2021 Market Outlook

The World Will Look Radically Different in 2021

2020 was a dramatic year by many measures. The global economy saw the worst annual GDP contraction (-4%) in 75 years, and a global pandemic took over 1.5 million lives. We expect an equally dramatic 2021, with immunity to COVID-19 reached in 2Q in the U.S. The combination of reopening, monetary and fiscal stimulus, and pent-up demand will supercharge growth in 2021. But stocks may only make modest returns, tempered by multiple compression, and overall equity returns will hide performance differentials at the region, sector, and style level, similar to 2020. As the world goes back to normal, the premium for highly valued stocks should also return to normal. It is more important to position for this rotation in style performance than to be overweight stocks in our view.
The cover of Time magazine recently proclaimed 2020 “the worst year ever.”1 While historians might argue that, in the past hundred years, the Great Depression, Stalin’s famines and purges in the 1930s and 1940s, World War II, Mao’s Great Leap Forward, or the Vietnam War included worse years for humanity, 68 million people—and counting—have been infected by COVID-19 in 2020 and a staggering one and a half million have died as a result of the virus. The global economy collapsed in the first half of the year and will shrink by nearly 4% in 2020, the worst annual contraction in nearly 75 years.

Millions lost their jobs, including more than 20 million in the U.S. and five million in the Eurozone. Corporate profits also collapsed by -17% for the year (and by -30% during the second and third quarters), with defaults of highly-indebted U.S. companies hitting nearly 9% despite significant monetary and fiscal support programs. Though the virus continues to rip through the global population, most of the economic damage occurred in the first half of the year, with the second half seeing the beginning of a recovery aided by unprecedented fiscal and monetary policy stimulus and the partial reopening of economies.

From an investment perspective the most extraordinary aspect of 2020 was that, despite the damage to people’s lives and livelihoods, global stocks rose +10% with China up +25%, the U.S. up +16%, and with Japan and EM ex-China up more modestly at +6% and +2% (the Eurozone was the only major region with slightly negative returns at -3%) year-to-date as of November 30.2 Most bond indices also rose strongly, led by U.S. Treasuries (+8%), TIPS (+10%) and high grade corporates (+9%), with only emerging market local currency bonds lagging, at -4%.3 Commodities had highly bifurcated performance, with gold and industrial metals rising +17% and +15%, respectively but oil dropping -29%.4

As eventful as 2020 has been for individuals and for economies, we expect an equally dramatic 2021. With two extremely efficacious vaccines soon to be widely available, we expect that broad herd immunity will be reached in the second quarter in the U.S., with the virus likely fully conquered by the third quarter (see Display 1). The Eurozone and other developed countries are likely to be less than a couple of months behind the U.S., while emerging markets may take six to 12 months longer to achieve total immunity. Clearly, the second (and potential third) waves are disrupting economic activity and could continue to do so for another few months. However, one thing is clear: if 2020 was the year of living with the virus, 2021 will be about the return to normalcy. Thanksgiving and the holidays in 2021 will be radically different than they were in 2020, in many ways the exact opposite, with people eager to return to normal, to gather in groups with family and friends indoors, in homes, bars, restaurants, sporting venues, and theaters, without fear; to return to shopping in person, traveling to see much-missed family or for vacation, adventure, and relaxation. Of course, some things will have changed, but most things—much more than expected—will go back to normal. We use China as a template for how the population might behave post-COVID-19, since China succeeded in controlling the spread of the virus earlier and better than most other countries. In China, hotel occupancy is back to 100% of pre-COVID-19 levels, domestic air travel is also back to 100%, as are restaurant sales. On the other hand, international travel is still down by 95% because COVID-19 is out of control outside of China and, maybe as an indication of a permanent shift in consumer preferences, movie

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2 Bloomberg; all returns MSCI net total return indices in local currency terms.
3 Bloomberg Barclays US Treasury Index; Bloomberg Barclays US TIPS Index; Bloomberg Barclays US Corporate Bond Index; JP Morgan GBI EM Index (USD unhedged).
4 Spot prices for gold and Brent crude oil; S&P GSCI Industrial Metals Index.
theater attendance is still at only 80% of pre-COVID-19 levels. Interestingly, while virtual video calls in China are still higher than they were before COVID-19, they have already collapsed -60% from this year’s peak levels (after having quintupled from pre-COVID-19 levels).

With normalcy returning—as the vaccines bring new infections down to zero—we expect the global economy to rebound as strongly as it was hit in 2020. In addition to the reopening of the economy driving a surge in activity, most countries, apart from China, have both their monetary and fiscal policy settings at maximum ease. We expect all developed countries to continue with zero or negative interest rates for years to come until inflation has fully returned to, or exceeded, target levels, supplemented by quantitative easing for at least the next year or two. Fiscal stimuli are continually being added to and increased, with the U.S., Eurozone, Japan and the U.K. all planning additions. Though clearly, the magnitude will be smaller in 2021 than in 2020 once lockdowns and restrictions are lifted. In 2021, we expect a fiscal deficit of 11% in the U.S. (down from 15% in 2020), with a 6% deficit in the Eurozone (down from nearly 10% in 2020). In addition, significant pent-up demand is likely to be released in 2021, as the economy reopens, especially in certain services which saw demand collapse during COVID-19, such as travel, hospitality, leisure and live entertainment, but also in depressed goods segments of the economy such as apparel and footwear.

This combination of reopening, monetary and fiscal stimulus, and pent-up demand will supercharge growth next year and allow many countries to close their output gaps in 2021 and 2022. We expect the U.S. economy to grow by 6-8% next year, nearly double the consensus’ expectation, and as a result, the U.S. output gap to close by summer 2021 (see Display 2) and Europe’s to close two quarters later. This is a crucial difference from the post-Global Financial Crisis (GFC) period: today

there is no crippled banking system to fix and revive, no housing bubble bust, no household deleveraging to work through, no peripheral crisis in Europe—in short, the world is not facing the long hangover of a balance sheet recession that it was 11 years ago. Therefore, rather than taking nearly a decade to return to full employment, two or three years may suffice.

If the output gap closes in 2021 with the support of monetary and fiscal policy, inflation is unlikely to stay depressed for as long as it did during the 2010s. Though core CPI inflation did average 1.85% during the 2010s (and the core PCE deflator favored by the Fed, 1.6%), economists and markets puzzled over the apparent failure of inflation to sustainably rise above 2.0%. Much of these inflation misses can be attributed to the hangover from the GFC and the years it took for the labor market to get back to full employment. Other idiosyncratic factors such as weak healthcare inflation, or cyclical ones such as a strong dollar and collapsing energy and commodity prices are already in the process of reversing. As a result, we expect inflation to continue to grind higher from 1.4% today to end 2021 at 1.75%, still below target but clearly nowhere near deflation and heading in the right direction. Given the Federal Reserve’s new Flexible Average Inflation Targeting framework, we expect that policy makers will not think about raising interest rates until inflation is above 2% and the economy is back at maximum employment, which may not occur until 2022 or 2023, but clearly deflation fears still present in the minds of many investors are no longer warranted. If correct, this means that long-term government bond yields which almost everyone expects to rise very modestly next year could surprise on the upside, despite the Fed anchoring the short end.

With the global economy growing 7% in 2021, we expect corporate profits to rebound spectacularly in 2021. After shrinking -17% in 2020, we expect global profits to rise as much as 35% in 2021, with bigger rebounds in the worst-hit regions in 2020. For example, in the Eurozone, where corporate profits shrank -35% in 2020, we expect them to rise +63% in 2021. In principle, big

**Display 2**

U.S. Output Gap Could Close by Summer and Exceed +3% by End-2021

U.S. GDP Forecasts, Billions of Chained 2012 US$

<table>
<thead>
<tr>
<th>Year</th>
<th>Trend GDP</th>
<th>Consensus GDP Forecasts</th>
<th>GMA GDP Base Case</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>17,000</td>
<td>-2.1%</td>
<td>-3.6%</td>
</tr>
<tr>
<td>2020</td>
<td>17,500</td>
<td>-10%</td>
<td>-0.6%</td>
</tr>
<tr>
<td>2021</td>
<td>19,500</td>
<td>+3.0%</td>
<td>+1.0%</td>
</tr>
<tr>
<td>2022</td>
<td>20,000</td>
<td>+1.0%</td>
<td>-1.3%</td>
</tr>
</tbody>
</table>


Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.
rebounds in profits should be positive for stock markets. However, while profits fell in 2020, stocks actually rose +10%.6 Obviously, that was driven by a massive re-rating of stocks, which went from trading at 19x trailing earnings-per-share (EPS) to 26x today (or 16.5x to 20x in forward price to earnings terms). Unlike 2020, stocks may only make modest returns in 2021, possibly as low as +5-6%, driven by a big profit rebound but tempered by multiple compression to more reasonable levels around 17-18x forward EPS—a typical pattern in the second year of a recovery.

Modest returns for broad equity indices in 2021 will likely hide substantial performance differentials “under the hood” (e.g. at the region, sector, and style level), similar to 2020. This is what we are focused on and what we think investors should be focused on. Global equity indices generally did well in 2020, but expensively-valued stocks of fast-growing companies had spectacular returns. Using the Russell 1000 indices, Growth stocks returned +31% while Value stocks fell by -1% year-to-date as of November 30.

On top of the prior nine years of strong performance, Growth’s return for the decade is now +364% (versus +130% for Value).6 We saw a similar bifurcation in the performance of countries and regions, with the U.S. and China massively outperforming Japan and the Eurozone, both last year and over the past decade. The majority of this regional performance differential can be explained by sector composition: technology and internet stocks make up 40-50% of the outperforming U.S. and Chinese indices; by contrast they make up less than one quarter of Japanese indices and less than 10% of Eurozone indices.

This bifurcated performance between Anti-Value (high multiple stocks) and Value (low multiple stocks) has resulted in one of the widest valuation gaps between the two that we have ever seen. In the past 30 years, using the Global Multi-Asset (GMA) team’s definitions of the Value and Anti-Value styles,7 Anti-Value stocks have, on average, traded at 25x forward earnings, compared with 11x for Value, a 138% premium. Anti-Value stocks now trade at 43x forward earnings, a 272% premium to Value stocks’ 11.6x (see Display 3). Note that in February 2000, Anti-Value stocks traded at 30x compared with Value at 7.9x, a 384% premium—incidentally the same premium as in March 2020, when Value was at 7.0x and Anti-Value at 27x.8 This kind of valuation premium for highly valued stocks—which do have lower debt, higher margins and higher returns on capital—might have been justified when the global economy was collapsing as panic over COVID-19 forced most of the world into lockdowns, and fears of deflation were pervasive. However, that was 2020. As mentioned, 2021 will look radically different with a vaccine and “pedal to the metal” policy. As the world goes back to normal, the premium for highly valued stocks should also return to normal. Prior cyclical rebounds in Value have seen rallies of +20% to +30% relative to Anti-Value, as in 2012-13 and 2016-17. But Value recoveries after recessions have seen outperformance of +80% to +140%, as in 2000-03 and 2008-2010. Given the degree of undervaluation of low multiple stocks today (relative to high multiple stocks), we are inclined to believe the latter is more likely than the former.

Given that we expect global equities to rally only modestly and government bonds to modestly sell off (to 1.25-1.50% on the U.S. 10-year Treasury), it is, in our opinion, much more important to position for this rotation in style

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6 MSIM Global Multi-Asset Team Analysis; Bloomberg; Factset; MSCI ACWI Net Total Return Index in local currency as of November 30, 2020.
7 Russell 1000 Value and Growth Price Return Indices, as of November 30, 2020.
8 The MSIM Global Multi-Asset team defines Anti-Value and Value as the 20% of stocks with the highest multiples, and the 20% with the lowest, respectively, on a sector-neutral, equal-weighted basis.
9 MSIM Global Multi-Asset Team analysis; Factset, Datastream, as of December 15, 2020.
performance, than to be overweight stocks overall in order to “play” the return to normalcy. Consequently, the majority of the risk in our portfolios is allocated to Value-related positions around the world. Our regional allocations are broadly a reflection of this view, with underweights in U.S. and China equities, and overweights in Eurozone, Japanese and EM ex-China equities. In addition, we expect the U.S. dollar to continue to weaken as the U.S. borrows from the rest of the world at real interest rates which will continue to fall as inflation rises. We also expect commodities and commodity stocks to outperform and have positioned accordingly. Given the negative carry on underweight positions in U.S. Treasuries, we are positioned with long-end steepeners and overweight positions in inflation breakevens.

The risks to these views are manifold, but we highlight three near-term ones:

First, the consensus appears to have radically shifted since Pfizer’s vaccine announcement in early November and almost all sell-side 2021 outlooks now expect an economic recovery and risky assets to perform well. Such uniform consensus, mostly in synch with our views, makes us uncomfortable. We do draw comfort from the fact that our portfolios have little active risk in expensive and frothy equities. Our portfolios are instead focused on positioning for a rotation “under the hood,” or below the asset class level, for example in Value stocks which are still not popular with investors (given their dire underperformance for many years).

In addition, we expect much stronger growth than the consensus and thus potentially higher inflation and higher yields than most, which would favor this rotation. But we are concerned about the increasing frothiness in overall stock market indices as exemplified by record inflows into equity mutual funds in the past six weeks, as this could cause some indigestion in the near term.

Second, COVID-19 new cases continue to grow around the world and it increasingly looks like nothing short of full lockdowns or a vaccine can prevent the spread of the virus. At the same time, governments’ and populations’ appetite for such restrictions has dramatically waned. This could lead to eventually more severe medical system crises and eventually more draconian measures with their attendant impact on economies and markets.

Finally, even though a vaccine is a game changer, reopenings are still a few months away. This makes fiscal relief essential as a bridge or offset for job losses and business failures that will occur in the interim. Months of difficult negotiations in the U.S. and the latest holdup of the European recovery fund by two countries show that fiscal stimulus may not be as easy to implement when the economy and markets are not in full crisis mode. Further delays in stimulus would increase the chances of a double-dip recession in the economy, which could cause a mini-version of March 2020.

In summary, we believe that the world will look radically different in 2021, and the following table (see Display 4) provides a summary of some of the key investment and economic trends we expect in the year ahead.

### Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult
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Longer-term securities may be more sensitive to interest rate changes. Mortgage- and asset-backed securities (MBS and ABS) are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain U.S. government securities purchased by the Portfolio, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the United States. It is possible that these issuers will not have the funds to meet their payment obligations in the future. The issuer or governmental authority that controls the repayment of sovereign debt may not be willing or able to repay the principal and/or pay interest when due in accordance with the terms of such obligations. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed countries. Real estate investment trusts are subject to risks similar to those associated with the direct ownership of real estate and they are sensitive to such factors as management skills and changes in tax laws. Restricted and illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. Trading in, and investment exposure to, the commodities markets may involve substantial risks and subject the Portfolio to greater volatility.

Nondiversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. By investing in investment company securities, the Portfolio is subject to the underlying risks of that investment company's portfolio securities. In addition to the Portfolio's fees and expenses, the Portfolio generally would bear its share of the investment company's fees and expenses.

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DEFINITIONS
The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership.

The Russell 1000® Value Index is an index that measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The S&P 500 Total Return Index is an index that consists of 500 stocks chosen for market size, liquidity and industry group representation. The S&P Index is a market value weighted index with each stock’s weight proportionate to its market value. The S&P Index is one of the most widely used benchmarks of U.S. equity performance. The performance of the S&P Index does not account for any management fees, incentive compensation, commissions or other expenses that would be incurred pursuing such strategy. Total return provides investors with a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend.

The S&P GSCI® is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets. Individual components qualify for inclusion in the S&P GSCI® on the basis of liquidity and are weighted by their respective world production quantities.

The Sharpe ratio was developed by Nobel laureate William F. Sharpe and is used to help investors understand the return of an investment compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Volatility is a measure of the price fluctuations of an asset or portfolio.

The S&P U.S. Treasury Bond Current 10-Year Index is a one-security index comprising the most recently issued 10-year U.S. Treasury note or bond.

The MSCI USA Energy Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Energy sector as per the Global Industry Classification Standard (GICS®).

The MSCI USA Materials Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Materials sector as per the Global Industry Classification Standard (GICS®). The S&P GSCI Gold Index, a sub-index of the S&P GSCI,
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