What risks do we foresee in 2021

We do not wish to compete with the ingenuity of Saxo Bank who every December publish their list of 'outrageous predictions' for markets ahead of every new year. Rather, we set ourselves a task of pinpointing more probable risks and discussing them in more detail. So…

Risk 1: 'Putin'

Lately there have been numerous opinions and rumours of the rapidly declining health of President Putin. We have said on many occasions that it is not the authoritarian regime that is bad for markets, but the uncertainty of any kind. So, if President Putin suddenly leaves his post and fails to transfer the power in a legitimate way, then we may have the inevitable squabble over power among contenders – and markets do not like it. Though, in the end, it may turn out positive for the country and subsequently for the Russian Eurobonds market.

Let us presume that events unravel according to the above scenario. What will happen on the markets? The first reaction of at least foreign holders of Russian Eurobonds will be 'sell now, analyse later'. Most likely, the first sell-off wave will include sovereign and quasi-sovereign issues, followed by bank issues, with the corporates going last. This risk, infamously known as the 'black swan', is impossible to predict. Plus, we should not forget that if one is accounting for all possible risks when building a portfolio, the yield from investment will equal a risk-free rate, in other words, in the current environment it will be practically '0'.

When it comes to our portfolios, the average weight of Russian issuers varies between 10% and 15% with the average duration of less than 4 years; we do not hold any sovereign, quasi-sovereign or bank issues either. This means that, should the above-described risk scenario become a reality, our portfolio should not be badly hit and we may actually have an opportunity to purchase good bonds at low prices and increase the weight of Russian issuers. We had done just that back in 2014, after a massive sell-off of Russian Eurobonds following the annexation of the Crimean Peninsula. And we had made a nice profit for our clients!

Risk 2: 'Coronavirus defeated! Or is it…?'

Analysts say that high prices on bond and equity markets are spurred on by markets 'trading the future'. In other words, what markets do is they 'buy the rumour and sell the fact'. Current expectations on markets are based on the belief that the coronavirus has already been defeated with the help of vaccines and by the end of this year this pandemic nightmare will become a distant memory. That would also mean that the economy will go back to its pre-covid levels, companies will be able to repay their loans and will start paying out dividends. However, the devil is always in the detail!

We cannot deny the huge progress in the development of vaccines. However, we still must answer several questions:

1.How much does it cost? Who will pay for it? For developed countries, most likely, this question is not so crucial. The state will roll out free vaccination for its people. But for EM countries the vaccine issue will be a most pressing one yet. If an EM country decides to finance mass vaccination, that would increase its sovereign debt, which is already at maximum for many EM countries following challenges in 2020. And if the state decides to sit on the sidelines, then there would be no mass vaccination and the economic recovery to pre-covid levels would take them not just one year, but two or even three. If this is the case, then the current equity and even bond prices are unjustifiably high.

2.Transportation and storage. Any delays with the vaccine deliveries will force markets to re-evaluate their economic growth forecasts for the following year and that will inevitably lead to a market correction.

3.Last but by no means not the least important question – do the vaccines and post-covid antibodies provide life-long protection? In other words, can one become sick with Covid-19 for the second time? If Yes, would it be just as bad as the first time round? With these questions only time will tell. Any event deriving from these questions will certainly give markets a scare and make them question their belief that the coronavirus saga is over. What if it is not over?...

Risk 3: 'Slowdown of the economic recovery'

A lot of financial market multipliers are currently at high values. Looking at equity markets: P/E (Price/Earnings) for S&P500 index has reached a multiple of 30, a record-breaking maximum since the year 2000. This means that the investor in the index would have to wait 30 years for his investments to break even. And we see a similar picture on bond markets. Debt burden, as indicated by Net Debt/EBITDA, has rapidly increased in the past year and for some companies it is even impossible to calculate EBITDA as their income for the last quarter has gone into red. At the same time, bond yields set their minimum records.

Rational explanation of serious discrepancies between financial indices and prices on market assets lies in the fact that, markets trade in future expectations, having priced in the financial recovery of the economy. But when it comes to statistics, it reflects the past, in our case, Q3 2020, which, to be fair, was not that bad given the circumstances.

And now – the most complex and debatable task of correlating the actual rates of economic recovery with market expectations. Our opinion is that many market segments are currently looking at the economy through rose-tinted glasses. Sooner or later, they will have to take them off. And then the disappointment will set in, followed by a market correction. Perhaps, some large international company defaults and that becomes 'The Event' that would force markets to wake up and smell the coffee. Because the number of so-called 'zombie companies', whose operational income is not enough to service their loans, has already broken the record of the 90-s and currently sits at 16% for OECD countries. That means that some of them may end up smelling not just the coffee!

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Maria Kotlyarchuk, CFA, Chief Investment Officer

We hope you will find this information useful and we will be glad to answer your questions

AXIOMA Wealth Management AG
Bleicherweg 50, CH-8002 Zurich
Tel.: + 41 43 305 07 10
info@axiomag.ch
www.axiomag.ch

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