Markets have continued to ride their upward momentum through the first quarter of 2021, with investor optimism fueled by wider distribution of COVID-19 vaccines and expectations for the sizeable fiscal stimulus package from the Biden Administration. Still, lingering questions remain on issues such as how uneven access to vaccines could affect global markets; the specter of rising bond yields; and when the U.S. Federal Reserve will tap the brakes to slow inflation. Clean energy and Big Tech continue to be dominant themes in the investor narrative and are proving to be important sources of risk and opportunity. Finally, complications surrounding the U.S. and its relationship with China will persist as economic regions are forced to finally choose their allegiances and find their footing in an escalating battle for economic supremacy. Here’s our take on five of the biggest questions facing the markets today.

## How will the uneven vaccine rollout affect emerging and developed markets?

After a slow start, COVID-19 vaccination programs in most major countries are beginning to accelerate. Investor optimism, which has been rising in lockstep with each shot, recently received another boost following indications that vaccinations are already bearing down on infection rates. The resulting positive sentiment is propelling global markets to new highs, even as economies struggle in the first quarter of 2021.

The same cannot be said of the emerging markets, which are unlikely to receive any meaningful vaccine supply until the most developed markets fulfill their needs. Russia, China and India are the notable exceptions as they’ve developed their own vaccine pipelines. As a result, most emerging countries will not receive the vaccines until late 2021 or 2022, and even then, poor infrastructure will hamper their distribution efforts.

### Share of people by country who received at least one dose of COVID-19 vaccine

**Percent, data as of March 3, 2021**

But there is a sense of urgency to move faster. The discovery of South African, Brazilian and UK variants of the virus is putting pressure on global vaccination efforts. Anything that impedes access to the vaccines could cause some countries to slow-walk their efforts to lift restrictions, particularly in relation to international borders. Emerging economies like those in Southeast Asia, which are dependent on tourism, may face a prolonged growth dip until further progress is made in the global vaccination effort.

**When will the Federal Reserve tighten monetary policy?**

While it’s still early days, economic reflation in response to stronger global growth is shaping up to be the defining theme for 2021. Yet, reflation inevitably comes hand-in-hand with expectations for higher inflation. With government debt in most advanced economies at post-World War II highs, and corporate debt testing its own records, investors may be getting anxious since a small upward move in interest rates would result in a disproportionately large increase in debt servicing costs compared to previous cycles.

Central banks are acutely aware of the underlying vulnerabilities that rising policy rates would expose. Thus, we can expect them to tread extremely cautiously. To tame concerns, the Federal Reserve (Fed) has indicated a strong commitment to their new average inflation-targeting framework, so a sustained overshoot of the 2% inflation target would be necessary before they tighten policy. We expect that any uptick in core inflation in the near term will be viewed as a welcome sign of a gradual return to normal given the substantial economy-wide output gaps.

The bottom line is that in the absence of a major growth shock that rapidly erodes labor market slack, the expected rise in core inflation will not be sufficient to motivate a monetary policy shift. A destabilizing U-turn from the Fed is unlikely, and the “lower for longer” theme will likely remain with markets for some time.
How much clean energy reform should investors expect from the Biden administration?

Investing in renewable energy is in vogue, but a favorable policy environment under the Biden administration is only part of the reason. Since U.S. markets bottomed in March 2020, the Nasdaq Clean Edge Green Energy Index has quadrupled in size. The outperformance in the green sector has further accelerated since November 2020 after President Biden won the U.S. election.

One of Biden’s first actions as president was to re-join the Paris Climate Agreement and commit to net-zero emissions by mid-century, if not sooner. To achieve this, he has planned significant public investments in energy, climate-related R&D and low-carbon infrastructure.

Climate change and the energy transition are increasingly becoming a fundamental part of U.S. foreign and trade policy. Therefore, even though Biden’s plan will likely face headwinds because of a thin Democratic majority in Congress, geopolitical factors could force the U.S. government’s hand. China, for instance, is launching a massive domestic decarbonization program that may pressure the U.S. to follow suit.

The Biden Administration isn’t the only reason the clean energy story is taking flight; it’s also topping the agenda for global central banks, albeit for different reasons. The European Central Bank (ECB) is looking for ways to bring the environmental agenda into their inflation target. Meanwhile, the Fed is considering stress tests to investigate how exposed financial institutions are to climate change.

While greater climate ambition will likely translate into higher costs for businesses and governments, and easy central bank policy may come under scrutiny for potentially cultivating asset price bubbles, one thing is certain: The clean energy agenda is highly unlikely to go into reverse and is a dimension that investors can no longer afford to ignore.
Given the bipartisan support to reform Big Tech, how aggressive will the Department of Justice be in its probe of antitrust issues?

Tech companies have driven U.S. equity returns both during the pandemic and in the years leading up to it. Since 2016, the FAANG stocks are up some 334%, while the S&P 500 is up 95% over the same period. Due to that run-up, technology-led sectors (information technology and communication services) now constitute 37% of the S&P 500 index. Add the Amazon-dominated consumer discretionary sector into the mix and technology’s weighting jumps above 50%, its highest since the tech bubble in the early 2000s. However, success has made Big Tech a target and a source of growing animosity from the U.S. government.

Complaints differ across the political spectrum, but there are two key questions facing Big Tech. The first is figuring out to what extent Biden’s Department of Justice will pursue the antitrust issues being raised, given the size and power that Big Tech wield within the economy. The second is the growing concern around the relationship between tech, regulation and free speech.

We expect there to be judiciary committee hearings in both houses of Congress this year as lawmakers further investigate the issues. What will come from those efforts is an open question. With tech driving the post-COVID market recovery, any action taken against these companies could have severe ramifications, not just for the technology sector, but also for the wider market. Politicians will have to balance the recovery against any desire to impose significant constraints on these companies.

On balance, while concerns around Big Tech are unlikely to fade, we don’t believe anything will significantly alter the earnings profile of tech companies in the near future and therefore, they still warrant allocation in portfolios.

FAANG stock performance
Indexed to 100 as of January 2016

Source: Standard & Poor’s, Clearnomics, Principal Global Investors. FAANG consists of Facebook (FB), Amazon (AMZN), Apple (AAPL), Netflix (NFLX) and Alphabet (GOOG). FAANG is simple equal weighted performance. Equal Weight is the S&P 500 Equal Weight Index. Data as of March 2, 2021.
How might the U.S.-China relationship change under President Biden?

The Biden Administration is promising to take a new approach towards China, but the approach is likely to do little to lower the tension with economic and technological supremacy at stake. President Biden’s plans will involve striking a more careful balance between economic and security interests, relying on multilateral levers to gain support from core allies, particularly the European Union, Japan and India.

Building this alliance will not be easy. Most countries would prefer not to have to choose between the world’s two largest economies. The EU-U.S. relationship will also face new tests following the bilateral investment agreement the EU signed with China in 2020 to become its largest trading partner. That agreement could constrain how much the EU is willing, or able, to coordinate trade with the U.S.

Moreover, given how critical technology is for both economic growth and military capacity, there is unlikely to be a substantial easing in U.S. intentions to slow the pace of China’s technological development. Biden’s recent call for a review of critical supply chains was clearly aimed at reducing U.S. dependence on China for everything from rare earth metals to semiconductors. For its part, China will look to reduce its dependence on U.S. parts for its technological processes.

Overall, despite immense pressure over the past few years, multinationals have shown little sign of cutting back on their commitment to China. Therefore, we believe that without significant policy change, U.S. efforts to constrain China are unlikely to have a meaningful impact on China’s investment prospects.

Actions for investors:

As the market adjusts to the forthcoming economic recovery and evolving global challenges, the balancing act of differentiating between temporary bouts of volatility and emerging secular themes will become increasingly important. Now is not the time for investors to take on undue risk in portfolios! Instead, disciplined investors would be well suited to focus on the underlying strong fundamentals and central bank support that are driving markets, and maintain overweights to risk assets, both cyclical and secular.
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