Market observations



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2021 outlook: from recovery to reflation

After an extremely abnormal year, 2021 promises greater normality. The speed of the vaccine response and efficacy of the leading treatments have confounded the sceptics. In the coming months, the deployment of vaccines and mass testing will pave the way for a return to a more familiar way of life.

In fact, there is a risk of having too much of a good thing by the second half of the year, as savings — which have rocketed in key economies — get run down, monetary and fiscal policies remain extremely stimulative, and a synchronised global expansion gains traction after some loss of momentum in the early part of the year. Inflation rates are set to rise quite briskly from their depressed COVID-19 lows, primarily due to base effects but also increasingly due to a weaker US dollar, supply bottlenecks and a sharp tightening of service prices. The market, however, still seems to be pricing in 'Japanification' (deflation and weak growth). But conditions in the wake of the pandemic are fundamentally different to those that prevailed after the Global Financial Crisis (GFC), and the inflation outcome following the present crisis may turn out to be quite different.

Western central banks are likely to keep official interest rates and the short end of bond yield curves pinned down. They are also likely to persist with quantitative easing, not wishing to risk snuffing out nascent recoveries. This continuation of 'financial repression' will allow governments to put off any fiscal reckoning well beyond 2021.

Government bond markets are set to remain heavily distorted, offering poor long-term real rates of return. Low interest rates mean that even modest yield rises threaten to wipe out carry. With short rates pinned down there is scope for yield curves to steepen further as the recovery becomes more firmly embedded. However, the move higher is likely to be punctuated by sharp rallies, given investors' ongoing propensity to reach for yield, while supply pressure will continue to be offset by quantitative easing.

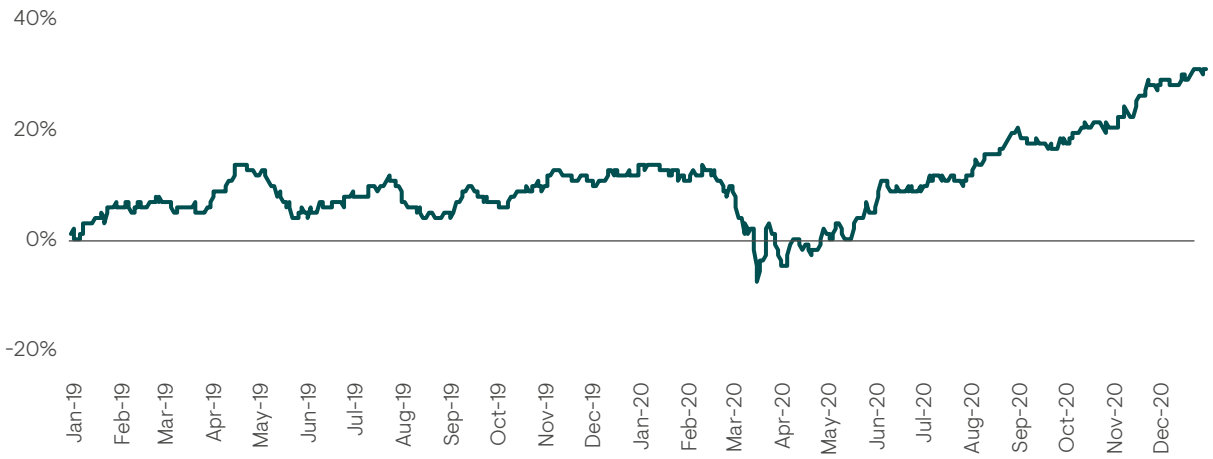
Credit spreads blew out spectacularly in the eye of the COVID-19 storm in March and corporate bonds temporarily became chronically illiquid. The US Federal Reserve acted decisively to backstop credit markets and prevent a liquidity crisis turning into an outright credit crisis. Over the summer, a tentative recovery became more full-blooded, resulting in credit spreads compressing to historically tight levels. However, both investment-grade and high-yield credit are likely to remain supported by central-bank policy in 2021. Technical factors are also likely to help these asset classes as the 2020 supply surge moderates, while fundamentals are improving too. There should be fewer downgrades and defaults and improving credit metrics generally.

In our view, the recent steepening of yield curves confirms an important inflection point in equity markets, which have been characterised by an extraordinary divergence between large-cap 'growth' stocks and cyclical 'value' stocks. Although equity markets overall recovered from the trough in late March, the rally was very narrow, with investors treating the FAANGs (Facebook, Apple, Amazon, Netflix and Google) as, 'safe havens', amid continued COVID-related uncertainties, and with their enthusiasm for these companies further stoked as the pandemic accelerated existing digital trends.

Although we may see modest growth reversals during the first half due to further coronavirus 'waves', there remains every prospect of a more broad-based recovery as 2021 progresses. This is already being signalled by steepening yield curves, marking the beginning of a rotation away from the stocks that had led the market recovery, and into some of the cyclical laggards. Market breadth — lacking hitherto — is now set to increase as confidence in the recovery builds, both from a sector level, but also a regional perspective.

To review our 2021 outlook in full, please click here.

Cyclicals have outperformed Defensives over the past two years



Source: Ninety One, Bloomberg as of 31 December 2020. Chart shows relative performance of aggregated sub component indices representing cyclical and defensive sectors from the MSCI World series.

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