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ECONOMIC RESEARCH AND STRATEGY

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2021 Economic and Financial Outlook – A Roadmap to Navigate a New Normal

Executive Summary

The COVID-19 pandemic affects human life more profoundly than any other societal event since WWII. Confronted with human tragedies, individuals, businesses and governments have adapted the best they could. Pre-existing social trends were reinforced and new habits were discovered in 2020. Also, the world recently got a major injection of hope. The high effectiveness of vaccines drove U.S. equities to record highs and contributed to another year of seeming disconnect between economic fundamentals and risk asset performance.

We propose our readers to focus on the nature of the COVID-19 societal shock in order to better understand how 2021 and 2022 could unfold. Compared to the last recession, the 2008-09 Financial Crisis, we note: the faster reactions of governments and central banks to support markets and the economy; the banking system escaping the pandemic relatively unscathed with large capital buffers; households building up unprecedented precautionary savings; a speedy consumer adaptation facilitated by technologies; cybersecurity threats becoming a bigger risk than before due to the popularity of teleworking; a new wave of inequality disproportionally affecting women and young people; elevated long-term unemployment; businesses adjusting their supply chains to an increasingly multi-polar world; more geopolitical tensions and social unrest; a growing preference for local sustainability; the increasing adoption of policies to accelerate the global reduction of carbon footprint.

Surrounded by a myriad of positive fundamentals, risks and vulnerabilities, on top of being in the midst of shaping a New Normal, investors should envision the future as a mix of: thriving pre-pandemic entertainment activities; efficient ways of doing things found because of the pandemic; post-COVID consumption trends.

A short-sighted investment view focusing on the current severe health challenges, elevated equity valuations and risk-on market sentiment favour prudence in tactical asset allocation. Most notably, the second wave of coronavirus infections generates quarantine fatigue and brings global health care capacities to their tipping point. As authorities sort out vaccination plans, another economic contraction cannot be ruled out in the coming months. The possibility of virus mutation and complications in the vaccine process are all downside risks that could slow the path to herd immunity and generate market volatility. This being said, investors with a strategic mindset should look pass these near term challenges. In addition to fast-changing consumer behaviour and continuous macro policy easing, our crucial expectation of an orderly vaccination process leading to herd immunity over the second half of 2021 favour a more offensive, risk-taking approach to asset management.

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"Roaring 2021-2022" to Begin the New Normal

How individuals will behave post-pandemic will more than depend on economic fundamentals, an essential element to consider from a strategic asset allocation perspective. In our view, mass immunization will more than simply remove health and economic anxiety. According to surveys, people will socialize more, have fun and do activities they kept aside for too long when social and economic restrictions were imposed. We see it as the end of pandemic hibernation, an unusual, vivid form of pent-up demand. Unprecedented precautionary savings, lower debt servicing costs fuelled by rock-bottom interest rates and new tools to boost confidence such as a potential vaccination passport will contribute to fuel decadence in late 2021 and in 2022.

At the same time, recent surveys reinforce our view that new habits saving time and money such as teleworking will persist post-COVID (chart 1). Beneficial to the fast-growing intangible economy, work from home represents a major structural challenge for large cities where housing is very expensive and for real estate commercial and office portfolios exposed to core downtown areas.

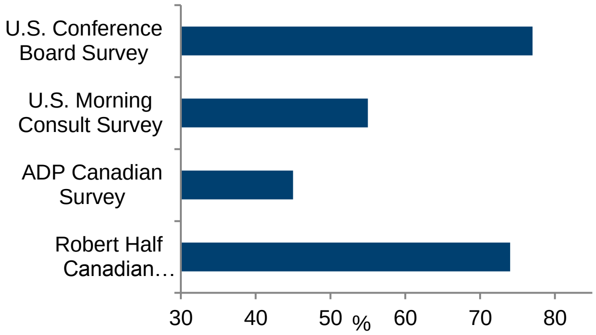
Overall, we see consumer spending as the main driver of GDP growth in 2021 and 2022. However, elevated household debt and high long-term unemployment prevent us from projecting a long lasting decade of above-trend growth in earnings. Thus, we project a "Roaring" moment in late 2021 and in 2022, significantly shorter than the Roaring 20s observed after the 1918 Spanish Flu and WWI.

Pro-Growth Fiscal Stance to Enter a Post-COVID Era

The unprecedented fiscal response to the pandemic drove global public debt to 100% of GDP in 2020, according to the IMF. In Canada, the federal government has been among the most supportive economy in terms of program spending and financial support during the pandemic (chart 2). Even if emergency programs will end in tandem with the full reopening of economies, we expect the fiscal tailwind to remain generally favourable during the first stage of the post-COVID era. In 2021, it will be too early for governments to talk about deficit reduction. Policymakers first need to limit the lingering impact from the pandemic taking the form of bankruptcies. In our central scenario, we assume that consumers and businesses with weak balance sheets and liquidity positions will put a small, limited dent in the pace of the economic recovery.

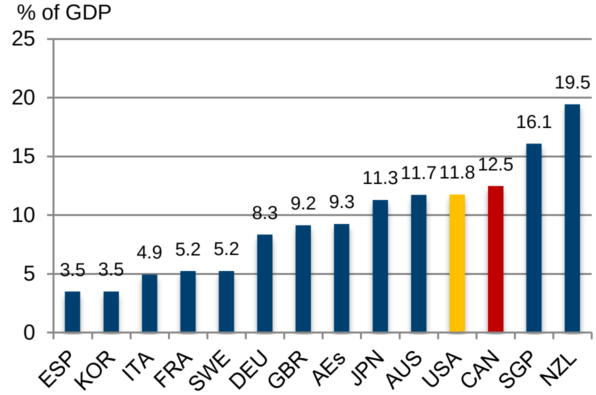
Most governments appear willing to promote growth during the first few years of the post-COVID world. In Canada, the federal government announced a post-COVID stimulus plan worth between $70B and $100B, depending on how the labour market recovers. In Australia, the federal government plans to lower taxes and spend as necessary until the economy reaches full employment. In the European Union, federalism seems stronger than ever due to Germany's pivot regarding fiscal integration. The old continent will not repeat the fiscal austerity that almost broke apart the EU a decade ago. In Asia, India, Taiwan and South Korea have introduced major stimulus packages since last summer, on top of reinforcing their trade relationships with the West. Earlier this year, the largest-ever stimulus package in China helped the more secluded economy to find back its footing before other economies. One big exception to the rule is the U.S. The political gridlock between a Democratic White House and a Republican Senate will likely provide subpar fiscal support.

Chart 1: Share of Workers or Businesses Expecting or Preferring More Teleworking Post-COVID-19 vs. pre-pandemic



Source: 2020 Surveys from Conference Board, Robert Half International, ADP, and Morning Consult.

Chart 2: Discretionary Fiscal Response to COVID-19



Note: AE = Advanced Economies average. Source: IMF Fiscal Monitor, October 2020.

Steeper Yield Curve, Fixed Income Universe Less Attractive than Stocks

In North America, interest rates were pushed to record lows across the yield curve and corporate and subnational spreads retracted significantly from their March peak. This led to strong total nominal returns for sovereign and subnational government bonds, as well as the IG corporate universe in 2020. In 2021, bonds will continue to play a valuable role in terms of income stability. However, the sequence of events leading to a post-COVID era makes fixed income less attractive. Accordingly, we recommend a slight underweight strategical allocation to fixed income.

First, we forecast short-term U.S. and Canadian interest rates to remain pinned down. The Federal Reserve's average inflation targeting and a more inclusive employment maximization mandate require the Fed funds target rate to remain at 0.25% for the next couple of years at the very least. North of the border, the Bank of Canada will stick to its 0.25% policy rate until CPI inflation does not steadily run at 2%, an outcome we do not foresee before 2024.

Relative to short-term rates staying ultra-low, we see a moderate increase in interest rates at the belly and long-end of the curve. First, look for another year of heavy debt supply despite the eventual end of emergency income programs and the non-recurrent nature of COVID-19 health-related expenses. Second, market participants will begin to anticipate the partial withdrawal of some of the unconventional monetary support introduced in 2020. Central bankers will have to deal with the delicate timing and magnitude of the future exit strategy without hampering the economic recovery. We think the lessons learned from the 2013 taper tantrum will inform central bankers in this new business cycle. Back then, long-term yields spiked, including the U.S. 10-year yield rising above 3%, when Ben Bernanke commented about eventually slowing down QE.

The second driver leading us to call for a steeper yield curve relates to a moderate rise in CPI inflation from 0.7% this year to 1.5% next year. Our forecast notably reflects the upcoming demand spike in leisure and entertainment services. Stronger demand in services will give pricing power to companies involved in those selected key CPI components. More generally, macro leftovers from the pandemic, including long-term unemployment, a wide output gap reflecting excess supply in some sectors and limited scarring effects from the pandemic will prevent CPI inflation from reaching 2% on a sustainable basis for a few years at least.

The very possible shift of central bankers' goalposts is the third factor supportive of a steeper curve in 2021. We are of the view that a growing number of central banks, including the BoC, will join Fed Chair Powell by including a form of increased tolerance for inflation above 2% and aiming for inclusive labour market objectives. Zero-bound policy rate and a new economic reality lead us to predict that the BoC will abandon its three-decade old 2% inflation target when it will renew its mandate in 2021.

Finally, longer term factors such as population aging and higher operating costs stemming from on-shoring could contribute to slowly increase medium-term market-based inflation expectations. However, other structural changes, including cheaper energy costs and the impact of new technologies, are disinflationary. Thus, we are not fully convinced that a significantly higher inflation regime is in the making for this decade. At the same time, a growing search for inflation-proof investments could give the edge to the TIPS/RRB segment of fixed income.

Altogether, we see 2021 as an extension of the bear steepening move observed since the end of July in the 2Y-5Y and 2Y-10Y segments of the curve. Yields in the belly and long end of the curve should rise moderately in 2021, without returning to pre-COVID levels.

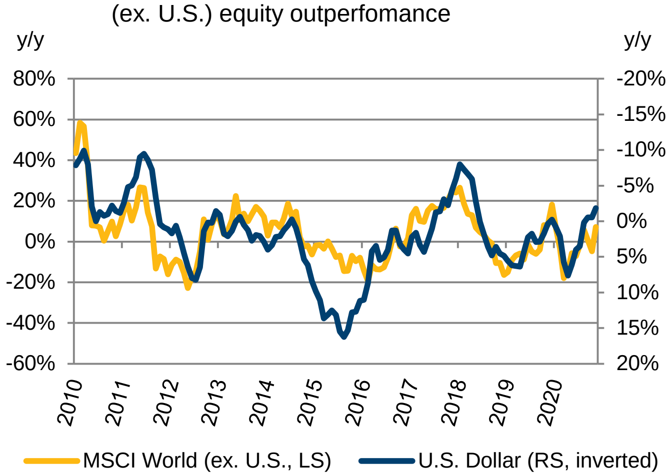
Equities Close to a Sweet Spot, Sectoral Weightings Favour TSX over U.S. Equities

Our expectation for a relatively constructive path to herd immunity favours an overweight strategic allocation to equities. The various themes discussed above also require a judicious equity allocation by regions and (sub)sectors. The gradual, full reopening of the economy favours undervalued stocks such as airlines (*industrials*), hotels and entertainment (*consumer discretionary*) and technology companies geared toward tourism (*communication services*). Similarly, exuberant consumers and new social trends post-COVID will drive up the most adaptable and creative companies in personal care, luxury items and entertainment sub-sectors (*consumer discretionary*).

With respect to geography, looser economic restrictions and a faster vaccination process in the U.K. and in the U.S. could bring these two equity markets to tactically outperform Europe and Canada. However, we do not overweight U.S. equities on a strategic basis. In addition to a weaker job market recovery and the political gridlock in Washington, green shoots for global growth usually leads to US dollar weakness and an outperformance of developed equity markets excluding the U.S. (chart 3). This has more to do with the various equity sector weightings among geographic regions rather than the performance of the respective domestic economies. On one hand, sectors currently cheaper on a valuation basis that have underperformed over the last two years, e.g. value stocks, are more subject to over perform going forward. On the other hand, growth sectors could underperform next year, including information technology, communication services and consumer discretionary excluding the sub-sectors highlighted above. Those three sectors are particularly prominent in the U.S. equity market. As a result, we expect the U.S. to underperform other advanced equity markets. Moreover, growing political pressure to regulate the IT sector could signal an end to years of outsized returns for mega-cap tech U.S. corporations.

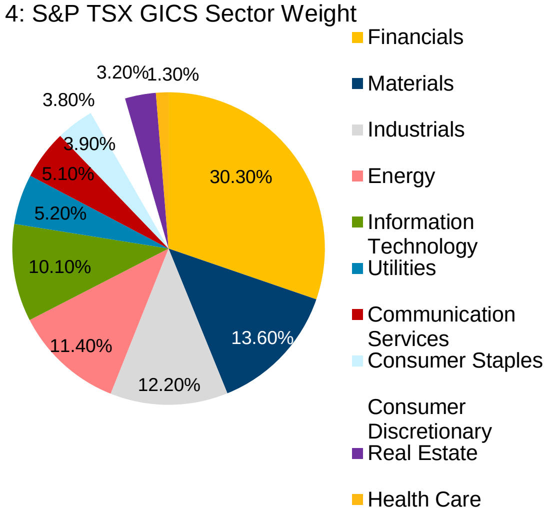
This “value trade” will be beneficial to Canada. Financials, energy and material stocks weigh heavily on the TSX index, at the heart of our call of an outperformance relative to U.S. stocks (chart 4). Accordingly, we expect Canadian stocks to outperform the U.S. market in 2021, with nearly a double-digit gain. First, increasing consumer confidence will replace the current focus on loan losses in the banking sector. A steeper yield curve and easy access to credit will also pave the way for a better return on investment. Second, the coming end of lockdowns will boost oil demand on a more sustainable basis, biting into excessive inventories. We therefore favour energy stocks in our strategic view despite a dimmer long term outlook tied to decarbonization of the global economy that could move faster with U.S. President Biden’s environmental agenda. Third, we see a potential divergence of performances among materials. An increase in CPI inflation and the end of COVID-19 uncertainty make gold less appealing. But, the demand for other materials such as silver and copper will be supported by the accelerating global economic pulse, particularly in emerging markets.

Chart 3: US Dollar weakness usually leads to DM (ex. U.S.) equity outperfomance



Source: Bloomberg Finance L.P.

Chart 4: S&P TSX GICS Sector Weight



Source: S&P Dow Jones Indices

In summary, the stars appear better aligned for the equity asset class than for fixed income. Furthermore, 2021 and 2022 could turn out to be the finest moment of the upcoming decade for equities. After the first stage of the recovery post-COVID, elevated indebtedness will take over short-lived consumer decadence. Central banks will start removing some unconventional support and governments will look for ways to restore fiscal sustainability. Tax increases will look appealing to them. Higher taxes usually stifle economic growth and generate market concerns about after-tax investment returns. Thus, the outlook for corporate earnings looks brighter in 2021 and 2022 than in the long run.

Outlook for the Canadian dollar: FX Markets appear to have priced-in most of the good news

Last spring, when no one knew how severe the pandemic would end up being, the Canadian dollar weakened to 1.42, its lowest level since January 2016. The risk-off movement pushed the value of the U.S. dollar, perceived as a safe haven currency, to a three-year high according to the DXY. At the same time, oil prices were hit by the collapse in demand and a short-lived price war between Russia and Saudi Arabia. Oil futures even traded in negative territory for the first time ever in April.

Since then, the Canadian dollar more than erased its early 2020 losses. First, OPEC+ agreed to increase and extend its massive oil production cuts. Second, prices for metals, minerals and agricultural products, also affecting the value of Canadian dollar, rallied on stronger foreign demand, particularly from China. Third, positive vaccine developments fostered risk-on sentiment further in November, driving down the value of the U.S. dollar and pushing the USDCAD cross rate to 1.28, its lowest level since early 2018.

We interpret the recent movement in the USDCAD as a front-loaded reaction to the upcoming end of the pandemic. In our view, most of the future global recovery has now been priced in. We see WTI oil prices moving up to US$55/bbl in 2021 as OPEC+ continues to draw down excess inventory and maintain production cuts. Net short speculative positions on the Canadian dollar also limit the scope for a sudden depreciation. Similar to the Australian dollar in 2020, we do not expect the loonie to significantly suffer if Canada loses its AAA credit rating in 2021. This likely downgrade would reflect credit agencies' focus on the apparent lack of fiscal discipline in Ottawa post-COVID. Altogether, we forecast the USDCAD to trade slightly below its longer-run PPP value of 1.25 during 2021.

Strategic Asset Allocation Recommendation	
Fixed Income	**-**
Government	-
Corporation	-
Equities	**+**
Canada	+
United States	-
Other Developed Markets	+
Emerging Markets	-
GICS Sectors (Canada)	
Financials	+
Energy	+
Industrials	+
Materials	+
Consumer Staples	=
Consumer Discretionary	=
Communication Services	-
Information Technology	-
Utitilies	=
Health Care	-
Gold	**=**
Cash	**-**

Financial Forecasts

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q4	23Q4
Canada										
Overnight Rate Target	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
3-Month Treasury Bills	0.22	0.20	0.12	0.15	0.22	0.25	0.25	0.25	0.25	0.25
2-Year Bond	0.42	0.28	0.24	0.25	0.30	0.45	0.55	0.65	0.75	0.95
5-Year Bond	0.58	0.37	0.35	0.50	0.65	0.80	0.90	1.10	1.45	1.55
10-Year Bond	0.69	0.53	0.56	0.78	1.00	1.20	1.35	1.50	1.75	1.90
30-Year Bond	1.30	0.99	1.11	1.30	1.55	1.70	1.75	1.85	1.90	2.00
United States										
Federal Funds Rate Target*	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
10-Year Bond	0.67	0.65	0.68	0.97	1.15	1.35	1.50	1.70	1.90	2.10
Canadian Dollar (US$/C$)	**0.70**	**0.73**	**0.75**	**0.79**	**0.81**	**0.82**	**0.82**	**0.82**	**0.80**	**0.80**
S&P 500 Index	2,585	3100	3363	3,750	3,850	3,900	3,950	4,025	4,200	4,400
TSX Index	13,379	15,515	16,121	17,800	18,000	18,500	19,000	19,500	20,500	21,000
Oil WTI (US$/barrel)	20	39	40	47	50	55	55	55	55	55

Quarter-end data

Updated: December 2020 * Upper bound of the target range for the Fed funds rate.