2021 Outlook:
Back to the Future

After a year that upended social and market norms, the distribution of a COVID-19 vaccine should allow the economy to return to a new normal as we progress through 2021:

- Household consumption will remain the backbone of GDP, but spending habits will be different.
- The labour market is poised to improve, benefiting from increased productivity and rising wages, but office settings and commutes won't look the same.
- We believe we are in the initial stages of a new expansionary cycle, offering a favourable runway for financial markets over time. That said, we expect a few bumps along the way as conditionslook to live up to the expectations that drove the strong stock market recovery last year.

Here are eight key views for the year ahead.

1 The economy gets a boost from the shift to a post-vaccine phase.

2020 included the largest quarterly decline (Q2) and increase (Q3) in GDP on record. The pandemic-induced shutdown and partial reopening produced seismic swings in consumption and output. We expect a smoother trajectory in 2021, with above-average GDP growth north of 4% for the full year.

We anticipate tepid expansion in the early portion of the year, stunted by lingering measures to slow the spread of COVID-19. Growth should accelerate as the vaccine becomes widely available, allowing consumer, work, leisure and travel habits to return toward more sustainable levels.

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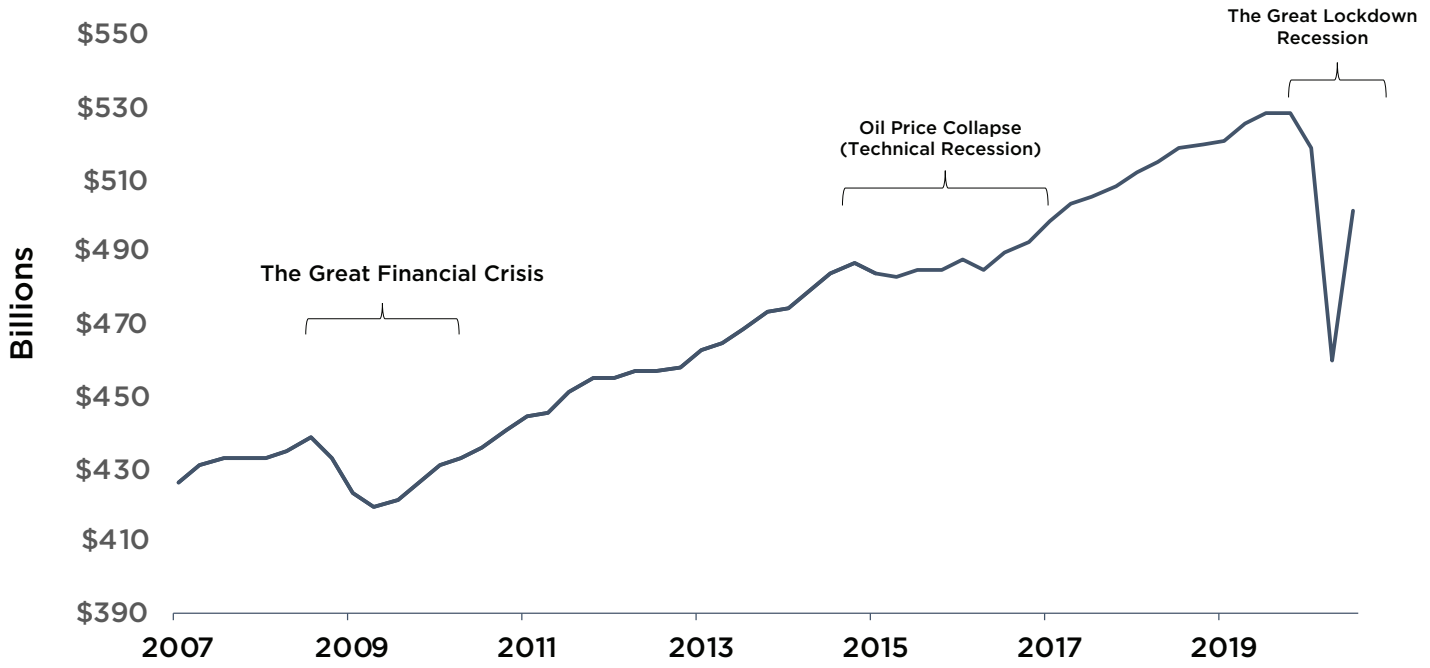
Canadian Quarterly Total GDP



Source: FRED, Statistics Canada, Canadian dollars, Expenditure based

We think 2021 will begin a multi-year economic expansion, with widespread distribution of the vaccine sparking progress toward a new normal for the Canadian and U.S. economies. Meanwhile, the one-two punch of monetary and fiscal policy stimulus may keep a tailwind at the economy's back.

We expect consumer spending to remain the lion's share of GDP, but habits are changing. Increased online shopping, firming of the domestic housing market along with renewed strength in U.S. housing-related purchases, and shifts in leisure and entertainment activities all impact GDP. We're also anticipating a larger work-from-home base, shifts in commercial real estate, increased automation and adjustments to business travel. Along with further labour market improvement, these can support healthy household consumption growth and spur higher labour productivity gains (similar to the trend in the late 1990s), which is a key driver of GDP.

We think still-elevated household debt levels will curb a bit of the upward momentum in domestic GDP growth, but a synchronized global rebound should offer a lift to domestic export activity and cyclical industries. With GDP entering the year below pre-pandemic levels, sufficient slack remains to fuel solid growth as the recovery gains traction.

Over the past 40 years, domestic GDP growth averaged 3.4% in the first year of an expansion, compared with an overall average of 2.6% since 1980. While we anticipate GDP growth to settle back toward more modest levels as the expansion persists, stronger growth in 2021 should form a reasonably firm foundation for corporate profits and stock market performance.

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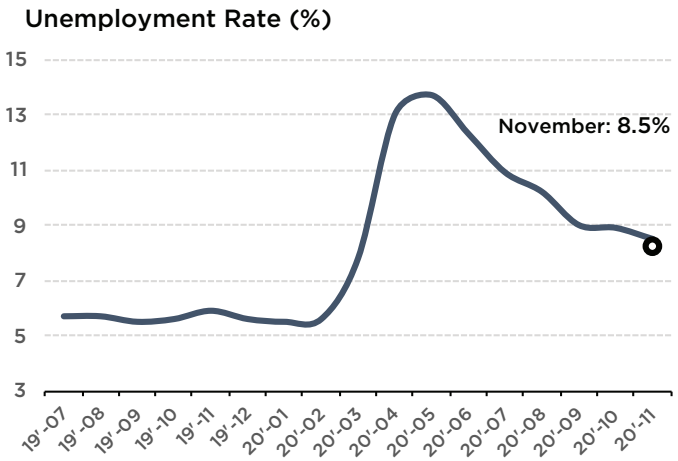
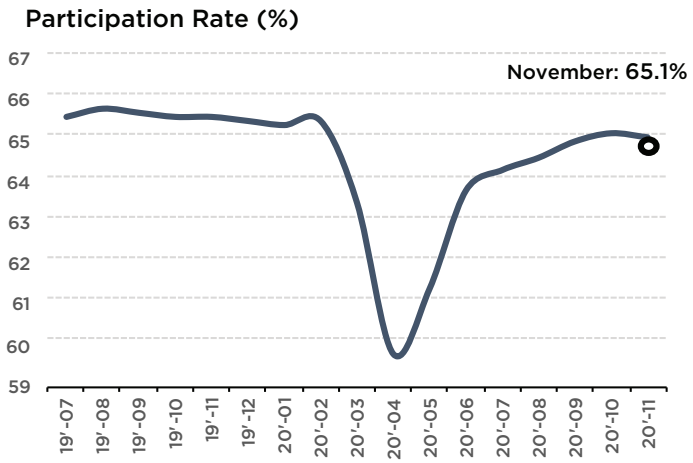
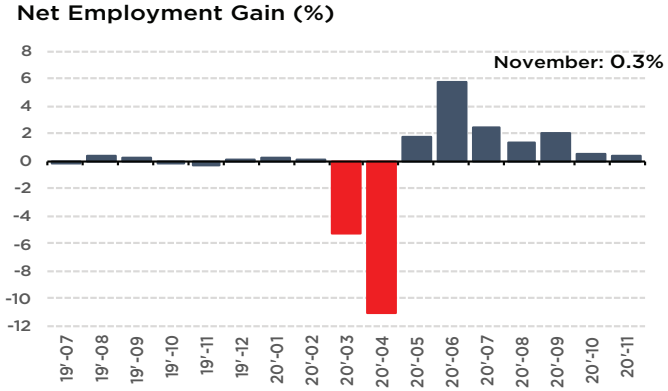
2 Unemployment continues to decline, supporting a consumer comeback.





Further improvement in the labour market will be a key driver to a durable, self-sustaining recovery in 2021, in our view. The unemployment rate has declined at a much faster pace than in previous recessions in Canada and the U.S., but there is still plenty of lost ground to make up. As of the end of November, a little over of the jobs lost in March and April have been recovered in the U.S. and about 80% in Canada. At 8.5%, our unemployment rate remains only marginally lower than its prior peak following the Great Financial Crisis in 2009.



The prospects of effective COVID-19 vaccines and a faster return to normal improve the medium-term outlook. However, the late-2020 surge in coronavirus infections and hospitalizations could weigh on the economy and job creation in the near term, especially in industries impacted by social distancing measures, such as leisure and hospitality. We don't think domestic unemployment will snap back to a pre-pandemic level of 5.5% in 2021, but the labour market will continue to heal as the economy gradually reopens.

Consumer spending has led the Canadian and U.S. economies out of recession in 2020, largely supported by government income transfers that helped bridge the income gap created by the pandemic. In Canada, government support programs for the unemployed extend into September of 2021, buying enough time in our view for economic conditions to normalize. As fiscal support is gradually phased out an improving labour market will take centre stage in sustaining the growth in household disposable income.

We believe further job gains and accumulated savings from lower spending during lockdowns and government support will drive personal consumption higher. At 14.6%, the domestic personal savings rate is four times its last 20-year average, representing pent-up spending power if consumers return to their usual spending patterns. However, considering the elevated household debt levels in Canada, we expect part of those savings to be directed toward debt servicing.

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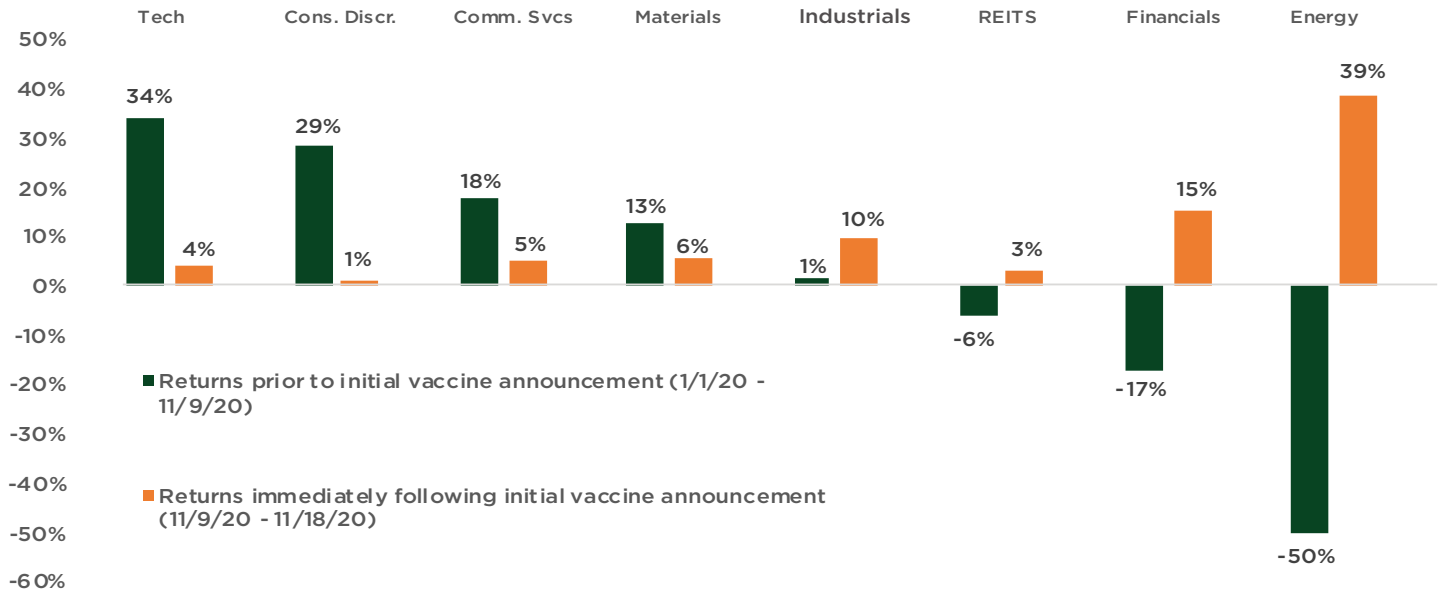
3 The bull market continues with broader shoulders.

Leadership shifted sharply after vaccine news (S&P 500 Sector Returns)



Source: Past performance is not indicative of future results.

We think the distribution of an effective COVID-19 vaccine will ease a durable rebound in economic activity. Along with accommodative central banks and the prospects for additional fiscal aid, this suggests the newly emerged bull market in stocks has legs. As the economy improves, pent-up demand for services is unleashed and interest rates remain relatively low, corporate earnings in North America will continue to recover and likely reach their 2019 pre-pandemic peak by the end of 2021.

A handful of U.S. large-cap tech names accounted for a disproportionate share of the market gains in 2020. Between January and the end of October, shares of the five largest companies in the S&P 500 – Apple, Microsoft, Amazon, Facebook and Google – rose 38% on average, compared with a 1% increase for the other 495 stocks in the index. Domestically, the divergence in security and sector performance in 2020 was also extreme. The technology sector which now accounts for 10% of the TSX weight compared to just 3% five years ago, rose 74% from January until mid-December, while energy stocks declined 26%. We believe that as the economic reopening accelerates in the second half of 2021, the rally will broaden to economically sensitive investments that have lagged, including small-cap and overseas stocks.

The TSX's cyclical tilt with large weights in financials, energy and materials sectors was a headwind for earnings in 2020 but will likely prove beneficial if global growth accelerates. Cyclical sectors face easy earnings comparisons in 2021 and trade at discounted valuations. But pandemic trends such as digitalization and staying at home are likely to last and will continue to support technology stocks. We recommend investors maintain appropriate diversification to benefit from the increased participation from stocks across market caps, investment styles and regions.

We see further upside in stocks but think some of the gains were pulled into 2020 as valuations expanded. The price-to-earnings ratio will likely normalize some in 2021, partially offsetting the boost from an expected 22% and 45% growth in S&P and TSX earnings, respectively. Therefore, we expect moderate equity returns and likely a continuing decline in volatility. With that said, the path to a full economic recovery will be bumpy, triggering occasional episodes of market indigestion, although likely less severe than what we witnessed in 2020.

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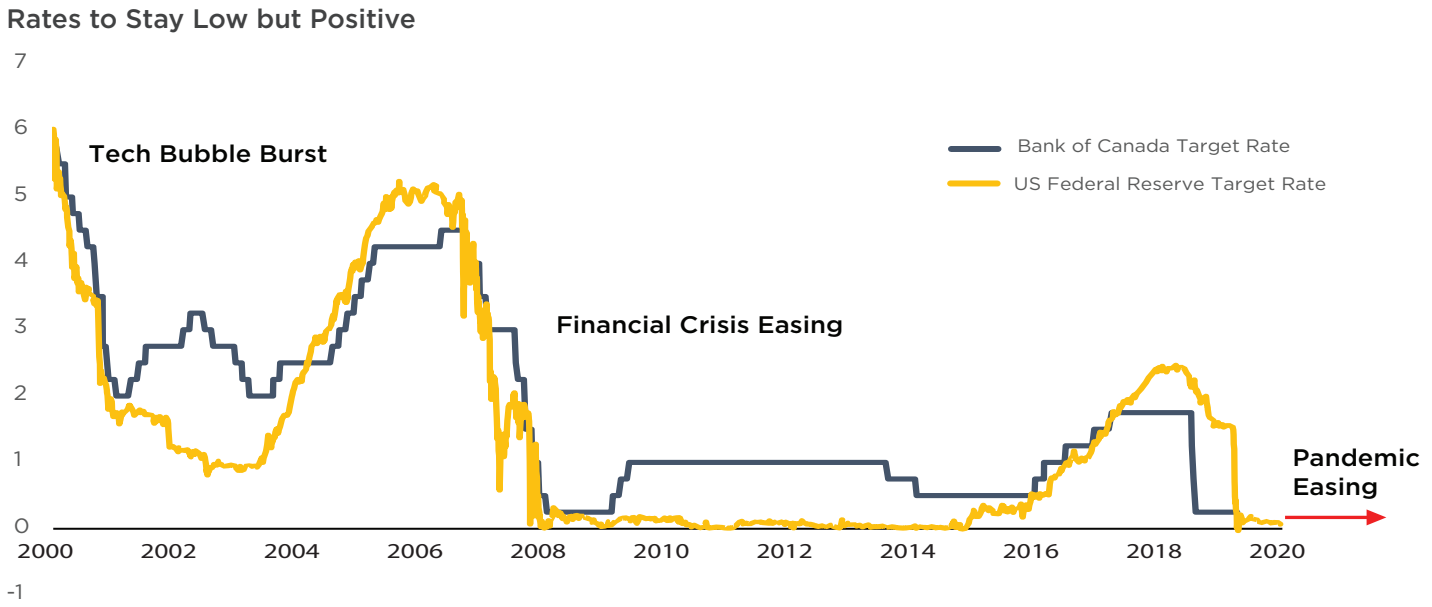
4 The Bank of Canada and Fed keeps its policy rate near zero even as the economies improves.



We expect the Bank of Canada (BoC) and Fed to keep rates near zero for at least the next two years. Even with the increasing likelihood of COVID-19 vaccines boosting activity in 2021, there will still be significant slack in the economy and labour market by the end of the year. Because of this, the central banks will avoid tightening policy prematurely and risk a repeat of the 2013 "taper tantrum," which saw in a surge in U.S. Treasury yields after the Fed communicated it would reduce the pace of its asset purchase program. With that said, investor fears about tapering could still create short-term volatility.

Under its recently updated policy framework, the Fed will tolerate above-target inflation to make up for earlier shortfalls. With consumer inflation expectations anchored at low levels, it will take time to achieve the BoC's and Fed's 2% inflation targets.

In the near term, if the economic recovery is threatened by renewed COVID-19 lockdowns, the BoC and Fed have additional capacity to act.

More support could come by:

a. Increasing the quantity of bond buying;

b. Shifting the composition of asset purchases toward longer-term bonds; or

c. Capping yields (yield curve control) to keep borrowing costs low.

We think the BoC and Fed are unlikely to consider negative interest rates given their limited evidence of success in other advanced economies.

5 Longer-term interest rates rise modestly as inflation ticks up.

While short-term rates remain anchored under continued central bank stimulus, we think the longer end of the rate spectrum will trend modestly higher this year. Ten-year government bond rates are starting the year well below 1%, the lowest level to start a calendar year in history. That said, 10-year yields have nearly risen appreciably from the all-time low in 2020, responding to an improved outlook for the economy.

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With the most severe economic effects of the pandemic behind us, we expect a durable rebound in demand to spur slightly firmer inflation, leading longer-term rates higher. Ten-year yields peaked out above 3% during the decade-long expansion leading up to 2020, well below peak rates of prior expansions. Given ongoing monetary policy stimulus, we don't anticipate yields returning to anything resembling that level in the coming year, but we do think the yield curve will steepen somewhat.

Rates will remain low by historical standards, meaning overall bond yields are unlikely to become dramatically more compelling for investors this year. We think appropriate allocations to investment-grade corporate bonds, as well as exposure to high-yield bonds, can offer some increased yield for fixed-income portfolios. Despite this, we think fixed-income allocations will continue to demonstrate their portfolio value by helping protect against bouts of equity market volatility. A gradually steepening yield curve would, in our view, support allocations to cyclical and value (dividend income) investments as the recovery broadens investment leadership.

With meaningful slack in the labour market and economy likely to persist in 2021, we doubt inflation pressures will rise dramatically in the short run. But central banks have dramatically expanded the money supply, and markets are firmly pricing in an extended period of extraordinary monetary policy stimulus, along with very low inflation. An unanticipated surge in consumer prices is a small but material market risk we're keeping a close eye on.

Investors should understand the risks involved of owning investments, including interest rate risk, credit risk and market risk. The value of investments fluctuates and investors can lose some or all of their principal.

6 The global economy recovers, but geopolitical uncertainties remain a source of volatility.

The pandemic hit the reset button on the economic cycle for most of the world's major economies. We think 2021 will see the world economy progress in the early stages of a new expansionary cycle that will support global equity market performance. Developed markets will, in our view, benefit from stronger fiscal and monetary policy coordination across Europe, which should help spur the recovery as many European economies emerge from lockdown protocols. Several major developing economies, most notably China, appear slightly further into the new expansion, given the timing of their pandemic experience and accelerated policy stimulus. We think global GDP will expand in 2021 by the fastest pace since 2010.

We expect U.S.-China relations to return to the headlines. While we don't believe the Biden administration will take the same approach President Trump did, we think President Biden will maintain a somewhat hard-line stance on China when it comes to trade and national security. We expect existing U.S. tariffs to be used as leverage, particularly as policy-makers seek to boost growth. We don't expect the trade rhetoric to be quite as contentious as it was in 2018 and 2019, but we suspect periodic tensions between the U.S. and China will be sources of occasional market anxiety this year.

Overseas equities outperformed U.S. markets in the early stage of the post-financial crisis recovery in 2010 and the phase of synchronized global growth in 2016-2017. The prospects of a renewed global up- swing should, in our view, lend a hand to international market performance, supporting our recommendation for an underweight position in domestic equities and an overweight allocation to international equities as part of a well-diversified portfolio.

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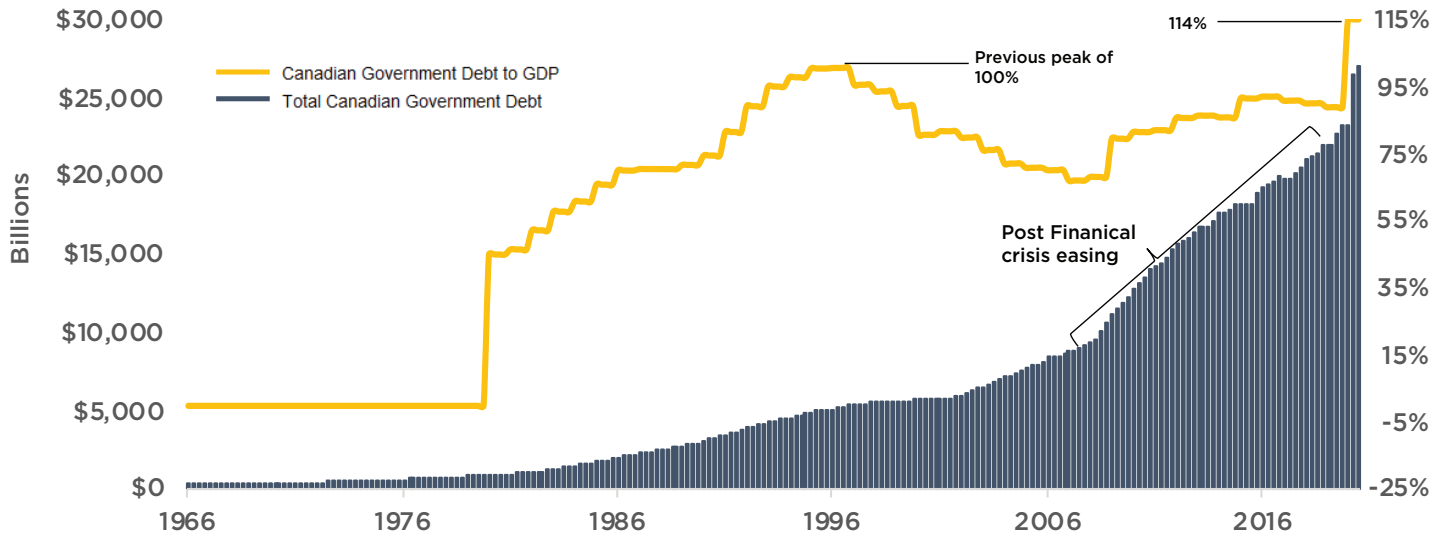
7 Government debt rises to new heights but doesn't come to a head yet.

Government Debt Set to Stay Elevated



Source: FRED

The pandemic has pushed the domestic and U.S. budget deficits to record levels. Our federal debt is set to rise notably this year, but the situation is more notable in the U.S., where federal debt will likely rise above 100% of GDP in 2021 for only the second time in history – the first was during World War II. Rising GDP here and south of the border will help slow the ascent, but sizeable fiscal aid packages that were needed to help get the economy to the other side of the pandemic will cause government debt to continue to climb this year.

This is not a pot set to boil over immediately, however. Domestic debt-to-GDP levels are near the 60% mark, and while this is up from less than 40% in 2019, debt loads relative to the size of the economy will remain significantly more favourable this year than other G7 nations. This should provide Ottawa with further budget flexibility to support the economy if necessary. Meanwhile in the U.S., though, debt as a percentage of GDP is headed for historic highs, it remains below levels that will initiate financial stress or insolvency. Fortunately, the U.S. remains one of the more vibrant economies in the developed world, and low interest rates will allow the government to borrow at low costs for some time to come.

Nevertheless, shifting demographics and ongoing structural deficits are likely to make rising government debt a more prominent risk down the road. We don't think this will threaten long-term opportunities in investment markets, but elevated government debt does pose a headwind to potential economic growth over time. It can limit the flexibility of fiscal policy, raise interest expense and, if left unchecked, eventually crowd out private investment.

We think these risks will become more acute decades from now, requiring tougher budget choices in the future.

If you're concerned about government debt risks, ensure appropriate diversification within your fixed-income portfolio, with the majority allocated to investment-grade bonds. To address long-term government debt/interest rate risks, ensure a proper allocation to global equities and domestic equities with rising dividend potential.

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8 The loonie stays near the top of its five-year range relative to the U.S. dollar

Short-term changes in the Canadian dollar's value are hard to predict, given all the factors that cause them. However, we think macroeconomic conditions will provide more support for the loonie in 2021 than they have over the last two years. The recent (late 2020) appreciation largely reflected a broad-based depreciation of the U.S. dollar against major world currencies and pushed the loonie towards the top of its five years range of around US$0.70 – US$0.82. We believe that further strengthening is possible as global growth accelerates with the rollout of vaccines, but a decisive breakout from this range will likely require much higher oil prices and a stronger domestic economy.

The dollar is a procyclical currency, rising when global growth accelerates and falling when it decelerates. As global growth beings to rebound, this will likely support the loonie and oil. Historically, the dollar has moved closely together with oil prices, which are likely to follow the demand recovery pace in the near-term as economies reopen. OPEC and its allies appear willing to ramp up production slowly, but the current demand-supply dynamics argue against a major spike in oil prices. Also, the long-term demand growth is uncertain given the global economy's transition to low-carbon fuels.

Another important driver for the dollar is the difference in interest rates between the U.S. and Canada. In 2020 both the BoC and the Fed cut rates aggressively to stimulate the economy in response to the pandemic. With policy rates not likely to change on either side of the border for at least two years, interest rate differential will be less of a driver for the loonie. Putting it all together we think that the dollar will be supported by the economic reopening next year and is likely to revisit the very top of its five-year range. Although currency movements have a sizable impact on short-term investment returns, over longer periods of time, they tend to have less impact. We continue to recommend investors overweighting overseas and U.S. large-cap equities based on the additional diversification value they can provide and the domestic economic recovery challenges stemming from elevated household debt levels.

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New Normal, Consistent Approach: Focus on What Matters Most to You in 2021

- **Make your financial resolutions.** Revisit your important financial goals for 2021 and beyond with your advisor. Review your budget to determine your flexibility, and then prioritize your financial resolutions. Depending on your situation, priorities could include replenishing your emergency fund, taking advantage of retirement accounts, paying down debt and/or increasing savings toward a financial goal.

- **Review your diversification.** As the market's focus swings between near-term uncertainties and longer-term growth prospects, we expect leadership among asset classes and sectors to rotate. Cyclical and more economically sensitive areas of the market are likely to benefit as a COVID-19 vaccine supports a sustained ex-pansion. Industries such as technology and growth-oriented investments are positioned for more secular growth trends.

  At the same time, periodic setbacks on the road to recovery will, in our view, favour allocations to bonds and defensive equity sectors. We recommend a neutral allocation between stocks and bonds, based on your strategy's risk and return profile. We believe maintaining diversification across a variety of asset classes, including international exposure, can improve your chances for long-term success and prepare you for rotating leadership.

- **Set appropriate expectations for your portfolio.** We think bonds will continue to play an important role in portfolios, particularly as a buffer against periodic market pullbacks. That said, we believe interest rates will remain at fairly low levels this year. We recommend reviewing the level of predictable income you expect your bond portfolio to generate. Consider an allocation to high-yield bonds as a way to enhance income now. Laddering bond maturities can help you take advantage of higher rates down the road.

- While full equity valuations and persistent economic challenges are likely to produce bouts of volatility, we expect rising corporate earnings and supportive policy to point toward positive returns in 2021. Systematic investing and periodic rebalancing can help you navigate volatility. Keep your investment per-formance expectations realistic and your portfolio decisions aligned to your long-term goals to help stay on track as you progress through 2021 and beyond.

- **Create or update your estate plan.** The past year has highlighted the importance of having up-to-date documentation that ensures your wishes are known and followed in case of unexpected illness or death. If appropriate, consult with your advisor and estate-planning professional to ensure you have adequate insurance, documented beneficiaries and an up-to-date estate plan.

Past performance does not guarantee future results. Diversification does not guarantee a profit or protect against loss in declining markets. Investors should understand the risks involved of owning investments, including interest rate risk, credit risk and market risk. The value of investments fluctuates and investors can lose some or all of their principal.

