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Executive Summary

The massive human tragedy of COVID-19 was met with a correspondingly massive response from science, technology and big government. Science delivered the vaccines. Technology delivered the digital world in which we carried on working. Big government delivered relatively successful economic management of the crisis through its immense combined fiscal and monetary response.

Over the long-term we remain acutely aware that record-breaking government debt issuance and record-breaking central bank balance sheet expansion leave investors vulnerable to asset bubbles and possible bouts of "taper tantrums" or high inflation if we see policy errors from governments and central banks.

Against this backdrop, we see a continuation of low investment returns in the decade ahead, underlining the importance of portfolio allocations to the less efficient sectors, well off the beaten path, with a bias toward private markets.

We are likely to experience more market volatility, more risk of excesses, more risk of policy errors, all pointing to higher returns from active management.

The greatest learning though, from 2020, was the critical importance of staying fully invested in the world of science and technology which is also most likely to be a meaningful part of the solution to preserving the health of the planet and the people on it.

Looking back. At the end of February 2020, we published *Partners Capital Insights 2020* with no visibility of where the pandemic would take us. With that uncertainty clouding our view, we looked to the long-term and hung onto the view that the fundamental underlying drivers of the global economy pointed to slow but volatile growth in the years ahead. Ongoing developments around the US-China trade war and the upcoming US election were moving markets at the time. It was clear even at that early point in COVID-19's spread that the virus would have a tragic impact on human life but we could only very broadly "bookend" the range of possible outcomes somewhere in between the 2002-03 Chinese SARS outbreak which killed fewer than a thousand people and the 1918-20 Spanish flu which is estimated to have killed 50 million. Now, tragically with 2.5 million deaths from COVID-19, we have a much clearer sense of where COVID-19 sits on the global pandemic spectrum. The history-making $20+ trillion global fiscal and monetary response was a welcome surprise during 2020 which flooded the market with support payments and liquidity. This support, combined with a COVID-fuelled acceleration in technology adoption, buoyed risk asset valuations. Global equities increased in value by +15% on top of the 2019 rise of +27%, compounding equity prices up 46% over the last two calendar years.

Looking forward. In stark contrast to where we were even one month ago, we can all "bookend" a much narrower range of scenarios depending on vaccine effectiveness against new emerging strains of COVID-19. As the dust settles on the trajectory of the virus and the fiscal and monetary stimulus, there is a light at the end of the tunnel. With this Insights 2021, we focus on what we think we will encounter once we are propelled out the end of this dark tunnel that none of us ever want to revisit. This document translates our views on eight key macro risks into a range of macro scenarios and overlays those on the strategies for each of our ten asset classes and, from that, we extract our investment themes and recommended 2021 tactical asset allocation.

The COVID-19 pandemic has already changed the world we live in more radically than perhaps any other event in most of our lives. Many of us now spend the majority of our days in the virtual or digital world and come to appreciate its advantages to productivity and its disadvantages on social and mental health dimensions. The pandemic gave a giant boost to the digital economy in the form of accelerated technology adoption and development that was already accelerating. In spite of the geographic origins of COVID-19, it has had the perverse impact of rebalancing economic power in favour of the East over the West, and China over the US in particular, as a result of differences in the past year's management of the virus and how its ongoing challenges will be managed.

The pandemic has enlarged the government's role in our daily lives and radically accelerated the shift of a new paradigm of zero interest rates and coordinated monetary and fiscal policy management. COVID-19 shined a spotlight on the economic and social inequality in the world and our time locked up at home led us to hold more sacred the goal of preserving our physical world for future generations.

While we can now see a light at the end of the COVID-19 tunnel, there remain significant uncertainties. When we re-read this passage during next year's writing, we will know that COVID-19 has become endemic in the world, meaning despite vaccinations, COVID-19 is going to be in circulation, at least in some regions, for the foreseeable future. The long-term implications of this range from continued small regional outbreaks to global annual seasonal vaccination campaigns. The exact point we reach one year from now depends on the extent of ongoing mutations in the virus, the degree to which the world becomes successfully vaccinated and the duration of immunity derived from infection or vaccination.

On the back of the shortest and sharpest recession in recent history where -3.5% was shaved off the global economy in 2020, the IMF and others now expect to see the much anticipated V-shaped recovery expanding global GDP by +5.5% in 2021 and +4.2% in 2022. This compares to a 20-year average global GDP growth rate of +3.3%. This will likely cause inflation to rise moderately, allowing central banks to keep monetary policy accommodative for several years. In addition, the targeted fiscal support to lower-income groups will help reduce imbalances, associated social tensions and populist forces that gained prominence in the post-GFC period of QE combined with fiscal austerity.

Near term, expect inflation. Long-term, not so much. In our base case scenario, developed market inflation is expected to increase from 0.7% in 2020 to 2.0% in 2021 and carry on at 2-3% in the US and 1.5-2% in Europe through to 2025. This is slightly above consensus estimates. The main factors supporting our base case view of moderately higher inflation are consumption increases resulting from the easing of mobility restrictions (which will mainly impact 2021), combined with aggressive (but not excessive) fiscal stimulus aimed at infrastructure and green investments which will persist over time.

There is a more severe high inflation scenario over the next five years which could result from an even more progressive political agenda across the developed markets. Such an agenda would be characterised by persistent fiscal largesse aimed at income support rather than investment, continued easy monetary policy, increased supply chain frictions as a result of both greater protectionism and post-pandemic supply chain localisation, and policies aimed at income redistribution. This more severe upside inflation scenario is lower in probability due to likely checks and balances from resulting tighter monetary policy.

Global fiscal stimulus in response to COVID-19 has accumulated to c. $15 trillion since the beginning of the pandemic. This represents 17% of 2019 global GDP of $87.6 trillion. “Normal” annual budget deficits range from 0% (Germany) to 4.7% (US in 2019) for the larger members of the OECD. This level of fiscal deficit has required the US government to borrow an average of $700B per annum from 2014-19. The required net increase in government borrowing spiked in 2020 to $4.3 trillion and the US government is forecast to borrow another $2.8 trillion in 2021. The incremental borrowing cost of COVID-19 to the US government therefore amounted to a total of $5.7 trillion ($4.3T + $2.8T less $700B for two years) for a one-time increase in US government debt representing 28% of US GDP.

So much debt. So many questions jump out at us when we ponder this $5.7T figure. Firstly, who will take up this debt and what impact will that have on interest rates? Secondly, how will this affect future growth of the US economy? There are four classic holders/buyers of US government bonds: Intragovernmental agencies (who hold 26% as of November 2019), the Fed (10%), foreign investors such as China and Japan (30%) and US investors such as mutual funds and pensions (34%). In 2020, the Treasury found out who could stump up for the total of $4.3T in net new bond issuances. Foreign investors took up only 3.5%, intragovernmental agencies cut back as well just taking up 3%, while US investors took up 40% which was just ahead of their 34% share of holdings. The Fed had to step up meaningfully and took 54% vs the 10% that they held of the total outstanding just prior to 2020. So clearly, the Fed seems to be the buyer of last resort. They did not leave it for the market to clear as that would have had undesirable consequences for interest rates. We expect a more extreme picture will emerge to fund the expected $2.8T in net new US treasury bond issuances in 2021 as US investors revert to their normal appetite leaving the Fed to purchase an estimated $2.1T or 75% of 2021 bond issuance.

Beyond 2021, we expect net new debt issuance to fall to a $1T per year rate, or c. $300B p.a. above historic norms, adding perhaps another $1.2T to the Fed balance sheet by 2025. This would take the total Fed balance sheet to roughly $11.3T (all assets, including Treasuries, MBS, etc.), which is c. 53% of the 2019 US GDP. The compares to 19% at the end of 2019. We note that the Fed’s balance sheet projection at 53% of GDP is marginally less than that of the ECB at 58% as of January 2020, and well below the BoJ’s current balance sheet size worth 128% of Japan’s GDP.

Central bank balance sheets – is the sky the limit? The implications of a growing central bank balance sheet are just as controversial today as they were in the heydays of quantitative easing after the GFC. Many experts believe there is no fixed limit on how much of its own government debt a central bank can buy. With a balance sheet measuring 128% of Japanese GDP, The Bank of Japan has proven that there may be no limit to the size of a central bank’s balance sheet as they have yet to be successful in creating inflation from massive asset purchases. However large central bank bond purchases run risks of increasing inflation, asset bubbles and, for some countries, currency volatility. In today’s context of low inflation, the goal of the Fed and

Exhibit 1

The Fed has had to step in to purchase the majority of US government bond issuance created by the massive 2020-21 stimulus

Holders of US Treasuries	1 November 2019 Balances Held		Purchases of 2020 Net Issuance		Estimated[1] Purchases of 2021 Net Issuance	
	US$ Billions	Portion of Total Debt	US$ Billions	Portion of total 2020 issuance	US$ Billions	Portion of total 2021 issuance
Intragovernmental	5,971	25.9%	126	2.9%	195	6.4%
Foreign Investors	6,902	29.9%	152	3.5%	198	6.5%
US Investors	7,997	34.7%	1,753	40.1%	293	9.6%
Fed	2,206	9.6%	2,340	53.5%	2,370	77.6%
Total Debt Held/Issued	**23,076**	**100%**	**4,370**	**100.0%**	**3,056**	**100.0%**

Note: Estimates assume purchases ex-Fed continue at their 5-year CAGR
Source: US Treasury, Partners Capital Analysis

other central banks is to modestly boost inflation, without creating bubbles that will lead to economic and financial market instability in later years. When inflation approaches target levels, the central banks will attempt to 'taper' asset purchases, without triggering much higher interest rates. This is the tricky bit that the Fed got wrong in the 2013 'taper tantrum' when bond yields spiked over 100bps on poor signaling, but got right in the subsequent 2014-2019 tapering and balance sheet reduction process which went smoother.

Interest rate implications. Central bank policy will remain highly accommodative over the next 1-2 years. Policy rates in major developed market economies are unlikely to be changed over this period. However, the combination of rising inflation expectations and elevated debt issuance, particularly in the US, may lead to rises in bond yields beyond what is priced in the market forward rates (i.e., 2.4% 10Y treasury yields at the end of 2025 vs 1.4% today). If the Fed deems any such yield rises as excessive, i.e., likely to imperil economic stability, it has the ability to actively intervene via asset purchases to limit rate increases. Moreover, private investors will look to take advantage of the rising yield differential between US treasuries and other DM government bonds (e.g. Bunds and JGBs). In January, US Fed Chair Powell described any focus on tapering of QE as "premature", but this is likely to remain a key focus of the market throughout 2021. A tail risk scenario of persistently high inflation remains the main risk over the long term as that could propel yield levels significantly higher. In the meantime, a moderate rise in yields in the context of rising economic growth should not imperil broad equity valuations but may favour Value stocks over Growth stocks.

China growth. The world's second largest economy's growth prospects have not changed from the aftermath of COVID. While global supply chains will be diversified away from China to other low cost offshore sources and back onshore, China's resilience in responding to COVID has put it on firmer ground for recovery. China needed far less stimulus than Western economies, leaving it with more fiscal spending headroom for the future. The continued economic prosperity of China may see international headwinds from geopolitical issues including human rights abuses and its relationships with Taiwan and Hong Kong. While tensions could escalate inadvertently, experts do not see China deliberately initiating a war over Taiwan any time soon. Recent events in the Taiwan Sea were merely heavy-handed signalling to the new US administration that they should be more careful than Biden's predecessor when interfering in the relationship between Taiwan and mainland China. It is clear that the strategic rivalry between the US and China will continue to intensify over these issues and the technology war and this rivalry will be one of the defining themes that shapes the world over the next decade.

Alternative Routes to Impact through Investing. Institutional investors have a number of alternative routes to having their capital have the most positive impact on the planet and the people on it. We see two particular paths to be most effective and both can be adopted by the same investor. The first is what we refer to as the positive impact allocation approach where we shift the portfolio in the direction of assets that are having the most positive impact. This would have us owning assets that are having a positive impact today e.g., investing in hydrogen fuel cell manufacturers such as Air Products or Fuel Cell Energy. We would also seek to own companies that are showing evidence of change and progress, e.g., by transforming themselves fastest from a high carbon emitting business to a low emissions business – companies like Hawaiian Electric which is rapidly converting its oil-based power infrastructure to renewables.

The second approach is what we refer to simply as the engagement approach. Here the institutional investor (which includes Partners Capital and its institutional clients) engages with their active asset managers to help them transform their processes for engagement with company management. We estimate that the managers with whom we work most closely manage over $2 trillion in assets, which reflects the leverage we can effectively gain from the $38B we manage today. Our efforts to take best practices in ESG integration to our managers is perhaps the highest and best use of our research team resources under the heading of impact investing. We should add that many of our asset managers are "activists" and have long engaged directly with management teams on ESG matters as well as other drivers of improved performance.

Also under the engagement approach, we encourage our clients to join investor collectives focused on ESG and impact including climate-focused alliances such as the Institutional Investor Group on Climate Change (IIGCC) which today represents over €35 trillion in assets and over 270 institutional investors across 16 countries. Its members use the combined weight of their capital to influence management teams of the businesses they own to cut emissions to help achieve the goals of the Paris Agreement, to accelerate the transition to net-zero emissions by 2050, and to ensure resilience of those investments to the impacts of a changing climate.

Our approach is to go down both of these routes on behalf of our clients, and in so doing, believe we are doing the most possible towards enabling our clients' capital to have the greatest impact on the future of our planet and society.

Macro Scenarios. Our base case scenario for 2021 is for the COVID-19 vaccines to do their job before new strains gain traction. The much touted "V-shaped" recovery is delivered as promised, generating 5.5% global growth in 2021. We see spikes in short term inflation, but longer term inflation remains just over 2% in the US and just under 2% in Europe. US relations with China improve under Biden, but are still tense given the importance of technology supremacy and China's influence in the region including Taiwan. We see bouts of concern about longer term inflation and interest rates correcting growth equities ahead of value and quality equities.

Investment Implications: One major touchstone in our investment process is our work on asset valuations as one of the last steps following all of our macro research and asset class trends analysis. Valuing assets in each asset class seeks to rein in all of this uncertainty and land on something tangible and reliable for making investment decisions. Our job at the end of the day is to deploy your risk budget optimally to a diverse set of opportunities that represent the best expected returns for that risk budget. Any given asset's returns are influenced by its modeled value at any point in time, and how that value differs from its price. There are two key inputs to an asset's valuation: the growth of its cash flows and the discount rate used to discount those cash flows back to the present.

How does the 2021 macro context fit into our valuation framework? With massive fiscal spending, economic reopening and the release of pent-up savings likely to lead to a perfect storm of record global economic growth over 5% in 2021, it is no surprise that developed market corporate earnings growth is expected to rise by c. 30%. Such an outcome would clearly be beneficial to the cash flow assumptions in our valuation models. The real question is around the rate at which those cash flows will be discounted at. Over the past decade we have become accustomed to very low or at best moderate inflation levels which have kept interest rates anchored at historical lows. We continue to expect that any rises in both inflation and interest rates will be moderate. However, perhaps more than ever since the GFC, there is a risk that inflation could rise higher than levels we have seen in the last decade. Some reflation is a healthy sign of a growing economy and supports returns across asset classes, including equity markets. However, it is never certain that policymakers will get the balancing act right, and mis-steps could lead to higher inflation and interest rates which would have negative consequences for both risky assets (particularly growth equities with back loaded earnings) and safe assets (bonds). In this context, we begin to increase our allocations towards those assets best positioned for rising growth and inflation as outlined in the Themes and TAA sections below. What falls out of this analysis is likely to be more volatility, more risk of excesses, more risk of policy error, all pointing to higher returns from active management.

Themes: Our themes every year are borne out of our core thinking on what the world will look like in the medium to long term. We look for multi-year themes that will benefit from our long-term investment outlook and so would expect few changes in any given year, even after one as turbulent at 2020. Accordingly, this year we maintain many of the themes from previous years, including our theme of "long innovation", focusing on technology and life sciences companies. We also maintain our overweight to China, focusing on domestic and secular themes with long-term tailwinds. Low future liquid asset class returns underpins our push for larger allocations to private markets where we skew client investments off the beaten path. We also maintain that investors should diversify their safety net allocation of assets, in particular those assets that would afford inflation protection in a portfolio, following a year of record monetary and fiscal stimulus in developed markets. In our *July 2020 Insights* update, we introduced our 'prepare for inflation' theme that is increasingly becoming a consensus view in shaping portfolios. While we prefer to think about ESG and impact investing as a permanent part of the fabric of any sensible long-term investment strategy rather than an investment theme, inclusion as one of our core themes keeps the spot light trained on our engagement with asset managers on their own ESG integration and on our scale of effort in finding and securing unique access to the managers most likely to drive impact and performance in tandem.

Tactical Asset Allocation: We constantly assess potential moves that could be made around a generic asset allocation to take advantage of our views on key asset drivers for the short term, and through our medium to longer-term themes. This year, in light of rising inflation risks, we are further reducing our nominal government bond and other interest rate duration exposure, boosting inflation-linked bond allocations, and increasing allocations to absolute return managers who are best placed to profit from rising volatility in interest rates. We continue to have a preference for private debt over liquid credit, and have strengthened this view this year, removing liquid credit entirely from our Strategic Asset Allocation (SAA). Private debt continues to take advantage of opportunistic lending strategies, sector specialists and less-correlated alternatives such as litigation-related strategies, offering a significant premium to Liquid Credit. We also continue to prefer specialist equity managers that can invest both long and short in opportunities.

Risks to our outlook: Following a year that saw our outlook rapidly change as COVID-19 unfolded, we continue to think of events that could most dramatically alter our outlook. In addition to the risk of inflation and rising interest rates outlined above, two risks that were centre-stage in 2020, continue to be present in 2021. First, with regard to COVID-19, the potential for further activity disruptions cannot be entirely excluded. While vaccine developments are unambiguously positive, the risk that emerging new variants that may bypass existing vaccines, or auto-immune responses, cannot be excluded. In the geopolitical arena, although the Biden presidency will decrease uncertainty around the US-China relationship, core strategic tensions will remain, particularly around the technology race and territorial expansion in Taiwan and in the South China Sea. We continue to monitor these risks most closely.

Reflections on Insights 2020

Taking a look at our base case macroeconomic scenario from this time last year offers a valuable opportunity for both humble introspection and positive reassurance. Our base case outlook did not envisage the largest pandemic since the 1918 Spanish flu, the biggest economic collapse since WWII, nor the largess of governments in providing over $20T in fiscal and monetary support that would shorten the collapse to one of shortest recessions in modern history. So we missed all that. What we got most right was our strong belief that client portfolios should be "long innovation," not because COVID would give it the boost it did, but just because of the accelerating nature of science in the world today which we think will be a tailwind in good and bad times. We also got our overweight to Asia right. This is based on a thesis of China's growing role in the global economy as inexorable. Most importantly of all, we went into 2020 with the right set of active asset managers – in both the liquid asset classes and illiquid. The quality of their teams meant that they were quick to see the importance of the pandemic and re-underwrite the prospects of each company in a post-pandemic world and move portfolios in the right direction. 2020 was a year of record outperformance for the majority of our asset managers. Our 26th January 2021 webinar provided our clients with a deep dive into the main drivers of that outperformance, but one word described it best – nimbleness.

Stepping back from the individual manager success and what macro views we got wrong or right, 2020 reminded us of some important and timeless lessons which should underpin investing as we look to 2021 and beyond. These lessons help us to invest with a clear head against a backdrop of imperfect knowledge of what lies ahead.

- The world is always uncertain. There are cycles of valuation excesses, debt bubbles, fiscal uncertainties, geopolitical and natural disaster risks. COVID-19 was the perfect example of this. While the future is looking more positive, there are always unanticipated events that could send the global economy into recession or worse. There could also be unexpected positive developments that surprise our upside scenarios
- Maintaining a steady risk level over the long-term outperforms short-term market timing. The COVID-19 experience illustrated this point perfectly. With DM equities declining -32% from February to March 2020, before recovering by +62% into year end, our process of strictly rebalancing portfolio risk to target levels allowed client portfolios to benefit from this recovery. Remember that taking exposure off only works if you know when to put it back on. One needs to get two calls right for it to make sense. So rationally, we advocate staying invested at all times.
- Avoid betting on a single outcome or scenario. As seen in our 'Macro Scenarios' chapter, we take a "probabilistic" approach with the aim of maximising expected returns across a range of scenarios.
- The multi-asset endowment investment model is a natural diversifier given the various risks we see ahead. Diversification both across and within asset classes is as critical to hedging against such unknowable risks as it is to the more known ones.

Below we review our key macro views for 2021 which in turn inform our economic scenarios.

Key Macroeconomic Questions for 2021

1. What is the near-term outlook for COVID-19?

Experts at the World Health Organisation believe that the ultimate endgame for COVID-19 is that the virus will likely become endemic. Endemic is a broad term but it means that despite vaccinations, COVID-19 is going to be in circulation, at least in some regions, for the foreseeable future. The long term implications of this could range from continued small regional outbreaks to global annual seasonal vaccination campaigns and the possibility of children being vaccinated as part of the routine childhood immunisation schedule. The exact path depends on the extent of future mutations in the virus, the degree to which the world becomes successfully vaccinated and the duration of immunity derived from infection or vaccination. The current vaccine campaign and therapeutics being utilised and developed at present will likely do most of the heavy lifting and reduce the main threat posed by COVID-19. This should mean that draconian lockdowns become a distant memory, but the virus' footprint will leave a lasting impression on the world. Importantly, this will not prevent the western world from returning to a state that is close to normality. It will mean that travel and border security will be more restrictive in the coming years though.

Vaccination of those most vulnerable should facilitate a controlled reopening of developed economies and a return close to normality in Q2 2021. Our base case outlook is for the US to have vaccinated c.70% of the population by mid-June, with the UK achieving this level about a month earlier and Europe about two months later. Assuming the vulnerable get priority access to vaccines, deaths associated with the virus will drop to near-zero by April. This will allow a phased removal of restrictions by early March, with something resembling normal activity levels achieved by the end of the second quarter. Experts believe this will lead to a consumption driven growth spurt in Q2 and Q3. Risks to this scenario could arise from more resistant variants or logistical issues in vaccine rollout. However, at this point in time, vaccine producers believe that a combination of existing vaccines and boosters currently in development will reduce the prevalence of COVID-19 and its variants to few regional outbreaks with low levels of resulting mortality.

2. What longer-term structural changes are expected to result from the pandemic?

Even as the pandemic fades over time, it will leave a lasting footprint on the planet, mostly around how we live and work. In the private sector, structural impacts will include a continued shift towards economic digitisation resulting in a greater proportion of time spent working remotely and a greater share of consumption shifting to e-commerce. Supply chains will become more domestic, often prioritising stability and redundancy over pure lowest cost sourcing and JIT management. Big government will loom large in our daily lives, with more spending, taxation, healthcare monitoring/provision, and regulation.

- **Big government is back:** We anticipate that governments will continue to play a more active role in our lives in the post pandemic world. Heightened control and influence are the price for aggressive stimulus schemes to rebuild the economy with an eye towards decarbonisation and wealth redistribution. The extent and the duration of this more active role remains uncertain.
- **Remote working has accelerated technology adoption:** COVID-19 has compressed a decade's worth of digital adoption into the space of a year. As well as the shift to remote working, consumption habits have changed forever with technology facilitators being the key beneficiaries.
- **The commercial real estate market has been fundamentally changed:** The shift to remote work means that office attendance is expected to drop by 15-30%. The impact on the real estate market is expected to be more benign and may have already been reflected in valuations.
- **Onshoring and diversification of global supply chains has become a priority:** The pandemic has laid bare all of the vulnerabilities in the global supply chain. Experts believe there will be a clear shift away from a focus on cost and efficiency to resilience. This could lead to lower corporate profits, inflationary pressures and some shift in production away from China.
- **Business travel will be structurally reduced:** While leisure travel will eventually recover, business travel is unlikely to ever return to pre-pandemic levels and this will have a significant impact on airlines, hotels and hospitality in general.
- **The physical economy has given way to the digital economy:** COVID-19 has reshaped the global economy with equity sector weightings reflecting a more digital future.

3. What are the long-term economic growth implications of the massive fiscal spending and related government deficits and debt?

In the base case scenario, the global economy is expected to get its much anticipated "V-shaped" recovery expanding by 5.5% in 2021 and 4.2% in 2022. This compares to a 20-year average global GDP growth of 3.3%. This will cause inflation to rise only modestly, allowing central banks to keep monetary policy accommodative for several years. In addition, the targeted fiscal support to lower-income groups will help reduce imbalances, associated social tensions and populist forces that gained prominence in the post-GFC period of QE combined with fiscal austerity.

However, there is a meaningful risk that inflation (and more importantly inflation expectations) become untethered for lengthy periods, central banks are forced to act and withdraw liquidity. This could result in a more classical boom/bust economic cycle that was typical before the great moderation of the post-GFC period, resulting not only in economic instability, but even greater social tensions and a devaluation of risk assets.

4. What is the outlook on inflation in the context of record levels of both fiscal and monetary stimulus?

In our base case scenario, developed market inflation is expected to increase from 0.7% in 2020 to 2.0% in 2021 and carry on at 2-3% in the US and 1.5-2% in Europe through to 2025 which is slightly above consensus estimates. The main factors supporting our base case view of moderately higher inflation are consumption increases resulting from the easing of mobility restrictions (which will mainly impact 2021), combined with aggressive (but not excessive) fiscal stimulus aimed at infrastructure and green investments which will persist over time.

However, there is a more severe high inflation scenario over the next five years which could result from an even more progressive political agenda across the developed markets. Such an agenda would be characterised by persistent fiscal largesse aimed at income support rather than investment, continued easy monetary policy, increased supply chain frictions as a result of both greater protectionism and post-pandemic supply chain localisation, and finally policies aimed at income redistribution. Investment implications of moderately higher inflation include favouring inflation-linked bonds over nominals, equities over liquid credit, real assets over cash, and discretionary active strategies over quantitative strategies. The more severe upside inflation scenario is lower in probability due to likely checks and balances from resulting tighter monetary policy. This would result in lower returns in both fixed income and equity-linked assets.

5. What is the outlook on interest rates?

Central bank policy will remain highly accommodative over the next two years. Policy rates in major developed market economies are unlikely to be changed over this period. Central banks are also likely to continue with large-scale asset purchases, helping to suppress the longer-dated bond yields. However, the combination of rising inflation expectations and elevated debt issuance, particularly in the US (estimated at c. $5.7T over 2021 and 2022), may lead to rises in bond yields beyond what is priced in the market forward rates -- although not likely to take place in an uncontrolled fashion. If the Fed deems any such yield rises as excessive, i.e. likely to imperil economic stability, it has the ability and will to actively intervene via asset purchases to limit increases as its overall treasury holdings. Moreover, private investors will look to take advantage of the rising yield differential between US treasuries and other DM government bonds. A potentially bigger risk than excess debt supply is if inflation levels were to exceed 2.5-3.0% for extended periods. In such a situation, the Fed may attempt to cool the economy and lower inflation by not purchasing excess debt supply and instead allowing longer-maturity interest rates to rise. This has the potential to unsettle financial asset prices, which have largely priced-in low bond yields. As noted in our earlier inflation discussion, this concern is less relevant for 2021 but could apply to 2022 and beyond. In the meantime, a moderate rise in yields in the context of rising growth is a sign of economic health and should not imperil broad equity valuations but may favour Value stocks over Growth stocks.

6. Can China continue its rapid growth in the face of rising tensions with the US?

This time last year, we were concerned about the effects of the coronavirus on the Chinese economy. Despite being the epicentre of the initial outbreak, the Chinese economy has emerged stronger than before, with 2020 GDP growth estimated at +2.3% while advanced economies collectively declined -4.9%. For 2021 and 2022, China is projected to grow at +8.1% and +5.6%, compared to +4.3% and +3.1% for advanced economies. At the same time, the Chinese dealt with the coronavirus more efficiently, requiring just 4.7% of GDP in additional fiscal stimulus compared to 16.7% in the United States or 16.3% for the United Kingdom.

Chinese growth will continue to outperform other major economies' growth – even if growth slows below their official targets of 5.5%. The shift towards a consumption and services-based economy will continue with domestic consumption expected to double by 2030 and China will increasingly use its internal demand as a lever to influence those countries exporting to China. This should create plenty of opportunities within the public and private investment markets.

The main risks to this scenario are geopolitical. In the short-term, the new US administration will maintain a hardline stance on China, particularly with respect to the technology sector that is seen as critical to national security. However, there will be a number of differences in approach compared to the previous administration including a reduced focus on goods tariffs, a greater emphasis on opening up Chinese markets to services (financials, healthcare etc.) and enhanced focus on climate change, with possible new tariffs related to carbon emissions. The new US administration will also elevate the issue of human rights and proactively engage and recruit strategic allies including Europe, Japan, and South Korea to pressure China into sticking to international norms. Over the longer-term, China's territorial ambitions in the region, particularly around Taiwan, and its desire for more comprehensive control over the South China Sea are critical risks to monitor. While tensions could escalate inadvertently, experts do not see China deliberately initiating a war over Taiwan in the short-term. But it is clear that the strategic rivalry between the US and China will continue to intensify over these issues and this rivalry will be one of the defining themes that shape the world over the next decade.

7. What is the outlook for Europe following the pandemic and Brexit?

As has been the experience since WWII, Europe has tended to grow stronger and more integrated following successive crises. Today, despite or perhaps as a result of the twin shocks of COVID-19 and Brexit, European integration is accelerating. This is evident in the nascent steps taken towards fiscal mutualisation as part of the pandemic response. Experts suggest Brexit will result in a 4-5% cumulative contraction in potential output in the UK over the next 10-15 years (-0.30% to -0.40% per annum), particularly if its large services sector is constrained in trading with the EU. The direct impact to the EU will be more benign but not costless, as the UK leaving is equivalent to 17% of the EU's GDP walking out of the door. The EU is also losing a leading free-market advocate.

On the political front, European populist parties have either ceded support or have shifted their policies closer to the centre. The risks from upcoming European elections appear relatively mild despite the departure later this year of Angela Merkel as Europe's longest-serving leader. Progress on structural reforms has naturally stalled as pandemic support has taken priority. Such reforms may now be more palatable given that they will be accompanied by significant fiscal stimulus, particularly in Italy with Mario Draghi as the new prime minister. In light of the above developments, the IMF forecasts that the Eurozone will grow at 4.2% in 2021 and 3.6% in 2022. Private-sector (e.g., bank economists) forecasts point to an additional percent higher growth each year. The key risks to this outlook, aside from the trajectory of the pandemic, are the timely and effective release of recovery funds, a decision on the permanent relaxation of fiscal spending limits and political stability across the region.

8. Where are we in the transition to risk + return + impact investing?

We are at dangerous cross-roads today with ESG and impact investing. The momentum from all corners -- institutional asset owners, asset managers, and financial reporting regulators -- has built to levels not anticipated, and has been boosted, rather than impeded, by the pandemic. This acute focus on the environment and social impact is an history-making socio-economic phenomenon. But its all-encompassing definition may be its biggest obstacle. ESG investing captures a vast array of impacts which impedes its own progress as we see inconsistent measurement systems and competing reporting proposals that will never reach a standard until they disperse into discrete impacts such as carbon emissions and workforce diversity and inclusion. As we said five years ago in our annual investor meeting, the virtuous circle of responsible investing needs a standard measurement solution and we see that in the form of multiple discrete impact measurement standards such as TCFD's carbon foot-printing and exposure metrics.

As a baffling array of incompatible measurement systems confound asset owners, asset managers are racing forward and launching a record-breaking number of ESG and Impact funds. There are only a handful of ESG and Impact investors with long-term investible track records and proven investment strategies, and most of those are not taking new investors. The rest have yet to experiment and learn how best to exploit the relationship between financial performance and impact in public equities security selection or private equity portfolio company investing and ownership. Many of these new funds and firms will fail, while others will persist, but with mediocre financial performance and questionable impact. It is our greatest challenge under the heading of ESG investing, to find those few managers who will be successful and be ahead of the queue of their potential investment partners. To that end, we seek to continue to build on our capability to know what industry sectors and what kind of company will deliver the most exceptional financial performance and impact in the years ahead.

With these views of the macroeconomic environment in hand, we now translate those into our usual base case, upside and downside scenarios as input to our 2021 investment return assumptions, investment themes and tactical asset allocation ("TAA") moves.

Macroeconomic Scenarios

The macroeconomic views above help us arrive at what we consider to be the most likely "base case" over the next three years with a focus on where we expect to be at the end of 2021. We also outline a plausible set of outcomes on either side of the base case which we refer to as the downside and the upside case.

Building a portfolio just for the base case is rarely optimal. Rather, the optimal portfolio will both weather the downside and benefit from the upside, but in doing so may give up some return in the base case. The tactical asset allocation and asset class strategies all seek to reflect the optimal allocation given the weighted probability of various scenarios. To that end, we lay out our three key scenarios below.

Base Case: "The herd slowly immunises" (60% probability)

Global growth recovers in 2021 as vaccines are successfully rolled-out in the developed world. The easing of mobility restrictions in Q2 and Q3 is expected to lead to a consumption-driven growth spurt. As consumer confidence returns, a surge in growth driven by pent-up household demand is fuelled by elevated levels of personal savings. The services sector, in particular hospitality and travel which has been hard hit, experiences a rapid rebound.

Most economic drivers are supportive of a positive outlook for consumption and growth in 2021. Fiscal policy and monetary policy being extremely supportive in many developed economies has created an unusual scenario whereby most consumers are exiting a recession wealthier than when they entered, due to replaced payment programs, unemployment support, combined with strong equities performance that largely looked through the 2020 recession, particularly in sectors set to benefit from global trends accelerated by the pandemic, such as clean energy and technology facilitators. Breaking down our base case there are a number of factors:

COVID-19: Our base economic case is predicated on several key assumptions related to COVID-19, and the vaccine roll-out.

— **Vaccine Availability.** There are only limited supply-side issues with vaccine availability. The predicted rates of vaccination in the UK, the US, and the EU see 70% of their populations vaccinated by the end of April, mid-June, and early-August respectively.

— **Vaccine Targeting Efficacy.** The more vulnerable members of society get early access to the vaccine. This rapidly decreases the mortality rate of COVID-19 in populations, allowing further easing of restrictions, with non-essential businesses and other outlets being re-opened.

— **Variants and Vaccine Adaptability.** A key concern at present is the potential for a significant mutation in the virus, a process known as antigenic drift, which could render the current vaccines and prior immunity to the virus ineffective. Experts view the risk of a variant completely evading the immunity provided by vaccines in the near-term as quite low, hence our base case assumes continued effectiveness of current and pending vaccines. The analysis from experts is that new variants could evade the antibody response of vaccines but they are highly unlikely to evade the T-cell response, resulting in only mild or asymptomatic cases and few hospitalisations or deaths.

Economic Growth: Global GDP is predicted to grow at +5.5% in 2021 and +4.2% in 2022, a positive outlook following an estimated contraction of -3.5% in 2020. Developed markets grow at a +4.3% rate in 2021 (vs. -4.9% in 2020) and Emerging economies grow at a 6.3% rate in 2021 (vs. -2.4% in 2020).

DM Inflation: Developed market inflation is expected to increase from 0.7% in 2020 to 2.0% in 2021 and carry on at 2-3% in the US and 1.5-2% in Europe through to 2025 which is slightly above consensus estimates.

DM Interest Rates: Developed market policy rates are highly unlikely to change over the next two years as policy remains supportive, while bond yields are likely to rise beyond current expectations in the US, Europe and Japan, reflecting the huge increases in new bond issuance to fund record-breaking fiscal spending.

Downside Scenario: "Ongoing waves of new strains" (20% probability)

Our downside scenario is centered on COVID-19 continuing to wreak havoc, in particular with the virus finding a way around existing vaccines, through the appearance of additional variants. Here we also consider the longer-term scars of COVID-19 as vulnerable sectors start to collapse and cause mass unemployment amid ongoing lockdowns. While government bond yields will decline back to 2020 levels, a spike in default rates and unemployment causes credit spreads to widen sharply, raising borrowing costs for businesses and households. Social unrest increases as people lose faith in their governments' ability to manage the pandemic and the economy. On the geopolitical side, as the Biden administration and other western governments focus on economic problems, China sees an opportunity to assert its control over Taiwan, creating further volatility.

In this scenario, global central banks have limited scope to provide fresh stimulus as most DM interest rates are near (or below) zero and asset purchases have reached their limits in Europe and Japan. Fiscal stimulus would be required but could be harder to pass through, particularly in western countries that have already increased debt levels significantly to reduce the economic impact of COVID-19 in 2020.

Economic Growth: In this scenario, global economic growth recovers somewhat, but only grows at +2.5% in 2021, up from -3.5% in 2020.

DM Inflation: Inflation in developed markets recovers slightly but only to 1.0%. Base effects from 2020 provide a floor preventing a more severe drop.

DM Interest Rates: Bond yields decline, with the US 10yr moving down to 0.7%. Further declines in bond yields are limited by increasing calls for large-scale fiscal stimulus, which would both increase the supply of bonds and, if inflationary, decrease the demand for them. Assuming the downside case is caused by a new variant, the medium-term outlook for yields will depend on the severity of the renewed outbreak and the ability of existing vaccines to be tweaked to prompt the correct immune response. If a new variant emerged that mutated faster or was more resistant to a vaccine, it is conceivable that US Treasury yields decline to 0% over the next 2-3 years as growth stalls and savings increase. In a less severe downside in which any new variant outbreak is subsequently controlled, bond yields would likely start to rise again over the medium-term if unlimited fiscal spending is unleashed (e.g., MMT) to support the economy. As noted below, we do not expect significant downside for Bunds which already trade at negative yield levels.

Upside Scenario: "Warp speed to normal growth" (20% probability)

Similar to the base case, but on an accelerated timescale as "Operation Warp Speed" and other measures accelerate vaccine production allowing for a more rapid rollout that we are seeing today (e.g., 1.3M doses/day in US), especially in developing countries. COVAX ramps up its purchases and distribution to large and small third world countries. Further improvements in vaccine technology in 2021 reduce distribution constraints. Existing vaccines prove to be very effective at reducing transmission rates, accelerating the reopening process. After a failed experiment with protectionism, western economies re-engage with globalisation. Economic activity returns to normal by the start of H2 2021. Pent-up consumer demand boosts activity including mass events and international travel. Supply-side constraints don't cause inflation to spike too high, allowing monetary policy to remain supportive. Longer bond yields steepen amid economic growth, while fiscal spending can be pared back with a switch to taxation. Any increases in fiscal spending are mainly targeted at building a low carbon global economy.

Economic Growth: Global growth rises to +7.5% in 2021 following negative growth of -3.5% in 2020, with Europe and Emerging market economies enjoying the largest increase in growth on a relative basis.

DM Inflation: DM inflation rises above central bank targets reaching 3.0% in the US and 2.3% in Europe by the end of 2021 as central banks allow inflation to run above target.

DM Interest Rates: Longer-dated government bond yields in developed markets move higher as growth and inflation expectations rise. In this scenario, the yield on the US 10-year bond moves towards 1.9% by the end of 2021, not significantly different from our base case as fiscal spending and deficit funding requirements are more modest than in the base case.

Potential Macroeconomic and Political Events

As we have shown in prior issues of Insights, in addition to our three discrete base, downside and upside scenarios, we include a more granular spectrum of downside and upside events arranged by their expected impact on the global economy and financial markets from '+3' being an event that could increase the GDP in next 2-3 years by 1% or more a year and '-3' being could decrease global GDP by 1% or more. The worst scenarios could result in equity markets dropping by -15% or more, but we do not see any structural aspect of the global financial system that could generate an outcome similar to the 2008 global financial crisis.

Exhibit 2

Partners Capital inventory of potential fat tail events (both tails)

Macroeconomic and Political Events	Risk Score (1-3)	Probability in 2021
Europe embraces fiscal integration in the form of broad-based debt mutualisation releasing a surge of investment-led growth further supported by structural reforms. UK strikes free trade deal in services with the EU.	2.5	10%
"Operation Warp Speed" and other measures accelerate vaccine production allowing for a more rapid rollout. COVAX ramps up its purchases and distribution to large and small third world countries. Existing vaccines prove to be very effective at reducing transmission rates, accelerating the reopening process.	2.0	20%
Large scale fiscal stimulus provided in an orderly fashion across developed markets, implemented with sensible monetary policy/QE, without causing rapid inflation or interest rate rises. MMT works.	2.0	20%
Acceleration in technology adoption exceeds all expectations benefitting tech and non-tech sectors in terms of digital transformation driving up productivity and growth, with low inflation. Drags US & China equity earnings higher still.	1.5	25%
Populist driven fragmentations of political order – in the US, ex-President Trump forms a new Patriot Party, splintering the Republicans and instigating social unrest . In the UK, Scottish nationalists succeed in calling a referendum that leads to a dis-integration of the UK. National Front takes over in France and Spanish populist parties form alliance, posing existential threats to the EU.	-2.0	5%
The $3T of 2021 net new bond issuances drive Treasury yields higher, with Japan and China showing less interest in raising Treasury bond purchases and Fed decides its balance sheet cannot take up the slack; 10Y bond yields rise above 2%, corporate defaults trickle in, equity markets correct by 20%.	-2.0	20%
A combination of rising rates and propoals to break up the largest social media platforms and increase regulation hits tech stocks hard, and drag down the global equity market with them by c. -20%.	-2.0	30%
Faster than expected rises in inflation lead central banks to abandon their low-for-long interest rate policies causing a broad-based decline in asset values including both risk assets (equities, commodities) and safety assets (bonds, credit).	-2.0	20%
COVID-19 continues to wreak havoc, in particular with new strains of the virus coming out of far flung regions and making their way around the world and current vaccines prove ineffectives on them. Stop/start lockdown measures lead to collapse of vulnerable sectors of the economy resulting in high unemployment and defaults.	-3.0	15%
China's leadership perceives Biden's team as distracted with domestic issues and takes steps to forcibly 'reclaim' Taiwan and Hong Kong leading to eventual military confrontation with the US.	-3	<5%

Scoring methodology: *Each event was defined to one level of extremity which stopped short of the worst case but was a clearly positive or negative event. Then based on that definition of the event, we estimated the impact it could have on global growth over the next 3 years. +3 is equivalent to adding 1% to global GDP in each of the next three years and -3% the opposite. A -3 score suggests the event, as defined, will have a severe enough impact to cause global growth to fall below 2.5% p.a. over the next 3 years (our downside scenario). A +3 points towards 4% global growth (our upside scenario) over the next 3 years.*

2021 Investment Themes

Our six core investment themes and strategies for 2021 and beyond fall naturally out of the macroeconomic views and the investment implications spelled out above.

1. Long Innovation

COVID-19 has accelerated the adoption of many technologies and provided tailwinds to the life sciences industry. While we see more evidence of frothy valuations, especially in venture capital, certain sub-sectors of listed technology companies and SPACs, we maintain conviction in our overweight expressed through specialist hedged equities managers.

We first recommended a "long innovation" theme in 2015 to highlight our investment thesis for technology and life sciences. Almost every industry is experiencing rapid change and disruption from technology, defined by advancements in areas such as drug discovery, mobile infrastructure, computing power and artificial intelligence. We maintain our conviction in this theme, though it is imperative to invest with active and specialist managers who can identify the winners and losers, and avoid sectors that can easily become crowded and over-valued.

Investment Implications: We recommend that clients allocate 5% of their overall portfolio to life sciences, comprised of up to 4% across at least two **life sciences** equities managers focused on small/mid cap stocks, and the remainder across private markets (in venture capital and private debt). We recommend that clients allocate 21% of their overall portfolio to **technology and innovative companies**, comprised of 12% in long-only and hedged equities, 7% in private equity and venture capital and 2% in private debt. At the portfolio level, these allocations translate into a 2% overweight to technology and innovative companies, and a 2% overweight to life sciences.

2. China's emerging middle class and digital economy

We target a 6% allocation to China, which has emerged stronger from the pandemic than many of their western counterparts. While geopolitical risks appear elevated, we are focused on domestic and secular themes with long-term tailwinds. We are also adding an allocation to long-short equities in China given recent regulatory reforms which support increased short-selling in the onshore A-share market.

In 2018, we increased our allocation to long-only Chinese equities from 2% of the overall portfolio to 3.5%. This represented approximately 12.5% of our long-only equities portfolio, compared to just 4% in the MSCI AC World index at the time. The growing inclusion of Chinese shares into the ACWI index has since increased the index weighting to 5.7%, now the third-largest country behind the United States and Japan. Our timing was fortunate, as after a -28% decline in 2018, the China A Shares index rebounded +37% in 2019 and then +52% in 2020. China A shares were the best-performing equity sub-index in 2020. We also recommended an additional c.1% look-through exposure from the private equity allocation, which typically has a c.5% allocation to Chinese venture capital and growth equity.

This year, we add an incremental 1.5% to long-short Chinese equities given the increased opportunities for short-selling in the onshore market due to recent regulatory developments. While short selling has never faced restrictions in the offshore Chinese market (given shares are listed in Hong Kong or the United States), it has virtually been non-existent in the onshore market.

Our recommended allocation to long-only equities (3.5% of the overall portfolio), hedged equities (1.5%) and private equity (1.0%) takes our overall allocation to China to 6%. Based on Preqin data on deal value over the past 5 years, we estimate that China represents about 15% of the global private equity market, including growth and venture capital. We have continued to increase our private equity allocations to China in recent years but remain underweight versus the broader global PE market. This reflects our approach to be highly selective in our investment decisions and when choosing managers in a market that is highly competitive and that has seen large amounts of capital being raised over recent years. We also believe that long-term regulatory risks remain higher in China compared to our core PE markets of the US and Europe. Our overweight to liquid markets reflects our belief that China continues to present an attractive alpha opportunity for active managers, especially when adjusted for liquidity.

Exhibit 3
China accounts for 6% of our recommended model portfolio

		As a % of Asset Class		As a % of Overall Portfolio	
	2021 TAA Allocation	Target Allocation to China	Index Weight	Target Allocation to China	Index Weight
Long Equities	32%	10.0%	5.5%	c.3.5%	1.8%
Hedged Equities	15%	10.0%	5.5%	c.1.5%	0.8%
Private Equity	18%	5.0%	15.0%	c.1.0%	2.7%
Total				**6.0%**	**5.3%**

Source: *MSCI indices, Preqin, Partners Capital estimates.*

Our overweight to China, especially in our equities allocation, reflects the continued under-representation of China in the MSCI indices, despite accounting for 16% of global GDP (in USD), 18% of the global population, nearly one-third of the growth of the global economy and over 40% of global consumption growth. By 2028, many analysts think that Chinese GDP will exceed that of the United States. By purchasing power parity measurements, China is already the largest economy in the world. The emergence of the Chinese consumer, combined with an increased decoupling from the West, will create more "national champions" across all sectors of the economy.

3. Sustainability and the green economy

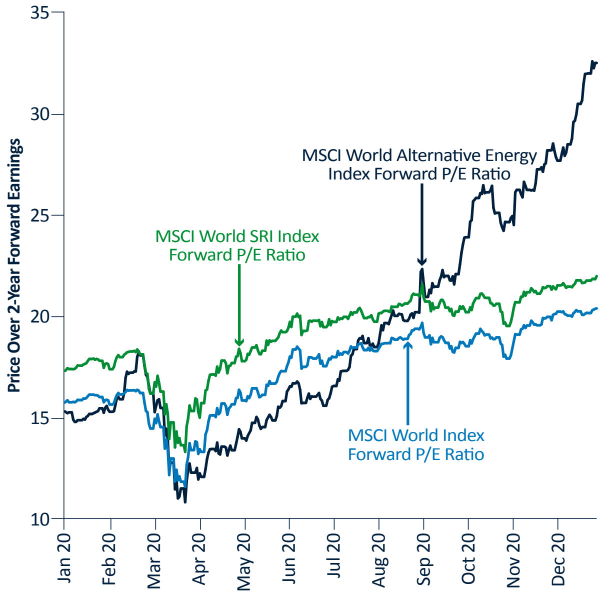
Consumers, corporations and government bodies appear aligned towards combating climate change and transitioning towards a sustainable low-carbon economy. Trillions of dollars of investment will be required to facilitate this transition, creating winners and losers, and reshaping entire industries and their supply chains. We see three major sub-themes – decarbonisation, electrification and the circular economy which we look to play through specialist active managers across both public and private markets.

Last year, we wrote about how responsible investing had reached a tipping point where the flow of funds towards responsible investment strategies had begun to affect asset prices. The COVID-19 pandemic has accelerated awareness of environmental issues, and has strengthened the resolve of consumers, corporations and governments towards action. With little real progress since the Paris Accord in 2015, there is now an increased urgency to the climate change crisis with the realisation that the next decade will be critical if we are to avert the worst impacts of climate change.

Investment Implications: While the long-term trends are clear, we are (as always) cautious about just jumping on the bandwagon. As can be seen below, we have also seen a significant increase in the forward P/E ratio for sectors such as alternative energy which are expected to benefit from these long-term trends, fuelled by low interest rates and the exuberance of many retail investors for all things green/sustainable. While the opportunities in sustainability and the green economy are far broader than just alternative energy, we advocate partnering with active specialist managers who will be best positioned to identify the winners and losers in public markets, and the next generation of technologies and services in private markets.

Exhibit 4

Clean energy and ESG leaders are trading at higher multiples



Source: *Bloomberg*

4. Maximise exposure to private markets

This year, we continue to recommend the maximum 35% allocation to private markets given the more challenging outlook for liquid asset classes. This allocation is split across private equity (16%), private equity real estate (10%) and private debt and uncorrelated strategies (9%). Private markets continue to offer substantial illiquidity premiums and alpha opportunities. Smaller and specialist PE managers with exceptional operating capabilities are the greatest mitigant to elevated purchase prices, while we continue to selectively allocate to growth/venture managers. Within private debt, we continue to see a substantial premium over liquid credit markets and build exposure to a diversified portfolio of alternative alternatives.

5. Diversify the safety net allocation

Last year we suggested investors diversify their safety net basket of assets against a number of potential risks. We continue to suggest this in 2021, although we are altering our outlook for certain assets based on the low level of interest rates that were reached in 2020 following the COVID-19 pandemic.

Our 2021 TAA increases our overweight towards hedging inflationary risks through gold and inflation-linked bonds, an allocation to tail-hedging strategies which are expressed in a capital efficient manner and maintaining exposure to a basket of defensive currencies (for non-USD investors). Rising risks of inflation, supported by accommodative monetary policy, point to lower real rates for longer. Gold has the added benefit of also performing well in the event of heightened geopolitical risk and monetary debasement.

However, it should be noted that in extreme shocks like March 2020, inflation-linked bonds and gold actually did not defend well on the darkest days given the collapse in inflation expectations offset the benefit of the embedded interest rate duration. Only nominal bonds defended on those specific days, but given today's starting yields and our base case inflationary outlook, we maintain a 0% allocation in our 2021 Tactical Asset Allocation.

6. Prepare for a greater risk of inflation.

We expect to see spikes in inflation starting in late Q2 of 2021 and carrying on through to early 2022. Beyond 2022, our base case is for 2-2.5% inflation in line with most other forecasters' expectations. However, as explained in detail in Section 2, we believe there is a not insignificant possibility of of inflation staying above 3% for a number of years in response to fiscal, monetary and cost-based

Exhibit 5

Recommended safety net allocation for 2021 TAA vs SAA

Asset Class	Equity Beta	Typical Liquidity (days)	SAA	2021 TAA
Traditional Safety Net Assets				
Cash	0.0	Daily	1.0%	1.0%
Government Bonds	0.0	Daily	5.0%	0.0%
Gold	0.0	Daily	0.0%	2.0%
Inflation-Linked Bonds	0.0	Daily	5.0%	5.0%
Tail-Hedging Solutions	-0.2	Weekly	0.0%	2.0%[1]
Other Defensive Assets				
Diversified FX exposure	Varies	N/A	Varies	Varies
Liquid Credit	0.4	Daily/Weekly	0.0%	0.0%
Absolute Return	0.1	Quarterly	12.0%	12.0%
Total Safety Net Allocation			**23.0%**	**22.0%[1]**

Notes: *[1] We recommend tail-hedging solutions which are managed as an overlay to traditional asset classes such as inflation-linked bonds or equities to improve capital efficiency.*
Source: *Partners Capital*

drivers discussed. Therefore, we recommend that clients prepare for the risk of higher inflation of 3-5% through allocations to inflation-linked bonds, gold, property and quality equities.

Policymakers are throwing fuel on the fire through unprecedented fiscal stimulus and commitments to keep rates low. This increases not only the risk of longer-term inflation, but also the risk of policy error, as central bankers will begin questioning whether higher inflation is temporary or structural. While our base case is for continued low inflation of 2-3%, clients should prepare for the risk of higher inflation of 3-5% through allocations to inflation-linked bonds, gold, property and quality equities.

In the face of a heightened risk we have been considering how different assets might place in a portfolio.

2021 Tactical Asset Allocation

The model portfolio SAA is long-term in nature and we try to avoid changing it. However, a recent review showed that our average client today has a higher risk tolerance and a higher illiquidity budget compared to the average client portfolio when the model portfolio SAA was last reviewed. As such, we are updating the model portfolio SAA for 2021 so that it better reflects the SAA for our average client today. Exhibit 6 below summarises the changes. This should not have a direct impact on client portfolios and should not be interpreted as a recommendation to increase risk in your portfolio.

An additional change to the model portfolio SAA is the inclusion of private debt as an asset class. We first invested in private debt in the wake of the 2008 financial crisis when the sudden withdrawal of bank-lending created attractive opportunities for alternative lenders. At the time, we viewed this as a tactical short-term opportunity, but after more than a decade we continue to find attractive opportunities within private debt especially relative to liquid credit which has reached record low yields.

Exhibit 6
Impact of higher inflation and higher interest rates on selected asset classes

	Impact of higher inflation	Impact of higher interest rates	Net impact if change in inflation > change in bond yields (i.e. lower real rates).
Inflation-linked bonds	All things being equal, higher inflation results in a lower real yield which will benefit ILB valuations.	All things being equal, higher interest rates will result in a higher real yield which will negatively impact ILB valuations.	ILBs will benefit from lower real yields.
Gold	All things being equal, gold benefits from correlation to lower real yields and thus higher inflation.	All things being equal, gold suffers from correlation to higher real yields and thus higher interest rates.	Gold is highly corelated to real yields but is highly volatile and may be susceptible to other factors.
Commodities	While commodities are real assets, commodity prices are driven more by demand vs supply cycles given no earnings yield. However, commodity-led inflation (e.g., 1970s, 2000s) will naturally be highly-correlated with commodities performing well.	Higher rates will negatively impact commodity prices because of higher carrying costs. On the other hand, commodities futures will benefit marginally from higher collateral yields.	Highly uncertain – depends on demand/supply dynamics of each underlying commodity.
Property	Depends on whether inflation is supported by real economic growth which drives demand. However, supply dynamics are equally important.	Higher interest rates result in higher cap rates, although cap rates will adjust lower for higher growth rates.	Mixed – depends on demand/supply dynamics in a given market and other trends such as eCommerce for retail or work-from-home for office.
Equities	Depends on whether inflation is supported by real economic growth which drives demand, and whether companies have ability to pass on cost inflation through higher prices.	Higher interest rates result in higher discount rates, which negatively impact valuations, especially for longer-dated cashflows.	Generally positive as long as inflation is supported by strong economic growth. However, sector and security selection are critical.

Source: *Partners Capital analysis*

Exhibit 7

Model portfolio Tactical Asset Allocation (TAA) compared to the long-term Strategic Asset Allocation (SAA) benchmark

Asset Class	SAA	New TAA	Difference	Rationale
Cash	1.0%	1.0%	—	Maintain minimum liquidity buffer subject to operational constraints given very low/negative yields.
Government Bonds	5.0%	—	-5.0%	Government Bonds are unattractive given low yields and asymmetric risk to the downside from any unexpected rise in inflation.
Liquid Credit	—	—	—	Generic Liquid Credit strategies offer little upside with very tight spreads providing scant compensation for either rising defaults or rising inflation. However, there are attractive sub-sector opportunities for investors who cannot allocate to Private Debt in structured credit and short duration lending strategies.
Private Debt	5.0%	8.0%	3.0%	Private Debt continues to take advantage of opportunistic lending strategies, sector specialists and less-correlated alternatives such as litigation-related strategies, offering a significant premium to Liquid Credit. Skew away from vanilla middle-market corporate lending strategies which remain competitive.
Absolute Return	12.0%	12.0%	—	Absolute Return appears more attractive compared to recent years due to (i) increased capital efficiency driving better total return potential from our focus on multi-manager platforms (ii) tactical opportunities in merger arbitrage and SPACs (iii) AR strategies may fare better in reflationary environment with rising rates e.g. macro, Fixed Income Relative Value.
Hedged Equities	11.0%	15.0%	4.0%	Maintain overweight reflecting the confidence in our manager lineup and their continued ability to generate outsized alpha, particularly in the current environment of high dispersion and low inter-stock correlation. Our "long innovation" theme is best expressed through specialist tech and biotech managers in Hedged Equities.
DM Equities	32.0%	27.0%	-5.0%	Underweight to long-only equities reflecting a preference for more nimble, specialist hedged equity managers and an overweight to EM equities. Within DM equities, we focus on long duration, co-investment and quantitative strategies.
EM Equities	4.0%	5.0%	1.0%	Overweight Emerging Markets, with allocations concentrated in Asia and Asian allocations concentrated in China, reflecting one of our core investment themes of benefiting from China's growing middle class and increasingly digitalised economy.
Private Equity	18.0%	18.0%	—	PE remains a reliable source of outperformance through our managers' ability to "create alpha" by making material improvements in the operating performance of private companies. We focus on the lower middle-market where there is less competition and better valuations. Also includes "long innovation" exposure to growth equity and venture capital.
Inflation-Linked Bonds	5.0%	5.0%	—	At weight ILBs/TIPS and +2% overweight to gold. Both gold and ILBs are real assets serving as a store of value that will protect portfolios in the event of higher-than-expected inflation. Both are also highly liquid, allowing for rapid portfolio rebalancing in a market sell-off.
Gold	—	2.0%	2.0%	
Commodities	—	—	—	Commodities (ex-gold) are an unreliable inflation hedge. We are neutral to mildly positive on the outlook for commodities but see the asset class as a blunt and volatile investment tool. We favour more surgical, income-generating investments which stand to benefit more from the same overarching macro trends that might favour commodities in 2021.
Core Property	—	—	—	Structural changes resulting from the COVID-19 pandemic creates both challenges and opportunities. Open-ended property vehicles are less attractive due to risk of a liquidity mismatch. Where possible, clients should gain property exposure via PERE instead where there is greater scope for value-add.
Private Equity Real Estate	7.0%	7.0%	—	
Total	**100%**	**100%**	—	
ENEB	**0.67**	**0.67**	—	
Allocation to Illiquids	**30%**	**33%**	**3%**	

Source: *Partners Capital*

Relative to the SAA, shown in exhibit 7 is well-positioned for a re-acceleration of global growth and a modest increase in inflation, which is our base case scenario, while still offering good protection against the more probable negative scenarios. The TAA is also designed to allocate capital in line with our core investment themes.

We continue to recommend a highly diversified allocation across a range of asset classes. Consistent with our above themes the primary deviations away from our long-term strategic asset allocation include an overweight to private markets, an underweight to low-yielding duration assets such as government bonds and liquid credit, an overweight to both hedged equities and emerging market equities, more specifically China, and a commensurate underweight to develop market equities.

We recommend a -5% underweight to government bonds, reflecting our view that over the medium-term higher inflation is a more credible threat to investment portfolios than deflation. The actions of central banks and policymakers over the last 12-months indicate a willingness to do whatever it takes to reflate the economy, and there is a risk that the recent fiscal and monetary profligacy goes too far. Long-dated bonds developed market government bonds with very low yields offer little protection from such a risk. However, if yields were to rise – for example to c. 2.5% on the US 10-year Treasury - we would consider adding back to nominal government bonds.

This -5% government bond underweight is used to fund an overweight to gold (+2%) and private debt (+3%). Gold provides an alternative safety asset that should serve as a store of real value should inflation move higher, while Private Debt has benefited from an expansion of the opportunity set resulting from the pandemic. The dispersion in fundamental outcomes created by the COVID-19 crisis has generated attractive opportunities in rescue lending and distressed private assets. We expect the continued economic impact of the crisis to create refinancing and restructuring opportunities over the next 12-18 months which will allow managers with available capital to benefit from improved pricing and better structural and legal protections.

Within public equities, we recommended a 26% allocation to developed market equities (-6% vs SAA), a 6% allocation to emerging markets (+2% vs SAA) and a 15% allocation to hedged equities (+4% vs SAA). This relative positioning within the public equity portfolio is largely a consequence of our positive outlook on technology, life sciences and China, all of which we access primarily through our strong line-up of sector specialist Hedged Equities managers with deep domain knowledge in their area of focus. The overweight allocation to Hedged Equities also reflects our belief that an environment characterised by increased volatility and uncertainty favours talented long/short active managers capable of exploiting the resulting market dislocations.

We continue to advocate maximum use of the illiquidity budget in client portfolios. This will vary depending on the underlying needs of the client. As a rule of thumb, our modelling suggests most clients can tolerate holding a third of the portfolio in illiquid assets. The TAA emphasises this point, with a total allocation of 33% in illiquid assets compared to 30% in the SAA. The 3% increase relative to the benchmark is allocated to Private Debt, as explained above. Private Equity is an 18% allocation in both the SAA and TAA, representing the largest component of an overall illiquidity budget. This reflects our conviction that private equity will continue to play its role in boosting overall portfolio returns by contributing the highest returns of any asset class. We also recommend a benchmark weight to property, with a focus on opportunistic and value-add private equity real estate ('PERE') investments which we believe will continue to offer better risk-adjusted returns with a greater opportunity for generating alpha compared to core property, particularly as structural changes resulting from COVID-19 pandemic continue to cause structural shifts in property markets.

Conclusion

As we emerge from the COVID-19 crisis, we take stock not just of the enormous human tragedy and economic costs that it generated, but also how much worse it could have been had it happened only a decade or two earlier. The mRNA technology that in the space of less than 10 months provided us with multiple successful vaccines did not even exist a decade ago. Nor did we have the degree of readily available digital interconnectivity that allowed us to remain in constant contact and keep the global economy moving at a tolerable, albeit slower pace. Without these two key ingredients, we could have found ourselves in a far worse situation, possibly closer to the 1918 Spanish Flu pandemic, which had far more severe human and economic consequences.

The pandemic also helped bring us closer together in many ways, reminding us that life on this planet that we inhabit is more fragile and more interconnected than previously imagined. So as we look ahead, we are encouraged to see both public sector policymakers and private sector businesses working closer together on accelerating advances in both medical science and environmental protection. Our investment themes feature both of the above, and we are encouraged that in addition to providing positive impact, they have provided attractive investment returns.

Our clients who know us well know that we are long-term investors. Our 'Insights' views are developed over several months and are meant to inform investment decisions over several years. We cannot anticipate every major development, on the upside or the downside. But we take comfort that our diversified multi-asset portfolios have weathered and even outperformed in the face of unforeseen events. The process of producing this time-consuming and challenging document, while primarily for your benefit, has also enhanced and deepened our own understanding of the main risks and opportunities that lie ahead, and how best to construct portfolios to position for them.

While it is always difficult to predict what the markets have in store for investors, we hope that Insights 2021 provides you with some useful perspectives into our investment process, and we look forward to discussing our findings with you in our next meeting – which hopefully will be in person rather than by video.

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