Schroders

For Financial Intermediary, Institutional and Consultant use only.
Not for redistribution under any circumstances.

Top 10 market themes for 2021 and beyond

March 2021

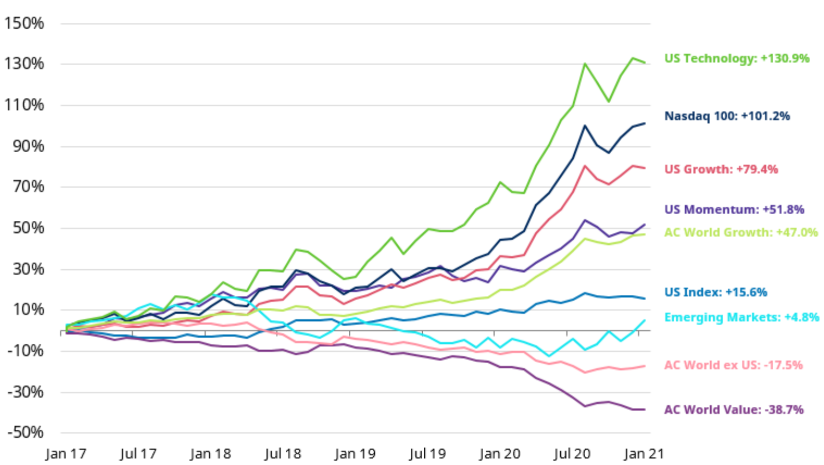
By the Schroders QEP Investment Team

As the global economy emerges from the pandemic, we have identified ten investment themes that could emerge in the wake of this very unusual chapter of history.

Introduction

The equity market environment since 2017 has clearly been dominated by the strong performance of a narrow group of popular mega-cap stocks in both the US and Emerging Asia. While this provided a favorable backdrop for growth and momentum focused stock-pickers, the other side of this extremely narrow market was the ongoing neglect of a much longer list of out of favor stocks, much to the chagrin of value focused managers. With even the affordable high quality stocks also lagging, there were essentially no places to hide for many value-based strategies, particularly those that embrace diversification.

Style and regional relative returns vs. MSCI AC World since 2017



Returns by Value and Quality (2017 – 2020)

	Cheap	Mkt. like	Expensive
High quality	-4.3%	-1.9%	2.3%
Moderate quality	-8.3%	-6.7%	0.9%
Low quality	-10.7%	-6.4%	-1.9%

*Source: **LHS:** Schroders, FactSet in USD as at January 31, 2021. MSCI indices are net dividend re-invested. The sectors, securities, regions and countries shown above are for illustrative purposes only and are not to be considered a recommendation to buy or sell. Relative to the MSCI AC World (NDR). **RHS:** Source: Schroders QEP. Data from Jan 2017 to Dec 2020. Each month all stocks in QEP's global mega to mid-cap universe, excluding financials and resources, are ranked using QEP's global value rank and global quality rank. Terciles of the value rank are used to classify stocks as cheap, market like or expensive, while terciles of the quality rank are used to classify stocks as high, moderate or low quality. Market capitalization-weighted portfolios are rebalanced monthly and US$ returns are calculated with transaction costs taken into account. A maximum stock weight of 3% is applied within each portfolio. Annualized excess returns are then calculated against a market capitalization-weighted universe. Past performance is no guarantee of future results.*

The headwinds against Value were evident for a number of years but 2020 was truly exceptional by historical standards as COVID-19 reinforced the already well-established equity leadership to the point where valid comparisons with the bubbles of the late 1990s and early 1970s were entirely reasonable.

"FOMO", or fear of missing out, is a powerful ally to momentum-based investors at the tail end of a cycle, but as 2020 progressed it became increasingly apparent that the very wide dispersion in performance between the winners and losers had stretched to an unjustified level. The arrival of successful vaccines in November was the catalyst behind a rotation that is, in our view, still very much in its early stages.

So far, this has benefitted some of the oversold deeper value cyclical areas such as resources, but with bond yields edging higher, we have only recently started to observe signs of capitulation in the market leaders of recent years. Admittedly, most of these stocks continued to churn out strong earnings in the recent reporting season, which leaves open the question of whether this is already reflected in their lofty share prices.

Four months on from November, there is still an abundance of examples where we believe a significant disconnect exists between stock prices and fundamentals. With some form of economic and market normalization appearing increasingly likely as we emerge from the pandemic, this seems an opportune time to look ahead and consider some of the most likely themes that we expect to emerge in the months and years to come.

1. Good news already in the price, making markets more vulnerable

At the outset, we would stress that despite ongoing fiscal stimulus, the triple headwinds of a high level of equity valuations, a lack of room for interest rates to fall significantly, and wartime-like government debt burdens point to a more difficult period ahead for equity returns. Much of the good news is already priced in and the potential for disappointment remains high.

While a strong recovery in global growth now appears very likely, this is far from a typical economic cycle. The widespread impact of COVID is more akin to a natural disaster than a typical policy induced slowdown or an endogenous financial risk crisis such as 2008. As such, the rebound is likely to be swifter and stronger than normal but may well stimulate short-term inflationary pressures, thereby creating a new conundrum for policymakers which could rattle both equity and bond markets.

Ultimately, valuations are the best long run predictor of returns, and with many stocks and most major equity indices only just off their all-time highs at the time of writing, they are naturally more vulnerable to any adverse news flow. To some extent, this is already reflected in equity market volatility as, following an extended period of extremely low volatility, the VIX index is currently trading around 25% higher than its average over the past 20 years. We regard this as a more appropriate response to the still very wide range of market and economic scenarios that may unfold.

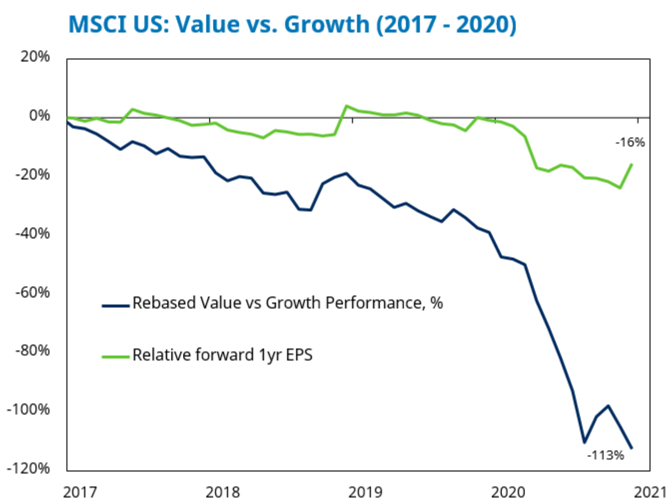
However, it is the very wide dispersion of valuation across the market that provides the best opportunities for active management. Such a backdrop increases the opportunity for more variable returns both between and within sectors and countries as desynchronized cycles, re-opening themes, and longer term trends play out alongside each other. This would be a marked contrast to the almost absolute dominance of growth and momentum-based strategies of recent years.

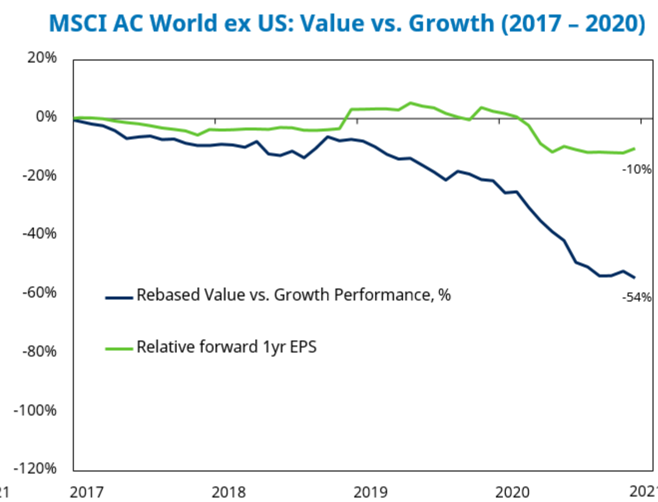
In short, given the current starting point, we fully expect the next decade to be very different to the past one as prices reconnect with fundamentals.

2. Significant opportunity for Value to rebound

The past decade has been a torrid one for value managers for a variety of well-discussed reasons, not least the deleveraging of banks following the global financial crisis and a sluggish economic backdrop which weighed heavily on bond yields at a time of heightened disruption to traditional business models. The global pandemic turbo-charged many of these trends, most notably the shift from offline to online, and resulted in an extremely narrow market where a dozen or so popular stocks soared, leading to a level of concentration in the US market not observed in six decades. The corollary to this is that the average stock was left well behind even as the mainstream indices advanced with a pervasive buy-on-the-dip mentality.

In essence, the market has, for an unusually prolonged period, failed to discriminate between cheap quality stocks with superior fundamentals and those which are truly facing cyclical or structural headwinds to their business models. On the other side of the coin, the lofty expectations still built into the premium valuations of many popular stocks leave little room for anything other than perfect execution. By way of illustration, the divergence in the earnings of Value stocks relative to Growth stocks in recent years is a fraction of the divergence in performance between the two groups, particularly within the US market.



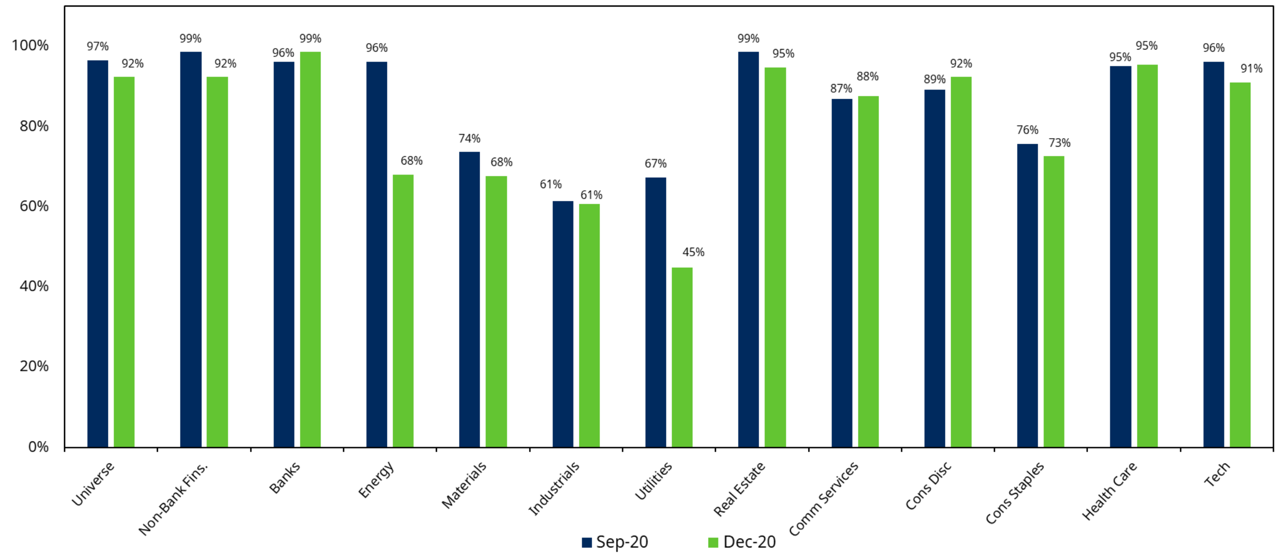


Source: Schroders, Datastream, as of December 31, 2020. Based on Index: MSCI USA Value (NDR), MSCI USA Growth (NDR), MSCI ACWI ex USA Value (NDR), MSCI ACWI ex USA Growth (NDR) – all in US Dollar. Performance shown reflects past performance which is no guarantee of future results.

By early November 2020, the degree of valuation dispersion across the market had reached the extreme levels last observed during the tech bubble of 1999-2000. The welcome news of vaccines and the fading of US political uncertainty appears to have been the necessary catalyst for a change in market leadership.

With valuation spreads within most sectors close to their all-time highs late last year, the rotation we have observed since has been relatively modest so far. The chart below measures the forward earnings yield spread between cheap stocks and the market, ranked relative to its history. For the global market as a whole, the valuation spread at the end of Q3 2020 was in the 97th percentile of its historical range, meaning that the spread had only been wider 3% of the time (or for eight months in nearly a quarter of a century). By the end of the year, spreads had narrowed to only the 92nd percentile, suggesting much greater opportunity for further reversion in the months and years ahead.

Valuation spread (FY2 price to earnings) relative to history (percentile rank, 1997-2020)



Source: Schroders QEP, MSCI, IBES, as of December 31, 2020. MSCI ACWI IMI universe using capitalization-weighted percentiles to measure value dispersion and excluding negatives. We split the universe into five buckets from cheap to expensive based on forward earnings yield and create the historical valuation spread between the cheapest quintile and most expensive quintile back to 1997 using capitalization-weighting. The higher the bar, the more stretched valuation spreads are relative to their history. Past performance is no guarantee of future results.

Following the bursting of the tech bubble of 2000, it took two years for the valuation spread across the global universe as a whole to return to the 75th percentile of its historical range relative to the market, and almost four years for it to return to its long run median. By way of illustration of the potential opportunity, a return to the historical norm would imply further outperformance of cheap stocks of 33% from this point. Even this is possibly a conservative estimate as history also suggests that reversionary forces also tend to overshoot.

3. Expensive stocks need to grow by 30% p.a. over the next three years to justify their valuation

Alongside value stocks being re-rated, there is also a high probability of a contraction in the multiple paid for the most expensive stocks, some of which may have entered bubble territory. There is no widely accepted definition of a bubble but in broad terms we think about it as the temporary detachment of fundamentals and valuation alongside a high degree of investor exuberance. It is not uncommon for bubbles to appear in individual stocks which correct over time, but there are an unusually large number of bubbles today that appear ripe for bursting.

In our view, investors have fallen in love with a simple “winner takes all” narrative. This has clearly been a successful approach over the past decade but is unlikely to be repeated. Due to the current extreme valuations of many of these “chosen” stocks, the bar is now set incredibly high for them in terms of their growth expectations which, despite many of them being secular winners, are unlikely to be realized in practice.

In terms of quantifying the impact, we use a residual income framework to back out the potential performance for cheap and expensive stocks based on a set of scenarios for changes in both valuation multiples and potential growth rates. This suggests that a very pessimistic scenario for value stocks is already priced in. Cheap stocks have an implied growth rate of almost -6% (annualized) over the next three years. If they actually grow at a faster rate than this, or their current large discount shrinks via revaluation, they would be expected to outperform. As the table below highlights, across all earnings growth scenarios, there is significant potential upside to value stocks.

Cheap stocks: Predicted 3 Year Annualized Returns on multiples scenarios

	Pessimistic scenario (Earnings growth matches implied growth, -5.7%)	Neutral scenario (Earnings growth between implied growth and analyst forecast, 2.0%)	Optimistic scenario (Earnings Growth matches analyst forecasts, 6.0%)
9.5 - Current P/E	**0.0%**	3.7%	5.6%
13	5.8%	9.1%	10.9%
15	8.8%	12.0%	13.7%
19.5 - Market Like P/E	15.1%	18.0%	19.5%

Expensive: Predicted 3 Year Annualized Returns on multiples scenarios

	Pessimistic scenario (Earnings growth matches analyst forecasts, 14.9%)	Neutral scenario (Earnings growth between implied growth and analyst forecast, 25%)	Optimistic scenario (Earnings Growth matches implied growth, 33.1%)
19.5 - Market Like P/E	-15.8%	-11.5%	-7.9%
22	-14.1%	-10.0%	-6.4%
28	-10.2%	-6.4%	-3.1%
33.5 - Current P/E	-6.9%	-3.4%	**0.0%**

Source: Schroders, as at end-September 2020. Prospective returns are the annualized returns over the coming years that would be expected based on future earnings growth and multiples scenarios for cheap and expensive portfolios. Expected returns simultaneously take into account both the impact of multiple re-rating (columns) and the impact from realized earnings relative to market implied earnings (rows). Cheap is defined as the top quintile of our Global Value Rank while expensive is the bottom quintile. We restrict the universe to stocks with a market capitalization above $1bn and also exclude Financials, which adopt a different business model. The returns shown are hypothetical. There is no guarantee that any forecasted returns will be accurate.

In contrast, earnings for expensive stocks need to grow by almost 31% p.a. just to perform in line with expectations. As such, there is large downside potential for expensive stocks across all but the most optimistic earnings growth scenarios.

In summary, many stocks are priced for perfection as the good news is already in the price. The potential revocation of Section 230 in the US by President Biden, which currently shields many Big Tech companies from liability for what their users post, as well as other anti-trust pressures, are just some examples of threats to this rosy outlook.

In contrast, the Armageddon scenario implicit in the valuations of cheaper stocks would suggest that they are a far less risky proposition. The strongest argument for why value has outperformed growth over the long run is that investors ultimately overpay for growth and this seems even more true today.

4. US market the most expensive it has been in five decades

From a country allocation perspective, the corollary of the expected de-rating of the most expensive stocks is the likely underperformance of the US market relative to the rest of the world. The US has clearly been the dominant market of the past few years, albeit largely driven by a small group of index heavyweights and an increasing number of popular thematic stocks, many of which could be categorized as "profitless tech". As such, the US also contains the most extreme examples of excessive valuations. There are still many good value opportunities within the US, most notably in left-behind areas such as pharmaceuticals and "old-school" technology companies, but the headwinds against the US market as a whole appear to be building.

Noting this caveat and also recognizing that high level comparisons often conceal more than they reveal, the forward price-to-earnings multiple of the US market is currently 23.5x, some 50% above its 20-year median. On a cyclically adjusted basis (using long term earnings), US share prices currently trade at 33x their historical earnings, the most expensive they have ever been in relative terms in 50 years, compared to 18x for global (ex US) equities. This is often justified by the higher quality nature of the US relative to the rest of the world, but even a partial unwinding of the growth bubble and a more buoyant global economic backdrop will favor the more cyclically sensitive international markets. Indeed, European earnings growth is forecast to be higher than US growth this year for the first time in nearly two decades.

Few commentators have an enviable track record in forecasting currencies, but there is also a widely held view that the US dollar will continue to weaken. A Democratic Blue sweep and the greater prospect of tax-funded stimulus has helped to reinforce this view. While the US dollar has recently enjoyed a partial reprieve, which is widely attributed to over-extended short positioning, downward pressure is likely to resume due to the re-emergence of the US twin deficits, i.e. a deterioration in the US trade balance alongside a significant decline in the fiscal balance. The last sustained dollar bear market in the early-to-mid 2000s was associated with deficits of a similar magnitude to what is unfolding at the moment.

Moreover, it is unlikely that the Federal Reserve (Fed) will consider tapering (i.e. winding down stimulus) until at least next year, although the timing of this policy reversal remains the key risk to the short USD trade. If the dollar does continue to weaken, this will also support the performance of non-US equities, particularly emerging markets which have the highest level of US-denominated debt.

As a final comment, we stress that countries will emerge from lockdowns at different speeds due to variations in vaccine rollouts and the limited ability of some countries to provide policy support due to fiscal constraints (e.g. India). In short, economic cycles are likely to be less synchronized in the years ahead. Country specific political risk is also likely to remain elevated given the greater pressures on society in the aftermath of the pandemic, most notably in exacerbating wealth distribution.

This all points to country allocation becoming increasingly important. In general, we would argue that country risk is still not efficiently priced, and we would advocate a heightened awareness of top-down considerations, particularly within investment strategies that are built bottom-up.

5. EM Asia 18% cheaper than developed markets, with better growth prospects

One likely beneficiary of a shift of assets away from the US are Asian emerging markets (EM), as these offer both growth and value opportunities. The strong gains posted by the emerging market heavyweights of China, Taiwan and South Korea during 2020 were predominantly driven by the high representation in these markets of a small number of strongly performing mega cap names. Stocks such as Alibaba, Tencent and the Chinese shopping platform Meituan are in many ways the counterpart to the FANGs (Facebook, Amazon, Netflix, Google). Just as the US market has become increasingly concentrated, the five largest stocks in the MSCI Emerging Market index now account for a quarter of the entire index. Despite this, EM Asia trades at an 18% discount to developed markets based on a forward earnings multiple.

China posted the highest GDP growth of any major country in 2020, abetted by a more effective approach to restricting COVID. Despite many commentators speculating that China's credit impulse may have peaked, the World Bank still expects per-capital incomes in East Asia to grow by nearly 7% this year, largely thanks to China. When coupled with very attractive valuations compared to their western counterparts, we expect Asian emerging markets to continue to outperform in the year ahead, particularly the export sensitive areas most geared into global recovery.

The prospects for other emerging markets are more mixed due to the likely uneven pace of vaccinations and potential negative impact of increased inequality as another legacy of the pandemic, particularly in those countries with less opportunity to provide aggressive policy support due to fiscal constraints. At a high level, EMEA (Europe, Middle East, Africa) and LATAM (Latin America) also offer fewer high quality stock opportunities and can be characterized as deep-value markets where, as with cyclicals more broadly, it is more important to trade off cheap valuations against weaker quality characteristics.

6. Higher inflation in the short run – good for commodities and Value

The long and drawn-out hangover from the global financial crisis has meant that inflation has not been top of mind for policymakers. Indeed, the risk of deflation along the lines of that experienced by Japan in the 1990s has been the key driver of low interest rates. However, one legacy of the current global pandemic has been the removal of capacity at a time when both the monetary and fiscal policy stance is extremely loose around the world and the household savings ratio is unusually high.

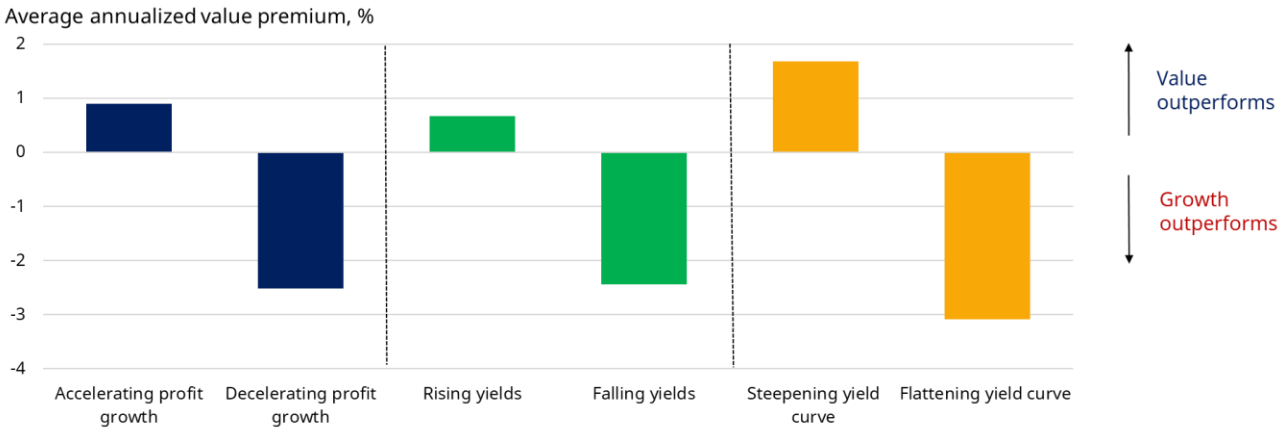
Until recently, investors were relatively sanguine about the prospect, but a combination of cost-push and demand-led forces could mean that the specter of inflation returns. We are already observing the impact of capacity restrictions feeding through into a tripling of shipping costs between the US and China in recent weeks. Much will depend on the extent to which the global pandemic has destroyed economic capacity but there is clearly a risk that stagflation returns for the first time in decades as high unemployment coexists with rising prices.

This is not a favorable scenario for policy makers, particularly against the backdrop of heavily indebted economies, although financial repression will most likely be preferred to fiscal tightening. The recent Fed policy shift to 'average inflation targeting' sets a precedent for tolerating a short-term pick-up in inflation and ongoing upward pressure on bond yields.

Rising inflation has historically tended to support cyclical sectors performing alongside the typical beneficiaries of higher rates, namely materials, industrials, consumer discretionary and banks. A 'lower for longer' Fed stance could weigh on net interest income for banks but their valuations have historically correlated more with a steepening yield curve than they have with the short-term impact implications for net interest income. Some of these inflationary beneficiaries are also COVID re-opening themes but many areas of the market face headwinds that will take many years to play out. We would also highlight that the key losers from inflation are areas regarded as bond-proxies, such as utilities, while many real estate stocks are already struggling due to the collapse in demand for office space.

While accepting that we are not in a standard economic cycle and the usual broad classification of cyclicals is probably less valid than in the past, the historical evidence suggests that recoveries and rising yields are beneficial to Value vs. Growth performance, largely due to the greater representation of cyclical stocks in the value universe.

Faster growth, higher yields and a steeper yield curve have historically been favorable to Value



Source: Datastream Refinitiv, MSCI and Schroders. Data from December 1974 to November 30, 2020. Notes: returns based on monthly rolling annualized returns of MSCI US Value versus MSCI US Growth total returns. Accelerating/decelerating profit growth = annual absolute change in rolling 12-month EPS growth of the MSCI US Index. Yields = US 10-year Treasury yield. Yield curve is 10-year US Treasury yield versus 3-month US Treasury Bill. Past performance is no guarantee of future results.

While most of the potential beneficiaries from a cyclical recovery and higher yields are currently very cheap, they are not necessarily high quality. As such, we would advocate a selective exposure to such "deep-value" themes, ensuring that financial strength is not compromised, particularly since the widely anticipated V-shape economic recovery may more bumpy than the assumed smooth take-off.

7. Healthcare: a valuation anomaly – cheapest in at least a quarter of a century

Fortunately, value-focused investors are currently spoiled for choice and do not need to rely solely on cyclicals to come good, as there are also many opportunities today in more defensive areas of the market, such as healthcare and telecoms.

With the notable exception of the COVID-19 inspired sell-off in markets last March, most traditional healthcare stocks such as pharmaceuticals have been out of favor in the recent past due to their defensive bias and the elevated risk of impending drug price regulation in the US. It is clearly a disparate sector and parts of healthcare are already very hot (e.g. biotech/genomics), but our high level view is that the potential hit to earnings from lower drug prices is already factored in.

Pharmaceutical stocks in particular are attractively valued and also offer stability in the sense of robust margins, decent dividend opportunities and low financial leverage. We believe these attributes will be increasingly recognized, particularly if economic growth ends up being more sluggish than expected. Moreover, unlike some so-called 'old economy' tech stocks, pharmaceuticals are less likely to be outmaneuvered by new entrants. Their strong balance sheets keep them at the center of both mergers and acquisitions and research and development.

The search for a COVID vaccine and the success of RNA-based vaccines has also shined a light on the huge potential of genomics. The 'storytelling' around the potential for personalized medicine has been made more accessible by the launch of ETFs which provide retail investors with pre-curated access to these trends. We return to the topic of thematic investing later, but we do regard genomics as a structural trend, albeit one that is currently exhibiting signs of exuberance and excessive valuations. We continue to track it closely and look for further opportunities to invest as market conditions evolve.

Just as it has for technology more broadly, COVID appears to have accelerated pre-existing trends, most notably in drug discovery and medical technology (medtech). In the widest sense, medtech encapsulates advances in healthcare IT systems, electronic patient records and advances in diagnostics, to machinery for genomic research, all of which are increasingly necessary in a post-pandemic world. The market re-rated some of these areas in 2020 but we expect performance to broaden out further going ahead.

8. Environmentally focused investing here to stay

The shift towards sustainable investing appears to be accelerating, although this covers a wide range of implementation options from the exclusion of offending areas to more targeted approaches. The downward trend in oil and many other commodity prices over the past decade, albeit not without considerable volatility, has reinforced the performance of environmentally conscious managers, which has only partially unwound of late due to the strong recovery in commodities from the extreme lows of early last year. This looks set to continue in the short term at least, if only due to a sharp reduction in capital spending, but the broader goal of achieving the Paris climate agreement suggests that downward pressure on carbon emissions will continue and companies will need to adapt.

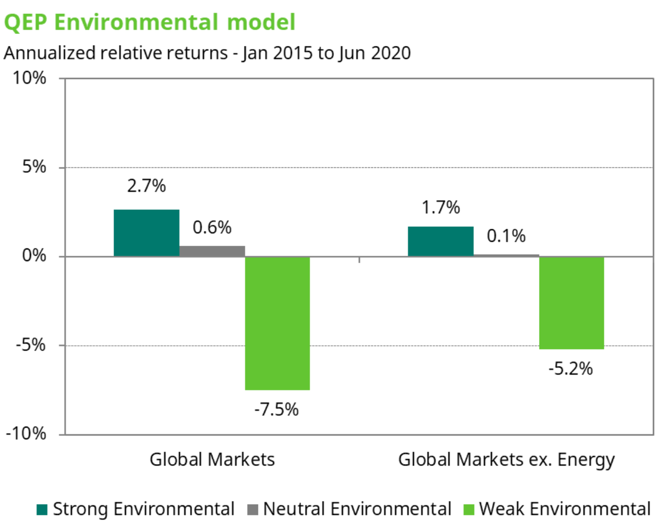
Investment in oil and gas production is expected to remain below pre-pandemic levels for the foreseeable future at a time when firms pivot towards alternative sources such as solar and wind power, where costs have declined significantly in recent years. The shift towards non-fossil fuels will be the key focus for investment in the decade to come, alongside emerging technologies in battery storage and biofuels. Indeed, the most likely solutions to achieving a low carbon economy rely heavily on technological transformation. Such disruption is already evident in many areas, but particularly in the auto and utility industries.

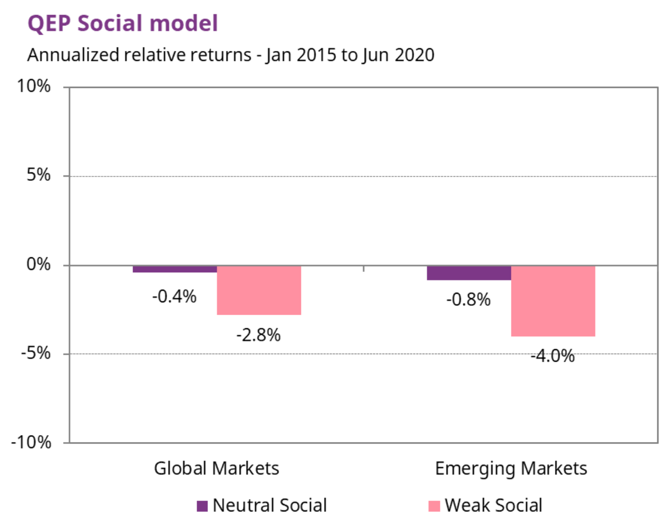
There is also increasing recognition that solar, wind and hydrogen energy alternatives are not just a growing niche within the energy complex but will most likely emerge as the main incumbents. At the stock level, we expect to see the use of more sophisticated environmental scoring to recognize sum-of-the-parts valuations more clearly with transition stocks, increasingly crystallizing value via spin-offs.

9. Social considerations also increasingly important in a post-COVID world

While an awareness of social issues has long been another key focus for us, they have not received the same broad recognition as environmental considerations, potentially because they are more subjective and harder to quantify. Social risks are inherently driven by the nature of the underlying business as well as management decisions, so it is important to adopt a tailored approach that reflects industry-specific absolute risks. Within our proprietary QEP ESG (environment, social, governance) rating, we focus on measurable risks where possible, such as business involvement, employee welfare, diversity, product safety, data privacy and supply chain labor standards. It is not always straightforward to determine if the lack of a policy is due to the company not managing their risks or a lack of public disclosure. For this reason, we do not automatically penalize companies that have low disclosure and view these as candidates for engagement.

Across all of our global strategies, we are particularly focused on avoiding or scaling back exposure to companies with higher social risks. For our dedicated ESG strategies, we will avoid areas involved in certain businesses altogether (e.g. tobacco) and risk manage our exposure to stocks with poor practices in areas such as labor management. Over the past few years, it has been beneficial to recognize both social and environmental considerations as stocks exposed to these risks have lagged behind on a relative basis.





Source: Schroders. Data is from Jan 2015 to Jun 2020 for QEP investment universe (Global and Emerging Markets), excluding small and micro-cap and Frontier Markets stocks. Performance is based on market capitalization weighted returns of portfolios formed by the QEP Environmental and Social Rank. Strong Environmental refers to 0%-45% rank, Neutral refers to 45%-85% rank and Weak refers to 85%-100% rank globally. Neutral Social refers to 50%-60% rank and Weak refers to 85%-100% globally. Returns are relative to Global and Emerging Markets respectively, annualized, expressed in local currency with gross dividends reinvested and are adjusted for transaction costs. Past performance is no guarantee of future results.

One of the very few positives arising from the pandemic is that it has increased awareness of the importance of these issues, particularly in areas such as mental health and rising inequality. We are strongly of the view that taking social harm into account will increasingly be accretive to future investment performance as companies become more responsive to their wider impact on society.

One example of a positive trend would be the increasing importance of online education. As a sector, education currently represents just 6% of global GDP, with over half of the world receiving no formal education beyond age 16. In response, online education spending is forecast to grow at a 25% CAGR for the next decade. We already favor education tech stocks in our portfolios but we believe this theme will also broaden out to vocational training, VR (virtual reality) training and career pathway management.

10. The continued rise of thematic investing

Related to many of the structural trends that we have already highlighted, we also expect thematic investing to become increasingly prominent as existing paradigms are challenged due to technological disruption. While thematic investing is in itself an ill-defined term, it is widely associated with broader trends that transcend the typical classification of stocks by their industry or sector.

A good example would be the rise of the internet and social media over the past two decades. At a high level, the rapid rise in technological disruption is pervasive in all areas of society, some of which have emerged only recently as a direct result of COVID-19. Examples include education tech, sports tech, cloud infrastructure, telemedicine and teleconferencing technologies, which have all enjoyed accelerated adoption due to work-from-home conditions.

On the 'supply' side, the number of potentially thematic stocks appears to be increasing by the day due to the greater pace of disruption when compared to recent decades. To some extent this is also self-perpetuating, with the recent SPAC phenomenon speeding up the timeline for disruptive ideas to be listed.

At the same time, investor demand for these stocks is also increasing. The significant increase in retail participation in the recent past, in part thanks to stimulus checks, has come at a time when traditional alternates to equities such as cash and bonds have lost their allure. Retail volumes overtook institutional volumes on the NYSE in January 2021 for the first time in history, but this is not just an American phenomenon, with record share account openings also seen in China last year.

If the significant news coverage of the recent Reddit/GameStop episode and the broader squeeze on short-interest is any guide, the rising influence of retail investors has already started to change the market dynamic. In this instance, the short-squeeze was mostly an issue for a handful of hedge funds rather than a portent of a wider seismic shift. It is not uncommon to observe bouts of short-covering and, with a few notable exceptions such as Volkswagen in 2008, it is relatively rare outside of smaller stocks such as GameStop.

Nevertheless, the rise of the “value indifferent” investor is likely to continue while regulators permit it and liquidity remains abundant. The observation that it is easier to penetrate Main Street with popular themes than it is with accounting-based valuation methodologies has also led to the rise of instruments, such as ETFs, which increasingly provide easier and pre-curated access to these popular ‘themes’. This is both an opportunity and a threat to traditional value-oriented investors. Most of the themes are, as outlined above, both disruptive and structural, which means that they are likely to persist. However, this also increases the risk of new bubbles emerging. The strong performance of some solar and biotech stocks and of “profitless tech” over the past year is already causing us concern about whether valuations have moved too quickly.

We take a diversified approach which naturally lends itself to capturing aspects of thematic investing without taking undue concentration risk in outcomes which may ultimately come good but are also less certain. Themes will almost certainly mature at different speeds as they transition from a 'hype' phase, where most participants are simply valued as winners, to a more mature phase where the actual winners become more discernible and value emerges. Looking ahead, we would highlight a few themes that we are already closely monitoring such as online care and telemedicine, genomics, rare earths, industrial automation, and 5G telecoms.

Other considerations

One concern at the moment is that investor predictions for the next year or two are in broad agreement, in terms of rotation towards attractively valued areas benefitting from the re-opening of global economies. The short-term outlook is still relatively uncertain due to multiple new faster-spreading COVID mutations. At the same time, there is a growing acceptance that COVID-19 is here to stay in some form, as it will take many years and probably decades before it becomes endemic.

Cyclical sectors have so far recovered at very different speeds post the initial market correction of early last year. Some sub-sectors such as autos, chemicals, resources and industrials bounced rapidly with the general recovery in economic activity, while the prospects for greater infrastructure-related stimulus in the US and Europe has recently provided further support. These areas remain good value relative to the market but are not necessarily cheap relative to history and establishing what is in the price will likely be harder and more idiosyncratic across stocks, industries and countries.

As a general point, we would advise against confusing cyclicals with “value”. As was the case in 2020, the future performance of cyclicals will most likely continue to bifurcate along their sensitivity to interest rates, energy prices, and COVID developments, versus those more closely correlated to broader economic activity (e.g. industrials).

Again, we would advise caution in blindly adopting the consensus. The “what’s in the price” debate will be more nuanced going ahead and sub-sectors and thematics may matter more than the frequently cited top-down sector-based calls. We are already observing signs of exuberance in the performance of the SPACs, recent IPOs, and crypto currency, and the crowding in some speculative areas of tech, biotech and green tech. The latter in particular is a good example of a large imbalance between stock availability and a huge flow of investor demand. However, we do think these trends are here to stay and pullbacks will present opportunities at the stock and sector level. Moreover, the historic underperformance of Value in 2020 should still provide a buffer against any stalling of the recovery if COVID takes an alternate path in 2021.

Summary

If 2020 has taught us anything it is that we should be prepared for the unexpected and that markets continue to overreact to events in the short term. While many of the themes mentioned above seem highly probable, it clearly makes sense to build portfolios that are robust enough to weather a range of alternative scenarios. We believe our diversified focus on value and quality alongside the integration of longer term ESG risks places us in good stead, but our main message would be that 2021 and beyond will require a greater focus on drilling down into the nuance. In particular, balancing what is already priced in relative to an uncertain short-term cyclical environment, as well as longer term themes, will be key to avoiding the many potential value-traps.

QEP Investment Team
March 2021

Important information