Outlook 2021

The Restoration Economy

19 December 2020

Summary

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Key Highlights

An extraordinary year

Asset returns this year haven’t followed the usual playbook. Despite the worst recession since the Great Depression, risk assets such as global equities have made annual gains.

At a broad level, cross-asset class behaviour looks more consistent with a recession. Gold and government bonds have been big winners, outperforming global equities. Meanwhile, other commodities and pro-cyclical parts of the equity market, such as Europe or emerging markets ex-Asia, have underperformed.

The pace of the market cycle has been remarkable. First, we had the fastest bear market on record, with global equities losing a third of their value in one month as the global pandemic and lockdown hit. Then we had the fastest recovery ever when equities regained their previous highs in less than six months, driven by bold policy support and improving macro trends. And, after a three-month range-bound hiatus, we saw a third round of fast markets in November following the US presidential election result and encouraging news on the Covid-19 vaccine.

Trends in investment markets

The letter ‘K’ was added to the alphabet of financial commentary, denoting a divergence in trends.

The most talked about ‘K’ is the strong performance of risk assets versus the stop-start economic recovery. This led many economists to suggest there was a bubble in markets. We think that view is mistaken. Markets always lead the economy in the recovery phase. A big market driver since March has been the collapse of global interest rates, which are used to discount future cash-flows. If the crisis hasn’t structurally reduced future cash-flows, lower discount rates can, in fact, inflate market values.

Another important ‘K’ has been the divergence between digital economy stocks and cyclical sectors. The former is up more than 40 per cent, the latter down ten per cent. Lockdown accelerated the shift toward remote working and helped tech profits. Lower interest rates have also boosted longer-duration equities.

A third ‘K’ has been in emerging markets where ‘fortress’ Asia has significantly outperformed. A better-managed health crisis, equity market exposure to tech and quality, as well as stronger macro-economic resilience to the recession have been key factors.

HSBC
Global Asset
Management

Expected returns for 2021

An important consequence of market performance in 2020 is expected returns are now lower for longer.

Today, we measure a prospective total return on global equities of 4.9 per cent. That's before inflation, and compares with 6.2 per cent at the start of the 2020 and 7.2 per cent at March's market lows.

We have lower interest rates today, plus central bankers' promise to pursue lower for even-longer rates. Meanwhile, the fast rally in market prices since March, combined with the difficult environment for fundamentals, has caused market-implied risk premia to drop.

There are selected pockets of attractive valuation but whether investors can realise those expected returns in 2021 will hinge on how the macroeconomic and policy environment develops.

visibility of stable and durable liquidity, we view the short-medium section of the G-sec curve to perform well. As such we intend to maintain a neutral to overweight duration stance versus the index in near term.

The restoration economy

The speed of the global rebound through the third quarter of 2020 surprised most economists. But the global recovery is now flattening-out. We are in the 'restoration economy' phase. But the precise cadence of recovery depends on where we are in the world, on the vaccine, and on policy support.

In the US, more economic momentum, greater policy activism, a willingness to live with the virus, plus being first in line for the vaccine should help sustain a relative growth advantage. Meanwhile, Europe faces some significant near-term challenge: a second wave of the virus and economic contraction in the fourth quarter.

Asian societies have generally been more successful in containing the virus, with China and North Asia outperforming India and Asean. There is more cyclical upside in 2021 but, as elsewhere, growth momentum is set to moderate. The arrival of the vaccine and easing of restrictions on cross-border travel should enable a catch-up story to play-out across Asia, buttressed by low rates, with Asean and Hong Kong benefitting the most.

Policy uncertainty is also receding. Ultimately, systematically-important central banks are likely to carry the burden of responsibility for macro stabilisation, reinforcing the current regime of lower for even-longer rates.

Do not short the recovery

A year of continued economic recovery should support profits, and we expect credit defaults to peak in the first quarter of 2021 too. That means that within portfolios, it is too risky to be selling or underweight the 'restoration economy'.

An overweight position in equities makes sense. But regional allocation will need to adapt through the year to reflect new developments and evolving macro trends. More stimulus or a faster vaccine will favour the laggard markets from 2020 (Europe, Latin America, Asean) whereas the quality winners of 2020 (North Asia, US) are set to remain relative havens.

The case for substituting some listed equity for a private equity allocation is also strong, where returns are tilted to high-beta, small-cap and value factors, which should do well as recovery progresses. We also think there are some good outright valuation opportunities in Asian and emerging market credits, which help balance the portfolio from being too pro-risk.

However, it is much harder to be confident allocating to global government bonds. While US treasuries and index-linked bonds remain our preferred areas, the reality is that investors need to look for new sources of diversification. These can be found in liquid alternatives such as commodities or trend-following strategies. Within illiquid alternatives, new diversifiers include securitised and private debt, or multi-strategy hedge funds.

In the world of lower-for-longer expected returns, embedding alternative allocations into our portfolios needs to become mainstream.

Source: HSBC Global Asset Management, Data as at Dec ’20 unless otherwise given.

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