Global Fixed Income Quarterly
Q3 2021 Outlook

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We present our Q3 2021 outlook for core markets, emerging markets and global credit.

By the Global Fixed Income Team

Core markets outlook

Steven Williams, Head Portfolio Manager, Core Markets

As we roll into the August lull, we cannot help but ask the question: Where has the reflation trade gone? Expectations were for a display of heroism by the Federal Reserve (Fed) with Chair Jerome Powell announcing his grand taper plan at the Jackson Hole symposium, but I guess we will still have to wait for the big reveal. We would be amiss to ignore the effect of the Delta variant, and broad expectations of a post summer 2021 victory following the vaccine rollout now seem a bit short sighted. A new, permanent normal now appears to have taken hold, in which new variants and increased risk, especially to the unvaccinated, are likely. In our view rates were able to rise in tandem with the surge in COVID-19 cases after January because vaccines were expected to have made the pandemic endemic by now. The upcoming August surge will throw heavy shade on the optimistic recovery path for now, though come October we think the market could be lulled into a sense of calm, ripe for a new reflationary push. That said, we do not foresee a scenario in which the US Treasury 10-year yield surpasses its March high of 1.74%. We expect this current infection wave to not only increase slowdown fears, but to also reinforce expectations of prolonged central bank stimulus.

We have read concerns that the Fed is headed towards a policy error. Perhaps so, but what we do know is that the market has priced in a little over two hikes over the next three years. Ultimately, the Fed's pace will largely depend on the path of the pandemic, and it is becoming clear that vaccines alone will not snuff out further cases for now. Perhaps an easier question is who is going to be the next Fed chair. It seems Powell has appeared dovish enough to retain his seat under the current administration's spending plans and any alternative option for chair will have to be at least as dovish as the incumbent.

With the European Central Bank (ECB) raising their inflation goal to 2% we expect any changes to their language to be dominated by hypotheticals, and these to err on the side of caution. We do think the case is building for the ECB's Public Sector Purchase Programme (PSPP) to be extended for some time if the substantial new wave, as forecast by epidemiological models, does come to fruition. As such, we do not see the ECB making any changes until 2022 at the earliest.

The debate remains over the transitory nature of inflation, though it is hard to see how 5% CPI prints can hold now that oil—and commodities for that matter—have come off their lofty levels. We think it will be some time for headline inflation prints to settle in given broad commodities are up over 60% versus their pandemic low. While this is the "transitory" period, we are less clear where we land. If commodities prices surge again, we think that new normal could be well north of 2%; however, if we continue on our current down trend, we think we could land back to the longer term average of 1.8%, although that is unlikely occur until next summer at the earliest. This all suggests a changing of the pace of taper depending on where we see the 10 December US CPI print, right before the Fed's final meeting of 2021 on 15 December. For what it's worth, we think that print will still be over 3%. This could also coincide with the start of the fourth COVID-19 wave—which we hope will be the last.

Emerging markets outlook

Raphael Marechal, Head Portfolio Manager, Emerging Markets

Overview of EM debt performance in Q2 2021

After a disappointing start to 2021 emerging markets (EM) fixed income returns rebounded in Q2. The drift lower in US Treasury yields most certainly helped as despite near-term inflation fears the Fed signalled a patient approach to monetary policy normalisation and emphasised the transitory nature of recent price pressures in the US economy. EM external debt delivered circa 4% (JPM EMBI Global Diversified), local debt delivered 3.5% (JPM GBI EM Global Diversified) and corporate debt delivered roughly 2% (JPM CEMBI Broad Diversified). Over the quarter, the ongoing boom in commodity markets supported a number of EM commodity currencies such as those of Brazil, Russia and South Africa while political uncertainty weighed on others such as those of Peru, Thailand, Chile and Colombia. In external debt space, in addition to the above, commodity exporters in the Middle East and Sub-Saharan Africa also performed strongly. Yet the star performer was Ecuador, following a surprise general elections victory for business-friendly conservative candidate Guillermo Lasso over the leftist favourite Andrés Arauz.

Outlook for Q3 2021

Looking ahead, we note that despite the tragic COVID-19 situation evolving in many emerging economies external factors have, with some country specific exceptions, been the chief driver of returns at asset class level, and we expect this to continue. The Fed has recently increased its level of vigilance regarding price pressures, which has seen some repricing of US interest rate expectations to a marginally earlier lift off and thus provided some support for the US dollar. Yet we believe that the Fed will remain highly accommodative, despite these near-term price pressures, given the economic uncertainty caused by the spread of COVID-19 variants in under-vaccinated regions and as the Fed's employment metrics are still a long way from target.

Consequently, we believe that the global reflation theme will persist despite the recent uncertainty and will increasingly migrate to EM economies as their vaccination rates catch up to those of the developed world. Some EM countries (Brazil, Russia and Mexico) have already responded to this external stimulus and started to normalise their monetary policies to remove some of the accommodation created at the peak of the COVID-19 pandemic. This pre-emptive approach should increase real rates in the EM space, particularly relative to developed markets. This, combined with healthy current accounts positions (in stark contrast to 2013), underscores the relative attractiveness of EM currencies and should see yield-seeking investors gravitate towards EM local bonds. We also see this as an important differentiator for EM currencies in the near term with the path of monetary policy normalisation likely to vary considerably across EM economies, given each country's unique growth and inflation dynamics and external position.

Risks to the outlook

There are two key risks to our constructive outlook. The first is price pressures in advanced economies that prove to be more persistent than expected, which could lead to an earlier-than-forecast tightening of global monetary conditions and cause a potential reversal of capital flows. The second is the proliferation of COVID-19 variants that are potentially more contagious and resistant to vaccines, which remains a threat to economic reopening plans for many countries that are still far from reaching herd immunity thresholds through vaccinations. This could be decisive for many countries which are dependent on human mobility, either directly via tourism or indirectly through demand for energy commodities. Hence, while we remain optimistic of a recovery, we do expect some delays and setbacks along the way.

Geopolitical uncertainty is another source of risk as incidents can often erupt without warning. Relations between China and the US remain tense regardless of the change in US presidency. Iran seems reluctant to ratchet down its nuclear program and hence appears to continue threatening geopolitical stability in the Middle East. Russia also seems intent on antagonising its democratic rivals, although financial sanctions against the country have been tightened. Meanwhile, domestic politics will continue to create uncertainty with several elections approaching in late 2021 (e.g. Chile) or early 2022 (e.g. Colombia, Costa Rica and India). Finally, the risk of social tensions could be exacerbated by rising inflation in emerging markets. We all remember how food price inflation triggered the Arab spring of December 2010 and government social programs may be needed to prevent a repeat of such an extreme scenario.

Global credit outlook

Holger Mertens, Head Portfolio Manager, Global Credit

The momentum gained by the global credit market in 2020 has continued into 2021 and we appear to be on track for another strong year of performance. Low government bond yields, ample liquidity and improving credit quality have supported a market that now trades with spreads at all-time lows in some pockets.

However, compared to 2020, the global credit market has become more relative value-driven and it is important for investors to focus on short as well as long-term themes impacting portfolio performance to keep returns positive.

We believe that maintaining a strong focus on the above mentioned themes of 1) reducing A-rated issuers, 2) caution when investing in oil majors, 3) preference of sustainability-linked bonds and 4) looking out for low correlated markets should enable investors to outperform in 2021. The markets, however, are dynamic and more opportunities within the global credit universe exist and will continue to present themselves. In our view, a research-driven investment approach best positions one to capitalise on these opportunities.

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