# 2021 Outlook: The rapid reopen

When we consider the outlook for 2021, we can break it down in terms of three key themes. First, when we look at the broad macroeconomic environment, what we wanted to do coming into 2021 is identify asset classes that would perform well in the environment that we think we're headed into. And that leads us to our growth inflation momentum matrix. So through each of these four quadrants in our growth inflation momentum matrix, we've then been able to identify how various asset classes perform within each of these micro cycles within the broader economic cycle. Now, we believe we're in the top-right quadrant, with accelerating growth and accelerating inflation. Now, this is actually a very positive environment for equities. The green denotes that these asset classes see good performance in this environment. And in fact, when we look at the TSX in particular or the MSCI emerging market index, these markets are at their best when growth is accelerating and inflation is accelerating.

Now, we highlight at the bottom here, the DXY, which is the broad U.S. dollar index, and the U.S. 10-year Treasury yield, which is the benchmark for bond yields in the United States, as risks to the environment for 2021. In a strong growth, strong inflationary environment, we tend to see the U.S. dollar weaken. At the same time, we also tend to see bond yields rise. On average, historically, bond yields, again using the 10-year Treasury yield again as our benchmark, rise by about 50 basis points or one-half of 1%. This week, we think, is going to be a headwind as we go forward into 2021. Looking at equities on their own, one of the things that we think is going to drive equity performance is the strong recovery that we've seen in global manufacturing.

When we look at our heat map of manufacturing activity, which highlights the major economies around the world over on the left, and then we roll through the two-year snapshot of manufacturing activity, you can clearly see the recession, the lockdowns, and the impact of the global pandemic between March and May of last year. But since then, we've advanced through that and have re-entered strength as far as the manufacturing economy is concerned. This is important to us because the manufacturing economy drives earnings growth for stock markets around the world, and that's the key to performance in 2021. We think we will see earnings growth not only get back to levels of 2019, but perhaps surpass those levels, because of all the monetary and fiscal stimulus that we've seen put into the system. Evidence of the potential for a rapid reopen theme comes in the form of pent up demand, and this pent up demand really has been a result of the various lockdowns that we've seen in this country, that we've seen in the United States and other countries around the world.

The pent-up demand is being represented here by the orange line, which is excess savings. So the savings rate in the United States is sitting at about 13%, which is twice the 20-year average. These savings have been built up as a result of the immobilization, if you will, of economies around the world, where we haven't been able to spend or consume at the same pace as we had pre-COVID. Also, the income support programs in Canada or in the United States, in this example, that really have gone to offset the economic lockdowns. So the savings rate is quite high, incomes actually have grown through this recessionary period, where if we compare to 2008-2009, we actually had contraction. As economies started to open up in the back half of the year, these excess savings and this pent-up demand will be released into a strong wave of economic growth that will fuel earnings growth. And we can already see evidence of this earnings growth coming.

We look at a proprietary manufacturing index has been a very good leading indicator for earnings growth. It is suggesting that we could see earnings growth this year of 30%, perhaps even 35%, over 2020, which again, would take us right back, if not even above, where we were in 2019. Another unique indicator, which is really looking at South Korean exports relative to the MSCIE EAFE, or think of it as international developed markets. We've seen a trough in earnings growth and we're likely to see earnings rebound potentially in a substantial way, as far as international equities are concerned. And again, it's this earnings growth that we think is going to drive markets forward through 2021. Now, in Canada, it's a little bit more nuanced. We do think that earnings growth is going to be strong, but we think that part of the reason of earnings growth tis going to be strong comes out of the energy sector.

Currently, at time of recording, oil prices per barrel, using the West Texas Intermediate benchmark, is sitting at just above 60 dollars. That equates to roughly a 50% increase on a year-over-year basis from where we were right around the start of COVID and through the back half of 2020. We believe that oil prices can remain at this level, and therefore 2021 over 2020 can see a total gain in oil prices of greater than 30%. What we've seen historically is that when oil prices are up, and up strongly, the TSX outperforms. When oil prices are down, then you see the TSX underperform. We're in a period where oil demand is likely to increase, and therefore that's going to drive or help drive performance for the TSX. Fixed income really becomes a tale of two ends of the curve. We have short-term interest rates controlled by central banks around the world, and they've committed to maintaining what we would describe as a zero interest rate policy, and they've committed to this through 2023.

We believe that interest rates will remain this low at least through 2022, but at the longer end of the yield curve, when we can illustrate it this way in terms of the change in long-term interest rates, we've really seen what we could describe as a dramatic move versus just where we were a month ago or where we were six months ago when we look at the U.S. 10-year Treasury yield. In an environment of accelerating growth and inflation, we tend to see long-term yields move up by an average of 50 basis points. While we've seen roughly that move, we think it can continue over the course of the next 12 months. Our target for the 10-year yield is 1.5%, but the risk is to the upside where we could see the 10-year Treasury yield even surpass that and approach 2% before the end of 2021. And this is the headwind that we see for bond investors. As we know, when bond yields move up, bond prices fall, so this could be a very similar environment to what we saw in 2018, which was a little bit more difficult for fixed-income investors. We do believe 2021 is going to be a positive year from an economic growth perspective and from an equity market perspective.

On our rapid reopen thesis, there are really three components to it. The first one, we are headed towards faster growth and higher inflation. The second one, though, is with that in mind, and as our matrix at the beginning has suggested, we want to favour cyclical equities in this environment. That includes Canadian equities, that includes emerging market equities, it includes those equities that are more sensitive to the economic cycle and an improving economic cycle. And then the third theme is bonds, it's this 2018 all over again. Well, we're seeing signs of higher inflation. We know central banks want to see higher inflation, they're going to keep short rates anchored at this lower bound of close to zero, but longer-term interest rates are going to move up. And so in this environment, we want to shift away from interest-sensitive bonds to those that are more economically sensitive. This would include high-yield, emerging market debt and investment-grade corporate bonds really focusing on shorter duration in order to protect ourselves from a rising rate environment.

When we put this together in terms of our model portfolio, we remain modestly underweight fixed income at 35% and overweight equities at 65%. Geographically, with our equity distribution, we can see that we're well balanced between Canada, the United States, international and emerging markets. But we would highlight the two areas that we've been increasing our exposure to: our Canadian equities and emerging market equities. And again within fixed income, our focus remains on corporate debt, credit and short duration bias.

12/19 AODA