Despite winter virus waves, an incipient pro-cyclical rotation is underway across asset classes and regions. Investors would be well-advised to remain sensibly diversified and balanced.

Reflation from massive policy stimulus will meet economic re-opening as COVID-19 vaccinations start to roll out in the months ahead across the developed world and various emerging markets. Recovery will be global, with world GDP slated to climb 5.2% in 2021 on consensus estimates after falling some 3.9% in the year of coronavirus.
The chief scientist of the U.S. government’s Operation Warp Speed vaccine development program said ramping inoculations in the months ahead could mean 70% of Americans becoming immunized and herd immunity achieved by May. Promising COVID-19 vaccines in final trials and deployment plans in Europe aren’t far behind, while China has already begun inoculations at home even though its leading pharma groups are still in phase III clinical trials in at least 13 countries, including Indonesia and Brazil.

Developed country monetary and fiscal authorities are doing their part to keep financial conditions extremely easy, even though fresh fiscal stimulus may be smaller and more targeted in the U.S. if Republicans retain control of the Senate in the January 5 runoff balloting. Still, with former Federal Reserve Chairwoman Janet Yellen tapped to become the next Treasury Secretary, there’s plenty of scope for debt monetization via quantitative easing, given that Fed Chairman Jerome Powell, like Yellen, has vocally recommended more fiscal stimulus. They’re not alone in this approach. In fact, Group of 10 central bank balance sheet assets grew nearly $8 trillion in 2020 to more than $25 trillion.

From 2020’s “Hope Phase” to 2021’s “Growth Phase”

The upshot is that, despite the latest infection waves and lockdowns in parts of Europe and the U.S., stock and bond markets and prices of hard assets such as commodities and real estate are booming in anticipation of the rebound in global trade, investment and spending. While valuation expansion fueled equity’s “hope phase” recovery in 2020, earnings with easy comps should become the main driver in 2021’s reopening “growth phase.”

To be sure, stock valuations vary across sectors, regions and “style” factors. If U.S. large-cap tech stocks are pricey, plenty of upside exists for cyclical value stocks, which lagged for years. But equities generally remain attractive relative to bonds, which now play more as a store of value than yield. Sovereign yields are paltry in the U.S. and close to flat or negative in Europe, Japan and other industrialized countries. Corporate investment-grade bond yields are meager, and spreads compressed. Speculative-grade paper offers more yield and forecast 12-month default rates will likely ebb in 2021 from relatively elevated 2020 levels thanks to easy financial conditions, debt-laden “zombies” and historically low recovery rates suggest near-term risks are to the upside. That’s due to intermittent lockdowns or consumers pulling back on their own amid any new virus outbreaks.

Still, pro-cyclical positioning is reflected in rotations toward previously unloved energy, industrial, material and financial sectors since the March 2020 bottom. It’s also evident in the rebounds of
small- and mid-capitalization stocks, as well as in shifting investors flows to “value” from “growth” and “blend” portfolios. It’s reflected in regional outperformance, as well.

When Markets and Economic Dynamics Align

The reflation trade is also evident in surging commodities prices. Copper and aluminum are up around 50% since the March bottom, while Brent crude has skyrocketed 150%. That suggests a broad rebound in manufacturing and potentially infrastructure spending. Bank of America Merrill Lynch recently noted the breadth of increasing manufacturing Purchasing Managers’ Indices, with 32 out of 41 countries, or 78%, signaling expansion above the 50-level threshold.

“The improvement is reflected in analysts’ earnings estimates as well—the global monthly earnings revisions ratio soared to 1.30 in November, with upgrades outnumbering downgrades in every region, most global sectors, and all global styles.”

We often hear that “markets are not the economy,” particularly when asset prices are rising as economic data deteriorate. There are times, though, when circumstances align and markets rise in anticipation of an improving economy, easy financial conditions and little inflationary pressure in the near term.

Developed economies are poised to accelerate some 3%, while emerging economies will sprint 5% in 2021, according to Bloomberg consensus estimates. After sinking roughly 3.6% in 2020, the U.S. economy is expected to advance 3.8% in 2021, while the European Union is seen growing 4.7% after contracting 7.7% in 2020. But China, which accounts for one-third of global GDP growth, is forecast to grow 8.2% in 2021 after sputtering 2% in 2020, helping emerging markets to expand 5% in 2021 after 0.8% decline the year before.

Inflation may not be a concern at the moment, given the virus’ lingering deflationary impact. Global annual Consumer Price Index is seen climbing to 2.7% in 2021 and 2.8% in 2022. Not too hot, not too cold. But as we’ve pointed out, a temporary deflationary shock followed by a highly reflationary policy response, supply chain disruption and increased protectionism present a real inflation risk. That’s already reflected in a variety of inflation hedges, from galloping price rises in gold and bitcoin to, as noted, huge increases in the prices of base metals and sundry agricultural commodities. At around 1.56%, U.S. two-year inflation breakevens aren’t alarming, though they’re back above their pre-COVID-19 levels at the highest point since May 2019.

Beyond 2021, Back to the Future?

Equities can also, of course, provide a hedge against inflation, given their potential pricing power. And stocks should also be better able to absorb rising bond yields than fixed income. But valuations matter and trying to time turns in the economic and market cycles is often a perilous exercise. Portfolios without sufficient fixed income stabilizers are vulnerable to the next shock. Crowded equity allocations usually make for limited upside, and sharp downside risk when investors start scrambling for the exits.

“It is a market of stocks, not a stock market.” As bottom-up, fundamental investors we adhere to that investing maxim, in selecting individual stocks and for that matter bonds, based both on their own merits and discrete contributions to our broader portfolios. Sensibly diversified, balanced strategies, we believe, allow for a focus on each investment thesis—its risk relative to its reward. We find this approach more effective than trying to time macro or market turns, inflation spikes and rate risks, or to join the conventional wisdom about what, in the long run, the virus has changed in consumer behavior, business investment or regulatory priorities.

There are, of course, compelling structural themes, from digital payments to the build-out of 5G capable telecom networks to green energy. But it’s crucial to examine the full capital stack, pick your shots at the best-positioned companies with strong business models, sound balance sheet dynamics and high-quality management. Such businesses proved resilient during the COVID-19 swoon in 2020 and should find themselves even better positioned for the growth to come in 2021. Beyond the expected economic and market rebounds in the year ahead, though, after herd immunity has been reached and COVID-19 is just one of countless other coronaviruses that humanity has learned to live with, we’ll still be grappling with all the accumulated debt from the policy response. Will that return us to a world of low growth, low inflation and low rates? Will growth stocks resume their upward march, value stocks decline, and fixed income become low- to no real-yield plays once again? We’ll see. Portfolios populated with attractively priced stocks and bonds that offer individually compelling business prospects should prove their worth, whatever the macro and market climates over time.

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