In this 2021 outlook, Luke Browne, Head of Asset Allocation (Asia) highlights how investors' interests can be well-served by focusing on macro themes and combining these with capital market asset-allocation views within a risk-management framework. By capturing opportunities while navigating and managing downside and upside risks, Luke Browne and the Multi-Asset Solutions Team believe that this should provide investors with sustainable and resilient solutions that can withstand market cycles.

Building resilient portfolios through market cycles

2020 review - Asset classes show a stronger rebound than the underlying macro economy

2020 was a year nobody expected but most quickly adapted to. In March, the pandemic drove an indiscriminate market sell-off. In our view, this was less about systemic risk, and more a coping mechanism when faced with a crisis of uncertain depth and duration.

Governments and central banks reacted quickly. The Federal Reserve (Fed) cut rates by 150 basis points (bps), bringing the target range down to 0–0.25% and enacted extensive liquidity-provisioning measures[1]. Trillions of dollars in stimulus, including wage subsidies and furloughs were also approved by governments across the globe. These measures supported global economies at the onset of the COVID-19 pandemic; capital markets, however, reacted a lot more positively: strong momentum in risk assets drove equity performance, as well as gold, which breached the US$2,000/ounce mark[2] for the first time. Meanwhile, GDP figures unveiled the full depth of the recession, with the G20 area seeing a 6.9% fall in growth for the second quarter[3]. The US experienced a 31.4% decline[4], while the UK[5], Japan[6], and India saw drops of 19.8%, 27.8%, and 23.9%[7], respectively. China was the exception, returning to modest growth in the same period[8].

However, in September and October, we saw sentiment dim as uncertainty surrounding the US presidential election came to the fore. In the period following the vote, risk assets rallied strongly, particularly with the addition of positive vaccine news to the mix. Risk assets extended gains in the post-election rally: for equities, the MSCI US and Asia ex-Japan indices outperformed[9]. Sector-wise, information technology and consumer discretionary led throughout the year, as COVID-related lockdown drove increased demand for higher growth equities and those corporates with online eco-systems that could sustain their business models better during the pandemic. Towards the year-end, market breadth expanded to cyclicals and value stocks. Within bonds, global corporate bonds took the lead gaining 9%, while the broader Global Aggregate index gained 7.8%. Global high-yield and emerging-market bonds delivered 5% returns[10]. The latter part of the year also saw dollar weakness which, on top of some rotation out of US growth assets towards global cyclicals and value, also added to the investment thesis of an increased exposure to non-US dollar assets.

1 "Federal Reserve announces extensive new measures to support the economy", Federal Reserve, 23 March 2020.
2 Bloomberg, as of 28 July 2020.
3 "Unprecedented falls in GDP in most G20 economies in second quarter of 2020", OECD, 14 September 2020.
4 Bureau of Economic Analysis, 29 October 2020.
5 Office for National Statistics, 30 September 2020.
6 Japan's Cabinet Office, 17 August 2020.
7 National Statistical Office India, 2 September 2020.
8 National Bureau Statistics of China, 17 July 2020.
9 Factset, as of 30 November 2020. MSCI US and MSCI Asia Pacific ex-Japan equities gained 16.6% and 15% versus MSCI World gained 11.72%) year-to-date respectively.
10 FactSet, as of 30 November 2020.

As the world breathed a sigh of relief that 2020 was finally over, the reality of 2021 still looms. The worst may be behind us, but uncertainty persists. In our view, one of the most critical features of the COVID-19 recession is that it has more disproportionately impacted the services side of the economy, while being much less painful for the manufacturing sector, which has recovered more quickly, promoting a "K-shaped" recovery. Successfully navigating this unprecedented environment will require specific near-term asset class, regional, and sectoral tactical shifts, underpinned by a longer-term strategic view. Looking at the opportunity set in 2021, taking a balanced approach could prove sensible with a tilt towards sectors that are poised to benefit from a continued economic recovery, while incorporating some more cyclical areas that look undervalued.

Tactical equities – A cyclical rotation with preference for the US and Asia

On the equity front and geographically speaking, we believe that market liquidity will continue to support US share prices in 2021, especially as short-term risk factors, such as US political uncertainty, dissipate. Global politics, however, will continue to grab the headlines, particularly between the US and China, even under a new Biden administration. Emerging-market stocks, bolstered by supportive monetary policy and heavily levered towards global trade and manufacturing, should also continue to outperform in the recovery. Two regions – US and Asia (largely China) – are preferred when considering tactical positioning.

On a sectoral basis, we could see the IT sector continue its leadership trend; however, the sector may come under further tax and regulatory scrutiny under a new Biden administration. Consumer discretionary is another sector in focus, despite elevated valuations. From a style perspective, we are aware that further stimulus and the re-opening of economies could spur a second wave of rotation away from growth into value and cyclicals. Value sectors may be relatively cheap, but our concern is that they remain just that. As such, having some exposure at this stage is, we believe, the right approach. Supported by low interest rates, a growth bias still holds favour – although in the near term, some of the cyclical and value-oriented markets, such as Europe and Japan, are worth considering.

Tactical fixed income – The hunt for yield

We expect the Fed to keep rates at the zero-lower bound, without dipping into negative territory. However, such a low-yield environment is a recipe for anaemic fixed income returns in developed-markets.

Therefore, emerging-market debt and global high-yield issues are in scope. The former boasts improved valuations, plus the potential of even greater yield for local-currency issues (albeit at the expense of higher volatility). Similarly, continued near-term uncertainty should offer investors attractive entry points for global high yield. Corporates are seeing better access to capital, which should improve their credit-risk metrics and ameliorate default-rate expectations.

As we shift beyond this near-term tactical view and explore longer-term strategic ideas, specific themes become more prominent.

Structural themes – Weakening dollar, retreating globalisation

Structurally, the Fed's liquidity-boosting measures and persistently low rates will see the US dollar gradually weaken over time. This should present a moderate tailwind for emerging-market assets, further supporting our strategic overweight towards such assets.

That said, we bear in mind that the US-China dispute will remain a key talking point, even under the Biden administration. Assuming a smooth transition to a new US administration on 20 January, we do not expect any material change in US foreign policy towards China, nor do we anticipate an imminent unwinding of the tough measures imposed by the Trump administration, e.g., trade tariffs, revoking of visas, sanctions, and travel restrictions. Indeed, the Biden administration prioritising climate change and human rights may present new challenges for the US-China relationship. Meanwhile, the potential for "financial decoupling" has risen, if the US follows through with additional financial sanctions on

Chinese corporates as well as threats of further action.

Beyond just the US, the larger Western trading blocs' perception of China will also have geopolitical implications. Deglobalisation is likely to continue rearing its head as we move forward, and may push economies towards smaller, more regional trading groups.

These structural themes reflect long-term strategic views – some of which differ from more tactical considerations.

Strategic views – Looking towards emerging markets

For our five-year strategic outlook, investors can favour emerging markets, both within equities and fixed income. Continued supportive monetary policies, a more synchronised global cyclical rebound, and a weaker US dollar should allow emerging-market equities to maintain a robust growth profile with attractive long-term valuations. A vaccine will be a game-changer for the economies of Latin America, Indonesia, and India. However, a medical solution is unlikely to drive a robust and rapid economic solution. Fiscal stimulus is unlikely to be enough for a rapid economic recovery, as a return to pre-COVID growth rates is likely to be pushed into 2022. Nevertheless, on a relative strategic basis, we see higher equity and fixed income returns in emerging markets (EM) versus developed markets (DM).

Among emerging markets, Asia is more attractive given its healthier economies versus Latin America and emerging Europe. A relatively stronger starting point in Asia versus the rest of the broad EM space, lends to a higher probability of targeted stimulus measures and the relaxation of credit standards. In the US, higher valuations and a weakening US dollar mean that investors can be strategically more neutral on its equity sector over a longer time horizon.

From a multi-asset perspective, in a world where investors are feeling increasingly compelled to reach for yield, we believe that the most attractive opportunities lie outside of the sovereign debt space, making investment-grade global credit and high-yield issues a preference. While investors must keep an eye on particular sectors that have a much more binary outcome determined by the path of COVID 19, such as energy and healthcare, we believe there's adequate room to run within this segment over the next five years.

Conclusion: Where uncertainty and opportunity collide

2020 saw investors embrace risk, despite one of the most distressed macro environments in a century. 2021 should be about balancing what feels like market complacency with rising risks. The key market drivers for 2021 are likely to be the Fed and the US dollar, government stimulus efforts, China and the pathway of COVID-19, and vaccine success. We expect the Fed to be more reactionary than it was back in Spring 2020, in anticipation that an end to COVID-lockdowns will release pent-up economic demand, spurring a consumer and economic led recovery. The expansion of the Fed's balance sheet has stalled and growth in balance -sheet expansion has been sideways since June 2020.

Geopolitics will remain a headline risk – we don't expect the Biden administration to remove Phase 1 tariffs on China, with expectations of a similar policy in the near term. The US and Europe, however, could see improved relations under Biden.

From ambiguity always arises opportunity. We believe that investors' interests can be well-served by focusing on macro themes and combining these with capital market asset-allocation views within a risk-management framework. This should point the way to capturing opportunities while managing potential downside and upside risks and providing investors with sustainable and resilient solutions that can withstand market cycles.

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