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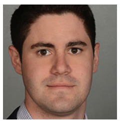
Outlook 2021

Oussama Himani
Chief Investment Officer
o@parkviewgroup.com



Paul Hoenck
Analyst
pho@parkviewgroup.com

London
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As 2020 comes to an end, the extreme uncertainty that defined the outlook over the past year is subsiding. There are many questions about the speed with which the Covid-19 vaccines can be made available across the world, but the high estimated efficacy rates imply that "herd immunity" can be achieved with a lower level of vaccination than had been assumed.

Some important political uncertainties will have also declined by January. The long-running Brexit negotiations will have ended. Any Brexit outcome will imply increased costs to businesses on both sides of the Channel. But the end of uncertainty about the future UK-EU economic relations will eliminate a factor that has weighed on business and investment decisions for the past 4 years. In the US, the Georgia run-off election will have determined the composition of the Senate. Whether the Biden administration will enjoy a Democratic majority has implications for the type of policy packages that are likely. But, importantly, a more predictable occupant at the White House will increase policy predictability.

Declining uncertainties are an important tail wind to the global economic recovery that is underway. But the speed and nature of the recovery are likely to be marked by two features. First, the Covid-19 crisis hit the global economy at the tail end of a long economic expansion in which investment growth was decelerating as capacity was built-up. The first phase of the economic recovery will necessarily depend on consumption growth, given existing capacities. Second, the crisis has accelerated existing trends in the global economy. Some sectors will see permanent change. Retail giants that were a casualty of this recession were on a declining path for years, and will not be resurrected in their erstwhile form. Increased reliance on technology from consumers and businesses is unlikely to be reversed either. The recovery will not be synchronised.

The trajectory of fiscal policy will have an important bearing on the nature and duration of the recovery. Current fiscal support packages are of limited duration. And absent further measures to expand expenditures, fiscal policy is set on a course that will be automatically contractionary. The success of further fiscal expansion is not assured. Income and business cashflow support measures have averted greater economic damage. But such spending has little multiplicative impact, and cannot make a meaningful contribution to GDP growth. This implies that debt levels will increase at a faster pace than GDP.

Fiscal policy therefore has limited room to manoeuvre: expenditure measures are needed to avert the economic contraction of a "fiscal cliff", but these measures need to be better targeted to ensure growth. Some public investment has been shown to have a multiplicative effect by catalysing private investment. Government spending that delivers less to GDP than it adds to national debt is ultimately unsustainable.

Whether governments can resist the public pressure for virtually indiscriminate spending in every area remains to be seen. The debate is not helped by the seemingly growing circus of economists who claim that endless monetary financing for fiscal deficits will have no adverse consequences. Inflation has not reared its head in recent years, but we find it reckless to assume that it won't. In the US, the broadest measure of the money supply has risen by 25% this year, while the quantity of goods and services in the economy has not. Once economic activity and consumer spending resumes to a more normal pattern, the price pressures are sure to rise.

As we start the new year, markets can be encouraged by the decline of the extraordinary levels of risks we experienced in 2020. But, the decisions taken during the crisis have increased the medium term challenges for both fiscal and monetary policies. Long term risks have increased, even as near-term risks declined.

The balance of risks in fixed income is skewed to the downside. The Fed and the ECB have signalled that short term interest rates will not change materially for the foreseeable future. Long term rates have been anchored at a low level by three factors: low short term interest rates, substantial purchases of government bonds by central banks, and a benign outlook for inflation. As the global economy moves closer to normalisation, these anchors begin to wobble. Inflation risks are skewed in one direction. Central bank purchases of government bonds will slow down or be halted. The increasing debt levels can ultimately lead to a reassessment of sovereign credit quality. There is a far greater likelihood that long term interest rates will rise than that they will grind lower or stay the same.

Against this background, with credit spreads already tight, achieving positive real returns in high quality bonds has become a daunting challenge. As a result, it is unreasonable to expect that balanced portfolios can achieve the same type of risk-adjusted returns that have been enjoyed by investors in the past few decades. Achieving positive real returns will necessarily require a higher allocation to equities, which in turn will be accompanied by higher levels of volatility.

Equities have had a stellar year, all things considered. Driven by strong performance from the “mega-cap growth” names, US large cap stocks are on track to finish the year with double digit returns. Valuations are now stretched by most metrics, but should normalise somewhat with strong earnings expected next year. The most compelling case for equities remains its relative attractiveness when compared to fixed income. In a world of low interest rates, equities are the only liquid asset class with positive expected returns over the coming years.

Looking forward, we do expect a rotation within equities to dominate near term performance. Cyclicals, which have taken the brunt of the damage related to the virus, have higher earnings growth upside in 2021 and are likely to outperform. However, we do not think that Growth is likely to post poor returns over the long term. Technology will continue to be supported by the structural shifts in the global economy. The dominant players within tech are profitable, offer high growth, and are innovation drivers with near monopolies in their respective industries.

The near-term rotation within equities implies a shift in regional preferences. Owing to the make-up of their respective indices, Europe and many emerging markets stand to benefit. A softer USD should also support emerging market risk assets in general.

But the outlook for emerging markets is mixed. Many EM have needed to take on record levels of debt to cope with the economic reality of the restriction measures this year. The damage to sovereign balance sheets has a greater impact than in Developed markets. This means that there will be less room for fiscal or monetary action into next year. As a result, we don’t expect all EM to outperform. Trade-dependent markets, that can ride the coattails of the recovery in developed markets, stand to benefit more than more closed economies.