Principal Asset Management (Asia)

2021

Economic and Asset Allocation Outlook

Principal Q&As To Get Through The Post-Pandemic Great Era

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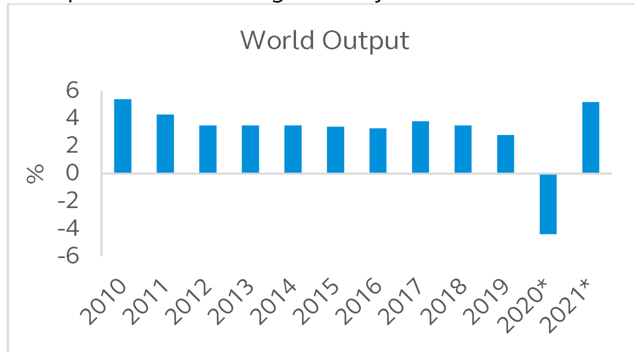
Will the global economy continue its strong recovery in 2021?

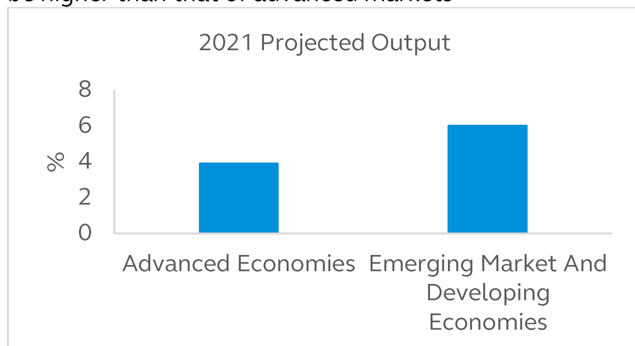
Short-term headwinds for the global recovery while widespread use of COVID-19 vaccines provide further momentum

Figure 1：Looking into 2021, global economic activity is anticipated to recover significantly



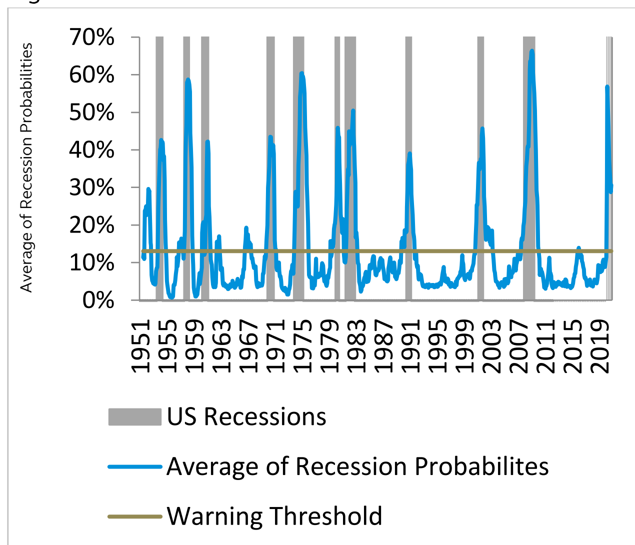
Source: Bloomberg, IMF, Principal Asset Management (Asia) Limited. Data as of October 2020.
*2020 and 2021 are projected numbers.

Figure 2: The economic growth of emerging markets may be higher than that of advanced markets



Source: Bloomberg, IMF, Principal Asset Management (Asia) Limited. Data as of October 2020.

Figure 3：Recession risk decreases



Source：Principal Global Investors, Principal Asset Management (Asia) Limited. Data as of 4 December 2020

Global confirmed cases of COVID-19 continue to surge into 2021. Under the influence of the new wave of the pandemic, economic activities in major regions have once again been constrained, while the global economic recovery was held back in the fourth quarter. Looking into 2021, global economic activity is anticipated to recover significantly, with a forecast of 5% overall global economic growth, reversing the 4% contraction in 2020(Figure 1). The most significant driver for growth is the prospect of various vaccines being widely adopted in the first half of 2021. In general, the economic growth of emerging markets may be higher than that of advanced markets (Figure 2). The growth rate in China and India may speed up to 8% or above which is generally higher than the 4-5% in Europe and America.

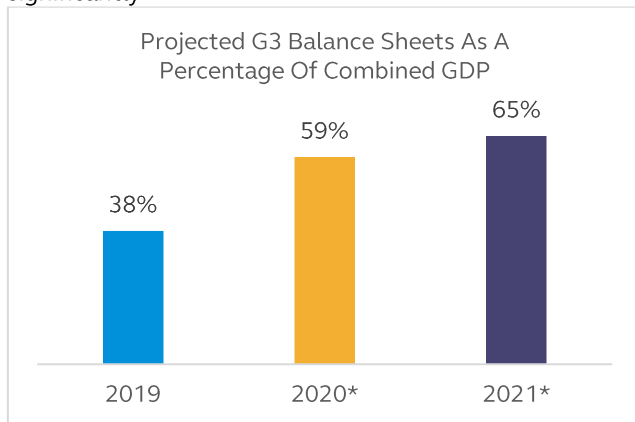
Take the U.S. as example with the data as of the end of November compared to April 2020, the current recession risk is 25% lower than before and indicators in the business and financial sectors have improved significantly. Of course, due to the relatively high statistical correlation between COVID-19 and the average probability of recession, the pace of the U.S. economic recovery will slow down if the number of new cases rises substantially again. Annualized fourth quarter economic growth may be significantly lower than the third quarter and this situation will probably last into the first quarter next year.

In the past few weeks, encouraging news on the development of the COVID-19 vaccine have been reported. The overall efficacy of the vaccines is higher than anticipated, which has shortened the duration of the global pandemic that the market anticipated. With the first vaccine approved by the U.S. Food and Drug Administration (FDA), it is expected that high-risk groups in the U.S. could start to be vaccinated before the end of 2020 with the majority of Americans possibly being vaccinated by June next year. If the development of vaccines can keep up with the anticipated progress, the global economy is expected to fully restart in the second half of the year which will support the annualized growth of 4%.

What factors in addition to the vaccines, are driving economic growth?

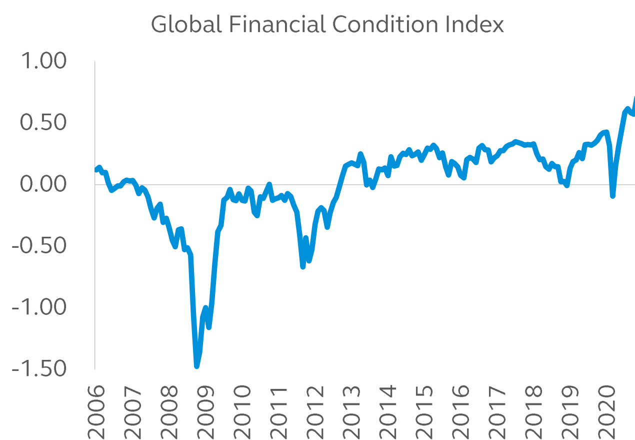
Expectations of monetary easing remain unchanged; fiscal strength may weaken

Figure 4：Central banks' balance sheets are expanded significantly



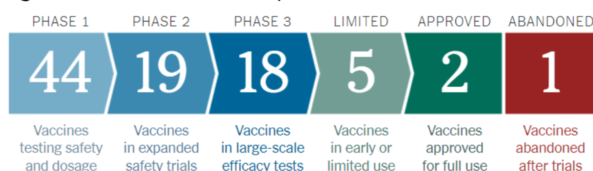
Source: Bloomberg, Principal Global Asset Allocation, Principal Asset Management (Asia) Limited. Data as of 30 November 2020.
*2020 and 2021 are projected numbers

Figure 5：Financial conditions are expected to remain at the loosest level since data available



Source: Bloomberg, Factset, Principal Global Asset Allocation, Principal Asset Management (Asia) Limited. Data as of 30 November 2020

Figure 6: Vaccines development



Source: The New York Times, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

The extension of global monetary easing and loose fiscal policies also provides important support to the further upside of economy. To tackle the pandemic, countries and regions around the world have launched a total amount of fiscal measures scaled as high as USD 12 trillion. Central banks in various regions have also lowered their interest rates to near zero. The real interest rates have fallen to negative levels which has significantly expanded their balance sheets.

The 2021 fiscal measures may be weaker than in 2020 since the economy is expected to improve. Take the U.S. as example, the amount of the latest fiscal stimulus package is only USD 900 billion, which is smaller than the previous round. However, monetary policies will remain loose in the foreseeable future even if inflation has a chance to rise slowly. At the December Federal Open Market Committee (FOMC) meeting, the Federal Reserve stated that the bond purchase plan will be linked to the maximum employment and inflation targets. This shows the Fed will maintain the USD 120 billion monthly asset-purchasing plan while the European Central Bank clearly stated that it will continue to purchase bonds until 2022. The balance sheets of three major industrial countries (the United States, Europe and Japan), as percentage of the GDP may climb from 38% in 2019 to 59% in 2020 and 65% in 2021 (Figure 4). Financial conditions are expected to remain at the loosest level since data was available (Figure 5).

On the other hand, the biggest potential risk factors that could threaten the market are the availability level of vaccines , the global epidemic truly controlled, and the prolonged negative impact of quarantine measures on the economy (Figure 6). Moreover, the market has to pay attention to the weakened stimulus effect from monetary and fiscal measures owing to the anticipation of an improving economy. Investors should pay attention to these related risks.

Will there be further upside to the global stock market?

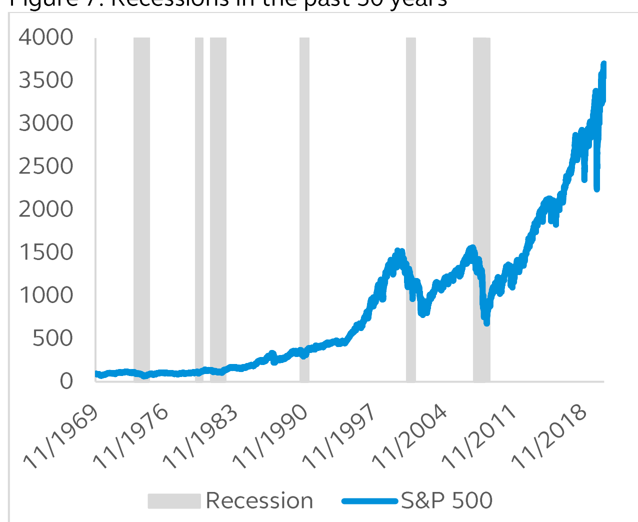
In the past 50 years, the U.S. stock market gained 2.2 times on average following recessions and the uptrend lasted up to 11 years at its longest record

Table 1: Recessions in the past 50 years

S&P 500 Low Date in Recession	Peak-to-Trough Decline	S&P 500 Next Peak Date	Trough to Next Peak Return	Trough to Next Peak (Months)
3/10/1974	-48.2%	13/2/1980	90.2%	64
27/3/1980	-17.1%	28/11/1980	43.1%	8
12/8/1982	-27.1%	16/7/1990	260.2%	95
11/10/1990	-19.9%	23/3/2000	417.0%	113
9/10/2002	-49.1%	9/10/2007	101.5%	60
9/3/2009	-56.8%	19/2/2020	409.5%	131
Average	**-36.4%**		**220.2%**	**79**

Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

Figure 7: Recessions in the past 50 years



Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

As the global economic recession took hold, most major global stock markets entered a bear market in the first quarter of 2020. Take the S&P 500 index as example, it declined nearly 34%. The market had a retaliatory rebound, subsequently, in the second quarter. As of December 16, the S&P index had rebounded by about 70%, more than enough to recover the lost ground from the beginning of the year.

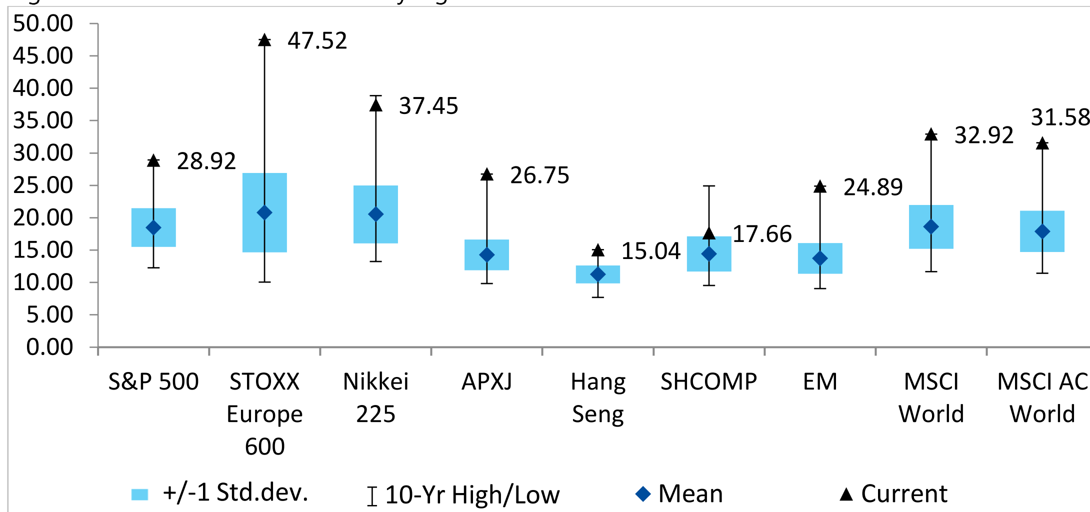
Highly correlated with the economy, almost every economic recession triggered a sharp retreat in the stock market. Looking back at the past 50 years, excluding the current recession caused by COVID-19, the United States has experienced 6 economic recessions and the S&P 500 index had an average decline of 36%. The stock market rose overall since then, until it peaked before the next economic recession. The whole period lasted 8 months to nearly 11 years while the average gain in these periods was 2.2 times (Table 1, Figure 7).

Apart from the economic stimulus, the success of R&D and the application of COVID-19 vaccines are also the biggest driving forces for the global stock market to extend its upward trend of the past few months, at least in the first half of 2021. We believe that the positive news on the vaccines has not been fully digested by the market, especially in some of the cyclical and value-oriented sectors that are highly correlated with the economy. The current prices of those sectors are still below the level before the pandemic at the beginning of the year.

What drives the markets higher?

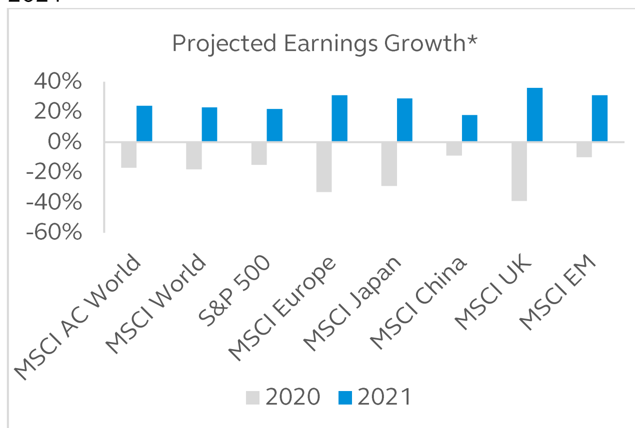
Continuously improving corporate earnings supports high valuations; room for capital flows into equity markets

Figure 8: Stock valuation is relatively high



Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

Figure 9: Corporate earnings are expected to rebound in 2021



Source: Bloomberg, Factset, Principal Global Asset Allocation, Principal Asset Management (Asia) Limited. Data as of 30 November 2020.
* Estimates are sell-side analysts' bottom-up aggregated expectations.

Table 2: Capital flow

Flows (US$ Bn)	20-Nov	YTD 2020	2019	Flows (US$ Bn)	20-Nov	YTD 2020	2019
Bonds	30	338	485	Equities	110	98	-150
Money Markets	-24	896	491	Commodities	-8	68	14
				Others	-2	17	-

Source: Jeffries Equity Research, Principal Global Asset Allocation, Principal Asset Management (Asia) Limited. Data as of 30 November 2020.

Going into 2021, the continued recovery of the global economy will favor the performance of global stock markets. Using the MSCI World Index as a benchmark and integrating market forecasts, earnings of global equities may rebound from negative 17% in 2020 to positive 24% in 2021. Due to its relatively low base figures, earnings growth in the U.K., European and Japanese markets are expected to increase more than 30%.

Of course, from the perspective of valuations, equities are very expensive when measured by the price-earnings ratio. After the surge in November (Figure 8) the price-earnings ratios in multiple markets are at 10-year highs. However, from an asset allocation perspective, stocks still have relative investment values compared to bonds. In this ultra-low interest rate environment, more investors may be willing to take higher risks to obtain better returns.

In terms of capital flows, as much as USD 110 billion inflow into the stock market was recorded in November, reversing the trend of annual net outflows (Table 2). Hence, if the economic recovery is stronger than expected while short-term political risks are subdued, funds may further flow out of the money market into risky assets. This will help sustain the high valuations of global stock markets.

Will sector rotation speed up?

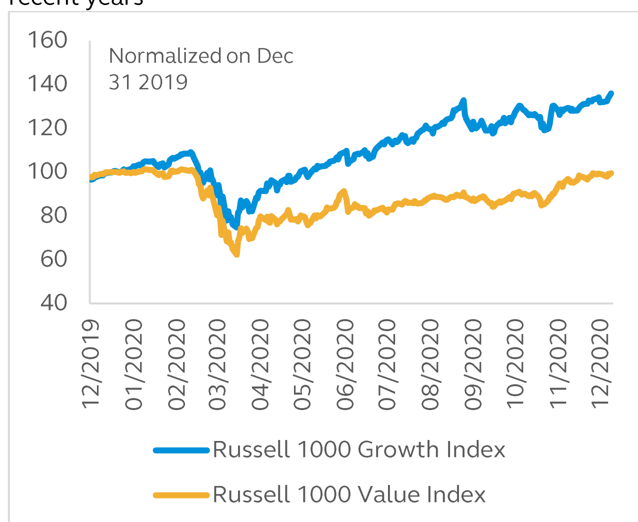
Economic recovery benefits value-oriented, cyclical and small-cap stocks

Table 3: 2021 EPS growth

2021 EPS Growth	MSCI AC World
Overall	24%
Financials	19%
Cons Disc	69%
Real Estate	8%
Materials	30%
Industrials	44%
Energy	430%
IT	16%
Comm Services	14%
Staples	9%
Health Care	12%
Utilities	7%

Source ：Bloomberg, Factset, Principal Global Asset Allocation, Principal Asset Management (Asia) Limited. Data as of 30 November 2020.
* Estimates are sell-side analysts' bottom-up aggregated expectations.

Figure 10: Capital will probably gradually rotate into value stocks which have underperformed relatively in recent years



Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

With the widespread use of COVID-19 vaccines and inflation outlook expected to improve, the global economic outlook is generally favorable for next year. Global central banks will hold interest rates steady near zero, supporting a steeper yield curve and helping the rebound in value-oriented sectors with a higher sensitivity to the economy.

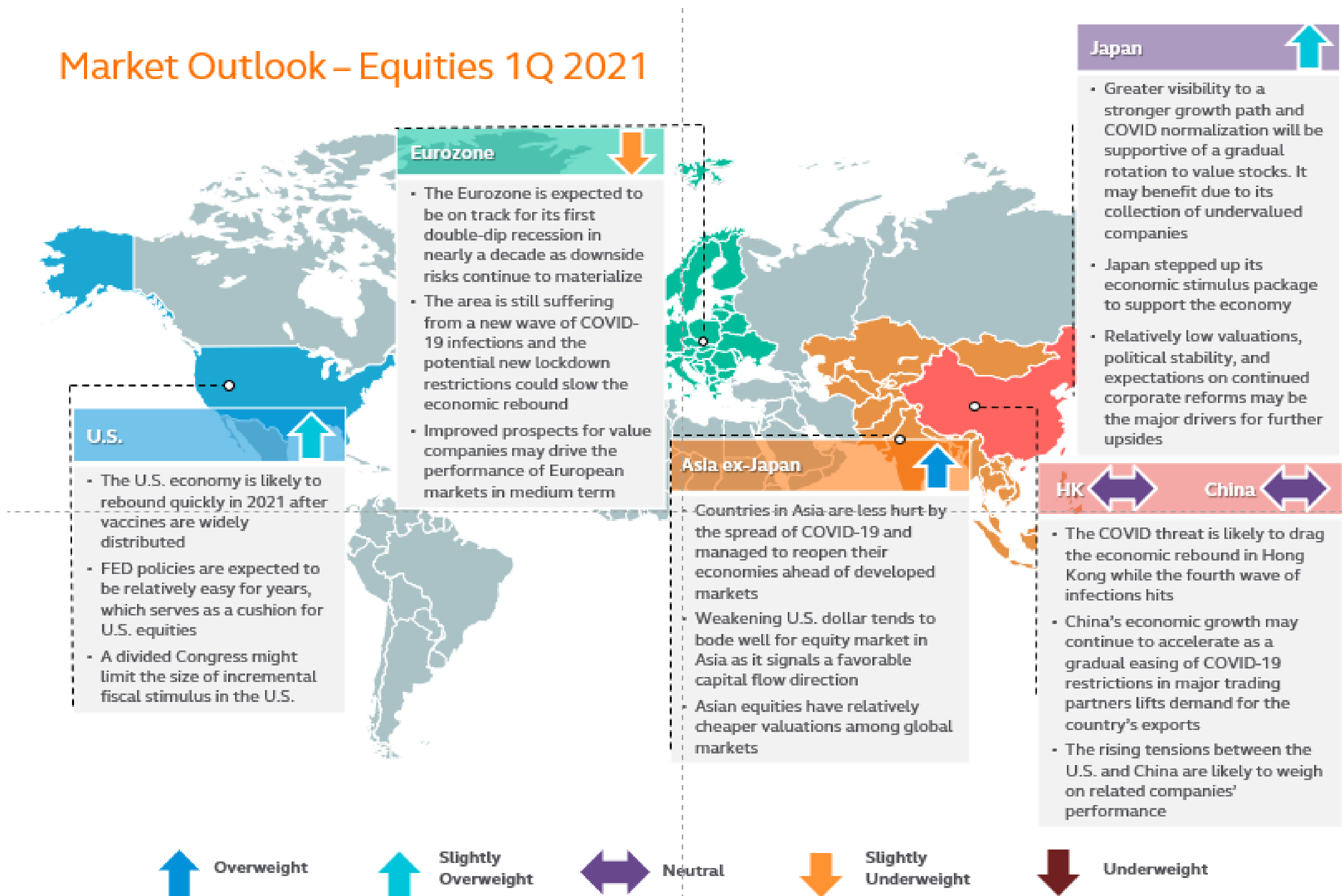
Markets should not ignore any short-term stress on the economy. Therefore, capital may not flow out of the U.S. large-cap and technology sectors in the near future, which have been leading the market. However, as the pandemic fades, capital could gradually rotate into value stocks, cyclical stocks and small-cap equities which have underperformed relatively in recent years (Figure 10).

Based on fundamental analysis, the earnings of traditional sectors such as energy, industry, materials and finance are expected to improve significantly next year. This especially holds true for energy stocks which have had weak earnings in recent years. Based on the MSCI All Country World Index, the market consensus forecast is for a more than a fourfold increase in earnings of global energy stocks. Relatively speaking, it is more difficult for technology companies to record significant profit growth next year (Table 3).

Due to the slow economic recovery and persistently low interest rates, the growth potential for traditional industries has been relatively weak since the financial tsunami of 2008 and the attractiveness of value stocks has declined. Following the outbreak of the pandemic at the beginning of this year, the gap between them has grown further while the valuation of growth stocks is very stretched. Therefore, the fundamental factors of value stocks are relatively attractive when we consider the spread of forward P/E between value stocks and growth stocks and earnings forecasts. Geographically, reasonably valued U.S. value stocks and Asian markets are worth looking into.

How should assets be allocated in the first quarter?

Asia has been revised upward to bullish. Overweight financials, industrials and energy stocks



Source: Principal Asset Management Company (Asia) Ltd. & Principal Global Investors – Principal Global Asset Allocation.
The geographical classification of above listed equity markets is based on MSCI 2020 annual market classification review. For more information, please refer to https://www.msci.com/market-classification

We remain bullish on the stock market for the first quarter. Among them, the Asian market has been revised upward to bullish, while the US and Japanese markets are slightly bullish. China and Hong Kong are neutral, and Europe is slightly bearish.

Asia – Countries in Asia are less hurt by the spread of COVID-19 and some countries managed to reopen their economies before 2020. The weakening U.S. dollar tends to bode well for Asia's equity market as it signals a favorable capital flow direction. Asian equities have relatively cheaper valuation among global major markets.

The United States – The United States economy is likely to rebound quickly in 2021 after vaccines are widely distributed. FED policies are expected to be relatively easy for years, which serves as a cushion for U.S equities. However, from a political perspective, a divided Congress might limit the size of incremental fiscal stimulus. U.S. stocks are at 10-year highs and it may curb the growth potential in 2021.

Japan – the economic outlook improves with their support of the large-scale fiscal policy. As the coronavirus epidemic eases, it might be supportive of a gradual rotation to value stocks as it has a collection of undervalued companies. Relatively low valuations, political stability, and expectations on continued corporate reform may be the major drivers for further upside.

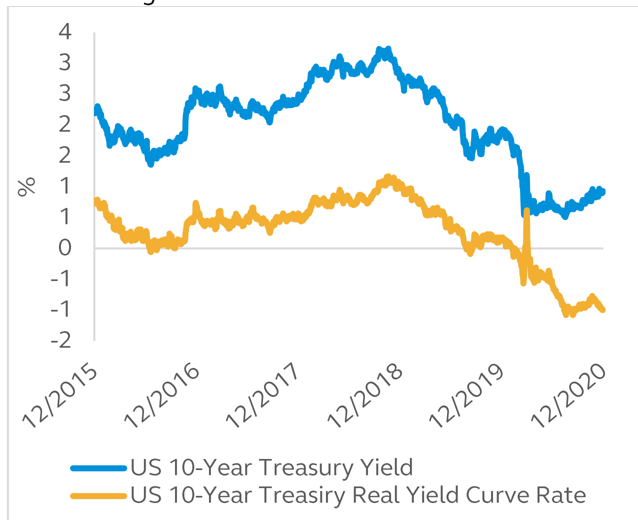
China and Hong Kong – China is the first major country to recover from the COVID-19 pandemic. The rising tensions between the U.S. and China, plus China enhancing regulation on technology companies will influence the China and Hong Kong stock markets. The Hong Kong economy is also impacted by the 4th wave of infection and the recovery path will be long. Although valuations are relatively reasonable, corporate prospects are expected to improve overall and we are cautiously optimistic.

Eurozone – The Eurozone is expected to be on track for its first double-dip recession in nearly a decade as downside risks continue to materialize. The area is still suffering from a new wave of COVID-19 infections and the potential new lockdown restrictions could slow the economic rebound. Improved prospects for value companies may drive the performance of European markets in the medium term.

What is the interest rate outlook for 2021?

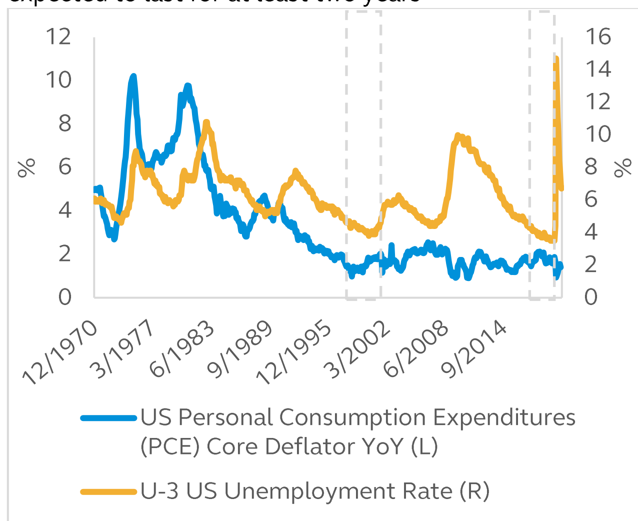
Limited upside for short-term bond yields; long-term yields may rise with expectations of economic growth

Figure 11: Market has already factored in expectations of an economic recovery while investors have started to focus on long-term value investments



Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

Figure 12: The extremely low-interest-rate policies are expected to last for at least two years



Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

For bonds, since the global outbreak of the COVID-19 pandemic, major central banks have actively introduced monetary-easing measures to respond to downward pressures on the economy brought about by the pandemic. In 2020, global central banks have reduced interest rates about 75 times to provide sufficient liquidity to the market. The ultra-low interest policy has caused real interest rates in major countries to go into negative territory. Government bond yields are also at historically low levels. The significant bond purchase programs of some central banks have markedly expanded the size of their balance sheets to record highs.

Frequent and positive news on COVID-19 vaccines has brought about hopes of an economic recovery. As a result, the U.S. 10-year Treasury yield increased gradually after bottoming out in August, rising from 0.6%-0.7% at the end of September to the current level of 0.9%, marking the highest level in more than eight months. Looking to 2021, global economic growth boosted by the development of vaccines will be one of the investment themes. When analyzing the real interest rate and inflation expectations that make up the 10-year bond yield, the real interest rate remains stable near to -1%. The increase in bond yields is mainly driven by investor expectations, reflecting that even under the uncertainties of the vaccines' rollout timeline and distribution, the market has already factored in expectations of an economic recovery while investors have started to focus on long-term value investments (Table 11).

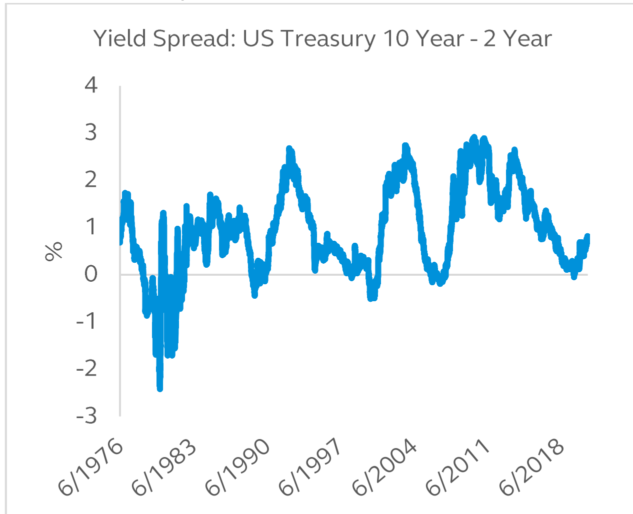
Taking into account the current bond yields are still near historic lows, as economies continue to recover gradually driven by positive news of the vaccines, the yields of long-term bonds may rise to reflect the expectations of economic growth. However, the possibility of major central banks raising interest rates in 2021 remains low. Take the United States as an example, unless inflation remains at an average of 2% for a prolonged period, the Federal Reserve will remain its monetary-easing policy. In fact, over the past 50 years the conditions for meeting a low unemployment rate and a continued 2%+ inflation rate have only occurred twice.

The extremely low-interest-rate policies in the United States and other developed markets are expected to last for at least two years. The rise in short-term bond yields may be relatively limited (Figure 12).

What signals is the highly regarded yield curve indicator sending?

The yield curve is expected to become steeper, consider to reduce the proportion of sovereign debt and shorten bond durations

Figure 13: After the economy enters recession, the long-term and short-term yield spreads usually widen rapidly and substantially for a period of time



Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

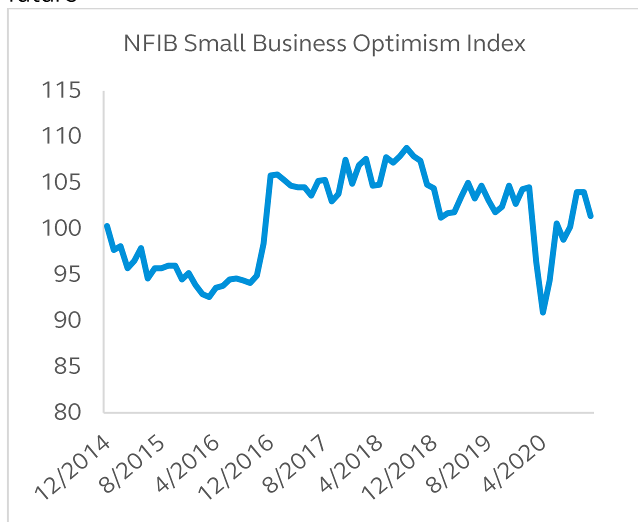
The yield curve is expected to become steeper, indicating that the market is optimistic about economic growth and subsequent inflation. The shape of the U.S. Treasury yield curve has always reflected investor sentiment on the short, and even long-term economic outlook. When the yield on short-term bonds is higher than that of long-term bonds, the yield curve is "inverted." The spread between 2-year and 10-year Treasury yields fell to negative territory just before every recession in the United States since 1965. This time was no exception; after the occurrence of an “inverted yield curve” from August to September 2019, the market experienced the worst economic recession in history within one year.

However, after the economy enters recession, the long-term and short-term yield spreads usually widen rapidly and substantially for a period of time (Figure 13). At the end of December, the US long-term and short-term bonds (2-year and 10-year) yield spread widened to more than 80 basis points at one time, the largest since February 2018. In response, investors may consider reducing the allocation of sovereign debt in their portfolios and shortening the bond duration.

Do corporate bonds have investment value?

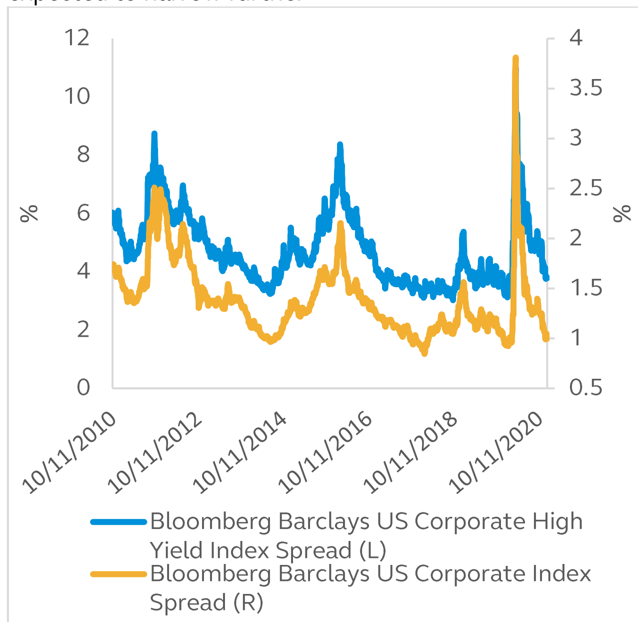
Yield spread has room for tightening; investment grade and high-yield bonds are favored in 1Q

Figure 14: The rising optimism of US companies in the future



Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

Figure 15: Credit spreads of corporate bonds are expected to narrow further



Source: Bloomberg, Principal Asset Management (Asia) Limited. Data as of 18 December 2020.

Fundamentally, if the vaccines are widely adopted successfully, the uncertainties with respect to the economic recovery will be greatly reduced. With a rebound in demand, corporate confidence is expected to gradually increase. The NFIB Small Business Optimism Index rose from 90.9 in April to a seven-month high of 104 in October, reflecting the rising optimism of US companies on the future with markets becoming more positive about corporate earnings forecasts (Figure 14). According to figures from the S&P, benefiting from the low interest rate environment, the issuance of high-yield bonds in the US as of November reached a record high of USD 389 billion this year. This huge volume of issuances allows for bonds maturing before 2022 to account for 8% of the overall market, thereby alleviating pressure on corporate repayments. Moreover, adequate market liquidity creates room for corporate financing. The number of mergers and acquisitions is expected to increase in 2021.

From the above, as the economy continues to recover in 2021, the credit spreads of corporate bonds are expected to narrow further. The launch of COVID-19 vaccines should support the global economy and corporate earnings are expected to rebound. This may improve investor confidence in the repayment of corporate debt. Corporate default rates may reach its peak in a short period of time. Investment-grade and high-yield bonds are worth looking into in the first quarter of 2021(Figure 15).

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