Principal Global Investors

Economic Insights: **New year, new optimism**

Outlook for 2021

Commentary by **Robert F. Baur, Ph.D.**, executive director, chief global economist

Personal note: This will be the last Insights by this author; best wishes to all readers.

The new year has the potential to be much better than 2020.

The late-year surge in COVID-19 cases and fatalities will be winding down. That virus activity impeded the United States and Euro area economic rebound, but growth will bounce by spring with vaccine delivery. The global economy should return to a sort of normalcy. Confidence will revive. Profits will come roaring back. Stock markets should have a decent year through late summer. At some point, the investment climate may shift to one with a bit more inflation. That would end the 39-year downtrend in long-term interest rates and be a problem for stocks and bonds.

Changes afoot

Apologies to Ernest Lawrence Thayer who wrote "Casey at the Bat," published in a predecessor to the *San Francisco Examiner* in 1888. It seemed fitting with baseball fans hoping for a more normal season in 2021. In fact, we're all hoping for a more normal year. The vaccine rollout suggests that yearning is not totally unreasonable.

The continuing wave of new COVID-19 cases and fatalities has slowed the rebound in the U.S. economy. Consumer confidence weakened in December and is staying well below pre-pandemic levels. The latest data shows household spending and retail sales dipped in November as coastal lockdowns kept people from normal activities. JPMorgan Chase private credit/debit card data shows a similar moderate downturn in spending from the pattern in October. Job growth had been stellar but slowed recently; total continuing claims for jobless benefits had been falling, but the pace has slackened for several weeks. However, the American Staffing Index of temp-help jobs keeps improving.

There's a clear divergence between households and business as the latter keeps reviving. National surveys of business purchasing managers did weaken modestly in December but are still at healthy levels. The New York Federal Reserve weekly economic indicator suggests U.S. gross domestic product (GDP) was only 1.32% below a year ago the week ending December 26, the best datapoint since the pandemic. That measure is an excellent summation of ten weekly business data series and should be a fair description of overall activity.

As the vaccine becomes more widely available, we expect a gradual return to normalcy. First quarter U.S. GDP may stall a bit as economic momentum dulled into January. But growth should rebound vigorously in the spring and summer quarters to the tune of 5% to 8%. U.S. GDP could reach a new record high in the second quarter. GDP gains will return to trend of 2.5% or so in 2022 assuming the vaccines are successful in quelling any return of COVID-19 or its mutants next winter. Employment will jump sharply with vaccine distribution. But with jobs still nine million short of the pre-pandemic peak, the total won't reach a new high until 2022.

Parts of Europe, especially Germany, are still under the scourge of rising new daily cases and fatalities. Stringent lockdowns and falling economic indicators suggest a moderate contraction in fourth quarter Eurozone GDP even though a trade deal has been mostly finalized as the United Kingdom exits the European Union. Eurozone business surveys plunged in November, but the collapse was mostly reversed in December. Retail sales likely tumbled in November, even though they are still well above the early year high. As in the U.S., widespread vaccine distribution and an end to stay-at-home orders should push GDP growth to mid-single digits by the second quarter and perhaps even 4% for the year.

Biden at the Bat

The year had started nicely til the COVID crud emerged.
The jobless rate neared record low as wage growth softly surged.
Investment strong as profits grew, stock markets validated
The confidence that households and investors advocated.
All was well, the year robust, economy was rockin';
But then in March and April, COVID virus came a-knockin'.

Business closed and jobs were lost, the streets were strangely silent.
Work from home and stay indoors; activity went quiet.
The closures brought recession worse than any knew before.
The virus raged; the death toll rose; fear spread from shore to shore.
Investors sold and prices plunged; the Fed stepped in to ease.
They backstopped bonds and markets calmed, investors were appeased.

The virus took a respite as the warmth returned last spring.
A June rebound pushed sprits up as only growth can bring.
The virus spent the summer hibernating out of sight;
But once the chill of fall returned, the crud came back to fight.
Closures, masks, and distance seemed the best that we could do;
But then some great researchers found a way to stop the flu.

And now the country sees ahead a promising New Year:
From restaurants to sports and cruises, travel less to fear.
Mutant strains are still a risk and public debt is soaring;
Investors, looking through the fog, think profits will start roaring.

The risks are real, stock values high, inflation could start rising;
But for a while and with some luck, we see those risks subsiding.
Fiscal programs won this game, but if markets start to fret,
We'll need much more than Biden's bat to cancel out the threat.

Japan's economy never recovered completely from the October 2019 two-percentage-point hike in the Value-Added Tax when the pandemic hit. So, its rebound from the virus-inspired recession has been sluggish. Households, self-isolating from a surge in COVID-19 cases, likely flattened activity in December. Global growth is helping; China's economic resurgence and U.S. demand are keeping Japan's exports surprisingly robust. Inventories fell to almost a decade low, suggesting strong gains in manufacturing output ahead. Business sentiment is recovering; the purchasing manager survey for manufacturing companies is the highest since May 2019. The labor market is improving with a drop in the jobless rate to an ultra-low 2.9%. We look for healthy Japanese growth in 2021.

Overall economic growth in China continues to rocket ahead, pushed by a stunning amount of government-directed stimulus. Retail sales have finally picked up nicely versus year-ago levels, but for the eleven months through November are still 4.8% below the same period of 2019. Investment by private companies is lagging dramatically even though capital spending by state-owned businesses is up significantly. China's trade surplus hit record levels, with vigorous exports of COVID-19-related materials. Growth in GDP in 2021 could be in the 7% to 8% range as the rebound matures.

Looking ahead

Growth in 2021 is partly about the virus. Rapid distribution of a successful vaccine will bring a sense of normalcy, healthy job growth, and a rejuvenation of leisure and hospitality. Ultra-low inventories will bring speedy hiring and brisk gains in output. A weaker U.S. dollar, spirited demand from China, rising commodity prices, and super-low interest rates are helping developing countries revive. A robust rebound will endure. 2021 will also be about fulfilling pent-up desires: for fun, travel, dining out, social get-togethers, yelling support for sports teams, singing in church. The revival could be terrific; all heaven could break loose.

Financial market outlook

Investors are giddy with enthusiasm, and it's no wonder. Just look at stock market performance. In a year with the ugliest recession since the 1930s, the highest jobless rate since the depression, the worst pandemic since 1918, the most violent protests since the 1960s, when oil was so worthless you couldn't even give it away, the S&P 500 Index was still up 16.3% after rocketing 67.9% from the March low. The Russell 2000 Index surged 18.4% for the year after nearly doubling from March 23.

It wasn't just the U.S. The MSCI Emerging Market Index jumped 15.6% and the MSCI All Country World Index ex U.S. rose 8.2% for the year. Even most bond investors were happy. Holders of long-term U.S. Treasury bonds had fat profits as interest rates plunged to unheard-of lows. Barclay's Global Aggregate Bond Index returned 9.2%. Except for oil, commodities had a great year.

In the past, when optimism was this broad, performance this strong, and investors so capitulated to the bullish story, the signal has been to sell, to take profits. But is this time different? Once again, in the past, the answer has always been no. There was no "New Era" for investors in 1929, nor in 1972 with the Nifty Fifty, nor in 1989 in Japan, nor in 1999 with the tech boom, nor with oil in 2008. Investor euphoria usually ends badly; the question is when. It's one of timing.

It may not be yet. The fact that the environment for the stock market and the economy is quite favorable isn't wrong just because it's been endorsed by the investment consensus. There seem to be good fundamental reasons for this positive climate to persist through part or much of 2021. First, this is the sweet part of the economic cycle, when just emerging from a recession, when growth is catching up to its potential. Secondly, there's plenty liquidity; interest rates are at historic lows. Financial conditions are extremely accommodative. Third, government policy will remain supportive. Central banks, including the Federal Reserve, have pledged to keep financial conditions relaxed until the economy is fully back. Another U.S. fiscal stimulus package has already been passed. Last, broad distribution of the vaccine(s) will allow a return to normalcy. Growth will surge as consumers strive to satisfy their huge pent-up demands.

But investor enthusiasm, combined with very high equity valuations, suggest that risks may be high and the margin for error low. The massive upmove since March and the rebound in earnings estimates mean that much of the positive outlook is already embedded in current stock prices. The key risk, however, is higher long-term interest rates as the super-easy financial conditions extant today cannot be sustained.

We've written before about the strong likelihood of a shift to a bit higher inflation later this decade--late 2022 or beyond. Globalization emerged from the world trade negotiations of the 1980s and brought with it three decades of disinflation. As it fades over time, especially in response to the pandemic's origin in China, the low inflation that came with it will fade, too. Further, giant fiscal initiatives around the world conjoined with aggressive monetary policy to repress interest rates will create demand faster than supply. And the demographic certainty of more retirees relative to the number of productive workers will also increase demand more than supply. All this implies significant interest rate risk down the road.

Given the robust fundamental underpinnings, we'd stay optimistic about 2021 and the stock market on a six- to maybe 12-month basis. We'd keep an equity portfolio balanced among sectors, not overweight tech or growth. Given recent great performance and lower valuations, one could have some exposure to U.S. small caps. With the U.S. dollar's weaker trend likely to persist, emerging market stocks could be a good overweight. But watch yields on 10-year U.S. treasury bonds. Stocks could be vulnerable to sizeable setbacks if yields rise above 1.5% or if the move to 1.5% happens too fast. Yields at 2% could put a long-term top in the U.S. stock market and might happen in 2022.

For bond investors, we stick to our long-standing suggestion of two- to four-year maturities of good quality high-yield or emerging market bonds. There will be better opportunities for bond investing later this decade. If inflation does surprise the consensus, real assets--such as commercial real estate, houses, farmland, commodities rather than financial assets—may win the performance derby for the 2020s.

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