

Q2 2021 OUTLOOK

QMA's Global Multi-Asset Solutions Team

MARCH 2021

EXECUTIVE SUMMARY

Economic Outlook:

- Global economic activity is on track for a continued strong rebound in 2021, after the COVID-19 global recession led to an economic rollercoaster ride in 2020.
- Economic forecasters expect the V-shaped economic recovery to continue, supported by significant fiscal stimulus and continued monetary accommodation, paired with greater vaccine inoculation and a relaxation of COVID-19 restrictions.
- The United States is leading the recovery among the advanced economies, while China and India lead a strong recovery in the emerging world.
- Accelerated rollout of the vaccine has moved forward the timeline for reopening economic activity in the United States and the United Kingdom.
- A slower rollout of the vaccine in Europe, in contrast, leaves the Eurozone economy likely facing a double-dip recession, however, we expect European growth to rebound later in the year as vaccines are more widely administered.
- We see upside risks to consensus growth forecasts, especially in the United States, with positive spillovers for key trading partners. Increased vaccine distribution, falling COVID-19 infection rates, and the passage of the \$1.9 trillion stimulus bill have the potential to turbocharge the recovery.
- Given the strong rebound in economic growth and fuel for continued strength, bond yields and market-implied inflation expectations have seen sharp increases.
- A pick-up in inflation this year is likely due to strong growth, supply shortages, and base effects. Whether this rise will turn out to be a temporary or not will depend on how governments and central banks adjust policy once the economy has returned to full employment. This could come sooner than expected, especially in the United States.
- With bond yields surging, major central banks have sought to reassure markets that they will not allow rising rates to stymie the ongoing economic recovery, especially with unemployment rates still high.

Investment Outlook:

- With economic growth surging, the corporate earnings outlook for 2021 is very strong. Stocks are off to a solid start, but more notable has been the market rotation as last year's losers are shaping up to be this year's winners, both in terms of earnings growth and total return.
- Rising growth forecasts, building inflation pressure from very low levels, and continued policy support appear to be the key drivers of market performance. With this potent combination, we continue to pursue a pro-risk investment strategy.
- On asset allocation, we are overweight stocks and commodities relative to cash and fixed income. Within equities, we are pro-risk: favoring value over growth, small-caps over large-caps, and cyclical sectors over defensive and secular growth segments.
- Regional equity strategy is complicated by the size of the US policy stimulus. The US should be expected to underperform during a strong global growth rebound, but given the size of the stimulus and the success of the vaccine rollout, the US is driving global growth. We are currently overweight US and emerging markets relative to EAFE markets within equities.
- Equity returns are unlikely to keep pace with explosive earnings growth this year (due to high equity market multiples), however, we believe stocks will post above-average returns in 2021.
- Government bond returns have been hit by rising inflation expectations. Benchmark ten-year rates could hit 2.0% this year (or even 2.5% in an overshoot scenario), though upside to sovereign bond yields should remain limited by the prospect of increased central bank bond purchases or jawboning, at a minimum.
- Within our fixed income allocation, we remain overweight risk assets, including US high yield bonds, as the pro-risk and strong growth environment could bring spreads lower, despite spreads that are already back at pre-pandemic levels.
- We believe the pandemic caused a final washout in the 12-year long commodity bear market and that a new commodity upcycle has begun.
- The US dollar has showed some strength so far this year, as the US economy has been a standout due to stellar performance on COVID inoculation and continued fiscal stimulus. Nevertheless, we expect the dollar will revert to its weakening trend as the year progresses.

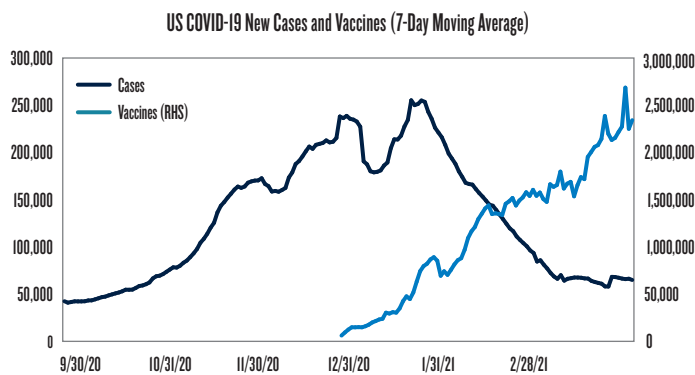
Economic Outlook:

Boom Times Ahead?

Global economic activity is on track for a continued strong rebound in 2021, after the COVID-19 global recession led to an economic rollercoaster ride in 2020. For the full year 2020, US GDP likely fell 3.5%, with larger contractions in Japan (-4.9%), the Eurozone (-6.6%), the UK (-10.1%), and in many emerging markets. China and Taiwan were exceptions, as their economies expanded by 2.3% and 3.1%, respectively, last year, benefiting from an earlier recovery, better overall management of the pandemic, and from their position as critical tech hubs, which thrived during the pandemic due to the accelerating trend in digitization.¹ Following last year's synchronized third-quarter growth surge, Q4 2020 growth was somewhat mixed, with most major economies experiencing solid growth but with output contracting by 2.6% in the Eurozone, as a third wave of the virus led to renewed lockdowns and related restrictions².

In early 2021, investor optimism about the recovery was tempered by concerns surrounding a spike in COVID-19 infections and the virus mutating into more transmissible and/or more virulent strains. Further, significant progress on vaccine testing and approval was followed by a slow and bumpy initial rollout of the vaccines in the United States, raising questions about how quickly restrictions on economic activity could be lifted. But, optimism about the recovery ratcheted higher during the quarter in tandem with progress on vaccine distribution. Since reaching a peak in January following the holidays, new COVID-19 cases in the US have plunged, with the surge in vaccine administration as the key driver of the decline. (Figure 1 shows the significant ramp up in vaccine administration in the US and the subsequent decline in new cases.)

Figure 1: Vaccines to the Rescue



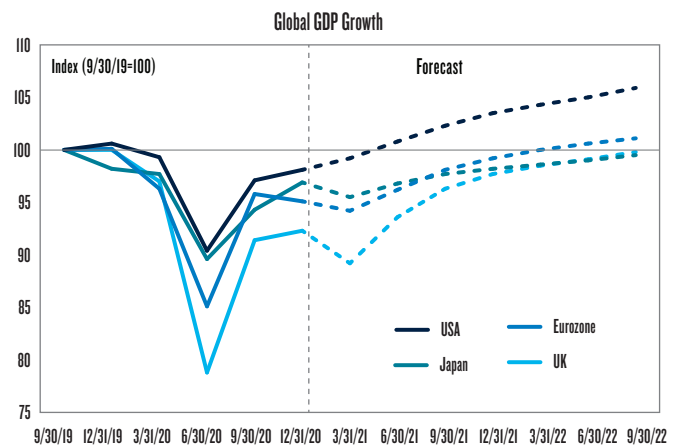
Source: WHO, Johns Hopkins, QMA. As of 3/19/21.

Global COVID-19 cases have also fallen from their peak in January, largely driven by developed markets that have made substantial progress in administering vaccines, especially the United States and the United Kingdom, albeit with some isolated outbreaks (France and Italy). However, emerging markets, led by Brazil, with less access to vaccines are experiencing a fresh wave of increasing COVID-19 cases in March. Accelerated rollout of the vaccine has

moved forward the timeline for reopening economic activity in the United States and the United Kingdom. A slower rollout of the vaccine in Europe, in contrast, leaves the Eurozone economy likely facing a double-dip recession, with negative growth expected to continue in the first quarter of 2021 after a decline in Q4 2020. We expect European growth to rebound thereafter, with a sharp bounce back in Q2 continuing into the second half supported by fiscal and monetary stimulus and a relaxation of restrictions once vaccines are more widely administered.

As highlighted in figures 2 and 3, economic forecasters expect the V-shaped economic recovery to continue, supported by continued fiscal stimulus and monetary accommodation paired with greater vaccine inoculation and a relaxation of COVID-19 restrictions. The United States is leading the recovery among the advanced economies, while China and India lead a strong recovery in the emerging world. Progress on vaccine distribution (or lack thereof) and the resulting trend in virus cases have led to growth upgrades in some countries and downgrades in others.

Figures 2 & 3: Global Recovery Continues



Source: Bloomberg, Consensus Expectations as of 3/19/21. There can be no assurance that the forecasts will be achieved.

	GDP Growth (%)			
	2020	2021 Forecast		
	Actual	12/31	3/31	Change
World	-3.8	5.2	5.5	0.3
USA	-3.5	3.9	5.5	1.6
Eurozone	-6.6	4.6	4.2	-0.4
Germany	-4.9	4	3.4	-0.6
Italy	-8.9	5.4	4.8	-0.6
UK	-10.1	5.3	4.6	-0.8
Japan	-4.9	2.7	2.7	0
China	2.3	8.2	8.4	0.2

Source: Bloomberg, Data as of 3/11/21. There can be no assurance that the forecasts will be achieved.

¹ 2020 saw an acceleration in the shift to electric vehicles, more widespread adoption of artificial intelligence, the rollout of 5G, and increased demand for cloud computing. Both countries are major suppliers of related tech hardware and components.

² All growth estimates referenced are Bloomberg consensus estimates. There can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this document.

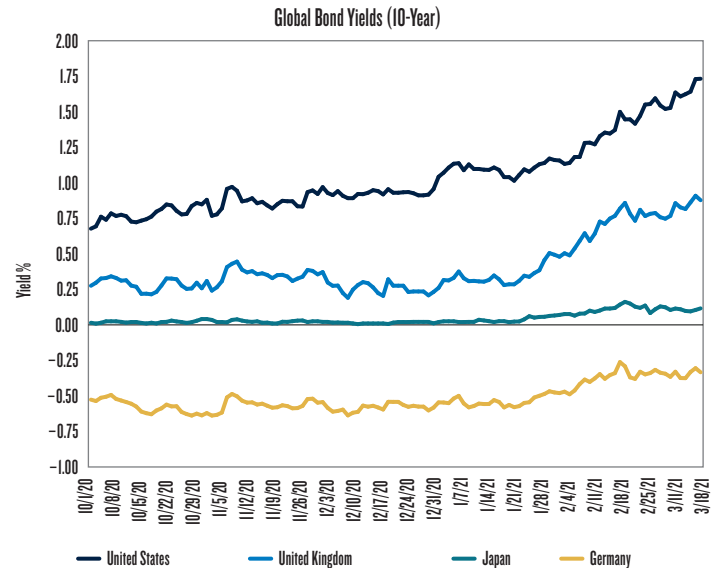
We see upside risks to consensus growth forecasts, especially in the United States, with positive spillovers for key trading partners. Increased vaccine distribution, falling COVID-19 infection rates, and the passage of the \$1.9 trillion stimulus bill have the potential to turbocharge the recovery. Pent-up demand, reopening of economic activity, and a steady increase in employment provide potent fuel for a potential economic boom. Further, given the cumulative impact of government relief over the past year and limited opportunity to spend given virus restrictions, the US now has around \$1.5 trillion in excess savings. Aggregate household savings are now three times the level they were pre-pandemic and should get another boost from the payments to households in the latest fiscal package. Supported by easy financial conditions and the ongoing job market recovery, the US housing market continues to surge.

Given the strong rebound in growth and fuel for continued strength, bond yields and market-implied inflation expectations have seen sharp increases. Headline inflation has risen recently in many developed economies, driven in part by the rebound in oil and commodity prices. Temporary supply shortages in sectors such as semiconductors and shipping are contributing to cost pressures. In emerging markets, additional price pressures could come from currencies depreciating against the US dollar and higher resource prices putting pressure on inflation in commodity-importing countries. Still, underlying price pressures should be contained by sizable output gaps with unemployment rates still elevated in major economies.

Many observers believe that while a temporary rise in inflation may linger due to supply shortages, the pace will likely revert to its pre-crisis norm after the sugar rush of the stimulus-fueled growth surge fades. However, the real test for whether inflation will be higher on a sustained basis will depend on how policymakers respond once the economy has returned to full employment, which could come sooner than expected. Those who are less sanguine about inflation trends note that policy makers (particularly in the US) are seeking to create a “high-pressure economy” that boosts wages to counter the long-term trend of increasing inequality.

With bond yields surging across markets (Figure 4) major central banks sought to reassure investors that they will not allow rising rates to stymie the ongoing economic recovery, especially with unemployment rates still high. Federal Reserve Chair Powell, in his recent semi-annual testimony to Congress and at the March 17th Federal Open Market Committee meeting, sought to downplay inflation fears, noting that the job market still needs to heal. In the Eurozone, where the recovery is lagging, the sharp rise in longer-term interest rates prompted the European Central Bank to announce a significant increase in bond purchases over the next quarter. Bank of Japan Governor Kuroda emphasized that it is important to keep long-term interest rates “stably low,” as the economy is still suffering from the impact of the pandemic.

Figure 4: Global Bond Yields on the Rise



Source: Datasteam. Data as of 3/19/21.

Investment Outlook:

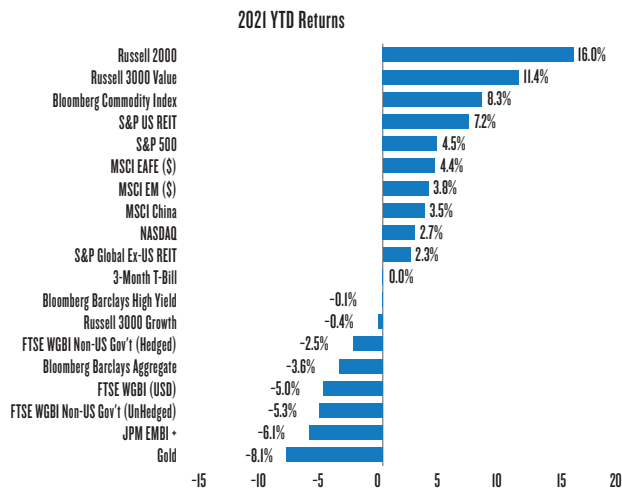
Clear Blue Skies and the Wind at Our Backs

Global stocks are off to a strong start so far this year, buoyed by progress on the vaccine front and the passage of another large fiscal relief package made possible by the Democrats taking control of the US Senate by the narrowest of margins. Political uncertainty eased further with the smooth transition to the new Biden Administration on January 20th, despite violence at the US Capitol earlier in the month during the official certification of the electoral college vote.

With the global economy on track for a robust rebound, the corporate earnings outlook for 2021 is very strong. Global earnings are expected to expand by 30%, and we see significant upside risks to these forecasts. Those regions/sectors that saw the steepest declines in 2020 are likely to see the sharpest profit bounce-back this year. Thus, cyclical sectors like energy, industrials, and consumer discretionary likely will see explosive earnings growth after last year's collapse. More resilient sectors, including technology, healthcare, and consumer staples, are likely to see earnings growth increase this year from 2020, but the acceleration is likely to be tame by comparison. Similarly, more cyclical-oriented regions, including emerging markets, Europe, and the UK, should lead, while the higher-quality US market lags on profit growth.

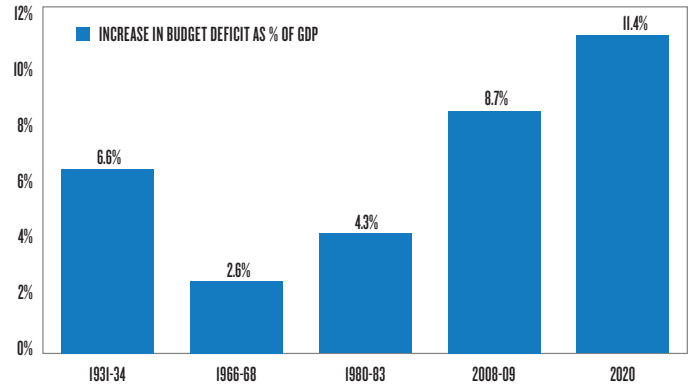
More notable than the performance of the stock market at the index level has been the rotation, as last year's losers are shaping up to be this year's winners, consistent with the aforementioned earnings trends (Figure 5). Within the United States, financials and energy, are up +16% and +31%, respectively, as of March 22nd while technology and healthcare are close to flat so far this year. We believe the outperformance of cyclicals and the reflation trade will continue and perhaps intensify as the year progresses since economic growth is likely to accelerate. This is especially true in the United States, where several reinforcing trends could produce the fastest growth in decades. Truly historic fiscal stimulus (Figure 6) has produced massive excess savings for households at a time when there is already tremendous pent-up demand from a year of restrictions and lockdowns. With vaccine distribution reaching critical mass, behavioral changes towards pre-pandemic norms could unleash a torrent of spending this spring and summer.

Figure 5: Reflation Trade Reigns



Source: Factset. Data as of 3/19/21.

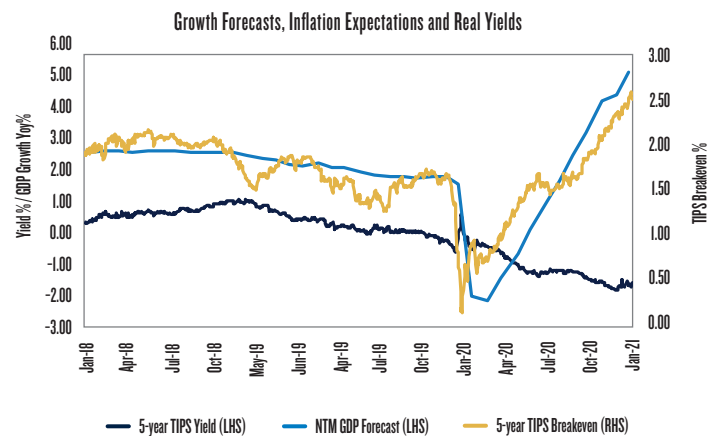
Figure 6: America's Biggest Peacetime Fiscal Expansions



Source: Bloomberg, Congressional Budget Office. As of 2/9/21.

Rising growth forecasts, building inflation pressure from very low levels, and continued policy support appear to be the key drivers of market performance (Figure 7). Given this potent combination, we continue to pursue a pro-risk investment strategy. On asset allocation, we are overweight stocks and commodities relative to cash and fixed income. Within equities we are pro-risk, favoring value over growth and small-caps over large-caps. We favor cyclical sectors over defensive and secular growth segments. Regional equity weightings are complicated by the size of the US policy stimulus. As a higher-quality market, the US should be expected to underperform during a strong global growth rebound, but given the size of the stimulus and the success of the vaccine rollout, the US should take the baton from China as the key driver of global growth. We are currently overweight US and emerging markets relative to EAFE markets within equities.

Figure 7: Rising Growth and Inflation Trend Driving Market Performance



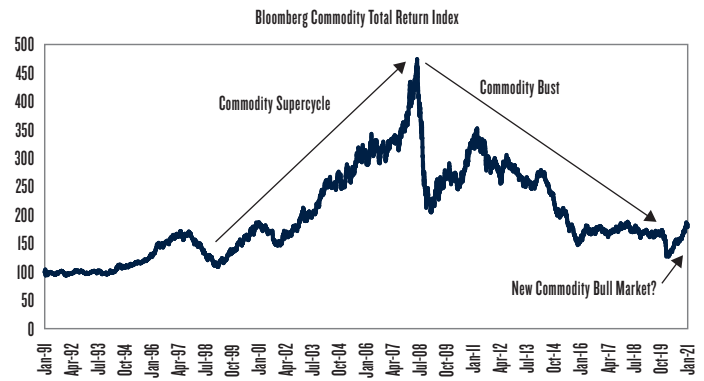
Source: Datastream, Consensus Economics. As of 3/19/21. There is no guarantee these forecasts will be met.

Strong growth in earnings does not necessarily translate into strong equity markets. Sometimes strong earnings growth coincides with central bank tightening, which drags down equity market multiples. In 2018, for example, earnings were up 28%, but the S&P 500 was down 4% on a total-return basis as the Fed hiked rates four times that year (after hiking rates four times in 2017). But currently the Fed has assured us that it won't hike rates until 2024 and has changed its operating playbook to allow inflation to overshoot its target. While we don't think equity returns will keep pace with this year's explosive earnings growth (due to already high equity market multiples), we still think stocks will deliver above-average returns relative to long-term history.

Government bond returns have been hit by rising rates. The ten-year US Treasury yield hit 1.7% on March 18th, while starting the year at 0.9%, up from 2020's low of 0.5%. TLT, the iShares 20yr+ Treasury Bond ETF, has fallen 20% from its peak in August of 2020. Given the surging growth environment, benchmark ten-year rates could hit 2.0% this year (or even 2.5% in an overshoot scenario), though upside to sovereign bond yields should remain limited by the prospect of increased central bank bond purchases or jawboning, at a minimum. However, we remain overweight fixed income risk assets, including US high yield bonds, as the pro-risk and strong-growth environment could bring spreads lower, despite spreads that are already back at pre-pandemic levels.

We believe the pandemic caused a final washout for the 12-year long commodity bear market, which saw prices decline by more than 70% during that period (Figure 8). The dramatic capitulation point was likely marked by sharply negative oil prices on the front-month futures contract in April of last year. We think commodity markets have likely entered a new up cycle driven by a number of factors: a robust post-pandemic global economic recovery, ultra-loose fiscal and monetary policies, increased inflation pressure, a lack of investment in new capacity over the past decade due to falling prices, environmental policies, and ESG investing. We expect increased financial flows to commodities as investors increasingly focus on hedging exposure to inflation risks.

Figure 8: Commodity Futures Prices: From Bust Back to Boom?



Source: Datastream. As of 3/19/21.

The US dollar has showed some strength so far this year as the US economy has been a standout due to stellar performance on COVID-19 inoculation and continued fiscal stimulus. Nevertheless, we expect the dollar to fall between now and year end. Despite improving growth prospects, real yields have not moved significantly in favor of the dollar. The US trade deficit has ballooned in recent quarters, and the dollar remains over valued on a purchasing power parity basis. Finally, the growth outlook in the rest of the world should improve later in the year as vaccine campaigns ramp up in other countries, narrowing the growth differential with the United States.

AUTHORS

Edward L. Campbell, CFA, Managing Director and Portfolio Manager
John Praveen, PhD, Managing Director and Portfolio Manager
Manoj Rengarajan, CFA, Principal and Portfolio Manager
QMA's Global Multi-Asset Solutions Team

FOR MORE INFORMATION

To learn more about our capabilities, please contact QMA by email at contactus@qma.com or by phone in the US at +1 (866) 748-0643 or in the UK at +44 (0) 20-7663-3400.

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*Assets under management (AUM) are based on company estimates and are subject to change.

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Notes to Disclosure

Sources: Datastream, FactSet, Bloomberg, Congressional Budget Office, Consensus Economics, World Health Organization, Johns Hopkins University and QMA. **This is intended for Professional Investors only. All investments involve risk, including the possible loss of capital. Past performance is not a guarantee or a reliable indicator of future results.**

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