
Economic headwinds pressure the US, UK and Europe

Weekly Market Compass: The next few months could be a slog for these economies

Jan 25, 2021 | Kristina Hooper, Chief Global Market Strategist

What a week – both the S&P 500 and NASDAQ Composite Indexes reached all-time highs last Thursday, but we also saw a reversal of the rotation from growth/defensives to cyclicals in both European and US markets. Markets are clearly reacting to the problems that many economies are facing as COVID-19 continues to impact growth.

Recent data shows evidence of these problems.

Europe may face a modest recession

Europe is clearly at risk of a double-dip recession, albeit a modest one. The IHS Markit Flash Eurozone Composite PMI (Purchasing Managers Index) clocked in at 47.5, down from December's 49.1.¹ And it's not just services that drug down that number; there was also a decline in manufacturing PMI, which actually fell to a seven-month low. And the weakness was spread throughout Europe.

This should come as no surprise. The Oxford Blavatnik Stringency Index, which tracks the level of economic lockdowns in various countries, indicates that stringency in many European countries is at or near the highest levels that have been experienced since the start of the pandemic. In other words, first-quarter economic activity could contract again, although if it does, I would expect this to be a very shallow contraction. More fiscal support is coming, and I expect the European Central Bank to remain supportive.

And so Europe just needs to get through this "fifth quarter of 2020," and then I expect the situation to improve. I think that by later in the second quarter we will see improvement in economic activity as vaccine distribution becomes widespread.

The UK get more bad news

The UK is in a worse situation, at an even greater risk than the eurozone of a double-dip recession in the current quarter. The preliminary reading of the IHS Markit/CIPS UK Composite PMI fell like a lead balloon, dropping from 50.4 in December to 40.6 in January.¹ Chris Williamson, chief economist at IHS Markit, explained the drop in the composite: "Services have once again been especially hard hit, but manufacturing has seen growth almost stall, blamed on a cocktail of COVID-19 and Brexit, which has led to increasingly widespread supply delays, rising costs and falling exports."¹

What's more, on Friday UK Prime Minister Boris Johnson shared more bad news: 1) the UK strain of the virus is not only more contagious but appears to be more deadly; 2) lockdowns might last until this summer. And so we should not expect economic strength in the near term, although I maintain that the economy is very likely to rebound substantially as vaccines are distributed.

Japan suffering too

Flash PMI readings for January indicate Japan is facing some headwinds too. Also last week the Bank of Japan warned of increasing risks to the economic outlook for Japan, and that efforts to control the virus could have impact beyond just the services sector. And while COVID-19 has been well-controlled in Japan relative to many Western countries, Japan has not yet rolled out any vaccines. They are still in clinical trials, but rollout is expected to start by late February

The US awaits the fate of fiscal stimulus

The US is also facing serious economic headwinds due to COVID. US markets seem to have focused recently on the potential for additional fiscal stimulus. Janet Yellen, President Joe Biden's nominee to be US Treasury Secretary, made a strong case for more fiscal stimulus last week. She recognized concerns about growing debt levels, but also argued that there's no time like the present to borrow since rates are so low. However, by the end of the week there was concern that President Biden would not have enough support to get his proposed \$1.9 trillion package passed.

On days when markets are encouraged by the likelihood of more stimulus and a stronger rebound, cyclical stocks have outperformed. But when markets are worried that no more stimulus is forthcoming, or when economic data disappoints, secular growth stocks - especially tech - have outperformed.

Key takeaways

I expect this "seesaw" stock market behavior to continue in the near term. While I still believe a strong economic rebound is in the offing later in 2021, there are likely to be glitches before we get there, as I have warned before. The tech sector has recently exhibited defensive qualities that I expect to continue and which I believe could be valuable in the next few months as we slog through what is likely to be a difficult time for the economy. Low interest rates help this situation given that tech valuations are admittedly stretched; investors have historically been more forgiving of valuations with rates so low.

The other side of the seesaw is exposure to cyclicals. I am most excited about one sector in particular: consumer discretionary. I think the global economic recovery will be robust and inclusive, creating and restoring jobs - and spurring consumers to spend. And in many countries, consumers have built up impressive savings because of a lack of spending during the pandemic. This could be deployed rather quickly once vaccines are distributed broadly and there is a return to something akin to "normalcy."

I expect that, in a world awash in monetary stimulus, with significant fiscal stimulus as well, there will continue to be an upward bias for stocks. That doesn't mean we won't see a stock sell-off in 2021. It could be triggered by the 10-year US Treasury yield rising (we could see a sell-off if it rises too quickly) or fears about inflation increasing - even though I expect the Federal Reserve to reiterate this week its commitment to remain very accommodative and tolerant of a spike in inflation over its target. There could be other triggers - a continued rise in infections, especially more serious strains, or a slowdown in vaccine rollouts. We don't know when this could occur - and while I believe it would be short-lived, I also believe it's very important to be broadly diversified both across and within stocks, bonds and alternatives.

While broad diversification is critical, investors could consider overweighting both the technology and consumer discretionary sectors within their equity sleeve. Both could serve different purposes in a portfolio - one offering some defensive qualities while the other offering the potential to participate in the recovery.

Source

¹Source: IHS Markit, Jan. 22, 2021

²Source: Business Insider, "Janet Yellen suggests 'curtailing' cryptocurrencies such as Bitcoin, saying they are mainly used for illegal financing," Jan. 20, 2021

Important information

Diversification does not guarantee a profit or eliminate the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

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.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

Many products and services offered in technology-related industries are subject to rapid obsolescence, which may lower the value of the issuers.

The NASDAQ Composite Index is the market capitalization-weighted index of approximately 3,000 common equities listed on the Nasdaq stock exchange.

The Eurozone PMI® (Purchasing Managers' Index®) is produced by IHS Markit and is based on original survey data collected from a representative panel of around 5,000 companies based in the euro area manufacturing and service sectors. The flash estimate is typically based on approximately 85%-90% of total PMI survey responses each month and is designed to provide an accurate advance indication of the final PMI data.

The IHS Markit / CIPS Flash UK Composite PMI® is compiled by IHS Markit from responses to questionnaires sent to survey panels of around 650 manufacturers and 650 service providers.

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