AA View

2021 outlook
A vaccine bridge over troubled water?

Summary

- Going into 2021, the improving prospect of mass Covid-19 immunisation with effective vaccines builds a bridge over troubled economic water.
- The market narrative is very different to the macroeconomic, however. This recovery happened much earlier on massive stimulus to protect investors, and markets then raced well ahead of economic fundamentals.
- The vaccine could be a bridge to narrow this disconnect, allowing fundamentals to catch up with high market levels. An essential condition is that policy stimulus and the interest rate environment is maintained.
- Though central banks will stay easy, there are risks to yields from a rise in inflation expectations or from much higher government spending. Bond yield paths in 2021 will remain the strongest overall market driver.
- Crystal ball gazing is tough, with a wide 'funnel of doubt'. We offer a scenario in which bond yields rise modestly, risky assets stay volatile and struggle to build on their 2020 gains and the US dollar weakens further.
- The best advice for investment planning going into 2021 is to be prepared for a wide range of market conditions and outcomes. We also look at wider investment preferences and trends going into next year.

An economic recovery narrative for 2021

- **We see the roll-out of an effective set of COVID-19 vaccines as helping to build an economic recovery narrative for 2021**. Without a decent prospect of mass immunisations with effective vaccines in H1 2021, this would not be possible. Worse, as second Covid-19 waves have taken hold in October-November, the retreat in economic activity in most developed economies would have led to fears of a double dip global recession. Lasting recovery prospects would have been limited given the likelihood of repeated 'lockdown-release' cycles.
- **The vaccines' high efficacy rates now build a bridge over this still very troubled economic water below.** As it happens, a move down in growth as the year ends is already baked-in to economies, with Europe and US conditions looking much softer, especially if sizable fiscal stimulus is not renewed soon in the US to protect consumers. Even after the summer recovery, GDP levels in Europe and the US are still around 3-4% below start of

Market data source FactSet and Bloomberg

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2020 levels. In fact, it is rather worse than that – since economies would have grown but for COVID-19, the shortfall is typically 5% or more over what would have been. This is two plus years of output lost. Only China has escaped this large shortfall.

- **The vaccine gives us licence to say this is temporary**. Economic bulls say that next year's output recovery should be strong as the pent-up demand from consumers unable or afraid to spend in 2020 is released. US, UK and German household savings ratios are at currently 16%, 19% and 15%, respectively, about double pre-Covid-19 levels.

Our view**: Whether you believe the more bullish macroeconomic rebound story or not, a recovery narrative for 2021 looks reasonable. The lasting imprints of the pandemic on economic structures and functioning will remain but that is another story. In headline growth-terms, there is a good chance of getting closer to normal by the end of 2021, but at a different pace[1] by country.

The market narrative for 2021 is very different

- **For markets, there is no 'recovery' narrative for 2021 because the recovery is well behind us.** The awesome comeback since April was the result of massive policy intervention by central banks and governments to protect investors from COVID-19 effects. Rates down to zero; the launch of combined fiscal and monetary firepower – so called 'fiscal QE'; directly putting central bank balance sheets on the line in credit markets; all of this unleashed a firestorm of a market recovery the likes of which have never been seen before. Investors needed no recovery narrative via a vaccine, they had been given one by the US Federal Reserve on March 23rd, 2020, the day it announced it would do everything to stabilise markets. As we argue below, the 2021 market dial looks harder to shift up after this.
- **The different economic and markets narratives highlight the disconnect between the two.** Even as economic output remains way below year-ago levels and developed market company profits are still 15% or more lower from then, global equities are up 12% (MSCI ACWI index in US dollars) and the US rather more in this period. No wonder US equities are at dotcom mania level valuations. Credit is no different. Spreads on investment grade and high yield are at similar levels or even slightly lower than a year ago but agency downgrades for investment grade bonds have outnumbered upgrades by 3 to 1 in 2020 (upgrades outnumbered downgrades by 3 to 2 in 2019). The global high yield default rate at 7% in the twelve months to November is more than twice pre-pandemic levels. Neither record equity valuations or credit spreads well below our long-term fair values can be described as anything other than expensive!
- **The vaccine could be a bridge for markets in 2021 too - but will work differently.** If we are lucky, it will allow markets to sustain levels that otherwise look disconnected from fundamentals, in other words, opening a breathing space for economies and corporate fundamentals to catch up with markets. For this to happen, a key condition must be met – the stimulus and policy environment that started the firestorm rally in late March must continue. Otherwise the vaccine bridge could be too short or not sturdy enough. Fortunately, this condition looks just about likely to be met.
- **This market narrative is entirely dependent on what happens now to interest rates and bond yields.** Given how vital low rates and yields are to maintaining confidence, the betting for 2021 is that all will be done everywhere to keep yields low. Yes, yield curves have steepened recently on the vaccine news. A bit more steepening and some mild yield increases into 2021 should be expected. The key point, though, is that the interest rate environment must remain entirely 'repressive' – i.e. rates well below inflation. This is stimulatory but also vital in preventing bad government debt dynamics, a big risk with such large budget deficits everywhere. Zero-like (or negative) rates prevent interest payments on rising public debt snowballing into something far more dangerous. As the only way to prevent damaged public finances from blowing up it is a vital condition to make this market narrative stand up.

Risks to this market narrative

There are two important risks to this market path.

The first risk is that central banks could fail to hold yields down. One cause might be that inflation pops up more quickly than currently expected, bringing a risk premium into bond yields for the future path of inflation in yield curves. Fortunately, it is hard to see a major breakout in inflation yet. That said, future inflation expectations, drifting up recently, could go higher still in 2021. Central banks do want inflation to go towards target or even a little beyond, but not so high that it risks a large pop in bond yields. This is a balancing act. There is another risk, from governments, carried away by free finance, going on even bigger spending sprees. Even with stepped up QE from central banks to buy, there could be a problem in absorbing ever larger bond supply without taking yields higher. More fiscal spending also risks raising bond markets' inflation expectations. Overall, given that zero interest rates are key to underpinning asset prices, bonds' importance to the market narrative cannot be overstated. Some yield rises are Ok, bigger rises are not.

The second risk is that the economic recovery narrative fails. Either the vaccine rollout does not go to plan, or more troubling, that economies fail to pick up even after mass vaccinations. This could happen if consumer and business expectations and confidence stay dampened. Worries over rising tax rates in the future to pay for higher government spending could be a factor holding spending back. This happened in Japan over long periods when large fiscal stimulus failed to rouse spending. This highlights a potential problem. Markets in their current mood are counting on a strong economic recovery

[1] Expect the UK to lag for a mix of reasons – its bigger impact from Covid-19 and from the impact of Brexit uncertainty even with the 'bare-bones' free trade agreement that we expect.

and a big increase in corporate earnings and cash flows. If they do not get one, risky asset markets could be quickly undone.

***Our view**: Ordinarily, the large disconnect between markets and fundamentals and such high valuations would argue for a rapid run to the hills and high levels of risk aversion. Yet, times are not ordinary. With zero interest rates and so much policy stimulus, a market scenario unfolding in 2021 that sustains current elevated levels in risky asset prices can hold, aided by the vaccine bridge. That is, provided the key conditions above are met.*

The outlook: crystal ball gazing in 2021

Given unprecedented economic and market conditions, crystal ball gazing is obviously problematic. The so-called 'funnel of doubt' on markets is probably wider than it has ever been. Seasoned investors' views that a very wide range of outcomes is possible under these conditions and for portfolios to be prepared for this makes a great deal of sense. With that caveat in mind, here is a path for bonds, credit, stocks and currency that look feasible to us under current conditions:

- **Global bond yields tick up in 2021 but rises are contained to within a range of 25-50bps**.This implies 10-year US yields move higher but staying within say a 1.1% to 1.4% range, lower than the level prevailing just before the pandemic struck. We would expect this upper bound of yield rises to hold in Europe and the UK too, though the UK has more uncertainty from Brexit risk unknowns. Such moves look to be ahead of market forwards on current yield curves, but not by very much.
- **Credit spreads fluctuate in a range around current levels – i.e. no further tightening is sustained** given the very large move already seen since April. This implies US and UK investment grade spreads, currently hovering close to 100bps, stay on average, in a range either side of these levels. It is completely correct that many elements of current market conditions are supportive of high/outlier valuations; we see that all around us. However, further spread falls would enter downright bubble territory. Equally, the vaccine, the economic recovery and abundant policy stimulus mitigate downside risk. Riskier bonds – high yield, emerging market debt, etc. can outperform on a yield 'carry' basis; spreads could tighten a little further in current conditions but would not then compensate for inherent risks.
- **Equities deliver mid-single digit gains** – income plus some limited appreciation based on earnings recovery in 2021. Current conditions argue for some sharp drawdowns during the year nonetheless, so risk-adjusted returns will not impress. Valuation multiple expansion like credit looks hard to sustain given current stratospheric levels especially since earnings projections are already high. We continue to expect non-US markets to outperform (led by emerging markets and Japan) during 2021 in this scenario. Less sector divergence should happen with lagging sectors recovering more (though not all) of the ground lost to technology this year. This change of market leadership means that even though the UK economy lags peers, UK stocks should be able to claw some more lost ground back.
- **US dollar weakness continues**. On the view that a sustained market downturn is avoided for 2021, we see this year's dollar weakness spilling into 2021. This ought not be bigger than a 5-10% move, however, against the euro and other developed market currencies. Emerging currencies ought to do a bit better. Sterling should be range-bound, a little above current level assuming it avoids a bad Brexit.

Planning for 2021

The vaccination programme and economic responses will probably be the big focus for 2021. After an action-packed year for markets, 2021 could see less drama though we expect to see elevated volatility nonetheless. Under the path sketched above, here are some very high-level pointers on investment planning:

- **Staying well protected versus rates** remains important, especially since bond markets have already priced in some further recovery in yields. Downside risks to yields have not gone away so any under-hedging needs to be managed very carefully. Inflation itself looks unlikely to pick up but expectations could easily drift higher given the all-out stimulus environment. I**nflation hedges – direct (inflation -linked bonds) and indirect (gold, other real assets) - may therefore become a bigger priority for investors.**
- **Risky asset allocations can remain at target levels going into 2021, but buffers and defensives will remain important** for the overall portfolio stance. This reflects the uncertainties posed by high risk asset valuations and the unnervingly high prospect that things go wrong somewhere.
- **Private markets will arguably become even more popular given dwindling prospects in liquid risk markets**. Real estate and infrastructure demand looks likely to make a comeback as recovery expectations strengthen and potential infrastructure spending programmes unfold.
- **For mature plans that are liquidity constrained, income-seeking activity will intensify given low yields and weak dividend growth**. This supports income generating assets. Liquid credit benefits but demand will be strong for private credit given a relatively short lock ups and cash generation.
- Finally, though not obviously related to the economic and market narratives above**, momentum in ESG-focused investing approaches in institutional portfolios looks likely to strengthen during 2021.**

Market data source FactSet and Bloomberg

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