As the Pandemic Surges, Global Economies Will Be Tested Anew

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COVID-19 has severely tested the global economy and markets in 2020. Aided by unprecedented monetary and fiscal stimulus, markets responded with surprising resilience. Equity valuations are critically dependent on whether a combination of treatments and vaccines will enable a full reopening of the economy within the next 12 months. This would be reason for concern even under the best of circumstances. Unfortunately, our current circumstances are far from the best.

As we move into 2021, uncertainty persists on many fronts. While the world waits for a medical resolution to the pandemic crisis, infections are once again surging and restrictions on movement are scaling up. Meanwhile, the liquidity unleashed to fight the crisis is triggering questions about the inflation outlook. And finally, policy uncertainty persists following tense US elections, with control of the US Senate still pending runoff elections in January. Brexit deadlines are looming; no agreement is yet in hand. As the helpful influence of earlier stimulus recedes, markets will likely face another major test in 2021.

Amid all this, it's important to recognize that there is potential for some upside risk as well, in the form of an effective, quickly scalable vaccine. The announcement of promising results from late-stage trials has led to a rapid re-evaluation of the timing of recovery. Should these trials lead to widespread deployment of an effective vaccine, such a development would go a long way toward reducing the lasting scars from the COVID-19-induced recession.

In this environment, we believe growth and quality assets represent investors' strongest opportunities — and we think they're most likely to find those opportunities in the United States and China.

Recovery Continues

Most asset classes bounced back from the March 2020 market shock to show positive returns in 2020, although increasing COVID-19 case counts and US-election-related uncertainty are leading to greater volatility and a modest pullback in asset prices in the fourth quarter of the year. Quantitative easing (QE) has strongly supported equity markets in 2020, but earnings have yet to come through. Meanwhile, in a marked contrast to past episodes of quantitative easing, this time QE seems to be capping bond yields despite rising expectations for inflation.

In the most recent update to our market outlook, we compared the economic recovery from the COVID-19 shock to a relay race, unfolding in a series of overlapping stages. During the first stage of the race — when economic and market dislocations were most acute — emergency monetary and fiscal stimulus played the most prominent role. Given the circumstances, that stimulus was not particularly targeted, but it was sizable and swift. Because stimulus efforts clearly succeeded in putting a floor under both economies and markets, we see the first stage of the relay recovery as a success.

During the second stage of recovery — the economic reopening — economies themselves picked up the baton. As third-quarter GDP figures in many economies demonstrate, economies around the world delivered impressive results as reopening unleashed pent-up demand. As of this writing, the number of COVID-19 cases is once again growing, and governments are imposing new restrictions. We continue to believe, however, that new restrictions are likely to be considerably less onerous than they were in the early days of the outbreak, which will allow economies to function at a higher operational capacity.

Ultimately, there cannot be a full recovery without an effective and scalable vaccine. Every week brings us closer to that goal — and every week also makes us more urgently dependent on a vaccine coming through. We cannot determine how successfully the overall recovery race has been run until we reach that final resolution.

Furthermore, once the crisis is past — when the pandemic has finally been beaten back and mobility restrictions are fully lifted around the world — yet another transition must occur. At some point, economies will need to transition back to autonomous growth, independent of monetary and fiscal stimulus. How perfect or how imperfect a substitution growth will be for stimulus remains to be seen. The adjustment is certain to be complex, and it is very likely to cause some market convulsions along the way.

Thus, while we at State Street Global Advisors are very comfortable with our expectations for a strong economic rebound in 2021, we are increasingly focusing our sights on everything that comes after that surge. A combination of alertness and agility is most likely to reward investors, as recession gives way to a powerful but temporary rebound followed by an as-yet-undecided new baseline of growth.

United States and China Most Likely to Outperform

The United States and China seem best placed to navigate upcoming challenges while sustaining relatively less long-term damage compared with their global peers. The US and Chinese economies have outperformed during the recent crisis and in the recovery so far.

This year, China will be the only large economy to see positive GDP growth (in the neighborhood of 2.5%). Because China experienced the COVID-19 crisis first, it also began recovering sooner than any other country, thereby leading the global business cycle. China's impressively effective virus control also makes it fairly impervious to the possibility of renewed shutdowns, which will help to ensure that its recovery is uninterrupted. Meanwhile, this year's US GDP contraction of around 3.7% will be considerably less acute than declines of over 9% in the UK and around 7% in the eurozone.

It is therefore important for investors to consider their exposures to China and to the United States in 2021; we believe these economies will present opportunities that investors can't afford to miss. Beyond short-term outperformance, both of these economies enjoy favorable potential growth dynamics relative to the rest of the world and therefore should remain attractive investment destinations over time as well.

This is not to say, of course, that investors should approach either market without carefully taking account of potential risk. China's narrative of success, for example, is extremely compelling. At the same time, high debt levels, geopolitical tensions, and deteriorating demographics pose some challenges. With Chinese stocks making up a substantial proportion of EM benchmarks, and with Chinese bonds now included in credit indexes, this may be the time to consider a dedicated allocation to China, so that relevant risks as well as opportunities can be considered fully.

Elsewhere, the UK looks like a clear underperformer from a macroeconomic perspective, with GDP growth lagging its European peers so far this year. The UK's handling of the COVID-19 outbreak was also fairly disappointing, as the tradeoff between mobility restrictions and outbreak management was suboptimal compared with, for example, Germany's experience. Both Germany and the UK are now experiencing a sharp increase in mobility restrictions, but this is occurring against the backdrop of an average 5.9% year-on-year decline in German GDP during the first three quarters of 2020, compared with an 11.0% plunge in the UK. Given the approaching Brexit deadline — with no deal in hand as of this writing — the UK faces rather unfavorable circumstances for near-term economic performance. In general, despite relatively cheap valuations, we see greater risk of earnings disappointment in the UK and eurozone and a lower concentration of the high-quality growth companies that we think are most likely to weather upcoming challenges.

Brexit: Compounding Crises

The COVID-19 crisis by itself would present a formidable challenge for UK policy makers. But, of course, there is also Brexit. Prospects for a deal look so bleak that the UK government's own base case scenario implies a fallback to WTO rules at the end of the year.

While we believe that both sides have an interest in avoiding a chaotic transition, and that the UK, in particular, will likely accept a lax implementation of border controls (at least temporarily) as well as regulations to mitigate the negative business impact, Brexit is a key downside risk to our 2021 forecast. It is with these risks in mind that the Bank of England has recently scaled up its QE program and engaged in an active implementation review of negative interest rates.

The eurozone may present the middle ground between an outperforming US and an underperforming UK. The eurozone certainly faces challenges, as clearly evidenced by mounting COVID-19 cases and renewed mobility restrictions. A fourth-quarter GDP contraction seems more likely than not, given these recent developments. On the other hand, though, a more cohesive and supportive macro policy will prove helpful, not only in supporting the 2021 recovery but also in reducing internal frictions and troublesome institutional limitations to growth (e.g., an insufficiently counter-cyclical fiscal policy).

In emerging markets (EM), the economic outlooks are as varied as they are many. Given their relatively greater dependence on both exports in general and commodities in particular, EM economies would see disproportionate relief from a medical solution to the crisis. Investors will need to weigh that positive propellant against the fundamental strength — i.e., the macroeconomic and institutional strength — of each market in order to identify the best performers.

Quantitative Easing and the Prospect of Inflation

Investors can take some solace in the knowledge that monetary policy will remain supportive globally for a while yet. The Fed's adoption of an average inflation targeting (AIT) framework is already proving influential, and the thinking behind the change — shared among many other central banks — has already triggered additional monetary easing elsewhere, including Canada, Australia, and the UK. Low interest rates and more QE could be a powerful combination that prevents bond yields from moving up too much even as investors start to more carefully ponder the possibility of higher inflation.

For our part, while we have raised our inflation forecasts for both this year and next, we only did so modestly. It remains very difficult to answer one of the most salient questions related to the COVID-19 crisis: Will it prove to be an inflationary or deflationary shock over the medium term?

Potential Change in US Policy Direction

The recent election of Democrat Joe Biden as the next US president has sparked fresh speculation about the timing, scale, and characteristics of further fiscal stimulus. Pressure to pass a stimulus package before the end of the year is mounting as the current wave of COVID-19 infections in the US threatens to slow the economic recovery. As of this writing, we believe that a smaller-but-sooner support package is most likely, somewhere between the $0.5 trillion proposed by Senate Majority Leader Mitch McConnell and the $2.2 trillion proposed by House Speaker Nancy Pelosi. A larger-than-expected package could trigger further questions about the potential for rising inflation.

In the global effort to address climate change, the outcome of the recent US presidential election represents a pivotal shift in the political landscape of the world's largest aggregate carbon emitter. The incoming president's $2 trillion climate package is focused on infrastructure improvement, job creation, and boosting renewable energy. Although the potential obstacles to this ambitious proposal remain unclear as the battle continues for Senate control, we believe the tone of the climate-change discussion will change with the new administration, supporting further adoption of ESG practices.

Closing Thoughts

As we cross the threshold into 2021, uncertainty continues to prevail, leading to many questions with few clear answers. Rising infection rates raise questions about the extent of restrictions that will be brought to bear in response. Ongoing quantitative easing leads to questions about the inflation outlook. Runoff elections in the United States lead to questions about the policy landscape. And the challenges in reaching a Brexit deal (as of this writing) lead to questions about the ability of the UK's economy to weather the transition.

In this environment, it's important to recognize the potential for positive developments — especially in the form of an effective, scalable vaccine — to exert a healing influence. In the meantime, as the world awaits final, medical resolution to the pandemic crisis, we believe that the United States and China will weather the looming test of global resilience best.

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* This figure is presented as of September 30, 2020 and includes approximately $80.51 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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