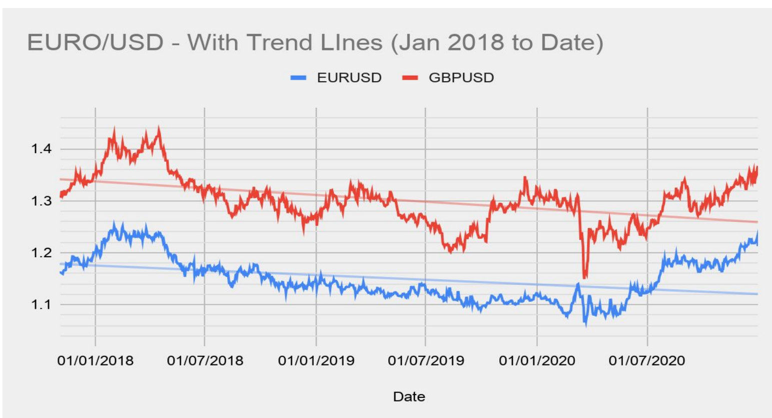
ORTEGA The Market Wrap December 2020

Introduction - Welcome to our fourth issue of our monthly summary of the market. We shall give you the price action across asset classes and offer our insights and opinions. We hope these will aid your understanding of markets and the complex system that is the global economy. We shall generally use ETFs in our market appraisals as these are easily accessible and liquid entities that are now in very common use and reflect most facets of the markets. We hope you enjoy and if you have any questions please visit our website: www.toiip.com or contact us at: info@toiip.com - Thank You and enjoy !

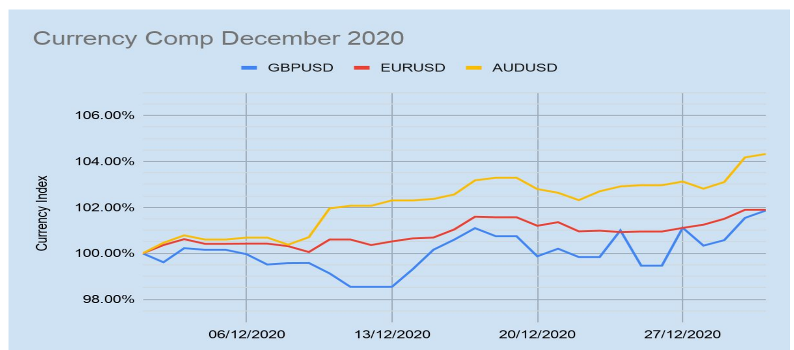
Currency

During December the DXY broke down below the 90 level and tested the 89 ish support levels. The short positioning on the USD is now exceptionally high, with everyone looking for further decreases. Brexit brought clarity to the GBP and saw small appreciation against the weakening USD. Globally Governments and central banks still show the intent to keep increasing base money and the money supply as the virus surges again especially in the northern hemisphere. The market sees a weaker USD as the globe thinks it needs this for a global reflation, however trading nations that need a competitive currency to export their goods may not in the longer run accept to have a weaker USD as it would limit their growth expansion.

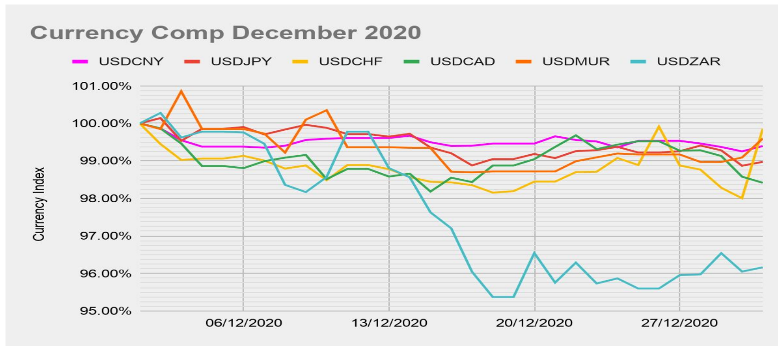


We continue the trend of USD weakening and both GBP and EUR appreciating against the USD. We do wonder if this trade is not a little bit over extended and how much further it has to run. It will require the democrats to control the senate in order for them to push through their fiscal plans for the USD to continue to depreciate and if this is not the case we could see a fairly strong bounce back in the USD. At present the virus is surging in Europe and the UK that may force further lockdowns.

Again this monthly chart shows USD weakness across the course of the month. The AUD being a commodity currency showed the greatest strength as the markets still see the reflation trade coming to fruition. Market positioning is extended and in the long run we still do not see much upside in currencies against the USD and the downside should be hedged. First half comparables are easy, but after that ?

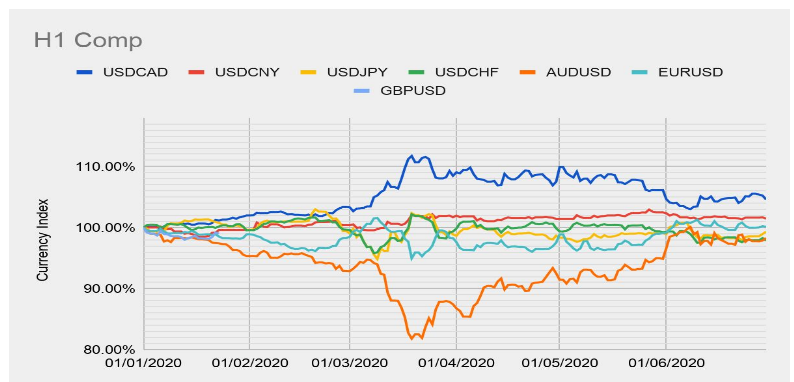


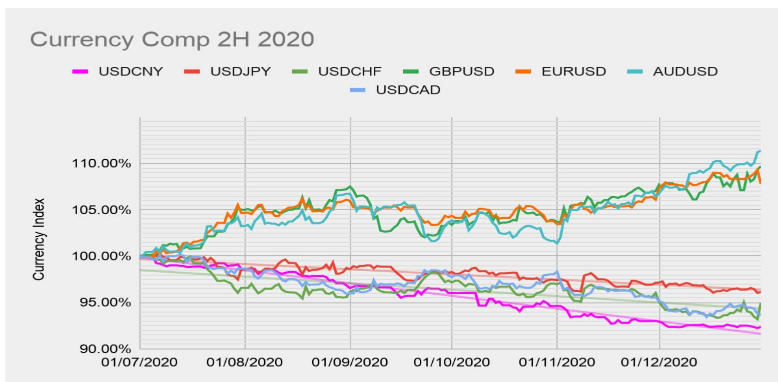
The Georgia senate race at the beginning of the month will be very important to see how much fiscal policy can be forced through.



Generally weak USD this month again with the South African Rand having a strong month yet again, primarily as it is a commodity currency and the reflation trade is in full swing. The US was certainly first out of the gate providing market liquidity and were also very aggressive in the quantity, however if they can keep up this level via fiscal policy we may start to see this trend reverse and people should evaluate this.

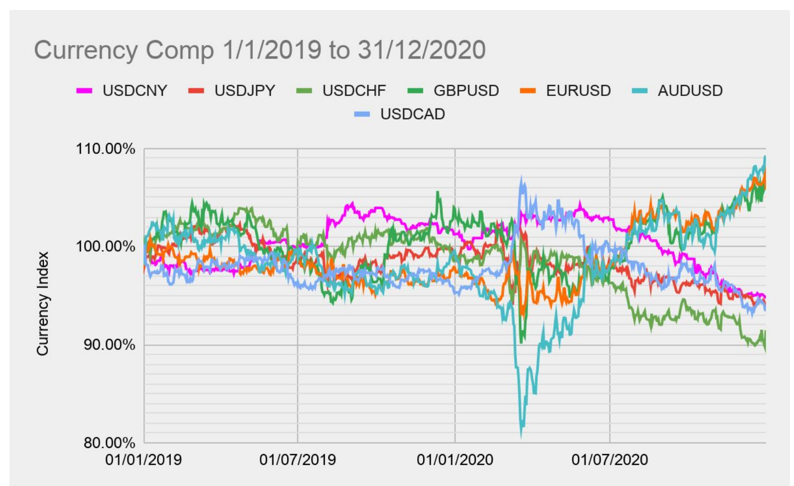
The first half of 2020 saw the liquidity event in March cause volatility in currency markets as investors rushed to access USDs. But as the FED stepped in to fill the void currencies began to settle down. Even though the FED continues to flood markets with liquidity whenever these events occur there never seems to be enough liquidity in the markets and this is a worrying trend. The FED started reprinting in September 2019 and 6 months later there was none to be found.





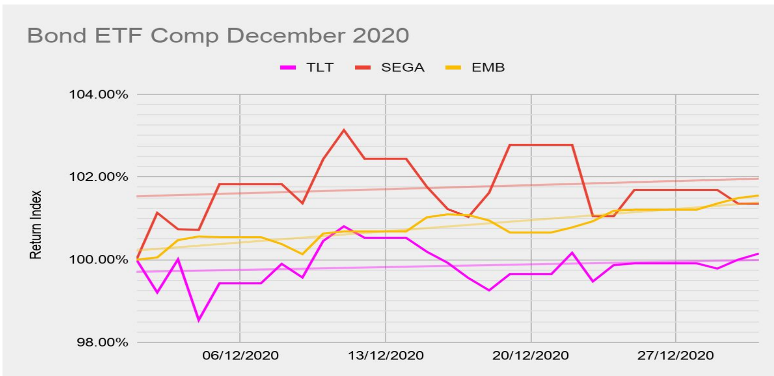
In the second half of 2020he started to see the USD weaken and this trend continued fairly consistently throughout the time period. The general market is convinced that the reflation trade is in play and whilst they continue with this belief it will be. The disparity between financial markets and the real economy has grown over this time period. Although the FED solved for the liquidity event they can do nothing for the solvency event that is coming.

Over a longer time frame we can also see that the USD has depreciated against most other currencies and there may be a tendency to find other currency solutions for international trade and payments. This may in time lessen the reserve currency status of the USD, however there is so much USD debt existing that this issue will not be resolved quickly Central banks are moving toward the implementation of digital currencies and the race is on with China leading the way. The others need to catch up or may lose their preeminence.



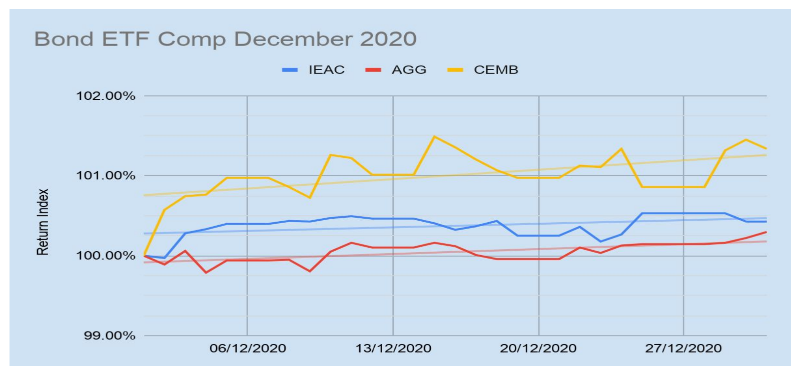
Fixed Income / Bonds

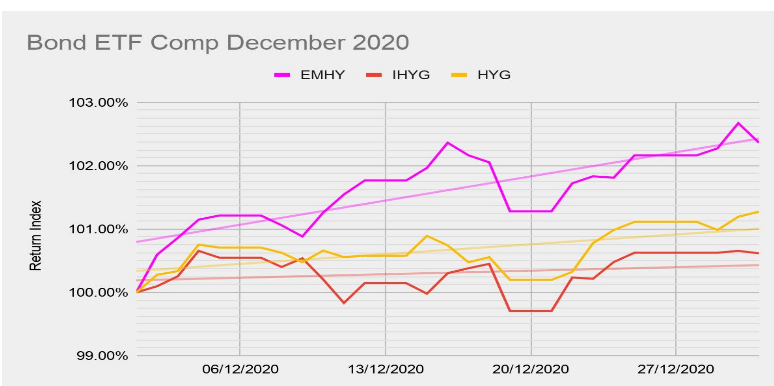
US 10 Y yield rose as high as 0.97 this month again testing the resistance level around 1%. Although the markets see the reflation trade playing out citing the growth in M2 money supply a large portion of this has been corporates drawing done on the credit lines and holding the cash. As and when we come out of the other side of this pandemic, how they utilise this cash could be very important and if we see severe scarring to the economy there may not be the demand to convince them to invest, and they may start to decrease their balance sheets.



December saw a slight outperformance from Europe and Emerging Markets but generally markets were fairly quiet. US markets await the outcome of the Georgia election at the beginning of January to provide some more information on the likely oath of bond yields. A point of interest is that if the global reflation trade is correct we should be seeing some up tick in European yields, but this does not appear to be the case.

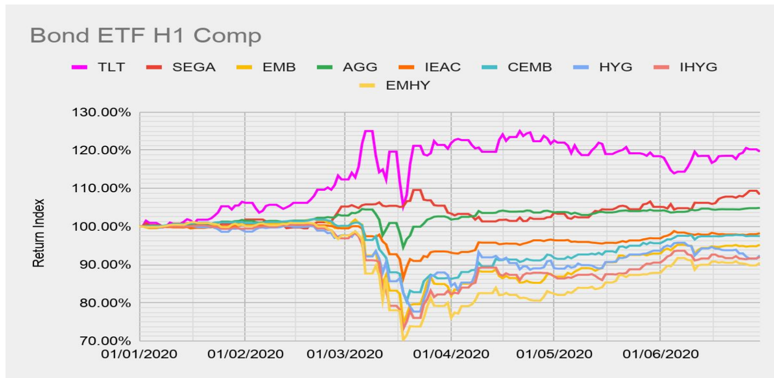
In the investment grade space we saw the same story with the outpermance of Europe and the Emerging Markets, with the latter attached quite a lot of inflows as the market chased yield. The virus is surging again in Europe and lockdowns look sure to happen into next year, which will slow the recovery. The vaccine has been approved and will start to be distributed hopefully helping the situation.





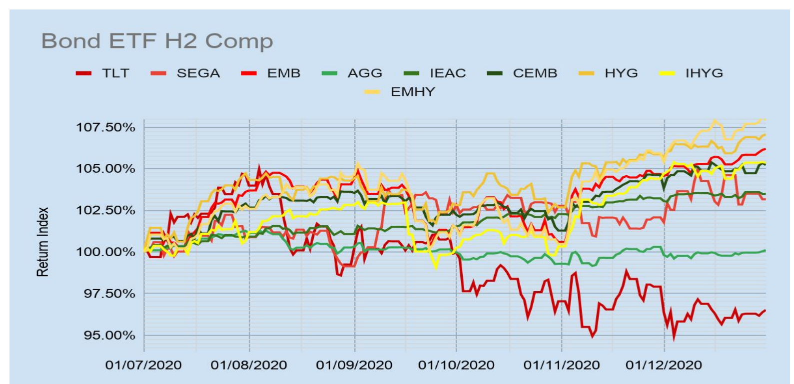
European high yield was the laggard here this month with Emerging markets outperforming the others. Europe still has many structural issues and seems at present to be suffering from disinflation which again does not tie in with the global reflation trade. For now the markets seem to be overlooking this and are still rotating into Europe. Emerging markets are still favoured more as you receive more reward for the risk you take.

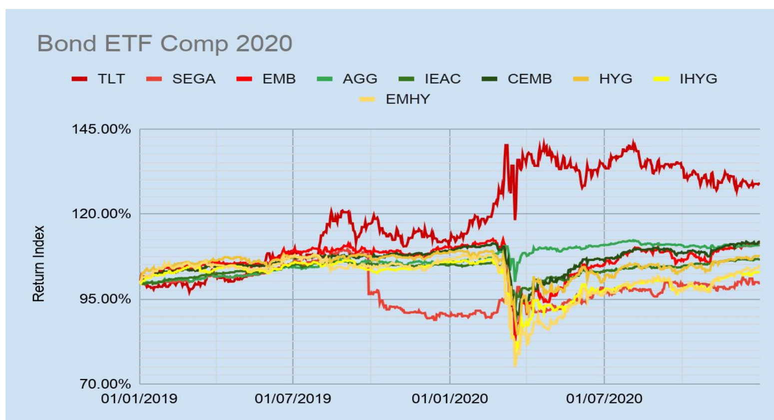
A double dip recession is possible in Europe depending on the pandemic and we still feel there are better places to put money to work.



The first half of 2020 saw the outperformance of quality with the TLT leading the way despite the market almost completely seizing up in March. The FED addressed the liquidity problem speedily and with huge size.Lesser markets fell more steeply and took longer to recover and some did not fully recover by the middle of the year. Each time there is an event they happen more quickly and are larger in size.

The second half saw the reflation narrative slowly take hold, with the safety and quality assets under performing the rest as the market slowly moved back into risk on mood. We do feel that now this trade is starting to get a bit over extended as so many are now positioned in very similar ways. The risk reward may soon start to favour a contrarian view but at the least hedges should be thought about.



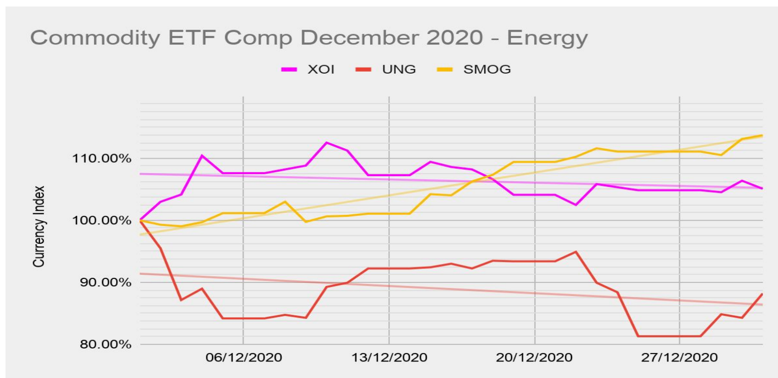


The overview of 2020 gives a very clear picture of which assets performed best over the course of the year. Now the big question is whether the reflation trade has legs, for the first half of 2021 the comparables will be easy and make the trade look good, but with the solvency issue still to unfold we do see some hurdles ahead for this narrative and whether governments and central banks can navigate this journey smoothly is a big question.

Back over a longer time frame it is still evident where the outperformance has been and once the FED did a u turn at the markets behest it really showed. Everyone is back to believing an institute that has continually failed in its objectives and blatantly lied about it. Is it going to be different this time? We are skeptical but we need to be conscious of what the markets are doing and for now they are full on into the reflation narrative. We are not so convinced but are along for the ride at the moment but certainly looking to jump ship when required.

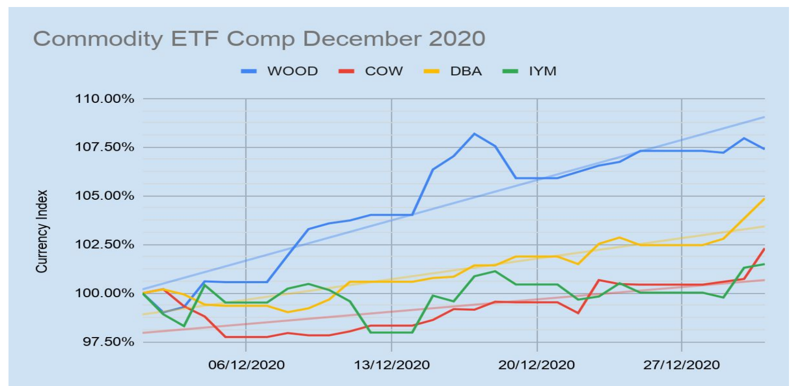
Commodities

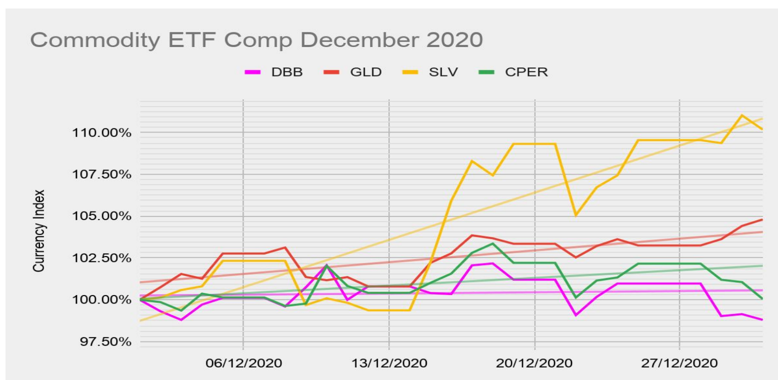
Commodities this month again have seen a pretty steady rise across the board as the USD has continued to weaken and the reflation narrative has started to take hold. If there is inflation we shall need to see this trend continuing. Even if the USD does not depreciate further, we would want to see commodities still rise in price. If this does not happen we should be wary about the whole reflation narrative, we certainly feel the commodity rise so far has a lot to do with supply disruptions, USD depreciation and demand perhaps being a little over keen.



Over December energy prices were reasonably calm with oil having a steady appreciation over the course of the month and Natural gas being a bit more volatile and losing some price of its previous gains. The low carbon energy ETF SMOG was the best performer in December as we saw more money come into this sector as we look to have a greener future. Energy density is still an issue that investors need to consider.

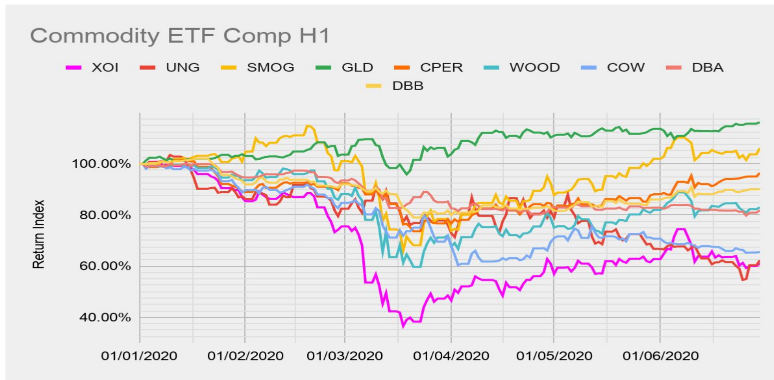
Lumber was again the best performer in December this may have more to do with supply side issues as the virus spikes again and maybe the real estate market has seen the initial burst of activity peeter out. There is a structural shortage of housing in the US but this is at the lower end of the market which most homebuilders are loathed to build as it is difficult to make a profit on these units. Regulation will need to be curtailed for this situation to change.





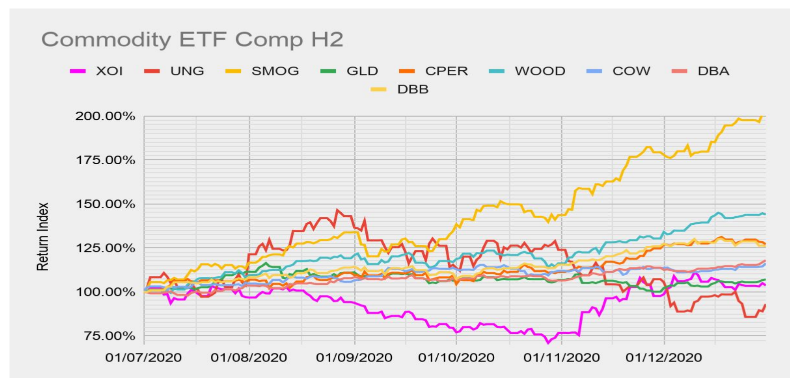
Across the metals complex Silver was the outperformer over the monthWith Gold seeing a small appreciation and copper and base metals seeing a small pullback.As nominal rates rise on the back of the reflation narrative as markets are anticipating we could see a pullback in gold. We still like gold in the long term and would look to add at decent levels. We need to watch copper in context of supply and demand and the inventory levels.

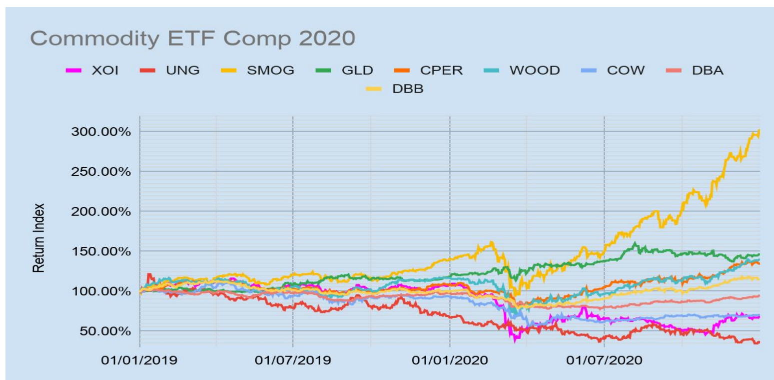
The world will look to electrify their infrastructures moving forward and copper will be important and demanded for this process.



In the first half of 2020 as the virus hit predictably Gold was the top performing asset as investors looked for safety in the uncertain times. Oil and natural gas took big hits as demand tumbled as the world went into shutdown. As some early hope emerged low carbon and copper were the first commodities to pick up as investors again started to look to a greener future. Oil and gas lagged after their initial recovery from the first shock.

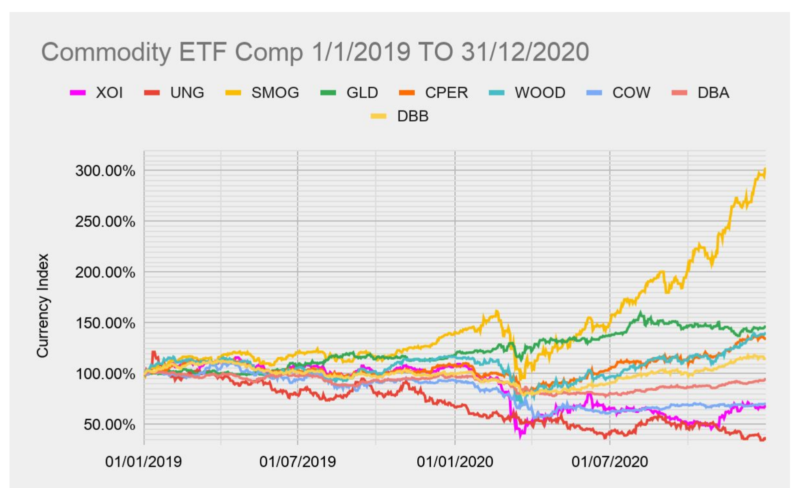
In The second half of the year we saw low carbon energy take off to the upside. Natural gas was the laggard, which is interesting as gas is part of the greener solution and is an established product in the energy infrastructure. Investors may be buying too much into the narrative of the greener energy and forgetting about the financials of the situation. However with passive investing and money flows this has a tendency to happen.





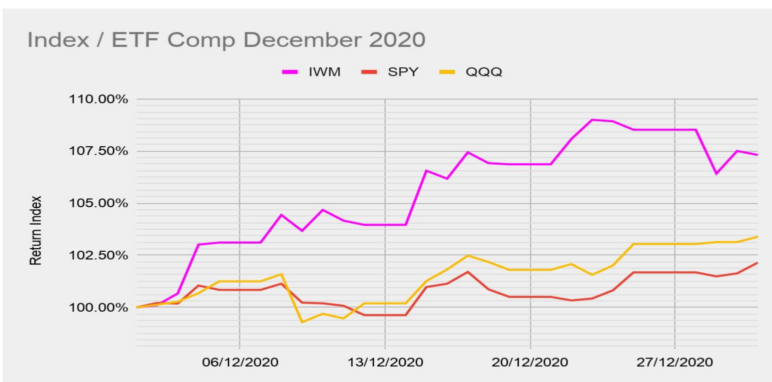
Over the course of the year we can see a huge divergence in the commodity space. The narrative of green energy and the money flows that it has created has been the clear winner. Again Natural gas has been the under performer which again is interesting and maybe there should be a closing of the divergence between these two.

Over a longer time frame we can clearly see that the big divergences have clearly occurred in recent months and are very much narrative based which has created the inflows into the in vogue stories, without much thought to the realities, practicalities and financials of the situation. Is the narrative reflective of the truth and facts of the journey we shall go on. We are not convinced and would look to always follow the money flows as in this time of passive investing it is these that will be the main driver of returns, not fundamentals.



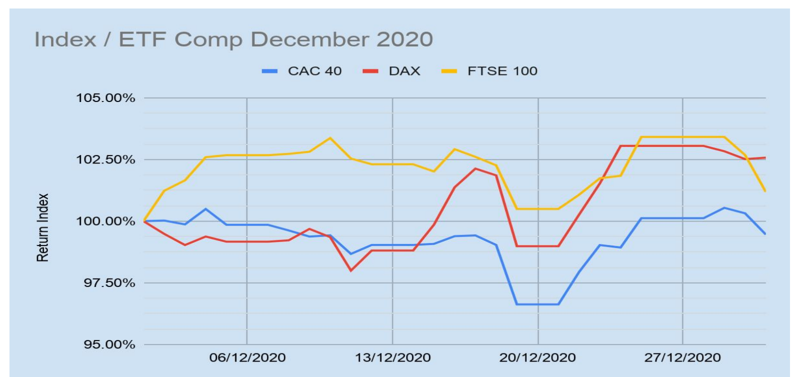
Stock Indexes

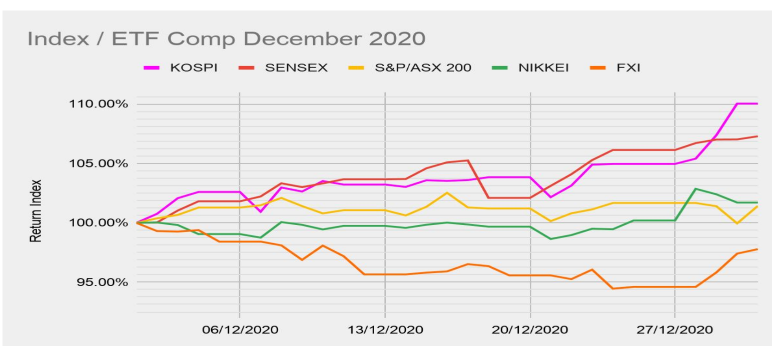
These are the local indexes of varying countries reflecting the value of the companies quoted on them, importantly in their local currency. We must always bear in mind the Index performance and the currency performance against other localities. Investing is a relative game and we like to show comparative charts to identify this and point out the opportunity cost of choosing one investment above another. For risk aspects we prefer developed markets, and prefer to enter smaller markets via investment vehicles that are located in developed markets. Liquidity can be an issue.



The IWM was the outperformer last month as the reflation trade was in place and in full swing. SPY & QQQ moved fairly closely in lock step throughout the and saw a small appreciation. We do still feel that the relation trade may still be over done and would caution investors to maybe look to book some gains or look to hedge their gains. Markets are still seeing more stimulus coming from the new administration and this should be supportive for risk markets.

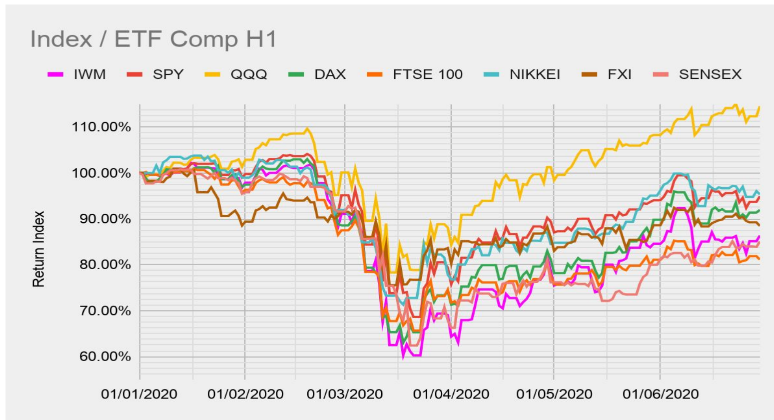
The UK and Germany lead the way here with France lagging. Brexit was finally agreed with a limited deal not including financial services which will play out over the coming months but we feel will not be very favourable to the UK unless they make some changes. The virus is still rising across Europe generally and this will cause a double dip recession across the region. How deep will probably depend on the duration of the pandemic.





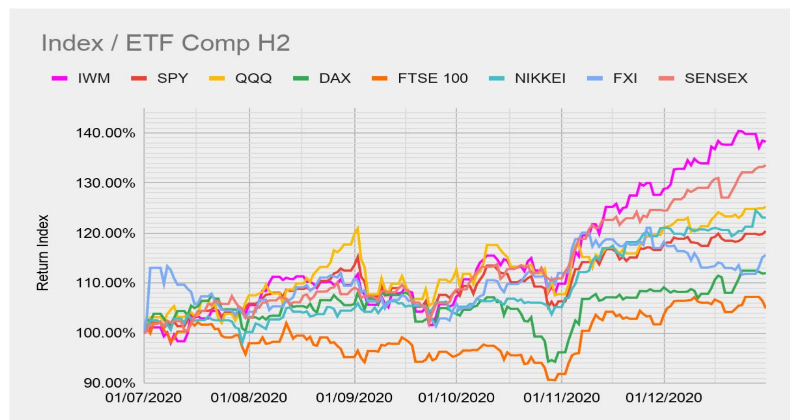
China was a laggard here as other global markets had better months. S/Korea and India lead the way as money moved into emerging markets now in a more selective manner. The direction of the USD will have a big influence on this trend. Fundamentals are better in some of the Emerging markets and these should continue to drive this trend if the virus can be held under control.

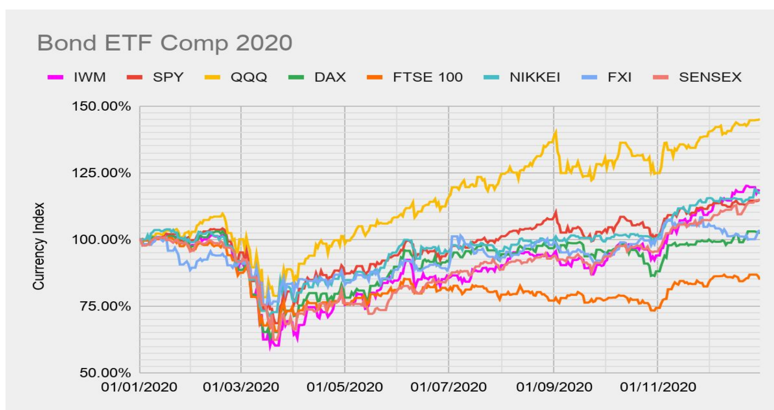
There is a general sentiment that the central bank support and the coming fiscal support will be good for risk markets , however we are still in the teeth of this pandemic. Let's take a big picture look:



The first half of the year saw the Tech market in the US leading the way out of the initial fall with the rest failing to recover the levels they held at the end of 2019. Markets generally recovered through Q2 as governments and central banks stepped into the breech and eased the liquidity situation and hope and confidence was restored. The UK brought up the bottom as it was hit quite hard by the initial pandemic wave and the government reaction, along with Brexit headwinds

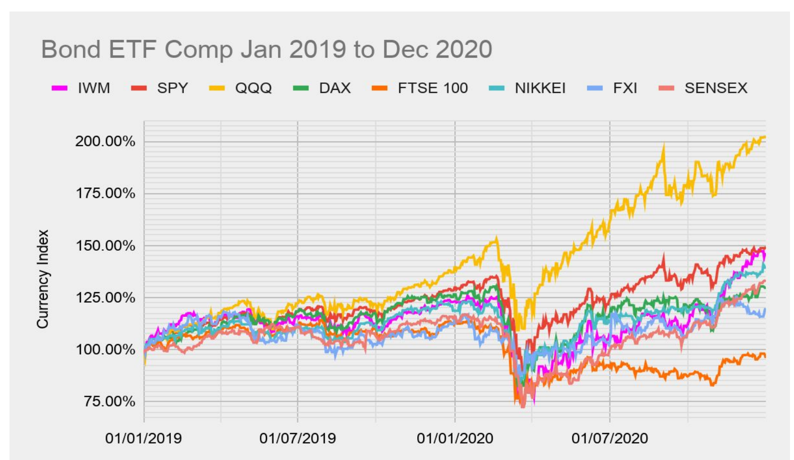
Q3 was much slower in comparison to Q2 but one thing was consistent was the underperformance of the UK markets. Again US tech led the way here really throughout the whole period. During this time frame there was more clarity about the virus and its economic effects with virus flare ups suppressing the recovery trade somewhat. At the end of this period the rotation trade from growth to value came to the forefront of the market. UK markets were also hindered by the looming Brexit.



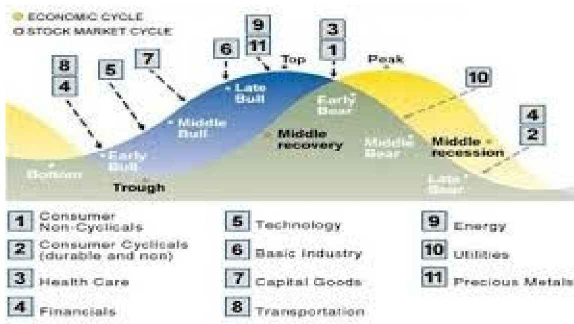


Over the course of this year we can clearly see that US Tech was the best performer, with the UK bringing up the rear. The UK was hit badly by the virus and also had the issues with Brexit to contend with. With the virus surging again in the Northern hemisphere winter time we would see this trend continuing even though many investors are looking to rotate to the reflation trade. We believe even though this trade idea has legs for the moment it may not last.

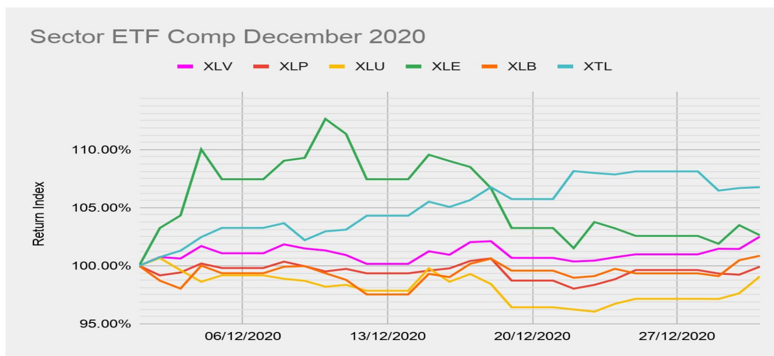
Over a 2 year time frame we can clearly see that there was little disparity between indexes in 2019, but US tech was still the best performer. 2019 was a relatively quiet year and not until 2020 did we get real market volatility. However the out performance of US tech over the worst performer UK index over this 2 year period is very large and demonstrates the importance of being allocated in the right markets. For the first half of 2021 the comps are easy but in H2 od 2021 we see issues.



Sectors

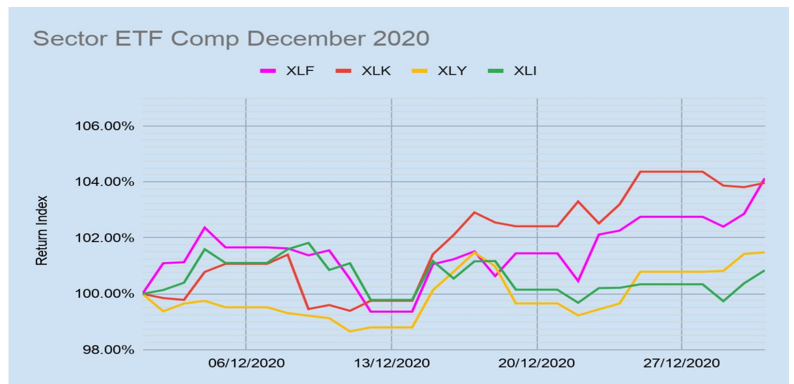


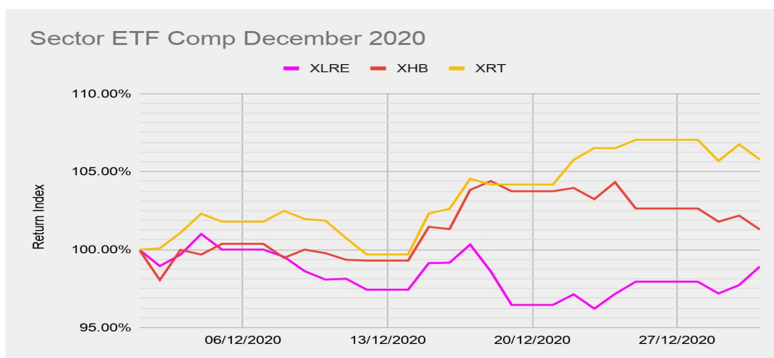
We use sectors to place stocks and other investments into categories such as technology, healthcare, energy, utilities and telecommunications. The different sectors have diverse risk profiles and perform at varying degrees throughout the business cycle. Here we shall contrast and compare the performance of the different sectors over time to help our understanding of their relative virtues with the target of augmenting our investment returns over time. We generally use US markets as these are the largest and most liquid.



Energy continued its rise early in the month but corrected down in the latter half. XTL saw a steady appreciation throughout the month. The other defensive sectors were flat on the month as the reflation narrative took hold and people continued their rotation into the more cyclical sectors. This trade seems to have legs for the moment but we feel it may reverse in Q2 of 2021 as the comps are more difficult and the economy stalls.

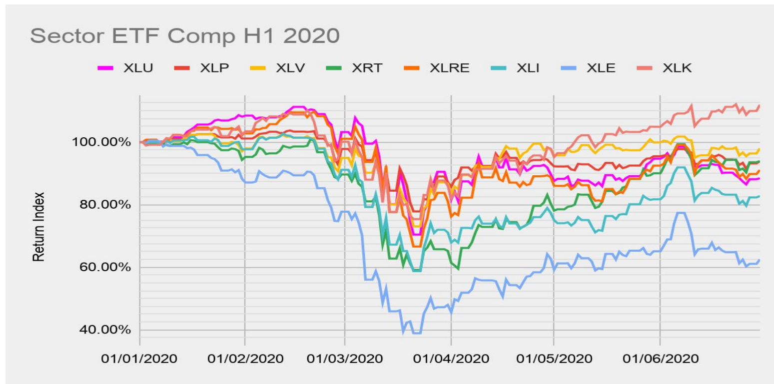
Financials and Tech sectors performed fairly well over the month of December, as the curve continued to steepen and the reflation trade continued. XLY and XLI were fairly flat over the month. As the 2 vs 10 year curve steepens at some point this will become a headwind for stocks and also the FED will not want the market to run away with rates. Inflation expectations continue to rise slightly but we feel that this will run out of steam over the coming months





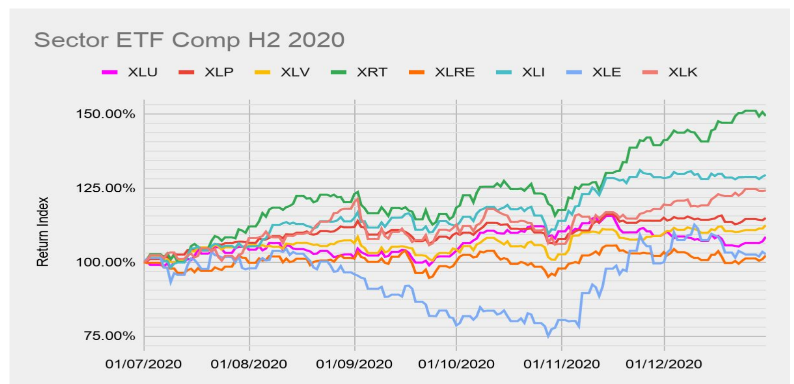
Retail was again a good performer over the course of the month of December as Christmas helped. We feel that this could begin to slow moving into next year and it would be a good time to start booking some gains. Real Estate Fell slightly over the months investors looked to become slightly more aggressive and rates were rising. The reflation trade may have legs for a few more months but we feel it will then run into problems.

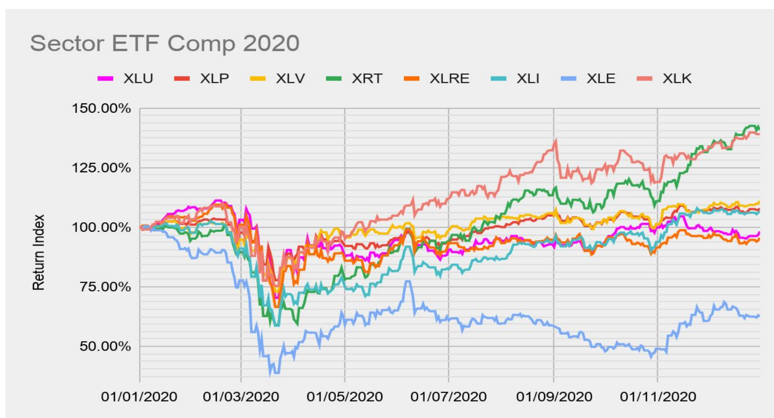
Let’s now review the sectors over the course of 2020 and 2019, by half year terms and then in whole timeframes to gain more perspective on these markets.



The first half of 2020 we saw the energy sector start off under performing and this only continued through the start of the pandemic and continued to lag throughout the course of the first half as investors tried to come to terms with what was happening and the likely outcomes. The Tech sector was the best performer and the quickest to recover after the initial shock and this also continued. The defensive sectors held up quite well initially but started to tail off.

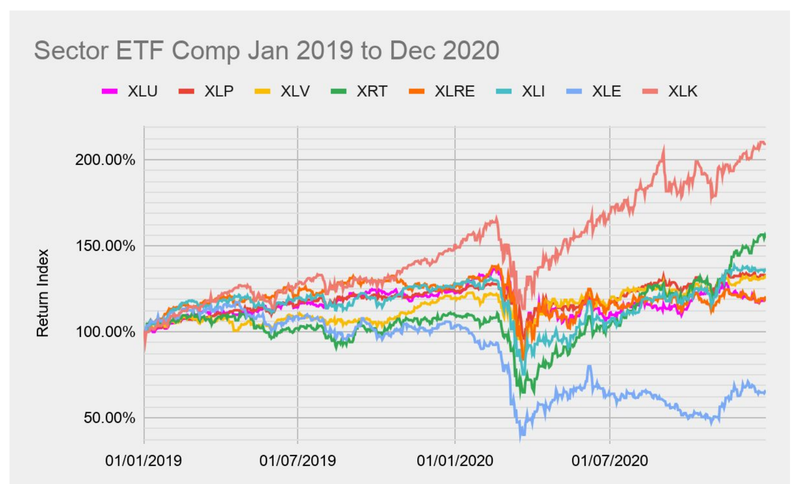
The second half of the year saw to us a quite surprising result of retail being the best performer. Especially in the last 2 months of the year. This is surprising as the retail sales data started to roll over in the last quarter of the year. The energy sector continued its fall in the 3rd quarter but then had a resurgence as the reflation narrative took hold and was a very good performer for the last 2 months of the year. Generally most sectors saw a recovery.





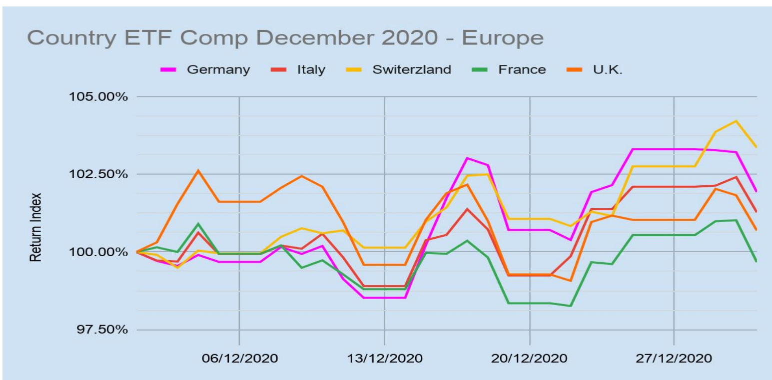
Over the course of the year we can clearly see here the sectors have clumped into 4 groups: the top 2 Tech and Retail. Next Healthcare, Industrials and Staples, Followed by Real Estate and Utilities and Energy lagging by quite dome measure. Once again the performance of retail to us is the big surprise and we feel this is overdone and should see some under performance going forward. The reflation narrative is still in vogue but may soon run out of steam.

Using a bigger time frame, looking back to the start of 2019 we can see that certain trends that were evident across 2019 became more exaggerated through the pandemic. Primarily the out performance of the Tech sector and the underperformance of the Energy sector. You can see that retail has a sharp rise into the end of 2020 which we would probably look to fade moving forward. If the global recovery is to become real we will need to see the energy sector further recover as this is essential for all production.



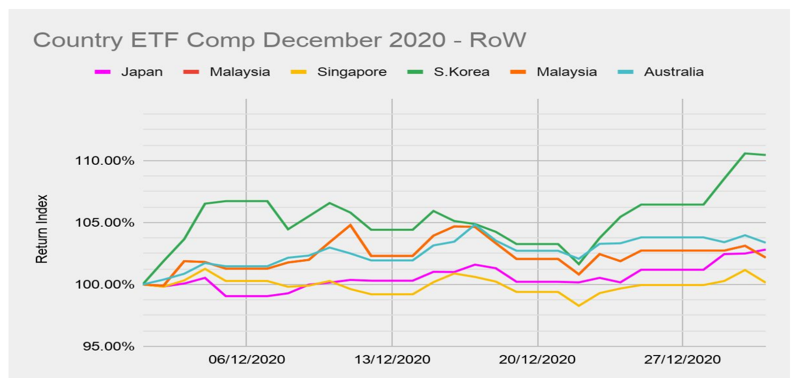
Geographic

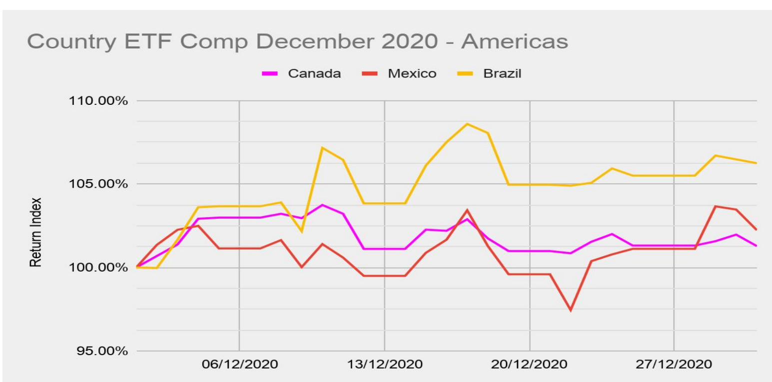
Certain countries or regions around the world will be experiencing different economic circumstances at any given time, usually. Therefore it is important to access these differences and utilise them in order to create greater returns on your capital. In this section we shall look at a range of ETFs, all quoted in USD covering varying countries around the world and look to analyse their differing performances and where they are in the economic cycle so that we may look to add value to our investment decisions



Quite a volatile month for Europe as the rotation trade into the potential value of Europe started to falter. Switzerland again was the top performer saying something for the continued safety aspect to investors' decision making process. There was a small sell off across the board going into the end of the year. The virus and its effects will have a large impact on the Q1 performance of Europe and we are not that hopeful.

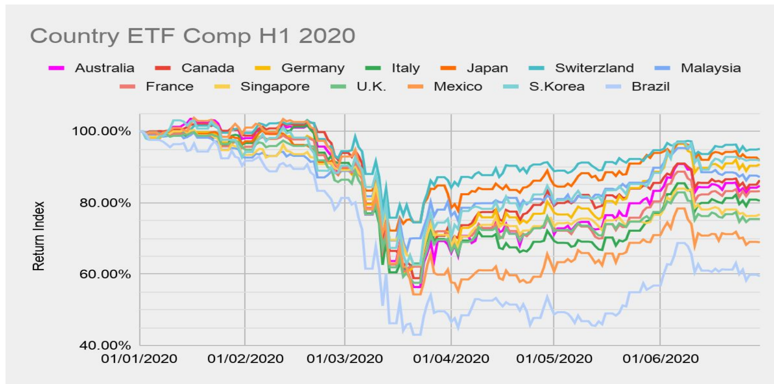
S.Korea: “The doctor” was again at the top of the performance list for the month. Their success in dealing with the virus has helped them bounce back quickly, along with the global relation narrative and the weakness of the USD. Other eastern nations have also performed well. However we do need aggregate demand to hold up for this to continue and we see that this will be an issue moving forward because of the insolvency event to come.





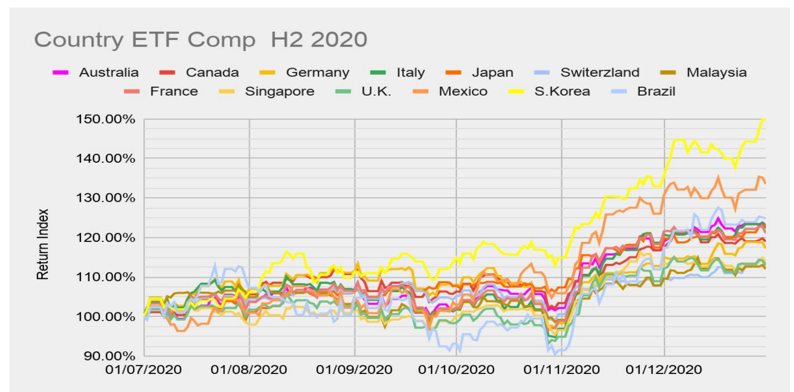
Here will see a continued steady recovery which looking forward will be dependent on the virus and the varting strains and how the governments react to these. At present there is a very potent strain of the virus apparently emanating from Brazil and this could be a threat to the economic recovery. USD strength or weakness moving forward will bear on the global reflation narrative and the new administration in the US will affect this.

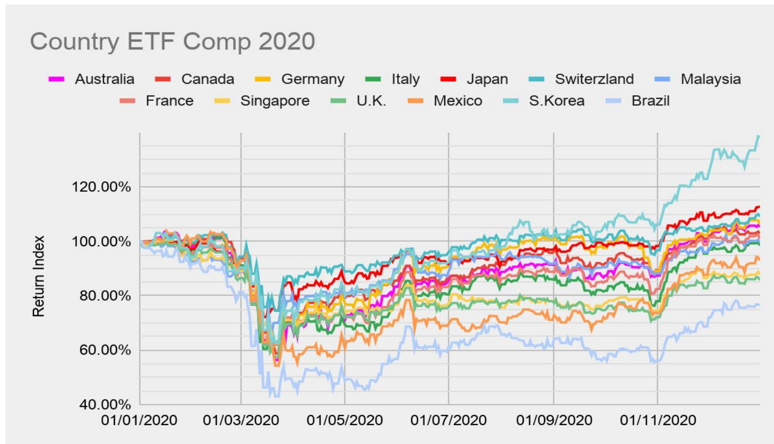
We shall now look at the country performance on a semi annual basis and a longer look back over the course of the year and also back to the beginning of 2019.



In the first half of 2020 we saw all countries fall in the march pandemic, to varying degrees. Brazil was the worst hit and Switzerland held up the best. The recovery was steady but slow from the initial panic botto. But with so much uncertainty around still countries struggled to get back to where they were before despite the huge injection of liquidity from central banks. Investors were loathed to put large amounts of money back to work initially.

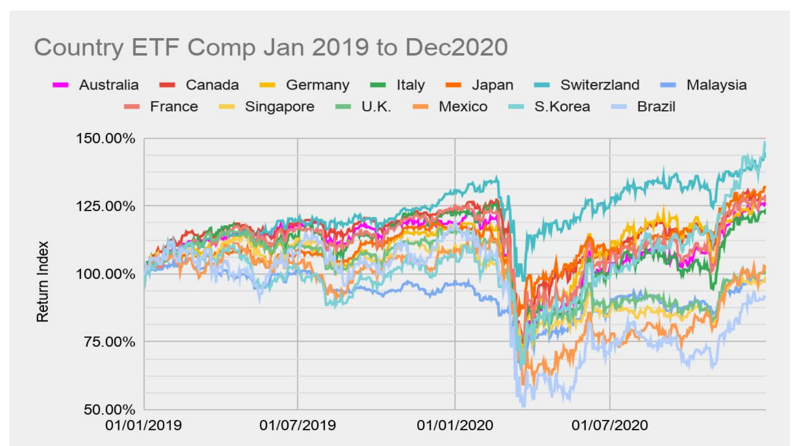
H2 of 2020 saw a continuing muted response from countries until the Start of November when we started to hear about vaccines and hope started to build. Most countries then saw a rise but again it was S.Korea that really led the way with Japan following on its heels. Both of these were helped by the USD weakness. For this to continue the global demand must hold up as these countries are exporters.





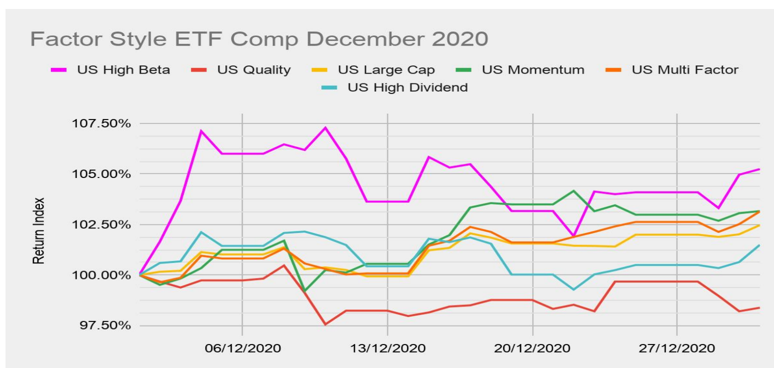
S Korea was the best performing country ETF over the whole year with the bulk of its out performance coming in the last 2 months, as the global reflation narrative really took hold. Brazil was consistently the worst performer throughout the year by some measure. The UK is also a notable poor performer with their handling of the pandemic and also Brexit weighing on their economic performance. Emerging markets have generally fared better than most developed markets.

Over this 2 year period it is Switzerland and S.Korea that have performed best as country ETFs and poor old Brazil bringing up the rear again. Divergences that mainly appeared after the onset of the pandemic seem to be remaining as well as being consistent. The global economy will need to deal with the pandemic truly on a global level to see a sustainable global recovery. Aggregate demand will need to be maintained and increased to see global growth recovery and advance, not easy!



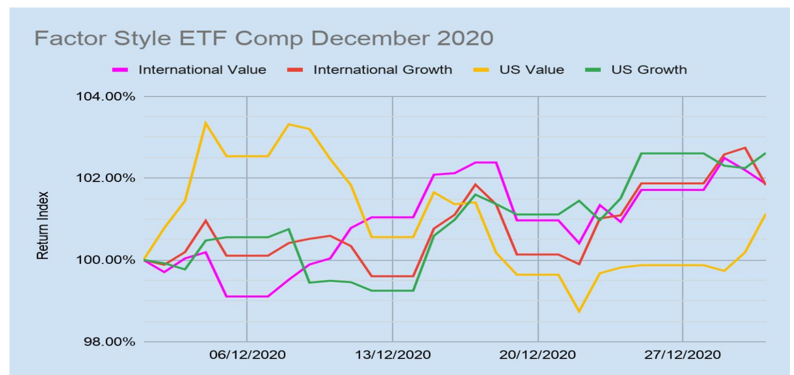
Factor Styles

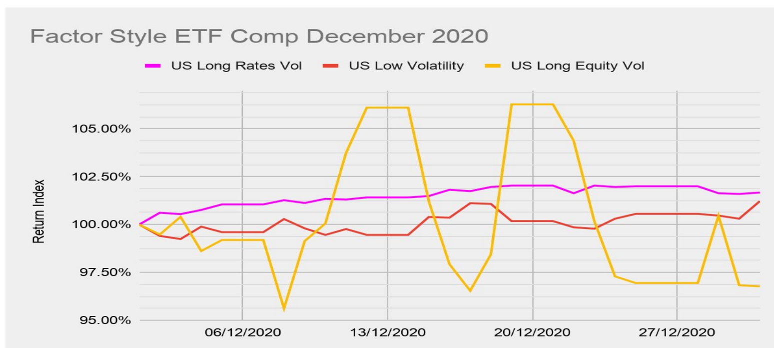
Factor investing is a strategy that chooses securities on attributes that are associated with higher returns. There are two main types of factors that have driven returns of stocks, bonds, and other factors: macroeconomic factors and style factors. The former captures broad risks across asset classes while the latter aims to explain returns and risks within asset classes. Macroeconomic factors include: the rate of inflation; GDP growth; and the unemployment rate. Microeconomic factors include: a company's credit; its share liquidity; and stock price volatility. Style factors encompass growth versus value stocks; market capitalization; and industry sector.



US High Beta led the way through December as we saw a risk on mood in the markets generally. Quality took a back seat this month as investors continued to rotate to a value basis and the reflation trade on the whole. Vaccines have started to be rolled out and the speed and efficacy of these will have a large bearing on how markets behave from here.

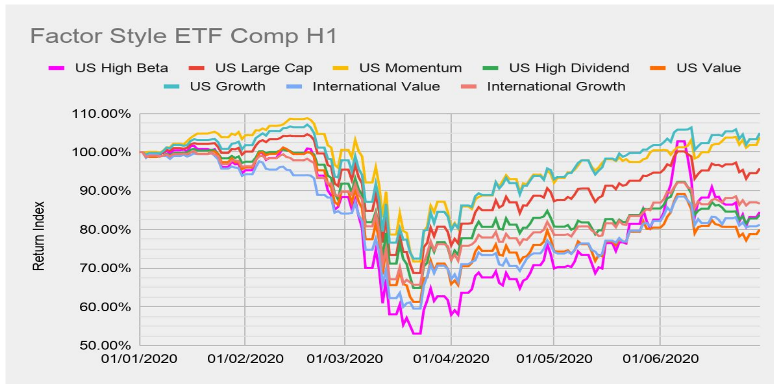
Surprisingly US growth outperformed US Value in December as investors weighed up the markets and started thinking about how they want to be positioned going into next year. The international trades, both growth and value had a steady performance over the month ending up positive. The strength or weakness of the USD will have a large effect on markets next year and should be closely watched.





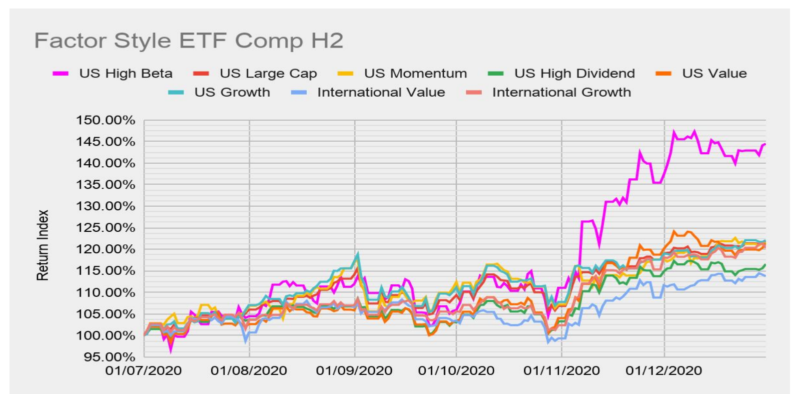
Equity Volatility had a couple of small spikes in the course of the month. Long rates volatility as well as US low volatility had quiet months with a gradual rise over the time period. Equity volatility is still quite elevated compared to previous years and for the moment seems to be having a base around the 20 level. By the structure of the markets at the moment this is likely to continue.

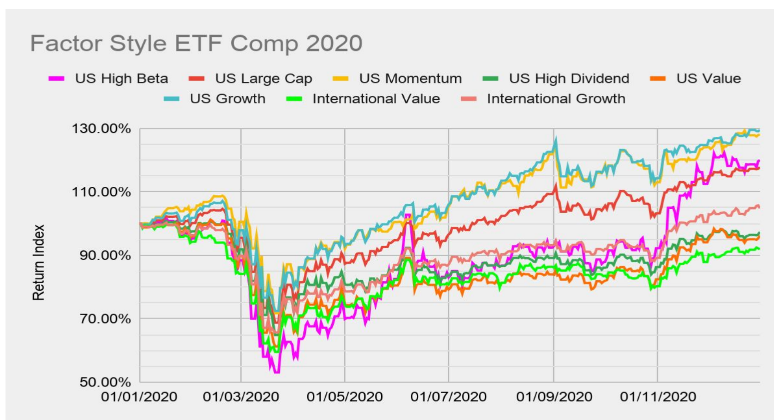
Let us now take a look over the longer time frames and see how we can look to utilise volatility as a hedge. Fundamentally there are just 2 asset classes, short volatility and long volatility.



Over the first half of last year it was US Growth and momentum that were the best performers and these were just slightly up on where they started the year. Every other factor style was down over the curse of the first half of the year. The injection of liquidity into the markets was what drove the recovery and certainly not the fundamental economy. Even now it is just the central bank and government support that drives markets not fundamental economics.

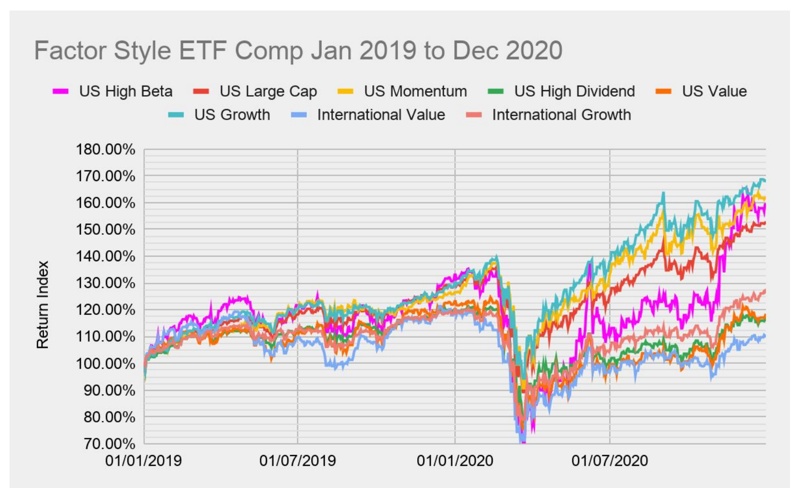
The second half of 2020 saw the out performance of US high beta as the other styles were grouped together at lower levels. This out performance was really from the beginning of November onwards as we saw the markets go risk on, the reflation narrative and the value rotation. International Value was actually the worst performer over the half year even though it was still positive. Perhaps hinting that value is a bit harder to judge through this virus.

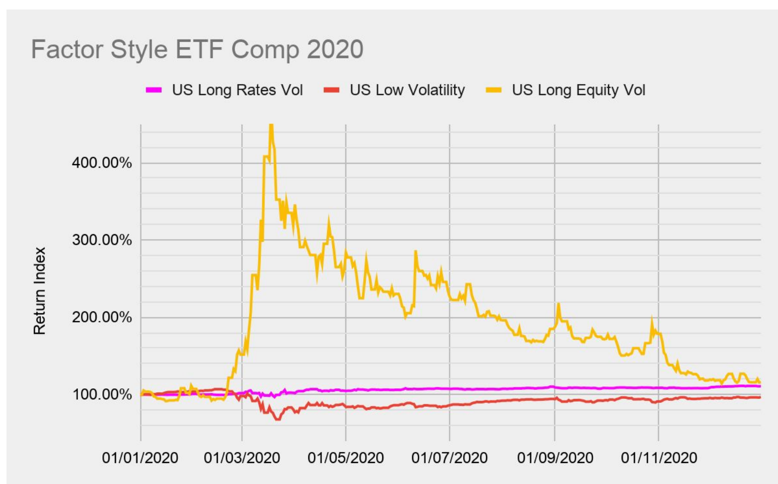




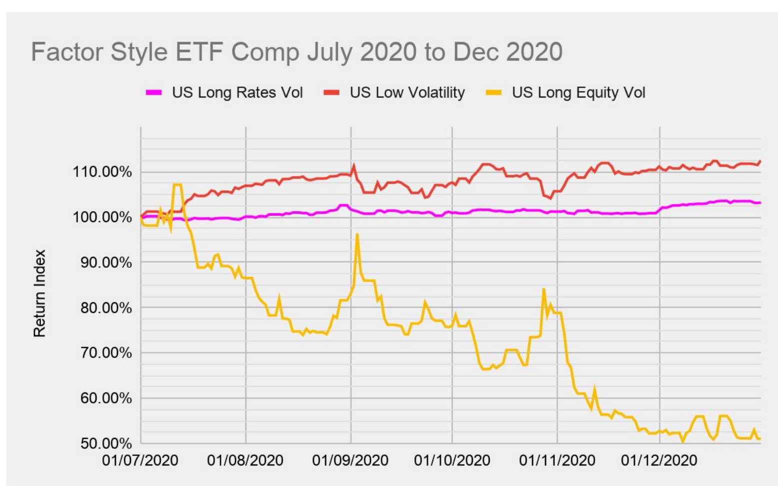
Over the whole year US Growth and momentum were the top performers with International value trailing in last, this seems to be an old story that seems will take a dramatic change in circumstances to change. With comparables being easy in the first half of next year we still may see reasonable performance but thereafter it could become a struggle. Debt burdens and credit creation should be watched to see where the real economy is.

Over 2019 and 2020 US Growth again has been the premier performer with International value bringing up the rear. With US yields likely to stay relatively low over the coming years this we believe this still favours growth over value as we just do not buy into the reflation trade. There may be some inflation over the coming months but we think that growth will be very hard to come by. The deflation forces tech demographics are very strong moving into the future and to get inflation will need a very large effort.





Over the course of 2020 we can see the big spike in equity volatility in late March and a couple of spikes later on in the year. This does demonstrate that long equity volatility is the best hedge against equity drawdowns and it will also provide liquidity to your portfolio when it is most needed. Low volatility strategy has under performed over the year and has not offered a positive return. Long rates volatility has been a consistent low return strategy that does provide stability to a portfolio and is worth consideration



Taking a closer look at the second half of 2020 we can clearly see how long equity volatility under performed (this does not take into account the inherent carry cost of this instrument). The low volatility strategy was actually the best performer in the second half of 2020 but there were much better places to put money to work. We do like IVOL for the stability that it provides to portfolios and we would look to carry an allocation to this throughout most of 2021. Volatility has a place in portfolios and is an important hedge. How and when to own it is the most important question.

Summary : December was a month that saw the continuation of the reflation narrative, with commodities still rising across the board and general USD weakness which aided this situation. We did see a spike in the virus across several parts of the world and this will lead to further lockdowns especially in Europe, this will more than likely cause a double dip recession in these places. The vaccine has started to be rolled out around the globe, and the rate at which this can be deployed and given to the population will have an effect on how economies will be deemed to behave and the speed of the recovery. The markets still seem to be very optimistic that the central bank's easy monetary policy and fiscal spending will be able to effect a quick recovery from this health and economic hit. We would caution that although we do have vaccines being rolled out, the efficacy and longevity of these is still not completely known in a real world circumstance. The virus is endemic in society and will not be going anywhere, so we shall have to learn to live with it. It as with all viruses continues to mutate and change and this will be an ongoing battle with the vaccines. It will also take an extraordinary amount of time to vaccinate all persons that wish to be. This is a global issue and will require a global solution with the world's population needed to be vaccinated to permit free travel around the globe. Mutations happen quickly and are spread around the world. Slow and ineffective vaccination programs may result in mutations that are immune to the vaccine. So much is still unknown and although it is good to be positive this must be tempered with reality. The Biden administration wish to have another 1.9 Trillion package , this will take time to get through and may have to change in size to pass both houses. Europe is experiencing delays in the vaccine roll out and this will be initially detrimental to their recovery. We still err on the side of caution and firmly believe that markets have got somewhat ahead of themselves. Options activity in US markets is quite exceptional and the tail is definitely wagging the dog at the moment. If a gamma flip occurs this could see a big reversal in the melt up.

2021 - What lies ahead: Bigger Government

On the health front, we still have a long way to go before any semblance of normality can be reached. For human's behaviour to return to normality we must conquer the pandemic and this will have to be done on a global basis. Fear will still be prevalent if there are pockets of the virus that can mutate and threaten to spread again. Vaccines are the primary hope to achieve this goal.

Across the globe both central banks and Governments are the ones plugging the holes left by the pandemic. They have both become more important in the continued functioning of daily economies and society. This is problematic as central banks cannot continue on their current paths indefinitely, confidence is the main limiting factor. Governments have all become larger parts of the global economy and this is troublesome as they are inefficient and do not create goods and services this is the domain of the private sector. Bigger government may have the intention of aiding the situation and may be required at present but it is the health and growth of the private sector that is most important.

Volatility is higher than before the pandemic and this trend we see persisting with spikes occurring. Strategies that involve being short volatility will carry elevated risks. Still so many unknowns around the virus and the vaccines exist that we feel that there will be some surprises in store down the road.

Insolvencies are still an issue that is being kicked down the road for now, but how long can this persist? This issue can seriously affect aggregate demand going forward and hinder the magnitude and speed of the recovery

Interest rates: the consensus view is that they shall rise over the course of the year, mainly due to inflation pressures that will come through. At some point if they do rise throughout this year the FED and other central banks may need to consider curtailing this rise as the debt load is a heavy burden for the economy to carry. The trade is very overcrowded and bad news on any front could see an unwind that could catch markets wrong footed.

Currencies: this year will really be a USD story with the market currently looking for the global reflation trade and being short the USD. As time passes and slowly the narrative gets pushed back from 2021 to 2022 we may see the USD creep higher.

Further stimulus and the amount will be important and although the new administration has control in both houses it may not be as clear cut as people imagine and the size and speed at which we get further stimulus may be unexpected.

Generally we feel that markets are highly inflated and that for the economy to grow into these valuations will be a problem There are many unknowns and the optimism that is being shown is laudable but may not come to fruition. If you recall the V shaped recovery which has not materialised. For growth to take hold we either need to see credit creation from commercial banks or the Government spending going directly to the private economy and where the money is most needed. Aggregate demand we feel will be slow to recover and will happen in fits and starts.

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Once again thank you for your time and see you again next month.

Ortega Capital Management Ltd
Suite 602, 6th Floor Hennessy Tower.
Pope Hennessy Street
Port Louis

T : (230) 606 3771
E : info@toiip.com
W : www.toiip.com
BRN : C123387

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