THE TUNES OF 2021: YEAR AHEAD OUTLOOK

FICC Strategy | Economics | Equity Research

November 2020

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Economics: Hit me with your best shot

Avery Shenfeld

We enter 2021 with one overriding challenge. In turn, that leaves our best shot at exiting the coming year with the strong momentum we expect resting on getting hit with your best shot – a vaccine (or vaccines) with sufficient production capacity, efficacy and public acceptance to achieve herd immunity against Covid-19. Mass vaccination around mid-2021 has been our assumed trajectory for the last several months, and it's still looking to be on track.

That will see diminishing Covid-19 case counts in the latter part of the year, and the early stages of a revival in services consumption, although a full return to a mask-free life as we knew it will be a 2022 story.

In the near term, we'll have to get through a few softer quarters (Table 1) which could include some individual negative months for GDP. The second wave of the virus is the most obvious factor ailing growth as the weather turns colder. Research comparing US states has shown the economic response isn't dictated solely by government mandated shutdowns: consumers' hesitancy to venture out as news on the illness worsens is, if anything, a greater influence.

US growth could be challenged in the near term as the CARES Act stimulus fades out before a replacement second package is enacted, although we do expect a compromise bill to emerge in either December or early after inauguration. In both the US and Canada, after Q3's sharp rebound, a greater share of the missing GDP and employment is concentrated in sectors where social distancing issues put major constraints on any pre-vaccine recovery.

A strong second half, and the easy base of comparison of 2020 output, will see most countries record impressive annual growth tallies next year (Table 2). Bond yields will climb as investors anticipate even better days ahead, and central banks will be less aggressive in leaning against such a move with QE as jobless rates ease.

But note that in Canada, the US and Europe, we'll have essentially missed two years of trend growth. That makes it an easy call that the Fed and the Bank of Canada will be on hold in 2021, and likely 2022 as well. Headline inflation will pop above 2% as we lap months with very cheap gasoline in 2020, but the Fed is now tolerant of temporary overshoots, and the Bank of Canada's core measures aren't showing much sensitivity these days to a widening or narrowing output gap. Both can be patient.

Where we differ from the Fed lies way out in 2023, by which time we expect to see enough progress to prompt the first, modest rate hikes (a year ahead of current Fed guidance), with the Bank of Canada following later that year so as to avoid pushing the loonie still stronger.

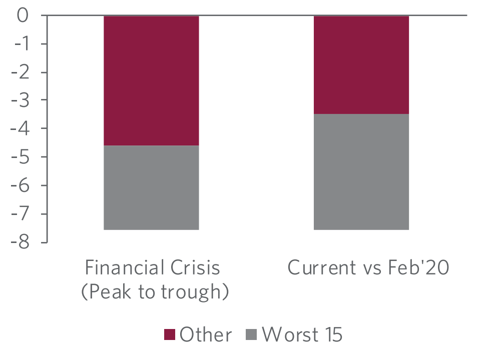
We're more optimistic than the central bankers on how quickly demand will recover once Covid fades away. Relative to past deep recessions, this one actually has a few salient features that should speed up post-vaccine progress. First, being centered on services is a plus. Goods sector recessions involve permanent factory closures, and rust belt economies take a long time to attract the large scale capital spending needed to fill the void. It's a much quicker process to open a new restaurant in a vacant storefront, or reopen a still-standing concert hall.

Second, many of the jobs lost have been in lower-wage service occupations (waiters, hotel cleaning staff etc.,) where skills shortages shouldn't be a problem. Our 2022 growth rate exceeds the Bank of Canada's outlook in part because, other than in the energy sector, we don't think there has been as large a permanent dent to productive capacity. If anything, we'll have excess capacity in the key asset for many services, commercial real estate space, although related construction is one area where sluggish capital spending will outlast the pandemic.

Finally, assuming the US delivers a second stimulus bill, both there and in Canada we've kept households sufficiently afloat that a collapse in spending by the ranks of the unemployed hasn't multiplied to as many job losses in sectors that aren't hit by the immediate shock, relative to what we some past downturns. The 15 US sectors that have seen the deepest job losses now account for a larger share of the missing employment than was the case during the 2008 recession (Chart 1). Fixing what's holding them back – the pandemic – will therefore be a fix for the majority of the missing economic activity.

Indeed, higher income earners, who have mostly been protected from job losses by working from home or in the goods sector, have been accumulating savings while they've cancelled vacations and other services spending. They're dying to attend a crowded sports event, but just aren't willing to risk dying to do so. So they represent enormous pent-up demand lying in wait for the period in which we've been hit with that best shot.

Chart 1: % Decline in US private sector payrolls contribution of worst performing 15 sectors vs others



Source: BLS, CIBC.

Table 1: Real GDP growth, Y/Y % change

Region	2017A	2018A	2019A	2020F	2021F	2022F
World[1]	3.8	3.5	2.8	-3.4	5.1	4.6
US	2.3	3.0	2.2	-3.7	3.4	4.3
Canada	3.2	2.0	1.7	-5.5	4.1	4.8
Euroland	2.4	1.9	1.3	-7.0	4.5	3.5
UK	1.7	1.3	1.3	-10.7	6.1	5.5
Australia	2.4	2.8	1.8	-3.5	3.4	3.2
Japan	2.2	0.3	0.7	-5.5	3.1	2.2
China	6.9	6.7	6.1	1.6	8.8	5.9

Source: IMF, CIBC.

Table 2: Economic update

Canada	21Q1F	21Q2F	21Q3F	21Q4F	2019A	2020F	2021F	2022F
Real GDP Growth (AR)	2.1	2.5	4.3	6.2	1.7	-5.5	4.1	4.8
Real Final Domestic Demand (AR)	1.2	4.2	5.0	6.7	1.3	-6.2	3.5	5.2
Household Consumption (AR)	0.5	4.3	5.4	7.8	1.6	-8.3	3.3	6.1
All Items CPI Inflation (Y/Y)	0.8	2.2	2.0	2.0	1.9	0.7	1.7	1.9
Unemployment Rate (%)	8.8	8.5	8.2	7.6	5.7	9.6	8.3	6.8

U.S.	21Q1F	21Q2F	21Q3F	21Q4F	2019A	2020F	2021F	2022F
Real GDP Growth (AR)	1.1	2.5	6.0	6.6	2.2	-3.7	3.4	4.3
Real Final Sales (AR)	1.0	2.7	4.9	6.5	2.2	-3.0	2.8	4.3
All Items CPI Inflation (Y/Y)	1.6	2.9	2.4	2.6	1.8	1.2	2.4	2.3
Core CPI Inflation (Y/Y)	1.7	2.7	2.2	2.3	2.2	1.7	2.2	2.1
Unemployment Rate (%)	6.9	6.7	6.3	5.8	3.7	8.2	6.5	4.5

Source: CIBC World Markets Economics, November 19, 2020.

[1] At Purchasing Power Parity.

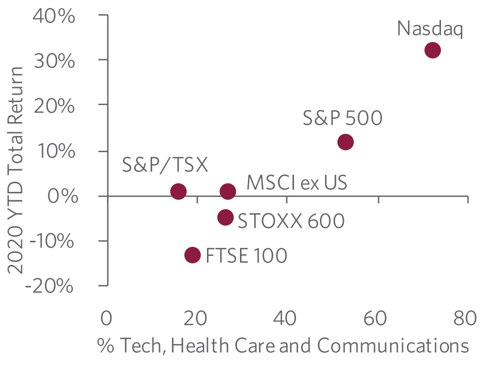
Equities: Nothing compares 2 u

Ian de Verteuil and Shaz Merwat

If there is one overwhelming takeaway for equities in 2020, it's that the stock market is not the economy. While economies are likely still years from fully recovering from the coronavirus pandemic, equities have largely already come full circle. As seen in Chart 1, the MSCI ex-U.S. stock index is flat in 2020 YTD, while U.S. equities are meaningfully up on the year. As is obvious, the variance largely reflects the importance of sectors which have benefitted from the virus.

The speed of the recovery took us by surprise, as aggressive monetary policy moves boosted valuations so as to mitigate what turned out to be only modest medium-term earnings declines. In Q3 of 2020, S&P 500 earnings were down less than 10% Y/Y – a remarkable achievement. The second wave has proven to be more pervasive than the first, but governments have resisted full lockdowns. In addition, news of early successes around vaccines coupled with additional rounds of stimulus (hopefully), means equities likely could have already seen the worst of earnings declines. This positions stocks well for 2021.

Chart 1: Equity total returns, 2020 YTD



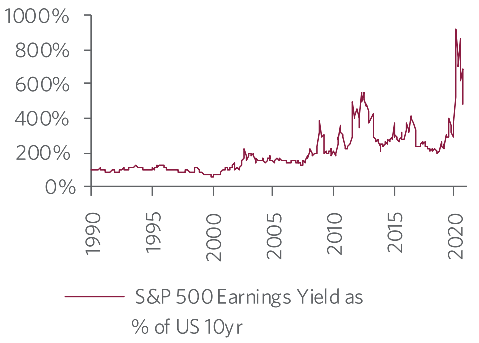
Source: Bloomberg and CIBC.

Are stocks expensive? Absolutely yes, relatively no

Resilient earnings coupled with ample liquidity and stimulus from governments has bid up assets, including equities. As of mid-November, the current 1yr forward P/E for the S&P 500 is 22x, relative to its 30yr average of 16x.

From this standpoint, equities look expensive. However, on a relative yield basis, equities look very appealing. In Chart 2, we chart the S&P 500 forward earnings yield (inverse of forward P/E ratio), relative to the U.S. 10yr Treasury yield. Pre-Financial Crisis, this relationship was largely around 100% but with the subsequent rounds of Quantitative Easing over the last decade, the 30yr average has trended to 2:1. Current levels are almost 500%, or 2.5x the historical average.

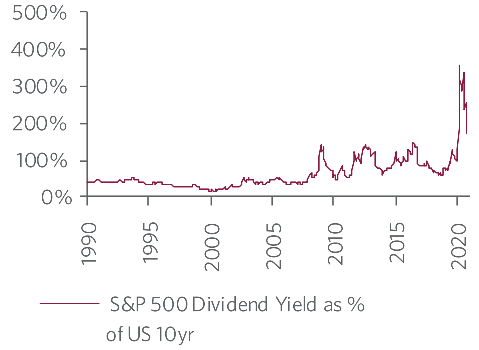
Chart 2: S&P 500 relative earnings yield



Source: Bloomberg and CIBC.

While reported earnings have beaten analyst estimates thus far, there is still risk to 2021 earnings estimates as the second wave of the coronavirus unfolds. Dividends, while not ever considered "safe", are less volatile than earnings and as such we can also look at relative valuation from a dividend yield perspective. Again, the equity dividend yield relative to the U.S. 10yr yield has also spiked, to about 175%, or almost 3x the long-term average of about 60%, as seen in Chart 3.

Chart 3: S&P 500 relative dividend yield



Source: Bloomberg and CIBC.

Clearly, risk sentiment in 2021 will depend on the path of the coronavirus but earnings visibility has improved as we approach year-end. While some dividend cuts may still be on the cards, we largely believe the overwhelming majority of dividend cuts has likely passed. This argues for reasonable equity performance in 2021.

In this light, we believe Canadian investors are well served owning high-yielding sectors such as Banks, Insurers, Telecommunications and Utilities. Their high-running yield, recent evidence of resilient business models and low historical risk of dividend cuts make them very attractive in this current, uncertain investment climate starved of yield. With that said, we do note the impact of rising rates as a key risk to our equity analysis.

A “spend first, tax later” policy likely under Biden

President-elect Joe Biden’s economic policies in 2021 will be the other key variable for equity performance in 2021. It is unlikely the Democrats take control of the Senate in early 2021, but this remains a possibility. Typical Democratic policies of higher taxes and increased regulation appear to be put to the side, until after the economic effects of the coronavirus has passed. An increase in the corporate tax rate to 28% (from 21% currently and 35% pre-Trump Tax Reform) has been promised, but easier said than done if the GOP hold on in the Senate.

In addition, the President-elect has put forward a US$2 trillion Climate Plan in his first term, which is largely an infrastructure package meant to modernize (and decarbonize) America’s ageing infrastructure. This additional fiscal boost could also bode well for equities, in particular cyclicals such as Industrials, but also for Renewables (Utilities).

It is largely in this vein we believe the push for increased stimulus from the Democrats will be good for equities, and most of their “bad for the market” policies may be stymied by Congress. The alignment of political and central bank interests to rebuild the economy, which was likely to have been the case irrespective of the U.S. election, will continue to drive equities next year.

G-10 FX: The miseducation of the USD

Bipan Rai and Jeremy Stretch

Are we channeling the classic Lauryn Hill album in our write-up for the USD? You bet we are. Any autopsy for the USD this year ought to start with the opening lyrics to "Ex-Factor" (that other classic song from Ms. Hill). Given the risk-off backdrop, the USD should have been an outperformer, but USD bulls were left with nothing more than battle scars.

We all remember the mad scramble for dollars in the midst of the liquidity crunch in March – which somehow led many to expect that the USD would continue to be bid given the uncertain nature of the pandemic and the economic contraction that followed. Instead, the trade-weighted USD dropped by 10+% as it was quicker to react to the themes of yield erosion, increased potential supply, and slowing inward portfolio flows among other factors. Calls have now swung in the other direction with many expecting the greenback to continue to fall while others question its status as a long-term reserve currency.

Our advice to those espousing the latter view is to dial it down a notch. The USD will remain a viable reserve currency over the coming years considering that there is no credible alternative. And while the 'network externalities' advantage of the USD might take a bit of a hit with the possible shift towards central bank digital currencies, we're still years away from that issue.

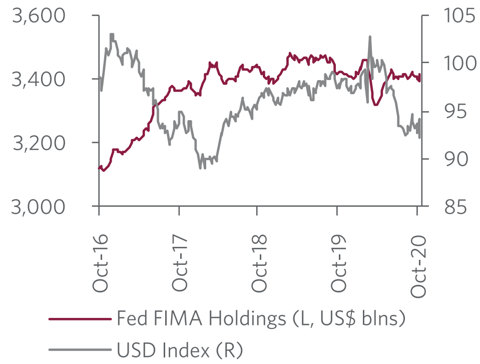
But what about 2021? In our view, the story of the USD will be split into two parts: the first will be 'rangebound and slightly down' against the majors/developed market currencies while the second will about its underperformance against the higher beta / carry EM currencies.

Against the majors, most of the reasons for USD bearishness this year are already in the price. Real and nominal UST yields have stabilized, as have spreads to other core sovereign bonds. Demand for USD has also ebbed in major economies – even with the expanded USD liquidity swap program and FIMA facility (both of which are expected to expire at the end of Q1). The Fed has been buying UST and MBS at the same clip for months now as well which has reduced the liquidity impulse into markets to a degree. With respect to slowing portfolio inflows, the depreciation of the USD should act as a stabilizer along with any potential steepening of the UST curve.

The result of the prior USD decline was a build in the depth and breadth of USD short positions globally. A lower USD is still the consensus trade, but the rationale for it has become far less compelling. Indeed, we'd need to see another round of stimulus – both on the monetary and fiscal ends to induce further downside against the majors. That's not impossible, but the scale will have to be larger than it was in the spring and that's a tall order.

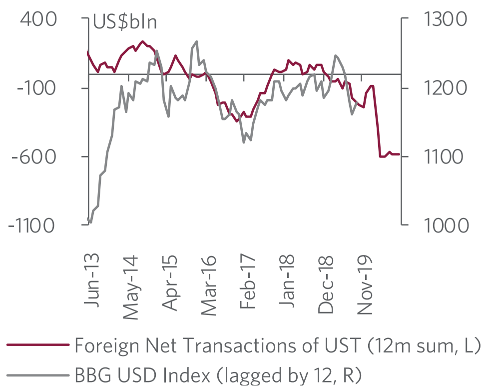
However, the key "Ex-factor" for the greenback and markets will be the ultimate of stimuli injections – a successful vaccine. The place where we'd expect the most follow through would be in the EM-space, as currencies in that basket outperform as vols decline.

Chart 1: Fed FIMA holdings and the USD



Source: CIBC Capital Markets, Federal Reserve.

Chart 2: Foreign net transactions of UST and the USD



Source: CIBC Capital Markets, US Treasury.

On the CAD – “Everything is everything”

To the north, we continue to see the CAD as an outperformer in some of the key crosses into early 2021. To borrow from another song from Ms. Hill, “Everything is Everything” for the CAD as several factors point to low realized volatility and an anchored USD/CAD. For instance, the BoC QE calibration process allows the Bank to rotate from owning a lot of bills and to a fewer dollar amount of bonds while keeping conditions accommodative for the real economy and reducing its market footprint. The drawback is that the decline in the balance has introduced upside risks to short-term rates – which is what the CAD is most sensitive to.

The important “Ex-Factor” for the CAD will be two-fold – the release of the vaccine and the Presidency of Joe Biden. For the former, the Canadian government has already signed pre-orders with Pfizer, Moderna and other firms that are manufacturing vaccines. That type of diversity should help the recovery relative to others. For the latter, Biden’s view on Keystone XL might not as important as it was in the past, but a return to “Buy American” policy of yore will almost certainly see premiums in USD/CAD rise.

But alas, “Nothing even Matters” over the long-term. The CAD will eventually need to come back to earth as the real economy will need a more competitive exchange rate to complete the rotation of growth from leveraged consumption to trade. Also, the market still has the BoC mispriced as a levered private sector will preclude any hikes ahead of the Fed. That might be a story once we’re past the mid-way point of 2021.

On the EUR – “I did it my way”

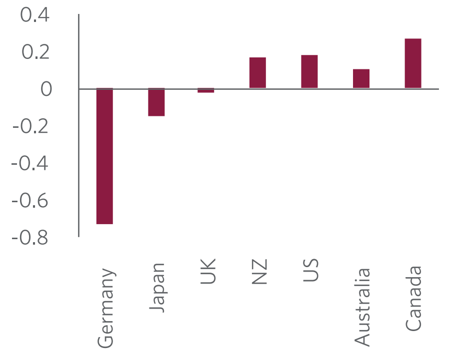
As we hop over the pond, we’re switching over to the smooth, baritone voice of the legendary Sinatra. A classic song from the icon seems apt for another icon set to depart the political scene next year – Angela Merkel.

A year ago we detailed that any easing in the German fiscal stance would provide positive spill-overs into the fortunes of the Eurozone economy. While we were not prescient enough to foresee the reason, the junking of the so-called ‘Black zero’ policy, allied to the German decision to support French proposals for an EU Rescue fund (of EUR750bln), have helped the EUR in 2020. In addition, monetary policy has supported the fiscal response with the ECB’s Pandemic Emergency Purchase Programme (PEPP) at the vanguard. We expect the extension of that mechanism will underpin the ECB policy response into 2021.

With respect to the ‘Rescue Fund’, the deal will result in the European Commission undertaking large scale borrowing for the first time. While the move should not be seen as the first step in debt mutualization, the policy shift underlined the recognition of economic divergence becoming irreversible without remedial action. The recognition of this fact helped to ease fragmentation risk. Peripheral spread compression benefited from the fact that some €390bn comes via non-repayable grants (Italy and Spain are the greatest recipients). The ground breaking move resulted in record real money long positions as the trade weighted EUR tested two-year highs. However, after the gains in 2020, we view EUR performance as being set to remain in the macro slow lane in 2021.

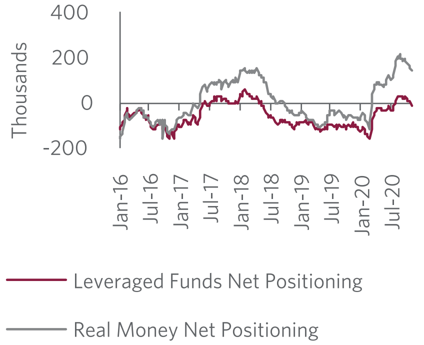
The ground breaking EU-27 agreement was only possible in the wake of the policy volte-face by German Chancellor Angela Merkel. The significance of this decision is accentuated as Europe faces up to Merkel’s exit from the political stage in H2 2021. Indeed, that could risk a political vacuum at the heart of Europe next year and after almost sixteen years of doing it ‘her way’, the EU will have to operate without its political anchor. Any lack of political cohesion is an unfortunate coincidence as the fiscal expansion that helped sustain EUR activity is set to gradually dissipate. The result, is a heavy onus upon the ECB to underwrite, a relatively modest Eurozone recovery.

Chart 3: Front-end CAD yields are the highest in the developed markets



Source: CIBC Capital Markets.

Chart 4: Real money and leveraged positions in EUR



Source: Refinitiv and CIBC FICC Strategy.

For now, the ECB is looking to work through its own, delayed, policy review. Expect the review to end up with a new framework that is similar to the Fed's inflation-targeting regime. Ahead of its conclusion, we'd expect future policy responses to be taken from the 2020 playbook, namely an expansion and extension in the PEPP envelope, along with an extension in financing to institutions via the 'Targeted Long-term Refinancing Operations' (TLTRO's).

A PEPP extension will act to further contain fragmentation risk as we watch for BTP-Bund spreads to compress towards 2016 lows around 100bps. Although, we expect the ECB to avoid taking rates further into negative territory, the EUR should still underperform. The perpetuation of an easy monetary stance, combined with modest growth in a reflationary world, suggests underperformance versus the high-beta currencies.

On the GBP – "I want to break free'

The Queen-inspired anthem is appropriate for the outlook on the UK and GBP going forward. More than four years after the Brexit referendum, the UK is set to 'break free' on January 1st, and end 47 years of EU membership. Still, we expect UK economic performance to remain compromised - deal or no deal.

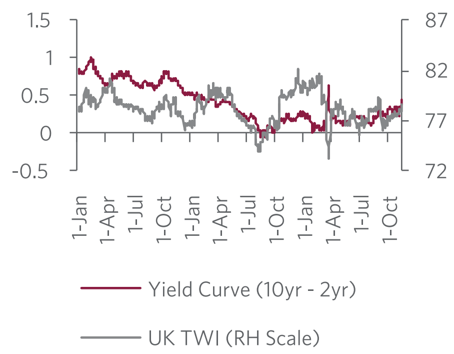
Post-Brexit headwinds, including costly customs checks, low productivity and weak business investment, have prompted downward revisions to trend UK-growth assumptions. The immediate macro trends appear far from promising, even if the expected spike in unemployment has been contained by the extension of the jobs furlough scheme to the end of Q1 2021. However, given the hit from Covid-19 to the domestic economy, the UK should materially benefit from any early vaccine utilization.

A near 20% q/q decline in Q2 GDP has been only partially retraced in Q3, as the economy remains around 9% smaller than a year ago. New lockdown restrictions suggest the economy is set to weaken again in Q4, with the BoE expecting a -2.0% result q/q. Record levels of redundancies in the three months to September risk weighing upon consumer sentiment, and undermining growth assumptions. We assume that the UK economy will not make up lost output until early 2023. Indeed, we remain more pessimistic than the BoE in that regard.

The annual UK fiscal shortfall has exploded towards 20% of GDP while the share of public spending to GDP is set to exceed 50% for the first time since the 1940's. Against such fiscal extremes, including concern over the prospect of rising debt repayments, expect pressure upon the BoE to continue to add to the Asset Purchase Facility (APF), and help to contain curve steepening. Expect discussion of yield curve control should additional APF purchases fail to materially contain long end yields.

A modest recovery phase, as the UK adapts to operating under a new trading regime, suggests that absent an unexpectedly early clearance from Covid restrictions, the BoE will remain active and Sterling will struggle for traction.

Chart 5: UK yield curve and trade-weighted GBP



Source: Refinitiv and CIBC FICC Strategy.

“But don’t look back in anger”

As Chancellor Merkel prepares to exit stage left, the risks of political uncertainty could rise next year. The combination of low productivity and structural growth headwinds is set to require continued ECB support. On the other side of the channel, the UK faces post Brexit trade frictions, potentially compromising both trade and FDI flows. The latter is important to offset a current account shortfall which is set to exceed 3% of GDP again in 2021. Thus, neither the EUR or GBP are set to prove strong regional performers.

Nevertheless, we would not put all the continent in the performance slow lane. After recent gains, the SEK should continue to benefit from an economy which has been less impacted than most by Covid-19 and is receptive to global demand trends. Another regional favorite of ours is the NOK, which should benefit from a solid fiscal stance and earlier than expected economic recovery.

On the JPY – “Every breath you take”

To JPY traders – “we’ll be watching you”. The JPY has long been regarded the de facto risk-off haven in the FX space. We’re expecting that the coming year should be no different. After all, as the world’s largest net capital supplier, Japanese portfolio flows play an integral role as a barometer for risk appetite.

Additional fiscal stimulus looks likely as incoming PM Suga has instructed his cabinet to prepare another package to revitalize the economy. That should serve to deepen the negative correlation between the JPY and risk assets. But over the long-term the JPY remains an undervalued currency given the large current account surplus.

Notes

Notes

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CIBC Capital Markets works with domestic and international organizations looking for a banking relationship that combines in-depth industry knowledge with comprehensive capital markets, corporate banking and investment banking capabilities to address their most pressing needs. We strive to forge strong and deep relationships with our clients to understand the demands of their business and bring distinctive and appropriate solutions to the table.

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