Outlook 2021: After the Storm Comes the Calm

In this issue of the Thinking Man, we offer our investment views for 2021. The Covid-19 pandemic was a once in a century event, which no investment professional could have reasonably anticipated. Just as the year was starting, most if not all of the 2020 outlook was instantly irrelevant, as the virus spread through the globe and lockdown orders were implemented in most countries around the world. This led to a temporary shutdown of the global economy, leading to a big decline in economic output, and putting an end to the previous economic expansion cycle.

With countries in lockdown and ICUs in the hardest hit regions overflowing with sick patients, investors started to anticipate a long lasting and deep recession, leading to sharp and quick selloff in financial assets. However, a swift and strong monetary and fiscal stimulus response, sent a strong signal that both central banks and government were willing to use all available tools at their disposal to prevent any temporary economic damage from becoming permanent. With this information, we quickly updated our outlook for the rest of the year, telling our clients and investors that we saw the correction as a once in a decade purchasing opportunity. Time has proven us correct, and clients who took the risk of following our suggestion have been rewarded handsomely.

Even as the pandemic dominated most of the investment landscape throughout the year, it will continue being at the forefront of investors' minds through most of 2021. As the year comes to an end, the successful development and approval of Covid-19 vaccines, has allowed us to start believing that the end is near. Nonetheless, significant hurdles must be overcome before we can regain some sense of normalcy in our lives, and it might be long before we can completely put the pandemic behind us.

The outlook is divided in four sections. In the first section, we discuss the current macroeconomic landscape, and how despite a significant rebound, the recovery seems to be losing steam. In the second section, we give our asset class views, where we mostly remain constructive in the equity market, and believe investors should continue increasing the allocation to illiquid alternatives. In the final section, we anticipate the major risks that we believe would have a major impact in the market if they were to materialize.

The Thinking Man's Approach

December 2020 | Series #82
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- 2020 was a once in century year, where a black swan event such as pandemic materialized, completely changing the investment landscape.
- Even as financial markets sold-off sharply at the start of the year, they have had a significant recovery, and should mostly end in positive territory, with most regional equity indices posting double digits returns.
- We remain constructive on equities, as they should continue to benefit from low interest rates and the expected strengthening of the economic recovery, with a focus on cyclical stocks and thematic strategies.
- Similarly, in fixed income we believe that higher yielding credit is expected to provide the highest upside, as sovereign bonds remain the most expensive securities.
- In alternatives, we continue to build our core portfolio, where the focus will remain on committing capital to blue chip managers that can invest strategically across market cycles and have proven track records.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

1. Macroeconomic Landscape

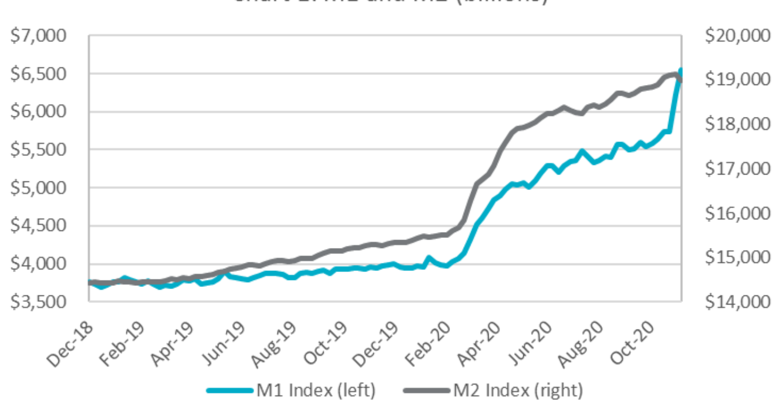
The global economic outlook has been significantly transformed by the pandemic. Instead of having a transition year, where global economic growth had been expected to consolidate, rates would remain stable, and countries would continue to approach or remain at full employment, the Covid-19 pandemic quickly changed the landscape. Because of the lockdowns implemented around the world to prevent the spread of the virus, central banks and governments had to quickly deploy monetary and fiscal stimulus in order to avoid long lasting economic damages.

In the U.S., the Federal Reserve (Fed) borrowed a play from the 2008 Great Financial Crisis (GFC) response, and immediately lowered rates to almost 0%, enacted another round of quantitative easing (QE), and revived several stimulus programs to support the liquidity and stability of financial markets. Other central banks, such as the European Central Bank (ECB), the Bank of England (BoE), and the Bank of Japan (BoJ), followed suit to a greater or lesser extent. Governments around the world also understood the urgency of the situation and contrary to their response during the GFC, also enacted fiscal stimulus programs to support the overall economy, focusing on the hardest hit sectors and individuals from the lockdown measures.

The combination of these measures currently seems to have been successful in avoiding an ugly, long-lasting depression. In the U.S., half of the jobs lost at the start of the year have been recovered. Even as the economy contracted by an annualized record setting 31.4% in the second quarter, the economy is only expected to contract by approximately 3.6% through the entire 2020, and possibly rebound by 3.8% in 2021. Similarly, financial markets quickly recovered, mostly in the spring and summer months, after having taken a deep dive at the end of the winter.

Despite the strong recovery, there is still a significant road ahead to reach pre-pandemic levels in many economic indicators. Furthermore, industries such as travel, hospitality, leisure and entertainment, remain in a severe contraction, with business activity sharply below the start of the year. Finally, the recent Covid-19 spike threatens to derail the economic recovery, and will most likely push Europe into a double dip recession.

Chart 1: M1 and M2 (billions)



Source: Bloomberg, Graph: BigSur Partners

Considering this, we believe that 2021 will most likely be a continuation of 2020, with central banks continuing to flood markets with liquidity (chart 1), governments continuing to support businesses and individuals through successive rounds of fiscal stimulus programs, and both nominal and real rates remaining artificially depressed for the foreseeable future. Despite the excellent news coming from the vaccine front, it will most likely be several months before a vast majority of the population is vaccinated, and we can reclaim some sense of normalcy. Consumption until now has managed to remain resilient, adapting to the new reality, but this could change, if in fact, the northern hemisphere is headed into a "dark winter", as predicted by Dr. Anthony Fauci and other epidemiology experts.

On a final note, even as the major risk of 2020, the U.S. presidential election, was mostly uneventful, the Senate election remains unresolved. Control of the Senate hangs in the balance of the results of two Georgia runoff elections at the start of January. We will discuss this event in the risks section of the document. However, a win by Democrats in both races would open the door to a different economic agenda than is currently anticipated. A win by Democrats in the runoffs would allow President elect Joe Biden to push for an additional stimulus package, similar to the 3 trillion HEROES act that was approved earlier in the year by the House. Nonetheless, this would be at the expense of a rollback of the tax cuts of the Trump administration, and increased regulation for energy and financial companies, amongst others.

2. Asset Allocation and Asset Class Views 2021

After a strong return in 2019, financial markets began 2020 with traditional valuation metrics looking expensive, both in equity and fixed income markets. However, at the beginning of 2020, markets carried on with the momentum of the previous year, reaching new all-time highs. All the enthusiasm abruptly ended because of the pandemic and the imposition of strict lockdown measures. Despite the expectation for a long-lasting and severe economic recession, the measures taken by governments and central banks around the world, described in the previous section, promoted a strong recovery and a stabilization of financial markets.

Regardless of the collapse in corporate earnings, low interest rates and easy monetary policy, promoted a strong rally since the beginning of spring, which continued almost uninterrupted through the end of the year, leading equity markets, particularly in the U.S., to further new all-time highs. On the fixed income side, sovereign bond rates plummeted, and spreads in corporate bonds have contracted almost to pre-pandemic levels. This places us in much more difficult situation than last year, as valuation metrics are currently more stretched, particularly in U.S. equity markets. In the next few sections, we discuss our main views for each of the main three asset classes, with some investment themes that we believe should develop through 2021.

Equities

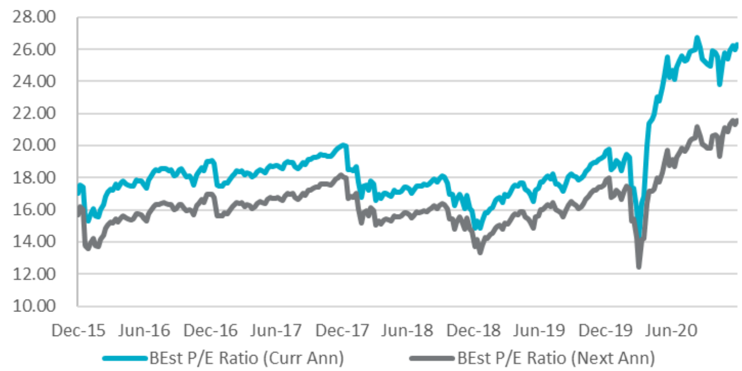
Despite a collapse in corporate earnings, and business activity remaining below pre-pandemic levels, global equities managed to have a fantastic year. As of the time of this writing, global equities[1] returned approximately 15% during the year, primarily boosted by spectacular performances from U.S. equities. The downside is that stocks, particularly in the U.S. are ending the year with somewhat stretched

[1] Measured by the MSCI ACWI

valuations. Earnings per share for the S&P 500 are expected to close 2020 at $141, down from $152 a year earlier, while expected to grow to around $172 by the end of 2021. The implied earnings growth of over 20% seems overly optimistic, despite the anticipated strong rebound in economic activity for next year. With these levels, U.S. equities are trading at 26x expected 2020 earnings and 21x expected 2021 earnings (chart 2), which is significantly above the long-term average, and above the forward 18x at the close of 2019.

Nonetheless, we remain constructive on equity markets. Arguably, fixed income, especially sovereign bonds are significantly more expensive. Additionally, investors remain with abundant cash, which we believe will continue to be deployed leading to continued asset inflation. Meanwhile, the reopening trade, where cyclical sectors should benefit from the economic recovery and normalization from the vaccine, should gain strength, and continue to boost stocks in 2021.

Chart 2: S&P 500 Forward P/E)



Source: Bloomberg, Graph: BigSur Partners

With this in mind, there are four main themes that we believe should play out in equity markets during 2021, which are as follows:

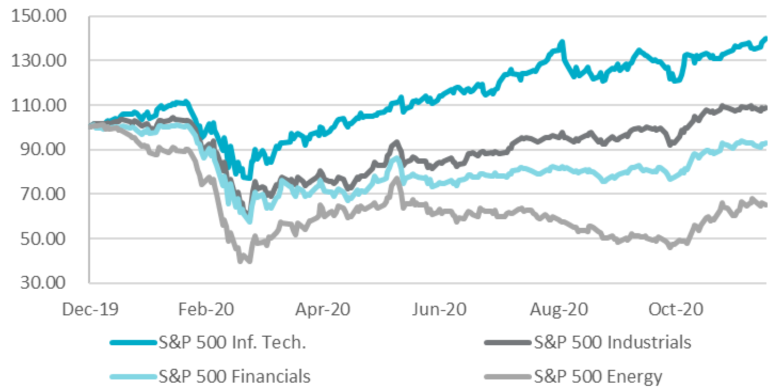
1. Favor cyclical sectors
2. Maintain a barbell portfolio
3. Look for hidden value in international markets
4. Include thematic themes in the portfolio

Favor cyclical sectors

Since the pandemic hit at the beginning of the year, many U.S. mega cap tech stocks benefited from people working and interacting remotely, making the sector the leader of the stock market recovery and subsequent rally through most of the year. This resulted in a huge divergence between a handful of stocks that kept pushing the market higher, and the rest of the market (chart 3). It got to a point where the five biggest names in the S&P 500[2] accounted for 25% of the index, which explains the big divergence between the benchmark and most investment portfolios. Even as restrictions have mostly been lifted, the majority of people who are able to, have continued working from home, while many interactions have remained mostly virtual. As result, the outperformance of these mega cap tech stocks to the overall market has diminished in the last few months of the year, but it has still not reversed course in a meaningful way.

[2] Amazon, Apple, Facebook, Google and Microsoft

Chart 3: S&P 500 Sectors (normalized on 12/31/19)



Source: Bloomberg, Graph: BigSur Partners

Tech stocks still command an important premium over the rest of the market, particularly to cyclical stocks that took a great hit from the negative economic impact generated by lockdown measures.

For 2021, we believe that the U.S. and most of the developed world will have successfully vaccinated most of its population, allowing the economy to fully recover to pre-pandemic levels. With this in mind, cyclical stocks stand to benefit from the continuation of the economic reactivation. Hence, our first recommendation to clients and investors is to increase the exposure to cyclical sectors in the equity portion of their portfolios. This theme has already demonstrated results towards the end of this year, but we expect it to consolidate through 2021. In fact, during November's rally, which was boosted by the announcement of the successful trials of several vaccine candidates, the best performing sectors were energy, financials and industrials. Small cap stocks, which also benefit from a cyclical uptick, have also started outperforming recently, finally breaking through the previous all-time high reached in the summer of 2018. Small cap stocks should also benefit from the reopening trade, continuing to catch up to its large cap peers in 2021.

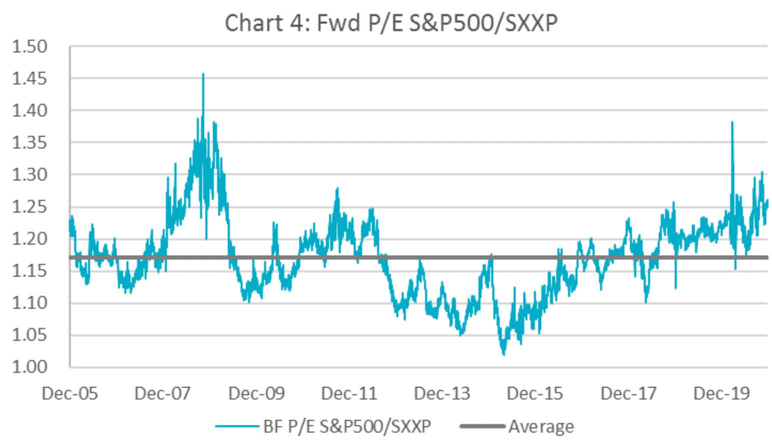
Maintain a barbell portfolio

Despite everything that we mentioned in the previous point, we believe that mega cap tech stocks still play an important role in investors' portfolios. This is mostly true because they have recently started behaving as safe havens. During 2020, in times of uncertainty particularly concerning the trajectory of the pandemic, these stocks protected the downside much better than the rest of the portfolio. As mentioned in the previous point, our base case scenario remains an economic normalization, helped by a successful vaccination campaign. However, as we will mention in the next section of this article, we believe there are several potential risks that could still derail the economic recovery.

Furthermore, in contrast to the excessive valuations during the dot com bubble, current tech companies have sound business models that mostly generate attractive revenues and profits for investors. Rather than selling off, the rest of the market should slowly continue catching up. Similar to what happened in November, the tech sector underperformed the cyclical sectors, but still posted an attractive return of approximately 11%, which was very close to the return of the S&P 500. Hence, our second recommendation to clients and investors is to create an equity "barbell" portfolio that combines cyclical stocks (which should benefit from the reopening trade), with mega cap tech stocks, which should still provide an attractive return, while potentially protecting the portfolio from potential volatility brought on by the pandemic, amongst other risks.

Look for hidden value in international stocks

At the end of 2019, U.S. equities seemed expensive on a relative basis when compared to international stocks. After a year in which global equities rallied, boosted by American mega cap tech stocks as previously explained, U.S. equities remain expensive. Based on 2021 earnings expectations, the S&P 500 is trading at a forward P/E of 21x, considerably higher than the one of European, Japanese and EM companies, which are trading on average at 17x, 16x and 14x, respectively. Valuation metrics of U.S. equities have always commanded a premium over other regions of the world, but the current is close to historical highs. For example, over the last 15 years, the forward P/E of the S&P 500 has traded at an average premium of 1.17x against the one of the Stoxx Europe 600. Currently it is valued at 1.26x, which is almost 1.5 standard deviations above the average (chart 4). We believe that this valuation gap should contract, as cyclical sectors are more representative of European indices and other international markets.



Source: Bloomberg, Graph: BigSur Partners

Furthermore, we believe that emerging markets (EM) in particular should be the biggest winners of many of the dynamics that we expect to play out throughout the year. First, many of the Asian EM countries have been the least affected by the pandemic as most of them have successfully prevented the massive spread of the virus that caused the Covid-19 disease. These countries have not suffered the massive economic losses that have prevailed in western countries, therefore, are in a much healthier economic position in the near future. Second, even the LatAm countries that were severely affected by the pandemic, both from a high number of contagions and from a huge outflow of investors, stand to reap significant benefits from the vaccination campaign and the continuation of the reopening trade. Finally, the U.S. dollar, typically a counter cyclical currency, is expected to continue weakening, which should lead to a strengthening of commodity prices, benefitting many of the EM commodity exporting countries.

Include thematic themes in the portfolio

2020 saw an extraordinary rise in volume from retail investors, as people stuck at home used the spare time to actively trade in the market. This was especially the case among millennials who are new to the market and took advantage of easy to access, commission free platforms such as Robinhood. These retail investors, now commonly referred to as “retail bros”, have become a more powerful force than professional investors, accounting for approximately 20% of daily trading volume on average, and as high as 25% on peak days, according to data from Citadel Securities. These new investors also do not rely on traditional valuation metrics such as P/E, and do not follow upgrade or downgrade recommendations from Wall St. analysts. The result has been a year where most traditional professional and institutional investors have been left sitting on the sidelines waiting for a meaningful correction, while millennials have made a "killing", pushing stocks and sectors to increasingly stretched valuations in the process.

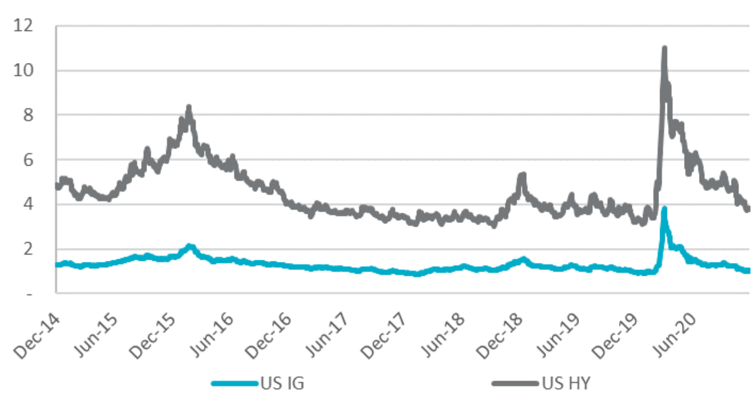
We do not necessarily agree with the methodology and analysis from these new to the market retail investors. Nonetheless, we believe there is valuable lesson to be learned. Clients should consider combining passive index funds, which had been growing in popularity, with theme-oriented strategies that have the potential of significantly increasing the expected return of a portfolio. The expected appeal of these themes usually revolve around disruptive technologies or processes to well established business models, which should continue to consolidate going forward. Through the year, we have been actively advocating for investments in companies or funds in thematic industries such as cybersecurity, digital payments, blockchain, and sharing and gig economy. Other themes that should be considered include software as a service, digitalization and cloud computing. Environmental, social and corporate governance investing (ESG) is one final theme that we believe has a huge potential, mainly driven by strong demand from millennial investors, and by proof from profitable companies that have embraced environmental sustainability as a business model.

Fixed Income

At the end of 2019, yields in fixed income securities were mostly unattractive, especially when compared to the earnings yield of equity markets. Bond yields were also expected to remain stable as the Fed, ECB and other central banks had signaled their intent of leaving monetary policy on hold. Hence, fixed income returns for 2020, both from an income and capital appreciation perspective, were expected to be muted. Nonetheless, the pandemic forced central banks into a renewed dovish policy stance, lowering reference interest rates and implementing additional rounds of bond purchasing programs. Safe haven assets such as U.S. Treasuries immediately rallied, with yields dropping to the lowest levels on record, where they have remained for most of the year. The yield on the benchmark U.S. 10-year Treasury dropped 100 bps from 1.92% at the end of 2019, to 0.9% currently, after reaching a low of 0.5% in the late summer months.

Credit markets, on the other hand, initially sold-off, particularly the lower rated high yield segment, but then later rallied bolstered by bond buying programs, while monetary and fiscal stimulus shielded the economy from long-lasting negative effects. Spreads on investment grade bonds in the U.S. have risen slightly, from 92 bps at the end of 2019 to current levels of 104 bps, despite reaching a spread of 380 bps at the height of the selloff towards the end of March. Similarly, spreads on U.S. high yield have risen from 340 bps at the end of 2019 to 380 bps, recovering from a staggering 1,100 bps spread (chart 5).

Chart 5: U.S. Corporate Bond Spreads (%)



Source: Bloomberg, Graph: BigSur Partners

Similar to equities, returns ended up being much more attractive than was anticipated, particularly in the U.S. As of mid-December, Treasuries, investment grade bonds and high yield bonds in the U.S. have returned 8%, 9.1% and 6.2%, respectively. However, this once again puts us in a difficult situation looking into 2021, with yields and spreads being on the expensive side with limited room for additional appreciation. Rather, yields seem more likely to increase throughout the year, especially if the vaccine effort is successful, people can return to their normal lives, the economy is able to operate at near full capacity and we finally have a break in inflation rates.

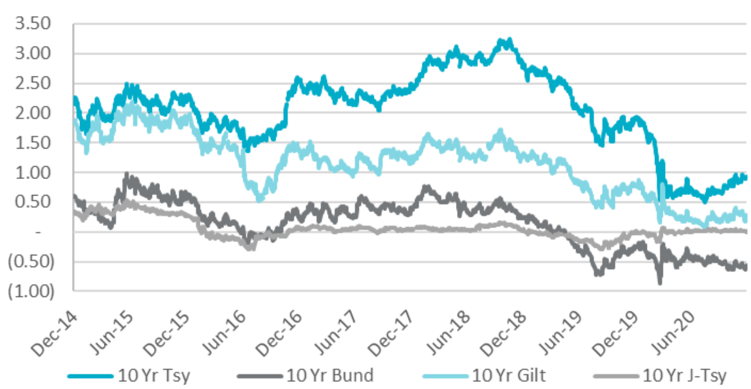
With this in mind, we believe there are three main investing themes for fixed income securities during 2021, which are as follows:

1. Underweight government bonds
2. Lower credit rating markets should outperform high-grade
3. Emerging markets remain attractive

Underweight government bonds

Sovereign bonds have rallied significantly through 2020, boosted by a rush of investors to safe haven assets, central bank implementation of bond purchasing programs and aggressive lowering of benchmark interest rates. As a result, government bond yields are ending the year significantly lower than at the end of 2019 (chart 6). This is a problem for fixed income investors, as bonds are not producing any meaningful income and in many cases have a negative yield, as is the case with many sovereign bonds in Europe. If things are bad with nominal yields, real yields, which remove inflation, are almost universally negative in developed countries. In this case, if rates were to remain stable, all investors would lose money, either by investing outright in negative yielding debt, or by earning a return that is below the increase in prices.

Chart 6: Sovereing Bond Yield (%)



Source: Bloomberg, Graph: BigSur Partners

We also believe that yields are actually more likely to increase, as has been the case recently, rather than fall. As markets continue to anticipate the end of the pandemic because of the expected widespread vaccination, investors will divest from safe havens such as sovereign bonds, while increasing the appetite towards risky assets that should benefit from the economic recovery. Finally, many investors buy sovereign bonds as ballast against market downturns. However, as we discussed in the previous Thinking Man[3], at current levels, sovereign bonds such as Treasuries are unlikely to continue offering protection to investors' portfolios, and have rather started moving in tandem with other risky assets. One of the recommendations of Thinking Man 81, which is a perfect segue for the next theme, is that investors

[3] Thinking Man 81 – The End of the 60/40 Portfolio

should consider replacing the government bond allocation, with a combination of cash and higher yielding credit.

Lower credit rating markets should outperform high-grade

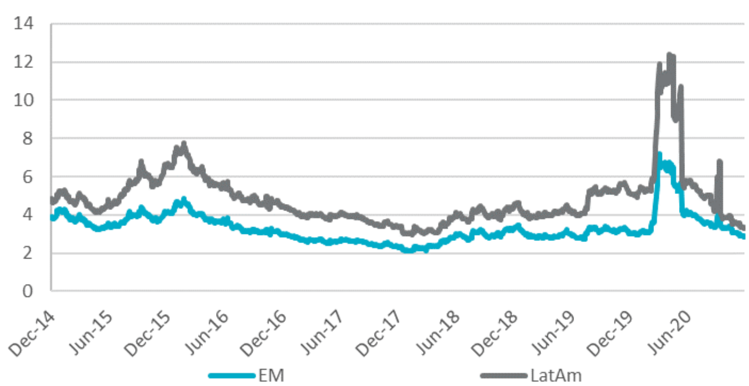
As mentioned in the introduction to this section, in credit markets, investment grade bonds have had the biggest returns in both the U.S. and Europe, as they have been one of the biggest beneficiaries of purchases from central bank bond purchasing programs. Even as the spread is slightly above the pre-pandemic level, additional spread compression from current levels seems limited. On the other hand, high yield bond in the U.S. remain close to 70 bps above pre-pandemic levels, offering more potential for spread compression. Additionally, from a yield standpoint, they are the only ones offering an attractive level of income for investors.

Nevertheless, high yields bonds remain relatively attractive because they are the most sensitive to defaults in case of a souring of the economic recovery, and many issuers in this segment correspond to the industries most affected by the pandemic, such as travel, leisure and energy. With this in mind, our recommendation is to select credits where investors are in fact rewarded for the risk taken, while avoiding the lowest rated bonds. One alternative is investing through mutual funds and ETFs, where credit risk is highly diversified, and who typically have a BB- or B+ average credit rating.

Emerging markets remain attractive

Emerging market bonds should benefit from the same reasons outlined in the equity portion of this article. Primarily, Asian countries have fared better throughout the pandemic, LatAm countries stand to benefit the most in case of a significant uptick of the regional and global economy, and a weakening of the U.S. dollar should benefit commodity-producing countries. Furthermore, a continuation of the economic recovery, accelerated by the vaccine, should increase the appetite of investors for risky assets, reversing the massive outflows seen during 2020. This will mostly be true for income deprived investors searching for yield. Both from a spread and yield perspective, EM bonds offer an attractive return, while still providing for some potential capital appreciation.

Chart 7: EM Fixed Income Spreads (%)



Source: Bloomberg, Graph: BigSur Partners

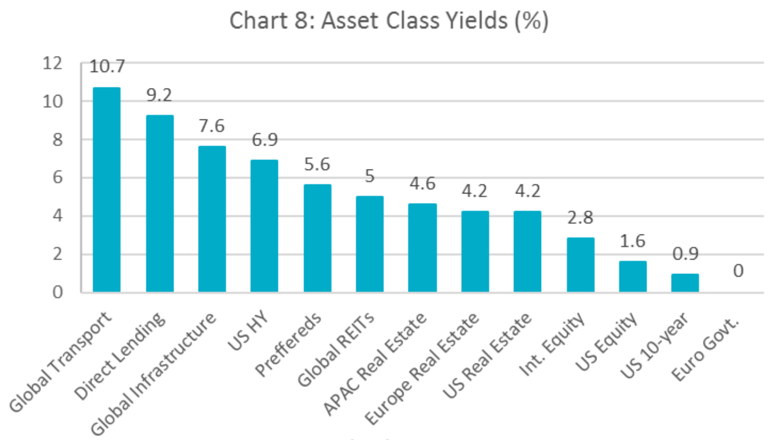
A weakening U.S. dollar also increases the appeal for EM local currency bonds, which could well end 2021 with the highest total return of any fixed income sub asset class, driven by higher yields, the potential for capital appreciation, and expected FX gains. Nonetheless, it is important to remember that despite commonly being pooled together, the EM regions are quite diverse, differing from extremely sound to extremely poor credits. Therefore, return dispersion in the region is likely to be significant, probably making credit selection more relevant than ever.

Alternatives

In last year's outlook, we spoke about the importance of manager selection, especially in the late stages of where we saw the economic cycle at that time. Throughout 2020, quality was key, and our focus was on continuing to carefully build-out our core alternative investment strategies. Alternative investment allocators need to navigate more anticipated volatility in 2021. Hence, we strongly recommend maintaining a focus on quality, not only for 2021, but also in subsequent years. Overall, we are pleased to report that our alternative investment managers have faired the COVID-19 pandemic quite well, with the exception of a number of assets.

Private Debt

Given the extremely low yield environment, we continue to recommend investments in private debt, which offer a significant illiquidity premium in today's market (chart 8). As of November 2020, the global stockpile of negative-yielding debt had ballooned to a record high, with the market value of the Bloomberg Barclays Global Negative Yielding Debt Index rising to $17.05 trillion.



Source: JPM Asset Management, Graph: BigSur Partners

The rigorous underwriting standard of private credit managers was put to the test amidst COVID-19, and proved the resiliency of private debt investments, in general, as they continued to generate income for portfolios without the same level of mark to market volatility.

While fixed income markets largely healed themselves and recovered, the spreads for liquid credit assets are below their historical averages given the unprecedented levels of central bank intervention and demand driven by investors searching for yield. Current spreads look fair assuming the default cycle has neared its peak, but if new shutdowns are put in place and reduced demand persists, defaults could quickly rise.

Private debt continues to serve as solution capital with wider and more attractive spreads, better documentation and lower leverage. Should markets once again enter a renewed period of stress, private credit strategies may find a new round of attractive entry points for lending capital, as a significant amount of "dry powder" has already been raised by private credit managers in 2020.[4]

Private Equity

When COVID hit, the majority of private equity managers entered defensive mode first rather than playing offense. Renewed market dislocations could provide access to attractive investment opportunities for long-term investors who are able to look through turbulences that could prompt other market participants to de-risk their portfolios. While the fundraising environment for private equity has been more muted than for private debt vs. beginning of year expectations, there is a record amount of unfunded commitments which could serve private-equity backed companies well in an environment where other companies are likely to face significant financial constraints. At the end of September 2020, private equity fund managers had $1,438 billion at their disposal, and had absorbed $317 billion of new capital, which is broadly in-line with the five-year average, but much lower than anticipated at the start of the year.

Initially prioritizing the protection of existing portfolio companies, managers have accelerated their investment pace amid lower entry multiples. According to data compiled by AlpInvest Partners (a core division of The Carlyle Group), between July and September, private equity managers announced leveraged buyouts (LBOs) totaling around $63 billion, more than tripling from the previous quarter when financial sponsors had given priority to helping protect existing portfolio companies from the adverse effects of the COVID-induced recession.

While larger publicly traded companies are performing strongly across the board, there are many small and mid-sized companies continuing to struggle, most likely providing for attractive entry points. This can particularly be seen for smaller companies, which serve as add-on acquisitions to platform investments. Valuations in private markets for large buyouts and larger middle market transactions remain quite high, but we continue to seek pockets of opportunities in markets with differentiated managers investing across secular trends.

Venture Capital

According to the same report published by AlpInvest (Carlyle), the rebound in LBO volume was accompanied by a significant increase in the funding of startups. Venture capital GPs accelerated their deployment in 2020, with investment volume totaling more than $100 billion globally by the end of Q3.

Valuations in late stage venture may be a sign of market froth, and it is something we are closely monitoring. A research piece published by CB Insights in 2019 eloquently stated this trend of jumbo-sized financings, calling it the "foie gras'ing" of startups because deal sizes and valuations have been significantly inflated, and VC funds continue to become larger and larger. This increase has not been necessarily justified, but is rather the result of investors feeding into the cycle of capital abundance to

[4] Dry Powder typically refers to the amount of committed, but unallocated capital. In other words, its unspent cash reserve that is waiting to be invested.

lavishly fund companies in order to ensure access to highly coveted names. In summary, this overfunding is expected to lead to diminished returns and multiples over the long-run, and could be the catalyst for a renewed tech bubble.

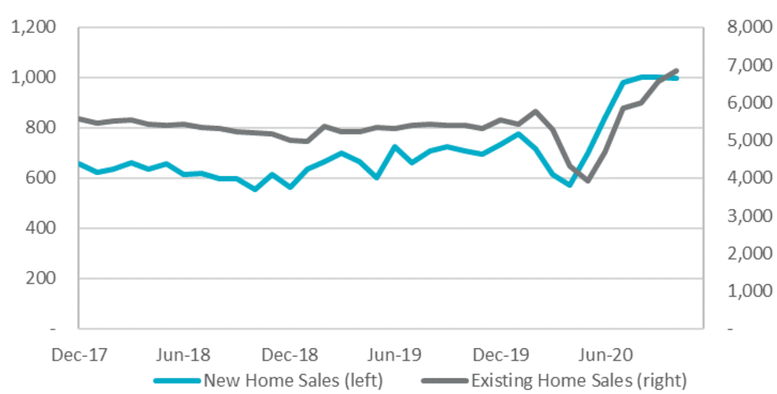
According to data compiled by Refinitiv, companies have raised a record $149 billion through initial public offerings and special purpose acquisition companies (SPACs) in the US this year. It is important to point out that the valuations of recent IPOs are at their highest levels since the dot-com bubble, with investors valuing newly public tech companies at a median of 23.9x the revenue they reported in the 12 months before going public. That measure is by far the highest of the past two decades. For most of the 2010s, the median multiple for a tech company after its first day of trading hovered around 6x its revenue in the prior 12 months.

We believe venture-backed technology companies will continue to revolutionize the world as we know it, and continue to increase our allocations in the space but in a controlled manner, ensuring that portfolio sizing is commensurate with the levels of risk. Our preference is to invest in early stage managers that have the most potential for value creation, and will continue to selectively make investments in late stage and pre-IPO opportunities that we believe offer defensible business models for the long term.

Real Estate

Despite the economic turmoil brought by the pandemic, real estate has been one of the few sweet spots. The combination of low interest rates and a spike in demand from individuals looking to relocate to escape from the pandemic has resulted in strong rebound in home sales. Both of existing and new home sales have not only surpassed pre-pandemic levels, but are currently at pre-GFC levels (chart 9). This exuberance of the housing market has extended to other real estate investments.

Chart 9: U.S. Home Sales (thousands)



Source: Bloomberg, Graph: BigSur Partners

Government transfers and aid programs prevented a massive wave of defaults in mortgages that was feared at the start of the pandemic. However, the majority of the current fiscal stimulus that has helped keep many individuals afloat expires at the end of the year, and the new approved stimulus is significantly smaller. If the new plan falls short of expectations and Washington were to remain in gridlock regarding additional stimulus, a wave of defaults could effectively hit the market through 2021.

Currently the worst hit sector has been office space, as many people remain working from home. The outlook remains weak, as many large companies have announced their plans to continue having their employees working from home until at least the summer of 2021. Some have even gone as far as disclosing plans for a flexible work schedule where employees would only be required to go to the office for a couple of days a week. If this trend were to consolidate, there would be less demand for office space going forward, with current supply significantly exceeding demand.

On the bright side, most of the other sectors have remained strong through the year. This includes multifamily, student housing, senior living, medical and logistic facilities. The stability of these sectors has proven the resiliency of these types of investments to the economic cycle, as demand has remained largely unchanged, while supply has not kept up. Thus, we continue to advocate for investments in these sectors, but as always through experienced managers, with a proven track record.

Asset Allocation

We conclude this section with our current recommended BigSur Partners Moderate Tactical Allocation. As usual, the asset allocation represents our suggested model portfolio that incorporates our views and themes discussed previously in the article. Starting this year, we are also comparing our suggested portfolio with the average family office asset allocation, published in the UBS Global Family Office report, which can be seen in Table 1.[5]

Table 1

	2020	
Asset Class/Type	**BigSur Partners**	**UBS GFO Report***
Cash	6%	13%
Fixed Income	32%	17%
Developed Markets	26%	11%
Emerging Markets	6%	6%
Equity	35%	29%
Developed Markets	30%	23%
Emerging Markets	5%	6%
Alternatives	24%	35%
Private Equity/Debt	15%	16%
Real Estate	7%	14%
Hedge Funds	2%	5%
Real Assets	3%	6%
Gold	2%	3%
Other commodities/intangibles	1%	3%

*Source: UBS Global Family Office Report 2020

For comparison and statistical purposes, 121 family offices were surveyed for the report. The average total net worth of those who reported was $1.6 billion. From the total family offices surveyed, 46% support only one generation, 48% support two generations and 5% support three generations. Looking at inception date, 69% were founded since 2000, 26%, were founded in the second half of the previous century, and 5% before then. Finally, the surveyed family offices are spread across 35 markets, with two-

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[5] The UBS Global Family Office Report focuses on 121 of the world's largest single family offices, covering a total net worth of approximately $142 billion USD, with individual families' net worth averaging $1.6 billion USD.

thirds based in EMEA (including Switzerland), with the remaining one-third located in Hong Kong, Singapore, the U.S. and Latin America.

3. Potential Risks

If there is a lesson to be learned from 2020, is that investors should not underestimate any potential risk, and should always structure their portfolios in a way that attempts to mitigate losses from unanticipated black swan events. For 2020, we had identified several risks, being the November U.S. election the most important in our view. However, the U.S. election was mostly uneventful for financial markets, despite claims of massive voter fraud by President Trump, and a series of lawsuits in several swing states. Throughout the year, markets and investors remained focused on the evolution of the Covid-19 pandemic, as it could have major short and long-term consequences.

For 2021, we have identified four significant risks that have the potential of derailing or delaying the global economic recovery, which are as follows:

1. The Georgia Senate runoff elections
2. The Covid-19 vaccine is not effective
3. The U.S. government pursues an aggressive Big tech breakup agenda
4. The U.S. – China confrontation continues to escalate

Georgia Senate runoff elections

Five days into the new year, Georgia has two runoff elections for both of its Senate seats. The elections have gained an unusual national attention because Democrats need a victory in both races to be able to reach 50 Senate seats[6], giving them more flexibility to implement a much more progressive agenda under the presidency of Joe Biden. Republicans, on the other hand, need to win at least one of the races to retain the majority of the Senate, preventing a Democratic control of the government. We believe that this is an imminent risk, as we believe that the market has priced in a divided government (where Republicans effectively retain control of the Senate). This is relevant as a gridlock in Washington, will prevent Democrats from passing legislation that can have a negative effect in financial markets, such as a rollback of the Trump tax cuts, and increased regulation for financial and energy companies, amongst others. In the event of a surprise victory by Democrats in both races, the market would probably have a temporary pullback as it adapts to new expectations.

Covid-19 vaccine is not effective

As we are writing the outlook, the U.S. and other countries around the world have begun the Covid-19 vaccination enterprise. Our base case scenario, as mentioned previously, is one where the vaccine is effective, at least 70% of the population gets inoculated, and the word is able to return to some sense of normalcy throughout the year. Nonetheless, the future of the global economy seems to rest in the success of this single event where there are many logistic, scientific and medical obstacles to overcome, and can

[6] In case an equally divided vote in the Senate, the Democratic Vice President elect, Kamala Harris, will be the deciding tie-breaker.

prevent the base case scenario from materializing. The first approved vaccine, at least in the western world, is from Pfizer/BioNTech, which requires a logistical nightmare, as it needs to be stored and shipped, while preserving a temperature of -94° F (-70° C). A second vaccine from Moderna, which uses more readily available cold chains, has recently been given the green light by the Food and Drug Administration, helping to simplify the logistical hurdles.

Even if the vast majority of the population can be offered a vaccine soon, it remains to be seen if people are going to be willing to take it. It is important to remember that before the pandemic, the U.S. had a growing number of parents who were rejecting to vaccinate their children. This adds to recent conspiracy theories, that could potentially prevent an important portion of the population from voluntarily getting vaccinated. Epidemiology experts believe that at least 70% of the population needs to have antibodies either by natural contagion or by a vaccine, and if a significant portion of the population are not willing to get inoculated, this could prevent the population from reaching the needed herd immunity. Finally, and probably the biggest threat, is that the virus could mutate, becoming resistant to the vaccines currently being developed. In fact, there have been documented cases of mutations of the SARS-CoV-2 virus in the U.K. and Denmark. If for any of the aforementioned reasons, the vaccine is not effective, then people will not be able to go back to their normal lives and most companies from troubled industries such as travel, leisure and entertainment would go bankrupt, generating an enormous economic destruction from which it would be difficult to recover from.

U.S. government pursues and aggressive big tech breakup agenda

One of the few things in which there is a consensus agreement in Washington, is that technological companies have been allowed to grow unchecked. A "Standard Oil" moment[7] could be in store for technological companies starting in 2021. Recently, the CEOs of many of the big tech companies have been summoned to Washington to testify before the Senate Committee on Commerce, Science and Transportation. Facebook has been sued by the Federal Trade Commission and by a group of 48 states for predatory behavior. This looks like just the beginning of an extensive process that apparently seeks to, at least, control the growing power of tech companies, but could well end up breaking them up. We believe this could generate unnecessary noise in the market, at least, in the short term. Increased control through regulation could very well limit the companies' potential profits in the future. Nevertheless, even as a complete break up into separate businesses could be a traumatic event for the market in the short term, in our view, these businesses might be worth more as standalone companies. If this were the case, even as it could be a short-term risk, it could end up being positive for investors in the long run.

U.S. – China confrontation continues to escalate

In the years prior to 2020, probably the main factor dominating investors' attention was the fear of an escalation of the trade confrontation between the U.S. and China. Even though this year the attention shifted to the pandemic, the Trump administration still signaled its intention to contain the growing Chinese threat. During 2020, the administration tried to block Chinese apps TikTok and WeChat, while at

[7] Referring to the mandated break-up of the oil giant at the beginning of the previous century

the same time trying to force a sale of the former. A bipartisan bill that forces exchanges to delist Chinese companies that do not comply with U.S. accounting standards has also been approved. Even as President elect Biden is widely expected to be more diplomatic, especially when it comes to trade, in recent comments he has acknowledged that he will not immediately rescind the tariffs imposed on China by the current administration. There is mounting pressure on lawmakers to contain the aggressive Chinese expansion, and this could push the Biden administration to continue or even escalate the current trade confrontation, in a time where a fragile global economy is still recovering from the pandemic shock.

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