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Q1 | 2021

INVESTMENT OUTLOOK

SUMMARY

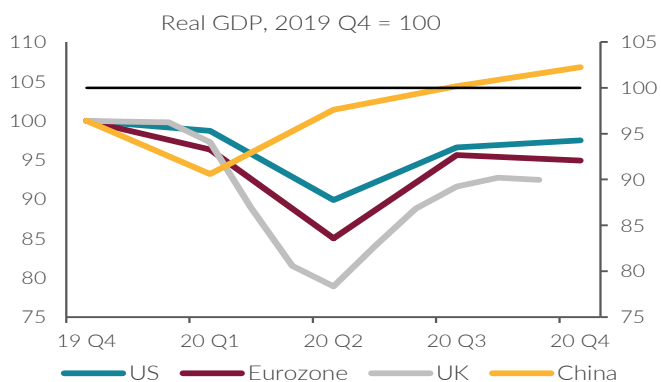
- The economic recovery has faltered in Europe and the UK due to renewed lockdowns
- However, the vaccine roll-out should fuel a strong global rebound from the second quarter
- Inflation should pick up but only slowly and looks unlikely to increase much above 2%
- No increase in interest rates looks likely for at least the next couple of years
- The outlook for fixed income is poor, with yields very low and likely to trend upwards
- Equity valuations are high, although the forthcoming rebound in growth means equities still have further upside
- Return prospects look significantly better for equities than for bonds and we have a moderate pro-risk/pro-equity stance
- Within equities, we are positive on Asia and a variety of specific themes

ECONOMIC AND MARKET OUTLOOK

The global economic recovery has, as anticipated, slowed significantly in the last few months, following the sharp rebound seen in the third quarter last year. However, the extent of the slowdown has varied considerably between the major regions.

The eurozone saw GDP contract in the fourth quarter and the UK looks set to see a fall in the current quarter. The reason, of course, is lockdowns, triggered by the worse-than-expected second surge in Covid infections. Still, these declines in activity are much smaller than those seen last spring as economies are better prepared, with more sectors remaining open.

The economic recovery has faltered in the UK and Eurozone



Source: Refinitiv

The US economy has proved rather more resilient and will also now have the benefit of a major fiscal boost. A stimulus package worth some \$900bn or 4.5% of GDP was agreed at the end of last year and President Biden is now trying to implement an additional package – but twice as large!

Following their wins in January in the two Senate seats in Georgia, the Democrats now have an effective majority in Congress overall. While this will make it possible to carry out rather more of their policy agenda, they will still be limited in what they can implement by their wafer-thin advantage and a hostile Republican party. We also expect that the new proposed fiscal boost will be reduced in size.

China has fared relatively well as a result of its success in containing the virus, with the economy already all but back to normal. Unlike all the other major economies, which saw significant falls in GDP last year, China saw positive growth of 2.3%.

Looking forward, the prospect is for a burst of strong global growth starting in the second quarter. The key here is a rapid roll-out of vaccines. The roll-out is proceeding well in the UK and should gather pace in the US, with the increased push from the new Administration. In both countries, 50% of the population could well be vaccinated by the summer. The roll-out in the EU, by contrast, has been dogged by problems and looks set to lag by a couple of months or more.

There are a rising number of vaccines which are reasonably effective against the virus and its latest variants. Some of these do not need storing at super-low temperatures and one requires just a single dose. This is encouraging and means a major relaxation of social distancing measures is likely to be underway by mid-year. This, in turn, should fuel a burst of pent-up demand, financed in part by a rundown of the high levels of household savings built up during the past year.

While a successful vaccine roll-out is crucial for the recovery, continued policy support from the authorities is also essential. Fiscal policy will remain supportive, particularly in the US but also in the EU where the €750bn recovery plan should start to be implemented.

Meanwhile, central banks will continue to do what they can, though, if truth be told, they are now largely out of ammunition. Crucially, they seem acutely aware of the danger of withdrawing support too soon.

There are no rate hikes on the cards anywhere for at least a couple of years and quantitative easing programmes are unlikely to start to be scaled back before next year.

A strong rebound in growth starting in the second quarter is very much our base case and what the equity market is pinning its hopes on. But it is not yet a done deal, with shortfalls in vaccine supply and the need to tweak the vaccines to contain new virus variants both posing potential risks.

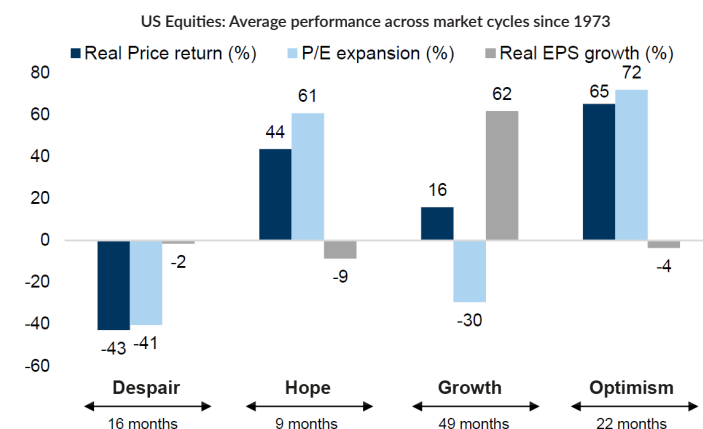
The outlook for growth is currently the main focus of markets but inflation is set to become more important. For the moment, inflation remains subdued and significantly below the 2% targets of the principal central banks. But, in the months to come, we are likely to see the rebound in oil prices from their collapse a year ago drive headline inflation above 2%.

This rise should be only temporary with core inflation remaining subdued. Nonetheless, it may increase nervousness that it heralds a more prolonged upturn down the road on the back of the massive monetary and fiscal stimulus.

We believe underlying inflation pressure will rise but only slowly, with core inflation unlikely to pick up much above 2% over the next couple of years. A surge in money growth and also physical demand later this year will be inflationary. But slack in the economies, along with forces such as innovation and the shift to online retail, will be exerting downward pressure.

The rebound in equity markets from the lows last March has matched the size and speed of the recovery from the global financial crisis. Global equities are now up some 70% from their lows. The rebound was driven in its initial 'hope' stage by the massive policy stimulus, and followed the usual pattern seen after a bear market. Sharp gains in prices reflected a large re-rating of valuations which far outweighed continued falls in corporate earnings.

We are now in the second stage of the equity bull market



Source: Goldman Sachs

Since the autumn, however, we have moved into the second 'growth' phase of the equity bull market. This typically lasts for a number of years rather than a number of months, and sees a much slower pace of price appreciation. Earnings gains are the primary driver with valuations coming under some downward pressure.

This time, the growth phase is off to a strong start, with markets buoyed by two key developments. First, the news in early November that vaccines had been developed with an unexpectedly high efficacy led to hopes of a return towards normality by the summer. Second, Biden's victory, along with the Democrats gaining control of Congress, fuelled hopes of a major fiscal stimulus in the US.

The positive market mood has been reinforced by earnings beating expectations substantially in the third quarter and in the fourth quarter reporting season currently underway.

Indeed, there is growing talk of a bubble, with the likes of Tesla up 900% since early last year and wild swings in some much smaller stocks, most notably GameStock.

While there are pockets of the market where conditions are undoubtedly frothy, **we do not believe equity valuations overall are excessive**. Although the forward-looking price-earnings ratio for global equities is up to around 20x, a twenty-year high, equities still look reasonably valued relative to bonds, where yields remain very low.

A strong rebound in earnings later this year means **equities still have further upside during 2021**, even if excessively optimistic sentiment leaves them at some risk of a near-term correction. **Prospective returns for bonds, by contrast, look very limited**.

Government bond yields have trended slowly higher from their lows last summer and should continue to do so as growth and inflation pick up. Even if, as we expect, the rise is limited with central banks not planning to scale back their buying any time soon, this still leaves government bonds set to produce negative returns.

As for developed-market investment-grade corporate bonds, they are somewhat better placed, but prospective returns still look likely to be no more than 1.5-2% or so. Spreads over government bonds are back down to their pre-Covid levels and close to their all-time lows, so have minimal room to contract any further.

➤ POSITIONING

We increased our equity exposure following the positive vaccine and US election news and now have a moderate pro-equity stance.

Our equity allocation is a little above the levels we expect to maintain over the long term. In addition, our positioning within equities is tilted towards the more cyclical areas of the market. This stance seems appropriate as we believe equities should outperform bonds significantly, even if the upside is less than it was.

We have turned somewhat more positive on UK equities. The UK is one of the cheapest markets, with a P/E ratio some 25% lower than the rest of the world. It should benefit if, as we expect, the recent rotation away from growth stocks towards value stocks has further to run. So far, UK equities have only clawed back a small part of their marked underperformance over the last few years.

The Brexit deal may be a somewhat bare-bones affair, but it still leaves the UK looking rather more investible. The vaccine roll-out is also proceeding faster than elsewhere. This will enhance the economy's scope to recover relatively quickly from last year's downturn which was particularly severe when compared to other comparable economies.

Within UK equities, we retain a tilt to small and mid-cap stocks. They have now more than recovered their underperformance in last year's sell-off. But their cyclical bias means they should continue to fare relatively well in a period of faster growth later this year. Their domestic focus will also be a help if, as seems quite likely, the pound strengthens a bit further, given its recovery so far has been limited.

We remain cautious on US equities, which have started to underperform in the last few months. The relative valuation of the US market is not as extreme as it was, but its P/E ratio is still some 35% above the rest of the world.

US equities benefited last year from their large exposure to the technology sector which has been the clear winner from Covid. However, this year, the rebound in global growth should fuel a move away from last year's winners towards former laggards, namely cheaper and more cyclical sectors and markets. The US typically underperforms in such an environment.

The US tech giants also face a regulatory and tax crackdown both in the US and Europe. With their valuations now on the high side, they could give back some of their sharp outperformance. We remain positive on the wider tech sector longer term because of the growth story, which looks as strong as ever. But this coming year, tech is unlikely to deliver the returns we have become accustomed to in recent years.

We continue to favour Asia and emerging markets, particularly China to which we have now made a specific allocation. China now accounts for around 40% of these regional indices but is still very under-represented in the global indices, relative to the size of its economy.

China survived Covid well and growth looks set to remain higher than in most other economies. Chinese equities have outperformed significantly but, along with Asia and emerging markets more generally, still trades at a significant discount to developed markets.

We are broadly neutral on Japan. Improving corporate governance and relatively cheap valuations remain positives, as does the cyclical bias of the market but the economic rebound looks likely to be muted.

As for Europe, we continue to be cautious. While valuations are on the low side, the delays in the vaccine roll-out and the latest turmoil in Italian politics argue for some caution, as do the underlying structural defects of the eurozone.

We maintain a sizeable exposure to thematic investments and believe the case for allocating to long-term growth themes is all the greater in a post-Covid world. We have had exposures to technology and artificial intelligence for a long while and plan to retain them. Their long-term growth potential warrants this, even if near term they face some performance headwinds, as discussed above.

We also have an allocation to healthcare. Ageing populations and rapid biotech innovation remain long-term attractions as are cheap valuations. Environmental change is another major area of growth, with governments, companies and investors ever more focused on the need to address climate change.

Infrastructure is another theme we favour as it offers enhanced inflation protection and should benefit from increased government spending. Finally, we have an allocation to frontier markets which are now benefiting from cheap valuations and hopes of a global rebound.

We reduced our fixed income exposure to fund our increased equity allocation and increased our underweight. This is warranted, given prospective returns look so limited. The majority of our allocation is to corporate bonds. We only have a relatively small allocation to government bonds, both because of their poor prospective returns and their reduced ability to provide protection in a major risk-off move.

However, we have added an allocation to inflation-linked government bonds in our medium to lower risk portfolios as these portfolios have limited inflation protection and inflation is expected to pick up somewhat.

Lower risk alternatives, which should provide moderate returns regardless of the moves in bonds or equities, **continue to look attractive in the current environment**.

Lastly, **we have an allocation to gold**. The gold price has fallen back somewhat in recent months, following a very strong run. However, it should have further upside in the medium term with rates set to remain low and inflation likely to trend higher.

Rupert Thompson
Chief Investment Officer



	Previous view	Change	Current view	
Lower Volatility Assets				
Cash	●	-	●	Remains unattractive with interest rates so low
Government Bonds	●●	-	●●	Yields to trend higher from very low levels and prospect is for zero/negative returns
Corporate Bonds	●	↓	●	Spreads are very low and prospective returns are limited although higher than for government bonds
Inflation-linked Bonds	●	-	●	Inflation to trend higher and offers some protection for fixed income heavy portfolios
Lower Volatility Alternatives	●●	-	●●	A considerably more attractive source of return and protection than government bonds
Higher Volatility Assets				
Equities	●	↑	●	Strong global economic rebound in prospect from Q2 means equities still have further upside
Higher Volatility Alternatives	●	-	●	Equity exposure with downside protection is appealing given significant risks remain
Property	●●	-	●●	Illiquidity is problematic and Covid represents a big headwind for retail and office space
Gold	●	-	●	Well supported by low rates and is hedge against risk of a major equity sell-off
Equities				
Regions				
UK	●	↑	●	Valuations are cheap and should benefit from a more general rotation away from growth into value
US	●	-	●	Valuations remain high and may suffer from rotation to other cheaper and more cyclical markets
Europe ex UK	●	-	●	Vaccine roll-out is proving problematic and long-term structural problems remain
Japan	●	-	●	Valuations are cheap but economic rebound is expected to be muted
Asia ex Japan	●●	-	●●	China is key attraction as growth set to remain significantly higher than in most other economies
Emerging Markets	●	-	●	Asia is the main attraction as other parts of EM will be held back by limited vaccine availability
Themes				
Global Infrastructure	●	-	●	Offers enhanced inflation protection and a beneficiary of increased government spending
Global Technology & AI	●●	↓	●	Valuations are on high side and may suffer from rotation to value but growth prospects remain strong
Global Healthcare	●●	-	●●	Good growth prospects on back of ageing populations and biotech innovation and valuations are cheap
Frontier Markets	●	-	●	Very cheap valuations are attractive as is structural reform and good demographics
Environmental Change	●●	-	●●	Climate change to remain major growth area and focus for governments, corporates and investors
Small & Mid Cap Stocks	●	-	●	Cyclical bias means scope for further outperformance if global growth picks up strongly in Q2

Our view reflects our assessment of the relative attractiveness of each asset class after taking into account its riskiness/volatility

Change = change in view over the last quarter

● = Positive ● = Negative ● = Neutral

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