Portfolio Strategy

10 Themes for 2021 - Unleashing Excess Cash

OUR TAKE: [Positive]. Our strategy game plan entering 2021 is to stick to an equity-over-bond preference, with a long bias on cyclical-value sectors such as Financials, Industrials, Discretionary and Resources. Although it will take some time to distribute vaccines and inoculate a critical mass, they are a game changer on account of their expected effectiveness. An economic rebound is broadly expected for 2021, but we believe excess cash at the consumer, business and investors levels could boost growth and asset prices further in 2021. We provide below our 10 themes for 2021:

1. **Piles of stacked cash could soon turn into hot money**
2. **Synchronized downturn, synchronized upturn**
3. **The road to US$200 EPS**
4. **Income scarcity: The hunt for yield intensifies**
5. **Bond yields: The great normalization**
6. **Go Global**
7. **Small could be big in 2021**
8. **Hard assets shining, CAD roaring**
9. **Sector rotation favors cyclicals**
10. **No Value left behind**
11. **Bonus - Capital markets spring back to life**

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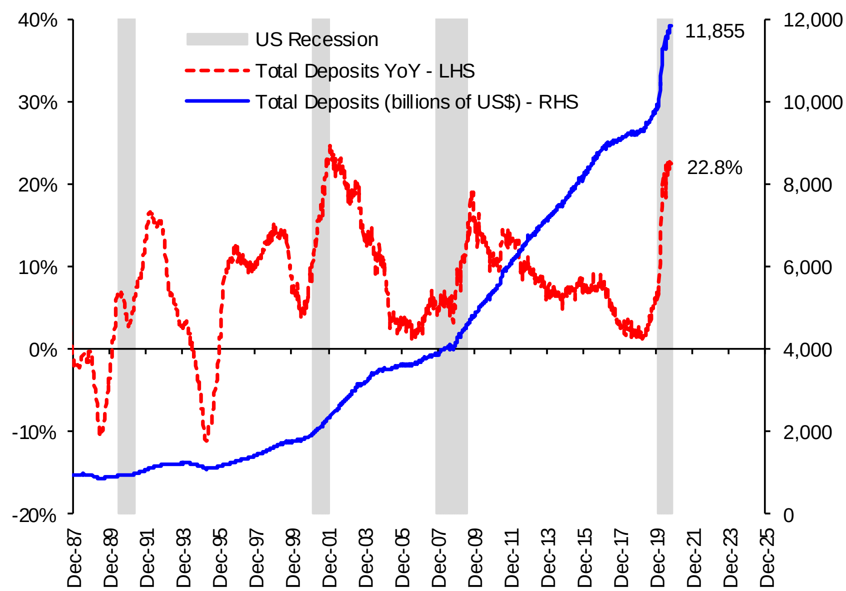
10 Themes for 2021 – Unleashing Excess Cash

1. Piles of Stacked Cash Could Soon Turn Into Hot Money

An economic rebound is broadly expected for 2021, but we believe the US economy could exceed expectations. Three factors could move the needle: consumer spending, an inventory re-stocking cycle, and corporations opening the spending spigots.

Unleashing consumer demand. Quick and sizable fiscal transfers on top of a rapidly healing job market explain why US consumers' financial position remains relatively healthy. In addition, cash stacked under the bed for rainy days has grown exponentially. As shown in Exhibit 1, cash held in US saving accounts has increased by US$2T since February to almost US$12T (+22.5% YOY). To provide some perspective, US$2T represents 13% of consumer spending in 2019. In our view, a strong appetite for some normalcy will return with the vaccine inoculation, unleashing consumer demand for most things that have been put aside for so long. Part of the extra cash will likely be spent, potentially boosting consumer spending more-than-expected.

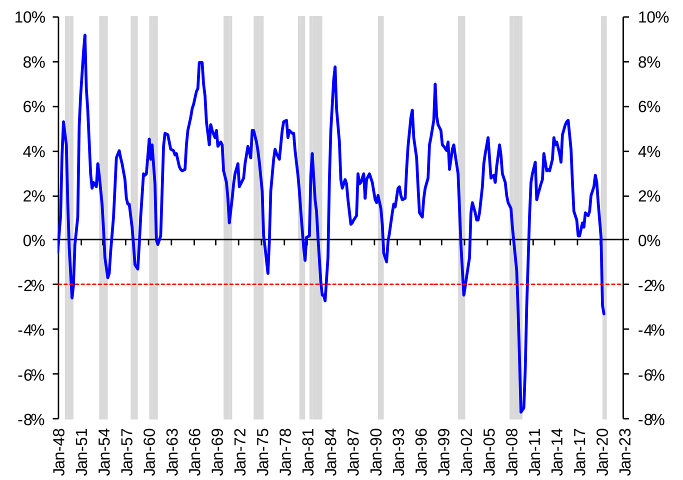
Exhibit 1: Total Savings Deposits (U.S. Depository Institutions)



Source: Scotiabank GBM Portfolio Strategy, FRED.

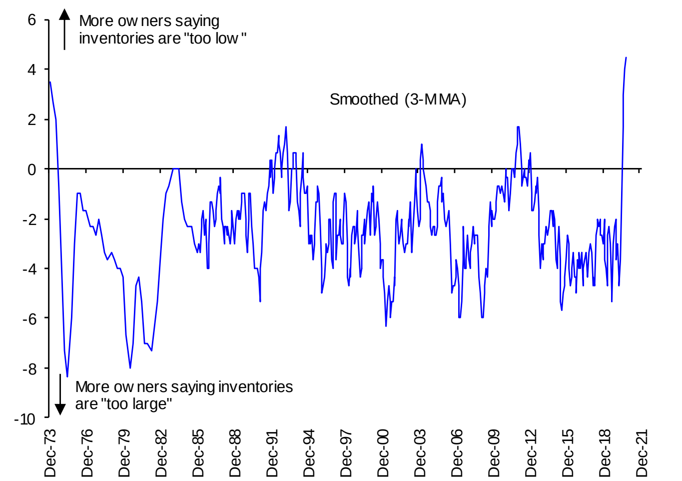
Inventory re-stocking coming. The YoY decline in US private inventories is one of the steepest on record going back to the 1940s. See Exhibit 2. If consumers are back, businesses will have to replenish their stock (positive for GDP). According to the latest NFIB survey of small businesses, the net percentage of owners viewing current inventory stocks as "too low" stands at record levels.

Exhibit 2: U.S. GDP - Real Private Inventories (YOY%)



Source: Scotiabank GBM Portfolio Strategy, FRED.

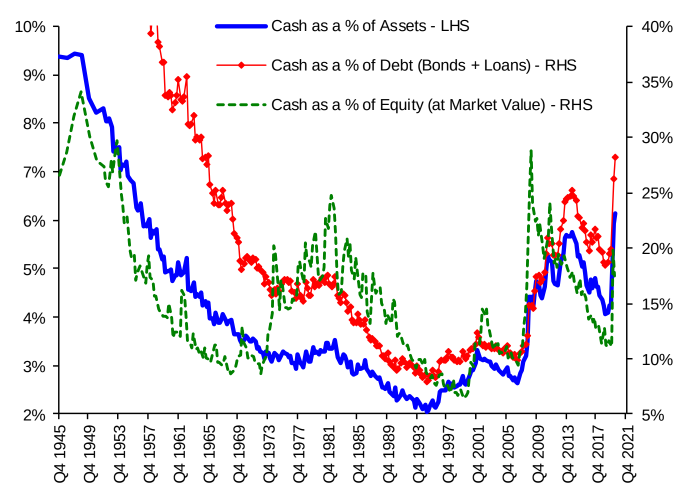
Exhibit 3: Small Biz Saying Inventories are "Too Low"



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

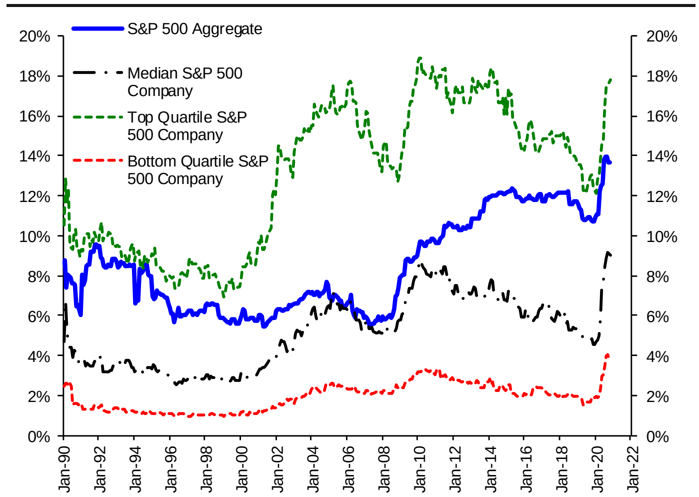
Corporate America also flush with cash. Based on several metrics, corporations have rarely set aside as much cash for rainy days as they did in the current crisis. For instance, cash as a % of assets for all US corporations hasn't been this high since the 1950s, while cash as a % of total debt is at levels last seen in the 1960s. See Exhibit 4. Although these high cash positions are skewed towards the mega cap names, even the median S&P 500 company has seen its cash balances exceed the levels reached during the last big scare of the financial crisis. Overall, we believe corporate America will face increasing heat to use that excess cash in various ways (deleverage, capex, M&A, buybacks, or even higher wages). More capex and higher wages would certainly give further boosts to the economy.

Exhibit 4: US Corporations are Flush with Cash



Source: Scotiabank GBM Portfolio Strategy, Bloomberg, Federal Reserve.

Exhibit 5: S&P 500 Companies - Cash as a % of Total Assets

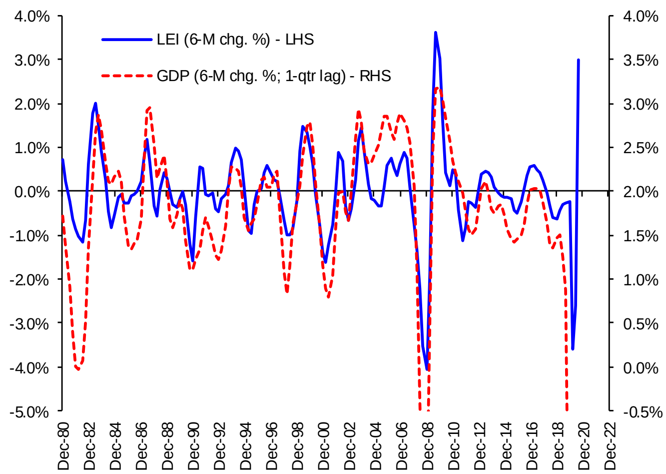


Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

2. Synchronized Downturn, Synchronized Upturn

The global downturn experienced in Q1/Q2 has now morphed into a global upturn which should extend into 2021 (see Exhibit 6), underpinned by fiscal and monetary largesse around the world. The leading economic indicator for OECD countries and six major non-OECD economies has indeed been spiking, hinting towards firmer growth ahead. China could be the growth engine next year according to Scotia Economics, which expects the economy to grow 8.5% – a pace of expansion not seen in years. See Exhibit 7.

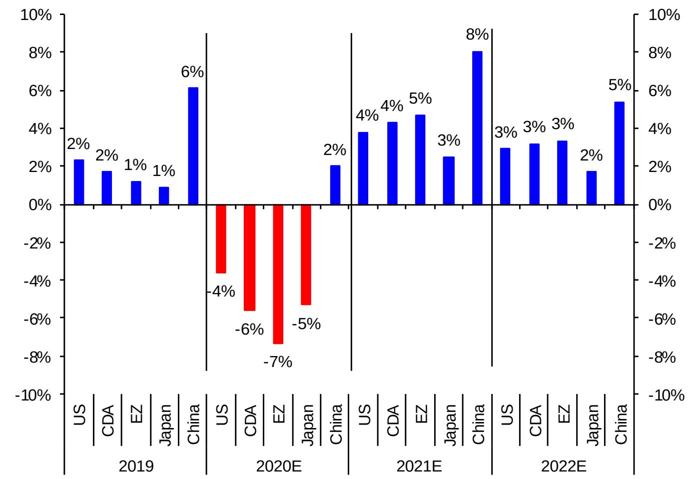
Exhibit 6: Global Leading Economic Indicator & GDP Growth*



*Our GDP/LEI basket includes OECD countries plus 6 major non-OECD economies.

Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 7: Global GDP – From Contraction to Expansion (consensus estimates)

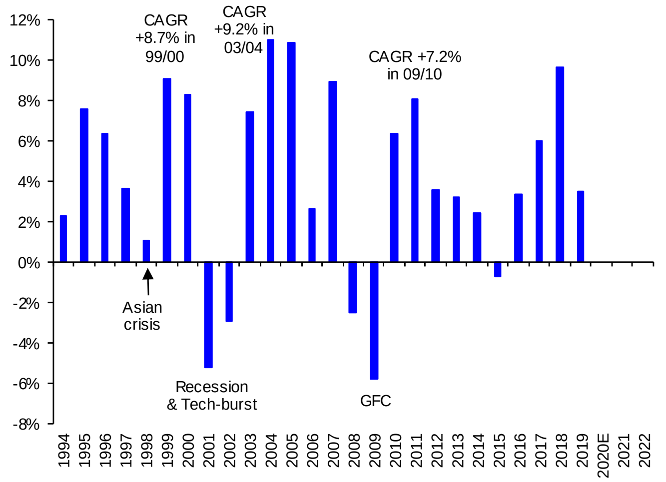


Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

3. The Road to US$200 EPS

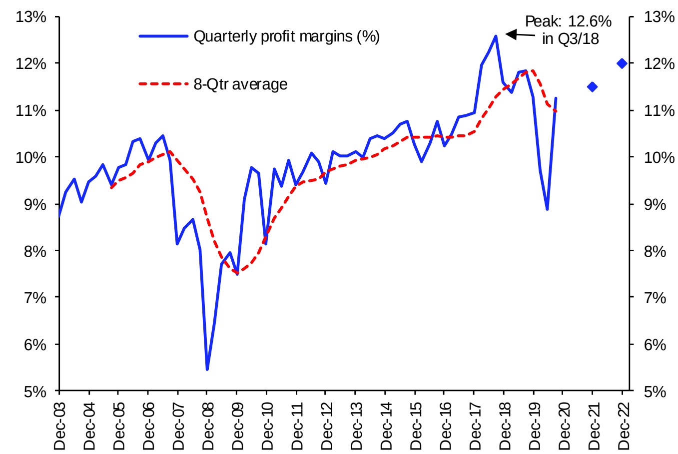
We believe that a combo of above-average top-line growth and impressive resiliency in profit margins could push S&P 500 EPS near the US$200 mark in FY 2022. As illustrated in Exhibit 8, S&P 500 revenue growth is usually quite strong in the two years following a crisis. Moreover, the Q3/20 reporting season highlighted the surprising resiliency of corporate profit margins. Corporate Canada (and America) has done a great job of taking costs out of the system during the pandemic. Turbo-charged top-line growth in ‘21/’22 (7%-8% CAGR) and profit margins reverting near pre-pandemic highs could pave the way to record earnings and higher stock prices.

Exhibit 8: S&P 500 Top-Line Growth Tends to Bounce Strongly Post Crisis



Source: Scotiabank GBM Portfolio Strategy, Bloomberg, Factset.

Exhibit 9: S&P 500 Quarterly Profit Margins



Source: Scotiabank GBM Portfolio Strategy, Factset.

EPS & targets increased. We review our TSX and S&P 500 EPS forecasts and targets higher. See Exhibit 10. Keep in mind that our EPS forecasts are based-off a weighted-average of our bull/base/bear cases. Based on Nov 30 levels, our new targets imply TR performances of about 9% for the S&P 500 and 12% for the TSX. Equities could deliver more upside if our 2022 EPS “bull” case scenario were to materialize.

High valuation levels are well supported. Investors (US$4.3T in money market assets) have cash to spend once the outlook clears. The Fed (along with other central banks) will also continue to print money. With few alternatives given flattish to negative real yields, hot money could continue to find its way into the stock market and inflate asset prices further.

Exhibit 10: Scotiabank GBM Financial Forecasts

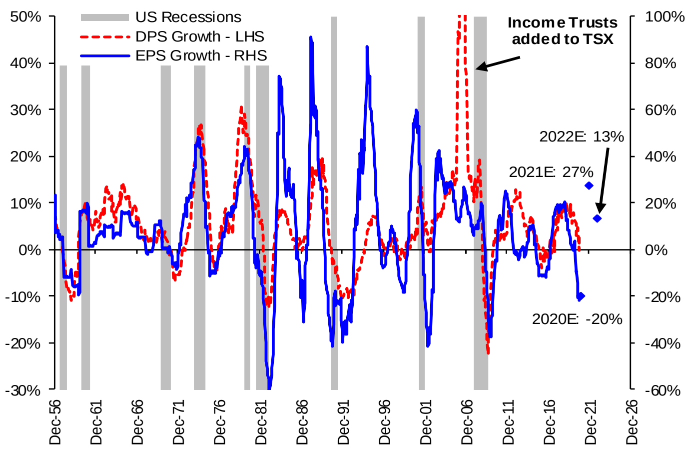
Forecasts	2017	2018	2019	2020E	2021E	2022E
Equity (Year End)						
S&P/TSX	16,209	15,300	17,063		**19,200** ↑	
EPS	909	1,018	1,052	**832** ↑	**1,060** ↑	**1,201** ↑
S&P 500	2,673	2,507	3,231		**3,900** ↑	
EPS	132	162	163	**136** ↑	**164** ↑	**184** ↑

Source: Scotiabank GBM Portfolio Strategy estimates.

4. Income Scarcity: The Hunt for Yield Intensifies

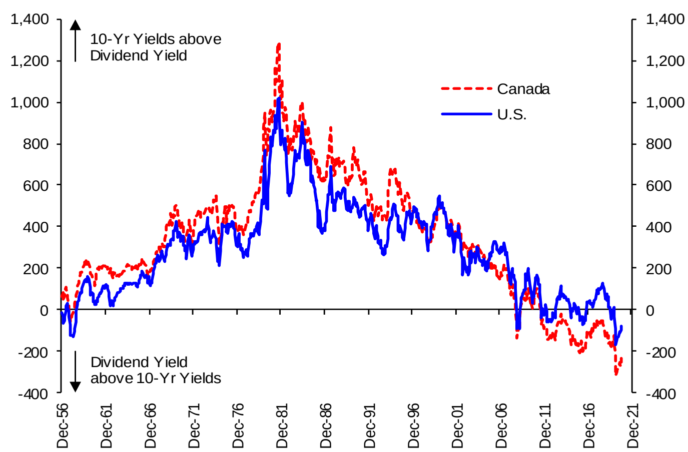
Interest rates on cash deposits and government bond yields should remain quite anemic next year. As traditional sources of income can't fulfill their role anymore, the hunt for yield will likely intensify and investors will have to look for alternatives. Equities appear an obvious choice. After a challenging year, dividend growth should resume in 2021 on the back of improving profitability trends. See Exhibit 11. Moreover, dividend yields have rarely been this attractive versus government bonds in over half a century. See Exhibit 12.

Exhibit 11: TSX Trailing EPS & DPS Growth (YOY%)



Source: Scotiabank GBM Portfolio Strategy estimates, CPMS

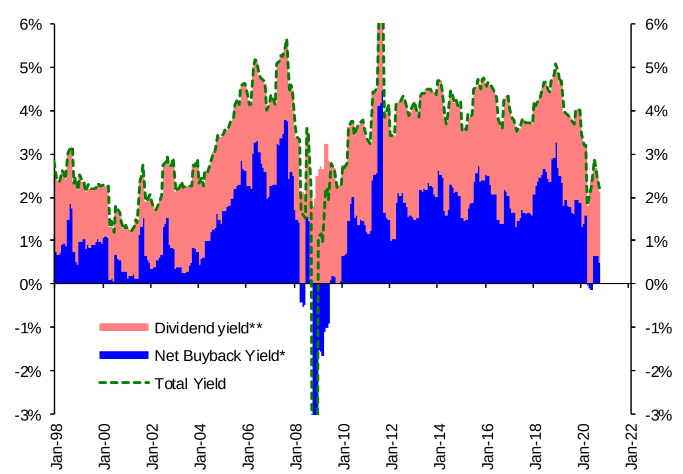
Exhibit 12: Bond Yields vs Dividend Yield Spread (bp)



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

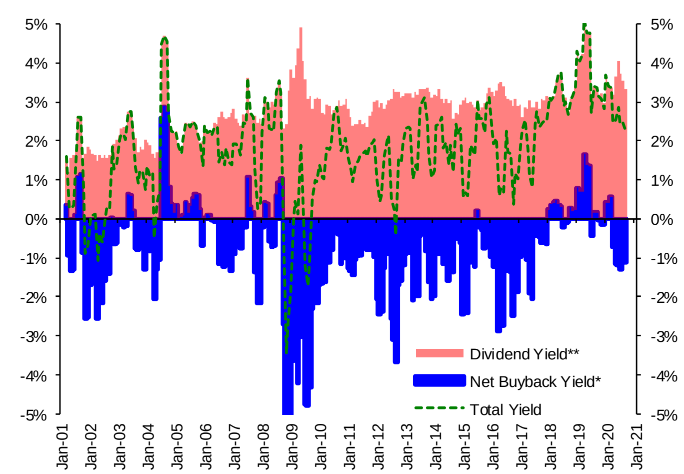
Buyback programs to restart. While not a direct source of income, buybacks are also set to recover, juicing total yield generated by equities. As part of cash conservation measures announced in H1/20, most corporations stopped their buyback programs while issuing shares. High cash balance in times of economic recovery should see investors clamour for more return, one way or another. See Exhibits 13 and 14.

Exhibit 13: S&P 500 Annualized Monthly Total Yield



*Measured using S&P 500 company level cash flow statements, netting equity issuance with equity retirement, including stock based compensation
**Last 3M of dividend paid annualized to account for quarterly patterns of dividends
Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 14: TSX Composite Annualized Monthly Total Yield

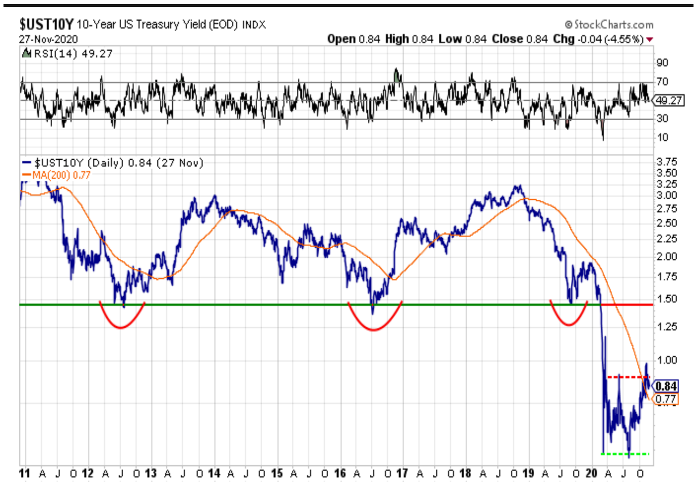


*Measured using TSX company level cash flow statements, netting equity issuance with equity retirement, including stock based compensation
**Last 3M of dividend paid annualized to account for quarterly patterns of dividends
Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

5. Bond Yields: The Great Normalization

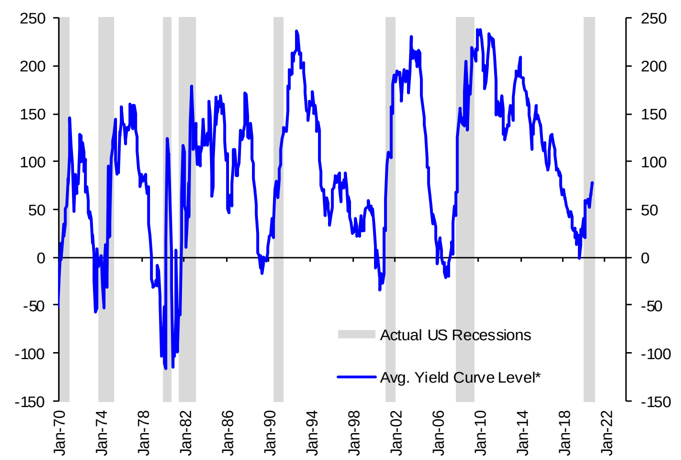
From an asset mix perspective, we believe government bonds have the worst outlook and possess the greatest risk of generating negative returns. Despite a broad normalization in macro data since last summer, bond yields have remained well anchored near their lows until recently. If growth is firmer next year, LT inflation expectations drift higher, and investors demand a higher premium to finance massive fiscal deficits around the world, we believe bond yields could also normalize. Prior to the pandemic, US 10-yr yields were hovering around 1.5%, as illustrated in Exhibit 15. Our US 10-yr bond yields model is even more aggressive, pegging fair value near 1.8%. Since short-term rates remain anchored by central banks, rising LT yields would imply a steeper curve. As shown in Exhibit 16, the steepening phase rarely stops at 75 bp: most of the time, it steepens well in excess of 100 bp. Investors should also start discussing and pricing-in less accommodative central banks by the end of 2021 if global growth is firmer and the COVID-19 stands in the rear-view mirror. A 2013-style "taper tantrum" is thus an increasing possibility late 2021 / early 2022. **SPY > LQD > TLT (or IEF).**

Exhibit 15: U.S. 10-Yr Yields: Normalization Expected



Source: Scotiabank GBM Portfolio Strategy, chart courtesy of StockCharts.com

Exhibit 16: YC Steepening Phases Rarely Peaked < 100 bp



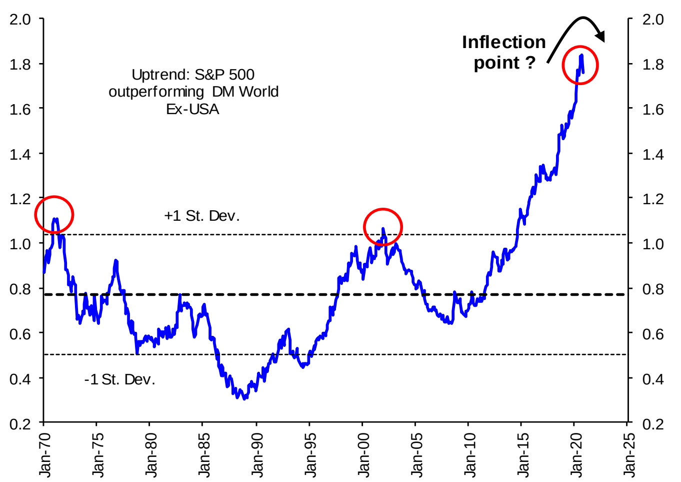
*Looking at all yield curve combinations between 3M, 2Yr, 5Yr, 10Yr, and 30Yr yields

Source: Scotiabank GBM Portfolio Strategy, Bloomberg, NBER, Federal Reserve.

6. Go Global

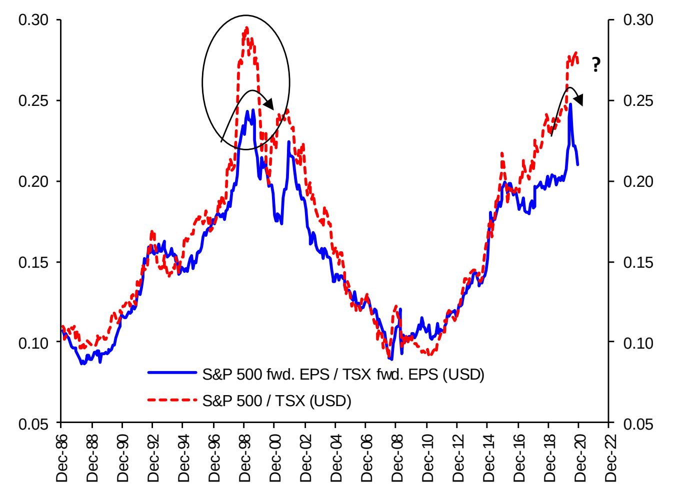
Our preference goes to international equities (TSX, EM, EAFE) over the US. After having underperformed almost continuously since the GFC, a synchronized economic lift-off should stimulate risk-appetite and provide more support to equity markets that have been left behind and trade at more compelling valuations than the US. See Exhibit 17. Although MSCI EAFE and EM indices have surged of late, it is surprising to see them still comfortably below their all-time high reached in 2007! A breakout to a new high would be, technically-speaking, quite bullish after having traded sideways for over a decade now. **Long EWC, EFA, EEM over SPY / XIU, XIN > XSP in Canada.**

Exhibit 17: S&P 500 vs. MSCI DM World Ex-USA



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 18: S&P 500 vs TSX: Fwd. EPS Ratio and Relative Performance

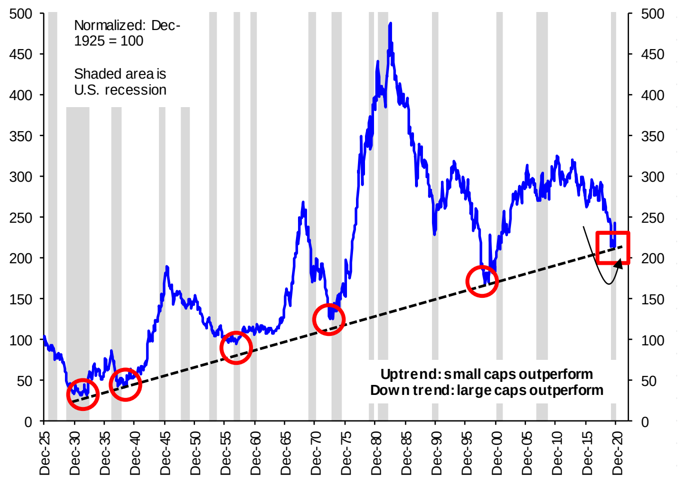


Source: Scotiabank GBM Portfolio Strategy, Refinitiv, Bloomberg

7. Small Could Be Big in 2021

If U.S. small caps end 2020 behind large caps, it would mark their fourth consecutive year of underperformance with six of the last seven years seeing underperformance. All U.S. small cap underperformance cycles since the 1920s ended when the small cap to large cap ratio (using total return indices) was in the vicinity of the ascending trend line shown in Exhibit 19. The ratio hit that trend line recently, suggesting the underperformance cycle has likely run its course. Historically, large cap domination cycle tends to last about six years on average. If the current cycle started in 2013 as we believe, its longevity roughly matches the historical average. Moreover, small cap equities have not been this attractive in years relative to large caps. While small caps' profitability has contracted this year, the percentage of small businesses losing money has likely peaked and should improve sharply next year. **IWM > SPY; XCS > XIU in Canada.**

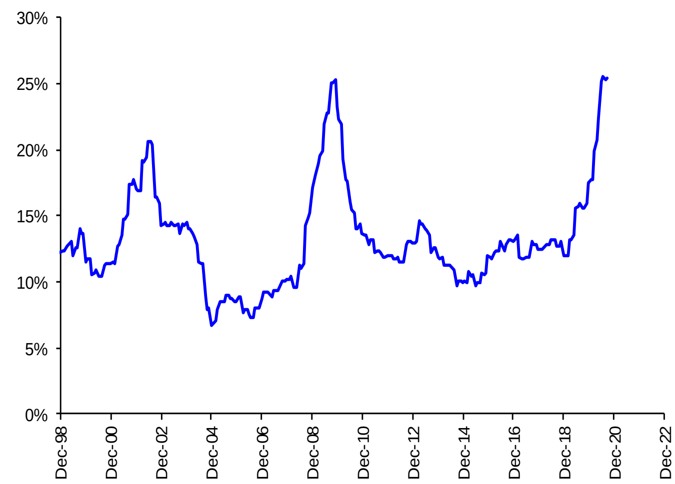
Exhibit 19: U.S. Small Caps Relative to Large Caps Since 1925 (TR)



Performance based on Ibbotson SC TR index from 1925 to 1978 and Russell 2000 (TR) thereafter.

Source: Scotiabank GBM Portfolio Strategy, Morningstar, Shiller.

Exhibit 20: S&P 600: % of Companies With Negative Trailing EPS



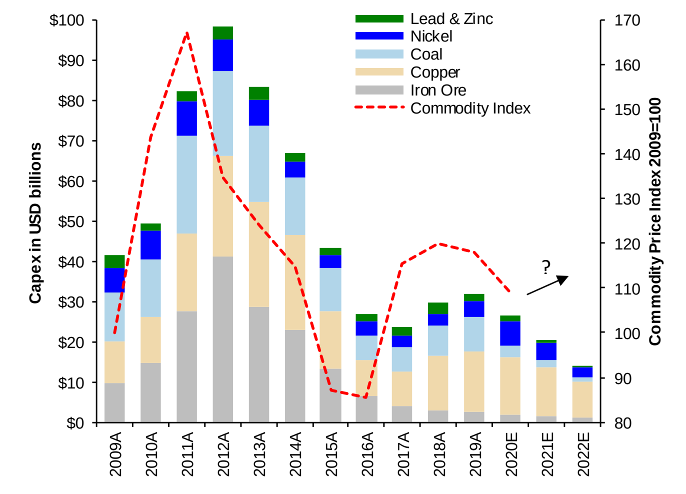
Source: Scotiabank GBM Portfolio Strategy, Bloomberg

8. Hard Assets Shining, CAD Roaring

Accelerating growth, dollar weakness, and a decade of falling capex in the mining industry (see Exhibit 21) could offer decent support to commodity markets in 2021/2022. However, the backdrop could be more supportive of base metals/energy than precious metals/gold. A wave of investment in green energy over the next few years bodes well for copper. Regarding energy, we believe oil & gas stocks have probably much more upside than the commodity. For the bullion, USD weakness should help, but lower uncertainty is usually less friendly and real US 10-yr bond yields (while still extremely low) could face upward momentum. We believe gold could trade sideways in a broad range unless inflation pressures accelerate. The environment should help the CAD to reach, and potentially exceed, the US$0.80 mark next year. **DBB (base metals) > GLD (gold).**

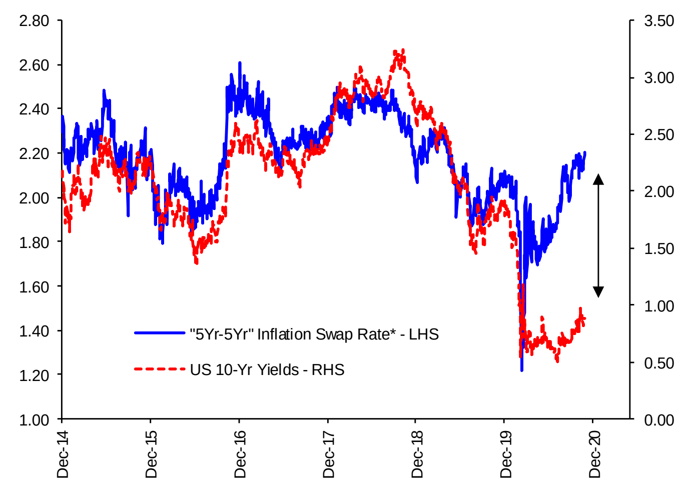
Inflation: Don't hold your breath, but keep it on the radar. Inflation pressures should remain weak for the time being: lack of demand or restrained appetite in several sectors as well as the idling of large parts of the workforce should keep price increases in check. Still, the narrative could change later in 2021 if central banks continue to contemplate extremely accommodative monetary policy at a time of closing output gaps and rising commodity prices. Ongoing supply chain disruptions could exacerbate the issue. Interestingly, LT inflation expectations have already started to move. The 5Y-5Y inflation swap forward, which measures market expectations of the average level of inflation over five years five years from now, is standing at 2.2% and rising. If consumer demand roars back to life, demanding normalcy and drawing down their cash savings, supply bottlenecks could turn into run away prices.

Exhibit 21: Expansion Capex by Commodity vs. Equal-Weighted Commodity Price Index



Source: Scotiabank GBM estimates, Wood Mackenzie, Bloomberg.

Exhibit 22: US 10Yr Yields & Inflation Expectations (%)



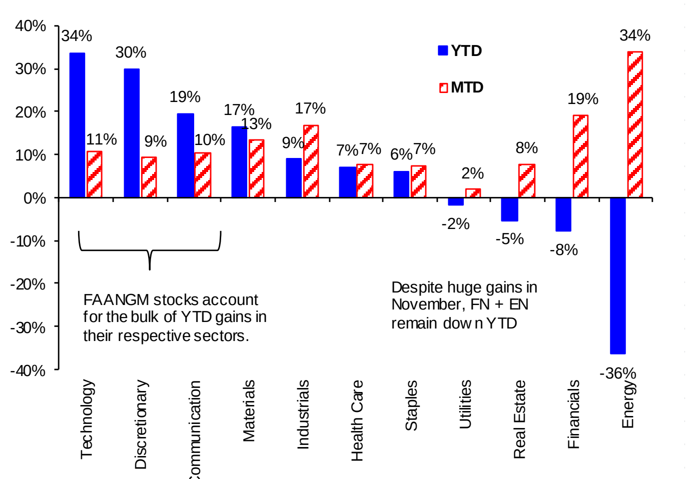
*Expected inflation in 5-yr for the next 5-yr

Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

9. Sector Rotation Favors Cyclicals

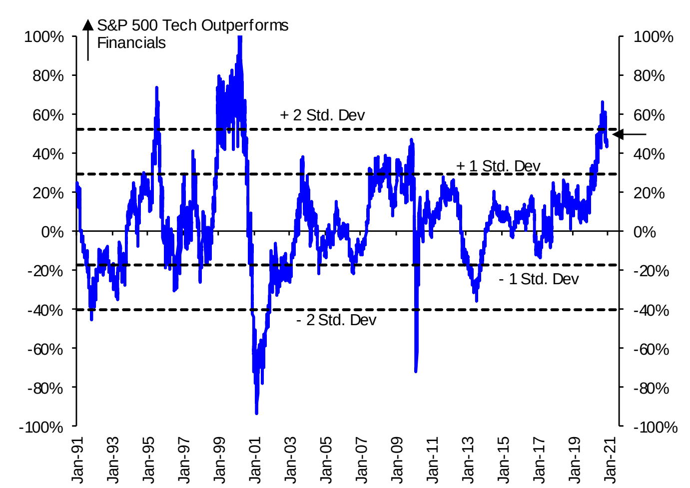
We believe the economic revival should provide more support to "old economy" stocks/sectors relative to their "digital" peers. Granted, cyclical sectors have enjoyed solid gains so far in November, but as illustrated below, some remain down on a YTD basis. Taking a longer-term view, it's worth highlighting that US Financials are lagging Tech by 46% YOY, which still appears quite extended to us. If growth is visible, cyclical-value sectors appear well positioned to lead next year.

Exhibit 23: S&P 500: Nov. Gainers Remain Down Big YTD



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 24: S&P 500 Tech Performance vs. Financials (YoY)

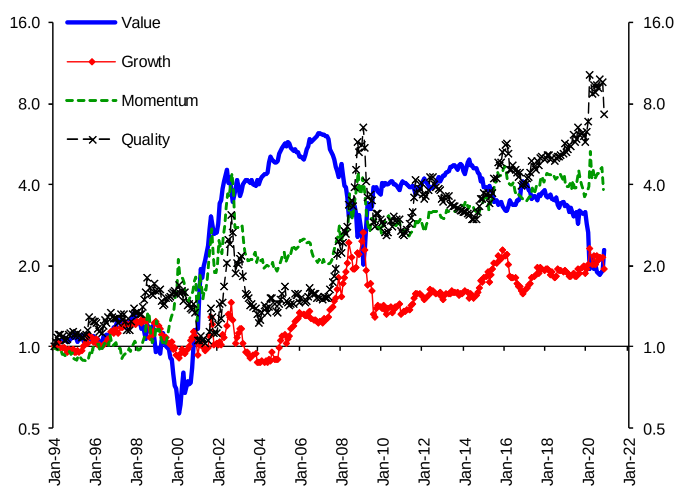


Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

10. No Value Left Behind

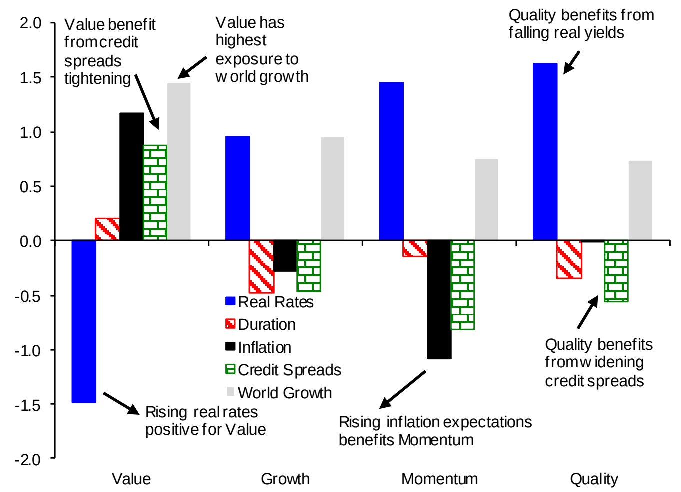
Value's sharp gain in November could be hard to repeat in the short run, but the number of quantitative and qualitative arguments for Value leadership in 2021 has never been greater. First, Value's underperformance cycle has rarely been this extended while relative valuation levels have rarely been as much in favour of Value as they are today. The potential for mean-reversion is thus extremely high. Second, after such a long run of underperformance, there are few true Value believers left. Institutional investors have been mostly net sellers of Value names in 2020 (up to Q3/20), creating large UW to the style. Sell-side has also set the bar extremely low in terms of consensus estimates. Positive surprises/performance in the sector could force a positive feedback loop as investors try to close down their exposure gap. Finally, Value typically enjoys an environment of rising yields and economic recovery. Overall, Value is extremely well positioned to outperform in 2021. We will discuss this theme in greater detail in our SQoRE update note that will be published later today. **IWD (R1000 Value) > IWF (R1000 Growth); XCV > XCG in Canada.**

Exhibit 25: SQoRE U.S. - Cumulative Outperformance Top 50 vs. Bottom 50 (Log scale)



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 26: SQoRE US Factor Exposure* by Style

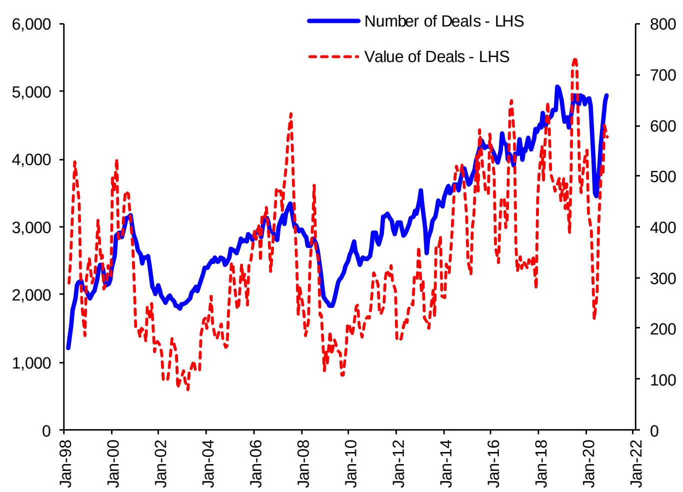


*Using Last 2 Year of Monthly Total Return
Source: Scotiabank GBM Portfolio Strategy, Bloomberg, Haver Analytics, FRED.

11. Bonus Theme - Capital Markets Spring Back to Life

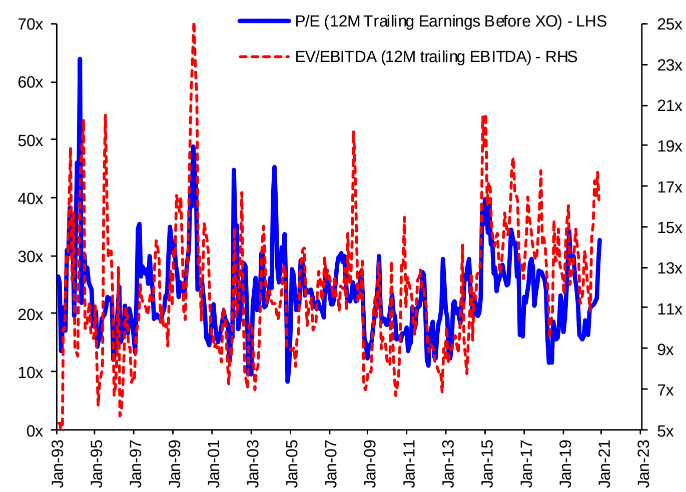
The March sell-off and capital market dislocation raised the spectre of an M&A drought as happened in 2002 and 2009. However, the number and volume of deals quickly jumped back near record highs (see Exhibit 27). Central bank support, cash burning holes in investors and companies' pockets alike, battered asset prices, as well as the need to rationalize or consolidate certain industries, have led to a flurry of M&A activity. Multiples paid on deals have also jumped to some of the highest levels of the last 30 years. We believe this trend will endure in 2021 as cash balances remain high, while debt financing is almost as cheap as prior to the pandemic (looking at corporate spreads on IG US bonds). Regarding positioning, Precious Metal miners in particular are in the midst of a merger boom. Energy could be the next sector in line. Finally, banks are likely to benefit from a bumper year in capital market activity, especially with high refinancing volume and a flurry of IPOs.

Exhibit 27: North American M&A - Deal Count & Volume (3M Rolling Sum)



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Exhibit 28: US M&A - Multiple Paid on Transactions (Rolling 3M Basis)



Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

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The rating assigned to each security covered in this report is based on the Scotiabank, Global Banking and Markets Research Analyst's 12-month view on the security. Research Analysts may sometimes express in research reports shorter-term views on these securities that may impact the price of the equity security in a manner directly counter to the Research Analyst's 12-month view. These shorter-term views are based upon catalysts or events that may have a shorter-term impact on the market price of the equity securities discussed in research reports, including but not limited to the inherent volatility of the marketplace. Any such shorter-term views expressed in research report are distinct from and do not affect the Research Analyst's 12-month view and are clearly noted as such.

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The stock is expected to perform approximately in line with the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.

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Focus Stock (FS)
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Other Ratings

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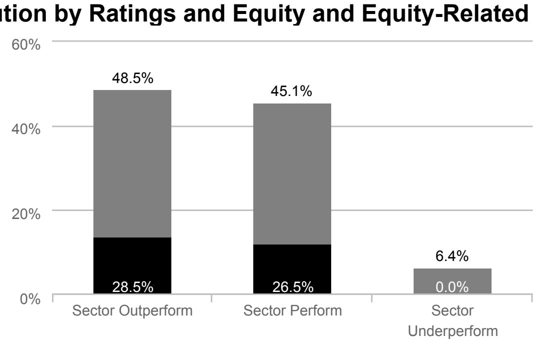
Scotiabank, Global Banking and Markets Equity Research Ratings Distribution*

Distribution by Ratings and Equity and Equity-Related Financings*



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* As of November 30, 2020. Source: Scotiabank GBM.

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