

Dear Investor,

When I wrote last year that we were positioning the flexible bond strategy to withstand unforeseen shocks and preserve investors' capital at a time when markets were partying like it was 1999, poor macroeconomic data and political risk, rather than a global pandemic, were my biggest concerns. The world and our day to day lives have changed unimaginably since then and I would like to thank you for your continued trust and patience.

Fortunately, the strategy entered the crisis last March in a defensive stance which allowed us to ride out the volatility and buy into attractive corporate credit opportunities just before central banks swooped in to support markets. The strategy's barbell structure – which balances medium-to long-dated US and Australian government bonds as a hedge against short-term risk and long-term deflation, with selective corporate credit in resilient businesses – was the performance key driver. I am pleased to say this meant the flexible bond strategy performed strongly during a highly unpredictable year.

Looking at financial markets one year on, it seems that the more things change, the more some things stay the same. Markets have gone back to the party and hopes of reflation abound. Behind this optimism are expectations of “animal spirits” and pent-up consumer demand once vaccines enable economies to re-open, spending packages from the likes of newly elected President Biden, and continually supportive policy from central banks.

The outlook does indeed look positive for corporate credit: central banks showed their hand last March by supporting credit markets. But the pandemic will also leave behind a very different world. If there is one lesson from last year, it is to be mindful of unexpected tail risks. Those tail risks cannot be foreseen and, like this time last year, risk markets are potentially vulnerable to any surprise events. I believe that a flexible approach that allocates to carefully selected credit alongside a significant allocation to developed market government bonds will be a prudent way to balance risk and reward in 2021.

Deflation is the “price of tomorrow”

A distillation of the “reflation trade” is to be short the US dollar, short US Treasuries, and long commodities, in anticipation of a post-pandemic economic boom and a resurgence of inflationary forces. We take the opposing stance. We remain firmly of the view that deflationary pressures are still the dominant forces rather than inflationary ones. We expect government bonds yields to remain at these low levels and perhaps move even lower, the US dollar's strength to stabilise, and for commodities to remain volatile.

While there will undoubtedly be a spike in growth and inflation once economies reopen due to low base effects, we expect this will fade away after one or two quarters at most and would certainly not be the start of a new inflationary trend. Even China, which has seen a strong rebound in economic growth since entering its recovery phase from the Covid-19 crisis, has not seen an associated pick-up in inflation.

This is because inflation everywhere is being kept in check by the combined structural drivers of too much debt, ageing demographics, and disruption from globalisation, technology and low-cost labour. Apart from demographics, Covid-19 has accelerated all these trends.

The excess capacity in the labour market and the public's expectations of price rises both currently point to prolonged low inflation. The 40-year trend of weak wage growth in developed economies means that labour today has little pricing power against capital. The increased power of global

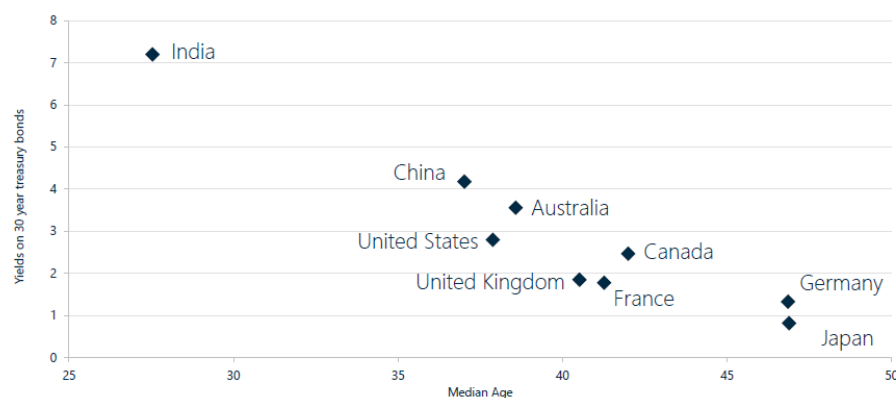
monopolies alongside the high unemployment levels caused by Covid-19 is a dynamic that will continue to suppress wages for some time to come.

We are also at the beginning of a technological revolution that is inherently price deflationary. We've seen a taster during the pandemic, as companies worked out even more efficient ways to operate, which places downward pressure on wages and employment; and we all turned to cost-efficient online services and apps for a host of reasons, from entertainment and health to food and essential goods. Disruption through AI, robotics and automation will further entrench weak wage growth. This force is so powerful that in his book *The Price of Tomorrow*, the technologist Jeff Booth asks whether it will in fact lead to an end of the "age of inflation".

Long-term deflation is further exacerbated by the ageing demographics of developed economies. The chart below highlights the significant correlation between a population's median age and its long-dated government bond yields.

Demographics are destiny

World's largest economies
30 year yield versus median age



Source: Bloomberg. Data as at 3 September 2020.

Debt, Democrats and the law of diminishing returns

At the last count, global debt levels stood at \$280 trillion and rising. With so much debt in the global economy – and much of it unproductive – any jump in government bond yields will create volatility in risk assets and cause yields to fall back again. The rise in bond yields is not conducive to the Federal Reserve meeting its long-term targets around inflation. As HSBC investment bank noted recently, a 1% hike in rates today is equivalent to a 3-4% hike in rates 20 years ago.

But growth is extremely hard to generate in a highly indebted world. Economic principle states that when you overuse one of the factors of production (land, labour or capital), the law of diminishing returns eventually kicks in. And in this instance, we have overused debt capital. The potency of fiscal policy is fading as a result – in the 1950s, \$1 of debt generated around \$0.80 of GDP; today it's less than \$0.40. This is one of many reasons why I'm sceptical that big spending packages from the Democrats in the US can generate inflation.

On a political level, Congress is still very divided despite the excitement about the blue wave victory for President Biden and the Democrats. The Democrat majority is so narrow that Vice President Harris has the deciding vote and many of the new Democrats are moderates. This may make pushing through big spending packages harder than supporters of the reflation trade may think.

Furthermore, in a country as highly bureaucratic and lobbyist driven as the US, enacting any infrastructure plans will likely take years before the economy sees any payback in terms of growth and inflation.

Plenty of opportunities, but credit analysis is critical

Given supportive central bank policy, investment grade and high yield bonds are a good place to be, but thorough credit analysis is critical. Many business models look vulnerable to a more challenging growth outlook, particularly in cyclical sectors and those that are highly indebted. Default rates have climbed in the US and will continue to do so.

The strategy has over 40% allocated to high yield in primarily defensive businesses that we think can ride through an extended period of economic volatility. These “through-the-cycle” businesses include some fast-food and food delivery companies, supermarkets, pharma and television streaming services, all of which have been booming during the pandemic. Many of these are BB-rated companies, allowing us to pick up yields that range from 3% to double digits, from names that provide the opportunity of getting the coupon plus the return of principle.

We’ve also built up a 5% allocation to oil & gas bonds where we have found pockets of value in US and European producers across high yield and investment grade. Oil production is set to decline this year which should boost oil prices.

Turning to government bonds, in a world where there are \$17 trillion of negative yielding bonds, the old saying “in the land of the blind, the one-eyed man is king” springs to mind. We recently added Chinese 10-year government bonds to the strategy – with yields of 3.15% versus US Treasuries at 1.1% this represented an attractive opportunity. As I mentioned earlier, China’s economy is growing strongly with no sign of inflation, while it has a contracting workforce, stagnant population growth, stalling productivity growth and a credit bubble – similar to conditions in the developed world – which means that the country’s economic growth will trend lower. This all adds up to positive real yields in China looking somewhat attractive.

Recessions tend to be short and violent, and recoveries long and gradual. There will undoubtedly be more surprises this year, and our strategy remains nimble enough to change as the facts change. I’m confident that our ability to invest right across global fixed markets gives us the freedom and flexibility to manage risk while seeking positive returns, and it remains a privilege to invest on your behalf.

Ariel Bezalel

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