2021 Investment Outlook: "US Resilient"

Jake Siewert: This is Exchanges at Goldman Sachs where we discussed developments currently shaping markets, industries, and the global economy. I'm Jake Siewert, Global Head of Corporate Communications here at the firm.

Today I have the pleasure of talking to Sharmin Mossavar-Rhamani as we always do this time of year. She's got a new investment outlook out called "US Resilient." Sharmin is the Chief Investment Officer for Wealth Management here at Goldman Sachs.

Sharmin, welcome back to the program.

Sharmin Mossavar-Rhamani: Thank you very much for having me.

Jake Siewert: So, the title of your investment outlook this year is "US Resilient." Explain what you mean by that and how it serves a strategic framework for investing in 2021.

Sharmin Mossavar-Rhamani: Jake, as you know, we spent an inordinate amount of time on our cover, whether it's the image that we use or the title that we have, because we'd like to have a message that's totally clear for our clients, where they can just look at the cover and get the key themes of the message of our whole outlook. So, for 2021 the title is "US Resilient." And we have a very strong image. It is a US flag, so the flag of the United States, embedded in a map of the United States. And then on top of that we just have a white graph that shows the performance of the S & P 500 since March of 2009. So, there are three messages that we're trying to convey to our clients with this. First and foremost, an investment theme that we've now had since the global financial crisis of US preeminence is alive and well. So, in spite of some of the so-called declinists talking about the decline of the US, they talked about it in the global financial crisis. And they talked about it during the pandemic in some of the riots that we saw and what we saw happening on Capitol Hill, that's been the theme of the decline of the US. And we're taking a very strong stand that, no, US preeminence is intact, and clients should have the preponderance of their assets in US equities and US private equity.

The second important theme that we have with that image is the graph of the S & P 500 actually telling you that we recommend clients stay invested. Again, that's the theme we've had since the trough of the global financial crisis. It's a theme of telling clients to stay invested, not to go underweight equities. Since March of '09 to the end of 2020 the S & P 500 is up providing a total return of 609 percent. That's about 18 percent annualized, far outperforming other developed economies and emerging market equities.

And so, the message to clients is to keep on staying invested. That our recommendation of US preeminence and staying invested has served our clients well. And people might think that those two themes have outlived their value. And our message is, no, continue with that theme.

Then the title, specifically "US Resilient," is meant to highlight to clients how resilient the US economy is and how resilient corporate management has been in terms of responding to the pandemic and managing to still generate reasonable earnings relative to what was expected at the beginning of the pandemic. We also want to convey the message that US institutions are very resilient. So, rule of law, the role of Congress, the role of the Senate, the role of the presidency, that these are strong institutions that no one person can derail or actually overcome and do what we see in other countries. That these US institutions are resilient. They can handle all kinds of people in all kinds of administrations and all kinds of pandemics. And eventually, they recover. And hence, the quote that we have on the bottom of our title from [UNINTEL] about the endurance of US institutions.

Jake Siewert: Well, I love the cover. My son picked it up. He's 12. And he looked at it and he said, "Is that the US stock market?" I said, "Absolutely." I hadn't even noticed that detail in the cover. So, he's more observant than I am.

So, global equity markets have continued to rally really strongly since the crash last March. And your advice to clients is to take some money off the table or stay the course?

Sharmin Mossavar-Rhamani: Our recommendation has been to stay a course now. In fact, we have a couple of really great exhibits in the outlook, which if I'm not mistaken, is available on GS.com for people who'd like to look at it. And there are two exhibits we show. One of which is that even though we say stay invested, it doesn't mean we don't want to be tactical. So, during the pandemic in the down draft in February and March, we actually were recommending clients start going overweight equities, rebalance their portfolios relative to their long-term strategic asset allocation. And then as the market rallied, we reduced that overweight. So, we do recommend clients be tactical. But it doesn't mean go underweight equities.

We also have another great exhibit that shows the path of the S & P 500 in 2020. And against that in the background, we have a shading of the number of global infections of COVID-19 over the course of the year. And the reason we put those exhibits together for the clients is to ask if anybody actually told you at the beginning of 2020 that we were going to have at the time about 20 million infected people in the US, we were going to have 340,000 fatalities, we would have a GDP that was down 3.5 percent, that we would have earnings down, at the time estimates were 20 to 25 percent, we think now earnings will be down maybe mid teens for all of 2021, so all fourth quarter earnings are out. But if somebody gave you all of that information and said another 10 - 11 million people will be unemployed by the end of the year, nobody would have predicted the equity market would be up 18 percent.

So, it's very important that clients realize that sometimes the equity market will look beyond immediate concerns and immediate issues. And so, to try to time the market and go underweight equities in anticipation of something that may or may not transpire, such as the risks of the new variants or the risks of a slower rollout of the vaccines, then you actually don't know if you'll get a chance to get back in again. Hence, we tell the clients to stay the course.

There is also an element of valuation. While people talk about valuations being high, we look at valuations in the context of periods of low and stable inflation. When you're in periods of low and stable inflation, equity market valuations are higher. So, while we do look at long-term averages since World War II, we also like to look at valuations since April of 1996 when we got into this period of low and stable inflation. And in that context, equities are above average in terms of valuation. But not that expensive and nowhere near the bubble levels that some people talk about. Again, another point to stay invested.

Jake Siewert: And yet, even with all the growth we've seen in the US and the equity markets, you're very bullish about the prospect for returns in 2021. Explain why that's so?

Sharmin Mossavar-Rhamani: So, obviously Jake, being bullish is a matter of perspective. So, our base case return for 2021 is 8 percent. 6 percent price return, 2 percent dividends. And our base case means we're assigning it 60 percent probability. But we also have a nice 25 percent allocation to the upside which is around 17 - 18 percent total return. Now our own David Kostin from Goldman Sachs actually has a view of a return around 17 percent for his base case. So, I think we're positive, but not extremely bullish. We also have some probability assigned to the downside. That probability we're assigning is around about, let's say, 15 percent. But the market could be down 17, 18 percent. So, our base case is good returns, but not spectacular returns.

Jake Siewert: Now, outside the US, what is your view of prospect for returns of equity markets in other developed nations?

Sharmin Mossavar-Rhamani: One of the questions our clients are asking us right now is exactly what you're asking. Meaning, given how much US equities have outperformed other developed economies and emerging markets since the global financial crisis, isn't it time to actually go overweight, let's say, Europe, the UK, Japan, emerging markets? And we actually suggest the preponderance of the assets still remain in the US. And the reason we say that is while we acknowledge that there are some tactical opportunities in these regions, we actually think that this cheapness is justified.

If we look across all US sectors and compare the earnings growth of these various sectors to the earnings growth of their counterparts in Europe and the UK and Japan and emerging markets, US companies have far outperformed on an earnings per share growth basis since 2007. And this is not one or two percentage points of better earnings growth. We're talking about 5 percent a year better earnings growth. In technology, for example, 10 percent a year better earnings growth. So, we feel that this discount is justified because the companies in these regions and these countries are not providing the kind of earnings per share growth that companies in the US are providing for their shareholders.

Jake Siewert: So, let's talk about emerging markets. Obviously, the pace of vaccines is lower there on a per capita basis, much lower than in the developed countries. How does your outlook differ for those emerging economies compared to the more developed ones?

Sharmin Mossavar-Rhamani: If we think of emerging markets, the largest driver in terms of the economic growth of emerging markets is China. And China has weathered the pandemic quite well. While most countries had moderate or significant down drafts in GDP in 2020, China is the only country that actually has a positive GDP number for 2020 and a very high forecast for 2021. So, China will actually end up 2021 at a GDP that is about 10 percent higher than what they had at the end of 2019. It's the only country that's going to have that kind of growth.

Now we know there are a lot of people who question the validity of some of the numbers that come out of China. But even if you discount some of the historical numbers, it's still pretty strong, robust growth.

In other countries, it's going to be very mixed. Some of the smaller countries will do quite poorly. Some of the numbers for, let's say, India are a little bit better, but they're just recovering from a very bad 2020. So, in aggregate when we look at it, it's not a very compelling argument that clients should actually add to their emerging markets. And then add to that, as you point out, the point about vaccinations and when and what will these countries actually have access to? When will they get some of the higher quality vaccines from Europe and the US versus some of the vaccines where, the vaccines like China or Russia, we just don't have enough data to really know how effective they're going to be, especially against the new variants?

Jake Siewert: So, there's been a lot of talk recently about the traditional allocation model, the so called 60-40 rule being [UNINTEL]. And there has been a lot of rethinking about whether that makes sense in these times. Equities have outperformed bonds for a number of years now. What's your view on that for the year ahead?

Sharmin Mossavar-Rhamani: That is also one of the more frequently asked questions we're getting now as we're talking to clients. They look at our expected returns for equities. So, let's say for US equities around 8 percent. Then they look at the returns we have for US bonds. So, if we're talking about very short duration instruments like cash, the base case return is basically zero. When we're looking at slightly longer maturity securities, like let's say a ten-year treasury, we're looking at moderately negative returns. Let's say, for example, a minus 1, a minus 2 percent. And so, clients are saying, well, with these negative returns, why should we hold onto any fixed income?

The response to that is that when you want a consistent, reliable hedge against down drafts, against deflation, against shocks, high quality US fixed income instruments are the only reliable hedge. No other investment, no other asset class, including hedge funds, including gold, provide that kind of a reliable, consistent hedge.

Since none of us actually have a crystal ball, who knows what kind of shocks could happen? It's not just the COVID-19 concerns and the risks of the variants, but obviously cyber security issues are significant. We don't know what actually SolarWinds hack has done. We don't know the full extent yet. So, there are a lot of uncertainties out there. We don't know the risks of how US/China relations will evolve over time. If the Biden administration changes tack, as they said they have, and try to work with the allies and present a more united front to some of the issues with China, then obviously that could create some more tension and some market downside in the interim, for the short run. And so, again, what would be a good hedge against all of these risk factors? In our view, fixed income.

So, while clients may want to underweight fixed income for some other tactical opportunities, we still think people should maintain a certain amount of high-quality fixed income to hedge against all these risks. And again, it's the only reliable hedge.

Jake Siewert: So, Sharmin, within the credit world do you see pockets of attractive investment opportunities this year, particularly in this low-rate environment?

Sharmin Mossavar-Rhamani: We were telling clients that to enhance yield in their fixed income portfolio, there's no doubt that they'll be taking some type of risk. So, one risk to take would be credit risk. And where we actually think it's a good idea to take credit risk is not in high-yield securities, generic corporate high yield, but actually in bank loans. We think that is a much better exposure for clients. First and foremost, they're based off of LIBOR, so there is less interest rate sensitivity. So, as rates continue a very slow and steady increase, the bank loans won't get hurt.

Second, they're higher in the capital structure, meaning they are higher credit quality and will not get hurt in the event of increasing default rates. We don't have an increase in default rates relative to 2020. But again, given that uncertainty, we think the risk/return trade-off in bank loans is more attractive. So that's one area we do like from an expected return perspective.

Some people have asked about emerging market local debt which has a similar expected return. But we'd rather be in an asset class based in the US so we have greater visibility, great understanding, and no currency risk.

Jake Siewert: So, Sharmin, if last year taught us anything, it's that the best outlook in the world can be made highly irrelevant by an exogenous shock. As you think about the year ahead, and you talked a little bit about some of them, what are some of the risks to your outlook?

Sharmin Mossavar-Rhamani: So, the biggest risk from our perspective is what happens with COVID-19 and the new variants? We still don't know the extent to which we're going to have enough vaccination, given that we still have more of the old variant than the new variants based on what we know so far, that at least get enough vaccinations, so people are protected. We don't really know whether they're going to get to much more effective rollouts and whether companies like Moderna and Pfizer are going to have enough vaccines to deliver and vaccinate everybody. So that's one important risk. Are we going to be able to vaccinate enough people before the new variants, the one from the UK, the one from South Africa, and now Brazil become more prevalent, given the base case that they are more transmissible? So, that's an important risk to keep in mind.

We also know that the vaccines do have some efficacy against, for example, the South Africa variant, but not as high. It's lesser efficacy. And we also know that companies like Moderna are thinking about their booster shots. So, there is a lot of uncertainty around the vaccines and around the variants if we're looking all the way to the end of 2021, for example. So, that creates some uncertainty.

Our view is there is as much downside risk in growth, as there is actually upside risk. So, for example, there's the stimulus. Will the fiscal stimulus package be larger than people anticipate? Some people think the number is going to be closer to 1 trillion. Is there any chance that it ends up being bigger? Is there any chance we have another stimulus package further down the road in 2021? So, those provide some upside to growth.

We know there's a lot of pent-up demand. So, maybe consumers will spend more than we are all modeling because they actually have been saving a fair amount during the pandemic. And the US savings rate was about 8 percent going into the pandemic. And now it's actually, let's say, in the low teens. And when you're looking at that, that could provide upside risk.

So, while the biggest risk is to the downside from things like COVID, US/China relations, the cyber security issues, the type of domestic concern between the far left and the far right that we still have to keep an eye on, and in terms of some of the populist movements at both extremes, those are all risks. But we also want to make sure clients know that we also think there is some risk to the upside.

Jake Siewert: So, Sharmin, you're a great student of history. You have an excellent history of the various strains of declinism, all of which have been proven wrong in this year's outlook. As we look back at last year, what lessons do you think we'll draw from 2020, particularly for investors?

Sharmin Mossavar-Rhamani: Over, the course of our investment strategy group history, and we got started in 2001, we always tell clients that the reason to underweight equities is if you have a very high expectation of a recession. And we say recessions are caused by Fed tightening. So, that's something we can observe and monitor. We talk about big market imbalances. And that's something we can observe. And then the third reason for reasons are shocks, like a pandemic. And so, it's very important to recognize we cannot anticipate shocks, otherwise they wouldn't be shocks. And so, you cannot invest in anticipation of a shock. So, that's a very important lesson.

The second important lesson is that even when you know the facts, as I mentioned earlier, you don't really know how the market will react. Who would have thought that the market would be up 18 percent in 2020? And the key message for that is investors should know we need to have a dose of humility about what we can forecast and what we really cannot. And I think that's very important. When you look at history, you can see that the market does not always respond to the facts on the ground in the way one would anticipate.

In the long run, what will drive equity prices is economic growth that leads to good earnings that will drive the S & P. and they always, eventually, converge. One just has to have the right investment horizon. And I think last year was a very good example of that.

Jake Siewert: Well, Sharmin, you've been right for a very long period of time. So, let's hope you're right again about 2021.

Thank you so much for joining us today.

Sharmin Mossavar-Rhamani: Thank you very much.

Jake Siewert: That concludes this episode of Exchanges at Goldman Sachs. Thank you very much for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcast and leave a rating or a comment. And tune in later in the week for our markets update where leaders around the firm provide a quick take on the latest in markets.

This podcast was recorded on February 2nd, 2021. Thanks for listening.