2021 outlook: recovery & rotation

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December 2020
Reading time: 5mins

2021 will mark an inflection point for the global economy and markets. We expect to see a more complete recovery as effective vaccines are deployed, alongside a rotation in market leadership from defensives and high-quality credit to the most growth-sensitive sectors. But the path to 'normality' will not be without bumps in the road.

Summary

- The global economic recovery depends on the deployment of an effective vaccine for Covid-19.
- We have upwardly revised our growth forecasts for 2021 on vaccine breakthroughs that should allow a quicker and more complete economic recovery.
- Monetary and fiscal policies will continue to support the economy until the recovery is complete.
- Sustained global expansion in 2021 and declining volatility should support risk markets and a rotation in performance leadership from long-duration growth assets (notably US technology), defensive sectors and higher-quality credit to the most growth-sensitive assets, including commodities, cyclicals, Covid-affected sectors and emerging markets.
- We expect the search for yield in an environment of zero/negative cash rates and ultra-low bond yields will continue to drive investor demand for investment-grade credit against the backdrop of less supply as companies reduce their leverage.
- Confidence in our positive outlook is tempered by continuing downside risks. The path back to 'normality' will not be without bumps in the road.
- We believe exploiting relative-value opportunities will require careful and timely asset allocation, fundamentally driven credit selection and active management of market risk.

Return to 'normality'

Our positive macro and market outlook for 2021 is underpinned by the discovery of effective vaccines against Covid-19. The path of the virus and efforts to control it have been the principal driver of the global economy, greatly ameliorated – but not cured – by unprecedented fiscal and monetary policy support.

An effective vaccine brings the return to 'normality' and a full economic recovery within much closer reach. We believe a broad-based and sustained global recovery will be mirrored by a rotation in market leadership. We would expect to see lower-rated credit, cyclical and Covid-affected sectors

Chart 1: Global growth forecast (annual % change)

	2019	2020f	2021f	Consensus 2021
China	6.1	1.6	8.6	8.1
DM	1.4	-5.5	4.7	4.2
EM	3.3	-2.9	7.0	6.3
Eurozone	1.3	-7.2	5.3	4.6
Japan	0.7	-5.2	3.1	2.5
UK	1.3	-11.0	5.1	5.4
US	2.2	-3.7	4.7	3.8

Source: Consensus forecast as reported by Bloomberg; BlueBay Asset Management forecasts, 1 December 2020

returning to favour, alongside emerging markets (EM), while higher-quality, defensive and long-duration growth assets could be displaced.

Vaccine recovery

It was a health crisis that plunged the global economy into its deepest recession in modern history, rather than unsustainable private-sector imbalances or excessive tightening of financial conditions by central banks, as has been the case in previous downturns. The policy response was similarly unprecedented in terms of the scale of interventions by central banks and governments, providing a financial bridge for households and companies to the other side of the pandemic. Notably, household incomes are higher than in 2019 and the number of company bankruptcies is lower.

The latest wave of the pandemic across the northern hemisphere is expected to hinder the economic recovery into the first quarter of next year. But thereafter, we expect activity to rebound as social distancing restrictions ease and vaccines are widely deployed. We foresee distressed sectors such as travel, leisure and hospitality leading this recovery.

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We revised higher our 2021 growth forecasts following the Pfizer/BioNTech and Moderna vaccine announcements, with both treatments showing 90%+ efficacy rates with no serious side-effects. As such, we can assume that a robust and effective Covid-19 vaccine will be available in the first half of next year. The higher-than-expected efficacy rate suggests that, once rolled out, vastly fewer people should become seriously ill. This in turn should ease pressure on health services and on governments to maintain restrictions on economic and social activity.

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Questions remain, including the duration of protection from the vaccine, its effectiveness across most-at-risk groups and the extent that it prevents the spread of infection. Nonetheless, a more effective vaccine sooner than expected meaningfully improves the prospects for a robust and more complete recovery in 2021 and reduces the risk of permanent economic 'scarring'.

Continuing monetary and fiscal support is crucial, in our view, for supporting the economy until the recovery is complete. We expect a USD750 billion to USD1 trillion fiscal package to be passed in Washington in the first quarter of 2021 in response to the US's third wave.

In Europe, in addition to the disbursements under the EUR750 billion Next Generation EU fund, national governments are planning additional fiscal support.

We expect central banks to remain very accommodative and continue to ease policy until the path to normalisation and a complete economic recovery is more firmly established. The European Central Bank (ECB) has committed to extend and expand its asset purchases likely by around EUR400 billion and the US Federal Reserve (Fed) will maintain quantitative easing and zero cash rates until inflation is sustainably at or above its 2% target and unemployment is close to its pre-pandemic low.

Our growth forecasts are higher than consensus, with the US returning to pre-crisis output level in the second half of 2021. The economic shock of the pandemic was far greater for Europe than the US and while the euro area is forecast to expand by more than 5% next year – faster than the US – we do not expect it to reach its pre-crisis peak until sometime in 2022.

China is the standout and has already surpassed its pre-crisis output level on the back of more effective containment of the virus and large fiscal and credit stimulus. The UK is forecast to experience its most rapid annual growth for decades in 2021, but this reflects the depth of the downturn this year – amongst the deepest of the major economies – and assumes that a 'thin' post-Brexit trade deal is reached with the EU.

The public vaccine rollout across emerging and developing countries may be slower and later than in advanced countries, but the risk of repeated waves of infection is reduced and their economies should benefit from the global recovery and continuing outperformance of the Chinese economy.

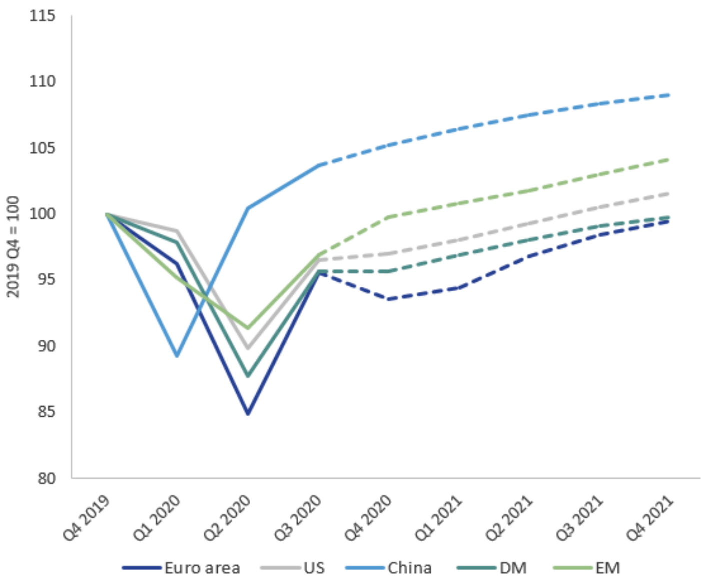
Taking a micro view, the outlook varies across EM by region, with emerging Asia predicted to do better than emerging Europe, while Latin America could lag the broad recovery trend due to the continuing severity of the pandemic and less room for policy support.

Leadership rotation

We expect a vaccine-led re-opening of the economy and subsequent global recovery to benefit the assets of sectors most adversely affected by Covid-19 and social distancing, as well as lifting cyclical assets. As in 2017, a broad-based and sustained global expansion in 2021 and decline in volatility should support risk markets and a rotation in leadership from long-duration growth assets (notably US technology), defensive sectors and higher-quality credit to the most growth-sensitive assets, including commodities, cyclicals, Covid-affected sectors and EM.

Compression in spreads between higher and lower-rated credit and the outperformance of Covid-affected and cyclical assets, including banks, are what we expect to be the dominant themes in credit markets in 2021. We predict safe-haven assets, such as the US dollar and Treasuries, will underperform.

Chart 2: Real GDP (Q4 2019 = 100)



Source: BlueBay Asset Management estimates and forecasts, 1 December 2020

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Global recovery and reflation are typically associated with a weaker US dollar and stronger EM currencies. The strength of the Chinese recovery, alongside a rising trade surplus and Chinese government bond yields being meaningfully higher than in developed economies, should continue to underpin a robust renminbi. EM currencies are considered 'cheap' on many measures and should benefit from the investor rotation into cyclical and 'value' assets. Meanwhile, yield curves are steep and real yields are considered attractive.

Higher medium-term growth and inflation expectations may support some modest steepening of core government yield curves, but we expect central banks to lean against any meaningful tightening in financial conditions. The Fed's shift to an 'average inflation target' regime, which is likely to be followed in some form by the ECB, suggests that policy rates and liquidity will continue through next year and until inflation is sustainably at or above target.

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Yield curves in many EM local debt markets remain relatively steep and currencies near historic lows. EM credit, especially in high yield, has also lagged the performance of investment grade and developed-market high yield.

We expect the search for yield in an environment of zero/negative cash rates and ultra-low bond yields will continue to drive investor demand for investment-grade credit, while we anticipate bond issuance will drop as companies focus on balance-sheet repair and have ample cash reserves.

In our view, high yield and distressed credit offer potentially the greater upside for investors, especially in cyclical assets such as bank subordinated debt and the Covid-impacted sectors of travel, leisure and hospitality. Mezzanine and sub-investment grade structured credit is also likely to deliver positive performance, in our opinion.

A bumpy path

Confidence in our positive outlook for 2021 is tempered by continuing downside risks. The current wave of coronavirus infections, hospitalisations and renewed social-distancing restrictions provide a stark reminder of the health and economic risks posed by the pandemic. The path back to 'normality' will not be without bumps in the road.

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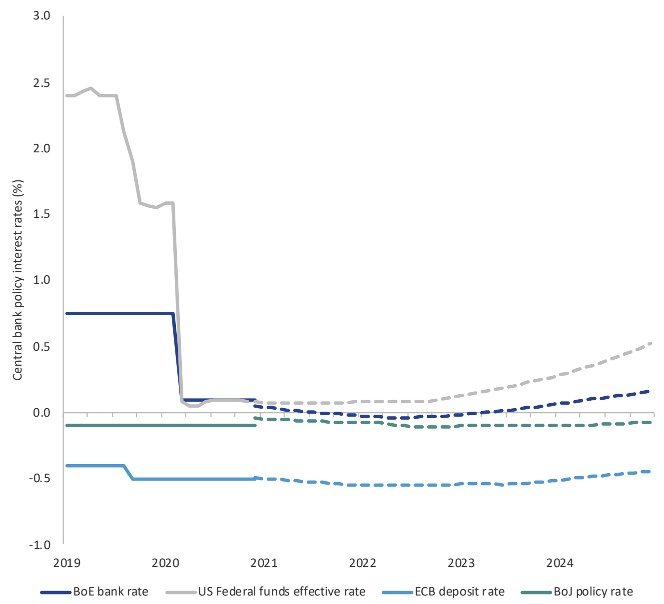
The logistical challenges of distributing billions of vaccines globally are daunting. Reaching sufficient population coverage to facilitate a return to normality by the middle of 2021 seems more likely if multiple vaccines gain approval.

Chart 3: Market implied path of short-term rates



Note: Implied future policy rate derived from Overnight Index Swap (OIS).
Source: Bloomberg, 1 December 2020

But regulatory delays, low public take-up and logistical challenges are all potential hindrances.

Although unlikely in our view, the risk of policy mistakes cannot be wholly discounted – especially a premature withdrawal of fiscal support. Finance ministry officials around the world are worried by record government borrowing and high and rising public debt, while the political will to maintain fiscal support may be eroded by the prospect of vaccines and a lower fatality rate. But with central banks expected to absorb virtually all net government issuance in 2021 and debt-servicing costs at historic lows, we believe it would be a policy mistake to withdraw fiscal support too quickly.

The risk that monetary support is withdrawn is even less likely, in our opinion, but central banks may signal a winding-down in asset purchases in the latter half of 2021, even if the commitment to lower-for-longer policy rates remains. The withdrawal of the comfort blanket of additional central-bank liquidity could prove a catalyst for market volatility, as it was in the summer of 2013.

High and rising inflation is the dog that never seems to bark. Yet, if vaccines pave the way for recovery in demand and employment, while supply is constrained by under-investment from cautious corporate management teams focused on balance-sheet repair, inflation pressures could quickly build. Central banks would likely react even under the more accommodating average inflation targeting regimes, which could prompt a dramatic re-adjustment of investor portfolios, in our view.

Conclusion: positive but not complacent

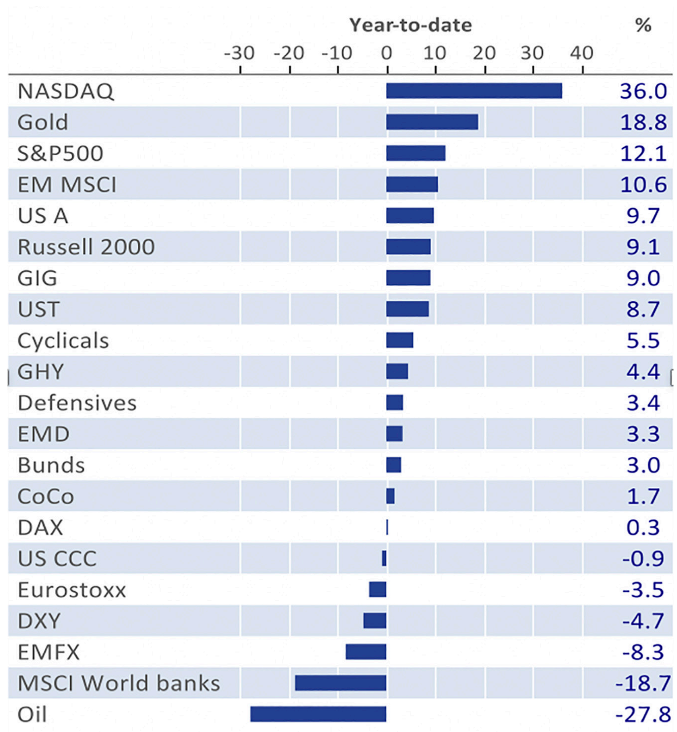
The discovery of an effective vaccine and continuing policy support underpin our positive macro and market outlook for 2021. Unlike previous global recessions, the business cycle was ended by a health crisis. As such, the economic recovery will not be held back by the unwinding of financial imbalances, as it was following the global financial crisis.

But the fight against the coronavirus is not yet won. Success rests on a public vaccine programme that could take longer-than-anticipated to be successful. And while permanent economic damage from the crisis is dramatically less as a result of central-bank support, the legacy of greater debt and the risk of a global liquidity trap leaves a diminished policy space to respond to future economic shocks.

Many assets are at historically high valuations and investors are rightly wary of the room for further gains. However, the market rally since March until the vaccine breakthrough in early November had a bearish tone to it, with investors paying a premium for sources of growth and defence in an environment characterised by extraordinary uncertainty and elevated volatility.

Despite the rotation in performance since early November with cyclical, value and EM assets outperforming, risk premiums on these assets remain relatively elevated. Although expectations for a recovery and rotation is now the consensus view, valuations and investor positioning suggest it is far from fully priced. Although markets are forward looking, they are also grappling with the second wave of the virus across the northern hemisphere and a deteriorating near-term economic outlook, as well as uncertainty around how quickly vaccines will allow a full re-opening of economies and a return to normality.

Chart 4: 2020 YTD returns from selected assets



Source: Bloomberg, Macrobond, BlueBay calculations,latest data at 1 December 2020.

A rotation in market leadership that will not necessarily be reflected in big rises in headline indices will be challenging for investors to navigate. We believe exploiting relative value opportunities will require careful and timely asset allocation, fundamentally driven credit selection and active management of market risk. In our view, investors should prepare for a recovery and rotation but not discount downside risks as complacency is invariably punished.

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Disclosure