationship for many years to come. To successfully compete, the UK may need to break from the current EU status quo, possibly inviting retaliation from the EU, depending on the prevailing political winds. The terms of this "thin" trade deal are relatively dynamic and depend on goodwill from both sides of the table. It would thus be a good time to remember that the 15-year Merkelian stability which has defined the EU may conceivably be coming to an end this year as the iconic Chancellor is set to step down later in the year. Ultimately, a lot will be decided on whether London will be able to keep its primacy as a global financial centre in the coming years, or whether European venues will be able or even willing, to compete successfully. As the "equivalence regime" for the financial sector remains under negotiation, the final shape of the trade deal is still uncertaint.

Third, deals already signed, like the one with Japan, promise third parties a framework similar to the current one.

And fourth, the UK's own internal political backdrop seems to be in flux, after the deal.

Meanwhile the Pound has been relatively steady versus the Euro, suggesting that the "Canada deal" scenario that had been priced in. The Pound's two-year high vs the US Dollar mostly reflects the Greenback's weakness which is trading near a 6-year low vs a basket of trade-weighted currencies.

What does this mean for asset allocation?

With UK stocks remaining at relatively undervalued levels versus their global peers, the deal still has the potential to trigger an upward revision of British risk assets, although we wouldn't be too surprised if investors remained sceptical until dividends return to vogue and until they have gotten a good look at what the post-Brexit environment looks like. Having said that, lack of volatility will allow us to proceed with a planned shift in our strategic allocations, which will see home bias significantly reduced (more on than in the next section).

Chart Source: Mazars Calculations, Refinitiv

Long-term outlook for risk assets

In this environment of consistently sluggish growth, further burdened with output gaps due to global de-synchronisation and flat yield curves resulting from more than a decade of risk suppression, we expect returns of traditional risk assets to be lower than the average assumptions made by a traditional Markowitz-type portfolio. These long-term assumptions were incorporated into the changes we made in terms of our strategic asset allocation.

Equities

We expect global developed equities to deliver 6.5% over the long term, as opposed to 8-9% delivered historically, or the 13% they delivered on average in the years of post-Lehman systematic risk suppression. One reason is high multiples by historical standards. Another is our view that secular stagnation will have a longer term impact on earnings. Of course, we also take the stance that the potency of quantitative easing will eventually diminish, and that central banks will not inflate assets ad infinitum. Additionally, we believe that tech monopolies, which have driven much of the upside, are under threat, and it's difficult to fathom how they can remain intact ("internet explorer had an 95% market share in 2003. After a court forced Microsoft to remove it as a standard feature of Windows, it dropped to today's eventual 6%). A rotation in sector dominance could eventually reduce risk premiums currently enjoyed by tech.

Bonds

Bonds are currently the most difficult asset class in our portfolio, especially government issued, which are the primary driver of yield for all ratings and designations thereafter. At the time of writing, Her Majesty's Government 10-year debt was at a near all-time low, of 0.26% per annum, about 2% below inflation. The US 10-year was at 0.9%, while Germany's entire yield curve (from 1 month to 30 years) had sunk below zero. In fact, near $18tr worth of bonds are yielding negative. Global investment grade bonds yield 0.85% for a seven year duration. All these numbers mean that consistent yield suppression by central banks have resulted to a large part of the bond spectrum having negative real (ex inflation) returns. We expect low bond yields to last, as withdrawal of monetary and fiscal stimulus will be protracted. We expect long term government bond returns to drop from a 5% assumed in traditional portfolios to 0.4% over the longer term. This would mean muted returns for more defensive portfolios, forcing managers to go higher in the risk spectrum or seek yield in less traditional bond classes (like convertibles) or even equities (which in the UK continue to offer a comfortable 3% yield).

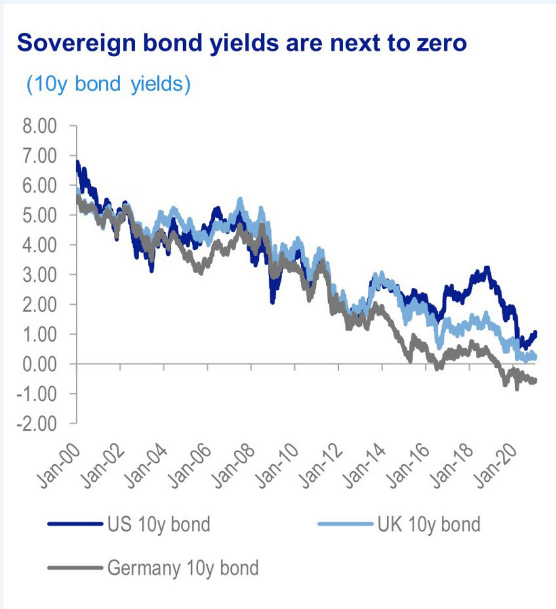


Chart Source: Mazars Calculations, Refinitiv

The undercurrents of 2021
The changes in portfolio

Following a re-evaluation of our long-term asset return and volatility assumptions, the Mazars investment committee has decided to proceed with a number of strategic changes in our portfolios.

In brief the main changes are:

Sales

The reduction of our home bias

We materially reduced our UK equity exposure, to make sure the portfolio better reflects international conditions. US assets have consistently outperformed other assets across the investment spectrum. A more internationally-focused portfolio will ensure a better risk/reward ratio for investors.

Reduction of government debt

High debt levels may ensure low yields for a long time, especially in sovereign debt which is the primary target of central bank buying. As a result of consistent risk suppression by central bankers, negative real rates (yield minus inflation) have become the rule for many parts of popular sovereign curves. We have transitioned to a greater proportion of corporate debt including high yield bonds, keeping in mind however that risk suppression across the board means that volatility could remain subdued for a lot of asset classes previously thought of as “riskier”.

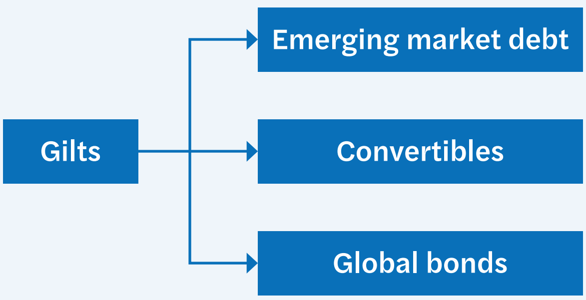
Removal of UK property funds

The move does not reflect our stance on the asset. Whereas we feel that office space will remain challenged for some time, we are not negative on warehousing and industrial related real estate. The move rather reflects a regulatory environment increasingly difficult to navigate and a bad history of exit barriers at times of stress. We feel that a time-honoured lesson for investors is that liquidity should always be placed ahead of any return considerations on the portfolio.

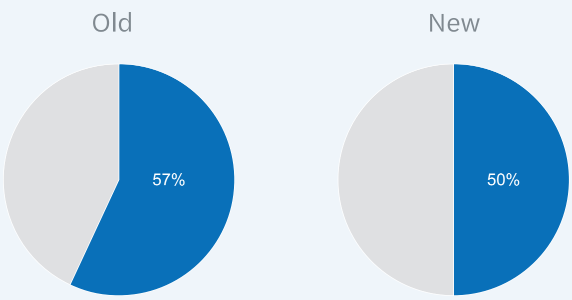
At the same time, we sought to maintain a balance in Sterling exposure, mainly by hedging some of the offshore equities back to Sterling.

Changes to fixed income:

- No gilts
- Majority exposure will now be in investment grade credit



Change in equity exposure



The undercurrents of 2021
The changes in portfolio

Purchases

We increased international exposure through global equity ETFs, which both reduce the cost of maintenance and have asset classes available to cater for our need to hedge to Sterling.

We also increased weight in less traditional areas of fixed income such as emerging market debt and convertible bonds. Convertible bonds often offer the upside of equities and the downside of bonds, while Emerging Market debt has held its own during this crisis and we feel it is a rare bond asset where investors can be rewarded for the risks they are assuming.

Dilution of the home bias

UK equities: 27% → 16.25%

Removing two asset classes from our SAA

Property

Absolute return

Asset allocation

We remain slightly overweight equities and risk, in the belief that even a central bank-guided market can still deliver returns.

In terms of geographical allocation we haven't made large deviations from the new benchmark, and rely more on our fund selection to create alpha. Our underweight in fixed income continues as a result of structurally low yields. In terms of Sterling, we keep close to the benchmark. We maintain a healthy exposure to gold, as the asset class remains uncorrelated with equity markets and would tend to gain in times of aggressive monetary accommodation. We zeroed out the asset class in our portfolios, mostly due to liquidity concerns. In terms of alternatives, we maintain exposure to infrastructure, which we believe might be a beneficiary of increased fiscal spending in the next few years.

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