

# 2021 Mid-Year Investment Outlook

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## Macro Views and Outlook Scenarios

Where are we in the cycle?

What's the direction of the economy?

What are the policy implications?

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## What are the asset allocation implications?

# Introduction

In just over a year, the world has gone through incredible change – thrown into a pandemic and plunged into a global recession. We last put out an outlook at the end of last year, sharing our expectations for 2021. In that outlook, our base case anticipated an effective vaccine rollout that improved confidence and lowered infection rates, with the US experiencing a strong economic reopening in the second quarter, followed by the eurozone. We favored risk assets and preferred cyclicals over defensives in this environment. We have largely seen that expectation come to fruition. Now, as we look to the back half of 2021, we at Invesco have again brought together some of our most experienced investment professionals and thought leaders to provide a mid-year update to our outlook. To continue to address the breadth of possibilities that lie ahead in the environment, we have provided a base case scenario that we believe is highly probable and two other possible scenarios.



**Kristina Hooper**  
Chief Global Market  
Strategist

## Our Base Case

Our base case anticipates that economies will accelerate as they reopen but that any accompanying rise in inflation would be transitory. The United States has had a very effective vaccine rollout and is likely to take the lead in the global economic recovery as growth in China moderates. The UK and eurozone are likely to follow the US recovery, with emerging markets countries generally lagging behind because of the obstacles they face vaccinating their respective populations, which is likely to result in episodic resurgences of COVID-19. As economies reopen and spending increases, inflation should rise significantly, especially in the US as the Fed expects, but we anticipate it will moderate to a rate faster than pre-crisis trends but not sufficient to induce rate hikes from central banks. Over the longer term, we expect demographics and innovation to place downward pressure on inflation.

## Pandemic Resurgence Scenario

In this scenario, we contemplate a resurgence of the pandemic as a result of the spread of more powerful virus mutations against which existing vaccines are substantially less effective. This would have a negative impact on economic growth globally, but the impact would not be nearly as dramatic as the initial wave of COVID-19 because economies have learned to adapt to lockdowns and other tools utilized to control the spread of the pandemic. Emerging market economies would likely be hit hardest due to relatively limited health care infrastructure as well as lower vaccination levels.

## High Inflation Scenario

In this scenario, we contemplate rapid growth accompanied by a quickening pace of inflation. Markets would anticipate higher inflation and Fed tightening, causing the yield curve to steepen.

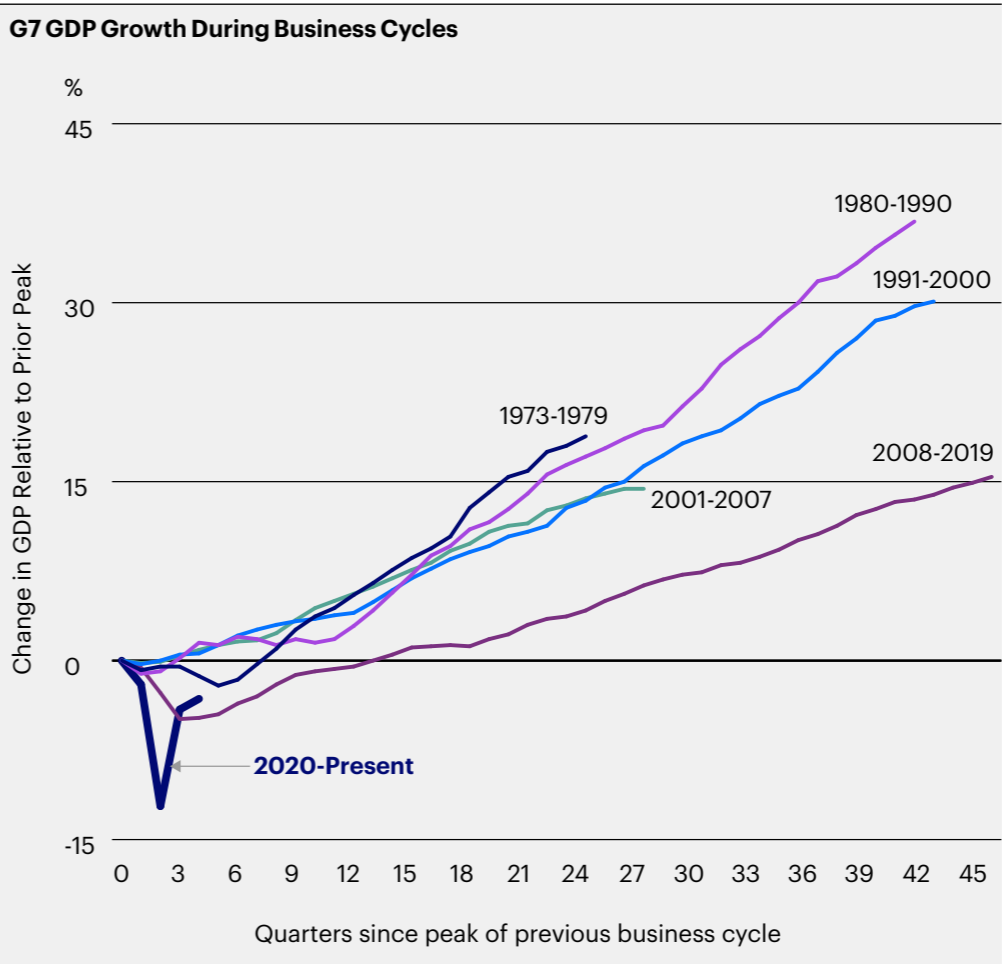
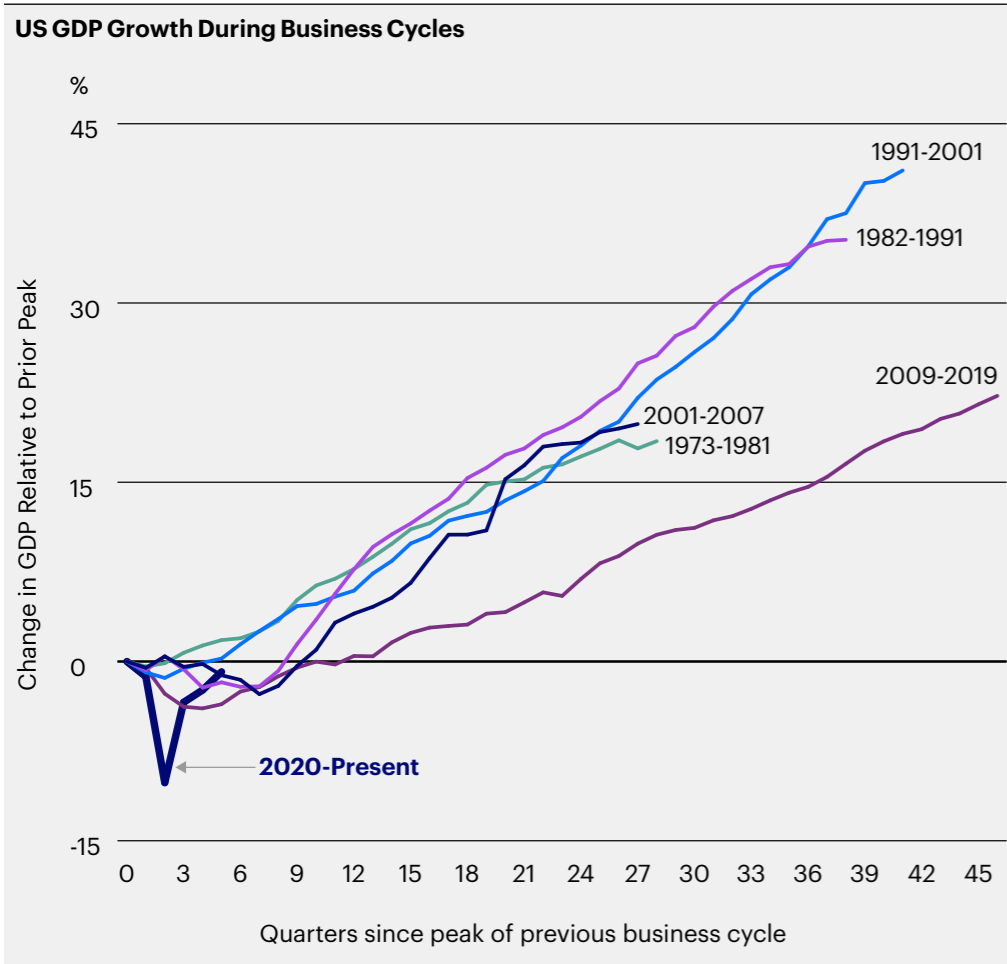


- **Base Case anticipates a strong economic re-acceleration with temporary inflation.**
- **Pandemic Resurgence Scenario anticipates a resurgence of the pandemic that negatively impacts economic growth.**
- **High Inflation Scenario contemplates a strong economic re-acceleration with quickening inflation and anticipation of Fed action.**

# Where Are We in the Cycle?

## Cycles begin well below potential growth and end with economy above capacity

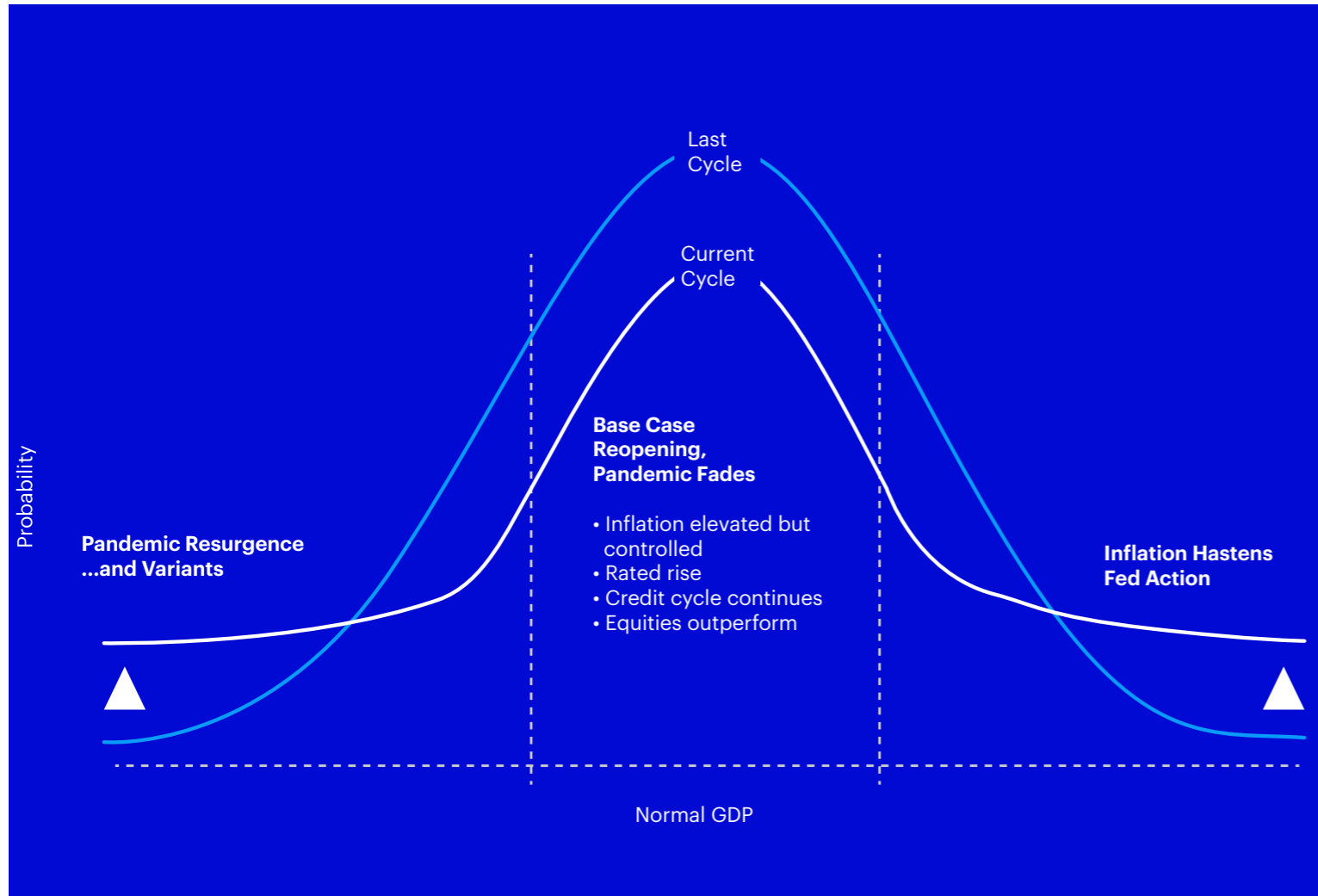
- The US is quickly moving into expansion on vaccines and stimulus.
- The European recovery appears to be gaining steam but lagging the US.
- Chinese growth is likely to moderate to a more sustainable rate.
- We believe we are in the early stages of the economic cycle. Though GDP is rapidly recovering to its pre-pandemic peak, we note that past cycles have shown growth can continue well beyond prior peaks.



Sources: Bloomberg L.P. and US Bureau of Economic Analysis. As of May 10, 2021.

# We Believe the Pandemic Continues to Fade, and Reopening Continues

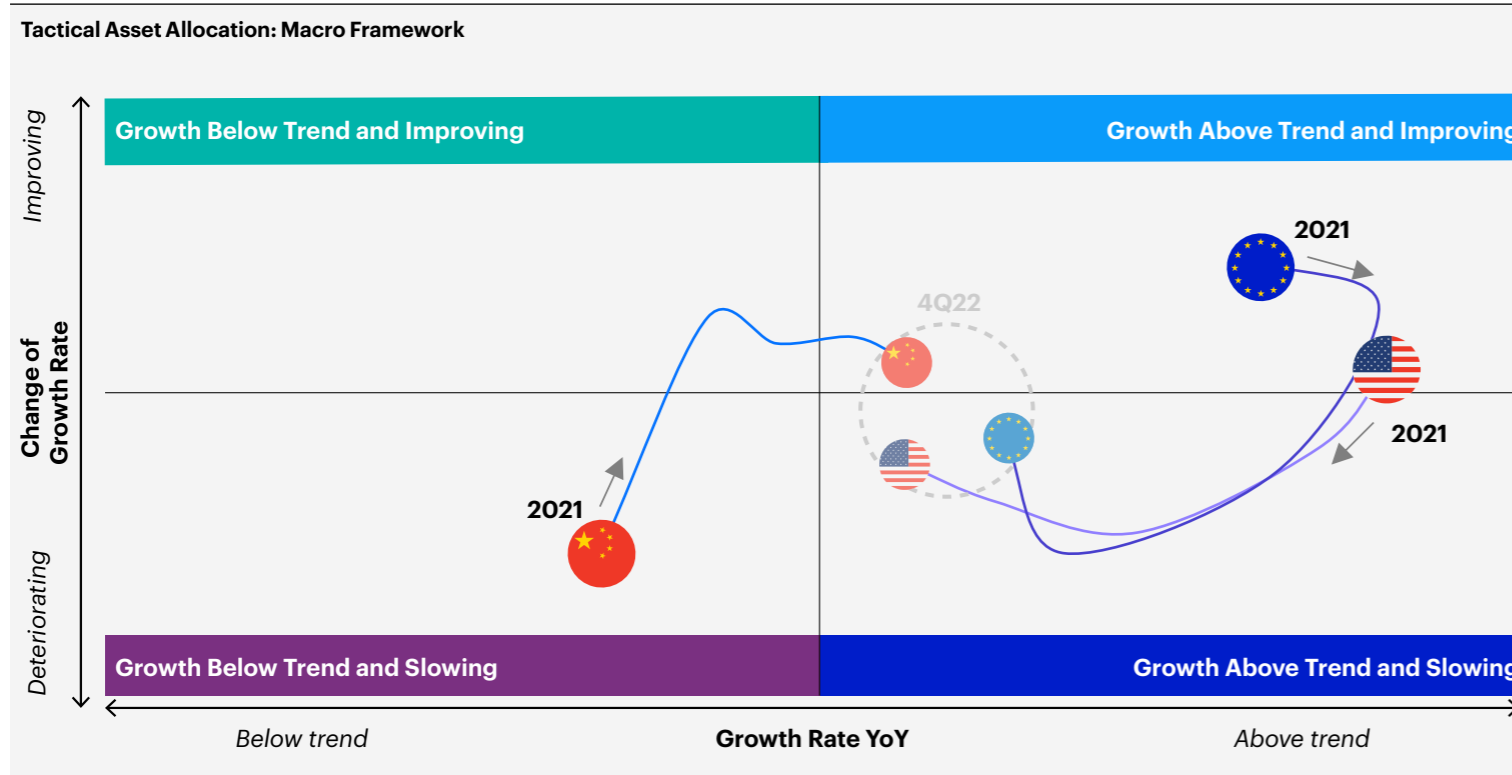
## Inflation to rise on the back of policy and pent-up demand, then moderate



- In contrast to most past cycles, we see the tail risks as being higher and better defined than is usual in a recovery environment such as the post-global financial crisis environment.
- In our base case scenario, which we believe is highly probable, we expect global growth will accelerate through early 2022. Inflation will rise during this period but will be temporary and controlled. We expect continued fiscal and monetary policy stimulus, which should help support risk assets.



# The Path Ahead: Our Base Case



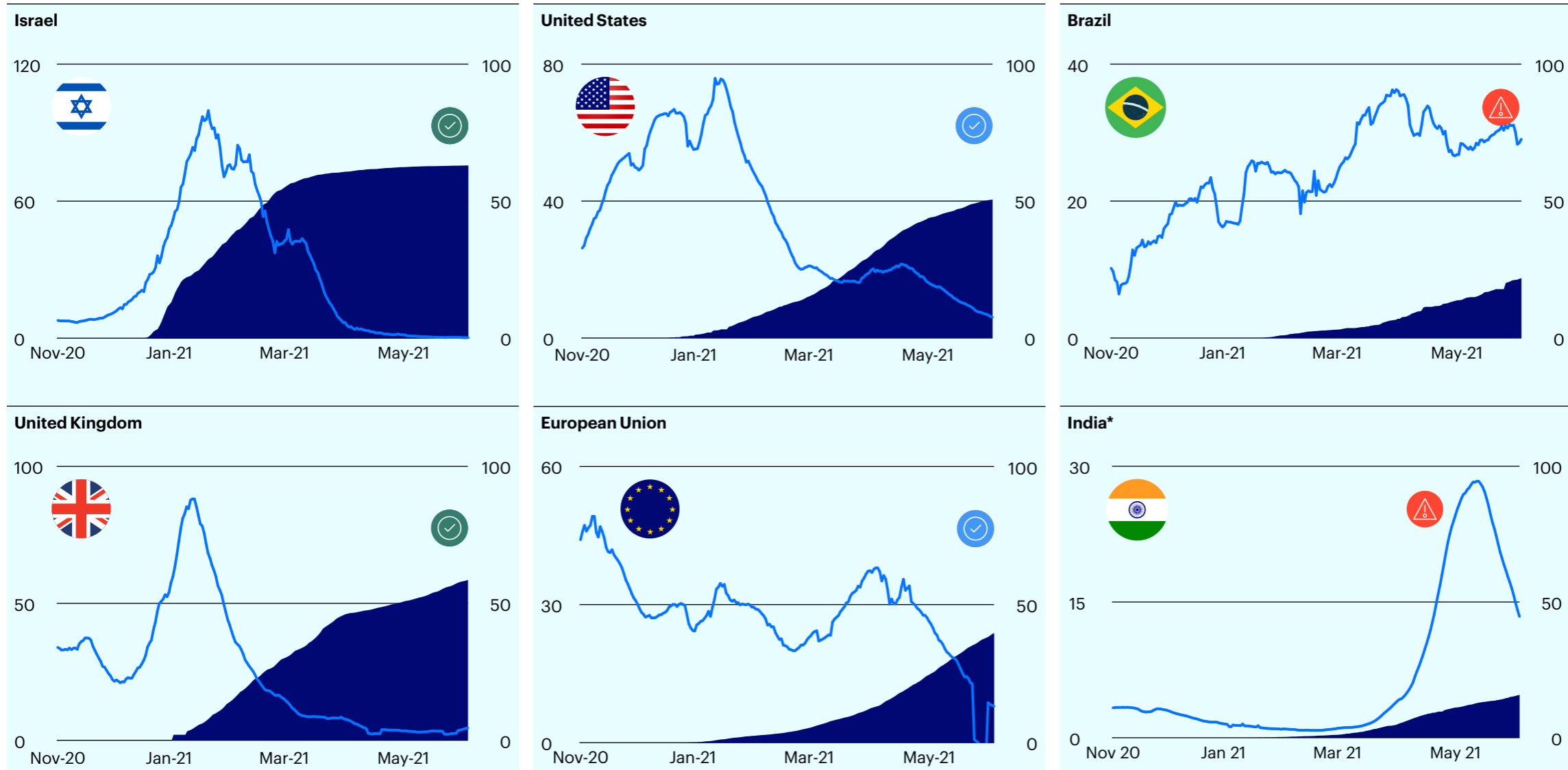
- We expect the eurozone and US to grow above trend through 2021 based on reopening and successful vaccination efforts. Though this will then moderate, we expect growth to remain above trend.
- China is poised to grow at a slower but still substantial clip, with an improving trajectory as COVID-19 fades.



Source: Invesco Investment Solutions' proprietary global business cycle framework mapping Invesco Global Market Strategy Office and Invesco Fixed Income scenario projections. For illustrative purposes only.

# Covid, This Cycle's Driver, Is Fading in Major Economies

## Successful vaccine rollouts appear to be limiting infections



■ Percentage of people who have received at least 1 vaccine dose, Total (Right Axis) — New Infections Per 100,000 People, Rolling 7-Day Average (Left Axis)

Sources: Invesco, JHU CSSE COVID-19 Data, and OurWorldinData, as of June 3, 2021.  
\*Doses Administered Per 100 People, Total.

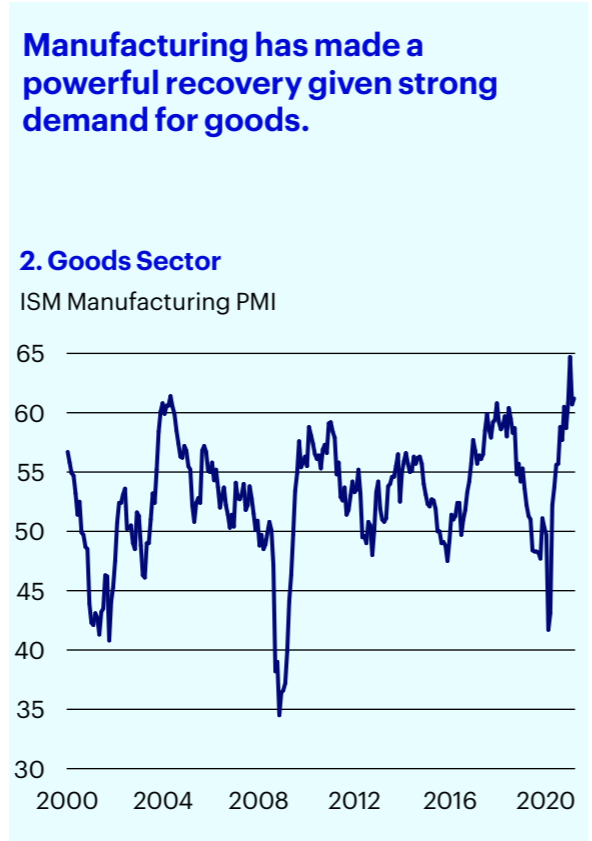
# The US Economic Recovery Is Well Underway

## US may provide clues for what is to come in other economies

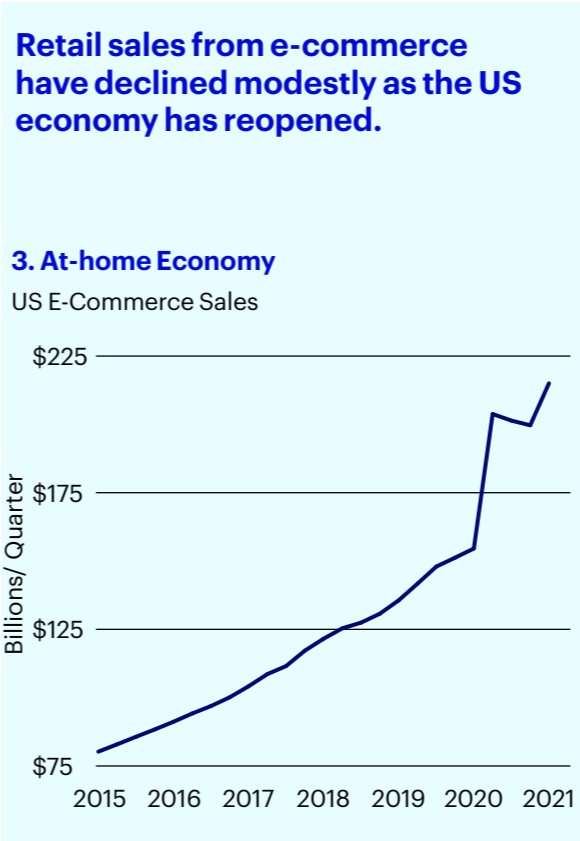
We expect other economies, as they vaccinate their populations, to accelerate as the US has.



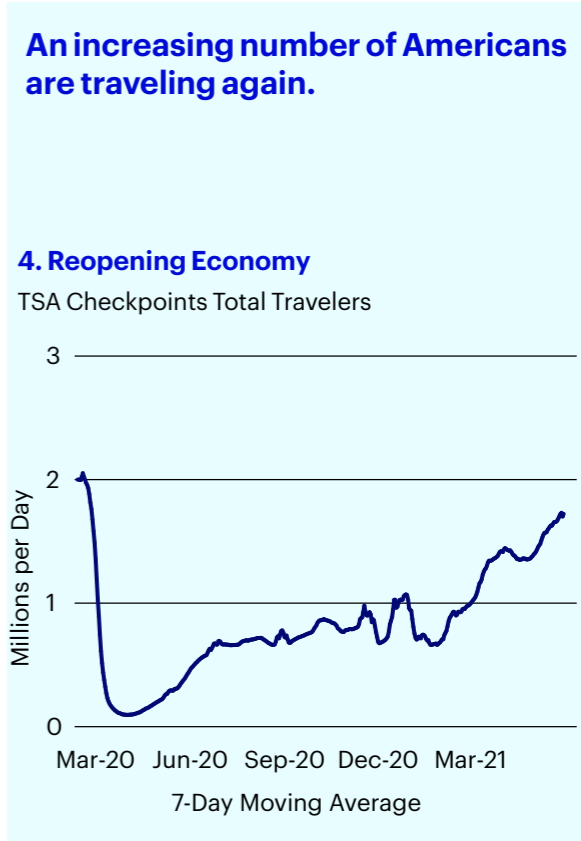
Source: Goldman Sachs, data as of June 2, 2021.



Source: Institute for Supply Management, data as of May 31, 2021.



Source: US Census Bureau, data as of May 31, 2021.



Source: US Transportation Security Authority, data as of May 31, 2021.

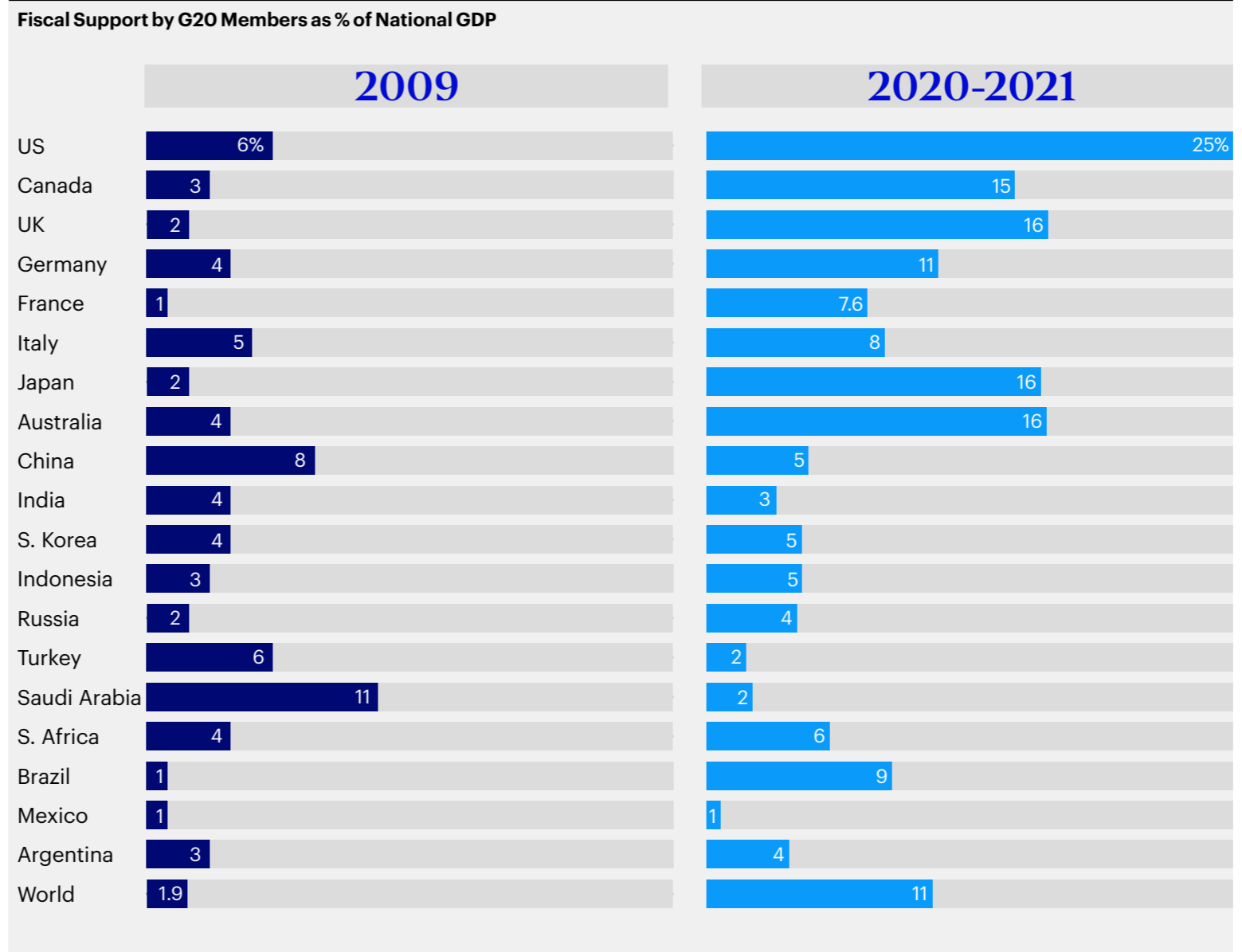


# Policy: Pandemic Fiscal Easing Far Outstrips 2009, Supporting Recovery

However, amount varies across regions, pointing to divergent growth

A substantial factor in our assessment of the macro environment is the outsized policy response. Countries across the globe have enacted large fiscal spending programs to carry economies through the virus, far surpassing the actions undertaken in the global financial crisis.

Sources: IMF Policy Tracker, IMF GDP Data, Atlantic Council, DE Data Wrapper, Invesco. Calculations based on data at various national release and announcement dates, and Atlantic Council as of March 31, 2021. 2009 based on IMF, Eurostat and G20 data. NB: Calculations exclude deferrals and guarantees; include discretionary fiscal support programs (aside from "automatic stabilizers"); announced and implemented programs -- all scaled against 2008 and 2019 GDP, respectively. The "World" aggregate represents G20 nations -- G20 comprises 19 major economies plus the EU.



# Monetary Policy Remains a Powerful Driver

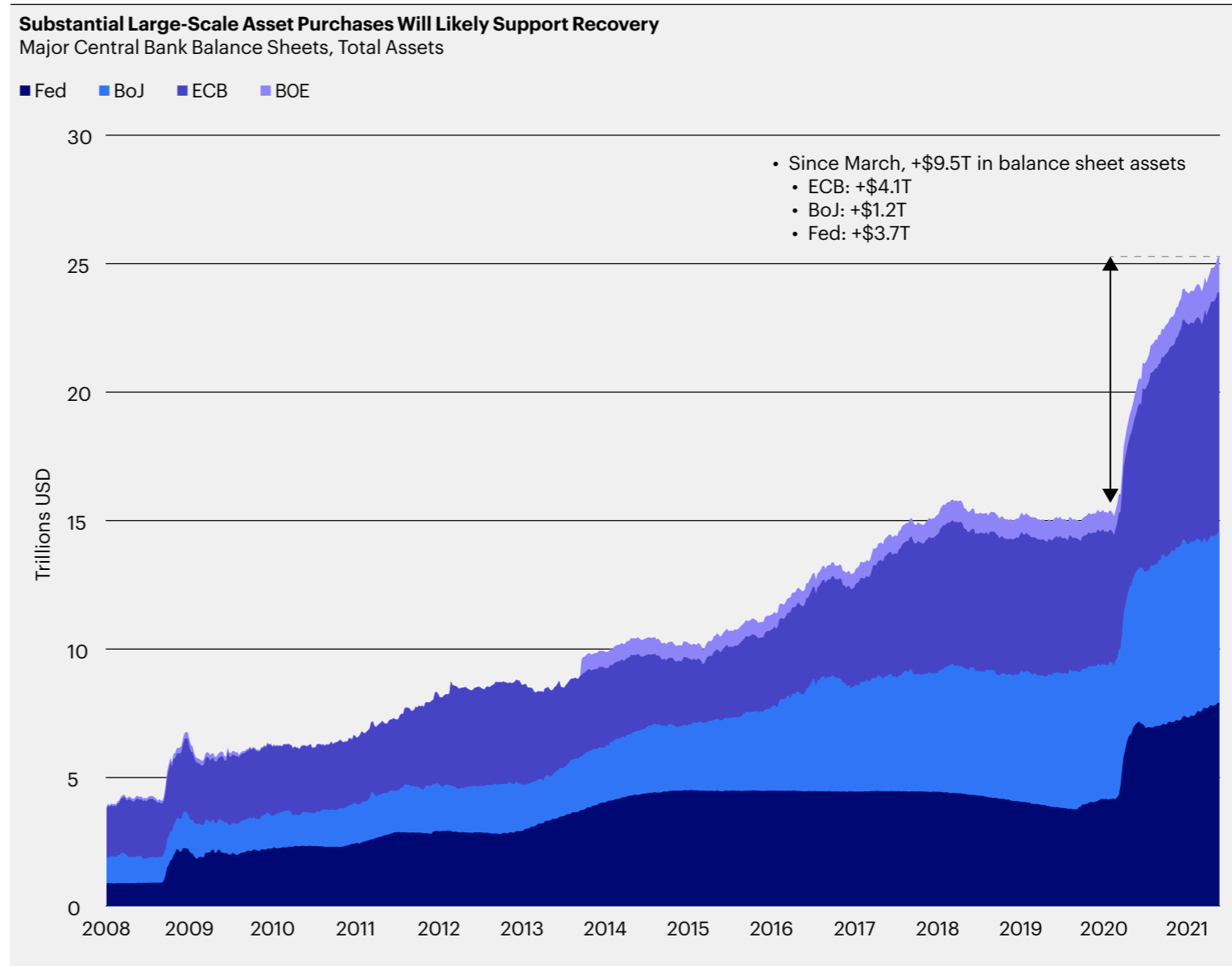
## Emergency monetary programs are pumping cash into banks

In addition to the large fiscal policy support that governments have put forward, major central banks are also undertaking a range of policies to support economies. As part of this, central banks have continued to grow their balance sheets via large-scale asset purchases. This additional cash in banks has helped ease financial conditions to support economic activity.

US commercial banks are also helping to fund the government's fiscal deficit. In the one-year period since March 2020 they have increased their holdings of bonds, mainly Treasury securities and MBS, by over US\$1 trillion, thereby contributing to an expansionary monetary policy.

We also note that China has not aggressively used monetary policy in this cycle, and the balance sheet of the People's Bank of China has been largely stable.

Sources: Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BoE), Bank of Japan (BoJ), as of May 24, 2021.

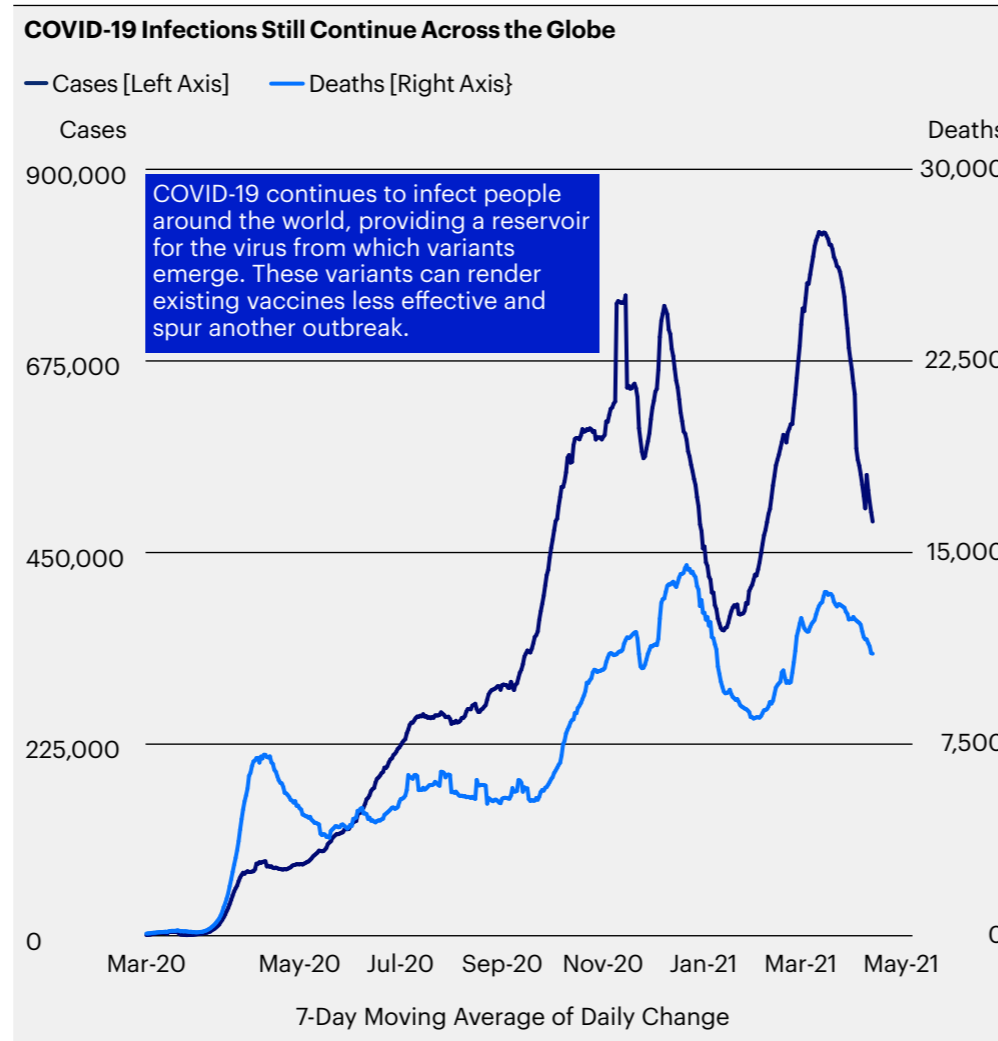


# Tail Risk 1: A Resurgence of the Pandemic and Variants

## Variants that are not protected against by current vaccines is a key risk to the outlook

A resurgence of the pandemic remains a key risk to the outlook: A renewed uptick in infections in developed economies where effective vaccination is widespread could prompt reinforced social distancing or partial lockdowns. Where effective vaccination is limited, notably in several economies (e.g., India, Brazil, Asia Pacific), stricter lockdowns may be required. These risks may prevent full reopening.

However, we expect a significantly less severe hit to the economy than in 2020: Much activity has moved online, and many services have not fully reopened. Instead of another major downturn, the economic rebound would be restrained, probably requiring extended monetary and fiscal policy support.



### B.1.1.7 “UK Variant”

- Identified September 2020 in the United Kingdom
- Spreads more easily and quickly, and more deadly than other variants
- Current vaccines are effective

### B.1.351 “South Africa Variant”

- First identified October 2020 in South Africa
- Spreads more easily and quickly
- Existing vaccines are somewhat less effective

### P.1 “Brazil Variant”

- First identified January 2021 in Brazil
- Spreads more easily and quickly
- Existing vaccines are somewhat less effective

### B.1.617.2 “India Variant”

- First identified Dec. 2020 in India
- Spreads more easily and quickly
- Existing vaccines appear to be somewhat less effective

# Tail Risk 2: Extensive Policy Measures Result in Inflationary Outcome

## Rapid money growth could yield strong inflation, necessitating central bank response



Sources: Invesco, Federal Reserve Bank contributions to the Beige Book, April 30, 2021, National Federation of Independent Businesses (NFIB), and Bureau of Labor Statistics. 3MMA = 3-month moving average. US Core Inflation measured by the US Consumer Price Index, less the effects of food and energy. There can be no assurance that projected data will be realized.

### Anecdotal Evidence of Inflation from Regional Fed Branches

#### Kansas City Fed

- “ Unemployed workers have **no incentive to return to work**, given the COVID-19 bonus payments.
- Entry-level pay will need to be increased.** This will create pressure on all other positions.
- Largest raw material provider is refusing to deliver** previously accepted purchased orders at accepted prices - demanding 18% price increase to fill previously accepted orders of flat-rolled USA stainless steel.

#### New York Fed

- “ Input prices rose at the fastest pace since 2008, and selling prices climbed at a record-setting pace.
- Looking ahead, firms remained optimistic that conditions would improve over the next six months, **expecting significant increases in employment and prices.**

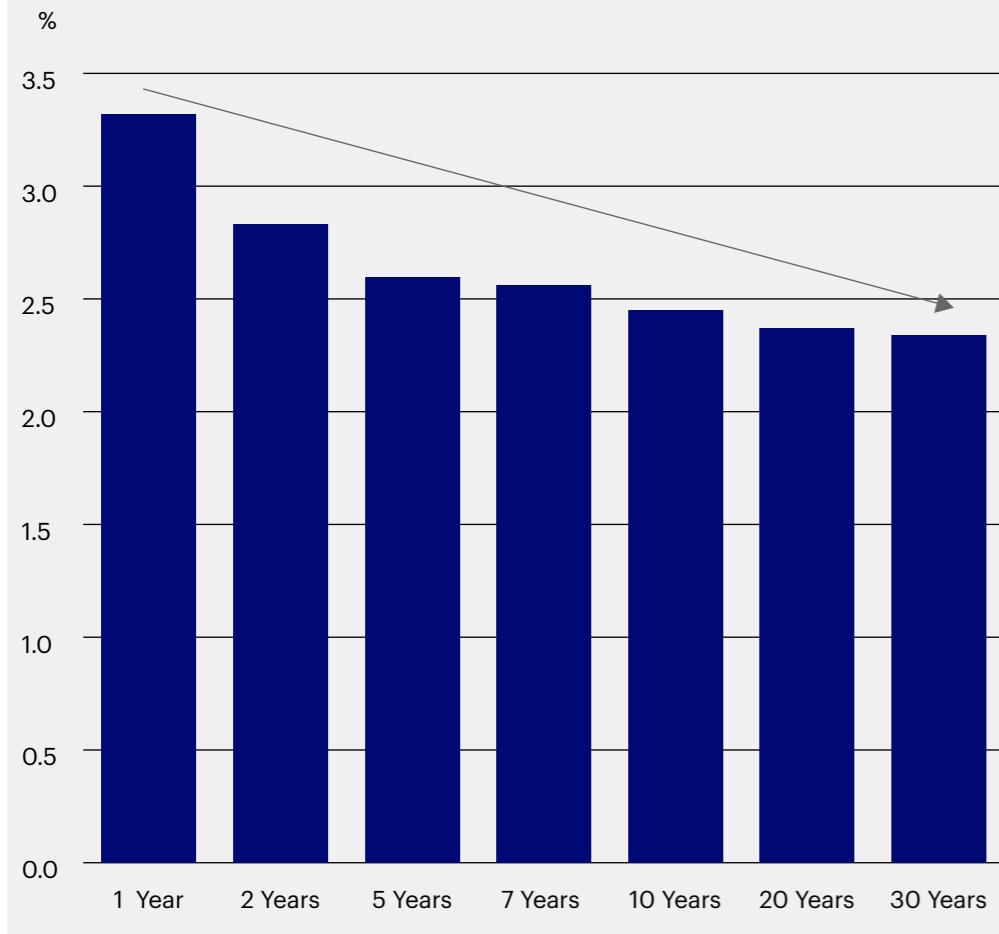
#### Dallas Fed

- “ We are under a significant amount of price pressure due to **rapidly rising raw material pricing.**
- It is **very difficult to find employees** to handle the significantly increased demand. We have never had this problem before in our 44-year history.
- We are experiencing rapid increases in the price of steel, lumber, and cement. This is increasing costs of production and will lead to higher prices eventually.
- We are seeing material inflation — **prices for raw goods (steel) are rising dramatically.**

# Market Is Not Expecting Inflation to Be Persistent

## Persistent inflation could cause market volatility

US Breakevens Indicate Relatively Lower Inflation Ahead



Source: Bloomberg L.P. As of May 31, 2021.

### Why is inflation expected to be transitory?

Markets see price pressures moderating but not dissipating

#### Pent-up demand is a one-off factor.

Pent-up demand will likely cause a pickup in inflation, but we expect this effect to be a one-off and short-lived.

#### Temporary supply-side issues.

Commodity and freight prices are partly surging on temporary, pandemic-induced supply factors. We believe this to be transitory.

#### Spending re-orienting.

Spending had shifted into goods due to social distancing. As reopening continues, spending is likely to rebalance more to services.

#### Income replacement fading.

Income replacement programs are beginning to fade, which is likely to reduce overheating risk.

#### Slack remains.

Capacity utilization remains depressed, indicating supply-side slack. Labor force participation is also rising.

#### Base effects to roll off.

Due to a substantial pullback in demand last year as the pandemic hit, there was a depressed level of prices that today will contribute to a higher year-over-year print in inflation measures, but this should be temporary as we roll off that time period.



# Tactical Asset Allocation:

## Macro Framework

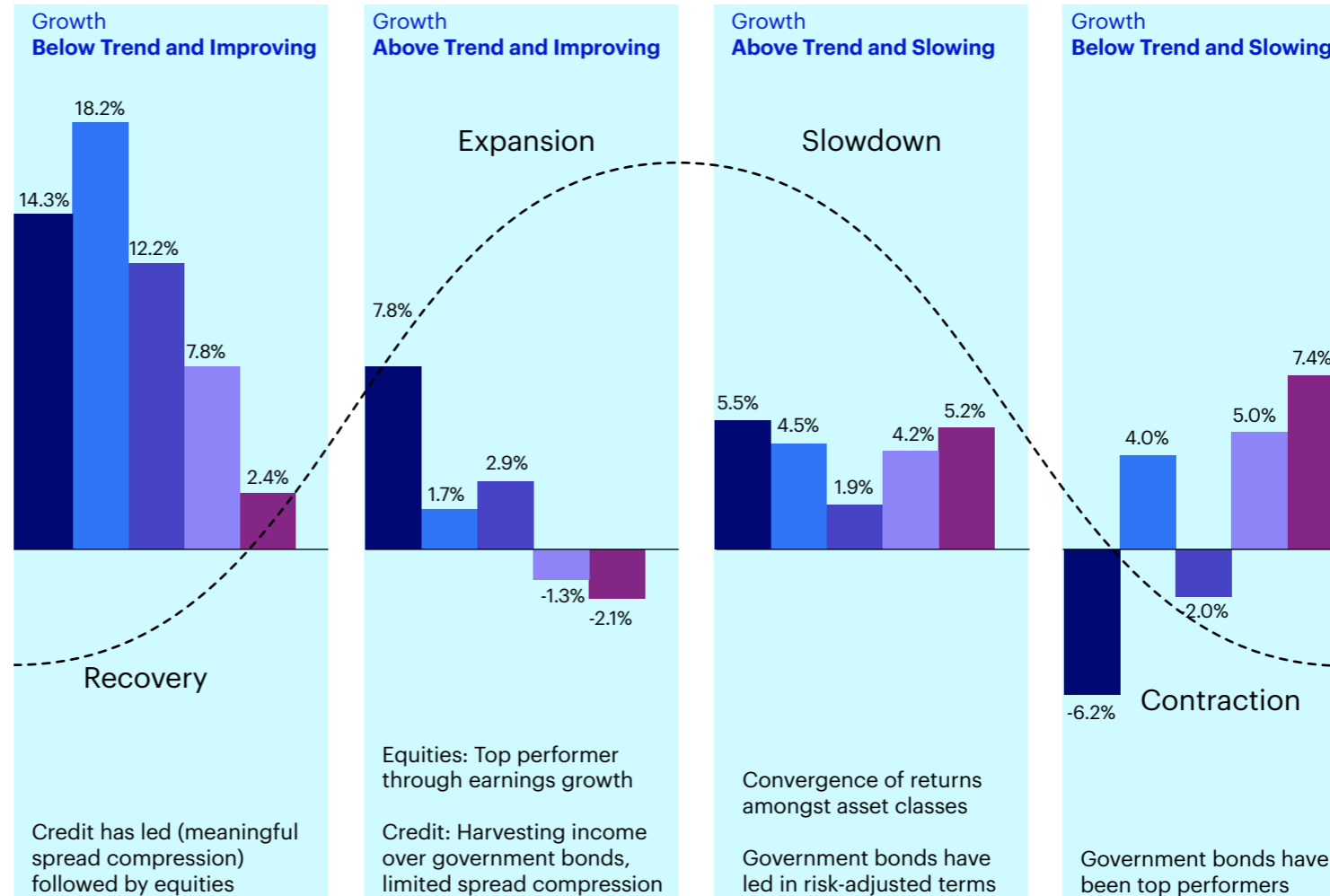
- In the medium term, asset prices are strongly influenced by the prevailing macro regime. Asset classes and their risk premia perform differently in different stages of the business cycle.
- Mapping our three macro scenarios into a macro regime framework can help guide tactical asset allocation decisions and support the analysis of current developments with a historical perspective.

Source: Invesco Investment Solutions' proprietary global business cycle framework and Bloomberg L.P. Index return information includes back-tested data. Returns, whether actual or back-tested, are no guarantee of future performance. Annualized monthly returns of the defined risk premia from January 1973 - December 2020, or since asset class inception if at later date. Asset classes excess returns defined as follows: Equities = MSCI ACWI - US T-bills 3-Month, High Yield = Bloomberg Barclays HY - US T-bills 3-Month, Bank loans = Credit Suisse Leveraged Loan Index - US T-bills 3-Month, Investment Grade = Bloomberg Barclays US Corporate - US T-bills 3-Month, Government bonds = US Treasuries 7-10y - US T-bills 3-Month. For illustrative purposes only. Past performance is not a guarantee of future results. An investment cannot be made in an index.

### Global Cycle: Historical excess returns across asset classes

- Risky credit has led in recoveries, while equities have led in expansions.
- Returns across asset classes have experienced convergence in slowdown regimes.
- Government bonds and safe assets have outperformed in contractions.

■ Equities ■ High Yield ■ Bank Loans ■ Investment Grade ■ Government Bonds



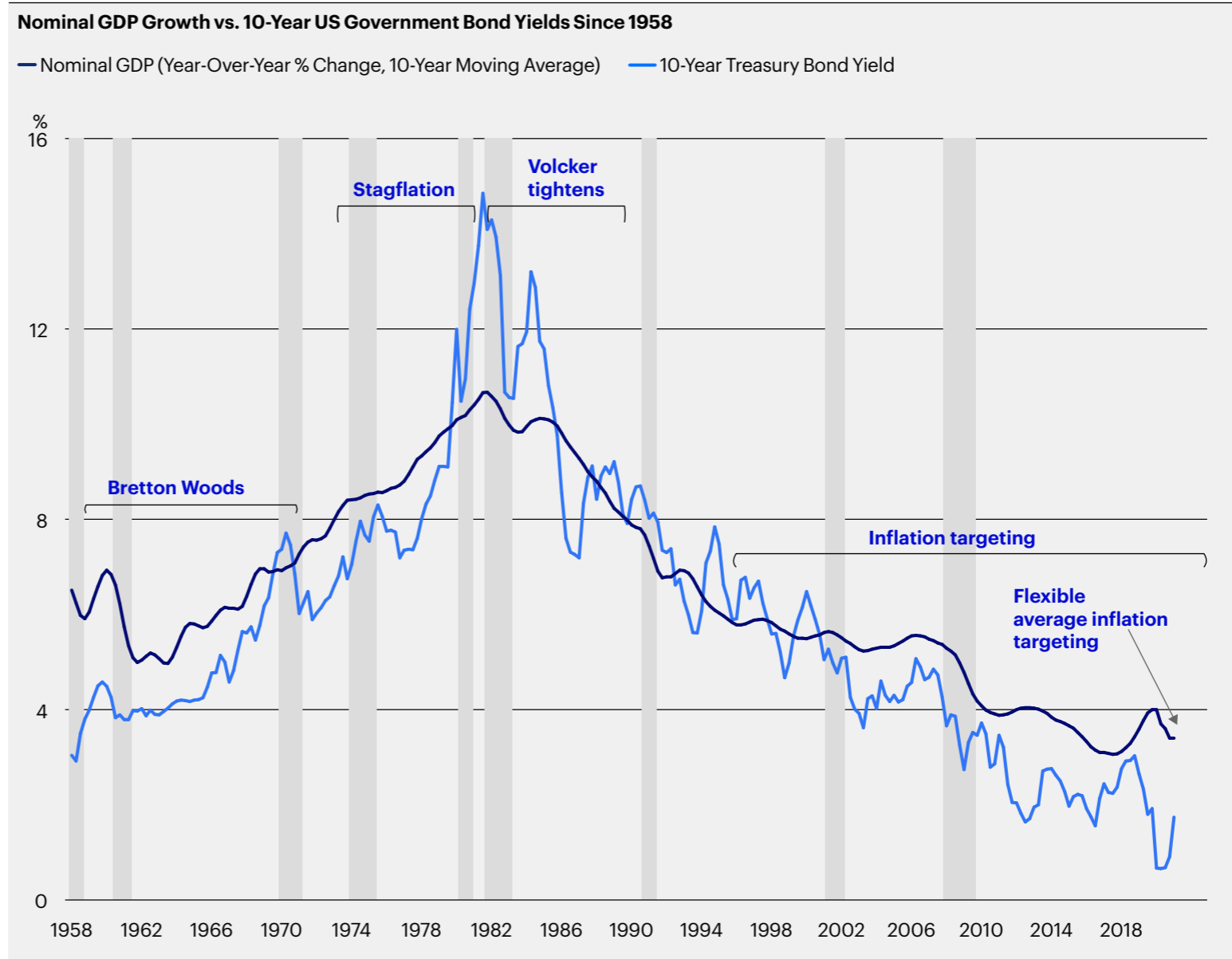
# Rates Are Likely to Rise

## We expect rates to rise as the US economy expands

History shows that nominal economic growth and bond yields generally move higher or lower together.

Bond yields are likely to rise with the rebound in economic growth and inflation following reopening after the pandemic.

The Fed's new flexible average inflation targeting framework means that it is likely to hold back on rate hikes, which should limit the rise in bond yields and extend the growth recovery.



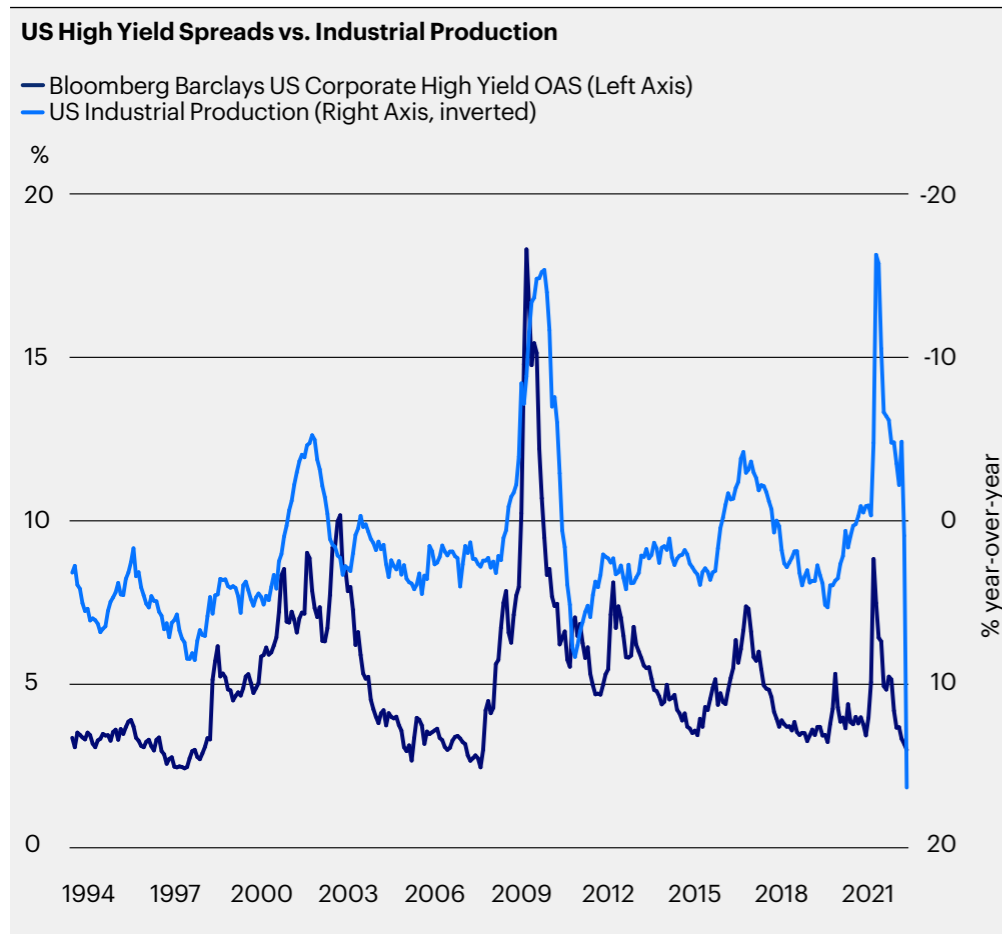
Sources: US Bureau of Economic Analysis, FRED, Invesco, March 31, 2021. Notes: Gross domestic product (GDP) is the total value of all final goods and services produced in a country in a given year. Nominal GDP = Real GDP + inflation. 10YMA = 10-year moving average. Shaded areas denote NBER-defined US recessions. An investment cannot be made directly in an index. Bretton Woods era defined as the period of the fixed dollar-gold exchange parity (until August 1971) and the Smithsonian Agreement temporary fixed exchange rate system (ending with floatation of the dollar in 1973). Inflation targeting era defined to include implicit, informal use of inflation targeting from the 1990s by the Federal Reserve, following its formal adoption in other countries from the late 80s/early 90s, though the Fed only adopted an explicit 2% inflation target in 2012 and switched to "Flexible Average Inflation Targeting" in 2020.

**Past performance does not guarantee future results.**

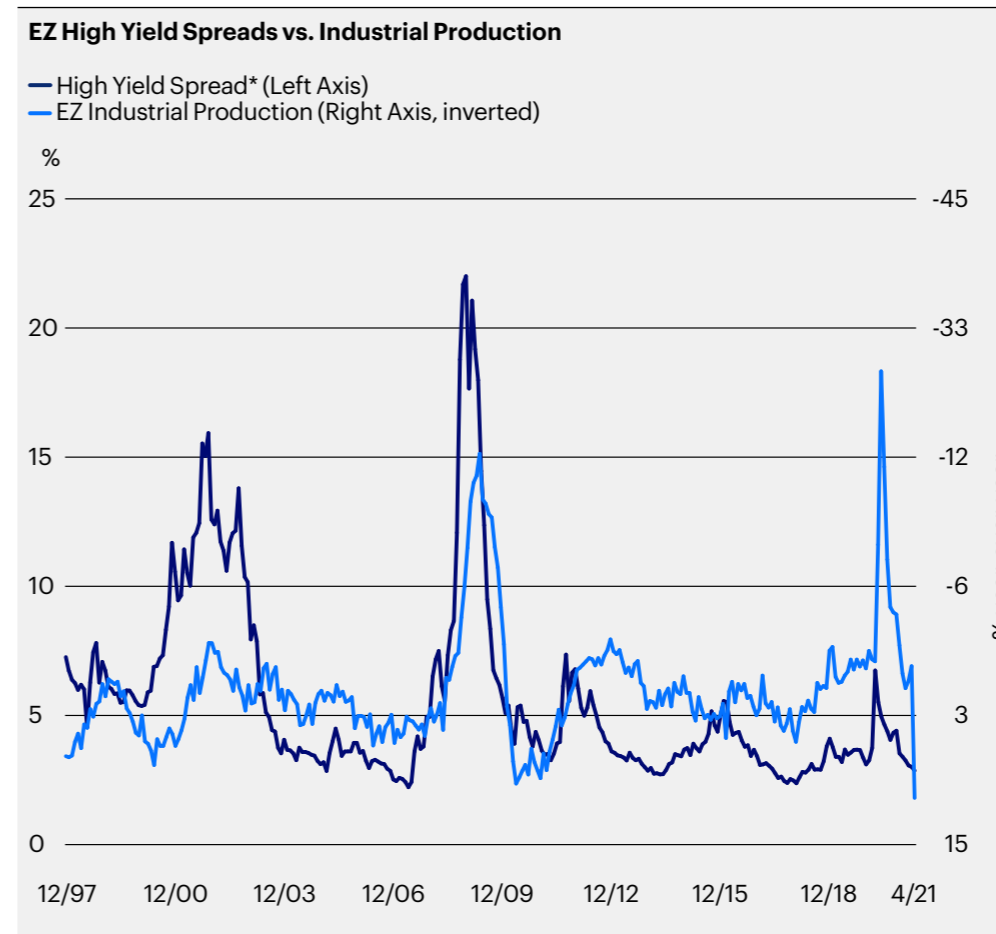
# Credit and High Yield Spreads Likely to Stay Tight

## We expect credit and high yield to outperform sovereign debt

- Fundamentals are positive and supportive for US and European high yield debt, but valuations are extremely tight.
- We expect US and European high yield to perform well versus sovereign debt in the coming year, given our expectations for economic growth.
- There has historically been a close correlation between industrial production and high yield spreads. The improvement in industrial production supports our view that spreads will remain tight.



Data as of April 30, 2021.



Data as of April 21, 2021.

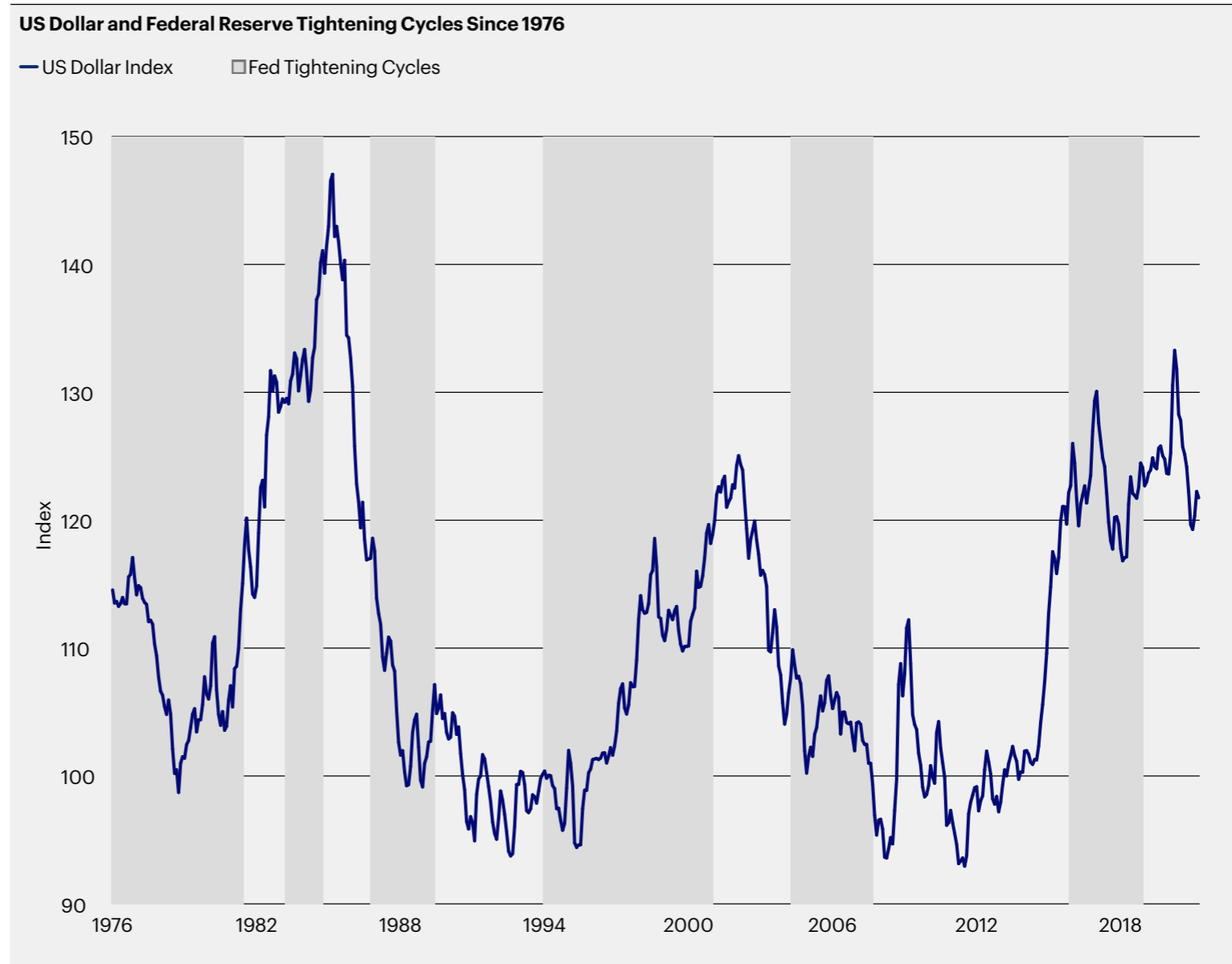
\*The High Yield Spread for the Eurozone is computed using the ICE BofA Euro High Yield Index minus the ICE BofA Euro Government Index.  
Sources: Bloomberg L.P., US Federal Reserve, Refinitiv Datastream and Invesco. Note: EU spread is versus the yield on the BAML Eurozone Govt Index.



# US Dollar Weakness Expected

## Fed's accommodative monetary policy should support dollar weakness

- We expect US dollar weakness, helped by reflation and the rotation into value trades.
- In general, strong dollar cycles end when Fed tightening cycles end. With the Fed firmly accommodative, the path of least resistance seems to be downward for the US currency. Indeed, the Fed — together with a host of other major central banks — is doing its part to boost US dollar-based liquidity and tamp down the greenback.
- The Fed's new average inflation targeting (AIT) policy and its 'patiently accommodative' stance suggests there will be some time before the Fed starts tightening, which is likely to result in dollar weakness in the near term.
- Commodities are a likely beneficiary of a weaker dollar.

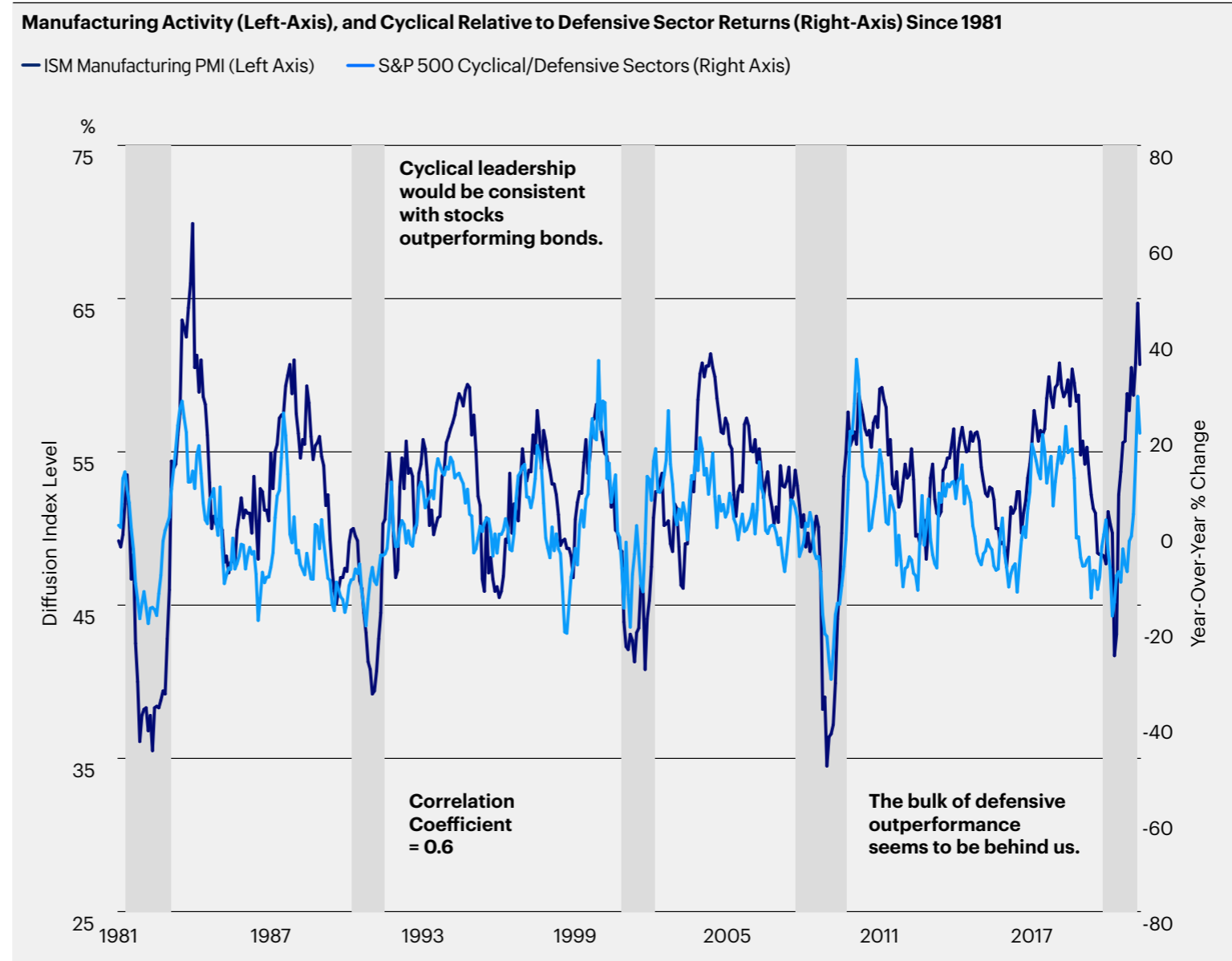


Sources: Bloomberg L.P., Invesco, April 30, 2021. Notes: Shaded areas denote Federal Reserve (Fed) tightening cycles. US Dollar = Bank for International Settlements Narrow Real Effective Exchange Rate. An investment cannot be made directly in an index. Past performance does not guarantee future results.

# Cyclicals or Defensives?

## An economic expansion typically results in cyclical outperformance

- We expect cyclicals to outperform defensive stocks in this economic expansion.
- There has historically been a strong correlation between manufacturing activity and the outperformance of cyclicals, which supports our view that cyclicals will outperform in the expansionary phase of an economic cycle.



Sources: Bloomberg L.P., Haver, and Invesco, as of May 31, 2021.  
Notes: S&P 500 cyclicals = Consumer Discretionary, Energy, Financials, Industrials, Technology and Materials. S&P 500 defensives = Consumer Staples, Health Care, Telecommunication Services and Utilities. Shaded areas denote NBER-defined US recessions. An investment cannot be made in an index. **Past performance does not guarantee future results.**

# We Favor Smaller-Cap and Value Stocks

## Small Caps and Value Stocks Tend to Outperform in Recovery

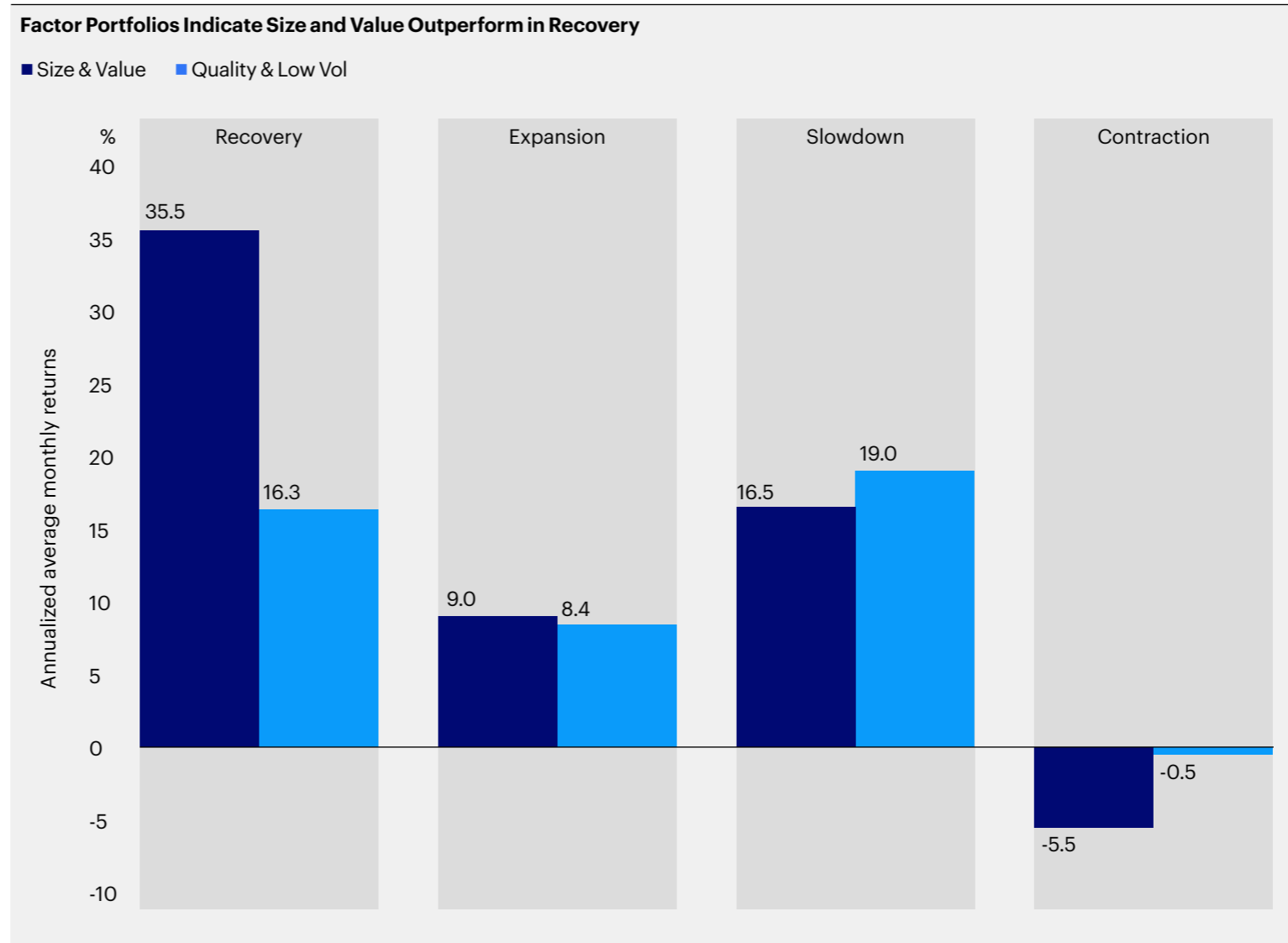
Our regime framework indicates that size and value outperform when economies are in recovery, which we define here as growth below trend but improving.

Sources: FTSE Russell Factor Indices and Invesco Investment Solutions. Russell 1000 Index. January 1989 - December 2020, annualized average monthly returns. Size & Value portfolio represents portfolio tilted towards Russell 1000 Size and Value Factors. Quality & Low Vol portfolio represents portfolio tilted towards Russell 1000 Quality and Low Vol Factors. Market Index refers to the Russell 1000 Index.

**Past performance is not indicative of future results.**

An investment cannot be made directly in an index.

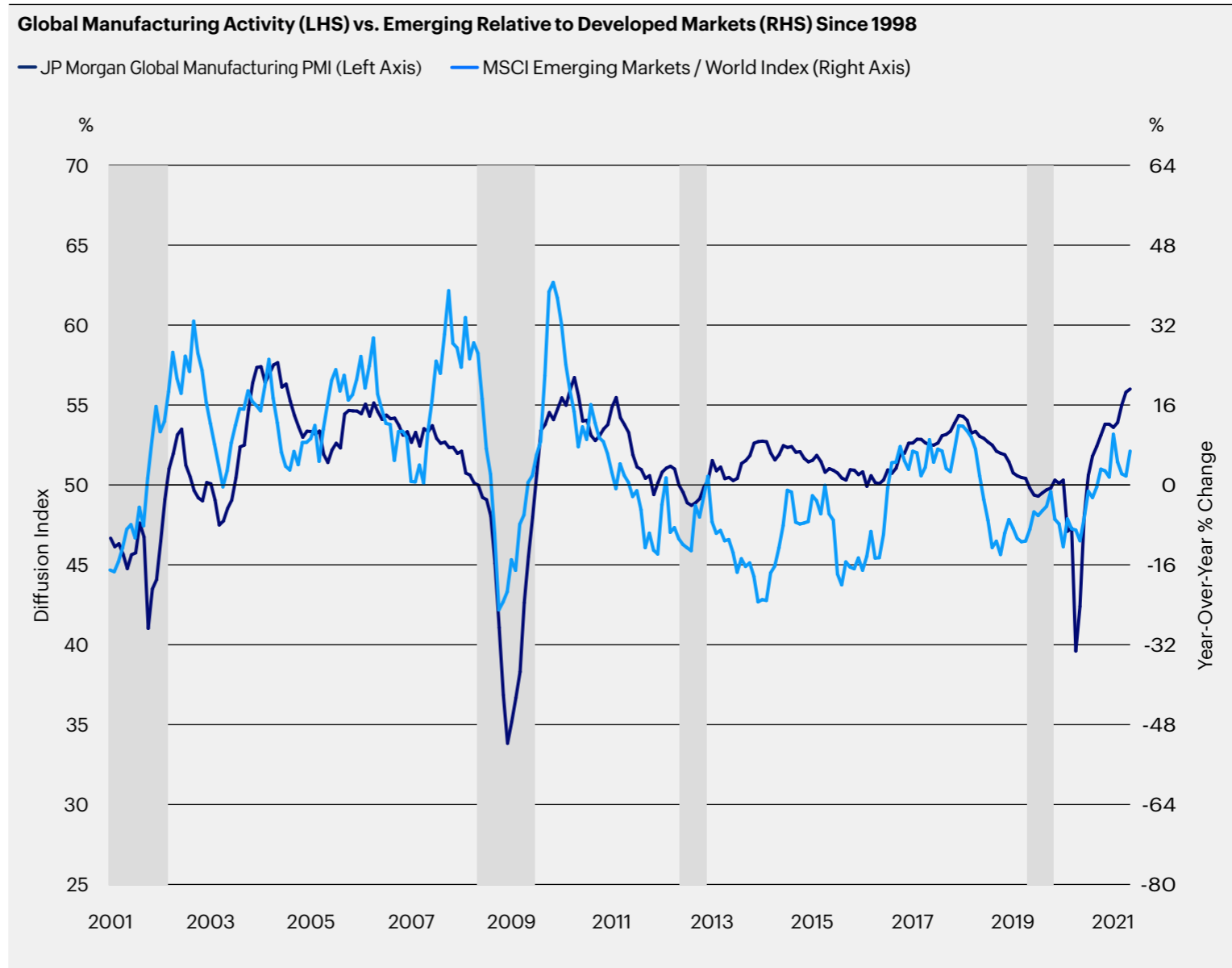
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# Emerging or Developed Market Equities? We Look to Global Manufacturing

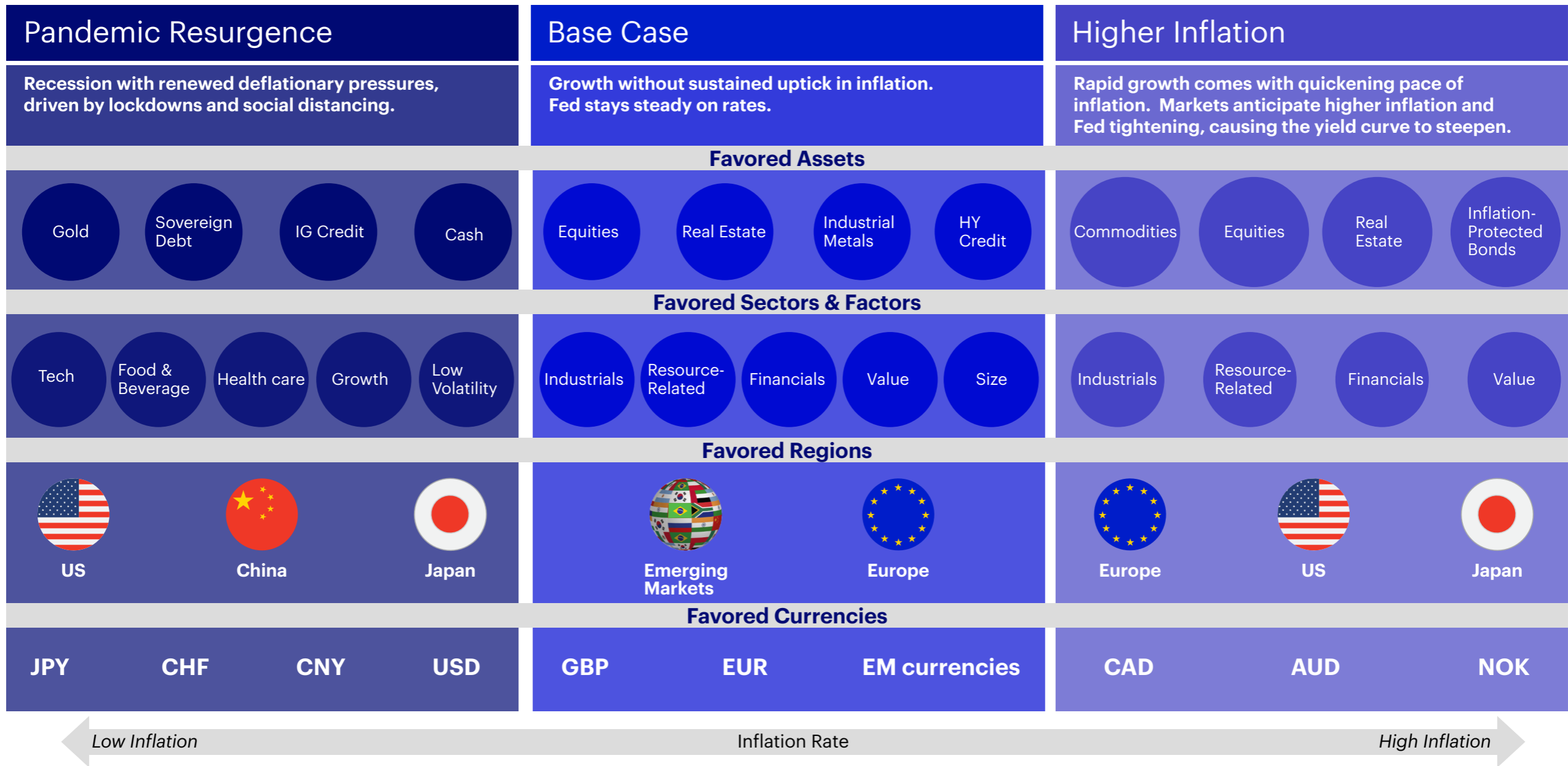
## Global manufacturing strength tends to yield emerging market outperformance

- We expect emerging markets equities generally to outperform developed markets equities, driven by global growth, easy monetary conditions and a weakening dollar. However, Covid may require regional selection due to varying paces of vaccination.
- Historically there has been a strong correlation between global manufacturing activity and emerging market outperformance.
- Emerging markets also typically benefit from higher commodities prices.



Sources: JPMorgan, Bloomberg L.P., and Invesco, as of May 31, 2021.  
Shaded area represents declines in global manufacturing activity lasting six months or more.

# Summary of Our Scenarios



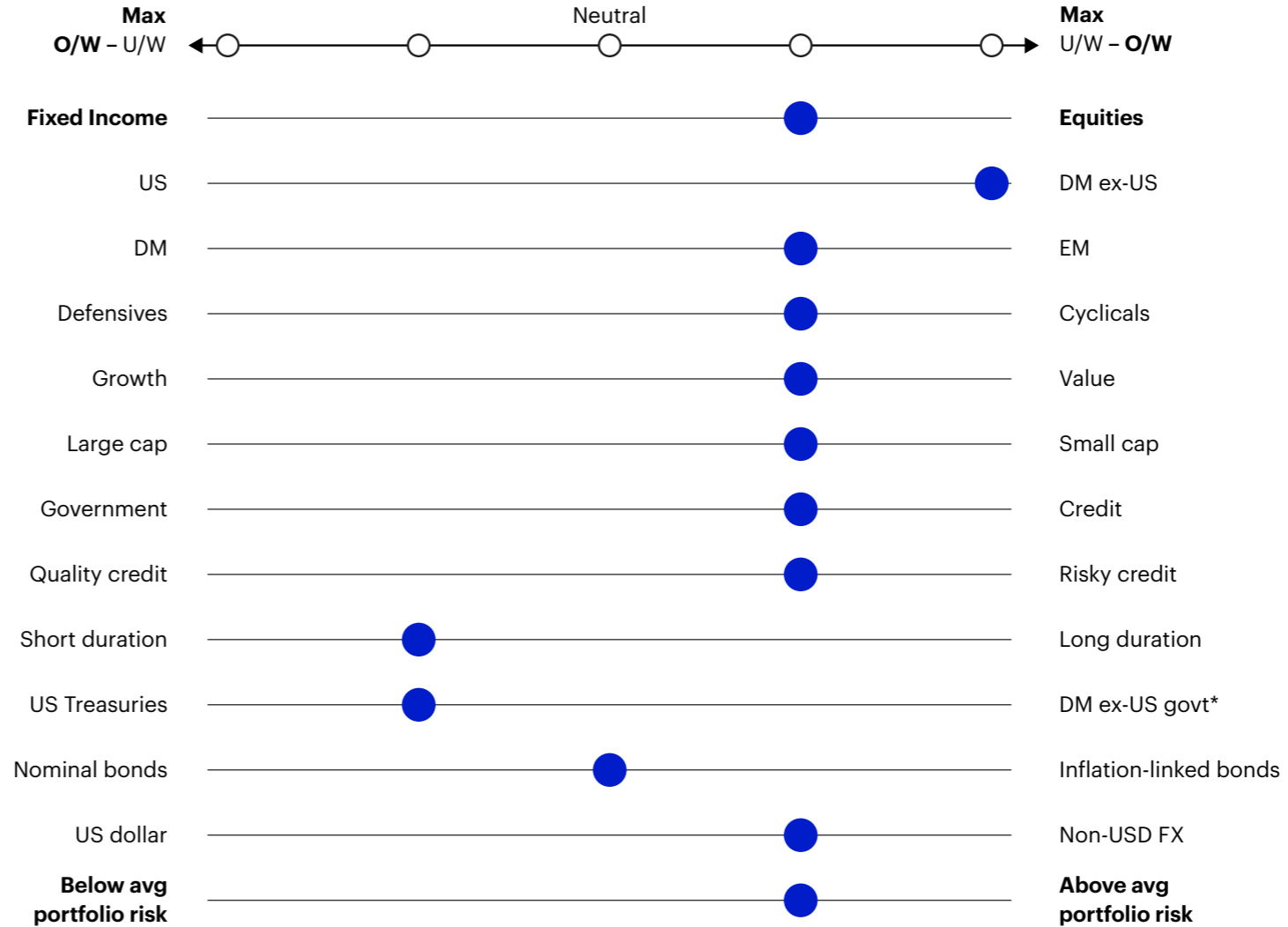
Source: Invesco.  
There can be no assurance that stated outcomes will be realized.

# Tactical Asset Allocation:

## Investing within the business cycle

- We expect equities to outperform fixed income as economies continue to accelerate through the end of the first quarter of 2022 and then decelerate but still remain well above trend.
- We expect fiscal stimulus and monetary policy accommodation to continue to support risk assets. We expect market volatility to decline across asset classes. We expect more cyclical regions, sectors, and styles to outperform.
- We expect US dollar weakness, driven by reflation and the rotation into value regions.

Relative Tactical Asset Allocation Positioning: Base Case



\* Hedged  
 Source: Invesco Investment Solutions, April 2021.  
 For illustrative purposes only.

# Tactical Asset Allocation:

## Fixed Income and Equities

### Investing in Fixed Income\*

- Growth and policy are supportive of credit fundamentals in our base case scenarios.
- Valuations are very tight in a historical context, limiting the potential upside from spread tightening, and increasing the potential downside in a widening scenario. Low overall yield levels increase the risks when overall yield levels rise.
- Bank Loans are supported by the strong credit fundamentals, and may benefit from rising rates as bank loans have floating interest rates.

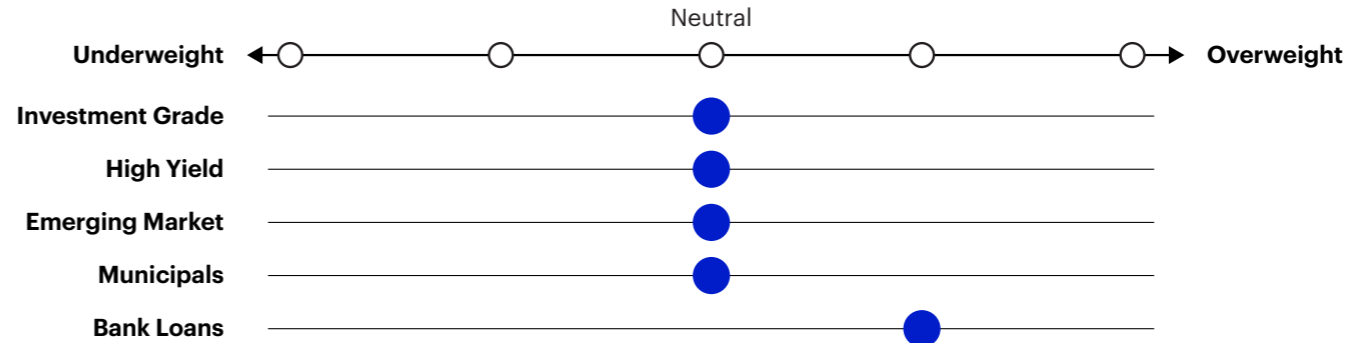
### Investing in Equities\*\*

- In terms of sectors, we expect the global cyclical rebound through the first quarter of 2022 to further support value sectors with higher operating leverage compared to more quality-oriented sectors. We favor industrials, materials, financials, and consumer discretionary over health care, staples, technology, and communication services. Momentum, which has recently included more value and smaller-capitalization characteristics, typically outperforms in this expansionary phase of the cycle, providing further support to this rotation.

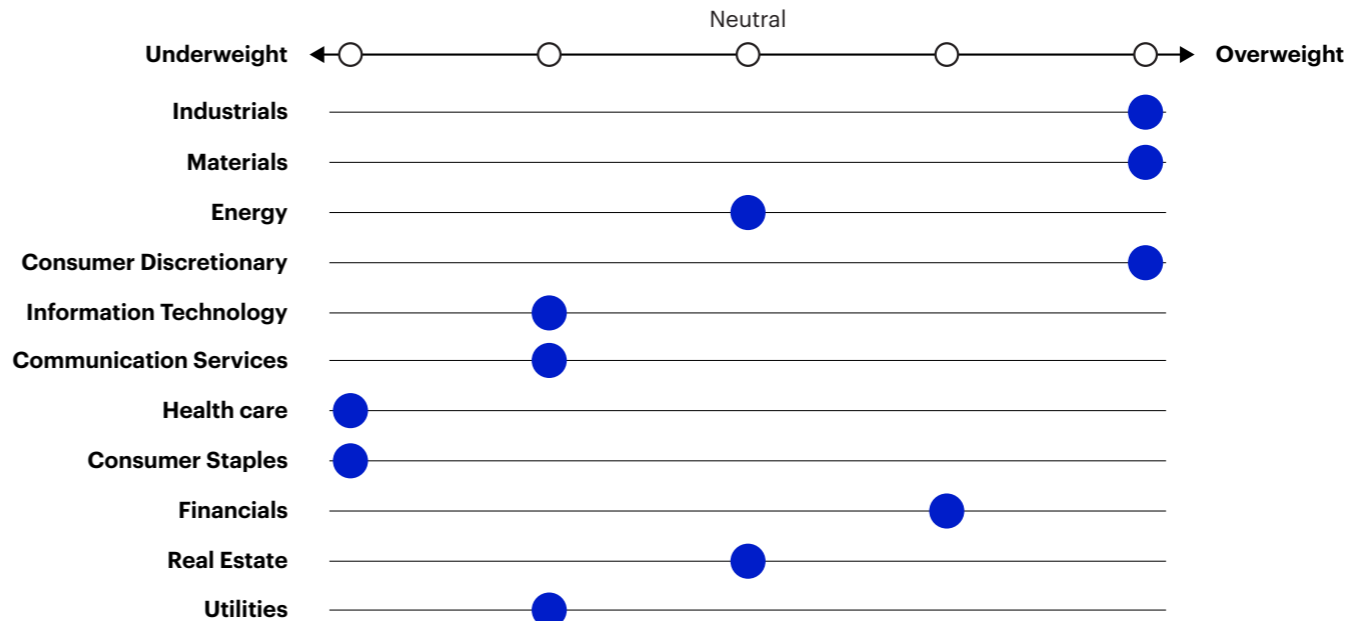
\* Source: Invesco Fixed Income

\*\* Source: Invesco Investment Solutions  
For illustrative purposes only.

Relative Tactical Asset Allocation Positioning: Base Case



Relative Tactical Asset Allocation Positioning: Base Case



# Tactical Asset Allocation:

## Commodities and Alternatives

### Investing in Commodities\*

- Given our expectation of a strong economic recovery, expect those more cyclically sensitive commodities to outperform, including industrial metals and energy.

### Investing in Alternatives\*\*

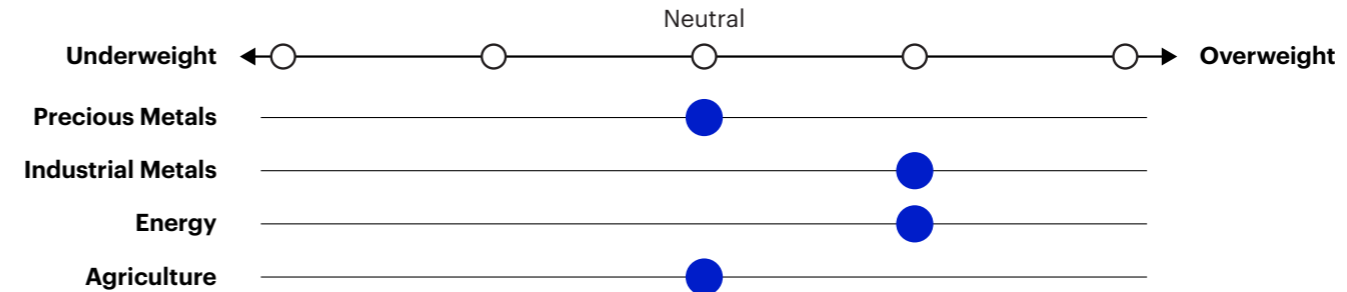
- In our base scenario, we remain constructive on many private strategies positioned to take advantage of continued global economic opening.
- Some COVID-19-related - related market dislocations remain an opportunity in private sub-asset classes, including sectors of real estate and infrastructure.
- In the event of increased global inflation, we favor floating rate private credit strategies as well as real asset strategies that often have revenues with imbedded inflationary linkage.

\* Source: Invesco Systemic & Factor Investing, ETF and Indexing teams.

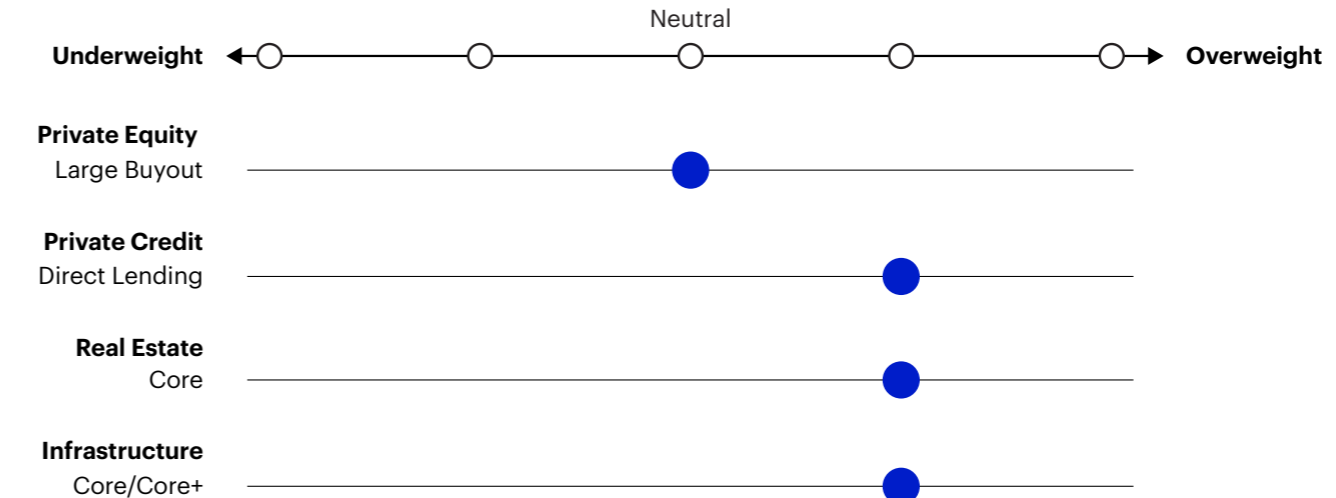
\*\* Source: Invesco Investment Solutions. Alternatives tactical asset valuations represent our view of which asset classes are likely poised to outperform over an approximate 3-5-year timeframe.

For illustrative purposes only.

### Absolute Tactical Asset Allocation Positioning: Base Case



### Alternative Tactical Asset Allocation Positioning: Base Case





## Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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