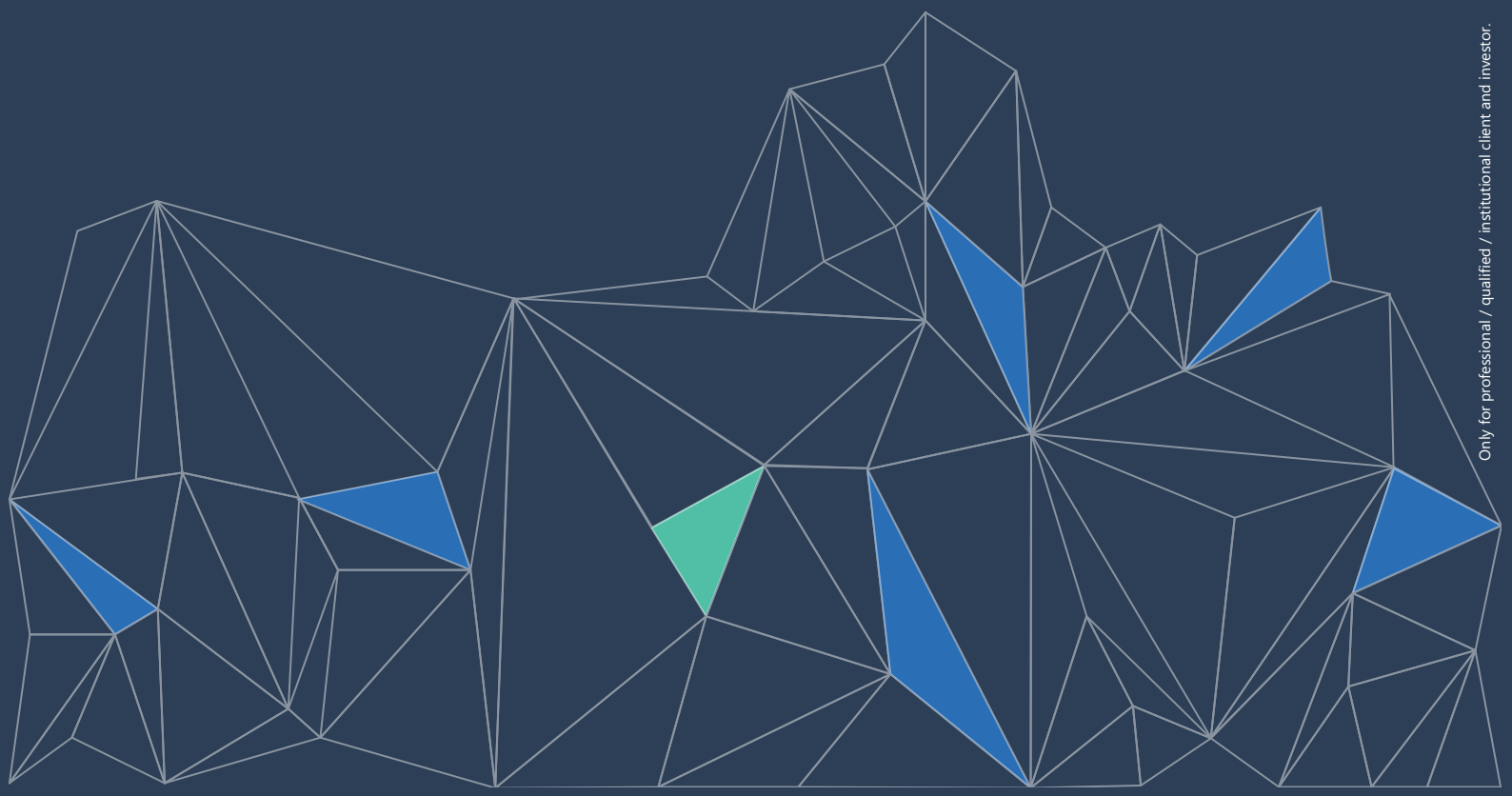
. January 2021 .

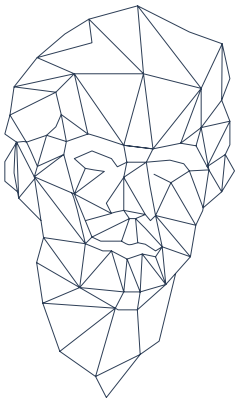
2021 OUTLOOK

by SILEX



Only for professional / qualified / institutional client and investor.

EDITORIAL



Xavier Laborde
CEO, Co-founder
SILEX

2020 proved to be a year that no one expected. As a young company, SILEX went through its first real-life stress test. We experienced challenges with our systems, our organisation, and our team spirit. I am proud of what we have achieved, most of all in being worthy of our clients' trust during this difficult period. Rock-solid!

From a market perspective, last year was a stark reminder of the need to be humble. There will always be unexpected events, no matter how skilful our portfolio managers are. Therefore, my personal lesson from 2020 is to maintain our focus on processes and risk management. The case for the "quantamental" approach we have developed since 2018 has strengthened and, more than ever, we will combine human expertise and SPARK, our quantitative platform, to run money in 2021.

We significantly extended our asset management franchise in 2020, with the launch of our convertible bond offering. Our experts, asset class by asset class, play a key role in establishing SILEX as a meaningful asset manager.

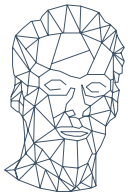
Today, I am delighted to present the new annual Outlook from SILEX. Our portfolio management team shares their convictions and recommendations for 2021. We hope you will enjoy it and look forward to getting the conversation going!

Happy New Year to all,

Xavier Laborde

ASSET ALLOCATION VIEW

By Maxime Alimi, Head of Macro & Allocation



Maxime joined SILEX in 2019 as Head of Macro & Allocation. He is in charge of both research and macro analysis on the one hand, and cross-asset portfolio management on the other. He began his career in London in 2007 as an economist at Lehman Brothers then as a multi-asset strategist at Goldman Sachs. In 2012, Maxime joined AXA Investment Managers and then became Head of Investment Strategy in Paris. Maxime holds a degree in international relations from Sciences Po Paris and the Freie Universität Berlin, and in economics from Paris I Sorbonne University and the London School of Economics.

BEST IDEA_ TIME TO REVISIT THE EM ALLOCATION

Emerging markets are back on investors' map after several years of underperformance. According to several surveys, the consensus has turned positive on EM equities, and rightly so in our view. Historically, periods of EM outperformance coincide with i) strong global growth; ii) a depreciating US dollar. This is the kind of environment we expect for 2021. Moreover, EM equities are cheap in relative terms compared to many developed markets.

Last year made clear, however, that China should no longer be considered part of this asset class. The correlation to the rest of EM is declining as the sector composition of Chinese indices reflects a modern economy. It is time to see the China allocation as a standalone decision. In effect, we start 2021 with an overweight to EM but an underweight to China.

KEY RISK_ IS GOVERNMENT DEBT STILL A DIVERSIFIER?

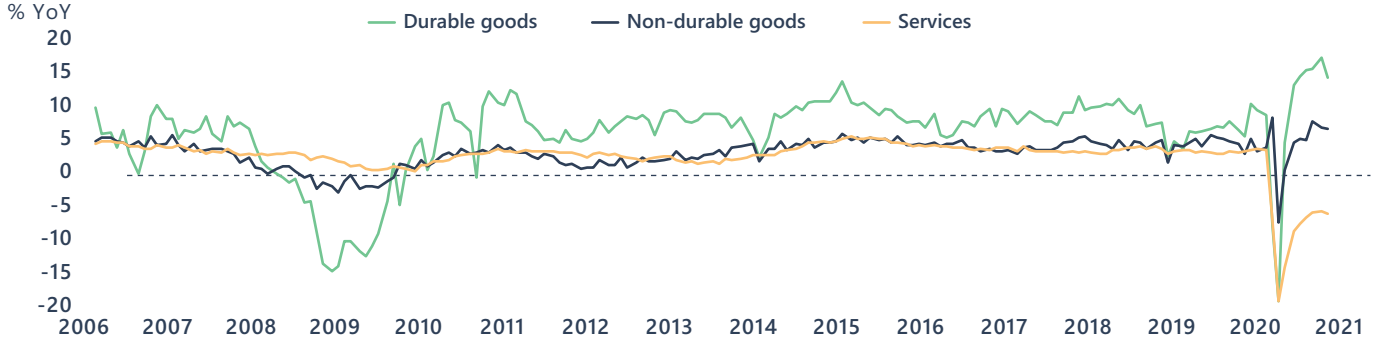
Central banks have taken control of the yield curve. Even though this is only official in Japan, monetary policy is increasingly targeting long-term interest rates as a way to manage funding costs for governments and corporates. As much as this makes sense from a policy perspective, it dramatically changes the environment for multi-asset investors. Government debt is much less likely to help reduce drawdowns in 2021 compared to history. This is not only because interest rates are nearing a natural bottom, which makes more difficult for bonds to appreciate in case of market stress, but also because their price is simply less and less determined by market forces.

Investors need to find alternative ways to manage risk. These include: i) take less risk overall; ii) use alternative safe assets, such as gold or currencies; iii) use derivatives. There is no 'one-size-fits-all' solution and all options are worth considering. The most important is to elaborate the battle plan before the time to execute it arises.

BEST CHART_ MASSIVE PENT-UP DEMAND FROM THE US CONSUMER

The coronacrisis has been unusual in many respects. One of them is unprecedented policy support to households during a recession: income went up rather than down last year. As a result, the consumption of goods continued to grow while services consumption is way down because of activity restrictions. This decline is constrained rather than chosen, as reflected in the high savings rate. This implies massive pent-up demand from the consumer and upside to growth once economic conditions normalise.

US private consumption



Source: BEA, SILEX

EQUITY VIEW_ RISK MANAGED

By Benoit Brochart, Senior Equity Portfolio Manager

Benoit is senior portfolio manager at SILEX IM since 2018. He started his career as a quantitative analyst at Total Oil Trading in 2004. From 2005 until 2011 he worked at Crédit Agricole CIB in the equity derivatives department as a prop trader, leading the development of index and statistical arbitrage. In 2011, Benoit became portfolio manager for Unigestion. As a member of the investment committee, he participated in managing Equity Risk Managed funds. In 2017 he joined SILEX, taking the lead on developing the asset management business. Benoit graduated from ENSAE.

BEST IDEA_ ESG IN AMERICA

Even with the Covid-19 crisis, ESG investment saw strong performance and inflows in 2020. From $3tr in January 2020, total ESG estimated assets have more than doubled at the end of last year. This trend should continue in 2021 with a major focus on US equities. These should see the biggest increase in ESG adoption and have the greatest scope for growth, as 80% of sustainable assets currently sit in Europe. A Biden Presidency and his "Build Back Better" plan associated with a $2tr infrastructure package should be an opportunity to make progress on climate policy. This includes significant research and development funding for clean energy, for local governments to continue their renewable energy expansion, and an extension of tax credits for renewable energy industries. The main sectors that should benefit from this package are the automobile industry, transportations, building, housing, and agriculture sectors.

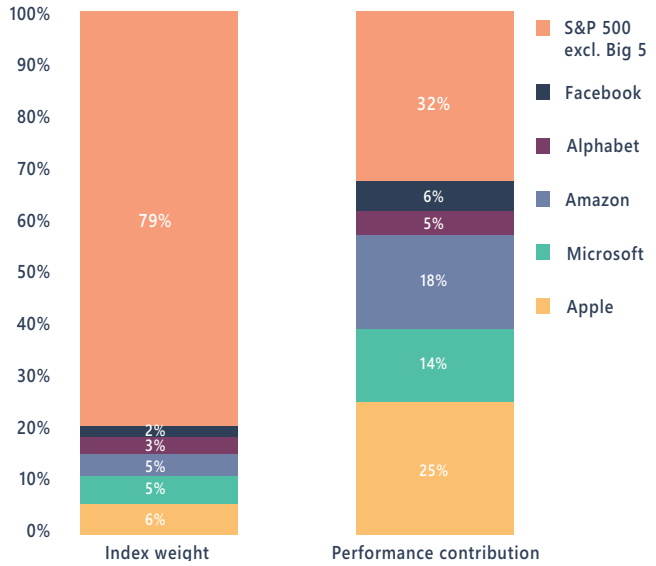
KEY RISK_ FLASH CRASHES

In 2021, equity markets should be driven by the recovery from the Covid-19 crisis on the back of effective vaccines and extraordinary monetary and fiscal support. Given the level of interest rates, money managers could initiate a substantial rotation into higher yielding assets such as high beta stocks. This would be an environment in which market volatility declines. A decline in volatility creates a positive feedback loop, whereby systematic and discretionary strategies increase allocations to equities. Furthermore, several quantitative drivers also put pressure on market volatility, such as the decline in realized correlation on the back of strong factor and sector rotation.

In that context of low volatility and apparent consensus across market participants (bullish equities, bearish the dollar, bearish Treasury bonds), the key risk is a complacent market exhibiting much lower volatility than uncertain fundamentals warrant. It leaves investors and markets highly susceptible to flash crashes, exacerbated by flows coming from systematic strategies.

BEST CHART_ BEWARE INDEX CONCENTRATION

S&P 500 performance decomposition in 2020



The US equity index poses increasing risks of concentration. This proved positive in 2020 as mega-caps outperformed but may lead to strong drawdowns in 2021 due to idiosyncratic risks and a crowding effect on very few names. A risk managed approach is warranted to improve diversification and outperform in the long run.

Source: S&P, SILEX

EQUITY VIEW_ SELECTION

By Barthélémy Debray, Head of Equities

Barthélémy began his career in 2006 as a junior equity portfolio manager at AXA Rosenberg in London. He then joined US asset manager Pinebridge in 2008 to help manage a $2bn small / mid cap technology fund and moved to Old Mutual 4 years later to manage a high conviction pan European equity strategy. He relocated to Geneva at Lombard Odier as a fund manager in 2018 before joining SILEX in 2019. Bart brings his expertise in stock picking and equity strategy. He holds a Master in asset management from Dauphine University and earned the CFA® qualification in 2011.

BEST IDEA_ EUROPEAN CYCLICAL RECOVERY

A new business cycle is starting, which will drive further upside for equities and a broadening of the market leadership. We may not be out of the woods yet, but the direction of travel is towards less uncertainty, higher growth, and a gradual return to normality. This will favour small caps over large caps, and European over US equities.

We expect European equities to reach new highs in 2021. The reflation trade has become more consensus of late although many unknowns remain. Yet, we note that a strong cyclical upswing will fuel further rotation out of still-crowded bond proxies (consumer staples, utilities, luxury, big tech), into less-owned, riskier assets.

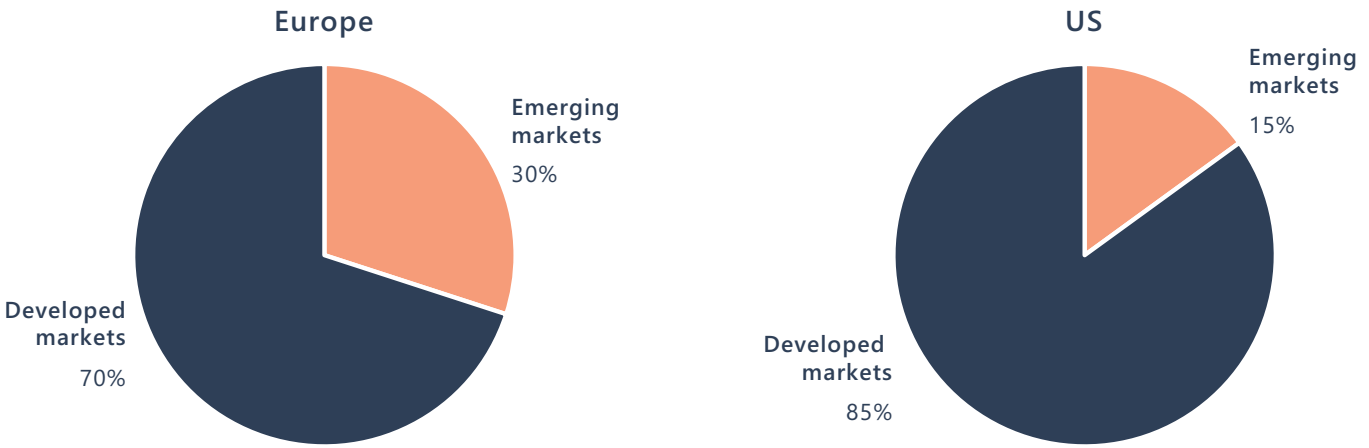
KEY RISK_ INFLATION

Inflation will be a key debate for 2021. In the near term, the virus outbreak and vaccine rollout remain a risk to both the growth and inflation outlook. Beyond that, as we enter the second half of the year, the acceleration in the recovery could lead to a quicker and more intense increase in wage and price pressures. Inflation could accelerate even faster, bringing a shift in expectations on central banks' policies, setting the stage for higher volatility especially for long-duration assets and bond proxies.

BEST CHART_ GEOGRAPHIC REVENUE EXPOSURE EM VS DM

The economic rebound is likely to come faster and stronger in emerging markets compared to developed markets as evidenced by the strength of the current manufacturing cycle. European listed companies benefit from greater revenue exposure in emerging economies compared to their US counterparts. This should act as a tailwind for European earnings and could be an additional source of outperformance.

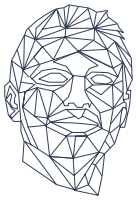
Geographic revenue exposure EM vs. DM



Source: SILEX, Bloomberg, UBS Equity Strategy

FIXED INCOME VIEW

By Philippe Kellerhals, Head of Fixed Income



Philippe has been Head of Fixed Income at SILEX IM since 2019. He started his career in 2003 at BNP Paribas, as a credit portfolio manager. In 2008, he joined Cairn Capital in London with responsibility for corporate credit strategies covering trading, portfolio management and research. Philippe joined SILEX in 2018 as Head of Fixed Income. He manages the SILEX Financial Credit and the SILEX Flexible Bond funds. Philippe holds a master's degree in Finance from ESCP Europe and is a CFA® charterholder.

BEST IDEA_ TIME TO OVERWEIGHT HIGH BETA CREDIT

The environment looks favourable for high beta credit (global high yield, EM debt and subordinated financials) as spread compression has further room to run. First, economic growth and earnings look set to normalise from 2021, supported by fiscal and monetary policies. At the same time, carry/yield opportunities in high-grade government and corporate bonds have become scarce and exposed to interest rate volatility.

Second, the High Yield default rate is a lagging indicator, which follows credit spreads and the distressed ratio.

We expect low default rates in 2021-22. Relative value is attractive: the BB-BBB spread is around 50bps too wide and more than compensates for the extra credit risk and volatility BBs carry compared to BBBs.

Third, issuance volumes will come down from 2020 levels and help strengthen the technical picture further. Further refinancing of the front end of the HY bond curve will occur. The best risk-reward sits in intermediate BB-B bonds, while one should avoid long-dated BBs and IG benchmark proxies.

Finally, subordinated financial debt is likely to outperform as banks' credit metrics remain stellar with financial policy still prudent, while net issuance will fall dramatically, and legacy paper is being taken out.

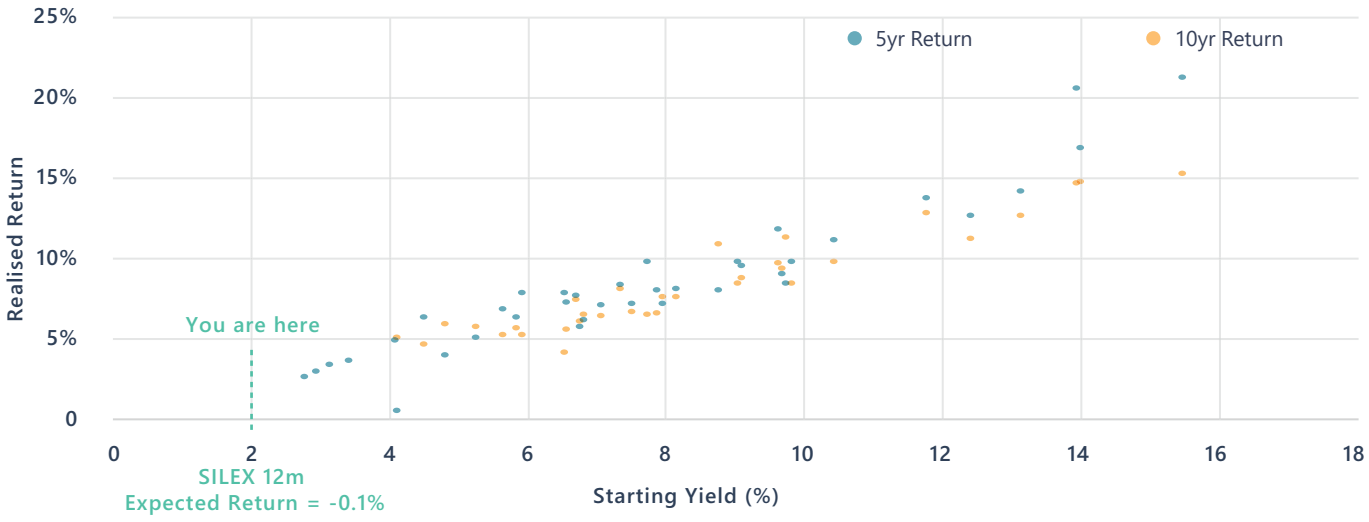
BEST CHART_ US IG LOOKS UNATTRACTIVE

This chart shows the forward return of US IG credit depending on its starting yield. We expect the absolute and risk-adjusted return of USD IG to be low in the short term (12 months) as duration losses offset modest spread tightening and a low carry. The longer-term expected return and ex-ante Sharpe ratio are likely to be much lower than in recent years.

KEY RISK_ CENTRAL BANKS

An early or poorly communicated exit from major central banks may spark much higher levels of interest rate volatility. Monetary policies are extremely accommodative and the transition to a more normal regime, if unorderly, could lead to sizeable outflows from bond funds. This in turn would imply higher liquidity risk premia and spread volatility.

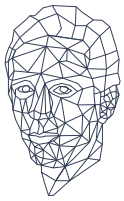
USD Investment Grade Credit Index



Source: BofA, SILEX

CONVERTIBLE BONDS VIEW

By Xavier Hoche, Head of Convertible bonds



Xavier has been Head of Convertible Bonds at SILEX IM since 2020. He began his career as fixed income portfolio manager at Crédit Mutuel in 1995, then joined Crédit Lyonnais AM and OFI Asset Management as Head of convertible bonds. From 2006 to 2008, he was convertible bonds manager at Schelcher Prince Gestion before taking responsibility for the convertible bonds and dated funds at Oddo Asset Management. In 2013, he founded AltaRocca AM dedicated to convertible bonds management and also served as a fund manager analyst there. Xavier graduated from ISFA in actuarial science.

BEST IDEA_ EUROPEAN CONVERTIBLE BONDS

The outperformance of US growth stocks in 2020 was primarily due to their ability to benefit from the COvid-19 pandemic. As this tailwind abates, a rotation to cyclical and value stocks is likely (although you should not expect a complete reversal of the medium-term trend). The European convertibles universe is more exposed to cyclicals and value than Asia or the US and may benefit. Furthermore, ESG matters more than ever in 2021 and Europe is well positioned with significant green convertibles issued in 2020 and early 2021.

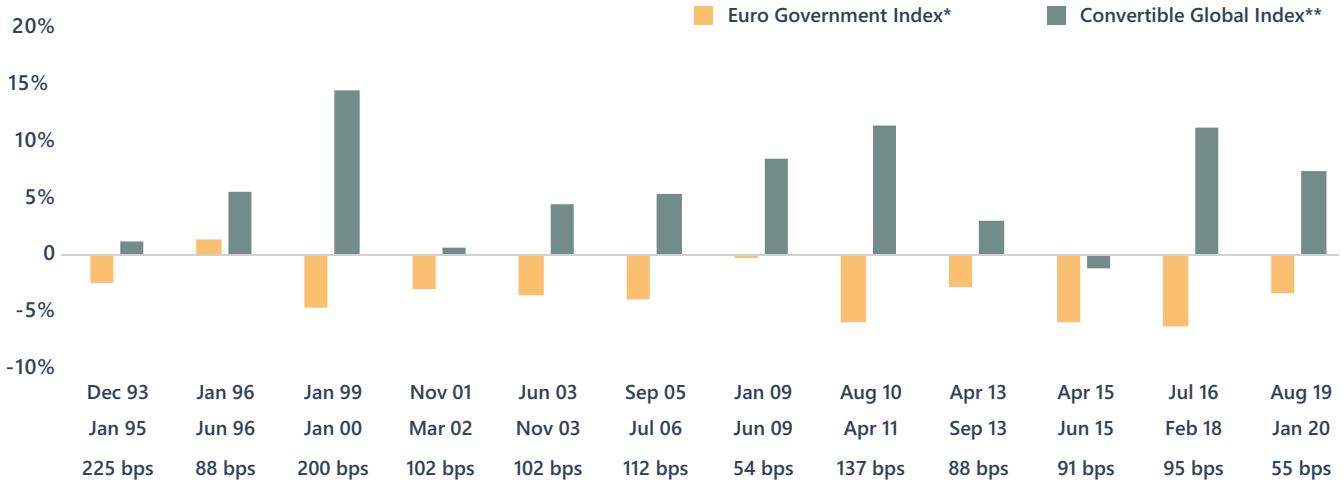
KEY RISK_ THE PANDEMIC LINGERS

A key risk to the market would be a potential hiccups in the economic recovery which hinges mainly on containing Covid. Any virus mutation not covered by existing vaccines would jeopardize much of the current consensus. Equity valuations, especially those underlying the convertible universe, reflect a high level of optimism for a sharp earnings' rebound, therefore posing a risk to the asset class. In the US, with ca. 61% of the convertible market being equity sensitive, any pullback in equity markets could negatively impact returns.

BEST CHART_ NO NEED TO WORRY ABOUT RISING INTEREST RATES

Convertibles have historically performed in a rising rate environment as these episodes tend to coincide with positive macro environments. The equity features of convertible bonds tend therefore to dominate and growth exposure more than offset bond features.

Performance of convertible bonds in rising rate environments



* BofA Euro Government index
** Thomson Reuters Convertible Global Focus EUR Hedged index
Past performance is no guarantee of future performance and is not constant over time.

Source: Bloomberg, SILEX

This article was finalised on 13 January 2021.

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