ClearBridge Investments

Market Should Gain More Balance in 2021

Key Takeaways

- Given resolution of the election and progress on a COVID vaccine, cyclical and value-oriented sectors should continue to outperform growth while small cap companies should continue to outperform large caps in anticipation of a rebound in profits.
- In an environment where interest rates should remain historically low and after a difficult relative year in 2020, we expect a better year for dividend stocks, which offer more attractive yields relative to fixed income and the potential for growing payouts.
- While technology valuations have expanded, growth has expanded as well and the major trends reliant on software and services remain in place. The pandemic accelerated those trends and we expect technology stocks will continue to grow faster than the overall market and should remain a healthy component of diversified portfolios.

Resolution of Major Uncertainties Provides Positive Momentum

The recent backdrop for equities is instructive in forming our views for the year ahead. 2020 has been a year of extremes, with the global COVID-19 pandemic leading to one of the sharpest but shortest bear markets on record that was immediately followed by the best ever 50-day rally for the S&P 500 Index. Equities appear to be ending the year on an upswing as two major uncertainties — the outcome of U.S. elections and the timeline for a COVID vaccine — were largely resolved.

Liquidity is another significant determinant in framing our outlook. Whether judged by money supply, interest rates or credit spreads, liquidity is ample in the current environment and likely to remain supportive of equities in the medium term as the Federal Reserve stays accommodative in its policy approach. Increased liquidity is especially beneficial for small cap companies in accessing the capital markets for financing as well as for the continuation of a robust IPO market. The beneficial effect of a higher liquidity environment tends to wane after 12 to 18 months.

Given these factors, we have a moderately positive view for equities in 2021. Volatility has come down since the election to a level where we do not expect to see significant spikes in the VIX, like markets experienced early in the pandemic, or significant declines. Investor sentiment and earnings forecasts for the first half of 2021 have become a bit exuberant, which will likely lead to consolidation and perhaps a slight correction early in the new year. Longer term, markets should head higher as the economy normalizes with the distribution of a vaccine and adjustment to a new presidential administration. Based on a green expansionary signal for the ClearBridge Recovery Dashboard, we also believe a durable economic bottom has formed, providing further support for equities, which tend to perform strongly coming out of recessions (Exhibit 1).

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The election outcome was very good for equities, which surprisingly tend to do best with a Democratic President and split Congress. This assumes at least one of the runoffs in Georgia will be won by the Republicans, allowing them to hold the Senate. The results take big tax increases off the table, but also lower the likelihood of a fiscal stimulus package in the $2 trillion range that Democrats have been pushing. We see the failure to pass some form of stimulus before the new Congress is sat in January as the biggest short-term risk to markets and the economy as many consumer assistance programs have already expired or will soon.

The approval and distribution of a COVID vaccine is critical for the market and economy to get back on track. Positive vaccine results from three separate drug candidates in November immediately boosted the outlook for cyclical stocks, a broadening of market leadership that should continue into 2021. Vaccine distribution is a complicated task, however, and one we will be monitoring closely. Our base case is that high risk groups and a good percentage of lower risk portions of the population will be getting the vaccine by the end of June.

Given these tailwinds, we believe the cyclical and value-oriented sectors most severely impacted by the pandemic shutdowns look the most attractive. This has been typical in most rebounds from severe equity drawdowns since 1987 (Exhibit 2). We expect the greatest increases in earnings growth will occur in these areas, as they will benefit from easier year-over-year comparisons and improving sentiment. The market has already responded to this anticipation for improvement and should continue to do so.

Dividend paying stocks are a good example of a beaten up segment poised for recovery. Dividend payers did not display their usual defensive characteristics during the height of the pandemic, but instead suffered their worst performance in the last 20 years. Dividend stock multiples are at about 60% of the overall market — the lowest they've been in a long time — and should do well as the broadening of leadership continues. In an environment where we expect interest rates to remain close to zero, dividend stocks offer more attractive yields relative to fixed income and the potential for growing payouts.

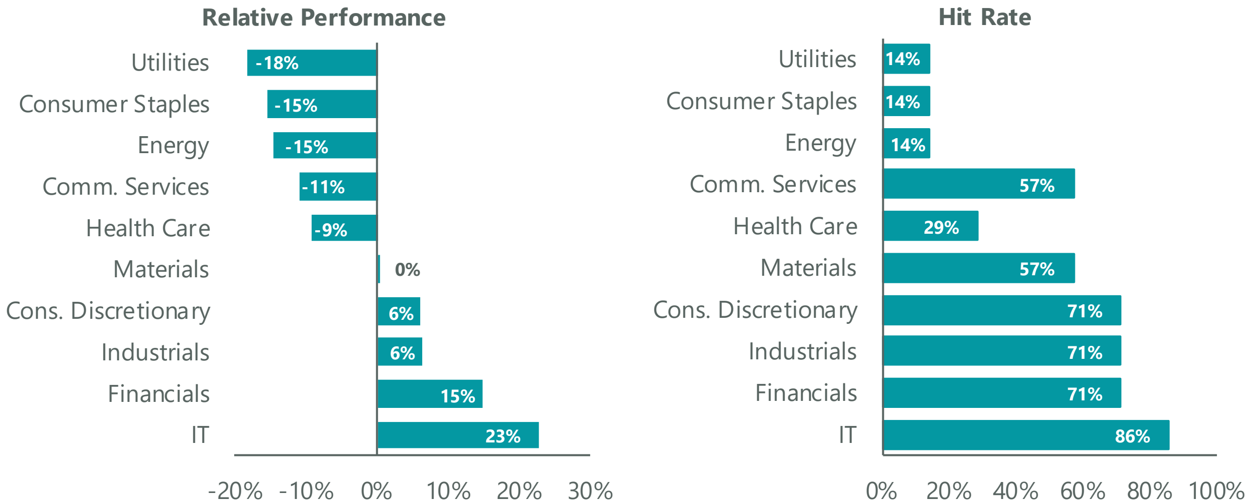
Exhibit 1: Equities Typically Do Well in Burgeoning Expansions

S&P 500 Returns During Economic Expansions

Trough Month	S&P 500 Level	Peak Month	S&P 500 Level	Duration (Months)	Change	Secular Trend
Nov. 30, 1970	87.2	Nov. 30, 1973	95.9	36	10.0%	Secular Bear
Mar. 31, 1975	83.4	Jan. 31, 1980	115.1	58	38.1%	Secular Bear
July 31, 1980	121.7	July 31, 1981	130.9	12	7.6%	Secular Bull
Nov. 30, 1982	138.5	July 31, 1990	356.2	92	157.1%	Secular Bull
Mar. 28, 1991	375.2	March 30, 2001	1160.3	120	209.2%	Secular Bull
Nov. 30, 2001	1139.5	Dec. 31, 2007	1468.4	73	28.9%	Secular Bear
June 30, 2009	919.3	Feb. 28, 2020	2954.2	128	221.3%	Secular Bull
Average:				**74**	**96.0%**	
Secular Bull Average:				**88**	**148.8%**	
Secular Bear Average:				**56**	**25.7%**	

Source: FactSet, NBER.

Exhibit 2: Cyclicals Tend To Outperform in Recoveries



Source: FactSet. Note: Market Drawdowns defined as pullbacks of 15% or greater in S&P 500 since 1987. Hit rate defined as % of severe declines with relative outperformance vs. S&P 500 12 months after each decline.

Don't Give Up on Tech

Simply looking at valuations would suggest technology stocks are overbought and most at risk of disappointing investors in 2021. Yet much of market forecasting is based on past analogs and we would argue that given the unique nature of the COVID-19 pandemic, which caused voluntary shutdowns of broad swaths of the economy, such analogs are not as applicable today. At current interest rates, technology valuations are well supported. Technology companies, which also include names in the communication services and consumer discretionary sectors, were direct beneficiaries of the shift to work-from-home and e-commerce. While valuations have expanded — especially among the largest stocks in these sectors as shown in Exhibit 3 — growth has expanded as well and the major trends reliant on technology software and services remain in place. The pandemic accelerated those trends, making digital parts of the economy larger, and we expect technology stocks will continue to grow faster than the overall market.

Exhibit 3: Technology Valuations Not as Extended as in Past Bubbles

December 1972		March 2000		Current	
Nifty Fifty	**P/E***	**Dot-Com Darlings**	**NTM P/E**	**FAANGM**	**NTM P/E**
Coca-Cola	46.4	Intel	44.3	Facebook	26.7
McDonald's	71.0	Cisco	126.3	Amazon	72.3
Texas Instruments	39.5	EMC	80.0	Apple	29.4
IBM	35.5	Microsoft	57.1	Netflix	55.6
Xerox	45.8	Oracle	107.2	Google	28.9
Polaroid	94.8	Nortel	92.0	Microsoft	30.3
Average	**55.5**	**Average**	**84.5**	**Average**	**40.5**
S&P 500	**18.9**	**S&P 500**	**23.8**	**S&P 500**	**21.8**

*Actual P/E ratios; forward P/Es unavailable for this period. NTM = next twelve month. Data as of Nov. 30, 2020. Source: FactSet; "Valuing Growth Stocks: Revisiting the Nifty Fifty" by Jeremy Siegel, AAII Journal, October 1998.

In addition to taking on a more cyclical bias in 2021, we believe it's important to maintain exposure to these technology disruptors that are transforming the economy. A more balanced market should lessen the index concentration of mega cap growth stocks and we expect the equally-weighted S&P 500 Index will outperform its market-cap weighted counterpart in the year ahead. Smaller companies should also benefit from abundant liquidity, greater savings and gradual normalization of the economy as vaccines become available.

About the Author

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- 29 years of investment industry experience
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