February-2021

Review of the financial markets

Equity markets

02-02-2021

The global stock market (euro-denominated MSCI World AC) gained around 14.1% in euro terms over the past six months ending 31 January 2021. Stock markets got off to a good start in January 2020,buoyed up by optimism about the thaw in the trade conflict between China and the US, and the gradual recovery of industry and trade, which had been hit hard by this conflict. In February, the coronavirus started to advance. Initially, this was limited to China and emerging Asia, though fears about the global economic impact of this new strain of coronavirus started to increase. The initial earnings for the year quickly dwindled. Following a brief rally, stock markets fell sharply once again from mid-February as first China and then the rest of the world were hit by the coronavirus crisis. Many countries went into lockdown, leading to a sharp reduction in economic activity. Economic growth figures and earnings forecasts throughout the world were revised sharply downwards. It wasn't until the end of March that stock markets appeared to stabilise somewhat thanks to the major government support packages, coupled with lower key rates and new asset purchase programmes by central banks.

In April, these massive support packages actually sparked off a resurgence, although economic activity remained at a low level due to the many lockdown measures. Markets became more stable after that. Stock markets moved ahead slightly in May and June, too, as the spread of the virus also seemed to be under control in Europe, and the lockdown measures were gradually eased.

The second half of the year got off to a hesitant start. Fears of a sooner-than-expected second wave caused stock markets to falter briefly in July, but they resumed their upward trend in August as the economic recovery appeared to be continuing and corporate results were better than forecast. There was a certain amount of profit-taking in September and especially October, when Covid-19 tightened its grip again. In Europe in particular, the number of infections and hospital admissions increased spectacularly, necessitating new lockdowns. This led to another dip in the economic outlook and confidence, causing stock markets to lose some ground.

The announcement that the vaccine candidates had been very successfully tested sent share prices soaring at the beginning of November. Shares that had suffered amid the Covid-19 crisis and lockdowns posted particularly strong returns,so the stock markets ended the year with wind in their sails.

Over the past six months, clear regional differences have been apparent.
The US recovered well on traditional markets, extending its lead (+12.5% in euro terms) in line with the global average of 14.1%. The euro area lagged far behind, though by November it had jumped up by 13% in the space of six months. The UK lost some ground (+11.7%) amid fears of a hard Brexit, weaker economic conditions and a crippling second wave of Covid-19 there. The eleventh-hour Brexit deal provided some stability.
In Asia, the Hong Kong stock market recovered (+17.3%) from the weakness caused by political as well as economic and financial uncertainty. Japan excelled in the pro-cyclical scenario with a 20% increase. Shares from emerging markets (countries or regions that are expected to experience rapid economic growth to make up their lag with the West) recorded gains of approximately 20.8% in the past six months. Stock markets in Asia recovered quite quickly after having been hit hard by fears about the new coronavirus strain. China gained around 19.4% over the past six months, while India was even up as much as 19.7%.
Latin America lost a lot of ground at the start of the Covid-19 crisis due to the poor performance turned in by Brazil, which was only able to recover some of its heavy losses (+8.9%). The weakest performers were Russia (+6.9%), which suffered from the low price of oil, and Turkey (+13%), though the latter still managed to rebound from a major crash caused by a financial crisis and the fall of its currency.

Sector differences over the past six months are quite pronounced.
Cyclical sectors struggled in the early days of the pandemic, but recovered well thereafter. Consumer Discretionary stocks were hit hard at the start of the crisis (the automotive, luxury goods and tourism industries all took a battering), but recovered by 20% in the second half of the year. The retail sector (including the online segment) held up particularly well initially, but the automotive (+64%) and consumer durables (+30%) industries also made a clear recovery. The other cyclical sectors were also hit hard at the beginning of the crisis, but recovered sharply from the second quarter onwards.
Materials kept the momentum going with a further increase of around 21.4%, and Industrials were also up 20%. Information Technology was able to recover quickly from the coronavirus crisis and continued in the same vain. Information Technology was up 17% compared to six months ago, mainly thanks to its more cyclical components, Technology Hardware and Semiconductors (up 22 and 24%, respectively).
In the IT-related sector, Communication Services (+12%), Telecommunication Services (defensive) remained fairly stable while Media and Entertainment (more IT-focused) gained around 16% over the past six months. Financials underperformed for some time due to fears of recession and low interest rates, but were pushed 18.5 higher by a strong rally in November.
Energy nosedived and barely recouped its losses (+6%). The sector has been in investors' bad books for a while now, taking a severe beating from the slump in oil prices in the wake of falling world demand, combined with the conflict between oil producers. Now that the vaccines are outlining a credible path towards reopening the economy, oil prices are rebounding slightly. However, the rise in oil prices hasn't fully translated into a rebound in the Energy sector.
Given their lower susceptibility to a recession, the defensive sectors performed relatively better in the early stages of the coronavirus crisis, but then ended up lagging somewhat behind the recovery in the summer months and November. Health Care rose by around 4% over six months, clearly underperforming the broad market,though medical technology stocks in the Health Care Equipment and Services industry did better than the Health Care sector as a whole (+8%). Consumer Staples did very well at the beginning of the coronavirus crisis, but has only managed to gain around 5.1% since the end of June. Utilities recorded a similar performance (+3.8%), driven mainly by green energy companies. Real Estate recovered somewhat (up 3.7%), but a sharp price rebound was off the cards, mainly due to falling demand for commercial property.

Bond markets

01-02-2021

The past six months has seen a minor break between the trend of interest rates in Europe and the US. The German 10-year rate fell on the back of slower economic growth caused by new lockdowns in Europe. At approximately -0.5%, the current level remains within the recent band of -0.65% to -0.45%. The extremely accommodating monetary policy pursued by the European Central Bank (ECB) and very weak inflation are keeping interest rates at low levels. The rollout of vaccinations holds out the prospect of economies reopening in the second half of 2021. Riskier bond themes, which have been benefiting from mounting investor confidence, have performed well in recent months. The improved outlook for growth – together with the election of Biden in the US and the prospect of more fiscal stimulus measures – fuelled fears of inflation and pushed US interest rates above 1% in January. Since hitting their low of 0.51% in August, the 10-year rate in the US has now risen to 1.06%.

The ECB has indicated that inflation will increase slowly, but remain (well) below its target level in the years to come. Therefore, the deposit rate of -0.5% will not be raised any time soon and KBC economists are working on the assumption that the first increase won't be before 2024. Moreover, the ECB is providing a stimulus by purchasing bonds in the market,meaning that the monetary tap will remain open for some considerable time to come. The ECB raised its bond-purchasing budget from 1 350 to 1 850 billion euros in December 2020. The decision was also taken to extend the programme by nine months (until March 2022). Investors have confidence in euro-area bonds because they realise that yields will also remain low for a long time yet.

The ECB's flexible monetary policy and the European support plan (Next Generation EU) have underpinned demand for riskier bonds over the past six months. Peripheral countries are again proving popular and risk premiums have narrowed relative to German yields. For example, the 10-year spread for Italian bonds has narrowed from about 1.53% to 1.16%. Demand for corporate bonds remains quite robust, due in part to the ECB's purchasing policy. This credit premium has fallen from 1.28% to 0.93%.

In the past six months, European bonds have made gains. Returns on euro-denominated government bonds come to approximately 0.3% for bonds with a term to maturity of between one and five years, and 1.5% for a diversified basket of maturities. A reduction in the risk premium enabled corporate bonds to make a fine gain of 2.3%. The euro strengthened against most currencies over this period. One such currency is the US dollar, which lost about 1%.

Outlook for the financial markets

Investment climate

First, a difficult winter to get through

- After a year of unprecedented turbulence, the global economy is on the cusp of recovery. We are sticking to our forecast of a gradual economic recovery. The winter months will still be tough, held in the grip of the virus, but the subsequent recovery should be stronger. The vaccination campaigns are getting off to a fairly sluggish start all over the developed economies, but will step up several gears over the coming months. That should open the way for a relatively rapid economic recovery later in the year. With strong support from economic policy, both the developed and emerging economies will see a synchronised continuation of the post-pandemic recovery until well into 2022.

Resilient euro area

- Economic activity in the euro area continues to be heavily influenced by the dynamic of the coronavirus pandemic. Despite this, there are encouraging signs, especially the recovery in sentiment indicators, which point to the resilience of the economy. Industrial production also remains strong, providing some counterweight to the weakness in the service sector as a result of the lockdowns. Against this backdrop, we still think the economy will have contracted in the fourth quarter of 2020, though probably slightly less than first forecast. On the other hand, the recent extensions of the lockdown measures reinforce our belief that economic activity in the first quarter of 2021 will remain very weak. It will take a while for the vaccinations to provide a boost for economic growth. The upshot of all these factors is a slight upgrading of our growth forecasts for real GDP to -7.2% in 2020 and +3.1% in 2021. We foresee a bigger catching-up exercise in 2022, with annualised average growth of 4.2%.

Good but not great Brexit deal

- Right at the last minute, the EU and the UK reached a trade deal at the end of December. The most important thing is that a deal was reached at all, thus avoiding a cliff-edge separation. A no-deal Brexit would have delivered an additional economic shock, with the sudden imposition of tariffs and other major trade barriers at a time when the European economies are already facing severe challenges. However, the limited scope of the deal means that the Brexit saga is far from over. The remaining risks also underline the fragile nature of international economic relations at this point in time.

Steadily growing risk of no-deal Brexit

- It is unclear at the time of writing whether the United Kingdom will conclude a limited trade agreement with the European Union before the UK leaves the EU completely on 31 December. Even though both parties will suffer economic damage if there is no deal, with the UK likely to be hit hardest, negotiations have been paralysed from the outset by differences of priority and approach. In the short term, the damage inflicted by Brexit will be limited compared to the pandemic. But it will still mean a significantly weaker economic recovery for the UK and a more difficult one in countries with strong trading links with Britain.

Resilient US economy

- Although the number of Covid infections has hit new records in the US too, economic activity there is proving more resilient. Large-scale lockdowns have not occurred. Meanwhile, frequently available indicators are pointing towards stronger economic momentum than in Europe, amongst both consumers and businesses. Risks related to the disputed presidential election results have eased significantly. However, the fur-

ther development of the pandemic and the deadlock over a potential new stimulus package remain major concerns. We nevertheless expect a new economic relief package to be agreed. This, together with the imminent roll-out of the vaccine, will put the US economy on track for gradual normalisation. In response, we have slightly increased our projected growth rate for the US economy from -3.7% to -3.6% in 2020. This also means a somewhat higher knock-on effect for the forecast growth figure in 2021, which we have raised from 4.0% to 4.2%.

Two trends on the financial markets

- The financial markets responded to the positive vaccine news in two different ways. On the one hand, stock exchanges and the commodity markets have positioned themselves firmly for economic normalisation and the final phase of the pandemic. The bond markets, on the other hand, are pricing in a continuation in supportive monetary policy due to the risk of a short-term resurgence in the virus and the downward pressure currently being exerted on inflation. Nevertheless, we still detect some scope for limited rises in long-dated sovereign yields, especially in the US and slightly less so in the euro area. On the foreign exchange markets, the euro gained a firm foothold above 1.20 USD. We expect some further structural strengthening of the euro to 1.25 USD by the end of 2021.

Portfolio allocation

Overall portfolio

- Our position in shares is neutral.
  - Since the beginning of November, international stock markets have risen by 15%. Much good news has already been factored into the share prices, which could lead to volatility and better times to buy.
- Given the extremely low interest rates (even negative in some cases), we are still invested below the benchmark level for bonds.
- We are holding the limited cash positions in euros so that we are ready to grasp opportunities as they arise.

Zooming in on the bond portfolio

- Fourth-quarter economic growth will ease once again due to the increase in the number of Covid infections and additional restrictions imposed by the authorities. All the same, investors are looking forward to the reopening of economies from the second half of 2021 onwards as the vaccines begin to rein in the pandemic. Stronger future GDP (Gross Domestic Product) growth could exert upward pressure on inflation and interest rates, especially in the US, potentially weighing on bond prices.
- We expect rates in the euro area to remain low for some considerable time to come. The European Central Bank (ECB) further expanded its bond-purchasing programme by 500 billion euros in December, taking it to 1 850 billion euros, and extended it to March 2022. It is not planning to raise interest rates before 2024, as the inflation outlook is far below the ECB's targets a structural problem that pre-dates the Covid crisis. Although bond yields will fluctuate in line with investors' appetite for risk, a significant upward trend does not seem likely in this context.
- Given the extremely low interest rates (even negative in some cases), we are invested below the benchmark level for bonds However, the interest rate risk (loss of value when rates rise) is limited. Long-dated bonds are therefore included for the additional compensation they offer and to provide a degree of protection if there is turbulence on the financial markets. Companies can turn to the support measures provided by governments and the ECB. Due to the relatively attractive yield and the ECB's bond-purchasing programme, corporate bonds occupy a prominent place in the portfolio. The uncertainties surrounding emerging markets remain, but the compensation adequately factors in the associated risks, enabling a limited position to be taken in this theme.

Zooming in on the share portfolio

- Asian emerging markets that give exposure mainly to China are our preferred region. It was the first region to be hit by the Covid virus, but was able to contain it relatively quickly by implementing effective measures, putting China ahead of the rest of the world economically. The Chinese economy is expanding rapidly again after a short-lived slowdown and the leading indicators for manufacturing, exports and consumption are stronger than in the rest of the world. The pandemic also appears to have been brought relatively well under control in Europe and the US, although recent figures paint an extremely negative picture in terms of infections. This has triggered partial lockdowns for the time being. These are likely to be less severe than previously, but will put a brake on economic recovery again, especially on the service side of the economy. We are therefore continuing to hold a balanced investment portfolio in regional terms. We remain overweighted in the US and the emerging markets of Asia, and prefer small caps in the euro area.

- The new lockdowns are weighing on sentiment, which is causing economic uncertainty to persist a little longer. Nevertheless, the news on the vaccine front that emerged in mid-November is regarded as a game changer. It promises a credible path towards a reopening of the economy. Although this is not expected until mid-2021, the market is factoring in a quicker improvement in the economic climate. It is therefore important to ensure sufficient cyclical exposure in the portfolio. We favour industrial stocks that stand to benefit from an economic revival. Within the transport sub-sector too, a certain amount of ground still has to be made up. Vaccines offer a glimmer of hope for airlines, airports and their suppliers. We are also focusing on Consumer Discretionary. This sector not only includes e-commerce companies, it also has a considerable exposure to shares that ought to benefit from a reopening of the economy (hospitality, tourism, etc.). The Materials sector has likewise been overweighted. It provides exposure to the multiple fiscal stimulus packages around the world, while also boasting strong balance sheets and high free cash flows. More financial stocks have also been included due to the improving economic outlook and somewhat higher inter-

est rates. In this pro-cyclical environment, banks should be able to slightly reduce their provisions for non-performing loans, while it ought to be possible to systematically increase lending volumes. Profit was taken on growth stocks (e-commerce, IT, communication services), but we continue to overweight them.

- The downside of this pro-cyclical positioning is that typical defensive sectors like health care, utilities and consumer staples are underweight. These often include high-quality businesses with predictable profits, but underperform in a rising market driven by strong economic recovery. Consequently, their earnings growth will be lower in the year ahead than that of the cyclical sectors.

- As regards investment themes, the focus is on medical technology. This sub-segment of the health care sector is characterised by robust cash flows and stronger growth, and outperforms the market over the long term. It contains many innovative companies with high margins. We also have a preference for water companies. Drinking water is in very short supply due to obsolete and inadequate water infrastructure, climate change and problems with water quality and waste-water processing. This offers robust long-term revenue growth opportunities for water companies. The traditional premium for water companies is also lower than the average over the last eight years. Lastly, we also continue to back Global Trends, a portfolio made up of businesses associated with themes that boast a structural tailwind, such as digitalisation, demographic trends, medical technology and urbanisation. Examples include the digital world, automation, the cloud, e-commerce, alternative energy, gene therapy and animal welfare.

Opportunities

Short-term themes

Within the equity component

Euro area small caps
- Grow strongly in the medium term
- Higher profit margins
- Less vulnerable to trade tensions

Consumer Discretionary
- Diversified sector comprising both growth and cyclical companies.
- Cyclical sector able to benefit from a recovering economy.
- Consumers have surplus savings and draw support from improving labour market.

Medium-term themes

Within the equity component

Water
- The scarcity of water will drive long-term growth.
- Companies addressing the scarcity issue will grow with the economy.
- Good valuation.

Medical Technology
- Defensive and growth oriented.
- Sustainable sales growth through innovation and geographical expansion.
- Strong US orientation.

Global Trends
- Focus on growth-oriented sectors.
- Less exposed to the vagaries of the economy.
- Boost given by the coronavirus crisis.