EUTIC Macro-Research Newsletter
Markets Outlook for 2021

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A quick recap

It's safe to say 2020 has been unique: both for markets and the global economy. The stock market has never been a poorer representation of the economy. Amid the pandemic, market indexes such as the S&P 500 and the NASDAQ Composite skyrocketed from lows in March to all-time highs just months later. Market-cap-weighted indexes have been carried by their large-cap holdings. In the case of the S&P 500 Facebook, Amazon, Netflix, Google (FANG) stocks accounted for 10% of the excess return on the S&P 500 since the lows in March (See Figure 1).

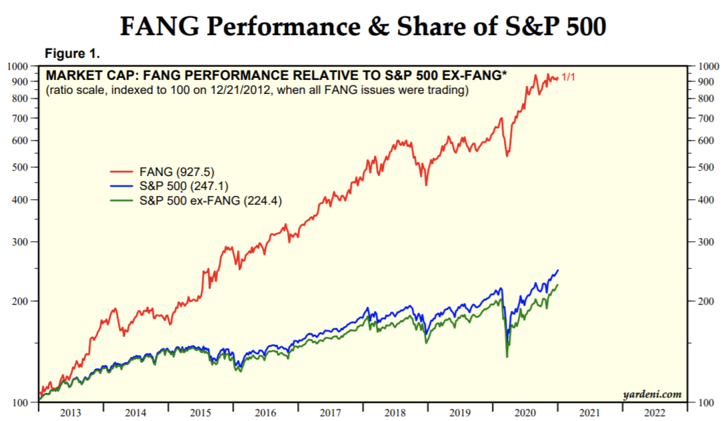

Figure 1: Big Tech and the S&P 500

The DOW, S&P 500, and NASDAQ all reached their all-time highs while the global economy shrunk more than 6.9% as a result of the coronavirus.[1] While it appears they have been "dragged up" by their tech counterparts, with the top 6 holdings of the S&P 500 accounting for 25% in weight, this is not the entire explanation. The Russell 2000 (a U.S small-cap index) reached an ATH this year with a rally of 37% in 10 weeks from November 1st through to January 15th. It appears that market is pricing in a very strong Q4 (perhaps even a Q3) market recovery. This is on the back of a timely and effective vaccine roll-out and the abundance of fiscal and monetary stimulus which can now be seamlessly passed by a Democratic sweep, holding the White house, Senate and House of Representatives.[5]

This shows the true power of fiscal and monetary policy. When the pandemic first hit the western world and markets plummeted, interest rates were cut in an emergency and bond-buying programs were launched by central banks to provide much-needed liquidity. In America, stimulus checks were given directly to the hands of the people and relief legislation kept many industries such as retail and aviation alive. As a result - one of the greatest, V-shaped, recoveries occurred in the equity markets.

Global Macroeconomics and Geopolitics

Economy

Predicting how 2021 will turn out is an arduous process. The World Bank predicts that the global economy will grow by 4% this year. That is if vaccines are rolled out efficiently and governments don't buckle under the financial pressure required, otherwise, we may be looking at only a 1.6% growth. Even in the best case scenario, it is not a total recovery from the pandemic and realistically, it will be many years until the after-effects are behind us.

Geography

The growth will be geographically prejudiced. China is expected to grow 7.9% compared to the Eurozone's 3.6% and U.S's 3.5%. The reasons are blatantly obvious; Europe and the United States are grappling with record number of COVID cases while China has fewer cases in total than the others countries receive in a day.

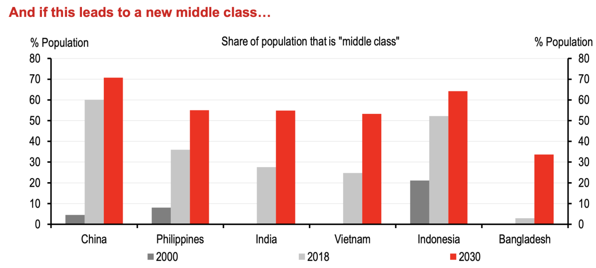

Figure 2: EM Middle Class

We believe India will be an interesting growth market to look out for in 2021. Despite currently wrestling with an out of control pandemic, the country continues to innovate in tech and has an exploding middle class (see Figure 2); both are major drivers of economic growth. Nonetheless, there are many obstacles in the way. The level of inflation remains above the central banks target, a record 250m strike for the agricultural sector(!), and the aforementioned pandemic. However, with a emerging market such as India risks of this magnitude are not out of the ordinary - they simply must be accounted for. [2]

Geopolitics

Undoubtedly, the single biggest driver of markets will be the recovery from the pandemic but there are other important geopolitical events that have the capacity to shape markets.

The trade agreements between the U.S and China have been left in tatters as tensions between the two superpowers are high. President Biden has shown an interest in keeping the pressure on China to fight "unfair trade practices" but he is still likely to be far more benevolent than Trump was. A trade war pitches the two largest economies against each other in a battle that can only end in large tariffs for both parties. However, with an incoming president more welcoming than the last, this ordeal is expected to mellow, but some degree of tension will likely always remain between the two countries.

Equities and Debt Securities

Cyclicals

Many Wall Street institutions still have faith in the rotation out of growth into value and so have recommended more exposure to sectors such as financials, industrials, and consumer. The thinking is that why pay a 30x P/E multiple for a growth stock with an expected 15% earnings growth when one can buy a value stock with similar earnings growth at a greater discount. Especially in the current Macro climate, where seeming dormant value companies will see significant earnings growth. Credit Suisse stated in a recent report that "non-cyclicals should lag in an improving economy as falling volatility supports higher P/Es for riskier assets, and rising rates makes their high dividend yields less appealing. The one exception is health care which should outperform given a more robust earnings trend." [3]

Financials

If we look more in detail at the financial sector, we can see it is looking like a good year for the majority. With the upturn of the economy on the horizon, the recent permission of buybacks due to sound stress tests, and historic lows in bank shares (HSBC) there is certainly a positive expectation for financials in 2021. However, there is a distinct split between digital wallets and neobanks (entirely online such as PayPal and SoFi) with traditional banks such as JPMorgan Chase and Bank of America. Squares' Cash app has been the leader in the U.S digital wallet space with gross profit increasing by 212% year over year (as of Q3 2020).[6] Comparatively, JPMorgan's gross profit decreased by 14.8% year over year.[5] The pandemic rapidly accelerated the shift of the digitisation of financial institutions: the macro research team believes that leaner operative business models coupled with the innovative structure of digital wallets and neobanks will see a growing market share over traditional financial institutions. However, both Square and PayPal are trading at P/S multiples of 12.5 and 14 respectively so a carefully thought out valuation model must be made before investing.

TMT

Last year was a remarkable one for TMT. In 2020, the S&P 500 grew a respectable 15.85% while the DJIA was flat. These sit nowhere near the NASDAQ's stellar performance of 43.34%. This out-performance can be largely attributed to the pandemic; the remote, technological business models benefited from a shift to a stay-at-home world. Due to this growth, you would expect other sectors to catch up as we return to normality. However, there is no real guarantee this will happen - tech has historically permanently gained market share during times of turmoil, even though during the bear market tech is often hit much harder. High-profit margin business models like cloud computing, telehealth and software as a service are growing at astonishing rates and will attribute to tech outpreforming the broader market. As well as this, the current P/E ratio of the NASDAQ sits at a historically modest 25.65 compared to the S&P's 38.21. [7] Nonetheless, there are some obstacles in the way. Big Tech has been under scrutiny for years for privacy breaching and it appears they are finally going to get punished in the upcoming months, with a potential break-up of the giants still a possibility. There is also the aforementioned conjecture of the rotation out of growth into value stocks with the upturn of the economy but even major Wall Street institutions are on either side of that argument.

ESG

ESG and climate funds outperformed their conventional counterparts in 2020 and it's likely that this trend will continue in the next 12 months. With governments worldwide adopting a "net-zero by 20XX" motto, Joe Biden declaring that the U.S will rejoin the Paris agreement, and the meteoric rise in popularity of electric vehicles, there is no doubt that ESG will remain firmly in the cross hairs of investors worldwide. [3]

Debt

In a low rate environment it's no secret that an unlevered long position on bonds is undesirable. With central banks worldwide openly saying they will keep rates at rock bottom for the foreseeable future, investors are left with few options. While it is likely rates will rise in the coming year or two, it is unlikely that the real yield on many government bonds will turn positive. The UK ten year gilt is yielding 0.3% as of late January and it is the macro-research team's view that a significant allocation to fixed income is not wise. Even if investors wish to hedge their equity bond prices are near their ceiling so better alternatives such as cash or gold should be considered.

Foreign Exchange Rates

Dollar

The vast majority of Wall Street is expecting a weakening Dollar in 2021.[3] This idea is supported by two factors - first, U.S monetary policy has been eased at a faster rate compared to the rest of the world, and easing monetary policy is often correlated with a weaker currency *ceteris paribus*. Secondly, dollar demand stresses are likely to ease relative to what they were when the pandemic hit and when foreign central banks and companies aggressively sought the reserve currency.[4] A weaker Dollar would send ripples throughout the global economy. U.S companies who receive a lot of overseas revenue would benefit from foreign currencies having additional buying power. For fixed-income - a weaker dollar has historically tightened Emerging market credit spreads (EM bond excess yields over similar U.S bonds). In general, a weaker dollar renders U.S assets less attractive from a Forex point of view. [4]

Pound Sterling

Forex traders have put Brexit in their rear view mirror as net futures positions are at their highest level since the pandemic. The U.K has been brutally hit by the pandemic and so naturally has tried to benefit from a vaccine head-start. Avoiding any setbacks that delay the economy's reopening will be crucial for the island and if the vaccine program succeeds, the country's assets will be looking favourable to their European counterparts. [9]

Yen

Due to the massive monetary stimulus provided by the trigger happy federal reserve and the recent appointment of Janet Yellen, inflation expectations in the states have soared. As inflation expectations push higher in the west, they remain sluggish in Japan, helping to push the country's real yield advantage over the U.S. to its widest in nine years. That increases the relative attractiveness of Japan's stocks and bonds, as well as restoring the currency to its previous safe-haven status. [8]

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A bit about us

We are the Macro Research Team at EUTIC providing short to medium-term outlooks on financial markets. We create reports that will include an overview of the macroeconomic climate, sector-specific outlook, and other interesting market theories. The team currently consists of Dominique Zahra, Guy Broadhurst and Caleb Demoz.

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