Outlook 2021: Reflation, Rotation and Reopening to Re-shape Equity, Bond Markets

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Despite winter virus waves, an incipient pro-cyclical rotation is underway across asset classes and regions. Investors would be well-advised to remain sensibly diversified and balanced.

Reflation from massive policy stimulus will meet economic re-opening as COVID-19 vaccinations start to roll out in the months ahead across the developed world and various emerging markets. Recovery will be global, with world GDP slated to climb 5.2% in 2021 on consensus estimates after falling some 3.9% in the year of coronavirus.

The chief scientist of the U.S. government's Operation Warp Speed vaccine development program said ramping inoculations in the months ahead could mean 70% of Americans becoming immunized and herd immunity achieved by May. Promising COVID-19 vaccines in final trials and deployment plans in Europe aren't far behind, while China has already begun inoculations at home even though its leading pharma groups are still in phase III clinical trials in at least 13 countries, including Indonesia and Brazil.

Developed country monetary and fiscal authorities are doing their part to keep financial conditions extremely easy, even though fresh fiscal stimulus may be smaller and more targeted in the U.S. if Republicans retain control of the Senate in the January 5 runoff balloting. Still, with former Federal Reserve Chairwoman Janet Yellen tapped to become the next Treasury Secretary, there's plenty of scope for debt monetization via quantitative easing, given that Fed Chairman Jerome Powell, like Yellen, has vocally recommended more fiscal stimulus. They're not alone in this approach. In fact, Group of 10 central bank balance sheet assets grew nearly $8 trillion in 2020 to more than $25 trillion.

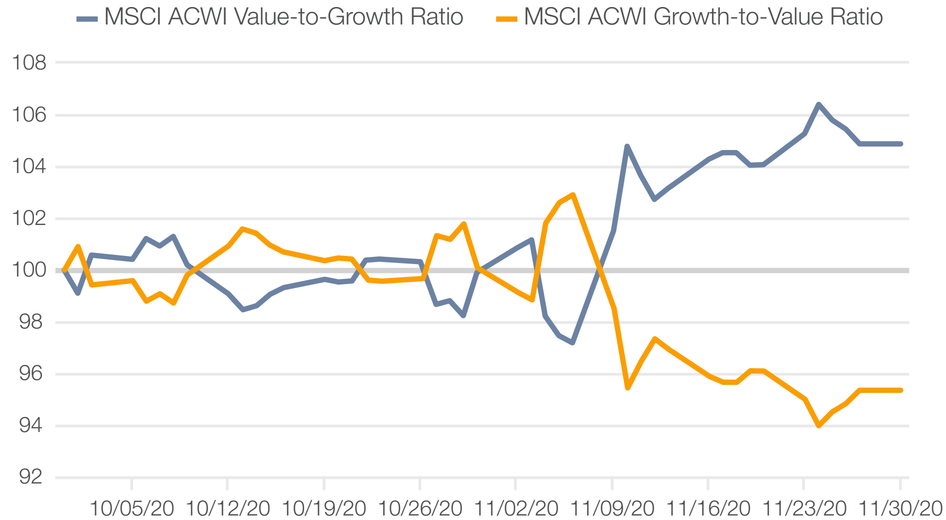
From 2020's "Hope Phase" to 2021's "Growth Phase"

The upshot is that, despite the latest infection waves and lockdowns in parts of Europe and the U.S., stock and bond markets and prices of hard assets such as commodities and real estate are booming in anticipation of the rebound in global trade, investment and spending. While valuation expansion fueled equity's "hope phase" recovery in 2020, earnings with easy comps should become the main driver in 2021's reopening "growth phase."

To be sure, stock valuations vary across sectors, regions and "style" factors. If U.S. large-cap tech stocks are pricey, plenty of upside exists for cyclical value stocks, which lagged for years. But equities generally remain attractive relative to bonds, which now play more as a store of value than yield. Sovereign yields are paltry in the U.S. and close to flat or negative in Europe, Japan and other industrialized countries. Corporate investment-grade bond yields are meager, and spreads compressed. Speculative-grade paper offers more yield and forecast 12-month default rates will likely ebb in 2021 from relatively elevated 2020 levels thanks to easy financial conditions, debt-laden "zombies" and historically low recovery rates suggest near-term risks are to the upside. That's due to intermittent lockdowns or consumers pulling back on their own amid any new virus outbreaks.

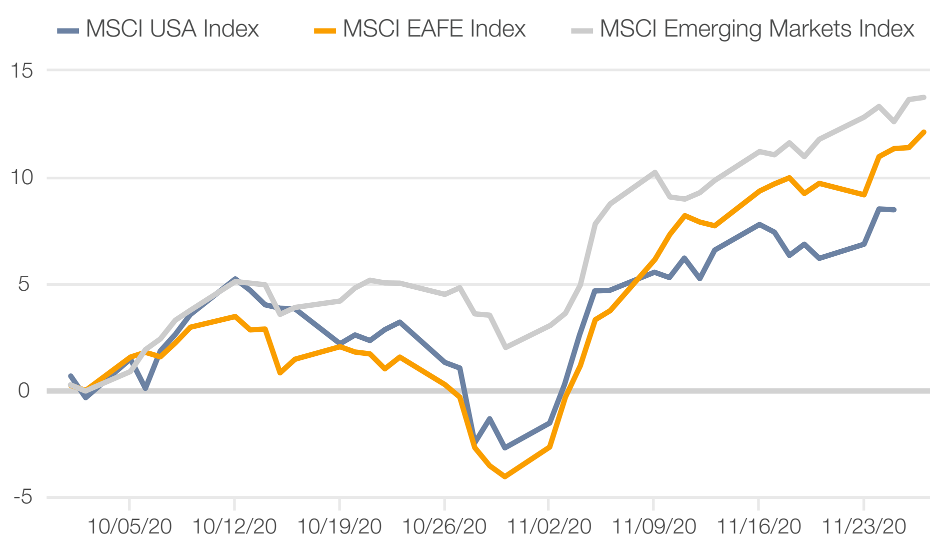
Still, pro-cyclical positioning is reflected in rotations toward previously unloved energy, industrial, material and financial sectors since the March 2020 bottom. It's also evident in the rebounds of

Global Value Takes Lead Over Growth (9/30/20–11/30/20)



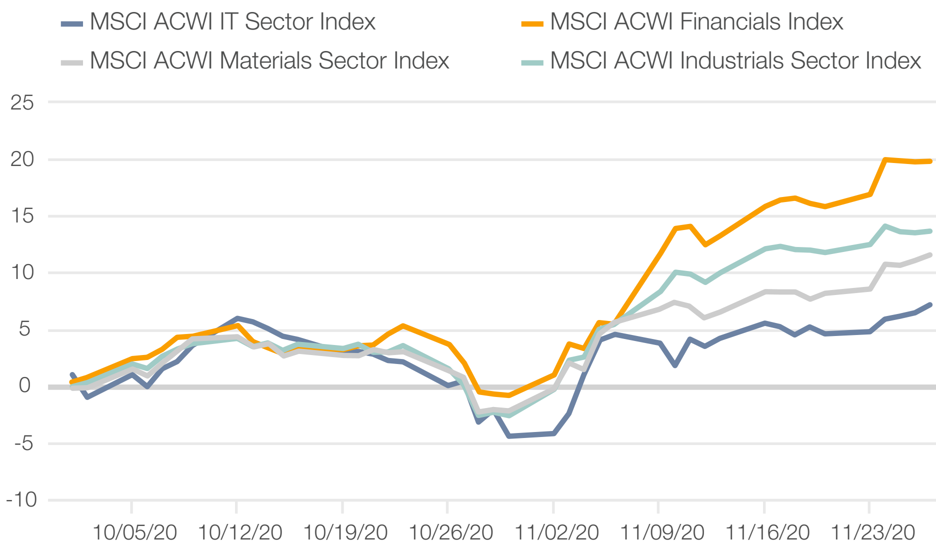
Source: Bloomberg

EM, International Stocks Lead U.S. Equities (9/30/20–11/27/20)



Source: Bloomberg

Sector Role Reversals (9/30/20–11/27/20)



Source: Bloomberg

small- and mid-capitalization stocks, as well as in shifting investors flows to "value" from "growth" and "blend" portfolios. It's reflected in regional outperformance, as well.

When Markets and Economic Dynamics Align

The reflation trade is also evident in surging commodities prices. Copper and aluminum are up around 50% since the March bottom, while Brent crude has skyrocketed 150%. That suggests a broad rebound in manufacturing and potentially infrastructure spending. Bank of America Merrill Lynch recently noted the breadth of increasing manufacturing Purchasing Managers' Indices, with 32 out of 41 countries, or 78%, signaling expansion above the 50-level threshold. "The improvement is reflected in analysts' earnings estimates as well—the global monthly earnings revisions ratio soared to 1.30 in November, with upgrades outnumbering downgrades in every region, most global sectors, and all global styles."

We often hear that "markets are not the economy," particularly when asset prices are rising as economic data deteriorate. There are times, though, when circumstances align and markets rise in anticipation of an improving economy, easy financial conditions and little inflationary pressure in the near term.

Developed economies are poised to accelerate some 3%, while emerging economies will sprint 5% in 2021, according to Bloomberg consensus estimates. After sinking roughly 3.6% in 2020, the U.S. economy is expected to advance 3.8% in 2021, while the European Union is seen growing 4.7% after contracting 7.7% in 2020. But China, which [accounts for one-third of global GDP growth](https://www.thornburg.com/insight-commentary/global-perspectives/are-emerging-market-equity-strategies-a-bet-on-china/),[1] is forecast to grow 8.2% in 2021 after sputtering 2% in 2020, helping emerging markets to expand 5% in 2021 after 0.8% decline the year before.

Inflation may not be a concern at the moment, given the virus' lingering deflationary impact. Global annual Consumer Price Index is seen climbing to 2.7% in 2021 and 2.8% in 2022. Not too hot, not too cold. But as we've pointed out, a temporary deflationary shock followed by [a highly reflationary policy response](https://www.thornburg.com/insight-commentary/global-perspectives/market-insights/how-covid-19s-deflation-shock-may-spawn-inflation-outbreak/),[2] supply chain disruption and increased protectionism present a real inflation risk. That's already reflected in a variety of inflation hedges, from galloping price rises in gold and bitcoin to, as noted, huge increases in the prices of base metals and sundry agricultural commodities. At around 1.56%, U.S. two-year inflation breakevens aren't alarming, though they're back above their pre-COVID-19 levels at the highest point since May 2019.

Beyond 2021, Back to the Future?

Equities can also, of course, provide a hedge against inflation, given their potential pricing power. And stocks should also be better able to absorb rising bond yields than fixed income. But valuations matter and trying to time turns in the economic and market cycles is often a perilous exercise. Portfolios without sufficient fixed income stabilizers are vulnerable to the next shock. Crowded equity allocations usually make for limited upside, and sharp downside risk when investors start scrambling for the exits.

"It is a market of stocks, not a stock market." As bottom-up, fundamental investors we adhere to that investing maxim, in selecting individual stocks and for that matter bonds, based both on their own merits and discrete contributions to our broader portfolios. Sensibly diversified, balanced strategies, we believe, allow for a focus on each investment thesis—its risk relative to its reward. We find this approach more effective than trying to time macro or market turns, inflation spikes and rate risks, or to join the conventional wisdom about what, in the long run, the virus has changed in consumer behavior, business investment or regulatory priorities.

1. "Are Emerging Market Equity Strategies a Bet on China?," https://www.thornburg.com/insight-commentary/global-perspectives/are-emerging-market-equity-strategies-a-bet-on-china/.

2. "How COVID-19's Deflation Shock May Spawn Inflation Outbreak," https://www.thornburg.com/insight-commentary/global-perspectives/market-insights/how-covid-19s-deflation-shock-may-spawn-inflation-outbreak/.

There are, of course, compelling structural themes, from digital payments to the build-out of 5G capable telecom networks to green energy. But it's crucial to examine the full capital stack, pick your shots at the best-positioned companies with strong business models, sound balance sheet dynamics and high-quality management. Such businesses proved resilient during the COVID-19 swoon in 2020 and should find themselves even better positioned for the growth to come in 2021.

Beyond the expected economic and market rebounds in the year ahead, though, after herd immunity has been reached and COVID-19 is just one of countless other coronaviruses that humanity has learned to live with, we'll still be grappling with all the accumulated debt from the policy response. Will that return us to a world of low growth, low inflation and low rates? Will growth stocks resume their upward march, value stocks decline, and fixed income become low- to no real-yield plays once again? We'll see.

Portfolios populated with attractively priced stocks and bonds that offer individually compelling business prospects should prove their worth, whatever the macro and market climates over time.

Important Information

Brent Crude Oil – A major trading classification of sweet light crude oil that serves as a benchmark price for purchases of oil worldwide.

Consumer Price Index (CPI) – Index that measures prices of a fixed basket of goods bought by a typical consumer, including food, transportation, shelter, utilities, clothing, medical care, entertainment and other items. The CPI, published by the Bureau of Labor Statistics in the Department of Labor, is based at 100 in 1982 and is released monthly. It is widely used as a cost-of-living benchmark to adjust Social Security payments and other payment schedules, union contracts and tax brackets. Also known as the cost-of-living index.

Gross Domestic Product (GDP) – A country's income minus foreign investments: the total value of all goods and services produced within a country in a year, minus net income from investments in other countries.

Quantitative Easing (QE) – An unconventional monetary policy in which a central bank purchases financial assets from the market in order to lower interest rates and increase the money supply.

Sovereign Bond Yield – The rate of interest at which a national government can borrow.

Yield Spread – The difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another.

PMI (Purchasing Managers' Index) – An indicator of the economic health of the manufacturing sector and for the economy as a whole. The PMI Index is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment. A PMI of 50 or higher generally indicates that the industry is expanding.

The MSCI ACWI Growth Index captures large and mid cap securities exhibiting overall growth style characteristics across 23 Developed Markets (DM) countries and 26 Emerging Markets (EM) countries. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

The MSCI ACWI Financials Index captures large- and mid-cap representation across 23 developed markets and 24 emerging markets countries. All securities in the index are classified in the Financials as per the Global Industry Classification Standard (GICS®).

The MSCI ACWI Industrials Index includes large and mid cap securities across 23 Developed Markets (DM) and 26 Emerging Markets (EM) countries*. All securities in the index are classified in the Industrials sector as perthe Global Industry Classification Standard (GICS®).

The MSCI ACWI Information Technology Index includes large and mid cap securities across 23 Developed Markets (DM) countries and 26 Emerging Markets (EM) countries. All securities in the index are classified in the Information Technology as per the Global Industry Classification Standard (GICS®).

The MSCI ACWI Materials Index includes large and mid cap securities across 23 Developed Markets (DM) and 26 Emerging Markets (EM) countries*. All securities in the index are classified in the Materials sector as per the Global Industry Classification Standard(GICS®).

The MSCI ACWI Value Index captures large and mid cap securities exhibiting overall value style characteristics across 23 Developed Markets countries and 26 Emerging Markets (EM) countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

The MSCI EAFE (Europe, Australasia, Far East) Net Total Return USD Index is an unmanaged index. It is a generally accepted benchmark for major overseas markets. Index weightings represent the relative capitalizations of the major overseas developed markets on a U.S. dollar adjusted basis. The index is calculated with net dividends reinvested in U.S. dollars.

The MSCI Emerging Markets Net Total Return USD Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 24 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the U.S. market.

Portfolio construction will have significant differences from that of a benchmark index in terms of security holdings, industry weightings, asset allocations and number of positions held, all of which may contribute to performance, characteristics and volatility differences. Investors may not make direct investments into any index.

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