Active is: Anticipating what's ahead

2021 outlook: regional views

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Amid the ongoing global economic recovery, investors may need to use a broader toolkit – beyond the regions that have recently done well. Equities in Europe and emerging Asia may offer better value than the US winners of 2020, while a continued low-yield environment could create attractive opportunities in Asian debt and corporate bonds globally. Visit allianzgi.com for our full 2021 outlook.

United States

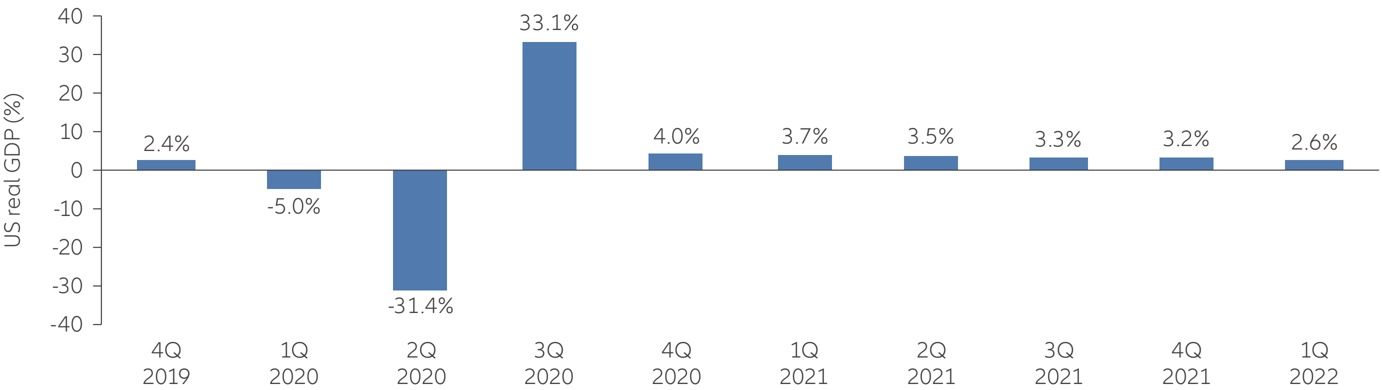
After a historic rebound in economic activity in the third quarter of 2020, the US growth outlook grew more moderate (see **Exhibit 1**). We expect this trend to continue throughout 2021, albeit with some surges and dips. Growth will likely still be above potential – meaning overall demand may outpace supply due to strong employment, high government expenditures and other factors – which may eventually spark inflation. Where the US economy ultimately ends up will likely depend on a few factors:

- The path of the virus will be a key determinant of consumer behaviour and economic activity. If new vaccines turn out to be as effective as promised, and if they are widely adopted, we expect to see strong growth.
- Until activity returns to pre-crisis levels, ongoing monetary and fiscal stimulus is critical for shoring up the economy in general, and small businesses in particular. Even so, we expect to see a rise in insolvencies among individuals and corporations unable to meet their financial obligations.
- The election of Joe Biden as the 46th US president will likely lead to new economic policies and more fiscal stimulus. The Biden administration's renewed focus on infrastructure spending and initiatives related to climate change and clean energy could create new opportunities for investors, including in the private markets space.

If US economic activity gradually returns to where it was before the coronavirus crisis hit, it may set up a generally benign backdrop for US risk assets such as equities and non-government bonds – though it will be important to choose carefully. In the case of another slowdown, markets will likely anticipate more fiscal and monetary stimulus – which could be supportive for risk assets as well. Either way, we may see a shift in which sectors are leading, and we expect market participation to broaden – meaning different sectors of the market may begin to outperform.

Exhibit 1: US growth will likely become more moderate as 2021 marches on

US real GDP forecast (quarter-over-quarter seasonally adjusted annual rate, in %)



Source: Bloomberg. Data as at October 2020.

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European Union

In the European Union, the Covid-19 pandemic is being battled by 27 different member states. This makes the path of containment, the reaction of market participants and the speed of any rebound very difficult to predict. Continued lockdowns and social distancing would have a particularly strong impact on the service sector, and we would likely see insolvencies rise and employment fall across the EU. The markets would anticipate some uptick in insolvencies; what matters is whether they rise beyond expectations. We also assume that fiscal and monetary policy measures will help preserve the region's economic fabric and avoid large-scale bankruptcies and layoffs.

The 19 countries in the euro zone carry the greatest weight – particularly Germany, France, Italy, Spain, the Netherlands, Belgium and Austria, which account for around 90% of the euro zone's aggregated GDP. Overall, we expect the euro zone to grow by around 5.5% in 2021 after a projected collapse of 7.7% in 2020. This will be helped by several factors:

- Private consumption will probably profit from targeted government measures, an expected normalisation of current excess savings and a rebound in consumer confidence. We have a generally positive base-case view of consumer behaviour, but it may take time to normalise. It's also unclear how consumers will react to continued coronavirus-related uncertainty, or how mass vaccinations may play out.
- Government consumption should help stem the economic fallout. A massive spending initiative such as the EUR 750 billion Recovery and Resilience Facility is an important milestone in addressing the crisis and a promising sign of European solidarity.
- Despite the uncertain outlook for domestic and external demand, we expect investment activity to pick up in 2021. The strain on company profit margins is likely to diminish and capacity utilisation is expected to rise.

The inflation outlook remains relaxed for the time being, with euro-zone headline inflation expected to accelerate to a still-moderate 1.3% in 2021, up from 0.4% in 2020. Higher food and oil prices will exert a gradual upward push. Against this backdrop, the European Central Bank will likely stick to its extremely expansionary policy stance of low interest rates and continued asset purchases (see **Exhibit 2**). Within fixed income, we continue to prefer bonds in the euro-zone periphery, including Italy and Spain, over German government bonds. We also have a positive view of investment-grade corporate bonds. Both segments benefit from ECB purchase programmes.

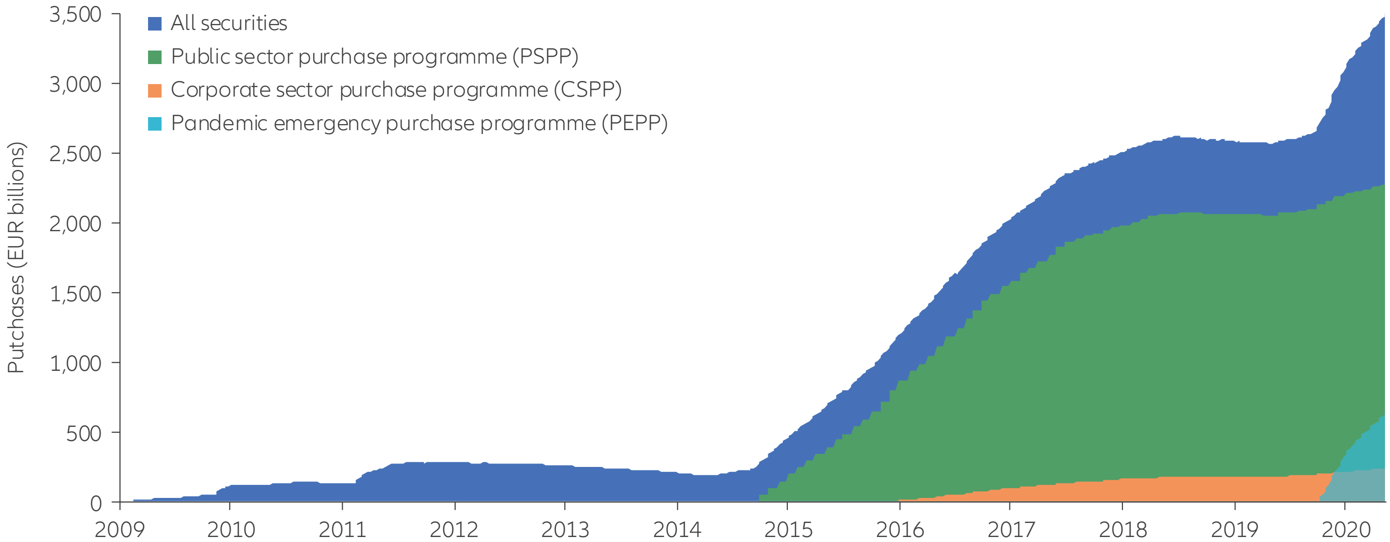
We have a constructive outlook for European equities over the long term, thanks to their moderate valuations and our expectation that today's promising vaccines, if broadly adopted, will help contain the virus's spread.

United Kingdom

Like the ECB, the Bank of England is planning to continue its bond-buying programme and keep interest rates low. The BoE is even contemplating a move into negative interest-rate territory. The UK economy has been in a difficult position as it grapples with the coronavirus and post-Brexit trade negotiations with the EU. As a result, significant uncertainty surrounds the pace and path of

Exhibit 2: the ECB's balance sheet shows no sign of shrinking

ECB balance sheet, including key asset-purchase programmes (2009-2020)



Source: European Central Bank. Data as at November 2020.

the recovery that started in May 2020. GDP is predicted to shrink 10%-12% in 2020, but given that we expect to see some success in containing the virus as well as the likely implementation of a UK-EU trade deal, we expect the UK to return to growth in 2021. Among the bright spots:

- Hard-hit sectors such as hotels, food service, transport, leisure and arts are set to benefit from a low starting point, boosting annual growth rates.
- Driven by the acceleration of e-commerce, the logistics sector is expected to expand forcefully.
- The construction sector should profit from fiscal measures to boost infrastructure investment.

All in all, we believe the UK economy will return to its pre-lockdown levels by the end of 2021, but our expectations could move significantly lower depending on the length and depth of the Covid-19 pandemic. We expect inflation to reach 1.6% in 2021, up from 1% in 2020, as energy prices normalise, the temporary VAT reduction fades and subdued wage growth picks up again. The UK's budget deficit is projected to fall to nearly 7% in 2021 – down significantly from 2020 levels – but there could be additional fiscal stimulus measures to boost the economy. Still, once the economy recovers fully, fiscal spending needs to be reined in over the longer term to shrink public debt levels. The BoE is expected to stay the course with its expansionary monetary policy, including low to negative interest rates and asset purchases – though there is a possibility BoE policy could grow even more expansive depending on how the economy responds.

Given the UK's challenges, we expect higher short-term volatility. This would emphasise the importance of taking an active investment approach in UK bonds as well as UK equities, which are relatively highly exposed to international developments. However, positive signals in the fight against the coronavirus and a UK-EU free trade agreement (instead of a "no-deal" scenario) would likely be buying opportunities.

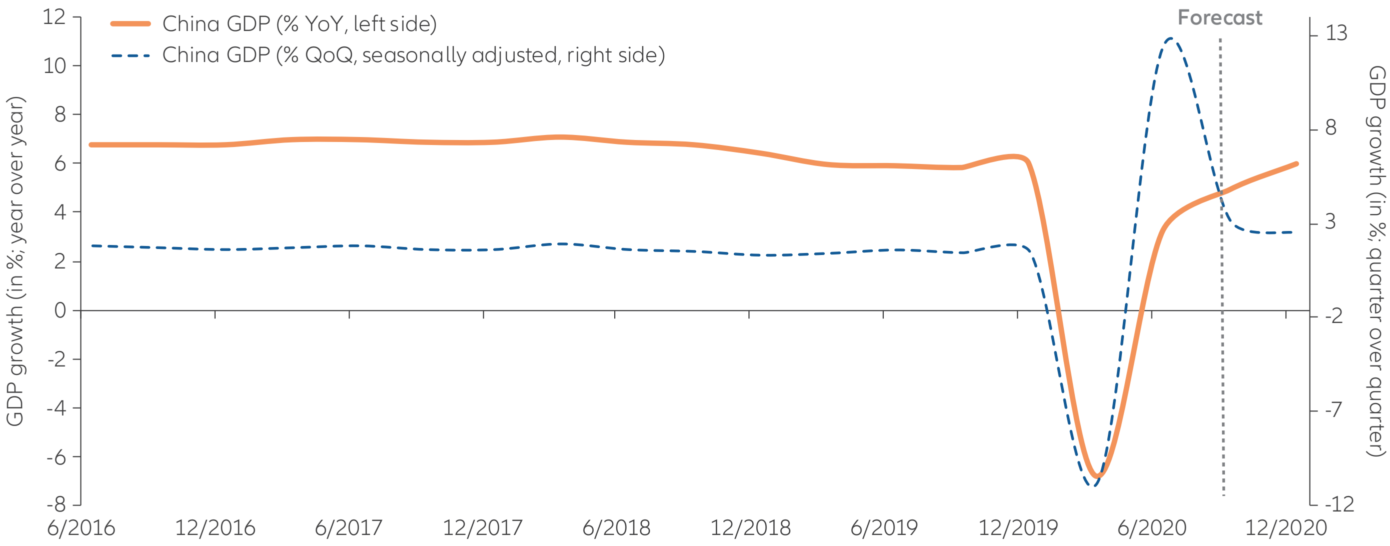
China

We expect China's economy to keep up its strong recovery from Covid-19, which had a hugely negative impact early in 2020 even though the authorities quickly got the pandemic under control. Year-on-year GDP growth could be impressive in the early part of 2021 – in large part because the same period in 2020 was so deeply depressed (see **Exhibit 3**) – before slowing somewhat through the rest of the year.

China's service sector seems set to continue its upward climb, assuming the government can suppress renewed outbreaks of the coronavirus. The manufacturing sector also seems likely to keep growing, helped by public investment projects and a gradual recovery of global demand as Covid-19 passes. And China is still positioning itself to win over the long-term by nurturing its own high-tech industries – particularly in the fields of robotics, aviation and other advanced-manufacturing areas.

Exhibit 3: China's GDP rebounded sharply in 2020, though it was still weaker than expected

Quarter-over-quarter and year-over-year GDP growth (actual through September 2020; estimated through December 2020)



Source: Bloomberg, CEIC, Allianz Global Investors. Data as at September 2020.

We think this environment will lead China's authorities to continue normalising the fiscal and monetary stimulus they provided in 2020. This means the government may start spending less, and the People's Bank of China (PBoC) seems unlikely to make any major monetary easing moves – including rate cuts – in 2021. On the contrary, we could even see the PBoC start to tighten towards the end of the year if growth returns and core inflation picks up.

We are somewhat cautious on China's investment outlook in the near term, given that fiscal and monetary policy are on a path of being normalised against an improving macroeconomic backdrop. Over the long term, however, China's economic story is a compelling one. We think investors should continue to think of China as an asset class in and of itself – meaning it's not so much a question of whether to invest in China, but how much to invest.

Emerging markets

Emerging economies generally rebounded sharply after substantial losses in March 2020 – in large part thanks to extremely accommodative support from central banks (see **Exhibit 4**). Over the long term, we may see this support contribute to higher inflation globally. In the short run, however, we expect that factors such as weaker commodity prices will likely help avoid meaningful inflation pressures in the developing world. This will allow their central banks to cut rates to record low levels and experiment with some forms of asset purchase programmes (known as "quantitative easing").

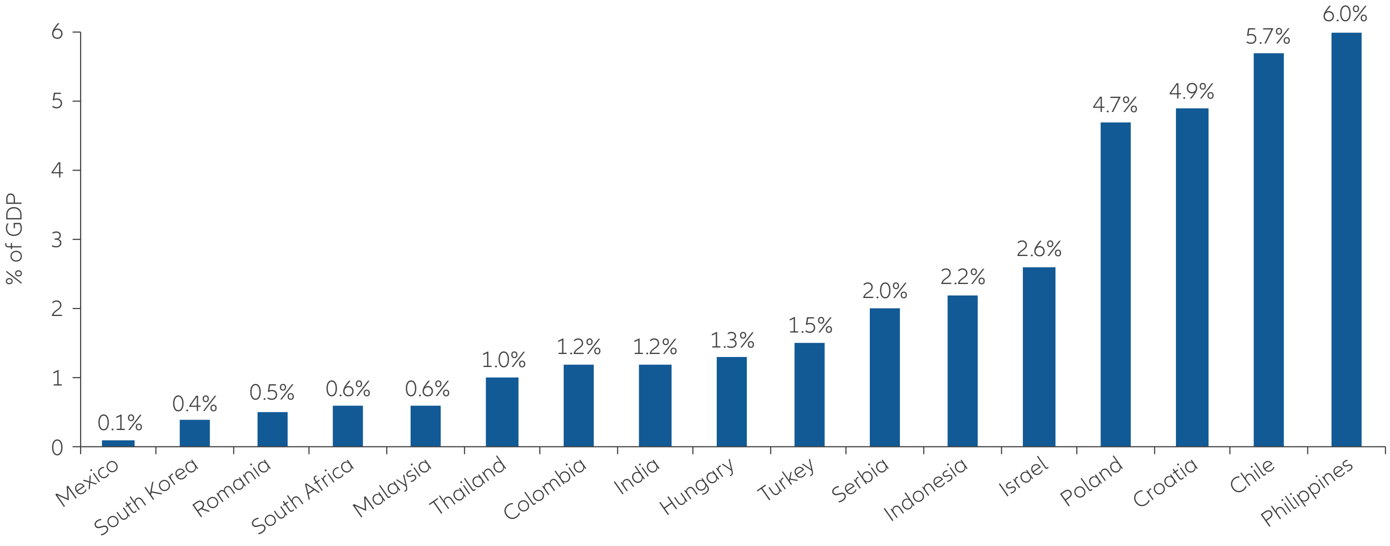
But the massive amount of monetary and fiscal stimulus measures at work in emerging economies won't last forever. For example, there is a limit to how low interest rates may go, given concerns about inflation, exchange rates and financial stability. Indeed, Turkey and Hungary already increased their policy rates in 2020. And fiscal stimulus measures – including increased spending – may soon become simultaneously less effective and increasingly scrutinised as investors assess whether too much spending hurts creditworthiness.

In the immediate future, Covid-19 continues to be the main risk for emerging-market growth. As viable vaccines become available, economic conditions around the world could normalise – which would help emerging and developed nations alike. But rising infection rates pose significant risk to vulnerable nations that have already spent much of their ammunition fighting the disease. As a result, we expect the recovery in emerging markets to be both fragile and diverse:

- While China and parts of Asia were the hardest hit by the pandemic initially, they were also the first to recover. Despite lingering concerns about second-wave infections that could pose a risk to the recovery, Asia saw a remarkable rebound in output when restrictive measures were lifted and factories resumed production. While this momentum may fade in 2021, governments throughout Asia will be providing fiscal support – and we expect this will help boost private consumption. Equities, credit and currencies appear attractive given our expectation that China and the rest of Asia will continue to bounce back.
- The CEEMEA region (Central and Eastern Europe, the Middle East and Africa) was off to a good start with its Covid-19 recovery until a spike in new cases. Poland could be a bright spot, thanks to its sizeable fiscal stimulus measures and closer integration with the European Union, while momentum in South Africa was already weak in the pre-Covid period. Similarly, the recovery in Russia was slower in part because of the oil industry, which reduced its output in recent negotiations with OPEC.

Exhibit 4: emerging-market central banks bought massive amounts of bonds to fight the effects of the coronavirus

Government-bond purchases by emerging-market central banks (March-October 2020)



Source: Bloomberg, IMF, Allianz Global Investors. Data as at October 2020.

- Latin America was hit extremely hard by the pandemic, despite higher commodity demand from China and other countries helping the region's commodity producers. Here, too, the recovery story is diverse. Brazil's economy is vulnerable, whereas Mexico may recover steadily thanks to a rebound in US demand and manufacturing.

Overall, some emerging economies could enjoy robust quarterly GDP growth rates in 2021 given how low they were in the spring of 2020. But in many nations, economic activity is still below pre-Covid levels even as other challenges persist – from increased geopolitical tensions to broken supply chains and higher protectionism. However, with core emerging-market central banks signalling that their accommodative policies will not be reversed anytime soon, and with multilateral support ramping up from developed nations, emerging economies should feel external financial pressures ease somewhat.

Among emerging-market sovereign bonds, investors may want to consider high-yield over investment-grade securities, in part thanks to the external support the Fed and IMF are providing to developing nations.

In emerging Asia, fiscal and monetary support – along with positive developments in the fight against coronavirus -- should help fuel the appetite for yield and risk assets. Across the region, we generally prefer fixed-income investments with shorter durations, and generally favour high-yield over investment-grade securities. In addition, a challenging environment for the US dollar could help India, Indonesia, the Philippines and other economies in South and South-East Asia. A weaker dollar means these countries' central banks may not need to raise rates to help their currencies. It also makes it cheaper to hold debt denominated in US dollars and could result in more foreign inflows into the region.

Japan

We expect Japan's real GDP to contract 5.5% in 2020 before recovering to 2.3% growth in 2021. Yet despite this rebound, the economic outlook remains uncertain. Households are likely to maintain a high savings rate and Japan's exports are highly correlated with global capital expenditures, which are likely to wane given coronavirus-related uncertainty.

Prime Minister Yoshihide Suga is likely to continue pushing forward "Abenomics" – the economic policies of previous Prime Minister Shinzo Abe – particularly the combination of fiscal stimulus and large-scale monetary easing. Mr Suga has also emphasised the importance of maintaining a close relationship with the Bank of Japan (BOJ) and promoting additional monetary easing measures if they are deemed necessary to sustain employment and keep companies afloat. But for now, we think the BoJ is unlikely to lower its short-term policy rate further into negative territory.

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Data as at 30 September, 2020