

The second coming



2021 Global Market Outlook - Q2 Update





The Second Coming

Vaccines and U.S. stimulus have the global economy on track for a strong rebound in the second half of 2021. We expect the reopening trade to favor equities over bonds, the value factor over the growth factor and non-U.S. over U.S. stocks.



Broad-based inflation pressures are unlikely to emerge until 2023, and we expect late 2023 or early 2024 for the first Fed funds rate hike.

Andrew Pease, Head of Global Investment Strategy



Introduction

After last year's false start, the prospects for a sustained reopening of economies through the second half of 2021 appear promising. The vaccination rollout as well as prior COVID-19 infections mean 60-70% of the population in most developed economies should have some immunity by early in the third quarter. This plus the [large U.S. fiscal stimulus](#) has shifted investors from worrying that growth will be too slow, to now fearing that growth will be too fast and put more upward pressure on interest rates.

We agree that economies are poised to rebound sharply as restrictions are gradually lifted, but we disagree that inflation pressures and interest rates are likely to increase significantly over the next 12 months. It's going to take until at least the middle of 2022 for the U.S. economy to recover the lost output from the lockdowns, and longer in other economies. This means that broad-based inflation pressures are unlikely to emerge until 2023. It also means that market expectations for U.S. Federal Reserve (Fed) lift-off in 2022 are premature, with late 2023 or early 2024 a more likely timing for the first Fed funds rate hike.

The vaccine rollout and large fiscal stimulus have upgraded our conviction in the cycle component of our cycle, value, and sentiment (CVS) investment decision-making process. Global equities remain expensive in early 2021, though the very expensive U.S. market offsets better value elsewhere. Sentiment is close to overbought, but not near dangerous levels of euphoria. The strong cycle delivers a preference for equities over bonds for the remainder of the year, despite expensive valuations. It also reinforces our preference for the [value equity factor over the growth factor](#) and for non-U.S. equities to outperform the U.S. market.

The US\$1.8 trillion American Rescue Plan of 2021 is set to supercharge the U.S. recovery as COVID-19 restrictions are lifted. This is equal to 8.4% of U.S. gross domestic product (GDP) and comes on top of the US\$900 billion stimulus passed in late December 2020. The United States is leading the charge in terms of fiscal support and as a result is likely to be the fastest-growing developed economy in 2021.

Although the rest of the world can't match the U.S. fiscal firepower, other countries will benefit from the spillover effects of the U.S. stimulus. According to the Organization for Economic Co-operation and Development's (OECD) macroeconomic model, the U.S. stimulus is likely to boost growth in Japan, Europe, and China by 0.5 percentage points over the next 12 months and lift global GDP growth by just over 1 percentage point.

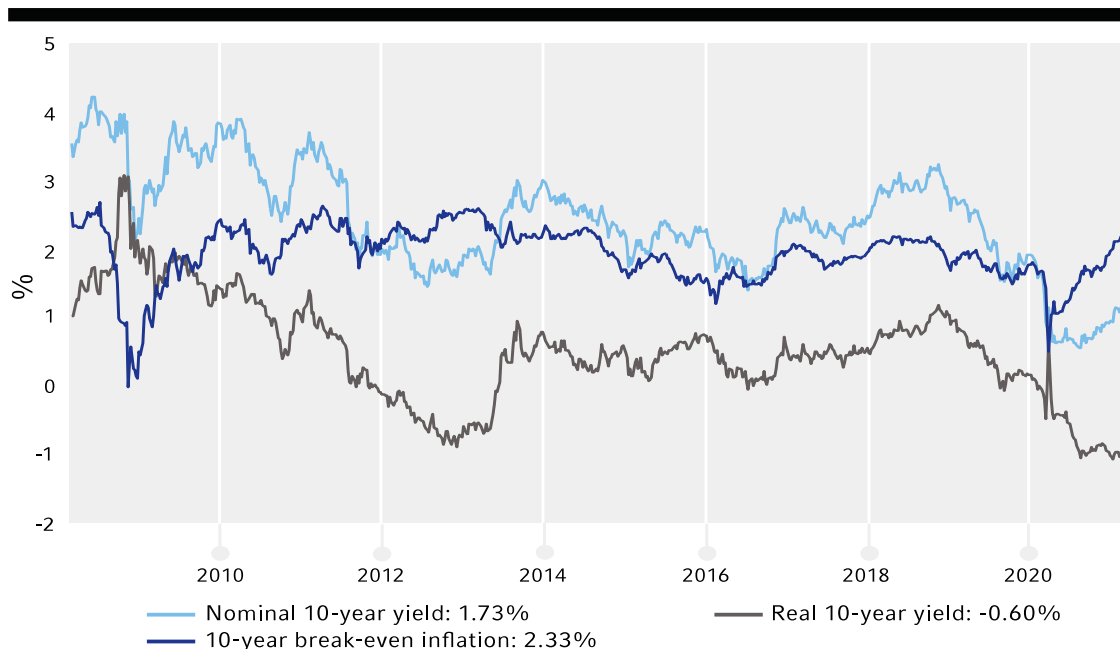
Bond selloff reaching its limit

Markets have greeted the vaccine and stimulus news with [higher bond yields](#), anticipating a move by the Fed to tighten monetary policy and raise interest rates. As of mid-March, bond investors expect the first Fed hike by the end of 2022 and a further two hikes in 2023. This seems premature and we agree with the [Federal Open Market Committee's mid-March projection](#) that rate hikes are unlikely before the end of 2023.

We expect super-strong post-lockdown growth will create inflation pressures in some sectors. This is already evident in commodity markets and in the manufacturing sector. The prices-paid index in the U.S. Institute for Supply Management (ISM) manufacturing survey hit a 13-year high in February 2021. Consumer prices, however, are dominated by services.

Spare capacity in the U.S. economy means that broad-based inflation pressures are unlikely until 2023. [Average inflation targeting](#) will allow the Fed to wait until the Consumer Price Index (CPI) measure of inflation has sustainably reached 2.5% before starting to tighten policy. This seems doubtful before late 2023.

U.S. 10-year Treasury yields since the Great Recession



Source: Refinitiv Datastream, as of 18 March 2021.

Break-even inflation is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality.

The chart above shows the U.S. 10-year Treasury yield broken into its two components—the expected inflation rate and the real yield, as measured by the yield on Treasury Inflation Protected Securities (TIPS). Most of the rise in the nominal yield this year is due to investors forecasting higher average inflation over the next 10 years. This expectation for the break-even rate of inflation has increased from 1.6% in early November 2020, before the announcement of a successful vaccine, to 2.3% in mid-March 2021. The other component, the real TIPS yield,

has risen from -0.9% to -0.6% over the same period. The rise in the real yield, in part, reflects the upgrade in Fed tightening expectations. We think that both components of the nominal yield are near their limits for 2021. Higher inflation expectations are unrealistic and bond investors are premature in expecting Fed tightening. Of course, market expectations can overshoot, and bond yields could rise further, but we expect the 10-year U.S. Treasury yield is near the upper end of its range for 2021.



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Rotations have further to run

The market rotation away from technology-heavy growth stocks toward more cyclical value stocks, which we discussed in our previous quarterly report, is underway. The MSCI World Value Index has gained more than 10% since the beginning of 2021 while the technology-heavy MSCI World Growth Index is unchanged. One reason has been the rise in U.S. Treasury yields. Technology stocks are regarded as *long duration* as they are expected to grow their earnings over the longer term. The [rise in bond yields this year](#) has made the present value of their future earnings less valuable. Higher bond yields have had the opposite effect on value stocks. Financial stocks are the largest sector in the value index, and these have benefitted from the increased spread between short- and long-term interest rates, which boosts the profitability of banks.

This catalyst for value outperformance is unlikely to be as powerful going forward. Even so, we still expect value to do better than growth. The value factor is still very cheap compared to the growth factor. Furthermore, the U.S. stimulus plus the reopening from lockdowns should boost the earnings growth of cyclical sectors such as materials and industrials that also have a high weight in the value index.

The [next phase of value outperformance](#) is likely to have greater leadership from non-U.S. markets. Europe, for example, has had less yield curve steepening than the United States. This has held back the performance of its financial stocks relative to the

U.S. We expect the vaccine rollout in Europe plus the lifting of lockdowns in the second half of the year will put upward pressure on European bond yields and give the value factor a further boost.

The S&P 500® Index of U.S. large-cap stocks in late March is overweight the technology and healthcare stocks that dominate the growth factor, while the rest of the global market has more of the financial and cyclical stocks that make up the value factor. The global reopening in the second half of the year should see more outperformance by non-U.S. equity markets.

Risks: Too much good news

There are still lingering concerns about new COVID-19 variants that may be resistant to vaccines, as well as the slow vaccine rollouts in some countries. Some European countries have recently increased lockdown measures as infection rates have trended higher. It's possible that lockdown measures may be maintained for longer. The evidence so far, however, is that the countries with the most successful vaccination programs—Israel, the United Kingdom and the United States—are experiencing [sustained downtrends in new infections and hospitalization rates](#).

The good news on vaccinations and stimulus means the more significant risk is that long-term interest rates rise by more than we expect. This could provide a test for the U.S. equity market, which is expensive in absolute terms and appears attractive only when compared to low Treasury yields.

Equity markets can usually navigate rising bond yields if the reason for the higher yields is better prospects for economic growth. It's a different story if yields are rising on concerns that

monetary policy will be tightened. A rise in the 10-year U.S. Treasury yield toward 2.5% would provide a test for equity markets. We think, however, that market concerns the Fed is about to turn hawkish are unwarranted, and that the Treasury yield should remain below 2%. The Fed has [made clear it will leave rates low](#) for an extended period to ensure the economic recovery is sustained. The other major central banks are similarly dovish.

Canada Market Perspective

As the global pandemic moves into the rear-view mirror, the reopening of the domestic economy and improving global growth keeps us positive on the outlook for the Canadian economy and domestic equities. However, this comes hand in hand with rising inflation expectations and bond yields

Spring Forward

The Canadian economy has shown remarkable resiliency despite more prohibitive lockdowns than in the U.S. Industry consensus estimates have been revised higher and suggest gross domestic product (GDP) growth of about 5.5% for 2021, a considerable margin above the Bank of Canada's (BoC) estimate of 4.0%. The contributing factors to this development have been two-fold: the housing market's resolute strength supporting the construction industry and a stimulus-primed U.S. economy boosting Canadian exports. These higher estimates seem appropriate and suggest the Canadian economy may converge toward its pre-pandemic level by the third quarter of 2021. This burgeoning optimism has raised several concerns related to inflation, yields and the interest rate outlook, all of which we discuss below:

Inflation and bond yields

One of the consequences of the improved outlook has been rising inflation expectations and higher bond yields. Higher inflation expectations are understandable. First, inflation pressures have naturally grown along with the recovering economy. Second, commodity prices have rallied vigorously. Crude oil, for example, is up roughly 70% from October 30, 2020 to late March 2021. The combination of economic recovery and higher commodity prices suggests more robust inflation pressures on the horizon, and this also makes the rise in bond yields understandable. The Government of Canada's (GoC) 10-year bond yield at one point fell below 0.5%. That might have made sense during the worst of the pandemic but not so much today. Therefore, higher bond yields are simply a recalibration to the current outlook. To better understand how much runway remains for bond yields, we move to the next topic on the BoC.

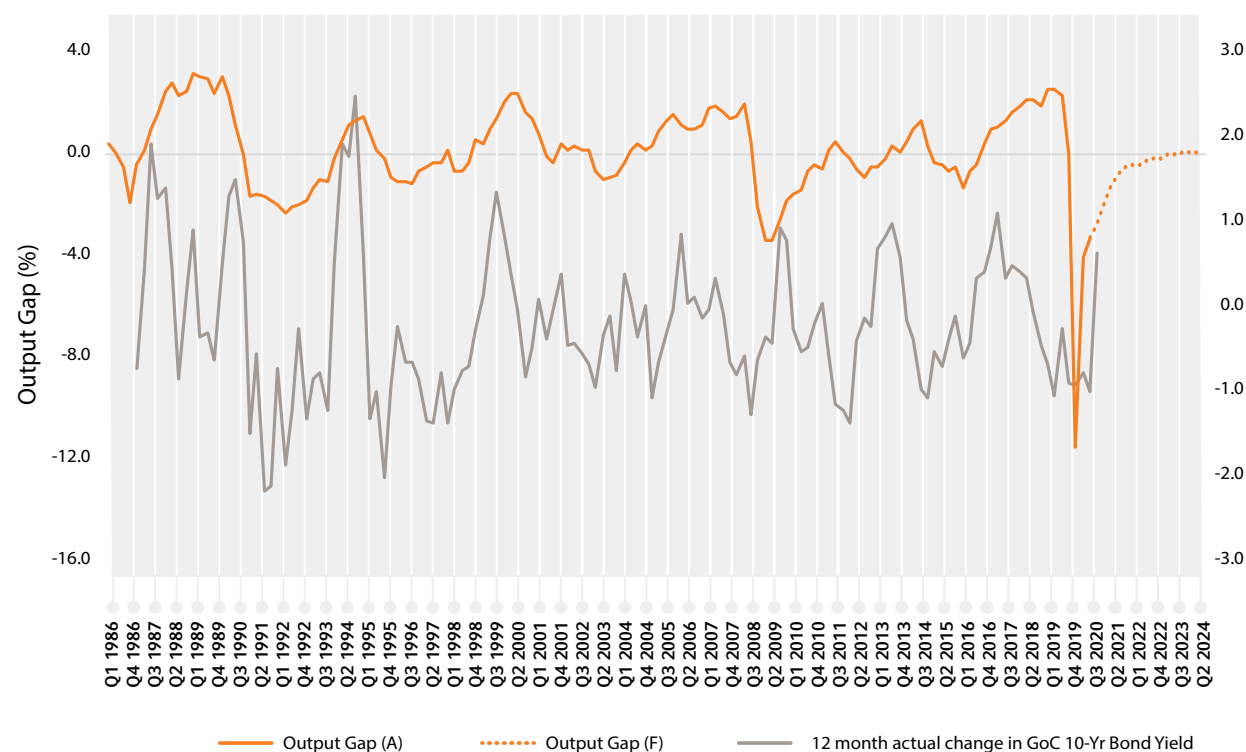
BoC and interest rate outlook

The economic outlook has sufficiently improved for the BoC to potentially adjust its bond purchase program, perhaps as early as at the April meeting; still, we don't expect the BoC to raise its policy rate anytime soon. The growth outlook has improved, but the economy still operates below potential. And it may be a while before the "output gap," which measures the difference between actual and potential growth, closes. This means the BoC will not rush to raise its interest rate target; as well, the output gap will act as an anchor on the potential for yields to move up. As Figure 1 demonstrates, the yield acceleration over the past year roughly matches the economy's rebound. The chart also illustrates that historically, it has been rare for bond yields to rise appreciably more than 100 basis points over a rolling one-year period. Finally, the BoC estimates the output gap as of Q4 2020 at 3.3%. This is crucial since the BoC deems

policy accommodation necessary until that gap has closed and the "inflation objective is sustainably achieved." The central bank's Governing Council doesn't anticipate these conditions to be met until 2023. Moreover, we don't expect the BoC to tighten policy before the U.S. Federal Reserve does. That would risk propelling the Canadian dollar, which has benefited from an improving global economy, and impede productivity. The critical takeaway is that bond yields may be range-bound to slightly higher, and the pace should moderate from here.

Optimism and a spirit of renewal that typically accompany winter's transition to spring take on a more significant meaning this year. One concern, however, has been the pace of vaccination. It has been slow in Canada relative to the U.S., but as that pace picks up over the coming months, we believe the Canadian economy should benefit from the domestic reopening and the broader global recovery.

Figure 1: Output gap of the Canadian economy



Source: Refinitiv DataStream, Russell Investments.

Output gap based on Oxford Economics data, forecasted data as of Q1 2021 to Q4 2024. A = Actual, F = Forecast. Output gap measures the difference between actual and potential output of an economy. GoC = Government of Canada.

Canadian equity outlook: Time to start catching-up

Figure 2 is a simple ratio of U.S. to Canadian equities. It is a crude way to measure relative value, but it illustrates the magnitude by which U.S. equities have outperformed. The S&P 500 Index (representing U.S. large-cap equities) is trading near the highest level relative to the S&P/TSX Composite Index (representing Canadian equities) since the early 1960s. The modest outperformance of domestic equities so far in 2021 barely registers from a historical perspective, suggesting a long runway ahead. For a broader assessment, we look to our investment decision-making building blocks of cycle, valuation and sentiment:

Cycle:

The Canadian economy is positioned well for the post-pandemic reopening. Accelerating global growth supports commodity prices. Monetary and fiscal policies will likely remain accommodative. Canadians are sitting on historically high levels of household savings. And Canada's most important trading partner, the U.S., is juiced with stimulus. We believe the business cycle is positive.

Value:

Canadian equities are up roughly 75% from the March 23, 2020 low to March 17, 2021. The rally has been impressive but validated by an improved earnings outlook. Still, some of the earnings optimism is now in the price, and we rate value as neutral.

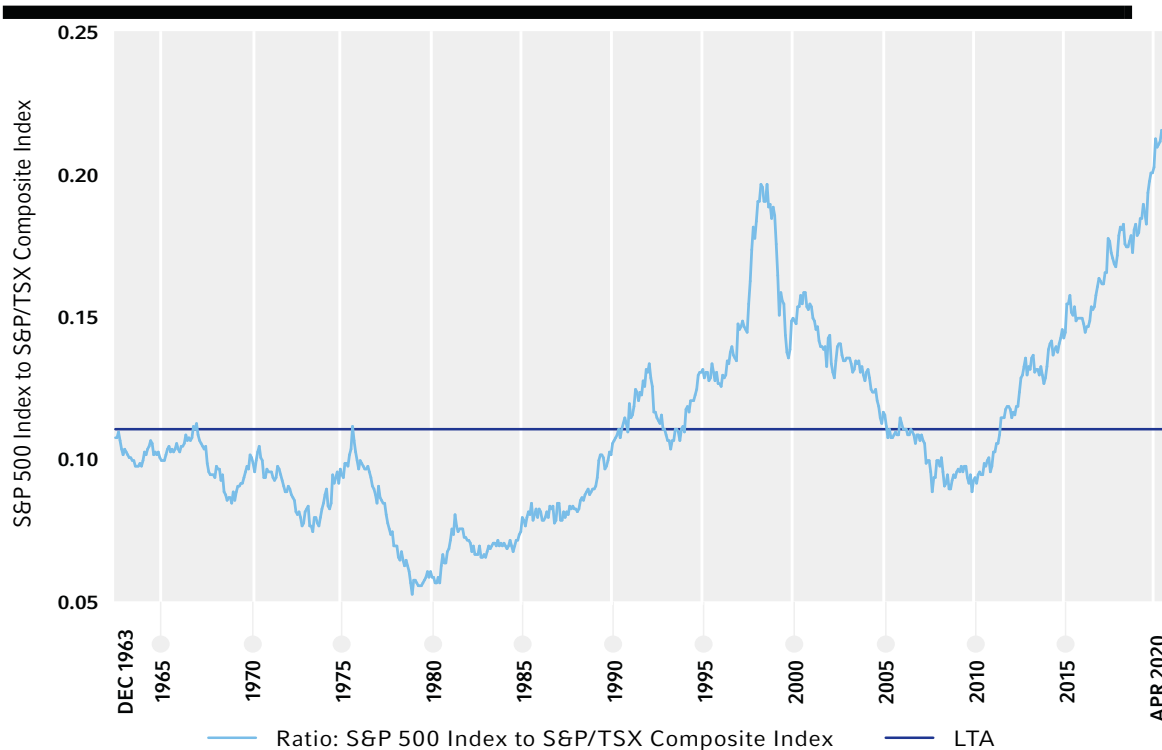
Sentiment:

Our contrarian indicators are broadly neutral, but improved price momentum makes sentiment positive overall.

Conclusion:

We are optimistic about the outlook for Canadian equities. The improving business cycle supports commodity prices and cyclical sectors, which favors domestic equities. Our higher conviction view, as noted above, is our preference for Canadian equities relative to the U.S.

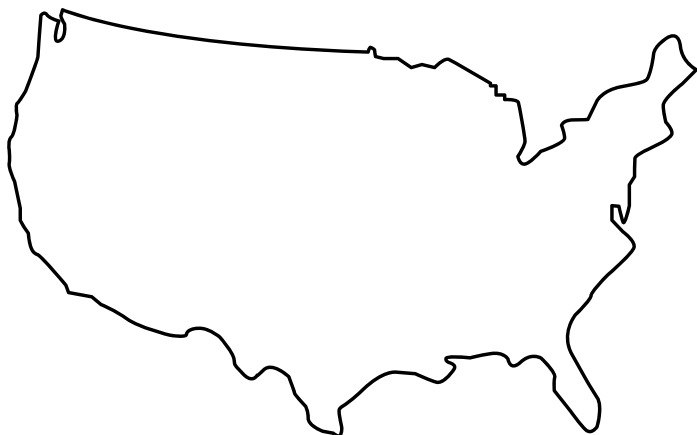
Figure 2: Ratio: S&P 500 Index to S&P/TSX Composite Index



Source: Refinitiv DataStream, Russell Investments, as of February 2021.

LTA = long-term average. Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

Regional Snapshots



United States

The United States is primed for supercharged growth. The recently enacted US\$1.8 trillion fiscal stimulus package provides another big shot in the arm for the U.S. consumer. And this stimulus comes at a time when the economy should already be re-accelerating as vaccines become broadly available around the middle of the year. With the economy reopening more-completely, we look for pent-up demand to drive a strong bounce in the service sectors. Demand for air travel, for example, is likely to overshoot as families go on vacations again. There is already evidence of this re-opening theme in the data, with sharply higher travel bookings scheduled more than 90 days into the future. [Real GDP growth of 7% looks possible for 2021](#), which would be the best calendar-year outcome since 1984. The good news is that there is spare capacity to absorb much of this above-trend growth. We look for the Fed to keep its benchmark rate at zero until late 2023 or early 2024, which should slow the rise in 10-year yields from here. The industry consensus for GDP and corporate earnings growth is now uniformly optimistic. Rather than focusing on benchmark U.S. equity market exposure—which skews heavily toward the 2020 COVID-19 winners such as mega-cap technology stocks—we continue to see bigger opportunities in the cheaper and more cyclical areas of the equity market. These securities have generally been performing strongly over the last two quarters, but we believe still trade at attractive relative valuations.

Eurozone

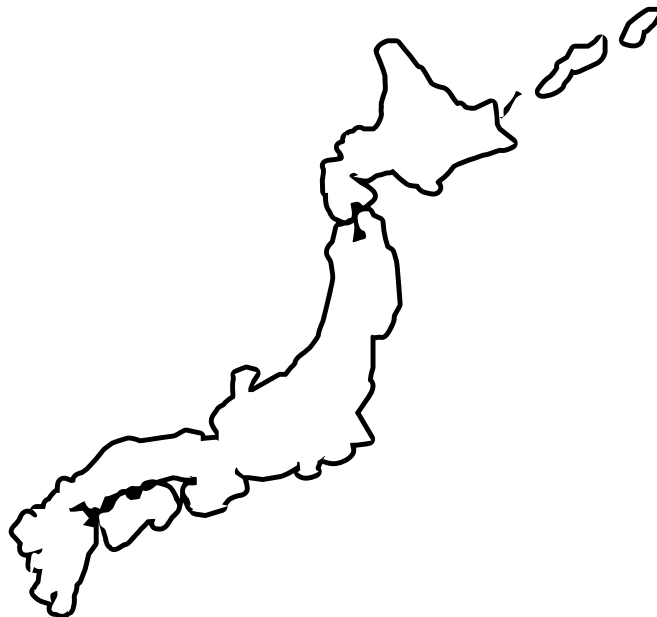
[Europe's relatively slow vaccine rollout](#) and relatively smaller fiscal stimulus means it continues to lag the United States in terms of economic performance. As of mid-March, less than 10% of the population in France, Germany, Italy and Spain had received at least one dose of vaccine. This compares to nearly 25% in the United States and 40% in the United Kingdom. Infection rates are rising in Europe and new lockdowns have been imposed in several countries. After a slow start, however, the vaccine rollout is gaining pace and Europe should be on track for economic reopening by Q3. The post-lockdown recovery is likely to be extremely strong and GDP should bounce back by around 5% this year following last year's near 7% decline.

We expect the MSCI EMU Index, which reflects the European Economic and Monetary Union, should outperform the S&P 500 in 2021. Europe's exposure to financials and cyclically sensitive sectors such as industrials, materials and energy, and its small exposure to technology, give it the potential to outperform in the post-vaccine phase of the recovery when economic activity picks up and yield curves in Europe steepen.



United Kingdom

The fast vaccine rollout should help the UK achieve a large rebound from last year's 9.9% GDP decline. GDP growth could be as high as 7% in 2021 and not much slower in 2022. The Bank of England is likely to [keep rates on hold during the recovery phase](#) and this should keep gilt yields contained and rising at most in line with U.S. Treasuries. The FTSE 100 Index has been the worst-performing regional equity market in recent years, but the outlook is improving in line with the economy. The FTSE 100 is the cheapest of the major markets and UK corporate earnings are set for a substantial rebound after declining by 35% in 2020. The UK market is overweight the cyclical value sectors, such as material and financials, that will benefit from post-pandemic reopening. Financials should also be boosted by the improvement in interest margins from yield-curve steepening. Small-cap stocks have run hard since the vaccine announcement, but we expect they still have upside as the economy rebounds from the lockdown-induced economic collapse. Sterling also has upside on a 12-month horizon, although at 1.39 to the U.S. dollar (USD) it is now close to the OECD's measure of purchasing power parity fair value. Sterling has appreciated by 20% against the USD since the depths of the pandemic last year. It can make further gains as the UK economic outlook brightens but valuation will be a headwind.



Japan

We continue to think Japan's growth will significantly lag other major economies, although 2021 growth will be above-trend. [The slower vaccine approval process](#) and subsequent rollout pushes back the potential for some form of herd immunity. There is still risk of short-term lockdowns, like those announced in early January 2021, but we expect that any future lockdown will have a less severe impact on growth than previous lockdowns.

The potential boost to the economy from the Tokyo Olympics scheduled to begin this July has been reduced, given it seems very likely they will go ahead without overseas spectators. However, the Olympics-related construction has been completed and contributed in part to some of the stronger growth through the last quarter of 2020.



China

We expect [Chinese economic growth to be strong in 2021](#), boosted by the recovery in the global economy. China was the first-in, first-out of the pandemic shutdown, and we expect China will be the first to start tightening its stance on policy this year. Importantly, this will be a gradual process and we expect that authorities will be sensitive to economic volatility and quickly ease back on tightening if there are signs of labor-market weakness. We also expect that domestic consumption will continue to catch up to the production side of the economy this year, boosted by government incentives (including for car purchases) as well as the increase to household income from further jobs growth.

U.S.-China tensions continue to linger in the background. [Our base case](#), however, is that there will not be further escalation from the new U.S. administration during these early stages of the economic recovery.



Canada

The Canadian economy has shown remarkable resilience despite larger lockdowns than the United States. Industry consensus forecasts for 2021 GDP have been revised higher to around 5.5% for 2021, a considerable improvement relative to the Bank of Canada's (BoC) estimate of 4.0%. The upgrade seems appropriate to us. The main supports to Canadian economic growth are the housing market's strength, which supports construction, a stimulus-primed U.S. economy that is boosting Canadian exports, and improving commodity prices.

We expect the BoC to upgrade its growth outlook at the April meeting and potentially adjust its bond purchase program. However, the crucial takeaway is policy will remain supportive. The BoC calculated that the output gap was equal to 3.3% of GDP at the end of 2020 and signaled policy accommodation is deemed necessary until that gap has closed and the inflation objective is "sustainably achieved." We also expect the BoC to delay raising interest rates until after the U.S. Fed has initiated tightening, which means the first BoC hike could still be two years away.

We're optimistic about the outlook for Canadian equities. The improving business cycle supports cyclical sectors and the value factor, which when combined with better relative value than U.S. equities, suggests Canadian equities likely will outperform the U.S. this year.



Australia/New Zealand

GDP growth in Australia and New Zealand is likely to be lower than most other developed nations this year, but this largely reflects the smaller drawdown that both countries experienced due to their lower COVID-19 infection rates.

Some of the support programs in Australia are set to taper off over the coming months, and we will closely monitor for any economic damage that was masked by these programs. We expect there will be a tick-up in insolvencies, but this doesn't overly concern us given they are coming from such a low base and were suppressed by temporary legislative changes.

Both the Reserve Bank of Australia (RBA) and Reserve Bank of New Zealand (RBNZ) are likely to keep policy accommodative over the next year. We don't expect any changes from the

RBNZ, while the RBA will probably undertake a third round of quantitative easing purchases after the conclusion of the second. The recent inclusion of the housing market into the RBNZ's mandate does not increase the odds of a rate rise, in our opinion, but will instead mean more focus on macroprudential policy. We see the potential for a return to tighter macroprudential policy¹ in Australia if there is evidence of deteriorating lending standards.

Australian equities should continue to outperform New Zealand equities over the next year. Australia has a relative valuation advantage and has more exposure than New Zealand to the cyclical value stocks that are likely to lead global equity markets higher. New Zealand bonds are likely to underperform Australian bonds, which means rates are likely to rise further in New Zealand than Australia, given the more active stance of the RBA.

¹ Macroprudential regulation is the approach to financial regulation that aims to mitigate risk to the financial system as a whole.

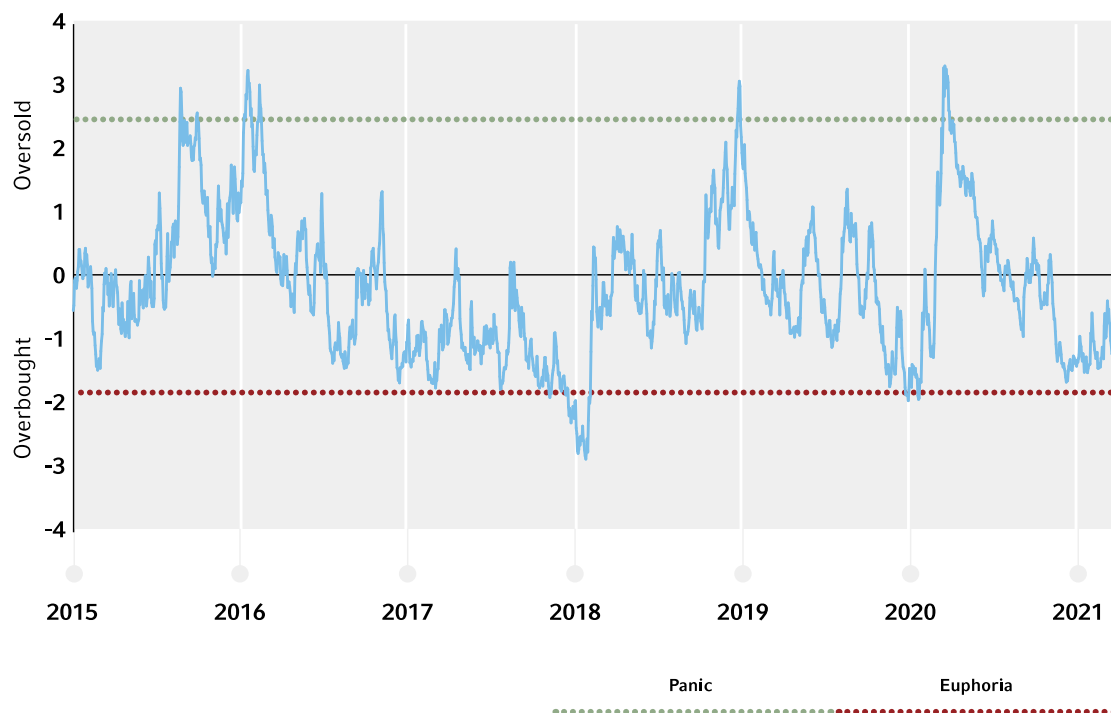
Europe's post-lockdown recovery is likely to be extremely strong and GDP should bounce back by around 5% this year following last year's near 7% decline.

Andrew Pease, Head of Global Investment Strategy

Asset class preferences

Our cycle, value and sentiment investment decision-making process in late March 2021 has a moderately positive medium-term view on global equities. Value is slightly expensive, with the expensive U.S. market offset by fair value in the rest of the world. Sentiment is slightly overbought but has retreated from the near euphoric levels reached after the runoff elections in January that gave [Democrats control of the U.S. Senate](#). The cycle is risk-asset supportive for the medium-term. The recovery from the recession means a long period of low-inflationary growth supported by monetary and fiscal stimulus.

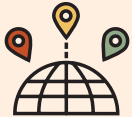
Composite Contrarian Indicator



Source: Russell Investments. Last observation: 19 March 2021. Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors at large are.



We prefer **non-U.S. equities** to U.S. equities. The post-vaccine economic recovery should [favor undervalued cyclical value stocks](#) over expensive technology and growth stocks. Relative to the U.S., the rest of the world is overweight cyclical value stocks.



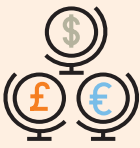
We like the value in **emerging markets (EM) equities**. China's early exit from the lockdown and stimulus measures should benefit EM more broadly, as will the recovery in global demand and a weaker U.S. dollar.



High yield and **investment grade credit** are slightly expensive on a spread basis but have an [attractive post-vaccine cycle outlook](#). Bank loans and U.S. dollar-denominated emerging markets debt, in our view, offer the best opportunities.



Government bonds are still expensive even after the recent selloff. Low inflation and dovish central banks should limit the rise in bond yields during the recovery.

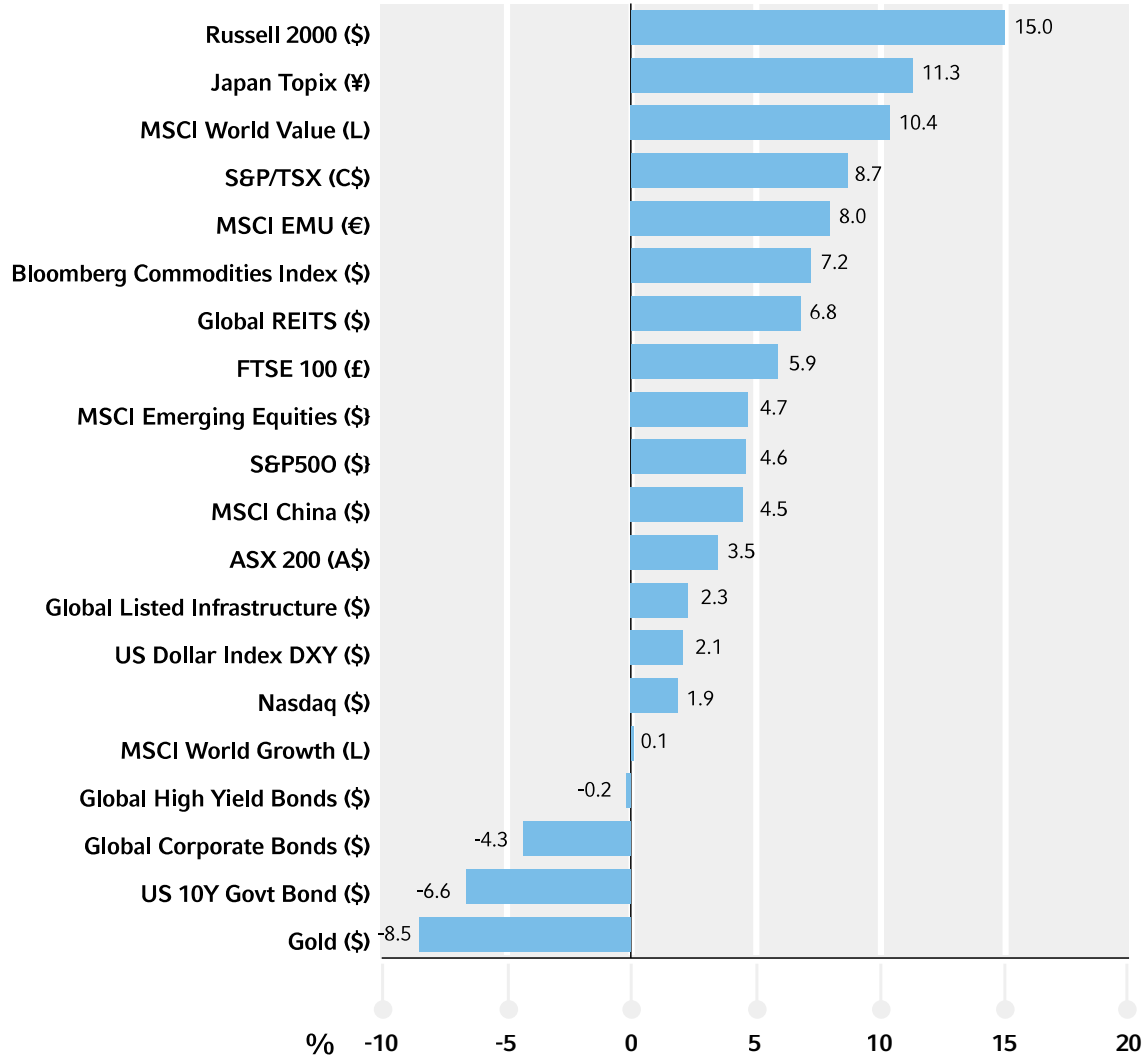


Real assets: Real Estate Investment Trusts (REITs) sold off heavily in 2020, with investors concerned about the implications of social distancing and online shopping for office buildings and shopping malls. REITs look relatively cheap and should be a pandemic recovery trade. Listed infrastructure, although expensive relative to REITs, should also benefit from the global recovery, boosting transport and energy infrastructure demand.



The **U.S. dollar** has been supported this year by the U.S. stimulus and expectations for early Fed tightening. The dollar should weaken later in the year as investors unwind Fed tightening expectations. It should also weaken as the global economic recovery gets underway, given the dollar typically gains during global downturns and declines in the recovery phase. The main beneficiary is likely to be the euro, which is still undervalued. We also believe **British sterling** and the economically sensitive *commodity* currencies—the **Canadian dollar**, **New Zealand dollar** and **Australian dollar**—can still make further gains, although these currencies are no longer undervalued from a longer-term perspective.

Asset performance since the beginning of 2021



Source: Refinitiv Datastream, as of 18 March 2021.

IMPORTANT INFORMATION

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Performance quoted represents past performance and should not be viewed as a guarantee of future results.

The FTSE 100 Index is a market-capitalization weighted index of UK-listed blue chip companies.

The S&P 500® Index, or the Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The MSCI EMU Index (European Economic and Monetary Union) captures large and mid cap representation across the 10 developed markets countries in the EMU. With 246 constituents, the index covers approximately 85% of the free float-adjusted market capitalization of the EMU.

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