Market Pulse: Investment Committee Insights
June 2021

Agenda

Market Update

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Markets in 2021

Risk – on sentiment despite recent jitters – 2021 started on a bullish note across the globe, except for some volatility towards the end of January, and also from end-February till beginning of March. However, the markets recovered swiftly and investors have bought on the dip on any correction in the year so far.

Wild Swings in stocks driven by retail investors in end – February, early March: Driven by retail investors, especially those in the US, some of the heavily-shorted (and probably structurally- declining) businesses like GameStop, AMC and Express experienced wild swings in share prices. For example – GameStop's market cap was USD 290mn at the end 2020 that rose to USD 30 bn in late January. This created panic in the markets and led to heavy losses for hedge funds who have been short such stocks. Hedge funds in turn started selling their profitable positions to make up for the losses in such crowded shorts, leading to wider selling.

Vaccine roll-out: Meanwhile, the vaccine roll – out continued with the UK and the US faring significantly better than the EU, which is now finally catching up. We are keeping a very close eye on this and also on the efficacy of different vaccines on virus– variants. Israel has seen a significant decline in new cases following mass–vaccination there.

Yields – One of the key developments in the year has been increase in yields across the curve. It started with rates rising in the longer end, followed by a sell off in the front end of the curve, thereby implying that the market is assuming earlier than previously anticipated rate hikes. However, the Fed continues to express little concern about inflation and is focused on the present task of encouraging the recovery.

MSCI Global Vs the US & Europe

GameStop Share price

Source: Bloomberg

The figures are for illustration only.

Recent Developments

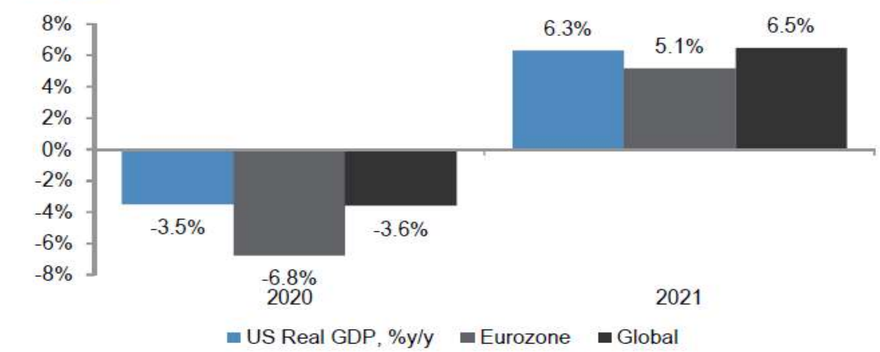
- **Equities continue to rally:** Equities rallied to make new highs with global indices rising c. 7% since the beginning of April till June 7. During this period, the US and European markets marginally outperformed the rest of the world. Faster vaccinations and an easing of restrictions, together with the $1.9 trillion pandemic relief bill, have helped fuel U.S. economic recovery hopes. Companies are more optimistic about their results than they were three months ago, as measured by the number increasing FY 2021 guidance.

- **Economic growth:** This positive tone in equity markets is also supported by the fact that economic growth expectations continue to be robust globally. Please refer to the chart below.

- **Jitters in between:** The collapse of Archegos Capital management towards the end of March led to a very brief market correction. The recovery in the markets was swift and they resumed their upward trend.

- **Style rotation**: The rotation into Value at the expense of Growth stocks that we saw in the early part of the year has stalled somewhat since mid-April and growth stocks staged a mini-resurgence. However, so far this year, Value continues to outperform both Growth and the rest of the market, as shown in the chart below.

Figure 2: Real GDP growth projections for US, Eurozone and Global



Source: J.P. Morgan

Chart: Relative performance of World, Emerging markets, Value and Growth stocks

Source: Bloomberg

The figures are for illustration only.

Recent Developments - Continued

- **Yields:** The rotation into Value stocks has been associated with the upward move in US yields, which has stalled recently. US 10 year yields which started the year at ~0.9% have come down to ~1.56%, having peaked near1.8% towards the end of March. Rising yields reflect market expectations of higher future inflation, which can favour Value stocks and also lead to underperformance of Growth names. It is likely that yields have further room to rise and therefore suggest that this style rotation may persist for a while longer.

- **Forex:** In this scenario, the US Dollar which has declined for most of 2020, was support by upward pressure on US rates. However, with yields stalling again, the USD has lost some underlying interest rate support.

Chart: USD vs basket of currencies

Source: Bloomberg

Chart: US 10 year yield

Source: Bloomberg

The figures are for illustration only.
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Recent Developments – Inflation fears

- **Recent spike in inflation:** Recent monthly CPI data for the US in April showed a rise in CPI inflation to 4.2%, stoking fears of inflation.
- **Market Nervousness:** Many commentators have been looking at the combination of massive monetary and fiscal stimulus across the G7, combined with recent evidence of localised price pressures to conclude that inflation is a real danger for markets. The argument goes that supply disruptions after the pandemic will mean that increased demand will not translate into increased supply, but rather into higher prices.
- **Our view is more balanced**: In our view it is hardly surprising that inflation is rising as the economic rebound takes hold. The questions are (i) how high does it go and (ii) the policy response - which is covered on the next slide.
- **The Supply response**: We think that it is possible that the supply side of the economy is much more resilient than feared by the inflation pessimists. Recall the massive increase in the supply of vaccines, PPE equipment, and the changes in supply (delivered meals, remote working) that have occurred in the last twelve months. Entrepreneurs will deliver in response to increased demand and looking at the changing complexion of the high street with new fitouts proceeding apace in many places one cannot rule out a supply response to the new demand. The great economist Joseph Schumpeter described " a process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." Perhaps this "creative destruction" will have been induced by the pandemic.
- **Inflation is a Supertanker**: Most economists will admit that inflation only becomes entrenched and persistent if inflationary expectations become widespread. So far, while prices have risen for some commodities and services that are in short supply, the sharp demand rebound will soon abate and normal growth will return in 2023 and beyond. While everyone is likely to go to the pub on May 17 th this is unlikely to be a permanent feature of the economy.
- **Inflation Expectations have risen, but are still low**: We will admit that inflation expectations have risen recently (5year forward inflation expectations five years forward have risen above 2% for the first time in a while). But they are still low, and inflation expectations will have to rise significantly further to change policy in our view.

Source: Bloomberg

Inflation – Policy Scenarios

- **We can see one benign and one highly negative policy scenario as inflation rises**
- **Scenario I (benign):** Inflation rises, but temporarily. The Fed will raise rates eventually but probably not before 2023 with policy rates expected to remain below 2 pct even at the end of 2025 as the market currently expects. In this scenario modest rises in inflation (and recognise that one woman's inflation is another's pricing power) are met by modest normalisation of interest rates and a gradual slowing of the economy. Stocks continue to grow in line with earnings, or maybe slightly slower as modestly rising rates cause modest valuation compression.
- **Scenario II (negative):** Inflation rises sharply and the Fed is jolted out its poise. Markets start to believe that the Fed is behind the curve, the yield curve steepens significantly, inflation expectations start to move higher. The Fed has no alternative but to slam on the brakes with sharp inflation rises and induce a recession in order to get inflation under control (there is a reason Economics is called "The Dismal Science"). Short rates rise to 3 pct by the end of 2022 and the ensuing recession causes a 30 pct drop in stocks. 1994 is instructive in this regard. Stocks stalled while investors tried to figure out how real a threat inflation was as the Fed raised rates, but then rallied sharply in 1995 as credibility was restored to the inflation fighting credentials of the Fed
- **Scenario I favoured for now**: We continue to believe that some variant of Scenario I will play out in this cycle. But we are never complacent and will move quickly if inflation expectations take hold and lead us into Scenario II.

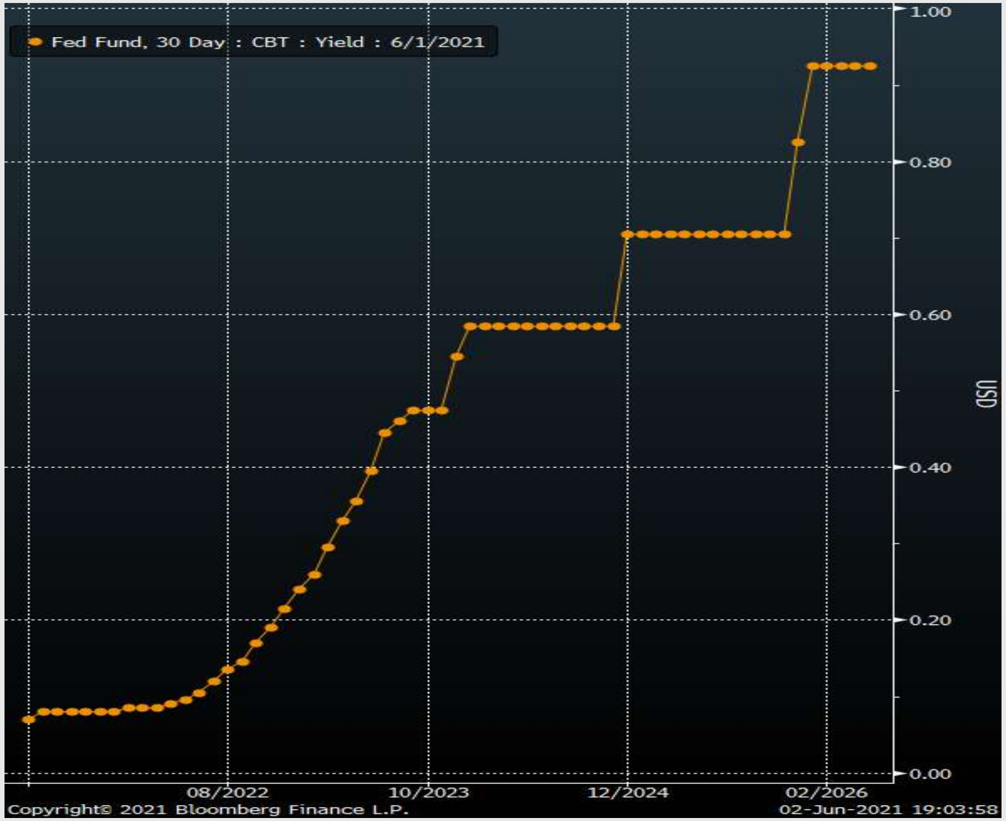
Source: Bloomberg

Recent Developments – Inflation fears - Continued

USD Inflation Swap Forward 5Y5Y

Source: Bloomberg

Fed rate expectation



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Recent Developments – Inflation fears - Continued

Stock market in 1994/5

Source: Bloomberg

Yield curve in 1994

Source: Bloomberg

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Implications for the Portfolio

Asset allocation: Rising yields and expectations of higher inflation have led us to amend our asset allocation as detailed below

Fixed Income:

- We have reduced the duration of our bond holdings
- We prefer allocating to cash over low-yielding and volatile bonds

Equities:

- **Value Vs Growth**: Within our allocation to equities, since the end of last year, we have maintained equal exposure between Growth and Value stocks. However, in anticipation of higher yields (which suggest an environment that could favour Value stocks), we have recently increased the relative allocation to Value stocks. Furthermore, under the scenario of higher inflation, Value stocks tend to outperform Growth stocks
- **Taking advantage of market dislocations**: We are taking advantage of any market dislocations, e.g. following the collapse of Archegos Capital, we bought the structurally growing company Tencent Music (a stock that we felt was oversold following the collapse in Archegos)
- **Event-based investments:** Investments that are based on certain events materialising usually tend to show lower correlation with the wider markets. For example, our positions in Veolia, Bayer and Vivendi are trades that we entered due to anticipation of a specific, idiosyncratic event, and thus, these positions could hold-up better, even if wider equity markets were falling.
- **Thematic investing** – Structural thematic investments like those in Volkswagen (which has a significant programme of investment in electric cars and thus could benefit from the moves towards emission reductions) and BB Biotech (this is a biotech investment fund, and thus could benefit from the need for new and more efficient pharmaceutical solutions) are another way to generate alpha, and these ideas are reflected in our portfolios

Source: Bloomberg

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Recent Fund purchase: BB Biotech

BB Biotech

BB Biotech is a closed-ended investment fund managed by experts in Biotech and Health Care sectors where our inhouse expertise is limited. Therefore, we have chosen an entity that has a very successful track record for a number of years and a proven record of alpha generation. We believe that the primacy of health and medical concerns after the pandemic, and the frenzy of innovation in this sector will lead to many new winners, and prefer to express this thematic view through a carefully chosen fund vehicle.

- BB Biotech invests in the US biotech sector. It is a long-only, long-term closed-end investment fund investing in listed companies that develop and commercialize new drugs
    - It has been operational since 1993
- Strong growth - BB Biotech has shown a strong track record since inception and offers, in our view, a solid basis for future growth in the high-growth and innovation-driven biotech industry
    - In the last 10 years its intrinsic or Net Asset Value (NAV) has increased at a rate of 16% every year. It is also reflected in the share price that has delivered an average annual return of c. 20% in the same period
- This compares to c.14% annual return of the Nasdaq Biotech Index in the last 10 years and management's target of a 15% avg. ROI over the mid & long term
    - Since 2018, the company announced and implemented a growing investment focus on small & midcap companies with promising R&D pipelines that is often where the highest potential return could be possibly found
- Management background – The Managers have strong medical and scientific backgrounds that a requirement for the understanding of early stage and more innovative companies. For a generalist asset manager, coping with the pace of innovation in the biotechnology industry has become increasingly challenging

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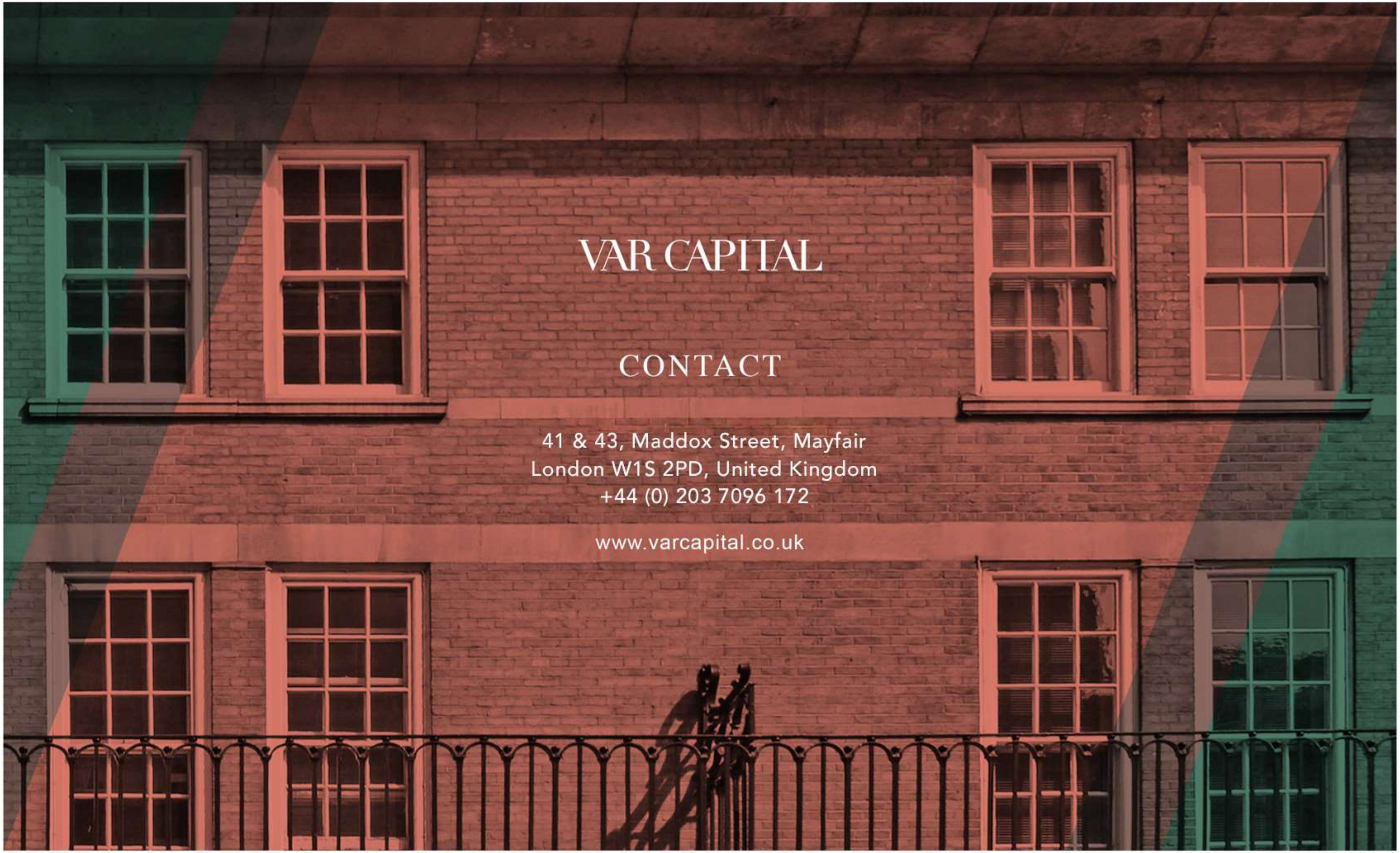

VAR CAPITAL

CONTACT

41 & 43, Maddox Street, Mayfair
London W1S 2PD, United Kingdom
+44 (0) 203 7096 172

www.varcapital.co.uk