Global Fixed Income Quarterly
Q4 2021 Outlook

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We present our Q4 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

The optimist says prices are cheap. The pessimist says prices are expensive. The central banker says inflation is transitory. We remain in the aftermath of a month where the worldview on the future of monetary policy has dramatically changed. US, Australian, UK, Canadian and New Zealand two-year rates have all spiked over the past month on the expectation that central banks around the world are gearing up to meet inflation at Thermopylae. The only one not invited to the party seems to be the Europeans. Certainly, worldwide labour shortages remain a concern and wages will certainly have to go up to meet demand. However, to say we have experienced a paradigm shift in markets would seem and overextended argument to say the least. Time will ultimately be the judge, but our view is that we have simply retraced the move in oil prices to pre-pandemic levels. Doubling prices will be exceedingly difficult from here without another significant rise in commodities. The world has no doubt changed and supply disruptions will last for a time as the market continues to settle, but we simply do not see the recent moves in demand as permanent enough to cause a lasting shift in nominal growth.

From a tactical perspective, given the developed world's high debt levels we think that real growth will remain challenged and therefore hold down prospects for longer-term rates. The bear flattener trade has likely run its course in some of the more vulnerable markets such as the UK, Australia and New Zealand, which arguably have priced in a full rate cycle at this point. However, we still think that the US has a little more to go in terms of bear flattening with short rates pricing in just shy of two full hikes in the latter half of 2022. This all depends of course on the US reaching full employment, a number you can only really know after the fact. However, if we were to pick a number, such as 3.5%, we could be hitting that figure by the second quarter of 2022. While we may not discover what "full employment" is until late 2022, we would certainly like to know who the next Federal Reserve (Fed) chair will be—something which should be known by now.

Emerging markets outlook

Raphael Marechal, Head Portfolio Manager, Emerging Markets

For the final quarter of 2021, we expect external factors (but with some country specific exceptions) to again drive asset class performance within emerging markets (EM). Indeed, the Fed has recently increased its level of vigilance regarding price pressures and reassured investors. However, investors could start to lose patience if they become convinced that this bout of inflation is not transitory. We also continue to see a lot of disruptions in the supply chain of goods and pressure on wages due to the shortage of workers in some sectors of the economy. Consequently, we believe that the global reflation theme will persist and will continue migrating to EM economies as economic activity returns to pre-COVID-19 levels. Almost all EM countries are now in the process of normalising their monetary policies to remove some of the accommodation created at the peak of the COVID-19 pandemic. We expect this pre-emptive approach to continue increasing real rates in the EM space, particularly in comparison to those of the developed markets. This, combined with still healthy current accounts positions, underscores the relative attractiveness of EM currencies and we could see yield-seeking investors gravitate towards EM local bonds. Sovereign external debt will also continue to be very appealing as normalisation of fiscal policies, combined with decent growth and reflation, should naturally lead to lower debt-to-GDP ratios and better debt sustainability.

There are two key risks to our constructive outlook. The first is price pressures in advanced economies proving to be more persistent than expected, which could lead to an earlier-than-forecast tightening of global monetary conditions and result in a reversal of capital flows. The second is the Chinese economy slowing down at a greater pace than expected. Such a slowdown could come from the combination of an ill-controlled consolidation of the real estate sector and regional lockdowns imposed by the resurgence of COVID-19. Policymakers have at least signalled some marginal easing of developers' access to finance. The aim is to preserve social stability by ensuring that developers have the funds to complete their ongoing projects so households can have access to housing they already paid for. Geopolitical uncertainty is another source of risk as incidents can often erupt without warning. Relations between China and the US remain tense despite the change in US presidency; in the Middle East, Iran's seeming reluctance towards negotiating a compromise for its nuclear program is expected to remain a destabilising factor.

Global credit outlook

Holger Mertens, Head Portfolio Manager, Global Credit

We expect the direction and volatility of rates to also become an overarching theme for the global credit market in the final quarter of 2021. We keep our overall positive view on the global credit market in light of a solid corporate earnings season, but we might take a slightly more cautious outlook with more emphasis on portfolio liquidity. In terms of investment themes, we remain confident that some BB-rated assets could soon return to the investment grade market; we also retain our favourable view of the banking sector. We are currently more cautious in our view towards Asia credit, but we think that valuation in that space could soon become attractive. We retain a cautious view towards highly-rated companies as their ratings could be challenged by a global push to increase corporate tax rates. We therefore see the bucket of instruments with BBB ratings increasing.

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