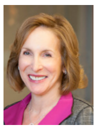
2021 Outlook: Is the Rotation for Real?

Insight from sub-adviser Wellington Management



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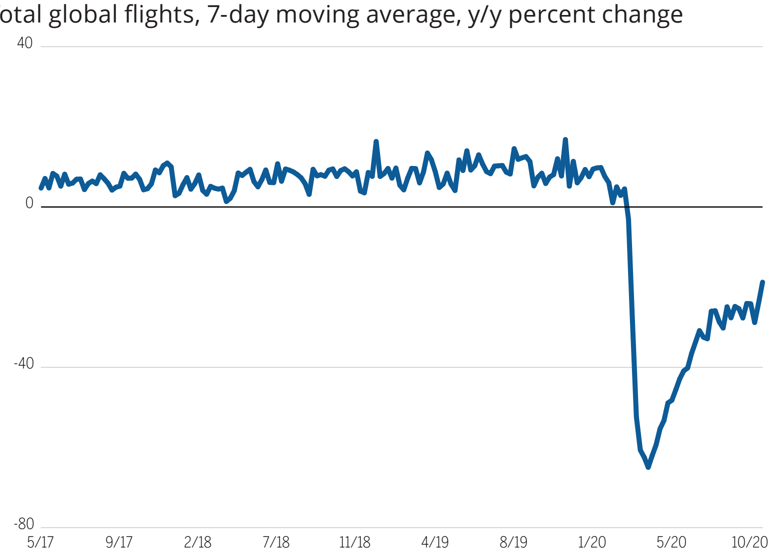
Key Points

- Encouraging vaccine data, policy support, and gradually reopening economies make us more confident in taking a pro-risk stance over our 12-month time frame.
- Safe, effective vaccines could be the catalyst for a durable rotation from growth- to value-oriented exposures.
- Within equities, we prefer Europe, Japan, emerging markets, and smaller caps, and think cyclical sectors are attractive relative to growth sectors.
- We think rates will drift higher and find some credit spreads[1] attractive relative to government bonds.
- Downside risks include broad lockdowns as a result of a second COVID-19 wave, a spike in interest rates, and geopolitical tensions during the US lame-duck session. Upside risks include another major dose of policy stimulus.

REMARKABLE, PAINFUL, UNSETTLING, HOPEFUL…2020 brought a roller-coaster ride of emotions, not to mention economic and market volatility. As the end of the year approached, the global economy was on its way to climbing out of the deepest hole ever. Markets, meanwhile, had moved forward, mostly on the strength and relative safety of US equities, growth stocks, gold, and fixed income, and then taken a baby step toward cyclical leadership at the end of the year. So, with the US election behind us (though Senate runoff elections are still to come as of this writing), COVID-19 cases spiking in Europe and the US, fiscal stimulus on hold in the US, and very encouraging vaccine data being announced, what is the investment thesis for 2021?

Over our 12-month horizon, we think vaccine news, reopening economies, and still-strong policy support will predominate and mark a turning point in the market narrative. Seeing a surer path to a safe and effective vaccine, we are more confident in an economic recovery in 2021 from still very depressed levels (**FIGURE 1**) and we think this will be the catalyst for value to outperform growth, as well as for sovereign rates to rise somewhat. We expect a range of value-oriented exposures to outperform, including non-US developed-market equities (versus US equities), emerging markets (EM), cyclical sectors such as financials, consumer discretionary, materials, and industrials, and smaller-cap equities. In sync with these views, we see the US dollar weakening too. Given large output gaps and low levels of valuations, sentiment, and positioning in these areas, we think a rotation will be an enduring theme in the coming year.

FIGURE 1
A Global Rebound Is Taking Wing, But Work Remains
Total global flights, 7-day moving average, y/y percent change



Source: Flightradar24, Wellington Management | Chart data: 5/7/17–11/8/20 | Total flights include commercial flights, business jet flights, private flights, gliders, most helicopter flights, government flights, some military flights, and drones.

[1] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

US equity markets are dominated by growth and technology, and we think a vaccine will unleash pent-up demand that could make value-oriented plays more attractive.

We remain moderately bullish on credit given the demand for yield, central-bank support, and fair spread levels. We are not concerned about inflation over the coming 12 months given the sizable global output gaps, and thus see commodities as a source of potential funds (though precious metals could be a complement to fixed income for diversification purposes). Our pro-risk stance on EM incorporates our expectation that China's recovery will continue to migrate from the industrial to the consumer side of the economy and that some other EM will potentially benefit from a better developed-market backdrop, a weaker US dollar, and low valuations.

Equities: Leaning Toward Value

We have tilted our view on equity exposures away from the US and toward Europe and Japan. Japan's domestic economy has benefitted from some fiscal stimulus and a mild experience with COVID-19. That combination has led to healthy balance sheets for both corporates and households. Moreover, we expect Prime Minister Suga to slowly ramp up economic reforms and the Bank of Japan to continue to push for reflation.

In Europe, the manufacturing side of the economy has performed well throughout the COVID-19 crisis but the services side has lagged badly. As Europe endures a second wave of infections, we anticipate further lockdowns in the near term. However, our optimism about a vaccine and the fact that European consumers have the most room to rebound make us bullish on an economic recovery in 2021. Taking these macro views into account, as well as attractive valuations, we think it may be time for investors to reconsider their long-standing underweights in Europe and Japan.

We are now moderately bullish on EM equities on the back of China's relative economic strength shifting from the industrial sectors to the consumer, and a more constructive outlook for some other large EM countries. In Turkey, President Erdogan's pick for the new central bank governor, a former finance minister, is a positive development. Brazil's current account surplus has actually improved during the pandemic, and inflation is at record-low levels. While EM countries' debt relative to GDP has increased, interest rates are low and some monetary easing is a possibility. Differentiation in EM remains key; for instance, we prefer countries whose economies are tied more to manufacturing than to tourism.

We are lowering our long-standing positive stance on US equities to neutral. US equity markets are dominated by growth and technology, and we think a vaccine will unleash pent-up demand that could make value-oriented plays more attractive, particularly if interest rates rise somewhat, as we believe they will. We think the economy, which has been hit hard by COVID-19, will rebound as it reopens, benefiting more cyclical areas (**FIGURE 2** on page 3). The rebound should be supportive of US equities overall, but given the market's concentration in relatively expensive areas, such as technology, we are left with a neutral stance.

Our Multi-Asset Views

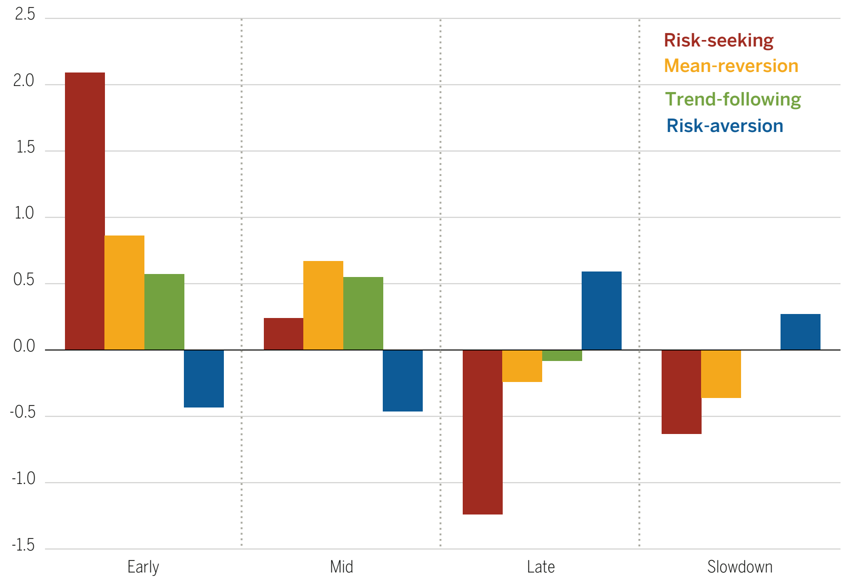
Asset class	View	Change
Developed market equities	**Moderately bullish**	—
US	Neutral	↓
Europe	Moderately bullish	↑
Japan	Moderately bullish	↑
Emerging market equities	**Moderately bullish**	↑
10-year rates	**Moderately bearish**	↓
US	Moderately bearish	↓
Europe	Moderately bearish	↓
Japan	Moderately bearish	↓
Credit	**Moderately bullish**	—
Investment-grade	Neutral	—
High yield	Moderately bullish	—
Bank loans	Neutral	—
Emerging market debt (external)	Neutral	↑
Securitized assets	Moderately bullish	—
Commodities	**Moderately bearish**	—

Change is from previous quarter. Views expressed have a 6–12 month horizon and are those of the authors. Views are as of November 2020, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

FIGURE 2

Value (Mean-Reversion) Tends To Outperform During the Upturn in the Cycle

Average monthly alpha* of factors in different stages of the economic cycle (%)



Source: FactSet, MSCI, Citi, Wellington Management. | For illustrative purposes only. Not representative of an actual account or strategy. | Investment Strategy team's proprietary factors. Representative factors within each theme: Risk-seeking factor= US beta; Mean-reversion factor = US low price/earnings (P/E); Trend-following factor = US revisions; Risk-aversion factor = US low volatility. **Past performance does not guarantee future results.** | Chart data: February 2003–December 2019. | * Alpha is the measure of the performance of a portfolio after adjusting for risk. Alpha is calculated by comparing the volatility of the portfolio to some benchmark. The alpha is the excess return of the portfolio over the benchmark. | Beta is a measure of risk that indicates the price sensitivity of a security or a portfolio relative to a specified market index. | Mean reversion is a financial term for the assumption that a stock's price will tend to move to the average price over time. | Price/Earnings (P/E) is the ratio of a stock's price to its earnings per share.

Rates and Credit: Higher Rates, for the Right Reason, Should Be Fine for Spreads

We believe that a cyclical recovery in 2021 will mean slightly higher yields in longer maturities while central banks will keep short rates pinned. The prospect of higher government bond yields augurs slightly worse for credit relative to the past, from a total return perspective. If higher rates are a result of better real growth, however, and rate moves are mild, then spreads should tighten. Valuations remain at median levels versus history and demand for extra yield remains strong. **FIGURE 3** shows that with the growth of the European Central Bank's (ECB) purchases of European government bonds and corporates, European asset allocators are being forced to increase their foreign debt purchases. This appears to be an additional source of US credit demand. Despite its longer duration,[2] the US investment-grade market could benefit from this dynamic, so we seek a neutral posture.

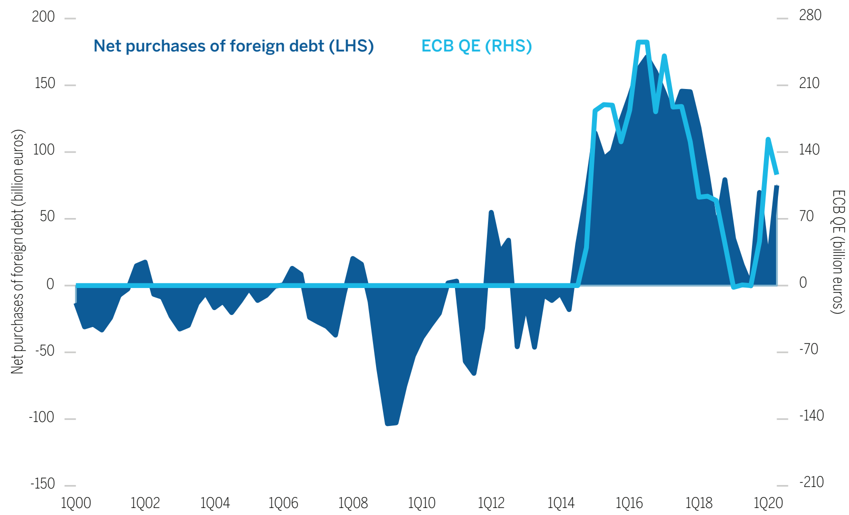
[2] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

We believe there are attractive opportunities in the higher-yielding local rates and currency markets in Latin America funded by the safer, lower-yielding Asian countries.

FIGURE 3

ECB Quantitative Easing (QE) Has Pushed European Investors Into US Credit

Euro area purchases of foreign debt and ECB QE



Sources: Datastream, Wellington Management | Chart data: 1Q2000–2Q2020

We remain moderately bullish on high yield and think spreads could potentially tighten 50–100 bps[3] more over the coming year. With the Federal Reserve's (Fed) support, US high-yield defaults have been lower than expected—8.5% as of September 30—and Moody's has lowered its peak default rate to 11.1% from 14.4% for March 2021. We expect a drawn-out default cycle with slightly elevated defaults relative to the long-term average of 4%. We prefer high yield to bank loans given the prospect of short-term yields staying at zero for several years.

We continue to view securitized assets as a way to express a positive view on residential housing, but remain cautious on commercial property, such as malls and offices, where we see enduring stress. Low mortgage rates, declining unemployment, and millennials' growing demand for housing are potential tailwinds for sectors such as workforce housing and credit-risk transfer.

Our view on EM debt has also improved to neutral. As with equities, we see a better developed-market backdrop supporting EM. We believe there are attractive opportunities in the higher-yielding local rates and currency markets in Latin America funded by the safer, lower-yielding Asian countries. We also continue to see opportunities in Central and Eastern European local debt.

Risks

We, like the markets, are optimistic that a safe, effective vaccine will be ready for distribution as early as the first quarter of 2021, so a disappointment on this front, or broad lockdowns as a result of the surge in cases, could derail the global recovery and reverse the rotation from growth to value that we expect.

As of this writing, some US election risk remains given Georgia's runoff Senate elections won't take place until January. Geopolitical risks have gone up as well, as Trump has taken a more aggressive foreign-policy stance recently.

About the authors

Nanette Abuhoff Jacobson consults with clients on strategic asset allocation issues and works with investment teams throughout the firm to develop relevant investment solutions across asset classes.

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[3] A basis point a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

Higher yields also present downside risk and not just for fixed-income investments. Extremely low yields and central-bank commitments to keep them that way for several years have supported risk assets[4] and justified lofty valuations, including in mega-cap technology names whose high future earnings are considered worth more today in light of lower discount rates. A spike in rates would likely damage markets broadly, particularly if the episode were accompanied by a sudden lack of liquidity.

We are watching closely for signs that the COVID-19 crisis inflicts lingering damage on the global economy. If worries about another surge restrain consumer spending and the savings rate grows, the expansion we expect could disappoint. Additionally, to the extent that changes made to adapt to the pandemic (e.g., remote work and education) become permanent, the impact in areas such as office space and business travel could reduce the likelihood of returning to pre-pandemic economic activity levels.

Given our moderately bullish stance, an upside risk is that the global recovery is stronger than we expect. In that case, asset classes even more levered to a recovery, such as natural resources and industrial metals, could be bigger beneficiaries.

[4] Risk assets (such as equities, commodities, high-yield bonds, real estate, and currencies) have a significant degree of price volatility.

Investment Implications

Looking beyond the election — The markets have moved past the US election and are now more focused on the path of COVID-19, the vaccine, and the global economy. We think an effective vaccine will be the catalyst for a cyclical recovery in 2021.

Leaning toward value in equities — With a better cycle, we prefer non-US equities and other value-oriented exposures such as cyclicals and smaller-cap equities. We prefer financials over energy given the slow recovery we expect in business travel and the structural headwind of the shift to renewables. We believe there are opportunities in companies with depressed valuations in cyclical sectors that have adapted to the pandemic and have seen improvement in medium-term fundamentals. In addition to financials, sectors we find attractive include REITS, materials, healthcare, aerospace/defense, and transport, which all have value-oriented characteristics.

Seeing some value in credit — Spreads have narrowed but are still around median levels. Given the Fed's unprecedented support for credit, we think spreads will continue to grind tighter. Structured credit is not the target of Fed credit programs, but the market offers exposure to the improving US residential housing market, a dynamic we think will persist through the recovery.

Diversifying with high-quality bonds — We think agency mortgage-backed securities and high-quality government bonds can potentially boost a portfolio's diversification and liquidity if the recession is deeper or longer than we expect. We think taxable investors should consider municipal bonds given attractive valuations.

Enhancing diversification with precious metals — Given rock-bottom fixed-income yields, we think precious metals can potentially play a role in boosting portfolio diversification and mitigating the effects of a stagflationary environment and geopolitical tensions.

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