2021 Outlook – Fixed Income

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Outlook

It's pretty much a no-brainer to suggest that economic growth in 2021 will be better than what we experienced in 2020. A combination of accommodative monetary and fiscal policy, and the deployment of COVID-19 vaccines will help continue the economic rebound from the March 2020 lows. Based on this view, markets are pricing in positive economic growth and reflation narratives, which bring to mind two key questions; 1) how much is already priced into risk assets? and 2) is this the start of a new cycle of stronger growth and higher inflation?

In terms of corporate credit, we answer the first question by suggesting that the race to tighter credit spreads is mostly complete. Financial markets are pricing in a great deal of good news, potentially pulling forward some of next year's returns. A better economic growth backdrop, static or improving credit fundamentals and strong technicals in credit warrant exposure to both investment-grade and high-yield credit. We expect credit will generate excess returns in 2021 so taking the additional yield still makes sense. However, returns will likely be more tempered and credit quality, in order to avoid downgrades and defaults, will be increasingly important.

Looking at the second question, we believe that improved growth and reflation will be limited to 2021 as this is not the start of a new cycle. Frankly, we think the global macro-economic backdrop is at a critical crossroad – higher growth and reflation versus policy exhaustion and deflation. With interest rates already effectively at zero, and likely to remain there for years, monetary policy is running out of gas and unlikely to contribute materially to economic growth. In order for a new dynamic cycle of economic growth to emerge with a reflation bias, we need; 1) strong and consistent fiscal policy stimulus (beyond what has been committed to the COVID-19 pandemic thus far); and 2) government policies that are directed at significant income redistribution. This is a very high bar to achieve given many industrialized country balance sheets are near the limits of extended fiscal policy support. Policies directed at income redistribution are possible, but they will unlikely be broad-based. We should also remember that longer term drivers of economic growth – credit growth, population growth and productivity – remain constrained. Global debt to GDP is at the highest in history, population growth has been declining for 40 years with no end in sight and productivity is bumping along the bottom of its longer-term wave cycle.

Beyond 2021, we are unlikely to see a cycle of higher growth and inflation, but equally, may not have policy exhaustion and deflation. Monetary policy and central balance sheet expansion will persist with the highest probability scenario being low growth, low yields and low inflation.

In this context, what do investors do with their fixed-income allocation and how do they make money in bonds? Look for fixed-income strategies that are actively managed with disciplined and experienced managers, and have flexibility to move across fixed-income asset classes (cash, investment-grade, high-yield and governments bonds). Focus on total return strategies versus yield as yields are low and an outsized risk in our view.

Large output gaps due to the COVID-19 pandemic are likely to persist well into 2022. As a result, central bank monetary policy across the industrialized world and low interest rates will stay anchored. Additionally, quantitative easing – central bank monetary policy to increase money supply in the markets – will continue as central banks will have no choice but to monetize high government deficits as any tapering will tighten financial conditions. We expect government-bond yields to exhibit some volatility in 2021 as markets wrestle with increased supply, quantitative easing, and economic and geo-political developments.

The expected range for ten-year U.S. Treasury is 0.70% to 1.30%. We would look to add duration towards the higher end of this range based on our view that central bank's will keep interest rates close to zero, and the growth and inflation outlook is muted in the longer run.

Positioning and opportunities

In the era of central bank financial suppression, volatility should remain low, especially in fixed income. Accordingly, understanding where there is volatility and exploiting those opportunities will be key in generating attractive returns in a low-yield environment. We see opportunities to generate total return in the long end of government bond markets (duration and curve), foreign government bond markets, investment-grade corporate credit curves, high-yield bonds, inflation linked securities and credits with sensitivity to commodities and currencies.

Risks

Long term, we are less optimistic relative to the consensus. What could prove us wrong would be:

1. More rapid deployment of the vaccine and global herd immunity.
2. A broad-based commitment to longer-term fiscal spending directed at infrastructure and a green economy.
3. Increased conventional and non-conventional monetary policy support from central banks.

What keeps us up at night:

1. A mutation of the COVID-19 virus that impacts the effectiveness of existing vaccines.
2. Government-bond yields rising sharply due to a lack of demand and rising supply.
3. A technology war that would disrupt global supply chains in the technology, automotive, industrial electronics and artificial intelligence advancement.

Source: Bloomberg Finance L.P. and Marret Asset Management Inc. as at December 21, 2020.

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