

November 20, 2020

Dear Clients and Colleagues:

Global equity markets were given renewed momentum last week when Pfizer and BioNTech announced that their vaccine was more than 90% effective in preventing COVID-19. The flow of good news continued this week as Moderna reported a 94.5% prevention rate for its vaccine. Before the end of the year, further news on vaccine efficacy is expected to be released, which should provide additional positive catalysts. Vaccine-led momentum is still on the rise and the road ahead will likely remain bumpy.

Regarding lockdown restrictions, the focus now appears to be more on limiting the number of new cases rather than easing restrictions. We expect regional lockdowns to continue in December and probably during the winter months. These measures could have a negative impact on economic output, even if the lockdown restrictions are less severe than in the first lockdown. For that reason, we could experience negative economic growth for the next four months followed by a rebound.

Looking into 2021, we think that there are significant rotation opportunities favouring small cap equities. European small caps trade at one of the cheapest levels relative to large caps in history. Looking at the historical trends, post-crisis periods have been favourable for small cap equities. We believe that a new economic cycle should be supportive to small caps in 2021.

Compared to large cap equities, the composition of the small cap indices could prove to be another advantage going into 2021. European large caps are highly weighted in defensive sectors, such as consumer staples, pharmaceuticals and utilities. In relative terms, small caps tend to be overweight in industrials, travel and leisure, and real estate. We think that this composition makes small caps more attractive for next year. An upcoming economic recovery combined with an important fiscal stimulus investment would certainly benefit small caps over their larger counterparts.

In recent weeks, we have attended many virtual events and calls with our holdings. The vast majority have commented on their Q3 trading update, but very few dared to comment on their 2021 projections. Here are some general thoughts on the sectors mentioned above.

Travel and leisure has been one of the industries most affected by this pandemic. The sector has been deeply unloved relative to COVID, but we think that the long-term opportunities remain positive. Post COVID-19, we expect to see stronger companies emerging. The strongest operators should capture more market share while benefiting from a better pricing power. Although the immediate risks remain,

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in particular due to the recent lockdown measures, this industry could soon regain interest and surprise positively in 2021.

Within industrials, many companies will emerge from the crisis considerably leaner as their profitability break-even has been reduced significantly. Many have deleveraged their balance sheet, meaning they will enter the new economic cycle with strong financial capabilities. Trends in the automotive segment signify signs of improvement, with China and North America leading the way over Europe. Auto suppliers and tire manufacturers should benefit from a higher usage of private vehicles over public transportations and an increase in miles driven. In the aerospace segment, manufacturers should anticipate a production cadence that will remain at the lower end. Positive news emerging from the vaccines and the potential re-opening of the Boeing 737 MAX programs could definitely give some hope to this industry.

The real estate sector, which has been under-owned, has also lagged this year. We think we will start to see some rerating of the sector next year. In the office segment, we favour flexible office operators over the traditional office space companies. As a consequence of the pandemic, the future of office space is being questioned. The more resilient residential segment should also see an improved level of activity for next year. Fewer uncertainties (Brexit, United States election, vaccine), combined with a low interest environment and plenty of fiscal stimulus, should propel that market in 2021. The pandemic has proven great for the logistics sector, as e-commerce adoption has soared dramatically. We do not anticipate this trend to fade out in 2021.

Have a great weekend.

The Global Alpha team

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