Kempen Outlook 2021
Macro and Markets

When writing an outlook, it's always tempting to say there's a great deal of uncertainty. After all, the future is always uncertain. But where we normally still have a grip on relationships between economic variables such as growth, inflation, interest rates or valuations, now we've got the coronavirus to contend with on top of all that.

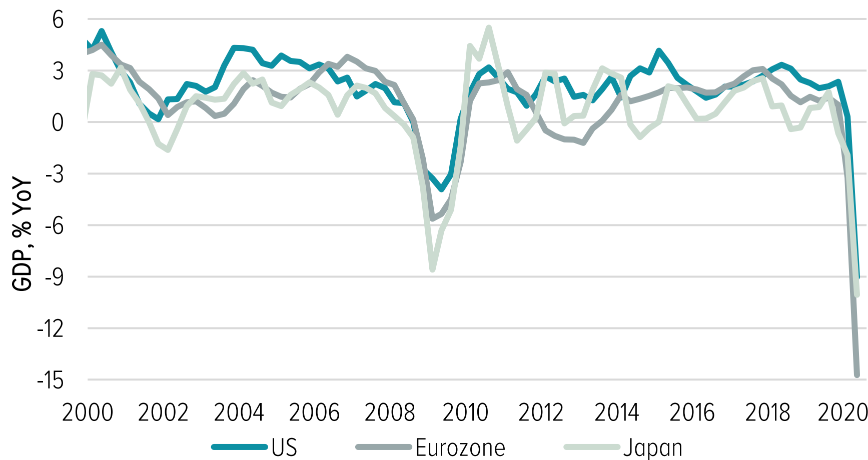
Our initial response to the coronavirus was to make relatively light of it, in the hope that its impact would remain confined to Asia, as was the case with SARS in 2002. Yet we're now facing a worldwide pandemic that has the global economy in a stranglehold. It's encouraging that the numbers of hospital admissions and patient fatalities are rising much less rapidly in the second wave than during the first. But while the prospect of a vaccine is over the horizon, we don't know when it will be made widely available.

How the coronavirus pandemic evolves will have a major impact on economic and market trends over the coming year, which in turn means a high level of uncertainty for investors.

AN EXCEPTIONAL CRISIS

The coronavirus recession is deeper than any other post-war recession. Major western economies have suffered badly, with the US and Dutch economies contracting by 10% in the first half of 2020, the German economy by 11.5%, and the French, Italian and Spanish economies by around 20%. And we thought contractions of up to 7% during the 2008-09 financial crisis were severe! The economic impact was much smaller in Japan, South Korea and Taiwan because these countries were quicker to get the virus under control, but countries in south-east Asia and South America were hit hard.

GRAPH 1: GDP GROWTH



The speed of the economic trends we've seen during the coronavirus crisis has also been remarkable. The lockdowns caused consumer spending, investment and international trade to plummet simultaneously, which is partly why the contraction has been so severe.

In terms of the outlook, however, what matters most is that the crisis was not caused by imbalances in the economic system, such as high inflation, excessive levels of corporate investment or borrowing, or bubbles in real estate or other financial markets. Consequently, once lockdowns are eased, the economy should be in a position to bounce back quickly.

And this is exactly what happened in the summer, when we saw unprecedented growth in the retail, services and industrial sectors. Which impacted the order backlog of companies and international trade. We believe that many economies have now recovered to 90–95% of their pre-pandemic levels. But even though the initial recovery was rapid, there's still a long way to go.

And the pace of the recovery will slow down due to the second wave of the virus. We'll probably move from what could have been a V-shaped recovery to something that looks more like a square root sign or, if things go really badly, a W-shaped recovery. This is because the rapid growth triggered by the easing of lockdowns and mass monetary and fiscal financing has passed its peak. While positive momentum continues to support the recovery, potential second-round effects such as corporate insolvencies and redundancies are likely to temper global growth.

We're working on the assumption that governments will only impose local or sector-specific lockdowns. Growth will flatten and it's likely to take until the end of 2021 for the global economy to recover fully from the coronavirus crisis. A vaccine will help next year, but it will take time to achieve sufficient levels of production, distribution and inoculation for it to take effect. What's more, we don't know how effective a vaccine will be and whether people will accept it.

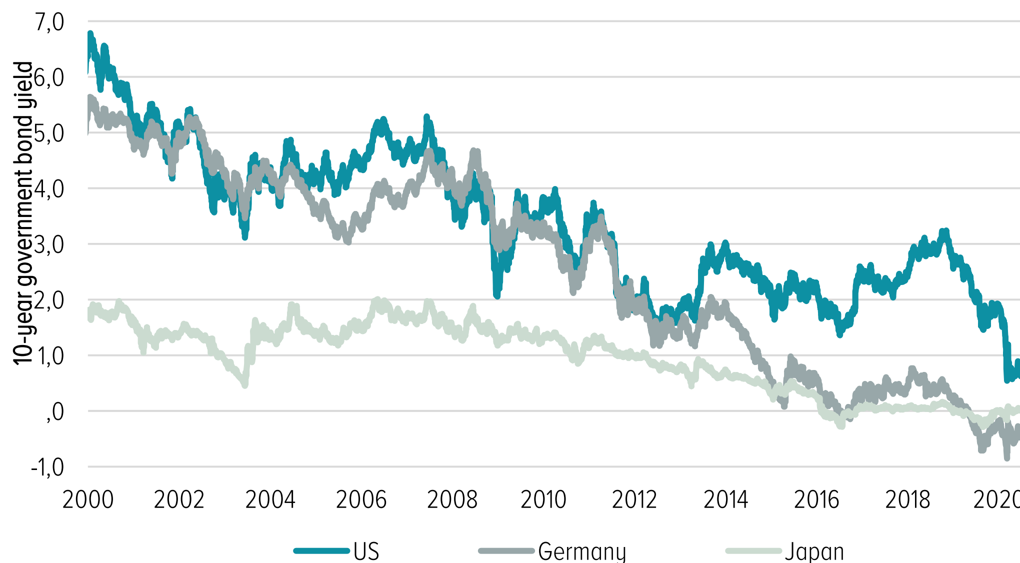
LOW INTEREST RATES

We can be fairly certain that money market rates will remain low next year. The Federal Reserve in the US recently announced that not only will it tolerate higher inflation, it will in fact actively aim to generate it. It is no longer targeting 2% inflation, but an *average* of 2% over time. In other words, the Fed now aims to compensate for periods of inflation below 2% by allowing inflation to move above this level afterwards. The Fed's job market target, which now includes specific analysis of groups that traditionally have more difficulty finding a job, also implies more expansionary monetary policy. The vast majority of Fed policymakers don't expect any interest rate hikes before the end of 2023.

European Central Bank (ECB) policymakers are traditionally warier of inflation or imbalances caused by expansionary monetary policies. Yet there are few valid arguments for raising interest rates at present: the eurozone economy is simply too weak and inflation is way below the ECB's target of 2%.

Things get more interesting when we look at quantitative easing. These government- and corporate-bond buying programmes are designed to keep capital market yields low. Given the high – and rapidly rising – levels of debt across the world, we believe that central banks in the US, the eurozone, Japan and the UK will continue these programmes in 2021. The Fed may well reduce its pace now that the acute stress caused by the pandemic has passed, but the ECB could easily shift up a gear towards the end of 2020.

GRAPH 2: TEN-YEAR GOVERNMENT BOND YIELDS



RISKS

An effective vaccine against coronavirus that can be made widely available quickly would of course be great news for the global economy, but we don't expect this in the short term. For now, there are concerns about the intensity of the second wave.

But there are other risks to consider away from coronavirus. The Brexit negotiations, for example, seem to have reached deadlock, and that makes a hard Brexit more likely. Meanwhile, if Democratic candidate Joe Biden wins the US election, he may adopt a more cooperative approach to the trade and technology war between the US and China, but surveys show that most people in the US are in favour of taking a hard line against China.

We believe that what investors want most of all at present is a clear outcome in the US presidential elections. If Trump wins, we know what to expect: deregulation, low taxation combined with enormous government deficits, and geopolitical turbulence. Yet according to the current polls, there's little chance of Trump winning. That also seemed to be the case four years ago, but Joe Biden's lead is bigger and more consistent than Hillary Clinton's was back then. What's more, Biden is doing well in most of the all-important swing states. What are the implications of who wins for the markets? Initially a Democrat victory might be bad news for the equity markets as there would be more regulation and higher taxation. Yet the Democrats also have much bigger plans for government spending. And that's what the market is focusing on at the moment.

Another risk is that governments choose, or are forced, to scale back fiscal stimuli too soon. In Europe, countries such as the Netherlands, Germany and France have already extended their support packages, which means there's a lower risk of the support stopping before the economy has recovered sufficiently. Low interest rates are a welcome bonus in these countries. In the US, Republicans and Democrats simply cannot agree on a new package of support measures at a time that the increment to unemployment benefits has ceased (it ended in July). Luckily, many families have put a sizeable portion of the additional income they received aside and new jobs are again being created, but a reduction in government support too soon would certainly hamper any recovery.

THE INVESTMENT CLIMATE IN 2021

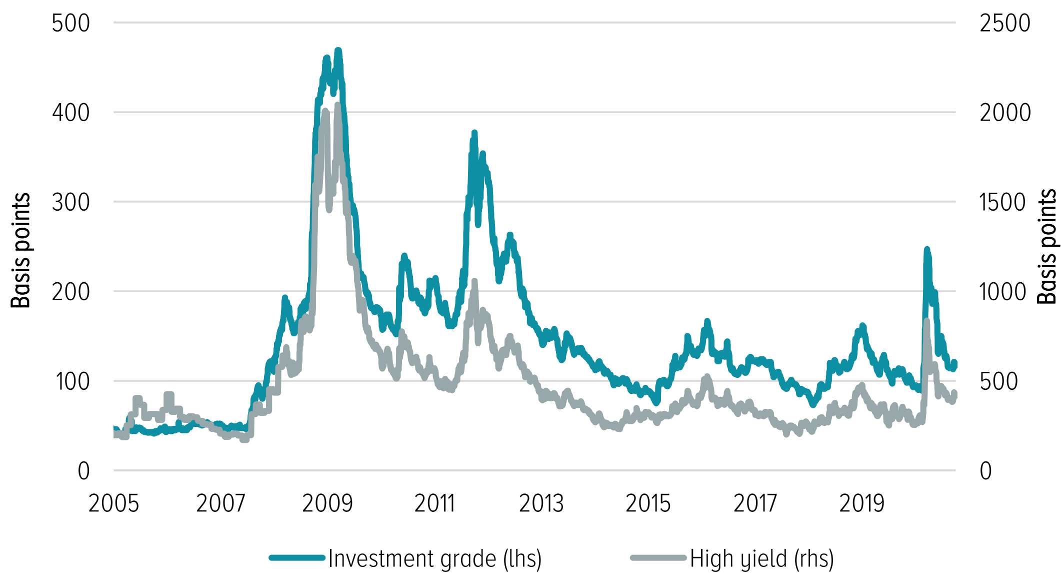
For investors looking for certainty, little return is expected in 2021. Interest rates are low and in many cases even negative, and we don't expect inflation to pick up next year. Even though there may be less downward pressure on inflation than we've seen over the last few years due to a reduction in globalisation and a greater focus on labour, there is still too much overcapacity in the global economy for inflation to rise meaningfully for the time being.

Neither do we expect interest rates to rise rapidly in 2021, and this means sovereign bond holders shouldn't be faced with large-scale losses. That said, government bond investors are faced with an asymmetrical risk: there's a bigger chance of interest rates rising than falling even lower than they are now. This also applies, albeit to a lesser extent, to investment-grade corporate bonds. Here, spreads could tighten marginally if uncertainty falls over the course of the year. This tightening of spreads is also possible for high-yield corporate bonds, where the expected yield is somewhat higher but so is it's risk profile. Although the yield is slightly lower in Europe than in the US, European investors aren't exposed to exchange rate risk when they allocate to European high yield.Moreover, the credit quality is higher in Europe with lower expected default rates.

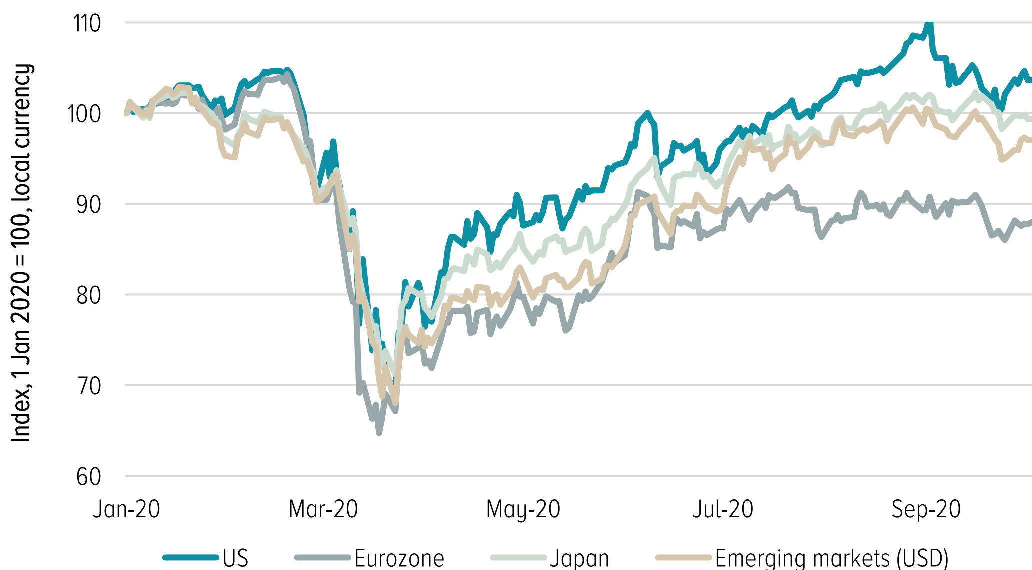
That said, expansionary monetary policy and low interest rates are helping to shore up corporate bonds in general. Companies can easily raise capital via the bond markets, where there is plenty of demand among

investors. What's more, companies have become more sensitive to the needs of their bondholders. They won't allow their balance sheets to deteriorate too far as they don't want downgrades by credit rating agencies. Moreover, dividends have generally been slashed and share redemption programmes scaled back or halted.

GRAPH 3: EUROPEAN CREDIT SPREADS



GRAPH 4: 2020 EQUITY RETURNS (IN LOCAL CURRENCY)



We remain cautious about equities. Stock markets around the world have rallied considerably since they slumped in March. Growth equities have done particularly well, with the US leading the way and Europe lagging in its wake.

Equities now look rather expensive in absolute terms, with US equities again heading the rankings. Compared with other asset classes, though, equities appear reasonably priced. It is of course possible that cyclical stocks and value equities will catch up if the economic recovery continues and yields rise slightly. This would be particularly beneficial for emerging market and European equities. But for the time being, it is too risky to start preparing for such a development, partly due to the second wave of coronavirus currently affecting Europe.

Earnings growth is a vital factor to consider when forming an outlook for equities. Although earnings took a severe hit earlier this year, equity investors quickly started to look forward to a recovery. In the very short term, it's positive for equities that earnings forecasts are now being adjusted upwards, but for 2021 as a whole we're sceptical that earnings will more or less get back to their former levels before the economy has fully recovered.

The shift in leadership to Europe and emerging markets we referred to above could receive a boost if the Democrats win the US presidential election. After all, this should create calmer conditions on the geopolitical front, while US corporate taxes would be raised, which would be likely to have an adverse effect on US equities.

In summary, we believe that inflation and interest rates will remain low and that there are opportunities to be found in corporate bonds, while we remain cautious about equities in the short term.

Disclaimer

The views expressed in this document may be subject to change at any given time, without prior notice. Kempen Capital Management N.V. (KCM) has no obligation to update the contents of this document. As asset manager KCM may have investments, generally for the benefit of third parties, in financial instruments mentioned in this document and it may at any time decide to execute buy or sell transactions in these financial instruments.

The information in this document is solely for your information. This article does not contain investment advice, no investment recommendation, no research, or an invitation to buy or sell any financial instruments, and should not be interpreted as such. This document is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such.

The views expressed herein are our current views as of the date appearing on this document. This document has been produced independently of the company and the views contained herein are entirely those of KCM.

KCM is licensed as a manager of various UCITS and AIFs and to provide investment services and is subject to supervision by the Netherlands Authority for the Financial Markets.