2022 Global Fixed Income Outlook

December 2021

We present our 2022 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

Well as it turns out, transitory might not be a thing, with the only thing transitory being the word transitory. With the Federal Reserve (Fed) now expected to double its pace of taper in response to ballooning inflation, we would have expected the bond market to at least sell off on the news. However, the arrival of the Omicron variant brought other ideas. While preliminary data suggest this new COVID-19 variant is more virulent but less severe, we can only point to anecdotal evidence for now, and if its severity remains unchanged, we may face lockdowns in several countries and another pandemic-driven slowdown.

While we would rather likely have only inflation to deal with, this cycle has been anything but typical. We remain optimistic and think the more virulent but less severe viral path will not lead to a dramatic increase in hospitalisations (hopefully, we won't rue these words). With inflation at its highest level in 40 years and this new variant likely not to meet the fanfare, we think the Fed is going to have to accelerate its tapering program to allow itself the option of raising rates by early second quarter of 2022, though the bond market couldn't care less it seems. With the US unemployment rate fast approaching the purported full employment 3.5% level, we do think the Fed will be facing increased pressure to hike rates on multiple fronts. In short, we expect 2022 to maintain the key "covidflation" (we think this should be a thing) story with a now hawkish, rather than dovish, Fed.

The US infrastructure bill was an easy pass with bipartisan support. President Joe Biden's Build Back Better (BBB) bill is unlikely to sway the core Democrat moderates given inflation is running hot. We think any programme will likely be USD 1.5 trillion or less and that is if BBB is passed at all, which is looking unlikely at this point, maybe Biden's luck will change in 2022. We suspect the global supply chain disruptions will eventually run their course with jobs filled, albeit at higher wages. Geopolitical risk looks likely to flare up again with Russia amassing troops on the Ukrainian border; that said, we fail to see this escalating into a multi-country conflict given the previous response to the Crimean invasion.

For Europe, the story is likely going to surround the cessation of the Pandemic Emergency Purchase Program (PEPP) and increase in the Asset Purchase Program (APP) and transition into a more ambiguous goal versus a hard monthly target. Europe, though, seems at a more difficult position relative to the US with growth trending towards zero for core Europe and inflation likely to fall below the European Central Bank's target of 2%. We think Europe will remain an outlier in terms of zero 2022 hikes for developed markets. We think 2023 is even questionable for hikes given current market pricing. In any event, we still like euro-hedged European assets due to their steeper curves given the strong FX carry back into the dollar. The French election in April 2022 will likely set the tone of the political landscape given President Emmanuel Macron is facing increasing challenges from the right with Valérie Pécresse, though polling suggests Macron remains the heavy favourite.

Lastly, in 2021 we saw a greater interest among numerous stakeholders in addressing climate change. Appetite for green bonds, in particular, is mobilising increased capital markets investment to meet climate goals and environmental protection. The success of these instruments reflects the fact that investors are increasingly conscious of the environmental consequences of the decisions that companies and governments make and are ready to exchange financial performance with the assurance of a more sustainable world. We believe that in 2022 more issuers will come to market especially in the US (Mortgages, Loans and Municipals). It might be too early for 2022, but we believe that a Green T-Bill is certainly on the radar for the US Treasury. This would be a true landmark event for the asset class and we look forward to seeing how this progresses in 2022.

Emerging markets outlook

Raphael Marechal, Head Portfolio Manager, Emerging Markets

Search for yields to lead to EM in 2022

Despite the positive sentiment associated with the COVID-19 vaccination campaign, increased mobility, and the promise of a progressive return to fully functioning economies, emerging market (EM) fixed income has fared poorly in 2021. At the time of writing, JPMorgan's index tracking debt issued in local currency is down close to 10% for the year to date in US dollar terms, the main reason being the poor performance of emerging market currencies versus the dollar. External debt indices, both sovereign and corporate, also failed to impress, with a fall in prices offsetting the generous interest payments investors earn from holding the bonds.

However, at the start of 2021, the growth outlook had benefited from massive base effects, rebuilding of inventories and a resumption of domestic demand. It rapidly became clear that there was a mismatch between the size of the global monetary and fiscal stimuli and production capacity, leading to price pressures, aggravated by disruptions in the supply chain.

Facing elevated inflation and the threat of a stronger dollar due to an imminent asset purchase tapering by the Fed, several EM countries decided to embark on a proactive tightening of monetary policy, well before developed economies. Those who did the most to stay ahead of price pressures were clearly rewarded by currency outperformance. At the other end of the spectrum, the Turkish lira was one of the worst performers, pressured by President Recep Tayyip Erdogan's demands for lower borrowing costs, despite Turkey's rampant inflation. Monetary policy divergence was a key theme for us throughout 2021, creating many alpha opportunities and dispersion in rates and FX.

Another key theme during 2021 was the political shift taking place in Latin America. After a few years of conservative right-wing leadership, most countries in the region are now contemplating a change. The reasons for this are numerous: discontent with economic performance, rising inequalities, mishandling of the COVID-19 crisis and a return to fiscal austerity after the largesse experienced during the lockdowns. Peru initiated the change when Pedro Castillo was finally confirmed as president-elect, after being cleared of fraud allegations. Similarly, we could see another leftist, Gabriel Boric, win the runoff vote in the Chile presidential elections in mid-December, although his lead is narrowing. Colombia's conservatives are also under pressure ahead of a 2022 vote after their highly unpopular tax reform. Brazil is also facing an election in 2022, with a galvanized left looking to replace right-wing President Jair Bolsonaro. Indeed, former Brazilian president Luiz Inacio Lula da Silva is energised by the wind of change blowing across Latin America and is already preparing for a potential return to the driver's seat.

Outlook

2022 may continue to prove challenging for EM asset returns as growth could moderate and with the Fed expected to start its hiking cycle. Growth is expected to remain above trend, though perhaps not as robust as it was at the start of the cycle in 2021, driven by strong base effects following the re-opening of economies. With the Fed likely to be less accommodative, emerging market currencies may continue to face headwinds, at least during the first half of 2022, and a careful selection based on country specifics will continue to prevail over market momentum.

Perhaps more interesting in the short term will be emerging market rates. They have already moved significantly higher in 2021 and, given that hiking cycles are already well underway in several emerging economies, they could prove to be a pillar of strength for local debt at the start of 2022, before currencies are able to strengthen against the dollar later on in the year. At this stage, emerging market central banks have essentially removed all of the

COVID-19 emergency easing during the course of 2021. There will be additional tightening next year as restoring positive real yields will be key to currency stability and will provide an extra insurance against the Fed's moves. Nonetheless, as we approach the end of this tightening cycle, we expect opportunities to increase duration in many emerging economies to become increasingly obvious as the end of Q1 2022 comes into view. Some emerging market rate curves are already inverted—a testimony of well anchored long-term inflation expectations and very prudent central banks.

In addition, let us not forget that base effects in food and energy are likely to exert a drag on inflation pressures during 2022. If we also factor in a progressive lifting of COVID-19 restrictions, an easing of labour force shortages and supply bottlenecks, we conclude that positive surprises on inflation are very likely during 2022. Finally, concerning timing, previous episodes of Fed hiking cycles have shown that emerging market local rates have tended to rise when Fed hikes are priced but begin to fall on their actual delivery. However, the dollar tends to remain strong as hikes are delivered, making emerging currencies a good investment proposition later in 2022.

Concerning emerging markets external debt, the mid-cycle environment is not as disruptive even with Fed tightening, given the constructive backdrop for growth and current accounts. Current accounts are expected to marginally deteriorate as they converge back toward their pre-pandemic levels. This is mainly due to a marginally less favourable terms of trade for commodity exporters and a recovery in emerging market domestic demand.

Risks

An obvious risk to the outlook is the emergence of new COVID-19 variants with the ability to get around vaccine defences. This risk is well known, though, and shouldn't have the same surprise and disruptive effect as the virus variants early on in the pandemic. Similarly, many market participants appear afraid of the taper tantrum being replayed. Again, this is unlikely, in our view, because the Fed has been very careful not to take investors by surprise. Moreover, many emerging economies have carefully built up buffers in the form of foreign exchange reserves and more resilient debt profiles, with less reliance on foreign currency debt or short-term borrowing. Concerning growth, the main challenge could come from a disorderly rebalancing of the Chinese economy and/or domestic policy mistakes in the form of a premature withdrawal of fiscal and/or monetary policy support. Again, the RRR cut at the start of December reminds us that the Chinese authorities are pragmatic and that they are ready to make a pause, if needed, on the path toward "common prosperity".

With deeply negative real yields (sometimes even negative nominal yields) in developed economies, foreign investors will continue to look for assets with attractive valuations; we believe they will have little other choice but to continue increasing their allocation to EM debt.

Global credit outlook

Holger Mertens, Head Portfolio Manager, Global Credit

Looking back on 2021

Tight valuations have been a popular topic for global credit markets recently. After multiple years of relentless spread tightening, the credit market now looks expensive. Nevertheless, as we look back on 2021, we see that the valuation situation once again didn't stop the credit markets from outperforming most developed government bond markets. Even the resurgence of COVID-19 in the form of the Delta variant and skyrocketing inflation numbers failed to push the global credit market out of its narrow trading range. After successfully passing these two challenges in 2021, we expect the market to remain rangebound and again outperform government bonds in 2022. Potential risk scenarios include policy errors by global central banks followed by more aggressive monetary tightening and a significant resurgence in COVID-19 cases over the coming months. We might experience some spread widening if either of these situations materialise, but we also expect strong technical factors to push spreads back into their narrow trading range. Regarding the technical situation, we see the lack of yields in fixed income markets as a major driver for fund flows into the global credit market. In particular, US credit still offers attractive income which cannot be found in the government bond markets, and Asian credit may also retrieve some its losses from 2021.

However, after 2021, during which "Beta" was the driver of performance and global central banks pushed up the entire credit market, we expect 2022 to test the skills of investment managers in finding the right opportunities.

For 2022, we will make full use of our quantitative and qualitative skill sets to build our portfolio around four key investment themes.

Four themes for 2022

1. BB-rated credits

The team currently prefers BB-rated credits over AA/A-rated credits. Already in the last couple of months, we have seen a group of credits being upgraded from BB into the investment grade market, with one of the most prominent examples being US streaming platform Netflix. We expect this trend to continue; as such, 2022 could become the year of upgrades with issuers' credit matrices fully recovering from the pandemic. For higher rated companies, the prospects could be much gloomier. A global push for higher corporate tax rates is increasing the costs to maintain an A or AA rating and we expect a growing number of companies to opt for a more cost-efficient BBB rating.

2. ESG

While we expect ESG to be a strong performance driver, ESG means more to us than just chasing green bonds. We implement ideas only if we expect them to provide our performance with a meaningful advantage. For example, in 2021 we saw some Real Estate sector bonds experiencing double-digit declines in prices due to poor corporate governance. Avoiding such situations supports stable results and highlights how ESG, in particular good corporate governance, matters.

3. Small or even negative correlations

The portfolio management team is constantly searching for ideas where the correlation of performance outcomes is small, or even negatively correlated, to the rest of our portfolio. An example is China's policy banks: their total returns have very little correlation with the rest of the portfolio. Recently, China's policy banks delivered positive total returns while inflation angst drove most developed markets into negative returns.

4. China offshore credit market

We expect investment opportunities to arise again in the Chinese offshore credit market (which was subject to a sell-off in 2021) given their attractive valuation levels. While spread diversion in most credit markets is low and therefore bond picking is difficult, the situation in China is different. The recent sell-off has opened an interesting opportunity for experienced credit analysts to be rewarded for in-depth credit research.

In addition to our four investment themes, other factors are crucial as well, such as portfolio construction. It is important not just to generate ideas, but to effectively factor them in to the portfolio. We aim to spread ourselves equally across our themes and refrain from concentrating on just one or two. This strategy has stabilised our alpha generation over the last few years. Furthermore, using the most liquid instruments in the credit market, including CDS indices, has enabled us to change our portfolio positions—even during periods of high volatility when liquidity normally dries up.

We expect the combination of well-researched investment ideas and systematic portfolio construction to benefit the Global Credit Strategy in 2022.

Reference to individual stocks is for illustration purpose only and does not guarantee their continued inclusion in the strategy's portfolio, nor constitute a recommendation to buy or sell.

Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document nether constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.

Republic of Korea: This document is being provided for general information purposes only, and shall not, and under no circumstances is, to be construed as, an offering of financial investment products or services. Nikko AM is not making any representation with respect to the eligibility of any person to acquire any financial investment product or service. The offering and sale of any financial investment product is subject to the applicable regulations of the Republic of Korea. Any interests in a fund or collective investment scheme shall be sold after such fund is registered under the private placement registration regime in accordance with the applicable regulations of the Republic of Korea, and the offering of such registered fund shall be conducted only through a locally licensed distributor.