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Investor Strategy

2021 Outlook – to a less eventful year

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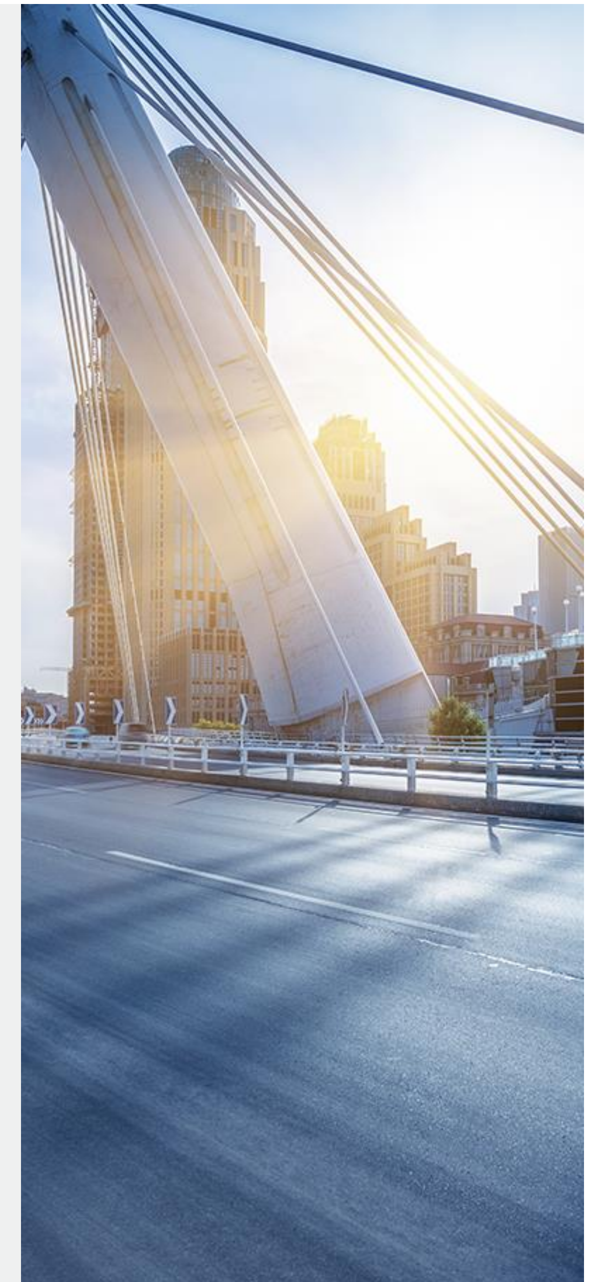


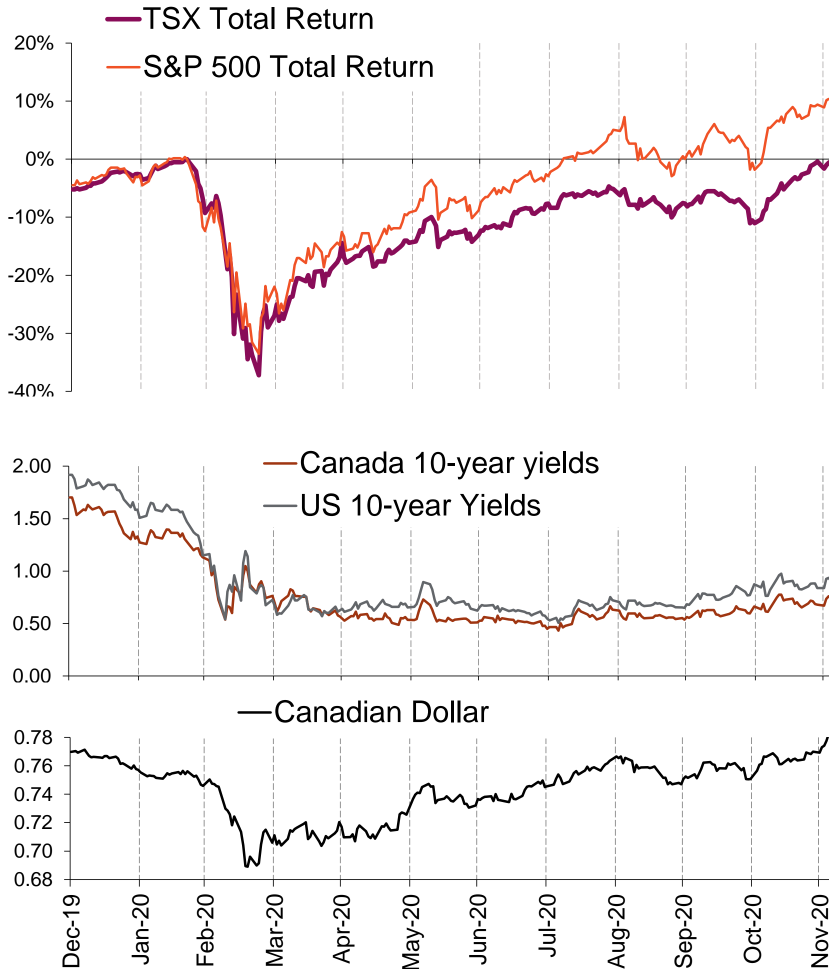
Executive Summary

- **Part 1: Market recap – It was the worst of times, it was the best of times**
  - A look back at one of the most volatile years, not just for the markets but for humanity
  - Pandemic induced global recession triggered the fastest bear which has now been replaced by the fastest recovery
- **Part 2: 2021 – what will drive markets next year?**
  - Light at the end of the pandemic – The path of the pandemic, lockdowns and vaccine will likely be the driving force for markets in 2021
  - But for now, it is up to government / monetary stimulus
  - China – this does look familiar
- **Part 3: Asset allocation – Dividends back in vogue**
  - After a tough 2020, dividend investing is poised to perform well in 2021
- **Part 4: Equities – International & Emerging Markets**
  - Earnings, style rotation, economic recovery and the dollar all favor international equities and emerging markets.
- **Part 6: Evolution of the 60/40 – Bonds aren't dead yet**
  - Given low yields and muted defensive characteristics, many investors are rethinking their bond allocations
  - Rethinking the '40' to incorporate different strategies to find income or defensive characteristics is well underway
  - But the death of bonds has been greatly exaggerated

Market Recap – It was the worst of times

Alexander Tjiang

Chart 1: A pandemic-shaped market



- At the start of the new decade, markets were fraught with uncertainty: global economic growth looked poised to slow, forecast corporate earnings expectations were mixed, valuations were at all-time highs, and central bank accommodation had pushed credit spreads to cycle lows. Add the uncertainty of an upcoming U.S. presidential election, correction risk was elevated with the big question being what would trigger it. **As it turned out, investors wouldn't have to wait long to find out: the COVID-19 pandemic served as the tail risk that changed everything!**
- The World Health Organization (WHO) officially declared the COVID-19 outbreak as a pandemic on March 11, but panic had already settled in weeks before that. Governments across the globe began shutting down their economies to create social distancing and combat this unknown pandemic. The result of these actions was a self-induced global recession that at its beginning phases sparked dramatic amounts of volatility in just about every asset class.
- Beginning in the last week of February, global equity markets were thrown into disarray at an unprecedented velocity, with the S&P 500 drawing down -33.9% in a mere 23 days and the VIX spiking to a high of 82.7 on March 16. The TSX fared worse, falling -37.4% over the same time span. At the same time, bond liquidity abruptly dried up and became the central issue in fixed income trading amid a flood of sellers and dealers' balance sheets being filled to their limits. This resulted in many bond ETFs widely disconnecting from their stated NAVs and corporate spreads ballooning to a 10-year high of 433 basis points (bps)
- While this was happening, the U.S. dollar whipsawed as investors struggled to decide if it was a safe-haven asset. Gold prices, though having fallen -12.5% in mid-March, began a rally to +US$2,000/oz. that wouldn't stop for another 6 months. Elsewhere, the precipitous decline in global energy consumption induced a surplus expansion and price free falls in the crude market that, due to the lack of physical storage capacity at the time, even caused many barrels of oil to trade in negative territory in April.
- It didn't take long for central banks to intervene. Beginning in March, the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC) vaccinated capital markets with steep interest rate cuts and balance sheet expansion programs that provided the necessary liquidity to support the system. By the end of the month, the U.S. Fed funds rate and the BoC's overnight lending were 2 bps and 25 bps, respectively. Governments simultaneously deployed unprecedented quantities of fiscal policy support to backstop the damage that social isolation would wreak on their economies.
- The combination and magnitude of these fiscal and monetary policy measures laid the foundation for a resumption in risk-on activity that turned markets upside-down almost as quickly as they had declined. What followed the carnage was a sharp reversal in perception and behaviour: global equity markets marched decidedly higher and fixed income markets closed their losses, **all while the global economy was in a very real recession**.

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Market Recap – It was the best of times

Alexander Tjiang

Chart 2: 2020 All multiple expansion; No earnings growth

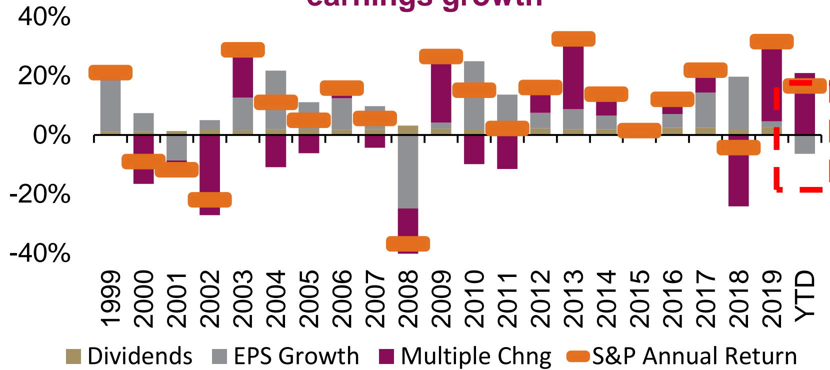


Chart 3: Credit spreads still at last cycle's lows

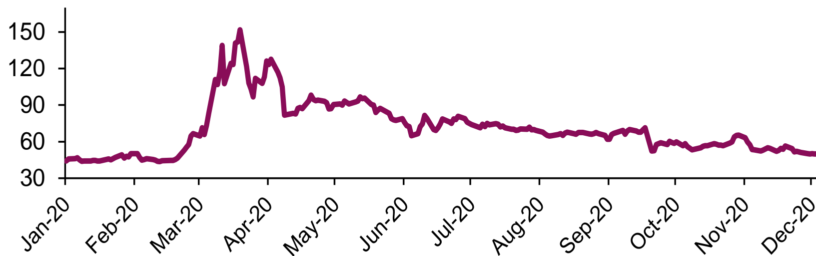


Chart 4: A frothy set-up for 2021

	1-Jan	Today	Δ	Historical
S&P 500 P/E Ratio	21.2x	29.0x	+37%	
TSX P/E Ratio	17.3x	26.8x	+55%	
10Y U.S. Yields	1.9%	1.0%	-50%	
10Y CA Yields	1.7%	0.8%	-53%	
IG Spreads	45 bps	50 bps	+10%	
World GDP Forecast	3.1%	-3.9%	-226%	

- Global equity markets have recovered their first-quarter losses and are trading up for the year, driven in large part by a heavy shift into risk-on sentiment post-March, central bank support, and most recently the resolution of the U.S. presidential election and higher visibility of a vaccine introduction. Year-to-date (YTD) the S&P 500 was up +16.5% and the MSCI World Index, as measured in Canadian Dollars, was up +9.6%. The TSX lagged but still managed to post a respectable +5.8% gain for the year.
- For most of 2020, return attributions were largely concentrated in growth stocks, mainly within the technology and health care sectors. However, November is proving to be potentially a pivotal month, as the deflationary forces of the pandemic started exhibiting signs of fading and the pendulum swung in favour of more value-oriented names (more on this ahead). Still, it goes without saying that we are currently operating in an earnings-starved market. YTD, just about all the S&P 500 returns were attributable to multiple expansion (**Chart 2**).
- This year was also a record-breaking year for IPOs, with a strong rebound in capital formation activity during the back half of the year certainly aiding in keeping sentiment bullish. YTD, U.S. primary listings via traditional IPO listings and special-purpose acquisition companies, or SPACs, have totalled ~US$128B, with SPACs representing ~48% of these issuances. Approximately US$203B was raised through secondary issuances, half of which was raised in the months of May and June alone as companies shored up cash on their books.
- Bond yields are even lower than a year ago today, with real rates having moved into negative territory. The combination of **1)** the Fed's shift in policy to average its inflation targeting, which implies lower rates are here to stay for longer; **2)** reflationary expectations; and **3)** continued liquidity support via bond purchasing programs and curve control will likely continue to support prices and put pressure on yields, though the road ahead remains unclear.
- Meanwhile, excluding the blowout in March, credit spreads have gradually returned to where they started the year at ~50 bps (**Chart 3**). This means that, after a year, the market is *still* rewarding investors for taking on the risk by less than half a percent a year. It seems like investors are still just as willing to pick up nickels ahead of a potential steamroller. This year's uncertain economic backdrop proved a boon for gold, amid haven-purchasing and inflation-hedging; YTD, ETF holdings of gold have increased +28.9%. The dollar, meanwhile, continues to hit fresh 2-year lows amid strong equity market performance; YTD, the DXY index is down -5.9%.
- The set up for 2021 appears challenging (**Chart 4**). Equity valuations are inflated, yields remain compressed, and both earnings and economic growth forecasts lay in uncertain waters. Still, government stimulus and monetary policy appear supportive, though this year's heavy reliance on these measures may prove to be a unique risk heading into the new year. **Today, the importance of flexible asset allocation has never been greater**. Many are beginning to see the light at the end of the tunnel; but if there's anything that this year has taught many, it's that those lights may very well be the headlights of an oncoming train.

2021: What will drive markets next year?

Craig Basinger

Chart 5: 3rd wave is big and widespread

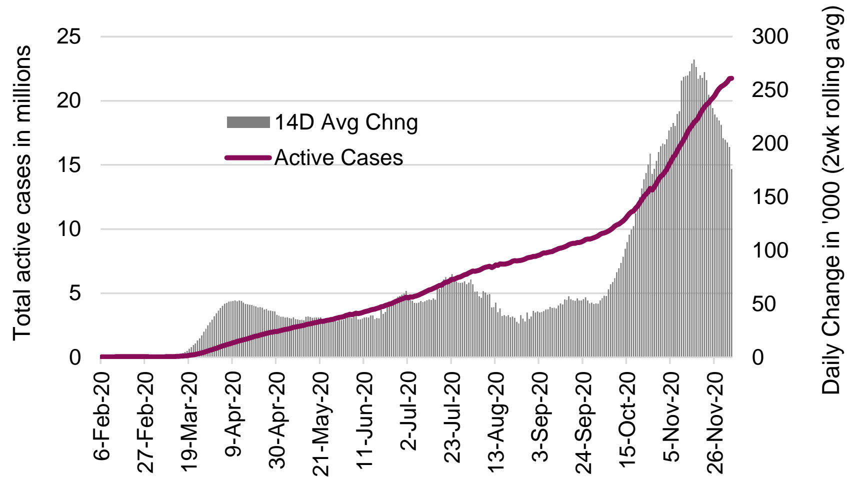
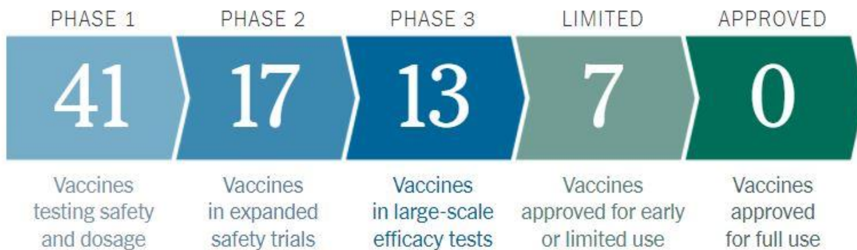


Chart 6: NY Times vaccine tracker



We believe there are going to be three key macro drivers of the markets and economy in 2021. The biggest is the path of the pandemic/vaccine, followed by the pace and trajectory of government stimulus, and China.

1. **Light at the end of the pandemic – The path of the pandemic, lockdowns and vaccine will likely be the driving force for markets in 2021**
   - The COVID-19 global pandemic has taken a turn for the worse in the late months of 2020, resulting in a wave of infections materially bigger than any previous months (**Chart 5**). This wave is widespread, not just focused on a few countries or states as with previous waves, putting tremendous strain on health care infrastructure. This is triggering pockets of increased lockdowns, slowing the re-opening process but not derailing.
   - There is good news though, treatments, better protocols and knowledge of which population cohorts are most at risk of the virus have improved materially over the past months. This has helped reduce the mortality rate and educated most that it is our social proximity to others that puts all of us at risk. As citizens we have a job to do: stay apart to avoid becoming a strain on the health care system and wait for a vaccine.
   - The vaccine news, especially in the final months of 2020, has been very encouraging (**Chart 6**). There are 13 vaccines in final testing and 7 that have been approved for limited use. The efficacy, success rate, has been much higher than most forecasts. Of course, the logistics of deployment will be challenging, but if Amazon can deliver laundry detergent to your door in a couple of hours, we are confident the logistics will be handled.
   - **The trajectory of new cases and vaccine rollout will largely dictate the speed at which the hardest-hit industries, such as travel & leisure, will recover.** As these industries recover, employment will improve as will consumer and business sentiment, aggregate demand and capital spending. This could easily set the stage for a stronger recovery than consensus. There is a lot of pent-up demand to do things and spend savings.
   - This won't be a straight line and there are likely to be advances and stalls along the way. As we move towards the "new normal" of vaccines, rapid testing, quicker tracing, the rest of the economy will likely quickly come back to life. These are service industries mainly, and they can be turned back on very quickly. As this happens, many of the mega trends over the past nine months will, at the very least, partially revert closer to normal.

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2021: What will drive markets next year?

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Chart 7: Central banks are expanding balance sheets very quickly

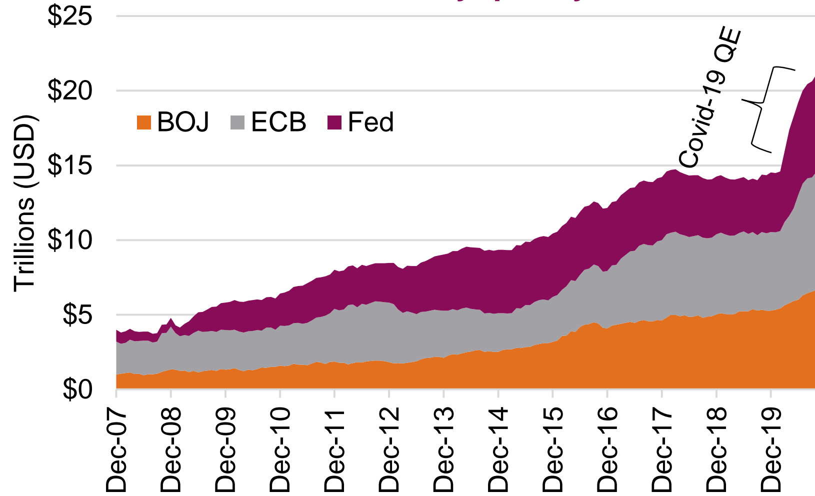
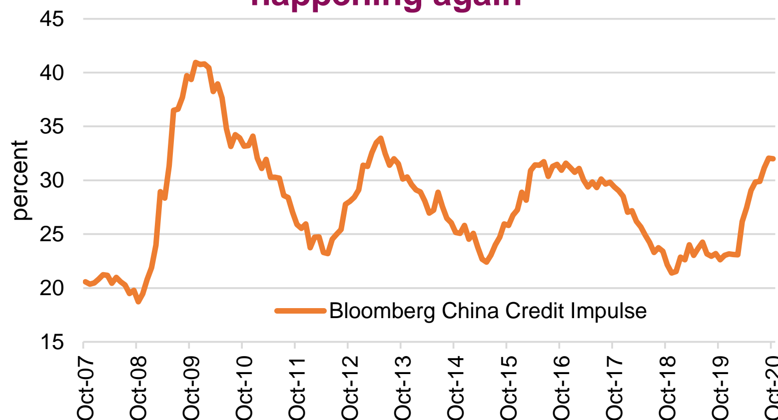


Chart 8: China credit has come to global economies aid before....it may be happening again



2. But for now, it is up to government / monetary stimulus

- While the vaccine news is positive and the market is partially looking past today towards tomorrow, the economy (people and businesses) still need the support from government stimulus to bridge the gap. Given portions of the economy are unable to operate, support is needed to reduce the long-term economic damage.
- Stimulus will likely remain in place and robust for longer, based on the indications from both central banks and most governments. This does have longer-term implications but for now it appears to be the best path through this. It is worth noting that most developed nations now have debt-to-GDP levels over 100%. In fact, over 50% of all government bonds are owned by the Bank of Japan; for the U.S., the number is 30% owned by the Fed.
- **There is risk of a taper tantrum in 2021.** The markets are now very sensitive to changes in liquidity and removal of liquidity, even if driven by improving economic fundamentals, may result in a repeat of the 2013 taper tantrum. It was a few years ago, so for those who don't recall, bond yields rose about 100bps which weighed on not just the bond market but equities as well. The world and this rally has become hooked on liquidity – reducing or even slowing it will likely have sizable consequences.

3. China – this does look familiar

- Trade tensions between the U.S. and China (and others for that matter), were a central theme over the past few years. This isn't going away but under the Biden administration, we are likely to see a less impulsive approach which will be welcomed by capital markets. One thing markets dislike the most is sudden change.
- Even more encouraging is that China appears to be turning on more credit (**Chart 8**). This is a familiar playbook. Coming out of the 2008 financial crisis, China increased credit growth which stimulated demand domestically and globally. If the same approach is being used today, this would be a positive for global economic growth and commodities.

Asset Allocation – Dividends back in vogue

Craig Basinger

Chart 9: this year has not been kind to dividend payers in the TSX

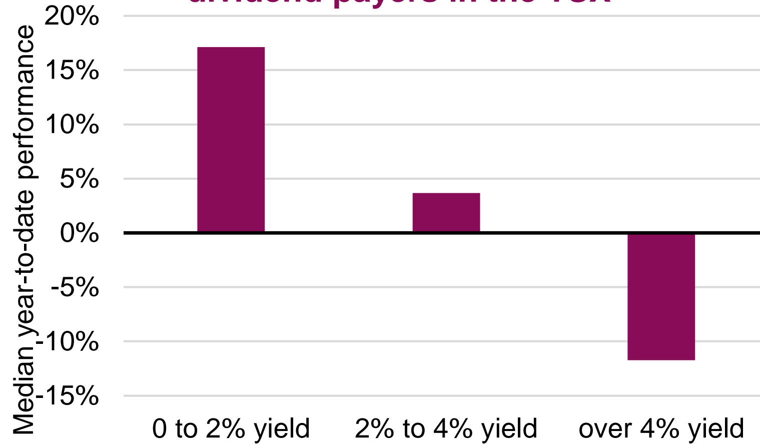


Chart 10: Massive growth premium valuation relative to value (S&P Growth & Value indices)

Dividends back in vogue

- 2020 was not kind to dividend investors, in case you hadn't noticed (**Chart 9**). Sectors that enjoy a higher proportion of companies that pay dividends happen to align with those sectors hardest hit by the behavioural changes caused by the pandemic. Financials, real estate, energy, communication services are atop the list.
- However, if 2021 progresses as we outlined earlier with the light at the end of the pandemic becoming increasingly brighter, government stimulus remaining supportive and China helping boost global aggregate demand, value & dividend investment strategies are very well positioned.
- The deflationary forces of the pandemic and recession have already started to fade, which could accelerate as the end of the pandemic becomes a clearer path. An improving economy, with still very accommodative policies, would likely kick inflation expectations higher. These are all much more positive for value/dividend companies compared to growth companies.
- Valuations in the dividend/value space are attractive, either by historical standards or versus many other cash flow strategies. U.S. high-yield bonds, aka junk, are yielding around 5%, Canadian investment-grade bonds yield about 2.8%. Compare this to the Canadian dividend space with a yield of 4.2%, most of which enjoys preferential tax treatment. Among U.S. equities, as measured by the relative price-to-earnings multiple of the S&P 500 Growth versus S&P 500 Value indices, Growth is trading at a HUGE premium. (**Chart 10**)
- November 2020 may have just been the start of the pendulum swinging back from growth to value. Growth companies have been outperforming for much of the past decade, which accelerated due to the pandemic. If this rotation back to value is on, it could run for some time even before just getting back to neutral. This would be very beneficial for dividend strategies which tend to hold more value names than growth. And it would also be more positive for Canadian and International equities over the U.S. market.

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Equities – International and emerging markets

Derek Benedet

Chart 11: U.S. Market is much less economically sensitive

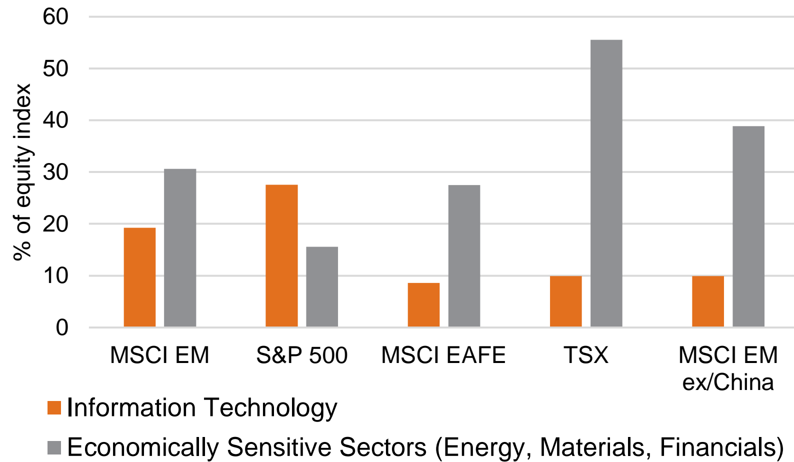
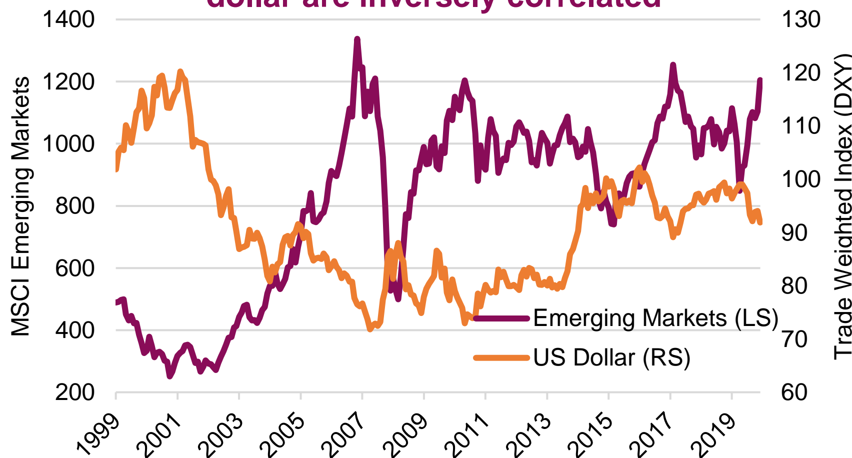


Chart 12: Emerging Markets and the U.S. dollar are inversely correlated



- The market's resilience to the ongoing recession and pandemic is nothing short of remarkable. Led by U.S. tech names and aided by unparalleled fiscal stimulus and liquidity by central banks, the markets continue to look past the pandemic. The latest part of the rally following the U.S. election and very encouraging vaccine news is the symbolic cherry on top. Being a great investor requires both an encyclopedic knowledge of the past as well as unique ability to see what's coming and gauge turning points. Rarely do we see the same market leadership during times of duress continue well past the recovery. Looking ahead, we reiterate our call for an international overweight and adding emerging markets (EM).
- Workable vaccines on the horizon are a key criteria for economic growth to continue to rebound into next year. This should benefit all economies, but especially those markets that are more closely aligned with economically sensitive sectors. **Chart 11** delineates the combined sector exposure of the Energy, Materials and Financials sectors for various markets. Note that the U.S. has the least amount of economically sensitive exposure when compared to Canada, EM as well as the EAFE index. These markets are also value tilted compared to U.S markets, which lean more growth. Regionally both the Eurozone and EM have lagged the U.S. this year mainly due to the lack of big tech exposure. We believe that international and EM show promise to outperform going forward for several reasons.
- The crux of the rationale lies in the massive valuation-adjusted gap between the Eurozone, EM and U.S. markets. Europe is currently trading at a greater than typical 15% discount to the U.S. Adjusted for sector weights, the valuation gap widens further. With U.S. markets at all-time highs, investors looking for attractively valued companies will increasingly have to start scouring the globe for opportunities. International markets have a clear value tilt and should continue to benefit from the ongoing style switch into value from momentum. The valuation gap has been present for several years, and there needs to be a catalyst to trigger the convergence and reversion to the mean. There are several potential catalysts at play, but the key one is the U.S. dollar.
- A strong U.S. dollar is a major constraint for EM stocks. As **Chart 12** exhibits, EM stocks and the dollar share a strong inverse relationship. The U.S. dollar has been in a strong uptrend since 2013. Just as it appeared the dollar would top-out, it got a massive safety bid as markets tumbled in March and the pandemic stoked fears. That bid has dried up, to the benefit of other currencies. From a purchasing power parity (PPP) perspective, many currencies including the Euro, C$ and most EM remain significantly undervalued and are bordering on an extreme discount. With the safety bid gone, and the rate differential advantage enjoyed by the dollar mostly irrelevant with global bonds all close to zero, further U.S. dollar weakness should provide a leg up on the global stock recovery. Past dollar decline cycles have shared a common trait: a re-acceleration of global growth which tends to pull capital away from the U.S.

Equities – International and emerging markets

Derek Benedet

Chart 13: IMF Forecasted Gross domestic product

	2020	2021	2022	2023	2024	2025
Advanced economies	-4%	8%	5%	4%	4%	4%
Major advanced economies (G7)	-4%	7%	5%	4%	4%	4%
EM and developing economies	-5%	9%	8%	8%	7%	7%
Emerging and developing Asia	1%	10%	8%	8%	8%	8%
Emerging and developing Europe	-10%	8%	7%	7%	6%	6%
Latin America and the Caribbean	-19%	6%	7%	6%	6%	5%

Chart 14: Earnings recovery has more room to run for international and EM equities

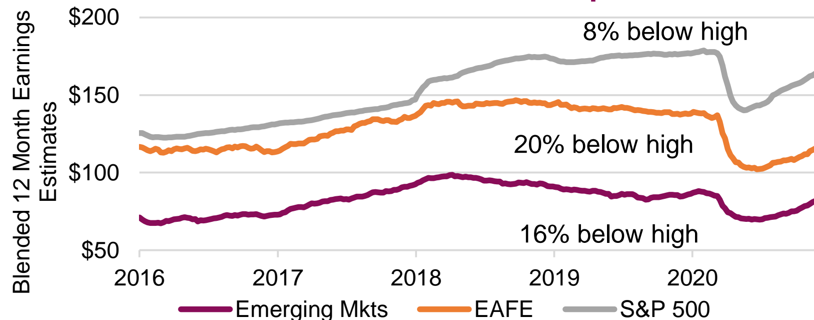
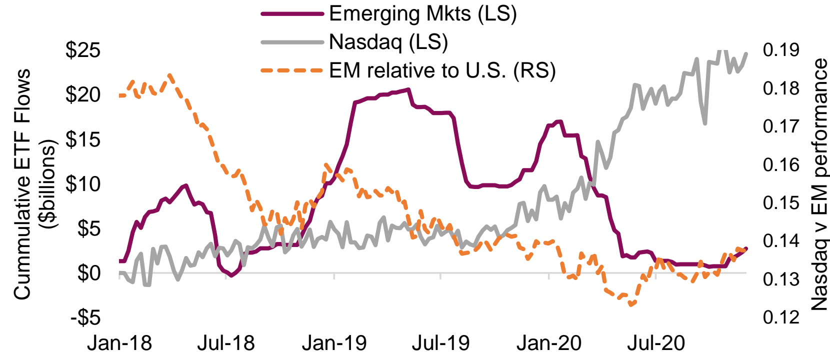


Chart 15: A tale of two flows



- The trade war is more of a skirmish now. With Joe Biden soon to be in the White House, the anti-China rhetoric should die down. While tariffs will stay in place while the policy is reassessed, we see little chance of any escalation from this point. This is good news for China, periphery economies as well as global trade in general. While still early to say for sure, the calls about the death of globalization have been greatly exaggerated. International markets and especially emerging markets are big beneficiaries to global growth and rising global Purchasing Manager's Indexes (PMI). **Chart 13** outlines GDP growth expectations by the IMF for the next 5 years. Many markets already have a leg up on the recovery with China and a few other Asian countries are already on their way to solid economic growth next year. The earnings outlook for emerging markets continues to look bright, with forward 12-month estimates for the MSCI Emerging Markets Index undergoing the most sustained earnings forecast uptrend since February 2018. While all markets are seeing a similar rebound in earnings growth expectations, emerging markets (EM) remain the furthest below their peak **(Chart 14).**
- We're not going out on a limb and we'll be the first to admit that the overweight international and EM call seems to be a popular theme among other investment houses based on their published outlooks. While sentiment has certainly improved, and the trade is gaining investor interest, there is still plenty of running room, based on ETF fund flows of the three largest EM ETFs as **Chart 15** shows. Despite relative EM outperformance to the S&P 500 in recent months, fund flows have a lot of room to make up to get back to 2019 levels. In contrast, inflows into the Invesco QQQ Trust ETF (NASDAQ 100) have been substantial but do appear to be topping out. Investors love to chase performance, but this usually comes with a delay. The recent outperformance of EM has not yet resulted in outsize inflows, though that trend is changing. In recent weeks we've seen above-average inflows for EM equities, which is good news as fund flows play an important role in deciding winning asset classes. Interestingly, one outlier in terms of asset gathering has been the EM ETF with an environmental, social and corporate governance (ESG) angle. Renewed fund flows should drive asset prices higher. There is also an argument to say that asset classes that are less liquid are also more susceptible to fund flow.
- Emerging markets are cyclical with many heavily exposed to commodities. The bullish outlook for the region is closely tied to the reflationary trade and does require a positive outlook on commodities. As global growth recovers, aided by a dovish U.S. dollar outlook, we continue to believe that commodity-exposed countries (including Canada) will be well positioned in 2021. Stocks and other risky assets outside the U.S. are now looking more attractive, bolstered by cheaper valuations, and improving economics potential for a weaker U.S. dollar.

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The evolution of the 60 / 40 – Bonds aren't dead yet!

Chris Kerlow & Joey Mack

Chart 16: Bonds are not as strong a diversification tool as they have been in years past

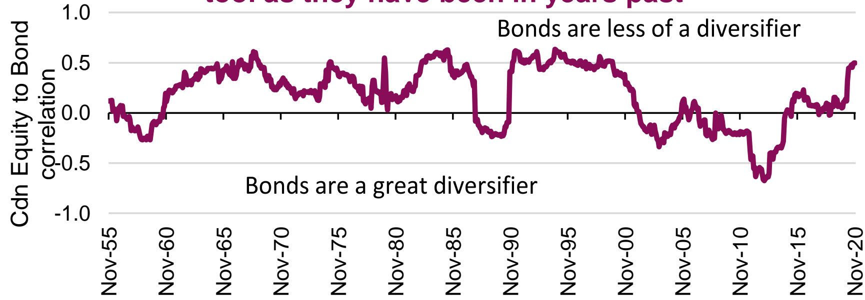


Chart 17: Bonds just aren't as defensive as they used to be

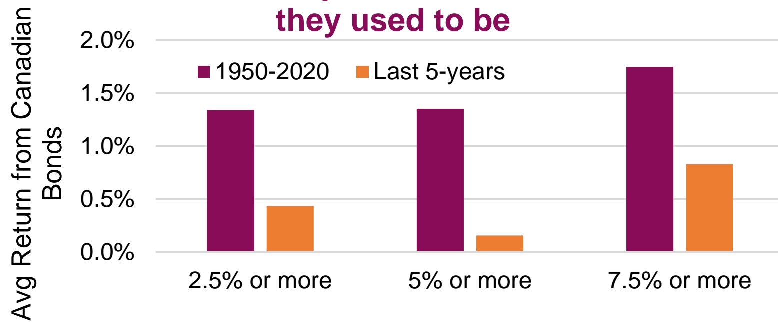
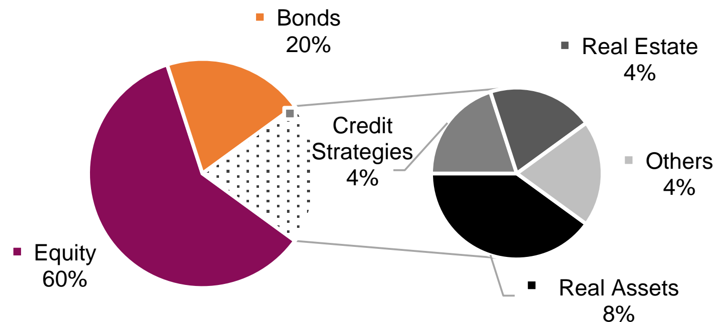


Chart 18: Expanding the 40



- A recurring theme over the past decade in the financial press, by investment product managers and many strategists has been the death of fixed income or the 60/40 portfolio (60% equity and 40% bonds). This chorus has grown even louder of late with such taglines as "rethinking the 40", referring to the 40% bonds in the 60/40.
- But once again this straightforward approach to asset allocation delivered in 2020. If the 60 was split evenly over Canadian, U.S. and international equities, as of the end of November you would have been up 7.3% thanks to positive equity markets and falling bond yields.
- Therein lies the rub; the success of the 60/40 in 2020 was driven by bond yields moving to historical lows which then implies lower future returns from bonds. Success today is a headwind for tomorrow. Nominal yields touched new lows and at the same time, real interest rates, which exclude inflation, moved into negative territory, and remain there today.
- This has brought into question the value of holding fixed income in your portfolio, especially to the extent of 40% as is the case in the traditional 60/40 equity/bond split, given the prospects for poor returns from bonds in the years ahead.
- We are of the opinion that we have likely seen the low in yields for this economic downturn and the likely path forward in the years ahead are somewhat higher yields. If rates move higher over the coming years, holding 40% of your portfolio statically in bonds does not seem like the best idea.
- But the role of your bond holdings in a portfolio is less about return and more about providing some income and stability. In today's low-yield world, investors seeking to generate income need to sacrifice stability by adding more credit exposure. Or they need to sacrifice yield for defensive characteristics via government bonds.
- It does get a bit worse though. With yields so low, the defensive characteristics of bonds are not what they used to be. The correlation between bonds and equities is now strongly positive **(Chart 16)**. And the average gain in bonds during periods of market weakness during the past few years is a fraction of what it used to be **(Chart 17).**
- Beyond traditional long bond allocations, available strategies have expanded greatly over the years offering innovative solutions for investors to utilize that can provide a buffer against downturns and/or generate income.
- Moving part of that 40 into different sources of diversification or income-generation strategies can help recreate what bonds used to be. These can include real assets such as gold, credit strategies, real estate and others (**Chart 18**), which can move the efficient frontier meaningfully higher; potentially adding returns and reducing risk.

Fixed Income – Rethinking part of the 40

Chris Kerlow & Joey Mack

Chart 19: Canadian Government Bonds - $Trillions traded on CanDeal

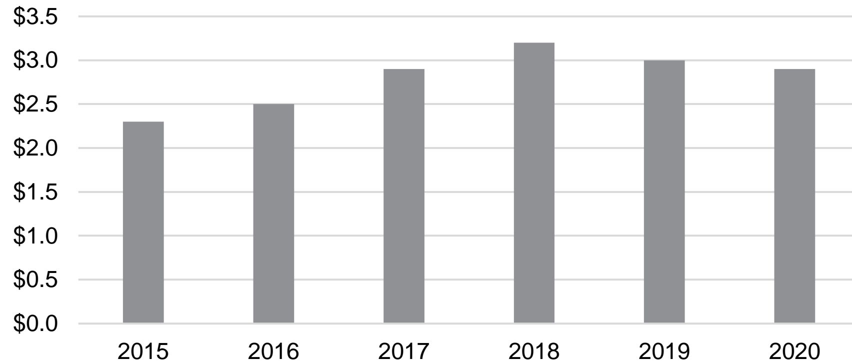
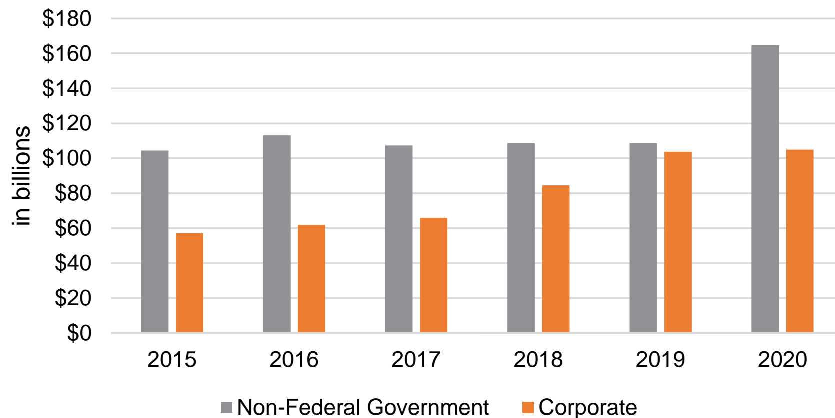


Chart 20: Debt Issuance In Canada



- However, alternatives are also not the silver bullet – they are complicated, often have high minimums and less liquidity than stocks, bonds and ETFs. Mixing the wrong ones together can cause more portfolio volatility and reduce returns.
- This also does not mean there is no place for good old-fashioned bonds. Rates can fall further and can even make new low record yields in the future. For example, German 10-year yields fell as low as -0.64% in December. There is no lower bound, and capital gains are still possible drivers of bond returns in the future.
- The evolution of “the 40” is already well underway. In fact, we have already seen a significant downturn in individual investor activity in fixed income securities. Notably, security purchases, excluding funds and ETFs, are down over 20% in comparison to five years ago
- Although client activity in actual fixed income security transactions is down substantially, this is partly explained by the broad trend of increased interest in ETFs and alternative investments (which include a significant amount of fixed income securities). At the same time, we have seen a record amount of new issuance and trade activity in 2020, as highlighted in the charts (**Chart 19 & 20**), which reflect persistent investor demand for fixed income.
- Bonds still are an important part of a portfolio. Although bonds do sometimes move lower in line with equities, as noticed in March of this year, they are still a strong diversification tool that provides secure cashflow. These are important attributes for investors drawing on their investment funds or controlling for risk.
- For fixed income as an asset class, to quote Mark Twain: “This report of my death was an exaggeration.”
- Fixed income remains a vital component to any strategic asset allocation. But given today’s yield environment, rethinking some of “the 40” towards alternative sources of either income, diversification or stability appears prudent.

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Source: Charts are sourced to Bloomberg L.P. and Richardson Wealth unless otherwise noted.

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