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2020

The Outlook for 2021: Post-Pandemic Boom?

This year has certainly been one for the record books, leaving many to speculate what 2021 may bring. Our top macroeconomic and investment thought leaders offer their views on the most important factors and themes across asset classes that may shape financial markets and the global economic landscape in the year ahead:

Macroeconomic Outlook: Post-Pandemic Boom?

Francis A. Scotland »

A bevy of traditional macro-indicators point to better global economic growth for 2021. Some of these indicators include the lagged influence of falling bond yields, the cumulative effect of past policy stimulus measures, the low level of energy prices, and high household savings rates in China, the U.S., and Europe, which indicate pent-up purchasing power. Recoveries already have been stronger than expected, but economic policymakers in the developed world want to cushion any economic slippage caused by new social isolation measures and remain laser-focused on supporting a full recovery in employment.

The pandemic has triggered a major regime shift, which also plays to a stronger outlook, at least for the near term. For 40 years, the macro policy regime of the U.S. was to guard against the return of inflation, work toward fiscal balance, and keep monetary and fiscal policy separate. That regime is over for the time being. Paul Volcker put his stake in the ground nearly 40 years ago with his announcement that the Federal Reserve (Fed) would use the monetary aggregates to crush inflation. Fed Chair Jay Powell has put his own stake in the ground with the commitment to keep rates at zero until inflation rises above 2% and his encouragement to Congress that the risks of too little fiscal stimulus are much greater than too much. The vehicle for achieving the Fed's goal of higher inflation will be coordinated fiscal spending. This new regime is a politician's dream come true.

The only known-unknown standing in the way of this upbeat outlook is the COVID-19 virus and how governments and people react. However, promising vaccine developments significantly strengthen the case for a stronger-than-expected recovery for the year. China has already demonstrated this result. There, the authorities have effectively gained control of the epidemic as only China can through rigid compliance on social isolation measures and extensive testing. Within the Chinese economy, many sectors have rebounded back to normal while others are regaining momentum. So advanced is the progress that China's monetary authorities already are throttling back stimulus. If the vaccines prove to be effective, the world recovery by the end of next year could be very surprising.

Global Fixed Income: The Year of Less Uncertainty, More Certainty

Jack P. McIntyre, CFA »

In determining where bond markets may head in 2021, there are three major developments to consider. First and right out of the gate is the remaining influence of COVID-19 on the global economy. The pandemic will impact economic activity through the first half of the year with a significant shift in the second half. However, this impact will not be linear across all economies. It also will be a case of "it's darkest before the dawn," as infection and mortality rates will remain elevated until the vaccine implementation program becomes more widespread. However, we need to consider what scenario is already being reflected in bond market sentiment. The Treasury market appears to be looking into 2021 when the vaccine will be readily available (see Chart 1). The prior two times when hospitalization rates were in the vicinity of 60,000 people there was a flight to safety bid in Treasuries. Not this time, despite the hospitalization rate being at 100,000 and likely to rise. This change signals the Treasury market is more forward looking and starting to discount 2021's normalization, aided by the widespread distribution of the vaccines.

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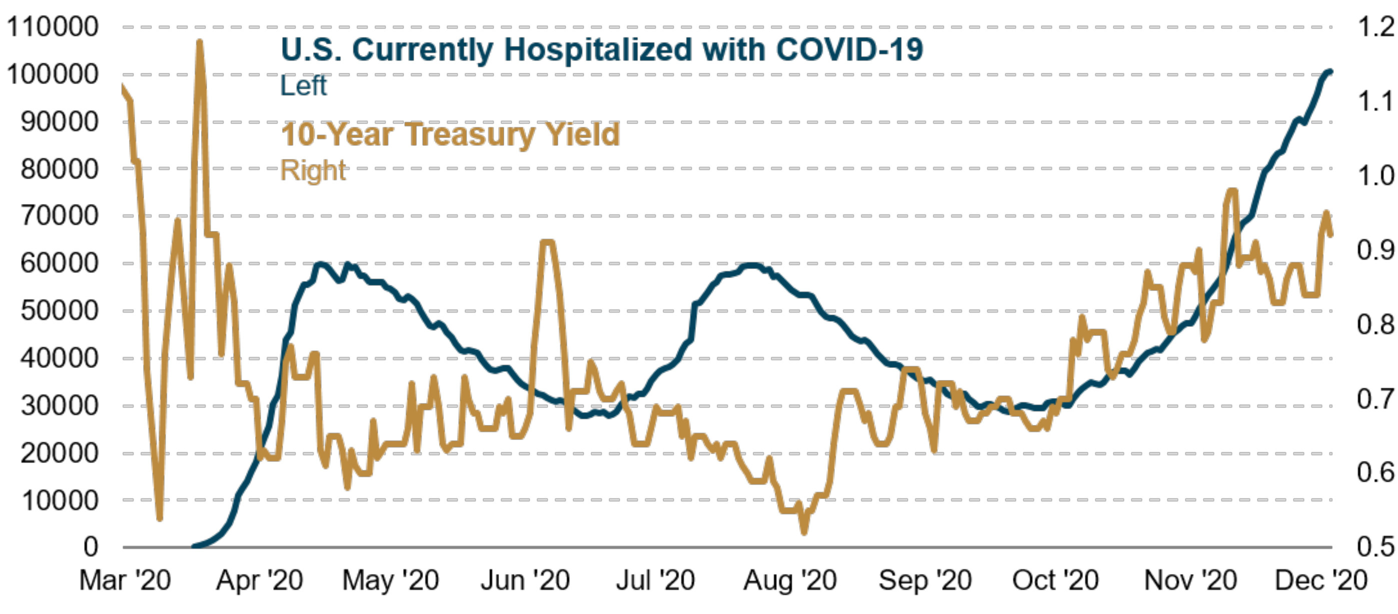
U.S. COVID-19 Hospitalizations vs. 10-Year Government Bond Yield

Persons, %, As of 12/3/2020



Source: Brandywine Global, Macrobond, The COVID Tracking Project

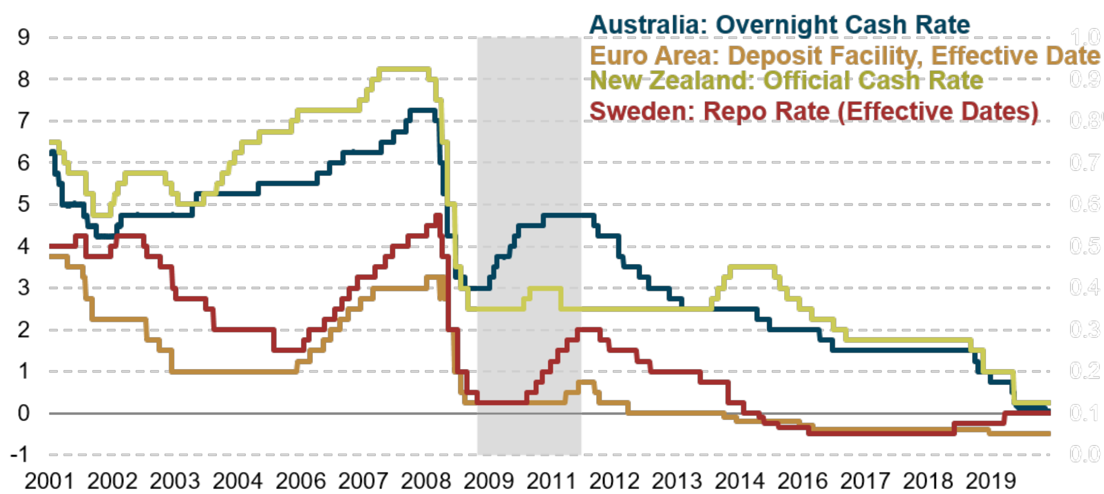
The second key factor to figuring out the glide path for global bond markets involves expanding the uncertainty analysis to also include "political and economic" uncertainty. This factor is more concentrated on the U.S. but has a global reach. In early January, we will learn the outcome of the run-off Senate election in the state of Georgia, which is critical to the U.S. political and economic agendas. When push comes to shove, we will see an orderly transition of power at the White House in mid-January. Unlike President Trump, President-elect Biden is not known to "weaponize" uncertainty, so we expect to see overall political volatility diminish in 2021 and beyond.

If the Senate remains under Republican control as expected, there will be less "economic" uncertainty. Gridlock will reallocate power to the "problem solver" caucus, which is a group of centrist politicians.

The third factor involves the global monetary policy front, where we also expect to see less uncertainty due to two key influences. First, and more important, is that inflation should not be a significant issue in 2021, which will keep global monetary policy biased toward more accommodative polices. This expectation is drastically different from the post-Global Financial Crisis (GFC) experience when there was a collective rush to remove policy stimulus (see Chart 2). The use of "unorthodox" policies back then ignited a fear of monetary induced inflation. However, it never happened. Central bankers have since changed their tune on inflation coming into 2021 with a more welcoming attitude toward higher prices. Unlike in the past, they won't fight it. If market rates were to spike higher, we would expect an increase in rhetoric on the potential use of yield curve manipulation, but we are not there yet.

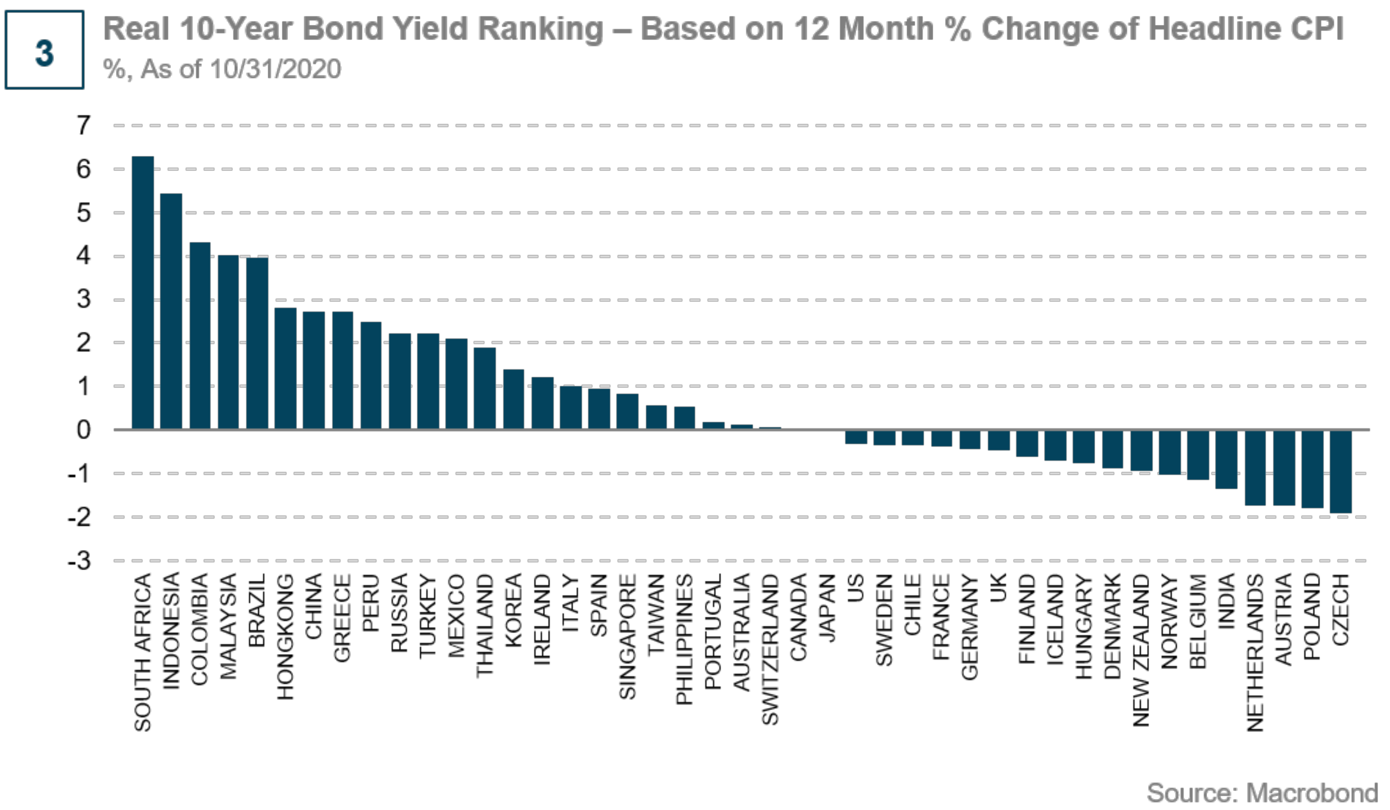
2 Central Banks Were Quick to Remove Stimulus after the GFC

%, As of 12/3/2020



Source: Brandywine Global, Macrobond, RBA, ECB, RBNZ, Riksbanken

What are the market implications of this "step function" lower in medical, political, economic, and monetary policy uncertainty? It means that bond market volatility will remain low, which will support the collective search for yield in 2021. Marry this development with a shortage of yield. There is now in excess of $17 trillion equivalent of negative-yielding nominal sovereign bonds. The bottom line is fixed income securities that offer a risk-adjusted yield relative to this giant pool of negative-yielding bonds will capture outsized capital flows. Yes, spreads have already narrowed across most non-sovereign credit, but there will be more room to go. However, we expect the primary beneficiary of these capital flows to be emerging market local currency bonds. On a real yield basis, they continue to look attractive outright and relative to developed market bonds (see Chart 3).



Global Currencies: U.S. Dollar Under Pressure

Anujeet Sareen, CFA »

Since March 2020, the U.S. dollar has weakened against a broad set of currencies, both developed and emerging markets. In 2021, we believe the dollar will remain under pressure but will more likely weaken against currencies that stand to benefit from an improving global growth environment. As the world economy recovers from the pandemic-induced recession, emerging market currencies are poised to strengthen, particularly those that are commodity-linked, manufacturing-oriented, or export-driven, like the Brazilian real, Chilean peso, and Colombian peso. The broader medium-term prospects for the dollar will depend on three factors. One, the country's large service sector faces a steep, lengthy recovery. Although the U.S. labor market recovery has been substantial since the spring, the rise in long-term unemployment in the service sector may mean that the economy will take longer to return to full potential, keeping the Fed highly accommodative, which would be dollar negative. Two, the Fed's recent policy review has led to a greater focus on average inflation targeting—it intends to accommodate inflation overshoots if inflation has previously undershot its target. Given the persistence of low inflation in recent years, the Fed may maintain easier monetary policy than it has previously, undermining the dollar more structurally. Third, policymakers will need to confront the sharp deterioration of the U.S. fiscal deficit. Unless the government can identify growth-enhancing policies, it faces the prospects of significant fiscal tightening (growth and dollar negative) or fiscal monetization (Modern Monetary Theory and dollar negative).

Global Credit: A Cyclical Recovery

Brian L. Kloss, JD, CPA »

Given expectations for a vaccine and the tremendous policy responses at work, we see a very high likelihood of a cyclical recovery and further spread tightening in corporate credit due to stronger global GDP growth. The new adminstration in the U.S. could lead to increased corporate tax rates and regulations, which introduces some uncertainty. However, we believe the extensive monetary and fiscal support, including the potential for another U.S. fiscal stimulus package, would outweigh any economic constraints resulting from these potential regulatory headwinds.

Therefore, we remain constructive on risk assets, expressing that view through corporate credit markets. A major tailwind for corporate credit markets is the continued strong demand from foreign investors, which has allowed credit markets to issue at record amounts and enabled companies to lower the cost of capital and extend their maturity profiles. Our focus now is on the economic cycle as basic industries, capital goods, energy, and other cyclical sectors in both developed and emerging markets are still trading at spreads wide to historical levels. We favor those industries that have a more cyclical tilt, like autos and mining, which should see marked improvement as the economy rebounds from the lockdowns. As the global recovery progresses, demand resumes, manufacturing and exports tick higher, and the medical front draws nearer to resolving the COVID-19 pandemic, conditions are in place for a reflationary trade and substantial spread tightening in these more cyclical areas of the economy (see Charts 4 and 5).

4 Investment Grade – Cyclicals Less Defensive – Rolling 1-Year Performance

%, As of 11/30/2020

Source: BAML ICE Indices, Brandywine Global

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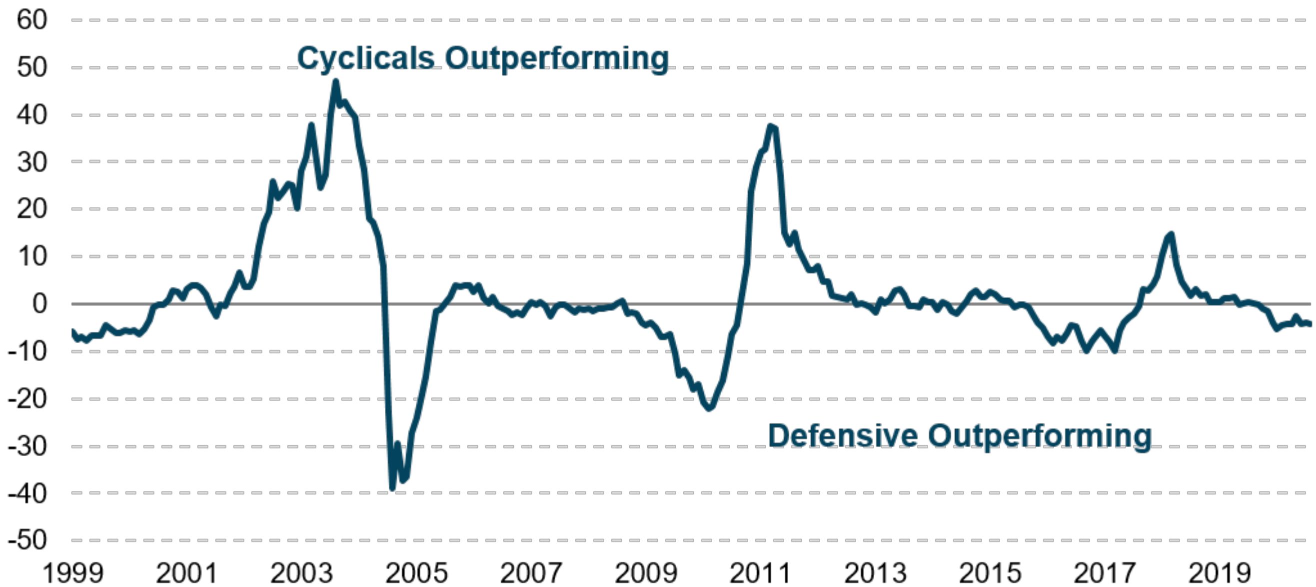
High Yield – Cyclicals Less Defensive – Rolling 1-Year Performance

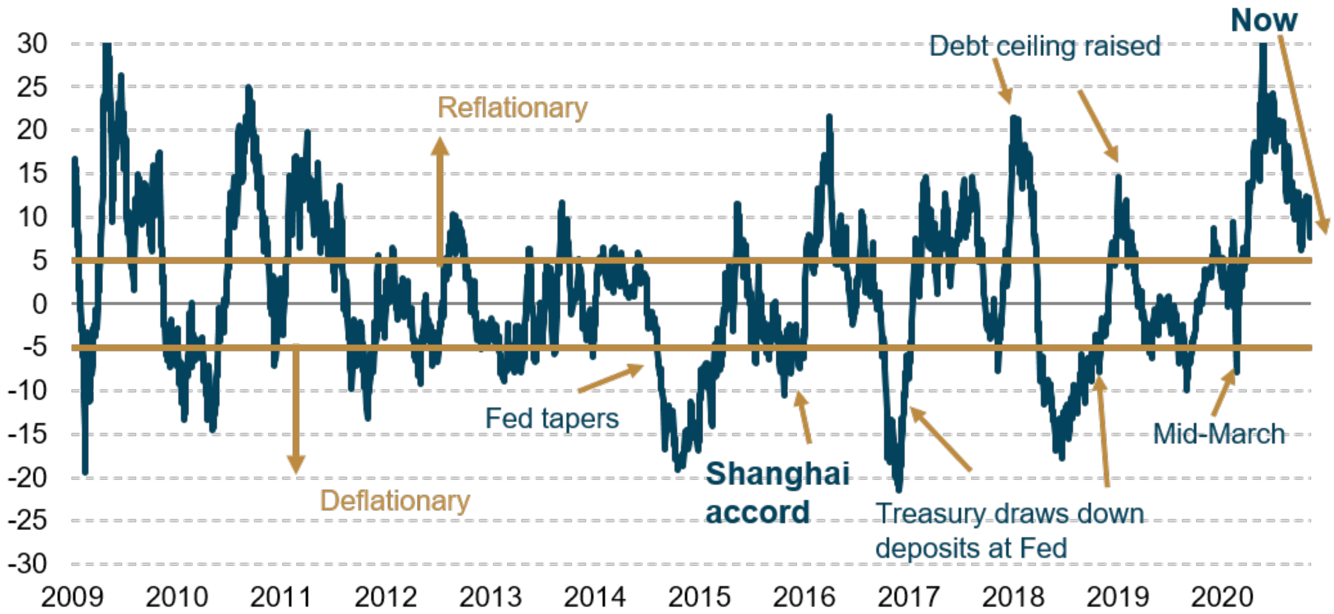
%, As of 11/30/2020



Source: BAML ICE Indices, Brandywine Global

Our team believes both the BBB and BB quality segments offer the best risk/return profile and should remain supported by monetary policy and the significant excess money supply currently in the system (see Chart 6). Also, we favor European high yield, which has more direct involvement from the central bank along with a lower predicted default rate in 2021 versus the U.S. market. Our energy exposure is split between foreign state-owned oil companies and recent fallen angels that hold some of the most sought-after assets in the U.S. Within the energy sector, we see the potential for continued supply contraction in the U.S. and a more normalized demand profile in 2021. We are generally avoiding both ends of the credit-quality spectrum, with high quality offering limited total return potential, and lower-quality bonds still susceptible to hiccups in the global economic recovery. However, if the global economy picks up steam, we would anticipate moving farther down the quality spectrum.

6 **Excess Global USD Money Supply, 3m Ann**
%, As of 12/4/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP), The MacroStrategy Partnership

Lastly, while inflation is a risk that we continuously assess, we do not envision a significant back-up in yields in the near term. However, we likely will continue to reduce spread duration in positions that have reached or traded through fair value in favor of opportunities that include some of the following charactersitics:

- a shorter maturity
- an OAS that will compensate or cushion an investor for a back-up in the risk-free rate
- cyclical exposure
- commodity exposure
- non-US assets
- lower-quality assets

Structured Credit: Down the Credit Stack with a New Cycle

Tracy Chen, CFA, CAIA »

Structured credit price recovery has been mostly lagging that of corporate credit, especially lower in the capital stack. Looking forward, vaccine breakthroughs have reduced the tail risk in structured credit while accommodative global monetary and fiscal policies should boost the momentum of the economic recovery. With a new credit cycle in place, we think that a “down in credit” trade should provide attractive opportunities, including moving down in the capital stack and investing in senior tranches of lower-quality collaterals or newer off-the-run products.

- U.S. housing market: In 2021, we believe the housing market will remain firm with 3% to 5% appreciation, boosted by a shortage of housing supply, low mortgage rates, demographic trends, including millennials buying, and the structural shift from urban renting to suburban home ownership. Low-to-middle price tier homes will outperform as a result of younger cohort buyers favoring more affordable areas. Household balance sheets are in solid shape with higher savings rates, less leverage, and support from forbearance and stimulus programs.
- Agency RMBS: Fed purchases will continue to provide a supportive backdrop, but higher interest rate volatility and prepayment risks will increase the negative convexity. We would prefer non-agency residential mortgage-backed securities (RMBS) as we believe taking credit risk will be more rewarding than taking interest rate risk.
- Non-Agency RMBS: We like CRT (credit risk transfer), single-family rental, and re-performing loan/non-performing loan (RPL/NPL) securitizations for exposure to the housing recovery with measured borrower default risk.
- ABS: We see a shift down in quality across consumer asset-backed securities (ABS), preferring subprime BBB/BB auto ABS, auto lease ABS, and sectors that were hit hard by COVID, e.g., container lease, timeshare, whole-business securitization, etc.
- CMBS: We expect commercial real estate (CRE) prices to decline gradually, mostly in retail and hotel sectors. However, this trend should be much less severe than the 35% decline during the Global Financial Crisis (GFC) due to better underwriting, attractive cap rate spreads to Treasuries, and large amounts of private money waiting on the sidelines to buy distressed CRE properties. Absolute stress levels in commercial mortgage-backed securities (CMBS) will remain high in the near term. We prefer to stay up in quality (AAA through A) in conduit CMBS and single-asset/single-borrower CMBS. CRE collateralized loan obligations (CLO) offer good value due to less exposure to retail and hotel sectors.
- CLO: BBB/BB CLOs and middle market CLOs can benefit from an early credit cycle rotation.
- European RMBS: Spanish and U.K. RMBS mezzanine tranches provide attractive value given the ECB’s very accommodative stance. However, capital appreciation is key as carry is minimal due to the floater nature.

Equities: Catalysts for Value

Patrick S. Kaser, CFA »

The travails of value investing are well-known, as current valuation differentials between growth and value stocks resemble those of the 2000 tech bubble when it popped (see Chart 7). While value has underperformed across cap segments, small-cap value stocks have lagged significantly this year—and subsequently may offer attractive upside potential. In addition to pure valuation, there are several other catalysts for value, most notably the end of the pandemic. Tech companies, in particular, have seen above-trend growth, and the difficult year/year comparisons that are set up will be challenging as those companies progress through 2021. Financials look like a sector that should be a notable beneficiary of the end of the pandemic. Many banks currently trade at discounts to tangible book value and also are poised to release reserves as credit quality has stayed strong. Banks have generally built capital levels in 2020, setting up an environment for robust capital return to shareholders. While we do not believe higher rates are a necessary catalyst for bank stocks to outperform, historically the yield curve has steepened in economic recoveries. This potential uptick in rates would be an additional catalyst for the sector.

We see the same pattern around the world, including both developed and emerging markets, with enormous gaps in performance and valuation between favored and unfavored sectors. Should the fever break, there is the potential for very meaningful convergence.

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Value Continues to Underperform but Could Be Poised for a Comeback

$, As of 9/30/2020

Source: FTSE Russell

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