WILSONS

The Global Investment Landscape in 2021

Asset allocation weekly.

21 December 2020

Issued by Wilsons Advisory and Stockbroking Limited (Wilsons) ABN 68 010 529 665 - Australian Financial Services Licence No 238375, a participant of ASX Group and should be read in conjunction with the disclosures and disclaimer in this report.

Global Economy to Bounce Back Strongly in 2021

Buoyed by the global roll-out of multiple COVID-19 vaccines, we think the pace of global GDP growth in 2021 will be close to the fastest in 50 years. Of course, this comes after 2020 saw one of the deepest (albeit short) contractions on record, but it will be a remarkable recovery nonetheless with the global share market revival poised to extend through 2021.

While 2021 will start on a soft global growth footing, risks are biased toward upside economic surprises later in the year. Assuming a successful vaccine roll-out, we anticipate a sustained relaxation of restrictions in many advanced economies in 2Q21, triggering a strong acceleration in growth by mid-year that will extend through 2H21.

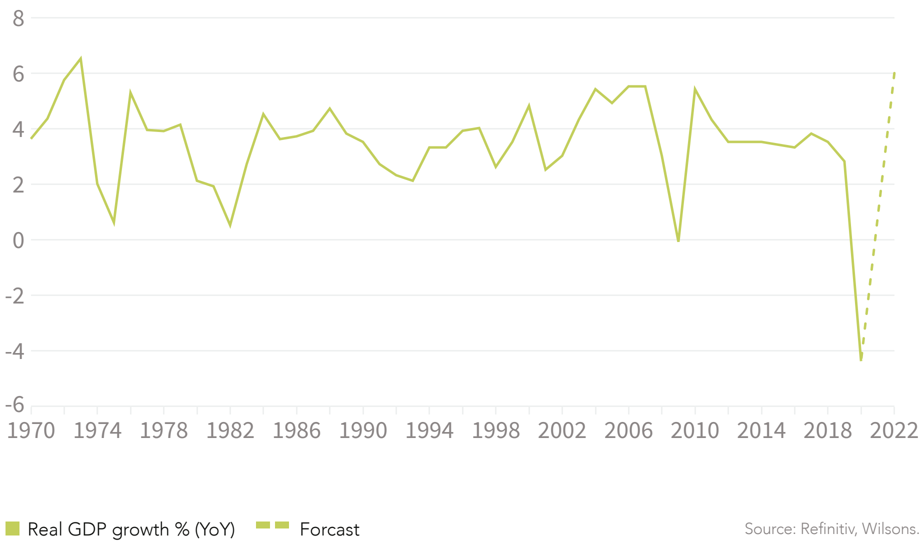
It may take a few months to crystallise; however, the ultimate market narrative in 2021 is likely to be one of synchronised global growth.

Exhibit 2 shows the US household savings rate remains unusually high due to the combination of large government transfer payments at a time of virus-enforced spending restraint. The pattern is similar across many economies, including Australia. This creates the potential for a large release of pent-up consumer demand next year which implies that global growth is well-positioned for a significant acceleration once the virus is contained.

Read our Australian Market Outlook: A View into 2021

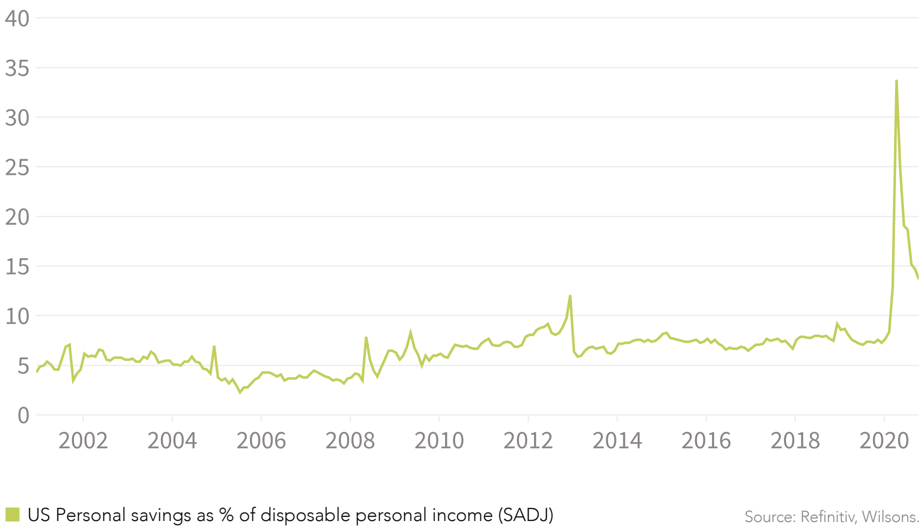
With interest rates so low and plenty of spare capacity in the global economy, a strong growth rebound provides a supportive backdrop for growth assets.

Exhibit 1: We believe global GDP growth could approach 50-year highs in 2021



Source: Refinitiv, Wilsons.

Exhibit 2: A high US savings rate suggests plenty of pent-up consumer demand for 2021



Source: Refinitiv, Wilsons.

Weighing up Cyclical and Structural Shifts in Demand

While headline growth will be strong as the vaccine roll-out helps economic activity normalise, leadership will likely shift relative to 2020. Activities that were hit hard by the pandemic will recover strongly, although in some cases they may not return to their pre-COVID-19 levels for a long time, if at all.

For example, in retail, consumers should return to brick-and-mortar stores and do less shopping online than in 2020. Yet the legacy of COVID-19 will be for structurally less foot traffic in malls and more spending with online retailers – a trend which will likely be repeated across a range of sectors.

As the equity rotation from COVID-19 winners to COVID-19 losers progresses, the looming challenge for 2021 will be to assess where the "new normal" sits for each industry. For now, a strong economic recovery is the dominant theme to take into 2021.

Earnings Recovery to Drive Equities Higher in 2021

We see further upside for global and local equities in 2021. November's rally has left absolute price-to-earnings (PE) valuations and (bullish) sentiment stretched, which suggests the market could be vulnerable to some consolidation in the near-term. However, a robust global earnings recovery is likely to drive solid returns over the next 12 months.

We continue to tilt toward sectors and markets with the greatest scope to experience an earnings rebound alongside the progressive global growth recovery we envisage in 2021. While the recovery trade has recently outperformed sharply following the positive vaccine news-flow, they are generally still big underperformers on longer time horizons that look cheap on normalised earnings.

For 2021 we prefer non-US developed market equities (including Australia) alongside emerging markets (EM), which have more cyclical exposure and hence recovery potential. We are underweight the US relative to other regions but remain positive towards the US on an absolute basis. We expect US tech to lag the value/recovery sectors in 2021, though it may surprise with its ability to keep up with benchmarks in 2021 given the underlying structural strength of the tech earnings cycle. Low growth defensives are likely to be the big laggards.

The significant recovery in equity prices since late March has been mostly a result of multiple expansion, with valuations boosted by the massive policy response to the pandemic, the anticipation of a significant recovery in earnings and lower bond yields. As we move into 2021, for equities to continue moving higher, earnings recovery now needs to be delivered.

Promising signs are already emerging in respect of positive consensus earnings per share (EPS) revisions. Next year will see a genuine earnings growth revival progressively take hold.

We see global GDP rebounding by 5-6% in 2021 and this is likely to translate into very strong double-digit earnings growth for the listed sector. Profit margins will expand rapidly as revenue growth revives and operating leverage kicks in, enhanced by cost reduction initiatives taken in 2020.

Consensus estimates are calling for a c22% rebound in S&P 500 operating EPS in 2021. This is likely to prove too conservative, and earnings growth is likely to be higher in other regions where we also see risks to the upside versus consensus.

The stock market leads earnings fundamentals, so the first stage of a new bull market is defined by rising prices and weak earnings. The result is rising PE multiples as experienced over the past 6-9 months. In the second stage of a bull market, earnings growth typically accelerates but price gains are moderate, leading to multiple compression. A degree of multiple compression is our central case for 2021 against a backdrop of very strong earnings growth. This suggests low double-digit total returns as a central case. Very low interest rates could moderate the degree of multiple compression over the coming year leading to the (upside) risk of outsized returns in 2021.

Exhibit 3: Global earnings estimates for 2021 are starting to be upgraded

MSCI AC World - 12MTH FWD 3MTH % CH

Source: Refinitiv, Wilsons.

Exhibit 4: Estimates for 2021 at more than 10% below pre-COVID-19 levels may prove too low

MSCI AC World - 12MTH FWD WTD EPS

Source: Refinitiv, Wilsons.

Global Recovery Bodes Well for China and EM Growth

China's economic comeback is in a more advanced phase than any other nation which has helped emerging market performance over the last 6 months or so. China's strong credit pulse may begin to ease as we progress through 2021 as the government focuses back on its structural reform agenda. While China policy tightening will be watched next year, it is unlikely to be dramatic, and the benefits of a broadening global recovery bode well for a strong year for China growth as well as a solid growth recovery across the EM complex.

Global Bond Yields Higher but Still a Low Rate World

Government bond yields may stay range-bound in the near-term as the market grapples with rising COVID-19 case counts in the US and Europe and the impact of renewed lockdowns. However, we expect that a cyclical bond bear market will begin in 2021.This reinforces the importance of a well-rounded fixed income portfolio that includes fixed interest alternatives to enhance downside protection and provide additional sources of return.

Read: Fixed Interest in a World of Ultra-Low Rates.

Clearer signs of economic recovery will eventually put upward pressure on longer-dated bond yields in 2021, although central banks will try to limit their rise by keeping policy very accommodative. Improving economies, recovering profits, and refinanced debt should help support credit outperformance in 2021 as spreads continue to compress. We prefer investment-grade credit, high yield credit and hybrids over government bonds.

As economic activity normalises in the US, inflation may surpass 2% by mid-year in large part due to depressed base effects from the fall in prices in 2Q20. This will test the Fed's commitment to its new flexible average inflation targeting framework. We expect monetary officials to look past the temporary rise in inflation and maintain policy rates pegged at the effective lower bound. Continued sizable asset purchases with an eye to keep long-term rates under control are likely. We expect the 10-year Treasury yield to rise by ~50bps to ~1.5% by year-end 2021. Such a move is unlikely to derail equity markets as equity valuations will remain relatively attractive, and earnings recovery will buoy sentiment toward stocks.

While our central case is for a moderate rise in bond yields, the risk case is likely to be skewed toward a larger move of c100bps. Equities can likely still cope with this if it occurs over the course of 2021. A quicker or even larger move in yields could prove more problematic for stocks, but this is more likely to be an issue later in the cycle in our view.

Exhibit 5: We expect valuation multiples to edge lower as the recovery unfolds

Source: Refinitiv, Wilsons.

Exhibit 6: We expect bond yields to rise at least 50bp in 2021 but remain low in a historical context

Source: Refinitiv, Wilsons.

US$ Dollar Weakness to Extend

The US$ still has downside potential in 2021 and remains expensive in a global context. In addition, the US' relatively large twin deficits and the tendency for the US$ to underperform in a global upswing all point to the potential for further weakness.

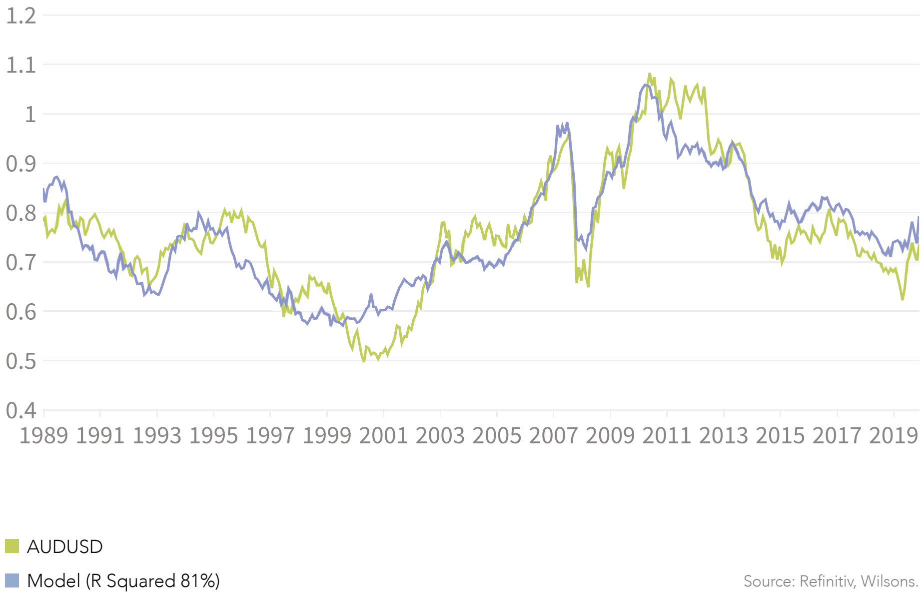
The A$ has its own positive supports in the form of strengthening commodity prices and a relatively advanced economic recovery. Our current fair value estimate for the A$ (based on commodity prices and interest rate differentials) is around 79c, which suggests retaining at least partial hedging on international holdings for now.

Potential Risks to Watch

Central to our constructive global economic and investment view for 2021 is the assumption that the global vaccine roll-out program progresses well with good levels of coverage achieved by mid-2021. Problems with the vaccine program in terms of unforeseen side effects, lower than expected effectiveness, or disappointing take-up rates are not our central case but are a key risk to our strong recovery view.

We also expect bond yields to move up moderately against a backdrop of strengthening growth but contained inflation. A surprisingly sharp rise in bond yields could pose problems for the equity market in 2021 though our central case is that this is more a risk for later in the cycle.

Exhibit 7: The A$ remains moderately below our fair value estimate



Source: Refinitiv, Wilsons.

A variety of geopolitical risks have the potential to create renewed uncertainty:

- The ultimate shape of Brexit and ongoing US./China tensions, which are unlikely to disappear under a Biden administration.
- Our own trading tensions with China bear watching with our largest export (iron ore) at 10-year highs (A$ terms) and export receipts from China currently very strong.
- The US Georgia Senate runoff is scheduled for January 5. Investors are leaning towards a Republican victory which would mean split control of Congress. A Democratic victory would give Biden much greater capacity to implement his economic and legislative platform. This would likely include additional fiscal stimulus which would potentially buoy markets near-term. However, the prospect of other elements of Biden's reform agenda such as a significant hike in the US corporate tax rate could ultimately worry markets.

We wish everyone the very best for the holiday season and look forward to returning in mid-January 2021.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons and Wilsons Corporate Finance Limited (ABN 65 057 547 323, AFSL 238 383) and their associates may have received and may continue to receive fees from any company or companies referred to in this document (the "Companies") in relation to corporate advisory, underwriting or other professional investment services. Please see relevant Wilsons disclosures at www.wilsonsadvisory.com.au/disclosures. In addition, the directors of Wilsons advise that at the date of this report they and their associates may have relevant interests in the securities of the Companies.

Wilsons contact

www.wilsonsadvisory.com.au