



## 2021 Market Outlook

# The Haze of Uncertainty Is Lifting

Going into 2021, we expect the haze of uncertainty wrought by COVID-19 and U.S. politics to lift. For the global economy, this could translate into meaningful growth catalysts.



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**GLOBALLY:** We believe the most promising of those catalysts is likely to be the introduction of effective and widely available COVID-19 vaccines around the world. Clearly, the eradication of COVID-19 would be a major factor in facilitating a quicker pace of economic normalisation in 2021.

**UNITED STATES:** Joe Biden is set to become the 46th U.S. president in January, with critical ramifications worldwide. In the near term, we expect the Biden team to provide a credible approach to managing COVID-19, coupled with an increase in fiscal stimulus to soften the ongoing economic impact of the virus. Longer term, we expect to see significant infrastructure spending, tied to innovative green technology, thus aligning the U.S. with the global “Schumpeterian” shake-up of the energy industry.

The Biden administration should ultimately be a boon to both domestic and international policy, in which greater certainty, consistency and co-operation with respect to U.S. global trade policy would be a game changer. This is not to imply that we expect Biden to turn “soft” on China, but more that the “rules of the road” will be clearer, with fewer unpredictable changes in direction, and greater alignment with traditional allies.

**CHINA:** The New Year will mark the start of China’s new five-year plan, which has a clear “growth” agenda—a reversal of the “deleveraging” goal of the previous five-year plan. While China’s focus is their domestic economy, their plan will nevertheless support global economies that export raw materials and equipment needed by China, helping to fuel growth in many of the world’s cyclical sectors.

As the world gratefully moves into 2021, we see plenty of reasons to be optimistic.

## A more synchronised economic recovery

The global economy is likely to see both developed market (DM) and emerging

market (EM) growth accelerate in 2021. This has not occurred since 2017, which marked the beginning of a period of divergent economic outcomes due to Chinese financial deleveraging, a manufacturing recession, global trade disruption and tightening financial conditions, as the Federal Reserve raised interest rates and the U.S. dollar surged.

Critically, the world’s two largest economies are both focused on increasing domestic demand and implementing an agenda for structural medium-term investment.

## Consumers will reach a crossroads in the spring of 2021

### POSITIVES FOR CONSUMPTION GOING INTO 2021, ESPECIALLY COMPARED TO THE 2008-2009 RECESSION:

- VACCINES:** The distribution of vaccines should coincide with spring, thus providing a healthy backdrop for the pace of economic activity to pick up in late Q1 2021.
- PENT-UP DEMAND AND EXCESS SAVINGS:** Forced lockdowns and generous government support programmes have resulted in consumer savings rising substantially above the historical average. As at the end of September, U.S. personal income was still 3.9% above pre-COVID-19 levels.<sup>1</sup> However, the follow-on fiscal stimulus from the U.S. may need to be greater than it has been so far to keep income high enough to sustain spending levels.
- STRONGER HOUSEHOLD BALANCE SHEETS:** Household balance sheets are considerably more robust than in the 2008/2009 recession, and there is evidence of consumers reducing leverage ratios in 2020, by using excess savings to pay down debt, particularly credit card debt.
- SURGE IN NEW BUSINESS FORMATION IN 1H 2020:** While further job losses are unavoidable (especially as the crisis accelerates trends towards

automation), current unemployment is less broad-based and less sticky than during the previous global recession (*Display 1*). Moreover, new business formations in the U.S. surged in 1H 2020, and despite a pull-back in Q3, remain elevated relative to recent history, a trend that bodes well for the employment outlook in the U.S. (*Display 2*).

### NEGATIVES FOR CONSUMPTION

#### GOING INTO 2021:

Surging cases of the virus in western developed nations, combined with a lack of further fiscal stimulus in the U.S., may reverse the positive trends for consumers, especially as unemployment remains elevated.

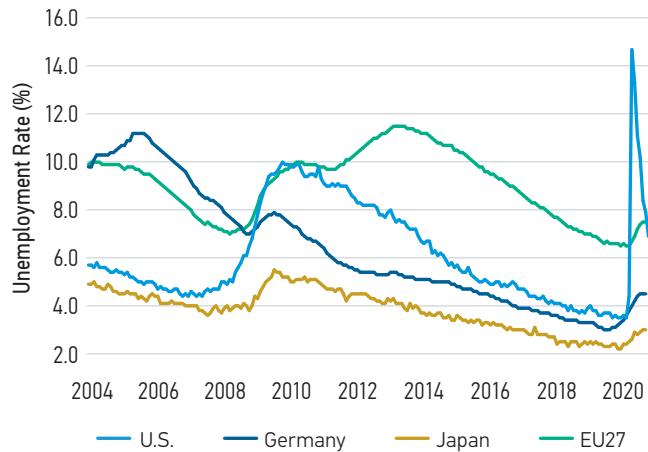
A more intangible variable is consumer sentiment or, as Keynes put it, “Animal Spirits.” After the initial shock from the virus in March and April, U.S. consumer sentiment remained robust as people saw continued improvement in the economy and enjoyed massive income support from the government. The question is whether the recent surge in the virus and Donald Trump’s loss in the U.S. presidential election are weakening these spirits. The latest Michigan Consumer Survey data showed a sharp drop in expectations among Republicans and only a negligible rise in expectations among Democrats. Since the country is roughly evenly split, a deterioration in sentiment among Republicans—if it results in less robust spending—could lead to a softening in U.S. consumer spending.

## Business activity and capex to pick up in 2021

As with the consumer, there are a number of reasons why we expect both manufacturing and capex activity to accelerate in 2021.

- INVENTORY REBUILD POINTS TO ONGOING MANUFACTURING:** Unlike during previous cycles (2000, 2008, 2014), both inventories and new orders had been slowing well ahead of

<sup>1</sup> Bloomberg, 30 September 2020

**DISPLAY 1****Unemployment has been maintained well below 2009 highs**

Source: Haver, 20 November 2020.

the COVID-19 crisis. Businesses did not have a large buildup of excessive inventories, as would have been the case in a booming economy, because growth momentum had already been softening in 2019. The combination of a lower inventory starting level, combined with unexpectedly robust post-lockdown demand, meant that businesses found themselves short

of stock that was in high demand. With new orders for durable goods and inventories now moving in opposite directions, the restocking of warehouses should continue into 2021.

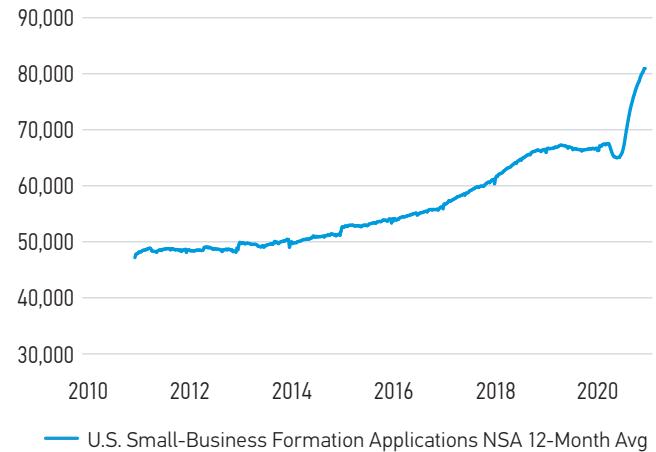
- **CAPEX RECOVERY EXPECTED IN 2021:**

There are already clear signs of a capex recovery playing out. Chinese orders for machine tools from Japan were up 20% YoY in September; the

last time growth was at similar levels was in March 2019.<sup>2</sup> In the U.S., core capital goods orders have surged in recent months and are not only above pre-COVID-19 levels, but are back at highs last seen in 2014 (Display 3). A similar positive trend can be observed in capital goods orders in Korea, whose economy is considered a bellwether for world trade (Display 4).

**DISPLAYS 3 AND 4****Capital expenditures at strong levels across the U.S., Japan and South Korea**

Source: Datastream, MSIM, Bloomberg. 3 December 2020.

**DISPLAY 2****A 2020 surge in U.S. small-business formations bodes well for the 2021 employment outlook**

Source: Bloomberg, Macrobond, U.S. Census Bureau. Data as of 3 December 2020.

<sup>2</sup> Bloomberg, November 2020

## China's 14th Five-Year Plan focuses on domestic growth

### HEAVY CAPEX SHOULD SPUR SHORT-TERM GROWTH

China's 14th five-year plan for the 2020-2025 period outlines a road map for growth in the medium term, but also provides insights into how China is likely to stimulate growth over the next 12-24 months. Capex will form the base of that strategy, as China looks to scale up investment in *transport* (intercity rail and urban transit), *technology* (5G networks, artificial intelligence and data centres, industrial internet, inter-city high-speed rail) and *new energy* (ultra-high voltage power and electric vehicle charging stations).<sup>3</sup> The size of this package is expected to total around US\$1.4 to US\$2.5 trillion (RMB 10 to 17 trillion), invested over the next five years through 2025, according to CCID Consulting.<sup>4</sup>

### CHINA'S MEDIUM-TERM FOCUS: A SHIFT TO QUALITY GROWTH

The 14th five-year plan emphasises a shift from quantity to quality of growth, to the point where the long-standing quantitative guidance on growth has been removed from the statement, creating a stronger focus on productivity and self-sufficiency. We outline the five (out of six) key pillars that are likely to serve as the clearest near-term economic growth engines.

#### 1. TECH LOCALISATION—SELF-SUFFICIENCY IN KEY TECHNOLOGIES:

China's aim is to become self-sufficient in key technologies such as semiconductors and software. China recognises that this is a transition that will take time, with self-sufficiency only targeted for 2035, but it implies that U.S. technology imports are set to decline in the long term.

#### 2. MODERNISING CHINA'S MANUFACTURING SECTOR:

China remains the world's key manufacturing superpower, with

### DISPLAY 5 Six key investment areas in the new infrastructure spending plan<sup>6</sup>

	EXPECTED INVESTMENT 2020-2025 Annual Average (in USD billions)	DEVELOPMENT STAGE	EXPECTED NEAR-TERM IMPACT ON ECONOMY
Artificial Intelligence Data Centres	57	Growth	Highest
Intercity High-Speed Railway	46	Earliest	Low
5G	35	Early Majority	Medium
Industrial Internet	27	Early	Low
Ultra-High Voltage	8	Earliest	Lowest
EV Charging	5	Earliest	Lowest

Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

close to a 30% share of global manufacturing output.<sup>5</sup> However, China seems intent on maintaining manufacturing's share in GDP by moving up the value chain within the manufacturing industry, slowly shifting from lower- to higher-value manufacturing and from old to new infrastructure, via strategies, including digitalisation, cloud computing, automation and robotics.

#### 3. OPENING UP AND ATTRACTING FOREIGN CAPITAL:

**CHINA WILL** continue its push to liberalise trade and investment and ultimately attract foreign capital. In line with its goal of improved self-sufficiency, we can expect a simultaneous effort to promote RMB internationalisation, reduce funding risks, secure capital and decrease the "dollar-centric" nature of international financial systems.

#### 4. A STRUCTURAL BOOST TO DOMESTIC CONSUMPTION:

**WHILE CHINA** is gradually liberalising its external markets, its key focus will be on stimulating domestic consumption in order to regain self-sufficiency and

avoid vulnerability to trade tensions. We see two main mechanisms to do so. Firstly, China could stimulate domestic consumption via investments, where the New Infrastructure fiscal plan will be the main growth catalyst for the economy. Secondly, China could focus on spurring domestic demand by implementing safety-net policies to reduce income inequality, such as social security, education, housing and affordable health care for lower income groups, or fiscal support via income transfer and taxes.

#### 5. GREEN ECONOMY:

In September, President Xi pledged that China would achieve carbon neutrality, or net-zero carbon emissions, by 2060. Likely policies include a carbon cap by 2030, the launch of China's emissions-trading system and green financing. Moreover, the level of carbon emissions could become a key performance indicator for evaluating local government officials.

<sup>3</sup> [www.bloomberg.com/news/articles/2020-05-20/china-has-a-new-1-4-trillion-plan-to-overtake-the-u-s-in-tech](http://www.bloomberg.com/news/articles/2020-05-20/china-has-a-new-1-4-trillion-plan-to-overtake-the-u-s-in-tech)

<sup>4</sup> [www.global.chinadaily.com.cn/a/202005/14/WS5ebcdf01a310a8b241155b32.html](http://www.global.chinadaily.com.cn/a/202005/14/WS5ebcdf01a310a8b241155b32.html)

<sup>5</sup> [www.weforum.org/agenda/2020/02/countries-manufacturing-trade-exports-economics/](http://www.weforum.org/agenda/2020/02/countries-manufacturing-trade-exports-economics/) World Economic Forum, February 2020

<sup>6</sup> China's Urbanization 2.0: New Infrastructure Opportunities Handbook, Morgan Stanley Research, March 2020

## DISPLAY 6

### Latest tactical views

ASSET CLASS	STRONGLY NEGATIVE	NEGATIVE	NEUTRAL	POSITIVE	STRONGLY POSITIVE	ASSET CLASS	STRONGLY NEGATIVE	NEGATIVE	NEUTRAL	POSITIVE	STRONGLY POSITIVE
<b>Equity</b>											
U.S.						Fixed Income					
U.S. Small Cap						IG Credit					
Eurozone						U.S. High Yield					
Germany						European High Yield					
U.K.						EM Sovereign Debt HC					
Japan						EM Sovereign Debt LC					
Asia ex-Japan						U.S. Treasuries					
China						U.S. Inflation					
Emerging Markets						German Bunds					
LatAm						EU Peripheral Bonds					
Global Infrastructure						JGBs					
Global Property						<b>Commodities</b>					
Global Clean Energy						Gold					
Global Financials						Industrial Metals					

Source: MSIM GBaR team, as of 5 January 2021. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor.

## Outlook: We expect equities to outperform in 2021

With diminishing global policy uncertainty and a constructive outlook on growth, we expect equities to outperform fixed income in 2021. We think this background will support the

VIX moving back into a more subdued range, with implied volatility likely to fall back below 20 in 2021.

Within our equity allocation, our portfolio has a tilt towards cyclicals and value—we are overweight the Russell 2000, the DAX, financials and Latin America—while in fixed income, we are underweight rates.

One risk we are keeping an eye on is high-equity valuations. By traditional metrics, equities are overvalued. If they were to adjust to more normal levels, the timing would be very difficult to anticipate. Moreover, history shows that when it occurs, it can lead to substantial negative volatility.

## APPENDIX: Asset class views in detail

### EQUITIES

<b>U.S.</b>	We are underweight growth-oriented large caps, but overweight U.S. small caps. Stronger economic growth is likely to reduce the premium that investors are willing to pay for growth stocks. Moreover, given the combination of extreme valuations and flows, we expect growth to underperform value in the next three to four months. We prefer U.S. small caps over large caps, as we believe this is a better way to position for a burgeoning economic recovery given more attractive valuations.
<b>UNDERWEIGHT</b>	
<b>Large Caps</b>	
<b>OVERWEIGHT</b>	
<b>Small Caps</b>	

	<b>FUNDAMENTALS</b>	<b>VALUATIONS</b>	<b>SENTIMENT</b>
<b>U.S. Small Caps (Russell 2000)</b>	<b>Positive:</b> Reopening of the economy on the back of vaccine availability and fiscal stimulus is likely to be supportive for small businesses. The performance of small caps has been highly correlated with improving macro-indicators in the U.S., such as Consumer Sentiment, ISM Manufacturing and NFIB Small Business Optimism.	<b>Neutral:</b> While U.S. small-cap valuations have risen sharply and appear expensive compared to their long-term average, they trade at a significant discount to large caps.	<b>Neutral:</b> As per EPFR data, fund flows into U.S. small caps have been accelerating in recent weeks, but still remain negative for the year.
<b>U.S. Large-Cap Growth (Russell 1000 Growth)</b>	<b>Negative:</b> Rise in productivity, driven by capex and accelerating inflation, should lead to higher nominal growth and interest rates, a significant headwind for growth stocks.	<b>Negative:</b> Based on the 12-month forward PEs, growth stocks continue to trade at extremely high levels, both on an absolute basis and relative to value stocks.	<b>Negative:</b> Investors piled into growth stocks amidst a belief they are defensive in the current environment, and despite recent underperformance, positioning remains at elevated levels.
<b>Europe</b> <b>Positive Tilt via DAX</b>	<b>Positive:</b> The DAX is one of the most cyclically geared indexes in Europe, so we expect it to benefit from improved economic growth next year. It also has high exposure to Asia and China, where we continue to expect strong growth.	<b>Neutral to positive:</b> German equities are trading at their largest discount to the eurozone in a decade, indicating a relative valuation opportunity.	<b>Positive:</b> Germany is still under-owned in portfolios. If global growth continues to improve, we expect sentiment towards Germany to become more positive.
<b>Japanese Equities</b> <b>NEUTRAL</b>	<b>Neutral:</b> We see some potential for positive developments in Japan coming from the new Suga Administration: a focus on digitalisation and consumer support could help restore consumer sentiment, improve productivity, benefit sectors such as IT and consumer discretionary, and unlock some of the upside from cheap valuations in the country. Nevertheless, we await more concrete developments in this direction, especially with the shadow of early elections lurking over the administration.	<b>Neutral:</b> Japanese valuations appear cheap on a relative basis, whilst on an absolute basis, they are at historically high levels (even when using FY2 EPS figures). Their relative cheapness reflects the outperformance of other regions in sectors such as IT and consumer discretionary. We believe a catalyst is needed to unlock the "value trap" in which Japan has been for some time.	<b>Neutral:</b> Despite generally not being an over-weighted asset class in investor portfolios, Japanese equities have benefited in the second half of 2020 from positive sentiment due to better management of the pandemic relative to the U.S. and Europe.
<b>Asia ex-Japan</b> <b>NEUTRAL</b>	<b>Positive:</b> Asian economic fundamentals across growth, trade, manufacturing and consumption rebounded strongly in 2020 and continue to hold up well. Economic strength has been coupled with strong virus management. The region is likely to perform well as China continues to outperform, benefitting its Asian trading partners who are net exporters to China (reinforced by the recent Regional Comprehensive Economic Partnership (RCEP) agreement). Taiwan and South Korea are also seeing improving economic activity with strong virus management.	<b>Negative:</b> Valuations are stretched, with the 18-month forward PE trading at a 26% premium to its 10-year median. <sup>7</sup>	<b>Negative:</b> Asia ex-Japan is currently trading above overbought levels in the Relative Strength Index, suggesting that sentiment and flows are slightly exuberant.

<sup>7</sup> Bloomberg, 19 November 2020

	FUNDAMENTALS	VALUATIONS	SENTIMENT
<b>Indian Equities</b> NEUTRAL	<b>Positive:</b> Although Indian equities continue to lag broad Asia ex-Japan performance YTD 2020, the growth recovery is now underway. Industrial activity has almost recovered to pre-COVID-19 levels, while auto sales and Good and Services Tax revenue collections also indicate that the recovery is gathering momentum. Government support has been particularly strong, with policies such as the corporate tax cut, incentivising domestic manufacturing of goods, and new agriculture and labour laws that could potentially have longer-term benefits.	<b>Neutral:</b> MSCI India is currently trading at ~23x 12-month forward PEs, above its 10-year average of ~16x and at a 40% premium to the MSCI Asia ex-Japan. <sup>8</sup> Current levels suggest that valuations are stretched, with most of the earnings recovery for 2021 already in the price. However, on a price/book basis, Indian equities screen cheaper both on an absolute basis and relative to emerging market peers.	<b>Neutral:</b> Flows have picked up strongly since May, taking the overall foreign institutional investor (FII) ownership back to 20%, levels last seen at the start of 2020. In contrast, domestic institutions turned net sellers in the past four months, mainly due to high redemption pressure on domestic mutual funds.
<b>China A Shares</b> NEUTRAL	<b>Positive:</b> The speed of China's recovery in both manufacturing and services continues to outperform the rest of the world. Looking forward to 2021, China's GDP is expected to grow 8%, with the credit impulse also at 8% (highest since 2016), coupled with strong virus management, a significant infrastructure fiscal plan, and its 14th five-year plan focusing on domestic and quality growth. <sup>9</sup> These factors provide significant tail winds for the Chinese economy. A Biden presidency will also provide greater certainty on U.S.-China trade relations, although the U.S. may still clamp down on its trade surpluses and intellectual property violations.	<b>Negative:</b> The 18-month forward PE multiple of China A-share is extended at 15.1x, 30% premium over its 10-year median. <sup>7</sup> We do not see much room for further multiple expansion, but expect mid-teens EPS growth to be the main source of return potential.	<b>Neutral:</b> Although we have witnessed modest inflows this year, there is still a structural underweight in Chinese equities among global investors, so we do not yet see positioning as stretched. Furthermore, the inclusion of China-A in the MSCI EM Index should continue to act as a tail wind for flows over the next couple of years.
<b>Latin America</b> OVERWEIGHT	<b>Neutral:</b> We remain overweight Latin American equities given attractive relative equity and currency valuations and the region's high relative exposure to cyclical sectors. This combination should see the region benefit from the current rotation into cyclical and value opportunities. However, both major countries within the index (Brazil and Mexico constitute 64% and 23% of the MSCI Emerging Markets Latin America Index, respectively) <sup>10</sup> are lacking positive fundamental growth drivers.	<b>Positive:</b> Latin American equities are only trading at a 6% premium on FY2 forward PE multiples relative to their 10-year median. <sup>11</sup> On the same metric, Mexico is still trading at a 10% discount. We believe the region has the most attractive valuations relative to EM Asia, EM EMEA and major developed markets.	<b>Positive:</b> Latin American equities are not yet in overbought territory and are likely to continue to benefit from the rotation trade into cyclical and value opportunities.
FIXED INCOME			
<b>U.S. Rates— U.S. 10Y Treasuries</b> UNDERWEIGHT	<b>Slightly Negative:</b> As the U.S. economy continues to recover in 2021, we expect U.S. GDP to get back to pre-crisis levels towards the end of next year. Inflation is likely to temporarily overshoot the Fed target due to favourable base effects, but the highly accommodative Fed and smaller fiscal stimulus impetus should act as an offset.	<b>Slightly Negative:</b> As we are expecting a reflationary environment in 2021, we see the U.S. 10-year yield moving beyond 1%, with the risk skewed towards the upside if activity normalisation occurs faster with the help of global vaccine distribution.	<b>Neutral:</b> We are currently seeing mixed signals from different sentiment indicators, but could see a further unwind of the 2020 inflow into bonds, especially if the recovery exceeds expectations.
<b>Eurozone Rates— 10Y German Bunds</b> UNDERWEIGHT	<b>Negative:</b> As a "safe haven" asset, Bunds remain exposed to selling pressure if uncertainty related to the pandemic decreases (especially on a relative basis as U.S. Treasuries have already retraced partially). The expected EU issuance level related to the Recovery Fund could also be a negative factor for Bunds, which have the same rating as EU sovereign bond issues, but lower yields.	<b>Negative:</b> Bund yield levels remain close to historical lows, offering deeply negative carry. Bunds have recently lagged the upward move in U.S. Treasuries on the back of positive vaccine news, which makes them more vulnerable to upward pressure if the perspective of a vaccine early in 2021 becomes more concrete and increases risk appetite in markets.	<b>Neutral:</b> Recent futures positioning, CTA and real money data suggest that Bunds have benefitted from some buying pressure, but on a relative basis, sentiment appears more positive on peripherals than core bonds, leading to a neutral sentiment assessment.

<sup>8</sup> Morgan Stanley Research, Bloomberg, 4 November 2020

<sup>9</sup> SCMP, Bloomberg, 14 December 2020  
<sup>10</sup> Bloomberg, 30 November 2020

<sup>11</sup> IBES, 2 December 2020

	FUNDAMENTALS	VALUATIONS	SENTIMENT
<b>Investment-Grade (IG) Credit</b> NEUTRAL	<b>Positive:</b> We expect continued economic recovery and positive vaccine news flows in 2021, if pharmaceutical companies make advances in curbing the virus and governments benefit from their experience of dealing with the pandemic. On the policy front, funding from both the ECB and the Fed should gradually come to an end in early 2021.	<b>Negative:</b> IG credit spreads have made a round trip from March wides. Currently, they are sitting at 116 bps, <sup>12</sup> still higher than 2019 lows, but close. This suggests that there is little room for further spread tightening.	<b>Positive:</b> We continue to see strong flows into IG credit. The supply of bonds has slowed after the many records broken earlier in 2020 and, as we begin 2021, we expect a material decline in supply as companies look to instead buy back debt to repair their balance sheets.
<b>High-Yield (HY) Credit</b> NEUTRAL	<b>Neutral:</b> With travel still curbed globally on a major scale, recovery across sectors will differ. Many companies have taken the chance this year to strengthen their balance sheet liquidity positions, improving their resilience to a longer, drawn-out recovery. Additionally, the Fed and ECB have demonstrated that they are willing to step in to support high yield if necessary. As we head into 2021, HY fundamentals are likely to continue to improve.	<b>Neutral:</b> As with its investment-grade counterpart, high-yield credit also made a round trip in spreads over 2020. The broad index is sitting close to 450 bps, after flirting with 500 bps, but there is still some room for spreads to narrow further. Pre-COVID-19 levels were at about 400 bps. <sup>12</sup>	<b>Positive:</b> Flows into HY credit remain robust, and we expect them to continue strongly in early 2021. As in IG credit, high-yield credit issuance also broke many records this year, and is likely to slow considerably next year. Companies are likely to engage in buying back debt and repairing balance sheets, if liquidity conditions permit.
<b>Emerging Market (EM) Hard Currency Debt</b> NEUTRAL	<b>Negative:</b> EM had a tough 2020. In 2021, we expect EM ex-China to underperform DM as the pandemic takes its toll on economies with already weak fiscal and debt positioning. A global economic recovery, higher expected oil prices and a lower VIX are likely to provide some cushioning for EM spreads to tighten slightly.	<b>Neutral:</b> The relationship between crude oil prices and EM sovereign spreads suggests they are currently trading around fair value if WTI trades above \$55/bbl. <sup>13</sup> While economic fundamentals have been priced in, EM sovereign debt continues to provide attractive carry relative to low-yielding DM markets.	<b>Neutral:</b> EM sovereign debt witnessed huge outflows at the start of the year. These flows have since reversed and turned net positive for 2020 YTD.
<b>Emerging Market (EM) Local Currency Debt</b> NEUTRAL	<b>Negative:</b> EM ex-China countries are likely to face further headwinds next year, though a global recovery combined with increased liquidity from global quantitative easing should provide tail winds for EM currencies to appreciate.	<b>Positive:</b> EM FX is currently trading at a 20% discount to its 10-year median. <sup>7</sup>	<b>Positive:</b> EM local currency also saw huge outflows. While there is an increase in appetite for local currency and rates due to undervaluation, flows are still net negative at -\$17 billion. <sup>14</sup>
<b>Emerging Market (EM) Corporate Debt</b> NEUTRAL	<b>Positive:</b> Owing to ample liquidity, EM corporates survived the pandemic shock with an impressive YTD default rate of ~3.2%. <sup>15</sup> Although revenues and earnings have been negatively impacted, EM companies continue to have stronger balance sheets than their DM counterparts, with net leverage still lower by 1-2x. As we enter 2021, we expect global growth recovery, lower market volatility and downward pressure on the U.S. dollar to favour this asset class.	<b>Negative:</b> After the post-U.S. election rally, the CEMBI Broad index spread is now close to 300 bp, which is below the historical average. <sup>7</sup> While there is scope for spreads to move below 300 bp, mainly led by tightening in the high-yield portion of the index as the investment-grade, high-yield gap still remains wide, we believe that upward pressure on U.S. Treasury yields has the potential to undermine the demand for EM corporate debt, especially at such stretched valuations.	<b>Neutral:</b> EM debt witnessed huge outflows at the start of the year due to the risk-off environment. Within EM debt, EM corporates have led the retail fund flows recovery, as flows turned positive for the year in June. Since then, they have continued their upward trend.

<sup>12</sup> Datastream, 20 November 2020<sup>13</sup> Goldman Sachs, 14 December 2020<sup>14</sup> Morgan Stanley, 12 November 2020<sup>15</sup> J.P. Morgan, 1 November 2020

## Risk Considerations

There is no assurance that the strategy 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. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks, such as currency, political, economic and market risks. **Stocks of small-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other **Investment Funds**, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. The use of leverage may increase volatility in the Portfolio. **Diversification** does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

## DEFINITIONS

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