Uncertain recovery

Developed markets outlook 2021

Investment Outlook

Triodos Investment Management

Due to the COVID-19-related lockdown measures, 2020 will go into the record books as the year that saw the deepest global recession in peacetime. For 2021, we expect global economic activity to rebound, although the recovery will likely be slow amidst recurring restrictive measures. Pre-pandemic activity levels can only be reached once a vaccine has become widely available. Despite positive vaccine trial results, we don’t expect this to happen before the final quarter of 2021. In the meantime, further stimulus will be needed. Bold policy choices need to be made so that the recovery can become sustainable and inclusive. This could be a vital first step towards a new economic system, one that is equipped to address the challenges of our time: climate change, biodiversity loss and inequality.

Developed Markets Outlook 2021

An uncertain recovery: divided US suits the global status quo

Joeri de Wilde

The US is still the largest economy in the world, with over 24% of global GDP. The change of leadership in Washington could, in theory, be the spark that ignites the much-needed global reset of our economic system. President-elect Joe Biden wants the US to ‘lead the world’ to address climate change and protectionism. This could speed up the global recovery and make it more sustainable. In practice this will be a very difficult task, however. A most likely Republican-controlled Senate will have a final say in almost any of Biden’s decisions, and reluctance towards free trade is also present within the Democratic Party. The waning international dominance of the US also asks for close cooperation with friendly nations in a search for global compromises, but the US will find it hard to step away from the idea of American hegemony. The result will likely be watered down policy from the US and a struggle to reach ground-breaking agreements with other global powers. This suits the global status quo and makes a sustainable and inclusive global recovery less likely.

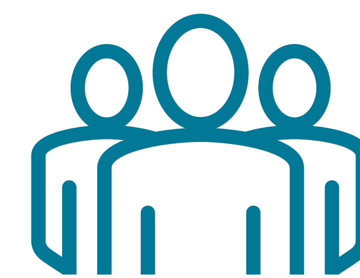
Global economy: growth rebound with much uncertainty

In 2020, we project global economic activity to contract by an astonishing 4.1%. Developed economies are expected to experience an aggregated growth contraction of 5.5%, as several regions have been hit by multiple COVID-19 infection waves. Countries have started to recover since the first series of lockdowns, supported by unprecedented monetary and fiscal stimulus. Nevertheless, we assume they will be unable to reach pre-pandemic activity levels before the final quarter of 2021, when a substantial part of their citizens have been vaccinated. In our outlook for 2020, we warned about the ultra-loose global monetary stance that merely sustained the ongoing inflation of asset prices and further financialisation of the economy. Of course, we did not envision that this would only be the tip of the iceberg. In 2020, financial markets have become even more detached from the real economy, floating in the air while the real, ‘earthly’ economic activities are in the midst of a hurricane. This trend may very well to continue in 2021, a worrying realisation.

For 2021, we expect global economic activity to rebound by 4.9% and developed economies to grow by an aggregated 3.7%. There is a great deal of uncertainty surrounding this forecast, which relates to vaccine timelines and the continued need for restrictive measures. In our baseline scenario, we assume that several vaccines will be approved by early 2021, with developed economies able to vaccinate

Environmental

1. Extreme weather
2. Pandemics
3. Biodiversity loss



Social

1. Unemployment
2. Populism
3. Wage and wealth inequality

(Geo) Political

1. Protectionism
2. Brexit
3. Ongoing political tensions in US and eurozone

their most vulnerable citizens in the first half of the year. This implies that restrictive measures will be necessary until at least mid-2021. After that, reduced pressure on hospitals will allow developed economies to gradually return to pre-pandemic activity levels, with most countries reaching normal activity levels in the final quarter of 2021. Economic growth rates for the United States and Japan are expected to rebound by 3.2% and 2.9% in 2021, whereas the eurozone and the UK are expected to report growth rates of 4.7% and 4.9%. Growth rates for the US and Japan will be somewhat lower because these countries are set to experience a less severe contraction in 2020, as a result of less stringent and/or shorter lockdowns.

Risks are determined by vaccination timelines

The biggest risks to our outlook concern vaccination timelines Shortened vaccination timelines are a clear upside risk. This would entail rapid approval, production, distribution and implementation of several highly effective vaccines, meaning all developed economies would be able to vaccinate most of their citizens before mid-2021. In this positive scenario, restrictive measures wouldn't be necessary anymore in the second half of the year, resulting in a swift return to pre-pandemic activity levels. This would obviously boost our expectations for global economic activity in 2021. In the second half of the year, a possible relief rally could even make up for some of the incurred losses in economic activity, with households spending excessively once restrictions are permanently lifted. Unrelated to vaccine timelines, the US Democrats gaining control of the Senate would also positively affect global economic activity in 2021.

The main downside risk is slow vaccine deployment. Vaccine approvement could be delayed and large-scale production, distribution and vaccination might not go as smoothly as hoped for. A decreased willingness of part of the global population to get vaccinated could be an important reason for delay. In this downside scenario, we assume that developed economies will be unable to vaccinate their most vulnerable citizens before late 2021. This will mean a full year of recurring restrictive measures that prevent a return to pre-pandemic activity levels. Improved knowledge on treatment and spreading and scaled up track-and-trace capacity may gradually require less severe restrictions, however. Other downside risks, associated with environmental, social and (geo-)political factors are depicted on the previous page.

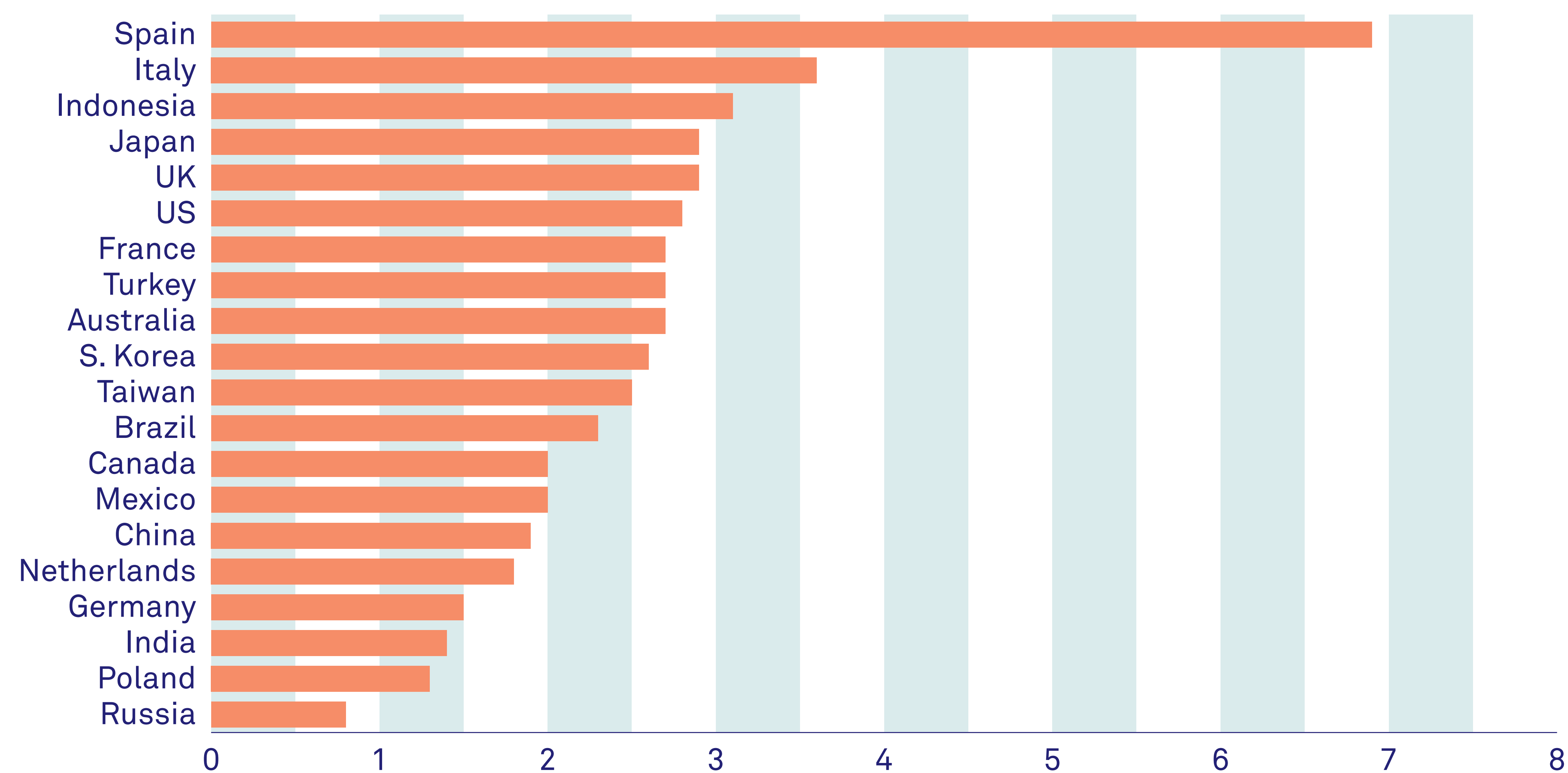
Bankruptcies, permanent job losses and sectoral divergence

Although economic growth in developed economies is set to rebound in 2021, the expected recovery will likely be slow and unequal. Many of the negative effects of 2020's recession have been postponed by the unprecedented fiscal and monetary measures. Job retention schemes have prevented significant rises in unemployment in most developed countries, and support to businesses has kept bankruptcies at artificially low levels. However, in the likely case that social restrictions continue to be required until at least mid-2021, even substantial additional policy measures might prove to be insufficient. The result would be solvency issues for businesses leading to bankruptcies and job losses, leaving permanent economic scars as viable businesses disappear and discouraged workers drop out of the labour force.

Recurring restrictions will likely enlarge the divergence between sectors and regions. The service sector has been the main victim of social restrictions and will continue to bear the brunt in the first half of 2021. However, since we don't expect the reimplementation of complete lockdowns, the manufacturing sector can probably continue its operations and global trade can further pick up. Goods consumption has already recovered, partly substituting demand for services. Overall, this means that countries that are disproportionately dependent on the most impacted service sectors such as the hospitality sector (e.g. Italy, Spain, United Kingdom) will fall further behind in the first half of 2021, while goods-producing economies (e.g. Germany, several Asian countries) are better positioned for an early recovery. Leisure-dependent countries could potentially catch up in the second half of 2021 if restrictive measures are permanently lifted and relief spending materialises.

Within countries, sectoral divergence will further increase inequality. Low-income households will continue to be disproportionately impacted, as they are overrepresented in the shutdown sectors and are often hired on a temporary basis. Small to medium-sized enterprises will also bear the brunt through tightening credit conditions, as they have to rely on bank loans. Large, listed companies, on the other hand, can raise capital through bond and share issuances, which due to implemented policies have become cheap (i.e. low interest rate environment and bullish equity market sentiment).

Figure 1 Size of the hospitality sector (% of GDP)



Source: Capital Economics

Biden's presidency reduces geopolitical tensions

Biden's victory in the US presidential elections will change the geopolitical landscape in 2021. We expect the US to return to diplomacy and break away from Trump's America First agenda. Relations with Western allies such as the EU will be strengthened again, and trade barriers potentially reduced. However, opposition from a Republican-controlled Senate and a substantial part of the population might make it difficult to completely step away from the current protectionism. Disputes on key issues such as regulation and taxation of US tech companies in the EU will also remain a divisive force between the traditional allies.

With respect to the EU-UK relationship, Biden's election victory will put pressure on the UK to forge a trade deal with the EU. Biden has stated several times that Brexit was a geopolitical mistake and that a UK-US trade deal would become more unlikely if Johnson undermined the Northern Ireland peace process. The EU and UK are still miles apart on several key issues. We expect that a deal will eventually be reached, as this is in the best interest of both parties, but ratification of the deal might be pushed further into the future, extending the period of uncertainty.

We expect the US to continue to oppose China's increasing global dominance, but the tone of voice will be more diplomatic and modest progress on the precarious phase one trade deal could potentially be made. Tensions will likely continue to dominate the relationship. The US is also likely to become more vocal regarding international conflicts, which might result in increased tensions with Russia, Iran, Turkey and North Korea, although Biden did pledge to return to the nuclear power agreement with Iran. A polarised US population will make it more difficult to find broad support for international engagement, however, reducing the chances for decisive US foreign policy actions.

Divided US unfavourable for global growth prospects

Reduced chances of a Democratic majority in the Senate will likely force US president-elect Biden to search for compromises. This does not favour his plans for a huge fiscal stimulus package financed by increased corporate and personal taxation. The result would likely be a less significant US-originated fiscal impulse for global growth early 2021. Later in the year, a more forward-looking stimulus package that focuses on investments in physical and digital infrastructure may be agreed on, as there is also support for such investments within the Republican Party.

For the eurozone and Japan, a more limited US fiscal package likely means less demand originating from their largest export partner. On top of that, widespread sympathy for protectionism in the US makes it difficult for Biden to completely step away from the built-up trade frictions, no matter the result in the Senate. For the eurozone, this adds to the

trouble within the region caused by the resurgence of the coronavirus in the final quarter of 2020, where restrictive measures have again lowered economic activity. Japan has been less severely impacted by domestic COVID-19 infections than most other developed economies, but the recovery has so far been rather sluggish. On top of that, Japan is still struggling with the low-growth-low-productivity paradigm from before the COVID-19 crisis. This will likely force the governments of the eurozone countries and Japan to continue their sizable fiscal support programmes well into 2021.

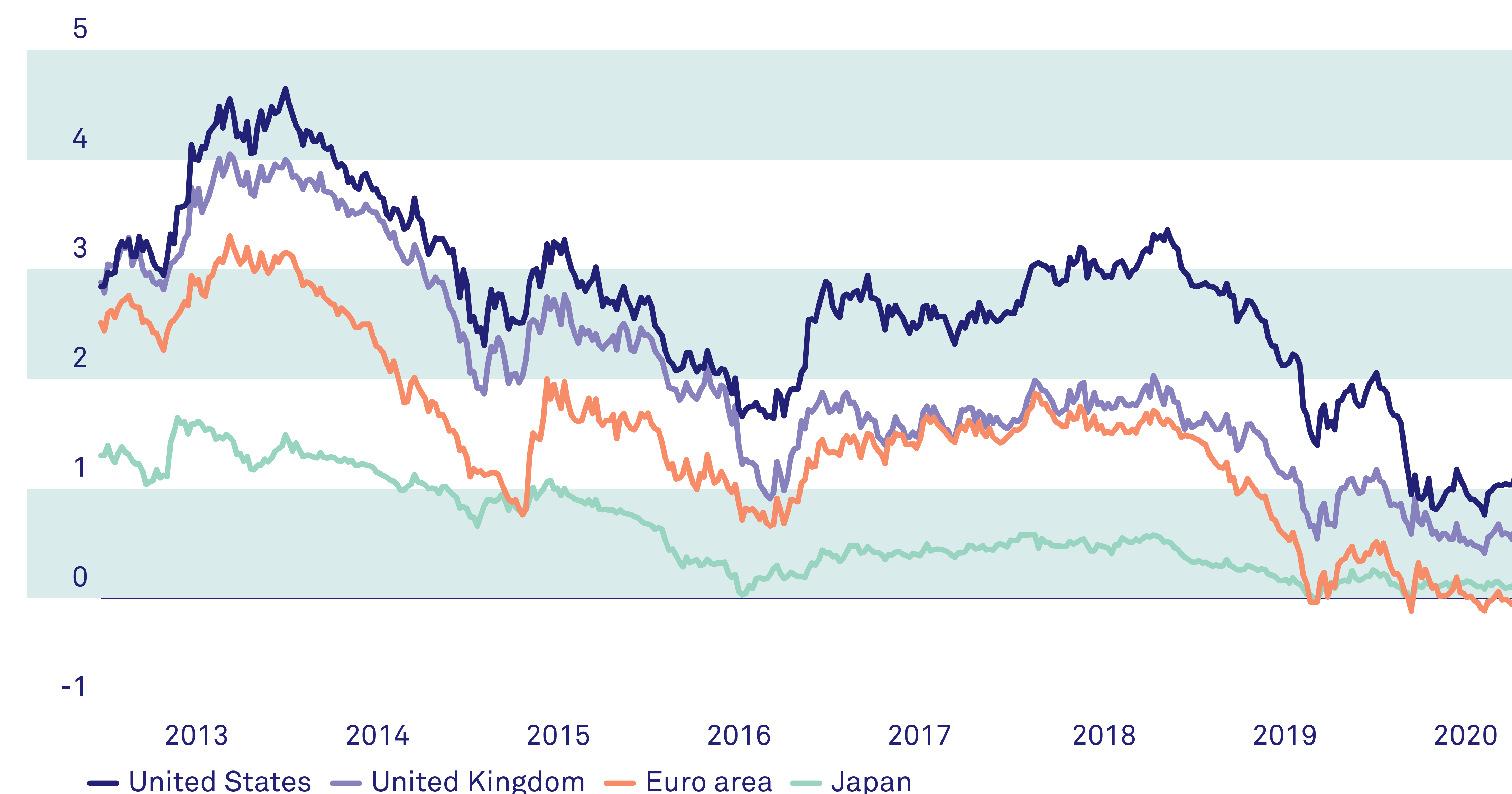
For the UK, much of its prosperity in 2021 depends on the result of the UK-EU trade negotiations. However, even when a trade deal arrives, the terms will be less favourable than they are now. In combination with the recent reimplementation of severe restrictive measures, this likely means that the UK will be one of the laggards of the developed market recovery. The UK will therefore be eager to increase its trade with the US, preferably through a trade deal. In any case, trade between the two countries will almost certainly benefit from a sizable US fiscal stimulus package.

Low inflation and high unemployment guarantee loose monetary stance

Although business confidence in developed economies has returned to pre-pandemic levels, consumer confidence has remained subdued. We expect this discrepancy to continue in 2021, as the recent positive vaccine developments might trigger firms to anticipate a future without restrictions and consequently increase investments. Consumers, on the other hand, could remain cautious until they have been vaccinated, leading to weak consumer demand and elevated levels of saving until at least mid-2021. Continued restrictive measures also limit the options to spend money. Moreover, an inability to return to pre-pandemic activity levels before the final quarter of 2021 will keep developed market unemployment at elevated levels, with the risk of future solvency issues leading to further job losses. This means a lack of wage pressure on labour costs. As a result, for 2021 we expect inflation to stay below the respective developed market central bank targets (around 2%).

The combination of high unemployment and low inflation expectations guarantees that all major central banks will maintain their ultra-accommodative stance throughout 2021. We expect that policy interest rates will be kept on hold, but central banks will not hesitate to take additional easing measures in case downside risks materialise. The US Federal Reserve (Fed) will likely lead the way in case sizable additional fiscal stimulus remains absent and economic data deteriorates. In combination with a gradual global recovery, the continued easing of the Fed will likely weaken the US dollar. In general, if fiscal policy measures disappoint or the coronavirus causes new

Figure 2 Inflation expectations (five year forward rates, %)



Source: Refinitiv Datastream / Triodos Investment Management

disruptions, central banks will likely step in with additional measures. The European Central Bank is already expected to expand its emergency bond buying programme (PEPP) and favourable long-term bank funding operations (TLTRO) in its last meeting of 2020.

Green and inclusive policy choices will remain scarce

In most developed economies, policy measures have understandably focused on emergency support, thereby putting existential threats such as climate change and biodiversity loss on hold. We acknowledge the necessity to support the economy by all possible means until the recovery has gained substantial strength. This avoids unnecessary permanent economic scars by losing viable businesses and jobs. However, current global efforts are insufficient to reach the Paris Agreement climate goals. On top of that, the economic recession induced by COVID-19 delays progress towards the world's 2030 Sustainable Development Goals (SDGs) by a further decade. Even before the coronavirus outbreak, it became clear that achieving the SDGs would not happen before 2080. This asks for targeted monetary and fiscal policies that facilitate a green and inclusive recovery, thereby catalysing the necessary transition towards a new economic system focused on long-term wellbeing. Immediate action is required.

Implementation of the International Monetary Fund's recommendations for public investment in green infrastructure, adequate carbon pricing and compensation for lower income households would mean significant progress. However, even the European Green Deal is way too limited to genuinely act upon these recommendations and deliver upon the Paris Climate Agreement and SDGs. Moreover, with a divided US incapable of leading the way, we are expecting even less government-induced progress outside Europe. This urgently asks for private investments that steer towards the required transition, aiming for impact rather than merely focussing on returns. This is precisely what we will continue to do in 2021, and we hope others will also find a new sense of urgency to jointly address short-term and longer-term challenges.

Growth projections 2020-2021

	GDP growth			Headline inflation		
	2019	2020	2021	2019	2020	2021
Global	**2.8**	**-4.1**	**4.9**	**3.6**	**3.2**	**2.8**
US	**2.2**	**-3.7**	**3.2**	**1.8**	**1.2**	**1.8**
Euro area	**1.3**	**-7.5**	**4.7**	**1.2**	**0.3**	**0.9**
Belgium	1.4	-8.1	5.1	1.2	0.6	1.2
Germany	0.6	-5.7	4.0	1.3	0.4	1.2
Netherlands	1.7	-5.2	3.6	2.7	1.2	1.4
Spain	2.0	-11.8	5.2	0.8	-0.4	0.7
UK	**1.5**	**-11.5**	**4.9**	**1.8**	**0.9**	**1.3**
China	**6.1**	**2.1**	**7.9**	**2.9**	**2.7**	**2.0**
Japan	**0.7**	**-5.6**	**2.9**	**0.5**	**-0.1**	**0.3**

Investment outlook

Financial markets have shown a spectacular recovery after the COVID-19-induced freefall. Bond and equity markets rallied as if a swift full-blown economic recovery was imminent, once again emphasising that financial markets have become completely detached from the real economy. The driving force behind the bullish investor sentiment continues to be a reliance on perpetual monetary stimulus. We acknowledge that this situation can continue for quite some time but remain cautious, as we believe a reality check is bound to happen and can have huge consequences.

Monetary dominance will continue

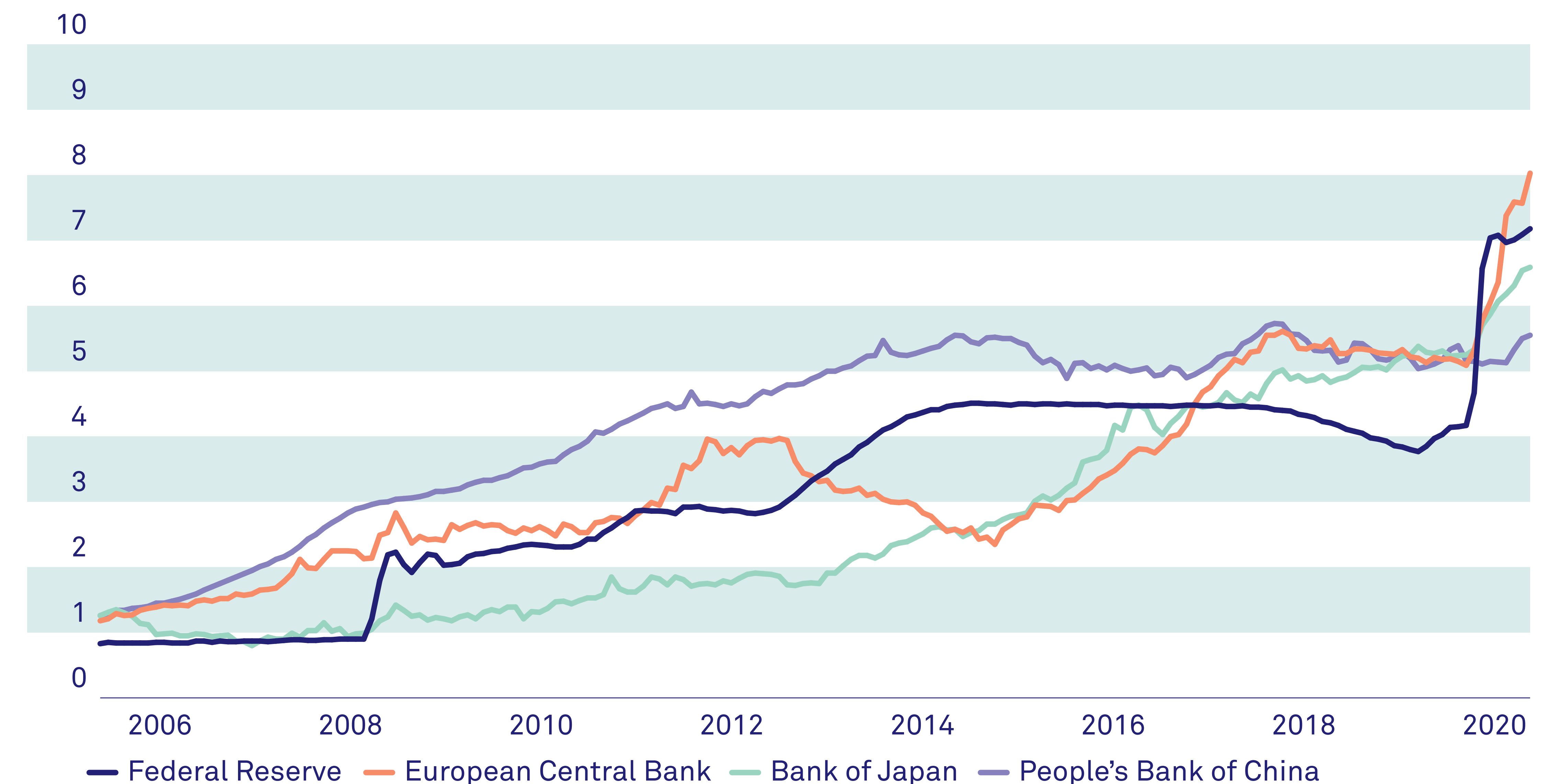
In 2020, investor sentiment was again soothed by policy makers implementing huge monetary and fiscal stimulus packages. This time, there was an actual crisis to justify action. As a result, the financial asset bubble became rapidly inflated, with some markets even surpassing their pre-COVID-19 highs. An uncanny development, considering the dire state of the global economy and huge uncertainty going forward. We are still convinced that valuations matter, and therefore believe that this situation cannot hold in the long term. We do however acknowledge that there is plenty of stimulus in the pipeline to satisfy short-term investor appetite. Low inflation expectations and the COVID-19-induced recession guarantee an ultra-loose monetary environment in 2021. Fiscal stimulus could also support investor sentiment, although the scattered political landscape in the US might result in smaller packages then hoped.

Based on our fundamental approach, we remain cautious and do not chase the rally. Central bank policies not living up to investor expectations are a key risk that could lead to a turnaround in market sentiment, next to substantially delayed vaccine timelines or an increase in profit warnings and bankruptcies. This is enough reason for us to remain slightly underweight in equities and neutral in bonds.

Bond yields will likely remain near historic lows

In 2020, the COVID-19-induced recession increased safe-haven appetite and led to unprecedented central bank measures, resulting in historically low government bond yields. For the EU, going into 2021, low inflation expectations and subdued economic growth prospects might force the ECB to further increase its quantitative easing schemes. This will keep European capital market rates low for longer. The same goes for credits, where the sole focus on central bank measures implies continued low corporate bond yields. In this dreadful growth environment, we prefer high-quality credits with strong balance sheets, as the collapse in economic activity is likely to trigger a rise in downgrades. Overall, these considerations make us want to maintain a neutral position in bonds.

Figure 5 Major central banks balance sheets - total assets (x 1.000 USD billions)



Source: Refinitiv Datastream / Triodos Investment Management

Equity markets remain reliant on central banks

Despite the temporary corrections in 2020, global equity valuations have remained elevated. Earnings estimates have declined, but we think that the anticipated broad and firm earnings recovery in 2021 is unrealistic. A weak global economy combined with a great deal of uncertainty means negative earnings surprises are lurking, in which case lower equity prices and valuations would be entirely warranted. The continuation of the upward trend in equity markets mostly depends on additional fiscal and especially monetary easing measures, next to continued good news on vaccine approval, distribution and implementation.

The US equity market continues to look expensive, both relative to other regions and from a historical perspective. A divided US government reduces the likelihood of a huge fiscal stimulus package, but also restrains the Biden administration with respect to corporate tax rises and increases in regulation. European and Japanese markets look cheap relative to the US but are still (equally) expensive in absolute terms. It seems eurozone political risks have somewhat diminished after EU leaders agreed on a joint recovery fund, but trade uncertainty with the UK remains a severe risk. Going forward, the main difficulty for Japan will be subdued confidence and weak external demand from regions where the virus still roams around. Taking all of this into account, we remain negative about US equity, neutral to slightly positive about European equity and positive about Japanese equity.

Impact opportunities

We continue to see opportunities in the sustainable investment landscape. The European Green Deal, the EU's roadmap for making its economy sustainable, will likely gain momentum. The related development of a green taxonomy will enable investors to steer their investments towards more sustainable technologies and businesses, and the creation of an EU Green Bond Standard will deliver a uniform tool to assess green bonds. The Green Deal will also force companies to become more transparent and can serve as an example for the rest of the world. Besides Europe, we expect to continue to find sustainable investment opportunities in Japan. Overall, we hope that an increased sense of urgency facilitates a renewed focus on investments in climate mitigation and adaption and the fulfilment of the Sustainable Development Goals in the next 10 years.

Tactical asset allocation

Asset class	Valuation	Cycle	Sentiment	Total
Government bonds	**–**	**0**	**+**	**0**
EMU government bonds	–	0	+	0
UK Gilts	–	0	+	0
US Treasuries	–	0	+	0
JP government bonds	–	0	+	0
Credits	**–**	**–/0**	**+**	**0**
Euro IG corporate credits	–	–/0	+	0
Equities	**–**	**–**	**+**	**–/0**
Europe ex UK equities	0	–	0/+	0
UK equities	+	–	–/0	0
US equities	–	–	+	–
Japanese equities	+	–/0	0/+	+
Emerging equities	+	–	+	+

+ = positive 0 = neutral – = negative

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Investing in positive change

For more information about our impact investment strategies, please contact our Investor Relations team at:

+31 (0)30 694 2400
TriodosIM@triodos.com
www.triodos-im.com/impact-equities-and-bonds

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Joeri de Wilde,
Triodos Investment Management

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Via Bertha, Utrecht

Cover photo
Absolutvision

Triodos Investment Management