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Solving for 2021: An Inside Look

Disruptive Forces in Investing

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Anu Rajakumar: As we approach year end, we're all reflecting on what has been a tumultuous year in so many ways, whilst also looking forward to 2021. Here at Neuberger Berman, we asked our chief investment officers to share thoughts on what might lie ahead, as highlighted in our Annual Investment Outlook: Solving for 2021. As we see the light at the end of the tunnel with an end to the pandemic, we think about how the global economy may fare, and how investors can operate after the monumental impact of the COVID-19 financial crisis. I'm Anu Rajakumar, and today on “Disruptive Forces,” I'm delighted to be joined by our chief investment officer for Multi-Asset Class, Erik Knutzen, who will speak with me in further detail on what to anticipate in 2021. Erik, thanks so much for joining me.

Erik Knutzen: Thanks, Anu. Great to be here.

Anu Rajakumar: Erik, after a year like 2020, I'm sure we all have so many questions on what to anticipate in 2021. But let's start with the path of the virus. Even as the cases unfortunately surge in Europe and the U.S., as we record this podcast, frontline health care workers and the elderly have started to receive Pfizer's vaccine, with Moderna’s vaccine on the way as well. What should investors keep in mind in terms of market valuations?

Erik Knutzen: Well, Anu, I think the first and most important thing is to acknowledge the incredible path of the vaccine development, and really a triumph of science in an – in an extraordinary environment, extraordinary short period of time. And what that does is that creates, as you said, a light at the end of the tunnel. A view to where, by as early as mid-2021, the global economy can begin to get back to normal. And what this creates, along with extraordinary monetary and fiscal policy stimulus that has been pursued by policy makers around the world, is the beginning of a new economic cycle. And we expect 2021, in total, to be characterized by early economic cycle dynamics of improving economic growth, rising corporate earnings, falling unemployment, likely rising prices, while policy support still remains quite strong. Now, while that seems like a pretty attractive economic picture, it is important to remember that volatility isn't over yet. We still have uncertainty about the path of the virus and the implementation of the vaccine. And at the same time, we have to acknowledge that many markets look fully valued after the significant rally we've seen in 2020. So, it is certainly a time where we expect volatility and risk to remain front and center with investors.

Anu Rajakumar: Thanks, Erik. You make some excellent points, there. On top of an already action-packed year, it was, of course, an election year here in the US. So, Erik, what are some of the key policy changes that investors should be conscious of with the change in the US administration, both here, domestically, as well as outside of the US?

Erik Knutzen: Well, global investors have been really focused on the US election, and the outcome appears to have been applauded by investors. The likelihood of a divided government, or at least even if the Democrats end up with a 50/50 split in the Senate, the unlikeliness of either party being able to make broad and sweeping policy changes. And that has served to reduce uncertainty and encourage investors, and we've certainly seen that in markets. That said, a fair amount of uncertainty still remains. What will that policy environment be after the inauguration? It does appear that there will be an interim stimulus deal during the session before the inauguration on January 20th, perhaps as much as $900 billion. That will be a good shot in the arm in the United States, at least for the first quarter and into the first half of 2021. Our expectation is that fiscal stimulus will continue even beyond that, although perhaps not at the levels that were expected when many polls were indicating more of a Democratic sweep or a blue wave election. The focus will be on areas where both parties can find common ground. So definitely continued crisis remediation stimulus, but also potentially focus on stimulus around infrastructure. Less so, around areas of climate change, and less likely to be sweeping tax reform, at least early on. At the same time, it will be important for investors to watch the evolution of the regulatory environment, as the new administration gets underway in the first half of 2021.

Anu Rajakumar: Great. Thanks, Erik. Now I want to talk about some key themes of the post-COVID environment. We have, of course, experienced a leap forward in the digital economy, with the new work-from-home environment. But we've also seen an impact on global supply chains. So, Erik, my question is, what are some of the critical changes that you're seeing as a result of pandemic?

Erik Knutzen: Yes. In addition to being a new economic cycle, we believe that the post-COVID environment represents a new investment regime, just as we saw a new investment regime emerge from the great financial crisis and the tech bubble bursting in the early 2000s. This new investment regime in many ways will represent an amplification and acceleration of some key themes that were going on, going into the COVID crisis. The increased digitalization of the global economy, digital transformation in so many ways and its associated disruption. And in that way, we think of this as really the – the crisis served in a way to pull forward at least two years of the kind of trend towards increased e-commerce and disruption across the digital economy.

Now, there are many winners in that theme, but there are also some challenged areas. One area we're watching very closely is real estate, where the work-from-home environment and the rise of e-commerce continues to disrupt areas like brick and mortar real estate, and central business district office. At the same time that other areas thrive, such as cell towers, warehouses, servers and data centers, as well as hot areas of the housing market. It is a time where we think it is important for investors to be selective in pursuing these opportunities, broadly, but particularly in areas like real estate. Another key theme that we are exploring is the impact that the crisis has had on global supply chains. We identified several years ago that globalization may have seen its maximum impact and was underchallenged even before the current US presidential administration.

We think that the COVID crisis continues to present a challenge for globalization, as companies see the need to localize and regionalize supply chains, create more robust business models. And we think that this will create a headwind to the growth of trade and increasing regionalization of economies. To a certain extent, the bifurcation of the global economic system that we've seen begin to emerge between a China-led portion and a U.S.- or Western-led portion, may be accelerated by the COVID experience. This doesn't necessarily mean that we won't see more global growth, as a result of transformational changes, the increasing digitalization, increasing application of technology and commerce. But these threats to globalization may represent some additional cost and some headwinds to growth, as well as potential catalysts for some inflation down the road.

Anu Rajakumar: Terrific, thanks. Maybe just sticking on the theme of investment regimes, you know, there's been an indication that central banks intend to keep interests rates low for a continued significant period. It appears the volatility we've seen in bond markets might be translating instead to currencies. Erik, what are your thoughts on this, and does this apply to cryptocurrencies, as well?

Erik Knutzen: You had to ask about cryptocurrencies! That's one of the questions we're getting. I'm going to hold off on that for a moment. I'm going to talk a little bit about central banks and yield curves and currencies, and then get back to crypto. Yeah, indeed, our expectation is that central banks will stay low for longer in terms of what priced in the forward markets. Investors are not expecting short rates in the United States to rise before two years. The Fed just reiterated that they don't expect to raise their policy rate through the end of 2023. Forward curves indicate that the Euribor, or euro short rates are not expected to go positive in the next five years. This lower-for-longer environment means that it is likely that yield curves will stay somewhat kind of stable on the short end, and that bond market volatility will be less than what we have seen historically, as central banks keep their thumbs on the scales of bond markets. As a result, we do expect some volatility to translate into currency markets. So investors who are looking for ways to both add value in portfolios, but also potentially create some uncorrelated return streams, may look to add exposures in currencies, either using currencies as developed market currencies, for example, as part of a hedging framework, or even looking to take advantage of the decline in value of certain developed market currencies, like the dollar, which is something we do expect some modest weakening of the dollar, and finding opportunities in emerging markets currencies, which we think can benefit from the early cycle dynamics we described earlier.

In terms of the potential impact for cryptocurrencies, such as Bitcoin, certainly there are many investors who are looking at this area as a possible area for both appreciation, as well as a hedge against monetary policy in central banks, perhaps seeking to devalue their currencies to continue to catalyze growth. And while we as investors are not yet able to really invest in crypto in any kind of an institutional fashion, and we still think that the risks probably outweigh the opportunities in crypto currencies. We do see an area, like gold, or precious metals, as being a potential beneficial exposure to both help hedge against the volatility that we expect to continue, as well as to help buffer investors against the potential devaluation of the odd currencies, as central banks continue to pursue very easy money policies.

Anu Rajakumar: Great. Thank you. Particularly thanks on the thoughts on crypto. Now, investors are increasingly leaning into both the public and private equity sectors when it comes to thematic investing. So, Erik, can you shed some light on how investors should consider this area of investing, especially with regard to key post-COVID themes?

Erik Knutzen: I think this is really about investors grappling with where they are going to find sustained secular growth in coming years. I mentioned that we have expectations that 2021 will be a generally positive economic environment, represented by early cycle dynamics. Once we get through 2021, and the significant fiscal stimulus that has been deployed, we begin to get concerned that in future years we may return to a longer-term environment of secular stagnation, characterized by low economic growth, relatively low-inflation and persistent low-interest rates, similar to what we experienced in the long post-GFC. Very moderate, very low growth period of economic recovery. In that secular stagnation environment, investors will find that any area where they can get sustained secular growth drivers, or find sustained secular growth drivers, will be particularly valuable. This can be in pursuing key themes, like disruptive technologies, like investing in companies that are leaders in 5G or autonomous vehicles, or fintech. Or it could be in pursuing areas or regions that represent particularly attractive growth dynamics, or where these disruptive technologies are more ubiquitous. An example of that would be China and Greater China, which is experiencing expected higher GDP growth, but also is the host to some of the technology leaders in these key disruptive areas. Finally, this thematic and these types of exposures can help diversify portfolios in an environment where we have lower expectations for returns from traditional stock and bond market categories. To have a higher growth component of portfolio can be quite beneficial.

Anu Rajakumar: Absolutely very important, particularly those comments on diversification. Now, as we wrap up here, Erik, any final thoughts on what investors should be keeping in mind across asset classes as we move into 2021?

Erik Knutzen: Well, as we opened, we do expect 2021 as a full year to be a reasonably good environment for investing in assets that benefit from that early cycle environment. That tends to be equity markets, tends to be credit markets, can include commodities, within our multi-asset class portfolios and consistent with our asset allocation committee views. We are biased towards equities. We are biased towards non-US equities, European and Japanese markets, and increasingly emerging markets that can benefit from that reflationary growth environment. We're biased towards smaller company stocks in the United States, and biased towards credit, which we think will generate an attractive return relative to very, very low-yielding government bond markets. We also see very interesting opportunities in private markets, where investors can both take advantage of the kind of long-term themes that we described in our earlier section on thematic investment, but also take advantage of the disruption and dislocation that remains to play out in the post-COVID environment. Finally, I'd close on the note to remind our investors that, despite this seemingly pretty rosy outlook for 2021, volatility isn't over yet. We're still in the midst of a very challenging global pandemic environment, and there are many, kind of, shoes yet to drop, as we work our way through this process. So, investors should, you know, manage the risk of their portfolios accordingly, and be ready to take advantage of volatility as it arises, to add to areas of opportunities, as we've discussed during this session.

Anu Rajakumar: Great. I think that's a perfect place to wrap this episode. Erik, appreciate you joining me on the show today to provide your insights on how to navigate markets. Happy New Year to you and thanks, again.

Erik Knutzen: Thanks, Anu. It was my pleasure.

Anu Rajakumar: And to our listeners, a reminder that Neuberger Berman's Annual Investment Outlook: Solving for 2021, is linked below in the show notes. And as we close 2020, we want to thank you for your listenership. We hope you've enjoyed the content we've delivered this year and we look forward to connecting with you in 2021. Have a healthy and safe new year.

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