Letter from the Oyat Advisors team

Dear family and friends,

In the years to come, we will likely look back at 2020 as a defining moment, a year during which we unreservedly committed to a course of action that has been increasingly prevalent for the past couple of decades. Nothing best exemplifies this other than the recent developments in monetary and fiscal policy around the globe. Take a moment to consider the following. This past year, the broad money supply of the world's largest economies increased by a record USD 14 trillion[1], which represents a yearly increase of close to 20%. By the same token, globally the government fiscal deficit will grow to a staggering 13% of GDP, according to IMF estimates[2]. These are sobering figures, that typically characterize economic depressions or war time economies.

Without a doubt, these developments were precipitated by the onset of the COVID-19 virus, which infected nearly 80 million people across the globe, including close to 1.8 million deaths, according to the World Health Organization[3]. This sudden crisis proved to be a real dilemma for governments worldwide that had to make difficult choices, oftentimes representing a trade-off between public health and the economy. Various countries imposed restrictive measures that temporarily shut down large segments of the global economy, which led to the steepest economic contraction in 75 years, nearly three times as severe as the one caused by the financial crisis of 2008/09.

The purpose of the actions taken by the authorities in response to the pandemic, including monetary stimulus and deficit spending, is clear to everyone. Their immediate effects are readily observable. Borrowing costs are artificially pressured downward and make further debt accumulation affordable. Deficit-financed government spending softens the blow of the crisis for corporations and households. Rising asset prices give asset owners the semblance of wealth and prosperity…

What is less clear, but merits our full consideration, is what the unintended consequences of these actions have been, and most importantly will be in the years to come. Debt levels increase rapidly, which – despite the resurgence of questionable economic doctrines such as Modern Monetary Theory (MMT) – still fundamentally amounts to borrowing from the future, in our view. Price signals are massively distorted, prompting capital to flow to unproductive uses, which further weighs on future growth prospects. The aggressive debasement of fiat currencies creates asset price inflation, which exacerbates wealth inequality and social tensions, while also greatly increasing the risk of significant consumer price inflation down the line. These are but some of the considerations we should be mainly preoccupied with at present.

As should be obvious from the paragraphs above, we should be extremely wary of determining actions based solely on their initial consequences. As Frédéric Bastiat wrote in 'That Which Is Seen, and That Which Is Unseen':[4]

'In the department of economy, an act, a habit, an institution, a law, gives birth not only to an effect, but to a series of effects. Of these effects, the first only is immediate; it manifests itself simultaneously with its cause — it is seen. The others unfold in succession — they are not seen: it is well for us, if they are foreseen. Between a good and a bad economist this

[1] Bloomberg
[2] International Monetary Fund (IMF)
[3] World Health Organization (WHO)
[4] F. Bastiat: That Which Is Seen, And That Which Is Unseen (1850)

constitutes the whole difference — the one takes account of the visible effect; the other takes account both of the effects which are seen, and also of those which it is necessary to foresee. Now this difference is enormous, for it almost always happens that when the immediate consequence is favourable, the ultimate consequences are fatal, and the converse. Hence it follows that the bad economist pursues a small present good, which will be followed by a great evil to come, while the true economist pursues a great good to come, — at the risk of a small present evil.'

Reflecting back on 2020, it seems clear to us that the policies which have been implemented in response to the COVID-19 crisis – to have the authorities 'print' and borrow more money – were mainly determined by merit of their immediate benefits, while largely ignoring the significant risks they pose going forward. Regrettably, this course of action has been the predictable response to any and all hints of economic and financial stress in the system these past couple of decades. It is by far the easiest choice for policy makers, who will always defend such a conduct by saying: 'the crisis would have been worse without our actions'. Yes, indeed. Let us hope it is not at a greater cost yet to come, and prepare for all possible outcomes.

In this context, it won't come as a surprise to readers that we have maintained a balanced, yet decidedly defensive positioning. By far the most significant event of the year was the capital deployments we made in public equities and precious metals in March and April/May respectively. As described in more detail later on in this report, our current asset allocation aims to strike a balance that maximizes the likelihood of satisfactory investment results, irrespective of how the situation unfolds. Despite operating in a highly uncertain environment, we remain confident in our ability to achieve our objectives of long-term capital preservation and appreciation in real terms.

In closing, we want to thank all of our clients and other stakeholders for their trust, and thank our employees for their valuable contribution throughout 2020.

On behalf of Oyat, we would like to extend our best wishes to you for the New Year.

Sincerely,

The Oyat Advisors team

Investment landscape

It would ordinarily appear counter-intuitive that during a year in which the world economy recorded its largest contraction since the Second World War, assets prices rebounded strongly from a steep initial decline and went on to reach new all-time highs.

But these are not ordinary times. As will be detailed throughout this section, the actions taken by central banks and governments in response to the crisis have resulted in one of the greatest disconnects between the fundamental health of the world economy and financial markets ever witnessed. They have also exacerbated a number of significant risks, notably related to debt accumulation and currency debasements, that pose a real threat for future economic and investment prospects. Last, the moral hazard that has been bolstered by the authorities' recent actions makes it almost inescapable, in our view, that the imbalances now built into the system will have to be redressed forcedly rather than willingly. In other words, there is little doubt that there will be another financial crisis down the line, likely sooner than later. But no one knows precisely when it will happen, or what will cause it.

Let us substantiate these opinions by briefly reviewing a number of fundamental macroeconomic indicators, as well as central bank policies, fiscal policies and debt levels, and finally financial markets and valuation levels.

Fundamental macroeconomic indicators

As shown in Table 1 in the Appendix, the COVID-19 pandemic has caused a global economic shock of enormous magnitude, leading to the steepest recession in eight decades. Despite unprecedented policy support, the world economy is expected to shrink by 4.3% in 2020 according to World Bank estimates[5], with both developed (-5.4%) and developing countries (-2.6%) being impacted meaningfully. Looking across the globe, the Euro area will most likely post the worst reading (-7.4%), followed by Japan (-5.3%) and the U.S. (-3.6%); while emerging markets are expected to show more resilience, with the exception of commodity-exporting countries that have once again been hard hit by the plunge in crude oil prices. Overall, China is one of a handful of countries that can be expected to grow real GDP in 2020, by approx. 2.0%.

Much of that slowdown can be attributed to the precipitous decline in global trade and foreign direct investment[6]. Unsurprisingly, global trade was severely hit by disruptions to international travel and global value chains. As a result, the value of trade globally is expected to decline for the second year in a row, by about 9.5% in 2020 (versus a decline of 1.4% last year, as the U.S.-Sino trade dispute escalated with the imposition of trade tariffs between the two countries). The precipitous fall in certain services sectors – notably tourism, which nearly came to a complete halt – played a large part in this sharp decline in traded goods and services.

Manufacturing activity also suffered massively from disruptions and restrictions, with the J.P Morgan Global Manufacturing PMI[7] falling below 40.0 in March, among the largest contractions in the 22-year survey history, and the worst since the last global financial crisis. The global PMI eventually recovered above 50.0 by July, and has been in expansion territory ever since.

[5] World Bank
[6] United Nations Conference on Trade and Development (UNCTAD)
[7] J.P Morgan Global Manufacturing PMI

Focusing on the U.S. economy, we can see that the impact of the COVID-19 virus was extremely severe. The state of manufacturing, as depicted by industrial production[8], durable goods orders[9], and capacity utilization[10], followed a similar pattern to the one described above – experiencing a sharp contraction followed by a gradual recovery. As far as consumers are concerned, the large amount of governmental support clearly helped, with real disposal incomes[11] actually increasing substantially in the second quarter thanks to stimulus checks. Having said that, the overall impact on personal consumption expenditures[12] and retail sales[13] was quite muted, relative to the steep declines in April, with many consumers choosing to save[14] their stimulus dollars rather than spend them.

The unemployment rate[15] shot up to nearly 15% in April, before gradually declining to 6.7% as of the end of November. Looking at the labour participation rate[16], we can see that a staggering 38.5% of the working age population (aged 16-64) is currently out of a job, having either purposefully exited the labour force, or being considered 'discouraged' workers that have not looked for new employment in the last four weeks. That is a high figure, judging by recent historical standards.

Last, we can see that all of these considerations were reflected in corporate earnings, which are expected to decline by 16.8% in 2020, according to I/B/E/S data by Refinitiv[17] for the S&P 500. The worst hit sectors included energy, consumer discretionary, and other cyclical sectors; while information technology, healthcare, and communication services were among the best performing sectors in terms of corporate earnings growth.

Overall, fundamental macroeconomic indicators have deteriorated sharply over the past year. Beyond its short-term impact, the deep recession triggered by the pandemic is likely to leave lasting scars on the global economy, through various channels. These include the erosion of human capital, declining labour productivity, lower investments, and a retreat from global trade and supply linkages. The extent to which this year's events will exert lasting damage to fundamental determinants of long-term growth prospects remains to be seen.

Central banks to the rescue, again

Perhaps the most predictable aspect of 2020 was the authorities' monetary and fiscal response to the COVID-19 crisis. Let's start with central banks[18].

Long gone seem the days of major central banks talking about 'monetary normalization', yet that was the course of action they were supposedly committed to only two years ago. Instead, we saw central banks make a hasty policy reversal back to monetary easing throughout 2019, and take that notion to a whole new level this past year.

As often seems to be the case, the Federal Reserve (FED) took the lead. In March, it dropped the federal fund rate by a full percentage point to 0-0.25%, a level not seen since 2015. As the year unfolded, the FED also announced a number of wide-ranging actions to support financial markets, including asset purchases, repurchase operations (repos), dollar

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[8] Federal Reserve Bank of St. Louis
[9] Federal Reserve Bank of St. Louis
[10] Federal Reserve Bank of St. Louis
[11] Federal Reserve Bank of St. Louis
[12] Federal Reserve Bank of St. Louis
[13] Federal Reserve Bank of St. Louis
[14] Federal Reserve Bank of St. Louis
[15] Federal Reserve Bank of St. Louis
[16] Federal Reserve Bank of St. Louis
[17] Yardeni
[18] Yardeni

swap lines with foreign banks, and a credit facility for commercial banks. All in, the FED aggressively expanded its balance sheet by nearly USD 3.2 trillion in 2020 to USD 7.3 trillion, up a shocking 76% year on year (yoy).

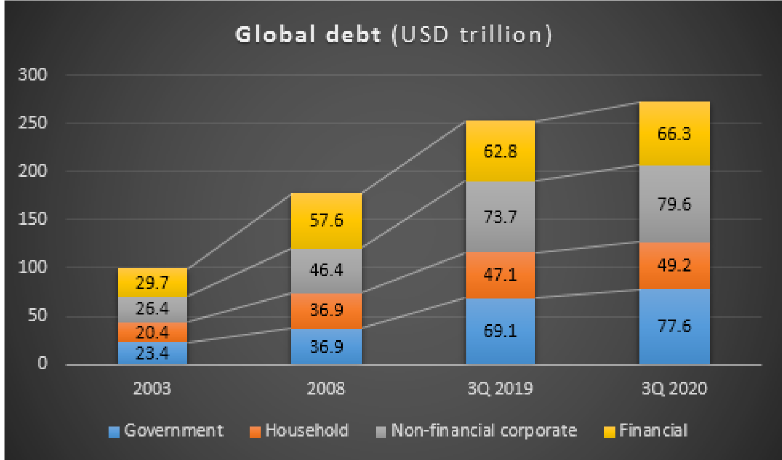
When compared to the financial crisis of 2008/09, the European Central Bank (ECB) reacted in a much quicker and decisive manner to deal with the current crisis. While it left its main deposit facility rate unchanged at -0.5%, having very little room to manoeuvre there, it expanded its balance sheet by nearly EUR 2.3 trillion to EUR 7.0 trillion, up 50% yoy.

The Bank of Japan (BoJ) and People's Bank of China (PBOC) also expanded their balance sheets, although at a slower pace than their Western counterparts.

Debt levels explode and are expected to keep growing

According to estimates by the Institute of International Finance[19] , total global debt increased to USD 273 trillion by the end of the third quarter of 2020, up 8% yoy. That's getting close to representing four times the size of the global economy (360% of global GDP), yet another metric that is currently at an all-time high.

Global debt (USD trillion)	2003	2008	3Q 2019	3Q 2020	*yoy*	% of GDP
Government	23.4	36.9	69.1	77.6	*12.3%*	102%
Household	20.4	36.9	47.1	49.2	*4.5%*	65%
Non-financial corporate	26.4	46.4	73.7	79.6	*8.0%*	105%
Financial	29.7	57.6	62.8	66.3	*5.6%*	88%
Total	**99.9**	**177.8**	**252.7**	**272.7**	***7.9%***	**360%**



Source: Institute of International Finance, Bloomberg

Government debt was once again the fastest-growing category in 2020, growing to USD 77.6 trillion, or approx. 102% of global GDP. Non-financial corporate debt continued to make new highs, reaching close to USD 80.0 trillion, or 105% of GDP. Household debt also grew in proportion to global GDP, albeit at a slower pace, to USD 49.2 trillion, or 65% of GDP.

Exploding debt levels were fuelled by growing budget deficits, which are expected to amount to a staggering 12.7% of global GDP in 2020, according to IMF estimates[20]. In the U.S., it is projected that the fiscal deficit will reach over USD 4 trillion, or close to a fifth of GDP this year! Globally, the budget deficit is expected to remain above 5% of GDP through to 2023, which essentially guarantees further rapid debt accumulation in the coming years.

[19] Institute of International Finance
[20] International Monetary Fund (IMF)

Looking at non-financial corporate debt, one troubling development that we have highlighted over recent years is not only the fact that corporate debt to GDP continues to make new highs, but also the rapid deterioration of corporate credit quality over the past decade. For instance, BBB-rated corporate bonds[21], as a percentage of the broad investment grade universe, has increased from 34% in 2008 to 50% in 2019, and approx. 60% by the end of March 2020. Another indicator that can be referred to is the number of so-called 'zombie companies' – firms that aren't earning enough to cover their debt interest expense – as well as the amount of debt they hold. As of today, 'zombies' account for nearly a quarter of publicly-listed U.S. companies, according to Bloomberg estimates[22], and hold close to USD 2 trillion in debt.

Perhaps the only small positive we can take away from this section is that the situation regarding household debt is better relative to government and corporate debt.

Financial markets and valuation levels

Now that we've reviewed a number of macroeconomic indicators, let us turn our attention to what valuation levels might reveal about the fundamental state of the world economy.

As shown in Figure 1 in the Appendix, the yields on 10-year government bonds across key geographies remain extraordinarily low (and even negative or close to 0% in the case of countries such as Switzerland, Japan, Germany, France, the Netherlands, Spain, and Portugal) and continued to decline in 2020. The yield on the 10-year U.S. Treasury fell as low as 0.52% in early August, before increasing to 1.1% currently.

Looking at corporate credit, while U.S.[23] and EU[24] high-yield spreads rose sharply at the start of the crisis, they then proceeded to decline fairly quickly throughout the year, and currently stand at 3.7% and 3.4% respectively. As such, the level of insurance against default that investors demand for corporate bonds of an increasingly deteriorating credit quality is gradually moving back towards all-time lows.

Overall, if we look at the global bond market across issuers by yield[25], we can see that a perplexing 30% of all bonds, or approx. USD 18 trillion, are yielding less than 0%. Add on the debt that currently only yields 0 to 1%, and you're left with only slightly more than 25% of all debt globally that yields more than 1%! No wonder investors have been forced into riskier assets…

Moving on to equities. Whether one looks at 12-months trailing or forward P/E multiples for major indices, one can see that the valuation levels of equities have risen quite rapidly in 2020, which should come as no surprise given that stock prices have risen while earnings declined substantially.

[21] S&P Global
[22] Bloomberg
[23] Federal Reserve Bank of St. Louis
[24] Federal Reserve Bank of St. Louis
[25] Deutsche Bank

Region / Country	Index	Trailing P/E	Yoy change	Forward P/E	Yoy change
World	MSCI World				
US	DJII	23.6	2.4	20.5	3.0
	S&P 500	29.2	5.5	21.9	3.2
	NASQAQ	36.0	6.5	28.1	4.5
EU	Stoxx Europe 600	22.0	4.0	17.2	2.2
	DAX Index	24.6	6.6	15.5	1.0
	FTSE 100 Index	17.4	1.4	14.4	1.0
	CAC 40 Index	22.6	2.7	17.7	3.0
	SMI Swiss Market Index	21.5	-0.2	17.4	0.2
China	Shanghai SE Composite Index	14.6	4.4	12.0	1.8
Japan	Topix	20.0	4.9	16.8	2.9

Source: Refinitiv, as of Jan. 5th 2021

Looking at two long-term valuation metrics, we can see that the Shiller P/E, which takes a 10-year average of earnings in order to smooth out cyclicality, currently stands at 33.7x, up from 31.7x a year ago, and it remains in the 90th+ percentile, or nearly the most expensive it has been for over a century[26]. Likewise, the ratio of total U.S. market capitalization to GDP surpassed 180%, which represents the all-time high and is meaningfully higher than the prior 1999 peak[27].

Briefly, a number of additional observations can be made about equities. First, the significant divergence in the performance across regions continued this year, with U.S. equities being the clear relative outperformer. In 2020, the U.S. market increased by 16.3% for the S&P 500 (in CHF), while European stocks (Stoxx 600) declined 4%, and Swiss stocks (SMI) were about flat (0.8%). This trend has been ongoing for over a decade now, which is clearly showing in the valuation gap with other regions, as depicted above.

Second, we can see that certain sectors, such as technology and related sectors, continue to massively outperform others, typically more capital-intensive, cyclical sectors. Just to illustrate the performance gap between technology stocks and the wider market, the NASDAQ increased by 47.6% last year, versus 16.3% for the S&P 500 (all in CHF).

This, in turn, has also contributed to an increasing level of concentration of stock market indices that are weighted by market capitalization. As of today, the largest 5 companies – Apple, Microsoft, Amazon, Facebook and Google – make up over 25% of the market capitalization of the S&P 500[28]. This has also been driven by the increasing share of passive flows in equities, which are expected to overtake actively-managed funds by 2022, according to BofA estimates[29]. And for the share of equity that remains actively-managed, we have seen a clear resurgence in the involvement of retail investors[30] this past year, no doubt enticed by the alluring equity returns of the recent past, as well as a sharp fall in the cost of online trading, including derivatives such as options.

[26] Shiller PE
[27] Gurufocus
[28] Advisor Perspectives
[29] Bank of America estimates
[30] Finanz.dk

Last, we can observe that the relative outperformance of 'growth' equities versus 'value'[31] has been massive since 2007, and has accelerated in recent years. Having said that, while it is way too early to make any definitive calls on a 'great rotation', it should be pointed out that 'value' has surged back in the fourth quarter, but it still has a long way to go to recoup years of relative underperformance[32].

Investment landscape - conclusion

Readers will excuse this rather dry section of our commentary on the investment landscape. Let us now discuss some of the broader implications and unintended consequences of what we've just outlined.

- The first point we want to stress relates to the unsustainable accumulation of debts. It will not have gone unnoticed that the rhetoric regarding fiscal responsibility has changed meaningfully over the recent past. Beyond the predictable emergency deficit spending in response to the crisis, there appears to be a clear resurgence of economic doctrines such as Modern Monetary Theory (MMT), a doctrine which proposes that *'monetarily sovereign countries that spend, tax, and borrow in a fiat currency they fully control, are not operationally constrained by revenues when it comes to federal government spending.'*[33] In other words, such governments and their central banks can 'print' and spend as much money as they want, without fear of ever going bankrupt or insolvent, since they have a monopoly over the issuance of their currency. The only real danger is if inflation skyrockets as a result of monetary expansion, to which MMT proponents argue that money can then be taken out of an overheated economy via taxes.

  Now, we count ourselves as firmly in the camp of critics of MMT, for many reasons. First, because it goes against our fundamental understanding of the key functions that money is supposed to perform: to be a store of value, a unit of account, and a medium of exchange. Second, because history shows that giving control of the printing press to elected officials is ill-advised, as they are primarily motivated by short-term considerations, like staying in power by winning the next election. Short of letting free market forces control the supply of money in the economy (which would be our preferred option), we believe that it remains far superior to have 'relatively independent' monetary authorities in charge, rather than politicians. Furthermore, it appears clear to us that MMT advocates drastically underestimate the inflationary risks of aggressive monetary expansion. Last, we see their remedy of taxing 'excess' money in an overheated economy, should inflation materialize, as largely impractical and nothing short of a fundamental rethink of the role of government in society; a transformation which is in opposition with our own views on political economy.

  Therefore, we remain convinced that unsustainable debt accumulation is problematic, because it gives us the illusion of prosperity, enabling us to temporarily live beyond our means; but inevitably, it amounts to borrowing from the future. Ultimately, debts have to be extinguished, or refinanced. Alternatively, they are defaulted on, or an attempt is made to reduce their real value via inflation. With government debt now over 100% of global GDP, it seems clear that many countries find themselves in a so-called debt trap, *'a condition where too much debt weakens growth, which elicits a policy response that*

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[31] Goldman Sachs
[32] Morningstar
[33] Investopedia

creates more debt that results in even more disappointing business conditions.' [34] The reason why high debt levels undermine economic growth is because it is subject to the law of diminishing returns, itself derived from the universally applicable production function. At the end of the day, given the current circumstances regarding the key drivers of long-term economic growth – namely demographic and productivity growth – it seems almost impossible to create the level of growth needed to meet future obligations. At least in real terms. Which brings us to our second point.

- The second point we want to emphasize relates to the debasement of fiat currencies, and the prospects for inflation. There should be little debate about the fact that central banks have aggressively debased their currencies over the past decade. When the broad money supply of the world's largest economies increases by 20% yoy, as it did in 2020, it is hard to argue against that notion. What is less clear is whether such monetary debasements have created any price inflation. Here we should differentiate between inflation in asset prices and consumer/producer prices. Evidently, currency debasements have produced massive asset price inflation, for just about every type of asset, listed or private. Yet, consumer prices, as measured by the Consumer Price Index (CPI), have not risen as feared. Now, that might partially be down to how we measure the CPI, and the numerous adjustments we make to it; or it might be down to the fact that there are also strong counterbalancing deflationary pressures related to demographics, globalization, technology, and debt, to name just a few. Likely it is a combination of both.

  Either way, what is clear is that if any one country tried to expand its money supply to such an extent in isolation, its exchange rate would plummet relative to other currencies. But since everyone has been doing it simultaneously, the phenomenon of monetary debasement is more easily observable by looking at competing forms of money, namely precious metals (and arguably cryptocurrencies, although we see these two asset classes as clearly distinct). Consumer price inflation may not have materialized yet, but the signposts are clear. Even the FED has telegraphed as much, arguing in a recent letter that average inflation targeting – in other words letting inflation run higher than 2% to make up for previous shortfalls – could be a useful approach going forward[35]. In truth, it is the only conceivable way to meet future debt obligations, a 'soft default' of sorts. The only other alternatives would be much more radical, like a sort of debt jubilee, or a gradual shift of sovereign debts to the balance sheet of their central banks or some multinational organization like the IMF.

  In our view, the stock of money has already been 'printed' to generate significant inflation, it just hasn't made its way through to the real economy yet. If it ever does, and the so-called velocity of money accelerates, then inflationary pressures are sure to come, at which point things can get out of control very rapidly. This is because inflation is as much a psychological phenomenon as a monetary one. Once the majority of people realize that the purchasing power of the currency they hold is eroding rapidly, there is a sudden and general rush to exchange said currency for anything real and tangible that should do a better job at acting as a store of value. Overall, we believe that the threat of higher consumer price inflation in the future should not be ignored, and that investors should position themselves accordingly. Even market-based measures of inflation

[34] Hoisington
[35] Federal Reserve Bank

expectations, such as the inflation breakeven rates[36], have rapidly rebounded from their March lows and moved noticeably above pre-crisis levels.

- The final point we'd like to conclude with relates to the manner in which the monetary and fiscal policies described above have created one of the greatest disconnects between the fundamental health of the world economy and financial markets ever witnessed. This is perhaps the strangest feature of the current market environment. Previous great 'bubbles' were generally characterized by favourable economic conditions being extrapolated indefinitely. But today's situation is quite different. The economy that has suffered a great blow, with likely lasting damage to fundamental determinants of long-term growth. Yet, the price of most financial assets is near an all-time high. This is perhaps the clearest indication of a speculative environment in financial markets today.

  There should be little doubt that the monetary policies of the past decades have impacted markets significantly. According to a recent analysis by Société Générale (SocGen)[37], the cumulative impact of the different waves of quantitative easing (QE) on the U.S. Treasury 10-year bond yield was approximately 180 basis points. In other words, without QE, the 10-year Treasury yield would be around 2.8%, a number which would quite simply be untenable in the current environment. Similarly, SocGen's model indicates that as much as 57% of the increase in price level in the NASDAQ since 2009 can be explained by QE. Without such asset purchase programs, the model predicts that the NASDAQ would be trading around 5'000, while the S&P 500 would be around the 1'800 mark.

  As previously described, valuation levels are very elevated as of today. One argument that is often presented to justify equity valuations is to say that relative to bond yields, the earning yield on equities is still attractive. True. But that argument fails to recognize that bond yields are being artificially suppressed. If they were this low of their own accord, it would imply that future growth prospects are extremely dim, which is contrary to what equities appear to be pricing in. We therefore find it quite unconvincing to justify current equity valuations by arguing that interest rates will stay low, whether forcedly or naturally. But most reasonable people will agree that as of today, valuation levels are elevated, and that this creates a fundamental disconnect with the fundamental health of the global economy. That gap gets closed in either one of two ways. Either the world economy grows faster than expected in real terms, or the future real return of various asset classes will be significantly below long-term averages, as GMO expects[38].

All things considered, as we enter 2021, the current investment landscape ranks among one of the most challenging we have ever experienced. As such, we believe that a balanced, yet decidedly defensive positioning is warranted.

[36] Federal Reserve Bank of St. Louis
[37] Finanz.dk
[38] GMO