

Three potential paths for markets in 2021

Weekly Market Compass: We present a base case, an upside case, and a downside case for our 2021 global market outlook

Nov 30, 2020 | Kristina Hooper, Chief Global Market Strategist

Every year at this time, we issue our global market outlook for the coming year. That exercise is especially complex at this moment – the shape of economic growth in 2021 is dependent on a wide variety of factors, including infection rates, fiscal policy, monetary policy, public health policy (including the severity – or “stringency” – of lockdowns), progress toward the development of COVID-19 therapies and vaccines, and consumer and business confidence. To address the breadth of possibilities that lie ahead in this environment, our global outlook for 2021 includes a base case, an upside scenario, and a downside scenario.

To create these scenarios, we at Invesco brought some of our experienced investment professionals and thought leaders together to talk through the range of possibilities. We begin first with an assessment of the macro outlook, followed by the investment implications we see tied to these conditions.

What we have learned thus far

In the absence of a vaccine, a region’s ability to manage the spread of the virus is critical to its economic recovery. East Asia – in particular, China, Japan, and South Korea – has managed the virus well as a result of targeted lockdowns and coordinated social efforts. Much of the developed world and many emerging markets, on the other hand, have struggled to contain the pandemic. This difference is reflected in economic activity: Those countries that have effectively curtailed the virus have been less impacted economically. We must also recognize that even in the absence of lockdowns, economic activity can be impacted by a rise in infections, which can impact confidence and result in behavioral shifts in consumption.

We have also learned that the pandemic has disproportionately impacted the services industry versus the manufacturing industry due to social distancing measures and changes in behavior. We expect this pattern is likely to continue until a vaccine is developed and distributed.

This recovery has also demonstrated the importance of policy support throughout this crisis for both economies and markets. Across the globe, countries have enacted significant fiscal spending programs; as a result, the economic recovery has been relatively strong in a number of economies. Some economies have run the risk of not providing adequate fiscal stimulus, especially in some emerging markets.

Major central banks around the world have provided even greater monetary policy support, undertaking a range of policies to support economies including a massive expansion of their balance sheets through large-scale asset purchases. In addition to impacting the economy, this has had a substantial impact on capital markets.

Our base case

Our base case scenario is that the global economy continues to recover, albeit unevenly and at a slower pace.

- COVID-19 had an extremely negative impact on the Chinese economy, but its recovery is well underway and we expect China to outperform given its better control of the virus.

- While we expect fiscal stimulus to continue to support activity, the US and eurozone are likely to experience pauses in their respective re-openings due to partial lockdowns.
- Our assumption in this scenario is that an effective vaccine will be developed and rolled out in the back half of 2021. In this environment, we expect the goods economy will continue to outpace services earlier in the year until the rollout of a vaccine in the second half of 2021, when services rebound more robustly.

Our upside case

We call this scenario “V” for “accelerated vaccine.”

- In this scenario, the global economic recovery is more robust, led by China but with other economies participating more quickly due to the development and distribution of a vaccine in the first half of 2021.
- We also assume greater fiscal stimulus in this scenario, which would enable a faster recovery.

Our downside case

We call this our “double-dip” scenario.

- We assume that the globe sees multiple waves of the virus, which are difficult to control, requiring renewed national lockdowns in many countries and weighing down the global economy.
- In this scenario, we assume fiscal and monetary stimulus is too slow and inadequate as the political will and fiscal space for these policy actions proves to be less than in 2020.

Asset allocation implications

These three scenarios in turn dictate our asset allocation views:

In our base case scenario, we expect equities to outperform fixed income as growth moves above trend, the global earnings cycle recovers, and ample money supply growth supports risky assets.

- We would expect the gradual re-opening of face-to-face sectors to favor cyclicals, value, and small-/mid-cap stocks, also supported by attractive valuations and rising bond yields.
- We expect that an improving risk appetite and a depreciating US dollar would drive outperformance in emerging market (EM) equities over developed markets (DM).
- At the same time, currency and local market valuations would favor DM ex-US over US equities, supported also by cyclical outperformance in 2021 and a rotation away from growth into value sectors and regions.
- In fixed income, we believe credit markets have room for additional spread compression and may offer attractive risk-adjusted returns.
- Global yield curves may steepen with gradually rising bond yields, but would remain well-anchored by asset purchase programs and low inflation expectations.
- Real assets are expected to do well with low and stable inflation in this scenario.

In our upside scenario, we would take a more “risk on” approach, expecting equities to more dramatically outperform fixed income.

- Given this scenario’s assumption that a vaccine will be developed more quickly, we would expect cyclicals, value, and small-/mid-cap stocks as well as EM equities to begin to perform well earlier in 2021.

In our downside scenario, we would take a more “risk off” approach, expecting fixed income to outperform equities.

- Within equities, we would favor defensive sectors, low volatility, and quality stocks, given this scenario's expectation that it will take longer for the development of a vaccine.
- Within fixed income, we would favor US Treasuries, credit, and longer-duration bonds.
- In this scenario, we would favor the US dollar versus other currencies.

For more of our team's thoughts on what 2021 could bring for markets and the economy, keep an eye on the blog next week, when my colleague Brian Levitt will break down his 2021 outlook for the US, including US market implications.

Important information

Real assets are physical assets with a tangible value, such as commodities, natural resources, and real estate. In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

Stocks of small and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The opinions referenced above are those of the authors as of **Nov. 30, 2020**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.