Economic and Market Outlook 2021

Great Expectations

Market Strategy and Macroeconomics
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Overview

The misery inflicted by the COVID-19 pandemic defined the passing year, accelerating trends and distorting imbalance yet further. Vaccine development marks an inflection point, giving hope that some semblance of normality will return and allowing plans to be made with spending and investment to follow. 2021 brings great expectations, though the path ahead will be arduous.

Though there is little good to be said of 2020, the global pandemic forced the hand of policy makers. Having learned valuable lessons from the Global Financial Crisis, austerity was shunned and coordinated fiscal and monetary measures were unleashed on a scale never seen before. Productive capacity has been maintained and workers have been supported, while science has triumphed. Of course, some regions have suffered more than others and the response to the pandemic has varied with economic circumstances, but there is reason to be optimistic.

After months of constraints, pent-up demand is evident, savings are elevated and interest rates are pledged to be on hold for years to come. Consequently, synchronised growth is expected to be substantially above trend in the coming year, driven by the service sectors once social distancing measures can be lifted. Deflationary forces should subside, although inflation is expected to be modest and bond yields capped, allowing credit and especially equity markets to prosper. Near-term challenges remain substantial, however, and must not be underestimated.

The most immediate battle centres around the operational elements of vaccinating millions if not billions of people and the logistics behind this. Clearly there are risks, yet so much depends on it being successful and it will unquestionably be the defining factor of the year ahead from a societal, economic and market perspective. However, navigating the intervening months before mass vaccination can be achieved will be paramount, particularly given the risk of third and fourth waves of infection.

Fiscal support programmes are running out and further measures are needed to bridge the gap to a self-sustaining recovery. This is something we delve into in the Global section, noting how critical ongoing support is for still highly fragile economies. While providing immediate backstops to plug holes is imperative, so too are more forward-looking investment plans. To this end the EU deserves credit for its recovery plan. We discuss the plan in detail in the EU sections and why we see it contributing to a powerful rebound in activity in the region in 2021. Not only does this finally embrace the fundamental yet controversial principle of debt mutualisation, albeit on a limited scale, but the construction of a long-term strategy for building sustainable growth is refreshing.

Central banks will continue to provide support and underwrite the financial markets. Their determination to prevent a financial crisis is resolute and additional balance sheet expansion is expected from the major players. The decision by the Fed to move to average inflation targeting is a sea change and a welcome development. The true test will be how the Fed responds when inflation reaches target, something we delve into in the US section. Fed forecasts indicate rates being on hold until 2024, though we suspect this may be brought in a bit if our encouraging US outlook unfolds.

China is perhaps one of the few countries in which stimulus is expected to be scaled back more materially. Surging growth is forecast and is the primary driver behind global activity returning to pre-crisis levels in the second half of the year. We discuss the details in the China and Taiwanese section. Infrastructure investment is expected to slow, but net exports and consumption are poised to take over as engines of growth for China, while the Taiwanese economy is forecast to be firing on all cylinders, with growth drivers broadening beyond technology exports. Elsewhere, prospects are also good for Australia, which is geared to the global recovery and spurred by impressive policy initiatives. Many idiosyncratic factors are expected to impact LatAm, suggesting a mixed performance amongst countries. Chile and Brazil are deemed to offer the most promise given the stimulus being applied and their exposures to the global cycle.

Financial markets are reviewed in detail in both the global and regional sections. Despite the remarkable recovery in credit and equity markets, we are anticipating further decent gains in the year ahead, while government bonds are deemed unattractive at current levels. Bond yields should rise modestly as recovery takes hold, but remain capped by policy initiatives, which aim to keep the carry cost of debt manageable. This is likely to maintain an appetite for credit given that the relative income pickup versus bonds is near an all-time high. Credit is well positioned, given the early stages of the new cycle, with defaults expected to fall appreciably over the course of the year. That noted, although credit has been the preferred risk asset for some time, returns should taper given tight spreads. Equities are better positioned for relative gains in the year ahead.

Though certainly not cheap, rising earnings and dividends against a backdrop of benign interest rates and abundant liquidity should lift prices higher. A multi-year rotation out of growth and into value sectors is not expected, but, over the months ahead, the excessive divergencies that became so apparent in the current year are expected to compress, with a broadening of sectoral and regional performance as economic growth becomes more abundant.

As 2021 beckons, damage from the pandemic remains, not least debt, deficits and an underlying economic vulnerability that still require policy support. The prospect of vaccination and suppression of COVID-19 is not just psychologically important, but it allows for making plans once again and the fostering of great expectations.

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Contents

Global

Outlook

- Near-term growth weakens as infections rates surge, but recovery remains intact with a reacceleration set for 2021
- Global inflation stays benign, with disinflationary trends persisting
- The policy environment should remain favourable, with coordinated monetary and fiscal support

Implications

- Bond yields likely to stay capped, as policy rates are left unchanged and disinflationary forces persist
- Credit markets to remain well supported given improving balance sheets and the allure of income
- Sizable upside remains for equities in a year expected to see a broadening in returns

Risks

- Near-term growth weakens as infections rates surge, but recovery remains intact with a reacceleration set for 2021
- Global inflation stays benign, with disinflationary trends persisting
- The policy environment should remain favourable, with coordinated monetary and fiscal support

The recovery remains in place, and a new economic cycle has begun

The global economy recovered strongly after spring lockdowns, as profound support measures ensured that economic capacity remained in place and prevented income and sentiment from collapsing. The growth upswing was bolstered by strong tech-led goods demand that triggered a firm rebound in global trade, with global supply-chains largely intact. Normalisation in services has, to no surprise, been more sluggish, with significant catchup still needed. The easier part of the recovery is well behind us and a weaker period of economic activity should be expected over the winter months, reflecting renewed restrictions to limit infections. However, with a return to full national lockdowns unlikely and extensive support measures in place a double-dip global recession should be avoided.

Policy support will be required until mass vaccination is feasible

Positive developments around a vaccine should bolster sentiment and spending over the winter as an exit from the pandemic now looks feasible. A mass vaccination programme will take time to roll out, however, and ongoing restrictions and lockdowns are likely to be needed over the coming months. This calls for support measures to stay in place and be extended, as required, to provide a safety net for households and businesses and prevent job losses and business closures. We expect this to be forthcoming as policy makers are aware of the difficulties that lie ahead and as borrowing conditions for most governments are favourable despite deep fiscal deficits and rising debt levels.

A reacceleration is likely given spare capacity and supportive policy

Once the current infection wave has peaked and restrictions are lifted the pace of expansion should pick up momentum. The global economy is still running well below capacity with elevated unemployment and involuntary part-time working in most regions. The policy environment and financial conditions are extremely favourable and there is pent-up demand at a global level. A period of synchronised and above-trend growth should take global economic output back to its pre-crisis level before the end of 2021 – though with large divergences across regions. Catching up with the level of output which would have prevailed if the COVID crisis had not happened, will be more challenging. It requires a stronger investment boom, with both the government and the private sector participating. In the absence of this, the COVID-19 pandemic will leave a permanent scar on the global economy, in terms of foregone output.

The hurdle remains high for stronger investment-led growth

While the economic outlook is challenging, the policy environment has arguably become more constructive. There is a realisation that governments need to take a lead on creating a more resilient recovery, where investment plays a larger role. One development over the past year is that over 50% of global GDP is now covered by a commitment to reduce net carbon emissions to zero by 2050/60. This requires a huge investment effort to be achieved and, with borrowing costs at a record low and free capacity in major economies, conditions are ripe for a shift higher in the trajectory for capital spending. If realised, this could generate a stronger rebound in the second half of 2021 and, crucially, a more sustainable recovery where a stronger growth phase lasts beyond 2021.

The EU's recovery fund is an important step, which led us to revise up our growth outlook for the Eurozone area. The hurdle for getting similar recovery plans in place elsewhere is high, however, given a likely divided government in the US, and stretched public finances in most regions. With this in mind, we believe that it is too early to assume a substantial improvement in the outlook for global capex spending, but risk around this is tilted to the upside.

Inflation is weak, allowing central banks to stay accommodative

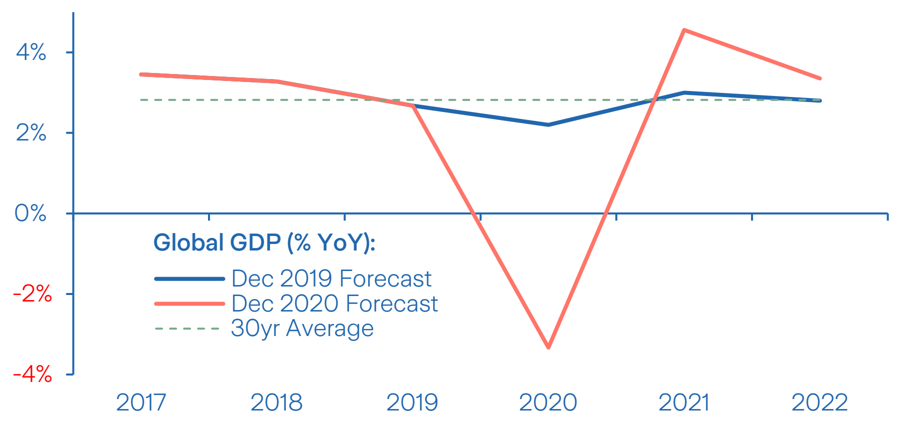
Central banks will maintain a very accommodative stance for an extended period, as inflation remains weak and as even a modest policy tightening risks choking off growth given stretched debt levels (see Inflation Focus Q4 2020). The Federal Reserve's shift to an average inflation target is also an important policy change. It should delay policy tightening compared to past economic cycles, and we suspect other central banks will adopt a similar approach. More asset purchases will be forthcoming, with even more liquidity provided to global financial markets. This policy backdrop should help to support the synchronised recovery that we anticipate.

Fiscal policy needs to remain supportive and debt must be tolerated

The fiscal expansion avoided a global depression but also led to a surge in fiscal deficits and debt. Coordinated monetary and fiscal actions have helped to keep government borrowing costs low, reducing near-term risk around debt sustainability, also in emerging markets (EM). The fiscal impulse will diminish going forward, but this should be manageable, as extraordinary fiscal injections last year largely offset lost income during lockdowns. A more rapid shift towards fiscal tightening needs to be avoided, as conditions are still extremely fragile.

While Abe's aggressive monetary policy easing deserves a high rating in terms of achievement, fiscal consolidation has been moving into focus again since autumn last year, when the consumption tax rate increased from 8% to 10%. More time is needed to tackle structural reform, however, and as such Abe will only receive partial credit for any success.

Substantially above trend growth expected in 2021



Source: ZIG

Bond yields to remain low in developed markets, anchored by policy and debt

Government bond yields are tracing close to their lows as central banks are expected to keep policy rates on hold for an extended period and as asset purchases compress risk premia. Inflation expectations have risen from depressed levels but remain well below their long run trends, as inflation dynamics are muted, and as the pandemic has created huge dislocations in the global economy that are likely to be disinflationary for longer.

Looking forward, we suspect yields will remain capped, both to the downside and to the upside. The downside is limited, given the resistance among central banks to cut rates further into negative territory. Vaccinations should also reduce the need for further monetary stimulus. Upside to yields is also limited, however, as central banks delay rate hikes and extend asset purchases, providing an anchor for yields. While we cannot rule out a spike higher in bond yields should vaccine developments surprise positively or investment get more traction than expected, a combination of elevated debt levels—which provides a strong self-correction mechanism—and a search for yield environment are likely to contain yields throughout 2021.

Periphery bond spreads are likely to remain at tight levels though most of 2021 given continued large asset purchases on a monthly basis by the ECB under its PEPP and QE programmes. There may be some modest widening in periphery spreads towards the end of the year as investors start to factor in the possibility of the ECB winding down these asset purchases in 2022, but a supportive economic environment should keep the extent of such widening modest.

Credit to remain a hot asset class

Having roared back from the abyss, as is typical during the early stage of a new credit cycle (please see <u>The credit cycle ends and a new one is born</u>), credit markets should remain supported into 2021 with returns driven by cyclical and lower rated names that have lagged the rally. Default rates should decline as should downgrades from investment grade to high yield. Our constructive outlook is driven by three factors: improving corporate balance sheets, the allure of a substantial income pickup from abysmally low government bond yields and, lastly, a global liquidity glut created by central banks.

Corporate credit fundamentals should improve in 2021 as the economic recovery takes hold. Balance sheet healing may have already begun with leverage in Q3 2020 declining from the record levels of Q2 2020, albeit still high. We expect corporate managements to remain prudent as companies cannot afford to become profligate, despite large cash piles. After all, around USD 1.4 trillion of BBB and BBB-rated corporate bonds across US and European credit indices still have a negative outlook. Record debt issuance in 2020 has helped companies achieve better liquidity buffers and longer debt maturities. We believe that improving fundamentals and better funding profiles should cause default rates to decline to around 6% for US high yield in 2021 and lower the risk of a fallen angel Tsunami as seen in Q1 2020.

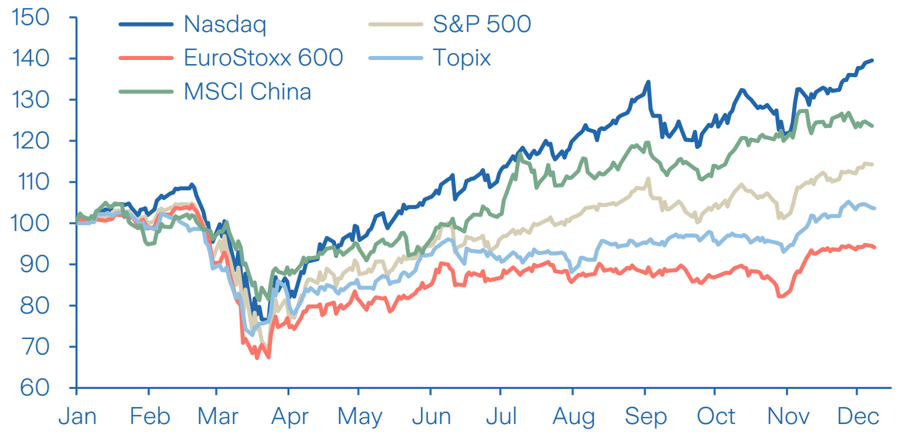
Overfunded balance sheets also imply that supply should decline, with net supply already slowing down. A struggle between investors in primary markets may develop, with some signs of this already emerging. Still sceptical investors fail to appreciate that the income pickup from switching into credit from government bonds in percentage terms is still within the top fifth percentile since the 90s in US credit. This should pull fixed income investors towards credit as already is evident in inflows.

Equities are poised for further upside against a backdrop of stimulus, economic recovery and frozen interest rates

Equity markets have experienced a remarkable recovery since March lows, with many now back in record territory. Investor sentiment has improved significantly, to the point where a great deal of good news is now priced in. That noted, while the early months of 2021 may experience bouts of volatility from overbought levels, the year as a whole is expected to be a good one for the asset class. The primary drivers are likely to centre on abundant liquidity being provided to bolster a recovering global economy. Central banks have committed to keeping rates on hold and thus the theme of searching for returns will continue to support stocks. There is no doubt that valuations are not cheap and indeed are again stretched in the case of US stock indices. However, earnings are likely to grow robustly and be reflected in rising dividends. Given the early stages of what we expect to be a new economic cycle, it is likely that the sector rotations that have recently emerged can persist for some time, though we are not yet anticipating a multi-year structural shift.

As global growth becomes more abundant, investors are likely to turn away from expensive 'growth' stocks, which typically do well when economic growth is scarce, towards the economically sensitive cyclical and cheaper 'value' sectors. Valuation divergencies had become too extreme and therefore this rotation has merit. The rotation is also likely to benefit geographic regions, such as Europe and some EMs that have been out of favour and have more exposure to these types of companies. However, we suspect that any relative underperformance by the US will be relatively modest. The large technology names had been doing well before the onset of COVID-19, based on their business models and market positioning. The virus amplified their strengths and market capitalisation, perhaps excessively, but they remain well positioned. Consequently, the year ahead seems likely to see more variation and broadening in performance from an asset class that is expected to remain strong.

Divergent equity market performance in 2020 creates opportunities



Source: Bloomberg, stock indices rebased 31/12/19 to 100

US

Outlook

- The economy faces near-term risks but should keep a solid momentum with growth considerably above trend
- Monetary policy is expected to remain loose for a long time
- The labour market will heal further, helped by positive business sentiment and hiring intentions

Implications

- Bond yields have limited upside potential as the Fed does not expect to hike rates soon
- Credit markets should remain well-bid amid improving fundamentals and strong supply/demand dynamics
- Liquidity and further economic normalisation will help to support the equity market

Risks

- The recovery stalls due to a surge in new infections and lockdown measures to fight the pandemic
- Inflation could rise faster than expected, forcing the Fed to tighten monetary policy more than intended
- Geopolitical tensions could flare up again undermining investors' confidence

Near-term headwinds followed by solid momentum in 2021

Once again, the US economy is proving how dynamic and resilient it is. Having fallen by an annualised rate of 31.4% in the second quarter, activity came back with a vengeance and GDP growth rebounded to 33.1% in the third quarter. While that still leaves GDP roughly 3% below its level a year ago, from an economic perspective the US has weathered the crisis better than many other regions. Given the renewed surge in infections and the lack of another fiscal stimulus package so far, we expect some near-term headwinds for the economy that are likely to persist into the first quarter of 2021. Beginning in Q2 2021 we expect a pickup in momentum fuelled by a steady return to normality thanks to a broader availability of a vaccine against COVID-19, a further recovery of the labour market and a substantial amount of pent-up demand, particularly in the service sector. A back-end recovery is expected towards the second half of 2021 after a couple of challenging months around the turn of the year.

A fiscal boost and monetary support helped to avoid a depression

The massive rebound in the aftermath of the crisis was made possible by a swift and targeted fiscal response, in coordination with an aggressive liquidity injection by the Fed. Significant support was provided directly to households by means of cash checks and generously topping up and extending unemployment benefits. This kept many households afloat and assured that private consumption quickly recovered after the first wave of COVID-19 hit the US earlier this year.

The savings ratio spiked to 33.6% in April, by far the highest on record. These savings helped to smooth the consumption path in the aftermath of the downturn and continue to be worked down. Further tailwinds for consumer spending arise from a significantly improved employment situation. The unemployment rate peaked at 14.7% in April and came back quicker than expected to 6.7% in November. We expect the trend to continue through the course of 2021, but we are unlikely to see pre-crisis levels anytime soon.

The economy needs more stimulus in the months ahead

The swift recovery of both the economic environment and the labour market are reassuring and the positive news on the efficacy of several vaccines against COVID-19 should lead to a further normalisation of the economy in the first half of 2021. However, the surge in new infections poses a significant near-term risk for the economy. Whether triggered by new lockdown measures or by consumers' self-imposed restrictions the economy is likely to suffer in the weeks and months ahead. As during the first wave of COVID-19 the service sector, and particularly the leisure and hospitality sector, will be most affected and related jobs will be at risk. In such an environment another tranche of fiscal stimulus will be crucial in bridging the gap until the economy finally begins to normalize. Small firms will be particularly hard hit by another wave of lockdowns and social distancing, increasing the risk of longer-term scars and rising long-term job losses.

Consumers are getting more cautious as infections rise again

First signs of weaker economic momentum already show up in recent data. Retail sales growth has slowed to a post-recession low, initial jobless claims have picked up again and consumer confidence surveys point to households turning more cautious. According to the Conference Board's survey the intention to buy a car or a major appliance within the next six months fell back after an initial recovery, providing potential headwinds for consumer spending in the coming months.

Despite muted consumer sentiment, the housing market remains a bright spot in the private sector. New home sales soared to the highest level since 2006 in August, fuelled by low mortgage rates, and although building permits started to level off in October the overall level remains high and residential construction and related spending are likely to be a crucial pillar of economic activity in 2021.

Business sentiment remains elevated as firms look through near-term risks

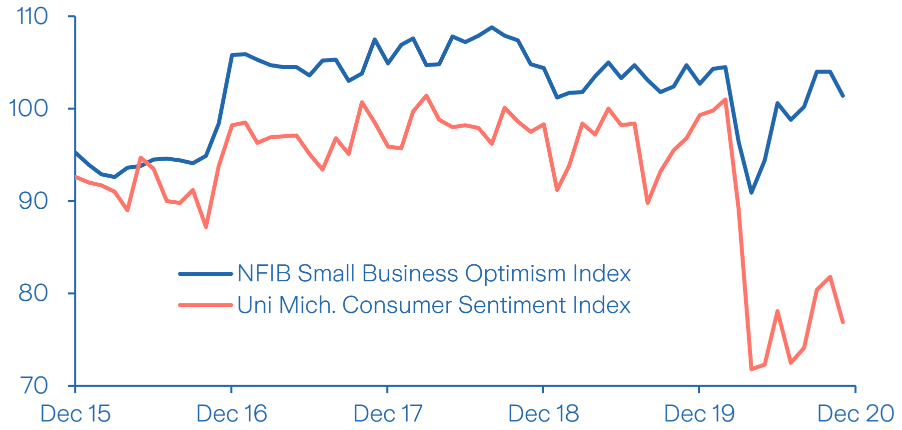
While the service sector is likely to face further headwinds in the coming months manufacturing shows strong momentum that is expected to last into the new year. The ISM Manufacturing survey rose to 59.3 in October, the highest level in more than two years. New orders even reached a 16-year high, indicating continuously strong demand in the sector. Importantly, small business confidence has also recovered from the depth of the crisis and crucial components like capital expenditure plans and hiring intentions are almost back at pre-crisis levels. Although these may come under pressure somewhat in the near future it shows that small firms, which are the backbone of the US economy, are willing to look through the current slowdown as an economic normalisation in the first half of next year is in sight.

The Fed does not expect any rate hikes for years

While some additional fiscal support is possible in the coming months, we don't expect a substantial increase in government spending next year given the political situation. The Fed, however, is likely to keep its taps open and would even increase monetary support if needed.

Following the review of its monetary policy framework the Fed has announced a crucial change in its policy approach by shifting to an average inflation target. The FOMC has

Households remain more cautious than firms



Source: Bloomberg

committed to maintaining the current low target range for the federal funds rate until labour market conditions have reached levels consistent with the committee's assessment of maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time. The Fed does not expect a rate hike before 2024. Although we think inflation will reach the Fed's target sooner than the FOMC's projection implies, we are unlikely to see any tightening in the coming year. The Fed's next steps will depend on the economic impact of the renewed surge in COVID-19 infections and the fiscal response to the expected slowdown in momentum.

The FOMC is ready to provide more stimulus if needed

Several Fed speakers have raised concerns over the lack of fiscal support at a time when the recovery is becoming more fragile. However, given the political situation a consensus on a large fiscal stimulus program will be difficult to achieve. If the Republicans win at least one of the two open seats in Georgia in January, Joe Biden will begin his Presidency without a majority in the Senate. This will make it very difficult to push through most of his key programs announced ahead of the election. A bipartisan agreement on an infrastructure package is possible though not easy to achieve. That means the US economy will probably have to cope without a substantial fiscal boost. In that case, we expect the Fed to provide more stimulus if the economic recovery is slowing markedly, e.g. by further expanding its balance sheet or by increasing the duration of its bond purchases.

Bond yields are expected to reflect the improving economic picture helped by rising inflation expectations later in 2021. At the same time, the Fed's commitment to keep the target rate close to zero for an extended period of time and potential further steps in the months ahead will keep a lid on the upside potential in the near- to mid-term.

Credit to remain well bid

Having rallied substantially since Q1 2020, credit markets should continue to remain supported through 2021. We expect high yield default rates to decline to 6% in 2021, while fallen angel volumes could possibly decline to around a third of the USD 200bn seen in 2020. As with global credit, improving balance sheets and a search for yield are likely to support US credit markets.

Leverage is likely to decline further in 2021 in a trend that has already started, with Q3 median leverage for US non-financial companies having fallen from around 3.1 to around 2.8. Of course, management's focus on balance sheet strength is critical and we expect that to remain the case, as USD 900bn of corporate index debt with a BBB/BBB- rating still has a negative outlook from at least one rating agency. Consequently, management cannot afford to be extravagant with the cash raised during record supply in 2020. Substantial cash buffers with maturity walls have been chipped away, underlying our expectation of lower volumes of defaults and downgrades. Large amounts of cash on corporate balance sheets also implies supply should decline going forward.

At the same time, while spreads are tighter than a few months ago, the percentage income pickup from switching into credit from Treasuries is still attractive, in fact within the top fifth percentile since the 90s. Consequently, credit is difficult to avoid for fixed income investors. Together with the cash on the sidelines, given the liquidity glut created by the Fed, this drives flows into credit funds. An end to the Fed's credit programs is disappointing, but less crucial than it was in Q1 2020.

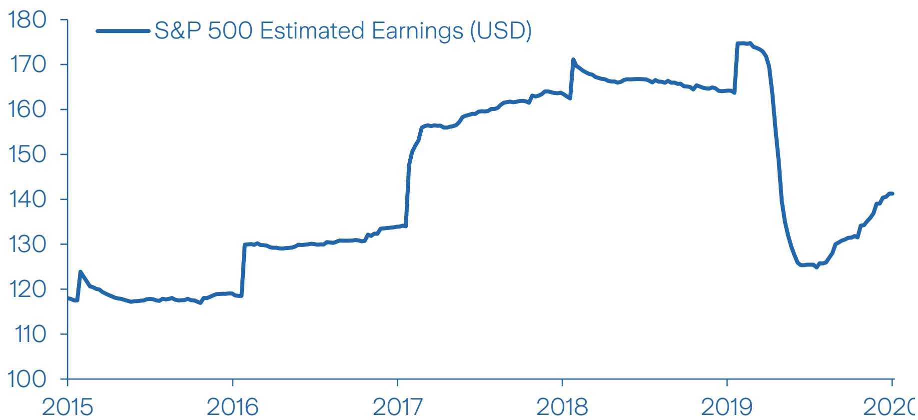
All in all, a constructive outlook for credit markets seems to be warranted. In terms of broad sectors, while non-financial and financial sectors are likely to see carry driven returns, ABS is also likely to remain resilient, as the uptick in delinquencies is likely to remain manageable, especially for credit cards and Autos. Notably, rating downgrades have been limited, even in the subprime sector. CMBS has a more mixed outlook, while US municipals are likely to benefit if higher income tax rates are enacted by the incoming Biden administration.

Liquidity and economic normalisation should support equity markets

Stock markets experienced huge swings in both directions over the course of 2020. The S&P 500 quickly rebounded after falling by more than 35% in a month. Massive fiscal and monetary support, partial normalisation of the economic situation as well as promising news regarding a vaccine drove the market to a new record high. Some of these factors are expected to support the market in 2021 as well.

Equity valuations are very high as investors are looking through the COVID-19 drawdown in profits. The S&P 500's forward price/earnings ratio rose to 26 in the aftermath of the crisis, the highest level since the dotcom-bubble. We don't expect valuation multiples to expand much further in 2021, but earnings estimates are rising briskly as economic activity moves towards normality and profits will benefit from a base effect next year. This is particularly true for the worst hit cyclical sectors which have the potential to make up for at least some of the recent underperformance. At the same time, as indicated above, central banks around the world keep providing substantial monetary support and are likely to limit the upside potential for yields. Economic recovery, reduced uncertainty regarding the outlook and a lot of liquidity should provide a healthy environment for stock returns in 2021.

Corporate profits are recovering



Source: Bloomberg

UK

Outlook

- Economic growth is expected to pick up substantially after a difficult start into the year
- Trade frictions and supply chain disruptions will weigh on the UK economy after the Brexit transition period
- Consumption expected to recover, but business investment remains under pressure until Brexit visibility improves

Implications

- Bond yields have limited upside potential as the Fed does not expect to hike rates soon
- Credit markets should remain well-bid amid improving fundamentals and strong supply/demand dynamics
- Liquidity and further economic normalisation will help to support the equity market

Risks

- A disorderly Brexit and trade frictions with the EU disrupt growth much more than expected
- The labour market and business investment deteriorate substantially, leaving permanent scars
- A premature move back to austerity chokes off the economic recovery

The UK economy is off to a difficult start in 2021

The British economy faces a tough start to the new year as several factors are weighing on activity. While the rate of new COVID-19 infections is currently levelling off, numbers are still high and there is a risk that they will start to rise again after the Christmas season, with at least some restrictions and lockdown measures still dragging down the economy in the first quarter of 2021. In addition, trade frictions with the EU will also hamper growth, particularly in the first few months of the year. Even under a lean trade deal, non-tariff barriers will have a negative impact on trade. On top of these longer-term headwinds there will be immediate supply chain disruptions and delays as importers and exporters will have to deal with an increase in paperwork and a growing number of checks at the border.

Later in the first half of 2021 we expect to see the beginning of a substantial recovery as the broader availability of a vaccine against COVID-19 will help the economy move back towards normality while the initial Brexit-related border frictions should begin to fade. Although the UK is expected to grow substantially above trend in 2021 it will probably not be enough to completely get back to the pre-crisis level.

Private consumption rebounds but business investment remains weak

The British economy was particularly hard hit by the COVID-19 pandemic and the related lockdown measures. The UK experienced one of the highest rates of infection, introduced its lockdown measures later but maintained them for longer than most other European countries. GDP fell by almost 20% QoQ in the second quarter as both private consumption and investment collapsed. Activity rebounded in Q3 as large parts of the economy reopened, but even the quarterly growth rate of 15.5% leaves GDP almost 10% lower than a year ago. This will be the largest drop in annual output in more than 300 years and the UK economy is lagging most other large economies. The recovery was driven by a rebound in private consumption as pent-up demand lifted the economy and households benefitted from temporary tax-relief and incentives to spend, such as the successful “Eat Out to Help Out” program.

Business investment, however, which has been week since the Brexit referendum in 2016 was still more than 20% below its level a year ago in the third quarter. Given the uncertainty caused by the second wave of infections, the looming end of the Brexit transition period and expected frictions as the UK finally leaves the EU’s customs union and single market, business investment is unlikely to provide much of a boost to the economy in the first half of 2021.

The service sector is weighed down by new restrictions

New lockdown measures that have been implemented to fight the second wave of COVID-19 will likely lead to another economic contraction in the final quarter of the year, putting more strain on households and firms. Markit’s latest PMI surveys from November show a sharp decline in business activity. At 49, the Composite Index fell back into contractionary territory. This was entirely driven by a significant slowdown in the service sector. The related PMI survey fell to 47.6, the lowest level since May. Not surprisingly given the measures implemented to get the virus situation under control, the hospitality and leisure sector was again among the hardest hit with hotels, bars, restaurants and other consumer facing service providers reporting the steepest downturns.

In contrast, manufacturing activity kept expanding at a robust pace in November, with the related PMI rising to a three-year high. In fact, the gap between activity in the manufacturing and the service sector was the widest in almost a quarter century.

Manufacturing has been less affected by the latest lockdown measures and has benefitted from a global rebound in activity, particularly in China and the European Union. In addition, stock building ahead of the end of the Brexit transition period also temporarily supported the sector.

In a sign of what the economy could face after the UK leaves the EU single market and customs union, an increasing number of firms are reporting a lengthening of suppliers’ delivery times. Much of the shipping delays were linked to bottlenecks at UK ports. Rising freight costs and stretched supply chains have played a significant role in lifting the overall rate of input price inflation to the fastest in two years.

Unemployment is expected to rise further as the labour market remains under pressure

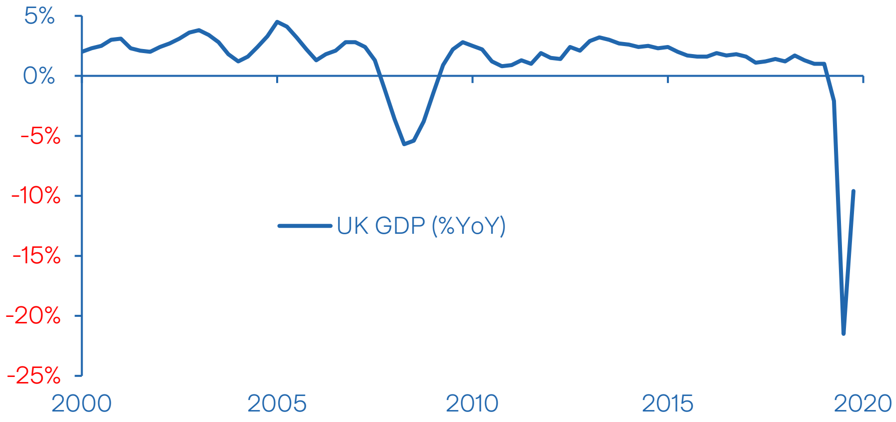
Worryingly, data suggest that job shedding in the private sector accelerated in November. The unemployment rate rose to 4.8% in September from its multi-decade low reached at the end of 2019.

Substantial fiscal support helped to mitigate the impact of the crisis on households and businesses, preventing an even deeper contraction. Particularly the government’s furlough program, which was recently extended, helped to avoid a larger rise in unemployment. Nevertheless, given the looming headwinds to economic activity and lagging impacts of the contraction, unemployment is expected to rise further in the coming months.

The fiscal deficit is soaring as the government tries to limit the impact of the pandemic

Fighting the economic fallout of the pandemic comes at a price, though. The combined impact of the virus on the economy and the government’s fiscal policy response will push the deficit to roughly 19% according to the Office for Budget

Still a long way to a full recovery



Source: Bloomberg

Responsibility (OBR), the highest level since World War II. Roughly three quarters of this is the result of the government's discretionary policy response rather than the hit to the economy caused by the pandemic. Government debt will reach 105% of GDP in 2020, the highest level since 1960.

The Bank of England boosts its QE program and cuts rates to almost zero

Despite the significant increase in government debt, gilt yields fell to record lows over the summer. Yields are expected to recover somewhat as the economy moves back to normal and the outlook begins to brighten. However, the upside potential remains limited given the headwinds the economy faces in the first half of the year and the Bank of England's (BoE) very loose monetary policy. To support economic activity as well as the financial markets the BoE has significantly increased its asset purchase program to GBP 895bn and cut the Bank Rate from 0.75% to 0.1% over the course of 2020. It is likely to keep its policy very loose in 2021. Inflation is not expected to rise enough to force the BoE into tightening its policy as a significant amount of slack will remain in the economy.

The end of the Brexit transition period will be the beginning of a new relationship with the EU

As mentioned above, the uncertainty created by the pandemic has been further exacerbated by the UK's unresolved future relationship with its largest trading partner. The end of the transition period will be the beginning of a new path in coexisting with the EU. In addition to the expected near-term trade frictions at the end of the transition period, the UK's longer-term growth potential crucially depends on the way the UK trades and cooperates with the EU.

Even if there is an orderly transition to a typical free-trade agreement, which would avoid most tariffs and simplify trade, the OBR expects the new trading relationship to lead to a long-run loss in output of around 4% compared to remaining in the EU. The welfare loss would be even larger should there be a disorderly transition to simple WTO terms. EU tariffs are generally quite low but some sectors like car manufacturing and agriculture would be hit particularly hard.

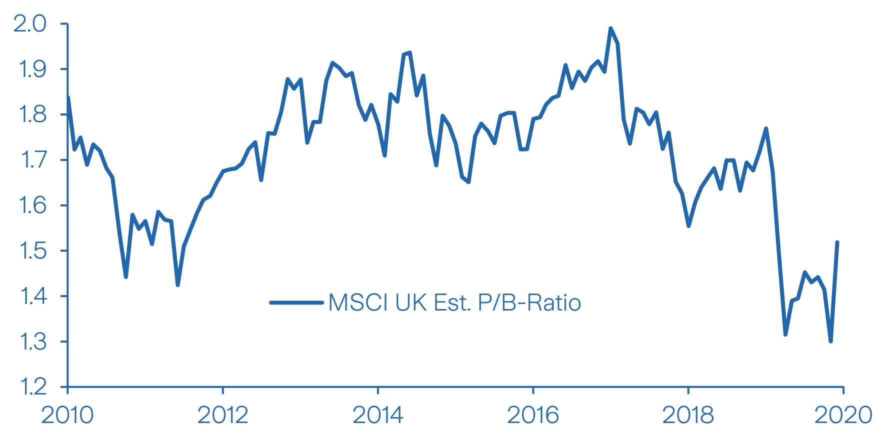
Failure to secure a trade deal could have deeper implications, however, as it would again raise difficult questions regarding the border between Northern Ireland and the Republic of Ireland. This would in turn undermine the UK's ability to negotiate a trade deal with the US as President-elect Joe Biden has already warned the UK not to let Brexit imperil the peace process in Northern Ireland.

Credit should remain supported in a post-Brexit world

We expect Sterling credit to remain supported in line with our view on global credit, largely driven by improving credit metrics and the search for yield environment supported by easy monetary policy globally. While the ramifications of Brexit are likely to impact some credits, this is already reflected in spread levels, with Sterling credit continuing to trade at a bigger discount to other markets.

Despite GBP denominated debt having smaller volumes than USD or EUR denominated debt, there is still a comparable share of BBB/BBB- rated debt with a negative outlook. We expect this will keep corporate management disciplined in maintaining prudence with credit metrics, which, together with positive supply/demand dynamics, should support credit. In terms of sectors, we think returns are likely to be driven by lower-rated cyclical names. At the same time, banks require some caution, while ABS and covered bonds have a constructive outlook.

British stocks are not expensive



Source: Bloomberg

British stocks have the potential to catch up, but a lack of visibility after Brexit is likely to keep weighing on the market

2020 was a particularly difficult year for UK stocks with the FTSE 100 lagging most other developed markets. The index's major headwind was sector composition with a value tilt in an environment in which growth stocks were favoured by the markets. As the pandemic took hold of the global economy leading to widespread lockdowns and severe economic downturns, investors flocked to large technology companies with recession-proof business models. On top of that, UK stocks are still weighed down by Brexit uncertainty.

Germany

Outlook

- Germany will use strong fiscal stimulus to support the economy in 2021
- The manufacturing sector should also continue to remain resilient as global demand improves
- Elections in September could lead to even more support for environmental initiatives

Implications

- Inflation to move back into positive territory as the economy recovers and a temporary VAT reduction expires
- Bund yields to move higher, though continued ECB asset purchases will limit the size of the move
- German equities will benefit from the global cyclical recovery given their large foreign exposure

Risks

- The COVID crisis worsens, especially over the remaining winter months
- Germany's exposure to Asian demand turns into a source of weakness if growth moderates there
- Angela Merkel's successor experiences challenges in commanding authority

Economy shows resilience

For a variety of reasons, the German economy has shown a substantial amount of resilience during the global COVID-19 pandemic and as a result is likely to come out in comparatively better shape than many of its neighbours. We expect that German GDP will have declined by around -5.5% in 2020, compared to an average for the Eurozone of around -7%, and expect a rebound in the German economy of around 4% in 2021.

Germany has coped better with COVID, so far

The health crisis and the duration of lockdowns in Q2 have been less severe in Germany than in many other European countries. For example, German GDP declined by 'just' -9.8% QoQ in Q2 compared to -13.8%, -13.0%, -17.8% for France, Italy and Spain respectively.

A better equipped health care system and a more efficient testing-and-tracing mechanism may have been part of the reason for a less aggressive first wave of infections and hence a shorter lockdown period in March and April compared to many other European countries

The second wave of infections is a risk

Admittedly, the second wave of infections in Germany in the autumn and winter months has been much worse so far in terms of numbers of cases than the first. Lockdown measures have been extended into at least January, and in some places in the state of Bavaria they have been more aggressive and are close to a full lockdown.

Nevertheless, the renewed November lockdowns in Germany were again less severe than in many other European countries overall. Germany concentrated mainly on closing leisure facilities such as restaurants, bars and gyms and places of entertainment while all other shops were left open and people were free to leave their homes and travel. In contrast, France, for example, closed all non-essential businesses in November and imposed a night-time curfew. Similar measures were taken in other European countries as well. However, the winter is not over and there are clearly risks going forward for Germany if it is not able to bring down new virus case numbers soon.

Manufacturing bounce back to continue

Another reason for Germany's resilience is that the economy is more weighted towards manufacturing than most other Eurozone countries. The industrial sector is around one quarter of the total economy.

This can often be a source of weakness as big-ticket spending items tend to be cut quickly in economic downturns. However, the unique feature of this downturn is that it has impacted the service sector the most, so Germany has seen a shallower contraction than its Eurozone counterparts.

Within manufacturing, Germany has maintained its focus on capital goods and auto production. Car manufacturers appear to be coping better with the transition to electric vehicle design and production than previously.

Strong Asian demand will help exports

Germany has a large exposure to emerging markets, especially in Asia, through its exports. Again, at times, this can be a source of weakness and volatility in terms of economic growth, but in the current downturn and recovery it has been a source of strength. Asia has coped relatively well with the COVID-19 health crisis and as a result its economies, especially China, have bounced back quickly. China is Germany's third largest export destination. This has meant that an important source of demand for German goods has remained relatively robust and we anticipate that this will continue to be the case in 2021, though there is a risk of some moderation in demand from China as it gradually reorients its economy. German growth could also lag a bit in the second half of 2021 relative to other Eurozone countries, as the European service sector finally recovers from the COVID-19 crisis.

Government embraces fiscal stimulus

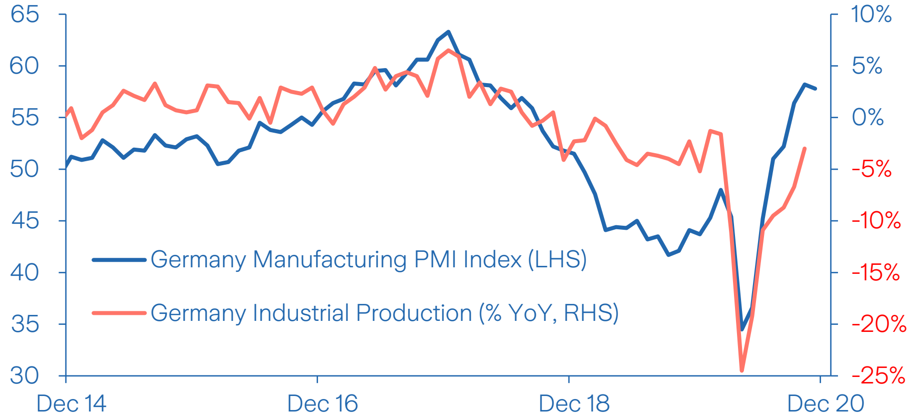
Nevertheless, perhaps most encouragingly, the German government has embraced some of the most aggressive national fiscal stimulus measures amongst the Eurozone countries. This is particularly noteworthy both because of Germany's size, within the overall Eurozone economy (around 30% of GDP), and because it has previously been reluctant to embrace large fiscal stimulus packages.

We have been particularly encouraged by the flexibility German political leadership has shown with respect to its formerly sacrosanct rules and commitments around not running budget deficits.

The so-called debt brake rule ('Schuldenbremse') was enshrined in the German constitution in 2009 and committed the federal government to not run a structural budget deficit that exceeds 0.35% of GDP in any one year. Furthermore, when they formed a coalition government in 2018, the CDU and SPD parties agreed not to run budget deficits at all.

They agreed that the annual budget should always be at least in balance or in surplus. This was the so called black zero ('Schwarze Null'). Even before this crisis, we had argued for some time that these debt rules were too restrictive. Germany had the capacity to spend more and we argued that it should do so both for its own sake, in order to upgrade its ageing infrastructure for example, and for the rest of the Eurozone's, by acting as a powerful extra source of demand.

The manufacturing sector continues to bounce back



Source: Bloomberg, Markit

Scholz fires EUR 1.3tn fiscal bazooka

Fortunately, in 2020 the government has shown flexibility with respect to the debt rules, invoking an emergency to authorise substantial spending and is expected to run a budget deficit in excess of 7% of GDP.

In a 180-degree turn from previous policy, finance minister, Olaf Scholz, famously fired a bazooka of EUR 1.3 trillion in stimulus in March, made up of loan and credit guarantees and tax deferrals for companies, substantial subsidies for short-time work schemes, and extra spending on healthcare amongst other measures.

In June, this stimulus was increased by approximately another EUR 130bn with a temporary cut to the VAT of a few percentage points for the rest of the year, a one-off EUR 300 payment per child to every household and subsidies for electric vehicle purchases amongst other measures. Many of these stimulus measures and support schemes have been extended into 2021 and will continue to support the economy.

In 2021 the government is still planning to run a large budget deficit, though we think this should not just be used to plug temporary missing gaps in company and household income, but also to invest for the long-term as well. Overall, it appears that the debt brake concept is gradually being consigned to history, though formal parliamentary approval in 2021 will still be required for it to be suspended for another year.

Germany also embraces debt mutualisation and fiscal transfers

Germany's new-found fiscal flexibility has gone beyond its borders. As part of the EUR 750bn Next Gen EU initiative, Germany has also finally accepted the need for substantial fiscal transfers between European nations.

At a Franco-German leaders meeting on May 18, German Chancellor Angela Merkel indicated for the first time that she would support the EU being allowed to borrow significant amounts of money by issuing debt on international capital markets, rather than relying simply on annual contributions from member countries to finance EU spending.

She also agreed that the EU could be given substantial tax-revenue raising powers to pay for this debt issuance and future spending. Mutualisation of debts and fiscal transfers between richer and poorer nations are an important and necessary element to make the single currency area more resilient to future shocks in our view.

Angela Merkel will be a tough act to follow

After being leader of her party from 2000 to 2018 and Chancellor since 2005, Angela Merkel will retire ahead of general elections in September 2021. Elections for the next CDU leader will take place soon.

Most of the candidates that are likely to succeed her would offer some form of continuity with her policies, but her stabilising force and presence, especially at times of crisis in Europe, may come to be missed.

Greens could form part of the next government

Nevertheless, more important from a policy perspective than personalities, is likely to be the actual result of the general elections in September. Whilst difficult to predict exactly, the Green Party have been doing reasonably well in opinion polls and there is a good chance that they will form part of the next government as a coalition partner. Overall, this would be likely to pull the direction of policy even more towards favouring government spending, especially on sustainability initiatives, as well as supporting further EU integration.

Inflation and bund yields to move modestly higher

Core and headline inflation in Germany have fallen to record lows of -0.1%YoY and -0.3% YoY respectively at the end of 2020. Inflation should bounce back early in 2021, as the temporary VAT cut introduced in the second half of 2020 to stimulate the economy expires. Higher oil prices and a recovering economy should also boost inflation.

Ordinarily a strong economic recovery and some upward movement in inflation would be expected to push bond yields much higher. We do expect there to be some upward movement in German government yields. However, the extent of any increase in yields will be moderated by what we anticipate will be continued large monthly government bond purchases by the ECB. In addition, German inflation is still likely to remain low by historical standards.

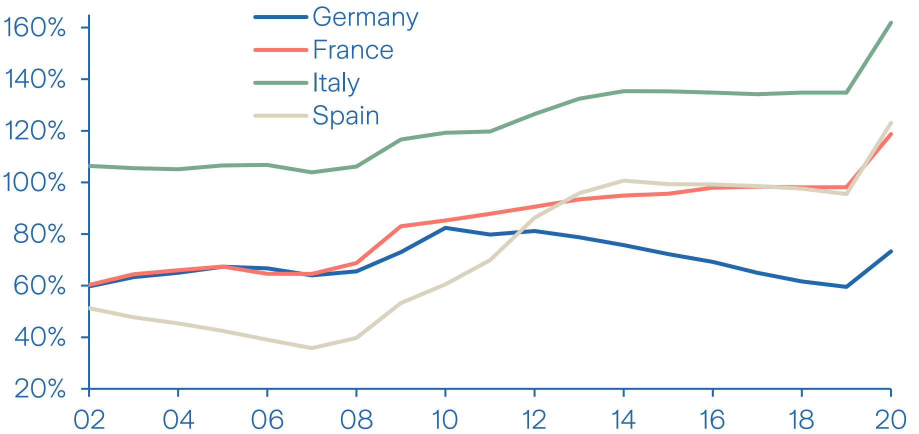
For the DAX, 40 is the new 30

German equities are likely to benefit from the global recovery we expect in 2021, given how large their exposure is to international markets.

From September 2021, the German benchmark equity index, the DAX, will increase the number of its constituent companies from 30 to 40. Following the change, the DAX will still have a substantial weighting towards industrials and chemicals and remain a highly cyclical index. It will also continue to generate a very large part of its revenues from outside of Germany.

However, we think that the German equity market`s lower weighting towards deep value sectors, such as financials, could weigh on its performance relative to other Eurozone countries such as Italy and Spain.

Government debt-to-GDP ratios head higher



Source: Bloomberg, IMF

Eurozone

Outlook

- Economic activity is set to rebound strongly in 2021
- The ECB will continue with large-scale asset purchases and provide ample liquidity
- Governments are also expected to continue providing support for their economies

Implications

- Core government bond yields to move gradually higher as growth and inflation recover
- Credit to remain in demand amid the allure of income vs government bonds and ECB support
- Equities, especially cyclicals, will be supported by growth, liquidity and favourable valuations

Risks

- A resurgence in COVID-19 virus cases, especially during the winter months
- Policymakers fail to take the Next Generation EU initiative from plan to reality
- High government debt levels weigh on future growth and create financial instability

Back to normal?

2020 was a year of unprecedented policy measures in the Eurozone. 2021 must be the year of embedding those policy initiatives, which are needed to make the region more resilient economically in the long-term. However, it will also be necessary to skilfully exit some temporary emergency measures when they are no longer required. While there will undoubtedly be some hiccups along the way, we expect to see progress on these fronts. We also expect that the COVID-19 health crisis will gradually diminish in intensity. 2021 should therefore be a positive year for the Eurozone in terms of economic recovery and for its risk assets.

The economy to bounce back in 2021

2020 saw the worst recession on record in the Eurozone. When the final figures are released, we expect that GDP will have contracted by around -7% in 2020 relative to 2019. This would be much worse than during the Global Financial Crisis, for example, when GDP declined by -4.5% in 2008. This was of course due to the unprecedented shock of COVID-19. The public health authorities' response involved shutting down large parts of the economy, especially in March and April. In 2021, we expect a sharp rebound in GDP, of around +4.5%, as lockdown restrictions are gradually eased, vaccines are rolled out and economic activity normalises accompanied by continued monetary and fiscal stimulus.

Successive lockdowns are diminishing in intensity

Admittedly, there is the risk of a resurgence in virus cases and renewed lockdowns, especially in the remaining winter months, but governments have learnt how to calibrate restrictions to dampen their damaging economic effects. What's more, a lot of government support schemes are now in place and businesses have had time to adapt. The November 2020 lockdowns for instance were much less damaging economically than the ones in March and April. In particular, schools and factories largely remained open. The key point is that even if there are renewed lockdowns in January or February 2021 (or even later in the year), each successive lockdown should be less damaging economically than the previous one. Looking further ahead in 2021, we anticipate that the rollout of vaccines will effectively put an end to the need for lockdowns at some point.

A few "Rubicons" have been crossed

One potential silver lining of the COVID-19 crisis has been the adoption of several policies that we have been arguing for some time were necessary to make the Eurozone more resilient economically and bring it closer to being an "Optimal Currency Area". (Optimal Currency Area theory is a branch of economics developed in the 1960s that sought to define the necessary criteria for a specific geographic area to benefit from having a common currency.)

Quite a few previously sacrosanct red lines, or 'Rubicons', were crossed by policymakers in the process of stabilising the economy in 2020. Germany abandoned its various budget deficit rules and Eurozone governments engaged more widely in aggressive fiscal stimulus, unprecedented large-scale credit guarantees and short-time work schemes.

The ECB engaged in asset purchases with even more flexibility than it had shown before, moving away from its self-imposed issue/issuer limit and capital key restrictions for example.

In addition, as part of the EUR 750bn Next Gen EU initiative, it was agreed for the first time that the EU would be given substantial tax revenue raising powers and that there would also be an effective mutualisation of some government debt.

In 2021, Eurozone governments need to be committed to ongoing fiscal stimulus and the ECB should accompany this with continued large-scale asset purchases for as long as needed. On the EU level, the Next Gen initiative needs to move from proposal to reality, with actual parliamentary ratification and disbursement of funds.

Long-lasting impacts and danger of economic scarring

While we expect the Eurozone economy to recover, there will be long-lasting negative economic impacts from the crisis. We do not expect GDP to return to pre-COVID levels until sometime in 2022. As a result, slack in the economy will remain substantial and unemployment could continue to rise during 2021 before eventually peaking. The longer people remain unemployed, the greater the chance of discouragement and deskilling.

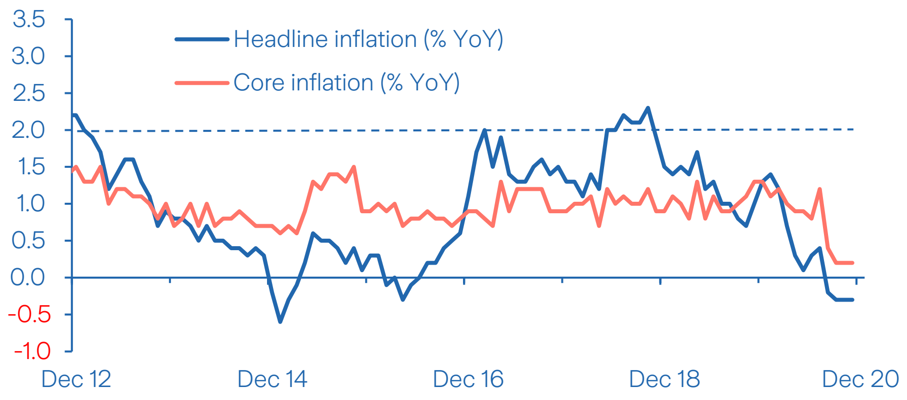
Government debt to hit record highs

Another impact of the crisis is a massive increase in the Eurozone's government debt levels. For example, Italy's debt-to-GDP ratio is expected by the IMF to rise from 135% in 2019 to 162% in 2020 and Spain's from 95% to 123%. While this is not a phenomenon unique to the region, the Eurozone debt crisis is still relatively fresh in investors' minds.

Great care is needed by policymakers

Policymakers will therefore need to be careful in how they exit the various temporary and extraordinary stimulus programs that they enacted in 2020, such as short-time work schemes and credit guarantee programmes. Governments will be in somewhat of a dilemma. Removing support too early could endanger the recovery and cause greater economic scarring. Removing support too late could risk supporting 'zombie' companies, encouraging the inefficient allocation of resources and

Eurozone inflation is well below the ECB's target



Source: Bloomberg, Note: The ECB`s inflation target is "below, but close to, 2% over the medum-term"

creating even larger government debt burdens.

The ECB's monetary policy will pursue a dual purpose

The ECB will also need to exercise great skill in its monetary policy. The worst recession on record led to a sharp fall in inflation in 2020, with core inflation declining to a record low of 0.2% and headline inflation turning negative.

Admittedly, headline inflation should rebound sharply into positive territory in the first half of 2021 given higher commodity prices, especially oil. The strong economic recovery we anticipate in 2021 should also allow core inflation to gradually stabilise and then move higher as well. However, underlying inflation is still likely to remain well below the ECB's target of 'below, but close to, 2%'. As a result, we expect it will continue with sizeable monthly asset purchases, primarily government bonds. This will also be needed to help indirectly absorb large government debt issuance.

2021 will also see the ECB resume and conclude its strategic review of monetary policy. A shift to the Fed's average inflation targeting model, or at least a more clearly symmetric inflation target, is possible. We think the review should also be used as an opportunity to make it clear that the ECB will not move policy rates further into negative territory.

Core bond yields to move higher

We expect core Eurozone government bond yields, such as those of Germany and France, to move higher through the course of next year as the economy recovers and inflation gradually rises. However, any upward move in yields will be moderated by continued large asset purchases by the ECB.

Periphery government bond spreads are likely to remain at tight levels through most of 2021 in our view, supressed by ECB bond buying as well as favourable macro conditions. However, political risks could flare up from time to time, creating some volatility. If there were to be a widening in spreads in 2021 on some political event, we would probably regard this as a buying opportunity for periphery government bonds.

Credit markets are likely to remain supported

European credit markets are likely to rally further in 2021, along with declining default rates and fallen angel volumes. In line with our view on credit globally, we think that improving fundamentals, substantial income pickup versus negative yielding core government bonds, and a supportive ECB are likely to underpin the bid for credit.

Fundamentals have begun to improve with fallen angel forecasts from earlier in the year proving overly pessimistic. Leverage has begun to decline, albeit at a slower pace than for more leveraged US corporates. We expect further improvements in credit metrics next year as the economy recovers and expect corporate management to retain a conservative focus on leverage, given that around EUR 450bn of BBB/BBB- bonds have a negative outlook.

The better credit quality in the European credit space relative to other markets such as the US has been evident in 2020 and reflected in spread differentials. We also expect European high yield to suffer fewer defaults in 2021 than in 2020, with default rates being close to 4% next year (versus 6% for US high yield).

Amid improving fundamentals, the liquidity backdrop remains positive with the ECB providing decent support, which we expect to continue. We also expect supply to remain muted, which should similarly support supply/demand dynamics.

In terms of sectors, non-financial corporates are expected to be favoured by investors, with cyclical BBBs that avoid becoming fallen angels likely to drive returns. Given the continuing fragilities in a low yield environment, financials, and banks in particular, require some caution around bail-in-able and subordinated bonds.

Covered bonds should continue to be viewed as safe havens within credit, remaining supported by declining supply and ECB reinvestment demand. European ABS should also be supported, although issuance should remain low.

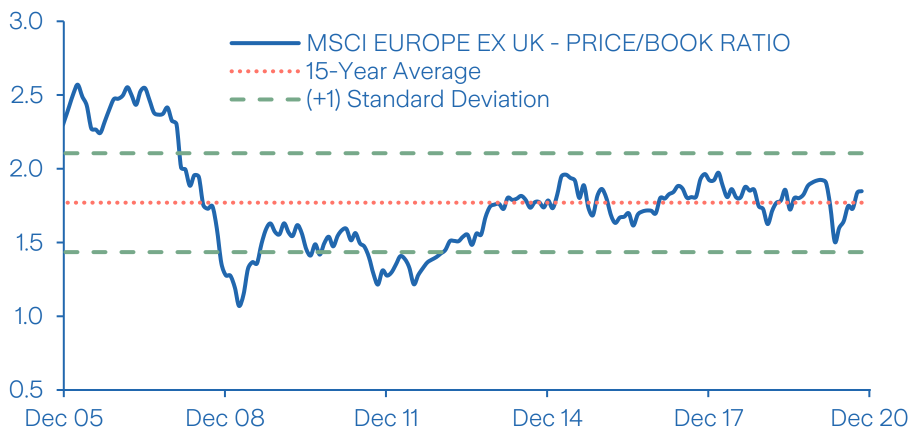
Equities will benefit from investor rotation

We expect 2021 to be a positive year for Eurozone equities as the early part of an economic cycle tends to favour cyclical and value-oriented sectors as their earnings tend to rebound sharply.

Most Eurozone equity markets have a higher weighting towards these sectors compared to the US equity market for example. Indeed, international investors could favour the region in their asset allocation decisions given that we are in the early phase of a new economic expansion, central banks continue to provide ample liquidity, and Eurozone equity valuations are not yet excessive on measures such as price-to-book ratios and cyclically adjusted earnings. Positive vaccine news in November 2020 was a major boost for these sectors and markets, and a possible early indicator of what is to come.

Within the Eurozone, we have a modest preference for those countries with the most cyclical and value-oriented equity markets. This means we favour equity markets such as Italy and Spain versus Germany and France (Italy and Spain are particularly skewed towards financials), though it is worth bearing in mind that all the major Eurozone equity markets are cyclical plays to a great degree.

Eurozone equity market valuations have room to expand



Source: Bloomberg

Switzerland

Outlook

- The economy is resilient, and the recovery should strengthen and broaden in 2021
- The deflationary environment will persist, as over-capacity and a strong currency limit pricing power
- The SNB will maintain its expansionary stance, with fiscal support also remaining in place

Implications

- Bond yields will stay low as policy rates are left unchanged and disinflationary forces persist
- The franc should lose some of its safe-haven strength as a vaccine ensure a road back towards normality

Risks

- A setback in vaccine development leads to renewed pressure on the Swiss franc
- An unexpected and disruptive change in SNB policy
- Negative rates lead to a further build up of imbalances in the housing market

The Swiss economy has proven its resilience, again

The Swiss economy has fared relatively well in 2020, particularly compared to other European nations. GDP contracted by 9% in the first half of the year, before rebounding sharply in Q3, making up three quarters of output lost in H1, and is set to expand modestly in Q4. This is likely to leave annual GDP down at around -3% compared to 2019. If this growth pattern materialises, it would be a very strong performance, with growth at the top end among developing economies.

Switzerland's highly diversified economy helps in times of crisis

As we have highlighted in the past, the Swiss economy is highly diversified, both across sectors and trading partners, with exports ranging from pharmaceuticals and high-end optical and medical instruments to specialised manufactured goods and energy. Trade flows are also diversified regionally and, while the Eurozone remains the key destination for Swiss exports, other markets have gained strongly over the past decade. Demand for Swiss exports also tends to be sticky and less price sensitive, due to their highly specialised nature. This diversification helps during crisis periods. This year, the pharmaceutical sector has helped to offset weakness from more traditional manufacturing industries. In the second quarter, when the Swiss and the global economy collapsed, the chemical and pharmaceutical industry increased its value added by 0.3%, despite the challenging situation, thus stabilising output for the manufacturing industry as a whole.

Domestic consumption was buoyed by travel and border restrictions

The economy has also benefitted from strong domestic consumption, as border and travel restrictions reduced cross-border shopping and as the Swiss turned to the Swiss mountains and lakes for their holidays. This did not prevent consumption from collapsing during spring, but retail sales rebounded firmly after the lockdown and over the summer period. The Swiss tourism sector also fared relatively better than in many other regions, with the number of hotel nights bolstered by domestic tourism. Accommodation and food services, for example, surged by over 70% QoQ in the third quarter, though still not recovering to its pre-crisis level. Consumption, which is usually a drag on the economy, particularly during crisis periods as the franc strengthens, appears to have been more of a tailwind this year.

Support measures have been swift and effective

The economy has benefitted from timely and effective support measures ranging from the SNB's COVID-19 refinancing facility – which provided government guaranteed credit to businesses – to short-time working compensation that was made use of by over 40% of the labour force during the early months of the crisis.

As in many other regions, the government's efforts limited business closures and lay-offs, with most capacity appearing to remain in place. With the latest surge in infections support measures, including the flexi-time work facility and a hardship fund, are being extended, which is critical for safeguarding the recovery.

The economy should continue to expand at a decent pace in 2021

Switzerland has avoided implementing more stringent measures to combat the second infection wave. While uncertainty remains, we expect this lighter touch and targeted approach to be maintained, which should help to avoid a contraction in Q4 and Q1. While external demand, particularly from the Eurozone, will weaken near term, other sectors of the economy should be sufficiently resilient to be able to offset this. The pharma sector should continue to see strong demand and activity through 2021, and some businesses will also benefit from being part of the COVID-19 vaccine supply chain. Domestic consumption should also remain resilient, particularly during the first half of the year, as travel restrictions and self-imposed social distancing remain in place and as household income is buffeted by support measures. We therefore expect growth of close to 4% in 2021, which is well above trend. This partly reflects favourable base effects (due to the collapse in GDP in 2020), but also a relatively resilient expansion.

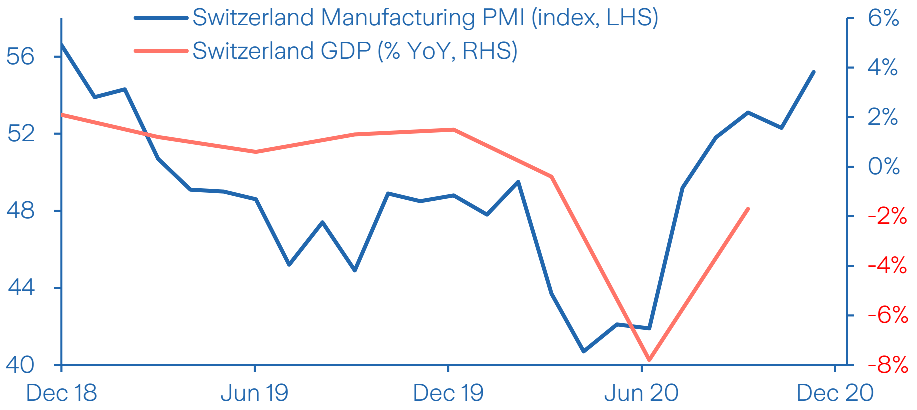
The housing market is booming, fuelled by the low rate environment

The housing market is doing well, supported by extremely favourable financing conditions and by expectations that policy and mortgage rates will remain low for an extended period. We suspect dynamics have also been amplified by accelerated changes in the workplace, in particular towards more flexible and remote working patterns. While the resilient housing market has been a tailwind this year, pre-existing imbalances have become even more stretched. Both home prices and mortgage volumes have spiked relative to household income as the economy has slumped, and the price-to-rent ratio is elevated following an extended period with negative rates. If the recovery continues, as we expect, some of these imbalances should unwind as household income picks up towards more normal levels. Risk is elevated, however, and we suspect that the SNB will monitor conditions in the housing market closely.

Business investment is likely to remain subdued in the first half of the year

Business investment is likely to be relatively subdued over the coming months as uncertainty around the economic outlook remains elevated and as many businesses are still faced with overcapacity. However, a synchronised global recovery in the second half of the year, particularly if it comes along with a more positive environment for global trade, could trigger a stronger upswing in business investment. While our base case

Resilient economy should continue to expand



Source: Bloomberg

remains relatively modest given the elevated uncertainty, we see upside risk to business investment.

Government spending will remain supportive, but less so than in 2020

Switzerland's fiscal position is favourable compared to other regions. Government debt (gross general government debt) was tracking at around 40% of GDP prior to the crisis and is estimated to rise to close to 50% by the end of 2020 as a result of fiscal support measures and a GDP contraction. The fiscal balance will have slumped from a surplus of 1.5% of GDP in 2019 to a deficit of over 4% in 2020, which is still limited compared to most other developed economies – the average deficit for G20 economies in 2020 is likely to be around -15%. Given that there is still significant fiscal space in Switzerland, we expect government measures to be extended and adjusted as needed over the coming year. This will be critical to bolster sentiment and maintain domestic spending during a fragile recovery, thereby limiting downside risk to the economy. We suspect that this tailwind will turn into a headwind at some point, as focus on fiscal prudence returns. However, this is unlikely to happen in 2021, unless growth surprises strongly to the upside.

The SNB does not rock the boat

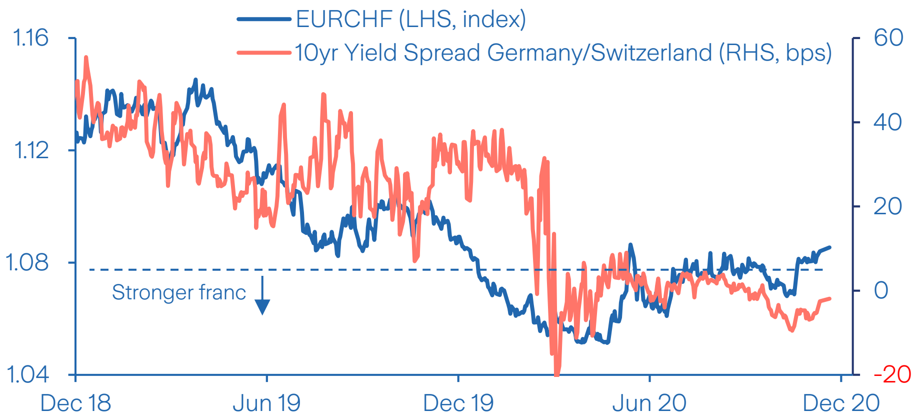
As we had expected, the SNB has refrained from cutting rates further, instead relying on interventions in currency markets to stabilise the franc, which has increased the balance sheet by over CHF 120bn this year, or close to 20% of GDP. As a percentage of GDP, this dwarfs the expansions of some other central banks and highlights the issues and constraints that the Swiss National Bank is facing. We expect this expansionary policy to be maintained going forward, with rates likely to remain unchanged at least until the end of 2022, and with recurrent interventions in forex markets during times of stress.

These foreign currency interventions provide support for the manufacturers and exporters, while more domestically focused services industries benefit less. In addition, the federal government also set up the SNB's Covid-19 refinancing facility, which has provided government-guaranteed loans for businesses. The facility was timely and provided a blueprint for other countries, and take-up was initially strong. While overall take-up has been limited (around 140'000 loans with a lending volume of CHF 18bn), 80% of the loans were provided to SMEs with less than 10 employees and were critical to ensuring the survival of these businesses. The COVID-19 facility has now closed and, while the market is currently functioning and banks are able and willing to provide sufficient credit to businesses, we would expect the guarantee programme to be re-opened, should conditions deteriorate more drastically.

Negative yields to persist as the SNB is stuck at the lower bound

Bond yields have rebounded from their lows but the whole yield curve remains supressed below zero, with the 10yr yield within a fairly narrow range around -0.5%. We expect the negative rate environment to remain in place through 2021. With the Fed and the ECB set to stay on hold for an extended period, this ties the hands of the SNB. In addition, the Swiss bond market remains relatively tight, despite increased fiscal spending, and disinflationary trends will be strong over the coming year. We therefore see no sustainable upside for Swiss yields over the coming year. That said, we suspect bond markets will be sensitive to positive vaccine news and do not rule out bouts of bond market volatility.

Strong franc as yield differential narrows further



Source: Bloomberg

Japan and Korea

Outlook

- Japan's growth outlook is positive, driven by a balanced contribution of the major GDP components
- Digital transformation, regulatory reform and carbon-free policies, core of 'Suganomics', will drive restructuring
- The Bank of Japan is likely to keep monetary policy unchanged

Implications

- Japanese equities are likely to perform well amid a favourable earnings outlook and fair valuations
- Foreign investors are likely to rediscover Japan's neglected equity market
- Rates and yields should remain stable at the current low levels

Risks

- A continuation of the third COVID-19 infection wave well into Q1
- Tokyo Olympics and Paralympics are cancelled
- Significant yen appreciation

2021: The year of the Ox, and the Olympics (again)

In 2020, the year of the Rat in the astrological calendar, the dominant themes were the three waves of COVID-19 infections, the 'Go To' campaign to revive consumption, PM Abe's surprising resignation and the reform policies by his successor, PM Suga. In 2021, the year of the Ox, one major focus will be whether Tokyo will be able to successfully host the postponed Olympics and Paralympics.

A 'Sayonara COVID-19' festival?

Many of last year's issues regarding holding the Olympics are still valid, but some new aspects need to be considered, as it is likely that the event will be scaled down. The International Olympic Committee (IOC) has recently guaranteed that all athletes and visitors will be safe. However, the mood has shifted from euphoria towards a more critical stance in Japan, as the high costs for holding the event has moved into public focus. The IOC wants the Olympics to become a festival celebrating the defeat of the coronavirus. If there is enough evidence by next summer that COVID-19 is on its way to being vanquished, then the Olympics may indeed become a glorious event that catch even more attention than would have been the case in 2020. However, we are sticking to last year's view that the overall impact on growth will be negligible, and more visible in specific consumer categories rather than igniting an overall boost. On the investment side, infrastructure capex already peaked in 2018, while various intended and necessary public infrastructure investments remain in the pipeline.

As for consumption, TV and camera producers may see a positive impact in H1, while the lodging and food segments will benefit during the Olympics. Hotels built in time for the Olympics have suffered due to lockdown measures in Tokyo and the fact that neither tourists nor business travellers could enter the country. Consumption may get a boost from upbeat consumer confidence before the event but will probably also experience a drag as many households will refrain from consuming while watching sport events live or at home in front of their screens. Potential foreign visitors will probably refrain from visiting Japan during the event due to high hotel prices, fear of overcrowding considering COVID-19 and the hot and humid weather conditions. Expenses per tourist will increase substantially.

The consumption outlook is expected to improve after Q1

The latest Eco Watchers Survey reveals that consumption has recovered from its Q2 slump, mainly due to public cash handouts and the 'Go To' 'Travel' and 'Eat' subsidised campaigns. These enabled consumers to benefit from major discounts for travelling and dining, particularly after the second wave of infections had subsided. We have some concerns for the rest of 2020 and the cold season in Q1 2021, as a third infection wave is developing with record high infection rates. This may dampen consumer confidence, which is still fragile after deteriorating even before the consumption tax hike in October 2019 and then the pandemic.

Personal income has benefitted from the cash handouts and savings have increased, which should enable higher spending activity once the pandemic recedes as a vaccine becomes available for a broader share of the population. We also note that online sales have been rising from a low level, a trend that should continue even after the pandemic. Department stores have suffered tremendously not only because consumers preferred to stay at home during the first two infection waves, but also because shopping by Asian, particularly Chinese tourists came to a standstill. Even though Chinese consumers have found domestic alternatives to buying duty free goods, we believe their interest in high quality Japanese products will return once they are able to travel and can visit Japan. However, this is more likely to be a story for the second half of the year.

Digital transformation investments should lift capex out of its current tailspin

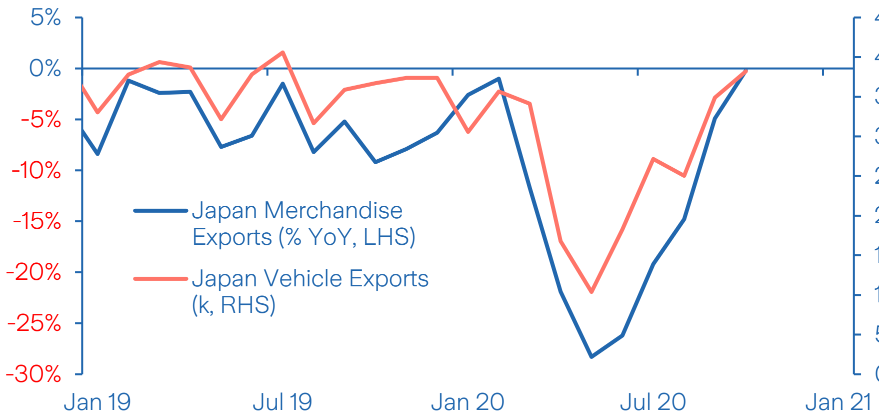
Capital expenditure has been lacklustre in 2020 even as the economy has recovered due to a rebound in consumption and exports. A difficult earnings environment and low business confidence has resulted in a slump in capex. Machinery orders slumped in Q2, while the bottoming out in Q3 leaves orders still far below prior year levels. We remain cautious for the last quarter in 2020 and the start of 2021, but already see light at the end of the tunnel. The corporate diffusion index within the Eco Watchers Survey, a leading indicator for capex, has spiked higher, while machine tool orders seem to be recovering, driven by both domestic and foreign demand.

A major impetus is expected from the digital transformation campaign, one of the policies at the heart of PM Suga's drive for structural change. The pandemic has revealed Japan's vulnerability as the digital economy has not yet taken hold in Japan's public administration, corporate sector and households. Digital transformation has now become a keyword in Japan, and it is likely that this will spur a digital investment boom that will become visible next year, particularly as Japan is suffering from labour shortages due to its demographic structure.

Export recovery should continue

Exports took a beating in Q2 2020 but have started to recover in the second half of the year. While exports to China have been holding up well, growing in line with China's recovery, exports to the US and Europe have suffered, particularly over the summer months. Tumbling car exports have contributed to the slump. However, exports were able to make up for some of the lost

Japan's exports plunged in 2020 before a 'V'-shaped recovery



Source: MoF, JAMA, Bloomberg

ground and are likely to perform well, in line with our optimistic outlook for global demand once the pandemic is retreating following broader availability of a vaccine.

Fiscal policy will remain supportive

A third supplementary budget is likely to be passed during the ordinary Diet session in early 2021. However, it is expected to pale in comparison to the two major supplementary budgets in 2020 that financed the cash handouts for households as well as emergency funding for the corporate sector. An extension and expansion of the 'Go To' campaign will require more public funding. Currently, debates are focussing on whether an extension to include the 'Golden Week' holidays in early May or even the Olympics/Paralympics until early August is needed. Employment subsidies and more targeted cash handouts are also in the offing.

The Bank of Japan will keep monetary policy expansive

In terms of monetary policy, it is likely that the Bank of Japan (BoJ) will extend its liquidity injection program to financial institutions, which enables them to provide loans to the corporate sector. It seems likely that this program, which is scheduled to end in Q1, will be extended, maybe even until the end of 2021. Meanwhile, the BoJ is expected to keep policy rates at the current low level for many more years, although it is unlikely that the BoJ will allow rates to move deeply into negative territory, so that pressure on the banking sector is avoided. As regional banks will need to restructure in line with PM Suga's policy targets, the BoJ is likely to assist this process.

No inflation — again

2021 will be another year of disinflationary tendencies, and it is highly unlikely that the BoJ's target of 2% will be met. Indeed, we suspect to see negative core inflation rates in the first half of 2021, while a pickup in the second half of the year will be subdued. The 'Go To' subsidies as well as a significant drop in mobile charges, a pet project of PM Suga, will pull prices lower. A return to slightly more positive inflations rates remains a story for 2022.

General Elections will be in focus

PM Suga's term as President of the LDP, the ruling party, will end in September, while the term of the Lower House Members of Parliament will end on October 21. The big question will be whether PM Suga will take the opportunity to call snap elections once the FY 2021 budget has been passed in late March. PM Suga may want to take the opportunity to call for snap elections as long as his approval ratings among the electorate remain high, because there is a tendency for these to erode over time, as prior PMs experienced. Meanwhile, other powerful candidates for the LDP presidential election are queuing up.

Positive equity market outlook

The recent 29-year high by the equal-weighted Nikkei 225 index made headlines. We prefer to focus on market-cap-weighted indices like the MSCI Japan Index and the broader Topix, which have not yet broken out to the upside. In 2020, both indices regained their year highs marked earlier after falling more than 30%. However, on a relative basis, apart from a short spike in March, the MSCI Japan underperformed its global peers by about 6% until mid-November.

Assuming the profit recovery to continue and considering fair valuations, Japanese equities have more upside potential. Further improvements in corporate governance as part of overall restructuring efforts should underpin this optimistic scenario. A rebound in interest by foreign investors and share buybacks by corporates are likely to support the market, while the Bank of Japan's ETF buying program should help to give support whenever the market undergoes phases of weakness.

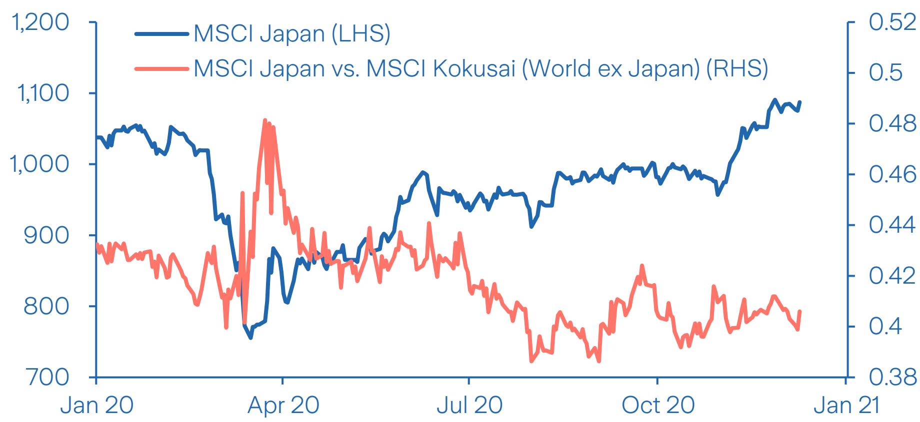
South Korea's success story will continue

South Korea has tackled the COVID-19 pandemic successfully due to its mobile tracing strategy. Positive impetus from the semiconductor cycle as well as strong global demand for its electronics products not least due the 'home office' boom were the main pillars for South Korea's export recovery, a trend that seems likely to continue in 2021. A recovery in global car demand has also helped, following a drop earlier in 2020. On the domestic front, demand should support the positive trend, unless a new breakout of the pandemic in H1 enforces new lockdown measures.

The Bank of Korea is expected to keep its policy rate at its record low of 0.5% at least in H1, while quantitative easing measures remain an option. On the fiscal front, the 2021 budget proposal remains expansionary.

The MSCI Korea Index is expected to continue to crawl higher versus the MSCI World Index, but the path is likely to be volatile rather than smooth.

MSCI Japan reaches year's high and outperforms during the slump



Source: MSCI, Bloomberg

China and Taiwan

Outlook

- China is leading the global economic recovery, with growth expected to surge to 8% in 2021
- While fixed asset investment has been the growth driver in 2020, consumption will take over in 2021
- China's focus will shift towards its own economy, particularly in terms of developing technology capabilities

Implications

- Stimulus measures, while significant, will normalise following the pandemic induced surge
- The CNY will continue to strengthen versus the USD and on a trade weighted basis
- Chinese equities are expected to perform well in 2020

Risks

- International relationships with key trading partners could deteriorate significantly
- The reform process of state-owned enterprises (SOEs) could slow down
- Credit defaults could occur more frequently, with investors becoming more cautious

Growth normalisation is expected

'First-in, first-out' has characterised China's growth pattern in 2020. COVID-19 erupted in the city of Wuhan, causing severe casualties, but following a delay, China took drastic measures to contain the virus wherever a new hotspot evolved, while shutting down international travel. The severe drop of economic activity in Q1 was followed by a steep recovery led by the manufacturing sector as well as infrastructure and property investment. The service sector was lagging, with catering, entertainment and travelling remaining a drag until recently.

However, China has not only been able to grow beyond its pre-crisis level, with a growth rate of 2.3% YoY expected for 2020, but even its growth rates are just about to return to where they had been before the pandemic erupted. Due to the base effect, China will report strong YoY growth rates in H1 2021, before growth is expected to normalise. Policy support is likely to be kept at a high level until consumer expenditure patterns have normalised and the broader availability of vaccines is evident globally, which is likely to happen in H2.

Also due to the statistical base effect, GDP growth is expected to reach about 8% in 2021, while in annualised QoQ terms, growth is likely to gradually decline from its estimated peak of above 11% in Q4 2020 towards China's trend growth rate in the range of 5-6%. This will help to achieve China's medium-term growth targets, as 2021 will be the first year of China's Five-Year plan passed during the 5th Plenum of the Communist Party's 19th Central Committee meeting held in November 2020.

Consumption: From being a drag to becoming a boost

Household consumption fell 8.2% per capita in Q1 2020 during the peak of the pandemic, as income slowed significantly and lockdown restrictions curtailed spending opportunities. Some consumer segments like transport and housing seem to be back to normal, while categories like education, culture and entertainment as well as other services are still a drag on consumption. To some extent restrictions like capacity limits at popular tourist attractions and cinemas have and continue to impinge on a return to prior consumption patterns. This is expected to change in 2021, presumably towards the summer and second half of the year. Indeed, consumption is likely to switch from being a drag to becoming the prime driver for growth, taking over the baton from fixed asset investment.

A normalising savings rate as well as a significant improvement in labour market conditions will be the prime drivers. The surveyed urban unemployment rate rose from 5.1% at the end of 2019 to a peak of 6.2% at the height of the crisis but has recovered to 5.3% recently and is expected to fall back to pre-crisis levels towards the end of 2021. In addition, labour market conditions for migrant workers, which are not covered sufficiently by government statistics, have improved from the dire circumstances during and shortly after the peak of the pandemic and are likely to improve further over the course of 2021.

Government consumption, which represents a significant portion of overall consumption, has acted as a boost in 2020 and is likely to remain a positive contributor in 2021, though at a slower pace.

Infrastructure boost is expected to slow

Infrastructure investment has been the main driver of the strong economic recovery that started in April 2020, which makes sense as it is a countercyclical policy tool that had already been used successfully by the government during the Global Financial Crisis in 2008. However, the government also learned from that experience that there are associated credit and debt risks. The 2020 infrastructure boom seems to have been less exuberant and better managed than in 2008/2009. As consumption and manufacturing investment are expected to pick up steam in 2021, infrastructure investment will contribute to growth at a slower pace than in 2020. The same is true for property investment. The government has been tightening standards to avoid a property bubble along the directive 'housing is for living, not speculation'. Slower land sales are already hinting that the strong pace of property investment in 2020 will subside in 2021. Meanwhile, manufacturing investment should benefit from upgrades to new technologies and production processes.

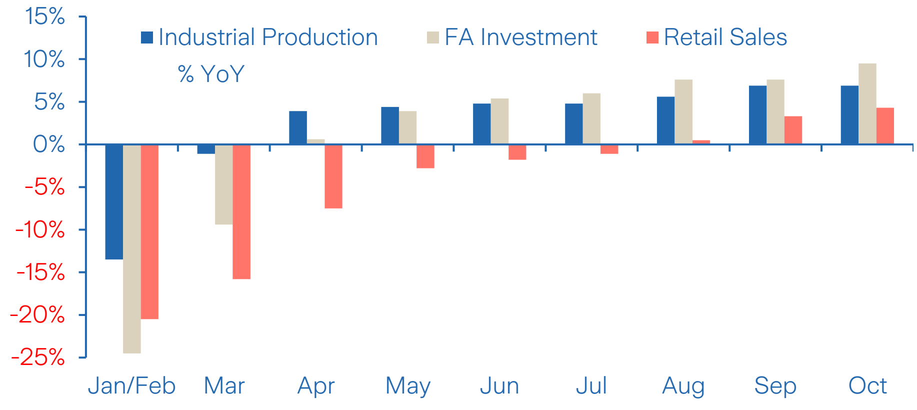
Net exports are likely to positively contribute to GDP growth in 2021

Following a steep drop in Q1, China's exports have recovered in Q2 and Q3 driven by heavy overseas, pandemic induced demand for masks, medical equipment and electronic devices. In the meantime, traditional export categories have picked up the baton as overseas growth has started to improve. This trend should continue well into 2021. While China's import growth has remined strong due to its quick domestic recovery, net exports have contributed negatively in 2020. For 2021, a reversal is likely, turning net exports to a positive contributor to GDP growth behind consumption and capex.

Both fiscal and monetary policy are likely to normalise following a strong boost in 2020

Fiscal policy has been highly expansive in 2020 in order to support the economy while tackling the pandemic induced shock. Taxes and fees have been cut, policy banks expanded their support and issuance of both special local and central government bonds has been ramped up, resulting in a substantial widening of the fiscal deficit. The economic recovery should help revenues to recover in 2021, while there is less urgency to support the economy on the expenditure side.

China's economic activity crawled back from its slump in Q1



Source: NBS, Bloomberg

Monetary policy is also expected to normalise in 2021, following a very supportive stance in 2020. While we expect policy rates to remain stable, aggregate financing growth is likely to slow down after providing a strong boost in H2 2020. Credit growth is expected to grow in line with nominal GDP growth, while the 30% ceiling for mortgage loans as a share of total bank lending will remain in place as a measure to avoid any signs of renewed exuberance in the housing sector.

The RMB is on its way to becoming everybody's darling

The CNY (or RMB) has appreciated significantly in H2 2020. From its double top marked in the summer of both 2019 and 2020 at 7.2 versus the USD, it strengthened to about 6.5 in November 2020. In trade-weighted terms, the CNY has recently appreciated back to the highs marked in spring of both years. USD weakness, as well as strong foreign capital inflows, have benefitted the CNY. Inflows are likely to remain strong in 2021 due to high interest rate differentials, a strong CNY, and global bond and equity index inclusions, while USD weakness may persist. This broader trend may be interrupted by countermoves once foreign interest becomes too lopsided or technical indicators get overextended. China's policy makers welcome the CNY's strength as a sign of greater RMB internationalisation, resulting in less dependency on the US dollar amid increasing US tensions. At the same time the risk of being labelled a currency manipulator by the US is rising.

A kaleidoscopic view on Chinese equity indices reveals interesting perspectives

When speaking about Chinese equities, a careful distinction is necessary. Among institutional investors, the MSCI China tends to be the core reference point, while 'A'-shares traded in Shanghai and Shenzen have gained attention versus 'H'-shares traded in Hong Kong, following the opening of this segment to foreign investors. Performance varies accordingly. While Shanghai 'B' shares have lost 6% in 2020 by early December, the Shenzen Composite index has gained 33%, the ChiNext index had rallied 52% and the MSCI China Index was up 25%. The latter has 724 index components, of which the top four internet related stocks make up about 40% of the index weight.

Focussing on the MSCI China, the earnings outlook appears promising and should be reflected in adequate equity market returns over the year, assuming valuations remain unchanged. Stocks reflecting the 'new' China are trading at far higher valuations than those in the 'old' sectors and are prone to sudden setbacks, as evidenced recently. However, equities in market segments linked to strategic policy areas, including digital transformation and a focus on the domestic market like clean energy, e-vehicles, high speed railways, 5G and healthcare may be less susceptible to sudden drawbacks as long as they adhere to domestic regulations. Chinese equities seem to have gained more attention due to the opening of domestic segments to foreign investors, but global institutional investors still appear to be underweighting Chinese equities compared to their benchmarks. Even though the US President elect is likely to keep a tough stance toward China, tensions may recede somewhat which should underpin increasing confidence by global investors.

Taiwan's outstanding economic and equity market performance is likely to continue

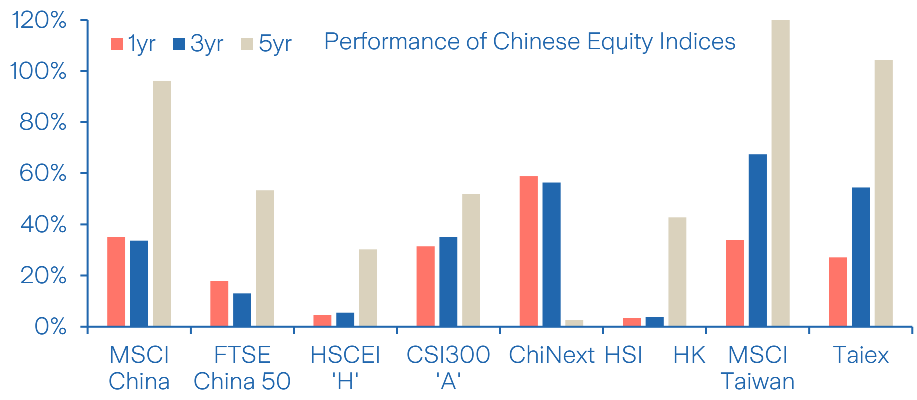
Taiwan, along with China and Vietnam, was the only economy showing positive GDP growth rates in 2020. Successfully tackling the COVID-19 pandemic and helped by a favourable semiconductor cycle and strong global demand for electronic products were important ingredients for the successful economic and equity market performances. However, Taiwan is not resting on its laurels, putting a lot of effort into advances in other promising fields including green technology, cybersecurity, artificial intelligence, 5G and biotechnology.

Monetary policy is likely to remain accommodative, with policy rates expected to remain unchanged over the next two years. Taiwan's fiscal balance has deteriorated from a small surplus in 2019 to a deficit of about 2% of GPD in 2020. Subsidies for companies suffering from the global pandemic are likely to be maintained, which does not allow for a reduction in the budget deficit. However, it must be recognised that Taiwan's budget deficit remains well below the one during and after the Global Financial Crisis.

Taiwan's strategy of diversifying its foreign investments away from Mainland China is likely to continue. Having peaked ten years ago, Mainland China's share of foreign direct investments has slowed markedly since 2019. Re-shoring and focusing on the ASEAN countries and India is likely to prevail over the next years and is driven by cost considerations, pressure from clients and geopolitical aspects. Taiwan is also eager to diversify its tourism industry towards a broader range of countries away from a strong dependence on Mainland tourists. Following a pandemic induced collapse in 2020, tourism is expected to slowly recover from H2 2021 onwards.

Taiwan's tech-heavy equity market started to outperform global equities in mid-2019. However, this was not a smooth, but rather volatile path of outperformance, a feature that is likely to continue in 2021.

MSCI Taiwan and MSCI China are leading on a 5-year horizon



Source: MSCI Taiwan and MSCI China are leading on a 5-year horizon

ASEAN and India

Outlook

- The growth outlook is encouraging, while the divergence in economic performance between economies should diminish
- There is limited scope for further interest rate cuts by the central banks following the aggressive easing in 2020
- The recovery in exports is likely to expand beyond the technology sector

Implications

- Equities should gain considerable momentum as corporate earnings and global risk sentiment improve
- The yield differential between regional bonds and those of developed markets should support inflows
- Regional currencies are expected to appreciate on the back of a recovery in market appetite for emerging market FX

Risks

- A new COVID-19 wave before vaccines are widely distributed triggers new restriction measures
- Increasing political risks in Malaysia and social unrest in Thailand weigh on growth
- Further downgrades in sovereign credit ratings have a negative impact on investor sentiment and contain capital inflows

Narrowing the gap

ASEAN and India experienced a sharp synchronised drop in economic output following draconian lockdowns in Q2 2020. However, countries have emerged from the crisis very differently. Varying abilities to contain the pandemic have created winners and losers in terms of economic performance. India, Indonesia and the Philippines lagged other economies such as Vietnam, Singapore, Thailand and until recently, Malaysia during the early recovery post lockdown.

While the divergence in growth might persist for some time, 2021 should be the year for underperformers to narrow the gap. India and the Philippines have already started to see signs of declining coronavirus infection rates. With the help of a large-scale vaccine supply potentially available next year, these countries should be able to fully open their economies safely and experience a swift rebound thanks to pent-up demand. However, increasing poverty and income gaps post COVID-19 will leave some long-term scars on economies with high poverty rates like India and the Philippines.

Trade recovery to broaden out

The technology sector has led the recovery in global trade. High-tech exporters like Singapore, Malaysia and manufacturing hubs like Vietnam and Thailand have reaped the benefits. We expect these economies to continue to gain from this trend in 2021 as the upturn in the tech cycle is not only a short-term recovery story but also reflects a long-term shift towards a more digitised world.

On top of that, we expect the recovery in trade to expand beyond the tech industry. Oil demand should pick up along with a further increase in manufacturing activity. Oil and gas companies in Malaysia and Indonesia should see a better outlook for earnings. Also, China's investment-led recovery will probably help Indonesia's coal exports. Agricultural product shipments should see signs of improvements as global consumption advances.

While vaccines are likely to be available early next year, it will take time until emerging countries can get sufficient doses for their populations, potentially in H2 2021. Thus, border closures should remain intact for some time, and tourism and hospitality services exports should be the last to recover. The Thai economy appears to be the most affected, given that both employment and domestic growth are very dependent on tourism. Nevertheless, a potential creation of safe 'travel bubbles' within ASEAN and other Asian countries should help absorb some weakness.

Furthermore, the signing of the Regional Comprehensive Economic Partnership (RCEP), which aims to eliminate 65% of tariffs and trade barriers, should boost trade flows between ASEAN and other members, starting from next year.

Fiscal impulse to remain limited

Indonesia, Malaysia, the Philippines and Thailand have announced their budgets for FY2021. Accordingly, regional budget deficits should remain well above their historical averages in the next few years, except for Vietnam, which is heading in the direction of narrowing fiscal deficits.

Overall, the 2021 budgets show the governments' willingness to provide further stimulus. However, except for Singapore, which has sufficient space for large fresh spending thanks to its outsized fiscal reserve, these countries have very little leeway to spend. Hence, we expect fiscal policy will centre around off-budget measures such as loan guarantees for businesses as we saw in 2020. With that, the fiscal impulse is likely to remain limited.

The major shift in 2021 fiscal prospects is the increase in infrastructure spending while cutting back short-term measures such as cash transfers. A restart of infrastructure projects should help to boost business investment and create more jobs. However, potential delays in these projects, which we have seen in the past, could limit the stimulating effects of the investment.

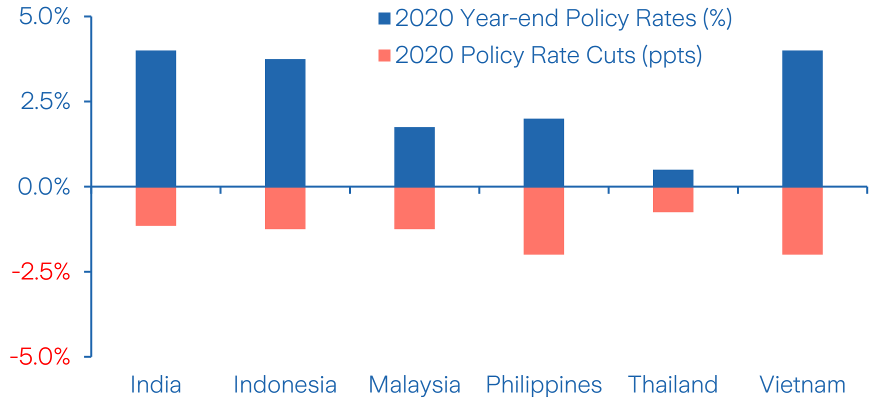
Monetary easing to decelerate

The easing cycle will likely slow in 2021. After a series of 2020 rate cuts, central banks now have less space for further easing, notably in Thailand where the policy rate stands only slightly above zero. The normalisation of economic and financial conditions should also reduce the urgency of interest rate cuts.

Regarding unconventional monetary policy, most central banks ramped up their government bond purchases in 2020, typically under their Open Market Operation (OMO) tool, to offset massive capital outflows in the first half of the year. While the scale of purchases was much larger than the conventional OMO, they mainly aimed at stabilising the markets and preventing liquidity from drying up. The purpose was therefore different from the Quantitative Easing seen in developed markets (DMs). With improving market conditions, we expect the pace of asset purchases by the central banks to slow.

Notably, Bank Indonesia (BI) has stepped into the realm of debt monetisation, committing to finance government debt with outright purchases of government bonds in the primary market. However, we expect BI to gradually scale back its debt monetisation in 2021 once financial conditions normalise and foreign investor's appetite for Indonesia's government bonds improves. Debt monetisation can provide a quick fix in downturns, but it has a negative impact on long-term inflation and currency trajectory, and it would raise a question about BI's credibility as an independent monetary policymaker.

The easing cycle should slow following a series of interest rate cuts



Source: Bloomberg

Malaysia: a brighter economic outlook

Malaysia's economy should recover swiftly in 2021 following setbacks caused by additional lockdown measures in Q4 2020. We are likely to see pent-up demand fuelling consumption in Q1 2021. In the second half of the year, the availability of vaccines should expedite the recovery.

Overall, the trade surplus and consumer spending should provide strong support to growth, with business investment slowly picking up. An additional boost should come from a tentative increase in infrastructure spending, with the government indicating its intention to restart infrastructure projects such as the high-speed rail project between Kuala Lumpur and Singapore and the Kuala Lumpur subway line 3.

Indonesia: containing the pandemic is critical for the economy

Indonesia was a perfect example of how a less stringent lockdown led to limited economic damages initially. However, the economic costs of lingering high infection rates prevented Indonesia from having a 'V'-shaped recovery like in the neighbouring countries.

While Indonesia's infection curves have not yet sustainably flattened, testing capacity has improved, and death rates are trending down. The distribution of vaccines on a large scale, potentially in the second half of 2021, should boost the speed with which activity rebounds. Indonesia's growth is likely to remain close to trend growth towards the end of next year.

Regarding structural reforms, the 'Omnibus Bill', which aims at reducing the current rigidity of investment and labour laws, should help attract more foreign direct investment. It will also make Indonesia less reliant on foreign indirect investment, which tends to be short-term in nature and extremely sensitive to global risk sentiment.

India: the recovery to gain momentum, but structural issues linger

India's growth seemed to have hit a wall even before the crisis with several structural issues lingering, including the impaired banking system as a consequence of the 2018 banking crisis, deteriorating infrastructure and grinding rural poverty. India has been among the economies hit the hardest by the pandemic due to a poorly prepared and severe lockdown in H1 2020 as well as mounting local transmission rates in H2 2020. The good news is that virus infection rates have begun to trend down in Q4 and plenty of pent-up demand should pave the way for the recovery to gain speed in 2021.

On the policy front, the government has very little space for additional fiscal support. India's fiscal package was among the smallest in emerging markets (EMs) during the crisis. The pre-crisis public debt was already as high as 70% of GDP, scratching the upper end of EMs' debt levels. With the collapse in tax revenue, India's budget deficit will widen, and public debt will surge before long. Therefore, the burden to stimulate the economy should be mainly on the central bank's shoulders. The Reserve Bank of India should have more space to act in 2021. The dilemma of the 2020 stagflation should ease with supply induced inflation to edge lower as supply conditions, especially in rural areas, slowly normalise.

Notably, poverty issues have intensified during the pandemic. The crisis has dialled back several years' worth of effort in combating poverty. Along with unresolved structural issues, India will face a considerable challenge to return to the level of growth seen before the crisis.

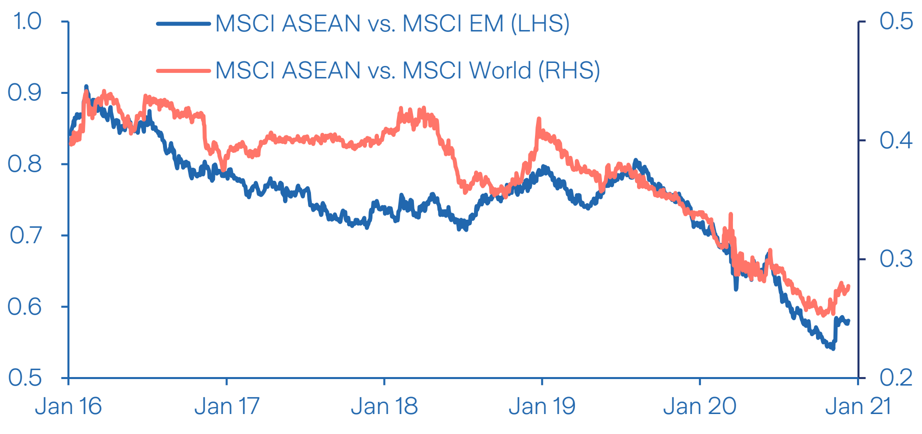
Markets: equities to gain traction

Our view on stocks is constructive. Corporate earnings are likely to rebound appreciably as macro conditions recover, especially for cyclical sectors such as financials and industrials. Regional equity indices have a heavy weight of bank stocks. A potential recovery in banks' profitability in the early phase of the recovery should help regional equities to perform well. The recovery of the manufacturing and energy sectors should also support equity markets that are more dominated by industrial stocks like the Philippines, Vietnam and India. The current light positioning of foreign investors in the local stock markets is likely to support further inflows in 2021.

Bond yields should remain subdued by historical standards. While we expect the easing cycle of central banks to slow, interest rates should remain at record lows in the coming year with some countries still having space for additional rate cuts. Abundant global liquidity and an ongoing hunt for yield should support regional bond markets given an attractive yield differential between regional yields and those in DMs. However, we expect bond yields to eventually edge higher, reflecting better economic conditions, especially once foreign inflows normalise.

Regional currencies are likely to have a decent performance in 2021. A further recovery in regional trade and a potential increase in both foreign direct investment and foreign indirect investment should buoy appetite for regional currencies.

ASEAN equities to play catch up



Source: Bloomberg

Australia

Outlook

- Growth is expected to be solid given the success in containing the pandemic and sizable fiscal and monetary stimulus
- Benign inflation is likely to persist, and wage growth is set to remain lacklustre
- Robust job growth should bring down the unemployment rate, but is unlikely to reverse all the job losses of the crisis

Implications

- Bond yields should move higher on the brighter macro outlook, but ultra-low interest rates will keep yields in check
- Equities are likely to benefit on the upside as appetite for risk assets recovers
- House prices are set to improve, but high unemployment and low immigration will constrain housing demand

Risks

- A resurgence of coronavirus triggers additional lockdown measures, slowing the recovery in activity
- A premature withdrawal of fiscal stimulus leads to a large jump in unemployment
- A delay in the distribution of vaccines prevents activity from fully normalising

Australia is well positioned for the recovery

2020 was a challenging year for Australia, starting with catastrophic bushfires raging through coastal cities and ending with a wounded economy exiting its first recession in 29 years. Despite all that, Australia belonged to the group of economies that held up better during the global downturn. Several aspects have helped the country to cope well with the crisis, and these factors should continue to lend support in 2021.

First, timely and decisive restriction measures right from the beginning prevented the outbreak from getting out of hand and straining the health system. If this success holds, Australia will continue to be ahead of the recovery curve compared to many other developed economies, especially in Europe.

Second, fiscal and monetary stimulus was substantial and highly targeted, focusing on the most vulnerable parts of the economy, including the labour market and household income. Policy support will remain a driving force for the recovery in the years to come. Also, low public debt leaves the government sufficient room to scale up fiscal spending if need be.

Third, China's ahead-of-the-pack recovery boosted Australia's commodity exports, offsetting some domestic weakness caused by the lockdown measures. The investment-led recovery of China coupled with rising global demand for commodities should continue to bolster Australia's trade in 2021, particularly iron ore shipments. However, the escalating trade tensions between Australia and China, if not resolved, will pose major challenges to Australia's exports of specific products, including coal.

Lastly, the scale and timing of vaccine distribution in Australia matters. It will have a strong impact on the timing of border closures and social distancing measures. The recovery of several sectors, including tourism and education exports, is highly reliant on how this issue develops.

The job market will take time to heal

The aftermath of the crisis was a 30% increase in job losses between March and July 2020. The damage was uneven, with the young workforce as well as low-paid workers being affected the most. While job growth has been quite robust post-lockdown, it still has a long way to go before the job market returns to its pre-crisis level.

The scaling back of wage subsidies by the government will potentially put additional upward pressure on unemployment. Nonetheless, this step is necessary in order to encourage households to look for jobs and allow a natural healing process of the labour market to take place. Given plenty of slack in the labour market, we expect wage growth will remain in the doldrums for some time.

Furthermore, some structural shifts in the job market, which had begun in 2020, should continue in 2021. They include the transition from brick-and-mortar retailers to virtual stores, rising demand for automation in the workplace and more people moving from city centres to suburban areas. These shifts will potentially lead to some movement of labourers between sectors and regions. As a result, some traditional sectors might scale down their workforce while others might be short of skilled staff. During the transition process, we are likely to see a rising need for vocational training.

Inflation is not a concern

Given plenty of spare capacity in the economy and the sizable gap between the actual unemployment rate and the Non-Accelerating Inflation Rate of Unemployment (NAIRU), inflation should remain muted. Furthermore, border closures and record low immigration should remove inflationary pressure coming from additional demand from immigrants.

Admittedly, the current high savings rate among households in 2020 might enable additional spending next year when economic conditions become more favourable. However, we doubt that consumers will scale up their spending excessively on the back of declining government cash handouts and the still-high unemployment rate coupled with households' high indebtedness. Therefore, we do not expect demand-pull factors to lift price levels substantially.

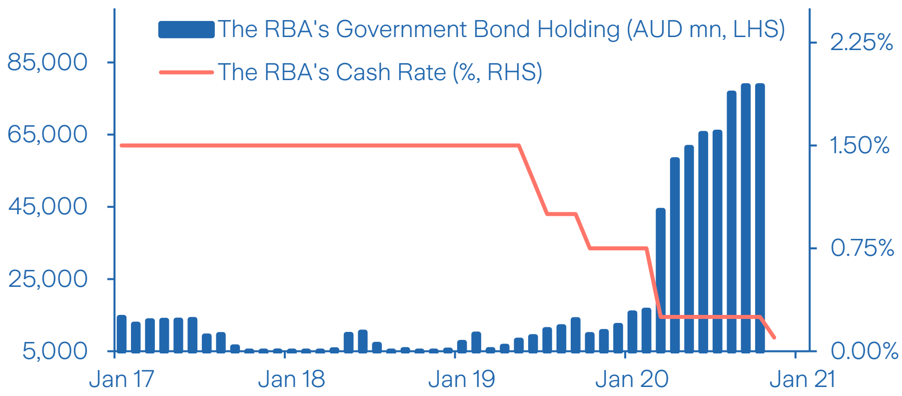
Policy stimulus is key to the recovery

The unprecedented fiscal and monetary stimulus helped reduce economic calamity in 2020. It should continue to play an integral part in the recovery process in 2021.

With the announcement of the federal budget 2020-21, the government unveiled an ambitious plan to rejuvenate the economy with sizable tax cuts and considerable spending. Fiscal deficits are likely to rise to around 11% of GDP with an additional stimulus for 2020-21 equivalent to 10% of GDP. If we sum up both federal and state packages during and post-pandemic, the total size of Australia's fiscal stimulus will exceed 20% of GDP making Australia one of the top spenders in developed markets (DMs).

The major shift in fiscal stimulus in 2021 will be a transition from short-term targeted cash handouts to medium-term broad-based measures such as tax cuts, subsidies for vocational training and incentives for businesses to expand their capital expenditures. The tapering of cash transfers through the JobKeeper scheme in H1 2021 might put temporary upward pressure on unemployment. Despite that, we expect the withdrawal to be orderly and without material economic consequences.

The RBA is set to ramp up its asset purchases significantly



Source: RBA

On the monetary front, the Reserve Bank of Australia (RBA) has been relatively modest in deploying Quantitative Easing (QE) compared to its counterparts in other DMs. However, with the expectation that monetary policy will be more effective during the recovery phase of the economy, the central bank has announced it will buy an additional AUD 100bn government bonds with tenures between 5-10 years over the next six months. With that, the RBA's government bond holdings will more than double in Q1 2021. Whether there will be an expansion of QE next year will largely depend on the speed of economic rebounds as well as the recovery of the labour market post-crisis.

The housing market is resilient

Historically low mortgage rates on the back of the RBA's sizable rate cuts and mortgage deferrals from banks have helped households to endure the financial strains caused by a collapse in employment and wages. During the pandemic, there were no signs of forced sales in the housing market and house prices fell only moderately. Unprecedented policy support seems to have made the cyclical nature of the housing market relatively muted this time.

With an improved economy on the horizon coupled with the RBA's strong commitment to maintaining near-zero interest rates, the housing market should recover steadily throughout 2021. Home prices already improved after the economy reopened in Q3 2020. Leading indicators such as the auction clearing rate and sales-to-listing ratio imply the recovery has further to run.

However, the rise in house prices should remain capped, given that the economy is still at a fragile stage of the recovery, and households are still facing a high unemployment rate. Moreover, immigration, a source of demand creation for the property market, is likely to remain close to zero for an extended period, leading to muted price pressure for housing.

The currency strength remains intact

The Australian dollar is closely linked with commodity prices and global demand for its exports. With the potential recovery of the global economy in 2021, demand for Australia's commodities should remain robust. Iron ore prices are now hovering around multi-year high levels. China's solid growth profile and the potential global recovery should continue to help Australia's iron ore exports next year. However, the normalisation of trade towards the end of 2021 might remove some of the upward pressure on the currency.

Also, the trajectory of the currency is tied to the monetary policy outlook. The yield differential between Australia's long-dated bonds and those of other DMs has partly contributed to the appreciation of the AUD. However, this effect is likely to diminish once the RBA scales up its asset purchase program next year with a focus on 5-10yr maturities. Yet it is not in the RBA's interest to devalue the currency below its fair value. Therefore, we expect the Australian dollar to remain strong, reflecting its underlying fundamentals.

Bond yields edge up but remain within a low range

Near-term QE should translate into lower bond yields for long-dated bonds, especially in the first half of the year when the recovery is still in an early stage.

The RBA has emphasised its commitment to keeping interest rates at ultra-low levels 'for at least three years' until 'actual inflation is sustainably within 2-3%'. Bond yields should therefore remain subdued compared to their historical averages. However, the yield curve tends to steepen during a recovery. We expect yields to edge higher towards the second half of 2021 as investors are likely to further rotate to riskier asset classes such as corporate credit or equities.

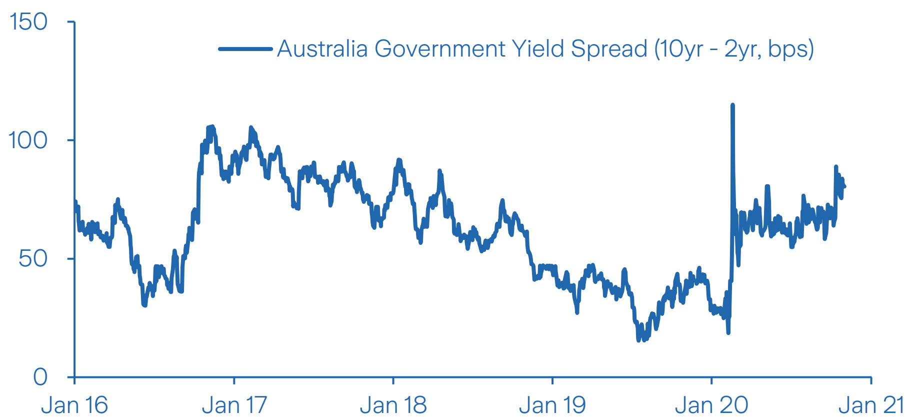
Equities: a year for the bull market

From the yield perspective, Australian equities offer better dividend yields compared to government bonds and bank deposit rates. With the recovery under way, the yield buffer itself should encourage investors to increase their positions in the equity market.

Meanwhile, Australia's early success in bringing down COVID-19 infection rates and a potential ahead-of-the-curve recovery should also lure some global investors back to Australia's stock markets. Abundant liquidity with a forthcoming expansion of QE from the RBA should encourage more inflows into equities from domestic players.

Besides, the economic recovery should boost a further rotation from defensive sectors to cyclical sectors like financials and industrials. The upturn of the business cycle should brighten earnings prospects for banks and lift commodity demand, which is favourable for mining companies. Given that Australian equity indices are heavily weighted with bank and mining stocks, we expect more upside for Australian equities.

The yield curve steepens on the back of a better economic outlook



Source: Bloomberg

LatAm

Outlook

- LatAm economies are expected to rebound in 2021, but the recovery is still fragile due to uncertainty on many levels
- Chile and Brazil should recover faster but idiosyncratic problems may impact confidence, delaying economic growth
- Inflation should remain within central banks' targets as the output gap and unemployment remain high

Implications

- Central banks should maintain their expansive monetary policies, while fiscal space is more limited
- Fiscal consolidation should boost the equity market
- A rotation process, depreciation of the US dollar and higher commodity prices should support financial markets

Risks

- Multiple political events increase uncertainty, undermine confidence, and impact capital inflows
- Fiscal deterioration leads to currency depreciation, increasing inflation and interest rates
- Breach of the fiscal rule in Brazil undermines investor confidence and increases volatility

Brazil: fiscal austerity is the key to restoring confidence in domestic assets

The Brazilian government has implemented one of the largest fiscal stimulus packages amongst emerging economies, accounting for 8.3% of GDP and slowing the fall in economic activity due to the pandemic. The emergency aid that benefited more than 60 million households has boosted consumption, with retail sales already showing growth over twelve months and manufacturing surveys reaching all-time highs. However, this recovery has not been homogeneous, and other sectors have not demonstrated such rapid recoveries. In particular, services, although recovering, remain below pre COVID-19 levels.

We expect the recovery to continue in 2021 with economic growth of 3.3% supported by accommodative monetary policy, the external sector, improved sentiment, and some improvement in the labour market. Moreover, the service sector, one of the sectors most affected by the pandemic, should also eventually begin to support economic activity. We see an upside risk to economic growth if political polarisation diminishes and accelerates the reform agenda and the privatisation process, allowing for a fiscal consolidation.

The rise in fiscal expenditures combined with lower tax revenues due to both the economic contraction and pandemic-related tax relief have led to significant increases in the fiscal deficit and public debt ratios. Furthermore, the pressure to maintain some aid programs related to COVID-19 for an extended period as well as the government's internal disagreements regarding fiscal management have increased uncertainty regarding its willingness to respect the fiscal rule and the expenditure ceiling, leading to a currency depreciation and rising volatility in financial markets. We expect that Brazil should restore its fiscal rule next year, but pressure to exceed the spending ceiling will be present. The situation is still uncertain, given that the government has not established how it will finance its social program in 2021. The reform process should also continue in 2021, but at a slow pace, as the government reaches agreements with the centre parties to approve and advance the reforms in Congress.

While we have seen an acceleration in inflation in recent months, most of the factors that have driven it are cyclical, and their impact should be transitory. Although inflation could be above target during the first part of 2021, we estimate that these pressures should diminish in H2 2021. Considering the output gap, the expected appreciation of the BRL and well-anchored inflation expectations, inflation could converge below target, closing the year at 3.2%. We expect that the Central Bank of Brazil (BCB) should maintain the monetary stimulus for a prolonged period. However, the BCB could begin to normalise the Selic rate during Q4 2021 to protect the lower inflation target for 2022 but keep rates at expansionary levels. However, a faster normalisation could occur if the fiscal situation deteriorates or inflation expectations become unanchored.

Chile: positioned to have one of the highest economic growth rates in the region in 2021, but medium-term prospects are uncertain

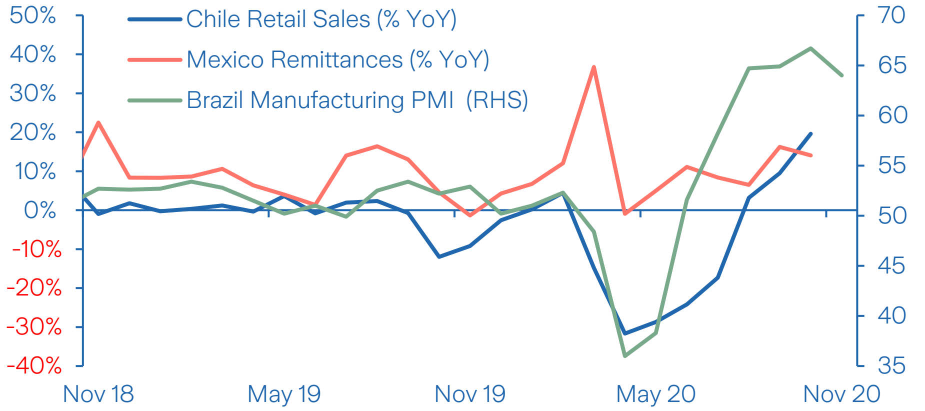
Fiscal space and an ultra-expansive monetary policy have allowed the economy to weather the pandemic better than other countries in the region during 2020. We forecast GDP growth of 4.2% in 2021. Private consumption should continue to recover—thanks to an improvement in the labour market, the effects of the fiscal stimulus and the 10% pension fund withdrawal—and should boost the economy in the first quarter of next year. The government has announced a robust infrastructure investment package, which, together with fiscal expenditure continuing to grow at the same rate as in 2020, should contribute to the recovery in 2021.

The low level of public debt and sovereign wealth funds have allowed the government to implement an unprecedented fiscal stimulus. However, public debt-to-GDP has increased significantly, and we expect it to stabilise at ~45% of GDP in the next years.

Price acceleration in recent months could make inflation converge more quickly with the central bank's inflation target, leaving inflation in the upper part of the target range during 2021. Notwithstanding this, we estimate that inflation should fall back to 3% by the end of 2021, allowing the central bank to maintain the MPR at 0.5% during 2021. However, there is still some upside risk to inflation and the central bank may consider modest changes to its forward guidance.

In the coming months, one of Chile's biggest challenges is the overcrowded 2021 electoral calendar, which includes the constituent assembly members' election to draft a new constitution and the presidential election at the end of the year. The constitutional process carries a high level of uncertainty that could keep private investment depressed, slowing down Chile's economic recovery. However, the current institutional framework and elevated quorums required to make significant changes, as well as the understanding that is needed in order to reach an agreement, lead us to believe that the new constitution would not make a substantial difference in the existing market model or add more significant fiscal pressure. Nonetheless, this process could lead to a bigger state and cause volatility in financial markets during 2021, making Chile lose its attractiveness to investors compared to other countries in the region.

The worst is now behind us



Source: Bloomberg

Argentina: the latest economic measures are heading in the right direction, but they are not going to be enough to solve macroeconomic imbalances

The economy should grow 4.7% in 2021, mainly due to a favourable base effect. We also expect investment to increase, helped primarily by public investment, while consumption should take a slower path to recovery.

Because the government did not have the fiscal space, its deficit has been financed through the Central Bank of Argentina (BCRA). Likewise, the sale of dollars to smooth exchange movements has weakened the central bank's foreign currency position, while the gap between the official and unofficial exchange rates has widened.

The latest economic measures will limit fiscal deficit monetisation. However, they are likely to be insufficient as they do not tackle the underlying problems that maintain imbalances and undermine investor confidence.

The substantial increase in the monetary base due to the fiscal deficit's monetisation, the increases in public service tariffs, the partial relaxation of administered prices and the exchange rate depreciation estimated for 2021 should continue to accelerate inflation, which we expect to reach 50% by the end of 2021. As result, the BCRA should continue raising interest rates, consistent with the most orthodox and market-friendly macroeconomic policies implemented in recent times.

The mid-term election has the potential to limit the authorities' willingness to continue with necessary structural reforms as some of the measures will be disliked. We anticipate exchange rate adjustments, along with other reforms, to be carried out sooner rather than later to mitigate the potential negative impact that they could have on the government's popularity. Nonetheless, the government may lose control of Congress in the next election due to the weak economic situation and the handling of the pandemic, which could be taken positively from a market perspective by investors.

It is very likely that the government will request an extended facility from the IMF. If granted the IMF will likely require that the government take steps to correct fiscal and monetary imbalances, so the measures announced in recent weeks may ease the way for an agreement to be reached with the IMF, which we expect to materialize in H1 2021.

Mexico: economic recovery in 2021 would be supported by the external sector, but medium-term structural challenges remain

We forecast economic growth of 3.2% for Mexico in 2021, driven by an improvement in external economic conditions, particularly an increase in exports due to the US's better outlook and the support that foreign remittances should continue to add to private consumption. The lack of fiscal stimulus has not helped the economy, which saw a significant contraction in domestic demand. The manufacturing sector is recovering slower than in the rest of the region. Although we do not see fiscal and current account imbalances, the growing misallocation of resources and recurring financial assistance demands from state-owned companies (particularly Pemex) may produce some fiscal pressures in the coming years.

The mid-term elections could mark a turning point in Mexico's economic outlook. It is still unclear if Morena, the party of President Lopez Obrador (AMLO), would maintain its majority in Congress. A setback for AMLO could mean greater openness towards more pro-market measures that could boost investment in the medium term, thus improving the outlook for the Mexican economy in the coming years.

We see the large output gap contributing to a decline in inflation, which should end 2021 at 3.5%. This should allow the central bank to continue easing monetary policy and cut the monetary policy rate another 25bps, keeping it at 4% in 2021.

The performance gap between the MSCI LatAm Index and MSCI EM Index should narrow

Corporate earnings are expected to recover in 2021, but depending on the country/sector, a full recovery is not expected before 2022-23. Upward earnings revisions should support valuations that may currently look somewhat expensive. However, the bulk of higher multiples in the region is explained by Brazil, and compared to other EMs, LatAm is trading at a discount. The region is ending 2020 on a positive note as earnings revisions have been better over the last months than in EMs globally.

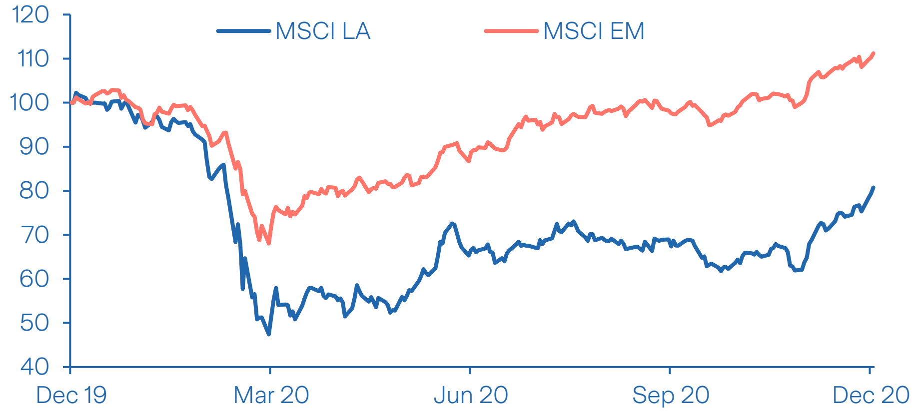
The continuation of the reform agenda and lower political risks compared to other countries in the region make us more positive on Brazil within LatAm. However, fiscal consolidation is key to our view.

In Mexico, greater exposure to external factors has allowed for a decorrelation between economic activity and company earnings that should continue to benefit the equity market.

Although Chile has one of the highest regional economic growth forecasts for 2021 and valuations continue to be favourable in relative terms, the political uncertainty due to the constitutional process should limit upside potential.

The expected rotation from growth to value, the depreciation of the dollar and the increase in commodity prices should support LatAm's financial markets, and subsequently the region's equity markets. As a result, the performance gap between the MSCI LatAm Index and MSCI Emerging Market Index could tighten in 2021.

The gap between LatAm and other EMs should diminish



Source: Bloomberg, stock indices rebased

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