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Heading for some kind of normality

The economy is starting a new cycle while capital markets are showing typical late-cycle characteristics. Overall, this makes us optimistic.

" While politics, environmental disasters and, the virus are dominating the headlines, the stock markets mainly care about earnings growth and interest rates. We are confident about both on a 12-month basis, but a temporary rise in real interest rates could keep markets on edge for a while. "

Stefan Kreuzkamp
Chief Investment Officer and
Head of Investment Division

Before we get to the new forecasts for the coming twelve months, a brief introduction to the new look of the CIO View, which accompanies our quarterly strategy meetings. It has been slimmed down a bit and reduced to three components: the focus topic, market outlook and this letter. In this way we hope to pass our thoughts on to you more quickly and succinctly.

Overall, our outlook to March 2022 is quite confident. We have raised our global growth forecast for the current year to 5.3% and see mid-single-digit return potential for equities on average. One reason to be cautious, however, is the very degree of optimism. The consensus among our investment professionals is surprisingly high, which reflects the situation on the markets: rarely before has such a large proportion of professional investors been as optimistic, and rarely before have their cash levels been so low. There are also increasing signs of very confident capital markets, which are actually rather typical of a late cycle: high levels of debt issuance, a large number of IPOs and price excesses in more exotic financial instruments[1]. However, there are also good reasons for optimism: progress in dealing with the pandemic, the reviving economic cycle, good corporate earnings and continuing central-bank support. Where the pandemic is concerned, the lockdown and easing debates are tense. But the highly effective vaccines now being distributed will probably put an end to the uncontrolled spread of the virus within reach this year. The global number of new infections has now halved within five weeks, even without a major contribution from the vaccines. While we are aware of the unpredictability of the virus, we don't expect a sustained market reaction unless there is a surprisingly severe deterioration in the pandemic. The economy is surprisingly robust overall. The U.S. and Asia are once again acting as growth engines, even if this dynamism is accompanied by very high government deficits in the U.S. In terms of corporate profits, the U.S. is ahead anyway thanks to its technology stocks. In the fourth quarter of 2020, the S&P 500 earned almost as much as in the same period in 2019. Finally, we expect central banks to leave interest rates unchanged at these low levels.

Whether they will be able to do so in light of the economic recovery is a critical question for the markets this year. Ten-year real interest rates in the U.S., which have been rising since mid-February for the first time since 2018, are already causing great nervousness. This is having a particularly unfavorable impact on the valuation of growth stocks, which argues for expanding the weight of cyclical stocks in equity portfolios. Commodity prices, which are trading at an eight-year high[2],

[1] Such as crypto-currencies and SPACs (special purpose acquisition verhicles).
[2] Bloomberg Commodity Index

are also evidence of hopes of a cyclical upswing. Against this backdrop, however, the much anticipated U.S. stimulus package could prove to be a double-edged sword. Much as equity markets would welcome the resulting consumption and investment stimulus, there is a risk that the package could further push up already rising inflation expectations and real yields. However, our forecasts are based on the assumption that inflation and government yields will rise only temporarily this year. Overall, we continue to expect a low-interest-rate environment, which we believe continues to favor equities, corporate bonds, Asian bonds and select real-estate markets. Structurally, we continue to focus on the themes of digitalization and sustainability.

Look at our forecasts to see our 12-month outlook in numbers.

GLOSSARY

Cyclical is something that moves with the cycle.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Initial public offering (IPO) is a type of public offering in which shares of stock in a company usually are sold to institutional investors that may in turn sell them to the general public, on a securities exchange, for the first time.

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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