2021 – THE YEAR OF RENEWAL?

The year 2020 brought unprecedented situations and shutdowns of economic activity, a fusion of monetary and fiscal policies, and a new leadership in the US.
2021 will have us start shifting back to pre-pandemic levels while simultaneously accelerating forward into the post-pandemic future.

A Renewed growth

We estimate that the approval and rollout of a coronavirus vaccine by the second quarter, fiscal policymaking, and US voters choosing legislative gridlock will enable corporate earnings in most regions to recover to pre-pandemic levels by the end of the year. We expect the more economically sensitive markets and sectors, many of which underperformed in 2020, to outperform in 2021. Our preferred areas include small- and mid-caps, select financial and energy names, and the industrial and consumer discretionary sectors.

2020 will be among the worst years for the global economy in more than 70 years. China will probably be the only large economy to record any growth, and we expect the US economy will have shrunk by roughly 4%, with developed markets as a whole and emerging markets ex-China contracting by 5%–6%.

Overall earnings should return to pre-crisis levels in 2021

CIO estimate for earnings, rebased to 2019 = 100

Earnings, rebased	2019	2020	2021	2022	Share price performance year-to-date
US	100	84.5	103.3	120.5	9.7%
Asia ex-Japan	100	98.7	118.4	137.3	9.9%
Euro area	100	58.4	85.7	102.1	–6.8%
UK	100	55.0	75.9	89.9	–16.5%
Switzerland	100	91.0	101.9	112.5	–2.4%
EM	**100**	**93.4**	**114.5**	**132.7**	**5.9%**
Developed markets	**100**	**83.1**	**103.8**	**119.8**	**6.3%**
Global	**100**	**84.4**	**105.2**	**121.9**	**6.3%**

Note: Consensus estimates for 2022

Source: Refinitiv Datastream, UBS, as of 11 November 2020

48%

of investors are very or somewhat optimistic about the outlook for the global economy over the next 12 months, but that figure rises to 66% on a five-year view.

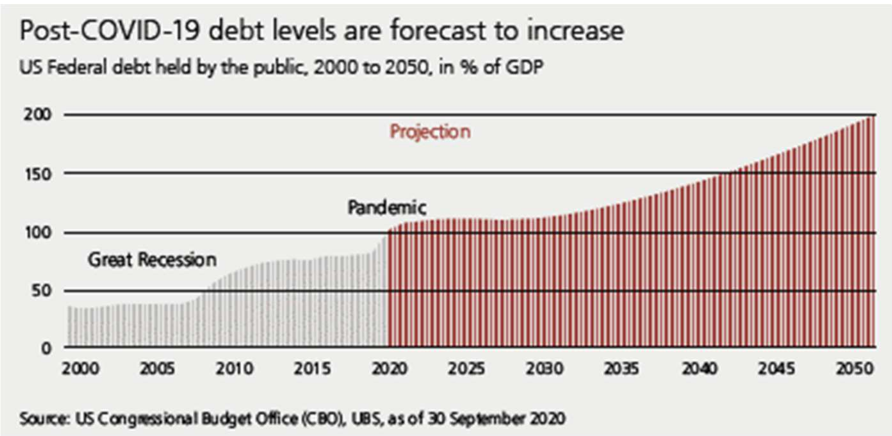
Source: 3Q20 UBS Investor Sentiment Survey

But we expect 2021 to be a Year of Renewal. Economic activity in China has already largely normalized. And following encouraging early vaccine efficacy data, we remain confident that vaccines will be widely available by the second quarter of 2021. This should help put Europe and the US on the path to a sustained recovery. If we are right, we expect corporate earnings to rebound quickly. We think developed market earnings will roughly match 2019 levels in 2021. Meanwhile, we anticipate emerging market companies will earn around 15% more in 2021 than in 2019, powered by robust earnings growth in Asia.

Revived economic and corporate earnings growth should also mean renewed outperformance from those cyclical companies and markets that underperformed in 2020. We see particular catch-up opportunity in small- and mid-caps, select cyclicals, particularly in the industrial and consumer discretionary sectors, and in markets outside the US.

How will the world change after the recovery?

The pandemic has made our world both more digital and more local, and not all companies and individuals will be able to adapt. So while we think that in the short term investors can profit by investing in companies exposed to a cyclical recovery, this needs to be combined with exposure to the disruptors set to drive technological transformation over the decade ahead, including 5G, fintech, healthtech, and Greentech. The global coronavirus pandemic has accelerated many of the trends already in evidence when we entered this Decade of Transformation. We think the post-crisis world will be more indebted, more unequal, and more local—but also more digital, and more sustainable.



More unequal. The pandemic has had a negative effect on employment for lower-skilled workers, while the nature of knowledge work, which can largely be performed from home, and the financial markets' good performance have favoured high-income and high-wealth individuals. In the future, technological disruption could widen the wealth gap even further. Whether wealth inequality reaches its political limits in the coming years remains to be seen, though we should expect to see more political leaders running on platforms that include some element of wealth redistribution. The resulting potential regional variations in economic policy make global diversification particularly important.

More local. Political considerations in an increasingly multipolar world, security concerns in light of the pandemic, consumer preferences tilting toward sustainability, and new technologies enabling localized production are all contributing to the world becoming more local. The aggregate effect on growth and inflation is unclear. But these factors can be expected to favour companies exposed to automation and robotics, companies already factoring sustainability into their supply chains, and companies based in ASEAN and India that could benefit from supply chain diversification out of China.

More digital. The COVID-19 pandemic has forced much faster digital adoption and disrupted established norms. This could transform various industries and, combined with the unfolding impact of the fourth industrial revolution, could boost medium-term productivity. The crisis could also have the effect of suppressing real interest rates because the more efficient use of capital stock and a shift from tangibles to intangibles lower the demand for investment capital. On the flip side, a more digital world will produce its fair share of losers too. We see particular risks for physical retail and traditional energy over the course of the next decade.

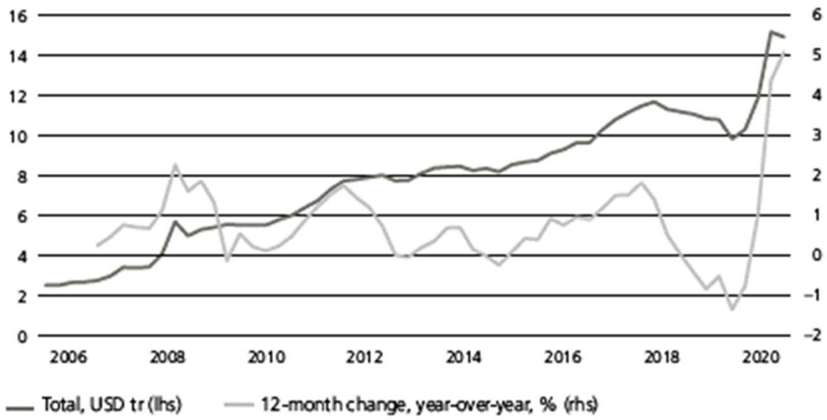
More sustainable. Demand for carbon is still rising, but in 2020 the EU and Japan pledged to go carbon neutral by 2050, and China promised to do the same by 2060. Stricter environmental regulations could mean higher costs for some businesses. But companies that are well positioned for the transition, such as those providing Greentech solutions, stand to benefit from a more sustainable world.

Where is economic policy headed?

In 2020 we saw an unprecedented fusion of fiscal and monetary policy: To fund social support packages, governments ran an aggregate deficit of over 11% of global GDP in 2020, while the world's top five central banks printed an aggregate of USD 5tr.

Central banks printed USD 5tr in 2020

Aggregate central bank balance sheets: Fed, BoJ, BoE, ECB, SNB



Source: Fed, BoJ, BoE, ECB, SNB, UBS, as of 20 October 2020

In 2021, we think governments in general will continue to "bridge the gap" until a vaccine enables a return to normal economic functioning. We also expect central banks to keep interest rates low to support growth and inflation. But the longer-term path is less predictable.

One possible danger is that governments recoil at the risk of higher debt and inflation and pull back fiscal spending programs too far or too fast. Monetary policy alone is unlikely to be sufficient to support the economic recovery, so this outcome would likely mean an extended period of disinflation and low growth.

A more likely possibility is that governments are reluctant to enact austerity policies, having so far run much higher deficits without suffering higher inflation or borrowing costs. In this scenario, governments continue to run large deficits and loose monetary policy persists even if inflation moves moderately higher.

Although neither scenario is likely to materialize in 2021, they could begin to shape a longer- term investor narrative, and therefore start to impact asset prices.

What is next for the US?

At the time of writing, it looks likely that we will see a divided government, with a Democratic President and House along with a Republican-led Senate. This is likely to mean a smaller-than-anticipated, but still sizable, fiscal stimulus package. Political gridlock could also have some positive effects. Republican control of the Senate would make significant tax increases on businesses or individuals unlikely in the coming years. It would also reduce the probability of aggressive new regulation on healthcare or fossil fuel companies. More broadly, divided government lowers the potential for significant policy changes, reducing the potential for policy-induced market volatility.

We identify three key effects:

- Stimulus to boost mid-caps. We think the new administration will be able to enact another coronavirus aid package worth between USD 500bn and 1tr, or roughly 2.5%–5% of GDP, which should bode well for consumer spending and business confidence, and help drive a shift in market leadership away from large-caps and toward mid-caps. Mid-cap earnings are more leveraged to an economic recovery, and we expect them to grow at around twice the pace of large-cap earnings in 2021.

- A higher deficit to weaken the US dollar. We expect higher fiscal spending to be funded by a rising deficit, rather than additional taxes. Although spending can largely be funded by private domestic savings in the near term, as the economy begins to recover in 2021, we expect the private sector to increase spending, widening the current account deficit and requiring a weaker dollar to attract external funding.

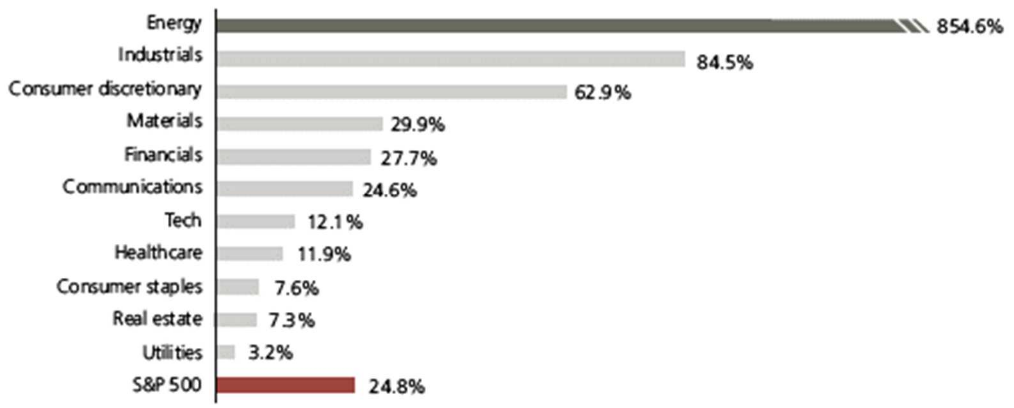
– A more predictable China rivalry to emerge. We think the Biden administration will renew the US's approach to foreign relations, a tack that should improve relations with Europe in particular. Although the fundamental US-China geostrategic rivalry won't change, we do think the new administration will be less likely to use tariffs as a tool of foreign policy. Reduced trade tensions should support the economic recovery, reinforcing our preference for cyclicals such as industrials.

US tech. After a rally of over 50% in 2020, the top five US technology firms alone now represent around one-eighth of the MSCI AC World equity index, more than China, the UK, and Switzerland combined. We expect the technology sector to continue to benefit from strong secular growth in digital advertising, e-commerce, cloud computing, and the 5G rollout.

However, valuations have increased, and we think other segments of the market will see stronger earnings growth in 2021 as they recover from depressed levels. Anti-trust scrutiny also bears monitoring, although a divided government would reduce the probability of new regulations, and in any case we would expect judicial proceedings to take years to reach resolution.

Cyclicals should see higher earnings growth than defensives and technology

Consensus earnings per share growth in 2021, in %



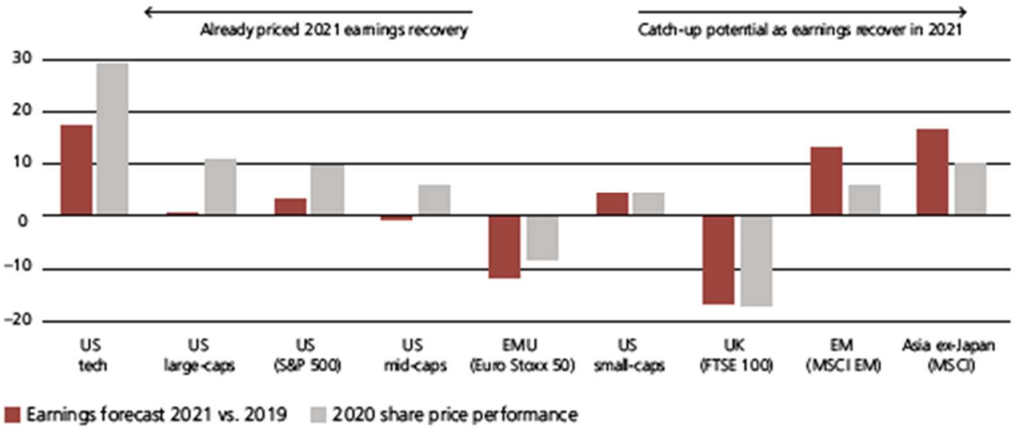
Source: FactSet, UBS as of 12 October 2020

EQUITIES

We expect equity markets to move higher in 2021. In a Year of Renewal, we also believe some of 2020's laggards will catch up. Investors need to think global, look for catch-up potential, and seek long-term winners. Profits underlying major equity indexes have proven surprisingly resilient through the pandemic when compared with the broader economy. This is because listed companies have a high exposure to digital, multinationals, and goods relative to services. Looking ahead monetary and fiscal stimulus should continue to provide a tailwind for stocks, and we anticipate significant earnings growth as the global economy recovers. Low interest rates also continue to make equity valuations look attractive relative to bonds and cash.

There is catch-up potential outside of US large-caps

Earnings per share growth in 2019 vs. 2021 (consensus estimates), including year-to-date performance, in %



Source: Refinitiv Datastream, UBS, as of 11 November 2020

Robust corporate earnings and exposure to secular trends still speak in favour of the US market at the time of writing. However, amid relatively high valuations and after outperforming global stocks in 10 of the past 11 years, US stocks will start to underperform other markets at some stage in the coming year, in our view.

We expect the post-pandemic recovery in corporate earnings to be stronger in the more cyclically exposed Eurozone and UK markets, while valuations are more favourable in emerging markets, and Asia retains a combination of reasonable valuations, robust earnings, and secular growth.

Investors should prepare for the year ahead by ensuring they are not overexposed to US stocks, and we recommend considering implementing hedges to US equity exposure and diversifying into markets and sectors that have potential to catch up. Investors can retain exposure to secular growth by seeking out companies outside of the US, especially in Asia, which are exposed to key long-term trends.

As economic normality starts to return, we expect some of the relative laggards in 2020 to become outperformers in 2021. Areas with the most catch-up potential, in our view, are US midcaps, EMU small- and mid-caps, select financial and energy stocks, and the industrial and consumer discretionary sectors. By contrast, we expect the earnings growth and performance of global consumer staples companies to lag in 2021, while some of the primary stay-at-home beneficiaries could also begin to underperform as conditions normalize.

INTEREST RATES

We expect interest rates on cash and bond yields to stay at very low levels for the foreseeable future. The renewed hunt for yield means investors need to take a look at the role of cash and bonds in portfolios and consider being more active, increasing exposure to emerging markets and Asia, or finding alternative means of earning income.

Excess capacity and accommodative central bank policy mean we do not expect rates or government bond yields to move significantly higher in 2021. While this makes it challenging for investors to find yield in cash and high-quality bonds, we think the investment environment is conducive to credit, with economic output steadily recovering, and fiscal and monetary policy helping keep defaults in check.

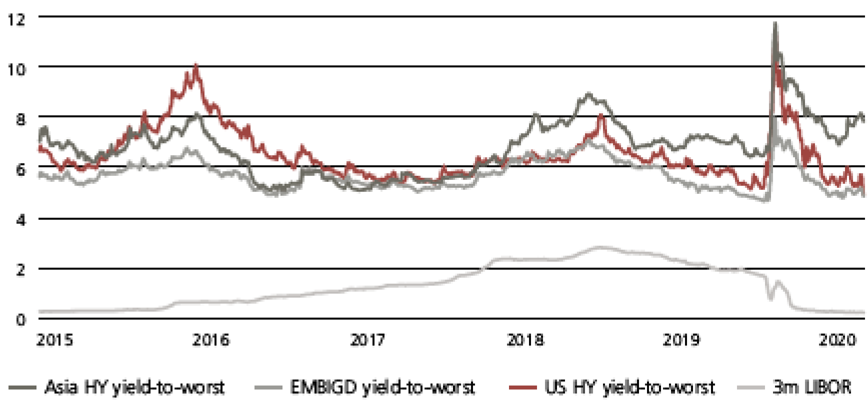
Investors looking to enhance portfolio income can consider the following options:

– Being more active. With earnings recovering in 2021, we think credit fundamentals and credit ratings will also start to improve. Yet the disruption caused by the pandemic will have divergent effects, which could boost returns for more active investors. For example, risk-tolerant investors can earn potentially significant returns by anticipating key rating agency action, and investing in select euro- or US dollar denominated bonds in the crossover zone (hence the name "crossover bonds") between investment grade and sub-investment grade.

– Looking to emerging markets and Asia. With yields of near 5% (or 400bps spreads over US Treasuries), emerging market USD-denominated sovereign bonds compensate well for their risks, in our view. We think spreads could tighten to 340bps as global demand returns and oil prices recover. Meanwhile, Asia HY offers some of the most attractive yields in the credit space, at near 8%. The asset class is backed by a positive outlook for Chinese property bonds that benefit from easy domestic liquidity conditions.

Select credit yields are high relative to cash rates

Select bond yields and LIBOR, in %



Source: Bloomberg, UBS, as of 6 November 2020

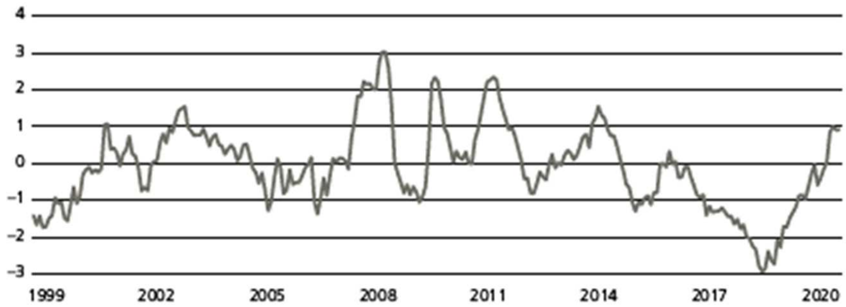
CURRENCIES

We expect the US dollar to weaken in 2021 due to a recovering global economy and a diminished interest rate differential. To position for this, we think investors should diversify across G10 currencies or into select emerging market currencies and gold.

The US dollar index has already dropped close to 10% from its highs in March 2020, and we anticipate renewed weakness in 2021. We expect continued large US fiscal deficits at the same time as US private sector savings are starting to fall, exacerbating external funding requirements. In addition, a recovering global economy and heightened focus on US indebtedness are likely to reduce safe-haven demand for the currency. And the interest rate advantage the US dollar previously held over other currencies in recent years has now eroded.

Real yields are higher in Europe

2-year EURUSD inflation-adjusted swap rate



Source: Macrobond, UBS, as of 1 November 2020

A diversified set of G10 currencies. We see medium- to long-term upside potential in the EUR, GBP, CHF, and AUD against the US dollar. The euro is well placed to benefit from a recovery in global export demand as the pandemic fades and US stimulus boosts growth. We forecast EURUSD to rise into the 1.20–1.25 range by end-2021. We also view the Swiss franc and the Japanese yen as superior safe havens to the US dollar, given that investors could become more concerned about the US's indebtedness at the same time as the Swiss National Bank relaxes its interventions, and as growth in Asia rebounds.

Emerging market and APAC currencies. We like Asian currencies with a high yield, such as the Indian rupee and Indonesian rupiah, and those with cyclical exposure, such as the Singapore dollar and Chinese yuan. The yuan could additionally benefit from capital inflows as access to Chinese capital markets eases further. The low-yielding Taiwan dollar is our least preferred currency in Asia. Elsewhere, we think the Russian ruble will benefit from a global economic recovery, especially if oil prices increase, as we forecast.

COMMODITIES

Prices are currently cyclically depressed, and energy prices in particular have ample room to recover in the wake of the pandemic.   Overall, we think broad commodities indexes will return roughly 5% annualized over the coming 15 years, driven by strong expected returns in energy.

Gold was one of the best-performing assets in 2020, rallying over 25%. In an environment of higher growth, we don't' expect last year's gains to be repeated in 2021. But the precious metal can still act as a hedge against inflation, a falling USD and geopolitical uncertainty, while low rates keep the opportunity cost of holding it low and may therefore well continue to be favoured by investors, with respective returns.

REAL ESTATE

In a low interest rate environment, real estate remains an attractive investment or income generation in our view, particularly when compared with cash or government bonds.

Real estate's inflation protection characteristics may prove beneficial in a more indebted world. While we do not think that either city living or the office market has been permanently impaired due to the pandemic, active private real estate strategies should provide better returns compared with low yield buy-and-hold strategies. We still expect nominal returns to average 6% - 7 % annually in private real estate (in USD), compared to the average of 8.5% over the past two decades, so REITS continue to be an attractive diversification.

Source: based on UBS House View / YEAR AHEAD 2021