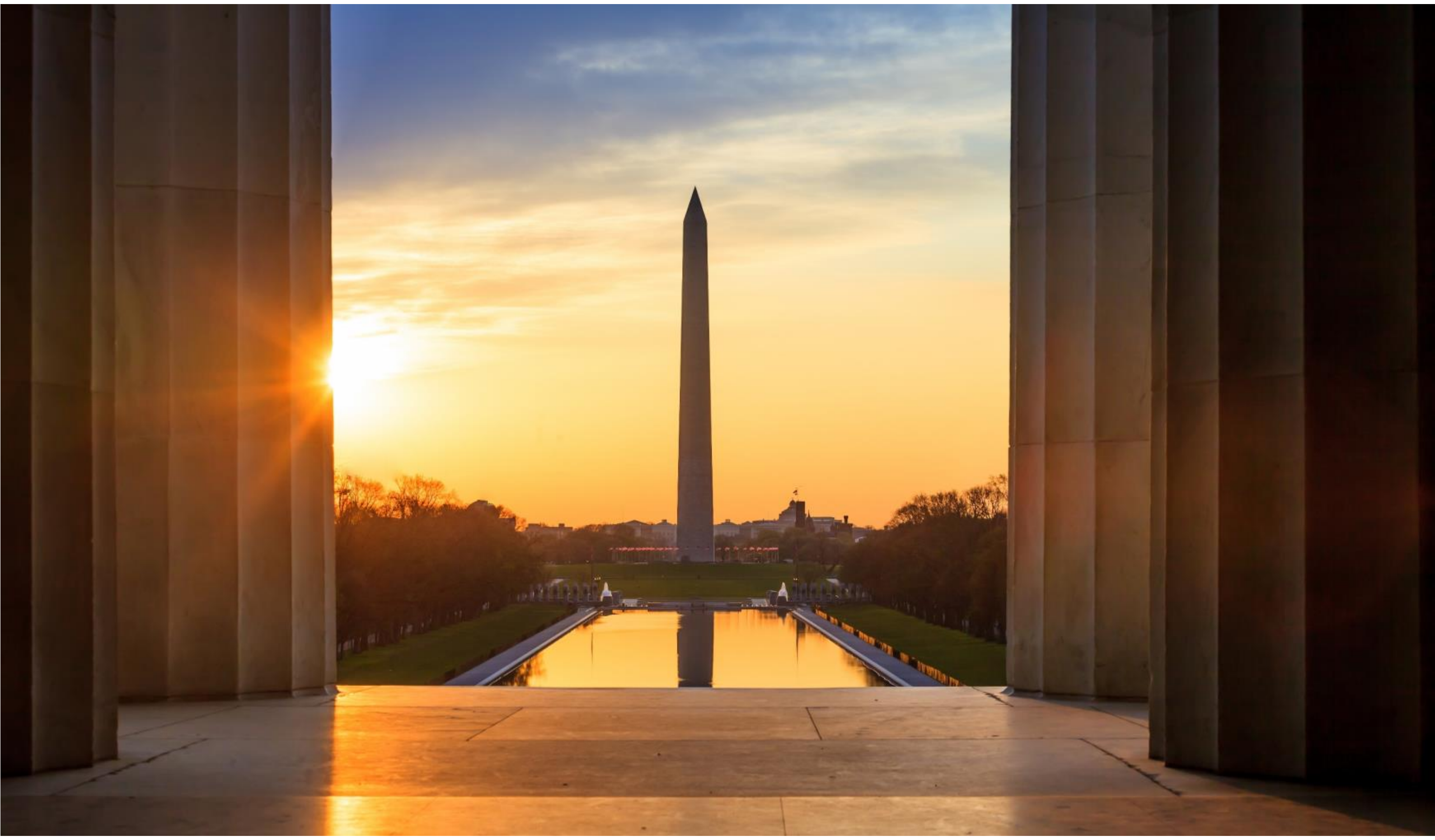
LAZARD
FRÈRES GESTION

ECONOMIC AND MARKET OUTLOOK

January 2021



Sunrise over the Lincoln memorial, the Washington Monument and the Capitol, Washington D.C.
Source: Shutterstock

Written on 25 January 2021

Short term economic activity will be shaped by changes to health restrictions, which in turn depend on the pandemic and this situation is likely to last for several months. Vaccinating those most at risk should enable restrictions to be eased and growth to accelerate in the second half of the year. Until then, the main challenge remains preserving the private sector's balance sheets via continued fiscal and monetary support during 2021. Against this backdrop, risky assets should continue to outperform their risk-free counterparts. With spreads on the riskiest credit having already tightened significantly, these assets can be expected to provide returns close to carry levels while equity market premia remain high and provide scope for healthy performances. The rise in long-term interest rates could be accompanied by a shift towards more cyclical segments.

ECONOMIC OUTLOOK

SHORT-TERM ACTIVITY STILL DEPENDENT ON HEALTH RESTRICTIONS

This winter's COVID-19 resurgence across Western countries is leading to tighter health restrictions and dragging on growth, even if the latest restrictions have been tailored to lessen their impact on the economy compared to those of last spring.

Europe has been most affected by these measures with the economic impact hitting the services sector worst. While the less severe restrictions in the United States have had a accordingly lower impact on growth, fourth-quarter consumption and employment figures indicate lost momentum. Economic conditions are more favourable in China, where health restrictions are minimal or implemented at a local level.

The chaos is likely to last for several more months, after which rising temperatures should limit the spread of the virus and vaccination campaigns should be more massive. Widespread vaccinations together with more of the population having been exposed to the virus should lead to restrictions being eased and growth accelerating in the second half of the year.

Figure 1
COVID-19: new cases per million of population (moving weekly average)
Source: Johns Hopkins au 20/01/2021

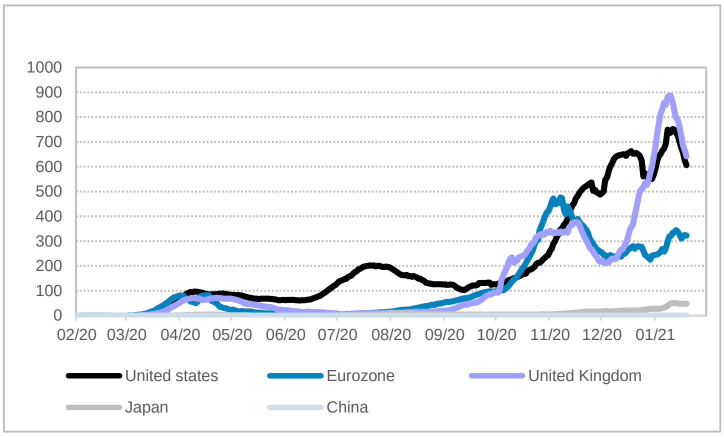
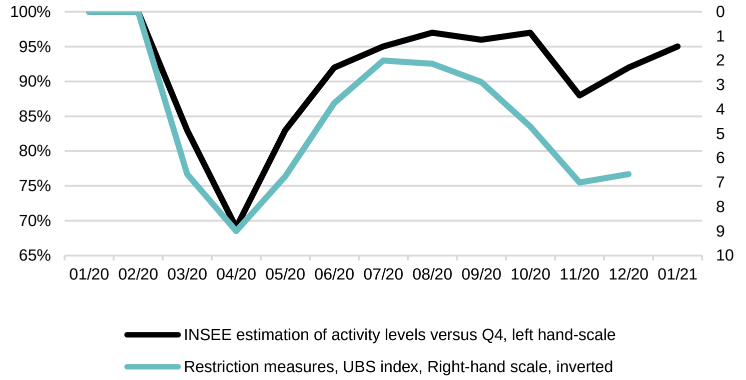


Figure 2
France: economic growth and restriction measures
Source: INSEE, UBS



WHAT IMPACT IS THE CRISIS HAVING?

The main challenge for the authorities at the moment is to prevent the health crisis from having a lasting impact on the economy. This would be the case if production capacity was destroyed through bankruptcies or layoffs, if capital stock fell due to lower investment expenditure, or if economic agents became more cautious in a bid to repair damaged balance sheets. For the time being, the economy's capacity to rebound seems to have been preserved.

Bankruptcies are at very low levels both in the United States and in France. While the number will no doubt rise, public authorities can be expected to provide support. The unemployment picture is also reassuring. In Europe, unemployment has remained well below the levels that prevailed after the 2008-09 financial crisis, thanks in particular to the strengthening of short-time working measures. In the United States, unemployment has fallen sharply from its initial abrupt rise.

Business investment is proving resilient, with capital goods orders rebounding strongly from their spring lows and investment intentions on the right track. While corporate financial positions do not seem to have deteriorated much, there are significant disparities between countries and sectors.

Household finances have been protected thanks to massive social transfers, particularly in the United States, where the response to the crisis has been extraordinarily strong. Transfers already received by US households have largely exceeded earnings losses and are increasing the forced savings that are a result of lower consumption. The bulk of these transfers is currently being kept as deposits and reducing net debt by the same amount. These large transfers have meant the least wealthy households have seen their net wealth increase sharply, more than outstripping the positive wealth effect for affluent households. Ironically, American households are now financially better-off than they were before the health crisis.

Figure 3
Western countries: unemployment rate
Source: Bloomberg

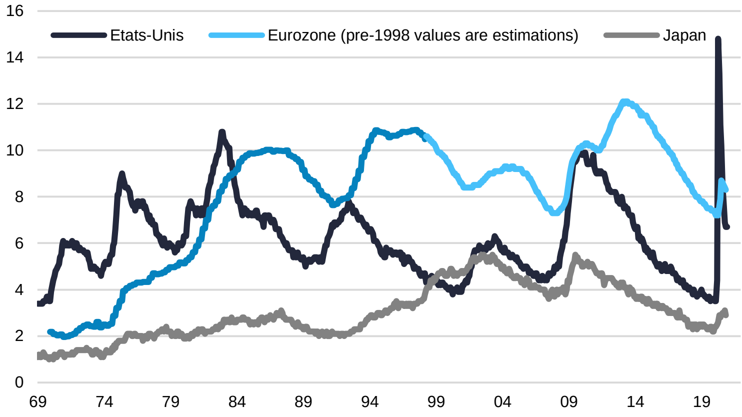


Figure 4
United States: quarterly bankruptcies (thousands)
Source: Bloomberg

Figure 5
Investment goods orders, excl. volatile elements, 2015 = base 100.
Source: Bloomberg

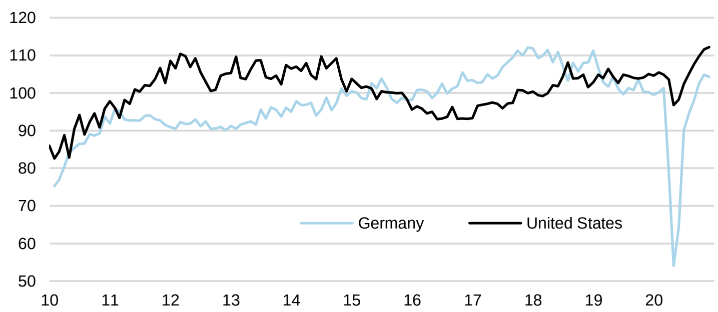
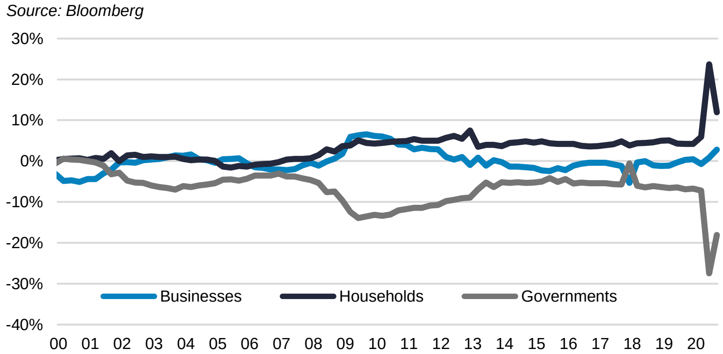


Figure 6
United States: economic agents' net financial savings (% GDP, annualised)
Source: Bloomberg



TOWARDS A STRONGER-THAN-EXPECTED ECONOMIC REBOUND?

Monetary and fiscal support will remain significant factors over the next twelve to eighteen months.

In the United States, the Democrat majority in Congress will allow the implementation of new stimulus measures, which promise to be massive, financed by a likely increase in corporate income tax. While fiscal support in the eurozone may be less significant, a tightening is not on the agenda and the Stability and Growth Pact safeguard clause will probably apply until 2022. International institutions are not currently calling for support to be scaled back, whereas this issue arose very quickly after the 2008 financial crisis.

This apparent shift in the fiscal policy paradigm also applies to monetary policy, with central banks moving towards more long-term accommodative policies. Broadly speaking, higher interest rates are out of the question and securities purchases are set to continue.

Against this backdrop, the use of accumulated savings and latent demand related to social restrictions may trigger a strong pick-up in economic activity in 2021, especially as the third quarter of 2020 showed that when lockdown restrictions are relaxed, economic activity picks up sharply.

In the short term, the main risk factor for the economic recovery appears to be the degree of vaccine efficacy against the new COVID-19 strains. In the medium term, the extraordinary level of money creation along with the rise in raw materials prices could increase the risk of higher inflation.

Figure 7
OECD: fiscal impact of stimulus measures
Source: OECD

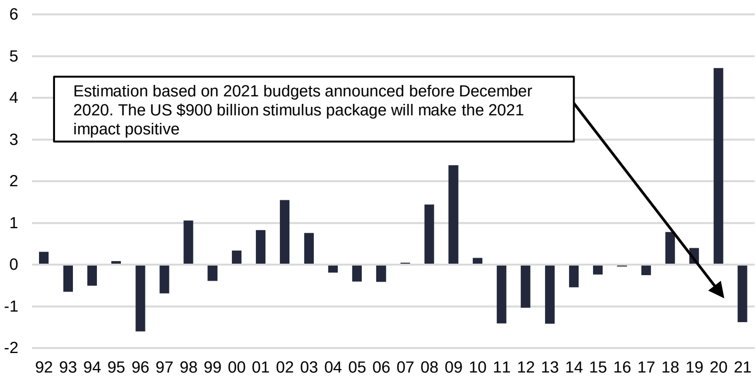


Figure 8
Developed countries' central bank balance sheets Fed, ECB, BoJ, BoE, BoC, Riksbank (USD trillion)
Source: Bloomberg

Figure 9
GDP in volume terms, Q4 2019 = base 100, actual and forecast (dotted line) at end May
Source: Bloomberg

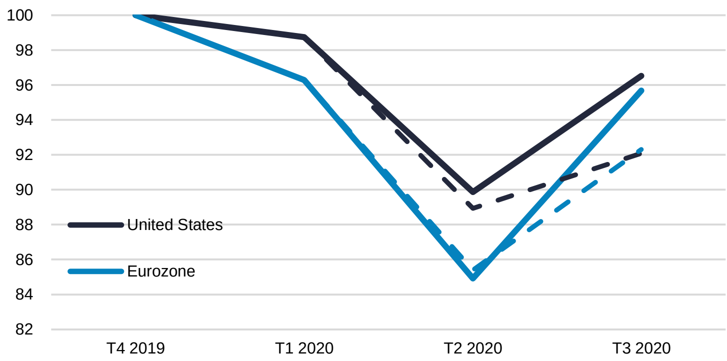
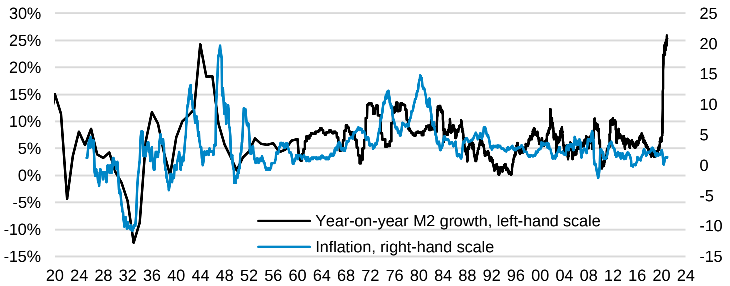


Figure 10
United States: Annual M2 money supply and inflation
source: Òscar Jordà, Moritz Schularick, and Alan M. Taylor 2017, Macrofinancial history and the new business cycles facts, Bloomberg



MARKET OUTLOOK

Against this backdrop, risky assets should continue to outperform their risk-free counterparts.

BOND MARKETS: HIGHER US LONG-TERM RATES AND CENTRAL BANK SUPPORT FOR CREDIT

The consensus expectation is that rates will remain low for at least four years. Even if the situation improves significantly, central bank rate hikes seem unimaginable before 2022. This does not, however, rule out higher long-term rates

Real interest rates are even lower now than they were before the 2013 taper tantrum, and the spread between long and short rates is still well below historic highs. Should long-term rates rise sharply, the Fed could conceivably intervene to manage the slope of the yield curve without flattening it so much that it no longer supported the financial sector.

In addition to the issuance resulting from the new fiscal support measures, the market will probably also have to absorb a recalibration in its average maturity profile, since the US Treasury issued a large volume of short-dated securities in 2020. Contagion effects could prompt a rise in European long-term rates, albeit to a lesser extent.

Amid very low government rates, the credit segment remains an attractive investment. Credit spreads are approaching their low point of recent years, but the additional yield offered by the riskiest segments is still attractive, with returns close to carry levels. High yield should significantly outperform cash, with central bank purchases limiting the risk of spread widening.

Figure 11
OIS Curve – short-term interest rate expectations
Source: Bloomberg

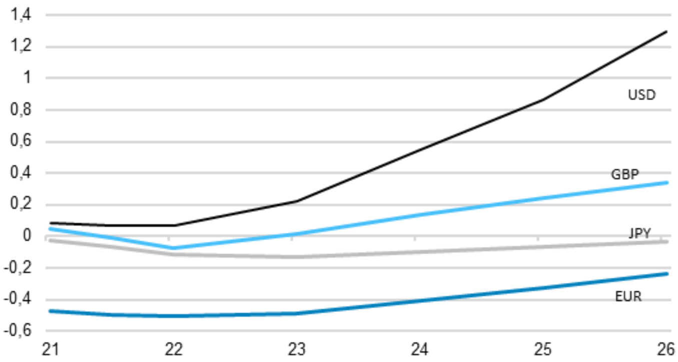
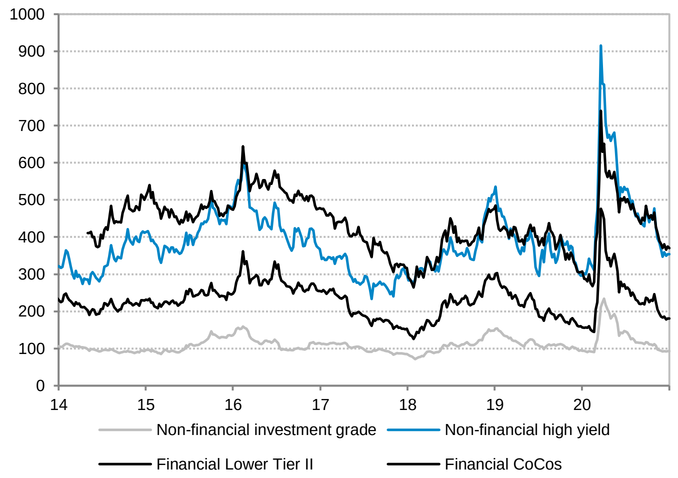


Figure 12
United States: 10-year bond yields minus 10-year inflation swap rates
Source: Bloomberg

Figure 13
Eurozone: private sector issuer spreads (basis points)
Source: FactSet



The opinion expressed above is dated January 2021 and is liable to change. Latest available data as of publication date.

EQUITY MARKETS: SET TO RISE FURTHER?

High risk premia on equities should enable these assets to perform well amid fiscal stimulus and a growth rebound.

Equity indices have already recovered much ground but implied volatility remains high, indicating that investors still have concerns over market developments and that markets, despite their lofty levels, probably have further to go before overreaching.

We prefer European and emerging-market equities to US stocks, as we believe they have relatively more attractive valuation levels and greater potential for earnings rebounds. Furthermore, emerging equities could benefit from the rise in commodity prices, while probable tax increases can be expected to penalise the largest US market capitalisations.

The continued upward movement in interest rates represents a powerful supportive factor for value stocks, which are those most exposed to an economic recovery and are also trading relatively attractively. Discounted small-cap stocks compared to their large-cap counterparts could also provide buying opportunities.

Glossary:

INSEE: The National Institute of Statistics and Economic Studies is responsible for the production, analysis and publication of official statistics in France.

ECB: European Central Bank

PEPP: The Pandemic Emergency Purchasing Programme, a plan implemented to purchase debt on the markets as a means of lowering financing costs for governments, businesses and households.

FED: The Federal Reserve, the central bank of the United States.

PMI indices: The Purchasing Managers' Index (PMI) summarises confidence levels among business purchasing managers who are surveyed to establish if market conditions are expanding, staying the same or contracting.

OIS: The Overnight Indexed Swap is an international interest rate swap agreement. The OIS mainly concerns interest rate swaps against a pre-determined published index of a daily overnight reference rate.

PE: The price-to-earnings ratio (PER, or P/E) is a stockmarket analysis indicator. It is used to value a stock relative to that of similar stocks within the same sector.

GDP: Gross domestic product is an economic indicator that quantifies the total value of annual wealth produced by economic agents residing within a territory.

Equity risk premium: The return in excess of the risk-free rate that an investment is expected to yield. This additional yield compensates the investor for taking more risk.

Swap: The swap or swap contract is a financial derivative. It is a contract for the exchange of financial flows between two parties, usually banks or financial institutions.

Taper Tantrum: The term 'taper tantrum' describes the rise in US Treasury yields that occurred in 2013, after the Federal Reserve (Fed) announced its intention to gradually reduce its quantitative easing policy in the future.

Figure 14
Equity risk premium estimates 1/PE – 10-year rate
Source: FactSet

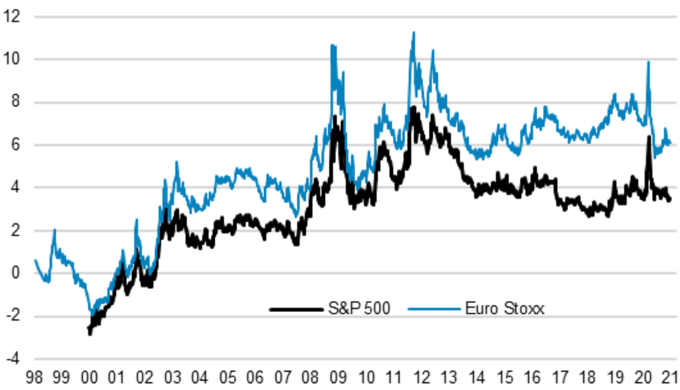


Figure 15
MSCI EM/MSCI World forward earnings and commodity prices
Source: Bloomberg

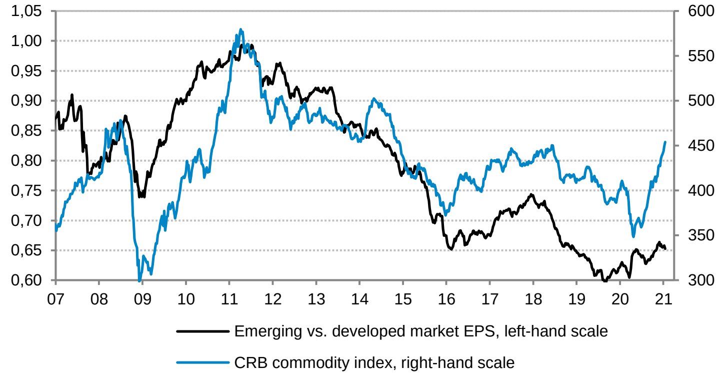
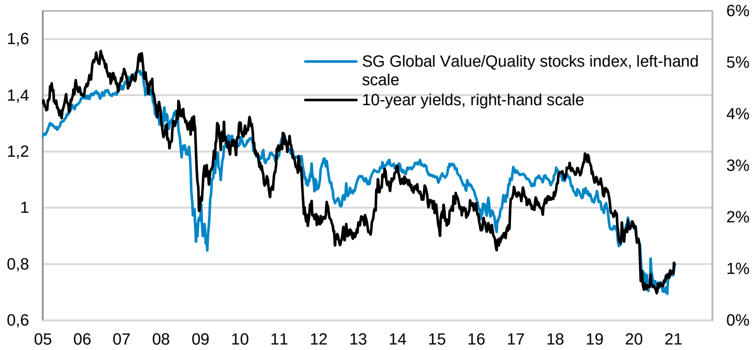


Figure 16
Relative performance for global value/quality stocks
Source: Bloomberg



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