2021: gotta have faith – in low discount rates

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- As the huge and synchronised shock to economic activity from Covid-19 was met with an equally vast and synchronous policy response, we, as most others, marked sharply lower our expectations for economic and corporate earnings growth in 2020.

- Three developments have since tilted the balance once more, this time in favour of select cyclicality within a more neutral risk budget: a relatively favourable US election outcome; a far greater number of meaningfully more efficacious vaccines for Covid-19 than expected; and shallower 2020 contractions than feared, which has led to more V-shaped forecasts for economic and earnings growth.

- Our focus has been on building exposures in Japanese and emerging Asian equities, held together with US equities. We also continue to like credit markets, but as spreads have normalised we are adding our incremental pound or dollar to higher-yielding credit that should also benefit from the better cyclical picture, in addition to continued ultra-easy policy. These are areas where we expect the best risk-adjusted returns to come from over the next 12-18 months.

- Columbia Threadneedle's central forecasts are for a ceiling of 2% on 30-year US yields, and 1% for 10-year yields, which should create fertile conditions for more persistent risk rallies.

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Both financial markets, and us, have come a long way since the dark days of spring to the (unseasonally) brighter days of winter. Back in March, as the huge and synchronised shock to economic activity from Covid-19[1] was met with an equally vast and synchronous policy response, we, as most others, marked sharply lower our expectations for economic and corporate earnings growth in 2020.

Stimulus notwithstanding, the short-term shock from sudden stops to economic activity was set to be enormous. But we also raised considerably our exposure to quality risk assets across multi-asset funds, which we held on to until late summer, locking in super-normal profits in areas that appeared to be both severely dislocated[2] and set to benefit most from ultra-easy policies, like high-quality investment grade bonds and higher-quality equities.

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Fast-forward to the brighter days of November and three developments have tilted the balance once more, but this time in favour of select cyclicality within a more neutral risk budget. First, a relatively favourable US election outcome has removed tail risks and brought with it some unanticipated fiscal reprieve. Second, a far greater number of meaningfully more efficacious vaccines for Covid-19 than we and most others expected. And last but not least, shallower 2020 contractions than feared, which has led to more V-shaped forecasts for economic and earnings growth in areas like the US and Japan, with Asian emerging markets notably shrugging off the disruption from Covid-19. While this last feature may matter less for forward-looking markets, which have also looked through second waves of the virus and the greater associated stringency, it does set the foundations for a more sustainable recovery.

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On the one hand, the combination of US quality growth and Asian quality cyclicals allows us to capture growing profits over the next couple of years. This is particularly striking in operationally levered Asia, where earnings are expected to grow by a compounded 10% in Japan and more than 17% in EM Asia between this year and 2022 – and for the same forward multiple as the UK, where earnings are expected to grow by 0.25%. Asia also has the added kicker of easy domestic monetary conditions: China's credit impulse, for example, just surpassed its 2016 high and is a whisker away from 2012/13.[3]

[1] For instance: purchaser manager indices fell to levels we have never seen before, including in 2008-2009; the US unemployment rate surged from a 50-year low to a nearly 80-year high in just two months; and the UK economy is poised to shrink by the most in 300 years in 2020.
[2] In March, global IG bonds were compensating investors for 50 times the historical default rate, while also being very direct beneficiaries of the alphabet soup of US, UK and European monetary policies. Many equity indices were priced at, or close to, book value, stripped down to the realisable value of assets in the event of liquidation.
[3] Bloomberg/Columbia Threadneedle analysis, December 2020.

On the other hand, valuations are full, with 40% of asset markets currently trading more than one sigma above their long-term averages[4] – a chief reason why we are not as positive on returns to risk as we were earlier this year. Equity index valuations are sky-high against their own histories on a range of metrics, with the yield-to worst on high-yield corporate bonds close to all-time lows. Put differently, companies' cost of finance has rarely looked so good.

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Columbia Threadneedle's central forecasts are for a ceiling of 2% on 30-year US yields, and 1% for 10-year yields, which should create fertile conditions for more persistent risk rallies. By equal measure, an unpinning of longer-dated yields is among the greatest risks.

Figure 1: Asset allocation snapshot with key recent changes highlighted

	Strongly Dislike	Dislike	Neutral	Favour	Strongly Favour
Asset Allocation		Government Index-linked	Cash Commodities Property	Credit Equities	
Equity Region		**UK** **↓ 21-July**	Emerging Markets Europe ex-UK	**Japan** **↑ 17-Nov** **US** **↑ 21-Apr**	**Asia ex-Japan** **↑ 10-Nov**
Bond – FX Hedged		Japan	Germany US UK	EM Local Australia Nordic	
Credit			EMD	**Corporate IG** **↓ 27-Aug** **Corporate HY** **↑ 21-Jul**	
FX		USD	AUD Nordics GBP EUR	JPY	
Risk appetite			**X** **↓ 30-Jun**		

Source: Columbia Threadneedle Investments, 8 December 2020.

[4] Columbia Threadneedle analysis, December 2020.

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