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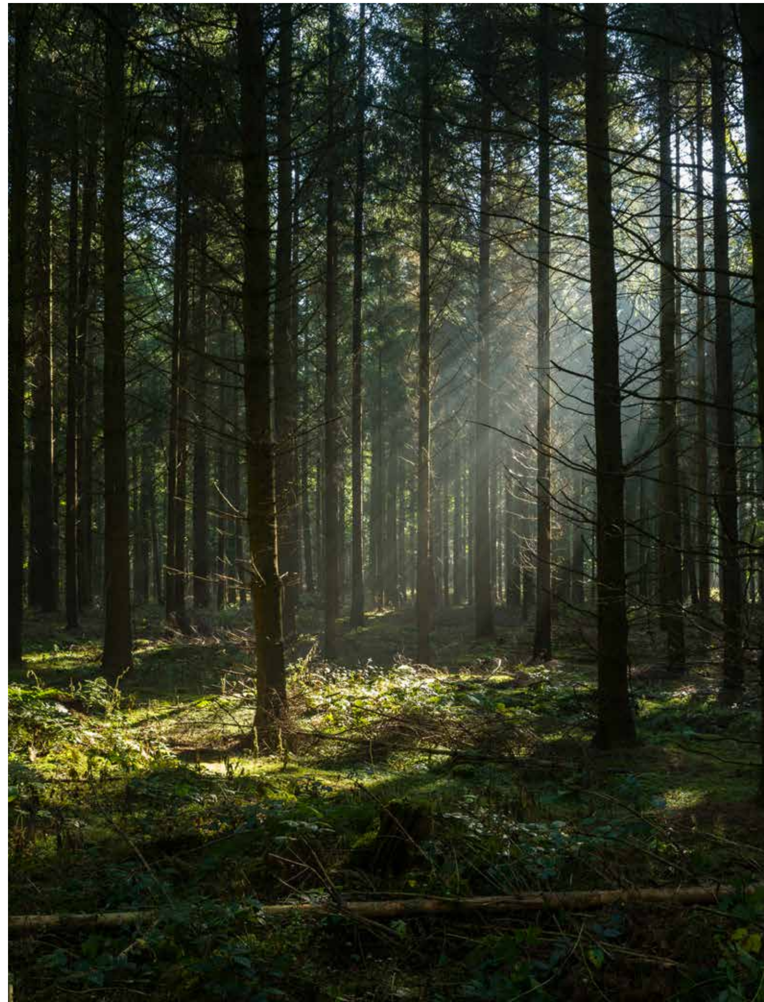

Q1 Outlook: Rays of light

We remain long risk assets, and are minded to increase this stance, as economic normalisation is on the horizon and policymakers remain supportive.

Emiel van den Heiligenberg
Emiel joined LGIM in August 2013 as Head of Asset Allocation, with responsibility for asset allocation, strategy and multi-asset macro research.

As we start 2021, there's much to worry about – from the new wave of COVID-19 to the shocking scenes in Washington, D.C. But there is also cause for optimism, with a new US administration set to take office and the vaccine rollout gathering steam.

Our investment outlook plays into the theme of normalisation. The global economy is early in the cycle and policymakers remain very supportive. Stocks may look expensive in absolute terms, but on a relative basis, we believe the equity risk premium remains attractive.

Still, we need to acknowledge that risk assets have digested lots of the good news, positioning is quite long and we believe investors are unanimously bullish on the outlook for 2021.

In this document, we address three key questions for investors:

- Which regions will reach herd immunity first?
- What is at the top of Joe Biden's to-do list?
- Are China's growth targets achievable?

Georgia on our minds

Following the Democratic victory in the Georgia Senatorial elections, expectations are building for another round of immediate pandemic relief followed by a broader increase in government spending later in the year. This would offer fresh support to the economy, and its beleaguered consumers, in addition to the $900 billion deal agreed in December.

Investors could be disappointed, should a smaller package ultimately be delivered. But then again, market weakness would strengthen the case for subsequent plans. So fiscal support for risk-on trades remains in place, in our view.

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We think it is the interplay between equities and bond yields that is relevant at this point. At some point the positive correlation between yields and stock prices might break and higher (real) yields could start to push equities down. Although this is a risk, at some point such a trend is likely to run out of steam, as risk aversion caps a further rise in yields.

Finally, productivity has risen significantly during the pandemic. How sustainable is this? Higher productivity tends to be a cycle-extender; all else equal it should push inflation lower and provides a pretty healthy environment for equities.

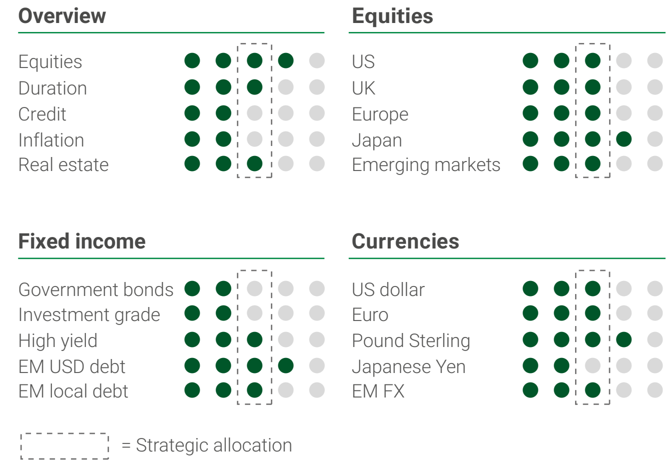
It's darkest before dawn

So yes, even though recent newsflow presents investors with a lot of darkness, rays of light are breaking through, which we believe are likely to grow in intensity over the coming months.

Against this backdrop, we remain long risk assets. We think equities are more attractive to play the current phase in the cycle than investment grade credit, as at current spread levels, corporate bonds have an unattractive asymmetric risk profile, in our view.

We are inclined to increase our long risk position by either buying a dip or letting our weighting to risk assets drift higher.

Key asset class views:



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 7 January 2021.

The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.

Summary of LGIM's asset allocation core view

Economic cycle

Coming out of recession is the most positive phase of cycle

Valuations

Relative valuations now less attractive

Systemic risk

Concerns around both political and credit risk

Source: LGIM. Views current as at 31 December 2020. Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.

Economic cycle

- Coming out of recession is most positive phase of cycle
- Vaccines rollout competing with rising case loads
- Monetary policy exceptionally easy and fiscal policy support stabilises the short term outlook

Valuations

- Absolute equity valuations are high but not stretched
- Credit spreads now below average
- But relative valuations remain positive and more relevant

Systemic risk

- Troubled relationship between US and China
- But Europe's core more unified and Brexit deal done
- Global debt burden becomes worrying if inflation re-emerges

Martin Dietz
Head of Diversified Strategies,
Asset Allocation

The lopsided global race for herd immunity

The current COVID-19 infection numbers look truly bad, with new lockdowns in many countries and a more contagious version of the virus spreading in the UK that is also showing up across other countries. At the same time, there is now strong hope for a return to 'normal': vaccinations have started across the world.

First to the market were modern mRNA vaccines from Moderna* and Pfizer/BioNTech*. Both have shown extremely high levels of protection/efficacy (around 95%) with no meaningful side effects. Even though these are relatively expensive and tricky to transport and store, neither will be an issue for the most developed countries. Both vaccines have now been approved and are already being deployed in the US, UK and EU.

Success stories around mRNA vaccines were quickly followed by the AstraZeneca*/Oxford vaccine, a more 'standard' vaccine, with a lower level of efficacy but cheaper to produce and easier to distribute. We expect further vaccines to become available over the coming months.

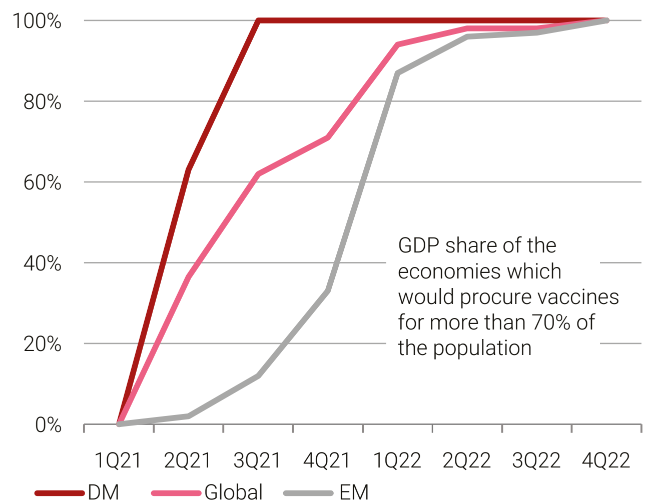
As the development and approval process has been completed, the production and distribution challenge has taken centre stage. At least two-thirds of the population need to be vaccinated to curb the spread of the virus, a monumental task and a race against time given the threat of a more contagious virus type (called B.1.1.7 or VOC-202012-01). We expect vaccine production to be ramped up quickly; the logistics of vaccinating a larger number of people will become the key challenge towards the end of the year.

Challenges for EM

Countries raced to secure enough production and developed markets, predictably due to their deeper pockets, are now first in line to receive scarce supply.

The US and then the UK started their vaccination campaigns first, with other developed markets a few weeks behind. Given the production is largely based in the US, that country has secured a large chunk of the early supply. However, other developed markets are just a few weeks behind.

Vaccine procurement (not distribution)



Source: Citi research, as at 5 January, 2021.

In terms of market and economic outcomes in 2021, this difference may not matter much. As vaccines are rolled out to those most at risk first, we expect hospital admissions and fatalities to drop sharply in Q2 even as infection numbers may stay high.

From the third quarter, we could see the virus starting to decline with the onset of 'herd immunity'. This is when the proportion of the population who are immune is sufficient to reduce the likelihood of infection for individuals who lack immunity.

The outlook appears less rosy for emerging markets. The modern mRNA vaccines are likely too costly and too difficult to handle for all but the most developed markets. And only a few emerging markets have secured enough supply of vaccines for their population yet.

While developed countries made speculative purchases in mid-2020, emerging economies are waiting for wider availability and proven efficacy. Greater choice of providers and capacity should cut costs. As a result, less-developed countries may receive vaccines with a six-month delay.

Assuming there are further logistical challenges to distribute vaccines, herd immunity for emerging markets seems realistic only in early 2022.

Lars Kreckel
Global Equity Strategist

The turmoil in D.C. and Joe Biden's first 100 days

At noon on 20 January, Biden will be inaugurated as the 46th US president, only two weeks after supporters of his predecessor, Donald Trump, stormed the Capitol building, disrupting a joint session of Congress.

Clearly these circumstances, and the larger than average differences between both men, make this transfer of power more important than most.

COVID-19 and climate

Despite the recent mayhem, the president elect's number one priority is obvious: fighting the pandemic. With US case numbers and deaths continuing to rise and the vaccine rollout only just beginning, this issue will dominate the new administration's bandwidth.

A commitment to vaccinate 100 million Americans in the first 100 days is the signature goal (in addition to a 100-day mask mandate and aim to enable most schools to reopen within this period). Success here is likely to decide how much political capital Biden will have to spend on other policy initiatives.

Biden described the recently enacted $900 billion stimulus as a down payment and his new administration will be working with Congress to push for greater funding for testing and vaccine distribution. The next relief package could also include additional stimulus checks, benefit extensions and state and local government aid.

Climate policy is also likely to feature prominently; Biden has already pledged to make re-joining the Paris Agreement one of his first acts as president.

But this is generally an area where he can accomplish much before his cabinet is fully sworn in and without having to rely on Congress. Indeed, Trump's executive orders on energy can be undone with a new executive order.

Foreign and trade policy

From a market perspective, any policy choices on China will be of particular interest.

Our expectation is that Biden's approach to the world's second largest economy will be similar to Trump's in substance – but calmer and less volatile in style. On the most important economic topic, tariffs have now become part of the policy arsenal. We expect material tariffs to stay in place even if there is some unwinding from current levels over time.

Foreign and trade policy is another area where the president has a lot of leeway to act without Congress; there is no shortage of topics on the agenda on which Biden can quickly make a mark and reveal the direction of travel. Will he revisit the stalled TikTok* deal with Oracle*? How will the US respond to China's progress on the milestones agreed in Phase 1 of its trade deal? And how will the new administration handle the many other skirmishes around tech and trade?

A wildcard not on many investors' agenda would be a forceful response to December's hacking revelations allegedly involving Russia. On the one hand it seems like too large a hacking attack for the administration to ignore; on the other, things appear to have gone quiet with no sign of the outgoing Trump administration increasing pressure on Russia.

While not a topic of much discussion among investors today, it is an area where the changing of the guard in Washington could also change the market narrative.

National unity

The chaotic events in Washington D.C. have sharpened the focus on Biden's other stated goal of bringing the country back together.

At this stage it is difficult to tell whether the riots have made achieving that goal more or less likely. The optimists among us hope that the chaotic scenes will serve as a catalyst for a coming-together moment. But the experience of the past five years suggests it is also possible that they simply remind many Republican politicians that Trump will continue to have great influence over a large part of the party's base and broader electorate, making it difficult to oppose him.

The coming months will tell us how the direction of the Republican party changes after the Trump presidency ends, but this is likely to have medium-term implications rather than drive markets in the short term.

Erik Lueth
Global Emerging Market Economist

China's growth: A tale of two targets

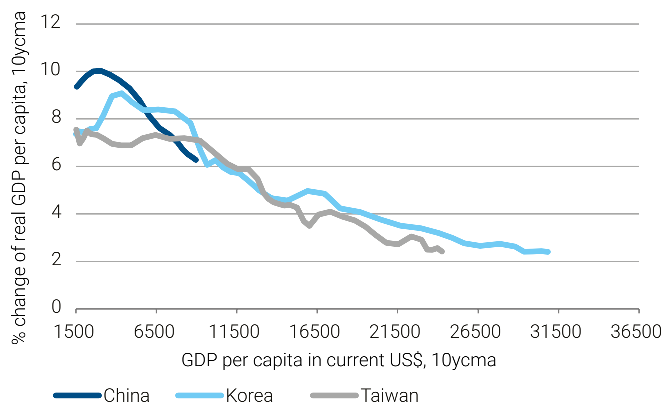
In November, the Chinese leadership spelled out its growth targets for the next five years and its long-term goals, according to which the world's second largest economy would reach high-income status by 2025 and double its GDP per capita by 2035.

The first goal does not look challenging and should be seen as a lower bound. The World Bank threshold for high-income countries is a per capita income of $12,500. China's economy would have to grow 3.7% per annum over the next five years to reach this threshold.

But China's 2020 GDP is not representative, given the pandemic shock. The rebound from these levels implies an 8-9% growth rate in 2021. Taking this into account, the economy would have to grow by merely 2.6% per annum over the next four years. For comparison, China grew 6% in the year before COVID-19.[1]

The doubling of GDP per capita by 2035, by contrast, implies a growth rate of 4.5% per annum, when taking into account the strong rebound in 2021. This will be challenging because China's population growth will likely stagnate; the credit impulse of earlier years will be lacking, given high debt levels; and economies tend to slow down as they mature.

China: Growth prospects



Source: Macrobond, as at 11 January, 2021.

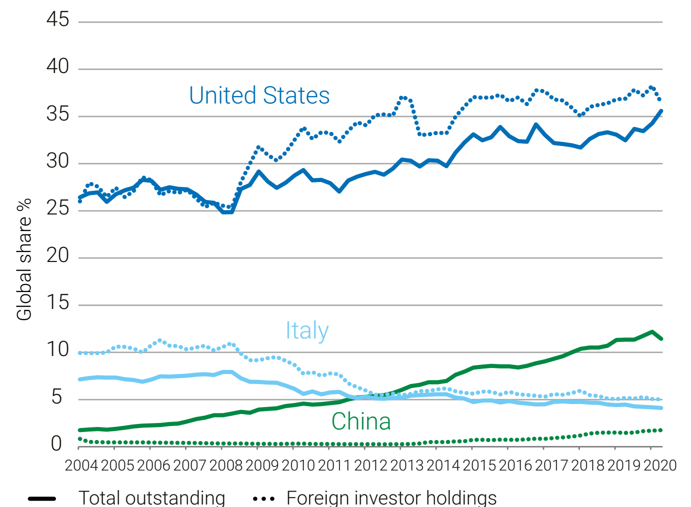
Low-hanging fruit

Can it be achieved? The experiences of Korea and Taiwan suggest it can. Both managed to double their GDP per capita over 15 years, at the same level of development, and in many respects China follows their example. Also, China has not yet picked all of the low-hanging fruit; for example, at 60%, its urbanization rate is where Japan's was in 1959.[1]

Where would this leave China and the world in 2035? China would still not be a rich country. Among the countries classified as advanced by the IMF, China would only have overtaken Greece in terms of GDP per capita (assuming these countries also continue to grow over the next 15 years). Its income per capita would be 10% below that of Portugal and 25% below that of Italy.

But it would be the biggest economy in the world. As soon as next year, China should overtake the European Union in economic might; by 2033, it would overtake the US; and by 2035, China would account for one quarter of global output and more than 40% of global growth.

Government bond positioning



Source: Macrobond, as at 11 January, 2021.

As investors we are interested in how to get exposure to this story. For starters, we believe government bonds appear to be an attractive option. They are massively under-owned and by October of next year will be included in all three of the most widely used global bond indices.

1. Source: Marcrobond, as at 13 January, 2021

*For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.

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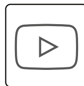

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