Handelsbanken
Asset Management

Mid-Year Outlook 2021

Contents

Welcome to this edition of our Mid-Year Outlook.

With some very notable exceptions, it increasingly feels like much of the world is emerging from a traumatic 18 months. The global economy is bouncing back swiftly, thanks to aggressive remedial action from policymakers, alongside a seemingly successful vaccination programme. We recognise, however, that these trends are neither universal nor linear. Overall, the outlook for the global economy remains encouraging, but there are important changes afoot to which, as investors, we must remain alert.

To begin with, what will the next chapter of the economic recovery look like? The first chapter of recovery saw almost unconditional support from central banks and governments. Our first article - *Consumers and businesses must drive the next phase of economic recovery* - notes that as the baton is passed for the next chapter of the global recovery, consumers and businesses are now beginning to regain their confidence and reduce their stores of 'dry powder' (or high savings). Revisiting the role of policymakers in holding the recovery steady, this edition of our Mid-Year Outlook also includes a short piece in response to the question: *When will central banks raise interest rates?*

As the next phase of economic recovery unfolds, the reaction of financial markets will be critical. Up until this point, markets have (as usual) looked beyond near-term turmoil, hence the outsized performance they have delivered to investors over the past few months. But this forward-looking nature also makes markets sensitive to policy uncertainty, even if this is only short-lived. Ultimately, being less reliant on stimulus from governments and central banks is a good thing, but transitions can be unsettling. Primarily for this reason, as we note in our next piece – *Where do financial markets go from here?* – we believe prospective returns will continue to be attractive, but accompanied by more volatility.

And speaking of volatility, in recent history, few areas of financial markets have captured the public consciousness quite like cryptocurrencies. Later in this edition of our Mid-Year Outlook, we ask, *Can cryptocurrencies play a part in a multi asset strategy?* In doing so, we consider the case for, and against, the inclusion of assets like Bitcoin in our strategies; for now, we are sceptical and are refraining, but the debate is very much alive and well.

Last, but certainly not least, we provide a rundown of *Our wish list for sustainable investing*. Progress in the sustainable investment space has been encouraging, but there are still some hurdles to overcome.

As ever, we welcome your thoughts and feedback.

G Bishop

Graham Bishop, Chief Investment Officer

Past performance is not a reliable indicator of future results.

Consumers and businesses must drive the next phase of economic recovery

At the height of the economic fallout of the COVID-19 pandemic, a potent combination of central bank and government support provided financial markets with their own vaccine. From some angles, the financial market vaccine's effectiveness looks even more impressive than its medical equivalents.

The first COVID-19 vaccine was not medicinal

The response from policymakers during COVID-19 followed a combination of conventional and deeply unconventional routes. First, the conventional. Central banks stepped up, as they tend to do, slashing interest rates and buying assets to inject more liquidity into the economy (also known as 'quantitative easing'), just as they did during the global financial crisis in 2008.

Second, the unconventional. Central banks also committed to corporate debt (credit) markets, by buying credit instruments – an untrodden path in the 2008 crisis. In addition, the government policy reaction from around the world was huge and broad-based, aiming to address the staggering economic impact of the pandemic. This government response remains in play today.

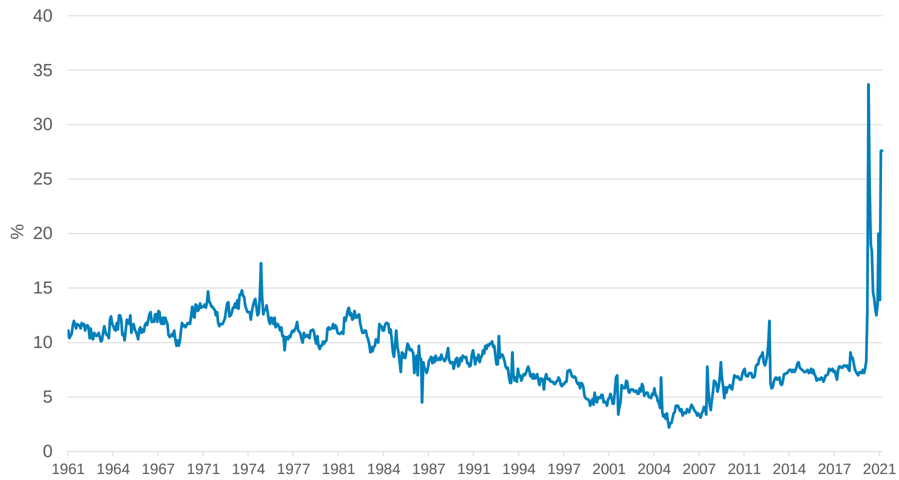
But while the medical vaccine is the route to normality, the government and central bank support described above must now begin to take a back seat. From here, the baton must be passed to the private sector, via consumers and businesses, to drive the next stage of the economic recovery.

The pandemic has boosted the average consumer's purse

The sharp economic downturn created by the pandemic was anything but traditional. One way of illustrating this is to take a glance at the finances of the average consumer (or the consumer 'balance sheet'). In a traditional downturn, consumer balance sheets are hit hard. However, in this pandemic-led recession, the opposite has been true. Personal incomes and saving rates in the US, for example, have improved markedly. This is a direct result of the policies deployed by the US government and central bank – from lowering the cost of financing their existing debt through lower interest rates, to direct payments from government support programmes, along with a whole host of other indirect benefits.

During the pandemic, US savings have skyrocketed

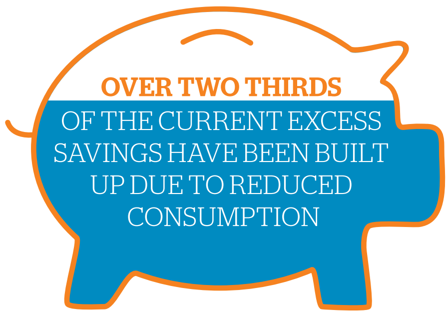
US savings rate



Source: Bloomberg

And this is not just a US phenomenon. A glance at savings rates in the UK and Europe demonstrates the same story: excess savings. In fact, in aggregate, estimates suggest that – relative to pre-pandemic levels – we currently have up to $2.7trn in global excess savings. In essence, this marks the passing of the baton from government and central bank policymakers, and onto those they have been attempting to support.

Of course not all of these excess consumer savings will be spent. Some will be used to pay down existing debt, or held in cash as an emergency reserve – this is especially the case for those who may have become permanently (rather than temporarily) unemployed. However, given that by some estimations, over two thirds of the current excess savings have been built up due to reduced consumption (a lack of spending, rather than deliberate savings), it is logical to assume that a reasonable chunk of this spending power will be deployed as the world returns to some kind of normality. If so, this will be a powerful propelling force for global growth, particularly in the US.



> "While the medical vaccine is the route to normality, the government and central bank support described above must now begin to take a back seat. From here, the baton must be passed to the private sector, via consumers and businesses, to drive the next stage of the economic recovery."
>
> David Absolon, Investment Director

Of course, the supportive stance of policymakers has also buoyed financial markets, with the impact of increasing household wealth (which includes assets such as shares and property or private dwellings). This too should offer a boost to economic growth, as consumers feel that their finances are in good shape.

Businesses have huge amounts of cash to deploy

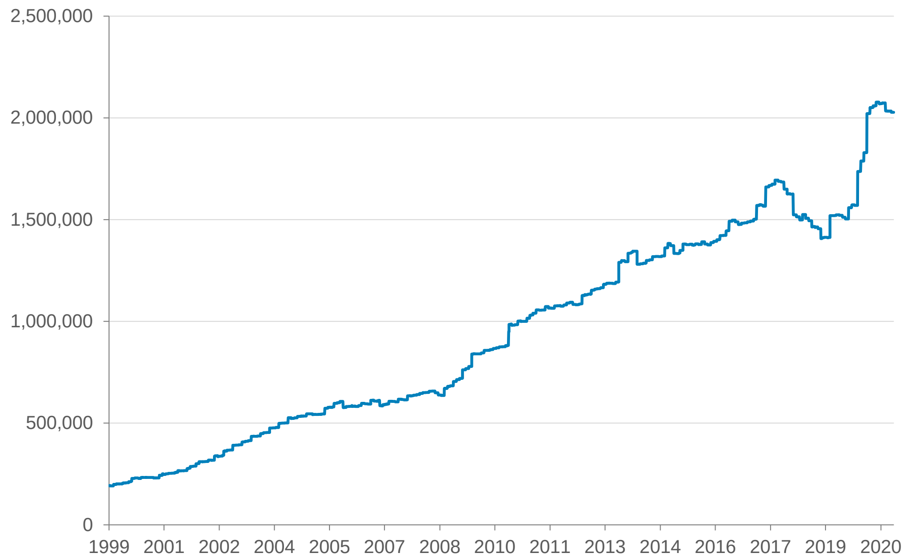
It is not only the consumer that has benefited from policymaker support during the pandemic. As central banks (particularly the US Federal Reserve Bank) have kept borrowing costs low for companies, and allowed corporate debt markets to remain open (unlike in the 2008 crisis), this has enabled businesses to raise cash or refinance their maturing debt. In turn, this has created headroom for business growth in the coming years.

In fact, aggregate cash levels for large US companies (represented by the S&P 500 index) currently stands at just over $2trn. This is a record since this data series began in 1999.

Of course, not all of this cash will be deployed by corporates. However, with a figure this large, it is safe to assume that some will be deployed, either via capital expenditure (investing in the business itself) or new employment – both an encouraging sign for growth. Some cash may be returned to benefit shareholders, such as by a capital distribution, share buybacks, or increased dividend payments.

US businesses are currently sitting on record cash levels

S&P 500 Aggregate Cash Levels ($trn)



Source: Bloomberg

> “Central banks have kept borrowing costs low for companies, enabling businesses to raise cash or refinance their maturing debt. In turn, this has created headroom for business growth.”
>
> Jaisal Pastakia, Investment Manager

What next for the global economic recovery?

Government and central bank support in combination was a tremendous shot in the arm for global economic health in the darkest days of the COVID-19 pandemic. From here, the direct and indirect benefits of these actions should allow the onus for the recovery to be passed from policymakers to the businesses and consumers their actions were designed to support. Put simply, the beneficiaries of extraordinary pandemic-era policies must now pick up the baton, and continue the journey for the global economic recovery.

When will central banks raise interest rates?

When the COVID-19 crisis began to hit home just over a year ago, the world's leading central banks sprang into action (alongside governments) to support their national economies. As part of this, already ultra-low interest rates were pushed lower still.

Today, recovery signals are emerging across a range of economic data, and as population restrictions are slowly being lifted, consumer activity is gathering pace. But for financial markets, good news sometimes hints at bad news: positive economic data and inflationary pressures can lead investors to panic about an ensuing withdrawal of central bank support, leading to price volatility across a range of asset types.

Are financial markets right to feel unnerved?

Changes to interest rates affect the cost of borrowing for businesses and individuals, impacting activity in the wider economy, and the relative attractiveness of different asset types to one another. Interest rate changes are particularly pertinent for bond markets, as they can affect the comparative appeal of the yields offered to bond investors.

Small wonder, then, that financial markets keep a close eye on the factors influencing central bank decision making. And there are certainly signals that one of these factors – inflation – is picking up as economies reopen following pandemic restrictions. However, we believe that inflationary pressures will be relatively transitory, and should fade over the medium term. In the meantime, though, it would be reasonable to expect occasional bouts of volatility in financial markets.

It is worth noting that central banks typically have a much wider remit than managing inflation. For example, the US Federal Reserve Bank (Fed) has a mandate to support the labour market too. At present, US unemployment remains elevated: despite improvement, the number of people signing up for unemployment benefits is still more than double the pre-pandemic figure (April 2021 data). The Fed is extremely unlikely to move rates before witnessing a much more mature economic recovery, including a durable improvement in employment data.

When will the next rate rising cycle begin?

Importantly, upwards moves in interest rates in the future are likely to be extremely gradual. Signals from financial markets suggest that investors expect leading central banks to begin raising interest rates in earnest in early 2023. However, this is at odds with the messaging given out by the banks themselves. At present, our best guess is that the Fed and the Bank of England will begin their next rate raising cycle in late 2023 at the earliest, while the European Central Bank is likely to follow suit a little later, potentially in 2024.

A number of factors could challenge our views on this over the coming months and years, and we remain vigilant to such signals, and flexible in our understanding of the journey for interest rates from here. What's certain is that central bank policymakers will aim to avoid unintentionally tightening financial conditions to a degree that puts the global economic recovery at risk.

Where do financial markets go from here?

Financial markets are frequently cited as good leading indicators of future economic trends. This is because while many economic data series tell us what has already happened, financial markets tend to reflect the majority view about what will happen next (only rarely falling prey to what 'should' happen).

In this way, in many respects, market participants turn probabilities into prices. This notion is worth remembering as it explains why, for example, share prices can be rallying when the backdrop appears to be terrible, and of course vice versa. But what are financial markets signalling now?

The market backdrop

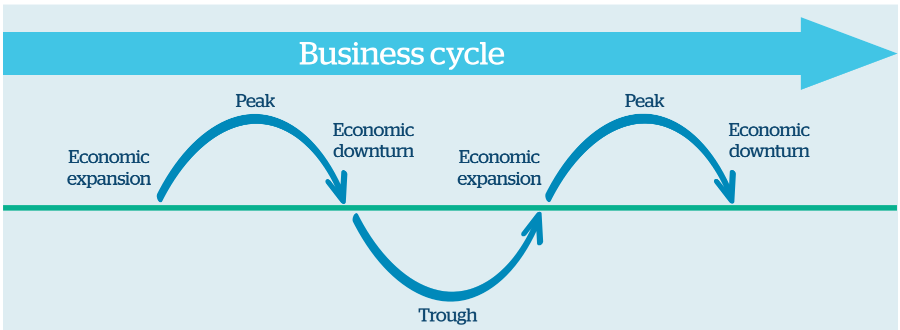
When population lockdowns gripped the world just over a year ago, the economic shock was devastating, and something many were ill-prepared for. Policymakers of all persuasions, to their credit, acted quickly and magnanimously. This demonstrated that lessons from the financial crisis, a decade ago, had indeed been learned. We recall the delays and disagreements about fiscal stimulus in 2008-9, which prolonged the economic and market turmoil; in 2020, there was no such procrastination, and this seemed to positively surprise investors and markets.

Government and central bank policies have remained accommodative in the intervening period, and policymakers have indicated that the early withdrawal of their support is unlikely. Simultaneously, pharmaceutical companies have created highly effective vaccines and governments have been busy rolling them out. While mutations in the virus and unrelated geopolitical tensions have been unwelcome challenges, the big picture is the most encouraging we have seen in a while.

Positioning ourselves in the 'global business cycle'

When we talk about the global business cycle, we are referring to fluctuations in economic growth around a long-term trend. The stage in the cycle in which we now find ourselves is critically important to financial markets, and there are lots of reasons to think that it is an early one, representing economic expansion.

While different business cycles can be a range of different lengths, two years' ago, one could have been forgiven for thinking that the world was in a 'late' cycle phase. While the intervening recession was extraordinary, its sharp emergence was brought about not by the normal imbalances that tend to characterise late-cycle environments, but rather a kind of natural disaster like an earthquake.



As we have already noted, financial markets look beyond the here and now. Thus an early-cycle phase is good news, although not without challenges. Today, the narrative gripping markets is all about economic overheating and related inflationary impulses. This is a marked shift on the last decade, during which secular stagnation (little or no economic growth) has been the primary concern.

Evolution creates volatility, but also opportunity

This backdrop and outlook is new for many market participants, who may not have experienced the strongly accelerating growth and pickup in inflation we have seen in very recent history. Small wonder, then, that uncertainty is high and commentators ever more vociferous.

From here, our view is that early-cycle conditions will turn into mid-cycle conditions through 2021 and 2022. Over this time period, central banks should begin to feel comfortable withdrawing stimulus, in turn allowing imbalances (particularly in supply chains) to normalise.

As with change of any kind, this evolution will naturally cause some volatility. While strong growth, commodity price rises, and supply-chain bottlenecks are causing inflation to pick up today, the balance between the demand for and supply of goods and services should settle in due course. As a result, our outlook for the global economy leads us to be cautiously optimistic, with a slight overweight to return drivers (or riskier asset types like shares), but we recognise that there will be bumps along the way.

Often enough, these bumps are opportunities in disguise, as they were in March/ April 2020. One of our key roles is to look through the apparent noise and take advantage of such opportunities, based on research, analysis and discussion. In this way, periods of 'indigestion' in financial markets are normal and rather welcome. Against this backdrop, though, we are mindful that asset price valuations are no longer cheap and a fair amount of 'good news' is already factored into prices – hence our use of the word 'cautiously'.

Another point of readjustment in financial markets has been the recent shift in the areas favoured by investors. As 2020 turned into 2021, investors pivoted towards shares in 'value' style companies, eschewing the growth-oriented businesses which had performed well in 2020's initial market recovery. Much of this market 'rotation' relates to higher yields (and lower prices) in bond markets, which in turn suggests greater optimism surrounding the economic outlook, meaning that rising bond yields (albeit from very low levels) are good news. However, this pivot towards value shares may lead to certain long-term growth angles being overlooked – something we are alive to. We are also well aware that market preferences can quickly reverse.

> "While strong growth, commodity price rises, and supply chain bottlenecks are causing inflation to pick up today, the balance between the demand for and supply of goods and services should settle in due course."

Graham Bishop, Chief Investment Officer

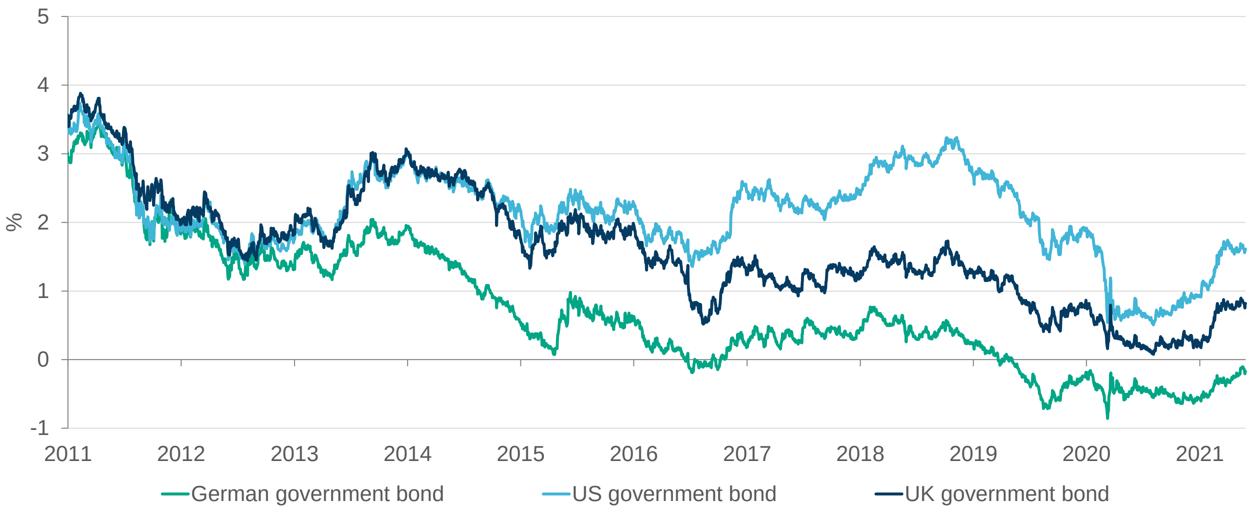
What can investors expect next?

We remain cautiously optimistic, but recognise that the journey ahead is unlikely to resemble the relatively smooth upwards trajectory investors enjoyed in the second half of 2020.

As investor sentiment ebbs and flows during these early business cycle phases, we should not be too alarmed by signs of market volatility – as we noted above, this is normal and often throws up opportunities. Prospective returns, in our view, will continue be positive, but more muted than in the recent past, when the wider recovery from the COVID-19 lows was at its most potent. As usual, patience will be a virtue as we look through the market noise in order to concentrate on long-term financial goals.

The recent pickup in bond yields points to an optimistic economic outlook

Yields on 10-year government bonds in three major economies



Source Macrobond

Can cryptocurrencies play a part in a multi asset strategy?

As multi asset investors, we strongly believe in the value of diversification. The majority of our investment strategies include a diverse range of asset types, including both 'traditional' (like shares and government bonds) and 'alternative' assets (the wide-ranging set of asset types that lie beyond traditional markets).

We actively seek out opportunities beyond the traditional investment universe that can offer an attractive trade-off between risk and reward, or provide diversification benefits to the broader strategy (or do both!). And when it comes to non-traditional assets, nothing has recently captured the public consciousness quite like cryptocurrencies – in particular Bitcoin.

But could Bitcoin work as part of one of our multi asset strategies? Like all asset managers, our investible universe – though large – has limits. In order to be considered for inclusion in our multi asset strategies, basic selection criteria apply. We maintain discipline by applying our selection criteria systematically to all potential investment opportunities, including cryptocurrencies.

Challenging to value

First and foremost, for any asset to fall into our investible universe, we must have a robust basis for assessing its underlying value, as well as the potential risks it poses. At present, we find that frameworks for evaluating the value of Bitcoin involve significant error terms and do not fully capture the negative risks to which we believe the asset is potentially exposed, rendering them too speculative to reliably use.

One way of potentially assessing Bitcoin's value is to assess its utility as a medium of exchange. In this context – so far at least – Bitcoin is not of much value, although it can be argued that this is changing as its adoption levels increase. Still, it is not a widely accepted form of payment, and remains expensive to transact, with a slower transaction speed than other commonly used payment systems. Even relatively conservative supply/demand models valuing Bitcoin as a medium of exchange, we believe, fail to appropriately price in some significant risks to which Bitcoin is exposed, such as government bans, technological advances and regulatory changes.

Bitcoin also has potential utility as a store of value, similar to a traditional 'safe-haven' asset such as gold. However, once again, we find insufficient evidence to suggest that Bitcoin can reliably or consistently behave as a hedge (offsetting risk) in our strategies, in the way that gold has typically been used. At present, Bitcoin's short history does not demonstrate that wider financial markets consider it to be a long-term store of value or a safe-haven asset, particularly given that it has historically behaved relatively similarly to riskier assets (like shares) during periods of market stress. In this sense, it is currently hard to argue that it could bring diversification benefits to our strategies.

We believe that financial models trying to value the potential utility of Bitcoin as 'digital gold' are, for the moment at least, replete with speculative assumptions which we find difficult to justify, especially as Bitcoin's fundamental utility as a medium of exchange remains unproven. While Bitcoin does have certain characteristics that may hypothetically make it a useful store of value in the future (e.g. it is a durable asset with a finite supply), we believe it is too nascent an asset class to be considered a reliable diversifier at present.

A highly volatile investment

For any investment considered for inclusion in our strategies, we must be able to form a reasonable expectation of the potential downside and volatility of holding that asset, what may cause that downside to manifest, and how we can manage its potential volatility. Cryptocurrencies such as Bitcoin are notoriously volatile, prone to large drawdowns and rallies. Whilst this in itself is not a reason for exclusion from our investible universe, it is difficult to justify adding such highly volatile assets to our strategies when we cannot reasonably make a case for the future financial returns which will compensate us for taking that risk.

A young market, subject to change

As fiduciaries of our clients' capital, we must also be comfortable that any asset we hold does not expose our portfolios to significant security, custodial, trading, liquidity and regulatory or legal risks. At present, we find cryptocurrency markets to fall short on a number of these metrics. While the risks of trading in Bitcoin are not fundamentally different from those applicable to trading in traditional assets, the nascent nature of the cryptocurrency market means than many of these risks are exacerbated by a young market infrastructure and low levels of regulation. The regulatory and legal permissibility, and the implications of directly holding assets like Bitcoin in strategies (today at least), is also less transparent than we would like, and still subject to significant change.

We continue to monitor for the right opportunities

On balance, we do not believe that cryptocurrencies like Bitcoin are suitable to be held in our strategies at present, but we continue to monitor the cryptocurrency space very closely. It is also worth noting that we do believe the blockchain infrastructure technology (which sits behind cryptocurrencies), has the potential to spawn significant shifts in global financial structures.

There are many things that could begin to change our view with regards to holding cryptocurrencies like Bitcoin in our portfolios, particularly in combination. These include (but are not limited to):

- The greater adoption of Bitcoin as a form of payment, to the point that its utility becomes significantly better established on a large scale.
- Much more refined regulatory frameworks governing cryptocurrencies around the world.
- Substantially increased liquidity and depth of cryptocurrency markets as these markets mature.

If major cryptocurrencies like Bitcoin hold their popularity over the long term, and demonstrate a track record as a store of value in the future, they could begin to earn a place as a useful diversifier within multi asset strategies. At this point, though, our view remains that cryptocurrencies do not sufficiently meet the fundamental criteria we use to define our investible universe.

> "The nascent nature of the cryptocurrency market means that risks are exacerbated by a young market infrastructure and low levels of regulation."
>
> Charu Lahiri, Investment Manager

Our wish list for sustainable investing

> "The next move must be a shift in the psychological frontier for investors, so that sustainable investing becomes the default investment option, not the alternative."
>
> Matt Toms, Investment Manager

In recent years, sustainably-managed assets have increased sharply in popularity. Sustainable investors have enjoyed broadly good performance figures, with financial markets choosing to reward assets boasting positive environmental, social and governance (ESG) credentials.

Against this backdrop, many of the battles for sustainable investing have arguably already been won. Nevertheless, we believe a few missing pieces of the puzzle remain, and that finding them could help to push sustainable investing forward. So, where do we go from here?

Sustainable products covering non-traditional investment areas

The core building blocks of traditional investment portfolios are increasingly well served by sustainable providers. This includes investment products focused on shares, bonds, property and infrastructure holdings. However, products focused on more peripheral areas of financial markets have yet to come aboard, such as funds centred on shares in smaller companies and the onshore stock market in China, as well as more complex asset types like hedge funds and derivatives.

We believe that, given time and continued pressure (via ongoing demand for sustainable products), these areas will also join the fray, expanding the product set available to sustainable investors.

Tax incentives to encourage investors to make the switch

At the moment, traditional funds and sustainable funds are treated equally in the eyes of the taxman. We think that giving sustainable investments preferential tax treatment could drastically accelerate the adoption of sustainable investing.

It may seem outlandish, but there is precedent for this, such as the tax relief related to Venture Capital Trusts and Enterprise Investment Schemes in the UK, or municipal (state and local government) bonds in the US. These examples show us that when it comes to encouraging investment into particular areas, building incentives into the tax system works.

With this in mind, a capital gains tax exemption (for instance) when switching to designated sustainable investments could provide the final push for many more investors to switch to a sustainable approach.

A sustainable approach as the default investment option

Over the past few years, we have seen a substantial shift in the profile of the average sustainable investor. Once upon a time, sustainable investing mostly tended to attract investors with a specific interest in ESG factors, but today the space is increasingly attracting more hardened capitalists, drawn to the idea that sustainable assets will be the investment stars of the future.

Rebranding sustainable from a very niche way of managing assets to a standard mainstream idea is great news for the sector. But it is important to remember that most assets are still managed with the more traditional approach (without taking sustainable considerations into account).

The next move from here must be a shift in the psychological frontier for investors, so that sustainable investing becomes the default investment option, not the alternative. Encouragingly, flows into sustainable funds over the past 18 months suggest that we are moving ever closer to this state of affairs, and pressure continues to build (on multiple fronts) for sustainable investing to be the norm.

As multi asset investors, our dream is for full, mandatory disclosure by companies on sustainability data, as well as standardised fund labelling, with labels relating clearly and directly to sustainability credentials.

Better investment product labelling, and standardised sustainability data

There is no industry standard for the labelling of sustainable investment products, nor is there a standard way to report on the data surrounding sustainable issues, such as carbon emissions reporting.

This is not a new challenge, and it's one we (and many of our peers) have raised in the past. As multi asset investors, our dream is for full, mandatory disclosure by companies on sustainability data, as well as standardised fund labelling, with labels relating clearly and directly to sustainability credentials. Once we reach this point, all investors will be able to make much more informed investment decisions, and have higher conviction in the impact they are having when they put our capital to work.

The good news is that progress is already being made in these areas, particularly with regard to product labelling. The EU has created a fund labelling system via the Sustainable Finance Disclosure Regulation, and other regions are bound to follow suit.

In our last *Investment Outlook*, we talked about how the future looked bright for sustainable investing, and it is certainly true that our wish list for the sustainable investment space is shrinking – a sign of the positive changes which have already taken place.

Importantly, the outstanding issues for sustainable investing are becoming more targeted, with key areas – like those outlined above – coming ever more into focus. On home shores, encouragingly, rhetoric from the UK government is positive, with the goal of enabling the UK to lead the way in sustainable finance. All else being equal, we are optimistic that our wish list could very soon become a reality.

Key investment terms

Assets	Anything having commercial or exchange value that is owned by a business, institution or individual.
Balance sheet	A summary of a company or institution's financial position, made up of assets, liabilities and (where applicable) shares. This can also refer to household or consumer assets and cash flows.
Bond (government or corporate)	An investment in the debt of a government or corporation, where investors receive a fixed rate of interest over a specified time period, at the end of which the initial amount is repaid.
Capital investment or expenditure	Funds used by a company to further its business objectives, which could include the acquisition of assets such as property, manufacturing plants, or machinery.
Capital distribution	Any money paid out by a company to its shareholders which (unlike a dividend) is not treated as income for tax purposes.
Cryptocurrency	A digital asset or virtual currency, not issued by a central authority (e.g. a central bank). Ownership records are typically protected by strong cryptography and stored in a digital ledger via specialist 'Blockchain' technology.
Dividend	A share of profits which a company pays out regularly (typically annually) to its shareholders.
Diversification	Holding different types of assets in a portfolio to spread the risk.
Hedging	A method of reducing unnecessary or unintended risk on a portfolio.
Index	A representative portfolio of assets which helps to track market trends and performance.
Inflation	The rate at which the price of goods and services rises.
Multi asset	Investment across different types of assets such as company shares, bonds, property or cash.
Quantitative easing	The introduction of new money into the money supply by a central bank.
Recession	A period of economic decline, technically defined as two consecutive quarters of negative growth.
Risk	The level of risk in a portfolio is essentially the probability for loss (though it can technically refer to the probability of gain too).
Share/stock	A stake representing part ownership of a company.
Share buybacks	Share buybacks take place when a company buys back its own shares in the marketplace (i.e. from existing shareholders).
Volatility	The degree to which the price of a given asset, or price levels of a given market, rapidly changes. The higher the volatility, the riskier the asset/market tends to be.
Yield	The income from an investment, usually stated as a percentage of the value of that investment.

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2021 Wealth Briefing European Awards

Winner: High Net Worth Team
Commended: Tax Team
Commended: Marketing or PR campaign

2021 PAM 50 Most Influential

Tracey Davidson, Chair of Handelsbanken Wealth & Asset Management has been named in the 2021 PAM 50 Most Influential list

FT Adviser – Top 100 Financial Advisers 2020

Handelsbanken Wealth Management was placed in the top 25 of FT Adviser's Top 100 Financial Advisers 2020 (17th)

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Past performance is not a reliable indicator of future results.

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