PORTFOLIO POSITIONING UPDATE SEPTEMBER 2020

18 September 2020

momentum
global investment management

Summary

After a strong August, markets are pulling back in September. Thus far, our updated protection strategy seems to be working (more on this below). Looking forward we see three primary risks on the horizon:

- A potential second wave of Covid-19 infections
- Overvaluation in certain sectors (particularly, certain US technology stocks and many sovereign & corporate bonds)
- Unexpected inflation not currently being priced in by many market participants

Performance

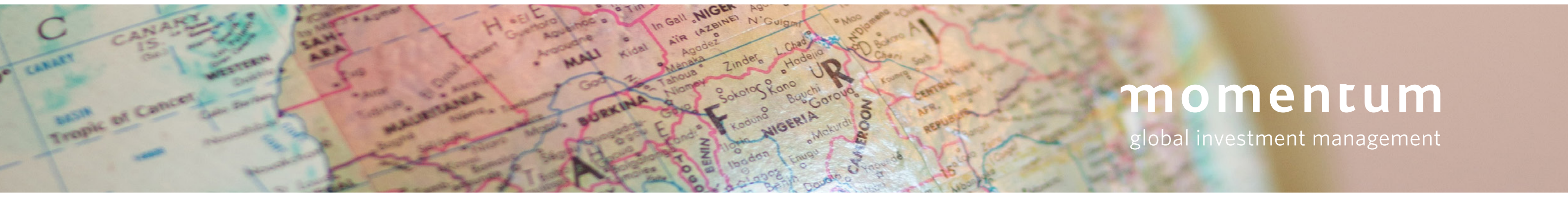
The Fintax International Funds delivered positive returns in August, with Balanced up +3.3% in US dollar terms and Growth rising +4.6%. This takes the three months return for the Funds to +12.3% and +14.5% respectively. Following the sharp rally in markets post March, the longer-term performance of the Funds has recovered: Balanced has returned +5.5% per annum in dollar terms over the past five years and Growth has returned +5.9%.

The biggest contributor to returns over the month were from the Funds' equity positions which rallied over 5%, led by Jennison, our global growth manager. Equity markets were supported by signs of continued economic recovery and ongoing fiscal and monetary policy support. Precious metal prices rose on the back of dollar weakness and silver performed strongly in both Funds, returning +14% in August.

Protection

As noted, one of the most obvious risks is a second wave of Covid cases, but despite this risk **asset prices in some areas appear extended.** We have used conservative assumptions in forecasting the behaviour of the Funds given a further period of weakness in markets. Our stress tests show that the Funds would not be immune to the falls but we expect **the new defensive positioning** to better protect your capital relative to global equities, more meaningfully in the case of the Balanced Fund compared to the Growth Fund, given the latter's higher risk mandate. Thus far in September, this has been the case.

The first quarter of the year demonstrated how even traditional defensive assets like property can be severely impacted by tail events like national lockdowns. With property companies continuing to trade at significant discounts to net asset value and with yields close to all-time highs, we think property, along with areas like value equities and credit, would be unlikely to fall to the same extent as they did during March. Much of the negative sentiment is already reflected in their price. **The Funds do not have significant exposure to government bonds because they are too expensive** and in many instances guarantee negative returns over the next five years. The Funds do, however, own carefully selected government bonds that compensate for holding them, alongside other defensive assets like gold and cash. Additionally, the S&P500 Index put options investors own in both Funds will rise in value should stock prices decline. The exercise index level of these S&P500 options is 3,375.

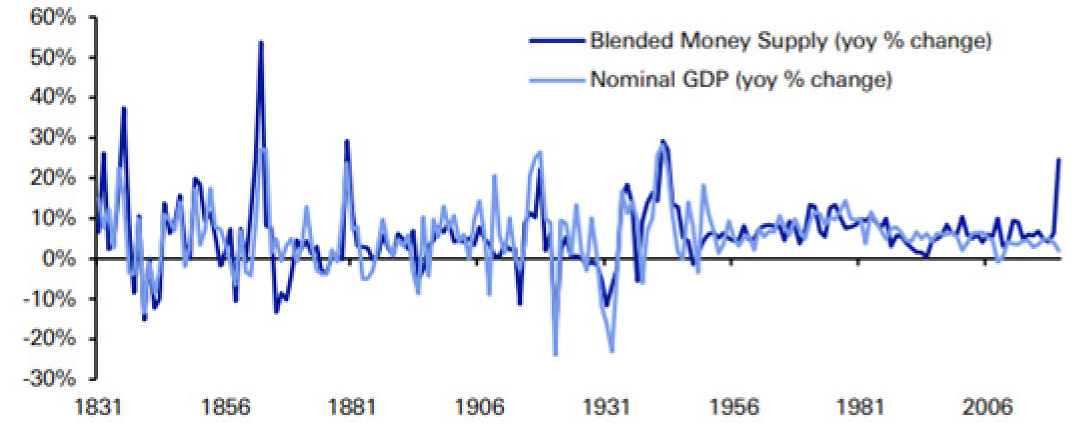


Looking forward: Inflation is a possibility that the market is overlooking

After the Covid crisis, inflation expectations fell dramatically in anticipation of the deflationary economic shock that has followed. While expectations have since recovered to pre-crisis levels, they remain low relative to history. **We are of the view that the market is yet to fully appreciate some developments which have further inflationary potential.** To this end, the Funds own real assets including infrastructure and commodities, as well as Treasury Inflation Protected Securities (TIPS) for Balanced, which will help protect against an unexpected inflationary environment.

The amount of stimulus applied by central banks has been unprecedented, with a combination of both fiscal and monetary policy. US money supply growth has shot up to 25% year-on-year in the US, significantly higher than any time post war. **This typically leads inflation** which impacts nominal GDP, as shown in the following chart from Deustche Bank:

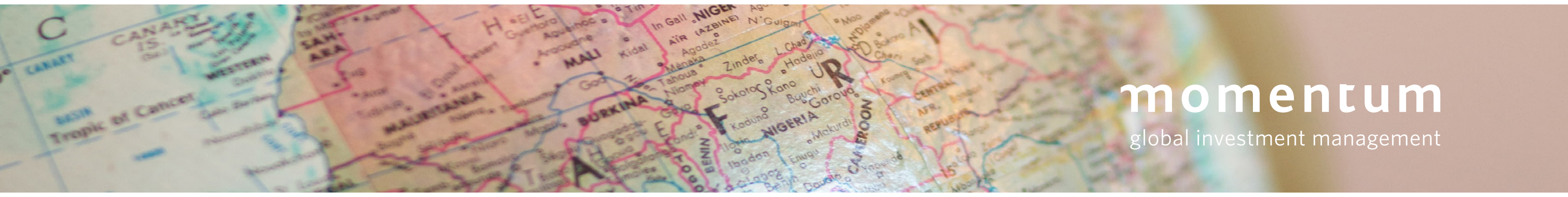
Figure 41: US money supply and nominal GDP growth



Note: We've tried to use the broad definition of the money supply available. This means it's a blend of currency in circulation (1831), M1 (1930-1948) and M2 (1949-current). The Fed discontinued M3 in 2006 so we did not blend that in historically.
Source : GFD, Deutsche Bank

Supporting the inflationary scenario, **we do not currently see any appetite from governments to return to austerity as economies recover.** President Trump has been vocal about further stimulus measures and negotiations are progressing in Congress. Recent comments from the Fed also signal both that monetary policy is likely to remain accommodative, and fiscal policy should play an important role, which should be good for your infrastructure exposure in the Funds. **Of course government policy could change, but right now there looks to be a significant change compared to the post-financial crisis period.**

Another key consideration is that the **trend of further globalisation has stalled and appears to have gone into reverse.** This pandemic has highlighted the dangers of globalised supply chains and there is political will to move businesses back onshore. This has the potential to generate **cost push inflation** (or at least arrest the supply side benefits of globalisation) over the longer term.



What does this mean?

Since very few market participants are pricing in future inflation in their valuation models, any inflationary surprise will likely negatively impact the prices of highly valued growth companies.

Conclusion

Despite the positive news flow in recent weeks, **there remains deep uncertainty about the sustainability and strength of economic growth. Valuations have risen substantially and in some cases to levels which are very difficult to justify on fundamentals. A correction is overdue,** and a rotation into underperforming sectors, typically value stocks, would be a healthy development for the market. As noted, some semblance of this is currently taking place in September. Overall, today we still think it is prudent to maintain selective equity exposure in the Funds while carefully monitoring potential risks, like inflation. Alongside these equity positions, the Funds maintain a diversified defensive positioning and we will use setbacks in the months ahead as a buying opportunity.