December 2020

Previously Investec
Asset Management

2021 outlook: from recovery to reflation

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The fast view

- Inflation rates are set to rise from their depressed COVID-19 lows. Beyond the usual base effects, we see supply bottlenecks, a sharp tightening of service prices and further weakness in the US dollar adding to inflation pressures.
- Developed market government bonds offered poor long-term real rates of return before the pandemic. Now they are even less attractive and will continue to be. Less correlated, higher-yielding Chinese government bonds offer an interesting alternative.
- Equity markets will start to rotate away from the stocks that had led the recovery, and into the cyclical laggards and 'COVID-victim' stocks.
- In commodities, risks to industrial-commodity prices are to the upside. We expect gold to revert to its medium-term uptrend. Energy stocks may benefit from a demand recovery.
- Investment-grade and high-yield credit are likely to remain supported by central bank policy in 2021. This should contribute to a 'carry-plus' year.
- Opportunities will be available in emerging market debt, as real interest rates in emerging markets are likely to remain at a premium to those in developed markets.

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Big picture: normal service may be resumed

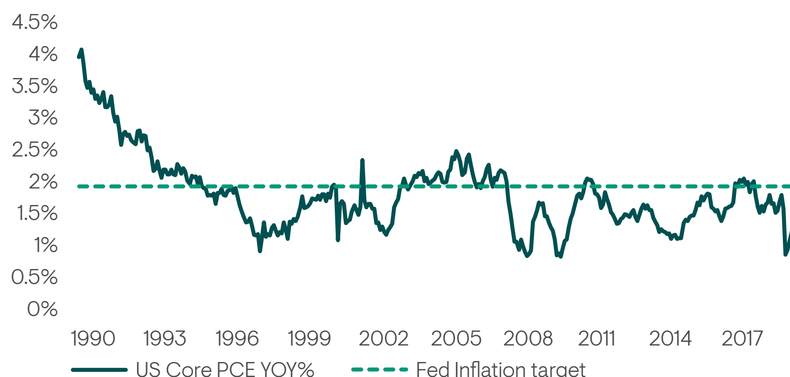
- Inflation rates are set to rise
- US real interest rates are likely to continue to fall, supporting global recoveries
- Geopolitical tensions may moderate but won't disappear
- 2021 could see an emerging market comeback, particularly in Asia

After an extremely abnormal year, 2021 promises to be a year of 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.

Figure 1: Inflation is set to rise beyond its depressed levels in 2021 as the cyclical recovery gains strength



Source: Bloomberg and Ninety One, 31 October 2020.

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Financial conditions will stay loose, supporting recoveries

Given the pre-eminent role of the US dollar in global markets, the US Federal Reserve Board (Fed) will continue to set the policy tone internationally. The Fed policy review, which ran from late 2019 to August 2020, has led to the Fed taking a much more asymmetric approach to its inflation target. That is to say, it now tolerates overshoots of the target but not undershoots. The review shows belated acceptance that attempting to normalise interest rates pre-emptively – which had characterised Fed policy since Paul Volcker's chairmanship in the early 1980s until 2015 – was counterproductive in a post-GFC world. The US economy will therefore be allowed to be run hot. As a consequence, US real interest rates are likely to continue to fall, keeping global financial conditions loose and supporting international recoveries.

The one (important) exception is China, where the People's Bank of China (PBoC) has stuck to its more orthodox monetary guns. The renminbi has been allowed to strengthen and although policy has been supportive of growth – the Chinese credit impulse as a percentage of GDP has exceeded the deliberate and material boost to growth in 2015-16 – a full-scale recourse to quantitative easing has been avoided. Indeed, China remains committed to addressing its structurally high indebtedness by continuing to focus on improving capital productivity. This is likely to be the major area of macro policy divergence.

The recurrent geopolitical flare-ups of recent years are likely to moderate somewhat, but will not go away entirely. President Trump's approach was unorthodox, but he succeeded in fundamentally changing US policy towards China from one of 'partner' to 'adversary'. Although the incoming administration is likely to use more conventional diplomacy, a Biden presidency will probably be less comfortable for China because US policy should be implemented in a more structured and internationally collaborative way. In the meantime, China is likely to tone down 'wolf-warrior diplomacy', and concentrate on its priorities of domestic growth and technological self-sufficiency.

2021 is potentially the year of a sustained emerging market comeback, particularly in Asia, given depressed real rates, a weaker US dollar and vaccine-driven cyclical recoveries. Notwithstanding US attempts at containment, China is already acting as a powerful regional and global locomotive.

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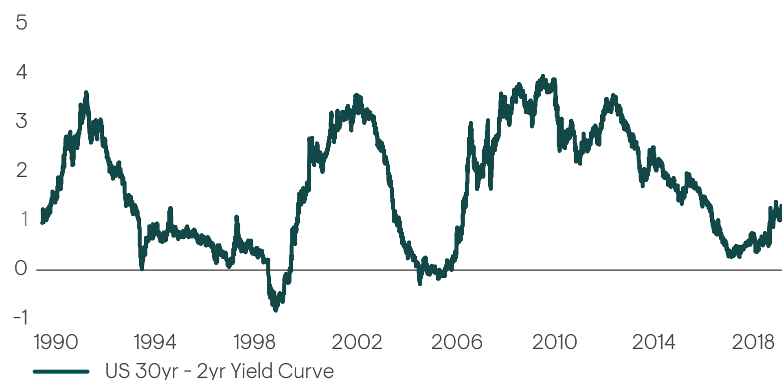
Government bonds: steeper yield curves

- Government bond markets are set to offer poor long-term real rates of return
- Breakevens should prove to be a purer play on rising inflation than index-linked bonds
- Chinese government bonds offer an interesting alternative to developed government bonds

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 and yield curves still relatively flat, there is scope for yield curves to steepen as the recovery becomes more firmly embedded. However, a 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.

In a sense, the yield curve has become the new duration. Breakevens should prove to be a purer play on rising inflation than index-linked bonds, because real rates should rise in longer maturities, offsetting the inflation-hedge benefit.

Figure 2: Government bonds offer poor real rates of return. There is scope for the yield curve to steepen



Source: Bloomberg and Ninety One, December 2020.

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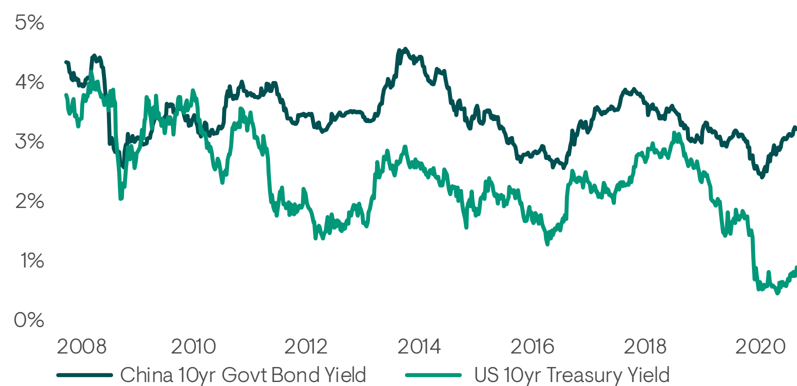
Chinese government debt: interesting alternative

Chinese government bonds offer an interesting alternative to developed government bonds. The PBoC has continued to state its desire to avoid unconventional policies and negative interest rates at all costs, and to maintain a more conventional policy framework focused on policy transmission rather than targeting the quantity of money. Hence, changes in yields should be correlated to the growth outlook. Having risen in response to China's strong recovery, Chinese bond valuations are currently at medium-term fair-value levels.

China is a creditor nation and has opened up its bond market to foreign investment, and it is now the second largest bond market in the world and one of the most liquid. While not yet considered a developed (and therefore defensive) government bond market in a conventional sense, the direction of travel is clear. It remains our strong belief that Chinese government bonds will play an increasing role in global fixed income and multi-asset portfolios as their return and diversification properties become more widely recognised.

Figure 3: Chinese bonds are the notable exception, offering relatively high and uncorrelated yields



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Commodities: industrial metals remain in the sweet spot, while gold marks time

- Risks to industrial-commodity prices are set to remain to the upside
- Energy stocks may benefit from a demand recovery, but structural pressures persist
- Gold should revert to its medium-term uptrend

After an initial hesitation, industrial commodities traced a classic v-shaped[1] recovery from early July 2020. This was underpinned by the recovery in China, the principal source of demand, and augmented by strategic stock-building by the Chinese government, which took advantage of low prices and the chance to diversify away from US dollars. With durable-goods demand recovering globally as consumers switched from services spending, and metals inventories being held lower by the COVID-related supply disruptions in Q2, metals balances tightened rapidly towards the end of 2020.

Although the momentum of the global recovery can be expected to moderate in the first half of 2021, this will not signal a change in direction for industrial-commodities markets. Risks to prices are set to remain to the upside as the recovery broadens and policy support remains intensive. The consolidation of the mining industry in the aftermath of the secular bull market of the 'noughties', and the increased financial discipline maintained by mining companies since, mean that supply in the key metals should remain tight.

The outlook for oil is more nuanced. We expect a further demand-driven recovery for oil from the current depressed levels, which should provide a cyclical lift for energy stocks. But structural uncertainties are unlikely to fully dissipate amid an accelerating energy transition.

1. Source: CBR Raw Industrial index.

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Gold and gold stocks may be useful if inflation surprises

Gold shone in 2020 as an under-owned safety asset at a time of intense uncertainty and concerns about the impact of central-bank intervention and the use of unconventional policies on an unprecedented scale. As coronavirus fears have eased, gold has corrected – an unusual phenomenon at a time of US dollar weakness, though consistent with gold's perception as a 'haven asset', given rising risk appetites after the summer. We consider this adjustment to be largely due to technical factors – with shorter-term momentum investors calling time on their gold holdings and a heavily overbought position being unwound – rather than fundamental ones, as real interest rates are set to remain low and will likely move lower as inflation pressures build, supporting gold. After a further period of consolidation, gold should revert to its medium-term uptrend and we think it continues to offer the potential for substantial optionality in the event of inflation surprising to the upside over the medium term.

Gold equities have retraced in the past two months as gold has retreated, but gold companies' Q3 results were the best we have seen for many years. Margins and free cashflows are the highest for the sector since 1980 in real terms and net debt levels are the lowest on average for any sector, meaning that shareholder returns are growing rapidly. Gold companies are following the lead of the gold majors in focusing on disciplined capital allocation and earnings per share, rather than volume growth. Industry consolidation is also helping to cut costs.

> Gold companies' Q3 results were the best we have seen for many years.

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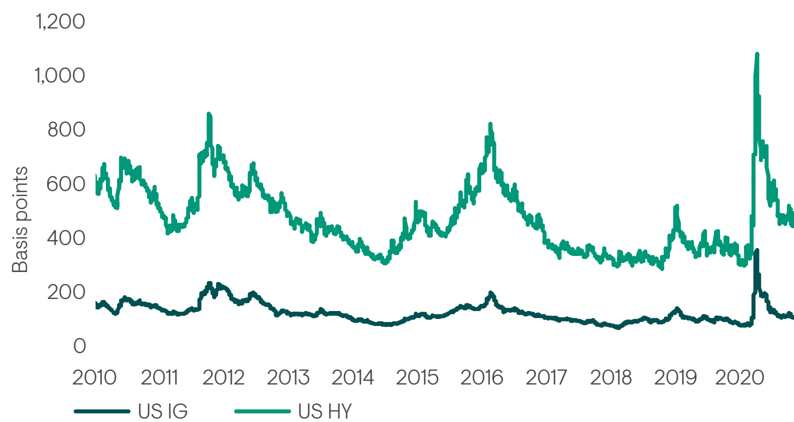
Credit: a 'carry-plus' year?

- Investment-grade and high-yield credit should remain supported by central-bank policy
- Expect fewer downgrades and defaults, and improving credit metrics

Credit spreads blew out spectacularly in the eye of the COVID-19 storm in March and the bonds temporarily became chronically illiquid. The Fed 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. This should set the market up for a 'carry-plus' year.

Pockets of opportunity exist within structured credit, corporate hybrids, and certain cyclical and COVID-impacted names. Conversely, areas with negative convexity – such as call-constrained high-yield bonds and credits suffering from structural (rather than just cyclical) imbalances, which includes certain energy and retail names – are likely to struggle.

Figure 4: Spreads for both IG and HY are close to pre-COVID tights



Source: Bloomberg, Goldman Sachs Research, Ninety One, 4 December 2020. US IG based on Bloomberg Barclays Agg Corp Index, US HY based on Bloomberg Barclays US High Yield Index. Supply estimates from Goldman Sachs Research.

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Equities: rotation, rotation, rotation

- A rotation back to cyclicals has begun; small and mid-cap stocks should also do better
- Mining stocks would benefit from higher commodity prices
- Strategically, we continue to favour Chinese and Asian equities
- Stock-level considerations should become more dominant as 2021 progresses

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. Despite the increasingly clear evidence of a strong v-shaped recovery, longer-dated bond yields remained relatively depressed, despite their objectively poor valuations.

Although we may see modest growth reversals in the next quarter or two 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 and 'COVID-victim' stocks such as airlines and tourism. Market breadth – lacking hitherto – is now set to increase as confidence in the recovery builds.

The cheap-cyclical recovery trade should do well

The recent equity-market inflection has been marked by a spike in stock correlations, with a sharp momentum reversal largely driven by relative exposure to the stay-at-home theme versus the end-of social-distancing theme. This should continue into the first half of 2021, albeit less sharply, helping the simple cheap-cyclical recovery trade to do well, independent of the inflation, interest rate and yield curve outcomes.

Although banks are more dependent on where yield curves go from here, big credit-loss write-backs are coming in the US which should in turn drive stock buy-backs. Finally, materials stocks are well placed to benefit from their continued capital discipline, which will help to fuel their significant operational gearing to higher commodity prices.

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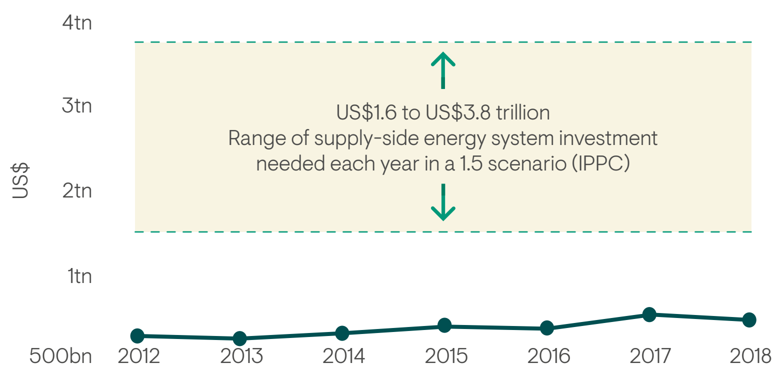
As confidence in the recovery grows, we expect stock-level considerations (as opposed to macro or sector-level issues) to reassert themselves as 2021 rolls on. Companies that made the best of the coronavirus crisis by using it as a catalyst to get their houses in order – by cutting organisational fat, accelerating their digital transformations or engaging in opportunistic M&A, among other things – should begin to pull away from their peers.

Should a reasonable level of inflation transpire, as we expect, then companies with strong current cashflows and pricing-power dynamics should also do well. This would benefit companies with higher-than-average dividend yields, which had a particularly tough year in 2021. In pronounced market sell-offs, high-yield stocks, supported by their income characteristics, normally display defensive characteristics. But not this time. Uncertainties about suspended or cut dividends have continued to hold this group of companies back. We believe that they still have significant recovery potential and that their longer-term properties – competitive total returns accompanied by lower volatility and defensive drawdown characteristics – remain intact. Our preference is for companies within the universe with above-average, but not the very highest, current dividend yields, sound balance sheets and the room to grow dividend streams.

Eventually, the battle lines between the purely cyclical and the structural will be drawn. Regarding the latter, we believe there has been a clear acceleration of pre-existing structural trends. For instance, the move to online has been a step change during the pandemic, as has the acceleration of decarbonisation. The low-carbon transition will be fuelled in 2021 and beyond by continued regulatory support and an improvement in corporate investment appetites as the economy continues to heal. This is a positive for industrials generally, but particularly for businesses offering products and services that will facilitate the energy transition.

Figure 5: The world is still US$2tn short of being able to reach a 1.5 degree scenario



Source: Climate Policy Initiative, 13 July 2020.

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Ex-US markets should catch up

From a regional perspective, markets outside the US, which have performed relatively poorly, should enjoy a catch-up. But this is largely a function of structure – the pandemic winners just happened to be better represented in the US. Strategically, we continue to favour Chinese and Asian equities, whose valuations remain attractive and secular-growth prospects strong. Ex-China Asia and broader emerging market equities are particularly well placed to enjoy a stronger cyclical bounce in the coming months, and to potentially benefit from the constructive backdrop of helpful financial conditions, positive flows driven by improved investor risk appetite and, for some, stronger commodity prices. But longer-term investors should still favour Asian stocks that are well aligned with the key regional growth themes over broader emerging market exposure.

Finally, small and mid-cap companies worldwide, having struggled relative to their larger peers, should perform strongly. Again, the survivors will benefit from better demand and pricing power.

While many commenters point to headline equity-market valuations, we believe that the average hides huge dispersion of valuations. Consequently, we think there are plenty of attractively valued equity opportunities for the discerning investor, albeit potentially with some volatility.

> Ex-China Asia and broader emerging market equities are well placed to enjoy a stronger cyclical bounce

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Currencies: a softer US dollar?

- A weaker US dollar will help emerging currencies
- We favour the renminbi and Asian currencies generally

A softer US dollar should help to drive emerging market currencies, and emerging market assets more generally. This is predicated on a continued decline in real US interest rates as the Fed keeps rates locked down and inflation rebounds. However, as we head into 2021, this has become a strongly consensus view, which implies caution towards strategies that are heavily dependent on this outcome. Nevertheless, the Fed's balance-sheet expansion is unlikely to be tapered for now – reducing the risk of a repeat of the 'taper tantrum' of 2013, which severely affected emerging market currencies and debt. This should ensure the continued flow of liquidity into emerging markets, even if the US dollar is not notably weak.

Positive outlook for the renminbi

Our core foreign-exchange policy continues to favour the renminbi – for the reasons articulated in the bond section – and Asian currencies more generally, where more orthodox monetary policies are set to prevail and where international capital is likely to migrate in pursuit of higher returns. Pressure should ease on the emerging market 'carry' currencies as liquidity headwinds abate and investors return to reaching for yield. These currencies have tended to perform with a lag once a new Chinese credit-cycle has become established, which is now the case.

All things equal, commodity producers should be particular beneficiaries of this confluence of supportive factors. This offers an opportunity for the likes of Brazil and South Africa to get their respective fundamental houses in order.

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Emerging market debt: selective carry opportunities

Inflation across emerging economies should continue to converge with that in developed markets as a result of the emerging currency strength already witnessed in 2020. This is against the structural backdrop of worsening demographics and higher debt, but also the increasing credibility of emerging market central banks and institutions. As a result, real interest rates in emerging markets are likely to remain at a premium to those in developed markets. Opportunities will remain, particularly in areas priced for interest-rate normalisation with strong fundamentals.

Selectivity will remain critical, given that average yields in emerging market local-currency bonds are already at record lows. Some markets remain susceptible to repricing, particularly those, such as Brazil, with negative real interest rates and weak fundamentals, and whose external balances have been flattered this year by a collapse in import demand.

Emerging market hard-currency spreads have yet to fully reverse the COVID-related spike. As a result, the stronger growth backdrop next year is likely to result in some further tightening. However, returns are becoming skinnier and more dependent on the underlying duration rate remaining stable for positive real returns to be delivered.

Red flags: watch central-bank policy

— Keep a close eye on central bank policy in 2021

As the old boxing adage warns, “it’s the punch you don’t see coming that knocks you out”. That was very much the case in 2020 with the COVID-19 pandemic. But from today’s vantage point, in 2021 central-bank policy should be watched closely because it is set to remain critically important for asset markets.

Should inflation come back more quickly than we envisage or these institutions start to pay more attention to financial stability, markets that have become dangerously dependent on liquidity infusions could struggle. We have also witnessed how heavily influenced global growth has become on the Chinese credit cycle. Should China signal a move back towards macroprudential tightening, growing expectations of a multi-year reflationary cycle might have to be aborted.

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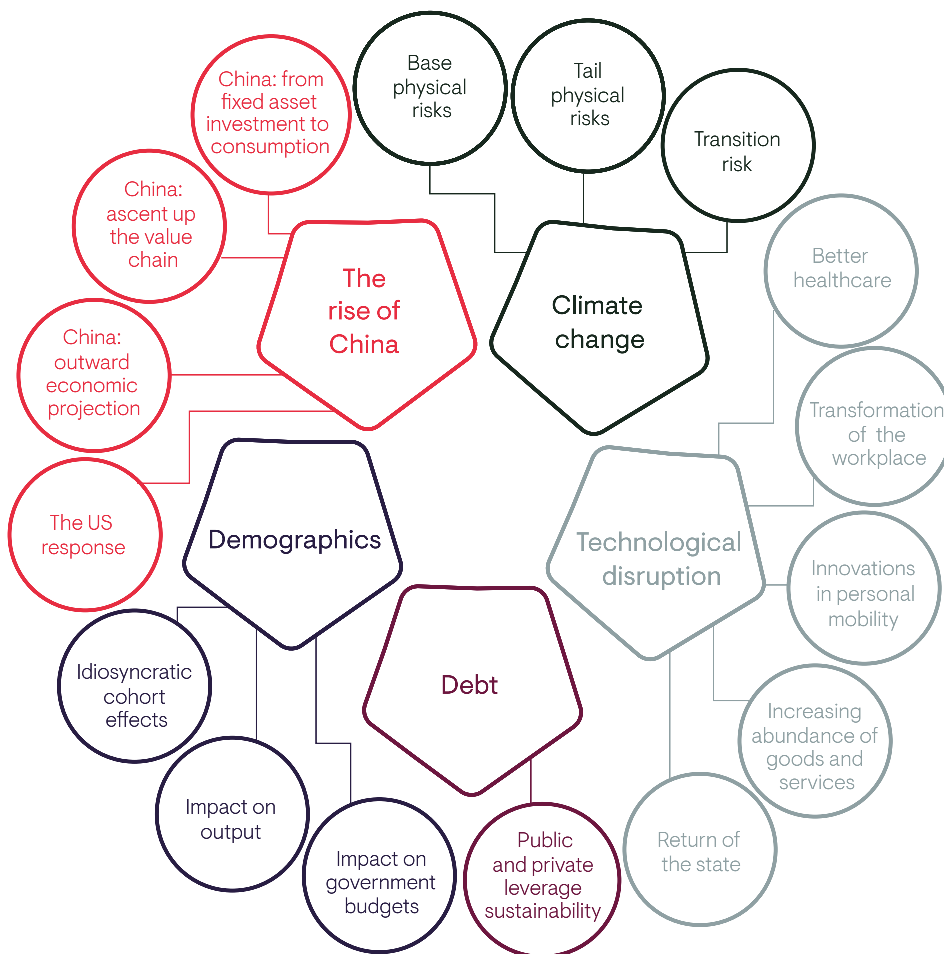
Structural themes: five major trends

- China's ascent up the value chain is accelerating
- Policy globally is focusing on decarbonisation
- Governments will use various tools to keep public and private debts sustainable

Our 'Road to 2030' framework envisioned scenarios for the world economy and markets over the coming decade, as seen through the lens of five themes. While these themes are expected to play out over a number of years, it is worth asking where things stand over the coming 12 months.

Figure 6: There have been key developments across the five themes in our Road to 2030 framework



Source: Ninety One, November 2020.

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1. Rise of China

In our Rise of China theme, the key drivers of economic change are the shift to a consumption-driven economy and China's ascent up the value chain. While the initial recovery in China was unbalanced, with supply rebounding faster than demand, over the next year consumption should broaden, with rising retail sales and services consumption. Meanwhile, China's ascent up the value chain has clearly been accelerated by the pandemic, with the Chinese government now committed to spending heavily to, among other things, secure its own semiconductor supply base.

The US attempt to cut off China's semiconductor progress will only embolden China's efforts over the medium-term, but it does provide a material tailwind for ex-China semiconductor producers over the next c.12 months.

China's recent commitment to net-zero emissions by 2060 is likely to unleash another wave of research and development, this time in decarbonisation. On a cyclical view, we expect a notable tailwind behind assets linked to this theme over the next 12 months, driven by China's expansionary credit cycle and the supportive backdrop of global liquidity and a softening US dollar.

2. Technological Disruption

In our Technological Disruption theme, we regard technology as an enabler, rather than an end in itself. This year, we have seen a vivid demonstration of that, with technology enabling notable progress in four of our five sub-themes:

- A transformation of the workplace (through the rise of home-working and a shift towards the globalisation of services)
- A shift towards better healthcare (the unprecedented discovery of multiple effective vaccine candidates in the span of months)
- An increasing abundance of goods and services (the pandemic-driven rise of e-commerce and video games)
- An increasing focus on innovations in personal mobility (the rapid increase in market capitalisations of electric-vehicle companies)

Our fifth tech-enabled sub-theme was the return of state power as governments intervene more. Given the many state failures in responding to COVID-19, along with the need for longer-term investment, government intervention is clearly set to increase in the coming year. Related to our Rise of China theme, Beijing understands that technology is at the heart of US dominance in the world, and is responding accordingly.

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Meanwhile, in Europe there is a consensus that state-driven investment is necessary to pursue decarbonisation. All of this points to more state intervention next year.

On a cyclical view, our Technological Disruption theme experienced notable tailwinds in 2020 as the global pandemic accelerated digitalisation and broader technology adoption. Assets linked to this theme may take a breather on a relative basis in 2021 as COVID-recovery plays benefit from a return to more normal lifestyles.

3. Climate Change

In our Climate Change theme, we highlight two categories of physical risks to the planet: base risks and tail risks. The former (mainly extreme weather events, like floods and wildfires) are likely to increase over the coming decade, while the latter (permanently elevated sea levels, permanent drought) are more likely to show themselves thereafter.

There are also transition risks, by which we mean the potential for governments and societies to put pressure on the economic system to accelerate the energy transition. In this regard, 2021 is likely to be a watershed year. With carbon emissions only dropping by 7% in 2020 despite widespread economic disruption, we clearly still need substantial decarbonisation. Policy is finally beginning to turn in that direction on a global basis with governments promising to raise carbon taxes, fund innovation, and generally commit to replacing less-efficient energy devices with more efficient ones. In September and October, China, South Korea and Japan all committed to net-zero emissions by 2060; over the next 12 months, we will see what those promises actually mean. In Europe, one in every 10 cars sold in 2020 was an electric or plug-in hybrid, triple the level last year, and 2021 – which brings emissions standards tightening – may push that share further. The US will commit to the Paris Agreement under a Biden administration, and much regulatory action will come from the Environmental Protection Agency. Therefore, the substantial increase seen in the global environment equities this year may not be a one-off. This theme will experience ongoing cyclical and secular tailwinds driven by government policy and regulatory developments.

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4. Debt

Regarding Debt, our fourth major theme, the events of the last year could not be more relevant. Fiscal deficits in 2020 are likely to be 11.1% of GDP in emerging markets and 15.6% in developed markets. Debts are projected to spike then stabilise as the recovery takes hold. We expect governments to continue using a number of tools to keep public and private leverage sustainability in check, including financial repression, currency wars, austerity/taxation, macroprudential policy and selective debt forgiveness. Given the rise in income and wealth inequality during the pandemic, as well as the imperative to restore the pre-pandemic economic order, it will be very difficult for states to pursue austerity and taxation as some did in the 2010s. Therefore, we are more likely to see a consensus building towards the use of unorthodox solutions. The 2010s may well come to be seen as the last gasp of fiscal responsibility, as traditionally understood.

5. Demographics

On demographics, the long-term effects of COVID-19 remain to be seen, but one impact could be more protected health budgets and healthcare spending. For instance, the recent UK spending review froze salaries for all public workers except those in healthcare. Combined with efforts to reduce obesity and increase vitamin-D intake, this could lead to longer lifespans in the years ahead. Meanwhile, the working-from-home trend, enabled by technological disruption, may also increase labour-market participation as flexible working widens opportunities to more people.

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Looking ahead to a different year

- Inflation pressures are building in the US
- Equities should remain supported; there's a risk of a stock-market 'melt-up'
- We see potential for an equity rotation away from the US towards Asia, and 'growth' may lose its leadership
- Developed bond valuations are unattractive; finding defensive assets will be tough
- Breakevens and creditor-nation currencies could be useful diversifiers
- Chinese government bonds could play a useful role in portfolios

Our key observation is that we think that the US is more likely to experience inflationary pressures over the medium term than was the case after the 2008 GFC. This is because deflationary demographic headwinds in the US have weakened, consumers are less leveraged, and monetary and fiscal policy are working in unison.

At the time of writing, equities are heading into the New Year in an ebullient mood, so a correction or period of consolidation is a relatively high probability in the early part of 2021. But equity markets should remain well supported by liquidity and universally pro-growth policies, which should feed through into strong earnings. Equities remain our preferred growth asset class. Indeed, the combination of extremely loose monetary policy, negative real interest rates, the rising velocity of money combined with strong growth, and poor value in bond markets runs the risk of a 'melt-up' in equity markets.

Within equities, we believe that there is further scope for rotation regionally out of the US – Asian markets being the prime beneficiaries – and away from the growth leadership that has been so dominant. But this is likely to prove more complex than a simple 'growth-to-value' switch. Over the medium to longer term, structural realities (highlighted in the thematic section) will remain powerful determinants of returns.

Within developed bond markets, valuations are profoundly unattractive, in our view, and finding defensive exposures to diversify portfolios will continue to be challenging until they normalise. We have highlighted the attractiveness of breakevens and creditor-nation currencies as diversifiers, and remain constructive about gold over the medium term. Finally, despite a more complex geopolitical situation, we believe that Chinese government bonds are set to become permanent additions to investors' core fixed income portfolios.

General risks. The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth.

Specific risks. Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems.

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CS_201_12_2020