



2021 Market Outlook

The Year Ahead: The Roaring 20s or The Scary 20s?

We're at the dawn of a new decade. Will it be a repeat of the Roaring 20s or something more subdued? Hear more from our International Equity Team's Bruno Paulson.



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November was a spectacular month for markets. The 13% rise in the MSCI World Index was the best monthly result since January 1975. There was some spectacular news though, with three vaccines achieving efficacy way in excess of the 50% that was deemed the minimum viable level. This opens up the genuine prospect of a world returning to something like “normal” in the second half of 2021, potentially ending the ominous cycles of flare-ups and lockdowns which had returned for the U.S. and Europe in the Northern Hemisphere’s autumn. In addition, the world breathed a sigh of relief that the U.S. seems on track for a peaceful transition of power, with the added bonus that the absence of a clear Democratic “Blue Sweep” makes significant corporate tax rises or radical regulation less likely, which may protect U.S. corporate profitability, particularly for the tech giants.

“Vaccines can open up the genuine prospect of a world returning to something like normal in the second half of 2021”

While the news was clearly positive in the month, the issue is whether the market has moved too far too soon. The MSCI World Index was roughly flat year-to-date (YTD) at the end of October, before the “month of miracles”, and is now up over 50% from its lows in March, bringing us to a 12% annualized return through the end of November—a higher-than-average annual return. This would seem to imply that the long-run outlook for corporate profits is better than at the start of the year, despite the impact of the pandemic, which is forecast to shrink global gross domestic product (GDP) by 4.4% this year according to the International

Monetary Fund, and has driven forward earnings down 9% YTD.

It is important to point out that this is not a market that was remotely cheap at the start of the year, on the back of a market rise of 26% in 2019, all of which was rerating, as earnings fell slightly. This has left the MSCI World Index’s current multiple of the next 12 months’ forward earnings above 20x, a metric that had never been above 17x before this year, in a history going back to 2005. Allowing another year of earnings recovery, the two years’ forward multiple is 17.7x, still 15% above the pre-2020 high of 15.4x. Risk definitely seems to be “on”.

“COVID-19 will still have left a major legacy, as seen in the acceleration of three existing trends: technology, government intervention and the growth of debt”

Even if we assume that the direct effects of the pandemic, the lockdowns and the voluntary self-isolations have faded by the second half of next year as the vaccination spreads across populations, COVID-19 will still have left a major legacy. This can be seen in the acceleration of three major existing trends.

The first is the step change in the adoption of technology. E-commerce has surged, along with remote working, while cash spending has shifted to cards and corporates are shifting their on-premise technology infrastructure to the cloud. This march of technology clearly creates winners and may give corporates in general the opportunity to cut some costs on a permanent basis, for instance, around office space or sourcing

newly remote labour from cheaper locations. But it also exposes losers, be it traditional retail without a unique selling proposition, real estate plays or IT services companies that manage on-premise infrastructure.

“Action on climate change may be the most important shift”

The second is the growth in government intervention. The unprecedented scale of support during the pandemic is likely to have added to governments’ already growing taste for involvement in the economy. The era where economies were run for the benefit of large corporates already seemed to be coming to an end, given the attacks on free trade, the revival of anti-trust activity, pushes to raise corporate taxation and the start of moves to rebalance the relationship between labour and capital, for instance, through raising minimum wage levels. The action on climate change may be the most important shift, with moves towards pricing carbon and constraining polluting activities. Optimists will point to the probable gridlock in the U.S., and even the potential for a wave of lucrative green infrastructure investment. But on the downside, much of the carbon-heavy status quo may become uneconomic or even forbidden.

The final trend that has been boosted is the growth of debt. Admittedly, the personal sector savings rate has risen sharply, given the large transfer payments by governments and the suppression of social consumption, be it holidays or eating out. The same is not true of the corporate sector, which has seen a further step up in leverage. Moody’s estimates that investment grade debt issuance will be up 60% this year, and even high yield is expected to see a 25% increase. This is dwarfed, though, by the increase in

government debt given the actions to shield economies from the pandemic. The U.S. alone has seen a \$4 trillion increase in its national debt so far this year, which has now reached 107% of GDP.¹ Again, there is an optimistic scenario, where newly freed consumers spend heavily in 2021 and 2022, reducing their high savings rates, while governments continue to support demand by running heavy deficits, helped by accommodating central banks and the relaxed attitudes of bond markets so far. Growth would therefore bounce back strongly, but hopefully without the significant rises in inflation or interest rates that might spook the markets. The less positive scenarios are either side of this Goldilocks outcome: either too cold, because of consumer caution or government cutbacks, or too hot, with the recovery driving up inflation and rates.

“Ebullient commentators suggest a second “Roaring ‘20s” may be the result; we would argue that investors should now be looking to preserve capital”

There are positive potential pay-offs from all three trends: corporates become more efficient, green infrastructure investment offers a boost and low interest rates allow governments to continue to spend. Along with the potential for consumers to spend their savings, the more ebullient of commentators suggest that this can set off a second “Roaring ‘20s”, presumably unworried by what happened at the end of the ‘20s the last time round. All these positive scenarios are possible, and some may even be probable, but the issue is that the current 20x plus multiple of earnings may be effectively taking them as a given. Given how much can go wrong, we see this multiple as the “Scary 20s”. Equally, growth investors may well be looking to the benefits of the acceleration of technological disruption to justify elevated valuations, without worrying about the potential curbs on the tech giants, while value players may be looking forward to the imminent reflation without taking sufficient account of the disruptive or environmental challenges.

In this “risk-on” world, after the spectacular market rises over the last eight months, we would argue that investors should now be looking to preserve capital, or to keep the lights on, rather than attempting to shoot the lights out. To quote Warren Buffett, “Be fearful when others are greedy.” As such,

we would be advocating the benefits of compounders. The idea is that these companies’ pricing power and recurring revenues allow them to grow earnings across cycles, making them far more resilient in tough times like 2020.

Our global portfolios have indeed managed to deliver this resilience, growing forward earnings by 3-5% so far in 2020, on the back of 8%-11% growth in 2019—a sharp contrast to the -9% and -1% that the MSCI World Index managed in 2020 and 2019, respectively. Interestingly, this 22-27% relative gain in earnings over the two years has not resulted in any significant outperformance over the period, given the violence of the recent value rally. As a result, the portfolios have sharply derated versus the index and are now only on a 9%-16% forward earnings premium to the MSCI World Index—a premium that vanishes in free cash flow terms, despite the massive gap in terms of quality, making compounders a relatively cheap insurance policy.

¹ Source: U.S. Department of the Treasury

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