LHV Portfolio Management

Monthly Investment Report

December 2020

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Fiscal policies are playing a bigger role for financial markets than ever before.

2020 review

Coming to 2020, we saw that economies are cooling down and corporate profit growth is slowing. As a result, we reduced the level of risk in our portfolios before the crisis, increased liquidity and exited most of our more illiquid investments. As we have said before, to reduce risks, it is usually the last moment when central banks start stimulating demand in the economy by lowering interest rates. When the US Federal Reserve started cutting interest rates in the second half of 2019, it was an important input for us to bring the risk level of our portfolios down.

2020 is difficult to sum up. This year has been a year of adaptation and change. Personally, this year has been very different for everyone. If the year reminded us of something in terms of markets, it is that the world is constantly changing, and we need to be flexible and adapt quickly if necessary. In the crisis, and after the crisis, we saw interesting new opportunities emerging, and as a result, we changed the position in the portfolios quite significantly, which has brought us good returns. March and April gave us a blank canvas to draw a new picture on, and we did.

Market index movements	**2020**
Eurozone bond index	4.1%
World stock markets	6.7%
North America	10.4%
Europe	-3.3%
Emerging markets	8.5%

Total return of MSCI indices, in euros

What do we expect from the new year?

The big surprise for market participants after the 2020 crisis has been how little the economies shrank over the year. We believe that there is an important lesson here that continues to be underestimated.

Whereas monetary policy (interest rate cuts) has been the main stabilization mechanism of the recession in the past, now that interest rates were at or near zero in almost all major countries and central banks were buying large volumes of government bonds, countries rushed to help with high budget deficit expenditures.

The lesson is that national deficit spending has a much stronger positive impact on the economy than the current central bank money printing in the form of financial asset purchase programs. While the central bank's previous money printing was high, this money did not actually make it from the financial system to the real economy. The prices of financial assets simply increased. Now, however, with large government deficit expenditures financed directly by central banks, this money flows directly into the economy through wage subsidies, investment, or other support measures. In terms of money flow, the public sector is minus the private sector surplus. We believe that large budget deficits are here to stay, and this will have a significant economic stimulus effect.

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The general opinion is that equities are a good hedge against inflation. Looking back, this is not really the case, few stocks offer protection against inflation. These stocks continue to be attractively priced today and make up the cornerstone of our portfolios.

In the United States, there has been a complete change of power in recent months, with both the presidency and the Senate both moving to the Democrats, who have promised significant stimulus measures through public investment and other support measures. Consequently, we believe that the real economy should do better than expected in 2021-22. As long as unemployment remains high, countries will be generous to spend on economic recovery to bring unemployment down.

Last time, because of the economic recovery in the United States, the central bank began to tighten monetary policy significantly. This time US central bank has indicated that the economy will be allowed to overheat. Now, however, market participants do not see this as such. We believe that this will be a surprise to the financial markets, although the central bank has repeatedly said that they intend to do so. With all that taken into consideration, we have built our portfolios to act well when real economies recover, and inflation pressure will emerge.

We believe that 2021 will not be easy either, because of US democrats taking power, markets have risen rapidly in the short term, but now work is just beginning and usually process in politics is nor quick or easy. At the same time, similarly to last spring and summer, we see several attractive opportunities in the markets that offer a good risk-return ratio, especially in the commodities sector and a number of investments open to the recovery of the real economy.

Best regards,
Kaius Kiivramees and Mikk Taras