CHIEF INVESTMENT OFFICE

Investment Insights

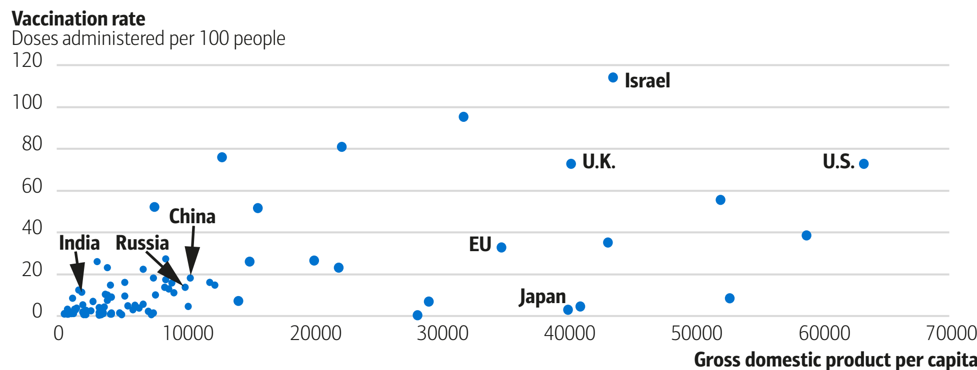
The Great Reopening

June 2021

The past year has been a historic period for global investors. Not only have they faced a once-in-a-century public health crisis, but also in 2020 the deepest economic contraction and most rapid bear market in post-war World War II history. Now more than 12 months since widespread shutdowns first brought large segments of the global economy to a virtual standstill, the world is gradually normalizing from the coronavirus pandemic. The recovery has been enabled by a combination of behavioral adaptation and public policy. Physical distancing and an offline-to-online shift in retail, business services, education and other day-to-day interactions have allowed economic activity to proceed with limited person-to-person contact. Individual case monitoring through testing and contact tracing has allowed public health professionals to identify and isolate at-risk individuals. Monetary and fiscal stimulus has boosted market liquidity, supported asset prices and replaced income that was lost during the recession. And most recently, the approval and rollout of new coronavirus vaccines developed by a series of leading pharmaceutical firms has begun to raise immunity levels within individual countries around the world. Vaccine distribution has been the final and most important step in responding to the public health crisis. And widespread global inoculation will ultimately be the most effective means of emerging from the pandemic on a sustained basis.

Well over a billion vaccine doses have now been distributed worldwide since last December. But the global rollout has so far been uneven, with higher-income countries generally reaching a much greater share of their populations (where this has been required by high case rates) than lower-income countries. The U.S., for example, had administered just over 70 doses per 100 people at the end of April, compared to just 13 doses per 100 residents in Russia and 11 per 100 in India (Exhibit 1).

Exhibit 1: Global Vaccination Rollout Has Been Slowest in Lower Income Countries.



Sources: International Monetary Fund, Johns Hopkins, Bloomberg. Data as of May 13,2021. Doses administered across 87 economies.

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CIO PERSPECTIVE

As we move further into 2021, we expect the "Great Reopening" should extend the market advance and see new investment themes develop as public policy and behavioral shifts by consumers and business help drive an ongoing normalization in economic activity. For investor allocations, in our opinion, this argues for an ongoing emphasis on stocks over bonds. And though cyclical sectors may remain in favor during the process of recovery and reflation, structural expansion in the digital economy should remain a longer-term tailwind for growth sectors and technology-oriented regions such as the U.S. and Asia. Investors should also look to gain exposure to emergent global themes such as climate change mitigation and decarbonization which are likely to gain more traction over the years ahead.

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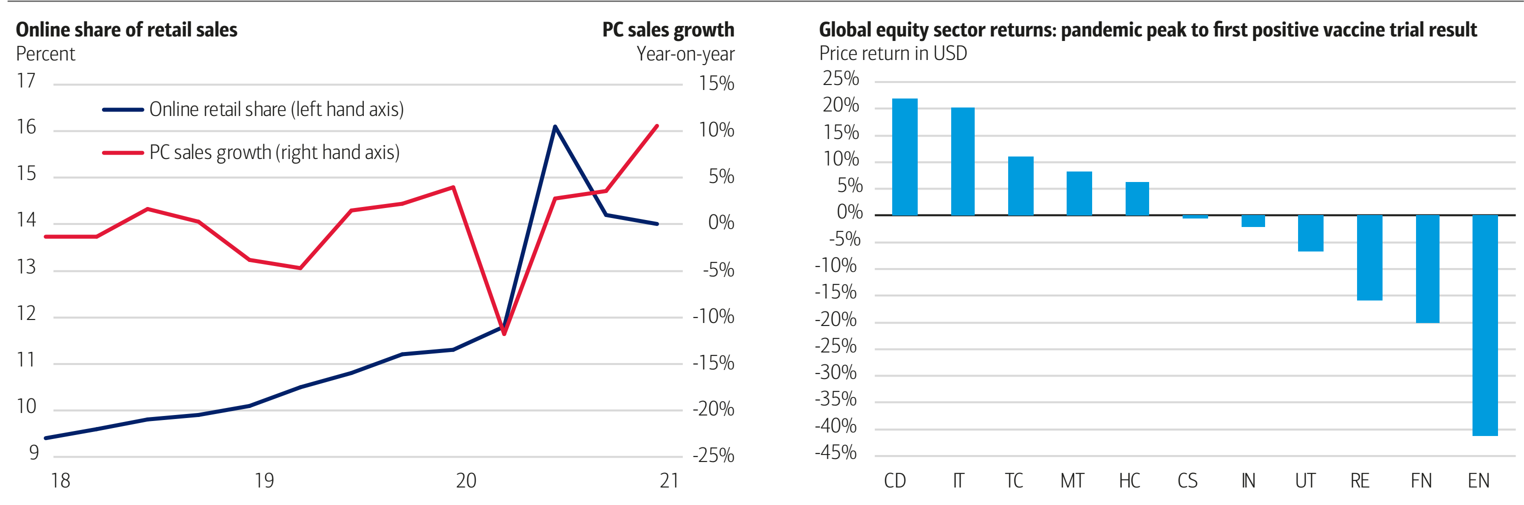
But even with payment and infrastructure constraints impeding vaccine delivery in much of the emerging world, supply surpluses in a number of individual markets and an increase in funding for the World Health Organization Covid-19 Vaccines Global Access (COVAX) program are expected to make close to two billion more doses available to middle- and lower-income countries by the end of 2021. As a greater share of the global population receive vaccinations, the process of economic reopening both within countries and across borders is likely to gather pace.

From retreat to recovery

Much of the pandemic period in 2020 was characterized by government-mandated shutdowns in high-contact and group-oriented services, giving way to an acceleration in virtual activity. The online share of U.S. retail sales spiked to 16.1% in the second quarter of 2020 from 11.8% in the first quarter as households were forced to make more of their purchases over the internet across product groups such as appliances, furniture and clothing. Connected device sales also surged in 2020. Global Personal Computer (PC) shipments reached a six-year high of 79 million units and a year-on-year growth rate of 10.6% at the end of the year in response to the shift toward remote work, distance learning and digital media consumption for entertainment. Related sectors within the equity market outperformed, with Consumer Discretionary, Information Technology and Communication Services delivering the strongest returns between the mid-February peak and the early-November release of the first positive vaccine results (Exhibit 2).

Exhibit 2: Digital Activity Acceleration Driven By The Pandemic.



Sources: Census Bureau, Statista, MSCI, Bloomberg. Data as of Q4 2020. U.S. online retail sales share. Global PC shipment growth. Sector returns based on MSCI All-Country World Index from February 12, 2020 to November 6, 2020. **CD** = Consumer Discretionary, **IT** = Information Technology, **TC** = Communication Services, **MT** = Materials, **HC** = Healthcare, **CS** = Consumer Staples, **IN** = Industrials, **UT** = Utilities, **RE** = Real Estate, **FN** = Financials, **EN** = Energy. Short term shown to illustrate more recent trend. Performance results are extremely short term and do not provide an adequate basis for evaluating performance potential over varying market conditions or economic cycles. Performance during periods of exceptional market conditions should not be expected to be repeated in a normal market environment. Past performance is no guarantee of future results.
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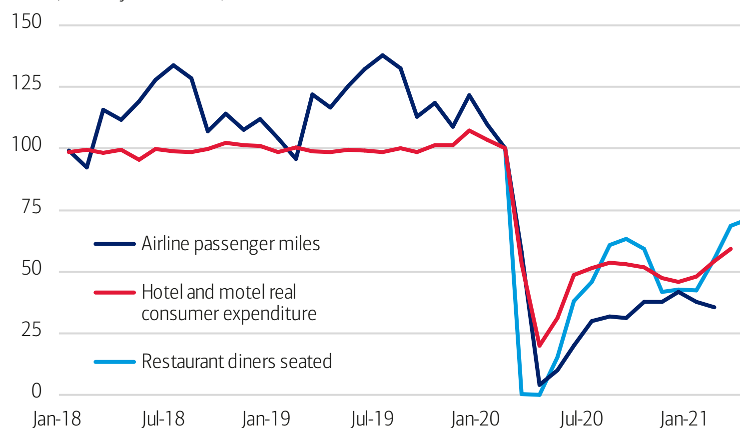
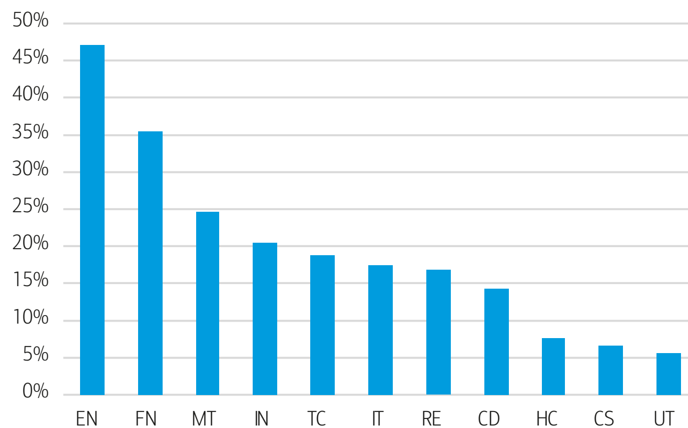
Even as economies around the world begin to reopen, we still look for growth in these areas to persist, and leading makers of connected devices have continued to report record sales in the early stages of 2021. Rapid expansion in the digital economy predated the pandemic, and the legacy of the crisis should only reinforce this trend as individuals and organizations accept the use of virtual tools for a greater share of personal and business activity including internet retail, online gaming, video streaming, telehealth and enterprise cloud processing.

In the nearer term however, we expect the recovery to be led by strength in more traditional services categories. After last year's collapse, in-person activity has considerable room to rise as shutdown measures are reversed and more businesses start to operate at higher capacity levels within the travel, leisure and hospitality segments that have been held back the most since the start of the pandemic. Airline passenger miles, outlays on hotel accommodation and restaurant dining are still one-third or more below their pre-pandemic levels of February 2020. And as economies around the world reopen, the potential remains for much higher rates of individual participation in these areas. The equity market has already begun to reflect this projected improvement with a rotation into cyclical and Value sectors that began last November as the vaccines first emerged. Energy, Financials, Materials and Industrials have led the global market over this period, and we would expect the advance in these sectors to continue as the demand recovery across activities that were hardest hit by the shutdowns extends further into 2021 and beyond (Exhibit 3).

Exhibit 3: In-person Service Activity To Strengthen As Demand Recovers In Areas Such As Travel, Leisure And Hospitality.





Sources: Department of Transportation, Bureau of Economic Analysis, OpenTable, Bloomberg. Data as of April 2021. Domestic and international passenger miles for U.S. airlines. Real U.S. consumer expenditure on hotels and motels. Global seated restaurant diners from online, phone and walk-in reservations. Sector returns based on MSCI All-Country World Index from November 6, 2020 to April 30, 2021. **CD** = Consumer Discretionary, **IT** = Information Technology, **TC** = Communication Services, **MT** = Materials, **HC** = Healthcare, **CS** = Consumer Staples, **IN** = Industrials, **UT** = Utilities, **RE** = Real Estate, **FN** = Financials, **EN** = Energy. Short term shown to illustrate more recent trend. Performance results are extremely short term and do not provide an adequate basis for evaluating performance potential over varying market conditions or economic cycles. Performance during periods of exceptional market conditions should not be expected to be repeated in a normal market environment. Past performance is no guarantee of future results.
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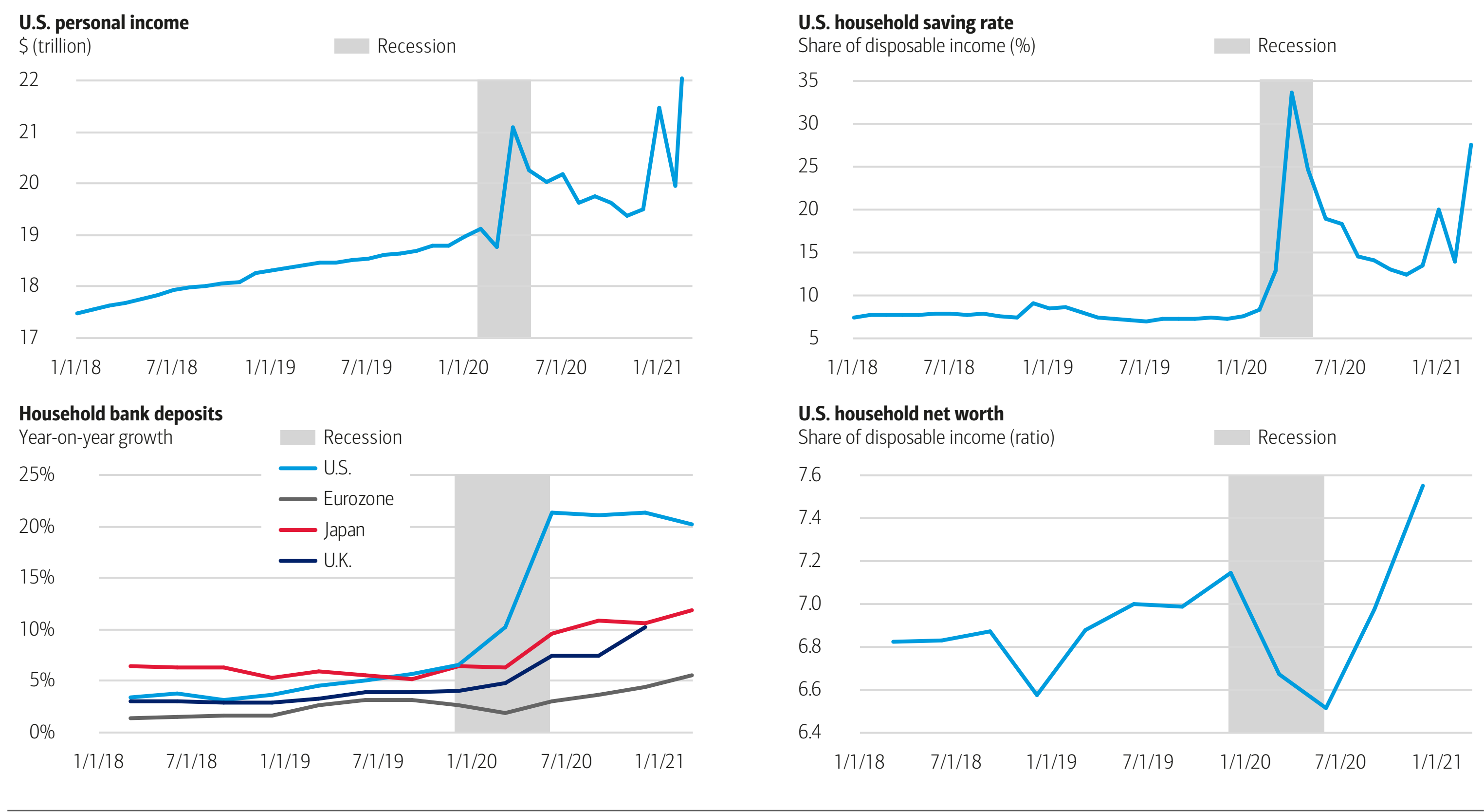
A consumer-fueled expansion

The rebound in these most depressed segments of the service economy should be further fueled by the strength of household finances. The scale of government intervention used to offset the economic effect of the outbreak meant that U.S. household incomes actually rose during last year's recession, unlike in past downturns in which falling employment and softening wages have typically made for a decline in aggregate personal income. Wages and salaries fell sharply in the early stages of the pandemic, but this was more than offset by a doubling in transfer payments in March and April which allowed total personal income to increase by over 10% during that period. The extraordinary levels of government support also helped to boost the saving rate, which peaked at 33.7% of disposable income and still stood at over 25% in the latest release for this past March–higher than any level previously recorded outside the current crisis. The pattern has been similar across the major developed markets, with household bank deposits growing at a double-digit pace in Japan and parts of Europe

as well as in the U.S. over the past year. At the same time, other significant portions of household wealth have also increased. Aggregate U.S. house prices as measured by the S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index rose by 10.2% in 2020 as mortgage rates fell and a decline in new listings contributed to a reduction in inventory. And households have also benefited from exposure to a rising equity market over the past 12-plus months. Both home prices and stock prices now stand well above their pre-pandemic levels of early 2020, driving net worth as a share of disposable income to record highs at the end of last year (Exhibit 4).

Exhibit 4: Household Income And Balance Sheet Strength Are Major Supports For Economic Recovery.



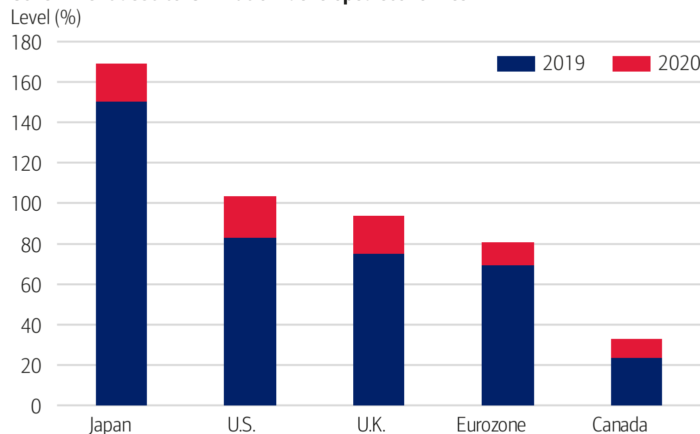
Sources: Bureau of Economic Analysis, Federal Reserve, European Central Bank, Bank of Japan, Office for National Statistics Bloomberg. Data as of March 2021.

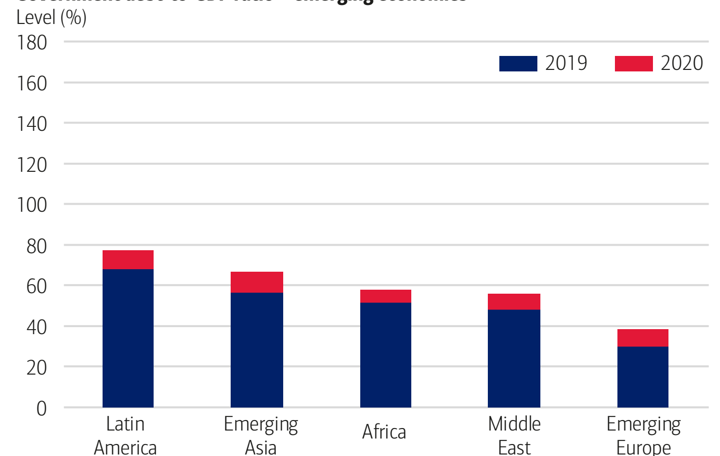
This combination of improving employment and income as economic restrictions are unwound, alongside strong household balance sheets, implies that consumer demand will be highly supportive for the unfolding economic recovery. Consumption is expected to lead a 6.4% surge in U.S. real gross domestic product (GDP) for 2021 on forecasts from the International Monetary Fund (IMF), ahead of a global growth projection of 6.0% for the full year.

Reopening risks: debt and inflation

But even as economic growth will likely continue to improve over the months ahead, new concerns are already developing as the expansion progresses. Public debt levels have exploded globally over the past year as a result of the fiscal response to the crisis, lower tax revenues and the contraction in output. Developed economies registered the largest increases in debt-to-GDP in 2020 at 10 to 20 percentage points across the five largest markets while the major emerging regions saw their debt-to-GDP ratios rise by five to 10 points (Exhibit 5).

Exhibit 5: Government Debt Levels Have Increased Globally During The Pandemic.

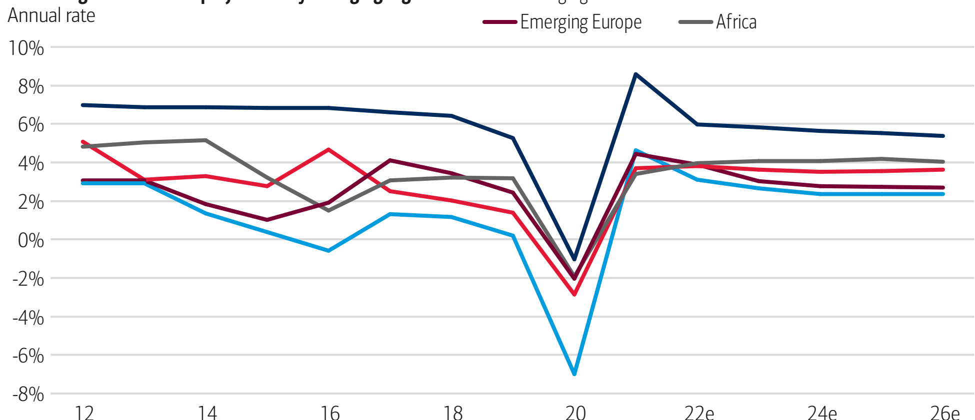




Source: International Monetary Fund. Data as of May 19, 2021.

In the U.S., the Congressional Budget Office projects a further rise in the public debt burden over the next decade from 102.3% of GDP in 2021 to 107.2% in 2031,[1] which would essentially match the levels reached in World War II. And the potential for corporate and capital gains tax increases will represent another growing risk for markets in 2022 should they be enacted next year. But we nonetheless see less cause for concern over the prospective growth in public debt and would expect the coming fiscal expansion to remain manageable. The fundamental U.S. advantages of financial market depth, rule of law, currency convertibility and a dominant role for the dollar in cross-border payments and global reserves mean that the government debt trajectory, all else equal, is unlikely to have any significant implications for the U.S. dollar exchange rate or interest rates. But debt sustainability may be a bigger concern in parts of the emerging world. Alongside current uncertainties over the future course of coronavirus variants and the pace of local vaccination rollouts, emerging economy growth projections outside emerging Asia over the next five years remain relatively weak (Exhibit 6), which will make current debt burdens harder to service.

Exhibit 6: Weaker Projected Growth Rates Outside Asia A Risk For Debt Sustainability In Many Low-income Emerging Economies.



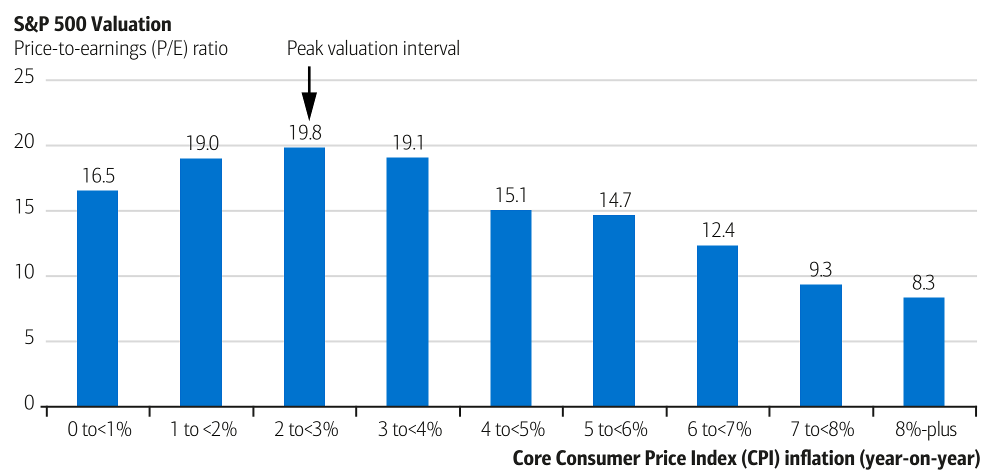
e=Estimate. Source: International Monetary Fund. Data as of May 19, 2021.

[1] Latest Congressional Budget Office 10-year budget projections do not include effects of H.R. 1319, American Rescue Plan, proposed $2.3 trillion American Jobs Plan or proposed $1.8 trillion American Families Plan.

Credit ratings will also play a part. Since March of 2020, rating agency Standard & Poor's has downgraded 28 out of 140 emerging economies, with all but two of these moves occurring outside the Asia-Pacific region. Limited access to funding should remain a particular challenge for lower-income emerging markets, and many may require financial assistance through programs such as the IMF Debt Service Suspension Initiative. This is a program that was launched last March to allow 73 low-income and lower-middle-income countries to request a pause in debt service payments to G20 creditors. And looking ahead, additional debt sustainability risks may also arise in individual markets where higher inflation pushes local interest rates higher. The result is likely to be bouts of volatility and ongoing trend underperformance in non-Asian emerging markets.

Inflation concerns have already risen in the U.S. due to the demand surge expected to come from higher household income and savings against a backdrop of highly accommodative monetary and fiscal policy, emergent shortages in key manufacturing inputs such as semiconductors and potential spillovers from rising home prices into shelter costs. Over the past 12 months, this has been reflected in increases for both breakeven rates on Treasury Inflation-Protected Securities (TIPS) and consumer survey measures of inflation expectations. In the near term, we would expect these developments to accompany a continuing move higher in U.S. equities. At this early stage in the cycle, inflation is still rising from low levels, and on a core basis remains within the 2%—3% threshold at which valuations have historically peaked. Only above this level have multiples tended to contract in past cycles (Exhibit 7).

Exhibit 7: Equity Market Valuations Tend To Decline As Inflation Moves To Higher Levels.



Source: Bloomberg. Data as of April 2021. P/E ratios are averages within inflation ranges based on monthly data from January 1958 to April 2021.

This period of reflation should therefore support an ongoing rotation into cyclical and Value sectors such as Industrials, Energy, Financials and Materials, especially as underlying activity levels normalize. And persistent disinflationary pressures from technology and globalization should in our view prevent the type of upward wage-price spiral that led to sustained levels of double-digit inflation in the past. But as we transition into a moderately higher inflation environment, valuation is likely to become a weaker driver of trend returns, which may eventually reduce the pace of the market advance at the index level.

Longer-term market tailwinds and portfolio considerations

We nonetheless look for the longer-term bull market to remain intact. Structural expansion of the digital economy remains a tailwind for growth sectors like Information Technology, Consumer Discretionary and Communication Services. And the broad market advance should also be supported by new investor participation as the large millennial cohort enters its peak earning and investing years while benefiting from a multi-decade

transfer of intergenerational wealth that is expected to stretch into the tens of trillions of dollars. On top of this we see new long-term themes emerging from the legacy of the pandemic and the policy priorities of Western governments. In the U.S., physical and digital infrastructure assets in areas such as transportation, communication, energy and manufacturing could receive a significant boost over the next several years. These categories are the main target of the Biden administration's $2.3 trillion American Jobs Plan, with proposals that may be classified into these groups accounting for roughly two-thirds of the spending program including improvements to highways, bridges and mass transit systems, expansion of high-speed broadband coverage, research and development in critical technologies and upgrades to the power grid (Exhibit 8).

Exhibit 8: Physical And Digital Infrastructure Proposals Under The American Jobs Plan.

Infrastructure Category	$ (Billion)	Key Proposals
Bridges, Highways, Roads	115	Modernize 20,000 miles of highways, roads and streets and repair the worst 10,000 bridges, including funding to improve air quality, limit carbon emissions and reduce congestion.
Mass Transit	85	Upgrade existing systems and help agencies expand to meet rider demand for bus and rail service in communities and neighborhoods across the country.
Rail	80	Address Amtrak repair backlog, improve existing corridors and enhance grant and loan programs that support passenger and freight rail safety, efficiency and electrification.
Electric Vehicles	174	Grant and incentive programs for state and local governments and the private sector to build a national network of 500,000 electric vehicle chargers by 2030.
Airports and Waterways	42	Upgrades to ensure safe and efficient air travel, and a new program to support terminal renovations. Mitigate the cumulative impact of air pollution on neighborhoods near ports.
Infrastructure Resilience	50	Invest in protection from extreme wildfires, coastal resilience and hurricanes, with support for agricultural resources management and climate-smart technologies.
Water Infrastructure	111	Upgrade and modernize drinking water, wastewater and stormwater systems, tackle new contaminants, and support clean water infrastructure across rural America.
High-Speed Broadband	100	Build "future-proof" broadband infrastructure in underserved areas to reach 100% high-speed broadband coverage.
Grid Modernization	100	Create a cleaner, more resilient grid on the path to achieving 100% carbon-free electricity by 2035.
Housing Retrofits	213	Produce, preserve and retrofit more than a million affordable, energy-efficient housing units through targeted tax credits, formula funding, grants and rental assistance.
Technology Research & Development	180	Advance U.S. leadership in critical technologies such as artificial intelligence and biotechnology.
Next-Generation Manufacturing	300	Strengthen manufacturing supply chains for critical goods, jumpstart clean energy manufacturing and increase access to capital for domestic manufacturers.

Sources: Whitehouse.gov, Chief Investment Office. Data as of May 19, 2021.

An emphasis on clean technology also demonstrates the focus on climate change mitigation from the new U.S. administration, particularly ahead of the first progress review on national emissions targets under the Paris Agreement framework to be held in November at the next United Nations climate conference. Indeed, we expect climate change to remain a major global theme over the coming years as all signatories to the Paris Agreement pursue their national decarbonization goals. And similar to the American Jobs Plan, the European Union Recovery and Resilience Facility agreed in 2020, and set to be launched in the second half of this year, also aims to make large-scale investments in digital infrastructure and the green transition over the next several years. Both programs will take on particular importance over the decade ahead as strategic competition between the U.S. and China intensifies. China is expected to surpass the U.S. in economic size by the end of the 2020s as its technological capability continues to improve. And as the U.S. and Europe look to enhance their competitiveness, new investment is likely to support related market segments such as semiconductors, networking equipment, advanced materials and component suppliers for electric vehicles, solar energy, wind power and battery storage.

The coronavirus pandemic began with a great global separation as economies around the world were forced to shut down, move online and mount their own individual responses to the crisis. But as we move further into 2021, we expect the "Great Reopening" should extend the market advance and see new investment themes develop as public policy and behavioral shifts by consumers and business help drive an ongoing normalization in economic activity. For investor allocations, in our opinion, this argues for an ongoing emphasis on stocks over bonds. And though cyclical sectors may remain in favor during the process of recovery and reflation, structural expansion in the digital economy should remain a longer-term tailwind for growth sectors and technology-oriented regions such as the U.S. and Asia. Investors should also look to gain exposure to emergent global themes such as climate change mitigation and decarbonization which are likely to gain more traction over the years ahead.

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S&P 500 Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index seeks to measures the value of residential real estate in 20 major U.S. metropolitan areas: Atlanta, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Detroit, Las Vegas, Los Angeles, Miami, Minneapolis, New York, Phoenix, Portland, San Diego, San Francisco, Seattle, Tampa and Washington, D.C.

MSCI All Country World Index (ACWI) is a stock index designed to track broad global equity-market performance.

Consumer Price Index (CPI) measures the average change in prices over time that consumers pay for a basket of goods and services.

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