Perspectives

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2021 Outlook: Looking to a post-COVID world

IN SHORT

- While the health crisis is ongoing, the prospects of vaccines suggest the beginning of the end of the pandemic
- We assume that politics will leave way to necessity and count on additional fiscal measures in the US and in Europe to support the growth rebound
- Our constructive outlook might be consensus, but we believe there is still plenty of upside potential

Writing a year-ahead outlook is always challenging, but writing it in the middle of a global pandemic takes that definition to the extreme. Nonetheless, as we look to 2021, we find ourselves optimistic again, despite the tough year and the ongoing health crisis. From today's vantage point, with the US elections behind us and encouraging news on the vaccine, the picture for next year is one of improvement and, hopefully, of a gradual return to normal. That said, one thing we learned from 2020 is that we should always expect surprises.

The beginning of the end of the pandemic

While we are in the middle of a second wave in Europe and a third wave in the US, recent vaccine announcements have changed the outlook for the pandemic dramatically. Indeed, efficacy levels are above expectations and side effects appear minimal. As such, pharmaceutical companies are confident in their ability to inoculate enough of the population and investors are looking towards getting back to normal already. However, a number of hurdles remain. First, broad-based immunisation is unlikely before mid-2021, and probably even later for the emerging markets, suggesting painful months ahead. Second, logistics remain a challenge. Not only do some of the vaccines require below-freezing temperatures for storage and transportation, but ramping up production sufficiently and rapidly is likely to prove difficult as well. Moreover, willingness to be vaccinated is not a given, even among the more vulnerable segments of the population. Finally, the risk of the virus mutating remains, and how long immunity lasts is still a question as well. Nonetheless, assuming these hurdles are cleared and distribution goes smoothly, we could start to get back to normal by the summer.

Diverging growth trajectories

In the meantime, it is going to be a long and likely painful winter. Containment measures are ongoing in Europe, and will only be partially loosened over the winter for fear of a third stringent lockdown. In the US, different states are enacting different measures, but we do not anticipate a national lockdown, even when Mr. Biden takes office. Indeed, the federal systems makes such measures difficult to enact, and the current polarisation of certain measures could make implementation even tougher. Still, it could look a lot like stop & go for the foreseeable future.

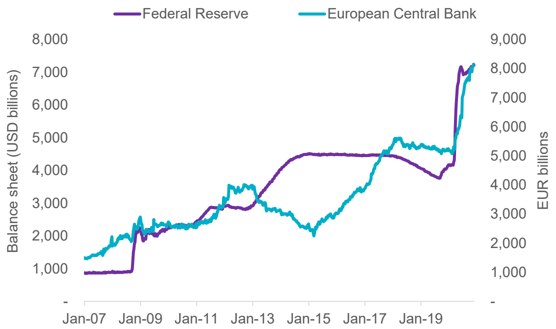
In this context, with China in the lead, Asia will show a much stronger growth path than the West, having better handled the health crisis and started a return to normal sooner than other regions. The recent regional free trade agreement (Regional Comprehensive Economic Partnership) and a Chinese growth engine that is back to 2019 levels are likely to be additional supports. The US, as has become usual, should continue to prove resilient with consumers drawing on savings to fuel consumption. That said, the next phase of fiscal stimulus is necessary as a number of unemployment benefits expire at the end of 2020. In our view, new fiscal impetus, coupled with softer confinement measures and then reopening, should lead to strong growth for the year. Bringing up the rear will be Europe, where more stringent restrictions and tougher fiscal conversations should keep growth subdued, even if there is catch up potential for the Old Continent from the spring.

Overall, we expect the first quarter to remain weak and for growth to strengthen throughout the year as vaccinations help the services sector recover. Still, the global economy, and developed countries in particular, will remain well below pre-crisis levels for some time yet.

Eternal support

One thing we can count on is the ongoing support from central banks. Indeed, they are ramping up QE programs, extending emergency facilities and pressuring policymakers for additional fiscal support. Next year – and beyond – should see a continuation of this.

QE programs are being topped up and extended



Source: Bloomberg, Natixis IM Solutions, 30 November 2020

Fiscal stimulus, on the other hand, is not as easily forthcoming, but we believe that necessity will eventually overtake politics. In the US, Democrats and Republicans have been arguing since May, and it might take the new administration to finally deliver a package. While the Senate races will not be settled before January, it appears unlikely that Democrats will manage to win both run-off seats in Georgia, and we assume Republicans will retain their majority. As such, the CARES Act 2 will be smaller than expected, likely closer to USD 500 billion or USD 1 trillion. However, with the nomination of Janet Yellen as Biden's Treasury Secretary, cooperation with the Federal Reserve is set to continue.

In Europe, the much-anticipated EU Recovery Fund should finally be approved and launched by the middle of 2021. Still, with negotiations so tenuous in the first place, and additional lockdowns since the initial size was agreed, the scale of the package could still fall short of needs, with additional packages unlikely. Individual countries are also struggling. Germany has set an example in fiscal expansion, but Southern European countries have been more reticent to add to their debt burdens, instead counting on the European Central Bank to keep debt servicing costs low and waiting for the EU Recovery Fund grants.

Not enough spending for inflation

With expectations for ongoing QE programs and further fiscal expansion, the subject of inflation is back at the fore. For 2021 at least, we do not believe that inflation will be a concern. We also expect any rise in inflation to be overlooked by central banks, who have committed to keeping interest rates at current levels for an extended period, even if inflation rises. Indeed, new average inflation targeting suggests inflation will need to overshoot for a long time before investors need to worry about rate hikes. Moreover, inflation expectations have only risen mildly since the Federal Reserve's summer announcement.

For the coming year, we expect inflation to remain subdued. While fiscal support has been significant, it has mostly been 'plugging the hole', and without the "Blue Wave", we do not expect enough fiscal spending to spark inflation. Moreover, QE programs have not generated inflation in the past and will probably not generate much now, as the velocity of money remains low even as the supply of money rises.

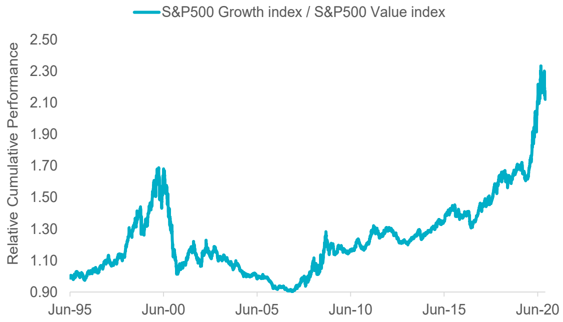
Consensus, consensus, consensus

While this outlook is constructive, it is unfortunately not very original. Indeed, the view that growth will be above trend, that inflation will remain muted, that central banks will remain ultra-accommodative, that fiscal support will arrive and that vaccines will lead to the beginning of getting back to normal is mostly consensus. As a result, expectations are for equities to rally, for a diversification away from the US and from defensives and a rotation into international equities and cyclical sectors, as well as smaller caps. And we agree that we are likely to see a continuation of these recent moves in 2021, or at least for part of it.

Consequently, the question is how much is already priced in, and is the upside therefore limited? In our view, much of the good news is priced in, but it does not mean the upside is more limited. Most markets, especially outside the US, are still well below February levels, suggesting plenty of remaining upside. Cash levels still sit in the trillions and many investors missed the recent rally. We are also likely to see some hiccups before the vaccines roll out and we actually start getting back to normal, suggesting further upside once the situation is clearer. Indeed, markets rarely go up in a straight line.

Moreover, there is a lot more room for the rotation towards cyclicals to continue. In the US, where benchmark indices have higher weights of growth stocks, the headline performance could hide the underlying rotation within and the catch-up by cyclical sectors. Still, the US could underperform as others play catch-up, but we do not believe this underperformance will last long. Indeed, better growth and earnings, as well as the log-term digital revolution should keep demand for US markets buoyant, even if performance lags in the short term as more cyclical sectors advance.

Room for catch-up



Source: Source: Bloomberg, Natixis IM Solutions, 30 November 2020

Europe should be one of the beneficiaries of the reopening trade, as indices remain well below the US and well below pre-crisis levels. The EU Recovery Fund and additional European Central Bank support should help with sentiment, supporting a recovery in financials among others.

With a strong growth rebound led by China and a better handling of the health situation, emerging Asia should remain in demand. Improvements in global trade and possible tariff rollbacks by Mr. Biden should be added supports. While the region has been viewed as a more defensive play in recent weeks, we still see potential for next year. Elsewhere in the emerging markets, the catch-up potential is big, but idiosyncratic risks remain and we maintain a preference for Asia.

Greenback on the back foot

Dollar weakness is another universal view. Risk on mood and a widening deficit should lead to further USD weakness. That said, without massive fiscal spending, inflation expectations might moderate, and US real yields should rise, bringing some support to the dollar. In addition, better growth, a stronger fiscal impetus and higher yields could also limit USD downside at some point as flows search for the US yield advantage.

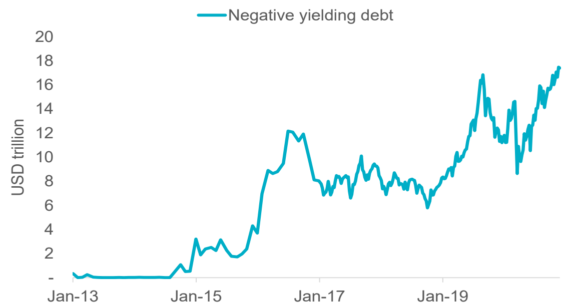
Hunting for yield

Developed market bonds are set to remain steady thanks to central bank actions. We believe that sovereign yields will rise on fiscal spending, growth rebounding and vaccine deployment, but this move should prove gradual and limited by central banks. If it were not, equity markets would struggle as well. However, even a mild rise paints a relatively poor return picture for sovereigns, and we therefore maintain our preference for credit, where carry is superior.

Indeed, in a context of ZIRP and NIRP across the major central banks, and a USD17 trillion mountain of negative yielding debt, the search for yield is set to continue. Nonetheless, spreads have already recovered much of their 2020 widening, leaving less room for compression, particularly in IG. There is more potential for spread tightening in HY and in emerging market (EM) debt, but some caution is warranted in HY given ongoing default risk. We believe that EM debt, both in local currency in a selective manner and in hard currency corporates, offer attractive opportunities.

The search for yield is also likely to further enhance another trend: in our view, investors will continue to look for yield and diversification with private assets.

Negative yielding debt



Source: Bloomberg, Natixis IM Solutions, 30 Novermber 2020

Risks

As we look to 2021, the outlook is one of improvement and leaving behind the chaos of the pandemic. Still, a number of risks remain. The virus first and foremost, as it is not yet behind us, as it could linger longer or the vaccine rollout could not be as quick or as effective as needed. If politics continue to get in the way of much-needed fiscal support, in the US and in Europe, growth and sentiment could suffer. Of course, if Georgia goes Democrat, and with it the Senate, markets would need to price tax hikes and regulation back in. While Brexit should (finally) be done and dusted by 2021, unexpected repercussions and costs can last. In terms of markets, an unruly spike in yields would hurt bonds and equities alike. And a wave of defaults would also put an abrupt end to risk appetite. Finally, with positioning now more bullish and a constructive view consensus, disappointment risk rises.

Conclusion

If all goes well with vaccines, we believe that 2021 will allow us to start to turn the page on the COVID pandemic and for markets to look to a gradual return to normal, with rebounding growth and earnings. As such, our outlook is constructive on risk assets. Still, we continue to look to alternative strategies and long-term secular winners, such as ESG strategies, for diversification.

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