5th Floor, Green Park Corner, 3 Lower Road, Morningside, South Africa, 2196
TEL: 011 883 0292/94 MAIL: info@effectuscapital.co.za www.effectuscapital.co.za
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Effectus Capital Management (ECM) Newsletter December 2020 – setting the scene for 2021

By Grant Nader

There is not much more to be said about 2020

2020 was a year for which in hindsight many of the opportunities seemed obvious (don't they always). The work-from-home, e-commerce, cloud and digital providers and healthcare stocks were obvious and easy winners as was some form of recovery trade in the latter part of the year. Overall, our focus on innovative companies with high growth paid off across our portfolios as we outperformed benchmarks across the board. But this is a new year…

Lessons learnt - from an investing perspective, 2020 was a stark reminder:

- **Only the magnificent few can really time the market**. Everyone else risks becoming perma-bears or perma-bulls, always looking for tops and bottoms but never finding them and suffering major losses or opportunity costs along the way.
- **Less-bad and more-bad**: Markets look ahead and rise when things begin to look less bad than what is priced in and fall when things look like they are going to get worse than what is priced in. Sometimes it is just that simple.
- **The future economy 10 and even 5 years from now** is going to look very different.

Looking ahead to 2021

Considering the numerous supportive factors for equities, we remain broadly bullish on the outlook for 2021. The lack of alternatives, cheap liquidity, monetary and fiscal stimulus are still firmly in place.

However, we expect **volatility to increase** relative to the almost surreal calm of the past 9 months - the constantly elevated levels of the VIX post Q2 recovery proving a false signal.

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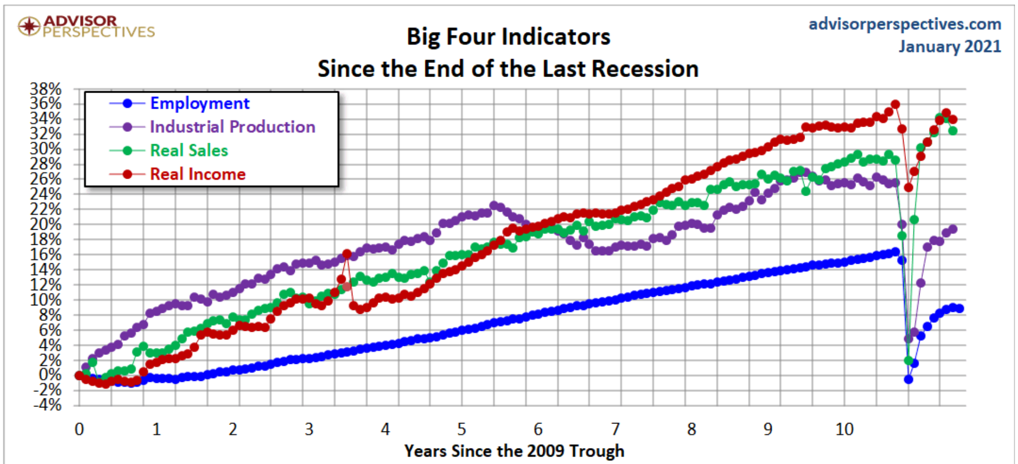
The market dynamics have evolved

Retail investors armed with Tik-Tok, Twitter and Robinhood have found their mojo again. Last year 10 million new brokerage accounts were opened in the US alone, as a new generation of retail investors discovered the market. A generation not scarred by major bear markets of the past. A generation with a far more intuitive sense of where the growing wave of convergent technologies is taking the world. A generation armed with cash and (thus far) ready to buy the rallies and dips in their favourite stocks.

The economy and the markets

The economic recovery has somewhat stalled in the face of the second wave of Covid-19 and the V-shaped recovery risks reversal, as seen in the key indicators below. Despite this (and because of this), we believe the further fiscal stimulus being injected into global economies coupled with critical mass in the vaccination roll-out will mean another upturn in the recovery toward the second half of the year and a resumption of the V-shape in economic indicators.



Big Four Indicators Month-over-Month

Indicator	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Employment	0.14%	0.16%	-0.90%	-13.76%	2.09%	3.59%	1.28%	1.07%	0.50%	0.46%	0.24%	-0.10%
Industrial Production	-0.43%	0.10%	-4.37%	-12.68%	0.87%	6.24%	4.18%	0.76%	-0.06%	0.95%	0.39%	
Real Sales	0.64%	-0.53%	-7.83%	-14.03%	18.34%	7.94%	0.54%	1.02%	1.52%	-0.10%	-1.27%	
Real Income	0.64%	0.77%	-2.46%	-5.81%	1.72%	1.58%	1.42%	1.21%	1.00%	0.74%	-0.61%	

Employment is released the first week of the month, Income the last week, Industrial Production and Sales mid-month.

New all-time highs in commodities, financials, emerging markets and transport averages are not indicative of bear markets.

We take a look at some informative charts. Unless these are false breakouts the signals are suggesting investors should not be looking for tops but rather look for buying opportunities.

- **Oil** is at its highest level since February last year indicating the global recovery is gaining traction and demand is recovering.

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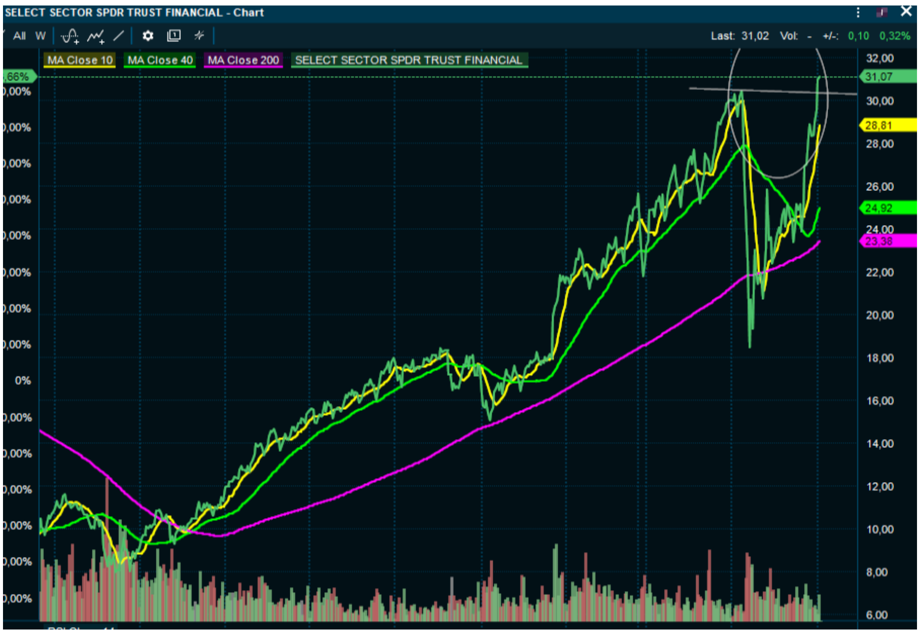
- **Emerging markets** are at all-time highs and the relative performance versus the S&P is signalling growing appetite for risk outside of the US.

- The **US financial sector** breaking out to highs as well…



- **Consumer discretionary stocks continue to outperform consumer staples**, a reliable indicator of consumer sentiment and market expectations for an improving economy as people feel more comfortable making purchases that are not only necessities.

Corporate Earnings: less bad or 'more bad'?

Barring the big lockdown winners, the earnings bar is set very low. 2020 was a year of forgiveness for even the worst earnings reports. Because of this, the bar has been raised for 2021 and we expect strong and rising earnings through the year off the low base of 2020.

Earnings that are rising and beating expectations coupled with positive outlook statements, should be supportive of equity markets.

If earnings and outlooks disappoint, expect some sharp re-ratings and volatility as things look 'more bad' than expected.

Our base case is for earnings to be improve significantly over the course of the year, supported by lower cost-cases, increasing margins and soft comparatives.

Corporate Cash

US corporates (ex-financials and utilities) are holding **record cash balances at over $2.5 trillion**. If we add record cash to rising earnings and a line of sight on a recovering economy, expect a significant resumption in corporate buybacks as the year progresses, which should further support equities.

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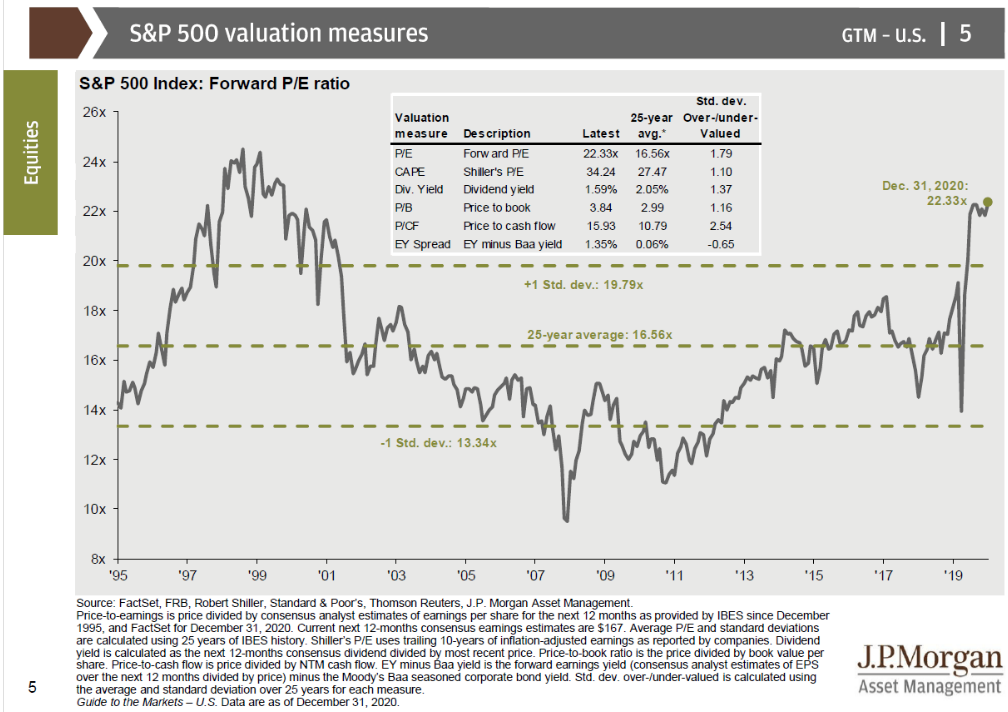
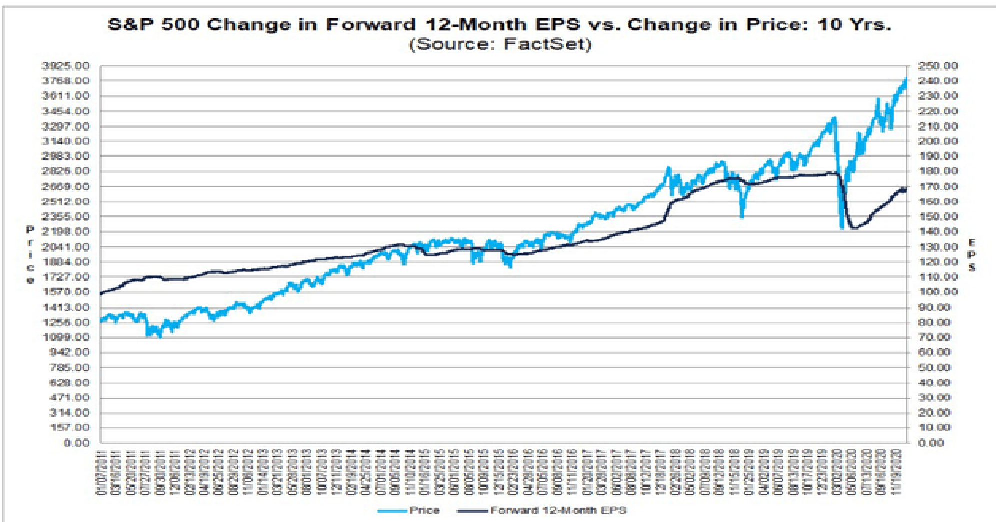
Mind the valuation gap though

A word of caution. Valuation multiples have risen dramatically. While rising valuations don't necessarily mean the market will top out in the near term and there are many contributing factors such as ZIRP, TINA etc.



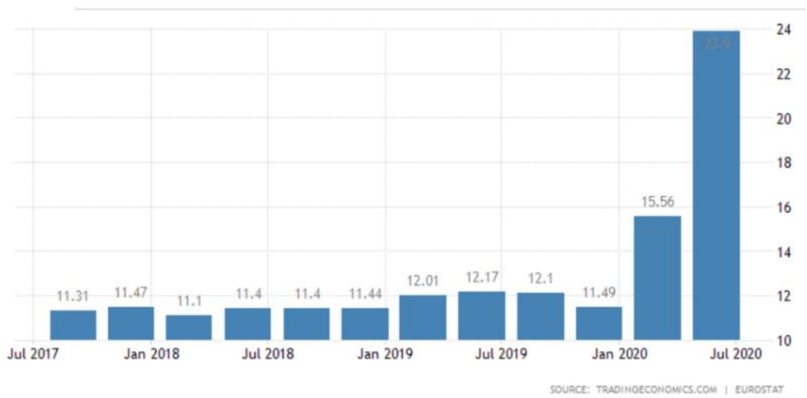
BUT, **earnings either need to rise quickly or multiples need to compress** to normalise the gap.



The developed market consumer will step up to the plate

There is much pent-up consumption demand globally. We have said a lot about the US consumer over the past year but it's not just the US consumer that has record savings rates**.** Consumer saving rates in most major economies have been at or near record levels during 2020 as uncertainty, risk and lack of opportunity to spend, drove people to hoard cash. This is especially so for those who have kept their jobs.
This cash hoarding slowed the velocity of money down significantly even as the money supply (M2) has exploded via to central bank interventions.
The graphs below of the European Union savings rate and money supply illustrate the point perfectly. potential for velocity to increase cannot be understated.
This very **high savings rate naturally means the consumers propensity and capacity to consume** will be that much greater as the world and economies improve, and confidence returns. The velocity of money is likely to increase along with it and will be a powerful economic and perhaps inflationary force supporting global GDP recovery. (As a reminder, the US consumer accounts for 68% of GDP).

European Union personal savings:



There remain risks to the outlook for equity markets in 2021

Inflation will be at the centre of monetary policy versus fiscal stimulus

Inflation and central banks response to it is one of the greatest unknowns and potential risk factors.

Our long-term view is that global inflation is in structural decline thanks to several deflationary forces:

- An ageing global population that tends to save more and consume less
- New embedded technological changes that will continue to drive down (or keep a lid on) the cost of labour
- The economic move toward industries that can scale massively without commensurate increases in capex and labour
- Ever greater concentration of wealth reducing the marginal propensity to consume as a result of the wealth effect
- The bargaining power of labour will continue to fall

However in the **short-term**, several potentially inflationary forces are in place:

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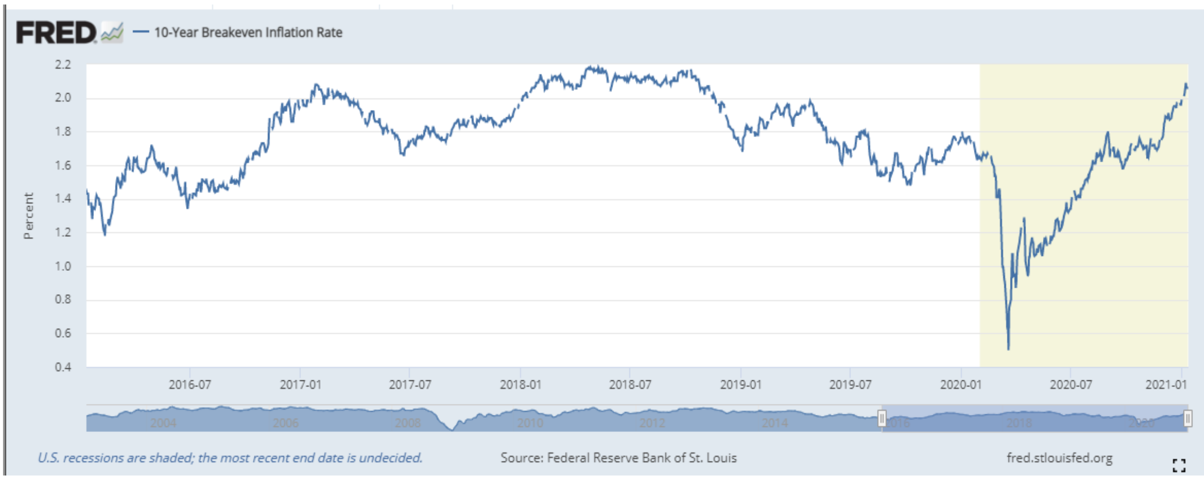
- Commodity prices are breaking out to multi-year highs as global recovery takes place and fiscal stimulus plans are put in place.
- Governments are printing money hand over fist, inflating short term demand while central banks have pledged to be patient on taming inflation.
- Consumers have significant pent up consumption demand for goods and services
- Successful deployment of vaccines and the economic reopening could lead to a surge in the velocity of money
- Several supply chains have been disrupted and inventory restocking is still not complete

If bond yields and inflation start to rise quickly, do not be surprised to see investors test the resolve of the central banks, either forcing them to manipulate the yield curve *a la* the BOJ or to allow rates to go higher than many would expect.

- The US 10-year break-even inflation is around 2.1% (see below) while the yield is roughly 1.2% - not an inviting prospect for bond investors and savers. Should they expand yield curve control, negative real yields could worsen, further supporting equity market.
- If yields are allowed to rise, at what point does it begin to impact asset allocation decisions?
- A bear market in bonds would be incredibly painful for global pension funds



China vs US to remain a massive global theme with technology dominance front and centre.

The source of the US-China trade wars and tensions (including Hong Kong, and now Taiwan) is not about things like soya exports, but rather hinges on one primary goal of both countries…global economic leadership into the new age (the US to keep it and China to take it). And ultimately such future global economic **dominance will belong to whomever has the technological dominance.**
The US under Trump has isolated many countries including its allies over the past 4 years while China, for the most part has been growing its strategic alliances (such as the recent Asian Pacific and European trade agreements).

The recent review of China's 5-year economic plan made it very clear where their ambitions regarding technological leadership lie. China believes that technology will play a central role in its future economic development and will not leave progress merely to the natural forces of the private sector.

It is a game of strategic, state-driven resource allocation versus the entrepreneurial, free market system that drives capital to where returns are greatest and innovation thrives.

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The themes of technology and innovation will continue to perform

Capital is freely available…the rich have got richer, savings balances have increased, venture capital funds are liquid and banks are fairly well capitalised.
This means that large pools of capital will continue to be readily available to new technologies and innovations. **If 2020 showed us anything, it is the power of combining capital and human resources coupled with technology and innovation.**

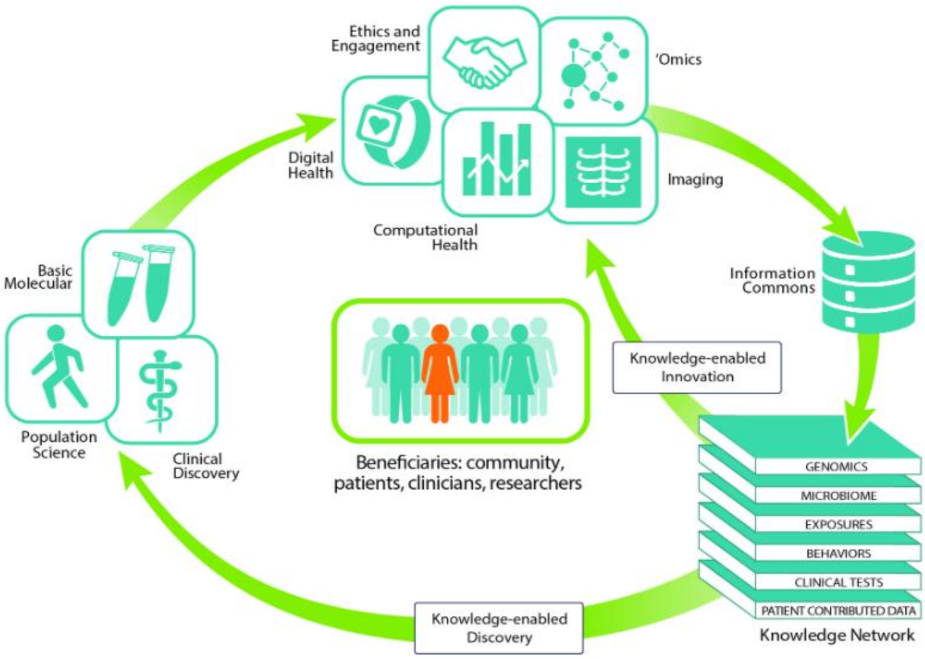
Bounces will be seen in beaten down unloved sectors of the economy, but the real long-term money is going to be made where the long-term growth is, and its clear as day that the long-term growth lies in the hands of the major innovations and technologies that are converging globally.

A few of our favourites for the year ahead in the flagship ECM Growth and Innovation Fund:

Healthcare, healthtech, biotech and related categories

The healthcare sector is a massive economic sector in every major economy. It is almost universally burdened with structurally high costs, vested interests and high inflation and undersupply. It is a sector that is ripe for significant disruption and we think 2020 has laid the foundations for this trend to accelerate faster than ever as access to capital and sharp minds combine.
The record development of numerous highly effective vaccines is just one proof of the potential for medical advancement that current technology allows. Investors have recognised the potential for breakthroughs and rich returns in the fields such as cancer and metabolic diseases.

We expect disruption and delivery in almost any area of the healthcare space. **We are focusing** on precision medicine and its component parts such as biopsies, screens and diagnostics, genome sequencing, gene-editing. Other disruptive areas in include virtual healthcare, digital administration and diagnostic software and surgical robotics.



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3D printing and collaborative robotics

The adoption of 3D printing technology is being led by automakers and the space industry. Tesla and SpaceX have been at the forefront, but all industry players are now using this technology. The potential for improved development timelines and production cost savings has been recognised. (See our previous article on 3D printing for further details).

Furthermore, in the aftermath of covid-19 and the China-US trade wars, we believe the corporate drive to re-engineer global supply chains and produce more goods locally will significantly increase demand for 3D printing technology and industrial as well as collaborative robotics.

The industry is forecast to grow at a CAGR of over 25% through to 2026.

Consumer driven commerce is expected to be robust.

It may seem strange given the crisis of last year, but many of those consumers who have kept their jobs are financially better off.
E-commerce and the experience economy will benefit from Millennials pent up demand and their natural propensity to shop online, to favour experiences over materials purchases. This is likely to accelerate into the second half of the year provided we begin to see normality return thanks to vaccine distribution.
We expect this trend to play out globally as e-commerce continues to take market share from traditional retail rather than seeing a reversal of e-commerce adoption. The sharing economy will also see a significant pickup in activity.

Climate change and clean energy will move closer to centre stage.

The newer world order under Joe Biden, in which **the US once again accepts its climate change responsibility** and steps up its participation in reducing carbon emissions will all be powerful drivers of this trend.

Global climate agreements are kicking into gear and cost curves have reached tipping points. The cost of solar, wind, battery storage and other new energy has declined to the point where the economics begin to tip into their favour.

Much like the vaccine in 2020, the attention and capital of private and public sectors globally are converging to find solutions to clean energy and carbon emissions.

Conclusion

We do not know if value versus growth moves to centre stage or how quickly vaccines will roll out. Nor do we know the short-term path of the markets. However, we believe that if we correctly identify the most innovative companies, best positioned to benefit from the growth in long term structural themes, we will continue to achieve significant alpha over the long term for investors in the **ECM Growth and Innovation Fund.**