2021 Outlook: Brighter Days Ahead

It has been a year like no other. No one could have predicted the shock of a global pandemic and the impact that it has had on economies, markets and society as a whole. This year, we saw the fastest bear market, a pandemic-induced global economic recession, a sharp recovery, a contentious U.S. election season and a second wave of the virus. And we recognize it may have been a challenging year for our clients personally.

Key Takeaways

- Global growth returns to pre-crisis levels, but path likely uneven
- Monetary and fiscal policy remain accommodative, helping to drive growth
- Historically low interest rates and a steeper yield curve create return challenges for high-quality government bonds, with credit offering more attractive opportunities
- Global equity rally broadens amid economic reopening, improved earnings and supportive monetary policy
- Discipline, diversification and active management needed to navigate post-coronavirus world

Yet an unprecedented amount of policy response, better-than-expected economic data, clarity around the election and positive news on the vaccine front have resulted in solid returns across asset classes for the year. Global equity markets delivered positive returns, with U.S. large caps leading the way. Fixed income produced mid- to high-single digits, benefiting from a move lower in interest rates and tighter credit spreads. The continued rally in risk assets also provided a tailwind to most diversifiers, or those strategies with low correlations to stocks and bonds.

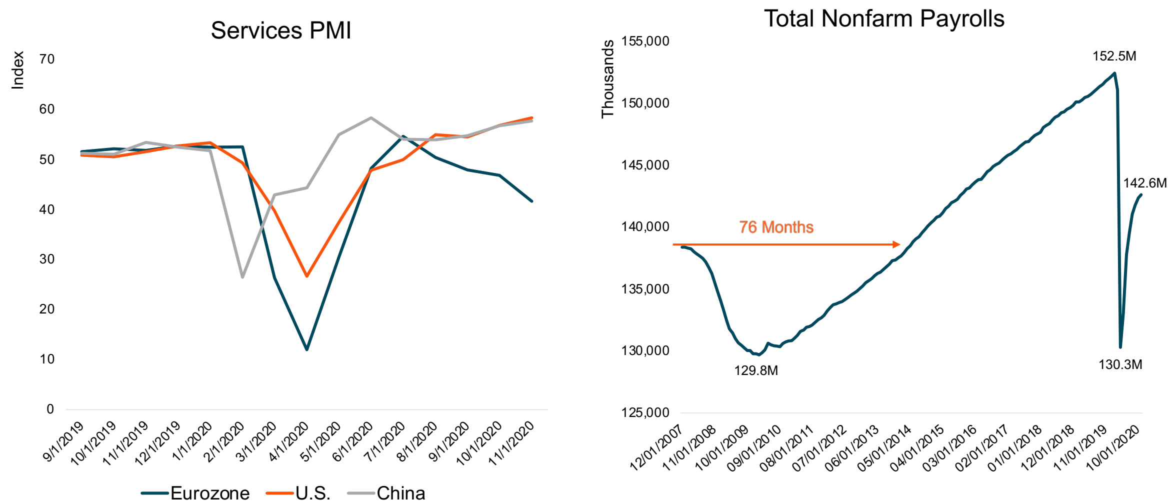
As we look ahead to 2021, we believe that developments on COVID-19, consumer behavior and continued policy response will shape the global economy and markets. While we still have tough days ahead of us amidst the second wave of the virus, the likelihood of access to vaccines becoming widely available by the middle of next year and the possibility of more fiscal relief should help reaccelerate economic growth in the second half of the year. Return expectations are likely to be more muted across asset classes given that equity and credit markets have largely priced in an improvement of economic activity in 2021.

Growth Returns to Pre-Crisis Levels With Potential for Upside Surprise

Our base case is that, by the middle of 2021, economic activity should reach near pre-crisis levels. The pattern of growth is likely to be uneven as the service sector continues to be hindered by the second wave of coronavirus cases and restrictions imposed to contain it. However, we could see growth reaccelerate and surprise to the upside in the latter part of the year. This assumes that global monetary policy remains extremely accommodative, lawmakers provide sufficient fiscal stimulus to support growth and there is a successful rollout of vaccines by the second quarter. Our single most likely forecast for 2021 gross domestic product (GDP) is 5.5% for the U.S., 6.9% for the Eurozone and 8.0% for China.

A softening of activity is already evident in the latest services and labor market numbers and it is a trend that we are going to see continue in fits and starts in the early part of 2021. The service sector, as measured by the IHS Markit Services Purchasing Managers' Index (PMI), continues to struggle in some parts of the world, as illustrated in Exhibit 1. The Eurozone has been hit especially hard after a second round of lockdowns were put into place. The IHS Markit Eurozone Services PMI dropped to 41.7 in November from 46.9 in October, remaining below the level that marks expansion (50). Although the U.S. service sector reading remains in expansion territory, November's reading of 58.4 marked the slowest increase in six months. China, on the other hand, has seen a steady growth in services, with November marking the seventh straight month of expansion.

Exhibit 1: Momentum Slowing



Source: Factset. As of 12/10/20

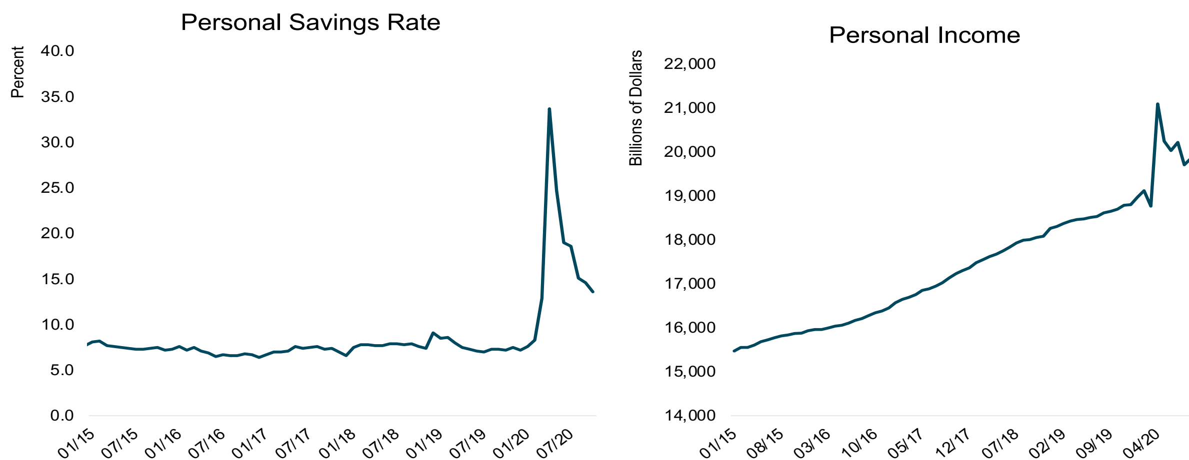
Another headwind to growth is the labor market. The U.S. economy lost more than 22 million jobs between February and April, sending the unemployment rate to 14.7%, a level unseen since the 1930s. Since May, the economy has added over 12 million jobs and the unemployment rate has fallen to 6.7%. However, the pace of job creation has slowed with November's nonfarm payroll growth of only 245,000, marking the fifth straight monthly easing in hiring. The number of Americans filing for initial jobless claims has also soared as the second wave of COVID-19 cases and stricter social distancing measures force more layoffs.

Parts of the economy, such as manufacturing and housing, have been rebounding strongly. In fact, manufacturing activity in the U.S., Europe and China has staged a V-shaped recovery since the March lows. Housing is another area that remains robust, supported by low interest rates, low inventory and a shift from urban to rural areas.

Importantly, the strength of the recovery will depend on the resilience of the consumer, as consumer spending makes up 70% of GDP. While retail sales rebounded this summer, the latest reading reflects a pause amid the resurgence of the virus. As effective vaccines become available globally and economies reopen more fully, we should see an improvement in consumer confidence and spending. As illustrated in Exhibit 2, personal savings and personal income are still elevated and are expected to play a critical role in fueling spending from here.

While we expect brighter days ahead, some parts of the economy may continue to struggle in the early part of the year given the uncertainty of this current wave. Thus, it is important for fiscal policy to continue to work in tandem with the monetary policy to support further growth. As of December 18, 2020, U.S. lawmakers were aiming to finalize a nearly $1 trillion COVID-19 stimulus plan that would include small business aid, direct payments to individuals and a federal unemployment supplement. While this stimulus should help those most in need of assistance, additional funds may be needed in the first quarter to support growth.

Exhibit 2: Consumer Spending Remains Critical to Recovery



Source: Factset. As of 12/10/20

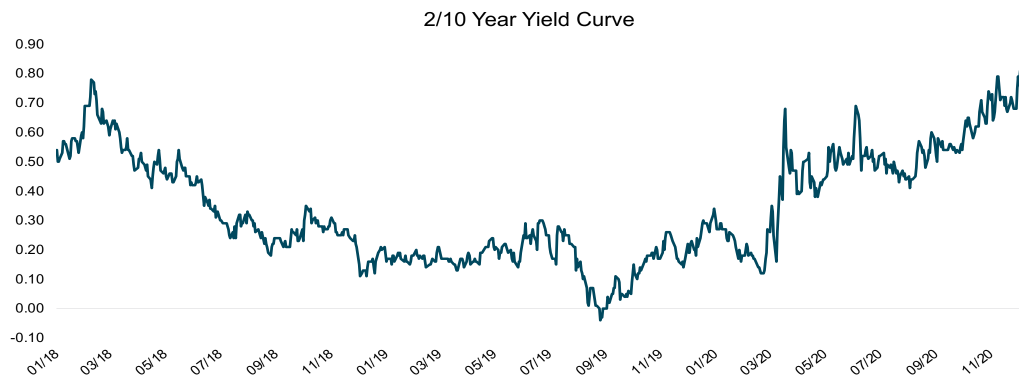
Expect More Muted Fixed Income Returns

The unprecedented actions of the Federal Reserve to drive down interest rates, along with the subsequent tightening of credit spreads, resulted in solid returns across all fixed income sectors in 2020. But investors should expect more muted total fixed income returns in 2021 as the majority of credit spread tightening and interest rate movement have likely already occurred.

While the massive monetary and fiscal stimulus may lead to inflation over the longer term, we expect only a modest increase in inflation in the short term as the economy reopens further. Treasury Inflation-Protected Securities (TIPS) breakeven rates, which reflect the market's inflation expectations over the next 10 years, currently stand at 1.9%. While we expect the 10-year TIPS may drift upwards toward 2-2.25% in 2021, we believe it will be difficult to consistently stay above 2% over a long time period given trends such as global excess capacity, slack in the labor market and aging demographics that have kept inflation at bay. Now that the Fed's policy framework allows for inflation to run above its 2% target for a sustained period of time, we would not expect the Fed to take steps to combat inflation until the time when inflation expectations get above 3%.

With the Fed's commitment not to change its policy anytime soon, interest rates on the short end of the curve should remain anchored near zero for many quarters. However, given the promising vaccine developments and expectations for stronger growth, intermediate- and long-term rates will likely drift higher, resulting in a modestly steeper yield curve (Exhibit 3). Our projection for the 10-year Treasury note yield during 2021 ranges from 0.50% to 1.50%, with a bias for ending the year close to 1.25%. There is a limit to how high long-term U.S. rates can go, as they remain tethered to negative/low global sovereign rates.

Exhibit 3: Yield Curve Steepening

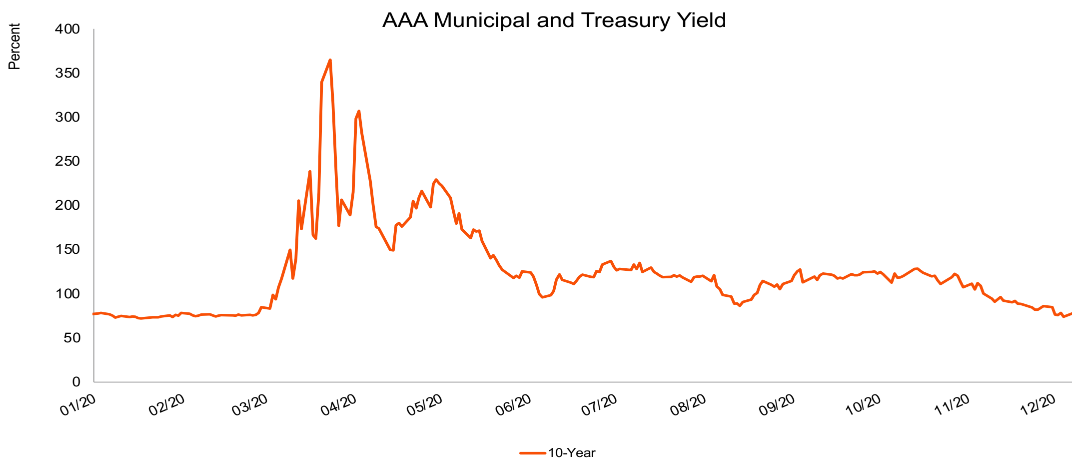


Source: Factset. As of 12/15/20

Credit spreads have had a volatile year but are now near where we began the year. We continue to like credit, but expect less price appreciation given that the recovery in spreads has largely already occurred. However, credit spreads could compress even further, though not to the degree experienced in 2020. Despite the recent volatility, investment grade and high yield corporate bonds still offer attractive yields over Treasuries and we expect they should outperform in 2021. Emerging market debt also offers higher yields in this low interest rate environment and tends to perform well in an environment with modest global growth, calm currency markets and a more stable geopolitical environment — all of which are present.

For tax-sensitive investors, municipal bonds remain attractive even though the relative yield relationship spread between AAA-rated municipal bonds and AAA-rated Treasuries is currently tight by historic standards (Exhibit 4). We believe it is increasingly likely that there will be higher personal income tax rates for the ultra wealthy at both the federal and state levels sometime in the near future, regardless of the make-up of Congress. This will result in continued strong demand for tax-exempt municipal bonds. While federal stimulus will aid states and municipalities, we still believe that many municipal entities will face a challenging budget environment this summer. To protect against this elevated risk, we advocate diversification within fixed income and a bottom-up, research-driven analysis of individual securities.

Exhibit 4: Municipal Bond Yield as a Percentage of Treasury Yields



Source: Bloomberg. As of 12/11/20

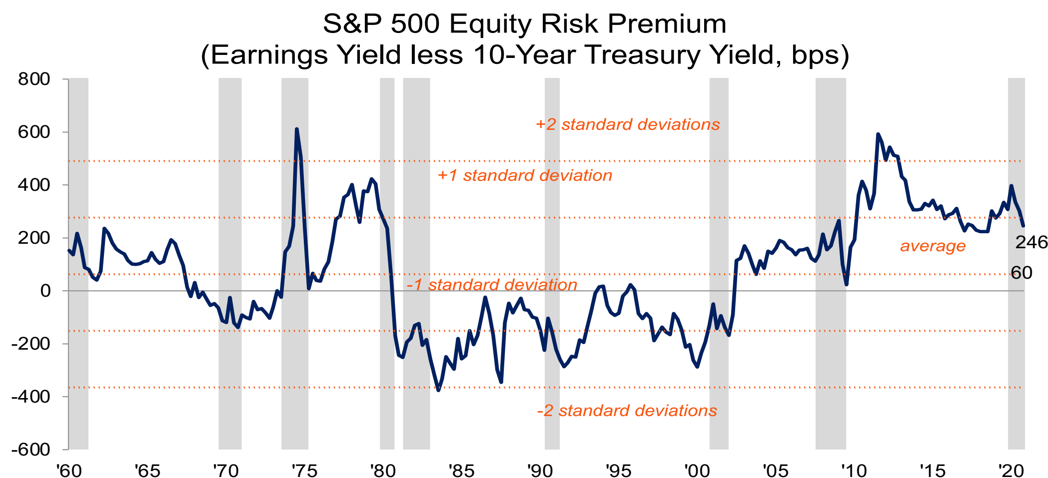
Global Equity Rally Broadens

Corporate earnings fell an estimated 22% in 2020 according to analytics firm FactSet as the government-induced shutdown weighed on earnings. However, some companies were able to thrive in the COVID-19 environment, with growth and technology stocks dominating as they were able to benefit from work-from-home mandates. As vaccines are distributed and the economy reopens, we expect profits to rebound more broadly in 2021, allowing cyclical stocks to participate in the recovery and make up lost ground. Thus, the rotation from those growth and momentum stocks that have led the way during the rally from March's lows to value or cyclical stocks should persist.

BNY Mellon Wealth Management estimates an S&P operating earnings range of $165 to $170 for 2021. From this, we also project an S&P 500 year-end target of around 3,850-3,950. Earnings growth outside the U.S. is also expected to improve, with FactSet consensus estimates of year-over-year earnings growth of over 30% for developed international equities and 33% for emerging market equities, based on expectations for stronger global growth and a weaker dollar.

The outperformance of U.S. stocks in 2020 has elevated valuations, as expressed by the price-to-earnings (P/E) ratios. As of the end of November, the S&P 500 P/E stood at 23x consensus 12-month forward earnings, far above the 10-year average of 16x. While this may appear overvalued, P/Es during an earnings recession often seem elevated when compared to all periods, as markets anticipate the eventual earnings recovery. Low interest rates are also making what may seem an expensive valuation more reasonable, as illustrated in Exhibit 5. When the equity risk premium, or yield on S&P 500 earnings less the 10-year Treasury yield, is greater than zero, stocks are attractive relative to bonds and historically outperform. Our expectation for muted inflation also makes current equity valuation levels more reasonable.

Exhibit 5: Equities Attractive Relative to Bonds



Source: Strategas. As of 12/10/20

A rebound in corporate earnings, low interest rates, modest inflation pressures and stronger economic activity should help equities broaden and move higher next year. However, in the near term, equities could be vulnerable to a pullback given their recent strong run and elevated levels of investor sentiment. If markets do consolidate, we believe the weakness should be short-lived as there is more than $4 trillion in cash (as measured by retail and institutional money market mutual funds) on the sidelines waiting to participate in the reopening of the global economy. If a pullback were to happen, we would consider it a buying opportunity, and you may see us lean in and take advantage of cyclical stocks expected to benefit from the global recovery.

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Positioned for the Global Reopening

In the midst of this year's coronavirus-induced bear market, we recognized that every crisis creates buying opportunities. We took advantage of the market volatility and leaned into the weakness, shifting to higher quality U.S. large cap equities from international developed markets. Mid-summer, we took steps to enable portfolios to benefit from the global recovery and weakening dollar by realizing gains in U.S. large cap stocks and adding exposure to international developed and emerging market equities. These moves have proven beneficial to clients.

We have positioned clients to benefit from the global reopening of the economy (Exhibit 6). We are optimistic about equity markets over the next 12 to 18 months given our favorable outlook for an improved macroeconomic backdrop, accommodative monetary policy and stronger earnings. We continue to have a small overweight to U.S. stocks over foreign stocks, while maintaining our neutral view on equities overall. This bull market should continue to broaden as the global economic recovery extends to more economically sensitive parts of the economy. Thus, expect to see us diversify equities further into those regions, capitalizations and sectors.

We have a small underweight to fixed income given the low level of interest rates, but expect the asset class to continue to play an important role as a source of diversification during periods of equity market volatility. We remain underweight U.S. Treasuries and favor credit, including investment grade, high yield, emerging market debt and municipal bonds.

We also have a slight overweight to diversifiers to buffer against the expected volatility. Private equity and real estate can provide attractive sources of return and can benefit from an overall economic recovery. For investors who have additional capital to put to work but are hesitant to enter the market at all-time highs, customized hedging solutions allow investors to gain exposure to the potential growth in the market while protecting against volatility.

Exhibit 6: Asset Class Positioning: Investment Strategy Committee Recommendations

	Underweight	Small Underweight	Neutral	Small Overweight	Overweight
Equity			◆		
Large Cap				◆	
Mid Cap			◆		
Small Cap			◆		
International Developed Large Cap		◆			
International Developed Small Cap			◆		
Emerging Markets			◆		
Private Equity			◆		
Private Equity-Real Estate			◆		
Real Estate (REITs)			◆		
Fixed Income		◆			
Treasuries	◆				
Investment-grade Corporate			◆		
Tax-exempt			◆		
High Yield				◆	
Emerging Market Debt		◆			
Diversifiers				◆	
Long/Short Hedge			◆		
Absolute Return Hedge					◆
Commodities			◆		

As of 12/2/20

Discipline, Diversification and Active Management Needed in Post-Coronavirus World

The global pandemic reminds us of the importance of basic investing principles, such as staying invested and rebalancing portfolios, which proved critical at the height of the market volatility. It required discipline to see that the efforts of central banks and governments around the world, the potential for progress on the treatment and vaccine front and the resilience of the human race would lead to better days ahead.

After a year in which the market has lifted all asset classes, it's important to ensure that portfolios remain aligned to the original, desired allocation and conform to the appropriate level of risk tolerance. We also highlight the importance of after-tax returns and work with clients to harvest losses to help minimize taxes, where appropriate.

The outlook for 2021 is brighter, with the promise of vaccines offering the potential for a world where individuals are free to be more mobile, economic activity builds and companies that have lagged during this pandemic thrive more broadly. However, there are risks that could cause some bumps along the way, including a delay in the rollout of vaccines, a transition to the new administration, a surprise uptick in inflation or ongoing tensions with China.

While our return expectations for 2021 are more muted than they were in 2020, we believe there are ample opportunities across asset classes. Our view is that clients should have broad diversification in order to fully participate in the global recovery. With interest rates historically low and valuations of many asset classes near or above their long-term averages, the need for active management — from both a portfolio positioning and a security selection standpoint — is more important than ever.

Long-Term Perspective

While the economic outlook is more promising in 2021, we believe it is important to maintain a long-term perspective when managing wealth. Our soon to be released 2021 Capital Market Assumptions provides our forward-looking, long-term risk and return forecasts across a range of asset classes. These Capital Market Assumptions (CMAs) help inform our long-term asset allocation decisions for our wealth management and institutional clients.

To provide you a glimpse into our forecast, we expect a period of slow growth, low levels of inflation and more muted returns over the next decade. In part this is a result of longer-term structural shifts of aging demographics and increased productivity. But it is also a result of the unprecedented policy response to this pandemic that has resulted in historically low interest rates and over $18 trillion in negative-yielding debt globally.

Overall, our 10-year return forecasts are more muted compared to asset class returns seen over the past 10 years. Fixed income returns are forecast to be limited where interest payments may offset some potential principal loss due to a rise in interest rates. We expect global equity market returns will range between 6.6% and 8.6%, slightly above our 10-year forecast from last year but below their historical averages. Alternative asset classes, especially investments in private markets, should continue to provide an additional source of return and diversification.

Taken together, this more challenging return environment suggests that a traditional 60/40 portfolio of stocks and bonds should be reset to include a wider array of asset classes. We have already taken steps to do that in client portfolios this year. We have recommended diversifying fixed income holdings beyond municipal bonds to incorporate credit strategies that can add yield, expanding the mix of equities to include more non-U.S. stocks and including alternatives, especially private investments.

Our capital market assumptions will likely also influence other aspects of active wealth management, such as spending plans, borrowing strategies and tax management. We welcome the opportunity to provide you with timely and informative advice to help you navigate what may lie ahead in 2021 and the decade to come.

Of equal importance as we embark on a new year is the overall well-being of our valued clients as we emerge from this global health crisis. We sincerely wish you and your loved ones not only continued financial success but continued good health and safety.

About the Author

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Leo Grohowski is chief investment officer of BNY Mellon Wealth Management. He leads all investment strategy and investment management functions for the wealth management organization.

Mr. Grohowski joined BNY Mellon in 2007 and has more than 30 years of industry experience. Previously, he was with US Trust, Bank of America, where he was chief investment officer, responsible for investment solutions and the end-to-end investment process, including portfolio management and investment strategy for Private Wealth Management clients. Prior to his role at US Trust, he was the chief investment officer for Deutsche Bank in the Americas, overseeing more than $250 billion in assets. From 1999 to 2002, Mr. Grohowski was chief investment officer of Deutsche Bank Private Banking, serving as chairman of the Global Markets Strategy Committee and Domestic Investment Strategy group, and head of Investment Products and Services for the DB Alex Brown unit. In 1996, Mr. Grohowski joined Bankers Trust where he served as a senior trust investment officer of the Private Bank and head of the U.S. Investment Strategy group. He was with HSBC Asset Management from 1988 to 1996 and was named chief investment officer in 1993, after heading the U.S. Equities group from 1988 to 1993.

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