Post-Pandemic 2021: Return of the Roaring Twenties or Market Overstretch?

Record high equities markets, ultra-low bond yields, a deadly pandemic and the inauguration of a new U.S. president set to recalibrate the world's largest economy and global geopolitics, make for a potent and challenging mix for investors to position themselves and navigate at the start of 2021.

Will markets burn and crash, or will economic health be restored by the successful vaccination of populations to open the floodgates to huge pent-up consumer savings, corporate investment and innovation? A curtain raise for the 2020s revival of the 'Roaring Twenties' era of the last century, where a mass consumer society arrived and the car economy was born. American wealth doubled in the course of that decade following the Spanish flu pandemic, which killed 50 million people worldwide, and the lucky few cast off the social mores of the past and partied to the liberated music of the 'Jazz Age'.

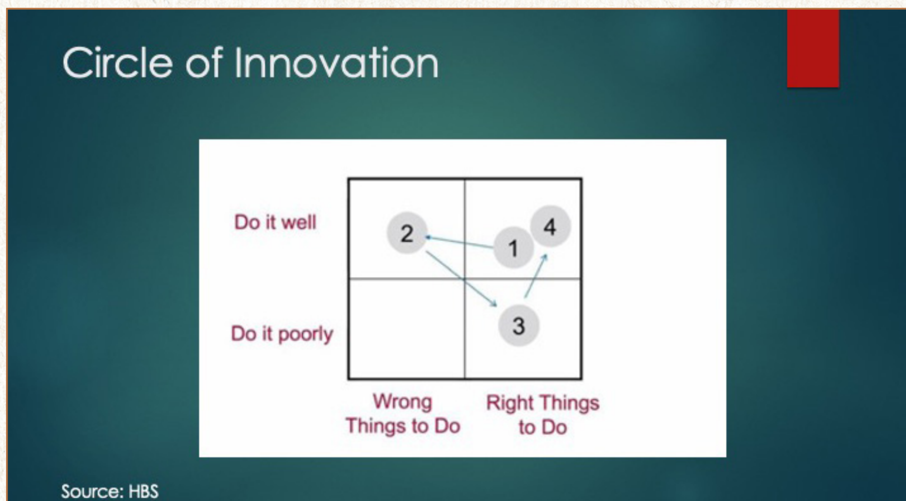
Against this formidable 2021 New Year backdrop, three leading investment strategists from the central bank of Switzerland, global alternative investment giant Apollo and AXA IM, one of the largest European asset managers, explained in a recent AXA IM online 'Experts Meeting' for institutional investors from the Netherlands, Germany and Switzerland, how they are positioning themselves for the likely roller-coaster year that lies ahead. **To view Experts Meeting** click here.

Fast-expanding German fintech mobile bank N26 and digital credit services platform Hypoport also outlined why the pandemic has boosted their growth and market shares. They forecast that mid-sized traditional banks and financial companies' business models in Europe's largest economy and beyond, will struggle to stay relevant without fast adaption to the new realities and drivers of the digital economy, despite German consumers' traditional reputation for financial conservatism.

Hanneke Veringa, AXA IM Netherlands country manager and moderator, opened the webinar by suggesting institutional investors could view the speakers' presentations through the prism of one of Harvard Business School's famous 2:2 teaching matrices: the 'Cycle of Innovation.' The matrix can also be used as a conceptual touchstone for revisiting approaches to asset allocation and investments in the new market environment and is particularly relevant for the €1.7 trillion Dutch pensions sector, she noted.

The largest institutional capital pool in the EU and the fourth biggest globally, is undergoing a tectonic shift under fundamental reforms of its mandate in the Netherlands within the next five years, towards an open economic framework for investments and away from previously rigid regulatory constraints.

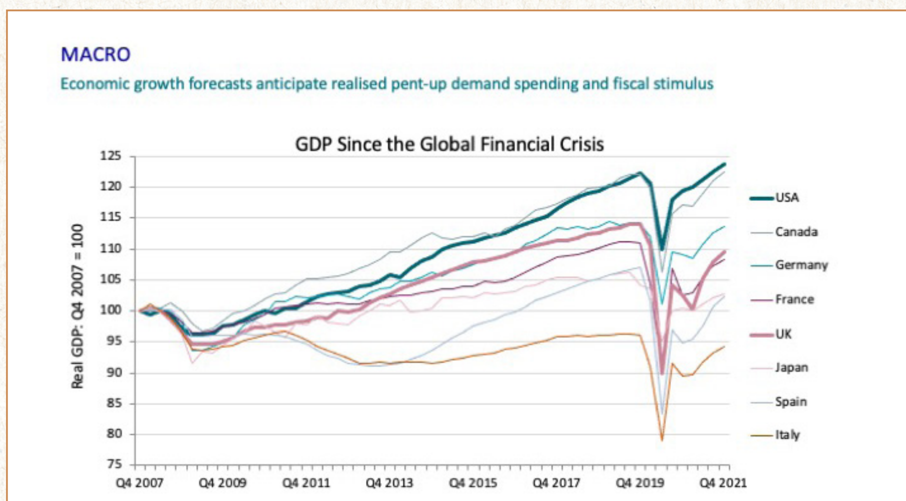
“Essentially it’s about being in a comfortable place that is maybe the wrong place and then pursuing growth by moving to the right place, even though that process may be very uncomfortable. Eventually you become more comfortable in the right place and can move forward,” Veringa said.



Release of Pent-up Consumer Spending and Corporate Investment to Support Equities

Lockdowns and other social distancing restrictions imposed by governments during the pandemic have greatly restricted consumers opportunities to spend money, but it most cases people are still earning income, so savings rates have gone up everywhere. In the U.S., the savings rate went up to close to 20% of disposal income in the middle of 2020 and it remains well above 10%, which is much higher than the historical average and it’s the same for all the G7 countries, **Chris Iggo, CIO, Core Investments at AXA IM**, told the webinar.

“There’s a lot of pent-up demand in the household sector, so consumer spending could really boom once we see progress on the pandemic and economic restrictions are lifted. It’s a similar story in the corporate sector. Companies have been very active at raising money, both in equities and, more importantly, in the bond markets, which were very quickly supported by the liquidity and other facilities put in place by central banks last year. We saw $1.7 trillion of money raised in the U.S. corporate bond market and the pace of borrowing has continued to be very strong in the first weeks of 2021. That cash generally hasn’t been spent, it’s sitting on corporate balance sheets. It will get spent at some point on investment, or M&A; on share buybacks; or returning capital to investors through dividends. These are activities that would tend to favour the equity investor rather than the credit investor,” Iggo said.



AXA uses a conceptual framework called MVST (Macro, Valuation, Sentiment and Technicals) to assess the investment environment and allow portfolio managers to make the best possible decisions, based on the understanding of where we are in the economic cycle and what the prevailing key drivers are across a range of different markets.

“There is a broad-based expectation that we will get a much stronger economic recovery in the second half of this year and that is based on the expectation that the rolling out of vaccination programmes across the world will help bring down infection rates, allow economies to open up and a return to normality that we’ve all been craving,” he added.

AXA IM’s MVST model is currently flashing that equities is the asset class still most likely to provide the best returns, despite the dizzying heights reached by the markets.

Iggo said the valuations of all markets are stretched after the strong performances of last year continuing into 2021, but probably more so in fixed income where central bank-provided liquidity has squashed risk premiums, than in stocks. A huge portion of the global bond market is trading at a negative yield and credit spreads are back down to their post-Global Financial Crisis lows.

“The ‘all-in yield’ for fixed income is not really very attractive compared to where we think inflation may be over the next two-to-three years. It’s very possible that you could get negative real returns from credit markets in the short to medium term,” Iggo said.

Although some investors are concerned over the high valuations of equity markets, there isn’t really an alternative to the asset class if they want capital growth and to participate in the recovery of corporate earnings post-pandemic, he concluded. IBES (Institutional Brokers Estimate System) consensus earnings per share forecasts for both the S&P 500 and the Euro Stoxx equity universes are showing a continued improvement compared with 2020, when they dropped precipitously in the first half of the year. Iggo said based on these trends equity markets should be between 20% to 25% higher by the end of 2022 and that he believed the IBES forecasts were a true reflection of what is going to happen in the earnings cycle.

Fourth quarter (2020) corporate results from the U.S. for the S&P 500 have been strong and beaten expectations with around 17% of earnings reports providing positive surprises on the upside relative to forecasts in the market before the results were released.

Chris Iggo concluded that the biggest potential risk to the investment markets was a shift in relative valuations stemming from a rise in long-term bond yields, which would start in the United States and result from expectations the U.S. economic recovery was so strong, and inflation picking up at a much quicker rate than anticipated, that the Federal Reserve would need to start to take its foot off the (monetary liquidity) pedal. But AXA IM doesn’t expect this scenario to materialise and forecasts only a modest rise in U.S. Treasury yields, which will not be enough to disrupt the strong performance of equities and some parts of the credit markets.

European Institutional Investors' Compromised Portfolios Trapped in a Vicious Circle

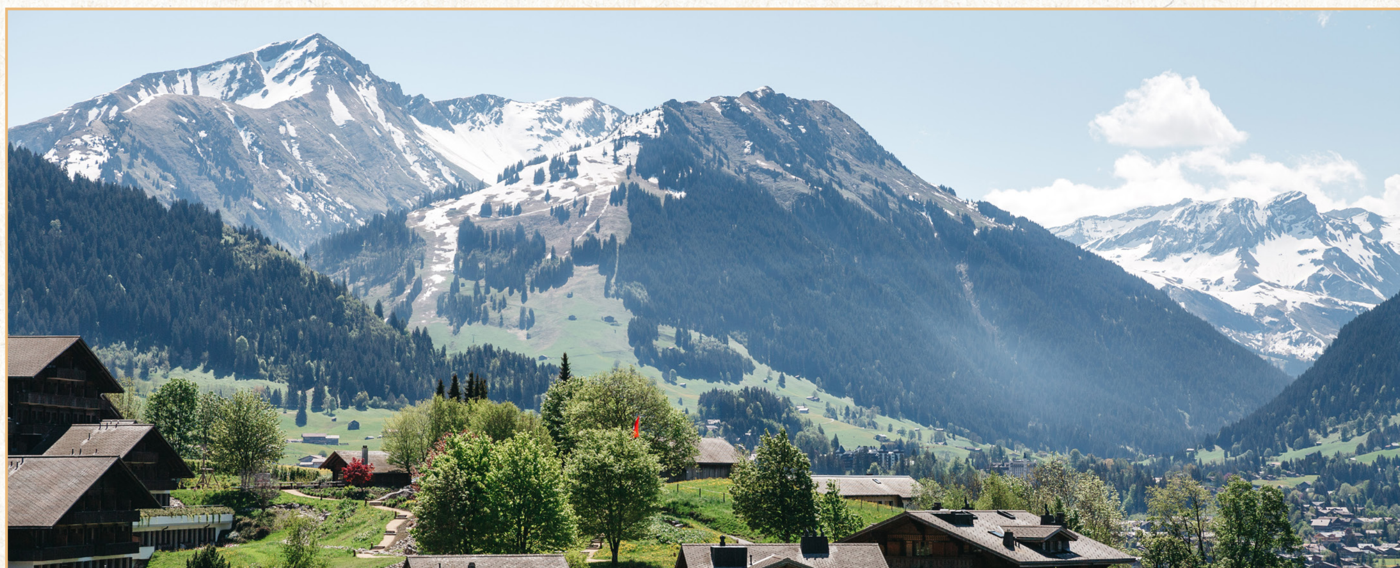
The traditional institutional investment portfolio construction model is reaching its limits in a sustained low interest rate environment. The mainstay of European pension funds and insurers is predicated on unsustainable return targets, which means that investors holding onto these traditional portfolio structures will not be able to service their future liabilities and will have to loosen their appetite for risk, while being constrained within a narrow investment universe of a few major selected asset classes where the economics are deteriorating and performance is increasingly correlated, **Eric Lhomond, Partner at alternative investment firm Apollo** told the webinar.

Lhomond said he considers the institutional investment universe to be very narrow, essentially focused on 'govies' (sovereign debt) and publicly quoted investment grade corporate bonds (IG) with a few other smaller asset classes thrown-in, but not on a sufficient scale to make a real difference to the overall returns of the portfolio. These traditional allocations may have worked very well in the past, in the 1990s and early 2000s, but in a world post-QE (quantitative easing), where credit spreads are very tight and interest rates close to all-time lows, he believes they generally don't work for investors seeking to cover their future pension or insurance liabilities.

"As you earn less on govies and public IG, you have to find ways to make a little more, by introducing high-yield bonds, or opening your risk to the 'duration gap.' Often what we find is that the world is thought of in a static manner: buy and hold, things don't change, or change very slowly, through very long cycles. This results, in our view, in a vicious cycle for some institutional investors: Constrained allocation and a narrower investment universe, which leads to a looser risk appetite. They have to compensate for the negative yield that is on their balance sheets and tend to ignore correlated risk. That results in deteriorating funding ratios, or capital, which further constrains the (institutional) balance sheet, and so on and so on....," Lhomond said.

Valuations in traditional institutional asset classes and equities are increasingly being driven by macroeconomics, government and central bank policies, or exposure to 'macro risk,' Lhomond added. This should push investors towards moving away from a static approach to portfolio construction and extending their investment universes with much higher allocations to alternative investments in private markets, both debt and equity, which offer greater diversification to macro risk and where a 'complexity premium' can be extracted by specialist-focused managers, due to the high barriers to entry into these markets.

"If you look at public IG and public stocks it feels very much like prices are macro-, or policy action-driven. The sell-off in February 2020 was very much driven by the exit of investors panicked by Covid-19. From April onwards, it was the monetary policies of the Fed and ECB that kicked-in and drove the recovery price-action. Well these are just macro risks and you buy or sell the market. The main challenge then is market timing. In the private space, in debt and equity, you mostly tend to extract the complexity premium, or illiquidity premium, and some credit-risk premium, as opposed to the macro risk," Lhomond concluded.

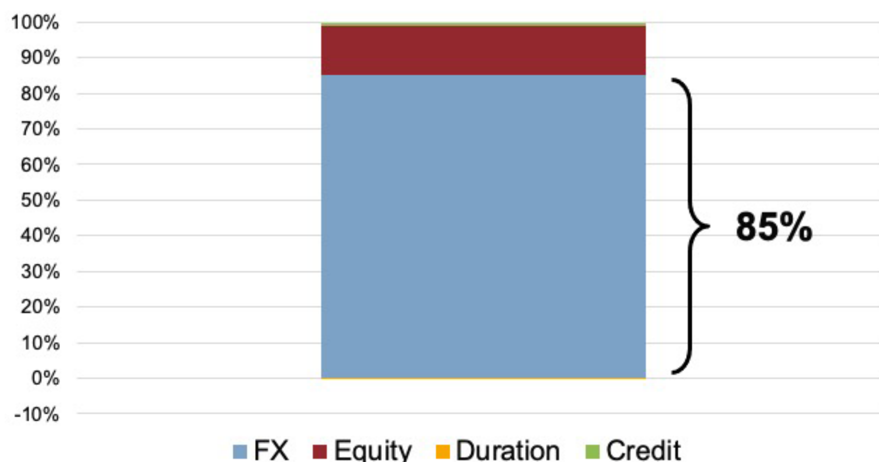


Swiss National Bank Embraces Equities for Capital Preservation, Mirror of Global Economy

The Swiss National Bank (SNB) stands out among its central bank peers because of the challenges it faces in preventing the exchange rate of the Swiss franc from appreciating too quickly and optimising investment returns from its massive foreign exchange reserves derived from the 'safe haven' status of the currency and huge inflows, particularly during times of global crisis, such as the coronavirus pandemic.

The SNB's monetary policies have led to an enormous expansion in FX reserves to around CHF 900 billion today from just 50 CHF billion in 2009.

"Our investment policy is subject to two main principles: To support monetary policy, which means we have to stay flexible at all times and be able to increase or decrease FX reserves. Liquidity is important for us and we therefore invest a large share of our reserves in highly liquid government bonds like German Bunds or U.S. Treasuries. We also have a market-neutral equity portfolio, which from a liquidity standpoint is the optimum. The other goal is long-term capital preservation, which we try to achieve through portfolio diversification and investments in equities and corporate bonds, which help to improve our risk/return profile," **Sandro Streit, Head of Asset Management at the SNB, told the AXA IM** webinar.

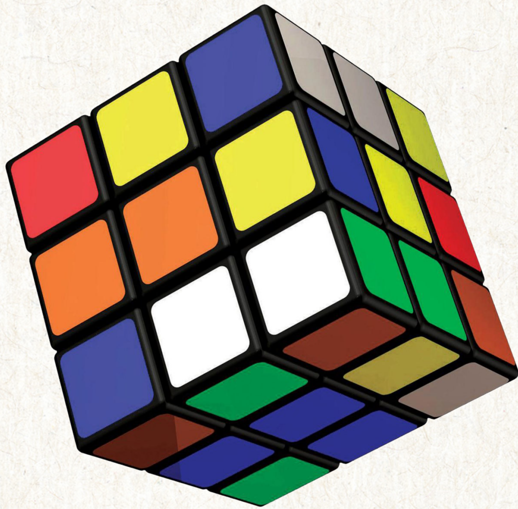


Some 85% of the SNB's portfolio risk comes from FX and 15% from equity investments, which are managed passively. The safe haven status of the Swiss franc means that if there is a global equities market crash the central bank will lose on its stock holdings in local currency terms and also as the Swiss franc appreciates.

The SNB also invests in equities as its market-neutral portfolio automatically reflects changes in the global economy and relative developments between industry sectors and
because it can sustain a market crash in stocks. The central bank should not be under pressure to sell equities to gain liquidity to support its currency, like some emerging market central banks, because the Swiss franc has historically appreciated during crises.

"If we had the allocation to equities in the portfolio we had today for the last 20 years then our annual returns would have averaged 3.5% in Swiss francs, even though the currency has appreciated 2.5% per annum over that period," Streit said.

The SNB diverges from its passive market-cap allocation to global equities indices through the removal of stocks that might create conflicts of interest. For example, the central bank does not invest in the shares of mid to large-sized commercial banks, or in Swiss companies. On ESG criteria, the SNB also does not invest in companies that violate basic Swiss values in the products they produce, or their production processes. From the breach of fundamental human rights, to firms that stand in the way of a transition to a carbon-neutral global economy, like coal miners.



N26 is the mobile bank, with slickly-designed cards touted by hipster millennials, that started off as a German FinTech and launched commercially online in 2015. Growing from around 75,000 customers in its first year to well over 5.0 million in early 2021. The bank's name is derived from the 26 cubes of a Rubik's Cube three-dimensional puzzle, which is very hard to solve if you don't know how, but can actually be very easy to solve with guidance. That's how N26 looks at banking in general: Something very complex - made intuitive and user-friendly. N26 operates across 25 markets globally, of which 24 are in Europe, plus the U.S. The bank now has 1,500 employees from 300 just three years ago.

Pandemic Turbo-charges N26's Mobile Banking Market

The Covid-19 pandemic has accelerated growth in 'contactless payments' by consumers, compressing a major market trend that would otherwise have played out over years into a matter of weeks. Lockdowns have also introduced a large swath of older generation customers to the speed and simplicity of digital mobile banking, after which they are unlikely to want to return to the traditional services of their previous High Street banks, **Georg Hauer, General Manager DACH and Northern Europe, at fast-growing German FinTech N26** told the webinar.

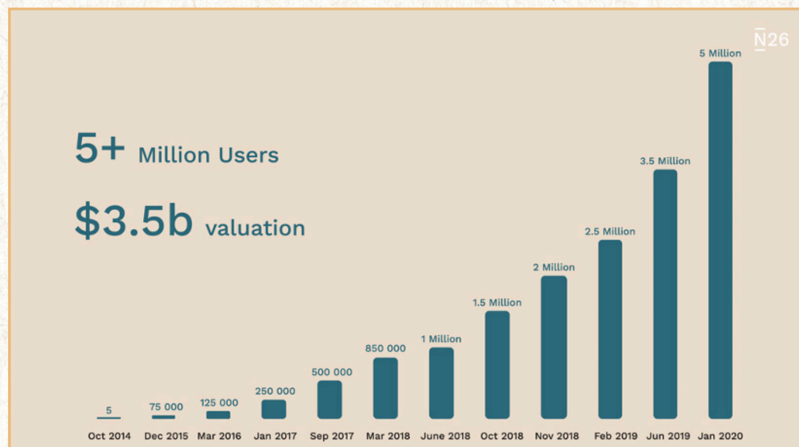
"In 2020, Covid-19 accelerated the digitization of many industries. Digital banking made a huge jump forward, especially in Germany which is generally a very 'cash-heavy' country, but it occurred all across Europe. During the lockdown, 75% of all card payments were done contactless which was unthinkable a few weeks earlier. We leapfrogged three years into the future compared to previous forecasts," Hauer said.

Some 38% of N26 customers reported that they were making contactless payments due to Covid and 71% of them said they will continue using it after the pandemic. At the same time, there was a 50% drop in ATM cash withdrawals, as many customers were ditching cash entirely, he added.

There has also been a 20% average increase in ecommerce transactions per person among N26 customers of diverse ages across Europe.

"Ecommerce is booming. Among customers over 50 we observed a 30% increase in ecommerce transactions, many of whom were adopting mobile, banking services for the first time. We've also seen a strong influx of new clients who are much older than our average age profile. This is a very positive trend for N26 because it shows that as a digital bank we are slowly moving into the mass market, " Hauer said.

When N26 started off six years ago in 2015, the average customer was in their mid-20s and by 2020 in the mid-30s. Within the next years, the mobile bank projects the average age will have risen to the late 30s, or even into the 40s.



N26 expects the 2020s to be the last decade where bank branches, already in sharp decline across European markets, will play any meaningful role in retail banking. Consumers of all ages are increasingly used to receiving a vast range of services on their smartphones, so why should banking be an exception?

In Europe it takes on average around €1.0 million to sustain one bank branch for 5,000 to 10,000 customers, or even fewer in rural areas. When people stop using their local branches it boosts the importance of the digital product as the main customer gateway. This can make the digital product the main reason for choosing one bank brand over another. But smaller regional banks typically don't have the financial and technical resources, marketing expertise and scale to create a compelling online app for increasingly demanding consumers.

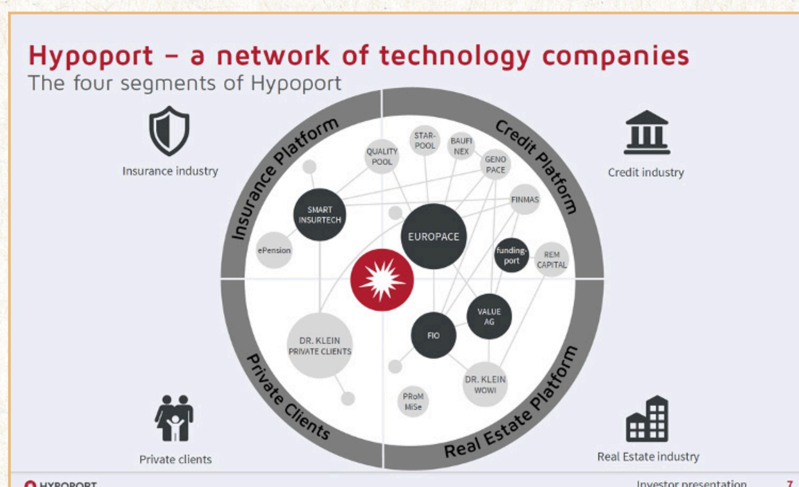
Hauer said this unstoppable online trend would create a new generation of European, and in the long term potentially global, mobile banks like N26 operating across national borders under a common EU banking license and one brand.

"N26 started with offering a very simple checking account. Today we offer shared account, credit and saving products and have started to move into money management and automated savings accounts. The next steps will see us expanding our credit portfolio and even into trading and investment products. We also already bundle insurances with premium services, and might eventually offer standalone insurance products with our insurance partners," Hauer concluded.

Covid Accelerates Online Mortgage and Credit Growth at German Hypoport

German consumers and businesses have been enthusiastically adopting online mortgage and credit services at a faster pace during the pandemic providing a hefty boost to the revenues and market share of **HypoPort, Germany's largest FinTech platform, CEO Ronald Slabke** told the AXA IM webinar.

"The coronavirus crisis is having a huge impact on the functioning of bank-based market structures and is accelerating digital transformation within financial product distribution. All four of Hypoport's distribution channels (financial product distributors, private commercial banks, cooperative institutions and savings banks) are growing at a much faster rate than the market," he said.



Online transaction volumes per sales days on Hypoport's Europace credit platform reached a record level of almost €345 million, a growth of 29% year-on-year in the first nine months of 2020. The biggest product group, mortgage finance expanded by 34% to €53 billion over the same period, lifting Europace's share of the €250 billion German mortgage market, Europe's largest, by a further 4% to around a quarter of the total.

Slabke said the full digital provision of advice and online processing of loan applications submitted to banks via Europace's Dr Klein franchise system for small financial intermediaries, also helped produce record growth of 24% in this unit in the first three quarters of 2020 and is clearly giving the company a competitive advantage during the pandemic over advisors and bank distributors who do not use digital technologies to the same extent.

"For the Dr. Klein advisors it was pretty normal already pre-corona to remotely process advice and transactions, while most competitors had to adapt to this new environment and have struggled with this up until today... We've just had our best year in history for Dr. Klein," Hypoport's CEO concluded.