2021 outlook: Mind the gap

The gap between economic output and the economy's potential will be key in 2021.

BY JURRIEN TIMMER, DIRECTOR OF GLOBAL MACRO FOR FIDELITY MANAGEMENT & RESEARCH COMPANY (FMRCO), FIDELITY VIEWPOINTS – 12/08/2020 - 7 MIN READ

Key takeaways

> With promising news on vaccines, the narrative in the markets has recently switched from the need for more fiscal policy reflation to the potential for a vaccine-driven reflation. The nuance may seem trivial, but it has important implications for how quickly and sustainably the gap between the economy's potential and real output can close.
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> The output gap has improved a lot, but that still leaves a large gap to fill, and the current wave of COVID-19 infections has caused the economy to stall out a bit.
>
> But with vaccines potentially on their way, the potential is there for the gap to close in 2021, despite the uncertainty around the timing and magnitude of additional fiscal policy stimulus.
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> Much of this is already priced into stocks, however, and with real rates possibly rising in 2021 amid already high valuations, I expect only modest returns for stocks from here. This is consistent with the first year of the presidential cycle.

Along the 17-mile drive on the Monterey peninsula in California, there's a

famous tree called the "Lone Cypress" perched on a cliff. It reminds me of the ongoing popular (and, in my view, incorrect) narrative that the current market is in an unsustainable, policy-induced bubble as we wind down this most surreal year. Teetering on a cliff, if you will.

I don't think the market is in a bubble at all, far from it. But in my view, with valuations full, rates (too) low and a robust earnings recovery already priced in, neither is there a ton of upside from current levels. Instead, for 2021 I expect something more mundane at the index level, and plenty of rotation below the surface.

Feedback

Fiscal vs. "vax" reflation

COVID cases are soaring and more and more states are reimposing restrictions, yet the market keeps gaining ground to new highs as the promise of effective vaccines continues to take shape. While the market "gap" has closed, the economic gap has not. Is it a disconnect as the bears claim, or just a matter of timing? After all, price tends to lead earnings, and this year has been no exception.

About the expert

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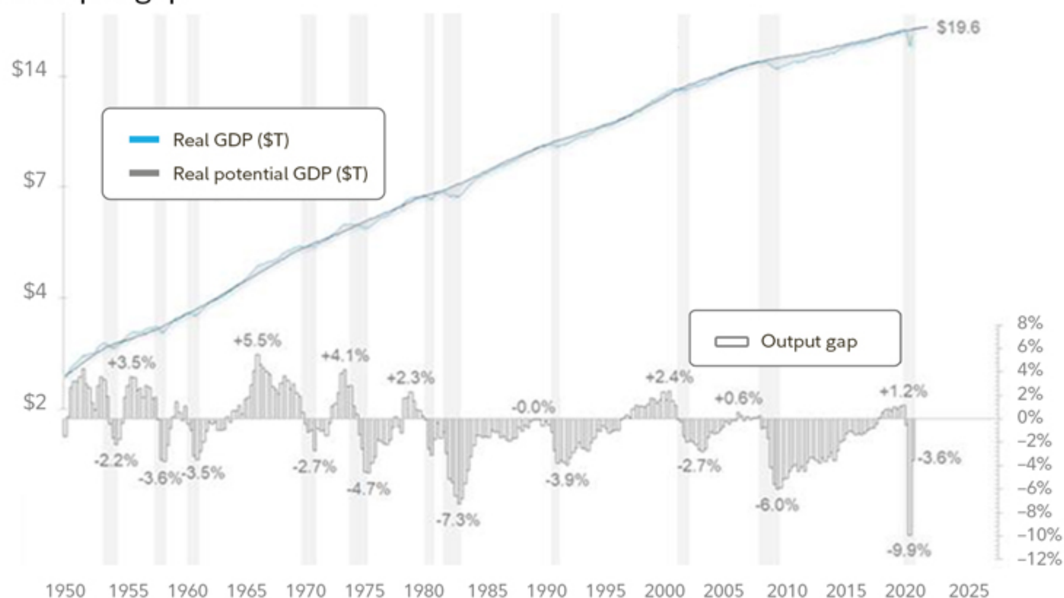
Hopefully 2021 will be a steadily improving, less-volatile year. But for a market that has recovered all of its COVID-induced losses and then some, 2021 could be pivotal in demonstrating whether that optimism is justified. It's all about the gap and how and when it will close.

Until a few months ago it was mostly a question of whether the economy could recover on its own in 2021, or whether new waves of COVID-19 cases would require ongoing support from the government and the Fed to help the economy close its gap—a fiscal/monetary bridge to the economic recovery. With COVID running rampant throughout much of the world, the answer has turned out to be the latter.

We don't yet know which party will control the Senate, which has sowed doubt on the scale, scope, and timing of the fiscal bridge. The Fed has made it clear that it can't do all the heavy lifting, and that the bridge needs to be a combination of fiscal and monetary policy.

But now with the promise of several effective vaccines on the way, the question becomes how much of a fiscal/monetary bridge is needed and whether this "fiscal reflation" can be replaced with a "vax reflation." It may not sound like a big difference, but for the markets it matters. A fiscal reflation might extend the bridge to the eventual full reopening of the economy, whereas a vaccine might unleash serious animal spirits sooner and maybe even cause an economic overheating in 2021.

Either way, the output gap needs to close in the coming quarters. As the chart shows below, a lot of progress has been made already. The output gap, which is the difference between actual GDP growth and potential GDP growth (which is the sum of labor force growth and productivity growth) went from +1.2% in Q1 to –9.8% in Q2, and since then has recovered nicely to –3.6% in Q3.



Quarterly data as of 11/29/2020. Source: FMRCo, Haver Analytics, Bloomberg.

But that's still a large gap, and now the question is whether vaccines will be available fast enough to prevent the economy from stalling out. The economies in Europe and the US have stalled out in recent weeks as rising COVID cases have led to renewed lockdowns. Only China and Taiwan have returned to their pre-COVID levels of activity.

Are the market highs justified?

With the impressive growth rebound in Q3 (33% annualized) behind us, the question understandably is whether the market's new highs are justified.

My sense is that the gains since the March 23 low are indeed justified and that there will likely be an ongoing reflation in 2021, and that the output gap will continue to close. Who knows, maybe it will be a combination of both fiscal and vax reflation. If the Democrats end up winning the 2 run-offs in Georgia, we may well get a lot of support from the government at the same time that vaccines are on the way and begin to allow the economy to return to something resembling normal.

If that happens, the economy may well run very hot for a while, especially against the backdrop of so much pent-up consumer demand. But if the Republicans hold on to the Senate, it may have to be the vaccines that do the heavy lifting.

Either way, the markets seem to be betting on a pretty good outcome in 2021. The tape has significantly broadened in recent weeks, with value and small caps and non-US equities catching up to growth stocks and gold. This cycle started as a very narrow recovery but it has broadened out nicely.

The rotation from growth to value and from large caps to small caps is happening right on schedule. This leadership change is what normally happens during early cycle, but this being 2020 it is happening later than usual. The rotation in sector and style leadership is particularly interesting this time around because it is coming off levels that are historically quite stretched. It has been all-one-trade for the past 10 years or so, and now we may finally have a catalyst for returning to historic averages, both cyclically and secularly. Secular refers to trends that play out over many years while cyclical trends tend to be short-term moves that align with the ebb and flow of the economy.

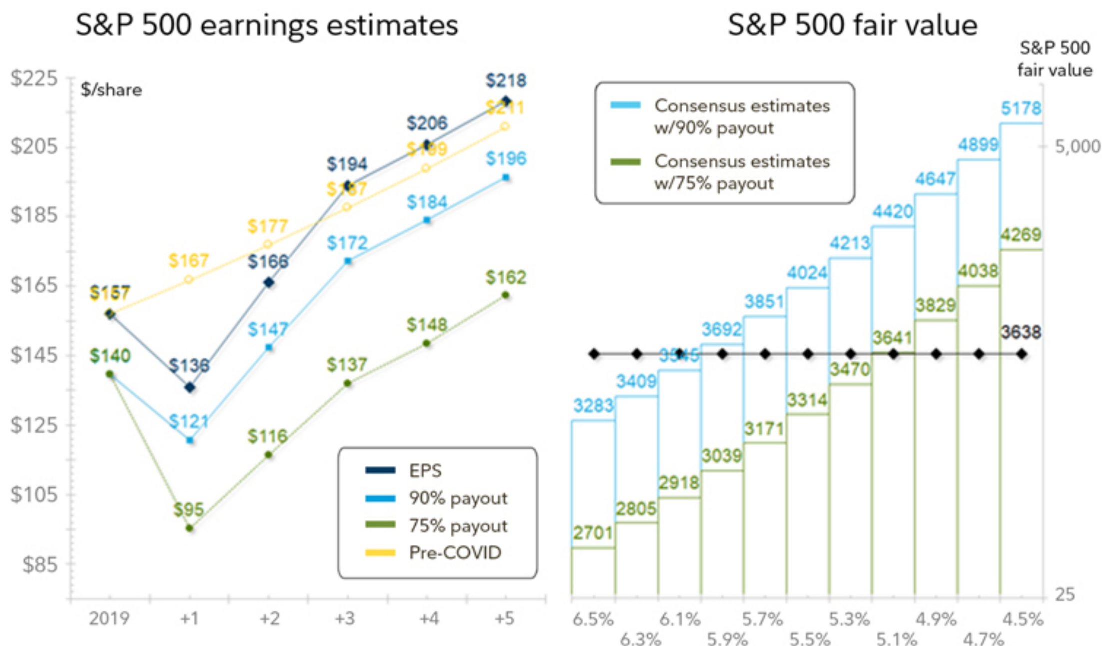
Is there a valuation gap?

If interest rates end up rising in 2021 (say to 1.5%), this could undermine the fair value of stocks, against a backdrop where the equity risk premium is already down to 4%. The equity risk premium (ERP) is the additional return that investors expect to earn over Treasury bonds or the risk-free rate of return.

The chart below shows the discounted cash flow model using the current consensus earnings estimates from Bloomberg, and applying a payout ratio of 90% (i.e., dividends plus share buybacks as a percentage of earnings), as well as a more modest 75% payout ratio.

On the right I show what that means for the market's fair value, based on

the current discount rate of 4.9% (risk-free rate of 0.9% + equity risk premium of 4%), as well as a higher discount rate of 5.9%. As you can see, changing the discount rate by 100 basis points (bps) moves the needle by 800 S&P points. A basis point is 1/100th of 1%.

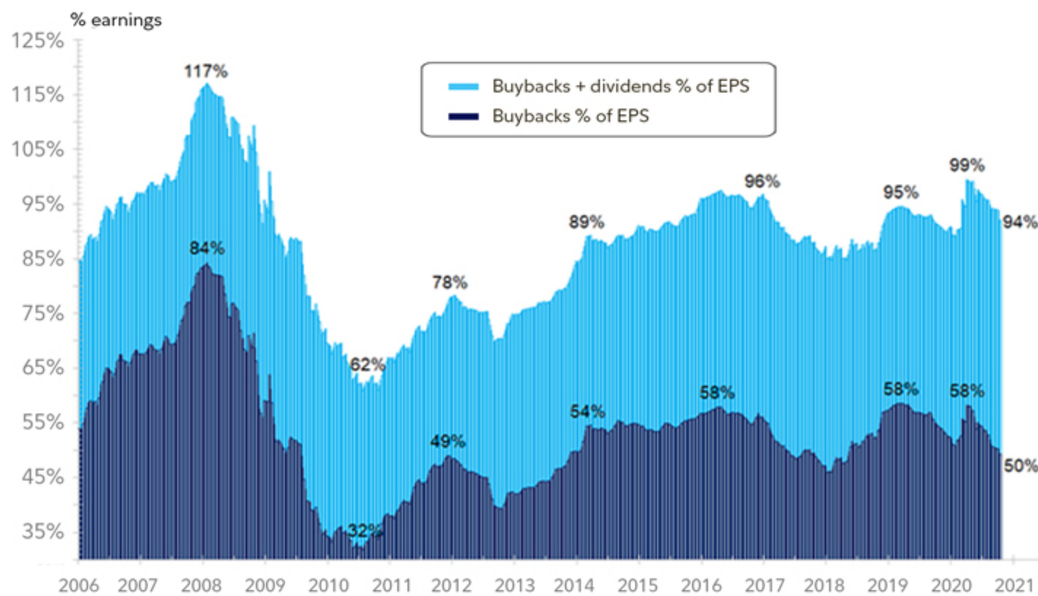


Source: Bloomberg, FMRCo.

The 3 major inputs into the discounted cash flow* (DCF) model are the 5-year earnings trajectory, the payout ratio, and the discount rate. With rates below where they should be, the evolution of share buybacks could be a major driver for stocks as the earnings recovery cycle continues into 2021 and beyond.

In 2020 buybacks have come down a lot, which is to be expected when earnings growth declines. When companies have extra cash, they sometimes buy shares from the marketplace. They may want to reduce the number of shares of stock in the market or try to help boost returns for shareholders. But earnings have lagged in 2021 and you do normally need to have earnings to buy back shares, after all.

But buybacks as a percentage of earnings are holding in nicely at around 50%. The chart below shows the 12-month trailing amount of buybacks per share, as well as the overall payout ratio (dividends plus buybacks). The payout ratio is still at a generous 94% of earnings, although that number is very likely to come down in the coming quarters as earnings continue to recover (much like they did in 2009). I think 75% is a reasonable estimate for where the payout ratio could end up in 2021.



Weekly data as of 11/29/2020. Source: Bloomberg, FMRCo.

If the earnings recovery is fully priced in via current consensus estimates, and the payout ratio falls from its current 90% to something lower, and the discount rate rises by, say, 50 bps, it is hard for me to see where further robust gains will come from in 2021. The ERP could come down further, but at 400 bps, I think it's already fully valued.

Indeed, a less robust uptrend fits with the first year of the presidential cycle. Typically, the first 2 years of a presidential term produce below average returns for stocks, while the last 2 years produce above-average returns. But that's "all else being equal," which is hardly how we can describe 2020.

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Investors seem optimistic about 2021

With the Dow Jones Industrials Index reaching 30,000 last week, investors are understandably getting more optimistic about the future.

That optimism is showing up in the fund flow data and it's evident in the market's internals, with value and small caps making a dramatic comeback.

All in all, I expect 2021 may be a more "normal" year for the market (i.e., average gains or even below average), but with more of the action happening below the surface than at the index level. If the current cyclical rotation into value and small caps ends up also reversing the secular trend,

then we still have a long ways to go.

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Dow Jones Industrial Average, published by Dow Jones & Company, is a price–weighted index that serves as a measure of the entire US market. The index comprises 30 actively traded stocks, covering such diverse industries as financial services, retail, entertainment, and consumer goods.

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