Core Markets Fixed Income Quarterly
Q2 2021 Outlook

7 May 2021

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The striking 52% year-on-year surge in prices of second-hand US vehicles has, as expected, caught market attention, with global chip shortages often blamed for the disruption in the market for used cars. Behind the scenes, however, stands Joe Biden, the US incumbent president, whose first 100 days in the office was marked by several milestones, some of which could quite convincingly add more “meat” to the story. The strikingly impressive roll out of the vaccine, with more than 200 million shots administered so far, has brought about much-needed respite from the relentless rise in active cases since the start of the pandemic. As the deployment of immunisation gained momentum, the rates of hospitalisation eased, which subsequently led to the much-desired decline in daily death toll, too. With the US seemingly moving out of the yet another wave of pandemic, the long-awaited process of a lasting return to economic normality is currently underway, as mobility restrictions are gradually being lifted across the states, boosting consumer and business sentiment in the process. President Biden’s fiscal relief package (worth USD 1.9 trillion) signed into law back in March is understood to have been the main reason behind one of the largest surges in monthly incomes in the country’s recent history with household earnings rising by over 20%. The significant injection of cash into household coffers and the enormous pent-up demand following a period of subdued economic activity led to a significant shift in consumer behaviour towards big ticket items such as autos.

With the activity in the service sector beginning to return to some form of normalcy, however, a good portion of the USD 6 trillion of personal savings (of which USD 5 trillion were accumulated since the outbreak of pandemic) will inevitably be spent on propping up the sector, which suffered the most during the pandemic. This type of spending is set to return a greater multiplier effect than the simple grocery shopping most people were left to indulge in during the best part of the pandemic. To add a more lasting effect to future economic activity, and more specifically to boost medium to long term growth potential, “Sleepy Joe” Biden, as once disparagingly branded by his predecessor, proposed to allocate further USD 4.5 trillion on infrastructure and social programs over the next 10 years, which notably are set to be budget neutral (which does seem somewhat ambitious) by merely taxing the wealthy and corporates. It must be said that for better or for worse, the initial period of Biden’s presidency does make him anything but “sleepy” at least as far as fiscal stimulus goes—the economy is on track to receive one of the largest amounts of government support in the country’s peacetime history.

The much-improved economic outlook coupled with the very accommodative policy mix triggered a sharp repricing of inflation expectations, with the 5-year breakeven price of inflation closing in on 2.65%, a level not seen since before the global financial crisis. Meanwhile, the rise in 10-year Treasury yields during Q1 2021 had reached a staggering +83 basis points (bps), marking one of the sharpest quarterly interest rates rises on record. Going forward, a low base effect is likely to see inflation drift higher from here. However, this is likely to be a relatively transient phenomenon, as the existing spare capacity should continue to keep domestically led price pressure largely contained at least for the time being.

As such we don’t foresee interest rates moving much higher from here, although some overshooting—however transient—due to higher inflation prints in the coming months cannot be entirely ruled out. The short end of the interest rate curve is likely, however, to be dominated and mostly anchored by the Federal Reserve’s (Fed) guidance to keep the policy rate unchanged in the foreseeable future. This was reaffirmed during the latest Federal Open

Market Committee meeting, at which the Committee decided to leave all its policy levers on a maximally accommodative setting amid its expectations towards the policy rate being unchanged for the next three years.

Moving to continental Europe, the European Union (EU) appears to have finally gotten its act together and the initial botched effort in vaccine deployment was replaced by a wide-scale roll out that one would have expected from a union that prides itself on institutional strength and cohesive approach, right from the start. The pickup in vaccine deployment has coincided with a general trend lower in active cases across the continent, which if sustained, could still save at least part of the tourism season, lending the much-needed boost to the European service sector on the whole. With the European Central Bank (ECB) maintaining its approach to keeping financial conditions accommodative in a broad and flexible sense, the peripheral spreads are set to be well supported, whilst short term interest rates remain anchored. Any episodes of heightened volatility leading to tightening of financial conditions will be dealt with in a timely fashion with the ECB adjusting the pace of weekly asset purchases at will.

In Italy, Prime Minister Mario Draghi unveiled unprecedented spending and reform plans worth more than 10% of the country's gross domestic product; these are mainly fuelled by the EU funds and aimed at boosting institutional strength and in turn future growth potential. Meanwhile Germany looks at the post Merkel era, with the latest polls for the Bundestag election later this year suggesting a sharp turn towards the Greens.

Among G10's main oil exporters, Canada and Norway both saw a marked change in their respective central banks' communique. The Bank of Canada (BOC) recognised much improved economic prospects by paring back the pace of net purchases of government bonds whilst also allowing some short-term maturities to roll off. The initial process of balance sheet normalisation saw a marked decline in the BOC's total assets from Canadian dollar (CAD) 575 billion at its peak in March to CAD 485 billon at the end of April. The Norges Bank went even further and suggested that the first policy rate hike is likely this year as a prolonged period of low interest rates heightens the risk related to a build-up of financial imbalances. The short end of the interest rate curve has already priced in over 50 bps worth of monetary policy tightening for the next 12 months.

In Australasia, both the reserve banks of Australia and New Zealand seem unyielding that despite the strength of the economic recoveries to date, their respective policy rates are likely to remain on hold for much longer whilst the economies absorb the remaining slack, boosting wages and in turn putting inflation on a sustainable trajectory in line with the official targets. The very much frothy property market, particular in New Zealand, are to be dealt via macroprudential tools. With a wide scale deployment of vaccines at its infancy at best, tourism in that part of the world is unlikely to recover anytime soon.

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