



## INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS AND THEIR CLIENTS

### TRENDS TO WATCH IN 2021

The investment themes driving each market cycle are different. Just take a look at the Global Financial Crisis (excessive leverage), the tech bubble (sector euphoria), the 1990s recession (economic downturn), and the 1987 share market crash (market induced).

Similarly, the coronavirus downturn has had its own themes, even if the situation has radically changed thanks to a quick V-shaped market (if not quite economic) recovery.

While things can change again, we've pinpointed three major themes for investors to watch. Understanding them is crucial to take advantage of opportunities for return while also avoiding unnecessary risk.

#### ARE MARKETS IN BUBBLE TERRITORY?

A year ago, the global economy was locked down, businesses endured a window of uncertainty without government support, and a COVID-19 vaccine didn't exist. The future was bleak, yet most investment markets spectacularly rebounded – some breaking new records.

Have investors pushed valuations to breaking point as governments and central banks have come to the rescue?

The US equity market (S&P 500) looks to be in a bubble. The index has climbed 56.25% (in US dollars) over the year ended March 29, although much of that growth has been driven by the tech sector. Underlying earnings have not kept up as excitement about the future prospects of new tech has taken hold.

Locally, some tech stocks (or 'new tech') also appear to be in bubble territory. While the revenues of buy-now-pay-later companies like Afterpay and Zip keep

rising, profit is another story. Investors are assuming future profits that don't seem plausible relative to current valuations.

Government bonds appear to be in a bubble (see below), but some of the air was let out over February as 10-year yields have risen. The market has recognised that long-term inflation is a genuine possibility thanks to massive fiscal and monetary support.

Other asset classes have also risen strongly since the COVID crash but have better underlying support to justify those prices. They may not be cheap, but there are pockets of opportunity.

Aside from the US share market, other equity markets range from fair value to mildly expensive. The broader Australian equity market is nearing its pre-COVID peak and, while it isn't cheap, it isn't in a bubble either.

Other asset classes like listed property, oil, and other commodities such as copper, are also not in bubble territory based on our analysis.

#### IS INFLATION REALLY SET TO RETURN?

The long-term impact of huge fiscal and monetary stimulus packages is to potentially stoke inflation. We've previously mentioned the possibility of **inflation** returning over the long-term, but the market has also now woken up to this risk.

The yield on longer duration or long dated-fixed-rate bonds have strongly risen with inflation expectations, particularly in recent months.

Since early August, the yield on 30-year bonds has doubled from 1.19% to 2.40% and the ten-year tripled from 0.53% to 1.61%, according to Morningstar. (Meanwhile, capital prices have declined as higher inflation makes assets with a fixed rate of payment – like a fixed rate bond – worth less.)

We expect Australia's March 2021 rolling CPI figures to be high, but this is not a sign that inflation is back: it's because the starting point 12 months ago was so low due to the pandemic locking down economic activity.

We believe the local economy is in a state of transition, and there's still plenty of slack in the workforce so inflation isn't a problem yet. Central banks around the world are still struggling to lift inflation to their target range of 2-3%.

While higher inflation isn't imminent, that doesn't mean it won't happen in future.

## THE RISE OF BITCOIN AND CRYPTOCURRENCIES

Institutional investors are starting to take cryptocurrencies seriously.

While more than three-quarters (78%) of institutional investors still say they're not planning on investing in cryptocurrencies, more than half admit they're "here to stay," according to a J.P. Morgan **survey**.

Perhaps it's not surprising given the rise in the price of bitcoin last year was astronomical. At one point in February, it had risen tenfold from its March 2020 lows, making surging share market gains seem pedestrian.

But does this make it an investment? It's straightforward for an individual to buy bitcoin, but institutional investing is a different matter. It's difficult to hold in an investment portfolio through a platform or super fund, and there are no cryptocurrency ETFs – at least yet.

While people can download the blockchain to their computers and convert dollars into bitcoins, this can take an inordinately long time, as we experienced first-hand.

External parties (the cryptocurrency version of your online broker) can store your bitcoins, but question

marks remain about how secure those platforms are and even whether they will still be around when you want to cash in.

They also aren't cheap. Buying a \$500 item in bitcoin can end up costing \$550 thanks to steep transaction costs.

We believe bitcoin is currently too volatile to function as a currency, but could it function as a commodity-like investment that can hedge a portfolio in the same way as, say, gold?

It's possible, but investors should keep in mind that bitcoin's decentralised nature acts counter to the goals of government and central banks. They need to track the flow of money and control its supply to manage the economy. Bitcoin can circumvent traditional capital controls and facilitate money laundering or illegal activity.

While government-issued currencies no longer have any real physical assets behind them, investors believe most governments will meet their liabilities, partly because they can tax people or sell assets to fund their debts. Would you trust that or new cryptocurrency Dogecoin, invented by software engineers Billy Markus and Jackson Palmer?

If governments decided the trading of cryptocurrencies had reached a level they were uncomfortable with, they could legislate it out of existence.

We believe this will be harder to do now that more institutional investors are owning it with more traditional safeguards (such as custodial protection) but it isn't an impossibility.

Investors who look at robust evidence and keep the longer term in view stand to benefit from emerging opportunities while avoiding being swept away by schemes that sound too good to be true.



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Dan Miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios for 8 years. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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