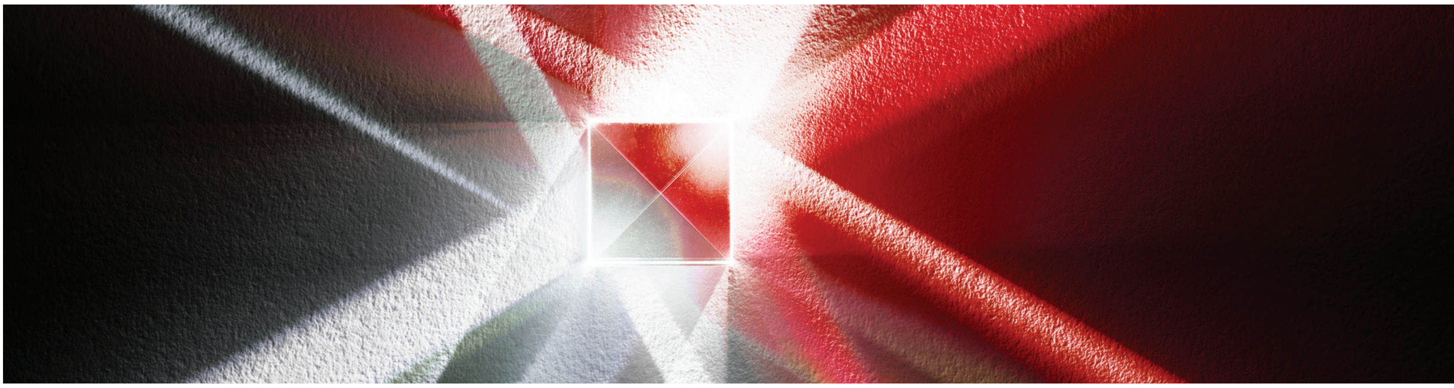

2021 MARKET OUTLOOK

Setting the stage

Ooi Boon Peng
Head of Investment Strategies

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Ooi Boon Peng, Head of Investment Strategies and Kelvin Blacklock, Head of Eastspring Portfolio Advisors set the stage for our 2021 Market Outlook by sharing their perspectives on policy settings, potential changes in market leadership and lessons from 2020 which investors can bring into the new year.

Q. WHAT IS YOUR CENTRAL SCENARIO AND WHAT ARE THE POTENTIAL RISKS?

Kelvin: After the initial acceleration from the trough in Q1 2020, global growth has moderated as economies are unable to return to pre-COVID-19 levels of activity. We expect this to continue into 2021 until a vaccine is made available to the public, potentially in Q2 - Q3. This would cause global growth to re-accelerate.

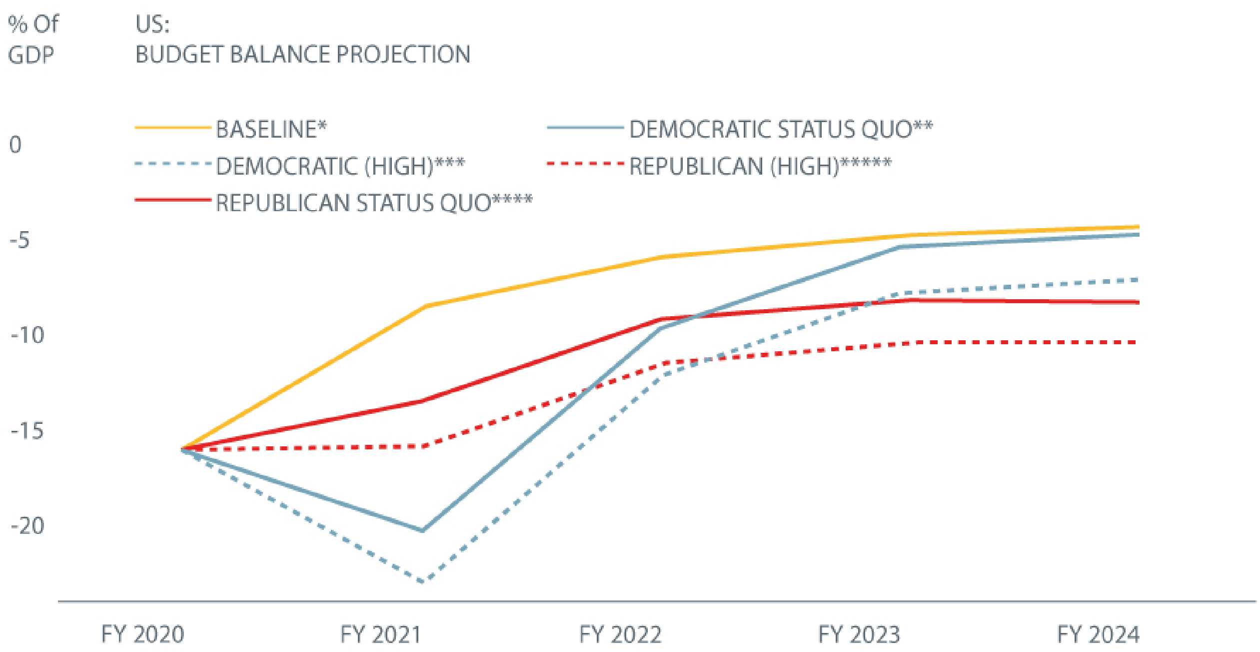
We do not expect Quantitative Easing (QE) programmes to be further expanded or extended as economies recover, unless market volatility rises sharply. Despite growth returning in the second half of 2021, any rise in core inflation is likely to be relatively muted and unlikely to prompt a policy response. Rates will probably not rise for several years. Fiscal policy is becoming the main tool for policy makers to support growth and there is broad political consensus for this globally. So, we expect fiscal policy to also support growth in 2021. See Fig. 1.

Valuations can normalise as earnings recover alongside the economy in 2021.

Improving fundamentals and business sentiment will be supportive of equities. Although current global equity valuations may appear expensive, such over valuation can persist, and equities can appreciate further. In addition, price earnings ratios have been elevated by both the decline in earnings, and one of the quickest recoveries in stock prices ever experienced. Valuations can normalise as earnings recover alongside the economy in 2021.

The main risks are a delay in the vaccine and/or intensifying waves of infections in key economies which can cause global growth to decelerate and even contract in 2021. As output gaps remain large, rising deflationary pressures also present a key risk for highly indebted economies and companies.

Fig 1: Both Democrats and Republicans are supportive of fiscal stimulus



*The baseline uses Congressional Budget Office's September FY2020 budget projections.
**This scenario assumes that the Heroes Act will be enacted in FY2021.
***This scenario assumes that on top of the Democratic status quo, Biden's USD5.6 tr policy agenda will also be enacted.
****This scenario assumes that the Heals Act will be enacted in FY2021.
*****This scenario assumes that on top of the Republican status quo, Trump's USD4.95 tr policy agenda will also be enacted.

Source: The Congressional Budget Office and the Committee for a Responsible Federal Budget.

Q. HOW DO YOU SEE FISCAL AND MONETARY POLICIES CHANGING IN 2021 AND WHAT ARE THE IMPLICATIONS FOR MARKETS?

Boon Peng: 2020 would go down as the year of the "Great Contraction". Due to the COVID-19 outbreak, global GDP is estimated to shrink 4.0% while the US economy is expected to contract about 3.5 - 4.0%. Substantial fiscal measures in the form of employment & business support have helped prevent double-digit GDP contractions in 2020, leading to a rise in government debt levels. At the point of writing[1], a resurgence of COVID-19 cases is pushing many countries to impose renewed lockdowns, which will weigh on consumer & business sentiment.

Without a vaccine, the ongoing health overhang posed by the COVID-19 pandemic will persist. Fresh stimulus measures would be required to support the economies in 2021. While governments remain committed to more pump priming - the magnitude of support needed may have to be as great as in 2020 to ensure positive growth in the new year. In the US, a divided government implies that the size of the stimulus would be more moderate than under a "blue wave", but the amount would still be meaningfully substantial. The Eurozone's continued suspension of its fiscal rules suggests that fiscal policy would remain accommodative in 2021, to the tune of 4% of GDP.

It would be more challenging for the emerging economies to continue with the same level of fiscal spending in 2021. To help finance widening fiscal deficits, emerging economies' central banks have purchased domestic government debt albeit to a much lesser extent than the Federal Reserve (Fed) in GDP terms. Those economies with

Source: [1]November 2020.

debt-to-GDP ratios that are close to or have breached the 60% threshold, such as Brazil or India, are limited in their ability to borrow and spend further without triggering a sell-off in their currencies or bond markets. There are limits to the extent of debt monetisation that Emerging Market (EM) central banks can carry out versus the developed economies which enjoy reserve currency status.

Hence, the successful development and wide distribution of a vaccine will be key for EM in 2021. Without this, EM equity and bond markets are likely to face headwinds versus their developed market peers. Within EM, Emerging Asia is in a stronger position as it boasts healthier balance sheets, and is benefitting from the global recovery in exports. China is a prime example. Following its successful management of the COVID-19 outbreak, China's industrial production has rebounded with the global export recovery.

Given the significant progress in vaccine research and development, I believe that a viable vaccine would be available by mid-2021. This bodes well for a strong recovery in the second half of the year. In the meantime, global central banks will keep rates low. Some of the Asian central banks (e.g. Bank of Indonesia) still have room to cut rates given the relatively high level of real rates. Such easy monetary conditions will help underpin asset markets over the long term.

> **"Within EM, Emerging Asia is in a stronger position as it boasts healthier balance sheets."**

Q. WILL CENTRAL BANKS START LOSING CREDIBILITY IF THE UNPRECEDENTED LEVEL OF MONETARY SUPPORT CONTINUES INTO 2021?

Boon Peng: Without a turnaround in the COVID-19 situation and hence a rebound in global growth, central banks are likely to keep monetary policy as accommodative as possible. As many of them have a pure inflation mandate (e.g. European Central Bank (ECB), Bank of Thailand), the current state of low inflation or even deflation from a contracting economy justifies their stance.

As mentioned earlier, if required, Developed Market central banks such as the Fed, Bank of Japan (BOJ) and ECB can continue their QE programmes and purchase domestic debt without significant investor "pushback". This is because of their reserve currency status. Their defence against accusations of debt monetisation suggests that QE is an emergency measure which would be unwound when conditions normalise. On the other hand, there is less patience and tolerance for EM central banks to undertake QE. At the point of writing, investors have expressed concerns over central banks' bond purchases leading to some steepening of the long-end yield curve in the US and EM.

Q. DO YOU EXPECT SHIFTS IN MARKET LEADERSHIP?

Kelvin: We do not anticipate valuations to be a headwind for the US equity market until later in 2021. We expect earnings to recover in EMs although this will likely be driven by China. Declining global macro risks and the unwinding of significant long positions in USD assets which were part of the crisis measures would provide a tailwind for EM currencies, and in turn EM equity markets. That said, some of the smaller EM equity markets could struggle, given lower fiscal stimulus and being potentially last in line for the vaccine. Those with high fiscal and current account deficits may also see their currencies under pressure.

Technological disruption, which has accelerated following the onset of the pandemic, will continue. Investors however may need to be more selective going forward, given the strong run of many tech and tech-enabled companies in 2020. Increasing regulation & taxation could also be a risk for this sector. Growth stocks would need to deliver against lofty earnings expectations to maintain their high valuations so there is a chance of earnings disappointments leading to a reversal of their recent outperformance.

On the other hand, cyclical/value stocks could benefit if the economic backdrop improves as per our central scenario. This includes materials, real estate, consumer discretionary and industrials. The long underperformance of value versus growth stocks has resulted in an unprecedented valuation gap so a pick up in earnings momentum, underpinned by the economic recovery, can help narrow the valuation gap between value and growth stocks in 2021.

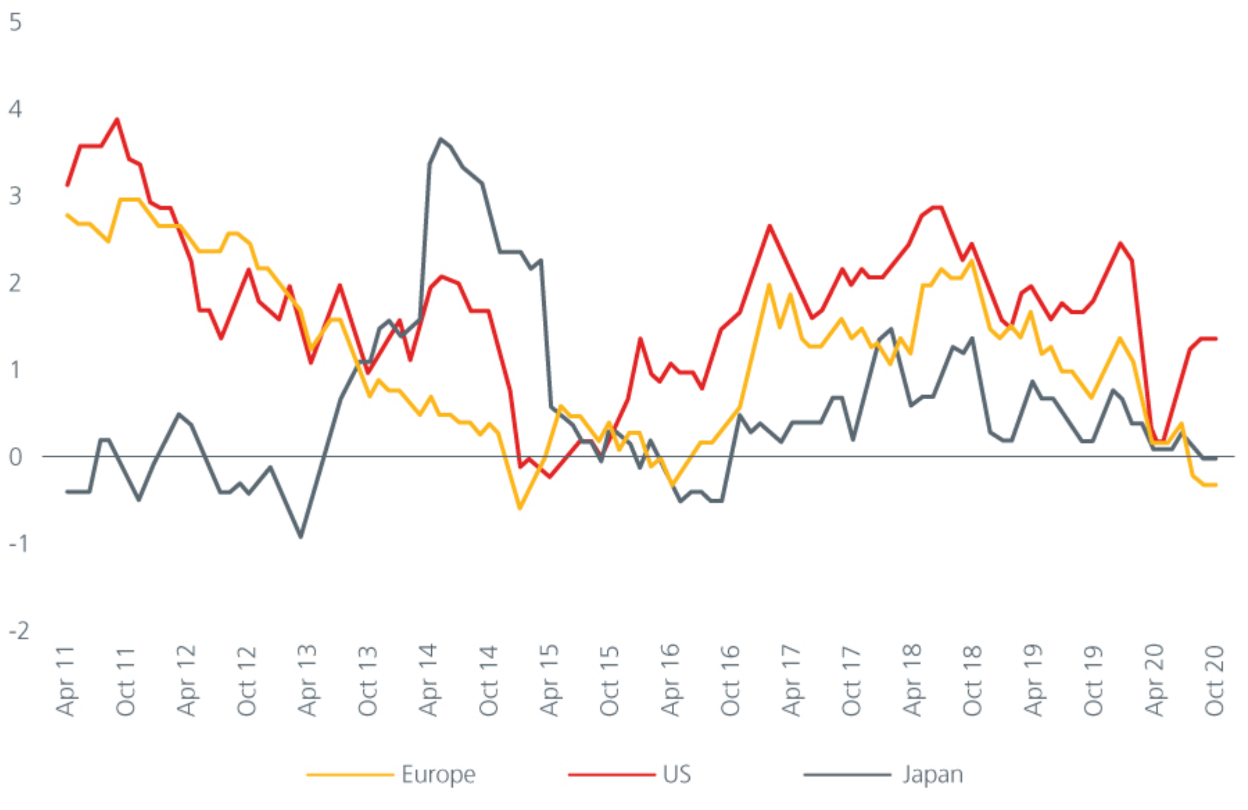
Q. WILL INFLATION RETURN AND HOW SHOULD INVESTORS NAVIGATE THIS BACKDROP?

Boon Peng: We need a strong and timely recovery in GDP in order for global inflation to rise. Visibility on this front is still limited as at 4Q 2020. Even if we achieve a very strong GDP rebound in 2021, long-term wages and inflation pressures are likely to pick up only gradually given the considerable slack in the labour market. The US jobless rate stood at 6.7% as of November 2020, significantly above the 3.8-4% level which represents full employment.

If the COVID-19 situation remains unresolved, persistently weak or negative growth into 2021 and even 2022 becomes a real risk. Uncertain prospects and balance sheet problems will lead to weak corporate investments and structural unemployment, leaving economic scars over the medium term. The cumulative loss in economic output increases deflationary pressures, exacerbating the downward price pressures already brought about by technological disruptions.

Inflation advocates point to the supply shocks created by the COVID-19 outbreak and the very sizeable central bank liquidity injections. Neither factors, in my view, would prove to be that impactful. On balance, the economic slack from the GDP contraction and the corresponding reduction in consumer purchasing power more than nullifies the impact of the supply disruptions. Note that the US, Japan and the Eurozone have deployed QE for many years and have been unable to lift inflation. See Fig.2. Despite excess liquidity, corporate activity has not risen to a level that causes inflation to return.

Fig 2: Inflation rates in US, Japan and Europe (% yoy)



Source: Bloomberg. As of November 2020.

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I expect the Fed to keep rates on hold until 2023 without feeling undue pressure to act earlier. Neither would the ECB and BOJ likely change their easy monetary stance for the next two to three years. With surplus liquidity supporting asset markets and the expectations of a global economic recovery in 2021, I see opportunities in the equity and credit markets. Sell-offs in the Asian credit and local bond markets potentially provide opportunities for investors to capture attractive yields, against a backdrop of depressed central bank policy rates.

“Sell-offs in the Asian credit and local bond markets potentially provide opportunities for investors to capture attractive yields.”

Q. WHAT ARE SOME OF THE IMPORTANT LESSONS FROM 2020 WHICH INVESTORS SHOULD BRING INTO THE NEW YEAR?

Kelvin: First, that disruption (change) although uncomfortable is a constant that we must embrace and the shifts in corporate and consumer behaviour resulting from COVID-19 are likely here to stay. Accepting this altered state and adapting with it will pay dividends.

Next, financial markets are inherently volatile and the market crunch in the first quarter of 2020 followed by the subsequent rebound are testament to this. The best defence is to invest in well diversified portfolios and be prepared for the volatility so that you can remain calm, manage risks and stay the course.

Investors should also note that opportunity comes with every crisis and there are some exciting growth stories in Asia and beyond that have been catalysed out of the upheaval in 2020.

Finally, rising political tension between the US as the old established global power and China as the challenger is set to continue. Investors will need to think harder about a more bipolar world with perhaps two main currencies, trading systems and technologies.

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