ANNUAL OUTLOOK ASSET ALLOCATION | November 2020

The investment landscape in 2021

Next year should see the global economy recover strongly from the ravages of the pandemic. Expect emerging market assets to shine.

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Overview: Back to(wards) normality

Optimism is in the air. And for good reason. Better treatments are now being deployed in the fight against Covid-19 and there is a growing possibility of effective vaccines being available in a matter of months. This improves the prospects for a recovery in the global economy and corporate profits.

Yet it will take a long time to return back to pre-pandemic normality. Next year will be only the start of the transition.

One thing is clear: emerging markets will lead the economic recovery in 2021, propelled by China and supported by a weaker US dollar.

A recovery in the job market and record levels of household savings should lift consumer spending worldwide. Investment will also get a boost from rising profits and maintenance cycles. Trade is also recovering fast and even though spending on services will remain well below pre-Covid levels, the sector should gain strength, too.

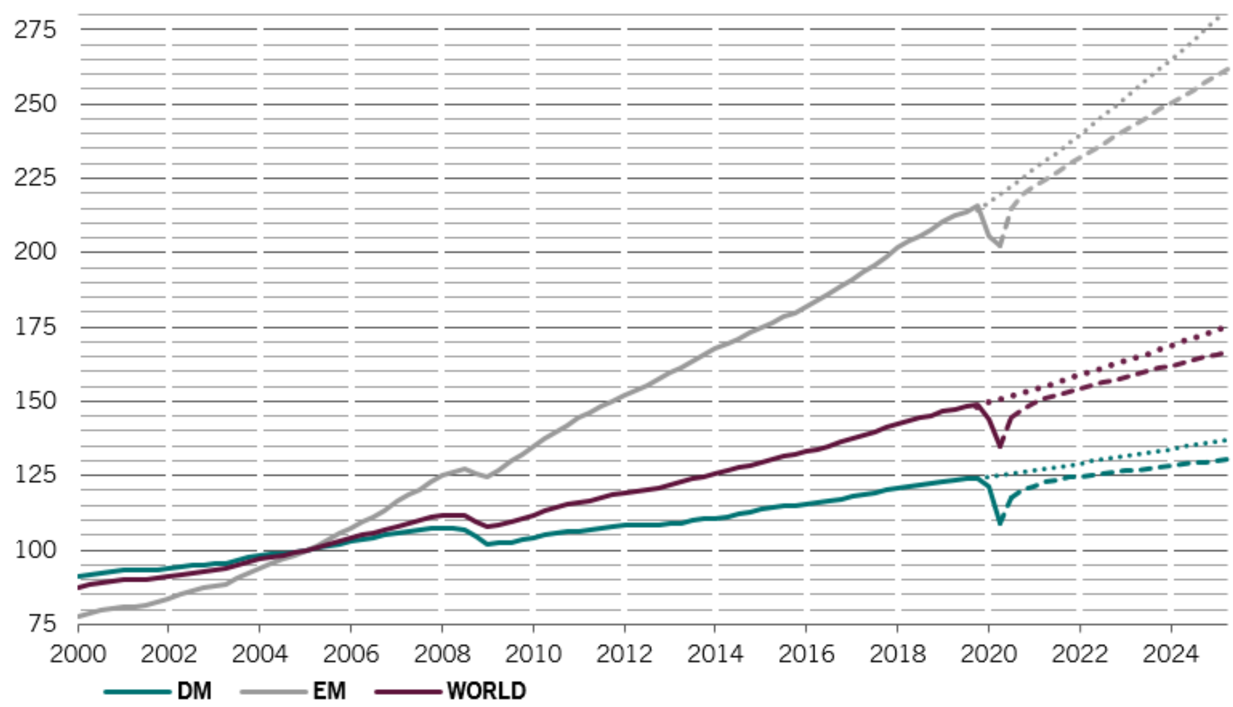
Investors should also expect the environment to become a greater priority in 2021 – fuelling growth in sectors like clean energy. Joe Biden's victory in the US presidential election will provide further momentum to this shift. Across the globe, green investment will form a key part of fiscal stimulus packages, feeding into a strong and synchronised economic recovery.

Our business cycle indicators point to to mid-single digit growth in world gross domestic product (GDP) in 2021, but positive base effects cannot hide the long-lasting damage caused by the pandemic. We estimate that the fallout from Covid-19 will permanently reduce global GDP by 4 percentage points (see Fig. 1). It will take years before the global economy can go back to pre-Covid-19 levels.

The growth gap between emerging and developed markets will widen further to the benefit of both developing world equities and debt, thanks in a large part to China – the only major economy to avoid a contraction this year. From industrial production to car sales and exports, most of China's primary economic activity indicators are already back at or above December 2019 levels, and set to expand further. Retail sales have lagged slightly but we expect private consumption to recover gradually in the coming months.

Fig. 1 - Economic loss

Real GDP: comparing history with pre- and post-pandemic outlook, 100 = Q1 2005



Source: Refinitiv Datastream, Pictet Asset Management, CEIC. Long dashes show current forecasts, small dots show 10Y past trend. Data as of 17.11.2020.

The near term outlook for the US economy is dependent on the fiscal relief programme currently under negotiation. A package north of USD1 trillion – our base case scenario – could push US growth above 5 per cent next year.

Globally, though, we would expect fiscal stimulus to be reduced compared to 2020 – not through a return to austerity policies, but because we expect fewer new measures. Central banks will act as “shock absorbers” by keeping rates low and maintaining stimulus. However, liquidity conditions are still likely to deteriorate. We estimate that the total assets of major central banks will expand only USD3 trillion next year. This is double the yearly average seen the 2008 financial crisis but significantly below this year’s record USD8 trillion.

History tells us that this matters for risk premia. Our models suggest that global equities' earnings multiples could contract by as much as 15 per cent next year, but this is likely to be more than offset by an approximate 25 per cent surge in corporate profits.

Government bond yields in the developed world are likely to move gently higher tempered by central bank action which could include balance sheet expansion by the European Central Bank and yield curve control by the US Federal Reserve.

02

Equities: China and Japan to lead 2021 gains

The world’s recovery from the Covid-19 pandemic should provide a strong boost to global stocks in 2021.

Aggressive fiscal and monetary stimulus from major economies since March is likely to engineer a strong rebound in trade, consumption and capital spending next year, which should translate into double-digit growth in corporate profits next year.

World stocks should gain 10-15 per cent in 2021, with annual growth in corporate earnings of around 25 percent more than offsetting an anticipated contraction in stocks' price-earnings multiples.

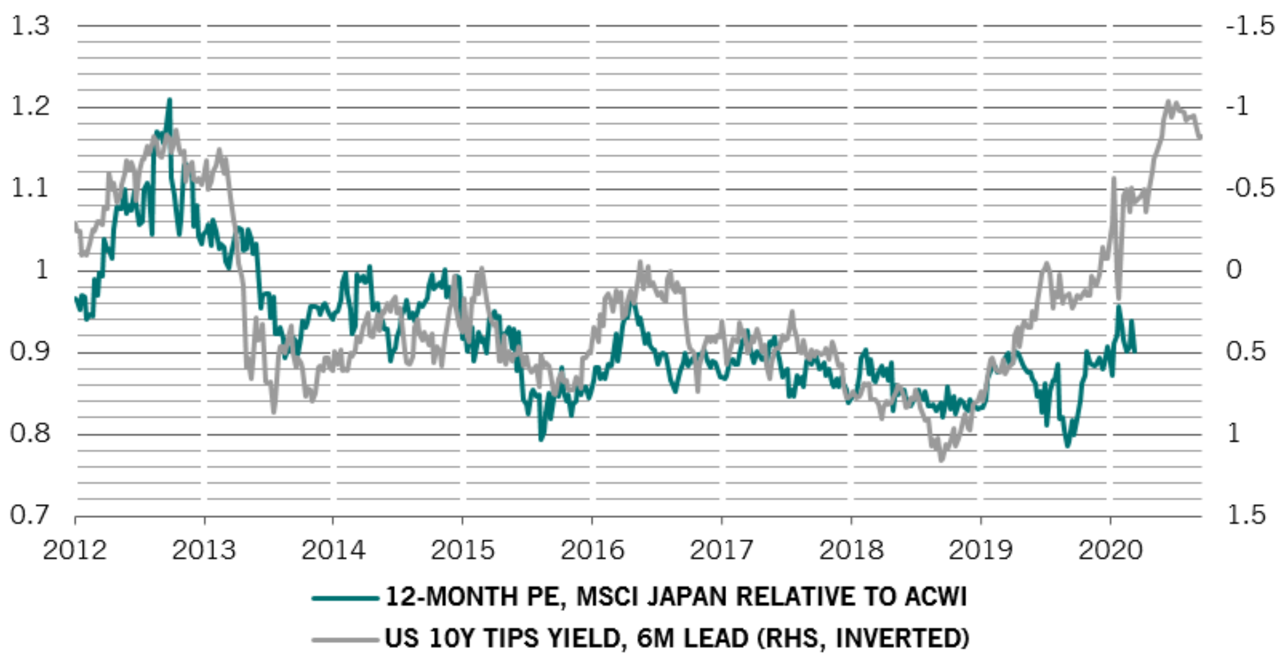
But those gains will mask a significant divergence in the returns of regional markets.

The resilience of China's economy - which has benefited its stock market and helped it gain nearly 30 per cent in 2020[1] - will continue to be a positive force. Which means Chinese stocks should be among the leaders next year too. Support will come in the form of continued stimulus from Beijing. According to IMF estimates, China is likely to be the only major economy with an expansionary fiscal policy next year — with its “fiscal thrust”, or changes in government spending, at 0.7 per cent of GDP.[2] In contrast , all other major economies will be forced to tighten the fiscal reigns in 2021, having delivered huge stimulus throughout this year.

Japan is poised to benefit from its neighbour’s strong economic recovery, as well its own effective response to the pandemic. The country’s stock market, which has a higher relative weighting than many other markets in cyclical sectors such as industrials and autos,[3] is well placed to capitalise on a revival in global trade and capital spending as the world emerges from the lockdown.

The world’s third largest economy is already enjoying a strong rebound, and it should build on that in the coming quarters thanks to the Bank of Japan’s monetary stimulus. What is more, Japan's stock market should be the biggest beneficiary of even lower real yields globally. As Fig 2. shows, Japanese stocks' price-earnings multiples expand by a wider margin that those of most other stock markets when inflation expectations rise. Adding to the market's appeal is ongoing corporate reform under Prime Minister Yoshihide Suga.

Fig. 2 - Japan: a play on global recovery
MSCI Japan relative valuation and US inflation-protected yield



Source: Refinitiv, Pictet Asset Management. Data covering period 31.08.2012 – 06.11.2020.

Elsewhere, we expect emerging equities to benefit from China's V-shaped recovery and a weaker dollar.

Emerging company earnings should rebound sharply and grow some 33 per cent next year after an expected decline in 2020 EPS of 9 per cent – a shallower contraction than that seen in the developed world.

Risks from persistent Covid cases will weigh on US and European markets, but the ambitious climate agenda of US President-elect Joe Biden, as well as Europe's green new deal, should see environment-related industries such as clean energy outperform.

Cyclical stocks that are sensitive to a recovery in capital spending, such as industrials and materials, have the brightest prospects as these industries should benefit from pent-up demand from companies that need to upgrade their technology.These sectors offer exposure to global reflation without the secular and ESG headwinds that weigh on other cyclical sectors like banks and energy.

We are, however, are less convinced that tech companies will repeat their stellar performance of 2020.

The darlings of the Covid-era, tech giants attracted huge investment inflows as the industry capitalised on demand for online retailing and remote working during the lockdowns. However, clouds are now gathering over tech, not least because of their stretched valuations – they are the most expensive sector after consumer discretionary on our scorecard.[4]

There are also growing calls for tighter regulatory oversight of the sector, with US legislators proposing major antitrust reforms which could potentially see some firms broken up.

However, in the absence of a very strong pick up in inflation and bond yields, we think it is premature to fully rotate from growth stocks to unloved "value" companies – those which trade at an attractive discount and tend to outperform in a period of rising risk appetite, such as banks.

[1] MSCI China index, performance YTD ending 10.11.2020. Currency impact equals the appreciation of the local currency vs. USD. Source: Refinitiv, Pictet Asset Management
[2] Annual change in cyclically-adjusted primary government balance as % of GDP under current legislation
[3] MSCI Japan sector weight in % relative to MSCI ACWI
[4] Our relative valuation scorecard is calculated with the average of Price to Book, 12m-forward Price Earnings, PE on trend EPS, Price/Sales & Equity Risk Premium (developed market regions only)

03

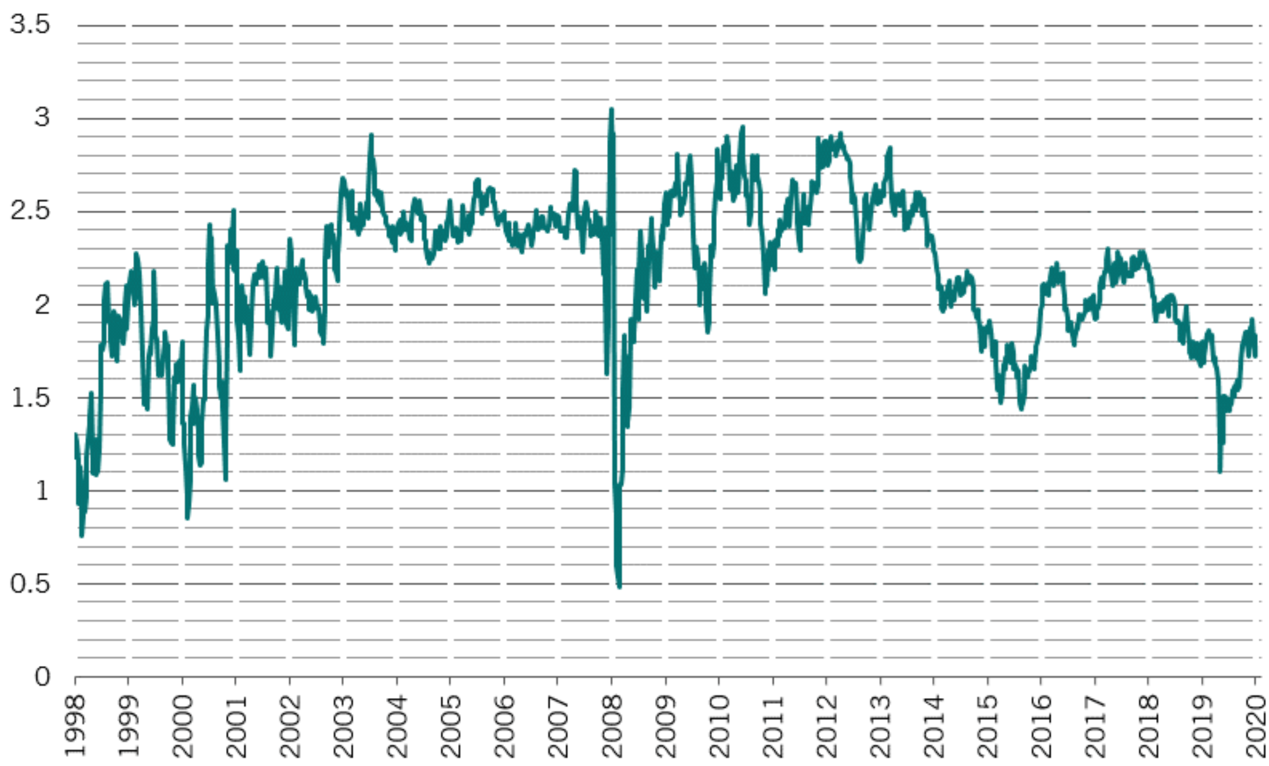
Fixed income and currencies: conditions improve for emerging bonds, TIPS

Even if we expect the global economy to recover strongly from the ravages of the pandemic in 2021, the surge in GDP growth is unlikely to lead to a sharp sell off in developed market government bonds. That’s primarily because central banks won’t take any unnecessary risks.

Both the ECB and the Fed will do whatever is required to keep policy accommodative and ensure a self-sustaining recovery. For the ECB that means more bond purchases and the continuation of cheap loans to banks; for the Fed, that could involve adding yield curve control (YCC) – anchoring policy to specific bond yield targets – to its anti-crisis measures.

All the while, inflation will remain below central banks' targets. Nevertheless, the combination of strong growth and rising commodity prices will feed through to a moderate pickup in inflation expectations. That's a dynamic investors should pay attention to: while it translates into only a very gentle rise in nominal government bond yields in 2021 (we see 10-year Treasury yields edging up to 1 per cent) it points to a further fall in real yields.

Fig. 3 - Price pressures building
US inflation expectations (5Y5Y forward inflation rate, %)



[Source: Refinitiv, Pictet Asset Management, data covering period 31.12.1997– 18.11.2020.

This would provide a boost to US Treasury Inflation-Protected Securities (TIPS). We expect them to outperform all developed market nominal bonds; real yields should remain close to -1 per cent as inflation expectations gather momentum (see Fig. 3).

In a year that will see healthy global growth and increased international trade, emerging market local currency bonds should also fare well. They are among the very few fixed income assets offering a yield of above 4 per cent. Adding to their investment appeal is the prospect of a strong rally in emerging market currencies – which should unfold as the global economy recovers and as trade tensions ease under a Biden administration. Currently, emerging market currencies are close to 25 per cent undervalued versus the US dollar according to our model. Chinese renminbi debt should have a particularly strong year – not only benefiting from its attractive yield compared to developed world bonds but also from the asset class's increased presence in mainstream bond benchmarks.

Prospects for developed market corporate bonds are mixed. High yield bonds are not especially attractive at this juncture. To seasoned fixed income investors that would seem unusual as history shows sub-investment grade bonds outpace equities during the final throes of a recession and in the early phase of a recovery. Yet the problem this time round is that high yield debt is already expensive.

In the past, high yield bonds' outperformance has taken hold whenever the gap between their real yields and stocks' dividend yields was above 10 percentage points. The strong run would then fade as the yield gap approached 3-5 percentage points. With the yield gap currently standing at 1.5 percentage points, however, the scope for high yield bonds to register significant gains appears very limited.

Investment-grade corporate bonds are more appealing – their returns compared to those of US Treasuries are low compared to the levels normally seen at this point of the economic cycle.

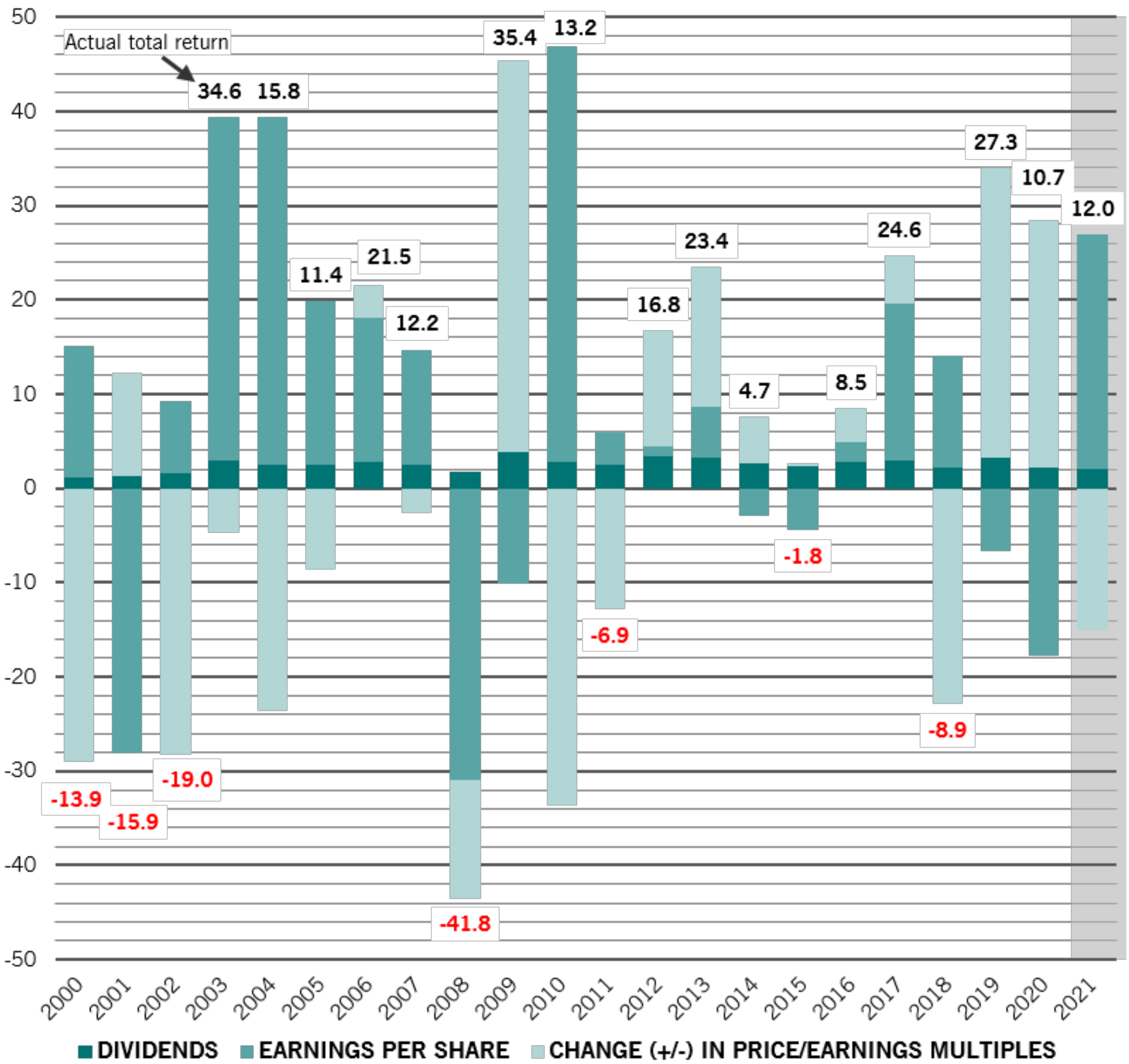
When it comes to currencies, 2021 doesn't promise to be a good year for the dollar. There are several reasons why. For one thing, the greenback's allure should fade in the face of a synchronised global economic recovery. Then there's the prospect of a surge in the US budget deficit and continued intervention from the Fed – a fiscal and monetary expansion which will likely place further downward pressure on the currency. The dollar continues to trade well above what fundamentals - such as interest rate and growth differentials to the rest of the developed world - suggest is fair value.

Gold should continue to rally – we forecast the gold price will hit USD2,000 by end-2021. Continued quantitative easing by global central banks, a weaker trajectory for the dollar and real rates dipping further into negative territory should all underpin demand for gold.

04

Appendix: Equity returns

Fig. 4 - Earning returns
MSCI AC World, total return composition per calendar year, %



Source: Refinitiv Datastream, Pictet Asset Management. Data as of 17.11.2020; 2021 numbers are a forecast.

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