



# Q4 2020 OUTLOOK & REVIEW

QMA's Global Multi-Asset Solutions Team

## EXECUTIVE SUMMARY

### Economic Outlook

- The pandemic and resulting lockdowns led to the most severe economic contraction in decades in the first half of 2020, which was followed by a surge in economic growth in the third quarter as the lockdowns were eased and restrictions were loosened.
- Nonetheless, there are already signs that growth is slowing, and it remains highly uncertain when the global economy will regain pre-COVID-19 levels of economic activity.
- China's economic recovery has been out of sync with rest of the world, suffering the worst of the virus's blows in February. Its economic recovery began in the second quarter, just as the rest of the world was beginning to lock down.
- China's draconian lockdown was highly effective in subduing the virus. As a result, its economy suffered less damage, bounced back sooner and is likely to post positive growth for 2020.
- The pace of the global economic recovery will depend on several critical factors:
  - How the pandemic evolves from here
  - How quickly medical breakthroughs emerge on the treatments and vaccine front
  - Whether or not US-China tensions escalate further
  - Whether governments continue to provide ample fiscal support
- The current downturn was sparked by a pandemic, an external shock, rather than a build-up of economic imbalances that precipitated previous downturns. Thus, the economy should be better positioned to bounce back more quickly.
- The US Federal Reserve (Fed) has changed its operating framework, enabling it to target an inflation overshoot during recoveries, following inflation shortfalls during downturns.
- We think this means the Fed will let the economy run hotter than it would otherwise and will delay tightening until actual inflation picks up a head of steam. The Fed's interest rate forecasts suggest it does not expect to raise rates until 2023.
- The biggest risk right now appears to be politics. The US Congress has not yet agreed on another round of fiscal stimulus, and the odds of an agreement ahead of the election are not good. The loss of fiscal support could undercut the economy's progress and endanger the recovery.
- The results of the US presidential election (including the possibility of a delayed result or a contested outcome) and new policies from the subsequent governing regime are other risks that could prove disruptive to the economy.

### Investment Outlook

- While economists continue to debate the shape of the economic recovery, the recovery in equity markets has clearly been V-shaped, with many markets fully erasing losses from March's severe drawdown.
- Massive divergence among equity market segments has been a defining feature of 2020, as we have generally seen a two-speed stock market.
  - Among US equity sectors, Information Technology and Consumer Discretionary are up more than 20%, while cyclical sectors, such as Industrials, Financials, and Energy, are down for the year. (The latter two are down significantly.)
  - Growth has massively outperformed value, and the US has outperformed non-US developed markets and emerging markets. Within emerging markets, bourses with larger technology sectors beat those heavily weighted in energy/cyclicals.
- The macro environment continues to be positive for equities and other risky assets:
  - Economic growth continues to recover in an environment with lots of spare capacity in both labor markets and industry.
  - Governments continue to provide massive support with fiscal and monetary largess.
  - Inflationary pressures are not likely to force authorities to hit the brakes anytime soon.
  - The Fed's new operating framework is likely to push real rates down even further.
  - The rebound in economic growth has pushed earning revisions sharply back into positive territory. (Thus, the earnings hole for 2020 won't be as deep as originally feared, and US earnings should reach new highs by year-end 2021 if consensus forecasts are correct.)
- The danger is that markets have already moved too far in discounting the improvement in fundamentals, as equity market multiples have reached levels last seen during the Tech Bubble.
- Equity valuations, however, look much less ominous compared to ultra-low/negative rates on cash or sovereign bonds. This, combined with the negative impact of the pandemic on commercial real estate, makes equities look like the only game in town and may be fueling a TINA ("there is no alternative") trade.
- Fixed income spread product will likely continue to benefit from central bank buying and the global search for yield, but spreads are not nearly as attractive as they were and some segments, such as speculative-grade debt, face significant fundamental challenges.
- We believe the US dollar has entered a structural bear market on the back of expensive valuation, narrowed interest rate differentials, and growing budget and current account deficits.
- The weaker dollar and recovering global economy should create a more constructive environment for commodity prices. We are still bullish on gold.

**For Professional Investors Only.**

**All investments involve risk, including the possible loss of capital.**

# The Global Economy: The Long Climb Back

## Economic Outlook:

The COVID-19 pandemic and resulting lockdowns led to the most severe global economic contraction in decades in the first half of 2020. But as the lockdowns were eased and restrictions were loosened, economic life moved back in the direction of normalcy. The JPMorgan Global Purchasing Manager Indexes (PMIs) composite measure, a broad measure of business confidence for both the manufacturing and services sectors, dipped below 50 (which signals contraction) in February, bottomed at shockingly low levels in April and then began to recover. Both the manufacturing and services PMIs moved above 50 in July and registered levels of 51.8 and 51.9 in August, consistent with expansion in both manufacturing and services globally. Measures of economic growth also surged over the summer months, with the major advanced economies expected to post double-digit GDP growth on an annualized basis in Q3 (Figure 1).

**Figure 1: Advanced Economy Growth Rebounds in Q3**

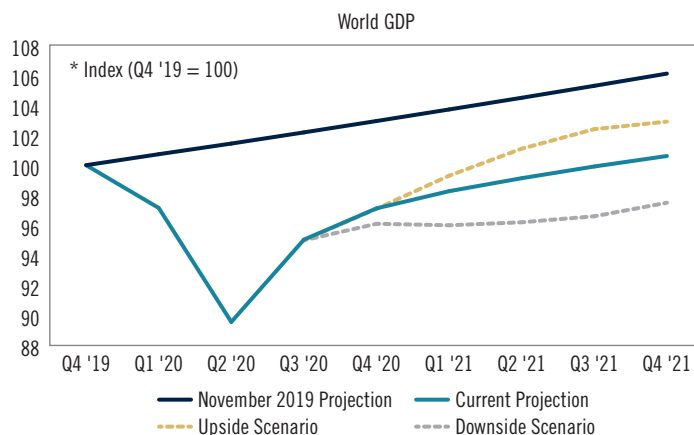
	GDP Growth				
	QoQ Annualized %				YoY%
	Q1 2020	Q2 2020	Q3 2020 F	Q4 2020 F	2020 F
USA	-5.0%	-31.7%	24.8%	5.0%	-4.5%
UK	-8.8%	-76.4%	60.4%	13.6%	-10.0%
Eurozone	-14.8%	-47.2%	33.2%	10.0%	-8.1%
Japan	-2.3%	-28.1%	15.1%	5.0%	-5.6%
	YoY%				
China	-6.8%	3.2%	5.2%	6.0%	2.1%

Source: Bloomberg.  
As of 9/11/20.

Nonetheless, there are already signs that the pace of growth is losing momentum. Growth in Q4 will inevitably be slower than in Q3, and major advanced economies will post annual GDP growth numbers for 2020 that are deep in the red. China's economic recovery has been out of sync with the rest of the world as its economy absorbed the worst of the virus's blow in February, and its economic recovery began in the second quarter when most other parts of the world were just beginning to lock down. China's draconian lockdown was highly effective in subduing the virus. As a result, its economy suffered less damage and bounced back sooner. Thus, China's economy is expected to post positive growth for calendar year 2020 and may have already regained its COVID-related lost output.

It remains highly uncertain when other major economies will regain pre-COVID-19 levels of economic activity. The Federal Reserve revised up its US growth forecast and expects a smaller GDP decline in 2020, projecting the US should fully regain lost output by late 2021. Consensus forecasts also expect a similar recovery trajectory for the US, while Europe and Japan are expected to take considerably longer. Forecasts by the Organisation for Economic Co-operation and Development (OECD) illustrate the considerable uncertainty about the speed and shape of the recovery (Figure 2). In the OECD's base case, the global economy recovers lost output by late 2021, but getting back on the pre-pandemic economic path will require additional time. The path ahead could be bumpy, as the global economy struggles with the pandemic and its residual effects.

**Figure 2: Considerable Uncertainty Around Speed and Shape of Global Recovery**

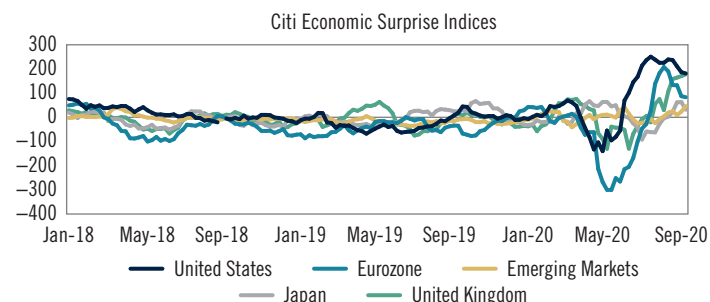


The scenarios illustrate the potential uncertainty around the main projections. The downside scenario reflects stronger and more persistent effects from the COVID-19 virus, which would weigh on confidence, heighten uncertainty and tighten global financial conditions. The upside scenario reflects faster progress in preventing the spread of the virus, boosting consumers and business confidence and spending.  
Source: OECD.  
As of September 2020.

The pace of the economic recovery will depend on the answers to several critical questions. How will the pandemic evolve as the northern hemisphere moves toward autumn and the flu season and as kids head back to school? How quickly will effective medical breakthroughs emerge on the treatments and vaccine fronts? How quickly will governments and the private sector be able to scale up production of an effective vaccine, distribute it, and inoculate large segments of the population? Will the US presidential election and subsequent governing regime prove disruptive to both the economy and markets? Will there be a reescalation of US-China tensions? Will governments around the world continue providing sufficient fiscal stimulus to support their economies, or will fatigue and complacency set in? More action is needed on that front, and the cost of letting up will be many times greater than the cost of continued support.

The current downturn was triggered by the pandemic, an external shock, rather than the build-up of economic imbalances that precipitated previous downturns. Therefore, the global economy should be better positioned to bounce back more quickly today than in the years after the Global Financial Crisis. Meanwhile, economic data continue to surprise to the upside (Figure 3), and news about the development of a COVID-19 vaccine and treatments continues to be positive.

**Figure 3: Global Economic Data Continue Beating Expectations**

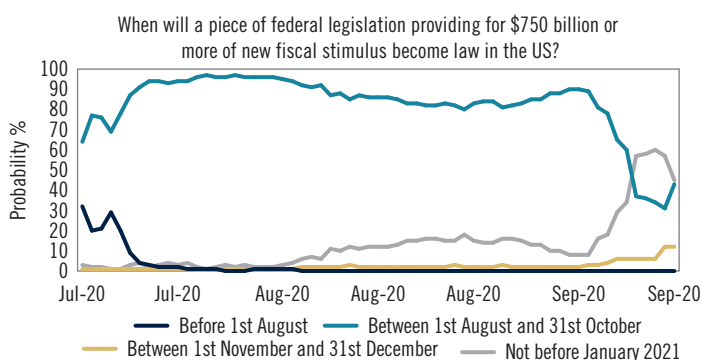


Source: Datastream, Citi.  
As of 9/11/20.

The Fed also announced in August that it would change its operating framework to a flexible inflation-targeting framework. This emphasizes that the Fed will target an inflation overshoot during economic recoveries, following inflation shortfalls during downturns. Thus, the Fed is likely to let the US economy run hotter than it would have in the absence of this change and likely would delay tightening policy until the economy and actual inflation has picked up a considerable head of steam. At its September meeting, the Fed indicated that it does not expect inflation to reach its 2% inflation target until 2023, at the earliest, and hence expects interest rates to remain at zero until 2023.

The biggest downside risks appear to be on the geopolitical and/or political fronts. In particular, the US Congress has been unable to agree on another round of fiscal stimulus, and forecasters are marking down the odds that this occurs before the election (Figure 4). This is a concern, as the economy has not felt the full impact of the pandemic because policy stimulus has filled the hole. While some sort of deal may still emerge, should Congress fail to act, the loss of fiscal support would undercut the progress the US economy has made since May. In that case, the economy's momentum could carry it a bit further, but ultimately the recovery would slow.

**Figure 4: Odds of More Fiscal Stimulus before US Election is Fading**



Source: Good Judgment Project. As of 9/17/20.

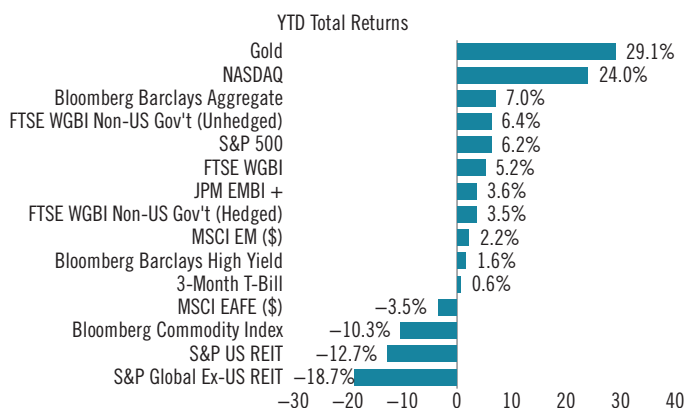
Following the US election, there is likely to be increased fiscal spending on health care and infrastructure (in the case of a Biden win) or further tax cuts and additional spending (in the case of Trump's reelection). We discuss the risks related to the US presidential election in the accompanying sidebar.

## Investment Outlook:

### Don't Fight the Fed

While economists continue to debate whether the economic recovery will be V-, U-, W- or even Nike Swoosh-shaped, the equity market recovery has been V-shaped with many markets fully erasing losses from March's severe drawdown. After surging 20% in Q2, global stocks posted solid gains in July and August, before paring gains in mid-September. Equity market gains continue to be led by the United States with the S&P 500 Index rising to a new all-time high of 3580 in early September before pulling back. International markets continue to lag the S&P 500, but all major markets have had very significant rallies since their March lows. The MSCI EAFE Index is still in negative territory year-to-date, while emerging markets have moved into positive territory (Figure 5), but even the MSCI EAFE Index has recouped losses that began in March.

**Figure 5: 2020 Market Performance: A Wild Ride with Significant Return Divergence**

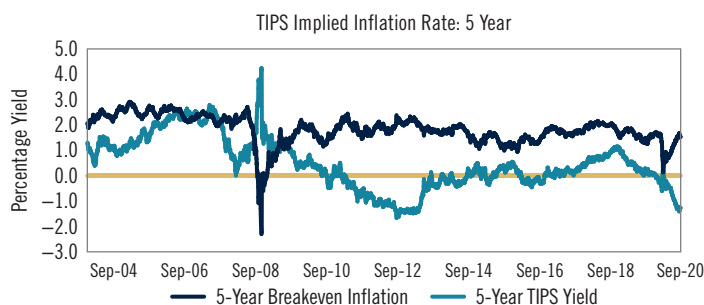


Source: FactSet. As of 9/16/20.

Q2 highlighted a big divergence between the economy and financial markets and validated the idea that markets discount future economic trends, given the surge in Q3 economic growth. Meanwhile, Q3 has further crystalized that we are in a two-speed economy and two-speed market. The S&P 500, for example, is up 6.2% year-to-date and up 50% from its March low. Meanwhile, the tech-heavy NASDAQ is up more than 20% year-to-date, gaining 57% since the March low. Among US sectors, Information Technology and Consumer Discretionary are up over 20%, while the cyclical sectors, Industrials, Financials and Energy, are down for the year. (The latter two are still down significantly.)

The macroenvironment continues to be positive for equities and other risky assets. Economic growth continues to recover in an environment with lots of spare capacity in both labor markets and industry. Governments continue to provide massive support with fiscal and monetary largess, and there is little concern that inflation pressures will force them to step on the brakes anytime soon. The Fed's new operating framework may push real rates further into negative territory (Figure 6). Meanwhile, longer-term inflation expectations have started moving in the Fed's preferred direction, but are still only rebounding from very low levels. On the vaccine front, the number of candidates continues to grow, and regulators are preparing to consider emergency approval measures, potentially allowing a vaccine to become available by year-end. With the rebound in economic growth, earnings revisions have moved sharply back into positive territory. As a result, the earnings growth hole for the S&P 500 Index in 2020 is not nearly as deep as originally feared, and estimates for calendar 2021 are expected to surpass results for calendar year 2019.

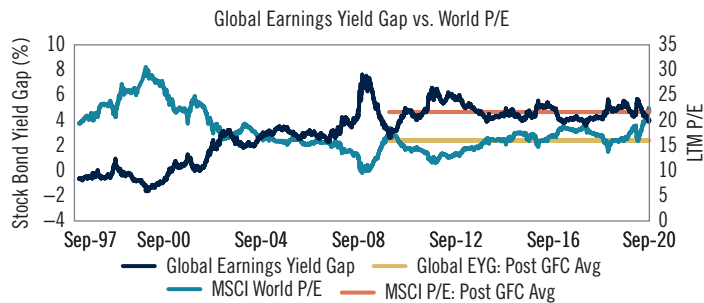
**Figure 6: Real Rates Fall Deeper into Negative Territory**



Source: FactSet. As of 9/14/20.

The danger here is that markets have already moved too far in discounting the improvement in fundamentals, as broad equity market multiples have reached levels last seen nearly two decades ago during the Tech Bubble. But equity valuations look much less ominous on a relative valuation basis compared to zero, near zero, or negative yields on cash and government bonds (Figure 7). This, combined with the lack of appeal of commercial real estate, has led to a perception among investors that equities are the only game in town and may be sparking a TINA (“There is no alternative”) trade, especially with the Fed seeking to push real rates further into negative territory.

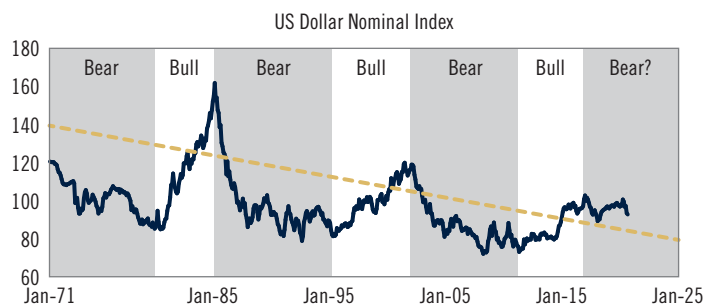
**Figure 7: Global Equities: Absolutely Expensive, But Relatively Cheap**



Source: FactSet.  
As of 9/9/20.

The zero-yield world means that government bonds’ ability to play their historic role of shock absorber in a portfolio context during recession is likely impaired. Thus, alternative tail-risk hedging assets are gaining traction. In July, we outlined a structural case for being positive on gold. We are still bullish on the yellow metal, and a further decline in real rates could fuel another powerful leg up. We believe the US dollar has likely entered a multi-year bear market on the back of expensive valuation, reduced interest rate differentials, and growing US budget and current account deficits (Figure 8). The weaker dollar and recovering global economy should create a more constructive environment for commodity prices, which suffered a truly miserable trailing decade.

**Figure 8: The US Dollar May Be Entering a Structural Bear Market**



Source: Datastream.  
As of 9/4/20.

REITs have underperformed the broader equity markets massively year-to-date, and we expect relative performance difficulties to continue, given the ongoing fundamental challenges facing key segments, including retail, hotels, and the office sector. Here, COVID-19 has been part change agent and part accelerant of existing trends. Either way, in a post-COVID-19 world, we should expect more working from home, more online shopping and less business travel. Our colleagues at PGIM Real Estate have pointed out that once a commercial real estate downturn has begun (and one certainly has) a central scenario involves a roughly 20% fall in values in real terms over two to three years, with a lower bound around negative 40% over the same period<sup>1</sup>. More optimistic scenarios could see prices little-changed over two years, they note, but the nature of the COVID-19 shock points toward higher-impact scenarios.

<sup>1</sup>Global Outlook: Real Estate During a Crisis, May 2020, PGIM Real Estate

## US Presidential Election: Will Politics Derail the Markets?

The US presidential election draws deep interest from investors around the world because of the size and importance of the US economy and the potential for the election to deliver significant changes in fiscal, trade, healthcare and regulatory policies, which, in turn, may have implications for corporate profits, consumer spending and financial markets. The 2020 election is particularly significant given the current political context. In 2017, President Trump and a Republican Congress delivered a massive tax cut, focused on corporate tax relief, and the administration also has broadly slashed regulations.

The real possibility of a blue wave (the Democratic Party winning back both the presidency and the Senate, while maintaining control of the House of Representatives) may result in at least a partial reversal of those policies. However, the margin of seats captured in any Democratic victory in both houses of Congress will impact Democrats’ ability to effect broad legislative change, and a new government may choose to tread carefully with respect to enacting large tax increases given the economy’s fragile state. Further, any negative economic impact from the reversal of corporate-friendly policies under a Biden administration could be offset by broad fiscal expansion skewed toward government spending, which may stimulate aggregate demand, and by a less confrontational stance on trade, which might reduce market risk premia. There is also the possibility that the Republicans retain control of the Senate, which would prevent the reversal of the tax cuts. Finally, no one should rule out the possibility of President Trump’s reelection with more than a month before election day and a Supreme Court battle offering a chance to reset the race.

Markets typically are able to quickly digest and price any risks associated with a new governing regime once the outcome of the election is clear, but the uncertainty in the run-up to an election typically results in increased volatility. Historically, after the election has passed, we have seen a clearing of uncertainty, which creates a more constructive environment for stocks as the outlines of the new administration’s policies take shape.

The structure of the VIX futures curve suggests investors are anticipating a rise in volatility, with a kink in the curve showing elevated implied volatility for the October-November contracts. The U.S. Economic Policy Uncertainty Index typically rises 8.7% in the first 10 months of a presidential election year, before easing in the months afterward. This year, that index has jumped 35%, even after falling 14% in the past two months.

Why has the uncertainty index increased so much? We have seen increased polarization in the US, with close presidential elections, Congress changing hands more frequently, and two presidential candidates winning elections without winning the popular vote. The pandemic has created additional uncertainty by increasing voter reliance on mail-in-balloting. Thus, there is an increased probability of a delay in knowing the election results and of a contested outcome. With a large percentage of Democratic voters indicating they will vote by mail and Republican voters planning to vote in person, there may be no clear winner on election night. This heightens the risk of litigation and demands for election audits. Thus, there is the risk that uncertainty could drag on for weeks after the election. An extended period of uncertainty would keep markets volatile and increase the potential for a drawdown in risky assets until clarity emerges with regard to control of the presidency and Congress.



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\*Assets under management (AUM) are based on company estimates and are subject to change.

## Notes to Disclosure

Sources: Datastream, FactSet, Good Judgment Project, OECD Economic Outlook and QMA. **This is intended for Professional Investors only. All investments involve risk, including the possible loss of capital. Past performance is not a guarantee or a reliable indicator of future results.**

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