OUTLOOK FOR 2021

An end to the crisis is in sight, with greater visibility for the markets

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Outlook for 2021: An end to the crisis is in sight, with greater visibility for the markets

Experts at Ostrum Asset Management expect the clouds to lift and risk to potentially ease in 2021 after 2020 was dominated by the Covid-19 crisis. However, challenges still remain, with growth set to vary considerably from one region to another as countries and zones have responded very differently to the crisis. Interest rates look set to edge up slightly, although remain low, and here at Ostrum AM we have reviewed our asset allocation to draw on the equity rally that kicked off at the end of 2020.

MACRO – What stakes and challenges are ahead for 2021?

- Varying growth momentum in China, the US and eurozone
- Inflation not expected to accelerate
- New balance in economic policies
- Level of public debt, particularly in Europe and the US

STRATEGY – Persistently depressed bond yields, but a modified risk profile

- Low for long rates
- A modified risk profile
- Shiller P/E ratio: very tight equity market valuations
- And what if inflation returned?

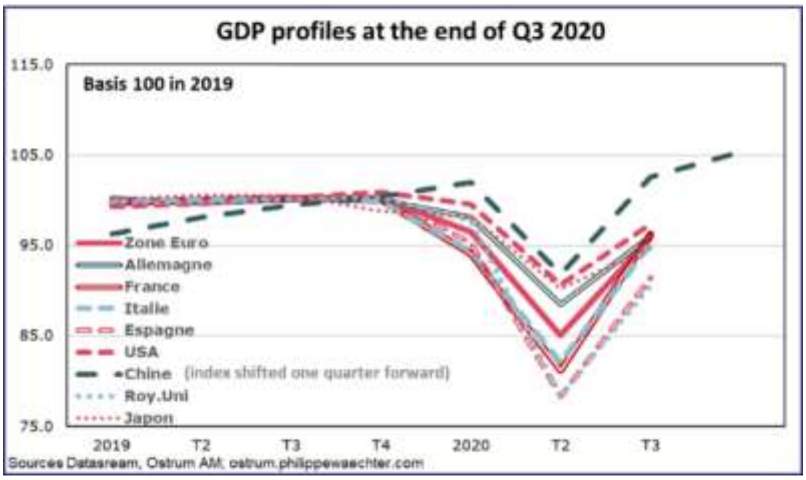
PORTFOLIO MANAGEMENT – Where can value be found in 2021?

- SOVEREIGN - focus on satellite countries
- CREDIT - potential for tighter spreads
- EQUITIES - growth making a comeback
- ALLOCATION - caution in the short term
- What are the potential risks for 2021?

MACRO – What stakes and challenges are ahead for 2021?

- Are central banks likely to keep basing their actions on what governments are doing for long?
- Management of the pandemic: vaccines will help lower risks and uncertainties in the economic cycle, in turn supporting the recovery, but vaccination will not be universal.
- Between China, Europe and the US, the global economy is set to become even more polarised in 2021. The policy adopted by the White House will be key.
- Momentum is expected to be relatively robust in terms of business investment.
- Global trade is solid with industrial momentum still going strong.

According to Philippe Waechter, Chief Economist at Ostrum AM, the more uneven showings from the various economies are down to the diverse range of individual economic policies rolled out in response to the health crisis. Similarly, unequal performances between goods and services sectors are set to have long-lasting effects on both output and the use of services, and these lingering consequences will firmly emphasize the role played by fiscal policy, as the crisis forces a rethink of economies' growth potential. The effects of Covid-19 vaccines should drive economies to revisit 2019 levels in 2021, but we will need to wait until 2022 or 2023 to set GDP back on a par with 2020's potential performances in a non-crisis scenario.



Contrasting growth momentum between China, the United States and the euro area.

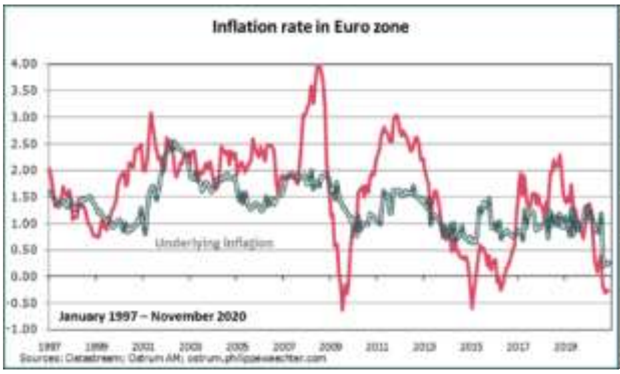
China is enjoying a solid situation and growth will be driven by the country's import substitution strategy in 2021, albeit with the presence of financial risk. Moderation will follow as the country gets back on track to its 5% pre-crisis growth, with 2021 GDP poised to outstrip 2019 figures.

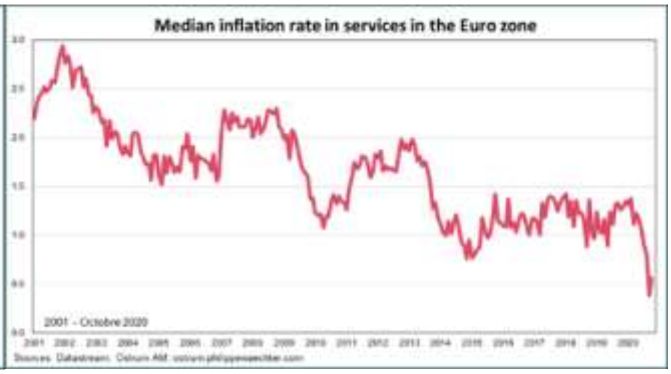
Meanwhile the situation in the United States is more challenging as the pandemic is taking a severe upsurge in the country. Growth will be pedestrian, and maybe even negative in the first quarter, making a stimulus program absolutely crucial. GDP will not revisit 2019 figures at end-2021, although growth should likely pick up the pace at the end of the year if the stimulus package is approved. Growth in 2022 will be very largely driven by carry-over from end-2021, but will be close to potential i.e. slightly short of 2.5% (growth carry-over is the starting point at the beginning of 2022 carried over from the end of 2021: it may be positive if GDP at end-2021 is above the GDP average across the full year 2021).

On this side of the Atlantic, various stimulus packages in the euro area will help the economy catch up its lag in 2021, as the European recovery plan will be waved through, even if Poland and Hungary veto. We can expect a return to growth potential in 2022 at around 1.5%, and vaccines will help drive this trend.

There is now a lesser risk that inflation will speed up over the months ahead.

Sectors that have been hardest hit will get back to normal, inflation will be higher, but given the time required to build up supply in these sectors, we should not expect a sharp surge in prices. However, inflation will probably be firmer in the medium term to cushion adjustments as the production system gets re-established.





Striking a new balance for economic policy.

Fiscal policy will be the driving force for macroeconomic trends, while monetary policy will merely support this development. Interest rates will therefore remain low for a very long time across all maturities, while central banks will not write off public debt.

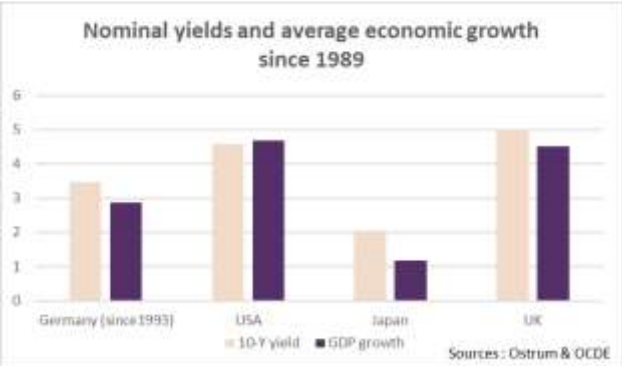
The extent of public debt raises a number of questions, particularly in Europe and the United States, at a time when growth is sluggish and fiscal policies look set to accommodate for a long time to come. How can states tackle a fresh dent to economic activity when national debts are already soaring and central banks' balance sheets are severely bloated by public debt, and what leeway can be carved out for short-term economic policy? Cancelling public debt is clearly a bad idea for a variety of reasons – credibility, euro area integration and sustainability, as ideas on public debt and fiscal policy often clash – but this lofty debt figure must be kept in mind while calls for public action increase. Inflation could be an option...

STRATEGY - Persistently depressed bond yields, but a modified risk profile

Low for long rates

- Decorrelation with fundamentals: interest rates are supposed to align with economic growth, but that is no longer the case. Their divergence with fundamentals is unusually significant and persistent.
- Counter-intuitive equation: more debt equals lower rates
- Based on the ECB's current policy, it is hard to see the Bund climbing above -0.30%.

Extremely low interest rates are the first key theme for the markets, and this trend is set to continue, albeit with a likely uptrend driven by the economic recovery. According to Stéphane Déo, Global Head of Strategy at Ostrum AM, a growing divergence is developing between observed rates and their potential figures if they actually followed economic fundamentals. This can be attributed to very high debt on the one hand, and intervention from the central banks on the other.

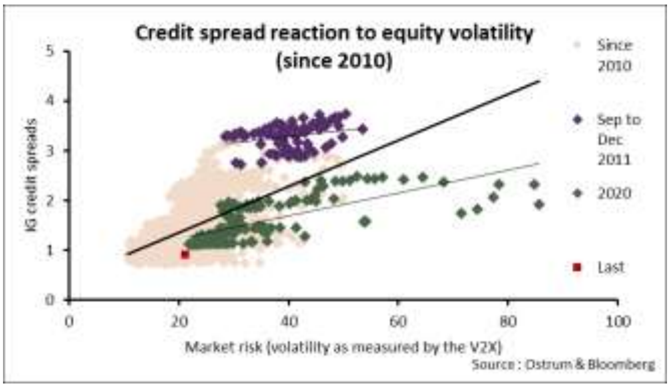


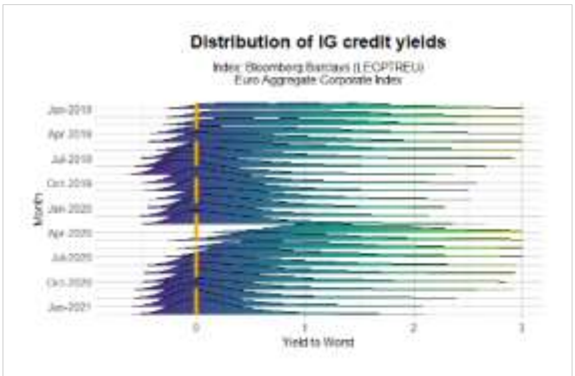
A modified risk profile

- Dramatic decline in yield volatility
- Yield dispersion on the credit market continuously distorted downward since March
- Shiller P/E ratio reflecting very tight equity market valuations, but understandable given current yield levels

The second major theme is easing risk for investors, where central bank action has once again played a crucial role. Sovereign yields reacted in a much more measured way than over the past decade – and credit followed the same path – with two main outcomes i.e. clearer visibility for states and hence greater scope to roll out fiscal stimulus packages, as well as an entirely different risk profile for investors.

Yield dispersion on the credit market continuously distorted downward since March





Shiller P/E ratio: very tight equity market valuations

Virtually all equity valuation measures are near record highs. However, the equity risk premium (i.e. compared to risk-free rates) gives the opposite indication, namely that equities are not expensive relatively speaking. There are two reasons for this:

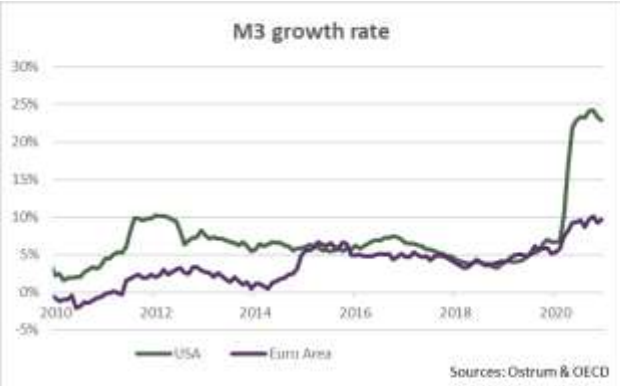
- 1) The infamous “TINA” = there is no alternative!
  e.g. Dividend yield is unusually high compared to risk-free rates.
- 2) The fact that valuations have to adjust to the discount rate.
  e.g. The BdF (French central bank) has shown that PER trends are rational if we factor in the decline in the risk-free rate.

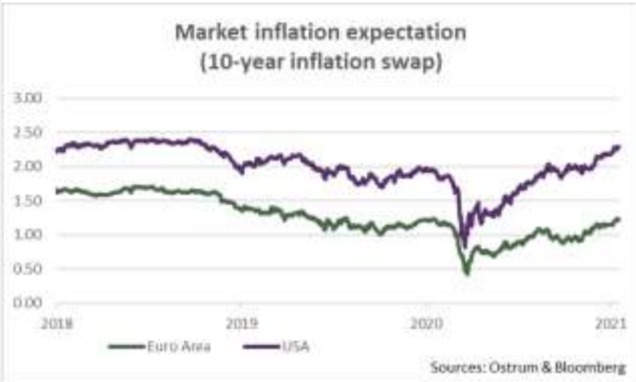
The Shiller P/E ratio (like many other valuation measures) points to very tight equity market valuations. But the same Shiller P/E ratio makes sense compared to current rates, even suggesting positive profitability over the next 10 years.

And what if inflation returned?

- A plausible scenario in light of the very sharp rise in monetary aggregates
- The market is still very hesitant in that regard
- Inflation is not expected to return to 2% for many years, but the markets tend to overreact to inflation news.

Inflation risk is the third main theme, and the markets have entirely failed to price in this factor. The medium-term effects of this crisis are far from obvious. While the short-term effect is unambiguously deflationary, it is plausible that the long-term effects will be reversed. In particular, the very strong progression of monetary aggregates is one of the reasons that may lead to an inflation trajectory much higher than that to which we have been accustomed for the last two decades. The market does not believe in this scenario at all. This may lead to fears of a rapid turnaround. Not only of the curve but of the related assets. We are thinking in particular of an increase in volatility and a rotation on the equity market.





PORTFOLIO MANAGEMENT – Where can value be found in 2021?

Sovereign yields

- Emerging countries
- Peripheral countries
- Steepening
- Green bonds

Credit

- Market dominated by technicals
- Limited issues in 2021
- On the lookout for sectors still relatively overlooked
- High Yield, taking a selective approach

Insurance stocks

- Growth making a comeback
- Energy transition
- Chinese luxury consumer goods
- Technology

Growth projections for the next two years have been upgraded on the back of the much hoped-for success of vaccination campaigns, offering significantly clearer visibility on the economic cycle. With this outlook in mind, Ibrahima Kobar, Chief Investment Officer at Ostrum AM, expects a solid recovery in 2021, shored up by hefty monetary and fiscal policy support.

Investors should continue to seek out yield and this will affect the markets in 2021. Yield on the 10Y Bund and the 10Y UST should gradually pick up and move towards -30bps and +1.30% respectively at the end of 2021, while the yield curve should also steepen, which would prompt us to cut back our allocation on sovereign securities. In a lower risk environment, we also think that peripheral spreads will continue to narrow.

Similarly, the equity markets should be further fuelled by the upturn in growth: with earnings picking up again, indices look set to put in showings of around 10% over the year.

SOVEREIGN - We are still partial to satellite countries

Weighting vs. 2020: reduced

Themes

- Emerging countries still offer an attractive source of return on investment. It's definitely worth keeping an eye on this asset class.
- Peripheral yields are down but risk has fallen. We like Italy because its spreads are relatively too wide.
- The curve should steepen again with the recovery and preliminary signs of inflation.
- The green bond market is fully expanding, with issues of more than €500 billion planned in 2021, including three new sovereign issuers (United Kingdom, Italy and Denmark). A must-invest market.

CREDIT - potential for tighter spreads that could partially offset the rise in core government benchmarks

Weighting vs. 2020: unchanged

Themes

- A market dominated by technicals, with central banks still intervening heavily to reduce volatility. Net issuance is slated to be low in 2921, at around €60-80bn.
- Our search for yield has led us to some still relatively overlooked sectors: subordinated vs. senior debt, as well as corporate hybrid AT1 instruments. We are sticking with a bias in favour of Financials (excluded from ECB's QE programme) vs. Cyclicals.
- High Yield offers an opportunity for yield + diversification, but you have to take a highly selective approach.

EQUITIES - the asset class should get a boost from renewed growth

Weighting vs. 2020: increased

Themes

- Bias towards emerging countries
- Sectors benefiting from the energy transition: utilities (deterministic European compact), some industrials.
- Exposure to Chinese luxury consumer goods: luxury sector, spirits (but not breweries), some sports brands.
- Tech: undeniable FCF generation, barriers to entry, overarching trend towards more technology.

ALLOCATION – caution in the short term

The markets adopted a much more positive attitude in the wake of the US elections and the Covid-19 vaccine announcement. November and December proved to be very risk-on months. As a result, the market started off 2021 with relatively optimistic valuations and needed time to catch its breath.

We are being cautious in the short term, especially considering that the health crisis is not as well under control as one might have hoped, with new variants emerging, vaccine efficacy called into question and vaccination campaigns very slow to get under way. The horizon is not as clear as it seems.

By the end of the year at least, it is reasonable to assume that a substantial percentage of the population will be vaccinated and we will have finally turned the tide on the Covid-19 virus. At that point, an economic upswing will take hold.

Against that backdrop, we expect rates to climb even as central banks maintain a highly accommodative stance, thus steepening the curve.

The default rate should also decline - we put it at around 5% at the top of the year for the Europe HY segment - bringing yield spreads down in its wake.

Lastly, equity valuations are very high, so we don’t expect P/E ratios to expand, but normalising profits should stimulate the markets by about 10% in Europe, in our view.

Accordingly, we are taking a measured risk-taking stance that will give us exposure to asset classes poised to benefit from the normalisation of economic activity.

Our views for 2021, allocation and major asset classes

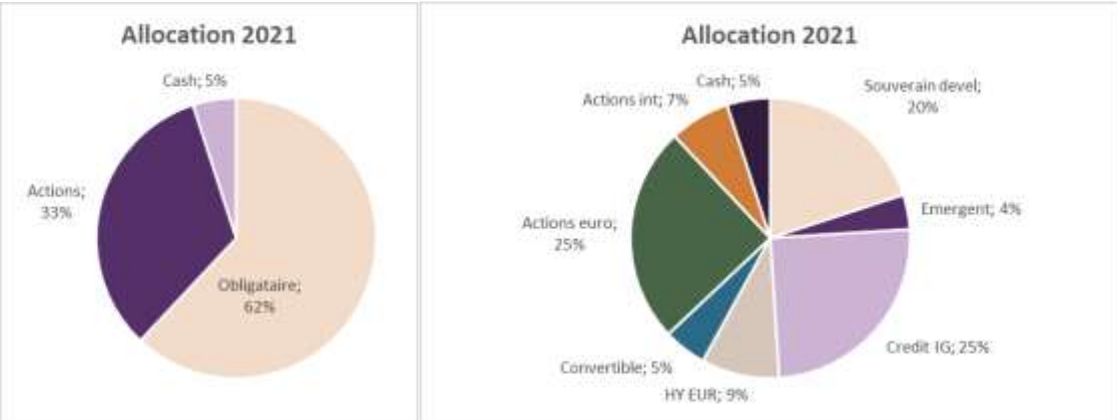
Relative views	Negative -	Neutral	Positive +
Equity vs Soverein			X
Equity vs Credit			X
Credit vs Soverein			X
Equity EURO vs US			X
Equity EUR vs EM	X		

Source : Ostrum AM, 14/12/2020

Sovereign	Negative -	Neutral	Positive +
US	X		
Bund	X		
OAT	X		
Emerging			X

Credit	Negative -	Neutral	Positive +
Investment Grade		X	
High Yield			X

Equity	Negative -	Neutral	Positive +
EUR			X
US			X
Emerging			X



Source: Ostrum AM, 14/12/2020

What are the potential risks for 2021?

1. Inflation

Probability: low over the next 12 months, plausible thereafter.

Scenario: inflation surprises on the upside; central banks stick to their commitment, not reacting and letting it slide.

Outcome: yield curve repositions very quickly (steepening), particularly with breakeven inflation on the rise. Growing knock-on effect on volatility, and major sector rotation in favour or equities.

2. Fiscal orthodoxy

Probability: low. The US and Europe alike are unlikely to venture down this path.

Scenario: in light of the recovery and monumental level of public debt, governments veer back towards fiscal conservatism and cut off support to the economy too soon. Growth flags as a result.

Outcome: a risk-off environment returns, sovereign yields tumble, risk assets (from credit to equities) take a hit.

3. Burst bubbles

Probability: low. There is no real evidence of a risk asset bubble.

Scenario: equity valuations are way too tight. The bubble bursts and we plunge back into a “2001” scenario. Of course, the argument would be just as valid for credit this time around.

Outcome: even more QE. The Fed and ECB could end up following the BoJ’s lead and buy equities. The curve remains hopelessly flat, risk assets suffer.

4. Collapse of the USD

Probability: low. That said, the gradual depreciation of the dollar is a very real possibility.

Scenario: the dollar picks up the pace of its decline, investors lose confidence and outflows swell. The twin deficits, forgotten by the markets, return to the forefront.

Outcome: the virtuous attributes of a depreciating dollar for some assets (EM, European equities) turn sour due to the precipitous nature of the downturn. Risk premiums take off once again and risk assets are impacted.

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Ostrum ASSET MANAGEMENT

ADDITIONAL NOTES

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