2021 Global Market Outlook

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Think long term

- Timing the direction of inflation, long-term interest rates and equity market styles is challenging even for the most successful tactical traders. Investors should **think long term** in designing an asset mix that delivers a target return with appropriate risk.
- Capital markets are expected to deliver **lower returns in the next 10 years compared to recent decades** due to exceptionally low yielding fixed income and more richly valued stock markets.
- **Building well-balanced portfolios** is more important than ever because of potentially lower stock-bond diversification compared to recent years. As the pro-cyclical Canadian dollar typically trades with global stocks, **unhedged foreign currency exposure can help reduce total risk**.
- With mass vaccinations expected to be completed before the end of 2021, major economies are expected to **rebound strongly in the second half of next year**. Downside economic risks will continue in the near term due to restrictions to contain the virus, a modestly sized US fiscal stimulus and an overleveraged corporate sector.

As investors turn their attention to the outlook for the global economy and financial markets next year, it's important to keep a focus on the long term. Popular narratives for the coming year range from a "reflation" scenario with higher inflation and interest rates to a "scarring" scenario in which the recovery from the pandemic-related downturn is more gradual with an extended period of low inflation and interest rates. There have been many false starts in the reflation and higher interest rate scenario over the past decade, including concerns about the impact of quantitative easing in 2008 after the Global Financial Crisis, the "Taper Tantrum" in 2013 and even the surprise election of Donald Trump in 2016 that raised expectations of a deficit-financed economic boom. In each case, the secular bull market rally in long-term government bonds and tech-driven stock markets ultimately prevailed. This time might be different, but investors shouldn't bet the farm on any one economic scenario next year.

Given the unusually uncertain economic outlook, it's more important than ever for investors to hold a well-balanced asset mix to achieve their target return in the long term. Timing the future direction of inflation, long-term interest rates and equity styles is notoriously difficult even for the most skilled tactical investors. We believe that investors should seek an asset mix that can achieve a target return over time. Robust assumptions about the expected return and risk of major asset classes are key inputs in designing a long-term asset mix with an appropriate balance between risk and return. In our annual outlook this year, we summarize our updated capital market assumptions and provide an accompanying economic outlook for major regions. Key highlights of our team's capital market assumptions by asset class include the following:

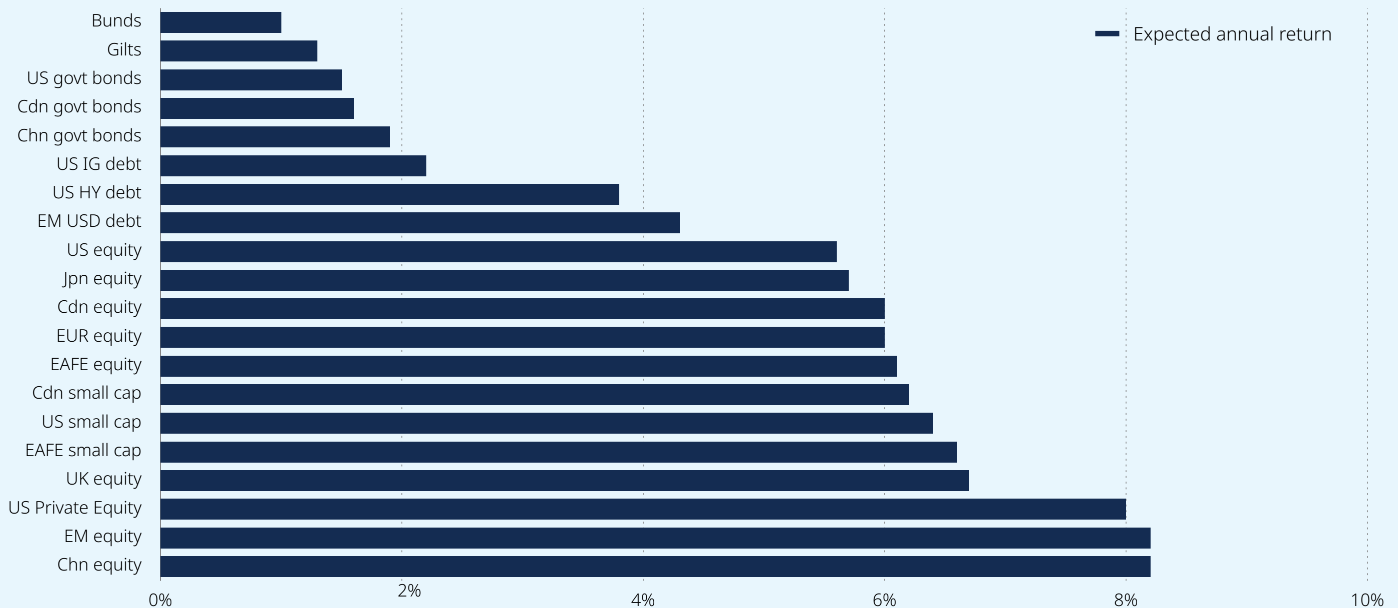
Fixed Income: With government bonds yielding near historic lows, expected average returns in the next decade remain much lower than in recent years (Figure 1). For 10-year government bonds, we translate expected returns in different geographies into Canadian dollars. Based on our forecast, 10-year government bonds provide an average expected return of around 1.5% in the next decade. A notable exception is China government 10-year bonds with an expected return of about 2%. While sovereign bonds offer relatively low expected returns, emerging markets (EM) dollar debt and corporate credit provide greater return-seeking opportunities.

Equity Markets: EM and China have the highest expected returns in the next decade at over 8%. While the US stock market outperformed in recent years driven by a narrow range of technology stocks, we expect US stock returns will be lower than in other major markets in the next decade. Given their more attractive starting valuations, the Canadian, European and small cap markets are expected to outperform.

Alternatives: Direct investments, such as private equity, have the potential to add value and provide access to parts of the capital market that have largely shifted out of traditional public markets. For instance, US private equity has an expected return of 8% in the next decade (Figure 1). Liquid alternative strategies with absolute return mandates employ leverage and security shorting in public markets to take advantage of opportunities in both rising and falling market conditions.

Figure 1 | Long-term expected returns in Canadian dollars

(geometric average expected return over 10 years hedged back into Canadian dollars)



Note: Mackenzie Multi-Asset Strategies Team, December 2020. Equity markets refer to national benchmark large-cap indexes unless otherwise stated. Government fixed income refer to 10-year bonds on a constant maturity basis. All expected returns are expressed in Canadian dollar terms after incorporating our FX hedging assumptions.

We expect capital markets will deliver lower average returns in the next 10 years compared to the realized average returns of recent decades. Fixed income yields remain near historic lows and stock markets are richly valued compared to history in key geographies, such as US large-cap stocks. Figure 2 compares the historical average return of a stylized 60/40 portfolio of US large-cap stocks and 10-year Treasuries, respectively, to our expected return for this portfolio in the next decade. In the last 40 years, the 60/40 generated an average annual return of 9.6% compared to an expected average return in the next decade of about 4%. Investors may face a dilemma as a given target return is expected to require greater investment risk.

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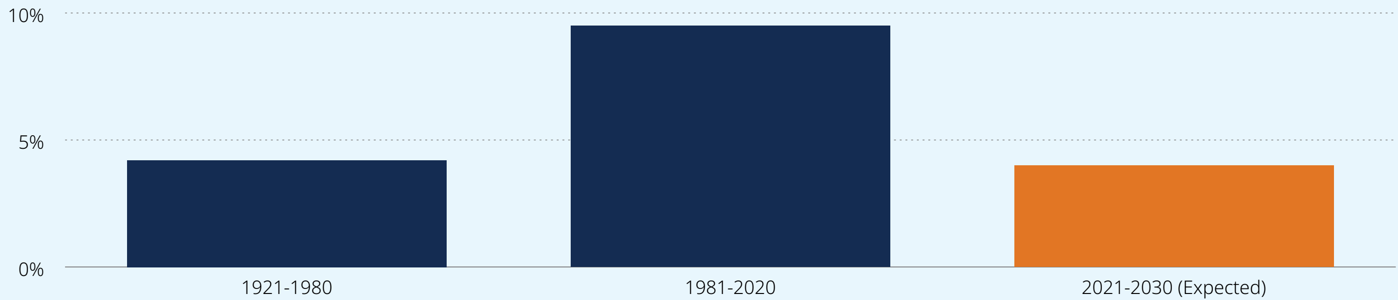
Figure 2 | Realized returns of the 60/40 portfolio vs. expected returns in next decade

(historical geometric average returns compared to 10-year expected returns)



Note: Historical returns for the 60/40 stock-bond portfolio provided via Bloomberg. Expected average returns in next decade are forecasts computed by Mackenzie's Multi-Asset Strategy Team.

While absolute returns for many key asset classes are expected to be lower in the next 10 years, we believe equities remain relatively attractive compared to government bonds. Major stock markets continue to offer an attractive long-term yield compared to safe government bonds. Other return-seeking asset classes, such as corporate credit, dividend stocks and related strategies can enhance a portfolio's expected return but typically involve taking greater risk. Individual investors should also increasingly have greater opportunities to enhance their long-term asset mix with alternative investment strategies and asset classes.

Diversifying equity risk will become increasingly important. Low yielding fixed income could provide weaker diversification benefits (Figure 3) because interest rates have less room to fall further when stock markets are stressed. Many asset classes are also expected to be less diversifying compared to recent years when correlations with stocks was low. An under-utilized tool by many individual investors is managing foreign currency exposure deliberately to minimize total fund risk. As the pro-cyclical Canadian dollar typically trades in line with global equities, unhedged foreign stock market exposure can help reduce the total risk of a portfolio in the short run following stock market downturns (Figure 4).

Figure 3 | Bond-equity correlations have been exceptionally low in the past 15 years

Note: 3-year rolling monthly correlations of 10-year US Treasury and S&P 500 Index returns. Data via Bloomberg.

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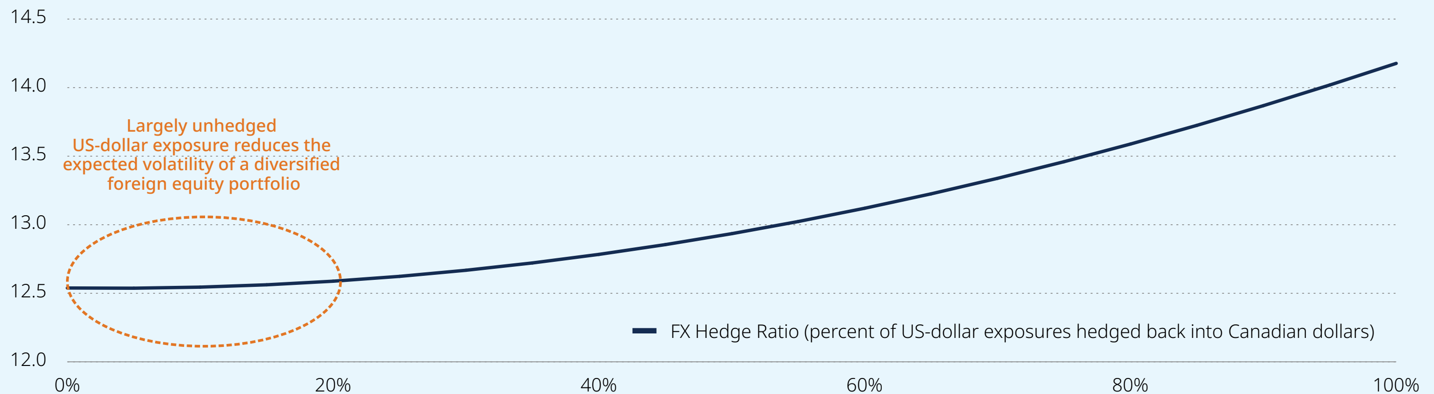
Figure 4 | Expected volatility of a foreign equity portfolio based on different FX hedge ratios

(MSCI World is a proxy for the foreign equity portfolio of a Canadian-resident investor)



Note: Estimated volatility for a Canadian resident investor of holding a foreign equity portfolio based on the MSCI World index of developed market stocks. The horizontal axis measures the FX hedge ratio for US dollars, or the share of US-dollar exposure that is hedged back into Canadian dollars. At 100%, US stocks in the portfolio are fully FX hedged, resulting in the highest forecast of total volatility because the investor loses the natural diversification benefit. Fully unhedged US-dollar exposure at 0% results in the lowest total expected volatility in the portfolio. Estimates prepared by the Mackenzie Multi-Asset Strategy team using Bloomberg data for MSCI World and exchange rates for 1990-2020.

Global macro outlook

We expect the global economy will soften in the next quarter as restrictions to contain the virus slow activity and policy stimulus becomes less aggressive. Fiscal policy in the US has become less responsive to the weakening outlook as Republicans in the divided Congress look through what they see as temporary economic weakness early next year to focus instead on controlling the rapid increase in government debt. As vaccines continue rolling out, we expect the global recovery will accelerate in the second half of 2021 with limited inflationary pressure given the extent of economic slack following the most severe economic downturn since the 1930s. China and the Asia-Pacific region are expected to lead global growth, especially in early 2021, as other major economies continue to get the virus under control. As a pro-cyclical commodity exporter, Canada's macro outlook hinges on a robust US recovery.

Canada outlook

After a blazing rebound in growth during the summer, most provinces are once again under partial lockdowns. GDP is expected to grow by close to 5% next year, but with Covid cases still climbing, additional restrictions could delay the recovery. The good news is that the pain is likely limited to the first half of 2021, as Canada is well positioned to have vaccinated a good portion of its population next summer (Figure 5). Even once herd immunity is reached, it will take years before unemployed workers get absorbed back into labour markets, with the unemployment rate standing at 8.5% at the end of November. We expect below-target inflation until at least 2023.

Looking beyond 2021, medium-term growth will be tied to global reflation and especially the path of oil prices. The Biden presidency is both a blessing and a curse: the US-Canada trade relationship should be normalized, a positive for non-energy commodities and manufacturing, but Biden's green plan could weigh on the beaten-down Canadian energy sector. On the domestic side, policy will be key. On one hand, a premature withdrawal of fiscal support could hurt the recovery. On the other, maintaining stimulus measures once the output gap is closed could raise public debt to unsustainable levels and generate inflation. The Bank of Canada could start tapering its asset purchasing program next year, but the overnight rate will likely stay around 0% until 2023. Finally, an underrated concern for medium-term growth is the sharp drop off in immigration in 2020. If new arrivals don't quickly recover to pre-pandemic levels, average economic growth could underwhelm.

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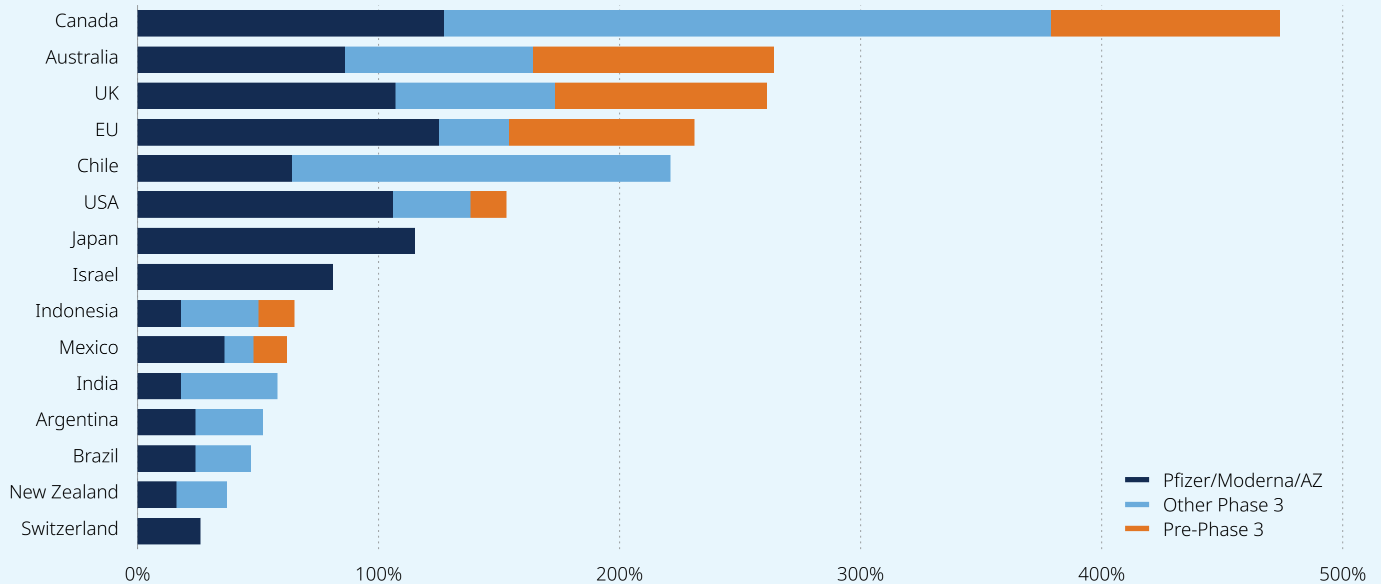
Figure 5 | Canada has the largest number of vaccine orders per capita



Note: Our calculations, inspired by Oxford Economics, and with data from the Duke Global Health Innovation Centre. Assumes two doses for all vaccines. 2020 population via the United Nations.

United States outlook

With less stringent Covid restrictions, the expected 3.6% drop in US real GDP in 2020 is smaller than other developed countries. The growth rebound in 2021 is projected at just under 4%, meaning US GDP should recover to its pre-pandemic level during 2021. With a narrower output gap, inflation pressures should emerge somewhat faster in the US than in other countries, but we don't expect them at any point in the next twelve months. While expected growth is encouraging, there remains a large downside risk to projections. The current pace of new Covid infections is out of control. A more stringent national lockdown imposed by the new administration in January could stall the fragile recovery. Even in the absence of renewed lockdowns, consumption and employment indicators have turned wavy and would suffer further if a new fiscal stimulus bill can't garner bipartisan support.

In the medium term, the current base case of a Biden White House with a split Congress might be the best scenario for growth, as outlined in our November commentary. We also expect the Fed to keep its policy rate at around zero until 2023 and tighten monetary conditions gradually in 2023-2024.

Europe outlook

In Europe and the UK, renewed lockdowns have managed to slow the Fall infection wave, but new daily cases are still elevated. The Eurozone could slip back to negative GDP growth in 2020 Q4, and with no signs of easing widespread lockdowns, the recovery will likely remain on pause for the first months of 2021. GDP growth is expected at just under 5% next year, but with 2020 growth estimated at around -7%, EU GDP may not recover to its pre-pandemic level in 2021. The Eurozone is ending the year in deflationary territory and inflation is expected to stay below 1% in 2021.

The current low inflation rate and depressed demand, coupled with anemic population growth, hint at the possibility of a Japanification of the European economy. If inflation does not pick up in coming years, Europe will need policymakers to step in more forcefully to avoid getting stuck in a disinflationary spiral. Luckily, the Eurozone might exit the Covid crisis with emboldened public powers. The European Central Bank has caught up to other central banks in its willingness to pursue aggressive monetary policy, while the EU has finally managed to coordinate large-scale fiscal programs. If the newfound might of the fiscal and monetary authorities survives in the post-Covid era, the long-term prospects for Europe would brighten.

EM and China outlook

China has shown extraordinary resiliency in 2020. While other large countries are entering 2021 under lockdowns and/or struggling with unchecked Covid transmission, China has the virus under control and domestic spending is ramping up as restrictions loosen. China spent the first stage of its recovery reopening and modernizing factories and launching infrastructure projects. Its share of world exports reached a record 13.5%. As restrictions on households are progressively lifted in 2021, domestic consumption should catch up to exports and capital spending. In addition, its massive infrastructure investments this year should give a boost to productivity growth in the coming decade. China will need that extra growth if it wants to lessen the burden of its climbing public debt.

China's reflationary policies will have positive spillover effects on other EM countries. Commodity exporters, including Russia and parts of South America, will benefit from China's demand in metals and materials. The intensifying trade war between China and Australia could be a boon for other commodity suppliers.

At the onset of the Covid crisis, many investors were worried about capital flight and government debt in emerging markets. Most EM countries held strong, supported by accommodative monetary policy both from the US Fed and, most surprisingly, from their own local central banks. In past crises, EM countries were unable to provide aggressive monetary easing in the same way as developed markets. However, risks have not disappeared for EM and other major economies. We should not forget that the European debt crisis blew up in 2010-2011, two years after the start of the Global Financial Crisis.

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