TierOne

World Economic and Market Outlook – 2021

Summary

When Economist and Harvard Professor Lawrence Summers identified the central importance of 'secular stagnation' (where there is little or no economic growth) for the global economy in his speech at the IMF in 2013, he put his finger on the most important driver for financial markets for the remainder of that decade. For those believers in an era of secular stagnation the opportunities provided by high quality growth companies benefitting from a lower discount rate on future rapid earnings growth in a low growth world has provided a meaningful and extremely profitable investment opportunity. Summers interpretation of the term argued that excess savings relative to intended investment had driven the global equilibrium real rate of interest down and well below zero by the mid-2000s making it difficult for monetary policy to provide the typical stimulus after a recession. As a result inflation dropped below the 2% central bank targets in the US, Eurozone, UK, and Japan. It is these forces which explain many of the key trends in global markets over the past decade. Short term interest rates were able to remain "lower for longer" not because central banks wanted to promote a bubble in asset prices, but in response to the downward pressure on equilibrium real rates. This allowed a continuation of the bull market in bonds with nominal and real bond yields continuing to fall in advanced economies even through and below levels previously seen as the effective lower bound (zero). The demand for safe fixed income securities exceeded supply, resulting in a frenzied search for yield which spilled into corporate credit including non-investment grade and emerging market debt, leading to a significant tightening of credit spreads.

As a result equities have benefitted from the lower discount rate on future profits, especially for stocks able to grow earnings on a reliable and regular basis. Corporate profitability benefitted from low wage inflation, another possible symptom of secular stagnation. Even Robert Shiller of Yale University, who had earlier warned of equity bubbles, has more recently written as discussed that lower bond yields support the current high valuation of equities and there is no obvious equity bubble in the overall market at this moment. Equities which gained from technological and structural changes, in particular the US FAANGS (Facebook, Apple, Amazon, Google, and Netflix) have delivered outstanding returns as have many less well known but equally technology enabled disruptive business models, all of which have benefitted the most from declining discount rates. Secular stagnation has also arguably allowed a change in fiscal policy during the pandemic to be received calmly by bond markets who had become accustomed to large scale central bank QE and rising budget deficits. If in contrast global savings had been in short supply high government bond issuance would have raised interest rates, dimming the prospects for economic recovery. The direction of secular stagnation after the pandemic passes into history will remain crucial for asset prices.

Fuelled by vaccine optimism, highly accommodative central bank policies and record fiscal stimulus equity markets have now moved a long way to discounting the anticipated improvement in economic activity over the next 12-18 months. Valuations and investor sentiment are at cautionary levels and the pandemic catchphrase "stay safe" is now appropriate and equity investors need to be very alert to potential threats. Unfortunately, outside of equities there are few other asset classes which look attractive. Cash rates are zero, or in many countries negative, as are high quality government bonds and even investment grade debt has seen spreads contract to levels where absolute yields will not provide the required growth many investors require for their longer term financial planning. Property,

in no small part due to the pandemic, has seen its attractiveness fall both in terms of retail and the likelihood of a contraction in future demand for office space. Equities have become the TINA (There Is No Alternative) asset class, but as more investors have come to recognise this, potential for a short, sharp setback on any bad news increases.

The critical near term economic variable is the virus, the effectiveness of the vaccine and the speed of roll out. There remains solid grounds for optimism here, although the South African strain changes a key part of the spike protein that the virus uses to enter cells, which potentially could, but only could, render the currently approved vaccines less effective. Tests are underway to examine this, with preliminary results from Pfizer appearing encouraging. At current levels equity markets are vulnerable should the timing for the vaccine fuelled economic recovery be delayed.

On the geopolitical front the rivalry between the US and China is likely to persist although in the initial stages of a Biden Presidency the Chinese are likely to adopt a cautious approach. Technology rivalry will remain a key battleground.

Looking a little further ahead to the second half of the year, assuming success with the roll out of vaccines there could be a sharper than expected upturn in global economic activity. This could see an increase in inflationary expectations and it is important that central banks continue to adopt an accommodative stance. Structural disinflationary forces remain but some cyclical inflationary forces are likely to gain ground and gather momentum over the next 12-18 months. There is no reason to yet believe that the three D's of Debt, Demographics and Devices (technological innovation) will result in a long-term breakout of inflation above central bank targets. The best outcome for markets is that the same long-term forces that have dominated recent decades will re-emerge after the pandemic the 'goldilocks world'. A continuation of the global savings glut is likely to keep equilibrium interest rates very low during the 2020s. As a result near zero bond yields should continue to support buoyant equity markets. This year, however, could see expansionary fiscal policy, especially in the United States, challenge in the short term the now more established or consensual view of low inflation and whilst this might be good for the world economy in the short term, it would not necessarily be good for asset prices. The factor most likely to puncture the long running bull market in global equities would be a rise in the long term discount rate applied to corporate earnings. Clearly, this battle will also determine over the short term the relative performance of growth versus value investment strategies. Value stocks typically outperform when growth becomes more plentiful and thus would be the primary beneficiary of the reflation trade if it persisted. Over the medium term, successful growth investors should benefit from the continuation of a winner takes most investment environment, but 2021 is a period when accepting volatility and market shocks is the price to pay for the likelihood of continued long term investment success.

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