

ARLINGTON CAPITAL

Markets in 2021

“Things can only get better”

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Followers of our notes will know we have a penchant for music at Arlington and for this piece we have chosen another totemic anthem as our title for this missive: “Things Can Only Get Better” by D:Ream. In case you’re wondering, the song originally reached number 24 in the UK chart on initial release, but after Peter Cunnah remixed it, his version spent 4 weeks at number 1 in the UK charts and reached the top 10 in 8 others. Happy New Year!

No one wants to relive 2020, hence our title for a 2021 outlook for financial markets. The crucial market related lesson learned from 2020 was that Central Banks did not run out of firepower. Quite the opposite, there was plenty of ammunition to aim at the Corona fire and their aim was astonishingly accurate. Central Banks can’t provide vaccines, but luckily Oxford University can(!) and while QE has not created jobs, we have seen their huge and timely ability to move markets and create much needed liquidity, which in turn turned investors back from the brink.

We expect the broad distribution of the COVID-19 vaccines to drive an economic recovery far more robust and inclusive than that seen coming out of the Global Financial Crisis of 2008/9. In particular we think that the services industry will rebound with greater intensity, benefiting many lower income workers. This time around there should be gains in productivity, maybe at the expense of the impressive levels of net job creation in comparison to employment growth seen after the GFC. The current UK job market sees significant redundancies and some companies will close, but new firms are opening at a steady rate and hiring new staff. The UK saw a net additional 31,265 businesses being formed so far during the pandemic and there are 300,000 more businesses in the UK than in the year before the Brexit vote of 2016. ¹

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<https://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/bulletins/ukbusinessactivitysizeandlocation/2020#growth-in-the-number-of-businesses-continues>

This resilient entrepreneurialism is likely to be underpinned by the relief factor of a return to normal life, and to drive recovery in 2021. However, our central expectation is that life won't get back to near normal until H2 2021. This is a more cautious view than we had six months ago. It would be unrealistic to discount further pandemic-related headwinds, such as the development of worse strains of the virus. However, once a substantial portion of the population is vaccinated, we expect the economic recovery to be swift and powerful. Based on vaccine production estimates, we expect both a relaxation in restrictions and a recovery in the consumption of services, such as travel and eating out, in the late first half of 2021. According to UBS this should drive a recovery in corporate earnings, they expect 27% EPS growth in the 2021 fiscal year globally.

The stock market has clearly begun to anticipate this, powered upwards in 2020 by the world's largest technology companies who drive markets due to their significant weight in the indices, the highest and most concentrated market values in history. As we emerge from lockdowns and other government interventions, many of these companies' growth will slow, and the current engine driving the market will splutter. To continue the rally will need to diversify. Something to keep an eye on is the (expected) increasing government scrutiny on these big tech companies. Just take a look at Beijing's crack-down on Alibaba/Ant, US antitrust lawsuit against Facebook, Ripple's collapse in the wake of a US lawsuit and the EU unveiling two draft digital-services laws. We feel sure there is more to come on this front.

Looking at UK markets we see a brighter outlook and we are not alone. According to UBS: "We expect a near 40% rebound in UK earnings in 2021, driven by the global economic recovery and the anticipated improvement in oil prices. The UK market also has a bias toward value stocks, which should perform well if the market begins to price in faster growth." Other investment banks have set their direction for the year already. During November Goldman Sachs advised its clients to invest in British shares, predicting that a last-minute "skinny" free trade deal with the European Union would be announced soon. The bank also advised clients to "go long" on the pound, predicting that it could rise to \$1.44 next year as the UK economy rebounds faster than previously forecast. This is in the context that the day before the Brexit referendum (22nd June 2016) a pound bought \$1.48 or €1.31. We at Arlington believe that international investors will gradually rotate back into UK equities as the year progresses, driven by cheap fundamentals, a more positive outlook for Sterling, earnings growth and an attractive yield. The Brexit deal is a strong help - even if "skinny" and signed at 1 minute to midnight!

Turning to fiscal policy, central bankers everywhere have uncharacteristically and extremely helpfully been falling over themselves to point out that interest rates will stay low for as long as possible. Or at least until inflation starts to rise above trend, and that, looking at the futures curve, is some way away. So, a business favourable environment of

zero inflation and very loose monetary policy looks set to continue even if government fiscal stimuli fall away. Taking all into account, we believe the net result is good for the stock market and private assets. To put a finer point on it, companies which are cheap due to recent earnings weakness, and that have market leading industry positions, will emerge stronger from the pandemic and should logically benefit from the threat of higher inflation because they have pricing power. The same metrics will continue to make private assets look attractive, particularly private equity. Investors who like distressed opportunities should have plenty to choose from in 2021 and we have recently seen much more interest in this area.

It is expected that European commercial real estate investment volumes will end 2020 down 25%. CBRE's current house view projects volumes will return to pre-COVID norms by H2 2022. Unlike other asset classes since the onset of the pandemic, secure prime property assets in core European markets have seen limited movement in yields. Notably, prime CBD office yields in the UK have experienced no change while those in Germany have marginally compressed. The outlook is less rosy for hotel and most retail assets, as well as for decentralised and secondary offices where we expect to see distressed sales. Arlington prefers defensive real estate which will pay an above average yield in all circumstances including pandemics and where active management can offer capital upside. As a result, we prefer the defensive characteristic of regional buildings let to the UK Government and small box retail, while we believe that our care home strategies offer solid capital upside.

What everyone agrees is that 2021 will be a year of significant economic growth and low inflation. Traditionally this has been a positive environment for asset prices, hence our title for this year's outlook, "things can only get better". However, in the new normal nothing is as it used to be, that's where Arlington comes in to help our clients find high quality opportunities in those areas where we have expertise.

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