

THE OLD
NORMAL



2021 Global Market Outlook





The old normal

COVID-19 vaccine prospects should make 2021 a year of global economic recovery. Markets have priced in a lot of good news, but more gains seem possible as corporate profits rebound and central banks remain on hold.

We have a positive medium-term outlook for economies and corporate earnings. We're in the early post-recession recovery phase of the cycle, which implies an extended period of low-inflation, low-interest rate growth that favours equities over bonds.

Andrew Pease, Head of Global Investment Strategy



Introduction

2020 was a year of surprises. There was the speed at which the pandemic escalated, the severity of the lockdowns, the size of the government stimulus measures globally and the magnitude of the equity market rebounds. Perhaps the biggest surprise is that global equities, as of late November, have gained around 12% since the beginning of the year—an outcome few would have predicted during a global pandemic. With the [U.S. election behind us](#) and effective vaccines on the way, investors have become bullish, pushing the S&P 500® to record highs.

Likewise, we have a positive medium-term outlook for economies and corporate earnings. We're in the early post-recession recovery phase of the cycle. This implies an extended period of low-inflation, low-interest rate growth that favours equities over bonds. There are some near-term risks, however. Investor sentiment has become overly optimistic following the vaccine announcements, making [markets vulnerable to negative news](#). This could include renewed lockdowns in Europe and North America as virus cases escalate, logistical difficulties in distributing the vaccine and negative economic growth in early 2021 if government support measures are unwound too quickly. Geopolitics could also deliver negative surprises from China, Iran or Russia as the new Biden administration takes power in the U.S.

Our cycle, value and sentiment (CVS) investment decision-making process scores global equities as expensive (with the very expensive U.S. market offsetting better value elsewhere), sentiment as overbought and the cycle as supportive. This leaves us slightly cautious on the near-term outlook, but moderately positive for the medium-term with expensive valuation offset by the positive cycle outlook.

Overall, we see the following asset class implications for 2021:

- Equities should outperform bonds.
- Long-term bond yields should rise, though with steeper yield curves likely limited by continued low inflation and central banks remaining on hold.
- The U.S. dollar will likely weaken given its countercyclical nature.
- Non-U.S. equities to outperform given their more cyclical nature and relative valuation advantage over U.S. stocks.
- The value equity factor to outperform the growth factor.

A return to normal by the second half of the year should help extend the rotation that began in early November away from technology/growth leadership [toward cyclical/value stocks](#). During the COVID-19 pandemic, technology and growth stocks enjoyed tailwinds from a boost to earnings and lower discount rates. These tailwinds should become headwinds once a vaccine is available and lockdowns have been eased. This should allow the normal early-cycle recovery dynamics to resume, with investors rotating towards relatively cheaper value and non-U.S. stocks that will benefit from the return to more normal economic activity.

Post-COVID vulnerability

The major economies have escaped the pandemic and lockdowns with relatively little long-term economic damage thanks to substantial monetary and fiscal support. Wage subsidies and job retention schemes have prevented unemployment rates from rising significantly in most countries. In the United States, corporate bankruptcies and delinquency rates on consumer loans were lower in the September quarter than the same period in 2019. The hospitality, tourism, transport and retail sectors have been hit hard, but the overall balance sheet damage to corporates and households has been relatively limited despite the large lockdowns.

The most notable damage from the pandemic is rising government debt. The International Monetary Fund (IMF) projects that gross government debt for the G7¹ economies will rise by 23% of gross domestic product (GDP) in 2020. High debt makes government finances vulnerable to rising interest rates. This is unlikely to be a significant problem in the next couple of years, but it will matter when spare capacity is eventually exhausted, and inflation starts to rise.

There is speculation that governments will soon start to trim deficits through tax hikes and lower spending, slowing the recovery. This seems unlikely anytime soon. The two

charts below show that despite the increase in debt levels, net interest expenses are projected to trend lower for all the major economies. By 2023, Japanese government net interest payments are expected to be close to zero, despite gross debt in excess of 250% of GDP. Two-thirds of Japanese government debt has a negative yield.

Governments will come under pressure to reduce deficits only after bond yields rise meaningfully and markets question debt sustainability. We expect fiscal austerity and tighter monetary policy are still some years away.

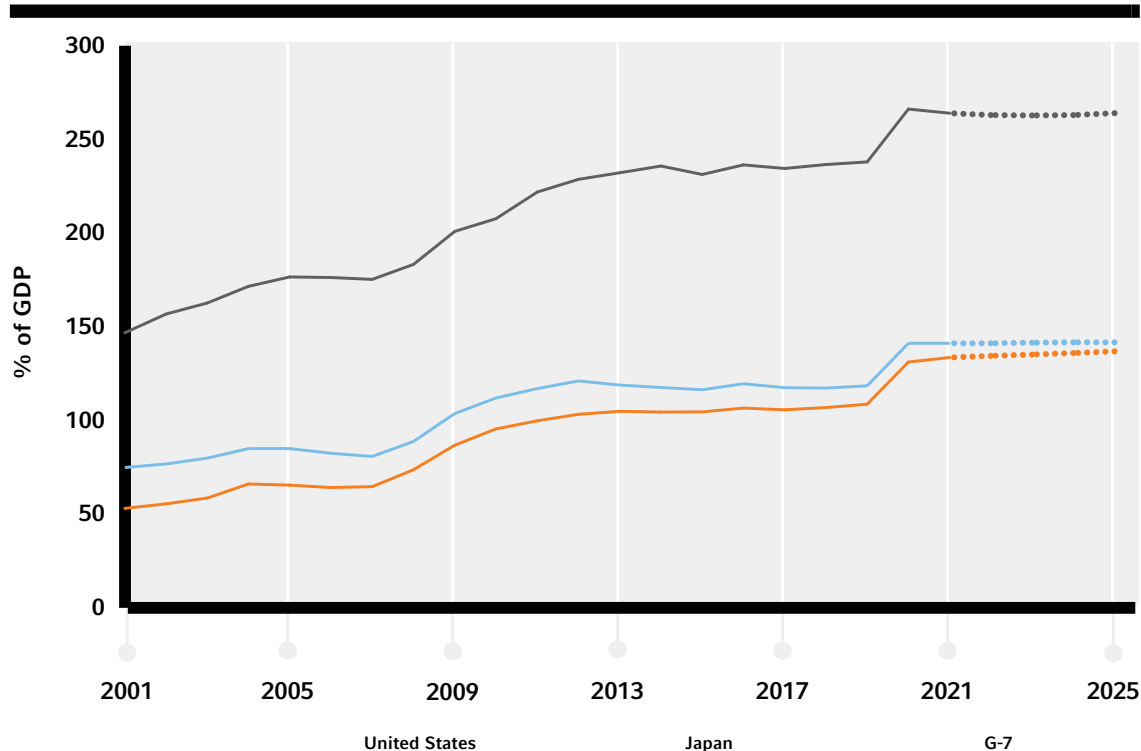


Our cycle, value and sentiment (CVS) investment decision-making process scores global equities as expensive, sentiment as overbought and the cycle as supportive.

Andrew Pease, Head of Global Investment Strategy

¹ The Group of Seven (G7) is an intergovernmental organization consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

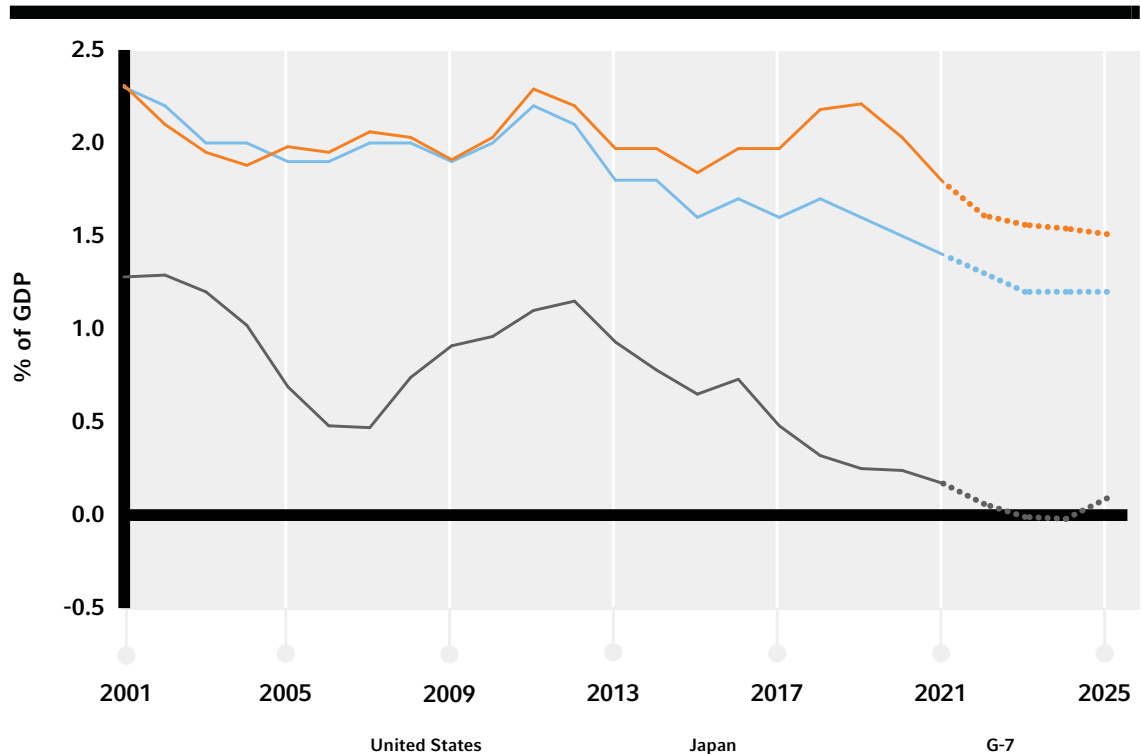
General Government Gross Debt



Source: International Monetary Fund (IMF) Fiscal Monitor, as of November 27, 2020.

Dashes after solid lines represent IMF forecasts for 2021-25. Gross government debt denotes all accrued external financial obligations.

Interest Expense (NET)



Source: International Monetary Fund (IMF) Fiscal Monitor, as of November 27, 2020.

Dashes after solid lines represent IMF forecasts for 2021-25. The Group of Seven (G7) is an intergovernmental organization consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Bond yields & equity rotations

Government bond yields to rise

Long-term government bond yields are likely to come under upward pressure from a vaccine-led recovery in 2021. Dovish central banks and the lack of inflation pressure in most countries as output gaps remain large should limit the rise in yields. The major central banks have made clear that they will wait until after inflation rises before raising rates. This was highlighted by the recent move by the U.S. Federal Reserve (the Fed) to target average inflation and allow an overshoot of its 2% target. A slow-to-react Fed should limit the rise in the 10-year Treasury yield to between 1.1 to 1.4% from the current 0.85%. It's reasonable to expect similar increases of between 25 to 50 basis points in German bund and British gilt yields. Japanese government bond yields, though, are likely to remain close to zero with the Bank of Japan continuing with yield curve control.

Equity market rotations to continue

The announcement of a successful COVID-19 vaccine in early November has led to tentative signs of a market rotation away from technology-heavy growth stocks towards more cyclical value stocks. Technology stocks received two benefits from the lockdowns. The first was the boost to earnings as consumers worked from home, spent online and made technology purchases. The second was from the decline in government bond yields. Technology stocks are regarded as long-duration as they are expected to grow their earnings over the longer term. The decline in bond yields made the present value of those future earnings more valuable.

The rotation away from technology stocks is likely to continue into 2021. The boost to tech-stock earnings from the lockdowns has peaked and there could be a demand shortfall in coming quarters since the pandemic brought some technology spending forward. Higher bond yields will also be a headwind for tech stocks. In contrast, the global recovery and higher bond yields should help value and cyclical stocks. Financial stocks are heavily weighted in value indices, and we expect these will benefit from higher margins as yield curves steepen, and from stronger revenues as credit growth improves. In late 2020, banks, globally, are trading at a large discount to the broader market.

The post-vaccine recovery outlook should also help non-U.S. markets outperform the U.S. The S&P 500 is [overweight the tech and healthcare stocks that dominate the growth factor](#), while the rest of the world has more of the financial and cyclical stocks that make up the value factor. Investors are likely to favour the relatively cheaper value and non-U.S. stocks that will benefit from the return to more normal economic activity.

Risks: lockdowns, vaccine delays and too much optimism

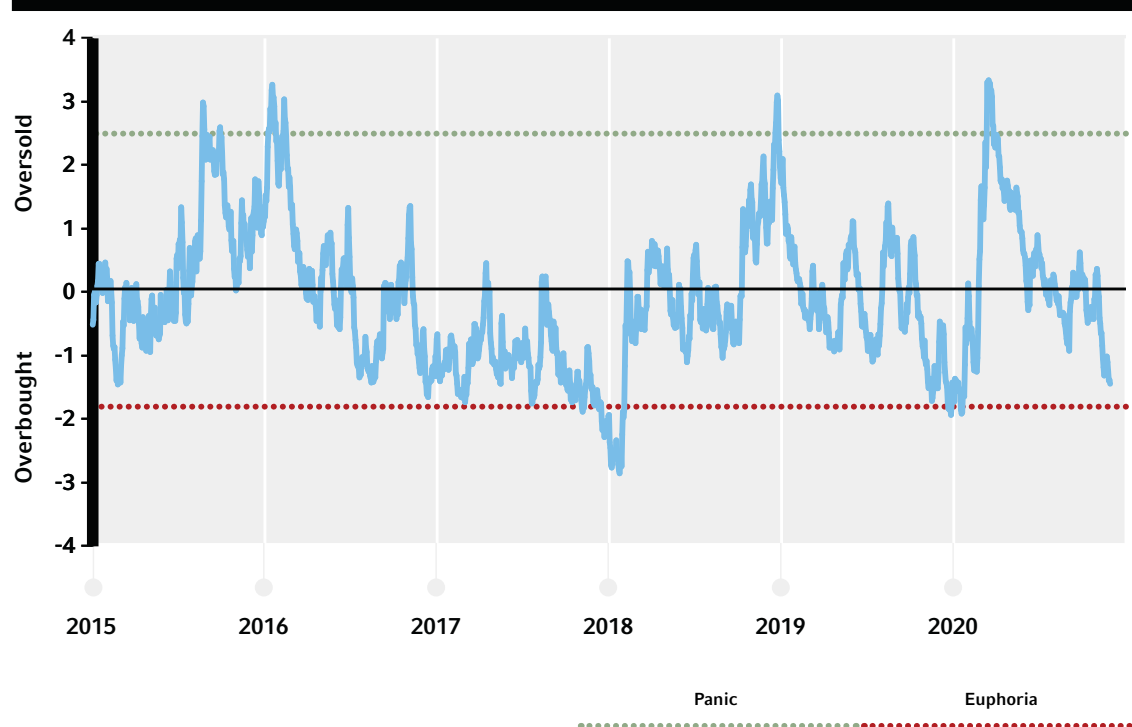
The vaccine announcements and passing of U.S. election uncertainty have removed two of the near-term worry points about the outlook. The major risk now is the amount of investor optimism since the vaccine announcements. Our composite contrarian sentiment indicator is not yet at the overbought threshold in early December, but it is getting close. Investors are positioned for upside gains, which makes markets vulnerable to disappointing news. This could come from the current upswing in virus cases and a potential demand shortfall in early 2021 as government support programmes expire and are not renewed. In particular:

- Infection rates are picking up across the United States. Schools have been closed in New York and there is a growing risk of more widespread lockdowns.
- Although infection rates are coming down in Europe following the recent lockdowns, there is the risk of a renewed spike in infections in early 2021 as lockdowns are eased.

- It seems likely that the Republicans will retain control of the U.S. Senate in 2021, making a further fiscal stimulus package subject to difficult negotiations with Democrats in the incoming Biden administration. A stimulus package may be small and delayed until late Q1, creating the risk of negative GDP growth in the first quarter of 2021.

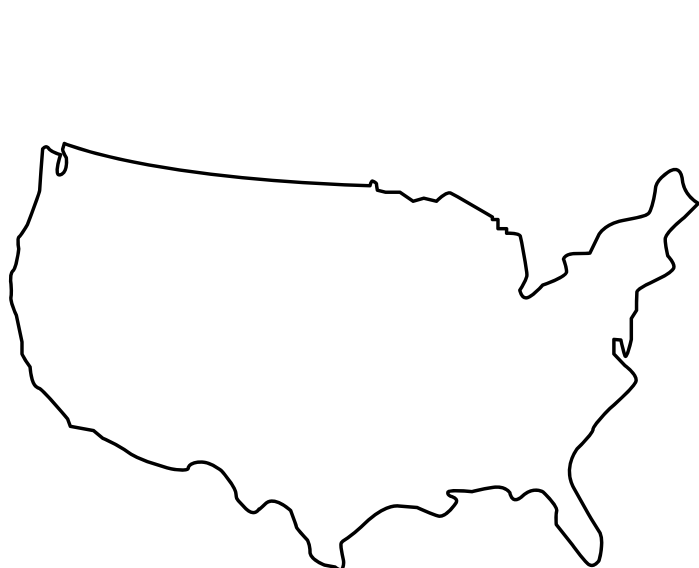
The other risk for equity markets in 2021 is rising bond yields. Equity markets can often navigate rising bond yields if the reason is better prospects for economic growth, but a rise in excess of 50 basis points may provide a test. Technology stocks received a large boost to valuation from lower discount rates. The large tech stocks make up around 25% of the S&P 500 capitalisation. They have accounted for almost all the gains in the overall market for 2020 through November. A bond market-led reversal in tech stocks could stall the overall market even if the remaining 75% of the S&P 500 makes post-pandemic gains.

Composite Contrarian Indicator



Source: Russell Investments. Last observation: November 27, 2020. Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors at large are.

Regional Snapshots



United States

We remain bullish about the economic outlook. There likely will be two distinct phases to the path forward. The first, over the northern winter months, appears challenging. COVID-19 infections are exploding across the country and leading to partial, localised lockdowns again. These lockdowns are a far cry from April when 95% of Americans were under stay-at-home orders, but the measures should slow the pace of positive economic performance into year-end. The post-vaccine period should deliver another strong, V-leg for the recovery that delivers real GDP growth in excess of 5% in 2021. Vaccines should allow dislocated sectors (e.g. restaurants, travel, hotels) to bounce back strongly in the second half of 2021.

Meanwhile, the Fed continues to maintain an [ultra-accommodative policy stance](#). Even with our expectation for a robust 2021, the Fed's focus on generating an inflation overshoot will leave plenty of runway for the expansion to strengthen and broaden. The three biggest challenges for U.S. investors are the concentration risk in major U.S. equity benchmarks that are skewed toward the stay-at-home mega cap technology stocks; moderately expensive valuations in equity and credit; and an increasingly optimistic industry consensus which has gravitated closer to our macro view.



Eurozone

The second wave of virus infections has reversed the Q3 V-shaped recovery and the region is [on track to record negative GDP growth in Q4](#). The new lockdowns are working, however, and infections across the region peaked in early November. Lockdowns are being eased in some countries heading into Christmas, but the likelihood is that this winter will see ongoing virus outbreaks and renewed lockdowns until a vaccine becomes widely available, possibly by spring. Europe is poised for a strong post-vaccine recovery. Its economy suffered a big hit from the pandemic, so can rebound from a low base. Europe is more exposed to global trade than the U.S. and will be a beneficiary of a recovery in Chinese demand.

After five years of underperformance, we expect the MSCI EMU Index 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 steepen.



United Kingdom

COVID and Brexit uncertainty have battered the United Kingdom and GDP is on track for an 11% contraction in 2020. The distribution of a vaccine and a Brexit deal could see the UK economy have one of the biggest rebounds in 2021 with GDP bouncing back by 6-7%. Longer-term, the non-tariff barriers on trade in services, even if there is a Brexit deal, will be a drag on growth, but the cyclical forces driving the GDP rebound should dominate over the next couple of years.

The Bank of England is likely to keep rates on hold during the recovery phase and this should keep gilt yields contained, at most rising in line with U.S. Treasuries. The FTSE 100 Index has been the worst-performing regional equity market by a wide margin so far in 2020 through November but could be one of the better performers in 2021. It is cheap relative to other markets and is overweight the financials, materials and cyclical sectors that will benefit most from the global recovery.



Japan

Japan's rebound from the pandemic is likely to lag other developed economies despite its less severe COVID outbreak. This reflects the structural weaknesses that were in place before the pandemic, such as subdued consumption due to the ageing population. Mobility has been slower to recover, reflecting the cautious attitude towards the pandemic from Japan's older, more vulnerable population.

The policy priorities of the new prime minister, Yoshihide Suga, will be an important watchpoint early next year. Suga has already expressed interest in reforms to improve productivity levels at small and medium enterprises (SME) through subsidising capital expenditure. This would be an encouraging development, given the low productivity level at Japanese SMEs.

The Olympics, assuming they go ahead in 2021, will still give a boost to the economy although smaller than previously expected given they are likely to be at a reduced scale.



China

The Chinese economy [has returned to almost pre-pandemic output levels](#)—a significant achievement given the depth of the first quarter downturn. The IMF does not expect other large countries to return to pre-COVID economic levels until at least 2022.

Consumption has played catch-up to production and this is important for the outlook for government policy. The Chinese government has a focus on the concept of dual circulation which aims to rebalance the economy towards domestic demand and away from reliance on exports and capital investment. The government believes this transition is needed to ensure that China does not fall into the middle-income trap.

The government and People's Bank of China have been discussing when to start reducing the amount of stimulus. The most likely outcome is a continuation of the hand-over from monetary policy to fiscal stimulus. Fiscal policy should remain supportive through 2021. More stimulus may be announced at the National People's Congress meeting (likely in March 2021) as the government continues to support consumption.

The trade war between the U.S. and China should be less heated under President-elect Joe Biden but we do not foresee a return to pre-Trump era relations with China. Two key watchpoints will offer clues to the future of U.S.-China relations. The first will be the initial meeting between Biden and Chinese President Xi Jinping, and subsequent discussions about the future of the current tariffs and the Phase One trade deal. The second watchpoint will be Biden's attempt (and ability) to forge a multi-country alliance to coerce China into improving access to its markets.



Australia and New Zealand

Australia and New Zealand have controlled the virus outbreak better than most other countries and, with relatively open economies, are poised to be beneficiaries from the post-vaccine global recovery. A direct benefit of the vaccine will be the return of inbound tourism. This will particularly benefit New Zealand given its reliance on Australian visitors.

The re-election of Jacinda Ardern's Labour government in New Zealand means a continuation of the supportive fiscal stance for the economy, while in Australia, the Liberal government has committed to deficit spending until the unemployment rate is below 6%. This won't be until 2022, as per their forecasts.

The central banks of both countries have become more aggressive in their accommodation, with the Reserve Bank of Australia (RBA) undertaking a quantitative easing programme and the Reserve Bank of New Zealand (RBNZ) implementing a Funding for Lending scheme (under which the RBNZ provides the banks with funds for lending, similar to the European Central Bank's targeted longer-term refinancing operations programme). Next year will likely see an expansion of the RBA's quantitative easing (QE) programme, and there remains a possibility of negative interest rates in New Zealand.

The recovery in the global economy, led by China, should benefit the equity markets in both countries. The offset, however, is that a return to economic normality will place upward pressure on both the Australian and New Zealand dollars.



Canada

Canada seems likely to be a bigger beneficiary from the post-vaccine rebound than the United States. Unlike the U.S., there are no concerns about political gridlock, and fiscal support is likely to remain in place for as long as needed. Canada's economy contracted by an annual rate of 13.4% over the first half of 2020 and fiscal policy has been critical to the recovery since then. The near-term risk is that virus cases are rising at a worrying pace, forcing provincial policy makers to reimpose business restrictions.

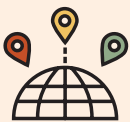
We expect the Canadian economy will grow by 5% in 2021. Canada's exposure to commodities, particularly oil, will benefit from the rebound in the global economy. Business investment may be slower to materialise but the housing market and improving commodity prices should serve as the foundation to the recovery. The S&P/TSX Composite Index has lagged the S&P 500 by a wide margin this year. It should recover some of this underperformance in 2021 in line with the global recovery. The Canadian dollar should also rebound in line with its commodity price correlation, with the potential for a \$0.79 CAD/USD exchange rate.

Asset class preferences

Our cycle, value and sentiment investment decision-making process in early December 2020 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 following the post-vaccine announcement optimism. The cycle is supportive of risk assets for the medium-term. The recovery from the recession means a long period of low-inflationary growth supported by monetary and fiscal stimulus.



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.



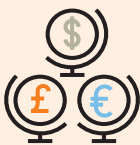
We like the value in **emerging markets (EM) equities**. China's early exit from the lockdown and stimulus measures should benefit EM more broadly, as will the recovery in global demand and a weaker U.S. dollar.



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 expensive. Low inflation and dovish central banks should limit the rise in bond yields during the recovery. U.S. inflation-linked bonds offer good value with break-even inflation rates well below the Fed's targeted rate of inflation.



Real assets: Real Estate Investment Trusts (REITs) sold off heavily in March 2020, with investors concerned about the implications of social distancing and online shopping for office buildings and shopping malls. Sentiment appears overly bearish, while value is positive. These should be a pandemic recovery trade. [Listed infrastructure](#) should also benefit from the global recovery, boosting transport and energy infrastructure demand.

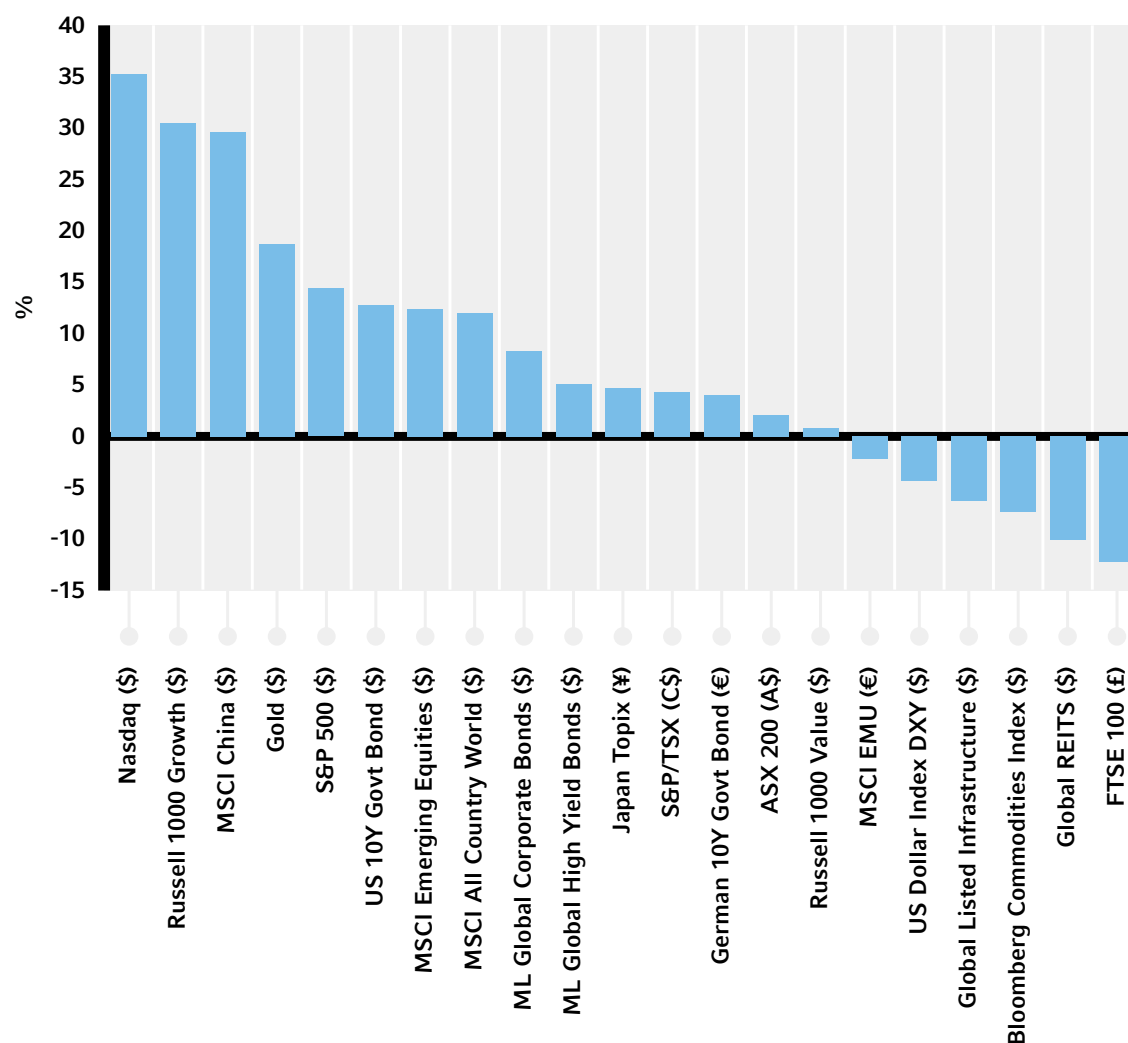


The **U.S. dollar** should weaken into the global economic recovery given its counter-cyclical behavior. The dollar typically gains during global downturns and declines in the recovery phase. The main beneficiaries should be the economically sensitive commodity currencies: the **Australian, New Zealand** and **Canadian dollars**. The **euro** and **British sterling** are undervalued. Both currencies should be boosted by the post-vaccine recovery.

The post-vaccine period should deliver another strong, V-leg for the U.S. recovery that delivers real GDP growth in excess of 5% in 2021.

Andrew Pease, Head of Global Investment Strategy

Asset performance since the beginning of 2020



Source: Refinitiv Datastream. Last observation: November 24, 2020.

IMPORTANT INFORMATION

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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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