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2021 MARKET OUTLOOK

Asset Allocation

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Eastspring's Singapore-based Eastspring Portfolio Advisors team believes global growth will come in above trend from the second half of 2021 but that any acceleration in core prices is unlikely to be sufficient to prompt a rate hike. That said, they remain bearish on a large portion of developed market government bonds and favour an allocation to equity on a selective basis.

Q. WHAT ARE SOME MACRO THEMES ONE NEEDS TO BE AWARE OF IN 2021 AND BEYOND?

Craig: Two macro themes stand out; the first being the US fiscal policy outlook and second, the COVID-19 progression. At the time of writing, the direction of fiscal policy remains unclear, but we believe the bias is for further expansion. The COVID-19 crisis quickly exposed the limits of accommodative monetary policy and led policymakers to jointly implement an expansionary fiscal policy to mitigate the exogenous demand shock.

As we emerge from the crisis, it will be very tempting for governments to continue expanding fiscal policy especially if inflation remains benign. But there are challenges. In the US for example, a fiscal gridlock may last until next year depending on the final Senate make up. Notwithstanding this, President-elect Joe Biden may want to achieve some level of bipartisan agreement between now and Jan 2021 or indeed through 2021 as he seeks to bridge the gap after four years of a divisive Trump presidency. The direction of US fiscal policy will be key to the path of future bond yields; an expansionary policy will likely see bond yields in the long end rise.

Two macro themes stand out; the first being the US fiscal policy outlook and second, the COVID-19 progression.

COVID-19 cases continue to rise in the US and Europe. Nevertheless, full-scale national lockdowns are unlikely as governments would not want to repeat the drastic approach taken in early 2020. Even if it comes to pass, markets are likely to look through any additional lockdowns and expect further monetary easing which will keep risk assets supported. In addition, the roll-out of a COVID-19 vaccine suggests that life can return to normal from spring 2021 and underpin risk sentiment.

Therefore, we believe the path for risk assets remains constructive. Fiscal policy will be supportive while a COVID-19 relapse would not disrupt the market for long. Bond yields, although off the lows in March still do not offer great value. Hence, we believe investors will gravitate to equities.

Q. WHAT ARE THE CHALLENGES FACING ASSET ALLOCATORS AND HOW ARE YOU POSITIONING YOUR PORTFOLIOS GOING INTO 2021?

Joanna: Constructing resilient portfolios in a low yield environment where asset prices appear disconnected from the real economy will continue to be the key challenge. This situation calls for more diversification, not less. We acknowledge that asset class correlations tend to rise during periods of heightened market volatility, but over the medium and long-term the traditional relationships between different asset classes should re-exert themselves and reflect the benefits of diversification. Therefore, one needs to have a medium-term investment horizon in order to enjoy the "free lunch" that diversification brings.

The current low bond yields and at-best neutral equity valuations in the medium-term context means that asset allocators should consider expanding their investment universe beyond the traditional bond and equity asset classes, into alternative assets or physical assets such as property or gold. In doing so, they can enhance their long-term expected portfolio returns and reap further diversification benefits.

We have approached the final quarter of 2020 with caution, in light of the growing number of economic lockdowns imposed again by COVID-19 and the risk of further US election outcome issues that may trigger market volatility.

We remain bearish on a large portion of developed market government bonds which seemingly offer return-free risk. Our central scenario projects positive economic growth into 2021 as a vaccine accompanied by expansionary monetary and fiscal policies combine to drive household and corporate demand. As this scenario plays out, we will increasingly express our pro-growth view in favour of an allocation to selective equity at the expense of cash and other low yielding fixed income assets.

Q. SHOULD LONG-TERM INVESTORS START THINKING ABOUT INFLATION PROTECTION GIVEN THE UNPRECEDENTED MONETARY AND FISCAL RESPONSE, AND THE US FEDERAL RESERVE'S (FED) SHIFT TO AVERAGE INFLATION TARGETING?

Joanna: Prior to COVID-19, the US economy experienced one of its longest ever growth periods aided by accommodative monetary policies. But, despite this expansion and low unemployment, inflation remained benign. The Fed's new average inflation targeting policy is aimed at pushing up inflationary expectations over time. Unsurprisingly, the initial market response was a bear steepening in the US yield curve in which longer term bond yields rose more than the short-dated ones.

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But we think the market is less convinced on the Fed's ability to achieve its 2% average inflation target simply through forward guidance rhetoric. Long-term inflation expectations are being questioned; Japan's "lost decade" of deflation is cited as a risk. With concerns over an undesirable cycle of ever-lower inflation and inflation expectations coming to the fore, a more proactive response from the Fed may be needed to see higher longer-dated bond yields in 2021.

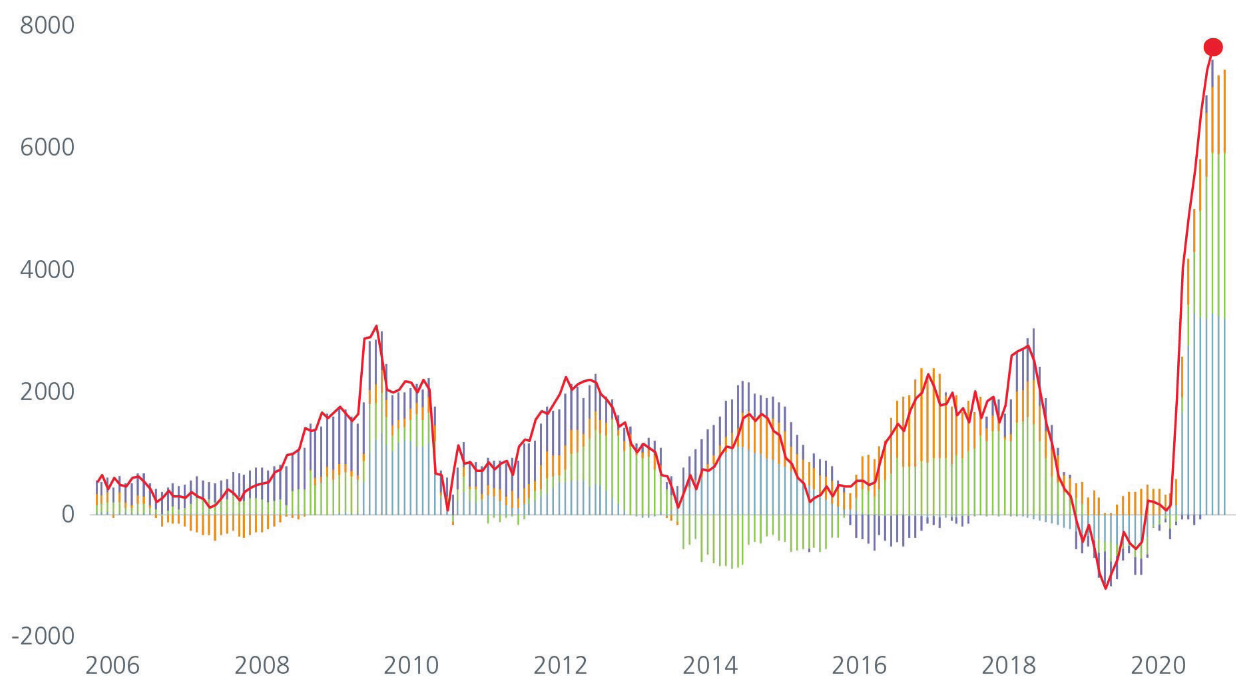
Craig: To add on, the Fed will likely continue its current policy until they see inflation shoot above its 2% target for an extended period. Historically, the Bank of Japan cut its interest rate to 0% in 1999, and it only managed to keep policy rate above 0% for a brief period of time in 2000-2001 and 2006-2008. It is a challenge to see a sustained rise in inflation given that on the demand side, we are still in an early cycle and far from experiencing labour and resource shortages.

Meanwhile, the secular disinflation trend spurred by an acceleration of technology adoption in the wake of COVID-19 and aging global demographics may persist for longer. But on the flip side, COVID-19 has further called into question globalisation which was already under political pressure. Increased onshoring and the costs associated could put upward pressure on prices.

Our base case is for above trend growth in the second half of 2021 at which point core inflation will rise, but this could prove temporary and insufficient to prompt a monetary policy response. If inflation, elusive for so many years, does return, investors will need to be mindful of the impact this will have on their investment returns. Cash deposits become even more unattractive as real yields fall and purchasing power is further eroded. This may well act as a catalyst for asset allocation away from cash and towards investments better suited to an inflationary environment. Traditional government bonds and credit, all else being equal, will suffer in an inflationary environment due to their fixed / nominal return. Inflation linked bonds could be an interesting alternative although selectivity here is key as valuations are currently unattractive. But with interest rates at zero and the yield curve relatively flat, the long-term benefit of holding developed government bonds is questionable.

Equities are traditionally seen as a good hedge against inflation as corporate revenues in certain sectors will track rising prices. However, it is not a linear relationship and changes to the input costs of production and a dampening effect on consumer demand need to be considered - so once again selectivity is key.

Fig 1: Central banks are likely to remain accommodative



Global Central Bank Balance Sheet Expansion YoY: 7,512 USD Bn
Fed Balance Sheet Expansion YOY: 3,144 USD Bn
ECB Balance Sheet Expansion YoY: 2,686 USD Bn
BOJ Balance Sheet Expansion YoY: 1,337 USD Bn
PBOC Balance Sheet Expansion YoY: 431 USD Bn

Source: Refinitiv Datastream as at 10 November 2020.

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