THE SONG REMAINS THE SAME

2021 Global Market Outlook – Q3 update
The song remains the same

The global reopening remains on track as COVID-19 vaccination rates climb. Inflation is the new concern, but the spike so far looks transitory. We still like the pandemic-recovery trade that favors equities over bonds, the value factor over the growth factor and non-U.S. over U.S. stocks.

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Andrew Pease, Head of Global Investment Strategy
Introduction

So far, so good. As of mid-June, vaccination rates are close to 50% in the United States and Europe, and over 60% in the United Kingdom. Japan is lagging, with just 15% of the population vaccinated, but should hit 50% by late August as the rollout accelerates. New, more contagious COVID-19 variants are spreading, but the good news is that the existing vaccines seem effective against these as well. This means the reopening should continue across the major developed economies through the second half of 2021. It also implies that the focus for markets has shifted to the strength of the growth rebound, the implications for inflation and the timing of central bank moves to taper asset purchases and eventually raise interest rates.

Our view is that the inflation spike is mostly transitory, a combination of base effects—from when the Consumer Price Index (CPI) fell during the initial lockdown last year—and temporary supply bottlenecks. We expect it will take until the middle of 2022 for the U.S. economy to recover the lost output from the lockdowns and longer in other economies. Broad-based inflation pressures are unlikely until then. It also means that market expectations for U.S. Federal Reserve (Fed) lift-off in 2022 are premature. We expect the Fed to commence tapering in 2022, with the second half of 2023 the likely timing for the first interest rate hike.

Two key indicators

We’re watching two indicators for whether the inflation spike becomes an issue for the Fed. The first is the Atlanta Fed Wage Tracker. This series is based on a matched sample of workers, so it minimizes the compositional problems that distort the average hourly earnings numbers in the monthly jobs report.

The second is five-year/five-year breakeven inflation expectations. This is the market’s expectations for average inflation over five years in five years’ time. Currently, it tells us the market’s forecast for average inflation in the five years from mid-2026 to mid-2031.

Annual wage growth, according to the Atlanta Fed Wage Tracker, was 3% in the year to May 2021 and has been trending lower since mid-2020. Rising wages will be a sign that the labor market is approaching full employment. Wage growth near 4% will suggest the labor market is overheating, and that unit labor costs (wages minus productivity growth) will threaten a sustained rise in core inflation beyond 2.5%.

Longer-term inflation expectations—as measured by the five-year/five-year breakeven rate—above 2.75% would also be a sign that the inflation spike is becoming entrenched. The Treasury Inflation Protected Securities (TIPS) used to measure the breakeven rate are based on the CPI, while the Fed targets inflation as measured by the personal consumption expenditure (PCE) deflator. The two move together over time, but CPI inflation is generally around 0.25% higher than PCE inflation. A breakeven rate of 2.75% would suggest the market sees PCE inflation above 2.5% in five years’ time.
Wage growth above 4% and breakeven inflation expectations above 2.75% would see the Fed turn hawkish and bring an earlier start to rate hikes.

Atlanta Fed’s Wage Growth Tracker

U.S. breakeven inflation rate
We’re still in the early recovery stages of the cycle following the lockdown-induced recession. The reopening trade can be dated from November 6, 2020, when Pfizer announced the first successful COVID-19 vaccine. Since then, the best performing asset classes have been small cap and non-U.S. equities, global real estate investment trusts (REITs), commodities and the value factor. A reasonable summary is that the asset classes that performed poorly during the lockdown have been the winners in the post-vaccine phase.

This pattern is likely to continue for the next few months. The cyclical stocks that comprise the value factor are reporting stronger earnings upgrades than technology-heavy growth stocks, and the value factor is still cheap compared to the growth factor. Financial stocks are the largest sector in the MSCI World Value Index, and these should benefit from further yield-curve steepening, which boosts the profitability of banks. We expect that long-term interest rates will have modest upside over the next few months as global growth continues to improve. Our modeling suggests a range of 1.5% to 2.0% for the U.S. 10-year Treasury yield over the remainder of the year.

The same dynamics should also help non-U.S. equity markets outperform the U.S. market. The rest of the world is overweight cyclical value stocks relative to the U.S., which has a higher weight to technology stocks. 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 that the vaccine rollout in Europe, plus the fiscal boost from the European Union (EU)’s recovery fund to support member states hit by the pandemic, will provide further support for the value factor and non-U.S. outperformance.

<table>
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<tr>
<th>Asset Class</th>
<th>Performance (%)</th>
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<tbody>
<tr>
<td>MSCI World Small Cap (L)</td>
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<tr>
<td>FTSE EPRA/NAREIT Global ($)</td>
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<td>Gold ($)</td>
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Source: Refinitiv Datastream, as of June 17, 2021; performance since November 6, 2020. (L) implies local currency. Indexes are unmanaged and cannot be invested in directly.
Emerging market (EM) equities have been laggards since the vaccine announcement. They have been held back by the high weighting toward technology stocks in the emerging markets benchmark, concerns about slowing credit growth in China and the slow rollout of COVID-19 vaccines. This should start to reverse later in the year as Chinese credit growth stabilizes and vaccines become more available across emerging markets.

The final piece of the reopening trade is U.S. dollar weakness. The U.S. Dollar Index (DXY) has traded sideways since the vaccine announcement. It should weaken once investors have fully priced in Fed tightening expectations and as the global economic recovery becomes more entrenched. The dollar typically gains during global downturns and declines in the recovery phase. Dollar weakness will support the performance of non-U.S. markets, particularly emerging markets.

We expect the inflation spike is mostly transitory and that the major central banks, led by the Fed, are still two years from raising interest rates.

Andrew Pease

Risks: inflation is sustained and a hawkish Fed

There are still risks from new COVID-19 variants, but these are fading with the success of the vaccine rollout. The biggest watchpoint now is inflation and the response of central banks. Our expectation is that the inflation spike is mostly transitory and that the major central banks, led by the Fed, are still two years from raising interest rates.

An inflation spike that persists into the second half of the year, however, could trigger a more hawkish tone from the Fed. This would be a challenge for equity markets that offer value only when compared to the current low level of interest rates. Our inclination would be to add risk on any market dips caused by changes in Fed tone. The cycle is still positive for risk assets and a good rule-of-thumb is to remain positive on equities until the Fed has lifted rates to a level that starts to slow economic activity.
Regional Snapshots

United States
We expect strong economic growth in the United States through the second half of this year. Real gross domestic product (GDP) growth of around 7% for 2021 would mark the best outcome for the U.S. economy since 1984. Corporate earnings are rocketing higher. S&P 500® earnings growth shattered expectations in the first quarter earnings season (52% actual vs. 24% expected) and we expect the results for the second quarter to be considerably stronger as the reopening progresses. Strong earnings delivery is important for the U.S. market, which scores as expensive on a range of standard valuation measures.

Inflation came in much hotter than our expectations in the spring. The combination of supercharged demand (from federal stimulus checks) and disrupted supply (bottlenecks and pandemic impacts) have created inflationary pressures in the short-term. However, as demand moderates in 2022 and the supply side heals, we expect core inflation to moderate back to the Fed’s target. We will watch five-year/five-year forward inflation expectations and wage growth for signs that inflation is more persistent than anticipated. Our outlook for U.S. interest rates has been tweaked slightly, with our baseline for Fed liftoff pulled forward from March 2024 to December 2023. Otherwise our U.S. outlook largely remains unchanged from last quarter.

Eurozone
Europe’s vaccine rollout has gathered pace and a more sustained reopening of economies is on track for the second half of the year. The EU’s recovery fund will help countries in southern Europe maintain the rebound. The grants and loans from the fund are equal to 12% of GDP for Italy and Spain, and 19% for Greece.

In Germany, the left-leaning Greens are polling strongly in advance of the federal elections in September. The most likely outcome looks to be a coalition between the Greens and the conservative Christian Democratic Union, in which the Greens would push for more expansionary fiscal policy.

The region’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.

We expect the MSCI EMU Index, which reflects the European Economic and Monetary Union, to outperform the S&P 500 in 2021. Europe’s exposure to financials and cyclically sensitive sectors such as industrials, materials and energy, and its relatively 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 UK is set for a strong rebound in both GDP and corporate profits as it recovers from the dual headwinds of Brexit and the pandemic. The UK market is overweight the cyclical value sectors, such as materials and financials, that are benefiting from the post-pandemic reopening. Financials should also be boosted by the improvement in interest margins from a steeper yield curve as the Bank of England (BOE) moves closer to lifting interest rates (although we don’t expect the BOE to move before the Fed). The UK, as reflected by the FTSE 100 Index, is the cheapest of the major developed equity markets, and this should help it deliver higher returns than other markets over the next decade. Around 70% of UK corporate earnings come from offshore, so one near-term risk is that further Sterling strength dampens earnings growth. The other risks are mostly around policy missteps—for example, early tightening by the BOE or a premature move to fiscal tightening before the recovery is entrenched.

Japan

Japan’s recovery has been constrained by localized outbreaks of COVID-19, which have led to renewed lockdowns of metro areas. We expect a solid economic recovery through the back half of the year, boosted by strong global capital-expenditure spending and the return to services activity domestically.

We expect interest rates will remain very low for some time, with the Bank of Japan maintaining its yield-curve control program and inflation expectations remaining depressed. There is the potential for further fiscal stimulus in the lead-up to the lower house of parliament elections, which need to be held before Oct. 22. The Japanese equity market looks expensive in our opinion, despite having underperformed through the year.
China
Chinese economic data has been mixed due to the distortions from the Lunar New Year, which started the calendar year on Feb. 12, but our base case remains that growth will be solid through this year. The credit impulse has deteriorated slightly faster than expected, but we suspect that most of the slowdown has been brought forward to the first five months of the year. There is still some catch-up potential from domestic consumption, and the production side of the economy should benefit from the global economic recovery.

Chinese equities have struggled over the last couple of months, in part due to increasing regulation on Chinese technology companies, and in particular their foray into financial services. Forecasting regulation measures is a difficult task, but our base assumption is that most of the regulation changes are behind us for now.

Of course, it would be remiss to discuss the outlook for China without touching on tensions between the U.S. and China. The two sides have recently met, with nothing substantial arising. The agreement on climate initiatives was a minor positive, but we think that tensions are likely to remain elevated.

Canada
Canada’s economy is on track for 3.5% GDP growth over the first half of 2021, despite the reimposition of lockdowns. Canada’s vaccination rollout has ramped up spectacularly over the past few months, and two-thirds of the population had received a dose by mid-June. Growth should broaden beyond residential investment over the second half of 2021 as greater mobility benefits the previously locked-down services sector. We see no reason to doubt the Bank of Canada’s 2021 forecast of 6.5% GDP growth, which would be the fastest annual rate since 1973. The revival of the domestic economy and the continuation of the global recovery are favorable conditions for cyclically oriented Canadian equities, particularly relative to the U.S.
The Australian and New Zealand economies continue to exhibit solid growth, and both countries now have more people employed than before the COVID-19 outbreak. The slow vaccine rollout is expected to ramp up, and we are seeing early signs of this following the recent lockdown in Melbourne. The positive results of the late-stage Novavax trial are encouraging, as both countries have significant purchases of that vaccine.

The Reserve Bank of Australia (RBA) has maintained its accommodative stance. We expect the RBA will continue its quantitative easing program until the U.S. Federal Reserve begins to taper, and that a rise in the cash rate is still some way away. The Reserve Bank of New Zealand (RBNZ), however, has joined the Bank of Canada and the Norges Bank in becoming more hawkish, and has indicated it’s thinking about potentially raising rates as soon as next year. Australian equities continue to look more attractive than New Zealand equities on a valuation basis, and our preference for value is also supportive of that relative trade. Given the RBA’s quantitative easing program and focus on the exchange rate, we think that Australian government bond rates will largely track the U.S., while New Zealand government bond yields have more upside potential, given the RBNZ’s more hawkish stance on monetary policy.

The UK is set for a strong rebound in both GDP and corporate profits as it recovers from the dual headwinds of Brexit and the pandemic.

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Asset class preferences

Our cycle, value and sentiment investment decision-making process in late June 2021 has a moderately positive medium-term view on global equities. Value is expensive across most markets except for UK equities, which are near fair value. Sentiment is near overbought levels but not signaling dangerous levels of euphoria. The cycle is risk-asset supportive for the medium-term. Central-bank tightening, led by the Fed, seems unlikely for the next two years and the major economies are in the early recovery phase from the 2020 lockdown recession.

Composite contrarian indicator

Source: Russell Investments. Last observation: June 14, 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.

Emerging markets (EM) equities have been laggards so far this year. They have been held back by the high weighting toward technology stocks in the emerging markets benchmark, concerns about slowing credit growth in China and the slow rollout of COVID-19 vaccines. This should start to reverse later in the year as Chinese credit growth stabilizes and vaccines become more available across emerging markets.

High yield and investment grade credit are expensive on a spread basis but benefit from a positive cycle view that supports corporate profits growth and keeps default rates low. U.S. dollar-denominated emerging markets debt is close to fair value in spread terms and should gain support on U.S. dollar weakness.

Government bonds are expensive, and yields should come under upward pressure as output gaps close and central banks look to taper back asset purchases. We expect the U.S. 10-year Treasury yield to trade in a 1.5% to 2.0% range over the second half of the year.

Real assets: Real Estate Investment Trusts (REITs) have rebounded in anticipation of economic reopenings and have recovered all their pandemic loss. They are no longer cheap but should still benefit from the pandemic recovery trade. Listed infrastructure has lost most of its valuation disadvantage to REITs and should benefit from the global recovery, boosting transport and energy infrastructure demand.

The U.S. dollar has been supported this year by expectations for early Fed tightening. It should weaken once investors have fully priced in Fed-tightening expectations and as the global economic recovery becomes more entrenched. 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 no longer undervalued from a longer-term perspective.

The post-vaccine economic recovery should favor undervalued cyclical value stocks over expensive technology and growth stocks.

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Bond investors should carefully consider risks such as interest accounting standards and foreign taxation. Fluctuation, political and economic instability, different accounting standards associated with foreign investments. Currency investing involves risks including fluctuations in currency values, whether the home currency or the foreign currency. They can either enhance or reduce the returns associated with foreign investments. Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation. Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield (“junk”) bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund’s exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries. 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. Indexes are unmanaged and cannot be invested in directly. Copyright © Russell Investments 2021. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an “as is” basis without warranty. Russell Investments’ ownership is composed of a majority stake held by funds managed by TA Associates with minority stakes held by funds managed by Reverence Capital Partners, Russell Investments’ management and Hamilton Lane Incorporated. Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the “FTSE RUSSELL” brand.