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in the moment

Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

Financial market outlook for 2021: Virus or vaccine victorious?

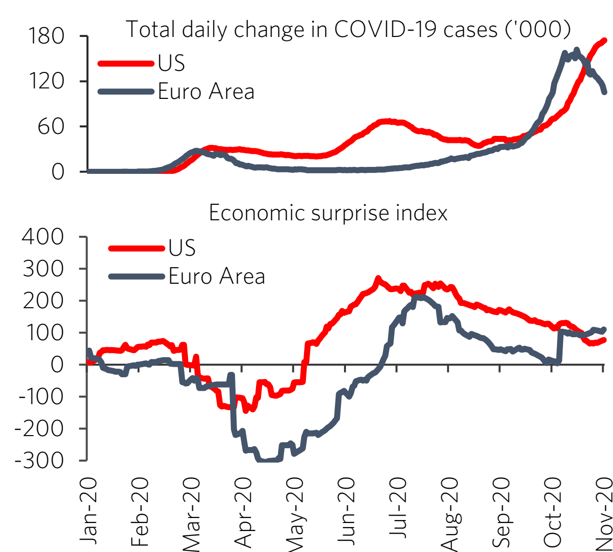
Highlights

- The ebb and flow of COVID-19 infections around the world and developments on the vaccine front are likely to be hugely influential in determining the outlook for the economy and financial markets in 2021.
- A flare-up in COVID-19 cases during the Northern Hemisphere winter is likely to cause some near-term pressure on global economic growth associated with renewed lockdown measures, but should fade during 2021 as progress is made with the approval, mass production, global distribution and widespread administering of virus vaccines.
- Although the balance of probabilities is in favour of a positive vaccine outcome and hence a conducive environment for riskier asset classes like equities in 2021, we acknowledge that there could be sporadic downside risks for these assets during the year in case of disappointments on the vaccine implementation front.
- Riskier asset classes should benefit from a split United States (US) Congress and more geopolitical predictability as the former should imply a lower likelihood for increased regulation and taxes, while the latter should intimate less volatility in markets.
- In general, an improved global growth picture, together with still ultra-easy policy settings, should reward less risk-averse investment behaviour in 2021. In such a risk-on environment, investors should be positioned for a weaker US dollar, a drift higher in US bond yields, expect general support for more risky asset classes such as equities and credit and be prepared for some equity style rotation from growth to value and regionally should favour non-US equity markets (including emerging markets (EM)) over the more defensive US equity market.
- In contrast, safe-haven asset classes like global bonds, cash and gold are likely to face headwinds in a cyclical recovery phase, with bonds facing the additional challenge of somewhat higher inflation.
- Valuations look expensive in most global asset classes, with low yields implying lower-than-historic forward returns across-the-board if there is some reversion towards longer-term valuation means.
- It looks like the stars are finally aligning for the South African (SA) equity market, with a strong expected profit recovery in 2021 providing fundamental support on top of an envisaged conducive global risk-on environment, while a more favourable valuation underpin after years of poor performance should enhance potential return upside.
- The almost zero real return available to investors from local cash looks unappealing, in contrast to the high real yields offered by SA inflation-linked bonds (ILBs) and vanilla bonds. The expected rise in SA inflation as 2021 progresses should provide a positive fundamental underpin for ILBs.
- Although listed property fundamentals have weakened considerably in recent years, this is already discounted by share prices. To bolster weak balance sheets, some property companies will be forced to do capital raises.
- The current level of US real interest rates gives a neutral tactical signal for gold exposure. However, we maintain that there is always a strategic rationale for gold as a portfolio risk diversifier.

COVID-19 and vaccine developments to determine market outlook

The ebb and flow of COVID-19 infections around the world and developments on the vaccine front are likely to be hugely influential in determining the outlook for the economy and financial markets in 2021. The reality of a flare-up in COVID-19 cases during the Northern Hemisphere winter is likely to cause some near-term pressure on global economic growth associated with renewed lockdown measures, as is currently evident in Europe and the US (see chart 1).

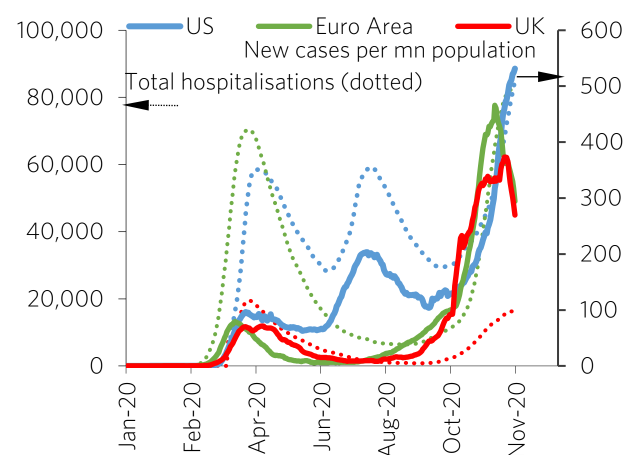
Chart 1: COVID-19 propels the global economy



Source: MRB Partners

However, the near-term negative growth impact of rising COVID-19 cases should fade during 2021. In this regard, the successful approval, mass production, global distribution and widespread administering of virus vaccines is a prerequisite for the sustainable normalisation of economic activity. Firstly, this will limit the risk of sporadic economic lockdowns in response to rising pressures on health systems as is currently evident in Europe, the United Kingdom (UK) and the US, with new infections now worse than the original wave and the number of hospitalisations similar (see chart 2). In addition, it could also increase the likelihood of enhanced fiscal spending on vaccine production, which could provide an additional boost to the global economy.

Chart 2: Vaccine needed for growth normalisation



Source: JP Morgan

In our view, whether or not the COVID-19 virus can be tempered successfully in 2021 will largely determine the risk appetite in global financial markets in the year. In turn, this will determine whether riskier asset classes or safe-haven asset classes will prevail in 2021. Although the balance of probabilities is in favour of a positive vaccine outcome and hence a conducive environment for more risky asset classes in 2021, we acknowledge that there could be sporadic downside risks for these asset classes during the year in case of disappointments on the vaccine implementation front.

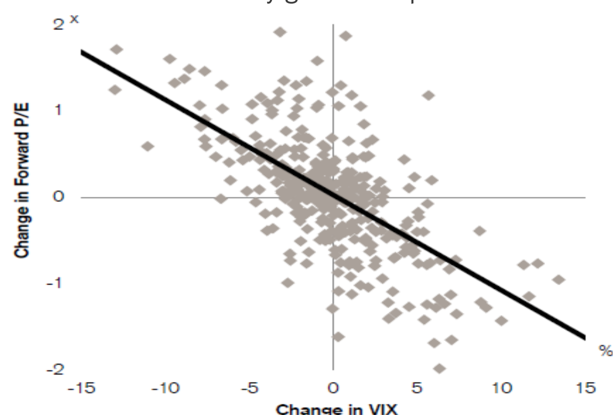
Riskier asset classes should benefit from a split US Congress and more geopolitical predictability

The reality of a divided US government after the recent election implies uncertainty about the timing and magnitude of further fiscal stimulus. Although a split Congress likely suggests a smaller Biden fiscal stimulus package and thus higher risk for fiscal drag hindering the magnitude of US economic recovery, it also means a lower likelihood for increased regulation and taxes which could offset some of the negative growth impact from a smaller fiscal package. A Biden presidency with legislative gridlock can indeed be regarded as a goldilocks environment for equities, with smaller fiscal

stimulus also enhancing the necessity for ongoing monetary support.

Furthermore, the envisaged transition from President Trump's unilateral and confrontational approach to international relations to Biden's likely more multilateral and cooperative approach should imply less volatility and probably more predictability in geopolitics. This would be good for risk-asset valuations and returns (see chart 3).

Chart 3: Lower volatility good for equities



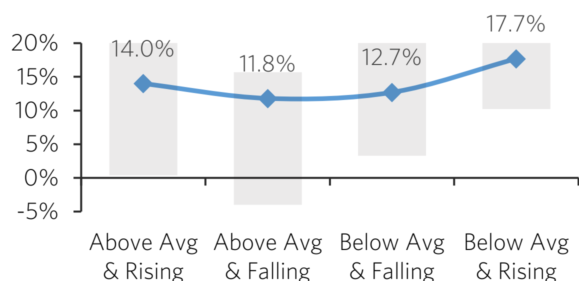
Source: Credit Suisse

Ultra-easy money to remain even as growth recovery ensues and inflation drifts up

A drifting up of inflation towards trend should be expected in 2021 as economic recovery ensues while loose policy remains and previous structural disinflationary forces like globalisation, technology deregulation and technology price declines start reversing. Upward pressure on minimum wages can also be expected in the coming years as policymakers seek to redress wide inequality gaps.

Chart 4: Equities do best when inflation is low and rising

S&P 500 forward 12-month returns by inflation bucket

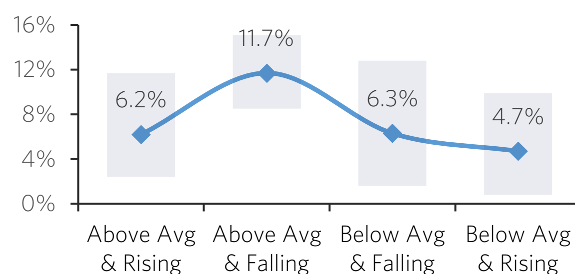


Source: Morgan Stanley

Research by Morgan Stanley shows that rising inflation periods historically provided the best absolute and relative equity returns as higher growth prospects and inflation expectations during these periods lifted nominal returns. While equities do best when inflation is below trend and rising, bond returns are the lowest during these periods (see charts 4 and 5).

Chart 5: Bonds do worst when inflation is low and rising

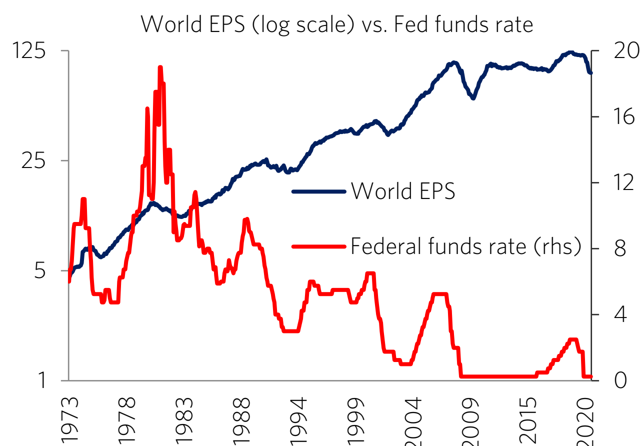
US 10-year bond forward 12-month returns by inflation bucket



Source: Morgan Stanley

Against the backdrop of many global risks and uncertainties, central banks are likely to remain firmly committed to ultra-easy money to counter rising inequality even as a growth recovery takes hold. One should thus expect interest rates to remain low and quantitative easing (QE) support measures to remain firmly in place even as inflation starts drifting upwards, particularly with the shift to average inflation targeting among global central banks. As such, the risk is low that rising policy rates will derail the profit recovery from the trough as has often been the case historically (see chart 6).

Chart 6: Rising policy rates not a risk to profits this time

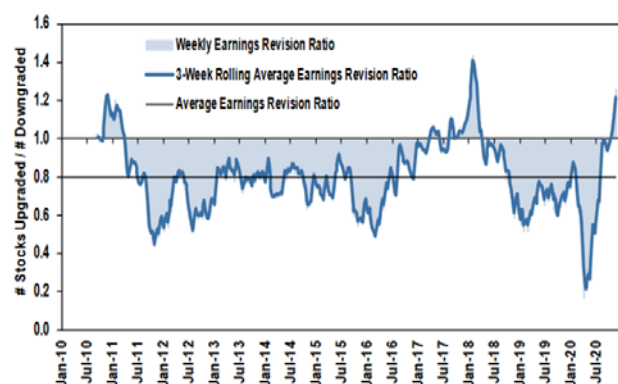


Source: Morgan Stanley

General risk-on environment in 2021 should favour risky asset classes

A likely move towards trend growth and inflation in 2021 point to a dual positive effect on global nominal GDP and hence companies' top-line revenue and profits. This expectation is currently evident in profit expectations, with a net 20% more corporate earnings upgrades than downgrades experienced in the US (see chart 7). Furthermore, as companies become more confident in the operating environment, this should reflect in higher payouts – dividends and share buybacks – in 2021. All of this should be unequivocally positive for global equity markets.

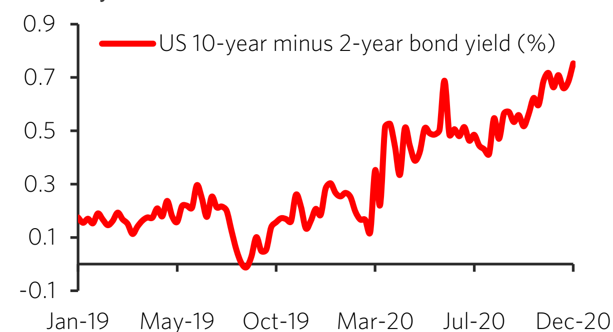
Chart 7: Profits being revised upwards



Source: BofA

In general, an improved picture of global growth, together with still ultra-easy policy settings, should reward less risk-averse investment behaviour in 2021. In such a risk-on environment, investors should be positioned for a weaker US dollar, a drift higher in US bond yields, expect general support for more risky asset classes such as equities and credit and be prepared for some equity style rotation from growth to value and regionally should favour non-US equity markets (including EM) over the more defensive US equity market. In contrast, safe-haven asset classes like global bonds, cash and gold are likely to face headwinds in a cyclical recovery phase, with bonds facing the additional challenge of somewhat higher inflation. The recent steepening in the US yield curve is a telling sign that the bond market is starting to discount economic recovery (see chart 8).

Chart 8: US yield curve starting to discount economic recovery

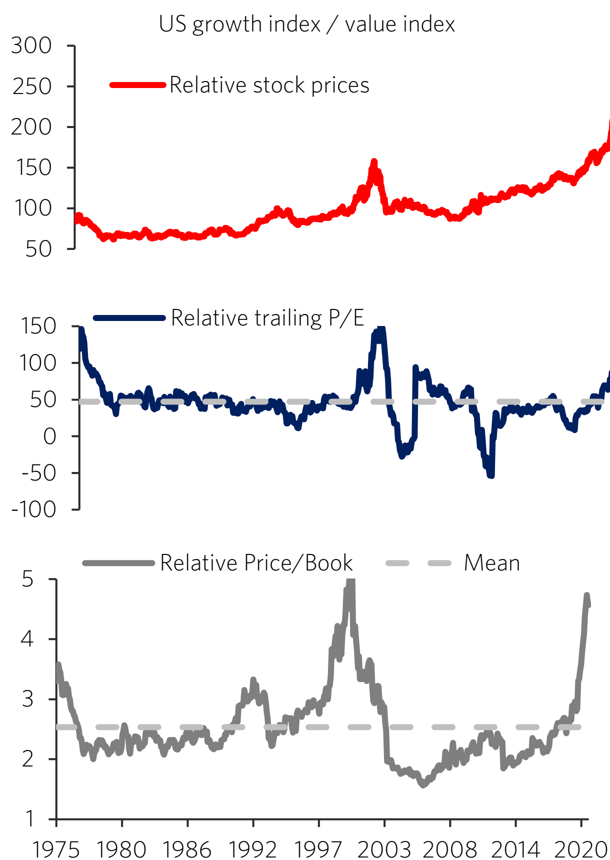


Source: Iress, Momentum Investments

With most global assets expensive, future absolute returns are likely to be lower

Valuations look expensive in most global asset classes, with low yields implying lower-than-historic forward returns across-the-board if there is some reversion towards longer-term valuation means. As such, the absolute return outlook is not an appealing one for investors. It then becomes a relative asset class choice story to defend overall portfolio returns for investors.

Chart 9: Value stocks now offer more attractive investment opportunity than growth stocks

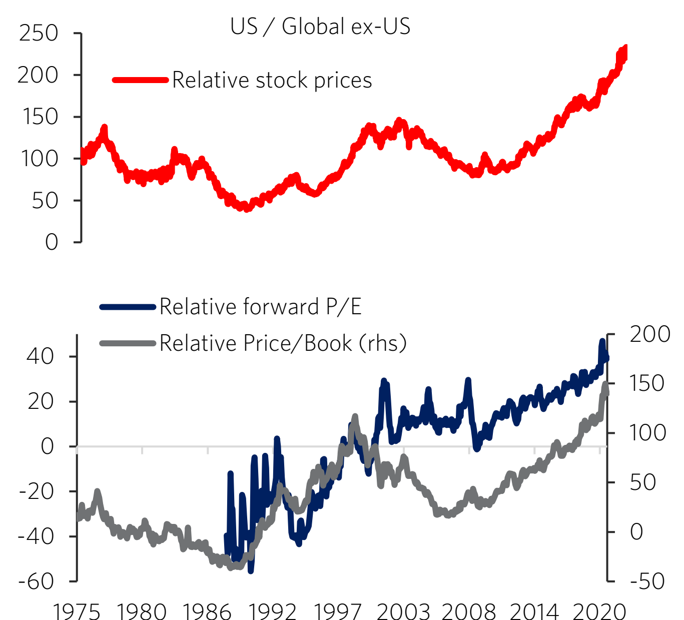


Source: MRB Partners

At the outset, cash exposure in a very low-interest rate environment should be limited. Secondly, global bond exposure would be at risk if global growth and inflation drift higher towards trend as expected in 2021. It makes sense to rather exploit the risk premia available in other asset classes to give some better absolute returns in a diversified balanced portfolio. Growth asset classes historically perform best around growth troughs in the global economic cycle, while safe-haven bonds do best when data deteriorates from the peak in the cycle.

Within equities, the positive relative profit trends in favour of both growth stocks and the US over the past decade already seem to be fully discounted in their respective valuations (see charts 9 and 10). As such, value stocks and non-US equity markets now offer more compelling long-term risk/reward profiles than growth stocks or the US equity market.

Chart 10: Better investment opportunity in non-US equities



Source: MRB Partners

Global risks in 2021

Problems with containing the COVID virus and a delay in the production, distribution and practical rollout of vaccines globally, leading to renewed restrictions on activities to curb hospitalisation levels, would be a major risk to global economic recovery and a higher risk appetite in financial markets in 2021.

Furthermore, a Democratic sweep should the Georgia Senate reruns go in favour of the Democrats in early

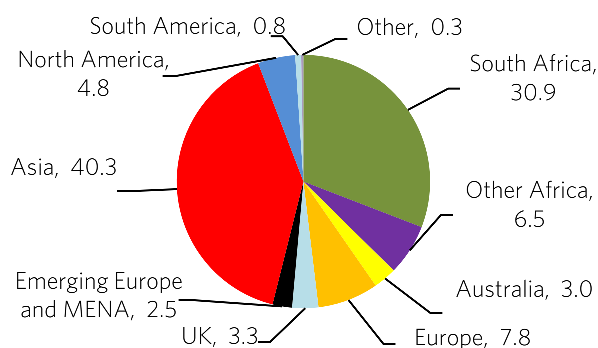
January 2021 would increase the likelihood for more regulation and higher taxes, which would be negative for equities.

Risk assets would also come under pressure from any peak in policy stimulus momentum, in case US political gridlock prevents further fiscal stimulus to be forthcoming, and should there be proactive, rather than reactive, monetary policy tightening as inflation drifts higher towards and eventually above target in the coming years.

Are the stars finally aligning for the SA equity market?

Although the SA economy will remain trapped in a low-growth quagmire until structural policy reforms are successfully implemented, the fortunate reality for investors in the SA equity market is that the local economy is only a secondary driver for the overall local stock market. Indeed, analysis done by RMB Morgan Stanley shows that less than one-third of the aggregated operating performance of the companies in the JSE Top 40 index originates from SA (see chart 11). Shares like Naspers, Prosus, British American Tobacco, Anheuser Busch InBev, BHP Billiton and Richemont generate the bulk of their production, revenue and profits outside SA and hence are more linked to global driving factors than those pertaining to the SA economy.

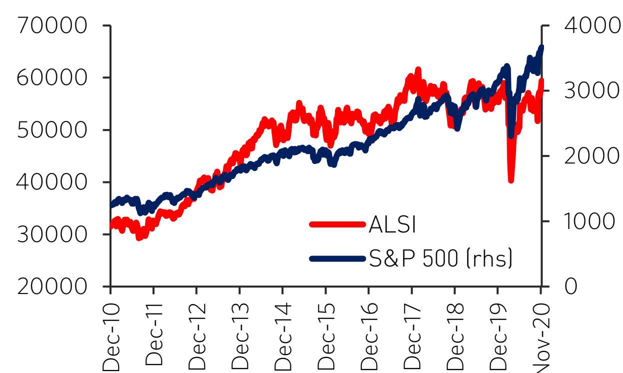
Chart 11: SA equity market ≠ SA economy



Source: RMB Morgan Stanley

It should therefore be no surprise that the SA equity market historically has followed the lead of global equity markets, particularly the US, over time (see chart 12), with non-US equity market factors only explaining 23% of local equity market movements in recent decades. SA idiosyncratic factors have thus only been of secondary importance to determine the local equity market's direction. Based on the current level of the US market, the SA market seems around 13% undervalued. The latter should also benefit from the envisaged global risk-on environment playing out in 2021.

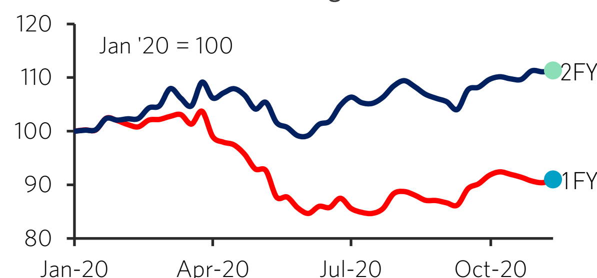
Chart 12: SA equity market follows the global lead



Source: Iress, Momentum Investments

There should also be fundamental support for SA equities from a strong expected profit recovery in 2021, driven mainly by an improving global operating environment on top of a decimated 2020 earnings base. SA earnings revisions already bottomed in June 2020 (see chart 13), with upward earnings momentum since then mainly driven by Naspers and the resource sector, with further positive revisions likely to be forthcoming in the coming months.

Chart 13: Positive SA earnings revisions trend



Source: Avior

After years of poor absolute and relative performance, the SA equity market now also has a more favourable valuation underpin that should enhance potential return upside from an improving fundamental backdrop.

SA real bond yields compelling, in sharp contrast to zero real cash yields

The carry trade remains alive and well in global fixed income markets, with funding rates close to zero or negative in developed markets and the nominal and real bond yields available in emerging markets far above those offered in developed markets. In addition, many EM currencies still look undervalued on fundamentals, adding to the attractiveness of EM assets for global hard-currency investors. Within the EM world, SA real vanilla bond yields remain one of the highest, more than compensating prospective investors for the high local fiscal risk premium required (see table 1). Current SA real bond yields and yield spreads are indeed multiple-sigma attractive events against their respective historical averages.

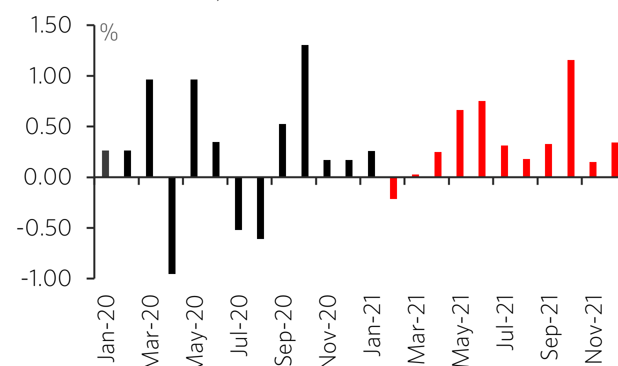
Table 1: Real ex-post 10-year government bond yields

DM	
Japan	0.4%
US	-0.3%
Europe	-0.3%
UK	-0.4%
EM	
South Africa	5.9%
Brazil	3.5%
Russia	1.9%
Mexico	1.4%
Turkey	0.1%

Source: Iress, Momentum Investments

In the ILB space, the expected rise in SA inflation as 2021 progresses should provide a positive fundamental underpin for the asset class going forward. More specifically, the meaningful positive monthly inflation accruals expected to be banked by ILB investors from the second quarter of 2021 should be particularly favourable for the asset class in coming months (see chart 14).

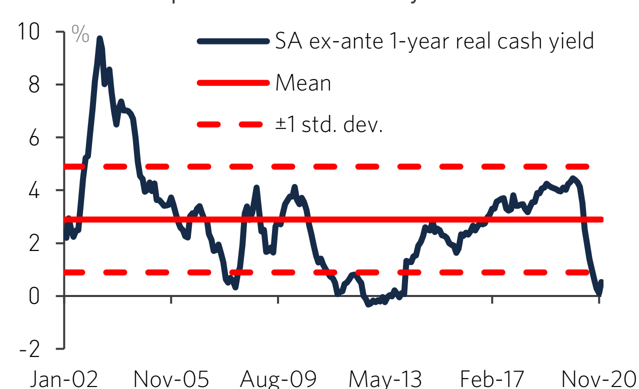
Chart 14: Monthly CPI accruals (% m/m pushed forward 3 months)



Source: Iress, Momentum Investments

Due to a combination of aggressive SA Reserve Bank rate cuts in 2020 in response to COVID-19, as well as expectations for higher local inflation in the next year, prospective SA real cash yields have fallen close to zero, which is more than one standard deviation below its historical average (see chart 15). This makes the real return available to investors from local cash unappealing, in contrast to the high real yields available from SA ILBs and vanilla bonds.

Chart 15: Prospective SA real cash yield



Source: Iress, Momentum Investments

How much of the weaker listed property fundamentals are already discounted by share prices?

The SA commercial property sector experienced a further rapid weakening in its fundamentals in 2020 due to the destructive effect of COVID-19 induced lockdowns on the economy and its tenant base. As a result, rental holidays had to be instituted, negative rental reversions became the norm and vacancies started to rise. While this trend is likely to continue in the immediate future, share prices of the listed companies have been decimated, with valuations at rock-bottom levels relative to history. As such, it can be postulated that the weaker fundamental environment has already been discounted by share prices in the sector.

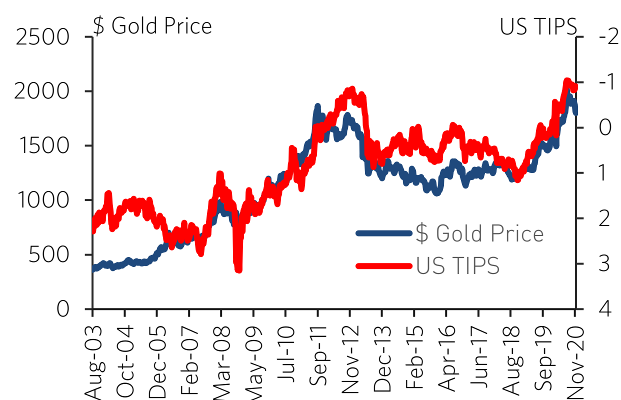
Although we anticipate property values to decline in the coming years as the reality of a weaker operating environment is reflected, our research shows that current share prices already discount a 30% decline in property values in the coming years. We see this as a worst-case outcome and think that a 25% decline in property values is a more realistic, but still conservative, outcome.

Balance sheet strengthening remains the main interim priority in the listed property space as property value declines push loan-to-value ratios up. As regulators will not allow real estate investment trusts (Reits) to retain dividends to bolster weak balance sheets, some companies in the sector will have little choice but to do capital raises, which are likely to dilute existing shareholders' interests.

Gold price currently in line with US real rates

With the fundamental driver for the gold price being the opportunity cost of holding a non-interest-bearing asset, it is unsurprising that US real interest rates have been the dominant determinant for the US dollar gold price in the last two decades (see chart 16). More surprising has been that movements in the US dollar no longer provide additional explanatory power for the behaviour of the dollar gold price.

Chart 16: US real rates and the gold price



Source: Iress, Momentum Investments

Based on the current level of US real interest rates, the predicted value of the dollar gold price is very much in line with its current actual spot level, providing a neutral tactical signal for gold exposure. However, we maintain that there is always a strategic rationale for gold as a portfolio risk diversifier due to its safe-haven characteristics during risk-off global bouts, as well as its limited correlation with other asset classes in a portfolio.

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