QUARTERLY INVESTMENT LETTER

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

DECEMBER 2020

2021 INVESTMENT OUTLOOK: DARKEST BEFORE THE DAWN

Executive Summary

2020 was a defining and historic year, characterised by an unprecedented global health crisis and peacetime policy response. We emphasised early on the pitfalls of market timing in a crisis and as a result **most of our multi-asset portfolios ended the year with competitive positive returns**

The contrast between the current economic freeze and future optimism suggests it's darkest before the dawn. There is a realistic prospect of the pandemic improving over the coming months as the vaccination roll-out accelerates and winter turns to spring in the Northern Hemisphere

Against the backdrop of a meaningful moderation in the pandemic and reduced geopolitical risks, **we identify three key drivers for markets and our investment strategy in 2021**:

- **Risk assets will remain well supported** by a favourable mix of economic recovery and expansionary monetary and fiscal policy

- The equity market dominance of 'pandemic beneficiaries', such as mega-cap technology stocks, will subside as **the recovery broadens and new leaders emerge**

- **Environmental, Social and Governance (ESG) factors will be emphasised** as drivers of core capital allocation

2020 reminded us all of the future's unpredictability. There are multiple risks that we can identify and evaluate investment strategy against, in particular:

- **The potential for the pandemic to persist for longer than expected** despite vaccines and other treatments

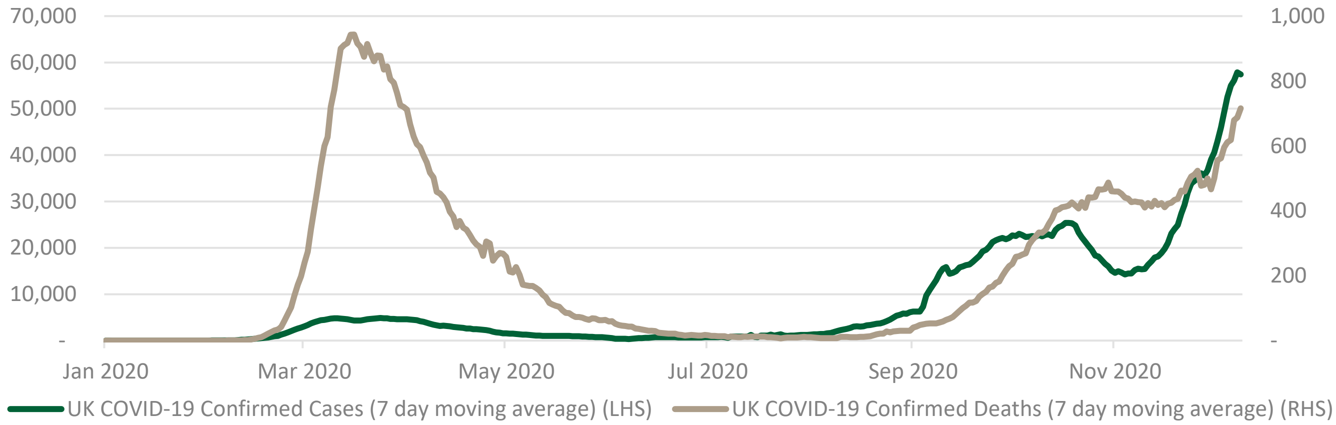
- **How quickly the global economy can rebound** should unemployment benefits be rolled back too soon

Above all, we look forward to meeting with you once again in 2021.

Introduction

2020 was a defining and historic year, characterised by an unprecedented global health crisis and peacetime policy response. At the time of writing in early January 2021 the pandemic continues to wreak havoc across the world. In the UK, a new virus mutation is driving a sharp acceleration in infections (*see chart 1*). This variant, and another more infectious mutation in South Africa, has already spread to other regions. Many developed countries are again in national lockdown, subjecting millions of people to tough restrictions on their daily life (*see chart 2*).

Chart 1: COVID-19 has accelerated sharply in the UK

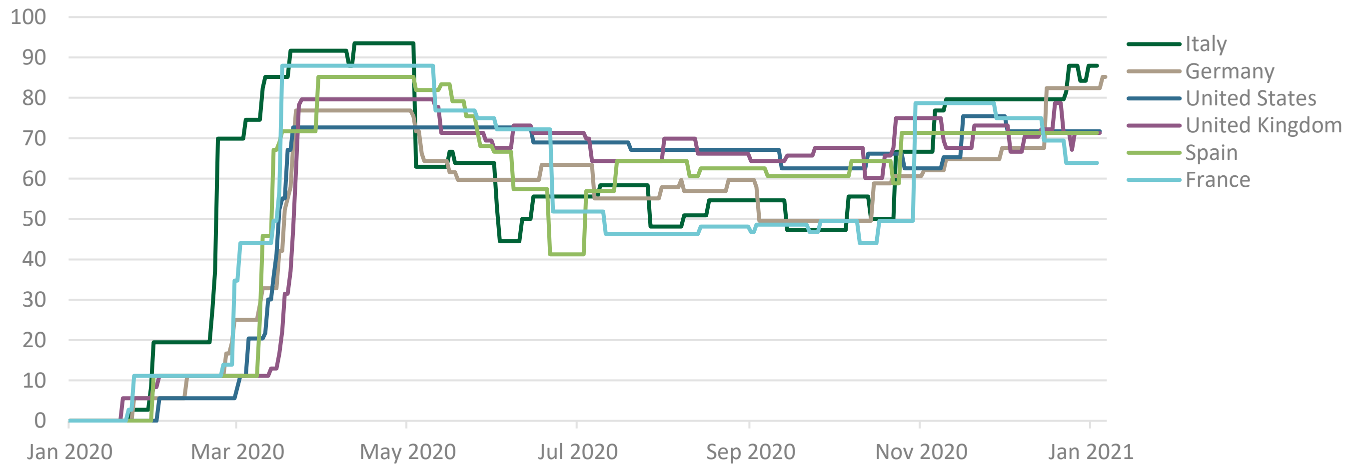


Source: Bloomberg, John Hopkins University, 8th January 2021

Chart 2: Government restrictions are now as severe as in April 2020

COVID-19: Government Response Stringency Index

This is a composite measure based on nine response indicators including school closures, workplace closures, and travel bans, rescaled to a value from 0 to 100 (100 = strictest). If policies vary at the subnational level, the index is shown as the response level of the strictest sub-region



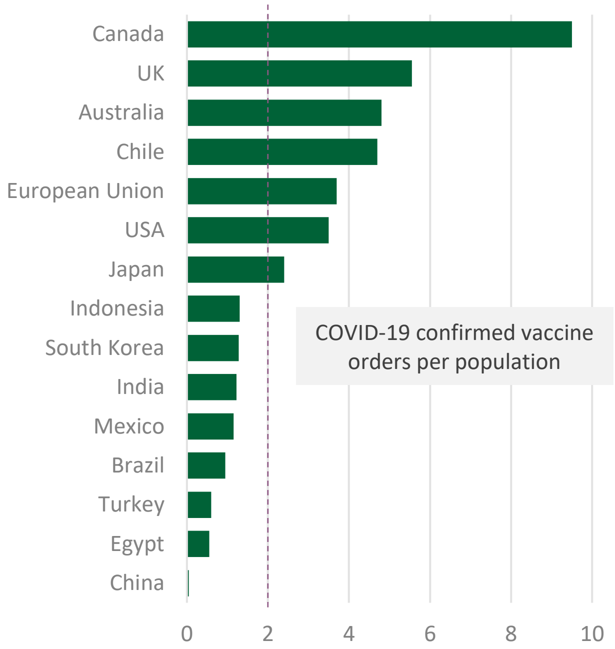
Source: Ourworldindata.org/coronavirus, Oxford COVID-19 Government Response Tracker, 4th January 2021.

The title of our outlook, 'Darkest Before the Dawn', reflects the contrast between the current economic freeze and a future optimism.

Whilst the daily news flow concentrates on the dire reality of this health crisis, there remains a realistic prospect of a meaningful moderation in the pandemic over the coming months.

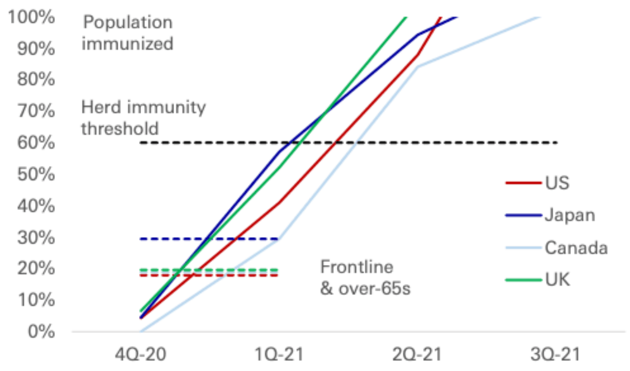
Already, c. 25 million people have been vaccinated across the world, with the UK accounting for c. 2 million people. This is a small number in the context of the global population, however most of the developed world have ordered sufficient doses to vaccinate their entire populations by the middle of the year (*see chart 3*). Furthermore, considering the high efficacy rate of approved vaccines and progress on treatment protocols, infections and hospitalisations should fall sharply by the second quarter as the ultimate goal of 'herd immunity' is reached (*see chart 4*). Capital markets, which should price in the future rather than present day, continue to recognise the high probability of recovery during the first half of the year, and have started 2021 on the front foot.

Chart 3: The Great Vaccine Roll-out



Source: BCA Research, Duke Global Health Innovation Center, (2020). Vertical line represents orders required to immunise entire population (i.e. two doses per person).

Chart 4: The Path to Herd Immunity



Source: Deutsche Bank, Haver Analytics, World Bank, December 2020.

Events of the past three months have been particularly critical in shaping our outlook for the coming year. In addition to the efficacy results of three major vaccination programmes, the outcome of the US Presidential election drove markets sharply higher in November and set the stage for a new market phase.

Despite unprecedented denial of the outcome by the incumbent, resulting in extraordinary scenes of violence at the US Capitol, the next four years are set to be governed by President-Elect Joe Biden. With over 40 years of experience as a US Senator, followed by 8 years as Vice-President, Biden reflects a return to more familiar ground.

The recent run-off in Georgia has confirmed a 'blue-sweep' of Democratic control across both Houses of Congress – an outcome considered improbable at the time of the Presidential election. However, the wafer thin majority held by the Democrats is likely to constrain sweeping reform. Higher taxes may be back on the agenda, but so are larger fiscal support packages that should be quicker to move through the legislative process.

Market participants, who anticipate relatively stable business conditions and a reduction in geopolitical friction, continue to take the outcome positively.

In the UK, driven by a strong preference to avoid the associated costs of a 'no-deal' Brexit on both sides, a free trade agreement was struck in late December. This removes significant uncertainty for many UK and EU businesses. The threat of a cliff-edge exit from the EU is now behind us. Much like the geopolitical shift in the US, this bodes well for risk appetite.

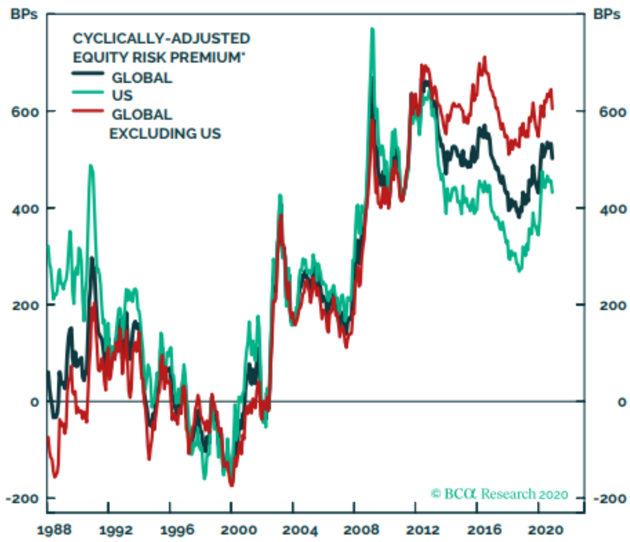
2021 and Beyond

Against the backdrop of a meaningful moderation in the pandemic and reduced geopolitical risk, we identify three key drivers for markets and our investment strategy in 2021.

1. **Following a surprisingly sharp recovery from the 2020 lows, we expect risk assets to remain well supported by a favourable mix of economic recovery and expansionary monetary and fiscal policy.**

This does not mean that the almost uninterrupted uptrend in equities since March last year will continue throughout 2021. Indeed, with the global economy still held to ransom by the virus resurgence, higher volatility will come as no surprise. However, for long-term investors focused on growing real capital over time, equities hold an important advantage. Valuations may be elevated relative to history, but traditional alternatives for generating income and capital growth are very scarce. The pandemic, and associated monetary stimulus packages, have flattened long dated bond yields to near zero and left the global equity market with few realistic competitors for capital. A simple comparison of the earnings yield available in equity markets, and the yield to maturity available in sovereign bond markets, illustrates the point (*see chart 5*).

Chart 5: Risk premium favours equities over bonds



Source: BCA Research, December 2020. *Cyclically - adjusted earnings yield minus real 10-year government bond yield. Bond yield deflated using headline consumer prices and 10-year CPI swaps.

History tells us that it is rare for bonds to outperform equities over the long term, and as capital markets enter a new cycle with such paltry bonds yields, we see little reason to expect a different outcome in the future. On this basis, short-term volatility may present good entry points for capital deployment

2. **The equity market dominance of 'pandemic beneficiaries', such as mega-cap technology stocks, will subside as the recovery broadens and new leaders emerge**

For global investors this presents opportunities to recycle capital across regions and industries whilst retaining a prudently balanced portfolio. Whilst the coming year is laden with uncertainties, particularly with respect to how quickly the recovery can take shape, we have the most confidence that we are now passing through the worst of the health crisis.

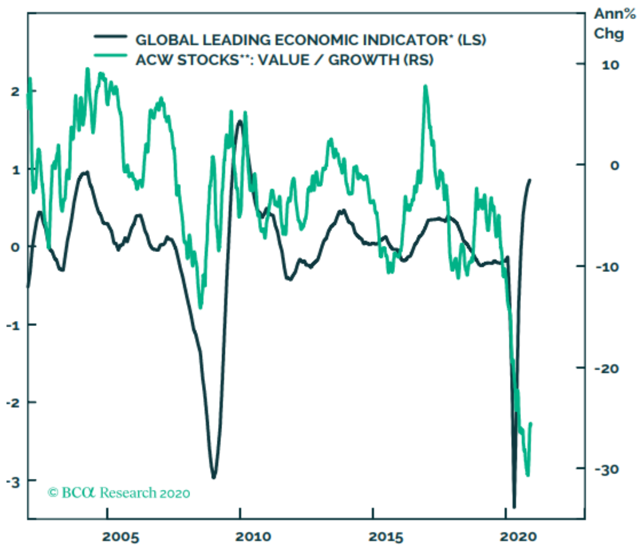
We therefore have conviction in key investment drivers that will govern capital allocation for 2021.

> We expect economic activity to improve, government bond yields to stop falling and market leadership to rotate away from the winners of the past 12 months.

Certainly, it remains the case that industry disrupters such as Facebook, Amazon, Apple and Netflix hold strong competitive advantages and can continue to compound earnings at an attractive pace. Several of our favoured active managers retain allocations to these companies.

However, we also see opportunities outside the US market, where parts of Europe, Asia and the emerging world can benefit from a rebound in capital flows. Within regional markets, an end to the persistent flattening in bond yields also has the potential to remove an important headwind for 'value' stocks, which are often highly sensitive to the economic cycle. Such market rotation is common in the early stages of a new economic cycle, when growth is recovering sharply (*see chart 6*).

Chart 6: A global economic recovery favours value



Source: BCA Research, December 2020. * Based on the deviation from economic growth trend for 23 countries. Past performance is not a guide to future returns. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.

Whilst we already allocate to different regions and styles in favour of a prudent balance, our approach supports 'tilting' towards those areas with the most attractive prospects. In this context, we expect to emphasise such themes in the coming period.

3. **Environmental, Social and Governance (ESG) factors will be emphasised as drivers of core capital allocation.**

As investment themes, ESG and sustainability have been growing in prominence in recent years, as investors reflect their personal values. However, in 2021 we expect to see this theme embedded across the investment landscape. Corporate reporting on sustainability is now the norm. The 2020 KPMG Survey of Sustainability Reporting found almost all (96%) of the world's largest 250 companies report on their sustainability performance. For the 5,200 companies comprising the largest 100 firms in 52 countries, 80% do so.

This broad availability of sustainability metrics enables investors to reward 'good behaviour' accordingly. Almost all the active managers in our core discretionary portfolios are signatories of the UN Principles of Responsible Investment, in addition to incorporating ESG factors into their stock selection process. It is a key part of our research and due diligence process into underlying managers.

As the definition of a 'quality' company evolves to reflect a sustainable and responsible business model, as well as a strong balance sheet and steady cash flow stream, we expect this trend to continue. Our Global Sustainable Investment Portfolio (GSIP) represents the fullest expression of sustainability in our investment offering, which has now built over a year of strong performance track record

What could possibly go wrong?

2020 reminded us all of the future's unpredictability. Events in Washington during the first week of January has been another unforeseeable twist.

> Looking forward, ever present 'unknown unknowns' justify the existence of diversifying assets in our otherwise 'growth-focused' portfolios.

The addition of physical gold to our portfolios last year is a good example. We retain conviction in the precious metal not just as a hedge against market turbulence and unexpected inflation, but also as a source of uncorrelated positive return over time.

However, there are multiple risks that we can identify and evaluate investment strategy against. The potential for the pandemic to persist for longer than hoped for is, of course, critical to the economic recovery. Whilst it is a small risk, approved vaccines may not prove sufficiently effective in protecting against current or future mutations of COVID-19.

Furthermore, the logistical challenges of immunising billions of citizens globally, in addition to concerns around broad adoption, are vast. The developed world's vaccination timetable may prove too ambitious.

Nevertheless, we believe it is only a matter of time before these logistical challenges are overcome, and we will continue to be informed by the scientific evidence on vaccination efficacy.

Even once the threat of the virus dissipates, the speed of the recovery is also uncertain. The ‘Great Disconnect’ between Wall Street and Main Street is not a new concept. We often witness periods of strong equity returns despite subdued economic growth, as was the case following the financial crisis of 2008-09. However, this divergence has rarely been as extreme as today. Capital markets have surged, while the economy has contracted significantly.

The explanation for this extreme situation is the exogenous nature of the economic collapse. It is the consequence of a health-crisis, which is expected to abate in the coming months and open the door to a swift recovery. However, the great unknown is whether consumers will take longer to ‘feel safe’, and for animal spirits to return. Many have relied on unemployment benefits and furlough schemes to replace lost employment income. As governments across the world contend with ballooning public debt burdens, these packages will be rolled back in tandem with COVID-19 restrictions, and suitable job openings may remain scarce.

> The post-COVID world will look different, and close monitoring of economic and industry developments will be critical to how our portfolios are positioned.

Summary

2020 was a year like no other, and whilst the start of 2021 has offered little immediate respite to the reality of this pandemic, we remain focused on the path ahead. Most of our multi-asset portfolios ended the year with competitive positive returns, benefiting from a strong recovery during the past nine months. We emphasised early on the pitfalls of market timing in a crisis, arguing in our first letter of the year that “selling during a crisis can be beneficial in the short term, but often leads to adding back to risk-assets at a higher level when the outlook has improved.” This discipline served us well last year, and is one we continue to embed in our approach.

Above all, we look forward to meeting with you once again in 2021.

SFIM Investment Committee
January 2021

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