

December 4, 2020

Dear Clients and Colleagues:

The last few weeks of 2020 are upon us, and what a year it has been. In February, a synchronized global economy achieved record lows in unemployment levels. Countries were balancing their budgets or reducing their deficits. Stock markets reached all-time highs. There were rumors of a virus in a province of China, but nothing to worry about. Surfing the strongest economy in decades, President Trump was all but assured of re-election.

We all know what happened next; over 64 million people infected by COVID-19 globally, with close to 1.5 million deaths. The United States (US), the worst-hit country, has counted over 14 million people infected so far, with over 1 million new cases each week. With over 275,000 deaths, the COVID pandemic has now claimed more American lives than the Vietnam War (58,000 deaths) and should unfortunately exceed the total American combat casualties of WWII before year-end.

The global pandemic has led to an unprecedented response globally, in terms of stopping economic activity to reduce the spread, launching stimulus and support programs for the economy and citizens, as well as research for a vaccine. November saw positive news regarding three vaccines, one from Pfizer/BioNTech, one from Moderna, and one from AstraZeneca/Oxford. On December 2, the United Kingdom became the first country to formally approve a vaccine (the Pfizer vaccine) and should start a vaccination program this week. The US expects a majority of the population to be vaccinated by the summer of 2021. In Canada, the timeline is Q3 or Q4 of 2021.

Many other vaccines are at different stages of research and testing. The Russians have developed Sputnik V, a vaccine already administered to the Russian military. The Chinese also have a vaccine. Many other large and small pharmaceutical and biotech companies are at different stages with at least 10 vaccines in phase three, conducting testing on humans.

What still needs to happen

Vaccines must be approved and proven to be safe before they are administered broadly. We need to find out how long the protection will last and if there is still propagation even though the host is protected. Additionally, a massive logistical effort must be undertaken to produce, distribute and administer billions of doses.

Equity markets globally have rallied strongly following the positive news regarding a vaccine, with the MSCI World Index and US benchmarks at all-time record highs. The US dollar has weakened, while commodity prices from oil to metals to agriculture have rebounded strongly, and in the case of metals

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and agriculture, they are at multi-year highs. With that, short-term interest rates have moved higher in the last few weeks. That could derail the strong equity rally.

ISM Index – Price Paid



Source: Bloomberg

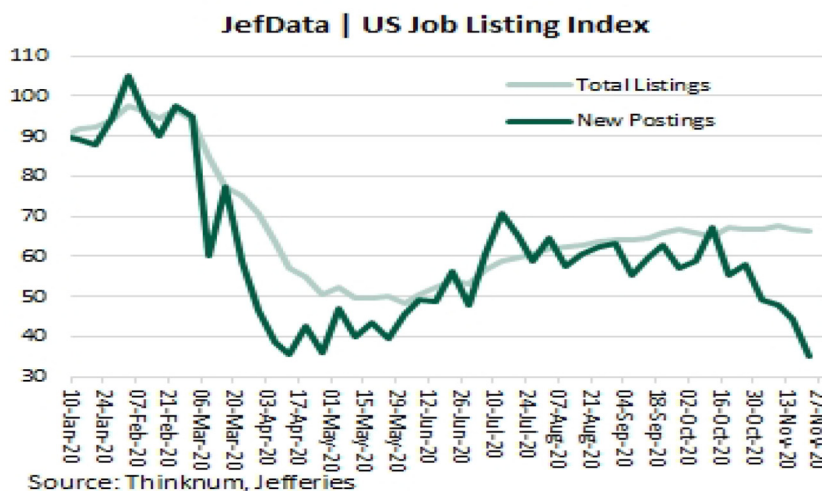


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On the other hand, with a vaccine still months away from being accessible, a stalemate in Washington regarding new stimulus programs, and many countries still in varying stages of confinement to contain a second wave, the economy has shown signs of slowing in the last few weeks. Unemployment claims are up again, and personal income and personal spending growth have slowed and in some cases declined.



Source: Thinknum, Jefferies
 Weekly aggregation of a dynamic universe of ~180 national firms representing an average of ~150k job listings. 100 represents 'normal' level based on observations from 2019. Aggregated and normalized by Jefferies and sourced from Thinknum.

As we are nearing 2021, let us try to answer some of the questions on investors' minds:

Q. Will the US economy go back into recession, i.e. experience a double dip?

A. Although the US economy may not be in a recession technically (defined as two subsequent quarters of GDP contraction), we believe that the economy will contract in the first six months of next year and experience a double dip.

Q. Does this mean the stock market will experience a correction?

A. That is a difficult question to answer. With rising interest rates and a vaccine in 2021, we believe that the stock market will continue to experience a rotation next year. Many benchmarks, because of their important weight in technology, may experience negative performance, but more stocks should be up than down in 2021.

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Q. What are the biggest risks/unknowns for the US stock markets in 2021?

A. A new administration will take power in January and intends to continue its stimulus program to support the middle class and reduce inequalities. They plan to achieve this by raising corporate taxes and the taxes of the wealthy, which may include higher capital gains taxes. This would have a negative impact on equity markets.

In addition, increased tensions with China may affect the market and rising interest rates and inflation fears are not to be dismissed. With the enormous amount of leverage in the global economy, a risk of stagflation (low growth combined with high inflation) is not to be dismissed. All these risk factors call for prudence, especially with very high-multiple stocks.

The current environment is reminiscent of the technology bubble of the late 1990s and the “Nifty Fifty” environment of the late 1960s and early 1970s. In both cases, the broader indices suffered large declines and took more than a decade to recover and get back to their starting point. However, in both of these episodes, small-cap companies, especially outside the technology sector, experienced very strong performance, both on an absolute and on a relative basis.

Q. What about our portfolio?

A. Although we cannot forecast what our returns will be next year, we know the following:

The portfolio holdings sell at very attractive price-earnings multiples on next year’s earnings, both at a discount to long-term averages for small cap, but also at a large discount to major indices. Our portfolio holdings are also at a discount on an EV/EBITDA basis and on an EV/Sales basis, and have a much stronger balance sheet when measured on a Net Debt/EBITDA multiple.

We forecast double-digit earnings growth for the holdings in the portfolios in 2021, even assuming no multiple expansion. We are already seeing increased M&A activity. Our holdings are well positioned to make acquisitions given their leadership positions and strong balance sheet. Some may also become acquisition targets. Finally, a rotation out of the mega-cap techs and some of the so-called COVID winners may provide a lift to the rest of the market.

Have a good weekend.

The Global Alpha Team

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