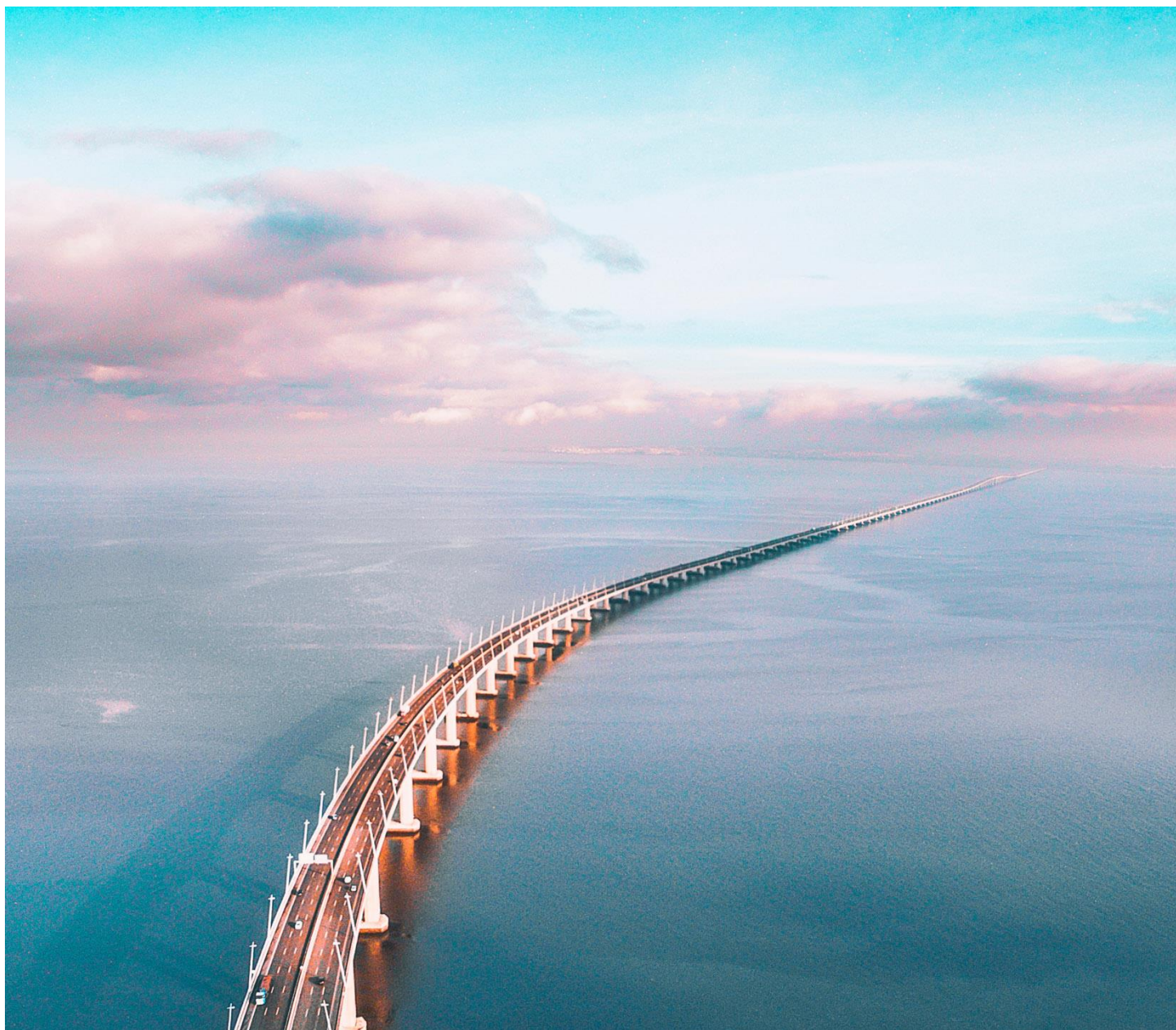


# OUR INVESTMENT THEMES FOR 2021



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## Waking up to a new dawn

Our ten investment themes for 2021 mainly focus on tactical and structural themes geared to equity markets.

This year, we grouped our themes by investment horizon, from short term to long term. Our first theme, entitled **'Vaccines, recovery, and reflation'**, focuses on assets that should be the first to recover in the cyclical turnaround that we anticipate over the coming months. Examples are early-cycle sectors, selected commodities and commodity currencies. The second group, with three medium-term themes, includes **'Low volatility absolute return: facing the challenge of a negative-yield world'** (alternative UCITs, absolute bond funds and structured products), **'Sniffing out yield truffles'** (corporate and Emerging Market bonds, infrastructure funds and real estate) and **'Constructing a new diversified portfolio for a changing world'** (asset diversification through selected commodities, currencies, US inflation-Indexed bonds, alternative UCITs and private equity). We have six long-term themes divided into two groups. The first group includes **'Enter the dragon: China's opening of capital markets and economic reform'** (China A-Shares, technology sector, onshore bonds etc.), **'New consumption habits in a post-lockdown world'** (home-based consumption, home entertainment/activities, etc.), **'Shifting generational influences: how demographic trends are improving the quality of life'** (nutrition, housing, medical care etc.) and **'Enablers of smart technologies'** (Artificial Intelligence, Big Data, cybersecurity etc.) The second group addresses ESG (Environmental, Social and Governance) themes, such as **'The energy transition and the 'green deal': long-term opportunities** (technological innovation, equipment and storage for renewable energies) and **'Strong corporate governance as an aid to low-risk outperformance: investing in trust and profitability'**.

### Looking back at 2020: what a year!

Last year will certainly stay in our memories for a very long time. The different waves of Covid-19 and lockdowns have resulted in the fastest and deepest recovery on record. The hardest-hit sectors include airlines, tourism and services. Furthermore, the virus acted as a powerful catalyst for some key themes we selected a year ago, such as disruptive innovation, the digitalisation of consumption, and technological innovations in the health care sector.

Our environment-related themes also benefited from sustainable investing. In addition, unprecedented economic stimulus packages of governments around the world, in particular infrastructure programmes, triggered a sharp rebound in the industrial sector.

### Low interest rates and yields are here to stay

Global central banks in concert remain very committed to supporting the nascent economic recoveries.

The US Federal Reserve (Fed) and the European Central Bank (ECB) are expected to step up their bond purchasing in 2021. In addition, the Fed is planning to extend the maturity of its bond purchases to match the issuance of the US Treasury that will have longer maturities than previously. This should limit the upside for US yields. However, at BNP Paribas Wealth Management, we forecast a gradual increase in the US 10-year government bond yield to 1.40% over the coming year, mainly due to growing long-term inflation expectations and a higher risk premium due to greater uncertainty over inflation rates.

As for Germany's 10-year sovereign yield, the ECB plans to keep interest rates and bond yields very low despite the positive vaccine-related news flow that came towards the end of 2020. Furthermore, the ECB has intensified its bond-buying recently. In 2021, we expect new issues of government bonds to be even smaller than targeted ECB bond purchases. This would imply negative net issuance, which would limit the upside for eurozone sovereign yields despite the expected rebound in economic growth. We forecast the German 10-year sovereign bond yield to tick up to -0.25% over the coming year. Short-term interest rates should stay at around current levels for at least one to two years. Consequently, we expect the yield differential between short-term and long-term yields to rise (i.e. a yield curve steepening).

### A positive runway for risky assets

Our positive outlook for risky assets is based on two assumptions: firstly, a Covid-19 vaccine will be distributed widely in 2021; and secondly, combined fiscal and monetary policy will remain highly accommodative. These two far-reaching factors should lead to a gradual acceleration in economic growth, boosted by multiplier effects including an improvement in consumer and business sentiment/spending against a backdrop of stubbornly-low interest rates. Bond yields could begin to renormalise but should remain close to historically low levels.





The first quarter of 2021 will remain challenging for economic activity due to the lagging effect of lockdowns, but financial markets are looking beyond this horizon. The current crop of Coronavirus vaccines should allow authorities to curb infection rates and allow a return to (relative) normality. Indeed, we remind investors that financial assets are theoretically valued according to multi-year future income (dividend, coupon etc.), thus short-term developments have a small impact on the present value of assets. The assumption of rates remaining low for a long period increases the present value of future dividends or coupons.

At BNP Paribas Wealth Management, we expect credit spreads to fall further, to below pre-Coronavirus levels in the near term. This implies positive expected returns for corporate bonds. Meanwhile, yield spreads and attractive currencies in Emerging Markets should support sovereign bonds in local currency. Equities offer further upside even though temporary periods of stress and profit-taking are to be expected at some point during the year. The US dollar is set to weaken against most major currencies. We forecast the greenback to trade at 1.25 against 1 euro by end-2021.

## What are the main risks?

At the time of writing, we see three main risks:

1. **A weaker-than-expected economic recovery.** A number of factors could lead to such an outcome. First, a divided government in the US could disagree on a budget compromise, implying a weaker recovery and lower-than-expected inflation. Second, in Europe, we could see a sharper and more lasting opposition to a compromise on the Recovery Fund through a relaxation of the Rule of Law. Another driver could be a sharp rise in non-performing loans that would reduce the capacity of banks to step up lending.

Third, vaccine take-up rates might fall short of expectations and mobility restrictions could then hurt economic activity for an extended period.

2. Despite a change in the US presidency, **China-US tensions** could reignite over access to strategic technology, potentially impacting global trade.
3. **A sharper-than-expected rise in bond yields, especially real yields.** Indeed, a sharp rebound in economic growth with stable inflation could push up real yields (nominal yields minus expected inflation). Rising real yields could have a negative effect on a range of asset classes, such as equities (especially growth stocks), bonds, gold and real estate. We see this outcome as unlikely at this stage.

## CONCLUSION

On balance, we are optimistic that 2021 will be a year of robust economic recovery, underpinned by historically-low short- and long-term interest rates. This should be a propitious environment for equities, credit, commodities and real estate, in particular.

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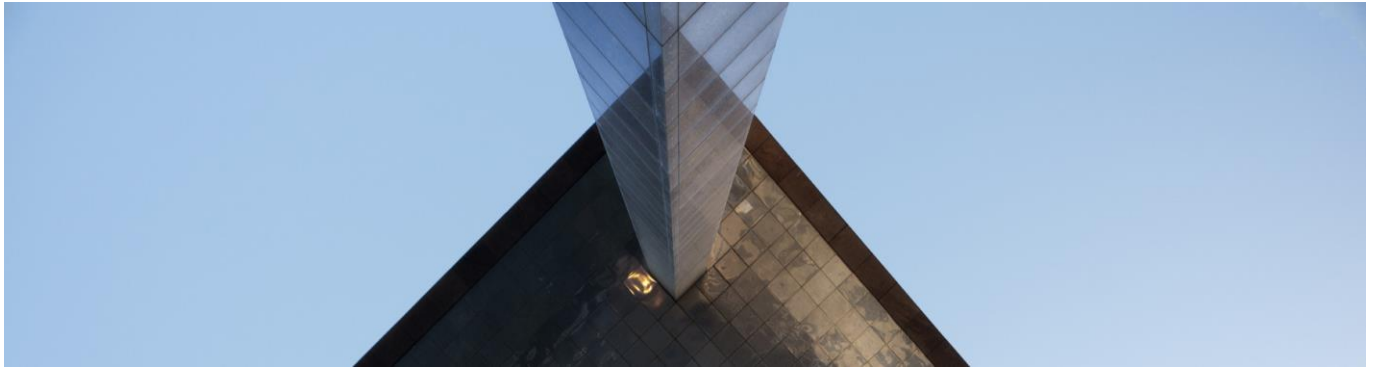
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## THEME 1

### **Vaccines, recovery, and reflation**

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## THEME 2

### **Low volatility absolute return: facing the challenge of a negative-yield world**

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## THEME 4

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### **Strong governance as an aid to low-risk outperformance: investing in trust and profitability**

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01

○ SHORT-TERM ■ HIGH RISK

# Vaccines, recovery, and reflation



## THEME 1

 SHORT-TERM  HIGH RISK


**2021 vs. 2020 will likely be the year of Recovery vs. Recession, Vaccine vs. Virus, Reopening vs. Shutdowns, Reflation (moderate) vs. Deflation, and Dollar Weakness vs. Strength. Monetary policy will remain easy and fiscal policy accommodative. Early cycle investing means balancing portfolio allocations: Non-US equities vs. US equities, Small-/mid-cap equities vs. Purely large caps, Cyclical vs. Growth shares, Non-Dollar currencies vs. the US dollar (for USD investors). Base metals, Precious metals, Inflation-linked bonds, Infrastructure and Real estate stand to profit from this new economic cycle.**

## OUR RECOMMENDATIONS

A cross-asset theme: Equities, Bonds, Foreign Exchange.

- Focus on 'early cycle' sectors such as Construction, Mining, Capital Goods, Materials, and selected consumer cyclicals.
- Focus on mid- and small-cap equity exposure in Europe and the US.
- Global infrastructure/renewable energy spend
- Income: Inflation-linked bonds and Real estate income.
- FX: Commodity FX vs. Low yielders, G-7 FX for USD investors.
- Precious metals: gold and silver for all investors.
- Base metals demand and EV-driven commodities demand.

## KEY RISKS

- An earlier-than-expected withdrawal of easy monetary policy before an economic recovery takes hold.
- Late cycle, large, unexpected defaults in the credit markets trigger a double-dip recession.
- Vaccine failures, Vaccine caution, or Coronavirus resurgence hurt(s) consumption.
- An insufficient targeted fiscal policy as an economic bridge before a broader distribution of vaccines.
- An unexpected inflation increase in the absence of a recovery in economic growth, which would be detrimental to bonds and equities.



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## Vaccine progress

With 11 drugs in large-scale Phase 3 trials, 18 in Phase 2 and 39 in Phase 1 at the time of writing, there will be ample news flow in late 2020/early 2021. The initial findings on Covid-19 vaccines were very positive, with many candidates achieving a higher-than-expected efficacy level, far above the average 50% for a flu vaccine. The FDA had set a 50% efficacy goal for emergency approval. Vaccines are key to reopening the economy in the medium term. Our base-case scenario is continued progress on vaccine development. Distribution, logistical challenges and consumer preferences will also determine the pace of success.

## A lower for longer monetary policy and targeted fiscal policy

The world's major central banks moved much faster than during the Great Financial Crisis as they unleashed the most broad-ranging and timely stimulus in financial history. A key event came on 23 March (and by no coincidence this was the day the second-fastest bear market in history ended) when the Federal Reserve (the Fed) announced the purchase of corporate debt for the first time. **In addition, at Jackson Hole, the Federal Reserve outlined monetary policy, which will likely allow inflation (and therefore the economy) to run hotter for longer.** The Fed will also continue to finance large deficits with low interest rates supported by quantitative easing. Global central banks' assets are expected to grow to USD 27 trillion in 2022.

Finally, given the high unemployment rates, fiscal policy will remain critical but lessen in importance as vaccine progress accelerates and reopening begins. Structurally there is an increasing global emphasis on infrastructure with a 'green' focus in government spending. The three largest economic blocs, namely the EU, the US (with Joe Biden's election) and China, are united in this regard.

## 2021 vs. 2020: portfolio rebalancing from recession to recovery

**2021 will likely be the year of Recovery vs. Recession, Vaccine vs. Virus, Reopening vs. Shutdowns, and Reflation (moderate) vs. Deflation, and Dollar Weakness vs. Strength.** We forecast a cyclical recovery in the economy in 2021 as global growth expands from -4% to +5.2%. In addition, we forecast a moderate rise in inflation as we exit the deflationary conditions of the post-pandemic crisis. Early in the economic recovery, there will likely be a combination of gradually rising bond yields, a weaker dollar, higher equity markets, and cyclical sectors picking up in the economy.

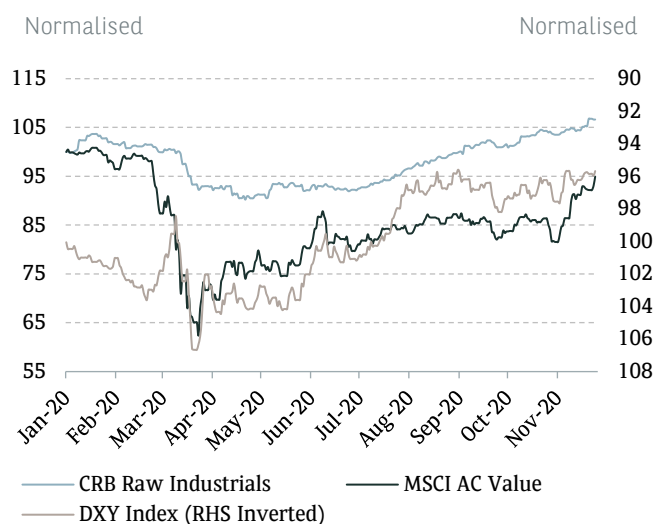
○ SHORT-TERM ■ HIGH RISK

**Higher yields and the Covid-19 vaccine are powerful catalysts to justify a 'barbell' allocation between growth and cyclicals, especially after a long period of outperformance by growth.** For example, MSCI World Growth has outperformed the MSCI World Value Index by 75% over the last three years and nearly 38% in the last one. But we started to see Value outperform over September-November 2020, by more than 6% in November alone. **The key from a portfolio allocation perspective is to have both styles, to broaden investors' portfolio allocation.**

Firstly, base metals have benefitted from a lack of capital investment over the past decade in oil and gas, and in mining sectors. Secondly, a gradual economic rebound will likely drive a cyclical rebound in demand in 2021. Thirdly, we favour certain 'green' base metals such as copper, nickel, zinc and lithium that have structural growth in demand due to climate change and electrification.

In terms of market implications, it is important that investors adjust portfolio allocations to reflect the new economic environment. **This means a portfolio balance between: Non-US equities vs. US equities, Small/mid-cap equities vs. Purely large caps, Cyclical vs. Growth shares, Non-Dollar currencies vs. the US dollar (for USD investors). In addition, Base metals, Precious metals, Inflation-linked bonds, and Real estate stand to profit from this new economic cycle.**

### FROM RECESSION TO RECOVERY: BASE METALS, CYCLICAL STOCKS, AND NON-DOLLAR CURRENCIES



Source: Refinitiv Datastream, BNP Paribas WM, 23 November 2020



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02

○ MEDIUM-TERM ■ LOW RISK

# Low volatility absolute return: facing the challenge of a negative-yield world



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## THEME 2

MEDIUM-TERM ■■■ LOW RISK



In a world of the ongoing financial repression, dominated by zero yields on cash and negative yields on more and more sovereign bonds, investors continue to grapple with the challenge of finding positive-yielding, low-risk solutions.

For clients unwilling to move further up the risk curve, we believe that an attractive way to diversify non-yielding cash is to invest in low-volatility, positive-yielding alternative investments.

## OUR RECOMMENDATIONS

We propose three classes of low-volatility, positive-yielding investment solutions:

1. Alternative UCITS funds with a focus on Global Macro, Long/Short Equity, Event-Driven and Relative Value strategies
2. Absolute return bond funds
3. Structured products

## KEY RISKS

The risks of this theme are mainly opportunity costs in the event of risky assets continuing their upward trend. The risks inherent in the proposed investment solutions also relate to a sudden rise in interest rates, the default of an issuer, reduced liquidity in the event of market tensions, and exchange rate fluctuations.

We will seek to limit these risks by investing in alternative UCITS funds, Absolute return bond funds and structured products.



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## Lockdowns have driven savings by default

Households' cash savings have exploded around the globe as a direct consequence of people being restricted from spending on discretionary consumer goods, travel, non-essential goods and entertainment outside the home. German households already held over 40% of their total financial assets in cash deposits prior to the 2020 lockdowns. At the time of writing, the value of negative-yielding debt worldwide has risen to a record of more than USD 17 trillion, according to the Bloomberg Barclays bond indices, and this figure has risen sharply in recent months. Investors are thus faced with a more pressing issue today: knowing how to redeploy cash to generate a positive return, while maintaining a low risk profile.

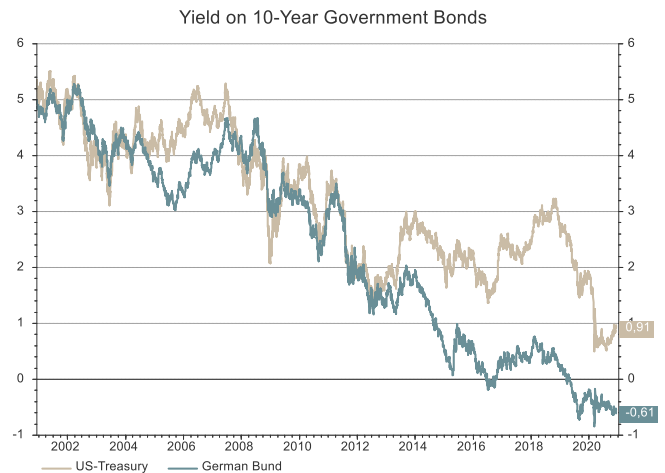
With traditional cash and bond investments no longer offering any yield to investors, we look to alternative sources for lower-risk returns in the medium term, including:

1. **Alternative UCITs strategies**, which can be classified into four main groups: i) Long/Short Equity; ii) Relative Value; (iii) Event-Driven; and iv) Global Macro. A number of alternative UCITs funds are managed with a level of risk in line with bond funds and often have a low correlation with general market trends. We see opportunities in these four strategies:

- **Long/Short Equity:** the current context of disruptive innovation and structural changes, amplified by the Covid-19 crisis (working from home, e-commerce, dematerialisation, deglobalisation) suggests a Schumpeterian environment of 'creative destruction' and thus a world of polarised winners and losers. Being 'long' or 'short' on an investment helps to limit the portfolio's sensitivity to a general fall in equity markets, or to a rise in interest rates, thus limiting the risks.
- **Relative Value:** managers focus on mispricing assets, anomalies in spreads (yield differences) as well as a mean-reversion of prices. The crisis will eventually create clear winners and losers, even if most companies have been able to issue bonds to meet short-term financing needs. Convertible bond arbitrage is in a sweet spot, with record issuance post crisis and high single-stock volatility.
- **Event-Driven:** these strategies take hedged positions on Merger & Acquisition targets to benefit from the difference between the market and offer prices. Disruption, US tax reforms and sector consolidation themes provide many opportunities. Capital market activity (IPOs, secondary issues, etc.) also offer profitable opportunities to those managers. Distressed debt is another promising avenue for Event-Driven funds at present.
- **Global Macro:** managers benefit from large movements in the price and volatility of broad macro markets, including currencies, interest rates, equity indices and commodities. They can protect a portfolio in a severe economic downturn.

○ MEDIUM-TERM ■ LOW RISK

### US AND GERMAN GOVERNMENT BOND YIELDS CLOSE TO HISTORIC LOWS



Source: Refinitiv Datastream, 8 December 2020

### 2. Absolute return bond funds

These funds use a flexible strategy mainly investing in short-maturity fixed-income products, or actively managing the duration (sensitivity to interest rate movements). These funds may enhance performance by gaining exposure to the volatility of other asset classes, such as equities.

3. Structured products are designed to use sophisticated instruments (futures, options or credit default swaps) to which individual investors usually have limited access. These instruments serve to optimise returns or limit losses while reducing sensitivity to a rise in interest rates or a fall in share prices. We recommend investing in short-dated defensive products (typically between 1 and 3 years). In other words, it is preferable to focus on investment products offering at least some protection of the invested capital. Underlying assets may include oil, gold, equity indices or interest rates.



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# Sniffing out yield truffles





## THEME 3

 LONG-TERM  LOW AND MEDIUM RISK


**Bond yields have been falling steadily for the past 40 years. With low (or negative) rates in developed markets, yield-hungry investors need to move away from traditional government bonds. Below, we explore some avenues.**

### OUR RECOMMENDATIONS

This theme is aimed at defensive investors seeking yield. It requires a degree of risk-taking to achieve the desired positive and above-inflation returns. However, the risk taken is less than in equity markets. We recommend a minimum investment of 12 months in fixed-income solutions, infrastructure funds and real estate.

### KEY RISKS

Several risks are associated with this theme:

- Interest rate risk: when interest rates rise, bonds go down in value. Unlisted assets, in the real estate market for example, are penalised by a rise in real interest rates.
- Liquidity risk: unlisted assets are, by nature, long-term investments that may be fairly illiquid.
- Default/restructuring risk: this risk materialises when an issuer cannot repay its debt. Hence, we recommend focusing on high-quality issuers.



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## Inexorably declining yields

Bond yields have been falling for 40 years. **In 2020, yields fell to an all-time low in most developed countries.** Indeed, in the eurozone, the average yield on 10-year government bonds is negative, -0.24% as at 8 December, according to the Bloomberg Barclays Index. By comparison, it is 0.94% in the US. Inflation, meanwhile, is historically low but still higher than the aforementioned bond yields. Consequently, an investment in government bonds may yield a negative return, but could potentially result in an even greater loss in real terms. This is likely to persist, as central banks do not intend to tighten monetary policy in the coming quarters or years. This implies that **bond yields will remain low for the foreseeable future.** Therefore, investors should move away from (risk-free) sovereign debt when seeking yield.

Turning to **corporate bonds**, the safest are senior credits which have priority in interest and capital payments if an issuer defaults. They offer an average near-zero yield of 0.2% in the Eurozone (at 8 December 2020), forcing investors to turn to **subordinated bonds**. Although they are a little riskier than their senior counterparts, the risk is ultimately limited if an investor chooses an Investment Grade issuer (i.e. with a solid credit rating). There, the average yield is around 1.8% (as of the same date).

Since March 2020, some 40 European issuers and about 20 American issuers have been downgraded by Standard and Poor's, a credit rating agency, from Investment Grade to High Yield. These bonds, dubbed 'fallen angels', typically see their credit spread widen sharply before they are relegated to the High Yield category. That occurs only one or two months after their credit spread normalises. So they can offer attractive opportunities. The average yield on fallen angel bonds is 2.7% in the euro area and 4.6% across the pond (at 8 December 2020).

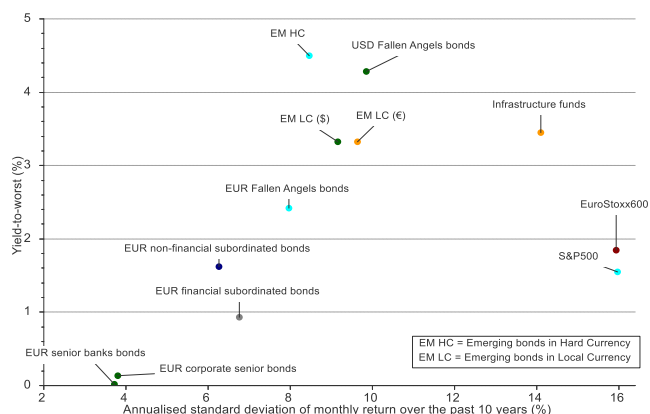
Elsewhere in the fixed-income universe, both hard currency and local currency **Emerging Market** bonds offer attractive yields of around 4.5% and 4.3% respectively. The risk of this sub-asset class, measured by the annual volatility of performance over the last ten years, is higher than other bond market segments. However, with a volatility of 8.4% for hard currency (US dollar) bonds, and 9.0% for bonds in local currency expressed in euros, the risk is still lower than equity markets (18.4% for the STOXX Europe 600 Index and 16.2% for the S&P500). Emerging Market assets are likely to be a key focus in 2021, as expected dollar weakness should direct financial flows in their direction.

LONG-TERM ■ LOW AND MEDIUM RISK

In addition, the **infrastructure funds** asset class has been growing for ten years. These funds invest in infrastructure in various fields: transport, environment, social, energy, health care, etc. They also offer stable and attractive long-term returns, with the MSCI World Core Infrastructure Index delivering a 3.4% dividend for a historical yield volatility of 14.5%, in other words lower than for equity markets. Some infrastructure funds focus on regular income distribution while others concentrate on capital appreciation.

Finally, **real estate** is an alternative solution for investors seeking recurring income. Covid-19 has sent structural shockwaves through the sector (e.g. teleworking and e-commerce), but price corrections already largely reflect this. The stubbornly low interest-rate environment has been offering major support for real estate investments. That said, it is important to diversify investments within real estate assets.

### RISK-RETURN PROFILES



Source: Refinitiv Datastream, 25 November 2020



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# 04

○ LONG-TERM ■ LOW AND MEDIUM RISK

## Constructing a new diversified portfolio for a changing world

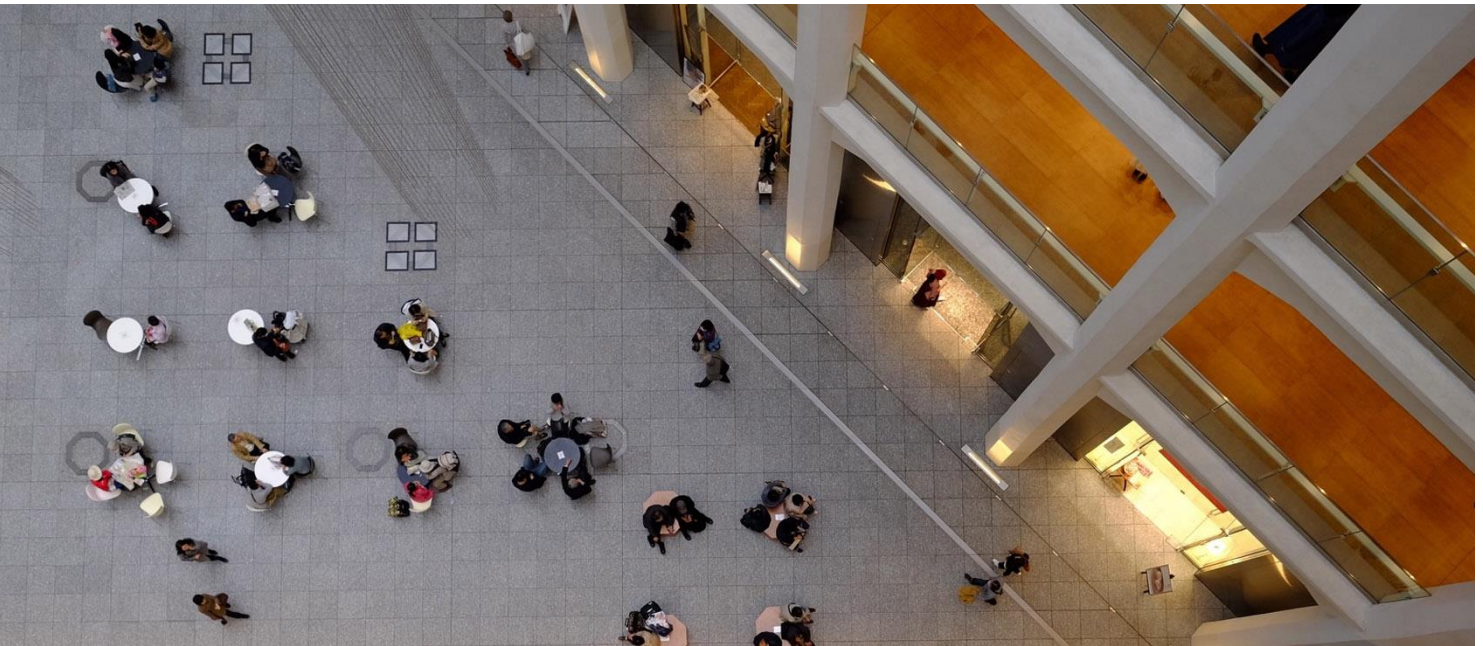


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## THEME 4

 LONG-TERM  LOW AND MEDIUM RISK


Traditionally, the optimal portfolio is composed of 60% equities and 40% bonds. However, bond yields are now so low that they are increasingly losing their role as an offset when equity markets fall. It is therefore necessary to add one or more other asset classes to this traditional mix in order to increase the expected return without raising the level of risk.

## OUR RECOMMENDATIONS

This theme is aimed at investors with a defensive or even moderate risk profile wishing to build up a portfolio, or adjust an existing portfolio, in order to adapt it to the current market environment of low interest rates.

The proposed diversifiers have little or no correlation to equity markets on a historical basis. However, they can be volatile and therefore require an investment horizon beyond 12 months.

## KEY RISKS

- Commodity prices can be volatile. A medium- to long-term investment is therefore recommended.
- Unlisted assets may be illiquid and require an investment over several years.
- US inflation-linked bonds are less liquid than nominal bonds. They can be penalised by a rise in real rates or deflation. However, at maturity, the US Treasury repays the highest amount between the original principal and the inflation-adjusted principal.



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## Seeking better diversification

The optimal portfolio for the long-term investor should be well-diversified. It is **traditionally composed of 60% equities and 40% bonds**. This portfolio rises thanks to the equity allocation when markets rise, while the fixed-income allocation helps mitigate the decline in more challenging times. That said, **the fall in bond yields over the past 40 years challenges this theory**. Indeed, it is increasingly difficult for bonds to play their role of shock absorber with such low yields. The Bloomberg Barclays Global Aggregate USD Index that is composed of developed and Emerging Market government and corporate bonds sat at an average yield of only 0.86% as at 8 December, down almost consistently since its creation in 1990 when it was flirting with the 10% threshold.

## We thus need to rethink this optimal portfolio

Adding to the equity allocation would certainly increase the desired return, but the level of risk too, so that is not an appropriate solution. As a result, one or more asset classes need to be added in order to strengthen the role of the fixed-income allocation and diversify further. These assets must be decorrelated from equity markets, or even better, inversely correlated to equity markets. The aim is for them to appreciate when equity markets fall.

## Consider adding a diversifier

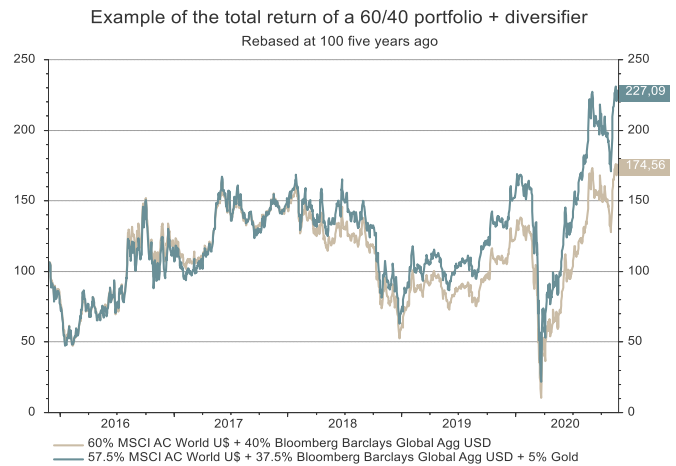
**We think of gold, precious metals and the yen**, which are all safe havens *par excellence*, and tend to appreciate during economic crises. Therefore, they make it possible to diversify the portfolio and thus improve the risk/return ratio.

**US inflation-linked bonds** may also be added. Their historical correlation to US and European equity markets is negative. Moreover, inflationary pressure could start to build up in the US if the economic recovery is stronger than expected, as the US Federal Reserve has injected billions of dollars into the economy and vowed that it would not raise its key interest rates at the first signs of inflation.

Finally, we should consider **alternative funds**, i.e. investment strategies which are uncorrelated to equity markets. We particularly like **Global Macro hedge funds** and **private equity**. The former could benefit from deglobalisation and differences in fiscal policy between countries. Private equity funds make it possible to invest in the real economy, specifically in unlisted companies at different stages of their growth, in Europe, the US and Asia. These funds cover a range of strategies, including leveraged buyouts, growth, mezzanine and secondary.

LONG-TERM  LOW AND MEDIUM RISK

### ADDING GOLD AS A DIVERSIFYING ASSET HAS BOOSTED PORTFOLIO RETURNS



05

○ LONG-TERM ■ HIGH RISK

# Enter the dragon: China's opening of capital markets and economic reform



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## THEME 5

 LONG-TERM  HIGH RISK


Beijing's five-year plan focuses on domestic demand, as well as the opening up the domestic system and RMB internationalisation.

China's priority in technology innovation and self-sufficiency benefits domestic tech companies.

The lifting of restrictions in domestic financial markets, plus the inclusion of China A-Shares and onshore bonds in major global indices are increasingly opening up China's onshore financial assets to foreign investors.

#### OUR RECOMMENDATIONS

- Basket of Chinese technology stocks, Chinese technology funds/ETFs.
- Basket of A-Shares, A-Shares funds/ETFs.
- China's onshore bond ETFs.
- China's bond/balanced funds that include tech stocks, A-Shares and/or onshore bonds.

#### KEY RISKS

- Slower-than-expected reform and the opening up of financial markets, which would hamper China's progress in entering all key global stock and bond indices.
- Lower-than-expected foreign acceptance of China's onshore assets.
- Intensified external scrutiny of China's tech market access and/or the Chinese government's increasing regulatory tightening that could suffocate growth of domestic technology companies.
- A serious escalation of US-China tensions that hurts investor sentiment towards Chinese assets.



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## Strategic policy shift

Beijing recently reiterated its strategic policy shift to 'Dual Circulation' in its new five-year plan, emphasising the 'internal circulation' (i.e. domestic demand), while continuing to push for 'external circulation' by opening up the domestic system and the internationalisation of the renminbi (RMB). This implies that China will continue to rebalance away from an export-driven economy and towards a more domestic-oriented economy as an insurance against deglobalisation, by focusing on technological self-sufficiency and continuing to open up its financial sector.



### INNOVATION & TECHNOLOGY INDEPENDENCE AS A STRATEGIC PILLAR

## Key drivers for China's technology companies

China would allocate more resources to fundamental and frontier research, as well as to the upgrading and further digitalisation of its economic structure.

US-China tensions have prompted the 'homecoming' of US-listed Chinese tech-related companies in the form of new secondary listings in Hong Kong and/or China's A-Shares market.

Some of China's technology companies are simply too big for global investors to ignore. Major Chinese technology names currently account for 67% of the MSCI China Index's market capitalisation, up 10 times from merely 6% ten years ago. In addition, relative valuations for China's top 5 tech companies (by market cap) are more attractive compared with the top 5 US tech companies at present.

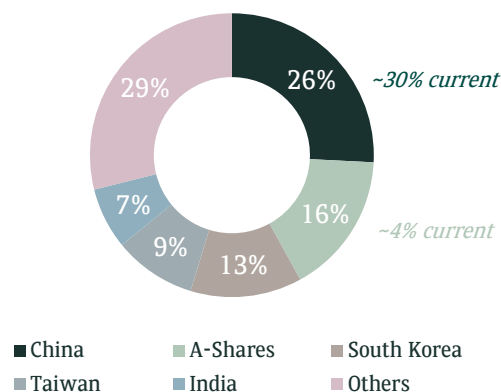
More Chinese tech behemoths were added to the Hang Seng Index in 2020, bringing a great number of 'new economy' stocks to this 50-year-old and traditionally more 'old economy-driven' Hong Kong equity index. Furthermore, Hong Kong launched a new Nasdaq-like technology index (the Hang Seng Tech Index) in July 2020 with its associated ETFs attracting plenty of inflows.



### A FURTHER OPENING UP OF DOMESTIC FINANCIAL MARKETS

LONG-TERM HIGH RISK

### A FULL INCLUSION OF A-SHARES IN THE MSCI EM INDEX WOULD POTENTIALLY IMPLY A 16% WEIGHTING VS. JUST 4% AT PRESENT



Source: MSCI, Datastream, 23 November 2020

## Key drivers for China A-Shares and onshore bonds

Foreign investors' accessibility to the onshore equity and bond markets has improved thanks to a further relaxation of restrictions in the domestic financial markets.

Stock Connect and Bond Connect enable foreign investors to trade China local bonds via the Hong Kong Stock Exchange. Strong inflows have gone through this Connect channel into the onshore markets year-to-date, likely driven by China's 'first in, first out' (FIFO) from Covid-19, RMB appreciation and an attractive yield spread between Chinese sovereign/quasi-sovereign bonds and developed market government bonds.

Global Index providers have embarked on the initial rounds of the inclusion of A-Shares and onshore bonds into their indices, driving significant foreign inflows to the domestic markets. China A-Shares currently have a 4% weighting in the MSCI Emerging Markets Index. A full inclusion would mean a 16% weighting of A-Shares in the MSCI EM Index. Additionally, following in the footsteps of Bloomberg Barclays and JPMorgan, FTSE Russell announced the inclusion of China's sovereign bonds into its indexes as of October 2021. Currently, foreign ownership in the second-largest bond market in the world (worth USD 15 trillion) is still below 3%. Hence, there is tremendous potential for foreign ownership of Chinese bonds to grow.

Onshore Chinese assets could be a great diversifier to global investors' portfolios (the correlation between the MSCI AC World and the CSI 300 Index is a mere 0.3).



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# New consumption habits in a post-lockdown world





## THEME 6

 LONG-TERM  MEDIUM AND HIGH RISK


The new breed of younger consumers purchase differently today: they like to shop and spend time online. In addition, they are often more interested in having an experience than owning a tangible good. This phenomenon is also serving the sharing economy.

Due to the Covid-19 crisis, a new 'home-based' consumption trend has accelerated towards more e-commerce, cocooning, do-it-yourself (DIY), gardening, healthy living, the care of animals and so on. There is significant pent-up demand, as households were not able to spend as per normal during lockdown. This very demand is about to be unleashed and vaccines could be a potent catalyst.

## OUR RECOMMENDATIONS

This equity theme is targeted at dynamic investors who want to profit from new global consumption habits.

This theme can be played with individual stocks, many of which are large caps and thus very liquid. On the other hand, some of these new habits are still in their infancy and will thus require diversification and/or more time to reach full potential. Therefore, funds, trackers and structured products represent other investment solutions for gaining exposure to this theme.

Finally, bear in mind that various new trends in streaming, music, gaming, online shopping, and e-payments are more mature and profitable in Asia, and promise greater potential than in the West. Above all, we recommend global diversification.

## KEY RISKS

Traditional retailers are facing strong competition from 'pure players' in the online space. Indeed, some of them have been slow to adapt. Even top luxury brands have taken steps to sell their products via the Internet.

While some online vendors/service providers enjoy booming business, many others are fast disappearing from the scene.

Even in e-commerce, competition is fierce, and new entrants take longer to become profitable and/or sometimes do not find the right skilled workers to propel their expansion, or because they are not willing to pay the necessary costs.



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## The key to success is online presence

Amazon and other established online merchants are enjoying runaway success. Traditional retailers have realised that in order to attract (and retain) young consumers, they must provide an attractive online offering. The e-commerce market continues to expand at a rapid pace, driven by the new hyper-connected generations. A host of traditional retailers are reinventing themselves. For instance, Wal-Mart, an American mass-market retailer, has rolled out an appealing online offering, whereas Marks & Spencer, a British food and apparel store, has been slow off the mark.

## Welcome home cocooning!

The Covid-19 crisis has ushered in new consumption habits. People have had to find novel ways to entertain themselves at home, due to mass closures of shops, restaurants, cinemas, amusement parks and other outdoor leisure hubs. Consumers have discovered a new range of products and services on the web.

Furthermore, individuals who were reluctant to buy online for security (or other) reasons have now been ensnared in the web. This trend of purchasing online has accelerated and is set to continue. E-commerce, streaming, video gaming, and e-sports are reaching a widening audience.

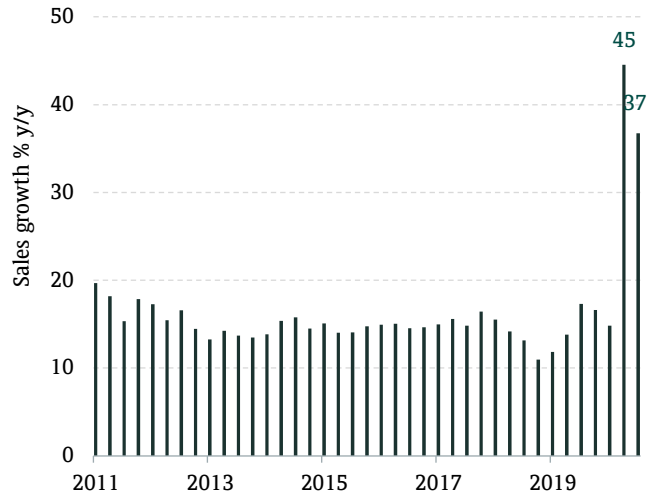
Just as they do for traditional products, smart companies participating in these new consumption trends regularly create new updated products for consumers who want to remain ahead of the game. In e-gaming, Sony has recently launched its PlayStation 5 (PS5) and Microsoft has rolled out the all-new Xbox Series X console. Game developers are also launching sequel after sequel of their top franchises.

Online retailing and streaming require an investment in infrastructure and services, including e-payment systems and efficient logistics for physical and online delivery.

In the physical world, against the backdrop of the Coronavirus pandemic, consumers have set about improving their 'habitats'. Some have decided that their city-centre abode is too small and have moved to the suburbs in search of more living space or a garden. As a result, DIY, gardening, furniture and interior decorating stores have been deluged with customers. Others yearn for (more) company and purchase a pet. Besides improving their mental wellbeing, dog owners for example have discovered that walking their new furry friend is also good exercise, enabling them to lead a healthier life.

○ LONG-TERM ■ MEDIUM AND HIGH RISK

### US RETAIL E-COMMERCE SALES GROWTH ACCELERATED IN 2020



Source: St Louis Fed, 30 November 2020

## Healthy living

Having an animal around the house can be beneficial for one's health, and gives pet lovers an additional focus, especially during lockdowns. This fad is not new. City-dwellers have started to spend increasing chunks of their money on keeping their new animal companion content. Moreover, numerous white-collar workers have sedentary jobs. When they do get out to partake in leisure activities, a prime focus is their health, so they often join a fitness club or practise another sport.

## The rise of the Asian middle class

In China, it is estimated that the middle class now outnumbers the entire American population! In India and other emerging markets, the middle class is also fast expanding on the back of swelling salaries. This means that after paying for their basic consumption needs, the up-and-coming in Asia have enough cash to spend on discretionary items, including luxury goods, sport equipment, (electric) cars and branded beverages.



07

LONG-TERM  MEDIUM RISK

# Shifting generational influences: how demographic trends are improving the quality of life

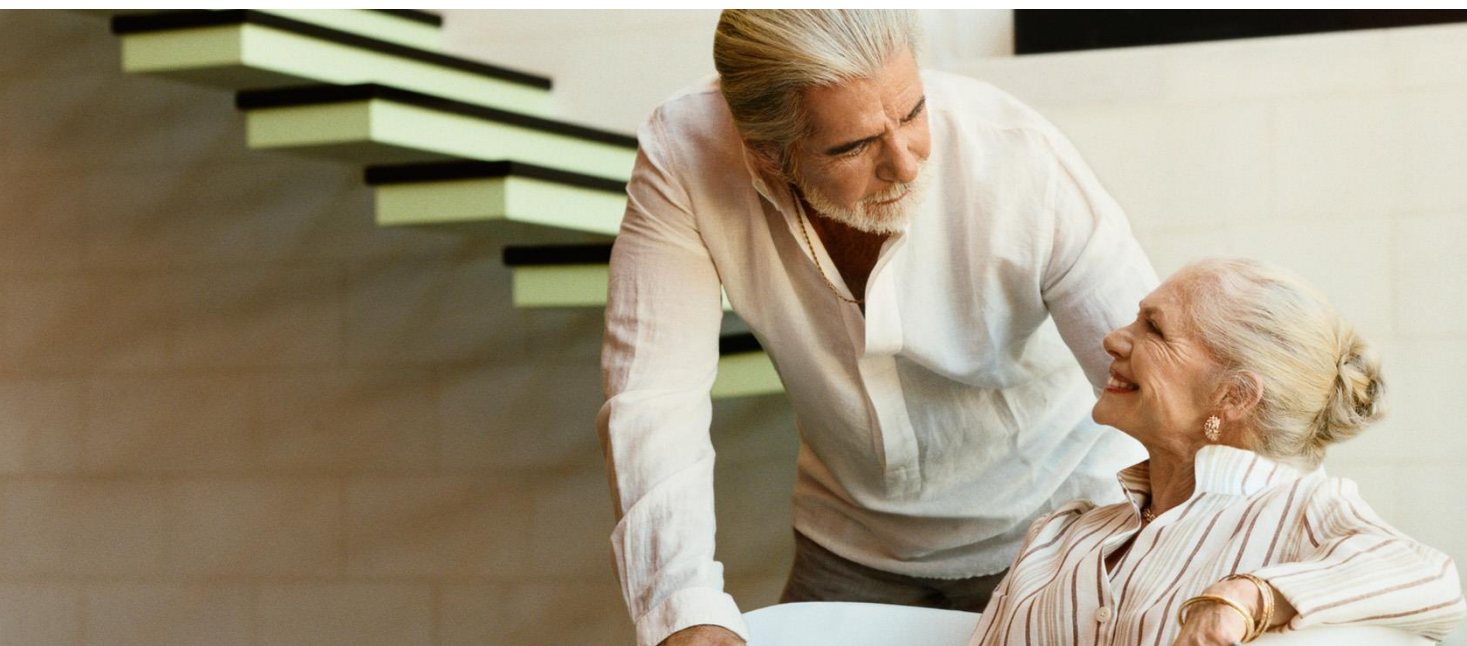


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## THEME 7

 LONG-TERM
  MEDIUM RISK


**The developed world is on the cusp of surging demand for housing, driven by a combination of demographic trends including an oversized Millennial cohort in the US that is now entering prime house-buying age. Ageing populations worldwide and the disproportionate health care costs in the later years of life are trends that are driving a desperate need for health care systems to extend healthy life years, while controlling costs. Preventative lifestyle and health care measures offer long-term structural growth opportunities for urgently addressing this public policy issue.**

## OUR RECOMMENDATIONS

**Structurally growing demand for housing in the US, Europe and Asia favours:**

- US and European homebuilding stocks
- Building materials and DIY retailing stocks
- Demand for copper and lumber raw commodities
- Residential housing-focused REITs

**Improvement in healthy lifespans drives demand in:**

- Pharmaceutical/biotech companies focused on oncology and Alzheimer's/dementia treatments
- Global medical device stocks
- Home fitness equipment and fitness trackers
- 'Nutraceuticals' - food and beverage companies operating in health-enhanced nutrition

## KEY RISKS

Rising long-term bond yields would inevitably lead to higher long-term fixed mortgage rates, which would hurt housing affordability. Sharp rises in the unemployment rate during economic recessions have also been traditionally associated with lower demand for new housing, squeezing the capacity to service mortgages.

Health care technology and device stocks performed very well in 2020 alongside the US technology sector; thus any rotation into the value style out of growth may well lead to under-performance of these health care-related technology stocks.



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In Emerging Markets, the key driver remains a combination of population growth and the increasing spending power of a growing middle class most evident in China and South-East Asia, and increasingly now in India. But in the more mature OECD economies in Europe and North America, there are different structural demographic forces at work.

- 1. US Millennial demographic bulge:** in the US, there is a population bulge in the key 20-29 and 30-39-year age cohorts, the key ages for household formation where adults see the fastest growth in income and also form their own family units for the first time, thus creating housing demand.
- 2. Single for longer:** what is exaggerating this growth in housing demand is the second structural trend: young adults are choosing to remain single for longer, leading to greater demand for small housing units. The third structural trend is the rise in non-nuclear family structures, accelerating housing demand for smaller housing units.
- 3. Passing of wealth to the next generations:** the final long-term trend is the passing of wealth to the next generations, typically from newly retired parents to their children who are often in the 30-39-year age bracket to help them purchase their first home. This is often achieved by releasing equity in their own homes, having benefited from strong house price growth over the last 20+ years on the back of declining long-term interest rates.

## Housing shortage

The starting point today for US and European housing demand is a shortage of existing housing stock, due to the crash in new residential construction following the 2007-2009 Great Financial Crisis and the ensuing collapse in house prices. While US and European housing starts have recovered modestly from the post-crisis lows, they remain very far from pre-crisis levels.

## Current health care inflation is unsustainable

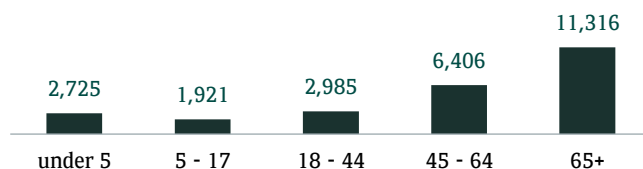
The key issue is the increasing cost burden on health care systems, whether largely private, and funded by insurance (as in the US) or public (as in Europe). In the UK, for example, it costs three times more to look after a 75-year-old and five times more to look after an 80-year-old than a 30-year-old. In the US, average health spending per person rises from under USD 3,000 in the 18-44 age range to USD 11,316 for those aged 65 and over.

The challenge is thus twofold; not just extending people's total lifespan, but more importantly, a) extending their number of 'healthy life years', while b) curbing the cost of health care provision for retirees.

○ LONG-TERM ■ MEDIUM RISK

### HEALTH SPENDING EXPLODES FOR RETIREES

Average US health spending by age (\$)



Source: US Department of Health & Human Sciences, 30 November 2020

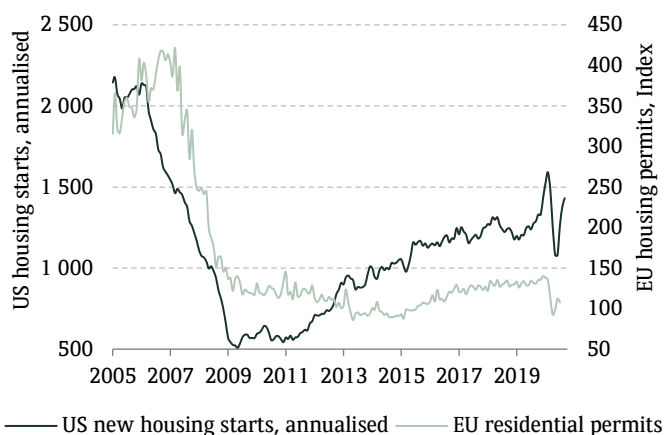
## Focus on prevention is more cost-effective than cure

On the basis that prevention is better than cure, a key focus for health care strategies has to be on promoting healthier lifestyles, not only for the older generation but also for people of working age, in a bid to prolong their healthy year lifespan in later years.

## Tackling the obesity epidemic

Rather than just dealing with the symptoms of heart disease and various cancers, the focus needs to be on the prevention of obesity and type 2 diabetes. This involves both healthier food (see the impressive growth trend in vegan/vegetarian-friendly and gluten-free food) and regular exercise (spanning the range of fitness-related technology from fitness trackers to exercise bikes and rowing machines). This is potentially where the greatest improvements in disease prevention can be made over time, at a relatively low lifetime economic cost.

### US AND EUROPEAN HOUSING STARTS RECOVER, BUT REMAIN FAR FROM THE PEAK



Source: Refinitiv Datastream, 30 November 2020



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08

LONG-TERM HIGH RISK

# Enablers of smart technologies



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## THEME 8

 LONG-TERM  HIGH RISK


Humanity is reaching an important new stage of development: the knowledge economy is increasingly at the core of our activities. To enable innovation, a number of disruptive technologies, such as 5G and Artificial Intelligence, are required and being rolled out.

In turn, these technologies are spurring demand growth in semiconductors, infrastructure, storage and cybersecurity, enabling Big Data processing and consumer profiling.

## OUR RECOMMENDATIONS

This is a global equity theme.

**It is a core long-term holding intended to figure prominently among other investments in megatrends.**

This theme is still in its infancy and will take several years before it reaches a certain degree of maturity. Sales and earnings growth rates will be impressive in the foreseeable future.

## KEY RISKS

Being disruptive by nature, enablers of smart technologies must **compete with other technology disruptors**. This is hence a high-risk theme. The best way to approach it is by avoiding idiosyncratic risks, i.e. by diversifying.

Depending on when the Coronavirus is brought under control, there may be delays in corporate and consumer spending. This would only be a transitory risk because investing in these technologies is likely to prove inescapable to remain competitive.

**Typically, disruptors are valued as relatively expensive on the stock exchange due to their very high growth. Their stocks also tend to be more volatile** and could therefore fall more sharply than stocks of more mature companies during a market correction or during valuation multiple contractions (for instance when interest rates soar, price/earnings generally decrease).



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## 5G: the door to myriad new opportunities

5G is the fifth generation of wireless technology. Thanks to internet speeds that can be up to 100 times faster than 4G, new frontiers such as autonomous driving, robotic telesurgery, the Internet of Things and virtual or augmented reality can be realistically explored. The 5G market is in its infancy but its potential in enabling a wide array of technologies is huge. According to the specialist technology market intelligence firm CCS Insight, 5G connections worldwide will explode from 250 million in 2019 to 3.6 billion in 2025! To build this market, huge spending will be required in this decade and probably beyond. Investments will range from equipment such as networking equipment, cellphone towers, semiconductors and phones to services (such as telecom, cloud, smart mobility, gaming).

## Artificial Intelligence: the knowledge-based economy is counting on it!

According to Wikipedia, 'Artificial intelligence (AI) is the ability of a computer programme or a machine to think and learn'. It combines Big Data and computing power. It is driving the **fourth industrial revolution** (after steam power, electricity and information technology) and can be used in almost every stage of a company's value creation process. Its main contributions are **improved productivity, cost reductions and the human-machine collaboration**. Spending in AI (software and hardware) should jump from USD 640 million in 2016 to USD 37 billion by 2025, according to the market research firm Tractica.

## Consumer profiling

Thanks to the ability nowadays to obtain, store and process big amounts of data, it is possible to **detect consumers' preferences and patterns more successfully**. Marketing strategies and campaigns are more efficient and can generate higher response rates. Prospects can be better profiled, targeted and engaged. Clients are more satisfied, leading to a higher level of repeat business. We are interested in companies that are specialised in handling massive amounts of data to profile clients.

## Cybersecurity and online privacy solutions

**Confidence is needed for people to provide their data and then let external parties process these data.** But this can only happen when a **high level of security** is in place throughout the chain from data collection to storing and processing, while ensuring the highest level of privacy. Nobody wants to discover that his/her personal data have become public without consent. Recent episodes of stolen data have resulted in very negative press for companies that suffered widescale data breaches.

○ LONG-TERM ■ HIGH RISK

### THE RELENTLESS UPWARDS MARCH OF THE MSCI ACWI DISRUPTIVE TECHNOLOGY INDEX



Source: MSCI, Refinitiv Datastream, 30 November 2020

## Infrastructure, storage, processors and semiconductors

Data processing software and applications require increasingly powerful systems. Good and reliable networks and storage facilities are needed for the exponentially growing amount of data available on the net. Huge databases also necessitate more and more powerful semiconductors to store, process, extract and analyse data sufficiently rapidly.

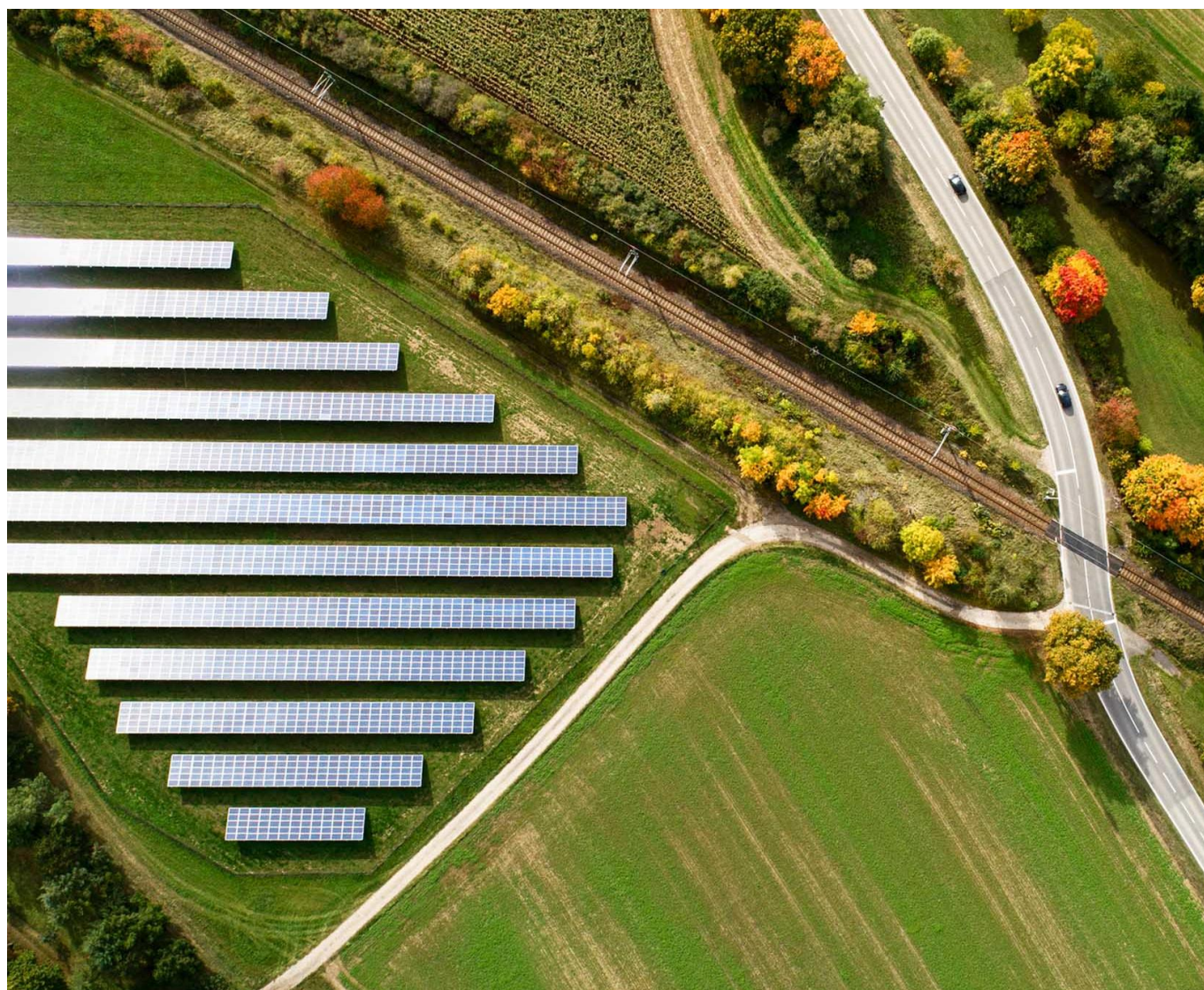


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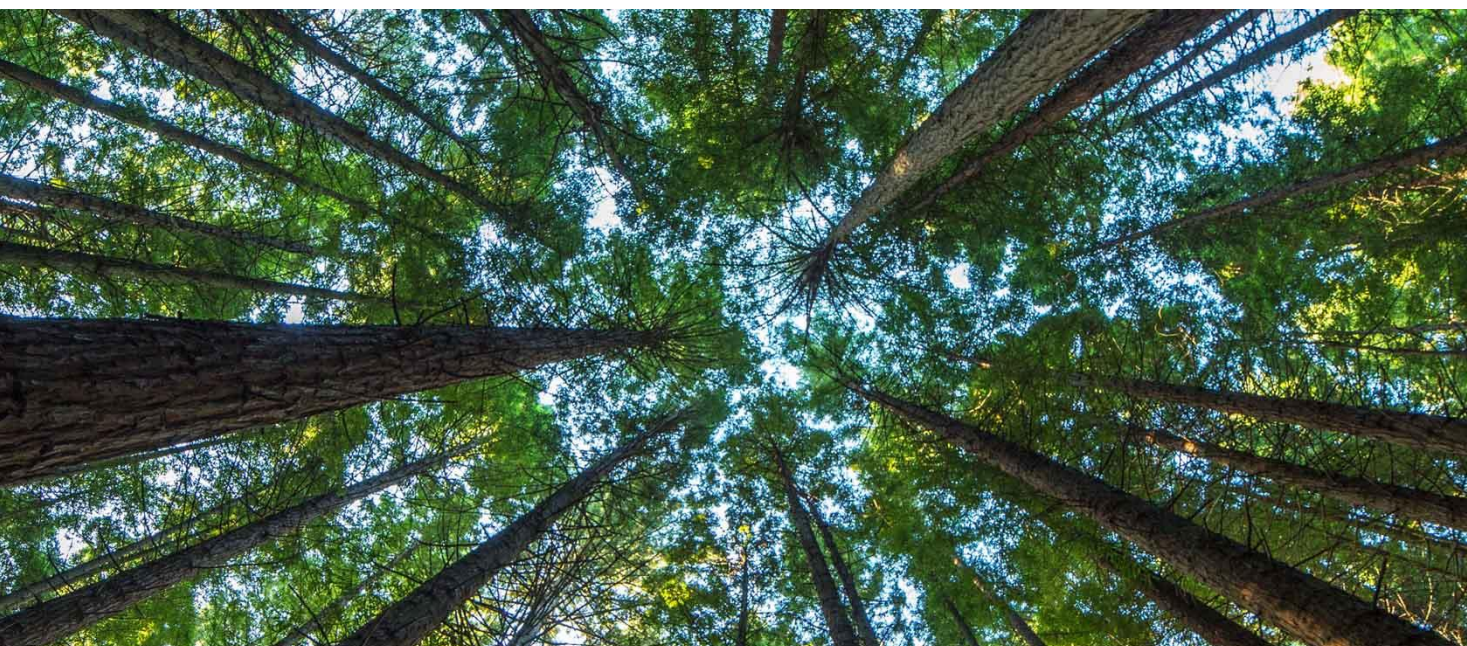


# The energy transition and the 'green deal': long-term opportunities





## THEME 9

 LONG-TERM  MEDIUM AND HIGH RISK


There is a growing awareness that human society and the global economy are both closely related to the ecosystem, CO<sub>2</sub> emissions and energy sources.

The energy transition is about structural shifts from centralised, fossil fuel-based production that did not have to pay for negative externalities, towards a clean/renewable and decentralised energy model.

We see huge demand for products and services in this area driven by innovations, government policies, CO<sub>2</sub> targets and changing consumer and investor preferences towards sustainability.

## OUR RECOMMENDATIONS

We focus on two sub-themes:

- Technological innovation and equipment in Solar, Wind, Geothermal energy, Hydroelectricity and fuel cells (Hydrogen)
- Energy storage, power and grid equipment makers, batteries and related chemicals/materials

We will focus our attention on equities of companies that are key players in these areas by also using actively-managed funds or thematic ETFs.

## KEY RISKS

The investment solutions related to this theme are mainly linked to equities. Despite the theme's relevance and attractive potential returns, investment solutions will still be subject to global equity market movements.

A factor that should limit the risk relative to global equity markets is that companies related to this theme should often benefit from a high rating for Environmental, Social and Governance (ESG) criteria. Some studies suggest a lower volatility of returns for such strategies. A global recession could severely limit governments' ability to support the necessary transitions. A sharp drop in oil and natural gas prices could slow the energy transition.



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We expect the energy transition to make a major breakthrough over the coming years. By 'energy transition' we mean structural shifts from traditional centralised, fossil-based production that did not have to pay for negative externalities, towards a clean/renewable energy and decentralised model where technological innovation and the pricing of externalities will be the key drivers. The speed of transition will be driven by i) technological innovations reducing the cost of producing and storing renewable energy; ii) government policies (carbon tax, subsidies for clean energies and infrastructure investments) and iii) changing consumer and investor preferences (for ESG/SRI-friendly investments).

The most important game changer of late emanates from governments and their expenditure programmes which focus on the energy transition and the reduction of CO<sub>2</sub> emissions: i) Europe continues to be a leader with the 'Green Deal' and the related Resilience and Recovery Fund; ii) China is also very ambitious with targets in the 2018 'three-year plan' that aim to accelerate the deployment of sustainable transport systems. We expect more measures to be announced in March when the Chinese Communist Party details its 14<sup>th</sup> China 5-year plan. Finally, the election of Joe Biden as US president opens the door for infrastructure investment in the US linked to electricity grids, electric vehicles, battery storage and renewable hydrogen.

#### We focus on two areas in particular:

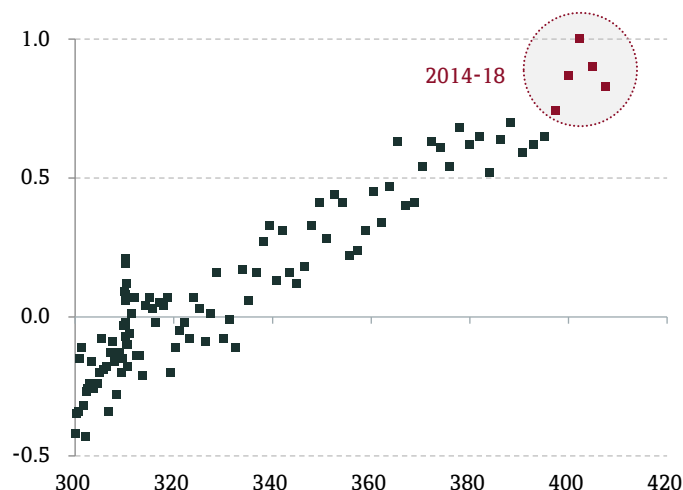
##### 1. Innovation and equipment in Solar, Wind, Geothermal energy, Hydroelectricity and fuel cells (hydrogen)

We do not expect one single renewable energy source to be the leader in all sources of production, for the following reasons. First, there are multiple sources of renewable energies, and the cost efficiency of producing these energies can be quite different from one country to the next. Second, recent studies conclude that electric cars will probably first rely on battery technologies while the new generation of buses and trucks is more likely to use fuel cell (hydrogen)-related technologies. It is thus important for investors to use a diversified approach when investing in this theme.

○ LONG-TERM ■ MEDIUM AND HIGH RISK

### THE GREENHOUSE EFFECT (1880-2018)

X Axis: Atmospheric CO<sub>2</sub> level (parts per million)  
Y Axis: Global mean surface temperature relative to 1850-1900 (°C)



Source: IPCC, NASA, BNP Paribas, 30 November 2020

##### 2. Storage, power and grid equipment-makers including batteries and related chemicals and materials

The International Energy Agency forecasts that as much as 80% of global growth in electricity generation could come from renewable energy sources by the end of the decade. But it is not only about more cost-effective and environment-friendly batteries. It is also about thermal energy storage, gravity storage, liquid air and hydrogen. Lithium-ion batteries enjoy a very big market share. There are, however, new areas of innovation such as vanadium redox-flow batteries, liquid metal batteries and low-cost batteries that use cheap raw materials. The focus is on lifespan, storage, fast charging, availability of commodities and environmentally-friendly batteries. Energy recycling in industries, such as steel, is also a hot topic.

Many technologies will likely co-exist and it is essential to diversify one's electricity storage-related investments.





10

LONG-TERM  MEDIUM RISK

# Strong governance as an aid to low-risk outperformance: investing in trust and profitability



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## THEME 10

LONG-TERM  MEDIUM RISK

Recent examples of corporate fraud have highlighted the importance to investors of the Governance criteria in ESG, in terms of reducing risk when investing in equities.

Since 2015, European companies with a strong track record of Corporate Governance (relating to transparency and shareholder rights) have collectively outperformed the STOXX Europe Index consistently, particularly when allied to an above-average level of profitability.

## OUR RECOMMENDATIONS

We believe that investors wishing to invest in companies with excellent ESG credentials should focus on companies with strong Governance, since this aspect of ESG is often neglected in favour of the more visible Environmental and Social criteria.

Marrying strong Corporate Governance with high profitability is an attractive long-term defensive equity strategy and a good alternative to sovereign and corporate bonds. Prospective returns from stocks with a combination of strong Governance and high profitability remain very attractive when compared with sovereign bond yields that are frequently negative, and with corporate bond yields that are currently as low as 0.5% for Euro BBB credit.

While equity exposure to companies with strong Corporate Governance and high profitability is our preference, this theme also applies to corporate bonds, as over time, stronger governance should be reflected in improved credit ratings.



## Trust takes time to build, a moment to lose and forever to repair

This mantra is becoming ever more relevant to listed companies, in the area of investor relations.

Governance in ESG incorporates a range of concepts including:

- Code of conduct
- Transparency
- Competition
- Legal issues
- Corruption
- Board independence
- Shareholder rights
- Supply chain management

## Strong Governance can improve returns at lower risk

Contained within these concepts is a wide array of potential risks to a company's profitability and even long-term viability, which may result in heightened risks. We believe that investors are unlikely to be compensated for these Governance-related risks.

Since 2015, a basket of European stocks demonstrating strong Corporate Governance characteristics have outperformed the benchmark STOXX Europe Index by 17%, underlining how strong Corporate Governance can be a powerful motor for stock performance over time.

## Higher profitability is also a driver of higher returns

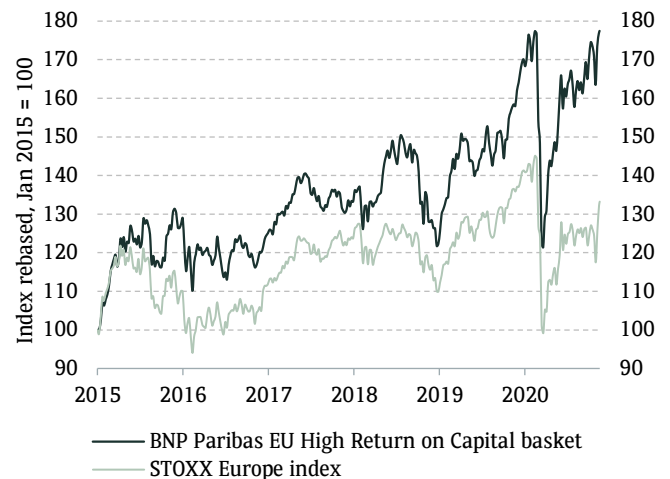
This is true for companies with sustainably above-average returns on capital employed (ROCE); since 2015, a basket of European high-ROCE stocks has outperformed the STOXX Europe Index by 33%.

Indeed, this underlines the investment attractions of highly profitable companies that typically have sustainable economic moats (such as strong brands or superior distribution networks) built into their business models, helping to protect companies and their products and services from competition.

Academic research has consistently demonstrated the superior risk-adjusted returns to investors from highly profitable companies with these economic moats. Investing in highly profitable companies demonstrating strong Corporate Governance is an attractive defensive equity strategy. This strategy should, in our view, continue to deliver attractive risk-adjusted returns to investors in 2021.

○ LONG-TERM ■ MEDIUM RISK

### EUROPEAN HIGH PROFITABILITY STOCKS HAVE DELIVERED MORE THAN DOUBLE THE BENCHMARK RETURN SINCE 2015

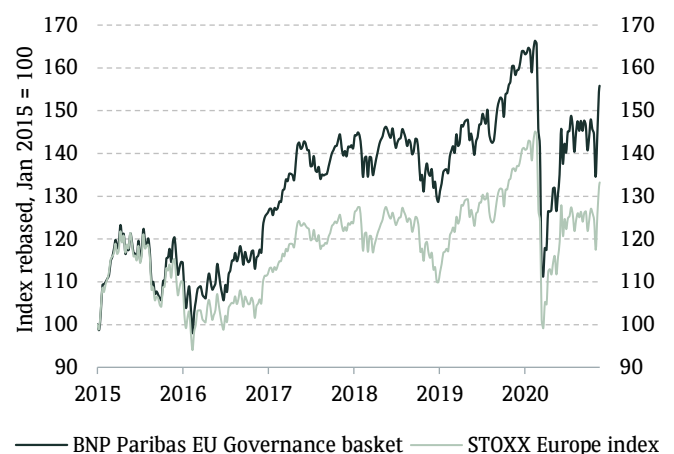


Source: BNP Paribas Global Markets, 30 November 2020

## ESG fund inflows to boost Governance

European companies, as a group, have been leading the global movement towards strengthening their ESG credentials. We see that the tsunami of fund flows into ESG equity funds is very likely to continue into 2021, which will drive more investment in companies with a strong and improving Corporate Governance track record.

### EUROPEAN STRONG GOVERNANCE STOCKS OUTPERFORM THE STOXX EUROPE INDEX



Source: BNP Paribas Global Markets, 30 November 2020



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