

2021



# OUTLOOK

HIGHLIGHTED IN THIS PUBLICATION:

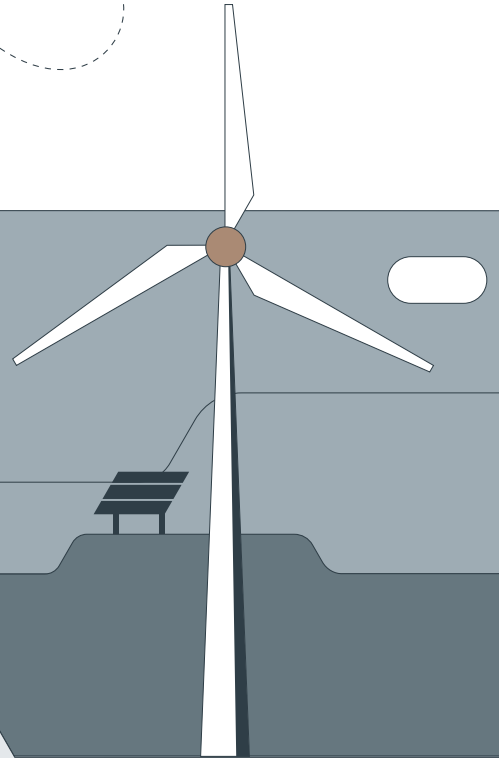
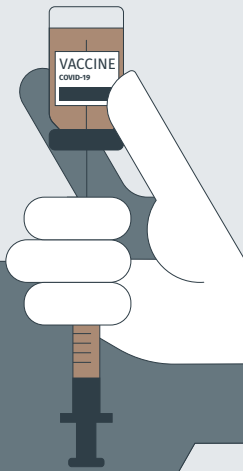
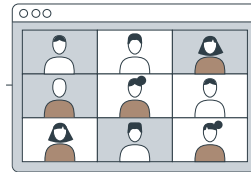
 GLOBAL STRATEGIC  
ASSET ALLOCATION

 GLOBAL SECURITY  
SELECTION

 REGIONAL  
ASSET ALLOCATION

 REGIONAL PORTFOLIO  
CONSTRUCTION

Our predictions  
and preferences



# Review of 2020 Outlook

Each December, we review the *Outlook* we presented a year earlier. In 2020 some of our predictions were derailed as a result of the Covid-19 pandemic. Despite that, we still scored 6/10.



1

Incorrect

## Global growth continues

Global growth took a big hit as a result of the Covid-19 pandemic. Nevertheless, after the first wave subsided, growth in many advanced economies recovered quickly. A more modest setback was seen after the second wave in the autumn. China, as well as several other Asian economies, had low levels of infections and deaths and recovered quickly. They are likely to have recorded positive GDP growth for the full year.

2

Partly  
Correct

## Workers catch up

We thought that although the gap between CEO pay and that of ordinary workers may not narrow much in 2020, the pressures in many countries would be for higher wages for normal workers. That was partly correct: certainly, there were pressures for the health and social care workers on the front line of dealing with the pandemic to be paid better; and furlough and income support schemes helped other lower-paid workers. But the main story of 2020 was one of very disparate behaviour of pay levels and employment prospects across industries.

3

Correct

## Austerity is over

We thought that austerity, restrictions on government spending, would be over in 2020. Admittedly for an unexpected reason, that was definitely the case.

4

Correct

## Green light for green spend

We thought that more spending on green initiatives would be a big theme for 2020. That issue certainly moved to the forefront and is set to be an even bigger issue in 2021.

5

Correct

## Fixed income: capital preservation is key

We thought that the environment for fixed income investing would be tough, given low interest rates and yields, but that investment grade corporate bonds would offer one of the safest places and that there were good opportunities in convertible bonds. The total return from 5-year BBB-rated corporate bonds, the sector we highlighted, was a respectable 6% in the year to 11 December 2020; while the return from convertible bonds was above 40%.

# 6

Incorrect

## Value in emerging market bonds

We saw value in emerging market local currency debt, thinking that with subdued inflation and the US dollar stable, emerging market interest rates could be cut further in 2020. Although that did not happen during the early stages of the Covid-19 crisis, by the end of the year interest rates in many emerging markets had fallen. Total returns in US\$ terms from emerging market local currency bonds were 2.3% for the full year.<sup>1</sup>

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# 7

Incorrect

## Banks bounce

We thought that, having been out of favour for a long time, bank stocks were due for a bounce. There was a bounce in banks' performance late in the year, but that was not enough to prevent an underperformance for the full year due to the dramatic economic impact of the Covid pandemic. The MSCI World Banks index produced total returns in the year to 11 December 2020 of -13.8%, compared to a 14.5% for the MSCI World index.

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# 8

Correct

## Smaller caps recover

The small cap index we highlighted (the Russell 2000 index of US small cap stocks) returned 16.0% in the year to 11 December; the S&P 500 index of large cap stocks returned 15.4% over that period.

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# 9

Partly  
Correct

## Brexit boost

We saw the potential for sterling to recover against the US dollar to the US\$1.35-US\$1.40/£ range. On 14 December 2020 it was just inside that target range. However, UK equities underperformed global markets.

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# 10

Correct

## Tripolar world

We thought that, with the trade war between the US and China continuing, the world would evolve towards a tripolar arrangement. Certainly, the evolution has been in that direction and this remains a theme for our 2021 *Outlook*.



<sup>1</sup> Source: Bloomberg; for the year to 29 December 2020.

# Synchronised global economic recovery



We see synchronised growth across all the major economies for 2021. After the sharp contraction in 2020, an across-the board expansion will take place.

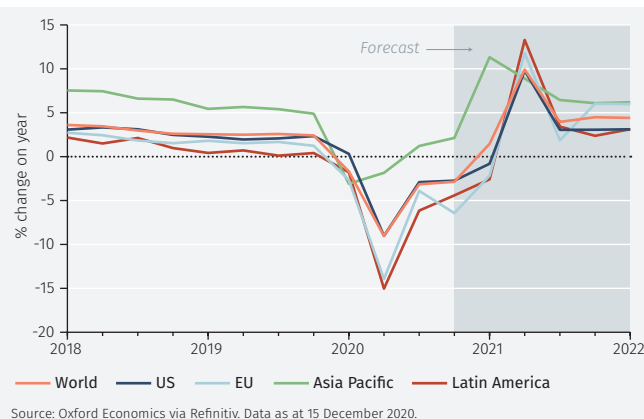
We see a broadly synchronised global economic recovery in 2021 (see Figure 1). The Asia-Pacific region, led by China, was the first to experience the Covid-19 related downturn in 2020 and has been the first to recover. We expect this to continue into 2021.

Globally, however, progress in the first half of 2021 is unlikely to be smooth. The path will depend on the speed with which vaccines are deployed, the extent to which lockdown restrictions are eased (or, as is still possible, tightened) and, most important of all, the degree to which business and consumer confidence returns.

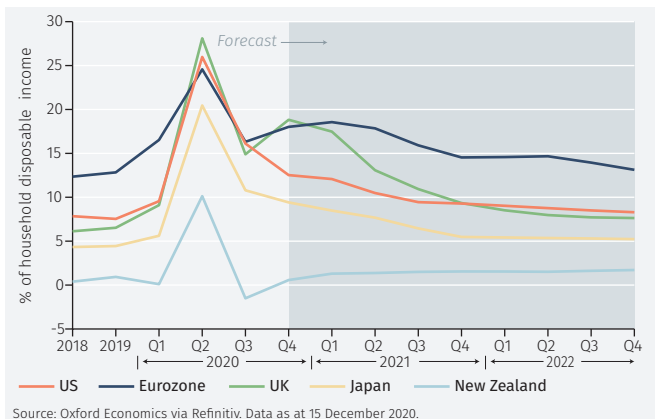
Consumer spending on entertainment, travel, concerts and sporting events has been particularly badly hit. As a result, savings have been built up (see Figure 2). The evidence from countries that have opened up after the virus has been successfully contained (such as China and New Zealand) is that these savings are quickly run down again, with spending especially strong in areas on which it was not possible to spend during lockdowns.

In the second half of 2021, we therefore expect a smoother path for growth in the developed economies as the virus subsides and confidence builds.

## 1. Synchronised global recovery: real GDP growth



## 2. Savings set to be run down



# Digital consumers

Changing consumer spending patterns will be a big theme in 2021 and beyond. Some will be a continuation of trends set in train by the pandemic. Others will be part of bigger structural changes.



Changing consumer spending patterns will be a big theme in 2021 and beyond.

Most significant will be the move to online, digital sales channels. In the UK, the first wave of Covid-19 saw as much as one third of retail spending take place online – up from a fifth in 2019 (see Figure 3). There, as in the US, the move to online and digital sales has been a slow-burn phenomenon which has been accelerated by the pandemic. We think the trend is most unlikely to reverse, especially as online shopping has become somewhat easier (doorstep, contactless delivery, for example) while the high street shopping experience has been compromised by store closures and residual health concerns.

Measuring the extent of sales taking place online is not straightforward. Most economies measure online sales of physical goods only; but it is clear that many of the services which boomed in the pandemic were delivered online (videoconferencing, online gym sessions and medical consultations are just three examples). China, in contrast to all other economies, does measure sales of online services; when these are considered, online sales account for almost 30% of retail sales (see Figure 4).

### 3. Share of retail sales online: UK and US



Associated with this trend are other important developments. Loyalty has been tested as retailers with the best online presence are often not those with the strongest presence in the high street. Retailers without a physical store presence, and especially those with a lead in automation, typically have lower costs; and consumers can make easier price comparisons while shopping online. These trends reinforce the likelihood of continued low inflation.

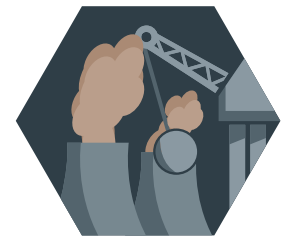
The IPOs of Airbnb, DoorDash and various fintech companies around the world in late 2020 show that consumer services are undoubtedly a very big aspect of the trend for consumers to adopt digital solutions.

Indeed, it is in this area that the rebound in consumer spending is likely to be most apparent as 2021 evolves.

### 4. Digital consumers: UK and China lead



# Climate change and creative destruction



2021 is a year when we expect the forces of creative destruction to be truly unleashed, especially in the energy and transportation sectors.

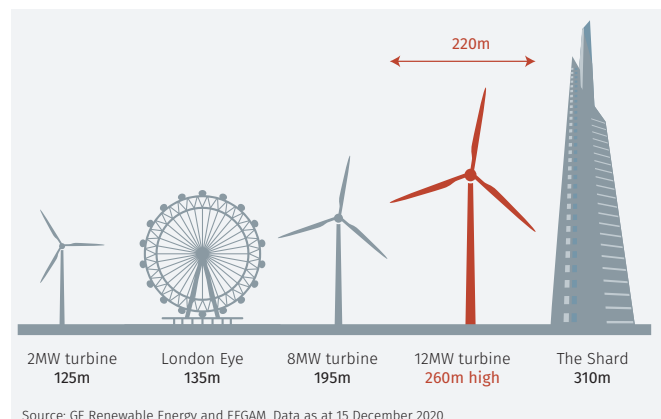
‘Creative destruction’, the term coined by economist Joseph Schumpeter, describes the way that economies create new inventions and methods of production which destroy old methods. In two key areas – transportation and energy generation – we see that process manifesting in 2021.

In transportation, the rise of electric cars, slow so far (see Figure 5), will accelerate. Partly this is because the mainstream car manufacturers will roll out a product range which can compete with more specialist electric vehicle manufacturers. Improved battery technology will further extend the range of such cars; and government action – notably measures such as the UK’s ban on sales of conventional (petrol and diesel) cars from 2030 – will reinforce the trend. Just as the replacement of horses by motor vehicles started slowly but then quickly gathered pace, so too will electric vehicles start to quickly replace conventional vehicles.

That will be part of a general trend towards electrification of economies – including other forms of transport, heating and industry. It is a trend which will be especially notable across Europe, China and, under the Biden administration, the US. Aligned with that trend will be a change in energy production, away from fossil fuels and with a much greater emphasis on electricity from renewable sources. In the UK, very large offshore wind turbines will be installed (see

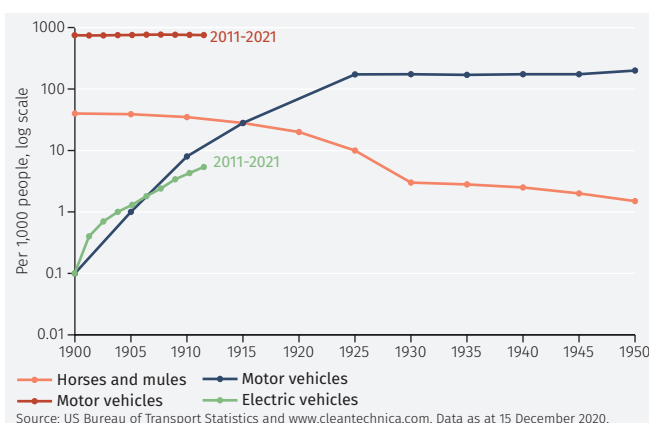
Figure 6) from 2021 onwards. The government’s (realistic) plan is for offshore wind to generate all the UK’s electricity by 2030.

## 6. Wind power: increased size and scale

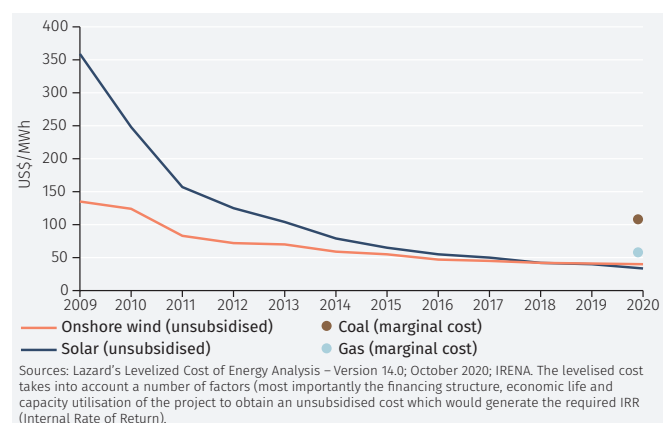


Even more important, wind and solar power are now cheaper in many cases than fossil fuels (see Figure 7). Of course, the concern is that such sources do not provide a smooth stream of electricity but we are encouraged by developments in battery technology: these both increase storage capacity and reduce the cost of doing so.

## 5. From horses to cars to EVs



## 7. Declining cost of renewables



# Inflation stays low

Despite the synchronised recovery and continued high government spending, we expect inflation to remain low. Excess supply will still characterise many global industries. Fears that a surge in monetary growth will lead to higher inflation will prove unfounded.



The synchronised global recovery and continued large government spending and deficits are unlikely to put any significant upward pressure on inflation. The main reason is that, despite a recovery in demand, many sectors of the global economy will be characterised by excess capacity in 2021. That will be the case in sectors (such as oil and energy) which have a particularly important effect on the overall inflation rate. Furthermore, with consumer confidence and spending building only slowly, we see consumers as remaining very price sensitive.

The evidence from those economies that have made a good recovery from Covid-19 is that inflationary pressures are muted. Consumer price inflation in China, at 0.5% year-on-year in October 2020, was the lowest in over a decade; and with producer prices falling by over 2% year-on-year, there is little inflation in the pipeline. New Zealand, also successful in tackling Covid-19, saw its inflation rate fall to just 1.4% in the third quarter of 2020.

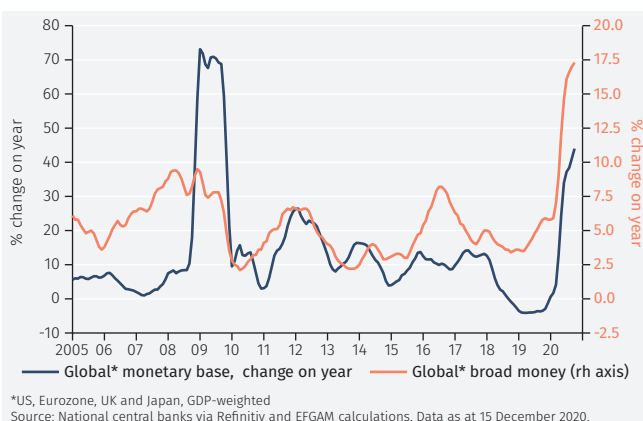
Some, however, point to the rapid rate of money growth seen across several advanced economies as indicating that higher inflation could lie ahead. Two monetary developments are of particular interest.

First, the sharp increase in the monetary base which has been similar to that seen in the Global Financial Crisis (see Figure 8). Now, as then, this increase reflects a rise in banks' reserves which in turn is due to central banks' asset purchases. Once again, we do not see this as presaging higher inflation.<sup>2</sup>

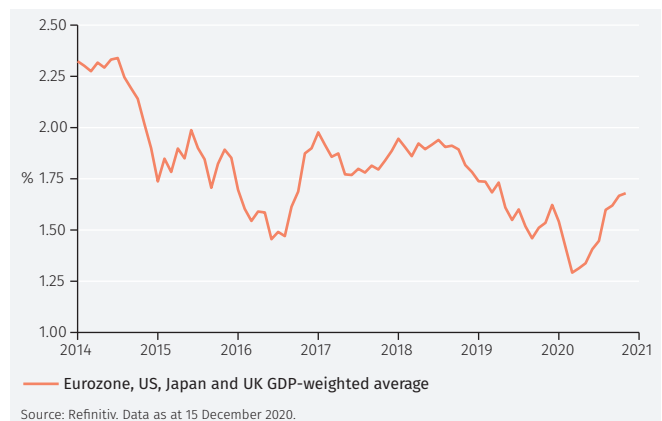
In contrast to the GFC, broad money growth has increased: this potentially poses a bigger threat to future inflation. However, the increase in broad money growth has largely reflected precautionary behaviour by the private sector: for consumers, an increase in bank deposits as consumer savings rates have surged; and, for businesses, an increase in their bank deposits as credit lines have been drawn down to bolster balance sheets and investment spending has been delayed.

So, unless this faster broad money growth is maintained – which we think is unlikely – the threat of higher inflation, certainly in 2021, seems exaggerated. That expectation is reflected in financial markets' pricing of future inflation in the major advanced economies (see Figure 9). Such expectations can be very fickle; but currently we think they are well-founded.

## 8. Global money growth



## 9. Expected inflation rates (5 year average, 5 years ahead)



<sup>2</sup> For a detailed explanation of the reasons for the disconnect see EFG *Infocus*, 'The Fed's balance sheet and the missing inflation', June 2020.

# Big government stays big



Governments have necessarily played a big role in the pandemic response and their spending has surged. They may well seek to scale back their spending or increase taxes in 2021. But such measures will be hard to introduce.

Governments clearly had a big role to play in the pandemic response and their spending has surged (see Figure 10). The worry, as Milton Friedman quipped, is that “there is nothing so permanent as a temporary government programme”. One example is the UK furlough scheme, which saw the government pay 80% of a worker’s pay to avoid redundancy. It should have ended in the summer but was extended twice, currently to March 2021.

In general, rolling back government spending will be a hard task, especially given the (entirely appropriate) increase in pay which we expect to see for key health and social care workers.

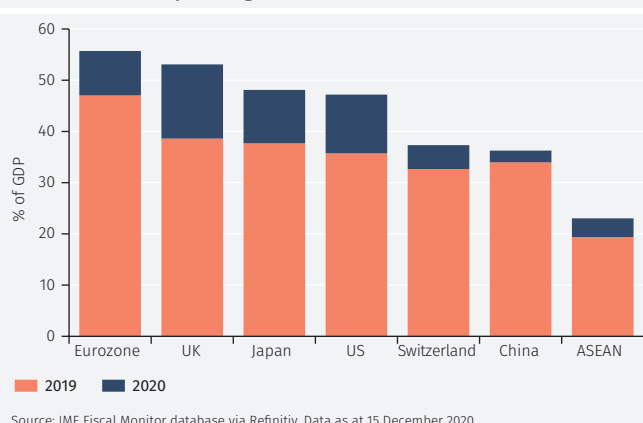
So, while Friedman’s maxim may well exaggerate the risks, it is equally the case that once the level of government spending has been ratcheted up, it is difficult to scale back.<sup>3</sup>

Governments will toy with the idea of raising taxes but we think that is unlikely in 2021 and would be a mistake. So government budget deficits look set to remain high for at least several years.

As long as the cost of financing government borrowing remains lower than the nominal growth rate of the economy, the government can run a budget deficit without the debt level exploding.<sup>4</sup> But while conditions are expected to be favourable for government borrowers in the next year or so, it would be hazardous to believe that this will be a permanent situation.

The more interventionist role which governments have adopted as a result of Covid-19 may well extend to other areas in 2021. In particular, greater regulation of large tech companies seems likely to be a key theme during the year.

10. Government spending



<sup>3</sup> A phenomenon first identified by economist Alfred Wagner in the nineteenth century and developed by Peacock and Wiseman. <http://econjournals.com/index.php/ijefi/article/viewFile/1317/pdf>

<sup>4</sup> A point discussed in our EFG *Infocus* ‘The fiscal dilemma: interest rates versus growth’, November 2020.

# Fixed income: attractive opportunities remain



Despite low government bond yields across the main developed markets and tight credit spreads, opportunities in fixed income remain. We see good risk/return profiles for wealthy nations' debt and convertible bonds.

With inflation expected to remain low across the advanced economies for some time to come, longer-term government bond yields are also likely to remain anchored (see Figure 11). However, the durability of US low inflation and bond yields has been questioned repeatedly in recent years. In 2021 the main concern is that with high deficits and debt levels governments may not be able to borrow as cheaply. Rising bond yields and the associated capital losses are a real concern.

This is one important reason why we think a continued emphasis on bonds issued by wealthy nations – those with limited borrowing and net external assets – are particularly interesting. Such issuers, especially those in the Gulf region and selected emerging markets, have stronger financial positions than many developed countries and their sovereign and quasi-sovereign bonds can offer an attractive yield pick-up.

Convertible bonds – those with a provision for converting into the equity of the issuer – are another interesting area of the fixed income market. Returns from such US bonds have been good for a number of years and were particularly attractive in 2020 (see Figure 12).

Both hard currency (e.g. US dollar or euro-denominated) and local currency-denominated emerging market debt remains an interesting area. That will be especially the case if we are right in our expectation of a synchronised global economic recovery, with emerging and advanced economies both recovering in 2021.

So, despite low yields in the main government bond markets, in our view these three opportunities in fixed income – wealthy nations, convertible and emerging market debt – offer good return opportunities with limited risk.

11. US 10-year Treasury yield and inflation



12. Bond market sector returns, % pa.

9.6%	59.4%	18.1%	13.6%	19.6%	24.4%	7.8%	1.5%	14.3%	16.8%	1.0%	23.0%	40.2%
8.3%	50.7%	14.8%	6.2%	18.1%	7.3%	6.1%	-0.2%	10.7%	14.4%	-0.7%	12.6%	9.7%
4.8%	35.6%	12.9%	6.2%	16.1%	-1.4%	3.6%	-1.4%	9.0%	10.4%	-1.2%	12.1%	8.0%
-2.4%	20.2%	10.9%	5.8%	15.6%	-2.6%	3.1%	-2.0%	7.9%	9.6%	-1.3%	11.1%	7.7%
-16.2%	11.4%	6.3%	5.6%	7.0%	-2.7%	0.6%	-2.7%	4.7%	7.5%	-2.0%	8.4%	5.3%
-26.9%	6.9%	5.9%	3.1%	4.3%	-4.3%	0.0%	-3.2%	2.1%	7.4%	-3.0%	6.8%	4.4%
-34.6%	5.9%	5.5%	0.6%	2.6%	-5.1%	-1.0%	-3.7%	1.7%	3.0%	-4.1%	6.4%	3.6%
n/a	3.3%	5.4%	-5.3%	2.0%	-8.6%	-3.4%	-11.1%	1.7%	2.5%	-5.7%	5.6%	2.1%
2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020*
US convertibles	Global aggregate	Emerging markets local currency bonds	US TIPS	Global government	Emerging markets hard currency	US mortgages	Global high yield					

\*Data to end-November. Source: Bloomberg Barclays indices. Data as at 15 December 2020. Past performance is not necessarily a guide to the future.

# Small is beautiful

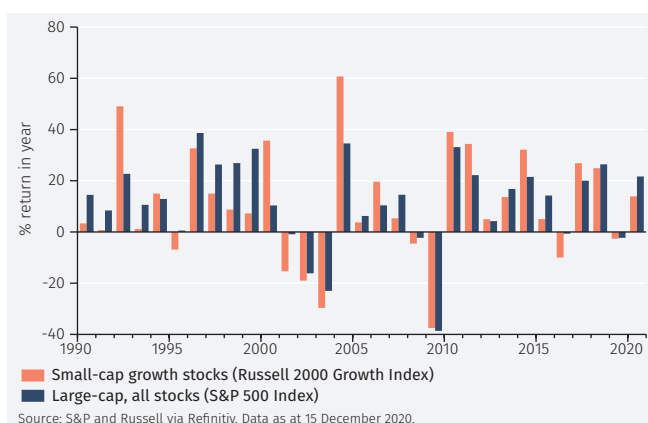
In 2020 many of the innovative products and services which came to the forefront had their origins in small companies. We look for small innovative companies to again make a splash in 2021, but exposure needs to be selective.



In 2020 many of the innovative products and services which developed rapidly as a result of Covid-19 came out of small companies. At the start of the year, few had heard of BioNTech, TikTok and Zoom; at the end of the year they were on everyone's lips. We look for small innovative companies to again make a splash in 2021.

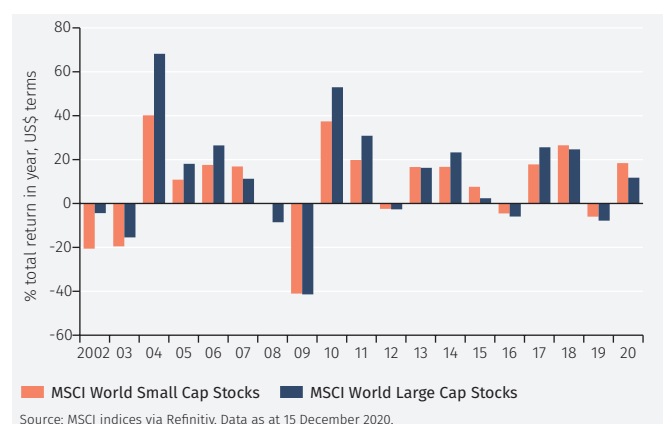
But the projection comes with a word of caution. For a long time, there was a good deal of evidence that small companies produced superior long-term returns to large cap stocks. It became known as the 'small cap premium'. That premium, however, has pretty much disappeared recently. For example, the US small cap growth sector has underperformed large cap stocks in four of the last five years (see Figure 13).

## 13. US small cap growth stocks vs large cap stocks



However, it is interesting that in 2020 global small cap stocks outperformed large cap stocks (see Figure 14). This reflected, in particular, the stronger performance of small cap stocks in Asia.

## 14. World large and small cap stocks



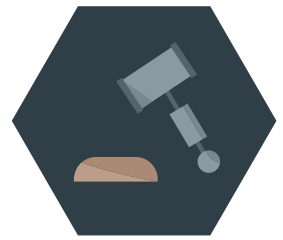
We think the performance of small cap relative to large cap stocks is due a revival for three main reasons. First, and most important, the agility and flexibility which is often found in small companies can allow them to be leaders in innovation. One criticism of this view that is sometimes made is that small companies lack scale. However, access to new technology, especially cloud-based computing, means that small companies can more easily and more cheaply increase their scale than in the past.

Second, small companies typically focus on a narrow area in which they have expertise.

Third, plentiful liquidity has been built up to support such companies. This is seen in the high levels of private equity dry powder (money raised but not yet deployed) and the recent growth of SPACs (special purpose acquisition companies) which seek out small private companies to take public.

# Big tech consolidates

Large US tech companies, which did very well in 2020 – buoyed by remote working, cloud storage, online shopping and so on – will continue to do so in 2021. They will increasingly be seen as regulated monopolies.



Just before the 2020 US presidential election, the House of Representatives published a 449-page report that criticised the practices, achieved as a result of their dominant market positions, of big US tech companies. It recommended increasing competition and strengthening antitrust laws and enforcement. In late December that was followed by the launch of antitrust action against Facebook in the US; UK threats of fines on companies for harmful content; and EU threats to break up big tech companies if they engage in anti-competitive behaviour.

But these companies have three broad advantages. First, they enjoy substantial network effects (as more people use them, the value of what they provide increases). It will be difficult for any US-based new entrant to establish a foothold. Second, the more able competitors are Chinese companies, but it is most unlikely that the US would ease market access for them. Third, US big tech companies are financially strong and well able to defend any legislative changes or antitrust cases against them.

One less-discussed option is to regulate US big tech companies more tightly: a federal agency overseeing big tech would be one possibility. There is a precedent. In 2009, after President Obama's election, the tobacco sector became, for the first time, regulated by the US FDA (Food and Drug Administration). In a somewhat paradoxical sense, that provided a degree of protection to the sector,

which then performed very well compared to the overall market, not least because of a wave of consolidation (see Figure 15). Even so, is it realistic to think that any federal regulator could successfully change the practices of big tech companies? Tobacco is a harmful product; and while there are complaints about the power of big tech, it has clearly brought substantial benefits to the US and global economy.

On balance, therefore, we still see US big tech continuing to do well in 2021 and beyond. Increasingly, such businesses will be seen as regulated monopolies. The cash flow generation of such companies is strong and their valuations can, we think, be justified.

15. Regulation may be no bad thing



# Healthcare sector



We see good opportunities in the healthcare sector. It is a sector with a variety of different companies, which look able to benefit from the important trends we see in the industry in 2021.

The healthcare sector is attractive for 2021 for three main reasons. First, it offers exposure to one of the most important global social megatrends – an ageing population and increased demand for healthcare for the elderly.

Second, large healthcare companies are still relatively defensive, dividend paying companies which are attractively valued. In aggregate, the companies in the US S&P 500 healthcare sector (see Figure 16) trade at a lower forward price/earnings multiple than all sectors apart from financials. We think this partly reflects concerns about the possible policies of President Biden but any likely changes seem well discounted in current valuations.

Third, the entire sector was disrupted by Covid-19 and the opportunities which arise from that will, we think, come to greater fruition in 2021 and beyond.

Most importantly, Covid-19 has triggered a much broader adoption of new digital technologies, especially remote patient consultations and diagnostics. At the same time, wearable devices for activity tracking, health monitoring and screening, look set for much broader adoption.

Minimally invasive techniques and robotic procedures are being seen in areas from heart surgery to orthodontics. The introduction of many of these new technologies is likely to be led by tech, rather than healthcare, companies further enhancing the competitive dynamic in the industry.

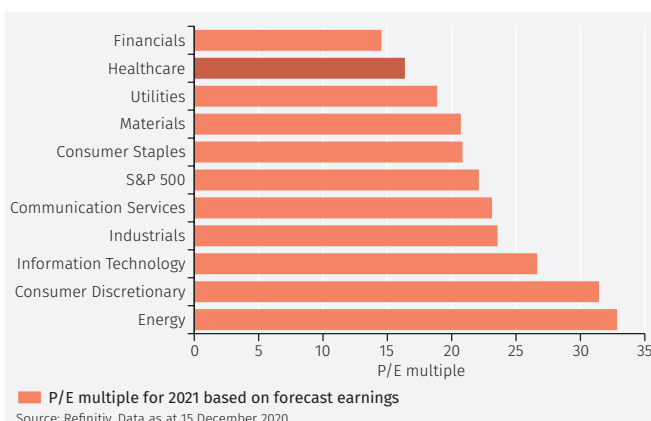
The healthcare sector has had an unfortunate reputation for operational inefficiency (fax and postal mail are the sector's preferred methods of communication in many cases) and this, too, can be transformed with digital technologies.

According to a study by McKinsey, global revenues from the broadly-defined digital health sector could increase to US\$600bn in 2024, up from US\$350bn in 2019.<sup>5</sup>

In the US, one risk is that the unemployment rate remains elevated and there is a loss of premium employer-sponsored health insurance: this could impact demand. Outside the US and especially in Asia, penetration of consumer healthcare products and ecommerce in the sector is low and is set for rapid growth.

Globally, we expect this to be an important factor contributing to a high level of merger and acquisition activity in the sector.

16. S&P 500 price/earnings ratios: 2021 forecast



<sup>5</sup> <https://www.mckinsey.com/industries/pharmaceuticals-and-medical-products/our-insights/healthtech-in-the-fast-lane-what-is-fueling-investor-excitement>

# Global co-operation reinvented



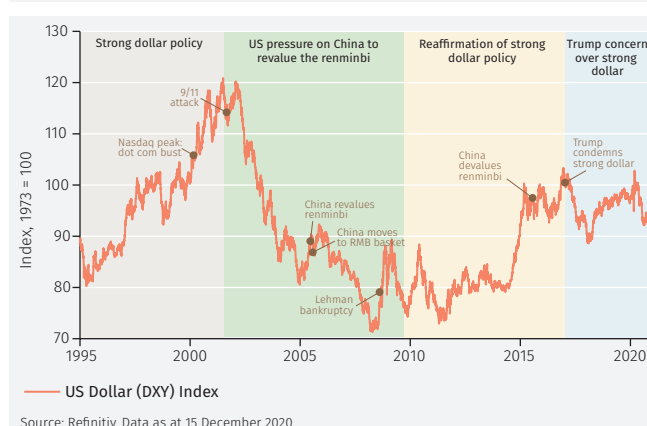
We see a spirit of greater co-operation returning to global relations. President Biden will clearly have a different style to his predecessor. His approach is almost certainly set to be more consensual, cross-party and multilateral.

President Biden will clearly have a different style to his predecessor. He may well use Executive Orders to elicit swift change in some areas: re-joining the Paris Climate Agreement and the World Health Organisation, for example. But Biden's likely more consensual, cross-party, multilateral approach will bring slower, more solid improvements. This will be welcomed by US businesses and financial markets and, we think, the international community. As far as China is concerned, 2021 marks the 100th anniversary of the Communist Party's formation, an anniversary which the country would presumably like to celebrate peacefully.

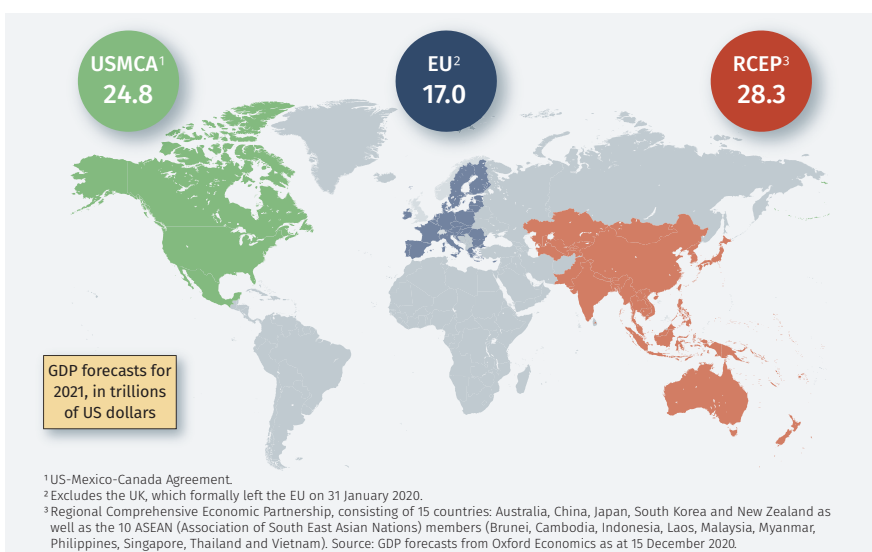
Although the world continues to evolve towards a tripolar arrangement, with supply chains more concentrated within large regional groupings (see Figure 17), it is unrealistic to think that China and the US can isolate themselves from each other. China imports more electronic integrated circuits than oil;<sup>6</sup> and those electronic imports rely to a great extent on US technology. Meanwhile, the experience of the last four years shows clearly that it is fanciful to think America can re-establish the manufacturing industry that moved to China.

The new administration's attitude to the US dollar will be closely watched. We doubt that there will be an overt commitment to a strong dollar policy. That was the policy from the mid-1990s until the early 2000s; and, after a period when attention changed to pressing China for a renminbi revaluation, from 2009 to President Trump's election (see Figure 18).

18. The rise and fall of the US dollar



17. A tripolar world



President Trump claimed that “the dollar is too strong and it is killing us” shortly before his inauguration. The dollar's DXY index fell 9% between then and 1 December 2020. According to our estimates, the dollar is still around 9% overvalued on that index measure. This suggests that over time it is more likely than not that it will decline.

Furthermore, as the world economy recovers and risk aversion recedes, that should also generally favour non-US dollar currencies.

<sup>6</sup> Source: Refinitiv; 10 December 2020.

# Macro Team



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Macro strategy is at the heart of our investment approach. Our macro team's work influences decisions not only at an asset class level, but also allocations at a geographic, sector and individual stock level.

# Investment Publications

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## Intime: Daily Market Note

Daily Market Note, summarising the most important market-moving events from the past 24 hours.

**Frequency:** Tuesday to Friday.  
Online only



## Invision: Weekly Macro Note

Weekly Macro Note, outlining the past week's main macroeconomic events.

**Frequency:** Every Monday.  
Online only



## Inview: Global House View

Global House View and Investment Perspectives; offering asset allocation guidelines, macro overview and investment ideas.

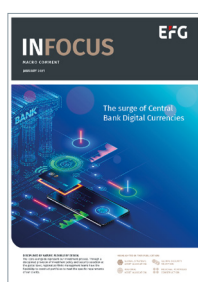
**Frequency:** Monthly



## Insight: Quarterly Market Review

Quarterly Market Review. High level overview of asset market performance, key regions and includes a special focus.

**Frequency:** Quarterly



## Infocus: Macro Comment

An analysis of prevailing market events.

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## Beyond The Benchmark: The EFG Podcast

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