OUR REVIEW FOR THE PAST YEAR & OUTLOOK FOR 2021

31 December 2020 / Authors >> **Florian D'AGOSTINI - Dominique MARCHESE - Jean Philippe VANDERBORGHT,** Analysts & Fund Managers

A year ago, our central scenario for the year 2020 was a global economic stabilisation. In the end, for a reason we all know, it was not. Impossible to predict, what looked like a flu has turned the world order upside down. Blinded by the precept that some things only happen to others, we Westerners fell from grace in February. In a few hours, the very foundations of our society began to falter: globalisation, consumption, travel, social contacts, all these habits so deeply rooted in our cultures stopped, giving way to uncertainty and anxiety. And yet there had been many warnings, SARS in 2003, H1N1 in 2010 and Ebola in 2013. Too local, too distant, these epidemics were never really taken seriously by our leaders. A few years later, Covid-19 would remind us that we all live on the same planet and that viruses do not care about borders or origins.

Throughout the year, the global pandemic will have gratified us with several successive waves of contamination that we will not need to comment on, but which have highlighted the organisational capacities in the world. South-East Asia, led by China, is a very good lesson, probably capitalizing on the various epidemics already controlled in the past. Australia, Taiwan but also New Zealand, with their natural isolation, are also at the top of the table. As for the United States and Europe, the sanitary situation has been and still is worrying.

Thankfully, for what is characterised as the greatest medicinal achievement of the 21st century, the discovery of a vaccine allows us to see the light at the end of the tunnel. Nevertheless, this success will only be one if the acceptance rate by the world population rises, which is not necessarily the case for the moment: *too fast, too good*, there are many reluctant people... But before talking about the future, let us look back at this intense year from an economic and financial point of view.

A LOOK BACK AT **2020**

From an economic point of view, the brutal exogenous shock caused by COVID-19 has no precedent before the end of the Second World War. Economic growth collapsed in the first half of the year when global activity was brought to an abrupt halt. Since then, momentum has returned, helped by Central Banks but also by "pandemic break" in the summer. The role of the State through fiscal stimulus has been paramount for companies, as the support of the Central Banks cannot solve everything on its own. One thing is clear: between low interest rates, quantitative easing with massive asset purchases and new refinancing operations, **inflation remains at modest levels**. Consumer price index is expected to rise by 1.2% in the US and 0.3% in Europe over the past year.

As for **world growth, over the year 2020**, it is expected to **fall by 3.9%,** slightly lower than the **United States (-3.6%)**, while **Europe** is expected to be well below **(-7.4%)**.

Some wavering at the beginning made us fear once again that Europe was too sluggish compared to our American counterparts, but the responses that followed quickly reassured. **The more severe impact on European growth would this time come from other factors**. Affected from the first quarter, Europe had to undergo this shock on a growth trajectory that was already less dynamic than that of the United States. The damage to an initially weaker economy was all the more significant, not to mention the even more radical plunge in the second quarter caused by the generally stricter containment measures throughout

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Europe. Let us also note the economic weight of some vulnerable sectors such as those linked to tourism in the peripheral countries.

Even if a common response during the first wave took a long time to materialise, the good news came out of the woodwork during the summer, with **a 750 billion euro recovery plan**. The principle of mutualisation of part of the debt is new. Hungary and Poland, known as conservative, first opposed to the mechanism tying EU funding to the rule of law. They almost ruined everything, but Germany, which held the rotating presidency of the Council of the European Union, managed to reassure the two protagonists at the last minute. In any case, in addition to this step taken in favour of the concept of **mutualisation of sovereign debts**, which is so difficult to graft onto our European project, **a recovery plan** has been added, **particularly oriented towards the major challenges of the 21st century**, including climate change, exacerbated by the current pandemic.

Billions for the climate will therefore rain down on Europe, China and perhaps even the United States. Not thanks to Donald Trump, but to his successor **Joe Biden**, newly elected in a sensational race for the White House, an outcome that the outgoing president has still not accepted. It does not matter, it is indeed the Democratic candidate who will replace the real estate magnate from January 2021. A breath of fresh air in international relationships and an election that has finally been well digested by financial markets, because well away from the blue wave hostile to Wall Street that investors could fear.

These financial markets will have played with our nerves in 2020. **Index volatility will have been the most brutal in history**. The big winners of the *COVID effect* are clearly all companies directly or indirectly linked to the digitalisation of the economy, online sales, the Cloud, home delivery. Amazon, STMicroelectronics, but also Microsoft and Delivery Hero, all these values were in full swing in a year that will go down in history.

In the end, in a **buoyant digital environment**, eyes inevitably turn to the Nasdaq, which ended the year up 44%. Its Chinese counterpart also performed very well, and quite logically in a country where digital has become almost cultural. The operators of e-commerce platforms such as Meituan, Pinduoduo or Vipshop, still unknown a few months ago, have become stars.

The bottom line is that, at the end of a turbulent year, growth stocks, focused on the sectors least affected by the health crisis (technology, e-commerce, but many others) continued to outperform, even if the Value segment rebounded strongly when Pfizer first announced an effective vaccine.

From a geographical point of view, Europe is still lagging behind, which is quite logical given the more cyclical nature of European companies. However, some companies in the payment industry (Wordline, Adyen), digital industry (Capgemini) or linked to the *green recovery* (Schneider Electric) have done well.

Valuations posted at the end of the year as well as the euphoria surrounding the new American tech IPOs certainly call for **caution**. The fact remains that **in an environment where one lockdown follows another** and freedom of movement remains weak, **the technology segment almost acted as a "safe haven".** Above all, apart from the equity market, there are not many alternatives for finding positive return.

On the **bond market**, the year was again marked by a pronounced **fall in yields**, with the 10-year Bund moving permanently into negative territory (-0.57%). In the United States, the 10-year Treasury also reached a low of 0.508% at the beginning of March. These interest rate movements, impacted by extremely accommodating monetary policies and global uncertainties related to COVID, made a major contribution to the strong performance of segments with longer durations. The various credit segments also performed well, although volatility at the beginning of the year was quite high.

In the **currency market**, **the US dollar has been the big loser** since the beginning of the year, even though it played its role as a safe haven at the peak of the crisis. As for the euro, it has regained some ground, particularly after the signature of an agreement on the regional recovery plan. The British pound remained subject to the many ups and downs surrounding the "Brexit" case. Some emerging currencies suffered terribly from the COVID-19 crisis when there were already many problems in these countries. Finally, a word on the Chinese yuan, which appreciated strongly against a basket of currencies including the dollar.

Let us remember that the year 2020 will probably remain a great catalyst for a new wave of digitalisation accelerated by COVID. There are doubts as to whether this will drastically change our consumption habits in the long term. The fact remains that many challenges remain, whether they be social, economic, health or environmental.
On the road to 2021...

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OUTLOOK FOR **2021**

MACROECONOMIC SITUATION

As a result, the economic cycle took on a rollercoaster ride in 2020, with spectacular rebounds following historic plunges. It seems clear that **the macro environment is deteriorating again at the turn of the year** due to the pandemic trajectory and associated restrictive measures. This is particularly true for Europe, which is likely to experience another episode of contraction in activity - though fortunately on a smaller scale than the previous one, and to a lesser extent in the United States.

However, the availability of promising vaccines suggests a better future with **a more sustainable re-acceleration from spring onwards**. Beyond the effects of reopening, greater visibility should boost **the confidence of economic agents**, which may encourage investment and hiring decisions, and reduce precautionary savings.

Although not as powerful as in 2020, the cocktail of monetary and fiscal policy and its effect on financial conditions should remain stimulating.

Finally, 2021 could benefit from **a less destabilising political context** than in recent years with a rather light political calendar, a change of approach in the White House and the Brexit settlement.

However, we should not be fooled: the health crisis will leave its mark with a slower normalisation in some sectors, increased indebtedness in the public and private sectors, and the sometimes permanent destruction of companies and jobs. **Despite the rapid growth anticipated, the level of activity in the major developed countries will remain below its pre-virus trajectory at the end of 2021**.

In our opinion, this production deficit is fundamental in the analysis of inflation prospects, as it will weigh on the "pricing power" of companies and on wage growth. Fears of **an inflationary take-off** linked to a relocation of supply chains or ultra-expansionary public policies seem to us to be **premature at the very least**. Leaving aside the noise created by a few purely mechanical effects (oil, German VAT, etc.), the trajectory should remain on **a very modest rise in core inflation** in 2021 towards still benign levels.

With their post-financial crisis experience, **the world's main central banks should remain extremely cautious**. The tool of key interest rates is obviously constrained given that zero has been reached or pushed down in most major countries. The emphasis is therefore placed on other parameters. The Fed will thus aim to temporarily exceed its inflation target of 2% to compensate for the past weakness of price increases, suggesting a long period of rate stability. It will also continue to purchase assets at least at the current level of $120 billion per month. In Europe, the ECB has just announced a further strengthening and extension of its measures on liquidity injections into the banking system and on its envelope for asset purchase programmes (EUR 500 billion more to be spent at least until March 2022).

IN THE BOND SEGMENT

Low inflation, the extended status quo on monetary rates and the massive purchase of **sovereign debt** by central banks should provide a strong anchor for bond yields. However, we expect **long-term rates to rise slightly** due to reduced uncertainty, cyclical acceleration and the increased supply of paper in the US. Given the historically low starting point, the expected rise, however moderate, is sufficient to produce slightly negative expected returns for the major developed markets. Except for short-term hedging or diversification purposes, **sovereign bonds do not seem to be an attractive option for the unconstrained investor**.

Within the bond universe, **credit seems to offer a slightly more attractive alternative**. Risk premiums have certainly melted after the extreme tension in March, largely anticipating the expected economic recovery and reducing the margin of error on valuations. However, the early stage of the cycle should prove favourable for this segment, along with reduced supply, central banks and the desperate search for assets with positive absolute returns. **All in all, credit should beat government bonds** and generate modestly positive returns, **but will require continued attention to bond picking and diversification**.

IN THE FX SEGMENT

On the foreign exchange market, **the US dollar** has been losing ground since the end of the first lockdown period, **having at least partially lost two of its major benefits**: the attractiveness of the ultimate safe haven in extreme situations and an appreciable interest rate differential. Despite this depreciation, the USD can certainly not yet be considered as fundamentally cheap.

As for **the euro, supported by a global recovery and long-term structural factors** - such as a robust balance of payments and the chronic under-exposure of international investors - we believe that it can still appreciate somewhat **towards a USD 1.25 zone**. A more sustained movement appears to us to be hampered by the region's macroeconomic and institutional fragility.

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IN THE EQUITY SEGMENT

Despite the many ongoing uncertainties and concerns related to the new wave of the pandemic in the Northern Hemisphere as outlined above, **the outlook for 2021 looks promising for equity markets**. There are **several reasons** for this:

1. If they overcome the reluctance of the population, **the next vaccination campaigns** against COVID-19 should reach a sustained rhythm from the 2nd quarter of 2021. The high quality results of the efficacy tests for several vaccine candidates and the rapid availability of considerable logistical and production resources suggest that the containment and traffic restriction measures will be significantly eased. As a result, we can expect **a strong cyclical recovery** in the northern hemisphere, starting next spring, as announced above.

2. **The financial and budgetary conditions, which remain very favourable**, obviously stay major supports for equities. Our inflation outlook suggests that central banks will maintain a very accommodating policy, at least until 2022. The resulting low real interest rates make equities attractive (reasonable risk premiums), even if their absolute valuation level may seem tense on a historical basis.

3. **The political sky should also clear up:**

   a. In the **United States**, the outcome of the presidential and legislative elections should steer **economic policy towards the Democratic centre**, good news for Wall Street. The first appointments in the new administration under President Joe Biden reflect choices rather far from the wishes of the radical progressive wing.

   b. In **Europe**, the prospects for economic recovery are also supported by the approval of **this ambitious recovery plan financed by the Commission**, focusing on energy transition and the digital sovereignty of the Union, not to mention the European budget for the period 2021-2027 (1,074 billion euros). The recovery plan, which will be targeted at the countries most affected by the pandemic, particularly in southern Europe, is indeed a first since it significantly strengthens European integration by allowing a much better flow of savings from north to south. Until now, the surplus savings of Germany and the Netherlands have been invested in US Treasury bonds, to the detriment of European growth. And even the **Brexit case**, the almost eternal pebble in the EU's shoe to attract the confidence of foreign investors, ends on a positive note.

Whole swathes of the stock market are still far from their pre-crisis levels. Even if many sectors will remain durably weakened by the crisis (air transport, tourism, oil sector...), **cyclical sectors considered as "value",** including financial stocks, which had particularly suffered from the broad lockdown decided last spring, should continue on the road to recovery, benefiting from a rotation of the portfolios of investors overexposed to the growth segments, big winners of the health crisis, but which today suffer from very demanding valuations.

The Old Continent's equity markets could thus catch up with the performance of the American stock market, which is heavily weighted in technology stocks (27% of the S&P 500 index, but 20% concentrated on only 5 companies increasingly under the spotlight of criticism from American and European political leaders and antitrust authorities).

But we will conclude this note almost as we started it: **the health crisis has however accelerated the fundamental trends of the economy**, in particular **digital transformation** (cloud, e-commerce, telework, 5G, Internet of Things, blockchain, artificial intelligence...waiting for quantum computing) and **ecological transition**. This is bound to have significant impacts on investors' allocation choices (increased importance of the ESG theme in investment flows; still significant allocation in new technology sectors). **Asian markets**, led by China which has demonstrated its great resilience during the crisis (the only major power whose GDP will grow in volume terms in 2020), the relevance of its macroeconomic policy choices and the effectiveness of its containment strategy, **should continue to benefit from the favours of international investors**.

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