GROWING PAINS

2021 Global Market Outlook – Q4 update

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Synopsis

The COVID-19 delta variant, inflation and central bank tapering are unnerving investors. We expect the pandemic-recovery trade to resume as inflation subsides, infection rates decline and tapering turns out to not equal tightening. Amid this backdrop, our outlook favours equities over bonds, the value factor over the growth factor and non-U.S. stocks over U.S. stocks.

Key market themes

The post-lockdown recovery has transitioned from energetic youthfulness to awkward adolescence. It's still growing, although at a slower pace, and there are worries about what happens next - particularly around monetary policy and the outlook for inflation. While the inflation spike has been larger than expected, we still think it's transitory, caused by base effects from when the U.S. consumer price index fell during the lockdown last year and by temporary supply bottlenecks. We believe that inflation may remain high through the remainder of 2021, but should decline in early 2022. This means that even though the U.S. Federal Reserve (the Fed) is likely to begin tapering asset purchases before the end of the year, we see rate hikes as unlikely before the second half of 2023.

Another market concern is the highly contagious COVID-19 delta variant. The evidence so far, however, shows that vaccines are effective in preventing serious COVID-19 infections. With vaccination rates accelerating globally, we believe that the broader economic reopening should continue through the rest of 2021.

Our cycle, value and sentiment (CVS) investment decision-making process leads us to conclude that global equities remain expensive, with the very expensive U.S. market offsetting better value elsewhere. Sentiment is slightly overbought, but not close to dangerous levels of euphoria. The strong business cycle gives us a preference for equities over bonds for at least the next 12 months, 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. We believe that the reopening trade should resume in the coming months, given that the cyclical stocks that comprise the value factor are reporting stronger earnings upgrades than technology-heavy growth stocks. In addition, the value factor is cheap compared to the growth factor.

Europe's exposure to financials and cyclically sensitive sectors such as industrials, materials and energy - as well as its relatively small exposure to technology - gives it the potential to outperform as delta-variant fears subside, economic activity picks up and yield curves steepen. We believe that the MSCI EMU Index, which reflects the European Economic and Monetary Union, has the potential to outperform the S&P 500® Index in the coming quarters.

In the UK, supply bottlenecks and labour shortages triggered a sharp rise in underlying inflation and led to concerns that the Bank of England (BoE) may begin raising rates in the first half of 2022. We believe the BoE is unlikely to be that aggressive and that an easing in supply constraints early next year will convince the central bank to delay rate hikes. The FTSE 100 Index is the cheapest of the major developed equity markets in late 2021, and this should help it reflect higher returns than other markets over the next decade.

We expect Chinese economic growth to be robust over the next 12 months, supported by a post-lockdown jump in consumer spending and incremental fiscal and monetary easing. Some uncertainty remains around the path of future regulation, especially as it relates to technology companies, and as a result we expect investors will remain cautious on Chinese equities in the coming months. The property market - and property developers in particular - remains a risk that we are monitoring closely.

We believe that Japanese equities look slightly more expensive than other regions, such as the UK and Europe. We maintain our view that the Bank of Japan will significantly lag other central banks in normalising policy.

In Australia, the economy is set to return to life, with lockdowns likely to be eased in October and November. Consumer and business balance sheets continue to look healthy, which should facilitate a strong recovery. The Reserve Bank of Australia has begun the process of tapering its bond-purchasing programme, but we expect that a rise in the cash rate is unlikely until at least the second half of 2023.

In Canada, growth remains above-trend and the odds of additional fiscal expenditures to support the economy have increased. In our view, this means that weaker growth due to COVID-19 is unlikely to change the Bank of Canada's tightening bias.

Economic views

U.S. GROWTH

We believe that the U.S. economy is likely to sustain above-trend growth into 2022, but think that the easiest gains are probably in the rear-view mirror, as the recovery phase of the business cycle matures.

FED RATE PROJECTIONS

Our models suggest that inflation is likely to drop back below the Fed's 2% target in 2022. If that's correct, we think the Fed will likely keep interest rates unchanged into the second half of 2023.

IMPACTS OF POTENTIAL U.S. TAX INCREASES

We estimate that higher corporate taxes in the U.S., if enacted, could subtract about four percentage points from S&P 500 earnings growth in 2022.

EUROPEAN GROWTH

Eurozone growth looks on track for a return to above-trend growth over the fourth quarter and into 2022, following the recent slowdown.

CHINA OUTLOOK

We believe there is a risk of a sharper-than-expected slowdown in China. Already, credit growth has slowed this year and recent purchasing managers' indexes have trended lower.

Asset class views

Equities: Preference for non-U.S. equities

We believe stronger economic growth and steeper yield curves after the third-quarter slowdown should favour 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.

Fixed income: Government bonds expensive

We think yields should be under upward pressure as output gaps close and central banks look to taper back asset purchases. We expect the 10-year U.S. Treasury yield to rise toward 1.75% in the coming months.

Currencies: U.S. dollar likely to weaken

The U.S. dollar has been supported this year by expectations for early Fed tightening and U.S. economic growth leadership. We believe it should weaken as global growth leadership rotates away from the U.S. and toward Europe and other developed economies. 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 Australian dollar, the New Zealand dollar and the Canadian dollar - can make further gains, although these currencies are not undervalued from a longer-term perspective.

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IMPORTANT INFORMATION

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