



2021 Global Market Outlook

Managing to the Other Side



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INTRODUCTION: CHALLENGES AHEAD

Managing to the Other Side

New vaccines could accelerate recovery, boost cyclical sectors.

December 2020

KEY INSIGHTS

- New coronavirus vaccines offer a potential lift for economies in 2021. However, a spike in COVID-19 cases could slow recovery in the first quarter.
- Economic improvement could shift spending from firms that gained during the pandemic to cyclical names damaged by it, potentially favoring value over growth.
- Fixed income investors will need to be creative in 2021, as low yields and tighter credit spreads could make attractive returns harder to find.
- Social and economic upheaval caused by the pandemic could worsen political divisions. Tensions between the U.S. and China are another potential flashpoint.

The 2020 global pandemic tested the ability of companies and investors to manage their way through an unforeseen and dangerous period. However, T. Rowe Price investment leaders believe the other side of that journey could come into view in 2021 if new vaccines and continued fiscal and monetary stimulus add momentum to the economic recovery.

Rapid progress with a first wave of new vaccines based on messenger RNA (mRNA) technology clearly is the most hopeful sign, says David Giroux, chief investment officer (CIO), Equity and Multi-Asset.

"The vaccines are an unmitigated positive, and I believe the next wave of them will be as efficacious or more efficacious than the mRNA vaccines," Giroux says.

"This could allow us to get back to normal at a faster rate."

A broader economic recovery is likely to benefit many of the sectors that were most damaged by the virus, such as travel, leisure, energy, and financials, notes Justin Thomson, CIO, International Equity. However, technology, e-commerce, and home delivery firms that saw sales surge during the pandemic could face tough earnings comparisons.

A stronger recovery in 2021 would carry risks for bond investors, warns Mark Vaselkiv, CIO, Fixed Income. He says investors will need to be creative in seeking out fixed income sectors—such as floating rate bank loans and emerging market corporates—that potentially can do well in a rising interest rate environment.



David Giroux

*Chief Investment Officer,
Equity and Multi-Asset*



Justin Thomson

*Chief Investment Officer,
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Mark Vaselkiv

*Chief Investment Officer,
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THEME ONE

An Uneven Road to Recovery

Although most global economies saw a relatively rapid economic rebound from the initial onset of the pandemic (Figure 1), the world still has not returned to normal. As 2020 approached its end, a major spike in COVID-19 cases in the U.S. and Europe posed a renewed threat to the recovery.

While the new vaccines and improved treatment therapies are encouraging signs for 2021, the economic effects of the pandemic are likely to echo for some time, T. Rowe Price investment leaders say. Uneven progress could produce periods of market volatility.

"We don't yet fully understand the pandemic's long-term impact on consumer behavior," Vaselkiv explains. "How quickly will the affected industries recover in 2021? We may not have a full picture until 2022."

The first quarter of 2021 could see a trough in economic activity, Giroux warns. However, assuming the new vaccines can be distributed on an accelerated scale, especially to higher-risk populations, economic

conditions could improve rapidly in the second quarter, he says.

"People are going to want to travel, to get back to work, to have deferred elective medical procedures," Giroux argues. "If so, I think the second half of 2021 could look more like 2019 than like the first half of 2020."

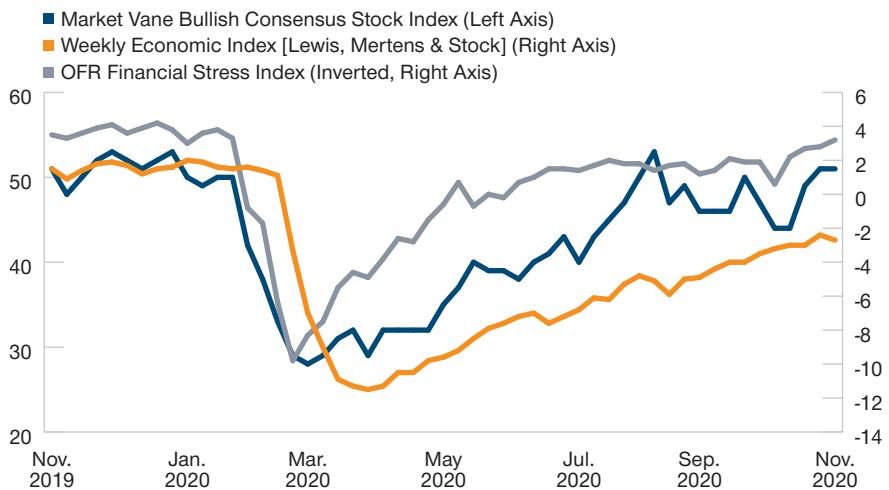
An Uncertain Outlook for Fiscal Stimulus

A key economic variable, Vaselkiv says, will be whether governments in the U.S. and Europe will provide additional fiscal support to supplement the monetary stimulus provided by the U.S. Federal Reserve and the European Central Bank. "Fed Chairman Jerome Powell has emphasized that fiscal stimulus needs to take priority over additional monetary stimulus because it has a more significant impact on the real economy," Vaselkiv notes.

The size and timing of any additional U.S. fiscal stimulus may depend on the partisan balance of power in Washington. Divided government could require lengthy negotiations and limit the scope of any aid package.

A "Swoosh" Shaped Recovery So Far

(Fig. 1) Investor sentiment, economic, and financial stress indicators



As of November 27, 2020.

Past performance is not a reliable indicator of future performance.

Sources: Bloomberg Finance L.P., Haver Analytics/Barron's, Federal Reserve Bank of New York, Office of Financial Research, and Standard & Poor's (see Additional Disclosures).

A lot of the recovery already is priced into the markets.

— David Giroux

Chief Investment Officer,
Equity and Multi-Asset

In Europe, on the other hand, the fiscal outlook appears encouraging, Thomson says. Unlike in past economic emergencies, such as the 2012 European sovereign debt crisis, the European Union (EU) is not imposing austerity but rather has committed to fiscal stimulus, he notes. "It finally appears that Europe is acting in a concerted, cohesive fashion."

China's recovery appears robust, relative both to the developed world and to other emerging market economies, Thomson says, and the country should see positive economic growth for 2020 as a whole. However, Chinese corporate bond yields have started to rise, which could limit credit growth in 2021.

A bullish 2021 case can be made for Japan, Thomson argues, based on historically close correlations between Japanese equities and the global cyclical sectors that could benefit most from a pandemic recovery. Increasing shareholder activism is another potentially positive factor, he adds.

Earnings Recovery Already May Be Priced In

For U.S. and global equity markets, a rapid economic recovery could bring an

accelerated earnings recovery, Giroux says. Following the last three recessions, he notes, it took the S&P 500 Index three, four, and five years, respectively, to regain its previous earnings per share peak. This time, he suggests, it potentially could happen in 2021.

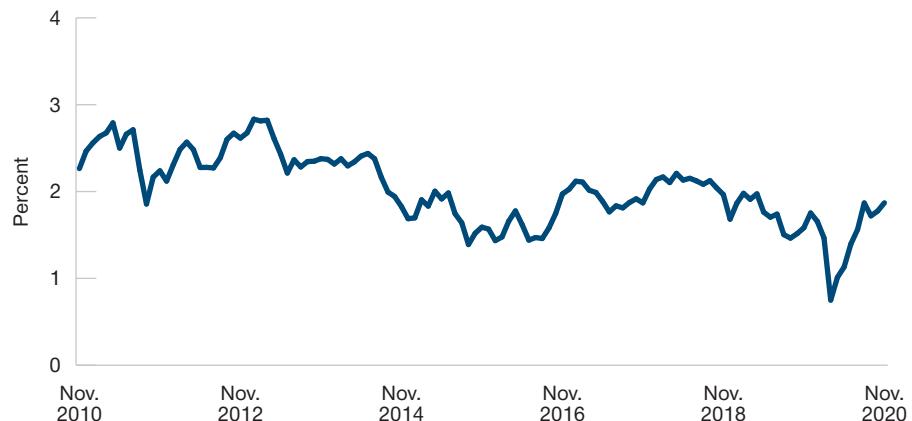
However, rapid earnings growth might not translate into strong equity returns in 2021, Giroux cautions. Despite the sharp earnings decline seen during the pandemic, he notes, most global equity markets appeared set to finish 2020 with strong gains for the year. "A lot of the recovery is already priced into the markets," Giroux says.

A broader economic recovery also could produce a modest uptick in inflation, which decelerated in early 2020 as the pandemic spread. Forward-looking measures of inflation expectations, such as spreads between nominal and inflation protected government bonds (Figure 2), have rebounded sharply since mid-2020, Giroux notes.

"I'm not saying we are going to see massive inflation, but I think there is a risk that the U.S. could pierce the 2% inflation ceiling—not quickly, but perhaps in 2022 or 2023."

Upside Inflation Risks Should Not Be Ignored

(Fig. 2) U.S. ten-year government yield minus government inflation-linked 7- to 10-year yield



As of November 30, 2020.

Past performance is not a reliable indicator of future performance.

Source: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

THEME TWO

Style Dispersion Amid Disruption

The pandemic has dramatically accelerated the adoption of the technologies and business models—from video conferencing to remote medicine to home meal delivery—needed for companies and consumers to function amid a public health emergency.

Moving into 2021, the key question for equity investors is whether mass vaccinations and a rapid decline in new COVID-19 cases could spur a rotation in market leadership toward cyclical sectors that are positioned to benefit from more normal economic conditions.

“The pandemic fundamentally changed how consumers spent money and time, and did it over an unprecedentedly short horizon,” Giroux notes. Spending on goods and services such as gym memberships, elective surgery, dental care, theme parks, and restaurants fell by 50% to 80%, he says. “We haven’t seen anything like it in my lifetime, and probably not since World War II.”

The second half of 2021, Giroux suggests, could see a partial reversal of those trends. If vaccination progress accelerates the economic recovery, he predicts, many of the industries badly

damaged by the pandemic could see their fundamentals improve rapidly. “I believe some of these companies could get back to 2019 earnings levels relatively quickly,” Giroux says.

By the same token, however, a spending shift toward the COVID losers could come at the expense of the sectors that many equity investors bought aggressively during the pandemic, particularly technology, e-commerce, social media, and housing.

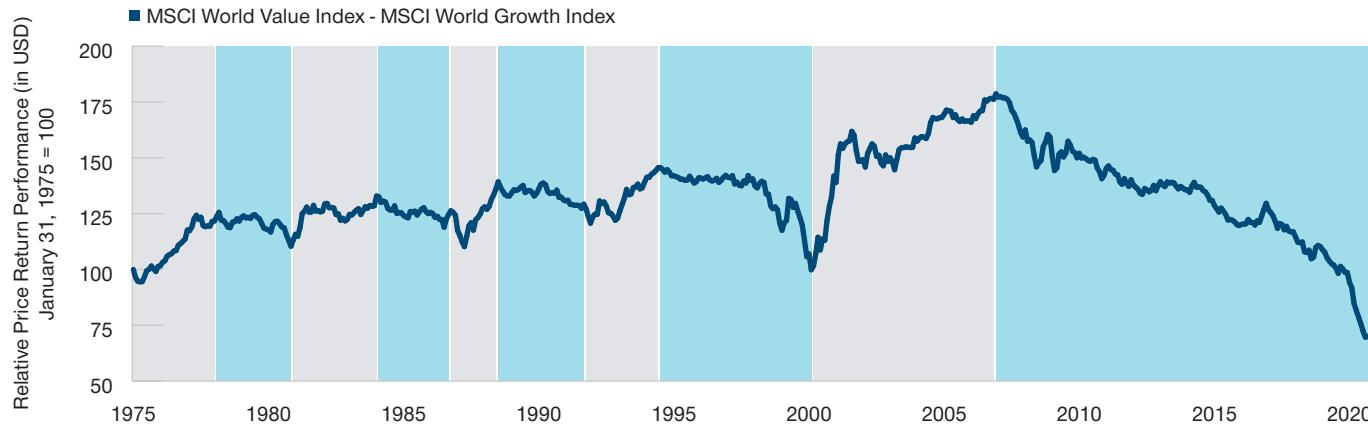
A Value Revival

In style terms, a more normal cyclical recovery could continue to boost value relative to growth, a reversal of the powerful trend toward growth dominance—and unprecedented dispersion of stock returns—seen since the 2008–2009 global financial crisis (Figure 3).

Signs of such a rotation appeared in late 2020 in response to the news about vaccine development, Thomson notes. However, valuations for many “pandemic winners” also have continued to rise, even though those firms could face difficult year-over-year earnings growth comparisons in 2021.

After an Era of Growth Dominance, Value Could Be Poised for a Rebound

(Fig. 3) MSCI World Value Index versus MSCI World Growth Index, relative price return in U.S. dollars (USD)



As of November 30, 2020.

Past performance is not a reliable indicator of future performance.

Source: MSCI via FactSet (see Additional Disclosures).

The backdrop for selective value investing hasn't been this strong in a decade.

— David Giroux
Chief Investment Officer,
Equity and Multi-Asset

A return toward pre-pandemic consumer spending patterns could further improve the attractiveness of sectors, such as financials and energy, that are heavily represented in the value universe relative to the tech stocks that dominate the major growth benchmarks (Figure 4).

“The backdrop for selective value investing hasn't been this strong in a decade,” Giroux contends. However, the gains seen in many value sectors in late 2020 suggest the market already has priced in some of the benefits of a faster recovery. “It's a little bit less of an easy call now than it was before the vaccine news,” he says.

Sector Opportunities and Risks

The financials and energy sectors could offer particularly attractive shorter-term value opportunities in 2021, according to Giroux:

 **Financials:** Steepening yield curves have improved net lending margins, and the reserves set aside to cover expected pandemic loan losses appear to be larger than needed, Giroux says. European banks appear especially cheap based on price/book value multiples, Thomson adds.

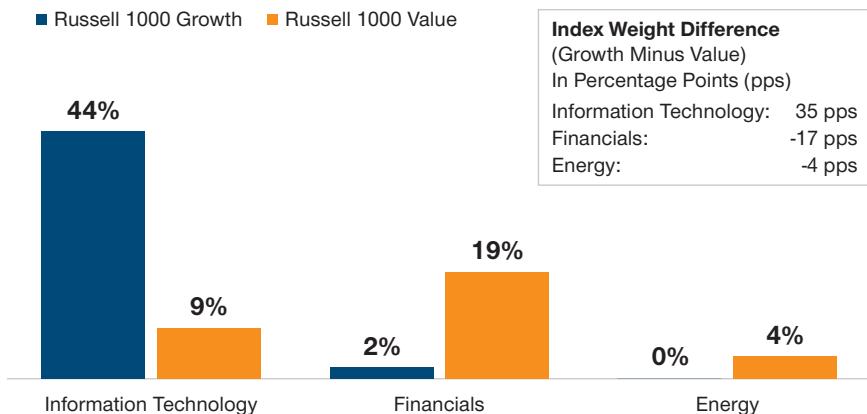
 **Energy:** A broad collapse in capital spending should reduce excess oil and gas supplies, potentially supporting prices, Giroux predicts. An easing of the pandemic could boost travel in 2021, reviving demand. However, the longer-term outlook for traditional fossil fuel producers remains challenged by renewables and regulatory pressures.

Giroux and Thomson both stress that investors seeking value opportunities will need to be careful about stock selection. They recommend seeking out companies that appear well positioned to emerge from the pandemic with lasting competitive advantages, while avoiding firms that face longer-term secular challenges—such as conventional automakers that have fallen behind in the race to dominate electric vehicle markets.

“You have to be able to distinguish between businesses that can expect normal cyclical recoveries and those that face existential risks,” Thomson says. In such an environment, skilled stock selection backed by strong fundamental research resources could be especially critical.

Strong Backdrop for Select Value Investing

(Fig. 4) Sector weights in Russell large-cap style indexes



As of October 31, 2020.

Source: Russell via FactSet (see Additional Disclosures).

THEME THREE

Creativity in a Low-Yield Era

Massive infusions of central bank liquidity successfully stabilized global credit markets in 2020, even as a pandemic-driven flight to quality pushed already low sovereign yields even lower. These dual trends produced strongly positive returns across most fixed income sectors.

Moving into 2021, however, investors face a more challenging environment, Vaselkiv says. With short-term yields at ultralow or negative levels and the U.S. yield curve steepening as economic growth and inflation expectations revive (Figure 5), interest rate risk could become a critical issue, he cautions.

Credit markets also no longer appear as attractive as they did after central banks launched their rescue operations in 2020, Vaselkiv says. With investment-grade (IG) and high yield credit spreads back closer to their historical norms—despite the lingering effects of the pandemic—active sector and security selection are likely to play more critical roles in seeking yield and managing risk in 2021.

“We think it will take significant creativity to find attractive opportunities in such a low interest rate environment,” Vaselkiv says.

Creativity, Vaselkiv notes, could mean moving further out the credit risk

spectrum, increasing allocations to floating rate loans and other low-duration assets, and seeking opportunities in ex-U.S. debt markets. Skilled credit analysis could be crucial to success.

An Expanded Credit Universe

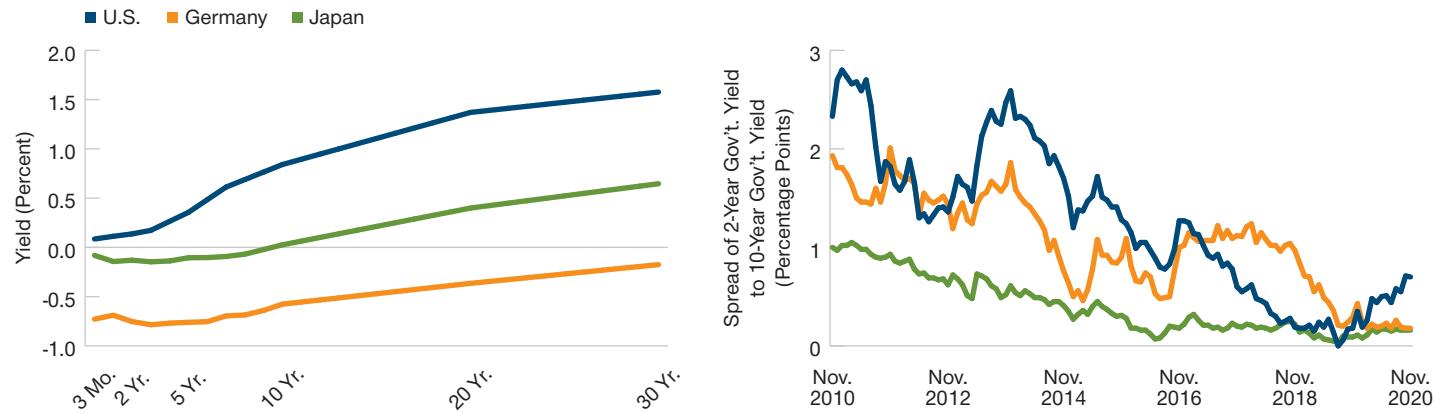
For credit investors, the flood of new USD-denominated corporate issuance seen in 2020—an estimated USD 2 trillion in investment-grade and more than USD 500 billion in high yield debt—offers both potential opportunities and additional risks, Vaselkiv says.¹

On the one hand, yields in the credit universe still appear attractive on a relative basis, in Vaselkiv’s view. While many companies have increased their debt loads, he says, in many cases liquidity ratios actually have improved. This should help businesses in cyclical sectors such as energy, airlines, and lodging fend off insolvency until economic conditions normalize.

However, ample financing also could allow structurally weak firms to survive even though their longer-term prospects for profitability appear dim. “We may end up with a universe of companies that limp along for the next five to seven years just because the credit markets keep them afloat,” Vaselkiv says.

Yield Curves Are Lower But Steeper Than at the Beginning of 2020

(Fig. 5) Sovereign yield curves (left) and yield curve slopes (right)



As of November 30, 2020.

Past performance is not a reliable indicator of future performance.

Source: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

¹ See: John Lonski, “Record-High Bond Issuance Aids Nascent Upturn,” Weekly Market Outlook, Moody’s Analytics, October 1, 2020. On the web at: <https://www.moodysanalytics.com/-/media/media/2020/weekly-market-outlook-record-high-bond-issuance-aids%20nascent-upturn.pdf>.

Historically, U.S. dollar currency cycles have tended to last for significant amounts of time.

— Mark Vaselkiv
Chief Investment Officer,
Fixed Income

In an environment where short-term rates are at or close to zero, but prospects for a post-pandemic recovery appear to be brightening, duration—a key measure of interest rate risk—could become a top issue for many fixed income investors in 2021, Vaselkiv says. Extended durations for high-quality sovereigns and investment grade corporates (Figure 6) mean that even modest upticks in interest rates and inflation could produce significant capital losses on those assets, he warns.

Potential Opportunities in Floating Rate and Emerging Market Debt

Floating rate bank loans—syndicated loans to companies that are then sold to mutual funds and other institutional investors—offer attractive advantages in this environment, Giroux says. Bank loans sit higher in the borrower's capital structure than high yield bonds, he notes. Historically, he says, this has resulted in higher recoveries in default situations.

The floating rate feature of bank loans also gives them an extremely low duration profile—comparable to U.S. Treasury bills and other short-term instruments—but

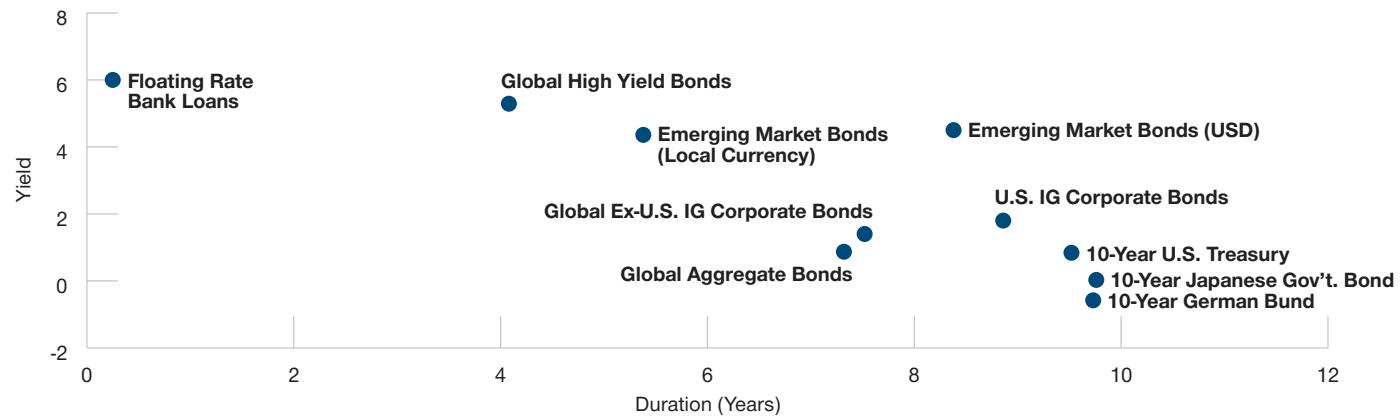
with substantially higher yields, Giroux says. "Historically, floating rate loans have been the one fixed income sector that has tended to appreciate when interest rates are rising," he argues.

Fixed income assets outside the U.S.—especially emerging markets corporate debt denominated in local currencies—also could hold opportunities for global bond investors in 2021, Vaselkiv says. A weaker U.S. dollar, he adds, could enhance that appeal by potentially boosting returns on nondollar assets for dollar-based investors and potentially improving the creditworthiness of U.S. dollar bond issuers.

Key factors such as relative interest rates, relative growth rates, and relative monetary liquidity suggest that the trend toward U.S. dollar depreciation could continue in 2021, Vaselkiv argues. "Historically, U.S. dollar currency cycles have tended to last for significant amounts of time," he says. "This potentially bodes well for international allocations—not just in fixed income, but also for equity names that generate a large portion of their earnings outside the United States."

Interest Rate Risk Potentially Makes Shorter-Duration Assets More Attractive

(Fig. 6) Yield versus interest rate risk (duration)



As of November 30, 2020.

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Floating Rate Bank Loans = J.P. Morgan Leveraged Loan Index; Global High Yield Bonds = Bloomberg Barclays Global High Yield Index; Emerging Market Bonds (Local Currency) = J.P. Morgan GBI-EM Global Diversified Composite Index; Emerging Market Bonds (USD) = J.P. Morgan EMBI Global Index; Global Ex-U.S. IG Corporate Bonds = Bloomberg Barclays Global Corporate IG Index; U.S. IG Corporate Bonds = Bloomberg Barclays U.S. Investment Grade Corporate (300MM) Index; Global Aggregate Bonds = Bloomberg Barclays Global Aggregate Index; 10-Year U.S. Treasury = US Benchmark Bond-10 Yr; 10-Year German Bund = Germany Benchmark Bond-10 Yr; 10-Year Japanese Gov't. Bond = Japan Benchmark Bond-10 Yr.

THEME FOUR

Politics and the Pandemic

The global pandemic has accelerated economic inequality and appears to have worsened political divisions in some countries, trends that could continue to create geopolitical tensions and influence markets in 2021.

In the U.S., the Biden administration is widely expected to seek additional fiscal stimulus to bolster the economy. However, divided government in Washington, D.C., would likely hamper the administration's more ambitious legislative proposals, Giroux notes. "If you think about some of the things the market was not looking forward to, like higher taxes, I think a lot of them probably are off the table for at least the next two years if you have a Republican Senate," Giroux says.

U.S.-China Relationship Could Remain Contentious

One potential flashpoint that could impact global markets in 2021 will be ongoing trade and diplomatic tensions between the U.S. and China. The Biden administration will have to decide whether and how to challenge Beijing on trade, intellectual property (IP) rights, human rights, and other issues.

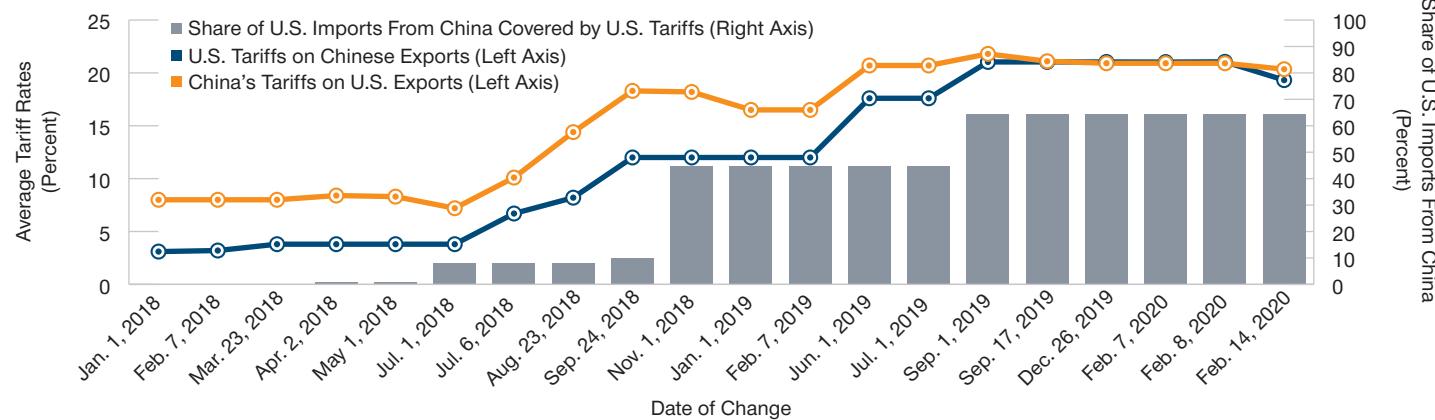
Given that a hardline trade policy toward China has broad bipartisan support in Washington, Thomson says he doesn't expect the new administration to roll back the tariffs on Chinese goods imposed by President Donald Trump (Figure 7). However, the intensity of the trade conflict might be reduced.

Control of IP, on the other hand, is likely to remain a key battleground, Thomson says. "The battle for dominance over the next generation of technology is one that neither side feels it can afford to lose," he explains. However, while the IP conflict poses potential economic risks, Thomson adds, it also could create new opportunities for investors as China seeks to develop its own supply chains, including an onshore semiconductor industry.

Meanwhile, Beijing's campaign to bring Hong Kong under tighter control appears to have achieved its objective, Thomson notes, as opposition members on the city's Legislative Council either have been removed or have resigned. But Thomson minimizes the risks these developments could pose to the city's status as a global financial center. "As long as the renminbi [China's currency] is not fully convertible, the Hong Kong dollar will remain highly relevant," he says.

Higher Tariffs on U.S.-China Trade Appear Unlikely To Be Rolled Back

(Fig. 7) U.S. and Chinese tariff rates and share of imports from China covered by U.S. tariffs



As of November 30, 2020.

Source: Peterson Institute for International Economics www.piie.com.

...additional fiscal stimulus is so important now—to help save jobs.

— Mark Vaselkiv

*Chief Investment Officer,
Fixed Income*

Brexit Nears Another Deadline

As 2020 approached its end, UK and EU leaders were seeking to finalize the terms of their divorce, amid uncertainty about what their future trade relationship would look like.

Thomson says he believes a workable set of post-Brexit arrangements can be achieved. “[German Chancellor] Angela Merkel is an arch pragmatist,” he says. “Given that the UK is one of Germany’s biggest export markets, she knows that a negative relationship would not be good for either side, and not good for Germany in particular.”

A workable post-Brexit relationship could have positive implications for the British pound versus the U.S. dollar, Thomson says, potentially boosting returns on sterling-denominated assets for non-British investors.

Stimulus Could Determine Strength of Labor Markets

While global capital markets have benefited from generous central bank liquidity and encouraging news on vaccines, the prosperity gap between

owners of financial assets and many workers and small businesses continued to widen in 2020. This could further fuel populist pressures.

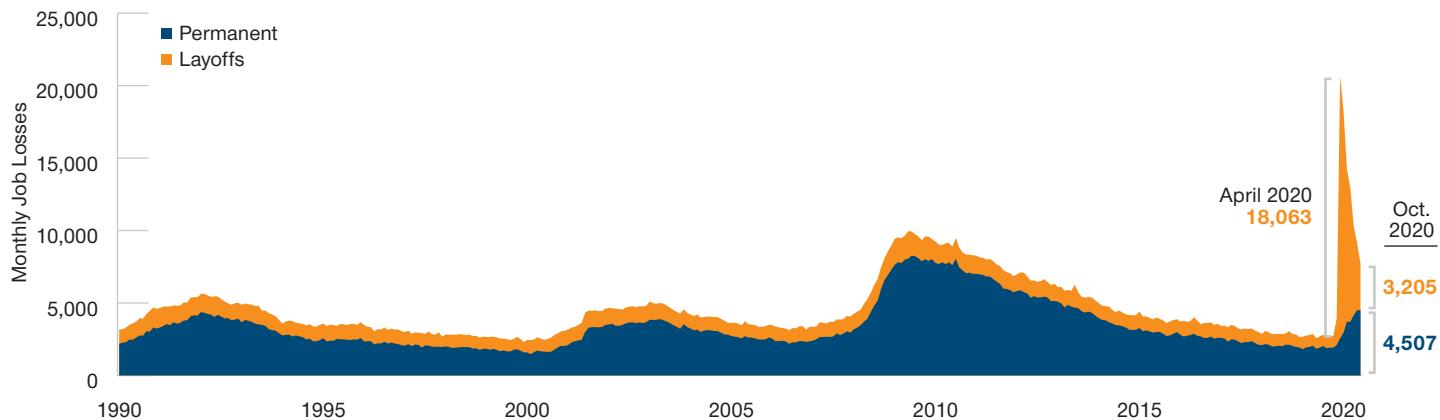
In the U.S., the initial waves of pandemic layoffs were primarily temporary, with federal paycheck assistance programs helping cushion the blow. Many of those employees have since returned to work (Figure 8). However, as the pandemic has dragged on, permanent job losses have mounted.

If new vaccines and continued fiscal and monetary stimulus support a return to more normal economic conditions in 2021, a key question—one with significant political implications—will be how quickly global labor markets improve as a result.

“Large corporations have access to the capital markets, but we shouldn’t forget that state and local governments employ millions of people. And small businesses are the lifeblood of many communities,” Vaselkiv argues. “That’s one reason additional fiscal stimulus is so important now—to help save jobs.”

The Gap Between Temporary and Permanent Job Losses Has Closed

(Fig. 8) U.S. layoffs versus permanent job losses



As of October 31, 2020.

Sources: U.S. Department of Labor/Haver Analytics.

Conclusions

In the opening months of 2021, the short-term economic risks from a worsening pandemic could weigh on global equity and credit markets, Giroux says. However, economic and earnings growth could improve dramatically later in the year if the new vaccines can rapidly bring down infection rates.

But a 2021 earnings recovery might not translate into continued strong rallies in global equity prices, Giroux cautions. To a large degree, he says, an economic and earnings recovery already has been priced in by the markets. "Expectations are high, so we could see good earnings results but still see the market trade off a bit."

Thomson thinks global equities could perform reasonably well in 2021, helped by the same factors that propelled the 2020 rally: supportive fiscal policy and ample monetary liquidity. "It feels to me

like there's still a lot of money on the sidelines that could make its way into risk assets," he says.

For fixed income investors, 2021 could be challenging, as the falling yields and tightening credit spreads that boosted broad market returns in 2020 aren't likely to play that role again. Rather, extended durations and the potential for a modest revival in inflation could make managing interest rate risk a portfolio priority, boosting the appeal of floating rate assets.

In both equity and credit markets, T. Rowe Price investment leaders say, the uneven impact of the pandemic and the recovery on countries, industries, and individual companies is likely to make strong fundamental analysis and skilled active security selection a critical component of investment success.

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