2021 Outlook: Most Favorable Environment for Value Style in Years

When we stated in our Market Outlook for 2020 that international equities were likely to return between 10 and 15% for the year, led by emerging markets, little did we, or anyone for that matter, know about the chaos and misery that awaited the world. The virus outbreak in distant China that the rest of the world watched curiously, without much worry, soon gripped the world in one of the most deadly and disruptive pandemics in a century. As much of the world was shutdown to limit the virus spread, upending numerous businesses and the livelihood of billions, equity markets cratered in a tumult that rivaled the 2008 financial crisis.

Yet, driven by the robust economic recovery made possible by the substantial fiscal and monetary support, international equities ended last year with the MSCI ACWI ex US Index gaining over 10%, after declining over 30% in February and March, led by emerging markets that returned more than 18% as represented by the MSCI EM Index. U.S. large cap equities performed just as well, with the S&P 500 Index also up over 18%. After such unexpectedly positive returns in an undoubtedly tragic year, what might lie ahead for equity markets this year when nearly everyone is trying to sound more optimistic than the next?

In a world of ultra-low interest rates and unrestrained fiscal spending, it is possible that equity market returns for this year could outperform 2020. However, as we explain below, we do see incipient risks that could make some investors more cautious as the year progresses. As such, the Thomas White Investment Committee expects the MSCI ACWI ex US Index to return between 10% and 13% in 2021, yet again led by emerging markets that are relatively inexpensive compared to other equity markets. We also expect U.S. large cap stocks to return between 5% and 7%, yet lag mid-cap and small-cap stocks. In our assessment, if the current economic and policy trends hold, this year is likely to provide a favorable environment for the relatively inexpensive stocks to outperform growth stocks that dominated the last decade.

MARKET OPTIMISM BACKED BY EXPECTED EARNINGS RECOVERY

The widely anticipated rebound in corporate earnings from the 2020 pandemic lows is likely to be the main driver of market sentiment and returns this year. Despite the widespread economic disruptions, corporate earnings proved very resilient during the second half of last year – except in the worst affected industries such as hospitality and entertainment. Household incomes for the more affluent consumers did not decline as feared and provided a floor to consumer spending in most countries.

In fact, with the income support programs from governments and reduced spending on services, household disposable incomes have increased from pre-pandemic levels for the more affluent consumers. Assuming this surplus boosted the savings rate last year, it is likely to provide a strong boost to consumer spending this year. While enjoying this robust demand growth, businesses are expected to hold on to some of the efficiency gains from the pandemic to boost margins even further.

KEY TAKEAWAYS

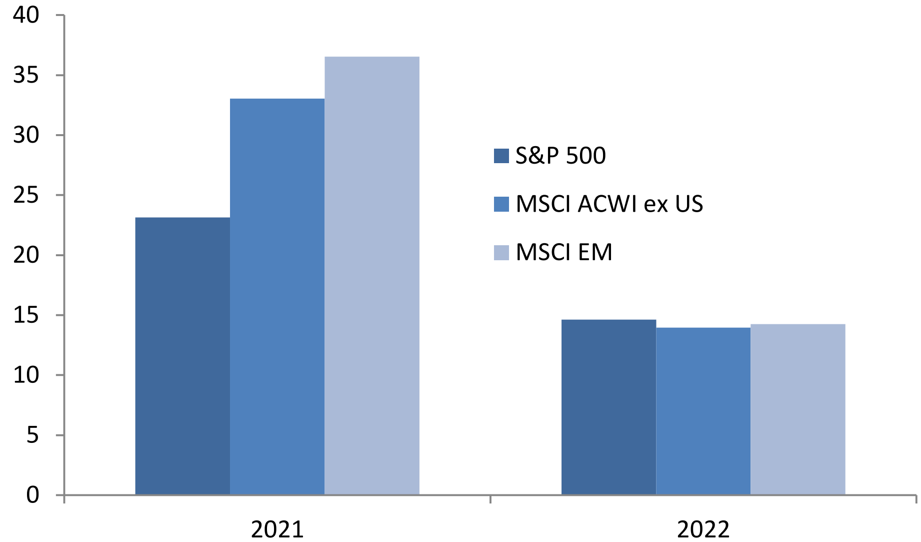
In a world of ultra-low interest rates and unrestrained fiscal spending, it is possible that equity market returns for this year could outperform 2020. However, as we explain below, we do see incipient risks that could make some investors more cautious as the year progresses.

For more information, please contact:

Gabriel McNerney, CFA
Dir. of Marketing & Client Service
(312) 663-8318
gmcnerney@thomaswhite.com

To strengthen the recovery, several countries are likely to increase public spending on infrastructure later this year. Despite elevated fiscal deficits, such plans have wide political support and would be relatively easy to implement. Cyclical stocks, especially in sectors such as industrials and materials, are likely to benefit the most from this government intervention.

Robust Earnings Rebound Expected



Consensus earnings growth forecasts, excluding negative earnings, in %
Source: Bloomberg

EVEN MORE FISCAL SPENDING ON THE WAY

Led by the incoming Biden administration in the U.S., governments in the developed world are likely to maintain high levels of fiscal support this year as well. Expanded U.S. fiscal stimulus is expected to result in increased payouts to small businesses, local governments and households. Several European governments that had announced partial lockdowns to contain a second virus wave have also increased income support payments.

To strengthen the recovery, several countries are likely to increase public spending on infrastructure later this year. Despite elevated fiscal deficits, such plans generally have wide political support and should be relatively easy to implement. Cyclical stocks, especially in sectors such as industrials and materials, are likely to benefit the most from this government intervention.

CENTRAL BANKS IN NO HURRY TO REVERSE COURSE

Despite the bubbling economic optimism, central banks led by the U.S. Federal Reserve have already started pushing back against suggestions of early normalization of monetary policy. They have repeatedly emphasized the fragility of the economic recovery and remain committed to maintain quantitative easing programs at least for the majority of this year.

Recent amendments to their policy frameworks give the central banks more leeway to stay the current course, even if inflation expectations move higher. This should also help them avoid abrupt or hawkish statements that can unnerve financial markets, such as during the 2013 'taper tantrum.'

LESS CALAMITOUS U.S.-CHINA RELATIONS

After the wild swings of the past four years, it is quite likely that U.S.-China relations will be less noisy going forward. That by itself would be a relief to financial markets that were frequently whipsawed by random tweets and abrupt policy flip flops.

Yet, we believe the Biden administration is likely to disappoint those who are optimistic about a quick roll back of trade tariffs and restrictions on Chinese companies. These are anticipated to be scaled back only gradually and in return for more specific, meaningful and enforceable commitments from China on market access and intellectual property protections. Under the new administration, there is also the risk of other friction points, such as human rights violations in China, emerging to delay a reduction in tensions between the two countries.

BREXIT TURNED OUT TO BE NOT AS HARD AS FEARED

All of Europe should be thankful that the European Union and the U.K. pulled off a last minute deal to avoid a hard Brexit. This provides a good starting point for both sides to move past old acrimonies and rebuild a more acceptable trade relationship. European policymakers now have the opportunity to spend more energy on the much needed structural changes to make their economies more efficient.

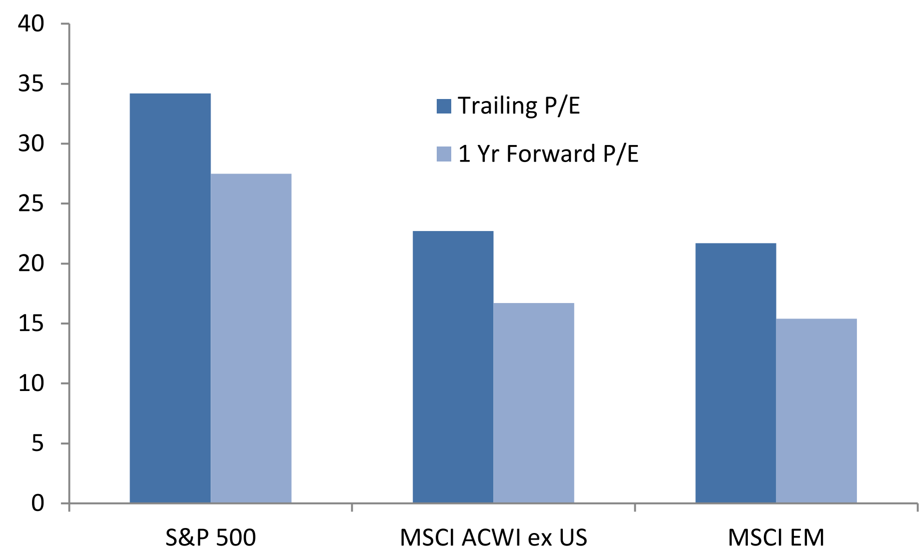
SO, WHAT DO WE SEE AS THE RISKS?

1. VALUATIONS: After two years of strong returns, it is not surprising that some investors have become more cautious about equity valuations. Indeed, the trailing P/E multiples of the widely followed stock indices such as the S&P 500, MSCI ACWI ex US and MSCI EM were all at what we believe are unsustainably elevated levels at the end of last year. Nevertheless, we would note that valuations based on expected earnings for the current year, while not inexpensive, are less demanding. We largely agree with the consensus argument that equities should command higher than normal valuations in an ultra-low interest rate environment.

All of Europe should be thankful that the European Union and the U.K. pulled off a last minute deal to avoid a hard Brexit. This provides a good starting point for both sides to move past old acrimonies and rebuild a more acceptable trade relationship.

Based on expected earnings for this year, the P/E multiple of MSCI ACWI ex US Index drops to 16.7x from 22.7x for last year's earnings. Similarly, the MSCI EM Index valuation drops from 21.7x to 15.4x and the S&P 500 Index's from 34.2x to 27.5x, based on trailing and forward earnings, respectively.

Forward P/E Valuations Are Less Demanding

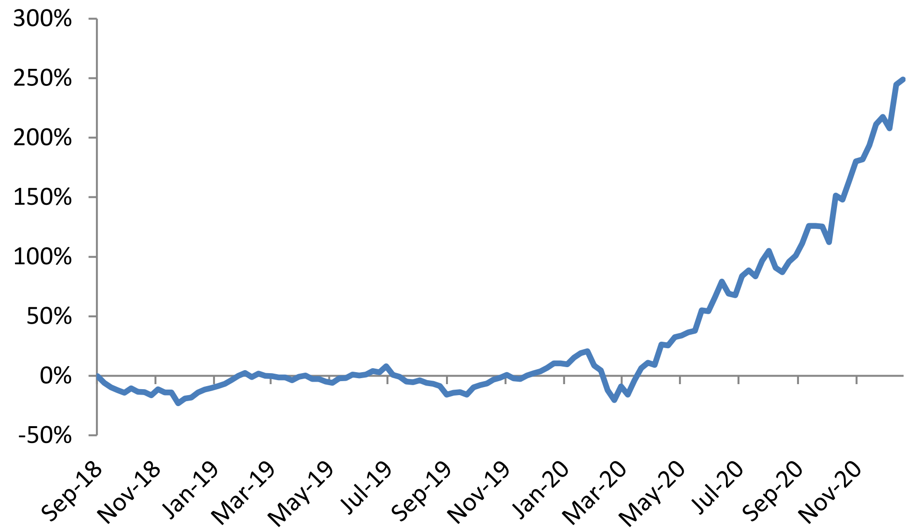


Source: Bloomberg

However, we are not oblivious to the obvious froth in select segments in the markets. In our opinion, current valuations of some businesses that are widely accepted as disruptive, but are yet to turn earnings positive, are unsustainably high. A basket of stocks of innovative companies that continue to incur losses has more than tripled in value just the last year. That is a clear sign of market froth to us and any correction in these overvalued names could also pull down the broader markets, at least temporarily.

However, if fiscal spending picks up pace and household consumption surges further, it is possible that inflation risks will become more evident. Higher than normal savings and elevated asset prices could very well encourage consumers to splurge.

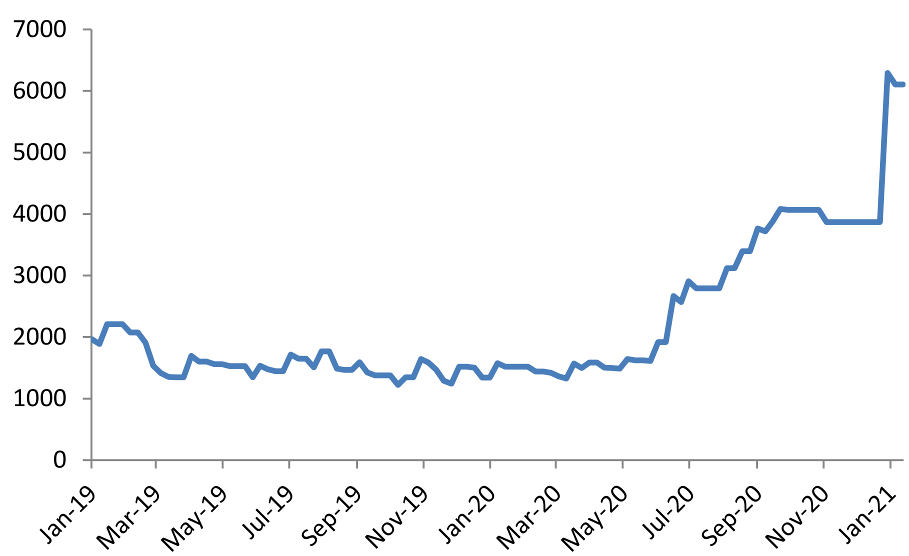
Market Value of Unprofitable Companies Has Soared



GS Non-Profitable Tech Basket (GSCBNPTC) - Cumulative price change in %
Source: Bloomberg

2. INFLATION: For more than a decade, global inflation has been so benign that financial markets seem to have become unmindful of this risk. However, if fiscal spending picks up pace and household consumption surges further, it is possible that inflation risks will become more evident. Higher than normal savings and elevated asset prices could very well encourage consumers to splurge.

Ocean Freight Rates Have Exploded



Freight rate in USD for 40' container from Hong Kong to Los Angeles.
Source: Bloomberg

In addition to this demand pull, we are also likely to see some cost push to prices in the not so distant future. Ocean freight rates from China to the U.S. surged more than 350% last year, and are expected to remain high this year. Manufacturers have already started complaining about shortage of semiconductors and other critical components.

If inflation expectations rise faster than currently expected, at some point financial markets will be forced to reset their interest rate expectations – even if central banks underplay the risks and keep their policy rates low. This could lead to increased volatility and a possible decline in valuations of more expensive growth equities.

At Thomas White, we believe our portfolios are positioned to do well in the scenario detailed above. Our sector and regional bets, especially our emerging markets overweight in the international strategies, have been calibrated to benefit from the robust earnings recovery as well as healthier industrial and consumer demand.

We wish you a less disruptive and prosperous year ahead.

If inflation expectations rise faster than currently expected, at some point financial markets would be forced to reset their interest rate expectations – even if central banks underplay the risks and keep their policy rates low.

Trailing P/E (price-to-earnings): A relative valuation multiple that is based on the last 12 months of actual earnings. It is calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months.

1 Year Forward P/E: The current fiscal year consensus P/E ratio estimate as reported by Institutional Brokers' Estimate System. It is calculated by taking the current stock price and dividing it by the expected earnings per share for the next 12 months.

The S&P 500 Index measures the performance of 500 leading companies in leading industries of the U.S. economy, capturing 80% coverage of U.S. equities. The MSCI ACWI ex US Index is a stock market index that is designed to measure equity market performance of both developed and emerging markets, excluding the U.S. The MSCI EM Index is designed to measure equity market performance of emerging markets. All indices are unmanaged and returns assume the reinvestment of dividends. It is not possible to invest directly in an index.